AIRLINE ECONOMICS GROWTH FRONTIERS CONFERENCE

Keynote Address

William A. Franke

Chairman of the Board, Frontier Airlines

Good morning. Let me begin by acknowledging Airline Economics for sponsoring this conference. And I'd like to thank the conference sponsors for providing me with this opportunity to address old friends and new faces.

By the way, it's great to see so many other 12-step airline addicts here who are also failing to control their compulsion to try earning a living in air transportation! We all promise that we can quit this business any time. And this is the year when we're going to give it up for good and find a more stable industry to get into, like biotech or telecom.But then someone tells us they heard there's a new start-up carrier in Paraguay and just when we thought we were out, we are sucked back in!!

First off, I'm not here to talk to you about interest rates, maintenance reserves or return conditions. Instead, let's talk about where the industry is going. Let's talk about costs, prevailing business models, risk factors, institutional constraints and a few more of the million or so things that keep us simultaneously frustrated, aggravated, puzzled, outraged and ultimately optimistic about this industry to which we're all hopelessly addicted.

All things considered, it's a pretty good time to be an airline addict. In the past year, commercial aviation has made steady progress and built momentum that looks to continue in the months ahead. According to the International Air Transport Association, airlines in 2014 posted a collective global net profit in the neighborhood of $20 billion. And IATA expects that net profit to rise to $25 billion this year as the global economy continues to recover and the impact of lower oil prices is realized. IATA also reported that global airline stock prices rose 40 percent last year.

So the industry outlook is encouraging, but that doesn't mean we can coast. Sure, there's nothing wrong with having a drink in the bar tonight and congratulating each other because we're in better shape than we were a year ago. But we'd do well to remember that this year's anticipated $25 billion profit represents a 3.2 percent net profit margin. Trust me, I've been CEO of businesses where that kind of a profit margin would get the CEO fired!

Let me start with a little history: In 2002, I founded Indigo Partners, a private equity firm focused on investments in the aviation sectors. Indigo seeks out opportunities in the world aviation market that require capital and management expertise. Our portfolio features or has included several successful new-generation, low-cost carriers, including Wizz Air in Europe and Volaris in Mexico. We have also successfully exited investments in Tiger Airways in Singapore and Spirit Airlines in the United States.

And about a year ago, Indigo acquired Frontier Airlines based in Denver.

We see Frontier as the next step in the Ultra Low-Cost Carrier evolution. And we're working to transform Frontier into a consumer-friendly, low-cost travel option.

The Frontier motto is "Low Fares, Done Right."Most low-cost carriers get the low fare part, but not necessarily the part about providing service the right way. Frontier will not only offer low fares, but will also focus on delivering the kind of service that fosters customer loyalty. This starts with operating the airline safely, reliably and on-time. And it continues with customer-centric services such as transparent pricing and a wide range of product options, from a pure a là carte ticket to a traditional bundled ticket. While getting this right will take time and commitment, Frontier has made exceptional forward progress in one year. By way of example, it took Spirit five years to get to the same financial condition as Frontier is now.

Looking forward, there should be more opportunities for investment in the market. So what could commercial aviation be doing better to attract the capital that will drive growth? Generally speaking, private equity firms and venture capital investors seek healthy business environments that offer a higher probability of earning a risk-adjusted return on their capital. And aviation, with U.S. carriers at the forefront, has taken significant steps toward creating a more favorable environment for investors, including focusing on reducing costs and taking a more disciplined approach to capacity planning. Among the most recent signs of this improving financial environment is the upgrade of Delta Airlines' S&P credit rating to BB in response to its steadily rising earnings and pay-down of debt. You now hear a lot of chatter about ROIC (we'll have to ask our friends at JetBlue just exactly what this means!) and less about market share.

That's all good! But the sad truth is that most long only institutional investors still avoid the industry and look for reasons not to invest. And we currently aren't generating meaningful risk-adjusted returns globally.

The Ultra Low-Cost Carrier model offers investors one of the best opportunities for improving return on capital. A big reason for this is that the low-cost guys are well positioned to capitalize on the new global middle class that is emerging.The OECD Development Center estimates the global middle class at 1.8 billion people and growing. And while this market segment and its spending power will continue to expand, most middle-class travelers still can't afford to buy full-fare tickets and premium services on full-service airlines.

In Volaris and Wizz Air, Indigo has seen the Ultra Low-Cost model succeed in targeting this emerging middle class. From where we stand, the future belongs to low-cost, short-haul carriers, or a measured product at a reduced fare for longer haul.This business model is not about stealing market share. It's about stimulating new fliers and growing market share.

If you want to see how the international aviation landscape is going to evolve, just look to the United States, where consolidation has left four major legacy carriers to compete with the low-cost airlines that serve the rest of the market. By the way, as an aside, don't we all wonder just how long will it be before the three to five low, or lower, cost airlines also consolidate?

In the post-consolidation world, the U.S. airline industry has settled into two major layers. At the top are the four major legacy carriers: American, United, Delta and Southwest. The first three employ the legacy business model with its attendant high cost structures.Southwest has been struggling with rising costs and its product offering currently resembles a legacy carrier's economy product more than it does an Ultra Low-Cost product. So the fearsome foursome, which control more than 85 percent of domestic U.S. capacity, all have similar cost structures and target roughly the same passengers.

As costs crept up in the wake of consolidation, room was created for Ultra Low-Cost Carriers to take advantage of the cost gap. And that's the place where you'll find airlines like Spirit and Allegiant. JetBlue and Virgin America are other carriers that have been fighting a battle against rising costs, pushing them closer to the legacy model. As we see it, this leaves the market under-served by the Ultra Low-Cost model. Which explains why we're in the process of moving Frontier to that ULCC model.

When we took over Frontier, it was still in the middle layer of airlines that includes JetBlue and Virgin America, sandwiched between the legacy carriers and the Ultra Low-Cost Carriers. The "tweener" layer. The tweener is a business model that hasn't produced returns equal to or better than low-cost carriers. You have to wonder if those carriers will be long for this world as they try to maintain this model. There's a piece of Irish wisdom that says "When you find yourself in a hole, the first order of business is to stop digging." The tweener carriers seem to think the answer is to use a bigger shovel.

As for the legacy guys, on the other hand, they're going to need to step up their games in terms of system advantage, global reach and loyalty programs because they're going to find it more and more difficult to compete in a low-cost, short-haul world.

The same shake-up that took place in the United States is being repeated elsewhere. In Europe, you see IAG, Lufthansa and KLM serving the top tier of the market while low-cost carriers like Wizz, RyanAir and easyJet serve the bottom tier. The airlines caught in the middle between those tiers have some fundamental questions to address about how they're going to make their business models work in the current environment. And, in my opinion, you'd have a better chance of getting a hot towel and a complimentary pair of slippers on a Ryanair flight than you'd have of making the European state-sponsored business model work.

Don't the disappointing results posted by many of the European name carriers offer clear evidence that a sufficient market doesn't exist to support a premium short-haul product? Some European and Asian legacy carriers have tried to emulate the low-cost operating model through measures such as unbundling certain fares. Or, in the extreme, creating low-cost subsidiaries offering a base fare model. But without making a commitment to lowering costs, these measures amount to little more than wishful thinking. And wishful thinking and $20,000 will get you a personal suite with a mini bar and a shower on an Emirates flight.

Matching your business model to the market requires an understanding of what the customer wants and then delivering it. Customers today want safe, punctual, low-cost travel. Maintaining low costs requires discipline. Think Ryanair CEO Michael O'Leary pre-2013: Total commitment to low costs — maybe not so much to "doing it right." But today, it's great to see his shining face telling us how friendly his service is and how happy his employees are in their new Silicon Valley-like office, complete with ping pong and a playground slide!

So the opportunities are out there for airlines to develop a business model that fits the market. However, that said, there are several significant barriers preventing the kind of sustainable profits that would promote growth and attract new investment in international aviation.

Let's start with currency risk. This is one of the major problems faced by investors outside of the United States. Europeans are more aware than most of this issue, due to their collective history of dealing with fluctuations among diverse currencies pre-euro. But for many airlines around the world, currency presents a significant hidden risk.

Consider the impact of a rapid devaluation of a foreign currency. Let's say the currency depreciates 20 percent over a three- to six-month period — a depreciation that has occurred in several countries over the past five years. Dollar-based costs are instantly increased by the same amount. And such costs typically represent about 60-plus percent of an airline's cost structure.That's a big hit to take all at once from an uptick in a foreign exchange rate.

We saw a prime example of currency risk just last week, when the Swiss Central Bank abandoned the cap on the Swiss franc's value against the euro and all hell broke loose. The euro and every other European currency promptly crashed relative to the value of the Swiss franc.

So what can airlines do to manage this risk?The first, and perhaps most important, step is to become aware of the issue and monitor it as closely as we do fuel.Where geography allows, operating in markets where they can collect more dollar-denominated revenue would provide airlines with a natural buffer against currency devaluation. If the local currency depreciates and dollar-denominated costs increase, dollar-denominated revenues increase as well. Hedging — a strategy that airlines have struggled with for years with jet fuel — offers another defense against currency fluctuation.But that strategy comes with its own risks, such as dreaded margin calls and locking in higher-than-market prices.

I can't resist adding that my own view on fuel-hedging is that it's a scam invented by bankers. Sure, it has value for carriers with smaller, more fragile, balance sheets. But that's about it!

Now if you were to say that airlines are principally responsible for their financial performance, I couldn't disagree with that. But other industry stakeholders have the ability to create conditions that are more conducive to robust financial results. Governments and regulators in particular can take measures to strengthen the economic environment for commercial aviation.

As we move forward, it's fairly obvious that commercial and equity alliances will continue to make the airline industry increasingly global. As globalization expands, it will be critical for the regulatory and investment frameworks to adapt at the same pace.

Take outdated restrictions on cross-border investment, for example. Restrictions on foreign capital and control are legacies of a bygone era that are about as useful today as frequent flier miles on Pan Am. Similar constraints apply to cross-border mergers. Archaic regulations throughout the world have forced commercial aviation to develop complex structures such as joint ventures, codeshares and alliances to partially achieve the benefits of integration.Freely allowing mergers across countries would deliver the full benefits of these synergies at lower costs. Does anyone actually think that if Lufthansa had a significant interest in JetBlue, America's national security would be threatened?

Cross-border investment and foreign control in aviation is limited in almost all geographies. This policy denies much-needed capital to airlines. I can tell you from personal experience that Indigo has been forced to pass on or withdraw from several opportunities due to regulatory constraints on foreign investment and arcane regulations about foreign influence and control.

In Europe, where traffic has grown more rapidly than GDP, there are several good examples of growth cultivated through cross-border investment, including the Air France/KLM merger; the British Airways/Iberia merger that created IAG; and the Lufthansa acquisition of carriers such as Swiss International Air Lines and Austrian Airlines. In Latin America, a merger of carriers from Chile and Brazil created the LATAM Airlines Group with carriers based in nine different countries.

As an investor in innovative airlines, Indigo is actively re-thinking the traditional airline business model. But this strategy is often limited by regulatory interference. In Mexico, for example, carriers are required to offer 25 kilograms of free luggage to travelers. In the European Union, regulators have forced airlines to cover disruption expense, whether it's actually the fault of the carrier or not, which effectively bundles travel insurance into airfares. China wants carriers to fly when it tells you while it influences pricing, fleet decisions, etc. India apparently wants to tax the industry to death ... and it appears it may get its wish!

Inevitably, short-sighted regulatory interference punishes consumers. Take the unbundled revenue concept. Certain governments and regulators have undercut this business model by placing restrictions on airlines' pricing and product. They say they're looking out for consumers. If you believe that, I'd like to talk to you about investing in a timeshare in North Korea — and I'll give you a smoking deal.

What these governments and regulators fail to recognize is that the unbundling of fees benefits consumers as well as airlines.Adding a surcharge for optional services such as checked luggage, onboard food, allocated seating or a reservation change allows passengers to purchase only the perks and options they want.And if they don't want one of these unbundled services, they're no longer paying for it. This helps keep the overall fare down.

There's an old Irish proverb that says "There's nothing so bad that it couldn't be worse." I've barely scratched the surface of the overabundance of regulatory impediments to airline profitability.

The benefits to consumers of liberalization are apparent throughout the European Union common air market. Let's use Wizz Air as an example. Indigo's investment in Wizz Air was predicated on the entrance of Hungary and nine other former Soviet Bloc countries into the EU common market. The investment thesis for Wizz was based on capitalizing on traffic flows from the former Soviet Bloc to Western Europe as those once-Soviet states moved toward the EU. This strategy has expanded as the airline has grown and now includes connecting markets as far east as Dubai, Ukraine and Azerbaijan. Wizz will carry more than 15 million passengers this fiscal year and has displaced many state-owned carriers that simply weren't capable of competing with a low-cost carrier.

There are other ways that governments can help promote a healthy economic environment for commercial aviation. Many countries provide financial support to state-owned carriers that sustain heavy losses.

Not only does this come at significant expense to the taxpayer, it weakens the overall industry as commercial carriers are forced to deal with irrational competitors on an uneven playing field. Consumers suffer in the long term when governments act to protect the sparse profitable segments of their state-owned carriers. The first person who can explain why the Indian government continues to subsidize Air India wins today's bingo prize! Time has proven again and again that the free market is much more efficient at shaping the airline industry than government patronage.

There are many government assessments and taxes that reduce airline profitability and constrain growth opportunities. Many municipalities have instituted excessive airport charges to fund "civic pride" projects like mass transit connectors and hotels. Airlines and their passengers bear the ultimate costs of these construction projects, which means that airports have limited accountability for their spending.It's not easy to create a consumer-friendly, low-cost environment and maintain profitability when you're paying $20 out of a $100 fare for airport projects.

There are probably people out there who think our industry is in for an extended period of smooth flying. And there are probably people out there who think it's a good idea to order hot soup on a flight that's making its final approach into Las Vegas in August, when the smart money is on turbulence. And if we can be proactive about addressing various barriers, deterrents and constraints now, we'll be in better shape when the global economy gets bumpy, as it inevitably will.

Ensuring that conditions are favorable for strong financial performance by our industry isn't just in our own best interests. Aviation is the engine that drives the global economy, supporting over 58 million jobs and $2.4 trillion in annual economic activity worldwide. By 2032, if forecasts are accurate, those numbers will grow to 103 million jobs and $5.8 trillion in economic activity. But funding that growth and expanding the benefits provided by commercial aviation will require investment.

So, as I said at the outset, commercial aviation is, in general, doing well. But we could be doing better. And through the cooperative efforts of all stakeholders, we will all do better. As legendary American automaker Henry Ford said "Coming together is a beginning. Keeping together is progress. Working together is success."

And if industry, government and investors can work together as global partners to our mutual benefit, our shared success is certain.With any luck, we'll all be back among our fellow airline addicts next year, claiming that we're not the least bit interested in the first-year ROIC on that Paraguayan start-up. Because we can walk away from this industry any time we want to.

Can't we?