

The Sky Secret

December 2014

ABSTRACT:

Nowadays, there are lots of new up coming airline operating in the world even though the airline industry is so competitive and tend to fail. This lead me to the question that is it because of mismatching information between peoples' and firms' perception toward income of airline companies. Some people believe that airline companies earn lots of profit but in reality most of airline companies can generate very little profit margin. In order to prove the hypothesis we use two types of method, which are survey and observational studies. According to the survey resulted, most of the people do not have mismatching information toward profit of the airline companies. However, 75% of people who choose to invest in airline companies believe that airline companies generate lots of profit. While for the observational studies result, low cost airline in Asian countries send the signal to make investor receive mismatching information toward profit of airline companies. This paper will close the mismatching gap between individual and airline companies toward profit. Moreover the government should restructure airline industry as we expect to have 16 billion people who want to fly in 2050 from 2.8 billion people in 2011. Without government intervention it is hard for an airline companies to raise fund from public and may not be able to meet the demand in the future.

INTRODUCTION:

Air transportation is one of the industries that make the world become smaller and fully globalization. It gives more opportunities for people all around the world, which lead to growing in global economy. According to this it leads to an expansion in airline industry. New comers think that there are opportunities for them to step in as the technology has allowed this industry to have relatively lower cost than the past. Therefore, allowing new firm to compete in the market causing all the airlines to generate less profit. Due to small sizeable profit only one small step mistake in the firm can generate a big problem that can lead to the end of the company. Nowadays, you may see lots of news about failing airlines and some unknown airline that pop into the market. Is it because of the mismatching perception between consumer and firm toward airline's profit that cause the new comer to come into this industry? Most of the people still think that the airline companies can generate lots of profit while the truth is today airline companies are struggling through competition to survive in this industry.

LITERATURE REVIEW:

Air transport is one of those industries that have transformed the world. However, Brian (2013) stated that today's returns on invested capital do not justify retaining the existing capital invested in the airline industry. This is mainly because of the low earning profit of airline companies. Brian (2013) provided the evidence showing the profit, cost, value chain, risk and inefficiency of the airline industry. He suggested that in order to survive the airline companies

needs to improve in cost efficiency by using the Remedies framework as shown in figure1 as a recommendation and using the market five forces¹ as an analysis.

CHART 25: REMEDIES FRAMEWORK

	Reduce inefficiency	Reduce excess profits	Reduce risk	Improve customer experience
Market forces	New entry, new technology	New entry		New technology
Regulation	Incentive-based economic regulation (CPI-X)	Competition law used to break up monopoly	Debt financed rate stabilization fund	Service level agreements
Standards	E-ticketing			NDC, Fast Travel, Checkpoint of the Future
Partnership	JV with airport on e.g. duty free		Engine "rental"	
Vertical integration			Buy e.g. oil refinery, airport terminal	Cargo integrators
Information	Cost benchmarking			

Figure 1: Remedies framework

Today cost efficiency is the only key for an airlines company to be able to compete and survive in the market. An emergence of the no-frills, low cost airlines (LCCs) leads to higher competition in the market, forcing the network airline to response or to fail. Mark and Brian (2006) had analyzed the airline cost performance and how to improve cost efficiency.

Since the entrant of LCCs has rapidly increased their market share in the market. Moreover, LCCs lead to an increase in demand toward the airline industry as a whole as it provides more opportunities for cheap air travel. Therefore, Mark and Brian (2006) were using the cost gap to analyze the cost efficiency between the network airlines and LCCs among regions. They suggested that working on cost efficiency is good but it does not mean that network airlines have to adopt the LCCs business model. They need to provide additional

¹ Porter's fives forces model is a model to analyze a particular industry. It looks at the five main factors that affect a particular industry which are competitive rivalry, power of suppliers, power of buyers, threat of substitutes and threat of new entrant.

services that suit the need of their target customer willing to pay and this will incur higher cost. The key to success is that these costs are delivered efficiently and economically relatively to the premium in yields that higher service quality can attract.

Cost efficiency is the only key for LCCs to beat networking airlines for further studied on this Matthew (2002) had studied on airline profitability determinants. Matthew (2002) uses the profit function to analyze the factors that affect the profit of the airline companies through regression. The profit function is $\pi = TR - TC$ where π is total profit, TR is total revenue and TC is total cost. To look deeper in this function $TR = f(Y, LF)$ where Y is yield and LF is load factor. While for total cost function $TC = f(Q_j, F, L, M, l, R)$, it contain many factors which are Q_j is cost per revenue passenger kilometer, F is cost paid for fuel, L is labor costs, M is maintenance cost, l is landing and other airport use fees, and R is rent paid for aircraft use. Matthew (2002) found out that the load factor and unit cost are the determinants of airline profitability. Only one percent change in average load or cost can make a difference of tens or even million of dollars in profit.

According to the Hurdle's, Gloria's, Richard's, Andrew's, Gregory's, and Michael's (1989) work, they said that airlines markets do not satisfy the theoretical condition for perfect contestability. However, there is no evidence that it has an effect on the market but there is a proved that the new entry did. So they had created the model to measure airline market concentration consider both number and size of incumbent and potential non-incumbent. From the above analysis most of the LLCs tend to create more profitability than network airlines but it does not mean that all LLCs will be profitable due to economies of scale and scope.

Airlines merger is one way to help the airlines to eliminate the competition in the market causing the price to increase. Kwoka, John, and Evgenia (2010) had proved that the mergers

between both incumbent and non-incumbent or between both two incumbent would raise the price in the market. They used the data from the Department of Transportation's Origin-Destination Survey of Airlines passenger Traffic as an evident to prove their data by running regression.

One of the most important factors of airlines industry is airport as it plays a major role in offering access to essential infrastructure and services that facilitate air transport. Wells, Alexander and Seth (2011) had analyzed the overall airport system and shown all the data of the airport structure and performance. After the analysis they had no suggestion for the airport industry as it is unforeseeable but they think that the airport management will stay steel as the fundamental physics of flight will never change.

On the other hand, James (2013) had provided the data of airport competition in the market as a whole and also a researched on the airline and passenger behavior toward airports. We can now conclude that larger airports is not strong enough to forces an effective constraint on airport pricing. Due to this, airport use their market power over both airlines and their customers, leading to higher price than they should be even during the most challenging economic conditions. Hence, James (2013) suggested that policy makers and regulators should publish the policy implication to exercise care and rigor in assessing the level of effective competition within the airport sector.

At this point of time, the airline industry now faces many types of cost pressure from their supply chain such as an increase in fuel price, an increase in airport charge, an increase in government tax, and etc. Although, they have improve their cost efficient but cost measure still continue and lead to higher cost and higher prices for consumer. Mark and Brain (2008) measured the air travel demand to changes in prices and incomes by using the price and income

elasticity method as their methodology. The evidence shown us that consumer are price elasticity and very sensitive in price changes. So they should establish right policies to support the demand elasticity if not it will be ineffective.

While in the Global airline industry text book stated by Belobaba, Peter, Cynthia, and Amedeo (2009) explained the overall airline industry on airline regulation, airline economics, airline management and other factor that affect airlines industry which some of the topics were similar to the above researchers. One of the similarities is that in this paper they used same methodology as Mark and Brian (2008) to measure airline demand. In this paper Belobaba, Peter, Cynthia, and Amedeo (2009) had point out the challenges that the airline industry are facing and had suggested that airline companies must find a right model that suite their business to sustained profitability and create more stability.

Last but not least Porter, Michael, Brian, and Kevin (2011) had gathered all the information of airline industry and use it as a tool of analysis to make a vision of airline industry in 2050. They had said that in the past 40 years the world population has increased from 6.9 billion to 8.9 billion and the airline industry has progressed from carrying 2.4 billion passengers in 2010 to 16 billion passengers in 2050. Due to this estimation, airline industry must fix their industry structure and need a better guide line of government intervention and strategies to improve their business model. Moreover, they need a better technology in order to create more cost efficiency and suite the need of the consumer in the future.

In conclusion, all the research papers had shown us the evident and the situation of the airline industry and firm leading to more understanding of air transport industry. Yet, we can use all of this data to explain firm's perspective but we cannot conclude the end result since

consumer's perspective is not yet revealed. Therefore, we need further research or survey on consumer perception toward airlines' profit to prove our hypothesis.

METHODOLOGIES:

The two chosen methods to prove our hypothesis are survey and observational study. Survey methodology studies the sampling of individual units from a population and the associated survey data collection techniques, such as through questionnaire construction and methods for improving the number and accuracy of responses to surveys. While for an observational study it draws inferences about the possible effect of a treatment on subjects, where the assignment of subjects into a treated group versus a control group is outside the control of the investigator.

For the first method, survey was conducted randomly by asking 34 stock investors as they are a group that directly affect from investing in an airline companies through stocks. The survey are being use to analyze the stock investor perception toward the profit of an airline companies by holding an assumption that the chosen participants reflect the overall society. The survey question and response will be in the appendix1.

Second method, observational study were used to observe ten airlines companies profit during the IPO period by separating into two groups which are Asian airline companies and Western airline companies. Five airlines companies in Asian countries are Air Asia, Nok Air, Tiger Air, Air Arabia and Star Flyer. Another five airlines companies in western countries are Spirit Airline, SouthWest, Westjet, Easy Jet and JetBlue. This study will observe these 10 airline companies to see whether they send any signal that lead stock investor to believe that airline companies generate high profit.

RESULT – SURVEY

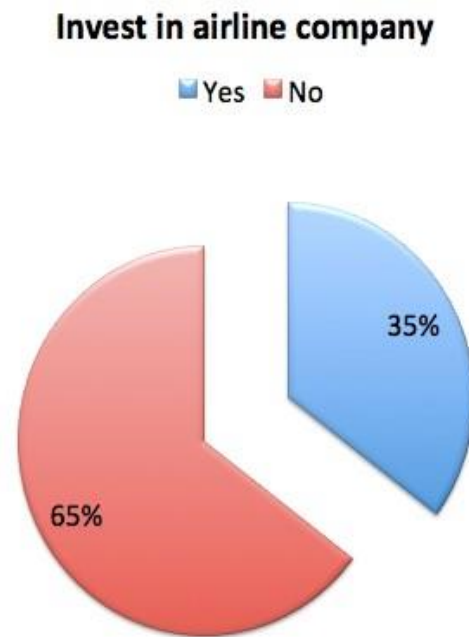


Figure 2: survey resulted conducted by 34 respondents answering the question “Do you interested in investing in an airline companies stock?”.

The survey’s result came out that 22 respondent or 65% choose not to invest in airline companies stock, which are shown in figure 2. The reasons behind this decision are separated into four main factors. The first reason is that they don’t understand about this industry, answered by 6 respondents. Second reason, this industry is highly competitive, answered by 9 respondents. Third reason, it has high risk answered by 3 respondents. Last reason, they fully understand about this industry answered by 4 respondents. All of the reasons except the first one show us that most of the people don’t have any mismatching information toward profit of the airline companies. This means that our hypothesis is being rejected. However, 35% of people who want to invest in airline companies show us that 75% of them believe that airline companies

generate lots of profit as shown in figure 3. This proves to us that there is mismatching information between firm and individual perception toward profit of the airline companies.

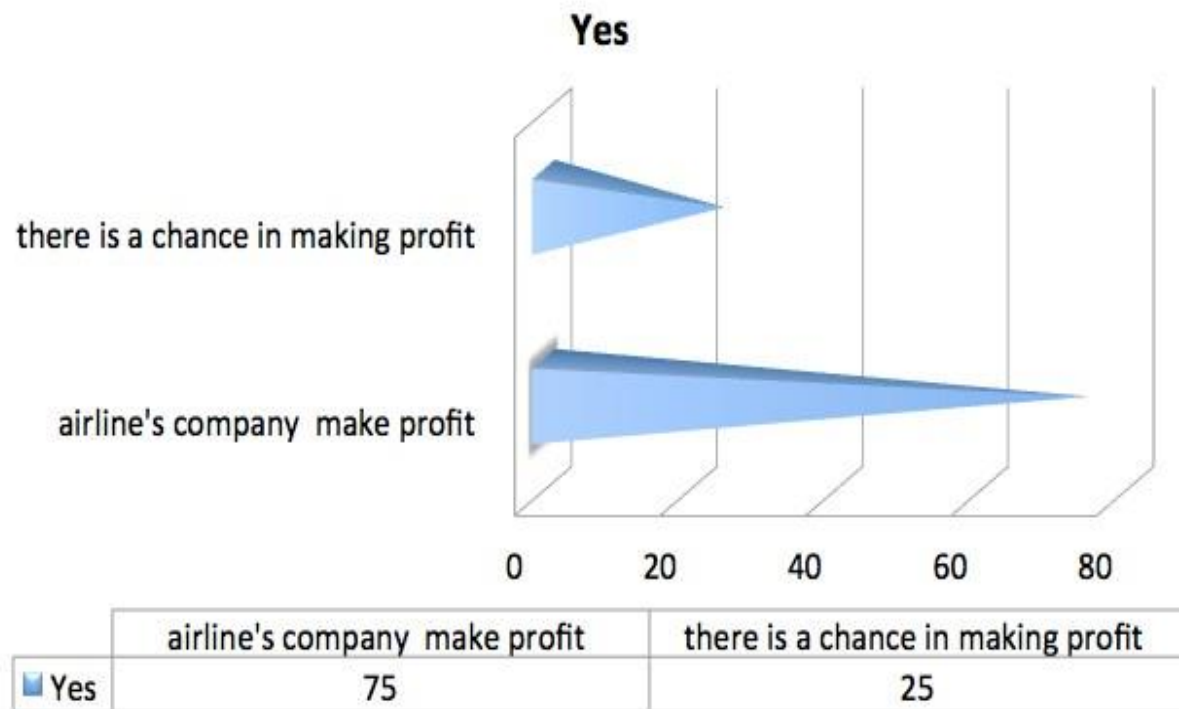
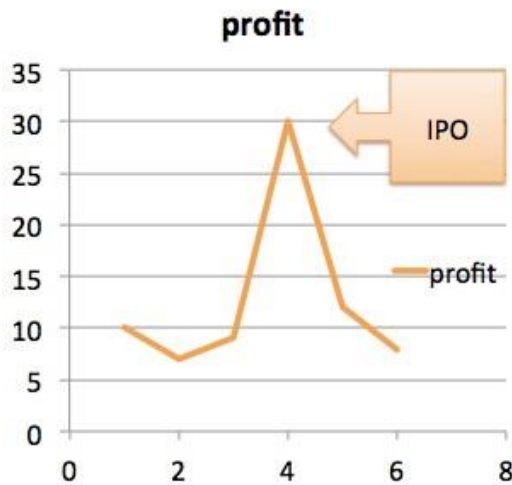


Figure 3: survey resulted – reason behind people who are interesting in investing in airline companies stock.

RESULT – OBSERVATIONAL STUDY

After an observation we can conclude that most of the low cost airline tend to have very high profit or high profit margin during the IPO period, which are shown in the figure 3. Whereas, national airlines have steady profit and profit margin as shown in figure 3.

Some Low-cost airlines



Other airlines (National airlines)

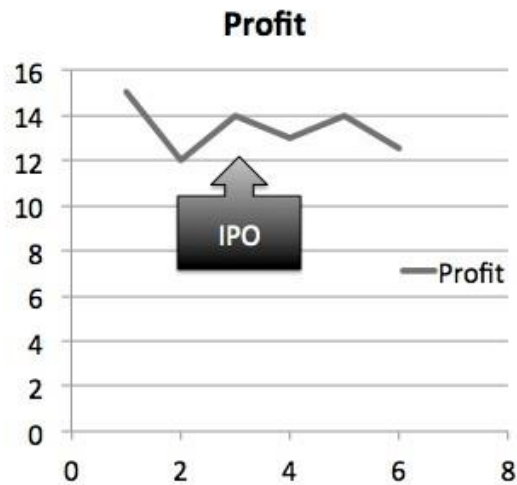


Figure 4: profit of airline companies during IPO period.

According to methodology part we had separated our observation into two parts, which are observing Asian airline companies and Western airline companies. For Asian airline companies all of the airline companies had very high profit margin or net profit during the IPO period. While for Western airline companies, only one airline, which is JetBlue, has high profit margin or net profit during IPO period. All the profit graphs of every airline companies that being observed will be in the appendix 2.

In order to do this we have to look at the profit function of the airline companies. The profit function are taken from Matthew's (2002) study where total revenue minus total cost.

$$\pi = TR - TC$$

The total revenue function by Matthew (2002) contained two factors which are yield and load factor, or,

$$TR = f(Y, LF)$$

where (Y, LF) are inversely proportional.

According to contestable market theory², we assume that total revenue is the same for all airlines. This theory was supported by Mark and Brian (2006), as they stated “every airline is now a lower cost airline. The worst financial crisis in the industry’s history over the last five years has forced all carriers to achieve cost efficiencies and higher productivity if they are to survive”. The only way to achieve high profit or high profit margin is to lower the cost. The total cost function by Matthew’s (2002) study is

$$TC = f(Q_j, F, L, M, l, R)$$

where

Q_j is cost per revenue passenger kilometer

F is cost paid for fuel

L is labor costs

M is maintenance cost

l is landing and other airport use fees

R is rent paid for aircraft use

The total cost function by Matthew (2002) contain six factors as we can see from above. From Matthew’s (2002) study, he found that not accounting costs, but unit costs are the determinants of the cost function and therefore profit. Fuel plays a major role in Airline Company’s total cost function as it has does not have the macroeconomic wage and price relationship that some other variable cost had and it is the airlines’ second largest cost.

² Contestable market theory assumes that even in a monopoly or oligopoly, the existing companies will behave competitively when there is a lack of barriers, such as government regulation and high entry costs, to prevent new companies from entering the market. Considerable criticism surrounds this theory because there are often large entry and exit costs associated with entering a market.

CONCLUSION:

Airline industry is one of the most important industries in the world. It link everything around the world together without this industry the world business, industry, relations and infrastructure will be unconnected. Today due to highly competitive industry it leads airline companies to act as contestable market to prevent new entrant. However, their still people who want to invest in airline companies. Thus, our purpose was to examine the mismatching information between individuals' and firms' perception toward profit of airline companies.

We found out that Most of the people do not have the mismatching information toward profit of the airline companies. Yet, 75% of people who are interesting in investing in airline stock believe that airline companies generate lots of profit. Further, Low cost airline in Asian countries send the signal to make stock investor receive mismatching information toward profit of airline companies. Hence, by sending the signal to make stock investor believe that their companies generate lots of profit it may ruin the firm reputation causing the firm to raise fewer funds in the future. Without any government intervention to restructure the airline industry the airline company may not be able to expand to meet the future demand.

This research paper will close the mismatching gap between individuals' and firms' perception toward profit of airline companies. For further study from this research paper, we can study more on how hard the airline companies will raise its fund after sending the signal to make people believe that it has high profit. Or what will happen if the airline companies cannot raise it fund to meet the future demand.

MODEL LIMITATIONS:

According to the survey, the resulted may be inaccurate as the survey was being conducted after Bangkok Airways started to trade on 3 November 2014. Stock investor may learn from the Bangkok Airways case before answering my survey.

Moreover, conducting a survey is not easy. Upon expectation you need more than three to four weeks to conduct more than 30 surveys. It is hard to get stock investor to answering the question, as most of them don't have much time on it. Need some social capital to send your survey to people who are widely known in the stock market to share it for you to get more respondents.

Furthermore, most of the airline companies from all around the world are private companies. Only some airline companies are public companies, so it is very hard to get the information from the airline companies to do observational studied. Also some of the airline companies did not publish the annual report the year before IPO. Therefore, it may be hard to see the signal from the airline. If you cannot find the annual report of the firm, you can feel free to contact the company directly as they have investor relation to help you finding the data you want.

From the above statement, it will help people who want to do further study on airline topic to conduct a research easier.

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APPENDIX:

Appendix 1

แบบสอบถามเกี่ยวกับมุมมองการลงทุนในหุ้น สายการบิน The Questionnaire regarding Investors' Perception towards Airline companies stock

โปรดระบุช่วงอายุของท่าน Please identify your age

- ☐ น้อยกว่า 20 (Under 20 years old)
- ☐ 20-30
- ☐ 31-40
- ☐ 41-50
- ☐ 51-60
- ☐ มากกว่า 60 (more than 60 years old)

โปรดระบุเพศของท่าน Please identify your gender

- ☐ ชาย (male)
- ☐ หญิง (female)

ท่านเป็นนักลงทุนประเภทไหน What is your investor types?

- ☐ นักลงทุนรายย่อย (Retail investor)
- ☐ นักลงทุนสถาบัน (Institutional investor)
- ☐ บัญชีบริษัทหลักทรัพย์ (Proprietary trading)
- ☐ นักลงทุนต่างประเทศ (Foreign investor)

ท่านมีความสนใจในการลงทุนในหุ้นสายการบินหรือไม่ Do you interested in investing in an airline companies stock?

- ☐ ใช่ (Yes)
- ☐ ไม่ใช่ (No)

เพราะเหตุใดคุณถึงลงทุนหรือไม่ลงทุนในหุ้นสายการบิน What is the reason for you to invest or not invest in airline companies stock?

Submit

Never submit passwords through Google Forms.

The survey respondent link:

https://docs.google.com/spreadsheets/d/1bjTAoQt4E6TNKlBKfuU5RILU7i2YX6SuAP_nyXiGI20/edit#gid=1032928388

Appendix 2

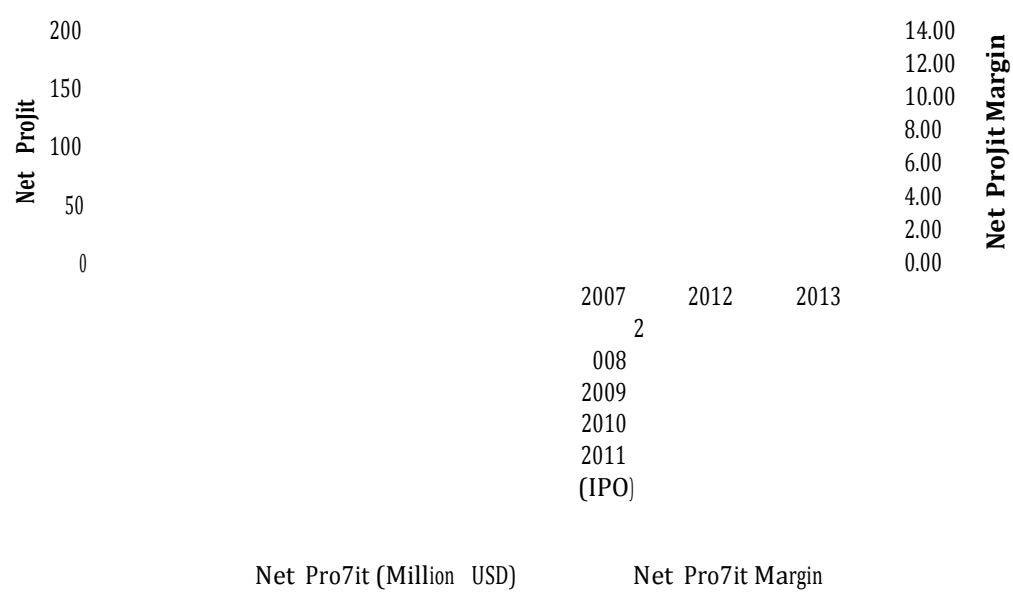
Western countries

Airlines	Year	Net Profit (Million USD)	Revenue	Net Profit Margin
Spirit Airlines	2007	1	763	0.18
	2008	33	787	4.22
	2009	84	700	11.96
	2010	72	781	9.28
	2011 (IPO)	76	1,071	7.14
	2012	108	1,318	8.23
	2013	177 ↑	1,654	10.69
et Profit (Million £)				
EasyJet	2000 (IPO)	22.10	263.70	8.38
	2001	37.90	356.90	10.62
	2002	49.00	551.80	8.88
	2003	32.40	931.80	3.48
	2004	41.10	1,091	3.77
	2005	42.60	1,341.40	3.18
	2006	94.10	1,619.70	5.81
	2007	152.30	1,797.20	8.47
	2008	83.20	2,362.80	3.52
	2009	71.20	2,666.80	2.67
	2010	121.30	2,973.10	4.08
	2011	225.00	3,452	6.52
	2012	255.00	3,854	6.62
	2013	398.00	4,258	9.35
Jetblue	2000	-21.3	104,618	-0.02
	2001	38.5	320,414	0.01
	2002 IPO	54.9	635,191	0.01
	2003	103	998	10.32
	2004	46	1,265	3.64
	2005	-25	1,701	-1.47
	2006	-7	2,363	-0.30
	2007	12	2,842	0.42
	2008	-85	3,388	-2.51
	2009	61	3,292	1.85
	2010	97	3,779	2.57
	2011	86	4,504	1.91
	2012	128	4,982	2.57
	2013	168	5,441	3.09

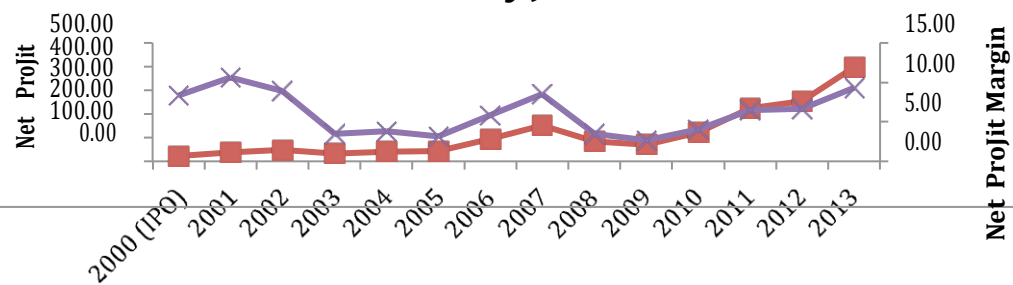
WestJet	1997	6.2	77.1	8.04
	1998	6.517	125.437	5.20
	1999 (IPO)	15.832	203.574	7.78
	2000	30.254	332.519	9.10
	2001	36.71	478.393	7.67
	2002	51.78	679.996	7.61
	2003	60.539	859.596	7.04
	2004	-17.168	1055.26	-1.63
	2005	24.001	1385.102	1.73
	2006	114.676	1765.084	6.50
	2007	189.048	2127.156	8.89
	2008	178.506	2549.506	7.00
	2009	98.178	2281.12	4.30
	2010	90.197	2607.294	3.46
	2011	148.702	3071.54	4.84
	2012	242.392	3427.409	7.07
	2013	268.722	3662.197	7.34

SouthWest	1990	47	1186.8	3.96
	1991	26.9	1313.6	2.05
	1992 (IPO)	97.4	1803	5.40
	1993	154.3	2296.7	6.72
	1994	179.3	2591.9	6.92
	1995	182.6	2872.8	6.36
	1996	207.3	3406.2	6.09
	1997	317.8	3816.8	8.33
	1998	433.4	4164	10.41
	1999	474.3	4735.6	10.02
	2000	625.2	5649.6	11.07
	2001	511.1	5555.2	9.20
	2002	241	5522	4.36
	2003	442	5937	7.44
	2004	313	6530	4.79
	2005	548	7584	7.23
	2006	934	9086	10.28
	2007	791	9861	8.02
	2008	178	11023	1.61
	2009	99	10350	0.96
	2010	459	12104	3.79
	2011	178	15658	1.14
	2012	421	17088	2.46
	2013	754	27699	2.72

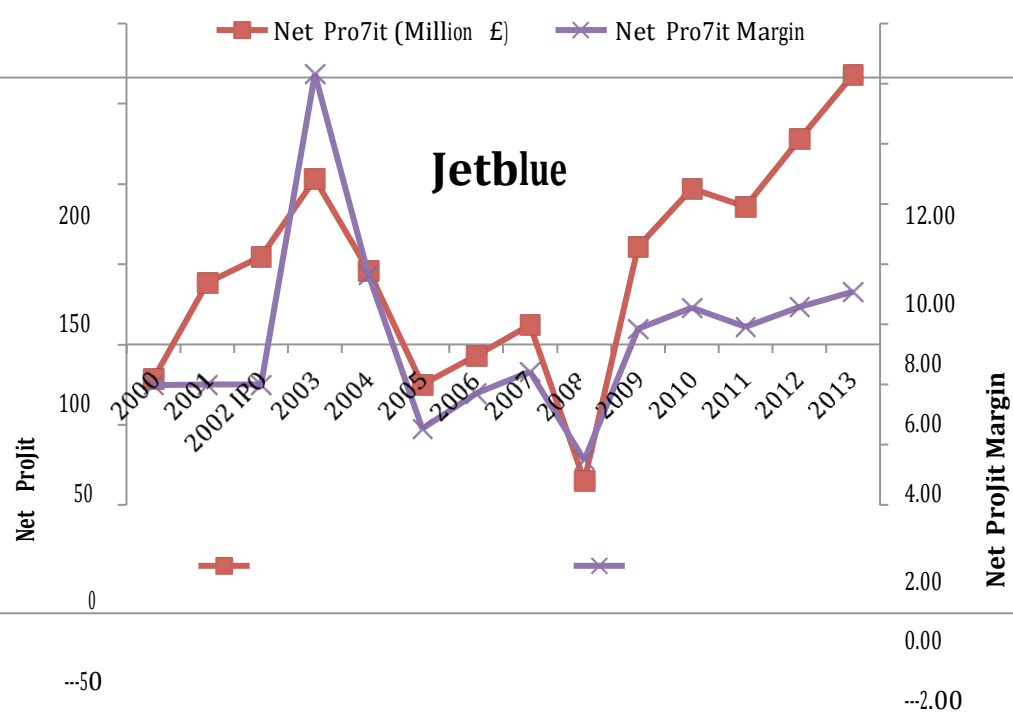
Spirit Airline

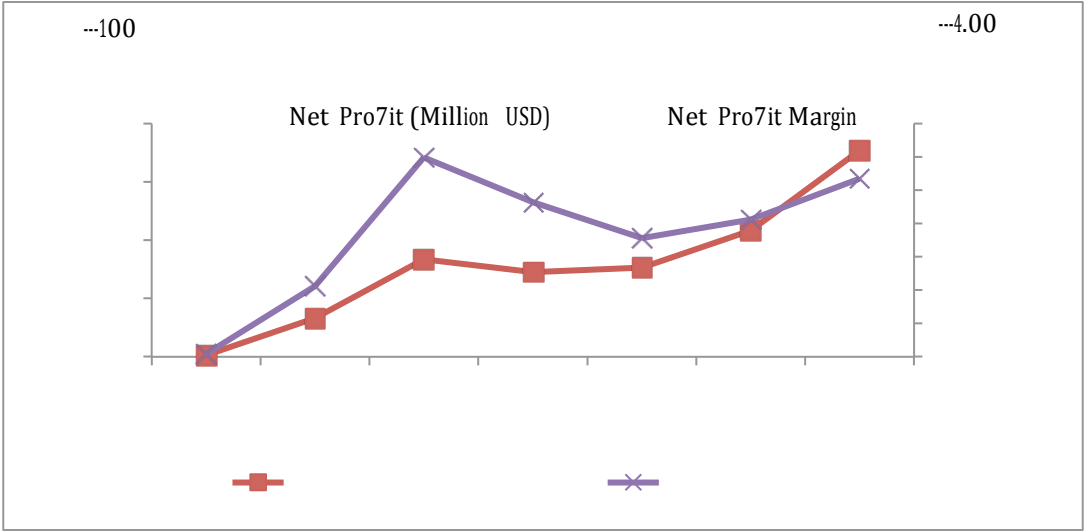


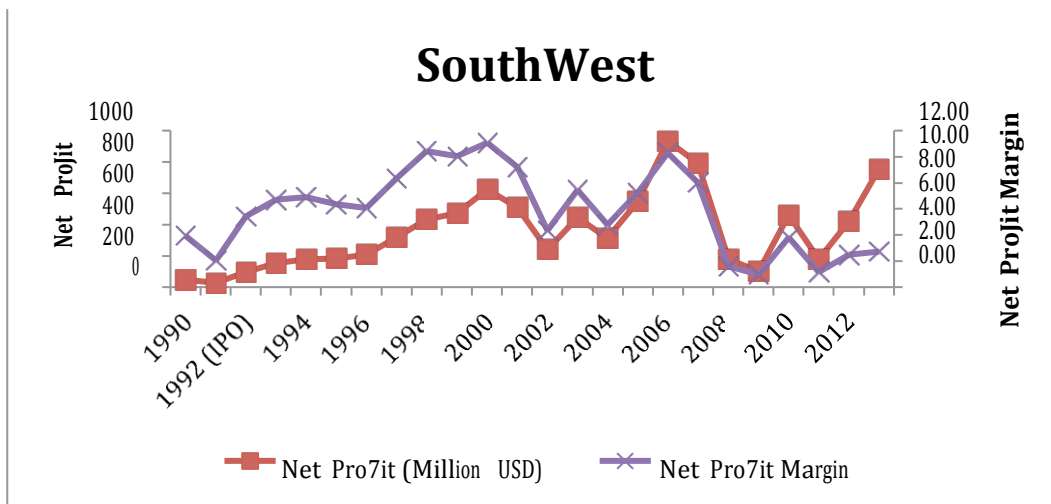
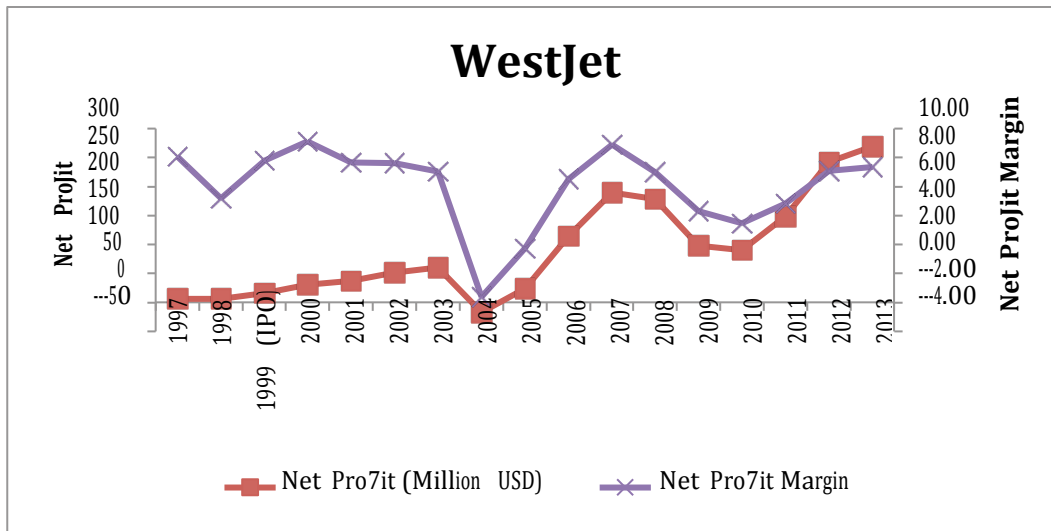
EasyJet



Jetblue







Asian countries

Years	Net Profit (Million THB)	Revenue	Net profit margin
Airasia			
2010	1,004.90	6049.4	16.61
2011	1,014.10	8123.2	12.48
2012 (IPO)	15,873.40	16103	98.57
2013	1,920.40	23485	8.18
Nok Air - sig profit			
2009	339.65	2,430.92	13.97
2010	601.53	4,191.71	14.35
2011	190.08	6,077.36	3.13
2012	504.68	8,259.56	6.11
2013 (IPO)	1066.10	11,314.73	9.42
2014 - 3q	-550.07	8,733	-6.30

Tiger air	Net Profit (Million SGD)	Revenue	Net profit margin
2010 (IPO)	28.2	486.2	5.80
2011	39.9	622.2	6.41
2012	-104	618	-16.83
2013	-45	866	-5.20
2014	-223	734	-30.38

Air Arabia	Net Profit (Million AED)		
2007 (IPO)	281,972	803,669	35.09
2008	509,725	2,065,786	24.67
2009	452,231	1,971,965	22.93
2010	309,559	2,090,737	14.81
2011	273,853	2,434,660	11.25
2012	424,810	2,832,483	15.00
2013	435,201	3,183,823	13.67

Starflyer	Net Profit (Million Yen)		
2007	-1,419	12,081	-11.75
2008	-1,555	15,847	-9.81
2009	-74	17,593	-0.42
2010	278	16,965	1.64
2011 (IPO)	811	18,186	4.46
2012	967	22,580	4.28
2013	288	25,167	1.14
2014	-3,040	33,024	-9.21

