

Is the Airline Industry Flying High or in for a Tough Landing?

Sam Gandhi, Bart Biggers, Michael Burke, and Kevin Lewis

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Sam Gandhi:

Airlines have hit their share of turbulence, from supply chain issues and staffing shortages, to the Russia-Ukraine conflict and higher fuel prices. As interest rates continue to rise and some airlines file for bankruptcy, the industry is just getting started in meeting its carbon emissions promises. In today's podcast, we'll discuss the current state of affairs in air travel, emerging trends in the industry, such as sustainable flight, and legal considerations regarding bankruptcies taking place in the industry.

Bart Biggers:

There has been an aircraft purchase boom, and it sort of makes sense that airlines are getting in line so that they won't be wiped out of the supply chain.

Sam Gandhi:

That's Bart Biggers. He's one of the co-leaders of Sidley's Aviation and Airlines Practice and is resident in the firm's Dallas office.

Michael Burke:

Carriers have added about 220 billion in debt since 2020 because of the pandemic, and overall debt load of airlines now stands at about 650 billion.

Sam Gandhi:

And that's Michael Burke, a partner in the firm's Restructuring practice based in New York.

Kevin Lewis:

The airline world has been dealing with this pilot shortage since before the pandemic, and then they play the game of can I take your pilot? Now we see people looking at M&A activity as an avenue to access pools of pilots.

Sam Gandhi:

And that's Kevin Lewis. With Bart, he's one of the co-leaders of Sidley's Aviation and Airlines practice and is the Office Managing Partner in Sidley's Houston office. From the international law firm Sidley Austin, this is The Sidley Podcast, where we tackle cutting-edge issues in the law and put them in perspective for businesspeople today. I'm Sam Gandhi.

Hello, and welcome to this edition of The Sidley Podcast, Episode Number 34. Bart, Michael, and Kevin, great to have you all on the podcast.

Bart Biggers:

Thanks, Sam. Great to be on.

Michael Burke:

Thank you, Sam. Pleasure to be on.

Kevin Lewis:

Happy to be here, Sam. Thanks.

Sam Gandhi:

So, let's start with a topic that everyone is interested in, the state of the airline industry and its customer experience. Everyone's been on air travel, and everyone's felt it in good ways and not-so-great ways, but globally, airlines lost over 200 billion dollars during COVID. Yet, the industry seems to have come out as well from the pandemic as can be expected, and despite the challenges, we've even seen major renovations to New York and New Jersey airports, which, frankly, I never thought I was ever going to see. Bart, so, set the stage for us in broad terms. What's the state of the industry, and what's going on in the airline customer experience?

Bart Biggers:

Sure, Sam. Just, overall, the airlines are starting to return to profitability. If you look at COVID, there was over a 200-billion-dollar loss for their airlines globally. So, they have high debt loads coming out, but actually, the road out, while it took longer to make their way out, it seems to be going fairly smoothly.

As we look at it, there's profitability across the globe projected for most regions, and in fact, the US, in particular, looks to be fairly strong after what is a slower first quarter, and we're continuing to see economic and global

risks, though, with the recession. I think that's a concern that's out there for the airlines, and globally, obviously, there's some overhang with Russia and China and how the routes are worked around those regions.

Supply chain and staffing are continuing to be major issues. In most industries, those are starting to smooth out. As we'll talk about more, this industry is not. Cargo demand is continuing to trickle downward, but it's still relatively high relative to what it was, as during the pandemic, we saw a bubble in that area based off home deliveries.

Passenger demand, we're seeing a change that occurred during COVID continue to stay consistent, where we see that there is leisure travel, which is more popular as it ever has been, as there was pent-up demand. Business travel continues to be down relative to pre-COVID.

And then we have a couple of new areas that are actually interesting, which are leisure, where people continue to travel for business, for pleasure at the end of their business or pre their business trip, and then, also, another one, just based off remote work, where people are either traveling to their place of business from working remotely or vacationing and working remotely from a location other than their home on, say, a Friday and a Monday.

Operationally, we'll talk about it a little bit more. There's still a concern for the summer, but overall, it's smoother than it was as we came out of the pandemic. I think that's one of the things that we've all experienced. That it was a rough go coming out of the pandemic, and globally, we're still seeing some issues, and it's been very public.

There's air traffic control shortage that is a concern, as well. Data privacy and security are still hot because data is power. Data's power in this industry. It's power in many things, and so, that continues to be a hot area, and finally, ESG is another area where we're seeing a movement that started in Europe pre-COVID. Has made its way around the pond.

You mentioned customer experience, and that's actually a very hot area, as well, interestingly, because of the debt loads. If we look at the customer experience, Sam, you go from booking, and there's been changes in the way that's happening with what's called the New Distribution Capability, or NDC. It has commercial advantages, and it's more of a modern distribution

model relative to the model that was created, say, 50 years ago through travel agents, and secondarily, it's creating a dynamic as to how we receive fares.

So, that's something that changes in your booking path, and it creates a little bit more of a change there, and also, mobile apps have become much, much more popular, to where they're becoming the prevalent way to book. Secondarily, when you get to the airport, as you get off the curb and you start to go through, in COVID, we moved to somewhere we were already starting to lean toward.

And that is a touchless experience with electronic boarding passes, biometrics at both TSA and the gate, and also advanced security technology with CT scanners so you have less frustration of your bag being stopped along the way. In fact, airports are even using robots for customer-facing...and also, suppliers are using them on non-customer-facing areas, such as ground handling and catering, and that, we think, will become more and more prevalent. We're seeing a lot of potential in that area.

From a comfort perspective, Sam, you nailed it. The airports in New York, as Kev many times quoted, have gone from third-world country to what we're seeing today, which is top in the world, frankly. I think when you were walking through Newark or La Guardia in particular, you feel like you're in a European airport because we just had not built as many airports. In fact, there's been a recent expansion announced at DFW and even updated lounges announced yesterday in Denver.

So, I think we're starting to see customer experience move in a forward direction, especially here in the US. Also, we're pushing, as I mentioned, through staffing. On-time performance has been an issue, and that's going to be something we'll talk about in just a second, but we're pushing through the staffing issues to hopefully see a better on-time experience as we smooth out from the COVID hangover that we had.

Once you're on the aircraft, we're seeing a new purchase boom that we'll talk about in a little bit, but also, more broad-based Wi-Fi. It's becoming more widespread. There's more entertainment on board, and also, as you see, the LED lighting and the seating is recently updated on many of the aircraft. So, we're seeing continual movement in that.

You know, the final area I just thought I would touch on, Sam, has gotten a lot of attention recently, and that's the Biden Administration recently announced that they were going to be pushing for compensation for flight disruptions, and while there's no time to get into that on this podcast, one of the things that we're seeing debated is the balance between performance and the airline's accountability to that, relative to scheduling and safety.

The more that there's a push toward that, there's a concern that we've seen from airlines as far as that there would be an imbalance...could be an imbalance related to safety there, which is something that you never want an administration to put the airlines in the place.

Secondarily, it affects the passengers if we cut back the schedules, as we've seen in New York recently, based off shortages for ATC, as requested, so it's a smoother experience for the customer, but then there's just less flights and less opportunity for the passengers.

Sam Gandhi:

Bart, we talked about the customer experience and the improvements that the airlines have been doing, not just in terms of in flight, but around the airports. Do you think that that competition is going to translate into lower prices over the long run, or are you still seeing flights are still pretty expensive?

Bart Biggers:

We have to look at it in two ways, right? We have to look pre-COVID, and then we have to kind of set COVID aside, and there was a big dip in fares there that we all experienced during COVID, and I think we got a little bit more used to it. So, I think fares are generally getting more in line, maybe slightly higher, than they were pre-COVID, but that's somewhat of a relation to some of the things we were just talking about, the lack of scheduling.

That scheduling is based on a few factors. One, I just mentioned the cutback in New York based off staffing shortages, including ATC, but also, you have the metal shortage where there's just not enough aircraft, and also, related to staffing, there's also the pilot shortage. So, based off those things in particular, at least for the near term, the next few years, I don't think we see a huge change in pricing, necessarily.

Kevin Lewis:

And Sam, let me also just add, it's also just our old friend supply and demand. I mean, you note that the prices are up, but you may also note that the airplanes are full for all the reasons that Bart just mentioned, but demand for travel is up. The fundamental laws of economics will probably continue to apply.

Sam Gandhi:

Yeah, and I think some of what's driving that is also commodity prices and oil prices and steel prices, et cetera. Let me talk a little bit about energy and what's driving that, Kevin. *The Washington Post* recently wrote an article about how trash could help curb emissions, and it explained that airlines want you to fly on airplanes fueled by old socks, rancid pistachio shells, and leftover French fry oil rather than petroleum. In all seriousness, airlines are probably at the forefront of major industry in terms of reaching their renewable energy goals, with varying degrees of success. So, what's really driving this initiative? Is it cost? Is it long-term goals? Is it ESG pressure?

Kevin Lewis:

What's driving the initiative is a combination, I would say, of current regulations, anticipated regulations, and perceptions of current and anticipated customer preferences, and then I don't want to omit varying degrees of just independent concern by management and boards over climate change and how it will impact and how it will be impacted by aviation.

So, with regard to customer preference, we should note that business travel has not recovered to pre-pandemic levels. Leisure travel has, and there is a growing third category that folks in the industry call bleisure, which is travel that's kind of business, kind of leisure. That travel has been spurred by the ability of millions of people to work remotely.

So, all of this means that passengers are skewing younger, and to airlines, that means they think that their customers are more likely, today and in the future, to be sensitive to carbon footprints and sustainability concerns. With regard to regulations, there are already regs on the books that mandate carbon emissions reductions.

One example is the Carbon Offsetting and Reduction Scheme for International Aviation, referred to as CORSIA, and people anticipate further regulation, including in the United States, to mandate carbon emission targets.

So, for both of those reasons, the regulatory and customer preference concerns, given those, what can the industry actually do? I think the options to transform a carbon-based transportation industry to something greener are generally viewed as the following. There's SAF, sustainable aviation fuel, which is referred to as SAF.

There's green hydrogen, and there's electricity, by which I mean eVTOLs, electric regional jets, battery-as-a-service, certain other inventions. Of these, the industry views SAF as the key option, and that's for two reasons. Number one, physics limits the range of aircraft that can be powered by electricity because of the weight-to-propulsion ratio of batteries.

And at some point, if you fly further, the battery has to be bigger and bigger and bigger, and at some point, the battery becomes too heavy to be transported the distance that it can otherwise power the aircraft. So, significant change in battery technology might change that, but I don't think anybody sees that in the offing. So, that means electric is limited. It will play a role, but it won't power you from LA to New York, much less over the ocean.

As for green hydrogen, I think it's currently viewed as being several steps behind SAF in terms of both technological development and scalability. So, if SAF is the key, one might ask, well, that's fine. Does that mean we have a solution? And the answer is, well, maybe. Maybe not. There are twin challenges to SAF as a sustainability solution. Scaling and cost.

So, the current supply of SAF is severely limited, and one of the reasons is feedstock. Almost all SAF today is sourced, as you noted, from food waste, mostly fats, oils, and grease, collected from restaurants and industrial kitchens. Maybe someone's doing it from old socks. I'm not aware, but it's very inefficient. New feedstock sources are needed, and with regard to cost, SAF remains 2 to 4 times more expensive than conventional jet fuel, which is referred to as Jet A.

With the scaling and production, the belief or the hope is that SAF's premium to the price of Jet A should decrease over time, but in addressing those two problems, we are really starting at square one. There are only a few refiners in the US producing SAF. The total supply today amounts to plus or minus 15 million gallons a year, and that's less than one-tenth of 1% of the fuel burned by the aviation industry annually.

So, there's a massive need for investment to find and scale new methods and new feedstocks to produce SAF and thus, reduce its price. I think the industry recognizes that these sustainability investments are, for the most part, long-term plays, which I guess is going to give opportunity for people, for a reasonable period of time, to question whether any of this is real, but as I said, the industry believes that it faces continuing pressure to reach these goals.

And it is embarked on trying to support technological development to achieve them. Now, there's good news in the Inflation Reduction Act, which provides incentives for SAF producers, and it's anticipated that these should be helpful to increase SAF production, particularly in encouraging producers to switch from producing renewable diesel to producing SAF.

And finally, I think it's worth noting that our clients have been extremely active in this space. They've been involved in more SAF investments and offtake agreements, really, than anyone else in the industry, and we have been there alongside them every step of the way. So, it's a very exciting area, and I think it's going to be an area that produces deals and technological investments for years to come.

Sam Gandhi:

Thanks, Kevin, and let me just pivot, Michael, to you. Bart and Kevin have talked about how the industry is growing. Planes are full. Yet, we've still seen a number of bankruptcy filings in the industry recently, and so, the question I have for you is that why is that happening, and what are the conditions that are precipitating this, and what are the trends you're seeing in some of these filings?

Michael Burke:

Certainly, Sam, and you're absolutely correct. At least since 2020, the pandemic has caused quite a few large public carriers to file Chapter 11.

Interesting fact here is that all of the entities that file Chapter 11 are non-US carriers. We haven't had a major US carrier file since the pandemic started and ended. Now, what I will say is a common element in all of these bankruptcies, obviously, there's a demand drop, revenue reduction, unsustainable debt loads.

And very importantly, those airlines that file Chapter 11 didn't have any governmental support to prop them up. So, they chose to come into the Southern District of New York to file Chapter 11. Some estimates have that, worldwide, there was about 244 billion in aid, governmental aid, but these six particular large public carriers were not the recipients of any of that aid.

I'm going to go through a little bit more on the large public carriers for a moment, but I also...because there was an interesting article in Bloomberg yesterday. There is another segment of aviation that I think your listeners would be interested in, known as Part 135, or private carriers. These are chartered aircraft, and a lot of your listeners may have bought prepaid miles or prepaid block hours. There's literally billions of dollars out there in this industry.

Interestingly, as demand went down for large public carriers, demands increased substantially for the private carriers, and now the reverse is happening, where they're losing customers because large public carriers are coming back, but getting back to the large public carriers, one might say, wow, why are all these non-US carriers filing bankruptcy in Manhattan? And I'd like to think...well, there are several reasons.

One of which is the bankruptcy code is very inviting, and it allows a debtor to be anyone that has actual property, among other things, in the US. They came in, and they were very blunt about it. There's obviously benefits in filing in 11, because your creditors are more familiar with the Chapter 11 process than in many other jurisdictions. There's also the availability of financing and capital that the US affords that may not be available in other countries.

Also, Chapter 11...and this goes not just for aviation industry, but all. Can clean up your balance sheet, discharge certain debt, and you've seen billions of dollars literally been shed off the balance sheets of these carriers

by going through Chapter 11. Another benefit of Chapter 11, a big cost of any airline, is the equipment cost, whether it's aircraft leasing, financing.

The bankruptcy code permits debtors an opportunity to renegotiate those costs. I hesitated a little bit there because this is maybe a little bit inside baseball, but Section 1110 of the bankruptcy code was specifically put in there to provide aircraft creditors with leverage. Unfortunately, maybe a drafting glitch or not, Section 1110 only applies when the debtor is a US-certificated carrier. It doesn't apply when it's a non-US carrier.

Even if Section 11-10 does not apply to non-US carriers, the Capetown Convention should provide very similar protections and leverage to aircraft creditors provided that the underlying requirements are met. Those requirements are a little bit beyond the scope of this podcast.

Having said that, many of these have effectively...well, they have emerged from Chapter 11. They have new capital structures. As I've said, shed billions of dollars in debt, and one of the interesting trends we saw in this round of aviation bankruptcies is something called the enterprise dip, where, effectively, a party will come in and lend money to the debtor, but they will want that loan converted into equity at the end of the case. Usually, you do that through a plan of reorganization. It's kind of a new phenomenon in bankruptcy, and we've only seen it in these particular aviation cases.

There's been some decisions where judges have said we don't like this. This kind of condenses or folds the Chapter 11 process into something much too early in the case, but they allowed it because, in at least two particular instances, there were not other lenders willing to lend. So, that is, essentially, it on the large carrier Chapter 11s, but now I want to switch to what I mentioned before. There's another segment of the industry, Part 135 carriers.

The Part 135 carriers suffer from many of the same issues that the large public carriers are suffering from, including pilots, equipment, looming maturities and a substantial debt load. But these carriers also have the problem of demand is now decreasing.

Now, the way this particular industry works is customers will buy block hours, and in large part, many of them rely on pre-payments, and they use that as revenue going forward.

We're just reviewing a 10-Q, and there's one in particular that has about a billion dollars' worth of prepaid block hours, paid for by customers. Now, it's interesting. If they were to file bankruptcy, could that simply be an unsecured claim? And that would make them, that group of customers, the largest unsecured creditors in the case. However, if they file bankruptcy, the conundrum there is will the customers ever buy block hours again?

So, in sum, that's the interesting issue with the large public carriers and the private carriers, but you know, for avoidance of all doubt, delivery of equipment delays, supply chain disruption, interest rates, these are all going to be issues in both segments going forward. The well-respected trade group that has put out a report recently and said that carriers have added about 220 billion in debt since 2020 because of the pandemic, and the overall debt load of airlines now stands at about 650 billion.

So, we'll see. As interest rates and carriers are going to have a difficult time refinancing, will they put more pressure on lessors to do sale leasebacks or how creative are they going to be to free up cash? Many of the carriers were refinancing in low interest rates and hoarding cash or preserving cash, but a lot of maturities are coming due in the near future. So, it's going to be another test of carriers.

Sam Gandhi:

Bart, are you seeing people willing to invest into those companies that are distressed? Meaning, do they take a much longer view of the airline industry, and is there enough liquidity to support those companies?

Bart Biggers:

I think it depends on the stage the company's in, obviously, and when you get in, but in general, yes. We're seeing strong interest in investments in the industry. Look, I think people feel, by and large, the industry has been taken as close to death as you possibly could be, right? I remember saying that the industry was getting up and starting to walk around after being in ICU for months.

So, I think, in general, yes, we are seeing that. You also have to remember, the beauty of this industry from an investment standpoint, to the extent you get an asset, is if it's related to aircraft, it's moveable, right? So, you can find a market that actually does make sense for that asset, as opposed to real estate where you're pretty much stuck where you are, obviously.

So, I think that that's part of the reason we see that, and in addition, as Mike is saying, the restructuring side of things is fairly well proven out and that there are protections that are put in place, like 1110 and Cape Town, to protect the investors, and so, yes, we are seeing strong interest in the industry and investments and saw quite a few deals last year, and expect to continue to see that.

Michael Burke:

And if I may, Sam, on that enterprise dip issue, there are several circumstances of the carriers that I just mentioned where large private equity came in, lent them money on the first day of their bankruptcy, but wanted to own a majority of the stock when they emerged. So, there are entities taking large bets that demand is going to return and the industry is going to be profitable going forward.

Especially, once you go into bankruptcy...and we saw it in the last cycle with US carriers. You shed so much of your debt. Actually, I'm not the financial analyst here, but once the debt is reduced in the billions of dollars and you're leaner, you have less debt to service once you have gone through Chapter 11 than if you haven't gone through a Chapter 11.

Sam Gandhi:

Kevin, what's your perspective on this issue of high debt for these airlines?

Kevin Lewis:

Well, let me just add on, before I answer that, to Mike's point. That he's exactly right. That is what we have seen, but you also have to ask yourself if we will continue to see these private equity guys vote for the equity option, because some of the cases in which they've done that, the companies have emerged, and they've emerged into another crappy economic situation, and that equity, not necessarily doing well.

So, the fun part about this is the incentives and the goals are constantly shifting, but to answer your question and to add onto Mike's very good points, I'll just note that, from a 50-thousand-foot view, what we in the airline industry refer to as the lower stratosphere, just in case you're wondering, post-pandemic, I think airlines all over the world are highly levered, right? There's been tens or even hundreds of billions of dollars that've been added to the balance sheets, as compared to 2019.

So, the bottom line, just when you step back from all of it, is if you're in jurisdictions where the combination of the passenger traffic and the fares have allowed at least your income statement to recover, those carriers are going to have more options as to how and when to de-lever, and if you're not in one of those jurisdictions, you have fewer options, and that's really the bottom line, and that's where we're seeing these bankruptcies come up, and suffice to say, it's going to be an interesting couple of years.

Sam Gandhi:

You're listening to The Sidley Podcast, and we're speaking with three of Sidley's thought leaders on the airline industry, Bart Biggers, Kevin Lewis, and Michael Burke, and we're talking about industry trends, including the impact of increasing travel demand and the legal intricacies of the bankruptcies taking place in the industry. Michael, what are some of the emerging trends that you're seeing in the industry in terms of debt loads and what airlines are doing about that debt?

Michael Burke:

Sam, as I mentioned before, there's about 220 billion more in debt put on the airlines since the pandemic began. So, airlines are being very creative, in my view, in looking at, for example, lessors to provide, essentially, cash flow and reduced rates. For example, the sale leaseback market now is at its highest it's been in the longest time. Though, essentially, the airline doesn't want to have the ownership and pay the debt costs.

So, they will sell the aircraft to the lessor and then get the cash for it, and then the lessor will lease it back, so that will free up cash flow. That's one of the items that we've seen. Secondly, a lot of the airlines took advantage of the low interest rate environment to try to refinance as much of their debt as possible. However, that has now passed, so they are looking for other

ways. Another interesting trend I'm seeing is collateral is not an easy question in this particular industry.

During the last cycle, gates, slots were used as collateral, and you could put out a bond issue or do some other financing on it. This cycle, it seems a lot of the mileage programs are being used as collateral to raise money. So, that is a brand new trend, I think, in this particular cycle. The other, as I said before, is enterprise dip, and this only applies in bankruptcy. However, typically, a company files bankruptcy. It will get money to operate. It will then, at the end of the case, propose a plan of reorganization.

And many times, debt will be equitized, and then you'll have new shareholders. This enterprise dip is now a dip lender, who's lending money in the beginning of the case, already wants to peg, essentially, how much equity they're going to own once the company emerges from bankruptcy. They usually give themselves the choice. I can take equity, or you can pay me back.

I think that, from a bankruptcy perspective, it's very interesting, because they're taking a bet on the future of the company the day the company files bankruptcy, and whatever the thesis is behind it...but I think it will be, you know, the airline had 4 billion in debt. Now it will only have 2 billion in debt going forward. So, this may be a good investment to loan to own in bankruptcy, but that's clearly a trend.

Sam Gandhi:

Kevin, Bart talked a little bit about the fact that there's an airline pilot issue in this country, and the Department of Labor estimates there have been 18 thousand openings for airline and commercial pilots each year, like, for the next decade. Is there any hopes of fulfilling this? Is that even feasible? And what do you see as some of the industry's other challenges?

Kevin Lewis:

The pilot shortage is an interesting issue. The whole world now is enduring the challenge of labor shortages, and then that's affecting all sorts of industries and across national boundaries, but the airline world has been dealing with this pilot shortage since before the pandemic. It has just, through the pandemic, grown in size and spread to mechanics and gate and ramp workers, air traffic controllers, et cetera.

So, we sort of have a new post-pandemic angle to a pre-pandemic problem. For what it's worth, let me give you a little context. The reason for this problem started about a dozen years ago when the FAA and DOT decided to increase dramatically the minimum flight hour requirements for pilots of US-flagged aircraft, which is basically all of the carriers in the US and all the planes that fly within the US. This happened after the crash, you may remember, of a regional aircraft near Buffalo, New York about...I don't know, I think that was about 14 years ago.

So, the rule was put in place, but its effects were so Draconian that the effectiveness was delayed for several years, but it ultimately did go into effect, and so, that rule is really the source of the particular pilot shortage, which is the most dramatic of all of the labor shortages I mentioned, and now, on top of that, we have a lot of other macroeconomic headwinds.

The retirement of a lot of pilots during the pandemic, which was not foreseen and has made the problem worse, and frankly, again, just to get back to supply and demand, the fact that the wars in Iraq and Afghanistan ended has a real material impact on this, because people who fly in the Air Force, when they leave the Air Force, frequently join airlines.

They're a major supply line for airline pilots, and when there are more people in the Air Force, they get more people coming out of the Air Force, and when there's fewer in, there's fewer out. So, both of those are having a real impact, and then you just add the pandemic labor shortage.

I don't really think people think there is an easy solution to this shortage anytime in the near future, but rather, they're just going to be chipping away at it, and everybody, of course, focuses on who bears the brunt of the problem. So, number one, the regional jet companies are having more of a problem because those salaries are lower. So, they feel the brunt of the shortage more than the mainline carriers do. Airlines are responding by building up their own pipeline of pilots.

They're starting their own pilot training academies. They're increasing pay, and then they play the game of can I take your pilot? They basically do whatever they can to increase their pilots, wherever they come from, including now we see people looking at M&A activity as an avenue to

access pools of pilots. So, I think the answer is there's no short-term solution to that, but it will hopefully just decrease in its impact year over year.

Finally, regarding your question about other macroeconomic headwinds affecting the industry, the Russia-Ukraine conflict is having an impact, both in terms of where people fly, how they get from place to place, areas of Europe that you can't fly over now, which has a bigger impact than you might think in terms of flight paths and what that does to travel, inflation, wage, and other goods.

Elevated fuel prices also impacted by the Russia-Ukraine conflict. Tensions with China as that both affects Transpacific flight and the supply chain because of aviation-related work and products that are made in China. Other supply chain constraints, staffing challenges, air traffic control challenges that Bart talked about.

And just to get us back to sustainability, I think a lot of folks in the airline industry are seeing increasingly frequent and powerful storms that happen across the US, and that affects flights and affects recovery, and you see what happened over Christmas with the powerful storms that went across the US and how long it took airlines to recover from that.

Sam Gandhi:

Bart, we talked about sustainable fuel. We've talked about pilot shortages and other issues relating to the industry, like debt and customer service issues, but we actually haven't really talked about the aircraft itself, and what are the trends you're seeing, actually, in the aircraft? And we hear a lot about aircraft purchases, flying taxis, supersonic planes that run on vegetables and other things. What do you see in terms of new technology relating to the craft that people are actually flying in?

Bart Biggers:

Tying all this together, we talked about the fact that there's supply and demand equilibriums that we see within the industry, and as we've said, there are staffing shortages, but there's also supply chain shortages related to the aircraft, and that ties into the fact that demand is still high, and I'll tie that into our economic question here in just a second, as well, but because of the high demand, we were continuing to see the airlines be bullish.

And in fact, even though operations are not fully smoothed out, as we said, globally, there has been an aircraft purchase boom. In certain extents, the airlines are getting in line so that they won't be locked out of the supply chain, because the manufacturers are late on delivery. That's been very public, and so, because of that, I think there's a concern that that could extend for a while, and if the airlines don't get in line, then they will be potentially locked out of the supply chain.

So, what we've seen over the last few months is actually four mega deals. We've been fortunate at Sidley to be part of some of that, but because of the dwindling supply and the net zero standard that Kevin talked about, there's been a big movement to purchasing of new aircraft that, frankly, won't deliver out for up to 7 plus to 10, even, years as the airlines get in line.

But it's not uncommon for us to be having conversations with our clients about just the fact that they have to get in line, and that shortage is causing the airlines to not be overly concerned about the recession. So, Sam, as we talked about finance earlier, just tying this all together, the airlines are not as concerned about an upcoming recession, by and large, simply because there's the pilot shortage.

There's all the staffing shortages, the cutbacks we talked about in the schedule, and the metal shortage here on the aircraft, which create it to where they feel that there is a...you know, there could be a slight reduction in the cost we were talking about earlier to the passengers, but by and large, they don't see a major dip that would cause a change in the equilibrium that we're seeing right now between supply and demand.

On the aircraft innovation side, this is something that we've been very fortunate to be part of, as our clients have been very involved in this area since the pandemic and we've seen eVTOLs, which is essentially flying taxis, you know, like a flying SUV. It's basically everything that you and I watched on The Jetsons years ago coming to fruition.

It's actually fun to watch in that regard, and the FAA has said that they hope to have that flying in the somewhat near future. I think, realistically, it would be helpful that we could see that in this decade. There's a lot of

infrastructure that has to go into that. Also, hydrogen has gotten a lot of attention, and I think it's something that people are very bullish on for an alternative power source, and one that we're seeing quite a few deals in.

Also, batteries for smaller aircraft, I don't think, right now, people see that as a viable option for larger aircraft. Definitely not wide bodies. Not even what you and I consider narrow bodies, but more even smaller than regionals that we see today, and then we've also seen supersonic aircraft operable on 100% SAF that we've seen the airlines investing in and lining up to purchase those aircraft, which is kind of fun to see again.

So, Sam, we've definitely seen a boom, and we even see it, you know, down chain as there's investment in areas that would lead up to the actual aircraft, as well, and in fact, Silicon Valley I think has somewhat reorganized themselves to look at these opportunities when we talk about investments.

Sam Gandhi:

I'm going to wrap up the podcast. What do you think your clients think of as the largest risks that they're seeing in the industry and the biggest opportunity?

Kevin Lewis:

I think what's on the minds of our clients are always, to some extent, the same three things. Passengers. It's always about passengers, except when it's about employees. So, the airlines are focused on increasing creature comforts with new planes, new lounges, new ways of providing specialized services at the high end and differentiating prices at the low end. For employees, they're looking at increased wages.

They're partly here, and they're partly coming, and there's always an interesting give and take between working conditions and work rules and wages. So, that is going to be the place where there's a lot of activity in the very near future for these airlines, and then, finally, both of those lead into the financial statements, which is really what is on their minds. First the income statement and then the balance sheet.

As we've discussed, they've gotten highly levered, not a level of debt in relation to the size of these companies that is, from a big picture,

sustainable. So, they are working on their income statement at the moment. Many of them, at least more in the US, achieving success at that, but they are all ultimately going to have to turn to the balance sheet and clean them up.

Bart Biggers:

As we've looked at it, what we're hearing from our clients, we're hearing help, and it's usually being yelled, and that's because, if you look at it, most of our clients have 70 to 75% of the employees that they had pre-pandemic. There's been a loss of experience, a lot of brain drain from early retirements as people said I don't know if I can see the other side of this, and then a lot of people are new to their role.

And there's also been pent-up projects as the can was kicked down the road. It's been told to me that this is the industry where you see an annual, once-in-a-lifetime event, so we're used to that, but this one is substantial in that regard, and so, we're having people talk about our industry expertise, being a trusted advisor, and what changes we're seeing in the market, but as we look at what their opportunities are, what the risks are, I bracket a few of those.

Number one, I think there is investment opportunity, as we discussed. Number two, as we discussed, I think there's customer experience opportunities out there. At the same time, I think there's a blend for the distribution dynamic that we talked about, of opportunities / risks there, because it is a change to the way business has been done, and similarly, I think there is a blend for ESG.

There's an opportunity there to separate yourself, but there's a risk the way it has to be done correctly, and then, finally, just on pure risk, I think there's no doubt, as we've discussed, supply chain and staffing are a major risk, and as Kevin said, the debt loads and the financial statements are definitely front of mind for everyone and something the industry's going to have to work its way through over the next few years.

Michael Burke:

Sam, I think a lot of credit has to be given to many parties for getting through the pandemic and keeping this industry alive, including the carriers

but also the lessors who were giving deferrals and providing sale leaseback financing, but the biggest issues right now are the substantial debt loads, looming maturities and the delivery of equipment.

For example, obviously, aircraft has a useful life, and right now we're seeing wide bodies, the cycle is ending. So, there needs to be more deliveries of aircraft, and there's various estimates of how far behind the manufacturers are, but I'll note, for example, the wide bodies not only will serve the commercial carriers, but also, it's important for cargo carriers, as well, to goods and supplies.

So, that affects another segment. On the private sector or on the private flying side, seeing as that demand is down, are customers now going to be willing to prepay for large block hours? So, it's going to be interesting in the private side on how that business is going to change with revenue now dropping, but again, on the large commercial side, by far, delivery of metal.

Sam Gandhi:

We've been speaking with three of Sidley's thought leaders, Bart Biggers, Michael Burke, and Kevin Lewis about sustainability in flights, what it's going to take to meet emissions goals, and trends they're seeing for future in the airline industry. Bart, Michael, Kevin, it's been a great look at the industry's landscape, and thanks for sharing your insights on the podcast today.

Michael Burke:

Thanks so much for having us, Sam.

Bart Biggers:

Thank you, Sam.

Kevin Lewis:

Thanks, Sam. This was interesting and a lot of fun.

Sam Gandhi:

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