

SAMPLE NOTE

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PLRA Daily REIT Note December 14th, 2022 Airlines vs. Hotels

In terms of the corporate travel pace and other current trends, today's **Delta** investor day was slightly more constructive than this week's other updates from their airline peers. But we'll come back to all this airline commentary in the weekly note. It's not great, but it's really not much worse than what we had already heard on the hotel side.

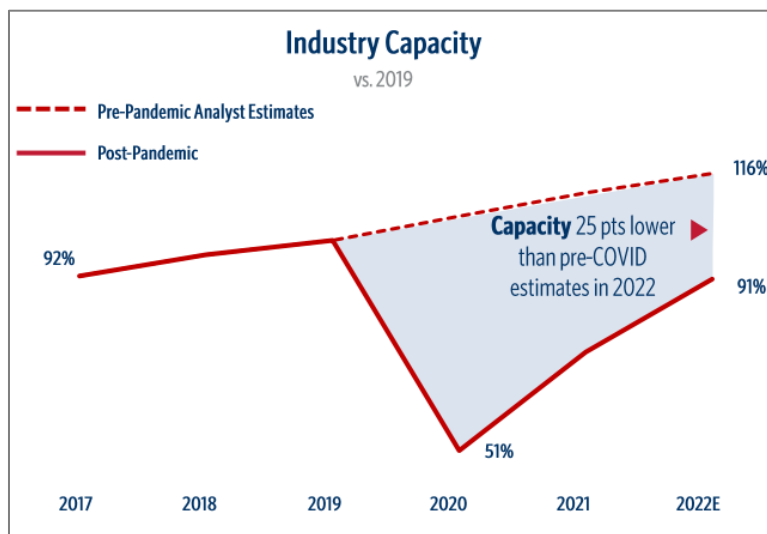
What I'll do here is use some of Delta's charts to look a bit further out, and dig deeper into the connection between an airline recovery and a hotel recovery, in 2023 and beyond. During the early stages of reopening, I think many of us were eyeing airline capacity (and airport chaos) as a potential brake on travel volumes, and we've now made it through that phase. But I've been increasingly cautious about this next phase — like in this note in November:

I'm getting more interested in the airlines as agents of hotel demand destruction, particularly in this segment of business travelers that still haven't returned...

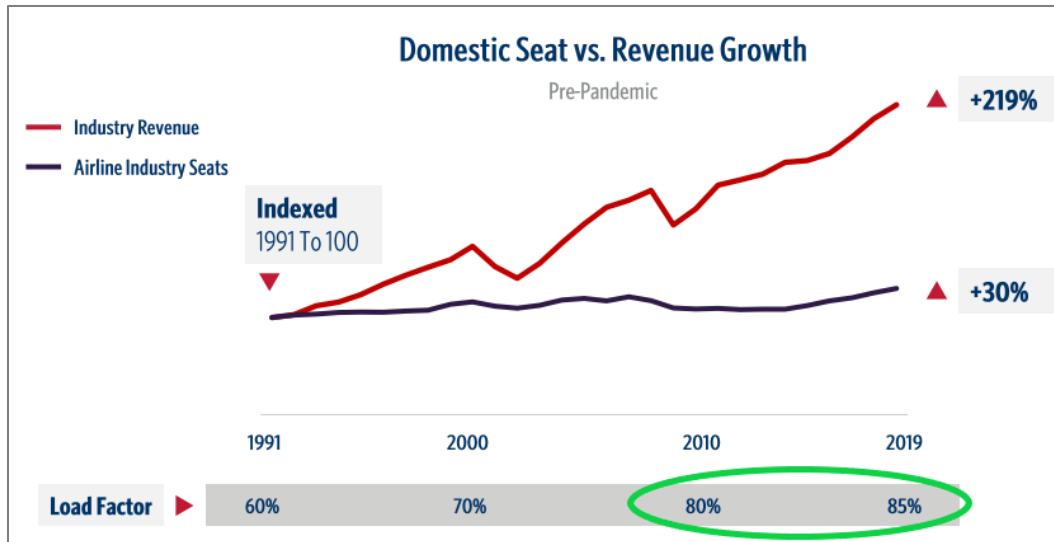
In any business, you want your complementary products and services to be as commoditized as possible, and hotels have benefited over the long term from the airlines' hapless descent into commoditization and price competition. If the airlines have finally turned the corner, and they're able to charge more for less — whether you attribute that to their own stories about brand value, or just to less competition and capacity — it could be a new constraint on travel volumes relative to the pre-Covid equilibrium.

And I know that sounds a little theoretical, so I'll try to bring it down to earth. Why would airlines benefit more than hotels from the same demand recovery? And could they really go further and become proactive "agents of demand destruction"?

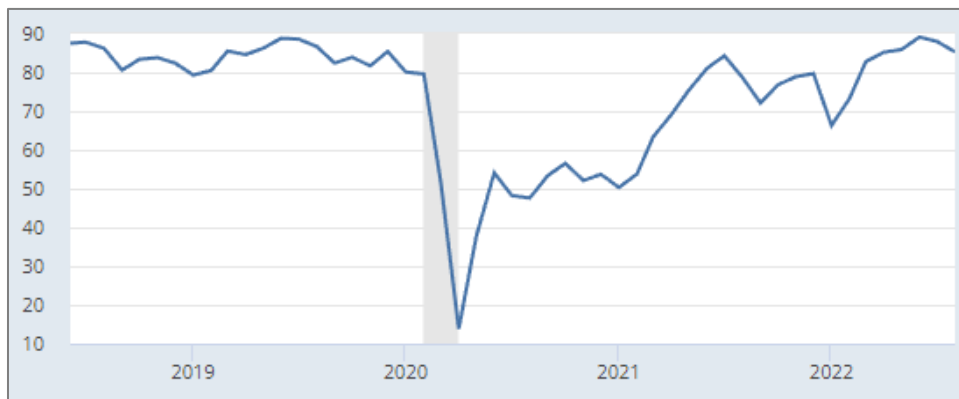
Let's start with the first question, and the most obvious answer. In comparison to the hotel sector, airlines have taken out a lot more supply:



This did not start with Covid, either. Airline supply growth has been lower than hotels for a long time, and their occupancy (“load factor”) has been steadily rising:



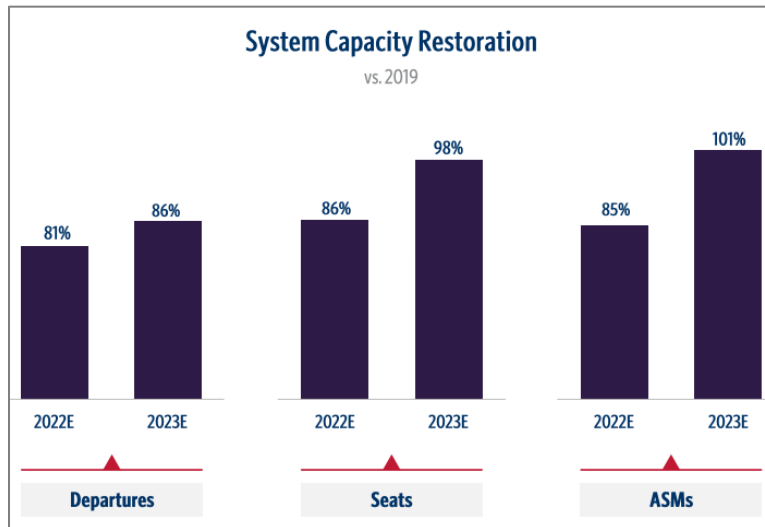
Of course it collapsed in 2020, but they’ve already gotten all the way back. They’re not showing that above, but this is the same government data:



Given the dramatic long-term “RevPAR” growth implied by the first chart above, why have airlines remained such a lousy business? It’s a long story, but if we stick with the hotel comparison, we might just start by noting that the product is more commoditized, and the pricing is even more competitive.

When you start to unpack this further into trends like the rise of the low cost carriers, the analogy between a seat and a room starts to break down. In fact, I think Delta is already mixing two different measures above: the +30% line is seats, but the load factors (and the chart on page 1) are in the more standard industry metric of seat *miles*. And the distribution of those miles matters even more for profitability, in terms of different routes and plane sizes and so on.

So it's really these second-order factors that are driving the optimistic outlooks from airline management teams. Next year, Delta hopes to be at 101% of 2019 capacity in terms of available seat miles — but with (1) larger planes, flying (2) fewer and (3) longer routes:



And yes, that could mean more pricing power. But it's already a kind of “shrinkflation,” and that's what I was trying to point out in the quoted passage at the beginning. You could rewrite the above chart from a passenger's perspective, and show that each of these changes that help Delta's margins are making the average trip longer and less convenient. On average, travelers will have to compromise a little more on their ideal departure time. On average, they'll have a longer drive to a more distant airport, where they'll wait longer to board a more crowded plane.

These may be small differences, but they add up. So even if you held pricing constant, you would expect some travelers at the margin to simply take fewer trips. And with corporate travel especially, it's important to tease that out from the other narratives we're talking about. For example, are CFOs now less likely to approve business class tickets because they cost more? Or because of general corporate belt-tightening in response to macro conditions? Or because there are more virtual meeting alternatives?

Sure, that could all be part of it. But even if none of these things had changed from 2019, and the average business traveler could still get the same fare class approved at the same price for the same origin and destination, we would still expect to see fewer trips — and thus fewer hotel room nights — because the same trip is now a little longer and more difficult.

And on top of that, it's entirely plausible that the efficient frontier has shifted for the airlines' revenue management, to the point where they're now pricing out travelers at the margin. After all, in those pre-Covid decades they were pricing them *in*, with lower fares generating more trips.

In the long run, airlines have been a pretty safe industry to bet against, and my guess is that they'll find a way back to commoditization and price compression sooner than they think. But right now, the stars may be aligning for a few years when they can really do some damage to complementary travel sectors. First, by having more pricing power and taking a greater share of that travel bundle on any given trip. And second, by shrinking the number of trips entirely.

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