
Southwest Airlines (NYSE: LUV): Preparing for Takeoff

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Investment Thesis

Recent Events

Airline Industry Overview

Catalyst for Value Realization

Company Background and Strategy

Relative Valuation & Performance

Financial Performance & Capital Structure

Key Risks



Investment Thesis

Airline Industry

U.S. airline operators are still being priced as if:

- They carry unmanageable amounts of debt.
- Price is the only basis of competition.
- “Worry premiums” merit inclusion in their discount rates.

None of this holds true today.

Investors remain skeptical due to the industry’s terrible track record, while applying excessive expected loss assumptions to tail risk events – even though things have fundamentally changed.

How have things changed? The main drivers are **consolidation, lower equilibrium capacity, and greatly reduced dependence on debt financing.**

Southwest

A niche with staying power. Southwest (SW) has demonstrated consistent success in executing upon its differentiated strategy.

- Using point-to-point service from secondary airport hubs.
- Balancing cost optimization with “Transparency.”
- Achieving best-in-class customer satisfaction.

Market biases persist. LUV remains range-bound due to events like 737 MAX grounding and recent oil price volatility. Excessive focus on these short-term events has prompted investors to ignore SW’s following traits:

- Strongest B/S and credit rating in peer group.
- Strongest unit economics.
- Growth opportunities in peripheral markets.

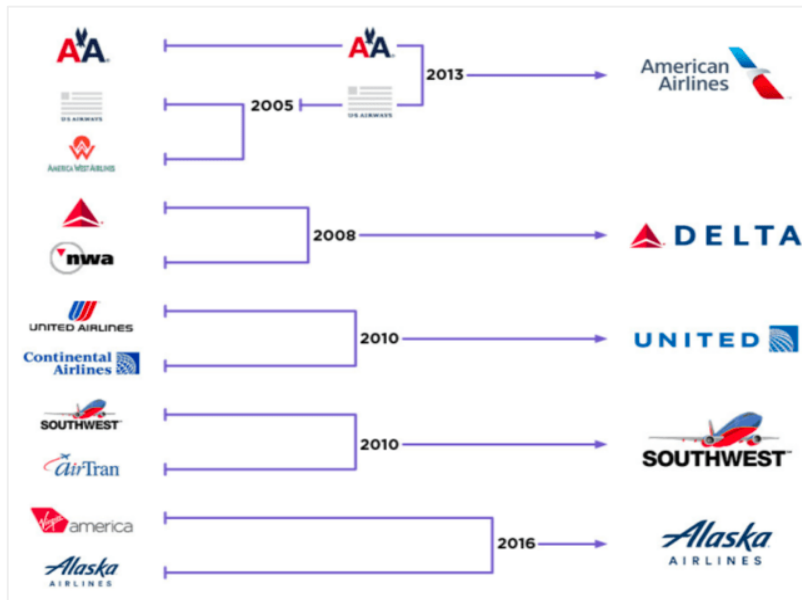
Aggressive market strategy in 2020 will lead LUV to recapture competitive capacity and take market share.

Airline Industry Overview

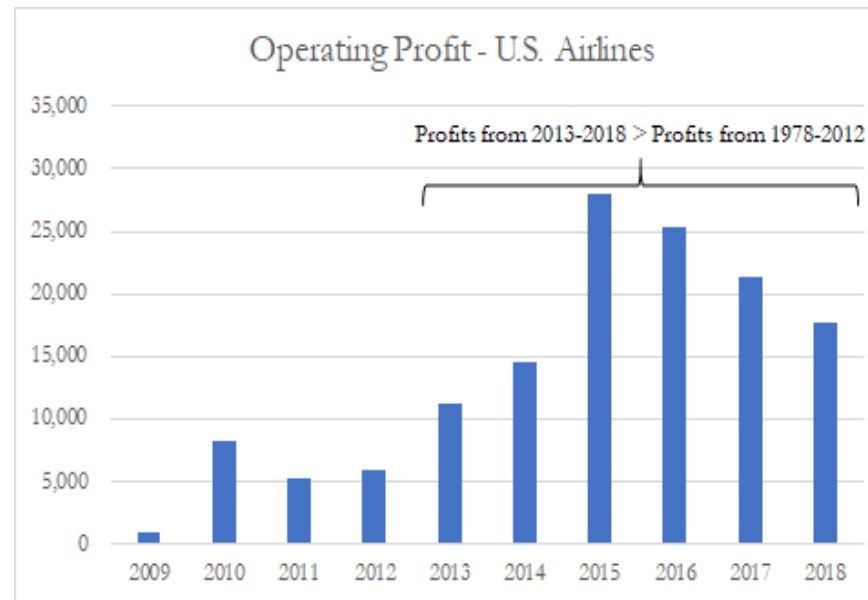
Key trends:

- Consolidation – Steady decline in the number of major U.S. airline operators
- Capacity discipline – Total domestic ASM growth has been more restrained leading to margin improvement
- Improved operating margins – driven by supply discipline as well as focus on **quality** and **convenience**, and an emphasis on particular hubs and the maintaining of a competitive capacity advantage

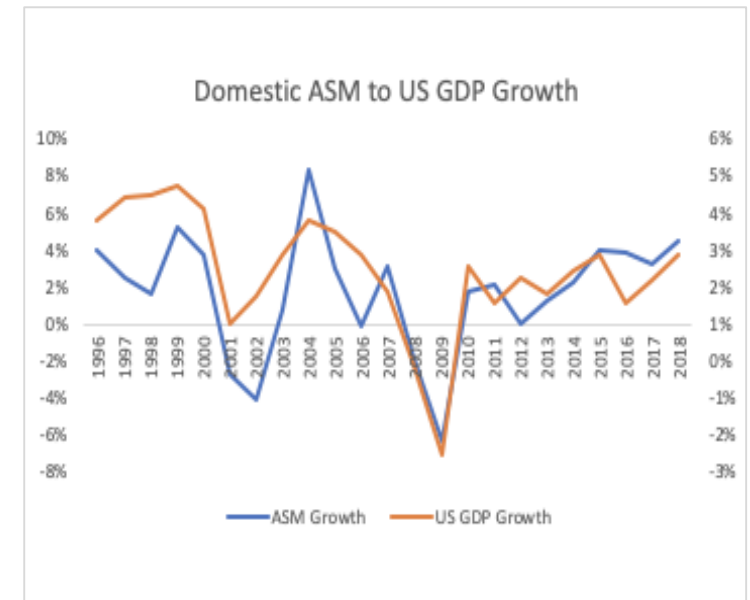
Consolidation



Improved operating margins



Supply Discipline



Competition

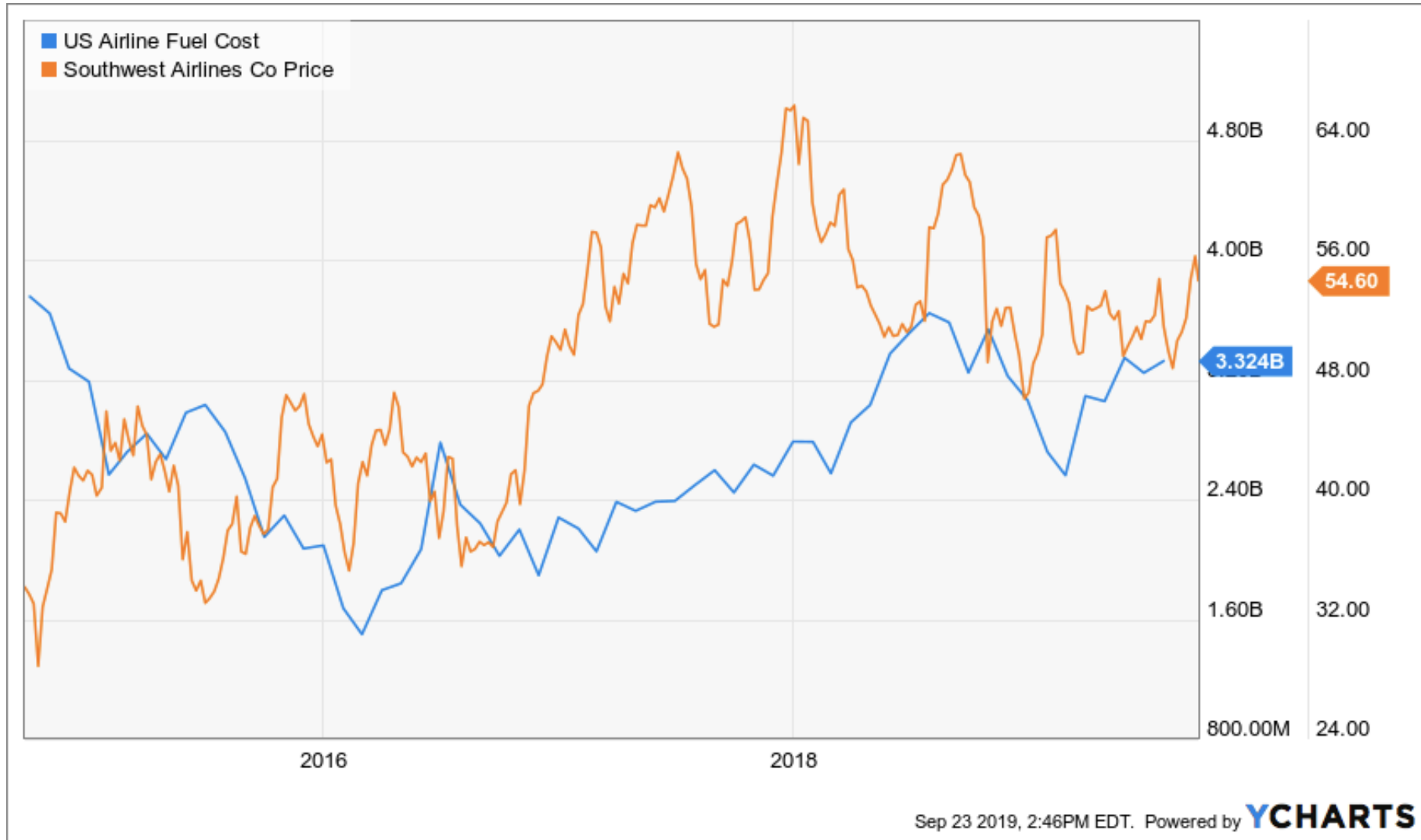
- Competition on two fronts
 - Legacy network carriers (American, Delta, and United)
 - Low-cost carriers (JetBlue, Allegiant, Spirit)
- Legacy offers higher quality services, and hub-and-spoke network allows these networks to service smaller markets for business travellers in particular
- LCC's debundled ticket fares and "no frills" capture the leisure traveller market, whose customers typically travel once per year
- Southwest: largest market share among low-cost carriers

Carrier	Revenue (\$B)
Southwest Airlines	22.3
Low-Cost Carriers	
JetBlue Airways	8.0
Allegiant Travel Company	1.8
Spirit Airlines	3.6
Legacy Network Carriers	
American Airlines	45.0
Delta Airlines	45.8
United Airlines	42.5
Alaska Airlines	8.4
Hawaiian Airlines	2.8

LUV Underperforming Despite Superior Operational Performance



Fuel Prices Are Passed On and Hedged



Company Background

- Share price: \$54.49 (as of 9/22/19)
- Market cap: \$29.29B
- Founded on March 15, 1967; adopted current name in 1971 after commencing intrastate routes in TX
- “**Triple bottom line approach** that contributes to the carrier's performance and productivity, the importance of its people and the communities they serve, and an overall commitment to efficiency and the planet”
- World’s **largest low-cost carrier**: ~\$22B in revenue
 - **46th consecutive year** of profitability
 - Spread out domestically to target lesser-served airports
- Only major US airline to offer “**bags fly free**”
- Returned **\$11.1B to shareholders** since 2010 and \$1.2B in the first half of 2019
- **Largest purchaser** of Boeing 737 MAX
- Carries **most domestic passengers** of any US airline
 - 101 destinations; 753 fleet
- Headquartered in Dallas, TX
- **Acquired AirTran** in 2010 for \$1.4B
- Began servicing **flights to Hawaii** in March 2019
 - Introducing \$99 introductory fares in January 2020
 - Doubling interisland flights and including more direct flights from California

Aloha, Hawaii!

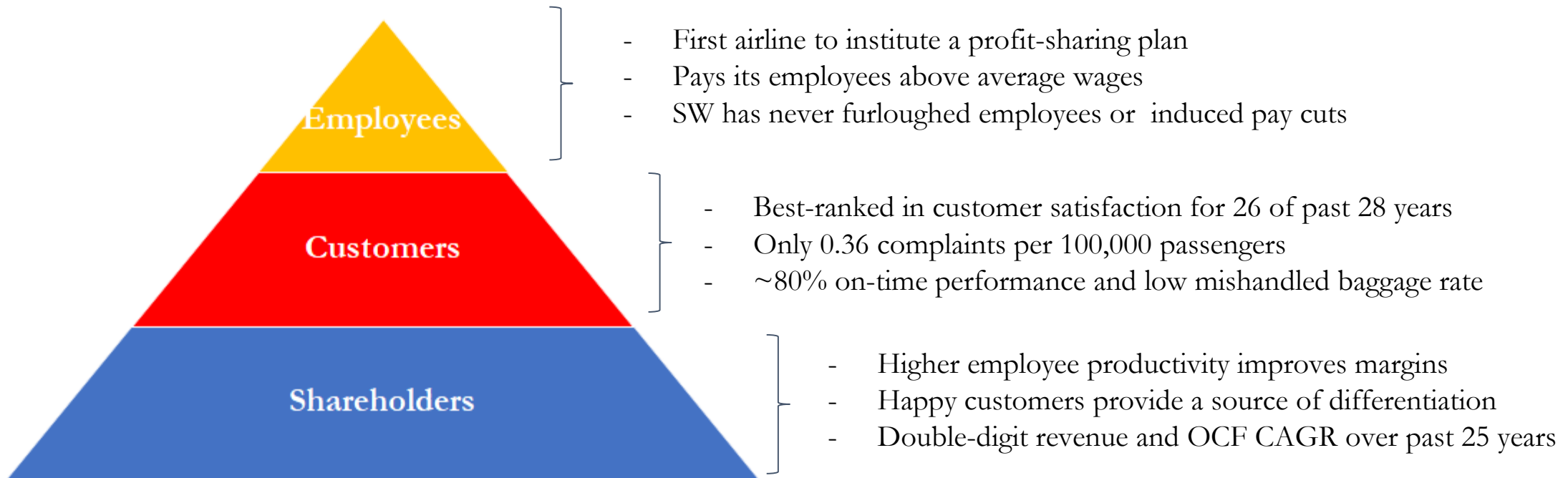
Southwest



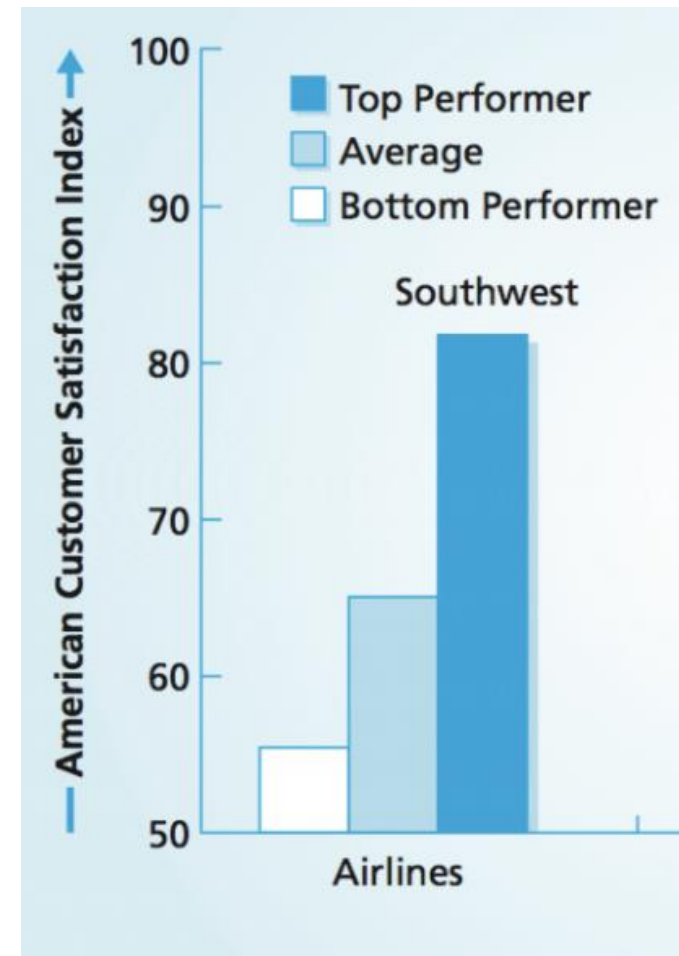
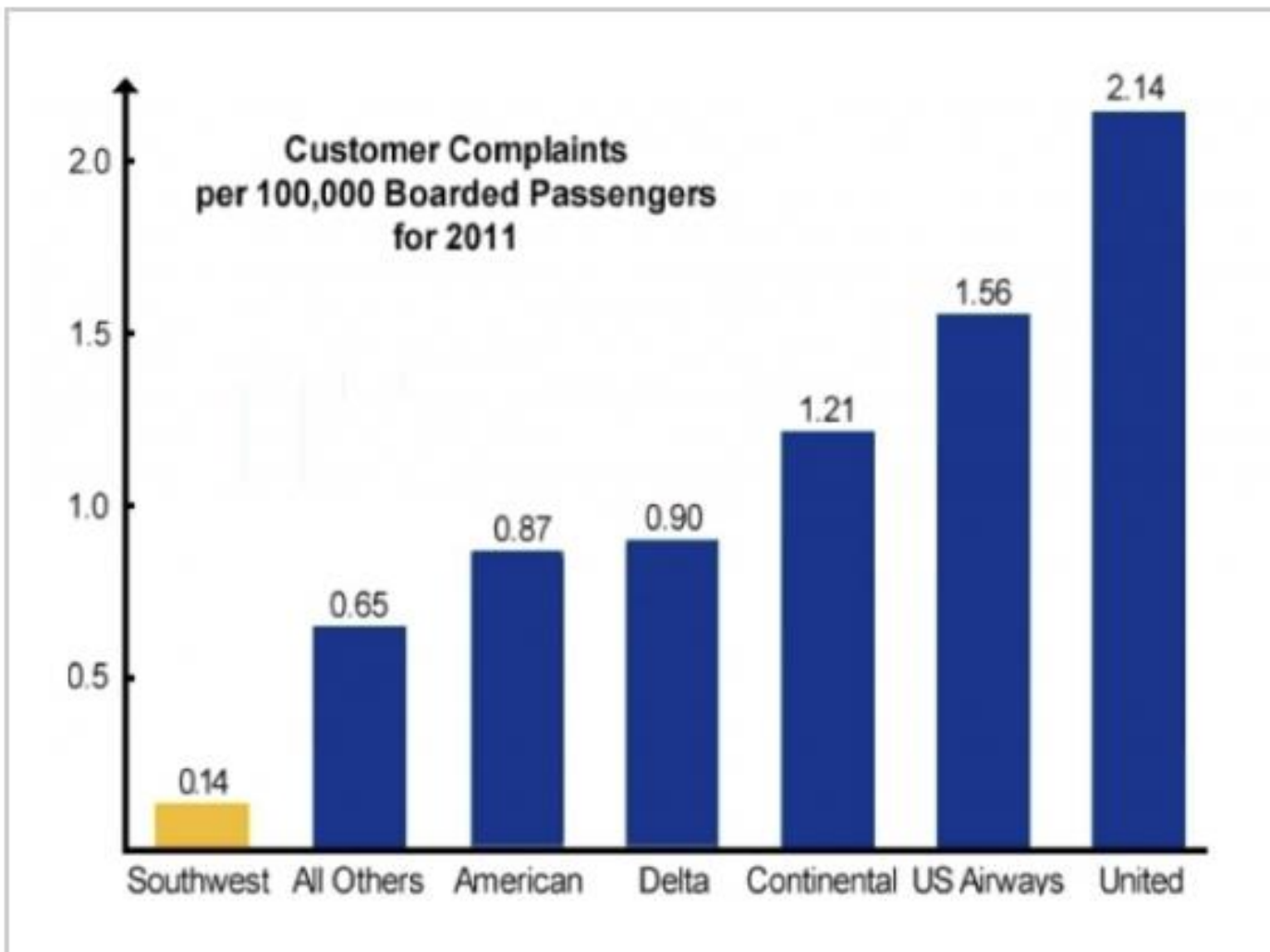
Corporate Strategy: Employees Come First

“If the employees come first, then they’re happy ... A motivated employee treats the customer well. The customer is happy to keep coming back, which pleases the shareholders. It’s not one of the enduring mysteries of all time, it is just the way it works.”

— Herb Kelleher



Ranks Highest in Customer Satisfaction



Low fares. Nothing to hide.

We're all about being open and honest with Customers and making sure pesky fees stay away from our low fares.

\$ **0** 
1st & 2nd
Checked bags*

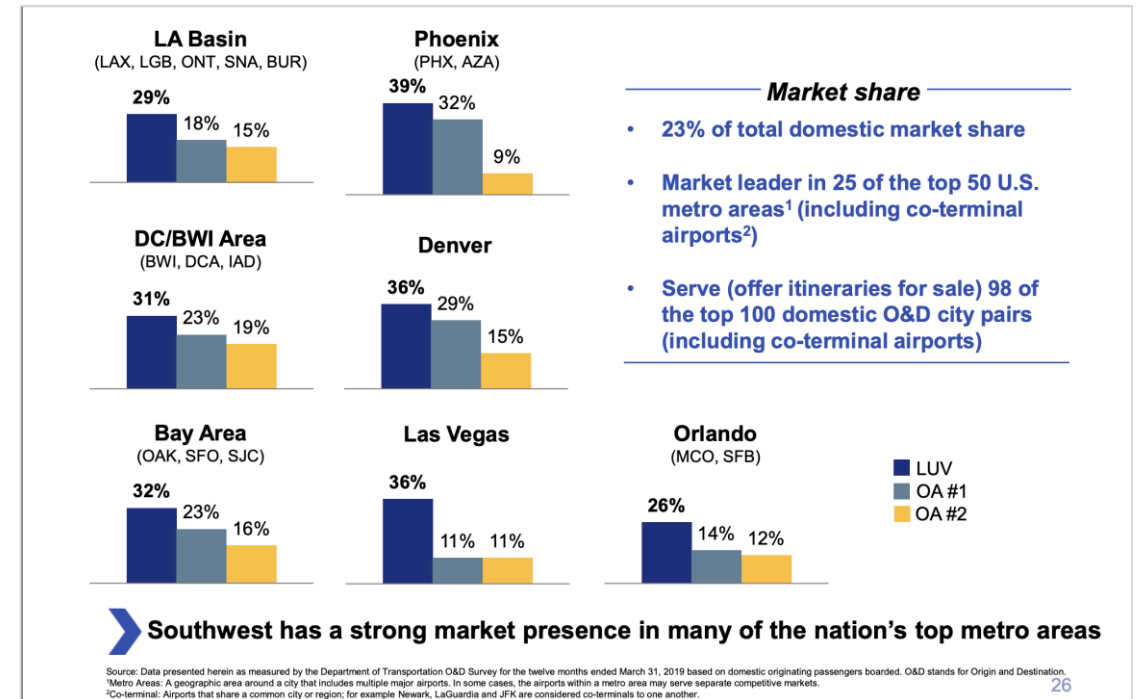
\$ **0** 
Change
fee*

\$ **0** 
Live
TV*

Yes! That's Transparency.®

Corporate Strategy: Low-Cost Model

- Emphasis on smaller, less competitive airports
- Fleet standardization allows for a fleet model that is easier to maintain, which brings forth cost savings
 - The strength of this model is affirmed through AAL's and DAL's recent moves towards fleet harmonization
- Emphasis on smaller markets that are leisure focused
- LUV almost exclusively uses the BA 737 and will incorporate the MAX
- LUV maintains market share in less competitive airports and fight for less competitive capacity



Financial Performance & Capital Structure

Financial Performance

- Record quarterly load factor in Q2'19 of 86.4%
- Q2'19 RASM growth of 6.8% on the heels of system-wide fare increases
- The ability to maximize the company's load factor even with fare increases indicates a rather sticky customer base
- Second quarter net income: \$741 million
 - Up nearly \$10 million from 2Q18
 - ~\$340 million 1Q19 net income (large losses)
 - Rebounding quickly, recovered from Boeing groundings
- YoY total operating revenue increased 2.9%

Capital Structure

- 37.7% equity financing
- 62.3% debt financing
- Interest coverage ratio of ~33x

Recent Events

737 Grounding

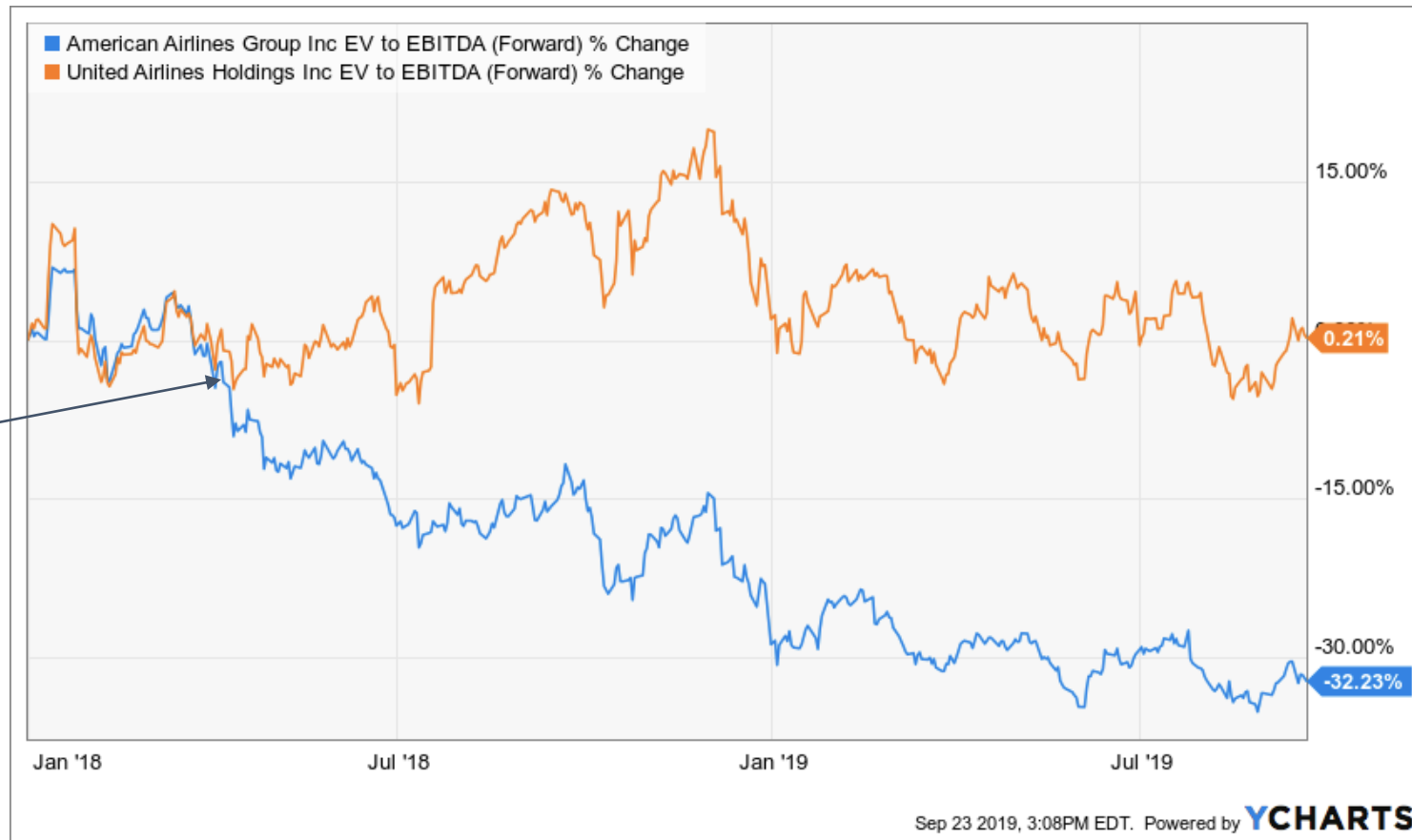
- 737 MAX planes key to Southwest's growth plans for next decade; Boeing's largest MAX customer.
- Plane offers higher seating capacity and new fuel-saving technology.
- Grounding of MAX planes on March 13, 2019 after two MAX 8 aircraft crashed.
- MAX planes to be added back to Southwest flight schedules in **Q1 2020**, contingent on FAA approval.
- Southwest is better positioned than competitors to benefit from cost benefits 737 MAX offers as the return of the MAX should allow LUV to grow margins even in a decelerating growth environment through continued cost-saving initiatives and the efficiency of the MAX
- Although Spirit overlaps with LUV 75%, Spirit has an older fleet and may not be able to compete on margins with LUV moving forward; LUV remains in a stronger competitive capacity position

Other Events

- Labor negotiations; flight - attendants in negotiation and pilot contract is amenable next September
- Approximately 83% of employees represented by labor unions
- Expect United's pilot union negotiation to influence the outcome of the later agreements

Aggressive 2020 Expansion to Generate Outsized Returns

“As we look at all of our route performance, and just market after market after market it is obvious that **we're short capacity that we're spilling traffic and leaving money on the table** and helping our competitors. And I will also tell you that that is not anything that we will leave unattended.” - CEO, Gary Kelly (Q2 2019)



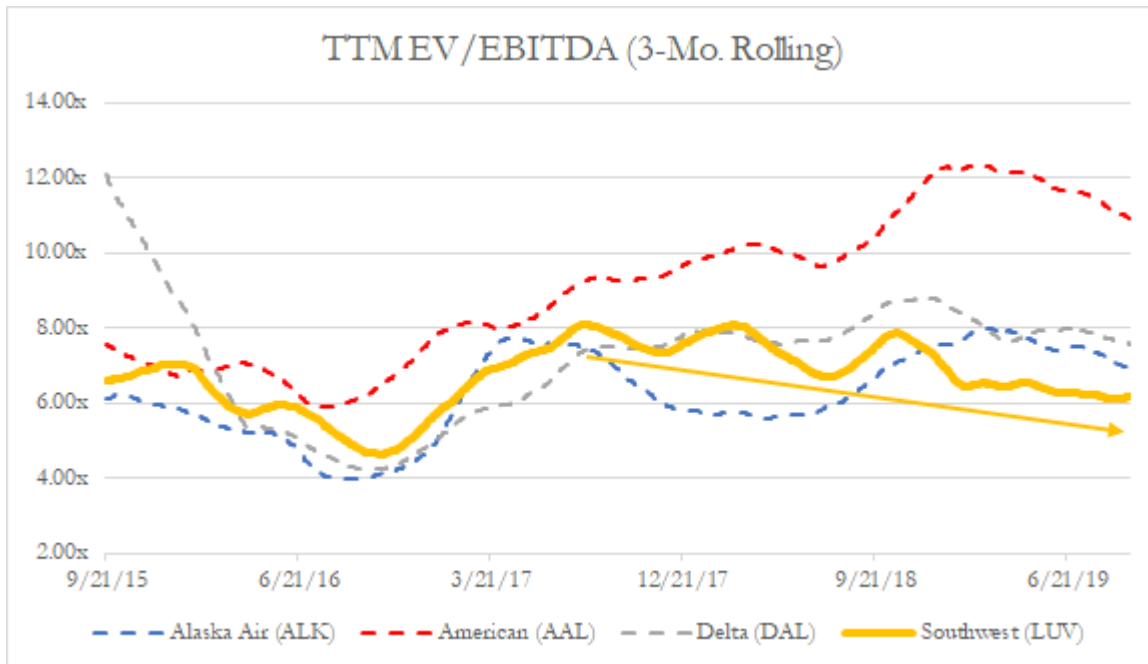
UAL encroaches on AAL's hubs, particularly ORD.

Strong ROIC Versus Competitors

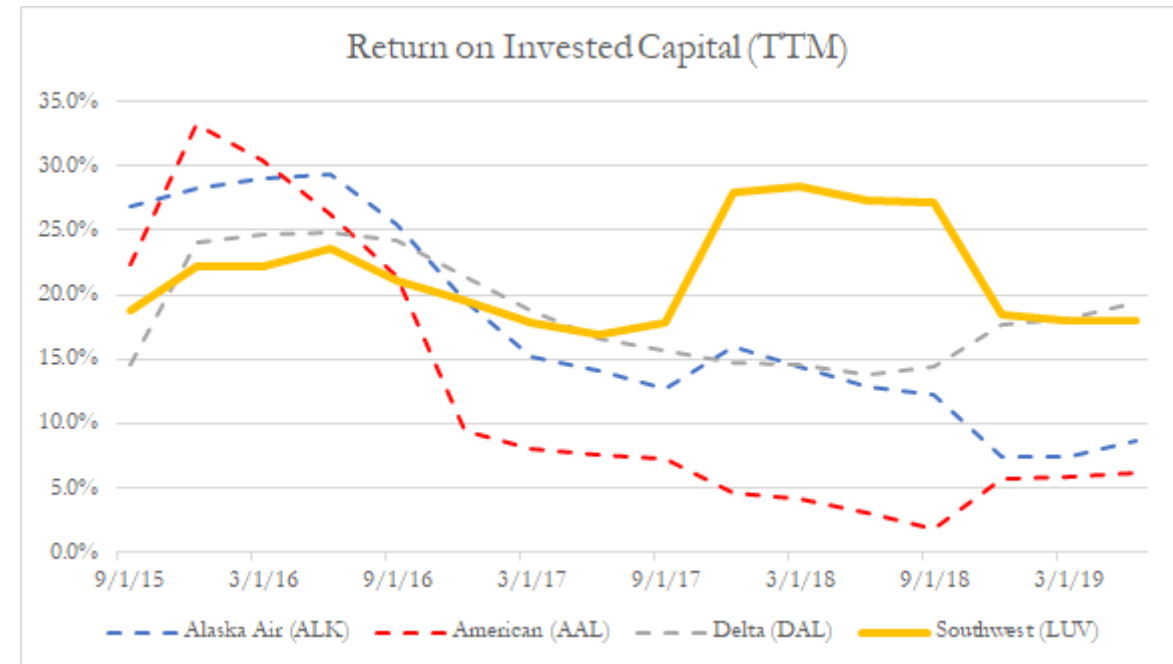
Carrier	Ticker	5-year average		LTM (last twelve months)		
		Operating Margin	ROIC	FCF Yield	Earnings Yield	P/E
Southwest Airlines	LUV	18.5%	20.3%	9.8%	8.3%	12.6x
Low-Cost Carriers						
JetBlue Airways	JBLU	14.6%	11.6%	2.0%	3.6%	10.0x
Allegiant Travel Company	ALGT	21.2%	16.4%	1.1%	7.7%	13.0x
Spirit Airlines	SAVE	18.6%	15.6%	NA	4.1%	7.1x
<u>Average</u>		18.1%	14.5%	1.6%	5.1%	10.0x
Legacy Network Carriers						
American Airlines	AAL	12.7%	15.2%	NA	9.1%	6.2x
Delta Airlines	DAL	15.5%	17.6%	6.1%	10.3%	9.1x
United Airlines	UAL	11.1%	17.0%	8.3%	8.8%	8.2x
Alaska Airlines	ALK	18.7%	19.1%	3.1%	5.9%	13.0x
Hawaiian Airlines	HA	15.9%	16.8%	1.4%	15.4%	5.6x
<u>Average</u>		14.8%	17.1%	4.7%	9.9%	8.4x

Relative Valuation

Southwest's EV/EBITDA has diverged from those of Alaska Air and Delta, **steadily declining from ~8x in early 2017 to ~6x currently.**

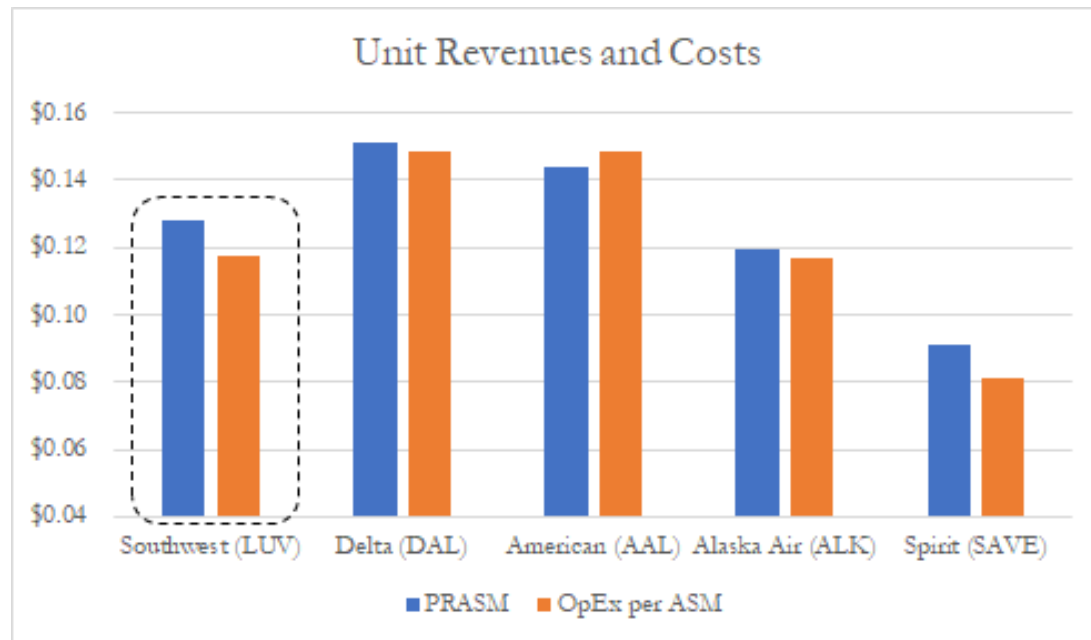


Multiple compression has occurred even while the company continues to boast industry-leading financial efficiency.

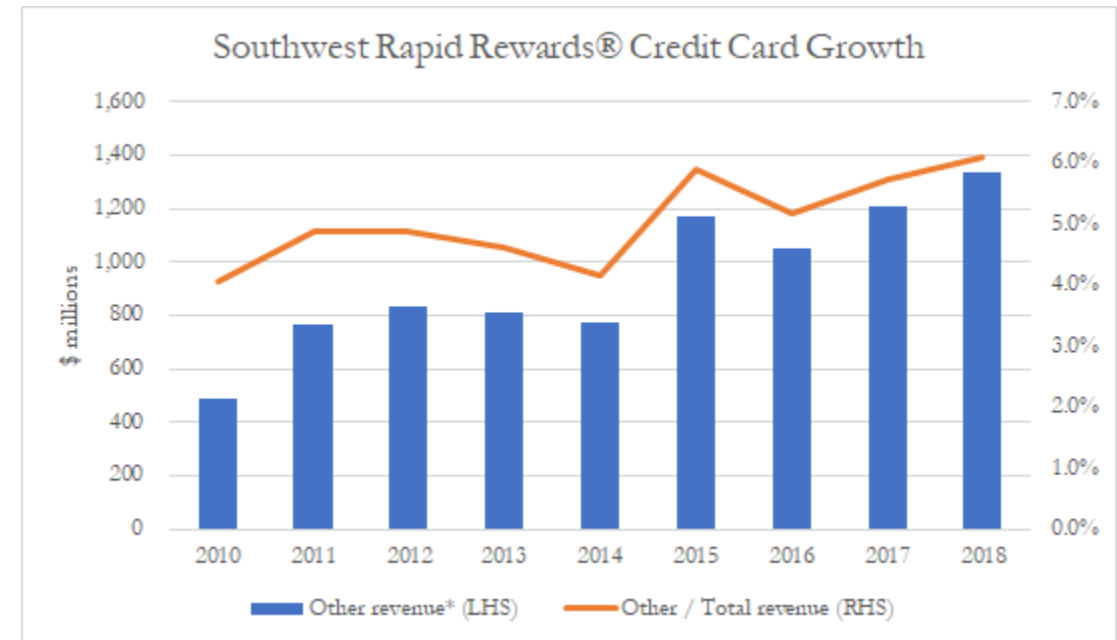


Unit Economics & Ancillary Revenues

Greatest spread between (1) passenger revenue per ASM and (2) operating expenses per ASM: an indicator of superior unit economics.



Loyalty/reward program contributions making up a greater proportion of total revenues. Serves as a source of high margin float to fund operations.



*Other revenue consists primarily of marketing royalties associated with Southwest's co-branded Chase® Visa credit card.

Key Risks

- Capacity shocks as airlines have had increased profitability, the smaller LCC's (Spirit, Allegiant) may continue push to capture market share
- Growth of Legacy airlines' product segmentation strategy could allow the larger carrier's to eat into Southwest's market as the Legacy carriers offer more premium product choice at a similar price point
- Continued delay of the MAX rollout would lead to further write-downs, rebookings, and cancellations for LUV as it is the most exposed airline
- Despite LUV's hedging strategies, continued oil price volatile and a move outside of the hedging band would be detrimental to LUV's margin profile
- Any negative sentiment from AAL's and UAL's labor negotiations would spill over to LUV

BRANDED BOARDING ORDER

Zone boarding, an aviation standard for decades, will soon be a thing of the past for Delta customers as the airline makes a global shift to boarding by branded fare purchased. This is the latest evolution in Delta's multi-year work to bring consistency, simplicity and clarity to the gate and boarding experience, efforts that have driven all-time high customer experience scores. SkyMiles Medallion[®] Members and eligible Delta SkyMiles American Express Credit Card Members will continue to receive priority boarding.

