



NYSE: LUV

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Introduction

Company Overview

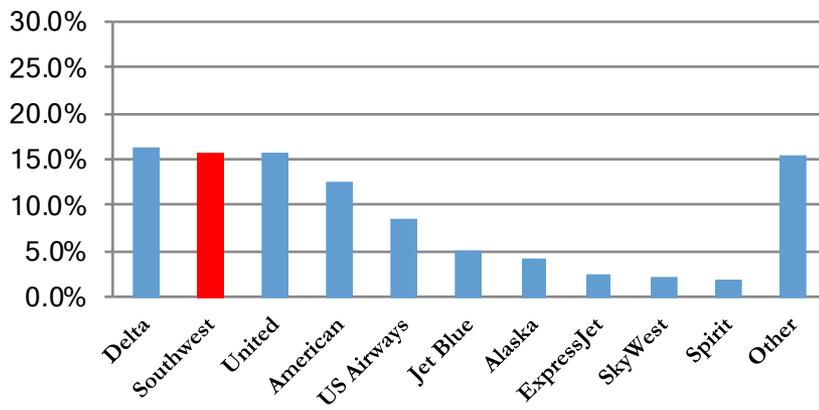
Business Description

- Industry-leading low-cost carrier (LCC) airline
- Operates in 91 US cities across 41 states
- Boasts second largest market share measured by revenue passenger miles (RPM), behind Delta Airlines (DAL)

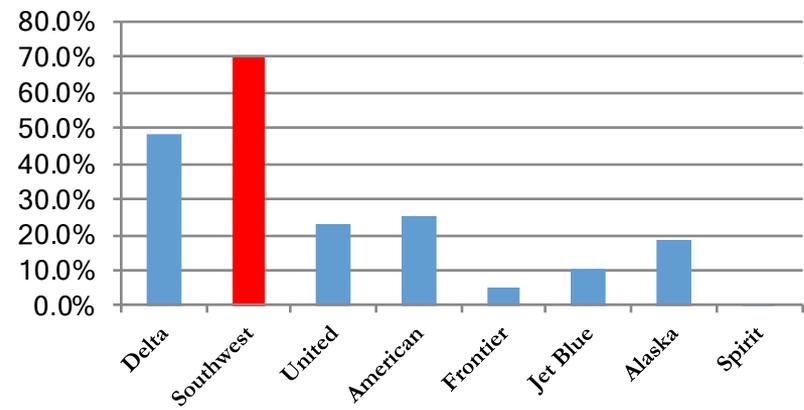
Key Differentiators

- Keeps services simple to keep cost to consumers low and increase operational efficiency
- Heavy emphasis on customer service and company culture
- Largest domestic airline measured by amount of domestic originating passengers

Airline Domestic Market Share (RPM)



Consumer Survey on Friendliest Airline



Industry Overview

Description

- Highly mature, competitive industry
- Oligopoly made up of several large conglomerates and smaller local players
- Company success is largely due to competitive fares and service to particular airports

Growth Drivers

- Somewhat cyclical industry
- Strong USD promotes international travel.
- Industry growth follows GDP growth, so as the US economy continues to grow in the late stages of a recovery, airlines benefit.

Industry Revenue and Growth Rates

- Industry revenue growth closely matches GDP growth, but capacity growth has recently exceeded GDP growth.
 - Lower fuel prices has given airlines more room to increase ASM.
- 2015 ASM grew 3.3% while GDP grew 2.4%.

Product and Services Segmentation

- Domestic and international airplane travel

Key Business Features

Three Ticket Types

Idea Behind Strategy

- Offering three different types allows for consumer flexibility with little change in operations
- Differences between three types is largely focused on reservations
 - Same core services are provided across all ticket types

“Wanna Get Away”

- Lowest fare tickets
- Tickets are non-refundable, but can be exchanged assuming all No Show Policy criteria are met
- **Trade-offs:** cheapest ticket but least flexible, often sell out first due to price
 - Best for customers with firm itineraries

“Anytime”

- Mid-tier tickets
- Tickets are easily changeable and refundable
- Higher multiple on points earned through Rapid Rewards program
- **Trade-offs:** more flexibility for customers at a premium
 - Best for customers who may have uncertain travel plans

“Business Select”

- Premium tickets
- Same as “Anytime” with additional benefits
 - Priority boarding for first 15 positions
 - Priority security and/or ticket counter access
 - One complementary adult beverage voucher per flight
- **Trade-offs:** premium travel at highest price

Simple, Straightforward Service

Core Services for All Ticket Types

- Complimentary snacks (peanuts and/or pretzels) and non-specialty beverages
- On-board entertainment accessible through laptops and mobile devices allows for streaming of major television networks
 - Free access to 19 live channels and up to 75 on-demand recorded TV episodes

Free Checked Baggage

- All ticketed passengers are allowed to check two bags for free, and are able to check additional baggage for a fee
- Passengers are also able to check strollers/car-seats for free with any ticket type

Boarding Process

- Non-reserved seating on all flights
- All passengers are given a number 1-59 in groups A, B, and C based on check-in time
 - A1-A15 reserved for Business Select passengers
 - Passengers line up according to number and select seats on a first-come, first-served basis

For-Purchase Services

- On-board Wi-Fi and messaging available for purchase
- Priority boarding and automatic check-in available when booking tickets
- Premium beverage service (alcoholic beverages, energy drinks, etc.)

Customer Benefit Programs

Rapid Rewards Program

- LUV's "frequent flyer" program
- Points awarded based on dollar-value of purchased ticket, then are multiplied based on ticket type ("Business Select" has highest multiple)
 - 2015: 7.3 million flight awards, accounting for 12% of revenue passenger miles flown
- As more points are earned, customers gain "A-List" or "A-List Preferred" status
 - These statuses earn incentives such as priority check-in, boarding, and free Wi-Fi

"Companion Pass" Status

- Highest possible status with LUV
- Earned after 100 one-way flights or 110,000 qualifying points within a calendar year
 - Grants unlimited free travel for one year to any of LUV destination as long as the person flies with the designated Member

Operational Efficiency

Homogenization of Fleet

- Over the past few years, LUV has made efforts to homogenize its fleet
 - At this point, all LUV planes are Boeing 737 models
 - This allows for lower-cost, more streamlined training and maintenance
- LUV will be first company to use Boeing 737-MAX in 2017

No Red-Eye

- LUV offers no red-eye flights to customers
 - Red-eye flights are typically underbooked and often result in losses
 - Customers don't enjoy red-eye flights
 - Maintenance is performed overnight, in order to increase flights during the day
 - Management believes giving employees time to rest provides for better service

Targeted Markets

- LUV has focused on acquiring gate space in underutilized airports near urban areas
 - Rather than follow traditional hub-and-spoke model of connecting passengers via dedicated hubs, LUV has focused on offering direct service
 - Avoidance of major hubs and large airports means faster turnaround time and more flights offered
 - In major urban areas, less popular airport is used
 - Bay Area: OAK vs. SFO
 - Chicago: Midway vs. O'Hare
- Customers still may have to connect, but these connections are typically short

Corporate Strategies: General Directions

Acquiring Business Passengers

- **Problem:** emphasis on low-cost flights has led to large number of low per-passenger revenues
- **Goal:** Focus on gaining more lucrative customers
 - Charge premiums for late booking, “Business Select” status, and other status-related upgrades
- Currently business passengers make up ~30% of passengers
 - Goal is to expand this to 35-40%

Cutting Low-Performing Flights

- **Problem:** LUV has 83% utilization rate (1 in 6 seats is empty, on average) due to use of less popular airports
- **Goal:** increase utilization rate to over 90% through acquisition of business passengers
 - **Solution:** cut less lucrative airports in favor of busier, more urban hubs
 - Redirect passengers through these areas – hope is to gain business passengers traveling to popular destinations

Expansion into International Markets

- **Problem:** international revenues make up only 1% of annual revenues
- **Goal:** offer more flights between US-LATAM markets
 - Trying to be one of airlines operating between US-Cuba
- Tourism growth means chance for LUV to jump into well-established market
 - Goal is to offer services similar to domestic operations, with new international destinations
- Allows for more destinations to redeem points, which gives higher incentive to obtain status with LUV

Competitive Strategies: Domestic Dominance

Mission

- **Goal:** Be the preemptive airline in the United States through acquisition of new customers and loyalty of existing customers
- **Solution:** Focus on perfecting company operations, generating higher per-unit revenues, and improve presence in key geographic areas
 - **Focusing on specific airports is key to company's growth**

Houston - Hobby

- **Reason:** Key airport for LUV's international operations, as it is near several LATAM destinations
 - October 2015: LUV spent \$156M to build 5-gate international terminal
 - LUV plans to undercut comparable average international fares by ~40%
- Potential to serve 50 Latin American destinations by 2020
 - *Fortune* estimates LUV could capture up to 5% of \$60B LATAM market

Atlanta

- **Reason:** former hub for AirTran
 - Control lost to Delta, who now controls 80% of seats sold in Atlanta
 - Controls 50% of seats from Atlanta to Colorado (a Southwest stronghold)
 - Control significant portions of flights to Phoenix, Houston, and Los Angeles
- LUV's per-seat revenue is 17% below big-city average

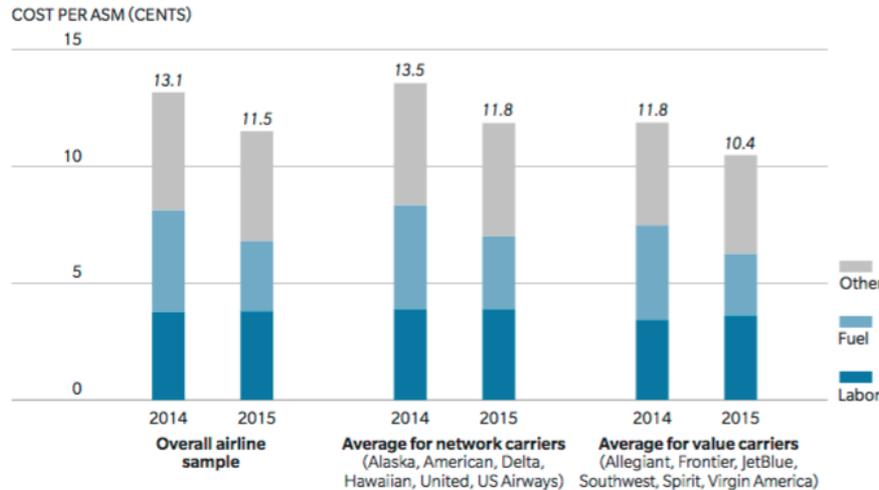
Dallas – Love Field

- Location of LUV's headquarters
- Elimination of Wright Amendment, which limited travel out of Love Field means there is still room to grow routes
 - Previously limited to states bordering TX, no longer a factor
 - LUV now offers 180 total flights daily to 34 destinations across the US

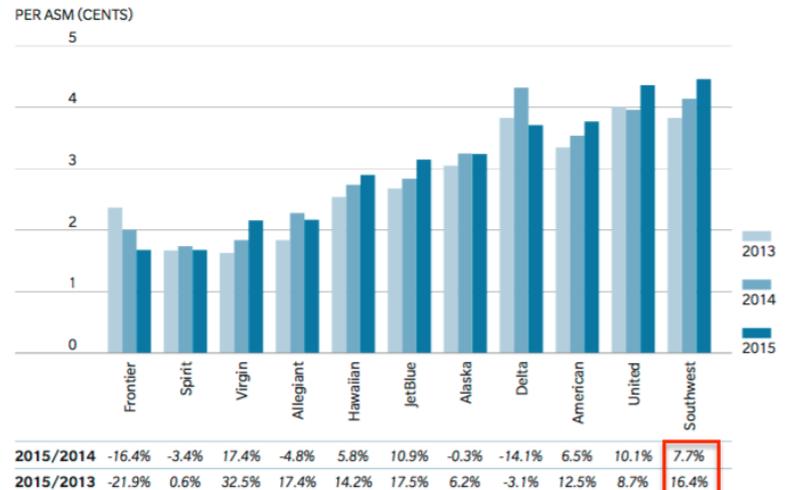
Cost Analysis

Labor makes of the majority of costs

- System CASM by Group, Q2 2014/2015



- US Carrier System Labor Unit Costs, Q2 13/14/15



Southwest's Fuel Price Hedging Program

- Southwest is known for its aggressive fuel hedging, which helped reduce costs when fuel was expensive, but has hurt the company in the current environment (currently liable for \$1.8B in hedge costs).
 - The company is reducing the percent of fuel it buys on hedge from 60-65% to 30-35% (United: 12%).
 - Based on prices at the end of 16Q1, management predicts Q2 fuel price per gallon to be \$1.70-\$1.80, and full year average price to be in \$1.85-\$1.90 range.
- While Southwest won't completely unhedge like American Airlines, it is still heavily benefiting from lower oil prices.

Recent Developments

Accelerated 787-Classic Retirement

- Unable to make an agreement with SWAPA (pilot union) to have separate pilot groups on 737-300, and announced in April that all “classic” 737s would be retired by 17Q3.
 - 143 seats in -700, 175 seats in -800, 137 in -300,
- Southwest doesn’t expect to meet available seat mile growth in the 5-6% range in 2017, but it’s reasonable to expect something near that.
 - As 737-300’s and 500’s are retired this year, orders for used -700 models will mitigate the loss in available seat miles (the -700 is ~20% larger than its -300 and -500 counterpart).
 - The acceleration will generate \$200M in EBIT improvement thanks to fuel and maintenance savings (net of the impact of the estimated accelerated depreciation of approximately \$130 million that will largely be expensed during 2016).
 - Fleet will be fully Wifi-equipped by end of Q3 2017 thanks to accelerated retirement.

Some 787-Max Orders Delayed

- The company will delay the delivery of 67 737-MAX planes.
 - There are a total of 200 MAXs on order book, along with options for 191 more.
 - These specific planes were originally scheduled to be delivered between 2019 and 2022, but will now be delivered between 2023 and 2025.
 - The company will still start flying MAXs in 2017Q4 and maintain at least 2% fleet growth through 2018.

Industry Considerations

Recent Trends & Expectations

Fares

- New travel-planning services make booking more accessible and transparent
 - Leads to more knowledgeable, price-oriented consumers
 - This has led to a high degree of price competition among airlines
 - Average industry fares have been falling over the past years as a result of increased competition
- LUV, already one of the least expensive major airlines, has offered price cuts on flights booked closer to departure date
 - This appeals to business travelers, who often book last-minute trips

Traveler Numbers

- Companies expect higher passenger numbers throughout the remainder of 2016
 - These expectations are based on past data, cyclical trends, and decreased fare prices relative to previous quarters

Oil

- In the past 24 months, a severely depressed oil price has greatly benefitted airlines
 - While hedging used to be a common tactic to ensure (relatively) lower oil prices, many airlines have shied away from this
 - This may be good now, but as we see oil rise these companies are ill-prepared to deal with higher prices
 - LUV has reduced hedging efforts, although realizes the potential concerns
 - Has maintained a low level of hedged oil, which is ideal scenario

Traveler Safety

- Fear of terrorist activity among passengers of international providers
 - LUV is almost entirely domestic, which has lower threat of terrorist attacks
 - LUV can avoid international paranoia

LUV vs. Comparable Airlines – Competitive Advantages

Utilization Metrics

- Passenger Load Factor
 - **Definition:** proportion of seats filled across all flights versus all seats offered for same flights
 - LUV has had increasing PLF numbers over the past years
 - 2015: 83.6%
 - 2014: 82.5%
 - 2013: 80.1%
- Passenger Revenue per Available Seat Mile
 - Industry-standard measure of unit economics, measured in cents
 - LUV has boasted strong growth
 - 2015: 13.02
 - 2014: 13.48
 - 2013: 12.83
 - 2012: 12.56
 - 2011: 12.24

Business Model

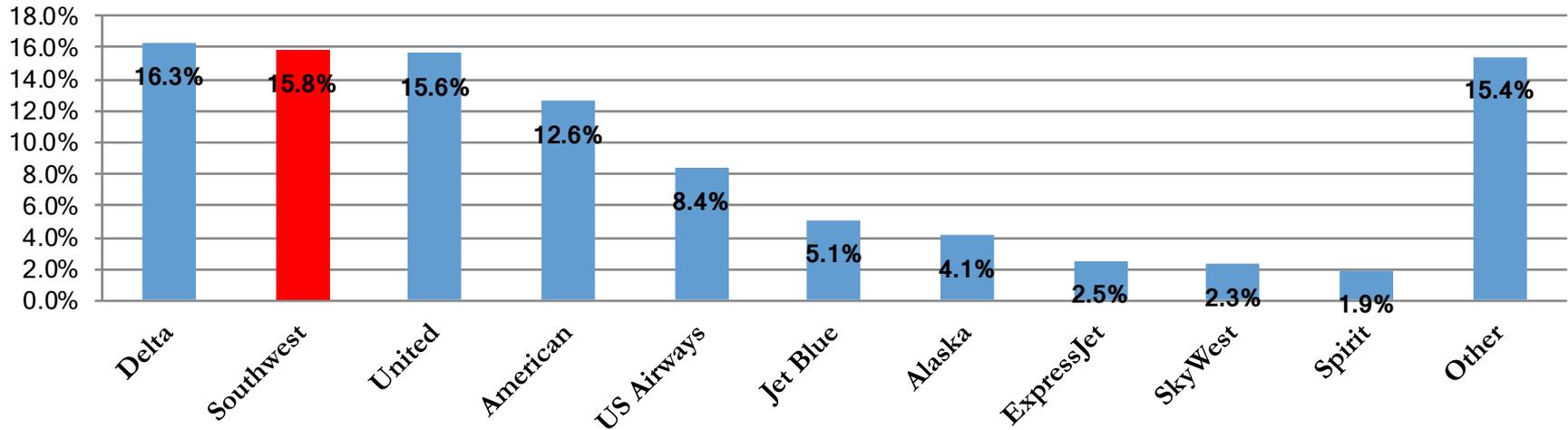
- Legacy airline's hub-and-spoke model is outdated and inefficient
 - Legacy airlines must pay high airport fees (for major hub cities) and deal with high traffic
- LUV uses point-to-point model
 - Focus on short-distance, non-stop, regional flights
 - Allows LUV to focus on offering more flights and better service without hassle of hubs
 - 2015: 74% of LUV flyers were non-stop passengers
 - 637 distinct non-stop city pairings offered

Strong Financials

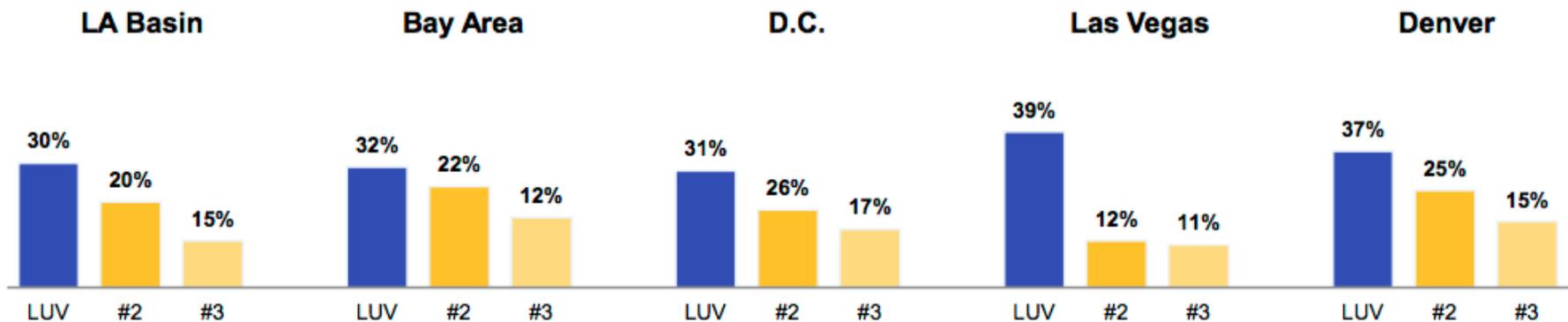
- 2015: LUV boasts industry leading ROIC at 32.7%, largely due to efficient strategy
- LUV also boasts lowest Debt/EBITDA ratio at .09
 - Debt reduction has been a key agenda, and company has used its high cash flow generation as a method to achieve this goal

LUV vs. Comparable Airlines

Domestic Market Share Among Major Airlines*



#1 market share in several greater metro areas

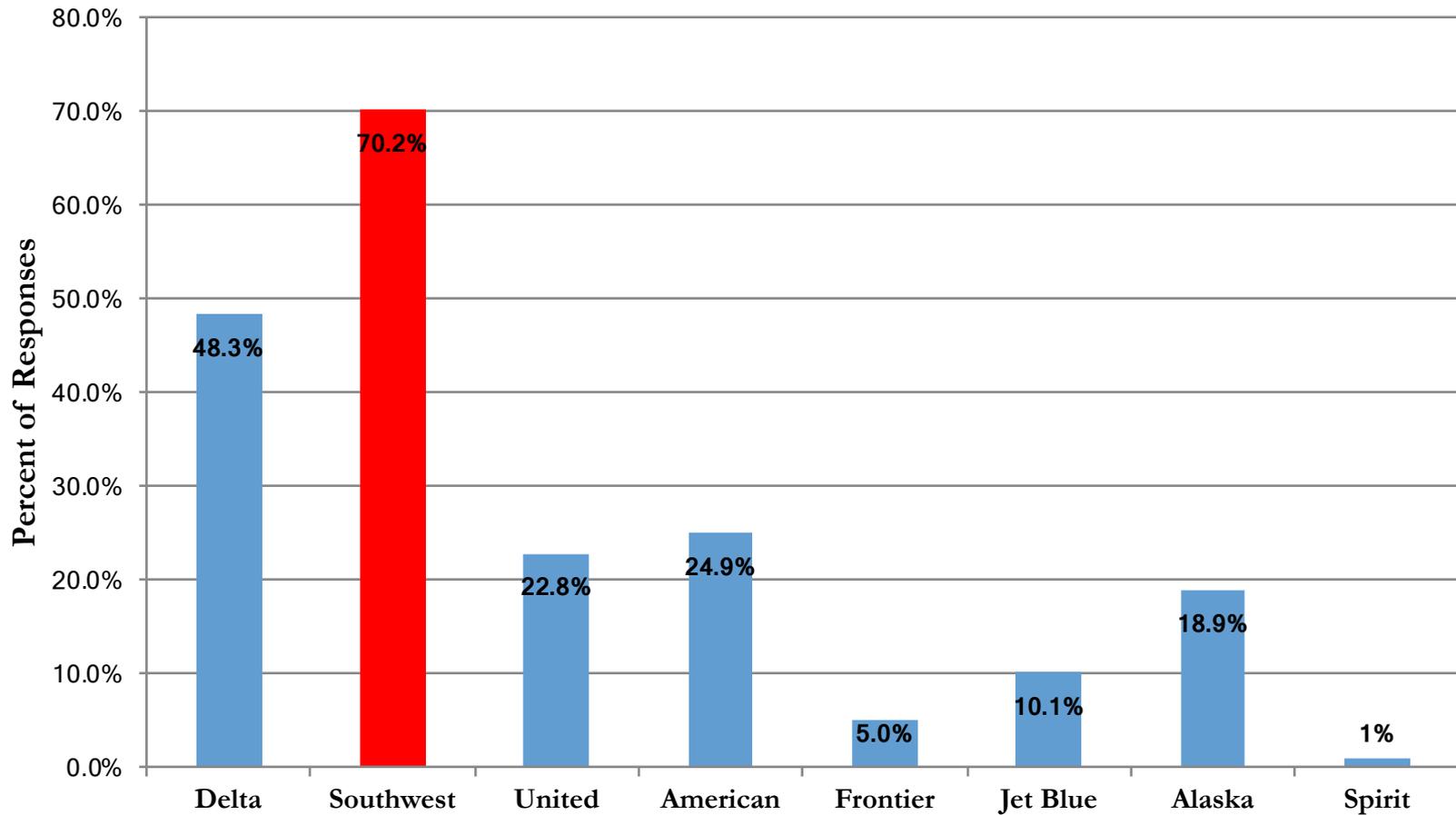


Source: Company filings

*Measured in Passenger Revenue Miles

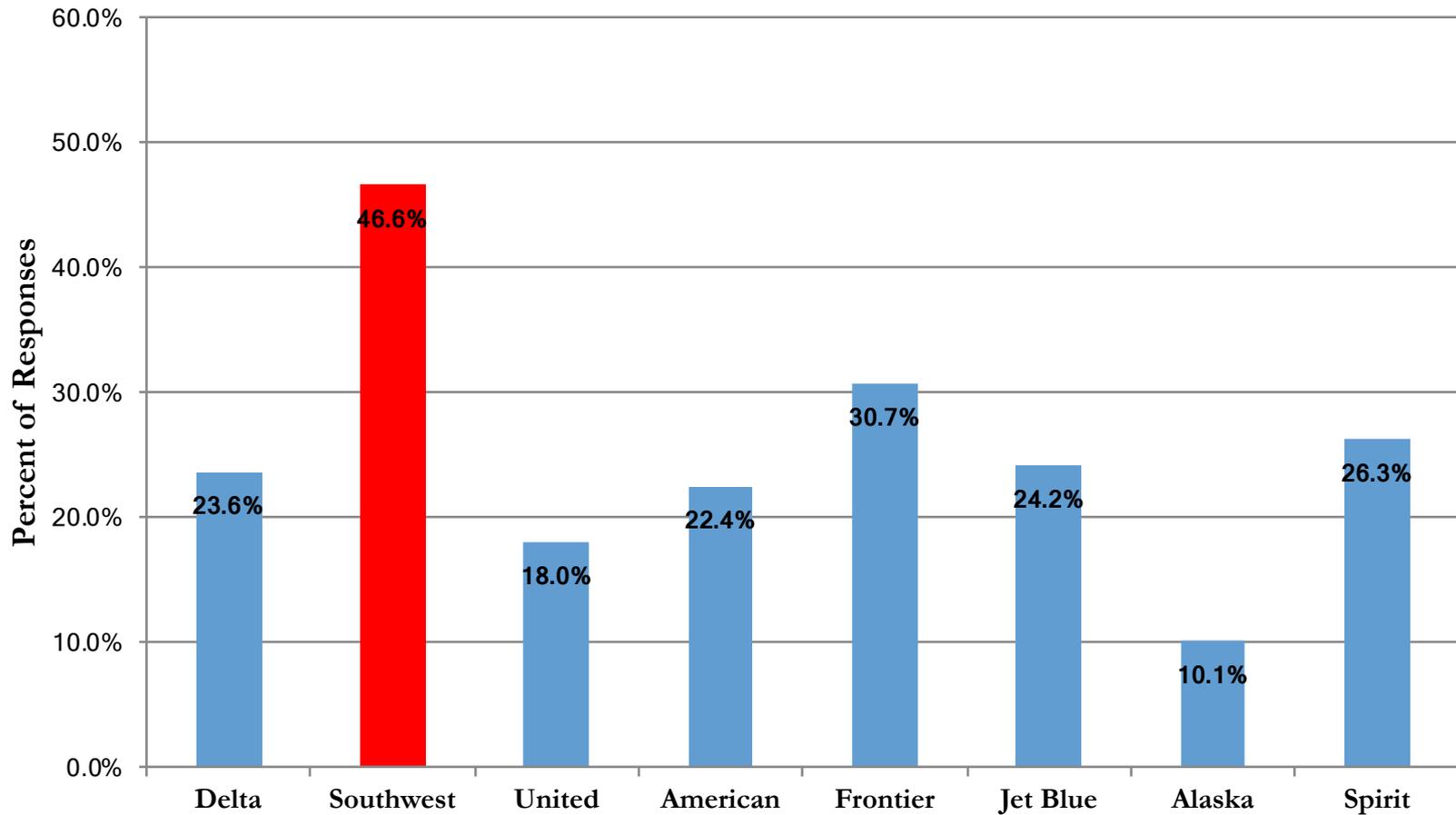
LUV vs. Comparable Airlines

Which two U.S. airlines offer the friendliest service?



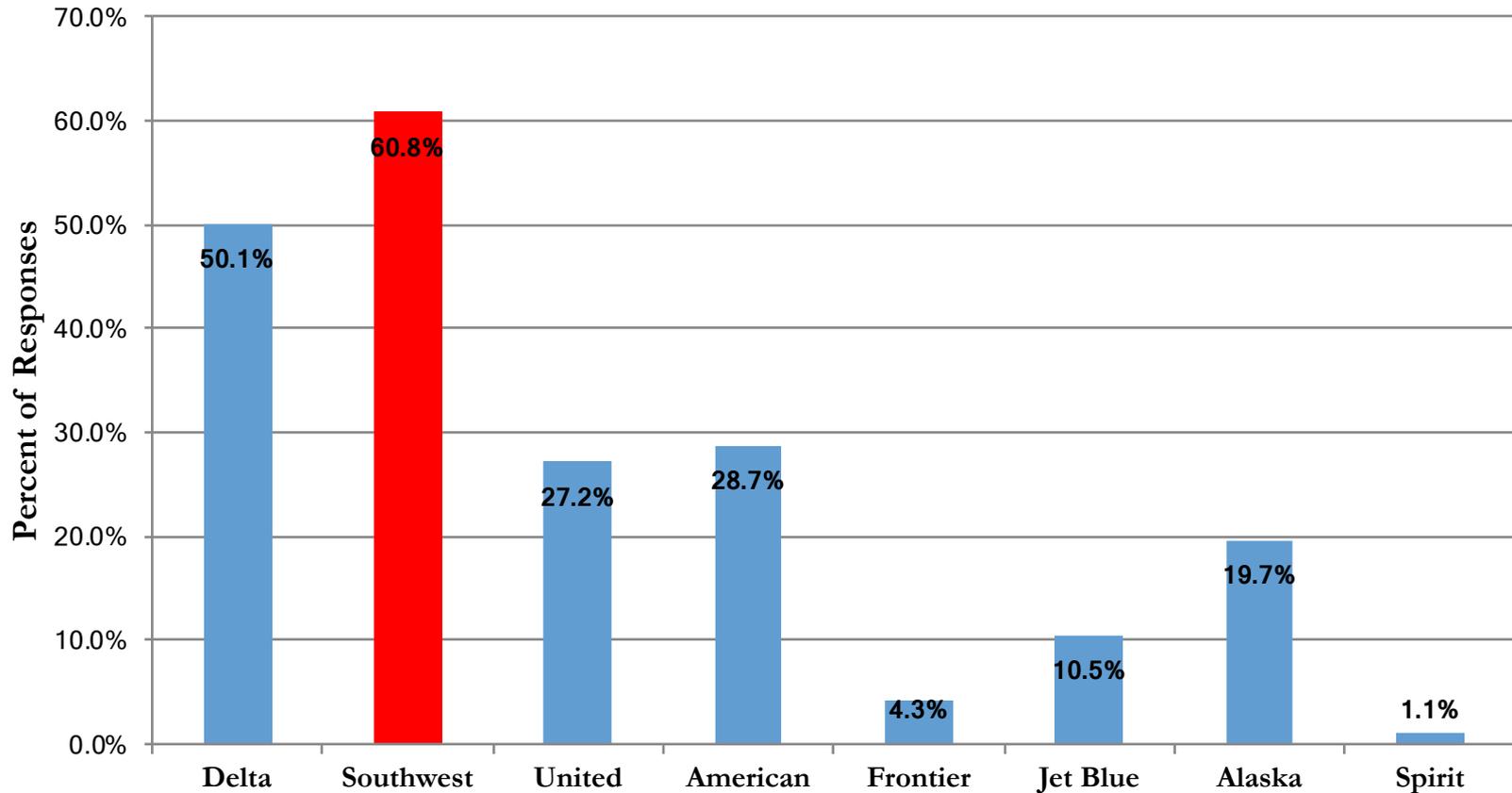
LUV vs. Comparable Airlines

Which two U.S. airlines offer the lowest prices?



LUV vs. Comparable Airlines

Which two U.S. airlines offer the best overall combination of service and value?



Variant Perception

Market Perception Summary

Skepticism Regarding Ability to Obtain Business Customers

- LUV is seen by The Street as a ‘budget airline,’ unappealing to executive travellers
- Market perception treats lack of First Class seating as deterrent for business travellers
 - Street fears business travellers will turn to airlines that offer First Class and more luxury options instead of LUV’s “no frills” service

Skepticism Regarding Competitors in CA

- While minor, LUV has faced increased competition in one of its most dominant markets
 - Key opposition comes from newly merged Alaska-Virgin Airlines
- The Street feels that the new, culturally charged Alaska-Virgin duo can challenge LUV’s monopoly on CA travellers

Skepticism Regarding Ability to Compete in International Sector

- LUV is regarded as a domestic airline, as its international operations are completely overshadowed by domestic success
- The Street fears customers will turn to legacy airlines for international offerings instead of LUV’s developing service

Lack of Credit Given to Strong Financials and Keen Management

- The Street has not given proper credit to LUV’s Management team, whose actions have positioned LUV well in the industry
 - As a result of Management’s actions, LUV boasts industry leading ROIC and Debt/EBITDA ratios

BIG Discrete Nonconformities - Qualitative

Ability to Obtain Business Travellers

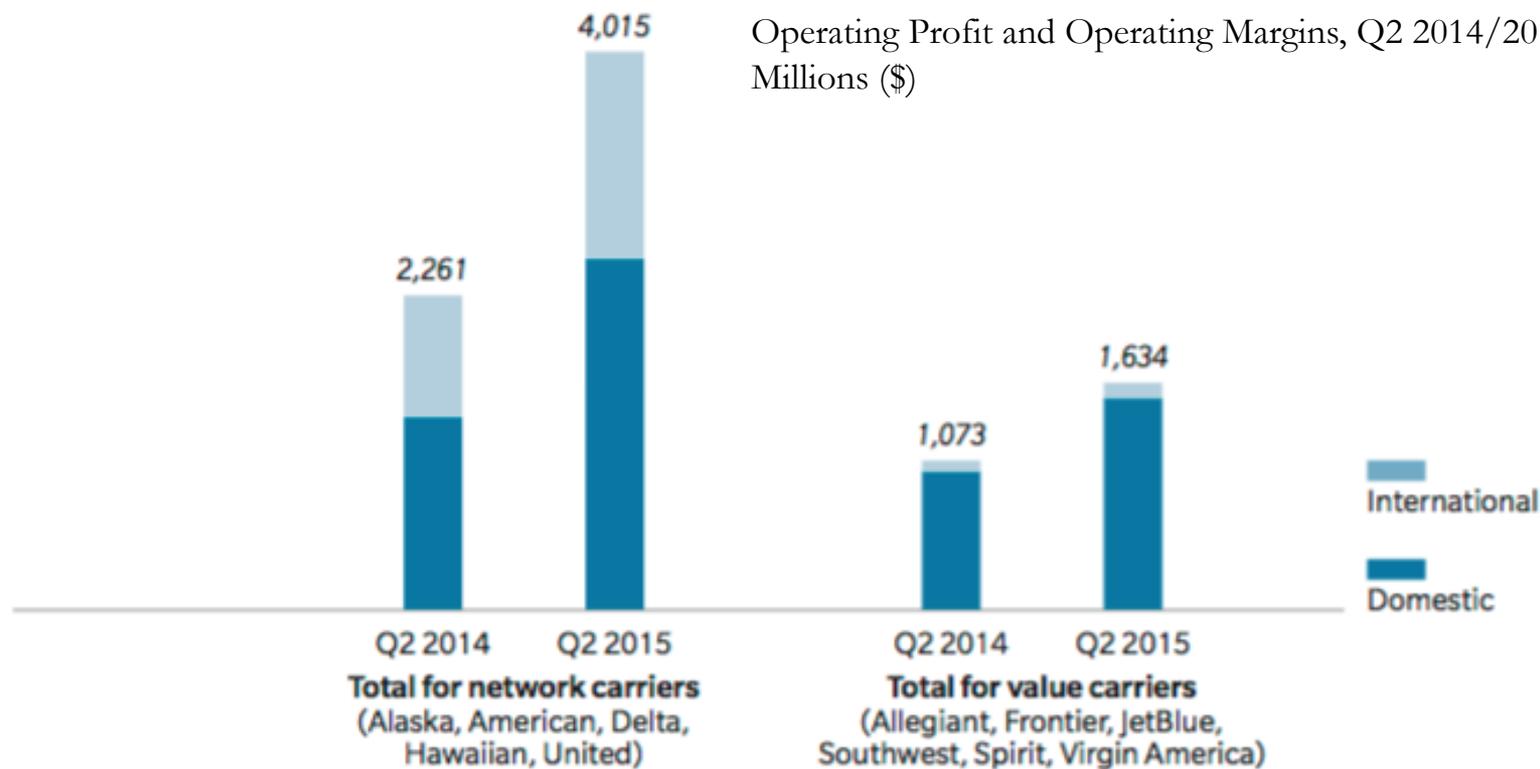
- LUV has made initiatives to offer direct, non-stop service to more major cities
 - Majority of business travellers prefer quick, direct flights over indirect luxury offerings
- LUV's flexibility for "Business Select" bookings appeals to travellers who may need to book or change flights last-minute
- Expanding international offerings incentivizes business travellers to spend Reward Points on these flights
 - Lower price for these international flights are appealing
- **Goal:** increase business passengers from 35% to 40% of passengers (and load factor from 85% to 90%), then number of non-discount passengers would increase from 52 to 63%.

Ability to Compete in International Markets

- LUV plans to undercut prices of legacy airlines and implement its "no-frills" model on an international level
 - CEO Kelly: LUV will be able to undercut current prices by up to 40%
- By 2020, LUV will serve up to 50 cities in Latin America
- *Fortune* magazine estimates that LUV could capture 5% of \$60Bn Latin American and Caribbean travel markets
 - This would give LUV an additional \$3Bn in revenue in increase the projected growth rate from 5.5% to 7%

Profitability of International Flights

Operating Profit and Operating Margins, Q2 2014/2015
Millions (\$)



Operating margins	2014	2015	2014	2015
System	8.4%	15.2%	13.5%	19.7%
International	8.1%	14.2%	17.6%	24.1%
Domestic	8.6%	15.8%	13.3%	19.5%

BIG Discrete Nonconformities - Qualitative

Ability to Mitigate Competition in CA

- For in-state or nearby flights, LUV's value proposition is the strongest for consumers
 - Flights are short (between 30 minutes and 90 minutes) so customers' key focus is price
 - They don't really care about luxury services (or paying for them) when flight is only an hour
- Prices for in-state flights are not dramatically lower than other airlines, but LUV's other benefits are attractive
 - 2 Free Checked bags appeals to customers, when compared to \$25 per bag minimum fee on legacy airlines
 - Flexibility in changing reservations
 - Offers flights to 10 CA cities, so customers can get where they need

Strong Financials and Management

- LUV's history of strong financial performance and solid management has been overlooked
 - Industry-leading Debt/EBITDA and strong cash generation allow for LUV to put capital to work, rather than paying off debt
 - Strong ROIC and utilization numbers compared to other airlines
 - Has been profitable for 41 years straight, no sign this will change
 - Only airline to not have gone bankrupt, entered restructuring, or been subject to an M&A during the Great Recession

Financial Review

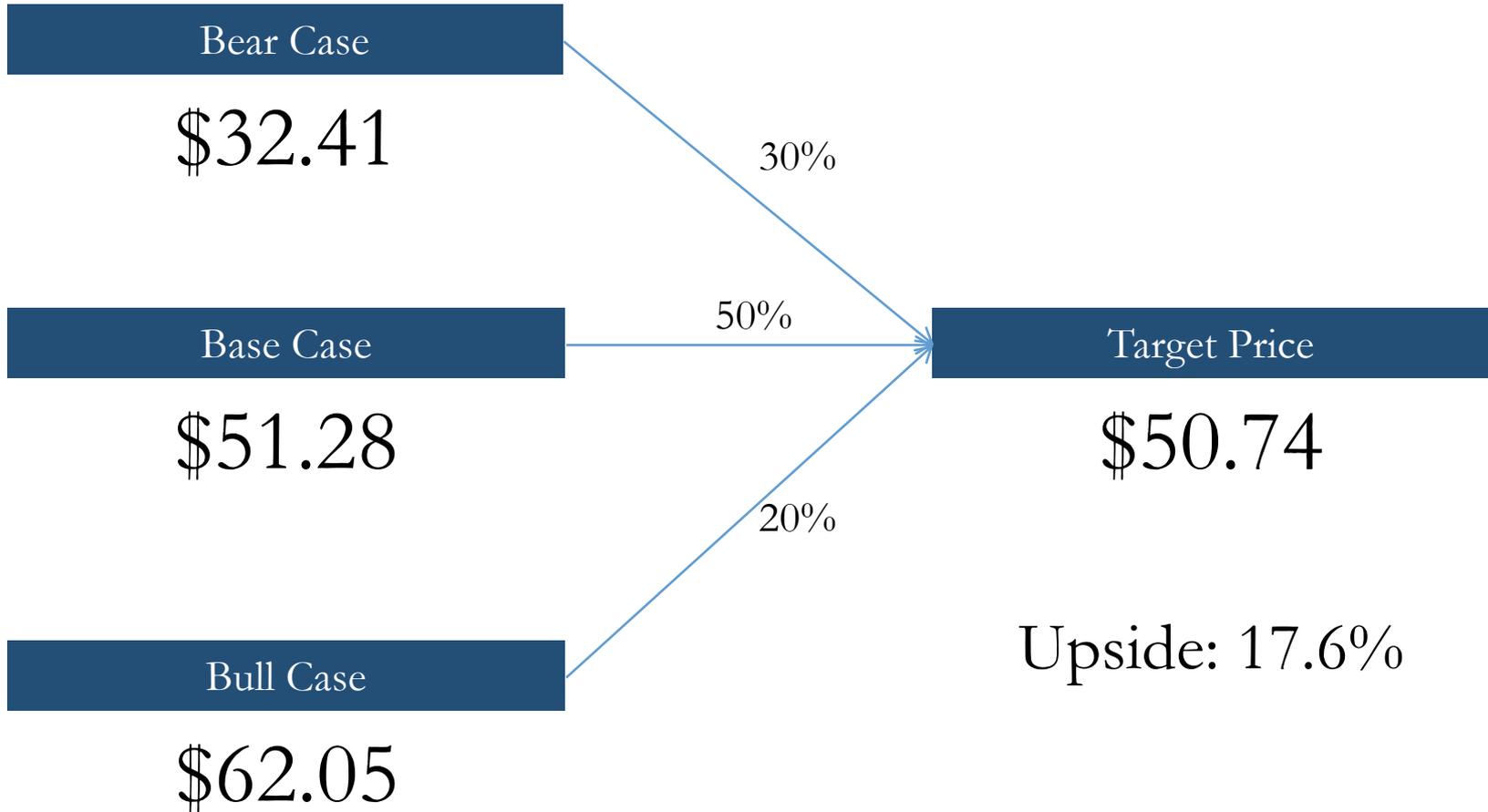
Southwest vs. Comparable Companies – Metrics

	Share Price	Enterprise Value (EV, \$ Bln)	Net Debt/EBITDA	Revenue (TTM, \$ Mln)	Book Value per Share	RASM (Revenue per Available Seat Mile)	Load Factor
Southwest Airlines (LUV)	\$43.16	\$25.66	2.44%	\$20,230.00	\$11.74	\$0.139	83.10%
United Airlines (UAL)	\$47.43	\$22.74	5.89%	\$37,450.00	\$23.11	\$0.133	81.40%
American Airlines (AAL)	\$35.89	\$31.78	7.34%	\$40,600.00	\$8.04	\$0.138	81.60%
Jetblue (JBLU)	\$43.66	\$6.52	6.06%	\$6,510.00	\$10.60	\$0.128	85.70%
Alaska (ALK)	\$65.04	\$5.74	8.80%	\$5,676.00	\$19.81	\$0.127	86.00%
Delta Airlines (DAL)	\$39.38	\$35.70		\$40,370.00	\$15.80	\$0.16	86.00%
Average (Excl. LUV)	\$46.28	\$20.50	7.02%	\$26,121.20	\$15.47	13.72%	84.14%

Model – Possible Outcomes Examination

Metric	Bear	Base	Bull
Growth of Total Aircrafts	1.5% in 2017, and 2% after. Retirement is worse than expected and negatively impacts growth.	2% throughout. Acceleration of 737-Classic retirement goes as planned.	3% by 2020. Classic retirement goes as planned, and demand is strong enough for company to exercise options for more MAXs.
Growth of Seats per Aircraft	1.5% in 2017, 1.75% in 2018, and 2% after. Retirement is worse than expected and negatively impacts growth.	2% throughout. Acceleration of 737-Classic retirement goes as planned.	2% throughout. Acceleration of 737-Classic retirement goes as planned.
Growth of Passenger Fare per Seat (2020)	2%. The company is slower than expected in bringing in business / more lucrative passengers	2.5%. 2016 sees strong price competition, but company delivers on increasing business travelers	3%. Company takes on a lot more business travelers and reaps stronger margins from international flights.
Fuel Cost per Gallon (2020)	\$3.00. Global supply reduces quickly and demand for oil rebounds.	\$2.50. Fuel cost projection is met, and we see a moderate increase in oil over time as global supply slowly decreases.	\$2.30. Global demand for oil remains low and supply stays stubbornly high.
Growth of Fuel Consumed	4% growth throughout.	4% growth throughout.	4.2% by 2020. Company is growing faster and thus requires more fuel.

Target Price



Recommendation

We recommend a long and suggest an 8% position. Summary of reasoning:

- The company gives us direct exposure to a well-performing US economy. It does not fly outside of the Western hemisphere, which blocks it from any lower European demand in the wake of terrorist attacks.
- The portfolio is currently not exposed to US airlines or directly to the domestic tourism industry, so there isn't a concern about overweighting to this specific industry.

Schedule for Future Due Diligence:

- In quarterly and annual conference calls, look for any discussions about growth of business travelers as percent of Southwest passengers. In general, it is important to monitor the company's unit revenue growth because this is an important growth driver for the company.
- Come the start of 2017, take note of the company's fuel hedging program and if it decides to continue lowering the percent of fuel consumption it hedges.
- Monitor the progress of 737-Classic retirement, especially around the company's guided deadline of Q3 2017.
- Monitor the ongoing negotiations between management and the pilots union. As labor makes of the majority of costs for value airlines, it important to see if a settlement drastically increases the company's own labor costs and makes it less competitive against the post-bankruptcy legacy fliers.

Risks

Overview of Risks

Federal Investigation into Airline Collusion

- 2015: Dept. of Justice announces investigation into price-setting among major airlines, including American, United, Delta, and Southwest
 - Claim: consumers pay higher fares when the same largest investors hold shares of multiple airlines
 - If true, fare increase among colluding airlines could be between 3-11%
 - Investigation goal: was there direct communication between managements or did shareholders serve as proxies for communication between different companies' management teams?

Counter Argument to Investigation

- Investigation launched during a time of depressed fares
 - During Great Recession, major airlines cut capacity and increased fares
- Per collusion claims, airlines argue that times of economic crises are times of airline mergers and capacity management

Potential Consequences

- If investigation shows there was collusion among managements directly or using shareholders as proxies...
 - Base case: there could be higher restrictions on communication between management teams and investors
 - More severe case: forced unwinding of some of these stockownership positions by the large investors

Other General Risks

General Industry Risks

- Significant rise in oil prices
 - This would affect all major airlines
- Possible degradation of consumer sentiment (in air travel)
 - There is always a potential for tragic events that affect all airlines
 - Airline crashes, terrorist attacks, etc.
 - The problem can affect the airline industry, not just a particular company
- Sociopolitical Turmoil
 - Consumers may avoid flying to a particular destination or flying altogether
- Macroeconomic trends
- Change in dominant mode of travel
 - High speed rail, more efficient cars, etc.

Q/A

Southwest Leadership

Visionary CEOs

- LUV co-founder and former CEO Herb Kelleher was crucial to company success
 - Achievements include growing LUV to one of America's largest airlines, nearly 30 consecutive years of profitability, highest customer satisfaction among airlines, and the recognition of one of America's most admired companies for 12 years
 - Biggest achievement was influence over company culture and legacy
 - LUV is known as having proud, loyal employees devoted to providing great service
- Current CEO is Gary Kelly, who has followed Kelleher's path
 - Named "Most Underrated CEO" of 2014 by *Fortune* Magazine
 - LUV grew net income by 51%, and had 126% total stockholder return in 2014
 - 22 year employee of LUV, very close to Kelleher

Incentives for Success

- Many high level LUV Executives receive stock-based compensation plans in addition to their normal salaries
 - This includes traditional share-based compensation and performance-based compensation
 - The value of the performance-based compensation is dependent upon a variety of metrics, including ROIC and bottom-line growth
 - 61% of compensation among Key Executives is stock-based, while 15% is salaried (for 2015)
 - A look at CEO Kelly's 2015 compensation...
 - \$675,000 salaried
 - \$3,780,011 in stock options
 - \$5,947,505 total compensation

Sources

In addition to company filings, reports, and conference calls:

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