

Southwest Airlines

Ticker Site BiG	LUV
Ticker BiGlobal Trade	LUV
Ticker BT24	LUV
Ticker BiG Power Trade	LUV
P/E Ratio 2019E	11.10
P/BV Ratio	2.79
EV/EBITDA	6.89

Source: BiG Research;

Price and Performance (Values in USD)

Price	50.30
52 week high	64.02
52 week low	44.28
YTD	8.2%
Average daily volume (un)	4,667,113
Market Capitalization (mn)	27,316
Beta	1.06
Dividend	0.61
EPS	4.30

Source: BiG Research;

Analysts Consensus (last 3 months)

Buy		11
Hold		11
Sell		2

Source: BiG Research;

Financial Data

Sales (USD mn)	21,965
EBITDA (USD mn)	4,407
Number of Employees	58,800
ROA	9.2%
ROE	24.6%
D/E	0.42
Dividend Yield	1.43%

Source: BiG Research;

Notes:

All quotes were updated in Bloomberg at 10h12 of June 11th, 2019.

Relevant Information:

Use the following link to view our most recent publications:

<https://www.big.pt/InformacaoMercado/s/TradingIdeas/Index/-1>

Use the following link to see our recommendation history:

<https://www.big.pt/pdf/Newsletters/nld.pdf>

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Southwest Airlines (Ticker: LUV US)

Description

Southwest Airlines was founded in 1971. Now it operates 750 Boeing 737 aircraft and serves 90 destinations in 40 US states and Caribbean countries. Daily it operates more than 4,000 departures and enplaned in 2018 163mn passengers. Its vision is “to become the world’s most loved, most flown and most profitable airline”. Southwest has been profitable for the last 46 consecutive years.

Southwest Airlines trades in the NYSE with a market capitalization of USD 27 bn.

Investment Case

Southwest is a very well run airline, with strong focus on customer and profitability, which is proven by its long track record. However recent negotiations with mechanics unions will increase employees’ costs which will drive margins down. A rise in oil prices will not help either. Despite current P/E of 11x, an increase of 8% in costs between salaries and oil price would decrease EBIT to around half of current value and drive the P/E to levels close to 21x. Consequently it would be prudent to wait for a correction in the stock price in order to make an investment in the long run in the company.

Environmental, Social and Governance (ESG)

Environment: In 2018, the company consumed 80.8mn MWh of jet fuel, 98k MWh of electricity, 78k MWh of diesel, 65k MWh of Gasoline and 35.5k MWh of Natural Gas. Regarding CO₂, Southwest emissions were 20.5 mn metric tons almost entirely from aircraft and fuel consumption. Water consumption was 375 mn liters in 2018 and the company generated 10.6 thousand tons of waste, of which 3.8 thousand were recycled.

Social: Southwest employees spent nearly 190 thousand hours in voluntary work for local organizations and causes they supported (around 3.2 hours per employee).

Governance: In the first quarter, Southwest was ranked #2 of the 500 companies on Forbe’s List of Best Employers for 2019 and received the perfect score of 100 on the 2019 Corporate Equality Index. 43% of total employees are female

Relative Valuation

Name	Country	Market Cap (mn)	Currency	P/E 2019E	YTD	Div. Yield	NetDebt/ EBITDA	Margin EBITDA
INTL CONSOLIDATED AIRLINE-DI	BRITAIN	10,465	EUR	4.7	-23.8%	5.5%	0.2	20.5%
RYANAIR HOLDINGS PLC	IRELAND	11,915	EUR	12.9	-1.9%	n.a.	0.3	21.5%
UNITED CONTINENTAL HOLDINGS	UNITED STATES	21,847	USD	7.4	-1.3%	n.a.	2.8	13.8%
AMERICAN AIRLINES GROUP INC	UNITED STATES	13,683	USD	6.1	-4.2%	1.3%	6.2	10.5%
DELTA AIR LINES INC	UNITED STATES	35,829	USD	8.2	9.7%	2.6%	2.0	17.3%
SPIRIT AIRLINES INC	UNITED STATES	3,358	USD	8.7	-15.3%	n.a.	3.0	19.2%
SOUTHWEST AIRLINES CO	UNITED STATES	27,316	USD	11.1	8.2%	1.3%	0.4	19.5%
Average exc. Southwest Airlines				8.0	-6.12%	3.12%	2.4	17.1%

Source: BiG Research

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Income Statement (USD mn)	2018	2017
Passengers	20,455	19,763
Freight	175	173
Others	1,335	1,210
Revenues	21,965	21,146
Salaries	7,649	7,305
Fuel and oil	4,616	4,076
maintenance materials and repair	1,107	1,001
Landing fees and airport rentals	1,334	1,292
Depreciation and Amortization	1,201	1,218
Other operating expenses	2,852	2,847
Operating Expenses	18,759	17,739
EBIT	3,206	3,407
Interest expenses	24	30
Other	18	112
EBT	3,164	3,265
Taxes	699	-92
Net Income	2,465	3,357
Earnings Per Share	4.30	5.58

Source: Company's data

Free Cash Flow (USD mn)	2018	2017
Operational Cash Flow	4,893	3,929
Business Net Income	2,465	3,357
Depreciation and Amortization	1,201	1,218
Changes in Working Capital	941	212
Others	286	-858
Investment Cash Flow	-2,038	-2,408
Capex	-1,976	-2,249
Financial investments & others	-62	-159
Financial Cash Flow	-2,496	-1,706
Debt change	-342	8
Share buyback	-1,965	-1,571
Dividends	-332	-274
Others	143	131
Change in free cash flow	359	-185
Cash at the end of period	1,854	1,495

Source: Company's data

Balance Sheet (USD mn)	2018	2017
Assets	26,243	25,110
Cash & Equivalents	1,854	1,495
Short term investments	1,835	1,778
Receivables	568	662
Inventories	461	420
Property and equipment	19,525	18,539
Intangible Assets & Goodwill	970	970
Other Assets	1,030	1,246
Liabilities	16,390	15,469
Short term Debt	606	348
Long term Debt	2,771	3,320
Accrued liabilities	1,749	1,700
Air traffic liabilities	5,070	4,565
Payables	1,416	1,320
Construction obligation	1,701	1,390
Other liabilities	3,077	2,826
Total Shareowner's Equity	9,853	9,641
Total Equity and Liabilities	26,243	25,110

Source: Company's data



Source: Company's data

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Income Statement

Southwest Airlines divides passenger revenues into non-loyalty (paid by cash or credit card), loyalty (paid with loyalty points) and ancillary revenues (in-flight purchases, Early Bird Check-in, Upgraded Boarding). In 2018 revenues increased 3.9% due to increases in capacity and despite lower fares, however, costs increased 5.8% due mainly to higher fuel and salaries costs, leading to a decrease in EBIT margin to 14.6% from 16.1% in 2017. In 2017 the tax rate was negative due to the reduction of tax provisions associated with the news Tax Cuts and Jobs Act legislation enacted in December of that year.

Operating Data	2018	2017	2016	2015	2014
Load factor	83,40%	83,90%	84,00%	83,60%	82,50%
Average length of passenger haul (miles)	988	991	1001	994	978
Trips flown	1.375.030	1.347.893	1.311.149	1.267.358	1.255.502
Seats per trip	150,7	149,03	147,33	145,94	143,16
Average passenger fare (USD)	151,64	151,73	152,89	154,85	159,8
Operating revenue per ASM (cents)	13,75	13,75	13,66	13,98	14,2
Operating expenses per ASM (cents)	11,74	11,53	11,29	11,26	12,55
Fuel consumed in gallons (millions)	2094	2045	1996	1901	1801
Aircraft at end of period	750	706	723	704	665

Source: Company's data

Free Cash Flow

In operational cash flow, the others segment includes cash outflows for collateral to derivative counterparties. In 2018 this value was USD 15mn, and in 2017 was USD 316mn. Capex relates to investments in aircrafts and other equipment, technology projects, and airport construction project payments. For 2019, Southwest expects Capex of USD 1.9bn to USD 2bn. In 2018, Southwest returned to Shareholders USD 2.3bn through share buybacks and dividends. In May 2019, the board approved a 12.5% increase in quarterly dividend to USD 0.18 and a new USD 2bn share buyback after the completion of the remaining USD 400 mn of the current program.

Balance Sheet

Taking into account the short term investments (US government certificates and certificates of deposits issued by domestic banks), Southwest Airlines has a negative net debt, which gives it a high degree of flexibility to increase debt if needed for investments. Air traffic liabilities correspond to the tickets already sold to clients and that will be recognized as revenue when the travel is provided.

First quarter earnings and guidance

In the first quarter of 2019, sales were USD 5.15bn (+4.1% yoy) vs est. USD 5.13bn and EPS were USD 0.70 vs est. USD 0.61. The business was affected by severe weather, MAX groundings, unscheduled maintenance stoppages and US government shutdown.

For the second quarter, Southwest expects RASM (revenue per available seat mile) +5.5% to +7.5% yoy, but CASM (cost per available seat mile) ex-fuel of +10.5% to +12.5% yoy, and ASM -2% to -3%.

For 2019, it expects CASM ex-fuel +5.5% to +6.5%, ASM of +2% to +3%, capex between USD 1.9bn to USD 2bn and effective tax rate of 23.5%.

Management Team

Gary C. Kelly (Chairman and CEO): Gary was born in Texas in 1955, where he received a bachelor of Business Administration in Accounting. He met his wife in eighth grade and they have two daughters. He started working as an audit manager and joined Southwest in 1986 as a Controller, being promoted to CFO in 1989. He became CEO in 2004 and chairman in 2008.

In 2018 Gary received from Southwest Airlines around USD 7.7mn, including salary (USD 0.75mn), stocks and options (USD 5.3mn), bonus (USD 1.4mn) and other benefits.

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▲ Airline Industry in US

Routes and plane distribution: Southwest Airlines chose a different kind of business model (point to point) than conventional US companies (hub-and-spoke). Usually the hub-and-spoke system concentrates most of an airline's operations at a limited number of central hub cities and serves alternative routes from these cities. The point to point model of Southwest enables it to provide more direct nonstop routing, while offering more conveniently timed flights and low fares.

Airports slots: Slots are designated rights for an air carrier to operate a take off and landing at a specific time at certain airports and is regulated by the FAA (Federal Aviation Administration). During 2018, the company entered into an agreement with Alaska Air to use 12 slots at New York's LaGuardia Airport and 8 slots at Washington Reagan National Airport until 2028

Customer protection: The Department of Transportation and the Federal Aviation Administration impose rules such as compensating the customer with 4x the paid ticket if his flight is overbooked and he did not have a seat available, or refund any checked bag fee for permanently lost luggage, disclosure of all ancillary fees and refund passengers for these fees if due to an oversold plane they cannot use these services.

Fees: There are multiple government fees that passengers pay which is included in the final ticket price. A USD 5.6 per one-way passenger trip is charged in relation to Homeland Security. There are fees in inbound international flights to support US Customs and Border Protection and the US Department of Agriculture's Animal and Plant Health Inspection Service.

Infrastructure spending: According to the company, in 2019 is expected that Congress considers legislation to increase federal spending on infrastructure or allow for the increase in the maximum Passenger Facility Charge collected by airlines currently capped at USD 4.5 per passenger.

Rules for staff rest: Currently there are regulations which require pilots to rest at least 10 hours before a flight. A new regulation intends to require also flight attendants to follow the same rest rule which may decrease the company's staff flexibility and increase costs.

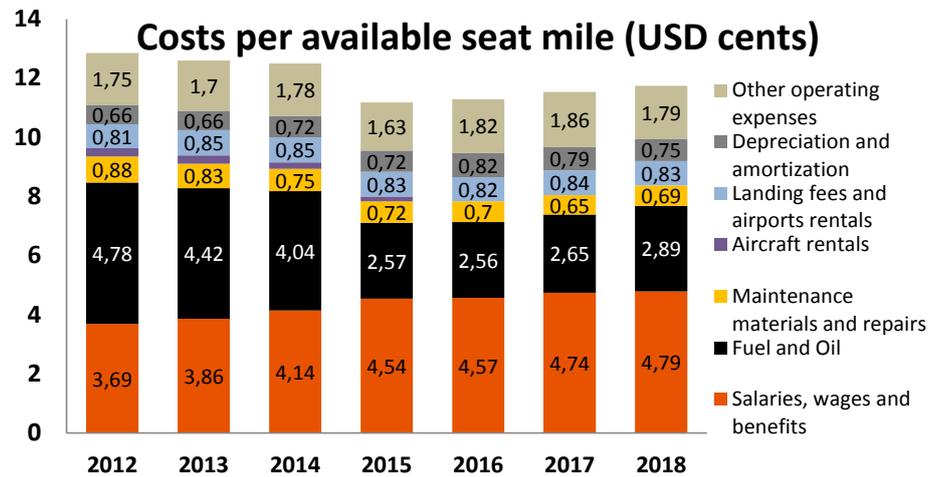
Unions: Collective bargaining agreements do not expire between the airline and the union, but instead become amendable at an agreed date. If by that date any of the parties wishes to change the agreement it must notify the other party and start direct negotiations. If these fail, either party may request the National Mediation board to appoint a federal mediator who may determine if an impasse exists and offer binding arbitration to the parties. If any party rejects it, a 30 day cooling off period begins and at the end of the period unions may strike, or the airline may impose its amendments or hire new employees to replace striking ones (called "Self Help" process). A presidential Emergency Board may be appointed to give additional time to the cooling off period and try to investigate and report on the dispute.

Differences between Europe and US Air Traffic Management: The US Air Traffic Management is controlled by one single service provider which uses the same tools and equipment, communication and set of rules and procedures. In Europe the system is much more fragmented and different rules and procedures exist within different countries. Europe has a much higher density of military zones which may close its airspace and constrain commercial air traffic.

Southwest Airline strategy

Heart: Southwest displays the symbol Heart in airplanes, tickets and logo, which symbolizes the company's and its employees care for the customer. In 2019 was in the Top 10 of best airlines of the world in the TripAdvisor's Traveler's awards, being the only US airline in that Top 10.

Strict cost control: Southwest uses only Boeing 737 aircrafts which allows for simplified scheduling, maintenance, flight operations and training activities. The use of secondary airports means that there is less congestion and the possibility of efficiently decrease the amount of time the planes are grounded.



Source: Company data

This cost control warranted that Southwest achieve profitability in the last 46 consecutive years while many other companies entered into bankruptcy processes:



Source: Company's data

Loyalty program: Clients receive points for each dollar spent in tickets, which are then multiplied depending on the fare chosen. These points do not expire, as long as there is activity in the last 24 months and can then be used to purchase new flight tickets, even in international flights with other airlines, cruises, hotel stays, rental cars, gift cars, event tickets and others. Points may also be transferred or donated to selected charities.

Efficient planes: The transition from Boeing 737 old models to the new MAX models will increase the company’s efficiency as the new planes have 4% more seats and reduce fuel consumption by 16%. Below is the fleet of Southwest Airlines at end of 2018 and the order book for the next years:

Type	Seats	Avg Age	# of aircrafts	Owned	Leased
737-700	143	15	512	396	116
737-800	175	3	207	200	7
737 MAX 8	175	1	31	31	
Total		11	750	627	123

Source: Company data

Orders	MAX 7 Firm orders	MAX 8 firm orders	MAX 8 options	Additional MAX 8	Total
2019	7	21		16	44
2020		35		3	38
2021		44			44
2022		27	14		41
2023	12	22	23		57
2024	11	30	23		64
2025		40	36		76
2026			19		19
Total	30	219	115	19	383

Source: Company data

Fares: Southwest has 3 major fares categories: “Wanna Get Away”, “Anytime” and “Business Select”. All the categories offer 2 free checked bags (only major airline in US that has this policy), seat selection, complimentary soft drinks and snacks, free movies-on-demand and live and on-demand tv for WiFi enabled aircrafts. Southwest does not charge fees for changes to flight reservations, except for the fare differences that may exist.

- **“Wanna Get Away”** are usually the lowest fares and subject to advance purchase requirements. Nonrefundable, except in certain specific situations. Under the loyalty program these fares earn 6 Rapid Reward Points for each dollar spent.
- **“Anytime”** fares are subject to Southwest’s No Show policy, refundable if canceled, or funds may be applied towards future travel. These earn 10 Rapid Reward Points for each dollar spent.
- **“Business Select”** include additional perks of such as priority boarding, 12 Rapid Reward points per dollar spent, “Fly By” priority security and ticker counter access in participating airports and one complimentary premium beverage coupon.

No Show Policy: as long as the customer does not change or cancel a flight in the ten minutes prior to the schedule departure and the customer does not travel on the scheduled flight, with the “Anytime” or “Business Select” fare, unused funds may be used in future travel.

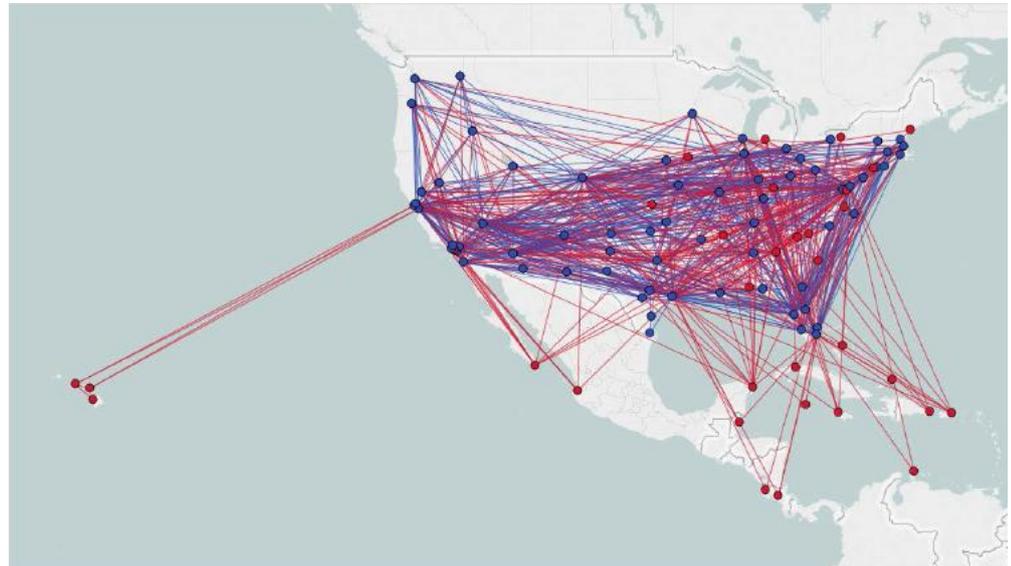
Ancillary Services: Customer’s may pay for ancillary services such as Early Bird Check-In, Upgraded boarding and transportation of pets or unaccompanied minors.

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Routes: The company operates more than 4,000 daily departures and has a market share in US of 23%, having in 2018 enplaned more than 163mn passengers. Southwest Airline has been increasing its focus on California and recently opened a route from California to Hawaii.



■ 2010
■ 2019

Source: Company's data

Employees

Employee Group	Approximate Number of Employees	Representatives	Status of Agreement
Southwest Pilots	9,100	Southwest Airlines Pilots' Association ("SWAPA")	Amendable September 2020
Southwest Flight Attendants	15,200	Transportation Workers of America, AFL-CIO, Local 556 ("TWU 556")	In negotiations
Southwest Ramp, Operations, Provisioning, Freight Agents	13,400	Transportation Workers of America, AFL-CIO, Local 555 ("TWU 555")	Amendable February 2021
Southwest Customer Service Agents, Customer Representatives, and Source of Support Representatives	7,400	International Association of Machinists and Aerospace Workers, AFL-CIO ("IAM 142")	In negotiations
Southwest Material Specialists (formerly known as Stock Clerks)	300	International Brotherhood of Teamsters, Local 19 ("IBT 19")	In negotiations. The Company reached a tentative agreement with IBT 19 in January 2019. If ratified by the Company's Material Specialists, the contract will become amendable in 2024.
Southwest Mechanics	2,400	Aircraft Mechanics Fraternal Association ("AMFA")	In negotiations
Southwest Aircraft Appearance Technicians	200	AMFA	Amendable November 2020
Southwest Facilities Maintenance Technicians	40	AMFA	Amendable November 2022
Southwest Dispatchers	300	Transportation Workers of America, AFL-CIO, Local 550 ("TWU 550")	Amendable June 2019
Southwest Flight Simulator Technicians	50	International Brotherhood of Teamsters ("IBT")	Amendable May 2019. The Company reached a tentative agreement with IBT in February 2019. If ratified by the Company's Flight Simulator Technicians, the contract will become amendable in 2024.
Southwest Flight Crew Training Instructors	130	Transportation Workers of America, AFL-CIO, Local 557 ("TWU 557")	Amendable January 2020
Southwest Meteorologists	10	TWU 550	Amendable June 2019

Source: Company's data at end of 2018

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▲ Risks

Economic conditions: Airlines are cyclical companies so in a cycle downturn a fall in demand and consequently fall in prices charged is expected, which may compress margins and net income due to high fixed costs.

Fuel Prices: In 2018, fuel represented around 25% of the company's costs. An increase in oil price may have a significant impact in the company's margin. The company partially hedges these costs, having at the end of 2018, 70% of fuel needs for 2019 hedged.

Dependence on Boeing: Due to the fact that the company only operates Boeing aircrafts, its dependence on Boeing is very high and a failure to fulfill orders of aircrafts may limit the Southwest capacity to expand or renovate its fleet. Recently the problems with the model 737-Max, forced the company to ground all these models of aircrafts (31) which cause disruptions in flights. There is still no concrete date for the permission to use these aircrafts again and the company changed its schedules in order to not have any flight with this type of plane at least until September of 2019, which will affect around 100 daily flights of the total 4000 flights the company does per day.

Strikes and unions disputes: Around 40% of total costs are in wages, salaries and benefits. The demand for higher salaries from workers may lead to higher costs or to strikes if the company rejects it, leading to constraints in the service and bad reputation with the customer.

In May the company agreed a new contract with the mechanics union, ending an impasse of 7 years. The new agreement includes USD 160mn in back pay to cover the period since the last contract ended in 2012, an immediate 20% salary increase and 3% annual raises in the next 5 years.

Government shutdowns: This would translate into inadequate FAA staffing levels which would result in disruptions in air traffic and in company's operations. In the first quarter of 2019, Southwest disclosed that the government shutdown cost the company USD 60mn in revenues.

Weather disruptions: Weather conditions may limit the company's operations. In the 3Q of 2018 Southwest had to cancel 2,200 flights due to adverse weather conditions.

Fixed airport costs: If there is a decrease of capacity of other airlines in certain airports, some fixed costs will be distributed by fewer flights which may impact negatively margins of Southwest flights.

Cybersecurity: A cyberattack may disrupt the airline business or expose client's information. Southwest has an insurance against these attacks, however its costs may rise or the coverage may change and fail to provide adequate protection.

Terrorist attacks or airplane accidents: These events can severely disrupt the company's business or perception about the safety of flying in its aircrafts. On April 17, 2018, Southwest had an engine failure in its Boeing 737-700 (CFM engine) which caused debris to damage the fuselage causing rapid depressurization of the aircraft after damaging a cabin window. One passenger died. It was the first accident of Southwest resulting in a death of a passenger. Southwest gave USD 5,000 to each passenger and a USD 1,000 voucher to fly in the airline. Bookings in the months following the accident declined.

FAA investigation on checked bags weight measurement: The Federal Aviation Association is investigating operational issues with measuring the bags of passengers which led in some cases to a distortion of 1000 pounds in the weight calculated by the pilots for take-off. The investigation started in February of 2018, and Southwest has already put in place measures to decrease this operational risk.

Rating		
Agency	Rating	Outlook
S&P	BBB+	STABLE
Moody's	A3	STABLE
Fitch	A-	STABLE

Source: BiG Research

Graph



Source: BiGlobal Trade (partner Saxo Bank); BiG Research

Calendar

July 25th, 2019: 2Q 2019 earnings

August 20th, 2019: Ex-date quarterly dividend

Airline Industry Glossary

Revenue Passenger miles: Also referred as “Traffic” is a measure of demand for a given period. Is one paying passenger flown one mile.

Available seat miles: Known also as “Capacity”, is a measure of space available to carry passengers. Is one seat (empty or full) flown one mile.

Load factor: Revenue passenger miles divided by available seat miles.

Passenger revenue yield per RPM: Average cost paid by a paying passenger to fly one mile. Is calculated by dividing passenger revenue per revenue passenger miles.

Operating revenues per ASM: Know also by “RASM”, is a measure of revenue per the total available seat miles flown during a certain period.

Operating expenses per ASM: Is a measure of cost efficiency, also known as “unit costs” or “cost per available seat mile”, is the average cost to fly an aircraft seat (empty or full) one mile.

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 - Accumulate, expected absolute return between +5% and +15%;
 - Keep/Neutral, expected absolute return between -5% and +5%;
 - Reduce, expected absolute return between -5% and -15%;
 - Sell, expected absolute return below -15%;
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PSI20 Notes in the last 12 months as of 31st of March of 2019:

	Number of Recommendations	%
Accumulate/Buy	1	33,3%
Keep/Neutral	1	33,3%
Reduce/Sell	1	33,3%
Total	3	100,0%

Source: BiG Research

Trading Ideas in the last 12 months as of 31st of March of 2019:

	Number of Recommendations	%
Profit Taking	8	50,0%
Stop Loss	8	50,0%
In Place	0	0,0%
Total	16	100,0%

Pair Trades in the last 12 months as of 31st of March of 2019:

	Number of Recommendations	%
Profit Taking	0	0%
Stop Loss	0	0%
In Place	0	0%
Total	0	0%

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