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ALK - Q4 2017 Alaska Air Group Inc Earnings Call

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OVERVIEW:

Co. reported 4Q17 revenues of approx. $2b, GAAP net income of $367m, adjusted net income of $103m and adjusted EPS of $0.83.

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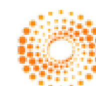

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PRESENTATION

Operator

Good morning. My name is Julie, and I will be your conference operator today. At this time, I would like to welcome everyone to the Alaska Air Group Fourth Quarter and Full Year 2017 Earnings Release Conference Call. Today's call is being recorded and will be accessible for future playback at www.alaskaair.com. (Operator Instructions)

Thank you. I would now like to turn the call over to Alaska Air Group's Director of Investor Relations, Matt Grady.

Matt Grady

Thanks, Julie. Good morning, everyone, and thank you for joining us for our fourth quarter 2017 earnings call. On the call today, our CEO, Brad Tilden, will provide an overview of the business; our CFO, Brandon Pedersen, will discuss our cost performance and cash flow; and Andrew Harrison, our Chief Commercial Officer, will share an update on our revenue performance and outlook. Several members of our senior management team are also on hand to help answer your questions.

Earlier this morning, Alaska Air Group recorded fourth quarter GAAP net income of $367 million. Excluding merger-related costs, mark-to-market fuel hedging adjustments and a special $274 million tax benefit associated with recent tax reform legislation, Air Group reported adjusted net income of $103 million and adjusted earnings per share of $0.83, or $0.01 ahead of the first call consensus.

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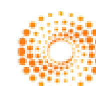

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As a reminder, our comments today will include forward-looking statements regarding our future expectations, which may differ significantly from actual results. Information on risk factors that could affect our business can be found in our SEC filings.

We will refer to certain non-GAAP financial measures, such as adjusted earnings and unit costs, excluding fuel. We've provided a reconciliation between the most directly comparable GAAP and non-GAAP measures in our earnings release.

We've also included certain unaudited, supplementary data labeled Combined Comparative statistics on Page 9 of our earnings release update to help investors make meaningful comparisons to the combined results of both airlines in last year's fourth quarter and full year. We think this provides investors better insights into how the overall business is performing.

And with that, I will turn the call over to Brad.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Thanks, Matt, and good morning, everyone. For 2017, we reported adjusted net income of $823 million or $6.64 per share compared to $911 million or $7.32 per share in 2016. For the quarter, we earned $103 million or $0.83 per share compared to $193 million or $1.56 per share in 2016. As we shared with you on our third quarter call, our earnings are under some pressure as we deal with some step function cost increases as well as significant new competitive capacity in markets where we fly. As we'll talk about on this call, we are optimistic about our future as we work our way through these issues as we complete the majority of the integration activity by early this spring as we begin capturing the advantages of the merger. As an example of our confidence in our future, our board today announced a 7% increase in our dividend to $0.32 per share.

I'd like to take a minute to frame for you where we are in the integration journey. As you know, we embarked on this journey because we believe we bring value to everyone who depends on us, and we wanted to continue doing this in the years ahead. We are in an industry where competitive advantage drives both current success and long-term staying power, and we believe that Alaska has real and durable competitive advantage. We have this with our operational processes and capability; with the fantastic service our people provide to our guests; with a very clear cost advantage that's matched with a history of offering low fares; with our growing route network; and most importantly, with the way we work with our employees to bring all of this together.

The merger closed on December 14, 2016, or just 13 months ago. Today, as we expected, we have substantially all of the costs of the combined company in our results with very little of the revenue. Of the $300 million original synergy target, we expect to realize $65 million in 2018, consistent with our prior forecast. We continue to believe the revenue potential of the new Alaska network is substantial, and we expect synergies to reach $200 million in 2019.

More important than the synergies, however, is the incredible platform that we'll have to grow revenue and profit in the years ahead and create value for our owners, our customers and our employees, just as we have in the last couple of decades.

On April 25, we'll transition to a common PSS system, which will give us a single shopping, buying, flight scheduling and airport check-in system as well as a single branded digital and airport experience. At that point, which will be just 16 months after closing, we'll be through 75% of the merger work and we'll begin realizing the full potential of the merger, as Andrew will further describe in just a moment.

We believe we're getting through our merger at a pace that is equal to or faster than the most rapid mergers in the industry. Some specific merger-related accomplishments from the last few months are as follows: we've co-located Alaska and Virgin America operations at 22 of 31 airports, the rest will co-locate in April. We've rapidly built out a route network, adding 44 new routes on top of the 38 we acquired with Virgin America. We've grown both loyalty members and credit card holders far in excess of our passenger growth. We converted to a single loyalty program for customers and single HR, finance and payroll systems in the back of the house. We've received a single operating certificate from the FAA, a herculean effort that allows us to operate Alaska and Virgin America as one airline, and which is also a prerequisite for other merger-related activities like the PSS cutover. We've made all aircraft delivery and interior decisions, and our first Airbus airplane came out of the paint shop yesterday with new Alaska colors. And as you know, we've financed the purchase of Virgin America in an accretive and all-cash transaction and have already brought our adjusted debt-to-cap ratio back to 51%.

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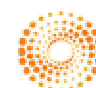

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On the labor front, while we still have work to do, at this point, we have single joint collective-bargaining agreements with our pilots and our customer service and reservation agents, and we believe we're closed with both our flight attendants and our maintenance technicians. One important priority we'll have remaining after April 25 is our move to a single crew planning and crew scheduling system.

In light of so many important achievements last year, I want to pause and personally thank our entire team of more than 23,000 people for their contributions in 2017, a year that I believe we'll look back on as having laid the foundation for our future growth and prosperity.

We will share $118 million in incentive pay tomorrow as annual bonuses are paid out. This is the ninth consecutive year in which we've proudly shared profits with our employees at levels that have averaged about 1 month of additional pay per employee per year. This year's payout averages 7.3% of pay for Air Group frontline employees.

As we look at our business in 2018, we have work in front of us. There is substantial competitive capacity in our markets, and we expect that this level of capacity will continue to put pressure on unit revenue, but there are a number of levers that we can and will hold this year. We plan to attack the revenue pressure by reconfiguring our Airbus fleet for greater revenue; by undertaking significant cross-fleeting in high-volume markets; by driving continued loyalty growth; and most importantly, by tapping into segmentation and upsell opportunities post-PSS.

While we focused on expanding our network in 2017, our growth will stabilize in 2018, and we expect it to slow to about 4% in 2019 and 2020 as we take advantage of the substantial growth over the last few years and optimize and refine our network. Of the growth plan for 2018, approximately 70% is flying today, and Paine Field represents the bulk of the rest. As Brandon will share in a moment, we expect capital spending to decline in 2019 and 2020, and free cash flow to increase, consistent with the lower-capacity growth.

On the cost side, our relative cost advantage has been a hallmark of our business for years and is one of our greatest assets, second only to our people. We'll sustain this advantage by focusing on low overhead and industry-leading productivity. As I mentioned earlier, we do face a step function increase in cost, which Brandon will detail for you in a moment. For now, I'll share that there are clear opportunities, which we will seize to improve our controllable cost structure.

This brings us to operations. Though we ranked second in operational performance last year, our on-time performance at the Air Group level was down about 5 points compared to 2016. While we struggled with external factors like challenging winter weather in the first quarter and ATC delays, we have room for improvement. For the fourth quarter of 2017, our on-time performance was up more than 2 points year-over-year, and we're focused on maintaining this positive momentum as we move through 2018.

And finally, I'd like to provide a brief update on Horizon, where we brought in Air Group veterans Gary Beck and Constance von Muehlen, and where we've made several other leadership changes. We've now operated 3 months without a single pilot-related cancellation. We're very optimistic about Horizon's future as we're consolidating our headquarters in Seattle as we're building better career pathways between the 2 companies for frontline employees, starting with pilots, and as we further grow and develop leadership talent between the 2 companies.

In summary, we laid a solid foundation for our future last year and the integration will be largely complete by early this spring. Alaska has real competitive advantage. And by the end of April, we'll be poised to focus our full attention on the things that matter most, being close to our people, running a great operation and preserving and enhancing both our great service and our low cost and low fares. We operate one of the best route networks in the country, based on some of the best-performing regional economies in the country.

And finally, we've long run this company in a balanced way to bring superior value to everyone who depends on us, including you, our owners, and we have a very talented team that is working hard to ensure this continues.

We appreciate you all tuning in. And once again, I want to thank our employees for their incredible commitment to Alaska.

And now I'll turn the call over to Brandon.

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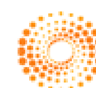

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Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Thanks, Brad, and good morning, everybody. As you've heard, we reported fourth quarter adjusted net income of $103 million, bringing full year net income to $823 million. This was the third-best year for us ever and came at a time of rapid growth, significant competitive pressure and an 18% increase in fuel prices, all while we were busy integrating 2 airlines.

Let's start with costs today. Q4 costs came in slightly better than our final guidance, and that's positive, but we also know that our cost-management practices, both in the operation and in the back office, can be improved. So with the integration on track, 2018 marks our return to the basics, and one of those is finely tuned cost management. This is not about cutting what guests care about. Instead, it's about productivity, a mindset of frugality, leaders knowing their cost drivers and making smart trade-offs. Cost management is like a diet. It needs to happen every day to work well. Keeping costs low is vital to our low-fare model and powers our business success.

All-in consolidated CASMex fuel should be up about 2.5% in 2018. This is on an apples-to-apples basis after conforming the 2017 numbers to the changes required by the new accounting rules for revenue recognition and presentation of pension expense, which are relatively small. There is Information in this morning's investor update that explains these expected changes to the way our 2017 results will be restated.

I talked last quarter about the pressures on 2018 cost, the new rates with our pilots, the power by the hour deal on our 737-800 engines and the growing mix of higher-cost regional flying. Excluding those items, our unit cost for 2018 would be down about 1% on the 7.5% increase in capacity, a strong result for the underlying business. While my point is not to create a new CASM metric that excludes big-cost items, but it is to underscore the hard work that our divisional leaders did through multiple budget cycles to produce a plan that recognizes our need to keep costs low.

I'll offer us a couple of specific goals. First, we measure overhead as a percentage of nonfuel costs and have set a budget goal for that to be less than 10%. Total overhead is growing by only 2.6%, and our overhead CASM declined by more than 3% in the budget. The second, we budgeted productivity improvements in nearly every operational division. Horizon is a great example, with pilot and flight attendant productivity budgeted to be up 3 points and 9 points, respectively.

We expect Q1 CASMex to increase 6%. Three things drive the increase. First, wages and benefits are higher, with much of that due to the increase in mainline pilot rates. Second, maintenance expense will be up 31% year-over-year, by far the largest increase expected in any of the 4 quarters. Some of this is the power by the hour deal, some is event-driven. And third, we expect to record higher incentive pay expense, particularly for our operational rewards program, which paid almost nothing in Q1 of last year, given our operational challenges. Of course, we have to hit those operational targets to earn those rewards. The Q1 CASM increase will be the highest of the year. We expect much smaller increases in Q2 and Q3, and an ex-fuel unit cost decline in Q4.

One open item that could impact our 2018 costs is a possible deal with our flight attendants. We're working with them now and hope to get a deal done soon. If and when we reach an agreement, we'll revise our cost guidance accordingly. If we can get this done, we'll have 63% of our unionized workforce and 80% of the payroll that they represent under contract through the end of 2019, giving us great cost visibility. Bottom line, our unit costs will rise in 2018, but our team is committed to having a cost structure that maintains a cost advantage over the legacy carriers. And even though the income of the 2019 budget is hardly dry, we're already thinking about 2019 and have a planning mindset that consolidated costs should be flat to down slightly in each 2019 and 2020. This will, of course, depend on capacity growth, it gets harder as capacity growth comes down. And it will also depend somewhat on the timing of the flight attendant deal. That's not guidance, but it is directionally where we think we want to go.

We ended the year with $1.6 billion in cash. Total cash flow from operations was $1.7 billion, excluding merger-related costs. This was a record for us, surpassing 2016's mark by more than $175 million and represents our fourth consecutive year of operating cash flow in excess of $1 billion. CapEx for the year was $1 billion, resulting in $670 million of free cash flow, again, ex-integration costs.

In 2018, we'll take delivery of 12 new mainline jets, bringing the mainline fleet to just over 230 aircraft. Our mainline fuel efficiency will continue to be among the best in the industry at about 80 ASMs per gallon. An efficient fleet is the best hedge against rising fuel prices, but it's worth noting that we also have fuel hedges with strike prices at about the $62 level in place for 50% of our expected consumption in the first 6 months of the year.

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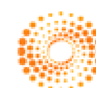

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On the regional side, we're scheduled to take delivery of 25 E175s between Horizon and our CPA arrangement with SkyWest. We expect to retire 13 Q400s, bringing the regional fleet to 95 units at the end of 2018, of which 61% will be modern, comfortable and versatile E175s. In total, we own 67 next-gen mainline and E175 jets free and clear and expect that number to grow in 2019.

Including our $400 million of undrawn lines of credit, our uncapped borrowing capacity will exceed $2 billion by the end of the year.

We expect total CapEx in 2018 to be about $1 billion. In my comments last quarter, I guided to $1.4 billion, which assumed we'd exercise all options for deliveries beyond 2018. Further, we're targeting 2019 and 2020 CapEx to each be about $750 million.

We've been looking at our delivery skyline across all fleet types and plan to take advantage of the substantial 18% growth that we've had in the last 2 years and refine and, as Brad said, optimize our network accordingly.

The CapEx figures above should allow for growth in the 4% range in 2019 and 2020, which is still be above GDP growth. We're very committed to generating free cash flow, and these moves will enhance that.

Free cash flow provides a convenient place to talk about the new tax laws and the anticipated impact on cash flows. In short, we'll benefit significantly. A nice tailwind at a time of rising fuel prices and competitive pressure. Our book effective rate for 2018 should be about 24.5%, but our cash effective rate should be between 10% and 15% after consideration of our acquired NOLs.

Our investment-grade balance sheet continues to get stronger. We ended the year with $2.6 billion of on-balance-sheet debt, down from the end of Q3, driven partly by the prepayment of $71 million of debt late in Q4. Including leases, our year-end adjusted debt-to-cap stands at 51%, an 8-point improvement in the last year.

We should have on-balance-sheet debt down under $2.5 billion by the end of 2018, and we expect debt-to-cap to improve to 50%, even with a couple of points of headwind that we'll face with the adoption of the new revenue recognition rules and the related hit to equity. We remain committed to getting to our goal of having debt-to-cap in the mid-40% range by 2020. We're also well positioned in a rising interest rate environment as roughly half of our total debt is fixed.

During 2017, we returned $223 million to shareholders via $148 million in dividends and $75 million in share repurchases. As you've seen in our press release, and as Brad mentioned, we're again increasing the dividend by 7% to $0.32 per share per quarter. We've now increased the dividends 5 times since we initiated it in 2013.

And before I turn the call over to Andrew, I do want to call out the impact of the new revenue recognition standard that will be effective for Q1 of 2018. Big picture, airlines like ours that have used the incremental cost method for miles earned through travel will now have to defer a portion of their related flight revenue instead. It's important to emphasize that although there will be an impact on reported revenues, it has nothing to do with pricing or cash flows. It's simply a question of timing of revenue recognition. We've provided more information in our investor update to help investors understand the impact on both revenues and costs.

And with that, I'll turn it over to Andrew.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Thanks, Brandon, and good morning, everybody. As reported, total revenues in 2017 rose 6% to $7.9 billion on a 7% capacity growth. Revenues for the fourth quarter grew 6% to approximately $2 billion on 10% growth.

There are specific drivers behind our current revenue performance, and it's important to look at each one to appreciate that our fundamentals are sound, and significant opportunities lie ahead for improved revenue performance. When you dissect the fourth quarter CASM performance of down 4% year-over-year, the following are important:

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Competitive capacity. I want to start with this since it's an environmental factor that is real and elevated at this time. Looking at our network, competitive capacity was up from a 1% increase in Q3 to 4% in Q4. Looking forward, first quarter 2018 competitive capacity is expected to increase 2 points to 6% and another 2 points in the second quarter to 8%. We believe that over time, conditions will improve and our ability compete will get better, which I'm going to discuss in detail shortly.

Same-store TRASM. Same stores represent approximately 90% of our total ASMs, and we grew capacity in these markets by 1.6% during the quarter. TRASM in these markets was down 1.5%. However, after factoring for stage length increases, TRASM was down about 0.8%. The nominal decline is being driven by a subset of markets, as pockets of industry pricing and capacity pressure remain in California. Most of our same-store markets continue to show either flat or positive TRASM.

Turning to new markets. The 44 markets in operation less than 1 year represented approximately 10% of our total capacity and contributed the remaining 2.5 points of the overall 4-point decline in TRASM. Importantly, 28 of the 44 new markets launched in 2017 commenced post-summer break, so many currently operate at TRASM levels well below our long-term expectations. And I want to drill into 2 specific points on this. First, promotional activity to both support these markets and grow loyalty has more than 1-point impact on the quarter. While challenging on the near-term results, this is great for the long-term health of our network. And then second, we are seeing improvement in the performance of our new markets. While it's too early to call in on the most recent additions to our schedule, markets that have operated at least 6 months are already profitable and are tracking ahead of our initial expectations. These results tell me that our service, product and low-fare offering are resonating with guests and gives us confidence that our newest routes will continue to mature over the course of 2018.

The brand health and guest loyalty data associated with our growth initiatives are showing strong year-over-year trends. In California, preference has increased 4 points on a year-over-year basis. And importantly, Alaska's unaided brand awareness now exceeds Virgin America in California by 9 points. We fully expect strong performance in these metrics will lead to greater market share and profitability.

In addition, the volume and quality of the growth we are seeing our Mileage Plan and credit card programs system-wide fuels our optimism that our efforts in 2017 laid the groundwork for strong future revenue performance.

Looking forward, TRASM guidance for the first quarter is down 3.5% to 4.5% on capacity growth of 8% and weighted competitive capacity growth of 6%. The headwinds reflected in this guidance are expected to be the same as the fourth quarter, new markets, pricing in California and promotional activity.

Alaska's full year 2018 capacity guidance is now 7.5%. More than 5 points in this growth comes from annualizing the new flying we launched last year. As Brad mentioned earlier, our network expansion is now largely complete, and our focus in 2018 is to optimize what we built in 2017.

Bearing in mind what I've just shared about fourth quarter performance and the first quarter outlook, I want to spend a moment talking to our owners. I was just reflecting this week that this is my 10th year with you on quarterly earnings calls. And while every call addresses current results, Alaska's executive team have always run this company with the express goal of delivering sustainable returns to our shareholders that are above our cost of capital, and we have done just that over this past decade.

The acquisition of Virgin America, which only closed 13 months ago, is arguably the single-largest impact to our business outside of the Great Recession over these past 10 years. And the reason I raise this is we're only 3 months away from a single reservation system. While some will insist on comparing our current revenue performance to carriers who achieved this single reservation system anywhere from 2 to 8 years ago, the reality is, we are about to unlock the critical levers we need to generate revenues required to continue delivering on returns to our shareholders. This upside is obviously not reflected in current results, but it will be reflected in future results.

The opportunities that will begin to materialize post-PSS include the following: first, all but one of our international partners that serve California, that's approximately 50 wide-body departures a day, will gain full access to the acquired network from Virgin America, including the 9 new markets we started with Airbus metal over the past 6 months.

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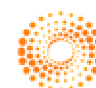

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We will commence moving Boeing and Airbus around our network to leverage the significant gauge and trip cost differences to ensure that we have the right aircraft in the right market to maximize revenue and profitability. This will build Q2 to Q4, with full cross-fleeting in effect by the beginning of 2019.

E-commerce resources will free up to ensure that the significant loyalty growth we've achieved since acquisition will continue and that we capitalize on a single guest experience, whether via digital channels at the airport or in the air, and this will drive incremental revenue over the long term.

Our first reconfigured Airbus will enter service in September, and the additional seats will -- we will gain will not only reduce Airbus fleet CASM, and now Airbus represents approximately 25% of our mainline fleet, it will result in meaningful increase in First Class seats and the introduction of Premium Class on these aircraft. This will drive both incremental revenues and the ability for our Elites to obtain better access to upgrades.

And finally, with a single reservation system, we will be able to address upsell and segmentation opportunities which the legacy carriers are executing on today and that we have not been able to participate in. There are a number of ways for us to participate. Basic economy is just one of those, fair families and ancillary bundles are others. And whatever approach we take, we are committed to tapping into the opportunity before us to increase upsell and ancillary revenues. This particular opportunity would represent incremental revenue above our stated synergy targets for the merger. We are just beginning to evaluate the full potential of upsell and will share more with you on our future calls.

While the full carriers that represent about 85% of U.S. domestic revenues have taken to adding significant capacity in our core network while we integrate, the switch to a single reservation system for all the reasons above will increase our ability to weather these challenges. Our history is one that is built upon adversity and has always resulted in us becoming stronger. And it is my firm believe that the competitive landscape we face today will do just that again. And since we'll only enter a handful of new markets in the year ahead, we'll be able to fully turn our attention to optimizing our product and pricing across the newly established network.

So with that, let's go to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Savi Syth with Raymond James.

Savanthi Nipunika Syth - *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

I was just wondering if I could follow up on the operational improvement in fourth quarter. And it seems like you're still kind of behind on historical levels. Just wondering what the expectation is for the improvement as you go through the year. And maybe kind of separate that out by the issues that you've had in kind of the Northwest versus California.

Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

It's Ben. Yes, you're right. We saw a great improvement in the fourth quarter. And one of the things we've done in 2017 with this merger is put our Alaska operational process within the Virgin network. So everything now is operating within the same framework, the same mentality of how we operated Alaska in the past. So our goal, just to be really honest, is to lead the industry in operational excellence.

Savanthi Nipunika Syth - *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

What's the timing around that, Ben?

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Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

Starting now. Starting immediately.

Savanthi Nipunika Syth - *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

Okay, all right. And if I may just ask the -- on the follow-up question on the targeting of flat to down CASMex in '19 and '20, given the slower growth, any drivers of that, that will help reach that goal?

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

So Savi, you're asking about our capital spending and capacity growth in '19 and '20?

Savanthi Nipunika Syth - *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

Or a more of the cost side of things than capex target.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Brandon, why don't you...?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

It's Brandon. Yes, it's the things I mentioned. It's being really, really keen on productivity. It's really being frugal in the back office. It's watching the overhead. There may be some structural things that we need to consider. But at the end of the day, we've had 2 years now of cost increases, and I think we need to get back to flat to down CASM. And that's where our mindset is, and we're already starting to think about 2019 today, as I said in the prepared remarks.

Operator

Your next question comes from Andrew Didora with Bank of America.

Andrew George Didora - *BofA Merrill Lynch, Research Division - Director*

I guess, just a follow-up to Savi's question, maybe to ask it in a little bit of a different way. I guess, now that you've gone through a big part of the integration, you've been operating in California on a bigger scale for a year now, how would you rank your operations in California versus your Pacific Northwest operations? I would think they are worse, and do you think they can ever get back to where Alaska was premerger?

Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

It's Ben, again. Obviously, California is a little tougher with San Francisco. We're dealing with ATC programs on a daily basis. One of the strategies we have in place right now is to operate the best we can in California. Part of doing that, one, like I said, is putting operational process in terms of departing airplanes always on time like we do. We call that controllable departures on zero. The second part is dealing with ATC strategies. So we've got a team focused on ATC mitigation on a daily basis with our management team and with our dispatchers. It also has schedule implications.

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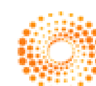

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How we structure the schedule when we depart, type of airplanes we put at different times of the day. So our goal really is to mitigate it to the largest extent possible and to, on a network basis, get the highest operational performance.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

And Andrew, this is Andrew Harrison. Just one follow up really to your questions and Savi's. We acquired -- with the Virgin America acquisition, we walked into 2017 inheriting a network with block hours totally separate than we planned for. And it wasn't until late in this year were we able to push through block changes and changes to the operation to start to stabilize it. That's why Ben and I are confident that as we move into '18, we would have time to restructure the network, get the block times right, understand how we're going to fly. And going into '19, we think this machine is really going to start to hum.

Operator

Your next question comes from Joseph DeNardi with Stifel.

Joseph William DeNardi - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

Brandon, just on the CapEx outlook, it seems like that's changed quite a bit relative to how you guys were thinking about it before. You're going to have to forego some options that you were maybe thinking about taking earlier. So can you just talk through, I guess, what changed? And what the uses of cash are going forward?

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Yes, Joe, this is Brad. I might start with this. One of the things that Alaska has prided itself in is being good stewards of capital. And as part of that, I think we've been a pretty contrarian management team. There've been times when the industry has been down where we've chosen to grow aggressively. And then in other environments, you've got to make the right decision. As we look at the environment today, I will say we are extraordinarily confident about our competitive advantage. We do think our low costs, our operational capability, our real -- our network is solidly profitable. But the opportunities aren't the same as they were 3 or 4 years ago. And so if you are a good steward of capital, you've got to make the right decision at the right time. So as we look at '19 and '20, we're going to grow considerably. We'll grow 4% each of those years. That's enough to hang onto our current market position and grow a little bit, but it's not at the same level. I was looking back last night, our growth over the last 5 years without Virgin America has been 7%, 7%, 10%, 10% and 7% or something like that. And it's -- if you look at -- fuel prices are up $20 a barrel in just the last 6 months. Capacity is up. As we look at the future, we're going to grow. But we just don't think -- in terms of us being great stewards of capital and providing the returns on capital that we want to provide and that we will provide, we just don't think this is an environment that argues for 7% or 8% growth. It argues for a lower growth number, and that's what we?ve got to do.

Joseph William DeNardi - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

Okay, that's very helpful. And then, Brad, another one for you. When you look back at kind of the experience thus far with acquiring Virgin, I think maybe you paid a little bit more than you would've wanted to. The integration seems to be largely on track, maybe a little bit better. Can you just talk about your appetite for M&A in the future? And whether your experience with Virgin makes you more or less comfortable looking at acquiring other airlines in the future?

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Joe, that is a great question that I don't think we're going to answer. But I will just say, the Virgin experience has been a good one. We've -- the company has got an $8 billion platform today. It's considerably better than our platform before. That brand has pushed us. Those people were

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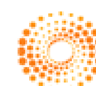

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great marketers. If you look at the way Alaska is promoting itself, I think it's activated something inside us in terms of getting into California, growing loyalty. It's been a really good thing for this company. We've got through a lot. We're very, very excited about the future. But in terms of us talking about other M&A activity, I don't think we're going to bite on that.

Operator

Your next question comes from Michael Linenberg with Deutsche Bank.

Michael John Linenberg - *Deutsche Bank AG, Research Division - MD and Senior Company Research Analyst*

Two questions here. Brandon, you talked about your cash tax rate being 10% to 15% after consideration of acquired NOLs. And I believe with the acquisition of the company, you may have called out in your, I don't know, if your 10-K or 10-Q, that maybe you would potentially be limited on the use of the NOLs. Or maybe I'm wrong on that. Do you have -- are you going to be able to use -- fully utilize the NOLs that you've got as a result of the Virgin acquisition?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Yes. We think we will. We started the year with, I don't know, $750 million of NOLs or something on a gross basis. We think we'll be through that by the end of 2019, so the 2019 tax year.

Michael John Linenberg - *Deutsche Bank AG, Research Division - MD and Senior Company Research Analyst*

Okay, very good. And just second question to Andrew. You called out some of the competitive pressures that you're seeing in California. And I believe last quarter, maybe it was the prior quarter, you called out California, I think you also called out maybe some pressure on the transcons, and I just -- I didn't hear that on this call. And I'm just -- I'm wondering has the -- for you -- your transcon sort of situation, revenue environment, has that improved or may be stabilized for you? If you could provide some color on that, that would be great, given it's a sizable part of your network.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Yes, thanks for the question. Transcon, we do have a lot of transcon in California. What I -- and we don't like to talk about regions, but what I will tell you is load factors are actually up and traffic is extremely strong. I think that what I've been looking at on a network basis is that our seasonality with the merger with Virgin America has actually got worse in the first quarter or in the September/October months and stronger in the summer peak periods. And so we have a real opportunity as we go through this year to restructure our network for these shoulder periods to actually leverage better growth and unit revenue performance. So I would say that California, we feel very good about. As I shared in my prepared remarks, in a lot of the places where we're feeling weakness and pressure, I should say, we have a lot of things coming that we feel are going to significantly strengthen our position.

Operator

Our next question comes from Rajeev Lalwani with Morgan Stanley.

Rajeev Lalwani - *Morgan Stanley, Research Division - Executive Director*

Two questions. Andrew, I guess, first for you. Can you just walk us through when we should start to see a lot of stability in your RASM? And then, I'm guessing 2Q might be tough, just given comparison to the competitive capacity. And what's the goal which you're trying to get to? I mean, you

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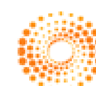

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did a good job of laying out capacity, et cetera, a bit. Are you trying to get RASM up sort of like Southwest is describing? Just how are you thinking about it?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Sorry, Rajeev, I missed the first part of your question, specifically to something. And I'm sorry, I'm -- could you repeat that?

Rajeev Lalwani - *Morgan Stanley, Research Division - Executive Director*

When do start getting to a level of stability on RASM trends? I'm guessing it's not the second quarter, or maybe it is?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Got it. Yes, stability, in fact, we're hoping for stability trends as we move into Q2, but really into the back half of the year, where, given all things were equal today, we feel like there should be stability northward trends in our unit revenues going forward, especially if some of the things that we shared earlier start to kick in. And as I shared earlier too, we're working on all of our schedules right now. We've got better seasonality coming up in the second half. So that's what we're focused on.

Rajeev Lalwani - *Morgan Stanley, Research Division - Executive Director*

Okay. Sorry, and then the second part of that question was just, in terms of RASM, do you have a general goal as far as where you want to go? And like Southwest talks about maintaining positive RASM going forward, is that something that you're looking to get to? Or are you approaching it in a different way?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

I think, really, what we're focused on is profits. And RASM needs to do what it needs to do, costs need to do what they need to do to get higher returns to our shareholders. So that's really what we're focused on.

Rajeev Lalwani - *Morgan Stanley, Research Division - Executive Director*

Okay. And Brandon, a quick one for you on the CASM side. More of a clarification, I guess. As far as flat-to-down goal that you laid out, that is based on 4% or so capacity growth and that does or doesn't take into account the flight attendants and technicians, et cetera?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Correct on both counts.

Operator

Your next question comes from Hunter Keay with Wolfe Research.

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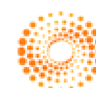

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Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace & Defense*

So you talked about $225 million of synergies originally with this deal, and $175 million of it was on the revenue side. So to look at this commentary about CASMex flat to down in '19 and '20, and you said you're going to get a couple hundred million dollars in revenue -- in synergies, I think you said this year. And given that 1 point of RASM is only about $70 million, I guess that implies that we could be sort of leaving 2018, given the deceleration in capacity, on a pretty strong trajectory on RASM if you are, in fact, capturing the majority of those synergies on the revenue side, as you laid out in the presentation. Is that fair?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

This is Andrew, again. Hunter, I don't have a crystal ball, but I -- that's what we see and that's what we believe. And I will also tell you just to say it now that the upsell and segmentation opportunity that we are looking at, that is not in the synergy numbers, and we think that's $100-plus million a year or more once we get that up and running.

Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace & Defense*

Okay, good. And when we think about the 4% capacity growth in 2019, and we'll just focus on 2019, you originally said you were going to be up 6% to 7%. What did you scale back? Was it some new market growth? Was it just a function of a little bit of stage length and some gauge moving around? Did you kill off certain underperforming routes? Or are you just not going to start certain routes you maybe planned on doing? Can you talk us through to the amount -- to the extent you can, what changed in the plans specifically?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

We have long-term plans. And quite frankly when we looked out, if you take the fuel of this last year, the capacity and the economic environment, there were markets that we wanted to continue to invest in, really not new markets but add to some of the core. But the environment has definitely changed, and so we're going to be watching our network and we won't be adding capacity to markets that don't need capacity added. So that's really the major change, but our core network and our footprint is fundamentally where it needs to be for a while.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Yes. And Hunter, I might add to that. With all of the growth that we've done in the last couple of years, we do have the utility that we wanted to get to California. I don't think we know exactly where the 4% of '19 or '20 are going to go, but I think our thinking is that we want to take care of our core. We've got core loyal customer bases, economic models that are working very, very well. We're going to sort of bolster those and invest in those, and then we'll see what opportunities happen beyond there. But I think we will pay attention to the core first is what I'm trying to say.

Operator

Your next question comes from Dan McKenzie with Buckingham Research.

Daniel J. McKenzie - *The Buckingham Research Group Incorporated - Research Analyst*

I guess first question here is, I'm wondering if you can just help us understand just how big the cost and revenue overhang is from the integration process in the first quarter here? So I think investors are having a hard time connecting the dots on what all these things could really mean to margins, so anything you can share is appreciated. So maybe imagine that you've got a single reservation system in place, the international partners are on the platform, the Airbus aircraft are reconfigured, you didn't have the cost inefficiencies, what might this have meant? What would this potentially mean, like, for the first quarter here, just for perhaps some perspective?

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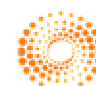

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Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Dan, it's Brandon. Can you just repeat your question, just so I can make sure I understand it?

Daniel J. McKenzie - *The Buckingham Research Group Incorporated - Research Analyst*

Well, yes. I'm just trying to get a sense of how big the overhangs, the cost and revenue inefficiencies are in the first quarter here, just by not having the airlines fully integrated. So there's a lot of things that happen after the integration, after April. I'm just trying to get a sense of -- investors are kind of having a hard time connecting the dots. I'm just trying to get a sense of what this potentially could mean? What this might -- what it could've meant, say, here in the first quarter if the merger had been completed, say, in December?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Yes, it's -- we haven't quantified it specifically, but what I will say is, we made the comment in the prepared remarks that we do really have all of the costs of the integrated company without all of the revenues. And there are specific costs in -- that we will incur that even, frankly, don't get quoted as integration costs that will be in our business through PSS, certainly perhaps through the first half of the year, and those are extra time in our call centers and extra time in the operation as we kind of put all this stuff together. Is it $50 million? No. Is it more than $5 million? Sure. If I had to just kind of put a number on it, I might say that there's $10 million in the first 4 months of the year of cost friction, if you will, that will dissipate as the year goes on. On the revenue side, we have, as Andrew described, the opportunity to unleash a whole bunch of new revenue once we get PSS behind us, starting in late April. And that will start then and continue to grow as we move through the year. And we've talked about it in the context of our revenue synergy opportunity. So there's -- you can do some math and kind of figure out what we would've had, had we pulled it forward to, say, January 1. But it's hard to quantify really. But it is real. Your point is right. It is real, and it's one of the opportunities that we see as we move into the second half of '18 and into '19 to really improve the financial performance of our business.

Daniel J. McKenzie - *The Buckingham Research Group Incorporated - Research Analyst*

Yes. And then Andrew, with respect to your remarks on the embrace of basic economy or something similar, can you elaborate a little bit further on what it's costing you today by not having it? And what could be the timing for any rollout as you move in that direction?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Dan, I'll let Shane talk to you more about that.

Shane Tackett - *Alaska Airlines, Inc. - SVP of Revenue Management & e-commerce*

Thanks. The -- I think that Andrew mentioned segmentation, obviously, basic is sort of where everybody else has gone. We have modeled the impact. Andrew just mentioned, we think it's north of $100 million once it's fully out and running and sort of optimized, which -- that would take some time. I would just say, other airlines, I think, it took a year or more to get to market and sort of fully roll it out to across their network. I think some of them are still expanding it now into international. And I think we'll go faster than that. We certainly are going to be motivated to be faster than that, but it's not something that's going to hit like Q2, as an example. And I'll just say, we haven't decided on what this would look like for us. And it could be something that's like basic. We tend to not do me too?s of sort of the network carriers, our business is a little bit different. It usually doesn't need the same product set. So we're looking forward to being able to talk with you guys on a future call about what this might look like for us.

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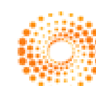

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Operator

Your next question comes from Jamie Baker with JPMorgan.

Jamie Nathaniel Baker - *JP Morgan Chase & Co, Research Division - U.S. Airline and Aircraft Leasing Equity Analyst*

Just a housekeeping question on this 4% growth figure for '19 and '20. I'm just trying to understand how new this actually is? I mean, you had already indicated at Investor Day that you were going to be slowing pretty significantly after 2018. So could -- wasn't this the original figure? Could you give us sort of a genesis of maybe when as opposed to how you reached the new figure?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Jamie, it's Brandon. We've always talked for the last 7 or 8 or 9 years about growing in the 4% to 8% range. As Brad alluded to earlier, we've been on the high side of that. Andrew, last quarter, I think articulated a desire to grow 5% to 6% in 2019. And so really that change has happened in the last 90 days, and the genesis of the changes are the things that Brad talked about, which is the rising fuel price environment, the additional capacity that we're seeing. And frankly, it's just we don't see as much opportunity to produce the kinds of returns that we want to. And so over the last 90 days, as I said, as we've thought about our 2018, '19 and '20 plan, we really wanted to dial it back. It's still on a big base and it's still higher than GDP, but it is the right level for us going forward.

Jamie Nathaniel Baker - *JP Morgan Chase & Co, Research Division - U.S. Airline and Aircraft Leasing Equity Analyst*

Okay. Yes, that's perfect clarification. And second, we got a RASM guide from you for the quarter. Thank you, very much appreciate it. But the industry is starting to pull ahead again. We're starting to see actual earnings guides from airlines, and look, they may prove wildly inaccurate. Who knows? But just like buybacks and dividends have the additional benefit of acting somewhat as a governor on growth, you could argue that having managements beholden to actual earnings guides could also limit maybe some of the riskier competitive behavior that we occasionally see out there. I kind of feel like a kid that already opened his Christmas present and now he's asking for another one, the first one being RASM. But have you given this any thought? Once we get a little bit further through, do you think you'd play catchup once again to the industry? Any thoughts?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Baby steps, Jamie. Baby steps. In all seriousness, what I would say is -- and we did talk about that a lot. And for us, you're right. It's the first time we've guided to RASM, and we plan to do this going forward. But we really landed on a way of thinking about where we say, let's guide to what we can control. We've got it on capacity. We've got it on CapEx. We've got it on near-term unit revenues, not long-term unit revenues. So I think we're very comfortable guiding to what we control. And on the rest, we'll respond to what we get in a way that's best for our shareholders.

Operator

Your next question comes from Helane Becker with Cowen.

Helane Renee Becker - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

So I don't know if Andrew or Brad want to answer this question, but what's the thought behind the growth at Paine Field? And looking at the roots that you're adding, I suppose you're not expecting connecting traffic there?

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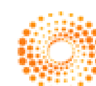

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Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Yes, Helane, maybe I'll start. We'll get Andrew to weigh in. But I think Paine is roughly 30 miles from Sea-Tac. But for those who live in Seattle, they know the getting from Snohomish County to Seattle is very, very difficult. Traffic -- there's long delays in the morning. So this is going to be an enormous benefit for our customers that live in the northern parts of the city, Snohomish County area. I think, Andrew, you'll correct me, but I think it's something like 20% or even more, 22%, 23% of our customers that are flying out of Sea-Tac might prefer Paine as an option for them. So that's some of the thinking behind it. In terms of connectivity, I think we're thinking more Portland than anywhere else, Andrew, but maybe you can elaborate on that.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Yes. No, I mean Brad's pretty much hit it dead on. I think what it does for us is it makes us able to provide more convenient travel for our guests directly. I mean, these are big markets for us that we serve today, and so we're going to serve them in a more convenient way for guests. And it allows us to move capacity around in Sea-Tac for other markets that we want to put metal in because it's getting constrained.

Helane Renee Becker - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Got you, okay. I think that was all my questions. I was going to ask a unit-revenue-related question on trends, with a peer group seeing up unit revenue and you guys still seeing down unit revenue, but it seems like you're starting to address that, this difference.

Shane Tackett - *Alaska Airlines, Inc. - SVP of Revenue Management & e-commerce*

Yes, Helane, this is Shane, again. You're absolutely right, we're fully aware of sort of the directionality of the industry and us. And I think we are interested in our sort of absolute revenue performance and what sort of revenue production this company needs to produce returns we want. And that's what we're committed to figuring out how to go get in the next several quarters.

Operator

Your next question comes from Brandon Oglenski with Barclays.

Brandon Robert Oglenski - *Barclays PLC, Research Division - VP and Senior Equity Analyst*

I just want to go back to the third quarter call, and I know as we move forward in the integration, you guys are going to talk more and more just about the Alaska network. But I think there's some lingering fears that the Virgin integration maybe isn't going quite to plan. And we talked about that last quarter, I think you guys called out some pretty significant revenue underperformance at Virgin. And Andrew, I think you talked about the transcon markets to an earlier question, but can you guys just comment further, how's the revenue dynamic playing out core of Alaska versus core of Virgin? And do you feel you've got the right strategy in place to fix some of those deficiencies?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Yes. I mean, just to get back on to the third quarter call, I mean, I can't reiterate enough how inheriting a network on December 17 that is already being scheduled and planned not done under Ben's operational parameters, not under our normal parameters has been very, very challenging for us. What you've heard me share on the call, Brandon, is that we view our network in really 2 pieces. There is same-store sales, which includes California and the rest of our network that's been in operation for a year and getting that improved, and then our new markets and getting those improved. I think as we look again into 2018, we look at the international connectivity, we look at these initiatives, the California marketplace, specifically, will benefit greatly from these changes that are occurring in 2018 and beyond.

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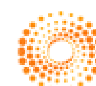

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Shane Tackett - *Alaska Airlines, Inc. - SVP of Revenue Management & e-commerce*

And I would just add that the California markets as a whole are up materially in load factor year-over-year. New markets, inter-Cal, California Transcon. So we're excited about the demand and traffic overall that we're seeing.

Brandon Robert Oglenski - *Barclays PLC, Research Division - VP and Senior Equity Analyst*

Okay. And this next question is going to be a little more difficult I think. If we go back a year in time, I think a lot of investors were benchmarking profitability at that time saying, okay, put a pilot deal and some headwinds in '18, but then wear in the synergies from a much higher earnings level. I mean just looking at consensus EPS for 2018 back then, and obviously fuel has changed and everything else, but we were talking about an 8-dollar handle, now we're talking about a 6-dollar handle with the lower tax rate. So what -- just looking forward, when you guys are talking about the synergies in the deal, should we be thinking the level of profitability that we're modeling this year is the right basis from which to now be adding the deal synergies? Or should we be thinking, hey, what was attainable a year ago, given a little bit of time and ability to catch up on fuel, we should be back to that level of profitability?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Brandon, it's Brandon. The only thing I can say to that is, and I actually don't know the answer to your question, is that we are focused on delivering adequate returns to our shareholders. And this is an extraordinarily dynamic industry with lots of competitive capacity that comes in, it comes out, labor markets move, plans change. So what I would say is that it's hard to say what was then versus what is now. What I can say is where we are now is not a place we want to be and we're looking to improve the results going forward.

Operator

Your next question comes from Susan Donofrio with Macquarie Capital.

Susan Marie Donofrio - *Macquarie Research - Senior Analyst*

Just wanted to touch base on the employee side. I'm just wondering what you're doing to smooth out and just make sure that the 2 cultures are blending together?

Benito Minicucci - *Alaska Air Group, Inc. - President of Alaska Airlines Inc and COO of Alaska Airlines Inc*

It's Ben. Well just to start, our people and culture are something we cherish a lot at Alaska. And Virgin had a great -- has a great culture. And if you remember what we said last time, it's one of the things we did first was align on the purpose of our airline, which is creating an airline people love, and then we reestablished the values of the airlines. One of the things we're doing is making sure that every 23,000 of us at Alaska, Horizon Air Group are delivering our purpose and values. That's the one thing how you get your culture aligned. The second thing we're doing is we're getting leaders out in the operation. We are out a lot. Our frontline leaders are out a lot, talking about the importance of coming together as one team, as a new Alaska coming together and focusing on just running the best airline we can, and I think we're making progress. We've been out the last couple of weeks, we're going to be out the next 2 weeks, and we have a steady cadence of communication and getting out with folks.

Susan Marie Donofrio - *Macquarie Research - Senior Analyst*

Terrific. And then just a follow-up just on the overall merger. You had spoken before about just some extra cost related to like res agents, et cetera, just explaining things that you didn't expect. Are those costs starting to abate now that you're getting more well known in your markets?

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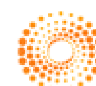

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Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Susan, it's Brandon. Yes, I think so. A lot of that cost really come as a result of transition, whether it's transition moving people from a Virgin flight to an Alaska flight or a transition because of changes in our loyalty program as we move people from Elevate into Mileage Plan. And by the way, I'd like to thank our res folks and our customer service agents because they've had to deal with the lion's share of this, but that does go away. And once we get through PSS, I think it's safe to say that the vast majority of that will have been abated.

Susan Marie Donofrio - *Macquarie Research - Senior Analyst*

Great. And then just can I -- an unrelated follow-up. Can you just comment on the Hawaiian market, and just what you're seeing there right now?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Susan, this is Andrew, again. We don't like to comment specifically on regions, but we have been in that market for 10 years now. We've got it finely tuned, and we're very happy with how we're running and operating that today.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO & President*

Okay. I guess our team is telling us that Susan had the last question. We want to thank you all for tuning in. We look forward to chatting with you next quarter. Thank you.

Operator

Thank you for participating in today's conference call. This call will be available for future playback at www.alaskaair.com. You may now disconnect.

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