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ALK.N - Q2 2022 Alaska Air Group Inc Earnings Call

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OVERVIEW:

Co. reported 2Q22 total revenues of $2.7b and GAAP net income of $139m.

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CORPORATE PARTICIPANTS

Andrew R. Harrison *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer & Executive VP*

Benito Minicucci *Alaska Air Group, Inc. - President, CEO & Director*

Emily Halverson *Alaska Air Group, Inc. - Controller & Principal Accounting Officer*

Joseph A. Sprague *Alaska Air Group, Inc. - President of Horizon Air Industries, Inc.*

Kyle B. Levine *Alaska Air Group, Inc. - Chief Ethics & Compliance Officer, Senior VP of Legal, General Counsel and Corporate Secretary*

Nathaniel Pieper *Alaska Airlines, Inc. - SVP of Fleet, Finance and Alliances*

Shane R. Tackett *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

CONFERENCE CALL PARTICIPANTS

Andrew George Didora *BofA Securities, Research Division - Director*

Christopher Nicholas Stathoulopoulos *Susquehanna Financial Group, LLLP, Research Division - Associate*

Daniel J. McKenzie *Seaport Research Partners - Research Analyst*

Duane Thomas Pfennigwerth *Evercore ISI Institutional Equities, Research Division - Senior MD*

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

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

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

Ravi Shanker *Morgan Stanley, Research Division - Executive Director*

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

Scott H. Group *Wolfe Research, LLC - MD & Senior Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Alaska Air Group 2022 Second Quarter Earnings Call. (Operator Instructions) Today's call is being recorded and will be accessible for future playback at alaskaair.com. (Operator Instructions)

I would now like to turn the call over to Alaska Air Group's Vice President of Finance, Emily Halverson.

Emily Halverson - *Alaska Air Group, Inc. - Controller & Principal Accounting Officer*

Thank you, operator, and good morning. Thank you for joining us for our second quarter 2022 earnings call. This morning, we issued our earnings release, which is available at investor.alaskaair.com. On today's call, you'll hear updates from Ben, Andrew and Shane. Several others of our management team are also on the line to answer your questions during the Q&A portion of the call.

This morning, Air Group reported second quarter GAAP net income of $139 million. Excluding special items and mark-to-market fuel hedge adjustments, Air Group reported adjusted net income of $280 million. As a reminder, our comments today will include forward-looking statements about future performance, which may differ materially from our actual results. Information on risk factors that could affect our business can be found in our SEC filings. We will also refer to certain non-GAAP financial measures such as adjusted earnings and unit costs, excluding fuel. And as usual, we have provided a reconciliation between the most directly comparable GAAP and non-GAAP measures in today's earnings release.

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Over to you, Ben.

Benito Minicucci - *Alaska Air Group, Inc. - President, CEO & Director*

Thanks, Emily, and good morning, everyone. Our performance this quarter continues to demonstrate the underlying strength of our business model and ability to adapt to a rapidly evolving external environment. We are in a period of record-breaking demand, which is reflected in the solid Q2 results we reported this morning.

Our 14% second quarter pretax margin lands us near the top of the industry - remarkable achievement, given the fact that fuel expense is up 65% versus the same period in 2019. June especially was a phenomenal month as revenue surpassed $1 billion, the highest monthly revenue recorded in our history. And we achieved this on capacity still below 2019 levels.

Bank cash remuneration increased 40% in June, demonstrating the power of our renewed credit card deal and the strength of our terrific partnership with Bank of America. And lastly, we generated record revenue from our airline partnerships during the month representing over 8% of coupon revenue, an exciting result given that international and business travel haven't fully unlocked yet.

Meeting these historic levels of demand is both exciting and challenging and we are rising to the occasion. June is proof of this, marking an important turnaround in our operation as we were at or near the top of the industry in both on-time performance and completion rate for the month, with this trend continuing into July. Our fundamental commitment to our guests and our people is to run a safe, reliable, on-time airline. It's that simple, and we will continue to prioritize those requirements as we move forward.

I'm very proud of the turnaround our team of 23,000 has delivered over the past 2 months, and I want to extend my thanks to all of them. This is a complex industry that has become more challenging lately. Our team has persevered, met new challenges with professionalism and care and continues to put their best into the company and operation each day. This year, we are celebrating our 90th year as an airline, which is a remarkable accomplishment for any business, but especially in this industry. To celebrate our remarkable people, we issued 90,000 miles to Air Group employees that they can use to fly with us or anywhere our oneworld and other partners' fly.

Now let me briefly outline some areas that are going well for us, along with the challenges we continue to manage through. Of course, demand is a bright spot as guests take summer vacations and get out to visit friends and family and business travel continues to return. Andrew will talk more about demand, including what we're seeing into Q3 and growing revenue contribution from our credit card as well as our domestic and international partners, which is great to see.

We continue hiring at a rapid pace and are consistently meeting our hiring goals. We are currently at our target staffing levels across most work groups and locations.

Our transition towards a single fleet remains on track. Our MAX fleet continues to grow, while the A320s and Q400s will be fully retired by early 2023, followed by the A321s at the end of 2023.

This quarter, we also reached a tentative agreement with the International Association of Machinists, who represent 5,000 customer service, stores, reservations, ramp and clerical agents. The TA is undergoing ratification voting and provides raises for our people and an extension of the current contract by 2 years to 2026. We look forward to reaching new contracts with both our Alaska and Horizon pilots as well.

Finally, our relative financial performance is strong, which is our commitment to owners. Year-to-date, we've generated $1.2 billion in cash flow from operations with $600 million in free cash flow.

On the challenge front, fuel costs remain an issue for the industry. Our hedges continued to dampen the impact for us, and we expect our full year hedge benefit to be approximately $200 million based on the forward curve as of July 18.

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Pilot attrition is another challenge we are attentive to across Alaska, Horizon and SkyWest. Attrition is most acute at our regional carriers and is a constraint across the industry. This is evidenced by industry regional capacity that is down 20% to 30% versus 2019 as mainline carriers hire pilots at unprecedented levels.

And lastly, as is the case for the entire economy, supply chains remain disrupted by the pandemic. We are working with key partners closer than ever before and will be more conservative in planning our operation and capacity until we see higher levels of stability and predictability. Our aircraft, engine and component partners are working extraordinarily hard and we'll continue to support them in their efforts.

As we look forward, we are committed to producing strong financial results this year while also priming our company for success in 2023 and beyond. I am excited about what we can deliver on this front over the next few years. We are growing our fleet with new efficient aircraft within an improved competitive network, and we're expanding global connections through our partnerships. Our relative cost advantage remains intact despite industry headwinds overall, and our focus on enabling structural cost improvements and our move to single fleet will be a powerful enabler for us going forward. And finally, we've unlocked commercial levers that are already materializing and are set to drive incremental benefit for us over the next few years.

We have all the elements in place to continue to drive sustainable and profitable growth here at Air Group, and we are setting ourselves up to continue to deliver industry-leading financial results as we have done so for so many years.

To wrap up, demand in the short term remains robust despite real headwinds that exist in the economy and our industry today. Headwinds like the war in Ukraine, stubbornly high fuel prices, high inflation and a potential recession. And even with these negative factors, we still expect to deliver strong financial performance this year with double-digit pretax margins in the third quarter as well as our 6% to 9% full year pretax margin.

As anyone who has been in the airline industry for a period of time learns, long-term success only comes from taking one step at a time. The strategic steps we've taken - streamlining our business, moving to a single fleet and capitalizing on commercial opportunities - are set to make Air Group a stronger company, positioning us well in any environment.

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

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer & Executive VP*

Thanks, Ben, and good morning, everyone. My comments today will focus on second quarter results, our third quarter guidance as well as progress on commercial initiatives.

I want to start with a tremendous revenue result for the quarter. This was the highest revenue-generating quarter in our history. Second quarter revenues totaled $2.7 billion, demonstrating the swift change in environment compared to how we started the year. Second quarter revenue was up 16% on capacity that was down 8%, leading to an impressive 26% increase in unit revenues. Very strong demand, coupled with reduced industry capacity, resulted in Air Group flying record load factors for all 3 months of the quarter; April at 87%, May at 87.5% and June finishing at 89.6%.

Yield increased over 20 points from April to June, and we outperformed our own midpoint guidance for the quarter by 3 percentage points. I'm also excited to share that May marked the first time revenues from our business channels exceeded pre-pandemic levels, a testament to our partnership with Amex GBT, American Airlines and the resilience of our small and medium business customers.

We saw revenue strength across all regions. And from a product perspective, premium revenues continued to accelerate from the first quarter. For this quarter, both first class and premium class revenues were up 30% with paid load factor up 8 points in first and 16 points in premium versus 2019. We offer a fantastic premium product, which aligns well with our long, average stage length for a domestic carrier. Today, premium seats account for about 1/4 of our total seats and this mix will only continue to improve as we retire the A320s and bring on the MAX 9, which will have 11% more premium seating.

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As we shared with you at Investor Day, our loyalty program and Bank of America card was going to be a revenue and profit accelerant. Q2 is proof of this. Cash remuneration from the bank this quarter was up 43%, while total loyalty revenues were up 58% versus the second quarter of 2019, both primarily driven by strong bank commissions and mileage plan redemptions.

As we've shared, approximately $195 million of my team's 400 million commercial initiatives relates to product and loyalty. We expect to recognize approximately 70% or $135 million of the revenue from this initiative in our P&L this year.

And lastly, we get to talk about meaningful results from our oneworld membership. As global travel restrictions have eased and international travel rebounds strongly, we've been encouraged by the incremental revenue we saw this quarter. In June, our alliance relationship drove a record amount of revenue, representing approximately 8% of total coupon revenue, as Ben mentioned earlier. This is a full 2-point increase over 2019. We are currently revisiting our revenue estimates from oneworld and our partners because if June volumes are indicative of what we will see going forward, we will need to revise our internal forecasts upwards.

Looking ahead, we are well positioned to produce another solid financial quarter. Undoubtedly, we are in an exceptional demand period and the moderated capacity outlook sets a strong backdrop for our revenue performance. Considering current trends, which I'll expand on in a minute, we expect third quarter revenues to be up 16% to 19% on capacity that is down 5% to 8% versus 2019. This implies unit revenues up approximately 26%, flat sequentially versus the second quarter but a strong result on slightly higher capacity.

With that guidance provided, I do want to offer more color on the trends we're seeing today, which are factored into these estimates. For clarity, demand remains very strong. Leisure demand continues to sit well above 2019 levels, while our business channels have now recovered fully revenue wise. While corporate business travel volumes have been a little choppy, we do expect these volumes to continue to recover from their approximate 75% to 80% levels today. That said, we do recognize that there are significant pressures on consumers, including rising interest rates, high oil prices and inflation, which if persists, are likely to put downward pressure on demand and therefore, pricing from where we are today as we enter the fall.

There was a very aggressive run-up in yield during the second quarter. And while we look to have peaked in yields, new bookings remain at historically high yields just not as high as the past few weeks.

Touching on capacity for a moment. Our regional partners, like all others across the industry continue to face pilot staffing and training challenges. Compared to 2019, approximately 35% of our CPA block hours have been removed from the rest of 2022, impacting our second half capacity by approximately 3 points. We expect these headwinds to persist well into 2023.

Apart from accelerating the retirement of our Q400 fleet, we've also taken several proactive network steps to mitigate the impact of this lost capacity. First, we've pivoted to mainline flying where we've had previously operated regional aircraft. Second, by reducing day of week capacity in long stage length regional markets. And then third, in a limited number of markets, suspending service through next spring. In no instances have we exited any cities.

Touching on mainline with the delivery of our 28th MAX last month, our MAX aircraft now represents 16% of mainline capacity. As our fleet grows, we're ready to take advantage of the up-gauging opportunities by putting more seats into core hubs like Seattle, where we now offer 100 nonstop destinations, which is 2x that of our competitors.

We've worked hard over the last several years in transitioning our company to enable profitable growth post pandemic, which includes a tangible commercial roadmap that we expect will deliver $400 million in incremental revenue over the next several years, and we are off to a very strong start. We have a solid fleet plan, high-quality hubs well placed across the West Coast, a growing loyalty program and expansive partnerships for our guests to serve the destinations that we cannot.

And with that, I'll pass it to Shane.

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Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Thanks, Andrew, and good morning, everyone. Our second quarter results highlight a dramatic turnaround in our financial performance, especially given the significant losses we experienced to start the year. Our adjusted profit this quarter in absolute dollar terms was higher than 2019 on record revenue for Air Group. Our teams have done a great job managing the revenue side of the ledger as demand returned quickly after this winter's Omicron wave.

More importantly, our operation has stabilized, and we have returned to running an airline with high completion factors and high on-time performance. Operational reliability and performance will remain our priority as we move forward into 2023 and towards single fleets at both Alaska and Horizon.

Turning to second quarter results. Our financial performance and strength remain solid. We ended the quarter with $3.8 billion in total liquidity, inclusive of on-hand cash and undrawn lines of credit. Year-to-date cash flows from operations are $1.2 billion, including tax refunds and free cash flow is approximately $600 million.

Debt-to-cap ended the quarter at 50% within our target leverage range. Debt payments are very manageable with approximately $100 million scheduled for Q3 and $50 million in Q4.

CASMex was up 19% versus 2Q '19. Sequentially, we increased capacity by 13% from Q1, while nonfuel operating costs rose 6%. Aside from performance-based pay accruals, which, as you know, is a program we believe strongly in, there are 2 primary cost pressure areas: wages, both for our employees and from our third-party partners; and airport rents and related expenses as large capital improvement projects are completed across our system. These pressures, we believe, are consistent throughout the industry and not unique to Alaska.

Obviously, our unit costs were also highly sensitive to our capacity and the lower capacity levels we are deploying this year are a headwind that will ultimately reverse. Despite these and continued high fuel prices, which are up over 50% versus the start of the year, we have line of sight to another double-digit pretax result in Q3 and are reiterating our expectation to deliver on our full year pretax margin guidance of 6% to 9%.

Speaking of capacity, this spring, we made adjustments to give us the necessary breathing room to get back to running a reliable operation, which is a requirement before we attempt to more aggressively grow. The primary driver of the schedule pull-down was lower output of new pilots from training versus what we needed. We have much improved visibility into our training throughput and will continue to more conservatively plan capacity in the near term to ensure staffing shortages are not driving an inability to operate the schedule we've sold.

Additionally, as you know, we are committed to exiting the Airbus fleet, and will begin retiring our 29 A320s in the fourth quarter. Given a more conservative approach to capacity for staffing reasons, better clarity on our Airbus retirement plan and the regional capacity reduction Andrew shared, we expect third quarter capacity to be down 5% to 8% versus 2019 and full year capacity to be down 8% to 9%.

The capacity outlook reductions from prior guidance are roughly 1/3 from regional capacity reductions and 2/3 from slower mainline growth. The near-term impact of lower capacity will pressure our CASMex performance for the balance of the year. Overall, we expect third quarter CASMex to be up 16% to 19% with full year CASMex of 15% to 17%. Apart from the direct impact of lower capacity, there are a few specific headwinds that also contribute to our CASMex guides.

First, wages and benefits. Given industry dynamics and the labor market overall, wages are increasing and productivity remains pressured. As Ben mentioned, we're excited to have recently reached a tentative agreement with IAM, and if it ratifies, we expect it to add $13 million in costs in the second half of 2022 and approximately $30 million on an annualized run rate. Overall wage increases are expected to add approximately 3 points of pressure to CASMex this year versus 2019.

Second, training and ramp-up costs. As we continue to bring up staffing levels, elevated training and related costs will persist through 2022 and 2023. For the full year, we expect these incremental training costs to add approximately $50 million or about 1 point of CASMex.

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Third, performance-based pay. We're proud of our incentive program, which is included in our CASMex. And for the full year, we expect the incremental expense to add nearly 1 point to CASMex. Additionally, the 90,000 mile bonus for employees that Ben shared earlier is adding another $30 million, or 2 points, in the third quarter.

Lastly, we expect fuel price per gallon to be $3.79 to $3.89 for the third quarter. Despite some of the headwinds our industry is currently facing, I believe we continue to have the right structure and low-cost business model in place to strengthen our competitive advantages and fortify our relative position within the industry. This company has succeeded on running a disciplined operation with a long-term view for 90 years, and we're not losing sight of that now.

All the elements to drive profitable growth remain intact, and our underlying business model is resilient. Our move to single fleets will drive structural cost improvements supported by continued focus on operational excellence. We are progressing nicely on the $400 million in commercial initiatives, and we are supported by a strong balance sheet. So while we face common industry pressures, this unique combination gives me confidence in our ability to strengthen our competitive position over the next several years.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Ravi Shanker.

Ravi Shanker - *Morgan Stanley, Research Division - Executive Director*

I wanted to follow up on the yield commentary. I think your RASM guidance for 3Q is still pretty strong, but I think there was some indication that maybe in recent weeks, there's been some slowing in trends. So can you just help us quantify that? I mean you said you're still going to run well ahead of 2019, but compared to the mid-20s kind of where is that looking at the very tail end of the booking curve?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer & Executive VP*

Yes. Thanks for the question, Ravi. I think what we're starting to see now, obviously, is that bookings that are coming in are now coming in progressively for the Fall period, which as we move out of the peak summer period. But just to reiterate, demand is still extremely strong. For July, August and September, our load factors are on average 1 to 2 points ahead of 2019. So we're just, say, in the last few weeks at these very peak yields. They're just starting to flatten out and come down just a small tad. But again, it's still extremely strong and as per our guidance, we expect a very strong third quarter unit revenue performance.

Ravi Shanker - *Morgan Stanley, Research Division - Executive Director*

Got it. And would you say that that's different from normal seasonality? Or is that consistent?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer & Executive VP*

Yes. I think as seasonality as the -- as we get away from the peak summer period, in the fall that wouldn't be unexpected.

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Ravi Shanker - *Morgan Stanley, Research Division - Executive Director*

Understood. And just one follow-up kind of on the -- at the Analyst Day, I think you guys had spoken about line of sight to resuming cash return. Obviously, very choppy environment out there, but do you have any latest update on that?

Nathaniel Pieper - *Alaska Airlines, Inc. - SVP of Fleet, Finance and Alliances*

Ravi, it's Nat Pieper. Regarding that, long term with the Alaska strategy, we're committed to generating returns on capital that exceed industry average. We think it's critical to run a successful business as well as attract and retain the high-quality owners that we want. As you know, with the pandemic, with CARES funding, we're restricted from doing shareholder returns until October of '22. And our plan is to discuss that with our Board once those restrictions roll off.

Operator

And our next question comes from Jamie Baker.

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

Any update on tech sector contribution to corporate travel?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer & Executive VP*

Yes, Jamie, I would say for us at least, the tech has probably been the weakest just to be frank, given our network. But as I also have shared in our prepared remarks, we are very excited about the restructuring of our distribution channels for business with Amex GBT as well as joint contracting with American Airlines. But the tech sector still has ways to go to recover. And so we look forward to seeing that happen.

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

Okay. And bear with me, it's a bit of a throwback. I remember prebankruptcy, American used to say, if we had continental's pilot contract, our earnings would have been, whatever, X. I'm just wondering if you've run the pay rates from the American and United TAs through your model? I'm not suggesting the work rules in those TAs would be applicable for Alaska. But if you simply ran the max wage rates through your earnings model, what's the impact on margins or ex-fuel CASM if you've done the analysis?

Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Jamie, it's Shane. Thanks for the question. We obviously are aware of sort of movements at other properties. When it comes to this, we are at the table regularly, almost weekly with our pilots. We're looking forward to getting a TA with them as soon as we can. Yes, we understand the economic impacts on the business, and it's totally fine, our employees across both companies need to be at market and that's where we're ultimately going to take folks. I'm not going to share anything about the impact because that sort of gets into that guidance that we haven't provided. But we're well aware of what it will mean in terms of the cost structure of the business.

Operator

Our next question is from Andrew Didora.

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Andrew George Didora - *BofA Securities, Research Division - Director*

Shane, maybe 2 quick questions on costs here. One more housekeeping. Just what was the fuel hedge benefit in 2Q and what is implied in your 3Q fuel guide? And then just on 2023 potential CASM, if you're on track for being basically well -- fully staffed next year, if your capacity is up, say, 10% in 2023 versus 2019, kind of where do you think CASMex shakes out in that type of scenario?

Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Thanks, Andrew. I'll have Nat take the fuel hedge one and then I'll follow back with the CASM question.

Nathaniel Pieper - *Alaska Airlines, Inc. - SVP of Fleet, Finance and Alliances*

Andrew, the 2Q impact on our -- with our hedge book is about $90 million and then for third quarter, it's about $50 million. And again, that's based on we snapped the curve on the 18th, so on Monday.

Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Great. Yes. And on CASM into sort of next year, and we're not going to talk a lot about like potential growth rates next year. I think it's -- we're still in the middle of trying to plan for that. But as I mentioned in the script, the real pressure areas are wages and then productivity. We're carrying the same amount of FTEs or maybe slightly more today than we had in 2019, but we're a smaller company. And so there's a lot of opportunity as we move forward to recover sort of more traditional productivity levels, which will help us. I think, Andrew, the big structural change is likely to be labor costs and wages across the industry. It's not unique to us and we'll participate in that. And so that will probably be the headwind into next year.

Certainly, we're flying less capacity today than what we had prepared for and have costs for. And I think in 2022, it's sort of a one-for-one exchange. Had we flown 1% more ASMs, we would have seen 1% lower unit cost, give or take, on the margin. So just to give you some flavor of where we had anticipated we could be in terms of capacity versus what the practical reality of what we can fly is right now.

Andrew George Didora - *BofA Securities, Research Division - Director*

Got it. That's really helpful. So then second question just for Andrew. You mentioned a little bit on the corporate booking side, maybe your tech exposure might be hurting you a little bit there. And I guess if I'm doing my math correct this morning, it looks like kind of your 4Q revenue growth might decel a little bit from 3Q to hit your margin outlook. So with all that said and what's going on in the macro, kind of just how are you thinking about kind of the demand trajectory from here between -- across your network and then sort of your thoughts about broken down between corporate and leisure.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer & Executive VP*

Yes. I think again, Q2 had a very strong run up. RASM was up 15% in April, 25% in May and 35% in June. And I think we've sort of flattened out. Again, as we're nearly done with July, and I'm looking at August is very, very strong. And even September, as we sit here today, we're very pleased with what we see coming in. I think corporate, they're a little bit choppy, but I think we've seen good strength there, relatively speaking. And so again, where I sit today, demand and pricing environment, we feel very, very good about that, the third quarter. And that's what reflected in our guide.

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Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

And Andrew, I might just say because I know you're sort of inferring the pretax guide reiteration. I think we don't know exactly what will happen with revenues in Q4, and it wouldn't be prudent to assume that what we just experienced in July is the new normal. And so we're just sort of being thoughtful about how we look at the rest of the year. But hopefully, demand stays super robust and we can outperform those.

Operator

We have a question from Mike Linenberg.

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

Yes. Andrew, I want you to get back to just the significant yield increases. I sort of think back in years past when the demand environment was strong, we would see lots of fare increases the industry would put through and there'd be good successes. And I -- my sense is that we really haven't seen meaningful increases. It seems like it's a lot more about just harnessing the power of, call it, next generation revenue management systems. And maybe distribution changes and how people purchase tickets and buying them off of their phones and the impulse buy, that's driving it as well. And I'm just curious if there is maybe structurally changes in how airlines are able to revenue manage up, right, rather than just across-the-board fare increases that we read about, where everybody moves $5 and $10 because demand is strong. Has there been a structural change there? Or just anything that you can kind of tell us on how things have evolved. And maybe this is sort of a pandemic consequence. Your thoughts on that.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer & Executive VP*

Yes. That's a very interesting question. The things that come to mind are 2 things. Yes, we've seen pricing increases here or there, but I think the team is leveraged heavily on inventory bucket closure and being very, very active with that. I think secondly, just to be frank, the one good thing about the pandemic is we are way more dialed in and way more granular on how we manage revenues every single day versus the weekly or whatever because the volatility in revenue over the last 2 years has given us muscles and skills that, quite frankly, were there but we didn't use. So I think with the new pricing and inventory management systems, with the volatility index for our teams looking at things way more closely, I think you're seeing better performance, better connection to the demand in the marketplace. So I think those are all good things.

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

Okay. Great. And then just a second question. And Ben, maybe this is to you. Given your exposure in California relative to your system, I'm curious about maybe any initial thoughts about that state court ruling as it pertains to duty times and rest requirements for flight attendants. And again, historically, I always thought the Regulation Act sort of meant that federal rule would trump state rule and you're kind of opening up a Pandora's box. It looks like at least for now, it's prevailing. Any thoughts on that? And I guess the dust hasn't yet settled but potential impacts and unintended consequences, maybe initial takes?

Benito Minicucci - *Alaska Air Group, Inc. - President, CEO & Director*

Yes. Thanks, Mike. Yes, I think we're going slow on that, Mike, and we're going to see how we head towards compliance on that. And so we'll take that step by step. And Kyle, I don't know if you have anything to add on that? I know you've been working it.

Kyle B. Levine - *Alaska Air Group, Inc. - Chief Ethics & Compliance Officer, Senior VP of Legal, General Counsel and Corporate Secretary*

Yes. Thanks, Mike. You're preaching to the choir about the deregulation Act. We had the same hope as you, the Supreme Court didn't see it that way. So our legal options are up. And as Ben mentioned, we need to figure out what happens next.

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Operator

And we have a question from Duane Pfennigwerth.

Duane Thomas Pfennigwerth - *Evercore ISI Institutional Equities, Research Division - Senior MD*

As you look at your plan and your recovery trajectory and your competitors' plans, when do you think -- assuming a stable macro, like when do you think supply catches back up with demand? It certainly doesn't feel like the third quarter, you've already gotten a couple of questions about the fourth quarter and my guess is that just a plug at this point. But as you just think supply-demand and stable macro, when is the earliest shot at sort of supply catching back up with demand?

Benito Minicucci - *Alaska Air Group, Inc. - President, CEO & Director*

Duane, for us at Alaska, right now, what we're focused on is getting our single fleet transition done. And I think what we're trying to do is set ourselves up for 2023 and beyond. So that is job one for us, both on the mainline side and the regional side. We want to be really well configured heading into 2023. We talked about some headwinds in the economy, so we're not sure right now. We're really happy with demand and yields, but we really want to configure our company to withstand whatever external shocks are out there, but also set ourselves up for growth. So once we get to single fleet, then the opportunity for growth is going to be there for us. And so that's how we're looking at it.

Duane Thomas Pfennigwerth - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Okay. It was a bit...

Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Duane, I would just add, I think it all depends on how much demand is. Is it 120% of normal today and capacity is negative 10%, it's probably several quarters before it catches up. If it's 100% of sort of normal demand, 2019 demand and we're negative 10% capacity, it's probably a couple of quarters. So it seems like it's to the right before we sort of fully catch up, assuming a stable economic backdrop.

Duane Thomas Pfennigwerth - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Yes. And then just could you comment a little bit on Hawaii, the level of recovery that you've seen there, what the booking curve looks like and maybe just the competitive environment. What level of industry capacity has been restored there?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer & Executive VP*

Yes, Duane, I think Hawaii, while we don't specifically talk a huge amount about regions, we feel very good about how we've constructed that. Obviously, the industry has pumped more seats into that marketplace. So relatively speaking, there's some headwinds there. But I'll also say, as I said in my prepared remarks, our premium cabin is off the chart in performance and Hawaii is one place where our premium cabin is really performing and helping mitigate some of those supply issues. So overall, very full airplanes, great demand and business as usual for now.

Operator

Our next question is from Helane Becker.

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

So 2 questions. One is with respect to Horizon Air. You own that company and you mentioned that you're seeing issues with your regional providers, most other airlines are as well. So how should we think about Horizon's future over the next, say, I don't know, say, 1 to 3 years, given the constraints that regional airlines have?

Benito Minicucci - *Alaska Air Group, Inc. - President, CEO & Director*

Helane, it's Ben. Thanks for the question. It's a good question. Well, first, what I'll say is our regional network is critical to our success. So all the Pacific Northwest markets we serve are just integral to our entire domestic network. So one, it's needed and required. I think secondly, there's no doubt there's a pilot shortage in the industry and where you see it is in the regional industry. It's down, like I said, 20% to 30%. So we're working -- again, this path to single fleet for us is one of our strategies to really try and mitigate that. And we've got a lot of plans with pipelines and pathways to mitigate the pilot shortage on the regionals, but we're working on it. And I think, honestly, Helane, this thing is going to evolve. It continues to evolve every quarter with changes in the industry, and we're going to stay close to it. Joe, did you want to add anything?

Joseph A. Sprague - *Alaska Air Group, Inc. - President of Horizon Air Industries, Inc.*

No, I think, Helane, this is Joe with Horizon. There is some optimism. We have a new fleet order for Horizon that was announced earlier this week, and we're excited about the timing of those deliveries over the next 4 years that in addition to the Q400s going away, which will make us smaller in the near term, it allows us to sort of rebuild our fleet size alongside sort of in tandem with rebuilding our pilot staffing capability over the next few years. And there is a lot of interest in becoming an airline pilot. There's never been a better time in history to become an airline pilot. We're seeing that interest at both Horizon and Alaska with a strong applicant pool and some things that we're doing at the sort of the top end of the funnel to encourage people to come into the industry, and there definitely is interest.

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

That's good to hear. And then my other question, my follow-up question has to do with like the decline, and I don't know, maybe Andrew, this is for you. Airline traffic tends to be good until it's not good. And I'm just wondering when would you see a decline in bookings related to an economic slowdown? And when would that start to manifest itself?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer & Executive VP*

Well, as you know, Helane, we look at this every day. I think sometimes it can get confusing here because demand is obviously -- is really a big part of pricing as well. I mean, just to be clear. And so demand right now, as I've shared, is very strong at very high yield increases over '19. So I think the first thing we'll see is maybe a slowdown in demand if and when it comes, and then we'll start to obviously play with the yield levers. But there is a lot of room to go before we really come down and reach the floors of 2019. So I would say, as of today, and this business changes, we're still seeing relatively good, strong position and even our held yields in September are well into the high 20s as we sit here today.

Operator

And our next question comes from Savi Syth.

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

First off, I wonder if I could just clarify the previous answer on the 2023 potential. I know at Investor Day, I think you mentioned 2023 could be up 9% capacity type of outlook, not that you gave specific guidance, but I'm curious, given the move that you made here in the second half and just

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kind of building in this caution and you have this transition going on in the early part. What could be kind of a realistic range for 2023? Or what do you think you can deliver in terms of capacity for 2023? Demand pending, obviously.

Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Savi, it's Shane. One thing that we've all learned over the last 2 years is most of our ability to forecast what's going to happen is not very -- not as good as it used to be pre-pandemic. So take some of this with a grain of salt. I think the 2 things that are going to be sort of critical, absent whatever the economy is doing is just our fleet transition Ben mentioned that we're totally committed to that. Our ability to get replacement aircraft sort of quickly from our supplier. And then just our ability to produce the right number of pilots and other staff for the operations. So I think if anything, we're going to be a little more conservative until we have several quarters under our belts of really good operational reliability, really good staffing levels.

I just think over the last year or 2, we've sort of assumed everything was going to work exactly as originally planned, and we've just -- that was probably a too aggressive set of assumptions. So I think in terms of aircraft units, we're going to have enough planes ultimately to grow quite a bit next year. I think what we decide to do with those is still up in the air, and that's a discussion we're going to be having over the next couple of months internally. And obviously, we know folks are interested and we'll say more as we get clarity on what our 2023 growth plans are, but they're probably somewhat moderated from what we were talking about at Investor Day.

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

That's helpful. And somewhat related, I want to -- basically there's regional airlines that are in-house that is one of your competitors, who've got pretty big pay increases. And I know as you pointed out, the regional capacity at Alaska is down quite a bit, and you're doing a fleet transition there as well that's kind of bringing that regional fleet down. I was just kind of curious if Horizon had to match some of those rates, what does that mean for kind of regional lift economics from a longer-term perspective? Because it's pretty much getting where your -- you can almost fly these with the mainline pilots.

Joseph A. Sprague - *Alaska Air Group, Inc. - President of Horizon Air Industries, Inc.*

Yes, Savi, it's Joe again. I think no question, there's cost pressure for regional airline pilots. The American deal certainly stood out. I think there's a lot of folks sort of watching to see what else transpires. We are working with our pilots to find some ways to improve retention at Horizon, but it's definitely a changing dynamic for the industry right now, and I bet Shane will have some additional thoughts.

Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Yes. And I -- number one, just a shout out to Joe. He's done a phenomenal job leading Horizon. Savi, you may -- you've been with us a long time. We actually had spent a lot of time in the regional business model, pre-pandemic. We had gotten it back to be a profitable contributor to the whole. So it's just the reality that it's going in a different direction. The cost of operating regionals are going to go up.

In terms of what that means for our long-term strategy, I think it's way too early to sort of tell or to share anything. What I will just reiterate is what Ben said that a large part of our network requires regional lift. We're committed to those communities. We have not exited a community yet. We don't want to. And so that aircraft, E175, fits really well within our network hole, and we see a future for them. And we're just going to have to figure out once we understand where everything ends up in terms of costs, how to make that a reasonable part of our network from an economic standpoint.

Operator

Our next question is from Dan McKenzie.

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Daniel J. McKenzie - *Seaport Research Partners - Research Analyst*

So my question is sort of similar to Savi's. It's really a flex up, flex down question on supply next year. And I'm just curious, what percent of the fleet is fully paid for or if you're looking to flex on supply, is the easier move simply to accelerate the Airbus retirements. And I guess I'm just trying to get some sense of the ability to flex down, flex up under sort of a tougher economic backdrop.

Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Yes, Dan, a couple of things, some color, give or take, I think Q4, Airbus capacity is about 8% of total Air Group capacity. Half of that is the A320 fleet that we're drawing down. And the remainder is the A321 fleet, which will be with us next year, it's about 4% of capacity. You could potentially move to retire that more quickly. And that's roughly the amount of ASMs you'd be talking about. I think the flex up thing, that's really a utilization question. And it gets back to how much sort of stress we want to put into the operation. And as I said a couple of questions ago, I think we were too aggressive in the spring. We're going to be a little more conservative for the next several quarters. So I would suspect we work the utilization lever a little more next year, but not try to maximize it. So there's -- I think there's a pretty tight range of capacity that we're going to end up in next year.

Nathaniel Pieper - *Alaska Airlines, Inc. - SVP of Fleet, Finance and Alliances*

Dan, it's Nat. One other point, too, just on your question, aircraft paid for unencumbered, et cetera. We've got large part, 60-65 airplanes that are fully paid for should capacity really go south because of the economy, et cetera, we could pull aircraft down with no problem at all and not have to pay leases on that -- on any of those, fully depreciated and owned.

Daniel J. McKenzie - *Seaport Research Partners - Research Analyst*

Yes. Well, next question here. I know Seattle is solid. I can see the competitive dynamic in that market. And just following up on an earlier question on Hawaii and inter-California, the pretax margin outlook is really solid. But in the back of my mind, I'm thinking that you have a couple of entities here that are still a drag on the system margins. So I'm just wondering if you could elaborate a little bit more on some of these, on these entities.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer & Executive VP*

Yes, Dan, I think and generally, what you've seen us do is obviously bring back capacity the quickest and the fastest to Seattle and obviously exceeds. As far as the rest of our network, and I presume you're alluding to California, I think, again, the good news there is that our capacity has been down significantly, and we're working to sort of bring that back. We have new corporate deals. We have new credit card programs. We have our Vice President in the Bay Area now whose full-time job it is, is to make sure other parts of our network continue to get better. So we feel very good. We think there's sort of only up from where we've been, just to be quite frank, as we continue to work it.

The last thing I will mention just because it's becoming a theme here, I think for me, personally, what 2022 has taught me is the best economic driver for Alaska Air Group, its loyalty and its guests, it's to set a financial plan and capacity and hit it. The amount of economic frustration and guest frustration when you set the plans and don't do it is very, very large. So I think that's why we feel very confident that whatever we grow next year, that we will hit it and we will execute extremely well, and that will be the best cost and revenue answer for Air Group.

Operator

Our next question is from Chris Stathoulopoulos.

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Christopher Nicholas Stathoulopoulos - *Susquehanna Financial Group, LLLP, Research Division - Associate*

So Shane, the 4% to 8% targeted growth through 2025 you outlined a few months ago. In light of everything that's happening right now, operational issues for the industry, labor tightness, likely economic slowdown, does 10% in the new market still makes sense or the 70% from frequency? And as peers, as you know, are taking down out year capacity guide, but the moving parts, at least for me, still are a bit murky. So any color on what's moving or what could move around with respect to that 4 buckets of growth you outlined a few months ago?

Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Yes. No, thanks, Chris. I think, yes, the idea of -- and I'm not saying we wouldn't get into new markets, but obviously, we're most focused on recovering the pre-pandemic network, even though it's been reshaped, but getting our California network back, our Portland network back, is it going to remain a priority. That's where the incremental capacity from here forward will go, and if there's a smart market opportunity in there that's new, we'll definitely take advantage of it, but a little bit less bias towards doing that as we grow at a slower rate than we had anticipated.

Christopher Nicholas Stathoulopoulos - *Susquehanna Financial Group, LLLP, Research Division - Associate*

Okay. And as a follow-up. So as we think about exit rates for CASMex and your pretax margins for this year, if you can, how are you thinking about volumes and yields here? Are you weighting the latter more heavily as you plan for 2023?

Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Sorry, Chris, that was on CASMex exit rate?

Christopher Nicholas Stathoulopoulos - *Susquehanna Financial Group, LLLP, Research Division - Associate*

Yes. Well, as we think about the CASMex we hear, we have a CASMex guide. We have your pretax margin guide. I think a lot of investors here are looking at exit rates in the setup for next year and to the extent, how are you thinking about the weight or the split between volume and yields? What are you emphasizing here in your projections?

Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

Got you. Yes. In terms of like the pretax sort of -- yes, I think what we'll see and what we anticipate, we're going to fly marginally more in capacity in Q3 relative to Q2. And then I think Q4, it's -- there's an implied guide out there based on our full year, but it's still a little bit up in the air based on the economy and ultimately the Airbus and Q400 drawdown. And I think those are going to be meaningful sort of determinants of how we exit the year on CASMex. As I had said before, I think there's kind of a one-to-one relationship right now. If we can fly the capacity, will 1 point of capacity should equal to something like a point of reduced CASMex.

I think right now, as it stands here today, our plan is to hit all of those guides that we set forth. And it would take a pretty dramatic economic and demand turnaround for us to think differently about that right now because we're still smaller than we were in 2019, and we think demand is higher than 2019. So I just think like right now, there's not a lot of bias to try to take further capacity down in Q4. We're going to go and execute what we've just shared in terms of guidance.

Operator

And our final question comes from Scott Group.

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Scott H. Group - *Wolfe Research, LLC - MD & Senior Analyst*

I'll just keep it to one. Shane, you talked about some puts and takes for CASMex next year. Just directionally, would you think that CASMex is up or down in '23 versus '22?

Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

I think assuming we get labor deals done, it very likely could be up.

Scott H. Group - *Wolfe Research, LLC - MD & Senior Analyst*

Versus '22?

Shane R. Tackett - *Alaska Air Group, Inc. - CFO & Executive VP of Finance*

I was thinking versus 2019. Versus '22, I don't know, it's probably -- it's going to be highly levered against the growth rate, but there's a chance it could be up. And I do anticipate us getting labor deals done. We're not sharing sort of guidance around that, but our hope is that they are done and in our cost base next year.

Benito Minicucci - *Alaska Air Group, Inc. - President, CEO & Director*

Thanks, Scott, and thank you, everyone, for joining us, and we'll talk to you next quarter.

Operator

This concludes today's conference call. Thank you for attending.

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