

Recommendation: BUY

Target Price until (12/31/2016): \$62

1. Reasons for the Recommendation

After detailed analysis of Southwest Airlines Company I recommend that we move to buy further shares of stock in the company. This recommendation is based upon a positive financial projection for the company with a target price for FY2016 of \$62. An increasing revenue forecast for 2016, strengthened financials, domestic growth potential and international growth potential were the largest factors contributing to my positive financial projection and buy recommendation.

Both 2014 and 2015-to-date have been spectacular for Southwest Airlines as a result of effective implementation of their strategic growth plan and beneficial jet fuel prices. Southwest concluded 2013 at a stock price of \$18.34 and grew to \$38.04 as of the end of Q3 2015 as a result of strong earnings-per-share growth¹. Looking forward 2015 and 2016 Southwest is again on target to show substantial earnings-per-share growth. Growth in 2016 will be the result of continued increased available passenger miles out of Dallas-Love Field due to the repealed Wright Amendment, additional service out of Regan National and LaGuardia, and new international service out of Houston Hobby. This will culminate in available seat mile growth between 5-6% according to the Company's forward guidance and gives cause for strong-top line revenue growth in my forecast. Additionally, the US Department of Transportation projects jet fuel prices to decrease again in 2016, albeit slightly, therefore I forecast that this strong revenue growth will result in strong bottom line performance as well².

As a result of spectacular performance over the past few years, Southwest is approaching the next few from a strong financial standpoint. The Company took advantage of strong cashflows from operating activities to use capital expenditures for fleet modernization and should reap rewards from this investment in the coming years. Specifically, their transition towards the 737 MAX series airplanes means more seats per plane and greater fuel efficiency, allowing Southwest to grow at a lower cost. However, per forward guidance, I don't expect the year-over-year impact of fleet modernization to be as big in 2016 as in 2015. Additionally, the Company has been fueling much of this growth organically while maintaining a leverage ratio around 3.0. This indicates that Southwest is using some level of debt to encourage growth yet Southwest's leverage ratio is half of its large competitors Delta Airlines and United Continental Holdings making it a lower risk investment. Also, the company has been participating in steady share repurchases which, if maintained, will contribute to strong earnings-per-share growth. In this way, Southwest is well positioned to grow at a low cost should my base case occur and is better positioned than its competitors for less than optimal case.

Domestic growth potential has contributed to my buy recommendation in the short term, however domestic growth will eventually decline over time. My opinion is as follows: ten years ago, Southwest Airlines wasn't in several of the major markets like Denver, Minneapolis, and Atlanta and it also wasn't serving the major hubs at critical large cities like New York and San Francisco. Today, Southwest is at all the major hubs and all the major airports. The Company is already capitalizing on the repeal of the Wright Amendment which they point to as a major contributor to their actual and anticipated revenue

¹ LUV: Summary for Southwest Airlines. Rep. Yahoo! Finance, n.d. Web. Oct. 2015. <http://finance.yahoo.com/q?s=luv&fr=uh3_finance_web&uhb=uhb2>.

growth in 2015 and 2016. Though airline travel will continue to grow at a rate in keeping with the overall economy over the near term², Southwest Airlines has traditionally outpaced that growth meaning it has gained market share, so the question is can this continue? Southwest currently has 85 domestic mainland destinations in 41 states³. According to their forward guidance there are not many more dots that can be added to the route map. However, they do state that among the 85 destinations they can add more nonstop segments and can also add frequency to short-haul markets. In the short-term horizon over the course of 2016 I foresee strong revenue growth in their forecasted 5-6% range as a result of domestic factors including further growth out of Dallas Love-Field, Washington Reagan, New York LaGuardia, and Houston Hobby due to international destinations. Domestic growth potential outpacing the FAA forecast will be the largest issue I see to Southwest maintaining its pace over the long-haul, but won't be an issue over the horizon of my forecast.

As a company Southwest's greatest potential, in my opinion, is to grow their international market as their domestic market matures and levels off. Through the Company's acquisition of AirTran, Southwest now serves near-international destinations in the Caribbean, Central America and Mexico. However, international service currently makes up just 1% of company revenue. Towards growing this market, Southwest began international service out of Houston in October and will add service out of Fort Lauderdale. Adding more domestic international gateways for their current near-international destinations should increase international revenues regardless of their timeline for adding more international destinations. The direction the Company gives for international growth is simply that they will make appropriate decisions regarding international growth but that there are lots of potential destinations to add to the route map internationally. International growth could eventually account for the majority of Southwest's growth in the coming decade.

2. Company Analysis

Southwest Airlines was founded in 1967 and is currently the largest carrier by originating domestic passengers³. Based out of Dallas, Southwest serves 85 US markets and 12 international markets³. Total operating revenues in 2014 were \$18.6 billion. \$17.6 billion can be attributed to passenger revenue, \$0.2 billion can be attributed to freight revenue, and \$0.8 billion can be attributed to other revenue⁴. International Operations after the acquisition of AirTran accounts for about 1.0% of overall company revenue⁵. Therefore, the passenger revenue which accounts for approximately 95% of overall revenue is almost entirely domestic. Its position in the marketplace is as a large low-cost carrier and Southwest stands out with its unique culture and customer service. The Company has experienced tremendous growth over the past few years as seen in their cash flows, capital expenditures, and payouts. Their

² 2015 National Forecast Report. Publication. N.p.: Federal Aviation Administration, n.d. Print.

³ Southwest Corporate Fact Sheet. Southwest Airlines, n.d. Web. Nov. 2015.

<<http://swamedia.com/channels/Corporate-Fact-Sheet/pages/corporate-fact-sheet#cities>>.

⁴ "Form 10K Southwest Airlines." SEC Edgar. 31 Dec. 2014. Web. 1 Sept. 2015.

<<http://www.sec.gov/Archives/edgar>>.

⁵ Haider, Zeeshan. "Industry Reports." Market Research Reports. IBISWorld, 1 May 2015. Web. 2 Sept. 2015.

<<http://www.ibisworld.com>>.

balance sheet is in a strengthening phase and I expect that they have the capacity to grow organically as well as compensate shareholders during the years to come.

Opportunity for Southwest Airlines will primarily come from international expansion, especially in nearby markets. Otherwise, opportunity for Southwest lies in gaining market share in the United States via their low fare offerings, adding routes, capturing more business travel, and gaining customer loyalty via their Rapid Rewards program. Additionally, the past few years and likely the coming one will provide opportunity to grow at a low cost from inexpensive jet fuel.

Nevertheless, Southwest Airlines not without weakness. As previously mentioned, they have nearly saturated their United States growth potential. The company anticipates seeing some pressure from employees for increased salaries, wages and benefits. Over the past couple of decades other low cost carriers have emerged and are attempting to gain market share, primarily JetBlue (2000), Spirit Airlines (1998), Frontier Airlines (1994), and Allegiant (1998). Finally, a large looming threat is the inevitable rise of jet fuel prices. The US Department of Transportation forecasts that this will happen in 2017², although fuel prices are volatile and prices could increase either soon or later. It should be noted, however, that Southwest participates in hedging and will be able to soften the increase in jet fuel prices as it occurs, and with a low leverage ratio and modernized fleet the increase is likely to be less impactful on Southwest than on other airlines.

3. Industry Analysis

The domestic airlines in the US market is the broader context in which Southwest Airlines conducts its business. As a domestic airline, Southwest Airlines provides air transportation for cargo and passengers along scheduled routes and on routine intervals. The airline industry is a service industry comprised of the following services: coach class passenger transportation, first class passenger transportation, business class passenger transportation, and cargo⁵. However, Southwest Airlines is unique from many of its competitors in the airline industry because it does not provide any distinctive classes of transportation. The single class of transportation it provides may be considered coach. Therefore, the two services that Southwest Airlines provides are coach class passenger transportation and cargo.

The highly competitive nature of the airline industry is one of its defining features. Although Southwest is the largest airline by originating domestic passengers, it is the fourth largest domestic airline following American Airlines Group Inc., Delta Airlines Inc. and United Continental Holdings Inc because these three all have substantial international service. Together these four large airline service providers make up nearly 70% of the market share⁵. Among these four, Southwest Airlines was the only carrier to be consistently profitable over the past five years⁵. The airlines compete on pricing, reliability, destinations, in-flight services and entertainment, among other factors and they must compete in an industry that is highly influenced by economic swings. Interestingly, Southwest Airlines itself defines its competitors within its 10k even more broadly as “other major domestic airlines, as well as regional and new entrant airlines, surface transportation, and alternatives to transportation such as videoconferencing and the Internet”⁴.

The customer base for the Domestic Airline services in the US industry is comprised of private customers, businesses, and freight forwarders. Private customers contribute approximately 72% of industry revenue and this share of the industry has been increasing due to the combination of higher disposable incomes post-recession and decreased prices of flights⁵. Businesses comprise an additional 25% of the market and a defining feature of business travelers is that they will usually pay a premium for their ticket because these bookings are on the company's dime or are made more last minute. Both private and business customers produce a less-than-steady demand as both are highly influenced by the economy. Finally freight forwarders are those who "organize transportation or air cargo for their customers, which include businesses, individuals and households"⁵. Although this customer base only makes up 3% of the market, it has expanded in recent years due to increased outsourcing⁵.

The Domestic Airlines in the US industry experiences low revenue volatility and medium capital intensity⁵. The average industry profit margin has increased from 4.0% in 2010 to an estimated 10.7% in 2015⁵. This increase in profitability has been attributed to increased demand and lowered costs which are the result of the M&A activity and technological improvements such as online ticketing. Industry revenue reached pre-recession levels in 2013 and has continued to rise through 2015.

Key economic drivers for the industry include: corporate profit, world price of crude oil, per capita disposable income, domestic trips by US residents, and inbound trips by non-US residents. Of these drivers, corporate profit and the world price of crude oil have the largest influence on the outlook for the industry. They have been volatile, for varying reasons, but in 2008 as the world price of crude oil increased, corporate profit was decreasing causing decreased passenger demand and increased cost of transporting passengers. Again in 2013, as the industry struggled and we saw mergers among even major airlines, corporate profit was again on the decline while crude oil was high. So, the relationship between these two industry drivers and the state of the industry is without question. In the coming years, we expect to see the world price of crude oil rise, but not dramatically, and we also expect to see corporate profits stabilize at a barely positive percentage change year-over-year. These two factors combined bode well for stability in the industry. Another important driver is per capita disposable income as the majority of revenue for the airline industry in fact comes from consumer's discretionary income⁵. Signs of changes in per capita disposable income will signal the direction of the industry. All in all, the outlook for the airline industry is positive and at this point, stable.

Appendix: Inputs into valuation using multiples

	2009A	2010A	2011A	2012A	2013A	2014A	2015F	2016F	2017F
Stock Price	7.96	12.45	10.36	8.97	14.14	28.83	63.14	65.21	62.14
EPS (basic)	0.13	0.62	0.23	0.56	1.06	1.65	3.41	3.52	3.36
Sales	10,350	12,104	15,658	17,088	17,699	18,605	20,383	21,198	22,176
Sales per Share (Basic)	13.97	16.20	20.20	22.57	24.65	26.73	29.29	30.46	31.86
P/E	85.5	21.1	41.8	18.4	22.1	25.6	18.5	18.5	18.5
P/S	0.8	0.8	0.4	0.5	0.8	1.6	2.2	2.1	2.0

** Analyst's own calculations. Source of basic data: company's 10-K; Yahoo! Finance*