

Recommendation: BUY

Target Price until 12/31/2016: \$65

1. Reasons for the Recommendation

There are many positive that we see when it comes to Southwest Airlines (LUV) and we foresee them being very successful in their near future. Their positives include their expansion that they have planned in the next few years, the airline industry and their projected growth, and lastly the cost structure and how they plan on improving that for the next few years.

Recently in 2014, the Wright Amendment was repealed. This impacted Southwest Airlines massively because their biggest hub city is in Dallas Love Field. Prior to this, they were limited to where they could fly to from Dallas and not they are able to make direct flights to major markets in the United States including Los Angeles, New York City, and Miami among other big cities. Southwest Airlines is well-known for being cheaper than other major airline options and with this in place, more customers have the opportunity to fly where they want to from Dallas without worrying about a layover in another city and also with that option there it ends up being cheaper for them.

Not only has Southwest Airlines expanded domestically, they have also expanded internationally. As of December they have incorporated five new cities in the routes to include near-international markets like Cabo San Lucas in Mexico, Jamaica, Aruba, along with other nearby countries. In the next few years, they also plan to expand to other countries in Asia and South America. This is definitely a plus because it gives future customers in a totally new market a chance to look at Southwest as an option when it comes to flying internationally. Again, because Southwest Airlines in a cheap choice, this could be beneficial for their business.

Secondly, the projected growth in the airline industry is another positive for Southwest Airlines. The domestic airlines industry is expected to grow 1.5% per year for the next five years. We believe that Southwest Airlines will not only beat that number every year, but also will lead the industry in growth. Economic factors also have a play in this. Since the 2008 recession, the economy has been improving every year. As the economy continues to improve, as will people's discretionary income, which will allow people to use that money towards things like travel.

Lastly, Southwest Airlines has plans to improve their cost structure with focus on new technology and fuel efficiency. The two largest drivers of cost are fuel and labor. The addition of the Boeing 737-MAX aircraft to the Southwest fleet will help the company cut their fuel costs. They expect these new improved aircraft beginning in 2017 and are the first major airline to implement these new aircraft from Boeing. Increased technology in both their booking and check-in systems have also allowed them to cut back on labor costs.

What worried us about Southwest Airlines was the fact that they will be competing in a new market internationally. Their competition will be airlines in Mexico, Jamaica and in the future Asia and South America. Compared to Southwest Airlines, there might be cheaper options for flights or even options that people are more familiar with that might stray customers away from them. Another piece of information that worried us was their recent success. Over the past year Southwest Airlines has done very well and has actually doubled their stock price. Compared to the S&P 500, they have outperformed the

growth by about 85%. Our concern is we do not know if Southwest Airlines can grow much more or if it has hit its peak in growth. We understand that most of the information is already priced in so we factored that in but we still believe that they will end up being great competitors in their new market and be a profitable company to invest in.

2. Company Analysis

The company we chose to analyze is Southwest Airlines Co. (LUV). They are a well-known passenger airline that provides air transportation in the United States. Today, Southwest Airlines operates with 665 Boeing 737 aircrafts which are short to medium range and narrow bodied airplanes. Just recently they have expanded and now provide air transportation to near-international markets like Mexico, Jamaica, and a few other destinations. In 2014, Southwest Airlines finished the year by serving 93 destinations in 40 states, Puerto Rico, and 5 international countries.

There are a couple big strengths we feel like Southwest Airlines has that makes them an attractive company to analyze. A strength they have is the fact that they are one of the largest carriers of U.S. passengers. Along with the fact that they have a low cost makes it attractive to customers to fly with them instead of their competitors. Another strength we feel like Southwest Airlines has is that they do plan on expanding to other markets. Recently, they have expanded to near-international markets and with the repeal of The Wright Amendment; it finally allows their flights to fly customers from Dallas directly to other major cities in the United States. Dallas Love Field holds their biggest hub in the United States where majority of their customers fly out of and now that they are able to fly there is a huge strength for them moving forward.

A weakness we found with Southwest Airlines is the fact that their competition in other countries might be difficult to compete with depending on prices and familiarity in other countries. If customers in the international markets do not find Southwest Airlines as an attractive option then the hopes we have for them to grow as much will not be as big. Another weakness we find with Southwest is that because of their prices people might not see them as having the greatest quality compared to the other airlines. According to the Annual Airline Quality Rating written by Dean Headley, Southwest Airlines was ranked as the 6th highest quality airline. This ranking is based on their on-time performance, mishandled baggage and their customer complaints. Behind them in 8th and 9th, respectively, was American Airlines and Frontier, their biggest competitors.

At the same time because of their operations here in the United States we feel like they have a great opportunity to expand in the United States as well as internationally. With people having more discretionary income, people will want take that money as use it to travel. Southwest Airlines' low prices make it such an attractive buy for those travelers. A threat for Southwest Airlines is the fluctuation of the oil prices in the United States. Lower oil prices could influence airlines to add more flights but if they rebound and go up, it could adversely affect the airlines. During the time when oil prices rose very quickly, Southwest Airlines was one of the few companies in the airline industry that was not heavily affected.

3. Industry Analysis

There are two industries that Southwest Airlines could fall into; they are the **Domestic Airlines in the US or International Airlines**. We have decided to do the industry analysis on the Domestic Airlines in the US industry due to the fact that less than 2% of Southwest Airlines business is done internationally. The industry services passenger and cargo air transportation over the United States. Most carriers base their operations out of at least one hub city where connections are made for flights to additional cities.

The industry's takes part in the following business transactions, they are domestic air transportation over the United States. Cargo and freight air transportation, but exclude large courier service such as UPS and FedEx. Southwest particularly participates in scheduling domestic air transport and transporting commuter domestic passengers. The major services that they offer are coach class passenger transportation, first class passenger transportation, business class passenger transportation, and air freight services. Southwest offers coach class transportation and have their own version of business class by providing extra services at the airport along with priority boarding.

Major players in the industry are American Airlines Group Inc. at 19.9% market share, United Continental Holdings Inc. at 18.0%, Delta Air Lines Inc. at 16%, and Southwest Airlines Co. at 12.1% market share. Supply Industries include Aircraft Maintenance, Repair and Overhaul, Aircraft, Engine & Parts Manufacturing, Aircraft, Marine & Railroad Transportation Equipment Wholesaling, Airport Operations, and Gasoline & Petroleum Wholesaling.

Key Economic Drivers in the industry are Corporate Profit, World Price of Crude Oil, Per Capita disposable income, Domestic trips by US residents, and Inbound trips by non-US residents. "Corporate profit, Per Capita disposable income, Domestic trips by US residents, and Inbound trips by non-US residents are all expected to increase in 2015" (Brennan). The key economic drivers for the industry are for the most part expected to be very steady over the next 5 years. Some of the economic drivers are interdependent. Following the recession, corporate profit has done nothing but increase in the improving economic conditions. Per Capita disposable income relies on corporate profit which increases domestic trips by US residents. Economic conditions can lead us to infer the preceding information, however it cannot suggest that non-US resident growth will be consistent. Most international flights fly into a large international airport where they then can board flights to other US cities.

Profit margins and demand have increased over the last five years in the industry. Costs are down due to oil, which is the second largest cost for the industry. The largest of cost come from salaries, and most airlines have cut cost by cutting their labor costs. They have done this by adding self-serve kiosks in airports. The industry as a whole is expected to cut jobs by 0.3% per year for the next five years. Oil prices have taken a huge hit since this report was written, and after analysis of the oil industry we believe that oil prices will remain stagnate for the foreseeable future due to global economic factors and improved technology. The industry will be profitable like never before.

Appendix: Inputs into valuation using multiples

	2010	2011	2012	2013	2014	2015 F	2016 F
Stock Price	\$12.45	\$10.36	\$8.97	\$18.95	\$42.32	\$54.78	\$65.01
Basic EPS	0.6	0.2	0.6	1.1	1.7	2.5	2.7
Sales	12104.0	15658.0	17088.0	17699.0	18605.0	19488.7	19976.0
Sales per Share	13.7	17.7	19.3	20.0	27.5	28.8	29.6
P/E	21.1	37.3	18.4	18.0	25.9	22.2	23.7
P/S	0.8	0.4	0.5	0.8	1.6	1.9	2.2

Source of basic data: company's 10-K; Yahoo! Finance