Recommendation: Buy **Target Price until (12/31/2017): $54**

1. Reasons for the Recommendation

Southwest Airlines is faced with challenges in the upcoming years. One current issue Southwest has begun to run into is the US dollar continues to be one of the World's strongest, potential causing Southwest's newly found international sales to not meet with expectations. With the continued growth in the global supply of oil, which continues to outpace demand, driving down the price of crude oil, allows Southwest to continue to reap the benefits of lower jet fuel costs. There are numerous reasons why Southwest will outperform its competitors through 2017. Southwest, through their award-winning happy, friendly customer service, has achieved customer loyalty and for many people, customer service is the principle reason they remain loyal Southwest customers. Southwest's customer services has become the most important method through which they continues to expand their net income and operating margin (post tax), since their passenger segment accounts to 95% of all revenues. Secondly, Southwest has a history of making a profitable acquisition that corresponded with the strategic direction of their business. Finally, Southwest's commitment to technological advances while maintaining their core business strategies offers a better return investment than its peers in the services sector. For these main factors, we recommend a buy evaluation for Southwest stock.

Customer Service

As Southwest continues to operate the World's largest fleet of Boeing aircraft, with the majority of this fleet being outfitted with satellite based Wi-Fi, which provides gate-to-gate connectivity. Southwest does not charge baggage fees and was an early adopter of jet fuel price hedging. From the US DOT's current data, Southwest Airlines is now the nation's largest carrier of originating domestic passengers boarded and the second-largest domestic airline market share, just behind Delta Air Lines. Southwest is also innovative and nimble, and has shown a willingness to think outside the box.

Southwest has been an early adaptor of oil hedging within their industry. Southwest Airlines, which slashed its fuel bills for years by hedging more of its fuel purchases than rivals, now finds itself on the losing side of the wager. They are on the hook for $1.8 billion in fuel hedging costs through 2018 at current market prices. That may sound painful, but overall Southwest still emerges a winner on its overall fuel bill. Even with hedging losses taken into account, Southwest still managed to slash its fuel costs by $189 million in the fourth quarter. The savings added about 17% of their fourth-quarter income before special items. Southwest is cutting the percentage of fuel it buys on hedging contracts in half to 30% to 35% in the second half of 2016, down from 60% to 70% in the last six months of 2015.

The majority of individuals with and yes, even without disposable income have been willing to pay for a plane ticket because many patrons see it as a necessity to fly rather than drive or take a train for long distance travel.

Profitable Acquisition

Southwest currently has had 43 consecutive years of profitability. They have developed into one of the most admired airlines in the world. Southwest is known for their 'triple bottom line' approach that adds to their performance and productivity, the importance of their people and the communities they serve and an overall commitment to efficiency and the planet.

Stock prices for Southwest have rapidly increased since the AirTran acquisition and investors seem to be greatly satisfied with the operating policies of Southwest. The company does not have high debt that needs to be paid down, but instead their debt is increasing proportionately with their expenses. Their expenses are increasing at a rate that should not affect the company. The company can continue to grow because all debt for the acquisition of AirTran has been paid off.

Since the integration of AirTran, Southwest planned their next big business decision, which was to start international routes and to continue to add more domestic routes. Southwest has also started to increase their stock buybacks, which has helped to increase the stock price. Southwest has recently declared the approval of a new share repurchase program worth $1.5 billion by its board. Simultaneously, the airline operator hiked its quarterly dividend by 25%.

Commitment to Technological Advancement

Southwest's commitment to a single type of aircraft, the Boeing 737 has played a big part in their success. In part, by keeping operations simple, simpler operations mean fewer things that can go awry and botch the whole process. Southwest is so devoted to the 737 that after it acquired AirTran, a rival carrier that was a leading operator of the Boeing 717, they decided to sublease all the newly acquired airline's entire Boeing 717 fleet, consisting of 88 planes to their rival Delta, which allows them to generate income from one of their biggest competitors.

93.25% of Southwest's current leased fleet is an operating lease and 6.75% are capital leases. Southwest gives a hint of guidance that by 2017, a majority of their fleet is scheduled to be upgraded with new Boeing 737-800 and 737 MAX, which likely will result in an exponential increase in passenger revenue because the newer fleet will offer a unique design that gives customers what they asked for, a larger amount of seating spaces in each airplane. The new aircraft seats will be the widest economy seats available in the single-aisle 737 market, the new seats are wider than current seats, include an adjustable headrest, increased legroom, as well as more personal storage, while decreasing the overall weight of the plane itself, which gives Southwest the ability to carry heavier amounts of cargo, allowing them to continue to improve on their fuel efficiency. The Boeing 737 MAX aircraft will offer improved fuel efficiency, along with significantly reduced emission levels and will provide the lowest operating costs among single-aisle aircraft. Southwest has also hinted at the possibility of future acquisitions after its fleet has been upgraded.

2. Company Analysis

Southwest Airlines is one of the most dominant airline carriers in the United States that competes with five other major companies. The company was founded in Dallas, Texas and the company serves customers in both the United States and as of 2015 a few international markets. International markets include places such as The Bahamas, Costa Rica, Jamaica, Mexico and Aruba. The high growth of Southwest has to do with their passenger segment revenue, and the new services Southwest offers to customers. Also, the acquisition and integration of AirTran caused the company to grow at a higher rate than management expected. Dividends have become higher than in years past and shareholder expectations have been met. Debt growth continues to slow, since the integration of AirTran. Lastly, the company strives to provide the lowest rates in the nation in relation to their competitors.

The sectors for Southwest Airlines are Passengers, Freight and Other. Passengers consist of business professionals, government employees and citizens that are traveling for leisure. Total revenues in 2015 were $19.8 billion. Passengers account for $18.3 billion in operating revenues, $179 million is attributed to freight revenue and $1.34 billion pertains to other and special revenue adjustment sources. Since passenger revenues contribute to 92.4% of Southwest's operating income, the company strives to offer the best customer service experience in order to attract more customers into their market share.

Strengths that we believe in highly are that Southwest is encompassing the core competency to expand to international markets. The 2015 fiscal year saw one of the highest expansions reaching 11 international locations for the first time in company history. Management sees this as the driving factor on top of the AirTran integration. Additionally, aircrafts only purchased or leased from Boeing in order to reduce costs and lower their total debt to reduce borrowing. Bonds are not frequently issued, indicating there is low debt accumulation, which makes allocation of more company reserves go toward other potential opportunities. It is also essential to know that necessary steps are taken to ensure the proper hiring and training of employees to aid with Southwest's goal of having the best possible customer experience.

Some imperfect characteristics affiliated with Southwest Airlines are their flight paths earn similar receipts flying to nearby locations compared to more distant locations. This indicates the case that additional revenue might not be earned towards company operations. Southwest's market share is at 18%, which is second highest within the industry. The price of oil and fuel may increase ticket prices because operating expenses with the company will increase. Due to this, a bad recession would make it difficult for passengers to fly with higher ticket prices and those with disposable income would not be affected as much. Due to the nature that Southwest is slowly expanding its operations to other countries and a substantially small portion of their income is attributed towards flying to international destinations; this demonstrates the importance that Southwest has not experienced enough growth in this area.

There are opportunities for Southwest Airlines such as, the ability to flourish in international markets where they do not currently operate. A larger customer base could be developed and Southwest's presence will present the opportunity for possible partnerships leading to further expansion of their operations. The Wright Amendment was cancelled in 2014 and flights can now be directed to another city without the worry of a layover, which resulted in higher customer satisfaction. In addition, the likelihood of more acquisitions can make it possible for Southwest to expand its operations and grow domestically and internationally. Another opportunity to gain an advantage is with the additional services that Southwest offers to customers making it easier to buy tickets and check luggage. Lastly, customer service may improve principally for their international services and there is a chance that Southwest will be seen as a world-class performer from new potential customers.

As of now, the revenue passenger miles (RPMs) had an amount of 28.4 billion. This value increased 9.9% on a yearly basis due to increased customer demand. Available seat miles equated to 35.3 billion and increased 9.2% which shows how many empty seats are on their airplanes. Revenue per available seat mile (RASM) was 13.67 cents and suggested that there was in improvement in company performance. But even Southwest, which has little exposure to international markets, has seen RASM declines. In addition, the load improved 10 points to an amount of 84.6% in the March. This is the highest load factor recorded by Southwest Airlines in 2016 and the current holding period return of 13.09% suggests that the company expects to have high returns on their operations. The industry holding period return is 4.62% and the S&P 500 is 0.46% respectively.

3. Industry Analysis

Southwest Airlines conducts the bulk of their operations in the U.S. market, which accounts for approximately 98% of operating income whereas only about 2% is generated from the international markets. We did an industry analysis for the major players in the U.S. and under the likelihood that not enough international growth has occurred yet. All of the domestic airline competitors share similar features based on their consistent market shares and ability to generate revenue. Southwest Airlines has a competitive advantage because customer programs such as their Rapid Rewards frequent flier program allow customers to earn more credits toward future flights. The industry favors competing on similar routes, with concerns to the possibility of whether, the domestic airlines are resourceful enough to have their own routes that differ from their competitors. Domestic RASM declines at the major airlines tells us that competition for domestic travelers continues to outstrip demand and all US carriers are having to cut their domestic prices more than anticipated in order to fill seats.

The main regional airline competitors domestically are American Airlines, Delta Airlines, United Continental Holdings, JetBlue Airways and Spirit Airlines. The degree of competiveness make these companies a threat for Southwest Airlines because they all compete for the same routes and they try to make their prices comparable to what Southwest charges. The airlines also compete on ticket prices, entertainment and reliability. Southwest does not make up for the largest market share because American Airlines, United Continental Holdings and Delta Airlines have substantial international service that Southwest cannot compete with at this point in time. Southwest has accumulated more revenue growth than all of its competitors and their popularity with customers who choose to pick Southwest for their flights based on their distinct programs they have to offer. Associations with the heavy advertising campaigns for the industry competitors are common practice that make them stand out from the others.

The types of business segments that all the regional airline competitors provide are flight travel for domestic customers, cargo/freight transportation, coach passenger transportation, first class passenger transportation, and business and government class transportation. Freight transportation services produce similar revenues in conjunction with the proportion of revenues that are produced. The industry's main suppliers are Boeing and they all gather their oil and fuel resources from similar resources that Southwest Airlines does business with. Freight services such as, FedEx, UPS and USPS are not related to nor do the industry competitors do business with them as all of their freight and cargo services are individually organized. In addition, Southwest Airlines considers its transportation services as coach class transportation, which consists of all different forms of passengers.

Revenue growth for the domestic airline industry is expected to see an increase in passenger demand, which will result in an increase of forecasted sales. Rising tourism and a growing population in the U.S. are the driving forces behind this and the industry will likely raise their prices with the increased demand, which will help elevate operating revenues. Technological improvements will also increase the airline industry growth rate due to new upgrades being implemented into the newer fleet which will save an exceedingly amount of expense with less fuel consumption. As a result, operating costs will substantially decrease. Lastly, the industry expects the company's Spirit Airlines and JetBlue Airways to slowly make their way towards expanding their operations towards international business, which should improve industry growth.

Specific economic drivers that affect the regional airline industry include, the world price of crude oil, disposable income, corporate profit, market health and domestic flights. The credit crisis and housing bubble of 2007 is an example based on the event, which caused lower amounts of domestic flights to be made because of low market health. As the world price of crude oil increased it has been shown that less corporate profit was made. The future years for the airline industry will likely face higher oil prices and possible market booms or crashes. Disposable income of customers will give an insight to how the perceived outlook for the industry will be, alongside the world price of crude oil. The outlook for the industry is positive and its growth is expected to gradually increase with higher customer demand.

4. Appendix: Inputs into valuation using multiples

	2010A	2011A	2012A	2013A	2014A	2015A	*2016F*	*2017F*	*2018F*
Stock price	14.26	13.32	10.56	18.95	42.32	49.58	*62.05*	*54.21*	*56.39*
Sales	12,104	15,658	17,088	17,699	18,605	19,820	*20,378*	*24,490*	*27,006.90*
Sales per share (basic)	16.23	20.23	22.78	24.93	27.08	29.98	*32.98*	*36.28*	*39.91*
EBIT	1,076	879	421	1,222	2,511	4,641	*4,873*	*5,360*	*5,628*
EBITDA	360	(1,408)	(221)	411	1,287	3,101	*3,205*	*3,582*	*3,761*
EPS (basic)	0.62	0.23	0.56	1.06	1.65	3.30	*3.47*	*3.81*	*3.62*
MVE	7,929.98	10,309.68	7,920.00	13,454.50	29,073.84	32,772.38	*34,851.26*	*38,514.94*	*40,166.12*
Debt	6,645	8,550	8,389	8,638	9,612	10,707	*10,101*	*10,845*	*11,666*
Enterprise Value	13,314	18,031	15,196	20,738	37,404	41,896	*43,991*	*48,390*	*50,810*
P/E	17.28	57.92	18.81	17.84	25.59	15.03	*16.28*	*14.97*	*16.39*
P/S	0.66	0.66	0.46	0.76	1.56	1.65	*1.71*	*1.57*	*1.49*
EV/EBIT	12.37	20.51	36.10	16.97	14.90	9.03	*9.03*	*9.03*	*9.03*
EV/EBITDA	36.98	-819.58	-68.76	50.46	29.06	13.51	*13.72*	*13.51*	*13.51*
EV/Sales	1.10	1.15	0.89	1.17	2.01	2.11	*2.16*	*1.98*	*1.88*

Current Multiples (TTM)	P/E (trailing)	P/E (forward)	PEG	P/S	P/B	EV/Sales	EV/EBITDA	Growth	Beta	ROE	ROIC
Southwest Airlines Co.	13.58	15.9	0.49	1.5	4	1.43	5.42	21.33%	1.42	30.86%	22.13%
American Airlines	3.7	6	-0.63	0.7	4.4	0.95	4.38	-10.27%	3.85	198.80%	35.37%
Delta Airlines	8.63	6.7	0.3	1	3.5	1.05	5.17	23.40%	1.31	46.04%	23.97%
United Continal Holdings	2.99	6.7	1.13	0.6	2.3	0.72	3.79	5.73%	0.99	129.20%	43.86%
JetBlue Airways	10.57	8.5	0.26	1.1	2.1	1.19	5.08	32.79%	0.79	23.59%	15.30%
Spirit Airlines	10.89	11.6	-4.68	1.6	2.8	1.5	5.97	-2.37%	0.92	28.47%	21.28%

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

Works Cited

EDGAR. U.S. Securities and Exchange Commission, n.d. Web. 16 Mar. 2016. <http://www.sec.gov/Archives/edgar/data/92380/000009238016000175/luv-12312015x10k.htm>.

Schmidt, Ally. "Is Debt a Concern for American Airlines?" *Yahoo Finance*. Yahoo, 15 Oct. 2015. Web. 29 Mar. 2016.

<http://finance.yahoo.com/news/debt-concern-american-airlines-150733310.html>.

Yahoo Finance. Yahoo, n.d. Web. 30 Mar. 2016. <http://finance.yahoo.com/q?s=LUV>.

Research, Zacks Equity. "Southwest Airlines March Traffic Up, RASM View Maintained." *Zacks*. N.p., 8 Apr. 2016. Web. 25 Apr. 2016. <http://www.zacks.com/stock/news/212801/southwest-airlines-march-traffic-up-rasm-view-maintained>.

Woodyard, Chris. "Airlines' Fuel Price Bets Not Always Paying off." USA Today. Gannett, 25 Jan. 2016. Web. 25 Apr. 2016.

"American Airlines Group Inc." *Yahoo! Finance*. Yahoo, n.d. Web. 01 Apr. 2016. <http://finance.yahoo.com/q;_ylt=At_37zsIaNWUTJRHA5y_nuonv7gF;_ylc=X1MDMjE0MjQ3ODk0OARfcgMyBGZyA3VoM19maW5hbmNlX3dlYl9ncwRmcjIDc2EtZ3AEZ3ByaWQDBG5fZ3BzAzEwBG9yaWdpbgNmaW5hbmNlLnlhaG9vLmNvbQRwb3MDMQRwcXN0cgMEcXVlcnkDQUFMLARzYWMDMQRzYW8DMQ--?p=http%3A%2F%2Ffinance.yahoo.com%2Fq%3Fs%3DAAL%26ql%3D0&uhb=uhb2&fr=uh3_finance_vert_gs&s=AAL>.

"Delta Air Lines, Inc." *Yahoo! Finance*. Yahoo, n.d. Web. 02 Apr. 2016. <http://finance.yahoo.com/q;_ylt=At_37zsIaNWUTJRHA5y_nuonv7gF;_ylc=X1MDMjE0MjQ3ODk0OARfcgMyBGZyA3VoM19maW5hbmNlX3dlYl9ncwRmcjIDc2EtZ3AEZ3ByaWQDBG5fZ3BzAzEwBG9yaWdpbgNmaW5hbmNlLnlhaG9vLmNvbQRwb3MDMQRwcXN0cgMEcXVl

cnkDREFMLARzYWMDMQRzYW8DMQ--?p=http%3A%2F%2Ffinance.yahoo.com%2Fq%3Fs%3DDAL%26ql%3D0&uhb=uhb2&fr=uh3_finance_vert_gs&s=DAL>.

"United Continental Holdings, Inc." *Yahoo! Finance*. Yahoo, n.d. Web. 02 Apr. 2016. <http://finance.yahoo.com/q;_ylt=At_37zsIaNWUTJRHA5y_nupaXsQF;_ylc=X1MDMjE0MjQ3ODk0OARfcgMyBGZyA3VoM19maW5hbmNlX3dlYl9ncwRmcjIDc2EtZ3AEZ3ByaWQDBG5fZ3BzAzEwBG9yaWdpbgNmaW5hbmNlLnlhaG9vLmNvbQRwb3MDMQRwcXN0cgMEcXVlcnkDVUFMLARzYWMDMQRzYW8DMQ--?p=http%3A%2F%2Ffinance.yahoo.com%2Fq%3Fs%3DUAL%26ql%3D0&uhb=uhb2&fr=uh3_finance_vert_gs&s=UAL>.

"JetBlue Airways Corporation." *Yahoo! Finance*. Yahoo, n.d. Web. 02 Apr. 2016. <http://finance.yahoo.com/q;_ylt=At_37zsIaNWUTJRHA5y_nuonv7gF;_ylc=X1MDMjE0MjQ3ODk0OARfcgMyBGZyA3VoM19maW5hbmNlX3dlYl9ncwRmcjIDc2EtZ3AEZ3ByaWQDBG5fZ3BzAzYEb3JpZ2luA2ZpbmFuY2UueWFob28uY29tBHBvcwMxBHBxc3RyAwRxdWVyeQNKQkxVLARzYWMDMQRzYW8DMQ--?p=http%3A%2F%2Ffinance.yahoo.com%2Fq%3Fs%3DJBLU%26ql%3D0&uhb=uhb2&fr=uh3_finance_vert_gs&s=JBLU>.

"Spirit Airlines, Inc." *Yahoo! Finance*. Yahoo, n.d. Web. 02 Apr. 2016. <http://finance.yahoo.com/q;_ylt=At_37zsIaNWUTJRHA5y_nuonv7gF;_ylc=X1MDMjE0MjQ3ODk0OARfcgMyBGZyA3VoM19maW5hbmNlX3dlYl9ncwRmcjIDc2EtZ3AEZ3ByaWQDBG5fZ3BzAzEwBG9yaWdpbgNmaW5hbmNlLnlhaG9vLmNvbQRwb3MDMQRwcXN0cgMEcXVlcnkDU0FWRSwEc2FjAzEEc2FvAzE-?p=http%3A%2F%2Ffinance.yahoo.com%2Fq%3Fs%3DSAVE%26ql%3D0&uhb=uhb2&fr=uh3_finance_vert_gs&s=SAVE>.

"LUV Southwest Airlines Co XNYS:LUV Stock Quote Price News." *LUV Southwest Airlines Co XNYS:LUV Stock Quote Price News*. Morning Star, n.d. Web. 02 Apr. 2016. <http://www.morningstar.com/stocks/XNYS/LUV/quote.html>.

"AAL American Airlines Group Inc XNAS:AAL Stock Quote Price News." *AAL American Airlines Group Inc XNAS:AAL Stock Quote Price News*. Morning Star, n.d. Web. 02 Apr. 2016. <http://www.morningstar.com/stocks/XNAS/AAL/quote.html>.

"DAL Delta Air Lines Inc XNYS:DAL Stock Quote Price News." *DAL Delta Air Lines Inc XNYS:DAL Stock Quote Price News*. Morning Star, n.d. Web. 02 Apr. 2016. <http://www.morningstar.com/stocks/XNYS/DAL/quote.html>.

"UAL United Continental Holdings Inc XNYS:UAL Stock Quote Price News." *UAL United Continental Holdings Inc XNYS:UAL Stock Quote Price News*. Morning Star, n.d. Web. 02 Apr. 2016. <http://www.morningstar.com/stocks/xnys/ual/quote.html>.

"JBLU JetBlue Airways Corp XNAS:JBLU Stock Quote Price News." *JBLU JetBlue Airways Corp XNAS:JBLU Stock Quote Price News*. Morning Star, n.d. Web. 02 Apr. 2016. <http://www.morningstar.com/stocks/xnas/jblu/quote.html>.

"SAVE Spirit Airlines Inc XNAS:SAVE Stock Quote Price News." *SAVE Spirit Airlines Inc XNAS:SAVE Stock Quote Price News*. Morning Star, n.d. Web. 02 Apr. 2016. <http://www.morningstar.com/stocks/xnas/save/quote.html>.