
Southwest Airlines Co. (NYSE: LUV)

ONE YEAR PRICE RANGE: \$69.66 - \$73.62

LAST PRICE: \$62.08

ANALYST RATING: Long

VALUATION DATE: July 13, 2017

NEXT EARNINGS DATE: July 27, 2017

Investment Thesis:

- Dominant market share (24% of total domestic) with room to grow. High customer and employee satisfaction ratings will drive return customers and superior talent acquisition.
- Investments in improved technology to elevate consumer experience and streamline scheduling efficiency – new reservation system, WiFi on plane, and schedule optimization. Future concerns include revenue management and network optimization capabilities, replacement of Southwest’s existing domestic reservation system, tools to improve operational management.
- The Company’s core operations are built around convenient travel to business epicenters across the country, with expansion opportunities arising in international tropical leisure locations such as Montego Bay, Jamaica; Belize City, Belize, and Cancun, Mexico. Business travel will prove more resilient in times of economic downturn while leisure travel will provide substantial supplementary income in times of high economic activity.
- Lower unit costs than majority of major domestic carriers (Trans World, American, US Airways, Northwest, Delta, Continental, United, America West)
- High operating cash flows (20.8% of net sales) give the Company the resources to continuously invest in the most modern aircraft technologies that utilize energy efficiencies – average age of fleet is 12 years. When input costs rise, Southwest Airlines will be less exposed than airlines lacking modernization capabilities.

Overview:

Southwest Airlines Co. (NYSE: LUV) operates the nation’s largest Boeing fleet of passenger airplanes, providing scheduled air transportation in domestic markets and some international markets. Despite operating in an industry littered with bankruptcies – Aloha Airlines, American Airlines, Frontier Airlines, Delta, and United, to name a few – Southwest has remained profitable for 44 consecutive years, a point of pride that the Company touches on numerous times throughout its financial reporting documents. While many airlines operate using a hub-and-spoke operational strategy, Southwest provides point-to-point service, meaning a much higher proportion of Southwest’s customers can fly nonstop due to decentralization of the Company’s service points. As of December 31, 2016, Southwest served 657 nonstop city pairs. The Company states that its competitive advantage arises through its ability to sustain lower unit costs, on average, than its competitors. Southwest mentions American Airlines, Delta Air Lines, and United Airlines in its annual report as major competitors.

Business Drivers:

- Price of oil and labor costs affect profit margins
- Demand Markets: leisure travel, business travel, freight transportation
- Ancillary services unoffered by all other airlines such as WiFi on the plane, transportation of pets, EarlyBird Check-In. The Company sells services unavailable through most other airlines, yet includes checked bags in the price of tickets, a service for which competing airlines charge fees on top of ticket prices.
- High switching costs through loyalty point systems drive repeat customers. Multi-tiered pricing strategy helps capture consumer surplus: “Wanna Get Away” fares are lowest prices/benefits, “Anytime” fares are middle pricing/benefits, “Business Select” fares are highest prices but are rewarded the most perks.

Customers:

- Leisure travelers (the purchaser)
- Business travelers (the user, but not the purchaser)

Services:

- Air travel
- Freight transportation
- Ancillary services:
 - Satellite WiFi while traveling
 - Pet transportation

Key Valuation Metrics vs. Industry Averages¹:

Price/Earnings: LUV 18.6x vs. Industry 13.18x

Dividend Yield: LUV 0.81% vs. Industry 0.84%

Gross Profit Margin: LUV 68.69% vs. Industry 47.84%

Operating Profit Margin: LUV 16.96% vs. Industry 14.79%

Net Profit Margin: LUV 10.16% vs. Industry 8.54%

Return on Equity: LUV 26.54% vs. Industry 30.47%

Return on Assets: LUV 9.05% vs. Industry 6.77%

Price to BV/share: LUV 4.56x vs. Industry 3.95x

Comp Universe

- American Airlines
- United Airlines
- Delta Airlines

¹ Industry averages provided by TD Ameritrade.

Glassdoor Metrics:

Glassdoor reviews rate Southwest Airlines a 4.2 out of 5, with 85% willing to recommend this employer to a friend, and 89% of reviewers approving of the CEO. These ratings are phenomenal and distinguish the company as a top employer that treats its employees well. The CEO, Gary C. Kelly, was the highest rated CEO of 2017 on Glassdoor. Ratings have steadily trended upward over the last year, and 79% of reviewers project a positive business outlook.

Industry Background - Airlines²

The Airline Industry is intensely competitive, littered with high debt levels and bankruptcies. The U.S. Department of Transportation separates the industry into four categories: International, National, Regional, and Cargo. International airlines represent the largest transportation companies with the most capabilities and largest revenue streams, while cargo airlines simply transport freight and generate the least revenue. Industry performance is heavily dependent upon weather, the cost of fuel, and the cost of labor. Industry participants typically hedge fuel price risk through derivatives and futures contracts. Consumer and business confidence are instrumental drivers of demand for air transportation. Load factor (percentage of available seating capacity filled with passengers) and available seat miles (seats available for passengers * miles flown during period) are also telling of an airline's utilization and total capacity.

Company Financials

In adjusting Southwest Airlines' financials, cost of sales are calculated as Fuel + Maintenance Materials, while SG&A expenses are calculated as Salaries + Aircraft rentals + Landing fees. From FY 2014 to TTM March 31, 2017, the Company has increased revenue at a compound annual growth rate of 3.3%, and net income at 13.9% (**Appendices A-B**). The Company's revenue and net income growth show promising stability, with the financial structure to withstand an economic downturn. Southwest boasts more favorable profitability margins than its peers, along with a debt to total invested capital ratio of 12.6%, and a ROIC of 8.6%.

WACC

- TD Ameritrade Beta: 1.3
- Equity risk premium (Damodaran monthly ERP): 5.13%
- Risk free rate (10 year treasury rate): 2.38%
- WACC: 6.78%

Valuation

A five-year discounted cash flow analysis of the Company yields an equity value per share of \$73.98 and a one year price target of \$80.68 based on a cost of equity of 9.05% (**Appendix C**). This valuation supports the conservative one year price range of \$69.66 - \$73.62 based on a capitalization rate of 17.5x to 18.5x and projected EPS of \$3.98. The Company consistently returns immense amounts of excess cash to shareholders through share buyback programs, increasing the proportional value of equity stakes. A higher than average price-to-earnings multiple is justified by higher than average profitability margins, and consistent surplus operating cash flows and free cash flows to equity.

² <http://www.investopedia.com/features/industryhandbook/airline.asp>

Appendices

Appendix A – Income Statement

Income Statement for Southwest Airlines Co						
<i>Dollars in millions, except per share data</i>						
				Fiscal year ended Dec 31,		
				Hist 1	Hist 2	Hist 3 (TTM)
Net Sales				\$18,605.0	\$19,820.0	\$20,482.0
Cost of sales, excluding depreciation (1)				6271.0	4621.0	4743.0
Gross Profit				12334.0	15199.0	15739.0
SG&A Expenses, excluding amortization				6840.0	7787.0	8438.0
Other Operating (Income)/Expenses				2205.0	2242.0	2578.0
EBITDA				3289.0	5170.0	4723.0
Depreciation (1)				925.0	996.0	1232.0
Amortization				13.0	19.0	17.0
EBIT (2)				2351.0	4155.0	3474.0
Interest Expense				130.0	121.0	121.0
Interest (Income)				-30.0	-40.0	-73.0
Other non-operating (income)/expense				162.0	556.0	142.0
Pretax Income				2089.0	3518.0	3284.0
Income taxes (3)				680.0	1298.0	1202.0
Net Income (4)				1409.0	2220.0	2082.0
<i>Diluted weighted average shares outstanding</i>				696.0	669.0	614.0
Earnings Per Share				2.02	3.32	3.39

Income Statement is adjusted for non-recurring charges.

Appendix B – Balance Sheet

Balance Sheet for Southwest Airlines Co						
<i>Dollars in millions, except per share data</i>						
				Fiscal year ending Dec 31,		
				Hist 1	Hist 2	Hist 3
Cash				\$2,988.0	\$3,051.0	\$3,482.0
Accounts receivable, net				365.0	474.0	585.0
Inventories				342.0	311.0	356.0
Other current assets				232.0	188.0	235.0
Total current assets				3,927.0	4,024.0	4,658.0
PP&E, net				14,292.0	15,601.0	17,286.0
Definite life intangibles				60.0	161.0	131.0
Indefinite life intangibles				303.0	303.0	295.0
Goodwill				970.0	970.0	970.0
Other long-term assets				171.0	253.0	423.0
Total assets				19,723.0	21,312.0	23,763.0
Accounts payable				\$1,203.0	\$1,188.0	\$1,214.0
Accrued liabilities				1,565.0	2,591.0	1,947.0
Unearned revenue				2,897.0	2,990.0	4,012.0
Total current liabilities				5,665.0	6,769.0	7,173.0
Long-term debt				2,692.0	3,178.0	3,066.0
Deferred income taxes				2,782.0	2,490.0	3,442.0
Construction obligation				554.0	757.0	1,175.0
Other long-term liabilities				1,255.0	760.0	703.0
Total liabilities				12,948.0	13,954.0	15,559.0
Total equity				6,775.0	7,358.0	8,204.0
Total liabilities & equity				19,723.0	21,312.0	23,763.0

Appendix C – Valuation

DCF for Southwest Airlines Co					
<i>Dollars in millions, except per share data</i>					
	Fiscal year ending Oct 1,				
	Proi 1	Proi 2	Proi 3	Proi 4	Proi 5
EBITDA	5094.726	5333.432	5579.626	5833.541	6095.41908
Less: Depreciation	1303.761	1342.874	1394.687	1448.399	1448.39935
Less: Amortization	13	13	13	12	12
EBIT	3777.964	3977.558	4171.939	4373.141	4635.01973
Less: Taxes	1125.825	1186.971	1250.541	1318.404	1408.64806
Tax-effected EBIT	2652.14	2790.587	2921.398	3054.738	3226.37167
Add: Depreciation	1303.761	1342.874	1394.687	1448.399	1448.39935
Add: Amortization	13	13	13	12	12
Less: Capital Expenditures	2172.935	2238.123	2305.267	2374.425	1448.39935
Less: Change in NWC	652.3551	-145.759	-150.136	-154.643	-178.11789
Unlevered FCF	1143.61	2054.097	2173.953	2295.355	3416.48956
Partial Period Adjustment	0	0	0	0	0
Mid-year convention	0.5	1.5	2.5	3.5	4.5
Discount Factor	0.967754	0.906347	0.848837	0.794976	0.74453243
Discounted UFCF	1106.733	1861.725	1845.331	1824.752	2543.68727
Sum of UFCF	9182.229				
Terminal Value	48763.35				
PV of Terminal Value	35135.17				
Enterprise Value	44317.4				
less: Net Debt	-416				
Equity Value	44733.4				
Outstanding shares	604.6627				
Equity Value per share	73.98074				
One year price target	80.67822				

Assumptions:	
WACC	6.8%
EBITDA Exit Multiple	8.0x
Discount Periods	5.0
TV Discount Factor	0.72052402

Appendix D – Sensitivity Analysis

WACC	Equity Value per share	Exit Multiple	Equity Value per share
	73.98074		73.98074
6.50%	74.8459	5.5	55.82229
7.00%	73.28346	6	59.45398
7.50%	71.76283	6.5	63.08567
8.00%	70.2827	7	66.71736
8.50%	68.84179	7.5	70.34905
9.00%	67.43888	8	73.98074
9.50%	66.07278	8.5	77.61244
10.00%	64.74236	9	81.24413
10.50%	63.44652	9.5	84.87582
11.00%	62.18419	10	88.50751
11.50%	60.95435	10.5	92.1392
12.00%	59.75601	11	95.77089