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HOLDING: ALASKA AIRLINES (ALK)

Summary

Alaska Air Group, through its mainline operations, covers western U.S., Canada and Mexico. Together with its parent regional carriers, it serves more than 100 cities across North America. The passenger revenues contributed approximately 85% to the company's total revenue while other revenues and Mail & Freight revenues respectively contributes 13.8% and 1.8% to its top line in 2016.

What the bulls say:

- Among legacy airlines in the US, Alaska Airlines' management are doing a great job in expanding its operation in regional markets that require less capital investment and it can also avoid competing with international airlines, especially the subsidized companies from the Middle East, who have aggressively cut American international full-service airlines' market share and profit margins over the last decade. ALK's net margin is 10.3% TTM, making it the only airline in the US who manages to maintain a double-digit net profit margin.
- ALK's acquisition of Virgin Airlines in 4Q16 significantly increase its outstanding debt and raised concerns among its investors. However, as of the beginning of October '17, its debt-to-capital has dropped to 53% from 59% at the beginning of 2017 thanks to its successful new flight routes over the last 1 year.
- The company's current ROA and ROE of 8% and 24.4% respectively are well above the sector median, evidently proving its ability to generate considerable value for investors. In addition, its growing dividends and stock repurchases with its own cash reserve boost investors' confidence in the airline.

What the bears say:

- 32 out of 44 new routes commenced this year are in California. This market has seen a fierce competition among major carriers and also small regional and local airlines. This expansion entails operating risks when business costs will rise sharply while competition pressure will drive down ticket price.
- In the most recent quarter earnings call, its earning per share is $2.24, 4 cents higher than the same period last year. But Revenue per available seat mile (RSM) and Costs per available seat mile (CASM) (excluding fuel & special items), 2 key metrics for operating efficiency in airline industry, fell 1.6% and rose 1% respectively.

Risks:

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INVESTMENT MANAGEMENT

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- The cost directly related to the merger of Virgin America contributed to a massive rise of 44% in ALK operating expenses, according to the latest earning calls. The integration process is expected to complete in the second quarter in 2018 and still requires more capital to transform into a single line of operation and ticket system.
- Alaska airlines, if it wants to maintain its healthy and unusually high profit margin, has to reverse the recent decline in key operation metrics including load factors, RSM, CASM.

4 reasons to buy/sell:

- Alaska Airline, with all the headwind in the market and its own integration of Virgin Airlines, carries considerable risks that makes it a risky holding in short run. However, its historical track record of turning its new routes profitable is a reliable indicator of its management's capability and competency. While the next year earning is expected to be $6.41 a share in 2018 compared to $6.78 this year, there is a consensus in an earning's rebound to $7.14 in 2019
- Compared to other major US international and regional airlines, ALK is the only airline that is able to sustain a double-digit net profit margin, currently at 10.3%. This allows Alaska Airline to generate strong cash flow and invest in new fleet of aircrafts that are more fuel efficient and able to offer customers more value-added experience that will reinforce the brand's loyalty.
- Its stock price has been down 21% YoY, significantly underperforming its major competitors and the industry. This provides a great buy opportunity give its sustainable profitability and fast growth potential in future. Its current P/E stands at 11.1, significantly lower than medians of the airline sector and the US equity market that, 20.3 and 23.3 respectively.
- Another major issues ALK had to cope with, beside the integration, is the pilot shortage at Horizon Air, one of its subsidiaries, resulted in numerous flight cancellations in 2017 summer. The recent arbitration deal with the pilots, while expected to drive up labor costs quite significantly, will also resolve the current inefficiency, generate and sustain the revenue reliably.

Recommendation:

We recommend a BUY rating on ALK.

Junior Financial Analyst | **Managing Partner**

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