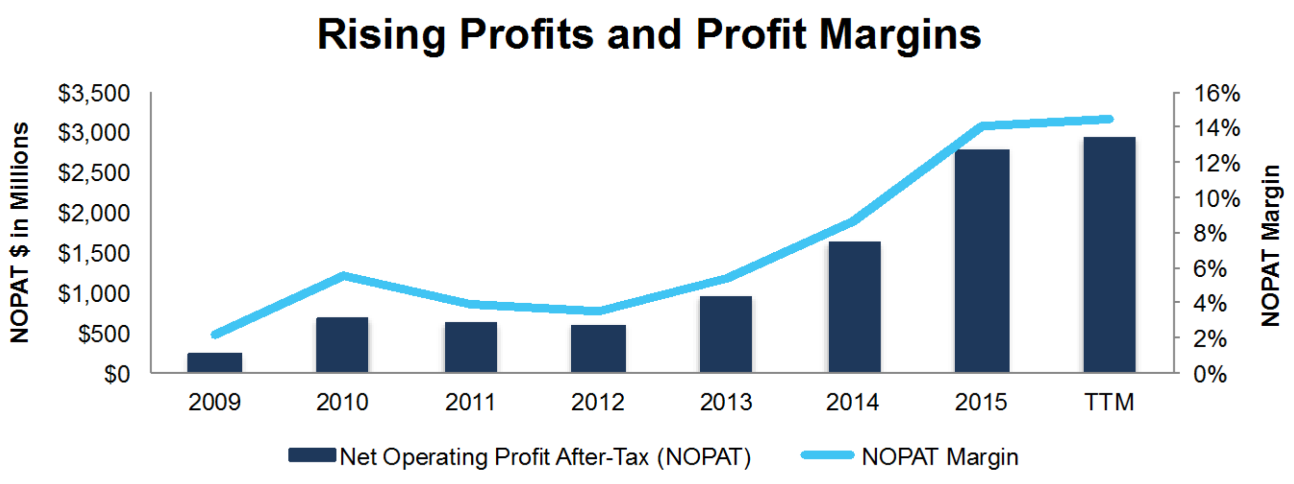
# Long Idea: Southwest Airlines (LUV)

Many times, when an entire industry faces selling pressure, buying opportunities arise for those willing to wade through the details. The airline industry has seen share prices significantly fall throughout 2016, and one firm stands out as undervalued. With a long history of industry-leading profits, improving ROIC, and an attractive valuation, Southwest Airlines (LUV: $39/share) is on July's Most Attractive Stocks list and is this week's Long Idea.

### Impressive Revenue & Profit Growth

Since 2009, Southwest's after-tax profit (NOPAT) has grown by an astounding 52% compounded annually to $2.8 billion in 2015 and $2.9 billion over the trailing twelve months. Similarly, Southwest's NOPAT margin has improved from 2% in 2009 to 14% TTM. See Figure 1. Since 1998, the company has grown NOPAT by 11% compounded annually.

**Figure 1: Southwest's Improving Margin & Profits**



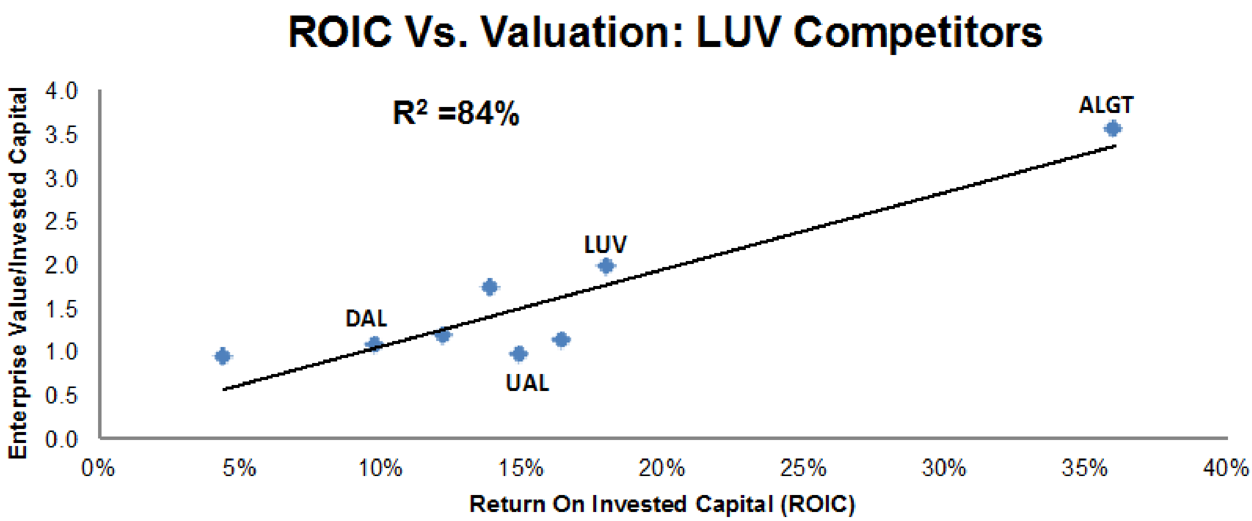

Sources: New Constructs, LLC and company filings

Further showcasing the strength of Southwest's operations, the company generated $2.8 billion in cumulative free cash flow (FCF) over the last decade.

### Improving ROIC Highly Correlated With Increasing Shareholder Value

The growth in profits has come without significant expansion of the balance sheet. As a result, Southwest's return on invested capital (ROIC) has improved from 6% in 2005 to a top-quintile 18% over the last twelve months. This improvement is impressive since ROIC is directly correlated with creating shareholder value. In fact, Figure 2 shows that ROIC explains 84% of the changes in stock valuation for LUV and its competition. Considering Southwest links executive compensation to improvements in ROIC (more on this below), it is clear executive interests are aligned with shareholders. As such, shareholders should expect LUV's ROIC to improve moving forward, which directly equates to growing shareholder value.

**Figure 2: ROIC's Correlation With Valuation**

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### Southwest's Consistent Profitability In A Volatile Industry

Southwest operates largely in the regional airline industry and offers select international flights. As such, the company faces competition from many providers, including JetBlue Airways (JBLU), United Continental (UAL), and Delta Air Lines (DAL), among others. As can be seen in Figure 3, Southwest's ROIC is surpassed only by low-cost regional provider Allegiant Travel Company (ALGT), a featured Long Idea in November 2015. While Southwest's NOPAT margin might not top the industry, its long-term track record of profitability (positive NOPAT in every year of our model, which dates to 1998), provides stability that has eluded many competitors. Additionally, Southwest is the largest domestic flight operator in the U.S., and in 1Q16, operated nearly 40% more flights than its nearest competitor, American Airlines (AAL).

**Figure 3: Southwest's Strong Profitability**

| Company | Ticker | Return On Invested Capital | NOPAT Margin |
|---|---|---|---|
| Allegiant Travel Company | ALGT | 36% | 19% |
| Southwest Airlines | LUV | 18% | 14% |
| American Airlines | AAL | 16% | 18% |
| United Continental | UAL | 15% | 17% |
| Hawaiian Holdings | HA | 14% | 13% |
| JetBlue Airways | JBLU | 12% | 13% |
| Delta Air Lines | DAL | 10% | 13% |
| SkyWest | SKYW | 4% | 7% |

Sources: New Constructs, LLC and company filings.

### Bear Concerns Are Largely Overdone

We see four major bear concerns:

1. The firm's impressive increase in profitability is only a result of low oil prices.
2. The supply of flights is at a cyclical low and is inviting new competition into the mix as we speak. As a result, flight prices will have to come down as more low-cost providers enter the business.
3. Concerns over global economic conditions cast a shadow over demand expectations across the entire airline industry.

4. Protracted negotiations with its pilots union over the introduction of a new, more efficient airplane could cause service disruptions or undermine cost structure.

The first concern is dispelled when comparing the timing of the recent oil price drop to the increase in the firm's profits. The decline in oil prices, which occurred in mid 2014, hits two years past the time that Southwest's profits and margins began improving. While the company certainly benefited from lower oil prices, it is not the sole reason for improved operations. Rather, the company's investment in technology and superior operations separates Southwest from the other providers. In addition, the decision to accelerate the retirement of its classic fleet will only help to lower maintenance costs and increase fuel savings going forward.

The second concern ultimately plays out in the form of margins. Low prices have long been a staple of Southwest, however, new competition, such as ALGT offering even lower pricing (albeit with some add-on costs). The success at ALGT will only invite new competition as low-cost providers see a path to success in the airline industry, which could bring prices down across the board. Not only is Southwest aware of this threat, it is actively investing in new technology for its reservation system that should bring additional cost savings from increasingly superior operational efficiencies. The new reservation system will allow the firm greater flexibility in scheduling routes, balancing capacity, and dynamic pricing. Once completely rolled out in 2017, the firm believes the new system could boost annual profit by $500 million by 2020. We think that the capabilities that have made Southwest more efficient will continue to make the company more efficient. Accordingly, the company will continue to operate with higher profits while offering lower prices.

The third concern is certainly piqued by 'brexit', which sent shockwaves through the market. For Southwest, operating a largely domestic flight base, with limited international flights to Mexico, parts of South America, and the Caribbean, the company faces little exposure to weakness in the European economy. Additionally, as noted in our Long Idea on Thor Industries, the domestic economy, despite its struggles, is still steadily showing signs of improvement in wage growth and unemployment rate.

Lastly, the biggest concern, and possibly largest risk to our thesis, is the potential strike organized by the union representing Southwest's pilots. The sticking point relates to Southwest's plans to introduce a more efficient airplane, the 737-800 MAX, which has a more efficient engine over its predecessor. The union contends that the new plane requires terms to be re-negotiated, and in May sued Southwest. Southwest noted that the negotiations have plenty of time to be resolved, and a lawsuit at this time is unnecessary. While the risk of labor strike is certainly present, Southwest has a longstanding history of negotiating deals with its employees, with only 1 work stoppage throughout its 45-year history. Furthermore introducing more efficient planes is key to long-term success of the company, which means both the firm and the employees are motivated to avoid any type of work stoppage.

As we'll show below, each of these concerns appears already priced into LUV, which leaves significant, upside potential should one, or all, of these issues dissipate or be proven otherwise.

**Valuation Ignores Southwest's Profits**

Despite the strength of Southwest's business, and potential for significant cost reduction, which could lead to greater profitability, the stock is down 9% year-to-date. LUV's current valuation represents an overly pessimistic view of the company's profit potential. At its current price of $39/share, Southwest has a price to economic book value (PEBV) ratio of 0.7. This ratio means that the market expects Southwest's NOPAT to permanently decline 30% from current levels. This expectation runs contrary to the reality of Southwest's profit growth throughout its history.

Even if Southwest were to never again grow profits from current levels, the economic book value, or no growth value of the firm is $52/share – a 33% upside from current valuation.

However, if Southwest can maintain 2015 NOPAT margins (14.1%) and grow NOPAT by just 5% compounded annually for the next decade, the stock is worth $69/share today – a 77% upside. This scenario also assumes that Southwest's spending on working capital and fixed assets will be 4% of revenue, which is the average change in invested capital over the past decade.

**Buy Backs Plus Dividend Offer 6.6% Yield**

Southwest exhausted its previous $1.5 billion stock repurchase program in April 2016, less than 1 year after authorizing the repurchases in May 2015. Through April 2016, the company repurchased $700 million worth of stock (nearly 3% of market cap). Subsequent to the exhaustion of its repurchase plan, Southwest unveiled a new

$2 billion repurchase program. If Southwest maintains its repurchase activity consistent with the first half of 2016, the new authorization will last ~18 months, and the firm would repurchase $1.4 billion in 2016. $1.4 billion represents 5.6% of the current market cap, which provides investors a total yield of 6.6% when combined with Southwest's 1% dividend yield.

**Growth In Fundamentals Will Push Shares Higher**

Compared to many high-flying stocks, Southwest is a slow and steady performer. Eventually, the earnings power will speak for itself and the stock will rise. With the introduction of the new reservation system and more efficient planes, Southwest is positioning itself to build on its impressive lead in efficiency and profit growth in the U.S. domestic market. The stock could see a boost if a deal was reached with the pilots union. In the meantime, investors are getting paid pretty well to wait given the nearly 7% yield (dividend and buyback), which compares pretty well with short and long term interest rates.

**Insider Trends/ Short Sales Raise No Red Flags**

Over the past 12 months, insiders have purchased 262,000 shares and sold 401,000 shares for a net effect of 139,000 insider shares sold. This amount represents less than 1% of shares outstanding. Additionally, short interest sits at 15.3 million shares, or just above 2% of shares outstanding.

**Executive Compensation Recognizes Importance of ROIC**

Southwest Airlines' executive compensation plan signals that the compensation committee recognizes the importance of ROIC and its correlation with shareholder value creation. Since 2009, base pay has been de-emphasized while bonuses and equity pay have grown as a percentage of total pay. Fortunately, the metrics on which bonuses and equity compensation are awarded directly related to ROIC. Nearly 17% of short-term incentive pay is based on meeting ROIC targets, while 100% of long-term performance equity awards are tied to meeting ROIC targets. Better yet, no performance equity awards are given if a minimum performance is not achieved. While we would like to see some of the non-GAAP metrics removed from short-term incentive pay, the large focus on ROIC is the best way to align the interests of executives with the interests of shareholders.

**Impact of Footnotes Adjustments and Forensic Accounting**

In order to derive the true recurring cash flows, an accurate invested capital, and a real shareholder value, we made the following adjustments to Southwest's 2015 10-K:

Income Statement: we made $1.4 billion of adjustments with a net effect of removing $609 million in non-operating expenses (3% of revenue). We removed $999 million related to non-operating expenses and $390 million related to non-operating income. See all adjustments made to LUV's income statement here.

Balance Sheet: we made $8.4 billion of adjustments to calculate invested capital with a net increase of $2.9 billion. The most notable adjustment was $3 billion (22% of net assets) related to operating leases. See all adjustments to LUV's balance sheet here.

Valuation: we made $12 billion of adjustments with a net effect of decreasing shareholder value by $6.8 billion. Despite this decrease in shareholder value, LUV remains undervalued. Apart from total debt, which includes off-balance sheet operating leases, one of the largest adjustments was $2.6 billion due to excess cash. This adjustment represents 10% of LUV's market cap.

**Attractive Funds That Hold LUV**

The following funds receive our Attractive-or-better rating and allocate significantly to Southwest Airlines.

1. U.S. Global Jets ETF (JETS)– 12.6% allocation and Very Attractive rating
2. Fidelity Select Air Transportation Portfolio (FSAIX) – 8.7% allocation and Very Attractive rating
3. Fidelity Select Transportation Portfolio (FSRFX) –7.1% allocation and Attractive rating.
4. Provident Trust Strategy Fund (PROVX) – 5.4% allocation and Very Attractive rating.
5. Catalyst Insider Buying Fund (INSIX) – 5.4% allocation and Very Attractive rating.

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*Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.*

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Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

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QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

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2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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