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ALK - Q3 2015 Alaska Air Group Inc Earnings Call

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PRESENTATION

Operator

Good morning. My name is Shauna and I will be your conference operator today. At this time I would like to welcome everyone to the Alaska Air Group third-quarter 2015 earnings conference call. Today's call is being recorded and will be accessible for future playback at www.AlaskaAir.com.

(Operator Instructions)

I would now like to turn the call over to Alaska Air Group's Managing Director of Investor Relations, Lavanya Sareen.

Lavanya Sareen - *Alaska Air Group, Inc. - Managing Director of IR*

Thanks, Shauna. Good morning everyone. Thank you for joining us for Alaska Air Group's third-quarter 2015 earnings call.

On the call today our CEO Brad Tilden will provide an overview of the business, our chief commercial Officer Andrew Harrison will share the revenue results for the third quarter and outlook for the rest of the year and then Brandon Pedersen, our CFO, will discuss our financial results and our capital allocation plans. Several members of our senior management team are also on hand to help answer your questions.

Our comments today will include forward-looking statements regarding our future expectations. Several risk factors could cause actual results to differ from our expectations. Information on risk factors that could affect our business can be found in our SEC filings.

During the call we will refer to certain non-GAAP financial measures such as unit cost excluding fuel. We have provided a reconciliation between GAAP and non-GAAP measures in our earnings release.

This morning Alaska Air Group reported a third-quarter GAAP profit of $274 million. Excluding the impact of mark-to-market adjustments related to our fuel hedge portfolio Air Group reported a record adjusted net income of $277 million. This is ahead of First Call mean estimate of $2.10 per share and higher than our last year's adjusted net income of $200 million, or $1.47 per share.

We've included additional information about cost expectations, capacity plans, capital expenditures and other items in our earnings release and investor update filed this morning.

So now I will turn the call over to Brad.

Brad Tilden - *Alaska Air Group, Inc. - CEO & President*

Thanks, Lavanya, and good morning. Lavanya just shared the numbers, I thought I would take a minute as we enter the fourth quarter to sort of look back and measure ourselves against the things that we set out to do at the beginning of the year.

And as you know we've got three strong quarters behind us now and 2015 is shaping up to be a really good year on almost all fronts. First, we're operating safely and reliably; second, our employees are engaged and our team of 15,000 people is providing our customers with great experiences every day on every flight; third, we are growing our customer base, our mileage plan members and our Alaska Airline's credit card holders are both growing at record rates; fourth, we're successfully entering new markets, we've entered 10 new markets thus far this year creating new, diverse and profitable revenue streams; and fifth, finally we believe we're doing the right things for our owners.

We have not only strong profitability but also excellent cash flow from operations, an extremely strong balance sheet and a commitment to shareholder-friendly stewardship and capital allocation that's been demonstrated over many years now. In this industry all of us know that there are always things to lose sleep over and we all do plenty of that. But we believe the first night months of 2015 have been very solid.

We believe that this new competition we're dealing with is making us better and we believe that our competitive position today is very strong. Our $442 million pretax profit for the quarter equates to a pretax margin of 29.2% which is 740 basis points higher than last year. In fact, this quarterly profit is larger than all but four of the annual profits we've produced in our 83-year history.

We expect our margin performance to lead the US industry this quarter and to also be better than about 90% of the companies in the S&P 500. Our ROIC for the trailing 12 months is 24.2% and that's driven by higher revenues, by strong non-fuel cost performance and by a large benefit from lower fuel cost.

Despite continued competition 2015 is shaping up to be a year of record profitability. Pretax income for the first nine months of the year is over $1 billion or about $130 million higher than our full-year results for last year. And year-to-date cash flow from operations is $1.2 billion which is enabling us to reinvest in the business and return a substantial amount of cash to shareholders. Brandon will talk more about this in a moment.

In the first half of the year investors worried about the industry's ability to capture the benefit of lower fuel prices. Today we are capturing two-thirds of this benefit and those savings are flowing directly back to our shareholders.

If you look back over the last several years we have successfully adjusted our business to many changes: to higher fuel in 2008, to a steep recession in 2009, to an unprecedented competitive incursion in 2013 and to a lower fuel price environment this year. Not only have we raised our margin profile but we have been an industry leader consistently through these changes. This speaks to our team's ability to quickly adjust to changes in the economic environment.

We're building a business that works throughout the cycle, that is sustainable and that creates value for all of our stakeholders.

Operationally the third quarter was challenging with high loads and record traffic flowing through our airports. Continued runway construction in Seattle and Los Angeles added additional complexity. But our people did a great job rising to the challenge and running a strong operation.

For the first nine months of the year we completed an industry-leading 99.6% of our flights and 86.4% of those flights in the third quarter arrived on time. That on-time percentage is the highest percentage of the US airlines with the exception of Hawaii. And as you know our team generates these strong results with aggressive block times.

And last, our people take pride in taking care of customers and offering them genuine and caring service. 6,500 of our front-line employees have completed our Beyond Service workshops thus far this year.

We're also making investments in our product. Earlier this month we garnered national media attention for becoming the launch customer for Boeing space bins. These new bins will allow us to carry up to 57 additional bags on each 737-900ER and that's a 50% increase in bag space.

And our year-to-date customer satisfaction score of 86% is a new record. Our customer satisfaction has improved an average of 2 percentage points each year since we first began tracking this data eight years ago. This continuous improvement reflects our thinking around everything we do.

While 2% might seem nominal, the compounding over the last seven years has allowed us to improve our score dramatically and create a durable competitive advantage.

I talked with you last year about a series of workshops we ran with our leadership team where we asked them to shoulder more of the responsibility for running the Company. This year we are taking this a step further and we are working with these same folks to enhance our high-performance culture. To us this means three things: first, not shying away from setting high standards and tough goals; second, getting to decisions quickly without compromising quality; and third, leveraging our culture and becoming expert at executing projects and delivering results.

Looking ahead we're just now putting the finishing touches on our 2016 plan and we look forward to sharing some of the details of this plan with you at our Investor Day which will be in New York City on December 3.

As I close I'd like to thank our employees for just a terrific quarter. We have a fantastic group of front-line employees who are fully engaged and a leadership team that is both talented and dedicated. All of these folks are working together like never before.

And with that I'd like to turn the call over Andrew.

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Thanks, Brad, and good morning everybody. Our third-quarter revenue performance was solid. And we were able to sustain high load factors while increasing capacity 8.2%.

We grew passenger revenue by $48 million or 3.8% despite competitive capacity increasing 13% in our markets. While strong demand in summer months is not surprising we were pleased with our year-over-year change in PRASM for the month of September. It was 40 basis points better than August despite year-over-year change in capacity for September being 250 basis points higher than August.

This strength despite Labor Day moving further into the fall which resulted in lost traffic as the majority of schoolchildren in Washington state had returned to class by Labor Day this year.

In the third quarter we continued to grow and diversify our revenue by adding more new markets to our network. We've added 15 market since the beginning of Q3 2014 and about half of those new markets were added in the last quarter. 75% of new markets are not only profitable for generating returns in excess of our cost of capital, some of them achieving this level of profitability within six months of launch.

This is unprecedented for Alaska Airlines and has been possible given our foundation of low costs, powerful Pacific Northwest network, global loyalty programs, award-winning customer service and industry-leading operation.

Specifically four key areas helped us deliver solid Q3 results. First, our strategy of adding nonstop service to destinations our frequent flyers previously flew from our hubs with one or more stops on other carriers. This is creating new and profitable revenue streams.

About 40% of seats on our new flights are filled with mileage plan members which is in line with our system average for mature routes. This demonstrates strong support for our brand and natural demand for our new nonstop markets.

Second, we added Embraer 175s into our fleet this quarter, allowing us to enter markets too thin for 737s to serve profitably and too far for the Q400s. All three E175 markets are exceeding expectations with very high load factors consistently near 90% and achieving profitability in their first quarter of operation.

Third, our cost profile continues to improve while our competitors are seeing their costs increase. For the 12 months ended June 2015 our nonfuel unit costs have come down about 2% while the industry's costs have increased 1.4%. This is an important sustainable advantage for Alaska.

Fourth, the tremendous loyalty we enjoy in the Pacific Northwest continues to support our expansion into new markets. Active members in our loyalty program are up 15% for the third consecutive quarter this year. Active credit card accounts are up 11% both ahead of our passenger growth of 9% with these rates being historic records for Alaska.

Greater network reach improves our schedule utility and drives greater customer affinity for our brand. To that end we entered a new code share and frequent flyer agreement with Iceland Air last month, adding service to over 20 European cities for our customers. The agreement with Iceland Air features reciprocal lounge access, priority check-in and boarding for late customers and builds on our previously announced frequent flyer partnership with Hainan Airlines.

Our foreign flag partners are putting 1,100 passengers per day on our network. With premier global foreign flag partners that fly out of Seattle including British Airways, Emirates, Hainan Airways and Korean Airways now members enjoy tremendous choices in both main and premium cabin service across the globe. Our partnerships are helping us create both a national and global network for our customers.

We want to congratulate American for smoothly transitioning all US Airways flights into the combined American Airlines system this past weekend, a monumental task to say the least. For Alaska this means our customers now have access to a 50% larger network with 2,900 additional daily flights from which to earn and redeem miles. This is very exciting for us and there's more to come as we continue to expand the number of flights that America and Alaska market for each other.

For the third quarter American put about 5,000 passengers per day on our network, a 10% increase over Q3 of last year. The benefit that Alaska provides to its partners is valuable local and connecting traffic for their international flights and additionally for American greater West Coast utility for their customers.

Lastly, for the third quarter we added 12% more regional seats into and out of Seattle and as a result have seen connecting passengers over Seattle increase 15%. Our feeder network is helping support our Seattle markets both core and new. This demonstrates the resilience of our network in the Pacific Northwest.

Looking ahead there's some important facts to highlight with respect to capacity in our markets. So let me start with our own capacity.

We expect Q4 capacity to be up 12.5%. About half of that growth is driven by longer stage and larger gauge, another 2 points by new markets with the remaining 4.5 points being additions to existing markets where there continues to be strong demand. This brings our full-year capacity growth to just over 10% and in line with previous guidance.

We are very pleased with our forward load factor for October, down only 8/10 of a point. It's actually up half a point for November and flat for December.

Looking at our Q1 2016 capacity it's expected to be up 13% which is the high-water mark of the year and will decline over subsequent quarters. The vast majority of our new market growth for 2016 will start this year with seven markets this past quarter and another 11 in the fourth quarter.

Moving to competitive capacity, as we look at published schedules we expect Q4 competitive capacity to be up 7%, Q1 of 2016 to be up 15% and then Q2 of 2016 moderating back to 8%. We've heard some concerns around the increase in the first-quarter competitive capacity and wanted to share some color. First, 40% of the incremental competitive ASMs in the first quarter are driven by the annualization of markets added by competitors in the second half of 2015.

In fact, there are only three new markets being launched in the first quarter of 2016 in our network which is Boise-Sacramento, Seattle-Victoria, and a once-weekly service from LA to Sun Valley.

Second, new competitive markets launched in the second half of this year are materially smaller as measured by passengers per day each way versus previously launched markets. In fact, the average size of the impacted market is 50% smaller compared to the same period last year.

Competitive capacity moderates in the second quarter of 2016 which is the seasonally stronger demand period. We believe that strong demand in Seattle, the loyalty of our customers, industry-leading margins and return on invested capital of over 20% warrant investment in our business and therefore we expect to grow about 8% on a consolidated basis in 2016. That 8% can be broken down into 1 point related to gauge, 1.5 points related to growth in stage length and then the remaining 5.5 points driven by departures.

Continued investment in our network and product while driving unit cost lower and growing profit is important for us. This enables us to continue delivering value to our customers and shareholders. We are working diligently to strengthen our commercial engine and we will share specifics of our 2016 revenue strategy at our upcoming Investor Day on December 3.

With that I will turn the call over to Brandon.

Brandon Pedersen - *Alaska Air Group, Inc. - EVP, Finance & CFO*

Thanks, Andrew, and hey everyone. Air Group's adjusted net profit improvement of 39% coupled with the 6% reduction in shares outstanding drove our Q3 earnings per share up 47%. Trailing 12-month after tax return on invested capital stands at 24.2% and is 700 basis points higher than at this point last year.

As Brad said our pretax margin also improved by more than 700 basis points to 29.2%. This marks our third consecutive quarter of 700 basis point plus improvement. We expect our margin performance to lead the industry this quarter.

We earned $442 million before taxes, a $122 million or 38% increase. Traffic was up nearly 8% contributing to a $50 million increase in revenues. Economic fuel declined by $150 million and nonfuel operating cost climbed by $82 million, or 11%.

On a unit basis nonfuel costs increased by 2.5%. Our cost performance was significantly better than our initial guidance driven by a favorable outcome, uncertain property tax assessments, a shift in maintenance and advertising initially planned for Q3 into Q4 and good cost performance throughout the business as people continue to focus on productivity and embrace our culture of frugality. I want to give a shout out to our tax team for doing a fantastic job ensuring that our property tax assessments were fair.

Looking forward we expect nonfuel unit costs to decrease about 1% in the fourth quarter. For the full year we now expect, excuse me, we now expect to report nonfuel unit cost reduction of about 6/10 of a percent, slightly better than the guidance we've been providing most of the year. This would make 2015 the sixth year in a row of unit cost reduction for Air Group and the 13th year out of the last 14 for mainline.

We will end this year with our lowest cost structure ever which is another way of saying our competitive advantage has never been greater. As we've been developing the 2016 plan, we've been talking internally about the notion of, quote, good costs and bad costs. An example of a good cost is employee incentive pay which is paid an average of about a full month's pay over the last five years.

This year should be no different based on current trends and a great result for our employees who have worked hard to meet safety, operational and financial goals set out in the plans. We've already accrued $90 million to date, 7% more than at this time last year. We're planning to share our initial 2016 cost guidance at Investor Day in December.

Our cost plan will reflect the excellent visibility and stability we have around our labor costs because our largest employee groups have contracts in place until at least 2018.

As I alluded to earlier our results reflect a significant decline in economic fuel costs. Our price per gallon was down 42% to $1.82, the lowest price yet this year.

Importantly our fuel efficiency continues to improve. Year to date, the mainline fleet is 2.9% more efficient than last year on an ASM per gallon basis. This will just continue to get better as we retire our 737-400 fleet over the next two years.

Fuel prices are low but they won't be low forever . And this remains an important source of competitive advantage for us.

During the first nine months of the year we generated $1.2 billion in operating cash flows, an increase of $337 million over the first nine months of last year. We have invested $650 million into the business this year, most of that into our fleet. We've taken delivery of eight Boeing 737-900ERs so far this year and have three more scheduled in the fourth quarter.

Next year is a particularly busy year for our fleet and maintenance teams with 19 new deliveries, 14 lease returns and the start of our initiative to modify three 737-700s into freighters. By the end of 2017 we will welcome 34 more 737-900ERs and our first MAX or about one per day on average, or excuse me, one per month on average. That's a lot of CapEx otherwise.

However, most of these deliveries support our plan to retire the 737-400 fleet in that period. And so our mainline fleet should only grow by about nine units from where it is today.

The Boeing 737 is a fabulous airplane for our network, Boeing is a great company to work with and our partnership with them could not be stronger.

We've produced more than $560 million of free cash flow so far this year and have aggressively returned much of that to our shareholders. So far this year we've repurchased 5.6 million shares of our common stock for $381 million, or more than 4% of the shares that were outstanding at the start of the year, utilizing both the prior $650 million authorization and the new $1 billion share repurchase authorization announced in August.

We've paid out $70 million in dividends, bringing total capital return this year to $460 million. Our dividend yield is just over 1% and it's the highest among North American airlines that pay a regular dividend. We're on track to return about $600 million to our owners in 2015, 43% more than our initial target.

Our investment grade balance sheet is in a net cash position and we have no required pension funding. So we expect that we'll continue to deploy our substantial free cash flow back to our shareholders.

We're building a high-quality business and I want to share three examples of how ALK compares to other well-run companies financially speaking. First, we expect our 24% ROIC over the last 12 months to be among the top 10 industrials in the S&P 500 and in the top 50 of the index overall. Second, our free cash flow yield of 6.2% based on consensus is 60% higher than the average and better than 75% of all the companies in the S&P 500. And third 4% of our stock that we've repurchased so far this year is about twice as much as an average S&P company.

We're working hard to make sure that these great financial results are sustainable. But just as importantly our employees are safe, they are running a great operation and they are taking great care of our customers which really is the foundation of our financial success. And we appreciate all their efforts.

And with that, let's open it up to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Julie Yates, Credit Suisse.

Julie Yates - *Credit Suisse - Analyst*

Good morning. Thanks for taking my question.

Based on the other calls it seems the rest of the industry has seen some sequential improvement in unit revenues in Q4. And I realize you don't give unit revenue guidance but can you offer any perspective on whether you at Alaska would expect to also see this dynamic despite the increase in capacity growth in the fourth quarter?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Hi, Julie, it's Andrew. You're right, we don't give fourth-quarter guidance because the CFO won't let me.

But other than that I would just go back to the remarks that I shared which is our advanced book load factor where we even have positive GAAP in November and December is flat on top of our capacity growth. So we aren't seeing any change in the demand environment. If anything it continues to be very robust here in Seattle.

Julie Yates - *Credit Suisse - Analyst*

Okay, that's helpful. And then with the 11 new markets in the fourth quarter, though, does that impact it as you have some introductory pricing in those markets?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

You know, we always do. But I think you touch on something that I think is important for me to clarify.

If you look at the fourth quarter we were up 12.5%, 9 points of that are in transcon, mid-con and the Pacific Northwest Hawaii where we've been doing very, very well. And in fact when we talk about new markets what we're really looking at is markets today that have either no nonstop service or very little nonstop service. So whether it's Milwaukee, Oklahoma City, Raleigh-Durham, Costa Rica, Nashville, Portland, Austin all of these new markets fit very well with our network and bringing good solid revenues in. So that's why we have good confidence with that.

Julie Yates - *Credit Suisse - Analyst*

Okay, excellent. Thank you.

Operator

Joseph DeNardi, Stifel.

Joseph DeNardi - *Stifel Nicolaus - Analyst*

Thank you. I think there was some concern, or maybe Brad there was some concern earlier in the year as the capacity guidance ticked up throughout the year. But can you just talk a little bit about how that additional capacity is translated into some of the additional cash that you've returned to shareholders?

Brad Tilden - *Alaska Air Group, Inc. - CEO & President*

Yes, Joe, hi, it's Brad. Maybe I will jump into that.

I think what I would just simply say is in Seattle what we see is quite a strong economy. We are adding, we're growing, we're taking delivery of these new airplanes, we're putting them into markets. As Andrew sort of suggested many of these markets are doing great right out of the gate.

Andrew, I can't remember the exact figure you quoted but 75% are early in their life producing returns that cover our cost of capital. So I think the simple answer to your question is yes, this is good new growth. We're producing returns as a Company that are far in excess of our cost of capital and this is helping us with our substantial returns to the owners of the Company.

Joseph DeNardi - *Stifel Nicolaus - Analyst*

Okay. And then for Brandon, just on the CASM trend going forward, is there any inflation in your CASM associated with addressing the competitive environment there and maybe you're investing more than you otherwise would and that starts to get better as the competitive pressures start to level off a bit?

Brandon Pedersen - *Alaska Air Group, Inc. - EVP, Finance & CFO*

I don't know that I would call it inflation necessarily. But what I would say is that we've done a lot to invest in our product. And ultimately at the end of the day customers choose your service because you operate well and you have got great people on board and you have got great product and we want to make sure that our product is as good as it can be.

So we are investing into food and beverage. We are investing in some of the training initiatives that we've talked about. I wouldn't necessarily call it inflation, I would call it intentional investment into what customers see every day.

Joseph DeNardi - *Stifel Nicolaus - Analyst*

Okay, thank you.

Operator

Hunter Keay, Wolfe Research.

Hunter Keay - *Wolfe Research - Analyst*

Good morning. So your last bags were up like 34% in the recent period, I forgot the period but it was up a lot. And presumably that's because you're giving away more of these checked bags for free with the credit card.

So Brandon you talked about bad costs. Are you going to have to maybe spend some money to address that problem? That's part one of the question.

And part two, if this feeds into a bigger membership base for when you recut your credit card deal, how should we think about the magnitude of that in relation to the roughly $50 million benefit you got when you did the deal with BofA a couple of years ago? Thanks.

Ben Minicucci - *Alaska Air Group, Inc. - COO & EVP, Operations*

Hunter, it's Ben. I will take the first question on the bag performance.

We had a rough quarter on mishandled bags and the operations folks own that. We're not happy with how we performed.

We actually have an initiative right now and going into 2016 to get our mishandled bags right in line. I don't want to put the cause on the free bag with the credit card. That is us to perform at the levels that I know we can perform.

Brad Tilden - *Alaska Air Group, Inc. - CEO & President*

And Hunter, in terms of if we were to renegotiate our bank card deal, whatever's in the base is in the base, so I just think the economics get better across the board. In terms of free bags is in the base is what I mean to say.

Hunter Keay - *Wolfe Research - Analyst*

Yes, I get you. I guess I was just trying to get to I think you said there are a lot more members, 75 what is it 40% of your seats are filled by mileage plan members or something. So I'm assuming the number of people that have credit cards and these mileage plan numbers are improving in volume which would lead one to conclude that you get more than $50 million when you recut the credit card deal whenever that would be, but anyway.

Okay, so yes whatever, asked and answered. Right? So how do you think about competition?

You talked a lot about competitive capacity in the context of where your passengers buy their ticket. So would you be, in an all-else-equal situation would you be generally more protective of keeping passengers that live in your core origination markets as it relates specifically to how you manage your inventory as opposed to customers on your planes that maybe originate in your destination markets? Does that change the way you think about managing your inventory?

Brad Tilden - *Alaska Air Group, Inc. - CEO & President*

Yes, Hunter I might start and then I'm going to turn it over to a new personality on the call. But sure, the way we would look at our network is we have incredible strength in the state of Alaska and Washington State and Oregon and considerable strength in California.

To the extent we have competition in those markets that's a lot of these results that you see are the results of the loyal customer base, the flight schedule, everything we're doing out of these markets. So for sure we would want to do to work hard for originating traffic out of those hubs, out of those regions and protect what we have here.

In terms of your second question I want to introduce a new personality. Shane Tackett is our Vice President of Revenue Management. Shane has been with the Company a long time, 15 years, Shane?

Shane Tackett - *Alaska Air Group, Inc. - VP, Revenue Management*

Yes.

Brad Tilden - *Alaska Air Group, Inc. - CEO & President*

Shane has worked in our corporate real estate group. He's spent a long time at financial planning and analysis.

He did a terrific job in labor relations. He is the one that helped us get many of these deals that we have today and now he's running revenue management. So Shane will -- there is your introduction.

Shane Tackett - *Alaska Air Group, Inc. - VP, Revenue Management*

Thanks, Brad. Good morning everybody.

Hey, I would add just a little bit to what Brad said. We are keenly focused on making sure we retain the loyalty of the customers in our work. And so we're very strategic about what competitors are doing, what fares they're offering and you'll find that we're competitive across the board.

We're not interested in yielding our base of strength. I think in terms of outside of Seattle I incurred some of the core parts of our network, we actually have been doing a little bit better in terms of focusing on getting originating passengers off of the core network.

One place that we've done a good job over the last 12 months is Salt Lake City where we sort of started struggling a little bit out of the gate in terms of load factor. We put a lot of energy into it as a commercial team and we've seen those load factors come up nearly to our system average. So we will do more that as the network gets broader and more complex but I think we're doing a great job and most of that is to the credit of my team down in RM.

Hunter Keay - *Wolfe Research - Analyst*

Thank you.

Operator

Savi Syth, Raymond James.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Good morning everyone. On the margin commentary that you made, stepping back I was curious what your thoughts were historically and you continue to have a leadership position on the margin versus the industry.

Maybe what drives that and how do you maintain that or how do you think about margins longer-term? Is it versus in relation to ROIC or how should we think about margins? And right now fuel has been a big tailwind but as we look forward is fuel recovering somewhat maybe with the competitive landscape much changed?

Brandon Pedersen - *Alaska Air Group, Inc. - EVP, Finance & CFO*

Good morning, Savi. It's Brandon. Maybe I'll start with that.

It's actually a good question and it's one that we're thinking a lot about right now. Back a decade or so ago when we set out a goal of having a 10% margin it was viewed as sort of aspirational in nature certainly by others in the industry. And we worked hard to get there and our 10% margin was directly connected to an ROIC goal.

What I will say is the industry is much different now than it was then, structurally revenue environment competition in Seattle. And so it's really fair to say that 10% or $0.10 on the dollar as we talk about internally is probably not a relevant place to be over the long-term. On the other hand we're at a 29% margin for the quarter, 23% on a rolling 12 basis among the top three in the industry, typically behind Spirit and Allegiant and congratulations to those guys, they are doing very well.

But that's probably not sustainable either both because as you say fuel will recover but I think just in the context of where airlines as a mature industry that's healthy are going to be it's probably going to look more like industrials broadly than as a real outlier like it is today. So it's a really good question. It's one I don't have a great answer for but I suppose what I've done is maybe set out the goalposts on each side and the right answer is probably somewhere in between.

Brad Tilden - *Alaska Air Group, Inc. - CEO & President*

I might sort of jump onto that as well. It is something we're spending time on right now just to make sure we understand where our profitability comes from so that we can sustain it.

I think a lot of our margin performance comes from our low cost structure, just simply said. Our costs as Brandon said they've been down 13 of the last 14 years. We did restructure this Company outside of bankruptcy.

We sit here today with a low cost position. And Brandon you know the exact numbers, I don't, but I think we're something like 20% lower CASM ex-fuel than the mainline airlines and we're just a little bit higher than the LCCs.

So part of that low cost structure gives us margin. Part of that low cost structure gives us the ability to offer our low fares. I think a second big thing that leads to our margin performance is customer preference.

Our customers do like to fly with Alaska Air Group. They like to fly with Alaska, with Horizon and some of that is the fare but a lot of it is the service.

So I think those two things. And then you might say okay you've got a low cost structure, where does that come from? And there's lots of answers to that. But I guess I just want to simply say that I think the low cost structure is a very, very important part of our margin advantage.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

That's helpful. Thank you.

Just more of a near-term question, ancillary revenue on a per passenger basis it seems like you might lag some of your peers on that front. Is that by choice and you get it more on the base fare or is there opportunity on the ancillary revenue side?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

It's Andrew. Yes, I think we're down about 2.8% and I think what you're seeing right now is sort of a transition period. As you know we've gone out with three bags on the first bag fee but we've also seen massive increases in our loyalty membership credit card holdings.

So our goal and we continue to be focused on getting to be more industry average on our ancillary revenues as far as the big network carriers go. And as you've heard from Shane a little bit his team is also very focused on our first-class cabin and continuing to as we invest in the product there continue to achieve the premium and the first-class load factors that we also need, even if it fell up at the gate and the preferred seating we've launched this year. All of these things together we think are going to continue to work well but we just need a little bit more time after the first three bag adjustment.

Savi Syth - *Raymond James & Associates, Inc. - Analyst*

Helpful. All right, thank you.

Operator

Rajiv Lalwani, Morgan Stanley.

Rajeev Lalwani - *Morgan Stanley - Analyst*

Thanks for the time. First question, just on Seattle it seems like the demand has been incredibly strong there. How do you get confidence that capacity growth from others won't stay elevated just given that dynamic as we look forward?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Rajeev, it's Andrew. It's hard to predict the future but what I will tell you as I look at our COO here that the room at the inn is getting very tight.

If you take our morning banks between 8 and 10 a.m. and our evening banks between 2,000, 2,200 these things are full, completely full. And we're already having to move our network around because we have a sizable network to accommodate. So while I don't know what the future holds, what I do know is that I think we're going to see it slow and in my prepared remarks the size of the new markets that competitors are coming into are getting smaller and smaller and smaller. So we've learned to adjust in this environment and so I don't have huge concerns that we will be continuing to be able to adjust as we move forward.

Brandon Pedersen - *Alaska Air Group, Inc. - EVP, Finance & CFO*

Rajeev, Brandon. Maybe I will add -- Brandon here, maybe I will add one other thought on that. We've tried to build our business to withstand competition.

We've seen it over the last three years to be sure but our mindset is that there's always going to be competition in our markets. This is an extremely competitive industry but for the reason that we just talked about with Savi I think this Company has been successful and will continue to be successful because of the great service that we provide, the excellent operation that we run and our low cost structure. So I think we'll be fine.

Rajeev Lalwani - *Morgan Stanley - Analyst*

Yes, that's great color, gentlemen. Then just a quick one for you, Brandon in terms of capital allocation I think you've been paying down a little bit of debt this year and correct me if I'm wrong there, but just thoughts going forward are you going to maybe continue to do that or is all the cash flow going to go exclusively to shareholders?

Brandon Pedersen - *Alaska Air Group, Inc. - EVP, Finance & CFO*

Any debt paydown that we've done has been just paying off normal maturities. We've got an awesome balance sheet right now. And we don't have any specific initiative to pay down more debt because we're already in a very substantial net cash position.

I think what I'm saying is the strong free cash flow that we're generating is for the most part going to get deployed back to our shareholders just like it has been over the last nine months or so.

Rajeev Lalwani - *Morgan Stanley - Analyst*

Great, thank you.

Operator

Jamie Baker, JPMorgan.

Jamie Baker - *JPMorgan - Analyst*

Hey, good morning team Alaska. As it relates to the American code share and accepting that American doesn't have a Northwestern Pacific gateway but they do still have a fairly respectable presence of their own out West, my assumption has been that your relationship with American won't fully replace what was once the high level of revenue cooperation with Delta. Is that the way that you see?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Good morning, Jamie, it's Andrew. You know I'd say a couple of things. We're focused on really two aspects: our partners and ourselves.

And I think if you look at the dynamics and we will share with you at Investor Day much more visibility on where we are today with all of our alliance partners and the traffic, so look forward to that. We're finding that we're basically American is as I shared in my comments up 10% but we're also finding a lot of traffic coming back onto our network. And so really the way we look at it is growing the overall traffic.

And so we're using our own network and our own expanded network as well as American and their expanded network to net-net be better off. And that's how we're looking today and that's where we want to keep moving forward.

Jamie Baker - *JPMorgan - Analyst*

Okay, that's helpful. And then just secondly, this is a housekeeping item, you cited your view that we're retaining about two-thirds of fuel's lower benefit and I'm just curious as to the methodology you use there. Are you simply looking at year-on-year fuel savings and comparing it to the year-on-year change in EBIT or is it something more complex and proprietary than that?

Lavanya Sareen - *Alaska Air Group, Inc. - Managing Director of IR*

Hey, Jamie, this is Lavanya. Nothing more proprietary than that, just what we're bringing to the bottom line and how much fuel prices have come down.

Jamie Baker - *JPMorgan - Analyst*

Okay perfect. We come up with the same figure.

I just didn't know if there was a way to build a better mousetrap. So okay, thanks so much everybody.

Operator

Michael Linenberg, Deutsche Bank.

Michael Linenberg - *Deutsche Bank - Analyst*

Yes, hey I guess to questions. I actually I think both for Andrew.

Andrew, you talked about connections in Seattle up 15%. And I think Seattle historically just based on how it's positioned would probably see a lot more local traffic historically than connect with the exception of some of the international.

Where is that split now when you look at your traffic in Seattle connect versus local and where could that go? It's never going to be a Chicago like 50/50 but where could that potentially go, especially given the significant amount of new flights coming from the international carriers?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

I think a couple of things and honestly, maybe we can follow up, I don't have a scientific split for you right in front of me on that whole question as it relates to the flow and the local. But the way I look at it is especially on the domestic side for our network good, solid, local demand where we have capacity that's coming in that's maybe incremental and that's where Shane and his team can use our expanded regional network to bring traffic in from our Montanas, Washingtons, Oregons and Alaska to help fill those additional seats.

I think what's really exciting on the international front to your point is Seattle relative to New York, Los Angeles, San Francisco demand is way, way smaller. And so the feed is imperative for these international carriers and partners of ours.

And so what we're seeing number one is our own members with our partners choosing to fly on our international partners and then we're using our network including all of our new markets to help bring traffic to the West Coast through their international network and beyond. So overall all these pieces have been working well for us and we have a lot of refining to do. We have more things to do but we are feeling very good about that.

Michael Linenberg - *Deutsche Bank - Analyst*

Okay, great. And then the second one and maybe this is just more sort of a footnote but the partnership that you have with United, is that just limited to a few club rooms? Is that all that is?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Yes I mean we have Interline with United. Maybe what you're referring to is there have been changes in our lounge agreements and we won't be partnering with Delta in our lounges anymore but we have a new agreement globally with American and so we've got about five club rooms where we're using United to help supplement our lounge system. So that's really what you're seeing.

Michael Linenberg - *Deutsche Bank - Analyst*

Okay, good, thank you.

Operator

Helane Becker, Cowen and Company.

Helane Becker - *Cowen Securities LLC - Analyst*

Thanks very much, operator. Hi everybody. Thank you for the time.

So you guys I noticed in the press release today you talked about new routes out of Portland and I know that airport tends to be somewhat underutilized. Is that something we should think about going forward that Portland is going to be an increasingly more relevant to the route network?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Helane, good morning, it's Andrew.

Yes, I think obviously Portland is extremely important to us, so well over 120-plus flights a day. And what we've seen with the strength of our cost performance and our lower cost performance and our rule of thumb is Portland is always half the demand of Seattle, we're seeing opportunity with our cost structure and new aircraft especially the 175 to grow Portland. So you see in the first quarter we got Portland-Minne, we've got Portland-Kansas City, Portland-Omaha, so I think you'll see us continue to grow Portland as we move forward.

Helane Becker - *Cowen Securities LLC - Analyst*

So those routes that you just mentioned are being flown with 175s?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Yes, I believe so.

Helane Becker - *Cowen Securities LLC - Analyst*

Okay. My other question I think Brad you talked about those new space bins and the fact that you can carry more bags on them. How do you monetize that for your for us, for your shareholders, or for yourself actually?

How do you get paid for having those extra bags onboard? Because you're not charging your frequent flyers for the checked bag and it seems like putting all those extra bags on board will just slow the boarding process down and you already have a pretty tight turn time. So how are we supposed to think about those bags coming on board and how it winds up measuring up to your high expectations for yourselves?

Brad Tilden - *Alaska Air Group, Inc. - CEO & President*

Helane, that's a hard question so I'm going to ask Ben to answer it.

Ben Minicucci - *Alaska Air Group, Inc. - COO & EVP, Operations*

Helane, most airlines today we struggle with carry-on bags. And the problem with airplanes today on 737-800 with 150 people we have maybe 120, 130 carry-on bags, there is at least 10 to 20 on every flight that don't fit. So we have a process to try and manage carry-on bags on every flight they get lined up in the jetway, they get taken downstairs.

These are legal carry-on bags. These are not bags that people would normally check. So what we've done, what the bigger bins will actually do is actually speed up the boarding process, have people bring their bags in instead of us having to create a process where after we check in 110 or on 110 people we start tagging bags and putting on the jetway for our rampers to come pick them up. So operation-wise this is going to be a massive, massive help and help for our operation.

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

And just on that, I mean you know Ben is talking about already regulation carry on board bags. So these were coming on anyway, it's just that he's not having to take them downstairs.

And one thing that I think we've shared this in the past but we're very aware of obviously what the bag fees generate for our business but that's not something that bags fees, the different views on those. We are investing in additional or ancillary products that our customers want to pay for, really enjoy, so our Preferred Seating is an example, our buy on board products and other things as we invest in our business. Those are the things that we are looking to increase the revenue per ship versus bag fee revenue.

Helane Becker - *Cowen Securities LLC - Analyst*

Great, okay, thanks very much. Those were my two questions.

Operator

Duane Pfennigwerth, Evercore ISI.

Duane Pfennigwerth - *Evercore ISI - Analyst*

Thanks for taking the question and squeezing me in there. Just curious, my model on a quarterly basis only goes back to 2006. When is the last time that Alaska has grown consolidated capacity 13%?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Off the top of my head I don't know. I'm pretty sure, well we've been growing it double digit per quarter or many quarters, first and second quarter were double-digit growth and in previous years.

Actual 13% off the top of my head. But it's certainly within a point or two of what we've done many, many times over the past few years. That's just off the top of my head.

Brad Tilden - *Alaska Air Group, Inc. - CEO & President*

And Duane, Lavanya pulled some data for us just in the last couple of days. We have, so 13% is the high-water mark. We plan to grow 8% next year for the year and we've actually grown 7.2% ASMs I think is what you told us Lavanya for the last five years.

We've grown 7% on average for the last 20 years. So next year's growth is on an annual basis is right in line with a little bit high given what's happening in Seattle but basically in line with what we have been doing. I mean it is what it is, it's a little high in the fourth quarter and the first quarter but there is no difference in our thinking about next year as compared to other years.

Lavanya Sareen - *Alaska Air Group, Inc. - Managing Director of IR*

Duane, just to add to that, if you sort of dissected that by five-year increments you would find that it's essentially about 7% in every five-year increment. So it's interesting to see that, and next year we're right in the ballpark of what we've said for the long term which is between 4% and 8%.

Duane Pfennigwerth - *Evercore ISI - Analyst*

I appreciate that. I guess we started this year at 8% and are ending at 11%. So maybe you can just help us understand what changed over the course of the year, how the thought process change, what's actually driving 13% right now?

Maybe the answer is, fuel is ridiculously low and we can make a lot more money doing this right now and if that changes then we'll revert back. But maybe you could help us think about your thought process over the course of the year. Thanks for taking the question.

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

I think what you're really seeing is us continuing to accelerate new markets as we see new revenue opportunities. And they are performing and we will continue to do this as long as they perform. Those are the main reasons.

Also next year we have a lot of gauge going on and even this year I think we updated our forecast to about 10%, we're going to be about 10.6%. That's basically flying half or more airplane than we had shared with you. So you're going to continue to find us waver around a little bit but we will make sure that we adjust capacity one way or the other given the economic environment if we see a change.

Brad Tilden - *Alaska Air Group, Inc. - CEO & President*

Further to your point, Andrew, Duane, if you go back and look at 2009 I think what you would see is Alaska quickly, quickly responding to a downturn in demand. So this is working now as Andrew says but if things change we will change.

Duane Pfennigwerth - *Evercore ISI - Analyst*

Okay guys again thank you for taking the question.

Operator

Dan McKenzie, Buckingham Research.

Dan McKenzie - *Buckingham Research Group - Analyst*

Hey, good morning guys. Thanks. A couple of questions here.

Andrew, in the competitive markets what percent of system PRASM are they trending, so 70%, 80% of what's normal and I guess what I'm trying to get at is what is the trajectory? We've got a very good demand story in Seattle and I guess I'm just trying to understand is that trajectory, is that gap narrowing or perhaps are you trying to suggest it may widen in the first quarter?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

I think high-level the color I would give you is that Shane's team has done a fantastic job where we've incursions in the first year. As they move into the second year our performance has actually improved and I think what you're also seeing is some of the downward pressure, especially on like Alaska long-haul being offset with good strong revenue performance in other areas of our system.

So I probably didn't do a great job answering your question. But overall where we see pressure on unit revenues we have offsetting benefits on our unit revenues from a network perspective.

Dan McKenzie - *Buckingham Research Group - Analyst*

Yes, maybe I can circle back. But I guess just on the offsets here, I guess I'm just wondering what percent of revenues now come from code share relationships? And with American systems now integrated I appreciate the commentary, but maybe you could just remind us how fast is that overall code share growing and what's really the target here as a percent of total revenue?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

I think overall on a complete partner basis I think traffic is about 15% for the third quarter. And I think what you're going to find, Dan, is that we will lose in some and gain in others.

Net-net the solid, the goal, though, is to increase the yield and really working with American and our other partners with premium product corporate customers and accounts. So we are we're very, very optimistic about turning that on in a powerful way. But as for specifics I will share what we can at Investor Day and I think you'll learn more there.

Dan McKenzie - *Buckingham Research Group - Analyst*

Okay. But I think if I can just maybe clarify maybe a little further, historically has that been 14% and so you've now recovered basically the code share traffic that you've lost to Delta?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Yes, I would say really broad scope here is anything we've lost we've replaced. And that's the big picture.

Brad Tilden - *Alaska Air Group, Inc. - CEO & President*

Yes, it's actually a touch over 15 right now, Dan. And that is my sense is that maybe is a little higher than we been the last few years.

Dan McKenzie - *Buckingham Research Group - Analyst*

Congratulations. Thanks, guys.

Operator

Darryl Genovesi, UBS.

Darryl Genovesi - *UBS Securities LLC - Analyst*

Hi guys, thanks for the time. Brandon, your main CASM has been for the most part a good guide for you guys for the last couple of years.

Just wondering now as we approach the time from where you're done retiring 737 Classics what would you anticipate there in terms of perhaps an upward movement? Is this something that should continue to benefit you until all the classics are gone or just I guess the 737 NGs that you have purchased over the last several years as they were off warranty likely to start to push the maintenance CASM back up again?

Brandon Pedersen - *Alaska Air Group, Inc. - EVP, Finance & CFO*

Maybe I will start and then Ben can jump in here. What I would say is that to the extent that 400s are exiting the fleet that's a benefit to maintenance CASM. But we are getting to a point where some of those initial NGs are getting to their first big overhaul and that's something that we're thinking about as we move into 2016 and certainly into 2017. Ben, you want to talk about that?

Ben Minicucci - *Alaska Air Group, Inc. - COO & EVP, Operations*

Yes, so we have of course we have our Classics and they will be going away but our NGs are reaching 13- to 15-years old. We've got brand-new ones and ones that are 15-years old.

So we manage those NGs with costs, larger heavy maintenance costs and getting into the first major overhaul on engines. So you will see an uptick in maintenance cost on our older NGs but with the younger airplanes, the NGs when they are new have just a terrific cost profile for the first 10 or so years.

Darryl Genovesi - *UBS Securities LLC - Analyst*

Great, thanks very much. Then Andrew, just with regard to these multiple partnership agreements that you have in place, when you go out and market to the corporate contract customer in particular, is there often a sort of joint marketing event that happens with the partner or are you still for the most part kind of marketing on your own? And does that create an opportunity down the road?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

I'm going to let Joe handle that one as he looks after our corporate accounts.

Joe Sprague - *Alaska Air Group, Inc. - Senior VP, Communications & External Affairs*

Hey, this is Joe Sprague. I've got external relations and sales as part of that team.

In fact we have a more intense effort going around corporate accounts in Seattle but throughout our system right now than probably ever before and the team is really doing great. We are doing more and more joint sales activities with American and we think that's a big opportunity for us going forward.

And then you've heard us talk about our partnerships with the foreign flag carriers, the international carriers particularly here in Seattle and promoting those to corporate accounts here in Seattle is another big opportunity. There's a lot of interest in folks that fly us domestically that can then use those other international carriers out of Seattle to get anywhere in the globe.

Darryl Genovesi - *UBS Securities LLC - Analyst*

Okay, thanks very much, guys.

Operator

David Fintzen, Barclays.

David Fintzen - *Barclays Capital - Analyst*

Hey, good morning everyone. When we think about the 8% growth that you're talking about for 2016 and if I go back to the last quarter I believe you had said something along the lines that your mindset had been you were to grow more, you weren't going to say exactly where you were going to grow, you gave us some guidance that kind of fits that mindset was pushing you to lower it that number. Is this 8% a continuation of that or is your view of 2016 stabilized through the course of this third quarter?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

We've still got 8% in the sites here and as I said earlier it's really mid-con and transcon are big primary drivers in the first part. And then as it relates to the landscape and the economy we will continue to look out and make adjustments as necessary. But nothing materially changed since we last spoke.

David Fintzen - *Barclays Capital - Analyst*

And are you seeing anything residual oil demand-related in Alaska that you're watching? Or where would that come from realistically or where are the places you're most concerned about?

Joe Sprague - *Alaska Air Group, Inc. - Senior VP, Communications & External Affairs*

This is Joe. I will touch on the state of Alaska piece and Andrew can pick up anything else. The state of Alaska, the falling oil prices there are having a big impact on the state government but overall consumer demand is strong.

Their permanent fund dividend check they get each year, all the state residents get was one of the highest ever. The tourism numbers up to the state of Alaska this summer were quite strong. So I think that market is steady and I think will be for the foreseeable future.

Brandon Pedersen - *Alaska Air Group, Inc. - EVP, Finance & CFO*

And Joe, isn't it correct that the state has big budget reserves that they will use to smooth out variations according to it?

Joe Sprague - *Alaska Air Group, Inc. - Senior VP, Communications & External Affairs*

They do.

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

And then just on the demand side, the only thing that's keeping me up most at night is just managing competitive capacity coming in on our markets and using the full breadth and depth of our network and our partners to compensate from that. All other things being equal demand is very good.

David Fintzen - *Barclays Capital - Analyst*

Okay. Thanks. I appreciate all that.

Operator

Andrew Didora, Bank of America.

Andrew Didora - *BofA Merrill Lynch - Analyst*

Hey guys, actually all my questions have been answered. Thanks for all the color though. Thank you.

Brad Tilden - *Alaska Air Group, Inc. - CEO & President*

Thanks, Andrew. So I think that sort of takes us to the end of our hour.

Thanks everybody for dialing in. And we look forward to seeing many of you in New York City on December 3 for our Investor Day. Thank you.

Operator

Thank you for participating in today's conference call. This call will be available for future playback at www.AlaskaAir.com. You may now disconnect.