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ALK - Q4 2013 Alaska Air Group, Inc. Earnings Conference Call

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OVERVIEW:

ALK reported 2013 adjusted net profit of $383m and adjusted diluted EPS of $5.40. 4Q13 GAAP net profit was $78m and adjusted diluted EPS was $1.10.

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PRESENTATION

Operator

Good morning. My name is Michelle, and I will be your conference Operator today. At this time, I would like to welcome everyone to the Alaska Air Group's third quarter 2013 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, Chris Berry, please go ahead.

Chris Berry - *Alaska Air Group Inc - Managing DIrector of IR*

Thanks, Michelle. Good morning, everyone, and thank you for joining us for our fourth quarter 2013 earnings call. Before we get started, I would like to congratulate the NFC Champion Seattle Seahawks on their win last Sunday and wish them and our honorary CFO, our Chief Football Officer, Russell Wilson, our best wishes in the Super Bowl next week. Go Hawks. Unfortunately we will hear from his back up, our Chief Financial Officer, Brandon Pedersen, and our CEO Brad Tilden, as they provide highlights from 2013 and our game plan for 2014. Several members of our Senior Management Team are also here to help answer your questions.

Our comments today will include forward-looking statements regarding our future expectations which may differ significantly from actual results. Information on Risk Factors that could affect our business can be found in our SEC filings, available on our website. We will refer to certain non-GAAP financial measures such as adjusted earnings and unit costs excluding fuel, and we have provided a reconciliation between the most directly comparable GAAP and non-GAAP measures in our Earnings Release.

This morning Alaska Air Group reported a fourth quarter GAAP net profit of $78 million. Excluding the impact of mark-to-market adjustments related to our fuel hedge portfolio, Air Group reported a record adjusted net profit of $77 million or $1.10 per diluted share. This result compares to First Call consensus of $1.07 per share and exceeds last year's Adjusted Net Income of $50 million or $0.70 per diluted share. For the full year Air Group reported a record adjusted net profit of $383 million compared to $339 million in 2012. Adjusted earnings per share grew by 14% from $4.73 per share in 2012 to $5.40 per share in 2013.

Additional information about cost expectations, our capacity plans, fuel hedging, Capital Expenditures and other items can be found in our Investor update included in our Form 8-K issued this morning and available on our website at www.alaskaair.com. And now I'll turn the call over to Brad.

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

Thanks, Chris, and good morning, everyone. Today we reported record fourth quarter results and our 19th consecutive quarterly profit. Our pretax margin was 10.2%, a 3 point improvement over 2012. The margin expansion was driven by solid demand during the holiday season, good cost control, and by a little help from lower fuel prices. Brandon will spend more time on the quarter's results as my comments will mostly be focused on the full year and on our strategy for 2014.

2013 was another year of solid execution, and I want to highlight several of our accomplishments. First, we won our sixth consecutive JD Power award for highest in customer satisfaction among traditional network airlines. This is one of the most respected measures of Customer Service in our industry, and we're proud to have earned this award again. Our people continue to provide excellent service, and the recent mid year results we've received show that we've improved further in the last six months. Second, our operational performance continued to lead the industry. We completed 87% of our main line flights on time, and this will likely lead to a fourth consecutive award from Flightstaff.com for on time performance.

Third, we reached new, five year agreements with Alaska's pilots and Horizon flight attendants, and we recently reached a tentative five year agreement with Alaska's flight attendants. We can't be our best without our people on board and fully engaged, and we're happy to have these contracts in place. Fourth, we met or exceeded most of our operational and financial goals this year which is resulting in record incentive pay for our employees. On February 26, each Air Group employee will receive a bonus check that will represent at least 4.5 weeks of pay. As the Company has performed well, our employees have benefited, and we believe this alignment has helped all of our stakeholders.

Fifth, because of significant contributions to our pension plans over the last decade and favorable market conditions more recently, we're very pleased to report that our DB plans are now more than 100% funded. We believe this is unique in the airline industry, and we're pleased that our financial success has provided retirement security for our people. As you also know, we've materially changed our retirement plans over the last 10 years, and our pension service cost is now much lower than it would have been without the changes. And last, but certainly not least, we continued to drive shareholder value. We produced $383 million of Adjusted Net Income, a 12.4% pretax margin, a 13.6% return on invested capital, and $415 million of free cash flow.

These are all records. With this strong cash flow generation over several years, we now have a very strong balance sheet. Debt and operating leases are just 35% of our capital structure. We have no net debt, and as I just mentioned we have fully funded pensions. We use cash flow appropriately in 2013 declaring our first dividend in 21 years and repurchasing 2.5 million shares of our stock. It's worth noting that we've repurchased 21 million shares of stock in the last seven years, and, because we made these repurchases, the $5.40 of earnings per share we reported today is 30% higher than it otherwise would have been.

We faced a number of challenges in 2013, and many of them will persist in the future. As a whole, the industry is performing well because capacity is in line with demand, but that's not necessarily the case in our Markets. If you look at the fourth quarter, industry capacity was up about 3%

domestically but 8% in the Markets we serve when you exclude our own growth. This was a similar story throughout the year, and it put a lot of pressure on our unit revenues especially in the long haul Alaska and West Coast Markets.

In the face of these challenges, Andrew and his team have done an excellent job defending and adjusting our network, and Joe and his team have done a terrific job marketing the Company. With their collective efforts, we reported an increase in PRASM in the fourth quarter, and this was on top of our own capacity increase of 5%. At or Investor Day in November, we talked about this new capacity, and we also shared what I believe are the real strengths of this Company and how we plan to sustain our performance as a strong and independent Northwest Company in the quarters and years ahead. I want to briefly review a few of these with you.

First and foremost, we are safe. We have a strong emphasis on safety, and we're improving on it every day, every process, every flight. This culture of doing things right is a value for the Company, and it helps us both in safety and non-safety arenas. Second, our people run an excellent operation. Because of our operational performance, the Wall Street Journal recently ranked Alaska as the nation's number one major airline. The good operation helps us in two ways. One, it gives our customers what they want most, and that is getting them and their bags to their destination on time; and two, it gives us the ability to work on optimizing our resources, almost all of which are very expensive in this industry.

Third, we have highly engaged employees who deliver JD Power caliber service to our customers every day. We think our small size gives us the ability to be better connected and aligned, and we believe this difference is visible to our customers on board our airplanes every day. Fourth, our customers benefit from low fares, because we have low costs. We've lowered our main line unit cost in 11 of the past 12 years, and our costs are now much closer to the low cost carriers than the legacy airlines.

Fifth, we have a high performance Management team. I get the privilege of working with great leaders at this Company who share our values, who push themselves and strive for excellence, who face challenges head on, and who want to see each other succeed. And finally, we focus on shareholders. I think we have probably done more for shareholders in the last five years than any other airline in terms of total return, and as I mentioned at our Investor Day, we don't plan to let up. These core advantages give us optimism for 2014 and beyond.

With our 13,000 employees working together every day to win new customers and keep the ones we have and with the revenue initiatives announced in 2013, we believe we have the right tools in place to produce another excellent year in 2014. I want to close by thanking the talented and dedicated folks at Alaska and Horizon for operating safely and on time and for providing exceptional Customer Service. And with that, I'll turn the call over to our Chief Financial Officer, Brandon Pedersen.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Thanks, Brad, and hi, everyone. Fourth quarter adjusted earnings grew by 54% to $77 million representing our highest fourth quarter profit ever. This tops off a record year as Brad mentioned where we produced a 12.4% pretax margin, a $383 million adjusted net profit, and a 13.6% after-tax ROIC, up from 13% in 2012. These record results underscore our ability to adapt to the changing environment while maintaining our focus on our employees, our customers and our owners. I echo Brad's comments and congratulate all of the Alaska and Horizon employees for these record achievements and thank them for their many contributions.

Revenues increased by $78 million in the fourth quarter or 7% on a 5% capacity increase. Passenger RASM was up slightly for the quarter on a strong December that more than offset the November decline that resulted from the shift in Thanksgiving travel. Total RASM was up 1.6% driven by the new Affinity card deal signed earlier this year. We'll continue to see year-over-year benefits from the new Affinity card agreement through the second quarter. We'll also start to see the benefit of higher bag and change fees beginning in Q1. With these changes you'll likely see total RASM outperform PRASM throughout much of 2014.

Yields increased by 1.4% in the fourth quarter marking the first year-over-year increase in quarterly yields since the fourth quarter of last year. As Brad noted, certain regions under-performed the system average because of higher competitive capacity, but other regions such as Hawaii, Transcon and Midcon showed improved yield strength. We were also pleased with the performance of our developing markets.

Economic fuel expense declined $8 million on a lower fuel cost per gallon offset by higher consumption. Fuel efficiency rose 1% in 2013 on an ASM per gallon basis as we took delivery of larger aircraft. Our fleet already ranks at or near the top in fuel efficiency, and we expect to see further improvement in 2014 and beyond as we replace smaller aircraft with the 900 ERs, and as we start to see the benefit of the cabin seat project strengthening our cost advantage over the network carriers. Total non-fuel operating costs increased by $42 million or 6% resulting in a 1% increase in CASM ex-fuel during the quarter.

The largest drivers of the increase were wages and benefits, incentive pay which I'll talk about more in a minute and higher contracted services and other expenses reflecting the ramp up of several large IT projects, new uniforms, and increases in contracted ramp handling costs. Airport costs declined, because we finally executed a new lease with the Port of Seattle. Although higher than the previous years, the new lease has costs that are much lower than those imposed by the port earlier this year, and so we recorded a favorable adjustment in Q4 to reflect the final rates.

The quarterly result was lumpy. Our Seattle costs were down $8 million year-over-year in Q4 but up $11 million for the year overall. Quarterly comps in 2014 will also be a bit lumpy because of the Sea-Tac lease. Annual incentive pay eclipsed $100 million for the first time and was $17 million higher than in 2012 with $10 million of that increase coming in Q4. Breaking it down, about $15 million was earned from our monthly operational performance reward program for meeting on time and customer satisfaction targets. The remaining $90 million is attributable to our annual performance-based pay plan where we again met or exceeded the safety, customer satisfaction, unit cost, and profit goals set by our Board. We expect that the PBP bonus of at least 4.5 weeks of pay will likely be the highest gain sharing pay out in the industry.

For the full year, unit costs were down slightly. This is the 11th time in the last 12 years as Brad said that we've been able to reduce unit cost and the 4th year in a row. Our division leaders performed better than ever managing their businesses and sticking to their game plans. For 2014, we're expecting ex-fuel unit costs to be up about 1% on the 5.5% expected capacity growth. You might recall we said at our Investor Day that CASM would be up between a 0.5% and 1%. This is basically in line with that guidance when taking into account the better than expected 2013 full year CASM ex results.

Let me walk you through some of the larger expected increases. First, we plan to increase IT spending again this year. We've budgeted a $27 million or about 30% increase in 2014 as several large infrastructure projects reach full stride and we increase our investment in functionality and aimed at making the travel experience more hassle free. The increase compares to increases of about $10 million in each of the past three years. Second, we've provided for costs associated with our brand refresh initiative, including a new aircraft delivery that will likely be rolled out later this year as well as higher advertising and promotion costs to support this and other marketing initiatives.

Third, we expect airport costs to increase particularly at Los Angeles where rates are increasing and at Seattle under terms of the new lease, and finally, we expect contracted services expenses to increase as we incur one-time costs associated with transferring ground handling services in some of our stations to new vendors and as we add three RJs to the CPA contract with Sky West.

A $40 million decline in pension expense provides a nice offset to the cost increases I just mentioned. The decline is the result of changes that we've made to the plans over the years including our previously announced freeze of the non-union plan that occurred on January 1 and as Brad mentioned, significant Company contributions and strong asset returns. Because the DB plans are now fully funded, we do not expect to make any contributions in 2014 which will increase the amount of Free Cash Flow available.

We also provided Q1 cost guidance in our investor update this morning, and I wanted to touch on it briefly. We expect Q1 unit costs to be up about 5.5% on the 4.5% increase in capacity. There are a number of reasons for the increase including the new Alaska pilot deal ratified last Summer, the new Sea-Tac rates, heavy IT spend on one specific large project in the first half of the year, the station transition costs I just mentioned and uniform costs. We've also included the impact of the higher wages contained in the TA with Alaska's flight attendants and will know the outcome of that in Mid February.

The Q1 cost increase will be an outlier. We expect unit costs in the remaining quarters to be flattish in Q2 and Q3 and down in Q4 to arrive at the expected 1% full year increase. Although costs are expected to increase in 2014 because of the reasons above, continually lowering costs over the long term so that we compete aggressively and effectively with the discounters and maintain our cost advantage over the network carriers remains an important element of our strategic plan.

Moving to our balance sheet, we ended the year with more than $1.3 billion in cash and investments. In 2013, we generated $945 million of operating cash flow. Capital spending was about $530 million resulting in $415 million of Free Cash Flow. This compares to $235 million of Free Cash Flow in 2012. Scheduled maturities of long term debt totaled $160 million bringing our adjusted debt-to-cap ratio to 35% and leaving our balance sheet in a net cash position giving us arguably the strongest balance sheet among the major airlines.

It's also a big driver of S&P's recent upgrade to BB plus which is our second upgrade in 2013 and leaves Alaska at just one notch below investment grade. We also returned $187 million to our owners through our recently initiated dividend and through both routine and opportunistic share buybacks. When considering both forms of capital return, we paid out more than 48% of the Company's Adjusted Net Income.

Taking a longer term view, we're proud of what we have produced as a result of the transformation that began more than a decade ago. Since 2009 we've generated $3.2 billion of operating cash flow, we've invested in our fleet and now operate one of the best and most efficient fleets in the business, and we still generated $1.2 billion of Free Cash Flow. We've used that Free Cash Flow in a balanced and thoughtful way. We've deleveraged the balance sheet by reducing long term debt and lease obligations by $1.6 billion. We've contributed $620 million to our pensions even though none was required, and we've returned $395 million to our owners.

Even though our cash tax burden will increase in 2014, we again expect our operating cash flow to be very robust. CapEx is expected to be $525 million, thus we expect another strong year of Free Cash Flow. We don't need to reduce debt any further. Pensions are fully funded, and we don't expect to retain more cash in the business, so we plan to return a significant amount of cash to our owners. We don't have any changes to announce today, but we expect that our Capital Returns will be higher than the amount we could return with the dividend at its current level and the $83 million remaining under our current repurchase program.

We're entering 2014 in better financial shape than we've ever been, and we have a compelling story when it comes to capital allocation and cash deployment; however, we recognize this is a very competitive business, and there's always more to do to insure that our success is sustainable. With that, we would now like to open it up to any questions that you might have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from Savi Syth, your line is open.

Savi Syth - *Raymond James & Associates - Analyst*

Hi. Good morning, everyone. Just on the competitive capacity side I was just wondering what you're seeing heading into the Summer here from the headwind. Is it -- is the year-over-year increase softening or is it continuing to see pressure there?

Andrew Harrison - *Alaska Air Group Inc - VP, Planning and Revenue Management*

Hi, Savi, good morning, it's Andrew. Yes, we will be seeing competitive pressures increase. Just to give you some perspective, in the Fourth Quarter of 2013, other airlines coming into our core network was up about 8%. And then for Q1 and Q2, it's around 7% to 8%, and then it will peak in the third quarter given current schedules at an increase of 8% year-over-year.

Savi Syth - *Raymond James & Associates - Analyst*

Okay, got it. And then just with the FAR of 117 rule, how many more pilots are you needing to have today versus kind of before the rule and what's that impact your expenses this year?

Ben Minicucci - *Alaska Air Group Inc - EVP, Coperations and COO*

It's Ben Minicucci here. We added approximately 20 pilots to offset 117, and we made that all up back in productivity. In fact, we more than made up for the 117 impact.

Savi Syth - *Raymond James & Associates - Analyst*

Okay, great. Thanks so much.

Operator

Your next question comes from Hunter Keay from Wolfe Research.

Hunter Keay - *Wolfe Research - Analyst*

Hi, everybody. Thanks.

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

Good morning Hunter.

Hunter Keay - *Wolfe Research - Analyst*

So, let's talk about cash flow with Brandon. If we've seen a little bit of margin expansion this year, you're probably looking at something like $1 billion in operating cash flow. Your free cash conversion is close to 100% so let's assume your CapEx is going to be $500 million. You're looking at roughly back of the envelope $500 million in Free Cash Flow.

You already have a cash drag on the balance sheet. You could argue that there's significant negative carry in earnings right now. You just don't have anywhere to put this money as far as I can tell.

Your balance sheet like you said seems to be optimized unless you're going to start raising CapEx maturity which I don't think you're going to do. Where is this going to go? I mean there's only really one place that I can think of, and I'm just trying to figure out why I should not be modeling in very aggressive cash deployment for you guys either via dividend raises or buybacks throughout 2014. I just can't think of a place to put the money. (laughter)

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Good morning, Hunter, it's Brandon. I can't tell you what to model for sure but what I can say is we agree that there's going to be significant free cash flow, and I think I articulated kind of an answer to your question in my remarks. We aren't going to pay down anymore debt. We aren't going to accumulate cash on the balance sheet. We don't have anymore pension funding to do.

I also said that we weren't going to announce anything today, and I can't pre-announce something that isn't already approved the Board or that isn't approved by the Board. So what I can really just do is point to our past practice and say we've always taken action when we needed to to deploy excess cash, and we can argue over whether we have excess cash or not. I don't think that's the question they you are asking really, though.

But to answer your question in a more direct way, we don't have anything to announce. But we do believe we are going to have strong free cash flow, and we don't have any other alternatives but to return that cash flow to shareholders based on what we're seeing today.

Hunter Keay - *Wolfe Research - Analyst*

Yes, okay. It is what it is. Thanks for the color. Thank you.

So I guess let's talk about this Delta situation for a second. They told me on the earnings call that about 15% of their traffic connects in Seattle. Wondering how much of that connecting traffic is actually produced on your metal. Where do you see that going within the framework of the existing agreement that you guys have there? And sort of secondary to that, you said the co-chair is about 3.5% of your revenue from Delta. Can you give us a sense of what percentage of your volumes comes from that Delta relationship specifically? Thanks a lot.

Andrew Harrison - *Alaska Air Group Inc - VP, Planning and Revenue Management*

Hunter, it's Andrew. You know, I think we shared everything that we're comfortable sharing at Investor Day, which is about $230 million or so that Delta puts on our metal. What I would tell you is that the nature of the contract is changing, and at the end of the day, we are operating way outside where the strict contractual terms are. So I think as I shared at Investor Day you're going to see and continue to see a reduction in the amount of traffic that Delta is putting on our metal and that's not unsurprising to us.

Hunter Keay - *Wolfe Research - Analyst*

Okay, so you do have some flexibility within the structure of the contract to move some things around?

Andrew Harrison - *Alaska Air Group Inc - VP, Planning and Revenue Management*

Yes, we do.

Hunter Keay - *Wolfe Research - Analyst*

Okay, thank you.

Andrew Harrison - *Alaska Air Group Inc - VP, Planning and Revenue Management*

Thanks, Hunter.

Operator

Your next question comes from Helane Becker from Cowen & Co. Your line is open.

Helane Becker - *Cowen Securities LLC - Analyst*

Thanks very much, Operator. Hi guys, thanks for the time. So as you look over the next three to five years or maybe two to four years, can you just talk about the opportunities you have to grow the operation either domestically or internationally? And I ask that because that's a question I get from investors all the time. Where is Alaska's growth going to come from, and I just wondered if you could maybe shed some light on that.

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

Sure, Helane, this is Brad. It's a great question. You've seen us try new things in a couple of California cities, we've tried some things out of San Diego. We're investing in San Jose and just saw some numbers yesterday, a lot of that new service is working very, very well. There's more we can do out of Seattle and Portland. If you look at our service out of Seattle and Portland today, we have really high market shares in North/South Markets but not nearly as high market shares in East/West Markets. So the mid con to the East Coast and certainly a chance over the years to increase those market shares. And then the biggest thing that I guess I think about is that if you look at the last 10 years, we've had two big waves of growth.

After 9/11 we had the trans con and mid con wave, and then in 2008 when we sort of had the high fuel prices and low fuel prices and the financial crisis, we had a big Hawaii wave of growth. And so the way we think about it is we sort of look at these opportunities, and we sort of feed them along at growth rates like you see now, 3%, 4%, 5%. But then if we keep our costs low, our operation great, a very compelling value proposition for customers, we think opportunities will come our way. And I think one of the things we've shown the market is that we are somewhat conservative when we are not seeing big opportunity, and when we do see the big opportunity we'll pounce on it. So that's our thinking about growth. I think it might be 3%, 4%, 5% until something pops, and when something pops you might see us try to take advantage of it.

Helane Becker - *Cowen Securities LLC - Analyst*

Okay, and then can I just ask Brandon a question? Given the status of the pension plan, can you immunize it at this level?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Helane, I am going to give that one to our Treasurer, Mark Eliasen.

Mark Eliasen - *Alaska Air Group Inc - Treasurer*

Hi, it's Mark here. What do you mean by immunize?

Helane Becker - *Cowen Securities LLC - Analyst*

Well I guess since it's fully funded or close to fully funded, doesn't that kind of imply you don't really have to make additional contributions to it going forward?

Mark Eliasen - *Alaska Air Group Inc - Treasurer*

Yes, that is absolutely what it implies, and that's our plan. We'll let it ride. The Management plan is frozen and closed of course, and the other plans are still active, so we will continue to have benefits being earned there. But our plan is we've got it under control, and we will monitor accordingly. We've been de-risking the plan which is a big approach we've taken to move more towards bonds.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

So the two big opportunities over time is the thing is 100% funded as we're no longer accruing service costs basically, and that's a right time in the market to move all of the assets into fixed income instruments that basically match the liability. And the other opportunity would be to basically transfer this obligation with the big pile of cash to an Insurance Company or something like that. We're probably not looking at either of those in the next 12 months, but we have been studying both of those ideas.

Mark Eliasen - *Alaska Air Group Inc - Treasurer*

Absolutely.

Helane Becker - *Cowen Securities LLC - Analyst*

Okay, well thanks for your help there guys.

Mark Eliasen - *Alaska Air Group Inc - Treasurer*

Thanks, Helane.

Operator

Your next question comes from John Godyn from Morgan Stanley. Your line is open.

John Godyn - *Morgan Stanley - Analyst*

Hi, thank you for taking my question. I was just sort of curious about how the team thinks about the margin profile over next few years. You guys have done a tremendous job sort of becoming more a low cost carrier, like there are low cost carriers out there that have EBITDAR margins in the 25% to 30% range, and there is a case to be made that the industry could be seeing a period of real pricing power and therefore margin expansion on the back of M&A concentration and conservative capacity growth. Is a 25% to 30% EBITDAR margin something that's really conceivable for Alaska as we look out years in the future?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

John, it's Brandon. Maybe I'll start and then either Joe or Andrew can chime in. I think you made a really important point when you said Alaska's costs are really close to the low cost carriers. That's one of the things we tried to articulate at Investor Day is how over the last decade we've really changed our cost structure, not just CASM ex but CASM including fuel and made our costs look a whole lot more like the LCCs and a whole lot less like the domestic carriers. And I think that gives us a huge competitive advantage going forward.

Your question about margins is a hard one. To the extent that there's industry wide margin expansion just because of the changes in the industry, that's something that we would certainly participate in.

In terms of just growing our own specific margins, we already have pretty high margins and what we want to try to balance is doing really well for our shareholders but also having a really good value proposition for our customers. We want to be known as the airline that has really good service and low fares, and that's a pressure. It's not a conflict, but it's something that we keep in mind when we think about margins. It's a balancing act.

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John Godyn - *Morgan Stanley - Analyst*

Great. That's very helpful and just on a separate topic, I think at the Investor Day if I remember correctly, you guys sort of suggested that there might be more opportunity that's on tap and working with American in the future. I know it's still early days, but I'm just curious if there's been any progress or momentum or any change in the nature of the discussions there.

Andrew Harrison - *Alaska Air Group Inc - VP, Planning and Revenue Management*

Good morning, John, it's Andrew. Yes, there have. We're getting to know the new American Management team, and I have met with their alliances folks, and we've started discussions about how we might work together with the new American. So it's very exciting, and we look forward to future things.

John Godyn - *Morgan Stanley - Analyst*

Okay, thanks a lot.

Operator

Your next question comes from Michael Linenberg from Deutsche Bank. Your line is open.

Michael Linenberg - *Deutsche Bank - Analyst*

Yes, two questions here. I want to just on the increased cost, Brandon, that you brought up sort of early part of the year, and then it moderates, you talked about IT spending. Wouldn't that show up -- wouldn't you be able to qualify that as CapEx rather than expense, or why is that being expensed? Is it -- how --

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Brandon Pedersen - *Alaska Air Group Inc - CFO*

Good question. (laughter) It's Brandon, good morning. It's a complicated thing and we are -- trust us we are putting a lot on the balance sheet, too. These are very, very significant cost projects or big projects that we're working on.

Some of the costs do go into the P&L; some of the costs go on the balance sheet and will get amortized over the future. There's complex rules around that. I can assure you to the extent we feel comfortable capitalizing something we will, but softer costs like project Management costs, costs of redesigning processes, under the accounting rules those are expensed. And so you'll see those hit the P&L, and it's an area that we're getting better at, honestly.

Project Management is super, super important to having a successful project, and to the extent we invest a little more at the front end on good solid project Management, and even if it runs through the P&L, it pays off in the long term. And even though the accounting rules drive us to a result that we might not be happy within terms of what it does to this quarter or this year's P&L, these are long, long, long term investments in projects that will make us much better as a Company, give us much more stable systems and make our business much more scalable.

Michael Linenberg - *Deutsche Bank - Analyst*

Okay, great. That's helpful and my second, and this is probably to Andrew.

When you look at some of the capacity additions coming in later this year, sort of the summer time frame, what are you seeing with some of the initial price points? Is it -- are they coming in at discounted levels? You would think with this amount of capacity that maybe there would be introductory fares on some of this new service. Or is it just maybe the fare structure's the status quo because we are seeing US economy continue to recover. So any early read on some of the pricing actions that you're seeing with the new service by the competition?

Andrew Harrison - *Alaska Air Group Inc - VP, Planning and Revenue Management*

You know, I think the way I'd like to answer that is that the third quarter is obviously a ways out. It's also the peak demand season where essentially the demand is extremely high versus supply. What I'm saying right now is from what I do see is somewhat stable, reasonable pricing. It's not to state that as we move closer in, changes may or may not occur.

I think from our perspective what we're seeing and that Brad alluded to it is we're seeing a real nice maturation of all of the new markets that we've started. We've started 20 new Markets in 2012 that came through in 2013 and maturing very nicely. We started another 15 Markets in 2013 that we're also seeing maturing nicely. So, yes, we may have some downward pressure on yields in some of these Markets where there's heavy competitive capacity. That said, we have a good source of new Markets and new revenues coming online into 2014.

Michael Linenberg - *Deutsche Bank - Analyst*

Okay, very good. Thanks, Andrew.

Operator

Your next question comes from Duane Pfennigwerth from Evercore. Your line is open.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Hi, thanks. I'm not sure if you mentioned this earlier in your script, but how much did OA capacity growth cost you in the Fourth Quarter? I wonder if you could either in terms of revenue or yields do you have any estimation on that?

Andrew Harrison - *Alaska Air Group Inc - VP, Planning and Revenue Management*

Duane, that's a tough question. Like anything in our network ebbs and flows, we have winners and losers as Brad did share or Brandon, that we had some pressure in the long haul in some California but good strength in other regions, so net-net overall the quarter was good.

Duane Pfennigwerth - *Evercore Partners - Analyst*

And I know you're reluctant to typically do this, but can you talk sort of qualitatively about the yield environment here into the first quarter?

Andrew Harrison - *Alaska Air Group Inc - VP, Planning and Revenue Management*

Yes, what I would say a couple of things actually. In our first quarter our growth in the main line side is six points lower year-over-year. We're also seeing a slight reduction in competitive capacity year-over-year from the fourth quarter, so if it was 8% in the fourth quarter, at 7% in the first. But other than that when I look at January and February I'm actually very pleased with the quality of traffic that's coming on to our books. So that's what I would say for now.

Duane Pfennigwerth - *Evercore Partners - Analyst*

That's great, thanks and then just lastly, and I should know this, could you just remind us what pension funding was in 2013?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

In 2013? It was about $50 million.

Duane Pfennigwerth - *Evercore Partners - Analyst*

Thank you.

Operator

Your next question comes from Steve O'Hara from Sidoti & Company. Your line is open.

Steve O'Hara - *Sidoti & Company - Analyst*

Hi, good morning.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Hi, Steve.

Steve O'Hara - *Sidoti & Company - Analyst*

Could you just talk about in terms of the environment that the industry is in, I mean it seems like it's certainly stronger than it's been in maybe a very long time at the very least. And I think that strength seems to be pretty much across-the-board. Do you see -- to me, this might give opportunity to other carriers to be more aggressive in certain markets that are for carriers that are larger it wouldn't have a adverse effect on the overall picture there. So I guess the question is really do you sense any change in behavior from your competitors in terms of maybe them being more aggressive, and then second, do you sense you have any disadvantage in being smaller than some of the bigger carriers?

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

Yes, Steve, yes, I think it's clear. We do have more capacity in our markets right now than we maybe had a couple years ago, and it is coming from places that we didn't completely anticipate. But I think as a small airline we're going to do quite well in the years ahead. We've been a small airline for a long time, but we've not only survived, we've thrived. We've done quite well.

I think in terms of the industry recovery, the scale, there are places where the size does hurt you, but I think we've shown with today's numbers, and I think we've shown over a long time that our small size helps us more than it hurts us.

So I don't know, I guess I'd tell you we're going to have some competition, we're going to do well. We've got low costs; we've got a great operation; we've got a highly aligned group of people. I'm very confident of how we're going to do, but we're going to be at this for awhile.

Steve O'Hara - *Sidoti & Company - Analyst*

Okay, and then I guess as a follow-up, I guess in terms of margins, in terms of protecting your markets, you probably wouldn't talk about any margins you'd be willing to fall through to protect your markets, so I guess I won't even ask that, thanks. (laughter)

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

Good answer.

Operator

Your next question comes from Dan McKenzie from Buckingham Research. Your line is open.

Dan McKenzie - *Buckingham Research - Analyst*

Hi, guys, thanks for the time year.

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

Hi, Dan.

Dan McKenzie - *Buckingham Research - Analyst*

Hi. Andrew, I guess regarding the conversations with AAL, how should we think about the potential timing for an expansion in the relationship? And then related to that, what is the lag typically between an agreement and the potential revenue contribution? I guess in other words what is the ramp up period for incremental revenue contribution once you reach an agreement?

Andrew Harrison - *Alaska Air Group Inc - VP, Planning and Revenue Management*

Dan, that's a difficult one to answer. What I would tell you is that American and US Air's number one priority is integration with themselves and co-chairing on each others metal as a new integrated entity. That said, this year, we will be finalizing how we're going to be working together, and I'll have more to say maybe in future quarters on that.

Dan McKenzie - *Buckingham Research - Analyst*

Okay, understood. And then I guess, Brandon, regarding the CapEx that Alaska has this year, is the plan to pay cash for the new deliveries, or is there some financing that might make sense to optimize the capital structure here?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Yes. Good morning, Dan. I think your question about capital structure optimization is a good one. We have said that we're very comfortable where we are, and so to the extent that we have improved equity, we'll naturally want to borrow to maintain that capital structure. So what that suggests is that we will borrow.

We like airplane specific financing a lot. I think a natural source of some financing would be EDC financing related to the three Q400s that we recently acquired. That's very reasonably priced financing, and to the extent we wanted to do more, we have lots of financing options available to us. But I will tell you that it's something that we're thinking a lot about.

Dan McKenzie - *Buckingham Research - Analyst*

Okay, very good, and I don't know if I could squeeze one more in here. I guess with respect to kind of the noise and the corporate travel background, just given the government shutdown, I wonder if you can talk about how corporate trends are in the fourth quarter are compared to what you're seeing so far in the first quarter. Are you seeing an acceleration?

It seems to me that that's what the GBTA essentially is calling for, and there's a lot of noise in their forecast, so I'm just curious if you can triangulate what you're seeing in the fourth quarter relative to what you're seeing so far in the first quarter.

Joe Sprague - *Alaska Air Group Inc - VP, Marketing*

Dan, this is Joe from Marketing. We do track our corporate travel trends pretty closely. Fourth quarter was down ever so slightly for us and mainly just tracking with some of the other competitive pressures that we saw in the fourth quarter.

For the full year, it was actually up a little bit for us, and as we are out talking to the corporate accounts, particularly here in Seattle, where we just have a heavy concentration of them and our significant root structure out of Seattle really provides them a lot of utility. So we've got great relations here locally, and they are all expressing a lot of confidence for their corporate travel throughout 2014.

Dan McKenzie - *Buckingham Research - Analyst*

Okay, thanks for the time.

Joe Sprague - *Alaska Air Group Inc - VP, Marketing*

Thanks, Dan.

Operator

The next question comes from Glenn Engel from Banc of America, Merrill Lynch.

Glenn Engel - *BofA Merrill Lynch - Analyst*

Hi, two questions. I think you touched on it a little bit, Andrew. Just if capacity, competitive capacity is running up 7% or 8% and really doesn't sound like it's changing much in the fourth, first, second and third quarters, is there any reason why the RASM numbers you saw in the fourth quarter should be very different in the first, second or third quarters.

Andrew Harrison - *Alaska Air Group Inc - VP, Planning and Revenue Management*

As I shared earlier, we don't -- I'm not permitted by the CFO here to talk about that. (laughter)

Glenn Engel - *BofA Merrill Lynch - Analyst*

I would just say -- I'm not trying to make -- just what factors would cause it to be better or worse than it was in the fourth quarter?

Andrew Harrison - *Alaska Air Group Inc - VP, Planning and Revenue Management*

I think the only thing I would tell you is that you're right. The competitive pressures are about the same. The capacity growth is about the same. January and February is just really our weakest two months of the year, so that's a way to challenge it.

Glenn Engel - *BofA Merrill Lynch - Analyst*

Second question -- okay, go ahead.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Glenn, it's Brandon. I would add and I touched on it in the prepared remarks is we have a nice tail wind coming from the annualization of the new Affinity card deal as well as the fee changes that we made that will help us certainly through those weaker months that Andrew mentioned.

Glenn Engel - *BofA Merrill Lynch - Analyst*

On the cost side if I get beyond the first quarter and you're talking about flattish type costs, afraid I'm not as -- not confident -- I'm not as impressed with that in terms of if you have a one point benefit from pension, you have a two point benefit from the extra seats per plane, the pilot cost anniversary, the Seattle cost anniversary, why aren't you going to be seeing an even better cost performance in 2014?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

I think the two big drivers are the investments that we're making in IT. As I mentioned it's a $27 million year-over-year increase in the IT spend, and, frankly, we've provided $25 million to $30 million related to the brand initiative, and that's a big piece of it as well.

It's sort of like the IT costs in terms of how we think about it hitting the P&L, but it really being a long term investment. That's really worthwhile spend in the context of our strategic goal of having a more energetic brand. Companies like ours periodically refresh delivery. We've had ours for 20 some years. And so, while a bunch of that cost will hit this year, we do view that as a long term investment. But it does impact costs in the second, third and fourth quarter.

Glenn Engel - *BofA Merrill Lynch - Analyst*

Does that suggest 2015 may be another year you could be flat to down?

Brandon Pedersen - *Alaska Air Group Inc - CFO*

You know, we're not guiding on 2015, but what I will say is that as we have growth of in the neighborhood of 5%, maybe 4% or 5%, our goal would be to continue to reduce unit costs. We've got a nice long streak going, and hopefully 2015 we will be able to get back on that horse.

Glenn Engel - *BofA Merrill Lynch - Analyst*

Thank you very much.

Operator

The next question comes from [Kevin Chrissy] from [Skylar Research]. Your line is open.

Kevin Crissy - *Skylar Research - Analyst*

Thanks for taking my call. So did you guys give the details of what the IT spend was like what specific projects? I'm sorry if I missed that.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

We did not give details, this is Brandon. We did not give details, but I can tell Glenn Johnson is itching to give that detail. (laughter)

Glenn Johnson - *Alaska Air Group Inc - EVP & President*

I'm not going to talk about specific costs, but I can tell you about big projects to get the context for the types of things we're doing. We're needing to make the transition to Windows 7 from our XP Operating Systems, and at the same time we'll take advantage to moving to Office 365 for all of our work productivity systems that other companies use.

In addition on the operating side we have a new load planning and control system that will benefit both operating entities, accrue scheduling system for the Alaska airlines side, and very importantly we're relocating our data center in 2014 as we move to kind of reduce the risk of running our own data center and move that to somebody who is expert at it.

Kevin Crissy - *Skylar Research - Analyst*

Okay, thank you. Andrew, if you give us specific like kind of summarized competitive capacity in one number. How do you come up with that? Is that, are you weighting that by the importance of your rue, the seats in the rue? Because you could do it a number of ways to come up with a different numbers. Are you looking at it on an airport pair basis or market pair basis. When you say 7%, how are you coming up with that?

Andrew Harrison - *Alaska Air Group Inc - VP, Planning and Revenue Management*

You hit the nail on the head. We use it on a weighted method. So we look at it as where it is in our core and how important it is in appropriately weighting it. So it's a good conservative view of the world.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

It's weighted by our share of ASMs.

Kevin Crissy - *Skylar Research - Analyst*

Okay, thank you very much.

Operator

The next question comes from Jamie Baker from JP Morgan. Your line is open.

Jamie Baker - *JPMorgan Chase & Co. - Analyst*

Hi, good morning, gentlemen.

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

Hi, Jamie.

Jamie Baker - *JPMorgan Chase & Co. - Analyst*

Actually disappointed that a Company as cool as Alaska wouldn't consider a migration to Apple, but I also respect where you're headquartered. My Company specific questions have been addressed, but I did want to ask your view on an industry question. Where are the start ups?

When you have an industry producing these types of returns, when you have virtually no regulatory barriers to entry, you have an abundant supply of aircraft available from the lessors, you'd expect some newcomers to enter in hopes of getting a taste of what's available. And yet the last domestic start up effort was in 2005. So as long as one of the -- and that was Virgin. I know they didn't actually start flying until I guess 2007, but dating back to the start up. As one of the longer sitting Management teams in the industry, I'd really like to hear your view on this phenomenon.

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

Jamie, I'm going to ask Ben Minicucci, our COO to address that, and the reason is I think the safety and FAA issues are significant. Ben is in a good position to talk about that.

Ben Minicucci - *Alaska Air Group Inc - EVP, Coperations and COO*

So, Jamie, I think there are opportunities for people out there to start an airline, but it is a significant challenge to get an airline going from the operation side from the safety side from the regulatory side, so there's a lot of up front cost. It is a good environment, but I think there are impediments to launching and doing it right from the get go, so, yes.

Jamie Baker - *JPMorgan Chase & Co. - Analyst*

Okay, fair enough. I definitely appreciate the color, thanks.

Ben Minicucci - *Alaska Air Group Inc - EVP, Coperations and COO*

Thanks, Jamie.

Operator

Your final question comes from John Godyn from Morgan Stanley. Your line is open.

John Godyn - *Morgan Stanley - Analyst*

Hi, thank you for taking my follow-up. I just wanted to -- Brandon follow-up on Hunter's interesting question earlier on shareholder returns. I appreciate that you don't want to sort of pre-announce anything, but could you remind us what the normal sort of policy is for revisiting shareholder returns? Are there any specific meetings that this normally occurs at, or should we just expect to be surprised one day, if you are moving in that direction? Thanks.

Brandon Pedersen - *Alaska Air Group Inc - CFO*

Well, what I will tell you is that this is something our Board is really focused on, and we talk about it at every single Board meeting. Our Board meets four times a year, and, yes, you'll be surprised. (laughter)

John Godyn - *Morgan Stanley - Analyst*

Okay, thank you.

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

Thanks, John.

Operator

I'll now turn the call back over to the presenters for closing remarks.

Chris Berry - *Alaska Air Group Inc - Managing DIrector of IR*

Okay, thanks, everybody for being with us this quarter. We look forward to getting back with you after the first quarter, and go Hawks.

Operator

Thank you for participating in today's Conference Call. This call will be available for replay beginning at 7:00 pm Eastern Time today through 11:59 pm Eastern Time on February 23, 2014. The conference ID number for the replay is 31061476. The number to dial for replay is 1-855-859-2056 or 1-404-537-3406. Also the call will be accessible for future playback at www.alaskaair.com. You may now disconnect.
