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ALK - Q3 2016 Alaska Air Group Inc Earnings Call

EVENT DATE/TIME: OCTOBER 20, 2016 / 3:30PM GMT

OVERVIEW:

Co. reported 3Q16 GAAP net profit of $256m, adjusted net income of $272m and adjusted EPS of $2.20.

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PRESENTATION

Operator

Good morning my name is Christina and I will be your conference operator today. At this time I would like to welcome everyone to the Alaska Air Group third-quarter 2016 earnings conference call. Today's call is being recorded and will be accessible for future playback at www.alaska.com. (Operator Instructions). Thank you. I would like to now 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, Christina. Good morning, everyone. Thank you for joining us for Alaska Air Group's third-quarter 2016 earnings call. On the call today, our CEO, Brad Tilden, will provide an overview of the business and share our progress on the proposed acquisition of Virgin America.

Our Chief Commercial Officer, Andrew Harrison, will share the revenue results for the quarter followed by Brandon Pedersen, our CFO, who will discuss our financial results and outlook for the rest of 2016. Several members of our senior management team are also on hand to help answer your questions.

As a reminder, 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.

We will refer to certain non-GAAP financial measures such as adjusted earnings and unit costs excluding fuel. 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 third-quarter of GAAP net profit of $256 million. Excluding $14 million in merger-related cost and a $2 million impact of mark-to-market adjustments related to our fuel hedge portfolio, air group reported an adjusted net income of $272 million and earnings per share grew by 2% to $2.20 per share. That compares to [first call] (inaudible) estimate of $2.09 per share.

Additional information about cost expectations, capacity plans, fuel hedging, capital expenditures and other [writings] can be found in our investor update included in our Form 8-K issued this morning and available on our website at AlaskaAir.com. And with that I will turn it over to Brad.

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

Thanks, Lavanya, and good morning, everyone. As Lavanya just shared, our third-quarter net income was $272 million, a bit below last year, but our earnings per share of $2.20 were 2% higher than last year and our highest quarterly earnings per share ever.

2016 is shaping up to be a year of record profitability. Pretax income for the first nine months of the year was over $1 billion and $90 million higher than last year. And on a trailing 12-month basis our pretax margin now stands at just under 25%. This is an extraordinary level of performance not only in relation to our industry but also in relation to other high-quality industrial companies.

Some have asked what Alaska's margin should be over the longer term. This is a good question and one that we can all speculate about. What we can say definitively is that our goal is to be a leader in this industry and that means we need to be safe, be on time, provide great service and, very importantly, have both low fares and low costs. If we do these things well we will be in a position to lead the industry in terms of financial performance regardless of what part of the cycle we are in.

Before we get into the details of the quarter I would like to touch briefly on Virgin America. Many of you have asked questions about the timing of the merger and about our ongoing discussions with the Justice Department.

As to timing, we were hoping to get this done a couple of weeks ago and we are obviously not there quite yet. The scope of issues that remain with the Justice Department is manageable, but they are important matters and we want to take the time that is necessary to work through them.

It is hard to predict the exact timing for when we will wrap up since there are two parties involved. There is a process at play and we are working through that process and we are respectful of that process. Our hope is that we will have antitrust clearance soon.

All that said, we continue to be very confident that the deal will get done and get done in a way that benefits all of our stakeholders, most importantly our customers. This is a pro-consumer merger of two smaller airlines that will bring new low-fare competition, industry-leading service and innovative product offerings for the customers we serve.

And unfortunately what I have just shared is the extent of the comments that we are going to be able to make this morning about the review process. As we prepare for the merger there are two things our leadership team is really focused on.

First, bringing together these two teams so everyone is aligned, motivated and working on the same things -- or pulling together in other words. And doing this well lays the groundwork for number two, which is achieving the synergies of the deal which, based on everything we have seen to date, we feel confident about doing.

Ben Minicucci and his team have been working hard on integration planning and Ben and others will be happy to share details of the planning work during the Q&A. And as a reminder, this combination ultimately positions us as the fifth-largest airline in the country, an airline with a national footprint and an unmatched ability to serve West Coast travelers.

And with that I would like to turn the focus of this call back to our standalone business and our Q3 performance. It is football season and we are all cheering on the Seahawks and our other CFO, Russell Wilson. One of the things the Seahawks do well to stick to their game plan and I'm really proud of our folks for sticking to our game plan during our busiest summer yet.

A big part of Alaska's success is built on being safe, on being on time and on taking great care of our customers. Our team flat delivered during the third quarter. Let me start with safety.

You have heard us say that safety is our number one priority. And last quarter we were the first airline to have our new safety management system, or SMS, accepted by the FAA. This system, which the FAA is mandating for all airlines, is the new way of monitoring, managing and mitigating safety risk. And it is a project that we've been working on for almost five years.

I'm really proud of the teams at Alaska and Horizon for being the first airlines to have this in place. And again leading the industry on this underscores our commitment to operating safely and to doing things right.

Second, we continue to run a solid operation and in fact this was one of our best quarters operationally ever. 89.1% of Alaska's flights arrived on time during the quarter and we completed 99.8% of our flights. On a year-to-date basis our on-time rate is 88.5% and we expect it will be the best among the six largest carriers for the seventh year in a row.

Over at Horizon Dave and his team have been focused on improving their operation and their efforts are paying off, as our third-quarter performance went from 79.9% last year to 85.3% this year. This is especially important as we continue to grow the regional side of the business including the addition of new Embraer jets.

And third, our people are taking care of customers. Our internal customer satisfaction score for the third quarter was 87.3%, our highest score since we started tracking this back in 2007. This is a fantastic achievement and I want to thank our employees for taking great care of our customers over the summer.

And it's no surprise that how you treat people matters. We are seeing the results as active members in our Mileage Plan have increased by 35% in the last two years and this in the face of intense competition in some of our markets. Being safe, being on time and offering great service and low fares are the key ingredients of our game plan, not only for customers but also for our owners.

Looking at the most recent quarter, we expect our trailing 12-month ROIC of 24% and our third-quarter pretax margin of 27% will be among the very best in the industry. These are strong results; you will hear more from Andrew and Brandon next on the underlying actions that drove these outcomes.

As I look to the future I'm very confident about our core business and even more excited about the future when the Virgin America merger is complete. A lot of people will say this but I really feel it is true at Alaska. We have a fantastic group of people here who are working together and I want to thank them for everything they are doing to make us the best airline that we can possibly be for our customers. Now I will turn the call over to Andrew.

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

Thanks, Brad, and good morning, everyone. Our third-quarter revenue performance was solid with growth of 3.4% or $51.2 million. This contrasts with the industry revenue contraction of approximately 2%. We were able to sustain high load factors while increasing capacity at a rate more than two times that of the industry.

Our PRASM change improved about 200 basis points from the prior quarter and outperformed the industry by approximately 40 basis points despite competitive capacity growing double-digits in our markets once again. Looking at monthly trends, RASM was down by an average of 6.5% in both July and August, yet it was up 0.5% in September.

Lower September growth and strong bookings within the month, along with an improved close in yield trajectory contributed to the strong performance during the shorter period. Our September load factor of 84.1% was up 2.5 points year-over-year and while fares remain low they appear to be stable and we are not seeing anything to suggest that this will not continue into the fourth quarter.

Our underlying business remains sound and we expect to continue our current momentum for several reasons. First, our revenue streams continue to grow and diversify due to our growth. We started our trans-con service 15 years ago in September of 2001 with one flight from Seattle to DCA.

Today we serve 15 cities in this region with 33 flights a day and trans-con service now accounts for approximately 15% of our revenues and a similar amount of our profits. We are continuing this growth with new flights to Newark from Portland, San Diego, San Jose and a third daily departure from Seattle.

And here is a little fun fact. If you combined our network with Virgin America we would have up to 31 flights a day to the New York City area alone.

Second, we added Embraer 175s into our fleet a year ago and this has been a fantastic aircraft for reaching markets in the mid-continent which were too far for the Q400 and to thin for the 737. We have rapidly grown the number of markets served by the Embraer to 29. These aircraft are delivering the results we'd hoped for as they are creating new and profitable revenue streams, supporting our mainline growth and providing greater nonstop convenience for our customers.

Even though many of our Embraer 175 markets are still maturing, in aggregate they are profitable and already earning their cost of capital. We take delivery of 18 175s next year.

Third, this growth is buttressed by the loyalty we enjoy from our members. We believe we have the most generous and far-reaching loyalty program in the industry. Members in our credit card portfolio grew 11.5% for the quarter with retail spend on the portfolio outpacing this membership growth. And additionally, our frequent flyer members grew 10%.

And fourth, our growth is enabled by offering low fares. In some recent analysis we conducted we found Alaska's one-way fares were more than $40, or 23%, lower than each of the three network carriers on a system-wide [stage length] adjusted basis. Our low fares are enabled by our low costs. We remain focused on bringing these low fares to our customers and maintaining the cost advantage that enables these fares.

I want to move to the fourth quarter now. Our Q4 growth will slow substantially to just over 3%. This brings our full-year capacity growth to about 8.5%, in line with our previous guidance. However, our competitive capacity is expected to stay elevated for the remainder of the year at about 10%.

While we expect close-in booking strengths we have seen in September to carry through to the fourth quarter, December is expected to be softer than October and November on a relative basis as both Christmas and New Years fall on a weekend this year compressing the holiday travel season. We estimate this will lower PRASM for the quarter by about half a point.

I also want to update you on the progress we are making on our premium class product. We expect to complete the conversion of all 61 737-800s by year end. We will start selling tickets for premium class in early November with travel starting January 5, 2017. As a reminder, we expect this to add approximately $50 million in revenue next year and achieve $85 million annual run rate by the end of 2018.

With that I would like to touch on 2017. On a standalone basis, that is excluding any impact from the acquisition of Virgin America, we expect our growth to slow by about 150 basis points versus this year to slightly more than 7%. This growth comprises approximately 2 points from longer stage length and 1 point from the annualization of markets we already launched in 2016.

As we look at published schedules we expect Q1 2017 competitive capacity to come down slightly to 9% in our markets, still elevated but a nice change from the double-digit increases we have been seeing for quite a while.

As we enter the last quarter of the year and look to 2017 we remain confident in our business. We are operating well, fundamentals in the economies we serve are strong; our loyal customer base continues to grow and we continue to add new and profitable revenue streams to our portfolio.

Like everyone else at Alaska, the rest of my commercial team and I are excited about the opportunity that Virgin America presents for our business, which will allow us to accelerate our growth while bringing low fares to more customers and strong returns for our shareholders. With that I will turn the call over to Brandon.

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

Thanks, Andrew, and good morning, everybody. We are pleased to report another very strong quarter financially punctuated by the 2% increase in earnings per share. Even though net profit declined very slightly, we are benefiting from the significant share repurchases that we have made since the end of the third quarter of last year.

As Andrew said, revenues grew by more than 3% and, although our nonfuel costs grew by nearly 10%, we were nonetheless pleased with our cost performance. Our nonfuel unit costs were up 1.6%, but that was lower than we initially expected for the quarter. We remain on track to have a full-year unit cost reduction of about 0.5% which would make this the seventh straight year of unit cost reduction.

Andrew offered some early guidance on next year's growth, but we aren't yet able to share initial 2017 unit cost guidance. Our leaders are busy compiling budgets right now. Folks across both Alaska and Horizon recognize that low-costs create an important competitive advantage over higher cost legacy carriers and are required for us to grow. We are planning to provide 2017 cost guidance on our fourth-quarter call.

And speaking of guidance, I want to remind everyone that we are taking a little different approach this year by having our Investor Day in March. We are looking forward to sharing much more with you about our post merger plans at that time.

Our earnings benefited less -- from less of a tailwind of lower fuel prices than in Q1 or Q2. Economic fuel costs declined by $18 million this quarter where the year-over-year declines in Q1 and Q2 were more than three times that amount. With oil prices now over $50 a barrel, it is worth mentioning the improving efficiency of our fleet that will help offset rising fuel costs.

ASMs per gallon improved by another 2% this quarter because of the ongoing retirement of the 737-400s and the addition of fuel efficient 900ERs. In fact, we've taken delivery of 21 737-900ERs since the end of the third quarter of last year. And our mainline efficiency should just continue to get better as we finish retiring the 400s and add another 13 900ERs by the end of 2017.

As we told you before, these new aircraft are 37 seats larger, they are more comfortable, they are more reliable and sip fuel like a Prius with wings. A 900ER burns less than 910 gallons per flight compared to 940 gallons per flight hour burned by the smaller 737-400.

Turning to the balance sheet. You might have noticed that we ended the quarter with more than $3.2 billion of cash. That total includes more than $1.5 billion that we'd raised at quarter end to fund the Virgin America acquisition. At this point we are fully prepared to close the deal once we have DOJ approval. Our treasury and legal teams did an incredible job putting all this together and I want to extend a huge thanks to both of them.

We are using a mix of fixed and floating rate debt and our weighted average interest rate on this new money currently stands at 2.37%. Even after the financing, we still have more than 40 unencumbered Boeing 737 aircraft including 20 next-generation 800s and 900ERs. The borrowing rate and the fact that we have so much remaining collateral are both a testament to the great balance sheet that we have built and the incredible amount of cash flow we have been able to generate over the last five years.

Cash flow from operations for the first nine months of the year was $1.2 billion, about flat compared to the first nine months of last year. Year to date CapEx is just over $500 million resulting in about $700 million of free cash flow. We expect full year CapEx to now be $680 million, down slightly from prior guidance. There are two drivers.

First, we elected to defer our first 737 MAX aircraft from the fall of 2017 to early 2018. The MAX will be a great airplane for Alaska with its extra range and lower fuel burned, but with so much going on we wanted a bit more time to bring it into service. We want to thank Boeing for accommodating our request.

And second, we have lowered our estimate of non-aircraft spending as certain projects have shifted to the right. Looking forward and as we told you last quarter, we are planning for 2017 CapEx to be about $1.1 billion, which of course is current Air Group only.

Andrew and I have thrown out a lot of information on fleet changes, so I thought I might recap. On the mainline side, in 2016 we are adding a total of 19 new aircraft and retiring 10. And in 2017 we are adding 12 new aircraft and retiring 16, which is the rest of the 737-400 fleet.

On the regional side we will take delivery of our first 13 E175 jets into the Horizon fleet - and by the way, I want to recognize the Horizon team that is working on entry into service - and we will add another five through our capacity purchase arrangement with SkyWest.

We are very pleased with the strong results, both operational and financial, and our people should celebrate the great summer we had. We are mindful that there is a lot going on, a lot of hard work lies ahead and we need to keep executing on the things that continue to make us successful. And with that let's go to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Savi Syth, Raymond James.

Savi Syth - *Raymond James & Assoc. - Analyst*

Just a quick follow-up on the Virgin comment you made, Brandon. Is everything then lined up as soon as you get approval you can close? Or are there kind of non-financing steps that need to happen? And if you get too close to the holidays then this [could] get pushed out into 2017?

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

Savi, it is Brandon. We are good to go from a financing perspective. But I might turn it over to Kyle to just touch on the other process things.

Kyle Levine - *Alaska Air Group, Inc. - VP, General Counsel, Chief Ethics & Compliance Officer*

Hey, Savi, good morning. Yes, as things currently stand, as soon as we get DOJ clearance and have the financing all set up, we are good to go.

Savi Syth - *Raymond James & Assoc. - Analyst*

Okay, that is great. And then on the Horizon front, just wondering with the -- if that's kind of middle of next year. And how should we think about, is there going to be some kind of transaction introduction expenses around that as we think about 2017?

David Campbell - *Alaska Air Group, Inc. - President & CEO of Horizon Air*

Savi, on the Horizon front, you are talking about the introduction of the E175s?

Savi Syth - *Raymond James & Assoc. - Analyst*

Exactly.

David Campbell - *Alaska Air Group, Inc. - President & CEO of Horizon Air*

^ Yes, so, the plan we have right now is we'll take the first aircraft in in March of next year, we will hope to be in service by May 1. We have committed all of our manuals to the FAA with the exception of one. So far the feedback from the FAA is very positive.

So I think we are pretty much on target and have no concerns at all. Training and staffing for the pilots, that is going very, very well. So, I think we are in a really, really good position overall (technical difficulty) E175s.

Savi Syth - *Raymond James & Assoc. - Analyst*

All right, great. Thanks. I will get back in the queue.

Operator

Rajeev Lalwani, Morgan Stanley.

Rajeev Lalwani - *Morgan Stanley - Analyst*

Just on the Virgin transaction, I have a high level question for you. Just given the various headlines out there, how do we get comfortable that the full price you pay doesn't get fuller and that synergies remain intact?

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

Rajeev, it is Brad. This is a hard deal, but I think the bottom line on this is we actually have said what we are going to say about it. I think everyone on the call is familiar with the M&A process in our country and we are going through that process.

And what we have said is that we are extremely confident that the deal will get done and we are also very confident that we are going to realize the synergies that we have talked about. But that is actually the limit of what we can talk about on the call today, unfortunately.

Rajeev Lalwani - *Morgan Stanley - Analyst*

Okay. That is okay, I know it is a tough question to answer. A related question, if I could maybe just explore sort of a Plan B in the event that the deal doesn't go through for whatever reason. What would you then do with the $3 billion or so of cash that you have got sitting on your balance sheet?

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

Again, Rajeev, I just don't think we can go there. But I do respect you for trying and thanks very much. We have actually just said what we can say about the process.

Rajeev Lalwani - *Morgan Stanley - Analyst*

Okay, no worries. Thanks.

Operator

Julie Yates, Credit Suisse.

Julie Yates - *Credit Suisse - Analyst*

A question on the growth cadence for 2017. Any color you guys could provide? I imagine you will be starting below the 7% in Q1 and ending above in Q4?

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

Julie, it is Andrew. At this time, because we normally have an Investor Day in November, we are just giving high-level guidance for growth today at about 7% for next year. To your point, we start lower as we come into the first quarter. But as we move through the year and come to Investor Day we will give you quarter-by-quarter guidance.

Julie Yates - *Credit Suisse - Analyst*

Okay, great. And then, Andrew, you mentioned competitive capacity remaining elevated but around 10% in Q4. I think last you told us it was 12%. So I assuming things are looking a bit better. Is that correct?

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

Yes, I don't want to celebrate too early, but in the third quarter competitive capacity was up 13%, fourth quarter 10%. As we mentioned, 9% in the first quarter. But as the bookings sit today, the booking schedule, it is only up 1% in the second quarter. So that is going to be very good.

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

Julie, it has been a long time since we have seen numbers like that in our markets, obviously.

Julie Yates - *Credit Suisse - Analyst*

That is great news. Okay, great. Thanks so much.

Operator

Hunter Keay, Wolfe Research.

Hunter Keay - *Wolfe Research - Analyst*

So, Brad, you talked about -- I think it was one of the first things you said about people are asking you about long-term margins. And you said they are going to be better than everybody else but you didn't give a number.

If I were to think about the average pretax margins you guys did in 2012, 2013 and 2014 it was about 14% pretax. So is that a good sort of all else equal guidepost to how to think about long-term margins? Or will it be a little bit lower than that given some likely dilution from Virgin? You can answer this standalone or pro forma, however you want.

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

Yes, yes. I think -- this is the place where we are all speculating, Hunter. You guys probably have a better view of what is going to happen with long-term margins in our industry than we do. But we do look at other industries, we look at other high-quality industrials. We look at sort of gaps that people are earning over their cost of capital.

And so I think the industry, you would hope that as we settle down and have capacity control and have consolidation that we settle into a place where we are earning as an industry margins that are several hundred points above our cost of capital. And then what we are saying is Alaska should be about that, that is sort of how we see ourselves. That is what we want to do.

How you do that math, I don't think I want to be the one -- I think I have told you what we know and one of the things we have always done is try to talk about what we know and not talk about what we don't know. So I think that is where I might leave it.

As to Virgin just to be really candid, yes, the two together, we are not issuing one new share for this acquisition. So, any profit that they bring into the Company is accretive to our profit. But I think you have seen the math. Virgin's historical margins are lower than Alaska, so I would expect that our companywide margins will dilute a little bit.

And, Brandon, I can't remember the exact numbers, but it is not huge. Once the synergies are realized it is not a significant decrease as I recall.

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

In the margin percentage.

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

In the margin percentage.

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

Yes. Once the synergies are realized and then obviously we need to have Virgin's actual numbers for this year in the next to know that with certainty.

Hunter Keay - *Wolfe Research - Analyst*

Yes, right, okay. Cool. And then what is on the table in terms of -- assuming this deal gets done, how do you guys think about communicating with the Street? You have been pretty consistent over the last seven, eight years about not giving RASM guidance, not giving margin guidance. I think the stability of your earnings are better than most.

Have you ever considered talking about -- I know we talked about this a few months ago about long-term RASM guidance. But are you guys giving any thought to how you want to think about communicating financial guidance in general once the deal closes? Particularly giving something like annual EPS guidance like a lot of high-quality industrial companies do so you can prove (laughter)?

Right, I mean like it fits -- I am serious, right, like you can prove that if you give me a range and you hit it year after year your multiple will go higher. If you believe that fuel and fares are correlated, for example, you should be able to hit a range of EPS. So as you think about this are you giving thought to how you communicate guidance longer-term in general, not just RASM but guidance in general?

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

Yes, Hunter, we are thinking about it. What I will tell you is we were on the cusp of giving a lot more forward-looking disclosure and then we went and did the deal with Virgin. And so, we are not going to do that right now. And what I would say is I recognize that that is what good high-quality industrials do. I would love to get there at some point.

What I will tell you is that the reality of putting business A together with business B we are going to have numbers that are unfamiliar to us for a while. And I think what we will do is we will wait until we get more familiar with those numbers and we'll get really confident on what the comps look like from our own perspective. And then once we are confident with that we will start giving more to you guys.

Hunter Keay - *Wolfe Research - Analyst*

All right, yes, that is cool. Thanks, guys.

Operator

Joseph DeNardi, Stifel.

Joseph DeNardi - *Stifel Nicolaus - Analyst*

Andrew, just kind of looking at the competitive capacity again, if you look at the composition of the growth it has changed a lot over the past 18 months; it was a lot more coming from Delta, now it seems to be American and Spirit.

So just -- can you just speak to conceptually kind of what that means for you guys from a PRASM standpoint? Is it better for you? I would imagine it is that the growth is coming from American and Spirit rather than Delta or is that not the case?

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

Joe, the numbers we give you are sort of -- they are weighted to us, so I think you can just -- 1% is 1% versus 9%. At the end of the day we compete with everybody. Each competitor comes with their different flavor. But at the end of the day as it relates to that, from my perspective, competitive capacity is competitive capacity on our network. And we just continue to deal with that irrespective of who it is.

Joseph DeNardi - *Stifel Nicolaus - Analyst*

Okay. And then, Brandon, you mentioned mainline fuel efficiency potentially getting better next year. I mean can you put a finer point on that? Should we think mainline ASMs per gallon up like 3% or 4% or just kind of in-line with what you guys have done the past couple years?

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

Yes, I don't have a number of the top of my head, but if I had to guess I would say it is probably what we have done over the last couple years. We have been on this course of phasing out the 400s now for a few years. Next year, as I said, the last 10 go out.

So I think it is probably pretty consistent with what we would expect to see again on an Alaska only basis. As we look ahead to the merger, Virgin America does enjoy very high fuel efficiency as well, and so the combined entity should be just as well positioned.

Joseph DeNardi - *Stifel Nicolaus - Analyst*

Great, thank you very much.

Operator

Jamie Baker, JPMorgan.

Jamie Baker - *JPMorgan - Analyst*

When the merger was announced you talked about re-deleveraging. And I am wondering as you have dug deeper into the integration planning process, have you established any timing or sort of annual progress that you hope to make in that regard?

I mean is it a five-year goal to return to where you currently are premerger or where you were in March or some other time frame? Is there some annual number in terms of how much you would like to -- how many turns of leverage you might want to decline, anything like that?

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

Hi, Jamie, it is Brandon, good morning. Maybe I will start and then Ben can tell you about the integration progress that we are making. We have modeled the re-deleveraging that we talked about. And when we come out of the gates we should have debt to cap right 59%-60%. And -- but our goal would be -- would be to get down into the mid-40%s within say three years or so. That is obviously dependent on the economic environment.

But if we do it right that is where we will be. And then I think we will stay there for a while. I think we like leverage in the mid -- low to mid-40% range. I don't see us going back down to 28% like we were pre deal. But I think we can get there quick. And at that level we will have a balance sheet that looks a lot like another -- or other high-quality industrials and it will look very favorable compared to other carriers in the industry.

Jamie Baker - *JPMorgan - Analyst*

Very helpful, I appreciate that. Second question, and this is not uniquely tied to merger specifics or negotiations, so hopefully you will choose to answer. Can you assure us that you have at least identified the terms under which you would not do the deal?

And the reason I ask is that I am just trying to assess whether the goal here is to get the deal done and give up as little as possible, which makes sense. Or get the deal done only if you can assure that -- pick a metric -- ROIC remains above X. I mean have you established a floor internally? Not asking you what the floor is, just trying to dig into the thought process here.

THOMSON REUTERS

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

Yes, Jamie, it is Brad. I think what we will say is that we have always run this business for the long term. We think about what is going to be good for all of the people that depend on this place over the long term, for customers, for our employees, for all of you, for the owners of the business. And that that is the mindset we are taking is we have this conversation with the Justice Department.

So we are pushing. There are some things that we feel are important to our future success and our ability to do good things for customers. And that is what is motivating us here. And I will just say we do have a pretty strong internal compass about what has worked for us and what will work for us in the future. So, if that is an answer to your question, there you have it. But there is just not a lot more that we can say about (multiple speakers).

Jamie Baker - *JPMorgan - Analyst*

No, that will suffice. And if I could just sneak in a housekeeping question and it's I guess somewhat reminiscent of what Hunter was asking about in terms of guidance. Have you thought about how you are going to be reporting post-merger?

Should we expect that you still break out regional and mainline? Or is there an opportunity to just move everything into a consolidated basis as you guide going forward? Any thoughts there or are we just jumping too far ahead? I am just thinking about how do I rebuild my model.

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

Yes. It's all about you, Jamie (laughter). What we will do is we will probably report regional and mainline I would say. But until we have a single operating certificate, Virgin America and Alaska Airline separate results would be available on Form 41 as well.

Jamie Baker - *JPMorgan - Analyst*

Yes, okay. Yes, makes sense. All right, I will turn it over to somebody else. Thanks for taking my questions.

Operator

Michael Linenberg, Deutsche Bank.

Michael Linenberg - *Deutsche Bank - Analyst*

Just a follow up on Jamie's question about, Brandon, where you would want to get to with respect to debt to cap. If getting back to the low to mid 40s still didn't get back you to an IG rating, would that be -- would that matter or is it at the very least you want to do what you need to do in order to get back to the coveted investment grade credit rating?

Mark Eliasen - *Alaska Air Group, Inc. - VP, Finance & Treasurer*

Hey, Mike, this is Mark Eliasen. Maybe I will take a shot at that one. First of all, we're not changing our principles and our principles got us to the investment grade rating. And that is generating good cash flow, a conservative balance sheet, running a good Company, good high-quality industrial Company.

So we are going to get there and we are confident that the rating agencies will come around when they see that and they know as well and they will see that we are going to just revert back to our pattern.

One point I will make about the -- we are going to have additional debt, but because the interest rate is quite a bit lower than what we had before, our actual interest expense will be right in the range of what we have had historically. So that is a good thing even though our leverage is a little bit higher.

Michael Linenberg - *Deutsche Bank - Analyst*

Okay, great. And then just a second question, and this is probably -- I don't know if it is for Brad or Ben, but we had the new -- I guess another phase from the DOT as it relates to consumer protection legislation. And while there was kind of a lot of verbiage, a lot of noise it seemed like that there were a couple things that are going to come into play here and one of it has to do with the on-time performance.

And I am just curious, I mean I know that under the new rules Horizon doesn't meet the new threshold, but it looks like it is likely very close to the threshold. So maybe it is a 2017-2018 type event. But if you were to include Horizon in with the Alaska numbers where would you stack up on on-time completion, completion factor?

Like how would you compare -- and I realize you would probably have to do that analysis for the other carriers, but does it enhance, is it neutral or does it take away from the numbers?

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

Hi, Mike, yes, that is a great question. In fact, and you guys would expect that from me. I track that every day, Alaska, Horizon, and I actually track every other carrier in the industry and how we stack up. And I will tell you today as the combined Alaska and Horizon we would still lead the industry in on-time and combined completion rate, hands down.

So Horizon -- I am looking forward to Horizon getting the 175, the more reliable airplane. And in fact we would include SkyWest in that total as well. So I think it is a good thing what the DOT has done. I mean the customer, when they book on an airline, they really don't distinguish whether they are flying a regional airplane or a mainline airplane.

And it is our commitment it has been our philosophy all the time here at Alaska that whether you fly mainline or regional we will look after you like -- the same across all touch points.

Michael Linenberg - *Deutsche Bank - Analyst*

That is suitable helpful, Ben. Thank you.

David Campbell - *Alaska Air Group, Inc. - President & CEO of Horizon Air*

Michael, this is David Campbell at Horizon. (Multiple speakers) for a second. One of the things that we have turned our attention towards is really [having] a clear focus on operational excellence. We have seen a 7% improvement so far this year on DOT performance as far as getting (inaudible) DOT on on-time performance as far as getting out of the gate and we're seeing about a 5% improvement as far as on-time arrivals.

One of the challenges I think we have here in Seattle is really dealing with ATC delays, but everything else that we can control we are driving a much, much stronger process in place. So I am pretty excited about the focus. I think you are going to see continued progress on performance from Horizon.

I think the second piece of this, the E175 is such a reliable great airplane that is going to actually help us a great deal as well. So that is going to be a really good tool in our toolbox to really take care of our customers.

Michael Linenberg - *Deutsche Bank - Analyst*

Great, thanks, David. Thanks, everyone.

Operator

Darryl Genovesi, UBS.

Darryl Genovesi - *UBS Securities LLC - Analyst*

Andrew, is there a further step up in the credit card economics in 2017?

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

I'm sorry, Darryl, could you repeat that?

Darryl Genovesi - *UBS Securities LLC - Analyst*

Right, I was asking if there is -- some of your peers have announced that credit card deals that they have signed recently have had a step up in the economics in year two as well. And I was wondering if that was the case on the deal that you announced at your Investor Day last year?

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

I am going to look at Brandon here; we don't normally disclose our contractual relationships with the bank. What I can tell you is that we expect and will continue to see a continuous strengthening of our economics through our credit card arrangement because we have got strong growth both on the Boeing side and the loyalty.

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

Yes, Darryl, it is Brandon. It does step up through the term, although I don't remember off the top of my head whether it is annually or if there is some years that we go flat for a year.

Darryl Genovesi - *UBS Securities LLC - Analyst*

Okay, thanks for that. And then, Brandon, you said you weren't ready to provide 2017 unit cost guidance yet, which is understandable. But just wondering if you could highlight what some of the big moving pieces are for us. I guess you have got the E175 introduction that has been discussed. But is there anything else? I think you have got a mechanics deal that is amendable and any other sort of big items that you would highlight.

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

Yes, you are right. We do have a mechanic deal that is amendable on the Alaska side. We have what I would call a likely increase in our pension expense just given returns and where rates are this year. We won't know that amount until the end of the year.

I think it is possible that we might have a deal with the OEM for a services agreement; we are still looking into that. So if that gets done that would be a cost win for us, although that is really just a smoothing arrangement over a longer term period. And then we do have a little bit of I would say both cost and ASM headwind associated with premium class.

As Andrew shared, premium class is going to be awesome from a margin perspective both dollars -- or from a dollars perspective on the margin line. Although it does dilute ASMs a little bit and there is additional cost of serving those premium class passengers. So those are kind of the big things off the top of my head.

Darryl Genovesi - *UBS Securities LLC - Analyst*

Okay. And then if I could just squeeze one last one in. When you retire the last 737 classic is there some sort of step down in infrastructure spend or something associated with that in addition to the fuel cost savings of no longer operating that airplane?

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

Yes, I will let Ben take that one.

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

Well first, Darryl, we're going to have a party when the last classic goes, at least the maintenance guys will. There will be some -- we are investing in an Anchorage hanger. The Anchorage hanger can only accommodate classics. We do need a bigger hanger up in the state of Alaska to accommodate the larger NGs -- sites that we have tooling and spares and parts for to maintain the rest of the fleet so we are solid there.

Darryl Genovesi - *UBS Securities LLC - Analyst*

Okay. All right, thanks, guys.

Operator

Helane Becker, Cowen.

Helane Becker - *Cowen and Company - Analyst*

So I have two questions. One, you didn't really mention much about Hawaii. I was kind of wondering if you could talk about the competitive capacity that is going on in the market and what you are seeing there and whether there are plans to increase capacity or not?

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

Helane, it is Andrew. I would say I would generally characterize Hawaii right now as stable. We have seen some capacity increases in California, especially in the Bay area. But again, without going into too much detail we feel very, very good about our Hawaii 26 plus flights a day franchise and it is performing very, very well, very, very stable right now.

Helane Becker - *Cowen and Company - Analyst*

Okay. And then I think over the past couple -- maybe last week or the week before there was some really bad weather in your neck of the woods, which you don't normally see. So maybe you can talk about the impact that would have on October results.

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

The weather, Helane, it has been -- yes, it was -- we were expecting extremely high winds and rain. What I will tell you is that we got some of it but it wasn't to the extent that we expected. We did cancel just a handful of flights, maybe about 30 flights. We accommodated most customers, we did that all in advance. So I can't tell you dollar amounts, maybe I will ask Brandon.

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

I think it will be immaterial.

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

Yes, so, we came through it pretty -- we don't get to see many of those storms, so hopefully it will be the last one we see in a while.

Helane Becker - *Cowen and Company - Analyst*

Okay. And then, Brandon, I noticed that the CRJs are going away at the end of the year. Is there any impact we need to be aware of from balance sheet perspective?

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

No, there is just a couple left that are flying or maybe one that is still flying. We have taken care of all of it from a balance sheet perspective.

Helane Becker - *Cowen and Company - Analyst*

Okay, thank you.

Operator

Dan McKenzie, Buckingham Research.

Dan McKenzie - *Buckingham Research - Analyst*

Andrew, taking a step back I'm wondering if you can help us understand how codeshare agreements work more broadly. There is a broad view that they are in the bit like a light switch, you either have one or you don't, you turn them on, you turn them off.

And so the question here is just how do they really work? What are the various components, how easy are they to customize it? And where does the value really come from? Is it on the routes that you don't serve but your partner does or is it on the markets that you both serve?

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

Dan, good morning. That is a very good question. I will keep it high level I think and I will just speak for a Alaska Air Group. A couple of key things here that codeshare provide us. Firstly, domestically we can connect into our partners' hubs in the middle of the country and then connect our customers to anywhere in the rest of the country.

So firstly, these codeshare agreements domestically give us a lot of ability to be able to get our passengers everywhere they need to go at the times they need to go and give them plenty of choice of fares when they need to go.

I think the other key component of that is also obviously the loyalty side. So our customers can still accrue elite status in miles when they fly on our partners' metal or on our own metal. And of course redemptions, our customers want to redeem; 85% of our customers redeem on us still.

And then the last piece is really international. And the international is really, really important. For our international partners we provide huge value to help them fill their airplanes. I mean the statistics are quite significant in our hubs especially on how many passengers we put on our foreign flag friends.

But for Alaska customers it allows them to both redeem globally 800 plus destinations globally as well as earn and redeem miles. So overall I would say that these codeshare relationships provide great utility. But at the end of the day, Alaska Air Group is built on its fundamental product and the majority of customers, the majority of loyalty, the majority of revenue is all based on Alaska Air Group's metal and what we do.

Dan McKenzie - *Buckingham Research - Analyst*

If I could just kind of backup, Andrew just a little bit there. How easy are they to customize them, to turn on or turn off certain routes I guess number one? And then secondly, does the majority of the value come from the markets that you don't serve or because I would presume there is some markets that you jointly serve. I am just wondering if you could just kind of help us understand a little bit further.

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

So I think for mechanics it is very easy to turn things on or off, we've just got to give notice to our customers to change the booking schedule and not disrupt passengers. So we work very closely with our partners. And there is no silver bullet on value.

In our Seattle hub it might come from connecting beyond some international loyalty. In California where we are less prevalent or maybe even in Los Angeles our partners give us a much fuller schedule and allow customers where we don't have a whole lot of utility to still stay in the family and in our program to travel on them.

I think loyalty, codeshare revenue, all of these things in the portfolio, Dan, I -- honestly there is no one single area that it is more important than the other. From my perspective at least.

Dan McKenzie - *Buckingham Research - Analyst*

Understood. And then I guess secondly here, Andrew, you mentioned the trans-con presence for Alaska and the rest of the industry has gone to a lie flat seat in this segment. And I guess I am just wondering what are your thoughts about this going forward just given the acquisition of Virgin here. Does the more upscale approach make sense or is the thought simply to maintain a density advantage?

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

Dan, it is a great question and that is a project that we are working on right now. I think the point you are making is a good one that an lot of carriers are moving to a certain number of lie flat seats in certain markets. The other side of it is Alaska has got a long-standing -- we are very proud of the low-cost, low-fare position that we have.

And so, those are the two -- and there is also a simplicity element in this thing. So those are the things that we are going to be balancing as we think about this decision and I think you will hear us say more about this in the next few months. But it is an open question, I think you know the two sides of -- the two arguments for each side.

Dan McKenzie - *Buckingham Research - Analyst*

Okay, thanks, guys.

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

Christina, we've got time for one more question.

Operator

Savi Syth, Raymond James.

Savi Syth - *Raymond James & Assoc. - Analyst*

Just maybe on the capacity growth side, I am a little bit surprised by next year's level of growth given that you are having pressure on the fuel side and you are going through this integration. Just any thoughts on what got you comfortable with that? And given the changes in the space that you've talked about, I know at Investor Day you had outlined maybe getting to like an 85 ASMs per gallon level of fuel efficiency and if that is still the thinking?

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

Savi, maybe I will start with the first part on capacity. So a couple of things. As you heard earlier, there is obviously decent growth on the regional side of our business. And all the CRJs going away that were 70 seats, we are going to 76 seats on the 175. So there is some good growth there.

A lot of our growth is really trans-con and mid-con; 80% of it was this quarter, 100% of it will be next quarter. We will give more detail later on. But these are markets that we found to be very, very good for us and adding a lot of new revenue.

As Brandon shared, these are high level estimates, again, as we stand today. The Havana's, all the Newark's -- each of those were 1 point of growth or 0.75 of a point of growth. So it is not hard to get to 7% already with what we have already done. We will continue to monitor this and of course with the new combined entity we will take a hard look at it.

But what we have seen to date is our growth has provided good economics for this Company. And if these economic conditions and the continuing strengthening of close in bookings in the environment are still there next year we will continue on with our plan.

Savi Syth - *Raymond James & Assoc. - Analyst*

Good point.

Mark Eliasen - *Alaska Air Group, Inc. - VP, Finance & Treasurer*

Hey, Savi, this is Mark. You talked about ASMs per gallon, are we talking about an objective or a goal for Alaska?

Savi Syth - *Raymond James & Assoc. - Analyst*

I thought at the Analyst Day you outlined like 85 -- reaching an 85 number.

Mark Eliasen - *Alaska Air Group, Inc. - VP, Finance & Treasurer*

Yes. So I can give you a couple of facts that I just looked up. The 900ER gets about 92 seat miles per gallon right now in our fleet. And the 800s are about 85. So as we phase out the 737-400s, as Brandon mentioned, we should approach that number; we should be in the 80s. That is going to be about 88% of our fleet will be those -- those very large jets and they are great airplanes for us.

Savi Syth - *Raymond James & Assoc. - Analyst*

Great, thanks.

Operator

At this time I would like to turn the call over to Brad Tilden.

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

All righty, thanks all of you for tuning in today. We appreciate your questions and we look forward to chatting with you in 90 days time. 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.