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ALK - Q1 2017 Alaska Air Group Inc Earnings Call

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OVERVIEW:

Co. reported 1Q17 GAAP net profit of $99m, adjusted net income of $130m, or $1.05 per share.

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PRESENTATION

Operator

Good morning. My name is Krista, and I will be your conference operator today. At this time, I would like welcome everyone to the Alaska Air Group FIrst Quarter 2017 Earnings Release Conference Call. Today's call is being recorded and will be accessible for future playback at www.alaskaair.com. (Operator Instructions)

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

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

Thanks, Krista, and good morning, everyone, and thank you for joining us for Alaska Air Group's First Quarter 2017 Earnings Call.

On the call today, our CEO, Brad Tilden, who'll provide an overview of the business; our Chief Commercial Officer, Andrew Harrison, who'll provide color on the revenue environment; an followed by Brandon Pedersen, our CFO, who will discuss our financial results and outlook for the rest of 2017. 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.

Moving to results. This morning, Alaska Air Group reported a first quarter GAAP net profit of $99 million. Excluding merger-related costs and impact of mark-to-market adjustments related to our fuel hedge portfolio, Air Group reported an adjusted net income of $130 million and earnings per share of $1.05, $0.04 better than the first call consensus of $1.01 per diluted share.

As a result of the merger, our business this year is nearly 1/3 better than last year. Passengers are up 28%, revenues are keeping pace and up 30%. And we [announced] 37 new market since the deal closed, with a lot of this growth coming in the state of California. While we're excited about this growth, to help investors make meaningful comparisons about the changes in our business, we've included certain unaudited supplementary data labeled Combined Comparative Statistics on Page 7 of our investor update.

Unless otherwise noted, the numbers discussed today will be on a combined comparative basis. In other words, comparing our Q1 results this year to the combined results of Alaska and Virgin America last year. We think this provides investors better insights into how the overall business is performing.

Additional information about cost expectations, 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 alaskaair.com.

And with that, I'll turn the call over to Brad.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO, President, Chairman of Alaska Airlines Inc, Chairman of Horizon Air Industries Inc, CEO of Horizon Air Industries Inc, CEO of Alaska Airlines Inc and President of Alaska Airlines Inc*

Thanks very much, Lavanya, and good morning, everybody. A few weeks ago, we had the chance to speak with you at our Investor Day about our strategy for the combined company, including our integration plans, the brand decision, our updated synergy commitments and our approach to capital allocation. For today, we want to focus on our first quarter results and provide a more near-term look at the business. We'll try to keep our comments brief so we'll have plenty of time for your questions.

We're 1 quarter into 2017 and the business is looking good. The West Coast economy remains very strong, as you saw with the Crane index that we showed you at Investor Day, and in this strength is not only benefiting our existing routes, but it's also helping unlock the value of the merger as shown by our many recent new route announcements.

Speaking of the merger, the integration continues to progress well. Last week, the flight attendants became the first labor group to receive a single carrier certification from the National Mediation Board. This is a an -- it's an important milestone and enabled them to start to move forward things like Seniority List Integration. Most of the other groups -- other labor groups have us also filed for certification and are currently going through the approval process

Finally, from a financial perspective, we reported $202 million of adjusted pretax profit for the quarter, which is down from last year with the higher fuel prices we've experienced but still very solid. This marks the eighth consecutive year of profitability in the first quarter and an 11.5% pretax margin in what is traditionally been our weakest quarter shows the strength of our business model.

Moving on to the operation. Being safe and reliable is one of the core promises we have for our guests. And we have a history of delivering, as shown by our recent #1 spot in the 2016 Airline Quality Ranking. However, this business has a way of keeping your humble and, a rough winter on the West Coast shows that we have room for improvement and our handling of our regular operations, particularly snow, deicing and ATC delays. And this is especially true in locations where real estate is already highly constrained.

We have 5 times more snow or freezing rain events in Seattle and Portland this year versus last. But even accounting for this, our performance was still disappointing. For the quarter, Alaska and Virgin mainline on-time performance was 78% and 65%, respectively. And on the regional side, Horizon came in at 71% while SkyWest came in at 80%. We are committed to doing a better job in getting our guests to their destinations on time, regardless of the weather, and we are on the process of reviewing our operational procedures, including the winter ops program.

While we need to improve our processes, our people did a fantastic job taking care of our guests throughout the quarter. Although Alaska's mainline customer satisfaction results were down in January, our employees quickly rebounded and exceeded our target in both February and March. I want to personally thank each of them for their hard work and for staying focused on our guests despite weather and operational challenges. I also want to thank our social care team. When the operation is under pressure, guests often post on social media and they expect a quick response, and this team delivers. A recent study found the average response time was under 5 minutes on Alaska's social media channels versus over an hour for the industry. Given that (inaudible) nature of many of our West Coast guests, this is an important and growing part of the customer experience and is one we remain focused on.

As we look ahead to the rest of 2017, I'm mindful that success isn't only about having the right strategy or plan. It's about execution. For the past year, we've been focused on getting DOJ approval, arranging financing, setting up integration and doing all of the other things that go with acquiring a business. In fact, we've got so many new things going on right now, you might say that our business is under construction. But in the midst of this construction, it's time for us to refocus on the fundamentals of running a good airline. This includes taking care of our guests, running a tight operation and having a frugal mindset with respect to cost and capital spending. In other words, it's time for us to execute the plans we've laid out and to make sure that we're doing the right things day in and day out to make this a great airline for our employees, our guests and our owners.

That's it for me. And now I'd like to turn the call over to Andrew and then Brandon, who will share more detail with you on how we did in the first quarter.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Thanks, Brad, and good morning, everyone. As Brad said, in the spirit of keeping things crisp, I'm going to briefly walk through our first quarter performance, share a few thoughts on our capacity in the revenue environment and then close with a brief update on our commercial integration work.

So starting with the first quarter. Our passenger revenue grew by $22 million or about 2%. This outpaced the industry, which grew less than 1%. And as anticipated, our March leisure travel was impacted by the Easter shifting into the second quarter this year. In total, the Easter shift costs March revenue approximately 3 points of unit revenue growth, which will shift into April. Overall, we're very pleased with how our first quarter, our traditional softness, shaped up. A load factor of 81.3% was essentially flat year-over-year despite a 4.9% increase in capacity as we saw solid demand across our network. Importantly, we saw continued strength in our loyalty program during the quarter. In fact, during March, we had the largest number of new members enrolling in both the state of California as well as our overall Mileage Plan on record. Building loyalty is critical part of our growth strategy in California. And while it's still early stages, initial results are encouraging.

Moving ahead to the second quarter. We expect competitive capacity increase in air markets to be approximately 2 points. While this is a fraction of what we've seen over the last several years, it is an increase from the last call when the second quarter capacity changes we're tracking closer to flat. Our capacity will be up about 6% the second quarter, with roughly 3 points of this growth due to the new markets, Brad mentioned; 2 points due to longer stage land in the remaining, a mix of core ads with some gauge adjustments. Although these (inaudible) that rought generally have a broad impact on present, the new markets are already performing in line with our initial forecasted, and we are confident that this both will be profit accretive.

Overall, we feel good about what we're seeing systemwide for the second quarter. And even after removing the benefit from the Easter shift, we expect to have positive unit revenue in the second quarter due to maturing markets, stabilization of competitive capacity and solid demand. We foresee the second quarter being the best quarter of the year with respect to year-over-year revenue performance, given our growth is weighted more heavily towards the third and fourth quarter.

Speaking of capacity, our guide for the full year is 8.5% and remains unchanged from previous guidance. With capacity in the first half of the year around 5.5%, this implies growth of approximately 11.5% for the second half of '17. For comparison, our growth in the second half of 2016 was 8% or 350 basis points lower. This will make unit revenues comps more difficult, however, we are also confident this added capacity will contribute to Air Group's long-term track record of profitable growth.

Moving to our progress on the revenue commitments and integration. As Dan and Darrell pointed out that Investor Day, revenue synergies can be hard for investors to see and measure. So I wanted to highlight recent changes at (inaudible) field as tangible examples of progress on the fleet deployment and network growth synergies.

First, as many of you know, Virgin's existing routes from Dallas Love Field to DCA in LaGuardia were losing money. The network team moved quickly to down gauge these routes to a 76-seat Embraer 175 regional jet, which is something Virgin couldn't do because they didn't have the breadth of fleet options that we do in Alaska. What this allow us to do is offer business travelers the same utility on DCA and more in the case of LaGuardia with the 3 cabin product while improving the economics of these routes.

Secondly, we also announced that we're adding new routes from Love Field to 4 points of strength on the West Coast: Seattle, Portland, San Jose, San Diego, which are routes we believe will make the best use of the 2 gates we have at this highly constrained airport. This is incremental revenue growth that was unlocked by the merger, will increase our relevance and loyalty on the West Coast and generate high utilization of gated airport space, thus reducing unit costs.

Very proud of the revenue management team. In April, we finished bringing 3 years of Virgin America's booking history into (inaudible). And this will help us better manage inventory as a single entity. We're also on track, thanks to air airports' organization and real estate to co-locate operations at key airports, including Seattle, Portland, San Francisco, LA, Newark and JFK by the end of this year. This will allow us operate more efficiently and also eliminate the potential source of confusion for our guests at the airports as they make connections across our expanded networks.

So in summary, we're really excited about the opportunities for the combined network and are moving forward on our revenue synergy commitments, consolidation of airport operations and aggressive brand and loyalty marketing now that the question about the Virgin brand had been answered. We look forward to a solid second quarter.

With that, I'll turn the call over to Brandon.

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP of Finance, CFO of Alaska Airlines Inc and EVP of Finance - Alaska Airlines Inc*

Thanks, Andrew, and good morning, everybody. Air Group's $130 million adjusted profit equates to a pretax profit of $202 million, which was $117 million or 37% lower than last year on a combined basis. Although operating revenues were up $39 million, they weren't sufficient to offset the $56 million increase in nonfuel costs and the $88 million increase in fuel prices.

Nonoperating costs also increased by $12 million due to the higher interest expense. Overall, our first quarter pretax margin fell by 710 basis points to 11.5%. We expect that to be to the largest decline of any quarter this year, given what we see currently in the revenue and fuel environment.

Andrew talked about unit revenue, so I'll focus on unit costs. CASM x fuel was basically flat, which was consistent with our initial guidance. While the operational challenges Brad mentioned did create some added costs during the quarter, we benefited from having lower-than-forecast maintenance costs and certain marketing spend that has shifted into the latter part of the year.

For Q2, we're currently forecasting CASMex fuel to increase by 3% on a 6% increase in capacity. There are a number of drivers for the increase, including the timing of maintenance events, some costs that shifted from Q1 and an assumed ratification bonus related to the tentative agreement that we reached with Horizon's pilots earlier this month that will improve our ability to recruit and retain pilots. Despite the 3% expected increase in unit costs in the second quarter, we're still on pace for flattish unit costs for the year, excluding the impact of an agreement with our Alaska and Virgin America pilots.

There's a lot going on at Air Group right now, and some of those activities drive costs but don't get captured on the merger cost line on our external P&L. We're working hard to make sure those costs don't get embedded in our long-term cost structure because we know how important low costs are to our long-term success.

Although profits are down, we continue to generate strong cash flow from operations approximately $470 million for the quarter and ended Q1 with $1.7 billion of cash on hand. Reinforcing what I said at Investor Day, we remain committed to a thoughtful capital allocation strategy.

First, we're going to make smart investments to leverage our acquisition of Virgin America. Those include growing the fee to support our West Coast expansion, retrofitting the cabins of the Virgin America aircraft to add premium class and adding satellite connectivity to Alaska's aircraft. We're also making important investments into airport and other facilities in many of our locations.

Given the elevated level of capital spending, working hard to make sure our controls over capital are robust and we're spending money as if it was are our own. And yes, that comment was directed to other group leaders.

We're currently projecting 2017 CapEx to be about $1.2 billion consistent with prior guidance. Most of that, of course, is fleet related. And we've added a bit more detail to the fleet section of our investor update help investors understand and all the moving parts.

We did have 2 notable fleet events since Investor Day. The first was Horizon taking delivery of our first E175. The second was Virgin America taking delivery of our first leap-powered A321 neo. In fact, we were the global launch customer of that aircraft type. Both airplanes will create additions to the fleet.

We also equally committed to redeleveraging our balance sheet. Our debt to cap fell by 1 point since the year-end of 58%, and we expect to end the year at about 55%, driven by profits, and roughly $320 million in scheduled principal payments.

Overall, our first full post-acquisition quarter was solid. There's a ton going on right now, and I want to credit our frontline folks for taking great care of our guests. But I also want to give a shout out to all the back-office folks who are working so hard to put these 2 companies together. This is a really hard work. But having said that, I hope everyone listening to the call today or reading the transcript can sense the optimism that we have here.

With that, we're ready for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from the line of Savi Syth with Raymond James.

Savanthi Nipunika Syth - *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

It's just -- if I may ask a question on the low -- the Dallas strategy. You guys talked about being a West Coast airline. And I think in past discussions, you focus on that being your strengths and knowing not really wanting to grow anywhere outside of that. And I know I'm just kind of curious about this thinking on the Dallas New York and Dallas (inaudible) just to -- how that fits into their overall strategy? I know it's very small, but in the grand scheme of things.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Savi, it's Andrew. I think those were 2 routes that obviously we inherited on the purchase of Virgin America. So as we look at those, as we look at our relevancy in New York City specifically and the network we're going to have there, these are 2 routes that, I think, as they get incrementally better, we're just going to watch and see. But the greater strategy, as you point out, is really directing things to the left side of the country, to the West, where we want to continue to build loyalty and the top destinations folks want to go. So that's why we are there. West Coast will be the focus.

Savanthi Nipunika Syth - *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

All right. Helpful. And then just on the kind of 2Q routes and color, wonder if you can give us a little bit more. If you're seeing an improvement. It sounds like it's beyond capacity that you are seeing an underlying improvement. Is any more color on that? And how that maybe that progresses through the quarter?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

So I'll maybe start with a high level and I'll turn it over to Shane. But I think in generally, what we're really excited about is as we continue to put the 2 airlines together in single revenue management system and start to work hold of levers and the loyalty as well is going into the second quarter is a much stronger quarter from us traditionally with the Easter move, we feel very, very good about the demand environment. But Shane can give you a little color on details there.

Shane Tackett - *Alaska Airlines, Inc. - VP of Revenue Management*

Yes. Thanks, Andrew. Yes, so I think the quarter, April will probably be the best month just because Easter's sitting in it. But if you sort of look at Q1 and you adjust Easter out, we sequentially got better every single month. We would have been closed to flat in March had we not had the Easter shift. So I think we kind of see that basic progression happening through April. And then I think that just (inaudible) one on the comments, we see May and June being good and positive. Just want to continue to note that second half of the year will be challenged with the uptick in capacity.

Operator

And your next question comes from the line of Joseph DeNardi with Stifel.

Joseph William DeNardi - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

Just one question for Andrew and one for Brandon. Andrew, you guys are pretty unique in that you have actually increased the value of your currency for your loyalty program members. Other airlines have kind of gone the other way. You're still distance based, others are spend based. I'm wondering if you could just talk about whether you made those decisions based on kind of the value of just being different? Or you if you made them in the context of actually trying to improve the value of the currency for your customers in the context of the value that you get from that relationship on the credit card?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Yes, thanks for the question, Joe. As we've shared on Investor Day and as we move with our strategy, we very much want to be the low-cost airline and provide great value to our guests. And we have a huge percentage of our guests who are earning miles and using miles. And that's just equally as important s how much you actually pay for that ticket. To your point being different in the industry, we all have different business models. But at the end of the day, we believe that a generous loyalty program for our business on what we want to achieve will be a very, very good thing for us longer term for our investors.

Joseph William DeNardi - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP*

Okay. And then Brandon, you spoke about the focus that you have on the cost side, and you guys have obviously done a really nice job in terms of CASM performance. But on the CapEx, you're right, '17 went up a tiny bit, '18 went up a little bit more and '19 went up more. It seems like that number kind of goes up every quarter. So can you just talk about why that is? And if we're sitting here and we're modeling a 20% margin for you guys in 2019, should we just assume shame that you're going to -- that CapEx for you will be $1,700,000,000? [$1,600,000,000]? I mean, that's a pretty good number.

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP of Finance, CFO of Alaska Airlines Inc and EVP of Finance - Alaska Airlines Inc*

Joe, yes, it is a really big number. What I would say at this point, I would not be too much to the modest adjustments that occur in 2018 and 2019. I think what you're seeing is changing estimates on the timing and the amount of the various initiatives that we have going here. And those range from putting satellite on the airplanes to the transition of the interiors of the Airbus airplane to the Alaska configuration and to all those business cases are in work right now. So as we get through the next 3, 4, 5, 6 months and pin down the timing and the scope of those projects, I think you'll have more confidence in the 2018 and 2019 numbers. I would say substantially, all of those changes come in the non-aircraft lines. I mean, aircraft stuff, what I would say is that right now we're in the process of finishing the final transition of the -- out of the 400s into the 900 ERs which is a great investment. It's into a more fuel-efficient, more reliable, more comfortable airplane. We're at the front end of taking E175s into the Horizon, which is going to be a great machine for us to reach [thin] Midcon markets. But we'll do the right thing with respect to aircraft deliveries like we always have. And to the extent we don't feel like they wouldn't be profitable endeavors, we would change the order book.

Operator

And your next question comes from the line of Hunter Keay with Wolf Research.

Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace and Defense*

So how much of the fourth quarter capacity growth had to do with Southwest being flat in the quarter? Because one may conclude that you're using Southwest retransition and their own flat capacity growth as an opportunity to kind of move in and take some share and be a little bit more aggressive.

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Hunter, I had media training along time ago, and I'm pretty sure that's called a (inaudible). But (inaudible) really what you're seeing here, which we think very transparent about is really I'm looking at the synergies and the potential of the acquisition to build a more stern network on which to build loyalty efficiency and revenue growth. And really, that's where you seeing going on here, that applies to our growth. And you're going to see these new markets slow down, but that's the reason.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO, President, Chairman of Alaska Airlines Inc, Chairman of Horizon Air Industries Inc, CEO of Horizon Air Industries Inc, CEO of Alaska Airlines Inc and President of Alaska Airlines Inc*

I might just jump on it. We really wanted to sort of activate the merger with Virgin with some of the stuff. I think if you actually go through and look at the markets, there's no carriers being targeted or anything like that. We're really try to improve utility for our customers. I think San Diego is an interesting example. I think we fly to 20 -- 46 flights with 29 or 30 different airports out of San Diego, so we're not picking out a route. Same thing in the Bay Area. We're really trying to add new utilities for our customers, and we believe that adding late utility is going to grow loyalty. Honestly we don't think a lot about -- we think about our customers and grow loyalty and doing good things that will help our business win. Our competition might be. And I think on a lot of these markets, you might (inaudible) but I think a lot of these markets are unserved today on an offset basis.

Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace and Defense*

Okay. That's fair. I am disappointed, by the way, that you have given, Andrew, media training. I like him better the old way, but the payload factor in your premium cabin, what is that? And how many Delta elites have historically gotten free upgrades on you guys? And that partnership kind of dissolves away. Does that free -- I mean, on the analysis in terms of how many premium seats that frees up for you to now sell on your own?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP of Finance, CFO of Alaska Airlines Inc and EVP of Finance - Alaska Airlines Inc*

(inaudible) First Class, Hunter?

Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace and Defense*

Yes, paid low factor and premium. What? Sorry.

Daniel Breslin - *Lazard Asset Management LLC - Director, SVP, Portfolio Manager, and Analyst*

In First Class -- in premium economy or just First Class?

Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace and Defense*

First Class.

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP of Finance, CFO of Alaska Airlines Inc and EVP of Finance - Alaska Airlines Inc*

The payload factors are sort of 35% to 40%. They've picked up a little bit as we've removed 4 seats out of the 800s to make room for Premium Economy. But they held steady there for a number of years now. And I think the Delta sort of a lead upgrade was a very small overall number.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO, President, Chairman of Alaska Airlines Inc, Chairman of Horizon Air Industries Inc, CEO of Horizon Air Industries Inc, CEO of Alaska Airlines Inc and President of Alaska Airlines Inc*

I mean, at the end of the day, Alaska elites got first preference than the Delta elites, and so that's the way it works. So really, what we're seeing now is, as Shane pointed out, adding premium class but reducing the number of first-class seats in a first-class cabin, we are seeing a tick-up in higher payload factor there, but we're also being mindful of making sure that we has again the philosophy for us have generous upgrade policy.

Operator

And your next question comes from the line of Helane Becker with Cowen & Company.

Helane Renee Becker - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Just a couple of questions. First is on the Virgin network. As you get into that, how much more is available to do changes like you did in Dallas with changing gauge and being more -- I don't know what the right word is but adjusting capacity that way, I guess?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

So we've made 2 big changes since the last field obviously. And then also where we -- on our routes, Seattle-San Francisco, Seattle-Los Angeles where we have a lot of overlap, we've sort of got better schedules. But with all the new markets, we're moving to the single operating certificate in the first quarter of next year. And so (inaudible) is what you're referring to is you're going to see much more of that starting in the spring of '18. Right now we're sort of holding tight until we get all this integration done. So that's the last of it you'll see. But spring next year, you're going to see some more in some of these high opportunity routes on the West Coast (inaudible)

Helane Renee Becker - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Okay. And then when you do that, will you talk more about the financial impact this kind of changes? Like what do you think -- like if you change Dallas, what's -- like how should we think about the financial impact of that? Because obviously, load factors improved, presumably pricing can improve a little bit. So how should we think about that benefiting you guys?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

I think, Helane, you won't find us getting into the specifics that I think you're asking about. What I hope that you will see is just a continual improvement and forward motion on the strength of both our margins, our unit revenue and our loyalty program. And I think when you see all those things working together, we will get confidence moves are everything.

Operator

Okay. And then did you say how much the ratification bonus was for the Horizon pilots?

Celley Buchanan

This is Steve Campbell. This is really about 9-point -- [$9.6 million]. But the real key for us, as you recall last year, we actually computed our (inaudible) fee. Those really about productivity and really driving that. So this agreement that we have really preserve that productivity, allow us to go and be competitive and really grow this network the right way. And so I really feel good that is a great deal for our pilots and for our employees, (inaudible) of peer group (inaudible) opportunity of growth this creates for Horizon.

Helane Renee Becker - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Okay. And then just this is a topic and actually, Brad, you may not have seen this. But just as your conference call started, your pilots put out a press release talking about your first quarter earnings. And I'm kind of (inaudible) that they would write this, but they talked about the fact that you guys are not being as forthcoming with them as they want you to be. I mean, I don't know if you saw what they wrote in that it's out there. So you might take a look at that.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO, President, Chairman of Alaska Airlines Inc, Chairman of Horizon Air Industries Inc, CEO of Horizon Air Industries Inc, CEO of Alaska Airlines Inc and President of Alaska Airlines Inc*

Thanks, Helane. Somebody just handed me a phone. We took a quick peek at it. I might talk about it a little bit and get (inaudible) as you want to chime in. But I would just tell you from my own perspective, we have invested a tremendous amount of time and energy into the relationships with all of our labor groups and all of our companies over the last 10 years. And it's something we're really proud of. It's something we really care a lot about. It is integral. Those great working relationships are integral to the culture that we've built here about us, everybody being committed to this airline and making this airline great, making it great for our customers. If things are changing in the industry, and I think we're -- they're changing in Alaska with this merger and if things are moving fast, and so expectations are changing. I think people are a little bit more on edge. I think that we're showing some -- they're -- we're showing signs of it. That's what's going on right now. But I'll just tell -- I'll tell you, Helane, and I'll tell any of our pilots that happen to be listening, that nothing has changed at Alaska. We value our employees. We are going to work with them. We have a model of working with our people to make this company great and do great things for our customers, and that's what we're going to do. We also need to keep -- I mean, we survive as an airline the size we are, but keeping our fares low. So the needle we've been able to thread the last couple of conflicts with the pilots that we will continue to strive to thread is how do we come up with a deal that honors them for the fantastic work that they do while keeping this company strong and in a way that we can keep growing. That's what we're all about, and that's what I have to say about that press release. Ben, anything you want to add to that?

Unidentified Company Representative

No, Brad, you said it all. What I'll say is the very nature of negotiations are not easy. We're going to go (inaudible) process these things, just the process is not easy and I know our pilots are listening. And what I'll say is we are committed to getting a deal. And we philosophically for the last 10, 15 years, we've used an approach that we're going to pay people well and fairly. We're going to provide them great benefits. They'll share in our profits in our PBP. We have high productivity. And historically, that's what we've done. We've always gotten deals, and we will continue to get deals going forward in the future.

Helane Renee Becker - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Yes. I'm sorry. I didn't mean to put you in the spot with the question. It's just that to your point, you've always had great labor relations. And to see them do that right at the start of the call is kind of surprising, that was all.

Operator

And your next question comes from the line of Jamie Baker with JPMorgan.

Jamie Nathaniel Baker - *JP Morgan Chase & Co, Research Division - U.S. Airline and Aircraft Leasing Equity Analyst*

Not to hammer you guys on the RASM commentary. What you said about second quarter was pretty clear. But when I think about the sequential revenue production, how your revenue typically rises from the second quarter to the third quarter and then contracts from the third quarter to the fourth quarter. Assuming those trends are consistent on a pro forma basis of what we've seen in recent years, it seems all but rule out anything but negative RASM in the back half. Is that too punitive of an interpretation of your earlier commentary?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Jamie, again, media training 102 kicking in there. We don't comment on unit revenue performance and certainly whether it's negative or positive (inaudible) but I think the thing that we are focused on is that by in the back end of the year, a lot of the things that we're working on and the momentum in the strength of the company going from 1 level to the next level with the integration is what we're clearly focused on. And I'll make your models (inaudible)

David E. Fintzen - *Barclays PLC, Research Division - VP and Equity Research Analyst*

Well, let me put it a different way and we'll take RASM off the table together. Given the shift in the network, would you expect the seasonality from 1 quarter to the next to differ slightly or materially from that in the past?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP of Finance, CFO of Alaska Airlines Inc and EVP of Finance - Alaska Airlines Inc*

Jamie, it's Brandon. Maybe I'll take that one. The forecast for the next 3 quarters, I think the seasonality is going to look pretty similar to what it has looked like in the past. We're currently seeing Q2 rise. Q3 would be above Q2. And consistent with all of our prior recent years, Q4's going to fall. And so that, I think your sense is right. You know our businesses very well, and we don't see anything that would change that seasonal pattern.

Jamie Nathaniel Baker - *JP Morgan Chase & Co, Research Division - U.S. Airline and Aircraft Leasing Equity Analyst*

Okay. That's fair. I appreciate it. Second question. Headcount obviously a touchy subject. In the case of postmerger American, they purposely staffed up in order to ease some of the complexities of integration. The result is today, they're kind of top-heavy from a headcount perspective. How should we think about your staffing levels as you approach the periods of heavy lifting? Is there going to be any sort of similar costs build there?

Unidentified Company Representative

Jamie, it's been here. We've done a lot of work in the last [few] months building the transitional board structure to take us through the milestones. So what you'll see in '17 is we're carrying a certain level of staffing to get us through single operating certificate. That people fall off. We have people -- we had people going away in the first quarter. We have people going away in June. We'll have people going away after single operating certificate. And as we reach (inaudible) the next big milestone is our passenger services. Sabre system more people will drop off. So we have the right line of path on what our full time (inaudible) is going to be from '17, '18 and through '19. And the goal is to have, you add the Virgin America headcount. I'm talking more management here because we're going to be growing on the top line. But when you add the Virgin headcount and the Alaska headcount, the goal is going to (inaudible) to be less than math (inaudible) '19.

Andrew George Didora - *BofA Merrill Lynch, Research Division - Director*

Okay. That color is helpful. And if I can just sneak one in. Simply the passenger, the consolidation of both airlines in the T7 and JFK, new lounge facility, BA facility, UA facility. What are you going to be using?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

The business case is pending with my CFO, but we have space already working with British Airways to create a lounge. And we're just working (inaudible). But either way, we'll have a facility there, whether it's our own or someone else's.

Operator

And your next question comes from the line of Rajeev Lalwani from Morgan Stanley.

Rajeev Lalwani - *Morgan Stanley, Research Division - Executive Director*

Andrew, question for you in terms of lower competitive capacity. It's clearly showing up in schedules and pricing. Can you just provide a little more color on the market that's showing up in? And just some real data points, if you can?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Rajeev, as you know, we use this weighted model. But I think the easiest way to describe what's going on is really the majority of that big chunk of that capacity is really related to Mason and Bay Area satellite airports. So at Yellow hub, Portland hub even San Francisco, there's some growth. What you're seeing is incrementing capacity from many carries from the satellite airports around LA basin and the course of (inaudible) basin and the course of San Jose's and the Oakland to the Bay Area to their hubs and other destinations. That's what you're seeing is really the movement. The rest of our core hubs are pretty stable.

Rajeev Lalwani - *Morgan Stanley, Research Division - Executive Director*

Okay. And then another one for you, Andrew. As you've added capacity fairly aggressively in some of the West Coast markets or traditional Virgin markets, what's been the reception to the Alaska brand? And maybe if you can share some quantitative great data points on booking color or surveys, if you don't mind?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

I don't have a quantitative data per se on the brand and all that good stuff. What I will tell you is that what we're hearing anecdotally and seeing is that the increased utility, the increased options as well as the loyalty growth that's coming along with all of this is being extremely positive. Again, we're about 15% of all the traffic being booked on Virgin America medal is coming through alaskaair.com. We continue to roll out benefits such as free bags, companion's fares onto the Virgin metal. So that's sort of what's going on there. I don't know, Shane, if you have any comments but...

Shane Tackett - *Alaska Airlines, Inc. - VP of Revenue Management*

No, most of the marks are actually on Virgin Metal. Some of the intra (inaudible) we've done recently is actually (inaudible) strong. Virgin Avalon has been (inaudible) but E175 has been performing well for us. And then this Delta, the Dallas Love Field change, we actually moved a lot of folks off of Virgin tickets onto Alaska Metal. We actually called everybody personally and most of the anecdotal sort of reports back from the rev agents and teammates on the Virgin side of it is super positive. People haven't had a problem with switching medal.

Operator

And your next question comes from the line of Andrew Didora with Bank of America Merrill Lynch.

Andrew George Didora - *BofA Merrill Lynch, Research Division - Director*

Brad or Andrew, you've done a good job articulating the opportunities you have in California. I certainly agree with that. But I guess, I do see this as a little bit more risky growth than you've done in the past. You're growing much more mature markets with a lot more competition in San Francisco and the LA Basin. As Andrew, can you maybe give us some color around what kind of response you've seen from others in those markets as you've kind of built out your schedules over the last few months? And is it fair to assume that the uptick in competitive capacity that you've mentioned in your prepared remarks is from new markets that you've recently not put up scheduled on?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Andrew, I think Brad sort of hit on the head a little early. But again, on the acquisition of Virgin America, they were already in the largest R&D markets in California, certainly to the East Coast and other places. And so there was no change in capacity there per se. What you've seen us doing is filling out some of the more secondary and third-tier cities. In some cases, with smaller aircraft where we connect in the cities that we serve from the

Pacific Northwest. So we believe that overall, this is actually utility growth and opens up opportunities for folks to get directly to where they want to go versus connecting historically.

Andrew George Didora - *BofA Merrill Lynch, Research Division - Director*

Just on that competitive -- just on the competitive capacity. Have you seen a come onto those new routes that you've put in? Or are they on all the Virgin America routes?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

We have not seen new -- we have not seen anything. It depends really on what we're doing.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO, President, Chairman of Alaska Airlines Inc, Chairman of Horizon Air Industries Inc, CEO of Horizon Air Industries Inc, CEO of Alaska Airlines Inc and President of Alaska Airlines Inc*

I think we're not thinking of any -- knock on wood, but I'm not thinking right now of any significant competitive reaction to any of our growth. Again, most of that growth -- Virgin was in all of the largest cities. I think in -- out of San Francisco is an example. They flew to all the top 10 cities out of SFO already. And so the cities we've added are smaller cities with lower demand. They're cities that add utility for our customers, enable our customers to get to those places on a nonstop basis, but they weren't -- they're not highly competitive cities in terms of other service.

Operator

And your next question comes from the line of Michael Linenberg with Deutsche Bank.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO, President, Chairman of Alaska Airlines Inc, Chairman of Horizon Air Industries Inc, CEO of Horizon Air Industries Inc, CEO of Alaska Airlines Inc and President of Alaska Airlines Inc*

Sounds like Mike's not there.

Operator

And your next question comes from the line of Brandon Oglenski with Barclays.

Unidentified Analyst

This is actually [Dan Cagon] on for Brandon. You've announced a record number in new routes. Do you think that was a bigger version footprint now in the West Coast you can (inaudible) up revenue faster relative to route additions in the past? Or will it take a little bit longer just given the magnitude of the acquisition and integration?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Yes, I think, Dan, it's -- it sort of goes both ways. On the one hand, when we add capacity on the Pacific Northwest where we're well known and have a big loyalty program, that goes well with it. In California, we're certainly less well-known, but now we have the breadth and the depth and the loyalty from Virgin America and their network and their presence. So yes, as Brad mentioned earlier, these are tougher markets, but we're also bringing equally new tools to the table, whether it's aircraft, loyalty, international partners, connectivity. So overall, we feel like we've got a good formula to continue to do this well.

Unidentified Company Representative

And as we've built network utility, I think it will get easier.

Unidentified Analyst

Okay. And then maybe just do you have any initial expectations for revenue performance in these new markets relative to maybe the network?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

We don't normally comment on that, Dan. What I will say is what we track very carefully is what my team forecast the new routes should do and then what they actually do, and that's what we focus on to get to maturity.

Operator

And your next question comes from the line of Dan McKenzie with Buckingham Research.

Daniel J. McKenzie - *The Buckingham Research Group Incorporated - Research Analyst*

My first question is on connectivity, so probably for Andrew or Shane. There's a lot you guys can do to increase connectivity and drive revenue even before you have the single operating certificate. So yes, just simply making sure you've got a plane for both airplanes land and take off when you ideally want them to. I guess that's what I'm really talking about here. So I guess, just looking at the second quarter schedule, I'm wondering what adjustments have been made along these lines? And how far along you are in this area? And then just, of course, what incremental revenue (inaudible) that's helping to drive?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

Yes, Dan. Just on the network, we've made very, very few changes as you can appreciate since closing. Certainly, the first and the second quarter, the biggest change we've made is trying to get some of those trunk routes a little bit more lined up. Shane and the team have done a fantastic job about rolling, pricing across the whole new network, connectivity across metal, across cities. And I think they're just about done with that. So that's going to be one of the biggest ways we're going to open up the route -- routing of our network going forward. But really honestly, you're going to see it more basically the single operating certificate is where you're going to see the really big changes going forward.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO, President, Chairman of Alaska Airlines Inc, Chairman of Horizon Air Industries Inc, CEO of Horizon Air Industries Inc, CEO of Alaska Airlines Inc and President of Alaska Airlines Inc*

Yes, Dan, if I may just add. The thing -- the other thing we're really focused on is the customer experience. On these connections, these are mostly codeshare connections right now not experience is different. So we want to be careful and make sure people have a really good experience with us when they sort of first do in Alaska that -- to Virgin connection. We'll get all that worked out throughout this year and then we'll really turn this on next year.

Daniel J. McKenzie - *The Buckingham Research Group Incorporated - Research Analyst*

Understood. I guess the second question actually be for Ben here. I know, I think, the commentary earlier in the call was to take a look at the operations and maybe make some adjustments. So I'm just wondering at this point, is the mandate to be cost neutral with these operational fixes?

Or is there some money that perhaps might need to be invested here that potentially could -- that might not be factored in to how we're thinking about cost for this year?

Benito Minicucci - *Alaska Air Group, Inc. - COO of Alaska Airlines Inc and EVP of Operations - Alaska Airlines Inc*

Dan, thanks for the question. A couple of things we're looking at. There's winter operations. So today, a lot of the costs is done internally. We use our own people. We are looking at other options. We're getting an outside provider to provide deicing operation in Seattle. So we're just looking at the business case now. Our hope is to make it as cost neutral as possible. On the other operational issues with -- in terms of block times, we have an enormous amount of analytical data that will be very, very laser like in where we add more block in specific markets, in time of day, day of week. So it will be very, very laser like. Our goal is to get the highest, highest performance at, at least the least costs. And today, we have the lowest block times in the industry, and we will continue to be the lowest block time with the highest performance, which is what our goal is.

Operator

And your next question comes from the line of Michael Linenberg with Deutsche Bank.

Catherine M. O'Brien - *Deutsche Bank AG, Research Division - Research Analyst*

It's actually Catherine O'Brien filling in for Mike. Can you hear me now?

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO, President, Chairman of Alaska Airlines Inc, Chairman of Horizon Air Industries Inc, CEO of Horizon Air Industries Inc, CEO of Alaska Airlines Inc and President of Alaska Airlines Inc*

Yes.

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP of Finance, CFO of Alaska Airlines Inc and EVP of Finance - Alaska Airlines Inc*

Yes.

Catherine M. O'Brien - *Deutsche Bank AG, Research Division - Research Analyst*

Sorry with that. Technical difficulties. So since the close of the Virgin merger, how do you incorporate contracts there? Have you seen uptick in your corporate signing up given the addition of Virgin service and the new markets that the merger has made possible?

Unidentified Company Representative

Catherine, this is Joe. Thank you for the Question. Yes, the corporate activity has been very encouraging since the close of the merger. Our corporate sales team, and it's worth noting that we took the entire, albeit a smaller one, but the entire Virgin America sales team and just brought them in with the Alaska team, brought them together. They've been working well together from the time of deal close, we quickly reached out to over 300 corporate accounts that either Alaska or Virgin are or both had agreements with and basically synched up those agreements to give the benefit of the agreement on one airline to the other if didn't already exist. And so that's been very positively received by corporate accounts. Also worth noting that a lot of those accounts are in Seattle and O'Mara where the tech activity is quite strong right now. And so overall, we are seeing an uptick in corporate revenue, and particular we saw from the Bay Area.

Catherine M. O'Brien - *Deutsche Bank AG, Research Division - Research Analyst*

That's great, and I have one more. So we've recently seen a strengthening in Transcon fares. One of your main competitors increasing fares and (inaudible) cabin and their front cabin last week. If that continues, do (inaudible) that can provide upside to your revenue synergy target?

Unidentified Company Representative

Thanks, Katie. Yes, we actually don't -- we didn't fares into any of the revenue synergies. I'm just -- that's why I'm (inaudible) that question. So no, we're not on the synergy side. And just note, a lot of the times fares are sort of on the higher end of the structures. They don't always sell a lot of those, so a lot of the airplane gets sold on discount. That's really where you need to focus.

Catherine M. O'Brien - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. If I can just sneak one more in there. While it's probably too early to count on, the fact that you generate free cash flow in this seasonally tough March quarter given especially (inaudible) that seems like that bodes well for the rest of the year. Do you have any updated thoughts on capital allocation this year given that? Or the focus is going to remain on deleveraging?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP of Finance, CFO of Alaska Airlines Inc and EVP of Finance - Alaska Airlines Inc*

Katie, this is Brad. The focus is going to remain on the deleveraging. I went through it a little bit in my remarks. We've got a lot of things we need to do on the fleet and non-aircraft side to just activity merger and pursue our growth plans. And then beyond that, we really do want to stay focused on redeleveraging the balance sheet. We recently increased the dividend. That's a positive effect. We announced at Investor Day we're going to build a little bit of share buyback this year. So I would say in general, our capital allocation plans remain unchanged.

Operator

And your next question comes from the line of Kevin Crissey with Citi.

Kevin William Crissey - *Citigroup Inc, Research Division - Director and Senior Analyst*

A couple of big picture questions maybe for Andrew. Just general, maybe this is in general when you look at a flight, how far in advance do you know we have a revenue problem or that it's likely to depart with the weak revenue performance?

Andrew R. Harrison - *Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP*

It's varies. What I would tell you is that as we built our (inaudible) and Shane, the team has than a great job. Essentially (inaudible) period if it's into California, it's a different period. But the teams have built in mechanisms that will reports that will tell us when aircraft booking sold. When we sold too many seats relative to last year. There's a whole sophisticated program going on. And I think really what we do is focus on the bigger picture, what's going in the industry, what's going with capacity. And then Shane and Kevin, Head of VP, translates that down to our fleet of analysts to do that. So we have very good and robust systems as it relates to that.

Kevin William Crissey - *Citigroup Inc, Research Division - Director and Senior Analyst*

Yes, okay. I appreciate that. The second question, I guess, is when you have a problem with a flight, and this in general for the industry I guess, but speaking for your firm specifically, what levers do you have to pull? Because it seems like what happens is there's a fare sale. Like other -- the flight's not booking and so the problem has to be on the price rather than maybe the quantity demanded. For instance, why is price necessarily the answer?

Maybe it means more online marketing dollars and stuff. Do you incorporate other types of marketing beyond just sending out an e-mail with a little bit lower fares? How does that work when the flight isn't working well? What other levers beyond price are there?

Shane Tackett - *Alaska Airlines, Inc. - VP of Revenue Management*

Thanks, Kevin, this is Shane. We can go on and on on this. I'll try to be brief. I will say just that again, what Andrew said. We can watch our forecast (inaudible) we have made. They tend to settle down about 45 days in advance, so we're pretty good in predicting the final phone revenue well over a month out, not with any in the ever lose of closing (inaudible) the situation have dealt with. But yes, Kevin Burke, who runs our Impress, now he came over from Virgin America. He actually host a quickly coordination meeting with e-commerce and with marketing, and they go through any number of sort of potential opportunities, whether it's digital marketing, sort of search marketing, sort of e-mail marketing. Sometimes, we just's say no. We don't need our fares (inaudible). We'll (inaudible) load factors and sort of hold out for good closing yield. So there's a real mixture based on our relevance in a market, our strength in the market sort of historically, what's worked well?

Operator

And we have time for one more question, which comes from the line of Savi Syth with Raymond James.

Savanthi Nipunika Syth - *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

On the fleet, I was just wondering, it looks like the retirement might be a little bit less than previously disclosed. Are the retirement will be 400? Is that getting pushed out? Or is that still expect to be done this year?

Mark G. Eliasen - *Alaska Air Group, Inc. - VP of Finance and Treasurer*

Savi, this is Mark. We are definitely going to be retiring the 400s. So I think what you're seeing is just the last few coming out of the fleet. And by the end of the year, we will be out of the classics completely.

Savanthi Nipunika Syth - *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

Got it. And if I may ask just on the unit revenue front. I think you're getting close to being maybe one of the only airlines that will be providing monthly unit revenue data and maybe one of the few the don't provide a kind of quarterly outlook on expectations, so I appreciate the color. Any thoughts on switching the way you manage expectations?

Brandon S. Pedersen - *Alaska Air Group, Inc. - CFO, EVP of Finance, CFO of Alaska Airlines Inc and EVP of Finance - Alaska Airlines Inc*

Savi, it's Brandon. Yes, I think we would ultimately want to join the rest of the industry in that regard. I think it's a mark of what good industrial companies do. I think once we need -- what we need to do is get through this year. We need to get through a good year of comps and have a clear forecast through to windshield of these 2 companies put together. But as I sit here today, if I had to say what does our guidance look like in 2018? I think there's strong bias toward more forward-looking guidance and less on the unit revenue side looking in backwards.

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

Thanks very much. So it's the operator.

Bradley D. Tilden - *Alaska Air Group, Inc. - Chairman, CEO, President, Chairman of Alaska Airlines Inc, Chairman of Horizon Air Industries Inc, CEO of Horizon Air Industries Inc, CEO of Alaska Airlines Inc and President of Alaska Airlines Inc*

Thanks very much, Savi. Thanks for tuning in today. We look forward to talking to you all at the end of the second quarter. 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.
