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Q3 2018 Alaska Air Group Inc Earnings Call

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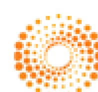

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PRESENTATION

Operator

Good morning. My name is Amber, and I will be your conference operator today. At this time, I would like to welcome everyone to the Alaska Air Group Third Quarter Earnings Release Conference Call. Today's call is being recorded and will be accessible for future payback at www.alaskaair.com. (Operator Instructions) I would now like to turn the call over to Alaska Air Group's Director of Investor Relations, Matt Grady.

Matt Grady ***Alaska Air Group, Inc. - Director of IR***

Thanks, Amber. Good morning, everyone, and thank you for joining us for our Third Quarter 2018 Earnings Call. On the call today, our CEO, Brad Tilden, will provide an overview of the business; Andrew Harrison, our Chief Commercial Officer, will share an update on our revenue results and outlook; and our CFO, Brandon Pedersen, will discuss our cost performance and cash flows. Several other members of our management team are also on hand to help answer your questions. Earlier this morning, Alaska Air group reported third quarter GAAP net income of $217 million. Excluding merger-related costs and mark-to-market fuel hedging adjustments, Air Group reported adjusted net income of $237 million and adjusted earnings per share of $1.91, ahead of the first call consensus. 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. On today's call, we will refer to certain non-GAAP financial measures such as adjusted earnings and unit costs, excluding fuel. And as usual, we have provided a reconciliation between the most directly comparable GAAP and non-GAAP measures in our earnings release. And with that, I will turn the call over to Brad.

Bradley D. Tilden ***Alaska Air Group, Inc. - Chairman, CEO & President***

Thanks, Matt, and good morning, everyone. We are rapidly approaching the 2-year mark since our merger closed. And while there is still a lot of work ahead of us, we are extremely happy about the pace of progress and we remain confident in our future. We've now completed roughly 90% of the integration milestones and have done so at a pace that is equal to or more rapid than virtually any other merger in the industry. The performance of our core business remains strong, and our brand and products are gaining increasing traction in California. As our network investments mature and the merger synergies accelerate, we're doubling down on the disciplines of productivity, teamwork and cost control. Discipline has been the source of our competitive advantage for many years now. In the third quarter, our financial performance started to turn the corner with our employees delivering unit revenues and unit cost that were both better than plan. We were especially encouraged to see RASM stabilize in the face of multiple headwinds. We expect RASM to inflect positive in the fourth quarter as we begin the steady climb towards the higher margin and higher returns that we believe are achievable with our combined network. As we've discussed, we are not satisfied with our current financial returns. Fuel prices continue to rise, and we need to do more to recover these higher costs. One way we've responded is by raising bag fees for the first time in 5 years, bringing

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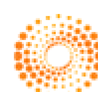

our fees into line with those that are now prevalent in the marketplace. We announced these changes last week, and Andrew will discuss them further in just a moment. Stepping back a bit, we see an industry environment that has not yet adequately adjusted to higher fuel prices. We've slowed out our growth in 2019 as market dynamics simply don't argue for adding much new capacity. That said, we are comfortable with our current growth and we're very comfortable with our new network footprint.

We have a solid plan in place to leverage the many factors within our control and to drive unit revenues and margins higher going forward. We're making it even more granular as we go through the budget process. We're confident that we are on a path to significantly improve our profitability and our free cash flow in both 2019 and 2020.

Before I discuss future plans though, I would like to highlight a few of our team's accomplishments in the third quarter. First, we were proud to win best U.S. airline from both Condé Nast Traveler and KAYAK. The Condé Nast recognition is especially meaningful as it continued a tradition. Virgin America had won this award for the past 10 years, and now our folks have extended this streak to 11. Second, our operation continues to run well. Our CD 0, or our controllable departures leaving within 0 minutes of their scheduled time, improved 90 basis points to an excellent 86.6%. Third, we continue to see operational strength at Horizon, where our on-time performance continues to be the best in the industry and where our pilot staffing pipeline is full. Fourth, our mainline pilot seniority list was recently integrated, which means that all but one of our workgroups has a single CBA and a single seniority list. And fifth, we achieved a number of additional milestones on the integration front. In August, we started repainting the Airbus fleet and we've now repainted 16 of 71 airplanes, and we've also integrated our aircraft movement systems, which means we can now swap between Boeing and Airbus aircraft on short notice.

The last accomplishment signals the shift in the type of the integration work we are now doing. During the last 22 months, we've been busy becoming a single airline. We were aligning hundreds of systems and processes, integrating guest facing platforms and programs and working with our labor leaders to negotiate single collective bargaining agreements. Now that the vast majority of this background work is laid, we're dedicated to realizing the value of our significantly larger platform. For example, our nearly 6,000 flight attendants have been training on both aircraft types for several months now, and they'll begin working both types on January 31. This will improve productivity. We're also preparing to fully deploy cross fleeting by March of next year. This will drive higher revenues and margins and will help us realize another key merger synergy. And third, we began to reconfigure Airbus cabins this quarter. We'll complete 4 to 5 aircraft per month between now and the end of 2019 when the entire fleet will be done. These changes bring with them a number of margin benefits including 4 additional seats, 10 additional First and Premium Class seats, a common experience for our guests and new opportunities to upgrade elites.

In addition to capturing merger synergies, our plan for the next year includes the pursuit of several revenue and cost initiatives. We've always been proud to run our business in a balanced way where all boats rise as our business succeeds. And these initiatives will help us improve returns for investors as we move from getting the integration done to realizing the benefits of the merger. Some of the levers we're managing to improve profitability include: slowing our capacity growth to let our investments mature; increasing segmentation through the launch of Saver Fares, which will produce $100 million in revenue next year; increasing bag fees and other ancillary revenues such as exit row sales, which will produce another $100 million in revenue next year; optimizing our larger route network and schedule, which is part of our broader plan to capture $130 million in synergies next year; improving the productivity of our operation; and finally, controlling management head count through the difficult but, we believe, necessary step of eliminating some positions. This will save overhead but more importantly, it will improve the speed of decision-making and the flow of information throughout our organization.

Finally, we're continuing our tradition of maintaining a strong balance sheet. We're on pace to have paid down $800 million or 40% of the debt we took on to purchase Virgin America by year-end. We look forward to discussing each of these opportunities in greater detail at our Investor Day next month. For now, let me conclude by saying that we feel confident we're on the road to producing better returns in the quarters ahead as we work together as a single team to demonstrate the true power of our combined company. And with that, I'll turn the call over to Andrew.

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

Thanks, Brad. And good morning, everyone. Total revenue for the third quarter rose 5% to $2.2 billion on capacity growth of 4.8%. RASM came in flat, which was our best unit revenue result in 5 quarters. We had good progression during the quarter with unit revenues down

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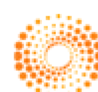

1.3% in July, but up 0.7% in August and up 0.5% in September. This is only the beginning, and we expect our unit revenue momentum to continue as we execute on a number of substantive initiatives to ensure our recent trajectory continues into the fourth quarter and well beyond. Other bright spots worth a mention include: Mileage Plan revenues were up 11%; Premium Class revenues were more than doubled at 122%; and First Class revenues increased 8%. Once we work through some IT issues related to paid upgrades on the Airbus, along with Airbus cabin modifications that begin this quarter to increase First Class capacity by 50%, we expect to see significant revenue increases from the front cabin in 2019.

Before I get to the outlook though, I'd like to provide some additional color on our third quarter results. First, same-stores or markets in operation longer than 12 months and representing about 94% of our capacity, delivered positive TRASM of 1.5%. Solid demand and stabilizing and improving close-in pricing across most of our network drove this result. Overall, we were pleased with the quarter's revenues given the 150 basis points headwind created by the higher level of award redemptions across our system, which we guided to last quarter and have mitigated going forward.

Now turning to new markets, or markets in operation less than 12 months. These negatively impacted RASM by 160 basis points versus the 210 basis points last quarter, as new market capacity declined to 6% of capacity from 9% in Q2. New market mix is set to decline again in the fourth quarter to just 3% of ASMs. And by the end of the year, we will have fully annualized the 44 markets we started last year when we made a strategic and long-term investment in the relevance of our California network. These markets continue to develop well. We are very pleased with the network foundation we have laid in California today, and our focus now is to continue maturing it in the coming months, quarters and years ahead.

Looking by region, we see a lot of strength versus last year. Yields are positive in the Pacific Northwest despite high single-digit industry capacity growth, and we continue our significant focus on California and are seeing positive momentum across a number of leading longer-term indicators. Specifically, Mileage Plan membership continued its double-digit growth this quarter; credit card acquisitions also grew double digits, and well in excess of passenger growth; brand awareness has improved 9 points in the past 4 months; and international traffic has increased 26% year-over-year, now that our California network is accessible to our global partners.

We forecast further improvement in all of these metrics as we finalize the integration and bring the guest experience on Boeing and Airbus into full alignment by the end of next year.

The only region in our system that is experiencing materially lower pricing today is Hawaii. West Coast ASMs to Hawaii grew 9% in the third quarter and is set to grow another 8% in the fourth quarter, while filed fares and yields are down significantly year-on-year. Nevertheless, we remain confident that we will be able to weather the softer near-term environment better than our competitors, due to the growth of our loyalty program across multiple West Coast origin markets, the additional segmentation we will introduce next year with the Saver Fare, and an onboard product that is very well suited for long-haul leisure markets such as Hawaii.

So looking to the fourth quarter, we continue to trim our initial capacity plan as we settle into a growth rate of just under 2%, which is where we expect to be for the next few quarters. After years of elevated growth, we are happy with our network footprint and are now focused on optimizing it. Our fourth quarter RASM guidance range of up 1.5% to 3.5% continues the positive trajectory we began in Q3 and will be our best RASM result in 6 quarters. Our guidance assumes recent strength in close-in pricing will continue and factors in a 125 basis point headwind from soft Hawaii pricing.

As we look ahead into 2019, we expect our positive revenue trajectory to continue as we implement a number of new initiatives that should generate in excess of $330 million next year. To resummarize some of the things that Brad mentioned: First, we're raising our bag fees for the first time in 5 years effective December 5, and we estimate that will generate $50 million in incremental revenues next year; secondly, our synergy opportunities, such as credit card growth, cross fleeting, Airbus fleet modifications, will produce an additional $130 million next year; third, the launch of our Saver Fare product on November 20 will add another $100 million; and then fourth, the other ancillary revenue changes we have already implemented, such as exit row sales and demand-based pricing for premium class, will reach a $50 million run rate next year. In sum, we are optimistic about our revenue outlook. Driving margin improvement through higher RASM is our team's #1 priority today, and we will achieve it as we reap the benefits of the significant investments we've made in our network, brand, product and loyalty program over the past 2 years. And with that, I'll turn the call over to Brandon.

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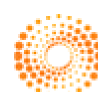

Brandon S. Pedersen ***Alaska Air Group, Inc. - CFO & Executive VP of Finance***

Thanks, Andrew. Good morning, everyone. As you've seen, Air Group posted a third quarter adjusted net profit of $237 million or $1.91 per share. Our pretax margin was about 14%, which was a 6.6 point decline from Q3 of last year. Flat unit revenue performance was certainly positive in light of recent trends, but inadequate to recapture much of the higher fuel prices and higher wages and benefits costs resulting from labor agreements we've amended over the last year.

Like Q1 and Q2, our unit costs were better than our original guidance despite completing fewer ASMs than we had planned. About $14 million of our better performance came from lower incentive pay accruals as the higher fuel prices take their toll on expected full year profits, and we failed to meet certain other non-financial metrics that are part of our annual goals-based plan that we call PBP, or performance-based pay. In addition, we had approximately $10 million of expense shift from Q3 into Q4 as the timing of certain maintenance and marketing activities was delayed versus prior plan. Yet even accounting for these 2 items leaves more than a point of CASMex of true cost outperformance in the quarter. This is partially a testament to the growth of the loyalty program, since more bookings are coming directly through our website and on our credit card today than at this time last year, which is our lowest cost form of distribution. But it also illustrates the hard work of our leaders and other employees who have delivered better productivity and have embraced the back-to-basics culture of frugality and cost discipline that has made us successful for many years. As mentioned, fuel continues to be a substantial headwind with per gallon cost rising 30%. Higher fuel prices alone reduced our pretax margin by 5 points or about 3 quarters of our year-over-year margin decline.

Without the $12 million net benefit from our hedging program, higher fuel would have cost us an additional 55 bps of pretax margin. Consistent with our standard hedging process, we currently have 50% of our planned fuel consumption hedged over the next 6 months and our average strike price during that period is $70 a barrel.

We expect Q4 unit cost to be up roughly 3.6% on a 1.4% increase in capacity, bringing our full year CASMex increase to 3.2% on 5.3% capacity growth. This compares favorably to our initial guide of up 3.5% on capacity growth of 6.5%. Bottom line, we are doing a good job managing cost this year with most of our divisions forecast to come in better than their original plans.

We've talked on the last couple of calls about the rigor with which we've been planning for next year and how we've been laying the groundwork for the 2019 budget for several months now. Well, the 2000 budget -- 2019 budget process is now in full swing, and we are leveraging opportunities for cost reduction in a number of areas including networks and costs -- excuse me network and schedule optimization, labor and aircraft productivity, hotel and healthcare costs and reducing overhead. Some investors have asked whether 2% growth is a negative for our business because it will put pressure on unit costs. It is true, 2% growth will put pressure on unit cost. But 2% capacity growth is the right answer for 2019 margins, especially in light of our rapid growth in recent years and growing faster than 2% when the environment simply doesn't justify more capacity than that just to take pressure off of unit costs would be irresponsible. We'll provide more details on our 2019 unit cost plan at Investor Day next month.

Turning to the balance sheet. We ended the quarter with $1.4 billion in cash. Total cash flow from operations for the first 9 months of the year was $1.05 billion, excluding merger-related costs, while net Capex was about $550 million over the same period. This resulted in the $0.5 billion of free cash flow.

The free cash flow we're generating has enabled us to continue to re-deleverage our balance sheet. Through the first 9 months of the year, we've reduced on balance sheet debt by nearly $550 million. It's also noteworthy, and bears repeating, that we'll have paid off nearly 40% or a net a $800 million of the $2 billion that we borrowed to acquire Virgin America less than 2 years after deal close. That improves our balance sheet, but also saves us more than $30 million in annual interest expense.

I want to give a shout out to our treasury team. Over the last 2 months, they've taken advantage of our balance sheet and today's credit markets to refinance or restructure $1.1 billion worth of our on-balance-sheet debt. This effort will continue into the fourth quarter and, when complete, will lower interest expense in 2019 to the tune of $4 million. I also want to acknowledge our partner banks who worked cooperatively with us on this initiative.

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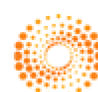

With leases, our quarter-end adjusted debt cap stood at 49%, 3 points lower than last quarter. And it should end the year at around the same level. Continuing to strengthen our conservative, investment-grade balance sheet is our #1 capital allocation priority right now. As we've repaid debt balances, we've also returned $155 million to shareholders during the first 9 months of the year via the dividend and share repurchases, and we still expect that number to exceed $200 million by year-end, consistent with our initial plan.

Let me close by offering some higher-level summary thoughts. First, most of the major merger integration milestones are behind us, and we're now squarely focused on 2 big things: culture and improving our financial performance; second, the slower growth for 2019 will let us digest the tremendous growth we've had over the last few years; third, our unit revenues are inflecting to positive, and we have specific plans that will add $330 million of new revenue to the business in 2019; fourth, our renewed back-to-basics focus on cost is evident and we're going to tightly manage cost again in 2019; and finally, the initiatives above give us line of sight to higher profitability in 2019. This will produce higher cash flow and, when combined with lower CapEx, will produce higher free cash flow, which we can use to further re-delever the balance sheet and ultimately improve the cash we return to our owners. And with that, let's go to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Savi Syth of Raymond James.

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

Listen, you laid out a lot of initiatives that should be -- different initiatives that should be kind of being a nice tailwind here. Could you talk a little bit about the progression as you go through the year on how those build?

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

Savi, this is Andrew. I think by -- probably as you go into the second quarter, we should be pretty much at full run rate. The Saver Fares will kick in and really be up and running for sales beginning January 1. Bag fees are already going in, and there's a booking curve that happens. So I would say that we'll start up a little lighter in the first quarter but as we go into the second quarter, we should be at full pace.

Operator

Michael Linenberg of Deutsche Bank.

Michael John Linenberg ***Deutsche Bank AG, Research Division - MD and Senior Company Research Analyst***

Two questions here. I think Brad, you've basically said you're at a point now where you're comfortable with the network and I guess there were what, 44 city pairs that were added, but there was also some culling, some cutting of frequency in some city pairs. Are we at a point now where going forward, and I guess maybe this is even a question for Andrew as well, that we're not going to see anything more material with respect to the network? Like the big changes have occurred and this is the network of 2019 and beyond?

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

Yes, Michael, this is Andrew. That's right, I think if you look at the culling, we cleaned up Dallas Love Field to the East Coast. We took care of our Mexico City slots, which weren't going to be long-term winners for us. And as we've shared previously, the network we inherited from Virgin America, we've made significant changes there. So we feel really good about the network. Our big opportunity, Ben might comment on this, is on the schedule but also just the marketing time of our network and getting our flights leaving at the times we want them to leave is our next big opportunity.

Bradley D. Tilden ***Alaska Air Group, Inc. - Chairman, CEO & President***

And Michael, when we talked about the cross fleeting of airplanes, putting the right airplanes on the right markets. So what we're doing by Q1 is making sure we deploy the bigger planes on the right markets and the smaller planes on the right markets as well.

Michael John Linenberg ***Deutsche Bank AG, Research Division - MD and Senior Company Research Analyst***

Okay, great. And just my second question, you did a really nice job, laying out all the different revenue initiatives next year, $330 million or exceeding $330 million. But you also threw out some things that clearly are going to benefit on the cost side. I mean, Ben, you just

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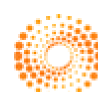

mentioned cross fleeting, your flight attendants are going to be working under single contracts. January next year, you'll be able to sort of mix and match, that's obviously going to help on the cost side. Any -- is there a number out there that we should use for the cost savings in 2019?

Brandon S. Pedersen ***Alaska Air Group, Inc. - CFO & Executive VP of Finance***

Mike, it's Brandon, maybe I'll take that one. No, not at this point. We do have a lot of stuff going on, but as I said in my prepared remarks, we're still working hard on the budget and we'll have more to say about that at Investor Day.

Operator

Your next question is from Duane Pfennigwerth of Evercore ISI.

Duane Thomas Pfennigwerth ***Evercore ISI Institutional Equities, Research Division - Senior MD***

Not to start exactly where Mike left off, but obviously lower growth has been discussed as a headwind. But from a high-level, could you just discuss the tailwinds that you see? For example, you've adjusted the plan lower, at least a couple of times this year, and my guess is there is some cost associated with that with those midcourse corrections. Can you just give us your list of tailwinds that you see?

Brandon S. Pedersen ***Alaska Air Group, Inc. - CFO & Executive VP of Finance***

Duane, it's Brandon, maybe I'll start with that. Certainly, the biggest tailwind for that is just the variable costs that come with the business and just the lack of start-up cost and things like that. Training costs, I would say, are a big one. You do have a certain element of cost structure that's fixed and obviously, with lower capacity growth, there'll be pressure on that. But to the extent that there are variable costs, both on an ongoing basis and then cost that we incur in anticipation of further growth, those will be certainly mitigated in 2019.

Bradley D. Tilden ***Alaska Air Group, Inc. - Chairman, CEO & President***

And Duane, it's been -- as you heard some of the things that are coming together with the integration, in terms of systems coming together and labor groups coming together. For example, our flight attendants will be flying together by the end of January of '19. That drives productivity back into our business. So as we bring systems together and we start aligning the operations and how we run it, those are going to be tailwinds for us in '19.

Duane Thomas Pfennigwerth ***Evercore ISI Institutional Equities, Research Division - Senior MD***

And then just for my follow-up on Hawaii. I wonder if you could provide a little more detail, historically. Because capacity has been up there for a while. You had high rates of growth from an industry perspective. 1Q, 2Q, my guess is the industry was absorbing it. You've had some nonrecurring events here, volcanoes, hurricanes and maybe there is some lingering impact. But maybe could you provide some longer-term perspective on Hawaii? And you've seen competitors come, you've seen competitors go. Typically, capacity finds a level, maybe the incumbents have overshot a bit here. Would love some more fleshed out thoughts on Hawaii.

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

Yes. That's a very good question, and you just said it. I think for those who've been in Hawaii and we've been here 11 years now. Hawaii really follows supply and demand of seats. And there's been an escalation of industry seats over the last few quarters and that will continue, and we've seen what that has done to the revenue environment. I think specifically to us, a couple of important things to note. Number one is that we serve Hawaii from 8 gateways off the West Coast, and many of those all 4 islands are on a nonstop basis. So very much have our flights not anchored to any single or specific city. But what's really exciting I think is you heard about on the initiatives as we roll out, many of these will directly impact the economics in a very positive way our Hawaii routes. And especially with our onboard product now with satellite coming on board, with the Premium Class seating, First Class seating, food and beverage programs both in the main cabin, we feel really good about our product, our network and the incremental revenues coming into 2019 that will help us deal with some of the softness as the industry finds its water level.

Operator

Our next question is from the line of Rajeev Lalwani with Morgan Stanley.

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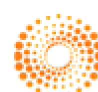

Rajeev Lalwani ***Morgan Stanley, Research Division - Executive Director***

Two questions, a RASM one and a CASM one. Andrew, I'll start with you. You're seeing a nice inflection in unit revenues here in the fourth quarter. Would it be unfair to assume that you can just build out some of these numbers as we go to next year? And then maybe just add on top of the 4Q levels be the 3 to 4 points of revenue initiatives that you're seeing? Is that too optimistic or too aggressive?

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

No, Rajeev, I'll give you my personal views. But I think we are going to continue to ramp. I mean, I think if you just look at the industry's revenue guidance for the fourth quarter, I think our guidance is starting to nestle right in there amongst many other ranges. And if you take into account all the real revenue initiatives that are kicking in as we speak, I would personally expect us to start to outperform the industry in unit revenue increases as we go into the first quarter.

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

Helpful. And then Brandon, a question for you. On the CASM side, so in the fourth quarter, you've got 1%, 2% capacity growth and you're seeing 3.5 points of unit cost pressures or an increase there. Can you just help break that down? And I'm assuming we shouldn't be using that as a run rate for 2019 and maybe, because some of the headwinds associated with lower growth? I think you get where I'm going?

Brandon S. Pedersen ***Alaska Air Group, Inc. - CFO & Executive VP of Finance***

Yes, yes. I totally get where you're going. It really just is a timing thing. I don't think the Q4 CASM guide should have surprised anybody, because our full year CASM guide really remains unchanged. When you put together a business plan, you make estimates of what certain things are going to land in certain quarters and stuff is just slipping into the fourth quarter and that's -- so it's really timing more of anything else, not indicative of where we think we're going to be long-term on the CASM guide with lower capacity.

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

And then within that 3.5, how much is timing? Can you parse that out a bit?

Brandon S. Pedersen ***Alaska Air Group, Inc. - CFO & Executive VP of Finance***

You know what, if I went back to our original CASM guide for the fourth quarter, which I don't have in front of me, I bet it's probably -- I would say, it's probably most of it. Hold on, I'm looking at something here.

Christopher Michael Berry ***Alaska Air Group, Inc. - VP of Finance & Controller***

This is Chris. About half of the increase in CASM really came from the decline in capacity, and then the other -- we got about $10 million, $15 million worth of shift in timing of cost into the fourth quarter. So those 2 things together pretty much get to your CASM guide for the fourth quarter.

Operator

Your next question is from Jamie Baker with JP Morgan.

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

A follow-up to Rajeev's question, which is a follow-up to Duane's question, which is a follow-up to Mike's question. I know you don't want to give a precise cost guide, you're holding something back for Investor Day, that's fine. But I can't figure a time since stand-alone United that an airline was ever able to materially decelerate without seeing a substantive year-on-year increase in x fuel CASM. And they only pulled it off -- it's quite some time ago, because they punted all of their 737 classics. So obviously that's not an option here. If x fuel CASM goes up 3% this year, which is the guide, isn't it a forgone conclusion that next year goes up more than this, it's just a question of magnitude?

Shane Tackett ***Alaska Airlines, Inc. - EVP of Planning and Strategy***

It's Shane Tackett. Love your questions. I think maybe I'd just start higher level. We spent something like $5.5 billion on nonfuel cost and natural sort of inflation of that might be, I don't know, call it 5%, something like $300 million. I don't think it's a forgone conclusion that we have to go up $300 million next year. And that's sort of where -- that's where our mindset has been, that's what Brandon has talked about throughout the year. That's sort of what we're alluding to as we lay out cost initiatives similar to a list of revenue initiatives that

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were very well laid out by Andrew. We just need to do the exact same thing with cost. The other thing that I think you can appreciate is as we've gone through the integration and merger, there's just a lot of potential opportunity to go in and look at areas that got a little bit ahead of themselves in the last couple of years.

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

Okay, fair enough. Can't blame a guy for trying. Second, on segmentation and this is somewhat similar to what I asked last quarter, but many of your peers -- well, not many. Your peers have stumbled out of the gate with basic economy. Do you plan to roll out Saver Fares all at once on January 1? It sounds like that's the plan. I'm just wondering if staggering the rollout might be an option that would minimize execution risk?

Shane Tackett ***Alaska Airlines, Inc. - EVP of Planning and Strategy***

Jamie, this is Shane again. And I might speak to this, I've been sort of principally involved with it. We are going to do what we're calling a soft launch on November 7, where we will start selling Saver Fares in a small subset of markets in December. We'll use those lessons learned throughout December to figure out if it makes sense to launch fully on January 1. It probably won't be January 1, it will be like the 10th. We'll get to the holiday returns or if we need to go out a little slower pace. But I will say, as is often the case, we go a little slower on these sorts of things. And the benefit of that is we've been able to learn from others that have gone before us. And so we should be able to get here quicker than others have had in the past.

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

And just super quick follow-up, are you going to disclose those markets or is up to us to find them? I mean, which we can do, I mean anybody can if -- trial and error.

Shane Tackett ***Alaska Airlines, Inc. - EVP of Planning and Strategy***

Yes, yes, I think we'll disclose them once we've got sort of the final decision on where they're going to be. We'll have to map it with you all.

Operator

Your next question is from the line by line of Helane Becker with Cowen Securities.

Helane R. Becker ***Cowen and Company, LLC, Research Division - MD & Senior Research Analyst***

When we look at the changes that you guys were talking about in terms of the retrofit of the fleet, is that in -- where are we seeing that on the income statement? And is there a reason why -- or is it in that line item for maintenance that was 22% in the last quarter?

Brandon S. Pedersen ***Alaska Air Group, Inc. - CFO & Executive VP of Finance***

Helane, it's Brandon. In terms of the retrofit cost, those are capital. And so you'll see those in CapEx, which will ultimately flow through in depreciation once those mods go into service. There's really nothing in the maintenance line per se related to reconfiguration of Airbus airplanes.

Helane R. Becker ***Cowen and Company, LLC, Research Division - MD & Senior Research Analyst***

Okay. And then was there a reason why those costs were up so much in the last quarter?

Brandon S. Pedersen ***Alaska Air Group, Inc. - CFO & Executive VP of Finance***

Not -- I mean, certainly there are reasons. It was just really timing of various activities. And some of it is the power by-the-hour deals. And on a year-over-year basis, it's driving some of that increase, but we've talked about that a couple of quarters in a row now.

Operator

Your next question is from the line of Hunter Keay with Wolfe Research.

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

You guys are probably disappointed not to pay out PBP at target. And I'm kind of curious on how you're thinking about setting PBP levels next year. Are you going to set them low? You like to set them generally sort of conservatively so you can make payments, I know that.

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But how are you preliminarily thinking about setting PBP targets? And how should I think about that variable kind of a line next year if you set them really low?

Brandon S. Pedersen ***Alaska Air Group, Inc. - CFO & Executive VP of Finance***

Hunter, it's been -- I think in terms of payout, we are going to be above target for 2018, so I just want to correct that. So we're going to be above target. I think our philosophy hasn't changed in terms of how we set our performance goals. We want them to be aggressive and reachable. Like if you look over the last 9 years, we've been about a month's pace. So a little lower this year, I mean fuel's been a big issue for us and some of the other targets we didn't miss. But I think we're looking hard at those goals. We're setting targets right now. And I think I personally feel good in where we're going to hit them. Just in terms of context, at least 20% of the PBP goals are nonfinancial elements, like safety and customer service. So there's always a good balance in terms of how we set them.

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

Okay. And then a little bit more on Hawaii and Saver Fares, to marry these 2 things up a little bit. How are you thinking about the appetite for those fares in Hawaii? And is there -- was one of the reasons why Hawaii might be soft right now because of some of that basic version that's being deployed that you can see in filings of course, by your competitors may be ahead of your Saver Fare launch? Is that one of the issues that you think maybe are optimistic that can get cleaned up pretty quickly once Saver Fares are in that market? If that makes any sense?

Bradley D. Tilden ***Alaska Air Group, Inc. - Chairman, CEO & President***

I think it does, Hunter. I think what you're saying actually is system-wide for us. Our hands are a little bit tied behind our back because we don't offer Saver Fares and so our competitors, 1 in 4 times, they are getting an extra $25 to $35 more than we are and that will be rectified going forward next year, and obviously we've seen that on Hawaii across all our major competitors.

Operator

Your next question is from the line of Dan McKenzie with Buckingham Research.

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

Andrew, I'm wondering if you can clarify the positive RASM result in the Northwest despite high single-digit capacity? I wouldn't have guessed that, that would have been the outcome. Is it that Anchorage offset some of the pressure at Seattle? Is it just local economic growth in Seattle? Is it corporate growth? All of the above? How do we think about the demand and revenue drivers in that market as we look ahead? Because it seems like capacity may continue to be somewhat elevated there.

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

Yes. I think a couple of things. I mean, we've had new growth everywhere, not just California but also the Pacific Northwest. But I think fundamentally, and you've heard us talk about this, is back to basics. We have been -- with most of this integration behind us, we are focusing back on our core disciplines and what we do and what we do well. And I think especially with the Pacific Northwest, we've continued to mature markets. We continue to look at our pricing environment and our network and our hub structure. Certainly, Horizon has been performing exceptionally. We had real challenges last year, as you know. So I think all of those things are coming together. And loyalty continues to grow at very significant rates, believe it or not, in the Pacific Northwest not just California.

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

Is there any international traffic benefit that's specific? I'm wondering, if you can elaborate a little bit more on that as well? You mentioned that in the prepared remarks. To what extent is that helping to benefit your revenues? Not just in San Francisco but across your system?

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

Yes. I mean, I think on the international it's not huge in the scheme of things. It helps us fill in some seats here and there. But the real advantage on the International is giving our loyalty members access to the globe, helping fill out partners' planes with valuable revenue, and giving our members award redemptions. So it's a very profitable relationship for both parties, and that's only going to get stronger.

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

If I could sneak a third one in here. Brandon, the cash levels. Now that Alaska is 90% integrated, you're essentially at your target leverage in the mid-40s. Does that loosen up some liquidity for some incremental shareholder returns as we look ahead to 2019? Or does it make sense to take down the debt a little bit further before you consider some more aggressive shareholder returns?

Brandon S. Pedersen ***Alaska Air Group, Inc. - CFO & Executive VP of Finance***

Dan, I wouldn't say we're at in the mid-40s yet. We ended the quarter at 49%, we'll be there by -- we'll be at that same level at year-end. Here's the way I'm looking at it though, and I'm glad you asked the question because I think it's a super exciting story. As we look to next year and we see profit improvement and cash flow improvement, free cash flow improvement, our current maturities will be about $300 million. Once we hit that, we'll probably be in the low 40% range debt to cap. Our dividend's probably in the neighborhood of $160 million, $170 Million. So anything in the free cash flow bucket beyond, say, $450 million to $500 million that would probably be available for a share buyback.

Bradley D. Tilden ***Alaska Air Group, Inc. - Chairman, CEO & President***

Dan, it's Brad. I might just weigh in. We've gone through this merger process, and the profitability has been challenged. A lot of the theme of this call and the last couple has been the different initiatives we have to improve margins improved return for shareholders. And we have got a lot of confidence in that stuff. That said, I've been super impressed with what cash flows the business can produce, what Brandon and his team have done with the balance sheet. To be sitting here 2 years into the merger, having paid off $800 million of the $2 billion we borrowed and have adjusted debt-to-capital of 50%, is really something else. And we've got -- I think you're asking a great question. We have the ability to improve that even further in 2019. And then this business is producing a lot of cash flow that we'll have -- a good problem to have is what do we do with that cash flow that we're producing.

Operator

Next question is from Joseph DeNardi with Stifel, Nicolaus & Company.

Joseph William DeNardi ***Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Airline Analyst***

Good segue. Brad, I think I asked you this question before, just going to try and ask it a little bit differently and in a multiple-choice format. Has your experience with Virgin and the M&A process made you more likely, less likely or equally likely to engage in further M&A in the future?

Bradley D. Tilden ***Alaska Air Group, Inc. - Chairman, CEO & President***

Everyone's -- they're all doing their hands -- they're pushing them sideways, Joe. Here's what we'll say about it is I think the industry has changed a lot. If you look 10 or 15 years ago, it took 9 airlines to make up 80% of the pie, today it's 4. I do think we're all really, really happy with what this company's done for everybody that depends on us over decades, and getting bigger was important. And so we're really happy with the merger in that respect. In terms of culturally, we've been up a lot and the interesting about business as in life is that you sort of learn as you go. I think in terms of us biting off another merger, our plate is more than full right now and we're just going to be completely focused on doing what we -- what we've got on our plate right now doing it as well as we possibly can. So thanks for the question, though.

Operator

Your final question comes from the line of Brandon Oglenski of Barclays.

Brandon Robert Oglenski ***Barclays Bank PLC, Research Division - VP & Senior Equity Analyst***

Andrew, I want to come back to the revenue question because it's been asked several ways. But if we think specifically about the Saver Fare opportunity I think you called it out as about $100 million, looking into next year. But if that's explaining some of your underperformance to the market, is it still fair to say, yes, we can get back to market RASM and then some of these initiatives will actually be additive above and beyond that?

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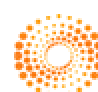

Andrew R. Harrison ***Alaska Airlines, Inc. - Chief Revenue Officer, Chief Commercial Officer and EVP***

Yes. I mean, I think if you want to talk about bag fees that's getting back to market, Saver Fares maybe getting back to market. Although, Saver Fares will help us compete very aggressively against other carriers that don't have Saver Fares. So that's a big win. But the big win that we've also been talking about is just really the synergies. And bringing our product to life across the system is going to be very incremental. We won't be -- we've still got low fares. I don't think we're ever going to be at market RASM, if you put it that way. We rely greatly, as well, on our low costs to have the low fares. But I think overall, all of these things come together to provide a good rising tide for us next year.

Brandon Robert Oglenski ***Barclays Bank PLC, Research Division - VP & Senior Equity Analyst***

Okay. And Brandon, I'm going to take it one more time on the cost side and see if we can get something out of you. But the -- it seems like you do have a lot of integration activities ongoing this year. I've got to believe that's impacting the operating cost structure too, just from even an overhead perspective. Shouldn't some of that activity come down as we head into 2019? And could you help us quantify what that was this year?

Brandon S. Pedersen ***Alaska Air Group, Inc. - CFO & Executive VP of Finance***

Brandon, thanks for the follow-up question to the follow-up question to the follow-up question. I appreciate that. Here's what I'll say, we have a long history of doing a good job managing cost because ultimately, we know it's important to our success. We're going to manage the heck out of cost in 2019, and we'd be delighted to tell you more about that at Investor Day.

Bradley D. Tilden ***Alaska Air Group, Inc. - Chairman, CEO & President***

Okay, thank you very much. Thanks everybody for tuning in today. Investor Day is November 27. We look forward to seeing hopefully all of you at Investor Day in New York on November 27. Thanks very much, have a great day.

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.

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