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ALK - Q2 2018 Alaska Air Group Inc Earnings Call

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OVERVIEW:

Co. reported 2Q18 revenues of $2.2b, GAAP net income of $193m, adjusted net income of $206m and adjusted EPS of $1.66.

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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 second quarter earnings release conference call. Today's call is being recorded and will be accessible for future playback at www.alaskaair.com. (Operator Instructions)

Thank you. 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 second 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 second quarter GAAP net income of $193 million. Excluding merger-related costs and mark-to-market fuel hedging adjustments, Air Group reported adjusted net income of $206 million and adjusted earnings per share of $1.66, 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 now, 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're halfway through 2018 and 19 months have passed since our merger closed. We're very pleased with the operational and customer service performance of the company, and we're very happy to have the vast majority of our systems and processes and facilities integrated and to have this work done at a pace that is equal to or more rapid than virtually every other merger in the industry. But we're not satisfied with our financial performance, and we're working hard to lean out our cost structure and to achieve revenues in the marketplace that recover the much higher fuel prices that every airline is experiencing. Fuel prices have been steadily increasing for 10 quarters now, and they are about $1 per gallon higher than they were in the first quarter of 2016. At our volumes, that means we have about $850 million of cost increases. It may be that the early 2016 prices were unusually low, but it's clear that we have higher costs and we need to be focused on taking actions that help us recover these higher costs.

Mergers are complicated, as anyone who's been involved in one can attest. Ours has required significant focus and has brought our frontline employees through a period of considerable change, transition and growth. At the same time, we've been managing rising fuel prices, significant network expansion and elevated competition. Our team has been resilient and has secured a number of important accomplishments that have laid the foundation for our long-term growth and success. As we sit here today, we believe we've now passed through the inflection point of the merger. And while we have a lot of work ahead of us to lean out our cost structure and drive revenues higher, we feel very good about the plan we're putting in place, and I'm optimistic about our future.

Before we talk about the work that lies ahead, I'd like to highlight a few of our employees' key accomplishments during the second quarter.

First, on April 24, we transitioned to a single-passenger service system with zero disruption to our operation. One of our most basic goals at the outside of the merger was to avoid any negative impact to our customers during the process. And unless you were at one of our 31 Virgin America airports on the night of April 24, you most likely would not have noticed that the PSS conversion occurred. This is a great accomplishment for our team.

Next, in June, we reached an agreement in principle with our dispatchers union, which was ratified earlier this month. We now have all but one of our labor groups, or 93% of our unionized payroll, under single-collective bargaining agreements. This is extremely important for any airline, but especially at Alaska, where we have such a unique culture that drives our success.

Third, our operation has been running very well. Our team delivered on-time performance of 84.1% in the second quarter, up 4 points year-over-year. We see operational strength today across our mainline and regional fleets. At horizon, our on-time performance is the best in the regional industry, and our pilot staffing pipeline is full.

Finally, we were very happy to see our employees win the J.D. Power Award for the 11th year in a row during the merger's toughest period. This continued recognition by our guests is fantastic, and we want to congratulate all of our employees for delivering the differentiated service that makes Alaska what it is.

With 85% of the integration work now behind us, the focus of the leadership has fully returned to the basics of running the airline. We are pleased to be getting back to our roots, working together with our people to deliver operational improvements, growing our cost advantage, and earning our guests' loyalty everyday through our fantastic route network, our low fares, and our genuine and caring service.

This is a group of leaders that have been together for a long time now, and we operate the business today with the same philosophy and mentality that we always have. At the same time, we've been fortunate to add a number of new, highly skilled leaders to key posts in recent years, who are complementing our core strengths and making us stronger.

Today, we're dedicated to realizing the value of our significantly larger platform. This means we are focused on delivering meaningful unit revenue improvements while tightly managing productivity and overhead. After a period of margin declines - which have come due to higher fuel prices but also due to the integration, investments in our network, and a step-function increase in labor costs - margin improvement is our primary focus today.

We believe we're on a path to deliver significant improvement in margins in both 2019 and 2020. And we see 4 specific opportunities in the near term that will help us do so. These are: first, network optimization; second, increasing upsell and other ancillary revenues; third, improving productivity; and fourth, investing in our culture.

Let me address each one of these briefly. On the network, we are actively managing the ROIC targets at the market level to make adjustments to total capacity and how we allocate it. We are just beginning to capture synergies from cross-scheduling Boeing and Airbus aircraft, which will ramp up between now and early next year. We've made several accretive network adjustments that take effect this quarter and next, and are slowing our 2019 growth rate to 2%. More on this latter change in a moment.

Next, on revenues, we're further segmenting our product to compete more directly with the basic economy fares that have been prevalent in our markets for several quarters now. As we introduce additional choice for our guests, we believe some will prefer the lowest fare while benefiting from an assigned seat and a carry-on bag not offered by our competitors, while others will be willing to pay a bit more for greater ticket flexibility and changeability. We're making changes to other ancillary revenues as well.

On productivity, we're targeting improvements within each operating division to get us back to or better than pre-merger levels, while also aggressively managing overheads.

Andrew and Brandon will talk more about these 3 focus areas in a moment. They're all designed to get us back to our long-term margins and our ROIC targets.

Our fourth and final focus areas is culture, which is the critical intangible asset that has always enabled Alaska to be different, and that we believe will help us do so in the future. With most of the integration behind us, we're spending more time with our employees, addressing their issues, helping them to be and feel empowered, and to foster the sense of teamwork and camaraderie that results in the genuine and caring service that put Alaska on the map and that has enabled us to compete effectively with airlines that have far greater scale.

Finally, a note on 2019 capacity. Given the very substantial increase in fuel prices over the last couple of years and a capacity environment that has not adequately adjusted to them, we have reduced our 2019 capacity growth to 2%. As we've said on prior calls, we want to be good stewards of capital, and in this environment, we're just not seeing the returns that justify higher levels of growth. However, given the competitive advantages that we maintain, we think there will be a time in the intermediate term when higher growth will once again make sense for us and our owners.

As we move forward with our initiatives, I'm encouraged by the strong foundation we've laid since the merger closed in late 2016. We're very happy that the integration proceeded at such a rapid clip. We're very happy with our new and expanded route map and the geographies we serve. And we're very encouraged by the loyalty growth that we've seen. From here on, we'll be pulling levers within our control to materially improve the company's financial performance. We have a good plan, and I'm confident that this leadership team, and in fact, the entire Air Group team, will deliver.

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 revenues for the second quarter rose 3% to $2.2 billion on capacity growth of 7.8%. As we shared on our last call, the second quarter reflected our highest capacity growth of the year, the highest competitive capacity growth of the year and a difficult comp with Easter. In addition, we had a significant increase in award travel following our conversion to a single reservation system in April. As you know, the conversion went flawlessly from an operational perspective, but it did release pent-up demand for award redemptions on our broader network. In fact, redemptions grew by 22%. Our goal is to make award travel easy for our guests, but we need to balance that with the revenue dilution it creates. We've already made the adjustments necessary to award seats and redemption prices so that the impact of higher award redemptions will moderate by the fourth quarter.

So while we are not happy with our unit revenues, we believe they represent the low point of our march towards stronger revenues and margins during the second half of the year and into '19.

Before turning to the future, I'd like to provide more color on our results. Roughly 3 points of our 5-point RASM decline was driven by same-store markets and the remaining 2 points resulted from new markets, and I'll address each of these separately.

First, same-store markets, or markets in operation longer than 12 months, 1 point of the decline came from a shift in the timing of Easter while another 1.5 points came from the increase in award redemption activity I just mentioned. And while we had budgeted for 50 basis points of dilution from award travel, the rapid acceleration and redemptions in May and June led to an additional 100 basis points of impact. Based on the redemption demand we see in our bookings for the remainder of the summer, we expect this 150 basis point headwind to continue into the third quarter, but then moderate after that. From a loyalty and brand perspective, higher redemptions are very encouraging and our go-forward objective is to strike the right balance between paid tickets and offering great value to our loyalty members.

Setting these 2.5 points of headwinds aside, same-store unit revenues would have been close to flat for the quarter. Overall, demand and pricing continue to be strong in our core Pacific Northwest markets and uptake on our Premium Class product continues to exceed our expectations. While competitive capacity remained elevated and pricing was still generally soft in the state of California, we have seen an improvement in pricing over the past 30 days that sets us up for positive momentum in Q3 and Q4.

Turning to new markets, or markets in operation less than 12 months, these accounted for the remaining 2 points of decline. New market capacity remained high at 9% of ASMs this quarter, though this will decline over the next 2 quarters, with new markets set to represent 6% of ASMs for Q3 and just 3% by Q4. We are encouraged by the recent performance of these markets, especially volume builds, and we expect them to contribute to stronger unit revenues later this year as many of them begin to annualize in September.

Looking ahead, our own growth slows to 5.9% in Q3; 3.1% in Q4; and competitive capacity, based on today's schedules, goes from 7.4% growth in Q2 to approximately 5% in the third and fourth quarter, again, setting us up for sequential unit revenue improvement over the next 2 quarters.

This upward trajectory in unit revenues actually began during the second quarter as we look by month. April was down 7%; May was down 5%; and June was down 3%. In that light, our third quarter RASM guidance range established this morning of down 3% to flat continues the upward trend. Of note, this guidance assumes 150 basis points of continuing headwinds from higher award redemptions and 25 basis points of demand softness in Hawaii from ongoing volcanic activity.

After 2 years of substantial capital deployment and execution of a complex integration, the commercial team is committed to improving returns on invested capital. A number of the initiatives currently underway will enable us to deliver on this.

First, we are capturing merger synergies as we fully integrate and optimize the deployment of our fleets, network, schedules and crews.

We will improve the revenue generation of the Airbus fleet starting this fall by modifying the cabin configuration and adding more seats.

We are enhancing our competitive position in transcon markets (these markets represent 31% of our network), as we swap in larger Boeing aircraft with better product segmentation and additional opportunity to reward our elite guests with upgrades.

We are optimizing our network and schedule, and we believe we have opportunity to more profitably assign our regional fleets across our West Coast short-haul networks.

We will launch our Saver Fare product in December, which will create significant revenue up-sell opportunities in the order of $100 million-plus annually.

We are increasing ancillary revenues through the adjustments to change fee policies, offering exit rows for sale and adding demand-based pricing to our Premium Class. And as we mentioned last quarter, these adjustments represent another $50 million run rate opportunity, $20 million of which we expect in the second half of '18 with these initiatives now in market.

And finally, we expect to reap the benefit of the new markets we launched in 2017 and '18 as they mature and expect to add only a handful of new markets in 2019.

And to that point, with our team fully focused on delivering higher margins and returns going forward, our decision to reduce capacity growth to 2% in 2019 will be favorable for both unit revenues and for profits. We still expect 2020 capacity growth to be 4%. And as Brad mentioned, we believe our durable competitive advantages will permit us to grow faster than both GDP and the industry over the medium- to long-term.

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

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

Thanks, Andrew. Morning, everyone. As you've seen, Air Group posted a second quarter adjusted net profit of $206 million or $1.66 a share. Our pretax margin was about 13%, an 11 point decline from last year. These results reflect the revenue pressures we faced, markedly higher fuel prices and a step-function increase in payroll costs. I'm going to echo the theme that you've heard already -- that these results are not the "new normal" for Alaska. We're working hard to improve the returns that this business can generate.

I too want to offer a bit more color on our decision to scale back 2019 growth. We believe the slower growth rate makes sense because with fuel and industry capacity at current levels, we just don't see the same opportunity to produce the returns we're seeking.

We're solidly in returns improvement mode, and 2% growth helps us get there because it will improve our ability to manage fares in a way that will help cover the cost increases we've seen. Like our 4% plan before it, the 2% plan lets us leverage the considerable growth that we've had over the last 5 years but demonstrates, once again, that Alaska is willing to right-size capacity when needed.

You've heard about the important initiatives that the commercial team is working on. On the cost side of the house, we're demonstrating better cost control than we've seen in about 2 years. We're having a good year in almost all divisions as people embrace the hard work of cost management. There are new processes that occur daily to manage productivity in our operation. Our marketing team gets a shout out for beating what I would say was an aggressive plan through 6 months. And our call center team is not just under plan but 4% under last year at the halfway mark. This is a prime example of the "cost friction" that I referred to last year that would go away as we got farther along in the merger integration. We also have new tools and processes to manage overhead, which, by the way, are tracking $12 million better than planned so far this year. For example, one of our folks developed a dashboard to ensure that contractors are leaving the property on schedule. And we're on track to meet our non-union headcount reduction goals by July 31.

And with that as the backdrop, let me provide some color on our Q2 cost performance. Q2 CASM ex fuel rose 2%, which was well below our initial guidance for the quarter. As we saw in Q1, we did benefit from the timing of certain maintenance and marketing expenses shifting to later in the year. Timing accounted for roughly half of our CASM improvement versus initial guide, which means the other half came from true outperformance. Fuel was a significant driver of our margin performance this quarter. Per gallon costs were up 34%, and total economic fuel expense rose 45% or $155 million. Though fuel costs are high, our WTI call options did reduce our economic fuel expense by approximately $9 million. And based on the current forward curve, we expect these hedges to save us a similar amount in the third quarter. We currently have hedges in place covering 50% of our planned consumption for the remainder of the year at an average strike price of $67 a barrel.

On the integration front, as Brad mentioned, we reached a merger transition agreement with our dispatchers union, bringing all but our maintenance technicians under a single CBA. This gives us great cost visibility, but more importantly, the ability to bring our Boeing and Airbus teams together and focus on culture and consistency of service.

We now expect Q3 nonfuel cost to be up about 5% on 6% capacity growth, which is a bit higher than our most recent guidance in April due to the timing shifts and the fact that capacity growth is lower. We also now expect full year unit costs to be up 3.2% or 30 bps better than our previous guidance on 30 bps lower capacity growth. This updated outlook reflects the benefit of the favorable unit cost trajectory that we have experienced so far this year.

Turning to the balance sheet. I might start by just underscoring that our revenue and cost initiatives are designed to improve both earnings per share and cash flow. We're trying to be smart allocators of the capital we're generating, balancing prudent investments where we can earn adequate returns, reducing our leverage to protect our long-term shareholders from the cyclicality of the industry, and returning capital to our owners. Total cash flow from operations for the first 6 months for the year was $800 million, excluding merger-related costs and the $1,000 employee tax bonus paid in January. Net CapEx was $425 million over the same period, resulting in approximately $375 million of adjusted free cash flow.

The free cash flow we're generating has allowed us to continue to strengthen our balance sheet. Total on-balance-sheet debt declined by $258 million during the first half of the year. By year-end, we'll have paid down $800 million of debt since our acquisition.

With leases, our quarter-end adjusted debt to cap stands at 52%, net debt to trailing 12-month EBITDAR stands at 1.4x, or 20% below the industry average, and we have 83 unencumbered airplanes in our fleet. We remain committed to improving our conservative investment-grade balance sheet, which has served this company well for many years. And rounding out our capital allocation plan, during the first 6 months, we've returned more than $100 million to shareholders via the dividend and share repurchases, and expect that number to exceed $200 million by year-end. We've increased our dividend every year since we initiated it in 2013, and our dividend is currently yielding about 2%.

I want to close by reiterating what we've tried to convey in the last 25 minutes -- that we're through the biggest part of the integration and - financially speaking - we're now working hard on revenue and cost initiatives with the goal of making sure this franchise that we're building can produce much higher returns than it is today.

And with that, let's go to your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Rajeev Lalwani with Morgan Stanley.

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

Brandon, a question for you. You're obviously pulling in your capacity growth quite a bit going into next year. Is that going to be creating sort of a casm problem? Do you think you can do flat to down, or I don't know if that's guidance, but -- your target was to sort of do that. And then just related to that, I don't think your CapEx numbers changed despite pulling in capacity. So just some color on both of those would be great.

Benito Minicucci - *Alaska Air Group, Inc. - President & COO of Alaska Airlines Inc and CEO of Virgin America Inc*

Rajeev, this is Ben Minicucci. Normally, Brandon would take that CASM question, but I think I'm going to start and have Brandon chime in. Simply because on the operations side, we drive mainly the execution part of the cost side and -- what I want to say is from me, I'm totally committed and my leadership team is totally committed and accountable for achieving our CASM targets. Maybe just a few points just to reiterate from the script.

First, we are past the biggest part of the integration and so we are now squarely focused on running this operation well. And what I'll say is a well-run operation has lower costs, and on top of that, we don't buy our performance. So that is something that, after this integration, we are totally focused on that.

Second is this network schedule. We are working hand-in-hand with Andrew at getting this Network schedule right; optimizing it for revenue and profit as well as cost and productivity is critical for us as we calibrate our growth to 2%. Third, and I'm going to put another exclamation point on this is getting back to this high productivity. As we've always had high productivity in our history, and we are going back to our peak levels that we've had pre-integration. My team's every division has clear goals on productivity. For this year, you've seen good cost performance this year on productivity. And as we're developing the 2019 budget, our productivity goals are clear, and we're managing this at the daily and weekly levels, so that we can make adjustments as we go. We're not waiting till the end of the month. And lastly, we're going to attack overhead. We got initiatives on healthcare, crew hotel costs and management headcounts. So with all of that, we're feeling confident on how we're going to attack CASM with our 2% growth that we're putting in place.

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

Hey Rajeev, it's Brandon, good morning. I'll take the second part of the question. Your question was did CapEx come down, given the lower growth rates. The answer is, no. Although, we were looking at that just yesterday -- I will remind you that we brought our 2019 CapEx guide down to $750 million from like $1.2 billion or something like that. That was a big move. At this point, I think we're through with our aircraft delivery stream restructuring. What we're going to do to accommodate the lower capacity is just try to get the mods done and the paints done more quickly, which I think is ultimately great for the guest experience and great for our ability to get through the integration fully and on to better things.

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

Thanks, just a brief follow-up. Ben, I appreciate your thoughts and your color, but what does that actually mean for unit costs going forward? I mean, can we do sort of flattish, down, just some color. Brandon, that's for you as well, obviously.

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

Yes, I might jump in. Ben did a good job listing all of the things that we're working on the cost side. What I would say is we had a very aggressive planning mindset around costs coming out of the integration to get those to be flat to down on 4% growth. What I can tell you is things are different around here in terms of our mindset about costs following the integration, as I said. We have no less vigor in the aggressiveness with which we're working in the costs planned, we just have fewer ASMs now to spread those costs over. So we're going to get into the budget process, and we'll see where that ultimately takes us.

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

So Brandon, Investor Day, is that your target for the 2019 cost guidance.

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

Yes, exactly.

Operator

Your next question is from the line of Michael Linenberg with Deutsche Bank.

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

Two kind of network questions here. Andrew, maybe you can help and, Brad, you can chime in as well. I just -- when I look at some of the capacity changes that you've made, it's good you're trying to do the right thing and it looks like markets that maybe aren't as relatively accretive or even may be the relative diluted that you're backing off of it. I just -- what I -- look at a market like Chicago to the West Coast and you scaled back maybe to 1 or 2 flights a day. On one hand, it may become a more profitable market, on one hand and yet, you run the risk of becoming less relevant. And I mean, you look at the competition in that market and some of your competitors may have half a dozen or even a dozen flights a day with some bigger planes. So can you talk about your thought there? Maybe you just want to cater to that loyal Alaska passenger who -- rather than its the Chicago passenger or you got less connecting passengers, I mean, does that become a potential concern? How does that weigh on your thinking on some of these cut backs? Because some of them are pretty deep.

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

Yes, thanks for the question. I think big picture #1, the network is a very complicated and evolving puzzle piece. I think we -- and again, we're not getting too deep in the weeds but what you are and what you will continue to see are deeper off-peak demand cuts, especially on seasonal flying. You are going to see less red eyes at these fuel prices, and you're going to see us, especially with Dallas Love Field, for instance, going to the east, getting out of Havana. And as I shared on the prior call, we, for the first time over the last little bit, have started taking down the legacy Virgin network where we felt like the capacity and the markets we were flying weren't the right ones. All the adjustments we're making, we believe, strategically, are still strong. We're going to pick and choose as we go along here where we going to cut and grow. But I think in answer to your question, we'll be focusing on our strength on the West Coast, we'll be focusing on our growing loyalty base, and we're going to be focusing on increasing our unit revenues and profitability.

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

And Andrew, I know you and your team do think a lot about utility. We want to have a schedule that works for people. Mike, to your specific question, we probably do think more about the West Coast origin customer as opposed to midcon or East Coast. So we probably don't need the same schedule coverage as somebody is really focusing hard on both ends. But yes, utility does matter, you try to balance utility, returns on capital and so forth.

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

And that -- this just brings up sort of my second question, and I would say that a lot of the things that you just said probably answer the second question. But when I look at Alaska pre-merger, you were spending the incremental effort beyond Seattle, Portland, et cetera, was growing California secondary cities, and you were building up a nice presence there. You then have the merger with Virgin, and now all of a sudden, you have big presence in California primary cities, notably San Fran, LAX airports. As I see today, on one hand, you've got Southwest breathing down your neck in the secondary markets, and you have the legacies in the primary markets, and I have been watching your schedule changes and you're sort of shifting back and forth, and -- I mean, can Alaska maintain a strong presence and relevance in both primary and secondary California markets and still achieve its return objectives? And I've sort of premised this with the fact that you have answered some of that in your prior question, but I do look at that as there are some areas where I suspect you may be struggling.

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

Mike, it's Brad. I think you're watching the schedule adjustments we make. What I would go back to is Alaska has a real competitive advantage that we believe in. We've got a great balance sheet, a great fleet, our people offer fantastic service, we've been able to run this thing in a way where we do have materially lower costs than the big guys and we translate that into lower fares. So we are big believers in the competitive advantage that Alaska has. You're right, we do fly into both secondary cities in California, and with the Virgin acquisition, more into SFO and LAX. I don't think we're going to say on this call what our plans are going to be in the future, but our idea in the future is going to be to grow the network consistent with our sense of where the opportunities are and consistent with our own sense of what our competitive advantage is. So maybe that's what we can share today.

Operator

Your next question is from the line of Duane Pfennigwerth with Evercore.

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

Can you talk a little bit more or expand on the underlying improvement you referred to in the last 30 days? Was that a state of California specific comment? And to what extent did you bake in that improvement into your 3Q revenue outlook?

Shane Tackett - *Alaska Airlines, Inc. - SVP of Revenue Management & e-commerce*

Duane, it's Shane Tackett. Thanks for the question. Yes, it's primarily been California that we've seen improvement in. That's primarily, and I think you've probably heard this from others on the closer-in fares that are sort of within 21 days of travel. Those have lapped some pretty low levels from last year and they're inching up, in fact, in a number of cases. Demand is super strong. There's lots of people flying still. So it's primarily been driven down in California, yes. And I mean, we're optimistic just about as we move through Q3 and Q4, not only what we're seeing in sort of the pricing environment stabilizing a little bit but all of the revenue initiatives and synergy capture that starts to turn on that Andrew alluded to in the script.

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

And then, just for my follow-up, the Saver Fare $100 million estimate, can you just remind us when that starts to turn on and how do you get to that estimate? And then maybe just more broadly, what are you seeing in terms of the basic economy fares in the marketplace? Is that where you've seen some of the improvement? Or are you still seeing sort of dilutive walk ups out there?

Shane Tackett - *Alaska Airlines, Inc. - SVP of Revenue Management & e-commerce*

Yes, thanks, Duane. I'll take the Saver question as well. And I would just remind folks, as Andrew mentioned in the script and we talked about last time, we actually had 5 or 6 different revenue initiatives that totaled $150 million. Saver is the biggest at $100 million. We are fully in development mode and build mode now. We expect this to be in market by Christmas of this year if not sooner. The way we got there is there's been sort of publicly discussed upsell rates out of what other folks' products are, basic economy into normal or standard main cabin tickets. Our expectation is to be a little less than that because we have a slightly more generous product and are slightly less reliant on business revenue network. But we're sort of basing that on what we know other take rates are. In terms of the basic upsell fares, they haven't really changed a lot in the past 6 to 12 months. There is sort of market-specific dynamics where they may move around a little bit, but they're pretty much in the range of $15 to $50 throughout the U.S. at this point.

Operator

Your next question is from the line of Savi Syth with Raymond James.

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

You mentioned this a little bit and I wonder if you can elaborate a little bit more on the transcon, and what you're doing there? One, what are you seeing today? And then, how quickly can we start to see kind of the benefits of these network optimization as you move some of the Boeing aircraft on to those routes?

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

Savi, we've actually already started that process. And as we do that, it's just simply put the Boeing equipment has a lot more seats, a lot more premium class seats and a lot more first-class seats into these frequencies. And as Shane mentioned too, on these longer-haul flights, these revenue initiatives that we're putting in place and they've already started, and especially, the strength in Premium Class, all of these initiatives really lend themselves strongly to these transcon flights. And so we expect good healthy improvement. And to Shane's earlier point, we are seeing strengthening in the close-in fare environment for these flights as well.

Benito Minicucci - *Alaska Air Group, Inc. - President & COO of Alaska Airlines Inc and CEO of Virgin America Inc*

And Andrew, I'm just going by memory. I think there's 200 flights transcon and Hawaii and about 70% of them by the fall will be on Boeing, correct?

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

Sounds about right, Ben.

Benito Minicucci - *Alaska Air Group, Inc. - President & COO of Alaska Airlines Inc and CEO of Virgin America Inc*

And that only increases from there.

Shane Tackett - *Alaska Airlines, Inc. - SVP of Revenue Management & e-commerce*

Yes. I think, Savi, just by January, we will be basically fully cross-fleeted and beginning at sort of full run rate value for that synergy.

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

All right, great. And then, if I may just follow-up on -- I know you mentioned kind of the softness in Hawaii. I know Cancun has been brought up a little bit more. Is there any kind of exposure on some of your international flying that you're doing? Or is it just too small to really show up?

Shane Tackett - *Alaska Airlines, Inc. - SVP of Revenue Management & e-commerce*

Thanks, Savi. I don't know that we mentioned softness in Hawaii, but Mexico...

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

The volcano.

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

Volcano, yes. That's -- I think that sort of stabilized itself. There was a bit of immediate -- when it was sort of on the national news every single day, there was some book away. But it's pretty much stabilized at this point. Mexico is good. It's a pretty small amount of our network today. So it doesn't have a major impact on results. There is some softness in Mexico Beach cities. I think you've heard other folks talking about that but nothing like materially concerning.

Operator

Our 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*

I kind of hate to ask a modeling question, but you mentioned sequential RASM improvement in Q3 and Q4 or tracking towards that outcome. And indeed, the midpoint of the succinct third quarter guide that you gave today does imply a sequential improvement from the $0.1281 that you achieved in the second quarter. So are you actually guiding to fourth quarter TRASM in cents per mile being above that of the third quarter? Because if that is the actual guide, I mean, that's quite healthy and nicely ahead of the usual seasonal change that one expects from Q3 to Q4?

Shane Tackett - *Alaska Airlines, Inc. - SVP of Revenue Management & e-commerce*

Jamie, this is Shane. I don't think we're prepared to give Q4 guidance today. I do think if you just sort of do the arithmetic of the revenue initiatives and if you look at a stabilized pricing environment as we lap all of the new market activity we had in Q3 and Q4 last year, it does set us up nicely for the fourth quarter.

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

I just want to make sure that I understood your prepared -- I think it was in the prepared remarks that you mentioned sequential RASM improvement in Q3 and Q4, is that correct? I'm not trying to pin you down, or saying it's a guide. I'm just trying to understand if I, perhaps, misunderstood your commentary as to sequential improvement.

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

It's Brandon. I think it's possible that you've misunderstood our succinct commentary. Our guide was more in the context of year-over-year improvement, which is what Andrew talked about in his prepared remarks, not the absolute value of TRASM from Q3 to Q4.

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

Got it. That's hugely helpful. And just as it relates to California, quick follow-up. And you've already given us some good granularity here. But we were seeing a lot more time channel pricing at your primary -- well, one of your primary competitors on the West Coast, you certainly won't hurt my feelings if you think that observation is irrelevant. But could you at least opine on whether you do think that it matters? And if it's something that you're seeing as well?

Shane Tackett - *Alaska Airlines, Inc. - SVP of Revenue Management & e-commerce*

Jim, I actually want to make I fully understand the question. West Coast time-based pricing?

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

Yes, time channel pricing. We're seeing a lot more -- well, I mean, it's not a state secret. We're seeing a lot more Southwest fares with very specific time channel rules as part of the fare base only available before 7:30 in the morning or only available on connections, nonstops after 10 pm, that kind of stuff. And I'm just trying to -- I'm not smart enough to say whether or not that matters, I think that it does. I'm just curious what the experts feel?

Shane Tackett - *Alaska Airlines, Inc. - SVP of Revenue Management & e-commerce*

Yes, so I just wanted to get the semantics right and make sure I knew what you're talking about. Yes, we've used time-banded prices for a long time here. I think they're a very, very normal revenue management tool in the industry. And I think that, in general, they make a lot of sense. And it's not surprising to me that others would adopt those at this point.

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

And when they do it, Shane, our basic deal would be to match in that time slot, not to try to grow the impact.

Shane Tackett - *Alaska Airlines, Inc. - SVP of Revenue Management & e-commerce*

Yes, we generally are very competitive on fares. And yes, we've used time banding to be competitive for a long time.

Operator

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

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

I just have 2 unrelated questions. The first is, do you guys focus on net promoter score? And if so, have you seen an improvement year-over-year since the merger? And my second question completely unrelated to that, you guys are a big part of cargo in the state of Alaska, especially the postal service. And obviously, there is some talk and we should hear in a week or 2 what the service levels of the USPS may be going forward. Is that something that you would see an opportunity in if postal service levels declined from 6 days a week to 3 or 4?

Benito Minicucci - *Alaska Air Group, Inc. - President & COO of Alaska Airlines Inc and CEO of Virgin America Inc*

Helane, it's Ben. Your first question on net promoter score, yes. The answer is yes. We do track net promoter score. We've got a great customer analytics team, and we have something called Alaska Listens, where we do ask the net promoter score. And what I'll say is we've seen just improved performance on our net promoter score as we're getting through this integration. It's very, very promising. We're actually making some refinements to that question to make sure that it's as pure of a net promoter score question as we can. And in other customer metrics, we're seeing those improve as well. So we feel very good about that. Maybe on the second question, some other folks can help me. What I can say is, we've got 3 freight airplanes that we just converted. There are 3 700s that are converted, and we're seeing a huge increase in revenues on our cargo airplanes as we're deploying them. I think we have some opportunity. This U.S. postal service recent events, I'm not too up to speed on that unless anybody else is, but I can tell you our current team is extremely motivated and will jump on any opportunity to make sure that we capture as much revenue as possible.

Shane Tackett - *Alaska Airlines, Inc. - SVP of Revenue Management & e-commerce*

One thing I might just point out, Helane, in the state Alaska, mail does work a little bit differently. We actually carry USPS mail on a bypass basis. I won't get into the technical vagaries of it, but we carry it on a daily basis on their behalf and it is a little different setup up there.

Operator

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

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

Brandon, I just want to make this totally clear. Does your 2% ASM growth preclude you from keeping CASMex flat to down? It sounds like there's a lot of moving parts, and I respect there's a budgeting process. But if you could just say yes or no, is that still in play for 2019?

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

Good morning, Hunter. We tried to address this in our prepared remarks. We have an extremely aggressive focus on cost. I will say that. It is difficult with 2% ASM growth to see a path to flat to down CASM, but that does not mean that we're not going to work on it.

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

Okay, that's fair. Thank you for that. And then, I don't know, this is maybe for Shane. What do you know about these people redeeming points Shane? Are these people with small point balances that are just like flushing 20,000 points, like their last 20,000 points away and then not going to come back? Or are these Alaska loyalists that are just taking advantage of like a dislocation in some of the offerings and just taking advantage of some maybe temporarily low price points? I just want to make sure that we didn't buy a bunch of Virgin customers that are just going to abandon the new airline because their beloved Virgin is now gone, and they're just like flushing away their points. You know what I mean?

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

Hunter, this is Andrew. I might take this on. I've been expecting this question. Take it up to the 50,000-foot level here. At the end of the day, what happened here is that, as you know, we have a very generous loyalty program. The problem was we were just way too generous post PSS. There's a couple of key drivers to that. Firstly, we just weren't step up correctly with our inventory. We were way too open, just to say it. Our lowest fare award redemptions were up 40% year-over-year. So we're all about generosity, but we had the inventory misaligned with the demand. The PSS transition happened right in the peak summer booking window, and then we board on all of these airbus that we underestimated how that was going to be, and then, of course, our good partner, American Airlines, had full access to our network as well. So when you combine all of those things together, that was the huge spike in demand. It was by our regular loyal members. Business as usual, we even saw some of it up in the Pacific Northwest because of our inventory challenges. So this was a one-time thing. There's about 150 basis points of drag this quarter, it'll be the same next quarter. And we've just made adjustments to bring the generosity back to our standard levels. This was a miss on our part. But it's behind us now, and we feel good going forward. So that's what happened with loyalty.

Operator

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

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

So non-fuel costs are likely up somewhat next year, but you were pretty clear you're expecting margin expansion. So revenue up even more, I guess. To what extent has Intra-california impacted RASM at the system level? Is this 5% of the business impacting RASM by, say, 100 basis points, 200 basis points? And I guess, I'm just trying to get a little bit of a handle on the source of sequential improvement as we head into the back half of the year and into next?

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

Yes, I'll take that. I mean, we obviously don't comment on specific market performance. Intra-cal is only 2.5% of our total capacity, just to put that into perspective. I think really, to your question, is what we are seeing is a sequential improvement in these new markets on a couple of levels across the system is volumes, and the volume is getting much stronger. And many of these markets too are on regional aircraft, and Shane and the team are getting much better and more sophisticated about how we sell both Premium Class and First Class in these areas. So I think bigger picture, really the story here is the pricing in general in California across the board. And as Shane mentioned and we had mentioned in our prepared remarks, we're seeing good positive changes, especially in the close-in booking windows in those fares. So that's really what's going on.

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

I see, okay.

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

Dan, it's Brandon, just one other thought. In your lead in, you had a couple of important points. One is, we have a margin improvement plan for 2019 - that's absolutely correct. The second is as you almost threw up the white flag on costs being up a couple of points or whatever you said, and I don't know that, that's fair. We haven't given any guidance yet for 2019 costs, and I don't want to just accept that as a given.

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

I thank you for that clarification. That's helpful. Another question here, just Hawaii becoming the bigger competitive dynamic. That's likely to persist into next year. So as we think about margin expansion, it seems to me there must be some confidence that you could execute on that even with some competitive challenges that are likely to persist. Is that a fair characterization?

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

You know, I think specifically, Dan, in relation to Hawaii, what we feel really good about and you've seen us made adjustments in the fourth quarter across the Pacific Northwest and California and our frequencies. But more importantly, the changes that we've been talking about, the Premium Class, the Saver Fares, the change fees and all of these revenue enhancements, Hawaii will be a very strong recipient of these increases in yields and improvement in profitability. So we feel really good about our Hawaii network, the strength of it, and the revenue initiatives we're putting in place, as well as the cost reductions will all go directly to the Hawaii franchise.

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

And competition is what makes this country and this industry great. But we have seen assignments in Hawaii. We have Premium Class, First class, as Andrew mentioned, we have fantastic on-board food and beverage service. And we have fares that frankly are about as low as anybody else's. So we actually think we're set up nicely for Hawaii in '19 and '20.

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

Thanks for that color. And I'll just really squeeze one last housecleaning, this is quick here. Ben, what are the primary metrics behind the productivity targets, and I guess, if you're using full-time equivalents per aircraft, where are you at today What does it look like in 2019?

Benito Minicucci - *Alaska Air Group, Inc. - President & COO of Alaska Airlines Inc and CEO of Virgin America Inc*

So, a great question. First, every division has a specific metrics, so it depends. I would say for pilots and flight attendants, we track hard time. So we will set a target, for example, at 69% hard time for pilots and 74% hard time for flight attendants. For mechanics, it's mechanics to airplanes. For customer service agents, it's the number of agents per departure. And then, it all rolls up, as you see, a number that we publish that is the number of passengers per FTE...

So what we do is we just get granular with every division to make sure that productivity is at peak level, and then it rolls up to an overall number that you see.

Lavanya Sareen

And then the number we really manage to is at the division level, like Ben said, and it obviously gets way more granular than that on hard time and soft time, and that's what we focus on, on a daily basis to drive the business.

Benito Minicucci - *Alaska Air Group, Inc. - President & COO of Alaska Airlines Inc and CEO of Virgin America Inc*

And Dan, it could be like training and how many people are on a company business and union business and all those sorts of things.

Operator

Your next question is from the line of Joseph DeNardi with Stifel, Nicolaus.

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

Just a follow-up on Hunter's question, he is slowly becoming the loyalty program expert here. Andrew, is it fair to say that come in a standard environment that you're indifferent from a PRASM standpoint, whether you sell a seat with miles or dollars?

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

I would say, in short, no, we're not indifferent. I think we're trying to balance 2 very important economic drivers of our business. One is obviously selling revenue tickets and the other one is to continue to grow the loyalty program, which is also generating significant economics through both the card and buying passengers. I think the industry right now is basically indifferent. I would say, we are not at that place. Although we are continuing to work on how indifferent we do plan to be as it relates to loyalty going forward. So we think we have the best of both worlds right now.

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

Okay. And then, when you think about going from a 4% to 2%, and I think you talked a little bit about this but maybe a little bit more detail would be helpful, like, where did those 2 points come out of? And is the market like Hawaii where there's clearly going to be a decent amount of capacity next year. Is that somewhere where you could reduce and fund capacity elsewhere? Just how should we think about that?

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

The easiest way to think about 2019 capacity at 2%, it's essentially everything we've announced and started this year continues on to next year. So to the extent we announced any new markets or changes, that just means to your point will be pulling down other areas of our network and reallocating it. But essentially, this is just this year's run rate going forward.

Operator

Your next question is from the line of Brandon Oglenski with Barclays.

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

So Brad, I mean, I guess, if we could do the postmodern here and, I guess, this kind of coming off Hunter's question too but maybe in a different way. Is it just proving to be more difficult for some of the bigger California markets to be a #2 or #3 player and you're just not getting the returns or the, let's say, revenue or recognition you would have thought you'd get from the customer base there as you've increased your presence?

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

No. Thanks, Brandon, good question. I don't think that's the case. I'll just say having been here a long time now, on some of these markets -- we've worked a long, long time to develop a loyalty position and a market share that we have developed. And then when you have that position, it's an incredible loyalty and economic driver for your business. So I don't think it would've been right for any of us to sort of expect overnight material shifts in market share, where you're holding industry standard RASM or anything like and that wasn't our expectation. I do think what's happening is as we've moved into a lot of these markets, there has been elevated competition in some of that. We brought on new flying ourselves, and we did it at a time when fuel prices were rising a lot. And that's one of the things we're trying to talk about now. So I think the combination of us putting new flying in, our competitors putting new flying in, fuel prices coming up, where we're trying to recover higher fares in that environment, it's been tough. --But tough is what we do. This is the airline business. So I think as we look at this now, you've seen over the last couple of calls, we've made downward adjustments to our own capacity, and we're just continuing to make the most intelligent network decisions that we can make. But I think California is a great marketplace, great business, great economy there. It's very natural, we've been in California for 40 years, it's very natural for us to have a bigger presence there. We're very optimistic about how we're going to do there over the mid-term. But this is what we're working through right now.

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

Okay. And to the extent that you're willing to share, I mean, nothing internally is suggesting that there was a niche brand following at Virgin and that's eroding or did erode. That doesn't seem to be the issue?

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

I don't think so.

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

Okay, everybody, thank you very much for tuning in today. We really appreciate your interest in Alaska, and we look forward to talking with you all again in 3 months' time. Thank you.

Operator

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