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# EDITED TRANSCRIPT

ALK - Q2 2014 Alaska Air Group Inc Earnings Call

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**OVERVIEW:**

Co. reported 2Q14 YoverY total revenue growth of 9% and adjusted net income of $157m or $1.13 per share.





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## CORPORATE PARTICIPANTS

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**Chris Berry** *Alaska Air Group, Inc. - Controller*

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## PRESENTATION

**Operator**

Good morning. My name is Stephanie and I will be your conference operator today. At this time, I would like to welcome, everyone, to the Alaska Air Group second quarter 2014 earnings conference call. Today's call is being recorded and will be accessible for future replay at www.AlaskaAir.com. (Operator Instructions) I would now like to turn the call over to Alaska Air Group's Executive Vice President and Chief Financial Officer, Brandon Pederson.

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

Good morning, everybody. Before we dig into the earnings call today, I want to quickly introduce Lavanya Sareen, our new Managing Director of Investor Relations. Lavanya brings a wealth of airline industry experience to Alaska Air Group and we're excited to welcome him into the Air Group family. Chris Berry is now our Controller and is with us today, so you'll continue to hear from him as well. Over to you, Lavanya.

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

Thanks, Brandon. Good morning, everyone. Thank you for joining us for Alaska Air Group's second quarter 2014 earnings call. I'm excited to be a part of the Alaska team and I'm looking forward to working with all of you. Starting this quarter, we're making a slight change to our earnings call format. In addition to hearing from Brad Tilden and Brandon Pederson, you will also hear from Andrew Harrison, our Senior VP of Planning and Revenue Management.

Several members of our Senior Management team are also on hand to help answer your questions. As usual, today's comments will include forward-looking statements regarding our future expectations, which may differ significantly from actual results. Information on risk factors that could affect our business can be found in our SEC filings available on our website.

We will refer often to certain non-GAAP financial measures, such as adjusted earnings or unit costs excluding fuel. We've provided a reconciliation between the most directly comparable GAAP and non-GAAP measures in our earnings release. This morning, Alaska Air Group reported a second quarter GAAP profit of $165 million, excluding the impact of mark-to-market adjustments related to our fuel hedge portfolio.

Air Group reported an adjusted net income of $157 million or $1.13 per share, an increase of 53% over last year's $0.74 per share. This compares to a first call mean estimate of $1.11. Additional information about cost expectations, capacity plans, fuel hedging, capital expenditures, and other items can be found in our investor update included in our Form 8-K issued this morning and available on our website at AlaskaAir.com. With that, I'll turn the call over to Brad.

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

Thanks, Lavanya, and good morning, everyone. We're pleased to report a record second quarter adjusted profit of $157 million, a 50% increase from the second quarter of last year. Our pretax margin expanded by almost 500 basis points to 18.3%, while our 12-month trailing ROIC grew by 300 basis points to 16.1%. We generated $285 million of free cash flow this year and in May, we announced a new $650 million share repurchase program.

To further increase returns for shareholders, we were proud to initiate a dividend one year ago and to have increased this dividend this past February. Our folks on the front line continue to run an excellent operation. 88% of our mainline flights arrived on time in the second quarter. We had the highest percentage of on-time flights among the eight largest carriers for the first five months of this year.

On-time performance is one of the biggest drivers of customer satisfaction, which in turn drives customer preference. Our 13,000 employees work hard every day to get our customers safely to their destinations on time and with their bags. We strive to provide a more personal experience in the process. In May, these efforts were recognized when we won JD Power's award for Highest in Customer Satisfaction Among Traditional Network Carriers for the seventh year in a row.

We could not be more proud of our people for this extraordinary accomplishment. Total revenue was up 9% for the quarter, while passenger revenue grew 8%. Revenues were favorably impacted by a strong yield environment and by the three ancillary revenue initiatives we announced last year. The revised agreement with Bank of America, our credit card partner, the revisions to our bag and change fee policies, and the seat retrofit program, which will add six seats to our 737-800s and nine seats to our 900s.

We've installed the new seats on approximately 40% of our 800s and 900s and we expect to complete the fleet of 94 aircraft by year-end. As you might recall, our new Recaro seats have 110-volt and USB power at every seat and the customer feedback has been great. Customer convenience and operational benefits were also the basis for our recent decision to be the launch customer for Boeing's new larger Space Bins.

We know that customer anxiety about carry-on bags is a major source of frustration in the boarding area. We believe this innovative bin design will ease the hassle of boarding with little or no impact on bag fee revenues. Our team has executed very well this year and that builds upon strong performance in the last several years, but we are keenly aware of the new capacity in Seattle.

To ensure that we maintain our strong position here, we recently announced an 11% increase in our Seattle departures, effective next spring. In addition to these network changes, we have a series of other initiatives related to our customers, our employees, our loyalty program, and our community involvement. We will continue to evolve our plans as the landscape around us changes.

With the continued commitment of our people across the system, we expect to deliver another year of exceptional financial and operational performance in 2014. The question we hear most often from investors these days is about the new flying in Seattle and how we'll respond and whether this will be a good or bad thing for Alaska. Here's our response to this question: our focus is on doing the right thing for investors and for all of our constituents over the long-term.

We've demonstrated this focus over many years now, with our commitment to running a good, safe operation and our commitment to providing outset outstanding customer service and our commitment to reducing costs and giving our customers the benefit of those low costs through lower fares and with our commitment to getting capacity right and basing our capacity on the natural underlying demand in the marketplace, and finally, with our commitment to providing returns on invested capital.

I'll note that we made this commitment at a time when this notion was not discussed or taken seriously in our industry. Competition is part of doing business in America and we believe that competition has made and will continue to make Alaska a better and stronger company. Our strategy to date has been based on executing in the areas I just mentioned and on running the business in a balanced way that works for customers, employees, and owners. We don't intend to change the strategy.

We are making some tactical network changes, as we've done many times before, to preserve and enhance the long-term value of this incredible franchise, but we're not going to take the eye off the ball in other areas like customer service or low costs or returns for investors. We're confident that this is the best approach for all of our constituents and we are fully focused on its execution. I want to thank all of our employees, including a terrific leadership team, for the great work they do every day.

These operational and financial results directly reflect their dedication to our Company and our customers. With that, I'll now turn the call over to Andrew.

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**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

Thanks, Brad, and good morning, everybody. Passenger revenue was up 8% for the quarter on a 5.2% increase in capacity. PRASM was up 2.6% as a result of the strong underlying demand environment and maturing of markets we launched over the last 12 months and drove a 2.8% increase in yield. Total RASM increased by 4% and was helped by the new Affinity credit card contract and previously announced fees changes.

Ancillary revenue is up $23 million so far this year, or more than 9% on a per passenger basis, so we're on our way to meeting our estimated $50 million benefit of the fee changes implemented late last year. We've produced solid unit revenue gains, despite the 8% increase in competitive capacity and 5% increase in overall capacity in our markets. Competitive flying in Seattle increased 9% with nearly all of that growth coming from Delta's additions, offset slightly by modest pull downs from other carriers.

Delta will continue to grow in Seattle based on announced schedules. To put that growth in context, today, Delta's Seattle flying overlaps with 41% of our ASMs. We expect that to grow to 50% by next summer with roughly 30 more daily departures in overlapping markets. Despite the increasing competition, we will still have 55% of the domestic seats in Seattle versus our closest competitor, at 16%, at the end of this year.

Delta's growth in Seattle impacts us in two ways. The largest is the negative impact on unit revenues from the increased seats in the market that I just talked about. We've seen that for several quarters now and we'll continue to see it for the foreseeable future and as a result, we expect our unit revenue performance will lag the industry. The second is the decline in local and connecting codeshare revenue, which was about $16 million during the quarter. There is good news, however, on this front.

We were able to replace 90% of that lost revenue through our own distribution channels and generating higher codeshare and interline revenues from other airlines, including American and United. Overall, total codeshare and interline revenues were actually up $11 million or 6%. Some investors have asked about our own capacity increases at a time when a competitor is bringing new capacity into our markets.

It's a fair question and I wanted to offer some thoughts on that subject. Much of the capacity we're adding is in new markets such as Tampa or Baltimore, as well as in markets where we are already generating very strong returns. Although this flying may slightly dilute margins, it will be profit accretive and will represent a good long-term investment for us. Our second quarter results give us confidence we are on the right track.

Taken together as a group, the 46 new markets that we've started since 2010 generated a PRASM gain of 13% in the second quarter; that's well above our system unit revenue performance. We do, however, believe there are certain markets that now have or will have too much capacity. Despite the supply and demand imbalance, we are making some tactical schedule adjustments to increase our flying in some of these markets to defend our franchise.

This may have short-term impact, but we believe the water will find its level eventually and we're confident these are the right actions for us to ensure the long-term sustainability of our business and preserve our ability to generate appropriate returns for our owners. We're supporting our network actions with initiatives designed to build customer loyalty, improve on our already award-winning customer service, and to stimulate new demand.

For example, we're planning more aggressive advertising, some of which will include Seattle Seahawks quarterback, and our other CFO, Russell Wilson, and that we think will really resonate with our customers. We're also working on improvements to our food and wine offerings and making our mileage plan even stronger. Given the network changes I just described, we now expect our capacity to be up 8% in the third quarter and just above 10% in the fourth, bringing our full-year capacity growth to about 7%.

Looking ahead, we see continued strength in broad underlying demand and bookings for the summer are in line with our expectations. Advanced book load factor is flat for July, up 1.5 points in August, and 2.5 points for September. There are a lot of changes happening in the marketplace, but we remain focused on actively managing our network and revenues in response to the competitive environment, growing responsibly, and executing to our strengths.

We're confident that the changes we are making will yield positive results over the long run. With that, I'll turn the call over to Brandon.

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

Thanks, Andrew, and hello, everyone. Air Group's adjusted net profit improved by nearly 50% and earnings per share improved by 53%. Our trailing 12-month return on invested capital stands at 16.1%, up from 13% at the end of the second quarter of last year. On an adjusted pretax basis, we earned $252 million in the quarter; an increase of $82 million. The increase was driven by a $119 million increase in revenue offset by a $42 million increase in non-fuel expenses, flat economic fuel costs, and lower nonoperating expenses.

Pretax margin improved by 480 basis points to 18.3%. There are some noteworthy items that contributed to the margin expansion. First, we saw a $15 million swing in airport costs in Seattle. In Q2 of last year, we recorded retroactive rates imposed during lease negotiations with the Port of Seattle whereas we received a credit this year. Second, we recorded about $10 million in gains associated with a refund of fuel taxes and the sale of American stock received in our bankruptcy claim.

Even excluding these items, strong revenue growth, good cost control, and lower hedging costs drove 250 basis points of margin expansion. Andrew already touched on revenues, so let me provide you with some color on our cost performance. Consolidated CASM ex-fuel was up 0.6% on the 5.2% increase in capacity. We did have a tailwind from the year-over-year swing in Seattle airport costs I just mentioned and lower maintenance costs.

Those declines were offset by a $23 million or 9% increase in wages and benefits. About $8.5 million of the increase was due to the new pilot contract ratified last summer. Implied productivity as measured by passengers per FTE continues to be a great story for us. The 1.5% increase this quarter marks the 20th consecutive quarter of productivity improvement.

We're now handling 187 passengers for every FTE, a 36% improvement over where we were in 2004. We're able to make this kind of progress because of the commitment to high productivity and low costs by our front-line employees, our labor leaders, and our divisional Management and I'd like to thank them all for their efforts. Their commitment to keeping costs low is imperative in our effort to remain the preferred carrier in Seattle by offering low fares and ensuring our costs are lower than the larger network carriers.

We expect non-fuel unit costs to increase about 1% in the third quarter and decline about 3.5% in the fourth quarter, which would result in a modest cost reduction for the year, marking the fifth year in a row of cost reduction and the 12th year out of the last 13. Moving to fuel, economic price per gallon was $3.20, down 2.4% from last year, even though raw fuel prices were up $0.06 a gallon. The price was impacted by the tax refund I mentioned and lower hedging costs as we realized the benefits of the changes we've been making to our hedging program.

Our fuel burn on an ASM per gallon basis improved by 2.5% and will continue to get better as we phase out the 737 classics and take new 900 ERs. We're also well underway with the installation of split scimitar winglet on our airplanes, which should even further improve our fuel efficiency. Turning to the balance sheet, Fitch Ratings initiated coverage of Alaska Air Group with a BB minus rating, making Alaska Air Group and Southwest Airlines the only two companies in the US airline industry to be rated investment grade.

This important recognition validates the work we've been doing to position Air Group as a high quality industrial company. The Fitch Rating is also a testament to the work our people do every day to produce strong financial results. With the resulting cash flow, we've been able to materially improve our balance sheet. Our adjusted debt to cap was 81% at the end of 2008, it's 32% today. We're in a net cash position.

Total debt including leases is just over $1 billion. Our pensions are fully funded and we own 73 of our airplanes free and clear. Our balance sheet strength puts us in an excellent position to defend the franchise we've created here in the Pacific Northwest. We ended the quarter with $1.5 billion in cash and short-term investments. During the first six months of the year, we've generated $635 million of operating cash flow, a $43 million increase over the first half of last year, and $285 million of free cash flow.

We also financed three Q400s for total proceeds of $51 million. We recently completed short-term extensions of three 737-400s that were previously scheduled to be returned this year. This represents a very low risk way of bringing on some additional capacity to fund the network changes that Andrew talked about. We also purchased one new Q400 that will be delivered in 2015 and exercised options to acquire four Boeing 737-900ERs that will be delivered in 2016 and 2017.

Importantly, we maintain a great deal of fleet flexibility because more than 3/4 of our fleet is owned. With after-tax ROIC at 16%, well above our cost of capital, we believe investing in our business is a prudent thing to do, in order to create long-term value for our owners. We now expect full-year capital spending to be about $550 million, up very modestly from last quarter's estimate. During the first half of the year, we paid out $34 million in dividends.

We also repurchased 1.8 million shares of our common stock for $83 million. We completed our $250 million stock repurchase authorization and are now repurchasing shares under our $650 million program. We're in the market every day and so far, in July alone, we've repurchased an additional 550,000 shares for $27 million.

We're targeting total returns to shareholders of at least $350 million this year and when viewed as a percentage of either free cash flow or net income, Air Group's distributions will likely lead the industry, underscoring our long-term commitment to ensuring that our owners get an appropriate return. With that, we'd like to open it up to any questions that you might have.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Helane Becker, Cowen & Company.

**Helane Becker** - *Cowen Securities LLC - Analyst*

I noticed that the Port of Seattle said they were raising salaries for some of their employees at the airport January of, I think, 2015 and January of 2017 and then I also noticed that you guys are raising the salaries for your contract workers there. Can you just talk about the thought behind that? Is that included in the current guidance?

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

It's Ben Minicucci. Yes. We raised our vendor employees at Seattle, we're talking baggage handlers, cleaners, fuelers to $12 an hour, as well as wheelchair pushers with tips over $12 an hour. That added about $2 million to our cost basis and we just felt that it was the right thing for us to do as a Company. Joe, do you want --

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

It's Joe Sprague. Then, as you've seen, the port of Seattle, just this week actually, passed new regulation that will set a new minimum wage for aeronautical workers, as they're calling it at the airport. Based on the action taken, this won't have any sort of near-term financial impact on us and we're still assessing the full regulation, there's a couple other details in there that we're not thrilled with. But, as Ben said, we've already taken action that will affect the wages for our workers.

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**Helane Becker** - *Cowen Securities LLC - Analyst*

Okay. Thanks. I don't know if it's Ben or who answers this question, but just on the airport at Seattle all together, I think there's some construction planned and some other stuff going on with the terminals. Can you just talk about where you stand with respect to that program?

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

There's a few big projects, Helane. This is Ben. One, the Port of Seattle is going to be starting a project to create a better international facility to deal with Customs and Immigration. That is a very large project slated to start sometime next year. We are looking at expanding the north satellite where we operate to expanding the footprint at our gates as well. Those are two major projects. There's a host of other small projects, but those are the two basic ones that will give the airport more flexibility internationally and domestically, as well.

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

Helane, this is Brad. We're very excited about the north satellite expansion. That's a $400 million-plus project. It won't come online until 2018, 2019 something like that, but it'll be a beautiful space for Alaska's customers.

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**Helane Becker** - *Cowen Securities LLC - Analyst*

Okay. Great. Thanks very much.

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**Operator**

Hunter Keay, Wolfe Research.

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**Hunter Keay** - *Wolfe Research - Analyst*

As I look at your CASM ex-growth rate and then the capacity growth rate, which is now 10% in the fourth quarter, you're going into 2015, both of those metrics growing a lot. Why should I not think that 2015 you're going to see big percentage moves on both of those metrics again next year? I'm asking to help me think about capacity and CASM ex-fuel for 2015 is what I'm asking.

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

Hunter, it's Brandon. We haven't given guidance yet on 2015 capacity. On the cost guidance, you're right, we are growing 10% in the fourth quarter and we did guide to capacity being down slightly for the year. The implied Q4 is down about 3.5%.

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**Hunter Keay** - *Wolfe Research - Analyst*

Sure. But Brandon, there's no reason to think why that growth on the capacity side obviously is not going to annualize. You told me spring departures are going to be up 11%. It feels to me like 2015, on a capacity basis, should be more than 2014, unless you're planning on dramatic changes in the back half of next year. Is that fair?

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

Yes. It's probably fair. We haven't given specific guidance, as I said. But what I would say is, if you look back over the last couple of years, we've grown in the high-end of 4% to 8% strategic plan area. We're going to grow 7% this year, I think we grew 7% last year. All the while, we're generating superior returns. As we think about as we think about the capacity growth for next year, we do have long-term investor interests in mind, but we do want to do the right thing for the network and we think we have a lot of opportunity to grow.

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**Hunter Keay** - *Wolfe Research - Analyst*

Okay. Yes.

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

I think we will be more specific probably next quarter or before then on our growth for 2015, but I think investors should expect to see us leverage that growth in the form of lower unit costs. That's something we've done for 12 of the last 13 years, Brandon, or something like that and I would be very surprised if that didn't happen again in 2015.

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**Hunter Keay** - *Wolfe Research - Analyst*

All right. Helpful, Brad. Thank you. I know that the terms of this are tough to talk about, but can you help me think about the agreement with Delta? Maybe I'll just be specific with some of my questions. Do you have the flexibility to take Delta's code off your flights without warning or is there a limit to the number of flights that you have to have a codeshare on while this agreement is in existence? Can you give us an idea of when the partnership expires and any sort of flexibility you have to get out of it early?

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**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

Hunter, it's Andrew. Unfortunately or fortunately, I don't know, a lot of your questions are all really privity of contract, so the expiration of the agreement's not public. Minimum flights and all the rest of it, but I will tell is that under the agreement there is flexibility for both partners to do the things that they need to do, as it relates to code, to maximize the benefit to each carrier's network.

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

Hunter, it's Brad. I might jump on that question as well. There are a ton of considerations in these decisions in terms of who we align with and so forth. We get the interest from investors. It's probably not in our interest to go through the considerations publicly. What I would say is there's arguments for and against changing relationships with all of our partners. One reason people ask about Delta, one reason to stay with them is the revenue that we get from feeding their flights and from the incentive that us connecting with them, the incentive we have for them to not fly against us in our markets.

Another reason to stay there is it's conceivable that, at some point, that relationship could get back on track and we could take advantage of natural end-to-end connection opportunities. I get the questions, we'll probably get some of them on the call today. There's a lot of it that we can't talk about, but they're just trying to express that there are reasons for and against changing these relationships.

**Hunter Keay** - *Wolfe Research - Analyst*

Thanks a lot, guys.

**Operator**

Savi Syth, Raymond James.

**Savi Syth** - *Raymond James & Associates - Analyst*

On the capacity growth as you head into the fourth quarter, you've got pockets of seasonal trends, but it's seasonally weak. I was wondering if you could provide any color on, is it 10% across the board or should we be expecting some pressure as you add a lot of capacity in seasonally weaker periods?

**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

It's Andrew. Put that probably in perspective, firstly, for the full year, which is about 7% growth, only 2 points of that is for the core. The new markets are about 2.5 points and gauge is another 2.5 points, which is very efficient growth. If you look across today and even in the fourth quarter, as you mentioned, the highest growth is in midcontinent, mountain and transcon regions. A lot of that new flying and also some additional Hawaii as well, which is actually seasonally stronger for us in the winter.

**Savi Syth** - *Raymond James & Associates - Analyst*

Okay. That's helpful. I was under the understanding that 2014, 2015 was going to be a time that you were consolidating some of the new markets that you had and I understand that the picture has changed since then. As you look out, what's going to be the mix of new markets as a percentage of overall?

**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

What I can tell you, Savi, is that you've seen in previous releases where we've sort of been public about our growth next spring. A lot of the new markets and the growth in the flying is already out there in the schedules. At this point, we sit we will continue to look at new market opportunities, but I think as it stands today, you won't see a material increase in new markets by any stretch next year.

I think the point we were trying to make earlier, which we probably haven't talked about as much as I think I should have, which is even in the second quarter of this year, there are 46 new markets that we started since 2010. They are delivering unit revenues that are 5 times the growth than our systems, so our investment in new markets, which we will continue to do, are bearing strong fruit.

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**Savi Syth** - *Raymond James & Associates - Analyst*

Got it. All right. I think you mentioned that. Thanks again.

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**Operator**

John Godyn, Morgan Stanley.

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**John Godyn** - *Morgan Stanley - Analyst*

Andrew, I was hoping that you might offer or elaborate on what's happened on specific routes, without saying which routes specifically, that Delta's entered in the past. I was hoping that you could offer some backward-looking commentary just so that we have an understanding of how this is playing out as Delta keeps adding more capacity in the months to come. It can be difficult to understand that play-by-play by looking at the aggregate level results.

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**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

John, maybe I'll just focus on the second quarter. What I can tell you, the specific markets that were entered and have been entered in our system, we actually experienced positive unit revenue growth in those markets. However, it was obviously less than system average. Going forward, we're obviously in peak season here, going forward, I think it would be fair to say that as more and more of those additional seats come online, that will put pressure on our unit revenues and likely have us lagging the industry.

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**John Godyn** - *Morgan Stanley - Analyst*

Okay. Fair enough. Brandon, I was just hoping that you could talk about, outside of the leverage from capacity, what levers are there to reduce costs going forward? Just as we think about your long history of beating on costs as an offset to any kind of PRASM pressures that you might see?

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

Related to costs, you're right. We have a long history of reducing costs, 12 out of the last 13 years, as I said in my prepared remarks. As we think about going into 2015, leverage will be a big part of that, but it's not the only story. I think we have continued opportunity with productivity. One big thing that we don't talk a lot about is fuel costs, since we look at our fuel burn, our fuel efficiency, that will continue to improve. I do think that there are additional opportunities out there, whether through technology, whether through process, to improve productivity and continue to drive costs down in the future.

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

John, it's Ben from Operations. Just to give some context on productivity, we have a really strong track record of creating a structure of delivering strong productivity increases in terms of really setting hard goals for every division, labor group in terms of hitting productivity goals. It's not something we set willy-nilly. It's something that is very specific, its tracked every day, every week, every month. We have a mindset of delivering productivity through the operation, which is where your costs can really slip away from you if you don't have a good focus.

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

John, Brandon. One more comment on top of that, the operational folks have done an absolutely fantastic job managing the costs, but it's not just limited to the operation. I think if you look at what we've done on what I would call the overhead side of the business, we've also made changes to the pension plans which we'll continue to see benefit from and I think there is an opportunity to continue to drive medical costs down as we go forward in the future as well.

**John Godyn** - *Morgan Stanley - Analyst*

Great. Thanks, guys.

**Operator**

Joe DeNardi, Stifel.

**Joe DeNardi** - *Stifel Nicolaus - Analyst*

Andrew, on the codeshare side, how should we think about the opportunities to further expand the relationship with American and United? How much more room is there and how big of a piece of the strategy for dealing with Delta is that?

**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

I think many of you are familiar with our share of codeshare and American and Delta obviously being the largest. I think we've seen American's revenue as it relates to codeshare and interline grow 20% in the second quarter. With adjustments made by other carriers in the Pacific Northwest, our interline revenues have continued to increase. One thing I will tell you is that, especially for international carriers, interline revenues are heavily used. Overall, I see continued opportunity to continue to grow as codeshare revenues drop on certain carriers in some part of our network, we've seen an ability to recapture that revenue back through other distribution channels.

**Joe DeNardi** - *Stifel Nicolaus - Analyst*

Okay.

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

This is Brad. I think a part of the story that is sometimes missed, we shared some of this at investor day last year, but we've got roughly a $5 billion revenue base. I think our two big domestic interline partners are roughly $200 million a piece, so the vast majority of our revenue and the vast majority of the revenue that produced our second quarter results is not connecting revenue. It's good, local revenue or its revenue where Alaska's connecting to Alaska. That's where the big piece of the pie is in terms of our revenues and our profits.

**Joe DeNardi** - *Stifel Nicolaus - Analyst*

Okay. That makes sense. Andrew, on the advanced book factors that you guys provide, why do you provide that? How should I interpret that? You could read that a couple different ways. Demand is strong or you guys are being a little less aggressive on inventory management, so help me how I should interpret that.

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

It's Brandon. Maybe I'll take that one. We provide it because the investment community asks for it, generally. But you're absolutely right in terms of the overall equation, it's half the equation. It is just an indicator of what's happening in the marketplace, but it doesn't represent the full picture. You are correct.

**Joe DeNardi** - *Stifel Nicolaus - Analyst*

Okay. Thanks.

**Operator**

Jamie Baker, JPMorgan.

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

One nit here and I got to call you guys out on this. I've never been asked by clients about the forward book load factor, just for what that's worth. Not to take you guys to task, you have a fantastic track record for putting a very heavy emphasis on shareholders, but that really also should provide or include providing a spotlight on the earnings trajectory. The fact that you don't provide, at a bare minimum, a forward month RASM commentary just seems inconsistent with that overall shareholder focus. Are you willing to share with us a RASM or PRASM guide for the month of July?

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

It's Brandon. I'll take that. No. (laughter) The other thing I can tell you that is that effective immediately, we're going to take advance book load factors out of the investor update and think about you in the process. (laughter)

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

Oh, boy. Here comes the hate mail. (laughter)

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

Just back to the forward-looking guidance, the reason that we don't do that is that it reinforces a short-term view of the business. We tried to hit it several times in the prepared remarks, we have a much longer-term view of the business. We're trying to stay focused on the long-term, not the short-term. We find that giving month to month CASM projections really does feed the short-term view and we're trying not see world that way.

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

Look, I think that is absolutely fair and we've applauded American for shifting gears towards a pretax quarterly guide. Maybe that's something that you can at least consider, a pretax margin quarterly guide, maybe that's something you guys can consider down the road. You've consistently had a more seasonal network that most airlines in the US, at least longer-term. You've smoothed out the peaks and valleys in recent years, but your third quarter does remain one that consistently outearns the second quarter.

My question is whether, with all of these competitive capacity adds, what you're doing in Salt Lake and of course the 11% planned growth in Seattle, does this impact the earnings seasonality? I'm not trying to back into guidance here, but it seems that, from a network perspective, your results may begin to get a little bit more pronounced and ignoring 2014, looking towards 2015, perhaps you shift to being more of a second quarter earnings peak than a third quarter? Can you help us think about the seasonality and I realize this is somewhat similar to what Savi was getting at before.

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**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

I'll take a shot at that. A lot of the markets that we're adding are a mixture of both summer and winter; certainly Salt Lake City has both summer and winter. I do believe, for the near-term, our first and fourth quarter will continue to be on the lower end versus our second and our third quarter. I don't foresee any material changes in our seasonality going forward.

I think we've done a good job at doing big surgery on the first and the fourth quarter capacity. We will continue, to Ben's point, we will not hire pilots and buy airplanes to fly them for 10 weeks or 12 weeks or even 15 weeks if it's during the spring break. It's important for us to have a level, loaded schedule that produces good productivity so I think that's where you're going to see our mind continue to be.

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

Okay. All right. That's helpful. I appreciate it, everyone.

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

Thanks, Jamie. I might just recognize Andrew and his team. One of the things that I think this Company's done really well in the last several years is sort of take a different view of the fourth quarter and the first quarter. They have been much, much more aggressive with capacity, ensuring we get the right amount of capacity in a market given the demand. I think they've done great.

The third quarter thing, Jamie, I think, is just a tribute to our greater reliance on leisure traffic and it's been that way for a long, long time and I think that's why we peak in the third quarter. Good food for us to think about in terms of the way we guide you guys, so thank you for pushing us there.

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

Okay. Thanks a lot, everybody. I appreciate it.

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**Operator**

Michael Linenberg, Deutsche Bank.

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**Michael Linenberg** - *Deutsche Bank - Analyst*

Just with respect to your Fitch Rating and congrats on that, Brandon and the team, if you look at the high-grade market, I think it's probably 10 times, maybe even greater than the high-yield market. Just wondering, given where your cap structure is right now, are there any opportunities to potentially tap into that market and maybe borrow money at an attractive rate on an unsecured basis? Your thoughts on that, Brandon?

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

Mike, this is Mark Eliasen. I will just say that Fitch took a very extensive look at our Company when they came out with that rating and we are pleased that they affirmed what our creditors have been telling us for a long time and that is that we are investment grade. We definitely are considering non-secured financing going forward. We're looking at it.

We're trying to balance out the benefits of being unsecured, which is what most high-quality industrial companies do, versus the low cost benefits of being secured. We're trying to factor all that in, but it is part of one of the things that we will consider when we do financing in the future.

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

Mike, it's just great to have options and this just gives us one more option and the treasury team did an outstanding job working with Fitch to get that done.

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**Michael Linenberg** - *Deutsche Bank - Analyst*

My sense is that if you were to go to market, you'd probably find a much bigger appetite for your paper than maybe you realize, given maybe just the lack of alternatives at your level. When we hear about all the flights that are being added, obviously, you're adding some flights, Delta's adding flights. As I recall, for some reason, I thought that airport was somewhat gate-constrained. Where are all these flights being put? Are they hard stands? Are the jetways available? How is the airport facilitating all of the expansion?

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

Mike, it's Ben. Like a lot of airports, where you're constrained is at peak times of the day, so I would say there is a constraint in the 6:00 to 9:00 early morning hours and then in the evening from about 8:00 to 11:00 at night when all the aircraft come back, so there is a problem there. I think there is capacity in the shoulder periods in Seattle. I think that's why you're seeing the Port of Seattle actually take on some of these big construction projects to actually add some gates to provide some relief in the short term.

We're looking at ways to put regional aircraft in different places through this construction to get them off gates, so mainline jets can be on there, so you're right. But it is a peak issue like it is at a lot of airports.

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**Michael Linenberg** - *Deutsche Bank - Analyst*

Okay. Great. Thanks, Ben.

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**Operator**

Duane Pfenningwerth, Evercore.

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**Duane Pfennigwerth** - *Evercore Partners - Analyst*

Your tone on capacity growth and competitive response sounds a little different and I just want to see if something's actually changing here. Are you stepping up capacity growth on routes where you have overlap or is your tone more related to just caution about seasonality generally?

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**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

Duane, no. Basically, most of where we're stepping up is actually on new markets, as well as, you've heard, adding an extra row to something like 62, 800s and getting ERs in here that are 181 seats and retiring 144 seats. A lot of this capacity growth is across our entire footprint and so that's where you're seeing the tone. As far as core overlap competitive markets, these are very high frequency markets for us and in some cases, we might add a flight here or there but in the scheme of things, it's not material to the overall network.

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**Duane Pfennigwerth** - *Evercore Partners - Analyst*

Okay. So your additions are consistent with what they have been, they're not stepping up?

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**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

If you look at March going forward, I would say that, as we look forward and the strong industry revenue environment right now, there are places in our network where we do need to add capacity and that's what we're doing.

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**Duane Pfennigwerth** - *Evercore Partners - Analyst*

Okay. Just a little detail here on the non-op expense, which has been, I guess, actually positive year-to-date given some gains on equity investments, is your guidance for 3Q reflective of a true run rate or is there still some gain in that number? Thanks for taking the questions.

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**Chris Berry** - *Alaska Air Group, Inc. - Controller*

Duane, this is Chris. We do expect, in Q3, to have a little bit more gain on the sale of some securities. It's not exactly a run rate but we're getting much closer, because I think it does flip to an expense in Q3 where it has been a credit in the past couple of quarters. We do expect a little bit more from the sale of securities in Q3.

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

Duane, it's Brandon. In my head, I always think of it as being about a net expense of around $5 million.

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**Duane Pfennigwerth** - *Evercore Partners - Analyst*

Okay. Thank you very much.

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**Operator**

Glenn Engel, Bank of America Merrill Lynch.

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**Glenn Engel** - *BofA Merrill Lynch - Analyst*

For the markets of Alaska and Hawaii, it would seem to me that Alaska competition seems to be easing and that should be a relatively good guy. Seems like Hawaii, which has been a good guy for a while, competition is starting to pick up and may start being a bad guy. Any comments on that?

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**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

Glenn, it's Andrew. I think you've you characterized it well. What I would say is that overall capacity in the State of Alaska, given all the puts and takes, is about flat. In Hawaii, you've seen some additions by Hawaiian in certain California markets that put a little bit of pressure on the Hawaii market but overall, we see stability in both those regions.

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**Glenn Engel** - *BofA Merrill Lynch - Analyst*

Can you give us an update, Brad, on labor?

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

I might ask Ben Minicucci to do that.

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

On labor, we have long-term deals with all our labor groups, which we're very, very pleased with and very good relationships. The one that's open is with our flight attendants, they recently rejected a tentative agreement that we had put together. We're back in talks. We got back together in early July, very productive meetings. We know the issues that are out there and we're confident that we're making good progress and we're hopeful we'll get a deal by the end of the year.

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**Glenn Engel** - *BofA Merrill Lynch - Analyst*

Thank you very much.

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**Operator**

Dan McKenzie, Buckingham Research.

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**Dan McKenzie** - *Buckingham Research Group - Analyst*

Given the growth in capacity at Seattle, I wonder if you can provide some perspective on how the local demand drivers are evolving. Obviously, you've got some Fortune 500 companies that are growing nicely. Amazon, Starbucks.

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

Alaska.

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**Dan McKenzie** - *Buckingham Research Group - Analyst*

There you go. (laughter) I'm just wondering if there's any observations you can share with respect to say, perhaps, the growth in the local workforce, local incomes. Anything you can call out for us with respect to the key demand drivers there?

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

I do think, Dan, we're seeing real strength in Seattle. You mentioned a couple of the big ones. Amazon is just growing like crazy. I don't know how many tens of thousands of employees they have, but those are great high income jobs and lots of travel. The city is doing well. I think if you were to look at unemployment or real estate prices or what have you, the economy here is quite strong.

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**Dan McKenzie** - *Buckingham Research Group - Analyst*

Okay. Very good. Separately, you guys have obviously done a great job pulling the ancillary revenue levers here. The question is how you're thinking about the opportunities looking ahead. Is there a need to introduce more? Are there any that might be in the works today that perhaps you're not ready to talk about or is the business about right from where you sit at this point?

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**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

Dan, it's Andrew. You're right. The 10% increase per passenger is due to the bag and change fees. We are, as fast as we can, getting through this year without with our cabin investment where we will add seats to our aircraft. We're going to continue to look at our cabin and as the industry changes and evolves, about what other changes we can make. I will take this opportunity to mention, although I don't know if it's really ancillary per se, but we've made some changes to our pricing and our first-class cabin and just in the second quarter, we introduced what we call P fares, which is basically discounted first-class.

We are now able to better match demand and supply across day of week and season and we've already seen, just in June alone, actually in the second quarter, nearly $8 million of incremental revenue from our first class cabin, only on 52 nonstop markets, and we will roll more and more markets out. We're seeing good, healthy increases in both our first-class cabin paid and good stable load factors, so we're very excited about that.

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**Dan McKenzie** - *Buckingham Research Group - Analyst*

Terrific. Thanks, guys. Appreciate it.

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**Operator**

Hunter Keay, Wolfe Research.

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**Hunter Keay** - *Wolfe Research - Analyst*

On the buyback, you guys I think have the full $650 million remaining? Is that right basically or close to it?

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

We basically started buying under the $650 million program right at the start of the quarter. As I said, we've bought about $27 million so far in July, so that would be $623 million roughly.

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**Hunter Keay** - *Wolfe Research - Analyst*

My question then, Brandon, is I don't think you guys have put a timeline on that. Did you announce this program with the assumption of the timing being directly tied to the Delta incursion? Is this what you're going to use to mitigate the impact to your shareholders as you expect -- if you ultimately expect to win the Seattle battle over time, which I know you do, when Delta starts to down gauge or reduce frequencies or thin out their Seattle service, is that when we should start to expect the buyback to decelerate? Is that why it's there and is that why you have not put a timeframe around it?

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

No, to answer your question directly. When we announced the buyback of $650 million in May, it was 10% of the market cap of the Company at the time, we did that because we thought it was the right thing to do. We've also been really clear that we're going to distribute at least $350 million to $400 million to shareholders this year and the reason that we didn't want to put a timeline on it is that we simply want to do a little Plan, Do, Check, Act here.

We want to do what's right for investors this year. We want to assess the market as we go into the fall and then winter and then spring and continue on at a rate that makes sense for us. I don't think that there's any direct tie between the buyback and when we use it and what happens on the competitive front. I think it's more about when we look at our cash balance, what's the right amount to distribute to shareholders at that given time.

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

Hunter, you know the math. We're making $800 million or $900 million of cash flow from operations a year and spending a little over $500 million on airplanes. We've got $300 million or $400 million that we have to do something with and I think that's driving our actions as much as anything.

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

Yes. With our leverage basically where we want it and our balance sheet improvement program, that we've been at since 2009, fully complete, the opportunity for us to distribute cash is significant.

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**Hunter Keay** - *Wolfe Research - Analyst*

Yes. The bulk case for Alaska right now is very difficult. It's very difficult and you guys are being very transparent about the issue that you're facing. I think a lot of people appreciate that. But the one thing that I think people can point to is the fact that you're going to be supporting your stock with a buyback and know it's going to happen. To that end, how much flexibility do you have in the buyback? How much is in the grid versus how much can you guys go in and just deploy if your stock is underperforming when you're not blacked out?

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

We have a great deal of flexibility and we may very well going to the market. We have done that in the past and we may continue to do so in the future.

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**Hunter Keay** - *Wolfe Research - Analyst*

Thanks a lot, guys.

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**Operator**

Savi Syth, Raymond James.

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**Savi Syth** - *Raymond James & Associates - Analyst*

I know there was the revenue contributions this quarter. Just wondering if you can give us an idea of maybe how the core revenue is performing outside of maybe the credit card contributions and maybe even some of the, I think it's a little harder to take out the fee increases, but generally, where the core revenue performance has been?

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**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

Savi, I think the easiest and the cleanest way to look at that is the difference between PRASM and RASM. You can see that our PRASM, again, for the network solid, 2.7% or something off the top of my head, but I think RASM was like 4%. I think that's where you see the difference in the bag fees and the change fees and other ancillary revenues.

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**Savi Syth** - *Raymond James & Associates - Analyst*

Got it.

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**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

Just about 1 point or so additional from other revenues.

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**Savi Syth** - *Raymond James & Associates - Analyst*

Understood. Could you remind us like when the headwinds from Hawaii anniversary?

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**Andrew Harrison** - *Alaska Air Group, Inc. - SVP, Planning & Revenue Management*

I think big picture on Hawaii, the last few quarters now, Savi, we've basically been flat, give or take capacity, and the industry is basically settled down, other than a few changes that we've noted from California. I think on a year-over-year basis, everything is now settled.

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**Savi Syth** - *Raymond James & Associates - Analyst*

Understood. All right. Very helpful. Thank you.

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**Operator**

I'm showing that we have no further questions at this time. I turn the call back over to Brad Tilden.

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

Thanks very much, everybody. We look forward to talking with you next quarter.

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**Operator**

Thank you for participating in today's conference call. This call will be available for replay beginning at 11:30 AM Eastern Time today through 11:59 PM Eastern Time on August 24, 2014. The conference ID number for the replay is 70977410. The number to dial for the replay is 1-855-859-2056 or 1-404-537-3406. Also, the call will be accessible for future playback at www.AlaskaAir.com. You may now disconnect.

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