Southwest Airlines is a low-fare, low-cost airline based in Dallas. It has nearly 50,000 employees, and currently serves 96 destinations in the U.S. and seven other countries. Its fleet is comprised mainly of Boeing 737s. LUV has approximately 700 aircraft, making it the world’s largest operator of this single-aisle aircraft. The company expects to grow the fleet by approximately 2% in 2016. Southwest has remained profitable for 43 consecutive years. It generated $19.8 billion in revenue in 2015.

**Analyst’s Notes**

**Analysis by David Coleman, April 26, 2016**

**ARGUS RATING: BUY**

- Reiterating BUY on well-managed airline
- On April 21, Southwest reported first-quarter results that benefited from low fuel prices. Adjusted earnings rose to $567 million or $0.88 per diluted share from $451 million or $0.66 per share in 1Q15. The operating margin was a robust 19.7%.
- In 2016, we expect the sale of boarding slots, improvements in the frequent-flier program, and a new credit card agreement with Chase to benefit revenue. We also look for lower fuel costs, a more profitable flight mix, and continued share repurchases to boost EPS.
- We are maintaining our 2016 EPS estimate of $4.32, which implies better than 20% growth from 2015. We are lowering our 2017 estimate from $5.00 to $4.73, which assumes continued strong traffic trends and moderately higher fuel prices next year.
- Our target price of $62 implies a multiple of 13.1-times our 2017 EPS estimate, and a potential total return of more than 32%, including the dividend.

**INVESTMENT THESIS**

Our rating on Southwest Airlines Co. (NYSE: LUV) is BUY with a target price of $62. Southwest is taking steps to increase revenue and lower costs, and management is focused on driving revenue and profits over both the short and long term. Management has been creative in generating additional sources of revenue, which adds to the top-line potential. The balance sheet is clean, and the company has an impressive record of returning capital to shareholders. The airline industry is notoriously risky, and the stocks tend to sell at discounts. We think the current discount on LUV shares is low, though, and see value at current prices around $47.

**RECENT DEVELOPMENTS**

LUV shares have outperformed over the past three months, rising 21% while the S&P has gained 12%. Over the past year, the shares have also outperformed, rising 10.3% versus a 0.7% gain for the index. The beta on LUV shares is 1.0.

**Market Data**

- **Price ($)**
- **Rating**
- **EPS ($)**
- **Revenue ($ in Bil.)**

**Key Statistics**

- **Financial Strength**
- **Price/Sales**
- **Market Overview**
- **Forecasted Growth**
- **Risk**

Please see important information about this report on page 5
On April 21, Southwest reported first-quarter earnings that topped the consensus estimate. Adjusted earnings rose to $567 million or $0.88 per diluted share from $451 million or $0.66 per diluted share in 1Q15. The consensus estimate was $0.84. Revenue grew 9.3% year-over-year, to $4.8 billion. The operating margin was a robust 19.7%.

Along with the 1Q results, management said that it expected to grow unit revenues, margins and earnings in 2016. Based on current trends, the company looks for second-quarter revenue per available seat mile (RASM) to be slightly up from 1Q15.

**EARNINGS & GROWTH ANALYSIS**

Southwest’s business model is straightforward. Drilling down into 1Q results, we note that passenger revenue was up 5.3% and freight revenues were down 4.5%. However, ‘other’ revenue, which represents just 8% of sales, rose a strong 101%. This boosted total operating revenue to $4.8 billion, up 9.2% from the prior-year period. The company also posted a 9.2% increase in available seat miles in 1Q.

On the expense side, total 1Q16 operating expenses rose 6.3% year-over-year, to $3.88 billion. Interest expense was $45 million, up from $25 million a year earlier. First-quarter economic fuel costs were $1.78 per gallon, down 11% from the prior year. Based on existing fuel derivative contracts and market prices, management expects economic fuel costs of $1.75-$1.80 per gallon in 2Q16, down from $2.02 in 2Q15.

The company ended the first quarter with 714 aircraft, which includes 7 new Boeing 737-8s and 13 pre-owned Boeing 737-7s. It also retired 10 Boeing 737 ’Classic’ jets. Southwest has moved up its plans to retire these jets to ‘no later than 3Q17.’ It previously expected to retire them in 2018. The Classic will be retired before the Boeing 737-8 enters service. CEO Gary Kelly noted that the accelerated retirement of the Classics would result in ‘fewer aircraft and lower available seat mile (capacity) growth in 2017 than previously planned.’

Management continues to plan for modest year-over-year fleet growth (no more than 2%) through 2018.

In 2016, we expect the sale of boarding slots, improvements in the frequent-flier program, and a new credit card agreement with Chase to benefit revenue. We also look for lower fuel costs, a more profitable flight mix, and continued share repurchases to boost EPS. We are maintaining our 2016 EPS estimate of $4.32, which implies better than 20% growth from 2015. We are lowering our 2017 estimate from $5.00 to $4.73, which assumes continued strong traffic trends along with moderately higher fuel prices next year.

**FINANCIAL STRENGTH & DIVIDEND**

Our financial strength rating for Southwest is Medium-High, the second-highest rank on our five-point scale. The company had $3.6 billion in cash and short-term investments as of the end of 1Q16. Total debt was $3.3 billion or 30.6% of total capital at the time.

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**Growth & Valuation Analysis**

<table>
<thead>
<tr>
<th>GROWTH ANALYSIS</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>12,577</td>
<td>16,546</td>
<td>17,181</td>
<td>17,781</td>
<td>18,885</td>
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<tr>
<td>COGS</td>
<td>5,618</td>
<td>8,506</td>
<td>8,633</td>
<td>8,111</td>
<td>7,217</td>
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<tr>
<td>Gross Profit</td>
<td>6,959</td>
<td>8,040</td>
<td>8,548</td>
<td>9,670</td>
<td>11,636</td>
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<tr>
<td>SG&amp;A</td>
<td>4,853</td>
<td>6,031</td>
<td>6,206</td>
<td>6,604</td>
<td>6,953</td>
</tr>
<tr>
<td>R&amp;D</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating Income</td>
<td>1,048</td>
<td>601</td>
<td>671</td>
<td>1,423</td>
<td>2,790</td>
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<tr>
<td>Interest Expense</td>
<td>141</td>
<td>168</td>
<td>108</td>
<td>103</td>
<td>101</td>
</tr>
<tr>
<td>Pretax Income</td>
<td>746</td>
<td>464</td>
<td>620</td>
<td>1,359</td>
<td>2,295</td>
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<tr>
<td>Income Taxes</td>
<td>293</td>
<td>193</td>
<td>238</td>
<td>512</td>
<td>858</td>
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<tr>
<td>Tax Rate (%)</td>
<td>45</td>
<td>39</td>
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<td>37</td>
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<tr>
<td>Net Income</td>
<td>453</td>
<td>271</td>
<td>382</td>
<td>847</td>
<td>1,437</td>
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<tr>
<td>Diluted Shares Outstanding</td>
<td>775</td>
<td>757</td>
<td>718</td>
<td>696</td>
<td>669</td>
</tr>
<tr>
<td>EPS</td>
<td>0.23</td>
<td>0.56</td>
<td>1.05</td>
<td>1.64</td>
<td>3.27</td>
</tr>
<tr>
<td>Dividend</td>
<td>0.02</td>
<td>0.03</td>
<td>0.13</td>
<td>0.22</td>
<td>0.28</td>
</tr>
</tbody>
</table>

**GROWTH RATES (%)**

| Revenue         | 29.4   | 9.1    | 3.6    | 5.1    | 6.5    |
| Operating Income| -29.9  | -10.1  | 105.1  | 74.1   | 85.0   |
| Net Income      | -61.2  | 136.5  | 79.1   | 50.7   | 92.0   |
| EPS             | -62.6  | 142.1  | 88.8   | 55.4   | 99.7   |
| Dividend        | -91.7  | 276.8  | 69.2   | 29.5   |        |
| Sustainable Growth Rate | 2.3 | 5.7    | 7.8    | 14.1   | 23.0   |

**VALUATION ANALYSIS**

| Price/High      | $13.59 | $10.61 | $19.00 | $43.19 | $51.34 |
| Price/Low       | $7.15  | $7.76  | $10.36 | $18.78 | $31.36 |
| Price/Sales: High-Low | 0.8 | 0.6 | 0.8 | 1.7 | 1.8 |
| P/E: High-Low   | 59.1   | 31.1   | 18.9   | 9.9    | 26.3   |
| Price/Cash Flow: High-Low | 8.3 | 4.4 | 3.9 | 2.8 | 5.7 |

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end of 1Q16. In our view, Southwest has a strong balance sheet relative to peers, as well as healthy cash flow and liquidity.

Net cash provided by operations in 1Q16 was $1.6 billion; capital expenditures were $438 billion; and assets constructed for others, net of reimbursements, were $1 million; this resulted in free cash flow of $1.2 billion. The company repaid $56 million in debt and capital lease obligations in 1Q16. It plans to repay $550 million in debt and capital lease obligations over the remainder of 2016.

Southwest has achieved impressive profitability. In the 12 months ended March 31, 2016, its ROIC was 33.4%, compared to 25.6% for the 12 months ended March 31, 2015.

The company buys back stock. Under its existing $1.5 billion share repurchase program, it repurchased $500 million of its stock in the first quarter.

Southwest pays an annualized dividend of $0.30 per share, for a yield of about 0.7%. Our dividend estimates are $0.33 for 2016 and $0.36 for 2017.

Southwest’s long-term debt is rated Baa1/positive by Moody’s, BBB/stable by Standard & Poor’s and BBB+/stable by Fitch.

**MANAGEMENT & RISKS**

Gary Kelly became CEO of Southwest in 2004 after serving as CFO for 15 years. Tammy Romo is the company’s EVP & CFO.

While earnings in the airline industry tend to be highly cyclical and volatile, we believe that airline stocks, which have historically been most appropriate for speculative investors, are entering a period in which they will benefit from solid financial results, driven by low oil prices, as well as from share repurchases. Favorable outcomes in labor negotiations and improved customer traffic also represent potential catalysts for airline stocks. At the same time, Southwest and its peers face ongoing risks from weather-related disruptions, accidents, and terrorist attacks. Southwest also faces tough competition from other low-cost carriers, as well as from major airlines that have slashed fares in recent years.

**COMPANY DESCRIPTION**

Southwest Airlines is a low-fare, low-cost airline based in Dallas. It has nearly 50,000 employees, and currently serves 96 destinations in the U.S. and seven other countries. Its fleet is comprised mainly of Boeing 737s. LUV has approximately 700 aircraft, making it the world’s largest operator of this single-aisle aircraft. The company expects to grow the fleet by approximately 2% in 2016. Southwest has remained profitable for 43 consecutive years. It generated $19.8 billion in revenue in 2015.

**VALUATION**

We believe that LUV shares are attractively valued at current prices near $47, in the upper half of their 52-week range of $31-$51. The stock is approaching its near-term high, in early December 2015, of more than $49 per share.

To value the stock on a fundamental basis, we use peer and historical multiple comparisons. LUV shares are trading at

**Peer & Industry Analysis**

The graphics in this section are designed to allow investors to compare LUV versus its industry peers, the broader sector, and the market as a whole, as defined by the Argus Universe of Coverage.

- The scatterplot shows how LUV stacks up versus its peers on two key characteristics: long-term growth and value. In general, companies in the lower left-hand corner are more value-oriented, while those in the upper right-hand corner are more growth-oriented.
- The table builds on the scatterplot by displaying more financial information.
- The bar charts on the right take the analysis two steps further, by broadening the comparison groups into the sector level and the market as a whole. This tool is designed to help investors understand how LUV might fit into or modify a diversified portfolio.

**Ticker** | **Company** | **Market Cap ($ in Millions)** | **5-year Growth Rate (%)** | **Current FY P/E** | **Net Margin (%)** | **1-year EPS Growth (%)** | **Argus Rating**
--- | --- | --- | --- | --- | --- | --- | ---
DAL | Delta Air Lines Inc (DE) | 33,896 | 20.0 | 6.2 | 11.6 | 17.2 | BUY
LUV | Southwest Airlines Co | 29,920 | 13.0 | 10.8 | 11.1 | 9.5 | BUY
JBLU | JetBlue Airways Corp | 6,560 | 13.0 | 8.4 | 10.6 | 2.5 | BUY

**Peer Average** | 23,459 | 15.3 | 8.5 | 11.1 | 9.7 |

**P/E**

<table>
<thead>
<tr>
<th></th>
<th>LUV vs. Market</th>
<th>LUV vs. Sector</th>
<th>More Value</th>
<th>More Growth</th>
</tr>
</thead>
</table>
**Price/Sales**

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<tr>
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<th>LUV vs. Market</th>
<th>LUV vs. Sector</th>
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<th>More Growth</th>
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</table>
**Price/Book**

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<th>LUV vs. Sector</th>
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<th>More Growth</th>
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**PEG**

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<th>More Growth</th>
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</table>
**5 Year Growth**

<table>
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<th>LUV vs. Sector</th>
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<th>More Growth</th>
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</thead>
</table>
**Debt/Capital**

<table>
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<th></th>
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<th>LUV vs. Sector</th>
<th>More Value</th>
<th>More Growth</th>
</tr>
</thead>
</table>
Analyst's Notes...Continued

11.0-times our 2016 EPS estimate, near the low end of the five year historical average range of 15.4-20.7 and below the peer average of 11.6. On a price/sales basis, they are trading at a multiple of 1.5, below the peer average of 1.7. The current dividend yield of 0.7% is at the high end of the five-year range of 0.1%-0.7%, and in line with the peer average. Low-fare carriers such as Southwest tend to trade at higher multiples than legacy carriers, reflecting their rapid growth and higher margins. As such, we believe that the shares have room to run at current prices. We are maintaining our target price of $62.

On April 26 at midday, BUY-rated LUV closed at $46.21, down $0.64.
About Argus

Argus Research, founded by Economist Harold Dorsey in 1934, has built a top-down, fundamental system that is used by Argus analysts. This six-point system includes Industry Analysis, Growth Analysis, Financial Strength Analysis, Management Assessment, Risk Analysis and Valuation Analysis.

Utilizing forecasts from Argus’ Economist, the Industry Analysis identifies industries expected to perform well over the next one-to-two years.

The Growth Analysis generates proprietary estimates for companies under coverage.

In the Financial Strength Analysis, analysts study ratios to understand profitability, liquidity and capital structure.

During the Management Assessment, analysts meet with and familiarize themselves with the processes of corporate management teams.

Quantitative trends and qualitative threats are assessed under the Risk Analysis.

And finally, Argus’ Valuation Analysis model integrates a historical ratio matrix, discounted cash flow modeling, and peer comparison.

THE ARGUS RESEARCH RATING SYSTEM

Argus uses three ratings for stocks: BUY, HOLD, and SELL. Stocks are rated relative to a benchmark, the S&P 500.

- A BUY-rated stock is expected to outperform the S&P 500 on a risk-adjusted basis over a 12-month period. To make this determination, Argus Analysts set target prices, use beta as the measure of risk, and compare expected risk-adjusted stock returns to the S&P 500 forecasts set by the Argus Market Strategist.
- A HOLD-rated stock is expected to perform in line with the S&P 500.
- A SELL-rated stock is expected to underperform the S&P 500.

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