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ALK - Q2 2016 Alaska Air Group Inc Earnings Call

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PRESENTATION

Operator

Good morning my name is Sally and I will be your conference operator today. At this time, I would like to welcome everyone to the Alaska Air Group second-quarter 2016 earnings conference call. Today's call is being recorded and will be accessible for future playback at www.AlaskaAir.com.

All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session for analysts and journalists. (Operator Instructions). Thank you. I would now like to turn the call over to Alaska Air Group's Managing Director of Investor Relations, Lavanya Sareen.

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

Thanks, Sally and good morning, everyone. Thank you for joining us for Alaska Air Group's second-quarter 2016 earnings call. On the call today are CEO, Brad Tilden, who will provide an overview of the business and share our progress on the proposed acquisition of Virgin America. Our Chief Commercial Officer, Andrew Harrison will share revenue results for the quarter followed by Brandon Pedersen, our CFO, who will discuss our financial results, capital allocation plans and outlook for the second half of 2016. Several members of our senior management team are also on hand to help answer your questions.

As a reminder, our comments today will include forward-looking statements regarding our future expectations, which may differ significantly from actual results. Information on risk factors that could affect our business can be found in our SEC filings. We will refer to certain non-GAAP financial measures such as adjusted earnings and unit costs, excluding fuel. We have provided a reconciliation between the most directly comparable GAAP and non-GAAP measures in our earnings release.

In addition, today's call may be deemed a solicitation in respect of Alaska Air Group's contemplated acquisition of Virgin America. The information discussed today is qualified in its entirety about Virgin America's definitive proxy statement that was filed with the SEC on June 20, along with other relevant solicitation materials, which are all available on Virgin America's investor relations page at ir.virginamerica.com.

And now that I have complied with our GC's request in completeness, we will move to the results. This morning, Alaska Air Group reported a second-quarter GAAP net profit of $260 million. Excluding the $6 million impact of mark-to-market adjustments related to our fuel hedge portfolio and a $9 million impact associated with merger-related costs, Air Group recorded a record adjusted net income of $263 million, up 14%.

Earnings per share grew by 20% to $2.12 per share. 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. Now I will turn the call over to Brad.

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

Thanks, Lavanya and good morning, everybody. As we progress through 2016 and look forward to the second half of the year, we know that investors have a lot on their minds and the equity markets certainly reflect that. As you know, we try to stay focused and concentrate our efforts here on building a fundamentally good business. As we look ahead, we feel very good about our underlying business and all of us here are very excited about the future.

The fundamentals of our business are strong. We are running a great airline and we believe the merger with Virgin America is going to create a very strong airline with reach across the entire country and with real strength in originating traffic up and down the West Coast.

I will start off today by talking about the underlying business and then share an update on the merger. First, we are operating safely and on time. Our ops folks are doing an outstanding job and I want to thank them. 88.7% of our flights arrived on time in the second quarter and we did this with much less block time than the average airline, which is a credit to how efficient and consistent we are on the ground. We expect this on-time performance will lead the six largest domestic airlines. We also completed 99.8% of our flights in the second quarter, canceling on average only one mainline flight per day.

Second, our employees are taking great care of our customers. We spend a lot of time with our front-line employees building alignment and talking with them about the sort of airline we want to be for our customers. We are seeing substantial evidence that these investments are paying off. Our customer satisfaction scores, which have been on a seven or eight-year run, continue to improve. In fact, our score for the second quarter was the highest second-quarter score ever.

And as you know, we also won our ninth consecutive J.D. Power award for customer service during the quarter. We earned the highest score of any airline included in the survey in each of the seven areas measured, including a move from fourth place to first place for in-flight service, which reflects investments we've made in food and beverage service, in-flight entertainment, seating, seat power and bins. This award is fantastic recognition for our employees and I want to congratulate them and thank them for everything they are doing to make Alaska stand out in the eyes of our customers.

Our model is based on building preference for our airline and we build this preference with on-time operations, fantastic customer service and of course low fares. This model has worked not only in the last couple of years, but in the last 15 to 20 years. Since the first quarter of 2010, we've launched 100 new markets and we've outpaced industry revenue growth by a factor of 3. This in the midst of one of the bigger competitive incursions this industry has seen in years. This growth would not have been possible without our mentality of continually reducing costs, which allows us to offer customers low fares while still maintaining industry-leading margins.

Brandon is going to share more detail in a moment on what the compounding effect of cost reductions since 2008 has meant to our financial performance. But to give you a sense of how powerful a low cost structure is, even if we adjusted our fuel prices to $2 a gallon, markets representing 97% of our revenue for the last 12 months would still be profitable and it's important to note that this is done with a full allocation of all costs.

This model is also delivering returns that are consistently in excess of our cost of capital. In fact, our trailing 12-month ROIC of 25.9% put us in the top 10% of all S&P 500 companies. Our successful growth shows that providing customers with a high-value experience and low fares is a winning formula, especially in the upper-end leisure and business segments, or what we call the leisure market. This is a great platform for our future. Combining our network, which has strength in the Pacific Northwest and Alaska, with Virgin America's strength in California, we will be a very strong airline with strength up and down the West Coast and of course we will have national reach.

For example, in the future, we will have 25 flights a day to New York City from 7 West Coast airports and 10 flights a day to Boston from 5 West Coast airports. We also see the increased choice and competition the merger will provide as fundamentally good for consumers.

Speaking of bringing the two companies together, I want to share a few thoughts around timing and the integration process. First, timing. We have an agreement in place with the Justice Department concerning the timing of their review and we are forecasting the close will occur in the fourth quarter. When the deal closes, Virgin America will operate as a subsidiary of Alaska Air Group until we achieve a single-operating certificate, which we expect in the first quarter of 2018.

We are committed to making this a very successful integration. During the post-close transition period, Ben will be the CEO of Virgin America in addition to his role as President and COO of Alaska Airlines. And Peter Hunt, who is currently Virgin America's CFO, will be its President and responsible for day-to-day operations. Ben and Peter are proven leaders who will do a great job leading Virgin America during this time. The integration management office is up and running and is being led by [Tork Zubek].

While there is a lot of functional work going on behind the scenes, I want to share a brief update with you on the key areas of culture, labor and brand. Starting with culture, we know that when mergers don't succeed, especially in our industry, often people, or in other words the culture, is the culprit. This is an area where we are spending a lot of time. Our high-level goal is simply to retain the best of Alaska Airlines and the best of Virgin America and position the new combined company to be aligned, to be bold and to grow successfully well into the future.

Moving to labor, we are meeting with labor leaders and having positive discussions. We appreciate all the work the labor relations team and our labor leaders are doing to make this a smooth integration and we are optimistic that the process will go well.

And finally, I know a lot of you are curious about the brand. And as we said before, the Alaska brand is staying. We're also doing in-depth market research to better understand the elements of Virgin America's product and brand that customers love most, especially in California. And we expect to have a final decision on the brand in early 2017.

To summarize, whether we are talking about Alaska as it stands today or the combined company post-merger, we are focused on the same bedrock principles. First, we want to be safe and on time. Second, we want to get the culture right and we want to build alignment with our people. Third, we want to protect and grow our customer base. Fourth, we want to maintain our low cost structure and low fares. And finally, we want to consistently generate the level of returns that you expect from high-quality industrial companies. With that, I will turn the call over to Andrew.

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Thanks, Brad and good morning, everyone. Total second-quarter revenue increased $57 million or 4%. This contrasts with the industry revenue shrinking by about 2%. Over the past five years, our revenues have grown 35%, outpacing the industry by 3 to 1. This growth has come with the strong returns that resemble high-quality companies.

Our second-quarter PRASM was down 7.7%. We were very pleased though that our unit revenue performance was within 150 basis points of the industry notwithstanding the fact that we grew capacity by 11% with competitive capacity growing 13%. We are also very pleased to see our load factors at 85%, which was flat for the first time since the first quarter of 2013.

That said, close-in pricing has been showing weakness for reasons you are already familiar with. While we are always mindful of the environment we operate in, the fundamentals of Alaska are sound for several reasons. First, we are offering a high-value product to customers at low fares. Our low fares are enabled by low cost and have allowed us to grow profitably. The 100 new markets Brad referenced earlier in aggregate are [running] margins at system-average levels and represent approximately 20% of our annual revenues.

I'm also pleased to announce that we just learned we've received approval for four additional flights to Newark. We plan to launch Portland and San Diego-Newark this November and then San Jose and a third Seattle-Newark in March and May respectively.

Secondly, when speaking of offering options to our customers, partnerships are key. Earlier in June, we launched a new mileage plan partnership with Japan Airlines making it the third international partner we've added in the last 12 months, Hainan and Iceland Air being the other two. That brings our total partners to 17 and allows us to serve over 950 destinations worldwide.

A combination of greater reach and targeted promotion has helped increase the number of our members flying on our international partners by 32%. And here is an interesting fact. Our international partners, along with American Airlines, on a combined basis account for 34% of all international seats into the US. That's more than any one of the global alliances. We expect the benefit of this offering to our customers to take a step change forward with our acquisition of Virgin America. This acquisition will result in us having a strong presence in the largest international West Coast gateways of Los Angeles and San Francisco.

And lastly, membership in our frequent flyer program is up 11%, and our credit card portfolio grew by 12%, both outpacing passenger growth in our network. Our loyalty program generated $200 million in cash for the second quarter. That's an increase of 16%. We expect this growth to continue given our card offering, which includes 30,000 bonus miles, annual companion tickets, free bags, no international transactions fees, and the lowest annual fees of any comparable airline card.

In addition, Costco, an iconic Pacific Northwest brand with a strong West Coast presence, moved to exclusive acceptance of Visa cards at its warehouses last month. It should come as no surprise that our customers also shop at Costco for its great products and prices. We have seen spend on our card increase significantly as a result.

Shifting our focus to the back half of the year, here are a few things to be mindful of. We expect competitive capacity in our markets to be up 13% in Q3 and 12% in Q4. That's about the same as we faced for more than a year and a half now. As others make post-summer trims to their schedules, competitive capacity has come down by 1 point in the third quarter and by 4 points for the fourth quarter since we last spoke to you in April.

Moving to Alaska's capacity, it will moderate significantly as we move through the rest of the year. Our capacity will be up about 8% in the third quarter and only 3% in the fourth quarter, which is a significant reduction from the 12% we grew during the first half of the year. Our full-year guidance sits at about 8.5%, which includes the Newark flight I just mentioned, as well as Cuba.

In summary, the fundamentals of our underlying business are strong. We are growing and diversifying revenues while continuing to build brand loyalty. We have confidence in our business model to continue to grow profitably and to earn strong returns for our owners. I am personally excited about speaking with you next quarter as we expect to have closed on Virgin America, which will begin the next chapter in our journey. And with that, I will turn the call over to Brandon.

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

Thanks, Andrew and good morning, everyone. It's a fabulous sunny morning here in Seattle and it's great to be speaking with you today. As Brad said, Air Group's adjusted net profit improved by 14% to $263 million and earnings per share improved by more than 20%. Our pre-tax margin was a strong 28.4%. It grew by 260 basis points and should be among the best in the domestic industry.

Trailing 12 ROIC grew by nearly 400 basis points to just under 26%. On an adjusted pretax basis, we earned $424 million, an increase of $54 million over the second quarter of last year. As Andrew said, revenues grew by 4% or $57 million, a result that we are happy with considering aggregate revenues across the S&P 500 are projected to shrink by 0.6 of 1% percent in the second quarter. Fuel costs declined by $56 million and non-fuel costs increased by about the same amount.

Our non-fuel unit cost performance in the quarter was really strong with unit costs declining by 3.7%. We did see a shift in some of the costs into the back half of the year, so our full-year guidance remains unchanged at this point. We continue to believe that our model of high productivity and low overhead is a winning combination to keep non-fuel costs in check.

Passengers per FTE, our broadest measure of productivity, improved by another 2.7% to 199, a new Q2 record for us. And it's working at the division level too. I want to give a shout out to our flight ops team. Pilot hard time this quarter was better than both budget and prior year.

We've been chipping away at our costs slowly each year going back to 2009 and in fact, even back to 2003 and sometimes it helps to go up to 41,000 feet to look at the progress we've made. Recently, our FP&A team did that and made a really important observation. If our ex-fuel unit costs had grown in line with the rest of the industry instead of the gradual decline we've seen each year since 2009, our pretax profit this year would be almost $800 million lower. That translates to about $4 a share or more than $4 billion of market cap at current multiples.

So while each individual year of a 0.5% or a 1% cost reduction doesn't sound like a lot, the cumulative effect is enormous. Looking forward, we will see the back side of that cost shift and currently expect ex-fuel costs to be up about 3% in Q3 and up about 0.5% in Q4, which keeps our full-year unit cost decline to about 0.5%, in line with prior guidance, as I said.

Cash flow from operations for the first half of the year was $900 million and we ended the June quarter with over $1.6 billion of cash on hand. Adjusted for leases, we have a net cash position of approximately $700 million and our debt to cap sits at 25%. Our balance sheet is in the best shape it's ever been and it positions us well for our planned merger with Virgin America in the fourth quarter.

Our treasury team has now obtained committed financing for the deal. Interest was very strong. We ended up oversubscribed and we were able to partner with a diverse set of leading aviation lenders. I want to thank our lenders for their partnership and support. We are finding that it's an excellent time to raise money, market rates are at historic lows and spreads for investment-grade secured loans are tight. Alaska's all-in interest rate will be low. I want to complement our treasury and legal teams for doing such a fabulous job in this process.

Air Group has built a reputation with both lenders and investors as a conservatively managed company with a strong balance sheet and that's not going to change. After we complete the transaction, we will still have about 20 unencumbered next-gen Boeing 737s and we are going to return to redeleveraging the balance sheet.

And speaking of fleet, we've taken delivery of 12 737-900ERs so far this year and have 7 additional 900-ERs coming in the back half of the year. As a reminder, many of these deliveries are replacements for older 737-400s.

During the quarter, we also exercised three options for E-175s for delivery in 2017. This is not new capital. Instead, we've chosen to buy them rather than lease them because we preferred the economics of owning.

We expect total CapEx for the year to be approximately $750 million, consistent with prior guidance. As a result of the three E-175 auctions I just talked about, our CapEx for 2017 ticks up slightly to just above $1 billion. And again, this is not new capital in our plan.

As a reminder, we have two big fleet initiatives in process -- full retirement of the 737-400s by the end of 2017, which will be good for reliability, passenger comfort and costs; and the introduction of 33 E-175s into the Horizon fleet, which will help us grow into longer, thinner markets where we believe we have significant opportunity to expand profitably.

So far this year, we've generated $559 million of free cash flow. We paused on the share repurchase program following the announcement of our planned merger, but continue to pay a meaningful dividend, which is currently yielding about 1.7%.

I agree with Andrew. Our business is humming along nicely and we are taking advantage of profitable growth opportunities. The resulting strong cash flow and our fortress balance sheet have positioned us well to complete the planned merger and set us up for long-term success. Everyone around the Company is working extra hard as we prepare to combine two great airlines and I want to thank our 15,000 employees for their efforts, and congratulate them once again on a record fabulous quarter. And with that, we would like to open it up to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Savi Syth, Raymond James.

Savi Syth - *Raymond James - Analyst*

I think Andrew mentioned that there is close-in fare weakness and I wonder if you could just elaborate on that a little bit, particularly maybe how it progressed through the quarter, or if there were certain regions that you saw greater weakness. And maybe along those lines, what the implications of your slowing capacity growth might be to maybe help offset those trends?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

I will start off and Shane may have something to add, but we are not experiencing anything materially different than the industry, Savi, but what I will tell you is that our close-in bookings from business volume is actually up. We still continue to see strong volume and demand closer in.

Big picture, I think the industry is in a place where there's been consolidation and there's new products like basic fares into the marketplace and I think there is just some adjustments going along. But as we've shared in our remarks, we feel very confident in how we are managing our revenues and building this business. Shane, do you have any comment there?

Shane Tackett - *Alaska Air Group, Inc. - VP, Revenue Management*

Maybe I would just add in terms of the progression, I think we started to see the close-in changes in pricing environment walk into the West Coast somewhere around March and they've just progressively made their way through the quarter, but nothing unexpected based on what we had seen going on in the industry elsewhere.

Savi Syth - *Raymond James - Analyst*

Thanks, Shane. And just a follow-up on that, so it progressed since March. Is it continuing to deteriorate, or is it just now that it's entered, it's just throughout?

Shane Tackett - *Alaska Air Group, Inc. - VP, Revenue Management*

More recently, it has felt more stable. It feels like we are at where we are going to be. I couldn't really -- I don't know what will happen in the near future, but nothing is getting worse recently. It's been here for the last month or two.

Savi Syth - *Raymond James - Analyst*

All right. Great. Thank you.

Operator

Joseph DeNardi, Stifel.

Joseph DeNardi - *Stifel Nicolaus - Analyst*

Andrew or Brandon, I'm wondering if you can just talk about capacity. You are going to be coming out of the year at a pretty low number. Does that continue into next year until the deliveries come in? In the release, you give fleet count at the end of 2018. What does it look like in 2017? Just any color on capacity plans for next year.

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

I will start with capacity and let Brandon touch on the fleet. You are right. In fact, the 3% in the fourth quarter, and I think if you look into the (technical difficulty) schedule into the first quarter, it's quite low. As I did share, we are going to have some very exciting opportunities with some Newark opportunities and Cuba. But we are going to be firming up, and as you know, we normally set our guidance for 2017 later in the year, and of course with the proposed Virgin America acquisition, we are going to be taking a long hard look at 2017 capacity. So for now, I would just say that keep focused on the next few quarters. 2017 will be much more information coming on that.

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

Joe, it's Brandon. Just to follow up on the fleet question, we will end this year with 153 airplanes on the mainline, as you see in the investor update. At the end of 2017, we will actually only have one more at 154 based on what we see right now. A big delivery year next year with 14 new 737-900s coming in. However, it's the year we finish returning all the 737-400s. So net growth of one. We will have some gauge growth that we can use for capacity growth, but on the fleet side, not much.

Joseph DeNardi - *Stifel Nicolaus - Analyst*

Okay. And then, Brandon, just on the dividend side, you've made it pretty clear that the buyback is probably going to slow, but you've been pretty good about growing the dividend. Do you see that as sustainable going forward even as the buyback comes down?

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

I do, yes. We've been saying for the last couple of years we want to be known as a company that pays a consistent and meaningful dividend, but also one that grows the dividend. I can't speak for the Board right now, but that would be our intent.

Joseph DeNardi - *Stifel Nicolaus - Analyst*

Okay. Thank you.

Operator

Rajeev Lalwani, Morgan Stanley.

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Rajeev Lalwani - *Morgan Stanley - Analyst*

Just given all the pressures we've seen out there with the airline stocks and pricing and macro, is it maybe causing you to take another look at Virgin and maybe you could just walk through the out that you have to the extent that the extremes out there do continue?

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

Rajeev, Thanks for the question. We continue to be super excited about Virgin America. If we take ourselves back up to 35,000 feet or 41,000 feet, I think this business is actually a better business than it was 5 or 10 years ago. We are very confident in our own company, our ability to do well with the assets we have.

As you know, we've got real strength in Alaska, fly to 35 states and 115 cities, but real strength of originating traffic in Alaska, Washington and Oregon. And then Virgin gives us California. So we try to not focus too much on the short term on what's happening with PRASM and more think about fundamentally what's going to happen in this industry over 5, 10, 15 years and all of us are just enormously excited about what we are going to do bringing these two great companies together. So that's where our head is.

Rajeev Lalwani - *Morgan Stanley - Analyst*

Okay. Thanks. And then a quick question for Andrew. Andrew, can you maybe provide on maybe a historical basis what the impact is to RASM to the extent that you have a move in capacity that's 5 points or 10 points. I'm just trying to figure out maybe how to think about pluses and minuses going forward just given that things are going to move a lot on the supply side.

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Yes, I think it's been some time since we've grown at this low a level, so I think you'd have to go back in history. But I think the other dynamic that's going on too is just the change in the competitive landscape. So I'm not sure history would be the best teller of the future. I think right now the lower growth is going to be a good move for us in the fourth quarter as we get ready and set our sights on 2017. That's the best I can give you.

Rajeev Lalwani - *Morgan Stanley - Analyst*

Okay. At least I tried.

Operator

Julie Yates, Credit Suisse.

Julie Yates - *Credit Suisse - Analyst*

First of all, I will ask a question on labor. At what point do you guys begin engaging the pilots for single contract negotiations and how long does that take in order -- do you need to get to a single contract to recognize any of the synergies that you guys have laid out?

Ben Minicucci - *Alaska Air Group, Inc. - President & COO*

Good morning, Julie. This is Ben Minicucci. Those discussions are ongoing as we speak, so we've engaged on our side, the Alaska side and the Virgin America negotiating team and it will probably be a 12-month process at the minimum before we get to some common labor agreements and common integrated seniority list. And, yes, once it's combined, we will be able to extract more synergy from that.

Julie Yates - *Credit Suisse - Analyst*

Okay, great. And then just a second one. You guys mentioned an agreement with the DOJ around the close for the fourth quarter. Is there any update following the second information request (technical difficulty) over the next data points to look for what will really be an approval decision?

Kyle Levine - *Alaska Air Group, Inc. - VP, Legal & General Counsel*

Hey, Julie. This is Kyle. We are making great progress with the second request and as we've said before, DOJ is looking really closely as we expected. We are still really confident that we can close in Q4 and what's going to come into focus for the Department, this is a great pro-consumer combination.

As you'd expect, some of the things they are looking at right now between now and the ultimate clearance date, if that does come, is that route overlaps, great story there. We have only seven route overlaps and of course they are really interested in our fare philosophies. That's a story we love to tell as a low-fare high-value airline. So all said and done, we are on track for a Q4 close and things are going well.

Julie Yates - *Credit Suisse - Analyst*

Great. Thanks so much.

Operator

Jamie Baker, JPMorgan.

Jamie Baker - *JPMorgan Chase - Analyst*

Brad, you spoke at the Wings Club about the potential for retaining the Virgin America brand as a separate entity. Today, it sounds more like you are studying which aspects of the brand you might want to retain. In the event that you were actually serious about the possibility of keeping it separate, could you identify any airline-within-an-airline construct anywhere in the world where margins approach those of Alaska Air Group?

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

Jamie, thank you for the question. We've actually thought about this quite a lot. I think we are not going to say a lot more at this point about this consideration. I will just tell you what we are doing is we are looking at a lot of data. We have built clean teams with Virgin and Alaska. We are looking at what's attractive in California to customers about the Virgin America offering. We are just trying to think about what might be best for our Company going forward, and I just think the best thing for the owners of this Company might be for us to do this work in quiet, quietly. And then when we have something to say -- I don't think it's going to be all that long. What we've said is first quarter 2017. When we actually have a viewpoint, when we have a perspective on this, we will share it. So sorry to not give you a better -- more information, but I just think that might be best for all involved right now.

Jamie Baker - *JPMorgan Chase - Analyst*

Yes, okay, okay. I will give you a chance to make it up to me on my second question then. We will see if I get lucky. I know that on paper the merger raises very few regulatory red flags, but I still can't escape this nagging feeling that DOJ may prove susceptible to its own emotions when it comes to the subject of airline M&A. In the event that the DOJ does move to block or tries to extract some sort of concessions, do you walk or do you fight?

Kyle Levine - *Alaska Air Group, Inc. - VP, Legal & General Counsel*

I guess I would say neither. We entered this contract expecting to enter a long marriage with Virgin America and our position really wouldn't change even if DOJ challenges or acquires some divestiture, which, by the way, just looking at precedent, I think that's highly unlikely. Obviously, I can't speak for the department, but again we are talking about a pro-consumer situation where there are seven overlap routes, none touching a slot-constrained airport.

Jamie Baker - *JPMorgan Chase - Analyst*

Yes, I definitely agree with everything on paper. It's just -- it's maybe having been here before that led me to ask the question, but I definitely appreciate the 1.5 answers that I got today. I will pass it on to the next guy. Thanks so much, guys.

Operator

Helane Becker, Cowen and Company.

Helane Becker - *Cowen and Company - Analyst*

Thank you for the time here. My first question is can you share what the interest rate is on the deal financing?

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

Helane, this is Mark. What we can tell you is obviously we won't know the exact rate until we close. What we can say is that margins are very tight and you know that market rates are down, and as Brandon said, at historic low levels. So what I can say is we will be comfortably below 3% and that's about all the guidance I can give you right now.

Helane Becker - *Cowen and Company - Analyst*

Okay. That's helpful. Thank you. And then my other question is actually on the income statement and the operating expense line. And maybe, Brandon, this might be for you. Given that you've turned over the fleet, why is your maintenance -- started to require order aircraft -- why is the maintenance cost up 25% in the quarter? Was there something going on last year that caused this increase to be so substantial this year?

Unidentified Company Representative

Helane, this is (inaudible); I will answer that one. Last year, you might recall, in the second quarter of last year, we had some maintenance credits that were related to some engine work we had done in previous periods, so we got all those credits and recognized those last year. That was about $10 million. So when you look at it year-over-year, if you take away that $10 million difference between the two periods then maintenance normalizes quite a bit. So that's really the big difference.

Helane Becker - *Cowen and Company - Analyst*

Okay, great. That's hugely helpful. Thank you. Those are really my only questions. Thanks very much.

Operator

Hunter Keay, Wolfe Research.

Hunter Keay - *Wolfe Research - Analyst*

So I get a little frustrated when I hear airlines talking about PRASM as some sort of short-term-only metric as if it's some sort of hedge fund-only thing that matters and like long-only guys don't care about it because it's just not true. This is going to be the fourth year where PRASM is basically down or flat or something like that for you guys. And that's not sustainable.

Brandon, you talked about the compounding effect of CASM. There's a compounding effect of PRASM too. So is there a thought to maybe thinking about this as you reevaluate a whole lot of things post-merger, whether it's guidance, conventions or long-term targets to maybe making PRASM a long-term metric somehow? And by that I mean we are going to have a target of roughly inflationary-like growth of PRASM plus or minus 200 basis points or something like that because I don't know why PRASM has to be so short-term-oriented and I feel like you guys might be in the position now to reevaluate things after the merger closes to do something about that.

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

Maybe I will take that. I agree with you. I don't know why there is so much focus on PRASM. What I would do if I were an investor is I would focus on profit, and I think as you think about our business going forward either as Alaska standalone or as a combined company, we are going to make profit-maximizing decisions and some of that is going to come from PRASM and some of that is going to come from CASM.

I think the danger in focusing just on PRASM is that you don't know what happens in any particular market. You don't know what happens with fuel prices and I think you are seeing a lot of that now. But at the end of the day, it's really MASM that matters and profit on the bottom line and actual cash that goes into your checking account that you can use to delever the balance sheet and pay back debt and return capital to shareholders. So I agree with you.

Hunter Keay - *Wolfe Research - Analyst*

Brandon, I'm sorry to interrupt you, but I think you misheard me. I'm saying the exact opposite, to be clear. I think PRASM matters a lot because it's a proxy for pricing power and that is what gets this group to [rerate].

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

I was going to jump on Brandon's answer as well. I think you are making a great point and I think Brandon does agree with you. If you look at this industry, 15 years ago, people didn't know what CASM was. We started talking about CASM. Now every airline has three-year objectives for CASM, two year, one year. We give really good and I think reliable guidance on CASM. Then I would say it was roughly 10 years ago, ROIC came into focus and we started talking about that.

I think you are giving us and other management teams a great challenge. If you were to -- Andrew Harrison and Shane Tackett -- if you were to give these guys a longer-term [message] to say what are you going to do for the revenue side of the business, how would you construct that goal. As we've thought about these things, they are hard questions and we looked at them and gotten our head around, it was hard to start producing CASM objectives. But I personally think you're giving us a good challenge and we should take that away and think about it. We might come away a stronger airline if we had a way of articulating our RASM objectives.

Hunter Keay - *Wolfe Research - Analyst*

Yes. Okay. Thank you, guys. I appreciate it.

Operator

Michael Linenberg, Deutsche Bank.

Catherine O'Brien - *Deutsche Bank - Analyst*

This is actually Catherine O'Brien filling in for Mike. So I know you are announcing close-in yield pressure on the West Coast, but last quarter you were actually seeing strength in your corporate segment and I believe though that that corporate was outpacing system revenue. I was just wondering has that trend continued into the June quarter and if so, do you think you've been gaining share because of your relative value proposition versus some of your network carrier competitors?

Joe Sprague - *Alaska Air Group, Inc. - SVP, Communications & External Relations*

This is Joe Sprague. Short answer is yes. For the quarter just ended, we did see continuing strength in the corporate sector. In fact, corporate customer activity was up both on flights and revenue, and particularly here in Seattle really good growth from companies, the key local corporations that we do business with here in the Seattle area.

And then just from a sector standpoint, I think some of the underlying strength in addition to us delivering a great product to our customers and our sales team really getting after it is the tech sector that we benefit from here on the West Coast is doing especially well right now.

Catherine O'Brien - *Deutsche Bank - Analyst*

Okay. And what about your share? Have you seen that go up in some of your home markets?

Joe Sprague - *Alaska Air Group, Inc. - SVP, Communications & External Relations*

Yes, yes, we have. In fact, share is up across all of our key markets.

Catherine O'Brien - *Deutsche Bank - Analyst*

Okay. And if I could just ask one more quick follow-up, I know you guys took a pause on the share repurchase program this quarter, but should we expect any additional buybacks this year to hit that $325 million target of dividends and share buybacks this year, or has that target changed?

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

No, you should not expect any additional share buybacks this year. I think the target -- what was your number?

Catherine O'Brien - *Deutsche Bank - Analyst*

I think you guys said $325 million last quarter.

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

No, I think we include the share buybacks that we did year-to-date plus the dividend payments that we would pay through the rest of the year would be right at that level.

Catherine O'Brien - *Deutsche Bank - Analyst*

Okay, great. Thanks so much for the time.

Operator

Darryl Genovesi, UBS.

Darryl Genovesi - *UBS - Analyst*

Maybe I will start with one for Andrew. Andrew, you had highlighted an outlook for 13% and 12% competitive growth in the next two quarters and you had commented that that was similar to what you had been seeing, but it looks like the mix changes a bit because most of the competitive growth that you guys have been seeing has been from Delta, which is building a connecting hub over Seattle, whereas the mix seems to be moving away from Delta as we move into the end of the year.

So just wondering is that emphasis on perhaps a little bit more of the local market by the competitors that are going to be growing in Seattle and your other markets in the second half, does that put more pressure on Alaska revenue perhaps than what you have been seeing?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

I think you are spot on with the mix and I think really the competitive pressure we are seeing a little bit is some of the network carriers, the hubs into Pacific Northwest and then to a much lesser extent some of the ULCCs. So it's a little bit fragmented across various markets that we compete in. At the end of the day, competitive capacity is competitive capacity, but from our perspective, there's no real changes to the dynamic to our network given the mix change.

Darryl Genovesi - *UBS - Analyst*

Okay. All right. Thanks for that. And then maybe if I could a quick follow-up for Brandon. Brandon, I think we've seen something like a 75 basis point compression in 10-year treasury yields this year. I'm just looking at your 10-K where you disclosed a $128 million impact to the pension deficit with every 50 basis point move in the discount rate. Is that a good number to use on a prospective basis?

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

Darryl, this is Mark. I can just tell you that rates have gone down. As we already mentioned, that's really going to help us with the financing as we finance a $2 billion acquisition. So it will impact the liability aspect of our pensions, but it really is what those rates end up at year-end. We don't know what it'll be. They are already going back. I think that they are already up about 20 basis points from where they ended up the quarter. So not sure where they are going, but it will have any impact on the liability, yes.

Darryl Genovesi - *UBS - Analyst*

But the sensitivity should be roughly the same as it would have been in 2015?

Mark Eliasen

Yes, it would be.

Darryl Genovesi - *UBS - Analyst*

Okay. Thanks, Mark.

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

And I will just tell you that on the asset side of the pensions, they are growing. And as you know, we were nearly fully funded at year-end and we are still remaining about that status. So no big story there for us.

Darryl Genovesi - *UBS - Analyst*

Great. Thanks very much.

Operator

Dan McKenzie, Buckingham Research.

Dan McKenzie - *Buckingham Research - Analyst*

Andrew, you talked about weakness in close-in yields and my question is I think somewhat related to an earlier question, but -- yet demand is pretty good here. So I'm wondering if you can just elaborate a little bit more on that. Is the weakness in close-in yields just simply a function of competitive capacity? Is it more of a spirit affect? Is it simply Alaska growing a little bit too fast to absorb the demand? What really has to happen -- well, I guess you can't really talk about pricing, but just wondered if you can just provide a little bit more perspective on what's really been probably the biggest culprit for that from your perspective?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Dan, I think saying a whole lot more is probably not helpful for anyone. I think fundamentally what I will share with you is that we've seen are changes in what are traditionally fare fences and just revenue management practices close in, and I think they are in some part reaction to a change in dynamics of how people are flowing passengers across their network across the country. There's certainly ULCC dynamics in here and there are certainly new products being launched by some of the network carriers. And I think when you put all that together, you're getting what you are getting today.

And so I don't have a whole lot more insight than that, Dan. But as Shane shared, we are managing it well. Because this stuff is close in, we have no view what it would be in three months time because by definition that's close in. We won't know until we are three months from now. So I know that's probably only half of an answer of a half, but I apologize. But that's what we are seeing. But we are not immune to what the rest of the industry is seeing.

Dan McKenzie - *Buckingham Research - Analyst*

I appreciate that. That was actually -- that was helpful. And then, Brandon, I think what stood out to me in the earnings release was mainline CASM ex-fuel of $0.0688, down 4% year-over-year. Obviously that factors in some deferred expenses in the quarter, but given that some of your key labor contracts are out of the way and just given your commentary of walking your non-fuel CASM down a little each year, what goal, if any, do you have with where that metric lands over the next year or two?

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

It's really just to continue to drive it down. We have a long streak of CASM reductions. I think this year will be 15 out of the last 16. As we close the acquisition with Virgin America in the fourth quarter, everything resets, but the philosophy of the Company does not reset, which is continuing to drive costs down so we can be more competitive, increase the gap between us and the legacy carriers and offer low fares to our customers.

Dan McKenzie - *Buckingham Research - Analyst*

If I could squeeze one last one in here, just following up on Jamie's question, just given the strength of Virgin's brand, Brad, of course it's great to hear you talk about how strong the Alaska brand is as well. So I'm wondering does it make sense to talk about it in terms of a net promoter score, which seems to be at least one of the more definitive measures of a company's brand? And if so, is it north or south of Google?

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

We like the net promoter score. I think we can say that. What's your exact question?

Dan McKenzie - *Buckingham Research - Analyst*

Just whether it makes sense to talk about the brand in terms of a net promoter score, talking about that publicly because I think there's a broad recognition that there is a very high correlation between where that score sits and revenue production.

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

Yes. Dan, I don't think we want to say a lot more about the brand, but I think I will say to you that we do like the net promoter score, and over time here we've been measuring customer satisfaction. We are thinking about relying more on net promoter score because I think it does have a lot of validity. But I don't think we want to say more about the brand today.

Dan McKenzie - *Buckingham Research - Analyst*

Understood. Okay. Thanks for the time, guys.

Operator

(Operator Instructions). Savi Syth, Raymond James.

Savi Syth - *Raymond James - Analyst*

I'm just wondering, I think you are still on track to start rolling out Preferred Class and if you could just remind us what the timing of that will be, and especially a little bit more on how that might ramp up through 2017 and maybe when we will start to see that benefiting the earnings.

Shane Tackett - *Alaska Air Group, Inc. - VP, Revenue Management*

Thanks for the question. Yes, Premium Class is the name that we are using to brand it and it is on track. We are still on track to begin configuring aircraft in late September and so we will have I think 60 aircraft done or 70 aircraft done by the end of the year. We did push the date that we decided to presell the actual product from this summer to Q4. There's just a lot going on right now and we wanted to pay attention to the right things and make sure we delivered this really well when we get there in Q4. So all of the economics are going to roll into 2017, but they will be up and running by January and very consistent with what we had shared at Investor Day some months ago.

Savi Syth - *Raymond James - Analyst*

All right. So the benefit this year probably not there, but you will have the run rate in 2017?

Shane Tackett - *Alaska Air Group, Inc. - VP, Revenue Management*

If we had a very di minimis amount.

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

I think we had $5 million for this year.

Savi Syth - *Raymond James - Analyst*

Got it. If I can quickly ask, just any update on how demand is in the state of Alaska as well as Hawaii?

Shane Tackett - *Alaska Air Group, Inc. - VP, Revenue Management*

I can answer that. Without getting too specific, demand has actually been very strong out of the state. It's grown in line with the rest of our system. The state of Hawaii is also very strong, especially out of the Pacific Northwest. And out of California, there's more capacity in the Bay Area that Hawaii and a lot of it is being filled, so both places continue to be fairly strong points for us on the network.

Savi Syth - *Raymond James - Analyst*

Great. Thank you.

Operator

Joseph DeNardi, Stifel.

Joseph DeNardi - *Stifel Nicolaus - Analyst*

Thanks for the follow-up. Andrew, just on the other revenue line, I think there's some noise there from the credit card deal. Can you just speak to excluding that or once you annualize that what the underlying growth in other revenue looks like and are you guys seeing any headwind to take rates on bag fees or anything like that as you build out your international partners? I think Virgin has actually spoken to as they've done that that's been a little bit of a headwind for bag fees.

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

Maybe I will start with the first part and Andrew can comment about ancillary. I would not call that noise at all. I would call that actual real economics associated with our credit card deal, which are fabulous. As you might recall, we had a new deal in the middle of last year so we are seeing the annualization of that both on increase in rate and the strong volumes that we are seeing. That should be basically done now in the second quarter, maybe trickles a little bit into the third quarter. In terms of ancillaries, Andrew?

Andrew Harrison - *Alaska Air Group, Inc. - EVP & Chief Commercial Officer*

Yes. I think really the main thing on ancillaries is really back to the card, as Brandon has said. The significant growth in the card and the first bag free up to seven passengers, but that's all been recouped in other places through the growth of the card, the economics in this trend. So net-net, we expect our bag fees to be down year-over-year on a per-passenger basis, but that's what we were hoping.

Joseph DeNardi - *Stifel Nicolaus - Analyst*

Okay. Brandon, can you just speak to, as you annualize that in third quarter, what the underlying growth in other revenue is so we can model that effectively in third quarter?

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

I don't have that off the top of my head, Joe. Maybe we will get back to you on that one.

Joseph DeNardi - *Stifel Nicolaus - Analyst*

Okay. All right, thank you.

Operator

Thank you, ladies and gentlemen. I will now turn the call back over to Mr. Brad Tilden.

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

Thanks, everybody. We appreciate your interest and your questions and we look forward to speaking with you next quarter.

Operator

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