

## Southwest

## Focused on earning its cost of capital

Reiterate Rating: NEUTRAL | PO: 31.00 USD | Price: 30.39 USD

## Focused on earning its cost of capital

LUV's cost pressures continue to be in the spotlight with 2024 unit cost guidance of +6-7% meaningfully higher than our estimate/Visible Alpha consensus of around +2% despite accruing for labor deals for several quarters. We expected LUV to make progress on its cost structure as the focus shifts toward optimization and efficiency, but labor, maintenance costs, and operational investments continue. LUV is focused on earning its cost of capital with margins still depressed vs pre-pandemic, a process that we expect could take the next few years. We maintain our Neutral rating.

## What will it take to earn its cost of capital?

LUV's operating margin/ROIC was 3.5%/4.0% at year end, well below its 2019 operating margin of 14.4% and weighted average cost of capital of 8-9%. Based on our forecasts, we expect slight operating margin improvement in 2024 to 4.1%, held back by the higher costs mentioned above. For LUV to earn a 10% ROIC in 2025, we estimate unit revenues would have to grow mid-single digits on low single digit unit cost growth at current fuel, which would imply operating margins would double from current levels. We find that tough to underwrite given the last time LUV's unit revenues grew mid-single digits was 2011. As such, we think earning its cost of capital could take into 2026 (vs goal of 2025) as LUV's capacity moderates to low- to mid-single digits in 2025-2026.

## Efficiency initiatives in place, but more work to be done

LUV has put in place \$1.5B of efficiency initiatives to help drive margins with 65/35 from stronger revenues/better costs. We expect this to be a focus of LUV's investor day later this year and is the key in improving LUV's returns. For 2024, we anticipate LUV's revenue recovery to begin with our unit revenue forecast of +3.6% vs -4.5% in 2023 driven by improvement in markets under development (10% of network today going to 5% by year end), managed corporate travel gains (most airlines and our bookings data cite better corporate), and LUV's moderating capacity growth in 2H24.

## Raising 2024E EPS; Price Objective to \$31 from \$29

Driven by better revenues, we are raising our 2024E EPS to \$1.79 from \$1.54. Based on our updated forecasts, our price objective moves to \$31 from \$29, which is still based on 6.0x our 2024E EBITDAR. We reiterate our Neutral rating.

Estimates (Dec) (US\$)	2022A	2023A	2024E	2025E	2026E
EPS	1.13	1.59	1.79	2.13	2.71
GAAP EPS	0.84	0.80	1.77	2.10	2.71
EPS Change (YoY)	NM	40.7%	12.6%	19.0%	27.2%
Consensus EPS (Bloomberg)			1.58	2.18	2.11
DPS	0	0.72	0.72	0.72	0.72
Valuation (Dec)					
P/E	26.9x	19.1x	17.0x	14.3x	11.2x
GAAP P/E	36.2x	38.0x	17.2x	14.5x	11.2x
Dividend Yield	0%	2.4%	2.4%	2.4%	2.4%
EV / EBITDA*	9.8x	9.9x	8.6x	7.4x	6.2x
Free Cash Flow Yield*	-0.7%	-1.8%	-7.3%	-1.6%	1.6%

\* For full definitions of *IQmethod*<sup>SM</sup> measures, see page 4.

29 January 2024

## Equity

## Key Changes

(US\$)	Previous	Current
Price Obj.	29.00	31.00
2024E Rev (m)	27,842.1	28,603.3
2025E Rev (m)	29,324.4	30,264.6
2026E Rev (m)	NA	32,312.2
2024E EPS	1.54	1.79
2025E EPS	1.73	2.13
2026E EPS	NA	2.71

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## Stock Data

Price	30.39 USD
Price Objective	31.00 USD
Date Established	26-Jan-2024
Investment Opinion	B-2-7
52-Week Range	21.91 USD - 39.53 USD
Mrkt Val (mn) / Shares Out (mn)	20,316 USD / 668.5
Free Float	99.6%
Average Daily Value (mn)	281.70 USD
BofA Ticker / Exchange	LUV / NYS
Bloomberg / Reuters	LUV US / LUV.N
ROE (2024E)	10.5%
Net Dbt to Eqty (Dec-2023A)	-0.8%
ESGMeter <sup>TM</sup>	Medium

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to ["BofA ESGMeter Methodology"](#).

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Timestamp: 29 January 2024 05:00AM EST

# iQprofile<sup>SM</sup> Southwest

## iQmethod<sup>SM</sup> – Bus Performance\*

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Return on Capital Employed	3.4%	2.5%	5.3%	5.9%	7.1%
Return on Equity	6.9%	9.6%	10.5%	11.6%	13.6%
Operating Margin	4.3%	1.0%	4.1%	4.9%	6.3%
Free Cash Flow	(134)	(357)	(1,486)	(321)	334

## iQmethod<sup>SM</sup> – Quality of Earnings\*

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash Realization Ratio	5.2x	3.1x	2.0x	2.7x	2.5x
Asset Replacement Ratio	2.9x	2.3x	2.3x	2.3x	2.1x
Tax Rate	25.8%	26.1%	23.5%	23.5%	23.5%
Net Debt-to-Equity Ratio	-0.6%	-0.8%	16.1%	21.0%	19.6%
Interest Cover	3.4x	1.1x	4.7x	6.1x	8.4x

## Income Statement Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Sales	23,814	26,090	28,603	30,265	32,312
% Change	50.8%	9.6%	9.6%	5.8%	6.8%
Gross Profit	2,367	1,789	2,800	3,247	3,919
% Change	-20.9%	-24.4%	56.5%	16.0%	20.7%
EBITDA	2,470	2,446	2,800	3,247	3,919
% Change	NM	-1.0%	14.5%	16.0%	20.7%
Net Interest & Other Income	(55)	1,043	317	268	223
<b>Net Income (Adjusted)</b>	<b>726</b>	<b>1,016</b>	<b>1,148</b>	<b>1,361</b>	<b>1,749</b>
<b>% Change</b>	<b>NM</b>	<b>39.9%</b>	<b>13.0%</b>	<b>18.5%</b>	<b>28.5%</b>

## Free Cash Flow Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Net Income from Cont Operations (GAAP)	539	512	1,133	1,346	1,734
Depreciation & Amortization	1,351	1,522	1,636	1,756	1,876
Change in Working Capital	1,773	1,430	(580)	428	532
Deferred Taxation Charge	283	30	126	150	193
Other Adjustments, Net	(156)	(331)	0	0	0
Capital Expenditure	(3,924)	(3,520)	(3,800)	(4,000)	(4,000)
<b>Free Cash Flow</b>	<b>-134</b>	<b>-357</b>	<b>-1,486</b>	<b>-321</b>	<b>334</b>
<b>% Change</b>	<b>NM</b>	<b>-166.4%</b>	<b>-316.1%</b>	<b>78.4%</b>	<b>NM</b>
Share / Issue Repurchase	43	48	40	40	40
Cost of Dividends Paid	0	(428)	(461)	(461)	(461)
Change in Debt	(2,853)	(85)	(20)	(20)	(20)

## Balance Sheet Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash & Equivalents	9,492	9,288	7,362	6,600	6,493
Trade Receivables	1,040	1,154	1,154	1,154	1,154
Other Current Assets	4,276	3,513	3,513	3,513	3,513
Property, Plant & Equipment	18,736	20,598	22,762	25,006	27,130
Other Non-Current Assets	1,825	1,934	1,934	1,934	1,934
<b>Total Assets</b>	<b>35,369</b>	<b>36,487</b>	<b>36,725</b>	<b>38,207</b>	<b>40,224</b>
Short-Term Debt	267	237	237	237	237
Other Current Liabilities	10,111	11,976	11,396	11,824	12,356
Long-Term Debt	9,164	8,963	8,943	8,923	8,903
Other Non-Current Liabilities	5,140	4,762	4,888	5,037	5,230
<b>Total Liabilities</b>	<b>24,682</b>	<b>25,938</b>	<b>25,464</b>	<b>26,021</b>	<b>26,726</b>
<b>Total Equity</b>	<b>10,687</b>	<b>10,549</b>	<b>11,261</b>	<b>12,186</b>	<b>13,499</b>
<b>Total Equity &amp; Liabilities</b>	<b>35,369</b>	<b>36,487</b>	<b>36,725</b>	<b>38,207</b>	<b>40,224</b>

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 4.

## Company Sector

Airlines

## Company Description

Southwest is the fourth-largest U.S. airline by revenues, but ranks first in the number of originating passengers boarded. LUV operates a customer-friendly, low-cost, point-to-point model without fees and offers flights throughout the continental U.S. LUV operates a fleet of 728 aircraft to 121 destinations in 42 states, the District of Columbia, Puerto Rico and 10 near-international destinations. LUV's six largest operations are in Denver, Chicago, Baltimore, Las Vegas, Dallas, and Phoenix.

## Investment Rationale

While LUV maintains net cash on its balance sheet, its low margins post-pandemic and capex program of \$4B per year results in negative free cash flow the next several years. Based on the earnings profile through 2025, we believe LUV shares are appropriately valued, which drives our Neutral rating.

## Stock Data

Average Daily Volume 9,269,355

## Quarterly Earnings Estimates

	2023	2024
Q1	-0.25A	-0.06E
Q2	1.09A	0.68E
Q3	0.38A	0.70E
Q4	0.37A	0.47E

## Price objective basis & risk

### Southwest (LUV)

Our \$31 PO is based on approximately 6.0x our 2024E EBITDAR. Our target multiple is below LUV's long-term historical average of 6.2x given the tough domestic operating environment.

Downside risks to our price objective are higher fuel prices, general economic weakness, government regulation/taxes, safety concerns and terrorism/geopolitical events.

## Analyst Certification

I, Andrew G. Didora, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

### US - Airlines and Cruise Coverage Cluster

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	Air Canada	ACDVF	ACDVF US	Andrew G. Didora, CFA
	Alaska Air Group	ALK	ALK US	Andrew G. Didora, CFA
	Carnival Corporation	CCL	CCL US	Andrew G. Didora, CFA
	Carnival Plc	CUKPF	CCL LN	Andrew G. Didora, CFA
	Delta Air Lines	DAL	DAL US	Andrew G. Didora, CFA
	United Airlines Holdings	UAL	UAL US	Andrew G. Didora, CFA
<b>NEUTRAL</b>				
	Frontier Airlines	ULCC	ULCC US	Andrew G. Didora, CFA
	Norwegian Cruise Line Holdings	NCLH	NCLH US	Andrew G. Didora, CFA
	Royal Caribbean Group	RCL	RCL US	Andrew G. Didora, CFA
	Southwest	LUV	LUV US	Andrew G. Didora, CFA
<b>UNDERPERFORM</b>				
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	American Airlines Group	AAL	AAL US	Andrew G. Didora, CFA
	JetBlue Airways	JBLU	JBLU US	Andrew G. Didora, CFA
	Spirit Airlines	SAVE	SAVE US	Andrew G. Didora, CFA
<b>RSTR</b>				
	Hawaiian Holdings	HA	HA US	Andrew G. Didora, CFA



## iQmethod<sup>SM</sup> Measures Definitions

### Business Performance

Return On Capital Employed

Return On Equity

Operating Margin

Earnings Growth

Free Cash Flow

### Quality of Earnings

Cash Realization Ratio

Asset Replacement Ratio

Tax Rate

Net Debt-To-Equity Ratio

Interest Cover

### Valuation Toolkit

Price / Earnings Ratio

Price / Book Value

Dividend Yield

Free Cash Flow Yield

Enterprise Value / Sales

EV / EBITDA

### Numerator

$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) \times (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$

Net Income

Operating Profit

Expected 5 Year CAGR From Latest Actual

Cash Flow From Operations – Total Capex

### Numerator

Cash Flow From Operations

Capex

Tax Charge

Net Debt = Total Debt – Cash & Equivalents

EBIT

### Numerator

Current Share Price

Current Share Price

Annualised Declared Cash Dividend

Cash Flow From Operations – Total Capex

$\text{EV} = \text{Current Share Price} \times \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} +$

Other LT Liabilities

Enterprise Value

### Denominator

$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill}$

Amortization

Shareholders' Equity

Sales

N/A

N/A

### Denominator

Net Income

Depreciation

Pre-Tax Income

Total Equity

Interest Expense

### Denominator

Diluted Earnings Per Share (Basis As Specified)

Shareholders' Equity / Current Basic Shares

Current Share Price

$\text{Market Cap} = \text{Current Share Price} \times \text{Current Basic Shares}$

Sales

Basic EBIT + Depreciation + Amortization

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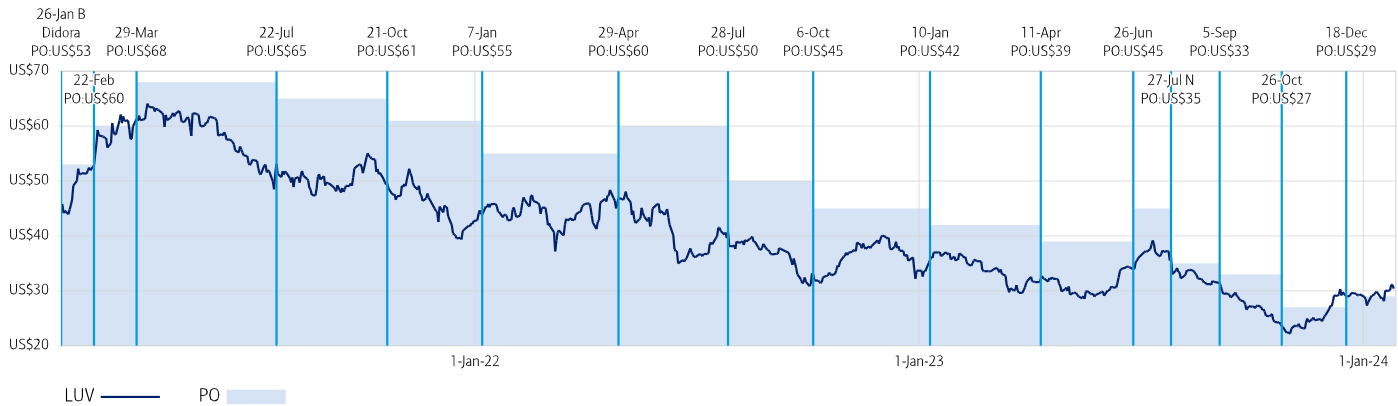
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### Southwest (LUV) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

### Equity Investment Rating Distribution: Transport/Infrastructure Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	67	50.38%	Buy	44	65.67%
Hold	31	23.31%	Hold	13	41.94%
Sell	35	26.32%	Sell	17	48.57%

### Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

<sup>R1</sup> Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Neutral	≥ 0%	≤ 30%
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