Alaska Air Group, Inc. (ALK) CEO Brad Tilden on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-24-19 Earnings Summary

Press Release SEC *10-Q*

EPS of $2.63 beats by $0.11 | Revenue of $2.39B (8.00% Y/Y) beats by $6.39M

Earning Call Audio

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Alaska Air Group, Inc. (NYSE:ALK) Q3 2019 Results Conference Call October 24, 2019 4:30 PM ET

Company Participants

Emily Halverson - Director, Investor Relations

Brad Tilden - Chief Executive Officer

Andrew Harrison - Chief Commercial Officer

Brandon Pedersen - Chief Financial Officer

Shane Tackett - Executive Vice President, Planning and Strategy

Ben Minicucci - Chief Operating Officer

Nathaniel Pieper - Senior Vice President, Fleet, Finance and Alliances

Chris Berry - Vice President of Finance and Controller

Conference Call Participants

Catherine O'Brien - Goldman Sachs

Duane Pfennigwerth - Evercore ISI

Savi Syth - Raymond James

Jamie Baker - JP Morgan

Helane Becker - Cowen

Hunter Keay - Wolfe Research

Michael Linenberg - Deutsche Bank

Joseph DeNardi - Stifel

Brandon Oglenski - Barclays

Dan McKenzie - Buckingham Research

Operator

Good afternoon. My name is Thea, and I will be your conference operator today. At this time, I would like to welcome everyone to the Alaska Air Group's Third Quarter Earnings Release Conference Call. Today’s call is being recorded and will be accessible for future playback at alaskaair.com [Operator Instructions] Thank you.

I would now like to turn the call over to Alaska Air Group's Director of Investor Relations, Emily Halverson.

Emily Halverson

Thank you, Thea. Good afternoon. And thank you for joining us for our third quarter 2019 earnings call. I started to get to know many of you. But for those who I haven't yet met, I've been with Alaska for four years in the accounting world, and I'm looking forward to working with each of you in my new role.

In today's prepared remarks, you'll hear updates from our leaders Brad Tilden, Andrew Harrison, Brandon Pederson and Ben Minicucci. Several other members of our management team are also on hand to answer your questions during the Q&A portion of the call.

This afternoon, Alaska Air Group reported third quarter GAAP net income of $322 million. Excluding merger related costs and mark-to-market fuel hedging adjustments Air Group reported adjusted net income of $326 million and adjusted earnings per share of $2.63, ahead of first call consensus. These results compare to adjusted net income of $237 million and adjusted earnings per share of $1.91 in the third quarter of 2018.

Our third quarter adjusted pre-tax margin expanded 360 basis points to 17.6%. As a reminder, our comments today will include forward-looking statements on our expected future performance, which may differ materially from actual results. Information on risk factors that could affect our business can be found in our SEC filings. On today's call, we will refer to certain non-GAAP financial measures, such as adjusted earnings and unit costs excluding fuel. And as usual, we've provided a reconciliation between the most directly comparable GAAP and non-GAAP measures in our earnings really filed today.

And now, I'll turn the call over to Brad for his opening remarks.

Brad Tilden

Thanks very much, Emily, and good afternoon, everybody. Before I get into this quarter's results, I want to take just a moment to acknowledge the recent incident at one of our Co-Chair partners in the state of Alaska, PenAir.

One of their Saab 2000 aircraft overran the runway in Dutch Harbor one week ago today, and this tragically resulted in one passenger fatality and one guest being in critical condition for one day. Our thoughts and prayers go out to the guests who are on board, to their families and loved ones, and to our partners at PenAir. This is a somber reminder to me and to the rest of our leadership team of the grave responsibility that we shoulder and of continued need for us to underscore the importance of safety with our people and our partners at every opportunity and to backup this understanding with our actions every day.

Now moving to our third quarter results. I want to congratulate the fantastic folks at Alaska, Horizon and McGee for delivering the industry's best customer service and operational performance, which together drove our strong results. Our revenue was up 8% for the quarter on 3.4% more capacity. And Horizon had a terrific quarter as they grew capacity by 24%, while reducing non-fuel cost by 1.5 points, as they absorb all 30 of their new E175 aircrafts that have been delivered over the past three years.

The team at Horizon led by Gary Beck has increased productivity for the fifth quarter in a row, and has met our goal for guest satisfaction in all but one month this year. Additionally, our commercial team has been working very hard and they produced industry-leading unit revenue growth of 4.5% on solid demand as evidenced by our highest quarterly load factor in the last five years. It is fantastic work like this that expanded our pre-tax margin by 360 basis points to 17.6% our best results in two years.

If we look at our results on an absolute basis, our adjusted net income for the last 12 month was $709 million, and that's up nearly 30% from the prior 12 months. We converted that net income to $1.6 billion of operating cash flow. And with our effort in the last couple of years to adjust capital spending, our free cash flow was very strong at $695 million. In other words, we're converting 98% of our net income to free cash flow.

Our company is producing good earnings and converting those earnings into solid free cash flow. We view free cash flow conversion as one of the critical measures of how we drive value for our shareholders. While it won't be the case in the next couple of years, in the last two years, we've been using our free cash flow to pay down acquisition debt and also to return cash to shareholders through our dividend and share purchases.

On debt reduction, by year-end we will have repaid $1.5 billion or 75% of the $2 billion we borrowed to buy Virgin America. And at 42%, we are quickly approaching our long term adjusted debt to cap goal of 40%. Strengthening our fortress balance sheet positions us to be flexible and opportunistic, and to make the best strategic and capital allocation decisions in the future.

We carried a record number of guests this past summer. Our team's full focus has returned to running a great airline, and it is showing. I'd like to share two recent achievements. First, our people were once again recognized as the best U.S. airline by

Condé Nast Traveler in its Annual Readers' Choice Awards. This is the second year in a row that we won this award, and we're continuing an 11-year run that Virgin America had before us. We can't thank our boys enough for their skill and dedication in serving our guests.

And second, three important labor deals, which represent over 6,000 of our people were ratified this quarter. We're proud to get these deals done for our folks. And Ben will tell you more about them in just a moment. If you've done the math on our recent guidance, you've likely estimated that our 2019 margins will be somewhere around 11% to 12%, up from just below 9% last year. We're encouraged by our progress, but we do not believe we're at the destination.

On the subject of ROIC, we expect to end 2019 in the range of 12% to 13%, which is up significantly from 9.4% last year. As we look beyond 2019, we're developing plans that will put us into our stated pre-tax margin range of 13% to 15% over the business cycle.

Andrew and Brandon will now share more detail about the quarter, and then Ben will round it out with some discussion on our five year strategic plan. The plan addresses our products and loyalty strategy, our revenue initiatives, our cost structure, our network structure, a vision for our fleet and more. We're challenging ourselves to create specific blueprints so that we can deliver in critical areas and thereby honor our commitments to all of the people who are depending on us. We're excited about the plan and we look forward to sharing components of it with you in the quarters ahead.

With that, I'll turn this over to Andrew.

Andrew Harrison

Thanks, Brad, and good afternoon, everyone. My comments this afternoon will focus on third quarter revenue performance, progress on guest pricing initiatives and revenue guidance for the fourth quarter. Our 4.5% improvement in unit revenues is 260 basis points better than the industry, and highlights the effectiveness of our revenue initiatives and the work we are doing to harness merger synergies. Our third quarter result was our best absolute RASM in the past three years, and as Brad mentioned, our load factor was the highest we've seen in five years.

Demand was healthy across our network during the quarter. This was demonstrated by 1 point improvement in load factor and 3.5 percentage point improvement in yield. Hawaii, which has been experiencing elevated industry capacity and soft pricing performed well. Notwithstanding the fact that industry capacity and our own capacity were both up nearly 7% we still produced a modest unit revenue increase.

We've continued the strong momentum that we started in Q2 in our transcon markets out of California and New York. Earlier this year, these regions were under a lot of yield pressure. Teams across the organization came together to diagnose the problems, develop a plan and execute the plan. Through cross fleeting, the addition of satellite Wi-Fi, dialing in the schedule and cash structure and a committed focus to improving the guest experience, we achieved meaningful RASM and margin improvement. Our value proposition hinges on offering low fares, while providing award winning service, generous rewards and premium product, and our people are delivering on this.

Our revenue improvement is a direct result of our initiatives and synergies. At Investor Day, we shared a roadmap we view laid out our intention to deliver $330 million in incremental 2019 revenues. Unlike in the first and second quarter, our initiatives delivered their full annual run rate this quarter. Three quarters into the year, we are confident that we'll deliver on the $330 million. I'm going to share more on go-forward initiatives and synergies in a moment.

We also continue to see double-digit percentage growth in our loyalty revenues, which as a reminder, comprise award redemptions and credit card commissions. A large driver of this result was the 8% increase in redemption revenue on our metal, evidence of our generous availability for award travel.

We continue to see growth in both mileage plan members and credit card holders, and are particularly encouraged to see that nearly one-third of our year-to-date growth in credit card holders are guests living in California. Nearly half of all of our guests are members of our loyalty program, which has consistently been recognized as the best in the industry, another bright spot with the improvement in the styles of our premium cabin products.

First Class revenue was up 16% on 10.5% more seats. Premium Class revenue was up 13% on 12% more seats. Our network has shifted over the years to where nearly 50% of our capacity is at trip length of five hours or longer. This drive strong demand for our premium products, and we're very pleased with these results. As we build out our Airbus interiors to add more premium seating, we expect premium revenue growth will continue to outpace system wide revenue increases.

Besides premium seating, we've made significant investments over the past few years in our product, while building our hubs and focus cities on the West Coast. These improvements include satellite Wi-Fi, new interiors on Airbus aircraft and investment in our lounges. This quarter, we expanded our lounge capacity nearly 60% when we opened our 15,000 square foot lounge in SeaTac's North terminal. Guest satisfaction scores at the new lounge are 15 points higher than the system average and day pass sales have doubled.

We've also seen record breaking trends in lounge membership growth. In the first month after opening, new member enrollments were quadruple our program average. We're applying our learnings from the North Satellite lounge to our new San Francisco lounge set to open in early 2020. And as you know, our lounge members are mostly elite and high frequency travelers. So these facilities are very important to us.

Before I move to guidance, I'd like to highlight that we made network adjustments that we announced during the third quarter, which are aimed at creating more desirable connections for our guests between our hubs and focus cities in California and our focus cities in the Northwest. These include flights from California to Spokane, Redmond Missoula, Boise and Anchorage.

As we grow capacity at a lower rate than we have historically, our focus is on careful reallocation of capacity given the seasonality in our network, as well as growing market share and our strategically important markets on the West Coast. Initial signs are encouraging as we are already seeing positive results in demand and margin generation from these types of changes.

Looking to Q4. Our capacity will grow moderately at approximately 4%. Our Q4 RASM guidance range is up 1% to 4% on much harder comps from Q4 of 2018. This guidance reflects our optimism in our revenue initiatives, as well as the continuation of demand and pricing trends we are currently seeing

Many of you ask regularly about how we're doing on revenue synergies, which we laid out at our Investor Day in November of 2018. As we shared with you at that time, our total expected merger synergies were $300 million, $240 million of which are revenue synergies. We realized $65 million of these through 2018. And as mentioned earlier, we're on pace to realize the full $130 million that we expect this year. All of that cost synergies have effectively been realized to-date, leaving $105 million of revenue synergies that we still need to achieve. Approximately $60 million of this is slated for 2020 and $45 million in 2021.

So we'd like to sort of tie off these historical synergies and commitments, and establish for the record that our remaining commitments heading into 2020 is for $60 million in revenue synergies and the annualization of our 2019 revenue initiatives, which will be approximately $65 million. So in total, that's $125 million in 2020 or about 1.5 of RASM. We will be adding our 2020 revenue initiatives to this commitment and we'll share these with you on our call in January. Continued delivery of revenue growth is my team's top priority, and we're optimistic about what we can bring in 2020.

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

Brandon Pedersen

Thanks, Andrew, and good afternoon, everybody. We're pleased to report 38% improvement in both adjusted net income and earnings per share, as well as our third consecutive quarter of margin improvement. As others have highlighted, our 17.6% pretax margin reflects that 360 basis point expansion year-over-year, and was a direct result of the initiatives we laid out at Investor Day last year.

With our Q3 results and our Q4 guidance issued today, we're on pace to have a full-year pre-tax margin of between 11% and 12%, which would be up 200 basis points to 300 basis points from last year and meaningful progress on our path to 13% to 15% margins.

Since Andrew touched on the revenues, I'll focus on the cost performance for Q3 and the outlook for the remainder of the year.

Our unit costs increased 3.4% on a similar increase in capacity and the result was about 150 basis points better than our initial guidance in July. It bears mentioning that the quarter included $24 million in signing bonuses associated with the ratification of new deals with Alaska's AMFA and IAM represented employees. Without the signing bonus, our CASM would have been up less than 2%.

We saw excellent cost performance for most of our operating divisions, although some cost did shift out to Q4 and even a little bit into Q1 of next year. Pilot cross-training is an example. We've talked many times about our dual-pronged strategy to manage costs, those being high productivity and low overhead. Productivity was strong during the quarter, Aggregate Air Group productivity which we measure using which we measure using guests per FTE came in better than planned, and improved nearly 2 points from prior year.

Year-to-date, productivity for our airports team and our guests contact team deserves special mention as both have exceeded productivity targets for both plan and prior year -- and over prior year. On the overhead side, there's another good story here too, overhead is tracking nearly 3% or $16 million under prior year for the first nine months of 2019.

Looking ahead to the fourth quarter, we expect CASMex to be up slightly on just less than 4% increase in capacity. This would be the best quarterly unit cost performance, since the fourth quarter of 2016. We're benefiting from higher growth, offset by some of the timing shifts we've been talking about over the last couple of quarters and higher rate wage rates, following ratification of the new contracts.

The modest increase in Q4 cost will bring the full year result to 2.2% CASM, ex-growth on a -- excuse me, 2.1% capacity growth. Normally, we would celebrate unit cost declines, not increases. But given the step change increase in labor costs we've had this year, and the very low growth relative to our recent history, we're pleased with the results and it demonstrates what we can achieve with a back to basics approach, to cost execution, with a sharp focus on productivity and operating our business with a low overhead mindset. As you've heard, our teams are working diligently on our 2020 plan, including our cost plan.

We recognize that low costs widen the competitive moat we have versus higher cost legacy carriers, and are critical for us to eventually return to the higher growth levels that we've historically enjoyed.

While we don't plan to share guidance with you today, I can share some higher level context for the cost challenges, and opportunities, we face in 2020. First, notable headwinds include, first, a higher number of scheduled engine and airframe events in 2020. Second, we'll begin to see the cost impact of Airbus lease returns. Although, we only have one return scheduled for 2020, we have nine return scheduled for 2021 and we began accruing for these lease return costs 12-months in advance, and third increased airport costs.

Offsetting those headwinds however, we see the following opportunities. First, higher ASM growth over which to spread our fixed costs, we'll grow between 3% to 4% next year with that growth nearly all coming from lower unit cost mainline growth as Horizon has now taken all of their E175s deliveries. Second, further productivity gains.

Third continued simplification of our overhead structure, including changes that will allow us to be more agile and more quick with our decision-making. And fourth annualization of many of the benefits of our supplier cost reduction initiatives, which generated more than $35 million in savings in 2019. Our planning mindset is one of aggressive cost management and progress toward our 13% to 15% pretax margin goal, and I look forward to sharing more detail with you on our year-end call in January.

Turning to the balance sheet; we ended the quarter with $1.6 billion in cash and marketable securities. Total cash flow from operations for the first nine months of the year was nearly $1.5 billion, excluding merger related costs and the pension contribution, while net CapEx was $525 million. This resulted in approximately $950 million of free cash flow, which marked a nearly $460 million improvement upon last year's results.

At full-year consensus, free cash flow yield is almost 11%. Free cash flow conversion over the first nine months of the year was exceptional, but we're benefiting from very low cash taxes combined with a low capex year. Our number one capital allocation priority for the year has been deleveraging our balance sheet. As Brad said, we closed the quarter with a debt to cap ratio of 42% and a trailing 12 month net debt-to-EBITDA ratio of 1. By year-end, debt to cap will be at 41% and as you've already heard, we'll have paid off 75% of the merger related debt.

Our treasury team has done a phenomenal job this year not only working to re-deleverage the balance sheet, but has also taken advantage of the historically low interest rates to refinance and or restructure our debt to low fixed rates. At the end of the third quarter, our weighted average interest rate is at 3.2% with over 75% of our portfolio now fixed at historically low interest rates.

Rounding out our fortress balance sheet, our 104 unencumbered mainline an E175 aircraft and $400 million of undrawn lines of credit. Our strong performance this year has also allowed us to make some positive changes to our capital allocation plan for the year. First, we elected to make a voluntary pension contribution of $65 million to our defined benefit pension plans, which are about 80% funded in the aggregate. And second, we increased our planned full year share repurchase from $50 million to $75 million, given our strong cash flow.

During the quarter, we bought back $28 million of our shares including $10 million over a two-day period at a volume weighted average price of around $58 per share. With the dividend, which we have increased six-times since we initiated it in 2013, we expect to return $248 million to our shareholders this year, or more than 25% of our free cash flow.

Coming back to our five-year plan, our fortress balance sheet positions us to substantially increase returns to our owners and or place an aircraft order that would fund growth, and allow us to retire smaller, less efficient aircraft which would improve both our ability to generate additional revenue and lower unit costs. As we finish up our long-term fleet steady, we're also developing an order strategy that allows us to best leverage our market position and structure delivery timing that preserves our ability to generate free cash flow. And now I'll turn the call over to Ben.

Ben Minicucci

Thanks Brian, and good afternoon everyone. As the financial results highlight, it has been a productive summer here at Alaska. With the bulk of the work of the integration largely behind us, we are focused on realizing synergies and initiatives and improving our cost profile. A large part of that is providing visibility into our future labor costs.

And as Brad mentioned there were three new labor deals ratified during the quarter; one with our aircraft technicians, another customer service agents and reservation agents and clerical workers and a third with our ramp, cargo and stores agents. We are thrilled to have these labor agreements in place to recognize who we believe to be the best employees in the industry, while also securing long-term contracts that provide line of sight for the company over the next several years.

In the case of our aircraft technicians, they have now begun cross-training on both fleet types, which we expect to be completed by the first quarter of 2020, further enhancing productivity and operational reliability. In addition to our industry-leading financial results, our frontline teams are delivering outstanding operational reliability, and award winning service to our guests.

As you know, we track these metrics religiously internally, but just as importantly, it is validated by external sources too. To add to the recent recognition by Condé Nast as the best US airline, Alaska was also just recognized as America's Best Customer Service and Airlines by Newsweek, Best Airline Rewards Program by U.S. News & World Report, the top rated airline and the Dow Jones Sustainability Index and ranked by Forbes Magazine as one of the top 100 Best Companies to Work For in the world.

These awards are significant, not only because we'd love to see our people recognized, but because they highlight that staying focused on our core competitive advantages resonates with guests and really does make a difference to the bottom line, even while executing a complex merger. We are creating a future that continues to build on these core principles, which drive preference for our product and operational reliability. They include low fares, and low costs, best-in-class customer service, the industry's most generous mileage plan, a fuel-efficient fleet, a well loved brand and a fortress balance sheet.

As we've navigated the integration over the past three years, we've admittedly put certain longer-term strategic planning efforts on pause. We believe it was the right thing to do to ensure we completed the integration on an aggressive timeline that exceeded expectations and allowed for a singular focus on returning to the well oiled machine that Alaska is known to be.

This past summer, our senior leadership team has been focused on building out our five-year strategic plan that addresses where we want to take our network, our fleet, brand, loyalty program and financial performance. While we aren't yet ready to share the specifics I'm pleased with how the plan is taking shape. There is still work to do, as we refine the strategy that has helped shape our past success while we develop new strategies to build an even stronger Alaska for the future, centered around sustainable growth, our people and a strong business model. We have a lot of work left to do. But the improvements, we've seen this year and the momentum we are building with our network, our product, our people and our financial results give us a ton of confidence in the future success of our company. And with that, we'll open up the line for your questions.

Question-and-Answer Session

Operator

[Operator Instructions] And the first question will come from Catherine O'Brien with Goldman Sachs. Please go ahead.

Catherine O'Brien

Maybe one for Andrew first. So, you called out the $125 million in Alaska specific revenue initiatives you've got next year, does that include any future initiatives? I'm pretty sure it has the annualization of this year and then continuation of some of the merger revenue synergies. Think you guys have a new M&A system coming online next year, should that drive any initial -- any incremental benefit or is that a right contemplating the number. Thank you.

Andrew Harrison

Yes, that's right Katie. What I shared was the carryover synergies and initiatives from 2019 is going to be about 1.5 points unit revenue. In January on our call, we will share with you the incremental revenues we expect from our initiatives for 2020. So, we'll do that in three months time.

Catherine O'Brien

And then maybe two quick ones on costs, so great cost performance again in the third quarter, guessing that we should assume that since you maintain the full-year cost outlook was that mostly timing or something else going on there? And then maybe just on the lease returns next year, are there any maintenance reserves that you're going to put those against here on the cash side? Thanks a lot.

Brandon Pedersen

Hi Katie, it's Brandon. Maybe, I'll take those. On the cost, we were really pleased with our third quarter cost performance as well, you're right. We maintained the full-year cost or the cost number at the same level. So we did see some of those costs that we've been talking about shifting out of Q2 and Q3 into Q4. That explains the vast majority of it. ASMs are down slightly. Yes, that's basically it.

On the second question maintenance reserves, yes, that's a really complicated area. Of course, there will be offsets associated with how we treat the maintenance reserves as we settle all these lease return obligations up, but that's factored into -- we'll factor that into the guidance.

Operator

The next question is from Duane Pfennigwerth with Evercore. Please go ahead.

Duane Pfennigwerth

Can you just remind us, maybe what the gating factors are on getting more aggressive on the buyback, if it's to completely repay all the debt you borrowed or to hit that leverage target, which you seem quite close to now?

Brandon Pedersen

Brandon Pedersen

I tried to cover it a little bit in the prepared remarks you know we are awfully close to our leverage target. We're going to end the year at 41%, our goal was 40% that wasn't an exact goal. I think we're going to cross into the sub 40% territory early to sort of mid-ish next year. I don't think, we've necessarily decided if we're going to pay off all of the Virgin America debt, although we simply could. The point really that we're trying to convey is that our balance sheet is rock solid, and it gives us some optionality whether it's increased returns to shareholders and or position us to do something with the fleet that doesn't impact the balance sheet too negatively.

Duane Pfennigwerth

And then, I think you have covered it as well. But, it's been a long day already admittedly, so I apologize. Just on the headwinds and tailwinds for costs and where those net out. I don't know if you're in a position to give guidance yet on 2020 CASM.

Brandon Pedersen

No, we're not. I mean, we're going through the planning process now, and what I can say is, is that we've got a lot of cost momentum going into 2020. But our people are working their budgets really hard right now.

Duane Pfennigwerth

Okay, thank you very much.

Brandon Pedersen

Duane, I might jump onto the sort of capital allocation question. I think everybody knows here, we strategically we felt like the industry is changing, we needed to get bigger. We bought Virgin America, borrowed $2 billion in the last 2.5 years, have paid $1.5 billion to that off and the one thing we know is it in 2020 and 2021 that we won't -- we might pay down a little bit more debt, but I think mentally we're sort of crossing a threshold year that we're done dealing with the Virgin America debt and we're going to be looking forward, looking at new capital allocation opportunities for the company.

Operator

The next question is from Savi Syth with Raymond James. Please go ahead.

Savi Syth

Andrew, you talked a little bit about some of the network changes that you've made kind of focusing on some of the shorter haul business markets. But, it is looking and it seems like it is shorter haul and you're kind of moving away from the transcon. Could you talk about what you're seeing on the transcon and why you need -- that the transcon might be funding some of those shorter haul growth?

Andrew Harrison

I'm not quite sure on the transcon, we've actually increased that flying especially out of Pacific Northwest with the seasonality. Really, if you look at the network moves, you're seeing a number of what I'd call Mid Continent flights out of California that quite frankly have a very seasonally pull in the fourth quarter and certainly the first quarter. And so, what we've been doing with aircraft is instead of doing that, we've been flying those aircraft up into our core Pacific Northwest, and connecting directly with some of our larger focus cities, and then we've also increased our capacity out of the Pacific Northwest during the winter quarters to take advantage of the seasonality there.

Overall, as I've mentioned in our notes, our transcon network from California is significantly improved and it's doing good things. And so, we continue to commit to that, but those are most of the changes it's just really some of the short-haul is going up -- the Pacific Northwest instead of Mid Continent.

Savi Syth

And then you mentioned Hawaii did well in the third quarter. I know there were some easy comps. Just, as we kind of look forward, any thoughts there since that was kind of one of the bigger areas and just a follow on to that, last time we talked about Alaska as well and is that -- I think that was supposed to be just like a summer -- a seasonal pressure, but just want to clarify that, that was still the case.

Andrew Harrison

Yes, on the Hawaii, you're right, there was some bad weather and volcanoes and all sorts of other things that were happening last year, but I think what we're seeing is still very solid demand, great load factors and as I mentioned in my prepared remarks, our airplanes are really configured well, especially for Hawaii with that premium class cabin, the first class cabin which has great demand on Hawaii flights and just the service we provide.

We're really made for these longer-haul flights and so, we feel really good about that. Of course, with Hawaii, if there's more capacity comes in, that puts yields under pressure, but we feel very well prepared for that. On the Alaska story, you're right. In the summer, we have a lot of people who like to fly to Alaska. Some folks are flying wide-bodies longer distances, but we cater to very much demand on the West Coast and we do a good job connecting it. So, I don't see that to be a huge issue as we move into 2020.

Operator

The next question is from Jamie Baker with JP Morgan. Please go ahead.

Jamie Baker

Starting on a housekeeping item, the fuel efficiency, that's implied by the fourth quarter guide shows more deterioration year-on-year than what we've seen earlier in the year. Also the sequential decline is a bit more than customary, I recognize there's probably some wiggle room in there around completion factor. But, is that just a modest shift to shorter stage lengths, because that's been going on for a while, so I'm just -- I'm surprised that it's more pronounced in the fourth quarter.

Brandon Pedersen

Are you looking at ASMs per gallon or what's your metric that you're looking at?

Jamie Baker

Yes, ASMs per gallon.

Brandon Pedersen

The only thing -- I don't have that at my fingertips, but the only thing I'm guessing is that on a year-over-year basis, it reflects the increase in regional flying as a percentage, given the fact that Horizon took so many E175s late last year, and then into this year and I'm guessing that's probably the contributing factor.

Jamie Baker

And second and this sort of follows on Duane's line of questioning, you talked about some of the headwinds and tailwinds, puts and takes on ex-fuel CASM for next year. I'd forgotten about lease return accruals for example, so thank you for that. But, I'm wondering if you could expand that narrative from costs to pre-tax margin? Synergies are obviously going to be a tailwind, you've talked about that, but how are you thinking about the other dynamics as it relates to pre-tax margin, next year? Fuel -- the industry impact of the MAX coming back, more Southwest service to Hawaii, what are the three or four items in the tailwind and the headwind buckets?

Shane Tackett

Jamie, its Shane. Good afternoon, this is an excellent question. I don't think I'm going to sort of delve into anything that gets close to guidance. But as we -- I'd just remind you that we laid out a roadmap to get to 13% to 15%, 18 month ago at Investor Day, I think as Andrew noted, we've got a bunch of commitment to you all that we need to deliver on, on the revenue side to sort of complete what we had talked about there, and we intend to do that next year -- and we intend to add to that amount ultimately ultimately and that's what Andrew alluded to in the script in terms of new initiatives that we'd like to talk to you guys about in the first quarter.

On the cost side, I think at Investor Day, Brandon mentioned or I did, we always say its 4% to 5% sort of just core cost pressure, internally within the company. We're growing 3% to 4%. So, we're trying to find ways to continue to manage ourselves to a number that's more in line with our historical norm of flattish on the cost side, but our goal would be to see margins ultimately continue to expand. But, we haven't done all that planning yet and to your point that the industry dynamic is changing. So, we obviously will be talking to you all, more in the coming months about next year.

Operator

The next question is from Helane Becker with Cowen. Please go ahead.

Helane Becker

So here's my one question, you are supposed to have some MAX this year. I think you're thinking all 10 of them are going to come next year, and I know they're not in the schedule, et cetera. But are you -- given those issues are you thinking about the Airbus aircraft on a more serious basis? I mean obviously, you are not because you're doing lease returns, but are you thinking about more Airbus aircraft unless Boeing aircraft or are you still kind of focused on the 73s?

Brandon Pedersen

I want to re-introduce to you and introduce to the rest of the folks on the call, Nat Pieper. Nat's our Senior Vice President of Fleet, Finance and Alliances that sounds like a perfect opportunity for him to share his views on that.

Helane Becker

Thanks Nat.

Nathaniel Pieper

Just a quick reminder, we of course have Airbus aircraft as well, 319s, 320s and A321 neos. It's all really part of the fleet initiatives that we've been working for some time. It's a core component of our three to five-year strategy and in the 15% margin targets. We're looking at near-term opportunities to retire inefficient aircraft, as well as longer term looking for the best aircraft for our future network.

We're confident in the margin accretion possibilities, there's going to be up gauge involved, new aircraft obviously feature a step function improvement in airframe and engine technology. So we're working closely talking to manufacturers, and really hoping to bring something out here in the next handful of months. We're going to order in a financially prudent way, obviously and manage our CapEx and cash flow and end up with an airplane that we know our guests and our Alaska team mates are going to really want to fly.

Helane Becker

I just had one follow-up question. I don't remember who talked about airport costs, but I've heard other of your peer group complain about airport costs to, but when to -- and actually Spirit, this morning they commented that airport costs should be a pass-through. So, wouldn't you -- as you think about those airport costs wouldn't you think about raising fares in those markets so that you recover some of that cost?

Brad Tilden

I might jump in Helane. The first thing -- one of the fun things about these jobs is you get to see your own people move up and sort of move around, you see new people coming to the organization. Nat is a tremendous addition to the team. I've known Nat for -- I don't know, how long, Nat? 15 years or 20 years now and it's just delightful to have you here. I think you're making an excellent point on airport cost. Other airlines may have different perspectives, but the truth is not only airports, but a whole lot of our infrastructure needs a lot of investment and SETAC Airport as an example, our home it needs a lot of investment and we have to -- we want them to invest efficiently, we want them to build the right projects, but we've got to be their partner in there. The investments need to be made, and I think they are investments that any of us would make, if it was our home or a car or whatever. So, yes and of course we do want to find a way to recover those investments through modest increases in fares that help us sort of keep the whole value proposition together. But, I don't think SETAC's that unique. I sort of think airports all across the country need investment, and that's sort of the season we're entering. We've been in it to some extent, but I think the next 10-years 15-years we're going to be seeing this in a lot of airports.

Operator

The next question is from Hunter Keay with Wolfe Research. Please go ahead.

Hunter Keay

So you talked a lot about the 8% growth in redemption Shane, can you talk to me about your current assumptions on breakage, which I think are around 17% that seems high, how do you feel about that number right now and sort of the modern loyalty era. And all else equal, forget the P&L for a second, would you rather see that 17% breakage go down or go up?

Chris Berry

Well, this is Chris. Hi, how are you.

Hunter Keay

Okay. I already know your answer.

Chris Berry

So you know what -- Shane answered it too, but the 17%, yes, we do actually look at that on a semi-annual basis, really to say is that still falling in line with our expectations and the reality is it, we would change it, if it were materially different from that. In terms of whether we would want that higher or lower I can tell you, my answer from an accounting standpoint but it's not probably the answer from a business standpoint, so I'll let Shane if he wants to take that or Shane or Andrew.

Andrew Harrison

I'll just take that. I think, Hunter I get the accounting side and all our estimate. But, I think, at the end of the day we want the breakage to go down. If the breakage goes down, that means people are using our program and we saw a lot of volume come through this quarter. So, we want to grow it, and make it stronger and healthier. So, that's just my take on it because I think breakage goes down strength and loyalty go up.

Hunter Keay

So if that were to change, you would prefer to actually force that down whether it's a change to the policy of miles or how people use them -- giving them more opportunities to use and things like that. And in that case, you would probably have to lower your breakage assumption, but obviously for a net long-term benefit. Is that fair?

Andrew Harrison

Yes.

Hunter Keay

And then, Brandon can you elaborate on this aircraft order strategy? What's going on with that? What do you mean by that? Is that like smoothing of capex, is that fleet types, like what do you -- what are you talking about?

Brandon Pedersen

It's all of the above. It's just doing it in a way that makes sense, both for the needs of the fleet long term, not just today and in a way that preserves our ability to generate free cash flow and do this in a way that allows us to do other things from a capital allocation standpoint too.

Operator

The next question will come from Michael Linenberg with Deutsche Bank. Please go ahead.

Michael Linenberg

I guess two here and I guess for Andrew. What's going on with the American relationship, it does look like maybe there is a potential. I don't know if there is a phase out as we look into 2020 or maybe the code share goes away. Can you just -- can you update us on that?

Andrew Harrison

The reality is that after the acquisition of Virgin America that's when the fundamentals of our relationship with American actually changed. The Department of Justice said, we couldn't do certain things around code and everything else, and just given the size and overlap at the time, there was a lot of adjustments made, a couple of years ago and most of that -- all of that economics is through our system today. So really what you saw is, we still have a partnership with American just -- it's still a good partner, we're working together on our mutual interests.

We still have a lounge program with them, we're still connecting guests through their Chicago hub and they are connecting folks here. But, we've really shrunk it and the footprint is smaller. I think at the highest level, which is I think a testament to Alaska Airlines a couple of years ago 15% of all of our traffic was code and into interline basically dependent. Today it's only 7%. I think that's just a testament to our ability to have grown, to cover most of the destinations where folks go, and then of course use partners where we can mutually benefit and work together.

Michael Linenberg

And I want to make sure that you said that you're still going to continue to connect through Chicago, is that interline or is that code share because like, if I look at schedules today, I still see the Alaska code on say Denver LA, or Austin LA where it's the American metal. Does that code go away, is that going away this spring, or is that...

Andrew Harrison

Yes. Going forward, it all winds down essentially from the Pacific Northwest. You can connect through to Chicago to about 20 destinations, and then on American you can connect through our hubs to about 20 destinations. So the code share will really basically be very, very small.

Michael Linenberg

And then just one other question. When I think about competitive capacity in your markets, as we look into, not just this quarter and also March quarter March quarter 2020, because there has been -- you alluded to this on the call earlier, there has been a lot of network adjustment and in many cases, you know to fund -- as you mentioned the growth into the Pacific Northwest from say LA and San Fran, in some cases you pulled down a whole bunch of capacity, in some markets where there was a decent amount of competition. So, I'm curious about what that number looks like, if you have that at your fingertips for both the December quarter and March quarter 2020 what the competitive capacity is?

Andrew Harrison

Yes, competitive capacity in the fourth quarter is only up about 1.6%. The first quarter is higher than that. It's showing about 4% right now. But of course, I think the first quarter is scheduled to still influx and I'm not sure what's going to happen with schedules with the MAX and everything like that. But, I think to your point, moving around some of this capacity has in some ways reduced some of the overlap, but net-net, we're still putting roughly the same amount of seats in California. At the end of the day, we're just pointing the airplane to different places.

Operator

The next question is from Joseph DeNardi with Stifel. Please go ahead.

Joseph DeNardi

Brad, two questions for you. I think for the last two years, you've been the only CEO in the industry, who's incentive compensation is driven in part by the airline's growth in credit cards. Can you talk a little bit about what change in terms of how you spend your time, how you manage the business before that was a metric versus after? And then, what was the motivation of the Board in making that a metric for your comp? Thank you.

Brad Tilden

Honestly, we went to the board with that idea, following our acquisition of Virgin America, and we just realized that you didn't -- we just really believe in the all idea of building loyalty, building preference, getting people into the club and we've seen the power of that in the rest of our network, and as we bought Virgin America and moved into California it was -- I mean, it's interesting you talk about me and it's certainly true. But, what we really wanted was that in the compensation base of 23,000 people, and that's what happened. So, I think it was 10% credit card loyalty and 10% mileage plan. 10% and 10%, that's how I think also, 10% credit card and then 10% mileage plan.

I think also, 10% credit card and then 10% mileage plan.

We just wanted the fantastic army of people at Alaska Air Group really focused on growing customers growing their loyalty, and so that is -- is that, that's what it was all about. I think the leadership team went to the board and proposed it, and the Board said, absolutely it sounds like something that will drive long-term value.

Brandon Pedersen

And Joe, this is Brandon. Just as a reminder, we have a gain sharing plan that is consistent across all of our employees, not just the leadership, but across the front line as well. So, it really gets down to alignment.

Joseph DeNardi

And then Brad I try and ask you this question every now and then, I'll ask it again. Just given your experience to-date with the Virgin transaction and turning that deal into value for shareholders, how successful do you think you've been and kind of in the context of your balance sheet, nearing a point where you'd be in a position to do something. Does M&A look more or less appealing now than it did before the Virgin deal? Thank you.

Brad Tilden

Yes, thanks for giving us a chance to talk about this. We, at that time -- if you go back to when we considered this it was when we announced it was April, 2016. I think we felt like, we had an amazing economic engine, a great brand. We're really proud of our culture in the way people take care of customers, we felt really positive about the long-term prospects for the industry. But, we did feel like industry conditions were such that we just needed more real estate, and we wanted to have strength beyond Alaska, Seattle and Portland. So that was the idea behind the Virgin merger.

It as you guys know, you go through life, you learn stuff. When you do stuff, you learn stuff and it was -- it was a lot of work. But, I think everyone here is feeling optimistic, we're feeling good that we're getting through it, and I think we really feel that we have materially enhanced sort of the cash producing sort of capability of this economic engine. We've enhanced career of security for our people in doing that. As you mentioned, I'm extraordinarily proud that we borrowed $2 billion to do it.

You guys know, our people did it with no investment banks with no, nothing like that, they just went to the banks and borrowed $2 billion on their own and we're going to pay three quarters of it off, in three months' time, so we're really proud of the team. As we look at doing more, you know I just think, my own view of the world is it's a combination of organic growth and M&A.

We've done amazing with organic growth. I'll just tell you -- and different people around this table may feel differently. But, as I look at the next few years, I sort of see the biggest opportunity us growing organically, pushing -- taking what we are proud of what we feel like we do well, and pushing it organically into markets where we're already strong.

Operator

The next question is from Brandon Oglenski with Barclays. Please go ahead.

Brandon Oglenski

I want to come back to the puts and takes on the cost discussion because I actually did hear the headwinds, but maybe could you elaborate again on where you see the tailwinds on cost looking in 2020. And again, I'm not looking to get guidance from you.

Brad Tilden

On the tailwind side, there's actually a number of those as well. First of all, we're going to be able to grow a little more next year than we've grown this year that will help. We're going to continue to work productivity, you might remember that we focus on two different things for cost control; productivity and overhead. Productivity is a huge lever going into next year. We have continued simplification of our overhead structure that's the other prong. And then, our team just did a great job on a lot of different initiatives. The supplier cost reduction campaign was one of them, and I think all of those initiatives that we worked hard to get this year's cost down will continue to bear fruit, as we go into next year as well.

Brandon Oglenski

And it seems like the Airbus restyling how far along are you in the fleet there?

Brad Tilden

Yes, in terms of the number of airplanes that we've reconfigured -- we'll have...

Ben Minicucci

We'll have -- so 60% of the fleet will be reconfigured by the end of the year, Brandon. This is Ben. So we have roughly 73 airplanes, we'll have 42 to 44 done by the end of the year.

Brandon Oglenski

So if anything, we would see the benefits from that even more so in 2020. Is that correct?

Ben Minicucci

Correct.

Brandon Oglenski

And then, I mean maybe this is just way too premature, but you guys obviously are delivering pretty decent results this year. I mean, does that make you go back to the drawing board on long-term growth because I think Brad in the past you said, if we can get into that targeted margin range, then we would think about expanding the network at a faster pace. Is that still the framework?

Brandon Pedersen

No, we're very comfortable of 4% to 6% growth. We used to talk about 4% to 8%, 8% is pretty big on a company our size now, so 4% to 6% is a pretty good clip. And if we can grow 4% to 6% per year for over four, five, six, seven, eight, nine, 10 years, that's a lot of growth. And we want to make sure that we can do it in a prudent way that keeps our balance sheet intact, where we can achieve our margin goals, it all needs to fit together, but we're really optimistic about our ability to grow 4% to 6% and we feel like that's the right growth rate for the time being.

Operator

The final question is from Dan McKenzie with Buckingham Research. Please go ahead.

The final question is from Dan McKenzie with Buckingham Research. Please go ahead.

Dan Mckenzie

Just following up on that last question, it's really sort of house cleaning the 60% of the A320s that were reconfigured with the new seats, what percent of the flying does that equate to? Brandon Pedersen - Alaska Air Group, Inc. Well, we have to have 53 A320s and on a fleet of 235 mainline airplanes.

Ben Minicucci

Dan, just a lot of the benefit from those actually comes on the revenue side, just to be frank. We're taking the first class cabin from 8 to 12, and we're going to have adding premium seats. And I think, it's anywhere from one to three extra seats per aircraft. So, it's actually more of a revenue boost than a cost one.

Shane Tackett

And so the big thing is we're moving the airplanes primarily North-South, here we're doing a lot of East West flying. Most of the airplanes as of January will be -- its north-south line, which will be more helpful, putting the Boeings and A320 Alliance transcon.

Dan Mckenzie

Going back to the prepared remarks about realizing the $330 million in incremental revenues that were targeted. What inning are we in with respect to saver fares? And I guess, how are you benchmarking to the industry at this point and I guess I'm just thinking the industry as a whole, seems to be finding more upside in this particular bucket. I'm just wondering what you guys can share.

Shane Tackett

We got these out really in full force full force in Q1 of this year. They've performed well, they performed above what we had committed to and talked about, and I don't think we've shared -- updated sort of take rate numbers or economics, but they've performed quite well. Our guess, just based on what we hear other people talk about is, we're on par, if not maybe a little better on the buyout of saver and that's really what we want. We want as few people as want to be on the actual ticket. We like the fact that people buy out more than we had originally sort of estimated.

In terms the -- and I think, we've got a full quarter next year to annualize, it was only sort of partially in Q1 of this year, and then we've not really done anything to try to optimize it anymore. So, there is the potential that, after we have used it for a year, we just get smarter about how we're managing it and it's sort of a tool in the toolkit. So, there's probably more value to be had, we're not quantifying that today. I don't know if we will when we get here in January either, but it's still more upside from saver for a little while.

Dan Mckenzie

And if I could just squeeze one last one in intra-California earlier this year, I think was a headwind to revenue production, or maybe it was partially last year that's changed. I think, you highlighted in the prepared remarks it's doing well. And I'm just wondering, is this in any that's gone from being a RASM drag to a RASM tailwind at this point or how are you thinking about this piece of the network puzzle?

Andrew Harrison

Dan, my prepared remarks were more around transcon, and we don't like to get into the details of specific regions. But what I will tell you is that this flying has also benefited from all the initiatives that we've shared with you and rolled out. And so we are seeing improved profitability across our network and including in intra-California as a result of our changes.

Brad Tilden

Thanks Dan. Thanks everybody for tuning in. We'll talk with you again at the -- for our full year report out in January. Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference call. This call will be available for future playback at alaskaair.com. You may now disconnect.