# Financial Analysis Report of Alaska Air Group

## 12/08/2018

# Alaska Air Group

## CASH MANAGEMENT

Alaska Air Group, Inc.('ALK'), based in Seattle, Washington and founded in 1932, provides passengers and cargo air transportation services. It also provides airlines with ground and ramp handling services. The company operates through three segments: Mainline, Regional, and Horizon. It has a network of approximately 1,200 daily flights to 118 destinations across the United States, Mexico, Canada, and Costa Rica.

From ALK's financial statements, we can see that it has been flush with cash in recent five years. The cash and equivalents have reached $328 million and $194 million in the year 2016 and 2017 respectively. The free cash flow to equity shows favorable signals to investors, maintaining at four-year constant growth until 2016, in which year ALK recorded $2.5 billion FCFE due to increased debt to finance the merger with Virgin Airlines. After that, its FCFE decreased to $167 million as a result of additional high capital expenditures and prepayment of long-term debt principals (see **Exhibit 1** for the variation of ALK' free cash flow to equity).

As regards its ability to produce cash, ALK had an operating cash flow of $1 billion from 2013 and increased it to more than $1.5 billion during 2017. The primary use of these operating cash flow includes capital expenditure, long-term debt principal payment, cash dividend payout and stock buyback. As we see from the cash flow statement, the capital expenditures have consumed most of the cash generated from business operating activities, ranging from $0.5 to $1 billion over the last five years. In a nutshell, ALK's cash flow fully supports its organic growth and returns to debt and equity investors. (see **Exhibit 2** for capital deployment of ALK's cash flow from operating) As we can see from Exhibit 2, the operating cash flow is increasing at 12% annual rate on average. Its relative stable, increasing pattern enables the company to forecast its future financing needs. And the strong operating cash flow gives the firm a lot of flexibility to its operating operation and capital allocation among employees, lenders, debt holders and equity investors.

Compared to peer competitors in the airline industry, JetBlue, United Airlines, WestJet, Alaska airline has a stable cash flow of operation shifting in a narrow band. It is totally in line with the trend of the industry. (see **Exhibit 3** for capital deployment of ALK's Competitors). However, as we can see from the Exhibit 3, the other three competitors' operating cash flow cannot cover the capital expenditure, long-term debt repayment and dividend pay-out, except JetBlue which has not paid any dividends or repurchase stocks over last five years.

## CAPITAL FORMATION

As regards ALK's interest-bearing loan, it has three credit facilities from the bank, totaling $516 million as of September 30, 2018. All of them have variable interest rates based on LIBOR plus a specified margin. And they are secured by aircraft, certain accounts receivable, spare engines, spare parts, and ground service equipment. Also, there is a requirement to maintain minimum unrestricted cash and marketable securities balance of $500 million. The Company has complied with this covenant all the time.

ALK's long-term debt is about $2.5 billion by the end of 2017, and most of it was raised in 2016 to realize the acquisition of Virgin airline. Before that, the long-term debt is $686 million only. Regarding the long-term debt, $959 million is a secured fixed-rate note payable, bearing interest at a weighted-average rate of 4.2% as of Dec.31, 2017 due through 2028. The remaining $1,625 million is a secured variable-rate note payable, bearing interest at a weighted-average variable-interest rate of 2.8% due through 2028. The interest payment in 2015 was only $8 million, but it increased to $24 million in 2016 and $84 million in 2017 because of the soring long-term debt. Coverage ratio (EBIT/interest) in 2015 was 166.3x and has declined to 48.4x in 2016 and 15.9x in 2017.

ALK announced a Public Offering of floating rate senior convertible notes due 2023 for gross proceeds of $150 million on March 17, 2003. The notes would be convertible into shares of common shares at a conversion price of $26 per share and would mature on March 21, 2023. However, in the second quarter of 2006, ALK called for redemption all of the $150 million senior convertible notes, and all of the notes were converted by the holders into shares of its common stock.

Furthermore, due to the debt raised in 2016, ALK's long-term debt-to-capital ratio (including the net present value of aircraft operating lease payments) has increased to 59%, then decreased to 51% by the end of 2017, compared to 27% in 2015. (see **Exhibit 4** for changes of ALK's capital structure, without adjustment of the operating lease). However, the credit rating for ALK remains at investment grade BB+ since 2016. Since 2016, the company's top priority has been deleveraging its debt-to-capital ratio to a target level of mid-40%, and we can see from Exhibit 2 that the company has allocated more cash resources to accelerate the repayment of debt principles.

The company has entered into the operating lease commitments which generally include aircraft operating leases, airport property and hangar leases, office space, and other equipment leases, the total related amount is around $430 million in 2018 and is expected to decrease over the following years.

The company went to the public on New York Stock Exchange at January 13, 1978. Over the last five years, the company has never raised money by offering equity.

During 2017, $54 million was increased in equity due to the implementation of stock-based compensation, employee stock purchase plan and other stock plans. And $37 and $36 million was increased in equity as a result of issuance of stock-based plan in 2016 and 2015 respectively. Stock options are given to the employees to retain them and incentivize them to behave in certain ways so that their interests are aligned with that of all the shareholders of the company. If the company compensates the option holders totally in terms of additional shares, the paid-up capital increases on the Balance Sheet while there will be no impact on the Cash Flow Statement. For 2017, the total increased stock-option is only 1.53% of the total equity.

ALK has 2 splits records in the past. The first split took place on March 19, 2012, and the second did on July 10, 2014. Both were 2 for 1 split, meaning for each share of ALK owned pre-split, the shareholders now owned 2 shares. The stock price of ALK had increased from about $18 per share at the beginning of 2012 to $47 per share May 2014. A stock split may increase liquidity as making it more affordable to small investors. But it also signals the market that the company's share price has been increasing, and investors may assume the growth will continue and start making investment and driving up the price. Actually, ALK's stock price increased to $80 per share by the end of 2015 after the stock split.

## PAYOUT POLICIES

During 2013, after years of strong operating performance, the Company started returning capital to shareholders in the form of cash dividend. Until the end of 2017, the ALK has paid out $482 million dividends to its shareholders (see **Exhibit 5** for annual dividend spend). The company has an annualized dividend $1.28 and 1.8% dividend yield in 2017. The dividend per share has continued to increase from $0.2 in 2013 to $0.32 in 2018. ALK expects to continue to return capital to shareholders in the future, primarily in the form of dividends (see **Exhibit 6** for dividend pay-out list).

Since 2007, ALK has repurchased 60 million shares of common stock for $1.6 billion at an average price of approximately $26.72 per share. The company's board of directors approves the stock repurchase program authorizing the company to repurchase its common stock with cash on hand. The repurchase program allows the company to purchase its common stock from time to time, through open market purchases, negotiated transactions or other means, including accelerated share repurchases and 10b5-1 trading plans by applicable securities laws. Overall, the company has returned $1.6 billion dollars to shareholders from 2013 to the end of 2017. Meanwhile, it has paid out $1.042 billion debt principal and $0.179 billion related interest expenses in cash within the same period.

Up to September 2018, the top five shareholders of ALK are T.Rowe Price Group, the Vanguard Group, BlackRock, PRIMECAP management and Managed Account Advisors which are all public or private owned investment managers. As to the composition of the shareholdings, about 80% of total shares outstanding are held by traditional investment managers, 5% are held by banks/ investment banks, 4% are held by hedge fund managers, and about 3% are held by government pension sponsors. Of those investment managers, mutual funds holders own 51.44% of shares. Normally, mutual funds that hold dividend-paying stock are very attractive to investors who are looking for low risk and long-term value since they can provide a steady income to investors and a potential long-term return. Thus, this type of shareholder may prefer cash dividend than stock buybacks.

As stated in the company's policy, ALK will continue providing strong, sustainable returns for its owners in the future.

## FINANCIAL STRATEGY

ALK's strong operating results are driven by several factors, including its reliable operation, highly effective marketing, long-term emphasis on high productivity, and most importantly, the consistent focus on customers. All these strengths, together with the company's low-cost structure and low fare policy, enable it to have consistent organic growth and generate massive amount of operating cash flow while reaching new markets and capturing more customers.

Even with increasing high Capex over the past ten years, ALK's debt-to-capital ratio had been decreasing all the time from 81% in 2008 to 27% in 2015. But in 2016, the borrowings to finance the merger with Virgin Airline has resulted in the leverage ratio to be around 59%. However, after that, the company continue to implement important revenue initiatives that boost up the top line while aggressively controlling cost and lowering the capital spending, which makes the company produce much more free cash flow and by the end of the quarter in 2018, the debt-to-capital ratio has been reduced at 49%. We think, for an airline company, maintaining the leverage ratio at a relative low-level is optimal to protect its long-term shareholders from the cyclicality of the industry. Meanwhile, the low-leverage would enable the company to borrow at a lower cost and return more capital to its shareholders by saving interest expenses.

ALK has committed to maintaining a conservative investment-grade balance sheet which indicates that the bonds it issues have a relatively low risk. Since ALK has a BB+ investment grade credit rating and has stable, sufficient cash flow, the current three types of low-cost interest-bearing debt, e.g., the fixed-rate note, the floating rate note, and credit facilities, are reasonable for the company's current situation. As the federal interest rate is expected to increase, the fixed-rate bonds are going to be more favorable to the company, while the floating-rate bonds are going to be more attractive to investors. We recommend it may increase the portion of fixed-rate note in its debt issuance if needed as demand for it shall still be high enough based on its quality.

As a large, consistently profitable and cash-rich company, we think implementing a strong dividend policy and regular stock buyback programs serve as a constant reminder to the management that the shareholder return is their priority. This also tends to make the executives more sensitive and selective towards the mergers and acquisition as cash is relatively scarcer. And regular and growing dividends payout profile allows the company to appeal those wealthier, more stable investors, and dividend paying company tend to fall less during a tough time, especially for the airline industry which is vulnerable to those exogenous events.

The Company has various equity incentive plans under which it may grant stock awards to directors, officers and employees. So, to protect the benefits of shareholders, ALK use its available cash to buy back shares to offset the dilution caused when employees exercise their options. And as we mentioned before, primary shareholders' preference of cash dividend may decrease the stock price and act oppositely to the benefits of employees with stock options. But we think their interests are still definitely aligned together since the dividend-paying stock normally will outperform the non-dividend paying stock in the long-term. The top priority for the company is to find a balanced capital allocation structure to make each category of stakeholders satisfied.

Overall, we recommend the company to maintain the status quo and stick to its operating and financing strategies. First, it shall continue to improve the operating performance by maintain the moderate organic growth and lower the CapEx investment, thereby produce higher free cash flow. Then it keeps on deleveraging the balance sheet and finally left more cash that it could return to its owners in the form of growing dividend and stock buyback. (**Exhibit 7** for Recommendation)

# Appendix

**Exhibit 1** Variation of ALK' free cash flow to equity

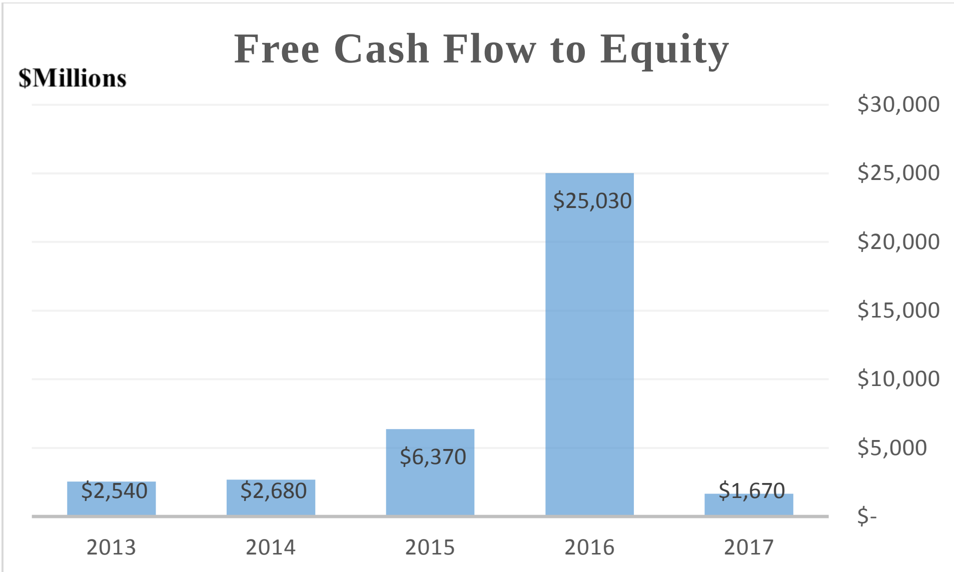



**Exhibit 2** Capital deployment of ALK's cash flow from operating

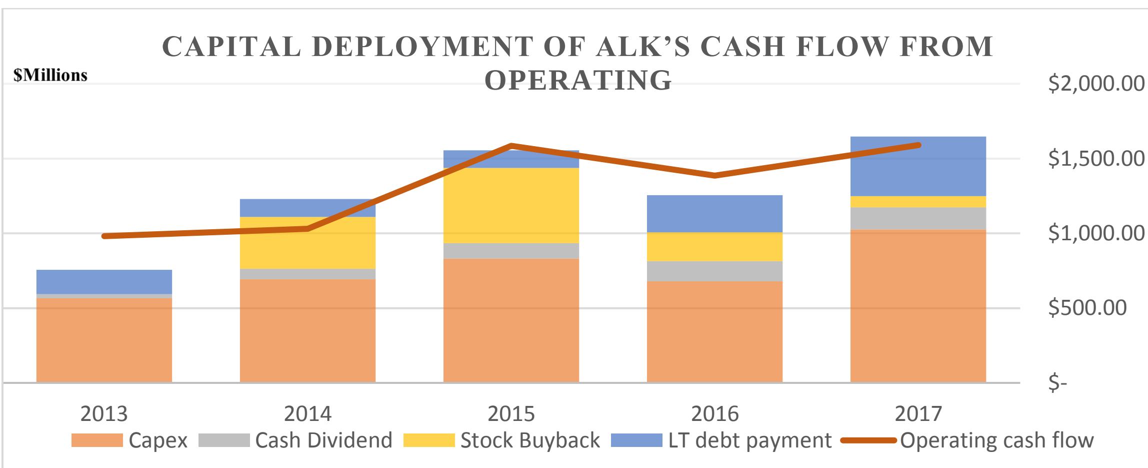
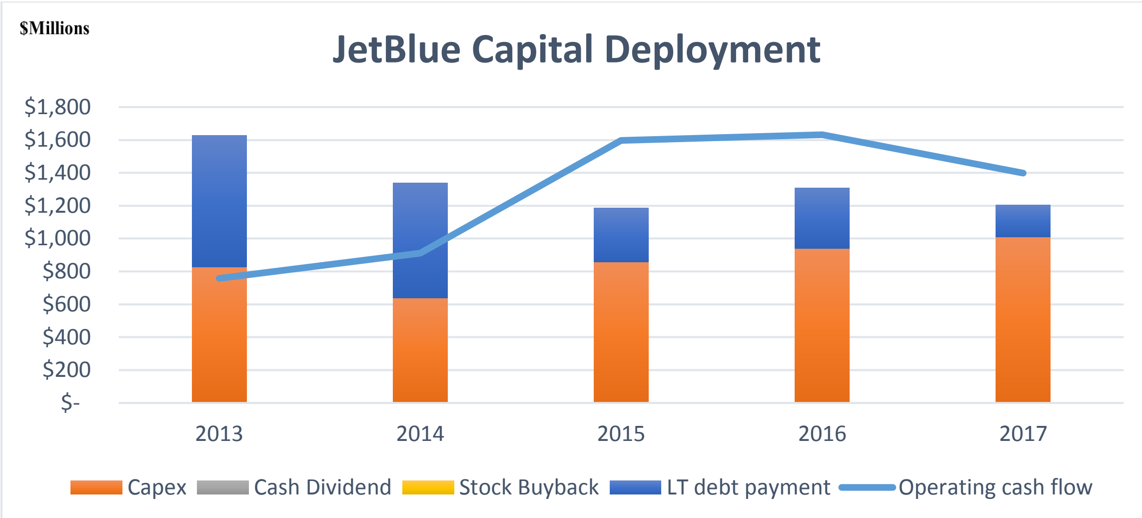
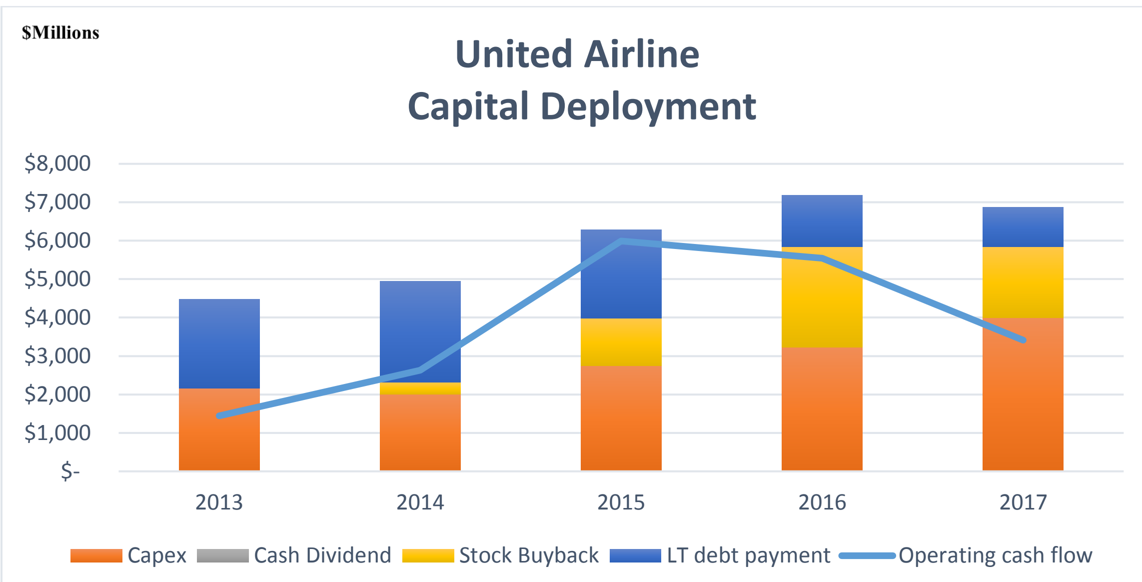


**Exhibit 3** Capital deployment of ALK's Competitors



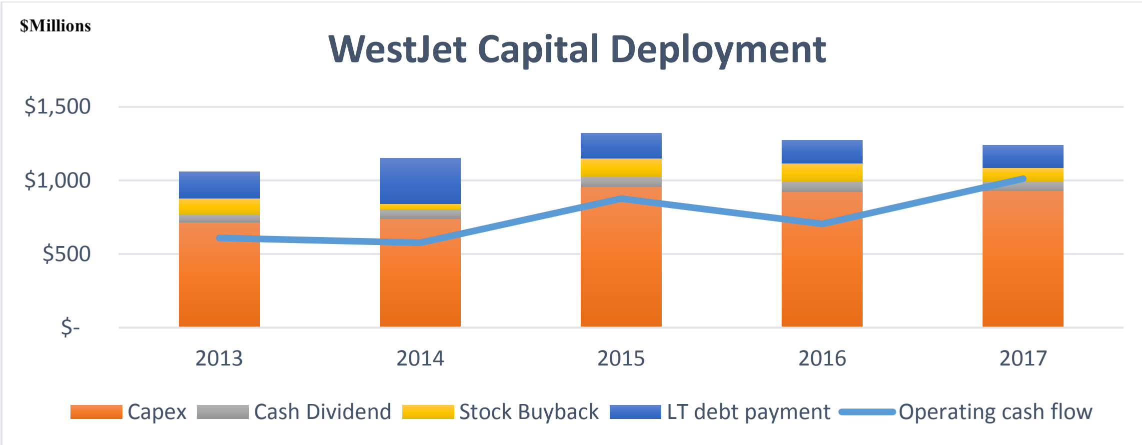
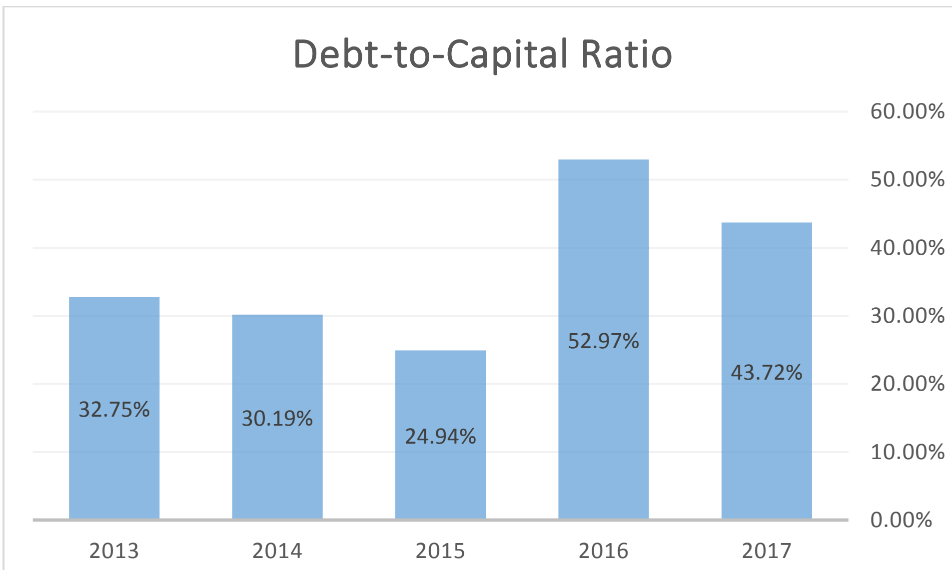



**Exhibit 4** Changes of ALK's capital structure




* without adjustment of operating lease

**Exhibit 5** Annual Dividend Spend

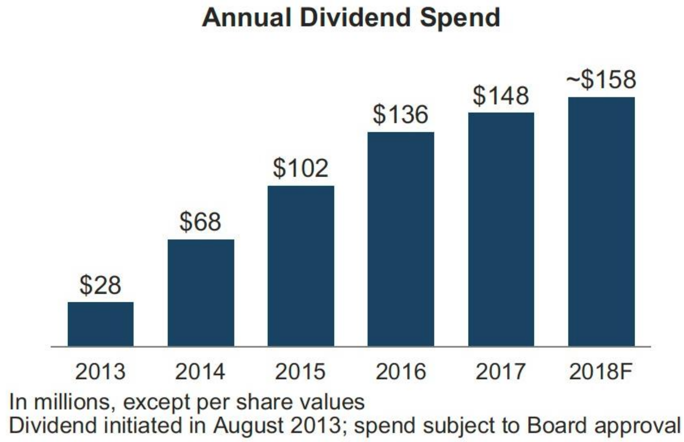
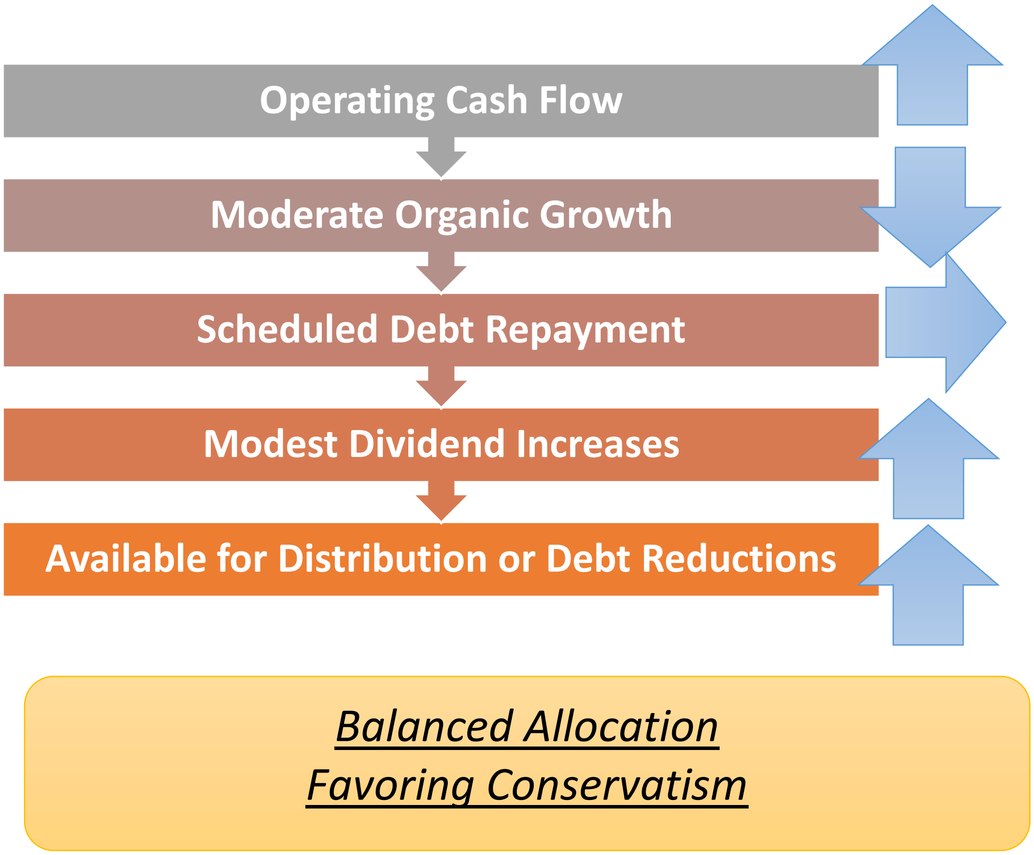



**Exhibit 6** Dividend pay-out list

## Dividends

| Declared | Record | Payable | Amount | Type |
|---|---|---|---|---|
| 11/01/18 | 11/02/18 | 12/06/18 | $.320 | Cash, quarterly |
| 05/04/18 | 05/22/18 | 06/07/18 | $.320 | Cash, quarterly |
| 01/25/18 | 02/20/18 | 03/08/18 | $.320 | Cash, quarterly |
| 11/03/17 | 11/21/17 | 12/07/17 | $0.300 | Cash, quarterly |
| 08/04/17 | 08/22/17 | 09/07/17 | $0.300 | Cash, quarterly |
| 05/05/17 | 05/23/17 | 06/28/17 | $0.300 | Cash, quarterly |
| 02/07/17 | 02/21/17 | 03/09/17 | $0.300 | Cash, quarterly |
| 11/02/16 | 11/15/16 | 12/01/16 | $0.275 | Cash, quarterly |
| 08/03/16 | 08/18/16 | 09/01/16 | $0.275 | Cash, quarterly |
| 05/13/16 | 05/24/16 | 06/07/16 | $0.275 | Cash, quarterly |
| 01/21/16 | 02/23/16 | 03/08/16 | $0.275 | Cash, quarterly |
| 11/04/15 | 11/17/15 | 12/03/15 | $0.200 | Cash, quarterly |
| 05/11/15 | 05/21/15 | 06/04/15 | $0.200 | Cash, quarterly |
| 11/06/14 | 11/18/14 | 12/03/14 | $0.125 | Cash, quarterly |
| 08/07/14 | 08/19/14 | 09/04/14 | $0.125 | Cash, quarterly |
| 05/13/14 | 05/23/14 | 06/10/14 | $0.250 | Cash, quarterly |
| 02/13/14 | 02/25/14 | 03/11/14 | $0.250 | Cash, quarterly |
| 11/07/13 | 11/19/13 | 12/04/13 | $0.200 | Cash, quarterly |
| 07/11/13 | 08/06/13 | 08/20/13 | $0.200 | Cash, quarterly |

**Exhibit 7** Recommendation



# Bibliography


- "Dividends." Alaska Air Group Inc, investor.alaskaair.com/stock-information/dividend-history.
- "2017 Form 10-K" Alaska Air Group Inc http://investor.alaskaair.com/financial-information/annual-reports
- "Investor Updates - November 27, 2018" Alaska Air Group Inc http://investor.alaskaair.com/static-files/fdaf10f4-55dd-457e-8b3d-060a99f987ec
- "Quarterly earnings" Alaska Air Group Inc http://investor.alaskaair.com/static-files/482cc4a4-fd53-4bf7-8424-4a4e7ae5a649
- "News Releases" Alaska Air Group Inc http://investor.alaskaair.com/news-release?field_nir_news_date_value%5Bmin%5D=2018
- Beers, Brian. "Understand the What and Why of Stock Splits." *Investopedia*, Investopedia, 4 Dec. 2018, www.investopedia.com/ask/answers/what-stock-split-why-do-stocks-split/.
- Vaidya, D. (2018). *Share / Stock Based Compensation Expense | Accounting*. [online] Learn Investment Banking: Financial Modeling Training Courses Online. Available at: https://www.wallstreetmojo.com/share-stock-based-compensation-expense/ [Accessed 9 Dec. 2018].