# paying DIVIDENDS

ALASKA AIRLINES

With Virgin America in the fold, Alaska Airlines says the merger's benefits are set to take off. **BY SEAN BRODERICK**

**CEO BRAD TILDEN** marked Alaska Airlines' 35th year on the New York Stock Exchange Nov. 27, 2018.

In the airline business, post-merger integrations are multiyear affairs, making it impossible to pinpoint when two combining carriers become one. In the case of Alaska Airlines and Virgin America, the history books will note sometime in 2018 as when the two airlines began to look and feel like one. Among the year's key milestones: integrated airport operations, a single reservations system and the all-important single operating certificate.

With most of the integration done, 2019 should be when the next, and most important, post-merger phase begins to gain critical mass.

"We believe that we passed through an inflection point in the last few months," Alaska president and CEO Brad Tilden said at the company's investor day in late November. "We're now moving to harvest time and to realizing the benefits of this merger."

Alaska's purchase of Virgin, announced in April 2016 and approved by shareholders and regulators in eight months, instantly created a larger airline. Adding Virgin increased Alaska's daily departures and annual passengers by about 20% and boosted annual revenue 25%. The combined airline is a solid fifth in total annual domestic seats, a Delta Airport Consultants analysis showed, leapfrogging New York-based JetBlue Airways and trailing only the US market's dominant four: American Airlines, Delta Air Lines, Southwest Airlines and United Airlines.

None of this, however, explains why Alaska paid a premium for Virgin, outbidding JetBlue in the process. Alaska's $2.6 billion all-cash purchase price—$57 per share, 30% higher than Virgin's shares closed the day the deal was inked—reflected Virgin's quality more than its size. Virgin's network was built on a foundation of serving large US commercial markets. The carrier's route network included 12 of the top 20 US metropolitan areas.

"This was a play for strategic assets like we have never seen."
William Swelbar, analyst

More importantly, it had significant presence at some of the US' most space-constrained airports. Among the most precious gems in Virgin's crown: eight gates at San Francisco International, giving the combined carrier 10, and six at Los Angeles International, doubling Alaska's previous total. On the US East Coast, Virgin had a combined 50 slots at the three main New York-area airports, as well as 10 at Ronald Reagan Washington National. Add in the fact that Virgin was making money, having posted net profits in 2013, 2014 and 2015, and the rationale behind Alaska's move becomes clearer.

"At the time of the deal, Virgin America's margins were improving, cash flow from operations was improving and liquidity levels were more than sufficient for Virgin to weather a downturn," Delta Airport Consultants chief industry analyst William Swelbar said.

## Thinking long-term

Virgin's performance combined with its valuable clutch of resources made it a smart long-term play, even at a premium price.

"Airports in large metro areas serving strategic commercial centers are simply running out of real estate to accommodate today's growth," Swelbar said. "The value of Virgin America's many assets will only increase over the next decade as airport real estate becomes even more expensive for those carriers that want to expand service. This was a play for strategic assets like we have never seen."

Integrating those assets into Alaska's network brought meaningful gains in key markets beyond the airline's traditional strongholds. In Los Angeles, its average daily-departure total has jumped from 63 to 115. In San Francisco, 17 pre-merger daily departures is now 69. Across the country, a meager three daily departures from the New York metro area is now 30, equally split between John F. Kennedy International and Newark Liberty International airports.

Taking its key West Coast markets in aggregate, Alaska says it has moved to market-leading positions in several key metrics. Before the merger, its West Coast operation fed 233 nonstop markets with 756 average daily departures and had a 20% share of all seats. Today, it serves 285 nonstop markets with 931 average daily departures and has 24% of the seats.

"But most importantly, we have the number one ranking across every one of these off the West Coast," Alaska EVP and CCO Andrew Harrison said. "We have built exactly what we wanted to build. ... [It's] a very, very significant foundation."

The next steps are likely to include more California-focused growth as the carrier seeks to build on its strong presence in the key Los Angeles and San Francisco markets. It also will use its new Paine Field service to tighten its grip on its home market. Located 20 miles north of downtown Seattle and home to Boeing's Washington-based widebody production and delivery facilities, Paine will soon be home to 18 daily Alaska departures. This is on top of 300 out of its increasingly crowded Seattle-Tacoma International hub, where it has added about 50 daily flights since 2015 just to keep its market share stable at 55%.

**ALASKA/VIRGIN COMBINATION***

| | ALASKA | VIRGIN | COMBINED |
|---|---|---|---|
| Annual revenue | $5.6b | $1.5b | $7.1b |
| Annual passengers | 32m | 7m | 39m |
| Fleet size | 219 | 63 | 282 |
| Daily departures | 1,000 | 200 | 1,200 |
| Destinations | 112 | 24 | 114 |

*At time of deal's announcement, April 2016.
*Source: Alaska Air Group*

Not surprisingly, California markets figure prominently in Paine's schedule, accounting for 11 of the 18 departures, with Los Angeles (4) topping the list.

## Goodbye, Virgin

While the purchase bought many valuable assets, Alaska has shed a few things, the most prominent being the Virgin America brand. The last official Virgin flights took place April 24, 2018, the day before Alaska moved to a single reservations system. Airbus narrowbodies with Virgin livery are slowly being converted to the Alaska brand, with the process expected to last through 2019.

The refurbishment goes well beyond new paint and cabin colors. Virgin's more spacious layouts are going as well—Alaska is adding four seats to its A319s and A320s, and five to its A321s.

"The Airbuses were not configured to be revenue-generating machines in our current network," Harrison said.

The changes add seats in first-class and Alaska's new premium economy sections, while removing seats from standard economy. The moves are part of a larger effort to generate incremental revenue through segmentation and ancillary-revenue generation—notably more seating options and higher baggage fees.

"They are going to be the largest levered piece of getting margin expansion into the business," Alaska EVP-planning and strategy Shane Tackett said.

Alaska's new mainline cabin-segmentation doubles passengers' options to four, adding premium-economy seats, including exit rows, and bare-bones basic economy that get the buyer a seat, but little else. The changes will help Alaska catch up to its peers, which have spent much of the last two years developing and testing their own segmentation programs.

"In the midst of an integration, as we were trying to move into a single passenger service system, it's just not the right time to bring new products to market like basic economy or other things that folks were ahead of us in doing," Tackett said. "Those opportunities are all available to us now."

Alaska, long a vocally proud all-Boeing mainline aircraft operator, plans to fly its Airbuses at least until the leases expire during the first half of the next decade. In the meantime, it is making the most of them in the new, combined network, including flying them more frequently. Daily utilization for the Airbus fleet averaged 9.3 block hours in the first quarter of 2018, up 31% from Virgin's first-quarter 2016 figure.

The new mixed fleet's routes are also being selected with more scrutiny. For instance, Alaska is using its larger Boeing 737s on more high-demand transcontinental routes, while running the Airbus narrowbodies in north-south markets. The carrier calculates that a reconfigured 178-seat 737-900ER between Los Angeles and Newark generates $2,500 more revenue per flight than a reconfigured 146-seat A320, even factoring in fleet-redeployment expenses. It also dropped flights at New York LaGuardia airport inherited from Virgin, leasing the slots to Southwest Airlines and concentrating its New York-area operations at Kennedy and Newark.

### Cost controls

Dense cabins and high utilization were part of Alaska's DNA before the merger, and that will not change. The carrier calculates that its non-fuel cost per available seat mile (CASM-ex), adjusted for stage length, was 8.38 cents for the 12 months ended June 30, 2018. That is nearly 20% lower than American Airlines, which had the lowest CASM-ex of the US' three global major carriers, and only 8% higher than the US major-airline LCC darling Southwest.

"We firmly believe that our success is rooted in a low-cost foundation," Tackett said. "The last two years hasn't changed that. That's what we're going to go work on in 2019 and beyond."

Keeping costs in check as it continues the integration is near the top of Alaska's 2019 to-do list. The carrier is projecting 2019 CASM-ex to rise 2%-2.5% on a capacity increase of about 2%. As 2018 came to a close, the carrier was on track to increase year-over-year CASM-ex 3.2% on 5.3% more capacity.

**ALASKA DAILY DEPATURES IN KEY MARKETS, 2016 vs TODAY**

| | 2016 | 2018 | CHANGE |
|---|---|---|---|
| Seattle | 283 | 298 | 5% |
| Portland | 122 | 129 | 6% |
| LAX | 63 | 115 | 83% |
| San Francisco | 17 | 86 | 406% |
| New York Metro | 3 | 30 | 900% |

*Source: Alaska Air Group*

**U.S. DOMESTIC SEATS BY CARRIER, 2018**

| RANK | CARRIER | SEATS* |
|---|---|---|
| 1 | American Airlines | 217m |
| 2 | Southwest Airlines | 204m |
| 3 | Delta Air Lines | 202m |
| 4 | United Airlines | 156m |
| 5 | Alaska Airlines | 55m |

**Based on 2018 schedules*

*Source: Delta Airport Consultants*


JOEPRIESAVIATION.NET

**ALASKA AIRLINES**
Boeing 737-900

Part of the cost increases is coming from a higher percentage of regional flying, which carries a CASM-ex about twice that of mainline, as it up-gauges. Alaska's Horizon Air subsidiary started 2018 with 83 regional aircraft: 50 Bombardier Q400s and 33 Embraer E175s. By the end of 2019, it will have 92: 62 E175s and 30 Q400s. Meanwhile, it is trimming where it can. Alaska cut about 200 management positions in 2018—about 10% of its upper-level staff.

Among the remaining integration to-dos: finalize a tentative agreement to bring mechanics together, joining the unified carrier's pilots, flight attendants, ground-service workers and dispatchers. By March, flight attendants will be a single, cross-trained team that can staff both Airbus and Boeing aircraft, increasing productivity.

### Shared vision

One post-merger focus area that will not be checked off soon is establishing the combined carrier's culture. Blending any two large organizations brings certain hurdles, and the fact that Alaska and Virgin had very distinct corporate personalities only adds to the challenge. Recognizing this, Alaska has set up several programs to help align its people.

In 2019, each of Alaska's director-level employees will spend a week working alongside front-line staff.

"This will help them understand the challenges that our front line face, and it will help make sure that we've got deeper relationships with the employees that we are here to support," VP-people Andrea Schneider said.

Alaska also has a new, forum-like program for its entire 23,000-strong workforce. The effort, Flight Path, brings in groups of employees, 600 at a time, for a five-hour session in a rented warehouse not far from the airline's Seattle headquarters.

"We talk about our history, where we come from, where our values have been built," president and COO Ben Minicucci said. "We talk about where we are. We say, here's the good, bad and ugly of where the company is. And then we talk about the vision [and] we finish it with a lot about culture and working together as one team."

While Flight Path's goal is to communicate the new airline's vision, management is using the sessions to solicit direct feedback from the ones tasked with making it a reality.

"The conversations are spicy," Schneider said. "We have people coming in with various perspectives, but at the end of the day when everybody leaves, they have a renewed sense of where we've come from, where we're headed, and why one team and working together really matters." ATW