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BJORKLUND FUND

April, 28th, 2017

Southwest Airlines Co.: LUV

Michael Capozzi

Sector: Services
Industry: Regional Airlines
Current Price: 57.09
Target Price: 77.04

Company Description: Southwest Airlines is a passenger airline that provides scheduled air transportation services. They have 101 destinations in 40 states, Washington D.C., and the common wealth of Puerto Rico. They fly 8 international destinations, which include Mexico, Jamaica, The Bahamas, Aruba, the Dominican Republic, Costa Rica, Belize, and Cuba. The company was founded in 1967 and is headquartered in Dallas, Texas.

BUY

Current Price:	$57.09
Target Price:	$77.04
Market Cap:	34.52B
Beta:	1.22
52 week range:	35.42-59.68
Average Volume:	5,634,367
WACC:	9.3%
EBITDA Margin:	25.4%
ROIC:	16.29%

Thesis:

Southwest continues to be one of the most successful airline company based out of the United States. Their low cost strategy was the first of its kind and has provided the company with value unlike their competitors. In the last 52 weeks the stock has surged from 35.42 to a high of 59.68. A weak Q1 earning call could set up a cheap price to buy LUV. Southwest is expected to return to its old self in future quarters, which would increase the stock price once again. In regards to the industry, Southwest has positioned itself in an industry that is growing and is expected to continue growing. Southwest is also able to block itself from the possible travel legislation that will be implemented because the company mostly operates in the United States. Southwest has also been able to meet its competitors or beat them in sales and margin growth.

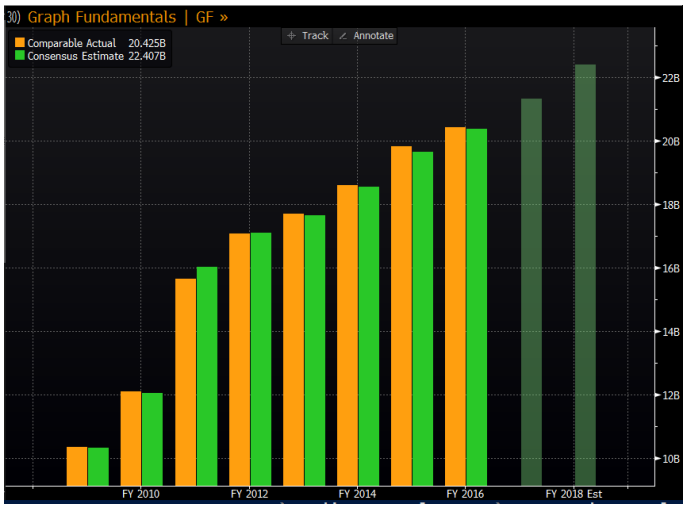
Catalysts:

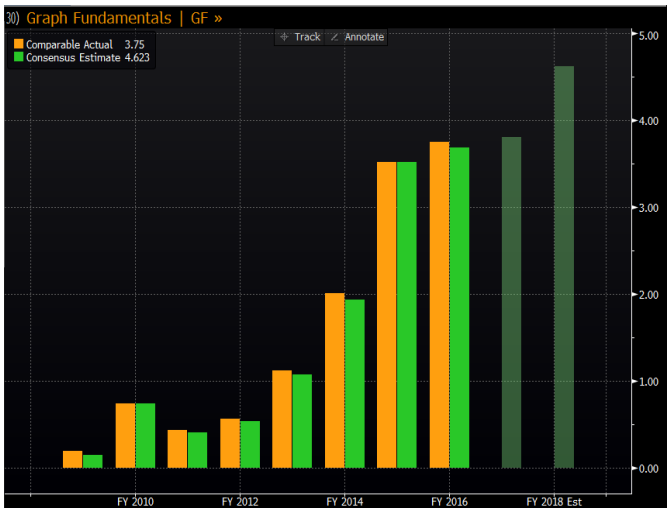
- Short Term(within the year): low buy price and positive Q2 earnings
- Mid Term(1-2 years): Increased revenues and margins due to strong unit cost performance
- Long Term(3+): If a strong economy continues the company will continue its success into the long term

SOUTHWEST AIRLINES®

Earnings Performance:

Airlines stocks have known to be to struggle at times to make earnings because of high fuel costs, narrow profit margins, and troublesome labor. Although Southwest has been able to be a profitable company for the last 44 years. Revenues have also increased 3.05% from 2015 to 2016 and have increased 19.5% in the last 5 years. Their Q4 2016 earnings call beat estimates. Revenues totaled $5.076B, which carried a 0.9% revenue surprise. Earnings per share rose beat estimates by 6 cents to finish the quarter at $0.75. Earnings per share for the year finished at 3.75, a 6.5% increase from the year before and a 569.64% increase in the last 5 years. Southwest is expected to report their Q1 2017 results on April 27, before the market opens. Expectations

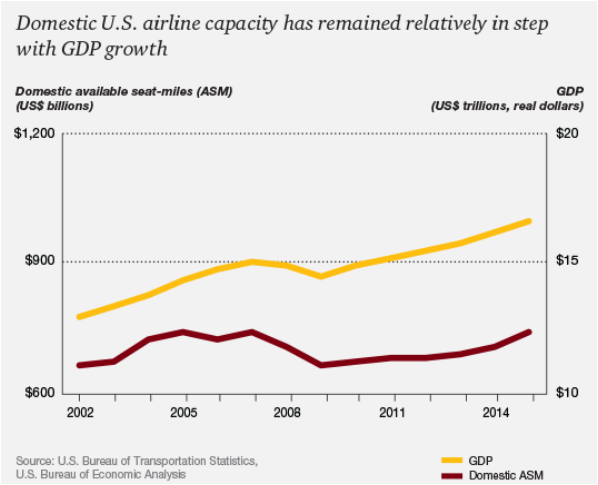




are an EPS of $0.62 and a revenue of $4.89 billion. The decrease could be due to an expected increase of 6% to 7% in CASM (cost per available seat mile). Option markets expect a 4.5% potential stock move up or down after the report is released. Due to this, I'd wait for to buy the stock after the market has already reacted to the announcement. A potential 4.5% drop could set up a cheaper buy. For the longer run, Southwest is projected to finish 2017 with revenues of $21323.7M, 4% increase from the year before. EPS are also expected to increase from 2016 to 2017 by 1.5%.

Industry Outlook:

Passenger demand is measured by RPM (revenue passenger miles). The global airline industry demand grew 6.3% YoY. Regional and Legacy carriers both saw improvements in 2016. For the airline industry future demand is based on economic growth. Analysts believe expect more growth going into the future. Warren Buffet once described the industry as a "death trap for investors," has recently changed his tone. He has recently invested more than $8 billion in U.S. commercial carriers: American Airlines, Delta, United Continental, and Southwest. Buffet expects the industry to stay hot. Although, there are a few factors that could harm the industry. The most important being the increase in oil prices. Oil prices have been known to seriously impact airline companies' margins. The industry is also extremely competitive and price wars can seriously impact these companies.

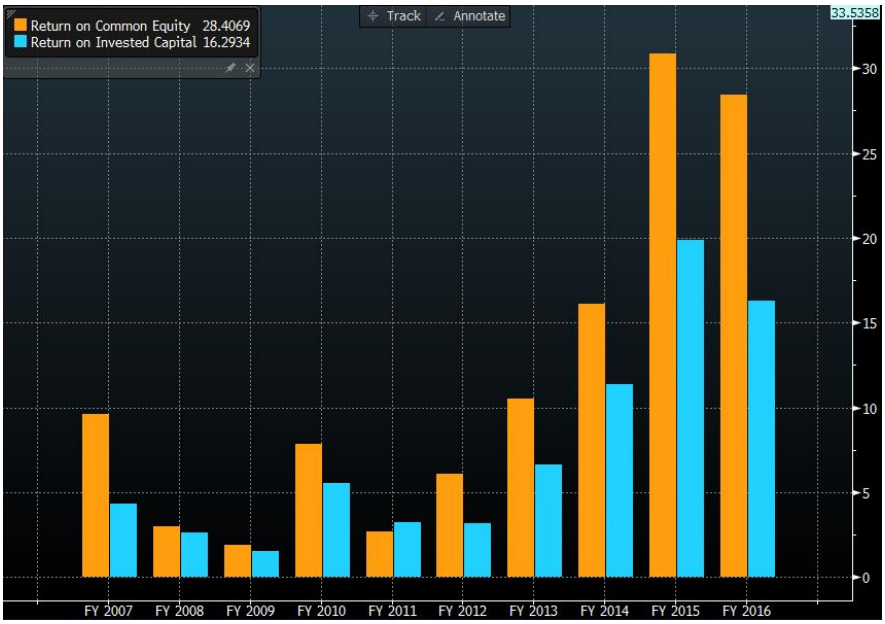


US Travel:

Southwest does most of its travel in the United States and near-countries such as the Dominican Republic and Mexico. This makes them a more sheltered against international travel problems that have emerged in recent months. New legislation that may emerge will not harm southwest. This has them placed to outperform companies that focus more on international travel. According to IATA's 2017 Regional Analysis, North American carriers are expected to finish 2017 with a net margin of 8.5% and an average profit per passenger of $19.58. The 8.5% net margin is the strongest out of any other region.

Profitability:

Southwest has been able to make their company more profitable over the last few years. They been able to do this by improving their low cost strategy. In just 6 years their EBITDA margin has increased from 8.99% to 24% and is projected to increase to 24.2% in 2017 and 25.9% in 2018. Their return on invested capital has increased 948% to 28.41% in just 6 years. Their sustainable growth rate was last recorded at 25.43%.



Chance to buy low:

The company is expected to report unfavorable earnings for Q1, because of this the stock is expected to drop around 4%. This hiccup will not indicate doom for the company, but will give investors the opportunity to buy the stock at a lower price. After the Q1 earnings report is released, LUV should be priced lower, which should give us a better price to buy at. This is because the company is expected to rebound in Q2 and further the company's success and growth.

Competitors:

Southwest has been able to perform better than their competitors. The companies used to compare were Jet Blue, Spirit Airlines, Delta, and United. Southwest was able to match the median sales growth YoY at 1.18%. They also beat all competitors in operating margin (LTM) at 17.89% other than Spirit, who saw a 20.89% increase. For last year Southwest posted an EBITDA margin of 25.35%, better than all competitors except Jet Blue who recorded a margin of 25.71%. Keep in mind Spirit is a younger company that is prone to more growth. They also better the median return on assets at 9.45% and matched the median ROE at 27.7%. Southwest also led competitors in return on capital at 20.14%. This shows investors that Southwest is near the top of its class.

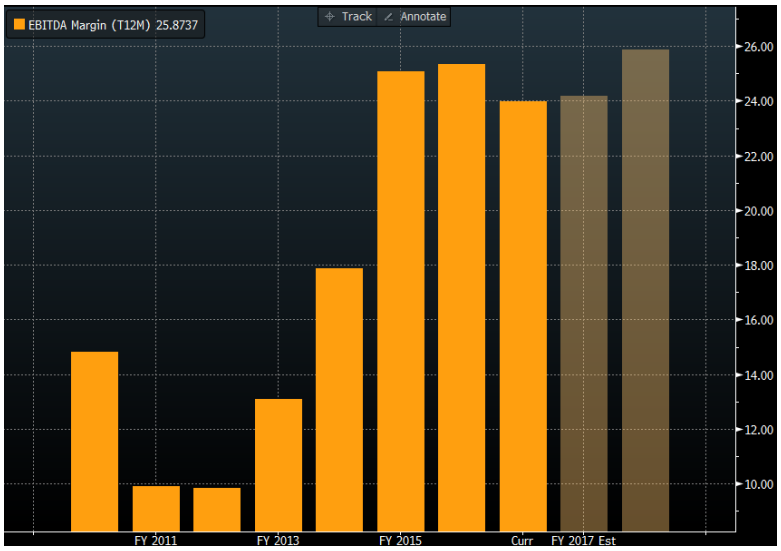
	Name	Sales (LTM)	Operating Profit (LTM)	Net Income (LTM)	Salaries	Fuel Expense	Capital Expenditures (LTM)	Sales Growth YoY	Operating Margin (LTM)	Return on Assets	Return on Equity	Return on Capital
	Median	20.48B	3.67B	2.17B	6.80k	3.65k	-2.01B	1.18%	16.77%	8.27%	27.70%	15.10%
100)	SOUTHWEST AIRLINES CO	20.48B	3.67B	2.17B	6.80k	3.65k	-2.01B	1.18%	17.89%	9.45%	27.70%	20.14%
101)	JETBLUE AIRWAYS CORP	6.62B	1.11B	636.00M	1.70k	1.07k	-1.01B	-0.74%	16.77%	8.27%	20.77%	15.59%
102)	SPIRIT AIRLINES INC	2.38B	485.04M	254.94M	472.47	447.55	-541.12M	9.96%	20.89%	10.27%	22.27%	14.60%
103)	DELTA AIR LINES INC	39.54B	6.47B	3.55B	10.03k	5.99k	-3.32B	-1.11%	16.35%	6.78%	29.35%	--
104)	UNITED CONTINENTAL HO...	36.78B	4.47B	2.55B	10.28k	5.81k	-3.10B	2.75%	12.14%	6.23%	31.31%	14.17%

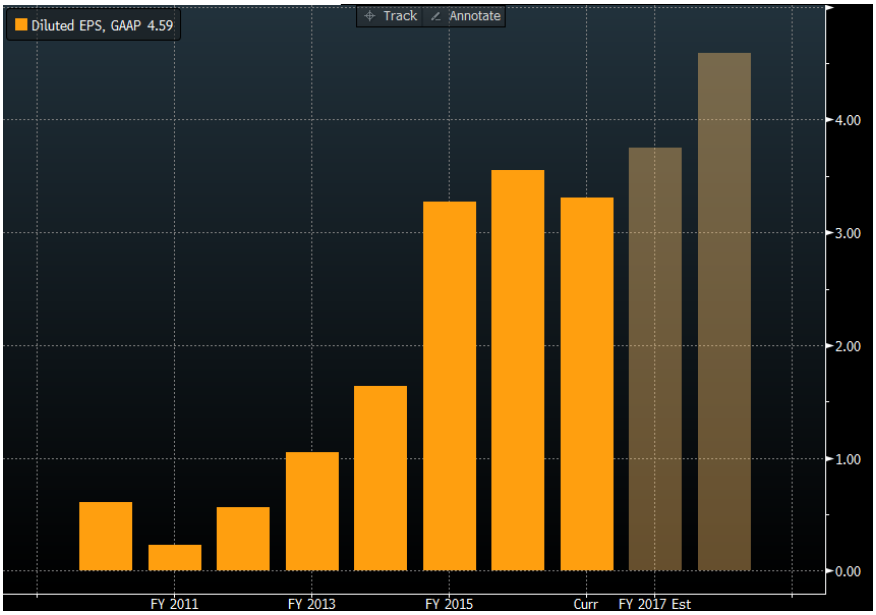
Metric	LUV	Low	Comp Range	High
Est P/E Current Yr	14.80	8.82		14.80
EV/T12 EBITDAR	6.64	4.24		6.64
Sales Growth Yoy (%)	3.05	-3.45		8.43
EBITDA Margin (%)	25.35	19.02		25.71
Yield per Passenge...	15.08	10.79		16.03

LUV US ◆ Median

The Future seems Bright:

Southwest hinted that future earnings will look a lot better than the projected Q1 earnings. Quarter 1 was hurt by rising non-fuel costs and big raises to several employee groups. These problems are supposed to be resolved in Q2 due to a projected increase in revenue. RASM is expected to rise 1% to 2% due to the increase in travel during the Easter season. Current cost pressure are also expected to end this year and by Q4 they are expected to be finished with its wage increases. Strong unit cost performance and profit growth is expected to return in at the end of 2017 or the beginning of 2018. Stock prices are expected to then rise during this time that is it is your best bet to buy LUV now while it is cheap.





Conclusion:

Due to the information provided, LUV is at a great time to buy. The negative Q1 earnings call should decrease the price to a nice point for investors to get in. The company is then expected to rebound in later quarters, thus sending the price back up. Southwest is able free from seeing the backlash of possible travel legislation due to the fact much of its business is in the US. The airline industry itself has been doing well and is expected to continue into the next few years. If macro-economic conditions persist and Southwest can continue to create value, LUV should have no problem reaching the target price of 77.04.

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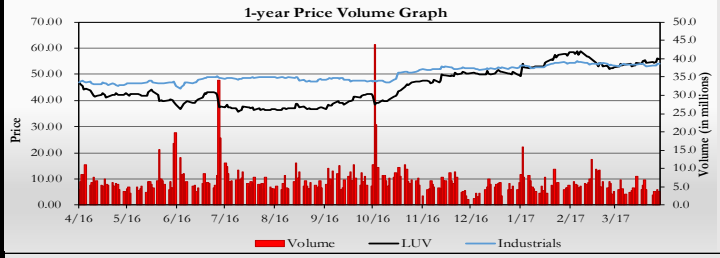
Southwest Airlines Co. (LUV)

CENTER FOR GLOBAL FINANCIAL STUDIES

BULLISH

Analysis by Michael Capozzi	Current Price:	$57.09	Intrinsic Value	$119.78	Target 1 year Return: 125.7%
4/25/2017	Divident Yield:	0.6%	Target Price	$128.49	Probability of Price Increase: 100%



Description

Southwest Airlines Co. operates a passenger airline that provides scheduled air transportation services in the United States and near-international markets.

General Information

Sector	Industrials
Industry	Airlines
Last Guidance	November 3, 2015
Next earnings date	April 27, 2017
Estimated Country Risk Premium	6.33%
Effective Tax rate	20%
Effective Operating Tax rate	-7%

Market Data

Market Capitalization	$34,517.18
Daily volume (mil)	5.24
Shares outstanding (mil)	604.61
Diluted shares outstanding (mil)	633.00
% shares held by institutions	74%
% shares held by investments Managers	69%
% shares held by hedge funds	9%
% shares held by insiders	0.21%
Short interest	1.38%
Days to cover short interest	1.44
52 week high	$59.68
52-week low	$35.42
Levered Beta	0.88
Volatility	26.98%

Past Earning Surprises

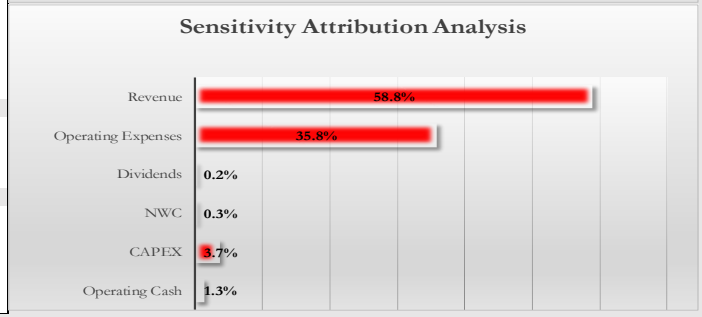
Quarter ending	Revenue	EBITDA
12/31/2015	-2.28%	-0.97%
3/31/2016	-0.08%	-4.02%
6/30/2016	-1.70%	-8.75%
9/30/2016	-1.59%	5.38%
12/31/2016	0.26%	-3.99%
Mean	-1.08%	-2.47%
Standard error	0.5%	2.3%

Peers

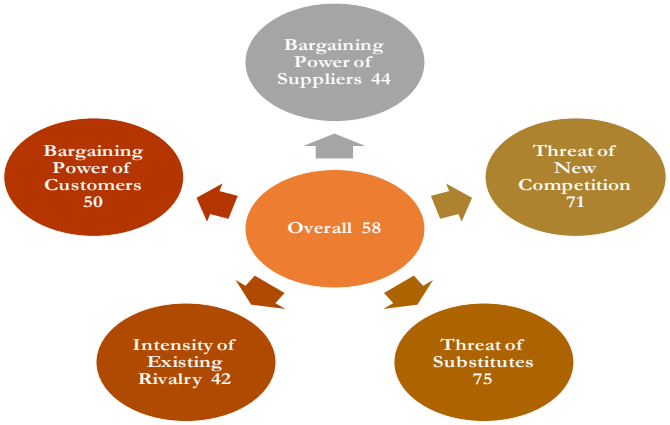
American Airlines Group Inc.
United Continental Holdings, Inc.
Delta Air Lines, Inc.
JetBlue Airways Corporation
Alaska Air Group, Inc.
Spirit Airlines, Inc.
Allegiant Travel Company
SkyWest, Inc.

Management	Position	Total compensations growth	Total return to shareholders
Kelly, Gary	Chairman and Chief Executive	10.71% per annum over 6y	-5.38% per annum over 6y
Romo, Tammy	Chief Financial Officer and	26.92% per annum over 4y	25.85% per annum over 4y
Van de Ven, Michael	Chief Operating Officer	8.07% per annum over 6y	-5.38% per annum over 6y
Jordan, Robert	Chief Commercial Officer and	9.44% per annum over 6y	-5.38% per annum over 6y
Lamb, Arthur	Executive Vice President of	5.5% per annum over 1y	16.67% per annum over 1y
Nealon, Thomas	President	155.58% per annum over 5y	8.61% per annum over 5y

Profitability	LUV (LTM)	LUV (5 years historical average)	Industry (LTM)
ROIC	29.8%	10.07%	27.80%
NOPAT Margin	21%	7.88%	14.0%
Revenue/Invested Capital	1.39	1.28	1.98
ROE	64.1%	16.12%	38.88%
Adjusted net margin	20%	6.33%	12.6%
Revenue/Adjusted Book Value	3.19	2.54	3.09
Invested Funds	**LUV (LTM)**	**LUV (5 years historical average)**	**Industry (LTM)**
Total Cash/Total Capital	17.6%	17.3%	22%
Estimated Operating Cash/Total Capital	8.9%	7.8%	N/A
Non-cash working Capital/Total Capital	-27.1%	-25.1%	-38%
Invested Capital/Total Capital	84.2%	83.4%	100%
Capital Structure	**LUV (LTM)**	**LUV (5 years historical average)**	**Industry (LTM)**
Total Debt/Common Equity (LTM)	0.32	0.64	0.45
Cost of Existing Debt	3.85%	4.38%	4.01%
Estimated Cost of new Borrowing	4.32%	4.76%	4.01%
CGFS Risk Rating	CCC	CC	CC
Unlevered Beta (LTM)	0.69	0.63	0.69
WACC	7.94%	7.25%	8.16%



Porter's 5 forces (scores are out of 100)



Valuation

Period	Revenue growth	NOPAT margin	ROIC/WACC
Base Year	4.0%	21.4%	3.75
12/31/2017	3.6%	9.4%	1.59
12/31/2018	4.3%	11.6%	1.79
12/31/2019	-9.0%	9.0%	1.19
12/31/2020	24.1%	12.6%	2.31
12/31/2021	21.2%	14.1%	2.76
12/31/2022	18.4%	14.9%	2.76
12/31/2023	15.5%	15.4%	2.72
12/31/2024	12.6%	15.7%	2.65
12/31/2025	9.8%	15.9%	2.57
12/31/2026	6.9%	16.0%	2.47
Continuing Period	4.1%	16.0%	2.22

Period	Invested Capital	Net Claims	Price per share
Base Year	$15,357.05	$8,337.75	$119.26
12/31/2017	$14,990.94	$9,929.45	$127.63
12/31/2018	$15,000.34	$9,660.76	$137.10
12/31/2019	$14,193.86	$6,939.11	$147.36
12/31/2020	$14,663.41	$7,329.82	$158.12
12/31/2021	$15,809.03	$9,040.10	$169.91
12/31/2022	$18,018.85	$10,049.68	$182.81
12/31/2023	$19,076.29	$10,140.61	$196.81
12/31/2024	$16,970.27	$9,062.92	$211.91
12/31/2025	$19,320.75	$6,695.29	$227.92
12/31/2026	$24,176.45	$2,590.18	$244.78
Continuing Period			