COMPANY PROFILE

# Southwest Airlines Co.

**REFERENCE CODE:** DEFBDE99-9B78-4A63-BE9C-7EA7568D476E
**PUBLICATION DATE**: 30 Sep 2016
www.marketline.com


MarketLine

# TABLE OF CONTENTS

# COMPANY OVERVIEW

Southwest Airlines Co. (Southwest Airlines or 'the company') is a passenger airline that provides scheduled passenger and freight transportation services. The company primarily provides point-to-point, low-fare services throughout the US and near-international markets. It is headquartered in Dallas, Texas and employed 49,583 people as on December 31, 2015.

The company recorded revenues of $19,820 million during the financial year ended December 2015 (FY2015), an increase of 6.5% over FY2014. The operating profit of the company was $4,116 million in FY2015, an increase of 85% over FY2014. The net profit of the company was $2,181 million in FY2015, an increase of 92% over FY2014.

# KEY FACTS

| | |
|---|---|
| **Head Office** | Southwest Airlines Co.<br>2702 Love Field Drive<br>Dallas<br>Texas 75235<br>USA |
| **Phone** | 1 214 792 4000 |
| **Fax** | |
| **Web Address** | http://www.southwest.com |
| **Revenue / turnover (USD Mn)** | 19,820.0 |
| **Financial Year End** | December |
| **Employees** | 49,583 |
| **New York Stock Exchange Ticker** | LUV |

# SWOT ANALYSIS

Southwest Airlines Co. (Southwest Airlines or 'the company') is a passenger airline that provides scheduled passenger and freight transportation services. It focuses mainly on point-to-point service, rather than the hub-and-spoke service provided by major US airlines. Robust operating strategy allows the company to achieve high asset utilization and reliable on-time performance, which in turn helps the company to increase its revenues and to tap profitable markets. However, intense competition could adversely impact the company's operating results, financial condition and liquidity.

| **Strength** | **Weakness** |
| --- | --- |
| Point-to-point service strategy increases revenues<br>Strong fleet base enhances ability to deliver effective service<br>Integration of AirTran's network and operations to enhance growth prospects | Heavy dependence on passenger revenues could increase risk<br>Lawsuits and litigations could adversely affect operating results<br>Dependent on single aircraft and engine supplier could impact the operations |
| **Opportunity** | **Threat** |
| Network expansion initiatives to create a positive impact on topline performance<br>Positive outlook for the global tourism industry<br>Favorable outlook of global air freight market could help to grow sales and profit | Intense competition could negatively impact margins<br>Stringent government regulation could increase operating costs<br>Consolidation in the airline industry may impact business performance |

## Strength

Point-to-point service strategy increases revenues

Southwest Airlines principally provides point-to-point service, rather than the 'hub-and-spoke' system used by majority of US airlines. The hub-and-spoke system concentrates most of an airline's operations at a limited number of central hub cities and serves most other destinations in the system by providing one-stop or connecting service through a hub. Any issue at a hub, such as bad weather or a security problem, can create delays throughout the system. Southwest Airlines' point-to-point route structure has allowed for more direct non-stop routing than hub-and-spoke service. For 2015, approximately 74% of the company's customers flew nonstop, and the average aircraft trip stage length was 750 miles, with an average duration of approximately two hours.

Southwest Airlines' point-to-point service has also enabled it to provide its markets with frequent, conveniently timed flights and low fares. For example, the company currently operates 20 weekday roundtrips from Dallas Love Field to Houston Hobby, nine weekday roundtrips from Washington Reagan to Chicago Midway, 11 weekday roundtrips from Phoenix to Las Vegas, and 14 weekday roundtrips from Los Angeles International to Oakland. Southwest Airlines complements these high-frequency routes with long-haul nonstop service between markets such as Los Angeles and Nashville, Las Vegas and Orlando, San Diego and Baltimore, and Houston and New York LaGuardia. As on December 31, 2015, Southwest Airlines served 637 nonstop city pairs.

Thus, the point-to-point service strategy enables the company to achieve better asset utilization and reliable on-time performance, which in turn helps it increase its revenues and tap profitable markets.

Strong fleet base enhances ability to deliver effective service

Southwest Airlines has a strong fleet network. According to the company, it is the operator of the largest fleet of Boeing aircraft in the world. Based on the US Department of Transportation's most recent data, Southwest Airlines is the US's largest carrier in terms of originating domestic passengers boarded The company operated a total of 704 Boeing 737s aircraft as on December 31, 2015, of which 95 and 28 were under operating and capital leases, respectively. Out of the 704 Boeing 737's, the company operated 471 Boeing 737-700s, 118 Boeing 737-300s, 104 Boeing 737-800s, and 11 Boeing 737-500s. Moreover, the company had some orders for new aircraft over the next few years.

Moreover, the company had firm deliveries and options for 35 Boeing 737-700, 89 737-800, 30 737 MAX 7, and 170 737 MAX 8 aircraft through the end of 2027. Hence, the company's strong fleet base enhances its ability to deliver effective service to its customers and also allows the company to quickly respond to opportunities available in the various service locations.

Integration of AirTran's network and operations to enhance growth prospects

The Integration of AirTran's network and operations into Southwest Airlines is expected to provide enhanced growth prospects for the company. Southwest Airlines acquired AirTran in 2011. The company's over three year-long integration of Southwest Airlines’ and AirTran's networks, fleets, systems, and people, was completed in 2014. The acquisition of AirTran expanded the company's network into key US markets, such as Atlanta and Washington, D.C. According to the company, this acquisition achieved approximately $500 million in net, pre-tax synergies during 2014 (excluding acquisition and integration expenses). In addition, the acquisition also aided the company's expansion into near-international locations, such as the Caribbean and Mexico, which led to the launch of Southwest international service during the second quarter of 2014. Additionally, the company opened four new international destinations in 2015: San Jose, Costa Rica; Puerto Vallarta, Mexico; Belize City, Belize; and Liberia, Costa Rica.

In addition, the company also completed the integration of booking functions of airtran.com into southwest.com, referring all customers who visit airtran.com to southwest.com. During FY2015, approximately 79.4% of the company's passenger revenues came through its website. Thus, the integration of Southwest Airlines and AirTran's network and operations could yield significant synergies and other benefits including improvement in Southwest Airlines' route network in the US. This may enhance its brand image in the market place.

## Weakness

Heavy dependence on passenger revenues could increase risk

Southwest Airlines is highly dependent on passenger revenues. The company derived revenues of $179 million (0.9% of total revenues) from its freight operations and $18,299 million (93.1% of total revenues) from passenger division in FY2015. The company has not yet completely leveraged its strong domestic network towards increasing its cargo revenues, which may lend more stability to its revenues. The cargo business has lower demand elasticity than the passenger business and serves as a natural hedge against higher jet fuel prices.

Therefore, a low level of cargo/freight operations exposes the company's dependence on passenger revenues, which increases its risks of operating in an environment characterized by rising fuel costs.

Lawsuits and litigations could adversely affect operating results

The company is involved in class action lawsuits. A complaint alleging violations of federal antitrust laws and seeking certification as a class action was filed against Delta Air Lines (Delta) and AirTran in the US District Court in 2009. The complaint alleged that AirTran attempted to monopolize air travel in violation of Section 2 of the Sherman Act. The initial complaint sought treble damages on behalf of a putative class of persons or entities in the US who directly paid Delta and AirTran such fees on domestic flights beginning 2008. After the filing of the 2009 complaint, various other nearly identical complaints also seeking certification as class actions were filed in federal district courts in Atlanta, Georgia; Orlando, Florida; and Las Vegas, Nevada. A consolidated amended complaint was filed in the consolidated action in 2010, which broadened the allegations to add claims that Delta and AirTran conspired to reduce capacity on competitive routes and to raise prices in violation of Section 1 of the Sherman Act. In addition to treble damages for the amount of first baggage fees paid to AirTran and to Delta, the consolidated amended complaint seeks injunctive relief against a broad range of alleged anticompetitive activities, as well as attorneys' fees.

In 2014, the court referred the sanctions dispute to a special master, the special master has issued a series of reports and recommendations, and plaintiffs and Delta have submitted objections to the special master's report and recommendations. While AirTran has denied all allegations of wrongdoing, including those in the consolidated amended complaint, and intends to defend vigorously any and all such allegations, results of legal proceedings such as this one cannot be predicted with certainty. Should AirTran and the company fail to prevail in this or other matters, the company may be faced with significant monetary damages or injunctive relief that could materially adversely affect its business and might materially affect its financial condition and operating results. On August 5, 2015, the court entered an order granting class certification, which was vacated on August 17, 2015, to permit further briefing on class certification and AirTran’s motion to exclude plaintiffs’ expert. Thereafter, the parties filed motions to exclude the opinions of the other parties’ experts. On January 8, 2016, the parties completed briefing on defendants’ motions for summary judgment, plaintiffs’ motion for class certification, and the motions to exclude the opinions of experts, and those motions have been submitted to the Court for decision. While AirTran has denied all allegations of wrongdoing, including those in the Consolidated Amended Complaint, and intends to defend vigorously any and all such allegations, results of legal proceedings such as this one cannot be predicted with certainty. Thus, any negative outcome of these lawsuits will have a material adverse effect on the Southwest Airlines' financial condition, results of operations, or cash flow.

Dependent on single aircraft and engine supplier could impact the operations

The company is dependent on Boeing as its sole supplier for aircraft and many of its aircraft parts and is dependent on other suppliers for certain other aircraft parts. Although Southwest Airlines is able to purchase some aircraft from parties other than Boeing, most of its purchases are directly from Boeing. Therefore, the company would be materially adversely affected in the event of a mechanical or regulatory issue associated with the Boeing 737 aircraft type, whether as a result of downtime for part or all of the company's fleet or because of a negative perception by the flying public. For instance, Southwest Airlines operated a total of 704 Boeing 737 aircraft as on December 31, 2015, of which 95 and 28 were under operating and capital leases, respectively.

The company is also dependent on sole suppliers for aircraft engines and certain other aircraft parts. Thus, if the company is unable to acquire additional aircraft from Boeing, or if Boeing is unable or unwilling to make timely deliveries of aircraft or to provide adequate support for its products, Southwest Airlines' operations would be materially adversely affected.

## Opportunity

Network expansion initiatives to create a positive impact on topline performance

The network expansion initiatives undertaken by the company in the recent past would enhance the company's growth prospects. For instance, in June 2016, Southwest Airlines launched new nonstop service at Long Beach Airport, and started more service between the L.A. Basin and San Francisco Bay. Southwest Airlines extended its bookable flight schedule by adding new nonstop service in 16 cities in the US, in February 2016. Further in December 2015, Southwest Airlines announced plans to offer nonstop service between Los Angeles International Airport and Daniel Oduber Quiros International Airport in Liberia/Guanacaste, Costa Rica beginning in April 2016. Also, the company plans to provide services to destinations in Central America by adding Southwest Airlines service to San Jose, Costa Rica beginning in March 2015 and to Belize City, Belize beginning in October 2015, each subject to government approval. The company also announced plans to commence Southwest Airlines service to Puerto Vallarta, Mexico in June 2015. In addition, during 2014, the company significantly increased its service at New York LaGuardia Airport and Washington Reagan National Airport as a result of the acquisition of slots divested by AMR, the parent company of American Airlines. Further, at Dallas Love Field, the company began serving seven new nonstop destinations in 2014, eight new nonstop destinations in 2014.

Furthermore, Southwest Airlines also launched international service in 2014, with service to Montego Bay, Nassau, and Oranjestad. The company also launched service to Cabo San Lucas/Los Cabos and Cancun in 2014 and to Mexico City and Punta Cana in 2014. Hence, network expansion initiatives help the company to enhance its route network and thereby serve new customers. This will have a positive impact on the company's topline performance.

Positive outlook for the global tourism industry

The global tourism industry is booming which could boost the demand for the company's services. According to the World Tourism Organization (UNWTO), the number of international tourists (overnight visitors) reached 1,184 million in 2015, 50 million more than in 2014. With an increase of 4%, this is the sixth consecutive year of above average growth since the post-crisis year of 2010. Geographically, Europe and Middle East registered 5% and 3% growth in tourist arrivals, respectively. In addition, the Americas and Asia Pacific regions each grew at a modest rate of 5%. Moreover, the UNWTO forecasts international tourism to grow by 4% worldwide in 2016. In terms of region, Asia Pacific is expected to grow by (4% to 5%), the Americas by (4% to 5%), followed by Europe with (3.5% to 4.5%). In addition, the decline in the global oil prices is expected to further lower transport costs and boost economic growth by lifting purchasing power and private demand in oil importing economies.

This growth in world tourism industry will enhance airline business. Thus, a growing end market auger well for the company as it is well positioned to capitalize on the growing global tourism industry.

Favorable outlook of global air freight market could help to grow sales and profit

The global air freight sector recovered in 2014 after a period of declines in 2012 and 2013. The sector is expected to slowly increase in value and volume terms over the next five years. According to MarketLine, the global air freight sector generated total revenues of $147.5 billion in 2015, representing a compound annual growth rate (CAGR) of 2% between 2011 and 2015. Furthermore, the performance of the sector is forecast to accelerate, with an anticipated CAGR of 7% for the 2015–20 period, which is expected to drive the sector to a value of $207.1 billion by the end of 2020.

Thus, the favorable outlook of global air freight market could help the company to grow its sales and profit.

## Threat

Intense competition could negatively impact margins

The US airline industry is characterized by intense price competition, especially in domestic markets. The company's primary competitors include other major domestic airlines, as well as regional and new entrant airlines, surface transportation, and alternatives to transportation such as videoconferencing and the Internet. The company's revenues are sensitive to the actions of other carriers with respect to pricing, routes, frequent flyer programs, scheduling, capacity, customer service, comfort and amenities, cost structure, aircraft fleet, and code sharing and similar activities. The company competes with other largest major US airlines, including American Airlines Group, Delta Air Lines, JetBlue Airways, Alaska Air Group, SkyWest, and United Continental Airlines, among others.

Some of the company's competitors have substantially greater financial resources, including more favorable hedges against fuel price increases and lower cost structures than the company. In recent years, the domestic market share held by low-cost carriers has increased significantly and is expected to continue to increase, which is dramatically changing the airline industry. The increased market presence of low-cost carriers, which engage in substantial price discounting, has diminished the ability of the network carriers to maintain sufficient pricing structures in domestic markets.

Hence, the increased competition could put a downward pressure on price and market share, which could negatively impact the company's margins.

Stringent government regulation could increase operating costs

Airlines are subject to extensive regulatory and legal compliance requirements that result in significant expenditures. For instance, the Federal Aviation Authority (FAA) from time to time issues directives and other regulations relating to the maintenance and operation of aircraft that necessitate significant costs. The company expects to continue incurring expenses to comply with the FAA's regulations. Other laws, regulations, taxes and airport rates and charges have also been imposed from time to time that significantly increase operating expenses or reduce revenues.

The airlines industry is also heavily taxed. The Aviation and Transportation Security Act mandates the federalization of certain airport security procedures and imposes security requirements on airports and airlines, most of which are funded by per ticket tax on passengers and a tax on airlines. The federal government has on several occasions proposed a significant increase in the per ticket tax, which, if implemented, could negatively impact the company's results of operations. Furthermore, proposals to address congestion issues at certain airports or in certain airspace, especially in the Northeast US, have included concepts such as "congestion-based" landing fees, "slot auctions" or other alternatives, which could impose a significant cost on the airlines operating in those airports or airspace.

Hence, complying with such laws, regulations and actions increases the operating costs of Southwest Airlines which could have a significant impact on its profitability.

Consolidation in the airline industry may impact business performance

The airline industry is highly fragmented, especially in Europe. In domestic European traffic, the five largest airline groups have a combined market share of less than 50%. In the much more profitable US market, the figure is now at around 90%. In the past, the consolidation of the airline industry required from an economic perspective was often delayed by offers of financial assistance from governments. However, the airline industry has undergone substantial consolidation in recent times and is heading for more because of the global recession. For instance, in 2013, American Airlines and US Airways merged together to create one of the largest airlines in the world. Earlier in 2011, British Airways and Iberia created a new group, IAG.

These consolidations have resulted in the creation of large corporations with substantially greater financial resources, including more favorable hedges against fuel price increases and lower cost structures than the company. The creation of large competitors, particularly due to consolidation in the airline industry, may have a material adverse impact on the company's business performance.