

Friendly Skies?

The enthusiasm among value investors for U.S. airlines in recent years has yet to embrace long-time industry outperformer Alaska Air. Black Bear Value Partners' Adam Schwartz explains why he considers that a missed opportunity.

Even when the U.S. airline industry was at its most insanely competitive, Alaska Air Group appeared to fly above the clouds. Highly ranked for customer service and sporting an advantaged cost structure, the company consistently outpaced competitors in growth and profitability. In the 10-year period ending in 2015, the Seattle-based airline's shares rose more than 800%.

But while the airline industry itself appears to have jettisoned its worst excesses and become more rational, Alaska Air has encountered turbulence. The market has been particularly disappointed by the company's 2016 purchase of Virgin America, a \$4 billion deal that deepened its presence in California and expanded its footprint to the U.S. East Coast. Synergies have been slow to surface, grounding the company's stock, which is down nearly 8% since the deal was announced in April 2016. Over that same time, United Continental's shares are up 70% and Delta Air's have advanced 25%.

Adam Schwartz of Black Bear Value Partners argues that the negativity around Alaska Air is overdone. While the airline's performance may not have improved as quickly as expected after the acquisition, it remains healthy, generating mid-cycle operating margins of 10-15%. Its costs, as measured by cost per available seat mile, ex-fuel costs, are still 10-20% lower than at big legacy carriers. In Forbes' latest ranking of the best and worst airlines, Alaska Air was ranked first for the second year in a row. "The market has already decided the acquisition was a bad idea," says Schwartz. "For a company this well run, it's way too soon to say that."

He also believes drama around the airline industry in general – "Can airlines pass on rising fuel costs?" "Is capacity going to grow too fast?" – helps obscure the crown-jewel asset Alaska Air has in its Mileage Plan loyalty program, anchored

by its branded Visa credit card. This business today generates roughly \$1 billion in annual revenue with a 50% operating margin, and Schwartz in his base case believes it can grow at 5-7% per year long term. It's growing faster than that now, at

INVESTMENT SNAPSHOT

Alaska Air (NYSE: ALK)

Business: Seattle-based airline that after the 2016 acquisition of Virgin America now flies to more than 115 primarily U.S. destinations.

Share Information (@11/29/18):

Price	72.94
52-Week Range	57.53 – 76.06
Dividend Yield	1.8%
Market Cap	\$8.99 billion

Financials (TTM):

Revenue	\$8.18 billion
Operating Profit Margin	10.6%
Net Profit Margin	9.8%

Valuation Metrics

(@11/29/18):

	ALK	S&P 500
P/E (TTM)	11.2	20.9
Forward P/E (Est.)	11.9	16.3

Largest Institutional Owners

(@9/30/18 or latest filing):

Company	% Owned
T. Rowe Price	10.4%
Vanguard Group	9.9%
Primecap Mgmt	4.9%

Short Interest (as of 11/15/18):

Shares Short/Float	7.5%
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ALK PRICE HISTORY



THE BOTTOM LINE

It's "way too soon" for the market to have concluded that the company's 2016 acquisition of Virgin America is a bust, says Adam Schwartz. Valuing its well-run airline and lucrative loyalty program separately, his base-case share-price estimate comes to just over \$100.

Sources: Company reports, other publicly available information

about 10% annually, which he attributes to what could be a longer-lived bump from signing up Virgin America customers.

At a recent \$73, Alaska Air shares currently trade at 11.2x trailing earnings and a roughly 9% free-cash-flow yield. Schwartz believes the loyalty program

alone is worth today's market cap, applying an 18x multiple to its run-rate free cash flow of \$500 million to arrive at a value for it of \$9 billion. For the airline, he estimates mid-cycle annual free cash flow at around \$400 million – a 13% margin on \$8 billion in revenue, less \$650 million

in capital spending – on which he assumes an 8% free-cash-flow yield (or 12.5x multiple), yielding an estimated value of \$3.6 billion. Subtracting a modest (and decreasing) amount of net debt, his base-case value for company comes to just over \$100 per share. [VII](#)



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Black Bear Value Fund, LP is an opportunistic, concentrated and fundamental value investment partnership. Our partnership operates with low fees and high levels of alignment between the Investment Manager and the Limited Partners. The Investment Manager seeks to preserve capital and achieve long term capital appreciation with sensible risk by focusing on the margin of safety of an investment.

The Fund is managed by Adam Schwartz who has 16 years of buy-side investment experience in a variety of themes including equities, structured products, corporate credit and capital structure arbitrage. Prior to founding the Investment Manager, Adam served as a Director and senior member of the investment team at Fir Tree Partners, a \$13BB peak-AUM multi-strategy investment manager (2007-2015).

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