JetBlue Airways (JBLU)

Price	$	15.3	Mkt Cap:	$	5,251	*FYE December*		*2012*		*2013*		*2014*		*2015*		*2016*		*2017*		*2018*
52 Wk High:	$	15.8	Debt:		2,362	Revenue:	$	4,982	$	5,441	$	5,858	$	6,486	$	7,320	$	8,079	$	8,734
52 Wk Low:	$	7.6	Pref Stk:		-	*Growth*		*11%*		*9%*		*8%*		*11%*		*13%*		*10%*		*8%*
Cash/shr:	$	2.2	Min Int:		-	EBIT	$	376	$	428	$	536	$	793	$	1,108	$	1,379	$	1,599
TBV/shr:	$	6.9	Cash:		742	EBIT Margin:		7.5%		7.9%		9.1%		12.2%		15.1%		17.1%		18.3%
Shrs OS:		343.4	Ent. Val.:	$	6,871	EPS		$0.34		$0.48		$0.70		$1.14		$1.70		$2.20		$2.62
Float Shrs:		242.8				*Consensus EPS*								*$1.17*		*$1.45*		*$1.82*		*NM*
Daily $ Vol:	$	148.2	Net Debt/EBITDA:		1.9x	ROIC (NOPAT/Eq+Debt)		5%		5%		6%		8%		11%		13%		14%
Shrt Int (%SO):		20.9%	Debt/EBITDA		2.8x	Valuation		P/E (HAWKSHAW):						13.4x		9.0x		7.0x		5.8x

What You Need to Know

JBLU was founded in 1999 with a focus on low prices and attractive amenities (e.g. free TV, free wifi, more leg room etc.). With an appealing offering, it quickly grew to become the fifth largest airline in the U.S. Historically, JBLU over-invested in its customers (e.g. limited ancillary fees), to the detriment of shareholders, leading to middling returns on capital. Following major airline consolidation that led to a dramatic improvement in industry ROICs and CEO Dave Barger's inability to hit newly initiated ROIC targets in both '12 and '13, JBLU announced his "retirement" in September '14 and the promotion of President Robin Hayes. Speculation quickly mounted about opportunities to drive better results, culminating at the November analyst day when Robin Hayes unveiled checked bag fees and other programs to drive an incremental 80c to EPS ($450 mil pre-tax) and 10%+ ROICs. As a result of these initiatives and falling oil prices, the stock has increased 45% since Sept. and 25% since our work started prior to the analyst day. **While it may seem the opportunity has passed, our research has uncovered 3 factors that will drive upside to the announced initiatives**: 1) our contacts believe it is quite likely that JBLU will begin the common industry practice of overbooking flights, leading to 100-200bps of higher load factors and 15-30c of additional EPS; 2) our research suggests JBLU's announced initiative to add two rows to most planes will drive $200-240 mil in pre-tax profits vs. guidance of $100+ mil (adding 10-15c to our 2017 EPS); and 3) contacts believe that JBLU will likely move aggressively to convert its airline partnerships into more lucrative code-sharing agreements, potentially adding 75-100bps to load factors and 10-15c to EPS. Combined, these opportunities drive 35-60c of EPS and 20-30% upside to consensus 2017 estimates, implying a PE of 6-7x.

Framing the Potential

With a new CEO and incentive comp tied to ROIC targets, JBLU seems to have finally gotten religion with regards to shareholder returns. Our research suggests their $450 mil of profit initiatives remains conservative and that JBLU is in a position to drive low teens ROICs (still below its peers). Using our lower end assumptions for overbooking, seat densification and code-sharing, and a 10x PE, imply ~45% upside to $22 (peers trade at 10-15x). Our higher end assumptions with a 13x PE imply a $31 target or 100% upside on '17 EPS of $2.41. Conversely, if our base case initiatives unfold but a recession causes load factors and pricing to fall as they did in '09, we see downside of 20% to $12 (10x '16 EPS of $1.20). Note: base/upside scenarios assume inflationary fare increases and a return to $3.00/gallon fuel (~$100/barrel oil); the downside scenario has fuel at $2.25/gallon.

Who's In, Who's Out

Before joining JBLU in 2008, Robin Hayes spent 19 years at British Airways, where he was Executive VP of the Americas. Contacts describe Hayes as "confident, customer focused, results driven, and he leads by example." Contacts also say, "Robin will be 100% committed to maintaining these [ROIC and profit targets]. He has a history of delivering on his commitments. He wouldn't make these commitments if he couldn't achieve them."

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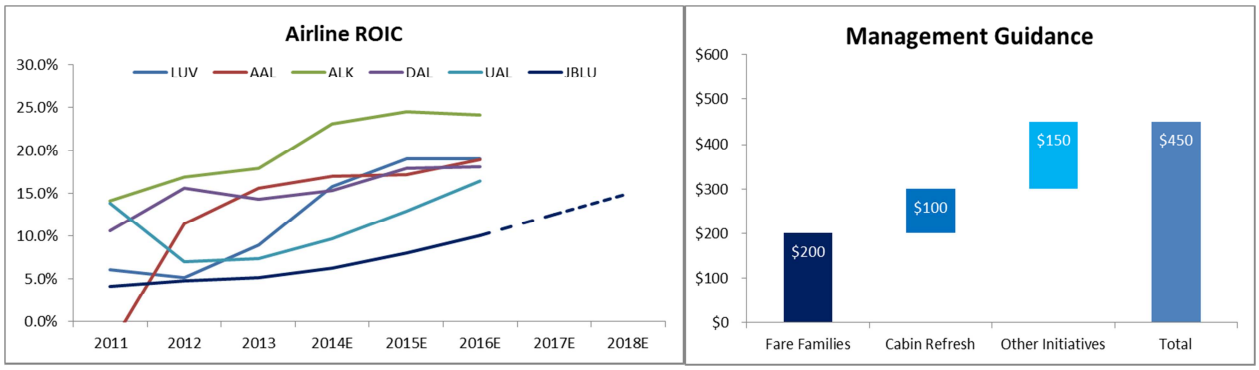
The Backdrop

There are several trends in the airline industry that have driven a major improvement in ROICs over the last 4-5 years. First, the industry has been consolidated by four large mergers. The combined market share of the top four carriers has increased from 59% in 2008 to 87% in 2013. Second, total system capacity has fallen since its peak in 2007. In fact, the three largest carriers have lower capacity than they did in 2000. One industry contact ascribes the reduction in capacity to a change in management mindset in which "management is being a better steward of capital. They are more interested in returns than global reach and market share." Fewer players and lower capacity has led to the third trend: stronger pricing. An industry veteran with over 40 years of experience says he has "never seen pricing power like this." He indicated airlines can now fully offset fuel price increases in a matter of days; previously, it would take months just to cover a fraction of the increase. These trends are apparent in the industry's total operating income, which went from a loss of $583 million in 2009 to almost $10 billion in 2013. On top of that, fuel prices have fallen nearly 50% since the most recent peak in 2013, which is likely to further fuel the rising ROICs. Despite these tailwinds, JetBlue was unable to earn its ROIC targets of 5%, 6% and 7% in '12, '13 and '14, respectively, which led to the CEO change.



Analyst Day Initiatives: In mid-November, JBLU outlined initiatives to achieve an additional $450 million of pre-tax operating income by 2018 ($0.80 EPS) and drive ROIC to 10%+ by 2017.

1. Fare Families: JBLU will charge different ticket prices for varying levels of services and features. For example, JBLU will charge first-checked-bag fees for the least expensive seats. Management expects a run rate of at least $200 million of incremental operating earnings by 2018 from Fare Families ($0.35 of EPS). Since all major airlines excluding Southwest have implemented bag fees, the likely outcome is fairly predictable. Currently, 50% of JBLU's customers check bags; for peers, this rate has dropped to 20% after the implementation of bag fees. This percentage was reconfirmed recently when Air Canada implemented a first-checked-bag fee on domestic flights.

2. Cabin Refresh: JBLU will increase seat density on the A320 (65% of its fleet) by decreasing seat thickness and seat pitch. The total number of seats on the A320 will increase 10% from 150 to 165. Several other airlines including United and Southwest have conducted similar retrofits successfully. A320 modification will begin in mid-2016. JBLU expects at least a $100 million run-rate of incremental operating earnings by 2019 ($0.18 EPS). Note: JBLU will still have industry best legroom following this change.

3. Ongoing Initiatives: This includes incremental operating income from Even More (charging for extra leg space and special security lines), Mint (first-class), Fly-Fi (in-flight broadband Wi-Fi), co-branded credit cards, Getaways (merchandising platform for car rentals and hotel booking) and partnerships (e.g. sale of insurance products). While these are not newly announced initiatives, management added clarity around their potential. JBLU expects an incremental $150 million from these initiatives by 2018 ($0.27 of EPS).

Key Insights:

Overbooking to Add 100-200bps to Load Factors and 15-30c to EPS

Overbooking is a common practice, not just for airlines, but also for hotels and cruise ships – industries with perishable assets and predictable "no-shows". As stated on its own website, "JetBlue does not overbook flights." A spokeswoman at JBLU was quoted in February saying "Our traditional mission is to bring humanity back to air travel, and we feel that customers that purchase a seat should get a seat." However, this is overly simplistic and financially unsound. Former JBLU Chief Revenue Officer, Trey Urbahn, was quoted saying "over-sales are a way of increasing revenue where the benefits significantly outweigh the risk. Airlines have effectively managed 'involuntary denied boardings' to zero." Given JBLU's renewed focus on shareholder returns, our contacts are convinced it will begin overbooking, adding ~100-200bps to load factors and 15-30c to EPS.

- When asked about the potential for overbooking, a former Senior Executive of JBLU said,
  - "I think you are exactly right. I would have argued for it if I was at the table. It could be done slowly. They could turn up the dial gradually. 15 years ago, the technology didn't give the predictability that it gives today. I think your hunch is very accurate and it's likely to be something they deploy after bag fees and after they manage the noise from seat changes."
  - How much might it benefit load factors? "1.5-2.0% is the number in my gut."
  - What is the likelihood of it happening? "I think the probability is very high."
- A General Manager at Delta and former airline industry consultant said,
  - "Not overbooking planes in my mind is ludicrous. There is so much information now. They're leaving millions of millions of dollars on the table. That is something at some point that they will change. They are the only airline that I know of doing that...They don't guarantee they won't overbook flights. So one day they will change it without much fanfare. We all overbook our flights. But we don't talk about it because it makes customers anxious."
  - How much could it add to load factors? "I'd be guessing but probably 1-2%."
  - What is the probability of it happening? "75%."
- The Director of Pricing and Revenue Management for a transcontinental airline said,
  - "I forgot about that (the fact that JBLU doesn't overbook). That is a huge thing. That will honestly do more for them than bag fees. Without a doubt. Any airline that doesn't overbook isn't extracting enough from their network…The cost of what you have to pay to someone bumped is much lower (than the price of the seat). Invariably there are a lot of volunteers; especially on a leisure airline like they have. That is a big driver of topline. They could generate a couple percent, if not 3% (to load factors) if they do it right…I would model 1-2% to be safe."
  - "If you are going to do bag fees, you are definitely going to do overbooking. It's a no brainer."
  - Asked if leisure passengers "no-show" similar to business flyers, he said, "There's a huge no-show rate on FL flights. That is the biggest part of their network. Leisure travelers no-show a lot. Passengers also change flights in the days before departure. That also allows you to overbook."
- The ex-CEO of a major airline said,
  - "I introduced the models to do overbooking in the '83 timeframe…You can create sophisticated models. It needs to be managed carefully. You can predict the amount of no-shows…You know normally that a route has 10 no-shows or 5 no-shows. And the probability can be calculated. And then you can create a risk factor. Not more than 1 in 10k people would be impacted."
  - How much could it benefit JBLU's load factor? "If done properly at least 1-2%."

- An ex-Chief Commercial Officer for a domestic airline said,
  - "I wasn't aware that they still weren't [overbooking]. You are exactly right. That would be number one on my list. You can be modest about it; just overbook every flight by 1. Start simple. It's probably worth at least $50 mil just overbooking by 1."
- Note: adding 1-2% to JBLU's load factor (1½ to 3 people per plane) adds 15-30c to the bottom line.

Seat Densification to Add $200-240 mil of EBIT vs. Guidance of $100+ mil (an incremental 10-15c to '17 EPS)

There are 3 main costs of the seat densification project: 1) depreciation on the capital investment, 2) an extra flight attendant (4 required instead of 3) and 3) additional fuel. The first two are fixed costs and the last is variable. By our math, JBLU's estimate of $100 mil of incremental profits implies 60% load factors and a 35% discount to average fares (at a ~60% margin). Our contacts suggest these are conservative estimates, and their feedback leads us to believe that load factors are likely to be 70-75% and average fares just 5-10% lower. This implies $200-240 mil in 2018 pre-tax profits vs. guidance of $100+ mil (10-15c of incremental 2017 EPS).

- The Director of Pricing And Revenue Management for an intercontinental airline said,
  - "I think you could see 70-80% of those seats filled. Not quite 80%. On the fare…I don't see the fare dropping too much. Maybe 5% lower than JBLU's average fare."
- An ex Chief Commercial Officer for a domestic airline said,
  - "The rule of thumb used to be an 80% load factor was your incremental if your network was full. Given that they are running at 84%, I would use 80%. Networks are running so full these days. The new normal is low to mid 80s. That's pretty incredible. Used to be mid 70s. So I would easily say 8 out of 10 [seats will get filled]. And probably take their average fares and multiply that by 90% or 85% is pretty conservative. At the end of the day, these will get fully absorbed. Demand is so terrific in the places they are flying… They are under-promising and they will over deliver."
  - "When asked what impact bag fees and less legroom will have on demand he said, "There will be no impact. There is no evidence that it does anything. What are people going to do, leave for another airline where they have even less leg room? You are trading off an experience for something that is even worse. They (customers) have nowhere to go."

Seat Densification Scenarios	Guidance	Base	Upside
Est. Load Factor	60%	70%	75%
Est. Discount from Avg Fare	-35%	-10%	-5%
Implied Revenues (2018)	$ 166	$ 269	$ 307
Depreciation	31	31	31
Flight Attendant	19	19	19
Fuel (and other variable costs)	15	18	19
Pre-tax Profits (2018)	$ 101	$ 201	$ 238
Implied Margin	61%	75%	78%

Active Push for Code-Sharing Agreements May Add 75-100bps to Load Factors and 10-15c of Incremental EPS

Historically, JBLU appeased its pilots by agreeing not to form code-sharing agreements with other airlines without pilot consent (pilots see code-sharing as stealing organic growth and the opportunity for advancement). Instead, JBLU established less lucrative interline agreements with other airlines, which simply allow the two to jointly market a route that requires one leg on each airline (with bags checked all the way through). With the recent unionization of JBLU's pilots however, the impetus to avoid code-sharing is greatly diminished. As of a 12/4/13 press release, JBLU had just one bilateral code-sharing agreement (Emirates) out of its 30 partnerships.

Today, JBLU has 38 partnerships and has announced additional code-sharing agreements with El Al, Singapore Air, Turkish Air, and South African Air. It seems the pace of code-sharing agreements has already accelerated since the pilot unionization on 4/22/14. The significance of code-sharing is that it allows two airlines to closely collaborate to optimize the pricing of each leg and maximize revenues. Contacts indicate this leads to higher load factors and higher fares, as foreign carriers bring full fare clients (note: we're assuming only the former).

- The ex Chief Commercial Officer of a domestic airline said,
  - "For JBLU…they've always been very employee friendly. Earlier this year, the pilots voted for a union. That broke the last pretense to the 'family' at JBLU. That was a big blow to Barger. When we first tried to get code sharing [with JBLU], they said we can't. They said if the pilots don't unionize, then the code-share won't happen for a long time. That was a third rail they wouldn't touch while the pilots weren't unionized. But the gloves came off when they did unionize."
  - "The code-share opportunity is very real and very measurable. The analysis would be straight forward if we had all their data. It's pretty certain. No question there is real money there. If I had to do quick and dirty math…I'd add one load factor point, and increase fares by 3%."
  - "It's not crazy at all that this could add 100bps to load factor over next three years. There's also a benefit to fares, which might be even more powerful than the load factor benefit."
- An ex Senior Executive at JBLU said,
  - "I can't overstate that the pilots had in their agreement that there wouldn't be domestic code-shares. Now all bets are off. That is one example how we may have limited ourselves by maintaining pilot relations."
  - How big of a deal is this? "It could really change the economics…Depending on how many routes are involved…if you convert 10 partnerships to code share over the next 3 years, you could easily increase the bottom line by 10%. But that's a swag."

New CEO Will be Committed to ROIC Targets; Unlike His Predecessor

In 2013, JBLU adopted a new long-term performance-based incentive program. Performance share units (PSUs) are earned based on two items: cost per available seat mile (ex-fuel) compared to peers (weighted 50%) and return on invested capital (weighted 50%). Our contacts were clear with their view that Robin Hayes will bring a greater commitment level to the new ROIC target (10%+ by 2017) than did former CEO Dave Barger.

- A former Senior Executive at JBLU said,
  - "I genuinely believe Robin is the right leader for the right time."
  - "Dave may have resisted some of these changes."
  - "Robin will be 100% committed to maintaining these commitments. That's Robin's focus. He has incredible business acumen. He has a history of delivering on his commitments. He wouldn't make these commitments if he couldn't achieve them. He and the board have fully vetted them.
  - "Robin will take the business where it needs to go to be profitable. He won't be so emotionally invested that he can't separate some of those decisions from the business needs. For Robin it will only be about shareholder value."
  - "One of the first things Robin did as President, it wasn't billed as a headcount reduction, but there was a fair amount of thinning out of Manager and VP level bloat. It was a year ago. It was a clear signal that Robin would be delivering results."
  - "When the debate gets stuck, Dave had a hard time making a decision. Robin will listen to all the internal debate but when consensus can't be achieved, Robin will make a decision." How does

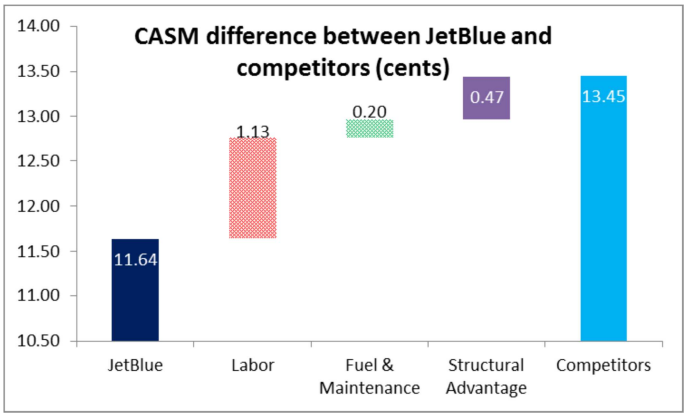
that manifest itself in the financials? "He won't be as conservative in not damaging the culture of the company. Decisions will be more based on business than culture. Robin will keep culture at the forefront, but it won't be the driving force that it was under Dave Barger."

- "Dave wasn't a finance guy. He grew into the CEO role...Robin is much more focused on the financials of the organization."
- "Robin will be willing to test the envelope and push the envelope. As an example, I expect Robin to have a different relationship with key suppliers (e.g. aircraft and engine manufacturers). He will be more demanding and have a higher expectation than Dave would."

- Another former Senior Executive at JBLU said,
  - "I think he (Robin) will be much more investor focused. Dave was primarily focused on people and culture first. Under Robin you are beginning to see a heavy focus on investors. He will bring a greater focus and commitment to the targets."
  - "Robin is someone that expects and delivers results. During my time with him at JBLU I saw a lot of change occur under him, which was very positive. It's not just talk with him; not just a hope and a dream. But real change. He is results oriented, which is different than JBLU which is more people and culture oriented. It's not that Robin isn't those things. But he focuses on results."
- A former JBLU executive credits Hayes with a laundry list of JBLU's most profitable initiatives, "Robin and his team can be credited with the company's revenue strategy. He developed the Even More product and brought on board Mint...With Mint he showed real change leadership. JBLU never had a First Class product before. It was not something that aligned with the culture." He went on to say that Even More has been a home run ($190 million of high margin revenue in 2014) and that "One of the greatest things that JBLU has done has been the launch of Mint."

Can JBLU (and the airline industry) maintain above average ROICs?

- By our estimates, JBLU will surpass its 10% ROIC target, reaching the low teens by 2017. This would still be below the major airlines which are currently achieving mid-teens ROICs.
- JBLU currently has a 1.81c cost advantage compared to the major airlines in terms of cost per average seat mile. Lower labor costs from a younger average pilot age and lower fuel/maintenance costs from a younger fleet represent the majority of the advantage and should wither as JBLU ages. Note: we assume 5% annual increases in salaries per average seat mile to account for this (and the unionization).
- ~50c of JBLU's cost advantage should remain, stemming from its point-to-point network vs. the legacy carriers' hub-and-spoke model. Under a point-to-point model, aircraft spend half the time on the ground between flights, because legacy carrier planes sit at hubs awaiting arrivals from multiple spokes.
- The sustainability of JBLU (and industry) double digit ROICs is a key question and warrants further work.



Valuation

- On the back of improved profitability, airlines have significantly cleaned up their balance sheets. With cleaner balance sheets and double digit ROICs, PE multiples seem increasingly relevant for the airlines.
- Currently, the network carriers, excluding American, trade at 10x 2015 EPS (ALK, DAL, HA, UAL). The low cost carriers trade at 15x (ALGT, LUV, SAVE).
- We see 45% 2-year upside potential to $22, using our lower end assumptions for overbooking, seat densification and code-sharing, and a 10x PE (on EPS of $2.20). We see 100% upside potential to $31, using our higher end assumptions and a 13x PE on EPS of $2.41.
- It is worth noting that base/upside scenarios assume inflationary fare increases and a return to $3.00/gallon fuel (~$100/barrel oil), which may prove conservative. $80 oil suggests fuel prices of ~$2.50/gallon. JBLU could maintain flat pricing at this level of fuel costs and still achieve our estimates.
- It is also worth highlighting that JBLU's $450 mil of targeted initiatives is projected through 2018. We have only ~$350 mil flowing through by 2017, which our 2-year price target is based on.
- The downside is 20% to $12 if our base case initiatives unfold but a recession causes a 4% drop in pricing (vs 5% in '09), a 5% drop in load factors (to '09 levels), and fuel of $2.25/gallon ('16 EPS of $1.20).
    - Note: in the last recession, low cost carriers faced a 5% drop in price vs. 14% for the majors.

Likes & Dislikes

LIKES	DISLIKES
▪ The airline industry backdrop is much improved. ▪ JBLU offers a quality service but historically wasn't focused on shareholder returns. Contacts say the new CEO is "results driven" and will "bring a greater commitment to (ROIC) targets." ▪ Analyst day announcements indicate a new and clear focus on driving shareholder returns. ▪ Research suggests analyst-day initiatives are the tip of the iceberg. JBLU will surprise to the upside. ▪ Lower fuel costs provide a nice tailwind.	▪ Airlines have historically destroyed capital. Are current above-average ROICs sustainable? ▪ Despite the CEO change, JBLU may find it difficult to properly balance its three stakeholders (customers, employees and shareholders). ▪ Contacts say JBLU's culture is unique and a key part of its quality service. The pilot unionization may be followed by other employee groups, which could ultimately impact service levels. ▪ It's possible that bag fees impact demand.

Primary Research Contacts

COMPANY	TITLE	AVAILABLE FOR CLIENT CALLS
JetBlue	Ex Senior Executive (worked with Hayes)	Yes
Major North American Airline	Ex CEO and President	Yes
Intercontinental Airline	Director of Pricing and Revenue Mgmt.	Yes
Domestic Airline	Ex Chief Commercial Officer	Yes
JetBlue	Ex Senior Executive (worked with Hayes)	No
JetBlue	Ex Senior Executive (worked with Hayes)	No
Delta Airlines	General Manager & ex Industry Consultant	No
Airline Consulting Group	President	Possibly
British Airways	Mid-level exec (worked with Robin Hayes)	No

Primary call write-ups, working model and transcript summaries available upon request.