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AAL - Q1 2018 American Airlines Group Inc Earnings Call

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OVERVIEW:

AAL reported 1Q18 GAAP net profit of $186m and GAAP EPS of $0.39.

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PRESENTATION

Operator

Good morning, and welcome to the American Airlines Group First Quarter 2018 Earnings Call. Today's conference is being recorded. (Operator Instructions)

And now I would like to turn the conference over to your moderator, Managing Director of Investor Relations, Mr. Dan Cravens.

Daniel Cravens

Thank you. Good morning, everyone, and welcome to the American Airlines Group First Quarter 2018 Earnings Call. In the room with us or joining us on the call this morning is: Doug Parker, our Chairman and CEO; Robert Isom, our President; and Derek Kerr, our Chief Financial Officer. Also in the room for the question-and-answer session is Elise Eberwein, our EVP of People and Communications; Maya Leibman, Chief Information Officer; Steve Johnson, our EVP of Corporate Affairs; and Don Casey, our Senior Vice President of Revenue Management.

We're going to start the call today with Doug, and he will provide an overview of our financial results. Derek will then walk us through the details on the first quarter and provide some additional information on our guidance for the remainder of the year. Robert will then follow with the commentary on the operational performance and revenue environment. And then after we hear from those comments, we'll open the call for analysts' questions and, lastly, questions from the media. To get to as many questions as possible, please limit yourself to one question and a follow-up.

Before we begin, we must state that today's call does contain forward-looking statements, including statements concerning future revenues and costs, forecasts of capacity, traffic, load factor, fleet plans and fuel prices. These statements represent our predictions and expectations as to future events, but there are numerous risks and uncertainties that could cause actual results to differ from those projected. Information about some of these risks and uncertainties can be found in our press release that was issued this morning and our Form 10-Q for the quarter ended March 31, 2018.

In addition, we will be discussing certain non-GAAP financial measures this morning, such as pretax profit and CASM, excluding unusual items. A reconciliation of those numbers to the GAAP financial measures is included in the earnings press release, and that can be found on our website at aa.com.

The webcast of this will also be archived on our website. The information that we're giving you on the call is as of today's date, and we undertake no obligation to update the information subsequently.

Thanks, again, for joining us. At this point, I would like to turn the call over to our Chairman and CEO, Doug Parker.

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

Thanks, Dan, and thanks, everybody, for being with us. We recorded this morning first quarter results of $357 million of income excluding net special items. That's $0.75 per share. Thanks to the hard working people of American Airlines, who are doing a phenomenal job in taking care of our teams and keeping us on track with all of our strategic initiatives. We feel very good about where we are. Those earnings, of course, are down year-over-year. That's driven by an increase in fuel year-over-year, which Derek will talk about. And indeed that fuel prices have increased yet again just in the last -- since we closed the quarter. So we've adjusted our full year earnings estimate accordingly.

Excluding the fuel price increase, as I was saying though, everything else feels very good at American. We continue to work against our strategic objectives and feel -- and had made really nice progress in each of those. First, in creating a world-class customer experience, we continue to bring in new aircraft and retire older airplanes and what is the most aggressive modernization of an aircraft fleet in the history of commercial aviation continues, with our aircraft aged now well below those of our large competitors. We've put in place the best property -- the best lounge product ever created by U.S. carrier, with Flagship Lounges in Miami, LA, JFK, Chicago, coming soon to Dallas.

With the introduction of the 737 MAXs, we now have satellite WiFi on domestic aircraft, something that will be continued to roll out through the entire fleet through 2019; just a huge advancement in the product for our customers, allowing consumers to stream, everyone in the aircraft streaming the same time. Much different than the ground-based WiFi that is in place on much of the American fleet and most of the industry's fleet today.

So that work continues. It is being well noticed by our customers. On making culture a competitive advantage, a huge initiative of American that continues, of course, in this quarter. We accrued $29 million of profit sharing for our team during the quarter. But leading forward is -- the biggest announcement in that regard for the quarter was the aircraft restructuring that we announced earlier in the quarter, which positions us for the future extremely well as it relates to our fleet addressing a couple of the issues that remain with our wide-body fleet and pushing off some 737s. That is allowing us to leave in the fleet some aircraft that weren't quite ready to retire.

And then lastly, on ensuring long-term financial strength, the earnings, in spite of those fuel price increases, contributed well to that initiative. We returned $498 million to shareholders through share repurchases and dividends in the quarter. We now have done $11.9 billion, $11 billion of which are share repurchases since the program was announced in mid-2014. And we announced yet again today a new $2 billion share repurchase authorization to be completed by December 31, 2020. So the team has done an amazing job at hitting in all cylinders.

I'll let Derek now talk about -- give you more detail on those financials, and Robert will give you more details on the operations and revenue performance.

Derek J. Kerr - *American Airlines Group Inc. - Executive VP, CFO & Principal Accounting Officer*

All right. Thanks, Doug, and good morning, everyone. To start, I'd like to recognize and thank our team members who did a great job looking after our customers despite some very difficult weather events over the past few months. Even in the face of some very challenging operational conditions, their hard work allowed us to continue showing the strong revenue growth that we have achieved in recent quarters.

We filed our first quarter earnings press release and 10-Q this morning. And as a reminder, on January 1, 2018, we adopted new accounting standards relating to revenue recognition as well as the income statement classification of certain pension and benefit costs. As a result, our 2017 statement of operations was recast to reflect these changes. All of the period-over-period comparisons I will talk about today are based on these recast results. Just refer to the first quarter 2018 10-Q filed this morning as well as our 8-K filed January 25, 2018 for our recast 2017 financial statements.

Higher fuel prices led to a decline in year-over-year earnings. Our first quarter 2018 GAAP net profit was $186 million or $0.39 per diluted share as compared to our first quarter 2017 GAAP net profit of $340 million or $0.67 per diluted share. Excluding net special items, we reported a net profit of $357 million in the first quarter of 2018 versus our first quarter 2017 net profit excluding special items of $414 million. Our diluted earnings per share excluding net special items was $0.75, $0.03 better than analyst consensus.

The winter storms I mentioned earlier in my remarks resulted in more than 8,000 flight cancellations, primarily in the Northeast, and these negatively impacted first quarter earnings by approximately $42 million.

On a pretax basis, our GAAP first quarter pretax profit was $273 million. Excluding net special items, our first quarter pretax profit was $468 million, resulting in a pretax margin of 4.5%.

For the sixth consecutive quarter, we achieved positive unit revenue growth. Total operating revenues were up 5.9% year-over-year to a first quarter record $10.4 billion. Passenger revenues were up 5.4% to $9.5 billion on a 1.5% improvement in yields.

Our cargo team continues to produce excellent results. Our fleet transformation over the past few years has led to significant up-gauging, which allows us to transport more cargo around our network. This contributed to a 10.9% increase in volume in the first quarter. This increase in traffic, when coupled with an improved global economy, enabled us to grow our cargo revenues by 18.8% to $227 million in the first quarter on a 7.1% increase in yields.

Other operating revenues were $694 million in the first quarter of 2018, up 10% year-over-year, primarily driven by revenues associated with our loyalty program.

Total GAAP operating expenses for the first quarter of 2018 were $10 billion, up 9.8% versus the same quarter last year. This increase was driven primarily by a $441 million increase in consolidated fuel expenses. Had fuel prices remained unchanged versus the first quarter 2017, our total expenses would have been $412 million lower.

Higher salaries and benefits expenses resulting from the mid-contract base pay increase given to our pilots and flight attendants in April of 2017 also contributed the increase in expenses. As a result, consolidated CASM was $0.1515 in the first quarter of 2018, up 7.3% year-over-year, and our consolidated CASM ex fuel and special items, was. $0.1157, up 2.8% year-over-year. This was lower than the guidance we provided earlier in the year due primarily to the timing of certain maintenance expenses, which shifted from the first quarter to the second quarter.

We ended the quarter with approximately $7.8 billion in total available liquidity, well above our $7 billion target minimum. The company also has a restricted cash position of $294 million.

During the quarter, we completed sale-leaseback transactions on the 16 remaining 2018 mainline new deliveries. In addition, we extended our financing commitment with BNDES to finance the 10 ERJ 175s delivered later this year and in early 2019. We now have all of our aircraft deliveries in 2018 financed.

The company made dividend payments of $48 million and repurchased 4.8 million (sic) [8.4 million] shares at a cost of $450 million in the first quarter. Since our share repurchase program started in 2014, we have bought back $11 billion of stock. Our buyback, as well as the net issuance of stock and cash extinguishment of convertible debt, has reduced our share count by 38% to 467.4 million shares outstanding as of March 31.

We also announced in our earnings release this morning that the Board has approved a new $2 billion share repurchase authorization for completion by the end of 2020.

We filed an investor update this morning, which included our guidance for the remainder of the year. Consistent with our previous guidance, we continue to expect our 2018 capacity to be up approximately 2.5% on a schedule-over-schedule basis or approximately 3% on a schedule-over-actual basis. By region, we expect our 2018 system capacity to be up approximately 3% domestically and 2.5% internationally. We also guided to a second quarter 2018 TRASM forecast increase of 1.5% to 3.5%, and Robert will provide more color on the trends we are seeing in the revenue environment.

I also want to tell you more about our One Airline initiative, the company-wide project that we discussed at our Media and Investor Day last fall. One Airline is designed to ensure we derive the maximum benefit from the efficiency opportunities created by the merger. We have forecasted on driving lower costs across the business -- are focused on driving lower costs across the business and have identified opportunities in a number of diverse areas such as simply returning unused airport space freed up by co-locations and other post-merger changes, shifting a portion of our higher costs, regional affiliate flying to lower -- our lower cost wholly-owned subsidiaries and new projects, such as our Dynamic Reaccom project, which enables customers to rebook themselves on the flight of their choice in the event of irregular operations, which in turn reduces pressure on our reservation call centers.

I mentioned on the last earnings call that we expected our One Airline initiative to generate approximately $250 million of cost reductions in 2018, which is $50 million higher than our expectations at our Investor Day. We're excited by the opportunities that we have identified through this process for 2018 and expect more than $1 billion in cost reductions over the next few years.

We continue to anticipate that our unit cost growth rate, excluding fuel and special items, will be approximately 2% for 2018, excluding the impact of any new labor agreements. Due to timing of the expenses moving out of the first quarter, we anticipate the CASM growth will now peak in the second quarter of 2018 at up 2.5% to 4.5% year-over-year with the rate of CASM declining each quarter after that.

Based on the forward curve as of April 20, we are forecasting a 30% increase year-over-year of consolidated fuel expense in 2018 or an increase of $2.3 billion. For the full year, we now anticipate our fuel price to be between $2.16 to $2.21 per gallon. With these higher forecasted fuel prices, we expect our second quarter of 2018 pretax margin excluding net special items to be between 7.5% and 9.5%.

Since we gave our EPS guide in early April, higher fuel costs have driven an increase of approximately $0.65 per share. Therefore, we are also updating our 2018 earnings per diluted share excluding net special items guidance to be between $5 and $6 a share.

Our CapEx plans for 2018 remain unchanged as we continue to expect to commit $1.8 billion in non-aircraft CapEx projects, with gross aircraft CapEx and PDPs of $1.9 billion. All of our new aircraft deliveries are designed to replace older fleet retirements.

Since our last call, we have announced a significant change in our aircraft delivery plans. Following negotiations with Boeing and Airbus, we announced earlier this month that we canceled our order for 22 Airbus A350 aircraft and expect to take delivery of additional 22 Boeing 787-8s and 25 Boeing 787-9 aircraft between 2020 and 2026. These aircraft will replace our Boeing 767s, Airbus A330-300s and certain older 777-200 aircraft. Boeing is also committed to provide operating lease financing for the 787-8 deliveries.

In addition, as Doug said, we agreed with Boeing to defer the delivery of 40 737 MAX aircraft from between 2020 and 2022 to 2025 and 2026 and agreed with Airbus to defer 3 A321neo aircraft from 2021 to 2023. These changes further simplify our fleet and better align our aircraft delivery stream with our replacement needs. They also significantly reduce our planned aircraft CapEx for 2019 and 2020. We now expect our aircraft CapEx for 2019 to be $2.5 billion with $1.7 billion expected for 2020. We will continue to work with the aircraft manufacturers to find mutually beneficial opportunities to fine-tune our delivery schedule to meet our network needs.

With respect to our pension obligations, we plan to make contributions of approximately 450 -- or sorry, $465 million in 2018, which will allow us to maintain the funded status of our plans at 80% for 2018. Roughly $207 million has been contributed through April 2018.

So in conclusion, I'd like to once again thank our entire team for another excellent quarter. Your hard work is the foundation of our continued success.

And with that, I will turn it over to Robert.

Robert D. Isom - *American Airlines Group Inc. - President*

Thanks, Derek. Good morning, everyone, and thanks for joining us. Like both Doug and Derek, I'd like to thank our team members for their impressive work throughout the quarter. They worked through challenging weather conditions, including an unprecedented 4 nor'easter storms in the first 20 days of March. As Derek said, during the quarter, we canceled more than 8,000 mainline and regional flights due to severe weather.

This past winter, our Philadelphia and Chicago O'Hare hubs de-iced a nearly 80 days each. Through all of that, our front-line teams did a great job of taking care of customers despite the difficult conditions and, once again, demonstrated the world what collaboration teamwork means. So again, thanks from all of us.

During the first quarter, we made tremendous progress on many of our commercial initiatives that we outlined at our Media and Investor Day last fall. As part of that plan, we said that we'd take advantage of the power of our hubs and gateways, strengthen our domestic network and leverage our existing and potential partnerships to improve our international network. Domestically, we will launch new service to 7 markets this summer. These markets not only strengthen the cities that -- with new service but also add more connecting routes to our network. For example, the addition of twice-daily from Panama City, Florida, to our hubs in Charlotte and DFW add more than 175 potential O&Ds to our network. The additional new destinations like Panama City is just one example how we can unleash the power of our global network, which not only add new destinations for our customers, but also drives new margin-accretive, high-quality revenue into our network.

Another objective that we outlined was to focus our network where we believe we have competitive advantage, which is our hubs. In Chicago, we recently opened 5 new gates that would allow us to offer a richer pattern of service for our customers. We also reached an agreement with DFW to get access to additional gates in Terminal E. This allows us to add departures at our largest hub, enabling more customers to access our global network. Over time and when these changes are complete, we'll operate more than 900 daily departures in DFW.

Lastly, in Charlotte, we continue to look for opportunities to add profitable growth. And recently, we announced that we gained access to 7 additional gates, which are expected to start going into service in the fall of 2019 and beyond.

We have also enhanced the travel experience between New York LaGuardia and Chicago for our business customers by adding that route to our shuttle portfolio. The shuttle is well-known among our business and top travelers and offers an hourly schedule, dedicated gates, dedicated check-in areas, complementary meals at mealtimes and first class to and from Chicago O'Hare, free spirits in first class, complementary snacks, beer and wine in all cabins.

In addition, we recently filed a new application with the U.S. Department of Transportation in February requesting antitrust immunity for our proposed joint venture with Qantas that will cover our North America and Australia and New Zealand operations. We're excited for this opportunity and look forward to its approval.

With respect to our co-brand program, we are really seeing the benefits of our dual-issuer model with very strong double-digit year-over-year growth in acquisitions in the first quarter. Our total card spend continues to significantly outpace GDP growth, and the growth in our overall program benefits to American grew measurably in the first quarter of '18 and is on track with our expectations.

Our sales initiatives continue to produce strong revenue growth in the corporate segment. In particular, we saw an acceleration of small- to medium-size corporate account acquisitions,[for] performance remains positive with our corporate accounts.

We continue to methodically expand Basic Economy, which has been effectively rolled out in the U.S. and certain markets in the Caribbean, Mexico and now across the Atlantic. We are seeing strong upsell up to our main cabin product with conversion rates now in excess of 60%. We expect further market expansion will follow as we measure our operational and revenue performance.

In addition, our highly differentiated Premium Economy product is now installed on 81 widebody aircraft. It is being sold on 58 routes at an average fare that is double the coach cabin fare.

Turning to revenue. Our first quarter revenue was up 5.9% year-over-year and was a record for the first quarter, with 3.5% year-over-year TRASM improvement. Our international performance is very strong due to solid overall demand, improved premium capital performance, favorable currency impact and Easter shifting to an earlier date compared to 2017. Domestic unit revenue was positive as well driven by approved load factor. This is the sixth consecutive quarter of positive unit revenue growth for the system and the second quarter in a row, where all geographic entities had positive PRASM growth. Much of this improvement is directly attributable to the significant investments we have made over the past few years in our product and operation as well as the world-class team we have assembled that continues to execute.

Our Latin American performance was very strong with PRASM up 12%, marking the seventh consecutive quarter of positive unit revenue growth. Strength was broad-based with Brazil and Mexico improving in the mid-single digits and all other entities improving by double digits.

Atlantic unit revenue was up 2%. Importantly, our underlying coupon performance improved by 8.6%, but we have headwinds this quarter due to the timing of joint business settlements. Premium demand remained strong while coach pricing improved year-over-year. Currency added 4.5 points to Atlantic performance.

Pacific PRASM was up 3.1% year-over-year on the basis of improved Premium Cabin performance. Hong Kong and Japan were our strongest markets year-over-year.

In domestic, our consolidated PRASM was up 2%. On a year-over-year basis, our top-performing hubs were Miami and DFW. PRASM from closed-in bookings was positive driven by Basic Economy and strong corporate demand.

First quarter cargo revenue improved 18.8% year-over-year on both strong volume and yield, continuing the positive trend we have seen since the second half of 2016. Our other revenue was up by 10%, driven by increased revenues associated with our loyalty program.

Looking forward, we are seeing strong demand for our product, both domestically and internationally. On a year-over-year basis, our comps get materially harder as the second quarter of 2017 was up significantly higher than our peers. However, our ongoing and future commercial initiatives will continue to drive revenue growth. We expect our year-over-year TRASM to be up 1.5% to 3.5% in the second quarter. This will mark the seventh quarter in a row of positive unit revenue growth for American.

Consistent with the last 2 quarters, we expect positive unit revenue growth across our network, led by the Atlantic, followed by Pacific and Latin America. As we head into the busy summer travel period, we are encouraged with the economic environment and the strength that we see in passenger demand. We remain focused on the long term, and we'll make smart investments and expand margins that drive value for our company. We're proud of our accomplishments thus far, and we look forward to the future.

And with that said, I'd like to turn the call back over to the operator and begin our question-and-answer session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we'll go first to Andrew Didora with Bank of America.

Andrew George Didora - *BofA Merrill Lynch, Research Division - Director*

Robert, can you give us a little bit more color around where your corporate negotiated rates are right now? Can you maybe give us some reference to where they are relative to prior peak? And have you been seeing traction accelerate of late on corporate pricing?

Robert D. Isom - *American Airlines Group Inc. - President*

I'm going to let -- I'm looking at Don here to...

Donald B. Casey - *American Airlines, Inc. - SVP of Revenue Management*

Yes. I mean the market -- corporate market continues to be pretty competitive, and we're seeing there a much stronger close in unit revenue growth. And part of that is related to kind of corporate and business markets. In the first quarter, our total revenue related to business travel, which we will call our corporates, was actually up 7%. So we're seeing quite strong demand. And part of that 7% growth was the increase in average ticket values. So we're seeing the yields and average values go up.

Andrew George Didora - *BofA Merrill Lynch, Research Division - Director*

Got it. And Doug, I guess, wanted to go on take to get back into the $5 billion kind of pretax income range that you talk about as being almost a baseline earnings number. Is there anything that the team can do to offset this higher fuel right now? Because it just seems like maybe some of the domestic capacity out there in the schedules might keep a little bit of a lid on pricing? So is there anything that you can do accelerate on the cost side to help try to get back towards that $5 billion number?

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

Yes, thanks. The answer, of course, is yes. I think we can talk about those things. We're just talking first about kind of what's going on here and what it does to earnings. The reality is -- I'll start with this. At this level of fuel price, I'm highly confident American Airlines could produce $5 billion of pretax earnings, not right now. But what I'm getting at is these fuel price increases is -- one of the reasons it happened very quickly, and it takes some time to -- for what's required to get to react to that to take place, a lot of which is capacity changes as you know. So anyway, the facts of these, since last summer, oil prices have increased over 60%. That's a big increase over a short period of time. And the last 12% of that's happened in the last 2 weeks. So that kind of an increase is going to have a material -- is going to have an impact on airline financials, and you don't see the impact in revenues as that happens. The way revenues respond, of course, is through either higher fares, higher revenue appraise, as you know. So that's what I think. And look, the one good thing, I guess, about higher fuel prices is it affects everybody. We all end up in the industry needing to pay for fuel, of course. And as it increases, all of our costs increase. And indeed, the lower-cost carriers costs increase at a greater rate. That's because their cost increase, of course, has nothing to do with fuel prices. It's all about having a lesser product and about paying people less. So as fuel prices increase, their costs increase at a greater rate, greater than rest of us. And the good news on that is those are the carriers that are growing the fastest, and those are the carriers that are the price leaders. So again, none of that's happened yet. We don't see it yet. But my strong view is that a business where fuel prices are going to stay for an extended period of time, you'll see those types of things respond. Back to your $5 billion number, our number, what we believe kind of steady-state pretax earnings for this business are -- in a normal year are the numbers Derek just gave you. Obviously, we don't always meet that number, but if our -- if we had simply the same fuel price in 2018 forecast that 2017 was, Derek told you $2.3 billion of higher fuel, some of that is a higher number of gallons but a very small amount.

Derek J. Kerr - *American Airlines Group Inc. - Executive VP, CFO & Principal Accounting Officer*

$.3 billion of the $2.3 billion.

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William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

$2 billion of the increase in our fuel price estimate for 2018 is driven entirely by higher prices. So if indeed that hadn't happened, [and our take on it is] I'm not suggesting revenues wouldn't be somewhat different if fuel prices were exactly the same, but we -- you all would have numbers that average over $5 billion in 2018 earnings. So that's what's going on. Fuel prices have risen very quickly, and it takes time to adapt. I view that as a near-term problem, not a long-term problem, one that will get addressed in the long term, one that the industry can certainly handle over time, but it doesn't happen immediately. And it's just like when oil prices fell precipitously, whenever it was, 3 or 4 years ago, and you saw earnings increase only to have capacity start to come in and then revenues to fall. I suspect as it goes back up like this, there's a lag effect as well. So finally, to your question, what can we do about it, our -- the main thing is we certain -- look, we're doing everything we can on costs. And we'll -- if there was more than what we thought made sense, we would have done it already. We don't have anything that says now that fuel prices are higher, let's stop doing something that didn't make sense before. We're already going after it. So I don't want to lead you to believe that we would go and increase or be able to reduce other costs in some material fashion. We'll certainly go do a re-look to make sure there's nothing out there that we can't do even faster, as Derek described. The way you deal with this primarily is on the revenue side. As our cost of production goes up, the cost of travel should go up in some way. We're not the price leaders in a lot of markets. So we'll see what happens. But none of the forecasts that you -- that we talk about anticipates that. So we'll see. But it would certainly seem logically to see over time. And you see in our capacity guidance, no change in the last capacity guidance. That's because as we look out first off in the very near term, right into the peak summer schedule, it's definitely not in our shareholders' best interest for us to be reducing capacity as we head into the best part of the year. But as we look beyond that, we will certainly take a look at whether or not -- again, assuming fuel prices stay at this level, what is the right level of capacity. And in our case, we're growing less than the others. So there's -- I'm not suggesting that -- I mean we adjust as well, but certainly, when you're talking about having less growth, those that are growing the less -- growing the least have less ability to make a large difference. But we certainly will look at ours, make sure that things like utilization, flying, yes -- that we've been adding in if still makes much sense and look at the fleet as well. So that's where the real leverage is, is in the capacity. And I do believe, as we move forward, if indeed this is the steady-state level of the fuel prices, you'll see less capacity growth that people are talking about right now.

Operator

We'll go next to Jamie Baker with JPMorgan.

Jamie Nathaniel Baker - *JP Morgan Chase & Co, Research Division - U.S. Airline and Aircraft Leasing Equity Analyst*

I'm not sure who wants to take this, but why shouldn't the ancillary revenue line also include revenue associated with domestic fuel surcharges? I mean, I get that they're not committed at the moment, but what I don't understand is why the industry isn't pushing to change this. Airlines want to be compared to other high-quality industrial transports, at least I think they do. But those companies are permitted to levy fuel surcharges. You kickstarted the industry consolidation. I mean, why isn't this another area where American can take a leadership position?

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

We're all looking at each other. Who wants to answer this?

Robert D. Isom - *American Airlines Group Inc. - President*

It's just at the end of the day, it all hits the customer, and so it's a matter of being competitive in our offering. And so we're conscious of that. And we've got to be and sure that we're incredibly competitive in terms of the pricing that we offer, all-in.

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William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

Yes. And Jamie, look, I could be wrong on this, but I don't think it can make any difference in the actual price. That's what it implies. It would just be a delineation and one that we'd need to be moving around fuel prices. The right answer is to price your product in line with your cost of production. And whether or not it's played as a fuel surcharge or not, as Robert says, the cost -- what matters is what the customer's willing to bear. And we should -- again, certainly, we should all work to set our prices accordingly. We can't...

Jamie Nathaniel Baker - *JP Morgan Chase & Co, Research Division - U.S. Airline and Aircraft Leasing Equity Analyst*

But don't you think that the pace of revenue recovery would be hastened, it would be faster if surcharge mechanisms were in place?

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

Yes. I don't know. I guess, it's a fair question, but I don't think it's material. I don't think it could have a material impact on revenues over time, and so it's not something that we've been pushing for.

Jamie Nathaniel Baker - *JP Morgan Chase & Co, Research Division - U.S. Airline and Aircraft Leasing Equity Analyst*

Okay. And second for Robert. Low-cost carriers have announced capacity reductions for next year, which most of them have. They're still growing, but at a retarded rate. In your mind, is this evidence that Basic Economy is having an impact? I mean, ULCC has, obviously, disagrees with that, but that doesn't necessarily mean that they're right. Do you have any opinion on this?

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

Whether Basic economy is affecting the ULCCs?

Jamie Nathaniel Baker - *JP Morgan Chase & Co, Research Division - U.S. Airline and Aircraft Leasing Equity Analyst*

And whether that potentially lies at the root of their decision to reduce capacity next year.

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

Jamie, we can't talk about why others may or may not change their capacity. If you're asking about whether we think -- if you asked me whether we think the Basic Economy price impact on ULCCs, of course, it is. Well -- but prior to Basic Economy, we were matching them across the board, so -- and that was having an impact. The real impact on Basic Economy that continues, but we can actually -- we have a product out there for those customers who don't want to purchase that product, where they can pay a little more and have a more -- a slightly improved product or largely improved products. So anyway, that's helped us more than them. What is impact on the ULCCs, I would imagine, is the fact that American and other airlines have dedicated themselves to making sure we're going be competitive on price for -- at any fare level they choose to go to.

Operator

We'll go next to Joseph DeNardi with Stifel.

Joseph William DeNardi - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Airline Analyst*

Robert, just on the 15 extra gates at DFW, can you just talk about what that means for Phoenix going forward? It would seem like those 15 gates could accommodate a lot of the flying being done through Phoenix. So how should we think about that?

Robert D. Isom - *American Airlines Group Inc. - President*

At least right now, I'd tell you, the 2 aren't connected. We know that we have profitable opportunities in the long run in DFW. And these additional gates, which I think are going to create a nice regional opportunity and, thereby, also create some -- free up some capacity for other mainline aircraft as well. I think it creates a nice opportunity for the growth that we do have it in the future. And as we take a look whether it's DFW or Charlotte, those are great opportunities for us to build on our strategy that we've outlined -- which is to make sure that our network is focused on our hubs and gateways and that we expand in the places where we have the greatest competitive advantage. And right now that is absolutely focused on DFW and Charlotte.

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

Let me say that Phoenix is doing well relative to other hub performance basis, and that is performing nicely. So we have nothing about that mix I think we should do -- we should be doing anything with the Phoenix hub other than continuing to do much like it's doing today. We just think there's opportunities to doing more in Dallas and Charlotte.

Joseph William DeNardi - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Airline Analyst*

Okay. And then Robert, you've mentioned before that you view the loyalty program and kind of selling miles as another distribution channel that the airline has. It would seem like a very good one, just given how opaque it can be. So I guess my question is, why not use it more? I get these e-mails offering to sell me miles pretty frequently. It's always a horrible exchange rate. I don't understand anyone -- why anyone would buy those miles. Why not offer consumers a fair rate to get their dollars into your ecosystem and kind of leverage that distribution channel more effectively?

Robert D. Isom - *American Airlines Group Inc. - President*

We think that we're using the channel and the program appropriately. It's designed to attract and retain customers, and then a tremendous amount of utility is offered by expanding through the relationships that we've been able to establish with the co-brand cards and other partners. We look for opportunities, but we think we're making smart decisions. And in the areas that we see growth, especially with the co-brand cards, we think we're doing the right thing and are really confident in enhancements in those products that we see coming throughout the rest of this year and beyond.

Operator

We'll go next to Hunter Keay with Wolfe Research.

Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace & Defense*

I realize that this might be a timing issue. And if it is, you can please tell me that. But can you help me understand the rationale for lowering the earnings guide on fuel and then not concurrently at the same time reducing some of that incrementally unproductive capacity? Or is it just sort of like a timing mismatch between the reporting cycle and capacity planning?

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

Yes, thank you. That's a good question, and I'll tried to answer -- I think I'll do better now that it's a more direct question. The answer is yes, we -- yes, we -- look, just yesterday, as we get ready for earnings go and set a new fuel price, and it's gone up from the 2 weeks we last did it enough that -- again, like 12% since the -- in the last 2 weeks. So that led to the EPS guide. And we hadn't yet made the decisions on capacity that I talked about. But there won't be any, by the way, [higher] for the summer, nor should there be. So to the extent there are going to be any, we'll look to do it as we start to build our fall schedule, and we don't have anything to report on that yet. So does it mean that we're -- you should expect that if fuel prices stay here, we won't make changes. But also, there's nothing for us to tell you right now [so it doesn't.]

Hunter Kent Keay - *Wolfe Research, LLC - MD and Senior Analyst of Airlines, Aerospace & Defense*

Okay. And then Derek, couple of years ago on one of these calls, you said we should expect roughly flat interest expense over the next 5 years. But since then, your margins and earnings have been cut in half. Is there a thought -- basically cut in half. Is a thought to redressing that view now that sort of the margin for error above the line is so much thinner?

Derek J. Kerr - *American Airlines Group Inc. - Executive VP, CFO & Principal Accounting Officer*

No, go ahead.

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

Derek said no, then I'll provide some color, which is -- I mean, part and parcel of that, Jamie is -- Hunter, whoever you are -- I'm sorry, yes. I'm sorry, Hunter. So anyway, the -- look, the question, of course, if you're asking lower interest expense is about (inaudible), and we feel really comfortable with our capital structure in good or bad times, that's why we have it set this way. The way we protect against bad times is by carrying a whole lot of cash, and we continue to do so. More than our competitors. We don't think the right thing for our shareholders is to go pay down incredibly efficient debt and which is what we have right now. We're paying down -- we pay down debt and have paid down all the higher cost debt but the debt we're adding now is tied to -- and other point I would make, of course, is we have much higher asset values than our other competitors because of the new aircraft. So there's a reason for the higher debt, and it's financed at really good rates. We think it's in the best interest of our shareholders to make sure that we avail ourselves at those rates certainly much lower than the cost of equity. And do so -- and then to protect ourselves against any sort of downturn by holding more cash than others, we like that structure. We think it's best for our shareholders, and we think it's best for American and our team.

Operator

We'll go next to Rajeev Lalwani with Morgan Stanley.

Rajeev Lalwani - *Morgan Stanley, Research Division - Executive Director*

Doug, not to beat you up on the fuel and capacity question, but you make a pretty compelling argument about higher fuel leading to lower capacity. But how do you reconcile that with the last year, where we've actually seen the opposite -- lower, high -- we had lower capacity and now higher capacity, as fuel has moved up? And help me out with that.

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

I'll try. To be clear, when I said the capacity would adjust to higher fuel prices over time, I don't think they'll be less capacity. I think there will be less capacity than there would have been otherwise. So it's hard to know what would have happen to capacity, had fuel prices stayed where they were. But I do believe -- but I would certainly agree with you, as fuel prices had risen, even through the back half of last year, I don't think you saw changes in people's capacity adjustment. My own personal view on that is, it ramped pretty quickly, and I don't know that everyone really believed that we're going to stay there. So if you're going to make capacity adjustments or -- a lot, requires some belief that out in the future, and I think the belief out in the future about oil prices was probably one of -- well, they ran up in a hurry, but there are a lot of fundamental reasons why you could go back to where it'd been for the last few years. If indeed -- now we see they just continue to grow. I can tell you, I think -- from our perspective and, therefore, I imagine for almost everyone, it leads you start questioning whether or not this is where we're going to be. If this is where we are, then there need to be adjustments. So that's what I think. I need you're going to see -- I think you're going to see changes that ran up in the back half of last year, largely because it was unclear as to whether or not that was the new normal. This is feeling somewhat more like the new normal. So we need to adjust our business plans accordingly.

Rajeev Lalwani - *Morgan Stanley, Research Division - Executive Director*

That's helpful, Doug. And another question for you. Historically, you've done a pretty good job of taking advantage of the volatility in your stock, and you've even showed that in some of your presentations. And we have seen that again more recently with the weakness in your stock. I mean, would you consider doing what you did before, which is sort of lever up, buyback your stock and sort of take advantage of these dislocations, if you will? Or do you feel like leverage is a bit full now relative to where you want it to be, maybe that's a question for Derek as well.

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

First of all, to be clear, I wouldn't describe what we do is levering up to our stock. It is not what we did. We increased the debt on the company, and as we acquired new long-life assets, which were aircraft, and we did that at really efficient rates. So -- and at the same time, we had after earnings and making sure we're taking care of our team and taking care of the exceptional amount of pent-up demand for capital in this airline and after making sure we paid off all of our high-cost debt to the extent we still had cash in excess of what we thought was the extremely high level that we like to keep, we did of course what we always do, which is return it to our shareholders, and that remains the commitment. So to the extent we have cash over and above what we believe the minimum is, having done all those other things, we'll continue to return it to our shareholders, in which we really -- we try very hard to do it in an intelligent way. And there is no doubt that where the stock is today, it looks like a nice buying opportunity for American Airlines' shareholders.

Operator

We'll go next to Brandon Oglenski with Barclays.

Brandon Robert Oglenski - *Barclays Bank PLC, Research Division - VP and Senior Equity Analyst*

So not to belabor this point, Doug, but can you talk about at that target earnings level that you guys have put out there, like what kind of macro assumptions should we be assuming in the economy? And first, assuming a stronger economy, shouldn't we also have baked in higher fuel prices looking back when you set those targets?

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

I'm sorry. Can you repeat them, I missed all of it?

Brandon Robert Oglenski - *Barclays Bank PLC, Research Division - VP and Senior Equity Analyst*

What -- I guess, what are you assuming underlying in the economy to hit your target earnings level? And shouldn't that also be associated with higher fuel prices? I mean economic growth and higher energy costs kind of go hand-in-hand, right?

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

Yes, perhaps. Look, as we got -- this may take a little longer than you wanted. All right. I've got to separate the $3 billion/$5 billion/$7billion from like a near-term forecast versus what it really is. So what we have said and continue to say and continue to believe is that we have an airline that has steady-state earnings potential at the current size of about $5 billion pretax per year. We believe that for about the time of the merger, it's been true. In some years, not true. In the last couple of years that we made that, made that or more. We continue to believe that's a good number. We believe in it so much, that's how we set our annual incentive compensation for the executives at American Airlines. So if we make $5 billion pretax, then we have target bonuses for the team. If it's less than that, we pay less. If it's below $3 billion, there's no bonus. So if it's high as $7 billion, it's a maximum bonus. Those are not -- not just statements we make. Those are -- that's how we compensate ourselves because that's what we believe. So then you ask -- I think what you asked was, well, gee, didn't your projections have higher fuel prices in it? We didn't go make that -- we didn't go set that number based on projections of any given year. That's a -- those are -- that's a number again that we say should be true in kind of a steady-state year. So I guess the better -- I prefer to answer the question this way, which is -- well then why isn't 2018 a steady-state year because you just gave give us earnings guidance lower than that? What I would tell you is it's because fuel price alone is driving $2 billion higher expenses in 2018 than in 2017, a year when we made $4 billion. So that is what's driving us to not have 2018 currently forecast as one of those years. It's the increase in fuel prices year-over-year. And I do believe, as I said at the outset, that we have an airline that can make $5 billion at $75 a barrel of oil. That's not the issue. This is a short-term -- a more near-term issue. It's happening so fast and going up so quickly. So if the earnings stayed at this level, we still believe we have an airline that will make $5 billion in steady-state times.

Brandon Robert Oglenski - *Barclays Bank PLC, Research Division - VP and Senior Equity Analyst*

I appreciate that. And then you guys laid out a lot of commercial initiatives at the Analyst Day last year. I mean, can you tell us where you're seeing the most traction right now across all of the new product offerings in the presentation?

Robert D. Isom - *American Airlines Group Inc. - President*

So yes, this is exciting for us because there's still so much to come, and we've really accomplished a lot. So Don and I have talked about where we stand with Basic Economy. We think that there's still more room to go there. We've obviously expanded recently into the Atlantic and Mexico and Caribbean. But it's not quite as broad as we think it will be. Premium Economy is really just getting started. We now have, as I mentioned, 81 aircraft in -- with Premium Economy seats and offering it. So it's really getting started. We won't be done with the fit-out of all of our aircraft until May of next year, but we'll have a sizable chunk out there and selling. And as we said, we're seeing great traction on that, and we're seeing fares that are basically double the main cabin fare, which is great. I'll let Don talk about, a little bit more about revenue management initiatives that we've seen. But then the other things that we laid out at Investor Day were along the lines of making sure our network is producing everything that it can. And we've made good progress, but we're probably only 1/4 to 1/3 of the way through where we think that, that will ultimately lead us. You know about the investment that we've made with our sales team and making sure that we're really aggressive out in the marketplace. Good traction there, but still really only just getting started. Frequent flyer programs and the work with our co-brand card, about half of the way through on that front which is great progress. And then we haven't even started yet on the seat harmonization work that we talked about, and that is putting new seats on our 737-300 -- 737-800 fleet and then also making sure that we have common cabin configurations throughout the rest of our fleet types. That has not even started. And so we think that there is nearly $500 million of benefit that we'll see over the next few years as those installations progress. Don?

Donald B. Casey - *American Airlines, Inc. - SVP of Revenue Management*

It's Don. On the really major front, we made our first kind of major enhancement to our kind of coach cabin new management system that we put in place in the middle of 2015, and we put that in place late last year. And just this month, we moved our premium cabin controls to mid-price controls which is going to enable the system to make much better network decisions at the individual flight level. As Robert mentioned, we had outlined $2.9 billion of revenue initiatives. Everything is on track, and people should really focus and also be aware that 60% of that benefits is going to improve in the '19 -- through '19 to '21.

Operator

We'll go next at Duane Pfennigwerth with Evercore ISI.

Duane Thomas Pfennigwerth - *Evercore ISI, Research Division - Senior MD & Fundamental Research Analyst*

I may have missed it in the commentary, but can you talk about what the implied domestic RASM is, if you see that positive in the second quarter? And then as my follow-up, United rolled out Basic Economy, I think, in May of last year pretty aggressively and a bit earlier than you did. It felt like there was some share shift positively to you. Do you -- can quantify what that impact was in the second and third quarters?

Robert D. Isom - *American Airlines Group Inc. - President*

Sure. So first of all, just in terms of domestic performance, as we look forward into the second quarter, we still expect our domestic unit revenue to be positive as we look over the second quarter. This will be the seventh consecutive quarter of positive [unit] revenue growth. Basic Economy will be the part of that. We rolled it out in September, so we're continuing to get the benefit of that as we go through the second and third quarters this year. To be honest with you, we did not see a large impact related to United's rollout of Basic Economy. They did aggressively [roll out a lower fare airliner when we] rolled out in May. But by the time they got through end of June, they had to have reverse that. And so we saw little bit of benefit in the second quarter, very little in the third quarter, and so we don't see that as a material year-over-year impact when we look at our own results.

Operator

We'll go next to Michael Linenberg with Deutsche Bank.

Michael John Linenberg - *Deutsche Bank AG, Research Division - MD and Senior Company Research Analyst*

Just 2 here. One for Derek. The cancellation of the A350 order, where does that show -- or where -- does that show up in your numbers? Or will it show up in things like equipment, purchase deposits? Should we see an impact on the balance sheet?

Derek J. Kerr - *American Airlines Group Inc. - Executive VP, CFO & Principal Accounting Officer*

No, you won't see any impact there. We can't talk about what we did to do that, but it's a very small portion. We had some PDPs that were out for that and we could use those for other things. So that's the -- the biggest thing is no return of PDPs that we had.

Michael John Linenberg - *Deutsche Bank AG, Research Division - MD and Senior Company Research Analyst*

Okay, great. And then just a second question to -- Robert, you brought this up and maybe Don can help answer. But when you talked about strong or good close in performance in the March quarter, I know you mentioned Premium or corporate -- but I think you also mentioned Basic Economy in the same sentence. Was that -- so Basic Economy driving close in, was that part of it? Or did I not hear correctly?

Donald B. Casey - *American Airlines, Inc. - SVP of Revenue Management*

Yes, this is Don. Yes, so our Basic Economy helps close in revenue because many of our corporate customers are not buying Basic Economy, and they're buying up to higher fares, where they were being able to buy at the Basic Economy level, before we had that Basic Economy product. So part of our kind of strong year-over-year PRASM performance [going to be -- have within it the] 7-days departure is related to Basic Economy.

Daniel Cravens

Operator, let's go to media.

Operator

(Operator Instructions) We'll go to Leslie Josephs with CNBC.

Leslie Josephs

On the fuel costs, I see some carrier-imposed charges already. Are fuel surcharges included in that? And do you see that expanding to other markets? I know you can't for domestic, but for some other ones.

Robert D. Isom - *American Airlines Group Inc. - President*

We'll just have to see. I mean we're not going to comment on forward pricing. It's just going to have to -- we'll see what happens with that.

Leslie Josephs

Okay. And then just on the Basic Economy, do you see that moving to other markets, too? And if so, where?

Robert D. Isom - *American Airlines Group Inc. - President*

Right now, as you know, we've recently rolled out into the Atlantic, and we're going to see how it does there. And we do think that there's opportunity elsewhere, and it will just take time to see.

Operator

We'll go next to John Biers with AFP Capital.

John Biers

John Biers with Agence France-Presse actually. My question is you guys talked a lot about higher fuel costs. I wondered we've been hearing from some other companies -- first of all, do you expect ultimately at the end of the day that, that will result in -- if they stay high, if fuel prices stay high that will result in overall higher fares by consumers, maybe it's not tomorrow but in the coming months? That's kind of my first question. And then second, I would say we've heard some from other companies about just, in general, about cost inflation on materials. I wondered if you had encountered that in, for example, you're talking with aerospace companies, about building the new planes. Is that something you're hearing a lot about in general is inflation -- do you think inflation in general is affecting things out there?

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

Yes, okay. On the first one, look, oil is our second largest expense and a material amount of our total expenses. So when it increases, the cost of air travel increases. And so I do believe that consumers will pay more, not so much, but they all affect demand in a material way. But that's what happens in most businesses, as you referenced. With your next question, as the cost of production goes up, then indeed, the cost of the product generally follows. So if indeed, this is where fuel prices are going to stay, I would expect you would see higher fares to consumers over time. On the second one, Robert, you take that.

Robert D. Isom - *American Airlines Group Inc. - President*

Yes. On the second one, yes, the answer is we're constantly engaged with aircraft manufacturers, engine manufacturers, all suppliers and partners to find new and better ways to work. And so whether that's aircraft design and work on fuel burn on aircraft and reducing weight and making things easier to maintain and service, those are all things that we work on all the time.

Operator

And at this time there are no further questions. I will turn the call back to management for further comments.

William Douglas Parker - *American Airlines Group Inc. - Chairman & CEO*

All right. Thank you very much, and thank you all for your interest. As always, if you have additional -- you have any questions, you can contact Dan Cravens. Media has any questions, contact corporate communications. We appreciate your interest. Thanks.

Operator

This does concludes today's conference. We thank you for your participation.
