Research Note:
**JetBlue Airways Corp. (JBLU)**
October 22, 2014

## JBLU: New Internal CEO, Same Concerns


David Barger (56) became CEO of JetBlue Airways in 2007 after the founder, David Neeleman, was ousted by the Board following a winter storm in which the low-cost carrier stumbled badly. We think that CEO Barger has successfully navigated the winter storms since then, but he hasn't been able to successfully navigate the changing industry dynamics. He failed to respond to many of the trends, like consolidation and baggage fees. And so Barger, who missed ROIC targets in 2012 and 2013, will be stepping down shortly. We like the customer friendly business model, but the margins in the airline industry are notoriously thin, and we think that JBLU needs someone who's willing to balance the business model between customer friendly and shareholder friendly policies. We think President Robin Hayes (47), who has been named as the next CEO, will also struggle to do so. Management has been consistent in allocating capital, though it has delivered poor ROA and ROE. We think that the compensation plan is too reliant on time-vesting restricted stock (RSUs). We also think equity skin-in-the game is weak among executives, particularly after Barger leaves.

**EXECUTIVE TEAM SKILLS FIT** We think there is significant transition risk within management at this point, especially with a departing CEO and recently departed COO. Beyond the near term, we are concerned that the remaining team lacks the operational skills to steer the Company in a more shareholder friendly direction. Barger, a member of the team that founded JBLU, was named CEO in 2007. He was President & COO from 1998 until 2007. Before joining JBLU, he held various Director level positions at Continental Airlines and New York Air. Barger had considered stepping down before his contract expires in February 2015, in part due to a depressed stock price. We think he did a reasonable job of growing revenues by sticking to the customer-friendly business model. Ultimately though, we think he failed to respond to competitors who lowered costs by streamlining and reorganizing in bankruptcy and as a result, profitability at JBLU has been weak during his tenure. He will be replaced by Robin Hayes, who has been President since January, and will officially take over as CEO in February 2015. He is not a founding member and thus may not be afraid to try something new, though we see no indication that he will diverge from Barger's strategy. He joined JBLU in 2008 as EVP & Chief Commercial Officer (CCO) after 19 years with British Airways (BA). At BA, he held various operational and commercial positions, including Area General Manager for Europe, Latin America and the Caribbean. We credit Hayes for improving JBLU's revenue, which was the highest ever at over $5 billion in 2013. We think that if he is to have a successful start in his new role, he will be expected to augment ancillary revenues, something competitors have done, and something CEO Barger was reluctant to do. We note that Hayes took over the responsibilities of former COO Robert Maruster (43) after his departure earlier this year. JBLU regularly receives high customer satisfaction scores, including the J.D. Power award for service excellence which it received for the 9th year in a row, so it is unclear why COO Maruster, who assumed the position in 2009, decided to leave. CFO Mark Powers (61), who has nearly 20 years of airline industry experience, joined in 2006. He started as Treasurer, was named interim CFO in 2011, and then took over the full-time role in 2012. Before joining, he was an independent advisor for various aviation-related companies, and held finance and legal positions at Continental Airlines, Northwest Airlines and GE's jet engine unit. We think he has done a poor job on the operating side (operating margins rank in our lowest quintile vs. similar-sized peers). We give him credit for focusing on debt reduction, though we note that he has delivered poor ROA, ROE and ROIC.

**COMPENSATION & ALIGNMENT ANALYSIS** We think that the Board relies too much on time-vesting restricted stock (RSUs) for executive pay, but we like the metrics used to determine the at-risk pay of the team. The team's total cash pay in 2013 was lower than peers on both an absolute basis ($3.7 million vs. $6.3 million) and as a percentage of EBIT (0.9% vs. 2.1%). CEO Barger was paid $3.1 million, consisting of: a $600k salary, a $415k cash bonus, and $2 million in stock awards. His equity pay was a significant 66% of total compensation, which we view positively. EVP Hayes was paid $1.6 million, consisting of: a $446k salary, *(continued on next page)*

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a $249k cash bonus, and $912k in stock awards. He received an 11% pay raise in 2013. CFO Powers was paid $1.3 million and EVP James Hnat (43) $1.1 million. Cash bonuses are targeted at 75% of salary for the CEO, 60% for the COO, CFO, and CCO, and 50% for the GC, which we think is reasonable. The performance goals for the cash bonus were based on customer net promoter score (NPS) (33.3%), operating margin (33.3%), and ex-fuel CASM (cost per available mile seat) (33.3%). NPS measures brand loyalty by taking customer surveys. We think NPS is weighted too high as a subjective measure, but we like the other 2 operating metrics, particularly ex-fuel CASM as it measures management's operating performance on controllable factors. The long term incentive plan (LTIP) is in the form of RSUs and performance shares (PSUs). About 80% of the equity payout to CEO Barger was in the form of time-vesting RSUs, which we do not like to see as they protect management's downside risk at the expense of shareholders. PSUs were determined based on ex-fuel CASM relative to industry peers (50%) and ROIC (50%) over a 3-year performance period. We dislike the heavy weighting given to RSUs in the LTIP, though we think that the PSU metrics are useful in promoting long-term success and enhancing shareholder value.

**EQUITY OWNERSHIP ANALYSIS** Officers and Directors beneficially own 4.6 million shares, or 1.6% of JBLU, which we think is a weak stake. Such weak skin-in-the-game is surprising given the long tenures of the executives, especially the CEO. The largest insider shareholder is CEO Barger with beneficial ownership of 1.5 million shares, or 0.5% of JBLU. EVP Hayes beneficially owns 436k shares and after him, no other executive has beneficial ownership of more than 265k shares. The weighted average strike price of outstanding options is about 15% out-of-the-money at $13.34, which we think still provides reasonable alignment with shareholders. The only significant selling in the last 18 months is by CFO Powers and EVP Hnat, who sold 88k (25% of his beneficial stake) and 75k shares (30% of his beneficial stake), respectively. We think that executive stock ownership guidelines are weak (3x salary for the CEO and 1x for other executives).

**CAPITAL ALLOCATION PRACTICES** We think management has been clear with its capital allocation strategy though produced weak operating results. Its strategy has been to grow JBLU's presence in popular destinations, including Puerto Rico and other Caribbean islands. We also like the 12 slot pairs out of Reagan National Airport that were recently acquired. We note that 40% of JBLU capacity is exposed to the New York market, so we view their continued expansion and diversification positively. Management has taken a view that the current operating environment is challenging and has intentionally slowed its growth by selling some planes, while at the same time deferring delivery of others. In 2009, management resumed its fuel hedging program after discontinuing it the prior year. We think this is an effective tool for combating volatile fuel prices which is typically the largest expense for an airline. We think that the team has done a solid job of strengthening the balance sheet. Management has been using available cash to pay down debt and purchase new planes. Cash was $797 million as of Q2'14 and long term debt was reduced to $2 billion in 2013. In Q2'14, management sold LiveTV for a one-time gain of $242 million and used the proceeds to reduce debt. The team is forecasting $625 million in CapEx for 2014. In September 2012, the Board authorized a repurchase plan for up to 25 million shares over a 5 year period. About 20.4 million shares were available at the end of 2013. We note, positively that the average price paid per share was $5.90. We note, negatively, that the Board does not pay a dividend, despite the fact that several of its competitors (including Delta, American and Southwest) do pay a dividend amounting to about a 1% annual yield.

**OTHER FIDUCIARY ISSUES** JBLU paid various subsidiaries of Deutsche Lufthansa AG, owner of 16% of JBLU, for services totaling $22.9 million in 2013. Director Jens Bischof (48) is an officer of Deutsche Lufthansa and Director Thomas Winkelman (54) is the CEO of Germanwings, a Deutsche Lufthansa subsidiary. In May 2013, an arbitrator, attempting to resolve a base pay dispute under the Pilot Employment Agreements (PEA), determined that a provision of the PEA was triggered in 2007. Management is discussing its options. In April, JBLU's pilots group decided to unionize and joined the Air Line Pilots Association. This is the 1st union in its history. *End*