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# More Planes, More Profits

- But a Risky Accumulation of Debt
- A Merger Changes Everything

# More Planes, More Profits

## But a Risky Accumulation of Debt

## A Merger Changes Everything

> *This airline transports here to there*
> *A frugal clientele,*
> *Its no-frills fares are more than fair,*
> *Its bonds? Low-priced as well!*
> *- Martin Fridson*

David Neeleman knew his Mormon missionary skills would come in handy someday.

It was Utah in 1978, and David had just spent two years in a suit and tie, going door-to-door to spread the good word of Joseph Smith. So when a friend mentioned that he was having trouble selling timeshares in Hawaii, David offered to help.

After all, he had plenty of experience talking people into things.

Turned out, David indeed had the magic touch. Since this was the pre-internet era, he industriously posted ads, made phone calls, got folks interested in a Hawaiian vacation – and took a generous cut of each booking.

To goose sales, he pre-paid for a batch of round-trip airline tickets to Hawaii and packaged them with the timeshares. The timeshare-plus-plane-trip combo took off (boosted by David's stellar missionary skills)... and soon he was hiring extra salespeople and pulling in a cool $6 million a year.

But then the airline he was working with – The Hawaii Express, whose yellow-painted planes had earned the company the nickname "The Big Pineapple" – went bankrupt.

It wasn't surprising that the Pineapple turned out to be a lemon. A lot of small airlines took off – and crash-landed – in the early 1980s, after U.S. President Jimmy Carter signed the 1978 Airline Deregulation Act, a sweeping piece of legislation that would open the American skies up to competition.

Until then, the federal government had heavily controlled prices and routes for airlines via the Civil Aeronautics Board – which meant that airplane tickets were pricey, and only large airlines could compete. (Those were the "Golden Days of Air Travel," where smartly dressed stewardesses offered cocktails and fancy meals on porcelain to well-heeled passengers.)

But following the passage of the Deregulation Act in October 1978, suddenly pretty much anybody could start an airline – or afford to book a seat on one. In the ensuing reshuffling of the competitive deck, one of the nation's largest airlines, Pan Am, went out of business, and a whole new crop of enterprising micro-airlines popped up: Presidential, PEOPLExpress, and New York Airlines among them.

Unfortunately, along with the fresh winds of competition came brutal price wars, and most of the new airlines were short-lived. The Hawaii Express was one of them.

When The Big Pineapple crashed in 1983, David had to refund thousands of prepaid airline tickets out of his own pocket... and he went bankrupt too.

By then, the devout young Mormon was building a family that would eventually include 10 kids... and they weren't going to feed and clothe themselves.

So, looking to capitalize on the brave new world of the post-airline-deregulation environment for air carriers, and build on his success as a timeshare salesman, Neeleman started his own chartered-airline business. And out of a weekly round-trip package between Salt Lake City, Utah, and Hawaii grew one of America's most iconic low-cost airlines.

It's that budget airline... one of the few tiny upstarts that thrived in the "Wild West" era of airline deregulation... that we're analyzing in this month's issue....

## Bond at a Glance

A leading U.S. airline, familiar to anyone who travels, is the issuer of this month's bond. It's a company with nearly 25 years of success and an industry-best customer-service record.

- The annual return on this bond is 16.7%.
- The bond matures in under three years.
- The company has $1.5 billion in cash.
- The company has $2 billion worth of highly liquid assets.
- The company reported strong results through September 30, 2023.

**JetBlue Airways (Nasdaq: JBLU)** issued the bond we are recommending in this issue – a 0.5% convertible bond maturing April 1, 2026.

When David Neeleman launched JetBlue nearly 25 years ago, it took the airline industry by storm and disrupted the playing field. It has since become a household name.

As of September 30, JetBlue had roughly $1.5 billion in cash and securities, $2 billion in fully owned airplanes, and one of the strongest balance sheets in the industry. The bonds we're recommending offer an annual yield of 16.7%. And if its proposed acquisition of Spirit Airlines goes through, JetBlue will take on an additional $3.5 billion in debt. And with that amount of debt, the company would have little room for error. In this issue, we recommend a way to invest in these JetBlue bonds that provides some downside protection – and lots of upside as well.

## How David Became Goliath

After the failure of his timeshare business, David Neeleman and some partners started a Utah-to-Hawaii airline-charter business that within a few years they sold to Southwest Airlines for $130 million.

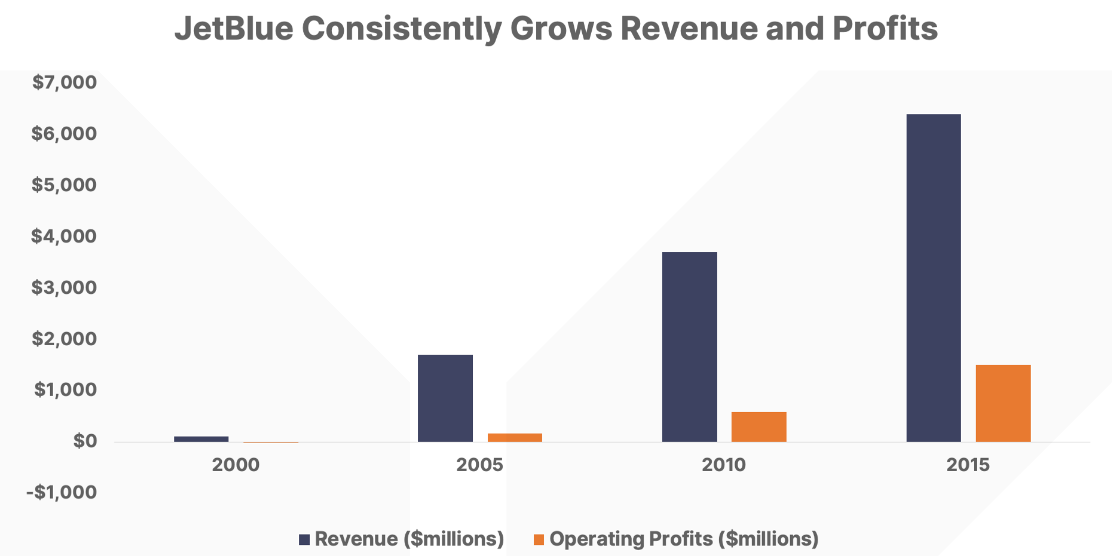
The pioneer founder of Southwest, Herb Kelleher, wanted Neeleman to run the charter business, and eventually succeed him as CEO. But their management styles clashed, and the young upstart was fired within six months. Neeleman promptly started planning a new airline modeled on Southwest. While Southwest flew into low-cost, remote airports, this new version would focus on bigger cities like Boston and New York.

That airline is JetBlue Airways, which started flying in February 2000.

It was a low-cost airline with a difference. The planes featured leather seats that were larger than other airlines offered. It provided free name-brand snacks, entire cans of soda, and an entertainment screen for each seat.

JetBlue grew quickly.

In its first year, the company had revenue of $105 million and lost $17 million on operations. And by 2015, as the chart below shows, the airline was generating operating profits above $1.5 billion a year on $6.4 billion in revenue.




Then in the winter of 2017, an ice storm hit the Northeast, affecting JetBlue's main hub, John F. Kennedy International Airport ("JFK") in New York, particularly hard. The storm caused the airline to cancel flights for nearly a week. By the time operations returned to normal, it had canceled roughly 1,900 flights affecting 130,000 passengers.

JetBlue's reputation for dependability took a big hit. CEO Neeleman accepted responsibility for the operational problems that magnified the storm's effects. Shortly afterward, the board named a new CEO – and expected Neeleman to become chairman. Instead, he left and founded new airlines in the U.S. and Brazil.

The company maintained conservative finances all along. Unlike most other airlines, JetBlue owns many of its aircraft outright. This careful approach enabled the carrier to weather the travel bans during the pandemic. Because it owns a high percentage of its aircraft, it had a low level of burdensome lease payments to make while the planes were not operating. With revenue down, JetBlue also benefited from its practice of maintaining a large cash cushion.

## Customer Service Above the Rest

While CEO, David Neeleman described JetBlue as "a customer service company that happens to fly planes." The JetBlue experience is about making the travel process as easy and pleasant as possible for its core leisure travelers – who make up 85% of the airline's customer base. The airline has won many awards over the years for best economy-class flying.

Though it experienced a blow to its reputation following the 2017 ice-storm disaster, the new CEO created a "passenger bill of rights," and earned back its customers' goodwill with automatic compensation for cancellations or boarding, takeoff, and a variety of other delays. And in 2022, it beat out Delta Air Lines and Southwest to top the American Customer Satisfaction Index for airlines.

JetBlue's main hubs are New York (JFK, Newark Liberty Airport, and LaGuardia Airport), Boston, Fort Lauderdale, Orlando, and San Juan, Puerto Rico.

For all its growth, JetBlue remains a New York-centered airline. About 50% of its flights begin or end in one of the three New York airports.

Historically, flights into and out of New York were among JetBlue's most profitable routes. There was a big fall off on these routes during the pandemic. The snapback in demand in this market has been slower than average. One of JetBlue's stated reasons for acquiring Spirit Airlines is to have greater geographic diversification, so it's less reliant on the New York market.

## Deregulation Created a Price-Tiered System

As we discuss JetBlue's proposed merger with Spirit Airlines, it will be helpful to understand the landscape of U.S. airlines, which fall into three categories, generally based on ticket prices:

- **Legacy carriers** are the airlines that had routes before the 1978 Airline Deregulation Act. American Airlines, Delta Air Lines, and United Airlines are the main legacy carriers. They typically run hub-and-spoke systems – where most flights begin or end in only a few cities. Their operating costs are high, and so generally are their ticket prices.
- **Low-cost carriers ("LCC")** emerged after the deregulation of the airline industry. The best known LCCs are Southwest Airlines, JetBlue, and Virgin Atlantic. These airlines keep costs down by not offering meals and charging for extras, like checking baggage and pre-boarding. They also reduce their costs by flying one type of airplane – which keeps training and maintenance costs down. Rather than running hub-and-spoke systems, these airlines operate between pairs of cities.
- **Ultra low-cost carriers ("ULCC")** offer low-priced, no-frills tickets. Frontier, Spirit, and Allegiant Air are the leading ULCCs. These carriers charge more for seat selection, baggage check, and snacks. (European ULCC Ryanair once tried charging extra to use the airplane bathroom, but quickly dropped the idea.) The ULCCs also typically fly one model of airplanes – often ones they purchase used – and fly point-to-point.

Though deregulation took place 45 years ago, American, Delta, United, and Southwest – sometimes referred to as the "big four" – maintain their dominance over the lower-cost competition. They carry roughly 80% of all U.S. passengers. JetBlue carries 4-5% and Spirit 3-4%. The remainder is split among all the other U.S. carriers.

## Spirit Becomes the Center of a Fight for Market Share

Airlines need scale to be profitable, and growth has typically occurred through acquisition and consolidation.

And in February 2022, we saw this begin to play out when Spirit agreed to be acquired by Frontier Airlines for a combination of cash and stock. The sale would have joined the two largest ULCCs in the U.S, creating the fifth-largest carrier overall with an 8% market share – behind Southwest at 13%. Based on Frontier's share price following the announcement, the cash-plus-stock offer had a value of $27.79 per share of Spirit stock – for a total value of $2.9 billion.

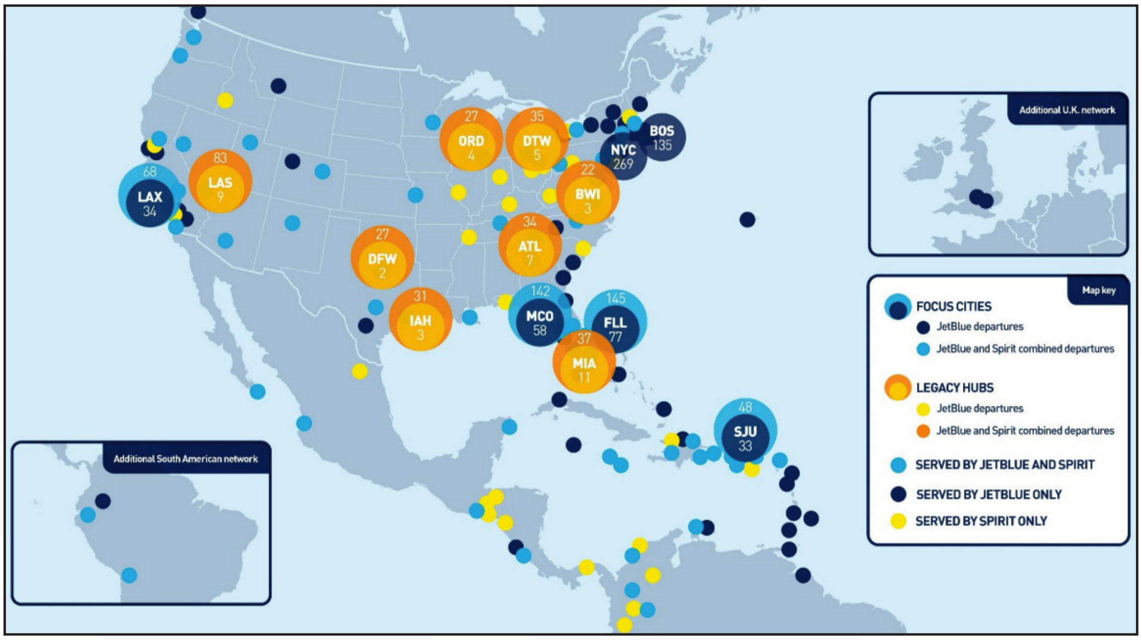
With around 5% market share, JetBlue had been looking to gain scale to compete more effectively against the big four, and was considering a merger with Spirit before the pandemic. Frontier's agreement to buy Spirit reignited JetBlue's interest in Spirit. The combination of the two largest ULCCs would have put JetBlue at a competitive disadvantage to what would be a larger rival.

So in February 2022, JetBlue went on the offensive to woo Spirit. Over the next five months, the company made various proposals to Spirit's shareholders, and on July 27, Spirit terminated its merger agreement with Frontier. The next day, it announced that it would merge with JetBlue and that its shareholders would receive between $33.50 and $34.15 per share in cash – or about $3.8 billion.

## Why JetBlue Wants to Merge With Spirit

JetBlue said the merger with Spirit would lead to numerous operating benefits. It would also become a more formidable competitor for legacy airlines and for Southwest. Together, JetBlue and Spirit would become the fifth-largest airline in the United States, with market share of roughly 8%.

Much of the value for JetBlue would come from Spirit's right to use terminals and gates at many of the busiest U.S. airports. This would add greater geographic diversity to JetBlue's route map – and would reduce its reliance on flights into and out of the New York airports:




In this map, the big blue circles represent the cities where JetBlue most frequently flies, and the big yellow circles represent the cities where Spirit most frequently flies. The small dark blue dots are cities that JetBlue also serves. Spirit serves the small yellow ones. Light blue dots are where the two overlap. The dots tell this story:

- JetBlue is an important competitor in Fort Lauderdale, Orlando, San Juan, and Los Angeles. Spirit will bulk up its presence in the Midwest and West.
- The combined company will have more flights into and out of the hub cities of the big four airlines: Las Vegas, Houston, Chicago, Detroit, Atlanta, and Miami. Together, the company will be able to compete for the legacy carriers' high-fare customers.
- The combined airlines would be the largest carrier in the Caribbean and Latin America, number two in flights to Florida and Las Vegas, and number five in and out of Los Angeles.
- JetBlue estimates that the merger would result in $600 million to $700 million in reduced expenses, largely from reallocating aircraft to busier (and more profitable) routes.

JetBlue has also cited various operational benefits from the merger with Spirit:

- Both airlines fly Airbus aircraft, which will generate savings in pilot training and maintenance costs.
- With the addition of Spirit's aircraft, JetBlue's fleet will expand from 290 to 458. Most of them are new and highly fuel-efficient – lessening the impact of swings in the price of fuel. By the end of 2024, the average aircraft in the combined fleet will be roughly eight years old, while the average American Airlines plane, for example, is 12 years old.
- The combined business would have orders for 300 additional Airbus aircraft – at a time when an existing place in line has value. An order placed today would be completed around 2030.
- JetBlue would have a larger base of employees at a time when the airline industry is experiencing a severe shortage of trained workers.

## There Are a Few Potential Problems

The combination of JetBlue and Spirit also brings with it some significant challenges:

- JetBlue's wage scale is roughly 25% higher than Spirit's. Bringing Spirit employees up to JetBlue's wage scale will add $400 million annually to wages – about 13%.
- While JetBlue has a modest debt repayment schedule over the next few years, Spirit has roughly $2 billion in debt coming due in 2025 and 2026.
- JetBlue intends to convert Spirit planes into JetBlue planes, which have larger seats – which means removing roughly 25 seats from each Spirit aircraft.
- Because an LCC is acquiring a ULCC carrier, the Justice Department is claiming JetBlue will be able to raise ticket prices, and that these price increases would fall hardest on Spirit's price-sensitive customer base.

For that final reason, the U.S. Justice Department filed suit in March 2023 to block the transaction.

## The Government Says "Not So Fast"

Spirit shareholders approved the JetBlue acquisition on October 19, 2022. On March 7, 2023, the Department of Justice filed a suit to block the deal. It alleged that the new JetBlue would offer fewer very low-priced seats for budget-conscious flyers. Specifically, the government argues that the resulting higher ticket prices would cost consumers $1 billion.

In response, JetBlue argued that the combined company would be able to compete more effectively against American, Delta, United, and Southwest. It argued too that turning Spirit planes into JetBlue planes would create a better consumer experience – since JetBlue gets high marks for customer service and Spirit gets terrible ones.

JetBlue also offered to forfeit certain sought-after landing slots in New York and Boston where JetBlue's and Spirit's routes overlap – and where the combined company's local market share (and pricing power) would be very high.

The trial started on October 31 of this year, in Massachusetts District Court, and ended on December 6. Although Judge William Young could issue his ruling at any time, most observers expect the verdict sometime in January.

## JetBlue's Recent Performance

JetBlue's performance for the first nine months of 2023 shows improvement over the same period last year. It generated more than $9 billion in revenue, and its operating profit rose 88%, to $177 million for the nine-month period, up from $94 million for the same time frame last year.

That said, JetBlue's results for the third and most recent quarter were disappointing. Much of the shortfall relative to the company's projections had to do with weather-related flight cancellations. The shortage of air-traffic controllers led to additional delays and cancellations.

JetBlue has adjusted to recent changes in the travel market. The demand for international travel remains strong, while the demand for domestic travel is still soft. JetBlue has added routes to London, Paris, and Amsterdam from New York and Boston. The company is also cutting operating costs – $70 million this year and an additional $80 million to $130 million in 2024.

JetBlue ended the third quarter with $1.5 billion in cash.

## Spirit's Recent Performance

Spirit's results for the first three quarters of 2023 have been disappointing. Though revenue was up 9% – to $4.04 billion, in the first three quarters of 2023, compared to $3.68 billion over the same period in 2022 – expenses rose by close to the same percentage. It generated an operating loss of $40 million compared with a loss of $62 million over the same period last year.

In addition to the weather, air-traffic-control issues, and weak domestic demand that JetBlue and other U.S. carriers faced, Spirit was slow to reduce capacity in response to weak demand. As a result, it was forced to slash prices to fill seats.

The company has responded to this poor performance with a program of cost cuts that are expected to improve results by $100 million in 2024. Spirit also agreed with Airbus to spread deliveries of new A320neo planes over six years rather than four years.

Spirit ended the third quarter with $1 billion in cash.

## Two Operational Issues for Both Airlines

There are two problems that are likely to have a negative effect on operating results for both carriers over the next couple of years.

The first problem is that there's a severe shortage of air-traffic controllers around the country. This problem has been particularly severe at the most crowded airports, and in some cases has forced JetBlue, Spirit, and other airlines to cancel flights since a reduced number of controllers means a reduced number of flights that air-traffic towers can handle. This is a lingering effect of the COVID-19 pandemic. With most airplanes grounded, retirements in air-traffic control increased. Health guidelines at the time prevented recruits from going to training classes. This shortage should get smaller over the next few years as the Federal Aviation Administration rebuilds its depleted staff of air-traffic controllers.

The other problem is that the companies will have to temporarily ground more planes over the next year than they normally would have to ground. Leading aerospace manufacturer Pratt & Whitney recalled the geared turbofan ("GTF") engines used in the A320neo aircraft. Spirit, the largest buyer of these airplanes, owns 82 of the aircraft – out of its fleet of 197. While the planes remain safe for flying, the company currently has six engines out of service for inspection. It expects to average an unusually high 41 planes out of service next year. These engine examinations will reduce the number of Spirit's available aircraft.

Pratt & Whitney has committed to making its customers whole – though the details are not yet clear. Between airplane rent – roughly $6 million per year per plane – and lost profits, the engine maker likely will end up paying Spirit hundreds of millions of dollars. In short, the reimbursement will make Spirit's poor results next year less bad.

JetBlue faces the same GTF engine issue, but on a much smaller scale. The company has 23 A320neo airplanes in its fleet of 290 aircraft and expects roughly 10 of them to be out of service by year end 2024.

## Some Hidden Value in the Combined Business

There are also two hidden assets that can add to the company's value over the long term.

One is something called order books.

A shortage of airplanes is another legacy of the pandemic. As travel collapsed in 2020, airlines deferred their commitments to buy new aircraft. Aircraft manufacturers, in turn, slowed their production. Since then, air traffic has rebounded faster than airplane production. Investment bank Jefferies estimates that airlines around the world are short 12,270 commercial airplanes.

Given this unfilled demand for aircraft – and the long lead time for new orders – JetBlue's contracts to purchase 139 aircraft through 2027 and Spirit's contracts to purchase 101 airplanes through 2029 provide a competitive advantage over other airlines. On average, a new aircraft generates $2 million to $3 million in operating profits per year. This means an airplane delivered today should be worth an extra $14 million to $21 million compared to one delivered in 2030. JetBlue and Spirit could easily sell or lease out new aircraft for a profit. In fact, industry newsletter Simple Flying reports that monthly lease prices on Airbus A321neos have surged 12% since January 2022.

The other not-so-obvious asset is landing rights.

At some airports, any airline can receive permission to take off and land. But at the most congested airports – New York's JFK and LaGuardia, Boston's Logan, and Reagan National in Washington, D.C. – the number of takeoff and landing slots is capped. According to the International Air Transport Association ("IATA"), 43% of air traffic worldwide flies into or out of these large airports. To schedule a flight into or out of these airports, the airline needs what's called a "slot pair."

An industry board with members from the IATA and other airline groups allocates slot pairs twice a year – in late March for the summer season and in late October for the winter season. If an airline operates at least 80% of its scheduled flights, it holds on to its slot pair the following year. What ends up happening at the busiest airports is that airlines hold on to their slots, so none become available for additional flights or airlines.

Slot pairs have scarcity value – and sometimes a lot of it. In 2016, Oman Air paid $75 million for one slot pair at London's Heathrow Airport. The scarcity value varies with the desirability of the time and day of the landing slots. For example, New Zealand Air sold a slot pair at a less desirable time at London's Heathrow Airport for $27 million. In 2014, JetBlue paid $48 million to purchase 12 landing slots that American Airlines was forced to divest when it bought USAir.

Over half of JetBlue's flights fly into or out of JFK or LaGuardia airports. Spirit also has many landing slots at LaGuardia, which serve as the collateral for its bank loans. Like the order books, these landing slots can be a source of cash if needed.

## What the New JetBlue Will Be Worth

There are a variety of ways to gauge the value of the "new JetBlue."

The combined market value of JetBlue's stock and of Spirit's stock is currently $3.2 billion. We can add that number to the debt of both companies minus all of their cash. Using this method, we arrive at a value of $8.2 billion.

| Value of JetBlue and Spirit | |
|---|---|
| JetBlue debt minus cash | $2.5 |
| Spirit debt minus cash | $2.5 |
| Market value of both stocks | $3.2 |
| Value of business | $8.2 |

*Data reported in $billions*

If we use the hard book value of both company's assets (excluding intangible assets), the valuation rises to $9.4 billion.

| Book Value of JetBlue and Spirit | |
|---|---|
| JetBlue debt minus cash | $2.5 |
| Spirit debt minus cash | $2.5 |
| Book value | $4.4 |
| Value of business | $9.4 |

*Data reported in $billions*

The most common way to value an airline is by looking at historical and projected performance. Since some airlines lean heavily toward leasing their equipment and others like JetBlue tend to own their planes, the standard metric for valuing airlines is operating profits before aircraft rental expense – to create a more accurate comparison.

## Operating Profit Before Aircraft Rental Expense

| | JetBlue | Spirit | Combined |
|---|---|---|---|
| 2017 | $1,504 | $678 | $2,182 |
| 2018 | $1,274 | $795 | $2,069 |
| 2019 | $1,424 | $910 | $2,334 |
| 2020 | $(1,377) | $(336) | $(1,713) |
| 2021 | $(274) | $110 | $(164) |
| 2022 | $504 | $416 | $920 |
| *Projections* | | | |
| 2023 | $580 | $235 | $815 |
| 2024 | $750 | $500 | $1,250 |
| 2025 | $1,050 | $950 | $2,000 |

*Data reported in $millions. Porter & Co. projections*

We see that both businesses generated substantial operating profits before the pandemic – but recorded large operating losses in 2020 and 2021. In 2022, both companies had positive operating profits before aircraft rent expense. We expect steady improvement over the next few years.

JetBlue and Spirit's operating profits are likely to increase next year based on a greater number of aircraft and their combined $175 million to $225 million in planned cost cuts. Assuming the merger is permitted to happen, JetBlue estimates additional savings will reach $650 million to $700 million once the fleets are combined. As the number of JetBlue's aircraft continues to increase, operating profits should rise again in 2025.

If the acquisition of Spirit is completed, JetBlue will pay Spirit shareholders $3.8 billion in cash. It will fund the purchase with up to $3.5 billion in borrowing secured by its assets. After the deal closes, we expect the new company's debt and rental obligations to be $11.9 billion.

| JetBlue Debt If the Acquisition Closes | |
|---|---|
| JetBlue debt and leases | $4.5 |
| Spirit debt and leases | $6.4 |
| Borrowing to purchase Spirit | $3.5 |
| Less cash at both companies | -$2.5 |
| Total | $11.9 |

*Data reported in $billions*

If we use JetBlue and Spirit's current annual interest expense and aircraft rental cost, and we assume 10% interest on the new debt, we see that the combined company will have annual obligations of $1.2 billion:

| Combined Company's Interest Obligations | |
|---|---|
| Interest and aircraft rental expenses – JetBlue | $330 |
| Interest and aircraft rental expenses – Spirit | $530 |
| Interest on $3.5 billion loan to fund purchase | $350 |
| Total interest cost and aircraft rental expense | $1,210 |

*Data reported in $millions*

Unless JetBlue sells some of its airplanes, our projection shows operating results over the combined company will barely cover its fixed costs.

In this table we show a range of possible operating profits in 2025. We also use valuation multiples of 5.0x to 7.5x operating profits before aircraft rental expense. (Most airline stocks tend to fall in this range.) We then deduct New JetBlue's debt and aircraft leases. Where the numbers are negative (red), the business is worth less that amount than the total of its borrowing and rental obligations.

For example, multiply $2 billion (column 3) in operating profit by a 6x multiple to get a $12 billion valuation – which is $100 million more than the $11.9 billion in debt. These scenarios in the table below show that operating profits will need to improve substantially above what they are to make the business worth more than the total debt of $11.9 billion of the merged companies.

### Value of Combined Company Over (Under) Debt

| 2025 Op. Profits before Rent Expense | $1,500 | $1,750 | $2,000 | $2,250 | $2,500 |
|---|---|---|---|---|---|
| ***Valuation Multiple*** | | | | | |
| 5x | $(4,400) | $(3,150) | $(1,900) | $(650) | $600 |
| 5.5x | $(3,650) | $(2,275) | $(900) | $475 | $1,850 |
| 6x | $(2,900) | $(1,400) | $100 | $1,600 | $3,100 |
| 6.5x | $(2,150) | $(525) | $1,100 | $2,725 | $4,350 |
| 7x | $(1,400) | $350 | $2,100 | $3,850 | $5,600 |
| 7.5x | $(650) | $1,225 | $3,100 | $4,975 | $6,850 |

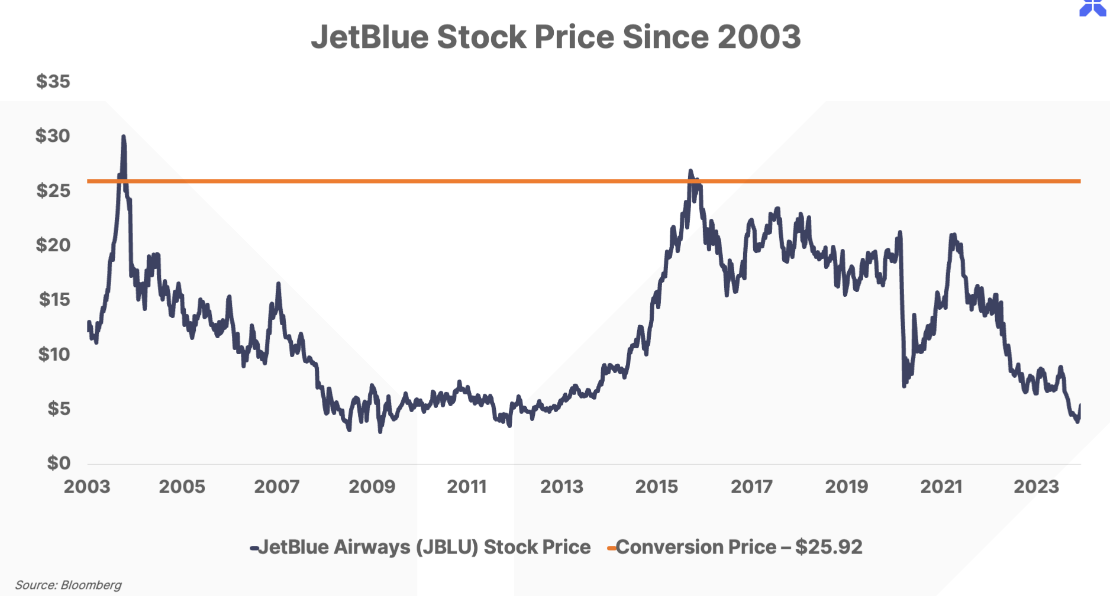
*Data reported in $millions*

## An Unlikely Scenario

The JetBlue 0.5% bonds are convertible into stock. However, we do not believe this conversion feature has value.

In April 2026 these JetBlue bonds will receive the higher of their $1,000 face value or the value of 38.58 shares of JetBlue's stock. This means that if the share price goes above $25.92 per share by April 2026, holders will end up receiving more than $1,000 per bond. With the stock currently trading at $5.54 per share and in light of the company's high debt level, we view this conversion feature as very close to worthless. The last time JBLU traded above the conversion price (very briefly and just barely) was in 2016..

Here is the JBLU price chart going back to 2003, with a line representing the conversion price:




If against extremely long odds the stock price rises above $25.92 before the bonds mature in April 2026, holders can convert the bonds into stock that will be worth more than the $1,000 face value. If the stock reaches this conversion point, holders of the bond should contact their broker, who will know how to do the conversion. Before maturity, the market price of the bond is likely to reflect that value – so you can sell it to someone else.

## A Look at Company Liquidity

As of September 30, JetBlue had $4 billion in debt. Almost $3 billion of it is secured by aircraft.

With cash and securities of roughly $1.5 billion and $2 billion of aircraft not backing debt, JetBlue should be able to handle its own debt load without problem. Another plus: more than half of JetBlue's debt does not come due before 2028.

The debt schedule becomes more difficult if JetBlue acquires Spirit, which currently has $1 billion cash and $3.3 billion in debt on its balance sheet. We estimate its receivable from Pratt & Whitney for the lost use of engines to be worth $300 million to $500 million, likely to be paid over the next two years.

## Amount of Debt Maturing

| | JetBlue | Spirit | JetBlue + Spirit |
|---|---|---|---|
| 2024 | $265 | $222 | $487 |
| 2025 | $234 | $1,324 | $1,558 |
| 2026 | $975 | $731 | $1,706 |
| 2027 | $223 | $197 | $420 |
| 2028 and on | $2,217 | $831 | $3,048 |

*Data reported in $millions*

As mentioned, JetBlue has arranged to borrow $3.5 billion to purchase Spirit Airlines. The loan is a senior secured bridge facility and matures in 364 days. It's likely that JetBlue will look to replace this financing with longer-term loans. Given $2.5 billion in combined cash at both companies, at least $2 billion in unpledged aircraft, plus a large payment expected from Pratt & Whitney, we think the merged company will be able to arrange the long-term financing.

This liquidity buys the company time. Operating profits will need to increase – as a result of increased capacity, cost cuts, or merger benefits – to succeed over the long term. Using some combination of operating profits, cash on hand, aircraft finance, and bank borrowing, New JetBlue has a good shot at meeting the 2024 and 2025 debt maturities as they come due.

The main risks of a heavy debt load and the air-traffic-controller shortage – which can force reductions in scheduled takeoffs and landings – apply to JetBlue whether or not it acquires Spirit Airlines. This said, the effects of the following factors are likely to be more serious for the more highly indebted New JetBlue:

- Salaries and benefits increases
- Maintenance costs, which can be unpredictable
- Since both companies achieve a high utilization rate for their aircraft, they are vulnerable to delays and cancellations from weather or backups in air-traffic control
- JetBlue derives a large part of its revenue from flights into or out of the three New York-area airports. How travel behavior returns to this region will play an important role in JetBlue's performance

## How the Judge's Decision Affects the Deal

Judge Young from the Massachusetts District Court, who is deciding if JetBlue's purchase of Spirit Airlines can move forward, is likely to reach one of three conclusions, which have different ramifications for bondholders and shareholders:

1. *Disallow the merger*. Since JetBlue is more conservatively financed than Spirit is (and than the combined company would be) on its own than it would be post-merger, this is the best alternative for bondholders.
2. *Approve the merger*. While JetBlue bonds would likely fall in value, Spirit's stock price would increase considerably.
3. *Approve the merger subject to more concessions by JetBlue*. If the concessions are modest, this outcome would be similar to possibility 2. If the required concessions are large enough, JetBlue may have a basis for walking away from a transaction that by many parameters is overpriced. It would have the same effect as disallowing the merger.

Regardless of the outcome, we will provide a special update to this report after Judge Young hands down his decision.

| Potential Merger Outcomes | |
|---|---|
| 1. Disallow the merger | Best alternative for JetBlue bondholders, bad for Spirit stockholders |
| 2. Approve the merger | Best alternative for Spirit stockholders, bad for JetBlue blond holders |
| 3. Approve the merger subject to more concessions by JetBlue | a. If concessions are modest, the merger would be approved<br>b. If concessions are excessive, would give JetBlue the opportunity to walk away from the deal, essentially disapproving the merger |

## Discussion of Bond Terms

JetBlue's 0.5% Convertible Bond Maturing 4/1/26 is a $750 million bond issue that is senior unsecured. This means that in the event of bankruptcy, bondholders would get paid along with all other unsecured debt – but after secured bonds and bank loans are satisfied. (As of September 30, there is roughly $2.9 billion in debt secured by certain aircraft.) All of the company's $1.1 billion in senior unsecured bonds – $750 million for these 0.5% convertible bonds and $350 million from pandemic-related loans – would get paid ahead of stockholders.

## Recommendation

Because we don't know the outcome of the case, as a hedge, we recommend buying a package of JetBlue's 0.5% convertible bonds maturing April 1, 2026, and 10 shares of Spirit Airlines stock for each $1,000 face amount of bonds. For example, if an investor buys $10,000 face amount of the JetBlue bonds, he should also buy 100 shares of Spirit stock. We believe this package will minimize the odds of a significant loss – regardless of the outcome of the case. If an investor buys only JetBlue's bonds or only Spirit stock, he would do well in one outcome and badly in the other.

And more specifically, we recommend purchasing the JetBlue 0.5% bond up to a price of $740 and purchasing Spirit stock up to $15.50 per share.

If the merger goes through, the big winners will be Spirit shareholders. They'll be paid roughly $30 per share ($300 for 10 shares) – in our estimation, much more than the company is currently worth. With the stock at roughly $14.50 per share, the potential gain in the stock price ($155 for 10 shares) would make up for the $150 to $200 trade down in the bonds. At that point it is a very risky bond that would likely be repriced by the market at around 55 cents on the dollar ($550 for each $1,000 face amount of bonds) compared to the 70 cents on the dollar it currently trades at.

If the merger falls apart, JetBlue's bondholders will be the big winners. The company will remain sensibly financed and less risky, and the odds are very high that these bonds will end up paid off on time and in full. We estimate the bonds will trade up from their current price of $700. We estimate the resulting price of around $850 would represent a yield of roughly 8% on a bond maturing in a little more than two years. The Spirit stock could trade down to $5 per share. This gain in the yield of the bond would be somewhat offset by the loss in the price of the stock.

In short, the package of one JetBlue bond and 10 shares of Spirit stock minimizes significant losses regardless of whether the merger is completed. It should result in annual returns of between 8% and 20%.

### Action to Take

Buy one JetBlue 0.5% bond maturing April 1, 2026 (CUSIP: 477143AP6) up to $740

Buy 10 shares of Spirit Airlines (NYSE: SAVE) stock up to $18 a share

In the best of all scenarios, JetBlue acquires Spirit and the new company thrives – just as management is projecting. Both the stock and the bond would (eventually) go up. But we have structured this issue's recommendation in a way that benefits investors no matter how the judge decides the case.

Martin Fridson

Porter & Co.

Stevenson, MD

P.S. If you'd like to learn more about the Porter & Co. team, you can get acquainted with us **here**.

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## Bond Box

| JetBlue Airways Corporation 0.5% Convertible Bond Maturing 4/1/2026 at $706.01 CUSIP#477143AP6 | | |
|---|---|---|
| **Summary** | | |
| December 13, 2023 | Amount Invested | $706.01 |
| | Total Interest and Principal | $25 |
| | Current Yield | 0.71% |
| | Total Return | 42.7% |
| | Term | Under 3 years |
| | Issue Size | $750 million |
| | Credit Rating | NR |
| | Callable | No |
| **Details** | | |
| December 13, 2023: Purchase the bond $705 | Accrued interest* | $1.01 per bond |
| | Total Cost | $706.01 per bond |
| April 1, 2024 | Receive interest payment | $2.50 per bond |
| October 1, 2024 | Receive interest payment | $2.50 per bond |
| April 1, 2025 | Receive interest payment | $2.50 per bond |
| October 1, 2025 | Receive interest payment | $2.50 per bond |
| April 1, 2026 | Receive interest and principal payment | $1,002.50 per bond |

* The accrued interest from October 1, 2023, until December 13, 2023. This amount is received by the seller on the settlement date and is added to the price of the bond. The first interest payment holders receive on April 1, 2024, is $2.50.

## How to Buy This Bond With a Live Broker

If you are putting in a phone call to your broker, here's a quick breakdown of the steps you'll go through.

1. For context, buy shares of Spirit Airlines (NYSE: SAVE) and tell your broker that you are buying them as part of an overall investment thesis that includes the JetBlue bonds.
2. Tell your broker the number of JetBlue bonds you'd like to acquire.
3. Provide the name of the borrower, the coupon, and date of maturity.
4. Provide the CUSIP number.

CUSIP stands for "Committee on Uniform Securities Identification Procedures" and is a unique series of numbers and letters assigned to every traded security. Providing the CUSIP will ensure that you're buying the right security. The CUSIP of the bond we recommend in this issue is 477143AP6.



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### Specific Instructions for Buying JetBlue Airways 0.5% 4/1/26 Convertible Bond

Now, the bond we are recommending today is not always tradeable online, so instead you will need to place your trade by phone. We've confirmed that the JetBlue Airways 0.5% 4/1/26 convertible bond is available through Schwab and at full-service brokerage firms.

> Recall that the bond market is much less popular (and there's much less trading volume) compared to the stock market, so don't be surprised if you are dealing with a broker who knows little about the bond market.
>
> This is part of the reason why, in the bond market, there are fewer market participants and less overall interest, so it's easier to scoop up bargains when opportunities arise.

The instructions for placing an order are usually standard across the brokerage platforms mentioned above.

Here's an example of how the conversation with your broker might go:

**Investor:** "Hello. I am interested in buying JetBlue Airways 0.5% 4/1/26 convertible bond. Can you get me the bond quote so I can decide whether or not I want to buy?"

**Broker:** "Yes, can you confirm with me the CUSIP?"

**Investor:** "The CUSIP is 477143AP6."

**Broker:** "We don't have these bonds in our inventory. However, we can place open market orders which allows for this bond to be traded and sold through an alternative trading system (ATS). We can get you a quote. How many of these JetBlue Airways convertible bonds are you looking to purchase?"

**Investor:** "I'd like to purchase 25 of the JetBlue Airways 0.5% 4/1/26 convertible bonds."

**Broker:** "Okay, I will get you a quote and call you back. Bye."

This is where the first conversation with the broker will come to an end... but within the next 24 to 48 hours of the next trading day, the broker should return your call and will give you the quote (the price) of the bond. This call is when you will place and confirm your order.

After your initial call to receive the quote, the broker will call you back in most cases and after he confirms he's speaking to the correct person, he can go ahead and place your order.

Here's how the second call might go:

**Broker:** "Hello, this is John Doe, the fixed-income specialist you spoke to earlier. I am calling to give you a quote for the 25 JetBlue Airways 0.5% 4/1/26 convertible bond bonds you inquired about earlier today. The price for the size of your request to buy 25 bonds is $74.25. Would you like to go ahead and place the trade?"

Note: If you buy 25 JetBlue bonds, you'd buy 250 shares of Spirit Airlines (SAVE) based on our recommendation.

Note: The $74.25 price he quoted is really $742.50 for the cost of each bond. When quoting bonds, brokers will most likely drop the last zero, so $74.25 becomes $742.50. Now, if the investor decides to purchase 25 bonds, his total will be $18,562.50 ($742.50 × 25 = $18,562.50) in addition to the commission or service fee.

**Investor:** "Yes. The total comes out to $18,562.50 plus the service fee. Is that correct?"

**Broker:** "Yes, it is correct. I will go ahead and make the transaction. You will get an email confirmation over the next 24 hours. Have a great day!"

As always, if you have questions, please call Lance, your personal Porter & Co. Concierge, toll-free at 888-610-8895, or internationally at +1 443-815-4447. We do not endorse any specific brokerage and are offering this guide for informational purposes only.