DIAMOND HILL

INVESTED IN THE LONG RUN

Small Company Monthly Musings

Staying Buckled Through the Turbulence: Reflecting on Allegiant Airlines

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For each holding within our Small Cap portfolio, there is a key characteristic or linchpin that holds the entire credibility of our fundamental assessment together. As long as that core concept holds, we can remain focused on the long-term valuation of the business — managing the position through bouts of volatility — with conviction that our long-term assumptions remain reasonable.

Allegiant Airlines represents an interesting example of this concept. We have seen exceptional price volatility throughout our holding period (2017-present) — the stock hit a low of roughly $36 in August 2024 and a high of nearly $269 in March 2021. In this piece, we examine the different phases of our ownership and how we have adjusted our position in alignment with our conviction and expected return throughout this period, with a consistent focus on the cornerstone of our thesis.

Establishing a Position (July 2017 – February 2019)

Our thesis at initiation was predicated on Allegiant's position as one of the best-run airlines serving a unique niche. It operates a direct-only, point-to-point network at an attractive base rate, appealing to a lot of cost-conscious customers, and focused on less traveled routes from second-tier destinations to major tourist hubs like Orlando or Las Vegas.

Insiders owned a fair share of the company, which kept them focused on the long term, and the balance sheet was relatively prudent, with debt supported by their hard assets. The company was going through a fleet transition from old MD-80 planes to significantly more reliable A320s, which we believed should support further margin improvement and solidify its position as a top-tier airline with improved on-time and service metrics. Buying mostly in the $120s, we established a 2.5% position in the Small Cap portfolio.

Managing Position Size for a Successful Long-Term Holding (October 2019)

Throughout 2019, Allegiant's margins improved by 500-600 basis points, and the new A320 planes proved to be much more reliable and efficient. The stock appreciated accordingly, and we trimmed our position throughout October in the $150s, paring back some of the appreciation but maintaining a 2.5% position.

Supporting the Position During the Pandemic (February 2020 – May 2020)

Predicting the fallout among airlines amid the news of the pandemic proved challenging. Our initial assessment was while this may affect international travel, a domestic-only, leisure-focused airline should be in a reasonable position. Plus, the company had a solid balance sheet backed by a fleet of owned planes. Thus, we saw the initial drawdown in February 2020 as a buying opportunity but quickly realized our error. We did not add to our position again until well after the CARES Act was signed — which infused capital into the airline industry. Given that such a large portion of the CARES Act for airlines was a grant, and Allegiant already had a strong operation, the company actually emerged from the pandemic shutdown with a better balance sheet than before.

Trimming After the Parabolic Recovery (December 2020 – March 2021)

In anticipation of one of the best travel markets in history after COVID-19 vaccines became available, investors quickly bid up Allegiant's stock price. In early 2021, the company was already discussing capacity growth that exceeded pre-pandemic levels. As prices appreciated, we began slowly trimming our position. Over the course of four months, we sold nearly 40% of our shares and the stock price was nearing $260 per share. We ended March 2021 with a 2% position. A fundamental recovery in travel was taking hold, and June 2021 ended up being one of the top three revenue months in company history.

Supporting the Position on Weakness (June 2021 – March 2023)

Allegiant's business is built to thrive in an environment with smooth logistical efficiency. The post-COVID reality was neither smooth nor predictable. Although demand surged, the environment was chaotic with multiple COVID variant disruptions, unpredictable employee wellness, and a need for more planes and labor, both of which were in short supply. Despite record revenues, the firm's margins struggled to recapture levels of the pre-pandemic era.

This was a period marked by a couple of large decisions that the company still faces today:

- **Sunseeker Resort:** Allegiant moved forward after pausing construction over the pandemic. The project has been challenged from the start with financing issues, delays, damage from Hurricane Ian, and now a poor opening and lackluster execution. In our opinion, this is a good example of what happens when a company deviates from its core competency, as Sunseeker has been nothing but a distraction for the business.

- **New plane contract with Boeing:** Allegiant has a history of being opportunistic with its fleet and engine management but has never chosen to become a dual-brand operator. Operating both Boeing and Airbus planes comes with additional costs and inefficiencies, which have been exacerbated by Boeing's manufacturing challenges. Allegiant is forced to carry the burden of the upfront costs while enduring delays from a discredited manufacturer.

Though this period was marked by significant inefficiencies and some chaos in the industry, the linchpin of our thesis remained intact. The company continued to show its potential profitability and the strength of the niche network it built, though masked with one-time expenses and costly distractions. This core of our thesis gave us the confidence to support a 2.0% position in the portfolio, purchasing shares all the way down into the $60s and then eventually increasing our weight to 2.75% as our expectations and conviction increased. By the end of March 2023, we had increased our share count by over 200%.

Right Sizing Our Exposure after a Brief Rebound (April 2023 – July 2023)

Allegiant's stock price doubled in six months, from December 2022 to June 2023, pushing our position size to more than 3%. In our view, the company was moving in the right direction: the Sunseeker Resort was in the final stages, operations within the airlines seemed to stabilize, and management had just increased guidance. Nonetheless, we felt this was a good opportunity to manage our exposure back to 3% — above our previous position size but not letting the exposure become larger than our conviction. We trimmed shares in the $120s in July 2023.

Establishing a New Level of Conviction (January 2024 – Present)

After the short rebound in 2023, Allegiant began a steady drawdown as fundamental momentum faded. With an eye to the long term, we continued to support our 3% position throughout the rest of 2023.

As 2024 began, we were optimistic about the potential for the business and that many challenges were beginning to be resolved. Sunseeker had been completed. The company had just produced nearly $9 of adjusted EPS for the airline. Challenges with integrating their new sales system, Navitaire, are expected to ease. Plus, Boeing should begin delivering planes, and the associated carrying costs would begin delivering revenue. At a price that was roughly 8.5X last year's adjusted earnings for just the airline, it seemed like a good opportunity to step in. We built a larger position as the price continued to stay depressed around the pandemic lows, purchasing shares all the way down to $36, supporting a position size in the 3% to 4% range for most of 2024.

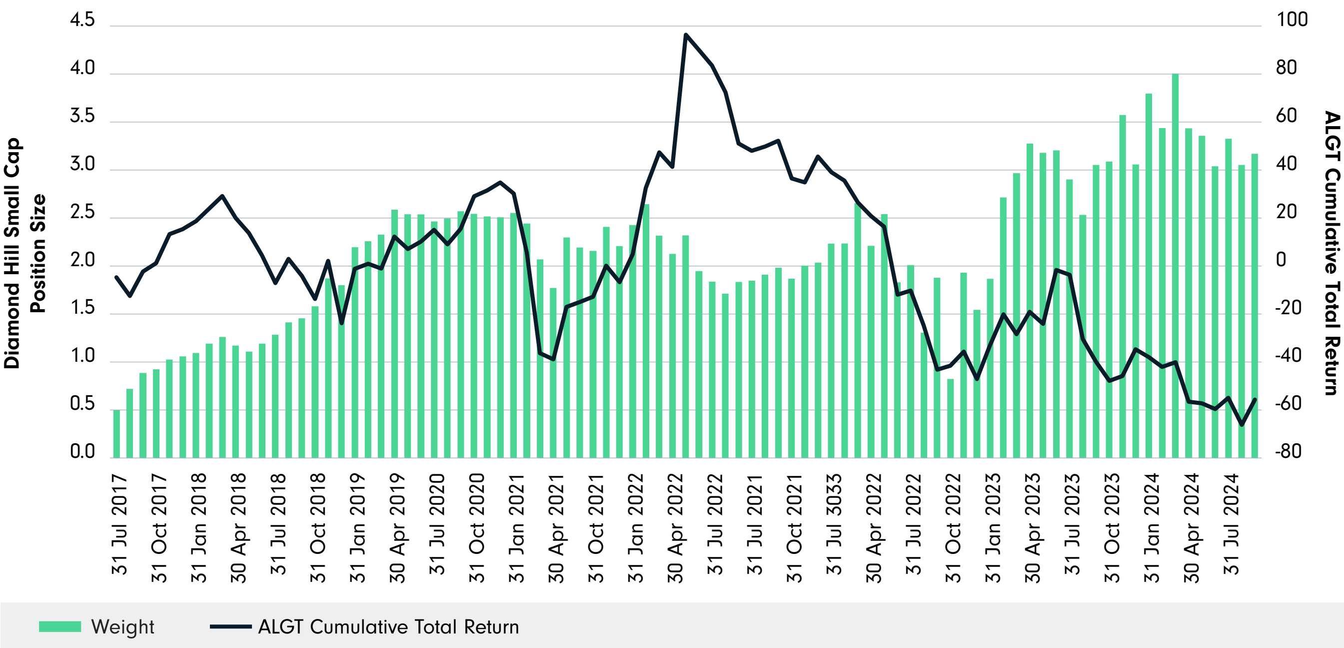
Where We Stand Today

- Sunseeker has been a massive disappointment and distraction. In our view, it was a large error in judgment by the company, though it has nothing to do with running an airline. We are encouraged by the announcement of a strategic review and having retained a specialist advisor.
- Allegiant has appointed a new CEO, Greg Anderson, formerly president of the airline, which hopefully illustrates a refocusing of the business back to its airline roots.
- Boeing has continued to face significant manufacturing delays as its internal problems have multiplied. This is outside of Allegiant's control and impacting many in the industry.
- Allegiant has assets that should more than support its debt burden, giving the company some time to fix these issues. When analyzing a business that uses leverage, we want it to be supported in some fashion. In Allegiant's case, we have hard assets — the company owns 80 planes, leases backed by the other planes, as well as property in Las Vegas and Florida along with the Sunseeker Resort, which may not cover its direct loan but still has some value.
- All the while, the airline itself — the main source of valuation creation — continues to plug along. Earnings for the airline have been volatile, and although currently down this year, are still positive, following earnings of roughly $9 per share for the airline last year. With a stock price in the $60s, we believe the company does not need to do much other than heal its wounds for the stock to be a good investment.

In summary, the crux of our thesis still holds: Allegiant is a well-run airline with a defensible position, manageable leverage, large insider ownership, and a focus on the long term.

Most prudent investors attempt to implement the mantra of "buy low, sell high," but what does this look like? What is the psychology around managing a position? Given our lengthy holding period and the substantial volatility, Allegiant uniquely illustrates how we think through our long-term ownership position in various environments. Our investment has been rocky, but we believe Allegiant's best days are still to come.

Exhibit — Diamond Hill Small Cap Strategy Position Size / Allegiant's Cumulative Total Return (%)



Source: FactSet.

As of 30 September 2024, the Diamond Hill Small Cap Strategy owned shares of Allegiant Travel Co.

The views expressed are those of the author as of October 2024 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal. Past performance is not a guarantee of future results.