This transcript is provided for convenience only and has been prepared by a third-party service. The Company has not reviewed the transcript for accuracy, and it may contain errors or omissions. This transcript should not be relied upon as a substitute for the Company's earnings call, press release, or filings with the Securities and Exchange Commission.

S&P Global
Market Intelligence

Southwest Airlines Co. NYSE:LUV

FQ2 2026 Earnings Call Transcripts

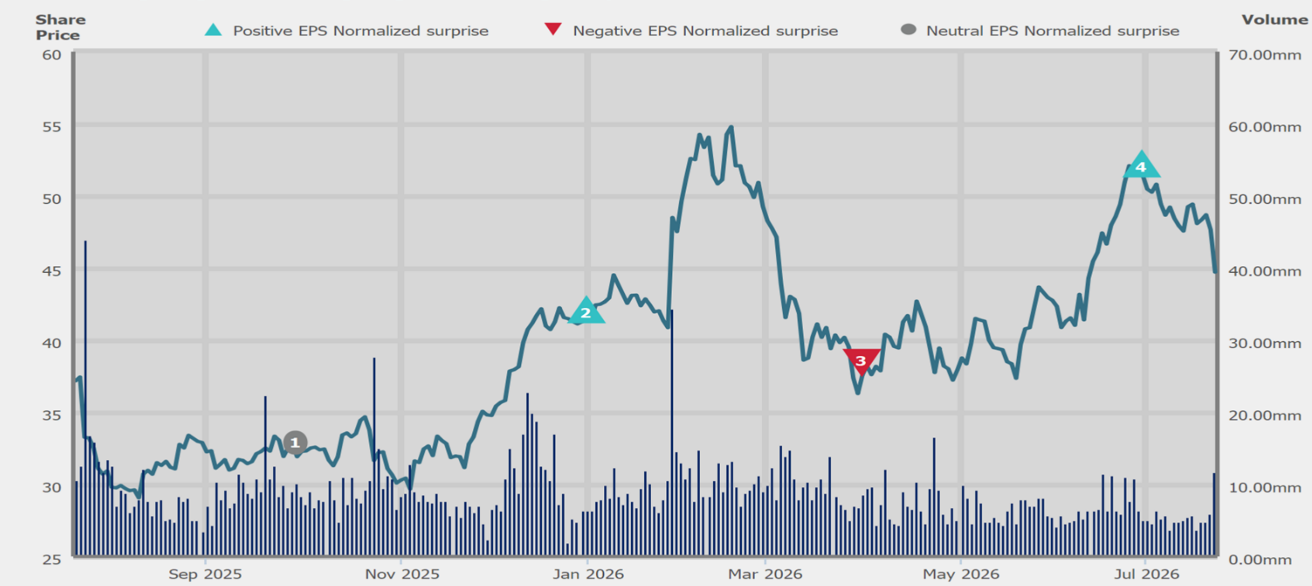
Thursday, July 23, 2026 2:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2026-			-FQ3 2026-	-FY 2026-	-FY 2027-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.52	0.94	▲80.77	0.87	3.26	NA
Revenue (mm)	8582.55	8432.00	▼(1.75 %)	8239.33	32790.15	NA

Currency: USD
Consensus as of Jul-23-2026 4:58 PM GMT

Stock Price [USD] vs. Volume [mm] with earnings surprise annotations



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2025	(0.04)	0.11	NM
FQ4 2025	0.57	0.58	▲1 1.75 %
FQ1 2026	0.47	0.45	▼2 (4.26 %)
FQ2 2026	0.52	0.94	▲3 80.77 %

Table of Contents

Call Participants

EXECUTIVES

Andrew M. Watterson
Chief Operating Officer

Danielle Collins
Managing Director of Investor Relations

Justin Jones
Executive VP & Chief Commercial Officer

Robert E. Jordan
President, CEO & Vice Chairman of the Board

Tom Doxey
Executive VP & CFO

ANALYSTS

Andrew George Didora
BofA Securities, Research Division

Atul Maheswari
UBS Investment Bank, Research Division

Brandon Robert Oglenski
Barclays Bank PLC, Research Division

Catherine Maureen O'Brien
Goldman Sachs Group, Inc., Research Division

Conor T. Cunningham
Melius Research LLC

Daniel J. McKenzie
Seaport Research Partners

David Scott Vernon
Bernstein Institutional Services LLC, Research Division

Duane Thomas Pfennigwerth
Evercore ISI Institutional Equities, Research Division

Jamie Nathaniel Baker
JPMorgan Chase & Co, Research Division

John David Godyn
Citigroup Inc., Research Division

Matthew Flemon Hortopan
Wells Fargo Securities, LLC, Research Division

Michael John Linenberg
Deutsche Bank AG, Research Division

Ravi Shanker
Morgan Stanley, Research Division

Savanthi Nipunika Prelis-Syth
Raymond James & Associates, Inc., Research Division

Scott H. Group
Wolfe Research, LLC

Sheila Karin Kahyaoglu
Jefferies LLC, Research Division

Thomas John Fitzgerald
TD Cowen, Research Division

Presentation

Operator

Hello, everyone, and welcome to the Southwest Airlines Second Quarter 2026 Earnings Conference Call. My name is Gary, and I'll be moderating today's call. Please note that this call is being recorded. A replay of today's call will be available in the Investor Relations section of southwest.com. [Operator Instructions]

At this time, I would like to turn the call over to Danielle Collins, Managing Director of Investor Relations. Danielle, please go ahead.

Danielle Collins
Managing Director of Investor Relations

Thank you. Hello, everyone, and welcome to Southwest Airlines Second Quarter 2026 Earnings Call. In just a moment, we will share our prepared remarks, after which we'll move into Q&A. Joining me today are Bob Jordan, our President and Chief Executive Officer; Andrew Watterson, our Chief Operating Officer; Justin Jones, our Chief Commercial Officer; and Tom Doxey, our Chief Financial Officer.

Before we begin, a reminder that we will be making forward-looking statements, which are based on our current expectations of future performance, and our actual results could differ materially from expectations. Also, we will reference our non-GAAP results, which exclude special items that are called out and reconciled to GAAP results in our earnings release.

With that, I'll turn the call over to Bob.

Robert E. Jordan
President, CEO & Vice Chairman of the Board

Thank you, Danielle, and good morning, everyone. I appreciate you joining our call today. Yesterday, we reported our second quarter results, marking the first time all of our major initiatives were contributing throughout the entire quarter. The results put the earnings power of our business on full display and demonstrate the benefits of the transformation that we have executed.

Our business now benefits from a broader and more diversified set of revenue and commercial levers than at any point in our history. The results demonstrate that the transformation is working, with a 9% after-tax return on invested capital and adjusted operating margin of 6.7% or a 3.3-point improvement year-over-year despite nearly $900 million year-over-year increase in second quarter fuel expense. We also generated nearly $2 billion in operating cash flow during the first half of the year despite record fuel expense.

We reported adjusted earnings per share of $0.94, up approximately 120% year-over-year and well above both our initial guidance and analyst consensus. Adjusted unit revenues increased 20.1% year-over-year to an all-time quarterly record, exceeding the high end of our prior guidance range, while adjusted operating revenues increased 20.3% on capacity growth of only 0.2%.

Managed business revenues grew 30% year-over-year to a new all-time quarterly record surpassing the record established just 1 quarter ago. Customer response to our enhanced product offering is showing up in strong engagement results. Rapid Rewards new member enrollments increased 35% year-over-year and overall program size is a record with nearly 100 million members. Tier qualification activity also reached a record high in the quarter. Chase co-branded credit card account growth was also exceptionally strong with card acquisitions in the quarter up 28% year-over-year.

Cost discipline continued as well with CASM-X increasing just 3.4% year-over-year on near flat capacity, below the low end of our prior guidance and cost discipline remains broad-based across the company. With transformational initiatives now fully in place, our focus has shifted to optimization and unlocking the full potential of the business. Specifically, we are focused on optimizing the network, refining new products and pricing, growing managed business revenues and expanding co-brand opportunities.

We have emerged as a stronger, more resilient and better-positioned Southwest while sustaining a unique set of core strengths that remain firmly intact, the largest domestic network with the most nonstop flights and the #1 position in nearly half of the 50 largest U.S. airports, operational efficiency, cost discipline, powerful brand loyalty, and importantly, legendary service and hospitality delivered by our incredible people. That creates a differentiated position in the marketplace that no other airline can replicate. And that differentiation continues to show in the results.

Southwest was named #1 in customer satisfaction among economy passengers in the J.D. Power 2026 North America Airline Satisfaction Study, our fifth consecutive year at the top spot, following recognition by The Wall Street Journal as its best U.S.

Airline of 2025. These recognitions reinforce that our hospitality, reliability, operational execution and value remain powerful core competitive advantages.

And we continue to evolve the product that we offer to our customers. Just a few weeks ago, our first Starlink-equipped aircraft entered service, marking the beginning of a new era of in-flight connectivity at Southwest. In early July, we expanded our airline partner network to 9 carriers with the addition of Air Premia. With the launch of Anchorage in May, we completed the rollout of service to all 5 previously announced new destinations, and we aren't stopping here. We will continue to drive enhancements that broaden our product offering and further deepen customer engagement.

Now let me turn to our outlook. While fuel prices have remained volatile and elevated, industry recapture has been swift and pricing has remained sticky. Forward bookings are robust, and we are optimistic the strong demand and pricing environment will be sustained. Importantly, the revenue strength we are seeing is not solely a fuel recovery story. It also reflects the idiosyncratic benefits of our own initiatives, which are improving revenue quality, strengthening customer acquisition and engagement, broadening the earnings power of the business and creating earnings durability regardless of the macro environment.

For full year 2026, we now expect adjusted earnings per share of $3.25 to $4.25. This updated range replaces our prior expectation of at least $4, reflects the forward fuel curve as of July 17 and assumes the current fare environment and demand trends remain broadly intact. Even with an estimated year-to-date fuel headwind of approximately $1.33 per share, Southwest remains positioned to generate earnings that are broadly in line with our guidance at the beginning of the year and represent significant earnings growth and margin expansion, underscoring the resiliency of our business model.

And before I close, I want to recognize our employees. None of what we have accomplished would have been possible without the dedication, resilience and commitment of our people, and we are proud to have accrued over $100 million year-to-date in profit sharing for our employees. Profit sharing reflects our long-standing belief that when the company succeeds, our people should share in that success. To our employees across the Southwest system, thank you for everything that you do for our customers and for one another.

We set out to transform the company. And today, you can see the proof in the earnings. We have built a more durable and diversified business with greater earnings power and our focus is now on unlocking Southwest's full potential, further expanding margins and creating additional long-term value for our customers, our employees and our shareholders.

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

Andrew M. Watterson
Chief Operating Officer

Thank you, Bob. As Southwest enters the next phase of evolution, our focus is increasingly on optimization. Across the operation, we are working to improve asset utilization, strengthen operational execution and drive greater efficiency while maintaining the reliability and hospitality that customers expect from Southwest. Operational excellence remains a key competitive advantage for our company and supports both the customer experience and the long-term profitability of the business.

During the second quarter, we ranked first among large domestic carriers in completion factor and improved mishandled baggage performance year-over-year, even with higher volumes of gate-checked bags. Trip Net Promoter Score also improved throughout the quarter, reinforcing that our operational execution and enhanced product offerings are resonating with customers. We also maintained the lowest customer complaint rate among the major U.S. airlines.

Our priorities remain straightforward: operate safely, serve our customers reliably and continue to improve the efficiency and productivity of the operation.

With that, I'll turn it over to Justin.

Justin Jones
Executive VP & Chief Commercial Officer

Thank you, Andrew. I'm excited to join today's call in my new role as Chief Commercial Officer, and I look forward to engaging with many of you in the months ahead. Our focus is clear: use Southwest's unique network, powerful brand, loyal customer base and expanded product offerings to improve revenue quality, strengthen returns and create durable earnings growth. We are not managing to any one metric. Our focus is on building a more productive commercial business, one that balances unit revenue growth, disciplined capacity, network profitability and long-term customer engagement.

As Bob noted, second quarter adjusted RASM increased 20.1% year-over-year, well above the high end of our prior guidance range of 16.5% to 18.5%. Importantly, this performance was broad-based, reflecting contributions from our expanded product offerings, bag fees, online travel agencies, change-related revenue and continued strength in our base business. Adjusted operating revenue reached a record $8.7 billion, the highest quarterly revenue in Southwest history, demonstrating the earnings power of a broader and more diversified revenue platform.

Looking ahead, we expect third quarter unit revenue growth of 17.5% to 19.5% year-over-year with a strong exit rate from Q2. We continue to see healthy demand, a constructive pricing environment and further opportunity to refine our commercial capabilities. Our third quarter unit revenue outlook includes a year-over-year headwind from lapping the 2025 implementation of bag fees and other initiatives.

The network remains one of Southwest's greatest competitive advantages, and we will continue using it more efficiently to maximize returns and support long-term profitable growth. As we move through the remainder of the year, my focus will be on further unlocking the potential of our commercial initiatives, deepening customer engagement and ensuring that Southwest's commercial strategy continues to support sustainable margin expansion and long-term shareholder value.

With that, I'll turn it over to Tom.

Tom Doxey
Executive VP & CFO

Thanks, Justin, and welcome to the call. I'm incredibly proud of our team for the continued focus on spending smartly as we've invested in our product, customers, operations and employees while expanding margins year-over-year despite significantly higher fuel costs in the quarter. We generated quarterly operating cash flow of $0.5 billion, more than 32% higher year-over-year, and ended the quarter with liquidity of $5.3 billion, above our target of approximately $4.5 billion.

Our gross leverage ratio was 2.1x, within our stated range of 1 to 2.5x and improved from the 2.4x at year-end 2025 despite macro volatility. Our investment-grade balance sheet remains a key differentiator, providing meaningful financial flexibility. Fuel prices averaged $3.92 per gallon during the quarter. Our fuel procurement team effectively managed through dynamic market conditions and took actions such as moving lower-priced Gulf Coast products to the West Coast to mitigate higher fuel costs in that part of our network.

Looking ahead, we expect third quarter CASM-X to increase 3.5% to 4% year-over-year on capacity of flat to down 1%. Consistent with Bob's comments, we continue to see a path toward long-term margin expansion and earnings growth, supported by disciplined execution, improving unit revenues and contributions from our initiatives. Combined with a strong balance sheet and substantial liquidity, we believe Southwest is well positioned to create sustainable long-term value for our shareholders.

And with that, I'll turn it back to Danielle for Q&A.

Danielle Collins
Managing Director of Investor Relations
Thanks, Tom. This now concludes our prepared remarks. We'll open the line for analyst questions. To help us manage time efficiently, please ask your 1 or 2 questions back to back at the outset. All right, operator, we are ready for your first question.

Question and Answer

Operator

[Operator Instructions] Our first question today is from Conor Cunningham with Melius Research.

Conor T. Cunningham
Melius Research LLC

I was hoping to start with the comp issue that you raised on unit revenue a little bit. And just maybe you could potentially size that impact in 3Q, just so we can understand a little bit more. Just I think what people are trying to get at is just the framing of how it progresses through the first half of 2027. Just I would have thought that there would have been more maturation period and more uplift from initiatives to kind of offset just the timing of it.

And then specifically to Justin, again, congrats on the new role. Just trying to understand your long-term growth, how you view long-term growth at Southwest and just network development in general. Should we be reading anything into the ramp in supply in the fourth quarter in 1Q '27 at all? Just like high level thoughts.

Robert E. Jordan
President, CEO & Vice Chairman of the Board

You bet, Conor. Thanks for the question. On the first, yes, I think to just start and just maybe zoom out, back up with the fact that our Q2 unit revenue, I mean, was up 20%. I mean, an extraordinary number. I mean, just far ahead of the rest of the industry, the transformation really kicked in and performed and showed up in the results.

The Q3 RASM guide is pretty simple to me. It includes the headwind from the initiatives that we put in place about a year ago in 2025, one of which was bag fees. Bag fees alone is about $1 billion a year. So we're just starting off at a much higher base. So if you adjust the guide for lapping those initiatives in Q3, our unit revenue guide would be well ahead of the unit revenues that we posted in the second quarter. And either way, we saw strong demand, really strong demand in revenues across the second quarter and all of that robust strength is fully in place and continuing here in the third quarter.

Justin Jones
Executive VP & Chief Commercial Officer

I was just going to address the long-term growth. It's Justin Jones, thanks for having me on the call. As Bob has talked about in his prepared remarks, we're going to continue to show capacity discipline, while we're focusing on building durable earnings. And so you can expect some modest growth from us moving forward. You see a little bit of that in the fourth quarter, you see some of that in 2027. We're well below our peers there.

But what my focus is going to be is on strengthening our points of strength that we have in the network. And you're going to see that with our capacity growth. But you're also going to see that with us moving and shifting capacity around, which you can already see. So you'll see capacity growth in our points of strength and making them more durable long term. And that will continue to be the focus as long as I'm in this role.

Operator

The next question is from Andrew Didora with Bank of America.

Andrew George Didora
BofA Securities, Research Division

Maybe Tom, drilling in on the new 2026 EPS outlook. Can you help us with some of the inputs that underpin that, particularly kind of fuel and CASM in 4Q? And on that note, yes, in terms of 4Q CASM, I know you're retiring with 37 aircraft in the back half versus 23 in the first half. I would assume you have more plane sales in the back half than what you've done to date. Any color that you can provide on how to think about that gain on sale piece in 3Q and 4Q? And anything that you booked in the second quarter would be helpful.

Tom Doxey
Executive VP & CFO

Yes. Thanks, Andrew. As far as fuel, we don't guide fuel. I think this is a bit of a nuance here, but we give you a fuel estimate based on a certain day, and we say it's the forward curve as of that day. We used July 17 here. We give you an estimate for the third quarter. You can run that out for the fourth quarter based on that information, even though we're not guiding it for 4Q. So that's fuel.

For the nonfuel side of things, I continue to be really, really pleased with the way that the management team broadly is managing costs. We're seeing cost savings happening everywhere in the business to the tune of literally hundreds of millions of dollars of incremental savings as we're working our way through the year.

To your question on fleet transactions in particular, this is something that I think is a unique strength. I think we -- I think when it comes to divesting of retiring assets, we are one of the best in the world of doing this. The team does a fantastic job. And we've got north of 450 NGs that we'll be retiring for years and years to come well into the next decade. So this is -- it may be a little lumpy by quarter, but this is something that will be durable and with us continually. And as far as the timing of some of that, I think 3Q is going to be a little bit elevated versus first quarter and second quarter, and then fourth quarter probably looks a lot like the first quarter and second quarter.

Operator

The next question is from Mike Linenberg with Deutsche Bank.

Michael John Linenberg
Deutsche Bank AG, Research Division

Two questions here. I guess to Andrew first, really well done on the completion factor, obviously, credit to you for running a good operation on one hand. On the other hand, we have seen the delays go up pretty dramatically even on what looks like blue sky days. And I'm just curious, how much of that is just a function of you reducing the turn times, which I know has been a stated objective, combined with the fact that you're also trying to increase connectivity?

And then my second question to Tom, and I'll throw Danielle in there as well. Kudos to reintroducing ROIC in the release, certainly important to us and investors. And I know management also gets compensated tied to ROIC measures. So nice to see that come back. But the fact is, can you detail, what was the gain in the quarter on sales for aircraft? And when you talk about CapEx, the guide for CapEx coming in at or below the low end because it is net. Is that a function of just a pickup in aircraft sales? Is it delayed deliveries from Boeing? What's driving that?

Andrew M. Watterson
Chief Operating Officer

Thanks, Mike. It's Andrew to start with. I appreciate the confidence on the completion factor. If we take a step back, the Wall Street Journal is a great measure of the operating quality in airline, 7 measures on that. We won it last year. We're tracking to win that again this year. If you look at those measures, some of them we've improved upon this year.

But one that we have come down on is OTP, on-time performance. And I kind of divide those into 2 categories. Large-scale events, which is like the weather you had in the Northeast earlier this week, when we had Texas rains and storms last week and Orlando a week before. And those situations, we continue to outperform our peers. You look at the geography that happens with all the big carriers, we have equivalent to better OTP and much better completion rate. And so I'm very proud of our control center, our frontline people, they make really good decisions in those moments and very good execution.

And then you have this, what I call, small-scale events, the day-to-day. And we've seen that as we've rolled out our new product, we knew that we'd have changes. We organized our management technology teams to kind of continually update that post the rollout January 27th, and we see consumers react positively, both the satisfaction scores have really inflected strongly as well as consumer behavior and choice. You see that in the RASM results.

What that leaves us is in the last 10 minutes of the turn when we have high load factors, and those high load factor volumes, we see that we don't turn as fast. And so we have a lot of smaller delays that don't drive consumer dissatisfaction per se, but it's something we need to clean up. So we've focused our ground operations team on how they can reengineer the last 10 minutes now that we've pretty much stabilized the changes to our boarding product so we can scrape that back and have that OTP number be much more flattering as we go forward.

We already see benefits here in July, and there's some schedule changes that come in, in October, but mostly it will be about this process optimization that we'll focus on throughout the next couple of months. We think that will do the trick by the time we get to the next high-volume period on the holidays.

Tom Doxey
Executive VP & CFO

And Mike, on your ROIC question, we like that metric a lot as well. And saw in your note from yesterday, the reference to ROIC and your calculation of weighted average cost of capital, it's an important milestone for us as we have that ROIC moving beyond the weighted cost of capital, that's an important metric.

As far as the gains on sales of aircraft, we actually, in our Q, which will come out later today, are going to provide a bit more detail. We thought that would be helpful as we've had some questions during the quarter on the quantum of that and what that looks like. So you'll see a little bit more detail, and hopefully, that's helpful to you all. It's worth probably just north of maybe 1 point or so of CASM-X or so in the quarter. And again, we think that, that's something really durable that we have that will continue with us for years and years to come.

As you think about gains on sales, that really works in tandem with depreciation expense and with maintenance expense. Of course, the more or less you depreciate, that changes your book value. And then as you spend on maintenance, especially on used assets, that brings a lot of economic value into those assets. Of course, we generally expense that as it comes through. And so that can be something that can result in some gains there as well. So you see a bit of that coming through.

Operator

The next question is from Savi Syth with Raymond James.

Savanthi Nipunika Prelis-Syth
Raymond James & Associates, Inc., Research Division

Just maybe to follow up on kind of Justin's response earlier just on where the growth is focused on. Are there kind of any common themes in where that capacity growth is happening, especially as you roll out the new schedules other than just maybe where there are kind of high-margin opportunities?

And then for the second question, just breakage accounting changes always a bit noisy. But it looked like the adjustment you took this quarter was related to kind of the forward credits, which I think you stopped issuing May of last year. Just curious if there were any implications from the change in assumption around the forward credits to how you're issuing credits today, which I think expires in like 6 to 12 months, and that margin contribution you had expected from that change?

Robert E. Jordan
President, CEO & Vice Chairman of the Board

Savi, it's Bob. Let me take the second one, and then Justin will obviously take the first. There's been some focus on the breakage adjustment. I think I would try to simplify it. It's a small change, I think, 3-point change in the estimate on a large pool of unused travel funds. They do relate to 2022 to 2025 when we had the policy of never expiring. So that was new to us and just had to learn about the trends. And then the trends changed again as we made significant policy changes mid last year related to funds expiration.

So there was a lot of moving parts here. I think the biggest thing is basic, which is none of this, the breakage that was booked or the adjustment related to 2026. 2026 is clean. I think that's the most important thing. And then as we go forward, yes, I think any learnings in the trend, particularly from the policy changes last year, we'll factor those into breakage on new pools of travel funds. But again, I think the main thing is this was new. We changed the policy. And again, main point, it does not relate in any way to 2026 financials.

Justin Jones
Executive VP & Chief Commercial Officer

Savi, just following up on the growth. So you asked about are there any common themes? And I'd say Southwest is in a position that no other airline is. We have a market-leading position in more cities in the top 50 U.S. locations in the U.S. than any other airline. And so the theme that you're going to see is us building on these points of strength. And the reason we're focused on those is because we're focused on customer loyalty and building diverse revenue streams. And our network changes are going to go exactly along with that theme. And the objective there is to build long-term predictable earnings that we can count on for years to come. So when you look at our capacity changes, that's where the focus will be.

Operator

The next question is from Jamie Baker with JPMorgan.

Jamie Nathaniel Baker
JPMorgan Chase & Co, Research Division

First one, so Justin, just a question on corporate recovery. In terms of revenue associated with seating initiatives, as business travelers continue to return to the network, how do their purchase patterns compare to those of consumers? The reason I'm asking is that it's still not clear to me what percentage of businesses reimburse corporate flyers for those expenses. JPMorgan does, for example, but another analyst on today's call shared that their firm does not. I'm just trying to figure out how much of a bump the new initiatives are driving as part of the overall corporate demand backdrop and whether it's different from consumer behavior.

And then for Tom, sorry to come in with a modeling question. But the implication on fourth quarter RASM is pretty sizable and a big number despite lapping last year's initiatives, there's also some capacity growth to overcome. I can't say that it's unachievable. I guess my question is whether my math is wrong, but if it's directionally correct, it seems like you are building even more demand resilience into your guide than just sort of flat -- well, I mean, the currently strong trend. So I wanted to give you an opportunity to push back on that.

Justin Jones
Executive VP & Chief Commercial Officer

Yes. Just following up on the corporate recovery, Bob talked a little bit about our corporate revenue being up 30% on a year-over-year basis. And you obviously know what our total revenue is up. And so that difference there probably explains some of that. Obviously, our corporate customers are more likely to book away from the basic economy fares, and that's going to be true for anybody out there. So the gap between that 30% growth and the rest of the revenue is probably how you would think about that.

But overall, we're super impressed with the adoption of our new products by our corporate customers, not only are we seeing substantial fair growth on a year-over-year basis, but nominal load factor points and our total mix of O&Ds is all up. And so every metric we're looking at is looking good there.

Tom Doxey
Executive VP & CFO

And Jamie, on your modeling question, of course, the guidance that we're providing is third quarter guidance when it comes to the unit metrics. We've given the full year guide for EPS, which, by the way, putting a guide out that within that guide includes the $4 that we guided at the beginning of the year, I think, is a tremendous accomplishment here and just zooming out a little bit.

We're comfortable -- as you think about kind of the 2 big parts of the rest of the year, you've got the cost side, which I think we feel we have good visibility to the nonfuel cost side of the business between now and the end of the year. And so that comes through into the full year guide. And then on the revenue side, without giving any sort of guidance around the fourth quarter unit revenues, I don't think that we're making any assumptions that show that escalating unit revenue into the fourth quarter. Really, the way I would see that is it's an assumption that we are comfortable with for revenue in the last 3 months of the year.

Operator

Your next question is from Duane Pfennigwerth with Evercore ISI.

Duane Thomas Pfennigwerth
Evercore ISI Institutional Equities, Research Division

Nice job to the team on the relative margin progress. I just wanted to ask you longer term how you're thinking about free cash flow conversion and the underlying drivers. Is free cash flow going to be simply a function of continued margin progress and earnings expansion? Or are there other levers that could drive a higher conversion even on, say, maybe a flattish earnings outlook into 2027? Not saying that's what you're calling for, but hypothetically, on a flattish earnings outlook, would we see improved free cash flow conversion?

Tom Doxey
Executive VP & CFO

Duane, I'll take that one as well. You've heard us talk a lot about operating cash flow, and you've seen meaningful improvement there as we've had improvements in the business. Moving from operating cash flow to free cash flow is largely going to depend on the timing of fleet transactions. It is a little more back weighted in the year as far as us taking deliveries. The non-aircraft CapEx is relatively constant through the year.

So yes, I think you're thinking about it the right way, Duane, which is we continue to improve the underlying profitability of the business that generates operating cash flow, and then that translation ultimately to free cash flow will depend largely on the timing of the deliveries. And because we largely pay cash and/or unsecured/some secured financing for the aircraft. Generally, as we take on those new deliveries, there's no net CapEx offset that would come with leasing that would bring more free cash flow and reduce the CapEx.

Operator

The next question is from Brandon Oglenski with Barclays.

Brandon Robert Oglenski
Barclays Bank PLC, Research Division

Bob, in your prepared remarks, I think 1 of the 2 or 3 things you said about the objectives looking for is refining the pricing of your products and the new suite of fares that you guys have out there. So I don't know if you or Justin want to comment on that. But does that help an environment where fuel is so volatile and maybe compare and contrast with how you did things in the past.

Robert E. Jordan
President, CEO & Vice Chairman of the Board

Yes. I think the point is really that -- I mean the changes in the business have been tremendous. I mean we have a much more diverse set of revenue streams, more than at any point in our history. The customer reaction to the products has been really strong. The engagement is really strong. We mentioned this, but 35% increase in new member record tiering qualification, 28% increase in co-brand card acquisition. So everything about the promise of the transformation is showing up in the business. And it fundamentally changes the model and it fundamentally changes the earnings ability in production and it changes the durability of the earnings stream in my mind.

Now you've got an opportunity to really continue to push in all of those areas. So as Justin has mentioned a lot, we have a lot of opportunity to continue to optimize the network to optimize our pricing around the new products, whether that's ancillary or fare buy-up. We have opportunities to continue to optimize the products themselves. I also see these customer engagement metrics that are super strong, I would say, leading indicators of the opportunity in co-brands. So we have the opportunity to continue to drive the co-brand contribution to the business and then continue to expand the co-brand opportunities, new cards, those kinds of things.

So the point is the transformation has fundamentally changed the earnings power of this company. You see that in the year-over-year margin change, the only airline to actually strengthen margins over 3 points year-over-year. And despite $900 million in fuel increase, and we have more to come out of the products that we have and then we'll continue to expand on the product set. So I'm incredibly bullish about where we are and I'm incredibly bullish about where we are going.

On top of that, the backdrop remains really strong, and some of that is the reaction to our new products. Some of that is the reaction, obviously, just generally that the industry is seeing. Demand in the third quarter -- in the second quarter was very robust. Revenue was very robust, and we saw that accelerate, managed business being up 30% year-over-year on basically flat capacity to me is just incredible. And we're seeing that same strength continue directly into the third quarter here. We're not seeing the strength. We exited the second quarter very strong, and we're seeing that same strength here in the third. I mean, just as one example. The third quarter, I think, right now is booked about 65% in place and yields are running up 24% year-over-year compared to 13% for Q2 at this point. So there is no deceleration in the strength and the demand, no deceleration in the strength in the revenues and the fares.

Operator

The next question is from Catherine O'Brien with Goldman Sachs.

Catherine Maureen O'Brien
Goldman Sachs Group, Inc., Research Division

On the revenue side, now that we're in the first full quarter of all the new product initiatives, I was just wondering if there's any stats you can maybe share on how buy-up from basic or baggage take rates are trending versus your initial expectations and how that factored into the revenue beat, if it did?

And then Tom, another beat on the cost side in the quarter. It would be great to hear what the main driver of that was and how we should think about the puts and takes on CASM to 4Q from here? And then can you just remind us if aircraft sales are included when you give the initial quarterly guide?

Justin Jones
Executive VP & Chief Commercial Officer

Yes, I'll take the first one. We're not going to break out the value of the individual initiatives, but I can talk a little bit about the trends of what they are versus our expectations. So we are outperforming. When we think about what we've done with basic economy, we are selling more basic economy fares, but that's because we've expanded the basic economy product into more of our fare structure overall.

We are also seeing incremental sell-up. So meaning that when people have options to trade up, we're providing those options more often, and we're seeing more of that trade up. And so both of those are outperforming what our initial expectations are. And as Bob noted, there is a clear expectation that we'll continue to tweak the models and work with Tony Roach's team to make the product better moving forward.

Tom Doxey
Executive VP & CFO

And Catie, to your question on drivers for CASM. It's really happening throughout the business, as I mentioned before, and this is everything from getting more efficient on the technology side. We've been, I think, really efficient on the supply chain and on the maintenance side of things. You've heard us talk in the past about nonfrontline head count dollars staying flat to 2025. We've had really good efficiency from our frontline teams as well, which sets a large part of our cost structure. So it's very broad-based.

And then separately to your question on aircraft sales, yes, you are right. As we move to a simplified EPS structure in the guide there, that is inclusive of any gains that would come as we are disposing of these assets. So yes.

Operator

The next question is from Sheila Kahyaoglu with Jefferies.

Sheila Karin Kahyaoglu
Jefferies LLC, Research Division

Maybe just a lot of questioning on this, but just putting a finer point on how we think about the Q2, the guidance in terms of the deceleration at the midpoint for Q3, while legacy peers are guiding to RASM acceleration. Maybe can you just parse out the tailwinds and headwinds, if possible, on the sequential deceleration across initiatives, the comp and the macro demand? Is that possible?

Robert E. Jordan
President, CEO & Vice Chairman of the Board

Yes, let me just talk in the -- and I don't -- yes, we're not going to break it out into components, but the change sequentially Q2 to Q3 is completely and simply the headwinds created by the initiatives that we put into place about this time last year in 2025 that contributed. So our bases as a comparator is just higher. It was bag fees, a number of things, as I mentioned, bag fees on their own is about $1 billion a year, so call it, maybe 2.5 points. And then on top of that, you have, obviously, other initiatives that we implemented that are in that headwind.

So you take even the bag fees, let alone the rest and you add that to the third quarter guide, and you are sequentially ahead of our second quarter, 20.1% and it's on a number, obviously, that is substantially higher than the rest of the industry. So there is no deceleration in demand. There's no deceleration in the fares. There's no deceleration in managed business. There's no deceleration in the strength of the product performance, none of that. This is simply a factor of the base stepping up because of the products that we implemented this time last year.

Operator

The next question is from John Godyn with Citi.

John David Godyn
Citigroup Inc., Research Division

Bob, in the prepared remarks, you mentioned a bunch of reasons it's impossible to replicate Southwest's assets. Of course, other airlines would argue it's impossible to replicate theirs, too. But some of them have been spending billions of dollars a year on CapEx, product, IT, other improvements, and they've been doing it for years.

So my question is just to think through this, not a specific number, but just to sort of discuss and think through how much incremental investment it takes to replicate assets that are thought to be impossible to replicate?

Robert E. Jordan
President, CEO & Vice Chairman of the Board

John, that's a wide-ranging question, but I think I would just start with the point is -- it's not what would it take to -- for us to take ourselves to an equivalent product to pick another airline. The point is that we've changed the business model of Southwest Airlines to meet customers' needs and expectations to broadly diversify the revenue streams, to create more durability and stability in the earnings, and you combine that with, I think, without question, historic core strengths at Southwest Airlines has always had. And no carrier can replicate or is even close. We have the largest domestic network, period. We have the most nonstop flights, which are incredibly important to customers, period.

As Justin said, we have the #1 position in not a few hubs, but in nearly half of the 50 largest U.S. cities. We have incredible cost discipline and efficiency. And our efficiency has always been very hard to replicate because it's a matter of how we manage the aircraft and aircraft utilization and the network. And you're seeing the discipline come through in cost quarter after quarter now. Cost in the low to mid-3s on flat capacity here.

And then we have without a doubt, the best service, the best hospitality from the best people, and that shows up in whether it's JD Power or the Wall Street Journal rankings or others, it shows up time and time again that, that is a huge differentiator for Southwest. Any one of those is tough to replicate like the network. Those in combination are incredibly tough to replicate. And you take all of those strengths and combine them with the fact that we've now dramatically improved our product, diversified our revenue streams. And we're going to do more. I think it's a combination that is incredibly tough to match. We may choose to continue to invest in products. We will without a doubt. But the real point is the combination of core strengths that no other airline can replicate.

Operator

The next question is from Ravi Shanker with Morgan Stanley.

Ravi Shanker
Morgan Stanley, Research Division

Just a couple of follow-ups here. Maybe on corporate, now that the revenue initiatives has some time to bed in. Can you just talk about how share may have shifted, particularly in corporate? And how much room do you think there is to get up to your ideal level there for corporate share?

And maybe as a follow-up, I thought I heard you guys mentioned hundreds of millions of dollars in incremental cost saves. I don't know if I misheard, but that sounds pretty exciting. Can you just talk about how much of that is already in the guide? And what is the long-term runway on that, please?

Justin Jones
Executive VP & Chief Commercial Officer

Yes. So I'm happy to take the corporate share one. So as we talked about the significant nominal increase in revenue on a year-over-year basis, and we also talked about seeing improvements not only in fare, but also in nominal load factor points as well as the mix of total O&Ds. So I think the way I look at it is we still actually have some pretty significant disadvantages relative to our peers, whether it's buying ancillary products through different channels that our corporate passengers book through.

So a lot of tactical things that the teams can go out and do to push that, but it's also going to ride right on the coattails of what we're going to be doing with the network. As we build these points of strength, as we move our capacity around to offer a much better network product to our customers, you're going to see that customer share increase, and that's exactly what we see already as we made these changes. As we improve the network, our corporate load factors are going up.

Tom Doxey
Executive VP & CFO

And Ravi, to your cost question, yes, the hundreds of millions of dollars of savings are in the guide. And this is just disciplined work by all of the leaders here. And what I've loved is, you've heard me say this before, this is not finance going around and having conversations about how we save money. This is every leader at the company figuring out ways to make their areas more efficient and collectively partnering with us to find savings throughout the entire business. So that comment of hundreds of millions of dollars of savings is incremental savings that we found since the beginning of the year as we've been working together. And yes, it is incorporated into the full year guide we gave you.

Operator

The next question is from Tom Fitzgerald with TD Cowen.

Thomas John Fitzgerald
TD Cowen, Research Division

I was curious on the fleet side, if you could talk a little bit about your long-term maintenance agreements and how that could be an advantage just because there's this transition to the new technology engines.

And then just as a follow-up, should we expect that airline benefit revenue component of loyalty, should that grow with the overall business in 2027? Or is that more kind of flat based on cardholder spend? Any color on that would be really helpful.

Tom Doxey
Executive VP & CFO

Tom, I'll take the first one on the fleet side. My comment before was around having maintenance value in the assets that we are selling. And that value is trading strongly in the market now. The underlying assets, aircraft and engines and other assets are -- that market is strong, and we think it will be strong for the foreseeable future. But then the actual value of the maintenance itself is also trading at higher amounts as well. And so as we sell assets into the market, we benefit from that strength. And I think that's pretty widely known that there's strength in those markets.

Robert E. Jordan
President, CEO & Vice Chairman of the Board

And then, Tom, it's Bob. I'll take the second. I think you're talking about the co-brand benefit. I think the answer is yes. You should expect over time as products mature, customer engagement with the new products mature, I would expect that to show in the co-brand remuneration. I mentioned this before, we have strong, to me, leading indicators of not only the fact that customers, business and leisure are strongly engaging in our new products, but it's causing them to strongly engage from a loyalty perspective. Again, the growth in new membership, the growth in tier, the growth in card acquisition, et cetera. So I see those as leading indicators that will, over time, turn into continued card spending growth and then co-brand.

The second piece of that, we fully intend to continue to expand the co-brand offering and opportunities for our customers. I know I've teased the lounges. That's something obviously that there's work underway. We're not ready to formally announce that yet. But the whole purpose, again, is to expand co-brand opportunities, expand the card set and provide to our customers something that they really, really want.

So I think you see evidence that the -- our customers are -- our customer engagement is moving quickly in the right direction. And over time, that will mature. And I think it matures into things like card spend and co-brand remuneration, and then we'll continue to expand the offering, which will do the same.

Operator

The next question is from Scott Group with Wolfe Research.

Scott H. Group
Wolfe Research, LLC

So I wanted to ask on capacity. If I look at Q4 up 4% to 5% year-over-year, I think it's the biggest sequential Q3, Q4 increase maybe we've ever seen. So I just wanted to sort of understand the thought on that. And I don't know if you have any sort of early thoughts about how you're thinking about capacity in 2027? Yes.

Justin Jones
Executive VP & Chief Commercial Officer

Yes. So well, looking at our sequential growth that we have going into Q4, it is up 4.5%. You'll probably see us make some slight tweaks to that schedule as we get closer out there. But if you look at where we have that capacity growth, again, it is in our point of strength. And so this is not trying to go and expand into new markets for us that are going to underperform the rest of the network.

Everywhere where we're putting aircraft, we expect to produce profitable earnings for us here this year. And again, it is -- you will see us focus on capacity discipline moving forward, not only this year but also into next.

Scott H. Group
Wolfe Research, LLC

To that point, any like early thoughts on what '27 capacity could look like?

Justin Jones
Executive VP & Chief Commercial Officer

No, we're not prepared to talk about that yet. You can kind of see what we have out in the first quarter out there, and we will probably make some adjustments from that, but we're not ready to talk about what the full year capacity looks like.

Operator

The next question is from David Vernon with Bernstein.

David Scott Vernon
Bernstein Institutional Services LLC, Research Division

A couple of questions for you on the commercial side. With the 28% growth in card acquisitions, any sort of geographic commentary or level of card spending activity within the co-brand would be helpful just because we're all trying to figure out kind of how strong the consumer is if you're seeing any sort of noticeable trends in terms of where people are spending and how much they are spending.

And then maybe a second question I'll tack in there around Starlink. And you've talked about 300 aircraft. Is that a hard cap? And do you ever intend to get the whole fleet up and running on Starlink? And if so, when would that deadline be?

Justin Jones
Executive VP & Chief Commercial Officer

So we expect the -- so where we're seeing the growth in the card is across the board. There's not any one region. We're seeing really good response, not only to our product changes, but also just with our offer that we have out there. So that's been across the board.

Andrew M. Watterson
Chief Operating Officer

Yes. For Starlink, we are paced by the output of antennas from Starlink. Our tech ops team is prepared to install as many as possible. We signed a contract with them and the progression will match the deliveries. And then for the long term, we haven't given guidance on that. But obviously, we have aircraft that are uncommitted that we could use any supplier for it. So we will make sure that we kind of get the best deal as we seek to provide high-quality Wi-Fi across our fleet. I think it's really telling that all of our aircraft have free Wi-Fi. And so everything is already updated. We're going to the next generation. So conceivably, we could be the first to have really superfast Wi-Fi across the fleet, and so we're excited about that.

Operator

Next question is from Atul Maheswari with UBS.

Atul Maheswari
UBS Investment Bank, Research Division

Two quick ones. First, on San Diego, one of your competitors talked about gaining several points of share in corporate in that market. So that's really been a market with sizable industry capacity growth. Can you talk about Southwest strategy in that key market?

And then second one on fuel. The second quarter, jet fuel was seemingly below others and also below the Gulf Coast average of $4 or a little over $4 for you. So could you remind us of your West Coast exposure and any additional fuel sourcing dynamics in the second quarter that might have driven your fuel per gallon to be below other airlines?

Robert E. Jordan
President, CEO & Vice Chairman of the Board

Justin will take the first, and Tom second.

Justin Jones
Executive VP & Chief Commercial Officer

Yes. I can't speak to everything that's going on in San Diego with -- if you have a smaller basis point and what growth you might see from that. But overall, we're seeing our load factor points coming from corporate growth. And as we've grown capacity there, we've seen corporate share come along with that.

Tom Doxey
Executive VP & CFO

On the fuel side, thank you for the shout-out to our fuel team. I love that. I think they're doing an incredible job. They're very strategic in the way that they think about what we do. We talked about our balance sheet being a differentiator. This is one of the ways that our balance sheet provides cost savings to us.

We're about 50% Gulf. I mentioned in my prepared remarks, we actually shipped some Gulf to the West Coast during a time when the pricing differential was most acute. I love that our team did that. And the fact that we are mostly Midwest and Gulf Coast that we don't have a lot of international. I mean there was a time during the quarter where international was $1-plus greater and that we were taking, mitigating actions around the West Coast, those are all things that led to fuel being where it was. So again, I'll give the same shout out to our team, but I totally appreciate the shout-out you just gave them, well deserved.

Operator

The next question is from Chris Wetherbee with Wells Fargo.

Matthew Flemon Hortopan
Wells Fargo Securities, LLC, Research Division

You got Matt on for Chris. Since the 1Q conference call, how many fare increases have you implemented? And then also, were there any in the month of July? And then just putting some of the initiatives to the side, we're just trying to get a sense of how that played out and if there's opportunity for more to come in the second half of this year?

And then second question, was the revenue breakage adjustment contemplated in the 2Q guide?

Justin Jones
Executive VP & Chief Commercial Officer

Yes. So just on the fare increase, we're not going to say the exact number that we had because there -- obviously, there's been a few system-wide ones, but then there's been a lot of them that have been to different parts and obviously, different parts of the network. And obviously, we've made our own fare adjustments there. But the only thing I will say is that the fare environment is very robust right now, and we're seeing strong response, not only in fares but also in actually bookings moving forward, and that continues into fall, and I don't see that changing.

Robert E. Jordan
President, CEO & Vice Chairman of the Board

I think the other thing to point out, too, is the -- if you just look at the 20.1% unit revenue increase and then the fact that we significantly outperformed the rest of the industry on unit revenues. Yes, some of that, of course, was the fare and pricing environment, but a significant -- the significant portion of that were our own idiosyncratic initiatives and those initiatives are performing. That is the reason we outperformed the rest of the industry and outperformed them substantially.

Tom Doxey
Executive VP & CFO

And on the accounting question on revenue breakage, as Bob mentioned earlier, the revenue breakage item that we had this quarter didn't relate at all to 2026. And so it just wasn't relevant to it. And I guess if you think about it, if the assumption around breakage changed slightly, it actually would have reduced a little bit of the revenue into 2025, which actually would have resulted in even higher year-over-year RASM had it been accounted for that way. So no, it was not accounted for nor should it have been.

Operator

We have time for one final question, and that will be from Dan McKenzie with Seaport Global Securities.

Daniel J. McKenzie
Seaport Research Partners

Congrats to the team on a breakout quarter here. Bob, I hear you loud and clear on the current demand and revenue trends, no deceleration. I hear you. So my question really is, this is for your longer-term holders, people who take a 2- to 3-year holding period, is how you're thinking about demand durability longer term? I'm just curious, what are the concrete data points that give you confidence that what we're seeing today is, in fact, durable. And I get that fares are 10% to 15% pre-COVID levels, and maybe it's an AI economy. But I'm just curious, what else gives you confidence? That's my first question.

And then the second question is just the appetite for returning additional capital to the shareholders from here.

Robert E. Jordan
President, CEO & Vice Chairman of the Board

Yes, Dan, thank you. And Tom will take the second one. Yes, you've heard me over and over and over, probably more than you wanted on this call, talk about the confidence in the performance of this transformation and then the confidence in the demand environment. So I think I'd break it into multiple pieces.

Number one, the consumer is incredibly resilient. You just sort of put aside everything that we're doing, just look at the industry, demand, pricing, revenue production has remained incredibly robust, and it's across all sectors, all geographies. This is the strongest I've seen it and the broadest that I've seen strength, period. And it does appear that consumers are prioritizing travel and you're seeing that even in the face of higher pricing. So just generally, I'm very bullish on the fact that consumers are going to continue to prioritize travel and drive demand.

Separately, for Southwest Airlines and unique to Southwest Airlines, the product changes that we put in place are resonating across the board with our customers and with customers that we are now gaining. And that's the reason managed business revenues were up 30%. That's the reason Rapid Rewards new members are up 35% and card acquisitions up 28%. And across the board, every measure of engagement, every engagement that would point to whether the products are being accepted and we're wanted by our customers are up and they're off the charts up. So it gives you a good indicator of the acceptance, but it also gives you a good indicator of future performance of those customers as they mature and they spend more with Southwest Airlines.

Third, the whole transformation is a demonstration that Southwest is willing to change, able to change and is executing that change in an incredibly strong manner, and we're not done. We're going to continue to pursue the customer, whether that is product related, it is co-brand related, it's different things that they want from the company, and that drives even more future engagement, revenue production, demand, all those things. And then this is really more about revenues, less demand, but we have -- you've heard all of us talk about the opportunity to really optimize what we have in place beyond these tremendous results in the second quarter. We have a lot of opportunity to continue to optimize the network, as Justin discussed, and play to our points of strength, lots of opportunity to optimize the products themselves, the pricing of the products and then continue to grow and enhance our products, whether that's Starlink Wi-Fi, whether it's continued changes in the cabin, whatever.

So I'm bullish across the board, bullish about the backdrop for the consumer and how that relates to travel and strength, incredibly bullish about the changes that we have made driving demand, driving pricing. And then third, the changes that we are going to make further driving demand for Southwest Airlines.

So yes, as you can tell, I'm a strong believer that this is all working and it's incredibly positive for us. It's incredibly positive for our shareholders. It's producing durable products that in turn produces a durable set of earnings for our shareholders. So yes, I'm optimistic across the board about this company.

Tom Doxey
Executive VP & CFO

And Dan, to your share repurchase question, as you know, we've repurchased a pretty meaningful amount of shares over the last couple of years, around the $4 billion or so mark there. Of course, we're not going to speak to specific plans around repurchasing shares here in the future. We've got some communicated guardrails that are out there on capital allocation. And so anything that we do with that capital allocation, including share repurchases, is going to fall within those guardrails.

And then I mentioned this earlier that as we think about the uses of cash, reinvesting in the business, including aircraft purchases, that is highly accretive. That's a very NPV positive thing to do as we replace older 737-700s with brand-new 737 MAXs, along with all the other investments that we're making in the business that's driving all of the great outperformance that you've seen here.

Danielle Collins
Managing Director of Investor Relations

Thank you, everyone, for joining us today, and of course, your continued interest in Southwest Airlines. We look forward to speaking to you again next quarter.

Operator
This concludes today's conference call. Thank you for your participation. You may now disconnect.