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Delta Air Lines, Inc. (DAL)

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MANAGEMENT DISCUSSION SECTION

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Hey, good morning everybody. Thanks for making it here bright and early. We have Delta up next and just to give some background for 2017, we're expecting Delta and the industry to be nicely profitable again and this will be the eighth year straight of profitability since the recovery, which, for an industry that's been notorious for destroying value, is an unusual thing.

In fact, over the last seven years, Delta has reinvested $16 billion in the industry – or it has reinvested $16 billion in the firm. At the same time, they have reduced their net adjusted debt-to-cap from 94% to 34%, and returned well over $7 billion to shareholders in the form of dividends and share buybacks; so definitely, a lot of value creation here. And as you may have heard recently, a very famous skeptic has been won over and invested in the airline industry. But the transformation is not done here. And most notably in the product segmentation side, there is more to come and we have a great team from Delta here and I'm happy to welcome to the podium Delta's CFO, Paul Jacobson. Thanks, Paul.

Paul A. Jacobson
Chief Financial Officer & Executive Vice President, Delta Air Lines, Inc.

Thank you, Savi and good morning everybody. Thank you for joining us on an early Monday morning. It's always a pleasure to be here at the Raymond James Conference, and I think it provides a little nice break from winter, particularly in the Northeast. So hopefully, everybody is enjoying their time here today.

I'm joined with me today with a couple of colleagues from our Investor Relations Department: Jill Greer, our Vice President of Investor Relations, as well as Elizabeth Lippitt Landers. Also joining us is Jenny Winter from our Air Line Pilots Association, Investor Relations Group to provide any context. Jenny, it's good to have you back. She is rejoining us after delivering a beautiful baby girl. So – she is nodding off a little bit; you will know why. But we're glad to have you back Jenny.

This morning's presentation is webcast, so please be aware that if you ask any questions, your voice will be heard on that webcast. Also, today's presentation contains forward-looking statements and expectations and our beliefs about the future. Those forward-looking statements are subject to a number of risk factors. You can find more information available in our 10-K or in our SEC filings as well.

As Savi said, we are really focused on fundamentally transforming the airline industry model for ourselves and trying to overcome our history. If there is a few words I could use to describe that in terms of what we really focus on, the keys are sustainability, durability, and consistency, because those are the things that have been lacking in the historical airline industry. We've seen peak earnings followed by peak losses. We've seldom seen a consistent stream of cash flow being distributed back to shareholders. And a great function of that has really been because of the leverage on the company as well as the cyclicality of our earnings.

So, we've been focused on really consistently producing solid results. And that really starts and ends with the customer, by taking our 80,000 members of our Delta family and focusing everybody in on serving the customer reliably and through the best way possible. We believe that's the ultimate tool that's going to lead to better and more consistent revenue performance through the cycle.

That being said, 2017 is a transition year for our business. We've talked about that since Investor Day, with the significant step-up in fuel prices that we've seen as well as labor cost escalation throughout the industry. We're transitioning out of the negative RASM that we've seen over the last couple of years and expect 2017 to be a little bit of a transition year.

That being said, even as margins are contracting, we expect to be on a path where we're expanding margins in the second half of the year and starting to pave the way back to our longer term goal of 17% to 19% operating margins. But it really is all dependent on balanced capital deployment. And that's how we drive the business going forward, and that's what I think is materially different than what you've seen in past cycles within the industry and within Delta.

We're focused on using our cash flow to balance between investing for the future, repairing the balance sheet, but also, importantly, creating a sustainable, consistent set of cash flows back to shareholders as a return on investment that historically, we think, has been lacking or at least, otherwise, has been required to be more theoretical in the application.

And you can see these results have worked. Since 2014, we've steadily increased our profit, setting records each and every year. As Savi mentioned, we've managed to pay down over $10 billion of adjusted net debt. We've also been making pension contributions at a level well above the minimum required in an effort to shore up that liability, and ensure that we've got the cash in that trust to fulfill all those obligations.

As you know, that pension plan is hard frozen. So, once we get that fully funded, we expect that it will no longer be a future draw on cash flow going forward. And that's still left enough cash flow to return capital to shareholders over $3 billion in 2016. And most importantly, three years of consecutive increases in the dividend, which we initiated in 2013, which was essentially the first meaningful dividend paid in the history of the airline industry. All of this balanced approach is really aimed at sustainability and consistency, because, again, as we look back at our history, the one thing that's been missing has not been the ability to produce cash flow. The airline industry has done that. It's the ability to produce it consistently over time, and to let the shareholders share in those results.

As I mentioned, 2017 is a bit of a transition year. We're coming into the year with more capacity discipline, with our total system capacity up about 1% for the year, which we think is the appropriate level to really balance supply and demand, as well as get us in a position where we can inflect RASM to fully cover the cost increases that we're seeing in 2017. And as we said in multiple presentations, we're committed to keeping that capacity in check as we pursue our 17% to 19% operating margin range that we still do believe is achievable despite the slight step backwards in 2017.

All of this pressure is concentrated in the first half of the year, most principally in the first half or in the first quarter of the year, where we're seeing over a $20 per barrel increase in year-over-year fuel prices in the first quarter alone. So, as the RASM trends continue to improve off of their lows, we're waiting for that pace to catch up. And ultimately, as fuel prices stabilize and cost normalize when we get into the second half of the year, we expect to be in a position to expand revenues and get back or expand margins, excuse me, and get back on track to that 17% to 19% range.

That margin pressure as I said is going to peak in the March quarter. We're revising guidance this morning off of our original January guidance. February results that we released last week, were a little bit choppier than we expected. We had built a little bit of optimism in on to the pace of improvement in the unit revenue story that had originally guided to an 11% to 13% operating margin guide for the quarter. We are now expecting to produce a 10% to 11% operating margin for the March quarter, as we continue to work through these headwinds. Normalizing for the pilot contract, this is a 6- to 7-point decline. And by normalizing, I mean, taking the retroactive component that was paid in the fourth quarter and spreading that over the full year in a balanced way. That's the way we want to measure the run rate of the business and that's largely being driven by fuel prices up 55% for the quarter.

The good news is we do expect this to be the trough for the full year in terms of year-over-year margin performance and, while unit revenues are tracking on the low-end of our original guide at flat versus up 0% to 2%, we still believe that we're on that trajectory. The pace of change hasn't deteriorated. It just hasn't improved as fast as we thought or expected that it might. And, we expect those unit revenue trends to continue through 2017 paving the way for that future margin expansion in the second half of the year.

Fuel prices are up slightly since our January call and our CASM is coming in at the midpoint of the range that we talked about. Although, we're still working hard to deliver a number in the lower end of the original range that we talked about.

Two items on here that we don't typically guide to mid-quarter, cargo and other revenue, and non-operating expense. We wanted to include this in here, because what we found is, across many analysts, we saw that they were overstating this. The full-year numbers tend to be actually directionally correct.

The March quarter was artificially high. This is due to a little bit of choppiness in how we measure joint venture performance, third-party refinery sales and some lumpiness in some of the other Sky Miles pieces as well. Like I said, the full-year numbers are right. We're just doing a little bit of a correction for timing and what we've seen in the model, so no surprises there.

The revenue outlook does remain favorable across regions. That is to say that the trends are continuing that we saw begin in late last year. Domestically, we see capacity growth across the industry moderating off of last year's growth. Strong business demand continues, which with that capacity discipline, we believe it's going to translate to continued improvement year-over-year on yields.

The RASM momentum domestically is probably best depicted in the percentage of markets that we're seeing in positive RASM territory. Last year, last summer, we saw about 20% of our domestic markets with year-on-year positive RASM. That number, as we've seen steadily increasing, is now up to 50% in individual markets domestically. That's what paving the way for our view that being the environment continues to improve and we'll ultimately catch up to costs going forward.

A Delta-specific initiative, Branded Fares continues to expand and improve its penetration. This has been a great story for us in terms of how we differentiate our product and how we're able to deliver differentiated value to customers who are seeking it onboard the airplane. And I think we're still in the early stages of what that's going to mean, not only for Delta, but for the industry as a whole.

The shining star in the network is really the Latin sector. We're achieving positive RASM in all segments of the region, led in particular by the Brazilian recovery, both in terms of currency as well as expected growth. And we expect those trends to continue through 2017. We do currently have a tender offer for up to 49% of Aeroméxico that is pending in the market. Those plans, as we've talked about, ultimately, we believe will conclude in an ATI joint venture between the two of us, and a model similar to what we see with the Virgin Atlantic model. We're very, very excited about the partnership with Aeroméxico and what it can do for us in the region together.

In the Pacific, 2017 is going to be a little bit of a choppy year. As we talked about, we phased out of the Boeing 747s by the end of the year and put in the new Airbus A350 product with five classes of service, including the new premium select product in economy. That switch of aircraft, as we've previously disclosed, we believe is worth $100 million a year in better margin performance in the region, simply from the operating efficiency and the RASM improvement we can get from down gauging some of those markets off of the Boeing 747s.

We're obviously doing a lot of restructuring in the region, utilizing our alliance partners in Korean and China Eastern, to try to overcome what has happened in Tokyo, particularly with the Haneda liberalization. As you know, we had a hub operation the Narita, which combined our Japanese O&D traffic alongside all of the connecting traffic from beyond Southeast Asia. Now that Haneda has opened up modestly for U.S. customers, that O&D traffic is now separated and we see that more in the future heading to Haneda, which is a much more convenient airport for people that are transiting to Tokyo, which puts pressure on the hub operation, because without that concentration of O&D traffic, costs start to go up as the connecting traffic isn't sustainable enough to hold that. So, working with our partners, Korean Airlines, who we expect to continue to boost our alliance and really kind of refocus on that alliance, as well as the relatively new alliance we have with China Eastern. China Eastern can give us connectivity in the Mainland China and all of the destinations that are rapidly growing there in a much more capital-efficient manner than us flying point-to-point to the largest cities in China, where every city that you add on a point-to-point basis between the U.S. and China for daily service requires two-wide body airplanes, or about a $300 million capital investment before you've flown your first passenger.

By aligning with China Eastern, we can provide much more capital-efficient opportunities to serve those markets in China through their hub in Shanghai. And that puts Korean in a position for us to utilize their strategic position in Incheon to be able to connect passengers further into Southeast Asia, as has historically been done at Narita.

All in all though, we believe the Pacific is improving. Currencies have stabilized there. We've lapped a significant amount of our year-over-year hedge declines in profitability, but we do expect that the Pacific is going to continue to perform better and better as we get the right aircraft on it.

Concluding with the Atlantic, we all know about the noise in the Atlantic market. Despite the RASM headwinds that we see, and the challenging revenue environment, low fuel prices have continued to make the trans-Atlantic our second best performing margin entity. So, that while RASM is down and we continue to have to adjust our business going forward for the way we sell in the midst of significantly greater low cost carrier penetration in the trans-Atlantic market, as well as currency adjustments, we do feel that the business is still strong. And with our alliances, it's still a great contributor to the overall profitability and margin performance for the company. So, our capacity is roughly flat. You're going to see us continue to focus on our partner hubs and leverage those strong business point-to-point destinations that you've seen over time. All of that is concluding with an expectation that we have flat PRASM in the first quarter of 2017.

We wanted to add this slide, slide 8 – sorry, it's not showing up on here. We wanted to add slide 8 to really show what's giving us the confidence about our ability to continue on this revenue trajectory. If you look since February of 2016, there's been a steady increase, a couple of blips there in July and August. July, as we talked about, was a little bit self-imposed. We made some changes within the organization, as Glen had mentioned, and the performance started improving. August, of course, was impacted by our power outage. But if you look at just the general sort of run rate trajectory of what we're seeing on a unit revenue basis, we are seeing steady improvement. As a finance person, obviously, in the face of higher cost, you'd like to see the improvement faster. But this is a certainly something that is giving us reason for optimism going forward.

That historical lag between fuel price increases and revenue recapture has probably been drawn out a little bit. I would attribute that just to the magnitude and the depth of the decline in fuel prices that we've seen, as well as some of the choppy recoveries. Just when we thought it was going back up in late 2015, we saw it hit rock bottom in the $20s on a WTI basis in the first quarter of last year. That choppiness, I think, has prolonged some of that recovery. But as we've seen prices steadily increased since the first quarter of last year, you are starting to see that RASM improvement going forward.

On a Delta-specific basis, we have a number of initiatives that are ours and ours alone including our continued progress on Branded Fares, which we expect to drive an incremental $300 million of revenue in 2017, and also another $1 billion a year through 2019. As we know through Branded Fares, the cost of serving the product is relatively unchanged. There are some benefits that we do on the catering model, but ultimately, every customer is going to enjoy Delta style of service at every point in the journey. As a result of that, much of that $1 billion is pure margin going forward, again, helping to fuel that climb back into that 17% to 19% range.

We've got the American Express partnership, which we believe is the leading co-brand portfolio in the world. With the leading partner, that partnership is expected to deliver $300 million in incremental value in 2017 across both the revenue and the cost lines. I mentioned the expanded Korean partnership as well as the implementation of the Aeroméxico joint venture. We believe that there is a lot of value there for all parties involved, but certainly some that's going to be accretive to us in 2017. And as we continue to use that cash flow to invest in the customer experience, we believe we can continue to sustain that sizable revenue premium, which system-wide against our peers, in the U.S. is currently sitting at 9%. Meaning, we get 109% of unit revenue performance against the industry average. We think that's a testament to the 80,000 members of the Delta family and the service quality that they deliver every single day.

We've got to maintain our commitment on costs. And this is one thing if you look across the organization. Personally, I'm very, very proud of what the team has been able to do and this really represents a fundamental shift in thinking and strategy for the history of Delta. And what I mean by that is historically, cost-cutting was something you did in the face of tragedy or in the face of declining performance that was really unstoppable. As a last ditch effort, you did whatever you could to try to cut service out of the product or cut product amenities or cut employees in an effort to try to stem the tide on margin erosion.

What cost-cutting means at Delta in the world post-consolidation, and now that we have scale, is a constant drive to make the product more efficient. And by delivering a more efficient service model, we're actually able to redeploy some of those savings into service enhancements for the customers and the benefits for the employees and to create a more engaged workforce that's constantly focused on serving the customer. And to be able to do that on a run rate basis, excluding profit sharing of less than 2%, I'm very, very proud of the team for doing that.

The core and the sort of foundational principle of our cost reduction is our upgauging strategy by adding density or adding seat to the average aircraft size. We're actually able to deliver our service much, much more efficiently, because one takeoff and landing today results in, on average, 5% more seats than it did five years ago. And as we fast forward through 2020, one takeoff and landing will result in, on average, 7% more seats than what it does today.

So, the foundational principle of upgauging, which we've attributed about $300 million to $350 million a year of unit cost savings historically, that trend will continue through at least 2020 as we continue to focus on creating those efficiencies. We also have leading productivity and innovation from our maintenance divisions, many of you who are new to the Delta story would look at Delta's fleet age, which is among the oldest in the United States or at least in the domestic markets. But it would probably defy logic for me to tell you that despite having the oldest fleet, we have the highest reliability, we have the lowest maintenance unit cost, and we have the highest customer satisfaction among all of our peers. Those are all core components of our strategy because while our average fleet age is old, we have a very healthy mix of both new aircraft and older airplanes which not only gives us the ability to utilize the savings of the newer airplanes, but also gives us added flexibility in the case of a downturn. If we find ourselves in the case of a rapid downturn or a recession, we can set those older airplanes down virtually cost free. In fact, it gets a little bit better than that because we can actually utilize that aircraft for parts in the remaining aircraft that are operating and ultimately lower the cost of operations for the remaining aircraft that are flying.

This has been a, what I would say, a complete 180 in the way that maintenance has historically been done in the business but because of the productivity of the operations team and the world-class work of our maintenance crew, we're able to take that strategy and deploy it in a much, much more capital-efficient baseline driving not only lower cost but higher return on invested capital for Delta than our peers because we're not as reliant on 100% new airplanes.

For 2017, as I mentioned, our cost pressures are weighted to the first half of the year, and on a normalized basis, are expecting to be in that 3.5% to 4.5% range for the first quarter. For the full year, we expect 2% to 3%. This is slightly above our 2% goal, largely because of the lower capacity growth. So, our long-term goal had said approximately 2% unit cost growth on approximately 2% capacity growth. So, we're feeling very, very good about where we are. We've got a lot of work ahead of us, both for this year, as well as going forward. But I'm convinced that the team has got what it takes to deliver the productivity that's necessary.

Turning to slide 10. I think there isn't a better page in my view of what represents the difference between then and now, particularly at Delta. So, we've put up two charts here to contrast the relationship between operating cash flow and capital expenditures during two periods of peak cash flow and peak earnings. The left hand side of the page shows the peak cycle from 1997 through 2000 and then the subsequent years of 2001 through 2003. And you can see the red line representing the operating cash flow. That was record levels at that point in time. We had never produced $4 billion of operating cash flow, but look at what happened on the investment side of it. Despite generating more cash flow than at any point in our history, we were actually investing as if that was never going to end. And we knew, we had the history of the cyclicality behind us, yet the behavior didn't change. So, despite earning record levels of operating cash flow, we were actually adding leverage to our balance sheet at the worst possible time. Then, we see the post 9/11 world and the recession that followed that, and you can see it was just too big of a drop to recover. By then, our forward order book had already been filled and we were committed to that capital even though we knew we didn't have the cash flow to be able to support it, and thus, the leverage story grew.

So, we knew on the right hand side of the page, if we were going to change one thing, we had to really manage the business for free cash flow. And I think this represents a pretty significant shift in mindset not only for Delta, but I think has occurred through the industry as a whole. By managing for free cash flow, what we're able to do is actually put more stock in the balance sheet and create a more sustainable and durable business model going forward. So, you can see, despite eclipsing significantly the prior records for operating cash flow, we've maintained that discipline with CapEx. And as a core strategy, we've said that we aim to invest about 50% of our operating cash flow back into the business, with the remaining 50% being utilized to fund our pension, pay down debt, and return cash to shareholders.

That cumulative free cash flow over the last seven years has been $17 billion. What a seismic difference between that and the seven-year period during the last peak earnings where our free cash flow was negative $8 billion over that time period. So, it starts and ends with that discipline on reinvestment and how we manage and steward our cash going forward to be sustainable for the future. And that gets even more important when you overlay the fact that as we burn through our remaining net operating losses, we have to prepare the business to become a consistent cash tax payer going forward, which we expect to happen in 2019. So, it's no coincidence that our balance sheet strategy and our goals have been focused on achieving those desired measures by 2020, which is $4 billion of adjusted net debt and a pension plan that's at least 80% funded, although we believe with a little bit of interest rate, pressure coming on over the next few years, that plan can be considerably closer to fully funded over time. So, we've got to use about $2 billion of cash between now and 2020, to get down to our stated balance sheet goal. We've committed $1.2 billion of annual cash flow into the pension plan to get that fully funded. That cash flow comes straight out of cash from operations as a reduction and represents more than double the minimum required amount under airline relief from the Pension Protection Act. We're certainly stewarding our resources well.

And then, taxes, as I mentioned, we expect to be a full cash tax payer in 2019. The current cash tax rate, we benefit from two major timing differences in between cash taxes and book taxes. The first is depreciation. For tax purposes, aircraft are allowed to be depreciated over 7 years versus 25 to 30 years per book, which represents a reduction in our cash tax rate. And, secondly, we get full deductibility of our pension contributions versus book taxes, which use expense. And, obviously, our cash contributions are significantly greater than our expense.

All in, we expect our cash tax rate, when we become a cash tax payer, to be in the 20% to 25% range. And by achieving our balance sheet targets over that time period, we can transition into a period where we're no longer utilizing cash to repair the balance sheet. We are using it to pay taxes, but there is no change in our philosophy as it relates to reinvesting in the business or distributing cash to shareholders.

And we're committed to those consistent shareholder returns. We've had three increases in the dividend consistently since 2013. We are all committed to continuing to see that dividend grow and we plan to complete our existing $5 billion share repurchase authorization by the middle of this year, which would be approximately six months earlier than the original goal.

And as we know, we've got a lot of opportunity here improving durability in the model. There is a sizable discount to our industry peers and industrial peers on our valuation, when you measure it against cash flow, against earnings per share, against free cash flow. That represents a stock price that would be well north of $100 in the event that we were able to close that gap.

This is not something that's going to happen overnight. As I tell many investors, we didn't earn this discount overnight. We're not going to earn our way out of it overnight, but we are committed to consistently returning sustainable results for our shareholders in a pursuit of ultimately being viewed as a healthy, consistent, durable company.

Thank you for your time. And with that, I think we might have a little bit of time for some questions.

QUESTION AND ANSWER SECTION

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Can I just ask about your Latin American strategy a bit more? Going into Aeroméxico, is that why you decided not to go ahead with the Avianca deal that you're obviously potentially thinking about?

Paul A. Jacobson
Chief Financial Officer & Executive Vice President, Delta Air Lines, Inc.

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Well, we never publicly confirmed that we were in the Avianca process. The strategy that we have with Aeroméxico and Gol provides us two very, very strong partners in the largest markets in the region. We believe that's a strong foundation to build and expand our presence in Latin America, particularly with Aeroméxico. It's the leading business carrier in the Mexican market with connectivity to our network. We believe that is a strong point of – strong foundational point, if you will, in the northern part of the region.

Brazil is obviously the largest region down there. And with our partnership with Gol, they've had a lot of success in their restructuring. We feel very, very good about where they are. And given the health and the improvement in the Brazilian economy, we think our Latin strategy is going to be just fine.

Savanthi N. Syth
Analyst, Raymond James & Associates, Inc.

All right. Well, thank you. We have a 30-minute breakout in Cordova if you want to continue with Q&A.

Paul A. Jacobson
Chief Financial Officer & Executive Vice President, Delta Air Lines, Inc.

Thank you for your time and thanks everybody for listening.