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Delta Air Lines, Inc. (DAL)

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MANAGEMENT DISCUSSION SECTION

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All right. We'll get started. Thanks, everybody, for your interest here today. Since the recovery in 2010, airlines and Delta have been reporting substantial profits and increasing profits every year. And this is despite challenging environments including rising fuel cost and the anemic demand in some areas. And in 2015, our expectations are no different. We see some great earnings growth here. And you'll have fuel as a tailwind, but you will also have headwinds such as a strong U.S. dollar that's putting pressure on international demand.

But what's more important is that with the path that Delta has been on over the last few years and continues to be on, which is going to – well, the goal is to create profitability throughout the business cycle which is not something that you've seen. And if they are successful on this, not only are you going to see earnings growth, you're also going to see multiple expansion.

So we're really excited to have again with us here today the CFO of Delta, Paul Jacobson, and we also have with us today the Managing Director of Investor Relations, Jill Greer. So with that I'll turn it over to, Paul.

Paul A. Jacobson
Chief Financial Officer & Executive Vice President

Great. Thank you, Savi, and good morning, everybody. It seems like we've got a standing-room-only crowd which is great to see. I'm not sure that was always the case for the airline industry certainly in over the long past. But this story has become a very compelling one, based on history and what we've been able to do and drive that improvement. And we're in a bit of a renaissance period, if you will, right now with focus on return on capital. And the industry is driving towards that in a way that we've really never seen before. So I'm going to share with you a little bit of the Delta story and where we've been and where we're headed.

The obligatory Safe Harbor statement, obviously, we've got some forward-looking statements in here. If you've got any questions or comments, we refer you to the risk factors in the publicly-filed documents.

Really, what we've been doing over the last several years is building upon our strengths of who we are and the network benefit, the consolidation and scale have brought to the industry and to Delta, specifically. We've been doing that with a relentless focus on free cash flow and expanding margins, and have had pretty strong results over the last several years.

In 2014, we had yet another record profitability year driving 7% of top line growth, 400 basis points of margin expansion, and almost $4 billion of free cash flow, which were all records for the business. But that's not enough. We think we can continue to expand margins irrespective of the fuel benefits that Savi mentioned earlier.

Our goal is to continue to drive the business to pre-tax margin expansion and let all of those fuel savings flow straight down to the bottom line in terms of improved profitability and cash flow. The way we do that is through disciplined capacity growth, an improving pricing environment, taking advantage of initiatives like the branded fares initiative, which we'll talk about in greater detail later in the presentation, and driving our cost productivity. This has been a great success story for Delta over the last few years and one that we continue to see – expect to see benefits from going forward.

But all of that doesn't matter if we don't exude some discipline in capital deployment and cash flow. If you look at the history of the business, this has been the part where probably the industry has lacked the most because during peak times, we tended to overinvest and add leverage to the balance sheet and shareholders were left with whatever was left at the end of the day, often through event-driven repurchases or immaterial dividends.

We've tried to change that and been on an upward trajectory for the last couple of years and focused on improving capital discipline throughout the entire construct of investing in the business and also paying down debt. And we'll spend some time talking about that today.

Delta is, by far, the industry leader and has been for a few years, largely because of the efficiencies that we had gained and the fact that, honestly, we had a head start in the consolidation side of the business. But in 2014, we generated more than $4.5 billion in pre-tax income which was about a 70% earnings accretion on a year-over-year basis for the second consecutive year.

As I mentioned earlier, $4 billion of – nearly $4 billion of free cash flow allowed us to get our debt balance below $7 billion, which was the lowest debt level that we'd had in 20 years for the company. We're on a track to drive towards a $5 billion net adjusted debt goal by 2015 and we've made great, great progress on that.

While also contributing excess contributions to our pension plan, we have the largest, at least on a percentage basis, under-funded pension plan in corporate America. But because of some special legislation that the airlines received in 2006, with a hard frozen plan, we have until 2024 to fund that at a fixed discount rate of 8.85%. But what we've announced is a strategy where we're going to contribute excess contributions to try to get to an 80% funded status by 2020, and we're making good progress against that goal. So we contributed about $900 million to the plan last year.

And we've done all this while continuing to invest in the business in a disciplined way, not by buying new airplanes although we are buying some, but by also focusing on investments in the product and the people and the reliability of the business. And as a result, the operational performance of the airline has never been better than what it is today.

In 2014, we had 450 cancellations on the Delta mainline product for the whole year. That's approximately one a day of a span of over 2,000 daily flights, well over 2,000 daily flights that we see. That type of cancelation is similar to what we would see from our competitors in a three-month to four-month period. But that's because of our relentless focus on reliability and driving that operational performance which ultimately has led to a unit revenue benefit.

Long term, we aspire to be viewed as a high-quality industrial transportation company. We understand and accept the history of this business. And the oscillations in the cycles that we've seen since deregulation had put a big strain on investors' appetite to be able to invest and trust future prognostications from the airline industry and we understand that. But contrary to – or acknowledging the fact that you guys have heard before this time is different thesis, we do fundamentally believe that this time is different.

And these goals that we've outlined have actually been revised over the last couple years as we've continued our upward trajectory because we do still believe that there is room to continue to expand margins and drive performance that's above these levels and we'll continue to look at potentially driving these levels higher in the future.

Our operating margin of 11% to 14%, this is intended to kind of be through the cycle. Obviously, if you look at where fuel prices are right now, you'd be pretty well above that. But overall, we think that through the cycle, this is a pretty strong aspirational goal where we've been as we continue to expand margins, we'll look at potentially resetting that goal because it's not enough to just get to a level and just kind of grow at that level to keep margins flat. We do still think there's an opportunity to expand it.

Annual EPS growth of 10% to 15%. When you look at the industrials, you see a 10% to 15% as a pretty good ballpark. Now, we've significantly eclipsed that over the last couple of years. Obviously, 70% annual earnings isn't sustainable for the long term, but we do believe that we're still in a cycle where we continue to expand that. And then when things do normalize, if they do at a higher level, we think 10% to 15% is a normal goal to get consistent earnings growth, year-in and year-out.

Return on invested capital. This has been a great success story for Delta. Last year, we drove almost 21% ROI, largely because of the financial performance, but also a function of our disciplined use of capital expenditures. We manage things a little bit differently at Delta especially our fleet where we haven't shown any hesitation about going out and acquiring pre-owned airplanes to fly in Delta's operation where we can put them and induct them into Delta's maintenance program and put them into a Delta product at a significant discount to what the cost of a new airplane might be.

Some great examples of this has been the MD-90s where we can buy a 10-year old airplane, a 10 to 12-year old airplane for about $10 million to $12 million a copy. You compare that to a brand new 737 which is going to run closer to $35 million to $45 million apiece for a little bit of extra life, the capital leverage that we get out of that is pretty significant and allows us to fly a competitive size and scale global airline while at the same time doing it on a much, much lower capital base for the long term.

And then the cash flow and the balance sheet goals. We're aiming to be an investment-grade balance sheet. Now, whether we actually get an investment-grade rating or not isn't necessarily the driving factor for us here, but rather measure the balance sheet against where we see other high-grade industrial companies with an investment-grade balance sheet.

Our current goal is sitting at about $5 billion of net adjusted debt or about $2 billion less than where we were at year-end. And we think we'll get largely the way there this year, although our goal is to get to $5 billion by 2016. And we'll continue to revise that as we go forward with the next phase of our capital allocation plan, which we said we'll roll out in May of this year.

How are we going to drive margin expansion? It's not enough to just say that we're going to continue to perform better, but what are the major tenets that we're going to be focused on in order to drive that margin expansion?

First and foremost, it starts with capacity discipline, making sure that we're sizing the airline and growing in line with increases in demand and sizing the airline to the demand environment, not necessarily to what the fuel price environment is. So we see the demand environment as pretty stable and we're going to continue to manage our capacity to whatever we need to do to try to drive that goal of getting our fuel savings, flowing them completely to the bottom line.

That growth is going to be focused on high-strength areas for us. So, for example, in Europe, we're spending – most of our resources focused on growing out our Heathrow franchise with the Delta-Virgin Atlantic partnership that we have and focus more on that in driving the value in the business context versus driving it in secondary markets or just trying to increase your footprint.

We're also working through pricing improvements. Just this weekend, we rolled out our branded fares initiative where we're further segmenting the cabin and allowing customers the choice and providing them the choice to be able to tailor the product and the service to the way that they want and they're willing to pay for. And we expect that through that branded fares initiative, we can get about $1.5 billion of incremental revenue by 2018 with some of those benefits beginning to accrue this year.

But what you see is a better focus on driving product value rather than punitive fees that customers rebel against. And I think with technology and with the product enhancements that we've made, we've got a good path in order to continue to drive better revenue performance as a result of offering customers more choice.

Cost productivity is the last piece of it and we have got to stay focused and absolutely diligent on our unit cost growth. We committed a couple of years ago to keeping our unit cost growth below 2%. We've done that and actually exceeded our expectations and our goals over the last several quarters from that and we see that continuing into the future.

We put in place a lot of reporting and forecasting mechanisms as well as a longer-term perspective on cost management that was probably lacking in years past. By focusing on capital improvement – capital investment, technology and productivity, we're able to stay focused on what the next several years are going to look like and are aiming our focus there.

Focusing and offering customers what they value is what really is going to drive that revenue growth as I mentioned. It starts with a network and focusing in on where we have our areas of strength and optimizing our capacity to leverage the hub presence that we have and serve those markets efficiently. We're focused in on improving the product because we've been more disciplined about the amount that we spent on new airplanes or incremental airplanes, that allows us more capital budget to improve the product on board the airplane.

So even if we have an older airplane than our competitors do, we have all the modern amenities and clean cabin and good seats and good technology on board the airplane that is going to induce customers to continue to want to fly for us. If we fly old airplanes that are rundown that customers perceive as old, then that formula tends to fall apart a little bit. We need to stay focused on maintaining a premium product for those customers and we're going to continue to see revenue benefits as a result of that.

And lastly, service, but it's certainly not least. Delta people every single day are providing a level of service that is the envy of the industry. Whether you look at it from a lowest customer complaints, on-time performance, Net Promoter Scores, all of those have improved significantly over the last several years as we've continued to invest in our employees through programs like profit sharing and Shared Rewards which gives people monthly bonuses based on the operational performance of the airline. And the people have responded and the service they're providing to our customers is really resulting in a significant piece of that revenue premium that we see across the board to the industry because people want to fly Delta more.

We talked about our cost performance, lately, it has been primarily driven by up-gauging of the airline we announced a couple of years ago that we're going to be retiring a significant portion of our 50-seat regional fleet and replacing it with higher gauge narrow-body airplanes at the mainline as well as 76-seat multiple class regional jets that have a first class and an economy comfort cabin.

That initiative is the type of thing that CFOs dream about because not only is it more cost-efficient, but it also is better revenue producer for passengers because it's got the comforts and the service that people expect versus a 50-seat regional jet where you may not have the premium product or the first-class product for customers.

That up-gauging has resulted in significant operating leverage for the business. Last year, capacity was up 2% on 4% fewer departures. And when you can drive that type of operating leverage in the business, you can drive significant cost performance or unit cost performance improvements because the seat miles that you're generating are significantly cheaper with a higher-gauge airplane.

So not only through up-gauging but also improvements in seat density where we can more efficiently put more seats on the airplane without jeopardizing passenger comfort or legroom, we do that by re-engineering the cabin on the aircrafts, so maybe there's not a mid-galley where historically there was one.

The seat technology has gotten stronger with thinner seats that allows you to put more seats on the airplane without compromising legroom and passenger comfort because that's at the forefront of our minds as a premium carrier, what we want to do.

As we continue to do that up-gauging and that density projects, this year, we expect about $350 million of benefit, cost benefit from that initiative alone this year. And we'll continue to get some benefits into 2016 as we run rate some of those improvements over time.

Other re-fleeting initiatives – sorry, that one's tougher to get out – include the retirement of the 747s. We sat down three 747s at the end of last year. We'll park another five this year, and we expect to be out of that fleet by 2017. We're making room for the new wide-body airplanes that are coming in. We just ordered 50 wide-body airplanes to be delivering through the end of the decade which are going to replace the 747s as well as some of our aging 767s with new Airbus technology across the A350s as well as the A330neos.

Those savings are going to be pretty significant. The improvement to the Pacific just from parking the 747s is estimated to be $100 million per year, split about halfway between cost performance and revenue performance as you can fly the airplanes with a much smaller gauge going forward across that length of haul.

Maintenance, this has been a great success story for Delta. As I mentioned earlier, we've got generally an older domestic fleet than our competitors do which intuition would tell you would mean we have higher maintenance cost. The reality is because of the productivity of our maintenance professionals and the fact that we have an endless supply of parts across airplanes that are being grounded that we can go buy and harvest for spare parts, we actually have the lowest maintenance unit cost in the industry.

And when you combine that with the highest reliability and the best customer service, you've got a real strong recipe to lever up return on invested capital by leveraging those benefits and using it to fly a similar schedule on a much lower capital base. And we can do that because of the productivity of our maintenance and supply chain organizations.

Technology, more and more companies are becoming technology companies whether or not they admit to it. Airlines are no different. The technology investments that we make every year are aimed at improving the customer experience, improving our own productivity across the board and putting our employees in a better position to be able to serve our customers effectively and quickly.

And those technology investments have paved the way for big cost savings, changing the way we staff th e airline and having our employees with more time spent in interacting with the customer than interacting with the computer, as well as customers giving them the ability to self-serve where they choose to. And those technology improvements have been great led by Theresa Wise, our Chief Investment (sic) [Information] (20:10) Officer. So we've got a solid plan in place. We'll have the second consecutive year this year of sub -2% unit cost growth and we look to keep that commitment going beyond 2016 as well.

As I've said, a lot of that doesn't matter if you don't ultimately handle the cash that you're generating in a prudent way. And that's where the balanced capital deployment initiative comes in. This really began for us in 2009 where we started focusing on disciplined capital expenditures to free up cash flow to allow us to pay down debt on the balance sheet.

So we set up at that time to invest about 50% of the business based on our cash flow performance, $2 billion to $3 billion annually and to capital expenditures is less than 50% of our cash flow today, but still represents a meaningful amount of reinvesting back into the product and back into the technology of the business.

That allows us to take our remaining cash flow and strengthen the balance sheet. We've paid down nearly $10 billion in debt in the last five years alone, and that's taken our interest expense burden from $1.3 billion in 2009 to about $475 million that we expect in 2015. That's had meaningful, meaningful benefit to the business, but als o part of the focus of de-risking the corporate entity to take away some of that cyclicality that we've seen in the past.

We are moving towards investment grade. I've mentioned in some of our one -on-ones, we've had three upgrades from S&P in the last 18 months showing that their confidence and growing confidence in the revaluation or re - risking of the business, especially considering the debt pay down that we've had. We now find ourselves only two notches away from investment grade and we're making great, great progress towards an investment grade balance sheet.

And then last but certainly not least, returning cash to shareholders. This has been a great focal point for Delta and for the industry as a whole as we only began really in earnest about 18 months ago, almost two years ago in May of 2013, with our intent to focus on the first meaningful dividend paid in the industry along with a systematic and serial return of capital through share buybacks.

Historically, share buybacks were really governed by event-driven situations in Delta's past. We had the Priceline benefit where we basically returned $1 billion back to shareholders from that. But there really wasn't a steady commitment to ongoing cash flow in the business. And that's what changed for Delta in 2013.

We're on track to complete our $2 billion share repurchase authorization by the end of this year. That is a year ahead of schedule in terms of what we announced last May and we'll be back to shareholders in May with an update to that program.

Everybody has a favorite slide when you go to conferences and present. This is my favorite slide because I think it summarizes, the this time, it's different thesis more than any one single slide could and that has to do with prudent deployment of capital and disciplined CapEx.

So the red line represents operating cash flow for the industry going all the way back to the late 1990s. The blue bars represent the CapEx. And what you can see the last time a lot of people compare a peak cycle was in the late 1990s and early 2000 timeframe. And what you can see is despite the fact that we had record levels of cash generation, at that time, Delta was still over investing, adding leverage to the balance sheet as if this would never change even though we know the history of the business was very cyclical in nature.

That led to a lot of airplanes and a lot leverage coming on in 2001, 2002 and 2003 that ultimately led to the restructuring of the industry. Because while this slide represents Delta, it's very emblematic of the industry as a whole of what was going on the last decade. So as we came out of restructuring and we came out of consolidation, there was a commitment to really pull down and manage CapEx more conservatively from that standpoint and the results have been pretty astounding.

That gap between the red line and the blue bars that you see from 2009 through 2014 has enabled us to pay down $10 billion of debt, fund a couple of billion dollars into the pension plan over that timeframe, and also return $2 billion of capital to shareholders. And that number is going to continue to go up over time as we continue to see the type of cash flow that we're generating.

Disciplined reinvestment in the business starts with the process that you have in place in order to govern CapEx. Because last year, we had over $4 billion worth of projects submitted. It's a not a shortage of ideas that drives this mentality, it's a disciplined approach to what we should invest in and how we should approach those investments.

So we meet regularly as part of a CapEx plan and most of the projects that have been approved have a pay back of less than one year and have internal rates of returns well in excess of 15% to 18%. And that comprises the portfolio of those projects that we approved.

Over time, this is shifting more into aircraft as we re-fleet the wide-body airplanes and then as we get into the next decade, starting to look at some of the MD-88s, et cetera, on the narrow-body side. But, overall, the composition – while the composition may change, the overall levels we think are manageable over that time in that $2 billion to $3 billion level for the future.

We've talked about adjusted net debt. I think for employees and investors alike, this is a pretty powerful chart from the standpoint of the risk that we've taken out of the business because we've managed to reduce our annual interest burden by almost $1 billion and put ourselves in a position where we're going to have much more consistent access to the capital markets rather than worry about diluting shareholders through a convertible bond or an equity issuance when we see rainy days and we don't have the balance sheet capacity to be able to absorb that.

So this is still – there's still uncertainty in this business and we have to make sure that we've got a risk profile that matches that. And that's what the balance sheet improvement has been all about.

My second favorite slide, or perhaps 1B, is this one because when we embarked upon the capital return program in 2013, we weren't shy about saying that we wanted the industry to follow. And we thought that it was going to be healthy for the industry as a whole if we were shifting that focus to returning capital to shareholders the way healthy industries and high-performing companies do.

And what you see is that, if you look against the historical context, there's $25 billion less capital committed over the next several years versus what we saw in the past on new aircraft. At the same time, capital returns are escalating, over $4 billion of capital returned by the industry last year. And that's what United just getting started on their program. And as they continue to evolve in their integration and their consolidation, you'd expect that number to come up more significantly as well. So this is a great success story for the industry, but I think we're still in the very early stages of where we are as an industry and where we can go.

And ultimately, that's the path to value creation. We are the lowest multiple and highest free cash flow yield stock in all of the S&P 500, despite this improvement in this cash flow type performance. And you see that when you compare to the S&P Industrials our EPS growth, return on capital and free cash flow are right in line with our high performing S&P counterparts, but the valuation is quite a bit lower.

It's not enough for me to just complain about valuation. In fact, I don't know a CFO who would necessarily be happy with their valuation. But we certainly think that there is a lot of room to go on this and we're committed and focused on improving that to make sure that the airlines become, for the long term, an investable sector online and in line with the high-performing industrial transports that we know we can be.

So with that, thank you for your time. I know we went very, very quickly. I think we have a break-out session for any questions and answers after this. But I thank you for your time and attention. And please don't hesitate to reach out to us if there is anything we can answer for you. Thanks and enjoy the conference.