09-Sep-2015

Delta Air Lines, Inc. (DAL)

Cowen and CompanyGlobal Transportation Conference

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MANAGEMENT DISCUSSION SECTION

Helane R. Becker
Cowen and Company, LLC

Well. Okay. So, moving right along, thanks again for being here. And next up, we have Delta Airlines. So, from Delta, we have Paul Jacobson, Executive Vice President and Chief Financial Officer. And Paul brought along with him Jill Greer and [ph] Winnie Smith (00:24) from Investor Relations, and Jenny Winter is also here. I don't know how many of you know Jenny. Jenny is a 767 pilot, I feel like, and is the Air Line Pilots Association IR person. So, we're really glad that everybody came today. We continue to be appreciative of your support of our conference.

And without further ado, Paul, take it over.

Paul A. Jacobson
Chief Financial Officer & Executive Vice President

Thank you, Helane, and good afternoon, everybody. We're also webcast today. So, good afternoon to the people that are listening via webcast. We've had a great day of meetings, a long day. As you can imagine, lots of questions. Some of those questions repeated. But overall, it's been a great day. So, Helane, thank you very much for the invitation, the opportunity to speak today.

The Delta story is one that we believe continues to be unique and continues to be a leading indicator of the industry and the renaissance that we've seen over the last 10 years. So I'm just going to spend a little bit of time today talking about how we got to where we are today, the current environment and where we see ourselves heading going forward. I think many of you are familiar with the story. But we're always seeing new faces and people who said never going to focus on the airline industry again. So, it's great to see new faces and to be able to tell the story.

Safe Harbor Statement, this presentation contains forward-looking statements. Any changes or risks, you could look at our risk factors on our Investor Relations website, as well as the non-GAAP reconciliation items on the website as well and in the back of this presentation.

But if you look at Delta over the last 10 years, really leading the way, so we were kind of reminiscing a little bit that, 10 years ago today, we were on the doorsteps of restructuring which really would begin kind of the renaissance of what you've seen in the airline industry today after we were able to get our cost structure fixed really paved the way for consolidation in the industry and what consolidation has been able to do for us that's never happened in the industry before is give us some advantage of scale that we've seen.

So, if you look at the historical fragmentation in the industry, it was difficult for anybody to get a leg up on any stability. And consolidation has really changed that. And over the past several years since completing the merger with Northwest, we've been focusing on leveraging that scale in order to produce much, much more efficiency in the way we generate revenues and, ultimately, more sustainability of our profitability.

Over that time, revenues have increased by about 20% but the – probably the most exciting part of that as a financial mind is we've done that on 20% fewer departures, we've done it on 6% fewer seats, and we've done it on 12% fewer airplanes.

So, in other words, the revenue generation model is much, much more capital efficient than we've ever seen in years past and one that we continue to see benefits from through our upgauging and what we've been able to drive.

That financial success has actually allowed us to continue to invest and create a high-quality product, and that's probably one of the things as someone who's been in the airline industry for 18 years that I think I'm most proud of for the team is we actually have a sustainable set of cash flows that we can reinvest back into the business and improve the overall product quality.

And when you look at those improvements, whether it be in the nature of the onboard experience, the technology innovations with the things like the mobile app and the purchase path, but also the investments in efficiency and reliability. We're actually driving a more reliable network than has ever been done in the airline industry before and certainly on a much higher scale than has ever been accomplished. And that's really led to a point where Delta is now driving a unit revenue premium to the industry that historically we couldn't do.

The key now is to create that in terms of a sustainable earnings and cash flow projection. We spend a lot of time talking about the real value of this airline and of the industry as one that should really be compared against industrial peers. But the one thing that we haven't done as an industry is proven that that model is sustainable. I think, as an industry, we've always been able to generate cash in good times, and while you may argue about whether we're truly in good times compared to historical U.S. GDP growth and a global environment, it is a choppy market out there.

We've got to be able to drive those, that cash flow consistently and actually allow shareholders to earn a tangible return on that versus the old model in which the cash flow was absorbed by increasing leverage and overcapacity, leading to more cyclicality in the business overall. So, if we're successful, we're going to continue to drive $4 billion to $5 billion of free cash flow. We're going to allocate that in a balanced way between continuing to de-risk the business model as well as returning cash back to shareholders and be able to do that over time because, ultimately, that's going to be the key to long-term capital efficiency and sustainability for us.

Right now, we're managing to a 20%-plus return on invested capital. We've improved that number by 22 points since the merger. So, certainly unprecedented when you look at that against the context of what past cycles have been, but one that we continue to believe is more emblematic of the future of the industry than necessarily a high point in the cycle.

And when you look at all that performance, that combines the financial performance whether you're measuring return on invested capital, you're investing free cash flow, you're investing EPS or looking at EPS growth, all of those are in the top 10% of the S&P Industrials and bodes very, very favorably for a continued comparison there.

We've done that really, through a lot of targeted investment and focused in, as I mentioned, on the customer experience and the operational reliability. And that's driven unprecedented levels of increase in customer satisfaction and, ultimately, better revenue performance as the demand for Delta product has never been greater.

Over that time period, we've also redeployed the cash and the income into things that are going to improve our pre-tax income, as a result, to improve our operating cash flow, allow us to pay down debt and shore up the balance sheet which, in turn, is going to enhance our return on invested capital. So, if you look at all these charts over what we've been able to do just over the last year, that goes back several years as well, but also a pattern that we think we can continue to improve upon going forward and, certainly, the standard that we're holding ourselves to as we look to the future.

That starts with making sure that we are really, really sizing capacity to the opportunities and the demand set that's out there. So, we're trying to maintain that system-wide capacity. But the key for us is also to be nimble where those opportunities that they might exist in a diversified geographic revenue portfolio in order to try to capitalize on that.

So, our capacity levels for the fourth quarter, for those of you that have followed our story this year, are flat, and that is consistent with the view that we've had over – since the summer when we said that we were going to try to target disciplined capacity to get to a flat RASM trajectory by the end of the year.

So, on a system basis, in the fourth quarter, we expect to be flat. This is a little bit of a change portfolio-wise from where we were. So, domestically, we'll be up 3%. Internationally, we'll be down about 4.5%, which brings us to that flat system capacity. But the point of the domestic growth is really to take advantage of previous investments that we've made whether it be in New York, at LaGuardia or JFK, Los Angeles, Seattle. We now offer, because we've got a platform there – we got a platform for superior network product and service that have allowed us to not only take advantage of our position there but also make sure that we're doing it in a way that we're increasing RASM.

So, while we've had this capacity, we've actually increased our RASM advantage domestically and the demand environment remains solid for us as we see going forward. So, we feel very good about that in terms of putting us on the right path and certainly setting us up for a good run into 2016.

Going forward, obviously, the biggest opportunity for improvement out there is the international environment. And while capacity is coming down internationally, that's a lot of targeted things where we see international weakness whether it be in Japan, Brazil, Russia, et cetera, but really aiming strategic growth at key markets, London, Mexico, China, and really focusing right now where the opportunities exist to leverage and create and drive international partnerships.

So, whether it's our transatlantic alliances with Air France/KLM, the joint venture we have with Virgin Atlantic, the partnerships with GOL and Aeromexico that we've helped supplement this year, or the new relationship with China Eastern in the Pacific, long term, we believe this is the most capital-efficient, capital-friendly way to expand our global reach and partner with people who have a much better economic prospect for connecting those networks to us and to ours. And by putting our networks together, longer term, we think that's a recipe for success.

But in the meantime, we've got to take prudent capacity decisions where we see weakness and challenges. And that's what you've seen internationally. And that's what you see on the chart here.

As we look on the fuel side, which is the other sort of big variable in the equation for us, we expect to accelerate the tailwind in the second half of 2015. In fact, in the third quarter, we expect it will have a slight advantage to industry average price in the third quarter, which is new for 2015. The fuel hedge losses of the first half of 2015 are behind us. And we actually shape up pretty well for the second half as well as into 2016.

So, for 2015, we expect it to be about a $9 billion expense, which is a $2 billion benefit. We also have $1.5 billion to $2 billion benefit that we expect to see in 2016 as we lap the hedge losses from the first half of this year. If you recall, we had about $1.7 billion in hedge losses in the first half of the year, but we do expect that to be better than industry average in the second half. We've tightened our guidance in the third quarter down to $1.83 to $1.88. Since the July guidance that we posted with earnings, we've participated in about 80% of the market declines over that time period. And the hedge book for 2015 is still positioned to get about 75% to 80% participation if prices go even lower from here.

So, we feel like we are well-positioned against the industry backdrop. And, of course, we have the unique privilege of having the refinery which has really, really driven a lot of incremental Delta-specific goodness in 2015 where we've delivered over $300 million of profits in the last 12 months, and we're on track to produce $300 million for the full year of 2015.

Third quarter alone, we expect our profitability from the refinery to be almost $100 million simply by capturing that crack spread benefit for ourself. And Graeme Burnett, John Hunter, Jeff Warman and the whole team that run the commercial aspects and the operational piece of the refinery have done a fantastic job of really going in and changing that [ph] crude tie (13:12) and enhancing the profitability of that asset, which continues to be a very, very unique asset for Delta that nobody else on the industry has.

All told for the September quarter, it's going to be a record September. If you look at the performance that we've seen in July and August, we are well on track to deliver results that are at the high end of our original guidance that we posted. But we want to maintain a cautious September – especially September month has some challenging comps. And especially you look in the second half of it on the revenue side of it, unique circumstances that were in September of last year that we want to be cautious about. But we feel generally very good about the quarter and where we're going to end up.

We had a slight tick to CASM. We were previously approximately flat. We're now showing approximately 1%. That really is timing of events where it's what I would consider to be small changes that, ultimately, for conservatism, want to round up instead of rounding down. And I think, all-in-all, we still feel very, very good about our ability to keep to our goal of less than 2% unit cost growth going forward.

So, as we think about the business, how are we going to continue to drive margin expansion? Because it's one thing to deliver industrial-like metrics, but we also have to deliver industrial-like consistency. And that's what we strive to continue to achieve overall. So, it really starts with driving efficient capacity growth and the continuation of our upgauging benefits and what we see where we're able to drive operating leverage in the business, but also focusing on investing in the network, investing in the product, continue to drive and protect and even improve that revenue premium that you see for Delta against the rest of the industry, certainly domestically.

And with all those network moves, we've got to keep cost efficiency in play and drive that productivity in the business. We're still in what I would consider the middle innings of the upgauging story and we still have opportunity to go. But this remains one of the biggest challenges and one that I think the operating team is up to, is driving that cost productivity to continue to create that operating leverage in the business.

And we've seen that, seen the results of that on the revenue side. So whether you're looking at unit revenue index that you can on a system-wide basis on the chart on page 9, total revenue or even looking at passenger unit revenue, by investing in the network, by investing in the product and by investing in our people that continue to drive the best customer performance in the industry, we're going to create an environment where people want to fly on Delta. And we get very unique demand characteristics for that in the network.

And by being able to take that operational advantage, that network advantage and leverage that in corporate traffic and being able to go out and monetize our operational performance by offering operational performance guarantees to our corporate customers, we feel very, very good about our commitment to the customer equation and to the value construct to make sure that people want to fly Delta over and above the other carriers, and we've seen the success of that over time.

As I mentioned, we do have a solid pipeline of initiatives going forward. We still have a lot of upgauging benefits as we go into 2016 and, as we've talked about, our long-term plan. We have said that, over the next few years, while we feel convicted about our ability to get to 2% unit cost growth or below, that trajectory may be a little bit different over the next few years as you – versus what you've seen in the past.

We do have an open – or will have an open contract with our pilots at the end of the year, which becomes amendable. When we reach an agreement with them, you might see some geography or other cost inflation. So while the trajectory might be a little bit different, over the long term, we feel that the 2% growth is sustainable in non-fuel CASM and keeping that low.

The upgauging benefit, the re-fleeting, the continued strong performance of the operations base where we're able to, despite the fact that we have an older fleet than our competitors, able to drive a unit cost advantage on the maintenance side with industry-leading reliability becomes a very unique Delta story that we believe we can continue to do.

So, when you utilize and you're able to leverage initiatives like part-outs where we actually buy airplanes to harvest all of the spare part value out of them rather than buying parts out of a catalog with high mark-ups, we're able to capture that margin benefit to us and, throughout the system, really figure out how to leverage scale in the business because, again, that's still relatively new for the airline industry. And we've historically been surrounded by industries that have made healthy consistent returns.

Now that we have scale, we can extract some of those economics for ourselves, and you see that through initiatives like those – the part-out or supply chain and the way we handle other vendors and contracts.

So, the other piece of this is technology, and whether you're looking at revenue-enhancing initiatives or customer-facing initiatives with our software or behind the scenes, technology innovations that are going to allow us to be more productive and focus the efforts of our employees on serving customers and serving them more efficiently, you're going to continue to see improved customer experience as well as improved operating leverage in that business because, as I tell employee work groups, if we're successful at our cost discipline, the employees and our customers are never going to see it. Because the old model of taking – putting product on the airplane and taking it off in an effort to conserve cost is worse than if you would never offer that in the first place.

So, we have to be focused on customer initiatives and enhancements that are sustainable over the long term and then seek our cost savings through efficiencies in the way we run the business and leveraging our scale where we can and make that transparent to the customer, if not actually enhancing to the overall customer experience. And we believe that we've got the plans in place to deliver, again, our second consecutive year of less than 2% growth but even holding that into the future.

And ultimately, I think, if you ask me, one of the things I think we are most proud of is really focusing on historically what was challenged and broken with the industry. And I think that starts and ends with cash flow and how that capital and cash flow was deployed. It was never deployed in a balanced fashion. It was always over-invested during times of peak cash generation followed closely by dilution of shareholders in a world where we had no access to any other capital. So, when times got tough, the airline industry typically ran to the convertible markets or those follow-on equity issuances in order to raise capital when the debt markets were all dried up in a highly levered balance sheet.

So, we started down this path, really, in 2009 to focus on free cash flow in the business and how we were going to allocate that. First and foremost, we had to take risk out of the business, and we began to de-lever very, very aggressively, and we created a lot of opportunities for profitability enhancement over that time as well. But we also needed to focus on driving less risk – driving more risk out of the business so that we could pressure test this when times do get tough going forward.

So, we focused on that by paying down over $10 billion of debt since 2009. We've set a long-term debt target for ourselves of $4 billion, but we're more measured about the pace from here on out than we have been in the past. The opportunities to drive a lot of yield aren't as significant as they were before. But the imperative and the necessity to continue to pay down debt to shore up the balance sheet is still as valid as ever, but also make sure that we get into a situation where we return cash to shareholders. And I think it was just about 27 months, 28 months ago that we unveiled our original sort of shareholder return strategy with a $500 million buyback that we thought would be completed within three years.

Now, we're at a point where we've actually committed to returning $2.5 billion of cash directly back to shareholders in 2015, which is a strong indicator of where things are and how far we've come. And I think that's not just the Delta story. That's an industry story as well where, by our calculations, and you can do your own, I think the industry will return over $8 billion of cash back to shareholders.

So, it's not your parent's airline industry the way it was over the last 15 years to 20 years. It's one that's focused a lot more on shareholder return and shareholder-friendly initiatives like return on invested capital and other simple concepts that industrials have gotten for a long, long time.

For me, I spend a lot of time with shareholders talking about history. And I think, no, there isn't a slide better positioned to talk about how different we are today than slide 12 that you see here in the investor materials. This depicts what I was just walking through that, if you look back to the last kind of peak cash generation cycle in the industry back in the late 1990s and 2000, it was a very different world. Nobody had more than about 15 percentage of market share. We had decent balance sheets but we spent like money was growing on trees despite the fact that we had never generated more cash before as an industry.

You can see that, in 2000 and 2001 and 1999, we were actually investing more cash than we were bringing in, adding leverage to the balance sheet, which really augmented and exaggerated the cycles that we see in the early 2000s. And that cyclicality is ultimately what has to change and what has had to change to really attract the new investor that would never invest in the airlines before is to prove that this time is, in fact, different.

So, as you look to that philosophy and going back to 2009 when we really took it upon ourselves to say we need to manage the business in a much shareholder-friendly manner and one that's focused on capital discipline and cash management, you see that we began this trajectory of disciplined capital expenditures against an increasing operating cash flow.

And what that's been able to do is really, really firmly improve the balance sheet while, at the same time, augmenting and creating a capital return model to shareholders that we think is the recipe for sustained success. Because, ultimately, if we can put more of that operating cash flow into shareholders' hands, we can get more fully valued for the cash that we're actually generating year in and year out. And to be able to do that while also paying down debt has been a really unique privilege that the Delta people have really provided us with in terms of their ability to drive cash.

So, our target is to get to a $4 billion net adjusted debt balance. We think that's the optimal level in multiple capital market environments where we can get to a sustainable weighted average cost of capital that, for us, can look very much like an investment-grade high-quality balance sheet. I think the prospects of us getting to an investment-grade rating are greater than they've been in years past. And given the momentum that we've seen from, really, all of the rating agencies, we feel good about the trajectory that we're on and the reinforcement that that gives us.

Not only are we paying down debt, we're also prefunding some of our pension liability. So we're funding about $1 billion a year, which is about $300 million to $400 million a year more than we have to under the airline relief of the Pension Protection Act through 2024. But our strategy is to get us on a trajectory where, with no change in interest rates, we can get to about an 80% funded status by 2020. That's going to provide even more flexibility and more de-risking of the business model and the balance sheet going forward, but ultimately gives us room to be able to flex that funded status upward in the event that interest rates do increase over time.

So, as we drive the business for cash flow, that's a part of it. But we plan to return at least 50% of free cash flow to shareholders through 2017. If you look at the pace of our buybacks, we have demonstrated a willingness and an ability to accelerate that. The first program we finished inside a year was a three-year authorization. The second program, the $2 billion authorization, was about a two-and-a-half year which we also finished just inside of 13 months.

So we feel good about the ability for us to accelerate that if we need to. We've actually returned more this year than we had originally planned back in May when we announced this. And as I said, we committed to return in 2015 at least $2.5 billion to shareholders, which is roughly equivalent to about 7% of our total market cap. So, obviously, tangible cash returns coming back to shareholders against a heavily discounted valuation.

Since undertaking this strategy, we've really outperformed our peers. And we think that there's still more to come from that as we continue to hopefully widen our gap and continue to expand our margins into 2016. But we have a long way to go. And again, as kind of a student of history in this business, we didn't earn this discount overnight. We're not going to earn our way out of it overnight. But what you have in Delta is a committed management team who is focused on really getting true valuation for the cash flow potential that the company has through the cycle. And we're going to do that through consistency over time and risk-adjusting the model to pressure test it, to make sure that we can maintain that sustainability going forward.

And with that commitment, we think we're on the right path. And I thank you for your attention, your attendance and the focus that you guys have had on Delta. And I think, with that, we've got a couple minutes for questions.

QUESTION AND ANSWER SECTION

Helane R. Becker
Cowen and Company, LLC
Q

Okay. Thanks very much for that. That was a great detailed presentation.

Paul A. Jacobson
Chief Financial Officer & Executive Vice President
A

Sure. I'm sorry, I've been talking all day, so if my voice is going a little bit.

Helane R. Becker
Cowen and Company, LLC
Q

Okay. Any questions from the audience? I've been – just so you know I've been hogging the mic all day. But it's like nice to have it in my hand. Okay. So, I actually have a question. I was looking at the website the other day. I've been doing better earnings status on Delta, I'm up to Silver, so that's an improvement.

Paul A. Jacobson
Chief Financial Officer & Executive Vice President
A

You've got a long way to go, Helane.

Helane R. Becker
Cowen and Company, LLC
Q

I do, but I don't live near a Delta-frequent airport.

Paul A. Jacobson
Chief Financial Officer & Executive Vice President
A

It's worth driving for.

Helane R. Becker
Cowen and Company, LLC
Q

But actually, I was looking at the website and I thought it was really transparent. That was kind of the word that came to my mind as I looked through the different fare options I had. I could pick a first-class flight or fare or I could pick a seat with more leg room or I could even pick a seat just a seat at the back of the plane. And then I was reading an article that said, not that I would do that, but then I was reading an article that said that I was wrong for thinking that you were being transparent, that you were actually trying to shame your passengers into buying a more expensive ticket.

And I have to say that never occurred to me that you were trying to do that. You were just trying to be – so maybe I'm being very naïve. But I thought you were just trying to offer to passengers an option that anybody – that made it apparent what they were buying. And I was kind of surprised to see that characterization. So, I'm kind of wondering if you are too and how you think about your different fare levels, I guess.

Paul A. Jacobson
Chief Financial Officer & Executive Vice President
A

Sure. Well, I think the key is understanding and creating flexibility and opportunity for passengers to create the experience that they want and that they're willing to pay for. This is not at all uncommon with the hotel industry, rental car industry where, if you're booking a hotel stay, right, you might get four or five different price points which inevitably may put you in the exact same room because what you're buying is the experience that you want, right?

You may buy – you may pre-pay with non-cancellable or non-changeable. You may want breakfast. You may want Wi-Fi. And what the hotel websites are very good at is creating that optionality, that menu for you to purchase that experience. There's no reason that the aircraft and the flight experience can't be the same because the experiences aren't equal for everybody. And having the opportunity for people to pay up for an experience that they prefer or that they value is something that's readily apparent and certainly an opportunity for passengers and for the airline alike.

The same model is being done widely by some of the low-cost carriers where the price that you – you originally enter the purchase path and you may tailor your experience to be different. And this gives us a unique opportunity to compete at the margin with some of those carriers as well but still offering a vastly superior product in terms of network, scope, breadth, reliability and product amenities.

So, I think it's quite the opposite in giving passengers visibility to the array of Delta experiences that they can pay up for. It's certainly one that other industries have done very, very well and airlines have been somewhat slow to realize either way through the historical view or the lack of sustainable ability to invest in the technology and the product to create that environment in the first place. So, I think that's one of the key differences to where we are today versus where we've been and really preaches to the sustainability of what we're trying to create.

Helane R. Becker
Cowen and Company, LLC
Q

Great. Okay. Actually, thank you for that answer. I appreciate it. I also had another question. I saw an article on The Loadstar magazine, which is a UK-based publication that talks mostly about freight and cargo, and in the article, you said that you were combining the cargo operations of Virgin Atlantic and Delta and that would be a very difficult undertaking. And I'm just kind of wondering why that would be the case.

Paul A. Jacobson
Chief Financial Officer & Executive Vice President
A

Well, we're always looking for synergies with all of our partners across the spectrum and we've got to figure out ways to leverage that. But any time you're putting operations together, you've got to make sure that it's seamless for the customers and you got to make sure that you've got a coordinated approach to that. So, historically, different approaches bringing together are going to require change but it's also going to require an ability to be able to match those together. So I don't think that that's anything different or unique than where you see with all of our international partnerships in order to try to harness the benefits of being together.

Helane R. Becker
Cowen and Company, LLC
Q

Great. Okay. Any audience-related – or audience questions?

Q

Just kind of a [ph] nit-gnat (34:09) but is the pension funding that you're doing, does that count towards the free cash flow? And a lot of times, pension funding, it's already deducted from the operating cash flow. So just wondering if you're treating it the same way?

Paul A. Jacobson
Chief Financial Officer & Executive Vice President

A

Yeah. So pension funding does come out of operating cash flow. But it is – we think about it as kind of the minimum contribution is core operating cash flow, the excess contribution is a deliberate capital allocation decision. But for all the metrics that we've seen, the $7 billion to $8 billion includes that billion dollars of additional funding that – or the $500 million of additional funding, the billion total already comes out of those numbers that you see on the cash projections.

Q

Great. Thanks.

Paul A. Jacobson
Chief Financial Officer & Executive Vice President

A

Yes.

Helane R. Becker
Cowen and Company, LLC

Q

Any other questions?

Helane R. Becker
Cowen and Company, LLC

Okay. Great. Well, thanks so much for that.

Paul A. Jacobson
Chief Financial Officer & Executive Vice President

Well, thank you, everybody, and thanks for those listening on the webcast. Appreciate the focus and the attention on Delta and hope you enjoy the rest of the conference. Thank you.