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Delta Air Lines, Inc. (DAL)

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MANAGEMENT DISCUSSION SECTION

Michael J. Linenberg
Analyst, Deutsche Bank Securities, Inc.

Okay, everybody, good morning. For those of you who don't know me, I am Mike Linenberg, Deutsche Bank's Airline Equity Research. Also with me today is my colleague, Katie O'Brien, who's sitting in the second row. So welcome and you'll see us in a lot of meetings today, glad you could be here, bright and early.

Our first presenter this morning is Paul Jacobson, he's the Chief Financial Officer of Delta. I think, for most of you in this room, Paul needs no introduction. Paul's going to be up here to give kind of a latest and greatest at Delta, and most recently you probably saw the news that Delta did announce that they were going to buyback another $5 billion of stock that was announced back in May. They also increased the dividend. I believe, it's the fourth time that they raised it 50% since they reinstituted it back in 2013.

So now, to give us the latest update on Delta, Paul Jacobson.

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

Thank you, Mike and good morning, everybody. Hope you've gotten off to a beautiful start here in sunny Chicago, we had a nice walk to the hotel. So thank you guys for joining us this morning. We are webcast this morning, so any questions that you may have would appear on the webcast. And as a result, as with most of our presentations, these financials do contain some forward-looking statements that are subject to risks. You can find more information about those risks in our SEC filings or at delta.ir.com.

As Mike mentioned, we are very excited about what we've done over the last several years on this journey of creating a sustainable, durable franchise model, which while common for many other industries and many other companies, there's something that has never really been said about a U.S. airline. And we've been on this journey, really focused on improving our product, improving our reliability for our customers and continuing to invest in the product, while we repair our historical balance sheet challenges and reduce leverage, and get into a position where we can sustainably distribute cash back to shareholders. As we've said before, this industry is one that historically has been able to generate significant amounts of cash in peak cycles, but they were often predicated by overinvestment and additional leverage in those times, which precluded any sort of consistent return back to shareholders.

We've been laser focused on that, really going back since 2009, but particularly since 2013 as we continue to increase our allocation of capital back to shareholders, while still maintaining discipline we need around investing in the product and also repairing the balance sheet.

On this journey 2017, as we've articulated in prior presentations, is a bit of transition year for us, coming out of a couple of years of declining rather than which, but for the benefit of significantly lower fuel prices, would have been very challenging circumstances. Nonetheless, over the last couple of years, we have been able to expand our margins, even in the face of declining prices. As fuel prices have come up in 2017, the RASM recovery has lagged a bit, but as we look forward through the rest of the year, we feel like the worst part is behind us for 2017. We look forward to continuing to expand our margins for the rest of the year.

And we're going to do that by focusing on the long-term value proposition that we've been trying to drive and I'd like to spend a minute, because we've spent the last month really reflecting on the last 10 years. At the beginning of May, we celebrated our 10-year anniversary of relisting on the New York Stock Exchange and we presented this slide in our May analyst deck, which was what

[indiscernible] (04:14) talked about, our capital market strategy for the next few years. And it really is an impressive line of work from the Delta family and what the Delta people have been able to accomplish, whether it's really creating the first truly global airline in the U.S. and then continuing to augment that with relationships with Air France/KLM and sort of the first ever profit-motivating joint venture, taking that model expanding it into Mexico, expanding it into the UK. And also during that process completely reinvigorating the product .

The way we sell our product is different than we've ever done it before, creating more opportunities for value in the eyes of the customer and differentiating that customer experience. That's come about through hundreds of millions of dollars of investment in technology, billions of dollars of investment in the product throughout our entire fleet. All the while, we've been increasing our operating margin, our relative unit revenue advantage versus the industry and taking our margin up more than 10 points since 2007 as we continue to raise the bar against ourselves. That has come really through consistent improvement in the operation going all the way back to the first summer after the merger with Northwest.

We recognize that in order to differentiate ourselves in an industry where our customers and our investors see historically largely a business that's been commoditized, we had to seek to differentiate ourselves and we focused on the product and we focused on reliability. And when you look across any measure, across all of the industry, we're the number one among all the network carriers since 2011. That's resulted in consistent rewards among business travelers, with six years in a row of the Business Travel News best airline in the U.S. and obviously contributed to our margin performance and our cash flow.

Our people have benefited from this as well, Delta employees have enjoyed over 80% in total compensation increases since 2007, that's a reward for incredible efforts on their behalf of serving our customers, and really reestablishing the airline industry as a go-to industry for service professionals.

And during that time, they've shared in over $5 billion of profit-sharing payments, a reflection on the fact that every one of our 80,000 employees is a revenue ambassador for the company that contributes to the bottom-line performance in the ultimate cash flow in the business. And while we've been repairing the balance sheet and returning cash to shareholders, it hasn't come at the expense of reinvesting in the business since 2010. Over $18 billion have been reinvested back into the business, whether it's product improvements, onboard the airplane technology, facilities improvements. We've really focused on what do we do to create in the long-term durability of the business model, while we have the cash flow invest what we can while being disciplined and continuing to pay down debt.

We have paid down over $8 billion of debt since 2009 and returned over $7.5 billion back to our shareholders. Truly a testament that the balanced capital allocation theory is working and one that we think we can keep up for years to come. And this is the ultimate result of that. We expect this year to be close to $6 billion in pre-tax profit which would be the third consecutive year of that pre-tax level in 2017 and certainly something that's unprecedented. But it all goes back to Delta people serving our customers in a way that really they've never been served before and being disciplined with the way we handle the cash and the profitability that comes to us.

With 2017 as a transition year, we knew going into the year that we needed to stem the tide of declining RASM and while we began to see early signs of that in the fall late 2016, that has certainly been coming along the same trajectory in the May results that we posted with RASM about 3.5% is a continued trajectory on that.

We expect that our margins while down about 1 point to a 1.5 point in the 15% range as we've articulated before for 2017, really all came on the backs of the first quarter performance on a year-over-year basis. Despite the fact that we had unit revenues improving through the first quarter, we still had a significant [ph] bogey (09:06) in fuel with over $500 million of additional fuel expense, which was pressuring margins in the first quarter. But as we've said then and as we're reiterating today, we believe that we will see margin expansion each quarter for the rest of the year, when we look at it on a normalized basis going forward through the rest of 2017.

June quarter, marks the return to margin expansion. Fuel prices have remained somewhat moderate in the range, while significantly above where we were last year. They've been relatively behaved notwithstanding the volatility that we've seen in the last three weeks to four weeks. And unit revenues are continuing the trajectory that we've seen. We expect, as we've said a couple of weeks ago, that our unit revenues for the quarter will be in the upper half of the range of 1% to 3% for the quarter, driven by continued improvement in close-in yields and close-in pricing. While those yields remain below historical levels, we've seen consistent improvement in them as a result of higher fuel prices and lower capacity growth.

For June month, we expect it to be at about the midpoint of their quarterly guidance, slightly lower than May. As we look through the quarter, there is a mix of capacity on a month-to-month basis. So we still expect it be in the upper end of that 1% to 3% range, but June will probably be slightly lower than May.

Although we still have lot of hopes and optimism since we've got 25 days left in the quarter, or in the month. I'm sorry 23 days, sorry my watch is behind.

Fuel prices as I said, while they have been volatile are now tracking probably, slightly below our original range. We talked about $1.68 to $1.73 when we came out with original guidance for the call, we're now tracking that at about $1.65 to $1.70, still up significantly on a year-over-year basis. But like I said, generally behaved within a range.

And non-fuel CASM, as we've said, we expect it to peak in the second quarter and taper down in the second half of the year, it still feels to be within that kind of a 2.5%, 3% range for the whole year as we go forward. I'm sorry, I said 2.5% to 3%, I meant 2% to 3%. Sorry.

All of this is going to require us to continue to leverage this foundation that we've built. These are our all long term goals that we highlighted in May. Our operating margin as we see over the next few years, we're targeting a 16% to 18% operating margin that's down about a point from what we said a year ago in May which simply takes into account the transition year of 2017. So if you look at the trajectory, it's very similar to what we articulated a year ago, although we're starting from a lower beginning point. But still within that realm of what we think is achievable to drive $8 billion to $9 billion of operating cash flow and $4.5 billion to $5.5 billion of free cash flow. We're going to do that because we still have a lot of runway on our commercial initiatives. We are going to continue to focus on differentiating the experience. This year we will rollout our premium select economy product with the A350 delivery and continuing to focus on what can we do to segment, [indiscernible] (12:36) experience in the cabin based on what customers value and what they're willing to pay for.

We've got the benefits of the newly formed joint venture with Aeroméxico which we expect to continue to drive significant synergies for both of us as we fine-tune our networks and take advantage of the joint venture opportunities that we have both in terms of improving the flows between us, but also working to help our partners in Mexico improve their margins as well with some of the skills and the tools that we've used and learning from them on how to serve our customers locally. All of this is going to contribute to what we think has the potential to be a very significant value driver for Delta in terms of margin and cash flow.

We've got to maintain cost productivity and we'll talk about what we still have ahead of us. The track record that our operational groups with their controllership partners have been able to achieve over the last several years is nothing short of outstanding amidst every challenge that they've faced. They've come through with flying colors and our cost discipline is a banner that we're proud to wave. We've got a maintain that and we've got significant efficiency gains coming with further up-gauging within the fleet, which has provided for that baseline of cost performance. But there's a lot of rolling up our sleeves that we need to continue to do. And as we go through 2017, we expect that our margin performance and the trajectory of expanding margins through the rest of the year will put us on this path into 2018 and beyond.

I touched a little bit on – we do have room for further top-line growth. All of the things that we've been doing for the last several years, but not nearly complete, we still have a lot of runway through that. Customer segmentation to me is one of the hallmarks of what's different about the industry this time and we frequently share with investors the parallels with the hotel industry, and how they sell their product. Historically, an airline seat was an airline seat was an airline seat and despite the fact that customers obviously differentiated the experience based on where they were in the cabin, we didn't have the ability or the wherewithal to sell it differently.

Now, what we've been able to do with the foundation of cash investment and capabilities in both the fleet as well as technology, we can differentiate the way we sell our product, much the same way hotels can differentiate the way they sell a room for the night. It's not just based on the square footage, it's based on the experience that you want. Do you want breakfast? Do you want Wi-Fi? Do you want parking? Based on those inclusions, you have a different package available for the customer.

And while the experience is different aboard the airplane, what we've done is, we've created multiple classes of service that our customers really value, and have demonstrated a willingness to pay for it. Whether it's the traditional Main Cabin experience, the Comfort+ experience with enhanced legroom, dedicated overhead bin space, as well as premium snacks and beverages. Or all the way down to the Basic Economy product, which is a great tool for us to compete head-to-head with the ultra-low-cost carriers in those travelers who were ultimately price sensitive, because at the end of the day, we can provide them with better customer service, better reliability, and a premium product at the same price. If not more value than what the ultra-low-cost carriers can do. And that's the feature that hasn't always existed for us and technology has enabled us to do that.

We can roll that out internationally. It will help us compete in the evolving transatlantic market, where we see a lot of low-cost carrier competition continuing to grow in that space, and we'll offer consistent distribution and product segmentation across the entire global network, which we believe will continue to allow us to grow our revenue base and achieve our ambitious goals of additional $1 billion plus through 2019 in annual revenue, sorry.

The international partnerships, I touched on Aeroméxico, the long-standing partnerships we have with Virgin Atlantic, as well as Air France-KLM, gives us a solid foothold in Europe, and a strong network presence that as we've seen provides very, very consistent profitability base, even in the face of more challenged capacity growth across the industry as a whole. And for us, the transatlantic will continue to perform well through the summer from a profitability perspective, and we expect to be a very, very strong summer going forward.

The product investment, we will see really kind of generational level investments in the airport experience over the next several years, significant investments in LaGuardia and Los Angeles on the coasts, a new airport in Salt Lake City, continued terminal investments in Seattle, and also more investment coming in Atlanta. This is an opportunity for us to partner with the airport authorities to really create the airport of the future. And as we think about these large projects at LaGuardia and LA, how are we designing it with not only the customer's needs in mind, but trying to anticipate what we need to do to serve the customer for years and decades to come.

And we're very excited about all of these projects. Not only will they improve our efficiency in terms of aircraft operations, but it's going to be a significant enhancement for our customer and ultimately improve the experience for them from the time they get out of their car to the time they ultimately get into their car at their destination. And that's something that has been different in the past versus just looking at we don't have enough money other than to survive and we don't have an ability to invest in that product.

So with the customer in mind, we expect that at Delta, the service level is going to continue to improve, and as a result of that, the loyalty that we enjoy from our most valuable customers is going to continue to remain, if not grow going forward.

And on the corporate travel side, as I mentioned, six consecutive years of the Business Travel News' coveted award for the best airline, really kind of speaks volumes to what our people were doing on the front lines operationally. When you go into a corporate travel department, and you can talk about the millions [indiscernible] (19:14) customers that are impacted by cancellations or delays versus our competitors, that has real value. And no longer are you focused on just competing, solely based on who can offer the biggest discount. You've also got a premium product and with that heightened reliability, we can partner with our corporate travel customers to show and to create that value in terms of improved productivity, and improved travel spend across the ribbon because we're ultimately more reliable.

Last year, we had to put that into perspective. We had 241 days in 2016, in which we didn't cancel a single flight on the mainline, that is more than 4 times all of our competitors combined in the U.S. And while I applaud the efforts of the other carriers who are making great strides in that area, ultimately, I think that's wonderful for the traveling customer, but Delta really has distanced itself. And when we look at 2016, we don't focus on the 241 days that we got it right. We focused on the 125 days and figure out, what is that that we can do to continue to improve further.

And that's the mindset that we have is, there is no investment too small, no investment too large to make on behalf of our customers, because the more we can become a consistent, reliable product choice for our customers, they're – more they are going to choose Delta with their traveling dollars and the more that's going to result in improved cash flow and margin performance for us moving forward. But ultimately, all those revenue initiatives will be for not, if we can't drop them down to the bottom line through cost efficiency.

Our non-fuel unit cost growth, as I mentioned, has been well inside of our goals or in line with our goals even with the profit-sharing impacts going forward. But it's about what can we do in the future, and the main foundation of this is going to continue to be our re-fleeting or our upgauging strategy as we've talked about. The MD-88s are up for retirement over the next several years and as we purchase A321s and Boeing 737-900s, to fulfill that we're adding more gauge, ultimately the incremental margin of those additional seats that are coming into those markets comes in a significantly higher than the base, because of the efficiency gains that we get from each take-off and landing and each time we put that airplane up in the air.

But despite the fact that we've got a bit of an older fleet as many have pointed out to us, it really starts and ends with our people. Our maintenance department through our productivity and through their innovation drives unit cost 15% below the industry average, which is impressive enough. But when you think about – our average fleet age is several years older than our domestic competition, it's almost unheard of. And when you add that further to the advantage that we have and reliability, you'll note that our maintenance department and all of the people in the maintenance and the customer service department deserve a big hats-off and a round of applause for what they've done to drive that type of efficiency in the business.

This is the new cost productivity, the new cost-cutting in the industry in this generation, which is find ways to deliver the product more efficiently, find ways to leverage our scale benefits to drive cost efficiencies, don't take it out of the pockets, or the value of the customer, and don't take it out of the pockets of the employees, which has been the historical cost model, which ultimately just reached further cyclicality in the business.

So as we focus on getting comfortable with our size, getting comfortable with the operation as well as the brand value that we have, we can use that and leverage that across all aspects of the operation to continue to drive efficiencies in the business and add to that technology. We basically, when you think about it, it kind of lost an entire generation of technology as we were going through restructuring and the difficulties of the early 2000s and we've been playing a lot of catch-up. We're playing catch-up both in infrastructure, as noted from our outage almost a year ago.

We are on track to building an additional state-of-the-art data center, which will dramatically improve our backup capabilities, and what we expect will render the power outage problems of the past, the infrastructure problems of the past, or [ph] render the move (23:52). That's a $200 million plus project, that will be completed by the end of this year, but represents the level of infrastructure that we need to continue to focus on, but while we're investing in that infrastructure, we can't forget that we've also got to invest in digital and keep up with the new technology going forward.

The way our customers interact with us changes day-by-day, and we need to make sure we stay up with that, because if there's anything that the technology outages that we've had that have been shared throughout many of the carriers in the global industry, recently it's shown us that as much as we're an airline, we're also a technology company, and we need that technology to keep up with changes not only from an infrastructure perspective, but from what our customers demand, if we're going to continue to drive the revenue that we need to in order to improve our bottom line going forward.

This chart on page 11, really depicts what is different this time. If you look at this chart compared to the last time, we saw peak cash flow in the business. You actually see where in the late 1990s despite record levels of operating cash flow as shown on the red line, you would see capital investment that actually exceeded it. So, in other words, a mindset that cash flow is coming in at a the level that was unprecedented, but obviously the beliefs that it was going to stay there forever is what led to the leverage increases and ultimately restructuring for the industry post 9/11.

And that's been a fundamental shift in the way that we've looked and viewed the cash. Cash flow for us starts with the balanced allocation that we articulated. About 50% of our cash flow, we target to reinvest back into the business and the other 50% we use to not only pay down debt, but also return cash to shareholders and that's been sufficient for us. The CapEx that we see over the next few years will allow for replacement of about 25% of the Delta mainline fleet, including the retirement of the MD-88s, as I mentioned. $1.5 billion in technology both in infrastructure as well as innovation to improve our digital footprint going forward and then making those ground and facility investments that we need to in a balanced way, so that we're not in peak replacement mode.

We're constantly refreshing and upgrading where we need to, to keep that base foundational level of operational performance steady. So that we don't put ourselves into the cyclicality of the past. And it's important to note that while we've got sizeable free cash flow and record levels of free cash flow really on a consistent basis, we still need to build flexibility into the operation, because as we know in this industry things do happen and all of this, is for not if we haven't created a more resilient durable business model going forward. So we built about 50% of our planned CapEx as we see it over the next few years, has discretion to it in terms of either differing it or cancelling it or putting it off for another day, should we run into any financial difficulties, we obviously want to preserve that free cash flow where we can.

The balance sheet has been an incredible success story as well on behalf of the Delta folks when we began this in 2009. When you combined our debt and our pension liability, we had over $25 billion in total obligations. We've paid down over almost $10 billion of that. And most importantly, we have, I think, used our pension relief that was granted to us in 2006, when we hard froze our plans. We've used it responsibly and with a stewardship mentality, because while we've had significant relief in terms of the annual contributions, we have dramatically increased and over contributed to the pension plan in that timeframe, culminating in $3.5 billion dollars of contribution this year, which was funded partially by a $2 billion unsecured offering at 3.25%.

This front-loaded many contributions that we expected to make through 2020, but puts us in a position where we'll be able to meet our 80% funded goal and with increases in interest rates, modest increases over the next few years of just a couple hundred basis points could put us in a position where that pension plan is fully funded, and put us in a position where it wouldn't any represent any future risk to the company.

But the good news is from a flexibility perspective with these contributions, we have completed all of our minimum required contributions under airline relief through 2024. So again it represents another flex point for us, while we've allocated about $500 million of cash annually through 2020. We have met all of our requirements and should we run into financial difficulties, there is another flex point there for us to preserve cash flow, should we need it.

And ultimately it really comes down to how consistently can we return cash flow to our shareholders. As I mentioned in my opening remarks, this is what in my mind in 20 years of this business what has really been missing is, what is it that investors can rely on not only from Delta, but from the industry as a whole? And at Delta, we've tried to set the bar in terms of what it means to be a strong industrial company that's capable of generating significant amounts of cash and handled it in a balanced, responsible way.

So, as Mike mentioned, we did announce our fourth consecutive 50% increase to our dividend, will increase to a $1.22 per share in the September quarter, which translates to about $875 million per year, about 15% to 20% of our free cash flow. At the time that we announced that, our dividend yield was about 2.6. I think it's down slightly from there for all the right reasons. But it really represents what I think is a fulfillment of our commitment that we made several years ago, that we're going to continue to focus on driving dividend growth and as we expected traverse through the path of ultimate revaluation and rerating of the stock. For Delta, ultimately bringing that dividend up alongside that to target about 25% of our free cash flow annually.

We also announced the new $5 billion share repurchase program to be completed by June of 2020, consistent with what we announced a few years ago, we expect to complete the prior authorization in the third quarter. I will begin repurchasing shares on that $5 billion authorization immediately after that. This represents a fulfillment of our commitment to return about 70% of our free cash flow back to shareholders and manage the company for that free cash flow through 2020.

So, all-in-all, I feel very, very good about where we are. It starts and ends with our people serving our customers in ways that they've never been serviced before and ultimately creating and driving what we think can be sustainable durable value through not only our earnings, but our cash flow and our returns back to shareholders.

So, with that, we've got a couple of minutes available for questions. Thank you for your attention.

QUESTION AND ANSWER SECTION

Michael J. Linenberg
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah, Paul, if I could just kick it off, and then we can go to a few more. Look, with your 49% stake in Virgin Atlantic, you have kind of a unique lens into the UK market, point of sale from both sides. Just curious what you're seeing with respect to bookings given the fact that I guess we've had what our third terror event in about four months in the UK? Are you seeing drop-off from the U.S. side? My sense is that maybe that's being offset by the fact that the UK side may be somewhat desensitized since it's occurring in that market. I'm just curious to sort of puts and takes, and again this has happened over the last several months.

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

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Sure. Well, first of all, as I'm sure all of you will echo, my heart goes out to the people of Britain. We've got beyond the business connections, I do have family over there. My mom is British, so I've got half of my family over there. And it really is a tragic, sad occurrence. From a business perspective, we've actually seen the bookings and the summer has been remarkably resilient. We don't see any impact to that. We are expecting a good summer there and I think it's always a fantastic place to visit. And the people are strong and we expect that to hold up, but we haven't really seen any impact in forward bookings from these, and I'm pleased to be able to report that. [ph] Barry? (33:03).

Q

Yeah. I've got two. One is you were the first ones to do cabin segmentation. As United and American start to roll out in different markets, are you seeing anything different in those markets where they've joined the party? [indiscernible] (33:15-33:25) One is an example of international JVs, in terms of things you might be doing to end up with a one plus one equals three, sort of what – what are you doing incremental within that JV? Thanks.

Paul A. Jacobson
Chief Financial Officer & Executive Vice President, Delta Air Lines, Inc.
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Sure, the first question for those of you who couldn't hear it, it was about with us leading the way in cabin segmentation and our competitors following, have we seen any change in the competitive landscape for the markets where they have rolled that out.

And, I would say, I think, obviously they're just getting started with that, particularly with basic economy, but products. But I think there is enough differentiation there, not only in Delta's service but also the product attributes as well, where we feel very, very good about that. And I think ultimately, cabin segmentation is good for the industry because it gives consumers choice. And the more choice that we can give consumers, the more consumers can approach the purchase decision with much more information about what they want to tailor their experience to and ultimately result in less commoditization across all of the industry, which I think is a good thing.

The second question was around our joint ventures, what are some examples of the synergies that we can create and drive the one plus one equals three across it. The best example of that is obviously the Virgin Atlantic scenario, where through our investment and through our partnership with them, we were able to get access to Heathrow that honestly would have probably been nearly impossible, if not been a decades-long exercise in order to try to create organically through the slot acquisition process. And when you think about where Delta was 10 years ago and the fact that we didn't even serve Heathrow, we were relegated to Gatwick and we couldn't participate in that market, that's a great example of what those synergies can do, not only for us, but also for Virgin in terms of linking them into Delta's domestic network and giving them a level of connectivity.

And while that's unique to Heathrow, that connectivity and that network breadth across the two carriers is what really drives those synergies and what we expect that we'll be able to create with Aeroméxico as well, and continue to enhance with AFKL and hopefully continue to focus on with our improving an expanded cooperation with Korean over in the Pacific.

So, thank you for your time and attention, look forward to speaking with many of you today. I hope you enjoy the day and thanks for attending Delta's presentation.