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Delta Air Lines, Inc. (DAL)

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MANAGEMENT DISCUSSION SECTION

Helane Becker
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Okay. Good morning, ladies and gentlemen. It's my pleasure to welcome you to Cowen's 11th Annual Transportation Conference. I'm Helane Becker, Cowen's senior airline analyst and with me in the audience today are my associates, Conor Cunningham and Tyler Seidman. They work for me and with me. This is a record year for us, here at the conference, we have presentations from 15 companies between now and Delta begins and 4:30 when Azul ends their presentation. In addition, we have another five airlines, Aeroméxico, Allegiant, Atlas, Azul and Volaris and Copa, actually six airlines hosting one-on-ones only.

So, with that in mind, I'm pleased to welcome Delta Air Lines. Making the presentation from Delta today is Paul Jacobson, sitting right to my left, Executive Vice President and Chief Financial Officer. With Paul in the audience today, are Elizabeth Lippitt and Julie Stewart from Delta's Investor Relations team. So, Paul, the floor is yours.

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

Great, thank you for that, Helane, and good morning, everybody. We are webcast today, so – and our presentation does contain forward-looking statements. As you know, these statements are subject to various risk factors which can be detailed in our SEC filings and our Form 10-K.

Well, first of all, let me start by saying welcome back. I think many of you have enjoyed a Labor Day weekend, and like most of America, traveled. In fact, people travelled in record numbers on Delta over the weekend and our people delivered a stellar operation over Labor Day weekend, with over almost 2 million passengers enplaned over the weekend and over 70% of those on time without a single minute of delay. That is a testament to what we have created together at Delta, particularly as it relates to our foundational strengths, including our culture, which is what the core of the – excuse me, sorry, our flipper is not working here.

We'll get that fixed, but for those of you following on webcast, the culture is the core of our foundation and where we believe that we can really make a difference within Delta, as our Founder, C.E. Woolman talked about. Everybody flies the same airplanes, everybody can stack the airplane with the same food and the same amenities, but people are what make the difference. And when you look at our culture, the Delta people are continuing to shine each and every day. In fact, in the month of August alone, we enplaned over 18 million customers, and this summer, we have nine of our all-time top-10 passenger days in the company's history.

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And you see that with the level of operational performance and reliability that we've been – we become known for, which is driving a revenue premium, the likes of which we haven't seen in the industry, particularly domestically. When you combine that level of service and that operational excellence with the best domestic network in the country, you get the type of results that we have been able to drive and we've been able to generate consistently over the last several years. And that is fundamentally what is different this time when we talk about that, and I know that phrase has been used often overused and it becomes a little bit cliché.

But what we do at Delta every day is really fundamentally different from the way we've done it in the past, and that's been generating a level of customer loyalty and differentiated revenue streams that are really helping to harvest and harness the benefits of all of these core foundational principles and these strengths that we have. And when you steward that with good capital allocation, you also end up in a position where you can drive an investment-grade balance sheet to really harness that foundation, if you will, to the point that we can drive sustainability and durability in our earnings stream and really kind of under – undo some of the historical volatility and cyclicality that we've seen in the business.

So, we focus on two different things; we're really focused on durability and sustainability. We know that this business has challenges that pop up, whether it'd be weather or fuel prices, volatility, in fact, you end up in a position where we have to drive consistency in the results, get out of the historical cyclicality that we've been in, and drive consistent returns for our shareholders. And that really starts with that customer-oriented reliable airline that we – that we see every day. But none of that is going to matter if at the end of the day, we can't stabilize margins.

We have been in a period of margin decline for the last few years, coming off low oil prices and while the industry has constantly been in shifting and we've seen some improvement there, we've got to get the business back to producing margin expansion and getting back to the margins that we've seen before. And we're positioned to be able to do that as soon as by the end of this year, heading into 2019, which really sets the table for what we think is going to be a terrific year, at least based on where we sit today and ultimately driving that long-term value for owners.

Despite the run that the stock has been on over the last several years, we still do feel that we're pretty consistently undervalued by the market against most metrics. We've got to be able to overcome that history and drive consistency in the business model in order to prove that this is foundational. We've been on a good start for that. If you look over the last several years, we have generated pretty consistent pre-tax profits, consistent operating cash flow and we've been growing our return of capital to shareholders, while at the same time, we've also been improving the balance sheet by paying down debt and funding our pension plan ahead of our expectations.

This recipe has been strong for Delta and I think has led to some of the differentiation that investors see in the Delta story going forward; and while 2018 has been a challenging year and we'll face over $2 billion in year-over-year fuel headwind, we still do expect that this will be our fourth consecutive year with over $5 billion in pre-tax profits. That's important because that's been in a low fuel environment, it's been in a challenging RASM environment, and now we can deliver it in a much higher fuel environment where we saw pretty heightened volatility in the early part of the year. That's why we're driving towards that goal and why we think that's important, because that's going to drive that steady operating cash flow that gives us an ability to plan, while returning our capital to shareholders and improving the balance sheet simultaneously.

So, we're not just whipsawing the capital structure of the company to appease short-term goals and objectives.

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We've highlighted on our June quarter call in July that we see a path towards margin stabilization as soon as by the end of this year. Strong revenue momentum in the businesses is augmenting our ability to recapture the higher fuel prices and certainly this quarter is shaping up both on the revenue and the cost side, much as we expected going into the quarter and that is a – that's a strong statement. When you can recover $2 billion of fuel costs and get back to flat to expanding margins, that really is setting the table, as I mentioned earlier, for a positive start to 2019 and a good foundational year.

So, we're reaffirming our earnings per share guidance of $1.65 to $1.85 per share for the September quarter. If you recall, we've talked about TRASM being in the up 3.5% to 4.5% range – 5.5% range, I'm sorry. 3.5% – 5.5% on TRASM for the quarter and costs flat, and we'll talk a little bit about how we abate the unit cost growth that we saw in the first half of the year.

So with those trajectories, we are looking at top-line growth of 8% for the year. That's up from where our initial expectations were, capturing somewhat our ability to go in and offset the higher fuel costs with some of the pricing actions that we've been able to take to pass through those higher fuel costs to the customer. The cost trajectory is a critical part of this, and we are on track, like I said, to deliver flat CASM for third quarter. But as that year-over-year fuel pressure abates, in fourth quarter it will go down to about 25% year-over-year, as well as lapping the profit sharing harmonization that we did in the fourth quarter of 2017. We do believe that there is a path to flat to expanding margins as soon as the fourth quarter of this year, and that's an important goal for us as we set our objectives for the coming weeks.

That revenue growth doesn't happen just by chance. This is a deliberate strategy that we pursue by trying to differentiate our product over time, both in terms of the customer service, which is driven by those strong cultural roots that I highlighted at the beginning, which are foundational for us, but also by the operational reliability. That doesn't happen by chance either. This has been a multi-year exercise really going back to the summer of 2010 and if you look at our improvement and our statistics, our cancellations for maintenance reasons since 2010 are down 99%. In 2010, we had over 5,000 cancellations due to maintenance. This year we'll have less than 100 for the entire year.

Our maintenance team and our spares team are doing a fantastic job of running the airline consistently, because at the core what customers want is that reliability and that consistency to know that when I buy a ticket on a flight, that plane is going to go and it's going to go on time, and that's another important driver for us. I highlighted that over 70% of our flights over the Labor Day weekend were on time. That's against an A0 metric, not the DOT's A14 metric. We believe that we should hold ourselves to a higher standard, and when we look at customer satisfaction, A0 is one of the highest drivers and highest correlated variables to net promoter score.

So, when you hit those types of levels, it's no surprise that you see net promoter scores in the domestic operation at all-time highs for us. And that has what – has been the fundamental driver of our revenue premium versus the industry, which domestically in the first half of this year hit almost 120%.

Like I said, that level of revenue premium on a unit basis is somewhat unprecedented, let alone driving it as consistently as we have over the last several years, and that's a testament to all of our people throughout the system and the job that they do every single day. But importantly, and I know we've spent a lot of time talking about this across the industry, but importantly that drives the customer loyalty that has been monetized in new and creative ways through our relationship with American Express, which this year will drive over $3.5 billion of additional revenue and value into Delta, which is a testament to the brand that we've created.

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If you go back 15 years, airlines chased credit card companies because we wanted the loyalty that the card provided to attach to the airline. That's almost completely reversed in the industry today and the changing economics of the credit card business and what credit card companies and issuers want is the loyalty that airlines have, and the airlines engender attached to those cards, and that has been an incredible value driver for airlines and one of the ways in which we can utilize our brand to create more durability and sustainability in the business.

We – cost has been a big story at Delta over the last several years and while we talked about it at Investor Day being below 2% for this year, the first half of the year was as quite a bit of a challenge. We knew that going into the year as we lapped investments in the product and our people, as well as year-over-year increases in depreciation driven by the acceleration of the MD-88 retirements, the grounding of other airplanes, et cetera. And that fuel cost is expected to flip by 3 to 4 points in the back half of the year. So, we were 3 to 4 points in the first half, we're looking at flat in 3Q, as we said on our June quarter call, better than that in the fourth quarter as we see.

This is more important than ever. This is going to be the source of the margin accretion as you see the top-line growth going forward and we believe we have the right momentum both in terms of lapping overhead, but also driving the efficiency in the business from the up-gauging of the larger airplanes that are coming in this year, as well as the beginning of the realization of some of our One Delta transformation efforts.

As we talked about at Investor Day and we've updated throughout the year, that One Delta project is – is transformational. In fact, we don't even like to think about it as a project because what we really need to do is think about the business at an enterprise level, the way our customers do. Our customers don't interact with our divisional silos, they interact with a horizontal swap across the company as a whole and when we can drive efficiencies horizontally through the company, through things like better network optimization, better logistics management, handling company materials, better coordination across the system, we know that we can drive savings.

In fact, many of those operational benefits have been implemented post summer as a way to minimize some of the risk of implementation and the impact that we might have on our customers, and put those in post summer. So we're starting to see those lap and that's a contributing factor to why our second half unit costs are going to be considerably lower than what we saw in the first half. Those initiatives will continue to annualize as we get into 2019 and we continue to drive even more ideas to really kind of kick that cost efficiency into high gear for us going forward, and that will be a consistent source of what we see as margin expansion over the coming – over the coming months and years.

But as you know, all of that is moot, if, at the end of the day, we aren't good stewards of the capital that we're generating, and the capital that we're raising every year. So we start with investing 50% in the business. This year that number will be a little bit higher as the business is adjusted to the higher fuel costs, but this is a long-term business and the long-term investments we need to continue to make as long as we can. We do have flexibility in our capital expenditures, and we do see opportunities to use them in the event that we see sustained drop in operating cash flow.

For example, one of the things that we have at our disposal is the ability to defer pension contributions. With the pension contributions that we've made, including $3.5 billion in 2017, we have actually exceeded the minimum required contributions under Airline Relief through 2024. That means that in the event that we see headwinds on cash flow, we could dial back our planned $500 million in annual contributions in 2019 and 2020, creating a very easy switch to pull in the event that we need to preserve that cash flow going forward. But we're also doing that through aircraft; we've got a ambitious fleet plan where we're replacing about 30% of the mainline fleet through

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2020, completely retiring the MD-88 airplanes, as I mentioned earlier, to drive not only efficiencies in the business but enhance customer service and enhance customer amenities on board.

It also provides for continued investment in technology as we completed last year, a heavy infrastructure year; this year is tilting more towards digital and how we interact with the consumer, and how we arm our people with the best tools in the business to serve our customers at a level that they've never seen before. And that technology is moving along very nicely and we'll see the result of that in early 2019.

We've got to continue to strengthen the balance sheet not just in terms of debt pay down, but also continuing to attack that pension liability. And what you've seen over the last – since 2009, is, over $11 billion in reduction in both debt and our pension liability going forward. That's important because while return to capital – return of capital to shareholders is critically important for our business thesis and what we think the industry has been missing for most of its – most of its history, that consistent return of capital can't come at the expense of the balance sheet over the long-term. We need to have an investment-grade balance sheet and we need to maintain that.

So the ability to return capital at the levels that we have, while also improving our balance sheet and reestablishing our investment-grade credit rating is paramount to that balance, so how we think about maintaining our cash flows and being strong stewards of that capital flow. But even with that, we have been committed to consistent return of capital to shareholders and we've been targeting 70% of free cash flow back to our owners. Again this year, it'll be a little bit higher based on lower cash flow, but we think there's value in the consistency of what we're driving.

So since 2013, we've returned more than $11 billion in the form of dividends and buybacks and this year we had our fifth consecutive increase in our dividend, which is testament to what we think both is the sustainability of what we've created here, but most importantly, the commitment to continuously returning capital back to our shareholders. We are making progress against our buyback. We have just over $3.5 billion remaining and we do expect to complete that by mid-2020.

So as we think about the business going forward, we have the right momentum. We've overcome two big increases in fuel prices, in March and May of this year, and as we start to lap the fuel increases from last year, we start to see that year-over-year fuel pressure come down, we believe that the business is in a strong position, heading into 2019, in order to drive those margin stability and ultimately margin expansion off the levels that we've seen, and we believe that the momentum is headed in absolutely the right direction. We feel good about where we sit.

With that, I will turn it over to Helane to ask any questions or ask any questions from the group.

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QUESTION AND ANSWER SECTION

Helane Becker
Analyst, Cowen and Company, LLC

Q

Okay. First of all, asking the group, does anybody have any questions because I have tons of questions; so I'll give the group a chance to ask a question. Okay, so Paul, thank you for that really great presentation.

Just first question that comes to mind is about data mining. So you have a lot of information on your customers and how do you use that to target, maybe, specific marketing, are there opportunities to use that information to appeal to certain customers certain times a year in terms of opportunities for travel for them?

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

A

Sure, Helane, that's a great question and one that I think we're in the infancy of – I think the airline industry has always been replete with lots of data across the system and our ability to harness that has been somewhat limited by our technology and the fact that we've been playing from behind for a lot of times, as evidenced by some of the infrastructure investment that you've seen over the last couple of years. But this is exactly what we mean and this is exactly what we're focused on with the digital transformation of Delta.

So, we have been – we've been good in terms of personalizing the experience, so when you log on to delta.com, making sure that the experience matches what your preferences are; but we've got to take that on to the service level and one of the tools that we have that will be coming out, I alluded to it briefly in the presentation is the single view of the customer in which we can connect all of the data sources that we have on customers, to enhance that travel experience.

So, for example, when you walk on board a flight today and interact with a flight attendant, they may not know the experience that you had last week or last month. When we can unite these systems together operationally in customer service, we can actually come in and acknowledge, I know we failed last week, we apologize for that. Here's what we do to make it up, or, we know that the flight today is going to be on time, you're not going to have those problems. That's a level of personalization that we really haven't seen before and digital is the key to that.

So, as we link all these systems together and give our customers a complete view – or our employees a complete view of the customer, then you'll have a consistent interaction regardless of whether you're dealing with somebody in reservations or flight attendants or somebody at the ticket counter. And that, we believe, is a game-changing opportunity for us, when you put those tools in the hands of the best customer service people in the industry.

Helane Becker
Analyst, Cowen and Company, LLC

Q

Let me just – for the webcast, I have to give you the mic.

Q

Sort of follow-on Helane's question and have another question too. Can you talk about upsell? I mean, that's something that's been a big opportunity and you've pretty much been very positive about that, but also then, can

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you – what can you do with upsell? I know when I go online, maybe I have a ticket [ph] in the pocket, (00:22:17) oh, for only X, you can upgrade to first class or something like that, but what about, oh, by the way, we also know that you have your Hilton account linked with us or your Marriott account or whatever is linked with you. Do you have the hotel in whatever city you're going in? We have this deal for you.

I mean, are you looking at things beyond just upselling to first class? Could you do things with data to make it tie to another royalty program?

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

A

Sure and I think this is a little bit of what I alluded to when I said I think that we're in the infancy. I mean, we're in a company now that is truly a world class identifiable, ascending brand and that is something that I think over the last few years, we've gotten better at harvesting that. But we have so much potential in that space, whether it'd be who we do with – business with in terms of partnering on board, all the way up to how we link our mileage and loyalty program and how we use that to cross-sell across the board.

Right now, what we're focused on uniquely is, how do we create that different experience for each and every customer that we can within a well-defined set of operational limitations, so that we don't try to be everything to everyone; and I think what the team has done an incredible job of is packaging those individual experiences.

10 years ago, it was just simply a matter of did you want to fly first-class or coach; and now what we've done is we've been able to differentiate those experiences across multiple cabins, multiple boarding experiences, multiple amenities onboard, and that's created an opportunity for us to really differentiate based on what customers value. And we've got to continue down that path, whether it be the onboard experience or also the purchasing experience wherever we can, in order to maximize those brand benefits.

Q

You mentioned in your presentation, the strong revenue momentum you're having. Can you just talk about kind of the fare environment, what you're seeing there in terms of closing pricing et cetera, and then just in terms of where you expect fuel recapture as we go into 2019, do you see momentum there given the higher fuel prices?

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

A

Sure. So we measure fuel recapture first based on all revenue has to go to cover the increases in our non-fuel costs, and then what's left goes to cover fuel, and that puts us in a position where we're ensuring that we're taking the most of what the market will give us. So, when we say that we can get to flat margins or expanding margins, by definition that gets to 100% fuel recapture the way we're measuring it.

So, we feel like we're on a good trajectory to do that. There's still obviously some risk as we look out into the future, but that's certainly what we're targeting. And the momentum that we've seen in close-in bookings as well as the heavy summer loads, I alluded to all the records that we set for passenger enplanements, has been a strong indicator that the business is trending in the direction that we need it to, particularly as it relates to close-in fares in order to drive that momentum to get us to flat margins and ultimately that 100% recapture by the end of this year, to set the table for 2019.

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Q

Well, Delta has always been known as employing a successful strategy with respect to its use of used aircraft to keep its capital investment low and I noticed and so like the MD-88 and the Boeing 717 et cetera. With your new-found cash flow, are you abandoning that historical strategy?

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

A

Well, I think the cash flow story has been somewhat consistent over the last several years and by definition, as we've talked about that used aircraft strategy, it's been opportunistic, all right. So when you look at the MD-90s that we were able to roll up, or the Boeing 717 transaction that we acquired from Southwest, those were both very opportunistic in nature. What we've been focused on over the last couple of years is how do we focus – how do we create that up-gauging momentum and use our negotiation leverage to the maximum of our abilities.

So when you see the forward order book, it's largely new airplanes coming. We still do have some dry powder in the event that we see those opportunities, but they haven't been as prevalent over the last few years as what we saw five, six, seven years ago with those transactions. But we are still open to it under the right opportunities.

Q

I just want to follow-on that with a different question; similar, but different. Delta TechOps, you know, that in the past has been talked about as being a $1 billion-plus business and can you just talk about your plans for that because I know, in a $45 billion revenue company, $1 billion in revenue is not a big number, but I suspect the margins on that business are fairly high. So can you just maybe talk a little bit about the plans for that business?

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

A

Sure, absolutely. Our TechOps professionals are the best in the business and when we see that ability to drive that third-party work, we've done it extraordinarily well. We had a dip down a couple of years ago. The margins weren't what we expected them to be and we kind of went in and cleaned up a number of contracts, but since that time, the business has been on a fantastic trajectory.

So, as we see going forward, we've done innovative partnerships with both Rolls Royce, where we built the – a large engine test facility, which is going to be a fantastic opportunity for us and then if you look at the most recent deal we signed with Pratt to be the North American exclusive MRO shop for the Geared Turbofan. Those are the types of momentum that are going to drive that business well beyond $1 billion in revenue as we see it going forward. And those margins are strong, but that's a testament to the work of the – the team that does that over in our maintenance base.

Helane Becker
Analyst, Cowen and Company, LLC

Q

So, I think we have time for maybe one or two more questions. So according to the work we've done, it looks like – and your own pilots, it looks like you have about 14,600 actually – 14,643, to be exact, pilots, maybe that's different today, on staff, and then between now and 2030, 7,925 turn 65. So we know that's the mandatory retirement date and obviously, some pilots retire younger. So, that's more than half your pilots. So, how do you replace them, and if you grow 2% a year, how do you – how do you view that and replace the pilots?

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

A

Well, thanks for that question, Helane, and first of all, I'm remiss in not having introduced Joe Pinkelton. I jumped into the slides too quickly and the frustration of them not moving. I didn't mean to omit Joe, who is with Investor Relations with Delta's ALPA Group. So Joe, welcome, and I apologize for that oversight earlier.

This is a challenge for the industry, but when you look at the career path that the Delta pilot has, it really is among the highest in the business. So, it's incumbent upon us to focus on training the next generation of pilots and also making sure that the career prospects for a Delta pilot are strong. And you see that both with the breadth and depth of our international network that gives more opportunities to fly bigger airplanes longer, but also that just the package that comes with being a Delta pilot, industry-leading profit sharing et cetera.

But we're partnering with a couple of innovative programs to help augment that. We've just recently launched the Propel program, which is a partnership with eight universities, particularly with aviation programs, to really help college students get a leg up on the training needs, as well as knowing that they've got the Delta job assuming they meet all the requirements and do what they need to do, at the end of a short period just after college.

So, focusing on innovative strategies like that, as well as combining it with the best career proposition in the industry is what ultimately is going to keep Delta well insulated from any pilot shortages in the future.

Helane Becker
Analyst, Cowen and Company, LLC

Perfect. Thanks very much. Okay. Thanks everybody. That's Delta's presentation. Thank you so much, Paul, for all these years and supporting our conference. We really appreciate that.

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

Thank you. Thank you for having us, Helane, and thanks everybody for joining.

Helane Becker
Analyst, Cowen and Company, LLC

Thanks for being here.

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