07-Sep-2016

Delta Air Lines, Inc. (DAL)

Cowen and Company Global Transportation Conference

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MANAGEMENT DISCUSSION SECTION

Helane Becker
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Okay. Good morning, everybody. Thank you very much for coming to the 9th Annual Cowen Transportation Conference. I'm Helane Becker; I follow the Airlines and Aircrafts leasing industry for Cowen. Our next presentation is from Delta Air Lines. This morning we have Glen Hauenstein, who's President of Delta. Winnie, I'm not sure I actually know your last name, Winnie Smith, how can I forget that, who's Investor Relations and our speaker this morning is CFO of Delta Air Lines, Paul Jacobson. Now that I know.

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

Thank you, Helane, and good morning everybody and thank you for joining us this morning. We are webcast this morning and thanks to everybody who is joining via webcast. Today's presentation does contains some forward-looking statements, please refer to the risk factors on our Investor Relations website and our SEC filed materials for an explanation.

Like I said, appreciate everybody joining this morning and especially to any customers or Delta family members that are listening today. Thank you for everything that you have done for us this quarter. This has been a challenging quarter, made more challenging by the challenges of the power outage that we had last month. But we do have a lot of momentum, and the business story – the fundamental business story over the long-term remains intact. And we feel good about where we are. There is some reasons to be optimistic, which we'll get into particularly in the domestic revenue environment, that makes us feel like we are on the right track heading back towards a positive RASM of trajectory. Our operations continue to really shine and despite the outage, the team is really, really pulled together to continue to drive brand loyalty and brand equity value to Delta, which actually helps in challenging times like we saw during the power outage. There were customers that forgave us that perhaps in other situations may not have, but the track record that we've established and most importantly the way the Delta family took care of our customers during that time was a really, really great opportunity to shine.

And through it all, we're able to maintain our continued discipline on cost and our focus on free cash flow and results because we know this industry is challenging. I don't have to tell you in this room or you listening that this

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industry has historically had a lot of challenges, a lot of risks, known and unknown, but through it all, we've maintained our focus on the long-term sustainability and durability of this business model to really prove things are different this time. And that starts with delivering results in the short-term and focusing on what's important in the short-term to drive cash flow, which is the RASM story.

Turning to our second slide and producing an updated guidance for the September quarter. We are on track, we're giving a slight revision to our guidance, operating margin of 18% to 19%. This is down from 19% to 21%, which was our original guide, but about a 1.5% or $150 million of impact from the power outage. So if you set that aside and understand it was really part of the quarter for sure, but the fundamental business is actually on track to perform right in line with what we anticipated, when we were looking at the quarter July, because that one point impact would put us right back into the midpoint of the original or one point and half sorry, would put us right back into the midpoint of the guidance. Passenger unit revenue down 7%, about a point of that is the revenue impact, we detailed that or highlighted it in our August traffic release, which went out on Friday, which we attributed about $100 million of revenue impact to the month of August.

We've caught a little bit of a good guy on fuel, as you all know; fuel is continuing to bounce around in that $45 to $50 level. But, we've seen a – we've seen a little bit of opportunity, and a little bit of upside in the fuel, that's given us a little bit of a boost. And CASM ex-fuel, we were projecting flat. The good news is we were trending probably a little bit favorable to that prior to the outage, but even taking into account the cost impact of the outage, we still expect that we're going to come in between flat to up 1%, which is contributing to, to the performance that we see during the quarter of 18% to 19% taking into account, the power outage.

That power outage just to spend a minute on it, I think, as I mentioned earlier was a real unique opportunity to showcase the Delta family, and I was personally touched by a lot of stories of what people did, whether it was the airport customer service agents working around the clock often without sleep. Fortunately, as I told our station manager in Atlanta, he went without sleep, but didn't go without a shower, because that's important for customer service. And we're all thankful that Greg was able to do that. The reservation's agents that worked long and tireless hours often getting a couple hours of sleep, just before getting back on the phone to meet our customers' needs and to go really above and beyond.

The pilots and the flight attendants, stories of employees who walked away from their vacations. They were with their families on vacation and saw that an airplane sitting at the gate because a crew member couldn't be located or couldn't make the connection, kissing their families goodbye and saying, I've got to go to work and showing up in their regular clothes out of uniform to work that flight, to help save those passengers and customers on that flight. Great, great stories of heroic efforts from people during that time, which is really a testament to the culture that that we have and the special unique culture that we have at Delta.

Operationally, we are right back on track. So, since the outage, which occurred on August 8, we've had 17 days of 100% completion factors. So, it was short lived, lot of lessons learned and then we can talk about that later, but 17 days of a 100% completion factor, which takes us up to 153 days, year-to-date of a 100% mainline completion factor versus just 86 days at this point last year. We are currently, I hope I don't jinx it, we're currently on a 10-day streak without a cancellation, so that's almost 32,000 flights without a cancellation in the system and hopefully, there's more of that to come because we recognize the importance of that operational performance to drive that brand equity and ultimately to drive value for the shareholders.

Let's turn the page to PRASM, as I mentioned in my opening comments, we see a lot of times reasons to be optimistic. There are some green shoots popping up, but if you look around the world domestically, we have just kind of begun the process of decelerating growth as we highlighted both back in May and in July on our earnings

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call, and we're starting to see early benefits and early reasons to be optimistic that we're heading in the right direction. We've seen solid improvement as those fall schedules have come in. But we've got to transition the business. As we go into the winter season, there's more of an emphasis on business travel and that requires a little bit of different techniques and a little bit of management as that becomes a bigger component of the overall revenue picture. But as we look ahead, we feel good about trending towards flat, which is what we had expected as we get towards the end of the year.

Latin has been a bright spot this quarter and certainly since June, as we've lapped some of the currency headwinds in the region. And some of the capacity discipline that we've seen in that region, we're actually trending positive and we expect to continue to trend positive into 4Q 2016 and 2017. Pacific, if you exclude the effects of the yen hedge, so we disclosed this in July that we had about $70 million of hedge headwinds on the yen. These are not losses; these are just the lower gains from the lapping of a long multiyear program that was done years ago. That has to average into these higher hedge level or higher yen levels today. But excluding that hedge impact, Pacific should be positive RASM for the quarter. And while 4Q is challenging, there's a lot of network changes that are occurring in that region with the split operation between Narita and Haneda and some Chinese expansion. The challenges are there, but we feel good about where that's heading and trending in the right direction over time.

And Atlantic continues to be a challenge despite the fact that it was a record year in the Transatlantic region, there is a lot of capacity and a lot of specific regional challenges there, particularly with some of the events in Paris, Brussels, Nice and Munich and Istanbul, which has impacted Transatlantic demand. So, that'll be a bit of a laggard, but certainly accretive to earnings and certainly accretive to profit, but we're going to continue to manage that aggressively and we're going to be continue to be down second year in a row on Transatlantic capacity marginally.

So, as we look around the world, we continue to feel good about where we are and trending in the right direction. And as we have stated before, if we feel things starting to deteriorate, we will take action. We've done that in the past. I think we've been very forward thinking about that. It's a little bit soon to tell, but there are reasons to be optimistic that we're heading in the right direction for the fourth quarter, which is actually pretty important because as we talked about before, the fuel tailwind is really behind us in the fourth quarter, based on where the current curve sits, will be the first quarter in about eight, where we will face year-over-year higher prices from a market perspective. Delta will still lap some hedge losses, so there should be some improvement for us.

But if you look at the market fuel environment, we have been trending considerably higher, almost double from the lows of January, February timeframe, but steadily higher over time. So, that effect has historically led to RASM traction in the industry, as everybody has to pass through those higher costs going forward.

So, we – as we begin to plan for 2017 and we'll talk more about that at Investor Day, are continuing to stick with our philosophy of planning for higher fuel prices. Ultimately, that is the healthiest way for us to run the business and to plan the business going forward because it leads to cost discipline and more capacity discipline internally for ourselves, if we're thinking about the world in terms of higher fuel prices and we'll continue to do that.

A shining star for Delta has been the performance of our commercial team, which is coupled by the presence of the refinery. If you look on an unhedged basis we will have an advantage to industry average on an unhedged basis despite the refinery having a loss of about $50 million this quarter which is in line with what we talked about in our July call. But that comes through a lot of hard work and a lot of commercial initiatives we've been able to harvest about a $0.03 a gallon unhedged advantage over our competitors just from a much, much deeper focus

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on how we source fuel and how we move commercial shipments around. So, that's a bright spot. We continue to look for opportunities to use that and to leverage that, for example, for our benefit.

Cost, I mentioned cost being a real shining star and a real bright spot. My hats off to the operating teams and the business unit leaders and the financial teams that support them. Our costs have really kind of been without question for the last several years – a lot of that is driven by a fleet strategy that will continue to accrue benefits for us for the next several years and by that I'm referring to the upgauging strategy where we're able to realize significant operational savings as a result of the density and the gauge benefits that we see on our fleet.

We estimate that that's been worth about $350 million annually give or take, and if you look at our cost performance from 2012 to 2016, that was on the benefit of about a 5% average gauge increase over that time period. The good news is as we look from 2016 to 2020 as we begin to retire the MD, ADA as we retire the 747s and continue to ferret out some of the regional jets. We actually will increase gauge by 7% between now and 2020.

So actually a slight premium to the benefits that we've seen over the last several years. So that will serve as the foundation for our cost performance and driving that continued emphasis and focus on cash flow and margin performance but we expect to be able to continue that trajectory for the foreseeable future but it also comes with a lot of heavy lifting. The teams rolling up their sleeves and finding better ways to do business.

We have talked about this in the past. The scale benefits of consolidation have allowed us to really go in and capture efficiencies throughout the entire supply chain and throughout the value chain such that our costs and productivity measures are different than what they've historically been. If you go back to the history of the airline industry, a lot of those costs savings at critical times came at the expense of customers or came at the expense of reliability or worse yet, it came at the expense of the employees.

We've managed to drive this cost productivity and this cost efficiency in ways while enhancing the product model for our customers, enhancing the reliability of the airline and enhancing the value proposition for our employees and our service professionals throughout the world. That has been very, very unique and it's really driven by the scale benefits and the efficiencies that we can do because we're a much more efficient, much bigger, much more scale-present airline than we've ever been before. And we continue to see opportunities to change that model historically, and the team has have done a fantastic job of that over time.

This is all aimed at focusing on our long-term goals, which if I can rewind back to 2013, has been really a fantastic success story, that I think is somewhat overshadowed by the current environment and understandably so. But if you look at our trajectory, when we first started having our May announcements, and we talked about our long-term goals, we started that in 2013, with a goal of delivering an operating margin sustained at the 10% to 12% level. 2015, we ramped that up to 14% to 16% and in the 2016 to 2018 framework that we announced in May, we saw those margins go from – all the way from 10% to 12% up to 17% to 19%.

Now, don't be mistaken, some of that is driven by fuel, but I think overshadowed in all this is the enhancements to the product, to the revenue model, to the way we sell our seats, and sell our experiences on board Delta that have really driven a lot of value creation over time, such that if you go back and look at 2013, fuel at that time was $3 a gallon, and I say that because I think by a lot of the metrics, the valuations would imply that we're going to return to a 10% to 12% operating margin level or essentially discounting the progress that we've made over the last three years assuming that it's has been all fuel-driven. The reality is, fuel is a component of that, but don't miss the underlying benefits, and the revenue premium that we've been able to generate through the brand

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preference, and through the enhanced customer service that we've provided over that time. And that's led to performance that has been really fantastic by any measure throughout the S&P transports.

We focused on improving our return on invested capital and we've done that. We focused on reducing our net adjusted debt, and we paid down over $10 billion of debt since 2009, and we focused on returning capital to shareholders. All of this is done in the spirit of durability and sustaibality in the business model. Historically, if you look shareholders really never participated in the business cycle in the airline industry. In fact, historically it was worse than that, because in good times airlines over-levered, and in bad times airlines diluted their shareholders, because convertibles were the only source of capital available.

If we're going to fix this for the long term, we need to be focused on a disciplined investment grade balance sheet. We've managed to achieve two investment grade ratings so far as a testament to the progress that we've made, but as we've talked about, we still have a goal of getting to $4 billion of net adjusted debt by 2020, and we're making progress to do that. But we can't starve the business in order to do that. So we need to continue to invest, and while we've taken up our capital spending from less than $2 billion five years ago, to $3.3 billion to $3.7 billion. We've done it in a disciplined way. We've done it as we've ramped up free cash, or cash flow performance or cash from operations, while growing free cash flow.

And we've been focused on investing where it matters. So with the $3.3 billion to $3.7 billion over the next few years, but through from the period of 2014 through 2020, we'll have replaced 50% of our mainline fleet. So a lot of questions around that we've received in the past of whether or not there is a bow-wave of CapEx. The reality is we're able to balance the needs of the company in – with fleet and the other initiatives that we want to do and scale it with the free cash flow generation.

Now, the key here is to make sure that we have scalability in the event that we run into some material headwinds and as I've talked about before the real pressure test of this business is sustainability through the cycle, not just proving that you can grow margins during the cycle. And we feel that with our balance sheet and with the flexibility that we've driven in the cash flow model that we've created that flexibility. But in the meantime, we believe that we can hit a goal of $4.5 billion to $5.5 billion of free cash flow, which will allow us to continue to fund the pension plan significantly above our minimum requirements. It will allow us to continue to pay down debt to get to that optimal net adjusted debt balance while also allowing us to invest in the business and return cash to shareholders.

And that's the balanced approach that we've talked about. We're committed to maintaining that investment grade rating. That provides the cushion against what may come while returning at least 70% of our free cash flow. Now this is cash flow after investments, so we've made the investments that we need to for the long-term health and innovation and sustainability in the business, but returning a significant portion of our free cash flow of what's left over in an effort to continue that cycle.

Now, our point is to really serially return capital rather than just simply try to take a bargain because the stock price is low, because we believe that the durability of cash returns to shareholders is reflected in our dividend and the fact that we've grown it 50% for each of the last several years provides that mechanism to do that because that's our commitment long term is to focus on balancing and running the airline for the shareholders and for the shareholder value. And as a result, in this area – era of challenged opportunities to find alpha in your portfolios, Delta really is a compelling investment and I don't say that lightly. I'd fully acknowledge as I have in many presentations before we didn't earn the discount to high quality industrial transports overnight, we did that over decades. We're not going to earn our way out of it overnight, but what you have at the Delta team and the Delta

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family is a commitment to fundamentally changing that business model, managing it for the long term, managing it to get through the cycles so that we don't see the ebbs and flows of profitability.

Because as I spend a lot of time with employees, one thing is clear, at the end of the day, if we end up cutting investments in reliability, we end up cutting product amenities, we end up cutting employee benefits at the end of the day, it'll be worse than if we never added them in the first place. Because that's the old airline model. The one that gives and takes away, the one that rides the cycles. We're focused on building sustainability and durability simply because it hasn't been done before in this industry.

So thank you for your time and attention. At this point, we'll open it up to any questions that you might have.

QUESTION AND ANSWER SECTION

Q

[indiscernible] .

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

A

Well, I think, I would qualify our dividend; excuse me, as somewhat evolutionary at this point. So we're just three years removed from really instituting what was the first meaningful dividend in airline history and that doesn't discount other airlines and Delta's history as well because back in pre-9/11 we paid a dividend as well. But I would affectionately refer to that as a check the box dividend, right, that was paying a dividend so that dividend funds could be eligible to buy you.

But the reality is with the advent in 2013 and the subsequent increases, we've really been focused on using the dividend as a meaningful tool to drive cash returns. Our cash flow has accelerated way beyond what our expectations were even a couple – even several years ago when we started that. And we've responded by steadily increasing the dividend, and I think the conversations with the board, I think everybody is convicted about dividend policy and what we need to do. But this is evolutionary and we're continuing to get there. But I think there's a lot of meaning in multiple 50% increases in the dividend that we believe that there's opportunities there.

Q

[indiscernible] .

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

A

Well, I think, it comes down to the opportunities that sit in front of us, some opportunities around the commercial side for us, some opportunities for modest growth, which we've been able to continue to expand our margins through. I think the biggest challenge we have is fuel prices and the revenue environment, but if you look historically as margins tighten, revenues ultimately have to be able to pass through those costs of fuel.

So we still feel good, despite the fact that we're a large company in a mature industry. We still have a lot of opportunities, a lot of commercial initiatives around the way we sell products. That's still relatively new with the

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Branded Fares initiative, and we've talked publicly about $1.5 billion of incremental revenue by 2018. We've gotten about a third of that so far. So there's still room to grow in that as that process becomes easier to buy for the consumers.

So we've been able to do it through capital efficiency, which is what's able to drive the return on invested capital. Now, the one wild card out there that we've talked about before is that some time as we get to the end of this framework, and certainly into 2018 and 2019, is adjusting to a world where we'd become a cash tax payer. But we've talked about – we've talked about that over time, it's significantly the cash burden because of the book tax differences is significantly lower than what we accrued for book. But it's going to be a big drain on the cash flow, and the cash returns of the company. But overall, we feel like we've got a balanced long-term plan to utilize our cash flow to prepare for that eventuality. But we do think it's achievable.

Q

[indiscernible] .

Paul A. Jacobson

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

A

Well, I think the one thing that you look at events like we had in August, and as unfortunate as it was, it becomes a complete tragedy if we don't use it as a learning experience. And I think the one thing that is reemphasized is we'd like to think of ourselves as an industrial transportation company. We're every bit as much a technology company as well and the reliability of the systems has to match that.

So while unfortunate, we have begun to outline a plan to ensure and to minimize the probability that that ever happens again. I think one of the most astute comments that I heard through this process that we have to keep in mind came from one of our board members during a board call and the question was what are you doing to prepare for the next event fully cognizant that the next event will be something different, and I think that is – that's the mindset that we need to have. It's not just reliability it's cyber security, it's ensuring that we've got an architecture that can stand up with the type of reliability that we need to run the operation that we need. So we will be investing this year, we'll be investing next year, and we'll be investing over the next couple of years to ultimately achieve that goal. So that is not lost on us and I appreciate the question.

Helane Becker

Analyst, Cowen & Co. LLC

Q

[indiscernible] .

Paul A. Jacobson

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

A

That's a great question, Helane and what I would say is that's pretty consistent with the way we articulated the walk of the quarter, during our analyst call in July for our earnings. We knew July and August, we are going to have some challenges, there are some calendar issues that flip a couple of points out of August into September. But most importantly, you get to the end of the summer season where the capacity reductions and the pull downs that we've talked about start to take hold in that post Labor Day period, some of it began end of August timeframe, so that's where we start to see that positive momentum. So, we have felt since the beginning of the quarter that September was going to be a bit of an inflection month on the quarter. So we do see it being significantly better than the July, August trajectory.

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Helane Becker
Analyst, Cowen & Co. LLC

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[indiscernible] .

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

A

Yes

Helane Becker
Analyst, Cowen & Co. LLC

Q

[indiscernible] .

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

A

No, I would classify that a little bit of noise, Helane, around the edges. I think the fourth quarter capacity plans are consistent with what we talked about first in May with some of the international pull downs that we talk about and then in July as well where we highlighted some additional pull downs domestically. So like I said in the remarks, it's a little soon, too soon to tell whether that's going to be enough, our initial indications are that we think the green shoots are there, that are going to get us to where we want to be, as we head into 2017. But to the extent we see things deteriorate, there's always room for movement after that. We just – it's a little bit too soon to tell. But the fourth quarter is pretty consistent with where we've been for several months.

Paul A. Jacobson

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

Okay. Thank you all for your time, and to those listening on the webcast. Hope you enjoyed the conference. And thank you Helane for having us.

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