

07-Nov-2019

# Delta Air Lines, Inc. (DAL)

Baird Global Industrial Conference

## CORPORATE PARTICIPANTS

Paul A. Jacobson

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

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## OTHER PARTICIPANTS

Peter J. Arment

*Analyst, Robert W. Baird & Co., Inc.*

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## MANAGEMENT DISCUSSION SECTION

Peter J. Arment

*Analyst, Robert W. Baird & Co., Inc.*

Thanks. Good morning, everyone. Thanks for joining us. Very excited to have with us Delta Air Lines this morning. My name is Peter Arment, Senior Aerospace Defense Analyst here at Baird and with us, Paul Jacobson, a longtime Delta Executive, Chief Financial Officer. Paul is going to go through some slides and if we have time at the end, we'll have a little Q&A. Thanks again.

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Paul A. Jacobson

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

Great. Thank you, Peter. If you don't mind, I'm going to standup behind the podium. But delighted to be here this morning. I'm joined by Jill Greer, Vice President of our Investor Relations and Elizabeth Lippitt, our Director at Investor Relations as well. We look forward to seeing many of you throughout the day in several small group sessions later today.

As with any investor presentation, we will be talking about forward-looking statements and there are risk factors that may impact those. You can find more information about those in our SEC filings and on our website at [ir.delta.com](http://ir.delta.com).

So, when we look at the airline industry, obviously, there have been a lot of questions and challenges over the years. Even as we have fundamentally transformed the business and lived through success, it's not immune from the challenges that we see day to day. But for some reason, the history of the airline business has particularly had its own challenges that have been unique, and we want to spend the time today talking a little bit about that journey that we've been on and give you what I believe are a lot of reasons to be optimistic that the transformation is far from over. And in fact as we focus the business on driving free cash flow and revenue diversification, there are a lot of reasons to be very optimistic about how we look forward.

A little bit of housekeeping on the current state of the business. We are on track to achieve our December quarter earnings and revenue guidance, we expect to grow our top line by over 5% in the December quarter, continuing the momentum that we've seen for the last couple of years. Top line revenue growth fueled by a lot of

improvement in the premium cabins, and that's important because it tends to be a sensitivity point as we are talking particularly to new investors that haven't been reviewing the space. Premium revenues tend to be a little bit of a concern, a red flag, if you will, based on the historical impact. But there's a lot of reasons to believe why, through the cycle, premium revenues will behave differently and that's an important aspect.

We've also seen a pretty significant growth and improvement in our ancillary businesses. This is one of those areas that historically has been lacking in the business, but our ability to drive scale particularly through multiple phases of the business has allowed us to grow up these businesses. Whether it is the credit card portfolio or it is the maintenance, repair and overhaul business, Delta Flight Products, many of our ancillary businesses are experiencing impressive growth numbers, and we see a lot of opportunity ahead of us for that.

We do expect to achieve more than \$4 billion of free cash flow this year. I think when you look at the long list of things that we've done to improve the health of the business and led the industry, free cash flow is probably the one that we are most proud of and one that we think we can consistently deliver.

But free cash flow is only as good as how you steward that resource. And as we've come out with our balanced capital allocation which we began in 2013, we have a particular focus on reinvesting in the business, maintaining our investment grade balance sheet, and also returning at least 70% of our free cash flow back to shareholders in the form of dividends and buybacks. And this year will be no exception, with over \$3 billion returned to shareholders directly in the form of dividends and also in buybacks.

And all of that comes really by consistently running the best operation in the industry. You will hear from a number of firms within the industry about fleet age. And Delta has the unique opportunity and the unique set of variables where despite having one of the oldest fleets in the business, we actually deliver the industry's best reliability at the lowest maintenance costs with the highest Net Promoter Scores, defying conventional wisdom that fleet age at the end of the day is the bellwether for the company's success.

We've managed to do this with a little bit of a challenge on our fleet but one that is changing pretty rapidly as we exit certain fleet types. For example, the MD-88 will be completely out of our fleet by next year. And we're doing that in a very balanced way while maintaining and preserving free cash flow generation, and that's an important aspect of how we think about that.

All of this is enabled by the best and most unique culture in the airline industry, and our people are absolutely the best. They represent our strongest competitive advantage and allow us to execute in unprecedented ways even when challenges of weather or load factors or fleet ultimately hinder some of their efforts to surprise and delight customers. And we've got more examples in the presentation about how we're utilizing that and really capitalizing on that culture in order to deliver stellar customer service.

So when you look at the year, we're on track to deliver 7% top line growth, solid margin expansion, more than 20% growth in EPS in 2019. And that performance is really among the top of the companies in the S&P 500 and one that we hope to continue that momentum going forward.

On the road, we probably get a question or a concern on investors' mind that really kind of sticks out from others. And that is, well, Delta, you got a head start, therefore, you've already kind of baked in all of your advantages of consolidation and at the end of the day, why wouldn't I purchase your competitors who have a lot more runway, because the only difference between airlines is when you've started. Really, that couldn't be further from the truth. Because when you think about now that we are 10 years since the merger with Northwest, you have to really look at how did we progress after that merger. And we kind of look at that in three distinct and unique phases of that

consolidation. The first one being we had to spend the first four to five years after consolidation really establishing a solid foundation.

In any construction project, when you're building something, you've got to have that solid foundation to be able to weather those storms whenever they might come. And for us, that meant driving the business for cash flow. It meant ultimately paying down more than \$10 billion of debt to establish an investment grade credit rating, and ultimately being opportunistic around our fleet strategy. We purchased a lot of used airplanes back then, used what cash we could to shore up the business but really were focused on getting that balance sheet in order.

And since that time, we've managed to create and achieve the investment-grade credit rating. We've managed to fund opportunistically more than \$12 billion into our pension plans, most of those being voluntary contributions because of airline relief, shoring up for that future rainy day. And once we were able to do that, we came out in 2013 with really the industry's first meaningful commitment to shareholders in the form of shareholder returns. We established the first meaningful dividend in the airline industry and many of our competitors have followed. And I think that's ultimately the recipe for a healthier, more shareholder-friendly industry when we're focused on returning cash to shareholders and doing that through a dividend. But then we also launched a series of buybacks, the most recent one being a \$5 billion buyback program, which we expect to complete by the middle of 2020.

After we did that, we had money to invest to ultimately strengthen those competitive advantages. We built out the most formidable set of domestic hubs in the business and, ultimately, have used that as a launching point for an international strategy that is far more capital efficient than anything we've seen before. Through the alliance network, our joint ventures, which are unique in the industry, what we are able to do is really broaden that network internationally and globally with a much more effective return on invested capital formula than it would be for us to buy widebody airplanes and go out and grow that organically. And you see that with investments in Virgin Atlantic. You see that with investments in Aeroméxico, the most recent investment we made with Korean, as well as the announcement that is pending regulatory approval of a new partnership and a 20% interest in LATAM in South and Latin America, building out that global network and creating feed through that basis of what we've been able to create.

We also completely differentiated the customer experience. One of the challenges of the business has been the historic commoditization of airplane seats. And for many decades throughout our history, we scratched our heads wondering why customers behaved as if we were a commodity when in every facet of the business in which we faced customers we presented ourselves as a commodity. Think about it. Under historic times, if you booked your seat a year in advance and you were going from Chicago to LA and you paid \$200 for your ticket, where would you sit? Well, you'd probably sit on an aisle or a window depending on your preference near the front of the airplane. And if you were buying a \$1,200 or \$1,400 business travel ticket for tomorrow, where would you sit? Well, you probably sat in the middle seat in the back because that was the only airplane that was left. Commodity-thinking.

At the end of the day, the availability of capital, the health of the business allowed us to invest in what we needed to do to change that, to ultimately drive value in the customer's eyes to have them pay for what they value and pay for what their preferences are, creating multiple phases and multiple experiences within the same journey from point A to point B.

Don't underestimate the power of this, because as we think about moving forward, the gap between premium cabins and main cabin has never been smaller than what we've seen over the last several years. The purchase points, the number of paths that a customer can take in terms of booking main cabin, coming back later and

purchasing a first class upgrade with cash or with miles and getting all these opportunities to change their experience and customize their experience within achievable operating parameters so that we can execute on that, that optionality both in terms of the customer as well as what it provides in pricing is ultimately we believe going to result in a significant increase in resiliency through an economic cycle than what we've seen before. And we're very excited about that. We're not excited about an economic cycle, but we're very excited about how we might perform through that for the avoidance of doubt. But with that, we have been able to pioneer a brand and build a brand such that our brand value has never been greater. And as a result of that increased brand value, we are able to go out and monetize that brand in new ways, not necessarily ways that are – never been done before, but certainly in ways that they have never been done before. And what I mean by that is the American Express partnership.

If you look historically at the relationship between airlines and credit cards, historically, airlines would chase credit cards because we wanted the loyalty of card providers to translate to our brands. So, if we could go to American Express and attract American Express cardholders to fly Delta, we would perform better than that.

Due to the evolution in the card industry where rebates are prevalent throughout every issuer that you can see out there, and that's what consumers are demanding, the number one form of currency that consumers want today really is airline miles. And so, what's completely flipped on its head now is there's much more balance between the brand attraction. So American Express wants Delta customers attracted to American Express every bit as much as we want American Express customers to attach to Delta.

And that symbiotic relationship is driving results that we've never seen before. This year, we'll have over \$4 billion of direct remuneration from American Express as a result of that card program, growing to nearly \$7 billion in annual remuneration by 2023. And we expect that to grow beyond that. Creating resiliency in that model is ultimately what's going to continue to accelerate our momentum. So as you think about us diversifying our revenue stream, leveraging the scale across the business that we really have never seen before and using that to deliver personalization and improvement in the brand are things that we can continue to see.

For example, just this week, we are rolling out a new international main cabin experience which is relatively unprecedented for what we've seen, part of the brand promise and part of what we think we can do to continue to establish premium customers across the board using Delta people in the best way that we can with the experiences that they have.

In fact, this international main cabin experience that we're rolling out was actually designed by our flight attendants, capitalizing on those strengths they felt they had in an effort to surprise and delight customers throughout the journey. Initial tests have already seen Net Promoter Scores up over 5 points in trial markets and we expect that to continue to grow. And as we have seen over time, our Net Promoter Scores have translated in direct correlation to that revenue premium that we're able to achieve over the rest of the industry.

All of that will allow us to maintain our financial leadership position both within the industry and against our historical backdrop, which gives us the confidence to be able to drive free cash flow improvement continuing forward as well as free cash flow throughout the cycle. Those types of achievements would be completely unprecedented from what we've seen historically in the airline industry. And one of the things that I think keeps fence sitters sitting on the edge is waiting to see how does the industry perform through that downturn. We don't know when it will be. It might be two years down the road. It might be five years down the road. But at the end of the day, we've been studying for this final exam for a long time and we feel the company is very well positioned whatever the economic cycles might be to continue to thrive.

And the results of these phases really underscore the magnitude of the transformation that we've seen. 2009 on the backs of the credit crisis, the last year that we lost money. We lost \$1.1 billion during the aftermath of the credit crisis in 2008. We generated about \$1.4 billion of operating cash flow. But importantly, throughout that year, a couple of things were very unique. Number one, we had \$1.3 billion of fuel hedge losses that we weren't able to fully participate as commodity prices dropped in the wake of that economic slowdown. We had over \$1.7 billion of interest in pension expense in 2009. Today, that number is actually a \$100 million credit across the board due to the balance sheet improvement as well as the financial health. And American Express in that year was about \$1.2 billion of remuneration.

So, as you fast forward to 2019, we expect about \$6 billion of pre-tax income, over \$8.5 billion of operating cash flow and over \$4 billion of free cash flow, with \$3 billion of that being returned to shareholders. Quite a transformation but one that, as you see, we have a lot of gas left in the tank in terms of the things that we can do to continue to drive benefits and scale and product.

But you really can't talk about resiliency unless you can talk about why is the revenue story different. If you think about where we made our money and where most of the industry made its money during past cycles and pre-consolidation, it was really in that gap between business and leisure traffic. The fares between point A and point B might have been \$150 for the deepest discount coach fare and \$1,500 for the walk-up first class fare, such that when you saw economic headwinds and the first thing any CFO does in the face of economic headwinds is says, get to the back of the airplane. So, you saw premium travel come sliding way, way down, ultimately resulting in a loss of that premium.

But when you look today, the difference between the main cabin and the different levels of premium experience and the first class experiences has narrowed considerably, as well as all those options for a purchase path that we talked about – that I mentioned earlier. That resiliency is expected to actually have a pretty significant benefit as we look through the downturn because you can, as a business traveler, comply with all your corporate travel policies but you have a separate and unique transaction where individually you can make a choice to buy up to first class or a premium experience. And you can do that with cash or you can also do that miles, improving the currency value of those miles in your portfolio to give you those choices in the event that you feel you don't want to spend dollars on that.

As a result of that, you can see how different our revenue picture looks between 2011 and 2018. The main cabin is about half of those revenues. And when you look at premium products, they've grown from 18%, nearly doubling to 31% of our total. And you see the growth in the loyalty program, doubling as well from 5% to almost 10% of the total revenue base that you see and we expect that to have a very different cyclical profile than what we've seen historically in the airline industry.

And then the ancillary businesses, like I talked about, this is going to continue to grow, our maintenance, repair and overhaul business, fueled by transactions with Rolls-Royce in which we're going to do heavy engine checks, and we built the new test cell which I believe was the first test cell built in the United States in over 40 years where we'll do maintenance, repair and overhaul on the large Rolls-Royce engines as well as the new Pratt geared turbofan. We're the exclusive North American engine shop for the GTF engine. We expect we'll be able to continue to grow those revenues into the future, again, leveraging that scale.

We remain focused on doing this with a consistent long-term non-fuel expense trajectory. We continue to believe that we can deliver over the long term less than 2% unit cost inflation. We'll be about that for this year. We did announce on our earnings call that we've guided to up 4% to 5% for the December quarter. Over 1.5 point of that is very unique onetime in nature as a result of lower treasury rates impacting some of the longer-dated liabilities,

workers' comp, disability programs, et cetera, as well as an actuarial adjustment for our long-term disability portfolio. That's resulting in a unique kind of onetime charge for the quarter. We are unique in our business in that we don't exclude items, and we are looking to include all of that into our reported earnings, which is why you see our unit cost ticking – trending a little bit higher. And we expect to be about 2% to 3% next year back into that range as we see – as we make some investments both in terms of employees as well as some of the customer service investments that I made reference to earlier in the presentation.

And that's an important piece. As we look at our fleet transformation, there's efficiencies that we will continue to generate both in fuel where we expect about 2% annual fuel efficiency from the re-fleeting of some of the older airplanes and replacement of some of the older airplanes as well as the cost efficiencies of up-gauging throughout the business and driving more people across our network in a more efficient manner.

So when you think about the combination of all those things, Delta is an incredibly powerful brand. We have several unmatched competitive advantages and they all start and end with our culture and with our people, because we're able to harness these advantages in a way that our competitors just can't and our fortress balance sheet which will help us weather any storm that we see coming forward as well as allowing us to take advantage of opportunities as they present themselves going forward to continue to improve the health and the projections of the company going forward. So we're very optimistic. We feel good about the demand environment, we feel good about our prospects heading forward and we're committed to stewarding those resources in a manner that is shareholder friendly. And we look forward to continuing to see those trends manifest themselves.

So with that, I'll open it up to any questions that you might have, Peter.

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## QUESTION AND ANSWER SECTION

Peter J. Arment

*Analyst, Robert W. Baird & Co., Inc.*

Q

Terrific. Thank you very much, Paul. Great overview. Still time for a couple questions here. Maybe just, have you been able to just quantify like the impact of the MAX grounding, how that's impacted your operations and how you've been able to kind of work through a lot of that and still serve all your customers?

Paul A. Jacobson

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

A

Sure. Well, we don't actually have any MAX airplanes. So one of the impacts out there you saw that manifest itself was really record load factors through the summer. We operated over 90% load factor pretty much from April through August. That had some impact, but the timing of the delays and when it's been coming out sequentially, a lot of that we felt had some impact over the summer, but not as much as you would think from that perspective, as summer travel tends to book pretty far in advance et cetera.

So we are hopeful that that airplane comes back. We have a lot of friends at Boeing and as you know in this business, we're very competitive. We never compete on safety. And that's the important aspect. And we're optimistic that Boeing will pull it out and will get that airplane back in the sky and eliminate some of this uncertainty that's out there about the prospects of the industry, because we feel good about demand and we feel good about where the industry is.

Peter J. Arment

*Analyst, Robert W. Baird & Co., Inc.*

Q

Terrific. And then just briefly on your – you mentioned the oldest fleet but you said that's changing rapidly. Maybe just talk about that path forward about how you're thinking about that.

Paul A. Jacobson

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

A

Sure. So the MD-88, we started the retirement of that fleet with over 120 airplanes. We're down to just under 40. Those will be out all by the end of next year. Those are being replaced with A321s, 737-900s next year. Some of them will be replaced with the A220 as we start to get more scale there. Beyond that, we've announced that the MD-90s are going to be out of the fleet by 2022.

And we're doing this in a very CapEx-managed and balanced way. I think one of the most important phases of capital allocation is that we invest within our means. If you look historically, every time we had strong free – strong operating cash flow, we ended up reinvesting all of it and then some and shareholders were really left behind with theoretical returns rather than actual tangible cash returns.

Peter J. Arment

*Analyst, Robert W. Baird & Co., Inc.*

Q

Right. Right.

Paul A. Jacobson

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

A

So we target our capital expenditures at 50% of operating cash flow. That has actually allowed us to grow our investment horizon. We've grown from about \$2 billion of CapEx to this year we'll do about \$4.5 billion and still generating over \$4 billion of free cash flow. That's the type of balance that we need to do going forward as we realize these benefits from re-fleeting.

So when you look down over the next decade, you've got 767s that will be up for retirement as well as some of the 757s and more narrowbodies. But we don't feel like there's a bow-wave. We feel like, at the end of the day, we can manage this within that specter. And I think the important thing is as managers, we're tasked with stewarding resources. And when you look at the fact that our return on invested capital has gone up by almost 300 basis points over the years while our invested capital base has grown by over \$2 billion dollars, that's ultimately what we're here for, is making investments in a balanced way and making investments that are going to drive ROIC for our shareholders.

Peter J. Arment

*Analyst, Robert W. Baird & Co., Inc.*

Terrific. Well, with that, we are out of time. So thank you very much, Paul, for joining us.

Paul A. Jacobson

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

Great. Thank you.

**Peter J. Arment**

*Analyst, Robert W. Baird & Co., Inc.*

Thank you, everyone.

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**Paul A. Jacobson**

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

Thank you.

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**Peter J. Arment**

*Analyst, Robert W. Baird & Co., Inc.*

Next up in here is Nasdaq. Thank you.

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