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Delta Air Lines, Inc. (DAL)

Cowen and Company Global Transportation Conference

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MANAGEMENT DISCUSSION SECTION

Helane Becker
Analyst, Cowen & Co. LLC

Okay. Good morning, ladies and gentlemen, and welcome to the 12th Annual Cowen Global Transportation Conference. I'm Helane Becker, Managing Director and Senior Airline Analyst and Aircraft Leasing Analyst. I'm joined in the audience by my Cowen colleagues from sales, as well as my associate, Conor Cunningham, sitting up here.

We're starting the conference off today with a presentation from Delta Air Lines' Chief Financial Officer, Paul Jacobson. And joining Paul in the audience today are Julie Stewart, Jill Greer, Elizabeth Lippitt, and Tim Heck, who is with Pilots Association I guess.

So I'm not going to take any more time. I'm going to introduce Paul and please take it away. Thank you for coming, also.

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

Absolutely. Absolutely. Well, Helane, thanks for having us today. It's always a delight to come to the conference and kind of sum up the summer. So I hope everybody enjoyed their Labor Day weekend. And as I saw a social media feed, lots of people sending their kids back to school yesterday, much to the chagrin of my children, who started a month ago. But delighted to be here. We're webcast today, so please understand that if you ask any questions, you will be on that webcast and recording.

We also, obviously, have some forward-looking statements today. Please read the Safe Harbor for the risk factors. Any information that you might need on those risk factors can be found on our Investor Relations webpage as well.

So, we are delighted to be here today to talk about the summer that we've had. It was an incredible summer by all standards. And so incredibly proud of the Delta team and all the people across the Delta system for the job that they did. We just completed August. August was our seventh consecutive record month for passengers carried.

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Year-to-date, we've carried nearly 8 million passengers more than last year, up about 6%. We're seeing increased engagement with our brand, rewards for the reliability and, obviously, a lot of the customer service improvements that we've made over time. And when you combine all of that together, what you see is a machine that is really accelerating its momentum in terms of cash generation, revenues, profitability and we'll get into that as we go forward.

This was a really challenging summer by all accounts. Those increased passenger volumes have taken a little bit of a toll on the system. People are a little bit tired and worn out, but really the Delta people did an amazing, amazing job through the summer. We had a pretty challenging summer from a weather perspective. We'll get into that in a little bit. But despite that, we're still running well ahead on our brand perfect days, which is 100% completion factor across the system. We're 100 days year-to-date, which is about 19 more than we were this time last year, despite having those weather challenges of the summer.

We continue to see Net Promoter Scores in the 50s, which is a far cry from where we were just several years ago when we were kind of in the mid-teens and we began this effort, and really what is creating some of that resiliency across the system both in terms of the passenger volumes, but also the revenue performance that you see.

And when you look at the performance of the Delta people, really kind of the least we can do of – announcing what we did last week of 4% raise for our ground and flight attendant population, continuing the trend that we've been on, as a reward and paying top-tier pay for top performance, and you'll see that across the board.

So want to just get the guidance out of the way, talk about where we've ended up in the summer. The demand remains strong. Our business is performing extraordinarily well. We've talked about the record load factors that we saw. The loyalty base that we have continues to pay big dividends across the system. And that brand momentum, that stickiness of getting customers attached to the Delta brand and using us for their travel, is continuing to drive that momentum. That really is centered around the culture and the employees.

So, while I think there's going to be a lot of news today from folks, we are just here really reaffirming what we've said in July. Revenue environment remains solid. We're on track to achieve our September quarter earnings and revenue guidance. We are seeing some pressure on non-fuel costs. That is coming from some of the things that I mentioned in my opening remarks of the weather pressures that we saw, the increased passenger volumes, and the loads through this summer, and some of the employee costs. We dealt with a lot of overtime over the summer, people going out and doing that extra mile to try to cover those customer needs.

Despite that, we're still on track for the EPS goals. But as we look out, with about a month to go in the quarter, we expect that we're going to come in at our high-end of our unit cost range or slightly above our guided range of 1% to 2%. We're working hard to try to offset that with some of the pressures that we've seen, has translated into strong profitability and EPS, but we are seeing that pressure on costs.

For the full year, we remain on track to deliver our updated guidance. So we initially guided top-line revenues of about 4% to 6% at Investor Day. We grew that, after we did the American Express deal, to 6% to 7% top-line growth, with solid margin expansion and 25% growth in EPS, and we remain on track to be able to deliver that through the year.

So, while you hear a lot of choppiness in the news about the global environment, we actually continue to see strength throughout the system. We do have some pockets of challenges, particularly ex-China and ex-Europe,

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but the domestic point-of-sale and the domestic system is really overcoming that, and the health that we see in the environment is strong and is giving us the confidence that we'll be able to hit the numbers for the year.

So I wanted to transfer a little bit to talk about our journey. Many of you have seen all of the elements of this journey, but we thought it was important today to reset a little bit in terms of how people were thinking about where Delta is positioned. We get a lot of feedback about we were the first to merge, therefore we've done it all and everything has really already manifested itself in our results.

But if you really think about what's happened in the last decade, we spent the first part of the decade really establishing our foundation. If you recall back then, while we were growing cash flow, it was still relatively small and we were deploying all of that into the balance sheet, into the product. We had to lay that foundation in an effort to make sure that we were strengthening the base that we were going to build on.

So, as we looked at making improvements in the product and reliability, we were really just getting started. We were able to achieve an investment grade rating during that phase, we were able to get back into the S&P 500, and we began the steps of establishing a shareholder return program. That foundation is what laid the path for the – and the groundwork for our success that we're seeing today.

But as we worked then and evolved and strengthened those competitive advantages, we focused on reliability, we focused on segmenting the customer experience, and really de-commoditizing the way we face our customers. We were investing in our hub structure, which, as we've said many times before, we feel is a far superior network across the system and what represents one of the core sustainable tenets of the Delta investment thesis.

Well, that wasn't enough, just to have that position. We also wanted to make sure we were leaders in Net Promoter Score in customer service, because ultimately that's what we wanted to do, is to drive that revenue premium. And we've done that very successfully, which takes me to the reason for this slide, because a lot of people will say, great, you've done that, what's next?

Well, the reality is what's next is probably even more exciting than what the last decade has been. We've got an increasingly diverse revenue stream, the likes of which we really have never seen in our history. We've got scale certainly that never has been replicated in the industry. And we're using that to not just get bigger, but to actually invest in delivering personalization, where we can, to our consumers. And that's what's fundamentally different about the business today. It's no longer just about, am I only going to get business fares to drive my outperformance in cycles? It's really about facing the customer in a different way to deliver better experiences for him or her based on what he or she would like to buy.

So, as you think about our platform and what we've created, there is a little bit more complexity in the system, and that's where some of the cost performance that we've seen. But that complexity in the system is actually leading to much better pass and much better resiliency across the revenue stream that we think.

And when you add to that the fact that we're doing this with the most complex fleet certainly in the U.S. and, I'd argue, even across all global airlines, the benefits that we see over the next decade of fleet simplification can help drive even more acceleration in our momentum and allow us to not only maintain our financial leadership position, but dare I say, even expand upon it, because it is all built on that foundation of culture and the network.

And this kind of shows you the phases that we've been in, as we look at page 4, that those years of establishing a solid foundation, we had limited cash flow, $1.4 billion of operating cash flow, you look at 2009, which was the last year that we lost money. We're a fundamentally different company than when we were back then.

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For example, in 2009 we had a little under $2 billion from American Express. This year we'll have $4 billion. We had $1.7 billion of interest expense and pension expense. Today, that number this year in 2019 is going to be about $100 million net. We had $1.3 billion of fuel hedges. Today, we don't really hedge fuel of any significance and, in fact, deliver a $0.04 to $0.06 per gallon advantage versus the rest of the industry because of the refinery and the investments we've made in those logistics.

So what we've been able to do is we went through and built that foundation. We strengthened those competitive advantages and really drove an improvement, not only in income, but also the cash yield of the company and the operating cash flow. And as you look to 2019 and beyond, that momentum is only accelerating as we continue to increase our free cash flow conversion as a result of the power of the American Express relationship and how that works through our financial statements.

So, we've guided this year $8 billion to $9 billion of operating cash flow. We've just chosen the midpoint for this slide, but really accelerating that momentum across the board. And while CapEx has gone up, our free cash flow has also improved over this time period and we're expecting to deliver over $4 billion this year and, as we've committed to, returning $3 billion of that back to our shareholders, while still investing $4.5 billion into the airline.

Slide 5 shows you a little bit about what I mean about that top line resiliency. So if you look at the inside of this chart, you'll see that in 2011 almost two-thirds of our revenue base was really Main Cabin revenues. We had a small segment of premium products. Loyalty was but a blip from that perspective. And we had some ancillary and cargo revenues.

Those ancillary businesses are continuing to hum. We've got a lot of momentum, as we've talked about before, particularly in the maintenance, repair, and overhaul space with the Pratt & Whitney Geared Turbofan deal and the Rolls Royce joint venture. We continue to expect to see that business grow and develop, as we have found ways to monetize and really take advantage of our competitive advantages around productivity and the expertise that we have in maintenance, repair, and overhaul.

But since that time in 2011, you see the massive change in segmentation. So premium products are about a third of what we do now, Main Cabin is down to half, and we've doubled what we're getting from the loyalty program, particularly under American Express. And as we've said before, that $4 billion that we expect in 2019 will be growing to about $7 billion by 2023, showing you the momentum that we have in that business and what loyalty means to the airline is a really strong growth in free cash flow conversion across the board.

Now, many investors have looked at this and said, well, your increased reliance on premium revenues should make you a little bit more volatile during an economic cycle, because, as we all know, historically what has happened is the loss of premium revenue and business traffic has been what ultimately led to the down cycles, because Main Cabin kind of trucked along at a normal rate and we saw the cyclicality in business fares but that really doesn't do justice to the story, because we have fundamentally transformed the purchase paths as well. So, now when corporate customers maybe in economic headwind scale back and pull people to the back of the cabin from the Comfort+ or from First Class, we have multiple purchase paths available for the individual traveler to make a decision on his or her own based on what he or she values.

So, if you want to comply with your corporate travel policy but you'd still like to fly First Class, you have an opportunity in a separate and unique transaction to buy that using cash or perhaps using SkyMiles. The value of that currency has gone up and the ability to use it for the individual traveler has also grown. So we actually expect that with those multiple variables, the multiple purchase paths, the ability to use cash or miles through the process

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is actually going to lead to more resiliency and premium revenues, not less, because we also have multiple tools to revenue manage the cabins. So, not only is it just the difference between First and Coach. It's also the difference between what can I do between First and Comfort+, and what can I do between Comfort+ and the Main Cabin, in an effort to stimulate demand where it might fall short.

So, the long and short of it is, we have many more tools at our disposal to manage through changing demand patterns than we've really ever had before. And as a result of that, we expect that this will ultimately lead to more resiliency, not less, in and through the economic cycle, whenever it may come. But in the meantime, what we're doing is we're focused on serving our customers to the best of our ability, exceeding their expectation, and giving them choice for how they want to interact with the brand, and that's led to pretty amazing results.

So, when you combine that powerful brand to the competitive advantages that we have, and we've gone over this many times and we're very proud of each and every one of these, but nobody can really stand with us on the culture. We've created the fortressed balance sheet. We spent years doing that in an effort to, as I frequently say, study for this final exam that is a recession, whenever it might happen.

But we're not just sitting around waiting for that. We're using that brand, we're using that scale to drive even more customer loyalty and stickiness through our operational reliability and our network, and that has led to the type of top-line growth and, ultimately, the capital allocation that has put us in the industry leadership position, and one that we expect to maintain, if not grow over time.

So, those are just some quick remarks. I wanted to make sure that we left plenty of time for Q&A, because I know there's probably a lot of things on your mind. So, Helane?

QUESTION AND ANSWER SECTION

Helane Becker
Analyst, Cowen & Co. LLC

Q

Great. Thanks, Paul. I'm going to sit over here.

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

A

Okay. Well, you want to sit here then? I don't want you to stay sideways.

Helane Becker
Analyst, Cowen & Co. LLC

Q

Feels like we're playing musical chairs. Okay. I've hooked this up. So, hopefully this is working. Okay. That was a great presentation. Thank you very much, and thank you very much for coming. So, one of the things that you talk about is culture as an advantage. How did you get buy-in from all your employees to the program and get to the point where you are today? I mean, it's not just money, because, as you pointed out, you do pay for exceptional work. But everybody is still within the range of, I think, what most of their peer groups are earning, or maybe that's not right. So, maybe you can just talk a little bit about how you got buy-in from your people.

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

A

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Sure. Well, as we've said for a long time, Helane, I appreciate you recognizing it, is culture is not something you put on a memo and dictate to the organization that this will be our culture. Culture is ultimately what's born out of the values of the company. And as we focused on serving others and we focused on serving each other, that's where the culture is born and that is, I think, probably the most important thing that we have at Delta.

And we haven't always gotten it right. We've gone through some real challenges. There were times historically, even in my 22 years, where we faced losing the culture, and in a lot of ways that brought us even closer together. And that's important. And as you look at compensation, that's just but one element. At the end of the day, the core value proposition is, am I satisfied coming to work? Do I enjoy the work that I'm doing? Do I feel like I'm supported by the company? And am I getting paid for the results? And that's where the profit sharing program comes in, and the fact that we've paid over $6 billion in profit sharing to our people over the last five years is something that no company really on the planet can say. And that is a strong statement of how we think about everybody's ability to drive profitability and revenue into the company, because, as I say in classic finance, we're often trained to look at people as a cost center.

Well, the way to manage a cost center is really very simple, right? Pay less for something or have less of it, and that's not at all the way we want to look at, at human capital and the people of Delta. So, we really look at it as every employee of Delta is a revenue ambassador of the company, whether you're in the community or at work, and we have people that really own that and feel very good about it. And as a result of that, I think things are just different at Delta, and that's an important part of who we are.

Helane Becker
Analyst, Cowen & Co. LLC

Q

That's great, because it certainly shows in all your numbers and the entire presentation that you made, and the fact that you're probably one of the few airlines today that's actually reaffirming guidance as opposed to talking to the midpoint or talking to the low-end of the guidance. Clearly you had a good summer.

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

A

We did have a good summer and that doesn't mean it wasn't hard. I referred to in my presentation about overtime and the costs that we've seen. This summer was a stretch. I mean, we were bursting at the seams in terms of passenger loads. You saw that in our monthly traffic reports. And it's important that we kind of collect ourselves and make sure that as we think about what it takes to serve the company, that we arm our people with the resources and the capabilities and the tools and the training to be able to deal with those high passenger loads, and we probably need to invest in that space and you'll probably hear more about that to come.

Helane Becker
Analyst, Cowen & Co. LLC

Q

So, as you think about this, like I don't know what the right number is for load factor, right? This summer you did 90% load factors and I think through the year you're doing sort of mid-to-high 80% load factor. What's the right number? Do you have to invest in more aircraft? Do you have to expand or do you have to switch to a larger aircraft? How are you thinking about this, getting through the future peaks? Because if you continue to do so well, people want to fly Delta versus other airlines.

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

A

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Yeah. Well, I'm not the operations expert, but I think I can speak for Gil when I say that the right load factor number is less than 90%, less than what it was this summer. I mean, this summer, obviously, was the confluence of some of the challenges across the industry with the MAX we ended up picking up. We ended up picking up additional passenger volume there. And the challenges are, on a perfectly sunny day, can you fly at 90% every day? Yeah. But with the type of weather issues that we had, recovery becomes very, very difficult and you start to diminish the passenger experience. So I think we all look back at the summer and say, it was really busy and we've got to reassess, because we can't continue to operate the airline at that level of stress, bursting at the seams with the types of loads that we've had.

Helane Becker
Analyst, Cowen & Co. LLC

Q

Got you. So I'm going to switch gears for a second and ask about the Narita hub. So you're moving everything to Haneda now. So does that mean that Narita hub has to get written off?

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

A

No. So years ago, we actually combined all of the Pacific operations and route slot values, et cetera, into one asset on the balance sheet. And what we're really doing is kind of shifting that hub network from Narita into Seoul. So, the shift to Haneda, what that's done, is it separated the origin and destination Tokyo traffic to Haneda from the hub in Narita and no longer could you support, because you didn't have the combined efficiencies of those passenger flows to sustain that hub.

So what we've done is we've formed the joint venture with Korea and we've moved many of those connecting and interport flights to Incheon, where we actually have more connectivity than we could have ever had at Narita, and it gives us that volume to be able to flow into the southeast region. So, we still feel very good about that asset and where it sits and we don't expect an impairment.

Helane Becker
Analyst, Cowen & Co. LLC

Q

Okay, great. And then when you talk about – your passenger revenue is now 48% of your total – or Main Cabin, I guess, is 48% of total. Where can that go?

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

A

Well, I think we're still in, what I would say, the early to middle innings on passenger segmentation. So, even just earlier this year is when we rolled out the ability to pay with miles. In some of the early rollouts without advertising, it even exceeded our earliest expectation. So we know that's going to be successful. We need to use our tools to make sure we're marketing at the appropriate level. We're personalizing the marketing where that's appropriate to do and just learning from the systems.

Part of the revenue management systems, as we all know, through consolidation they go through periods where they're learning too, right, understand how does the Comfort+ cabin look over time, how do we see people post-purchase coming in and buying upgrades, and making sure that we get a good core history of the demand for each of these products, not just at the point-of-sale, but post-purchase as well.

So, we're getting better at that every day. But as you start to – we still are rolling out the Premium Select cabin internationally. So there's another level of segmentation here. And we feel pretty good about the growth rate in

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revenues across the premium cabins. In fact, as we've disclosed it, you've seen that growing pretty healthy double digits for a while now, and we still see good opportunity ahead of us.

Helane Becker
Analyst, Cowen & Co. LLC

Q

Great. And then, what do you think the – other than a recession, what do you think the biggest challenges are facing the company over, say, the next three to five years? As you guys look ahead – I mean, you don't just look ahead to the next quarter, right? You're looking three, five, seven years down the line. And, obviously, in your presentation, which I thought was terrific, took us over the last decade to go from where you were to where you are, and again, you have to start planning for the next decade.

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

A

Right.

Helane Becker
Analyst, Cowen & Co. LLC

Q

So what are the biggest challenges that will be facing you?

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

A

Well, I think, just to follow on what you said within the question, I think the biggest opportunity ahead of us, and I'll talk about the challenges, is I was having breakfast with a longtime friend this morning and I mentioned this that at the end of the day this industry has never seen the benefit of compounded annual investment, right? By this time in a cycle, we've already been undoing all of the brand improvements that we did in the prior cycle historically, because we were fighting for our survival.

So, as much as we've seen transformation over the last decade, I actually think the next decade is going to be even more exciting, whether it's digital personalization, more brand segmentation, the growth in the American Express card program. The level of investment out there is really unprecedented and certainly laying even a stronger foundation for what we see over the next decade. And I think our biggest challenge is we're deploying a lot of capital today. So, there is the core capital in the fleet.

Last year, we inducted I think – or this year, I think, we're inducting 87 airplanes into the fleet, which is by far a record year. We'll have over 60 next year. There is a lot of effort going into deploying this capital. And for us, it hasn't really been an issue of we don't have enough ideas or we don't have enough capital to do the things that we've done. We're limited based on the human capital to implement that.

So, you look at $12.5 billion of airport projects and construction projects, most of which we're managing ourselves, it's a big strain and we've got to get that right, right? We've got to be able to deploy the capital effectively, and we've also got to be able to design these terminals that they're going to survive through a generation or two for what evolving customer needs are.

LaGuardia never anticipated the types of interactions that customers were going to have when it was built 50 years ago. We've got to be able to make sure that if we're going to put that level of capital into that facility, we design a world-class facility that is going to make it easier for customers to travel.

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And one of the things that I've said publicly before is, I think one of the interesting developments in the business is we're all kind of reaching the end of what we can do to compete onboard the airplane for differentiated service. The next arena of competition over the next decade or so is going to be in that airport. What can you do to streamline the customers' experience and enhance the customers' experience for the airport part of their journey, and we've got a lot of ideas and we're deploying a lot of capital in that space.

Helane Becker
Analyst, Cowen & Co. LLC

Q

So one of the things that brings up is how congested – or maybe they're not congested; the skies are. But certainly air traffic control hasn't kept pace with what you guys are doing. How do you get the government to move off this air traffic control delay issue every day, ground delay programs, the whole issue? I mean I know – and I fly back to Newark, I know if I'm pulling up at rush hour any time between, say, 4:30 and 7:00, I'm going to be at least one to two hours delayed. And I build it into my schedule. But that's not a good way of managing customer expectations, and I know you guys are not big at Newark, but there are other airports around the country that have those same issues. So how do you manage what you guys want to do and can do with what the government is sort of allowing to be done?

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

A

Sure. Well, I mean, the first tenet of what we do every day – and this is true of any carrier that's going to speak today – is safety. The second one is safety. The third one is safety, and we need to make sure that whatever changes get made, safety is at the forefront for our people and for our customers as well. So, there's a lot of good work going on with next-gen technology and with all things, it tends to be slower than we all think it should be. But there is progress, and I think ultimately we need that and we owe that for an infrastructure that more than any other country on the planet is focused on air travel as its primary means of long distance efficient travel.

And I feel like we're going to make strides. In the meantime, we're looking at things where we've partnered with the TSA, we've made investments for the TSA down in Atlanta with some of the screening systems and so on, try to help them out in a joint effort to improve the customer experience where we can, and it's that partnership that I think is somewhat unique in the world working with the regulators and both having that customer focus in mind.

Helane Becker
Analyst, Cowen & Co. LLC

Q

Great. Got you. Is there any questions in the audience? We have about a minute or two if there's any audience questions. I know I always – once you give an analyst a mic, not given enough. Anyway. Just for the webcast.

Q

Good morning. You've announced expansion plans here in Boston. Can you talk about not only that, but your thoughts over the next several years of capacity expansion, and where and how you think about it?

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

A

Yeah. So that's a great question. We are growing in Boston. We've talked about Boston being a really important city for us. A lot of international connectivity opportunities for us as we grow that, and we'll be filling up our terminal and see some of the move signs of what's happening there now. Despite the growth, Boston has actually

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been one of our strongest margin improvers and unit revenue generators over the last period of growth and we feel good about that.

But if you think about our strategy, we are growing where the top revenue cities are. And if you look, I think, across the top 100 revenue generating cities, I think we're number one or number two in about three quarters of them across the system. So we see lots of opportunity out there and Boston is a good fit for us. It's not the first time we've been here, but we feel like with our scale, with our brand, there's a great opportunity for us to expand the global network right here. And so far it's performing quite well.

Q

Any further expansion?

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

A

Well, it's generally focused around our hubs. So, we spent a lot of time with gauge and those coastal hubs. So you look at the work that we've done in Seattle. Everything that we can do to grow in Atlanta has got a great return on it and you've seen that in the past. You see the work that we're doing at L.A. with that terminal project connecting into Terminal 2 and 3, and having that connectivity to the Tom Bradley International Terminal will have a very unique and streamlined customer experience there on the West Coast. But we've taken these strong revenue cities and really improved our presence, which you've seen as a way to monetize that brand premium that we've been able to establish. And in partnership with American Express, we can jointly market to areas where one or either of us has a particularly brand advantaged position. We can leverage that to grow the portfolio together as well.

Helane Becker
Analyst, Cowen & Co. LLC

Great. Okay. And in interest in keeping everybody on time and I know some one-on-ones are up for you next. So, we'll say thank you all very much, and see you next time.

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

Thank you, Helane. Thanks everybody for joining us.

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