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Delta Air Lines: Ready For Unexpected Turbulence?

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Fierce and growing competitors, low switching costs, hurricanes, terrorist attacks, geopolitical hostilities, government regulation, high costs of fuel, labor, insurance and capital, over indebtedness, stringent emission standards, and on and on… the risks facing global airlines are enough to make your head swirl. With such a tumultuous operating environment it is no wonder that in 2005 Delta Air Lines (DAL), Northwest, United (UAL) and US Air (LCC) were all bankrupt.

In fact, according to an article published by CNNMoney in September 2005 nearly half the capacity in the U.S. airline industry was operating under bankruptcy court oversight. (CNNMoney: Delta Air Lines Files for Bankruptcy)

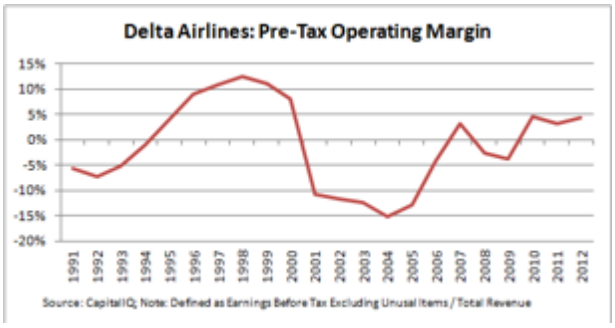
Given the history and structure of the industry it is surprising that Delta recently announced it was planning on resuming its regular dividend and returning an additional $500MM in cash to shareholders via a share repurchase. All in, Delta communicated that it intends to return more than $1Bn in cash to shareholders over the next three years.

After preliminary analysis of Delta's investor presentation (Delta: A Balanced Approach to Capital Deployment) we find that the company's strategy has two potential fatal flaws embedded in it.

First, with regards to the ongoing "regular" dividend: As discussed above Delta and all airlines face tremendous operating risk; additionally Delta faces significant financial risk. Based on the company's filings it had Adjusted Net Debt of $11.7Bn and $13.3Bn in unfunded benefit obligations or fully adjusted net debt of approximately $25Bn (as of December 31, 2012). That's a significant amount of debt for a company that generated approximately $5.2Bn in Earnings Before Interest Tax Depreciation Amortization and Rent (EBITDAR) last year. In fact, the total debt is roughly 1.6x more than the company's current market capitalization.

In the investor presentation Delta's management does stress that its Capital Deployment Strategy still emphasizes balance sheet improvement and debt reduction. Yet, like all financial analysis the devil is in the details. Page 13 of the company's filing (see link above) shows the assumptions embedded in Delta's five-year plan, which drives its Free Cash Flow (FCF) generation and subsequently its Capital Deployment Strategy.

The first bullet point is eye-catching. It reads "steady pre-tax margin expansion over the next five years." Now clearly no one knows what the future holds but in this industry assuming steady margin expansion for five years is a fairly bold input to a planning model. In fact based on analysis of Capital IQ Data (chart below) Delta hasn't experienced five consecutive years of margin expansion since the mid-1990s.



The investor presentation goes on to say (last bullet point on page 13) that the five-year plan assumes "unfunded pension liability steadily declines over the entire period assuming no change to funding levels or financial market conditions."

Delta's management goes on to assert (on page 19 of the report) that it expects a 9% return on pension assets, which (along with the minimum pension contributions) ultimately reduces the unfunded pension liability.

In today's low yield, highly volatile market it seems difficult to assume both no change to market conditions and a 9% return. This raises the question whether the company will be able to reduce its pension liabilities as expected or whether they'll need to devote more cash or cash flow to it over time.

All of this is to say, given Delta's volatile past performance and ruthless industry conditions management may be better served by building up its cash balance to further enhance its liquidity in preparation for the next (inevitable) cyclical downturn. For a company like Delta, its "optimal capital structure" likely requires more financial slack than its current capital deployment strategy suggests.

As famed financier Michael Milken once said: *"over the past four decades, many companies have struggled with the wrong capital structures. During cycles of credit expansion they've often failed to build up enough liquidity to survive the inevitable contractions."*

The second potential fatal flaw with Delta's strategy relates to the $500 million share repurchase authorization. While a share repurchase carries the same financial risk discussed above (reduced liquidity) it also carries an additional "valuation risk." In other words, for a share repurchase to create value the company must repurchase shares when they're "low" rather than when they're "high." This is no different than any individual investor making a stock purchase decision or the decision by one company to acquire another.

Delta's share price has increased more than 50% year to date and more than 70% over the past year. Initiating a share repurchase after a "big run up" in price would seem to leave little room to create additional value thereby increasing the "valuation risk." It would have been much better for the company to buy back shares a year ago when they were trading at $11 rather than at their current price of $18.

However, given its highly levered capital structure Delta's management faces a dog-chasing-its-tail conundrum with regards to share repurchases. The company has significantly improved its operating performance, which has led to significant FCF growth. However, it also resulted in share price appreciation.

This makes it difficult for a highly levered company to make shareholder value accretive repurchases since cash flow growth tends to lead to share price growth. If the company had greater financial slack it could be more opportunistic in its buyback strategy and repurchase shares when they're trading at an abnormal discount like they were a year ago.

If the company is intent on distributing cash rather than increasing liquidity management may want to consider a special dividend. Given Delta's relatively high current share price a special dividend preserves the flexibility of a buyback and eliminates the "valuation risk."

So while investors generally applaud dividends and repurchases initially our preliminary analysis indicates that this may not be a sound capital deployment strategy for Delta as it leaves the company overly exposed to the turbulence inherent in its business.