

Update on Our Investments in U.S. Airlines

This article is excerpted from a letter by MOI Global instructor Phil Ordway, Managing Principal at Anabatic Investment Partners, based in Chicago, Illinois.

Alaska (ALK) remains our largest airline investment. We have also added to our investment in Delta (DAL) while selling some of our shares in Spirit (SAVE).^[1]

There is never a dull moment in the airline business, and the first half of 2019 was no exception. Gyration oil prices, fierce competition, swirling macro conditions, and the Boeing 737 MAX tragedy and grounding made for plenty of headlines. In reality, most U.S. airlines did well and continued to make slow, steady progress.

Across the domestic industry the big picture hasn't changed much since last year. Passenger demand remains strong. Costs have increased, but the rate of change has slowed and come (mostly) back in line with pricing. Most balance sheets are healthy. The competition is fierce but rational. Margins should improve in 2019 for the first time in a few years. Levels of free cash flow and returns on capital remain appealing, especially as weighed against the prevailing market prices.

If the airlines simply mailed us a check with our share of the company's cash earnings, my guess is that all of us would feel much more confident and secure. Instead, the quoted market prices next to the word "airline" continue to create one of the widest gaps between perception and reality that I've ever seen. So long as the business-level analysis is correct that is a gap we can exploit. As always, the best gift we can get as investors is low expectations.

Alaska

ALK has made progress integrating Virgin America. The network and workforce are being fine-tuned, and the cost structure is in good shape. More than half of the acquisition financing has been repaid and the balance sheet is healthy. Margins should improve this year, and management's goal of 13-15% pre-tax, through-the-cycle margins is achievable. Free cash flow has remained significant and should grow in 2019 and beyond as margins improve and capital spending declines. There is also a meaningful chance of striking a new loyalty-program credit card agreement with Bank of America just as Delta recently did with American Express (see below).

The cultural aspect of Alaska might be the most encouraging element. In my experience there are many organizations with a pocket of talented people or a few prominent executives that exude excellence, but it is rare to find a company with exceptional people at all levels. The people I meet at Alaska - from gate agents and flight attendants and pilots to HQ staffers and senior executives and board members - are impressive. They are enthusiastic about working for their company and serving the customer, and it is impossible miss the difference when compared to most of their peers. There is no way to quantify this cultural edge, but it is a massive advantage over time.

Delta

DAL is now our second-largest airline investment and our fourth-largest overall. Our initial purchases in the first quarter of 2018 were small, but we added at several points throughout the year. In January and March of this year we bought more shares just before two important developments came to light.

In early April Delta announced an extension of its partnership with American Express through 2029. The extension came earlier and the duration is longer than expected. The deal also comes with better economics for Delta.^[2] A lot has changed since the years after 9/11 when AmEx tried to keep Delta out of bankruptcy court by pre-buying SkyMiles at cut-rate prices. Today, the balance of power has clearly swung in favor of Delta.

The new agreement – which was effective retroactively on January 1st of this year – comes with relatively few details, as both the airlines and credit card issuers keep the specifics under lock and key for competitive reasons. But Delta did disclose that its estimate for the cash flow contribution from AmEx each year will grow from \$3.4 billion in 2018 to \$7.0 billion by 2023.^[3] That is a huge improvement from Delta’s perspective, and with some well-founded assumptions it is reasonable to expect that Delta will now generate \$2-4 billion of free cash flow per year just from the American Express relationship.^[4]

A fountain of free cash flow has many obvious attributes, but the AmEx cash flow also comes with an element of “float” – Delta gets paid each month, but the redemptions don’t occur until months or years later. There is also a substantial amount of “breakage” due to miles that go unused.^[5] Delta gets the benefit of both time (the cash upfront can replace debt or equity financing) and margin (attractive deal terms and a mid-teens breakage rate). The only major risk of disappointment on this front would be a cataclysmic failure by either Delta or American Express, or a complete overhaul of the global payments industry. Neither is impossible, but our odds are favorable.

The second major development was announced soon after the American Express extension: Delta repurchased more than \$1.3 billion of its stock during the March quarter, retiring almost 4% of the shares outstanding at attractive prices^[6]. It was particularly encouraging to see the company accelerate its repurchases to acquire a meaningful amount of stock based on the opportunity in the market.

Delta has many virtues and shares a positive culture that is similar to Alaska’s. The difference in reliability and customer service that Delta provides relative to its network peers help reinforce a virtuous cycle. Delta can charge more for tickets, and it takes much of that premium and reinvests it in even better reliability and service. It then widens its lead and wins more business at a premium.

Delta also has an industry-leading billion-dollar MRO business and a \$2 billion collection of equity investments in its international JV partners.^[7] Its competitive position in its key hubs would be almost impossible to replicate, and management is making investments that should pay off for years to come.

Spirit

SAVE is doing well both financially and operationally. It continues to grow at a high rate and may produce higher margins this year than last. The roll out of “Basic Economy” by many of its network peers didn’t crush pricing or demand, as feared by some, and it may have helped

legitimize the “ultra-low cost” concept in the minds of many flyers.

Two concerns stand out. One is Spirit’s lack of a big loyalty program. Spirit’s non-ULCC peers like Delta and Alaska get a working capital benefit and a boost to margins and ROIC that are huge advantages over time. Spirit’s business is attractive in many ways, but the lack of a powerhouse loyalty program still hurts.

The other concern is the prospect of a dual fleet. Spirit needs to place a large aircraft order within the next year or so, and it is considering the Airbus A220. The A220 has many virtues, but it would add quite a bit of cost and complexity. It might also signal a shift in strategy and it would likely reduce the attractiveness of a potential tie-up with Frontier. The company’s fleet decision – which has already been delayed – should be announced later in 2019.

^[1] This section contains references to prior letters and presentations. Please email us for a copy.

^[2] “The new agreements increase the value we receive,” according to page 31 of Delta’s March 31, 2019 10-Q filing.

^[3] Delta’s results prior to this extension had been consistently ahead of expectations, and its previous estimate for 2021 was >\$4 billion, a level it is likely to achieve in 2019. According President Glen Hauenstein on the 1Q19 conference call, “In 2019, our total contribution from American Express relationship will be over \$4 billion, up from the \$3.7 billion we previously expected. Over the next three years, we expect continued solid growth with a more significant step-up, starting in 2023 that will drive our total contribution to nearly \$7 billion, double what we achieved last year. We expect the [incremental] revenue benefit to Delta in 2019 will be approximately \$500 million.” [emphasis added] <https://news.delta.com/american-express-and-delta-renew-industry-leading-partnership-lay-foundation-continue-innovating>

^[4] All estimates are based on our analysis and assumptions. Starting with \$1.2 billion of cash flow in 2009, Delta generated \$1.7 billion in 2012, \$2.0 billion in 2014, \$2.7 billion in 2016, and \$3.4 billion in 2018, which management estimates will grow to \$7 billion by 2023. Using Delta’s disclosure of “Other Revenue – Loyalty Program” that captures “brand usage by third parties and other performance obligations embedded in mileage credits sold, including redemption of mileage credits for non-travel awards” we can begin to estimate the margins and economic results for Delta. Please email or call to discuss further.

^[5] Alaska estimates its breakage at 17.2% but Delta does not disclose a specific number. Our research suggests that 10-20% is a reasonable estimate for most U.S. airlines. We also estimate the “duration of float” – that is, the average time between cash payment to the airline and the ultimate redemption of awards – at 1 ½ to 3 ½ years, depending on the airline.

^[6] Share repurchases of \$1.3 billion in the first quarter of 2019 were made at an average price per share of \$50.55, a price we believe to be beneficial to continuing owners. \$268 million of repurchases in the second quarter were made at prices between \$50 and \$60 per share.

^[7] As of June 30, 2019, Delta had significant equity investments in global airlines such as Virgin Atlantic, China Eastern, Air France-KLM, Aeroméxico, Korean Air, and others, carried at \$2.3 billion.

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