This article[1] is excerpted from a letter by MOI Global instructor Phil Ordway, Managing Principal at Anabatic Investment Partners, based in Chicago, Illinois.

Airlines (ALK, DAL, and SAVE)[2] – Our three airline investments remain a significant part of the portfolio and I remain optimistic about our prospects. Several factors have made U.S.-based airlines far better businesses than they were a decade or two ago, and I believe their momentum is accelerating. Competition is rational, demand will likely grow over time, balance sheets are healthy, and cash flow is pouring in. But it's not all sunshine and rainbows – despite all the improvements this remains a tough industry. It doesn't take much to screw up an airline, and the competition is unrelenting. I am clear-eyed about the challenges these companies face and I am more than willing to reverse course should the facts dictate a change.

The game theory of U.S. airline competition is fascinating, and few industries better capture every element of microeconomics *and* macroeconomics better than the airlines. One journalist covering the sector is known to say that no matter what is happening in the world, there is always an aviation angle.[3] He's right, and the same idea could be applied to the airlines as businesses. Pick any topic in economics or finance and it will somehow be applicable to the airlines.

An already multifaceted situation was made more challenging in 2019 by the grounding of the 737 MAX. There is not much new to be said on the topic, but the results of 2020 will have long-lasting ramifications. Major fleet changes and even an acquisition or two are dependent on the MAX and a few other variables. There's never a dull moment, but as investors we can take advantage of that endless flow of information – which should be nothing but background music for long-term owners – by applying dispassionate analysis and patience. In a sector that is overfocused on answering, "What's next?" we should pause to ask, "What's it worth?"

In January and October 2019, we bought more shares of **Delta (DAL)** and it is now of almost equal importance to our investment in Alaska (ALK). Delta shares returned 20% in 2019 but the business improvement was even more significant.

Operational performance reached all-time highs, with many metrics – cancellations, on-time arrivals, baggage handling, customer satisfaction, etc. – reaching levels that were thought to be unrealistic just a few years ago. Delta is widening its lead in happy customers, and it is also getting paid for its performance with a meaningful revenue premium over its peers. The biggest news of 2019 came in April when Delta announced an 11-year extension of its co-branded loyalty program with American Express. The power dynamic is in Delta's favor, but both sides win by securing this agreement through the end of the decade. Delta will benefit from billions of dollars in annual cash flow on terms that were improved from their already-lucrative levels. That cash flow provides both "float" – money Delta can use at better-than-free rates for at least a year or two – and a high-margin stream of earnings.

Delta also extended its vast international influence with a September 2019 acquisition of a

minority stake in LATAM, the leading airline in South America. Delta paid $1.9 billion for a 20% equity stake and it will invest an additional $350 million in a new strategic partnership, creating the biggest airline alliance between North and South America.[4] LATAM adds to a multi-billion-dollar portfolio of equity stakes Delta owns in international carriers.

The most encouraging development in 2019 might have been a shift in capital allocation and investor relations policies. In the first quarter of 2019 Delta took advantage of a market dip to repurchase $1.3 billion of stock, retiring almost 4% of its outstanding shares.[5] Delta saw an investment opportunity and took decisive action to seize it, just as any ongoing partner would hope. That simple logic is all too rare in corporate America when it comes to share repurchases. Delta is likely to produce several billion dollars in free cash flow each year, through the cycle, and rational investment of that capital could produce exceptional results for owners.

At Delta's December 2019 investor day – an impressive event in many regards – management announced changes to its IR practices that will emphasize a long-term perspective.

- Monthly traffic reports and end-of-quarter financial updates have been discontinued.[6]
- Quarterly EPS guidance has been eliminated and financial guidance has been streamlined.
- Enhanced disclosure around the loyalty program, fewer adjustments to key performance metrics, and new multi-year financial targets are forthcoming in 2020.
- The annual investor event is moving from December to June in hopes of focusing attention on multi-year horizons rather than the outlook for the upcoming fiscal year.
- Management compensation will now include a tie to rolling three-year free cash flow generation.[7]

I am a big supporter of these efforts to steer investor and management attention toward the issues we should care about as owners.

The people at Delta – from senior management to frontline employees to the board of directors – are exemplary in many regards.[8] An ingrained culture of customer service, an employee-centric management philosophy, and a sense of ownership make a powerful combination. Delta is an impressive company and one I hope to own for years to come.

We bought more stock in **Alaska (ALK)** in March 2019. ALK shares returned 14% for the year but the company made headway that I believe is not yet reflected in the market price. Overall, our Alaska investment has produced essentially no return over the more than two years we've owned it. As noted above with regard to Armstrong, that alone should not be a cause for concern.[9] The business performance and outlook for future profits and cash flow will be the primary drivers of our ultimate return.

The merger with Virgin America is now almost complete. In hindsight, the deal brought the added scale management sought, but it also brought challenges. Thankfully the integration was well-managed from an operational perspective, and there are no signs that the company

suffered a decline in its culture. Over just three years Alaska has paid down roughly 75% of the debt used in the all-cash acquisition. The balance sheet is now in good shape and offers the flexibility Alaska will need to respond to future problems or opportunities.

Alaska posted solid operational performance in 2019, and margins reverted to a level closer to what I view as normal. Customers remained happy with Alaska's level of service, and improvements to the fleet and airport facilities should pay off in future years. Looking ahead, Alaska is positioned to produce good returns on capital and many hundreds of millions of dollars in free cash flow each year. Its decisions in spending that cash will play a big role in determining our result as part owners.

I continue to be impressed by the people of Alaska at all levels. As a smaller and more regionally-focused airline, Alaska's service advantage is easy to overlook by customers (or investors) who exclusively fly certain competitors. At the management and board level it is also good to see leaders who embrace change and want to improve, and I am hopeful there will be further advances on several corporate initiatives in 2020.

As noted in our last letter, we sold a portion of our **Spirit (SAVE)** shares in the first quarter of 2019. Prices then appeared to be somewhat above a reasonable estimate of value, and the decision to sell also weighed Spirit's powerful low-cost business model and growth opportunities against better opportunities in other airlines and other companies. Not long after our initial sales the stock began sliding and it finished 2019 with a decline of 30.4%.

A drop in the market price would bring an opportunity, not a cause for concern, so long as the business continued to perform well. In Spirit's case, that's where the worry crept in. Spirit has a strong presence in the U.S. airline business, but its lack of a big loyalty co-brand program hurts cash flow and returns on capital. The balance sheet is still adequate, but financial leverage has increased in recent years.

Three new issues in the second half of 2019 added to those concerns. The long-awaited decision to order more A320-family aircraft was, in all probability, the right one, which makes the big delay in that process hard to explain. On the heels of the fleet decision Spirit announced plans for a new $250 million headquarters and training facility. The price tag is eye-popping, and it is tough to reconcile a company with an ultra-lean cost strategy deciding to spend a quarter-billion dollars on a corporate campus. The summer of 2019 also brought a self-inflicted cost overrun. In a business that depends on a cost advantage, a misstep on that side of ledger is troubling.

Things are not all bad at Spirit. The relative cost advantage remains, and it could widen over time as cost pressures escalate at other airlines. Growth should continue at a rapid clip (albeit with returns on capital that have been lagging) and operational performance is still better than it was just a few years ago.

Given the concerns about the business we sold most of our remaining shares in October 2019, and our remaining shares were sold in January 2020. The price we paid for our Spirit shares offered some room for disappointment and we posted a modest gain on our Spirit investment in the two and a half years we held it.[10] It would be no surprise to see the share

price move higher for any number of reasons, but predicting those price movements is a "securities-first" practice that I cannot do with any reliability.

[1] This is section is used to discuss investments – both good and bad – that have had a material impact on our recent results or have the potential to do so in the future; it is not meant to be a comprehensive portfolio review. Please note that discussion of any positions currently being bought or sold, or any that may be difficult to buy or sell in the future, will be omitted.
[2] Please see our letter dated September 7, 2017 for the full introduction to our airline investments. Email me if you need a copy.
[3] Jon Ostrower of "The Air Current."
[4] The strategic benefits are undeniable. South America was the one hole in Delta's global map of influence, and LATAM lines up well in many other regards. The price paid may have been higher than I would have liked, but verdict will have to wait at least a few years.
[5] Delta's repurchases totaled $2 billion in 2019, retiring approximately 6% of its outstanding shares at what appeared to be bargain prices. Source: SEC filings
[6] Look at early 2019 for an example of the silliness caused by the "pre-announcement" of results. Government data will also still provide a lagging view of almost every operating metric.
[7] Source: DAL filings with the SEC
[8] CEO Ed Bastian gave the keynote address at the Consumer Electronics Show in January 2020, emphasizing the company's tech- and consumer-focused strategies – further proof this is not your father's airline. Chairman Frank Blake is also leading a very impressive board of directors with practices that many other companies would be wise to emulate.
[9] The point is that patience is necessary to evaluate the result, and there is no implication that we'll get a result from ALK that is similar to our result from AWI.
[10] Our average cost was just under $38 per share and our proceeds averaged $46 per share.

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