



FITCH UPGRADES DELTA TO 'BB+'; OUTLOOK POSITIVE

News / Finance



Fitch Ratings has upgraded **Delta** Air Lines' Issuer Default Rating (IDR) to 'BB+' from 'BB'. Fitch has also upgraded Delta's Seattle project bonds to '**BB+**' from 'BB' and assigned ratings of 'BBB-' to Delta's 2015 secured credit facility. The Rating Outlook is Positive.

The ratings upgrade reflects on-going improvements to Delta's balance sheet, continued solid operating performance, better than expected free cash flow (FCF), and successful efforts to combat operating cost inflation. The ratings are also supported by underlying improvements in the airline industry including consolidation among the legacy carriers and capacity constraint, which have led to an improved risk profile and better profitability for the industry as a whole.

The Positive Outlook reflects Fitch's view that Delta's credit profile will continue to improve over the intermediate term. Delta continues to focus on debt reduction and addressing its underfunded pension plan as key priorities. Fitch may upgrade Delta if adjusted debt/EBITDAR is maintained below 2.0 – 2.5x (2.2x at June 30, 2015) and as Fitch gains further comfort that Delta's metrics and financial health will be sustainable through future downturns. A ratings upgrade could also follow maintenance or improvement of profitability metrics from current levels over the next 18 months as the industry absorbs some of the capacity expansion that the market is experiencing in 2015. Further improvement in fixed charge coverage ratios and evidence that Delta will be able to maintain its solid cash flow generation over the longer term despite increasing payments to

shareholders could also support an upgrade.

Delta's underfunded pension plan remains a concern, though Fitch believes this concern is manageable. The plans were underfunded by \$12.5 billion at year end 2014, leading to sizeable required annual cash contributions. These risks are partially mitigated by Delta's cash flow generation, which enables the company to fund its pension requirements while still generating positive FCF, and by Delta's efforts to make pension contributions over and above the required minimums. Pension risk is also mitigated by the Pension Protection act which governs Delta's minimum required cash contributions into the next decade.

International markets continue to present a concern with U.S. airlines reporting broad-based unit revenue weakness, which has been exacerbated by the rise of the U.S. dollar. Certain international markets also remain weak, such as Brazil, Venezuela and Russia. Other rating concerns are primarily reflective of risks inherent in the airline industry. Cyclical, exposure to exogenous shocks (i.e. war, terrorism, etc.), capital intensity, operating leverage, and sensitivity to global oil prices remain key considerations.

KEY RATING DRIVERS

Improving Credit Metrics: Credit metrics at Delta have continued to improve since Fitch upgraded Delta's rating to 'BB' in 2014. Fitch expects further improvement going forward supported by a solid domestic demand environment and by Delta's commitment to future debt reduction. Fitch calculates Delta's adjusted debt/EBITDAR at 2.2x as of June 30, 2015, which is down from more than 9x at year end 2009. Adjusted leverage is now notably lower than all other large North American competitors with the exception of Southwest Airlines and Alaska Air Group, both of which Fitch rates in the 'BBB' category. Fitch believes that Delta's improved credit profile puts it in a much stronger position to weather future market downturns. Delta intends to further reduce debt in the near-term, setting a net adjusted debt target of \$4 billion to be reached by year end 2017. Fitch views this goal as achievable given the company's capacity to produce free cash flow, and track record of bringing down debt since the previous recession.

Managing Costs: The ratings upgrade is supported by Delta's successful efforts to manage its unit costs. CASM ex fuel was essentially flat in 2014 and decreased slightly through the first half of this year. Fitch's forecast includes moderate cost inflation in the 2016 – 2017 time frame largely related to pilot wages and salaries. Delta's pilot contract becomes amendable later this year, and any new contract will likely include raises particularly given the profitability of the airline industry in recent years. Union contracts aside, Delta is focused on maintaining its annual CASM inflation below 2%.

The success of Delta's cost containment program has pushed profit margins higher. EBITDAR margin for the LTM period ended June 30, 2015 totaled 18.6%, higher than the 18% margin posted FY 2014, and a large improvement over margins in the high single digit/low double digits that were seen in 2008 and 2009. Note that margins would have been much higher through the first six months of the year setting aside Delta's hedge losses.

Strong FCF and Financial Flexibility: Fitch expects Delta's healthy operating profits and manageable upcoming capex will allow the company to produce sizeable free cash flows for the foreseeable future. In our base forecast, Fitch anticipates that FCF will top \$3 billion this year and approach or exceed \$3.5 billion/year in 2016 and 2017. Delta has now produced positive cash flow in each of the past six years, with cumulative FCF totaling more than \$10.5 billion over that time period. The capacity to consistently produce positive free cash flow is a key consideration in the recommendation to upgrade the ratings.

Total liquidity as of June 30, 2015 was equal to 14.1% of LTM revenue. Liquidity consists of \$2.3 billion of cash & equivalents, \$1.5 billion of short-term investments, and \$2.0 billion of revolver availability. While some of Delta's airline peers have a higher liquidity balance on a cash/revenue basis, Fitch considers DAL's current liquidity balance to be more than adequate to fund near-term requirements, particularly since the company is consistently generating solid cash flow. Fitch's base case forecasts that DAL will generate cumulative cash flow from operations of more than \$20 billion between 2015 – 2017, exceeding anticipated capex, dividends, and debt maturities.

Manageable Cash Obligations: Fitch expects capital expenditures to approach \$3 billion annually for the next several years, the majority of which will consist of new aircraft deliveries as Delta takes 737-900ERs, A330-300s in 2015 and A321s starting in 2016. Debt maturities range from \$1.0 to \$2.1 billion annually over the next three years. These obligations are manageable in light of Delta's expected cash generation.

Returning Cash To Shareholders: Fitch does not expect shareholder friendly actions to harm Delta's credit profile in the near-term, as evidenced by management's continued public statements about reducing net debt, contributing to pension plans, and improving its credit profile. Delta announced a 50% dividend increase in May 2015, increasing the payout to roughly \$430 million per year. Delta's board also authorized a \$5 billion share repurchase program to be completed by year end 2017. This comes after the company's 2014 announcement that it would complete a \$2 billion repurchase program by the end of 2016. It completed that program more than 18 months ahead of schedule prompting a much larger authorization. Although the planned cash outflows are sizeable, they should be manageable given Delta's strong cash generation. Share repurchases are also flexible and can be scaled back or cancelled in the case of a downturn. Fitch would have a negative view of any future dividends or buybacks that were to occur at the expense of Delta's balance sheet health or at the expense of necessary investments in the business.

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