Blue Diamond Investing

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U.S. Airline Industry Report

Analyzing how COVID-19 is affecting the Industry

COVID-19 has been a detrimental setback to the economy in countless ways. One major market affected by the virus is the airline industry. This report walks through how severe this downturn has been, how airlines will adjust in the next 12 months, and the effects of the government bailouts.

Airlines in 2019

2019 was a great year for airlines. According to the Bureau of Transportation Statistics, airlines carried 925.5 million passengers last year, their highest mark yet. The number of airline passengers has grown each year for the past five, improving 4.1% from 2018, and 21.3% since 2014. Better yet, commercial airlines combined for almost $16 billion USD in profits after tax. 2020 will not be the same in many regards.

The COVID-19 Effect

While February airline sales showed improvement from last year, airline sales have dramatically fallen since COVID-19 entered the U.S. later that month. Domestic Air travel is reportedly down 90% compared to this time last year, and projections think 2020 will be down 40%. United Airlines recently reported its passenger counts for the first two weeks in April and they were down a whopping 97%. While they usually transport around 6,000,000 passengers in that time frame, they only had 200,000 customers.

	Delta Air Lines	American Airlines	United Airlines	Southwest Airlines	JetBlue Airways	Alaska Airlines	Spirit Airlines
	DAL	AAL	UAL	LUV	JBLU	ALK	SAVE
2019 Revenue	$47,007	$45,768	$43,259	$22,428	$8,094	$8,781	$3,831
Projected 12 Months Forward Revenue	$17,413	$16,361	$15,522	$7,885	$2,644	$3,115	$1,200
Expenses and Depreciation	$27,780	$30,491	$27,045	$13,908	$4,873	$5,300	$2,422
Net Income	**(10,367)**	**(14,130)**	**(11,523)**	**(6,023)**	**(2,229)**	**(2,185)**	**(1,222)**
Cash Flow (Burn)	(9,267)	(13,428)	(10,594)	(5,112)	(2,051)	(1,869)	(788)
Total Liquidity (Cash + Credit)	$5,991	$7,069	$6,944	$5,072	$2,078	$2,921	$1,244
Months before running out of Liquidity	**7.8**	**6.3**	**7.9**	**11.9**	**12.2**	**12.3**	**18.9**
Cash needed to survive next 12 Months	**$3,276**	**$6,359**	**$3,650**	**$40**	**$0**	**$0**	**$0**

$ in millions

The chart above is a visual breakdown of how each major airline will fair in the next 12 months (April 2020-April 2021). These calculations are based on projections that domestic air travel will operate at 30% average capacity rate in this time frame. At this capacity, airlines will cut fuel costs by 50%, reduce their payroll by 5%, and limit fixed costs – i.e. airport rent – by 30%. These factors will

"Risk comes from not knowing what you are doing."

-Warren Buffet

help offset the net loss of income, but because revenues are so low, all major airlines will be operating at a net loss, meaning their cash flow (how much they spend) is more than they are earning. This leaves airlines with the only option of using their total available cash to stay in operation. Total available cash is another term for liquidity, which is simply the amount of cash they have on hand, plus the amount of pre-approved credit they have access too. Another way of looking at liquidity is as their immediate spending power. Using this information, you can calculate the number of months can operate at a loss. After the designated number of months, each company will be heading for bankruptcy. This is, of course, unless they can secure private loans, or they are bailed out by the government. The data shows Delta, American, United, and Southwest all do not have enough money to survive a full 12 months at 30% passenger capacity and expense cuts.

Bailout Terms and Conditions

With U.S. airlines in dire need of assistance, the companies reached terms with the U.S. Treasury on April 15 for a government bailout. Under the CARES act, the FED granted the U.S. Treasury $25 Billion for grants and $25 Billion for a separate pool of loans for future use, should the airlines need it down the road. Treasury Secretary Steve Mnuchin decided exactly how this grant money gets implemented. While many airline lobbyists wanted these grants to be totally unrepaid, Mnuchin proposed a compromise. All major airlines are roughly taking the same deal, a 70/30 unpaid/loan backed split. This means that 70% of the money given will be issued as a grant that does not need to be repaid, while the other 30% will need to be repaid as a loan. These will be 10-year loans with a relatively low-interest rate. In exchange, the airlines will have to give a certain amount of stock warrants, pegged at April 9th prices. This means that the airlines are agreeing to give the U.S. Treasury the option to buy stock in their company at this low price for as long as the loan is unpaid.

	Delta Air Lines	American Airlines	United Airlines*	Southwest Airlines	JetBlue Airways*	Alaska Airlines*	Spirit Airlines*
	DAL	AAL	UAL	LUV	JBLU	ALK	SAVE
Total Aid Received	$5,400	$5,800	$5,000	$3,200	$936	$800	$800
Warrants Issued	6.6	15.2	4.8	26	2.6	7.5	1.75
% Dilution	**1.00%**	**3.30%**	**2.00%**	**0.50%**	**1.00%**	**0.60%**	**2.50%**

*Deals not finalized
$ and warrants in millions

For example, the chart above demonstrates Delta is giving the Treasury 6.6 million (1%) of its outstanding shares of stock as warrants with the April 9th strike price of $24.39. This means that if Delta's shares rise 100% to $50 in 1-2 years, the treasury can still buy its stock at $24.39. The downside with these stock warrants is that it effectively dilutes the airlines, and the more the stock prices rise, the more diluted their earnings will potentially get. Some airlines will give fewer stock warrants than others, as indicated in the chart. The good news is that while many analysts predicted some dilution to occur, they were surprised by how low the numbers turned out to be. "The equity dilution risk is more moderate than we had previously believed," Bernstein analyst David Vernon wrote. Many predicted a 10-12% dilution, which would be very bad for the airlines' long-term outlook. In addition, stock warrants will not generate any balance sheet debt for the companies, which is crucial during this time period when they are crunched for cash.

These grants come with certain implications that will affect the long-term outlook for these companies. The money given must be used to cover their payroll and the companies must also keep at least 90% of their staff. Airlines must also suspend stock dividends and refrain from stock buybacks until September of 2021. Executive pay will also be limited until March 2022, which could potentially make it difficult for them to recruit top tier talent upstairs. Additionally, if these

airlines decide to tap into the remaining $25 billion for full-on, government-backed loans they will have to give up their information about airline finances, profit streams, and frequent flier accounts. Frequent flier mileage programs, which bring in billions for airlines, will most likely be the collateral for these loans. These implications are bad for the long-term outlook of profitability and efficiency. These factors, especially suspended dividends, will hurt investors.

Although these grants seem promising, they are only a temporary fix. This money is only enough to carry airlines through September 2020. Based on the data in the chart below, these grants are basically just adding around 5 months to the "months before running out of liquidity" section. These grants do not fix the problem of people not getting on planes. They are only a band-aid solution, issued with the hopes of air travel picking up in the next 12 months. If it doesn't, these airlines will be back on track for bankruptcy, and most likely asking the government for more money. For the time being though, these grants are good news for shareholders. They immediately add liquidity to their balance sheets which helps temporarily fight off bankruptcy.

	Delta Air Lines	American Airlines	United Airlines*	Southwest Airlines	JetBlue Airways*	Alaska Airlines*	Spirit Airlines*
	DAL	AAL	UAL	LUV	JBLU	ALK	SAVE
Months before running out of Liquidity	7.8	6.3	7.9	11.9	12.2	12.3	18.9
Cash needed to survive next 12 Months	$3,276	$6,359	$3,650	$40	$0	$0	$0

$ in millions

So What Are These Stocks Worth?

To decide if these airline stocks are correctly priced, our model had to make some assumptions to determine what their fair/implied values are. This number is determined by taking the implied enterprise value (EV), subtracting the amount of debt on the company, and dividing it by the number of outstanding shares. EV is a measure of a company's total value, but it is very similar to its market cap. The end implied share price is based off a few assumptions. The next few paragraphs are the technical analysis behind this report, it will get complicated/hard to understand if this is your first real technical application. Please feel free to contact us by email if you are confused, Blue Diamond Investing is here to help you through the process.

First, the model estimates airlines will run at 30% passenger capacity for the next twelve months. Second, airlines will assume a fuel expense cut of 50% due a limited number of flights and oil prices at 37-year lows. Next, airlines will assume overall salary expenses to be down 5% due to pay cuts and layoffs during the time period. Additionally, airlines will assume a capital expenditure cut of 70%, which is another fancy word for investing and maintaining equipment. Lastly, the model assumes airlines will cut fixed costs by 30% because these companies will not be docking planes as frequently, thus limiting the amount of fees charged by airports. These projections output the next twelve months free cash flow, which is negative for all airlines because they are operating at a loss.

Quick Highlights by Airline

Delta Air Lines:

- Brings in the most annual revenue of any U.S. Airline
- Berkshire Hathaway has ~ 9% stake (Warren Buffet)

American Airlines:

- Filed for bankruptcy in 2011, though it did not cease operations
- Picked up new management in 2013
- Most leveraged airline (Highest D/E ratio)

United Airlines:

- The only U.S. Airline to be a part of the International Star Alliance, which is a special group of 26 Airlines
- This alliance gives customers exclusive rewards, and easier access to transferred flights and baggage checks

Southwest Airlines

- In its 49 years of operation it has never had an unprofitable year, and it has never furloughed
- Consistently has the strongest balance sheet
- Berkshire Hathaway has ~ 9% stake in it (Warren Buffet)

JetBlue Airways

- CEO Robin Hayes admits that while they have one of the strongest balance sheets, they will have trouble recovering from all this debt

Alaska Airlines

- Offers the best rated mileage program in the industry
- Has disclosed that they may look for an additional private loan

Spirit Airlines

- Second most leveraged airline
- Commonly known as a discount airline with cheap prices, yet poor customer satisfaction

Implied Share Price (Continued)

WACC: 12.5%

	Delta Air Lines	American Airlines	United Airlines*	Southwest Airlines	JetBlue Airways*	Alaska Airlines*	Spirit Airlines*
	DAL	AAL	UAL	LUV	JBLU	ALK	SAVE
Est. 2020 Unlev. Cash Flow (UFCF)	($5,186)	($8,273)	($5,803)	($2,754)	($1,317)	($1,230)	($149)
Est. 2021 UFCF	($1,032)	($3,136)	($1,746)	$49	($509)	($258)	($15)
Est. 2022 UFCF	$3,122	$2,000	$2,310	$2,852	$299	$714	$119
Est. 2023 UFCF	$4,163	$2,667	$3,080	$3,802	$399	$952	$158
Est. 2024 UFCF	$4,246	$2,667	$3,142	$3,897	$409	$971	$162
Present Value of Terminal Value	$22,890	$14,665	$16,936	$22,167	$2,326	$5,235	$922
Sum of Present Value UFCF	$1,723	($5,252)	($1,249)	$4,129	($886)	$338	$127
Enterprise Value	$24,613	$9,412	$15,686	$26,296	$1,440	$5,572	$1,049
Net Debt currently on business	$7,224	$20,030	$9,789	($1,394)	$1,024	($22)	$1,561
Fair Value of Equity Today	**$17,389**	**($10,618)**	**$5,897**	**$27,690**	**$416**	**$5,594**	**($511)**

Using the assumptions above, the next step is creating a discounted cash flow analysis to arrive at an implied enterprise value and share price. First, the 2020 unlevered free cash flow (UFCF) is the cash burned through plus available liquidity. 2021 UFCF is based on the average of 2020 and 2022 unlevered free cash flows which is 52% of 2019's numbers. 2022 UFCF is calculated using the assumption airlines will operate at 75% of 2019's numbers. Next, 2023 is calculated assuming the industry will arrive back at 2019's original numbers. 2024 UFCF is calculated using a perpetual growth of 2.5%. Lastly, the model uses the perpetuity growth method to calculate terminal value, formula located below. After all UFCF's and the terminal value were calculated, the values were discounted back to present value and summed. To get a simplified equity value, debt was subtracted from the enterprise value. The last step in the model was to determine the implied share price for each company.

$$\text{Terminal Value} = \frac{(\text{Last year UFCF}) * (1+\text{Growth Rate})}{(\text{WACC} - \text{Growth Rate})}$$

Implied Share Price

To calculate the implied share price at this point, all that was left to do was divide the equity value by the number of shares outstanding for each company. The chart below demonstrates which companies have an upside with Southwest Airlines being the strongest at 56%. The data also points to the possibility of American Airlines and Spirit Airlines declaring bankruptcy in the near future. These two airlines are carrying a significant amount of debt on their balance sheet and it is likely to hurt them for years to come.

	Delta Air Lines	American Airlines	United Airlines*	Southwest Airlines	JetBlue Airways*	Alaska Airlines*	Spirit Airlines*
	DAL	AAL	UAL	LUV	JBLU	ALK	SAVE
Fair Value of Stock Price Today	$22.51	$0.00	$15.13	$46.55	$0.52	$40.07	$0.00
Current Stock Price	24.36	12.29	31.86	32.83	9.19	30.07	13.76
Upside %	8%	-100%	-30%	56%	-85%	49%	-100%

How Do We Suggest Trading the Airlines?

At Blue Diamond Investing, we do not suggest taking any long-term positions in these airlines. While you may be able to get a short-term gain here if the market picks up, we think that most investors should steer clear of this sector. A combination of the projected slow return to full capacity, the stipulations tied to paying back the government, and the fact that these airlines are depending on government grants to stay afloat, leads us to believe there are better options for long term investors. However, if you are interested in a trade in the airlines that could give you a quick return, you can contact us directly for advice on how to play the charts correctly.

The Bottom Line

Hopefully you better understand the situation that major U.S. airlines are currently facing, and the risks involved in investing in any of these companies. However, remember that there is never a right answer in investing. For instance, one investor may look at this data/the long-term damages it will succumb and think there is no way he/she would invest right now. A different investor may recognize that while there is a chance for bankruptcy, international airlines do not always have access to bailouts like U.S. companies do, therefore potentially clearing out some competition if foreign airlines do go bankrupt. These investors may want to scoop up some shares while they are so low priced. Nonetheless, U.S. airlines will face a crucial few upcoming months as they wait for news on the virus and possible extensions on restricted air travel.

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