

Equity Research

North America

United States of America

Airlines

Delta Air Lines

Reuters: DAL.N Bloomberg: DAL US NYSE: DAL

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Company Update

March 21, 2004

Highlights from Delta's Sober 2003 10-K

STOCK RATING	EQUAL-WEIGHT-V
Price (March 18, 2004)	\$7.65
Price Target	NA
52-Week Range	\$16.05 - 7.36

Stock ratings are relative to the analyst's industry (or industry team's) coverage universe.

GICS SECTOR	INDUSTRIALS
US Strategist Weight	11.8%
S&P 500 Weight	10.6%

On March 12, Delta filed its 10-K for 2003

After sifting through the filing, we highlight in this report a number of disclosures we believe investors should study.

- Delta warns of a tough road ahead**
Delta mgt. noted if significant losses continue without success in lowering oper. expenses (esp. labor), the company "may be unable to maintain sufficient liquidity to provide for (its) operating needs."
- Liquidity looks sufficient for 2004**
We updated our liquidity analysis. We believe DAL has sufficient cash to meet obligations in '04. We estimate DAL will have a free cash deficit (i.e., before financing) of \$800M in '04.
- Pension funding looms large; losses may limit tax benefits**
DAL will add \$440M in cash to pensions in '04 and warns of large funding requirements in 2005-08. DAL still recognizes a tax benefit from reported losses, but if large losses continue, DAL may stop recognizing the benefit, which would sharply increase reported losses.
- Industry View: In-Line**
Overcapacity, high fuel prices and substantial pricing pressure suggest that despite a sharp pull-back in the stocks over the past few months, there are few near-term catalysts for the group.

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Fiscal Year Ends (Dec 31)	2003	2004e	2005e	2006e			
EPS (\$)	(8.58)	(6.85)	(2.20)	-			
Prior EPS Ests. (\$)	-	-	-	-			
First Call Consensus (\$)	(8.58)	(5.02)	0.21	1.20			
P/E	---	---	---	-			
Price/Book	16.4	---	---	-			
EV/EBITDA	69.4	28.3	11.7	-			
Yield (%)	0.0	0.0	0.0	-			
Market Cap (\$mn)	944.6						
Enterprise Value (\$mn)	17,770.6						
Debt/Cap (12/03) (%)	99.4						
Return on Equity (12/03) (%)	(89.2)						
LT Est EPS Growth ('yy - 'yy) (%)	2.5						
P/E to Growth	-						
Shares Outstanding (mn)	123.5						
		Q'trly	2004e	2005e			
		EPS	actual	curr			
			prior	curr			
			prior	prior			
		Q1	(3.49)	(3.15)e	-	NA	-
		Q2	(1.95)	NA	-	NA	-
		Q3	(1.43)	NA	-	NA	-
		Q4	(1.71)	NA	-	NA	-

e = Morgan Stanley Research estimates

Please see analyst certification and important disclosures starting on page 5.

Highlights from Delta's Sober 2003 10-K

Company Description

Delta Air Lines is the nation's second largest passenger airline in terms of passengers boarded and the third largest in terms of revenues and revenue passenger miles.

On March 12, Delta Air Lines (DAL) filed its 10-K for the year ending December 31, 2003. After sifting through the filing, we found a number of disclosures that we believe investors should study.

Delta Describes a Depressing Forward View

Delta management's discussion of its 2004 outlook and beyond is rather sobering. The company highlights a lack of pricing power, industry overcapacity, costs out of line with revenue and substantial cash needs in the future as significant risks to the company. In what is probably one of the more depressing paragraphs we've read in an airline 10-K this year, Delta management wrote "if we continue to experience significant losses without successfully reducing our operating expenses, **we may be unable to maintain sufficient liquidity to provide for our operating needs.**" We believe investors in shares of Delta should heed these words and be prepared for significant stock price volatility over the coming months.

Overcapacity: Identification of the Problem Is a Start

The airline industry lacks any capacity discipline, in our view. As the February revenue trends demonstrate (see our March 20, 2004 report), aggressive price actions coupled with overcapacity continue to weigh on the revenue recovery. Delta management highlights overcapacity in 2004 as a key issue adversely affecting its results. Although we agree overcapacity is a problem, we found the comment ironic in that Delta currently intends to grow its capacity faster than any other major network airline in 2004. Perhaps, this suggests Delta is re-thinking its capacity plans in 2004.

Waiting for a Pilot Deal

It is hardly news that Delta has a cost problem. Given that labor costs are the company's largest single expense (representing 45% of total costs in 2003), a turnaround in the company's financial performance and share price requires a significant reduction in labor expense. As we wrote in our January 14 report entitled "Everything Rests on a Labor Deal," in the perverse logic of the airline industry, the worse the financial condition of the company becomes, the more likely a pilot deal becomes. We are hopeful that a

deal can come within the next 6-9 months though management has suggested in other public forums negotiations with the pilots could drag on until spring 2005.

Perhaps as a tool to jump-start the negotiations, Delta's 10-K filing contained some ominous language in the section where pilot negotiations are discussed. Management warned: "to the extent that we deplete our cash reserves and are unable to access the capital markets for long-term capital spending requirements or short-term liquidity needs, we will be unable to fund our obligations and sustain our operations." This may simply be to satisfy the spirit of a full disclosure of risks. Nevertheless, we believe risks like this are worth noting.

Fuel: No More Hedges

Delta liquidated all of its fuel hedging contracts in February prior to the scheduled settlement dates. Delta will amortize the benefit of the fuel hedging gains on the income statement (reducing fuel expense) as the related fuel purchases are consumed. **We assume that Delta's liquidation of its fuel hedges was a cash management decision.** The airline received \$83 million in cash by settling the hedges. Interestingly, AMR Corporation liquidated its hedges in March 2003 as its financial condition deteriorated and cash became increasingly important.

As we wrote in our March 12 Delta report, despite the cash benefit of the liquidation, **Delta is now unhedged at a time when its credit outlook is deteriorating** (S&P cut ratings on Delta's debt this past week). In our view, this may make it more difficult to establish future hedges. Insofar as fuel prices do not moderate, or increase further, Delta's financial condition will obviously be adversely affected.

Liquidity Outlook

Based on data provided in the company's 10-K, we updated our liquidity projections for Delta in 2004. As shown in Exhibit 1, we estimate that Delta will generate \$2.9 million per day in operating cash flow in 2004 (totaling \$1.1 billion). We estimate that Delta will need approximately \$1.8 billion in 2004 to fund commitments including capital spending, pensions and debt repayments (see Exhibit 2).

Exhibit 1

Delta Air Lines: Liquidity Analysis

Delta Air Lines	2004E (US\$ mil)
Net Income	(\$847)
Noncash Pension Expense	\$675
Depreciation	\$1,223
Deferred Taxes	\$0
Total Cash Flow From Operations (1)	\$1,051
CFFO per day	\$2.9
Net Capital Spending (2)	(\$700)
Pension Cash Funding (3)	(\$440)
Principal Repayments on Debt (4)	(\$702)
Total CF Before Debt or Equity Issuance	(\$791)
Total FCF/Burn Per Day	(\$2.2)
As % of Period Beginning Cash on Hand	29.3%

(1) We assume that there is no net impact on cash flow from changes in working capital. (2) Capital spending is net of asset sales and pre-funding estimates. (3) Delta's 2004 10-K. (4) Delta's 2004 10-K.

Source: Morgan Stanley Research, Delta Air Lines 2004 10-K

Before debt or equity issuance, we estimate that Delta will burn through \$2.2 million per day for full year 2004 (equating to a free cash flow deficit of \$790 million). This is roughly 30% of Delta's beginning-of-year cash-on-hand, suggesting to us that absent an exogenous event, Delta has sufficient liquidity for the remainder of 2004.

Management noted in the 10-K that it expects cash flow from operations to be sufficient to fund daily operations and non-fleet capital spending.

Exhibit 2

Delta Air Lines: Scheduled Principal Repayments

Year	Principal Payment Due
2004	\$1,002 million*
2005	\$1,164 million
2006	\$781 million
2007	\$463 million
2008	\$1,272 million
Thereafter	\$7,780 million

*Delta has long-term, secured financing available that can be used to finance regional jet deliveries through 2004. Election to use these commitments would result in the refinancing of approximately \$300 million of the 2004 maturities.

Source: Delta Air Lines 2004 10-K

We should note that Delta has executed a number of financial transactions in early 2004 that we estimate generated roughly \$150 million in cash for the company.

1) The liquidation of fuel hedging contracts generated \$83 million in cash. 2) Delta issued a convertible note, generating roughly \$325 million in cash. 3) On April 2, Delta Air Lines - March 21, 2004

Delta paid \$250 million (presumably from cash) for an equivalent amount of receivables it had previously sold to a third party. The third party receivables contract expired on March 31, 2004.

Significant Pension Funding Requirements Ahead

Delta estimates it will contribute \$440 million to its pension plans this year. Of this, \$325 million is a voluntary contribution to the non-pilot pension plan (the majority of which was contributed in February 2004). The remaining \$115 million is a required contribution that the company will make to its pilot pension plan. Delta offered no guidance on funding estimates beyond 2004, but noted funding obligations for 2005 - 2008 will be significant and could have a material adverse impact on liquidity.

Based on information provided in the company's 10-K, we estimate the funding status of Delta's pension plans at 57.5%. We define funding status as fair value of the plan assets (\$6,818 million) divided by the accumulated benefit obligation (\$11,863 million). If we used the projected benefit obligation (\$12,477 million), the funding status would drop to 54.6%. Actuarial assumptions for the pension plan can be found in Exhibit 3.

Exhibit 3

Actuarial Assumptions for Delta's Defined Benefit Plans

	2003	2002	2001	2000
Discount Rate	6.1%	6.8%	7.8%	8.3%
Rate of increase in future compensation	1.9%	2.7%	4.7%	5.4%
Expected rate of return on plan assets	9%	10%	10%	10%

Source: Delta Air Lines 2004 10-K

Taxing Implications from Net Losses

Since the current airline recession began, Delta has been recognizing a tax benefit from its reported losses, and building a large deferred tax asset on the balance sheet. According to US GAAP, deferred tax assets should be reduced by a valuation allowance if it is more likely than not that some portion of all of the deferred tax assets will not be realized. The future realization of these deferred tax assets depends on the availability of future taxable income. In performing this test, **Delta concluded there remains sufficient evidence that it is more likely than not the deferred tax asset will be realized.**

As a result, the Street continues recognizing an income tax benefit in published estimates. AMR Corporation and

Northwest Airlines have both determined that the future availability of their taxable income is uncertain enough that they no longer recognize a tax benefit for income statement losses. **We believe it is possible that in the next few quarters (depending on the magnitude of Delta's losses), that Delta will also be unable to recognize further income tax benefits for its losses.** If we assumed no tax benefit for losses in 2004 (i.e., a tax rate of 0%), our loss estimate per share would be \$10.60, as compared to our current loss estimate of \$6.85 per share.

Other highlights from Delta's 10-K

- **No pricing power.** The government reimposed security fees on airline tickets purchased after October 1, 2003. Delta has been unable to increase fares to pass along these fees to customers.
- **Unit costs continue to rise.** Delta believes its unit costs have gone from being among the lowest of the hub-and-spoke airlines to among the highest for full-year 2003.
- **Growth of Song.** Starting operations on April 15, 2003, Song is nearly a year old. The subsidiary will offer 144 daily flights using 36 757s by March 2004. This represents exactly four flights per aircraft per day.
- **Free Travel Awards.** At year-end, Delta had 14.3 million outstanding free round-trip travel awards under its frequent flyer program, up 4% from 2002. In 2003, frequent flyer tickets accounted for 9% of total RPMs.
- **Aircraft deliveries.** Delta has no mainline aircraft deliveries scheduled in 2004. There are nine mainline

aircraft deliveries scheduled in 2005 (net of 11 aircraft sold to a third party). Delta is scheduled to take delivery of 23 CRJ-700s this year.

- **Interest costs rising.** Due to the company's increased debt balance, Delta expects to pay \$75 million more in interest expense this year.
- **Expensing options.** Had Delta expensed stock options in 2003, it would have reduced earnings (technically, increased the reported loss) by \$0.26 per share.
- **Payments to regional partners.** Delta expects to spend \$890 million on its contracted regional flying with ACA, SkyWest and Chautauqua in 2004.
- **Delta may need to cancel its contract with ACA.** In the event that Atlantic Coast Airlines begins service as a separate low-cost carrier in late 2004 and takes jets with greater than 70 seats, Delta may have to terminate its contract with ACA based on its collective bargaining agreement with its pilots. In this scenario, Delta would likely be required to assume the leases on the 30 ACA RJs now flown under the Delta code. Delta estimates future lease commitments under this scenario totaling \$300 million and lasting approximately 13 years.
- **Large off-balance sheet liabilities.** We estimate that the present value of Delta's off-balance sheet liability is \$8.5 billion using a 6.6% discount rate.

Analyst Certification

The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report: William J. Greene, CFA.

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Within the last 12 months, Morgan Stanley managed or co-managed a public offering of securities of Delta Air Lines.

Within the last 12 months, Morgan Stanley has received compensation for investment banking services from Delta Air Lines.

In the next 3 months, Morgan Stanley expects to receive or intends to seek compensation for investment banking services from Delta Air Lines.

The research analysts, strategists, or research associates principally responsible for the preparation of this research report have received compensation based upon various factors, including quality of research, investor client feedback, stock picking, competitive factors, firm revenues and overall investment banking revenues.

Morgan Stanley & Co. Incorporated makes a market in the securities of Delta Air Lines.

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(as of Feb 29, 2004)

Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight	604	34%	252	40%	42%
Equal-weight	800	45%	277	44%	35%
Underweight	385	22%	103	16%	27%
Total	1,789		632		

Data include common stock and ADRs currently assigned ratings. For disclosure purposes (in accordance with NASD and NYSE requirements), we note that Overweight, our most positive stock rating, most closely corresponds to a buy recommendation; Equal-weight and Underweight most closely correspond to neutral and sell recommendations, respectively. However, Overweight, Equal-weight, and Underweight are not the equivalent of buy, neutral, and sell but represent recommended relative weightings (see definitions below). An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Equal-weight (E). The stocks's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

More volatile (V). We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months. Ratings prior to March 18, 2002: SB=Strong Buy; OP=Outperform; N=Neutral; UP=Underperform. For definitions, please go to www.morganstanley.com/companycharts.

Analyst Industry Views

Attractive (A). The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark named on the cover of this report.

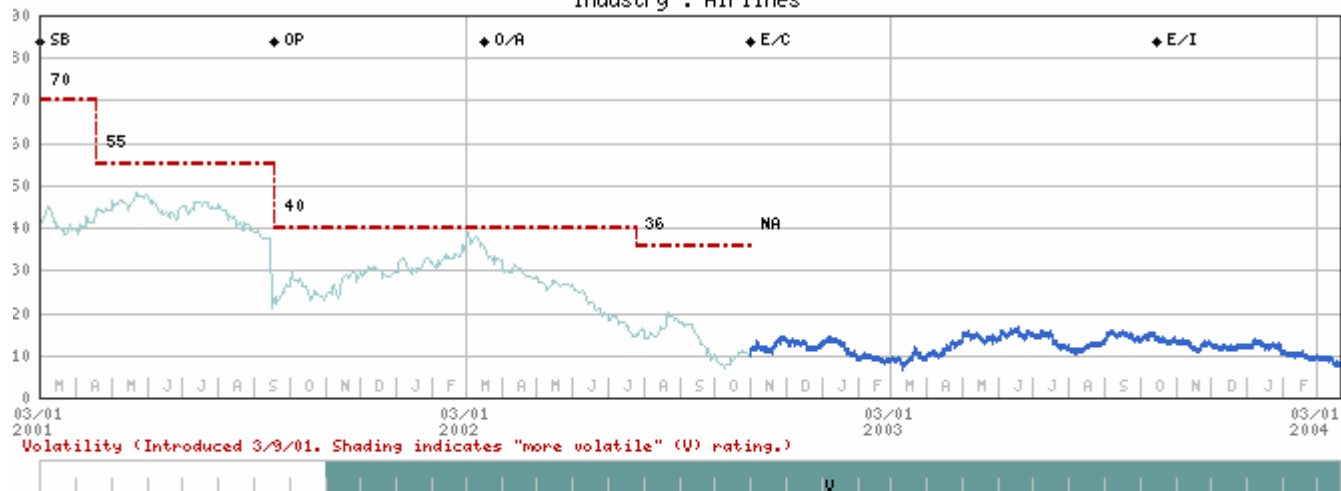
In-Line (I). The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark named on the cover of this report.

Cautious (C). The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark named on the cover of this report.

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Stock Price, Price Target and Rating History (See Rating Definitions)

Delta Air Lines (DAL.N) - As of 3/19/04 in USD
Industry : Airlines



Stock Rating History: 1/3/01 : SB; 9/18/01 : OP; 3/18/02 : O/A; 10/31/02 : E/C; 10/15/03 : E/I
Price Target History: 3/2/00 : 70; 4/18/01 : 55; 9/18/01 : 40; 7/25/02 : 36; 10/31/02 : NA

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target - - No Price Target Assigned (NA)
Stock Price (Not Covered by Current Analyst) — Stock Price (Covered by Current Analyst) ■
Stock Ratings abbreviated as below (Effective 3/18/02, ratings appear as Stock Ratings/Industry View) ♦
Stock Ratings as of 3/18/02: Overweight (O) Equal-weight (E) Underweight (U) More Volatile (V) No Rating Available (NAU)
Stock Ratings prior to 3/18/02: Strong Buy (SB) Outperform (OP) Neutral (N) Underperform (UP) No Rating Available (NAU)
Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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INDUSTRY COVERAGE: AIRLINES

Company	Ticker	Rating as of	Price at 3/18/04	Company	Ticker	Rating as of	Price at 3/18/04
AirTran Airways	AAI.N	E-V 3/20/02	\$11.11	Northwest Airlines	NWAC.O	E-V 3/18/02	\$9.19
AMR Corp.	AMR.N	E-V 10/9/03	\$12.15	Pinnacle Airlines	PNCL.O	O-V 1/5/04	\$13.55
Atlantic Coast Airlines	ACAI.O	NR-V 10/8/03	\$7.24	Skywest Airlines	SKYW.O	E-V 10/15/03	\$17.82
Continental Airlines	CAL.N	E-V 10/9/03	\$11.94	Southwest Air	LUV.N	O 9/10/03	\$13.55
Delta Air Lines	DAL.N	E-V 10/31/02	\$7.65				
ExpressJet Holdings Inc.	XJT.N	U-V 10/15/03	\$12.48				
Frontier Airlines	FRNT.O	O-V 6/16/03	\$9.60				
JetBlue Airways	JBLU.O	E-V 5/29/03	\$21.38				

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