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Industry Note

Airlines

Pension Gremlins Lurking for the Airlines

September 22, 2004

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United States

SUMMARY

- On 9/21 SB hosted a conf call for investors on pension issues. The call featured a presentation by pension expert, Ethan Kra, F.S.A., Ph.D. Chief Actuary Retirement at Mercer Human Resource Consulting. To hear a replay of the call dial 800-642-1687 and provide the reservation number: "221570" (until 11:59pm EST 9/23/04) for int'l call 706-645-9291.
- Key take-aways: Airlines have limited flexibility to terminate db pension plans outside of Chap11 (standard termination) and are still required to pay in full any amount under funded. If a major carrier terminates its db plan in Chap 11 (distressed termination), we think competitive dynamics will force other carriers to follow suit, potentially requiring bankruptcy in some cases.
- Impact: UAL will have a significant competitive advantage if PBGC takes over its db plan. Consequently, we think there remains a high risk that DAL (if UAL distress terminates) will have to file Ch 11 to resolve pension issues.

OPINION

Yesterday's presentation covered a wide array of topics and issues in great detail, however, we think the key takeaways for investors include:

1) Outside of chapter 11, there are limits and costs of terminating a defined benefit plan, referred to as a "standard termination," which requires labor union member approval and full payment of any under funded amount (e.g. involving immediate cash payment and even supplemented with an insurance annuity). Alternatively, assuming union approval, a company can freeze the benefits on its defined benefit plans, with funding required over approximately 4-5 years.

2) Inside chapter 11, airlines would need to resort to the more common: "distressed termination" of a defined benefit plan.

3) As widely feared by the PBGC and speculated in the press, we think the domino effect is real. The scenario of carriers with severely under funded plans following UAL into Chapter 11 to complete a distress termination to remain competitive. This would be especially true in our view should the second and third largest carriers in the industry, UAL and DAL, and also US Airways, successfully terminate their DB obligations. Free of $1B payments due in each of the coming years based on current under funded levels, UAL/DAL et al could instead use this money to pay down debt and/or strengthen to balance sheet to "buy" market share.

UAL CEO Tilton said last week the company will announce their decision regarding its pensions plan within 90 days. Should UAL terminate its pension obligations, we may

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again, need to rethink our investment thesis on each of the airlines in our coverage universe.

First, we outline the options an airline has for terminating under funded defined benefit plans in and out of bankruptcy.

Options or Procedures for Terminating a Defined Benefit Plan
There are two ways to terminate a defined benefit plan:

1) "Standard Termination," typically completed outside of Chapter 11 and does not decrease under funded liabilities.

2) "Distress Termination," completed within bankruptcy, and where pension liabilities are assumed by the PBGC.

Standard Termination
If a company chooses to terminate a defined benefit plan through a standard termination (assuming they have cleared all legal and procedural hurdles -- discussed below) they are required to fully fund the plan to cover lump sum payments for employees choosing them and to purchase annuities to cover the remaining employees. The company must also account for and adequately fund for other potential scenarios such as: early retirement and further growing into entitlements for various plan options, including the right for qualified employees to chose lump sum payments in the future. Therefore a standard termination creates, according to Kra, a "significant increase in perceived or recorded liabilities" and requires immediate cash payment to fully fund the plan and cover all possible employee elections.

An alternative standard termination option for a company with a severely under funded defined benefit plan is to "freeze" the plan. When a plan is frozen, all benefit accruals are ceased, the plan continues to operate with frozen benefit levels while the under funding is paid over time. Companies with frozen plans are required to pay 20 to 30% of the under funding each year with quarterly or annual payments. If over this several year period market returns and interest rates turn favorable ("perfect weather" vs. "the perfect storm"), the company may be able to do a standard termination (pay-off the plan under funding at once). The difference is "limping wounded for quite a long time with a financial drain on the company" but paying in smaller amounts over a few years instead a big payment up front. Either option does not reduce the amount of under funded obligations.

The legal hurdle for a standard termination of a labor union defined benefit plan outside of bankruptcy is the completion of a collective bargaining agreement with the respective labor union(s). A company cannot unilaterally change a contract. Reasons for why a union would agree to a standard termination include: the termination is coupled with a replacement plan that is to their satisfaction, or in the case of a financially distressed company, union leadership believes it's in the best interest of their members and can convey that to union membership (e.g. it will save jobs that would otherwise be eliminated).

Note: just because unions agree to a standard termination doesn't mean the company can afford it. Furthermore, mgmt and labor unions have repeatedly proven an inability to act rationally since deregulation and so if there is one industry that is condemned to repeat history, we think it's the airline industry. Although we're open and in fact poking around in the hopes of disproving ourselves, we do not see why it will be different this time given the level of labor/mgmt distrust. Moving on.

Distress Termination
A distress termination typically occurs within bankruptcy when a company does not have the

funds to complete a standard termination and when continuing to fund the plan limits the ability of the company to continue as a viable entity. Under this scenario, the PBGC takes over the plan. While it's not necessarily easy as a carrier must pass certain legal hurdles, it is easier than a Standard Termination.

Domino Effect
This brings us to the scenario where an airline completes a distressed termination of its db plan(s). The competitive advantage stemming from a company terminating its pension plan is real. With $1B plus or minus due in each of the coming years, this amount could instead be used to pay down debt/shore up the balance sheet and/or "buy" market share. In our initiation report, we've talked about the industry being on the cusp of a hypercompetitive phase, perhaps worse than the mid 80s or early 90s. And the other carriers need to find ways to level the playing field. For those companies with severely under funded plans, we would become increasingly concerned under the scenario where the second and third largest carriers in the industry (and US Airways as well), successfully terminated their defined pension plans in chapter 11 (and replaced their DB plans with much less generous plans, such as a defined contribution of 7-9%). Given that the amount involves billions, short of rising interest rates and the Dow at 14-15000 ("perfect weather"), we would be increasingly concerned that the only way for others to follow suit is via a distress termination in chapter 11.

Delta
Although we don't have details, we understand via news reports that DAL mgmt is hoping to freeze its pilots db plan going forward and replace it with a 9% dc plan. Under this proposal, DAL is still on the hook for $5,659 million dollars (based upon 12/31/03 projected benefit obligation from DAL 2003 10-K. Note: in the case of a standard termination or freeze the amount would be higher accounting for adequate funding for the purchase of annuities for employees not taking a lump sum and other potential scenarios such as: early retirement and further growing into entitlements for various plan options, including the right for qualified employees to chose lump sum payments in the future)

This would require billions over the next few years to pay off the under funded amount of the frozen plan. We do not see a reason, especially given the amount of concessions that mgmt is seeking ($1Billion), that DAL pilots would agree to voluntarily accept this proposal. We believe they would rather take their chances in bankruptcy court than to accept changes to their current pension benefits.

We certainly do not see DAL's proposal as viable in the case of a UAL distressed termination when its plan liabilities are taken over by the PBGC.

Note: There were several other important issues discussed during the call, including potential changes to FAS accounting standards for treating pension assets and liabilities. We will publish the call transcript, which included the entire call, as soon as it is available.

VALUATION AND RISKS

Delta Air Lines (DAL–$3.86; 3S)

Valuation

To capture the option-like behavior of airline stocks, we take an "expected value" approach. We have selected five scenarios (two extreme and three that fall within the middle including our base case) that we think are probable. Thus, our target price of $1 is a probability weighted, risk-adjusted target price based on our assessment of the scenarios in the figure below. After estimating what we think DAL could earn in each of these likely scenarios, we

apply a target multiple to determine a price target (under each of our scenarios); see figure below.

Next, we apply a discount to account for specific risks (such as potential labor conflicts, balance sheet leverage, weak liquidity position, and other financial risks including chapter 11, etc...) or a premium to account specific catalysts (e.g. consolidation candidate, strong hub and route structure, a competitor exiting the market, etc...). In the case of Delta, we start with a base earnings multiple of 9.5x, consistent with how Delta traded coming out of the last downturn for the airline industry, which we then discount by 90% to account for the substantially increased risk of a chapter 11 filing (particularly following bankruptcy court filing in which they said they are "likely" to terminate their pension plans and our view that the carrier may be unable to secure needed labor cost savings). We note that some investors may argue that the chapter 11 risks go away under our scenario where Delta earns $5 or $8/share, with which we agree, and as a result, that we should apply a higher multiple under these better scenarios, with which we disagree. We disagree because of our view that Delta's financial distress requires a near term solution (i.e. within 6 months). In other words, we believe there is a materially high risk of Delta filing for chapter 11 before things could potentially improve for the industry under our deep profitability/good profitability scenarios, particularly because of Delta's overlap with low cost carriers. Consequently, our $1 price target is an expected value factoring in a number of scenarios and risks, including the high probability of a near-term chapter 11 filing, making potential 05 earnings estimates moot for purposes of valuation.

Figure 10. Smith Barney Target Price Methodology*

	Industry Backdrop Scenario	Smith Barney Est. Probability	DAL 2005E EPS	2005E Oper. Margin	Target Multiple	Potential Price Target	Comments/Revenue Assumptions
1) Base	Earnings outlook poor; margin pinched by high fuel costs & simplified pricing resulting from LCC growth/DAL network realignment.	50%	-$2.00	2%	NM	$0	05E RASM down 1%; high risk of ch 11 prior to 05 makes PT moot; ests. post-restructuring; DAL ch. 11 tied to pension termination at UAL.
2) Improving	Economic backdrop not bad, traffic recovers, pricing is weak; fuel experts predicting easing fuel prices ultimately prove correct thereby lifting earnings	25%	$3.35	6%	0.95x	$1	Same outlook as above, tho fuel prices ease to $30/barrel, consistent w/ what the fuel experts are forecasting. Valuation moot b/c of near-term ch.
3) Dire	Econ. double-dips, fuel climbs to $45 and remains high, traffic falls off; pricing pressure becomes extreme, potential terrorism, ind. restructuring	5%	NM	NM	NM	$0	Restructuring Likely
4) Good Profitabilit	Economic recovery stronger than expected, fuel prices ease, and business traffic restored more quickly:	15%	$5.25	8%	0.95x	$5	We think an op margin for DAL in good times; assumes labor savings; 05 RASM up 1-2% & remedied biz/leisure gap.
5) Deep Profitabilit	Assumes scenario 4 plus the exit of an airlines unable to restructure.	5%	$8.00	10%	0.95x	$8	Our estimate of near-peak margin for DAL; RASM up 3-4%; remedied biz/leisure gap of +-4x; an airlines exit ind.
	Probability Weighted Price Target	**100%**				**$1**	

*Scenario estimates are no longer tax-adjusted (we account the impairment of the carrier's NOLs) and price targets are updated accordingly. Note: We selected five scenarios that we think are probable; however, investors should note that there are an unlimited number of scenarios that could occur. Investors interested in valuing Delta on an infinite number of scenarios would be better off applying a Monte Carlo simulation.

Source: Company reports and Smith Barney

Our second valuation methodology, Price/EBITDAR, which we do not use to determine our target price, provides perspective on our primary valuation methodology above. Using this approach, we derived a target price of $2. This is based on Delta's equity trading at 0.1x our 2005 EBITDAR estimate, approximately a 90% discount to DAL's average historical low on this measure. Our price/EBITDAR multiple of 0.1x accounts for heightened financial and labor risk, as well as the substantially increased risk of the carrier filing for chapter 11 before the carrier is able to secure needed savings.

Risks

We rate Delta Airlines Speculative Risk based on both quantitative and qualitative factors.

Quantitative factors included stock price volatility, earnings stability, its debt rating, and Delta's market capital.

Additional qualitative factors include: Labor (Delta is currently trying to secure about $1 billion in labor cost savings from its mainline pilots and has an open contract for pilots at its ASA subsidiary), low cost competition (including AirTran (at its Atlanta hub) and Southwest (in Florida, which accounts for about 25% of Delta's revenues), in Salt Lake City, and JetBlue (in its Northeast to Florida markets, and Boston to New York market)), a likely slip in Delta's relative regional jet (RJ) advantage, operational and execution risk tied its dehubbing its DFW operations and restructures 51% of its route network. The most important qualitative factor is Delta's severely under-funded defined benefit pension plan for its pilots. If UAL goes down the path of rejecting its defined benefit pension obligations as we anticipate, we think DAL, too, will need to follow suit. Under such a scenario, we think Delta management will likely conclude that the $1B of savings needed from the pilots is inadequate and instead ask for further cuts. If we are correct, we think this will complicate the carrier's negotiations, making it hard to achieve labor savings outside of a filing.

Delta also shares general industry risks including 1) change in demand for travel, 2) fuel pricing, 3) pricing pressure resulting from heightened competition, 4) terrorism, 5) labor and maintenance issues, 6) weather, 7) foreign currency exposure and competition. If the impact on the company from any of these factors proves to be greater/less than we anticipate, it may prevent the stock from achieving our target price.

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APPENDIX A-1

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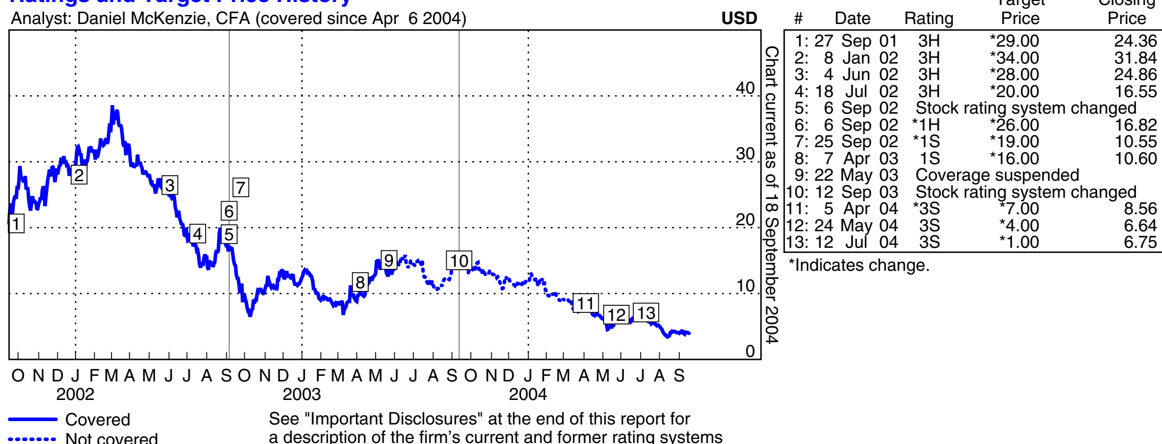

#	Date	Rating	Target Price	Closing Price
1:	27 Sep 01	3H	*29.00	24.36
2:	8 Jan 02	3H	*34.00	31.84
3:	4 Jun 02	3H	*28.00	24.86
4:	18 Jul 02	3H	*20.00	16.55
5:	6 Sep 02	Stock rating system changed		
6:	6 Sep 02	*1H	*26.00	16.82
7:	25 Sep 02	*1S	*19.00	10.55
8:	7 Apr 03	1S	*16.00	10.60
9:	22 May 03	Coverage suspended		
10:	12 Sep 03	Stock rating system changed		
11:	5 Apr 04	*3S	*7.00	8.56
12:	24 May 04	3S	*4.00	6.64
13:	12 Jul 04	3S	*1.00	6.75

*Indicates change.

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% of companies in each rating category that are investment banking clients	100%	100%	100%

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