

Eric Gillin

Delta Air Fights to Stay Aloft

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It's always darkest before the dawn, especially in the airline industry, but the black clouds surrounding **Delta Air Lines** (DAL:NYSE) could prove to be a black hole from which it cannot escape.

Delta shares are down 51% since June 30 as fears the company will have to file for bankruptcy reach a fever pitch. On Monday, the company revealed that it has been burning through more cash than previously expected in a quarterly filing with the **Securities and Exchange Commission**, prompting Moody's Investors Service and Fitch Ratings to downgrade its already-low credit rating.

Recent company announcements have not been promising, but even more troubling are the increasingly hostile rhetoric and distant tone in negotiations between pilots and management, prompting Goldman Sachs to downgrade the company on Aug. 6. Delta management has insisted it needs \$1 billion in order to survive. In July, pilots put a \$700 million offer on the table. Neither side appears willing to compromise, and there are currently no negotiation sessions scheduled.

Delta's CEO Gerald Grinstein has good reason to stick to his billion-dollar demands. Other carriers that did not cut deep enough have been slowly bleeding to death. **UAL** (UALAQ.OB:OTC:BB) , parent of United Airlines, has been operating under bankruptcy for more than a year and a half and recently asked the bankruptcy court for another extension to file its reorganization plan. Recent reports maintain that **US Airways** (UAIR:Nasdaq) may have to re-enter Chapter 11 sometime in mid-September, just 17 months after emerging from bankruptcy protection.

Pilots have their own reasons for not digging deeper, frustrated by a management team that originally asked for \$850 million in concessions and has been slow to come to the table to discuss the state of the company -- or even present a plan to turn things around. In short, pilots don't want to be the only ones to pay for the blunders committed by Delta's management.

"The Delta pilots did not create Delta's financial problems," said John Malone, chairman of Delta's pilots union, in a letter to the *Atlanta Journal-Constitution* last week. "Nevertheless, we stepped forward a year ago to be part of the solution even though we knew the pilots alone could not solve the problem. Our latest offer is our third attempt to reach agreement with Delta management. ... Slashing labor costs alone is not a business plan. "

Pilots Are Willing to Pay

But while tough talk has investors spooked, pilots are privately far more afraid of losing their pensions -- a painful process that US Airways employees know too well. Unlike other carriers,

such as **JetBlue Airways** (JBLU:Nasdaq) , Delta has pilots who are older, and that is why the carrier has been taking big charges related to the early retirement of pilots, who are leaving the company to keep their pensions.

"Despite the chest-thumping, the pilots union has learned from the lessons of the last few restructurings," said Stuart Klaskin, founding partner of KKC Aviation Consulting. "Delta has a far more middle-of-the-road, mature workforce than other carriers. They're pragmatic people who are realizing what we make now is important -- but is it as important as a pension? They're looking at US Air and going, 'Oh, man.'"

For an old, deeply Southern company like Delta, which has been celebrating its 75th anniversary throughout 2004, the fact that it is in such dire straits has left some in denial and others so disillusioned that they fear bankruptcy is inevitable.

"There are people at Delta whose fathers and sons and uncles work there alongside them," said Klaskin. "That's been a great source of strength, this 'Delta Way.' But it's just difficult intellectually and emotionally to change a culture. So what has been a strength is now a weakness. They're not fast on their feet and loath to change. Some are still in disbelief they even need to change."

Regardless, change is coming, and it could be cataclysmic. In the next two weeks, management will reveal its top-to-bottom restructuring plan, a blueprint designed to make it competitive over the long run. For investors, employees and creditors, this plan is more important than anything else -- and it could affect the timbre of pilot negotiations.

If management can convince pilots it knows what it is doing, the rank-and-file could be willing to cut even deeper. While the union ultimately determines the level of concessions, private conversations with Delta's pilots reveal a softer, more fearful tone than the one usually associated with the kick-down, drag-out world of airline employee management relations. "I'm really worried that if we give \$700 million or \$800 million that we'll still end up in Chapter 11," said a Boeing 767 pilot with the company. "They have yet to show us anything that would indicate that they some sort of competent plan. I would absolutely give 40% if I knew we had a game plan. I'd give more. But it's tough to trust them unless they show us there's a light at the end of the tunnel."

The Billion-Dollar Question

But can management turn things around when so many others have already failed? Delta certainly doesn't sound confident. In its SEC filing earlier this week, the carrier noted that while it's working hard to cut costs and make strategic changes to avoid bankruptcy, "there can be no assurance this effort will succeed."

And with oil nearing \$45 a barrel, analysts are losing faith, too.

"They may be forced in; especially with oil prices where they are, they're going through more cash than they originally thought," said Helene Becker, an airline analyst at The Benchmark

Company. "I think the board would tell you they didn't expect to take two years, almost three, to get a pilot agreement. Quite frankly, that was ridiculous."

Turning Delta around could be impossible. None of the network carriers have completely solved their problems. American Airlines, a unit of **AMR** (AMR:NYSE) , has cut costs by \$4 billion annually but has seen its turnaround plan fall \$1 billion short of targets. **Northwest Airlines** (NWAC:Nasdaq) must negotiate concessions with a number of workgroups over the next few years, while **Continental Airlines** (CAL:NYSE) is already warning they may have to. And of course, there are United and US Airways.

"I give them a 50% chance to avoid bankruptcy," said Klaskin. "They are not ever going to become an efficient low-cost carrier. They are a big, traditional, multiclass, multiservice, hub-based carrier with a superior international alliance. They need to rightsize around that. It sounds simple -- it's not -- but that's what they need to do. You don't see Morton's Steakhouse selling burgers outside of a drive-through window."

Do You Buy It?

With Delta shares down 51% since June 30, the stock may seem like an attractive gamble at or around \$3.50, a level unseen in more than 25 years. And while the situation is bleak, Delta's pilots may be more willing to help out, allowing the company to dodge the bankruptcy bullet. If that happens, the positive catalyst would cause shares to spike -- a phenomenon seen by American Airlines' shareholders in 2003. Traders had shorted 58.5 million Delta shares through the end of July, roughly half its float, betting so heavily that Delta's stock will plunge they've created pent-up demand for shares if they don't.

But while the risk-reward seems compelling, now may not be the time. The odds appear long, and the deck is stacked against Delta.

"In a bankruptcy filing, you won't see the stock going to zero -- you can probably get out around \$1.50," said Becker. "If they file, you have \$2 of downside risk. And the stock could jump in the short term as the shorts rush to cover in the even of a filing. You have \$2 of upside and \$2 of downside, and that's not quite where we need to be. There is a price, probably under \$3, where I'd step up to the plate."