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By Dr. Israel Shaked and Brad Orelowitz

The Airline Industry and COVID-19: Saving for a Rainy Day

Dr. Israel Shaked
The Michel-Shaked Group and Boston University; Boston

Brad Orelowitz
The Michel-Shaked Group; Boston

Editor's Note: *ABI recently launched its COVID-19/Coronovirus Resources for Bankruptcy Professionals web page (abi.org/covid19), which aggregates information for bankruptcy professionals to assist clients and provide guidance due to the fallout from the COVID-19 pandemic.*

When considering whether to lend money to a company, lenders consider a company's historical performance and its projections for several years in the future. In addition, lenders conduct various ratio and sensitivity analyses.

Sensitivity analyses study how various sources of uncertainty contribute to the model's overall risk profile. They are typically performed by changing one or more variables in the company's financial projections and measuring the outcome. The extent by which these variables are changed is typically based on historical company-specific information, industry information and macro-economic factors. It is important to consider the industry in which the company operates. For example, it is not uncommon to consider variations of 30 percent when running sensitivity analyses for seasonal businesses such as toy manufacturers, or 3 percent when running sensitivity analyses on utilities. However, none of these sensitivity analyses are based on extreme cases like COVID-19.

The authors were recently engaged to testify on valuation and ability to pay debt for a well-known professional sports franchise. The working assumption was that the beta (the volatility of the company compared to the volatility of the overall market) of the professional sports franchise was low as the business is somewhat stable and does not move with the market. Even in 2008 when the markets collapsed, sports franchises did not feel the full brunt of the decline. Besides valuation and the analysis of the sports franchise's ability to repay its debt, at issue in this case was whether a debt guarantee had any value.

The common approach adopted by ratings agencies like Standard & Poor's and Moody's is to stress test the projections by considering a downside scenario to account for a possible event. Usually, the worst-case scenario for a professional sports franchise is a players' strike. In court, experts were challenged on the severity of the downside projections. However, none of the sensitivity analyses presented during the trial considered a delayed start to the season as a result of a global pandemic. With hindsight, one can say that the downside scenarios presented in the case were not extreme enough.

Airline Industry[1]

Since the airline industry's deregulation in 1978, market factors have resulted in dozens of bankruptcies, restructurings and consolidations within the industry.[2] Many of these airlines were put out of business by losing flight slots due to price competition. Other companies were gobbled up by their stronger competitors.

Airlines that were household names that no longer exist include Eastern Airlines, Pan Am and TWA (which filed for bankruptcy three times). More recently, US Airways, Continental Airlines and Northwest Airlines were taken over by American Airlines, United Airlines and Delta Air Lines, respectively. Further, even the larger airlines are not immune to recessions, with the three largest airlines (American, United and Delta) all filing for bankruptcy within the past 18 years.

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1 The authors thank David Cooper, an analyst with The Michel-Shaked Group, for his extensive research on the airline industry.

2 There is earlier research on airline deregulation. *See, e.g.*, Israel Shaked & Allen Michel, "Airline Deregulation and the Probability of Air-Carrier Insolvency," *Financial Review* (February 1987); Israel Shaked & Allen Michel, "Airline Performance Under Deregulation: The Shareholders' Perspective," *Financial Management* (Summer 1984).

The airline industry has experienced an extended boom period. Through the end of fiscal year 2019, the industry experienced historic levels of profitability. For example, as shown in Exhibit 1, in 2019 the six largest U.S.-based airlines (Delta, American, United, Southwest, Alaskan and JetBlue) had combined revenues of more than $175 billion, with a combined operating income of almost $19 billion.[3]

The combined-income statement for 2019 shows the profitability of these airlines. Debt levels were very manageable, as illustrated in the coverage ratios. For example, the median earnings before income, taxes, depreciation and amortization (EBITDA) coverage ratio for the top six airlines, which measures how many times interest expense is covered by EBITDA, was 23 times (extraordinarily high). Moreover, it is far higher than at the beginning of the decade, when it was four times. Similarly, the median net income margin (a measure of profitability) in 2019 was 8 percent, compared to 2 percent at the beginning of the decade.

Dr. Israel Shaked is the managing director of The Michel-Shaked Group and a professor of finance and economics at Boston University's Questrom School of Business. He also served for 20 years as a coordinating editor for the ABI Journal *and co-authored ABI's* A Practical Guide to Bankruptcy Valuation, Second Edition. *Brad Orelowitz, CPA is a senior vice president with the firm and has more than 25 years of experience in finance and accounting.*

In addition to the increased profitability, the balance sheets of these airline companies have also improved substantially over the past decade. It was assumed that these airlines had strengthened their financial positions to levels that will enable them to withstand a downturn in the economy. The median ratio of debt as a percentage of total capitalization decreased from 79 percent as of 2010 to 37 percent as of 2019, a dramatic decline. This resulted in a substantially lower degree of leverage.

Furthermore, debt represented more than four times annual EBITDA in 2010, and only 1.5 times annual EBITDA at the end of the decade. The median return on assets for the top six airlines was a little over 1 percent in 2010, compared to more than 5 percent by 2019.

Despite the stronger balance sheets and improved profitability, the combined cash on hand and cash equivalents for the six largest U.S.-based airlines actually decreased over the decade, from $23.5 billion in 2010 (when their combined operating expenses were $91 billion) to $19 billion in 2019 (when their combined operating expenses were $157 billion). It is well known in the financial world that for meeting unexpected liquidity needs, cash on hand should be higher when the overall activity and operating expenses increase. However, these six airlines were able to reduce debt, incur capital expenditures and invest in acquisitions. Over the past decade, these airlines invested significantly in their fleets and operations and, on a combined basis, spent $126 billion on capital expenditures (see Exhibit 2).

Furthermore, one of the primary factors affecting airlines' liquidity is that these six airlines took the opportunity to return funds to shareholders, through dividends and share repurchases. Consider the following distribution activities taken by these six airlines.

Delta Air Lines

In 2019, Delta Air Lines reported in its Form 10-K that "[t]he total number of shares purchased includes shares repurchased pursuant to our $5 billion share repurchase program, which was publicly announced on May 11, 2017, and will terminate no later than December 31, 2020."[4] The company also added that its "$8.4 billion of cash flows from operations helped fund $4.9 billion in capital expenditures, resulting in free cash flow of $4.2 billion, representing a $1.8 billion improvement to the prior year. We returned 72 percent of free cash flow, or $3 billion, to shareholders through share repurchases and dividends."[5]

Delta also stated, under the heading "Capital Returns to Shareholders," that "[s]ince first implementing our quarterly dividend in 2013, we have annually increased the dividend per share and paid $3.8 billion in total dividends, including $980 million in 2019. Through dividends and share repurchases, we have returned $15.3 billion to shareholders since 2013, while reducing outstanding shares by approximately 25 percent compared to the beginning of 2013. During 2019, we repurchased and retired 38 million shares at a cost of $2.0 billion. On February 6, 2020, the Board of Directors approved and we will pay a quarterly dividend of $0.4025 per share to shareholders of record as of February 20, 2020."[6] Delta also borrowed funds to participate in a rights issue to acquire common shares of one of its investments.

American Airlines

Similarly, American Airlines stated in its 2019 Form 10-K that "[s]ince July 2014, as part of our capital deployment program, our Board of Directors has approved seven share repurchase programs aggregating $13.0 billion of authority. As of December 31, 2019, there was $565 million of remaining authority to repurchase shares under our current $2 billion share repurchase program. Share repurchases under our repurchase programs may be made through a variety of methods, which may include open market purchases, privately negotiated transactions, block trades or accelerated share repurchase transactions."[7] In addition, the company stated that it has "returned $1.3 billion to our stockholders in 2019, including the repurchase of $1.1 billion of our common stock, or 33.8 million shares, and quarterly dividend payments totaling $178 million. Since our capital return program commenced in mid-2014, we have returned $13.6 bil-

3 All data in this article has been provided by FactSet.

4 Delta Air Lines Form 10-K for the year ending Dec. 31, 2019, p. 26.
5 *Id.* at 29.
6 *Id.* at 39.
7 American Airlines Form 10-K for the year ending Dec. 31, 2019, p. 34.

lion to stockholders, including $12.4 billion in share repurchases, or 312.7 million shares, and $1.2 billion in quarterly dividend payments."[8]

United Airlines

United Airlines' financial statements included similar language. For example, in the company's 2019 Form 10-K, United stated that it "repurchased approximately 19.2 million shares of [United] common stock for $1.6 billion. In December 2017, [United]'s Board of Directors authorized a $3.0 billion share repurchase program to acquire [United]'s common stock. In July 2019, [United]'s Board of Directors authorized a new $3.0 billion share repurchase program to acquire [United]'s common stock, in addition to any amounts remaining under the prior program. As of December 31, 2019, the company had approximately $3.1 billion remaining to purchase shares under its repurchase programs."[9]

Southwest Airlines

Southwest Airlines described its return of value to its shareholders in its 2019 Form 10-K: "The Company returned $2.4 billion to Shareholders through $372 million in dividend payments and $2.0 billion through four separate accelerated share repurchase programs and other open market share repurchases."[10]

Alaska Air Group

Consistent with the other companies in the industry, Alaska Air Group reported in its 2019 Form 10-K, under the heading "Shareholder Return," that the company had "paid cash dividends of $173 million and repurchased 1,192,820 shares of our common stock for $75 million under the $1 billion share repurchase program authorized by our Board of Directors in August 2015. As of December 31, 2019, the Company has repurchased approximately 7.1 million shares for $513 million under

8 *Id.* at 51.
9 United Airlines Form 10-K for the year ending Dec. 31, 2019, p. 26.
10 Southwest Airlines Form 10-K for the year ending Dec. 31, 2019 p. 41.

Exhibit 1: Income Statements for Fiscal Years Ending Dec. 31, 2019 (in $ Millions)

	Delta	American	United	Southwest	Alaska	JetBlue	Combined
Total Operating Revenue	$47,007	$45,768	$43,259	$22,428	$8,781	$8,094	$175,337
Total Operating Expenses	(40,389)	(42,703)	(38,958)	(19,471)	(7,718)	(7,294)	(156,533)
Salaries, Wages, Benefits and Related Costs	(11,225)	(12,609)	(12,071)	(8,293)	(2,533)	(2,320)	(49,051)
Aircraft Fuel and Related Taxes	(8,519)	(7,526)	(8,953)	(4,347)	(1,878)	(1,847)	(33,070)
Maintenance, Materials and Outside Repairs	(1,751)	(2,380)	(1,794)	(1,223)	(437)	(619)	(8,204)
Aircraft Rent	(423)	(1,326)	(288)	—	(331)	(99)	(2,467)
Landing Fees, Regional Expenses and Rent	(5,346)	(9,556)	(5,392)	(1,363)	(697)	(474)	(22,828)
Depreciation and Amortization	(2,581)	(1,982)	(2,288)	(1,219)	(423)	(525)	(9,018)
Other Operating Expenses and Special Items	(10,544)	(7,324)	(8,172)	(3,026)	(1,419)	(1,410)	(31,895)
Operating Income	6,618	3,065	4,301	2,957	1,063	800	18,804
Total Non-Operating Income (Expense)	(420)	(809)	(387)	—	(47)	(32)	(1,695)
Interest Expense	(301)	(1,095)	(731)	(118)	(78)	(79)	(2,402)
Interest Income	—	127	133	90	42	18	410
Capitalized Interest	—	—	85	36	15	14	150
Gain (Loss) on Investments	119	—	153	(8)	—	15	279
Other, Net	(238)	159	(27)	—	(26)	—	(132)
Income Before Taxes	6,198	2,256	3,914	2,957	1,016	768	17,109
Benefit (Provision) for Income Taxes	(1,431)	(570)	(905)	(657)	(247)	(199)	(4,009)
Net Income	$4,767	$1,686	$3,009	$2,300	$769	$569	$13,100

Exhibit 2: Total Capital Expenditures for Fiscal Years Annually Ending Dec. 31 (in $ Millions)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Delta	$1,342	$1,254	$1,968	$2,568	$2,249	$2,945	$3,391	$3,891	$5,168	$4,936
American	1,962	1,614	1,888	3,114	5,311	6,151	5,731	5,971	3,745	4,268
United	371	700	2,016	2,164	2,005	2,747	3,223	3,998	4,070	4,528
Southwest	493	968	1,348	1,447	1,828	2,143	2,147	2,249	1,976	1,027
Alaska	183	387	518	569	694	831	678	1,026	960	696
JetBlue	313	528	826	615	730	941	1,011	1,202	1,114	1,156
Total	$4,664	$5,451	$8,564	$10,477	$12,817	$15,758	$16,181	$18,337	$17,033	$16,611

this program. Since 2007, we have repurchased 62 million shares of common stock for $1.7 billion for an average price of approximately $27.89 per share. In 2019, we increased our quarterly dividend 9 percent from $0.32 per share to $0.35 per share, and, subsequent to December 31, 2019, we announced a 7 percent increase to $0.375 per share for 2020. Overall, we returned $248 million to shareholders during 2019. We currently expect to increase capital returns to shareholders in 2020 to approximately $430 million, of which approximately $250 million will be from share repurchases."[11]

JetBlue Airways

JetBlue Airways also had a share-repurchase plan in place. This plan was increased several times due to the company's improved condition. For example, the company stated in its 2019 Form 10-K that "[o]n September 10, 2015, our Board of Directors approved a share repurchase program of up to $250 million worth of JetBlue common stock over a three-year period beginning in January 2016. On December 7, 2016, the Board approved certain changes to our share repurchase program, or the 2016 Authorization, to increase the aggregate authorization to $500 million worth of common stock, and to extend the term of the program through December 2019. The 2016 Authorization was completed in 2017. On December 8, 2017, the Board of Directors approved a two-year share repurchase program, or the 2017 Authorization, of up to $750 million worth of common stock beginning on January 1, 2018. The 2017 Authorization was completed in 2019. On September 19, 2019, the Board of Directors approved a share repurchase program, or the 2019 Authorization, of up to $800 million worth of common stock beginning on October 1, 2019, and ending no later than December 31, 2021."[12] Exhibit 3 illustrates the dividends paid and Exhibit 4 presents the share repurchases for the six-largest U.S.-based airlines from 2010-19.

Summary

Through dividends and share repurchases, these six airlines have distributed almost $55 billion to shareholders in the past decade. Share repurchases are akin to dividends in that they represent a distribution to shareholders. However, a majority of academics challenge the value created for the company through share repurchases.[13] Once used to repurchase shares, these funds are no longer available to pay creditors, suppliers, employees and other non-equity stakeholders.

This is a case of "heads I win, tails you lose." When times are good, these companies are able to cover their fixed costs and are highly profitable. They are able to invest in their equipment and distribute very significant funds to shareholders. However, in a recession, they are unable to pay their debts and file for bankruptcy.

While the fallout from COVID-19 was totally unexpected, one needs to assess whether the distributions to shareholders were reasonable or excessive. In 2010, cash and cash equivalents for these six companies represented more than 24 percent of annual revenue. By 2019, this number had decreased to less than 11 percent.

Conclusion

Due to the suddenness and severity of COVID-19, there was no way to predict the fallout to the airline

11 Alaska Air Group Form 10-K for the year ending Dec. 31, 2019, p. 32.
12 Jet Blue Form 10-K for the year ending Dec. 31, 2019, p. 28.

13 *See, e.g.*, Allen Michel, Jacob Oded & Israel Shaked, "Not All Buybacks Are Created Equal: The Case of Accelerated Stock Repurchases," *Financial Analysts Journal*, Vol. 66, No. 6 (November/December 2010).

Exhibit 3: Cash Dividends Paid for the Fiscal Years Annually Ending Dec. 31 (in $ Millions)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Delta	$—	$—	$—	$102	$251	$359	$509	$731	$909	$980
American	—	—	—	—	144	278	224	198	186	178
United	—	—	—	—	—	—	—	—	—	—
Southwest	13	14	22	71	139	180	222	274	332	372
Alaska	—	—	—	28	68	102	136	148	158	173
JetBlue	—	—	—	—	—	—	—	—	—	—
Total	$13	$14	$22	$201	$602	$919	$1,091	$1,351	$1,585	$1,703

Exhibit 4: Share Repurchases for the Fiscal Years Annually Ending Dec. 31 (in $ Millions)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Delta	$—	$—	$—	$250	$1,100	$2,200	$2,601	$1,677	$1,575	$2,027
American	—	—	—	—	1,062	3,846	4,500	1,615	837	1,097
United	3	—	4	3	312	1,233	2,614	1,844	1,235	1,645
Southwest	—	225	400	540	955	1,180	1,750	1,600	2,000	2,000
Alaska	45	80	60	159	348	505	193	75	50	75
JetBlue	—	—	—	—	82	241	134	390	382	542
Total	$48	$305	$464	$952	$3,859	$9,205	$11,792	$7,201	$6,079	$7,386

industry. Similarly, when budgeting, one typically does not plan for a once-in-a-lifetime event. The authors do not believe that lenders and credit-rating agencies would — or should — change the way they perform their sensitivity analyses, as there is no way to reliably predict an event that is so many standard deviations away from the expected mean. If lenders would consider these events in their assessments, they would never lend money. However, in a cyclical industry, it is essential to retain some liquidity for a rainy day. abi

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