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Airline Financials – Understanding the Cash Flow Statement

This edition of *Touch & Gos* is another in a series of ongoing efforts to help you understand some of the financial aspects of our industry and our company as your union continues to prepare for contract negotiations. Delta's 2011 first quarter earnings will be reported on April 26, 2011.

In *Touch & Gos 11-02,* we looked at the Profit & Loss Statement, also known as the Income Statement. While the Income Statement shows the profits or losses that a company has generated over a certain period of time, it does not show how much cash the company has generated. Keep in mind that income generated is not the same thing as cash generated. To better understand how the company is generating (and spending) cash, we must look to the *Statement of Cash Flows*. This edition of *Touch & Gos* is not intended to be a detailed accounting treatise. As such, we will try to keep everything on a general level (but as in life, there are exceptions to just about everything).

There are three parts to the Statement of Cash Flows – cash flows from operating activities, cash flows from investing activities and cash flows from financing activities.

Cash Flows from Operating Activities

As the name suggests, this section of the cash flow statement shows how much cash a company is able to generate from its operations. Generally speaking, we would want to see a positive number here, as a negative number is an indicator that the company is spending more cash on its operations than it is bringing in.

To calculate the cash generated by operations, we begin with the net income as shown on the Income Statement. But net income is based on the *accrual method* of accounting and therefore includes items that are non-cash transactions. To arrive at the cash figure, appropriate additions or subtractions are made to net income.

For purposes of this discussion, we will focus on two of the adjustments that are typically made to net income – depreciation and amortization and air traffic liabilities.

Depreciation and Amortization

In 2010, Delta recognized $1.5 billion of depreciation and amortization (D&A) expense on its income statement. D&A is, however, a non-cash expense. When a company buys an asset, it spreads the cost of that asset over its useful life, rather than recognize the full purchase price of the asset on the day it is acquired.

For example, suppose Delta buys an airplane for $40 million and it expects to use that plane for 20 years. Instead of taking a $40 million hit to the income statement in the first year, generally accepted accounting principles dictate that Delta spread the $40 million cost over the next 20 years, so Delta would recognize $2 million of depreciation expense per year for the next 20 years.

Spreading the cost of the airplane over many years causes Delta to show depreciation expense on its income statement without actually spending cash. Therefore, we add the D&A expense back to net income to calculate cash generated from operations. (The full purchase price of the aircraft will be reflected in the *Cash Flow from Investing Activities* section of the cash flow statement, which is discussed below.)

Air Traffic Liability

When a passenger buys a ticket from Delta for future travel, Delta will not initially book that purchase as revenue. Accounting rules require that companies cannot

book revenue until they have actually earned it, so Delta cannot recognize that ticket sale as revenue until the passenger has actually completed his flight.

Delta does, however, receive the cash for the purchase right away, and it does owe the passenger a flight. Therefore, Delta will show an increase of cash on its balance sheet and will show a liability for the future flight. That liability is called *Air Traffic Liability* (ATL). When the passenger completes his flight, Delta will recognize the revenue for the flight and it will reduce the ATL account by the same amount.

What this means is that the revenue generated by ticket sales for a given time frame is not the same as the cash received during that same time frame. While this may seem like a trivial distinction, it is important when calculating net income and cash flow. Because of this timing issue, we adjust net income by the amount that the ATL account has changed.

For 2010, the ATL account increased $232 million. In other words, the cash that Delta *received* for future travel exceeded the cash value of tickets *used* by $232 million. As this represents an increase in cash, this amount gets added to net income.

After all adjustments were made, Delta generated $2.8 billion in cash from its operations in 2010.

Cash Flows from Investing Activities

This section of the cash flow statement shows how much a company is investing in its business. This section usually produces a negative number, as it shows the cash used to buy equipment, properties and investments. It also shows the sales of existing assets. This is where you would see the $40 million that Delta used to purchase the airplane in the earlier example.

If we focus on the "property and equipment additions" area, we see the amount of money that Delta is spending on acquiring (or modifying) assets. This is commonly referred to as *capital expenditures* or *CapEx*. For 2010, Delta spent $1.3 billion on CapEx.

Another frequently used term is *free cash flow*. This is simply a calculation of the cash from operating activities minus CapEx. For 2010, Delta had $1.5 billion of free cash flow.

Cash Flows from Financing Activities

The last section of the cash flow statement shows how much debt a company is either borrowing or paying back (and how much equity it is issuing or buying back). When this section produces a positive number, it means a company is borrowing more money than it is paying back. Conversely, when the section produces a negative number, it means a company is paying off more debt than it is issuing.

In Delta's case, we can see that Delta paid off $3.7 billion in debt, while at the same time issuing $1.1 billion of new debt. The $3.7 billion reduction in debt is a combination of scheduled debt payments and early retirement of debt. But, why would Delta pay off debt early while issuing new debt?

They do it for the same reason you might choose to refinance your mortgage – to get a lower interest rate. Delta (and Northwest) had issued debt upon emergence from bankruptcy, at a time when both were viewed as "less than stellar" credit risks and at a time when interest rates were relatively high. Now, Delta's credit rating has improved and interest rates have come down. It makes sense for Delta to pay off high interest loans and replace them with low interest loans.

Rumor Alert: *Yeah, but isn't paying off debt early just a ploy that management uses to cut into our profit sharing checks?*

Actually, paying off debt early has a positive effect on our profit sharing checks.

Remember that profit sharing is based on *pre-tax income*, or PTIX. The cash used to pay off the principal portion of debt does not show up on the income statement. The only thing related to debt that shows up on the income statement is the interest expense. So, when Delta pays off debt early, that means the interest associated with that debt no longer exists, and Delta's interest expense decreases. Similarly, when Delta pays off a high interest loan and replaces it with a low interest loan, Delta's interest expense will decrease. And, all other things being equal, lower interest expense means more pre-tax income, which means more profit sharing.

DELTA AIR LINES, INC.   Consolidated Statements of Cash Flows

(in millions)	Year E 2010
Cash Flows From Operating Activities:	
Net income (loss)	$ 593
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Depreciation and amortization	1,511
Amortization of debt discount, net	216
Loss on extinguishment of debt	391
Fuel hedge derivative instruments	(136)
Deferred income taxes	9
Pension, postretirement and postemployment expense (less than) in excess of payments	(301)
Equity-based compensation expense	89
Impairment of goodwill and other intangible assets	—
Restructuring and merger-related items	182
Changes in certain current assets and liabilities:	
(Increase) decrease in receivables	(141)
Decrease (increase) in hedge margin receivables	—
Decrease in restricted cash and cash equivalents	16
Increase in prepaid expenses and other current assets	(105)
Increase (decrease) in air traffic liability	232
Decrease in frequent flyer deferred revenue	(345)
Increase (decrease) in accounts payable and accrued liabilities	516
Other, net	105
Net cash provided by (used in) operating activities	2,832
Cash Flows From Investing Activities:	
Property and equipment additions:	
Flight equipment, including advance payments	(1,055)
Ground property and equipment, including technology	(287)
(Increase) decrease in restricted cash and cash equivalents	(2)
(Purchase) redemption of investments	(730)
Increase in cash in connection with the Merger	—
Proceeds from sales of flight equipment	36
Other, net	12
Net cash (used in) provided by investing activities	(2,026)
Cash Flows From Financing Activities:	
Payments on long-term debt and capital lease obligations	(3,722)
Proceeds from long-term obligations	1,130
Proceeds from American Express Agreement	—
Payment of short-term obligations, net	—
Proceeds from sale of treasury stock, net of commissions	—
Other, net	71
Net cash (used in) provided by financing activities	(2,521)

Depreciation

Air Traffic Liability

CapEx

Debt reduction

New Borrowing