

INVESTMENT NOTE

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What's behind Delta's top-flight performance?

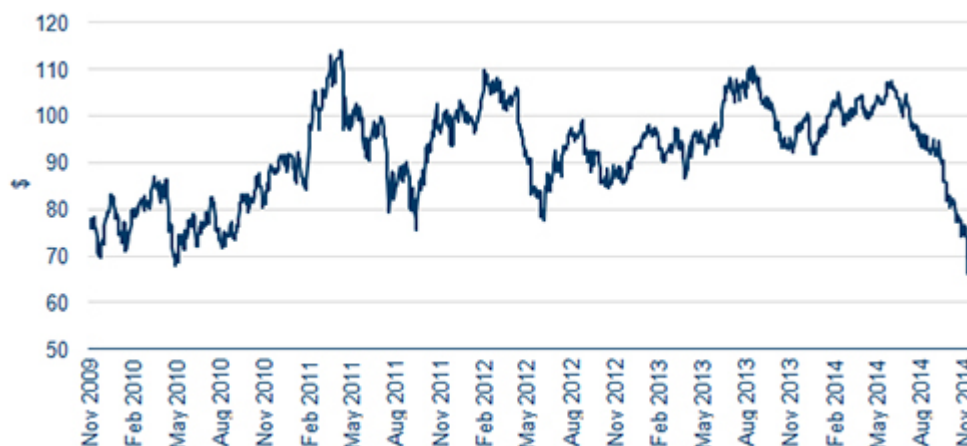
Geir Lode, Head of Hermes Global Equities, discusses how one portfolio stock best captured two of the major global equity themes of 2014 – the falling oil price and investors' support of good corporate governance –Delta Airlines.

We initially purchased stock in the Atlanta-based carrier in 2013. In our research, we identified strong fundamentals: improving margins and revenues, a stable balance sheet, improving market sentiment and an attractive valuation relative to peers. The company was generating high levels of cash and returning a generous amount of it to shareholders through a newly announced capital deployment program featuring both dividends and share buy-backs.

Its positive story backed up these fundamentals. As the second-largest US airline and the dominant transatlantic carrier, Delta was well positioned to benefit from steadily increasing corporate travel revenues. Further, US airlines continue to be less exposed to low-cost competitors such as Ryanair, which have taken market share from legacy European carriers.

The determination of OPEC to keep oil production at current levels and drive prices below the point of economic viability for US shale drillers has driven the oil price lower for five consecutive months (see figure 1). Like other transport businesses, Delta is benefiting from cheaper fuel, and this has contributed to its stellar returns in the last month. However, this is only the latest positive development for Delta: it has been a successful investment and its appreciation can be partially attributed to its high standards of corporate governance. In 2014 it has become the best performer for the Hermes Global Equity ESG Fund (see figure 2).

Figure 1. Under the pump: the oil price has tanked in recent months



Source: Bloomberg

The corporate governance practices guiding Delta are impressive: the company's board is focused on long-term sustainability, with strong governance structures in place that include the separation of chairman and CEO duties. It consists of 11 independent members and three executives, and is led by an independent chair. In 2013, 99% of shareholders voted in favour of the airline's executive pay scheme, which is totally driven by performance. This alignment with investors is strengthened by its

commendable disclosure of business information.

Delta has a track record of implementing important and progressive social initiatives ahead of its competitors. In 2011, it became the first US airline to sign a code of conduct for tourism businesses, known as ECPAT International, seeking to end child prostitution, pornography and trafficking. This focus became compulsory for all carriers in 2013 when the Blue Lightning initiative, led by the Department of Homeland and Department of Transportation, required airlines to train their personnel to identify potential offenders and report them to the authorities.

Environmental pollution is a continuous concern for airlines. Delta has not achieved best practice, partially due to its old fleet, but is improving. It is satisfying stricter regulatory standards by upgrading ground-handling equipment, using low-carbon jet fuels and implementing measures to conserve fuel.

Figure 2. Ascending: the share price of Delta Airlines, May 2013 to December 2014



Source: Bloomberg

Looking into 2015, we are optimistic about Delta's performance prospects. Cheaper fuel in the US, driven by lower oil prices, not only reduces the carrier's input costs but also acts as a tax cut for middle-class households. This increases their disposable income and makes travel more affordable. Delta's free cash flow yield continues to improve, and despite the recent rally its stock valuation remains attractive.

The main risks to its performance are macroeconomic developments and the movement of oil prices in 2015. If OPEC backs down, or if the recent plunge in oil prices is due to weak demand rather than abundant supply, the short-term outlook for the stock is less favourable. However, we believe that the macroeconomic picture is positive, with US growth likely to continue, and that demand – at least in the US – will remain strong, making Delta an excellent opportunity for investors.

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For further information, please contact:

Hermes Investment Management

Jeannie Dumas
+44 (0)20 7680 2152
jeannie.dumas@hermes-investment.com
investment.com

Melanie Bradley
+44 (0)20 7680 2218
[melanie.bradley@hermes-](mailto:melanie.bradley@hermes-investment.com)

Notes to Editors:

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- **Responsibility:** We believe it is our responsibility to lead discussion and debate about the fiduciary responsibilities of fund managers to our clients, their stakeholders and, ultimately, society at large. We have always sought positive engagement with the firms in which we invest.
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