
United Continental Holdings, Inc (NYSE: UAL)

ONE YEAR PRICE RANGE: \$61.91 – 68.76

LAST PRICE: \$68.39

ANALYST RATING: Sell

VALUATION DATE: August 3, 2017

NEXT EARNINGS DATE: October 17, 2017

Investment Thesis:

- Off-balance sheet debt in the form of operating leases doubles United Airlines long-term debt. When including retirement-related liabilities, the Company's D/C ratio is 61%. High levels of debt can make bottom line performance volatile.
- ROIC is close to equal the cost of capital. Discrepancy between low beta of 1.03, and the amount of debt relative to equity. Calculated alternative beta in DCF.
- Discrepancy between high per share value in the DCF and earnings model price range is due to high depreciation expense.
- No margin of safety in dividends, although the Company returns cash to shareholders through huge share repurchase programs. The levels it currently repurchases shares are unsustainable (115% of net income spent on repurchases in 2016).
- Operating cash flow is 17.7% of net income
- Currently exposed to fuel price risks, no hedges. A one dollar change in the price of a barrel of crude oil changes the Company's annual fuel expense by \$95 million.
- Lack of control over the quality of service offered to passengers when contracting out flights to regional airlines, and lack of autonomous decision making abilities due to alliance relationships

Overview:

United Continental Holdings, Inc. is the holding company of United Airlines, Inc. United Airlines operating revenues and expenses comprise nearly 100% of the Holding Company's revenues and operating expenses. The Company was incorporated on December 30, 1968, and is currently headquartered in Chicago, Illinois. United operates using the hub and spoke system to transport people and cargo through its mainline and regional operations. The hub system allows for both more frequent service between a large number of destinations and allows for the addition of service from a major city using minimal aircraft equipment.

Hubs:

- Newark Liberty International Airport
- Chicago O'Hare International Airport
- Denver International Airport

- George Bush International Airport
- Los Angeles International Airport
- A.B. Won Pat International Airport
- San Francisco International Airport
- Washington Dulles International Airport

To supplement its hub and spoke network, the Company has contracts (Capacity Purchase Agreements) with regional carriers including Republic Airlines, Champlain Enterprises, CommutAir, ExpressJet Airlines, GoJet Airlines, Mesa Airlines, Shuttle America, SkyWest Airlines, and Trans States Airlines. The regional carriers are required to dedicate an agreed-upon amount of capacity in exchange for reimbursement of operating expenses and contractually agreed fees.

United is also a member of Star Alliance, a global integrated airline network that serves 1,300 airports in 190 countries and obliges the Company to certain earning and redemption of frequent flyer miles, access to airport lounges, and codesharing of flight operations.

Business Drivers:

- Price of oil and labor costs affect profit margins
- Demand Markets: leisure travel, business travel, freight transportation
- High switching costs through loyalty point systems drive repeat customers

Customers:

- Leisure travelers (the purchaser)
- Business travelers (the user, but not the purchaser)

Services:

- Air travel
- Freight transportation
- Ancillary services:
 - Sells customized ancillary services through its Global Distribution Systems

Key Valuation Metrics vs. Industry Averages¹:

Price/Earnings: UAL 8.77x vs. Industry 11.81x

Dividend Yield: UAL 0% vs. Industry 0.84%

Gross Profit Margin: UAL 26.77% vs. Industry 48.28%

Operating Profit Margin: UAL 11.52% vs. Industry 14.34%

Net Profit Margin: UAL 6.57% vs. Industry 8.46%

Return on Equity: UAL 29.52% vs. Industry 30.47%

Return on Assets: UAL 5.93% vs. Industry 6.80%

¹ Industry averages provided by TD Ameritrade.

Price to BV/share: UAL 2.32x vs. Industry 3.56x

Comp Universe

- American Airlines
- Southwest Airlines
- Delta Airlines

Glassdoor Metrics:

Glassdoor reviews rate United Airlines a 3.9 out of 5, with 77% willing to recommend this employer to a friend, and 94% of reviewers approving of the CEO. These ratings are a positive signal of employee morale and quality of work within the Company. The CEO, Oscar Munoz, was the 18th highest rated CEO of 2017 on Glassdoor. Ratings have steadily trended upward over the last year, and 69% of reviewers project a positive business outlook.

Industry Background - Airlines²

The Airline Industry is intensely competitive, littered with high debt levels and bankruptcies. The U.S. Department of Transportation separates the industry into four categories: International, National, Regional, and Cargo. International airlines represent the largest transportation companies with the most capabilities and largest revenue streams, while cargo airlines simply transport freight and generate the least revenue. Industry performance is heavily dependent upon weather, the cost of fuel, and the cost of labor. Industry participants typically hedge fuel price risk through derivatives and futures contracts. Consumer and business confidence are instrumental drivers of demand for air transportation. Load factor (percentage of available seating capacity filled with passengers) and available seat miles (seats available for passengers * miles flown during period) are also telling of an airline's utilization and total capacity.

Company Financials

In adjusting United Airlines' financials, cost of sales include aircraft fuel, and aircraft maintenance materials and outside repairs, while SG&A expenses include salaries, regional capacity purchase, landing fees and other rent, distribution expenses, and aircraft rent. From FY 2014 to TTM June 30, 2017, the Company has decreased revenue at a compound annual growth rate of 1.1%, but has increased net income at 22% (**Appendices A-B**). The Company's revenue decreases are relatively concerning albeit small over a three and a half year period, while net income growth has been large yet volatile over a longer period. The Company had a net loss of \$723 million in 2012. The Company's profitability metrics are average to below average, which is discouraging considering its size and global reach. United has a meager ROA of 5.4%, and a tangible book value per share of \$2.40.

WACC

- Relevered Beta: 1.42
- Equity risk premium (Damodaran monthly ERP): 5.13%
- Risk free rate (10 year treasury rate): 2.38%
- WACC: 5.11%

² <http://www.investopedia.com/features/industryhandbook/airline.asp>

Valuation

A five-year discounted cash flow analysis of the Company yields an equity value per share of \$73.53 and a one year price target of \$80.64 based on a cost of equity of 9.67% (**Appendix C**). The WACC in this case seems low as a proper representation of risk as the company has very high levels of debt – especially when factoring in operating leases and retirement related liabilities. This valuation contrasts the one year price range of \$61.91 - \$68.76 based on a capitalization rate of 9.0x to 10.0x and projected EPS of \$6.88.

Appendices

Appendix A – Income Statement

Income Statement for United Continental Holdings, Inc.					
<i>Dollars in millions, except per share data</i>					
				Fiscal year ended Dec 31,	
				Hist 1	Hist 2
				Hist 3 (TTM)	
Net Sales				\$38,901.0	\$37,864.0
Cost of sales, excluding depreciation (1)				13454.0	9173.0
Gross Profit				25447.0	28691.0
SG&A Expenses, excluding amortization				16252.0	16628.0
Other Operating (Income)/Expenses				5143.0	5078.0
EBITDA				4052.0	6985.0
Depreciation (1)				1551.0	1714.0
Amortization				128.0	105.0
EBIT (2)				2373.0	5166.0
Interest Expense				735.0	669.0
Interest (Income)				-74.0	-74.0
Other non-operating (income)/expense				584.0	352.0
Pretax Income				1128.0	4219.0
Income taxes (3)				-4.0	-3121.0
Net Income (4)				1132.0	7340.0
<i>Diluted weighted average shares outstanding</i>				382.1	376.1
Earnings Per Share				2.96	19.52
					7.32

Income Statement is adjusted for non-recurring charges.

Appendix B – Balance Sheet

Balance Sheet for United Continental Holdings, Inc.						
<i>Dollars in millions, except per share data</i>						
				Fiscal year ending Dec 31,		
				Hist 1	Hist 2	Hist 3
Cash				\$4,384.0	\$5,196.0	\$4,649.0
Accounts receivable, net				1,146.0	1,128.0	1,499.0
Inventories				666.0	738.0	882.0
Other current assets				1,351.0	766.0	1,218.0
Total current assets				7,547.0	7,828.0	8,248.0
PP&E, net				19,467.0	21,580.0	25,017.0
Definite life intangibles				2,533.0	2,398.0	2,268.0
Indefinite life intangibles				1,751.0	1,738.0	1,324.0
Goodwill				4,523.0	4,523.0	4,523.0
Other long-term assets				774.0	2,794.0	927.0
Total assets				36,595.0	40,861.0	42,307.0
Accounts payable				\$1,882.0	\$1,869.0	\$2,225.0
Accrued liabilities				2,512.0	2,474.0	1,812.0
Unearned revenue				5,759.0	5,870.0	7,171.0
Other				932.0	842.0	837.0
Total current liabilities				11,085.0	11,055.0	12,045.0
Long-term debt				11,947.0	11,759.0	13,163.0
Retirement-related liabilities				4,159.0	3,370.0	3,336.0
Long-term deferred revenue and purchased miles				4,096.0	3,836.0	3,013.0
Other long-term liabilities				2,912.0	1,875.0	1,896.0
Total liabilities				34,199.0	31,895.0	33,453.0
Total equity				2,396.0	8,966.0	8,854.0
Total liabilities & equity				36,595.0	40,861.0	42,307.0

Appendix C – Valuation

DCF for United Continental Holdings, Inc.

Dollars in millions, except per share data

	Fiscal year ending Oct 1,				
	Proj 1	Proj 2	Proj 3	Proj 4	Proj 5
EBITDA	6590.309	6729.714	6993.18	7262.293	7537.17315
Less: Depreciation	2143.282	2146.213	2170.265	2194.421	2194.42142
Less: Amortization	79	70	64	58	53
EBIT	4368.027	4513.501	4758.915	5009.872	5289.75173
Less: Taxes	1426.192	1484.675	1585.654	1687.105	1802.50698
Tax-effected EBIT	2941.835	3028.826	3173.26	3322.766	3487.24475
Add: Depreciation	2143.282	2146.213	2170.265	2194.421	2194.42142
Add: Amortization	79	70	64	58	53
Less: Capital Expenditures	3663.73	3700.367	3774.375	3849.862	2194.42142
Less: Change in NWC	-263.272	-24.5774	-112.239	-113.625	-174.80884
Unlevered FCF	1763.659	1569.249	1745.39	1838.951	3715.05359
Partial Period Adjustment	0	0	0	0	0
Mid-year convention	0.5	1.5	2.5	3.5	4.5
Discount Factor	0.975404	0.928013	0.882924	0.840026	0.79921229
Discounted UFCF	1720.281	1456.283	1541.047	1544.767	2969.11648
Sum of UFCF	9231.494				
Terminal Value	60297.39				
PV of Terminal Value	47005.14				
Enterprise Value	56236.63				
less: Net Debt	33361.72				
Equity Value	22874.91				
Outstanding shares	311.1				
Equity Value per share	73.52911				
One year price target	80.64036				

Assumptions:	
WACC	5.1%
EBITDA Exit Multiple	8.0x
Discount Periods	5.0
TV Discount Factor	0.77955513

Appendix D – Sensitivity Analysis

WACC	Equity Value per share	Exit Multiple	Equity Value per share
	73.52911		73.52911
6.50%	62.84019	5.5	26.31244
7.00%	59.20018	6	35.75578
7.50%	55.65844	6.5	45.19911
8.00%	52.21186	7	54.64244
8.50%	48.85742	7.5	64.08578
9.00%	45.59224	8	73.52911
9.50%	42.41353	8.5	82.97244
10.00%	39.31859	9	92.41578
10.50%	36.30483	9.5	101.8591
11.00%	33.36974	10	111.3024
11.50%	30.51092	10.5	120.7458
12.00%	27.72602	11	130.1891