



## Did Airlines Just Become a Good Business?

### Description

*"Indeed, if a farsighted capitalists had been present at Kitty Hawk, he would have done his successors a huge favour by shooting Orville down."* — Warren Buffett, annual letter to Berkshire Hathaway shareholders, February 2008.

Airlines are a terrible business. It's both capital intensive and notoriously competitive. No wonder the industry has a poor reputation. But recent headlines should prompt investors to rethink their view of the industry.

### Lots of changes overhead

There were several positive developments out of the airline industry this week.

South of the border, the U.S. Justice Department gave the greenlight for a merger between American Airlines and **U.S. Airways** creating the world's largest carrier. The deal would create viable competitor to **United Airlines** and **Delta Air Lines** which have grown through mergers themselves.

North of the 49', shares of **Air Canada** (TSX: AC.A, AC.B) just hit a five year high. On Tuesday the company reported spectacular results on the back of higher margins and cost cutting. The carrier's adjusted net income jumped 60% increase year-over-year to \$365 million. Adjusted earnings totaled \$1.29 per share, 26 cents per share above the street's estimate.

Hey, wait a minute. Here is an industry that is consolidating into an oligopoly. The players are starting to muscle pricing power.

### Did the airline industry just become a good business?

Looking over Air Canada's quarterly results, it's evident that the company has addressed many of the problems that have plagued the industry since Kitty Hawk.

What about high fuel costs? Air Canada has purchased a fuel efficient fleet drastically cutting energy consumption. And by introducing fuel surcharges the airline has effectively passed on volatile commodity prices to customers.

How about margins? The price war between Air Canada and its biggest rival **Westjet** has died down to a dull skirmish. You may have noticed this yourself when booking flights. There're simply no more cheap fares. And those \$2 headphones and baggage fees really add up.

Historically whenever the economy ramps up, carriers would flood the market with new routes. But this cycle executives have learned their lesson opting to fly fewer planes at full capacity. A much more profitable formula.

And what about the unions? Once again this issue may have been solved. Last year when employees threatened to strike, the federal government stepped in to block the action. This has eliminated much of labour's negotiating power.

Mergers south of the border are also encouraging. The industry is starting to resemble an oligopoly of a few lightly competing rivals. That's a lucrative situation for investors.

In many ways the airline business could be analogous to the railroad industry 30 years ago. Throughout its history, railroads were a terrible business with hundreds of firms competing against each other. High costs forced many into bankruptcy.

Today, the industry is a collection of a dozen major corporations each with near monopolies in their respective markets. High barriers to entry make it nearly impossible for any upstart to grab a peice of those profits.

### **But don't pop the cork yet**

Unfortunately, there are a few holes in my thesis which I haven't yet resolved.

First, Air Canada's ability to control labour costs was only possible because the business friendly Progressive Conservative party is running the show in Ottawa. Would a Liberal or NDP government side with labour in future negotiations? With the political polls running at a near 30-30-30 split, that's a real possibility.

Second, while it might be hard to start a railroad it's easy to enter the airline business. Higher profit margins will attract competitors as already evident in the States with **Spirit Airlines**. Suppliers like **Boeing** and Airbus are happy to finance new fleets with cheap loans.

### **Foolish bottom line**

Concerns aside, the economics of the airline business are starting to change. It might be time for investors to rethink their views on this industry.

## **CATEGORY**

1. Investing

## **TICKERS GLOBAL**

1. NYSE:BA (The Boeing Company)

**Category**

1. Investing

**Date**

2025/07/06

**Date Created**

2013/11/13

**Author**

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