Which Airline Belongs in Your Portfolio?

Description

There is a reason why Warren Buffett hates airline stocks. As he put it in 2002, “You’ve got huge fixed costs, you’ve got strong labour unions and you’ve got commodity pricing. That is not a great recipe for success.”

In the past 15 years, September 11, the financial crisis, rising fuel prices, and worker strikes have not been kind to the airlines. As a result, many investors have sworn off airline stocks altogether. After all, you can’t lose if you don’t play. But with an entire sector so despised by the investment community, has that created any opportunities? Below we look at three major operators.

1. Air Canada

In 2013, everything seemed to go right for **Air Canada** (TSX: AC.B). Cost-cutting programs and more favourable labour contracts helped the airline achieve cost savings of $530 million per year (over $2 per share, not bad for a company with an $8 stock price). It also helped that demand rebounded — global revenue passenger kilometres increased 5% for the industry in 2013. As a result of all this, the stock returned 323%.

But Air Canada still has further room to run (or fly). The company can cut costs further, and the stock still trades at a discount relative to its peers — according to Morningstar, Air Canada trades at a forward P/E ratio of 4.4. Part of this is due to troubled history (the company declared bankruptcy in 2003 and has since come close twice), and part due to a scary balance sheet (debt plus pension deficit totals $25 per share). Investors willing to bet that the company can continue its turnaround will be rewarded handsomely if they are right.

2. WestJet

Throughout its history, **WestJet Airlines** (TSX: WJA) has been a stronger operator than Air Canada, and thus its shares are less of a gamble. Since 2005, WestJet has reported a profit every single year, even during the economic crisis. WestJet hopes to generate a 12% return on invested capital overtime, very impressive for an airline – over the past two years, this number has been close to 14%. Andunlike Air Canada, WestJet actually pays a dividend, which is currently yielding 2%.

Of course, WestJet trades at a premium to Air Canada, with a forward P/E of 10.1. But with a better track record than Air Canada, WestJet shares are still likely the better choice.

3. Transat

Transat (TSX: TRZ.B) is an integrated tour operator, and thus has a wider range of services than both Air Canada and WestJet. But the company still has some of the same challenges, mainly commoditized pricing and paper-thin margins. For example, the company's operating margin was only 2% last year.

But Transat still has some small advantages, such as a strong brand and a completely integrated model — the company can sell you every part of your vacation. That being said, the company is quite risky, one that Warren Buffett would never buy.

So which one should you go for?

I don't like to advocate for rolling the dice with your investments. So with that in mind, you should choose either WestJet or none of them at all.

CATEGORY

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