Attention, Airline Investors: Trouble Is Coming for Air Canada and Westjet Airlines Ltd.

Description

Even during boom times, airlines are precarious businesses.

Take **Air Canada** (TSX: AC.B) as an example. Even though the company's load factor — a measure of how full its planes are — is at record highs, profitability just hasn't followed. Over the company's past five quarters, it's managed to make a profit just twice. And this is during an era where business travel has largely recovered since the Great Recession, and travel for recreational purposes is more popular than ever. If Air Canada can't stay consistently profitable now, what chance does it have when business inevitably slows down?

Meanwhile, **Westjet Airlines Ltd**. (TSX: WJA) continues to perform well. The company consistently posts solid profits, pays out a rising dividend, and only trades at a P/E ratio of just over 15. It recently started flying from St. John's to Dublin, which marked its first foray into Europe. It also has, at least in my opinion, staff that go head and shoulders above its competitors in service.

Westjet also has terrific management. For years, the company kept maintenance costs low by only using one type of plane, a conscious decision by the folks in charge. And while Air Canada and its labor unions were locked into heated battles, Westjet has not only kept unions out, but has arguably kept staff happier as well. That's a huge win for the upstart competitor from Calgary.

Both of Canada's incumbents have had a pretty easy time over the last few years. Demand is up, oil prices have moderated, and on many routes they're the only two players in the sky. But that's about to change.

Competition is coming

Rumors have been swirling for months that competitors could start coming into the market, and now it looks almost a certainty.

Back in June, an upstart airline called Jet Naked started gaining publicity. The company, which has Westjet co-founder Tim Morgan as one of its founders, has already acquired three Boeing 737 jets, and is looking for an additional $30 million-$50 million in startup financing. If it all goes to plan, Jet Naked could be serving western Canada by early next year.

Jet Naked would introduce the concept of a true discount airline to Canadians, like Spirit Airlines in the U.S. or Ryanair in Europe. It hopes to cater to Canadians who don't fly very often or those who are just tired of paying for expensive tickets from the current operators. Management is targeting a ticket price of approximately 40% lower than its competitors.

A rogue startup trying to steal away price sensitive customers wouldn't be a big deal to Air Canada and Westjet, at least to begin with. Both companies can cut prices and hope to squeeze out the new player, making up for it on other routes.

But what if a real competitor comes to Canada?

That looks to be happening, as rumors are that **Southwest Airlines Co.** (NYSE: LUV) is close to announcing its own expansion into Canada. Company execs have been candid about discussions that have happened with Canadian airports, and CEO Gary Kelly told reporters that "[He'd] be surprised if we weren't in Canada at least by the end of the decade."

Southwest represents a major potential competitor in routes from Canada to the U.S. The company is well known for keeping costs under control, and isn't likely to enter the market without a solid plan to undercut the existing competition. It's a definite potential problem for the incumbents.

Bottom line

Ultimately, it's a poor time to invest in airlines. The boom times never last, and the busts are among the worst of any industry. Even billionaire Warren Buffett refuses to invest in it. With upcoming competition an almost certainty, I'd avoid the sector.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:LUV (Southwest Airlines Co.)

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