Do Airline Stocks Provide Investors With the Same Opportunity as Rails Did 20 Years Ago?

Description

Publicly listed airlines, including **Air Canada** (TSX:AC.B) and **WestJet Airlines Ltd** (TSX:WJA) have been on a tear over the past few months as investors consider the impact that lower fuel costs will have. This has not been a short-term phenomenon however as airline stocks in both the U.S and Canada have performed better than the general market, as well as the railroad operators, over the past 5 years.

However, historically, airlines have not performed well and the investment landscape is littered with the wreckage of failed airlines. Warren Buffet once famously remarked: “I have an 800 (free call) number now that I call if I get the urge to buy an airline stock. I call at two in the morning and I say: ‘My name is Warren and I’m an aeroholic.’ And then they talk me down.”

The reasons for poor longer term performance of the airlines include – high capital costs and fixed overheads, abundant competition, fuel prices that are largely out of the control of management and strong labour unions.

Can the airlines become as profitable as the railroad companies?

The railroad operators, including **Canadian National Railways** (TSX:CNR)(NYSE:CNI) and **Canadian Pacific Railways** (TSX:CP)(NYSE:CP) have also not always had the greatest reputations. However, over the past 20 years, these companies have established almost impenetrable barriers to entry and considerable cost advantages over other modes of land based transport resulting in much improved profitability with a great result for shareholders.

Helping with this was significant consolidation in the 1980’s that reduced the number of North American Class I railroads from forty to eight. This limited competition and allowed the largest railroads to improve their efficiencies through the elimination of unprofitable routes, better asset utilisation and improvements in labour and fuel efficiencies.

Canadian National, arguably the prominent railroader in North America, managed to improve its operating margin from below 10% in the early 1990's to more than 40% by 2004 where it still remains in 2014. The return on equity followed a similar pattern and has stabilised between 17% and 25% since 2004.

Could a similar dynamic have taken hold in the airline industry? The 2008 downturn, combined with high fuel costs pushed large U.S. carriers to merge in hopes of improved competitive positions. The largest four U.S. carriers now control more than 80% of the domestic market. This certainly helps to control competition and capacity additions.

In addition, U.S. airlines started to charge customers for options such as preferred seating, checked baggage, onboard Wi-Fi and itinerary changes. In the case of **United Continental Holdings Inc** (NYSE:UAL), ancillary fees totalled $2.8 billion in 2013 compared to $2.2 billion 3 years earlier. Air Canada and WestJet have also implemented several of these charges in their fee schedules.

Despite the high fuel costs of the past few years, Air Canada (especially) and WestJet have succeeded in improving their levels of profitability. The current CEO of Air Canada, Calin Rovinescu, appointed in 2009, has taken significant steps to improve the business. This has resulted in improvements in almost all of the key operating and cost measures and even the achievement of a small net profit (gasp!) in 2013. More profits are expected in 2014 and 2015. And now that fuel costs (the single largest expense of an airline) have declined, actual profits may exceed expectations.

Is it time to buy?

The benefits of industry consolidation, capacity constraints, additional charges for "value added" services and fuel surcharges have certainly improved the profitability of the major North American airlines. Lower fuel costs should also support profits for some time to come.

In addition, valuations remain reasonable with Air Canada trading at a forward EV/EBITDA ratio of 2.9 times and WestJet at 4.4 times. This is about a third of the multiples afforded to the Canadian railroad operators and also offer a discount to the major U.S airlines.

Despite the legacy issues that the industry has faced, and may face again, it would seem if the confluence of several positive factors, including lower fuel costs, will at least support the prices of these stocks for the foreseeable future.

CATEGORY

1. Investing

TICKERS GLOBAL

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2. NYSE:CP (Canadian Pacific Railway)
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4. TSX:CP (Canadian Pacific Railway)

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