Why Now Might Be the Worst Time to Buy Air Canada and Westjet Airlines Ltd.

Description

In 2015 it's good to be in the aviation business.

It isn't very often someone gets to say that. The price of fuel has collapsed thanks to a decrease in the price of crude. But unlike last time the price of fuel was this low back in 2009, planes are full. Both **Air Canada** (TSX:AC) and **Westjet Airlines Ltd.** (TSX:WJA) have recently reported great load factors, which is basically a measure of how many seats are occupied. Both airlines' load factors are comfortably over 80%, which is about as good as it gets.

And thanks to the duopoly setup we have in Canada, fares are high. This is mostly because the two major Canadian airlines got smart and realized it just wasn't worth it to compete on price. If you take a look for just about every domestic route, prices are usually within a few dollars of each other. That's not a coincidence.

And especially in Air Canada's case, labour relations have finally taken a turn for the better. Gone are the days where unions and management are fighting about salaries or benefits. The unions have taken their medicine, and the health of the business has drastically improved because of it.

Finally, both airlines trade at cheap valuations. If you believe analysts' estimates, Air Canada trades at less than four times projected 2015 earnings with a median target price of almost $24, almost double compared with current levels. Even Westjet is cheap, trading at just 10.2 times trailing earnings.

With all that good news, it would seem like both stocks are a screaming buy. So, why am I sour on the sector?

Are there upcoming storm clouds?

The airlines are cyclical businesses. When times are good, airlines do well. And when times are not so good, they struggle. There's no avoiding it. Think about an airline's cost structure: the majority of costs are wrapped up in a few different categories, like acquiring the airplane in the first place, fueling it, and hiring staff to run it. All the other stuff doesn't really matter that much.

If the overall economy deteriorates and less folks fly, there isn't much the airlines can do to cut costs. Sure, they can lay some staff off, but that's difficult with carriers where unions are strongly entrenched, like Air Canada. Besides, most airlines are run pretty efficiently, thanks to issues faced the last time the sector struggled.

If load factors fall from the low 80% range into the mid-to-low 70% range, both of Canada's major airlines would see profitability fall probably pretty dramatically. If you don't think that's possible, let me remind you that it has happened as recently as 2010. Just a year later, Air Canada flirted with bankruptcy and Westjet shares briefly dipped below $12 each.

The other thing that happens during periods of weakness is that airlines become desperate to fill seats, and will begin to compete on price again. Even in today's age of checked baggage fees, that's still not a spot a carrier wants to be in.

Both carriers are reporting great load factors, and are being helped by low fuel costs and a robust economy. That's a lot of helpful things happening at once. It looks like these things will continue, but as we all know, the future is really unpredictable. Something will happen to change the story. With the airline business, something always does.

So, even though both Air Canada and Westjet are trading at low valuations, I'm avoiding both stocks. Airlines have a way of sucking you in when times are good, but things can get very bad in a hurry. It could be years before it happens, but if history is any guide, investors will have to deal with it at some point.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:AC (Air Canada)

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Date
2025/09/18
Date Created
2015/05/25
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