



Should Value Investors Load Up On Canada's Airlines?

Description

Value investors have traditionally hated investing in airlines. Warren Buffett, the best known value investor in the world, had this to say about the sector: "I have an 800 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."

Buffett has gone on to further lambaste the sector, saying "If a capitalist had been present at Kitty Hawk back in the early 1900s, he should have shot Orville Wright. He would have saved his progeny money."

Needless to say, the Oracle of Omaha isn't bullish on the airline sector.

But in 2015, I'm not sure that's the right attitude to have. Airlines around the world have done a nice job reeling in costs, hedging fuel prices, and growing revenue from non-traditional sources. Does that compensate for the inherent weaknesses of the business model? Let's take a closer look.

Cheap earnings

Right now, it's unbelievable just how cheap Canada's airlines are looking from a price-to-earnings standpoint. **Air Canada** ([TSX:AC](#)) currently trades at just 3.1 times its projected 2015 earnings, and at just 3.4 times what analysts expect it to earn in 2016. **Westjet Airlines Ltd.** ([TSX:WJA](#)) also trades at a very low valuation, with shares at just 7.1 times 2015's estimated earnings, and 6.9 times 2016's projected earnings.

What gives? Why do both of these stocks have such low P/E ratios?

I think it's a matter of the market having no confidence these earnings will continue. Many input costs are in U.S. dollars, while the majority of revenues collected are in Canadian dollars. That essentially makes the airlines importers, which isn't good for the bottom line. And there's also some pretty significant weakness in the Canadian economy, which leads to folks cutting out non-essentials. Air travel is definitely a discretionary expense .

Better strategy

Much to the chagrin of domestic travelers, seat sales for destinations inside Canada are virtually nonexistent.

That's because both Air Canada and Westjet got smart and stopped the price wars. As much as I like Westjet's flying experience, the fact is flying is pretty much commoditized at this point. It doesn't really matter if you take an Air Canada or a Westjet flight. Both do a good job with a top-notch safety record.

Price used to be the differentiating factor, especially when Westjet was just a startup. But now with the company expanding internationally, that's where the growth comes from. Both of Canada's main airlines are content to keep prices high on domestic routes and then cut prices to get market share on international flights, where they compete with U.S. airlines.

Auxiliary revenue

Thanks to new technology and a greater emphasis on upselling, the airlines have done a nice job getting away from just collecting revenue from flying.

Two terrific new advancements — at least, from an investor's standpoint — are charging for checked bags and higher pricing for premium seats. It even costs money now to pick your own seat. Combine that with making money selling food and other goods while in the air, and suddenly we have a business sort of like the razor blade model. Break even on the flight and make money selling auxiliary stuff.

But is it enough?

As much as I like these new revenue streams from the industry, I'm still not sure value investors should be interested in the airlines.

The big knock against airlines is still there, and that's operating leverage. Air Canada is consistently paying off tons of debt, and even Westjet has increased its gross debt to nearly \$1.2 billion. At least Westjet's debt is offset by a cash balance of \$1.4 billion.

In short, there's a reason why Air Canada trades at such a low multiple. The market is concerned with its long-term profitability, and its debt load.

There is, however, a case to be made for investing in Westjet as a value play. The company is consistently profitable, pays a rising dividend, and has a pretty solid balance sheet. The only issue is price, since I can see it continuing to fall as Alberta's economy continues to suffer.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:AC (Air Canada)

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