



Warren Buffett Says Avoid Airlines. He's Wrong About WestJet Airlines Ltd.

Description

"Investors have poured their money into airlines for 100 years with terrible results ... It's been a death trap for investors." –Warren Buffett

Like many investors, I idolize Warren Buffett. I haven't only followed his investing advice; I've also been a staunch supporter of his general life advice as well. Buffett's wisdom on things like integrity, hard work, and patience might even be better than his knowledge about balance sheets and cash flow.

But at the same time, Warren Buffett isn't infallible. He's made mistakes over his investment career, just like everyone else. He's done a nice job minimizing those mistakes, but they certainly exist if you look back at **Berkshire Hathaway's** results.

One sector Buffett is famous for hating is the airlines. And I can certainly see his point. It's a commoditized business. Fixed expenses are huge and legacy costs don't help either. When the economy tanks, it seems like price wars are the natural response.

But amid all the carnage, there have been a select few operators that have not only survived, but they've actually thrived. One of these companies is **WestJet Airlines Ltd.** (TSX:WJA).

Here's why I think Warren Buffett is wrong, at least about WestJet.

An underrated moat

Warren Buffett likes to invest in companies that have sustainable competitive advantages, a characteristic he compares to a moat that protects a castle. Buffett doesn't believe the airlines have a moat.

WestJet does, and for a few different reasons, too. Firstly, most of its revenue comes from domestic routes, which are protected from foreign operators by government regulations. As airline travel has morphed in to a more steady business—especially domestically—this has led to prices that stay high even when the economy isn't so hot.

Start-up operators have tried and failed to make a dent in the duopoly that dominates Canada's skies. The most recent entrant, NewLeaf Airlines, was recently grounded before it even officially made a flight. Before NewLeaf, many other Canadian start-up airlines tried and failed to dethrone the incumbents.

Needless to say, I don't like NewLeaf's chances.

Secondly, WestJet has operated with one mantra in mind over the last almost 20 years, which is to provide great service while being a low-cost operator. And it's worked. Because WestJet has no unions (and therefore no legacy costs), it enjoys costs of 25% less per mile flown compared to **Air Canada**. That's a huge advantage in a business where price is often the deciding factor for customers.

Finally, WestJet is doing a great job getting revenue from sources that aren't airline tickets. High-margin ancillary revenue has soared, increasing from \$6.03 per guest in 2010 to \$16.64 in the company's most recent quarter. And that should increase in 2016 as the company rolls out WiFi on all of its planes.

Great financials

It isn't just enough to have a company with an obvious moat. I also don't want to pay too much, or else potential returns go down.

From an earnings perspective, WestJet is very cheap. Over the last 12 months the company has earned \$3.10 per share. At a price of \$18.45, that puts shares at less than six times trailing earnings.

Analysts don't predict that earnings will fall off a cliff for 2016 either. The current consensus estimates that WestJet will earn \$2.76 per share next year, increasing the forward P/E ratio to 6.7. That's still a bargain.

The balance sheet is also rock solid. WestJet is currently sitting on some \$1.4 billion in cash compared to \$1.2 billion in debt. Its leverage ratios are among the lowest in the sector of its North American peers.

Management knows how to take care of shareholders, too. Over the last year, the company has bought back a net 4.6 million shares and boosted the dividend 16.7%. The current yield has just recently pushed over 3%, and the payout ratio is a minuscule 18% of trailing earnings.

As much as it pains me to go against one of my investing idols, I just can't group WestJet in with the rest of the airlines. Sorry Warren, but I think you're wrong—at least about one thing.

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