Is Warren Buffett Wrong About WestJet Airlines Ltd.?

Description

Billionaire investor Warren Buffett is famously anti-airline.

His feelings can be accurately summed up by a couple of quotes. He once said, “Investors have poured their money into airlines for 100 years with terrible results … It’s been a death trap for investors.”

He followed that up with this, from his 2008 shareholders letter: “Here a durable competitive advantage has proven elusive ever since the days of the Wright Brothers. Indeed, if a farsighted capitalist had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down.”

It’s hard to get much more bearish than that about airlines.

Although there are major themes that emerge across the whole industry, Buffett is mainly talking about airlines located in the United States–a part of the world where anyone with the capital and expertise can start flying people around for potential profit.

Up here in Canada, things are a little different. Our skies are dominated by a duopoly which consists of **WestJet Airlines Ltd.** (TSX:WJA) and **Air Canada** (TSX:AC)(TSX:AC.B). In theory, as long as the company is at least 50.1% owned by Canadians, anyone can compete with these incumbents. And yet, nobody does–at least on a national scale.

Is this duopoly enough for investors to reconsider the sector? Let’s take a closer look at WestJet–the company many consider to be the strongest player.

Not just butts in seats

Traditionally, the airline business has been about one thing–butts in seats. When times were good and people were flying, they were profitable. When times were bad and people stayed at home, they posted huge losses. The operating leverage was huge because there was only one source of revenue.

This is changing. WestJet now has many sources of revenue, including checked bag fees, selling food and alcohol aboard planes, fees for WiFi, and from folks upgrading to premium seats.

WestJet refers to this as ancillary revenue, and it's growing nicely. In the company's latest quarterly results, it posted $18.18 in ancillary revenue per guest, up 8.6% from the same quarter in 2015. Thus far in 2016, WestJet has recorded $190.6 million in total ancillary revenue; that's up 14.9% compared with the first half of 2015–a gain because of increases in the number of total passengers.

A history of profitability

Unlike many airlines that bounce between profit and loss, WestJet is consistently profitable. Its most recent quarter marked its 45th consecutive quarter of profitability–a record most other North American airlines can't touch.

How does WestJet remain so consistently profitable? A big reason is that its employees aren't unionized, which translates into noticeable cost savings. WestJet also saves money by sticking with just a couple of aircraft models for its entire fleet, which makes repairing the units both easier and cheaper.

Because of these two big factors, WestJet is able to consistently keep costs much lower than its chief rival. It costs WestJet approximately 25% less than Air Canada to fly a mile, which is a huge competitive advantage.

This allows WestJet to easily expand, especially to smaller markets. The strategy goes something like this: WestJet expands into a market formerly only served by Air Canada. It cuts rates to gain market share. Once it becomes popular, it can then raise prices back to normal levels, maintaining its market share.

WestJet's solid profitability translates into a dependable dividend. The company currently pays $0.14 per share each quarter, which is good enough for a yield of 2.5%. With the dividend only coming in at 24% of trailing earnings, look for the company to continue raising the payout.

A solid balance sheet

Finally, an airline needs a solid balance sheet to survive. Airline balance sheets don't get much better than WestJet's.

The company is sitting on a mountain of cash. It currently has some $1.7 billion in cash, versus $1.9 billion in debt. Compare that to Air Canada, which has $3.1 billion in cash versus $6.9 billion in debt. Air Canada has a debt-to-assets ratio of approximately 50%, while WestJet's ratio has only recently popped over 25%.

Bottom line

WestJet has a lot going for it. Perhaps it's not enough to entice the Oracle of Omaha, but that's okay. He's been wrong before.

CATEGORY

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2. Investing

TICKERS GLOBAL

1. TSX:AC (Air Canada)

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