Why Airlines Continue to Be Risky Despite Lower Oil Prices

Description

As oil prices fluctuate near five-year lows, airline stocks, including **WestJet Airlines Ltd.** (TSX:WJA) and **Air Canada** (TSX:AC)(TSX:AC.B) have been making headlines amid record profits and margins fueled by the boon of lower costs and an ever-increasing demand for travel. As a result, airlines have invested heavily in increasing capacity and destination offerings to please customers and compete for their share of traffic.

airline-chart
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Demand for travel has been soaring over the past four years. Source: Annual Reports

While soaring profits are leading to investor interest, the industry has not fundamentally changed from what Warren Buffett has called "a death trap for investors." Here are the top three reasons why airlines continue to be risky investments.

Major fixed and uncontrollable expenses

Airlines not only have to invest up front and heavily into equipment, but they often also need to work with expensive unions and are subject to wide fluctuations in fuel prices. All of these factors lead to weak structural economics and fluctuating expenses that either need to be absorbed by the company or passed on to consumers in what I believe is a price-elastic business.

Revenue is a race to the bottom

Price-screening services (SkyScanner, Hopper, Kayak, and Google Flights, just to name a few) have driven heavy price competition in an industry that already has a high reliance on loyalty programs that provide hefty (and expensive) rewards. Cost savings also tend to get passed on to consumers in a bid to remain competitive, which is and will be increasingly difficult with the growing presence of low cost carriers (LCCs).

LCCs remain a significant threat to NA operators as they expand and increase pricing pressure. LCCs had a 26% market share in 2015 (2% below the global average) and could grow to over 30% if the NA market continues the trend.

Revenue per RPM dropped as airlines lowered air fares to compete in response to falling oil prices. S

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Relentless competition

Airlines are constantly competing to see who can offer the best flying experience and service for the lowest dollar cost. Upgrades in infrastructure and in-flight entertainment are costs often borne by the company in order to simply remain relevant to consumers; as a result, individual airlines not only have low pricing power (inability to increase prices), but will likely have difficulty innovating to command a price premium to peers.

Conclusion

Airlines are big businesses that, unfortunately, come with big expenses and big uncertainty. While strong brand names, economies of scale, and large start-up costs offer great entry barriers, the competition within the industry remains fierce and unforgiving, resulting in an inability to offer what makes a consumer service stock great: high loyalty and strong pricing power that create long-lasting returns.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:AC (Air Canada)

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