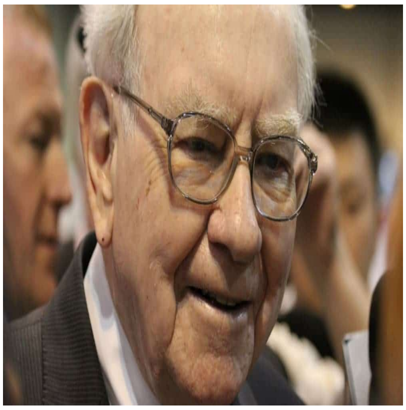

Airlines Remind Buffett of His Textile Mistake

Description

Recently, Warren Buffett's decision to exit airlines came in the limelight after stocks of U.S. airlines increased by 6-11% on positive jobs data and rising travel demand. U.S. President Donald Trump called Buffett's decision a mistake. But CNBC's Mad Money host Jim Kramer sided with Buffett because fundamentals did not back airline stock price momentum.

Traders gamble on airline stocks momentum

If you look at the last three days' trading volume of **American Airlines** (NASDAQ:AAL), **United Airlines**, **Delta Airlines**, and **Air Canada** (TSX:AC), it was three to five times their average trading volumes. Most of these trades were buys pushing the four shares to the overbought category. Traders are driving this stock price momentum to make short-term gains.

Trading volume	**American Airlines**	**Delta Airlines**	**United Airlines**	**Air Ca**
Average trading volume	84.4 million	58.4 million	46.4 million	7.3 mi
June 5 trading volume	428.6 million	130.7 million	135.6 million	19.7 m

American Airlines stock jumped a whopping 70% from US$11.85 to US$20.3 in just three trading days. Jim Kramer suggested selling the stock as a price of US$20 is not sustainable, and he was right. Airline stocks were down 7-10% on June 9 as traders cashed out profits.

Riding on this stock momentum can be risky, and Buffett doesn't play short term. In **Berkshire Hathaway's** 2020 annual meeting, he admitted that airline stocks were a mistake.

Buffett: Airlines and textile suffer from the pitfalls of capital-intensive businesses

For a long time, Warren Buffett avoided airline stocks as he had burnt his hands before in another capital-intensive business of textile. Back in 1962, he invested in textile company Berkshire Hathaway when it was closing mills and repurchasing stocks.

The billionaire investor thought that he could turn around the company by downsizing and replacing management and therefore held onto it for 20 years. The decision to stick to a loss-making company cost him an estimated US$200 billion.

Later, when Buffett purchased US$358 million worth of U.S. Airways shares in 1989, he realized that airlines and textiles face similar challenges of capital-intensive business. Both businesses require substantial capital investments to produce commoditized products that are sold at competitive prices. Both suffer from capacity issues.

They earn high returns on invested capital when there is a supply shortage and suffer from overcapacity when demand is weak. At times of overcapacity, they incur high fixed costs, which leads to losses.

Exit when the time is right

For years Buffett criticized airlines in his letter to shareholders, calling it a business that generates “profitless growth.” In the 2007 letter, he said, “And I, to my shame, participated in this foolishness when I had Berkshire buy U.S. Air preferred stock in 1989.”

He managed to sell these shares in 1998 in profit when the company witnessed a brief period of growth. He exited at the right time because the company filed for bankruptcy twice in the next 10 years.

After 18 years, Buffett ignored his advice and invested in the top four U.S. airlines in the second half of 2016. He noted that travel demand was growing, and airlines are unlikely to shrink capacity. He believed that airlines would continue to buy back shares, but he was also cautious about the risk.

Hence, when the COVID-19 pandemic disrupted air travel, Buffett didn’t think twice and sold his $6 billion worth of airline stocks in April.

Air Canada is at risk of bankruptcy

Air Canada spent $3.6 billion in capital expenditure and 90% of its revenue on operating expenses last year. As it is heavily dependent on revenue for profits, it lost $1 billion in the first quarter when its revenue fell by 16%.

By the end of March, AC had 85-90% of its capacity grounded and $4.1 billion in net debt. The company has cut its workforce by 60% and reduced its fleet size by over 40%. Even though travel demand has increased, airlines are operating at less than 40% capacity.

AC will continue to report losses for the rest of the year. But if its loss widens to the point where it is not able to pay its interest on the debt, it might file for bankruptcy.

The risk is too high in airline stocks. If you hold AC shares, sell them at any short-term bump.

CATEGORY

1. Coronavirus
2. Investing

TICKERS GLOBAL

1. NASDAQ:AAL (American Airlines Group Inc.)
2. TSX:AC (Air Canada)

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Date
2025/08/19
Date Created
2020/06/10
Author
pujatayal