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Stocks in Detail

Confessions of an aeroholic

Comparative Review

Company	ASX	Price at Review	Current Price	Change since review	Fund. Risk	Share Risk	Our View
Qantas Airways Limited	QAN	$3.62	$3.45	-4.70%	3.5	3	Coverage Ceased
Regional Express Holdings Ltd	REX	$1.040	$1.100	+5.77%	4.5	4.5	No View
Virgin Blue	VBA	$0.795	$0.715	-10.06%	4	4.5	Coverage Ceased

It's been hard for us contrarians to ignore the massive share price declines of Australia's airline stocks. If it was any other business, we'd probably be loading up. But airlines are a uniquely difficult business.

Hi, my name is Tim and I'm an aeroholic. I've bought shares in airline companies recently, and I have the urge to buy more. Rather than attending a meeting, my fellow analysts at *The Intelligent Investor* suggested a confessional review to cure me of this painful and financially crippling disease.

Luckily, there's a large aeroholics support network. Its founder is Warren Buffett, who lost money on his 1989 investment in USAir and explained in a 2002 interview with Britain's *Sunday Telegraph* that he has a special phone number to call if he ever has the urge to invest in another airline. In the same interview, he described the industry like this:

'It has eaten up capital over the past century like almost no other business because people seem to keep coming back to it and putting fresh money in. You've got huge fixed costs, you've got strong labour unions and you've got commodity pricing. That is not a great recipe for success.'

It's just as well that we have such an impressive sponsor; otherwise a company such as Virgin Blue might be very tempting. It has a well recognised brand and good management, only one competitor, low debt, a history of profit growth and an (apparently) above-average return on capital.

The other companies in this review, Qantas and Regional Express, are in a similar situation. What's even more interesting, though, is that each of their share prices is languishing under the weight of a raging oil price.

Natural duopoly

Two brave and dangerous words in share analysis are 'it's different', but Australia's airline industry is unique in an important way. Basically, our geography and climate combine to thwart competition.

That's because Australia is relatively isolated, with a small but highly concentrated population in cities and towns spread around our huge coastline. Travelling by plane is often the most practical – and cheapest – method of transport. It explains why Sydney-Melbourne is one of the world's busiest air routes, an incredible statistic considering Australia's population. Almost as revealing is Virgin's domestic flight schedule, where Canberra is its only non-coastal destination.

Our geography is most likely the reason a third domestic airline has never worked, despite many attempts. A certain scale is needed to have a national network and our small population only seems able to support two profitable airlines.

Impressive returns

Qantas has been in business for almost 90 years, so the industry must have something going for it. Either that or investors inexplicably 'keep coming back to it and putting fresh money in'. Last financial year, to June 2007, was a good example of what airlines can achieve. With the aid of a strong economy and the high Australian dollar, all three airlines made a record profit.

In fact, the 2007 results might help explain some of the causes of aeroholism. As the table shows, the returns were impressive, particularly the return on capital employed (ROCE) of almost 40% for Virgin Blue and Rex. Even Qantas's ROCE of 13% was pretty good considering the size and nature of its business.

With single-digit PERs across the board, the value is tempting. Virgin, despite having the best ROCE, is the cheapest, with a historical PER of 3.6.

However, one-off figures are fool's gold. Airlines are notoriously cyclical because revenue is very sensitive to changes in demand. Profits are greatest when strong demand results in full planes ('load') and high prices ('yield'), but they can disappear quickly when demand falls because costs are relatively fixed and flights can't easily be cancelled.

Cash flow was also impressive in 2007. Virgin collected $450m in operating cash flow – more than half its $836m market capitalisation. However, you can't look at operating cash flow without also considering capital expenditure. Virgin spent $317m on new planes and other property, plant and equipment in 2007, about 70% of its operating cash flow. And its free cash flow – operating cash flow less capital expenditure – will be negative in 2008 due to aircraft purchases worth almost $1bn. That's why Focus on the free cash flow is one of the twelve steps in our aeroholics meetings.

2007 financials

	Qantas	Virgin Blue	Regional Express
Profit margin	6.8%	16.0%	14.2%
ROCE	13.2%	39.1%	35.8%
Net debt/equity	27.7%	19.2%	NA
PER	10.1	3.6	5.2

Oil price concerns

Fuel became the biggest single cost for Qantas in the 2007 financial year for the first time, having increased from approximately 13% of revenue in 2004 to 23% in 2007. That's about an extra $1.5bn, and it comes straight off the bottom line.

The rise in oil prices above US$100 per barrel is having a massive impact on airline profitability. Virgin has forecast a fall in net profit from $232m in 2007 to less than $140m this financial year. Its loads and yields have been holding up, so the dramatic fall has come from higher costs, mainly fuel. Ticket prices just haven't increased fast enough to cover the higher cost of fuel.

Fuel cost as a % of revenue

	2005	2006	2007
Qantas	16.4%	22.9%	23.4%
Virgin Blue	19.3%	23.8%	24.0%
Regional Express	13.6%	15.8%	15.6%

All quiet at Qantas

It's now a little over 12 months since Airline Partners Australia's $11bn takeover bid for Qantas fell apart. The partners, which included Macquarie Group, Allco and CEO Geoff Dixon, came within a whisker of success, but were apparently thwarted by a hedge fund that missed the deadline.

That's probably a good thing considering what's happened to credit markets, though shareholders might not agree. Qantas's share price is down 34% from the takeover price and 35% since our last update on 2 Oct 07 (Avoid – $5.56).

Geoff Dixon came through the process with a few battle scars but is basically implementing many of the private equity ideas. These include expanding Jetstar domestically and into Asia, upgrading its fleet with new planes such as the Airbus 380 and Boeing 787, and floating Frequent Flyer as a separate business. However, the 'capital management' strategy, which basically meant more debt, has been put on hold.

Qantas looks cheap from a number of different angles. For example, it owns a number of assets and businesses that are probably worth more than its total market value. However, being the oldest and largest of the three operators, Qantas is particularly exposed to the industry's poor economics, such as the need to replace ageing planes. To make sure we're not tempted we're **CEASING COVERAGE**.

Virgin's fuel blues

As we've already mentioned, Virgin Blue has the lowest PER of the three. But that's based on the 2007 result which will be the high-water mark for some time to come. The company reported a net profit of $135m in the first half of 2008 and has forecast a net profit for the full year of only $140m. And that's before $40m in expected losses from 'new initiatives' such as its new international airline, V Australia, and its expansion into New Zealand's domestic market. The lower profit is mainly due to higher fuel costs, but competition from Tiger Airways is also a factor.

Whilst establishing a new route to America (supposedly Qantas's most profitable) should pay off in the long run, it has increased Virgin's risks. It will buy six Boeing 777 planes for the route at a cost of $2.2bn and has ordered more planes for the domestic market. As a result, the company's gearing has leapt – and that's all the more worrying with profit under pressure.

The next couple of years will be tough for Virgin. While it might come through the other side, the risks are many and unpredictable. Again, we're **CEASING COVERAGE**.

Regional Express impresses

The much smaller, regionally focused Regional Express is a different proposition for a number of reasons. It doesn't face as much competition as its national peers – it's the only option on 33 of its 39 routes – and its financials are in much better shape, with the company owning 22 of its 38 passenger planes and having no debt. In fact, it had net cash of $13m at December 2007 and is currently buying back shares. Directors have also been buying.

Being so much smaller, however, Regional Express is at the pointy end of a worldwide pilot shortage, and this has resulted in cuts to its flight schedule. To rectify the situation, the company has bought its own pilot training academy, which is expected to produce 80 graduates per year.

Higher costs resulted in a 10% fall in profit in the first half of 2008. Though its regional focus protects the company from some of the industry's poor economics, it brings other risks such as finding staff and dealing with drought. Anyway, the company is too small and illiquid for us to recommend. **NO VIEW**.

Before signing off my confessional, I should add that there's another reason for my interest in airlines, which is that they serve as a hedge against a lower oil price. It's something I worry about because I have a relatively large holding in Roc Oil. Gareth Brown has mentioned a similar natural hedging arrangement in a past review of ARB Corporation. This has been of limited success so far, though, so it may be another one of those ideas that's good in theory but not so good in practice.

Time will tell whether I'll be cured of aeroholism, but it's been therapeutic to put it all down on paper. If you find yourself getting hooked, you might find a similar process helps. Alternatively, do feel free to call us on 1800 620 414 and we'll do our best to talk you down.

Disclosure: The author, Tim Searles, owns shares in Virgin Blue, Regional Express and Roc Oil. Other staff members own shares in Roc Oil, Macquarie Group and ARB Corporation.

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