14 APRIL 2020

Stocks Down Under

The Airline Special

"If you want to be a millionaire, start with a billion dollars and launch a new airline"

- 'Sir Richard Branson (b. 1950), British entrepreneur

QANTAS AIRWAYS

Come fly with me, not the competition

AIR NEW ZEALAND

Flightless Kiwi to take flight soon

VIRGIN AUSTRALIA

Touching the government for the very first time

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Come fly with me, not the competition

Stocks Down Under rating: ★★★★

ASX: QAN
Share price: A$ 3.56
Market cap: A$ 5.2BN

Of all the times to buy an airline stock, surely the Coronavirus Crisis, where people's freedom of movement has been severely curtailed in just about every country you care to name, is not the right time. And yet, the stock of Australia's flagship carrier, Qantas Airways, has managed to rise 66% since 19 March, from a low at that time of $2.14 to a close of $3.56 on the day before Good Friday. We believe there is a lot more altitude to be gained from here.

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Share price chart

Source: Tradingview

One faulty perception investors have of airlines is that they will always cost you money. We've lost count of the number of times people have quoted Warren Buffett on airline stocks 'death traps for investors'. Well, if the Wizard of Omaha had bought Qantas on 12 September 2001 and held for just a year, he'd be up 34%. So much for this supposed death trap. With good airlines, you just have to know when to sell and buy.

Good airlines keep flying

Qantas Airways was already trending down before the Coronavirus Crisis got underway in earnest. Its peak was $7.40 back on 19 December 2019, whereas at the time of the general market peak on 20 February 2020 it had retreated to $6.67. In that simpler time the only thing most investors worried about was that Covid-19 was going to be another SARS, which would impact Qantas's routes in and out of Asia, where the airline had been growing strongly in recent years. Alas, the Covid-19 panic then took the stock down another 68% between 20 February and 19 March on the assumption that Qantas would be more or less grounded the world over for the foreseeable future and maybe go to that great Airport in the Sky – which is to say, go broke.

Which brings us to another faulty perception of airlines – that they all go broke when there's trouble in the world that could reasonably impact air travel. Actually, most major airlines with a decent brand name survive in times like these and then go on to bigger and better things. And if they are 'flagship' carriers – the airline a country believes it absolutely has to have in order stay connected to the rest of the world – well, they're basically 'too big to fail'. Many Australians still think of Qantas like that, even though the airline was privatised between 1993 and 1995 and the Australian government now has no major stake in the company anymore.

The First Gulf War was a long time ago

The reason investors worry about mass bankruptcies in the airline industry is because of the First Gulf War, which happened, you may recall, way back in 1991. That war proved to be the nail in the coffin for three former icons of the US industry that had grown tired - Eastern Air Lines (January 1991), Pan American World Airways (December 1991), and Trans World Airlines (January 1992), but even here the latter airline was out of Chapter 11 by late 1993. Admittedly TWA was permanently grounded in the aftermath of September 11, 2001, and that was the incident which also ended the flying career of the Belgian airline Sabena, not to mention Ansett here in Australia. But those carriers had all lost their mojo long before. The point we're trying to make is this: Quality airlines like Qantas will not fail in 2020.

Down but far from out

Qantas had $5.3bn in net debt as at December 2019 but its interest cover as measured by EBIT to net finance costs was a healthy 7x in the December 2019 half. The company's 25 March 2020 announcement that it was able to easily borrow another $1.05bn tells you the balance sheet is in good shape. Indeed, one could make the case that Qantas will do well out of this current crisis because it won't need a government bailout, unlike competitor Virgin, which wants one.

Andrew Curran gave us a screaming glimpse of the obvious in an article in Simple Flying on Sunday when he wrote, 'Disregarding a smattering of government underwritten international services, freight flights and FIFO mining operations, Qantas and Virgin Australia have all but shut down'. To us that's irrelevant. The real question is what Qantas can achieve when it is allowed to get all its planes back in the air again. In FY19 the airline generated close to A$18bn in revenue, up 5%, and underlying profit before tax was $1.3bn, which was down $200m but only because fuel prices went against the airline to the tune of $600m or so.

A P/E under 7x? Get on board

We think FY19 is a benchmark that the airline can get back to in FY22 when the Coronavirus Crisis is history and people have stopped being scared of flying, which we believe could take a year or so after lockdown restrictions are lifted. The reason to back this airline into the recovery is that it has one of the best margins in the world because of the loyalty its Australian customer base routinely shows it on domestic routes and because the company continues to pioneer new business internationally such as Melbourne to San Francisco, the route that started in September 2018.

Currently you can get this well managed airline at a mere 6.5x forecast FY22 earnings. It's rare that Qantas trades this inexpensively. Once the business hits cruising altitude again, a re-rating will probably take place and we believe that might be sooner rather than later.

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If you are buying airlines at a time like this, you can't go past Air New Zealand if you want more than one in your portfolio after Qantas. At the moment you can buy stock in the Kiwi carrier for a mere 3.2x forecast FY22 EBITDA while Qantas is trading at 3.0x EV/EBITDA. Basically the market is treating both flagships similarly. Which is fair enough because both airlines are part of a select group of airlines around the world that are so good operationally and so well placed in terms of their market standing and political importance that they can survive just about any crisis. Singapore Airlines, ANA All Nippon Airways and Lufthansa are also members of that club.

Trans-Tasman champions

Of the two Australasians flagships Qantas is probably the leader. Air New Zealand's safety record isn't quite as good as Qantas', which, as everyone in the world has known since that 1988 film Rain Man, is always the safest airline in the world to fly with. And the airline isn't quite as good overall as Qantas - in the 2019 survey from Skytrax it was only rated the world's No. 16 airline whereas Qantas was No. 8.

Air New Zealand does, however, have something Qantas doesn't have yet – a loan from its home government. Air New Zealand's net debt of NZ$2.5bn as at December 2019 was more than sustainable, however now the government will support that with another NZ$900m, in a package announced on 20 March. So Air New Zealand's survival is more or less assured coming out of this crisis.

Enter the new man

Air New Zealand also has something else Qantas doesn't have a – a new CEO. Greg Foran, a native of New Zealand who had been chief executive of retail giant Walmart's US operations, was named the new boss of Air New Zealand in October 2019. He started with the airline on 3 February, just as the Coronavirus Crisis was getting started. We see potential for Foran to bring new thinking to this airline as it comes out of the crisis by bringing perspective from outside the airline industry. In particular, Air New Zealand's costs are in danger of being too high, and if there's one thing people at Walmart are good at, it is managing costs.

In FY19 Air New Zealand enjoyed record operating revenue of NZ$5.8bn, up 5.3%, and even after it absorbed higher fuel costs it was able to come in with NPAT of $270m, although that was 31% lower than FY18. We predict that, like Qantas, Air New Zealand can get back to those kinds of numbers once this crisis is over, probably by FY22, given the loyalty of its customers and its track record of growth over time. Indeed, it might go further if tourists start to return to New Zealand in earnest, which people in Australia and Asia locked down for months on end in 2020 might just be inclined to do in FY22.

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Source: Tradingview

Virgin Australia was arguably not a very strong airline coming into this crisis. In the six months to December 2019 the airline grew passenger numbers by 2.1%, but total revenue by only 1.5%. And underlying Profit Before Tax crumbled, down 87% to just $14.5m. More importantly, it entered this crisis saddled with a lot of net debt - $5.05bn of it - with the only consolation being there were no significant maturities in that debt profile until FY22.

Should we bail this one out?

Now, with Virgin grounded Down Under for the duration of the Coronavirus Crisis, there are questions about whether the airline will survive. This company may not necessarily be able to hibernate its business because, while its stood-down employees may be supported by the government, Virgin Australia still has other costs including aircraft leases. Most commentators believe that it runs out of cash in September, which is why the company has been asking the Australian government to bail it out to the turn of $1.4bn to make sure this doesn't happen.

Not only would that bailout guarantee that Qantas continues to have a serious competitor, it would also help to maintain about 10,000 jobs (and that's just counting the direct employees). Balanced against that is the fact that Virgin Australia's major shareholders are not Australian – Etihad (21%) is the flagship carrier of the UAE. Singapore Airlines (20%) is the flagship carrier of that city-state. Nanshan (20%) and HNA (20%) are a couple of Chinese conglomerates. And the original Virgin (10%), that the celebrated Sir Richard Branson created, is British and asking unsuccessfully for a bailout itself. The Australian government might be reluctant to provide all these shareholders with support from the Australian taxpayer.

No pain, no gain

Now, a bailout might still happen. $1.4bn is, after all, a fraction of the $130bn or so which the government is using to support about 6 million at-risk Australian workers through this crisis. The bailout would save the government the hassle of having to arrange a new entrant to Australia's domestic routes at short notice. And, if the foreign shareholders are also perceived to be taking some pain in return, the bailout might be politically palatable to the voters. Moreover, at least two of those foreign shareholders would have a good reason to take some pain - Virgin is important to the long-term strategies of both Etihad and Singapore Airlines, and those airlines have been supported by their governments, enabling them to afford to be part of a bailout solution.

So, assume Virgin Australia is bailed out and survives. The trouble with the airline in this scenario is that it is more reliant on low-cost passengers for its customer base than Qantas. If unemployment is higher after this crisis is over it will impact Virgin before it hits Qantas. Which means it may take a long time to recover. It's worthwhile remembering that the moment Qantas launched JetStar in May 2004, Virgin's growth was crimped. With Qantas such a serious competitor today Virgin may be in danger of entering the same decline phase that Ansett went through in the 1990s.

For all that, Virgin is still trading at 6.4x expected FY22 EBITDA. Qantas, arguably the stronger airline, is at just 3x. In short, if you like airline stocks, we believe Virgin is the riskier bet in this rebound.

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