Back to Contents

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Value Line: Why I won't hold airlines

By Roger Montgomery

PORTFOLIO POINT: If you ever hear I've bought an airline, call an ambulance. Here's why.

I would like to impart a warning to all share investors, a warning I plan to give frequently as is necessary to ensure each and every generation of investors hear it. Ignore it to your financial peril.

When the airline Virgin Blue listed, it was exactly a year after United Airlines had filed for Chapter 11 protection from creditors. The company was denied $1.8 billion in backing for new loans. The hat went around and came back empty. Remember the hat.

The contrast between the hype surrounding the float of Virgin Blue and the depression surrounding the collapse of United could not have been starker and yet the two businesses operate in the same industry.

So was the difference in fortunes due to the ability of management, the owners of the airline or the country in which it operates? Or is there a fundamental failing with airlines that destroys wealth?

Suppose we go back to 1999, and decide to start a business. We reach into our pockets and write cheques for $1.9 billion, using our own money, to kick the business off. That $1.9 billion represents our equity in the business. We also head down to the bank and ask to borrow $3 billion.

So the business in 1999 kicks off with $1.9 billion of our equity and $3 billion of debt, borrowed from the bank. We have a total of $5 billion invested and our loan to value ratio is 60%. Most people reckon that's pretty safe but another way to think about it is that we owe more than we own. Let's worry about debt later on.

After the first year of being in business, the manager we hired to run it for us reports a profit of $515 million. Pretty good, don't you agree? Half a billion profit on our $1.9 billion of equity is about a 25% return. It is always useful to compare this return to what we can get elsewhere and you can't get that in a bank account! Well done.

Now fast-forward 10 years to the present day and look back over the past decade. Profits have been as high as $970 million in one year and as low as $300 million in another. But this year – our 10th year, the company made $100 million.

Value Line Portfolio, as at September 22. 2009

Company	Buy price	Price today	Est value	Margin of safety	Bought	Invested ($)	Cap value ($)	Divs rec	Total return	Total return
JB Hi Fi	14.8	19.13	21.7	11.8%	845	$12,500	$16,157	0.29	$3,902	31.22%
Cochlear	56.36	66.96	58.7	-14.1%	102	$5,744	$6,824	0.95	$1,177	20.49%
CSL	31.81	34.06	28.99	-17.5%	163	$5,197	$5,565	0.4	$433	8.33%
Woolworths	26.16	29.27	26.7	-9.6%	206	$5,377	$6,017	0.56	$754	14.03%
Reece	17.8	22.52	13.7	-64.4%	236	$4,209	$5,326	0.33	$1,194	28.37%
Platinum Asset Mgt	4.06	5.32	2.84	-87.3%	854	$3,467	$4,543	0.12	$1,178	33.99%
Commonwealth Bank	46.51	49.9	51.36	2.8%	215	$10,000	$10,729	0	$729	7.29%

Since July 1

Security Value	$55,160
Cash Value	$56,635
Total Value	$111,795
Total Return ($)	$11,794.88
Return Invested (%)	24.44%
Total Return (%)	11.79%
All Ordinaries change	+22.30%
* Outperformance (I): Outperformance of Invested Portion	+2.14%
* Outperformance (T): Outperformance of total portfolio	-10.51%

Under observation

ISOFT	0.635	0.84	0.19	-342.1%				0.01		-33.86%
Amcor	4.79	5.5	2.84	-93.7%				0.17		-18.37%

That's less than a quarter of the profit we made 10 years ago! I am sure you are beginning to think this is not a great predicament and certainly not a great business, especially remembering that inflation over the past 10 years has made the $100 million of profit this year worth a lot less than it would have been a decade earlier.

To add insult to injury and to get the business to this auspicious point, we have tipped in an additional $2 billion of our own money and borrowed an additional $3 billion from the bank. Now, we have also collected about $3.7 billion in dividends but what we have taken out in dividends we have had to tip right back in and then some. Importantly, this hasn't really gone to growing the business at all. We might have more staff, more machinery to serve more customers but inflation has made sure they cost more to service and our profit this year will be lower than 10 years ago!

So we have a business that we have been running for 10 years. We have tipped in a total of $4 billion of our own money and borrowed $6 billion from the bank and this year we make just $100 million.

So do you still think this is a good business? Would you be happy to own it outright? Or would you like to try and get out of it?

Well it gets worse. The profits reported in the accounts are illusory.

When it comes to capital-intensive businesses like airlines, accounting standards are inadequate for measuring the true performance of the business. The standards allow such businesses to depreciate their property, plant and equipment based on the price paid decades ago. The result is that reported "accounting profits" mask real losses.

And the proof is that darned hat. Remember the hat?

As an investor you use accounting to determine whether to invest. The problem is that it will be the real profits of the business that will determine whether your decision was correct.

An aircraft purchased today costs considerably more than an aircraft purchased two decades ago.

Yet accounting standards allow depreciation to provide for the expense associated with the wear and tear of the aircraft and ultimately its replacement. The profit, after such inadequate expenses have been subtracted, is artificial – an accounting invention.

Take a business that bought $10 million of equipment 25 years ago. Over the next 25 years, profits have been reduced by $10 million in depreciation, leaving an assumed total profit of $25 million spread over the 25 years. If inflation has been 4%, the replacement cost of the equipment will be $27 million.

And airlines must replace their equipment. If they don't, people die. So just to compete, the business must incur costs that are 2.5 times more than that which has been accounted for.

This type of business effort is akin to running in quicksand and it doesn't matter how good the runner is or how much you pay him, he'll do no good. To keep going, the business will have to outlay $27 million and the accounting profits have thus been exaggerated by $17 million. The company has made an economic profit over the 25 years of $8 million, not the $25 million it announced.

If debt facilities have already been stretched, lenders will not be willing to keep the business afloat, as United Airlines shareholders discovered.

The company could then pass the hat around and ask existing owners to refund some of their dividends through a bonus or rights issue or to ask new shareholders to inject capital through a capital raising of some description but if the hat comes back empty. Game over.

It is proof positive of a poor business to discover that airlines are monotonous in their efforts to raise fresh capital. They are tough businesses: capital-intensive, labour-intensive, fiercely competitive and ultimately selling something that people want to pay the lowest price for. These are not the ingredients of a sound long-term investment.

When I first wrote about this subject in 2003, Qantas shares were trading between $3.20 and $3.40. Today, they are just $2.80. Virgin Blue's shares had only just listed with great fanfare, and were trading between $1.91 and $2.13. Today, they trade at 40¢. And if you ever hear that Roger Montgomery has bought an airline, call an ambulance because I will have lost my marbles. ◆

Roger Montgomery is an independent analyst and investor, having previously founded and listed a boutique funds management investment firm.