

ANALYST VIEWPOINT

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AIRLINES – IT’S ALL ABOUT CHOICE AND TIMING

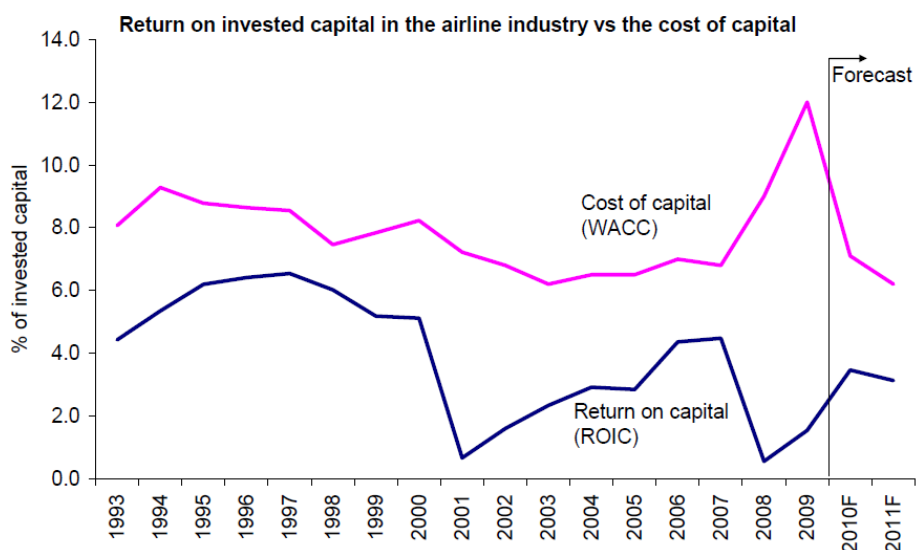
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Amongst numerous other things the last two editions of IATA’s Airlines Financial Monitor show very clearly how important timing is when it comes to not only buying but more importantly selling airline shares in order to crystallise the return from the investment. The December edition of the Monitor which was published at the beginning of February reported that airline shares had outperformed global stock markets by some 23% during 2010 and appeared to highlight the apparent conundrum whereas the airline industry is considered a value destroyer it is possible for direct investors to make money. However by the time the January – February edition of the Monitor was published in early March airline share prices, although still significantly above the trough values of 2009 had fallen some 6% since the start of the year against a background where the global all share index had risen by some 4%. In fact airline shares had begun to fall from their peaks during the third quarter of 2010.

On traditional measures there is little disagreement that the airline industry in aggregate is a value destroyer. Using the relationship between the return on invested capital (generally understood to be net profit minus dividends divided by invested capital which itself is generally defined as equity plus debt) and the weighted average cost of capital (in essence the minimum return that a business must generate to satisfy its providers of capital), as the measure of whether value is created or destroyed, Chart 1 which is from last presentation associated with IATA’s industry forecast needs little comment. The greatest gap, almost inevitably, was in 2008-09 reflecting not only poor returns but also a sharp increase in the cost of capital reflecting the much greater perceived risk associated with investing in/lending to the industry.

It is of course possible to quantify the value gap; IATA’s own economists considered that the forecast record outcome for 2010 would result in what they described as “inadequate profits” indeed for profits to become “adequate”, in other words for the return on in invested capital which was in the order of 4% in 2010 to rise to between 7% and 8% and at least match the weighted average cost of capital, net profits would need to increase to some \$30bn (from \$16.0bn)

and on a pro-rated basis operating profit would need to increase to some \$45bn (from \$27.4bn) which would represent an operating margin of some 8% compared with the 5% expected for 2010.



Source: IATA Financial Forecast December 2010

Indeed over the more normal decade of the 1990s, the average WACC was 8% and the ROIC was closer to 5%. Of course whilst the greatest improvement to ROIC is likely to come through a stronger profit performance, there is also the question of whether there is too much invested capital but that is perhaps an issue for another day.

Whilst the calculation of the return on invested capital (ROIC) is reasonably straightforward – as indeed is the weighted average cost of capital, there is however scope for judgemental analysis in estimating the cost of equity in terms of the risk premium. This is not only a reflection of the cost of debt but also the beta factor which is used in effect price the risk – a higher beta reflects a greater volatility of the shares. Following this through, the greater the volatility the larger the number of opportunities to trade the shares - which in one respect is attractive. However, the converse case is that a higher beta factor by definition increased the WACC. To put this another way for the airline industry the beta associated with its shares is a bit of a “two edged sword” reflecting the fact that they are generally considered to be good trading stocks but this then feeds back through the calculation of the beta factor to increase the cost of capital.

The fact that most airlines are considered to be destroyers of value on the traditionally accepted measures of course doesn't mean that you cannot make money from investing in airlines. Although the underlying investment principles are similar, there are however significant differences between being an investor in an unquoted business and buying shares in a company that is listed on a stock exchange as in the case of the latter you realise the value of your investment by being able to sell your shares – and the ability to be able to sell is a particularly important consideration too. Private Equity investors for example are likely not only to be interested in the potential of a business that they invest in but are equally, if indeed not more interested, in how they will realise that potential by either selling the business on or by floating it.

We have seen a number of equity capital raising exercises during 2010 and into 2011- starting with Tiger Airways' IPO and ending with Garuda's IPO in January 2011, with a number in between. Whilst share issues are always priced to sell in most cases the price was at the bottom of what was, in a number of cases, an already lowered range but also there were a number of cases where the offers were cut back due to lack of demand. Most recently with Garuda where the issue had originally been expected to raise \$1.1bn but in the event raised \$530m (of which \$370m was new money for the company) – still a reasonable sum of money. Elsewhere whilst Cebu Pacific raised \$542m this reflected what was originally expected although lower than the subsequent target of some \$730m. It is interesting to take a look at some of these new entrants and their recent share price movements; Over the last month Tiger Airways has been one of the worst performers within a representative sample of airlines with its price falling by some 15.7% and indeed it is now trading below its issue price of SG\$1.5 (having reached a peak of SG\$ 2.25 in August 2010); Elsewhere Cebu fell by some 8.6% over the last month and is trading at PHP 85 compared with the issue price of PHP 125 in October 2010,

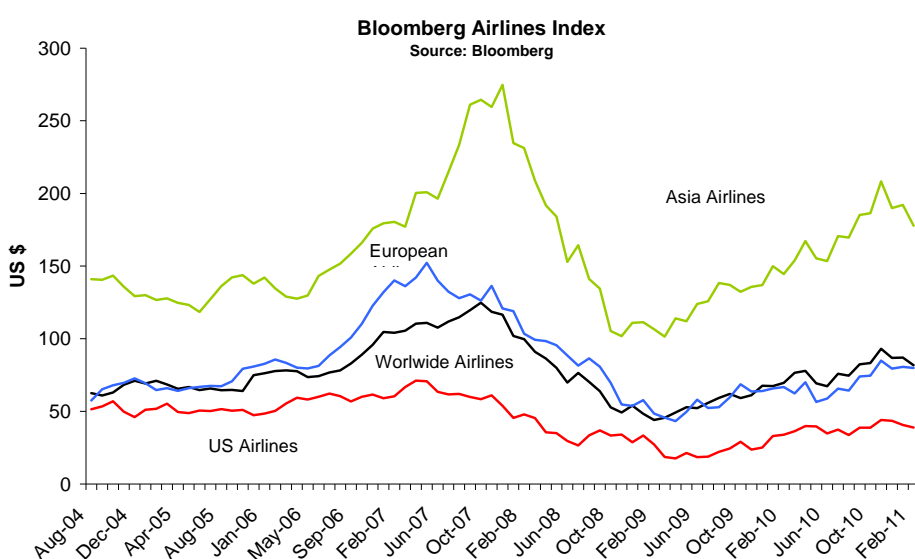
Whilst it may be easy to talk in terms of the performance and outlook for airlines at an industry level, the reality is that those either providing new capital or buying shares already in issue make their decisions in respect of a particular company. Although sentiment towards an industry sector is important it is the “fundamentals” displayed by a particular company that matter. It is worth recalling that stock markets are expectational and that the two behavioural factors that are considered to drive share prices, fear and greed, can work in the same direction at the same time. The stronger and louder the positive investment story is, the better (at least in theory). At the present time sentiment towards the airline sector is being set by concerns over the oil price, a series of geopolitical events, and the consequences of these on the world's economies.

For 2010 airlines represented one of the best performing sectors in the world's stock markets and whilst the extent of the outperformance was not universal, it was considered a good sector to be in. This share

price performance was not only against the background of a sharply recovering industry but also reflected the greater volatility of the airlines which is captured by beta factors greater than one.

Even the most cursory examination of the analysts' recommendations on the airline sector appears to show that the number of bulls of the sector is very significantly greater than those who are neutral, even if we have seen some trimming of near term target share prices and a focus on performance over a longer period than before.

As the warnings on any advertisement exhorting investment in almost anything clearly state the value of the investments will go down just as well as going up after all investment is not risk free – the issue is how to minimise the risk and maximise the return. Given that shares are for selling as well as buying and indeed it is as important to know when to sell as it is to know when to buy – perhaps more so in the case of airlines given the paucity if indeed any returns from dividend payments and the need to realise the rewards in the form of capital gains.



For an equity investor in shares already in issue, the principal source of return will be the change in the share price which provides the capital gain. Even where airlines are expected to pay a dividend the share of this in any total return calculation supporting a buy or similarly positive share recommendation whilst important, is not significant. For example if we take Lufthansa where it is in fact expected to announce a dividend with its 2010 results of

€0.6-0.7, the median target price on a twelve month view is €18.75 compared with €14.96 now. Combining the dividend yield of 4.3% with the expected (hoped for) share price increase of 25.3% gives a total return of 29.6% of which 85% would result from reaching the target share price.

The problem is that if the dreams and expectations are not met then markets tend to be very unforgiving and also have relatively long memories. The immediate 16% fall in the easyJet share price following the release of its interim management statement on 20th January where amongst other things the key story was that the cost of fuel would be markedly higher for the rest of the year and that because of this, and some other factors, forecasts would need to be cut dramatically, has continued and the current price is some 26% below the closing price on the 19th January. Whilst the price fall may be seen by some as a buying opportunity it appears that there has been little change in analysts' views on easyJet from that before the announcement with the latest data suggesting that 14 out of 23 analysts surveyed by the Financial Times are positive with either a "Buy" or "Outperform" rating on the shares – of the others 7 have a hold recommendation and there is one each for "underperform" and a "sell".

The sharp increase in airline share prices in 2010 and the sector's outperformance in retrospect was not surprising and if anything has followed a near traditional pattern – a relatively strong recovery in share prices over the first 12-18 months after the initial turning point and then more of a sideways movement.; this time round however what might have been a period of price consolidation has been exacerbated by the change in the fuel price environment but more importantly the fears over how much higher the price will go. The differential rates of share price growth seen in 2010 if anything act to highlight the differences

between those airlines which face structural opportunity and those where the upside is limited to a cyclical recovery and here in Europe most airlines are being valued by reference to mid-cycle multiples. The region that may be slightly different is North America where the capacity discipline that has been evident has resulted in almost a structural resetting of the relationship between supply and demand. However as with most things past performance is not necessarily a guide to the future. In this respect concerns and uncertainty over the fuel price, where IATA is forecasting an increase of \$45bn in the underlying fuel bill before hedging between 2010 and 2011 (close to 8% of 2010's revenue), and the continuing concerns over too much capacity re-entering to soon suggests that there is further "downside risk". Indeed at the end of the year share price corrections began to be evident. Notwithstanding this there will still be opportunities to make money from investing in airlines even if at an industry level the gap between the cost of capital and its returns widens again in 2011 – as ever the key to success is selectivity and timing and from an investors' perspective 2011 events and the resulting volatility is likely to result in a substantial number of share trading opportunities. For an equity investor it is of course possible to make money from airline shares however and it is not only about selecting the best opportunities but also getting the timing right not only in respect of buying but more so in respect of selling given that it is the rise in share prices that deliver the majority of the forecast returns. Against this background it perhaps matters little that at an aggregate level that the industry appears to destroy shareholder value as the investors are acting rationally as they see opportunities that they may be able to capitalise on and indeed there will be no shortage of these as we move through 2011 and into 2012. However despite the very significant number of buy recommendations it is quite likely that the better opportunities may lie further into the future.

The views expressed in this article are the author's and not necessarily those of IATA.