

# AIRLINE INDUSTRY

## WHEN DO YOU BUY AIRLINES?

### REGIONAL | TRANSPORTATION | SECTOR NOTE

11 March 2015

- Airline profits should benefit from lower oil prices in 1Q15 results
- Airlines stocks generally perform poorly over the long-term, but can perform marvelously over short periods
- Best time to buy airlines is during crisis
- AirAsia (AIRA MK, Not Rated) is in its own crisis

#### Publicly listed airline stocks

The US is the land of cars and Europe has its trains. Asia is huge. We take planes everywhere. Unsurprisingly, there are numerous publicly listed airlines within Asia Pacific. Half of the region's six biggest airlines operate from mainland China.

**Figure: Asia-Pacific Airlines by market cap**

| Stock              | Home market | Ticker   | Market cap (US\$ bn) |
|--------------------|-------------|----------|----------------------|
| Air China          | China       | 753 HK   | 13.7                 |
| Singapore Airlines | Singapore   | SIA SP   | 9.8                  |
| ANA                | Japan       | 9202 JP  | 9.5                  |
| China Eastern      | China       | 670 HK   | 9.0                  |
| Cathay Pacific     | HK SAR      | 293 HK   | 8.4                  |
| China Southern     | China       | 1055 HK  | 6.8                  |
| Qantas             | Australia   | QAN AU   | 4.8                  |
| Korean Air         | Korea       | 3490 KS  | 3.0                  |
| EVA Airways        | Taiwan ROC  | 2618 TT  | 2.6                  |
| Air New Zealand    | New Zealand | AIR NZ   | 2.4                  |
| China Airlines     | Taiwan ROC  | 2610 TT  | 2.4                  |
| AirAsia            | Malaysia    | AIRA MK  | 1.8                  |
| Asiana             | Korea       | 20560 KS | 1.5                  |
| Virgin Australia   | Australia   | VAH AU   | 1.3                  |
| Cebu Air           | Philippines | CEB PM   | 1.2                  |
| Garuda             | Indonesia   | GIAA IJ  | 1.0                  |
| Thai Airways       | Thailand    | THAI TB  | 0.8                  |
| Jet Airways        | India       | JETIN IN | 0.8                  |
| Tiger Airways      | Singapore   | TGR SP   | 0.5                  |

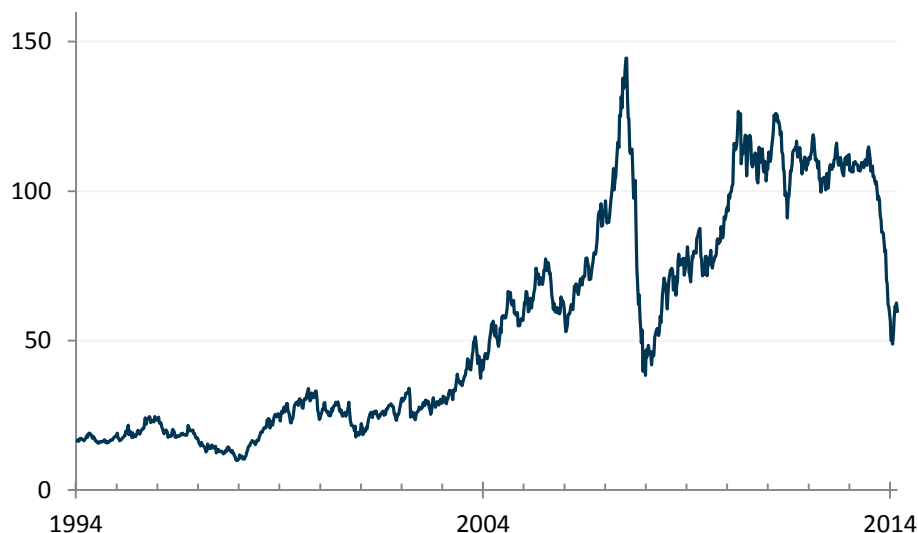
Source: PSR, Bloomberg

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### Lower crude oil prices → Good for airlines, right?

Crude oil prices have declined from the low 110 dollar/barrel range in June 2014 to a low in January 2015. Crude oil prices have rebounded off the bottom, but remain nearly half the level they were nine months ago.

**Figure: Brent crude oil price (US\$/bbl)**

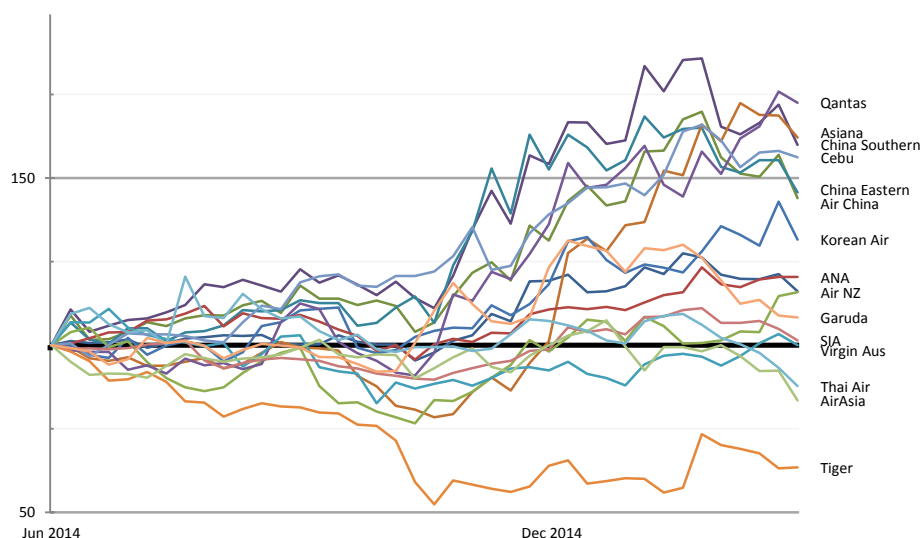


Source: Bloomberg

### Lower fuel prices = better for airlines

Fuel is a large percent of company's operating costs (eg, fuel was 37.7% of Singapore Airlines' 3FY15 operating expenses). So, common wisdom is that airlines are the prime beneficiaries of lower crude oil prices. But how positively have they reacted? The following chart shows airline price performance indexed to nine months ago when crude oil prices were in the low 110 dollar range and translated into US dollars. In general, airlines have reacted positively to the lower energy prices.

**Figure: Asia-Pacific airline share price performance (in US dollars, 100=nine months ago)**



Source: Bloomberg, PSR

### How have profits reacted to lower energy prices?

Airlines are an interesting business to analyze. If the planes are too empty, they lose money. If they are too full, then they are turning away customers who would otherwise fly on their planes. But managements' challenge is generally more focused on downside risk. Airlines need to operate efficiently to keep costs low. Airlines generally hedge some of their fuel price exposure, but their policies vary by company.

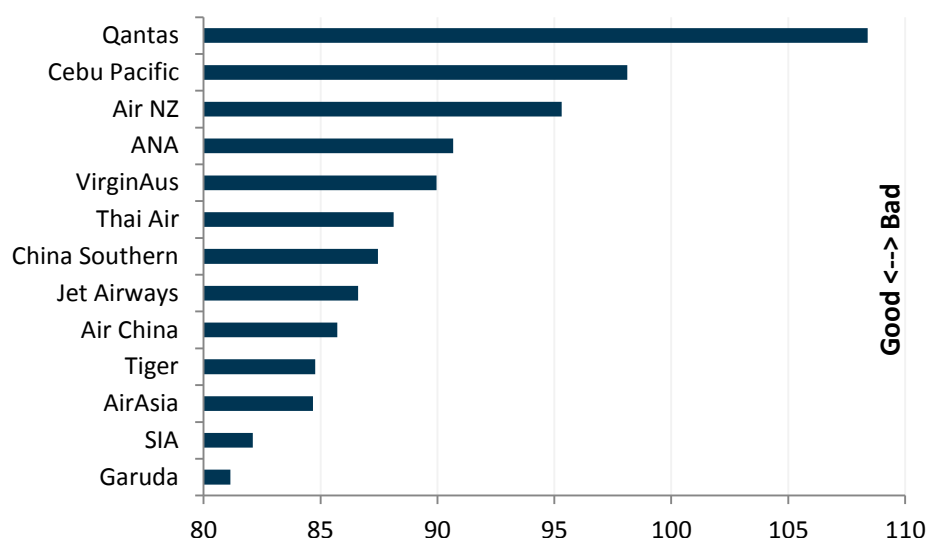
### Lower energy prices: positive impact not yet reported in corporate results

The drop in energy prices was in 4Q14, so realistically one can only expect the impact to happen in 1Q15 and, to a lesser extent, 2Q15. The 4Q14 results still reflected a time when energy prices were in the 100s of dollars per barrel.

### How investors should look at future operational performance?

One can analyze airlines by dividing their expenses by their passenger capacity. This is called the "break-even load factor". We reduce the population of airlines we look at because not all airlines report operational data and some companies have large accounting adjustments (eg, revaluation of dollar-denominated debt). The below chart show the 2013 break-even load factor of airline. One can see that airline run the spectrum of operational efficiency. Notoriously inefficient Qantas had a break-even load factor above 100%, whereas known efficiency experts AirAsia (due to adherence to low-cost carrier business model) and Singapore Airlines (due to reliance on long-haul flights/premium service/premium pricing). However, you might be surprised to see how efficient Garuda (GIAA LJ, Not rated). In general, one should see these break-even load factors decline over the next two quarters thanks to the positive impact of lower fuel prices.

**Figure: Average 2013 Asia-Pacific airline break-even load factor (%)**



Source: Bloomberg. Note: calculated by taking simple average of interim break-even load factor.

### Ugh... airlines stocks

Over the past two decades of marketing to various institutional investors, we have noted that airline investors can be lumped into two different categories: 1) those who hate investing in airlines and 2) those who are begrudgingly forced to invest in airlines because they are benchmarked. If you look at the group of publicly listed airlines below, you can see a reason why. One can see the annualized returns for almost all the stocks (excluding dividends) is negative to low single digit annualized returns. This group also benefit from “survivorship-bias”, which means that it already excludes those airlines that have already delisted or gone bankrupt (eg, Malaysian Airlines, Japan Airlines, Skymark) and scores of airlines that were private and never came public before going bankrupt. This list also excludes unlisted national carriers that may have less pressure to report profits (eg, Air India, Philippine Air, Pakistan International Airlines, Cambodia Angkor Air, Vietnam Airlines, Lao Airlines). In other words, it is hard getting rich being a long-term investor in airlines.

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

- Sir Richard Branson

### Asia-Pacific airlines stock price returns (dollarized)

| Airlines       | Since     | CAGR   |
|----------------|-----------|--------|
| Air NZ         | 28-Dec-01 | 9.1    |
| AirAsia        | 19-Nov-04 | 7.6    |
| Air China      | 17-Dec-04 | 7.1    |
| China Eastern  | 07-Feb-97 | 4.9    |
| Korean Air     | 10-Feb-95 | 2.7    |
| SIA            | 30-Dec-94 | 2.2    |
| Cathay Pacific | 30-Dec-94 | 1.9    |
| Qantas         | 04-Aug-95 | 1.8    |
| Asiana         | 24-Dec-99 | 1.8    |
| China Southern | 01-Aug-97 | 0.7    |
| ANA            | 30-Dec-94 | (6.7)  |
| Cebu           | 29-Oct-10 | (8.0)  |
| Thai Air       | 30-Dec-94 | (8.2)  |
| Virgin Aus     | 05-Dec-03 | (10.8) |
| Jet Airways    | 11-Mar-05 | (12.4) |
| Garuda         | 04-Mar-11 | (13.0) |
| Spicejet       | 07-May-10 | (22.4) |
| Tiger          | 22-Jan-10 | (22.5) |

Source: Bloomberg

**Q: When do you invest in airlines? A: When in crisis.**

Poor long-term performance does not mean that one should not invest in airlines. On the contrary, there are many opportunities to invest in airlines. The following few charts show performance of ASEAN airlines as an example of the broader market. The chart is shown on a logrhythmic scale and indexed to 100 for today. One should note that some airlines are exceptionally volatile with stocks routinely being multi-baggers or performing poorly, depending on when and what airline. Flag carriers MAS and Thai Airlines have been exceptionally volatile over the past 20 years as they neared bankruptcy and were bailed out. But even less volatile/high quality stocks like Singapore Airlines represented a great investment opportunity after the Asian Currency Crisis, SARS, and the Global Credit Crisis. In summary, the best times to invest in airlines are when they are in crisis. The challenge is to make sure that they survive the crisis.

**ASEAN airlines stock price performance (dollarized, 100 = today)**



Source: Bloomberg, PSR

**Stock recommendations**

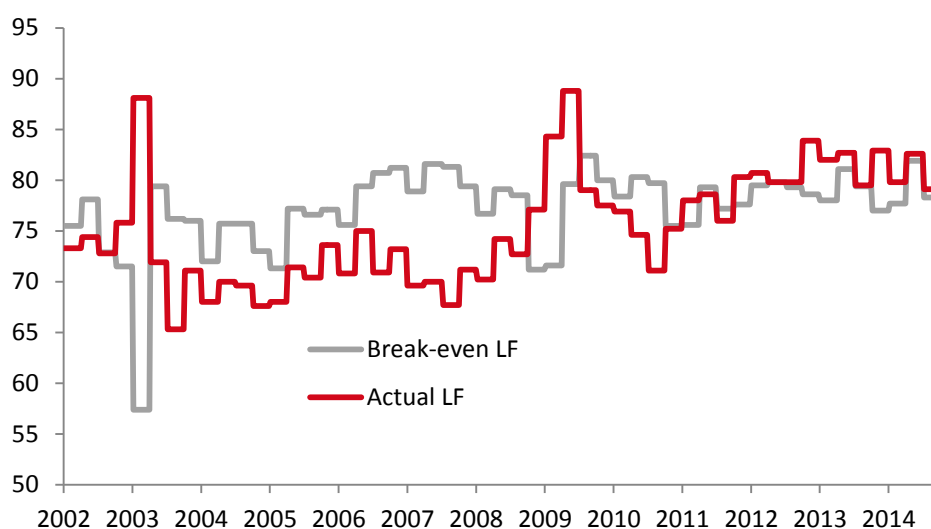
We do not have formal coverage on any airline stocks in Singapore.

However, we highlight that Air Asia (AIRA MK) is in its own crisis after its airliner QZ8501 crashed into the Java sea on 28 December 2014, the third Malaysia-related airline to crash within six months (MH370: missing on 8 March 2014 over southern Indian Ocean, MH17: shot down over Ukraine 17 July 2014).

Tiger Airways (TGR SP, Not rated) is also emerging from its own crisis, needing recapitalization from its equity holders (which includes Singapore Airlines) to remain financially solvent. We do not have an investment recommendation on Tiger Airways, nor will we forecast whether we think the company will be solvent in 10 years.

We do not have coverage of Singapore Airlines (SIA SP, Not rated), but we do note that its airlines break-even load factors and actual load factors are near the average of the higher end of the range of the past 13 years. In summary, its performance appears “normal”.

#### Singapore Airlines: break-even and actual passenger load factors



Source: Bloomberg

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