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Flight Centre – things to excite investors

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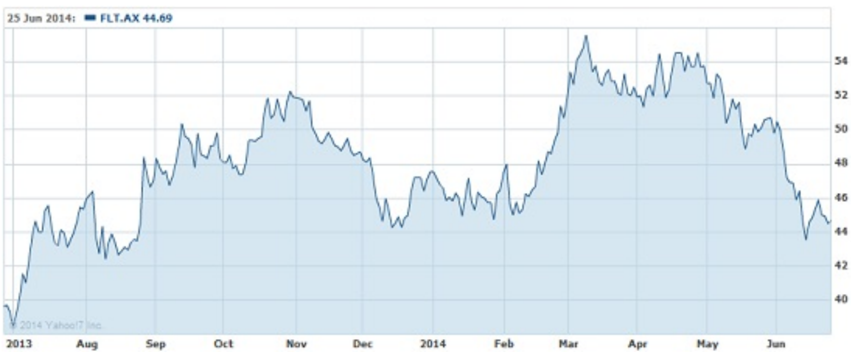
The evolution of the Australian travel agency space is a topic of much debate. In a world in which there is an “app” for just about everything, questions have been asked if the brick-and-mortar travel agency model exhibited by Flight Centre (FLT) is sustainable. First the cons.

The cons

The competition from online travel agents is formidable. International online competitors such as Priceline and Expedia, as well as local competitors Webjet and Wotif do not incur the costs associated with renting physical storefronts. Furthermore, these online offerings primarily use software algorithms to search for flight and hotel reservations that might suit a prospective customer’s travel needs. This saves on salary and commission expenses that Flight Centre needs to pay its army of consultants on an ongoing basis. Finally, when it comes to bargaining power with airline and hotel vendors – a key source of profit for Flight Centre – the big international competitors are a serious threat to this too. Consider that, while Flight Centre is almost as large as Qantas with a market valuation of around $4-5 billion, US-based Priceline is worth around $60 billion and Expedia $10 billion.

Flight Centre (FLT)



The pros

On the other hand, perhaps we are being too hasty in our assessment of industry disruption. And perhaps there is something unique about the Australian travel agency space that helps protect it from the onslaught of online competition.

Given how far we are located from the rest of the world, most of our long-haul flights typically require connections. Furthermore, when most of us make such a long trip, it makes sense to spend a bit more time in said location, or travel to surrounding regions to maximize bang for travel buck. All of this results in travel itineraries, which are rather complicated to compile. And few of us have the experience (or patience) to prepare multi-destination travel itineraries, which are both seamless and cost-effective. For these reasons, it is entirely rational to pay a little extra for the services of a Flight Centre consultant who can take care of the headaches associated with working through the near-infinite number of travel options we are faced with.

There is also perhaps a demographics argument, which further lends support to the bricks-and-mortar Flight Centre model. As the baby boomers begin to retire en masse, there will arguably be an increase in overseas travel expenditure from this demographic. This is the age group that will be the last to switch to DIY online travel agents for complicated itineraries. Leveraging the expertise of a Flight Centre consultant to book the travel will likely prove to be an attractive proposition for the retiree, notwithstanding the nominal mark-up that is applied to the ticket.

Facing challenges head on

Flight Centre knows what it is up against and is doing its best to prepare for a more intensely competitive market in the future. In the 2013 financial year, the company launched its "Killer Theme" corporate strategy to directly address the challenges it faces. The strategy focuses on a number of themes around branding, product uniqueness, expert advice, marketing and intelligent information management. The company is also redesigning its customer experience – both in-store and across digital channels. Essentially, Flight Centre is trying to increase its "customer captivity" with an effort to increase the costs for customers to switch to (online) alternatives.

Flight Centre's initiatives are sensible and the company's management is highly capable. The ultimate question, however, is to what extent will customers value expert advice over cost? The experience of regions such as North America, Europe and the UK suggest that many travelers – typically the younger generations initially – prefer the cost savings. Even in Australia, the data clearly shows an increase in the rate of penetration of online travel reservations, though they are rising off a low base.

What cannot be disputed is Flight Centre's business quality when viewed from a historical perspective. The company has consistently generated returns on equity north of 20% – a truly impressive feat. Flight Centre is also in a highly enviable financial position: the company has almost no debt and over $400 million in cash at its disposal. In addition, the business generates around $300 million in additional free cash flow each year. These are great characteristics that should excite shareholders and one would expect significant dividends or share buy-backs going forward.

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