VALUE.ABLE STOCKS

Back down to earth

Nifty accounting can't hide a business's underlying woes, writes Ben MacNevin

THOSE OF YOU WHO FOLLOW Montgomery Investment Management would be familiar with our negative position on airlines. We have penned numerous articles that decry their ability to generate long-term value for shareholders. When a business operates in a highly competitive environment with capital-intensive assets and a difficult-to-control major expense (the oil price), investors are likely to part with more capital than what can be returned.

Given the market's positive reaction to the full-year results of Qantas (QAN), we feel compelled to stand on our soapbox and warn that this time it's not different.

For the 2014 financial year, Qantas reported an underlying loss before tax of $646 million. In addition, it wrote down the value of its international fleet by $2.6 billion. Yet, after announcing one of the largest losses in its history, Qantas's share price appreciated by 15% in subsequent days – a perplexing reaction to be sure.

Market conditions in 2014 deteriorated significantly as Virgin waged a bitter price war to win market share from its rival. Facing this pricing pressure, Qantas also had to contend with higher fuel costs and continue to service its large debt.

Perhaps the market's price reaction was in response to a favourable outlook?

Not so. Virgin has reaffirmed its intention to pursue more market share in Australia and Qantas expects the international market for air travel to stay oversupplied. We feel these two forces will have a greater impact on profitability than Qantas's attempt to remove $2 billion worth of costs from the business.

We sense, then, that the positive share price reaction may have more to do with the $2.6 billion impairment charge. If this is the case, then it is certainly cause for concern.

Before 2014, Qantas tested its assets for impairment at a group level. In the 2014 financial year, management decided to test the assets by division, revealing surplus values in the domestic, freight and loyalty divisions but a $2.6 billion deficit in the international division. The size of the writedown was attributed to the purchase of aircraft when the Australian dollar was materially weaker against the US dollar.

It is important to understand that an impairment charge is an accounting construct. The disclosure is recognition from management that investors were tapped for $2.6 billion worth of capital that cannot be recovered at current market values.

While there is no improvement to the underlying returns on a cash basis from the impairment charge, investors may perceive an improvement on an accounting basis in a number of ways.

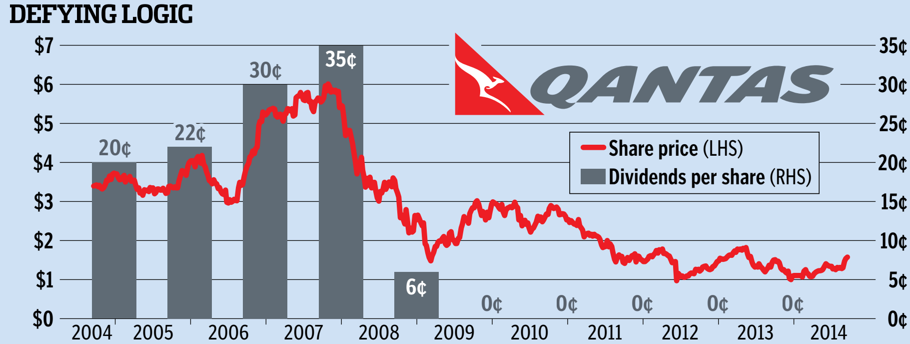
The impairment value will reduce depreciation (another accounting construct) by $200 million a year. This gives the impression that profitability has improved, yet the capital expenditure that's required to maintain the aircraft is unaffected.

An impairment charge also reduces the equity of a business, which inflates the return on equity (ROE). Remember, investors entrusted $2.6 billion worth of capital to the company that can no longer be returned or redeployed, so this is not a true representation of historical profitability. While the impairment charge is designed to reflect the current market value of the fleet, investors must exercise caution when applying this revised ROE to any capital deployment in the future, particularly in the context of excess supply in the global air travel market.

The hard truth is that the current economics of the airline industry are hardly conducive to long-term shareholder value. Even with some nifty accounting changes.

Ben MacNevin is an analyst at The Montgomery Fund.

DEFYING LOGIC



SOURCE: BLOOMBERG

GETTY IMAGES