A wing and a prayer

by Roger Montgomery

Key points

- *When it comes to capital-intensive businesses like airlines, accounting standards can be inadequate for measuring the true performance of the business.*
- *The profit, after such inadequate expenses and depreciation have been subtracted, is artificial and doesn't take into account equipment replacement costs.*
- *Airlines are tough businesses: capital-intensive, labour-intensive, fiercely competitive and ultimately selling something that people want to pay the lowest price for.*

It's true I am getting nervous about the market. I can't tell you what will be the catalyst, nor that the market is wildly expensive – it isn't – and I cannot even tell you when or even if there will be a correction, but I can say that there are many signs – economic, market, corporate, sentiment and the level of unprofitable IPOs – that suggest it is wise to dance close to the door.

My nervousness is perhaps best illustrated by the enormous and arguably illogical gains seen in the share prices of airlines. I suggest illogical because the very long-term economics of these businesses are, more than many if not most others, so unpalatable as to be dangerous to your wealth.

It might surprise you that when Virgin Australia Holdings (ASX:VAH) listed in 2003, it was exactly a year after United Airlines had filed for Chapter 11 protection from creditors. That company was denied $1.8 billion in backing for new loans. The hat went around and came back empty. Remember the hat because I am going to come back to that.

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 they operate? Or is there a fundamental gene in airlines that threatens wealth?

A cautionary tale

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 much 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 15 years to the present-day and look back over the past decade and a half. Profits have been as high as $970 million in one year and as low as a loss of $144 million in the last financial year.

That most recent year is substantially less than the profit we made 15 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 15 years has made the losses of the current year even more painful.

To add insult to injury, and to get the business to this auspicious point, we have tipped in an additional $2.7 billion of our own money and borrowed an additional $3.5 billion from the bank.

So we have a business that we have been running for 15 years. We have tipped in a total of $4.6 billion of our own money and borrowed $6.5 billion from the bank and last year we made just $100 million.

The hidden costs

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 before you answer that, the company is now forecast to earn some substantial profits thanks to the low oil price and efficiencies extracted by management restructurings, the profits reported in the accounts, however, might just be 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 generally 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 – $27 million in replacement costs compared to the $10 million in depreciation.

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, and 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 challenging business to discover that airlines are monotonous in their efforts to raise fresh capital or in their suspension of dividends. 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. In 1999, they traded as high as $5.00. Today, they are $3.36. Virgin Blue’s shares had only just listed in 2003, with great fanfare, and were trading between

$1.91 and $2.15. Today, they trade at 50 cents.

The recent tripling of the share price of Qantas does not give me cause for comfort nor does it suggest the economics of the airline has permanently improved. Indeed the rally is potentially a signal that the market is becoming increasingly irrational.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*