

The Economics of Airlines

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By: Direk Khanijou



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

- Sir Richard Branson

Airlines have given so much to the world: safe travel, greater mobility, and facilitation of tourism, trade and humanitarian aid.

Yet, the airline industry has been unprofitable its entire life. In fact, by some estimates, the net amount of money that's been made by the shareholders of airlines since the industry's inception in Kitty Hawk is a negative figure. It is probably the worst industry in the history of the world.

Why is that? It is because the airline industry has terrible economics. Below are some of the reasons:

- Huge fixed costs
- Capital intensive – planes are expensive!
- High operating and financial leverage
- Low barriers to entry with no incumbent competitive advantage. Capital not a barrier since you can go to an airline leasing company
- Airbus and Boeing have an oligopoly on planes

- Fuel intensive. Fuel is an airline's biggest and most volatile input cost, accounting for almost 40% of its cost base. To make matters worse, an airline cannot hedge itself long-term to fuel
- Non-existent customer switching costs
- Airline seats is a commodity that is price-elastic
- Surprises are negative and cost money – bad weather, war, crashes, strikes, flight delays etc.
- Kamikaze pricing tactics by carriers. Dumbest competitor only trying to cover marginal costs. However, recent consolidation have made for more rational competition
- Strong labor unions. Strikes can end an airline's revenue stream. No airline can afford a shutdown very long. A business that cannot take a long strike is playing a game of chicken with labor. Ironically, a financially weak airline will be in a stronger negotiating position with the unions

When you have all of that in a commodity business with very small market shares, it's a recipe for bankruptcies and price wars.

Base-rate neglect

- Before investing in the airline industry, you should be aware that the odds of making money in the industry are bleak
- However, not all airlines fall under the 'crappy business' label
- Ryanair and Southwest Airlines have done extremely well
- Mr. Market sometimes gets biased and has the tendency to paint everything with the same brush
- Take advantage of situations when a Ryanair might be priced like the average airline company

Why I think business class will get smaller

- An airplane is one of the most expensive real estate you will ever be in
- The cheapest airplane is a \$45 million machine while an Airbus A380 costs about \$400 million
- Therefore, it makes sense for airlines to start filling that real estate as densely as possible – a trend that's already happening

Why I still won't invest in an airline

1. I do not like businesses with excessive leverage in its capital structure because little margin of safety exists
2. Today, ultra-low-cost carriers (ULCC) such as Allegiant, Frontier, Spirit Airlines, EasyJet and Ryanair are affecting the business models of last cycle's winners like Southwest and JetBlue. My concern is, if Ryanair can appear all of a sudden, how can I be confident that another Ryanair doesn't all of a sudden appear?

Just like in any industry, there are successful businesses and there are unsuccessful businesses. Many consider retailing to be one of the toughest industries because it is transparent and trade secrets are virtually non-existent. However, one only has to look at the contrast in performance between Wal-Mart and Sears. The same principle applies to airlines and the rest of capitalism – there are good and bad spots.

For a more complete understanding of the airline industry, check out this blog post by my friend: <http://value-edge.com/2016/07/22/understanding-the-budget-airline-industry/>