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& Private Portfolio Managers

Roger J. Montgomery
Chairman

Airlines.
Profitable Economics?

"Sizing all this up, I like to think that if I'd been at Kitty Hawk in 1903 when Orville Wright took off, I would have been farsighted enough, and public-spirited enough--I owed this to future capitalists--to shoot him down. I mean, Karl Marx couldn't have done as much damage to capitalists as Orville did."

Warren Buffett

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Warren Buffett, the second richest man on Earth and perhaps its most successful investor offered some advice to gifted management; *“When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is usually the reputation of the business that remains intact.”*

Make no mistake, before we begin this discussion, that Geoff Dixon and his team are exceptional. It is however frightening to imagine what they might have achieved over the last 5 years, had they been running a business with economics far superior to an airline. It is these economics that is the subject of this note.

About a year ago, in August 2005, market commentators reported to their readers, the frequency of better-than-expected profit results being released, they included in their list of businesses to be lauded and perhaps by implication, shares to be purchased, Qantas – an airline.

We found this curious at the time, because, over a long period, airlines have rarely, if ever, produced enviable economics for their owners. Indeed, Richard Branson, founder of Virgin Atlantic Airways, once grimly quipped that the best way to become a millionaire was to start out as a billionaire, and then buy an airline.

We would guess that you may hesitate at owning an airline outright, if one were offered to you, so we cannot understand why there is little, if any, trepidation when it comes to buying a small piece of an airline on the stock market. Shares in Qantas following the aforementioned lauding and the 2005 results, rallied from \$3.29 to \$4.29 reflecting enthusiasm for the business and its management.

Perhaps the buying was more accurately a reflection of irrational exuberance? At the time of writing, the share price is again \$3.00 – unchanged over 7½ years, from December 1998, although we do concede there are now more shares on issue!

This note argues that there may be inescapable economics driving the long-term share price of airlines and share market investors should be aware of them.

When Qantas reported their full year results for 2005, they were exceptional relative to their peers but their peers are nothing to write home about and, as we will demonstrate, for a 100% owner, the 2005 result was only marginally superior to cash in the bank earning interest of 5.75% per year.

Let me show you how we, at Clime Capital Limited, think about the returns a company generates and you can gain some appreciation for our approach to examining the business in its entirety – as if we owned it outright, rather than merely looking at shares as bits of paper that wiggle and jiggle on a screen.

In March 2001 Geoff Dixon was appointed CEO of Qantas. That financial year, the company reported a profit of \$419 million (let's ignore, for now, the fact that the adoption of historical cost depreciation may be understating the cost of owning and maintaining aircraft and other equipment and machinery and so the reported accounting profit could be overstating the true economic profit – we'll explain later).

Fast forward to 2005. Qantas reported an after tax profit of \$760 million. Qantas management has done a sterling job of increasing profits by \$330 million in 4 years and increasing profits by \$110 in the last year. But, while management had been working hard and succeeding, they may have been flogging a dead horse – a business with poor economics and prospects that are unlikely to change those economics.

While profits rose, the company has also had the benefit, between 2001 and 2004, of an additional \$1.8 billion of share capital - funds raised *from* shareholders, an additional \$2.6 billion in borrowings over the same period and 3/4's of a billion in retained profits. All up, the company has had the benefit of \$5.5 billion in *additional* invested capital. Give any company an extra \$5.5 billion and their profits had better go up! Management have been described as exceptional, and I would agree with that assertion, but the economics of the business are difficult to overcome and despite all of management's hard work, the company really has not done anything remarkable.

Let me take you on journey which at once is both simplistic and fanciful. Suppose you personally scrape together \$5.5 billion (\$2.6 billion of which is borrowed) between 2001 and 2004 and deposit it in the bank at 5.75% on 1 July 2004. Today you could report interest earned of \$316 million - earnings before interest and tax (EBIT) for the year ended July 30, 2005 and after deducting interest on the borrowings (at say 7%) and tax (at 30%), report \$94 million after tax. To compare, give an additional \$5.5 billion to Qantas – an airline - at 1 July 2004 and the business produced additional earnings of \$110 million. Not significantly higher than cash in the bank. And according to the commentators this is supposed to be a great investment? Cash deposited in a bank account last year generated a similar return with, arguably, significantly less risk.

That's why Buffett's views are so strong on the subject of airline investments. Given the risks and hard work involved "investors" can easily come up with better investment metrics than this. Buffett adds;

“You've got huge fixed costs, you've got strong labour unions and you've got commodity pricing. That is not a great recipe for success. I have an 800 (free call) number now that I call if I get the urge to buy an airline stock. I call at two in the morning and I say: 'My name is Warren and I'm an aeroholic'. And then they talk me down.”

And add to “huge fixed costs” and “strong labour unions”, irrational competition. When a US airline enters Chapter 11 bankruptcy protection, it can continue to compete with Qantas, continue to offer services and take business away from the other participants, all the while operating without the obligation of having to pay its creditors.

The poor economics of airlines don't really change irrespective of who owns them. But such warnings have been ignored for decades by millions of small investors, often to their financial detriment.

In the above example we used the reported profits of the company as a comparison against the returns a bank account would produce. The picture gets worse when you understand that capital intensive businesses often produce cash profits that are much lower than the accounting profits reported to shareholders and which we used above.

Just one year before the successful listing in Australia of Virgin Blue, United Airlines filed for Chapter 11 protection from creditors in part because the company was denied \$US1.8 billion in backing for new loans. The contrast could not have been starker and yet the two businesses operated in the same industry. Since listing the share price of Virgin Blue has succumbed to the same economic pressures faced by all airlines. But what are the flaws with airlines that destroy rather than create true owners' wealth?

When accounting standards and methods - which can be regarded as inadequate at measuring economic performance - allow capital-intensive businesses to depreciate their property, plant and equipment based on a historical cost basis, reported "accounting profits" fall far from reflecting the economic reality of the business.

Unfortunately, while the investor uses accounting to determine whether to invest, it is the economic performance of the business that will determine whether the decision was correct.

An aircraft purchased today and maintained or modified with services and parts at present prices costs considerably more than an aircraft purchased two decades ago and maintained and serviced since.

Yet accounting standards allow historical cost depreciation to provide for the expense. In 2005 Qantas reported \$705 million dollars in depreciation of aircraft, engines and spare parts. Its aircraft are depreciated over 20 years on a straight-line historical cost basis with a 0-20% residual.

The resultant profit - after inadequate expenses (historical cost depreciation) have been deducted - is therefore an accounting construct and bears little resemblance to the true economics of owning and running the business.

To correctly reflect the economic performance of a capital-intensive business, the accounting entry "depreciation" should be replaced with a provision that more accurately reflects the replacement cost of the property, plant and equipment.

Take a business that purchased \$1million of machinery 25 years ago. Over the ensuing 2 decades, profits have been reduced by \$1million in depreciation, leaving an assumed total profit over the period of \$2.5 million. If we assume that machinery with the same capacity has risen in price by the rate of inflation, say 4 per cent, then the replacement cost of the machinery would be \$2.7 million.

If the machinery is to be replaced so that the businesses is in the same position, the cost to and the cost of running the business is 2 times more than that which has been accounted for.

For the business to continue it will have to outlay \$2.7 million, thus the accounting profits have been exaggerated by \$1.7 million. The company has made an economic profit over the 25 years of \$800,000, not the \$2.5 million it declared.

Even worse, the company would have paid taxes on a higher declared profit and may have paid dividends it could not afford – and probably funded by either additional equity or borrowings. Move from millions to tens of billions and you get some idea of the magnitude of the problem.

If debt and leasing arrangements have already been stretched to acceptable limits, creditors will be unlikely to keep the business on life support, as United Airlines shareholders discovered in 2004.

An alternative is to ask existing shareholders to return some of their dividends (also known as a rights issue, share purchase plan or placement) or to ask new shareholders to tip in funds through a capital raising of some description.

This revolving door of funds - sometimes taking funds from new shareholders to pay dividends to existing shareholders - echoes a scheme developed by Charles Ponzi in 1920.

The shareholders will now be required to keep the company afloat by injecting further capital. It is no coincidence that airlines are monotonous in their efforts to raise fresh capital for "growth". Such growth, however, is arguably illusory and not of the profitable variety.

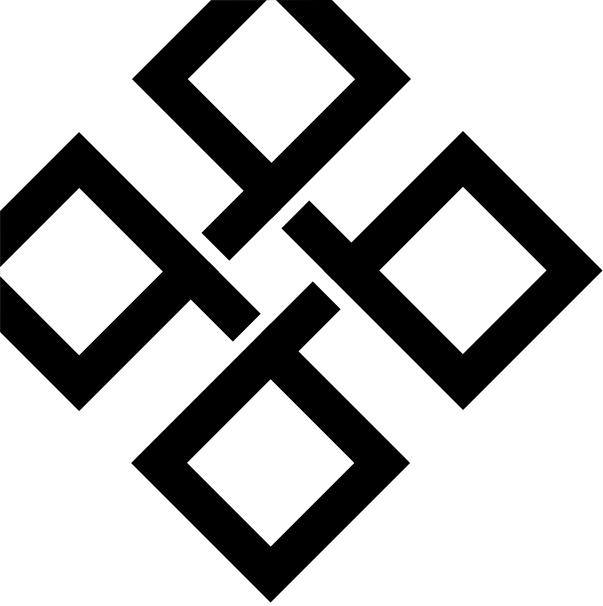
Airlines are a tough business - capital and labour-intensive, fiercely competitive and from which legislated protection is required and even holidays from debt repayment for some competitors as well as ultimately selling a commodity – a product where for many, the buying decision is based on price alone. Not the ingredients of a sound long-term investment.

Investors however will not change until their advisers and market commentators start to explain the relevant facts and they will continue to buy shares in airlines, trying to pick the highs and lows in the share price (speculation) as the airlines, in turn, jockey for market share and report illusory benefits from restructures, merger synergies, staff reductions and route cancellations and embargoes, while paying dividends from borrowed funds and new capital.

At the time of writing, Qantas as warned of further job cuts and a 27% profit slump, battling a \$1 billion increase in fuel costs.

Roger J. Montgomery, b.Comm., SF Fin
Chairman
Clime Capital Limited
(ASX Code: CAM)

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