Industry Perspectives

A MONTHLY RESEARCH ANALYST SERIES

DIAMOND HILL | CAPITAL MANAGEMENT

Ready for Takeoff or Grounded Indefinitely? - An Airlines Update

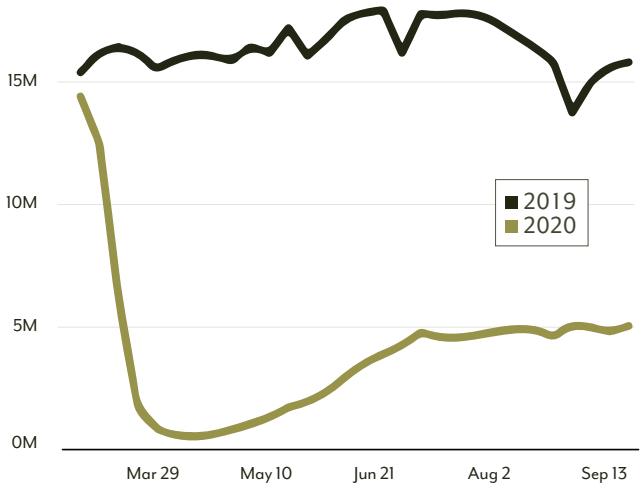
October 2020

Blake Haxton, CFA
Research Analyst

COVID-19 has radically altered the way most Americans live their lives and conduct business. As nationwide lockdowns began in March, the demand for air travel cratered— at one point in April airlines were carrying fewer than 5% of the passengers compared to one year before. (Exhibit 1 shows 2020's dramatic fall-off in airline security screenings compared to 2019.) In a historically unprecedented move, Congress passed the CARES Act, which provided grants and loans to help U.S. airlines avoid mass layoffs and bankruptcy. As spring turned to summer, travel restrictions began easing across the country. By the end of June, air traffic rose, but just to one third of its June 2019 level, and demand has remained flat through the end of September. Any further recovery is likely dependent on the broad distribution of a viable vaccine.

As long-term value investors who take a five-year view of businesses' fundamentals, we try not to overreact to bad news or temporary headwinds. We are vigilant, however, not to let a long-term investment horizon lead to short-term complacency. The historic downturn in air travel has made the future of the industry extraordinarily uncertain, as the industry has never seen such a rapid or prolonged reduction in miles traveled. We believe that a vaccine will eventually be broadly distributed, but several key questions remain. Will corporate travelers resume flying at their previous pace, or has lockdown permanently shifted the way the country does business? Will Americans be as quick to travel in large groups on tightly spaced aircrafts after such a dramatic public health crisis? Will airlines be able to adjust their levels of service to accommodate changes in passenger behavior?

EXHIBIT 1: PEOPLE SCREENED AT AIRPORTS



Source: Bureau of Transportation Statistics.

Today, we are cautiously optimistic that Americans will eventually return to the skies for both business and leisure. However, we remain aware that the future is hard to predict. As such, we are focused on investing in airlines that possess a few distinct features. First, carriers must have access to capital and the operational flexibility to survive a downturn that lasts even longer than we anticipate. Second, shares of the business must be available for purchase at a level that offers an exceptionally wide margin of safety to our estimate of intrinsic value. We believe both Allegiant Airlines and Alaska Airlines meet these criteria.

Bright Spots in a Challenged Market

Allegiant Airlines is the smallest U.S. public carrier and specializes primarily in flying leisure-oriented passengers to vacation destinations, with Orlando and Las Vegas being its two largest destination markets. Attractions in both cities have seen dramatic capacity reductions or outright closures since the pandemic began and visitors remain scarce, though green shoots are starting to appear as some travelers are eager to travel again. In the long run, we do not believe that Disney World or the Las Vegas Strip have lost their appeal, but the reduced number of visitors directly impacts the number of passengers available for Allegiant to carry. Fortunately, Allegiant's route system is built in such a way that individual flights can be taken out of the system as demand dictates. This allows Allegiant to shed costs rapidly and leave planes on the ground until flying becomes profitable again. With a strong balance sheet and assistance from the CARES Act, we believe Allegiant is well situated to endure the crisis and recover well.

Alaska Airlines is a mid-sized carrier concentrated in the Pacific Northwest and California, applying the traditional hub-and-spoke route model to domestic and North American intracontinental flying. Alaska carries many more business travelers than Allegiant, but does carry fewer than Delta, United or American Airlines. The company has a much smaller operating cost base than the large legacy carriers, and as such has greater freedom to reduce costs in a downturn. Management has maintained a conservative balance sheet and an owner-operator mindsight, and by focusing on controlling cash flow through the crisis, Alaska Airlines is positioned to withstand the downturn and emerge with a strong franchise on the other side.

One segment where neither Allegiant nor Alaska Airlines have significant exposure is the international market. While air travel within the U.S. has suffered, the demand for long-haul international travel has declined even further, with intercontinental corporate travel being particularly weak. Long-haul operations require high utilization rates for flights to be profitable, and we are more cautious around predicting a return to previous levels for global airline traffic.

Looking Ahead

The aviation industry remains challenged, though prospects for a vaccine and a second round of congressional support offer hope for an accelerated recovery. We believe we are finding compelling opportunities that could benefit from a rapid rebound while still being resilient enough to withstand a prolonged downturn.

As of September 30, 2020, Diamond Hill owned equity shares of Allegiant Travel Co. and Alaska Air Group, Inc.

As of July 31, 2020, Diamond Hill owned bonds of Alaska Air Group, Inc., Delta Air Lines, Inc., United Airlines Holdings, Inc. and American Airlines Group, Inc.

The views expressed are those of the research analyst as of October 2020, are subject to change, and may differ from the views of other research analysts, portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice.