Oftentimes, the source of a business model's strength may not immediately be obvious. In Copa's case, its business model is based on aggregating various low-passenger-volume markets from their “Hub of the Americas” in Panama. This hub provides convenient connections to 80 cities in 32 countries across North, Central, and South America. Cities throughout South and Central America depend on Copa for access to the world, in many cases with few alternatives. In fact, over half of Copa's passengers come from cities where the airline has over 50% market share. Copa collects enough demand for each flight by taking all passengers to the “Hub of the Americas” first. Passengers then connect, along with other passengers from many different starting points, on another flight to their final destination. For the most part, direct flights between many cities within Copa's network are not viable and thus require a hub-based model.

Skill and integrity of management are other critical factors for any sustainable business. After meeting Copa CEO Pedro Heilbron last fall, we quickly recognized that he was an anomaly in the industry. To start, he has been CEO since 1988 when Copa was a tiny regional airline with two airplanes. Under his leadership, Copa is a great example of how disciplined expansion can build significant competitive advantages over time. Each new city that Copa serves strengthens their “Hub of the Americas,” as it further optimizes connecting traffic. Management has also been instrumental in shaping a pragmatic and cost-obsessed culture. Copa's unique culture has built a reputation for reliable customer service and is consistently recognized as one of the most on-time airlines in the world. Their world-class operating performance, combined with its cost-obsessed culture, help drive the lowest unit costs in the industry.

At Diamond Hill, one of our key advantages is that we always invest with a long-term mindset. We understand that it can take years for a business to execute a strategy and decades to transform an industry. We also understand that while businesses are built for the long term, they are measured quarterly. Few investors bother to assess the long-term value of a business and instead react to the latest data points to determine the direction of the stock price. Nervous investors tend to shoot first and ask questions later. This behavior both excites us and provides investment opportunity.

Our approach to investing requires managing both risk and uncertainty. Long-term investors hate risk but can tolerate uncertainty. Markets hate uncertainty and frequently discount businesses when they are not operating at full potential, preferring expensive stability to bargain uncertainty.

During the fourth quarter of 2018, we made an investment in Copa Holdings. Shortly thereafter, we read a research report on Copa titled, “Too much uncertainty for us to recommend these shares.” Copa had recently reported one of their weakest quarterly results ever amidst a challenging backdrop caused by volatile foreign exchange rates and jet fuel prices. The analyst writing the research report, along with the market, appeared to be making a common mistake of confusing uncertainty with risk. In this Industry Perspective, we examine the pillars of Copa's business model, which allowed us to see an attractive investment opportunity as others perceived uncertainty.

**Accumulating Advantages**

Copa operates a hub-based airline from Tocumen International Airport in Panama City, Panama, and it is this prime geographical position that sets the foundation for their competitive advantages. Panama is perfectly situated between North and South America, allowing single-aisle aircraft to reach nearly all points in the Western Hemisphere. Additionally, Panama has several other advantages over competing regional hubs, such as better infrastructure, competitive labor costs, and an aviation-friendly business environment.

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While the airline industry has a well-deserved reputation as an investing graveyard, Copa breaks this mold. In addition to a hub-based business model and an industry-leading cost structure, Copa’s conservative balance sheet provides a strong defense against competitive pressures. Copa’s balance sheet allows the company to endure – and likely take advantage of – even the most
challenging economic environments. Other Latin American airlines are not in the same enviable position, as their aggressive balance sheets are now stretched to the limit.

In addition to Copa’s advantages described above, there are a few unique features of the Latin American airline industry that should naturally help reduce competitive pressures. A key factor is the strong secular tailwind in air traffic growth that we expect in Latin America. Supplementing a healthy industry outlook is the recent string of joint venture announcements between the major United States and Latin American airlines. After receiving regulatory approval, nearly 75% of the airline capacity between the United States and Latin America would be managed by three joint ventures, and Copa is involved in one of these along with partners United Airlines and Avianca Holdings. These factors, along with reasonably rational industry behavior in the past, give us comfort that competitive tensions will be manageable for Copa.

Turbulent Times in Latin America

Over the past five years, Latin America has seen its fair share of instability. The region’s largest economy, Brazil, has been mired in a recession that some call its worst in modern history. Argentina has faced hyperinflation and Venezuela is facing a humanitarian crisis. Political dysfunction has been at the root of these various economic roadblocks and change will not come easily. Like most Latin American airlines, Copa has stumbled as the weakness in the region depressed operating profits and forced a reduction in growth plans. However, we find it encouraging that Copa managed to prudently grow capacity by around 6% annually over the past five years, while Latin American GDP grew below 1% annually.

Just as Copa was adapting to their new operating environment, the second half of 2018 brought another round of economic surprises. A difficult combination of higher jet fuel costs along with steep currency depreciation in Brazil and Argentina again rapidly eroded profitability. The pace and magnitude of the weakness in local currencies limited Copa’s historical ability to pass through higher jet fuel costs to ticket prices. What happens in Brazil and Argentina, unfortunately, does not stay in Brazil and Argentina. A hub-based model means weakness in one region leads to fewer connecting passengers on flights throughout the network. In response, the region’s airlines - including Copa - have rationally reconsidered near-term growth plans. While this is an encouraging sign of industry discipline, the effect is a further reduction in short-term earnings potential.

Despite these recent headwinds, Copa is not standing still and will continue to evolve in order to maintain a healthy revenue and cost advantage relative to peers. Historically, we have seen that the initiatives within Copa’s control have been well executed. Unfortunately, the financial impact of their past actions is being overwhelmed by the challenging operating environments in Brazil and Argentina. Looking ahead, we see plenty of opportunity for Copa to implement technology throughout the business. Successful execution of automated ancillary revenue opportunities (i.e. seat selection, upgrades, baggage fees), along with the introduction of fare families, could generate surprising results over the next five years. Additionally, the arrival of a new terminal at the “Hub of the Americas” dovetails with cost efficiencies that will come with the transition to new Boeing aircraft that Copa has ordered. Finally, Copa maintains a very flexible fleet plan that allows it to respond to passenger demand, in either direction, on short notice. Given all these factors, we believe Copa is well-positioned to outperform peers in the current downturn and to also capture more than its share of the eventual recovery.

Looking Ahead

While we believe that Latin America will eventually break out of its economic slump, our investment in Copa is not based on an imminent rebound. The real benefit of a long-term framework is that it allows us to rely on factors that we can be confident about, such as an increase in miles flown, the persistence of an industry-leading cost structure, and growing competitive advantages. When we focus on the probability of these items over timing, temporary setbacks fade in importance. What really matters is the continuous reinforcement of Copa’s advantages with a pragmatic and cost-obsessed culture as the guiding force. These are the traits that led Copa to do the right thing in the past and are likely to guide them again in the future.