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BA Stock Has Rallied as Union Talks Falter

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A BA plane takes off over Canary Wharf

British Airways has been making front-page news for all the wrong reasons over the past few months, yet its share price has greatly outperformed that of its competitors since the start of the year.

Whether this rally can continue, analysts and fund managers say, depends greatly on the airline's ability to deliver expected benefits from deals with Iberia and American Airlines, and to extract permanent concessions from its disgruntled staff.

Only then, can it hope to improve its margins enough to boost annual earnings back to around 45 pence a share, and thus sustain its stock in the longer term.

In recent months though, good news about British Airways has been scarce.

Most visible perhaps has been the souring of the airline's relationship with its workforce. It narrowly avoided a 12-day cabin-crew strike over the Christmas holidays, only to see it rescheduled for later this month. The disagreement is straightforward: essentially the airline is asking for permanent changes to working conditions that employees believe are unwarranted.

The threat of industrial action comes at an unprecedentedly difficult time for the airline. Battered by lower demand for air travel, particularly in its more lucrative business class, it is preparing to report its biggest-ever annual loss in May.

Nine-month results, which showed losses nearly doubling to £245 million (US$375 million), give an idea of the extent of the damage.

Yet British Airways' share price has shrugged off the red ink, as well as the strikes.

The stock is up around 30% since the start of the year compared to a 2% increase for Air France-KLM shares and a 4% rise for Deutsche Lufthansa, two airlines that are arguably in better shape. Since July, BA's stock has more than doubled to 244 pence from 117 pence.

The rally has fazed many investors. But industry experts say there are elements of explanation.

Uptick in transatlantic traffic, perhaps?

"This rally's quite amusing, isn't it? It's somehow contradicting the general sentiment around the airline, which has been pretty negative to say the least," said Nick Cunningham, aerospace and airline analyst at Evolution Securities.

To Cunningham, the recent performance makes perfect sense, and serves as a good illustration of how cyclical the airline business is.

He identified the turning point for the stock as the moment when British Airways signaled an uptick in both volumes and yields — average fares — across the Atlantic.

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"That was crucial. Because what you have to remember is that what makes British Airways different from other European flag carriers is that it's so Atlantic focused," he said.

While Air France-KLM and Lufthansa derive a significant portion of business from flights to Asia and freight, British Airways is much more focused on the Atlantic. In fact data for the second quarter shows that over 48% of its revenue is accounted for on routes to the Americas.

So when businesses in financial capitals like London and New York tightened their travel budgets in the wake of the financial meltdown, British Airways took a bigger hit than its European rivals. Now that transatlantic traffic has started to recover, the airline's getting the strongest lift.

Capacity reduction; deals finally coming through

But not everything is down to signs of a traffic recovery. Some of the recent rally is also the result of British Airways' actions.

"British Airways has a lot on its plate. But it's taking action in the right direction on all fronts, whether it's solving its pension-deficit issues, reducing labor costs or pursuing alliances," said Francis Claro, portfolio manager of Evergreen International Equity Fund .

The airline has indeed wasted no time in adjusting to its new economic circumstances.

A 12% capacity reduction across the North Atlantic, in particular, was pretty drastic and should help margins recover, said David Hussey, head of pan-European equities at MFC Global Investment Manager.

He noted that the airline's margins have historically oscillated wildly between "big minus numbers" — causing no investor to want to touch it — and 10%. With the current level of business, if margins recovered to 10%, BA would actually earn around 45 pence a share. Even if that turned out to be peak earnings, it would still imply reasonable upside for the shares, he said.

The other significant development for the airline has been its ability to finally bring home tie-ups it's worked for years to engineer: with carrier Spanish carrier Iberia and U.S. carrier American Airlines.

The idea of an expanded alliance with American is one that British Airways has explored twice before. Both times the deal collapsed on competition grounds. But the regulatory landscape has changed significantly since the last attempt, in 2002, with both Air France and Lufthansa having since gotten the green light for joint ventures with American carriers.

It now seems that the BA-AA deal could go through. Last week the European Commission took a step toward approving the alliance when it said it seemed satisfied with the carriers' offer to give up a number of landing slots at London's Heathrow and Gatwick airports.

That deal, said Max Sukkhasantikul, commercial aviation consulting analyst at Frost & Sullivan, is the main driver of British Airways shares right now. He said:

> *It's the key point that other airlines don't have. While other airlines have done deals, such as Lufthansa with Swiss and Austrian Airlines, the cost savings of an expanded alliance with American would be much greater.*

As far as Iberia is concerned, the merger is expected to be completed in the fourth quarter of 2010, if British Airways' 3.7 billion-pound pension-deficit issue can be sorted out.

The merged company — to be called TopCo — will have joint annual revenue of roughly 15 billion euros and a combined network of 205 destinations.

Earlier this week there was a bit of good news on the Iberia merger when British Airways said it's reached an agreement with trade unions on the future of its pension plan.

The market meanwhile seems convinced the deal will go through, with the Iberia share price closely tracking that of British Airways.

Market wants to see BA fight it out with unions

The pension-deficit union deal is good news but it's unrelated to the dispute with cabin crew, which is showing no sign of abating.

On one side there's British Airways saying that to cope with the downturn and return to an acceptable level of profitability, it needs cabin crew to agree permanent changes to their working conditions. On the other there's cabin crew accusing the airline of "industrial dictatorship" and announcing two strikes: a three-day one from March 20 and a four-day one from March 27.

The threat of strikes, less than three months after a major one was averted at the last minute, has led to very negative coverage for the airline.

But, as Hussey said this time the company seems to be "in a mood for a fight," which could actually eventually deliver the savings it needs.

Cunningham shared the opinion that the strike could actually have a positive outcome, emphasizing that only now, at the bottom of the cycle, does the airline actually stand a chance of getting the concessions and long-term changes it needs to return to a profit.

"I think the market realizes that and would be much happier for British Airways to fight it out than to give. There might be some costs involved but the benefits in the long term greatly outweigh them," he said.

Yesterday, BA CEO Willie Walsh said BA was aiming to fly 65% of affected flights; today, that number is back at 60%, the number it out out on Monday.

J.P. Morgan analysts calculated that if BA manages to fly 65% of affected flights, this means the action will only cost the airline about 8 million pounds a day in lost revenue. As a result, they noted the level of service could undermine the resolve of striking cabin crew.

Meanwhile management is showing no sign of backing down. Evergreen's Claro said its firmness is part of the reason he owns the shares. He said:

> *They're showing they're willing to take short-term pain for long-term gain. I'm willing to go on this journey for now with them and see how they execute on their various initiatives. I think that's what investors are thinking. They're seeing the stock through some short-term turbulence.*