

Traveling in the Unknown

Disruptive Forces in Investing

September 22, 2020

Peter: As we all know, COVID has disrupted our definition of what normal means. So it should come as no surprise that when we have been told to stay home and maintain social distancing, you would think that none of these concepts align when it comes to travel. But as we have all adjusted to today's new normal, we have to ask: what does this mean for those who want and need to travel during this time? Is there still hope for these industries? So, with that said, we're turning to the experts who can give us a better understanding of how these industries are tackling society's response to the pandemic. I'm your guest host, Peter Andjelkovich, and I'm here today with two of our senior research analysts, Kevin McCarthy and Michael Barr, who can share more about the hotel, cruise and airline industries' response to COVID-19 and where we go from here. Kevin and Michael, thanks for joining me today.

Michael: Thanks for having us.

Kevin: Thanks for having us, Peter.

Peter: Great. Well, so to just get right into it, let's start with a broad overview of how these industries are doing. Kevin, let's start with you to get a sense of outlook on the hotel and cruise spaces.

Kevin: Great. Thank you, Peter. I appreciate it. Um, to start off, it's important to maybe start with a baseline of where we were and where we are now. The whole travel complex has obviously been hugely disrupted, and likely set back several years. For context, we started – entered COVID with occupancy levels hovering around 80 percent. During the spring, that fell to virtually zero percent, and we clawed back to about 30 percent now. At the current pace of recovery, perhaps we can get to 40 percent by the end of this year, 50 to 60 percent by next year, and a full recovery not until 2023. The linchpin for the recovery really depends on business travel, and this tends to lag. Business accounts for about 50 percent of overall room nights. Leisure is the other half, and leisure has done relatively well over the summer, with travel – uh, family-oriented travel taking place.

The smaller piece of it, which you referenced, is-is – is the cruise line, which is exclusively a leisure, uh, a leisure channel. Currently they're leaning heavily on repeat cruisers. Uh, we should see that start to pan out and broaden out over the next month or so, but it's still early days on that recovery.

Peter: Great, thanks. Michael, same question to you with respect to the airline sector.

Michael: Yeah, thanks. Uh, well, I-I think it goes without saying the se – the sector's struggled with COVID, um, mightily. Uh, the industry is – we've seen traffic down over – anywhere north of 90 percent at certain times, and while it's still coming back since basically COVID hit, we haven't really gotten much above 60 percent. Uh, the other thing that you've seen is the total – the fleet, uh, of the airlines, they've parked almost 60, north of 60 percent of planes. Uh, again, that's coming back, uh, but, you know, we haven't seen anything like this. You can combine 9/11 and the SARS impact, uh, a while ago, and we-we still aren't getting touched – getting close to this type of impact. Um, so it's been pretty, uh, devastating to the industry. Um,

however, when we look at it, and kind of highlighting what Kevin talked about, there is some underlying desire to travel. Um, if you kind of look at it over, uh, the summer holidays, you've seen a slight increase in miles driven over, um, 100 miles, uh, that shows there is a willingness of people wanting to travel.

It's just try – finding the method and mode with which they want to travel, in which they want to feel safe. So, um, we kind of feel positive that there is going to be some sort of recovery. Uh, the consensus has come around 2023 when we kind of get back to the, uh, “new norm”. Um, but it's – you know, it's still up for – up for debate on how that happens. Uh, but we think that's kind of, uh, a fair-fair point to look at it. Uh, the other way to think about it and that we're looking at is the international side of the equation is crossing borders, not only from a ... a regulation point of view of if you're allowed as a, um, a citizen or non-citizen to cross borders, but the fear of crossing borders and being in, uh, a separate country, uh, when – if you were to get – contract the virus, has, uh, really devastated the international side of the equation. So when we talk about recovery we think there's going to be recovery in the domestic side first, followed by international as we-we get more comfortable with the travelling.

But overall, while we're [unintelligible 00:04:35] sighing – seeing signs of, uh, the industry trying to come back and demand trying to come back, it's still very muted out there as people are still not quite comfortable getting on an airplane.

Peter: That's helpful. You know, given what you, you outlined in terms of, uh, the timeline, what has it done, you know, to the airlines and their, you know, future orders for planes, and how does that trickle down to, um, you know, manufacturers and suppliers? And, you know, who's having the hardest time right now as it, as it pertains to, to those sectors?

Michael: Right, so, uh, that-that's a – that's a lot in that question. Uh, and the simple answer is everybody's gotten impacted just as much as the airlines. Uh, what we haven't seen is too many cancelations yet. Uh, but that makes sense, because if you – the backlogs that the OE – the airline OEMs, sort of the air – airline maker OEMs, was already pretty large. Um, so if you were going to cancel, you're going to get in the back of the line. Uh, so most people didn't want to cancel yet. Uh, they wanted to see if they could defer planes, um, and things like that, before the outbreak cancelation, because if things do recover and then you're flying the older aircraft or the less efficient aircraft, you find yourself at a disadvantage. So the airlines are hesitant to cancel, but that doesn't mean they can't defer. And you didn't ask the question, but, you know, adding onto the-the chaos that has, uh, been created by the-the Max grounding, has added a whole 'nother layer of, uh, confusion and complication to the whole route structure of the airlines, as well as the delivery structure of the OEMs.

So, um, there's a lot of moving parts embedded in there. Uh, COVID has made the situation worse, um, but what we're seeing there is un-until we start travelling, until takeoff and landings start increasing substantially more than they are, until traffic gets north of – you know, or down 60 percent, getting back to some sort of normal levels, there's – there's pressures throughout the ecosystem of the – of the airlines, in – including the manufacturers and the aftermarket suppliers.

Peter: Great, thank you for that perspective. You know, Kevin, you mentioned, um, you know, occupancy and-and booking rates earlier. You know, moving forward, what – what are some of the factors that will bring those numbers up or down?

Kevin: Yeah, the – I think there are two ways of looking at that or answering that question. One is from a near term perspective and one is more of a medium term. Near term, it's really – it sounds rather simple, but the obvious is consumer comfort with travel. Lodging companies, for the most part, have done an excellent job with ensuring safety, um, offering keyless check-in, electrostatic sprayers, optionality around room service. Um, the bigger challenge, actually, is, though, the rest of the travel complex and making sure that everybody is on a same level playing field with ensuring customer safety. So, you know, that – that requires everybody, from, um, when you leave your house to putting your head on the pillow at a hotel, everything in between, and the travel. So that-that – that is probably one of the more near term occupancy levers that can, um, drive back normalcy, um, over the near term, in a – in a step function manner.

Over the – over probably the medium term and longer term, um, we’re going to be looking towards, uh, a significant variable, which is corporate bookings for group travel. Um, that – group travel is roughly 30 to 40 percent of the mix, and meeting planners are going to be getting together this fall – they don’t want to give up their spots but they obviously want to ensure safety. So, um, that’s going to be a-a – you know, when we think about step function changes in occupancy it’s – it’s number one, near term, getting the consumer comfortable with the entire travel complex, and number two, making sure that the group planners, when they make their plans this fall, uh, you know, make commitments towards 2021 and 2022.

Peter: Yeah, and-and that’s interesting. I mean, Michael mentioned earlier with respect to the airlines of, you know, extensions versus cancelations in terms of-of orders. Do you see a situation where hotels will almost be non-negotiable as it pertains to those larger corporate contracts, and setting expectations? Or do you think that there still will be a future of hey, you have the flexibility to cancel as a – you know, a corporate, um, you know, provider, or whatever it might be.

Kevin: No, there-there’s definitely going to be some wiggle room in that whole process, given where occupancies are today. Um, you know, I think that the, um – it’s a scenario where, um, there-there are certain assets, certain, um, venues that are, um, very suitable for group travel. Um, those-those – those places will be booked, but, um, you know, when you start to get into the secondary and the tertiary, that’s where I think you’ll see a –you know, a lot of flexibility with allowing, um – you know, whether or not it’s per diem spends or number of attendees, um, there will be some flexibility in that piece of the equation.

Peter: Thank you. Michael, any – anymore perspective with respect to the airline? Airlines?

Michael: So I think Kevin made a great point. It is going to be the entire ecosystem of the travel sector that, if there’s a pinch point, i.e. if someone’s worried about getting on an aircraft or someone’s worried about getting on a cruise line, that could impact everything. I do think it’s going to be really important for these industries to kind of calm fears about COVID. I think it’s –the airlines are trying to explain but it’s hard to – if you will, it’s hard to accept from a consuming public, is the safety aspects and the air filtration aspects of these modern planes. They use state-of-the-art filtration, they circulate the air significantly faster, and they vent the air from the top to the bottom of the cabin. So in essence, they have the same filtration, infrastructure as an emergency room. So they’re exceptionally safe, but we understand the fear of getting on a metal tube with a bunch of people and having the fear of contracting COVID. Um, I-I do think– like Kevin pointed out, there’s more opportunities, and we highlighted a little bit earlier about the extended duration of miles driven was up over the summer. There seems to be more opportunities for the hotel chains to, um, have more ways to win, if you will. Uh, versus the airlines or the cruise lines. So I think that’s a key point. The other thing, uh, that I think is kind of interesting to point out is we’ve heard – we’ve long heard about videoconferencing being one of the, the problem children – problems for the industry going – for the airline industry going forward.

Um, that hasn’t occurred, um, for as long as we’ve been having videoconferencing, um ... However, I think what COVID has created is an environment where we’ve been in our work-from-home situation for, you know, eight, nine, ten months now, and that’s actually starting to create some habits. Uh, that’s starting to create some familiarity with, uh, certain products for videoconferencing. So I think there is a little bit of a risk where you-you have some of the – of the fringe business travel might have, uh, finally figured out how to use videoconferencing efficiently. And that might that travel come back. However, I always use examples where we talk about business travel – and Kevin talked about the return of business travel. I always use examples about the salesperson who lost his first contract, uh, to someone who got on a plane and went and saw a customer in person. That salesperson is quickly going to get back on a plane.

Uh, the other example I use is it’s very easy if you’re, uh, a potential client to, if you will, ignore Zoom calls. Uh, it’s a lot more difficult to ig – ignore someone who will say, “Be in London the week of August 27th. I will be there. Can I meet with you?” Uh, so I think there’s always going to be reason and need for business travel, but I do think the overall, overarching dynamic of videoconferencing that’s happened over the course of the past, uh, like I said, eight to ten months, has actually kind of probably eroded some of the business travel on the fringe side.

Peter: And-and Kevin, I assume that's the similar collateral damage with respects to the hotel space?

Kevin: It has. Hotel operators and owners are continual optimists, and, you know, they've got a 50-year track record of looking at major challenges for the industry. So they tend to believe that, um, you know, travel is the backbone of business, and that it will come back over time. It just happens to be, um, you know, maybe an extended, you know, three to five year period for the RevPAR to get back to prior peak levels. Um, so, you know, while I think there's probably going to be, um, some fallout, uh, ultimately, um, we do think that, you know, this is a cyclical business, it will come back, it will come back stronger than it was in 2019. It's just a matter of picking the year.

Michael: And just so we're on the same page, right? Um, some of the fringe stuff I was talking about were – maybe daytrips, are long daytrips that wouldn't have had a touch point on the, uh, hotel and lodging industry to begin with. So, um, I think that – that blend pretty closely with what Kevin's saying.

Peter: Absolutely. So a question that I'll pose to both of you – and maybe Michael, I'll start with you – but just progressively going forward, you know, what are the ways that the industry, the airline industry, will prosper? And from your seat, you know, what will be the opportunities from an investment standpoint?

Michael: So, you know, as we said, right now it's not very good. Um, there – when you have traffic and demand down as much as it is. But we-we've had a scenario multiple times in this industry where, um, there-there's been significant demand shocks. We referenced one of 9/11 and things like that. Um, they've always come out of it. Uh, they've worked their – worked their way out of it. Uh, as Kevin said earlier, there-there is an innate want and need to travel. Uh, there is an underlying business reason as well to travel. So I believe that we're going to come out of this. Uh, the duration is a little bit uncertain. Uh, there's vaccines and then there's vaccination. Um, vaccination is what's going to be key, just having a vaccine is not. Uh, it'll help sentiment, but it's not really going to really get people travelling all – as-as much as people think, in our opinion. I think you need more summer vaccination.

So the timeline is a little uncertain and hard to see at – for – at this point – point in time, but when we look at it there's no reason to think that these airlines won't come out of – out of this, uh, stronger than they went into it. Uh, they've really had to look at route structures, they've really had to look at cost profiles, uh, pricing dynamics, uh, who their core customers are and who – who they should be serving and who they shouldn't be serving. And while probably all of them are going to come out of this smaller, um, that doesn't mean they're not going to be better. And hopefully they've – they're going to learn a lot of things from this. So there's inevitably going to be the next COVID. So hopefully they'll – hopefully not as bad, to be fair, but they're going to come out of this, uh, better equipped to handle these – some of these shocks, which, uh, should bode well for the future opportunity and future multiples that could be applied to this industry.

Peter: And Kevin, how are you and your team thinking about the opportunities from an investment standpoint?

Kevin: Yeah, I would really echo what Michael just said. Um, you know, we think that – looking at the context of the lodging and travel, you've got leisure, which is in a multi-decade bull cycle, uh, and then business being – you know, travel being the backbone of business. You know, these are going to come back. Uh, it's a – it's a matter of time. We do think that we – we approach peak RevPAR again. Um, but from a stock perspective there is, you know, going to be, uh, probably some shifts, uh, in terms of the, uh, benefits going to the larger operators, and in particular the asset light, capital light business models.

Typically during a downturn what you see is the independents, which actually represent the vast majority of the lodging companies, um, tend to be in more financial distress.

Um, that is elevated right now, um, and so what you see is them reflag or re-banner and going in underneath one of the, um, larger lodging companies, um, that are capital light franchise business models. So we think that, you know, if we look at past cycles and-and kind of look at the conversions and what took place from a market share, uh, situation, we think that is kind of on hyper drive, uh, during, during this cycle.

Peter: Well, thank – thank you both. I mean, from somebody who, you know, used to travel weekly, this has been extremely insightful, and – and hopefully this will help to encourage our listeners to continue to travel with a better understanding of what’s going on in the industry.

Kevin: Great. Thank you very much, Peter.

Michael: Thank you.

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