Contact Asset Management

INSIGHTS

JUNE 2023

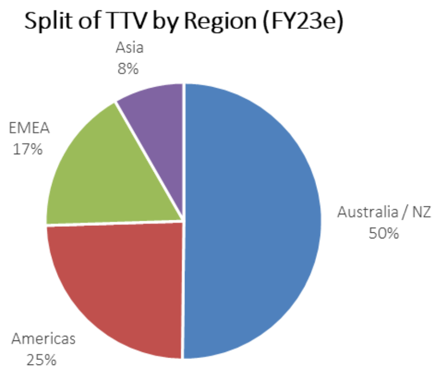
Stock Discussion – Flight Centre Limited (FLT)

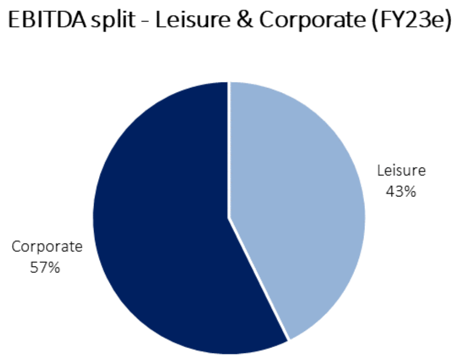
We re-established a position in Flight Centre Ltd (FLT) earlier this year, having last owned it in 2018. While FLT is a somewhat changed business to pre-pandemic, we see several compelling characteristics. The business is founder-led, has strong growth prospects (across products and geographies) and is well positioned to benefit from the ongoing recovery in demand for travel.

About Flight Centre

FLT was co-founded by Graham Turner and Geoff Harris in 1982 and began with one store in Sydney. However, its origins go back to Turner buying a double decker bus and running tours in Europe. This became Top Deck Travel in 1975. Once Flight Centre was established in the early eighties, it soon expanded to London in 1984, with early success of the "Lowest Airfares Guaranteed" slogan. In 1995, as the business passed $10 million in profits, it also listed on the ASX.

Today, FLT has company-owned operations in 23 countries and a corporate travel management network that spans more than 90 countries. FLT's main sources of revenue are commissions and booking fees. Its key geographies are ANZ (45%), Americas (29%), EMEA (23%) and Asia (3%). Revenues are split evenly between Corporate and Leisure markets. The corporate business is now more significant than ever before. We expect Corporate to be almost 60% of earnings this year.





Source: FLT Financials, FactSet, Contact Asset Management

Why did we revisit the stock after several years?

BKI Investment Company owned FLT several years ago, however we exited the stock in mid-2018. At the time, we struggled to reconcile the company's goals for margin and TTV (Total Travel Value) growth and what the market was willing to pay for that growth – which seemed excessive. The reduced dividend yield on offer made it difficult to justify owning for an income focused company like BKI. Our exit price was in the mid-$50 range.

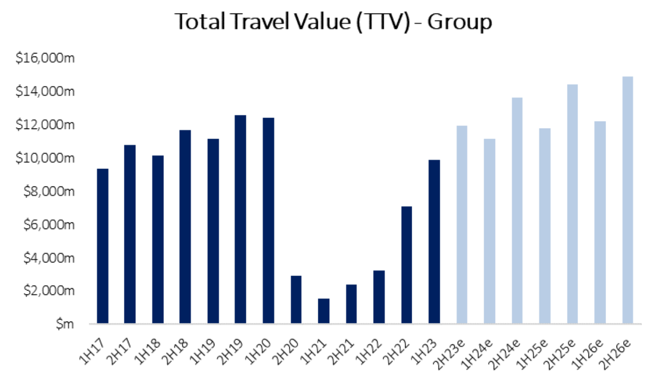
We had already been out of the stock for over 18 months when COVID hit. As we know, COVID decimated the travel industry. The following table highlights the extent of the impact:

	FY20	FY21
Forecast Consensus NPAT (at December 2019) ($m)	245	290
Actual NPAT delivered ($m)	-764	-442

Source: FLT Financials, FactSet Consensus Estimates, Contact Asset Management

We watched the stock from a distance and established a position in the stock again a few months ago in the Contact Australian Ex-50 Fund. We re-established a position in FLT as we believe that its profitability is sustainable, growth prospects are attractive, there is a path to dividends restarting and the Balance Sheet is reasonable. The fact that the business continues to be founder-led adds to our confidence.

The following chart shows the extent of revenue decline and the anticipated recovery.



Source: FLT Financials, FactSet, Contact Asset Management

What are the competitive dynamics and other key demand drivers to consider?

The travel industry is extremely competitive. However, one legacy from the pandemic has been the increased complexity during travel. With increased occurrences of cancelled flights, less supply, volatile pricing etc., a good travel agent is critical. For leading travel agents, the opportunities are significant, as FLT management believes that 15% of agents left the industry[1].

In the Corporate segment, there are limited competitors that can deal with large corporate clients. Amex and BCD are two examples. FLT (through its FCM brand) is gaining share. It is on track to secure new accounts this year that will have projected annual spends of $2 billion during FY23. That is significant for a division that will do about $10 billion in sales this year and then takes a 9% or 10% revenue margin.

The changing dynamics of the Online segment is another interesting consideration. The Flight Centre brand is capturing 75% of pre-Covid TTV in Australia with 35% of the pre-covid workforce[1]. Group online traffic accounted for $750m of TTV. The rationalisation of agents mentioned above presents an excellent opportunity for market share gains. The Online segment is a big opportunity for FLT. Profit margins are lower, but the total addressable market is huge.

The last couple of years has seen a massive reduction in the number of shop fronts (which was traditionally FLT's "bread and butter"). At the peak of the pandemic, FLT cut 50% of the shopfronts. A lot are back open, but to the Online segment point, the Leisure business is now capturing 40% of Leisure TTV via online (vs less than 20% pre-2020). Several independent travel agents tap into the FLT network.

How do we assess FLT Management?

We value alignment between management and shareholders and FLT is a great example of this. FLT is founder-led by Managing Director Graham Turner. The management structure is simple, lean, flat and transparent, with accessible leaders (Turner is in the office everyday sitting amongst his team in an open office). FLT business model is centred on being one of the world's best and biggest *small business* operators. The senior management team all have long tenure with the business and the founding families own over $800 million or about 20% of this business.

[1] This statistic was noted at the February 2023 Results Presentation.

What is our assessment of the value of FLT and what are the risks?

FLT has re-rated since we bought it earlier in the year and is now trading at c.$21.50. We'd consider $25 to be close to fair value based on our current assumptions using a DCF valuation. If one was to look out a year or two, this suggests a P/E multiple of about 20 times.

On income and dividends, dividend growth was attractive pre-Covid and FLT generally paid out between 50-60% of earnings. Dividends are expected to return in FY24 (but could be FY23). There are $1.1 billion of losses on the Balance Sheet so franking likely to be limited.

Its worth noting that the net debt position looks better than it is as FLT holds the prepaid cost of travel. The real debt position is approximately $400 million. The Balance Sheet is in reasonable shape now, but Covid caused a major dilution to restore the Balance Sheet. FLT has raised $900 million of new equity and issued two convertible notes (worth $650m). Once activity normalises, FLT is expected to generate solid FCF and returns.

Our Conclusion

FLT provides exposure to the ongoing reopening trend and recovery in travel. We consider our earnings forecasts to be sensible, if not conservative. For example, we do not have revenue returning to 2019 levels until 2025. There is some execution risk given FLT has adapted its business model and reduced its Leisure store network by >50%. FLT needs to hire new staff, which will be dominated by newcomers to the industry and will take time to be productive.

The company is founder led and has been through a near death experience. It comes out of Covid in a stronger position. We expect the recovery in travel to continue to gain momentum and consider FLT to be an attractive stock to achieve exposure to this positive trend.

Find out more: This note complements the recording of the *Australian Investors Podcast* with Owen Raszkiewicz on 10 May 2023. https://www.raskmedia.com.au/podcasts/australian-investors-podcast/