MACRO OPS

RESEARCH

TravelSky Technologies (0696.HK): A Sticky, High-Margin Business w/ Aligned Shareholders & Path To 10-15% Earnings CAGR

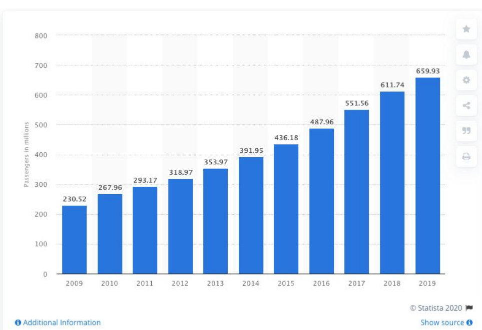
TL;DR Thesis:

- China is in the middle of a secular growth trend in air travel that should increase over the next decade
- Travelsky is a state-owned monopoly providing IT services to China's major airlines.
- The business provides critical services to airlines making it hard to switch providers
- Nearly every Chinese airline owns shares in Travelsky stock. This further solidifies their competitive advantage
- On a run-rate basis, Travelsky does 70% Gross Margins and 40% EBITDA margins
- Travelsky operates an asset/capital-light business with a fortress balance sheet
- The company trades at an attractive 14.50x EV/EBITDA and 25x normalized earnings

*****Note: H/T to Andrew Rosenblum of Bonsai Partners for the original idea source*****

Pure-Play Bet On Chinese Travel/Income Secular Growth Trend

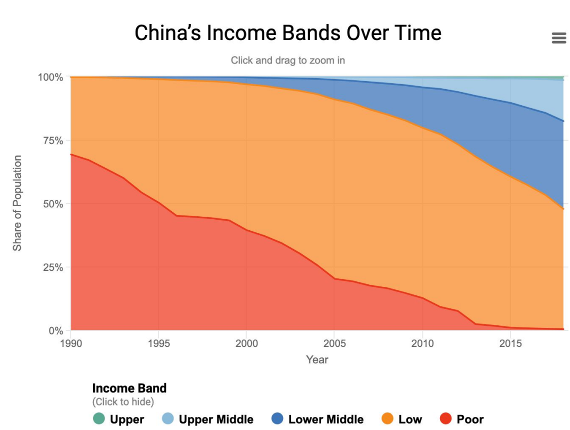
Chinese citizens are traveling more than ever thanks to increased incomes and a general rise in the middle-class economy. In 2009, for instance, China saw 230M passengers travel. Ten years later that number reached 660M passengers. That's a 19% 10YR CAGR.



China's population has quickly moved up the income ladder. For example, in 1990, lower income households comprised 75% of China's population. That figure is just 0.33% today.

Today, China's middle class makes up 50% of the population (34% lower-middle-class, 16% upper-middle-class). More money in the hands of more peoples means more spending on travel.

In a perfect world, we'd invest in a pure-play company directly tied to the growing number of Chinese passengers. This company would also have strong competitive advantages, high switching costs, and above-average profit margins.



Even better, we would invest in a company whose *actual customers* invest in their business, further solidifying their market position. Finally, the company would offer an earnings yield equal to/greater than the S&P 500 while paying shareholders a dividend.

Travelsky Technology is that company.

Travelsky provides every service an airline and its customers need to book a flight, track their flight, and monitor check-ins and luggage. Without it, airlines wouldn't fill planes and travel agencies wouldn't book trips. You can buy this company for 14.5x EBITDA and ride the high double-digit volume passenger growth.

Why Travelsky Is A Sticky Business: Business Segments

As we mentioned before, Travelsky provides every service an airline needs to help passengers book flights, track flights, check-in, and store luggage. Specifically, the company operates two main segments:

- **Aviation Information Tech (AIT)**

Travelsky's AIT segment provides services to 41 domestic airlines and 350+ international commercial airlines. Services include inventory control, computer reservation, airport passenger processing, e-ticketing and e-commerce. The AIT segment also launched a "Fast Travel" check-in service in 318 domestic and international airports. This goes with Travelsky's mobile/SMS-text check-in service offering.

Another exciting service launch is the company's electronic boarding pass clearance app, *Umetrip*. The app supports eID identification certificates and is active in 82 airports. This is the industry's *first* eID electronic certificate service.

Finally, AIT completed its full-process baggage tracking platform with the service operating at four large domestic airlines.

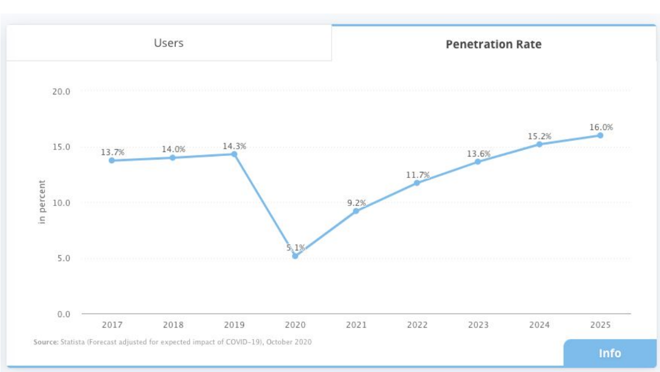
- **Accounting, Settlement and Clearing**

Travelsky offers accounting, settlement and clearing services through its wholly-owned subsidiary, ACCA. ACCA is one of Travelsky's greatest assets. The segment is the world's largest service provider of IATA Billing and Settlement Plans. It's also the largest provider of outsourced services like revenue settlement and clearing in all China.

ACCA handled 1.07 *billion* transactions and processed 433 *million* BSP (Billings and Settlement Plan) tickets.

How Travelsky Makes Money

Travelsky is a volume-based company in that it's revenue and profits move in lock-step with the volume of Chinese airplane passengers. This bodes well for our long-term thesis of a growing middle class + more dollars for travel.



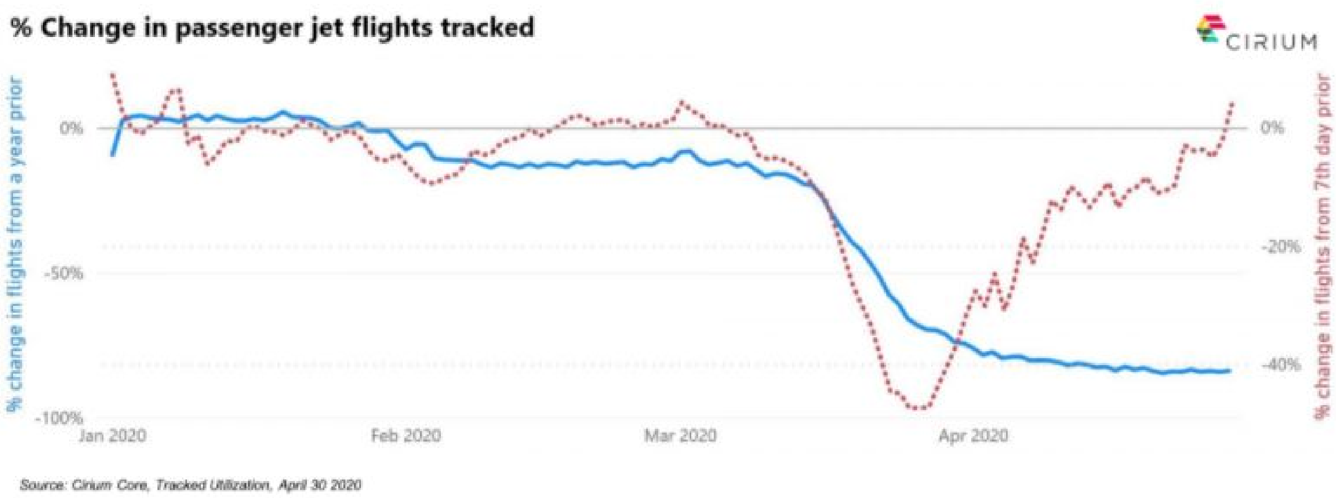
Travelsky makes roughly $0.80 for each domestic flight booked and $5.00 for each international flight booked. The company will make a ton of money as long as passenger volumes increase in the next 5-10 years.

Which isn't a tough bet to justify. In fact, all we need to look at is Chinese air travel penetration rates.

Pre-COVD, China had a 14% penetration rate. COVID dropped China's penetration rate to 5%. Statista estimates China will see 16% penetration by 2025. Compare that to the US penetration rates are expected to hit 27% by 2025. There's still *a lot of room* left for Chinese penetration rates to increase.

Moreover, China's expected to surpass the US as the world's largest aviation market. That's music to Travelsky shareholders' ears. If the IATA is correct, that's 1.3B passengers a year by 2022. That's a lot of toll-like fees collected for Travelsky.

And we're already seeing positive signs in China's passenger flight economy post-COVID. The % change in flights from the 7th day prior turned positive for the first time since March (see below):



% Change in flights tracked. Source: Cirium

With this as our growth driver backdrop, let's shift focus to the company's unique structural advantages over its peers.

Travelsky's Competitive Advantages: Aligned Interests & Reasonable Prices

One of the greatest aspects of this investment is the aligned incentives from the company, the Chinese government and Travelsky's customers. Travelsky is a State-Owned-Enterprise (SOE). This means the company's controlled by the Chinese government.

While stomach-churning at first, operating as an SOE actually reinforces their competitive advantage in China. Why run two aviation IT companies when you can back Travelsky? The aviation industry is a crucial part of China's success as a nation. I don't see them outsourcing that to anyone except a state-run business. China will argue that as a point of national security.

Second, the company's prominent shareholders include the major Chinese domestic airlines. This isn't normal. It's like Southwest, Spirit and American Airlines taking large stakes in Boeing (BA). Chinese domestic airlines have an incentive to keep Travelsky not only operating, but profitable. That's a huge safety net for the company. It also removes the idea that those companies will find in-house ways to go around Travelsky's suite of offerings.

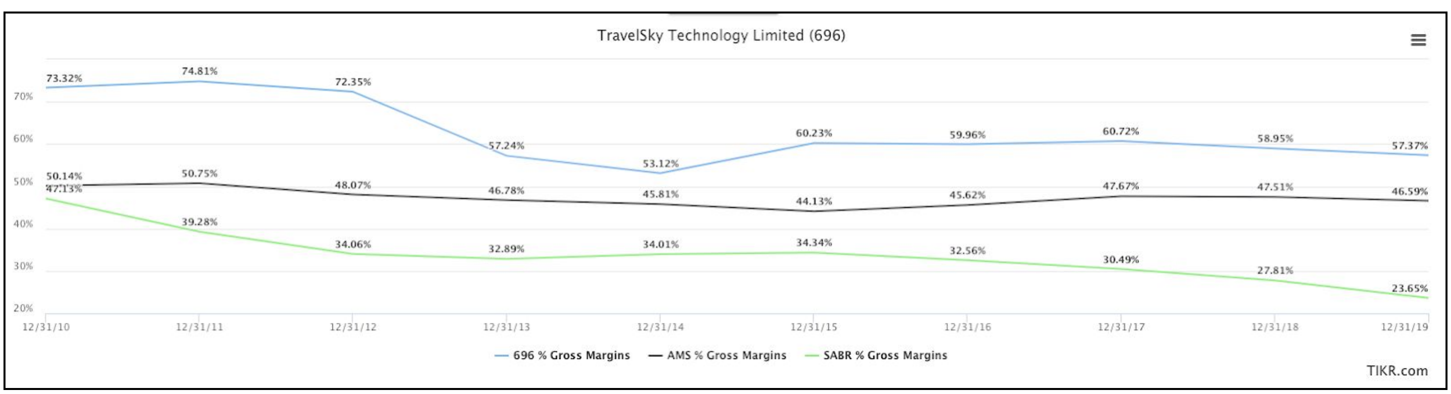
Here's how the shareholding structure breaks down (as of 2019 annual report):

- Travelsky Corporation: 29.29%
- China Eastern Air: 11.22%
- China National Aviation: 9.17%
- China Southern Air: 6.93%
- China Mobile Capital: 5.01%

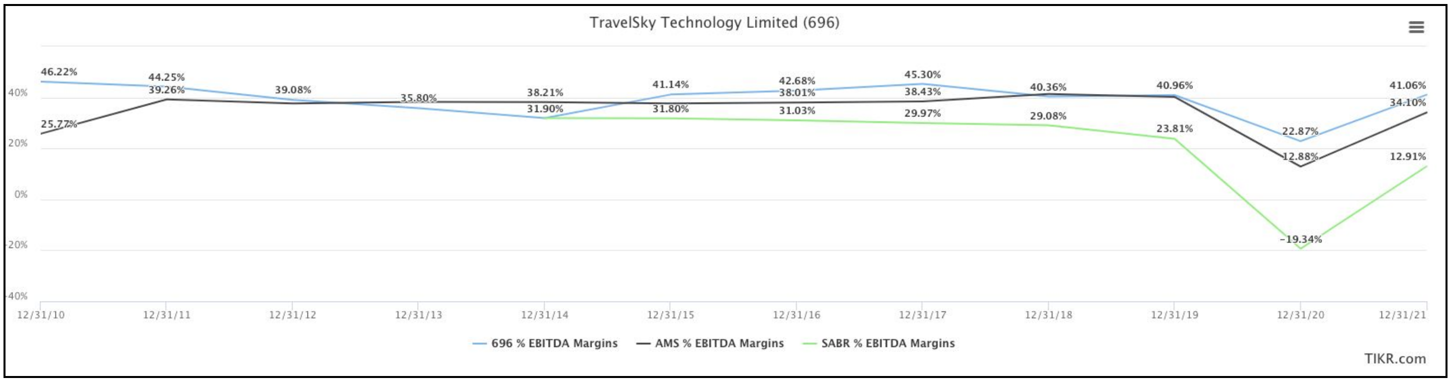
One more positive about the SOE and customer-aligned interests. Travelsky makes less money than its peers Amadeus (AMS) and Sabre Corp (SABR). Remember Travelsky's $0.80 revenue per domestic booking and $5.00 revenue per international booking? Companies like AMS and SABR generate $4-$15 per booking for the same flights.

Here's why that's a positive feature. Airlines are low-margin businesses. Over time, they're going to find ways to bypass the crazy-high costs of AMS and SABR services. That's the danger when you make a killing relative to your customer's total margin. In essence, Travelsky's lower relative revenue per booking is a competitive advantage because their customers won't feel the need to remove them from their profit margin equation. To the airlines, Travelsky is a small price to pay for every essential need to book, track and manage flights.

Remove the higher revenues that AMS and SABR capture and Travelsky is the better business. They sport higher gross margins over the last ten years and generate higher EBITDA margins through the cycle. Check out the Gross Margin chart below. Travelsky averages around 62.3% GM while AMS/SABR do 47% and 33.2% respectively.



Going further down the income statement, we find Travelsky with superior EBITDA margin across a full 10YR cycle. Travelsky hovers around 40% while AMS/SABR do low 30% (see below):



We know Travelsky is a better business than AMS and SABR. Lucky for us, Mr. Market isn't pricing it like that. There's plenty of reasons why Mr. Market would offer Travelsky at a discount which we'll get to later. Next let's focus on the company's valuation and estimating the next 3-5 years of operations.

Valuation: Double-Digit Growth For Cheap w/ Dividend

As we mentioned earlier, Travelsky's revenues and profits should follow the Chinese passenger growth curve (mid-double-digits). Our 5YR DCF model assumes the following:

- 12% average revenue growth
- 59% average gross margin
- 28% average EBIT margin
- 35% average EBITDA margin
- 10% discount rate
- 15x EV/EBITDA exit multiple

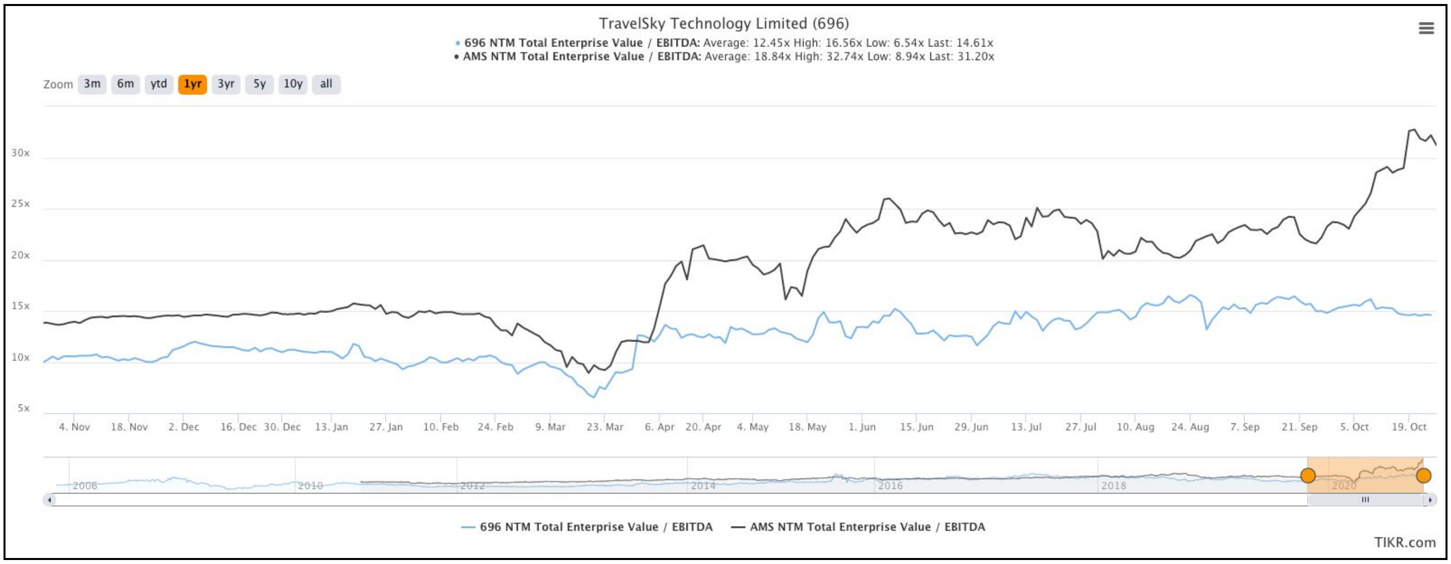
This gave us the following figures (in CNY):

- 12.8B in revenues
- 4.48B in operating income
- 5.38B in EBITDA
- 2.9B in Free Cash Flow

Applying our 15x EBITDA multiple on 2024 EBITDA gets us close to $23/share in shareholder value (near 50% upside). Said another way, the business trades at <10x our estimate of 2022 EBITDA. That's a 10% EBITDA yield at current prices. Plus you get a dividend on top of that.

While a 10% return is above the S&P average yield, we'd love to see lower prices. We'll be eager to buy on lower prices that give us a 15-20% forward yield on operating cash flow. That said, we aren't against a starter position at these prices.

The company is cheap compared to AMS. Check out the below graph of the two companies' EV/EBITDA ratios:



That's a huge gap. Of course, there's reasons Mr. Market values one higher than the other. But as we'll see, its more about the non-business risks than pure fundamentals.

Risks: China, China, and China

The largest risk for US investors is China and the Chinese government. We outlined that an SOE in Travelsky's case is a good thing. But that still won't dampen the sting of investing in a Chinese state-run company. There's also the major risk of sustained travel restrictions from COVID-19 (or another potential virus). Since Travelsky is a call-option on passenger volumes, when volumes drop to zero, so do Travelsky's revenues.

The other large risk is the chance that China allows another competitor in the aviation IT space. This would chew into Travelsky's 40% EBITDA margins and reduce profitability. It might also cause its existing shareholder base of domestic airlines to sell their shares.

Another more nuanced risk I see with Travelsky is their accounts receivable. It's gobbled much of their operating cushion as airlines defer payments. You see this in their Average Cash Conversion (ACC), which ballooned from 129 days in 2016 to 239 days in 2019. This means the company has to hold more cash to make up for the delay in payments received. A continuation of this trend in the wrong direction would sign major red flags.

Finally, corporate governance is another risk. We've seen a few issues in the past (2008) where the company booted the entire board of directors for violating Hong Kong's listing rules. These errors were due to failure to disclose related party transactions with domestic Chinese airlines. We believe these issues are no longer present.

Reading The Tape: Beautiful Downward Trend For Bottom-Fishing

Travelsky's chart is tantalizing for long-term investors. The stock is in a sustained downward channel on the monthly time frame. We're looking to enter on a breakout above the downward channel or on a reversion to the bottom of the channel.

Also, you can check out Travelsky's MOCS report [here](). The company scored a 67. Note that 7 of those points detracted were from country and currency risk. If this was a US-based company, Travelsky scores a 74.

