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Holland Views: What to buy – Ryanair, EasyJet, Ashtead, JDW, Booking¹

The ‘Perfect’ Storm + Peak Fear

“you make most of your money in a bear market, you just don’t realise it at the time” – anon

This research piece is in part to help our clients think about what stocks to buy and when, it is also intended to reflect on our bullish stance on the EU low cost carriers (Ryanair and EasyJet). It does however contain many other ideas on other stocks and sectors, so please don’t stop reading yet!

Imagine sitting down with Michael O’Leary for a drink at Christmas 2019. As the conversation rolled on you found yourself discussing the pivotal moment in Ryanair’s history when Ryanair put in the mega order for deeply discounted Boeing planes post 9/11. It seemed obvious segue to ask *“Michael, if you could imagine another scenario where things got really tough for the sector but ultimately – again – worked massively in your advantage what might that look like?”* O’Leary we surmise might have said something along the following lines²:

- *“Well we would need a black swan, a really monumental shock to demand that would expose and wash out all those poorly capitalised competitors of ours*
- *The shock would be global so that the demand hit is global and thus impede the usual geographic capacity arbitrage*
- *And it would be preferable if something happened that was severe enough to not only cause some short term disruption, but also to linger in the memory so that anyone following in competitor footsteps would think twice before setting up a new airline*
- *It needs to be something that is not about airline safety, so that when the event passes all will want to travel fully again*
- *And in a perfect world it would be great if all those guys we buy these new more efficient aircraft from get squeezed so we can get some really great capacity deals*
- *Oh, and while you are at it. Let’s have a collapse in our largest single cost item – fuel”*

[O’Leary’s Perfect Storm](#)

So, this is where we find ourselves today – in what we imagine might be Michael O’Leary’s perfect storm. Indulge us here a little more – maybe we could extend the analogy from the film of the same name. Imagine that you are part of a fishing group of 20 trawlers based in an isolated fishing area. You have the best, biggest, safest boat and one day a truly enormous, once in 50 year storm comes through. One that is big enough to wreck all of your competitor boats and leave just you and one or two others with sea-strong vessels intact. For months and years after this period the fishing will be easy and plentiful due to less competition. However, as you tossed and turned in a force 9 gale for a week how did it feel at that time? The honest answer would have to be “truly awful”.

¹ Share Prices (respectively) €10.70, 872p, 1751p, 1062p, US\$1442

² This is obviously a fictional account from our imaginations and do not want to diminish, belittle or ignore the awful human suffering and tragedy ongoing with this virus globally. That said, our job is economic forecasters and business valuers and such exercises help frame events for us and readers.

We surmise that today's confluence of events (Covid-19 + oil price collapse + poor policy response) are the airline industries (and indeed more than a few others') perfect storm.

When we are assessing the opportunities in front of us today, we can say that it is 'most likely' that surviving industry players who were positioned appropriately to survive such an event will make some super normal profits once it is over. However, that does not mean things do not feel truly awful now and that day by day the news coming out of such companies and industries is not going to get worse.

Are we at peak fear? – Sentiment reflections

There is an old saying that if your neighbour loses his job that is a 'recession', if you lose yours it is a 'depression'. This mentality we think has been prevalent as this crisis has spread. Simply put, too few have taken it seriously enough until it is outside their door. As we have been studying this virus for >6 weeks (see Twitter link at end of note) now we have noticed a few common traits that we think it fair to observe:

- Western stock markets were slow (really slow) to pay enough attention to this virus even when it had clearly made its way to countries like Italy. (NB: That Monday evening of 24th February, Carnival shares closed in New York at \$36. Today they are \$22). Now, we accept, markets are trying hard to catch up.
- There has been the recession vs. depression mentality visible in Western populations. Too many young Italians were still socialising a week ago and too many Brits believe that a 'stiff upper lip' might solve the problem. Additionally, far too many Americans (one in particular) were totally under estimating the real threat of the whole situation and thus have not prepared suitably for it.
- Those countries that have stopped the virus spreading best are those that were the most draconian in the measures they enacted (huge testing/use of red/green apps/city lockdowns). Western countries had a chance to learn from these experiences but rather than do so some have instead presented these as the acts of totalitarian regimes with an alternative agenda!

Maybe SARS and MERS viruses and the fact they did not spread so widely play a part here. In the West's eyes they were the boy that cried wolf twice? Now we open our door and Mr Wolf is standing right there.

The tide is turning

We would suggest some Western politicians were very much like Mr Market, slow to take the issue seriously enough and now trying to catch up fast.

As country by country in Europe the penny drops a new mentality kicks in. i.e. those that were telling all a few weeks ago this will not be a big deal will soon shout from the roof tops about how it is affecting them, without any irony. (See CNBC anchors for this full 180-degree view change in only 3 weeks).

Sadly, it is exactly this too relaxed Western mentality that has perhaps helped this virus spread. Time and time again the WHO team who visited China and South Korea have praised the response they saw. Seemingly too many in the West are too busy criticising to take the important lessons they could from such early responder experiences. Even as we type the US President is making unplanned actions designed to point blame at other countries rather than focusing on the real threat and preparing, as the US should have done weeks ago.

Peak fear?

In almost all scenarios we come across as investors, we should focus on the intrinsic value offered to us in a share and act to buy it if we think we are being offered a bargain price against that value. However as is the case in a prolonged bear market, investors only get so many cash bullets to fire so they do not want to waste them. This bear market/correction might not end up being prolonged but it is starting to offer us once in a generation pricing of some shares that normally only long downturns come with. So, whilst timing is clearly difficult it is worth us pausing before buying the first cheap stock we see.

Maybe in the UK we sit in an advantageous position as investors as we have been able to look both East and West. Whilst it was hard to envisage the extent of what scale of impact the virus might bring from Asia to Europe, we can now more clearly experience the pain closer to home and see that:

1. The now high likelihood of further closures of many EU national economies as we have seen in Italy
2. The real change of attitudes all around us in the wider population as views change from cynical of the virus' importance to panic about how it will affect daily lives

In the same way that the US is behind Europe in the spread of virus cases it is perhaps also behind in both the policy response (UK having gone first, courtesy of the budget). Also, in the changing sentiment of its population which is perhaps still lagging behind that currently being experienced in Italy and soon likely wider Europe.

Looking for the whites of the eyes

For analysts that mostly look to find undervalued great companies this is all very crystal ball gazing stuff. When trying to decide when you buy the businesses you have identified as already mispriced vs. longer term intrinsic values a great time is likely to be when the markets, they operate in have just been engulfed in a tidal wave. 'Peak Fear' if you like.

Earlier this week we wrote on the value being offered in **Jardine Strategic**. In doing so we suggested its value was in a *relatively* steady state as the tidal wave of Hong Kong protests and Covid-19 was at least past its peak. Events in Europe and US are progressing at speed suggesting that the moment of peak fear is perhaps near. However, whilst poor leadership and inadequate policy responses (to the virus and its threat) in some countries may have consequences, Mr Market is reacting to these too.

Additionally, each of us as investor's will seemingly quite soon be forced to confront fear in our daily lives that comes from worrying about our parents/grandparents or even our own health. As such it is highly likely that we will bring some of that fear into our work decisions. That will be as true in New York as it is in Milan or London and we should be mindful of this tendency as it can lead us to make poor decisions.

What we are looking to buy

Each portfolio manager amongst us will have a list of pet shares they are looking to buy. Our list is getting longer by the day but for now we will include **Ryanair**, **EasyJet**, **JD Weatherspoon**, **Booking.com** and **Ashtead**. Some of these we have written on extensively, others we have not had the chance to do so yet, nor might we get chance before the optimum moment for purchase arrives. However, each of these companies:

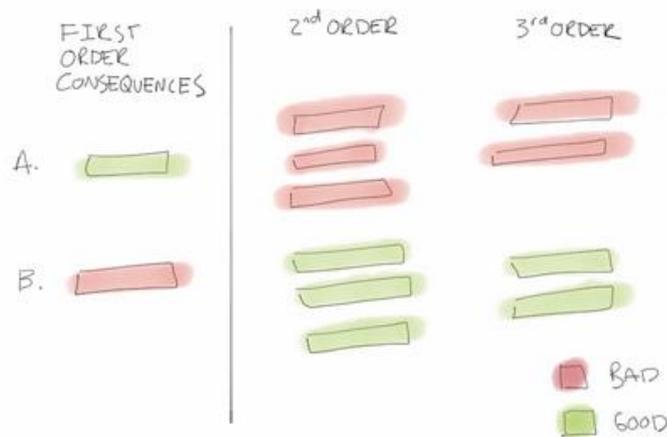
- We feel we know either well or very well
- We have spent a good amount of time studying their past compounding and modelling their most likely future

- We think each most likely offers investor's excellent long-term IRRs (c.20% or more) if purchased near today's share prices

[First and Second order thinking](#)

This is not really a time for naval gazing but we think it is right to remind ourselves of why some business outcomes might be more powerful than others.

Fig.1: A banquet of consequences!



Source: Farnam St Blog (no relation!)

Returning to our thinking on airlines, the damage currently being inflicted on the global airline sector is consistent with that of a first order negative effects. For those airlines that have the resilience to survive they are surely examples of exactly what we outline above, i.e. where a negative first order effect is then followed by a positive second or third order one. **Ryanair**, **SouthWest** and most likely **EasyJet**, **IAG** and **Delta** will be surviving entities in this (soon to be consolidated) sector.

We think the travel, leisure and related sectors have within it some wonderful investment franchises that we expect will compound their intrinsic value per share at high rates for many years into the future. This is in part due to growth that will one day (hopefully soon) return, but also due to the likely strengthened market positions these businesses will then have. Investor IRR's on the equity of those companies purchased around this time we think will be excellent (>20%pa). Our best compounding ideas in this area would be **Ryanair** and **Booking.com**. But we also have great enthusiasm for the other airlines mentioned. Whether yesterday, today or tomorrow represents the peak fear of these companies we cannot tell, but we feel we are much closer to it today than we were only a week ago.

[Modelling Ryanair for some amazing prospective IRRs](#)

For Ryanair watchers we attach a copy of our long-standing model for it. When we started using it we took the shortcut to look at what 2022 or 2024 profitability might look like without realising how helpful it might be to not try to forecast the periods in between! During the three years we have used this model fares have generally trended lower as new capacity additions were filled and fuel costs have been volatile.

Today we assess the likelihood of the stronger fare period in 2022 or 2024 as just as likely (if not more so) than in all our previous studies. The tabs in the model show two scenarios, both have oil assumed to cost \$50 a barrel as a constant (our past work always assumed it at \$80). The first tab assumes fares in 2022 average €40 (up from €37 currently). The second assumes fares at €45.

We remind readers that these figures are way, way, below what our discussion with Michael O'Leary suggested to us as the likely end pricing environment for a consolidated industry. The prospective IRRs that these modest assumptions throw out are pretty startling (30-40%pa) when the starting share price is €10-€11.

Missed second order thinking

For all the degree of caution we entered recent weeks with in relation to how the virus might affect sectors like travel and leisure we were completely blindsided by another second order effect. That being the knock-on effect that has occurred to the banking and financial industry valuations as a result of the equity market discounting lower for longer interest rates. Our past positivity in this sector has focused around the very strongest franchises that we think have been undervalued by Mr Market. If you have not listened to us on this sector up to now, then 'well done' for today RBS, Lloyds and Wells Fargo trade in most cases at significant discounts to their tangible book values. To state that we think they are cheap is obvious, but also suggests we do not see how hard making money in this sector at such low interest rates will be. We do concede this seemingly new fact of life and realise that a future that looks somewhat Japanese in interest rates and banking profitability is indeed possible.

That said *maybe* the policy responses we are seeing in countries like the UK will lead bond markets to change their thinking. Also, we think those either invested here or tempted to be should start to ask themselves other questions about these company's business models. Today a great deal of us bank for free. Might that need to change if the largest banks in our country are discounting making ROTE of c.5-7% even from c.30% market share positions? Similarly, the share price of Charles Schwab discounts a similar scenario. With so few credible competitors left (we note the multiple Robin Hood system crashes this week) might it not be credible to bring in slightly greater custody fees charged to clients? Are these ideas clutching at straws? Short term it feels that way. Longer term if huge numbers of people (current account holders or investors) are getting truly wonderful deals from these super scale businesses maybe they could be charged just a little for the privilege.

Arbitrage opportunities + spokes in the flywheel

In a recent piece on Berkshire highlighting its value we noted the arbitrage opportunity that is presented to some companies in a world of super low interest rates. (See link below to Berkshire raising 5 year money at 0%!). These need to be businesses with end markets that are largely stable in their cash flow generation and/or have strong asset backing, with a strong market positions also. This is where the availability of credit and its prudent use can make the difference between low-ish ROICs (7-12%) and higher ROTE (15-30%) returns. A company we feel strongly is in a great position to benefit from this is J D Wetherspoons. Right now, Mr Market is digesting the fact that very very few people will be going to its pubs in the next few weeks but the long-term dominance of its industry position that we have written about many times remains intact and deeply attractive we suggest (model available on request).

<https://www.sec.gov/Archives/edgar/data/1067983/000119312520064645/d853116d424b5.htm>

Another company we have been looking at in detail in 2020 is Ashtead. We found a very similar compounding model in its business also, where it is using a number of levers to both consolidate its industry and profit from its continuing growth using its scale cleverly to do so. What Ashtead also does like Wetherspoon is use debt prudently to enable a faster rate of growth in compounding to be achieved. With the shares down c.30% since January they look attractive to us also.

The new 'New Deal'

When deciding to buy into such companies however we need to be mindful of not just short-term trading hits, but also how their business models are affected by changing events. Indeed, our whole attraction to flywheel businesses goes slightly into reverse when an event like this occurs. E.g. Why does JDW make a good return on Tangible Equity selling beer at a fraction of the price that others do? The answer is because it attracts high volumes of people. Why does Ashtead have an advantage over its peers? Largely due to the scale of its depot and fleet network offering the good throughput these depots get. For a period of time we are likely to see such operational gearing in such companies work in reverse. Additional to which whilst these companies do not have levels of debts that we would assess as high in almost all outcomes, they do still have leverage. That in JDW's case its debt has a longer-term maturity and has now been fixed at low rates we find very reassuring. Other investors may see it differently however, when the warnings on customer throughput surely come. We need to be ready to act to buy such **wonderful companies at wonderful prices** assuming we have judged them fit for survivable in all market scenarios.

NB. As we write today the UK market enjoys another rout but one small cap is resilient, **VP Plc**, one of Ashtead's UK peers. Likely it is responding to yesterday's enormous new infrastructure spending announced by Government. We remain of the view that these types of policies were always coming from this UK Government, but maybe they just got bigger and more urgent. As for the US policy response, well we would expect something similarly large that takes advantage of such uber low interest rates to boost infrastructure spending. With companies like Ashtead marketed down so aggressively it could soon be a wonderful opportunity to buy them.

The good thing about these arbitrage ideas rather than the banking type ones is that they just need a return to some semblance of order, they do not need higher interest rates or changes in business models. In closing we will share with you a comment an older investment strategist shared with us years ago in a similar moment of market turmoil.

"markets stop panicking when policy makers start panicking". Anon

Were that adage to be true it would suggest there is hope that at least in investment circles things might be reaching a nadir.

Good luck – keep well.

Andrew & Mark

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Andrew Hollingworth @andrewhollingw · Feb 13

Harvard expert: Coronavirus: 'gathering steam' - His suggestion of what happens next is far more realistic than western mainstream pressA Black Swan in plain sight?

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