



Holland Views: Ryanair/EasyJet, €15.5/775p, MCap: €17.4bn/£3.5bn;

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## A Matter of Trust

*“The test of a first-rate intelligence is the ability to hold two opposed ideas in mind at the same time and still retain the ability to function” – F Scott Fitzgerald*

That the low-cost airlines of Europe are ultimate beneficiaries of a post-Covid world is something we have believed all through 2020. The recent share price performance of Ryanair and Wizz suggest that Mr Market now agrees with this view. Both are in a strong position to reduce their unit cost bases further while bloated competitors accept state aid and the handcuff conditions that accompany them. Hopefully we expressed these views clearly during the year.

Now we would like to add a new idea; this being that ‘trust’ as much as low costs will play an important role in the recovery of the airline and holiday sector.

### Unprecedented pent up demand

We will not write at length on this issue only to state again that we think the scale of pent up demand for leisure travel post a Covid recovery we believe will be simply enormous. In a recent piece on Ryanair we noted that this could lead to a ‘feast’ following the recent ‘famine’, i.e. Travel and airline companies could potentially make supernormal profits were a portion of this massive demand to accompany maybe a slight shortage of supply. The latter possibly occurring due to company bankruptcies or lack of available pilot flying hours or ATOL licenses etc. In the summer when writing about the Spanish airport operator AENA we talked about ‘the time to buy a road toll was when no one was on it’. Today we ask:

*“when travel demand does recover which companies will it benefit most?”*

### **A Matter of Trust....**

The reason we have used the F Scott Fitzgerald quote above is that we think there are two types of attractive travel companies right now and they are not mutually exclusive. The first being the lowest cost producers that we always seek out in our work across sectors. This leads us to Ryan (and we accept also Wizz). All of our recent work shows their cost leadership position only being strengthened further. However, those that have followed our work on this sector will know that our work on EasyJet was subsequent and adjacent to our Ryan work. We noted there was room for both companies to operate in this low-cost market. The second type of company that we see as attractive right now are those that are trusted by their stakeholders (customers, suppliers and regulators).

### A story of travel past...

In 2018 your author took a number of flights. He is a frugal individual, so keen to save money where he can. A family holiday to Majorca was booked with friends *“the cheapest flights are coming up with a company called Air Europa, Andrew, what do you think?”* I checked them out for a whole five minutes and we booked them. Later that year I had to go to New York for business. Something I dread, due to its expense. I flew with Norwegian from Gatwick. Were in 2021, I to be making either of those trips again am I likely to pick either of those airlines? No, I will pick a more reputable alternative.

[... and future](#)

And what about all our travel plans for 2021-2023. We will all be looking forward to our holidays. The first thing we will do is book with a company that we know has not gone bust (so that rules out STA and Thomas Cook). We are likely to want to avoid those that have been in the news as rumoured to be ‘in trouble’ or ‘needing help’ (Virgin and Norwegian). Next, we are likely to use brands that we know and trust where maybe we have already had a good relationship before. As much as our friend Michael O’Leary might squeal at the next point that does not put him at the front of the queue! We will also want to use a company that if something goes wrong, will look after our family. This all points to incremental demand for trusted brands like BA/EasyJet and Jet2 in the UK.

Fig.1: References to Customer trust in Annual Reports

	<b><u>EasyJet</u></b>	<b><u>Ryanair</u></b>	<b><u>Jet2</u></b>
References to “Customer Trust”	<b>5</b>	<b>0</b>	<b>13</b>
Mentioned in Risk Factor Section?	<b>Yes</b>	<b>No</b>	<b>Yes</b>
	<i>“We believe that in times of uncertainty customers look to brands they can trust and which offer them the best value”.</i>		<i>“we relish the trust our customers place in us to give them a fantastic holiday experience”</i>

Source: Company Annual Reports

[Trust and Travel](#)

Much of travel is sold on romance. The wonderful time you and your family will have on that beach in Spain, or the luxurious relaxation you and your wife will enjoy on that city break.

After that comes the cost. But underlying it all is trust. Will it all work out OK? Web photos of apartments and reliable low-cost flights have meant we have taken that trust component for granted in recent years. This was what we used to pay package holiday companies for and indeed what some people still do pay them for: to ensure a lack of hassle or fixing of the cost. Covid we think has thrown the trust cards up in the air as far as travellers are concerned. At least for a while. The desire to travel/get out of the house and live will be an enormous driver of demand post covid. However, the best low risk way to do it will be unclear. With that in mind we ask a few rhetorical questions about your leisure travel plans in the next few years:

- Will you trust a new company, say one you have not used much before?
- Will you trust a company that has had bad press about insolvency of treatment of customers over the Covid period?
- Will you trust to fly from new airports or the one you know?
- Will you trust paying for a villa and flight separately or might you want them all packaged in case something goes wrong?

Clearly, we do not know exactly in what scale and where leisure/holiday demand is going to resurface when it recovers. What we do know is that it will not be in the same place as it was before as some of those suppliers no longer exist. What interests us is that Mr Market’s interpretation of this recovery is that it is skewed heavily towards Wizz and Ryanair holding all the aces. Our work on these lowest cost providers agrees that they have some of the aces but not all of them. In terms of share of customer mind and trust, companies like EasyJet, BA(IAG) and Jet2 we think, look very well positioned in the customers’ eyes. Arguably better positioned than Ryanair on the Trust issue for holidays.

### [A study of cash \(and voucher\) refunds](#)

Like other investors this year we have been closely focused on the free-cashflow burn of the airlines that we look at. Perhaps we have been a little too focused...?

That Ryanair has shown itself to be a brilliant low-cost base business that has managed not to produce sizable losses or significant cash outflows during this Covid period we have been impressed by. Are its customers as impressed...? The influential Which? magazine thinks possibly not<sup>1</sup>. Clients will find attached a study we have done ourselves of Ryan, Jet2 and EasyJet cashflows over the last 6-month period. Whilst there are many moving parts for each, a couple of small points and one very large one stand out. First the smaller ones:

- EasyJet takes its aircraft depreciation on a straight line basis (Ryan takes it on a usage basis). EasyJet also undertook a little kitchen-sink provisioning in H2. As such EasyJet's P/L losses look worse in the period, all other things being equal.
- Jet2 (as it always does) separates cash between customer cash and its company owned cash.

### **Now the elephant in the room – cash refunds or Ryanair's lack of them**

*“In July, we analysed 12,000 complaints about airline refunds and found customers were owed £5.6 million in refunds. That is just the tip of the iceberg. It was also clear that while some airlines, such as Jet2, had done a good job on refunds, several were clearly delaying or refusing refunds. In total, Ryanair customers were responsible for 44% of all the complaints received. EasyJet was the second-most complained about airline, with 14% of all complaints coming from its customers.” – Which? Statement<sup>2</sup>, July 2020*

We are fans of Michael O'Leary, but he is prone to conflict and hyperbole. Recently he gave an analyst a very hard time when she said Ryan were not giving cash refunds. A recent BBC interviewer suffered a similar fate<sup>3</sup>. We will just present the facts as we see them from the accounts. The first obvious fact we point out is that 'paying' out a voucher refund is not the same as paying out cash refund. Ryan looks to have given many refunds of flights to customers but done so in the form of providing these customers with Ryanair vouchers as opposed to hard cash. Ryanair had circa €1.5bn of such vouchers on its balance sheet as of March 2020. Our work suggests, customer vouchers still amount to an accrued liability of c.€1.3bn today. In that context, the following excerpt from Ryanair's Risk Statement is revealing.

*“There is also a risk that some authorities may find Ryanair's decision to encourage passengers to accept travel voucher in lieu of a refund to amount to a breach of the information obligations contained in the Regulation and/or a misleading commercial practice.” – Ryanair FY20 annual report Risk Statement p.73 (emphasis ours)*

By sharp contrast in the last 6 months EasyJet and Jet2, we estimate, have given hard CASH customer refunds of £863m and £409m respectively.

<sup>1</sup> <https://www.which.co.uk/news/2020/11/ryanair-claim-that-all-requests-for-cash-refunds-have-been-paid-is-untrue/>

<sup>2</sup> <https://www.which.co.uk/news/2020/07/civil-aviation-authority-fails-to-take-action-over-airline-refunds/>

<sup>3</sup> Michael O'Leary on The BBC <https://www.bbc.com/news/business-54776678>

### Follow the Cash

We have not got to these conclusions by reading company press releases or the like but by studying the cash in/out flow of each group's cashflow statement. Needless to say, the greater the cash refunds paid-out, the worse said company's cashflow statements look. In turn the greater financial peril a company it *might* be judged to be in by analysts (ourselves included) were they too fixated on just that cash burn number for an uncertain period.

Conversely how might such a company's customers feel **and importantly how would we know** (answer - they would feel fairly treated, but **we would only know when/if they came back to the company in the future with their business**). The corollary to this cashflow issue is that when these happy customers re-book such monies will return boosting cashflows for Jet2 and EasyJet. In Ryanair's case upon the eventual use of vouchers for flights will not result in a cash inflow.

Our point here is not to criticise Ryan for conserving cash in a crisis at the expense of its customers. Its ultra-low-cost model suggest it was likely to do nothing other. Instead it is to illustrate that customer trust might surely flow back more freely to those brands they feel better looked after by who they can maybe trust more? Partially so in the family holiday market where so much is at stake if something goes wrong as opposed to just on point to point flights

### Regulator and supplier trust

We have known Jet2 (formerly Dart Group) for many years. We learned a great deal from it as the requirements made by both regulators (CAA) and credit providers (merchant acquirers) on travel companies like Jet2. Simply put a credit card company and the bank that sit behind it needs to be sure that the travel company is going to be able to deliver the £2,000 holiday before it is prepared to release the client funds for the transaction. Said travel company needs to show a balance sheet strength commensurate with that commitment. That may sound easy enough. In fact, it is anything but, especially if you are wanting to grow at a fast rate as Jet2 has done and many might like to in this recovery environment. This is the main reason Dart Group sat on such a prudently financed balance sheet during its strong growth years.

Now consider the role of the regulator. Travel companies have ATOL protection meaning the CAA gets everyone home if you are stranded (as I was when Monarch went bust in 2017). The CAA keeps a close eye on who has what capital and who is selling what holidays knowing they are one who picks up the pieces. Investors should be thinking of the CAA today as they would the banking regulator post 2008/9 "*no, you can't do that,*" "*no you can't sell that holiday,*" "*no you can't have an ATOL license*". They went into Covid a bit like the banking regulator went into the Credit Crunch, thinking their systems were fail-safe. Now they are far less sure. They will want to make sure the operators that carry the ATOL badge in 2021 and beyond are well capitalised enough to do so. Another point for investors to be aware of is that the CAA look at Company capital and past expertise and effectively decide how many holidays you can sell in a coming year.

All of this is, in addition to suppliers that want to get paid by an operator that will not fail, points in the same direction. That direction is huge consolidation, but not by deals or M&A, but just by suppliers, regulators and customers all wanting holidays and flights via the same few big **Trusted** companies.

### A few other points re ATOL and regulators

- ATOL is mainly a *package holiday* financial protection scheme. It is not intended and doesn't really apply to flight-only bookings i.e. its relevant for Jet2, and EasyJet Holidays but far less relevant for Ryanair's or Easyjet's main flight only business.
- ATOL Licenses are awarded for specific passenger capacities by the CAA.
  - CAA confirmed that of the 1,261 ATOL licensees that expired in Sept 2020, only 995 were renewed.
- As of May 2020, here is the top ATOL licenses by passengers in the UK for 2020 travel:
  - TUI UK – 5.55m,
  - Jet2Holidays – 4.8m,
  - On the Beach Travel – 1.2m,
  - We Love Holidays – 1.09m,
  - British Airways Holidays – 1.01m,
  - Expedia Group – 874,208,
  - EasyJet Airline Company – 793,874, EasyJet Holidays 726,000,
  - BravoNext (lastminute.com) – 640,555,
  - Travel Republic – 555,060
- We note that Jet2holiday's ATOL licenses of 4.8m passengers should be considered in the context of 3.7m Jet2 package holiday customers in 2019. That was a c.27% growth projection.

### Trust = Flight to Quality

What the future of business travel looks like we are unsure of. The future of leisure travel we think may normalise much quicker than many of us today imagine. Whilst it might feel odd to want to cram into a plane or airport today, there will be millions of people writing bucket lists and planning to live for today rather than work so hard. That there will be plenty of plane capacity we accept, for the world is awash with them, a bit like it is awash with video content. But as is the case in other industries only a few network operators of scale in each industry win most of the spoils. Ryan's and Wizz' places are secure as the super low-cost point to point travel providers. But others have a role to play too. Jet2 is trusted by many in the UK to provide the whole package holiday for a low hassle and good price. Many more will now come to it for this service as other competitors have failed.

EasyJet arguably sits between these three players. It provides the point to point network also, but does so in far more sought-after (rare + central) locations. The result of which is that it has a catchment area and thus client base in northern Europe (London/France/Switzerland). It also has 'trust' with large number of the wealthy populations that live near these airports and are its customers. We suspect that when these people travel again, they will do with EasyJet for it has not broken that customer trust, nor have competitors displaced it.

The other interesting part of EasyJet's future is its holiday business. This was a smaller but interesting development for the group last year, but one we think with significant potential for growth in its margins.

The fact that this was an extension of the airline that Ryanair was not able to make in any scale suggests it is hard to do. Again, we think the role of trust was and will be critical here<sup>4</sup>. In 2020 the damage inflicted on other tour operators means that many hotels in Europe are keener than ever to have good new partners who can sell rooms for them. Other than Booking.com. When hotels are looking for a new partner who has massive scale (100m passengers) but also access to wealthy customers (rather than just bargain-basement hunters) Easyjet looks the perfect Pan European candidate.

## Roughly right, or exactly wrong

We have long term models for both EasyJet and Ryanair which we are happy to share with clients that request them. They are not attached for the reasons expressed in the sub-heading above. Trying to forecast these businesses in a period such as this is tantamount to doing a jigsaw puzzle in a hurricane. We have focused on these businesses ability to survive in cash terms in recent months. Prior to Covid and now into the future we are focusing again on their compounding ability to growth as low (or lowest) cost providers of much valued travel services.

We would remind readers of a crucial point that differentiated our work on these companies from other analysts in the months and years up to Covid which remain valid today. Unlike the USA we believe strongly that the starting yields for short haul (fares) in Europe are artificially depressed. This is due to the aggressive discounting that Ryan has done up to this point to win market share. Longer term yields will be a little higher than 2019's, but that 'little' will have a big effect on profits of the teams that are still on the field at the time the final whistle blows! The greatest driver of our long term firmer yield environment was industry consolidation and Covid has brought that about at breath-taking speed.

There may have been a bump in the road, but we stick by the thesis of our end game. Fewer bigger players, and a win-win for all. Cheap fares. Lower than ever unit costs and great return on capital for the few companies that offer super low fares or the right balance of cost and trust

We see significant upside in both shares

### Buy EasyJet + Ryanair

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<sup>4</sup> <https://www.easyjet.com/en/holidays/info/protection-promise>

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