HollAnd Advisors

Holland Views: Ryanair – Price: €11.5; Mcap: €13bn

End Game

We recently sat down on a couple of occasions with Michael O'Leary (MOL). As ever we learnt a lot! As this is research note circa number 15 on Ryanair we will try not to repeat ourselves too much. Below is a short reminder of our long-standing thesis and how it is evolving. The end-game for EU short haul is getting **a lot** closer. It will show Ryanair as a highly profitable market-leader.

The short version of our long-standing bullish Ryanair view is perhaps easiest split into two parts:

1. We love lowest unit cost businesses lead by aligned owner managers. Particularity when they are the lone low unit cost player in a wider less competitive sector. The result is plenty of growth to target. Also, the sector analysts and investors often don't grasp the true power of the Scale Economy Shared model such businesses are employing.
2. Part one (above) of our thesis is admittedly understood by more than a few investors. Part two however, we think is where the real money can be made. It makes an important assumption (well informed we think). This being that the 2019 pre-Covid average price for flying short haul in Europe is not the appropriate base case for the future. We expect a higher future fare for Ryan's flights a few years out and this will a have a huge positive effect on its profitability*.

*Any readers of Saturdays FT interview with O'Leary will have heard him talk about fares likely to rise from €40 to more like €50-€60. We consider such an interview wonderful 'covering-fire' and will explain why later. For now, we will just point out that MOL was privately talking about future €50-60 fares long before staff shortages or $120 oil costs were 'a thing'!!

Guessing future fares

Your author was an airline analyst for a number of years. He learnt that in a sector with so many stats (ASK/RPK/Fuel/Load Factors) one trumped them all. This was fare prices (Yield). The trouble is, it is hard to forecast…Or is it? Our assumption of higher fares in Ryanair's end game we have had for a while now. Many investors might see this as little more than a 'guess' We think it is anything but and have a high confidence in its likelihood. We explain why below, but first a word on low-cost operators from WB:

> *"I have always been attracted to the low-cost operator in any business and, when you can find a combination of (i) an extremely large business, (ii) a more or less homogenous product, and (iii) a very large gap in operating costs between the low cost operator and all of the other companies in the industry, you have a really attractive investment situation. That situation prevailed twenty five years ago when I first became interested in the company, and it still prevails."* – **Warren Buffett (letter to Geico), 1976**

Other's opinion that fares in the future are hard to estimate makes an implied assumption. This being that today's fares are a function of unpredictable competitor behaviour. But what if recent year's fares were the result of one ultra-low cost huge operator choosing to keep them depressed. If that operator stopped discounting so heavily might fares not be likely to rise (over and above that needed for cost inflation)?

Time with Owner Managers

In the last five years we have listened to MOL numerous times in conference calls and group meetings. We are also lucky enough to have had two 1-1 meetings with him. These were crucial as they enabled us to focus on a few small areas of the business outlook that we wanted clarification on. On both occasions we chose to focus on the 'endgame' as we call it.

We meet many owner managers and each is different. It is crucial as investors we spend enough time considering them as individuals, assessing their capabilities and skills. To expect them to fit into your preconceived mould of what a great CEO looks, sounds and acts like is a fatal mistake. The colourful language, flair and direct nature of MOL in the past has upset many investors and commentators we think. Many misjudge him.

The more we meet MOL the more impressed we are. His clarity of thinking is super-impressive and the only other person we can think of as a peer in Europe would be Lord Wolfson. The ability to have a very long-term view of where your industry is headed and thus clearly see your company's role within it, we think is important and rare. But some long-term strategic thinkers can get caught out by short term events. MOL and Lord Wolfson are also very micro in terms of what is happening day to day and what matters and what does not. Finally, and importantly is the full understanding of not just the important business and competitive levers, but the asset allocation ones as well. We will state again, the more we meet MOL the more impressed we are. For context we like to think that as we have refined our investing approach further our hurdle rate gets ever higher when judging management.

Endgame

We wrote a Ryan piece earlier this year called '*The land that time forgot'*. Its title was referencing a period (pre-Covid) when Ryanair used to speak about the EU short haul market endgame. I.e. how fares would more closely resemble those in the US, as a consolidated market. Since first hearing this outlook from MOL we found it compelling. This is because of the huge operational gearing benefit any airline has to higher fares. Most fare recoveries however are short lived, due to the sectors cyclicality. However what MOL was (and still is spelling out if you ask him) is more rational <u>permanent</u> pricing that comes once market share has stabilised post consolidation (i.e. the same as was seen post-sector consolidation in the US).

Here is O'Leary and a colleague in 2012 & 2017

> "*I think over the medium term, our revenue per passenger will rise. I think we're very much in the same situation Southwest was in 10 or 12 years ago where they enjoyed, I think, 12 or 14 years of yield growth"* – **Michael O'Leary, May <u>2012</u>**
>
> *"For now, we see significant opportunities to expand and wish to do so ahead of others that might see that opportunity too. However, we have always believed that one day there will be 5 Airlines in Europe, 3 long haul carriers and 2 low-cost carriers. We are getting closer to that point. <u>When we get to that point fares will be higher</u> <u>but not while this new opportunity exists</u>"* **Ciaran Brannigan – Head of Ryanair revenue management, May 2017**

And here he is last year on the growth opportunity/fare outlook ahead

> *"I don't think certainly in my 30 years in this industry post 9/11, post-Gulf War; there never been a growth opportunity in front of Ryanair such as we have at the moment….*
> *… So I mean, I have never seen in 30 years the amount of growth potential we have over the next four years. We could allocate the 200 new MAX aircraft <u>twice over</u> I think in the next four years.* **Michael O'Leary, May <u>2021</u>**

> *I think it's inevitable that what will really, I think drive fare rises in the next two or three years will be shortage of intra-EU capacity. And there is going to be meaningful shortages over capacity - short-haul EU capacity reductions. And I think a combination of that and probably increased environmental taxation will undoubtedly put upward pressure on airfares and yields. And we will be poised .. to be a significant beneficiary of that as we have roll out lower operating costs and but probably if anything in a less intensely competitive environment and in those markets where we are expanding"*
> **Michael O'Leary, 27th July 2021**

Readers new to this idea should note the above comments and their dates. Higher fares a few years out are nothing new, but at Ryanair they will not just be to pass on cost inflation, whatever MOL says!!

Reflections on our Endgame thesis

MOL is a deeply intelligent man (anyone not agreeing with that statement needs to stop reading now and research him more thoroughly[1]). Such individuals realise there are consequences from what you do, and say. Much of MOL's public persona was once designed to just bring attention to Ryan commitment to low prices. Now it is the broad audience of Boeing, unions, staff and travellers he is talking to. MOL's discussion of the unfolding consolidation of the sector and the likely medium-term effect on fares was something mostly kept for private meetings up to now. That he has now chosen to bring the second part of this discussion out into the open is not by chance:

> *"It's got too cheap for what it is. I find it absurd that every time I fly to Stansted the train journey into central London is more expensive than the airfare"* **– Michael O'Leary, FT, 2nd July 2022**

> *'A combination of high oil prices and environmental charge will push the average fare up from €40 to between €50-€60 over the medium term, he added'* **– Michael O'Leary, FT, 2nd July 2022**

Cover Fire

Whilst he cites cost pressures, he is also observing Ryan's absolute cheapness vs competitors and frankly vs life in general. Cost inflation will see many high unit-cost airlines forced to raise prices, but Ryan is not one. Ryan remains super cost focused and efficient, but the rising tide of higher fares will see its profits potentially boom. In the course of a few weeks 'respected' airlines like EasyJet, BA and TUI have struggled with costs, schedules and reliability, each scoring a daily PR disaster. Meanwhile the once hated upstart, (Ryanair and MOL) has seemingly become a respected spokesman for the industry!

Rather than jumping on competitors' misfortune MOL seems almost sympathetic. What the hell is going on? Some years ago, MOL said "*to hell with Yields*" as his company sought to aggressively take share from weaker players at almost any price. This market share grab lasted for years and was still underway in 2019/20 when Covid came along. **Indeed, this is the main reason why we think pre-Covid yardsticks of fares or profit per passenger are not the correct benchmarks for those looking to assess this company's profitability in the medium term.** MOL's now public discussion of higher future fares we think is notable**.**

[1] Background reading on Michael O'Leary – we suggest https://www.amazon.co.uk/Michael-OLeary-Turbulent-Times-Ryanair-ebook/dp/B07C67S642

We think his referencing of higher cost inflation is cover fire for the post consolidation future rise in fares he has discussed with us on a number of occasions. *"Dear traveller. We are still cheaper than everyone else, but not quite as cheap as we used to be. Still fly with us."*

Many analysts we think are anchored to a profit recovery potential of c.€10 net profit per passenger (Ryan was at c.€11 in 2016-2018). From our discussions with MOL we think €15 net profit per passenger (NPPP) a very achievable target. We even think in certain years this level might be exceeded. We also expect c.25% EBIT margins, i.e., at least matching the group's past peaks. At 225m passengers (i.e. RYA's 2026 target), €10 and €15 NPPP gives net incomes' of €2.25bn and €3.4bn respectively. For a little perspective Ryan's almost debt free Market Cap today is €13bn. It should also be remembered that up to 2019 Ryan had a 70% dividend/SBB payout ratio. Doing so despite growing passenger numbers c.10%pa. The eagle-eyed looking at c.20% ROE's will suggest this is impossible – we assure you it is. The magic comes from negative working op that is c.30% of sales. Customers and suppliers fund much of Ryan's growth – so shareholders don't have to!

We remind readers that pre the Covid period 2019/20 was a part of multiyear period 2013-2019 when Ryanair purposely attacked fare levels in this sector aggressively to drive further market share gains. When questioned during this period Ryan were happy to admit that they were doing this to try and push what they considered uneconomic airlines into collapsing. Targets 1, 2 and 3 on MOL's dartboard were Norwegian, Alitalia and TAP Portugal. This, lower prices for more volume strategy worked (Ryan called this '*fare passive, load factor active'* – i.e., pricing to fill the planes). We called it: *'Shark attack!'* Ryan's pricing strategy was wearing many such companies down, Covid 19 killed them off. The resulting future competitive environment will be very different.

In future, if you are adding less capacity, you do not need to price as aggressively as you once did to gain share. But if your cost base, is still industry leading you can keep offering compelling customer prices. **Another way to think about it might be to say that future Ryanair will still be a Scale Economy Shared business, but one that has just come out the other side of a deep investment phase.**

A word on state aid and second order consequences

Not only did Covid 19 kill off a few airlines that were struggling it also inadvertently hurt others by helping them! The indented section below we wrote in a Ryanair piece in 2020. Arguably the points made then on state aid are just as important today as we now see their consequences:

> What is interesting to note currently is that EU airlines are either radically addressing their cost bases or they are being bailed out. Few are doing both. Why? Because the tacit agreement to protect jobs is the flip side of the €XXbn a bailed-out airline is accepting.
>
> *"So, I think you will see us respond very quickly but I think pricing in a recovery environment would be **much stronger** that we have had historically because so much capacity is being taken it out of the system."* **– Michael O'Leary (emphasis ours) 2020**
>
> This means that whilst some discounting might take place by all airlines to fill seats in the very short term, bail out money received will not (we suggest) be used to subsidise lower fares… Instead, it will be used to pay the inflated wage structures (+ other benefits) of the incumbent flag carriers. Indeed, a look at either our flywheel model or the price positioning of companies like Air France/Lufthansa in the past proves this point.

> They have never slashed fares in the hope to drive greater demand but instead tried to protect monopoly airport positions to shore up premium pricing. Why would bail-out funds designed to avert bankruptcy change that? These are not capitalisations for new growth phases.
>
> The interesting part of the state aid story is the longer-term consequences. Short term, a bailed-out airline (or any company) is expected to protect most jobs, but longer-term government priorities then change. Will countries like France and Germany be happy two years hence to see the carriers they bailed-out run unprofitable routes and keep making sizable losses? No. These state backers assume they are saving such companies for a better future! So as Lufthansa was forced to do last year, they will be pushed to further curtail unprofitable activities and routes. **Source: Holland Views: Ryanair – Second order thinking + Once in a lifetime, May 2020**

It is interesting to reflect of these points today. Also, the ones we made in our piece that talked of the importance of customer trust in this industry. In a commoditised industry **scale and low unit-costs really matter.**

Scale really matters

> *"You can't take on someone with lower costs because they dig deeper than you to lower their prices and still make money, while you're bleeding."* – **Barbara Cassani, former CEO of British Airways in reference to Ryanair's aggressive reaction to British Airways Irish market entry in 2001!**

Post-Covid many airlines have been forced to scale down their route networks, or at the very least stop ambitious expansion plans (easyJet is notable on this). By doing so their unit cost position deteriorates. At the same time a competitor (Ryanair) keeps growing thus reducing their unit-costs further still. Incumbents (we now include easyJet in this list) are in effect entering a doom loop of dis-economy of scale and thus higher relative unit costs. Without cost or service advantages all they have left is location (i.e. control of Charles de Gaulle, Heathrow or Gatwick). But consumers are now paying an enormous premium for such locations and they know it. These are not good business models, just gougers of past loyal customers who have not yet found a better replacement product. Melting icebergs comes to mind.

For those who have not spent the past five years reading our Ryanair analysis we remind you of our favourite statistic. That pre Covid-19 Ryanair's unit prices are/were 21% below easyJet's unit costs. While we need to update this calculation, we know which way it has gone, the gap will have increased!

> Using a crude but consistent measure of yields (total revenue / available-seat-km), **Ryanair's prices are** still -21% below **easyJet's costs** as of 2018. This is a statistic we gave seven years ago and it is still true today. **Source: Holland Views: Ryanair – Tiger Roll, June 2019**

The End of "Shark Attack"

> *"Ryanair is the barrier to entry in this industry. Why would you enter a country as a new airline when we start prices at €10."* **Michael O'Leary May 2022**

MOL made the above comment to us in our recent meeting. We thought it spoke volumes.

EU fares will rise in the short and medium term and do so for some over and above that required just to pass on cost inflation. Those with poor unit-cost positions will make some money. Whether that is more or less than that expected by investors we cannot say.

Post expansion in Portugal, Italy and Scandinavia, Ryanair has few geographies left to conquer and not many competitors left it needs to inflict mortal pain on. As such it is exiting the *Shark Attack* mode we once described. Whilst the US fare environment is an interesting precedent for what might happen now to EU fares, we still think there is one important difference. The US required consolidation and the resulting outbreak of peace between different waring airline groups for domestic fares to stabilise. The structure of the EU is different. Arguably Ryanair alone was responsible for the war/shark attack. So it alone will decide when the hostilities should cease. Rightly MOL has decided that begins when they have the market share they need in the main western geographies (i.e. about now..?).

> *Investors we think currently confuse price war tactics with the long-run likely profitability of a consolidated market. The US precedent shows that consolidation and pricing power go hand in hand. OK, so not this year, but in time. That's the end game. Making competitors too fearful of entering/staying in the market is part of the dominant player's arsenal.* **Source: Holland Views: Ryanair – Tiger Roll, June 2019**

Pre/post-Covid competitor positions

Whilst our view on Ryanair's future has not changed during Covid, a few other things have. Arguably the capital cycle of Ryan forcing competitors to leave was accelerated. Additionally, those that were challenging Ryan in its low-cost model look weaker too, perhaps surprisingly. For a while easyJet to us looked like a low-cost carrier with a good brand and better access to main airports. Now it looks more like an incumbent, with wage inflation, and service problems. Crucially for us the decision to stop growing saw it lose the unit cost advantage that ever-greater scale brings. It then entered the quicksand of yield/slot value maximisation.

Much has been written about Wizz and the difference between it and Ryan (Leasehold vs Freehold aircraft ownership and East vs Western European focus). Whether some of Wizz recent problems are down to mistakes or bad luck is hard to tell (Ukraine and unhedged oil). What is clear however is that when countries like Portugal and Italy opened up as their flag carriers failed it was Ryan that grabbed the available market share, not Wizz. With a similar aircraft expansion rate to Ryan's it has been interesting to see Wizz announce new routes to countries like Saudi Arabia and UAE. Whether this is mission creep or a need to fill aircraft that they seemingly cannot deploy in western/eastern Europe we cannot say. We observe only the relative strength of Ryanair having gained more market share in key western countries is clear. The strength of its competitive position in its target markets over Wizz has clearly grown.

On numerous occasions in the past we have calculated potential IRR's for what returns future ownership of Ryanair shares might result in. Covid put pay to most such projections! Today the shares sit on a c.4x multiple of what we think this dominant low-cost player might earn in net profits c.3-4 years out. That, and its past 70% pay-out ratio likely gives you enough information to construct a sexy IRR should you want it.

Let's sign off with an O'Leary 'charm offensive'

MOL manages to redefine the definition of "*charm offensive*". We recommend a recent Daily Telegraph interview with him. A few (insightful and amusing) extracts from which are below:

> In person he is great company: courteous, entertaining and despite his profound attachment to swearing, clearly intelligent. **Source: The Telegraph, 24th June 2022**
>
> Ryanair is now sitting pretty as one of the more reliable carries in Europe- *(*Telegraph comment not MOL's). **Source: The Telegraph, 24th June 2022**
>
> Whatever you think of his abrasive approach, in this day and age there is something refreshingly un-corporate about O'Leary. **Source: The Telegraph, 24th June 2022**
>
> *"We've never been recession-proof but generally what happens in recessions is people trade down to the lowest-cost provider,"* he says. *"If you look at the companies that do better in a recession, it is the Lidls, Aldis, Ikeas, and we are the Lidl, Aldi, Ikea of the air travel industry. We have lower costs and lower fares than any other airline, and we will do spectacularly well in a recession. "* **Source: Michael O'Leary interview, The Telegraph, 24th June 2022**
>
> *"I frankly don't care about the woke f------ debates. If it helps us reduce our costs and get our plane out on time, we'll sign up for it. "* **Source: Michael O'Leary interview, The Telegraph, 24th June 2022**
>
> Has he met Boris Johnson? *"No, and I've no desire to meet him. He's an idiot of the highest f------ order."* **Source: Michael O'Leary interview, The Telegraph, 24th June 2022**

Those are pretty fair insights as to what a meeting with Michael O'Leary is like. 😃

Buy Ryanair.

With kind regards

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