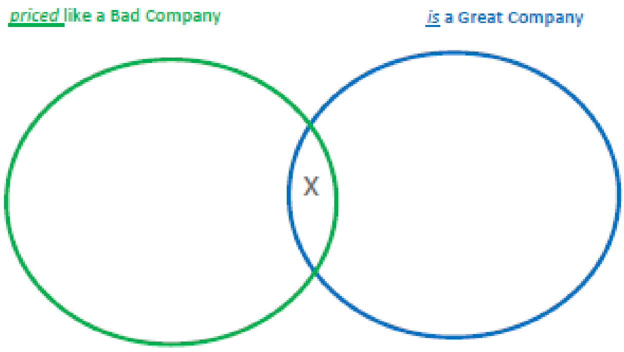
HollAnd
Advisors

Holland Views – *redacted* – Price: €10, Mkt Cap: €12bn – Buy

Tiger Roll[1]

Our proposition is straightforward. We seek to identify Great Businesses that are priced as bad ones. These bargains often crop up in unlikely end markets and it is our experience that investors' pre-conceived ideas of certain industries can inadvertently bias them away from these great companies and thus great investments. We present one such company without initially naming it. To tempt the reader we offer 3-5y investor IRR's of 20-25%.



- It has a 35 year **track record** of exceptional organic growth (20y sales cagr to 2019 +15%) and high returns (20-40% RoNTA). It is a true disruptor in its field.
- It is the **lowest cost operator** by a very wide margin and is the price setter.
- It has 25-35% market share but its low-cost position affords it a clear runway for further growth as the industry consolidates. **We think it can grow volumes >5% cagr**.
- It has the best operating margins in the business. Whilst highly operationally geared, the company has never lost money and thrived in the 2008 and 2009 period.
- It **enjoys negative working capital**, thus has better RoNTA than most investors realise. It has a very strong balance sheet with low debt & consistently pays-out excess capital.
- Its **CEO/owner-manager is one of the best we've seen;** another 'Outsider'. He owns 4% of the equity and has options worth $100m if he can double earnings.
- **Its industry has become (relatively) more rational** and is following the playbook of the US market. In time, this company will realise its currently untapped pricing power.
- It trades on a 4-year low share price, equivalent to c11x P/E. We think its earnings power is possibly twice today's level (as, we suspect, does the CEO!).

A great business, agreed? …yet, it is priced like a poor one. Why?

- Its industry is volatile again. There is some over-capacity by irrational competitors.
- There is a perception that secular cost inflation will kill its low-cost model.
- Above all, investors remain myopically focussed on the near-term flux rather the long-term opportunity of growth and pricing power.

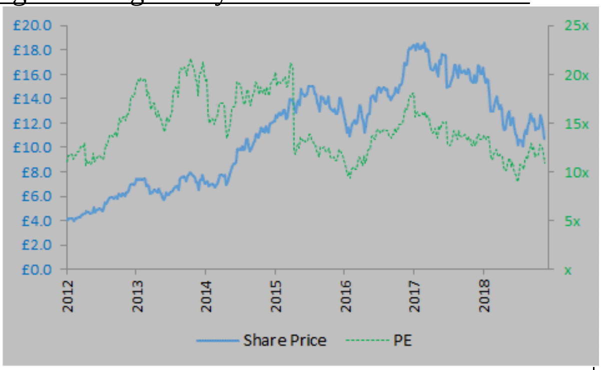
[1] Tiger Roll won back-back Aintree Grand Nationals in 2018/19, and is another racing legend from the CEO's Gigginstown House Stud. Readers of our early work on this company will get the connection.

Enough teasing: the sector is airlines and the company is: **Ryanair**.

Ryanair has long been one of our favourite global businesses and we have advocated owning the shares since 2012 backing up our conviction with much research over the years (Fig.1). It is a business we believe we have gotten to know very well. Its EDLP[2] business model is, we have argued, one of the most defendable and conducive models to growth. It has thrived even in the worst industry and through economic downturns.

In Ryanair, we have a great horse, jockey, a long runway and a low starting multiple.

Fig.1: Riding the Ryanair waves with Holland



- Ryanair - War of Attrition 1012 €4.56
- Ryanair - A growing Cash Cow 1112 E4.83
- Ryanair - Fare dues and operational gearing squared - 0113 - E5.62
- Ryanair - To Hell with Yields - 0913 - E6.02
- Ryanair Sky - Is it different this time - 1113
- Ryanair - The rocky road to Damascus - 0114 - E6.71
- Ryanair -Time to Buy 0716
- Ryanair -Shark Attack - 0617
- Ryanair - An evolving predator 1117 1650p
- Ryanair - An agile super tanker 0518 €16.5
- Ryanair - Watch Fares not Wages 0818 €13.6 £16
- Ryanair - Reach for a bucket 1018 €11.14

Source: Holland Advisors

Can we kill one of our best-loved ideas?

We try to be careful not to fall in love with our longstanding ideas. Charlie Munger suggests we should try to "destroy our best loved ideas"[3]. So, in this spirit, we recently asked our most cynical analyst at Holland (aka 'the professional worrier') to take another look at Ryanair to see if our conviction could be shaken. He failed to break it. This note reflects that fresh look at the business, in effect an update on our 2012 original work (at a price of €4.56), seven years on. We think most bearish arguments on Ryanair are tactical and centre on the continued irrationality of certain airlines. The future we believe could be very different!

In any case, 'events' have been trying to kill the Ryanair model for years:

> *"pick a year, any year and you'll find that there has almost always been a sound macro, political, or industry-specific reason not to invest in Ryanair stock: ATC strikes, terrorism, austerity measures, economic contraction, fuel shocks, low-cost competition from incumbents, low-cost competition from upstarts, foot and mouth disease, the Iraq War, Avian flu, Volcanic ash clouds"* – **US-based investor, David Kim (written before Brexit, the Boeing MAX controversy etc etc!!)**

Context is really important, 'Wood for the Trees' and all that. That's why we wrote the front page without naming the company. What has been really interesting in undertaking this latest work, is the sense of déjà vu we had whilst writing it. Ryanair (and easyJet) watchers in 2019 are fearful of much uncertainty as regards the outlook for fares, competitor capacity, the weakness of the Ryanair competitiveness, its brand, etc. etc. All of those issues were front and centre in 2013 too – another year of much uncertainty (and profit warnings).

For context, Ryanair flew c.80m passengers in 2013 and generated €719m of net income (vs. 139m passengers and €1,025m last year!). Its shares were €6. With hindsight, in 2013 few it seems were watching the big picture of Ryanair's trajectory. We suspect, in 2025, we will view 2019 in the same light.

[2] Every Day Lower Prices, coined by Wal Mart, a pioneer of the lowest-cost, high volume business model

[3] For those who missed it, Munger's unabridged WSJ interview with Jason Zweig from early May is superb: https://www.wsj.com/articles/charlie-munger-unplugged-11556935195

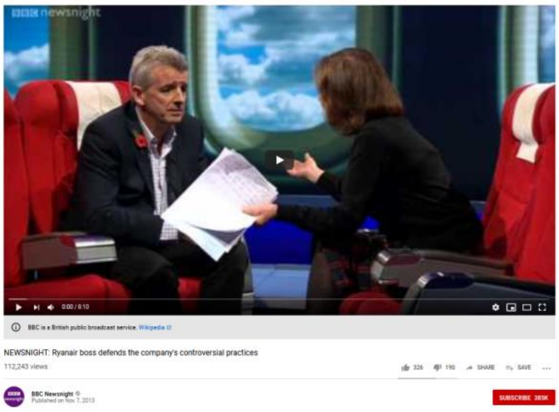
In that context we think it worth comparing two interviews that CEO Michael O'Leary gave, one from back then in 2013 and one from last week. The 2019 interview shows a remarkably similar message from the company against today's backdrop, it being the same as that expressed by Ryanair in 2013 also. Interestingly the recent video being hosted on US TV suggests something else; that US has perhaps a better understanding of the low-cost model and the potential positive effects of industry consolidation.

For what it is worth, we think investors regularly dismiss the power of low-cost models such as Schwab, Wetherspoons etc. often because they are not regular users of the product. Also because sometimes their founders are thick-skinned maverick-types who attract (even relish) media attention of any sort. This can be valuable publicity but it can also confuse investors. We also think there is a cheapness in many of these products that investors who breathe more rarefied air sometimes fail to appreciate the importance of to the general public.

Please do watch these interviews (via links in Fig.2).

Fig.2: Déjà Vu – 2013 vs. 2019

BBC Newsnight 2013



https://www.youtube.com/watch?v=qQqGKMU5_NM

CNBC 2019

https://www.youtube.com/watch?v=kaMLjqX1TeA&feature=youtu.be

Source: BBC, CNBC

In short, our conclusions are:

- Ryanair has a beautiful business model that 1) affords it an ever widening moat and more subtly, 2) generates excess cash well above what its ROE might suggest. The latter trait is not well understood.
- Ryanair employs a flywheel business model (i.e. lowest cost/EDLP ala Schwab, Costco, Wetherspoons et al) that we continue to believe this will be massively rewarding for shareholders. This gives the company a significant (and underestimated) moat with market share (and thus pricing) leadership in the European LCC[4] market.
- Europe is clearly following the US' lead in becoming a consolidated/more rational market. Notwithstanding some current over capacity, improved airline rationality is a global phenomenon. It is therefore instructive to see how the US market is developing considering it has consolidated 5-10 years ahead of Europe.
- 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.

[4] LCC: Low Cost Carrier

- At c.11x PE, Ryanair's shares are today trading at an attractive starting multiple but one struck against depressed profits. The latest €700m buyback suggests the value-savvy CEO concurs.
- Crucially however, today profits are a function of today's fare levels, which are at a record low due to the pricing behaviour of some loss-making airlines and Ryanair's attack on them.
- Future profits will, we believe, be at slightly better fares (or margin, i.e. costs could fall but fares stay at current levels) on a higher number of passengers carried. Added to that we think Mr Market's assessment of the company then changes also – i.e. the PE will rise.
- Based on all the above we see a lollapalooza outcome. **Our compounding model suggests that Ryanair shares offer compelling and almost unbelievable c.20-30% IRRs** to today's investor. This is thanks to this trio of operational gearing, re-rating and ongoing wise capital allocation.

We conclude that great companies in poor industries can make great investments too. If they are the cost leader:

> *"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**

In this note

1. We briefly remind readers of **the evolution of the Ryanair story** since 2012
2. A recap **of Unit Cost and Yield comparisons** vs. European peers
3. A look at the **US market** and a reminder of the SouthWest precedent
4. And a look at **European consolidation trends**
5. **Always Getting Better** but with some lingering **Concerns** to ponder

1. Ryanair's evolution since 2012: A Franchise in plain (hind) sight

Before we update our 2012 work, it is worth looking at how Ryanair has evolved since then and what we have learned from that journey. It has been fascinating and rewarding to have be so close to the evolving Ryanair corporate story in the last seven years. In 2012, we outlined Ryanair's tremendous cost leadership position versus the competition and its ruthlessness in driving low-cost in what had been a bloated government-championed industry. The company and our understanding of it has evolved much since that early work.

This evolution of our learning has been expressed in our research (as per Fig.1). Of note,

1. Our original realisation in 2012 of the unmatched advantages in the Ryanair model and early signs of prodigious cash generation within the business.
2. O'Leary's pragmatism in prioritising volume over prices (as he put it: "*to hell with yields*") – that is, in adapting to the prevailing market conditions of the day.
3. The new growth plan announced in 2014 (6% cagr passenger cagr to 200m in 2024 2024, underpinned by a 200 plane 737 MAX order).

4. His ‘Damascean conversion’ towards a softer customer stance. Admitting that easyJet got it right and that he was “asleep at the wheel”. Thus steering the company towards better customer service. A sign of a maturing culture as befits a market leader and world-class company.
5. Brexit de-rating. Our growing understanding of the precedent set by the US market (and thus long-term potential for fare increases). Buffett invests in airlines in late 2016.
6. O’Leary’s pragmatic Shark Attack tactic to kill the competition by reinvesting in lower prices in 2017. With hindsight, this marked a top in the share price as the crowd fretted about fare deflation (not without reason but without an eye on the end-game, we suggest).
7. Ryanair has a rare operational slip-up: a major pilot and staff scheduling failure causes lost revenue and bad publicity. It shed light on many areas for operational improvement (and raised questions of a business being run too hard).
8. A seminal moment – Ryanair becomes unionised in 2018 and agrees on wage increases.
9. A change in corporate structure with new sub-brands (Buzz, Lauda) and new leadership structure with a clear eye on being prepared for more consolidation opportunities.
10. 2019 marks another profit warning cycle. The shark attack on competition via low pricing continues. Profits fall, but competitors feel intense pain.

A capital-intensive **Dream Business**. Really? How does that work?

Perhaps the biggest progression of our understanding of Ryanair was piecing together the Operate, Generate and Allocate picture. Our compounding model was a huge help here in highlighting a central aspect: Ryanair’s low or negative cost of growth derived from its negative working capital. It is this business attribute that has geared investor returns (past and future) – something we admit we had not fully grasped in 2012. We think most investors do not realise the impact that this has on Ryanair’s per-share compounding. Again and again, we see some of the best businesses have this subtle, non-obvious compounding characteristic within their DNA. (Actually, it’s the owner-managers of those businesses that have this DNA and instil it in their life’s work[5]).

We have come to realise that Ryanair is a beautiful compounder with Dream business characteristics because it has high margins, a low cost of growth and thus has a bounty of excess cash which it consistently uses to buy its own shares.

This can be seen in the historical fact that despite a headline ROE of 15-20% and 10% sales growth since 2008, the company has managed to distribute c.70% of historical Net Income to shareholders – actually our low cost compounder looks more like a ‘Dream business’ close-up.

What’s happening in today, in 2019?

Fast forward to 2019 and after what has been a turbulent couple of years for Ryanair’s staff and shareholders it became apparent to us at least, that Ryanair was probably being run too aggressively. The staff rostering crisis in 2017 highlighted this fact.

It is in this context that we thought the following statement from Ryanair’s Chief Marketing Officer some weeks ago was revealing and representative of a now (we hope!) more prudent-minded company.

[5] Michael O’Leary owned a chain of newsagents on the side whilst he worked for Tony Ryan back in the 1980s – not because they were wonderful businesses but because he understood they generated masses of cash via working capital.

> *"We're a very functional brand. Passengers don't choose us because they love us. They choose us for price, reliably and the route network. Everyone is talking about digital, but we could have the most personalised website, chocolate fountains at the boarding gate and Ed Sheeran playing live on our flights…but if your flight is delayed you don't give a shit. So, it's the summer of reliability. Our biggest thing we're working on, including the marketing department, is making it a boring summer of fewer cancelled flights, best on time performance. We want this to be a boring summer with good performance. Reliability really drives customer sentiment for airlines as much as low fares."* **– Ryanair Chief Marketing Officer, Kenny Jacobs, May 2019**

We also think this serves as a reminder that, O'Leary is a good learner. He drives the business hard, makes mistakes but crucially fixes the mistakes, learns from them and moves on. This results in a better, more robust business, but one that can still grow fast. This behaviour is classic 'Anti-Fragile', a powerful characteristic outlined by Nassim Taleb in his excellent book of the same name.

> *"Some things benefit from shocks; they thrive and grow when exposed to volatility, randomness, disorder, and stressors and love adventure, risk, and uncertainty. Yet, in spite of the ubiquity of the phenomenon, there is no word for the exact opposite of fragile. Let us call it antifragile. Antifragility is beyond resilience or robustness. The resilient resists shocks and stays the same; the antifragile gets better."* **– N.N. Taleb, Anti-Fragile**

In short, what we have learned most of all is that whilst Ryanair is an imperfect business it is one that learns from customers, its competitors and its own failures – sometimes quickly sometimes a little slowly too! It is highly adaptable to change – a superb characteristic for a business operating in such a hairy industry.

On the recent investor call discussing the FY19 results, O'Leary was his usual straight-forward self. He acknowledged the huge challenges faced by the business internally in the last 18 months (rostering failures, strikes, unionisation) but convincingly showed that these issues were all faced down and resolved. We think Ryanair emerges as a stronger business as a result. The company has not lost its shark instincts either. This is a business that has grown-up and mellowed (a little) but we would not fancy being its competitor.

> *"If we have to suck up lower fares for next 6-12m, we will happily do it as we are the most profitable"* **– O'Leary, May 2019**

A word on today's valuation

> *"We suggest a stock like Ryanair is better to get 80% right: i.e. it is far better to understand the drivers of competitive positioning, the medium term growth prospects and capital allocation than try to predict 2014 yields to within a €1 (please don't ask for our 2014 EPS forecasts!)."* **– Holland Views – Ryanair – Sept 2013 at €6 share price**

Tactically, we were wrong not to be cautious on the shares in mid-2017 when it begun its shark attack – the difference between then and today is that the business was operating at peak margins (i.e. 23%) i.e. it and the industry had a low fuel price tailwind. Today, Ryanair margins are c.16% and the competition is far more precariously positioned.

So how cheap are the shares today? At €10, they trade on c.11.3x the FY19 earnings (excluding the Lauda integration costs of c.€200m). Lauda will not be treated as an exceptional activity in FY20 and will be breakeven (likely better) in FY21.

As we said in the quote above in 2013, this is a stock to get 80% right and once again, there is no point in asking for our FY20 forecasts. This is not a cop-out on our part – this business is so sensitive to fare assumptions that forecasts are very volatile and will remain so. Instead we focus on a period three years out:

- Assuming Ryanair realises its capacity growth of 6% cagr this would imply 163m passengers (ex-Lauda) in FY22.
- We assume some fare stabilisation/pricing power – average fares are up a little to €44, close to FY12 levels (vs. €36 now). Ancillaries stay at 31% of the sales mix. Crucially (and a better way to think about Ryanair) that means Rev per passenger increases from €54 to €61 (FY16 levels, but with a much lower headline fare).
- We assume $75 effective oil price in 2022 (vs. $58 hedged in FY19) and that non-fuel costs grow proportional to volume, i.e. we do not assume any benefit from 737 Max fuel efficiency.
- We make a crude assumption of a further 146m share buyback (i.e. c.€1.5bn at today's prices – in effect assuming another €800m buyback beyond that already announced over three years). This is prudent as it assumes a lower pay-out ratio than Ryan's past.
- All together this leads to a €1.37 EPS, or 25% compounding over three years. You can see why we are keen!
- We think these are modest assumptions and see a maturing EU short haul market as having fares/margins for market leaders that might be higher than those assumed above.

In this context, it is worth bearing in mind that O'Leary (a 4% equity owner) also enjoys 10m options issued earlier this year, which vest if either Ryanair's annual profit exceeds €2bn or if the share price exceeds €21. The above shareholder IRR of 25% between now and 2022 results in a share price of €20 and profits of €1.7bn. While these outcomes might make investors richer, they are not sufficient enough to trigger those options for Mr O'Leary! Looked at it this light, and that of a consolidating industry we think the above forecasts are conservative. Notably, too, our scenario assumes very little margin expansion by 2022.

2. Ryanair's Cost and Competitive Position – an update

> *"I now believe that the single most important question to ask any management team is "what matters?" In other words, what metric do you care about the most?* **– FT op-ed May 19, 2019**[6]

The airline sector generates reams of data for analysts to crunch and ruminate on (perhaps that's why so much discussion of the sector is so backward looking?). We too watch the data to assess the track record of Ryanair and importantly, watch the gap with competitors. But we agree with Michael O'Leary that the single most important metric for Ryanair remains its unit cost. Obviously yields are a close second, but they are still not as important as costs. We continue to assess Ryanair's cost competitiveness as excellent.

[6] A good piece by a former Banks analyst, Simon Samuels, on why analysts keep missing the Banking crises such as Northern Rock and most recently Metro Bank.

Unit Cost (and yield) data update

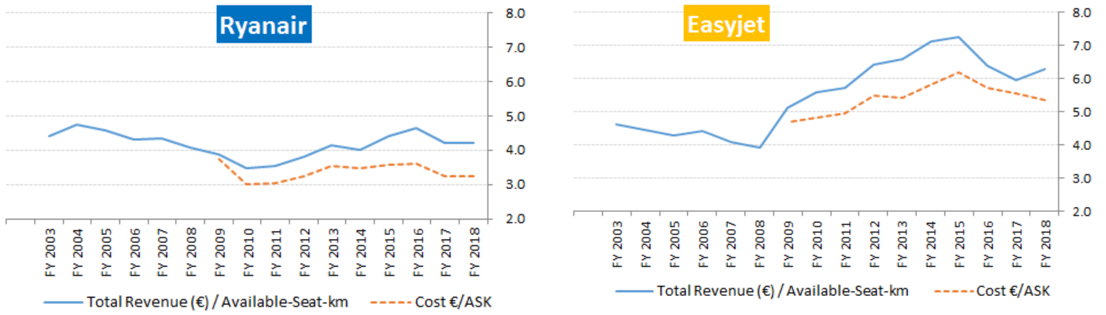
There is a valid argument that Ryanair and easyJet, are not competing head-to-head in Europe. Fig.3 shows the primary reason why that is the case – despite being so-called LCC, they have very different pricing strategies and cost bases (easyJet has 'slots' at more higher cost 'primary' airports too). Eastern Europe focussed Wizz (with c.1/3 of Ryanair's scale) is a closer comparable though its unit costs benefit from longer sector lengths than Ryanair.

We also think there is another reason Ryan and easyJet do not complete head-to-head – O'Leary's pragmatism. He knows that the end game needs more than one player and thus as Ryanair's largest and most profitable competitor easyJet is the likely candidate. Despite in recent years slot space becoming available at Gatwick Ryanair has chosen not to go head-to-head with easyJet on its routes. This behaviour is crucial to our easyJet analysis.

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.

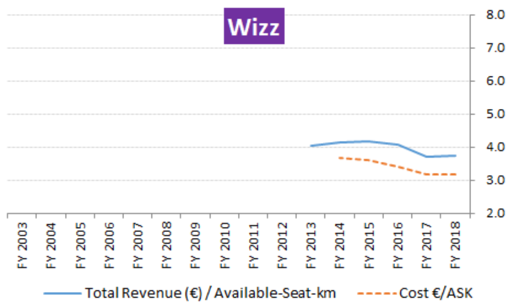
With our professional worrier hat on, we might say that we'd much rather if Ryanair's unit costs were declining rather than going sideways, and indeed that is why the fuel-efficient 737 MAX is important. We might also acknowledge the progress that Wizz has made on its unit costs – Wizz is truly the only ultra LCC comparable in cost to Ryanair. But, and it's a big but, Wizz's leasehold model has not been truly tested in a downturn and is a disadvantage in comparison to Ryanair's (and easyJet) owned-fleet.

Fig.3a: The cost gap vs. easyJet remains very wide



Source: Holland Advisors

Fig.3b: Wizz has the closest unit-cost base to Ryanair (helped by 27% longer flight lengths*)



Source: Holland Advisors

* We note that whilst our unit analysis is comparable, it does not allow for the fact that the airlines have different average sector length. easyJet's average flight distance ('sector length') is c.1,100km, Ryanair's is 1,250km and Wizz is 1,600km: Longer sector length help the per unit economics making cost metrics appear lower.

A comparison across Europe

> *"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!**

This quote is a brutally honest reminder from a BA executive why cost per unit is the primary performance indicator for this industry and why BA has consistently failed to compete with the low coast carriers. Fig.4 gives an overview of the key players in European LCC market (or 76% of it!). The main take-aways are:

- Ryanair has c.26% of the LCC market by seats, but as % of the entire intra-Europe air market, its share is much lower at c.14% (130m/929m seats). This suggest a further runway of growth is still available to the company.
- Ryanair is today now well below peak margins.
- Ryanair owns its own fleet (Wizz owns none of its fleet which is 100% leased). In that light, the following quote from Southwest's founder is insightful!

> *"(Herb) Kelleher counted on his industry facing at least two crises a decade and made sure its balance sheet would be ready for them"* – **FT Obituary to Harb Kelleher, Founder of Southwest**

Fig.4: An overview of the main European LCC market

		SH (short-haul) only?	passengers (m)	Rough LCC* Market Share	adjusted EBIT	EBIT/pax	Current Margins pro-forma	Peak Margins	RASK (yield proxy)	CASK (cost proxy)	% fleet owned	Net Debt €
Ryanair	Ultra LCC	SH	130	26%	€1600m	12.3	16%	23%	4.2	3.2	93%	1600
Easyjet	LCC	SH	100	20%	£550m	5.5	9%	15%	5.6	5.3	70%	-400
Norwegian	LCC	SH + LH	42	4%	-€385m	-9.2						6000
Veuling (IAG)	LCC	SH	39	8%	€200m	5.1	8%					
Wizz	Ultra LCC	SH	36	7%	€290m	8.1	14%	16%	3.8	3.2	0%	-1000
top 5			347									
as % of total est				69%								
Pegasus (Turkey)	Ultra LCC	SH	30	6%	€117m	3.9	10%			3.6		
Iberia Express (IAG)	Ultra LCC	SH	5.5	1%	€46m	8.4	14%					
as % of total est				76%								
Total LCC Market est (incl Turkey)*			**501**									
Total intra-Europe market			**929**									

Source: Holland Advisors, www.anna.aero

3. The US precedent

> "*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 2012**

The airline industry is beginning to be accepted as becoming better behaved from a capital allocation perspective, so if you think your competitor will behave rationally you can price rationally too. This has been the driver of greater investor acceptance of the US carriers (we include Charlie Munger's comments on airlines in the Appendix).

It is not easy to make direct and linear cross-geography extrapolations on the whole airline industry between say what has happened in US and what will happen in Europe. This is in part due to geography (i.e. a person flying from the UK to South America might be happy to go via a Madrid hub but not via a Berlin one). Equally as the inter-City distances in the EU are shorter – both to drive to alternative airports and fly, low cost competitors offer alternative routes.

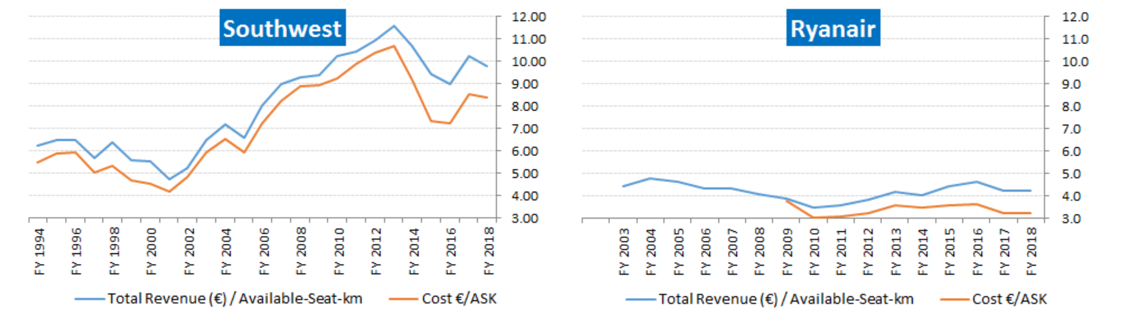
However one change is consistent and common to both US and Europe. That being that the owners of the major airlines have now long pressed for unprofitable routes to be dropped with a focus on where unique landing slots give the carrier a pricing edge. The CEOs of those airlines are delivering on that idea as recent rise in ROIC at companies like IAG illustrates. This more sensible capital allocation by major airlines is the driving force that enables more scale and more market share to be won by point to point carriers with high reliability and low costs (easyJet and Ryan). Assessing whether higher returns on capital at company like IAG are sustainable however, we think is hard as they are ultimately trying to use a degree of protectionism which we dislike as a business model. Assessing that the lowest cost producer keeps winning in a more rational industry we think is a much easier call. This is why we major on and favour Ryanair (and by extension easyJet).

In an EU and global airline market that is better behaved from a capital cycle standpoint many strong incumbent players *may* continue to benefit. However, we favour Ryanair (and to a lesser extent easyJet) due to the downside protection their low cost of production (and pricing) offers in what is ultimately a commodity sector.

We present a few EU/US comparison charts. From which we conclude:

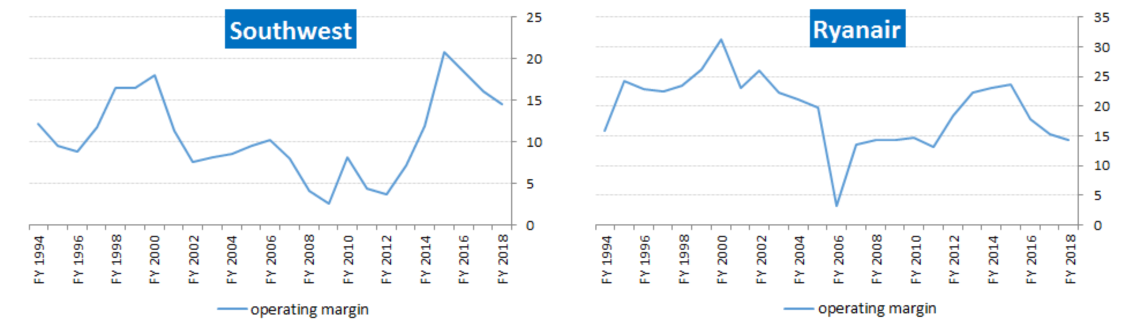
- Ryanair originally cloned the SouthWest model so it is worth understanding this business and its development over time.
- SouthWest's fare trends are thus interesting (as is the widening revenue vs. cost gap post 2012 – when consolidation kicked in). Its EBIT margin trebled!
- Consolidation has already happened in the US.
- Broader US fares have trended up too, to which all airline profitability are hugely geared to.

Fig.5a: Southwest vs. Ryanair Yields/Costs



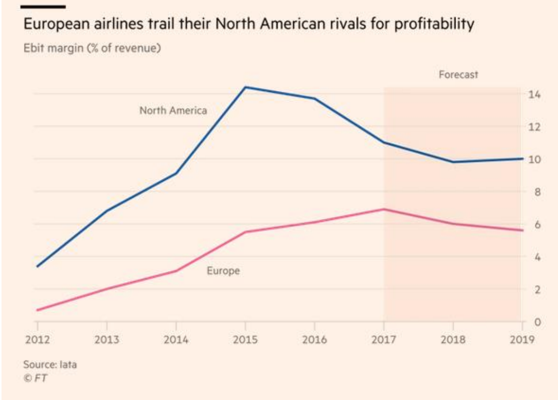
Source: Holland Advisors

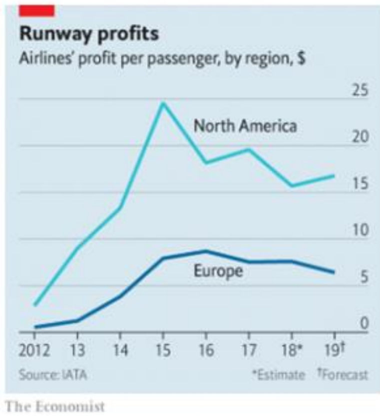
Fig.5b: Southwest vs. Ryanair operating margins



Source: Holland Advisors

Fig.5c: US vs. Europe fares and profit per passenger





Source: FT, The Economist

4. European consolidation is actually well underway too

> *"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. When we get to that point fares will be higher but not while this new opportunity exists"* **Ciaran Brannigan – Head of Ryanair revenue management, May 2017**

Obituaries have already been written for: Monarch, Air Berlin, FlyBMI, FlyBE, Germania, Primera Air, Cobalt Air, Azur Air, Small Planey Airlines, Skywork, TUI and considering that there are apparently 115 licensed carriers in Europe still, there will be many more.

We are impressed by the way that Ryanair is being opportunistic and lying in wait for opportunities that arise from airline failures and take-overs. It might not be obvious, but having optionality via the right planes (e.g. Airbus), staff attitude (unions) and existing geographical presence (slots or carrier licences) could be a big benefit in being able to act swiftly when opportunities arise. Ryanair is thus well placed today.

> *"Ryanair plans to use its new group structure to take advantage of further consolidation in the European airline industry by snapping up airlines, jets, or airport slots that might become available because of competition rules…*
>
> *…You look at Lufthansa, for example, at the moment, [they] are interested in Condor/Thomas Cook. It's inevitable that there would have to be significant consolidations coming out of that kind of a merger [if it] were to take place. And we now can participate in those mergers: a, because we're unionized, which I think would previously have been a blockage; and b, because we are both an Airbus operator and a Boeing operator."* **– Skift.com**[7]
>
> *We are interested in the mergers and acquisitions of others. If IAG bought Norwegian – a more remote possibility today – that has a large presence in Spain, they would have to divest because they could not merge Iberia, Express, Vueling and Norwegian's Spanish business. If there was a competitive process, we would be interested in participating and that could mean the creation of a Spanish subsidiary"* **– Michael O'Leary**

[7] https://skift.com/2019/05/20/ryanair-ready-to-pounce-on-opportunities-from-pending-airline-mergers

Fig.6 (alongside Fig.8a-d in the Appendix) provides big picture context on the European market. Low cost carriers account for c.54% of traffic now in Europe and this is clearly a secular trend.

Fig.6: LCC is eating in the short-haul intra-European market

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
intra-Europe total seats	696	725	734	724	723	743	775	837	888	929
'European' Low Cost Seats	224	245	263	281	297	329	372	419	467	501
LCC % of mix	32%	34%	36%	39%	41%	44%	48%	50%	53%	54%
Ryanair passengers	59	67	72	76	79	82	91	106	120	130
LF	83%	84%	75%	82%	82%	83%	88%	93%	94%	95%
Seats	70	79	96	92	96	99	103	114	128	137
Ryanair Notional Share	10%	11%	13%	13%	13%	13%	13%	14%	14%	15%
Ryaanir share of LCC	**31%**	**32%**	**37%**	**33%**	**32%**	**30%**	**28%**	**27%**	**27%**	**27%**
Wizz passengers				10	11.2	13	14.8	17.4	23.8	30
Wizz share of LCC				**4%**	**4%**	**4%**	**4%**	**4%**	**5%**	**6%**
EZY Passengers	45.2	48.8	54.5	58.4	60.8	64.8	68.6	73.1	80.2	88.5
LF	86%	87%	87%	89%	89%	91%	92%	92%	93%	93%
EZY Seats	53	56	63	66	68	71	75	79	86	95
EZY share of LCC	**23%**	**23%**	**24%**	**23%**	**23%**	**22%**	**20%**	**19%**	**18%**	**19%**

Source: Holland Advisors

5. Always Getting Better but Lingering concerns

> *"The downside of success that we really worry about is the danger that the more successful you are, the more likely you are to lose sight of the things that made you successful"* – **Michael O'Leary**

We think Ryanair, as a business, is genuinely always getting better – though its progress is not always in a straight line! Here are a sample of moves that are emblematic of a business that changes with the times and is maturing in its corporate culture:

- The hiring of Eddie Wilson as Chief People Officer (aka union negotiator!).
- The creation of a Chief Risk Officer position.
- The creation of Ryanair Labs, its in-house technology division and appointment of a CTO. It is worth noting that Ryanair's scale of close to 200m "guests" (as it now calls them) is ripe for monetisation into adjacent markets like Hotel rooms etc.
- The unionisation of staff.
- Creating and/or acquiring Sub-brands
    - Lauda Air as a sub-brands brings Austrian/German slots, a well-regarded brand and more subtly, a fleet of Airbus.
    - Ryanair Sun rebranded as Buzz fosters internal competition and again.
- Ancillary revenue, we think remains untapped and ties-in with earlier comments on Ryanair Labs.

Lingering concerns

It would be imprudent that say that we do not have lingering concerns investing in this business. As Munger said below, it's still an airline. We note the following concerns which we regularly hear from investors. Some of these were far more valid a year ago but we list them for completeness.

- What if the 737 MAX deliveries are deferred for much longer? This would surely impede capacity growth. This is an uncertainty rather than a risk we suggest.
- Cost creep is real and is causing cost reduction to stagnate (i.e. labour costs, EU261 refunds, bureaucracy, plane availability etc.).
- Ryanair is running operations staff too aggressively without contingency buffers?
- And the big one: the Capital Cycle.
    - There are still 115 intra-European airlines in operation – this will take much longer to play out!
    - The capital cycle is still running against it. Zero interest rates have helped the competition more than Ryanair who is financially far more self-sufficient.

Conclusion

We try not to get wedded to our best ideas and thus spend much time assessing downside risk and where we could be wrong. Airline safety relies heavily on checklists and Charlie Munger too is a big proponent in the power of checklists for all walks of life but especially investing. Here is one such checklist:

1. Does the company meet an economic need?
2. High and consistent returns?
3. Long history of constantly high cashflows?
4. Balance sheet strength
5. Insider ownership
6. Shareholder friendliness
7. Is the stock a bargain compared to last 5 or 10 years?

Ryanair is a highly operationally geared business in a noisy sector that offers much data for analysis and debate. Its share price is thus volatile. Yet the quality of this business is world-class and our work suggests that shareholders buying at today's prices will be hugely rewarded for tolerating such volatility.

Our spreadsheets for both Ryan and easyJet are attached to this work and are included in the Appendix. They show how each will be a major beneficiary of combined volume growth, slightly higher fares and a higher PE that we think one day results. We suggest 25-30% IRRs for 3-5y are a very realistic outcome for investors.

Buy Ryanair/easyJet.

Andrew & Mark **firstname@hollandadvisors.co.uk**

The Directors and employees of Holland Advisors may have a beneficial interest in some of the companies mentioned in this report via holdings in a fund that they also act as advisors to.

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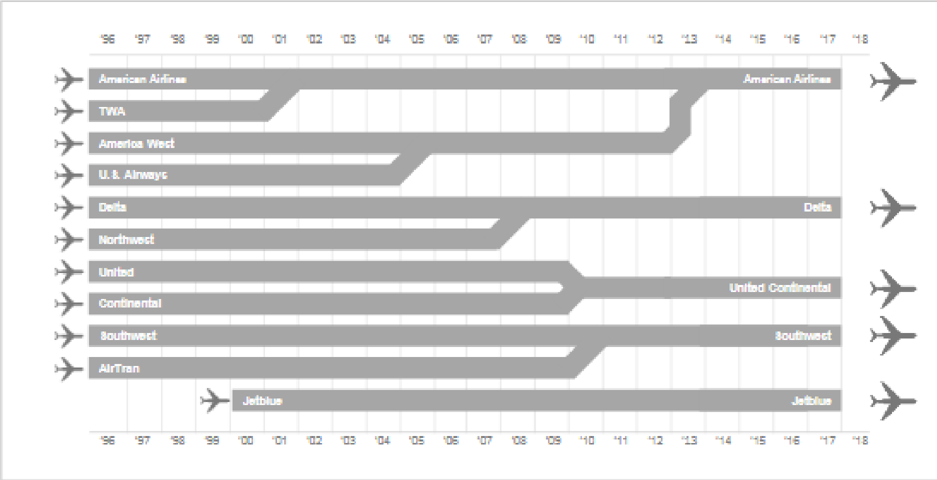
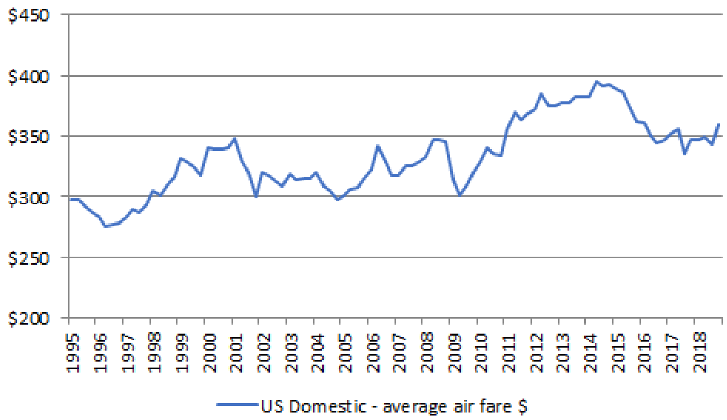
Appendix

Fig.7a: US consolidation



Source: American Airlines

Fig.7b: US Consolidation wave led to rationality – aka fare rises



Source: Holland Advisors, www.bts.gov

Munger on Berkshire's stake in US airlines

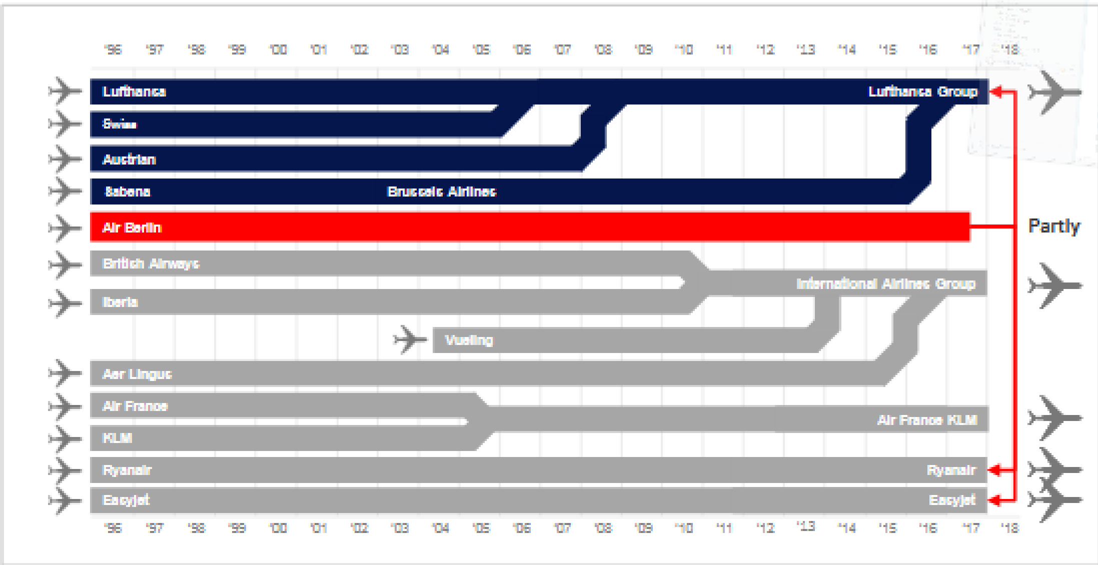
Question 34: I was hoping to gain some insight regarding your and Warren's discussions into airlines. Whether or not it was a light-bulb that went off in a certain year. Or whether it morphed over time. Just trying to get an idea about when you got open minded about maybe investing into airlines and how you changed your mind.

Charlie: Well, we did change our mind. For a long time, Warren and I (painted over) the railroad because there were too many of them, and it was too competitive, and union rules were too crazy. They were lousy investments for about 75 years. And then they finally…**the world changed** and they double decked all the trains and they got down to four big rail systems in all the United States in terms of freight and all of a sudden we liked railroads. It took about 75 years. Warren and I never looked at railroads for about 50 years, and then we bought one. (link)

Now airlines, Warren use to joke about them. He'd say that the investing class would have done better if the Wright Brothers would never have invented flight. But given the conditions that were present when the stock was purchased and given the conditions of Berkshire Hathaway where it was drowning in money, we thought it was ok to buy a bunch of airline stocks. What more can I say? Certainly it's ok to change your mind when the facts change. And to some extent the facts had changed, and to some extent they haven't. It is harder to create the little competing airlines than it was. And the industry has maybe learned something. I hope it works better, but I don't think its…I think the chances of us buying airlines and holding them for 100 years is going to work that well. I think that's pretty low.

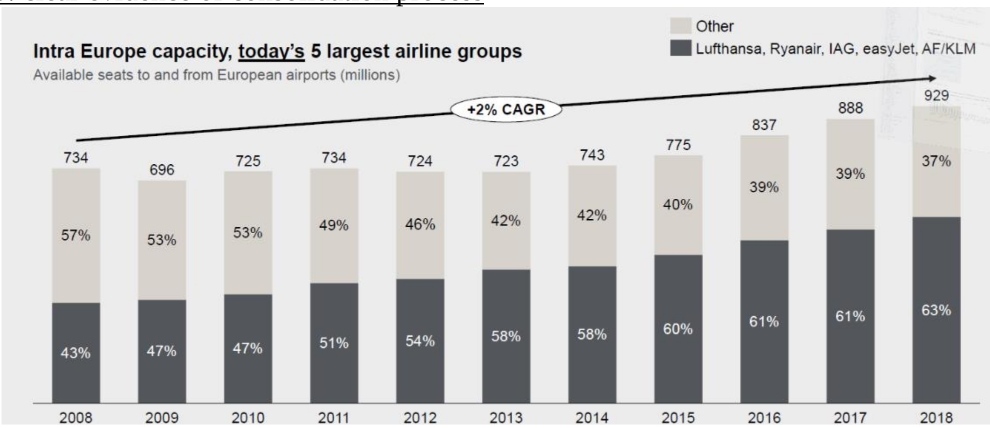
Source: Charlie Munger, Berkshire 2019 AGM

Fig.8a: a chart from Lufthansa – game on!



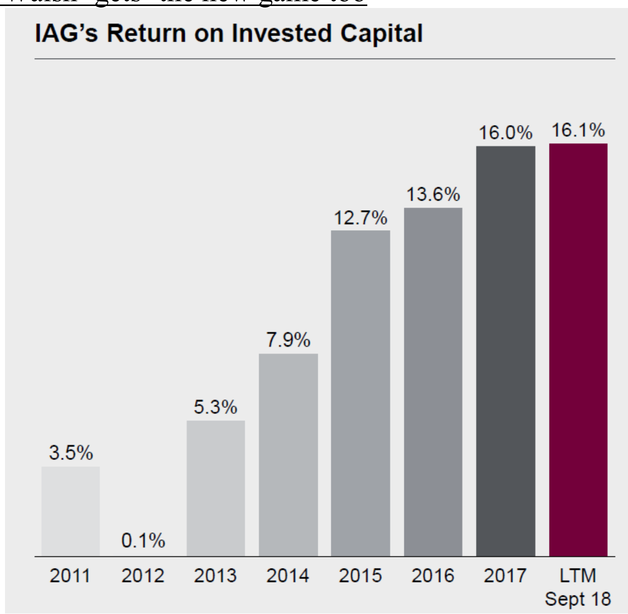
Source: Lufthansa

Fig.8b: clear evidence of consolidation process



Source: Lufthansa

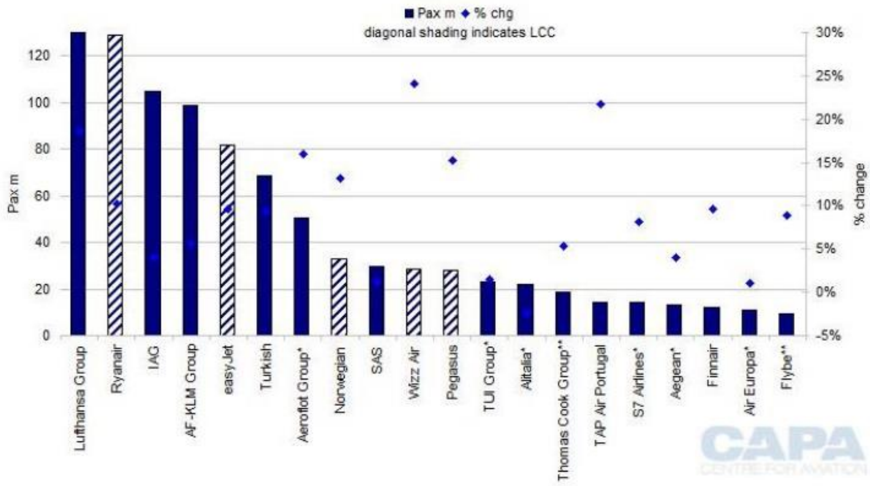
Fig.8c: IAG's Willie Walsh 'gets' the new game too



Source: IAG

Fig.8d: though there is a still a long tail of Zombie airlines

Figure: Europe's top 20 airline groups by passenger numbers 2017



Source: CAPA – Centre for Aviation, airline company traffic reports

Note: * Indicates 2017 passenger numbers not yet reported; figures are CAPA estimates based on Nov-2017 YTD growth or on calendar 2017 seat growth data from OAG. ** Figures for 12 months to Sep-2017.

Price	€10.38
M Cap	€12,622
EV	€13,072

INPUTS	IN BLUE
4yr opex productivity gain est	0%

RYANAIR ¦ €m ¦ March y/end	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20e...	...FY22e	...FY24e	19-22 cagr
Passengers	**58.6**	**66.5**	**72**	**75.8**	**79.3**	**81.7**	**90.6**	**106.4**	**120**	**130**	**139**	153	163	**200**	5%
YoY		13%	8%	5%	5%	3%	11%	17%	13%	8.	142m incl Lauda		**17%**		
Load Factor	83%	84%	75%	82%	82%	83%	88%	93%	94%	95%	96%				
Fare (not yield)	€ 40	€ 35	€ 39	€ 45	€ 48	€ 46	€ 47	€ 46	€ 41	€ 39	€ 37		€ 44	175m remains guidance	6%
YoY		-13%	12%	16%	6%	-5%	2%	-1%	-13%	-4.1%	-5.9%		18%		
EZY est fare					€ 71	€ 75	€ 75	€ 63	€ 58	€ 59					
Scheduled Revenue	**2344**	**2324**	**2825**	**3438**	**3822**	**3758**	**4258**	**4894**	**4920**	**5134**	**5166**		**6940**		
YoY		-1%	22%	22%	11%	-2%	13%	15%	0%	4%	1%		35%	2018-22 cagr	
Ancillary Revenues	**598**	**664**	**802**	**886**	**1064**	**1247**	**1394**	**1568**	**1780**	**2017**	**2396**		**3026**	11%	
YoY		11%	21%	10%	20%	17%	12%	12%	13%	13%	19%		50%		
% total revenue		22%	22%	20%	22%	25%	25%	24%	27%	28%	32%		30%		
ancillary/pax	€ 10	€ 10	€ 11	€ 12	€ 13	€ 15	€ 15	€ 15	€ 15	€ 16	ex Lauda 7				
Total Revenue	**2942**	**2988**	**3629**	**4390**	**4884**	**5036**	**5654**	**6536**	**6648**	**7151**	**7563**		**9966**	**10%**	**9.6%**
Revenue per passenger	€ 50	€ 45	€ 50	€ 58	€ 62	€ 62	€ 62	€ 61	€ 55	€ 55	€ 54		€ 61		
Fuel costs	1,257	894	1,227	1,594	1,886	2,013	1991	2071	1913	1903	2343	2803	3532	17%	
YoY		-29%	37%	30%	18%	7%	-1%	4%	-8%	-1%	23%	20%		NB: no fuel efficiency	
Ryanair **hedged** Oil Price (metric tonne)						975.0	$ 950	$ 898	$ 623	$ 493	$ 583	$ 709	$ 750	from Boeing	
converted into barrels							$ 95	$ 90	$ 62	$ 49	$ 58	$ 71	$ 75	Gamechangers	
hedged oil price yoy							-3%	-5%	-31%	-21%					
EUR:USD								1.10	1.15						
ex-fuel opex	1592	1692	1886	2113	2279	2365	2622	3004	3114	3581	4031		4724		
YoY		6%	11%	12%	8%	4%	11%	15%	4%	15%	13%				
opex/passenger(ex fuel)	27	25	26	28	29	29	29	28	26	28	29		0		
YoY		-6%	3%	6%	3%	1%	0%	-2%	-8%	6%	5%				
Opex	2849	2586	3113	3707	4165	4378	4614	5075	5113	5484	6374		8256		9.0%
opex/passenger	49	39	43	49	53	54	51	48	43	42	46		51		
YoY		-20%	11%	13%	7%	2%	-5%	-6%	-11%	-1%	9%				
Lauda 2018 exceptional											223				
EBIT	**93**	**402**	**516**	**683**	**719**	**658**	**1040**	**1461**	**1535**	**1667**	**1189**		**1710**		
EBIT Margin	3%	13%	14%	16%	15%	13%	18%	22%	23%	23%	15.7%		17.2%		
Finance								-56	-62.8	**-56**	**-57.8**		-50		
PTP								1405	1472	1611	1131		1660		
Tax								-169	-154	-193	-106		-199		
Adj Net Income				**560.4**	**569.3**	**522.8**	**866.7**	**1236**	**1318**	**1417**	**1025**	"750-950"	**1461**		
Statutory Net Income											**885**	"broadly flat"			
# shares								1341	1257	1204	1154		1070		
Ryanair EPS								€ 0.92	€ 1.05	€ 1.18	€ 0.89	€ 0.86	€ 1.37		
consensus										€ 1.21					
Net Debt	**497**	**211**	**752**	**145**	**46**	**-72**	**-347**	**-284**	**244**	**283**	**450** ex-Lauda				
GBPEUR hit (€10m for every 1p in GBPEUR move)									-150						
EUR:USD								1.10	1.10						
EV/EBIT								8.9x	8.5x	7.8x			7.6x		
P/E (in 2022 assumes falling share count via SBB)								**11.3x**	**9.9x**	**8.8x**	**11.7x**		**7.6x**		
Share price on a 15x multiple													€ 20		
Upside from today's share price													97%		
annualised													25%		

** INPUTS IN BLUE**

SP= £ 9.12 # shares= 397 M Cap= 3621 N Debt= -201 EV= 3420

PE= 11x PE= 5x

Easyjet ¦ GBP£ ¦ Sept y/end	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19e	10y cagr	FY22e	17-22 cagr	fy18-fy22 cagr
Passengers	**45.2**	**48.8**	**54.5**	**58.4**	**60.8**	**64.8**	**68.6**	**73.1**	**80.2**	**88.5**	**97**	**8%**	**107**	6%	6%
YoY		8%	12%	7%	4%	7%	6%	7%	10%	10%	10%		21% vs FY18		
Load Factor	**86%**	**87%**	**87%**	**89%**	**89%**	**91%**	**92%**	**92%**	**93%**	**93%**					
NEW KPIs					estimates	estimates	estimates								
Passenger Rev/Passenger (~ *Fare*) in £					**£ 61.6**	**£ 60.1**	**£ 57.4**	**£ 52.4**	**£ 50.6**	**£ 53.0**			£ 60.0	3%	
YoY									-3%	5%					
Fare in €					€ 71	€ 75	€ 75	€ 63	€ 58	€ 59					
Passenger Revenue				**3,854**	**3,747**	**3,893**	**3,936**	**3,832**	**4,061**	**4688**			**6,440**	10%	9%
YoY															
Ancillary Rev per Seat (incl non-seat)					£ 8.4	£ 9.8	£ 10.9	£ 11.5	£ 12.3	£ 13.7					
Ancillary Revenues (undisclosed until FY15)					**511**	**634**	**750**	**837**	**986**	**1210**			**1500**	9%	
YoY						24%	18%	12%	18%	23%					
% total revenue					12%	14%	16%	18%	20%	21%			19%		
Total Revenue	**2,667**	**2,973**	**3,452**	**3,854**	**4,258**	**4,527**	**4,686**	**4,669**	**5,047**	**5,898**	**6,367**	**8%**	**7,940**	9%	**8.9%**
Total Revenue per passenger	£ 59	£ 61	£ 63	£ 66	£ 70	£ 70	£ 68	£ 64	£ 63	£ 67			£ 74		
										2018 costs distorted by Tegel (air berlin)					
Fuel costs	**807**	**733**	**917**	**1149**	**1182**	**1251**	**1199**	**1,114**	**1,062**	**1184**			**1958**	13%	
YoY		-9%	25%	25%	3%	6%	-4%	-7%	-5%						
Oil Price assumption									$ 62.00	$ 55.00			$ 75.00		
ex-fuel opex (pre 2015 is pre depreciation)	**1635**	**1851**	**2067**	**2174**	**2365**	**2453**	**2801**	**3061**	**3577**	**4,194**			**5,086**		
as % sales		62%	60%	56%	56%	54%	60%	66%	71%				64%		
YoY		13%	12%	5%	9%	4%	14%	9%	17%						
opex/passenger(ex fuel)	36.2	37.9	37.9	37.2	38.9	37.9	40.8	41.9	44.6	47.4	40.8?	3%	47.4		
YoY															
Reported Cost/Seat (ex Fuel)						37.7	37.4	38.3	41.2	43.0					
Opex	**2,442**	**2,584**	**2,984**	**3,323**	**3,547**	**3,704**	**4,000**	**4,175**	**4,639**	**5,378**			**7,044**		**8.0%**
opex/passenger	54.0	53.0	54.8	56.9	58.3	57.2	58.3	57.1	57.8	60.8			65.6		
YoY		-2%	3%	4%	3%	-2%	2%	-2%	1%	5%					
non-recurring										133					
"ownership costs" aka depn + leases	181	200	220	214	233	242					consensus				
Reported EBIT										460					
Headline EBIT										592					
Clean EBIT (pre Air Berlin costs)	**44**	**189**	**248**	**317**	**478**	**581**	**686**	**494**	**408**	**520**	**435**	**32%**	**895**		
EBIT Margin	2%	6%	7%	8%	11%	13%	15%	11%	8%	9%	7%		11%		
Finance									-20	-14	-14		-20		
PTP									**408**	**578**	**421**		875		
Tax									-83				175		
Net Income									**325**		337		**700**		
EPS									0.82		0.85		1.78		
# shares									397		394		394		
dividend payout ratio				33%	77%	40%	40%	50%	50%	50%					
Share price on 15x multiple												Share price on 15x	£ 26.66		
												IRR	36%	pre -DIVI	
										520					
												Dividend per sh	2.33		
												Total Return = S.Pric	£ 28.99		
												T.Return IRR	39%		

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