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easyJet 16/10/2014 **FAT-UK-558**

EZJ GBP £14.00 Core **HIGH** **B**

Oils well for easyJet

In last week's report we profiled the budget airline easyJet and noted that the group is one of the highest quality operators in its space. This has allowed it to earn a return on capital ahead of the rest of the industry. With the oil price recently having slumped we are now rate easyJet as a high risk buy.

Before recommending and airline it is worth pointing out the numerous caveats that the industry warrants. The sector often engages in price wars and is subject to susceptible to changing economic conditions.

The biggest proportion of easyJet flights are either UK domestic or between the UK and Europe. As such the economic strength of the UK should help offset the weakness in the eurozone.

A further factor for airlines is the oil price with fuel around a third of the costs for narrow body aircraft. With oil having slumped recently the prospects for airline industry margins are therefore solid.

The budget airline industry benefits further by having high load rates which allows for strong returns. As such while airlines are a volatile the long-term success of budget airlines as investments suggests they are worth considering.

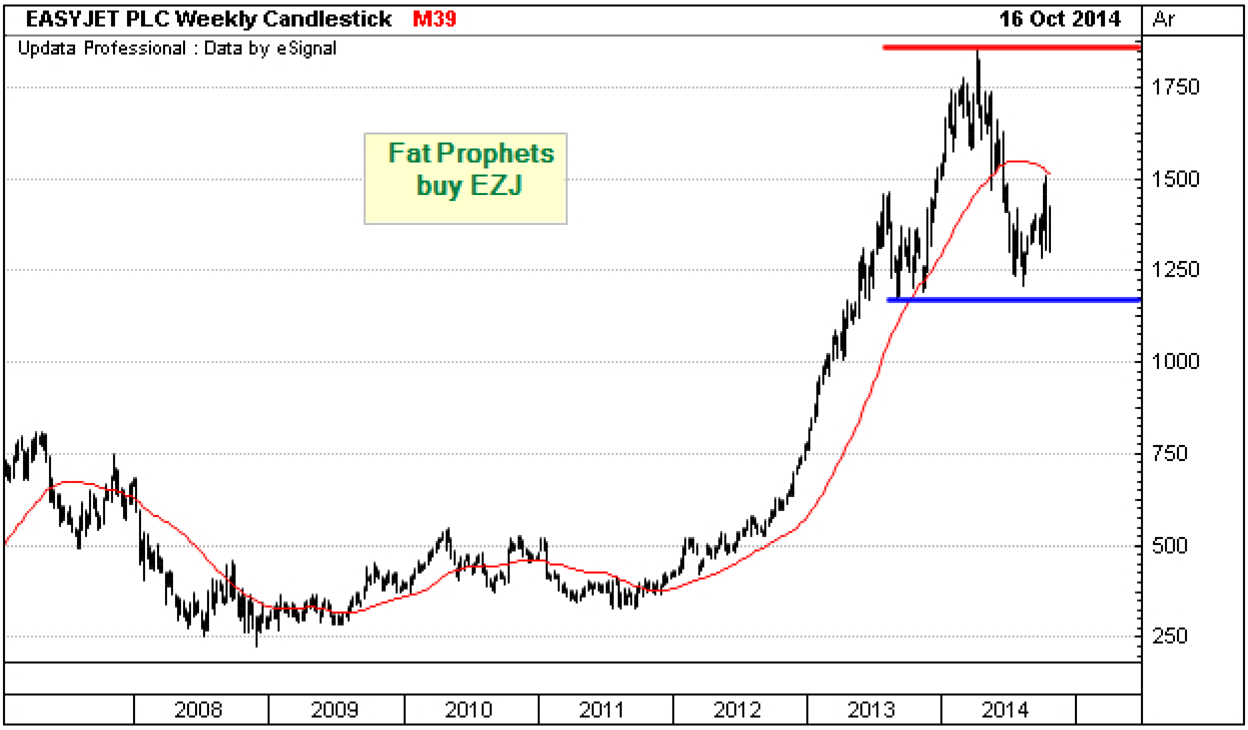
Currently easyJet is on around 11X forecast earnings for the year to September 2015. However, the growth story at the group sees this fall to around 7X in the year to September 2018 suggesting meaningful upside potential.

Brand and customer proposition

- Pan-European
- Strong and improving affinity and recognition scores
- Engaging communication
- Easy and affordable

Growth should also not come at the expense of returns on capital with easyJet having seen higher returns as it has grown. This is due to factors like economies of scale as the market share at any one airport increases.

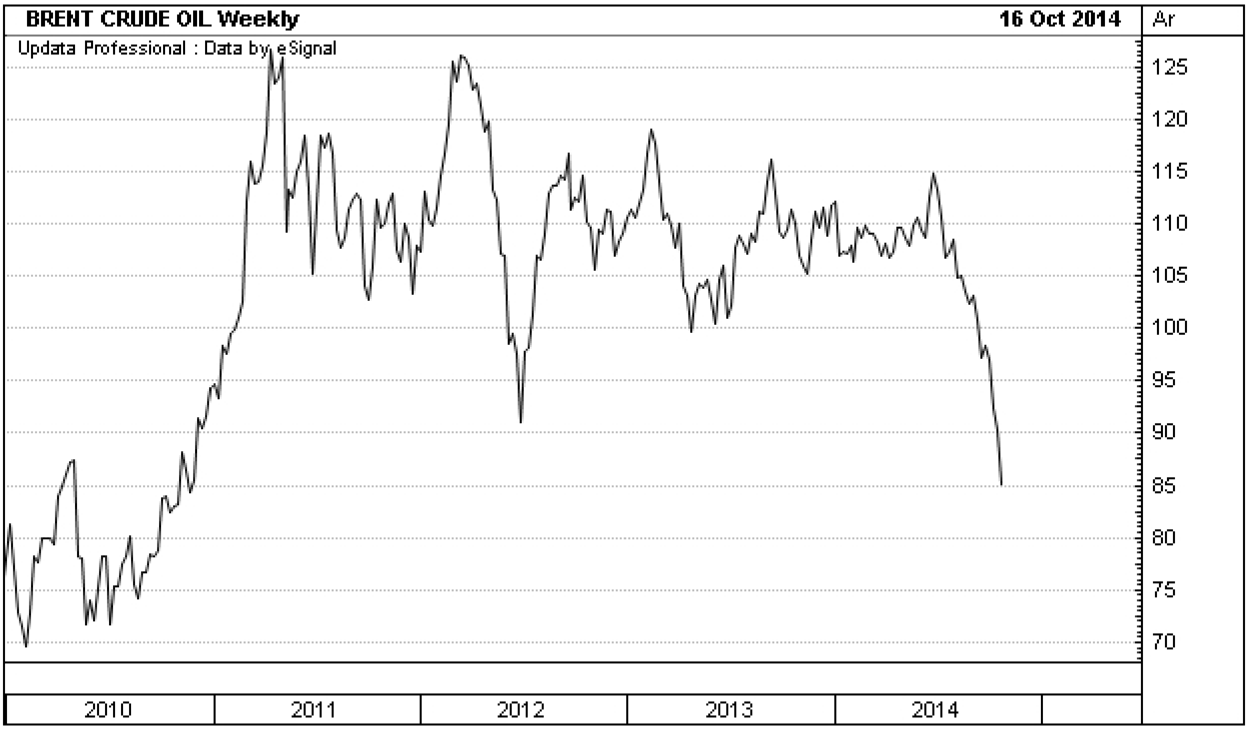
The share price has been in a bull run for a period of twenty four months up until first week of last April. Since then there was a correction with prices returning to its support at 1196p. Positively, the ensued rotation higher and the break above the 50-day moving average serves as a good precursor for further gains in the midterm. Therefore, should the prices conquer its long term 200-day moving average it will set the stage for the continuation of the ongoing recovery.



Oil price weakness

When we looked at easyJet last week Brent oil prices were around US$91 a barrel but have since fallen to under US$84 a barrel. The near 8% drop fall has taken Brent oil to the lowest since late 2010 i.e. around four years ago.

Brent oil prices



On Tuesday the International Energy Agency (IEA) cut its outlook for oil demand growth by a 22%. As such oil demand is expected to grow by 700,000 barrels a day this year versus 900,000 previously forecast.

At the same time oil production has been growing with OPEC increasing monthly production to the highest in 13 months. Non-OPEC members have also been increasing output with the US the key driver.

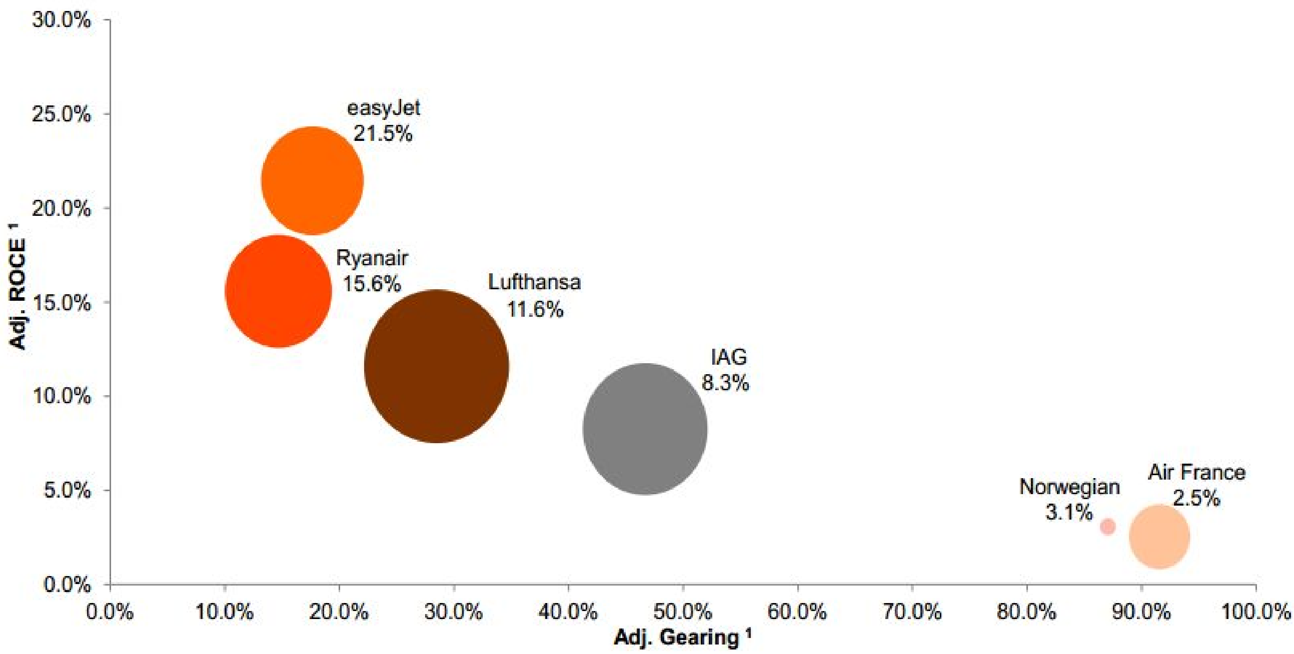
Looking to 2015 and the IEA belives that demand growth may increase by 1.1m barrels a day. However, it also notes that oil supply is set to increase strongly and as such weaker oil prices look set to be here to stay for some time.

This is a clear benefit to airlines where fuel costs are a third of the total for narrow body aircraft. For budget airlines like easyJet narrow body, or single aisle aircraft, are all or the vast bulk of the fleet.

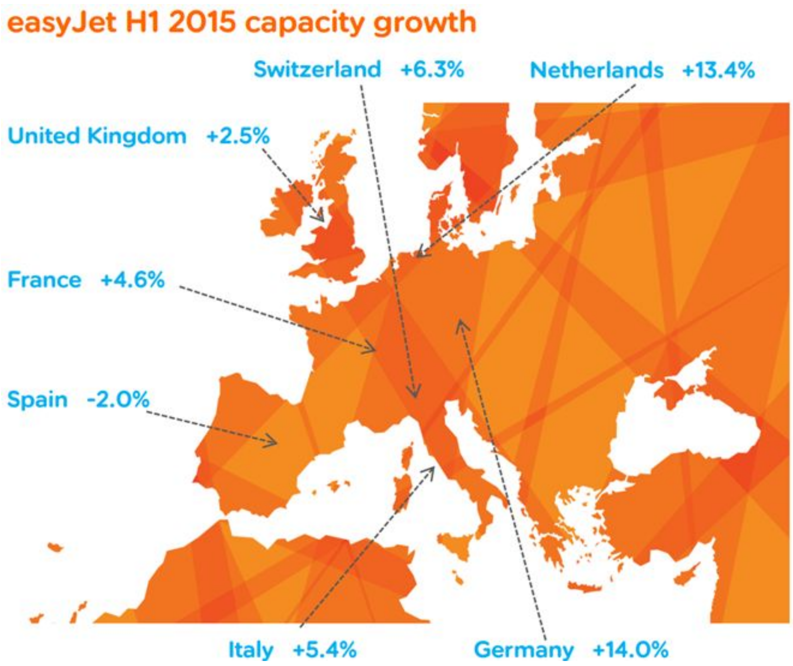
EasyJet's financial proposition

Even without this boost easyJet appears to be well placed given industry leading returns on capital and relatively low levels of gearing. This provides a compelling combination of high returns and low risk for the industry.

Easyjet offers high financial returns and low financial risk



With a focus on the whole of Europe the group is also able to focus on those economies which offer growth. In the first half of 2015 the group is expecting to decrease its capacity in Spain, for example, but grow it elsewhere.



London Gatwick

- 9% capacity growth following purchase of Flybe slots
- Thickening routes such as Amsterdam, Inverness and Vienna

Amsterdam

- New base opening in Spring 2015
- New routes include Hamburg from November 2014

Hamburg

- New base opened in 2014
- Now connecting 23 points of the easyJet network

Easyjet risks and rewards

Set against the impressive performance to date easyJet is likely to be a volatile and risky investment. A current key risk is the prospect of a further European downturn and the chance that an outbreak of ebola will hit air travel.

These risks are hard to quantify but the volatility of airlines is real with easyJet's shares having fallen from £7.20 in early 2007 to £2.20 in late 2009. Ryanair's share price fell from a peak of €6 to €2 over the same period.

As such while the long-term investment returns from both groups have been strong they have also been volatile and cyclical. A further downturn in Europe would inevitably see the share prices of easyJet suffer a significant hit.

With regard to the ebola virus this is what is often referred to as a "black swan" or a "long-tail" event. Something which is very unlikely to occur but such extreme negative events do occur every so often.

However, on the reward side of the coin no matter what the risks the airline industry faces the budget airlines should be survivors. With higher load factors and lower price points they will inevitably be the "last man standing."

This doesn't mean that they won't see extreme share price volatility but it does mean that they should come out on top. On this front we note that Ryanair and easyJet have some of the lowest rates for adjusted gearing in the industry.

At around 20% it is much lower than Germany's flag carrier Lufthansa at around 30% and International Airline Group at just under 50%. The budget airlines are clearly operationally and financially resilient.

Competitive position: Ryanair waiting in the wings

A clear risk for easyJet in the longer-term is the growth of the ultra-low cost airline Ryanair. The company is undertaking aggressive growth in Europe and is keenly focused on offering lower prices than peers.

Ryanair is a fierce price competitor

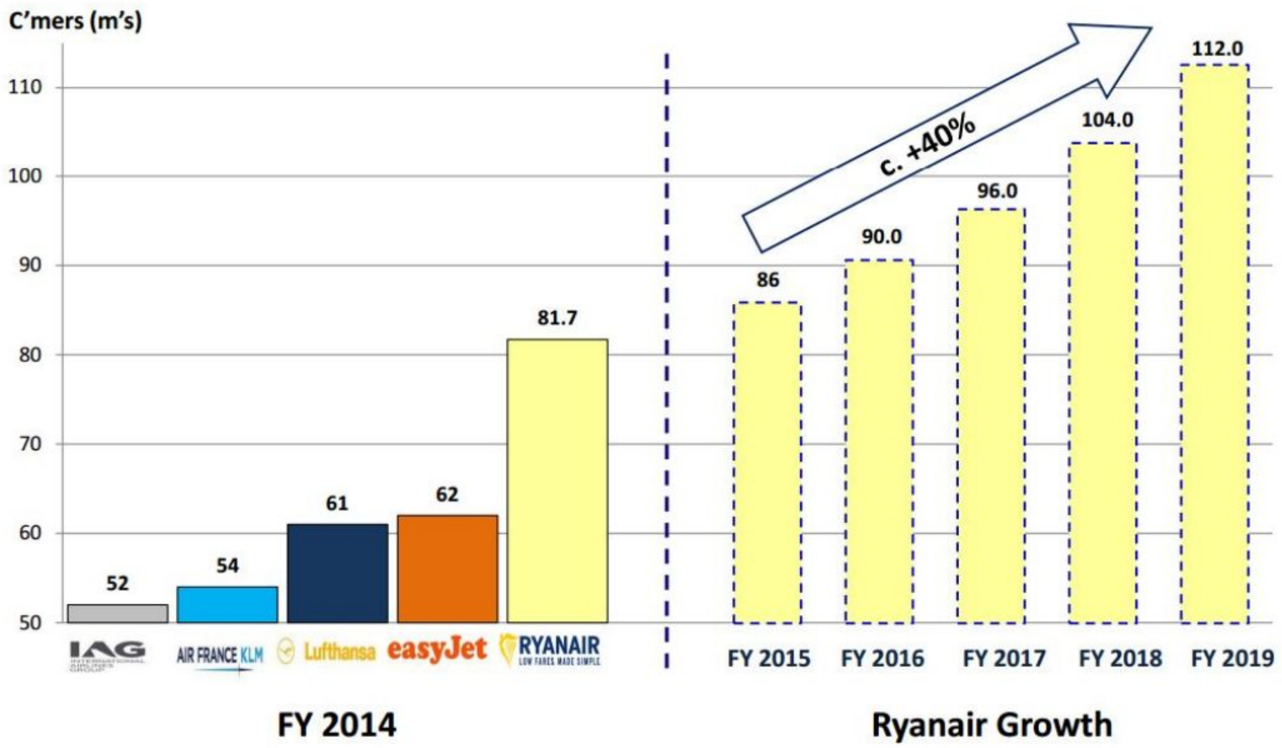
		Avg. Fare	% > Ryanair
LOW	**Ryanair**	**€46** (-4%)	
MEDIUM	Norwegian	€83	**+ 80%**
	easyJet	€84	**+ 83%**
	Aer Lingus (s/h)	€93	**+ 102%**
	Air Berlin	€121	**+ 163%**
HIGH	Alitalia	€148	**+ 222%**
	Lufthansa	€235	**+ 411%**
	IAG	€242	**+ 426%**
	AF-KLM	€300	**+ 552%**

Source: Latest company annual reports

However, we believe easyJet offers an attractive combination of quality and relatively low pricing. Ryanair is trying to move up the quality curve but it appears unlikely to be able to change its culture anytime soon.

On the GlassDoor website less than a third of Ryanair reviewers would recommend it to a friend and less than a fifth approve of the CEO. By contrast at easyJet 80% would recommend it to a friend and all approve of the CEO.

Ryanair is going for growth



We also note that Ryanair focuses much more on non-primary airports while easyJet is almost totally at primary airports. This allows easyJet to attract higher paying and more price sensitive customers.

Summary

We gave more detail on easyJet in last week's report and as such in this update we are reflecting more on the risk to reward ratio. Given the prospect for a European slowdown and ebola to hit air travel we are rating the stock high risk.

However, we expect the risk profile to come back to medium risk when the ebola outbreak dies down. The economic risks in Europe are clear but easyJet has a strong exposure to the UK which is performing well.

On balance we believe the strong end of year-trading statement provides a good opportunity to buy easyJet ahead of full year results in November. This is not least as the weaker oil prices should help lift margins going forward.

As a high risk position it is not unlikely that we are incorrect in our timing and as such risk averse investors may look to buy over time. On paper at least easyJet offers a strong combination of growth, high returns and a modest valuation.

Airline travel tends to grow over time while the budget airlines are also taking market share from the established players. As such on a forecast P/E ratio of around 11X for the current financial year easyJet doesn't appear expensive.

Accordingly, we recommend easyJet to all members as a high risk buy.

Snapshot EZJ

easyJet

Latest Closing Price: £14.00

easyJet plc and its subsidiaries is a airline carrier operating principally in Europe. The Company operates approximately 600 routes across more than 30 countries with its fleet of over 200 Airbus aircraft.

Market Capitalisation:£5.5bn

	FY1	FY2
Price to Earnings	11.9	10.7
Dividend Yield (%)	3	3.4
Price to Book	2.5	2.2
Return on Equity (%)	21.2	21.5