Spirit Airlines: The Next Ryanair

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The Basics

- Stock price (10/30/17 close): $36.92
- Market cap: $2.6 billion
- Cash: $964 million
- Debt: $1,320 million
- Enterprise value: $2.9 billion
- TTM EPS: $3.15
- 2017 est. EPS: $3.04
- 2018 est. EPS: $3.26
- P/E (TTM): 11.7x
- P/E (2018 est.): 11.3x
- EV/EBITDA (TTM): 6.0x
- Revenue (TTM): $2.6 billion
- EV/S (TTM): 1.1x

There are very few companies I'm aware of that are growing revenues 10%+, with 15%+ operating margins, 15%+ returns on equity, whose stocks are trading at a P/E of ~11x

Spirit's Stock Has Been Extremely Volatile

Spirit's Stock Is Down 35% This Year, the Worst of Any U.S. Airline By Far

Spirit Is A Rapidly Growing Ultra-Low-Cost Carrier

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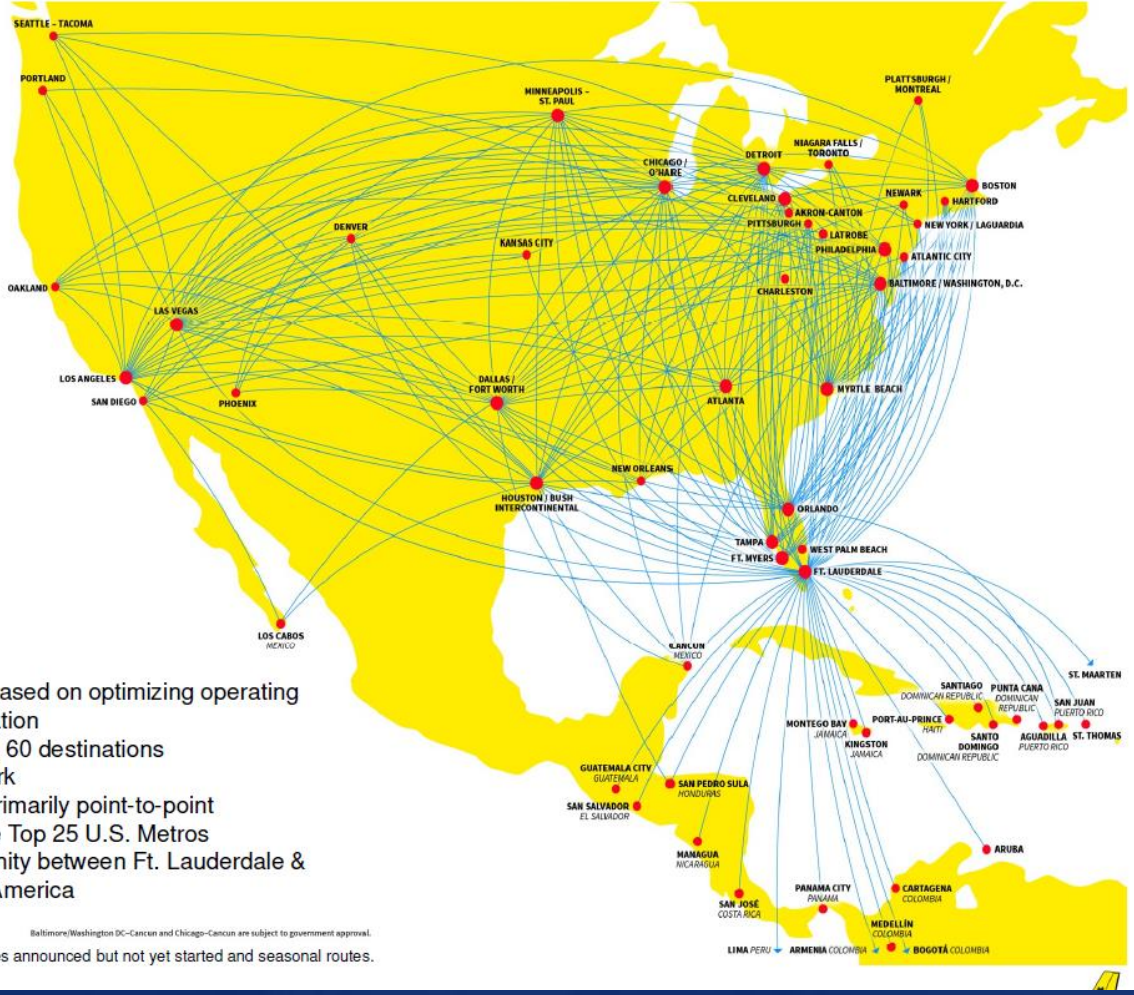
Serving Over 225 Non-Stop Markets



- Route selection based on optimizing operating margin and utilization
- 470+ daily flights, 60 destinations
- Diversified network
- Low frequency, primarily point-to-point
- Serve most of the Top 25 U.S. Metros
- Demographic affinity between Ft. Lauderdale & Caribbean/Latin America

Baltimore/Washington DC–Cancun and Chicago–Cancun are subject to government approval.

As of July 2017, includes routes announced but not yet started and seasonal routes.
--- = seasonal

Source: Spirit investor presentation, 8/17.

Growth

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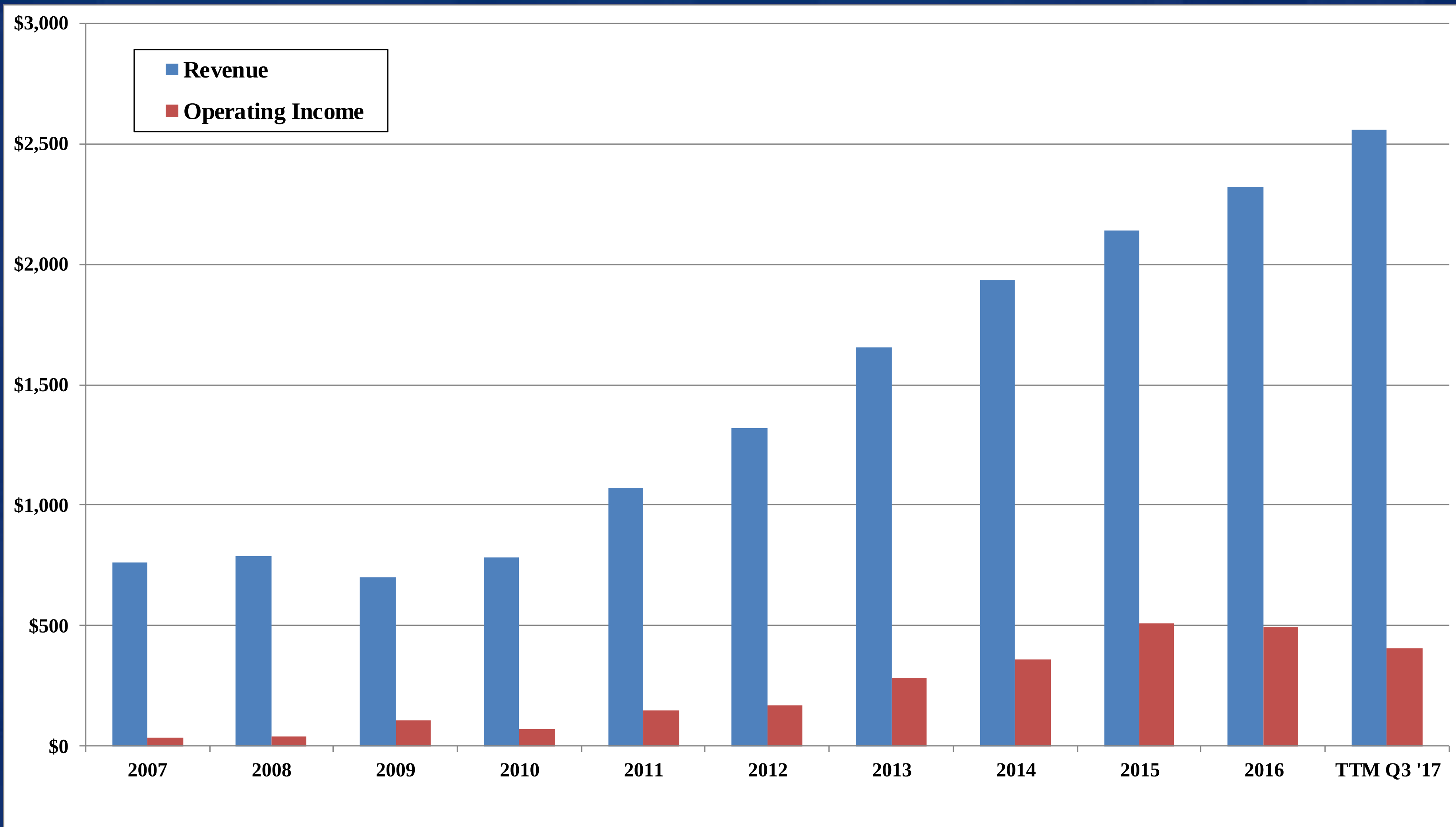
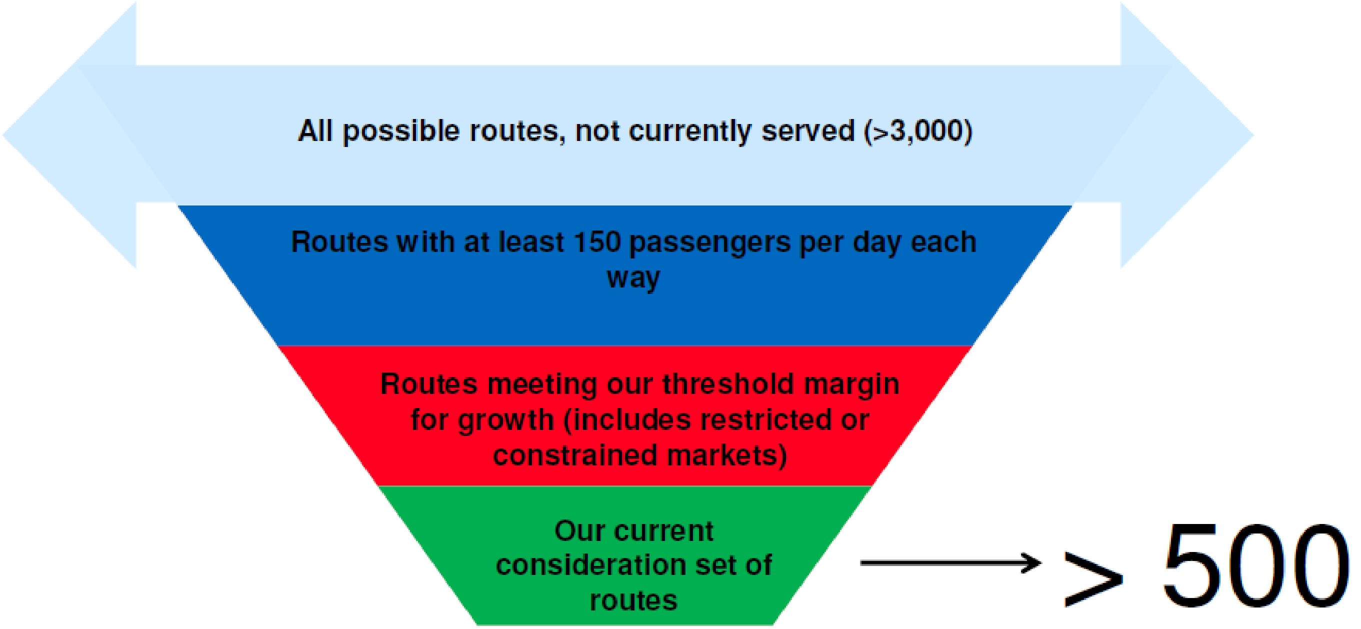
Spirit Has Grown Its Revenues at a High, Steady Rate, But Profits Have Lagged in 2016-17



Spirit Has a Long Runway for Future Growth

Addressable Market Remains Very Large

Spirit's market opportunities far exceed the anticipated number of new markets to be launched over the next five years.



Number of routes we plan to add in the next 5 years: ~125

Source: Spirit investor presentation, 8/17.

Spirit Has the Potential to Follow in Ryanair's Footsteps

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European Low Cost Providers' Share Growth

U.S. Low Cost Providers' Potential

Notes: Slide courtesy of Kellogg MBAs Justin Hess, Alexander Hunstad, David van der Keyl.
Other ULCCs (ultra-low-cost carriers) include Easyjet, Vueling & germanwings in Europe and Frontier & Allegiant in the U.S.
Source: OAG Aviation Worldwide.

I Think the Best Comp for Spirit Is Ryanair, Which Has Been Enormously Successful in Europe

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Ryanair ADR Since 2002

Spirit's Cost Advantage

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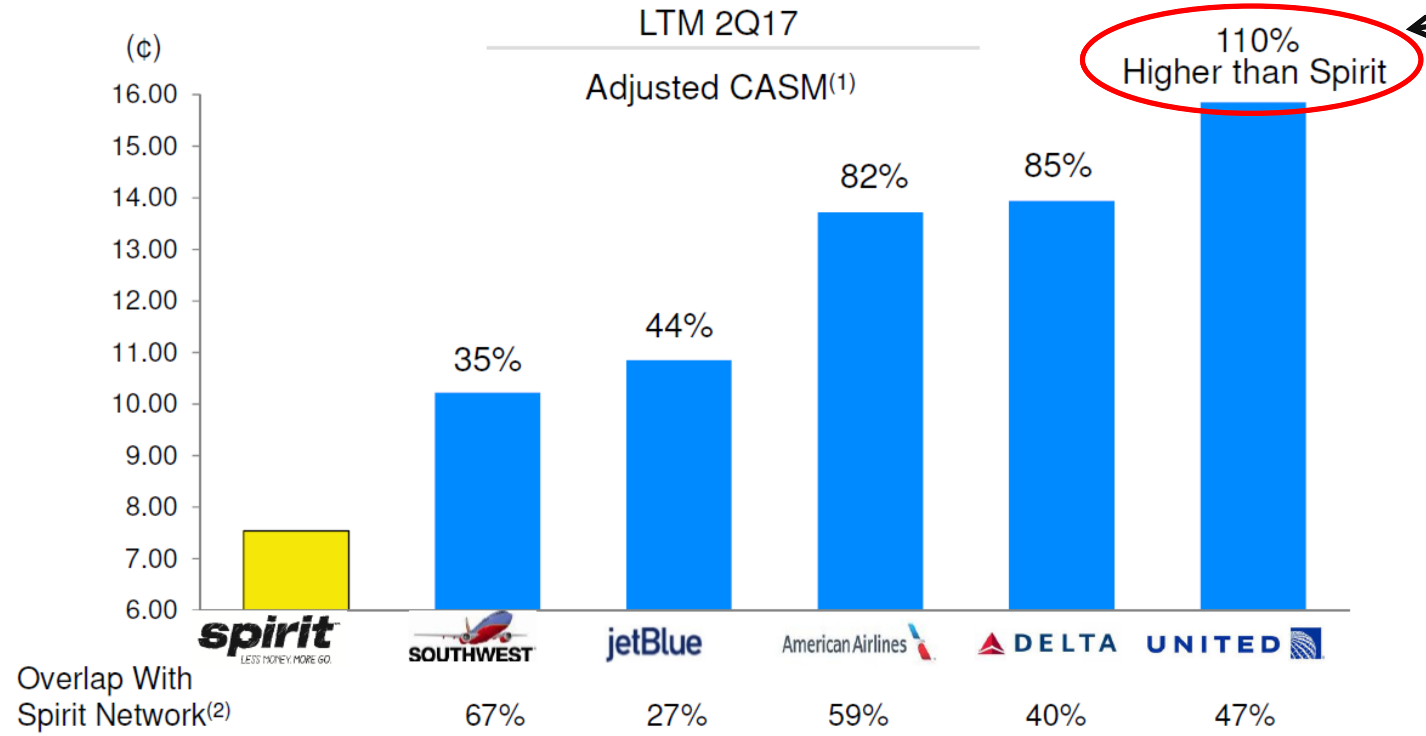
Spirit's Costs Are *Massively* Lower Than Other Airlines

Lowest Cost Producer in Our Primary Markets

Spirit's unit cost advantage is one of our most important assets. We believe that our relative cost advantage will increase over the next five years.



With costs more than double Spirit's, United cannot win a price war – though it can inflict short-term pain

1. Cost data based on public company reports for the twelve months ended 06/30/17. Reflects mainline operations only. Stage length adjusted to Spirit's average stage length for twelve months ended 06/30/17, formula = other airline CASM x (other airline stage length / Spirit stage length)^0.5. Stage length for American, JetBlue, and Southwest derived from company reports for the twelve months ended 06/30/17; Delta and United derived from Form 41 data for the twelve months ended 03/31/17. Excludes special items and unrealized mark-to-market gains and losses for all carriers shown. See Appendix for reconciliation detail for Spirit Adjusted CASM.
2. Based on publicly available data as of July 24, 2017 for routes operated or scheduled to be operated in 3Q17 (includes seasonal markets served in the period). Airports within same metropolitan areas considered single market.

Source: Spirit investor presentation, 8/17.

Spirit's Growth and Profitability Are Driven By Its Ultra-Low Costs

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- Ultra-low-cost carriers (ULCCs) like Spirit, Allegiant and Frontier in the U.S. and Ryanair, Easyjet, etc. in Europe are not to be confused with low-cost carriers like Southwest, JetBlue and Virgin America
- ULCCs have an extremely low cost structure, usually driven by:
  - One type of plane and one class of service
  - Cramming the maximum number of seats (~20% more) onto every plane by reducing legroom and having seats that don't recline
  - No seat-back pockets, window shades, wifi or entertainment systems
  - All direct flights (no hub-and-spoke)
  - Limited (or no) customer loyalty/frequent flyer programs
  - Personnel who do multiple jobs (e.g., flight attendants who also clean the plane and act as gate agents)
  - Turning aircraft quickly and flying at all hours, thereby maximizing daily flight time (~13 hours/day for Spirit; ~12 for JetBlue; ~11 for Southwest)
  - Flying out of regional or secondary airports
- Consequently, ULCCs offer extremely low base fares – and then charge extra for nearly everything such as a seat assignment, any bag beyond a small carry-on item, all drinks and food, etc.
- While these extras cause some travelers to feel nickeled-and-dimed, almost all travelers on Spirit pay less in total than they would on any other airline

Spirit Stimulates Demand

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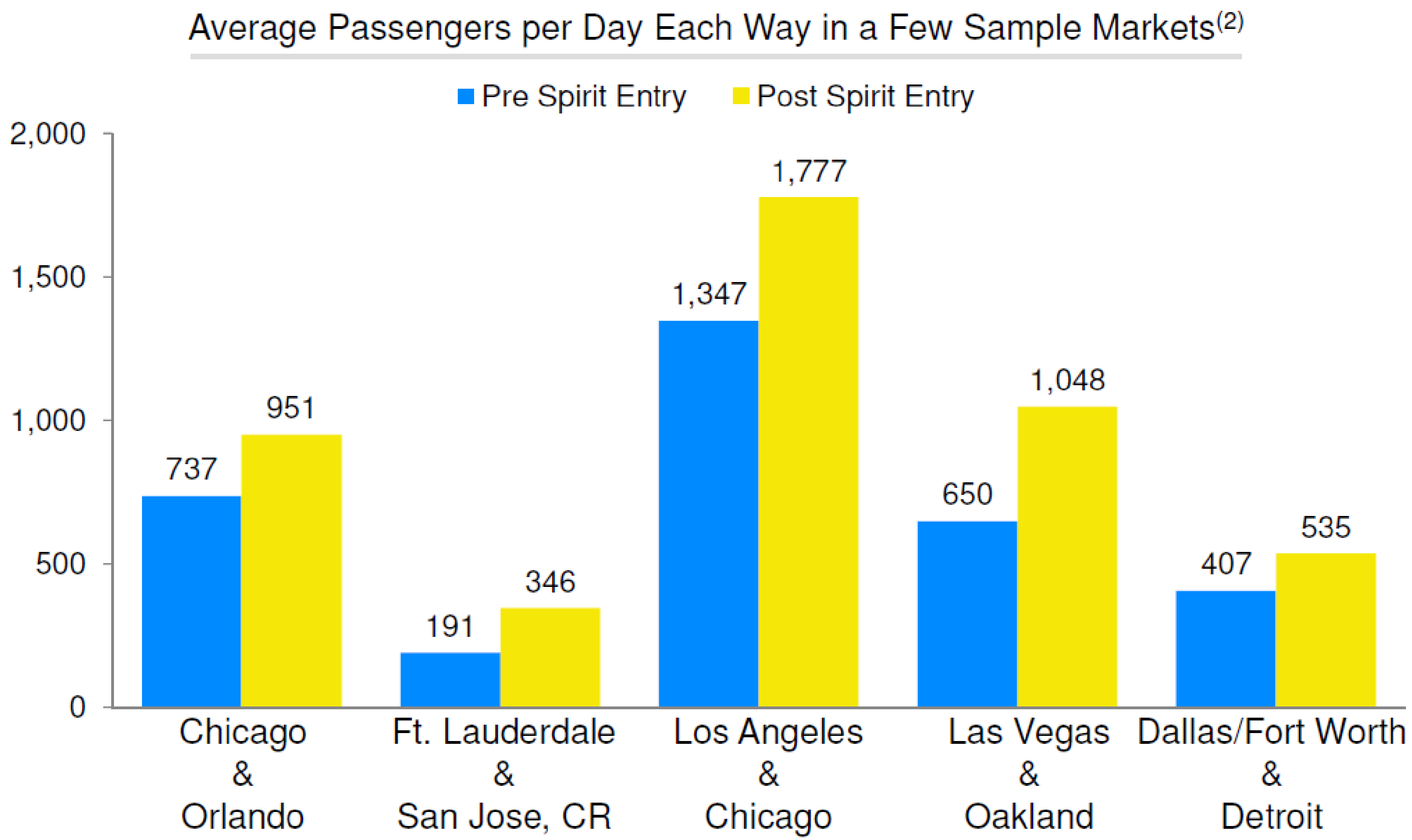
Spirit's Entry Grows the Number of Travelers

When fares are low, more people fly more places more often. On average, Spirit's low fares grow the traffic base by 35-40%[1]



Source: Spirit investor presentation, 8/17.

Why Has the Stock Been Crushed This Year?

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- Spirit opened one gate at Newark, a United hub, which caused United to retaliate with an aggressive price-matching strategy in June (what I call a "spanking action") that has impacted Spirit's revenue and margins (ticket revenue per passenger flight segment was down 3.2% YOY in Q3)
- This price war has led analysts to project that Spirit's earnings per share will be down 26% in 2017 and only rebound 7% in 2018
- In summary, the near-term outlook for Spirit is cloudy, leading analysts and investors to fear the worst (more revenue and earnings reductions), so most of them don't want to own the stock until there's more clarity
- The growth investors who owned this stock above $60 hate no growth, even for a year, so they've fled – and no self-respecting value investor would ever own an airline stock, right?
- This is exactly what happened in 2015, except it was American leading the price war
- Eventually the price war ended and the stock nearly doubled

But What About Travelers Hating Spirit?

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A Disturbingly High Percentage of People Despise Spirit

- Show of hands:
  1. Raise your hand if you've ever flown Spirit
  2. Raise your hand if you've had at least one terrible experience flying Spirit
  3. Raise your hand if you know someone who's had such a terrible experience flying Spirit that they vowed never to fly it again
- A review in AirlineReporter.com:
  - It's true, people vehemently despise Spirit Airlines. Just the mention of the company elicits emotion-filled horror stories. Indeed they have a solid 1 out of 5 star rating on TripAdvisor, and they are frequently found at, or near, the top of various "worst airline" rankings. In direct contrast to these ratings and frequent "I'll never fly Spirit again" claims, the airline continues to grow and increase market share.

Spirit's Customer Service Problem

- Spirit's customer service problems fall into two areas: reality and perception
- Reality
  - According to the Department of Transportation, Spirit consistently is among the worst airlines in terms of late arrivals, cancellations, and "bumping"
  - Spirit's complaint rate in Aug. 2017 was ~3x higher than average (4.91 complaints/100,000 enplanements vs. 1.50)
    - This is terrible, but it's a dramatic improvement from previous years and only one complaint for every ~20,000 passengers
  - On the plus side, the rate of mishandled bags was second lowest in Aug. 2017
- Perception
  - Many of Spirit's customers (especially first-time ones) aren't used to being charged for extras and therefore resent it, but this is becoming less of a problem as more and more of Spirit's competitors create comparable bare-bones products
  - Spirit is doing a better job of setting expectations

Analysts and Investors Are Not Average Americans and Thus Shouldn't Overweight Their Own Experiences and Behavior

- I made this mistake and it was costly: the stock was ~$20 when I first looked at it in early 2013 – and then it quadrupled to above $80 in less than two years:

- It was a mistake to think about this from my perspective, not the average Americans': I am willing/able to pay an extra $50-$100 for a flight with better service, a few extra inches of legroom, a seat that reclines, etc., but many (most?) Americans don't have this luxury
- As an article in AirReporter.com notes:
  - Ultra-low-cost carriers can be a great option. They can provide you fast and safe transportation, the cheapest way possible. If you only care about getting your body from one place to another, without frills or high expectation of service, you cannot beat an ultra-low-cost carrier. It is about being an informed customer and doing the math to make sure you are choosing the right airline. I don't walk into McDonald's expecting a delicious meal. I expect to get a cheap meal and mediocre service. Why would a passenger pay for an ultra-low-cost airline and expect MGM Grand Air level of service?

Summary: Price Target

- Most companies with Spirit's characteristics – growing 10%+ annually with a long growth runway and 15%+ operating margins and returns on equity – trade above 20x earnings
- Ryanair and Southwest consistently traded at 15-20x forward earnings in the early stages of their growth cycles
- Applying a 15 multiple to 2018 estimates of $3.26 results in a stock price of $49, 33% above today's price
- That sounds about right to me for a one-year target – and I think the upside is much higher over many years, which is how long I hope to own this stock