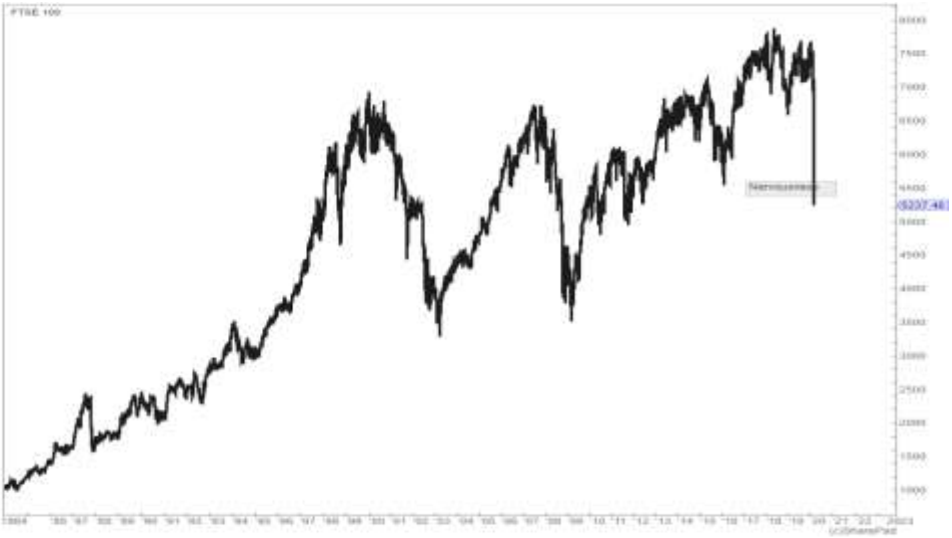
Jeremy Grime's Weekly Commentary

Exclusively for SharePad & ShareScope subscribers

Timing is everything

16 March 2020

Bull markets go up most days and go down sharply on bad news. Bear markets go down most days and go up sharply on good news. It is pretty clear where we are now. At times of pain perspective can help. Alongside extended holidays. And hobnobs. The chart of the FTSE 100 index since it started in January 1984 could be inclined to cause an investors' "buy" nerve to start to twitch.



Source: SharePad

However, my suspicion is we have a while to go yet. A look at the table below soon calms those buying impulses. During the last two crashes the market fell close to 50% which suggests that this bear market could fall further. But what seems more probable is that this bear market will last more than one month. On average since world war 2 bear markets have lasted 14 months while the financial crisis lasted 27 months and the tech bubble unwind lasted 17 months.

Peak	FTSE 100	Trough	FTSE 100	Fall (%)	Duration Months
Dec-99	6930	Mar-03	3436	50.4%	27
Oct-07	6730	Mar-09	3512	47.8%	17
Feb-20	7457	Mar-20	5237	29.8%	1

Source: thisismoney.co.uk

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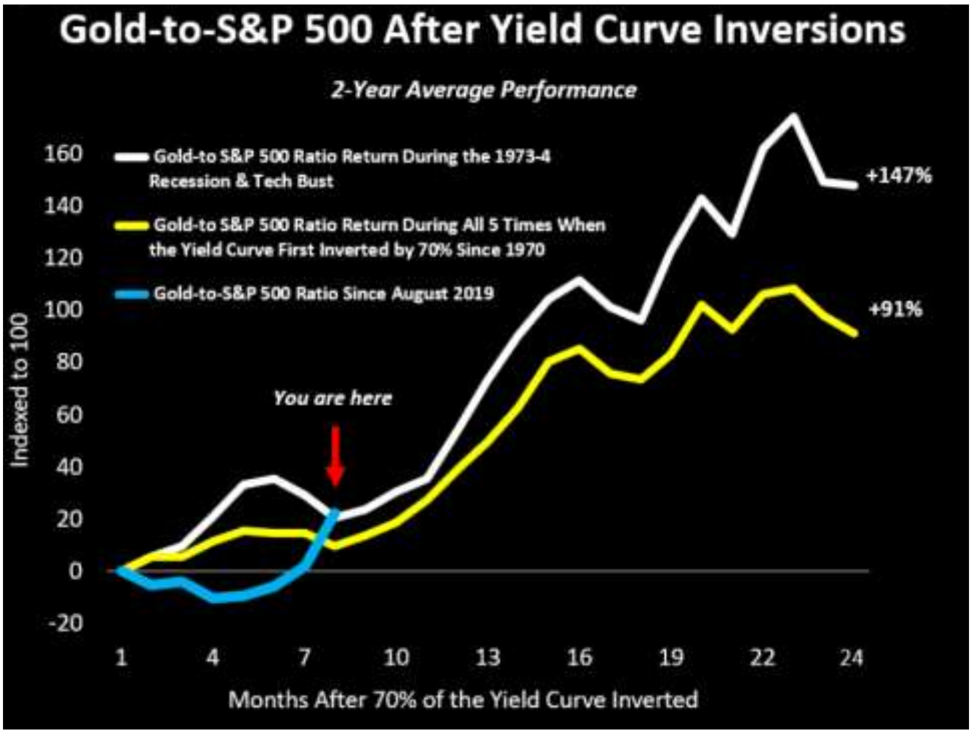
The speed of the governments co ordinated response has been fast this time with rate cuts, fiscal bail outs in the budget, and trillion dollar stimuli, so it is conceivable that the slow down caused by corona virus will be short lived, but with UK GDP at zero growth before the virus we are probably already in a recession.

Yield Curve

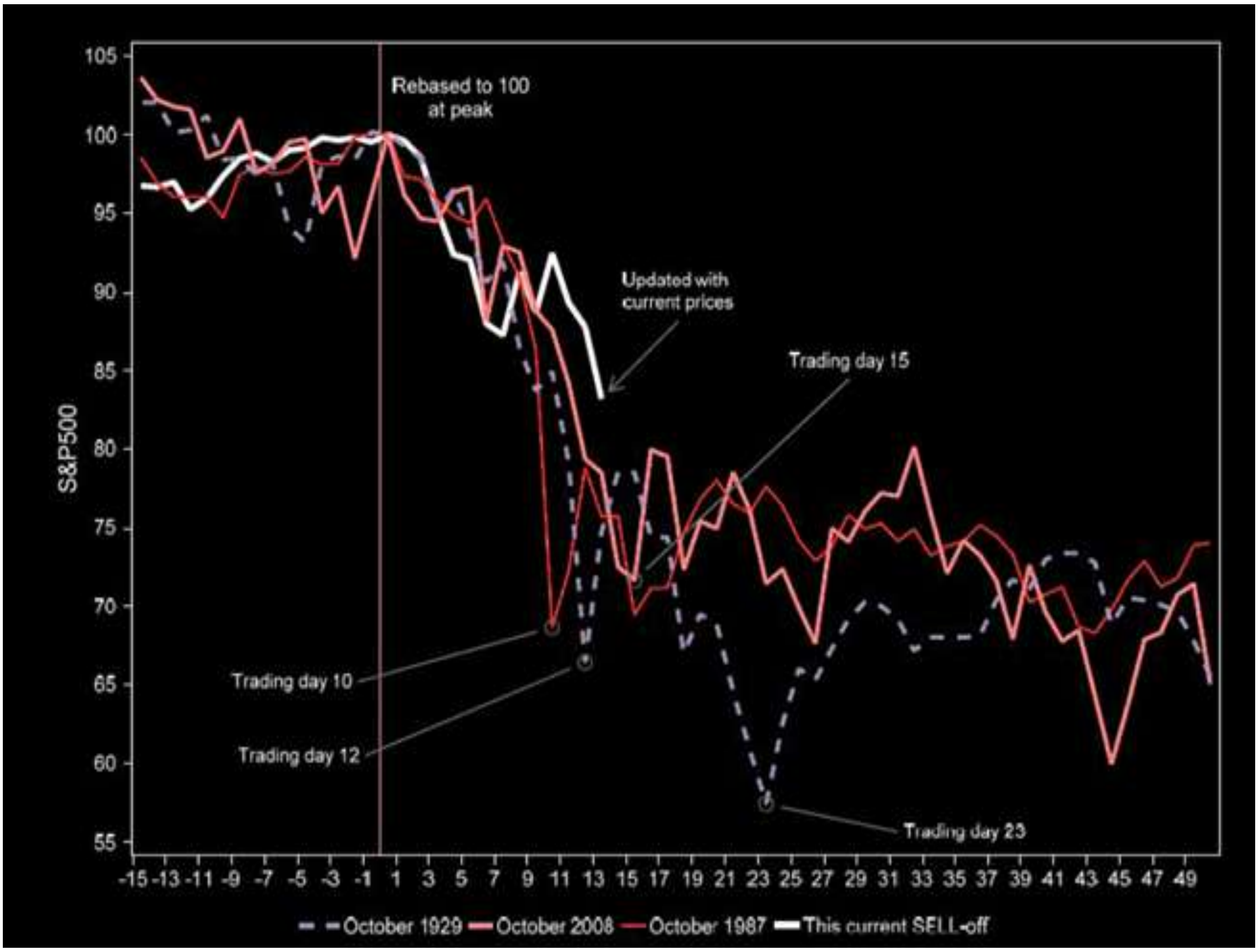
The credit markets are better than equity markets at predicting recessions. I suspect it is because credit markets are so much more liquid than equity markets, they can be more efficient. An inverted yield curve, which is lower yields on 10-year bonds than 2-year bonds, has preceded every recession since the 1950's. This inverted last August. And yet the credit markets can't have known about the virus which was about to be unleashed in Wuhan. Perhaps the virus, or the Saudi's fighting with the Russians over the oil price, is merely the catalyst that the market was searching for, rather than the cause, of the bear market. At the end of the day markets are dictated by human nature.

And human nature doesn't allow bear markets to be finished with in 1 month. A chart from Zerohedge compare the relative performance of gold with the S&P 500 during yield curve inversions. Interestingly the shape of the line is similar for each time the yield curve inverts, underlining that the performance is dictated by the animal spirits of human nature. And we are only 7 months post yield curve inversion.



Source: Zerohedge

This chart suggests there is no hurry to go piling into the market. Further evidence of this arrived last week when Chris Watling of Longview economics produced a useful illustration of the psychology of a bear market, suggesting we are tracking along similar lines to 2008 and 1929.



Source: Longview economics

Cyclicals?

The more pertinent question may be which stocks to buy for the recovery, when it comes. Those long-term quality stocks such as Andrews Sykes have outperformed the market in the last month while some cyclicals have been carted off the pitch. If there is ever a time to own a cyclical it is in a recovery. When we are done with corona virus, the recovery will be sharp and fast, ensuring that everyone who has been resting on the side-lines warmed by the glow of their cash pile, will miss the boat. So, it may be time to dust off the cyclical folder.

The table below illustrates that except for oil equipment, Travel & Leisure has been hardest hit in the last 20 trading days. Both very cyclical sectors. While at the other end of the table it is possible that Food and drug retailers have enjoyed buoyant sales of toilet roll and painkillers.

FTSE 350 Sector	**%chg 20td**
Oil Equipment, Services	-44.2
Travel & Leisure	-41.7
Oil & Gas Producers	-41.7
Automobiles & Parts	-40.8
Industrial Metals	-38.3
Life Insurance	-38
General Retailers	-34.8
Mining	-31.5
Software & Com Services	-30.3
Mobile Telco	-30.3
Financial Services	-30
General Industrials	-29.1
Media	-29.1
Construction & Materials	-28.6
Support Services	-28.4
Industrial Transportation	-28.1
Food Producers	-28
Banks	-27.5
Fixed Line Telco	-26.8
Household Goods	-26.4
Real Estate IT	-25.2
Health Care Equip.	-25.2
Aerospace & Defense	-24.5
Real Estate Inv. & Servs	-24.1
Leisure Goods	-23.5
Ind. Engineering	-23.3
Chemicals	-22.4
Electricity	-22.4
Beverages	-21.9
Nonlife Insurance	-21
Tobacco	-20.8
Investment Instruments	-19.2
Forestry & Paper	-18.5
Personal Goods	-18.4
Electronic & Electrical	-18.1
Gas, Water & utilities	-17.7
Technology Hardware	-17.3
Pharma. & Biotech	-14.5
Food & Drug Retailers	-11.9

Source: SharePad

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The most cyclical stocks are airlines whose share prices have understandably been hard hit on the back of the virus. Should we be buying these airline stocks in the downturn, or is it akin to buying the banks in 2008 when they will all be wiped out yet?

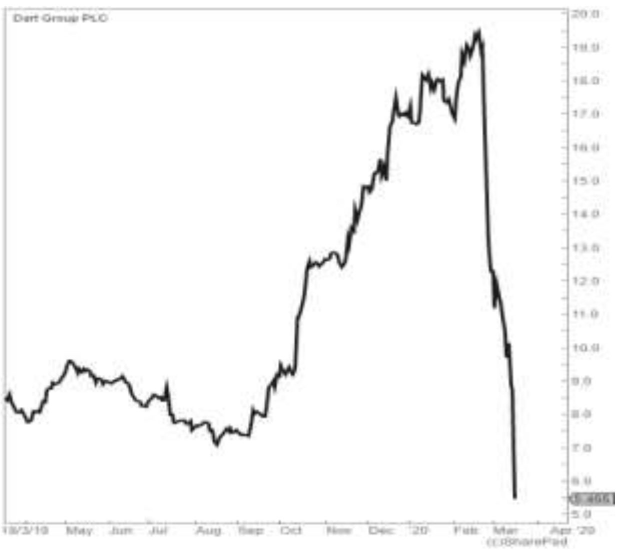
No.	Name	Price	%chg 20td
1	TUI AG	360p	▼-59.9
2	Dart Group PLC	871p	▼-54.1
3	On The Beach Group PLC	207.6p	▼-51
4	easyJet PLC	786.8p	▼-47.5
5	International Consolidated Airlines Grou...	350.3p	▼-45.2
6	Wizz Air Holding PLC	£27.35	▼-39
7	Ryanair Holdings PLC	€10.50	▼-32.4

Source: SharePad

One of the most conservatively run airline stocks is Dart Group, partly because of its fanatic founder Philip Meeson. An ex-RAF fighter pilot, he got the money to found the company by trading around 800 second hand Citroen 2CV's between Europe and London, alongside founding an aerobatics team. He won the British championship five times and obtained lucrative sponsorship from Marlboro. People close to him say he has a singular focus on running the business, regularly checking last night's bookings after waking up. He has a long track record of meeting or exceeding expectations.

Dart Group

Share Price 554p
Mkt Cap £825m (Intraday)



Source: SharePad

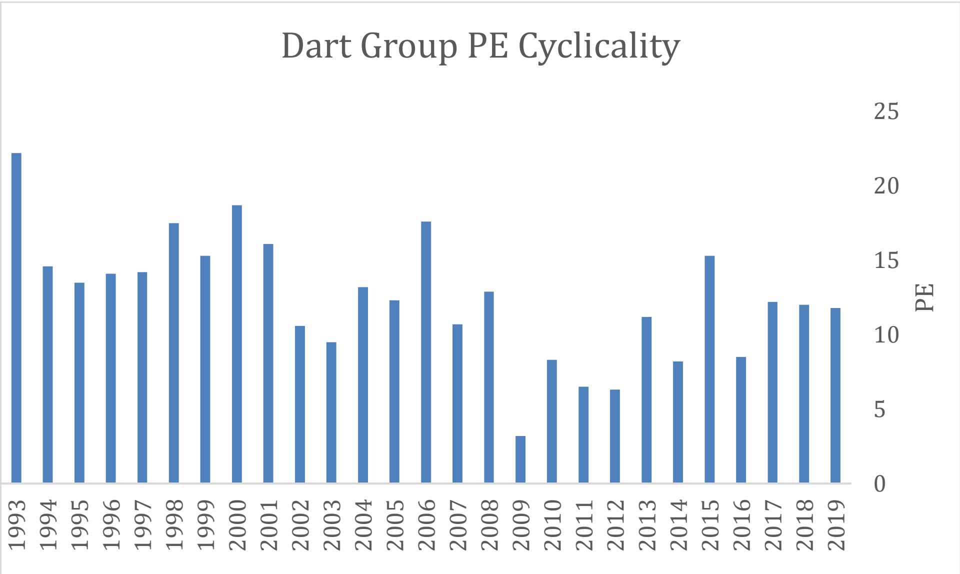
In the cyclical travel industry weak operators go bankrupt and survivors emerge stronger. Dart group benefitted from Thomas Cook going bankrupt last year as it's share price more than doubled. But what the market gives the market takes away. Flybe has now gone too, British Airways and Virgin aired their crises over the week end with staff but there is now also a significant future tailwind through lower fuel costs in the future. So, survivors are likely to prosper.

Business

This is largely a play on Jet 2 which accounts for 95% of the company's revenue. This is an owner operated low cost airline and package holiday provider. It has grown profitably by avoiding route competition and operating mostly older aircraft. An analysis from Jefferies who screen scraped Google flights prices comparing Ryanair, Wizz, easyJet and TUI confirmed that Jet 2 was cheaper on around 60% of the 550 routes scraped. This is achieved by using opportunistically acquired older aircraft when airlines go bankrupt. That opportunity may soon present itself once again.

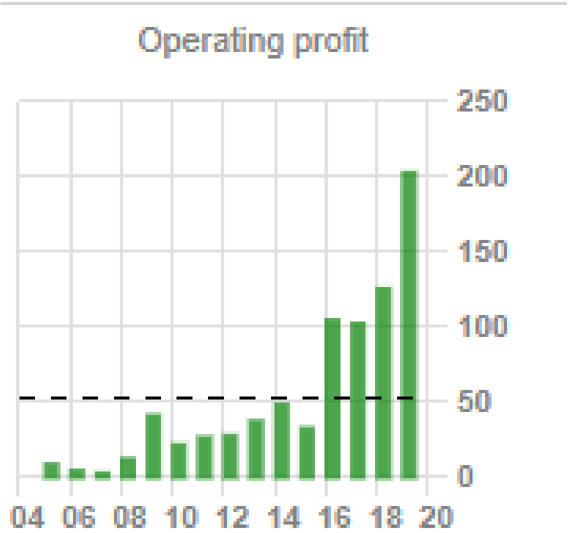
Cyclicality

In 2016-2018 the stock market was worried. In late 2015 Jet2 ordered 27 (later increased to 34) Boeing 737's. The list price was $3bn at a time when Dart Group's operating profit was £50m, although commentators speculate that Dart would have obtained a 52%-55% discount from Boeing. As the company moved from net cash into debt while Brexit loomed the shares sank to 350p which was a £500m market cap. With £250m net cash the company was trading at the time at an EV/EBITDA of 1.4X. The valuation cyclicality in PE terms is here:



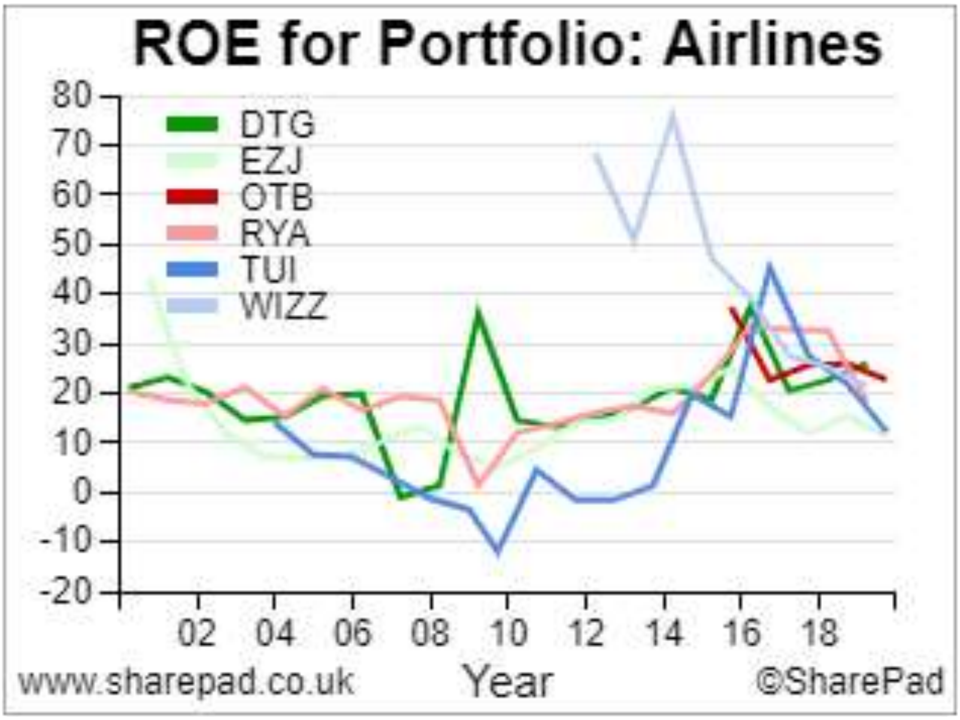
Source: SharePad

Over the last 12 years the operating profit has grown strongly



Source: SharePad

And The ROE, now higher than any of it's peers, has been improving while peers ROE have been declining on the back of Brexit



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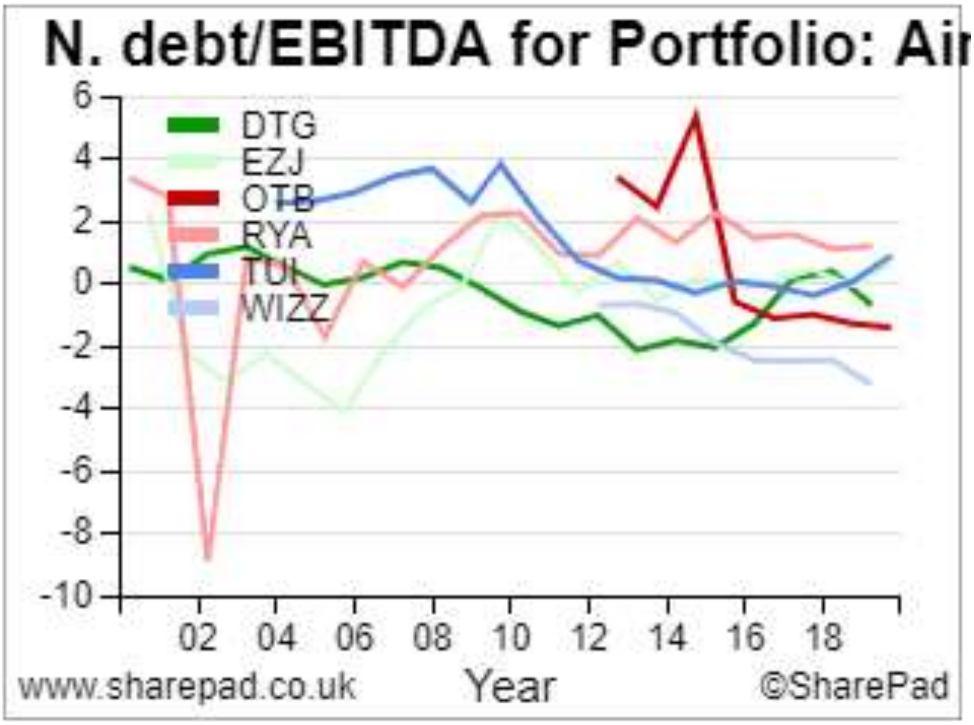
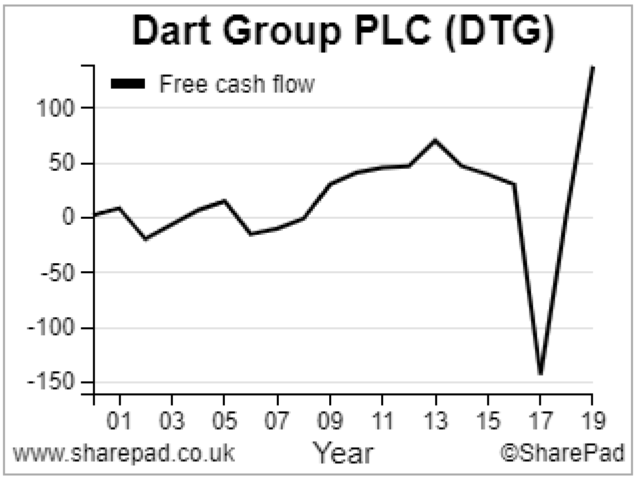
As the company has rarely had net debt save in 2016 after acquiring 34 Boening 737's. The leverage of the peer group is below. On the Beach, Dart, and Wizz all have net cash on their balance sheets while Ryanair and Tui have net debt.



The company was set to start to reap the benefits of its investment in aeroplanes over the past 3 years as the cash generation was set to accelerate before the virus arrived:



Source: SharePad

Trading Statement

Last week the company announced that the business is expected to report results for the year to March 31st "significantly" ahead of expectations. However, over recent weeks the strong start to bookings ("well

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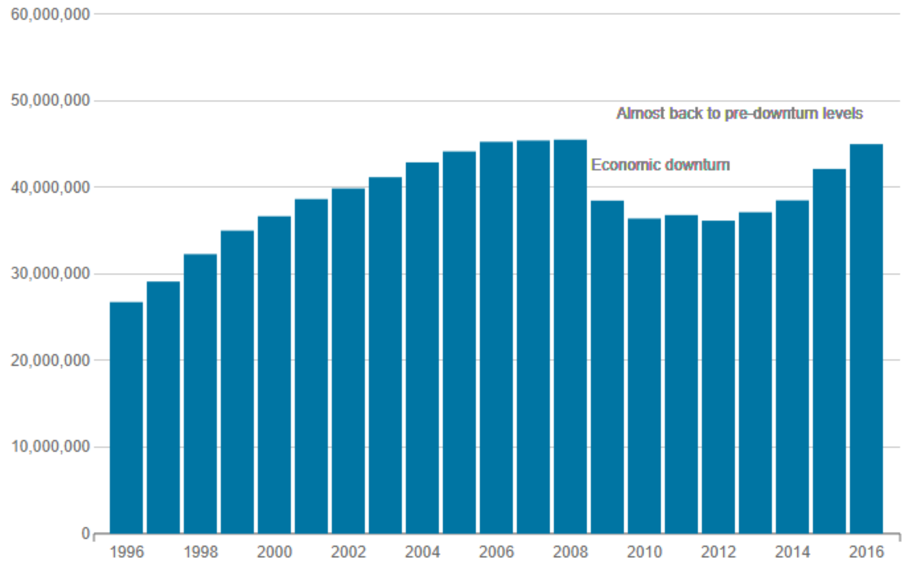
ahead of the 16% summer seat capacity increase") has weakened. The company will provide further updates as circumstances evolve. In the global financial crisis, the company remained profitable. The distribution and logistics business, Fowler Welch, is trading in line with expectations and growing its pipeline of new business.

The company cancelled all flights to Spain over the week end which accounts for perhaps 35% of Jet 2's routes.

This ONS chart shows us the cyclicality of the market in 2009:

Total number of holidays overseas by UK residents, 1996 to 2016



The aircraft fleet was 100 for Summer 2019 which provided capacity for 10.8m seats available. In 2009 Jet2's passenger numbers fell 20% to 3.2m which represented a load factor of 78%. In H1 to September 2019 the load factor was running at 93%. With the 93% load factor the company delivered £365m of operating profit, a 14% operating margin. In 2009 the operating margin was 9.5% when the company operated at 78% load factor.

Sensitivity & Downside risk

If we assumed a 40% reduction in holidays below the March 2019 year, which appears relatively gloomy considering that March 2020 has turned out to be a bumper year, that would imply £1.9bn revenue. Gross margin in 2019 was 13.7%. With planes now likely to be parked up this could be entirely eliminated but we shouldn't forget that in 2009 the operating margin was 9.5%. Then there is £229m of admin costs last year which need to be covered or reduced.

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Exceptional market dislocation

In the event of this sudden market change, there may also be customer cancellations. Last year Dart incurred £1.1bn in accommodation costs and they place a deposit up front but are not liable for the rest in the event of cancellation. Analyst notes suggest that Jet2 pays 12-13% of hotel costs in advance which could suggest there is up to £200m of deposits at risk, though the likelihood of all deposits being lost may be remote.

Hedging

The company has a mechanical approach to hedging its FX risk and fuel price risk 18 months in advance so the benefit of today's lower oil price together with any risk of weakening sterling will take time to filter through.

Valuation

As we stand today the market cap (Intraday) of the company is £825. There are 6 analysts covering the stock, all with "buy" recommendations and the shares have declined 72% in the last month, which is a fine testament to the helpfulness of analyst recommendations.

The current year to March 2021 is highly uncertain. However, with a 16% capacity increase the potential profits may have been 16% ahead of the £220m expected for March 2019, so let's say £250m. Then we have the benefit of lower oil prices and profits could be significantly more than £250m in a recovery. Making this a multi-bagger on a recovery.

However, just how cheap the shares can get is hard to know. In 2016 when the company was acquiring planes and gearing up the EV/EBITDA sank to 1.4X. Using 2019 EBITDA which is expected to be £345m that would imply an EV of of £480m. With net cash of c £241m that suggests a market cap of £724m, some 13% below the current level.

Competition

Jet2's most popular destination is Spain, accounting for about 1/3rd of travel, followed by Portugal, Greece, and Turkey. Within Spain, Alicante, Mallorca and Tenerife are most popular. Other destinations include Western Europe, Croatia, Hungary, Poland, USA (summer holiday/ ski/city trip).
EasyJet has now cancelled flights to and from Italy and Jet2 have announced plans to cancel flights from Leeds to Italy until April 26th. They have been flying to Rome, Naples, Pisa, Turin, Venice and Verona. And all Spain flights have now been grounded.

As capacity contracts this will stress airlines and survivors will be well placed to pick up the passengers. As the CEO of British Airways said on Friday airlines face a crisis "like no other".

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Conclusion

With the grounding of Spanish flights the company is likely to become stressed but it has £241m cash on its balance sheet. Relief measures are unlikely to come from governments but the capital requirements set by the Civil aviation authority may be flexed. While there is no visibility today on the duration or extent of this downturn it may be a reasonable assumption that with Spain now adopting a policy of "lock down" the Spanish crisis may pass within a few months. But there will also be a recession to contend with. There looks likely to be more stress which could well end up with the company requiring a rights issue to survive. I suspect institutional investors may support a capital raise at such low valuations when the potential rewards for survivors are so huge. For now I will be waiting on the sidelines but on any rights issue this will be a fantastic stock in which to participate in.

PrimaryBid

Primary Bid is a platform that enables retail investors to participate in corporate issuance. By registering interest on their site they will contact the corporate broker to register they have demand should a corporate issue occur, which may enable investors to participate in a rights issue. I shall be doing that. If only I could buy shares in primary bid as this crisis could be the opportunity that brings it scale in refinancing companies. But in confirmation of the strange world that has caused this crisis the funding round for Primary bid itself last September was led by private equity.

Summary

Despite the speed of the market falls it may be that because of the vagaries of human nature there is plenty of time left for this bear market to work its way through. However, when the recovery comes the cyclical stocks could outperform sharply. Airlines are the most cyclical of stocks and they now face a "crisis like no other". But for survivors the rewards are huge with the lower oil price. Dart Group is now likely to be stressed with all Spanish flights grounded but is one of the most conservatively run. It seems very dangerous as yet to buy the shares after their 72% fall but if it needs rescuing participating in that may yield huge results. Primary bid enables retail investors to participate in corporate issuance and I shall be registering my interest in re-financing Dart Group on that platform.

Forthcoming Events

Last year Dart Group announced results to March on 11 July, but we will get updates ahead of that as the virus pandemic evolves.

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