

# easyJet plc

INDUSTRIALS | EUROPEAN TRANSPORTATION

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# COMPANY REPORT

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## Lean, strong and determined

- **We initiate coverage of easyJet (EZJ) with a [BUY] recommendation and a FY15 target price of £21.90.** The stock is currently trading at a **discount** to its main European peers (EV/EBITDA of **8.06x** vs industry avg. **14.21x**) and is clearly undervalued in terms of **the P/E ratio 14.69 EZJ vs 20.58 RYA**
- **Dividends.** EZJ capital discipline is expected to support further ad hoc cash returns, which will continue to be an important part of EZJ equity story
- **EZJ is the best positioned low cost carrier (LCC) to take further material revenue share from weak legacy carriers** – capacity is expected to **further “free up”** due to legacy carriers' (FSC) retrenchment. FSC share in all European flights has fallen (**58%** 2008 to **55%** 2013) and with a number of legacy-dominated countries, characterized by low LCC penetration remaining, **potential growth markets for EZJ exist – this market change story is, in our opinion, equally important as economic variable variations** (i.e. GDP growth or fuel prices)
- **Although risk of increased capacity is becoming more evident, EZJ is rightly positioned in this crowded space.** Additionally, EZJ has proven time over time that it is capable of growing its business and profits under fierce competition, which adds confidence in the company's business model.

### Company description

EZJ is a British LCC operating in the European short haul segment with a market share of **8.3%**. It is the largest airline in the UK with strong positions in a number of key European markets (#1 in 24 airports – 48% of capacity and #2 in 29 airports – 29% capacity)

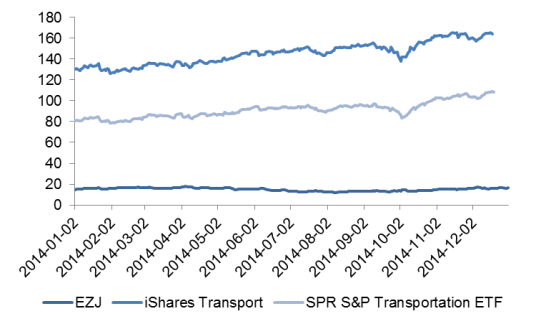
**Recommendation: BUY****Price Target FY15: 21.90 £****Price (as of 7-Jan-15) 16.82 £**

### Trading data

52-week range (£)	12.07 - 18.53
Market Cap (£B)	6.76
Outstanding Shares (m)	393
Free- Float	63.11%

Source: Bloomberg

### Performance



Source: Bloomberg

### Highlights

(Values in £ millions)	2014A	2015F	2016F
Revenues	4 527	5 038	5 461
EBITDA	701	948	1208
Net Profit	450	628	862
EPS	1.15	1.61	2.21
P/E (x)	14.69x	10.47x	7.62x
Dividend Yield(%)	3.19%	2.77%	4.11%
EV/EBITDA (x)	8.06x	5.26x	4.77x
Net Debt/EBITDA(x)	-0.63	-0.3	-0.59
ROA (%)	10%	13.7%	16.7%
ROIC (%)	17.2%	25.1%	30%
ROCE (%)	21.2%	25.7%	35%

Source: Company Data; Analyst's estimates

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## Investment Case

***EZJ is continuing to reinforce its position in the European short-haul market***

**EZJ is continuing to reinforce its position in the European short-haul market** with a forecasted passenger increase of **2.3% CAGR (2014-2019)**, after significant growth in the previous five years (**6.8 % CAGR**). Our projections come short of management's forecasts (**+3 to 5% p.a.**<sup>1</sup>, for the respective period) on the grounds of a more conservative view of current and future market developments

***Looking to further increase cost advantage through i.e. Lean programme***

Additionally, EZJ **rolling Lean Programme**, which is expected to deliver **£30-40m cost-savings p.a.** in the next 5 years (i.e. **1.2 - 1.6%** of FY13 Total Non-fuel expenses), although achievable, will not, in our opinion, be sufficient for the increase in non-fuel cost per seat to be below inflation, as projected by EZJ Management (1% in November 2014 and forecasted to reach 2.38% in 2024<sup>2</sup>). Growth of non-fuel costs/seat, amounting to **2.9% CAGR 2014-2019** and **3.2% CAGR 2014-2024**, is in our view more likely

***Limited effect of jet oil price decrease due to EZJ hedging policy***

As far as fuel expenses are concerned, **crude oil prices have declined significantly** with jet fuel prices moving in line (**-47% y/y**). Although this slump in fuel prices is benign for airlines, EZJ hedging policy (**1H15 91%** of fuel hedged at **\$958/mt**; **2H15 80%** hedged at **\$944/mt**; **FY16 58%** hedged at **\$921/mt**) and the forecasted return of oil prices to historical levels in the short to medium term **mitigate the effect the current oil price tumble could have on EZJ bottom line**

***Commitment to maintain profitability***

**Furthermore, EZJ continues to be committed to maintaining profitability.** EZJ has been profitable throughout the past 10 years (net profit from **£22M** to **£581M** in 2014 –**28.64% CAGR** ) which substantiates the argument that EZJ has its strategy figured out. EZJ EBITDAR has grown by **22.9%** over the past five years and further solid growth is projected, although, on a much lower level, **9.7% (2014-2019)** and **3.4% (2014-2024)**. This gradual decline in projected EBITDAR values stems from an assumed scenario, which entails **no significant M&A, increasing competition and overcapacity in the European short haul market**. Should EZJ merge (low probability, looking at the current and short term European short haul market structure) EBITDAR values would be revised

***Industry leading load factors***

**Industry leading load factors**<sup>3</sup> . EZJ has consistently increased this metric, from **80%** (low) in 2000 **to more than 90%**, which is around 22 pp higher than the average European legacy airline. With **load factors projected to hover around 87% in the first half of the operating year to 90% in the second,**

<sup>1</sup> EZJ forecasts capacity growth amounting to 3-5% p.a. until 2022 which equals 19 to 35 million new seats – currently 71.5 m thus increase of 26.7% and 49%, respectively

<sup>2</sup> Consensus forecasts; Bloomberg and IECONOMICS

<sup>3</sup> **Load Factor** - the proportion of airline output that is actually consumed; computed by dividing the number of passengers by seats flown

**significant increases in this metric, are in our opinion, highly improbable.**

This is due to EZJ planned strategy to maintain already high load factors while maximizing yields<sup>4</sup>, which is, in our view, an economically sound strategy for the established LCC<sup>5</sup>.

***Appropriately aligned incentives***

8 300 employees collectively own 19M EZJ shares (av./EE 2 290 shares) which shows that EZJ has put an effort into aligning employees incentives, which directly translates into **low staff risk** (i.e. union problems), an issue legacy carriers (FSC) are currently facing

***Commitment to maintain liquidity has partially led to EZJ current net cash position***

**EZJ has shown that it is capable of growing its business and profits under intense competition while managing its borrowings, with short-term cash as a counter balance<sup>6</sup>.** EZJ net cash position in FY14 amounted to **£422M** (\$622m), compared to RYA net debt position of **€364M** (\$447m). When compared to European airline<sup>7</sup> median and average total debt/equity (**107%** and **124%**, respectively), **EZJ low total debt to equity (26%)** further strengthens our premise that EZJ has a **strong capital structure**

***Cautious as to the level of CAPEX and form of financing***

**EZJ is using its CAPEX and leases wisely** - relative to revenue, CAPEX spending in 2006-2007 represented c. **40-45%** of revenue, **25%** in 2013-14 and is expected to drop to **15% by 2022** if revenue exceeds £7B (\$11B). This gives an 8% CAGR which is, in our opinion, a conservative measure. Thus, **solid FCF growth can be expected (£ -113M FY10A ; £ 590M FY15E ; £ 1 136M FY19E)**

***Low route overlap with greatest competitor but this situation is bound to change***

**Low EZJ/RYA route overlap namely due to RYA (EZJ main competitor) focus on non-primary airports and strong presence in Eastern Europe** (avg. % of route overlap 25.6%<sup>8</sup> - with greatest competition in **England (63.2%)** and **Portugal & Spain (48.5%)**). This is, however, expected to change as RYA gradually increases its presence in primary airports

***Solid return to shareholders in the form of dividends***

EZJ recent increase in its dividend payout ratio from **1/3 to 40% LTM Net profit (+20.12%)** sends a strong signal as to the **cash generation capabilities of EZJ** strategies and business operations and the company's commitment to return cash to its shareholders

***Industry leading net profit margin***

**EZJ 9.9% net profit margin is one of the highest in the industry (Europe)** much higher than the European average amounting to 1.3% . Thus, EZJ has

<sup>4</sup> **Yield** – average fare net of air passenger duties and internet booking discounts; calculated by dividing passenger revenue by revenue passenger miles  
<sup>5</sup> "Airline pricing under different market conditions: : Evidence from European Low-Cost Carriers" Volodymyr Bilotkacha, Alberto A. Gaggerob, Claudio A. Pigac; Tourism Management Volume 47, April 2014. This paper and analysis of other European LCC show that a reduction of the offered airfare by one standard deviation raises a flight's load factor on average by 2.7% and the importance of implementing dynamic yield management to maximize yield per seat as opposed to load factor.

<sup>6</sup> EZJ has been consistent in its commitment to keep a **minimum level of cash amounting to £4M per plane.**

<sup>7</sup> Industry comparables include: easyjet, Ryanair Holdings, International Consolidated Group, Duetsche Lufthansa AG, Turkish Airlines (Turk Hava Yollari), Air France-KLM, Norwegian Air Shuttle, Aer Lingus, SAS AB, Finnair, Air Berlin and Flybe.

<sup>8</sup> **Analyst metric** which quantifies the level of competition on EZJ vs RYA routes. Methodology: for each country (region in the case of Portugal and Spain) EZJ and RYA routes were compared and a weight was assigned to each route (on which the two competing airlines are present) based on the country's contribution to total revenue.

proven the profitability of its operations, even in the wake of struggling European carriers, gives **further confidence in EZJ business model**

Despite a significant appreciation in its valuation, **EZJ remains undervalued<sup>9</sup>** compared to rivals – EZJ stock is currently trading at a discount to its main European peers (EV/EBITDA of **8.06x** vs industry mean **14.21x**) and clearly undervalued when the P/E ratio is considered - **14.69** EZJ vs **20.58** RYA

Finally, EZJ share price may have reached a consolidation phase after having appreciated quite rapidly (**+271% over 5 years**), thus we expect the growth momentum to subside (forecasted upside **+30.0%**)

## EU Airlines Industry

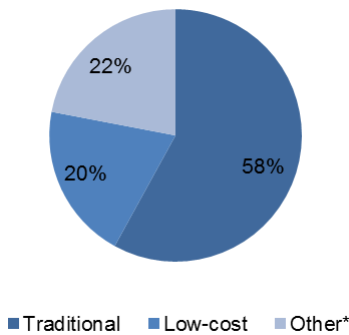
### Overview

From 2008 to 2013<sup>10</sup>, total European air traffic declined by 6% as markets felt the effects of the economic crisis. During this period, legacy carriers noted a **decrease in flights per day amounting to 11%** (1,700 less flights/day) in all years except 2011. On the contrary, **low cost carriers increased** the number of flights offered consistently, **recording 18% growth**. As far as market structure is concerned, in 2013, the FSC segment represented the main share of flights in Europe amounting to **55% (- 3 pp)<sup>11</sup>**, followed by LCC which constituted **26% (+6 pp)** and, finally business aviation, non-scheduled and all-cargo which held a **19% (-3 pp)** (Figure 1a./1b.) stake. This data clearly shows the pending structural shift in the European airlines industry, which has resulted in the notable growth of LCC, namely at the cost of legacy carriers.

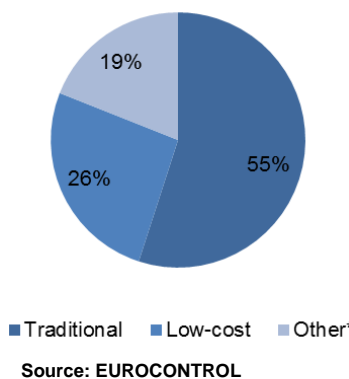
**...However, different typologies in the market segments (LCC vs FSC) can be observed when the EU Airline Industry is analyzed on a country by country basis**

Despite LCC consistent growth, **FSC continue to have a significant share in most of EU countries** (i.e. Scandinavian states values reach **76%**). On the contrary, **LCC in Spain** account for **46%** of the market (+5 pp more than FSC) and in the **UK LCC** share amounts to **37%**, compared to 46% for FSC. This evident disparity divides the European market into three arbitrary structural types; i.e. those characterized by low<sup>12</sup>, medium<sup>13</sup> and high<sup>14</sup> LCC penetration.

**Figure 1a. Market segments share of all flights (ESRA<sup>1</sup>) in 2008**



**Figure 1b. Market segments share of all flights (ESRA<sup>1</sup>) in 2013<sup>1</sup>**



<sup>9</sup> As of 31.12.2014

<sup>10</sup> EUROCONTROL/NMD/STATFOR Market Segments in European Air Traffic 2013

<sup>11</sup> Categories: Business aviation, non-scheduled and all-cargo will be ignored or grouped in the latter parts of this report due to their low significance in the market analysis conducted

<sup>12</sup> Greece (20%), Switzerland (25%), France (25%), Finland (26%)

<sup>13</sup> Belgium (31%), UK, Portugal (38%), Norway (40%), Germany (41%)

<sup>14</sup> Spain, Poland (50%), Ireland (48%) or Italy (48%)

## 2014 – Current Market Structure and Key

### Developements

In 2014, LCC market share has remained fairly stable (**26%**) with the exception of the summer period, during which LCC market share increased by 2 percentage points. The LCC segment was also the only segment that grew consistently y/y, increasing capacity by, on average, **6.5%**. FSC grew minimally, with a capacity increase amounting to **0.7%** since the beginning of 2014. On an aggregate flight level, Ukraine removed the most flights from the European airline network (**-90 flights/day**), which can be viewed as immaterial relative to the size of the European network. Internal traffic weakness in France caused a decrease of more than 40 flights/day. On the other side of the spectrum, **Turkey, UK and Greece contributed a significant amount of capacity in 2014, with further grow expected in these markets.** Considering the market shares and growth observed, **we expect that Turkey will continue to be one of the main drivers of passenger traffic growth and forecast that the LC segment has the greatest growth potential, even in markets were this segment's penetration is already significant.**

#### **LCC profitability and FSC strain to achieve positive net profit**

Moving from market share to European carrier's operations and profitability, the majority of 13/14 FY profits were generated in the short-haul market by LCC (Net income – **RYA €523M, Aer Lingus €40M or Flybe £8M**) with FC profitability driven by long-haul flights (**IAG €122M, Lufthansa €313M**) in some cases insufficient to post positive net profit (**AF-KLM €-1 827M**). Norwegian and Wizz Air, continue to implement their aggressive growth plans (**21.16%** and **15.3% revenue growth y/y**) while other smaller network carriers recorded losses, looked to restructure or find external sources of funding (e.g. Alitalia; Air Berlin). In order to mitigate their short-haul losses, large FSC have turned to restructuring their cost base and/or transfer traffic to their lower cost subsidiary airlines<sup>15</sup>. Although, the majority of these “transferring” initiatives are **at the early stage of implementation** (characterized by low levels of customer awareness), we expect that as this process progresses, **FSC and LCC's products will converge**, pushing smaller legacy, regional and charter operators out of the equation (i.e. Etihad has increased its presence in Europe by acquiring Air Berlin's frequent flyer program and a stake in JAT/Air Serbia; Korean Air has purchased a stake in Czech Airlines). Furthermore, Flybe has cut costs, restructured and sold its slots at Gatwick to EZJ; Thomas Cook has restructured its airline division; Alitalia has been partly acquired by Etihad while Aegean and Olympic are in the process of

<sup>15</sup> Air France-KLM - HOP!/Transavia; Lufthansa – Germanwings; IAG - Iberia Express/Vueling

merging their operations. Thus, **further consolidation cannot be ruled out and potential for both organic growth and M&A opportunities seems imminent.**

***Issue of restructuring FSC – as struggling carriers restructure and take out capacity, top discount airlines will most surely take advantage***

In the absence of Chapter 11 in Europe, restructuring will most probably not achieve the harmonization between FSC and LCC observed in the US and European restructuring efforts are not likely to limit the significant growth appetites of LCC, which are expected to continue expanding and take market share to the detriment of European FSC. As such, **LCC, particularly those with low costs, superior growth prospects, and strong balance sheets, can be viewed as best positioned to take advantage of current and future market developments.**

***Hope to increase route density in the European airline network amid airline's hindered hunt for growth***

Looking for growth, European carriers have shown a substantial increase in sector length<sup>16</sup>, ranging from i.e. a 40% increase in the case of EZJ to 75% growth for RYA between 2001 and 2010. However, this strategy i.e. looking further to find new, economically viable routes is close to running out, due to the currently developed network of connections throughout Europe. Furthermore, with the rigid capacity increase, specific to the airline industry (i.e. due to lag in plane orders and actual delivery - min 1 year or 1-2 years to optimize route specifics) **airlines, both FSC and LCC, will inevitably attempt to increase capacity by increasing flight frequencies; an action potentially detrimental to load factors and revenue per seat measures.**

***Observable changes in LCC strategy leading to the creation of hybrid LCC's***

With LCC (i.e. RYA) recent strive to increase its presence in primary airports<sup>17</sup>, a certain shift in the LCC model can be observed. Altering and hybridizing the LCC business strategy is expected to be characterized by greater presence in primary airports (as opposed to cheaper secondary airports), facilitating transfers, engaging in code sharing, entering alliances or finally through acquiring other airlines (further consolidation). **LCC's use of code sharing in the near term is assessed to be low**, however, the currently random connect system between a LCC and a hub carrier may result in more substantial feeder flows from unique LCC routes at the hub airport should airlines look to capitalize on this potential – e.g. **only 17.2% of RYA passengers are connected to other flights at secondary airports. Thus, airlines can achieve this by improving coordination between the LCC and FSC schedules without incurring costs associated with fully fledged hubing.**

## Medium and Long tem Perspective (2015-20124)

<sup>16</sup> **Sector length** - the length of the journey flown by the aircraft, usually provided as an average for a given airline

<sup>17</sup> Classification of airport that concerns airports which are among the 100 busiest airports in EU, ranked by total passengers per year, including both terminal and transit passengers

European carriers are expected to record an increase in capacity amounting to **1.8%** (+ 0.3 pp) in **2014** and **2.4%** (+1.6 pp) for **2015**. From 2016, growth is forecasted to return to stable rates of **3%**, however, airport capacity will increasingly constrain growth in 2017 and 2018. By 2020, it is anticipated that the annual number of flights will reach 11.2 million, c. 19% more than in 2013. During the following period (2019-2024) flight growth rates are expected to continue to hover around 3% (mid/high 2%) as additional capacity is brought into the market; **mainly in Turkey and a number of Eastern European countries (growth >6%)**. The 2008 peak of traffic (10.1 million flights) is expected to be reached again in 2016 (8 year period of growth recovery). **Annual growth in revenue per kilometer is predicted to amount to 2%** (pessimistic scenario), **3.5%** (base) **3.9%** (optimistic) **between 2013 and 2024<sup>18</sup>**. We also forecast that LCC penetration rates will converge towards 40-45% (on the aggregate European level, **currently 36%**), creating a much smaller range in LCC penetration % between countries with high LCC penetration i.e. Spain 65% and that of low i.e. Switzerland 25% (range currently equal to c.40 pp) to c. 35%.

## Macroeconomic Outlook

### GDP growth

***Airline travel reacts strongly to changes in GDP growth rates, thus GDP growth forecasts shed much light on the potential of demand for airline service in a given country***

The growth in airline travel depends greatly on GDP growth and GDP per capita. Historical data analysis depicts that airline industry growth is high when large segments of the population reach middle-income status (emerging economies); it then falls towards the trend rate of GDP growth when the size of the middle class begins to stabilize. Keeping this relationship in mind, we will now proceed to analyze GDP growth in Europe.

GDP appears to have slightly improved (+0.4% 2013) after -0.2% GDP growth in 2012. Furthermore, GDP growth is projected to increase to **+1.5% in 2014 (Figure 2.)** but not consistently and some EU states continue to look weak (2014F; **Cyprus -3.9%, Greece -0.1%, Italy -0.2%, Ukraine -5.4%**). On an aggregate level, although ESRA Mediterranean<sup>19</sup> is expected to rebound (**-0.8%**) and achieve **+2.10% in 2020**, ESRA East<sup>20</sup> and Other Europe<sup>21</sup> regions will experience greater growth (**+2.7% and +3.10%** respectively) signaling the potential for airline travel growth in these markets.

<sup>18</sup> Based on Airbus Global Market Forecast (GMF) and Analyst estimates. Scenerio analysis will be conducted for EZJ in a latter part of this report

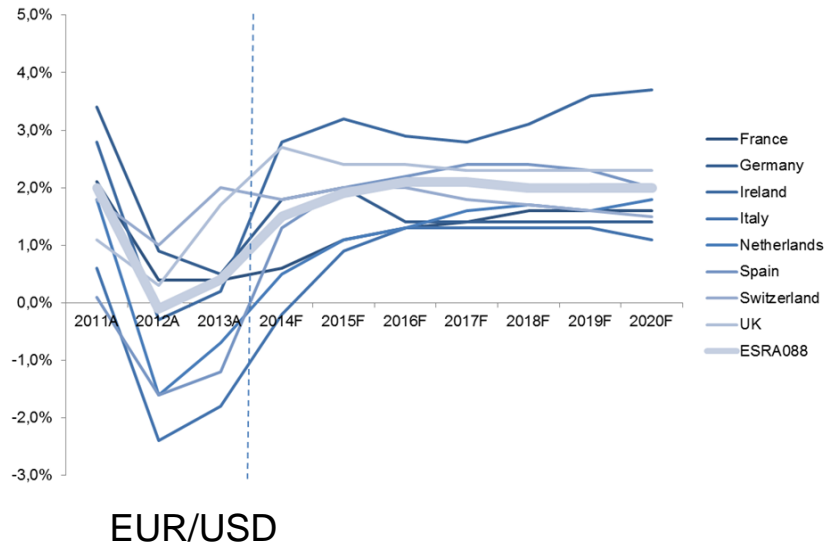
<sup>19</sup> Countries in the Eastern part of Europe: GC, LC, LE, LG, LI, LM, LP, LT

<sup>20</sup> Eastern Europe BK, EP, LA, LB, LD, LH, LJ, LK, LQ, LR, LU, LW, LY, LZ, UK

<sup>21</sup> Other European countries not included in the above mentioned categories: BG, BI, EE, EK (Faroe Islands), ENSB (Bodo Oc.), EV, EY, GE, LX, UB, UD, UG, UH, UI, UL, UM, UN, UO, UR, US, UU, UW, Shanwick, Santa Maria, FIR

**Figure 2. Real GDP Growth in Europe (ESRA) and Forecasts for Key EU States**

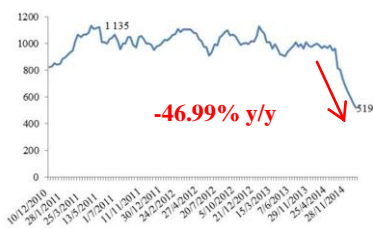
Source: 2005-2020 Oxford Economics Ltd /Official Governmental Forecasts. As of 03/09/2014



**USD / EUR exchange rates and jet fuel prices two common risks for European airlines affected significantly by macroeconomic developments**

USD / EUR exchange rates and jet fuel prices are two common risks factors for European airlines, both of which are affected significantly by macroeconomic developments. Apart from influencing airlines’ operating costs and bottom line (although mitigated by natural or derivative hedging), we have observed that European airlines’ (i.e. EZJ, RYA, IAG, AF-KLM and Lufthansa) stock price movements have demonstrated an observable correlation with the EUR/USD FX rate (**Appendix Table 1a./ 1b.**) Namely, the depreciation of the USD since Q1 2014 has been parallel to the decrease in main European airline stocks. As of the date of this analysis<sup>22</sup>, **EUR has depreciated by (-9%) vs USD**, with the MSCI Europe Airline Index moving in unison (-7%). With the EUR / USD forecasted to reach 1.26<sup>23</sup> (September 2015), when a simple linear regression is applied on the MSCI Europe Airlines Index, strong predicting power is achieved (R2 = 0.6). **This results in forecasted downside movement in the index (-11%) and a 13% decrease in EZJ stock price EZJ.** As for the GBP/USD, a moderate but significant negative relationship (-0.51) could be observed with the GBP/USD FX rate and EZJ share price movement (**Appendix Table 1c.**). This downside movement in EZJ share price stands in contradiction to our projected share price upside potential (see valuation section of this report).

**Figure 3a. Jet Fuel Prices (USD/mt)**



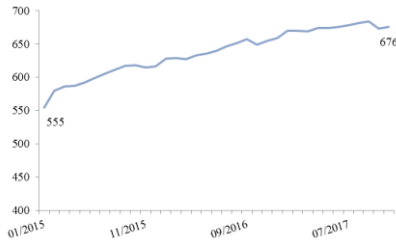
**Jet Fuel Prices**

**Brent crude oil prices have fallen by -48.37% since January 2014** (\$112.06/barrel to \$57.86/barrel ); this slump is explained by a strong US dollar,

<sup>22</sup> Analysis conducted as of 31/10/2014

<sup>23</sup> Analyst estimates based on FX contracts and FX market analysis

**Figure 3b. Jet Fuel Futures (USD/mt)**



abundant supply (held up by OPEC's<sup>24</sup> decision to maintain production levels despite price slash) and slowing demand growth (i.e. China). Jet Oil reached \$65.5/barrel or c. \$519/metric ton (-46.99% y/y) (Figure 3a). The EUR depreciated to its lowest level against the dollar since May 2013, therefore making it more expensive for European airlines to purchase oil (priced in USD). **Fuel price of \$99.90/barrel is anticipated in 2015<sup>25</sup>**, down significantly from \$116.60/b in 2014 and \$124.50/b in 2013. On this note, **European airline profits are expected to increase in line with the decreasing fuel prices but much of the potential cost savings will be mitigated by hedging policies implemented by airlines** (on average airlines hedge 70-90% of fuel needed in FY+1 and 50-60% in FY+2). Brent crude forward curves forecast slight upward movement in the following two years, supported by markets participants expectations as to price increase in the medium term (Figure 3b.)

## Other variables

### ▪ Inflationary environment

***Inflationary environment is expected to remain benign for the European Airline Industry***

**Inflation rate in the Europe is projected to remain fairly low (+0.3% 2014; 0.19% 2024<sup>26</sup>)**. Thus, we expect changes in airline fares (due to inflation) to remain miniscule, while changes in airline's inflation-linked operating costs (e.g. regulated/non-regulated airport charges) to remain stable.

### ▪ Business Confidence and Consumer Spending

***Business Confidence and Consumer Spending as Key Variables Effecting Air Travel Propensity***

With GDP growth improving sluggishly business confidence, consumer confidence and spending are sending mixed messages. Business confidence is **up from low 0.02 to 0.18 in Nov 2014** and is projected to **hover around 0.12 in 2024<sup>27</sup>**. Consumer confidence is decreasing (-11.6 Nov 2014) and is expected to remain at that given level. In line with this, consumer spending (1 417.1) is also **forecasted to rise minimally** and remain fairly constant in the medium and long term (1 423 in 2024).

### ▪ Regulatory Environment

***EU Regulation – no significant changes expected although the current regulatory environment is certainly more harsh for LCC***

**The regulatory environment continues to have a significant impact on European LCC** (despite progress made in airspace costs and increased competition on restricted routes), as protectionism (e.g. state subsidy of failing carriers) is still present. Additionally, uneconomic increases in prices by

<sup>24</sup> OPEC at a Nov. 27 meeting this year decided against cutting output. Despite its own forecasts of a growing surplus, the group opted to defend its market share against shale oil and other rival supply sources.

<sup>25</sup> IATA estimates

<sup>26</sup> ECB and official governmental data for remaining EU countries

<sup>27</sup> European Commission and official governmental data for remaining EU

monopoly infrastructure providers, continual increases in taxes on aviation across Europe and aviation's reduced role in (EU ETS<sup>28</sup>) remain a threat, especially for the LCC business model

## easyJet plc

### Company Description

EasyJet is a British low cost carrier operating in the European short haul segment with a market share (Europe) of **8.3%**. It is the **largest airline in the United Kingdom**, considering the number of passengers carried, operating domestic and international scheduled services on 675 routes in 32 countries. The airline has developed strong positions in a number of key European markets (**#1 in 24 airports with 48% of total capacity allocated and # 2 in 29 airports – 29% capacity<sup>29</sup>**)

### Shareholder Structure

EasyGroup Holdings Ltd (investment vehicle belonging to EZJ founder Sir Stelios Haji-loannou and family) and Polys Haji-loannou, both directly or indirectly held by Sir Stelios Haji-loannou, are combined the company's largest stakeholder with a **36.9% stake (Table 2.)**.

**Table 2. Shareholder's Structure**

	% owned	Of which % voting rights	Of which % free to float
easyGroup Holdings Limited	25.9%	25.9%	0.00%
Polys Haji-loannou	11.0%	11.0%	0.00%
Standard Life Investments	6.97%	6.97%	6.97%
Blackrock Inc.	5.00%	5.00%	5.00%
<b>Free Float</b>			<b>63.11%</b>

Source: Bloomberg

### Dividend Policy

EZJ adopted a dividend policy with a dividend payout ratio amounting to 33 1/3% of profits in 2011 only to **raise it to 40% in September 2014** (LTM Dividend Yield amounting to 3.19%). EZJ has over the past 3 years paid out in total **£589M**, both in the form of ordinary and special dividends, setting a precedence for LCC. Rival European LCC, RYA implemented a share buyback paying out €390M (\$480M) in 2014 which is expected to expand to €600M (\$738M) by 2015 (equivalent to **3.7%** and **5.5%** LTM dividend yield). **Legacy carriers, on the other hand, troubled with achieving sustainable profitability, have in the past, and currently shun away from paying out dividends (excl. Lufthansa 2.94%).**

<sup>28</sup> EU efforts to increase the importance of its emission trading scheme (ETS) and the expected increase in price of carbon whose price has been benign for the airline industry till the date of this report

<sup>29</sup> Company estimates based on OAG data

Thus, continued dividend payouts will continue to **stand at the core of EZJ's equity story** with the probability of special dividends being paid greater in the next 5-10 years as the company further increases ( **EPS - £1.61 FY15, £2.74 FY19, £2.40 FY24 and DPS – £0.45 FY15, £1.00 FY19, £1.23 FY24** )<sup>30</sup> its net cash position (**£1 659M FY19, £1 999M FY24**)

## Business Operations

### Air Travel

In the 12 months to September 2014, European short-haul capacity increased by **4.3% (3.0% in EZJ markets)** while EZJ seat growth surpassed this rate (**5.1%**). However, **capacity and demand are not expected to be broadly aligned over the next 5 years** due to the following factors: significant increase in short-haul European fleet orders (4 year highs for both Boeing (1 083 orders) and Airbus (1 068), conservative assumptions on aircraft retirements and GDP growth in EZJ main markets<sup>31</sup>

- Key Business Trends

**Focus on Yield Management – targeting both business and affluent older passengers (PAX)** - EZJ is attracting more affluent older PAX (av. age of EZJ customers 41.5; **+1.2 years vs 2009**) and business passengers (market share **+4%; 12M PAX p.a.**<sup>32</sup>). These two groups of customers are characterized by significant growth potential, firstly, due to EZJ current business passenger penetration (**20%**) being much lower than the average for European legacy carriers – **49%**<sup>33</sup>. Secondly, in terms of trade-offs between price and quality<sup>34</sup>, at least a proportion of business travelers currently flying short or medium haul flights are ready to sacrifice i.e. in-flight service in exchange for lower prices. Greater awareness of the traits of low cost flights may affect how they are valued. **Huse and Evangelho (2007)** found that travelers who had flown often with LCC put smaller strain on loyalty programs or inflight services. This observation could be viewed as favourable for EZJ, since in the case of business travelers, Huse and Evangelho underline that greater experience of flying with LCCs is positively and significantly correlated to higher perception of flight quality and a smaller to that of price. For the tourist travelers (min 25% on each EZJ flight<sup>35</sup>), the relationship is statistically significant, and positively correlated to flight quality and

<sup>30</sup> Given no M&A activity or other developments requiring a significant amount of cash

<sup>31</sup> EZJ key markets include: United Kingdom, France, Switzerland, Italy, Germany, Portugal and Spain. Developments in these markets will be presented in the EZJ Key Markets section of this report

<sup>32</sup> 20-24% of seats sold targeted in 2014/15 vs 18% in 2010/11 which implies passenger growth above the expected market trend

<sup>33</sup> Analyst estimation based on data provided by the following legacy carriers: International Consolidated Group, Duetsche Lufthansa AG and Air France-KLM

<sup>34</sup> Analysis of the profile of business and leisure travelers using LCC

<sup>35</sup> Company Data

proximity of airport to destination, yet not price. Thus, EZJ could maximize its revenues by fare differentiation, and in particular, charging higher fares to those who book closer to take-off time, often business travelers that are fairly fare insensitive because they have to make the flight at short notice. EZJ has done just that in the previous FY, i.e. continuing to drive sales of new business products, such as **inclusive fare and flexi fare (+48% y/y)**. EZJ also grew its managed business with those corporates where EZJ has a contractual relationship (by 10% y/y). EZJ sales through dedicated business channels (e.g. Global Distribution Systems, API and on-line booking tools) increased by 34%. These efforts, in our opinion will translate into both an increase in business travelers (+ **6.23% p.a. 2014-2019**) and revenue per seat (**+3.8% CAGR 2014-2019**).

**Capitalizing on FSC Retrenchment – Potential Market Share.** Retrenchment by less efficient FSC can be viewed as an opportunity for EZJ to continue to take profitable share in its core markets (greater overlap with FSC than other LCC due to EZJ great presence in primary airports – remains FSC bridgehead). FSC are only at the beginning of their restructuring efforts and this market structure change story is, in our opinion, equally important to economic variables (i.e. GDP growth or fuel prices)<sup>36</sup>.

**End of EZJ and RYA Duopoly?** - RYA previous strategy, which focused on presence in secondary airports resulted in RYA with a market share **c.75% at nearly 50% of its bases and 80% of routes not contested by any other carrier** (shows how EZJ and RYA have been able to function not disturbing each other i.e. duopoly). This strategy has, however, reached its limits and is no longer sustainable since the density on RYA routes is insufficient to allow RYA to generate greater frequencies. Furthermore, RYA strong growth shows (**4.13% CAGR PAX 2010-2014**) that RYA is mainly capable of starting thin routes, **an indication of a saturating market and future/existing route density problems in both RYA markets and the European network as a whole**. This further explains RYA recent announced plans to increasingly shift from low yield secondary airports to major airports, which will result in an imminent increase in capacity concentrated mainly at major airports. Although, the implementation of this strategy is expected to take time (due to e.g. slot constraints), EZJ is expected to be affected in the medium term (2-5 years). Additionally, the EC lenient approach to regional airport sweeteners<sup>37</sup> will further, although not on a scale expected, had the approach been different, strengthen RYA cost

<sup>36</sup> Potential opportunities within current network; c. 86M (28M – thickening routes; 33M – connecting network points; 25M- expanding existing network); based on Management projections and analysts analysis

<sup>37</sup> European Commission guidelines will allow airports with < 3M PAX per year to offer cut-price deals to airlines and receive public funds for investment in infrastructure – to end by 2024. It will mean that 28 ongoing investigations into subsidized regional airports – majority involving RYA – will now be decided under the new, more lenient rules.

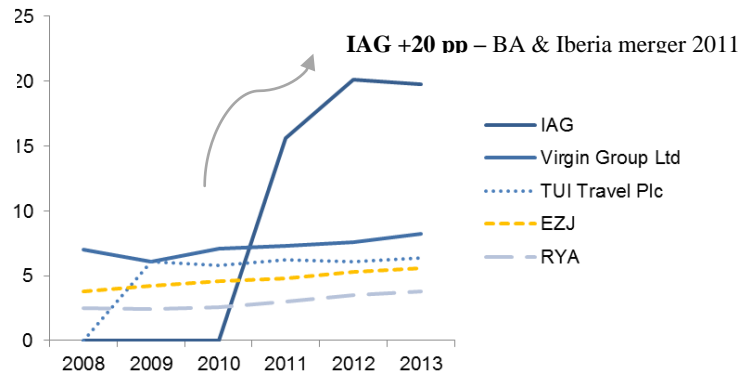
advantage (highly dependent on indirect state subsidies) and **incentivize RYA to pursue its change in strategy.**

▪ **EZJ Key Markets**

○ **United Kingdom**

**Figure 4. UK - Top 5 Airlines - Company Market Shares (% of Total revenues)**

**Strong IAG  
+ 14.2pp over EZJ (#4)**



Source: Passport Euromonitor International

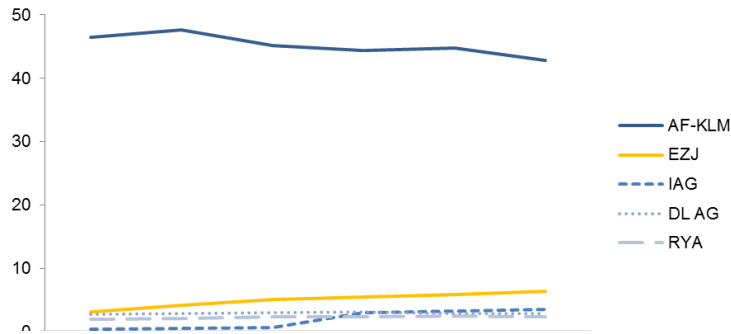
EZJ is UK's largest short-haul carrier (**Market share c. 20%<sup>38</sup>; 5.6% Retail Value RSP<sup>39</sup> Figure 4.**). EZJ forecasted capacity growth in the UK amounts to **+2.5% in H1 2015**. London Gatwick is currently facing yield pressure as EZJ optimizes the slot portfolio it acquired from Flybe. This is expected to continue until the 2H 2015, based on management forecasts and historical analysis, which show that it takes EZJ around 12 to 18 months to optimize its slot portfolios. Furthermore, given EZJ significant concentration (c. 45% of EZJ capacity and 56% market share) at Gatwick, continued yield weakness is expected to have a large impact on EZJ yields. Advanced plans to build a "LCC single terminal" is expected to bring, on the one hand, operational efficiencies and the threat of an increase in landing charge on the other<sup>40</sup>. An increase in new slots available due to airport enlargement is unavoidable with further yield pressure viewed as imminent. Norwegian plans to increase capacity (+4.6% - mainly international flights) and potential for a decrease in demand as RYA increases capacity at Stanstead by 1M (5% route overlap) **stand behind EZJ moderate projected growth in UK.**

<sup>38</sup> Market share computed based on capacity provided by each airline (same approach throughout this section of the report)  
<sup>39</sup> RSP – market share computed based on revenue – calculated as the percentage of total revenue generated by airlines in a given market (same approach throughout this section of the report)  
<sup>40</sup> EasyJet makes on average £8 profit per seat. If Gatwick's charges double ( £9 to £18 predicted by Airports Commission) EZJ will be materially effected

○ France

**Figure 5. France - Top 5 Airlines - Company Market Shares (%)**

**Strong AF-KLM  
+ 36.4pp over EZJ (#2)**



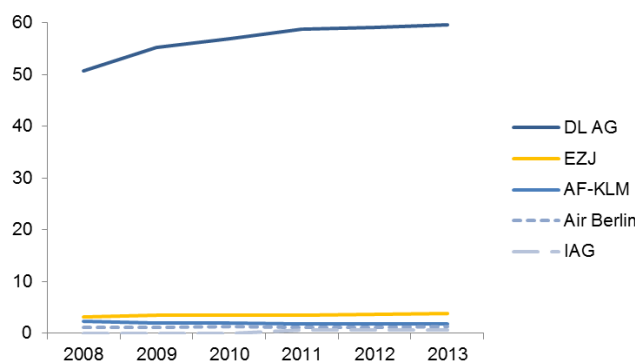
Source: Passport Euromonitor International

France continues to be EZJ fortress<sup>41</sup> (**Market share c.14%; RSP 6.4% 2013 (Figure 5.)**) EZJ is expected to grow its capacity in 1H15 by +4.6%. Looking forward, EZJ aims to address regional demand ( domestic<sup>42</sup> and international flights) and become the alternative carrier to Air France (**RSP 42.8% 2013**). AF-KLM recently decided to abandon expansion of Transavia (planned investment amounting to €1B) which entailed the further international expansion (increase the number of international flights to and from 3 main French airports) of the low cost segment of AF-KLM operations. We view this as a positive development for EZJ since AF-KLM decision to scale back on its plans, Air France-KLM plans to expand Transavia on its domestic market but EZJ cost base is more competitive

○ Switzerland

**Figure 6. Switzerland - Top 5 Airlines - Company Market Shares (%)**

**Lufthansa (#1)  
+ 55.8 pp above EZJ (#2)**



Source: Passport Euromonitor

EZJ grew its capacity in this market by **+ 6.8% y/y** and plans to continue solid growth in **1H15 (+6.3%)** and is currently number 2 (**Figure 6.**) with a 55.8 pp differential to Lufthansa, ranked first. Growing Etihad Regional in Switzerland

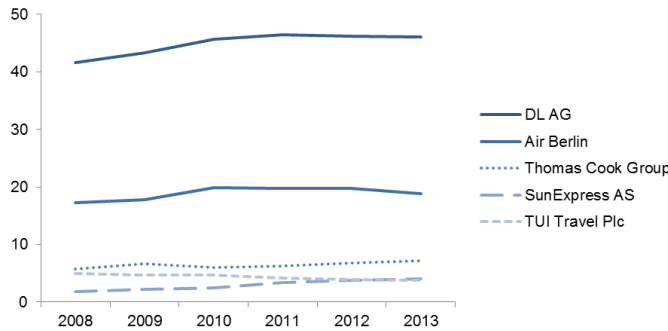
<sup>41</sup> Only – 13th largest airport in Europe, c.29m seats/year, EZJ #2 with 12% MS; Charles de Gualle – 4th largest airport in Europe, c.45m seats/ year, EZJ #2 with 11% MS. Capacity growth amounting to 11% CAGR and returns 13% CAGR over the past 5 years.  
<sup>42</sup> Air France (via Hop!) account for 76% of French domestic capacity

(business founded from former Swiss regional airline Darwin) whose regional proposed product will in no way compete with EZJ unit cost, could certainly, however, destabilize yields on short-haul routes.

○ **Germany**

**Figure 7. Germany - Top 5 Airlines - Company Market Shares (%)**

**Lufthansa (#1)  
EZJ market share c.0%**



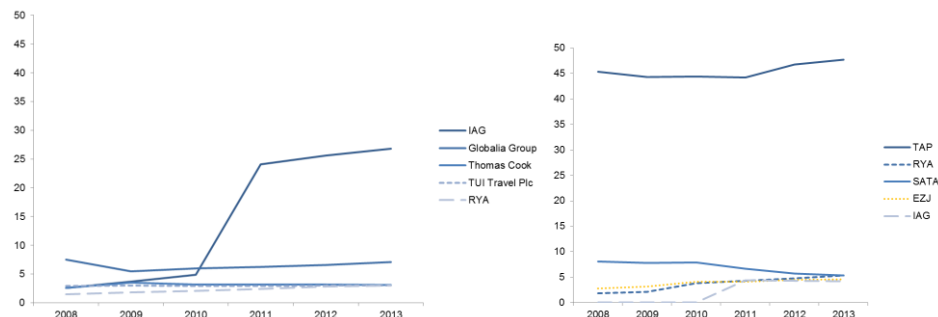
Source: Passport Euromonitor

EZJ increased its capacity in this market by **+6.7% y/y** and plans to **continue with expected 1H15 capacity growth amounting to +14%**. However, EZJ market share continues to be minuscule (**c. 0% RSP 2013 (Figure 7)**). EZJ has performed well in Berlin (taking share from Lufthansa as it transfers domestic traffic to Germanwings) and is in a strong position to drive substantial returns when the new Brandenburg airport eventually opens (c. 2017) due to planned greater slot allocation. Germany has very low penetration of its domestic market by foreign carriers, with 99% of domestic market seats operated by German carriers (71% Germanwings; Air Berlin<sup>43</sup> 27%), making EZJ efforts to expand in the packed German market a great effort. Moreover, only 16% of Germany's domestic capacity is operated by LCC, which explains EZJ "tip-toe" approach to the German market.

○ **Spain and Portugal**

**Figure 8. Spain and Portugal - Top 5 Airlines - Company Market Shares (%)**

**Spain – IAG (#1), EZJ not in the Top 5 with market share of 2.2%**  
**Portugal – TAP (#1), EZJ (#4) with market share of 4.6%**



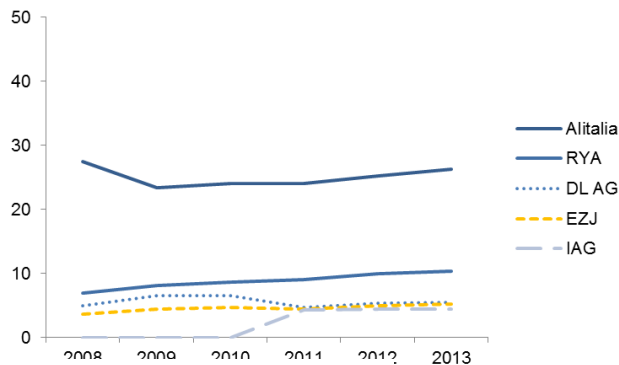
Source: Passport Euromonitor

<sup>43</sup> Expected to increase in the medium term as Etihad Airways (49% stake in airberlin) planes to increase its involvement in Europe (esp. in the German market)

Spain has a similar profile to France in that 81% of domestic capacity is operated by Spanish FSC carriers (51% LCCs). After reallocating its Spanish bases, **EZJ has held its ground with 2.2% RSP 2013 (Figure 8.)** and has achieved a noteworthy presence in Lisbon (12% MS). In the case of Spain, **projected 1H15 capacity decrease amounting to -2%** reflects our anticipation of LCC overcapacity in the Spanish market (i.e. Vueling planned to increase its capacity by +22% in 4Q14).

### ○ Italy

**Figure 9. Italy - Top 5 Airlines - Company Market Shares (%)**



Source: Passport Euromonitor

EZJ is the third largest carrier in Italy, with a **market share of 12% and 5.6% RSP 2013 (Figure 9.)**. Like Spain, Italy also has a relatively high penetration of LCC in its domestic market; 52% seats operated by LCCs. Italy is the only country in Europe where almost half of all domestic seats are operated by foreign carriers. Alitalia accounts for 42% of domestic capacity; RYA (31%) and EZJ (11%). EZJ grew in capacity + 6.2% over the previous year and with solid positions at its key bases (Milan Malpensa, Rome Fiumicino and Naples) we project an increase in capacity amounting to **+5.3% in 1H15**. Overcapacity in Rome Fiumicino poses a relatively small risk to EZJ since Vueling (main capacity contributor) and RYA have and plan to grow capacity in the domestic Italian market while EZJ is strong in international routes in and out of Italy. As far as recent developments are concerned, Ethihad's further stake purchase of Alitalia will, we expect, to continued "taking out" of capacity. However, since both Vueling and RYA plan to increase capacity at their Italian bases, **incremental capacity will be minimal**.

### ○ Other Markets

EZJ plans to **increase its capacity significantly in the Netherlands 1H15 by +13.4% y/y**. Longer distance routes - Israel (250,00 seats <1% of the group capacity) and Moscow remain in EZJ strategy with the yield on the latter route severely marked by the Ukraine-Russian conflict. A potential threat to EZJ Russian and Middle East operations stands RYA who could potentially "step into

” EZJ territory, should RYA receive a Cypriot Aircraft Operators Certificate (AOC) from Cyprus’ Department of Civil Aviation. This would negatively affect EZJ since Cyprus’ bilateral agreements with third non EU countries would enable RYA to fly to Russia and the Middle East thus, increasing capacity (potential yield pressure). EZJ also plans to increase capacity in Brussels and Greece (i.e. Athens) which we view positively due to low LCC penetration in both of these areas.

### Ancillary Business

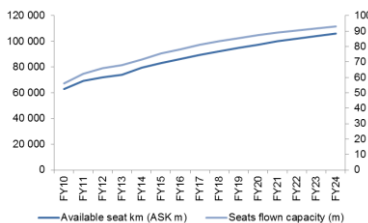
EZJ ancillary business remains non - core (**1.4% of total revenues FY14**). Partnerships with service providers e.g. EZJ Holidays & Hotelopia, Booking.com, Europcar have contributed minimally to developing EZJ core product as the actual conversion rates of these initiatives remain minuscule (non-seat revenue decreased in **2H14 to £0.99 after having high of £1.14 in 2H13**). Looking forward, we project that EZJ non-seat revenue/seat performance will stabilize and hover around **£1.04 to £1.14** as commissions from travel insurance and in-flight sales increase only slightly. With growth of seat revenue surpassing that of non-seat, this figure/value as % of total revenue will amount to **1.28% in 2019** and **1.23% in 2024**.

## Financial Analysis and Forecasts

### Key Revenue Drivers

- ASK and seats flown

**Figure 10. EZJ Available Seat km (ASK) and Seats flown**



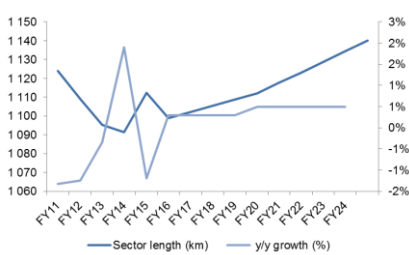
Source: Company Data, Analyst ‘s Estimates

EZJ is expected to continue to reinforce its position in the European short-haul market with projected passenger growth amounting to **+3.6% CAGR (2014-2019)**, after achieving above avg. market growth in **FY14 (+7.14% y/y growth)** but before moving into a **steady growth phase of 2.0%<sup>44</sup> CAGR (2019-2024)** (**Figure 10**). This growth is based on forecasted 2% to 4% capacity growth coming from new routes or increased frequencies on existing routes (namely) and c. 1% thanks to the introduction of larger A320 aircraft on existing flights (180 seats available in A320 planes vs 156 in A319). EZJ is expected, as mentioned above, to increase frequencies (i.e. thicken routes) which can be substantiated by the fact that **67% of EZJ capacity (46M seats) touches primary airports<sup>45</sup>** (EZJ present in 48 primary and 1 secondary airport) which are, in the presence of legacy retrenchment and sufficient customer capacity feeds, best suited to implement route thickening strategies. This cannot be said, however, about secondary airports, where carriers (RYA being a great example)

<sup>44</sup> In line with the avg. weighted growth in GDP of EZJ key markets

<sup>45</sup> Significant competitive advantage when compared to competitors: RYA 23:20, IAG 39:1, Lufthansa 24:0, Norwegian 24:0

**Figure 11. Sector length and y/y growth (%)**

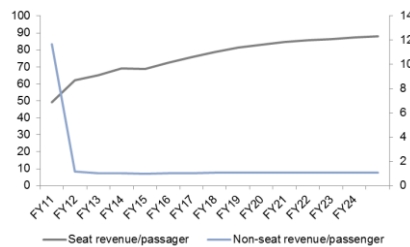


Source: Company Data, Analyst ‘s Estimates

are finding it hard to find demand to match increased frequencies. **Our estimates indicate that c. 91 million seats are currently offered by non-LCC carriers on point-to-point routes, which when juxtaposed with EZJ significant cost advantage, sets economically sound foundations for successful route thickening strategies in a number of EZJ markets (i.e. France).** Sector length, as a key component affecting ASK, is projected to increase only slightly (**1 112 km FY14 to 1 140 km FY24**) (Figure 11.) due to the limited destinations to which this European carrier could potentially fly – EZJ European focus and fleet specifics cap the potential distance EZJ planes could travel.

- Revenue per passenger (RPP)<sup>46</sup>

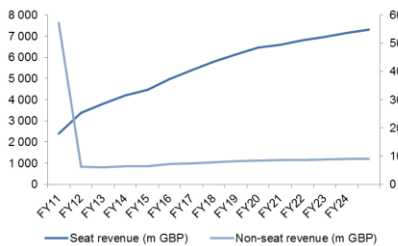
**Figure 12. Revenue per passenger (seat and non-seat)**



Source: Company Data, Analyst ‘s Estimates

The average sector length increase (+3.1% FY14/13), through the development of farther-flung destinations, (e.g. Moscow, North Africa, Israel) had a **positive effect on revenue per seat** (although lower potential expected moving on due to current geopolitical conflicts). **RPP growth is expected to maintain at (4-6%) as the effects of allocated seating and yield management tools materialize** (i.e. dynamic pricing targeted at business travelers). Once again, due to EZJ presence in primary airports and favorable time slots, one can observe that business traveler’s substitution rates (i.e. switching costs from legacy to EZJ) are declining. Further potential of allocated seating is highly probable since only **16% of allocated seats were yield managed in 2014**<sup>47</sup> (many on longer flights>2.5 h). With EZJ tailoring its offer to better fit business travelers i.e. by introducing recently a loyalty scheme and its prolonged hybridization effort (i.e. showing traits of both LCC and FSC), **EZJ is well positioned to further increase its yields thanks to the increase in business travelers (£61 1HFY14; £75 2HFY14)** (Figure 12. And 13.<sup>48</sup>). When converted to EUR, EZJ average fare amounted to **€88**, which, although 57.1% higher than the corresponding value for RYA or 6.02% to Norwegian’s, is lower than other European carriers<sup>49</sup>. Another aspect speaking for these assumptions is the fact that carriers primary compete on their base ticker fares since passengers tend to compare these fares when deciding which flight to purchase. Thus, an increase in the less transparent part of the product’s service ( i.e. the optional services) has less of an effect on sales than do price increases for the product itself underlining the premise of potential RPP increase.

**Figure 13. Seat and non-seat revenue (in £M )**



Source: Company Data, Analyst ‘s Estimates

<sup>46</sup> Seat revenue includes direct flight fare , provision for checked baggage, allocated seating, administration, credit card and change fees

<sup>47</sup> Company Data

<sup>48</sup> Non-seat revenue/passenger for FY 2010 was not considered in analysis (although depicted on graph) due to change in method of classifying seat vs non-seat revenue (significant difference 11.7 in FY10 to 1.2 in FY11)

<sup>49</sup> Aer Lingus (€93), Air Berlin (€121), Alitalia (€148), Lufthansa (€235), IAG (€242), AF-KLM (€300) – avg. fare amounting to €163 (46.01% lower than EZJs)

▪ Load Factors

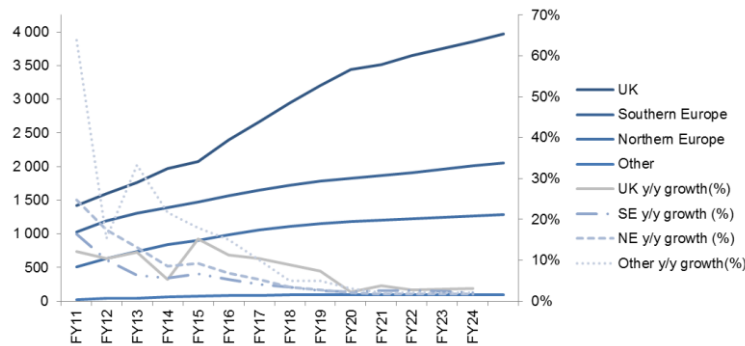
EZJ is expected to maintain its load factors at **c. 87% in 1H** and **c. 90% 2H** (avg. industry – 80%) as the company attempts to maximize yields in a less benign, characterized by “overcapacity” state of the world (2016-2020).

Divisional Breakdown of Revenue

Divisional Breakdown of Revenues - Seat revenue/seat reached **£4 462 (+6.4%)**. 2014/15 revenue (**Figure 14.**) estimate is based on a capacity increase of +3.7% (o/w +6.4% in 1H15) and a further positive impact of allocated seating. Non-seat revenue/seat increased to **£70 (+7.7%)** and is expected to remain relatively constant throughout the projection period.

**Figure 14. Regional Breakdown of Revenues (Actual and Estimates)**

Source: Company Data, Analyst’s Estimates



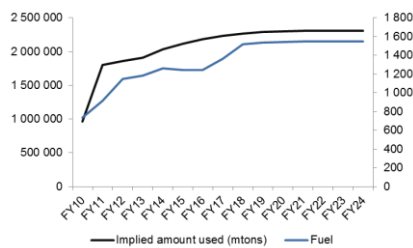
On a regional level (geographical areas determined based on methodology applied by EZJ), revenues are expected to grow at levels depicted in **Figure 14.**

**Figure 15. Fuel Expense**

Key Expense Drivers

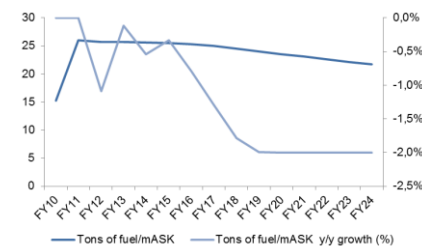
▪ Fuel Expense

Fuel Expense is an important expense driver for airlines, EZJ included, since oil prices are subject to significant fluctuations, as can be observed in the current fuel price slump. Despite the current benign fuel cost environment, EZJ, as many of its peers use hedging to lock in fuel prices (**Figure 15.**) (EZJ has persistently over the last 3Y hedged 12 to 18 months out<sup>50</sup>). Additionally, with the weakening of the EUR, European airlines including EZJ, who pay for jet oil priced in dollars, will further observe the potential gains from lower fuel prices balance out. As far as fuel efficiency is concerned (**Figure 16.**) **fuel expense per flight is projected to decrease in future years** with the gradual introduction of the A320neos and as fuel efficiency measures (entailed in the EasyJet lean programme) are implemented. A320neos are expected to **save around 15% (higher than management projections of 7-9%<sup>51</sup>)** fuel when compared to A319 planes, but



Source: Company Data, Analyst’s Estimates

**Figure 16. Fuel Efficiency**



<sup>50</sup> Company data:1H15 91% of fuel hedged at 958\$/mt; 2H15 80% hedged at 944\$/mt; 2016 58% hedged at 921\$/mt

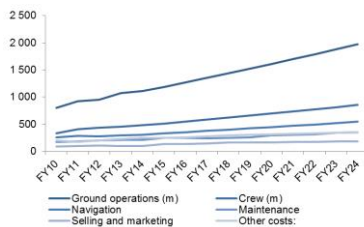
<sup>51</sup> Channel checks

the cost effect will not be material until only at the end of the projection period when this A320neo planes start to make up a significant portion of EZJ fleet i.e. **12% of fleet by 2019 and 29% by 2024.**

- Non-Fuel Expense

Non- fuel expenses are expected to be affected by a number of efficiency measures, one of which is the **EZJ Lean programme**, a cost savings plan whose overarching aim is to ensure cost/seat (excluding fuel costs) growth be below inflation in the next 5 years. In FY13, cost savings amounted to a **£43M (cumulative £143M)** and were the result of various actions, such as: renegotiation of ground handling contracts, agreements with non-regulated airports (potential for decrease in Airport and Navigation charges), the introduction of lightweight trolleys and one engine taxing. **In this fiscal year**, EZJ set ground operations, crew flexibility and engineering and maintenance (renegotiation of 95% of annual contracts, review of options available from full insource to full outsource) at the focal point. **In FY15 and onwards**, EZJ is expected to focus on decreasing fuel consumption (i.e. by introducing lightweight seats), navigation, maintenance and engineering and maintenance through a number of lobbying measures, working with European authorities to optimize airspace fees. **The extent of measures entailed in the programme are, however, in our opinion, insufficient to achieve the overarching aim of ensuring cost/seat (excluding fuel costs) growth below inflation** (1% in November 2014 and forecasted to reach 2.38% in 2024). Our more conservative non-fuel expense estimates are depicted in **Figure 17.**

**Figure 17. Non-Fuel Expense**



Source: Company Data, Analyst's Estimates

## EBITDAR and EBITDAR margin (%)

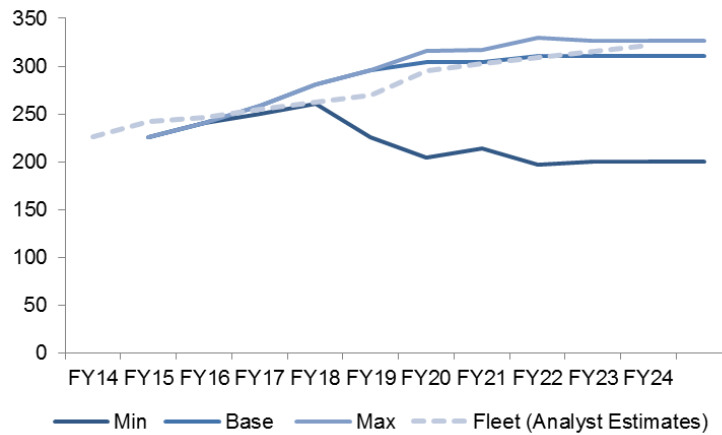
EBITDA/ R & EBITDA/ R margin (%) EZJ benefited from higher load factor (**89%**), more A320s in its fleet, a moderate increase in fuel costs (**+7.3%**) and non-fuel cost management which attenuated the higher charges at regulated airports and de-icing costs. 2014/15 EBITDA/R (21%) estimate takes into account a stable load factor at a historic high level, a moderate decrease in fuel costs (a significant proportion already hedged) and further cost-savings related to the EZJ Lean programme.

## CAPEX, Depreciation and Fleet Projections

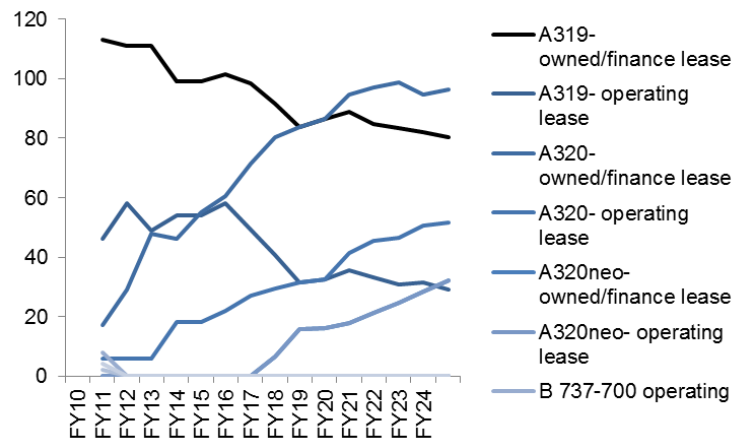
EZJ has exercised 33 options and two purchase rights over current generation A320s (35 aircraft are to be delivered between 2015 and 2017) and continues to have six options and 29 purchase rights. The company has also entered into a new contract for 100 new generation A320neo 180 seat aircraft for delivery between 2017 and 2022 as well as additional purchase rights (for A320neo family

aircraft) contingent on the exercise of purchase rights by 2025 and availability of delivery slots (i.e. capacity needed). Thus, EZJ has incorporated flexible fleet arrangements to respond appropriately to market conditions. Based on company fleet projections and research on projected fuel efficiency (i.e. greater cost savings c.15% rather than the 7-8% stated by EZJ)) we forecast that EZJ will purchase more A320neo than entailed in fleet projections<sup>52</sup> (Figure 18. and 19.)

**Figure 18. Fleet size (Actual and Projected)**



**Figure 19. Fleet – types of planes (Actual and Projected)**



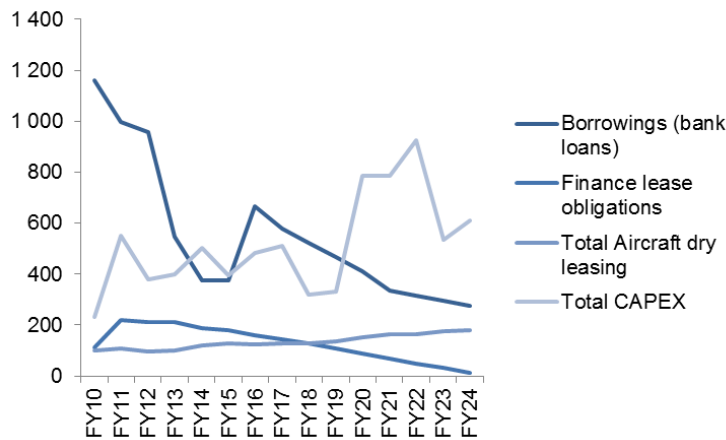
Source: Company Data, Analyst ‘s Estimates

Number of new owned or finance leased planes delivered in 2015 (**20 aircrafts**) based on EZJ projections and confirmed (exercised purchase options). 2016-2024 forecasts based on company’s guidelines (cross referenced with data for comparable European LCC) of a stable **70:30 split between planes financed using operating and finance leases.**

<sup>52</sup> Fleet projections – cross reference management forecasts and fleet needed based on ASK/Total Fleet, keeping in mind that block hours per day can’t exceed given levels (FY 14- 11 hours - higher than for peer LCC). Additionally, in our opinion, by forecasted pending in the delivery of NEO aircraft EZJ is allowing its overall fleet to age. These economics of planned aging of the fleet have been altered to better match our forecasted earlier deliveries of A320neo planes

CAPEX<sup>53</sup> (Figure 18.) as a percentage of revenue is expected to move in line with EZJ forecasted total expected fleet acquisition and overhaul expenditure as a percentage of revenue - **(18%) 2005-2012, (9%) 2013-14, (11%) 2015-17 and (10-12%) 2018-22**. EZJ depreciates each of its owned aircraft on a straight basis to a residual value at the end of its useful life amounting to 7 years which reflects EZJ policy of seeking to maintain a young fleet resulting in higher annual depreciation rates than other airlines (additionally due to greater use of aircraft due to the short-haul nature of EZJ routes and higher utilization rates). This value (depreciation per owned/finance leased aircraft) is expected to increase with the purchase of new (more expensive planes). As far as aircraft leasing costs per seat is concerned, this value **increased by 3.7% driven by the sale and leaseback of 12 new A320 aircraft and 12 mid-life A319 aircraft**. Seven A319 aircraft were returned to lessors, so overall the number of leased aircraft increased by 17 to 72. Leased aircraft represent 33% of the fleet, which allows EZJ to eliminate future residual value risk and provide fleet flexibility over and above that provided by the new framework arrangements. Furthermore, we expect the owned/leased mix to fluctuate in advance of the delivery of new generation A320neo aircraft from 2017 (reflected in our projections).

**Figure 18. Borrowings, Finance lease obligations, CAPEX**



### Key Revenue and Expense Drivers –Sensitivity

#### Analysis

Based on our projections, return on capital employed (ROCE<sup>54</sup>) is projected to **increase to 34.8% in 2019 only to decrease gradually to 17.7% in FY24**. Due to the fact that ROCE and EBITDAR are key metrics on which airline companies

<sup>53</sup> CAPEX includes deposits for future aircraft deliveries, payments on delivery for new aircraft (wholly owned), other aircraft-related expenditures (spare engines and aircraft modifications) and heavy maintenance costs that are capitalized.

<sup>54</sup> Based on company methodology using a **7x operating to capital lease conversion**. Formula = Operating profit after taxes (adjusted for the implied interest included in the operating lease expense) / average capital employed. The average capital employed in this formula is equal to capital employed (av. shareholder's equity and av. net debt (cash)) and operating lease adjustment

like EZJ are valued, the following part of this report will present the findings of a sensitivity analysis conducted on the above two values.

#### ▪ EBITDAR

Firstly, the year 5 EBITDAR value was tested by altering the following key revenue and expense drivers i.e. ASK, non-fuel expense, jet fuel price. By changing the revenue per passenger and ASK by a differential range (-4% to 4% to assumptions made), we found that EBITDAR is expected to increase with the growth in ASK. Furthermore, EBITDAR could potentially increase under many scenarios including i.e. 4% more ASK than expected, each year, or 1% higher seat revenue per passenger. Since our projections, as to both of these measures are in our opinion optimistic, we view that the most likely range of year 5 (2019) EBITDAR values equal to **£1 568 - £1 599**. (our forecast **£1 584**).

Next looking at non fuel expenses, in order for EBITDAR to achieve a higher (**£1 600 - £1 800 range**), a **3-4% improvement of non-fuel expenses** (higher than base case assumptions) **or an 3-4% improvement in revenue per passenger would be required**. Looking at the values, one can be fairly confident that year 5 EBITDAR **will stay above £1 500**, without the occurrence of extreme circumstances but a value in the £1 600 - £1 800 range seems fairly improbable, since the base case assumptions already reflect solid improvements in both non-fuel expenses and revenue per passenger (2.5% CAGR 2015-2024)

**Knowing that jet fuel prices materially affect airlines' bottom line, we assessed how changes in non-fuel expense differentials (ranging from -4% to 4%) and those of jet fuel prices (range from -20% to +20%) would affect year 5 EBITDAR.** Keeping in mind the current benign fuel cost environment and expected return of fuel prices to pre-slump prices, we found that Y5 EBITDAR is likely to increase to **min £1 500 with significant upwards potential if jet fuel prices decrease (instead of increasing as forecasted)**.

#### ▪ ROCE

By analogy to the analysis conducted above, **the year 5 ROCE was tested by altering the following key revenue and expense drivers** i.e. ASK, non-fuel expense, jet fuel price. As revenue per passenger (RPP) and ASK were altered, we observed that as ASK increases Y5 ROCE decreased ( -4% differential X% and for +4% differential Y%). This is exactly the opposite to what we have observed in the EBITDAR analysis discussed above. Since EZJ fleet plan is pretty set (although there is potential flexibility), we view EZJ ASK as relatively rigid too (i.e. no "wobble" room for significant differential). **For ROCE to exceed 40% (FY15) RPP would have to increase by 4% p.a. above already**, in our

opinion, **optimistic projections**. Value at the bottom/middle 30% or high 20% is more plausible. This shows that small changes to seat revenue per passenger can make a significant difference in this metric.

As for revenue per passenger and non-fuel expense (NFE) effects on ROCE, RPP confirms to be important but non-fuel expenses seem to be relatively immaterial (e.g. base case 0% differential in RPP and -4% to 4% NFE differential shows that a 8% difference in NFE causes a change in ROCE of around 6.5%. For ROCE to increase above 40%, NFE would have to be 3-4% of revenue less than expected each year and RPP would have to be greater by 3-4%.

**When analyzing fuel efficiency and jet fuel price changes** one needs to keep in mind that planned future fuel efficiency isn't expected to be significant until the end of the projection period when **c. 20% of the fleet will be A320neo**. Interesting to see is that small changes in jet fuel price affects ROCE significantly. **Each 5% increase in fuel prices decreases ROCE by c.2%**. We view that the probability of jet fuel falling further by a significant amount are very low (keeping in mind the already substantial decrease in oil price), thus, ROCE growth due to drop in fuel prices was taken out of the equation. **Surprising is the small variation in ROCE when taking into account the changes in fuel efficiency (3p.p difference).**

**Finally, when changes in non-fuel expense and CAPEX per Aircraft were analyzed, we found that CAPEX per aircraft doesn't seem to affect ROCE greatly.** It is true that more CAPEX spending reduces i.e. ROE but when CAPEX values are decreased or increased by e.g. 40%, this results in a 4-5% ROCE difference. **Thus, changes in CAPEX effect ROCE forecasts marginally.**

**To conclude**, this analysis has shown that ROCE is a key metric and thus deserves appropriate scrutiny. **ROCE is likely to hover around the 30% mark in Y5 of our projections.** ASK and non-fuel expenses unlikely to differ when compared to analyst projections and **EZJ fuel efficiency measures are expected to have a very minuscule impact on ROCE.** After the recent jet fuel price decrease it is expected that fuel prices will return to avg. levels,<sup>55</sup> which will lead to the reducing of ROCE (**each 5% increase in fuel prices reduces ROCE by c.2%**). Bearing in mind the sensitivity of ROCE to changes in revenue per passenger growth, **we view that the company should focus on improving revenue per passenger via more allocated seating, marketing to companies or by increasing spending to optimize its load factor.** Finally, the impact of this analysis on EZJ valuation is as follows. We view that the fact that, EZJ generates industry leading ROCE and has a cost advantage over all European

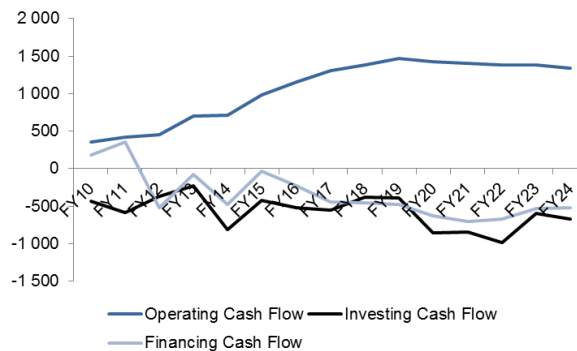
<sup>55</sup> EZJ Annual reports and Investor Presentations

airlines (excl. RYA) is already reflected in EZJ stock price (i.e. increased c. 3 times over the past 4 years) making **further capital gains purely on this measure (ROCE) highly unlikely**. Significant growth potential could come in effect of i.e. catalyst such as M&A activity or divestiture, continued lower than expected fuel prices, greater than expected revenue per passenger growth.

## Leverage and FCF

EZJ cash holdings are currently above the required net level of cash set by the company (**min £4M per plane**). Furthermore, this value is expected to grow from 2017 onwards (**Figure 19.**), thus, we view this development as positive and look to **(a) EZJ needing cash holdings to potentially support a rating in advance of financing or (b) EZJ looking to hold cash to offer strategic M&A options as potential explanations for EZJ growing cash balance**. As far as leverage is concerned, EZJ has the following targets set in place to ensure its capital structure remains both robust and efficient: **(1) maximum gearing of 50%**, thus committing to keep its capital providers and investor assured that it will not over-leverage; **(2) limit of £10M net debt per aircraft; and the target of £4M liquidity per aircraft** mentioned above. We view these targets as economically sound and vital for a company operating in this competitive industry. That being said, we found it appropriate to incorporate these assumptions into our projections

**Figure 19. Operating, Investing and Finance Cash Flow**



As far as **dividends paid** are concerned, EZJ dividend payout ratio was recently increased to 40% (September 2014) and is expected, on the grounds of strong projected operating cash flows (**Figure 19.**) to remain at this level throughout the projection period (potential special dividends payouts should not be ruled out). Thus, **EZJ capital discipline is expected to support further ad-hoc cash returns, which will remain an important part of EasyJet's equity story**.

## Valuation

EZJ was valued using the DCF (discounted cash flow) model with this choice substantiated by the fact that the company has over the last 5 years clearly communicated and has acted in the direction to keep leverage below 30% debt (currently Debt to Enterprise value (at market values) **8.19%** and Equity to Enterprise Value **91.81%**). Thus, we have accordingly set EZJ target D/EV and E/EV at 15% and 85%, respectively.

### WACC

When computing EZJ beta, the MSCI World Index was used as the market portfolio and stock data (5Y daily data) of 4 peer companies (Ryanair, Aer Lingus, Norwegian Air Shuttle, Turkish Airlines) was regressed to arrive at levered beta values. After unlevering the computed betas, a simple average was calculated and assumed further as the unlevered beta for the LCC industry. As far as taxation is concerned, due to the change expected to take place in 2015 (decrease in tax rate from 23.5% to 20%), 20% was assumed and used. Next, the computed industry beta was relevered using the target debt-to-equity ratio, giving a **value amounting to 1.1**.

In order to estimate EZJ **cost of debt**, the company's interest coverage ratio was used to estimate EZJ implied bond rating (EZJ has not been assigned a credit rating and has not issued any bonds). With EZJ high interest coverage ratio amounting to 52.82, a synthetic AAA rating was assigned with a spread equal to 0.4 pp over the risk-free rate (**cost of debt equal to 2.9%**).

The **cost of equity** was calculated using the Capital Asset Pricing Model (CAPM), with the market risk premium set at **5.6%** and risk free rate equal to **2.51%**. The risk free rate used is the average 2014UK 10Y Bond yield since we believe that the current rate, amounting to 1.756% (-42.16% down from Dec 31st 2013) will surely not remain at this low level throughout the projection period. The final component, target D/D+E and E/D+E amounting to 15% and 85% respectively was used to arrive at our estimated **7.71%** WACC.

### Terminal Value

As for the terminal value, two approaches were used i.e. the Gordon Growth Model and the Exit multiple method (although difficult to use for cyclical companies i.e. EZJ). The perpetuity growth rate was set at 2% on the grounds of the expected growth of the British economy (EZJ main market). For the second method, an exit EBITDA amounting to 6x (average for a group of airlines) was applied, which implied a terminal growth rate of 1.6%. The forecasted out-year

FY 24 EBITDA equal to £1 505M (EBITDA margin 20%) gives a discounted terminal value amounting to **£4 151** (54% of implied EV). In the GGM, the discounted terminal value is equal to **£4 690** (57% of implied EV). After summing both the discounted cash flows and terminal values i.e. calculating the implied EV, the EV was adjusted to arrive at the implied equity value (Exit multiple - £7 648 and GGM - £8 187). Lastly using the current number of shares outstanding, 393M, the implied share price was computed £20.52 (22% premium to 06.01.2015 share price) and £21.90 (30.2% premium), for the exit multiple and GGM, respectively.

## Scenario Analysis

Each scenario has different input assumptions: economic growth, fuel prices, load factors, hub-and spoke versus point-to-point etc. This leads to different volumes of traffic, and different underlying patterns of growth: long- vs. short-haul, rates of up-gauging of aircraft.

(a) (30%) Upside scenario assumes \$100/barrel oil (Brent) for the unhedged part of EZJ fuel expenses, and 5% growth in revenue per seat in 2015-16 in a very benign capacity environment. Such a scenario also implies some multiple expansions with such a positive backdrop for airlines (**Implied Share Price – £26.52**)

(b) (50%) Base Scenario (**Implied Share Price – £21.90**)

(c) (20%) Downside scenario assumes \$130/barrel oil (Brent) for the unhedged part of EZJ fuel expenses, and 2% growth in revenue per seat in 2015, decreasing to flat pricing in 2016-18 with increased competitive pressures (**Implied share price – £15.93**)

The weighted implied share price amounts to **£ 22.09** and is in close range to the value arrived at using the normal DCF approach above.

## Conclusion

EZJ is valued at £ 21.90 using the discounted cash flow (DCF) method. Our **buy recommendation** is further strengthened by the projected dividend yield (**2.68%**).

# Appendix

## Appendix 1

**Table 1a. Stock Price Performance and EUR/USD FX rate**

	EZJ	RYA	IAG*	AF	LHA	MSCI Europe Airlines Index	EUR/USD
<b>2009</b>	26%	11%		20%	5%		3%
<b>2010</b>	25%	14%		24%	39%		-7%
<b>2011</b>	-11%	-4%		-71%	-44%		-3%
<b>2012</b>	79%	30%	28%	76%	55%	43%	2%
<b>2013</b>	101%	33%	117%	8%	8%	50%	4%
<b>2014TD**</b>	-6%	21%	-5%	-6%	-20%	<b>-7%</b>	<b>-9%</b>
<b>Q1 13</b>	41%	26%	35%	5%	7%	19%	-3%
<b>Q2 13</b>	20%	19%	3%	-6%	3%	7%	1%
<b>Q3 13</b>	-1%	-12%	31%	7%	-8%	4%	4%
<b>Q4 13</b>	20%	0%	20%	3%	7%	14%	2%
<b>Q1 14</b>	12%	21%	5%	44%	23%	13%	0%
<b>Q2 14</b>	-20%	-9%	-8%	-16%	-17%	-14%	-1%
<b>Q3 14TD</b>	7%	9%	1%	-22%	-24%	-5%	-10%

Source: Bloomberg; ; Analyst analysis

\* IAG; company established after BA and Iberia merger in 2011

\*\*TD - To date - 31/11/2014

**Table 1b. Correlation between stock price and EUR/USD FX rate**

	EZJ	RYA	IAG	AF	LHA	MSCI Europe Airlines Index
<b>Correlation coefficient</b>	0.72	0.63	0.75	0.72	0.74	0.78

Source: Bloomberg; Analyst analysis

**Table 1c. Correlation Coefficient (GBP/USD FX rate vs. EZJ)**

	10/31/00 - 30/11/14	31/01/12 - 30/11/14	31/01/13 - 30/11/14
<b>Correlation coefficient</b>	0,072	-0,393	-0,504

Source: Bloomberg, Analyst analysis

## Appendix 2

## Financial Statements (Income Statement, Balance Sheet, Cash Flow Statement)

Income Statement	Historical					Projected									
	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24
Seat revenue	2 402	2 733	3 794	4 194	4 462	4 966	5 386	5 788	6 141	6 453	6 595	6 794	6 964	7 139	7 318
Non-seat revenue (ancillary)	571	719	60	64	65	72	75	78	81	83	85	87	88	89	91
<b>Total Revenue</b>	<b>2 973</b>	<b>3 452</b>	<b>3 854</b>	<b>4 258</b>	<b>4 527</b>	<b>5 038</b>	<b>5 461</b>	<b>5 867</b>	<b>6 223</b>	<b>6 537</b>	<b>6 680</b>	<b>6 881</b>	<b>7 052</b>	<b>7 228</b>	<b>7 409</b>
Growth y/y (%)	NA	16%	12%	10%	6%	11%	8%	7%	6%	5%	2%	3%	2%	2%	2%
<b>Operating Expenses:</b>															
Ground operations	-805	-923	-955	-1 182	-1 107	-1 182	-1 267	-1 353	-1 438	-1 526	-1 611	-1 701	-1 787	-1 877	-1 972
Fuel	-733	-917	-1 149	-1 078	-1 251	-1 241	-1 243	-1 364	-1 521	-1 535	-1 542	-1 549	-1 548	-1 548	-1 547
Crew	-336	-407	-432	-454	-479	-513	-550	-587	-624	-663	-699	-738	-776	-815	-856
Navigation	-256	-285	-280	-294	-307	-329	-352	-376	-400	-424	-448	-473	-497	-522	-549
Maintenance	-177	-179	-203	-212	-212	-244	-245	-239	-247	-254	-291	-308	-314	-344	-351
Selling and marketing	-92	-102	-104	-101	-103	-134	-137	-145	-162	-162	-166	-171	-175	-179	-184
Aircraft wet leasing	-14	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Volcanic ash disruption	-27	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Royalty	0	-4	0	0	0	-71	-72	-74	-76	-78	-81	-84	-86	-89	-92
Other costs	-172	-167	-200	-226	-245	-250	-262	-272	-298	-309	-316	-327	-334	-343	-352
<b>Total Operating Expenses</b>	<b>-2 612</b>	<b>-2 984</b>	<b>-3 323</b>	<b>-3 547</b>	<b>-3 704</b>	<b>-3 965</b>	<b>-4 128</b>	<b>-4 410</b>	<b>-4 768</b>	<b>-4 952</b>	<b>-5 154</b>	<b>-5 351</b>	<b>-5 518</b>	<b>-5 718</b>	<b>-5 903</b>
<b>EBITDAR</b>	<b>361</b>	<b>468</b>	<b>531</b>	<b>711</b>	<b>823</b>	<b>1 074</b>	<b>1 333</b>	<b>1 456</b>	<b>1 455</b>	<b>1 584</b>	<b>1 526</b>	<b>1 530</b>	<b>1 535</b>	<b>1 510</b>	<b>1 505</b>
EBITDAR margin (%)	12.1%	13.6%	13.8%	16.7%	18.2%	21.3%	24.4%	24.8%	23.4%	24.2%	22.8%	22.2%	21.8%	20.9%	20.3%
Aircraft dry leasing	-102	-109	-95	-102	-124	-126	-126	-126	-128	-134	-153	-162	-162	-177	-180
Depreciation	-72	-83	-97	-102	-106	-113	-121	-130	-139	-147	-161	-162	-182	-182	-182
Amortization of intangible assets	-6	-7	-8	-10	-12	-14	-16	-18	-20	-20	-20	-20	-20	-20	-20
Loss on disposal of assets held for sale	-7	0	0	0	0	0	0	0	0	0	0	0	0	0	0
<b>Operating profit</b>	<b>174</b>	<b>269</b>	<b>331</b>	<b>497</b>	<b>581</b>	<b>821</b>	<b>1 071</b>	<b>1 182</b>	<b>1 167</b>	<b>1 283</b>	<b>1 192</b>	<b>1 185</b>	<b>1 171</b>	<b>1 132</b>	<b>1 123</b>
Operating profit margin (%)	6%	8%	9%	12%	13%	16%	20%	20%	19%	20%	18%	17%	17%	16%	15%
Interest receivable and other financing inc	7	9	11	5	11	10	19	27	37	46	50	48	44	44	47
Interest payable and other financing charge	-27	-30	-25	-24	-11	-9	-13	-13	-11	-10	-9	-7	-6	-6	-5
Foreign Exchange, net gain/ (loss)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
<b>Net finance charges</b>	<b>-20</b>	<b>-21</b>	<b>-14</b>	<b>-19</b>	<b>0</b>	<b>0</b>	<b>6</b>	<b>14</b>	<b>25</b>	<b>36</b>	<b>42</b>	<b>41</b>	<b>38</b>	<b>38</b>	<b>42</b>
<b>Profit before tax</b>	<b>154</b>	<b>248</b>	<b>317</b>	<b>478</b>	<b>581</b>	<b>821</b>	<b>1 077</b>	<b>1 196</b>	<b>1 193</b>	<b>1 319</b>	<b>1 234</b>	<b>1 226</b>	<b>1 209</b>	<b>1 170</b>	<b>1 165</b>
Profit before tax margin (%)	5%	7%	8%	11%	13%	16%	20%	20%	19%	20%	18%	18%	17%	16%	16%
Tax credit (charge)	-33	-23	-62	-80	-131	-193	-215	-239	-239	-264	-247	-245	-242	-234	-233
Effective tax rate (%)	21.4%	9.3%	19.6%	16.7%	22.5%	23.5%	20%	20%	20%	20%	20%	20%	20%	20%	20%
<b>Profit for the period/year</b>	<b>121</b>	<b>225</b>	<b>255</b>	<b>398</b>	<b>450</b>	<b>628</b>	<b>862</b>	<b>957</b>	<b>954</b>	<b>1 055</b>	<b>987</b>	<b>981</b>	<b>967</b>	<b>936</b>	<b>932</b>
Net Profit margin (%)	4%	7%	7%	9%	9.9%	12%	16%	16%	15%	16%	15%	14%	14%	13%	13%

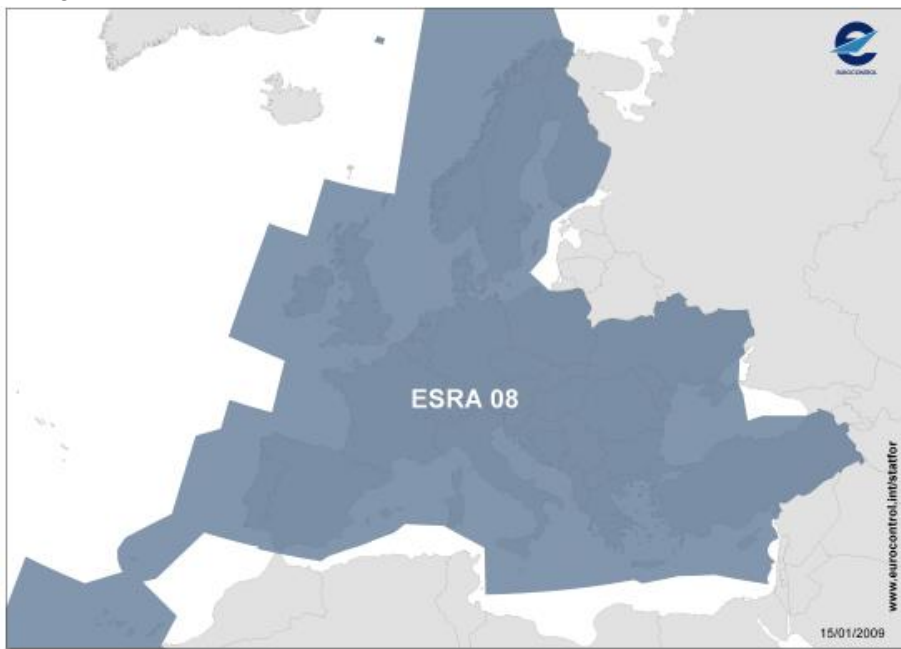
Assets	Historical					Projected									
	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24
<b>Current assets</b>															
Trade and other receivables	227	158	211	273	200	261	291	314	318	351	366	374	385	394	404
Derivative financial instruments	86	174	104	64	53	41	41	0	0	0	0	0	0	0	0
Short-term investments	418	386	362	259	584	580	570	559	547	534	523	517	510	503	495
Cash and cash equivalents	1 069	1 130	979	937	434	258	972	1 149	1 453	2 008	1 933	1 767	1 492	1 726	1 887
<b>Total Current Assets</b>	<b>1 800</b>	<b>1 848</b>	<b>1 656</b>	<b>1 533</b>	<b>1 261</b>	<b>1 140</b>	<b>1 874</b>	<b>2 022</b>	<b>2 318</b>	<b>2 892</b>	<b>2 822</b>	<b>2 657</b>	<b>2 386</b>	<b>2 623</b>	<b>2 786</b>
<b>Non-current assets</b>															
Goodwill	365	365	365	365	365	365	365	365	365	365	365	365	365	365	365
Other intangible assets	85	86	87	91	113	126	159	198	247	299	351	403	455	507	559
Property, plant and equipment (net)	1 739	1 932	2 193	2 192	2 542	2 881	3 024	3 401	3 788	3 973	4 633	5 255	6 008	6 360	6 785
Derivative financial instruments	26	46	43	39	36	27	27	0	0	0	0	0	0	0	0
Other non-current assets	116	111	103	176	165	170	188	204	218	231	241	246	253	259	266
<b>Total Non-Current Assets</b>	<b>2 332</b>	<b>2 540</b>	<b>2 791</b>	<b>2 863</b>	<b>3 221</b>	<b>3 569</b>	<b>3 763</b>	<b>4 168</b>	<b>4 618</b>	<b>4 867</b>	<b>5 590</b>	<b>6 269</b>	<b>7 081</b>	<b>7 492</b>	<b>7 975</b>
<b>Total Assets</b>	<b>4 132</b>	<b>4 388</b>	<b>4 447</b>	<b>4 396</b>	<b>4 482</b>	<b>4 709</b>	<b>5 636</b>	<b>6 189</b>	<b>6 936</b>	<b>7 760</b>	<b>8 412</b>	<b>8 927</b>	<b>9 467</b>	<b>10 115</b>	<b>10 761</b>
<b>Equity and Liabilities</b>															
<b>Current liabilities</b>															
Trade and other payables	1 070	1 182	1 308	1 440	1 110	1 612	1 689	1 791	1 913	2 038	2 075	2 154	2 230	2 304	2 384
Derivative financial instruments	34	9	12	34	87	87	87	0	0	0	0	0	0	0	0
Maintenance provisions and Other	130	73	38	75	132	134	153	161	158	176	192	209	217	228	243
<b>Total Current Liabilities</b>	<b>1 233</b>	<b>1 264</b>	<b>1 358</b>	<b>1 549</b>	<b>1 329</b>	<b>1 832</b>	<b>1 929</b>	<b>1 952</b>	<b>2 071</b>	<b>2 214</b>	<b>2 266</b>	<b>2 363</b>	<b>2 447</b>	<b>2 532</b>	<b>2 627</b>
<b>Non-current liabilities</b>															
Borrowings (bank loans)	1 162	998	957	548	377	377	667	578	523	468	413	337	316	295	274
Finance lease obligations	114	219	212	213	186	178	162	144	126	108	88	69	49	31	14
Derivative financial instruments	1	3	6	21	23	23	23	0	0	0	0	0	0	0	0
Non-current deferred income	62	63	52	63	62	32	35	38	41	43	45	46	48	49	50
Maintenance provisions	133	185	175	155	147	156	158	147	132	138	151	164	171	179	191
Deferred tax liabilities	85	147	181	180	186	159	286	417	550	691	831	957	1 075	1 180	1 277
<b>Total Non-Current Liabilities</b>	<b>1 557</b>	<b>1 615</b>	<b>1 583</b>	<b>1 180</b>	<b>981</b>	<b>924</b>	<b>1 332</b>	<b>1 324</b>	<b>1 372</b>	<b>1 448</b>	<b>1 528</b>	<b>1 573</b>	<b>1 657</b>	<b>1 733</b>	<b>1 806</b>
<b>Total Liabilities</b>	<b>2 790</b>	<b>2 879</b>	<b>2 941</b>	<b>2 729</b>	<b>2 310</b>	<b>2 757</b>	<b>3 261</b>	<b>3 276</b>	<b>3 442</b>	<b>3 662</b>	<b>3 795</b>	<b>3 936</b>	<b>4 105</b>	<b>4 265</b>	<b>4 433</b>
<b>Equity</b>															
<b>Shareholder's equity</b>															
Share capital and premium	758	762	763	765	766	772	793	820	847	876	908	946	985	1 026	1 068
Hedging reserve and Translation reserve	57	155	101	39	-16	-21	-25	-29	-33	-37	-41	-45	-49	-54	-58
Retained earnings	527	592	642	863	1 422	1 201	1 607	2 122	2 680	3 258	3 750	4 089	4 426	4 877	5 319
<b>Total Equity</b>	<b>1 342</b>	<b>1 509</b>	<b>1 506</b>	<b>1 667</b>	<b>2 172</b>	<b>1 952</b>	<b>2 375</b>	<b>2 913</b>	<b>3 494</b>	<b>4 098</b>	<b>4 617</b>	<b>4 991</b>	<b>5 362</b>	<b>5 850</b>	<b>6 328</b>
<b>Total Equity and Liabilities</b>	<b>4 132</b>	<b>4 388</b>	<b>4 447</b>	<b>4 396</b>	<b>4 482</b>	<b>4 709</b>	<b>5 636</b>	<b>6 189</b>	<b>6 936</b>	<b>7 760</b>	<b>8 412</b>	<b>8 927</b>	<b>9 467</b>	<b>10 115</b>	<b>10 761</b>

	Historical					Projected									
	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>															
Net Profit / (Loss) After Income Tax:	121	225	255	398	450	628	862	957	954	1 055	987	981	967	936	932
<b>Adjustments for Non-Cash Charges:</b>															
Depreciation	73	83	97	102	106	113	121	130	139	147	161	162	182	182	182
Amortization of Intangible Assets	6	7	8	10	12	14	16	18	20	20	20	20	20	20	20
Deferred Income Tax (benefit)	19	21	34	15	35	99	133	146	136	155	134	128	119	105	99
Stock-based Compensation Expense	5	6	12	18	23	33	40	42	44	46	47	48	49	51	52
Loss on Disposal of PP&E	2	0	1	0	2	0	0	0	0	0	0	0	0	0	0
Other Cash Interest Paid (earned)	32	-2	5	-3	11	0	0	0	0	0	0	0	0	0	0
Goodwill Impairment	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
<b>Change in working capital and other operational items:</b>															
Trade and Other Receivables	43	27	-44	74	-6	-26	-43	-1	-17	-18	-7	-9	-8	-8	-8
Trade and Other Payables	45	87	74	64	18	101	48	84	105	61	44	59	50	60	56
Provisions	-1	-5	18	29	32	39	-4	-13	8	9	46	21	8	38	9
Other Non-current Assets	9	-9	6	8	33	-19	-15	-15	-13	-11	-5	-7	-6	-6	-7
Derivative Financial Instruments	2	-2	4	0	-2	30	-3	-48	0	0	0	0	0	0	0
Deferred Revenue	4	-14	-13	-14	-6	-27	3	3	2	2	1	1	1	1	1
<b>Net Cash Provided by Operating Acti</b>	<b>359</b>	<b>424</b>	<b>457</b>	<b>701</b>	<b>708</b>	<b>984</b>	<b>1 157</b>	<b>1 304</b>	<b>1 378</b>	<b>1 466</b>	<b>1 428</b>	<b>1 404</b>	<b>1 382</b>	<b>1 378</b>	<b>1 336</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>															
Purchase of PP&E (CAPEX)	-472	-550	-379	-400	-426	-394	-484	-509	-321	-330	-785	-784	-925	-533	-609
Proceeds from Sale of Property, Plant an	0	75	1	1	1	0	0	0	0	0	0	0	0	0	0
Purchase of Intangible Assets	-11	-6	-13	-21	-23	-44	-52	-60	-72	-72	-72	-72	-72	-72	-72
(Purchase) Sale of STI	48	-102	20	193	-361	10	11	12	12	13	7	7	7	7	7
<b>Net Cash Used in Investing Activities</b>	<b>-435</b>	<b>-583</b>	<b>-371</b>	<b>-227</b>	<b>-809</b>	<b>-428</b>	<b>-525</b>	<b>-557</b>	<b>-380</b>	<b>-389</b>	<b>-851</b>	<b>-849</b>	<b>-990</b>	<b>-598</b>	<b>-674</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>															
Proceeds from Share Capital	10	3	2	1	1	2	2	2	2	2	2	2	2	2	2
Repurchase of Common Stock	-1	-8	-15	-26	-57	-17	-17	-17	-17	-17	-11	-11	-11	-11	-11
Bank Loan Proceeds	213	172	0	0	0	216	163	0	0	0	0	0	0	0	0
Bank Loan Repayments	-188	-154	-305	-273	-104	-45	-89	-72	-55	-55	-66	-49	-21	-21	-21
Finance Lease Proceeds	47	71	0	0	0	0	0	0	0	0	0	0	0	0	0
Finance Lease Repaid	-4	-6	-9	-10	-8	-16	-17	-18	-18	-19	-20	-20	-20	-16	-16
Aircraft Sale and Leaseback Proceeds	109	273	0	316	0	0	0	0	0	0	0	0	0	0	0
Dividends Paid*	0	0	-196	-85	-308	-176	-271	-343	-372	-386	-533	-630	-625	-489	-478
<b>Net Cash Provided by Financing Acti</b>	<b>186</b>	<b>351</b>	<b>-523</b>	<b>-77</b>	<b>-476</b>	<b>-36</b>	<b>-228</b>	<b>-448</b>	<b>-461</b>	<b>-475</b>	<b>-627</b>	<b>-708</b>	<b>-675</b>	<b>-535</b>	<b>-525</b>
Effect of Exchange Rate Changes:	9	-4	-18	-29	-12	-3	-3	-4	-4	-4	-4	-4	-4	-4	-4
<b>Change in Cash and Cash Equivalent</b>	<b>119</b>	<b>188</b>	<b>-455</b>	<b>368</b>	<b>-589</b>	<b>517</b>	<b>400</b>	<b>295</b>	<b>534</b>	<b>598</b>	<b>-54</b>	<b>-157</b>	<b>-288</b>	<b>240</b>	<b>133</b>
Beginning Cash:	793	912	1 100	645	1 013	424	941	1 342	1 637	2 170	2 769	2 715	2 557	2 269	2 510
<b>Ending Cash:</b>	<b>912</b>	<b>1 100</b>	<b>645</b>	<b>1 013</b>	<b>424</b>	<b>941</b>	<b>1 342</b>	<b>1 637</b>	<b>2 170</b>	<b>2 769</b>	<b>2 715</b>	<b>2 557</b>	<b>2 269</b>	<b>2 510</b>	<b>2 643</b>

## Appendix 3

	As of 1st January 2015				As of 31st December 2015			
	Terminal Value - Multiples Method:	Terminal Value - Perpetuity Growth Method:	Terminal Value - Multiples Method:	Terminal Value - Perpetuity Growth Method:				
Discount rate (WACC):	7.7%	2%	6	2%				
Percentage of Year Remaining	75%	2%	6	2%				
Stub Period Fraction:	3/4	1.3%	7 949	8 982				
		1.3%	Implied Terminal FCF growth rate	Implied Terminal FCF growth rate				
		3 853	NPV of Terminal Value:	4 151				
		3 928	Sum of NPV of FCF:	3 497				
		7 782	Implied EV	7 648				
Beta	1.1	53%	% of Implied EV from TV	54%				
Rf	2.5%	333	Plus: Cash & Cash Equivalents (Ex	157				
ERP	5.6%	0	Plus: Equity Investments:	0				
CoE	8.7%	732	Plus: Other Non-core assets, net:	773				
Default spread	0.40%	0	Plus: Net Operating losses:	0				
CoD	2.90%	-563	Less: Total Debt:	-555				
CoD (implied interest rate)	1.48%	0	Less: Preferred Stock	0				
		0	Less: Noncontrolling Interests:	0				
Dividends Payout	40%	0	Less: Unfunded Pension Obligations	0				
Debt / Enterprise Value (accou	8.2%	0	Less: Capitalized leases:	0				
Equity / Enterprise Value (@ n	91.8%	0	Less: Restructuring & Other Liab	0				
WACC	8.14%	8 284	Implied Equity Value	8 023				
Terminal Growth Rate	2.0%	393	Shares Outstanding (m):	391				
Terminal EBITDA Multiple	6	21.08	Implied Share Price from DCF	20.52				
		25.3%	Premium/(Discount) to Current:	22.0%				
		22.36	Implied Share Price from DCF	21.90				
		32.9%	Premium/(Discount) to Current:	30.2%				

**Annex 1.**



## STRENGTHS

- **EZJ has a strong pan-European airport network** - 134 airports across Europe, North Africa and the Middle East (675 routes). Presence in **49/100** top pairs in Europe (mainly primary airports). Winter seat capacity a share of 6.5%, behind RYA on 9.8% and Lufthansa on 7.6% (OAG data). summer seat share of 8.1% ranks it second only to RYA 11.7%
- **EZJ low pricing vs. main competitors** - ~ 44,4 % lower (avg. fare/ TRPP - RYA EUR 46, Norwegian EUR83, EZJ EUR 84, Aer Lingus EUR 93, airberlin EUR 121, Alitalia EUR 148, Lufthansa EUR 121, IAG EUR 135, AF-KLM EUR 151(For legacy carriers – average fare/total revenue per passenger adjusted to reflect short-haul routes to aid appropriate comparison)
- **Relative cost position is powerful** - CASK ~ is 20% to 45% below FSCs with a similar average sector length
- **EZJ brand is strengthening** - EZJ has successfully raised its brand awareness in recent years substantiated in the **upward trajectory of RPS in recent years.**
- **EZJ financial performance ranks among the best in Europe** - EZJ FY2014 (pre-tax profit GBP 581M - pre-tax margin of 12.8% vs. FY2011 GBP248 million - 7.2% margin. Over the same period, FY2011 to FY2014, its pre-tax profit per seat has more than doubled from GBP 3.97 to GBP 8.12 and its return on capital employed (ROCE) has grown from 9.8% to 20.5%. **EZJ is one of the few airlines consistently earning returns > WACC**

## WEAKNESSES

- **Cost base is not as low as that of Europe's ultra-LCCs** - EZJ has a unit cost advantage vs. most competitors excl. Europe's three ultra-LCC; RYA, Wizz Air and Pegasus. EZJ CASK ~ 70% > than RYA - vulnerable to direct competition. Although, RYA and EZJ only compete head to head rarely, competition is likely to increase as RYA grows its presence in primary airports and attacks the business traveler segment where EZJ has had a head start.
- **Seasonal earnings pattern persists** - EZJ annual profits rely heavily on 2H (April to September) to offset a loss-making winter (October to March) - seasonality of demand. However, over the past 2Y, EZJ has reduced its 1H loss (-2/3) and increased its 2H profit (+1/2). Although 2H still accounts for more than 100% of its annual profit, **EZJ dependency on 2H has reduced slightly**

## OPPORTUNITIES

- **Further profitable growth opportunities exist** - focusing on its top 20 airports in the year to Sep-2014, EZJ has a total market share of around 20% by number of seats<sup>1</sup>. Excluding market already taken by other LCCs and non-LCC transfer traffic, EZJ estimates potential of +86M seats<sup>1</sup> operated by non-LCCs on point-to-point routes at its top 20 airports - relatively low risk opportunity for growth within its current
- **Further growth potential in business segment** - number of EZJ business passengers has increased (~10M FY2011-12M FY2014 (+6.27% CAGR)). Business travelers are attracted by: (a) primary airports, (b) high frequencies on key business routes and (c) offer of a bundled product with features aimed at business travelers. In addition, EZJ has an appropriate distribution strategy (implemented agreements with GDS, online travel agents and corporate accounts) - an approach now followed by RYA. With lower fares vs. direct competitors in its markets, **EZJ is well positioned to increase short-haul business travel market penetration**
- **Aircraft orders have a flexible delivery schedule** -EZJ is expected to need 20-30 planes to accommodate natural market growth of 2.2% p.a.; 40-65 to capture growth in its existing network (thickening existing routes and joining the dots); and 30 to 45 from new network points and routes. Net of route churn - requirement of 296 - 356 will be needed in FY2019. EZJ has exercised its final 27 purchase rights over A320neo aircraft delivery (2015 – 2017) and will take delivery of 100 A320 neo aircraft (2017 – 2022). Under the base case, the fleet plan will take the FY2019 total to 304 aircraft, at the lower end of its requirement range, with flexibility to raise it to 316, or to cut quite significantly to 204, depending on market conditions. The base case total for FY2019 (+6% CAGR) from FY2014. The up-gauging of the fleet - growing proportion of A320s vs. A319s and the introduction of the A320 neo **will contribute to savings in cost per seat**
- **Unit cost reduction opportunities still exist** - identified in EZJ lean program (incl. engineering and maintenance, airport deals, engine selection, the up-gauging of the fleet (see above) and the introduction of the A320 neo)

## THREATS

- **Competitor response (i.e. RYA)** - One of the main threats to EZJ strategic plans is possible competitor response. As FSC increasingly offer unbundled short haul fares, seat pricing is expected to converge. Provided that EZJ maintains its relative cost advantage, underpricing most competitors on avg. can be expected to continue. RYA recent strategic shift (i.e. increase in number of primary airports in its network and targeting business passengers) should be viewed as a more credible threat, especially given RYA unit cost advantage vs. EZJ. This threat relatively insignificant in the short-term (relative lack of airport overlap) but could potentially become material in the long term.
- **External events/accident** - air travel is vulnerable to geopolitical events and natural phenomena (e.g. earthquakes, volcanic ash disruption). EZJ relatively focused geographic exposure arguably mitigates this exposure relative to airlines with a global network. However, a Europe-wide event would affect EZJ significantly
- **The European economy** - the airline industry is economically cyclical, although LCCs in Europe have often performed well in a downturn as FSCs have often accelerated their capacity cuts and passengers have traded down in times of austerity. However, with EZJ relative dependency on primary airports and premium product features (relative to other European LCC) **may leave it more exposed to the economic cycle** than a pure LCC whose passengers are mainly price-motivated
- **Cost creep** - EZJ efforts to increase its attraction to business travelers (aim: yield maximization) only makes sense if this is not offset by corresponding growth in unit costs. The shift towards a more premium product positioning comes might lead to growing cost – low risk - EZJ track record shows that management is effective in managing this issue
- **Labor unrest** - airlines are vulnerable to labor unrest (e.g. staff or key airport-based suppliers - ATC, ground-handling, security and ground transport). EZJ has been successful in keeping its labor relations in tact (same can't be said about FSC) and this is currently of no specific cause for concern. However, as EZJ size, geographical diversity and growing unionization increase, the risk of internal labor disputes will surely rise.
- **EZJ founder Stelios' shareholder activism** - EZJ has two major shareholders (easyGroup Holdings Limited and Polys Holding Limited – brand owner) which together control 34.6% of EZJ common shares. **Shareholder activism could adversely impact the reputation of EasyJet and potentially cause a distraction to management.**

## Disclosures and Disclaimer

### Research Recommendations

<b>Buy</b>	Expected total return (including dividends) of more than 15% over a 12-month period.
<b>Hold</b>	Expected total return (including dividends) between 0% and 15% over a 12-month period.
<b>Sell</b>	Expected negative total return (including dividends) over a 12-month period.

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