Fasten Your Seat Belts

Update 7 of "Diary of a Private Investor" Colm Fagan 10 September 2018

"We are experiencing some turbulence. Please stay in your seats and fasten your seat belts." We are familiar with such in-flight announcements, and they don't worry us. It never occurred to me that the financial turbulence of owning shares in an airline company could be more worrying than the physical turbulence of flying in their planes.

My financial turbulence started shortly after I bought Ryanair shares in March 2016. I continued loading up over the next couple of months, at an average of €13.47 a share. By the start of June, Ryanair was my second-biggest holding, accounting for 18% of my portfolio, up from zero three months previously. Little did I know the turbulence that lay ahead.

My purchases derived from a projection that its shares could be worth €24 by 2024. Ryanair doesn't normally pay dividends, so the projection was based solely on projected growth in share price. Growth from €13.47 to €24 over an eight-year period would equate to a compound annual return of 7.5%, comfortably ahead of my target return of 6% to 7% a year. The core assumption underlying the projection was a belief that Ryanair's management could deliver on its target of 180 million passengers by 2024, up from 106 million in Financial Year 2016, without sacrificing margin.

I was able to grow my holding quickly between March and June 2016 by employing something I had discovered only a short time previously: financial spread bets. With spread bets, I only had to pay 10% of the cost up front. Effectively, the spread betting firm would lend me the full cost of the shares, on the security of a 10% deposit. For larger companies, such as Apple, the deposit requirement was only 5%. For Ryanair, the margin increased to 20% above a certain level.

I was like a child with a new toy, fascinated by what it could do but oblivious to its dangers. I realised of course that a fall in the share price would result in a margin call, and I took the precaution of bolstering my deposit account, so that I would have ready access to funds in such an eventuality. I thought I had my risks covered. How naïve of me.

Then came the Brexit vote on Thursday, June 23. I stayed up well into the night, horrified as the results came in. I also had to do some last-minute packing for going on holidays the next day. At 7:30 on Friday morning, when I should have been winding down for the holiday, I got a call from the spread betting firm, demanding funds immediately or my position would be closed. He said that he expected Ryanair to be down about 15% from Thursday's closing price of €13.69 when the markets opened in half an hour. This was more than I had feared, even in my worst nightmares. To avoid having my holding liquidated, I would have to come up with more funds than I could withdraw in a single day without visiting my bank, which I had no intention of doing on the day I was going on holidays. I transferred enough to avoid immediate closure of my positions, but eventually bowed to the inevitable. In mid-morning, my entire Ryanair position was closed at €11.90 a share. The price was higher than I would have got first thing in the morning, so I was grateful for small mercies. Nevertheless, I had to swallow a major loss.

When the dust settled, I decided that Ryanair's prospects had not been that badly dented, so I started rebuilding my position. By the end of August 2016, I was back to where I was just before the Brexit vote and by September my Ryanair holding exceeded the previous peak. There were two big differences from before, though. Firstly, I was able to buy back at much cheaper prices: the average price for purchases between June and September was just €11.52 a share. Secondly, I made certain to over-fund the spread bet account by a significant margin, to avoid ever being caught the same way again. To date, my strategy has been successful, but I know there are greater tests to come.

It is hard to make sense of my purchases and sales of Ryanair since then. I have finally rationalised them by concluding that I have the same schizophrenic attitude to investing in Ryanair as I have to flying with it: I don't like it, but it's cheap (most of the time) and I end up buying, even though I don't really want to. I think it represents particularly good value at the current price (€13.20 at time of writing), so it's now my third largest holding (after Renishaw and Phoenix).

Part of Ryanair's attraction is the thermal uplift of share buybacks. To illustrate their impact, profits for FY2018 were up 10% on last year, but earnings per share were up 15%. The difference is because Ryanair generates lots of cash, but instead of paying dividends, it uses the spare cash to buy back shares from investors and then cancels them. The net result is that profits are being distributed to a smaller group of people, so we all get more. It gives a nice lift to earnings each year.

Profits are expected to fall by around 10% in 2019, but the thermal uplift of share buybacks means that earnings per share are likely to fall by less than 7%. (This forecast excludes losses on recently acquired Laudamotion, which I've excluded on the grounds that Ryanair bought the company in the belief that it will eventually add value. I've assumed – cautiously I hope - that the purchase will neither add to nor detract from Ryanair's value). Even at the lower profits, I can expect an earnings yield of 8.5% from the current price. I believe that this represents excellent value ………
Unless there's a hard Brexit, in which case I'd better fasten my seat belt for further turbulence.