2017 THIRD QUARTER RESULTS TELECONFERENCE TRANSCRIPT

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Presentation

Operator

Ladies and gentlemen, welcome to Pegasus Airlines Third Quarter Financial Results conference call. I will now hand you over to Mr Mehmet Nane, CEO, and Mr Serhan Ulga, CFO. Dear, Mr Mehmet, the floor is yours.

Mehmet Nane

Welcome to our third quarter conference. Today we are proud of what we have done as a team in the third quarter. I would like to give you the brief highlights, then my colleague, our CFO, Serhan, will go into the details and we will take the questions afterwards.

When we look at the total industry, after April we saw a really big recovery. You can see this on slide five of the presentation (the figures), and this continued in our best season, the summer season, and this time the figures were almost quadrupled according to April and May increases, and this is [audio] on top of that the measures we took at 3C yesterday, the management initiatives, had a perfect solution on our figures, both on the sales side and on the cost side. We increased the sales, we decreased the costs, so we have more cash compared to our budget and our outlook, we have more turnover, both from ancillary and from ticket sales and we have more EBITDAR and EBT compared to our outlook and the forecast.

So, this is a brief introduction how the last nine months and especially the last quarter went, and we will see how these are reflected in detail to our numbers. Now, I am giving the word to our CFO, Serhan Bey.

Serhan Ulga

Hello everyone. I will be starting from slide number seven. Again, on the back of what Mehmet Bey said, we have reached all-time high load factor on the back of a double-digit capacity growth and in terms of cost containment and cost performance, also this resulted – the all-time high EBITDAR margins, not only for the quarter but for year-to-date as well.

On the revenue development side, the increase is significant, you are looking at almost TL 700 million worth of increases, and we see all moving parts contributing positively, the biggest one coming, of course, from the operation, meaning sales performance from the load factor to yield and ancillary revenue. Of course, the growth also contributed to this with a fixed impact reaching us to TL 2 billion revenues.

On the overall operation metrics, if you look at that, operational metrics is also very robust. We have exceeded, if not matched the overall growth in the market, and the yields also on the right side, if you see the yields are up from TL 98 to 114 and €77 to 80, not only with the load factor growth, the capacity growth, but also the yield growth came on top.

Page number 12 is mostly for your models, indeed, but triple target achieved on this one; we had yield improvements together with load factor increased on a growing production base. Again, to reiterate, a 14% increase on international RASK is, I think, extremely important on a hard currency basis.

On the fleet side, there is nothing new that is unknown. It's just that the continuing of the aircraft deliveries is robust, also what we have promised that we are selling from the existing fleet, we're selling 737-800 production line – our production line, I can say, is intact. We have delivered already before the high season six aircraft and we have five more to go. As you may remember, most of you who have listened to our previous webcast, and they are to be concluded before the end of the year, which would not only resize the fleet, but also contribute to cash levels further by the end of the year.

The new footprint is on slide number 16. The number of countries that we are flying to has reached 40 with 108 destinations, of which 72 are international.

On the EBITDAR, our second most loved slide after CASK, again shows all the factors that result in an increase of almost TL 400 million, which results in all-time high margin of 44.1%. Again, the only thing year over year, if we compare the third quarters, is the only negative seems to be coming from fuel costs. Of course, the fuel prices have increased on the back of OPEC decisions to stand firm on reducing capacity (production capacity) and disruption in the Middle East in a geopolitical sense, but one of the other things that is still continuing is for the management's accomplishment is achieve all these sales results with lower marketing expense and the manpower optimisation, or let's say reduction continues to play into the numbers in the EBITDAR performance.

The most important slide, I think, in this one is always, as you see, is the CASK base, a comparison of the CASK base. The non-fuel CASK has gone down from 260 to 233 on an adjusted basis. If you take the wet lease impact, this is where the economical non-fuel CASK is for the third quarter. The only increasing impact is actually something that we welcome, that 0.09 which we were managing, also the expectations of our own friends in the company is, basically, an accrual or reserve for a good performance and a bonus distribution for all our eligible employees in the company, which is practically almost everyone with more than six months of tenure in the company. So as rare as it may seem, actually it is a good thing to share what we have accomplished with our own people, because those are the people who did contribute to the accomplishment of this, so that is one thing I wanted to note on this. It is just not another other, it is a real other from a management perspective.

On the balance sheet, again, as Mehmet Bey indicated, the increase – the cash from operations went up by a billion, cash from investments due to aircraft sales on a net basis went up by 300 million and there were other impacts of obviously, the financing of the existing new and older aircraft, continuing pay down of the aircraft loans. The asset size reached to TL 7.2 billion compared to the year-end, this is thanks to the incoming new aircraft, which helped the growth of the balance sheet.

On foreign currency exposure on the income statement side, we again… this is mostly semantics, in terms of reiterating what we have been doing and nothing has changed from what we have been doing. Again, we wrote down our strategies from both sides, a hedged strategy of the fuel on the upper right side, again, as discussed and indicated before, 30% non-discretionary with the products listed there right next to it, as well as a potential 30% discretionary of the company or the management, which we have not exercised in the past quarter, so that the same strategy continues on the FX side. We have tried to explain this before is because of the changing proportions of the FX in our P&L, we are actively managing our Turkish lira surplus and domestic ticket sales on a next-day basis to convert into dollars, which we have seen and experienced that has taken out quite a bit of volatility in the marketplace, as opposed to buying and going to market buying U.S. dollars at different times, so it is a continuous process, which helps us to secure our dollar needs of our operations. We have also provided sensitivity analysis for you to understand what that means on a quarterly basis on the income statement, on the lower right side.

All in all, no change, just an update on the numbers, which will help you understand where we are at this time.

Last but not least, of course, is our new guidance that we would like to share with you, because we have much better granular visibility towards the year-end. as we have experienced a very, very strong third quarter and looking into the fourth quarter, probably a very strong fourth quarter still playing out every day is that guest growth is going up a couple of ticks, the capacity will be the same, utilisation similar, but on an annual basis, if you look at the new guidance on the load factors, domestic loads are up by 4-5 percentage points year over year, and international loads are up by 7-8 percentage points year over year compared to 2016, and domestic yields are up, it basically shows the market prices, inflation into the pricing of the air travel, which is welcomed by us. However, on the international yield, we are going to be basically staying with the same guidance we gave you, but the loads are going to be there for us to benefit from the ancillary upside if possible towards the end of the year. Even though the ancillary revenue guidance has not changed, I would expect that it will be on the upper end of it, and perhaps a little tick more.

Overall, the non-fuel CASK is going to be intact and because of the topside improvements and significant growth, I think we will be looking at – even north side of the range that we give here on the EBITDAR margin, which will also be record all-time high, when we close this year-end based on our expectations.

With that, I think, this pretty much concludes the formal part of the presentation, which I know is sort of quick, because when the numbers are great, it may be quick.

Mehmet Nane

They speak by themselves.

Serhan Ulga

We don't have to say too much, but of course a lot has been, Mehmet Bey [audible] last year, a lot of pain, a lot of effort, a lot of restructuring, a lot of cost cutting and a lot of other efforts that went in, also on the revenue management side, as we have discussed with many of you before how we have reshaped revenue management with BCG assistance.

I would shut up right now and leave the floor for questions, if there are any.

Question and Answer Session

Operator

[Operator instructions]

Our first question comes from Gorkem Goker, from Yapı Kredi.

Gorkem Goker

My question is maybe it could be too immature, but your capacity growth plans for 2018, could you please give us more colour on that front? Should we expect a similar growth like 2017? A follow-up to that question, should we expect these new capacities coming from secondary airports, such as Ankara, as there is limited capacity might be left Sabiha Gökçen, and in such a case, how different in terms of load factor yields, I mean main KPIs when compared with Sabiha Gökçen-based flights with that of Ankara or rest of the airports? Thank you very much.

Serhan Ulga

Let me answer one part of the question, perhaps Mehmet Bey may pick up the other part, the part of the question in terms of capacity increase is 12% plus as you can see from the… let's say 10% plus growth with the right-sizing that happened in 2017. From a network LCC standpoint, we continue to be very vigilant on the Sabiha Gökçen capacity that we are going to be deploying to the best and max we can deploy to feed the network. There will be, however, new domestic routes that are being introduced. Also, there are further new routes that are expected to be introduced in Ankara and some in Izmir as well, but Mehmet Bey, perhaps how you see…

Mehmet Nane

I think the growth, it is not confirmed yet, because we didn't get approval from our board yet. Our board will be next month on the 14th, we are still working on it, but it is going to be in line with this year's growth. This is ceteris paribus, because the neighbourhood countries are very hot at the moment, and Saudi Arabia included into this hotness. According to developments, if everything continues as is, the growth rate will be in line of 2017 in 2018.

Serhan Ulga

And one other question, you asked the final part of the multiple question in one single sentence, you ask is how the loads will be on the back of another growth of 10% plus, this is evident in the fleet expansion plan on a base case.

Looking at the fourth quarter load factors, especially domestic and also international, I would expect nothing less that would be comparable to this year's performance. As Mehmet Bey said, ceteris paribus and I don't know if Saudi Arabia is going to do something with Lebanon, and I don't know what other things are going to unwind in the Southeastern borders and beyond. Everything has been equal and there is no further geopolitical disruption in the marketplace, it looks like from a revenue side and yield and load factor side, the revenue management system seems to be doing just fine.

Operator

Our next question comes from Kerem Tezcan from Citi. Please go ahead.

Kerem Tezcan

My question is actually kind of a follow-up question to Görkem. After you initiated your operations at Ankara Airport, we know that Turkish Airlines initiated some international flights over there as well. Are you seeing an increase in competition on that front, or they are totally again reducing the prices and try to compete with you? Another question is actually about the fuel price. I personally think that the recent underperformance of the stock despite the very good operational performances is increasing jet fuel price, and when we look at your 2018 figures, it is basically, you are hedged by 13%, if I am not wrong, and I just wanted to understand what is the level for 2018 that you are looking, around 40-45, and what will be the price of jet fuel that you see happening for 2018 on a 12-month perspective maybe.

Mehmet Nane

I will answer the first part, Serhan Bey will answer the second part. When we look at the first part, we don't see any tough competition or price reductions in Ankara, because there is huge potential from Ankara and Turkish Airlines is cultivating that potential also. We came into that market first, we have certain advantages, but there is no tough competition at the moment.

Serhan Ulga

To answer the second part of your question with jet fuel, we don't necessarily have our – we try to stick with what the market overall perceives the fuel to be when we do our business models. I would expect that it would be somewhere around 60 – on the average $60 range. Now this, again, is ceteris paribus, but based on the demand side of things, the distribution – the difficult distribution of the supply and how it comes to the market, 60, 65 range is something we can handle, and our existing – of course, we have handled $100 fuel ranges as well and we made money and had this in EBITDAR then, but of course, as the fuel prices go up, one thing that categorically happens is the gap – our difference we can produce as an LCC versus the other legacy carriers – narrows the gap, because the fuel becomes a bigger part of your cost base and the differential that you can create on the cost base unfortunately narrows, that means the competition increases and that may have, in turn, somehow a negative effect on the yield and perhaps some load factor impact as well, but again, it is very difficult to foresee what it is going to be. As far as our hedging policy is concerned, the 30% is – we're going to be at 30% on an annual rolling basis by December, and that will be – most of it will then be filled by, compared to what we are right now, more advantageous levels like mid-50s and upper 50s versus 60-pluses. So, there will be some minute, I should say, without knowing exactly, beneficial benefits we will reap in the first half of the year from the hedges that are coming from the earlier – in the second half of this year, so to speak, if you look at it on a 12-month basis, but the second half of 2018 will be probably hedged around 60-plus basis.

Operator

Our next question comes from Mahir Ereren from Ata Invest.

Mahir Ereren

Could you give us some color regarding the forward-looking bookings in the fourth quarter in terms of the demand and pricing sides? Do you still observe an upward trend in yields both international and domestic growth in dollar terms?

Serhan Ulga

For the fourth quarter, what I can say is that compared to year-on-year, we are seeing double-digit yield improvements. We are also seeing single-digit – high single-digit load factor improvements vis-à-vis the same network we are looking at, and this appears material to the first quarter as well. So again, revisiting the fact that especially in domestic, most of the decisions are made a couple of days before, seeing so much upside swing in both domestic and yield is very encouraging for us. International has a little more a time spend between book and flight time, but it's not that significant, perhaps a couple of weeks to 3 weeks range. There, we are seeing also improvement again, which is quarter-over-quarter and also spilling over into the first quarter of 2018. So, it seems that the demand side and the interest to fly continues to – has come back and more in domestic and international has come back and improving. I think this is the best way to describe it.

Operator

We have our follow-up question from Kerem Tezcan from Citi.

Kerem Tezcan

I have one more question regarding, I completely agree, Serhan Bey, regarding increasing fuel prices. Pricing competition will be tough and might put some pressure on revenue yields. In that sense, looking at 2018 capacity growth, are you – how flexible are you in adjusting these new entries? Is there going to be any unexpected headwinds that we might potentially experience that had been the case in 2016?

Serhan Ulga

Ah Kerem, all of the deliveries are Airbus deliveries, plus 3 Boeing deliveries. We will be taking 3 Boeing deliveries for sure, but as far as the Airbus deliveries are concerned, I think Airbus is extremely well versed in Turkish markets, much more than Boeing, I will have to say, unfortunately, but nevertheless, what this means is that if such a thing happens, Kerem, we have not only contractual rights to defer this but we have more importantly have some relationships where we have been actually questioned why we didn't ask for any deferral in 2016. So, Airbus is very aware of this. Not only can we use our contractual rights to defer, I would say, on a bigger contract basis, all of our 2018 deliveries, if we have to, but I think without even going through the contract, we can easily do this, reach some sort of an agreement with Airbus from that perspective.

Kerem Tezcan

In terms of your contractual rights, if defer, is there – there must be some costs associated with that, right?

Serhan Ulga

There must be what?

Kerem Tezcan

Some costs that might be associated with that? The contractual? I don't understand.

Serhan Ulga

No. No. Contractual allows us a certain portion of the fleet in a certain timescale to deferral rights without any costs. One other thing I would like to add to this, which is something that we are working to finalize but has not been certain – but has not been presented to you yet, when we look at – we get this question all the time, especially from European investors and European analyst friends. When we look at, analyse, Wizz Air, Ryanair and easyJet, their load factors are on a booked basis, meaning they don't – we present our load factors on a flown basis. So, what we are planning to do, either as an additional schedule or actually fully convert and be in parallel presentation base with Ryanair, Wizz Air or easyJet, or our own environment, let's say, our own world, LCC world, we will be presenting booked basis load factors, which categorically yields 3 percentage points plus jump in the load factors – in our load. So then, the load factors with us and them, those three airlines would be apples to apples. This is something we had historically got in our various interactions with the European investor base, but we did not do this in the third quarter. We plan to do this at the end of the year by restating the previous quarters and year-end as well to make it comparable. So, this is something new that we will be kicking off after year-end.

Operator

We will continue with the next question. It comes from Görkem Göker from Yapi Kredi.

Gorkem Goker

My question is regarding your handling expenses. It is the only CASK item that I see increase on a year-on-year basis despite TL weakness. Are there any particular reasons for that? And for 2018, consequently, in a situation due to inflation in the country, should we expect an increase on that front in 2018?

Serhan Ulga

Other than contractual impact what is compared to 2016, is described in the CASK schedule of the CASK slide, there is no – there is not anything significant that jumps at me at this time to elaborate on it, but some of the handling contracts are based on the number of packs handled versus flight basis. So, increase in – and I don't know of the list of the vehicles, so I don't have to tell you. Increase in the loads have also triggered some increase – natural increase in the cost of handling that was negotiated, but also there is, as we mentioned, FX impact of the foreign destinations where we have flown back to Turkey.

Operator

Our next question comes from Cenk Orcan from HSBC.

Cenk Orcan

I have a couple of questions. First is, was there any hedging impact in your third quarter fuel expenses? That's what I'm interested about. Secondly, can you remind the cash flow that you expect from the sale of remaining 5 aircraft this quarter? And the third and final question, any update on the tax penalty issue, especially about the expected timing of this or a potential resolution? Should we expect anything before the end of this year? Or is this a matter of next year?

Serhan Ulga

Let me start from the third part of the question, which is something we've been very diligently working on with the rest of the industry. Just so everybody knows that the entire aviation industry in Turkey got together and we were able to reach through Mehmet Bey's connections and assistance as well the Ministry of Finance, and the Ministry of Finance understood how stupid this penalty reasoning was in the announcement that, in the audit that we had from the Ministry of Finance's audit department, let's say. And the entire industry, without ah well, we went and met with the President of the Internal Revenue Service, which is half of the Ministry of Finance, that reports to the Ministry of Finance, Gelir İdaresi Başkanlığı, okay? We met last Tuesday actually and explained our case not only on the spirit of the law but also on the word of the law, and other communiqués that came out that clarified this. So, the point was taken, and I can say on my personal perception that the decision is that to revise a new communiqué from the Ministry of Finance to clarify this without any hesitation, without any question mark. Actually, we wrote that one-page communiqué and gave it to the Ministry of Finance, so they are working on that.

I expect – I cannot promise, but I hope that a new revision of a tebliğ will come out, hopefully, before the end of the year, and what this will mean for us is that before – if this comes up before the settlement that we're going to go through the process, that means all the charges, so to speak, are going to be kicked off. If it comes up after the settlement, we'll be taking it and obviously defending it at the court level. Then the platform changes that, of course and perhaps, unfortunately, but nevertheless, I think what we have shared with you when we first did a teleconference call, after this, we have to plan when we published this. I think as we discussed and argued, things developed that way, and we are at a very close resolution base here. One important thing, of course, that helped was the fact that Turkish Airlines was presented by all their Chief CHRO and the rest of their crew that does the payroll at Turkey Airlines. They did present a good case as well, and I think the message was heard. By all means, this is not only political, economical but also legally the spirit and the word of the law. So that's the third question, the answer to the third question.

Cenk Orcan

Can I just follow up before you pass on to the next question? If we assume the best case for you here is zero penalty, is there any worst case that you can cite, any figure that you can cite as a represent of a worst case for you out of this issue?

Serhan Ulga

I think it's zero, but if again, it should be zero, but I have also seen – we have also heard – unrelated to us, other cases in the – you know perhaps when we go for a settlement just for the sake of settling, they may ask for a couple million TL just so because they get something from us, and this may be then that will be the worst case, a couple of million TL and I think, in light of the things that we are going through right now, it's peanuts, Cenk. We call it the beard money, sakal parası.

Cenk Orcan

[Inaudible].

Serhan Ulga

Okay. You asked for hedge loss. In the third quarter, we had TRY 6.4 million worth of hedge loss, mostly coming from – not loss, expense, hedge expense. This is because this is mostly coming from the option premiums we wrote, which materialized in the 3 months because due to the, of course, excessive fuel burnt and excessive usage of fuel, which is about USD 1.8 million, and the first question was?

Cenk Orcan

The expected cash flow from remaining aircraft sales.

Serhan Ulga

I think it's somewhere around USD 120 million, if I'm not mistaken, but for the next – the remaining 6 aircraft, the total USD will be around that. The total was USD 235 million, if I'm not mistaken. So, USD 120 million of them will come in the next couple of months, this month or next month.

Cenk Orcan

Dollars, right? USD 120 million?

Serhan Ulga

Yes.

Operator

We have no more questions for the moment. Dear speakers, back to you for the conclusion.

Mehmet Nane

Thank you for joining our third quarter conference. I hope we will give you a better solution by the end of the year and for the coming quarters. Thanks for joining and following us. Have a nice weekend.