Spirit Airlines Is Poised to be the Next Ryanair

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The Basics

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- Stock price (11/19/15 close): $36.83
- Market cap: $2.6 billion
- Cash: $749 million
- Debt: $538 million
- Enterprise value: $2.4 billion
- TTM EPS: $4.10
- 2015 est. EPS: $4.08
- 2016 est. EPS: $4.03
- P/E (TTM): 8.7x
- P/E (2015 est.): 8.8x
- P/E (2016 est.): 8.9x
- EV/EBITDA (TTM): 4.6x
- Revenue (TTM): $2.1 billion
- EV/S (TTM): 1.2x

There are very few companies I'm aware of that are growing 20%+, with 25%+ operating margins, 25%+ returns on equity, with net cash positions, whose stocks are trading at a P/E of <9x

Spirit's Stock Had Been a Huge Winner – Until This Year

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Spirit's Stock Is Down 53% This Year, By Far the Worst of Any U.S. Airline

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Spirit Is A Rapidly Growing Ultra-Low-Cost Carrier

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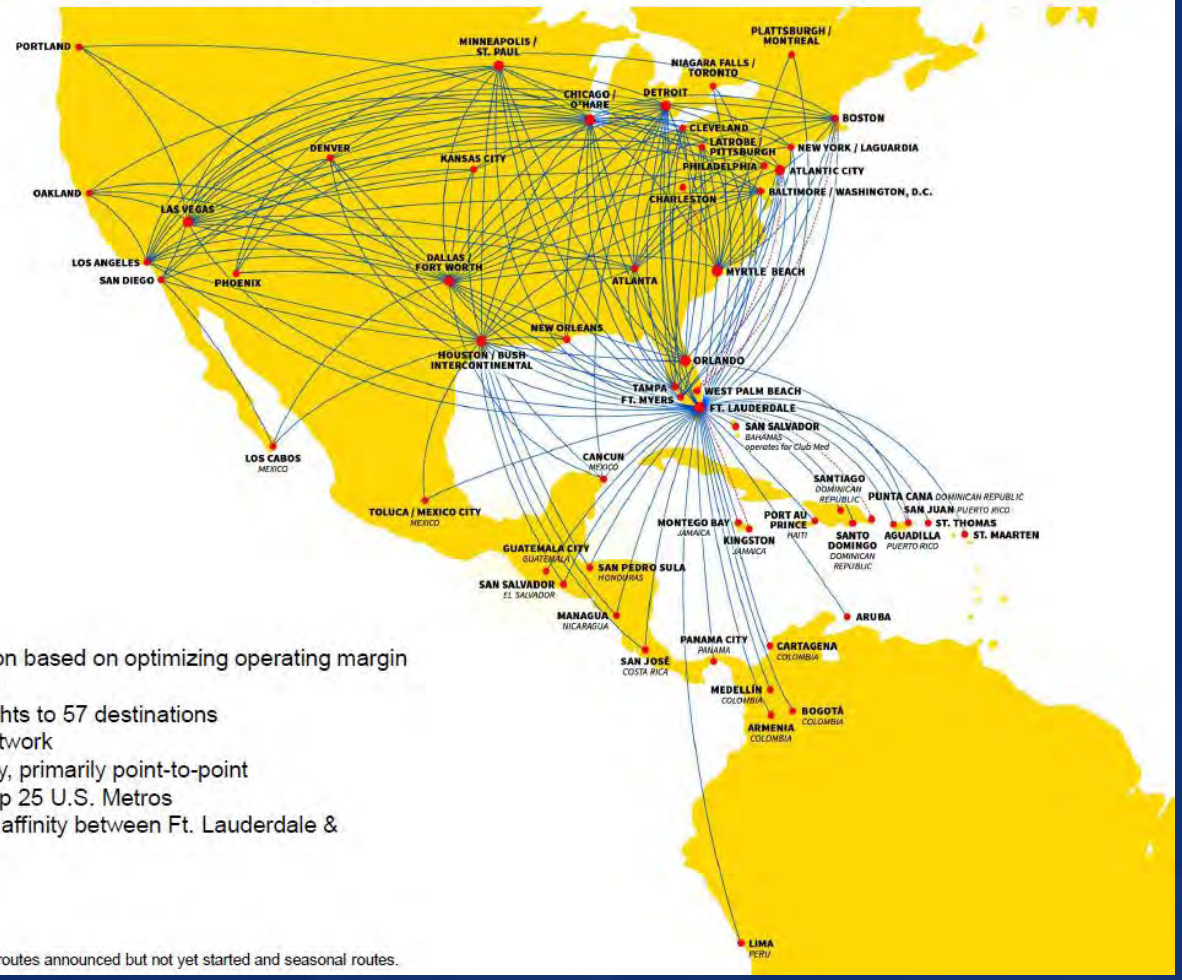
74 Aircraft Serving Over 180 Non-Stop Markets



- Route selection based on optimizing operating margin and utilization
- 360+ daily flights to 57 destinations
- Diversified network
- Low frequency, primarily point-to-point
- 84% of the Top 25 U.S. Metros
- Demographic affinity between Ft. Lauderdale & Caribbean

As of July 2015, includes routes announced but not yet started and seasonal routes.

Source: Spirit investor presentation, 8/13/15.

Growth

Spirit Has Grown Its Revenues and Profits at a High, Steady Rate

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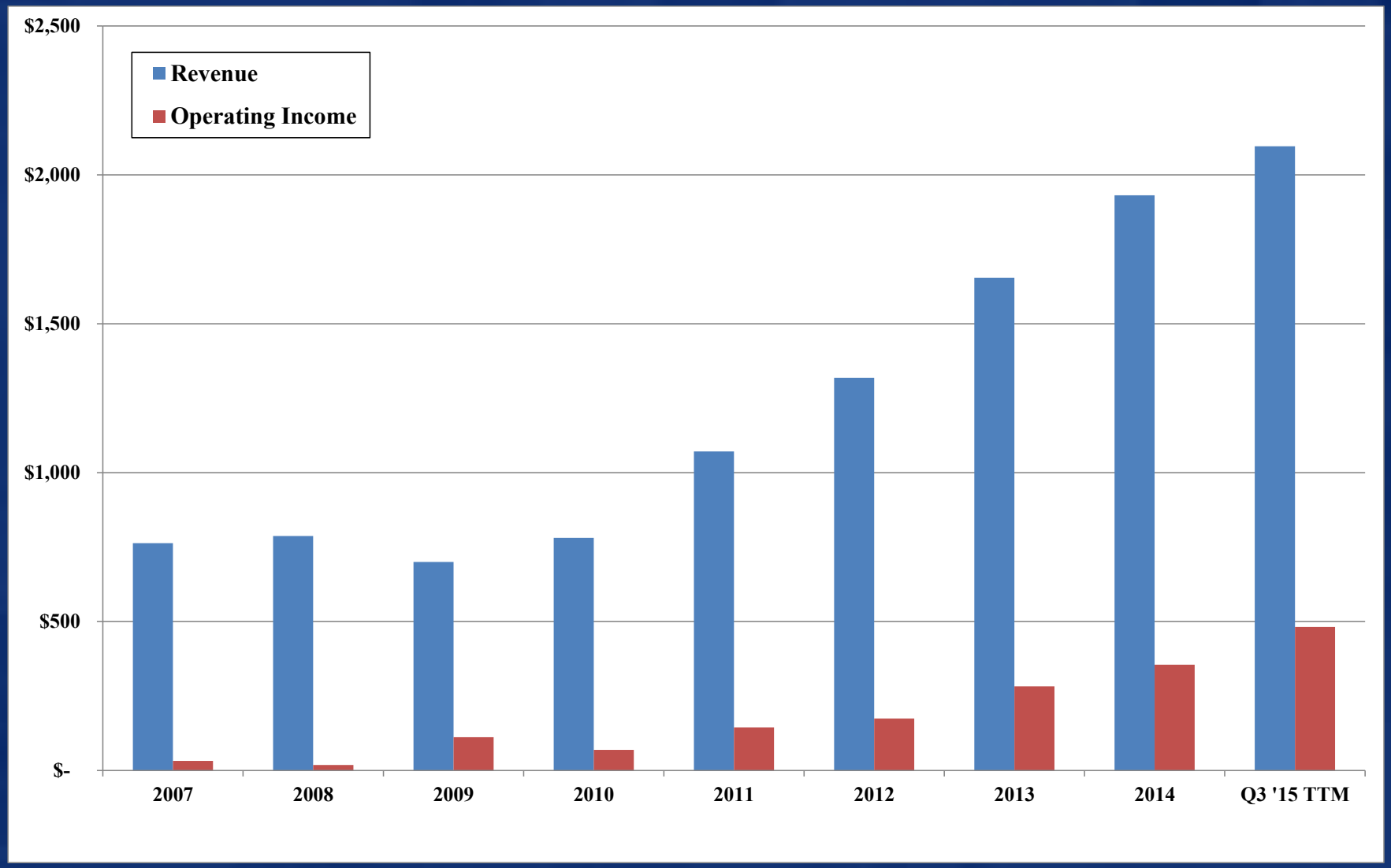

Spirit Has an Enormously Long Runway for Future Growth

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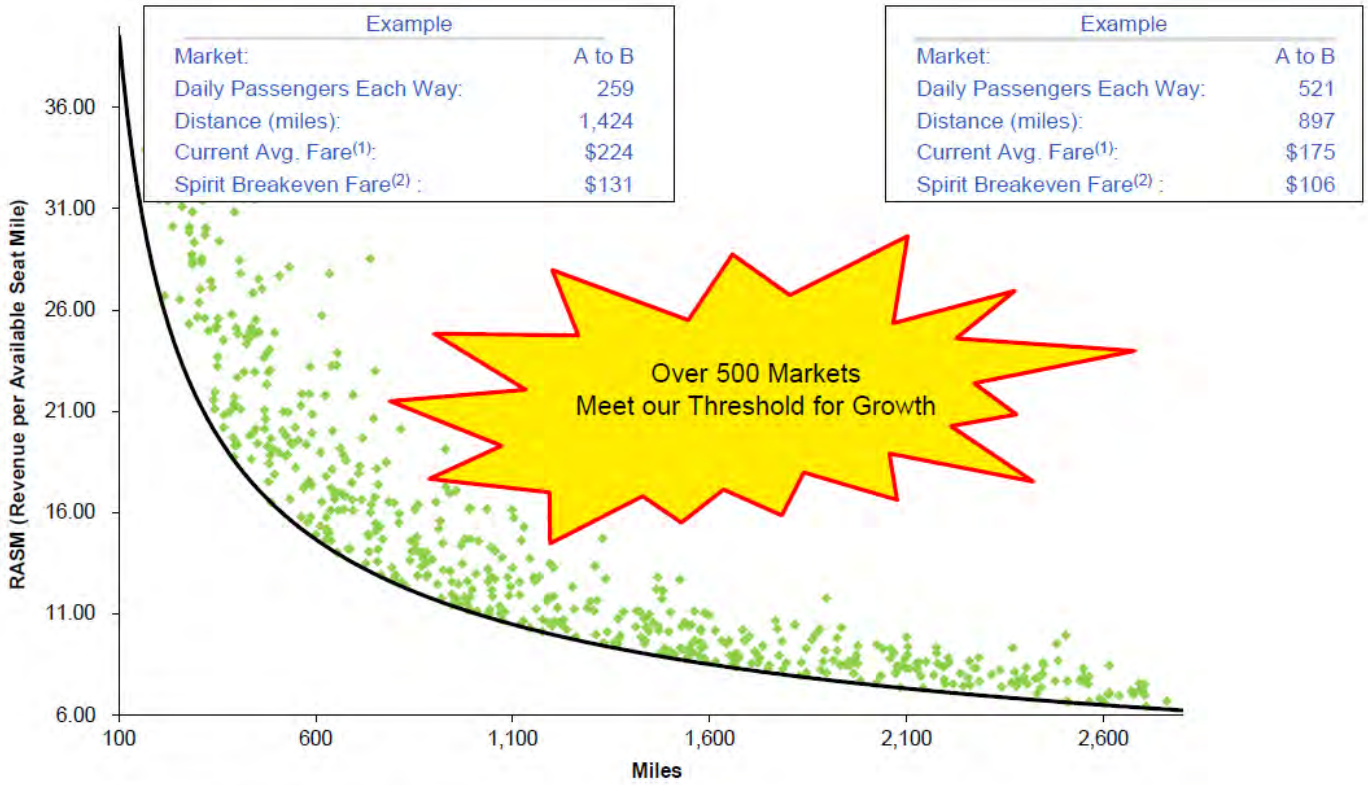
Spirit plans to expand to 20 new markets in 2016 & 310 total within five years

Target large markets with high average fares



1. Based on USDOT DB1B twelve months ended 12/31/14.
2. Assumes avg. fares for the twelve months ended 12/31/14 discounted at 25% and Spirit's Adjusted CASM for the twelve months ended 12/31/14 adjusted for each respective market stage length, formula = Spirit's Adj. CASM x (Sprit's avg. stage length / market stage length)$^{A0.5}$. See Appendix for Spirit's Adjusted CASM reconciliation.

Source: Spirit investor presentation, 8/13/15.

Spirit Has the Potential to Follow in Ryanair's Footsteps

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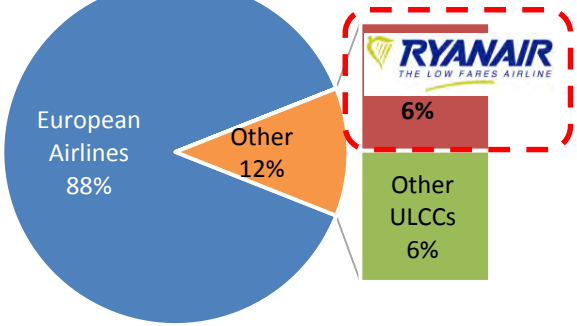
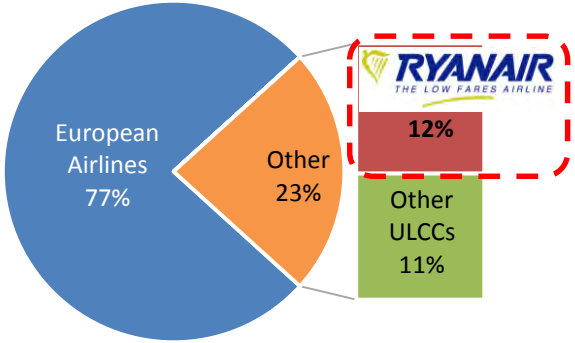
European Low Cost Providers' Share Growth

10 Years Ago

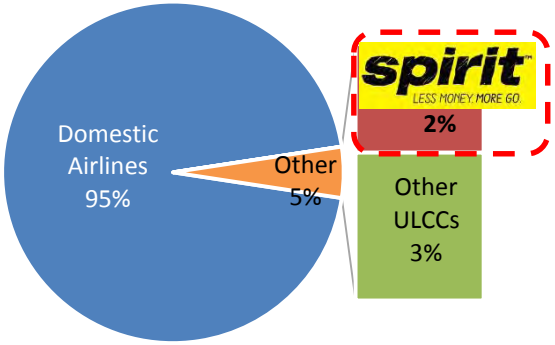


Today

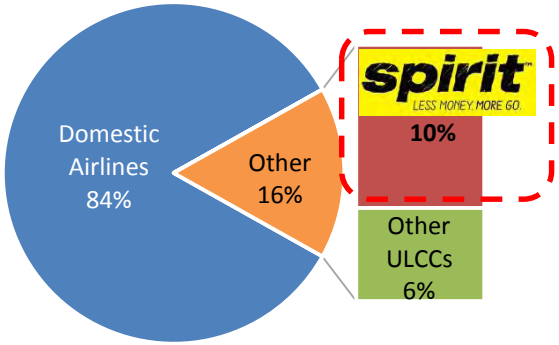


U.S. Low Cost Providers' Potential

Today



10 Years From Now?



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

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

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Ryanair ADR Since 2002

Spirit's Cost Advantage

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

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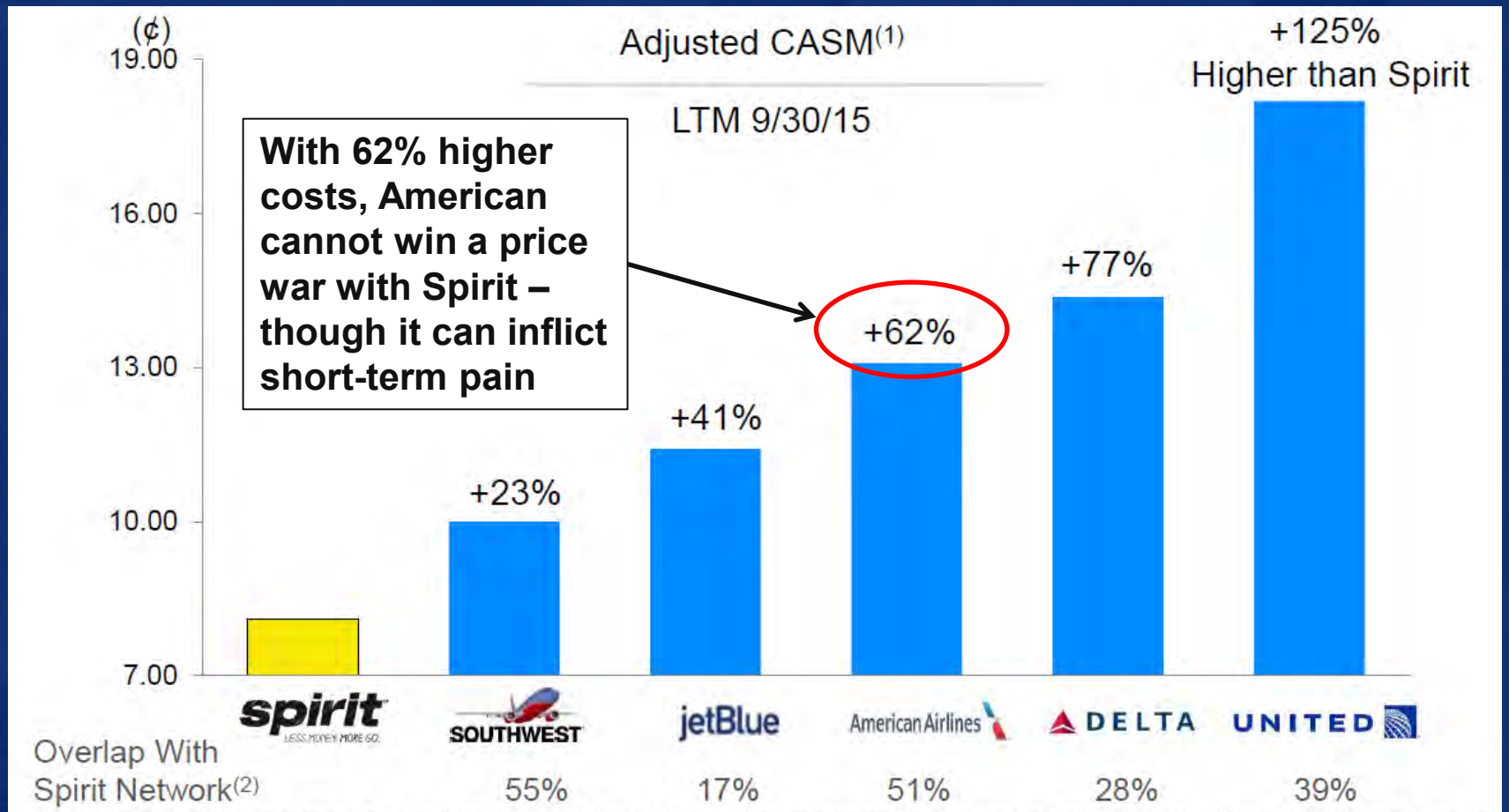

1. Cost data based on public company reports for the twelve months ended September 30, 2015. Reflects mainline operations only. Stage length adjusted to Spirit's average stage length for twelve months ended September 30, 2015, formula = other airline CASM x (other airline stage length / Spirit stage length)$^{0.5}$. Stage length for American, JetBlue, and Southwest based on company reports for the twelve months ended September 30, 2015; Delta and United derived from Form 41 data for the twelve months ended June 30, 2015. Excludes special items and unrealized mark-to-market gains and losses for all carriers shown. See Appendix for reconciliation detail for Spirit Adjusted CASM.
2. Based on publicly available data as of July 10, 2015 for routes operated or scheduled to be operated in 2015 (includes seasonal markets served in the period). Airports within same metropolitan area considered single market.

Source: Spirit investor presentation, 11/9/15.

Spirit's Costs Are So Low That Its Total *Price* (Including Extras) Is Lower Than Its Competitors' *Costs*

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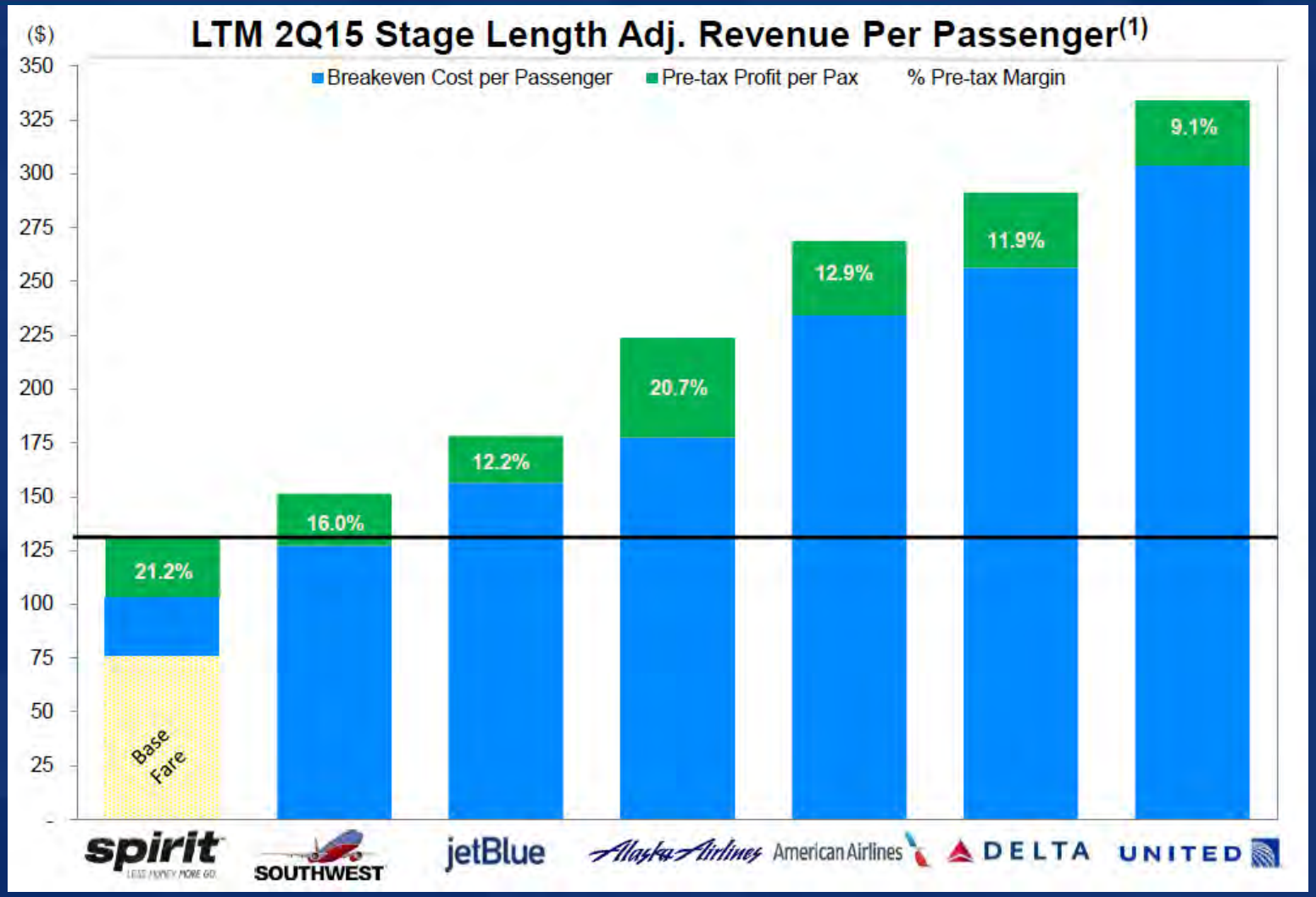

Source: Spirit investor presentation, 11/9/15.

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

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- Ultra-low-cost carriers (ULCCs) like Spirit, Allegiant and (recently) Frontier in the U.S. and Ryanair in Europe are not to be confused with low-cost carriers like Southwest, JetBlue and Virgin America
- ULCCs have an extremely low cost structure, usually driven by:
  - One type of plane and one class of service
  - Cramming the maximum number of seats (~20% more) onto every plane by reducing legroom and having seats that don't recline
  - No seat-back pockets, window shades, wifi or entertainment systems
  - All direct flights (no hub-and-spoke)
  - Limited (or no) customer loyalty/frequent flyer programs
  - Personnel who do multiple jobs (e.g., flight attendants who also clean the plane and act as gate agents)
  - Turning aircraft quickly and flying at all hours, thereby maximizing daily flight time (12.7 hours/day for Spirit; 11.8 for JetBlue; 10.9 for Southwest)
  - Flying out of regional or secondary airports
- Consequently, ULCCs offer extremely low base fares – and then charge extra for nearly everything such as a seat assignment, any bag beyond a small carry-on item, all drinks and food, etc.
- While these extras cause some travelers to feel nickeled-and-dimed, almost all travelers on Spirit pay less in total than they would on any other airline

Spirit's Price Advantage

Spirit's Ultra-Low Costs Translate Into Prices That Are *Massively* Lower Than Other Airlines

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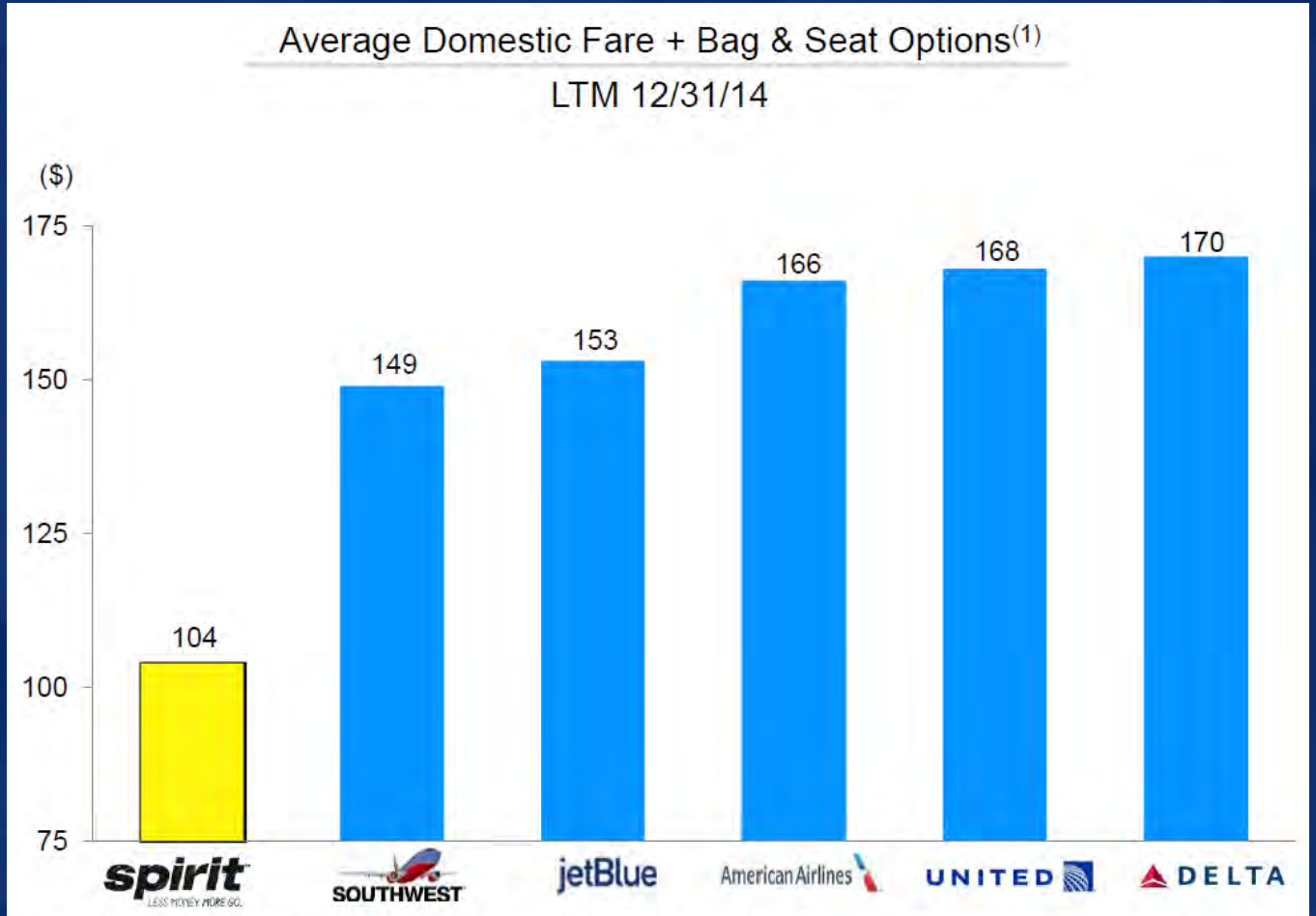

1. Mainline domestic data only for all carriers shown. Data derived from Form 41 for the twelve months ended December 31, 2014; includes domestic passenger revenue (includes seat revenue) plus domestic excess bag revenue divided by domestic revenue passenger enplanements. Data length of haul ("LOH") adjusted to Spirit's domestic LOH for twelve months ended December 31, 2014 (1,008 miles), formula = other airline amount x (other airline LOH / Spirit LOH)$^{-0.55}$. American includes American and US Airways and Southwest includes Southwest and AirTran.

Source: Spirit investor presentation, 8/13/15.

Spirit Stimulates Demand

Spirit's Entry Grows the Population of Travelers (1)

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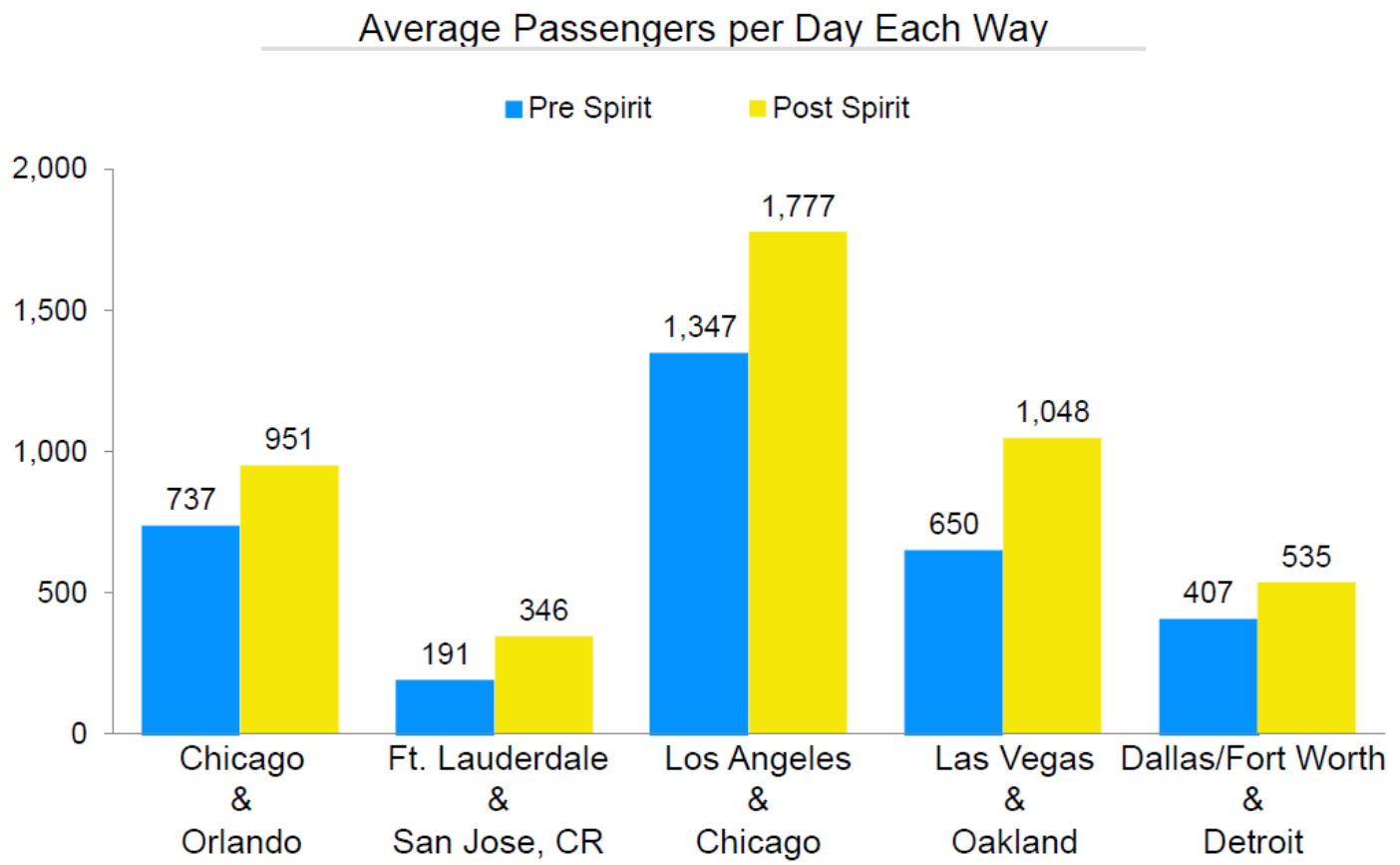
On average, Spirit's low fares grow the traffic base by about 37%[1]



1. Measurement period begins January 2007 through June 2014. System average measures only those markets Spirit has served for at least twelve months.
2. Sample markets do not necessarily reflect system average. Pre Spirit is the average for the four calendar quarters prior to Spirit's entry; Post Spirit is the average for the four calendar quarters following Spirit's entry

Source: Spirit investor presentation, 8/13/15.

Spirit's Entry Grows the Population of Travelers (2)

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Source: Spirit investor presentation, 11/9/15.

Stable Revenue from Extras

While the Price War With American Has Reduced Spirit's Ticket Revenue, Non-Ticket Revenue Has Remained Stable

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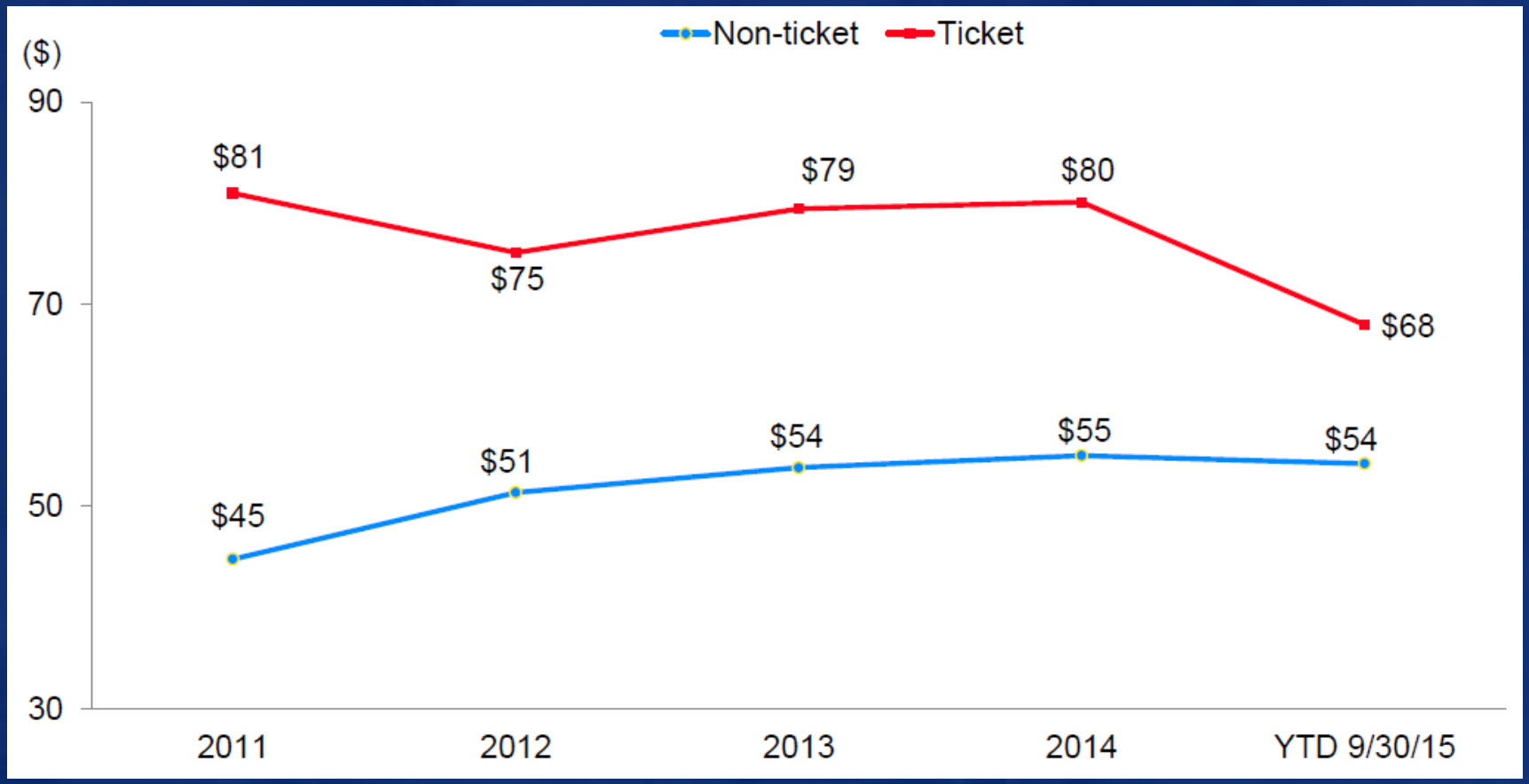

Source: Spirit investor presentation, 11/9/15.

Why Has the Stock Been Cut in Half This Year?

Why Has Spirit's Stock Fallen So Much This Year?

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- Low fuel prices lead competitors to price more aggressively against Spirit; in particular, American, which overlaps with 51% of Spirit's routes (second only to Southwest's 55%), rolled out an aggressive price-matching strategy in June that has impacted Spirit's pricing (and stock), causing Spirit to report in Q3:
  - "Total revenue per passenger flight segment ("PFS") for the third quarter 2015 decreased 13.1 percent year over year to $120.35, primarily driven by a 20.8 percent decrease in ticket revenue per PFS. The decline in ticket revenue per PFS was driven by lower fare levels as a result of increased competitive pressures [60% of impact] as well as a higher percentage of Spirit's markets being under development compared to the same period last year [40% of impact]."
  - Load factor in Q3 fell from 87.6% to 85.2% YOY
  - Q4 guidance is for unit revenue to decline even more than Q3
- This price war is affecting both Spirit's revenue and margins, which has led analysts to project that earnings per share will be roughly flat in 2016. The growth investors who owned this stock above $80 hate no growth, even for a year, so they've fled – and no self-respecting value investor would ever own an airline stock, right?
- There's also concern that Spirit is growing too fast (available seat miles rose 34% in Q3), though this will likely be the peak as capacity growth is projected to be only ~20% in 2016
- In summary, the near-term outlook for Spirit is cloudy, leading analysts and investors to fear the worst (more revenue and earnings reductions), so most of them don't want to own the stock until there's more clarity:
  - Here is the typical analyst view today (from Credit Suisse): "We see few catalysts near-term to bring investors back. Q4 needs a revenue beat & guidance that shows unit revenue declines have bottomed – this won't be known until February."

The Market Is Assuming (Likely Incorrectly) That Current Conditions Continue Indefinitely

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- The market assumes that Spirit's revenue tumbles even further and remains depressed for years:

- I think this is overly pessimistic. Analysts are not just projecting a continuation of the depressed 2015 number – they're forecasting that the decline from 2014 *doubles*, resulting in total revenue per flight segment of barely over $100, and staying that way for years. This is ridiculous
- With 62% higher costs, American is surely incurring significant losses trying to match Spirit's pricing, which is clearly unsustainable
  - My understanding is that this may be a temporary strategy to push Spirit out of a few key markets
- Spirit has demonstrated a willingness in the past to avoid share battles and move aircraft to more attractive markets, which is likely what will happen if the price war persists. As Spirit noted in its latest investor presentation, it has "no emotional attachment to any particular route – if a route is underperforming expectations and we no longer believe it will be able to achieve its target threshold, it is cut from the schedule"

Note: Slide courtesy of Kellogg MBAs Justin Hess, Alexander Hunstad, David van der Keyl.
Source: Street Revenue per segment calculations based off Bloomberg consensus revenue estimates.

The Market Is Overly Bearish on Spirit's Projected 2016 RASM Decline

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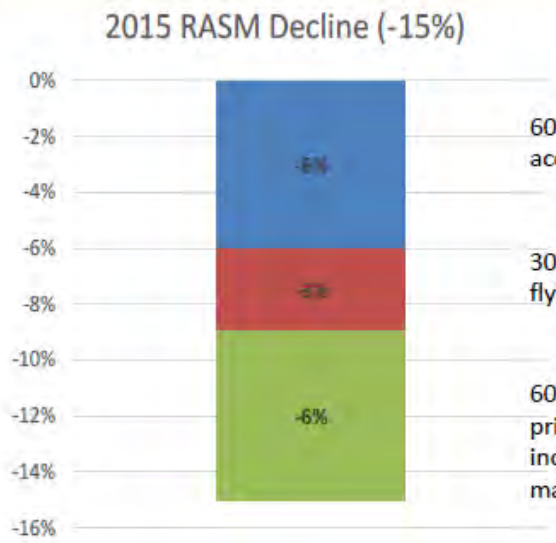
- The market is pricing in another ~14% RASM decline in 2016 vs. compared to current street estimates of ~7%
- Many of the headwinds that pushed 2015 pricing lower are unlikely to recur

Components of 2015 RASM Decline	2016 RASM Mitigants



600bp = impact of accelerated growth → Spirit plans to slow growth from 30% in 2015 to 20% in 2016

300bp = New LUV flying out of Dallas → New LUV flying out of Dallas began in October 2014, and fully annualizes in mid-2016

600bp = Industry pricing pressure, including AAL matching → Off-peak, "utilization flying" driven by lower fuel prices annualizes in 2016; AAL impact likely to persist near-term

Note: Slide courtesy of Kellogg MBAs Justin Hess, Alexander Hunstad, David van der Keyl.

Source: Bloomberg, company filings.

Spirit's Mouth-Watering Economic Characteristics

Spirit Has Been Consistently Profitable

It Was One of the Few Airlines to Post a Profit in 2008 & 2009

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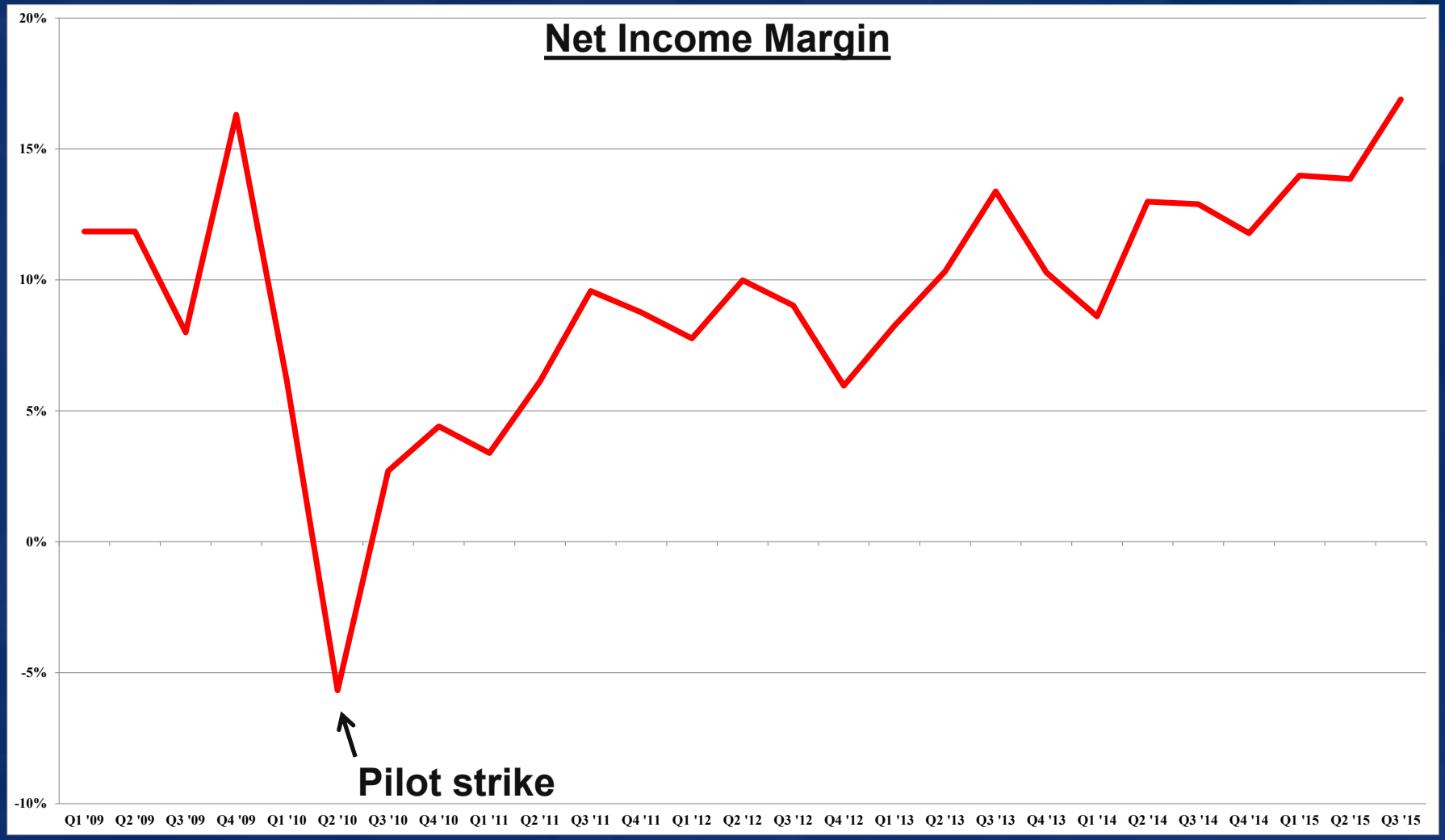

Spirit Has Consistently Been One of the Most Profitable U.S. Airlines

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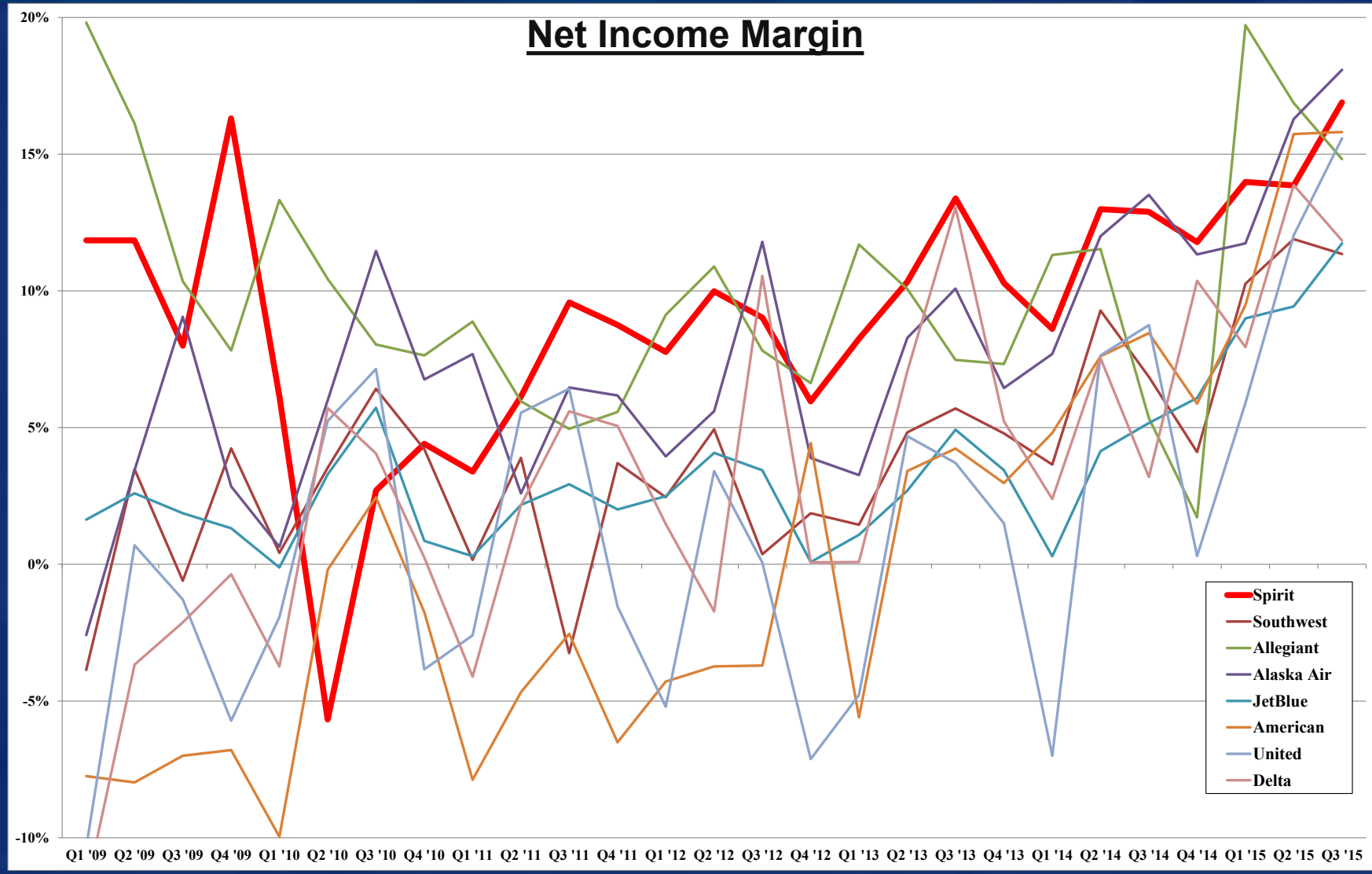
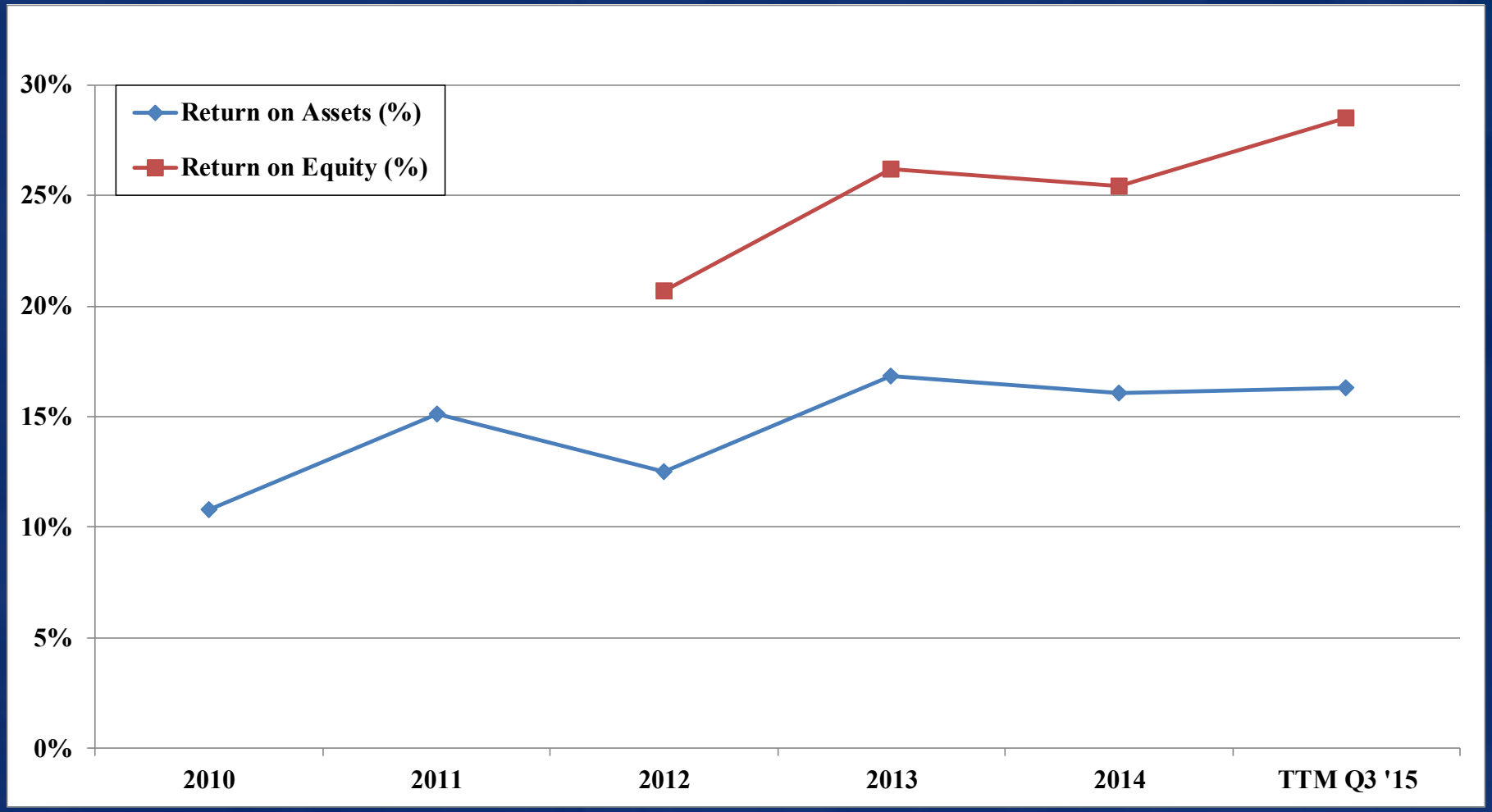


Spirit Earns Extremely High (and Rising) Returns on Assets and Equity



Spirit's Ridiculously Cheap Stock

Spirit Is Trading at Close to Its Lowest P/E Multiple in Many Years

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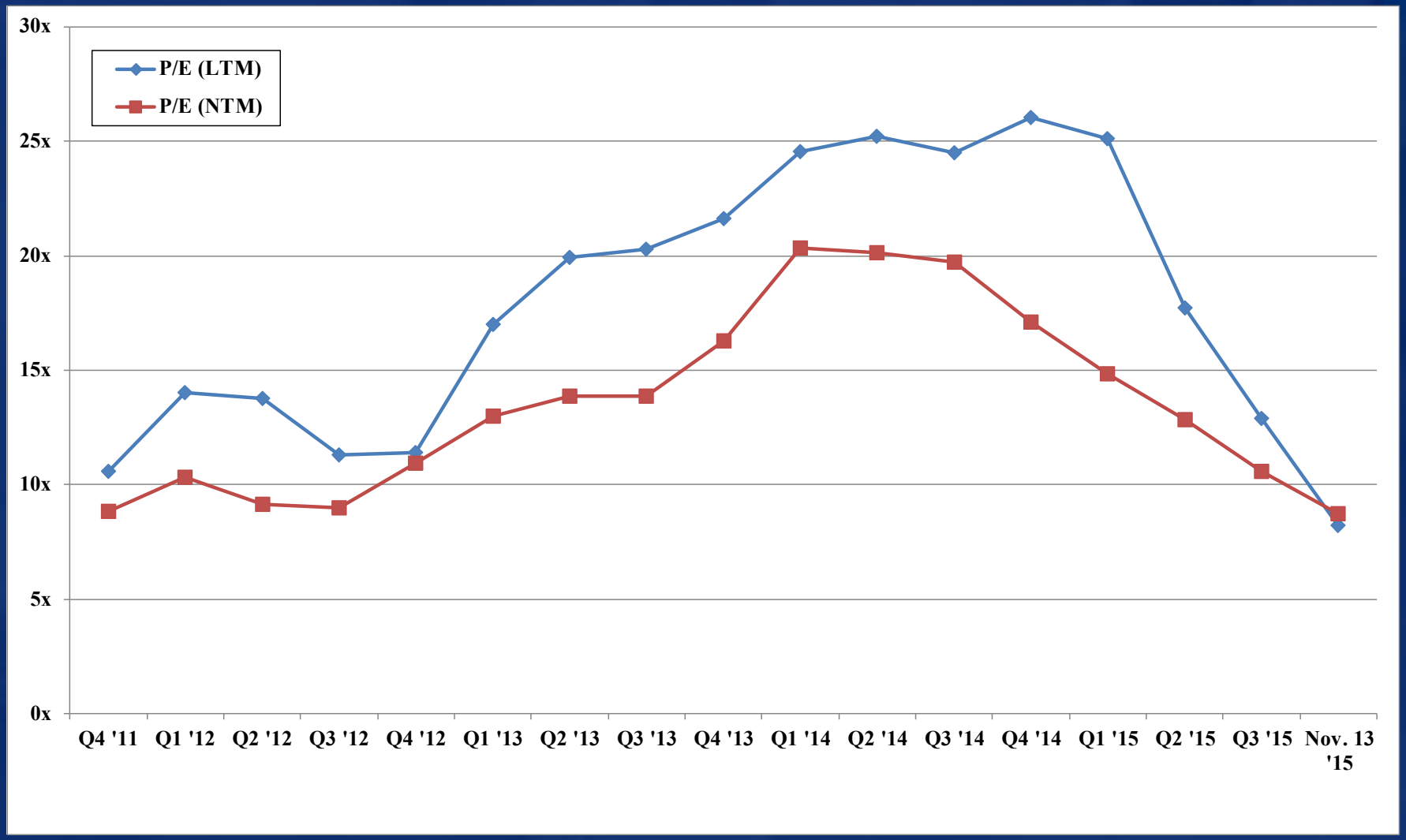

The Selloff in Spirit's Stock Is Hugely Overdone

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- Spirit is trading at a significant discount relative to its peers, when it should be valued at a premium in light of its leading cost position and long-term growth prospects
- Over the past 14 years, the stock of Ryanair has traded at a ~6-turn P/E *premium* to the airline industry, whereas today Spirit trades at a ~6-turn *discount*

Comparable Company Valuation

($ in millions, except per share values)

				P/E				EV/EBITDAR		
	Price	**% Δ YTD**	**Market Cap**	**2015**	**2016**	**2017**	**PEG (2015)**	**2015**	**2016**	**2017**
Alaska	$76.68	28.3%	$10,082.0	11.9x	11.1x	10.0x	1.34x	5.9x	5.7x	5.5x
Allegiant	184.95	23.0%	3,220.6	14.7x	13.6x	12.1x	1.43x	7.4x	7.0x	6.6x
EasyJet	17.81	6.6%	7,070.6	13.0x	12.1x	10.3x	1.04x	7.9x	7.4x	6.6x
JetBlue	25.76	62.4%	7,982.3	13.3x	11.5x	10.6x	1.07x	6.2x	5.5x	5.2x
Southwest	46.69	10.3%	31,543.5	13.2x	11.5x	10.7x	1.17x	6.4x	5.9x	5.8x
Ryanair	14.49	48.0%	19,958.0	23.3x	15.8x	13.6x	0.76x	13.2x	10.3x	9.0x
Peer Mean				**14.9x**	**12.6x**	**11.2x**	**1.14x**	**7.8x**	**7.0x**	**6.5x**
Spirit	**$34.30**	**(19.0%)**	**$2,496.2**	**8.5x**	**9.1x**	**8.1x**	**3.53x**	**5.2x**	**5.1x**	**4.5x**
Variance from Peer Mean				*(42.7%)*	*(28.2%)*	*(27.4%)*	*210.7%*	*(33.1%)*	*(27.1%)*	*(30.4%)*

Note: Slide courtesy of Kellogg MBAs Justin Hess, Alexander Hunstad, David van der Keyl.

Source: Bloomberg consensus estimates as of 11/13/15.

Spirit Has Grown Its Revenue Far Faster Than Allegiant

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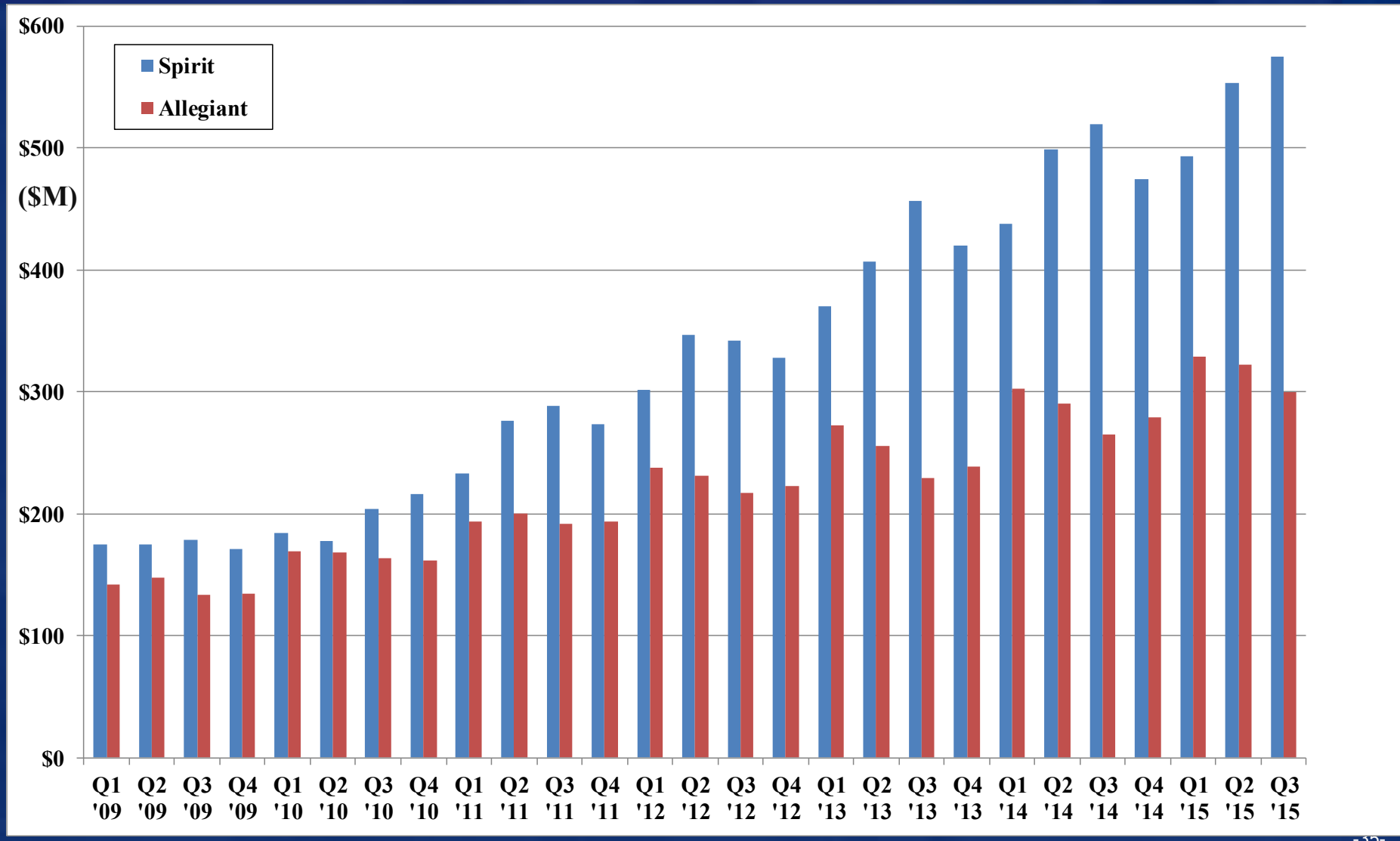

Spirit Has Also Consistently Generated More Operating Income Than Allegiant

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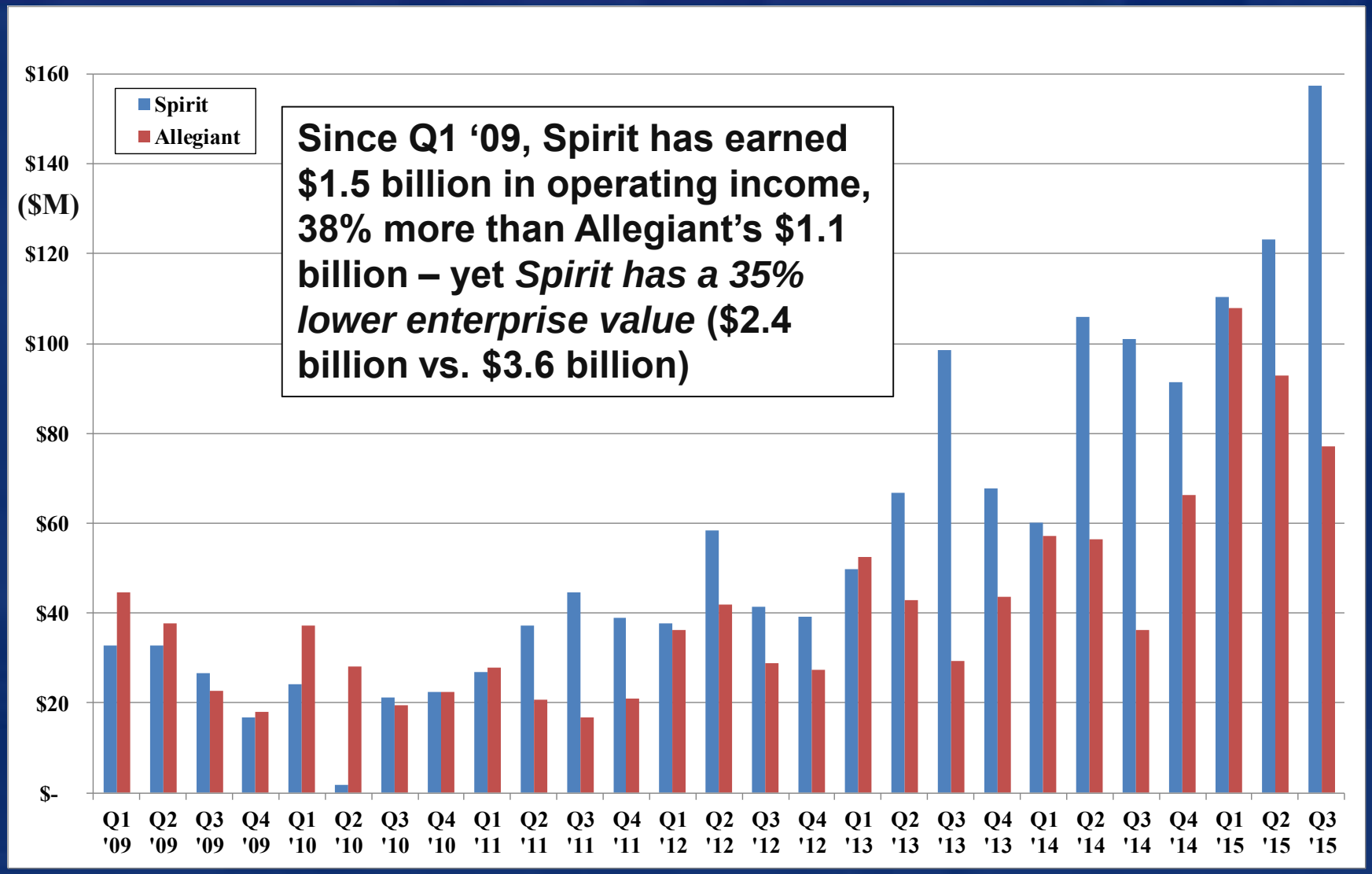

Since Q1 '09, Spirit has earned $1.5 billion in operating income, 38% more than Allegiant's $1.1 billion – yet *Spirit has a 35% lower enterprise value* ($2.4 billion vs. $3.6 billion)

In Spite of Higher Growth and Profitability and Similar Margins, Spirit's Stock Trades at a Huge Discount to Allegiant's on Every Valuation Metric

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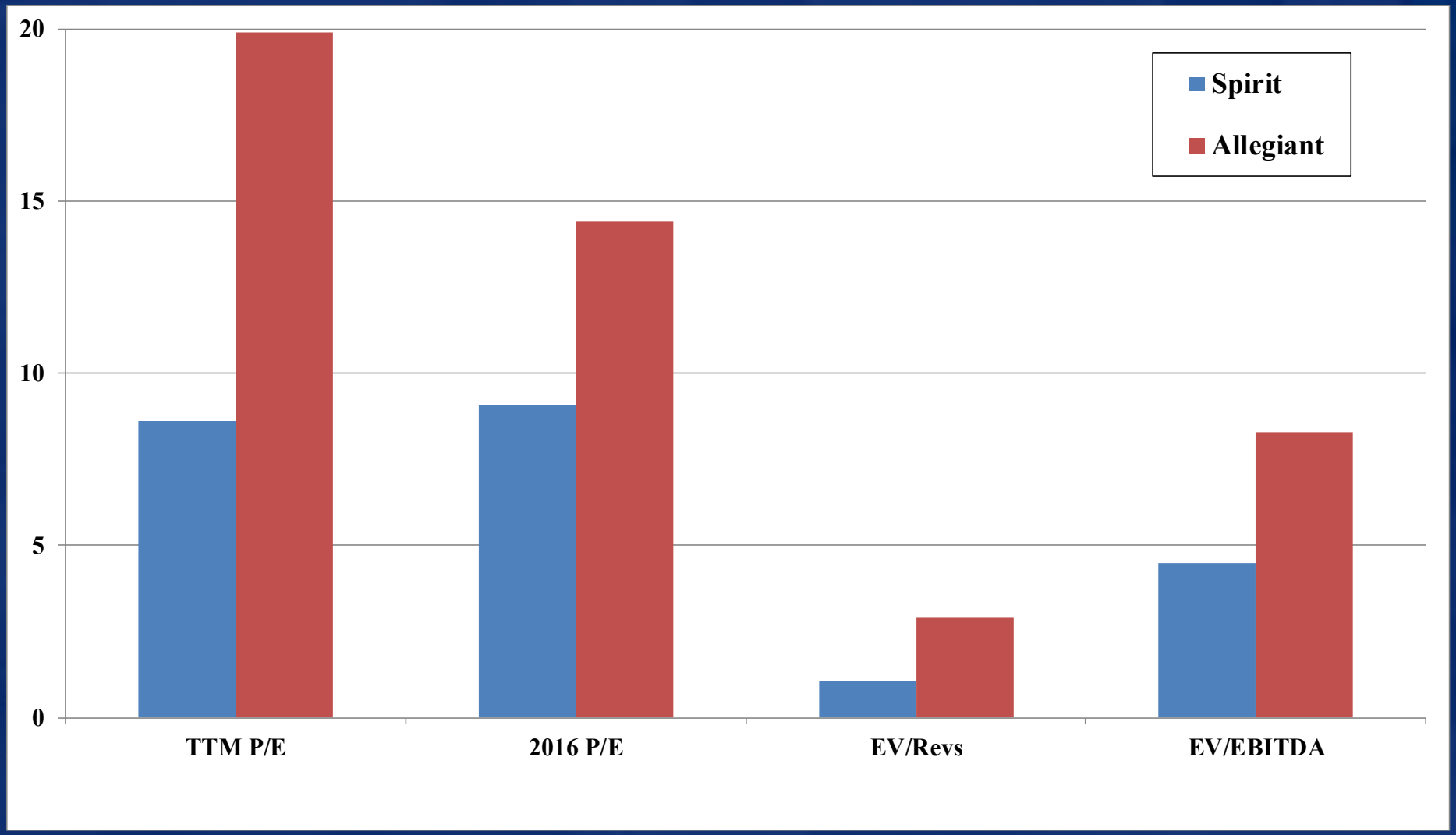

But What About Travelers Hating Spirit?

A Disturbingly High Percentage of People Despise Spirit

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

Spirit's Customer Service Problem

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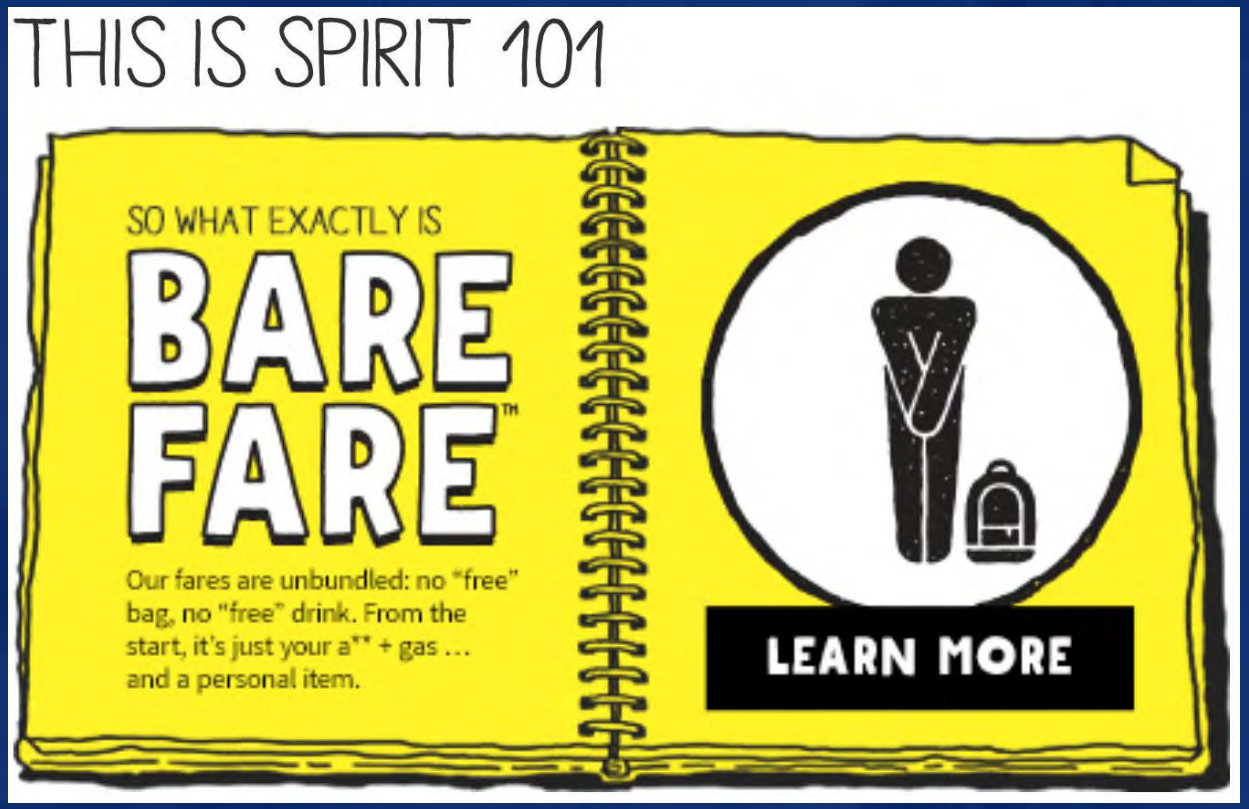
- Spirit's customer service problems fall into two areas: reality and perception
- Reality
  - According to the Department of Transportation, Spirit consistently is among the worst airlines in terms of on-time arrivals
  - In the first nine months of 2015, Spirit's percentage of flights cancelled was better than the industry in four months and worse in five, with the average slightly worse (1.94% vs. 1.73%)
  - On the plus side, the rate of mishandled bags is better than average (2.73 vs. 3.33 reports/1,000 passengers), and the rate of "bumping" passengers is half the average
- Perception
  - Many of Spirit's customers (especially first-time ones) aren't used to being charged for so many extras
  - Spirit needs to do a better job of setting expectations
- In total, Spirit's complaint rate in the first nine months of this year was 6x higher than average (11.93 complaints/100,000 enplanements vs. 1.97)
  - This is terrible, but it's still only one complaint for every 8,400 passengers

Spirit Is Trying to Do a Better Job of Setting Its Customers' Expectations

- This is on the home page of Spirit's web site ("just ass + gas…and a personal item"):



- The best that can be said about Spirit's customer service is that there's a lot of room for improvement!

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

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

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

Summary: Risks and Mitigants

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Potential Risks	Mitigants
• **Industry Risks** – Oil price increase – Sustained low prices from oversupply – Consumer spending decline • **Increased Competition** – Discount (Frontier, Allegiant) – National carriers moving downmarket • **Fee Issues** – Potential for increased FAA / airport fees • **Growth Pains** – Execution risk as company adds 20-30% capacity and enters new markets	• **Capture Customers Trading Down to Discount Airlines** – In event of economic weakness, Spirit is best positioned to capture price conscious customers • **Competition Validates Growth Potential** – National carriers more focused on different customer segment – There is a massive addressable domestic market that has not been tapped by discount airlines • **Ability to Pass Through Costs** – Changes in regulatory / tax regime will be borne by the entire industry, increasing prices – Proven record of cost control • **Spirit has demonstrated the ability to grow while expanding margins**

Note: Slide courtesy of Kellogg MBAs Justin Hess, Alexander Hunstad, David van der Keyl.

Summary: Price Target

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- Most companies with Spirit's characteristics – growing 20%+ annually with a long runway, 25%+ operating margins and returns on equity, and a net cash position – trade above 20x earnings
- Ryanair and Southwest consistently traded at 15-20x forward earnings in the early stages of their growth cycles
- Applying a 15 multiple to 2016 estimates of $4.03 results in a stock price of $60.45, 64% above today's price
- That sounds about right to me for a one-year target – and I think the upside is much higher over many years, which is how long I hope to own this stock

Spirit Airlines Is Poised To Be The Next Ryanair

Whitney Tilson
Nov. 20, 2015 7:26 AM ET | About: Spirit Airlines (SAVE), Includes: RYAAY
Disclosure: I am/we are long SAVE. **(More...)**

http://seekingalpha.com/article/3701366-spirit-airlines-is-poised-to-be-the-next-ryanair

Summary

- The selloff in Spirit Airlines' stock, down 51% this year, is hugely overdone.
- The company has amazing economic characteristics and the long growth runway, yet the stock trades at less than 9x earnings.
- Over the next decade, I believe that Spirit – both the company and the stock – will do what Ryanair has done over the past decade in Europe.

On Monday afternoon I presented Spirit Airlines (NASDAQ:SAVE) as my favorite long idea at the Robin Hood Investors Conference. Since then, I've updated my slides and posted them here.

My investment thesis can be summarized in one sentence: there are very few companies I'm aware of that are growing 20%+, with 25%+ operating margins, 25%+ returns on equity, with net cash positions, whose stocks are trading at a P/E of less than 9x.

After soaring from $10 to $85 from 2011 through 2014, the stock has been crushed this year for a variety of reasons that I'll discuss below, tumbling 51%, far worse than any other airline, as these two charts show:

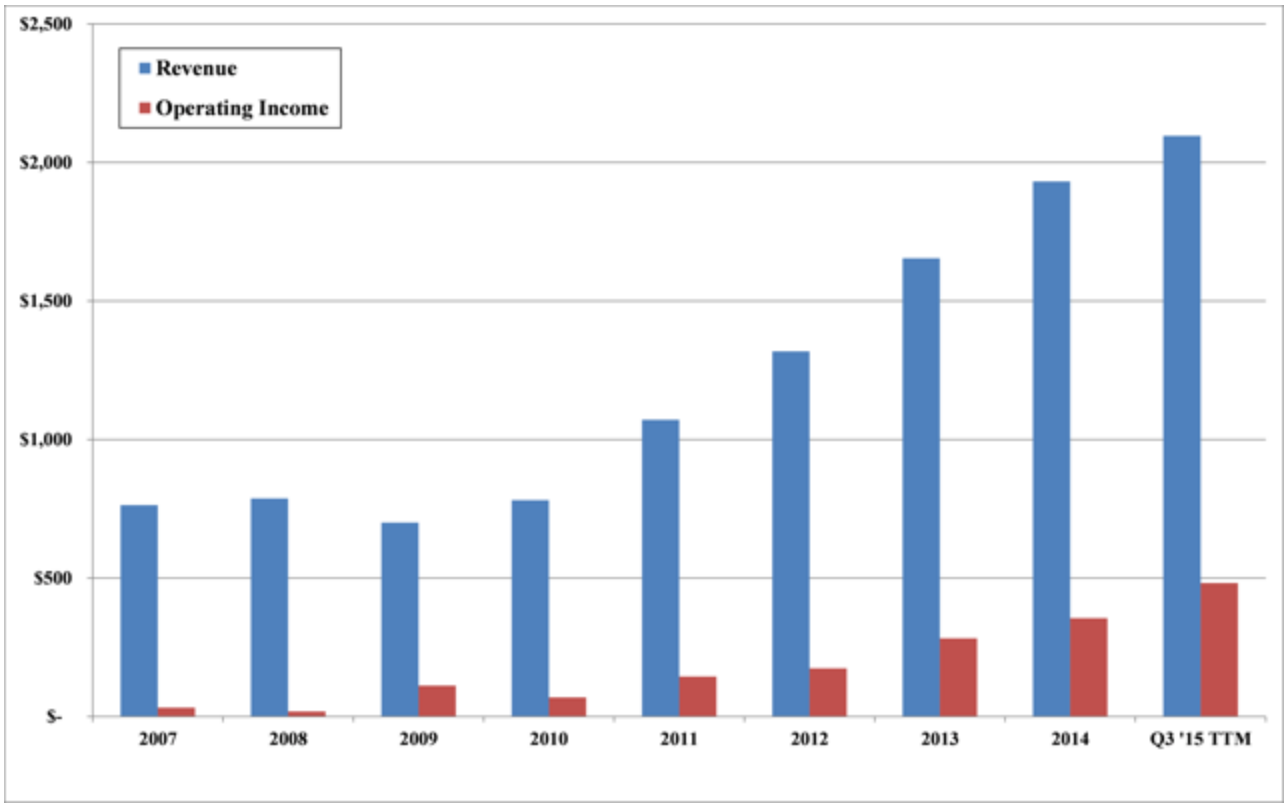
I think this selloff is massively overdone. Despite its significant customer service problems and current price war with American Airlines (NASDAQ:AAL), Spirit is - and will remain - an excellent business and has tremendous room to grow over the next decade.

Background

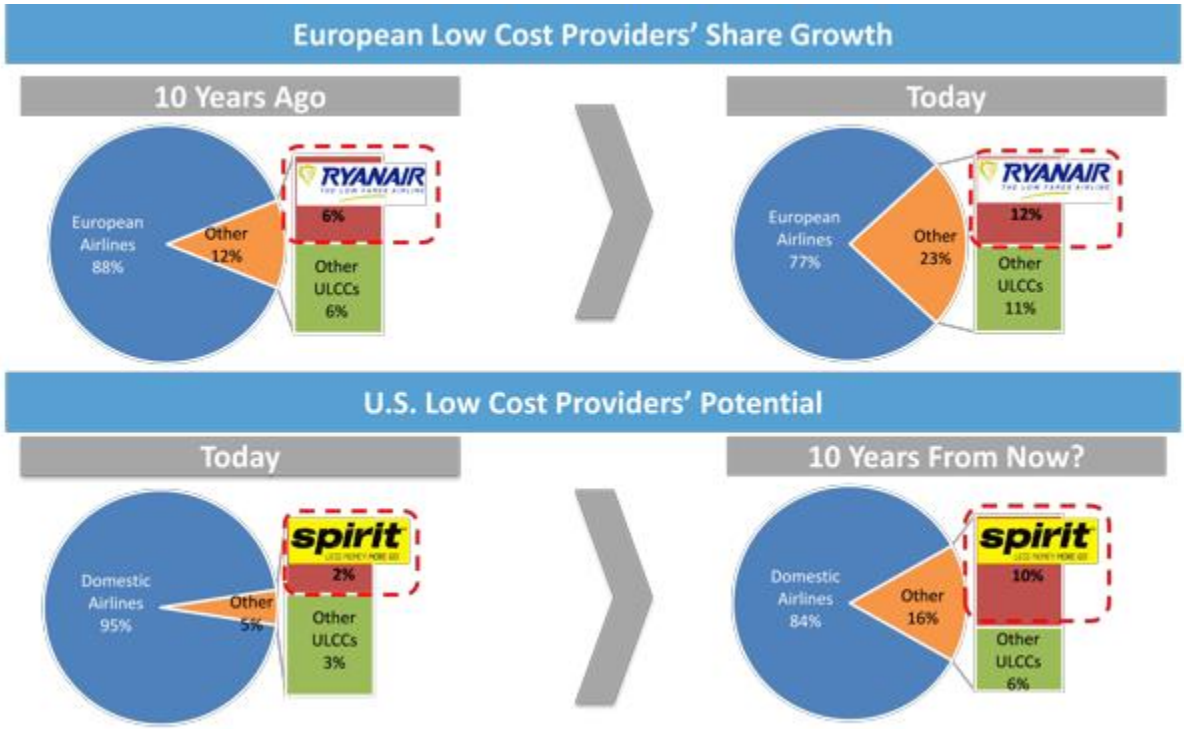
Spirit has 76 aircraft operating more than 350 daily flights to 56 destinations in the U.S., Latin America and the Caribbean. It is an ultra-low-cost carrier (ULCC), which is not to be confused with low-cost carriers like Southwest (NYSE:LUV), JetBlue (NASDAQ:JBLU) and Virgin America (NASDAQ:VA). ULCCs include Allegiant (NASDAQ:ALGT) and Frontier in the U.S. and Ryanair (NASDAQ:RYAAY) in Europe.

Growth

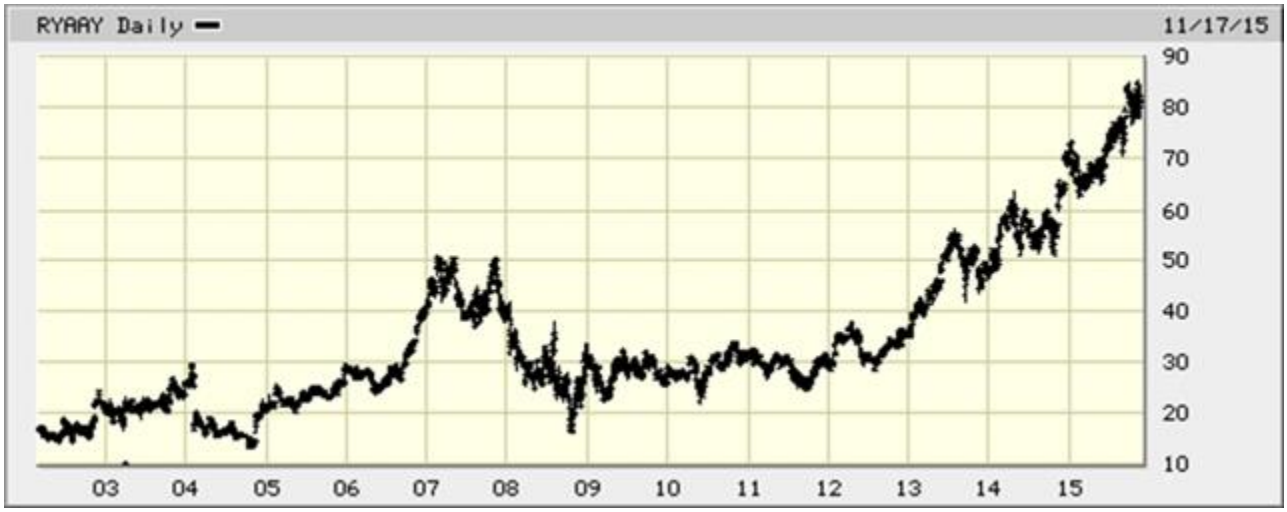
Spirit has been growing like a weed, tripling its revenue and more than quadrupling its operating income since the 2009 low, as this chart shows:



More importantly, Spirit has an enormous growth runway in front of it. It serves fewer than 200 markets currently, but believes that more than 500 markets meet its threshold for growth. I don't doubt this and think that Spirit will continue to grow at a rapid clip for at least another decade, just as Ryanair has done in Europe over the past decade, as shown in this chart (courtesy of Kellogg MBAs Justin Hess, Alexander Hunstad and David van der Keyl):

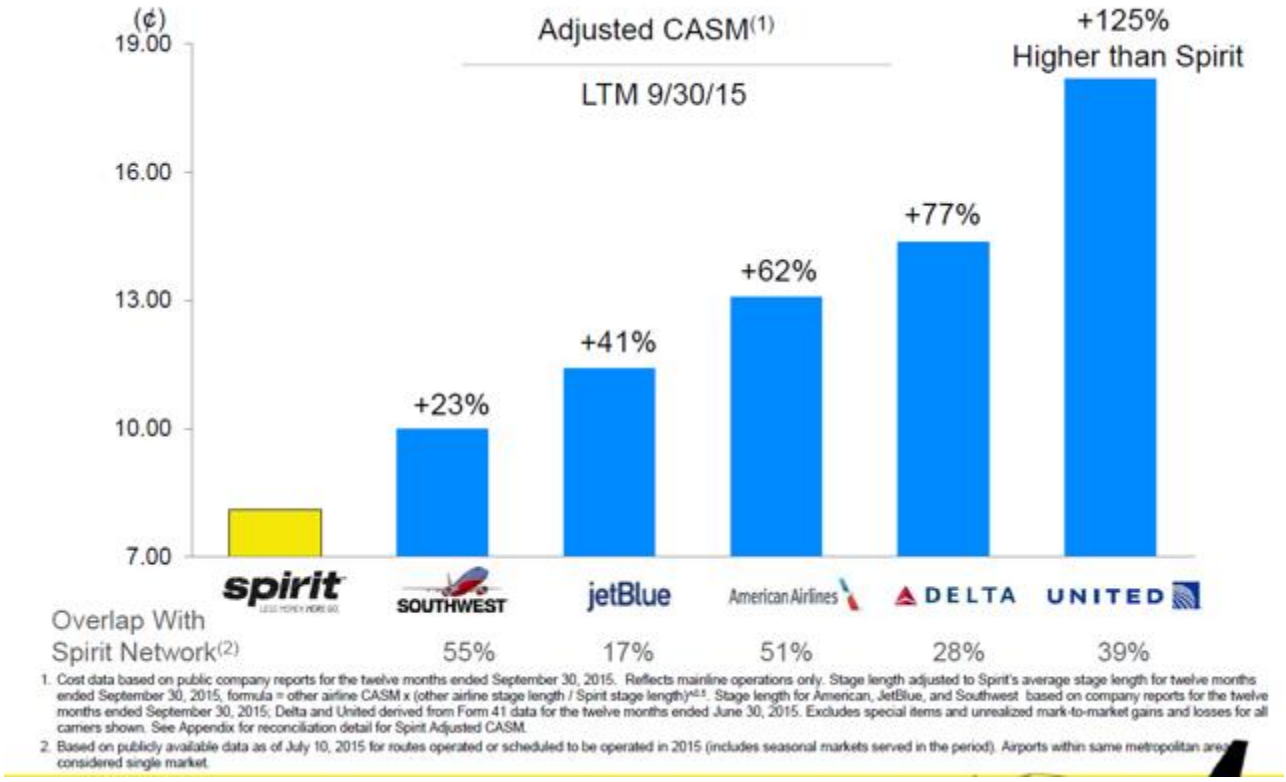


If I'm right, then I expect Spirit's stock will perform along the same lines as Ryanair's. Here's a chart showing how well Ryanair's stock (ADR) has done over the past 14 years:



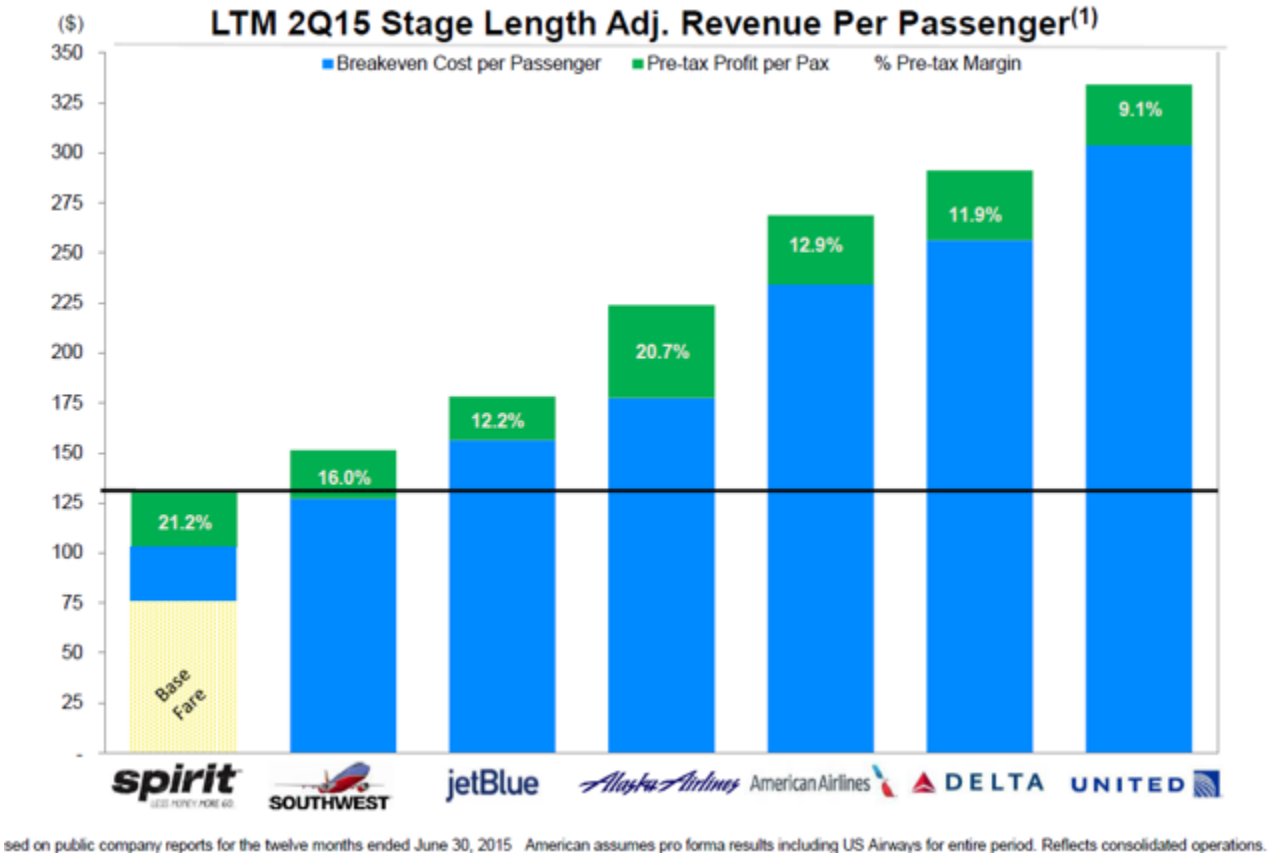
Spirit's Cost Advantage

The key to Spirit's success is its ultra-low costs, which translate into almost absurdly low prices (one personal example: yesterday I booked a round-trip nonstop flight on Dec. 8-9 from NYC (LaGuardia) to Dallas (DFW) for $43.09 each way). Here's a chart from Spirit's investor presentation showing its cost advantage vs. its major competitors:



(Note in particular the 62% cost advantage vs. American, which has started a price war against Spirit - discussed below. Hmmm, I wonder who's going to win that one???)

In fact, Spirit's costs are so low that its total average price (including extras and the company's very high profit margin) is lower than its competitors' *costs*, as this chart shows:



sed on public company reports for the twelve months ended June 30, 2015 American assumes pro forma results including US Airways for entire period. Reflects consolidated operations.

Spirit's extremely low costs are driven by many factors:

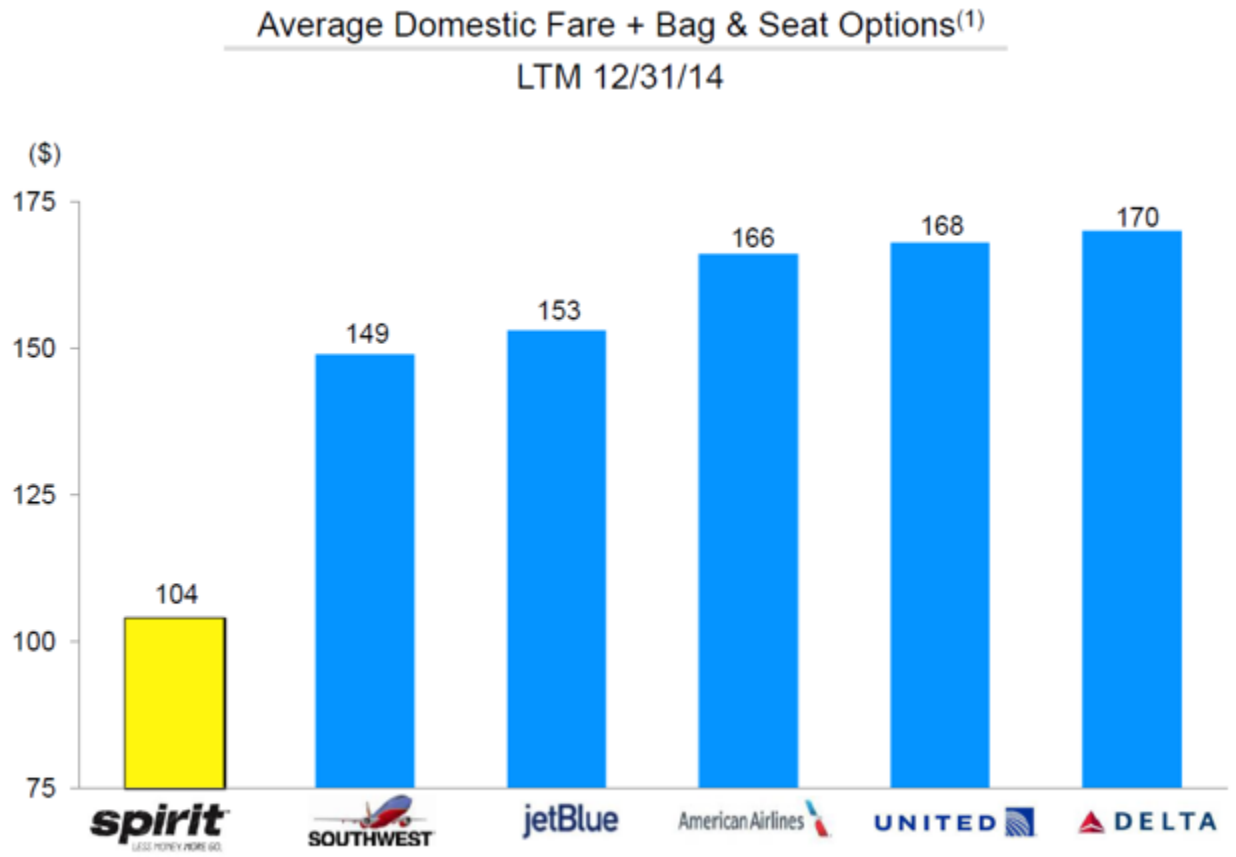
- One type of plane and one class of service
- Cramming the maximum number of seats (~20% more) onto every plane by reducing legroom and having seats that don't recline
- No seat-back pockets, wifi or entertainment systems
- All direct flights (no hub-and-spoke)
- A limited frequent flyer program
- Personnel who do multiple jobs (e.g., flight attendants who also clean the plane and act as gate agents)
- Turning aircraft quickly and flying at all hours, thereby maximizing daily flight time (12.7 hours/day for Spirit; 11.8 for JetBlue; 10.9 for Southwest)
- Rapid growth means lots of new airplanes, which reduces maintenance expense

Every one of these factors, other than the last one, strikes me as sustainable - as Ryanair has proved.

Spirit's Price Advantage

Spirit charges extremely low base fares ($66.96 in Q3) and then charges extra for nearly everything such as a seat assignment, any bag beyond a small carry-on item, all drinks and food, etc. These extras averaged $53.39 for Spirit last quarter, resulting in total revenue per passenger flight segment of

$120.35. While these extras cause some travelers to feel nickeled-and-dimed, almost all travelers on Spirit pay less in total than they would on any other airline (even if one adds Spirit's charge for seat selection and one bag), as this chart shows:

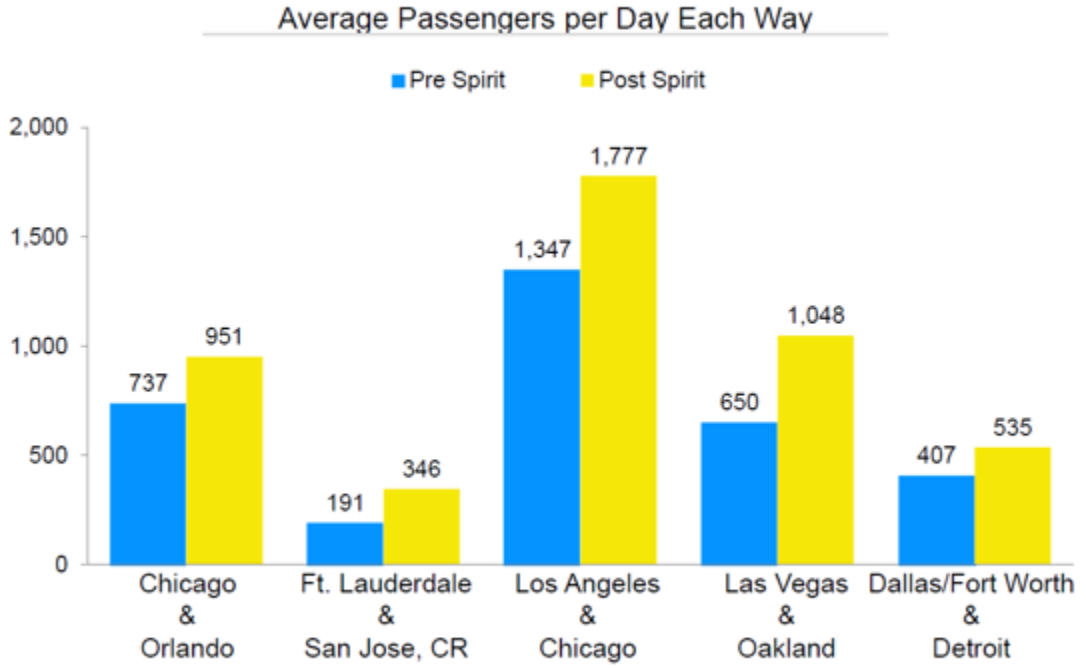


1. Mainline domestic data only for all carriers shown. Data derived from Form 41 for the twelve months ended December 31, 2014; includes domestic passenger revenue (includes seat revenue) plus domestic excess bag revenue divided by domestic revenue passenger enplanements. Data length of haul ("LOH") adjusted to Spirit's domestic LOH for twelve months ended December 31, 2014 (1,008 miles), formula = other airline amount x (other airline LOH / Spirit LOH)$^{0.55}$. American includes American and US Airways and Southwest includes Southwest and AirTran.

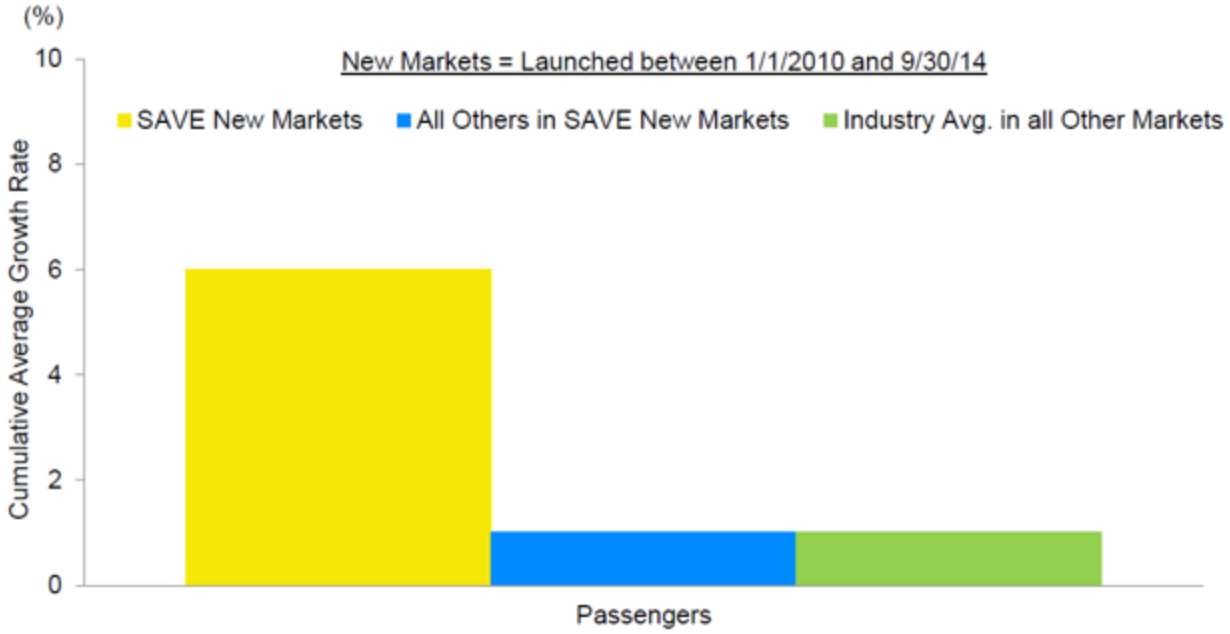
Spirit Stimulates Demand

Spirit's prices are so low, in fact, that its entry into a market stimulates demand, as these two charts show:

On average, Spirit's low fares grow the traffic base by about 37%[1]



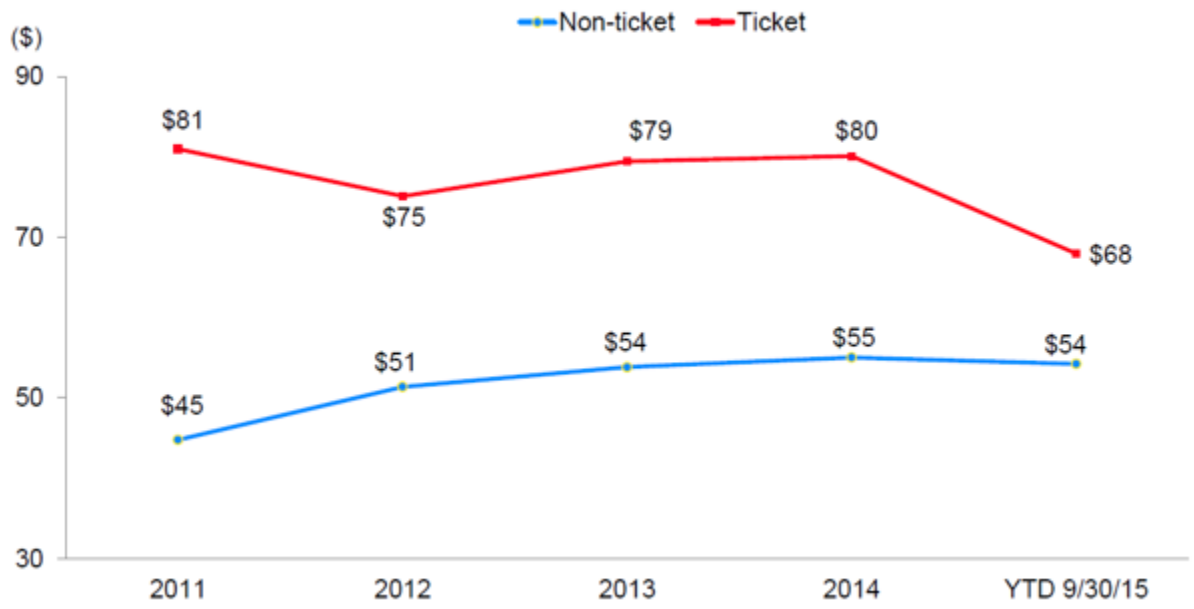
1. Measurement period begins January 2007 through June 2014. System average measures only those markets Spirit has served for at least twelve months.
2. Sample markets do not necessarily reflect system average. Pre Spirit is the average for the four calendar quarters prior to Spirit's entry; Post Spirit is the average for the four calendar quarters following Spirit's entry



This demand stimulation is really important because if Spirit is filling its planes in new markets with new travelers (rather than stealing them from another airline), there's less likely to be a fierce competitive response.

Stable Revenue from Extras

While charging for everything beyond a seat and a small carry-on bag may irritate some customers, it provides Spirit with a very stable and profitable source of revenue. As one can see from this chart, Spirit's average ticket price has dropped significantly (by 15%) this year, yet total revenue is down only 10% because of stable non-ticket revenue.



Why Has the Stock Been Cut in Half this Year?

The stock's halving this year is due to a variety of factors, the most important of which is that American, perhaps emboldened by low fuel prices, rolled out an aggressive price-matching strategy in June that has impacted Spirit's pricing, causing Spirit to report in Q3:

> "Total revenue per passenger flight segment ("PFS") for the third quarter 2015 decreased 13.1 percent year over year to $120.35, primarily driven by a 20.8 percent decrease in ticket revenue per PFS. The decline in ticket revenue per PFS was driven by lower fare levels as a result of increased competitive pressures [60% of impact] as well as a higher percentage of Spirit's markets being under development compared to the same period last year [40% of impact]."

In addition, Spirit's load factor in Q3 fell from 87.6% to 85.2% YOY and Q4 guidance is for unit revenue to decline even more than Q3.

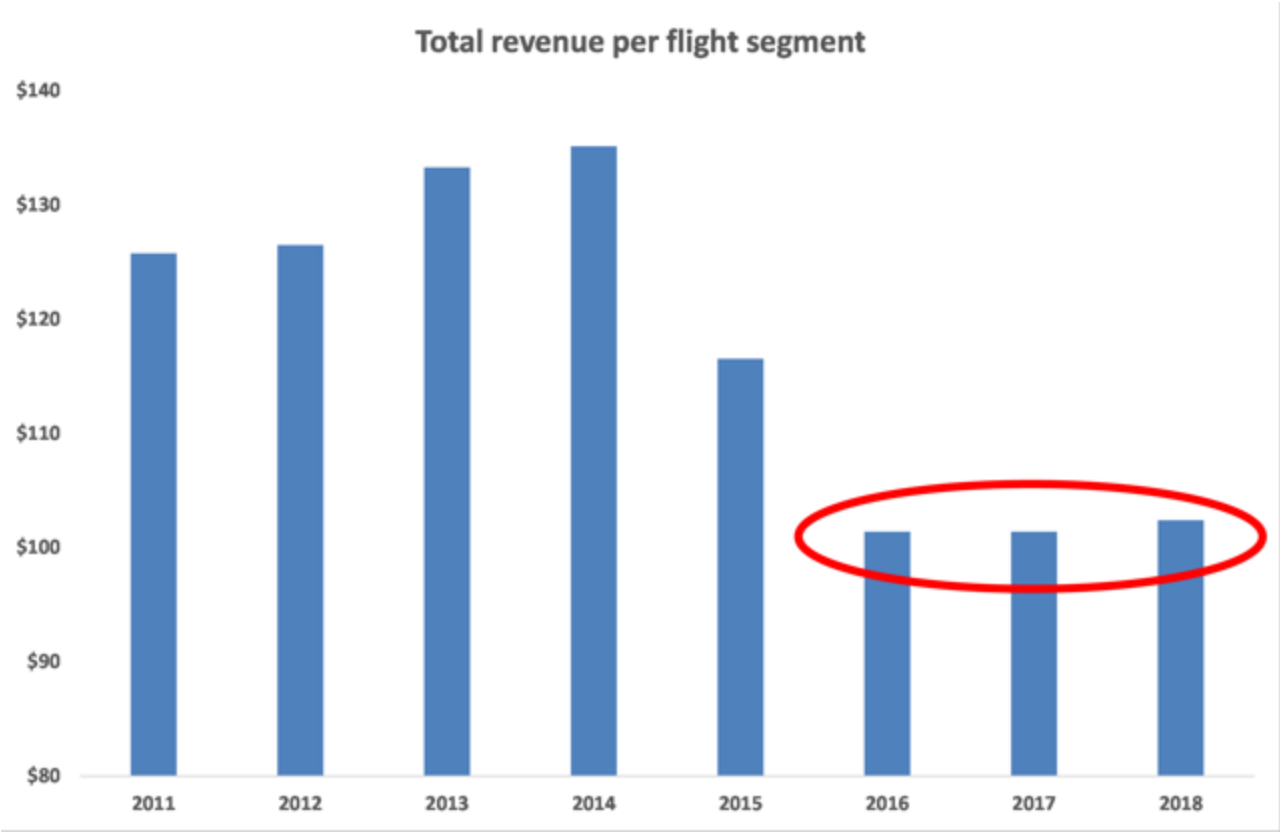
This price war is affecting both Spirit's revenue and margins, which has led analysts to project that earnings per share will be roughly flat in 2016. The growth investors who owned this stock above $80 hate no growth, even for a year, so they've fled - and no self-respecting value investor would ever own an airline stock, right?

There's also concern that Spirit is growing too fast (available seat miles rose 34% in Q3), though this will likely be the peak as capacity growth is projected to be only ~20% in 2016.

In summary, the near-term outlook for Spirit is cloudy, leading analysts and investors to fear the worst (more revenue and earnings reductions), so most of them don't want to own the stock until there's more clarity. Here is the typical analyst view today (from Credit Suisse): "We see few catalysts near-term to bring investors back. Q4 needs a revenue beat & guidance that shows unit revenue declines have bottomed - this won't be known until February."

Why I Think the Analysts Are Wrong

Analysts are, I think, making the classic mistake of projecting the immediate past indefinitely into the future. This chart shows Spirit's total revenue per flight segment, with 2016-2018 numbers based on current analyst estimates:



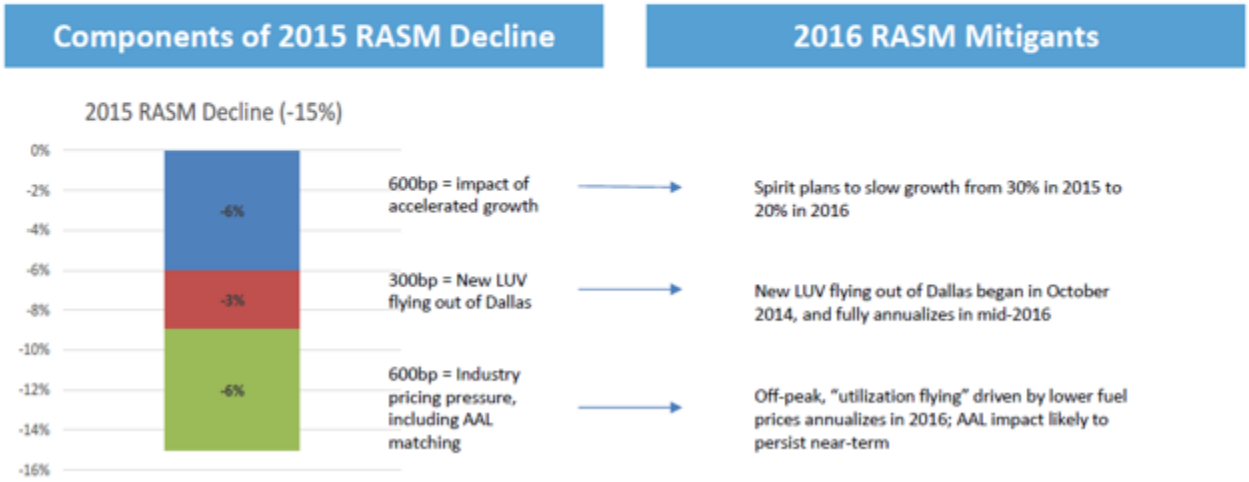
I think this is overly pessimistic. Analysts are not just projecting a continuation of the depressed 2015 number - they're forecasting that the decline from 2014 *doubles*, resulting in total revenue per flight segment of barely over $100, and staying that way for years. This is ridiculous.

First, with 62% higher costs, American is surely incurring significant losses trying to match Spirit's pricing, which is clearly unsustainable. My understanding is that this may be a temporary strategy to push Spirit out of a few key markets.

And it may succeed. Spirit has demonstrated a willingness to avoid share battles and move aircraft to more attractive markets, which is likely what will happen if the price war persists. As Spirit noted in its latest investor presentation, it has "no emotional attachment to any particular route - if a route is underperforming expectations and we no longer believe it will be able to achieve its target threshold, it is cut from the schedule."

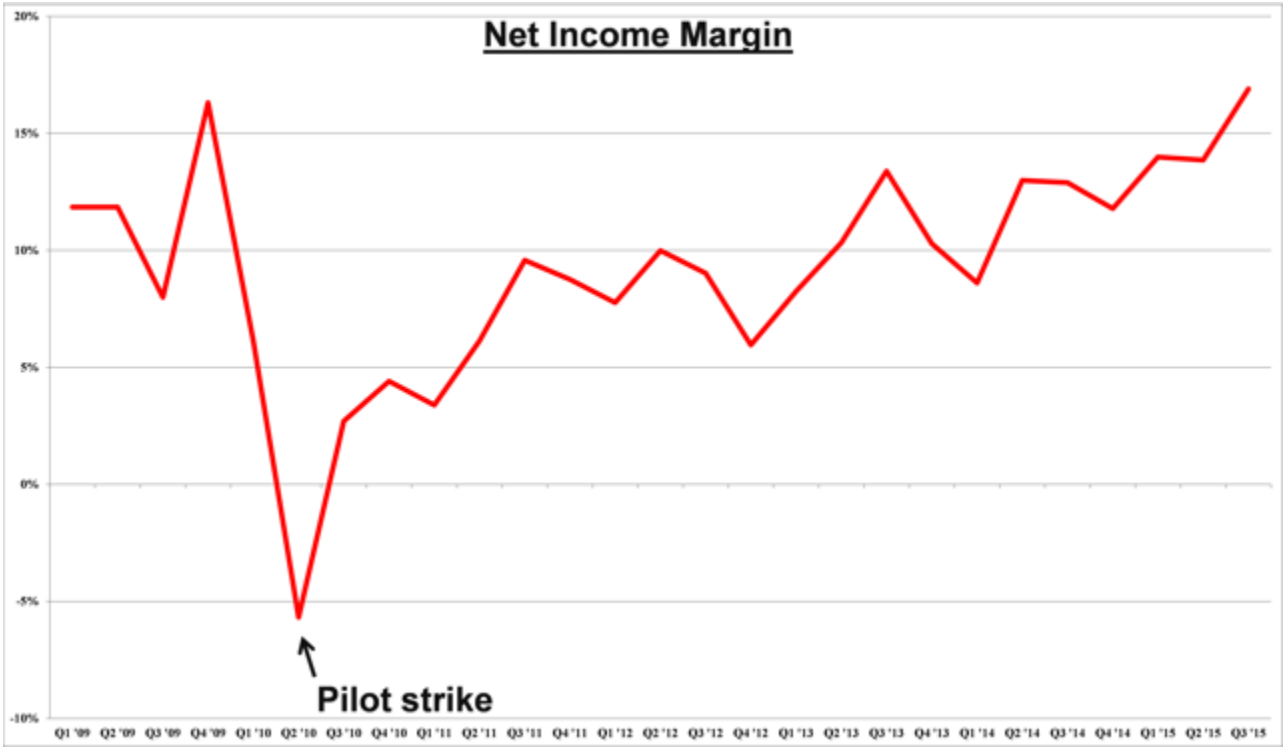
In summary, as this chart (again, courtesy of the three Kellogg MBAs) shows, the major drivers of Spirit's revenue decline in 2015 are very likely to at least stabilize and even reverse in 2016 (and thereafter):

- We believe the market is pricing in another 13-14% RASM decline in 2016 as compared to current street estimates of 6-7%.
- Many of the headwinds that pushed 2015 pricing lower are unlikely to recur.

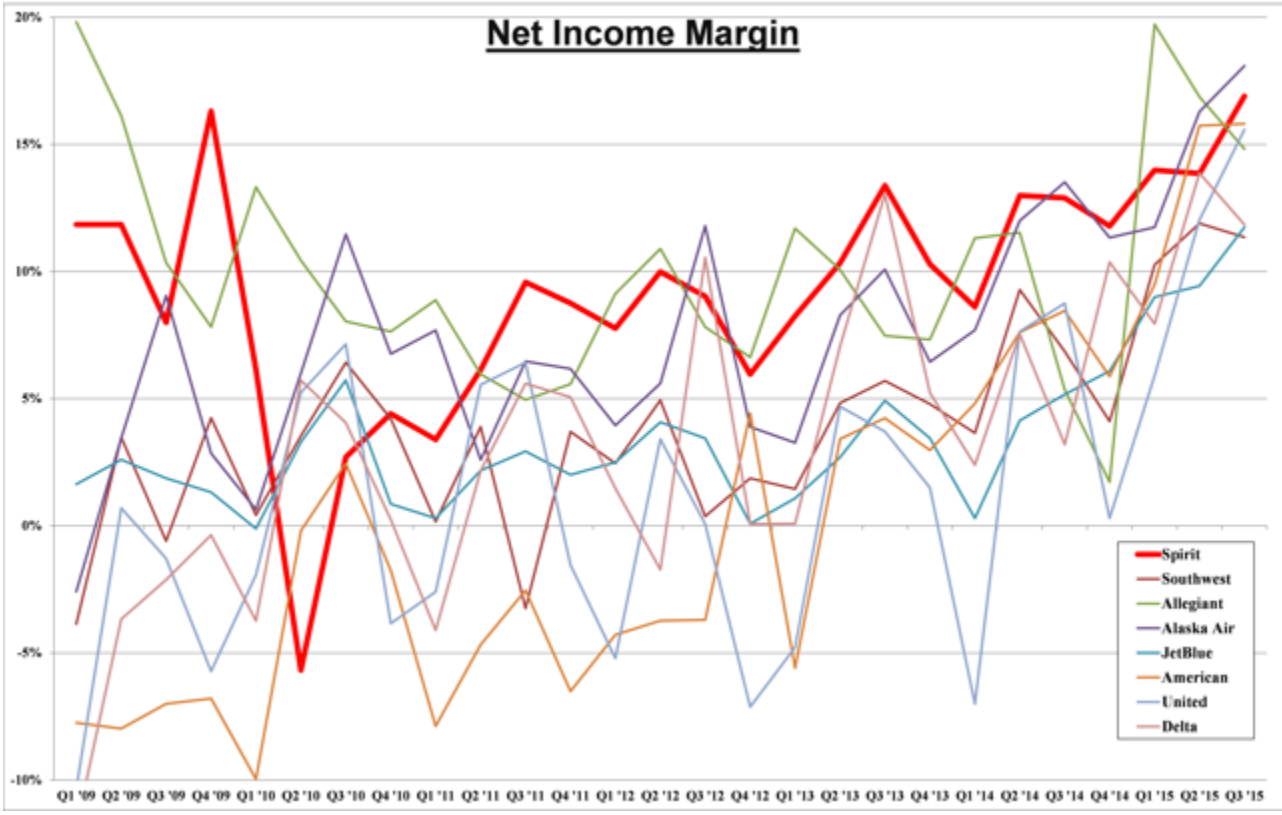


Spirit's Mouth-Watering Economic Characteristics

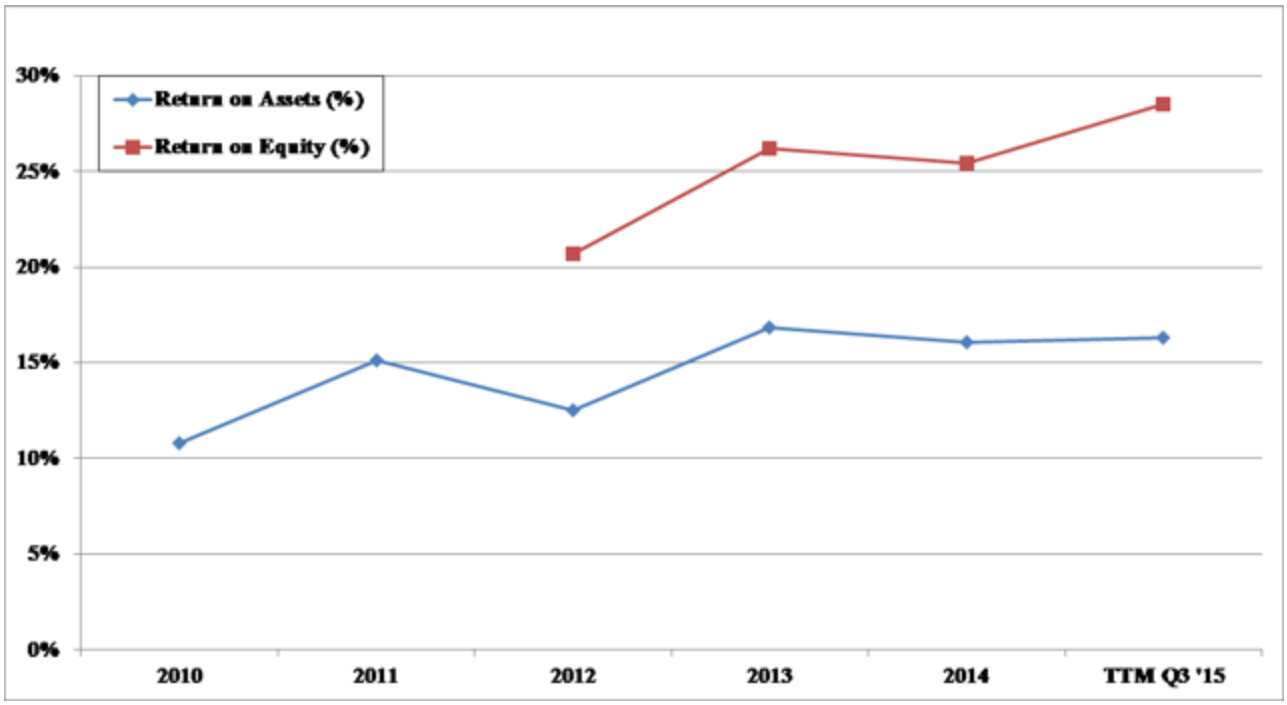
Spirit has astonishingly good economic characteristics. It was one of the only airlines to make a profit in both 2008 and 2009, and has consistently high margins that are the envy of the industry. This chart shows Spirit's net income margin every quarter since Q1 '09:



Now here's the same chart showing Spirit's margin compared to every other U.S. airline - note that while Spirit isn't the highest every quarter, it's consistently one of the best:



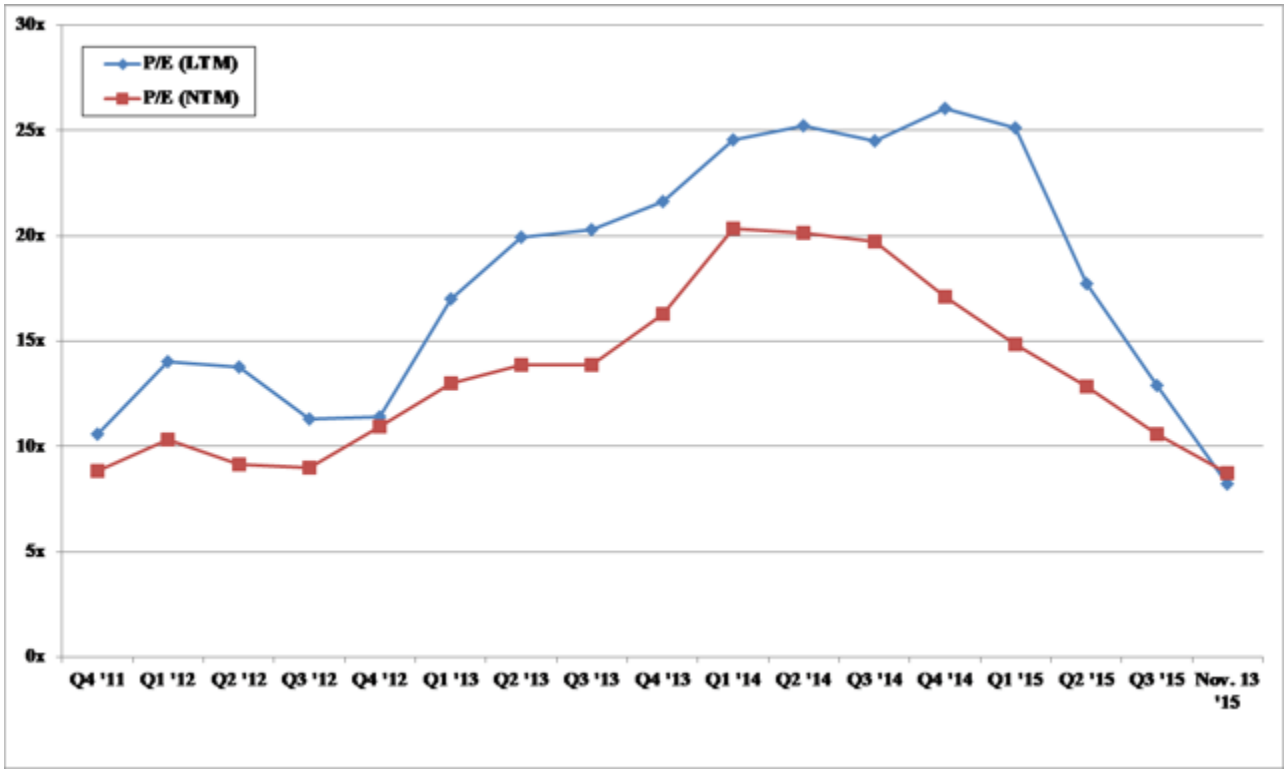
Lastly, this chart shows Spirit's high and rising returns on assets and equity:



Spirit's Ridiculously Cheap Stock

So what would you pay for the stock of a company with an enormous (and likely permanent) cost advantage, growing 20%+ annually, with 25%+ operating margins, 25%+ returns on equity, and a net cash position? 15x earnings? 20x? In fact, Ryanair today trades at 23x 2015 earnings and Southwest in its early years (when it was the size of Spirit today) also traded at similar multiples.

Yet Spirit today trades at less than 9x trailing, 2015 and 2016 estimated earnings, at close to the lowest P/E ratio it's traded at in years, as this chart shows:



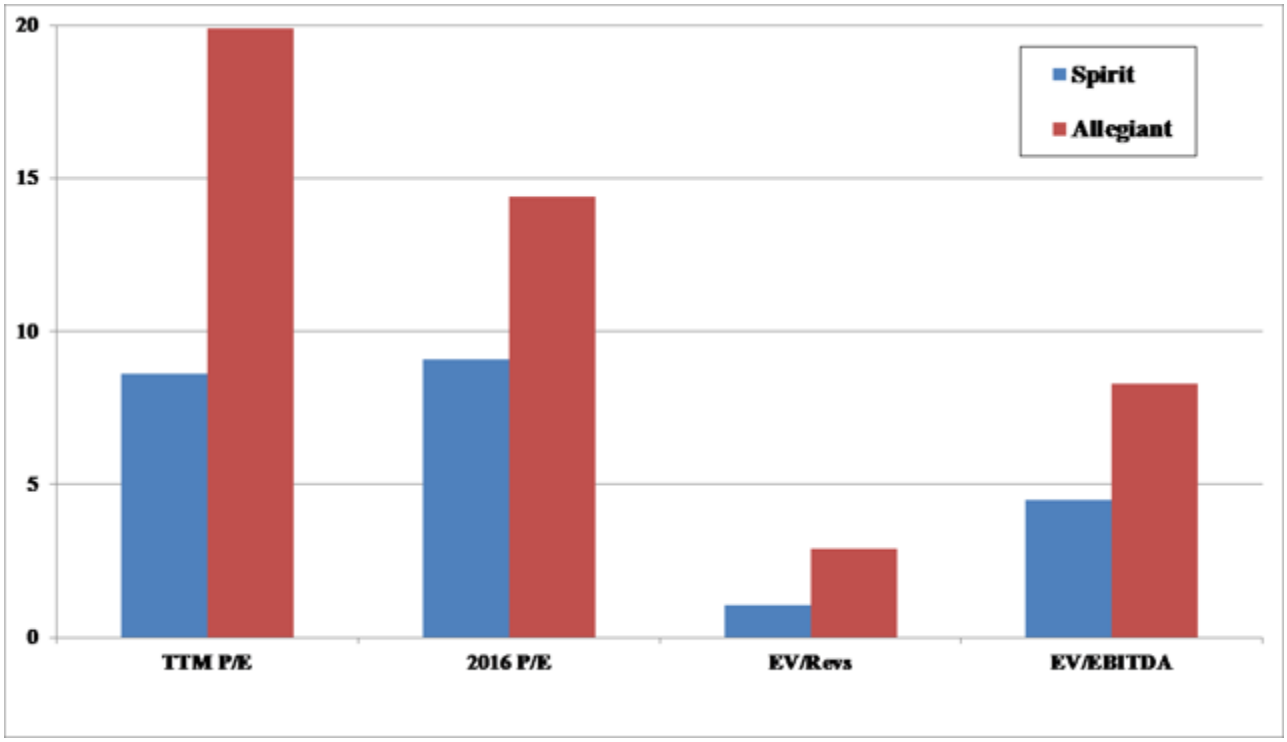
Spirit is also trading at a steep discount to all of its peers, both domestically and internationally, as this table shows:

Comparable Company Valuation

($ in millions, except per share values)

				P/E				EV/EBITDAR		
	Price	% Δ YTD	Market Cap	2015	2016	2017	PEG (2015)	2015	2016	2017
Alaska	$76.68	28.3%	$10,082.0	11.9x	11.1x	10.0x	1.34x	5.9x	5.7x	5.5x
Allegiant	184.95	23.0%	3,220.6	14.7x	13.6x	12.1x	1.43x	7.4x	7.0x	6.6x
EasyJet	17.81	6.6%	7,070.6	13.0x	12.1x	10.3x	1.04x	7.9x	7.4x	6.6x
JetBlue	25.76	62.4%	7,982.3	13.3x	11.5x	10.6x	1.07x	6.2x	5.5x	5.2x
Southwest	46.69	10.3%	31,543.5	13.2x	11.5x	10.7x	1.17x	6.4x	5.9x	5.8x
Ryanair	14.49	48.0%	19,958.0	23.3x	15.8x	13.6x	0.76x	13.2x	10.3x	9.0x
Peer Mean				**14.9x**	**12.6x**	**11.2x**	**1.14x**	**7.8x**	**7.0x**	**6.5x**
Spirit	**$34.30**	**(19.0%)**	**$2,496.2**	**8.5x**	**9.1x**	**8.1x**	**3.53x**	**5.2x**	**5.1x**	**4.5x**
Variance from Peer Mean				*(42.7%)*	*(28.2%)*	*(27.4%)*	*210.7%*	*(33.1%)*	*(27.1%)*	*(30.4%)*

Lastly, despite growing both its revenue and profits faster than its most similar peer, Allegiant, Spirit's stock trades at a huge discount to Allegiant's on every metric, as this chart shows:



But What About Travelers Hating Spirit?

A quick Google search reveals endless stories that are summarized in this blurb in AirlineReporter.com:

> It's true, people vehemently despise Spirit Airlines. Just the mention of the company elicits emotion-filled horror stories. Indeed they have a solid 1 out of 5 star rating on TripAdvisor, and they are frequently found at, or near, the top of various "worst airline" rankings.

Heck, even my wife cringed when I told her I bought the stock, and when I disclosed this purchase to my investors, I felt compelled to write: "I know, I know, it's really horrible airline - but at least read my slides with an open mind."

So let's look at the facts. Spirit's customer service problems fall into two areas: reality and perception. Regarding the former, according to the Department of Transportation, Spirit consistently is among the worst airlines in terms of on-time arrivals, though its cancellation rate it about average (in the first nine months of 2015, Spirit's percentage of flights cancelled was better than the industry in four months and worse in five, with the average slightly worse: 1.94% vs. 1.73%).

On the plus side, the rate of mishandled bags is 18% better than average (2.73 vs. 3.33 reports/1,000 passengers), and the rate of "bumping" passengers is half the average.

So, overall, Spirit does indeed have a genuine service problem, but its perception problem might be worse. Many of Spirit's customers (especially first-time ones) aren't used to being charged for so many extras, so clearly Spirit needs to do a better job of setting expectations (which it's trying to do).

Add up both the reality and perception problems and Spirit's complaint rate in the first nine months of this year was 6x higher than average (11.93 complaints/100,000 enplanements vs. 1.97). (While terrible,

it's still only one complaint for every 8,400 passengers.) Perhaps the best that can be said about Spirit's customer service is that there's a lot of room for improvement!

Surely so many customers hating Spirit will eventually cripple the business, right? This was my concern when I first looked at this stock three years ago - and was the main reason I didn't buy it (causing me to miss the run from $20 to over $80 - arrrrh!).

I now realize that this was a serious mistake, mainly because I was thinking about this business from my perspective - but I'm not the customer Spirit is targeting! I am willing/able to pay an extra $50-$100 for a flight with better service, a few extra inches of legroom, a seat that reclines, etc., but many (most?) Americans don't have this luxury.

An article in AirReporter.com has a good summary:

> Ultra-low-cost carriers can be a great option. They can provide you fast and safe transportation, the cheapest way possible. If you only care about getting your body from one place to another, without frills or high expectation of service, you cannot beat an ultra-low-cost carrier. It is about being an informed customer and doing the math to make sure you are choosing the right airline.
>
> I don't walk into McDonald's expecting a delicious meal. I expect to get a cheap meal and mediocre service. Why would a passenger pay for an ultra-low-cost airline and expect MGM Grand Air level of service?
>
> In direct contrast to these [low] ratings and frequent "I'll never fly Spirit again" claims, the airline continues to grow and increase market share.

Price Target

Most companies with Spirit's characteristics - growing 20%+ annually with a long runway, 25%+ operating margins and returns on equity, and a net cash position - trade above 20x earnings. Indeed, Ryanair and Southwest consistently traded at 15-20x forward earnings in the early stages of their growth cycles.

Applying a 15 multiple to 2016 estimates of $4.03 results in a stock price of $60.45, 64% above today's price. That sounds about right to me for a one-year target - and I think the upside is much higher over many years, which is how long I hope to own this stock.

An Analysis Of The Price War Between American And Spirit Airlines

Whitney Tilson
Nov. 25, 2015 6:45 AM ET
Disclosure: I am/we are long SAVE. **(More...)**

http://seekingalpha.com/article/3712526-an-analysis-of-the-price-war-between-american-and-spirit-airlines

Summary

- American Airlines rolled out an aggressive price-matching strategy in June that has impacted Spirit's pricing and revenues.
- This is the major factor that has caused Spirit's stock to be cut in half this year.
- With 62% higher costs, I question how long American can continue this strategy.
- I suspect it is more likely to be a warning to Spirit to pursue growth in markets not served by American.
- If so, it makes me even more bullish on Spirit's stock.

In my article earlier this week, *Spirit Airlines Is Poised To Be The Next Ryanair*, I wrote:

> American, perhaps emboldened by low fuel prices, rolled out an aggressive price-matching strategy in June that has impacted Spirit's pricing…This price war is affecting both Spirit's revenue and margins…

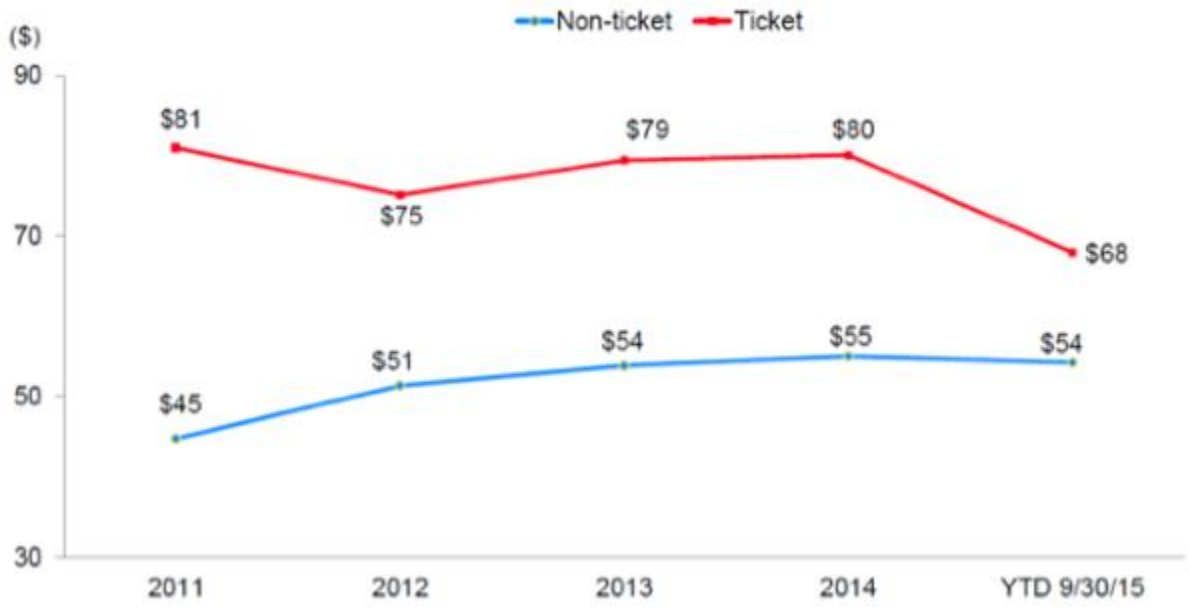
It would be hard to find a better example of this price war than on the NYC (LaGuardia) - Dallas (DFW) route, which has reached an extreme degree. Because I haven't flown Spirit in many years and want to experience the airline for myself, I looked for an ultra-cheap flight I could take - and found a round-trip nonstop to Dallas on Dec. 8-9 for $43.09 each way (that's not a typo; heck, the taxis to and from LaGuardia will cost almost as much as the flights!).

I didn't check any other airlines because I want to fly Spirit to check it out - but also because I was certain that no other airline would have a price anything close to Spirit's (the last time I flew to Dallas a year or two ago, I recall it was around $450 round-trip). But I was wrong: if I booked the right American flights (it has a dozen each way every day vs. only one for Spirit), the price was only $79 - and that presumably included an assigned seat and carry-on bag (which Spirit charges extra for)!

(A few hours ago, I checked the same flights again and, sure enough, American underpriced Spirit again: it had three morning flights to Dallas on the 8th and two late afternoon/early evening flights back on the 9th for only $97 vs. $107 for Spirit.)

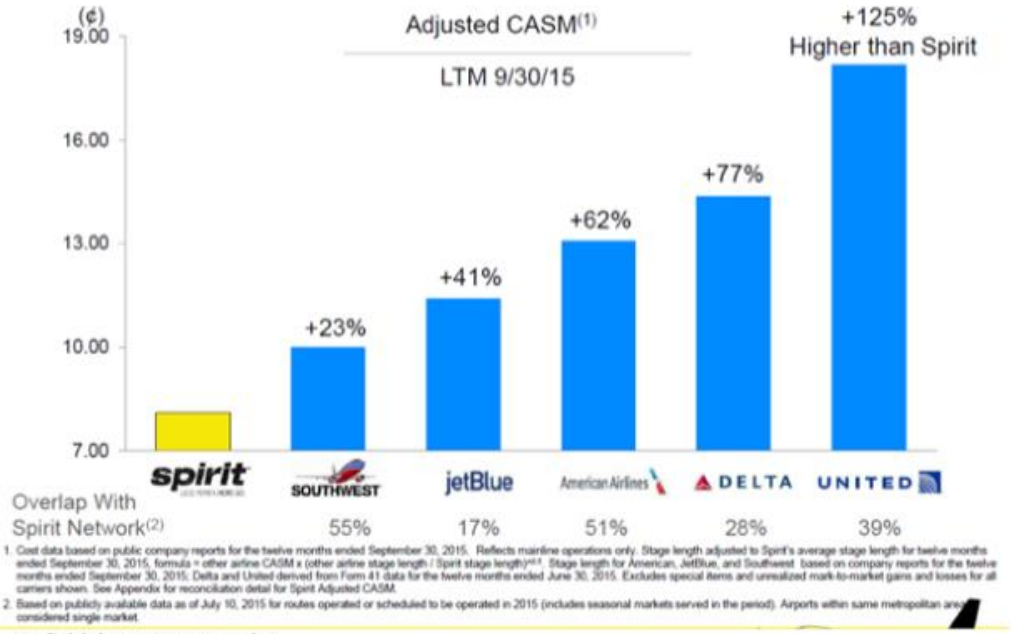
This Isn't Sustainable for American

Such low prices aren't good for Spirit, as its base fares are normally around $80 (they've fallen to $68 this year due mainly to the price war with American), but at least its non-ticket revenue has remained steady, as this chart shows:



Source: Spirit investor presentation.

But such low prices cause American to lose *far* more money than Spirit for two main reasons: it doesn't make nearly as much on non-ticket charges and its costs are *62% higher* than Spirit's, as this chart shows:



1. Cost data based on public company reports for the twelve months ended September 30, 2015. Reflects mainline operations only. Stage length adjusted to Spirit's average stage length for twelve months ended September 30, 2015, formula = other airline CASM x (other airline stage length / Spirit stage length)^0.5. Stage length for American, JetBlue, and Southwest based on company reports for the twelve months ended September 30, 2015. Delta and United derived from Form 41 data for the twelve months ended June 30, 2015. Excludes special items and unrealized mark-to-market gains and losses for all carriers shown. See Appendix for reconciliation detail for Spirit Adjusted CASM.
2. Based on publicly available data as of July 10, 2015 for routes operated or scheduled to be operated in 2015 (includes seasonal markets served in the period). Airports within same metropolitan area considered single market.

Source: Spirit investor presentation.

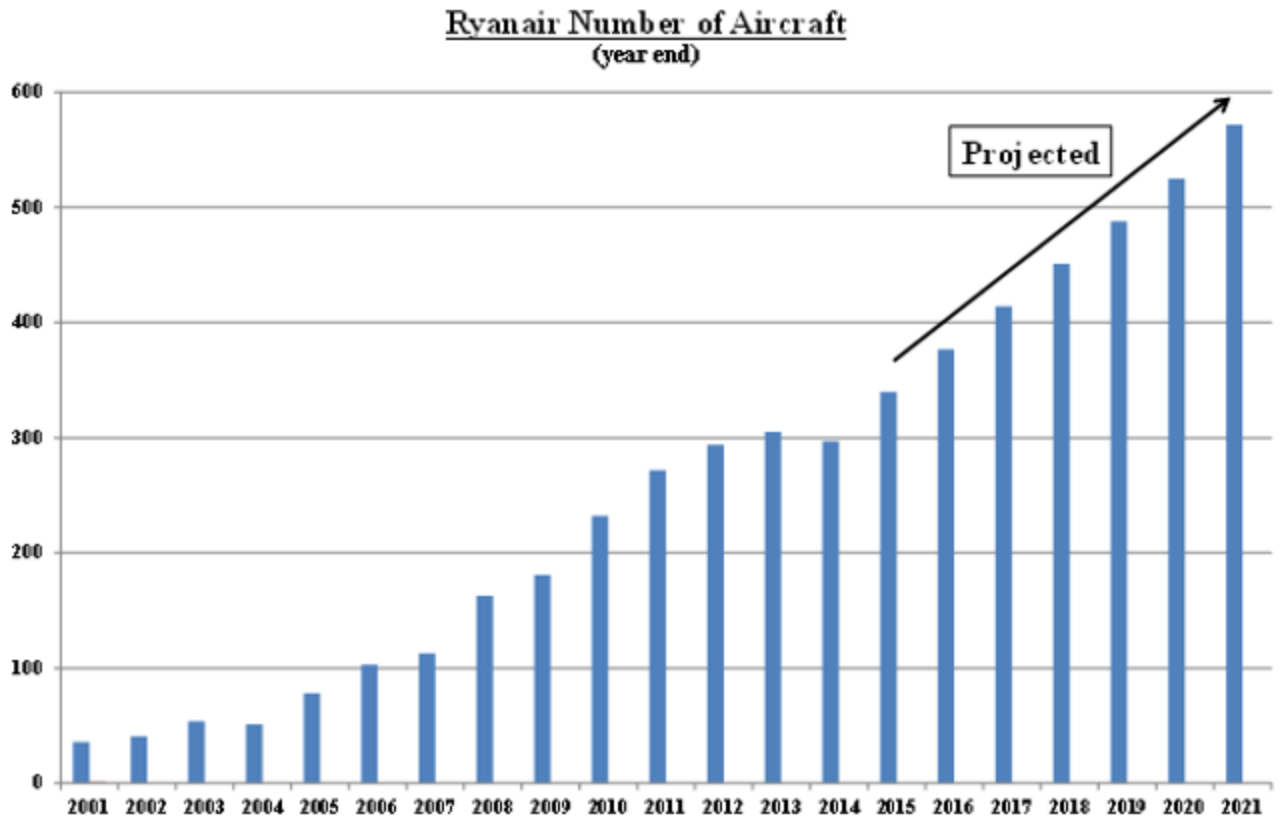
What Is American Thinking?

Obviously American is aware of its massive (and permanent) cost disadvantage vs. Spirit and it knows it can't possibly drive Spirit out of business (Spirit has $200 million of net cash and just reported its most profitable quarter ever, despite the price war), so what on earth could American's management be thinking? Have they lost their minds?

Perhaps not. I think American first considers its cost structure vs. Spirit's, and then looks at Spirit's growth plan, which (with firm orders for 106 Airbus A320 planes) looks like this:

Source: Spirit 10K 2014.

Then, I think American's management team looks at what Ryanair (NASDAQ:RYAAY) has done to the major carriers in Europe over the past decade with this growth:



Source: Ryanair 20-Fs.

I think American's management, not unreasonably, came to the conclusion that Spirit, while not a major threat today (American's revenues in Q3 were 19x greater than Spirit's), is likely to become one, and therefore decided - at a time when low fuel prices have swelled its margins and cash hoard - to engage in a price war to, in part, weaken Spirit, but more importantly send a powerful (and painful) message:

> "Take your growth elsewhere! If you bring your new planes onto routes that compete with us, expect us to continue to lash out and hurt you. Even though we'll lose more money than you, we're a lot bigger, so we can afford it - and you can't, as evidenced by our respective stock prices this year." (American's stock is down 23% while Spirit's is down 53%.)

Implications for Spirit

At first glance, American's "spanking action" might appear to be terrible news for Spirit and make one not want to own the stock. After all, American is so much bigger and, if it chose, could inflict quite a bit of pain on Spirit indefinitely.

But, if my assessment of American's thinking is correct, it actually makes me more bullish on Spirit's stock because it means that the price war is likely to end in the reasonable future (I hesitate to put a date on it, but I'd be surprised if it continues much into 2016; in part it depends on Spirit's actions - I hope management is wise enough to back off a bit against American - as well as on oil prices: if they go up, American is likely to end the price war sooner in order to maintain its own profitability).

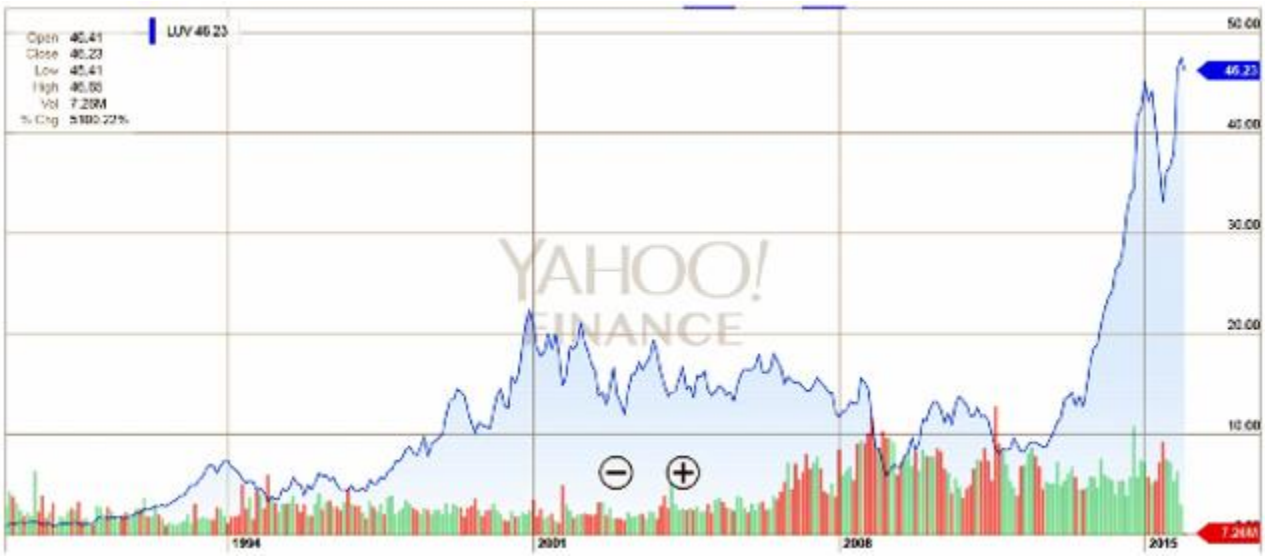
Conclusion

Ultimately, however, this is just short-term noise (though this is all that investors and analysts seem to be able to focus on). In the long run, the better business model wins - and I think Spirit has a better one than its competitors (which isn't to say that there won't be multiple winners, as I own Delta's (NYSE:DAL) and JetBlue's (NASDAQ:JBLU) stocks as well). Americans love a bargain and are willing to put up with various inconveniences and/or minimal service levels to save a lot of money. As a result, well-managed companies with sustainably much lower costs than their competitors tend to do very well over time - just look at Wal-Mart (NYSE:WMT) and Costco (NASDAQ:COST) over the past few decades.

More relevantly, consider Southwest (NYSE:LUV) and Ryanair - companies with low-cost models similar to Spirit's and whose success I think Spirit has a decent chance of replicating. When Southwest and Ryanair were much smaller, the major carriers periodically engaged in price wars that hurt their earnings and stocks - and each time, the stocks proved to be screaming buys.

Here are their price charts going back decades:

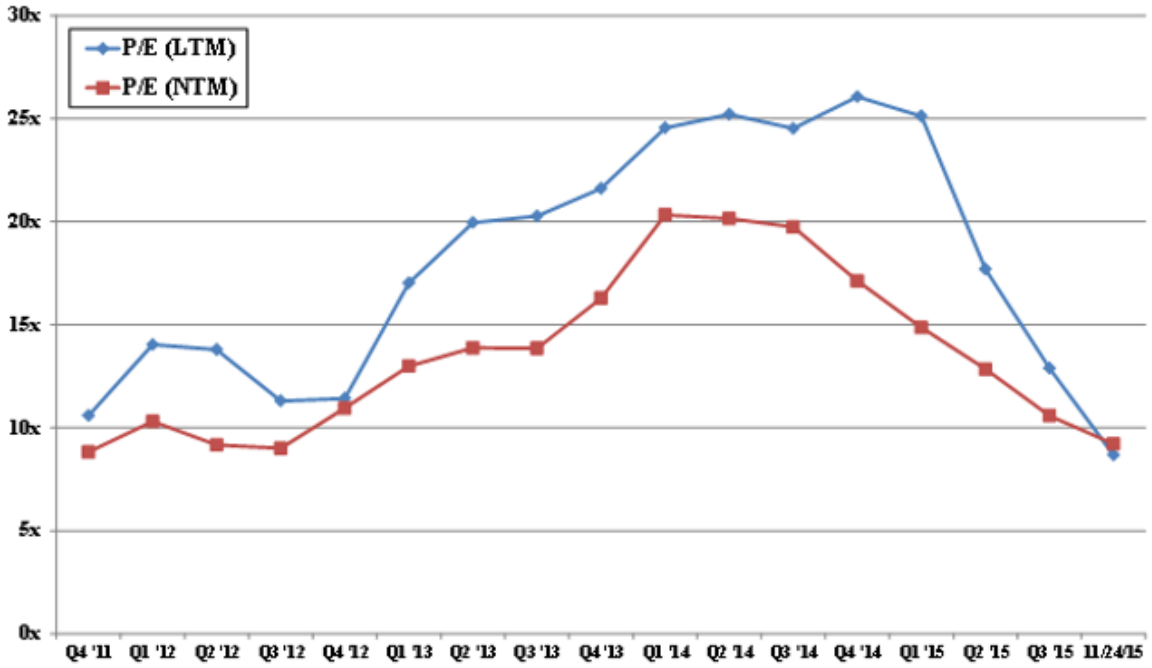
Southwest



Ryanair

Note that there were long periods when both stocks performed very poorly, so it's important to keep two primary lessons in mind: a) the airline industry is cyclical, so size these positions appropriately as even the best companies (and stocks) are going to get hurt during recessions (2008 being the most extreme example, when both stocks got cut in half); and b) it's very important not to overpay for any stock, but especially airline stocks. Investors who bought Southwest in late 2000 and Ryanair in late 2003, paying more than 30x trailing earnings in each case, didn't make any money for 13 years and eight years, respectively. They were and are great companies but, at inflated prices, they were lousy stocks.

Ditto for Spirit: investors who bought the stock earlier this year when it was trading at a trailing P/E in excess of 25x have paid a heavy price. But today the opposite is true, as the stock is downright cheap, trading at a mere ~9x trailing, 2015 and 2016 estimated earnings, close to the lowest P/E ratio it's traded at in years, as this chart shows:



Spirit is also trading at a steep discount to all of its peers, both domestically and internationally, as this table shows:

Comparable Company Valuation

($ in millions, except per share values)

				P/E				EV/EBITDAR		
	Price	% Δ YTD	Market Cap	2015	2016	2017	PEG (2015)	2015	2016	2017
Alaska	$76.68	28.3%	$10,082.0	11.9x	11.1x	10.0x	1.34x	5.9x	5.7x	5.5x
Allegiant	184.95	23.0%	3,220.6	14.7x	13.6x	12.1x	1.43x	7.4x	7.0x	6.6x
EasyJet	17.81	6.6%	7,070.6	13.0x	12.1x	10.3x	1.04x	7.9x	7.4x	6.6x
JetBlue	25.76	62.4%	7,982.3	13.3x	11.5x	10.6x	1.07x	6.2x	5.5x	5.2x
Southwest	46.69	10.3%	31,543.5	13.2x	11.5x	10.7x	1.17x	6.4x	5.9x	5.8x
Ryanair	14.49	48.0%	19,958.0	23.3x	15.8x	13.6x	0.76x	13.2x	10.3x	9.0x
Peer Mean				**14.9x**	**12.6x**	**11.2x**	**1.14x**	**7.8x**	**7.0x**	**6.5x**
Spirit	**$34.30**	**(19.0%)**	**$2,496.2**	**8.5x**	**9.1x**	**8.1x**	**3.53x**	**5.2x**	**5.1x**	**4.5x**
Variance from Peer Mean				*(42.7%)*	*(28.2%)*	*(27.4%)*	*210.7%*	*(33.1%)*	*(27.1%)*	*(30.4%)*

Source: Price data and Bloomberg consensus estimates as of 11/13/15.

In summary, there are very few companies I'm aware of that are growing 20%+, with a 25%+ operating margin, 25%+ return on equity, with a net cash position – yet a stock trading at a P/E of ~9x. Hence, I have made it one of my top five positions.

My Experience Flying Spirit Airlines This Week

Whitney Tilson
Dec. 10, 2015 1:56 PM ET
Disclosure: I am/we are long SAVE. **(More...)**

http://seekingalpha.com/article/3747856-my-experience-flying-spirit-airlines-this-week

Summary

- Having recently bought the stock, I wanted to experience Spirit for myself.
- Though Spirit has a much higher complaint rate than other airlines, I had a great experience and didn't observe any customer service problems on either flight.
- The customers Spirit serves, how it's handling areas of customer dissatisfaction and how it generates extra revenues and keeps costs low makes me more bullish on the future of the company.
- The stock which, even though it's up 20% since my first article three weeks ago, remains exceptionally cheap at ~10x earnings.

My biggest concern in owning the stock of Spirit Airlines (NASDAQ:SAVE), which I added to my portfolio last month, is the very high complaint rate among its customers, as I discussed in my recent article, Spirit Airlines Is Poised To Be The Next Ryanair. Thus, to see what it's really like to fly Spirit, I booked a flight from New York City (LGA) to Dallas (DFW) on Tuesday afternoon and returned the next morning. Below are my impressions and pictures.

Overall, it was a great experience. Both flights boarded smoothly, departed on time and arrived early. The flight attendants were nice and the one making the safety announcements was genuinely funny - sort of the like old days of Southwest (NYSE:LUV) from what I've heard.

The boarding area at LGA was pretty dingy - it reminded me of the Greyhound station at the Port Authority - as you can see in this picture (forgive the low quality of my cell phone pictures):

Note, however, that LGA is a small hub for Spirit - only 11 flights/day in and out. The gate areas at DFW were brand spanking new.

Many of the other flyers appeared to be of low to moderate income - I suspect a fair percentage are folks who couldn't afford to fly were it not for Spirit's rock-bottom prices (the base fare for my round-trip flight was an astonishingly low $86.18). As a shareholder, I'm delighted to see this, as it's a large base of customers that the major carriers, as they rush to add seat-back screens, wifi and other perks - and jack prices up accordingly - aren't serving well.

This also means that, as Spirit grows, it's not primarily taking share from other airlines, but rather stimulating new demand from people who otherwise wouldn't be flying at all. This, in turn, means the major carriers, over time, are less likely to engage in price wars with Spirit, as American (NASDAQ:AAL) has done in recent months (though there are signs that it is easing up). (For more on this, see my article, An Analysis Of The Price War Between American And Spirit Airlines.)

In light of Sprit's high complaint rate, I watched closely for any signs of irate customers - and didn't see any in either gate area or on either flight.

One thing that I'm sure would infuriate anyone would be to get hit with an unexpected $100 charge for a carry-on bag, but Spirit addressed this well in many ways:

- First, on the web site when I booked the ticket, I could pay for a carry-on or checked bag for only $35 and $30, respectively (and even lower, $26/$21, for members of Spirit's "$9 Fare Club");
- I received two email reminders about paying in advance for bags (the price is $40/$35 if you pay after you book the ticket but before online check-in; $45/$40 if after online check-in but before arriving at the airport; and $55/$50 at the ticket counter);

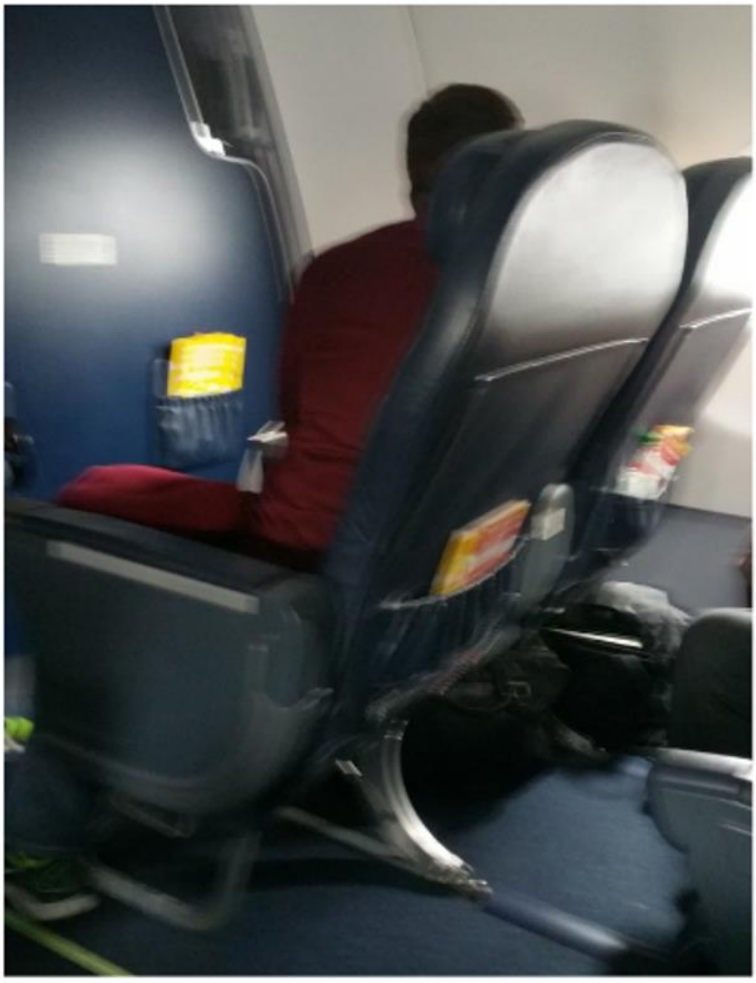
- The gate agent made an announcement about 45 minutes before the flight, saying if you went back to the ticket counter, it was $55 for a carry-on and $50 for a checked bag; otherwise, it would be $100; and
- Lastly, there was this in the gate area:

If, after all of this, someone gets stuck paying $100 they didn't expect, they have only themselves to blame. (I didn't notice anyone paying this on either flight.)

As I walked down the gangway to the plane, a nice man greeted me - it turns out that he was one of five supervisors for Spirit at LGA and he read my recent article about Spirit, so knew that I was on this flight. We ended up chatting for 10 minutes while everyone else boarded the plane. He's worked for Spirit for four years and says it's a great airline - he really believes in its business model.

I asked about customer service issues/complaints and he said that anytime a customer files a formal complaint, every Spirit supervisor (not just at the airport it occurred) is notified so that they can all learn from it. I inquired whether Spirit gets many complaints for its $100 bag fee at the gate and he acknowledged that he sometimes he has to placate an irate customer about this - but has the discretion to charge the $55 ticket counter rate if need be. He also said that, with only one flight a day each way to Dallas, if there's a maintenance issue, there are no backup flights to put passengers on (unlike, say, American, which has 12 flights daily each way). In this case, they book passengers on other airlines.

As for the flight itself, I paid an extra $50 for a front row seat on the outbound flight - and it was money well spent. As you can see from these two pictures, the seats are large, have lots of legroom, and recline (unlike the other 174 seats on the plane; about 20% more than other carriers):



Basically, they're similar to first class seats on most domestic flights on other carriers - at a massively lower price.

On the return flight, I didn't pay extra to reserve a seat, so I likely would have been assigned a middle seat at check-in (both flights were ~85% full), but the supervisor very kindly booked me in the second row (which is the next-best row because it has more legroom due to the first-row seats reclining). In short, I recommend paying $50 extra for a front-row seat or $14 extra for a second-row seat.

During the flights, the flight attendants hawked the Spirit MasterCard (lots of people asked for the brochures) and served drinks and snacks, which nobody seemed to mind paying extra for (a bottle of water or soft drink is $3), as this is well communicated. Here are pictures of the front and back of the menu:

Note the Coca-Cola ad on the menu - Spirit is always trying to raise a few extra dollars! Similarly, there were a handful of ads for a Vegas casino on the walls of the cabin - similar to what you see on the NYC subway car. Sure, it was a little cheesy - but everything about Spirit is a little cheesy! The airline does a good job of communicating its low-cost/low-price message.

Conclusion

In light of Spirit's well-known customer service issues, I feared the worst when I went to the airport on Tuesday, but I was very, very pleasantly surprised by every aspect of my experience -

and, as best I could tell, the other ~300 passengers on my two flights had a similarly good experience. Of course this is just one anecdote - and the plural of anecdote isn't data - but overall what I observed - in particular, the customers Spirit serves, how it's handling potential areas of customer dissatisfaction, and how it both generates extra revenues and keeps costs low - makes me more bullish on the future of the company and the stock which, even though it's up 20% since my first article three weeks ago, remains exceptionally cheap at ~10x earnings.