

Air New Zealand

NEUTRAL

FY19 Preview — A Year of Turbulence

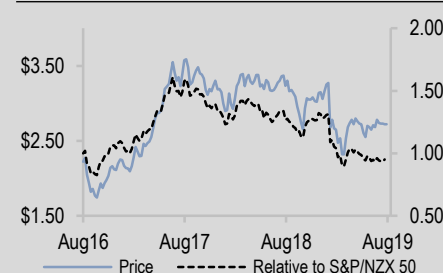
Air New Zealand (AIR) will report its FY19 result on Thursday 22 August; we forecast profit before tax (PBT) of NZ\$352m, down -35% against the prior year. AIR's profitability has come under pressure during the year from (1) fuel cost increases, (2) other inflationary pressures, (3) weaker demand from the domestic leisure segment, and (4) increased trans-Pacific competition.

Key issues to consider at AIR's FY19 result

- **Softer demand:** AIR downgraded its guidance in January 2019 given a deteriorating demand backdrop, with particular reference to domestic leisure and trans-Pacific, given greater North America–Australia direct capacity. NZ outbound demand has remained robust through 2H19 but represents a key risk for FY20 given economic headwinds.
- **Capacity growth:** AIR has previously guided to +5% capacity growth for FY20, which includes -2% drop in domestic capacity. If demand headwinds increase then capacity growth may slow through the year.
- **Cost-out programme:** AIR is targeting annualised cost savings of NZ\$60m via a two year cost reduction programme. However, at its investor day in May 2019 management outlined that the rate of unit CASK ex-fuel (cost per available seat km) improvement would be moderated by (1) higher labour agreements, (2) heightened supplier inflation pressures, and (3) a lower rate of capacity growth.
- **Elevated gearing:** We forecast AIR to be above the top end of its gearing target band of 45%–55%. In tandem with a sharp decline in profitability, this brings into question the sustainability of the current dividend. At the 1H19 result management made reference to *"the Board's commitment to its distribution policy that looks through short term earnings volatility to provide shareholders with a consistent and sustainable dividend"*. While we expect the current level of dividend to be payable through FY20, any sustained downturn and ROIC below 10% will put the dividend at risk.

NZX Code	AIR
Share price	NZ\$2.72
Target price	NZ\$2.50
Risk rating	High
Issued shares	1123.0m
Market cap	NZ\$3,055m
Average daily turnover	856.9k (NZ\$2,416k)

Share Price Performance



Financials: June	18A	19E	20E	21E
NPAT* (NZ\$m)	390.0	259.9	300.6	340.6
EPS* (NZc)	34.4	22.9	26.5	30.0
EPS growth* (%)	3.4	-33.4	15.7	13.3
DPS (NZc)	22.0	22.0	22.0	22.0
Imputation (%)	100	100	100	100
Valuation (x)	18A	19E	20E	21E
EV/EBITDA	4.1	5.0	4.8	4.5
EV/EBIT	8.0	13.0	11.5	10.3
PE	7.9	11.9	10.3	9.1
Price / NTA	1.5	1.7	1.7	1.6
Cash dividend yield (%)	8.1	8.1	8.1	8.1
Gross dividend yield (%)	11.2	11.2	11.2	11.2

*Historic and forecast numbers based on underlying profits

Figure 1. Summary of earnings forecasts (NZ\$m)

	FY18	FY19E	Change	Consensus
Sales revenue	5,485	5,790	5.6%	5,797
EBITDRA	1,292	1,134	-12.2%	n/a
Underlying PBT	540	352	-34.8%	353
Reported NPAT	390	260	-33.4%	n/a
Underlying NPAT	390	260	-33.4%	260
Underlying diluted EPS (cents)	34.4	22.9	-33.4%	23.0
Final DPS (cents)	11.0	11.0	0.0%	11.0

Source: Eikon, Forsyth Barr analysis

Investment View

Investing in AIR is more about timing than taking a long term view. The airline industry generates volatile returns. While AIR is no exception it has a better recent track record than most of its international peers. Strong management and the structural advantage of being based in NZ with a dominant local business offers some earnings support through the cycle. However, AIR is not immune to cyclical swings as evidenced in recent months. NEUTRAL.

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Air New Zealand Ltd (AIR)

Priced as at 16 Aug 2019: NZ\$2.72

June year end

Forsyth Barr valuation					Valuation Ratios				
Valuation methodology					Average of DCF, PE relative and price to book				
12-month target price (NZ\$)*					2.50				
Expected share price return					-8.1%				
Net dividend yield					8.1%				
Estimated 12-month return					0.0%				
Key WACC assumptions					DCF valuation summary (NZ\$m)				
Risk free rate					2.75%				
Equity beta					1.40				
WACC					10.2%				
Terminal growth					1.5%				
Profit and Loss Account (NZ\$m)					2017A 2018A 2019E 2020E 2021E				
Sales revenue					5,109 5,485 5,790 6,033 6,250				
Normalised EBITDA					1,035 1,065 900 971 1,031				
Depreciation and amortisation					(493) (525) (550) (567) (579)				
Normalised EBIT					542 540 349 404 452				
Net interest					(44) (33) (37) (36) (29)				
Associate income					26 33 40 41 42				
Tax					(145) (150) (92) (109) (125)				
Minority interests					- - - - -				
Normalised NPAT					379 390 260 301 341				
Abnormals/other					(3) - - - -				
Reported NPAT					382 390 260 301 341				
Normalised EPS (cps)					33 34 23 27 30				
DPS (cps)					21 22 22 22 22				
Growth Rates					2017A 2018A 2019E 2020E 2021E				
Revenue (%)					-2.3 7.4 5.6 4.2 3.6				
EBITDA (%)					-20.3 2.9 -15.5 8.0 6.2				
EBIT (%)					-34.9 -0.4 -35.4 15.8 11.8				
Normalised NPAT (%)					-33.0 2.9 -33.4 15.7 13.3				
Normalised EPS (%)					-33.3 3.4 -33.4 15.7 13.3				
Ordinary DPS (%)					5.0 4.8 0.0 0.0 0.0				
Cash Flow (NZ\$m)					2017A 2018A 2019E 2020E 2021E				
EBITDA					1,035 1,065 900 971 1,031				
Working capital change					230 227 235 258 271				
Interest & tax paid					(189) (183) (129) (145) (154)				
Other					(172) (78) (205) (228) (241)				
Operating cash flow					904 1,031 800 857 908				
Capital expenditure					(853) (809) (800) (400) (400)				
(Acquisitions)/divestments					105 33 30 30 30				
Other					132 (2) 24 25 25				
Funding available/(required)					288 253 54 511 563				
Dividends paid					(530) (260) (247) (247) (247)				
Equity raised/(returned)					(19) - - - -				
Increase/(decrease) in net debt					261 7 193 (264) (316)				
Balance Sheet (NZ\$m)					2017A 2018A 2019E 2020E 2021E				
Working capital					10 89 (41) (46) (50)				
Fixed assets					4,745 5,035 5,255 5,057 4,848				
Intangibles					149 170 170 170 170				
Other assets					436 647 647 647 647				
Total funds employed					5,340 5,941 6,031 5,829 5,615				
Net debt/(cash)					1,145 1,391 1,584 1,319 1,003				
Other non current liabilities					2,209 2,374 2,458 2,525 2,584				
Shareholder's funds					1,986 2,176 1,989 1,985 2,027				
Minority interests					- - - - -				
Total funding sources					5,340 5,941 6,031 5,829 5,615				
Valuation Ratios					2017A 2018A 2019E 2020E 2021E				
EV/EBITDA (x)					4.0 4.1 5.0 4.8 4.5				
EV/EBIT (x)					7.6 8.0 13.0 11.5 10.3				
PE (x)					8.2 7.9 11.9 10.3 9.1				
Price/NTA (x)					1.7 1.5 1.7 1.7 1.6				
Free cash flow yield (%)					1.7 7.3 0.0 14.9 16.6				
Net dividend yield (%)					7.7 8.1 8.1 8.1 8.1				
Gross dividend yield (%)					10.7 11.2 11.2 11.2 11.2				
Imputation (%)					100 100 100 100 100				
Pay-out ratio (%)					63 64 96 83 73				
Capital Structure					2017A 2018A 2019E 2020E 2021E				
Interest cover EBIT (x)					12.3 16.4 9.4 11.1 15.6				
Interest cover EBITDA (x)					23.5 32.3 24.2 26.8 35.5				
Net debt/ND+E (%)					36.6 39.0 44.3 39.9 33.1				
Net debt/EBITDA (x)					1.1 1.3 1.8 1.4 1.0				
Key Ratios					2017A 2018A 2019E 2020E 2021E				
Return on assets (%)					7.6 6.9 4.5 5.4 6.2				
Return on equity (%)					19.1 17.9 13.1 15.1 16.8				
Return on funds employed (%)					n/a n/a n/a n/a n/a				
EBITDA margin (%)					20.3 19.4 15.5 16.1 16.5				
EBIT margin (%)					10.6 9.8 6.0 6.7 7.2				
Capex to sales (%)					16.7 14.7 13.8 6.6 6.4				
Capex to depreciation (%)					173 154 145 71 69				
Operating Performance					2017A 2018A 2019E 2020E 2021E				
Normalised NPAT					379 390 260 301 341				
Tax					145 150 92 109 125				
Other					- - - - -				
Underlying PBT					524 540 352 409 465				
Available Seat Km (ASK)					2017A 2018A 2019E 2020E 2021E				
Domestic					6,597 6,905 7,098 7,027 7,133				
Tasman and Pacific					12,039 12,964 13,716 14,127 14,551				
Long-haul					23,533 24,406 25,382 27,413 28,372				
Total					42,169 44,275 46,196 48,568 50,056				
Change (%)					n/a 5.0 4.3 5.1 3.1				
Revenue Passenger Km (RPK)					2017A 2018A 2019E 2020E 2021E				
Domestic					5,311 5,719 5,750 5,692 5,778				
Tasman and Pacific					9,784 10,584 11,247 11,584 11,932				
Long-haul					19,719 20,359 21,067 22,753 23,549				
Total					34,814 36,662 38,064 40,029 41,259				
Load factor (%)					2017A 2018A 2019E 2020E 2021E				
Domestic					80.5 81.0 81.0 81.0 81.0				
Tasman and Pacific					81.3 82.0 82.0 82.0 82.0				

FY19 preview

Figure 2. Earnings forecasts (NZ\$m)

	FY18	FY19E	Change
<u>Profit and loss account</u>			
Sales revenue	5,485	5,790	5.6%
EBITDRA	1,292	1,134	-12.2%
Rentals	(227)	(235)	3.5%
Depreciation and amortisation	(525)	(550)	4.9%
Interest expense	(33)	(37)	12.7%
Associates	33	40	21.2%
PBT	540	352	-34.8%
Taxation	(150)	(92)	-38.7%
Underlying NPAT	390	260	-33.4%
Abnormals (post tax)	0	0	n/a
Reported NPAT	390	260	-33.4%
EPS (cents)	34.4	22.9	-33.4%
Final DPS (cents)	11.0	11.0	0.0%
<u>Cashflow and net debt</u>			
Operating cashflow	1,031	800	-22.4%
Maintenance capex = depreciation	(525)	(550)	4.9%
Disposals	33	30	-9.1%
Free cash flow	539	280	-48.1%
(Acquisitions)/divestments	0	0	n/a
Net debt/(cash)	1,391	1,584	13.9%

Source: AIR, Forsyth Barr analysis

Investment summary

Air New Zealand (AIR) offers one of the most favourable structural positions for any airline globally. A dominant domestic business with ~80% market share and an international business that has mitigated competitive threats through JVs, lower cost capacity, and its brand positioning among higher yielding NZ travellers. Management is pursuing a rational value accretive strategy of optimising revenues through yield and capacity initiatives, and keeping a lid on costs. A softening demand backdrop and higher fuel costs means a step down in profitability in FY19, albeit a stable dividend offers share price support. **NEUTRAL**.

Business quality

- **Strong position in tough industry:** AIR operates in an intensely competitive industry. It benefits from a duopoly industry structure in NZ.
- **Fleet investment:** AIR continues to invest in new lower cost capacity, which provides scope for growth and a more competitive fleet.

Earnings and cash flow outlook

- **Fuel prices:** Jet fuel represents ~25% of the cost base at AIR and can have a significant impact on company profitability from period to period. AIR hedges forward most of its exposure, which offers near term certainty. Crack spread risks are apparent over the next 18 months given IMO2020.
- **Passenger demand:** Rising demand both domestically and from offshore markets is supportive to yields and load factors.
- **Cost control:** Management believes cost control measures can more than offset inflationary pressures to lower CASK (cost per available seat km).

Company description

AIR is the dominant airline in New Zealand, with a market share of around 80% in the domestic duopoly. In addition it operates and has the leading market shares on key international routes to Asia, Australia, Pacific Islands, North America and South America reflective of its Pacific Rim focussed strategy. Several of these routes including Singapore (Singapore Airlines), trans-Tasman (Virgin Australia until 27 Octo 2018), Hong Kong (Cathay Pacific), China (Air China), and the US (United) are operated on a full revenue sharing JV basis.

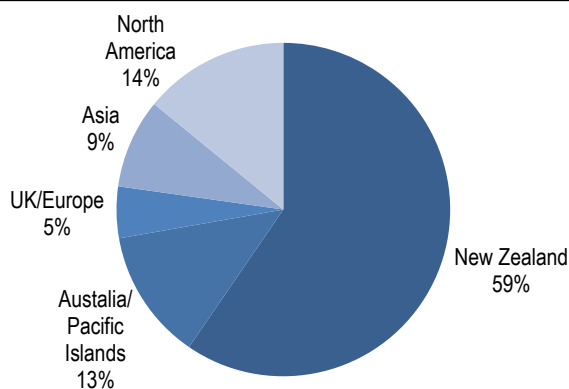
Financial structure

- **Balance sheet:** Gearing is at the top end of management's 45%–55% target band but is likely to fall ahead of the wide-body capex from FY23.
- **Special dividend opportunity:** A relative capex holiday in FY21 and FY22 provides scope for special dividends.

Risks factors

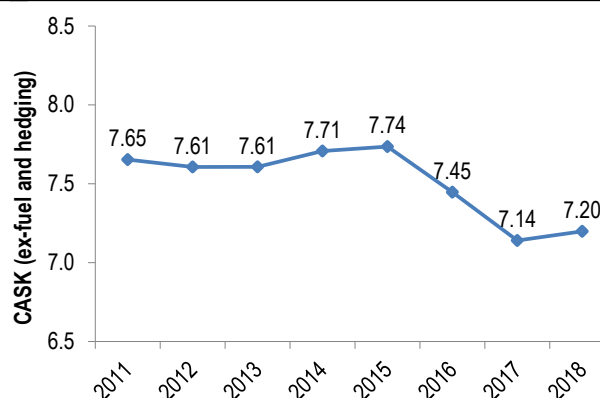
- **Left field events:** Disease outbreak, volcanic ash clouds, terrorism events.
- **Macro:** Volatility in exchange rates and global oil prices can have a dramatic impact on profitability.
- **Safety:** Any blip on AIR's good safety record could impact passenger confidence in the airline.

Figure 3. Geographic revenue mix in FY18



Source: Company reports, Forsyth Barr analysis

Figure 4. Cost per ASK under control (cents per ASK)



Source: Forsyth Barr analysis

Figure 5. Substantial Shareholders

Shareholder	Latest Holding
NZ Govt	52.5%

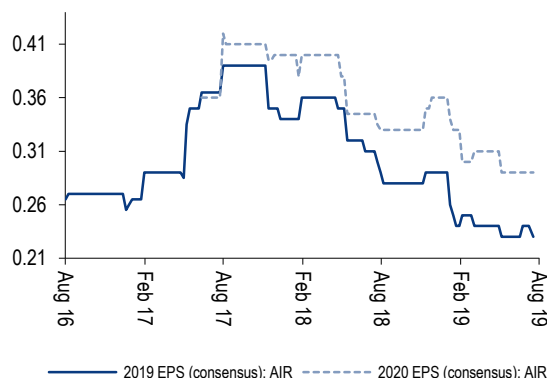
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 6. International Compcos

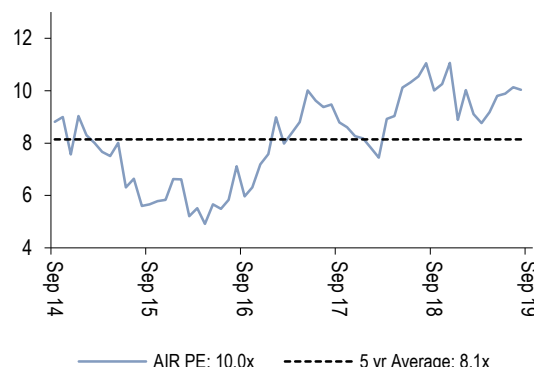
Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld	
(metrics re-weighted to reflect AIR's balance date - June)											
			(m)	2019E	2020E	2019E	2020E	2019E	2020E	2020E	
Air New Zealand	AIR NZ	NZ\$2.72	NZ\$3,055	11.9x	10.3x	4.9x	4.6x	12.7x	11.0x	8.1%	
Deutsche Lufthansa AG	LHA GY	€12.85	€6,104	3.7x	4.1x	2.6x	2.5x	5.3x	5.7x	6.0%	
Air France-KLM	AF FP	€9.92	€4,253	8.9x	6.6x	2.6x	2.5x	8.4x	8.2x	0.2%	
Singapore Airlines	SIA SP	S\$8.97	S\$10,629	15.0x	13.4x	6.6x	5.7x	15.0x	14.4x	3.9%	
Cathay Pacific Airways	293 HK	HK\$10.38	HK\$40,833	14.0x	9.9x	7.6x	6.3x	27.6x	23.6x	4.0%	
Qantas Airways	QAN AT	A\$5.57	A\$8,748	9.5x	8.5x	3.8x	3.7x	7.9x	7.8x	4.7%	
Virgin Australia Holdings	VAH AT	A\$0.16	A\$1,351	<0x	<0x	5.7x	5.3x	22.1x	13.1x	0.0%	
American Airlines Group Inc	AAL US	US\$25.28	US\$11,274	6.7x	4.8x	6.5x	6.7x	13.1x	10.3x	1.7%	
United Airlines Holdings Inc	UAL US	US\$81.55	US\$20,957	8.8x	6.7x	5.5x	5.4x	9.9x	8.3x	n/a	
Compcos Average:				9.5x	7.7x	5.1x	4.8x	13.6x	11.4x	2.9%	
EV = Current Market Cap + Actual Net Debt				AIR Relative:	+25%	+33%	-3%	-4%	-7%	-4%	+175%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (AIR) companies fiscal year end

Figure 7. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 8. 12 Month Forward PE


Source: Forsyth Barr analysis

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