

Air New Zealand

NEUTRAL

Propstar Exits Regional Charts

Jetstar's decision to withdraw from the New Zealand regional market ends a four year incursion into Air New Zealand's (AIR) heartland. AIR will benefit from enhanced market structure albeit the likely earnings uplift will be limited by (1) the affected routes represent a small proportion of its total domestic business; (2) it will retain existing lead-in fares for the affected routes until the end of 2020; and (3) it will be very conscious of the political interest in its regional pricing tactics beyond the lead-in fares. We make no changes to our earnings forecasts or target price at this stage. Valuation is undemanding at a one year forward PE of ~10x and a cash dividend yield of ~8%. However, beyond the potential small regional yield uplift, we believe earnings risk is weighted to the downside from weakening demand and higher fuel costs.

Key points

- Jetstar will end its regional services on 1 December 2019; four years after entering the market
- Jetstar has an ~8% share of regional capacity vs. AIR at ~89%
- Affected routes only account for ~9% of AIR's domestic operations

Jetstar's strategic need for regional diluted

Jetstar entered the regional New Zealand market in December 2015 with five Q300 turbo-prop aircraft. We understand it has been loss-making since inception and one of its key strategic needs, connectivity into the Qantas (QAN)/American Airlines services was diluted when AIR and QAN began a code-share arrangement on either side of the Tasman in mid-2018.

Boost to regional profit pool; immaterial at a group level

We estimate Jetstar's regional business is generating annualised revenue of ~NZ\$50m but has incurred persistent losses since services commenced. AIR should benefit from an immediate yield uplift despite its commitment to hold lead-in fares on affected routes until at least the end of CY20. However, the impact at a group level will be largely immaterial, in our opinion. The five regional routes that it competed on against Jetstar account for just ~9% of its domestic capacity.

AIR was already winning the regional capacity game

Jetstar's entry in 2015 helped grow the regional market significantly, yet since then AIR has grown its regional operations by ~+18% and Jetstar has cut by ~10%. AIR's capacity increases have been gradual but slowed this year as a result of reduced domestic leisure demand. Jetstar currently represents ~8% of regional industry capacity compared to its ~25% capacity share of trunk routes.

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**.

| NZX Code | AIR |
|------------------------|---------------------|
| Share price | NZ\$2.68 |
| Target price | NZ\$2.60 |
| Risk rating | High |
| Issued shares | 1123.0m |
| Market cap | NZ\$3,010m |
| Average daily turnover | 864.6k (NZ\$2,386k) |

Share Price Performance



| Financials: June | 19A | 20E | 21E | 22E |
|--------------------------|-------|-------|-------|-------|
| NPAT* (NZ\$m) | 270.1 | 294.4 | 335.7 | 345.4 |
| EPS* (NZc) | 23.9 | 26.1 | 29.7 | 30.6 |
| EPS growth* (%) | -30.4 | 9.0 | 14.0 | 2.9 |
| DPS (NZc) | 22.0 | 22.0 | 22.0 | 22.0 |
| Imputation (%) | 100 | 100 | 100 | 100 |
| Valuation (x) | 19A | 20E | 21E | 22E |
| EV/EBITDA | 4.8 | 4.4 | 4.0 | 4.0 |
| EV/EBIT | 12.2 | 11.3 | 9.9 | 9.8 |
| PE | 11.2 | 10.3 | 9.0 | 8.8 |
| Price / NTA | 1.6 | 1.5 | 1.4 | n/a |
| Cash dividend yield (%) | 8.2 | 8.2 | 8.2 | 8.2 |
| Gross dividend yield (%) | 11.4 | 11.4 | 11.4 | 11.4 |

*Historic and forecast numbers based on underlying profits

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Air New Zealand Ltd (AIR)

Priced as at 23 Sep 2019: NZ\$2.68

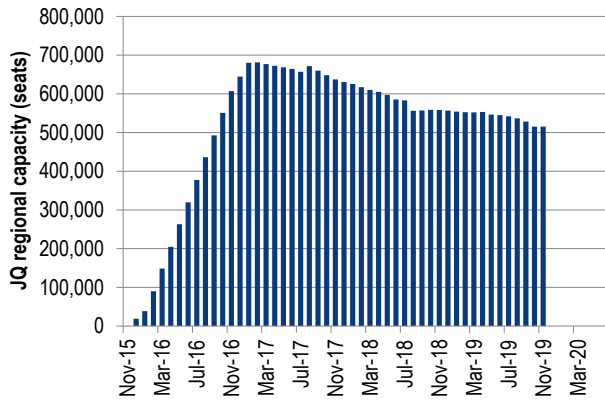
June year end

| Forsyth Barr valuation | | | | | | Valuation Ratios | | 2018A | 2019A | 2020E | 2021E | 2022E | |
|---------------------------------|--|---|-------------------------------|-------|---------|---------------------------|------------------------------------|-------|--------|--------|--------|--------|--------|
| Valuation methodology | | Average of DCF, PE relative and price to book | | | | EV/EBITDA (x) | | 4.0 | 4.8 | 4.4 | 4.0 | 4.0 | |
| | | | | | | EV/EBIT (x) | | 7.9 | 12.2 | 11.3 | 9.9 | 9.8 | |
| 12-month target price (NZ\$)* | | 2.60 | Spot valuations (NZ\$) | | | PE (x) | | 7.8 | 11.2 | 10.3 | 9.0 | 8.8 | |
| Expected share price return | | -3.0% | 1. DCF | | 2.68 | Price/NTA (x) | | 1.5 | 1.6 | 1.5 | 1.4 | 1.3 | |
| Net dividend yield | | 8.2% | 2. Price to book | | 2.51 | Free cash flow yield (%) | | 7.4 | 5.5 | 7.4 | 13.9 | 14.7 | |
| Estimated 12-month return | | 5.2% | 3. PE relative | | 2.38 | Net dividend yield (%) | | 8.2 | 8.2 | 8.2 | 8.2 | 8.2 | |
| | | | | | | Gross dividend yield (%) | | 11.4 | 11.4 | 11.4 | 11.4 | 11.4 | |
| Key WACC assumptions | | | DCF valuation summary (NZ\$m) | | | Imputation (%) | | 100 | 100 | 100 | 100 | 100 | |
| Risk free rate | | 2.00% | Total firm value | | 4,568 | Pay-out ratio (%) | | 64 | 92 | 84 | 74 | 72 | |
| Equity beta | | 1.40 | (Net debt)/cash | | (1,559) | | | | | | | | |
| WACC | | 9.7% | Value of equity | | 3,009 | Capital Structure | | 2018A | 2019A | 2020E | 2021E | 2022E | |
| Terminal growth | | 1.5% | Shares (m) | | 1,123 | Interest cover EBIT (x) | | 16.4 | 11.9 | 13.2 | 16.4 | 20.3 | |
| | | | | | | Interest cover EBITDA (x) | | 32.3 | 30.2 | 34.1 | 40.3 | 49.5 | |
| Profit and Loss Account (NZ\$m) | | 2018A | 2019A | 2020E | 2021E | 2022E | Net debt/ND+E (%) | | 39.0 | 42.5 | 40.9 | 35.7 | 29.4 |
| Sales revenue | | 5,485 | 5,785 | 6,006 | 6,237 | 6,492 | Net debt/EBITDA (x) | | 1.3 | 1.6 | 1.4 | 1.1 | 0.9 |
| Normalised EBITDA | | 1,065 | 935 | 1,039 | 1,117 | 1,128 | | | | | | | |
| Depreciation and amortisation | | (525) | (567) | (638) | (662) | (666) | Key Ratios | | 2018A | 2019A | 2020E | 2021E | 2022E |
| Normalised EBIT | | 540 | 368 | 401 | 455 | 462 | Return on assets (%) | | 6.9 | 4.7 | 5.1 | 5.8 | 5.9 |
| Net interest | | (33) | (31) | (30) | (28) | (23) | Return on equity (%) | | 17.9 | 12.9 | 13.6 | 14.7 | 14.3 |
| Associate income | | 33 | 37 | 38 | 39 | 40 | Return on funds employed (%) | | n/a | n/a | n/a | n/a | n/a |
| Tax | | (150) | (104) | (114) | (131) | (134) | EBITDA margin (%) | | 19.4 | 16.2 | 17.3 | 17.9 | 17.4 |
| Minority interests | | - | - | - | - | - | EBIT margin (%) | | 9.8 | 6.4 | 6.7 | 7.3 | 7.1 |
| Normalised NPAT | | 390 | 270 | 294 | 336 | 345 | Capex to sales (%) | | 14.7 | 14.2 | 12.9 | 10.4 | 10.0 |
| Abnormals/other | | - | - | - | - | - | Capex to depreciation (%) | | 154 | 145 | 121 | 98 | 98 |
| Reported NPAT | | 390 | 270 | 294 | 336 | 345 | | | | | | | |
| Normalised EPS (cps) | | 34 | 24 | 26 | 30 | 31 | Operating Performance | | 2018A | 2019A | 2020E | 2021E | 2022E |
| DPS (cps) | | 22 | 22 | 22 | 22 | 22 | Normalised NPAT | | 390 | 270 | 294 | 336 | 345 |
| | | | | | | | Tax | | 150 | 104 | 114 | 131 | 134 |
| Growth Rates | | 2018A | 2019A | 2020E | 2021E | 2022E | Other | | - | - | - | - | - |
| Revenue (%) | | 7.4 | 5.5 | 3.8 | 3.8 | 4.1 | Underlying PBT | | 540 | 374 | 409 | 466 | 480 |
| EBITDA (%) | | 2.9 | -12.2 | 11.1 | 7.5 | 1.0 | Available Seat Km (ASK) | | | | | | |
| EBIT (%) | | -0.4 | -31.8 | 9.0 | 13.3 | 1.6 | Domestic | | 6,905 | 7,104 | 6,926 | 7,030 | 7,136 |
| Normalised NPAT (%) | | 2.9 | -30.8 | 9.0 | 14.0 | 2.9 | Tasman and Pacific | | 12,964 | 13,640 | 13,981 | 14,400 | 14,832 |
| Normalised EPS (%) | | 3.4 | -30.4 | 9.0 | 14.0 | 2.9 | Long-haul | | 24,406 | 25,285 | 27,181 | 27,997 | 28,837 |
| Ordinary DPS (%) | | 4.8 | 0.0 | 0.0 | 0.0 | 0.0 | Total | | 44,275 | 46,029 | 48,089 | 49,428 | 50,805 |
| | | | | | | | Change (%) | | n/a | 4.0 | 4.5 | 2.8 | 2.8 |
| Cash Flow (NZ\$m) | | 2018A | 2019A | 2020E | 2021E | 2022E | Revenue Passenger Km (RPK) | | | | | | |
| EBITDA | | 1,065 | 935 | 1,039 | 1,117 | 1,128 | Domestic | | 5,719 | 5,957 | 5,784 | 5,870 | 5,958 |
| Working capital change | | 227 | 245 | 242 | 242 | 264 | Tasman and Pacific | | 10,584 | 11,195 | 11,464 | 11,808 | 12,163 |
| Interest & tax paid | | (183) | (135) | (145) | (158) | (157) | Long-haul | | 20,359 | 21,421 | 22,832 | 23,517 | 24,223 |
| Other | | (78) | (59) | (137) | (133) | (144) | Total | | 36,662 | 38,573 | 40,080 | 41,196 | 42,344 |
| Operating cash flow | | 1,031 | 986 | 999 | 1,068 | 1,091 | Load factor (%) | | | | | | |
| Capital expenditure | | (809) | (821) | (775) | (650) | (650) | Domestic | | 82.8 | 83.9 | 83.5 | 83.5 | 83.5 |
| (Acquisitions)/divestments | | 33 | 13 | 40 | 40 | 40 | Tasman and Pacific | | 81.6 | 82.1 | 82.0 | 82.0 | 82.0 |
| Other | | (2) | (75) | 23 | 24 | 24 | Long-haul | | 83.4 | 84.7 | 84.0 | 84.0 | 84.0 |
| Funding available/(required) | | 253 | 103 | 287 | 481 | 505 | Total | | 82.8 | 83.8 | 83.3 | 83.3 | 83.3 |
| Dividends paid | | (260) | (260) | (247) | (247) | (247) | | | | | | | |
| Equity raised/(returned) | | (17) | (14) | - | - | - | | | | | | | |
| Increase/(decrease) in net debt | | 24 | 171 | (40) | (234) | (258) | | | | | | | |
| Balance Sheet (NZ\$m) | | 2018A | 2019A | 2020E | 2021E | 2022E | RASK (cents per ASK) | | | | | | |
| Working capital | | 89 | 60 | 63 | 62 | 62 | Domestic | | 22.0 | 22.5 | 23.6 | 24.1 | 24.6 |
| Fixed assets | | 5,035 | 5,268 | 5,365 | 5,313 | 5,257 | Tasman and Pacific | | 9.6 | 9.6 | 9.8 | 9.9 | 10.0 |
| Intangibles | | 170 | 186 | 186 | 186 | 186 | Long-haul | | 7.9 | 8.1 | 8.0 | 8.2 | 8.3 |
| Other assets | | 647 | 602 | 602 | 602 | 602 | Total | | 10.6 | 10.8 | 10.8 | 11.0 | 11.1 |
| Total funds employed | | 5,941 | 6,116 | 6,216 | 6,163 | 6,107 | | | | | | | |
| Net debt/(cash) | | 1,391 | 1,542 | 1,502 | 1,268 | 1,010 | | | | | | | |
| Other non current liabilities | | 2,374 | 2,485 | 2,545 | 2,608 | 2,677 | Costs | | | | | | |
| Shareholder's funds | | 2,176 | 2,089 | 2,169 | 2,287 | 2,420 | CASK ex-fuel/forex (cents per ASK) | | 7.22 | 7.36 | 7.21 | 7.25 | 7.35 |
| Minority interests | | - | - | - | - | - | Fuel (NZ\$m) | | 987 | 1,271 | 1,274 | 1,290 | 1,359 |
| Total funding sources | | 5,941 | 6,116 | 6,216 | 6,163 | 6,107 | Fuel per ASK | | 2.2 | 2.8 | 2.6 | 2.6 | 2.7 |

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

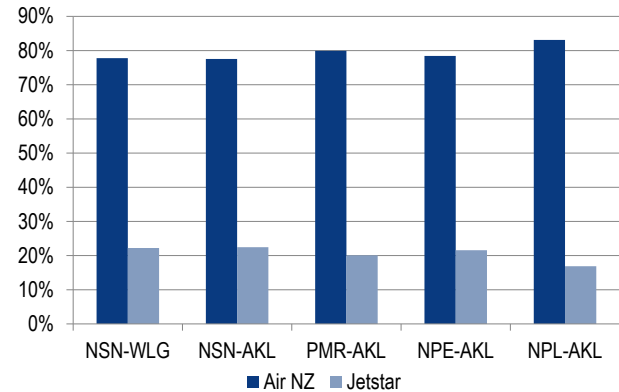
Jetstar regional exit in pictures

Figure 1. Jetstar's regional capacity on 12m rolling basis



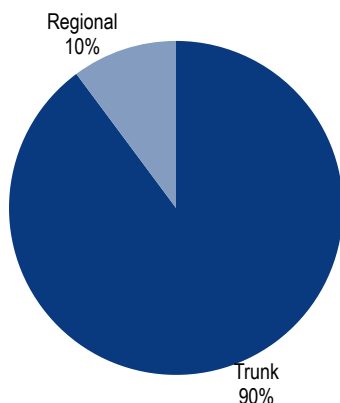
Source: OAG, Forsyth Barr analysis

Figure 2. Jetstar's current share of serviced regional routes



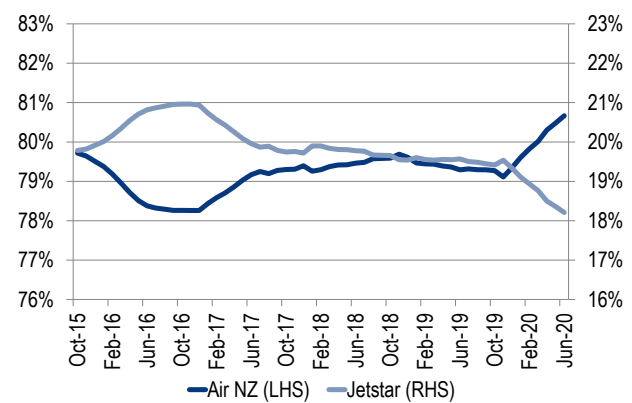
Source: OAG, Forsyth Barr analysis

Figure 3. Jetstar in New Zealand (current ASK split)



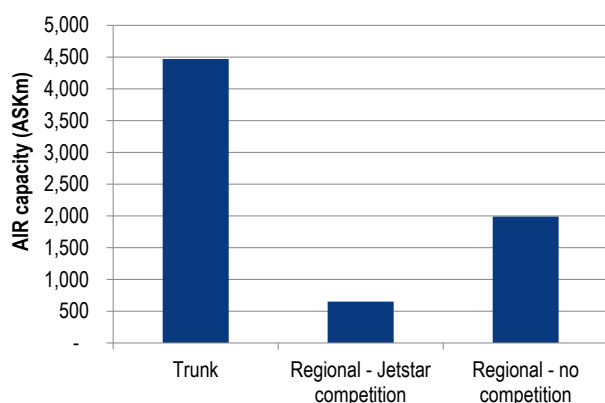
Source: OAG, Forsyth Barr analysis

Figure 4. Domestic capacity share timeseries (rolling 12m)



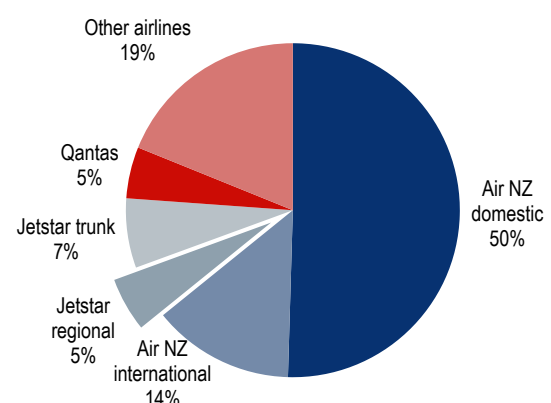
Source: OAG, Forsyth Barr analysis

Figure 5. AIR's domestic capacity split for CY19



Source: OAG, Forsyth Barr analysis

Figure 6. Current runway movements split at AIA



Source: OAG, Forsyth Barr analysis NOTE: this excludes non-scheduled passenger aircraft

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.

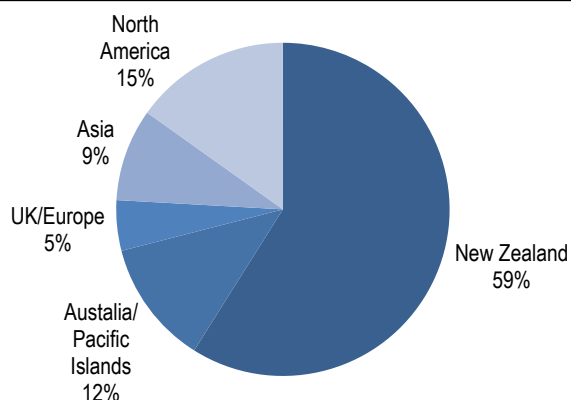
Financial structure

- **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

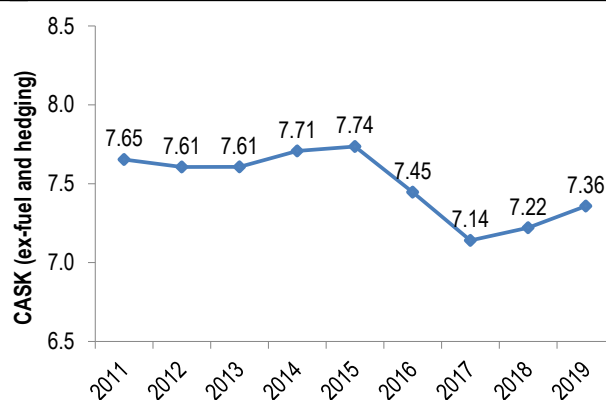
- **Left field events:** Disease outbreak, volcanic ash clouds, terrorism events.
- **Macro:** Volatility in exchange rates and global oil prices can have a dramatic impact on profitability.
- **Safety:** Any blip on AIR's good safety record could impact passenger confidence in the airline.

Figure 7. Geographic revenue mix in FY19



Source: Company reports, Forsyth Barr analysis

Figure 8. Cost per ASK under control (cents per ASK)



Source: Forsyth Barr analysis

Figure 9. Substantial Shareholders

| Shareholder | Latest Holding |
|-------------|----------------|
| NZ Govt | 52.5% |

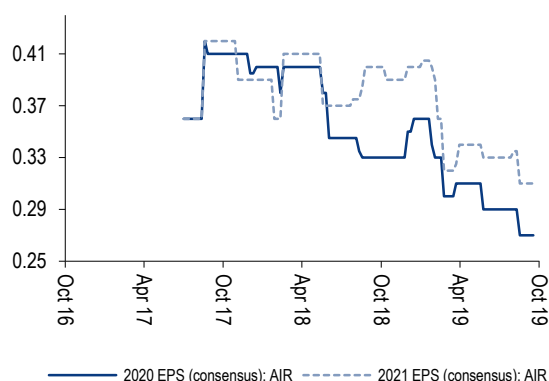
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 10. International Compcos

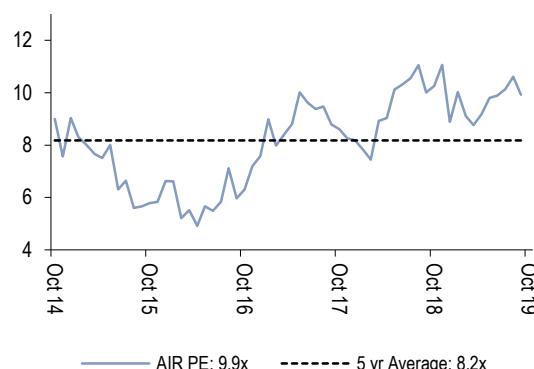
| Company | Code | Price | Mkt Cap | PE | | EV/EBITDA | | EV/EBIT | | Cash D/Yld | |
|--|--------|-----------|------------|---------------|-------|-----------|-------|---------|-------|------------|-------|
| (metrics re-weighted to reflect AIR's balance date - June) | | | | | | | | | | | |
| | | | (m) | 2020E | 2021E | 2020E | 2021E | 2020E | 2021E | 2021E | |
| Air New Zealand | AIR NZ | NZ\$2.68 | NZ\$3,010 | 10.3x | 9.0x | 4.4x | 4.1x | 11.3x | 10.0x | 8.2% | |
| Deutsche Lufthansa AG | LHA GY | €14.08 | €6,689 | 4.8x | 3.9x | 2.7x | 2.5x | 5.9x | 5.2x | 6.0% | |
| Air France-KLM | AF FP | €9.07 | €3,887 | 6.1x | 4.8x | 2.5x | 2.3x | 8.0x | 7.1x | 0.5% | |
| Singapore Airlines | SIA SP | S\$9.24 | S\$10,951 | 14.1x | 13.8x | 5.7x | 5.2x | 14.8x | 13.2x | 3.6% | |
| Cathay Pacific Airways | 293 HK | HK\$10.12 | HK\$39,811 | 10.3x | 9.0x | 6.8x | 6.3x | 38.7x | 26.0x | 3.9% | |
| Qantas Airways | QAN AT | A\$6.21 | A\$9,753 | 9.5x | 8.7x | 3.9x | 3.7x | 8.2x | 7.8x | 4.6% | |
| Virgin Australia Holdings | VAH AT | A\$0.16 | A\$1,351 | <0x | n/a | 5.1x | 4.4x | 20.6x | 12.8x | n/a | |
| American Airlines Group Inc | AAL US | US\$27.99 | US\$12,463 | 5.4x | 4.8x | 7.0x | 6.7x | 10.6x | 10.2x | 1.4% | |
| United Airlines Holdings Inc | UAL US | US\$89.09 | US\$22,889 | 7.3x | 6.7x | 5.7x | 5.5x | 8.7x | 8.4x | n/a | |
| Compcos Average: | | | | 8.2x | 7.4x | 4.9x | 4.6x | 14.4x | 11.3x | 3.4% | |
| EV = Current Market Cap + Actual Net Debt | | | | AIR Relative: | +25% | +22% | -11% | -11% | -21% | -12% | +144% |

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 11. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 12. 12 Month Forward PE


Source: Forsyth Barr analysis

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