

Air New Zealand

1H20 Preview – Maiden Flight in Poor Visibility

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NEUTRAL 

We expect Air New Zealand (AIR) to report a subdued 1H20 result on 27 February 2020, impacted by softer revenue growth – a function of weaker demand and consequent reductions in capacity. We forecast underlying profit before tax (PBT) of NZ\$202m, down -4% against the prior year. The potential for demand weakness from the coronavirus outbreak beyond China poses a key near term revenue risk. However, this will at least be partly mitigated by lower oil prices for its unhedged fuel exposure. The balance between these two key drivers (demand and fuel) should be weighted to the former through 2H20 (downgrade risk) given fuel price hedging in place but the latter through FY21 (upgrade risk).

| NZX Code | AIR | Financials: Jun/ | 19A | 20E | 21E | 22E | Valuation (x) | 19A | 20E | 21E | 22E |
|--------------------|---------------------|------------------------------|-------|-------|-------|-------|-------------------|------|------|------|------|
| Share price | NZ\$2.71 | NPAT* (NZ\$m) | 270.1 | 285.0 | 326.0 | 335.0 | EV/EBITDA | 4.8 | 4.5 | 4.1 | 4.1 |
| Target price | NZ\$2.60 | EPS* (NZc) | 23.9 | 25.2 | 28.9 | 29.7 | EV/EBIT | 12.3 | 11.8 | 10.3 | 10.2 |
| Risk rating | High | EPS growth* (%) | -30.4 | 5.5 | 14.4 | 2.8 | PE | 11.3 | 10.7 | 9.4 | 9.1 |
| Issued shares | 1123.0m | DPS (NZc) | 22.0 | 22.0 | 22.0 | 22.0 | Price / NTA | 1.6 | 1.5 | 1.5 | 1.4 |
| Market cap | NZ\$3,043m | Imputation (%) | 100 | 100 | 100 | 100 | Cash div yld (%) | 8.1 | 8.1 | 8.1 | 8.1 |
| Avg daily turnover | 844.5k (NZ\$2,296k) | *Based on normalised profits | | | | | Gross div yld (%) | 11.3 | 11.3 | 11.3 | 11.3 |

Key issues to consider at AIR's 1H20 result

- **Passenger demand outlook:** The demand backdrop finished the period better than it started, particularly in the domestic business in light of capacity reductions and the Jetstar regional withdrawal. However, the outlook is uncertain in AIR's international business given the coronavirus outbreak and risk of contagion beyond China.
- **Capacity growth:** Recent schedule changes for Shanghai and Hong Kong services, the uncertainty created by coronavirus, and the ongoing Rolls Royce engine issues, mean the company's +4% to +5% capacity growth guidance for FY20 is likely to be missed.
- **Cargo:** IATA international air freight statistics and Auckland Airport cargo data suggest AIR endured a challenging six months. We expect a modest volume decline with some pressure on yields.
- **Significant items:** AIR recently flagged significant items that would adversely impact the 1H20 reported result: (1) reorganisation costs of NZ\$13m and an NZ\$46m non-cash charge relating to disestablishment of fair value hedges.
- **IFRS 16:** This will be the first period that AIR reports under the new accounting for leases accounting standards. We expect the company to provide both pre and post-IFRS 16 results to aid investors in interpreting like-for-like performance.
- **New CEO:** Greg Foran will host the 1H20 result. While he's only just commenced his tenure we expect him to outline initial observations on his feedback from staff and customers.

Figure 1. Summary of 1H20 forecasts (NZ\$m)

| | 1H19 | 1H20E | Change |
|--------------------------------|------------|------------|--------------|
| Sales revenue | 2,927 | 2,963 | 1.2% |
| EBITDRA | 609 | 622 | 2.2% |
| Underlying PBT | 211 | 202 | -4.4% |
| Reported NPAT | 152 | 145 | -4.4% |
| Underlying NPAT | 152 | 145 | -4.4% |
| Underlying diluted EPS (cents) | 13.4 | 12.8 | -4.4% |
| Interim DPS (cents) | 11.0 | 11.0 | 0.0% |

Source: Forsyth Barr analysis

Figure 2. Revenue growth estimates (NZ\$m)

| | 1H19 | 1H20E | Change |
|--------------------------|--------------|--------------|-------------|
| Domestic | 807 | 822 | 1.9% |
| Tasman & Pacific Islands | 697 | 718 | 3.0% |
| International | 994 | 1,027 | 3.4% |
| Passenger revenue | 2,497 | 2,567 | 2.8% |
| Cargo | 213 | 181 | -15.0% |
| Contract and other | 217 | 215 | -0.9% |
| Total revenue | 2,927 | 2,963 | 1.2% |

Source: Forsyth Barr analysis

Air New Zealand Ltd (AIR)

| | | | | | | | | | | | | |
|--|---------|---------|---------|---------|---------|--------------------------------------|------------------------------------|--------|--------|--------|--------|---------|
| Priced as at 19 Feb 2020 (NZ\$) | | | | | | 2.71 | | | | | | |
| 12-month target price (NZ\$)* | | | | | | 2.60 | Spot valuations (NZ\$) | | | | | |
| Expected share price return | | | | | | -4.1% | 1. DCF | | | | | 2.79 |
| Net dividend yield | | | | | | 8.1% | 2. Price to book | | | | | 2.51 |
| Estimated 12-month return | | | | | | 4.1% | 3. PE relative | | | | | 2.95 |
| Key WACC assumptions | | | | | | DCF valuation summary (NZ\$m) | | | | | | |
| Risk free rate | | | | | | 2.00% | Total firm value | | | | | 4,619 |
| Equity beta | | | | | | 1.40 | (Net debt)/cash | | | | | (1,491) |
| WACC | | | | | | 9.7% | Less: Capitalised operating leases | | | | | |
| Terminal growth | | | | | | 1.5% | Value of equity | | | | | 3,128 |
| Profit and Loss Account (NZ\$m) | | | | | | Valuation Ratios | | | | | | |
| Sales revenue | 2018A | 2019A | 2020E | 2021E | 2022E | 2018A | 2019A | 2020E | 2021E | 2022E | | |
| Normalised EBITDA | 5,485.0 | 5,785.1 | 6,006.4 | 6,237.3 | 6,491.6 | EV/EBITDA (x) | 4.0 | 4.8 | 4.5 | 4.1 | 4.1 | |
| Depreciation and amortisation | 1,065.0 | 935.1 | 1,026.2 | 1,103.6 | 1,114.1 | EV/EBIT (x) | 8.0 | 12.3 | 11.8 | 10.3 | 10.2 | |
| Normalised EBIT | (525.0) | (567.0) | (638.0) | (662.0) | (665.9) | PE (x) | 7.9 | 11.3 | 10.7 | 9.4 | 9.1 | |
| Net interest | 540.0 | 368.1 | 388.3 | 441.5 | 448.1 | Price/NTA (x) | 1.5 | 1.6 | 1.5 | 1.5 | 1.4 | |
| Associate income | (33.0) | (31.0) | (30.5) | (28.0) | (23.3) | Free cash flow yield (%) | 7.3 | 5.4 | 7.0 | 13.4 | 14.2 | |
| Tax | 33.0 | 37.0 | 38.1 | 39.3 | 40.4 | Net dividend yield (%) | 8.1 | 8.1 | 8.1 | 8.1 | 8.1 | |
| Minority interests | (150.0) | (104.0) | (110.8) | (126.8) | (130.3) | Gross dividend yield (%) | 11.3 | 11.3 | 11.3 | 11.3 | 11.3 | |
| Normalised NPAT | 0 | 0 | 0 | 0 | 0 | Capital Structure | | | | | | |
| Abnormals/other | 390.0 | 270.1 | 285.0 | 326.0 | 335.0 | Interest cover EBIT (x) | 16.4 | 11.9 | 12.7 | 15.8 | 19.3 | |
| Reported NPAT | 0 | 0 | 0 | 0 | 0 | Interest cover EBITDA (x) | 32.3 | 30.2 | 33.6 | 39.4 | 47.9 | |
| Normalised EPS (cps) | 390.0 | 270.1 | 285.0 | 326.0 | 335.0 | Net debt/ND+E (%) | 39.0 | 42.5 | 41.2 | 36.2 | 30.3 | |
| DPS (cps) | 34.4 | 23.9 | 25.2 | 28.9 | 29.7 | Net debt/EBITDA (x) | 1.3 | 1.6 | 1.5 | 1.2 | 0.9 | |
| | 22.0 | 22.0 | 22.0 | 22.0 | 22.0 | Key Ratios | | | | | | |
| Growth Rates | | | | | | 2018A | 2019A | 2020E | 2021E | 2022E | | |
| Revenue (%) | 7.4 | 5.5 | 3.8 | 3.8 | 4.1 | Return on assets (%) | 6.9 | 4.7 | 4.9 | 5.6 | 5.7 | |
| EBITDA (%) | 2.9 | -12.2 | 9.7 | 7.5 | 1.0 | Return on equity (%) | 17.9 | 12.9 | 13.2 | 14.4 | 14.0 | |
| EBIT (%) | -0.4 | -31.8 | 5.5 | 13.7 | 1.5 | Return on funds employed (%) | n/a | n/a | n/a | n/a | n/a | |
| Normalised NPAT (%) | 2.9 | -30.8 | 5.5 | 14.4 | 2.8 | EBITDA margin (%) | 19.4 | 16.2 | 17.1 | 17.7 | 17.2 | |
| Normalised EPS (%) | 3.4 | -30.4 | 5.5 | 14.4 | 2.8 | EBIT margin (%) | 9.8 | 6.4 | 6.5 | 7.1 | 6.9 | |
| Ordinary DPS (%) | 4.8 | 0.0 | 0.0 | 0.0 | 0.0 | Capex to sales (%) | 14.7 | 14.2 | 12.9 | 10.4 | 10.0 | |
| Cash Flow (NZ\$m) | | | | | | 154 | 145 | 121 | 98 | 98 | | |
| EBITDA | 1,065.0 | 935.1 | 1,026.2 | 1,103.6 | 1,114.1 | Capex to depreciation (%) | 100 | 100 | 100 | 100 | 100 | |
| Working capital change | 227.0 | 245.0 | 242.0 | 242.5 | 263.8 | Imputation (%) | 100 | 100 | 100 | 100 | 100 | |
| Interest & tax paid | (183.0) | (135.0) | (141.4) | (154.8) | (153.6) | Pay-out ratio (%) | 64 | 92 | 87 | 76 | 74 | |
| Other | (78.0) | (59.1) | (137.5) | (133.4) | (143.6) | Operating Performance | | | | | | |
| Operating cash flow | 1,031.0 | 986.0 | 989.4 | 1,057.9 | 1,080.7 | 2018A | 2019A | 2020E | 2021E | 2022E | | |
| Capital expenditure | (809.0) | (821.0) | (775.0) | (650.0) | (650.0) | Available Seat Km (ASK) | | | | | | |
| (Acquisitions)/divestments | 33.0 | 13.0 | 40.0 | 40.0 | 40.0 | Domestic | 6,905 | 7,104 | 6,926 | 7,030 | 7,136 | |
| Other | (2.0) | (75.0) | 22.9 | 23.6 | 24.3 | Tasman and Pacific | 12,964 | 13,640 | 13,981 | 14,400 | 14,832 | |
| Funding available/(required) | 253.0 | 103.0 | 277.3 | 471.5 | 495.0 | Long-haul | 24,406 | 25,285 | 27,181 | 27,997 | 28,837 | |
| Dividends paid | (260.0) | (260.0) | (247.1) | (247.1) | (247.1) | Total | 44,275 | 46,029 | 48,089 | 49,428 | 50,805 | |
| Equity raised/(returned) | (17.0) | (14.0) | 0 | 0 | 0 | Change (%) | 5.0 | 4.0 | 4.5 | 2.8 | 2.8 | |
| (Increase)/decrease in net debt | (24.0) | (171.0) | 30.3 | 224.4 | 247.9 | RASK (cents per ASK) | | | | | | |
| Balance Sheet (NZ\$m) | | | | | | 2018A | 2019A | 2020E | 2021E | 2022E | | |
| Working capital | 89.0 | 60.0 | 63.0 | 62.3 | 61.5 | Domestic | 22.0 | 22.5 | 23.6 | 24.1 | 24.6 | |
| Fixed assets | 5,035.0 | 5,268.0 | 5,365.0 | 5,313.0 | 5,257.1 | Tasman and Pacific | 9.6 | 9.6 | 9.8 | 9.9 | 10.0 | |
| Intangibles | 170.0 | 186.0 | 186.0 | 186.0 | 186.0 | Long-haul | 7.9 | 8.1 | 8.0 | 8.2 | 8.3 | |
| Right of use asset | 0 | 0 | 0 | 0 | 0 | Total | 10.6 | 10.8 | 10.8 | 11.0 | 11.1 | |
| Other assets | 647.0 | 602.0 | 602.0 | 602.0 | 602.0 | Costs | | | | | | |
| Total funds employed | 5,941.0 | 6,116.0 | 6,216.0 | 6,163.3 | 6,106.6 | Ave. jet fuel price (US\$/bbl) | 68.6 | 82.0 | 77.5 | 78.0 | 83.0 | |
| Net debt/(cash) | 1,391.0 | 1,542.0 | 1,511.7 | 1,287.4 | 1,039.5 | Fuel supply chain (US\$/bbl) | 10.0 | 11.4 | 11.0 | 11.0 | 11.0 | |
| Lease liability | 0 | 0 | 0 | 0 | 0 | Jet fuel cost (US\$/bbl) | 78.6 | 93.4 | 88.5 | 89.0 | 94.0 | |
| Other liabilities | 2,374.0 | 2,485.0 | 2,545.1 | 2,607.9 | 2,677.0 | Jet fuel volume (bbl in millions) | 9.0 | 9.1 | 9.5 | 9.6 | 9.8 | |
| Shareholder's funds | 2,176.0 | 2,089.0 | 2,159.1 | 2,268.0 | 2,390.1 | Ave. NZDUSD rate | 0.72 | 0.67 | 0.65 | 0.66 | 0.67 | |
| Minority interests | 0 | 0 | 0 | 0 | 0 | Jet fuel (NZ\$m) | 987 | 1,271 | 1,287 | 1,303 | 1,373 | |
| Total funding sources | 5,941.0 | 6,116.0 | 6,216.0 | 6,163.3 | 6,106.6 | Unit fuel (cents/ASK) | 2.2 | 2.8 | 2.7 | 2.6 | 2.7 | |
| | | | | | | CASK ex-fuel/forex (cents/ASK) | 7.2 | 7.4 | 7.2 | 7.3 | 7.3 | |

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

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 softer demand backdrop than in recent years, given weaker cyclical conditions and the coronavirus outbreak, will likely dampen the near term earnings outlook. However, a stable and relatively secure dividend offers share price support.

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 cashflow 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.
- **Passenger demand:** Rising demand both domestically and from offshore markets is supportive to yields and load factors. However, demand is cyclical and subject to external shocks/influences.
- **Cost control:** Management believes cost control measures can more than offset inflationary pressures to lower CASK (cost per available seat km).

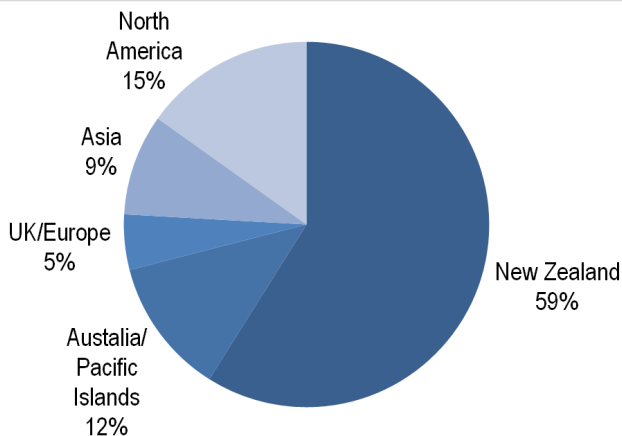
Financial structure

- **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.

Risk factors

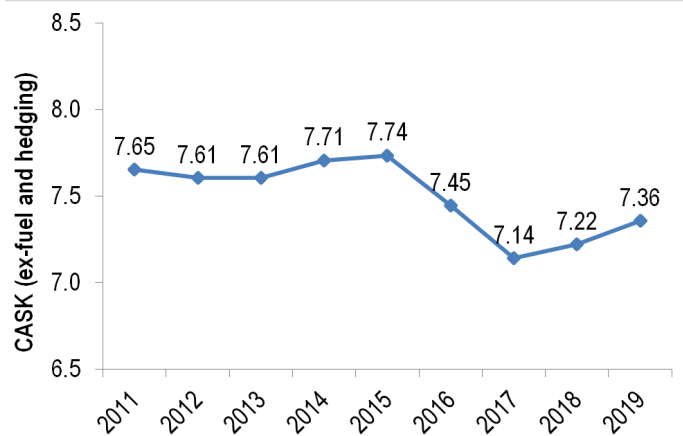
- **Left field events:** Disease outbreak (for example coronavirus), volcanic ash clouds, terrorism events.
- **Macro:** Volatility in exchange rates and global oil prices can have a dramatic impact on profitability.
- **Safety:** Any blip on AIR’s good safety record could impact passenger confidence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

Figure 3. Geographic revenue mix in FY19

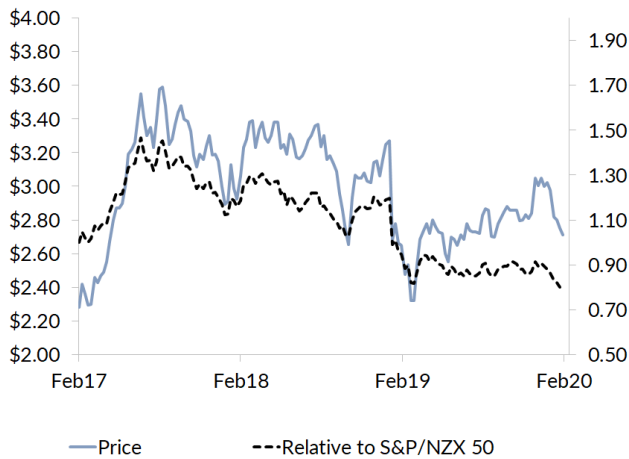


Source: Forsyth Barr analysis

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



Source: Forsyth Barr analysis

Figure 5. Price performance


Source: Forsyth Barr analysis

Figure 6. Substantial shareholders

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

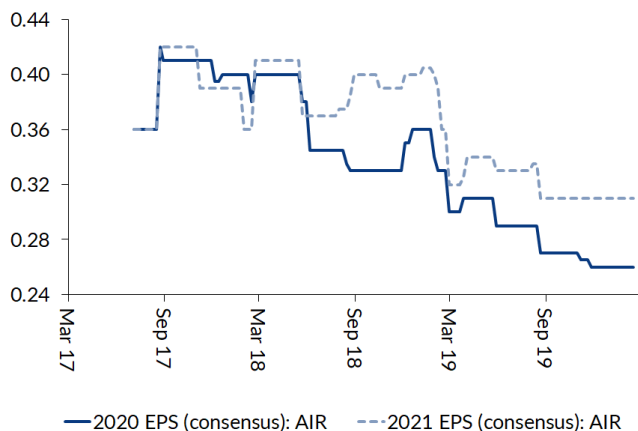
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International valuation comparisons

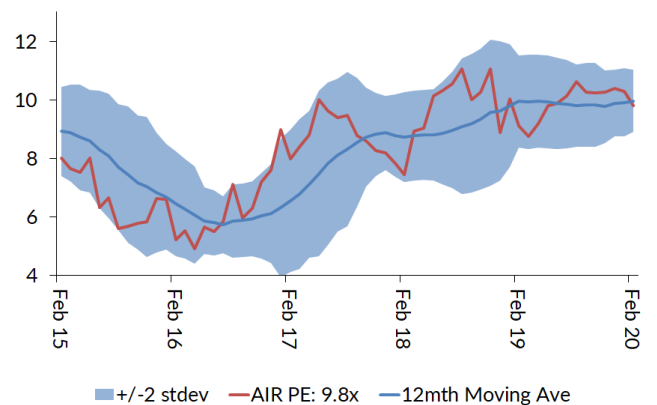
| Company | Code | Price | Mkt Cap (m) | PE 2020E | PE 2021E | EV/EBITDA 2020E | EV/EBITDA 2021E | EV/EBIT 2020E | EV/EBIT 2021E | Cash Yld 2021E |
|------------------------------|---------------|-----------------|------------------|--------------|-------------|-----------------|-----------------|---------------|---------------|----------------|
| Air New Zealand | AIR NZ | NZ\$2.71 | NZ\$3,043 | 10.7x | 9.4x | 4.5x | 4.2x | 11.8x | 10.4x | 8.1% |
| Deutsche Lufthansa AG | LHA GY | €15.29 | €7,312 | 5.3x | 4.5x | 2.8x | 2.6x | 6.4x | 5.7x | 5.7% |
| Air France-KLM | AF FP | €9.81 | €4,205 | 8.2x | 5.7x | 2.7x | 2.5x | 9.5x | 8.1x | 0.1% |
| Singapore Airlines | SIA SP | S\$8.51 | S\$10,085 | 18.2x | 15.7x | 6.2x | 5.6x | 19.8x | 17.5x | 3.5% |
| Cathay Pacific Airways | 293 HK | HK\$10.28 | HK\$40,440 | 23.4x | 17.2x | 7.1x | 6.6x | 57.0x | 46.4x | 2.6% |
| Qantas Airways | QAN AT | A\$6.23 | A\$9,288 | 10.7x | 9.0x | 3.9x | 3.6x | 8.6x | 7.8x | 4.7% |
| Virgin Australia Holdings | VAH AT | A\$0.13 | A\$1,098 | <0x | <0x | 4.0x | 3.3x | 12.8x | 7.7x | n/a |
| American Airlines Group Inc | AAL US | US\$28.76 | US\$12,596 | 6.6x | 5.3x | 9.8x | 7.1x | 12.9x | 11.5x | 1.5% |
| United Airlines Holdings Inc | UAL US | US\$80.26 | US\$20,309 | 6.6x | 6.0x | 5.3x | 4.9x | 8.1x | 7.6x | 0.0% |
| Compc Average: | | | | 11.3x | 9.1x | 5.2x | 4.5x | 16.9x | 14.0x | 2.6% |
| AIR Relative: | | | | -5% | 4% | -15% | -8% | -30% | -26% | 216% |

EV = Current Market Cap + Actual Net Debt

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

Figure 8. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 9. One year forward PE (x)


Source: Forsyth Barr analysis

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