

Air New Zealand

Flying the White Bird Above the Black Swan

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OUTPERFORM

We upgrade Air New Zealand (AIR) to OUTPERFORM from NEUTRAL in light of what we perceive to be a market overreaction to the risk posed by the coronavirus (COVID-19) outbreak. We recognise that picking the trough of any downturn is difficult (not least for an airline), particularly as troughs tend to occur before the peak of negative newsflow. However, AIR's share price has fallen by ~30% since the emergence of the virus, wiping close to NZ\$1bn from its market capitalisation. We believe it is now significantly overpricing the risks. The market cap decline equates to ~3.6x AIR's FY19 underlying NPAT, implying a significant decline in profitability for an extended period of time, or material losses over the medium term. In contrast, AIR guided to a COVID-19 hit for 2H20 NPAT of NZ\$35m-NZ\$75m on 24 February 2020. Our analysis shows that AIR's capacity cuts are deeper than its competitors and historically its responses to black swan events have been rapid and rational. In particular, we highlight that it remained profitable through the global financial crisis, in contrast to most other airlines globally. AIR now trades at a one year forward PE of ~9x and offers a double digit cash yield.

NZX Code	AIR	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$2.12	NPAT* (NZ\$m)	270.1	234.7	280.3	331.4	EV/EBITDA	4.1	2.8	2.3	2.2
Target price	NZ\$2.50	EPS* (NZc)	23.9	20.8	24.8	29.4	EV/EBIT	10.4	6.0	4.6	4.2
Risk rating	High	EPS growth* (%)	-30.4	-13.1	19.4	18.2	PE	8.8	10.2	8.5	7.2
Issued shares	1123.0m	DPS (NZc)	22.0	22.0	22.0	22.0	Price / NTA	1.2	1.4	3.6	3.0
Market cap	NZ\$2,375m	Imputation (%)	100	100	100	100	Cash div yld (%)	10.4	10.4	10.4	10.4
Avg daily turnover	871.5k (NZ\$2,343k)	*Based on normalised profits					Gross div yld (%)	14.4	14.4	14.4	14.4

Earnings risk weight to downside particularly for FY21, but more than discounted in share price

AIR downgraded its FY20 earnings guidance ahead of its recent interim result due to (1) COVID-19 demand concerns, and (2) weaker first half performance than previously implied. Its revised guidance is predicated on a 2H20 capacity hit of ~-5%. This captures all existing schedule changes plus scope for further cuts. While we currently see more downside than upside risk to FY20 earnings, the greater risk, in our opinion, is to FY21; particularly if the COVID-19 impact on demand is prolonged. However, this risk is more than factored into the current share price, in our opinion.

Capacity cuts will mitigate yield impact

The response to lower demand has been textbook from AIR, but also far quicker from other international airlines than has historically been the case. Flight schedule data shows that AIR has cut its capacity deeper than its competitors, thereby maintaining higher load factors and protecting yields. Capacity cuts to date have largely focussed on lower yielding Asian and Tasman services. Further capacity adjustments are likely as it continues to demonstrate its nimble approach to managing supply.

Opportunity to strengthen competitive position

AIR's structural position and balance sheet strengths leave it well placed to weather the COVID-19 storm. In contrast, some of its competitors (for example Virgin Australia) are more challenged, in our opinion. We believe there is potential for industry rationalisation and consolidation as a result of any prolonged downturn that could be favourable for AIR's competitive position longer term.

Air New Zealand Ltd (AIR)

Priced as at 04 Mar 2020 (NZ\$)

2.12
12-month target price (NZ\$)*
2.50

Expected share price return	17.9%
Net dividend yield	10.4%
Estimated 12-month return	28.3%

Spot valuations (NZ\$)

1. DCF	2.55
2. Price to book	1.86
3. PE relative	2.10

Key WACC assumptions

Risk free rate	2.00%
Equity beta	1.40
WACC	9.8%
Terminal growth	1.5%

DCF valuation summary (NZ\$m)

Total firm value	7,499
(Net debt)/cash	(1,496)
Less: Capitalised operating leases	(3,141)
Value of equity	2,862

Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	5,485.0	5,785.1	5,913.3	6,013.1	6,341.2
Normalised EBITDA	1,065.0	935.1	1,213.0	1,264.9	1,327.6
Depreciation and amortisation	(525.0)	(567.0)	(870.8)	(860.7)	(857.2)
Normalised EBIT	540.0	368.1	562.8	624.7	691.0
Net interest	(33.0)	(31.0)	(59.2)	(59.2)	(55.8)
Associate income	33.0	37.0	43.0	44.3	45.6
Tax	(150.0)	(104.0)	(91.3)	(109.0)	(128.9)
Minority interests	0	0	0	0	0
Normalised NPAT	390.0	270.1	234.7	280.3	331.4
Abnormals/other	0	0	33.1	0	0
Reported NPAT	390.0	270.1	201.6	280.3	331.4
Normalised EPS (cps)	34.4	23.9	20.8	24.8	29.4
DPS (cps)	22.0	22.0	22.0	22.0	22.0

Growth Rates	2018A	2019A	2020A	2021A	2022A
Revenue (%)	7.4	5.5	2.2	1.7	5.5
EBITDA (%)	2.9	-12.2	29.7	4.3	5.0
EBIT (%)	-0.4	-31.8	52.9	11.0	10.6
Normalised NPAT (%)	2.9	-30.8	-13.1	19.4	18.2
Normalised EPS (%)	3.4	-30.4	-13.1	19.4	18.2
Ordinary DPS (%)	4.8	0.0	0.0	0.0	0.0

Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	1,065.0	935.1	1,213.0	1,264.9	1,327.6
Working capital change	227.0	245.0	0	(0.0)	0
Interest & tax paid	(183.0)	(135.0)	(110.1)	(140.6)	(157.1)
Other	(78.0)	(59.1)	(233.5)	(201.0)	(93.0)
Operating cash flow	1,031.0	986.0	869.4	923.3	1,077.4
Capital expenditure	(809.0)	(821.0)	(775.0)	(650.0)	(650.0)
(Acquisitions)/divestments	33.0	13.0	40.0	40.0	40.0
Other	(2.0)	(75.0)	25.8	26.6	27.4
Funding available/(required)	253.0	103.0	160.2	339.8	494.8
Dividends paid	(260.0)	(260.0)	(247.1)	(247.1)	(247.1)
Equity raised/(returned)	(17.0)	(14.0)	0	0	0
(Increase)/decrease in net debt	(24.0)	(171.0)	(86.9)	92.8	247.8

Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E
Working capital	89.0	60.0	63.3	63.0	62.0
Fixed assets	5,035.0	5,268.0	3,838.0	3,807.9	3,781.3
Intangibles	170.0	186.0	186.0	186.0	186.0
Right of use asset	0	0	2,459.0	2,459.0	2,459.0
Other assets	647.0	602.0	602.0	602.0	602.0
Total funds employed	5,941.0	6,116.0	7,148.3	7,117.8	7,090.3
Net debt/(cash)	1,391.0	1,542.0	507.0	1,536.1	1,288.3
Lease liability	0	0	2,186.0	2,186.0	2,186.0
Other liabilities	2,374.0	2,485.0	2,519.8	2,547.0	2,636.1
Shareholder's funds	2,176.0	2,089.0	1,935.4	848.8	979.8
Minority interests	0	0	0	0	0
Total funding sources	5,941.0	6,116.0	7,148.3	7,117.8	7,090.3

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	3.4	4.1	2.8	2.3	2.2
EV/EBIT (x)	6.8	10.5	6.1	4.6	4.2
PE (x)	6.2	8.9	10.2	8.5	7.2
Price/NTA (x)	1.2	1.3	1.4	3.6	3.0
Free cash flow yield (%)	9.3	6.9	4.0	11.5	18.0
Net dividend yield (%)	10.4	10.4	10.4	10.4	10.4
Gross dividend yield (%)	14.4	14.4	14.4	14.4	14.4

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	16.4	11.9	9.5	10.6	12.4
Interest cover EBITDA (x)	32.3	30.2	20.5	21.4	23.8
Net debt/ND+E (%)	39.0	42.5	20.8	64.4	56.8
Net debt/EBITDA (x)	1.3	1.6	0.4	1.2	1.0

Operating Performance

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	6.9	4.7	6.4	7.1	7.8
Return on equity (%)	17.9	12.9	12.1	33.0	33.8
Return on funds employed (%)	n/a	n/a	n/a	n/a	n/a
EBITDA margin (%)	19.4	16.2	20.5	21.0	20.9
EBIT margin (%)	9.8	6.4	9.5	10.4	10.9
Capex to sales (%)	14.7	14.2	13.1	10.8	10.3
Capex to depreciation (%)	154	145	89	76	76
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	64	92	106	89	75

Available Seat Km (ASK)	2018A	2019A	2020E	2021E	2022E
Domestic	6,905	7,104	6,997	7,032	7,138
Tasman and Pacific	12,964	13,640	13,708	13,708	14,119
Long-haul	24,406	25,285	26,170	26,693	28,295
Total	44,275	46,029	46,876	47,434	49,552
Change (%)	5.0	4.0	1.8	1.2	4.5

RASK (cents per ASK)	2018A	2019A	2020E	2021E	2022E
Domestic	22.0	22.5	23.9	23.9	24.3
Tasman and Pacific	9.6	9.6	9.5	9.5	9.7
Long-haul	7.9	8.1	7.9	8.1	8.3
Total	10.6	10.8	10.8	10.8	11.0

Costs

Costs	2018A	2019A	2020E	2021E	2022E
Ave. jet fuel price (US\$/bbl)	68.6	82.0	75.5	72.0	77.0
Fuel supply chain (US\$/bbl)	10.0	11.4	11.0	11.0	11.0
Jet fuel cost (US\$/bbl)	78.6	93.4	86.5	83.0	88.0
Jet fuel volume (bbl in millions)	9.0	9.1	9.4	9.5	9.8
Ave. NZDUSD rate	0.72	0.67	0.65	0.66	0.67
Jet fuel (NZ\$m)	987	1,271	1,251	1,202	1,292
Unit fuel (cents/ASK)	2.2	2.8	2.7	2.5	2.6
CASK ex-fuel/forex (cents/ASK)	7.2	7.4	7.4	7.5	7.5

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

Valuation

Our target price of NZ\$2.50 is retained.

Figure 1. AIR vs Qantas one year forward PE



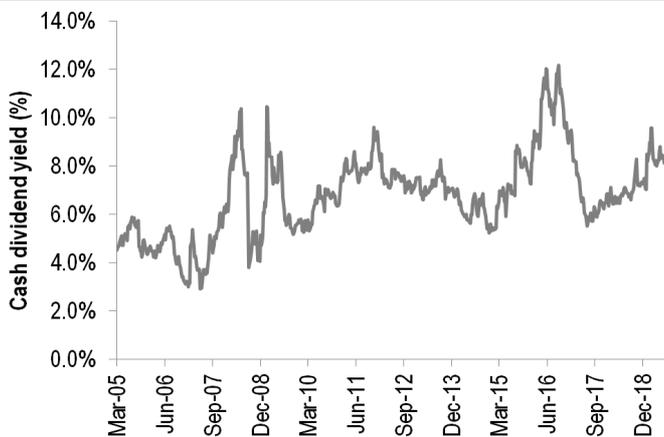
Source: Eikon, Forsyth Barr analysis

Figure 2. Near term earnings are a key driver of valuation



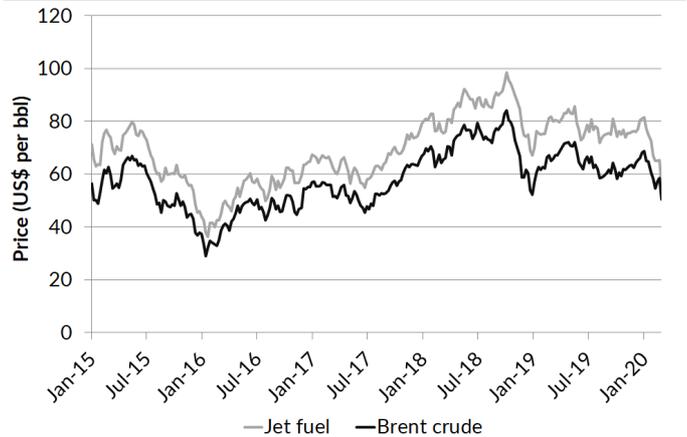
Source: Eikon, Forsyth Barr analysis

Figure 3. Dividend yield attraction — ~10% cash yield



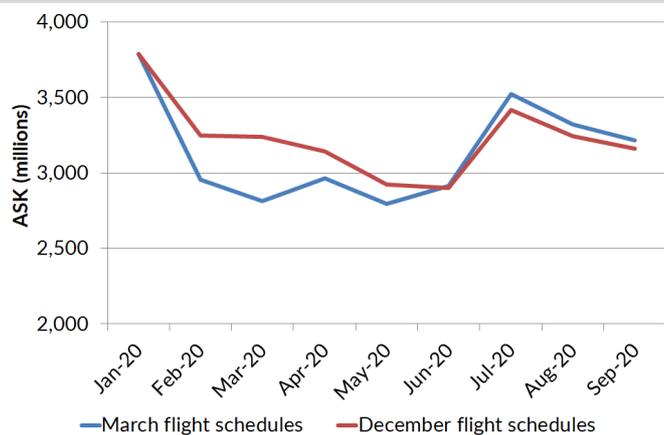
Source: Eikon, Forsyth Barr analysis

Figure 4. Jet fuel provides partial offset to lower demand



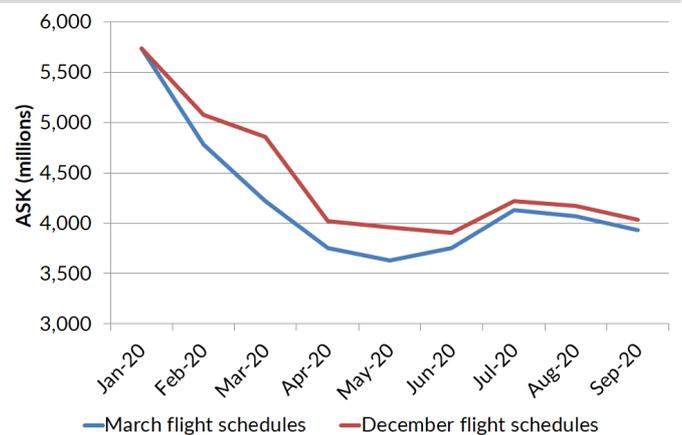
Source: Bloomberg, Forsyth Barr analysis

Figure 5. Air typically cuts capacity quicker....



Source: OAG, Forsyth Barr analysis

Figure 6. ...than its competitors into New Zealand



Source: OAG, 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 softer demand backdrop than in recent years, given weaker cyclical conditions and the COVID-19 outbreak, will likely dampen the near term earnings outlook. However, this is more than factored into the current share price and a stable and relatively secure dividend offers share price support. **OUTPERFORM.**

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).

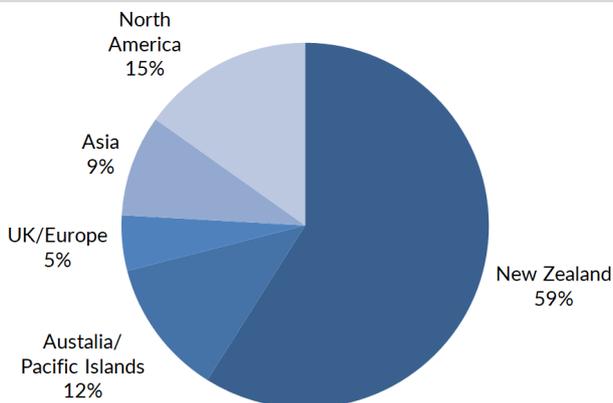
Financial structure

- **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

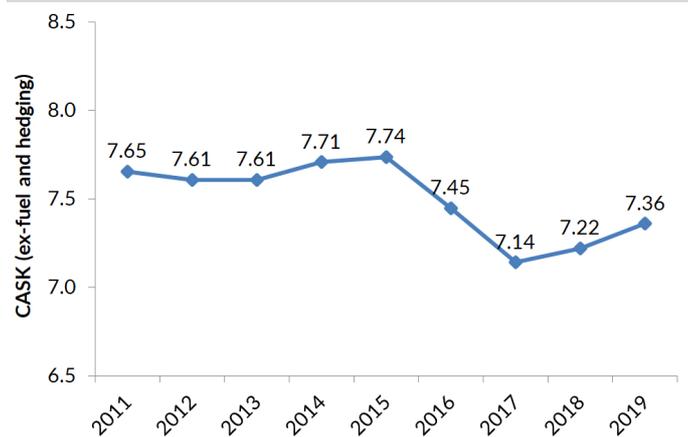
- **Left field events:** Disease outbreak (for example coronavirus), volcanic ash clouds, terrorism events.
- **Macro:** Volatility in exchange rates and global oil prices can have a dramatic impact on profitability.
- **Safety:** Any blip on AIR’s good safety record could impact passenger confidence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

Figure 7. Geographic revenue mix in FY19



Source: Forsyth Barr analysis

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



Source: Forsyth Barr analysis

Figure 9. Price performance



Source: Forsyth Barr analysis

Figure 10. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	52.5%

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

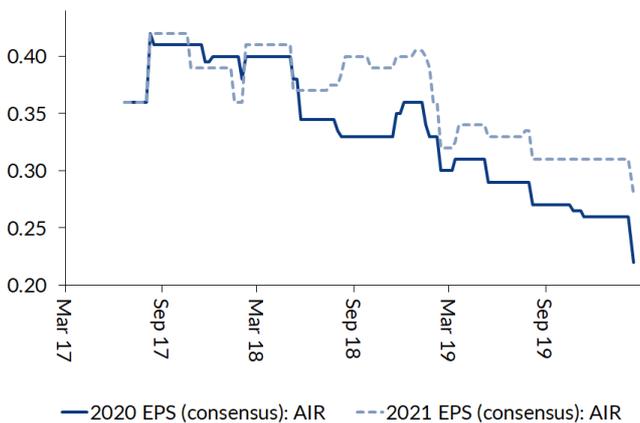
Figure 11. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
Air New Zealand	AIR NZ	NZ\$2.12	NZ\$2,375	10.2x	8.5x	3.2x	3.1x	7.0x	6.3x	10.4%
DEUTSCHE LUFTHANSA-REG	LHA GY	€11.90	€5,691	4.2x	3.6x	2.5x	2.3x	5.7x	5.1x	7.1%
AIR FRANCE-KLM	AF FP	€6.49	€2,783	7.2x	4.1x	2.3x	2.1x	8.8x	7.1x	0.0%
SINGAPORE AIRLINES	SIA SP	S\$8.10	S\$9,600	18.9x	15.1x	6.2x	5.6x	20.1x	17.3x	3.6%
CATHAY PACIFIC AIRWAYS	293 HK	HK\$10.20	HK\$40,125	26.0x	19.9x	7.1x	6.6x	56.9x	46.2x	2.6%
QANTAS AIRWAYS	QAN AT	A\$5.23	A\$7,797	10.3x	8.0x	4.0x	3.7x	9.7x	8.5x	5.4%
VIRGIN AUSTRALIA HOLDINGS LT	VAH AT	A\$0.11	A\$887	<0x	<0x	7.3x	6.0x	23.9x	13.8x	n/a
AMERICAN AIRLINES GROUP INC	AAL US	US\$18.69	US\$7,946	4.3x	3.4x	5.8x	6.3x	11.4x	10.2x	2.2%
UNITED AIRLINES HOLDINGS INC	UAL US	US\$60.44	US\$14,981	5.0x	4.5x	4.4x	4.2x	7.0x	6.6x	0.0%
Compcpo Average:				10.8x	8.4x	4.9x	4.6x	17.9x	14.4x	3.0%
AIR Relative:				-6%	2%	-35%	-33%	-61%	-56%	249%

EV = Current Market Cap + Actual Net Debt

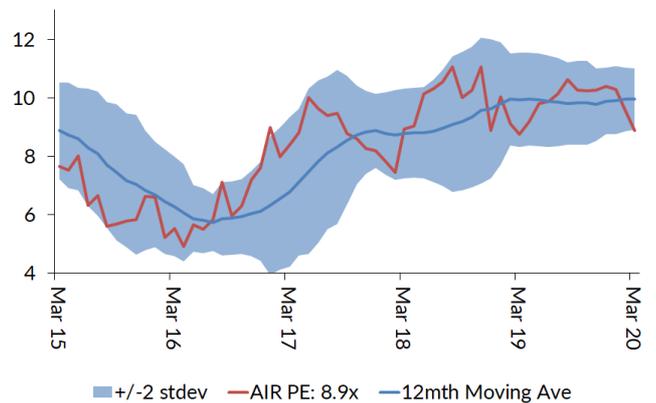
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcpo metrics re-weighted to reflect headline (AIR) companies fiscal year end

Figure 12. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 13. One year forward PE (x)



Source: Forsyth Barr analysis

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