

Air New Zealand

Symptomatic; Dynamic; No Panic

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OUTPERFORM

Air New Zealand (AIR) has withdrawn its FY20 earnings guidance just two weeks after revising it for the impact of the coronavirus (COVID-19) outbreak; the speed and severity of the change in market conditions is unprecedented. The further and sudden deterioration in forward demand means the impact on pre-tax profit (PBT) from the pandemic will be more than its previous forecast range. While market expectations for both FY20 and FY21 need to be lowered further, the -30% cut to the share price since mid-January 2020 suggests this is already in the price. While we acknowledge that AIR is a high risk proposition, particularly in the current environment, we are also conscious that the market tends to over-price risk in downturns, which can provide attractive buying opportunities. We make material cuts to near term earnings forecasts, which are partially mitigated from FY21 by lower oil prices, and reduce our 12-month target price to NZ\$2.25, but retain an OUTPERFORM rating.

NZX Code	AIR	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$1.95	NPAT* (NZ\$m)	270.1	102.4	194.4	387.4	EV/EBITDA	3.9	3.2	2.5	2.1
Target price	NZ\$2.25	EPS* (NZc)	23.9	9.1	17.2	34.3	EV/EBIT	9.9	20.5	10.5	5.4
Risk rating	High	EPS growth* (%)	-30.4	-62.1	89.8	99.3	PE	8.2	21.5	11.3	5.7
Issued shares	1123.0m	DPS (NZc)	22.0	11.0	11.0	22.0	Price / NTA	1.2	1.3	1.3	1.1
Market cap	NZ\$2,190m	Imputation (%)	100	100	100	100	Cash div yld (%)	11.3	5.6	5.6	11.3
Avg daily turnover	901.3k (NZ\$2,400k)	*Based on normalised profits					Gross div yld (%)	15.7	7.8	7.8	15.7

Guidance removed

In light of further demand weakness and increasing uncertainty over the near term demand outlook AIR, like other listed airlines, has removed its FY20 earnings guidance. Two weeks ago it lowered its full year PBT guidance to NZ\$300m–NZ\$350m, at the same time it suggested the COVID-19 impact on 2H20 would be NZ\$35m–NZ\$75m. With both ranges removed within just two weeks of being issued, it is apparent that AIR is suffering from a severe downturn in forward bookings and an elevated level of cancellations. We now expect AIR to incur a loss during 2H20.

Revenue hit before cost measures at least partially mitigate

The significant rate of decline in forward demand has happened at a pace that AIR has been unable to as quickly respond to from a cost perspective. The airline is managing its capacity to ensure load factors are optimised but yields will likely be down and other cost mitigation exercises will take longer to assist. Therefore, we now expect 2H20 earnings to be the trough of this demand shock, with some recovery in 1H21, steepening into 2H21. The corresponding significant decline in oil prices is helpful to a 'V' shaped recovery, but fuel hedging in place for the next 6–9 months limits near term benefits. We expect newsflow to continue to deteriorate over the near term, with further capacity adjustments likely to lower the current -10% reduction for the five months to June 2020.

Dividend at risk though balance sheet can absorb a severe downturn

Our base case for AIR is that its dividend is impacted in 2H20. It will trade ex-dividend for the 11c/share 1H20 dividend later this week. We now assume that it suspends the 2H20 dividend in light of our forecast losses. The dividend is reinstated in 1H21 at a lower level before recovering over the following 18 months. While capital injections are likely to become a reality in the global airlines sector, in our opinion, we expect AIR can navigate this downturn, unless it is materially longer and/or deeper than our current expectations.

Air New Zealand Ltd (AIR)

Priced as at 09 Mar 2020 (NZ\$)

1.95
12-month target price (NZ\$)*
2.25

Expected share price return	15.4%
Net dividend yield	5.6%
Estimated 12-month return	21.0%

Spot valuations (NZ\$)

1. DCF	2.35
2. Price to book	1.86
3. PE relative	0.00

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	7,082
(Net debt)/cash	(1,618)
Less: Capitalised operating leases	(2,821)
Value of equity	2,644

Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Valuation Ratios	2018A	2019A	2020E	2021E	2022E
Sales revenue	5,485.0	5,785.1	5,610.9	5,548.0	6,031.3	EV/EBITDA (x)	3.2	3.9	3.2	2.5	2.1
Normalised EBITDA	1,065.0	935.1	1,030.1	1,117.3	1,354.7	EV/EBIT (x)	6.4	9.9	20.5	10.5	5.4
Depreciation and amortisation	(525.0)	(567.0)	(870.8)	(848.9)	(830.3)	PE (x)	5.7	8.2	21.5	11.3	5.7
Normalised EBIT	540.0	368.1	159.3	268.4	524.4	Price/NTA (x)	1.1	1.2	1.3	1.3	1.1
Net interest	(33.0)	(31.0)	(60.0)	(42.7)	(32.0)	Free cash flow yield (%)	10.1	7.5	-5.7	13.3	30.2
Associate income	33.0	37.0	43.0	44.3	45.6	Net dividend yield (%)	11.3	11.3	5.6	5.6	11.3
Tax	(150.0)	(104.0)	(39.8)	(75.6)	(150.7)	Gross dividend yield (%)	15.7	15.7	7.8	7.8	15.7
Minority interests	0	0	0	0	0						
Normalised NPAT	390.0	270.1	102.4	194.4	387.4	Capital Structure	2018A	2019A	2020E	2021E	2022E
Abnormals/other	0	0	33.1	0	0	Interest cover EBIT (x)	16.4	11.9	2.7	6.3	16.4
Reported NPAT	390.0	270.1	69.3	194.4	387.4	Interest cover EBITDA (x)	32.3	30.2	17.2	26.2	42.4
Normalised EPS (cps)	34.4	23.9	9.1	17.2	34.3	Net debt/ND+E (%)	39.0	42.5	24.7	16.7	-4.4
DPS (cps)	22.0	22.0	11.0	11.0	22.0	Net debt/EBITDA (x)	1.3	1.6	0.6	0.3	n/a
Growth Rates	2018A	2019A	2020E	2021E	2022E	Key Ratios	2018A	2019A	2020E	2021E	2022E
Revenue (%)	7.4	5.5	-3.0	-1.1	8.7	Return on assets (%)	6.9	4.7	1.8	3.1	6.1
EBITDA (%)	2.9	-12.2	10.2	8.5	21.2	Return on equity (%)	17.9	12.9	5.4	10.0	17.6
EBIT (%)	-0.4	-31.8	-56.7	68.5	95.4	Return on funds employed (%)	n/a	n/a	n/a	n/a	n/a
Normalised NPAT (%)	2.9	-30.8	-62.1	89.8	99.3	EBITDA margin (%)	19.4	16.2	18.4	20.1	22.5
Normalised EPS (%)	3.4	-30.4	-62.1	89.8	99.3	EBIT margin (%)	9.8	6.4	2.8	4.8	8.7
Ordinary DPS (%)	4.8	0.0	-50.0	0.0	100.0	Capex to sales (%)	14.7	14.2	12.5	8.1	9.5
						Capex to depreciation (%)	154	145	80	53	69
						Imputation (%)	100	100	100	100	100
						Pay-out ratio (%)	64	92	121	64	64
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Operating Performance	2018A	2019A	2020E	2021E	2022E
EBITDA	1,065.0	935.1	1,030.1	1,117.3	1,354.7	Available Seat Km (ASK)					
Working capital change	227.0	245.0	(0.0)	0	0	Domestic	6,905	7,104	6,749	6,749	7,086
Interest & tax paid	(183.0)	(135.0)	(59.4)	(90.8)	(155.1)	Tasman and Pacific	12,964	13,640	13,094	13,094	13,749
Other	(78.0)	(59.1)	(395.2)	(284.6)	32.1	Long-haul	24,406	25,285	25,285	25,285	26,802
Operating cash flow	1,031.0	986.0	575.5	742.0	1,231.8	Total	44,275	46,029	45,128	45,128	47,637
Capital expenditure	(809.0)	(821.0)	(700.0)	(450.0)	(570.0)	Change (%)	5.0	4.0	-2.0	0.0	5.6
(Acquisitions)/divestments	33.0	13.0	40.0	40.0	40.0						
Other	(2.0)	(75.0)	25.8	26.6	27.4	RASK (cents per ASK)					
Funding available/(required)	253.0	103.0	(58.7)	358.6	729.1	Domestic	22.0	22.5	23.0	22.5	23.2
Dividends paid	(260.0)	(260.0)	(123.5)	(123.5)	(247.1)	Tasman and Pacific	9.6	9.6	9.4	9.4	9.7
Equity raised/(returned)	(17.0)	(14.0)	0	0	0	Long-haul	7.9	8.1	7.8	7.6	8.0
(Increase)/decrease in net debt	(24.0)	(171.0)	(182.2)	235.0	482.1	Total	10.6	10.8	10.5	10.4	10.8
						Costs					
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Ave. jet fuel price (US\$/bbl)	68.6	82.0	75.8	60.0	64.5
Working capital	89.0	60.0	64.2	64.4	62.9	Fuel supply chain (US\$/bbl)	10.0	11.4	11.0	11.0	11.0
Fixed assets	5,035.0	5,268.0	3,838.0	3,619.6	3,539.9	Jet fuel cost (US\$/bbl)	78.6	93.4	86.8	71.0	75.5
Intangibles	170.0	186.0	186.0	186.0	186.0	Jet fuel volume (bbl in millions)	9.0	9.1	8.9	9.1	9.5
Right of use asset	0	0	2,459.0	2,459.0	2,459.0	Ave. NZDUSD rate	0.72	0.67	0.65	0.66	0.67
Other assets	647.0	602.0	602.0	602.0	602.0	Jet fuel (NZ\$m)	987	1,271	1,184	978	1,066
Total funds employed	5,941.0	6,116.0	7,149.2	6,931.0	6,849.8	Unit fuel (cents/ASK)	2.2	2.8	2.6	2.2	2.2
Net debt/(cash)	1,391.0	1,542.0	624.2	389.2	(92.9)	CASK ex-fuel/forex (cents/ASK)	7.2	7.4	7.6	7.6	7.6
Lease liability	0	0	2,186.0	2,186.0	2,186.0						
Other liabilities	2,374.0	2,485.0	2,437.7	2,420.6	2,551.9						
Shareholder's funds	2,176.0	2,089.0	1,901.3	1,935.3	2,204.9						
Minority interests	0	0	0	0	0						
Total funding sources	5,941.0	6,116.0	7,149.2	6,931.0	6,849.8						

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

Unprecedented demand impact from COVID-19

Air New Zealand (AIR) has been impacted by a severe and unprecedented reduction in demand, even relative to what it outlined along with its 1H20 result commentary less than two weeks ago. Its profitability will be significantly compromised in the short term. It is responding as quickly and effectively as realistically possible. Ultimately, we don't expect these measures to insulate it from a sharp reduction in profitability – we now expect AIR to be loss making in 2H20.

Capacity reductions highlight deterioration in demand

AIR has progressively cut its forward capacity in recent weeks reflective of the deteriorating demand outlook. Over the past two weeks the impact on capacity reduction for the February–June 2020 period has doubled from -5% to -10%.

Figure 1. Time-line of capacity reductions; a rapid deterioration

	Asia	Tasman/Pacific Islands	Domestic	Overall
2-Feb-20	Shanghai: suspended until 29 Mar			
18-Feb-20	Shanghai: 30 Mar-30 Apr reduced from 7/week to every second day; HK: 29 Mar resumption on AIR aircraft, 21 Apr-31 May reduced from 7 to 4 weekly services; HK: 29 Mar-19 Apr seven weekly to five, 19 Apr-Jun three weekly			
24-Feb-20	-17% for Feb-Jun; Seoul suspended from 7 Mar to Jun; Seoul suspended 7 Mar-Jun	Tasman -3% for Mar-May	-2% for Mar/Apr for on ZQN services from CHC and AKL	Overall capacity cut by -5% (Feb-Jun)
4-Mar-20	Singapore: 14 weekly to 11 from 4 May-30 Jun; Taipei: one less weekly Mar-Jun	Tasman: -4% to Jun	-2% to Jun	
9-Mar-20	Total capacity cut by -26%	Tasman cut by -7% through Jun; Pacific Islands -6% through Jun	-4% reduction; -10% to -15% in Mar and Apr	Overall capacity cut by -10% (Feb-Jun)

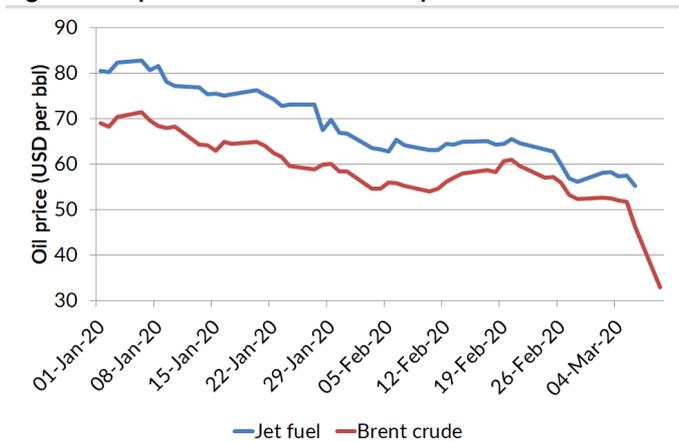
Source: AIR, Forsyth Barr analysis

Oil price offset won't feature until FY21

The impact of lower revenue on airlines is being partially offset by the dramatic fall in oil prices, which have fallen substantially (Brent crude is down -37% in the past week and down -49% since 17 January 2020) after Saudi Arabia launched a price war against Russia, which refused to go along with OPEC's efforts to stem the COVID-19 impact on pricing by cutting production. As a result, Saudi Arabia slashed its selling prices in a bid to retake market share and heap pressure on Russia.

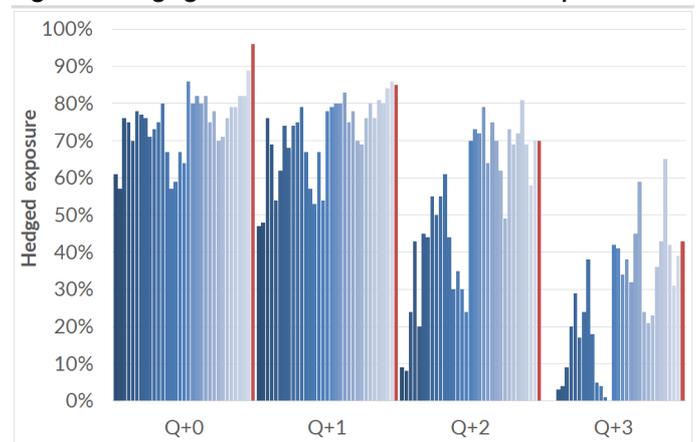
Lower fuel costs provide a key cost mitigating opportunity for AIR. However, its ability to benefit from lower oil prices is compromised, at least near term, given (1) hedging already in place for the majority of its jet fuel exposure, and (2) the reduction in capacity that means it has less exposure to spot prices than it ordinarily would. The benefit will, therefore, be delayed until late 1H21.

Figure 2. Oil price decline has been sharp



Source: Eikon, Forsyth Barr analysis

Figure 3. Hedging will hinder near term benefit of oil prices



Source: AIR, Forsyth Barr analysis

Earnings revisions

We dramatically lower our earnings forecasts in FY20 and FY21 to reflect the severe nature of the demand impact from COVID-19 hysteria. Our revised FY20 forecast implies a 2H20 PBT loss of -NZ\$56m. We expect a resumption of more normal demand patterns during FY22. This, coupled with lower oil prices, allows us to upgrade our medium term estimates.

We assume an average jet fuel price of NZ\$60/bbl in FY21, which is significantly above current spot market levels.

We cut our dividend forecast to 11c in FY20, which implies a suspension of the dividend in 2H20, with reinstatement in FY21 albeit at 50% of the current run-rate, before full resumption in FY22.

Figure 4. Earnings revisions (NZ\$m)

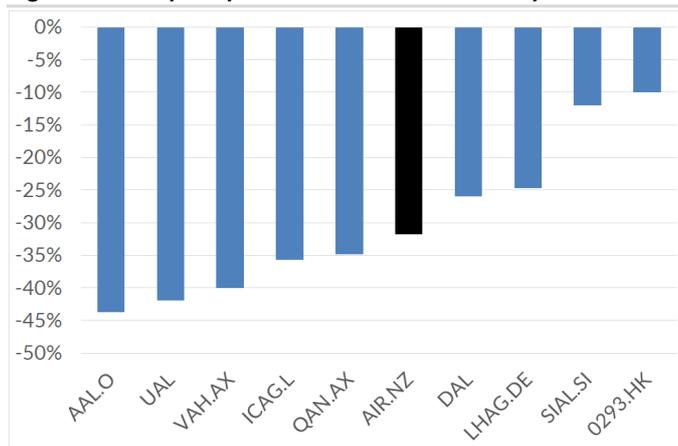
	FY20E			FY21E			FY22E		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Group RASK growth	0.0%	-2.3%	-234 bps	0.6%	-1.5%	-211 bps	1.3%	3.7%	236 bps
Group ASK growth	1.8%	-2.0%	-380 bps	1.2%	0.0%	-119 bps	4.5%	5.6%	109 bps
Jet fuel (average US\$ price)	76	76	0%	72	60	-17%	72	65	-10%
Total fuel cost	1,251	1,184	(67)	1,202	978	(224)	1,292	1,066	(226)
Sales revenue	5,913	5,611	-5%	6,013	5,548	-8%	6,341	6,031	-5%
Underlying PB T	326	142	-56%	389	270	-31%	460	538	17%
Underlying NPAT	235	102	-56%	280	194	-31%	331	387	17%
Underlying EPS (cents)	20.8	9.1	-56%	24.8	17.2	-31%	29.4	34.3	17%
DPS (cents)	22.0	11.0	-50%	22.0	11.0	-50%	22.0	22.0	0%

Source: Forsyth Barr analysis

Valuation

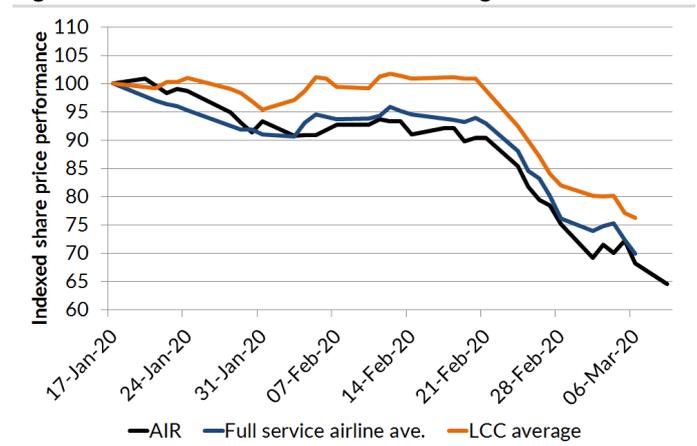
AIR's share price has fallen by -35% since 17 January 2020 (on 20 January 2020 Chinese premier Li Keqiang urged decisive and effective efforts to prevent and control the epidemic), amounting to a ~NZ\$1.2bn reduction in its market capitalisation. The share price decline is in the middle of the range of its international full-service airline peers (Figure 5).

Figure 5. Share price performance since 17 January 2020



Source: Eikon, Forsyth Barr analysis

Figure 6. AIR has tracked other airlines during downturn



Source: Eikon, Forsyth Barr analysis LCC=low cost carrier

Target price approach revised

We remove our peer comparatives valuation from our target price methodology in light of the fast moving nature of COVID-19 on share prices and the lagged impact on market consensus earnings forecasts. Our target price is now based on a 50:50 split of (1) price to book, and (2) discounted cash flow.

Our revised target price falls 25c to NZ\$2.25. This remains comfortably above both book value (~NZ\$1.80/share) and NTA (~NZ\$1.60/share) reflecting our view that AIR will recover in a position of relative strength – financial and competitive – from the current downturn.

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, is severely impacting the near term earnings outlook. However, a substantial drop in oil prices provides some respite to profitability over the medium term. **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.
- **Cost control:** Management believes cost control measures can more than offset inflationary pressures to lower CASK (cost per available seat km).

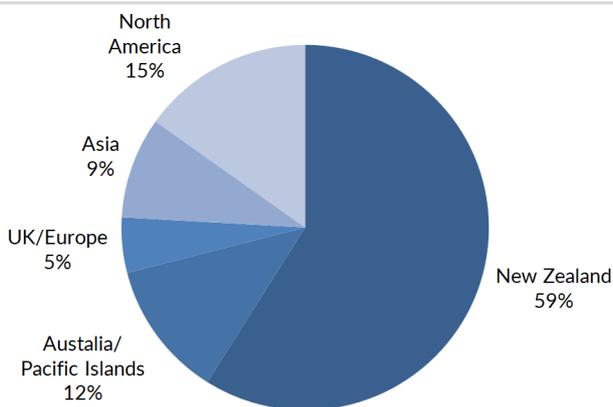
Financial structure

- **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

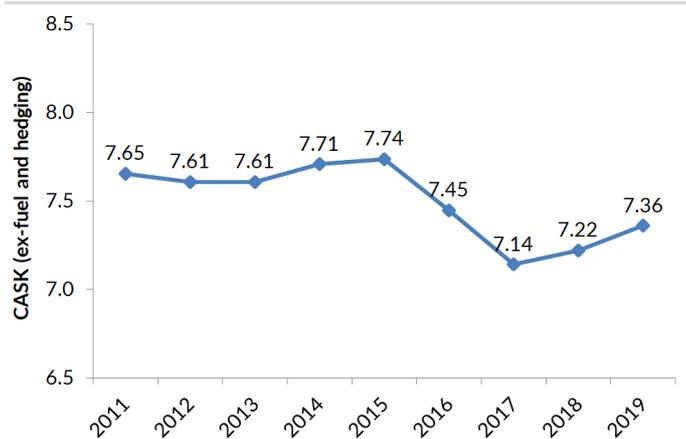
- **Left field events:** Disease outbreak (for example coronavirus), volcanic ash clouds, terrorism events.
- **Macro:** Volatility in exchange rates and global oil prices can have a dramatic impact on profitability.
- **Safety:** Any blip on AIR’s good safety record could impact passenger confidence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

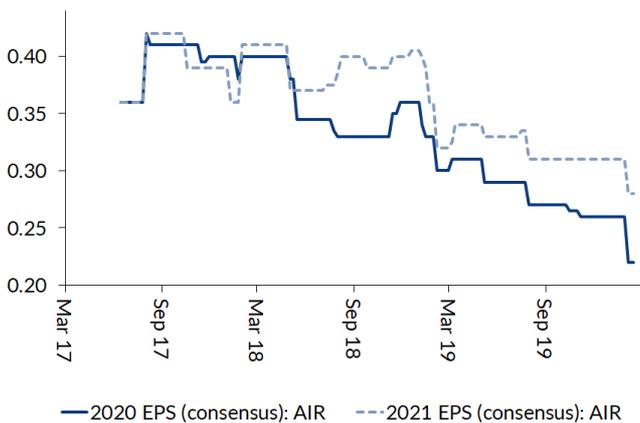
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 11. International valuation comparisons

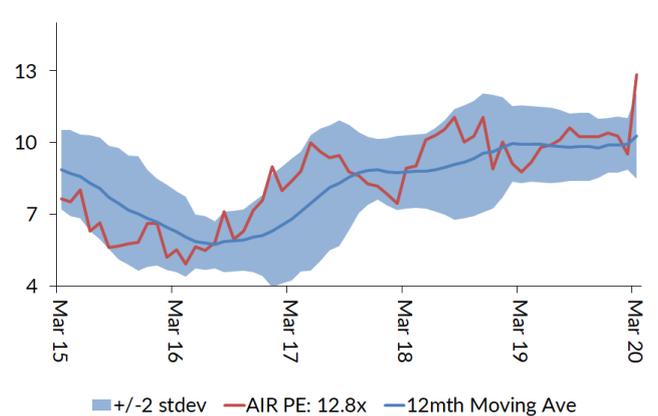
Company (metrics re-weighted to reflect AIR's balance date - June)	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
Air New Zealand	AIR NZ	NZ\$1.95	NZ\$2,190	21.5x	11.3x	3.6x	3.3x	23.4x	13.9x	5.6%
DEUTSCHE LUFTHANSA-REG	LHA GY	€11.48	€5,487	4.1x	3.6x	2.5x	2.3x	5.6x	5.0x	7.3%
AIR FRANCE-KLM	AF FP	€5.71	€2,447	6.3x	3.6x	2.2x	2.1x	8.5x	6.9x	0.0%
SINGAPORE AIRLINES	SIA SP	S\$7.96	S\$9,434	18.6x	14.8x	6.1x	5.5x	19.9x	17.2x	3.7%
CATHAY PACIFIC AIRWAYS	293 HK	HK\$9.93	HK\$39,063	28.0x	21.1x	7.1x	6.5x	56.4x	45.8x	2.7%
QANTAS AIRWAYS	QAN AT	A\$4.66	A\$6,947	9.1x	7.1x	3.7x	3.4x	9.0x	7.9x	6.0%
VIRGIN AUSTRALIA HOLDINGS LT	VAH AT	A\$0.09	A\$735	<0x	<0x	7.0x	5.8x	23.2x	13.4x	n/a
AMERICAN AIRLINES GROUP INC	AAL US	US\$15.97	US\$6,804	3.8x	3.1x	5.6x	6.2x	11.3x	10.2x	2.6%
UNITED AIRLINES HOLDINGS INC	UAL US	US\$52.10	US\$12,918	4.3x	3.9x	4.1x	4.0x	6.5x	6.1x	0.0%
Compco Average:				10.6x	8.2x	4.8x	4.5x	17.5x	14.1x	3.2%
AIR Relative:				102%	39%	-25%	-25%	34%	-1%	78%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco 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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