FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | TRANSPORT | INTERNATIONAL AIRLINE
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Air New Zealand
Speed and Severity of Slowdown Surprises; Downgrade to NEUTRAL

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NEUTRAL

We downgrade Air New Zealand (AIR) to NEUTRAL from OUTPERFORM, a little over a week since upgrading; the speed and severity of the coronavirus (COVID-19) outbreak on demand continues to surprise us. We previously took the view that the market was overpricing risk, as it typically does through black swan events. However, the risk and uncertainty has become extreme and for the foreseeable future investors are likely to assume the worst. AIR's demand profile could deteriorate substantially from what its current forward capacity cuts imply. Consequently, the potential near term economic impact on AIR is substantially more than we previously thought, yet still very difficult to quantify. We make further cuts to our estimates for both FY20 and FY21. We continue to believe the balance sheet has capacity to absorb a short, sharp shock to operating cashflows. AIR's net asset value per share of ~NZ$1.70 provides support, but cash flow losses and/or asset write downs could adversely impact.

NZX Code	AIR
Share price	NZ$1.76
Target price	NZ$1.80
Risk rating	High
Issued shares	1123.0m
Market cap	NZ$1,976m
Avg daily turnover	931.5k (NZ$2,444k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	270.1	76.6	113.8	388.8
EPS* (NZc)	23.9	6.8	10.1	34.4
EPS growth* (%)	-30.4	-71.6	48.5	n/a
DPS (NZc)	22.0	11.0	11.0	22.0
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	3.7	3.3	2.8	2.1
EV/EBIT	9.4	25.1	17.3	5.4
PE	7.4	25.9	17.5	5.1
Price / NTA	1.0	1.3	1.4	1.1
Cash div yld (%)	12.5	6.3	6.3	12.5
Gross div yld (%)	17.4	8.7	8.7	17.4

What's changed?

- **Earnings**: Further significant cuts to FY20 and FY21
- **Target price**: Lowered to NZ$1.80 (from NZ$2.25)
- **Rating**: Downgrade to NEUTRAL (from OUTPERFORM)

Demand hole getting bigger

The demand backdrop is deteriorating rapidly in countries with growing rates of COVID-19 infection. In light of the ease of transmission and the global spread, the likelihood that it develops in New Zealand is rapidly increasing. If it does, we expect it to have a dramatic impact on AIR's domestic network and result in substantial demand declines for inbound passengers.

Balance sheet stress; ability to absorb short sharp shock

AIR's balance sheet is in relatively good health. However, there is a point where operating losses become problematic. It has no covenants to adhere to within its current debt facilities, which provides a degree of operating flexibility. Our base case continues to assume that AIR will not require any additional capital through this downturn.

Oil price supportive to "V" shaped recovery

The dramatic decline in oil prices over the past week provides some respite for AIR, albeit delayed. Its fuel costs in FY21 will be substantially lower than FY20. We currently assume that fuel costs fall by almost NZ$250m in FY21. Lower fuel costs should ease the financial impact of reduced demand in FY21 and help a swift recovery in FY22.

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Air New Zealand Ltd (AIR)

Priced as at 12 Mar 2020 (NZ$)	1.76

12-month target price (NZ$)*	1.80
Expected share price return	2.3%
Net dividend yield	6.2%
Estimated 12-month return	8.5%

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

Profit and Loss Account (NZ$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	5,485.0	5,785.1	5,426.3	5,276.3	5,957.8
Normalised EBITDA	**1,065.0**	**935.1**	**972.7**	**1,016.3**	**1,365.9**
Depreciation and amortisation	(525.0)	(567.0)	(844.8)	(848.9)	(830.3)
Normalised EBIT	**540.0**	**368.1**	**127.9**	**167.4**	**535.6**
Net interest	(33.0)	(31.0)	(64.5)	(53.6)	(41.2)
Associate income	33.0	37.0	43.0	44.3	45.6
Tax	(150.0)	(104.0)	(29.8)	(44.3)	(151.2)
Minority interests	0	0	0	0	0
Normalised NPAT	**390.0**	**270.1**	**76.6**	**113.8**	**388.8**
Abnormals/other	0	0	33.1	0	0
Reported NPAT	**390.0**	**270.1**	**43.5**	**113.8**	**388.8**
Normalised EPS (cps)	34.4	23.9	6.8	10.1	34.4
DPS (cps)	22.0	22.0	11.0	11.0	22.0

Growth Rates	2018A	2019A	2020E	2021E	2022E
Revenue (%)	7.4	5.5	-6.2	-2.8	12.9
EBITDA (%)	2.9	-12.2	4.0	4.5	34.4
EBIT (%)	-0.4	-31.8	-65.3	30.9	>100
Normalised NPAT (%)	2.9	-30.8	-71.6	48.5	>100
Normalised EPS (%)	3.4	-30.4	-71.6	48.5	>100
Ordinary DPS (%)	4.8	0.0	-50.0	0.0	100.0

Cash Flow (NZ$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	**1,065.0**	**935.1**	**972.7**	**1,016.3**	**1,365.9**
Working capital change	227.0	245.0	0.0	0.0	0
Interest & tax paid	(183.0)	(135.0)	(53.8)	(70.3)	(164.8)
Other	(78.0)	(59.1)	(502.2)	(335.1)	147.2
Operating cash flow	**1,031.0**	**986.0**	**416.7**	**610.9**	**1,348.2**
Capital expenditure	(809.0)	(821.0)	(700.0)	(450.0)	(570.0)
(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**	**(217.5)**	**227.5**	**845.6**
Dividends paid	(260.0)	(260.0)	(260.0)	(123.5)	(123.5)
Equity raised/(returned)	(17.0)	(14.0)	0	0	0
(Increase)/decrease in net debt	**(24.0)**	**(171.0)**	**(477.5)**	**103.9**	**722.1**

Balance Sheet (NZ$m)	2018A	2019A	2020E	2021E	2022E
Working capital	89.0	60.0	64.7	65.2	63.1
Fixed assets	5,035.0	5,268.0	3,838.0	3,619.6	3,539.9
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**	**7,149.7**	**6,931.8**	**6,850.1**
Net debt/(cash)	1,391.0	1,542.0	919.5	815.6	93.5
Lease liability	0	0	2,186.0	2,186.0	2,186.0
Other liabilities	2,374.0	2,485.0	2,387.5	2,346.7	2,531.9
Shareholder's funds	2,176.0	2,089.0	1,656.7	1,583.5	2,038.6
Minority interests	0	0	0	0	0
Total funding sources	**5,941.0**	**6,116.0**	**7,149.7**	**6,931.8**	**6,850.1**

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

Spot valuations (NZ$)	
1. Price to book	1.69
2. n/a	n/a
3. n/a	n/a

DCF valuation summary (NZ$m)	
Total firm value	6,919
(Net debt)/cash	(1,619)
Less: Capitalised operating leases	(2,821)
Value of equity	2,479

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	3.0	3.7	3.3	2.8	2.1
EV/EBIT (x)	6.0	9.4	25.1	17.3	5.4
PE (x)	5.1	7.4	25.9	17.5	5.1
Price/NTA (x)	1.0	1.0	1.3	1.4	1.1
Free cash flow yield (%)	11.2	8.3	-14.3	8.1	39.4
Net dividend yield (%)	12.5	12.5	6.3	6.3	12.5
Gross dividend yield (%)	17.4	17.4	8.7	8.7	17.4

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	16.4	11.9	2.0	3.1	13.0
Interest cover EBITDA (x)	32.3	30.2	15.1	19.0	33.2
Net debt/ND+E (%)	39.0	42.5	35.7	34.0	4.4
Net debt/EBITDA (x)	1.3	1.6	0.9	0.8	0.1

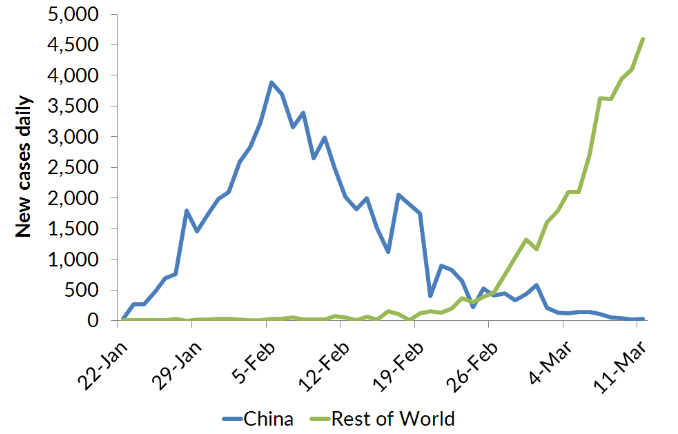
Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	6.9	4.7	1.5	2.0	6.3
Return on equity (%)	17.9	12.9	4.6	7.2	19.1
Return on funds employed (%)	n/a	n/a	n/a	n/a	n/a
EBITDA margin (%)	19.4	16.2	17.9	19.3	22.9
EBIT margin (%)	9.8	6.4	2.4	3.2	9.0
Capex to sales (%)	14.7	14.2	12.9	8.5	9.6
Capex to depreciation (%)	154	145	83	53	69
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	64	92	162	109	64

Operating Performance	2018A	2019A	2020E	2021E	2022E
Available Seat Km (ASK)					
Domestic	6,905	7,104	6,536	6,405	7,045
Tasman and Pacific	12,964	13,640	12,685	12,431	13,675
Long-haul	24,406	25,285	24,021	23,540	25,894
Total	**44,275**	**46,029**	**43,242**	**42,377**	**46,614**
Change (%)	5.0	4.0	-6.1	-2.0	10.0
RASK (cents per ASK)					
Domestic	22.0	22.5	23.1	22.6	23.1
Tasman and Pacific	9.6	9.6	9.4	9.4	9.8
Long-haul	7.9	8.1	7.8	7.6	8.0
Total	**10.6**	**10.8**	**10.6**	**10.4**	**10.8**
Costs					
Ave. jet fuel price (US$/bbl)	68.6	82.0	75.8	60.0	64.5
Fuel supply chain (US$/bbl)	10.0	11.4	11.0	11.0	11.0
Jet fuel cost (US$/bbl)	78.6	93.4	86.8	71.0	75.5
Jet fuel volume (bbl in millions)	9.0	9.1	8.5	8.5	9.3
Ave. NZDUSD rate	0.72	0.67	0.64	0.66	0.67
Jet fuel (NZ$m)	**987**	**1,271**	**1,152**	**918**	**1,043**
Unit fuel (cents/ASK)	2.2	2.8	2.7	2.2	2.2
CASK ex-fuel/forex (cents/ASK)	7.2	7.4	7.7	7.9	7.6

Situation to get a lot worse before it gets better

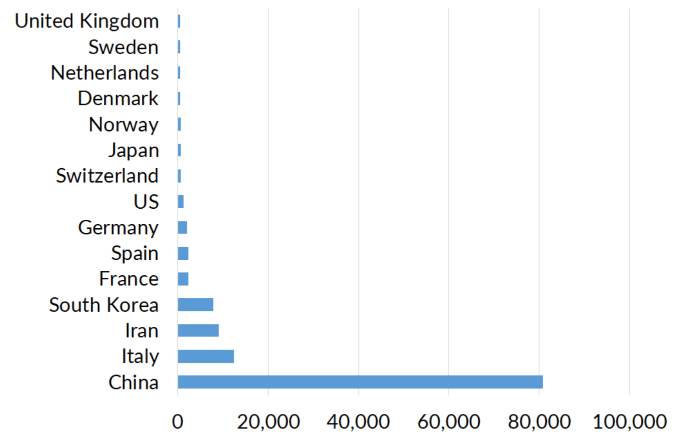
The human reaction to COVID-19 outbreak is escalating at an alarming rate. AIR last cut its capacity expectations for 2H20 earlier this week, while also removing its FY20 earnings guidance. We expect it to make further capacity adjustments reflecting a steeper decline in forward bookings over the coming days/weeks.

Figure 1. It's now a pandemic



Source: WHO, Forsyth Barr analysis

Figure 2. Cases by country (top 15 outbreaks)



Source: WHO Forsyth Barr analysis

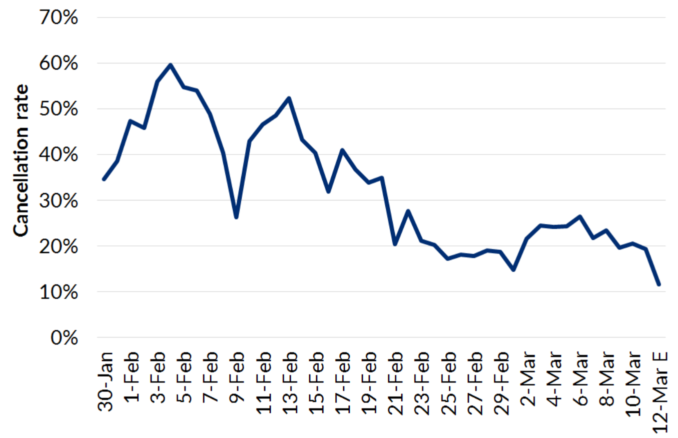
International observations

Below is commentary from airlines and airports from the past few days that highlight the severity of the downturn. AIR's existing capacity cuts (-10% for February to June) appear light in comparison and therefore we envisage further reductions over the coming days and weeks.

- **Qantas:** International capacity to be cut by -25% for the next six months
- **Lufthansa:** -25% capacity cuts to end of March. Up to -50% cuts across group from April
- **Air France:** -25% capacity cuts across European business, -13% in long haul flights
- **United:** Expects 1Q20 loss and revenue to fall by as much as -70% in April/May
- **American:** Reducing international capacity by -10% for northern summer
- **Delta:** Net bookings have fallen by 25–30%. International capacity cut by 20–25% and domestic capacity by 10–15%
- **Auckland Airport:** Shares went into a trading halt yesterday, pending an annoucement
- **Copenhagen Airport:** The first 10 days of March saw international pax fall by one third
- **Sydney Airport:** February international pax down -16.8%; domestic down -4.5%

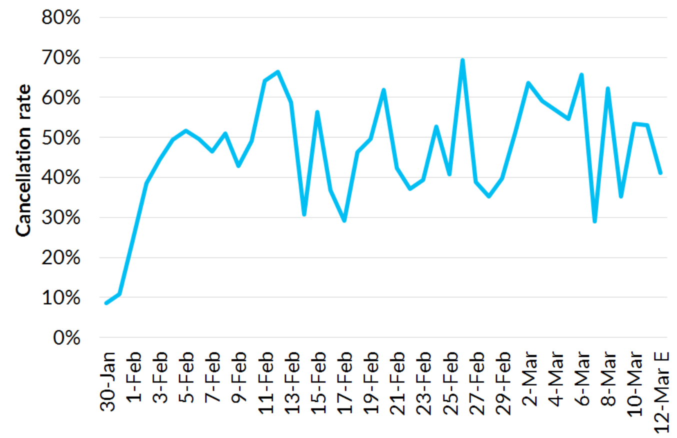
The airline capacity situation in China continues to improve domestically (Figure 1), assisted by Government financial support to the major airlines, but international capacity remains severely impacted (Figure 2) with around half of flights still being cancelled.

Figure 3. Chinese domestic capacity slowly recovering...



Source: Forsyth Barr analysis

Figure 4. ...but international capacity still well down



Source: Forsyth Barr analysis

AIR's operating de-leverage

As a rule of thumb we consider AIR's cost base excluding fuel to be ~40% variable and ~60% fixed. In extreme circumstances (such as now) AIR will variablise some of its fixed cost base through measures such as providing unpaid leave to employees, initiating a hiring freeze for new staff to allow churn to lower labour costs, and delaying capex.

We estimate it has annual fixed operating costs of ~NZ$1.6bn and has generated an average after fuel contribution margin of ~35% in recent years (though we recognise the sensitivity of this margin to fuel cost changes). Consequently, in broad terms, revenue needs to fall ~-20% for AIR to hit PBT break-even. However, this simple assessment is complicated by shifts in RASK (revenue per available seat km), which effectively flow straight to the bottom line. RASK declines have a far more material impact on profitability than volume declines. Therefore, while our revised estimates show a 2H20 revenue decline of -15%, we assume AIR is loss-making. A +/-1% change in RASK impacts AIR's PBT by ~+/-NZ$50m.

Earnings revisions

We make further deep cuts to our earnings forecasts as outlined in Figure 5. We now assume that total group capacity declines by -15% in 2H20, with similar declines in 1H21. AIR generates a PBT loss in 2H20, with losses narrowing through 1H21 as cost measures and lower fuel prices begin to positively impact. The impact on cashflows in FY20 and FY21 is exacerbated by the working capital impact of lower forward bookings, which weakens AIR's balance sheet temporarily.

Figure 5. Earnings revisions (NZ$m)

	FY20E			FY21E			FY22E		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Group RASK growth	-2.3%	-2.0%	30 bps	-1.5%	-1.5%	0 bps	3.7%	3.7%	7 bps
Group ASK growth	-2.0%	-6.1%	-410 bps	0.0%	-2.0%	-200 bps	5.6%	10.0%	444 bps
Total fuel cost (ex forex hedging)	1,184	1,152	(32)	978	918	(60)	1,066	1,043	(23)
Sales revenue	5,611	5,426	-3%	5,548	5,276	-5%	6,031	5,958	-1%
Underlying PBT	**142**	**106**	**-25%**	**270**	**158**	**-41%**	**538**	**540**	**0%**
Underlying NPAT	102	77	-25%	194	114	-41%	387	389	0%
Underlying EPS (cents)	9.1	6.8	-25%	17.2	10.1	-41%	34.3	34.4	0%
DPS (cents)	11.0	11.0	0%	11.0	11.0	0%	22.0	22.0	0%

Source: Forsyth Barr analysis

Valuation

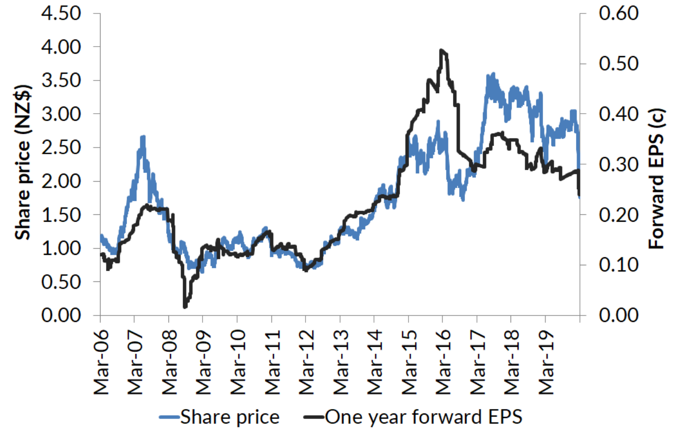
The book values of asset heavy companies provide useful valuation benchmark during times of heightened uncertainty. AIR's share price has fallen to book value in recent weeks. Earlier this week we removed our PE relative measure from our target price methodology. We now also remove our DCF, leaving just a price to book measure, which we adjust to incorporate net tangible assets (NTA) only. This lowers our target price to NZ$1.80.

Historically, AIR has trading for long periods at meaningful discounts to book value. However, these periods, particularly post-GFC were impacted by sluggish demand and high/rising oil prices. The medium term outlook, beyond COVID-19, is supported by a material decline in fuel prices, which will support a "V" shaped recovery in earnings. Therefore, any material discount to book value that opens up may provide a better entry point for investors.

Figure 6. Price to book value

Source: Datastream, Forsyth Barr analysis

Figure 7. Near term earnings are a key driver of share price



Source: Eikon, 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, is severely impacting the near term earnings outlook. However, a substantial drop in oil prices provides some respite to profitability over the medium term. 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 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).

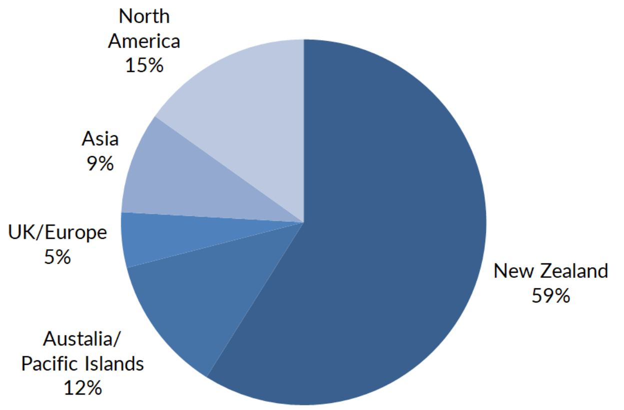
Financial structure

- **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

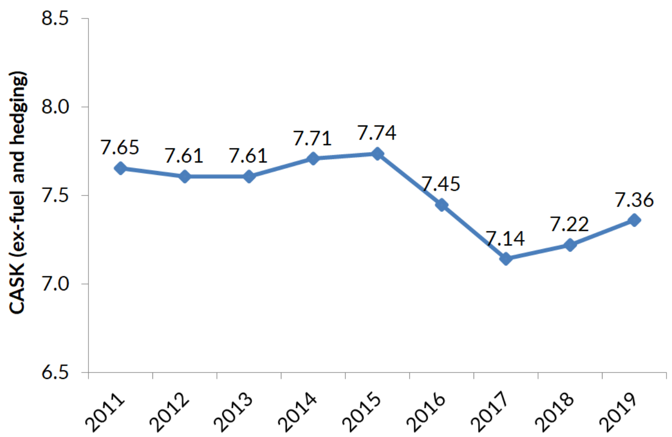
- **Left field events**: Disease outbreak (for example coronavirus), volcanic ash clouds, terrorism events.
- **Macro**: Volatility in exchange rates and global oil prices can have a dramatic impact on profitability.
- **Safety**: Any blip on AIR's good safety record could impact passenger confidence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

Figure 8. Geographic revenue mix in FY19



Source: Forsyth Barr analysis

Figure 9. Cost per ASK under control (cents per ASK)



Source: Forsyth Barr analysis

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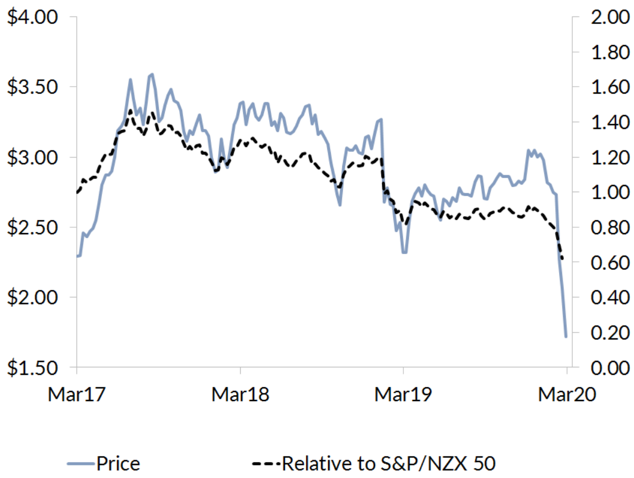
Figure 10. Price performance



Source: Forsyth Barr analysis

Figure 11. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	52.5%

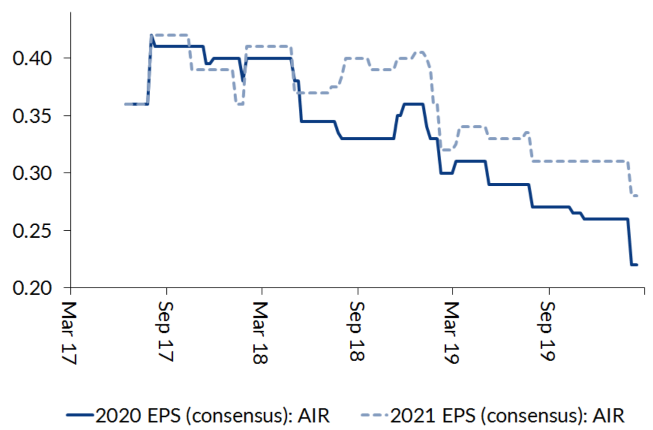
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 12. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash 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$1.76**	**NZ$1,976**	**25.9x**	**17.5x**	**3.6x**	**3.5x**	**27.5x**	**21.0x**	**6.2%**
DEUTSCHE LUFTHANSA-REG	LHA GY	€10.20	€4,875	3.8x	3.3x	2.4x	2.2x	5.4x	4.9x	8.0%
AIR FRANCE-KLM	AF FP	€4.88	€2,093	5.3x	3.0x	2.1x	2.0x	8.1x	6.6x	0.0%
SINGAPORE AIRLINES	SIA SP	S$7.68	S$9,102	18.0x	14.3x	6.0x	5.4x	19.5x	16.8x	3.8%
CATHAY PACIFIC AIRWAYS	293 HK	HK$10.18	HK$40,047	30.7x	25.4x	8.8x	n/a	54.3x	48.3x	2.4%
QANTAS AIRWAYS	QAN AT	A$4.04	A$6,023	10.4x	7.5x	3.7x	3.4x	11.1x	8.9x	5.9%
VIRGIN AUSTRALIA HOLDINGS LT	VAH AT	A$0.07	A$608	<0x	<0x	7.1x	5.9x	25.5x	14.1x	n/a
AMERICAN AIRLINES GROUP INC	AAL US	US$15.85	US$6,751	3.9x	3.3x	5.8x	6.3x	11.8x	10.6x	2.6%
UNITED AIRLINES HOLDINGS INC	UAL US	US$49.01	US$12,152	4.3x	3.9x	4.1x	3.9x	6.6x	6.2x	0.0%
			Compco Average:	**10.9x**	**8.7x**	**5.0x**	**4.2x**	**17.8x**	**14.6x**	**3.3%**
EV = Current Market Cap + Actual Net Debt			**AIR Relative:**	**138%**	**101%**	**-28%**	**-17%**	**55%**	**44%**	**92%**

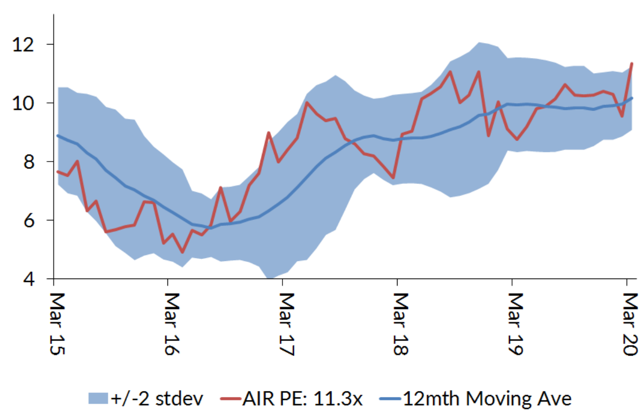
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (AIR) companies fiscal year end

Figure 13. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 14. One year forward PE (x)



Source: Forsyth Barr analysis

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OUTPERFORM	NEUTRAL	UNDERPERFORM
37.3%	49.0%	13.7%

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