

Air New Zealand

Airline Armageddon; Downgrade to UNDERPERFORM

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UNDERPERFORM

We lower our rating on Air New Zealand (AIR) to UNDERPERFORM from NEUTRAL in light of the New Zealand Government's heightened travel restrictions in response to the worsening COVID-19 outbreak, which we expect to have an unprecedented impact on AIR's financial health. Substantial earnings losses are now likely over the coming months and the need for balance sheet support is increasingly likely. While we don't know what the impact on demand will be, it will be substantial. In our forecasts we assume -75% on international sectors and -50% on domestic for the duration of the travel restrictions. We have no visibility as to when the restrictions will lift, however, we view it as prudent to assume that air travel will be severely impacted for at least the next six months. While we believe AIR may require additional capital to provide liquidity and protect its balance sheet, the government's position as majority shareholder is helpful (we expect it would step in and underwrite a capital raise, if required), assuming politics don't get in the way of potential financial assistance.

NZX Code	AIR	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$1.54	NPAT* (NZ\$m)	270.1	-116.4	-91.9	383.2	EV/EBITDA	3.4	4.8	4.7	2.6
Target price	NZ\$1.00	EPS* (NZc)	23.9	-10.3	-8.1	33.9	EV/EBIT	8.7	n/a	n/a	6.6
Risk rating	High	EPS growth* (%)	-30.4	n/a	21.1	n/a	PE	6.4	n/a	n/a	4.5
Issued shares	1123.0m	DPS (NZc)	22.0	11.0	11.0	22.0	Price / NTA	0.9	1.3	1.5	1.2
Market cap	NZ\$1,729m	Imputation (%)	100	100	100	100	Cash div yld (%)	14.3	7.1	7.1	14.3
Avg daily turnover	933.1k (NZ\$2,434k)	*Based on normalised profits					Gross div yld (%)	19.8	9.9	9.9	19.8

What's changed?

- **Earnings forecasts:** Further material declines for both FY20 and FY21; forecasts have a high margin for error
- **Target price:** Lowered to NZ\$1.00 (based on NTA adjusted for cash losses over next 12 months)

Government restrictions will cripple international business

The mandatory self-isolation requirement for international arrivals will have a devastating impact on air travel demand. We expect AIR to undertake severe capacity cuts over the coming days, and variablise as much of its fixed cost base as possible; a large proportion is labour. Excluding capex, we estimate its fixed overheads are ~NZ\$160m per month.

In need of additional capital

Our revised modelling, which has a very high margin of error, assumes that AIR generates material losses in both FY20 and FY21. This, combined with the working capital hit from a sharp decline in forward bookings, means its balance sheet will be under duress. A capital injection may be necessary, which we expect the government would fully underwrite, given the circumstances.

Book value needs to be adjusted for impending losses

AIR's net tangible asset (NTA) value per share is NZ\$1.69 based on FY19, and NZ\$1.63 based on 1H20. NTA provides an important valuation benchmark, however, the impending cash losses that AIR will incur during this downturn will detrimentally impact. We forecast NTA of NZ\$1.23 at FY20 year end and NZ\$1.02 at FY21.

Air New Zealand Ltd (AIR)

Priced as at 13 Mar 2020 (NZ\$)

1.54
12-month target price (NZ\$)*
1.00

Expected share price return	-35.1%
Net dividend yield	7.1%
Estimated 12-month return	-27.9%

Spot valuations (NZ\$)

1. Price to book	1.00
2. n/a	n/a
3. n/a	n/a

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	
(Net debt)/cash	(1,620)
Less: Capitalised operating leases	(2,821)
Value of equity	

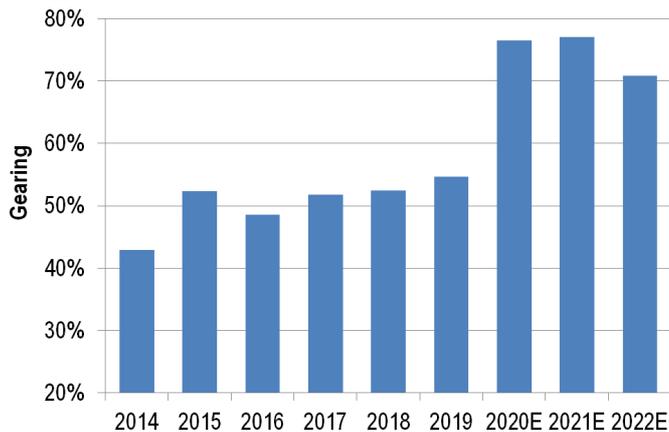
Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Valuation Ratios	2018A	2019A	2020E	2021E	2022E
Sales revenue	5,485.0	5,785.1	4,837.1	4,707.2	5,966.8	EV/EBITDA (x)	2.8	3.4	4.8	4.7	2.6
Normalised EBITDA	1,065.0	935.1	718.2	750.3	1,371.0	EV/EBIT (x)	5.6	8.7	n/a	n/a	6.6
Depreciation and amortisation	(525.0)	(567.0)	(844.8)	(848.9)	(830.3)	PE (x)	4.5	6.4	n/a	n/a	4.5
Normalised EBIT	540.0	368.1	(126.6)	(98.7)	540.7	Price/NTA (x)	0.9	0.9	1.3	1.5	1.2
Net interest	(33.0)	(31.0)	(78.0)	(73.2)	(54.1)	Free cash flow yield (%)	12.8	9.5	-68.8	38.4	41.8
Associate income	33.0	37.0	43.0	44.3	45.6	Net dividend yield (%)	14.3	14.3	7.1	7.1	14.3
Tax	(150.0)	(104.0)	45.3	35.7	(149.0)	Gross dividend yield (%)	19.8	19.8	9.9	9.9	19.8
Minority interests	0	0	0	0	0						
Normalised NPAT	390.0	270.1	(116.4)	(91.9)	383.2	Capital Structure	2018A	2019A	2020E	2021E	2022E
Abnormals/other	0	0	33.1	0	0	Interest cover EBIT (x)	16.4	11.9	n/a	n/a	10.0
Reported NPAT	390.0	270.1	(149.5)	(91.9)	383.2	Interest cover EBITDA (x)	32.3	30.2	9.2	10.2	25.3
Normalised EPS (cps)	34.4	23.9	(10.3)	(8.1)	33.9	Net debt/ND+E (%)	39.0	42.5	53.8	47.7	25.9
DPS (cps)	22.0	22.0	11.0	11.0	22.0	Net debt/EBITDA (x)	1.3	1.6	2.5	1.6	0.4
Growth Rates	2018A	2019A	2020E	2021E	2022E	Key Ratios	2018A	2019A	2020E	2021E	2022E
Revenue (%)	7.4	5.5	-16.4	-2.7	26.8	Return on assets (%)	6.9	4.7	-1.4	-1.2	6.3
EBITDA (%)	2.9	-12.2	-23.2	4.5	82.7	Return on equity (%)	17.9	12.9	-7.4	-6.9	24.3
EBIT (%)	-0.4	-31.8	n/a	n/a	n/a	Return on funds employed (%)	n/a	n/a	n/a	n/a	n/a
Normalised NPAT (%)	2.9	-30.8	n/a	n/a	n/a	EBITDA margin (%)	19.4	16.2	14.8	15.9	23.0
Normalised EPS (%)	3.4	-30.4	n/a	n/a	n/a	EBIT margin (%)	9.8	6.4	-2.6	-2.1	9.1
Ordinary DPS (%)	4.8	0.0	-50.0	0.0	100.0	Capex to sales (%)	14.7	14.2	14.5	9.6	9.6
						Capex to depreciation (%)	154	145	83	53	69
						Imputation (%)	100	100	100	100	100
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Pay-out ratio (%)	64	92	-107	-135	65
EBITDA	1,065.0	935.1	718.2	750.3	1,371.0						
Working capital change	227.0	245.0	0	0	0	Operating Performance	2018A	2019A	2020E	2021E	2022E
Interest & tax paid	(183.0)	(135.0)	7.6	(9.9)	(175.6)	Available Seat Km (ASK)					
Other	(78.0)	(59.1)	(1,215.4)	373.4	97.9	Domestic	6,905	7,104	5,896	5,778	7,000
Operating cash flow	1,031.0	986.0	(489.6)	1,113.7	1,293.3	Tasman and Pacific	12,964	13,640	10,912	10,694	14,000
Capital expenditure	(809.0)	(821.0)	(700.0)	(450.0)	(570.0)	Long-haul	24,406	25,285	20,481	20,071	25,000
(Acquisitions)/divestments	33.0	13.0	40.0	40.0	40.0	Total	44,275	46,029	37,289	36,543	46,000
Other	(2.0)	(75.0)	25.8	26.6	27.4	Change (%)	5.0	4.0	-19.0	-2.0	25.9
Funding available/(required)	253.0	103.0	(1,123.8)	730.3	790.7						
Dividends paid	(260.0)	(260.0)	(260.0)	(123.5)	(123.5)	RASK (cents per ASK)					
Equity raised/(returned)	(17.0)	(14.0)	0	0	0	Domestic	22.0	22.5	23.1	22.6	23.1
(Increase)/decrease in net debt	(24.0)	(171.0)	(1,383.8)	606.7	667.2	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	10.7	10.5	10.8
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Costs					
Working capital	89.0	60.0	66.5	66.9	63.1	Ave. jet fuel price (US\$/bbl)	68.6	82.0	75.8	60.0	64.5
Fixed assets	5,035.0	5,268.0	3,838.0	3,619.6	3,539.9	Fuel supply chain (US\$/bbl)	10.0	11.4	11.0	11.0	11.0
Intangibles	170.0	186.0	186.0	186.0	186.0	Jet fuel cost (US\$/bbl)	78.6	93.4	86.8	71.0	75.5
Right of use asset	0	0	2,459.0	2,459.0	2,459.0	Jet fuel volume (bbl in millions)	9.0	9.1	7.3	7.3	9.1
Other assets	647.0	602.0	602.0	602.0	602.0	Ave. NZDUSD rate	0.72	0.67	0.64	0.66	0.67
Total funds employed	5,941.0	6,116.0	7,151.5	6,933.5	6,850.0	Jet fuel (NZ\$m)	987	1,271	993	792	1,029
Net debt/(cash)	1,391.0	1,542.0	1,825.8	1,219.0	551.8	Unit fuel (cents/ASK)	2.2	2.8	2.7	2.2	2.2
Lease liability	0	0	2,186.0	2,186.0	2,186.0	CASK ex-fuel/forex (cents/ASK)	7.2	7.4	8.4	8.6	7.7
Other liabilities	2,374.0	2,485.0	1,570.2	2,192.1	2,534.4						
Shareholder's funds	2,176.0	2,089.0	1,569.5	1,336.4	1,577.8						
Minority interests	0	0	0	0	0						
Total funding sources	5,941.0	6,116.0	7,151.5	6,933.5	6,850.0						

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

In need of capital; government as majority shareholder should help

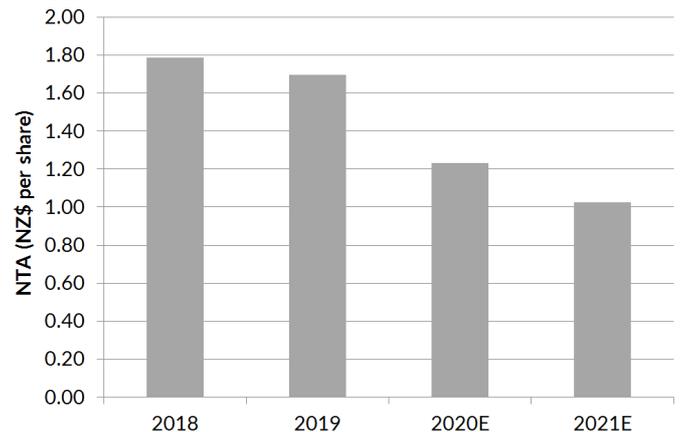
Air New Zealand's (AIR) balance sheet will be severely tested by the devastating impact of the COVID-19 outbreak on demand, in our opinion. We expect gearing to rise dramatically to ~76% in FY20, well in excess of the company's target range of 45%–55%.

Figure 1. Gearing to lift well beyond 45%–55% target band



Source: AIR, Forsyth Barr analysis

Figure 2. NTA – historic and forecast



Source: AIR, Forsyth Barr analysis

Valuation

The book values of asset heavy companies provide useful valuation benchmarks during times of heightened uncertainty. AIR's share price has fallen below its book value. However, we expect its book value to fall materially from current levels over the next 12 months, in light of impending cash flow losses – NZ\$1.23 per share at year end FY20 and NZ\$1.02 at year end FY21. We, therefore, lower our target price to N\$1.00 (from NZ\$1.80).

Earnings revisions

We make further deep cuts to our earnings forecasts as outlined in Figure 3. This downgrade reflects the fourth time we've downgraded earnings in the past 2.5 weeks, reflective of the speed and severity of the COVID-19 outbreak.

We now assume that total group capacity declines by -41% in 2H20. We expect AIR's PBT loss in 2H20 to more than offset the PBT profit in 1H20. 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.

Figure 3. Earnings revisions (NZ\$m)

	FY20E			FY21E			FY22E		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Group RASK growth	-2.0%	-1.0%	98 bps	-1.5%	-1.5%	-1 bps	3.7%	3.1%	-69 bps
Group ASK growth	-6.1%	-19.0%	-1293 bps	-2.0%	-2.0%	0 bps	10.0%	25.9%	1588 bps
Total fuel cost (ex forex hedging)	1,152	993	(159)	918	792	(126)	1,043	1,029	(14)
Sales revenue	5,426	4,837	-11%	5,276	4,707	-11%	5,958	5,967	0%
Underlying PBT	106	(162)	-252%	158	(128)	-181%	540	532	-1%
Underlying NPAT	77	(116)	-252%	114	(92)	-181%	389	383	-1%
Underlying EPS (cents)	6.8	(10.3)	-252%	10.1	(8.1)	-181%	34.4	33.9	-1%
DPS (cents)	11.0	11.0	0%	11.0	0.0	-100%	22.0	22.0	0%

Source: 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. However, the dramatic impact of COVID-19 on demand through consumer behaviour and government intervention is likely to shift AIR well into loss-making territory for the next few months. A substantial drop in oil prices provides some respite to profitability over the medium term, but that seems a long way off. **UNDERPERFORM.**

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).

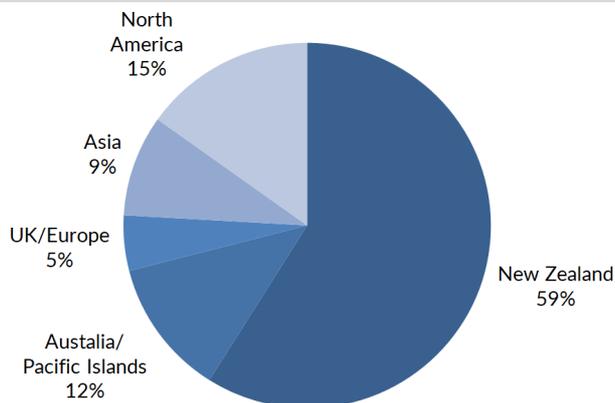
Financial structure

- **Balance sheet:** Gearing is at the top end of management’s 45%–55% target band.
- **Capital raise:** In light of the severe demand implications of COVID-19 we believe a capital raise is increasingly likely to provide liquidity and protect the balance sheet.

Risk factors

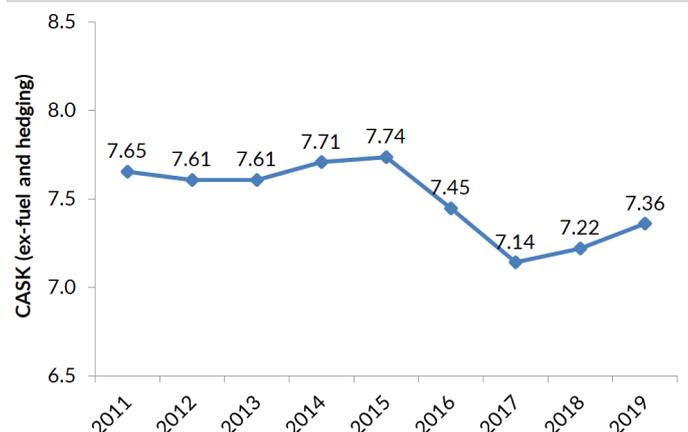
- **Left field events:** Disease outbreak (for example coronavirus), volcanic ash clouds, terrorism events.
- **Macro:** Volatility in exchange rates and global oil prices can have a dramatic impact on profitability.
- **Safety:** Any blip on AIR’s good safety record could impact passenger confidence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

Figure 4. Geographic revenue mix in FY19



Source: Forsyth Barr analysis

Figure 5. Cost per ASK under control (cents per ASK)



Source: Forsyth Barr analysis

Figure 6. Price performance



Source: Forsyth Barr analysis

Figure 7. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	52.5%

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

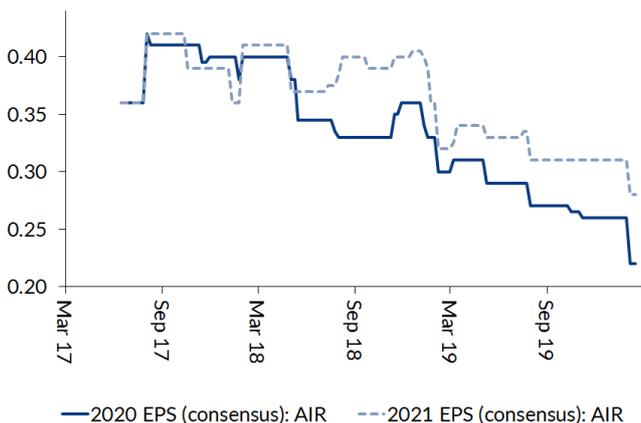
Figure 8. International valuation comparisons

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\$1.54	NZ\$1,729	<0x	<0x	4.6x	4.4x	<0x	<0x	7.1%
DEUTSCHE LUFTHANSA-REG	LHA GY	€8.76	€4,191	3.4x	3.0x	2.3x	2.1x	5.3x	4.7x	9.3%
AIR FRANCE-KLM	AF FP	€4.26	€1,828	4.7x	2.7x	2.1x	1.9x	8.0x	6.5x	0.0%
SINGAPORE AIRLINES	SIA SP	S\$7.34	S\$8,699	17.2x	13.9x	5.9x	5.3x	19.2x	16.8x	4.0%
CATHAY PACIFIC AIRWAYS	293 HK	HK\$9.77	HK\$38,434	1.5x	<0x	7.7x	7.4x	>75x	>75x	2.2%
QANTAS AIRWAYS	QAN AT	A\$3.64	A\$5,426	9.4x	6.8x	3.5x	3.3x	10.5x	8.4x	6.6%
VIRGIN AUSTRALIA HOLDINGS LT	VAH AT	A\$0.06	A\$507	<0x	<0x	7.0x	5.8x	25.0x	13.8x	n/a
AMERICAN AIRLINES GROUP INC	AAL US	US\$14.80	US\$6,306	3.6x	3.1x	5.7x	6.2x	11.7x	10.5x	2.8%
UNITED AIRLINES HOLDINGS INC	UAL US	US\$40.42	US\$10,023	3.5x	3.3x	3.8x	3.6x	6.1x	5.9x	0.0%
Compco Average:				6.2x	5.4x	4.7x	4.5x	12.2x	9.5x	3.5%
AIR Relative:				n/a	n/a	-4%	-2%	n/a	n/a	102%

EV = Current Market Cap + Actual Net Debt

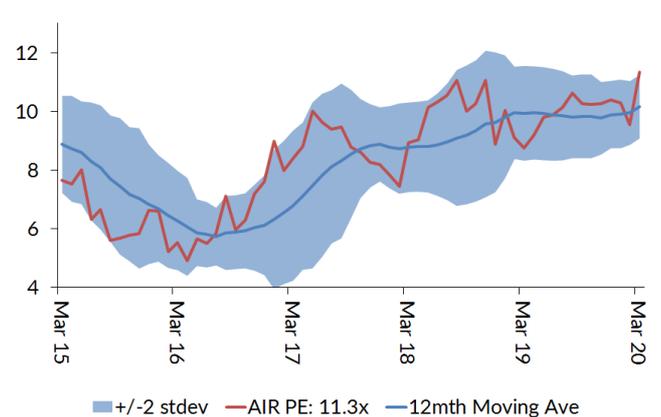
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (AIR) companies fiscal year end

Figure 9. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)



Source: Forsyth Barr analysis

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OUTPERFORM	NEUTRAL	UNDERPERFORM
33.3%	52.9%	13.7%

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