

Air New Zealand

Government Provides a Necessary Evil

ANDY BOWLEY

andy.bowley@forsythbarr.co.nz
+64 4 495 8246

SCOTT ANDERSON

scott.anderson@forsythbarr.co.nz
+64 4 914 2219

UNDERPERFORM

Air New Zealand (AIR) has funding certainty in the form of a government loan of up to NZ\$900m, which provides ample liquidity and cash burn financing for the foreseeable future, however, we believe it will need additional equity within the next 12 months. The loan is conditional on AIR cancelling its interim dividend and not paying any further dividends until the loan facility ends. Other terms are favourable to the government. AIR's immediate future is secure, despite a worsening demand backdrop with its international fleet soon to be all but grounded. Consequently, there is too much demand (and therefore cash flow) uncertainty over the near term to have any degree of confidence on what position AIR's balance sheet will look like in six, let alone 12 months. We, therefore, retain an UNDERPERFORM rating, acknowledging that downside risk exists to our adjusted NTA derived target price (NZ\$1.00) from potential aircraft impairments.

NZX Code	AIR	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$0.99	NPAT* (NZ\$m)	270.1	-116.4	-91.9	383.2	EV/EBITDA	2.8	3.9	3.9	2.1
Target price	NZ\$1.00	EPS* (NZc)	23.9	-10.3	-8.1	33.9	EV/EBIT	7.0	n/a	n/a	5.4
Risk rating	High	EPS growth* (%)	-30.4	n/a	21.1	n/a	PE	4.1	n/a	n/a	2.9
Issued shares	1123.0m	DPS (NZc)	22.0	11.0	11.0	22.0	Price / NTA	0.6	0.8	1.0	0.8
Market cap	NZ\$1,112m	Imputation (%)	100	100	100	100	Cash div yld (%)	22.2	11.1	11.1	22.2
Avg daily turnover	965.6k (NZ\$2,430k)	*Based on normalised profits					Gross div yld (%)	30.9	15.4	15.4	30.9

Loan terms favourable to government

The NZ\$900m loan facility comes in two tranches: (1) NZ\$600m — effective interest rate 7%–8%, and (2) NZ\$300m — ~9% effective interest rate. It has a duration of up to 24 months. The effective interest rates step up by +1% on both tranches after 12 months. The government has the ability to trigger a capital raise after six months, or convert the loan to equity. It is conditional on (i) the cancellation of the 11c interim dividend, which was due to be paid on 25 March 2020, and (ii) Government agreement of AIR's operating finance plan. AIR may choose not to draw down the facility if other cheaper forms of funding become available.

Further capacity cuts; minimising cash burn

AIR is likely to cut back on its already depleted international scheduling in light of the government's effective border closure announcement. The majority of its fleet will be grounded. It has signalled a need to reduce its workforce by ~30%, in recognition that (1) it needs to lower its cash burn as much as possible over the coming months, and (2) it will be a smaller airline when COVID-19 ends, acknowledging that the aviation industry won't return to "normal" quickly. The longer the fleet is grounded the deeper the workforce cuts are likely to get. In the meantime, its cash burn will be a proportion of monthly cash overheads of ~NZ\$160m.

Adjusted NTA approach; impairment risk

Our target price of NZ\$1.00 is unchanged, though we recognise some downside risk as although we account for impending cash losses in our adjusted NTA approach, we have yet to factor in the prospect of aircraft impairments, which is possible particularly if the demand for aviation is structurally lower longer term as a result of COVID-19. AIR may need to divest excess fleet, in light of its management commentary that the airline will be smaller as a result of the outbreak. While the company has taken few impairment charges in recent history, in FY11, immediately after the global financial crisis, the market value of the fleet was ~NZ\$437m lower than book (or -22%). It didn't take an impairment charge then given the recoverable value from continued use was considered higher.

Air New Zealand Ltd (AIR)

Priced as at 20 Mar 2020 (NZ\$)

0.99

12-month target price (NZ\$)*

1.00

Expected share price return

1.0%

Net dividend yield

11.1%

Estimated 12-month return

12.1%

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

(1,623)

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)	2.2	2.8	3.9	3.9	2.1
Normalised EBITDA	1,065.0	935.1	718.2	750.3	1,371.0	EV/EBIT (x)	4.4	7.0	n/a	n/a	5.4
Depreciation and amortisation	(525.0)	(567.0)	(844.8)	(848.9)	(830.3)	PE (x)	2.9	4.1	n/a	n/a	2.9
Normalised EBIT	540.0	368.1	(126.6)	(98.7)	540.7	Price/NTA (x)	0.6	0.6	0.8	1.0	0.8
Net interest	(33.0)	(31.0)	(78.0)	(73.2)	(54.1)	Free cash flow yield (%)	20.0	14.8	-107.0	59.7	65.1
Associate income	33.0	37.0	43.0	44.3	45.6	Net dividend yield (%)	22.2	22.2	11.1	11.1	22.2
Tax	(150.0)	(104.0)	45.3	35.7	(149.0)	Gross dividend yield (%)	30.9	30.9	15.4	15.4	30.9
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
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Imputation (%)	100	100	100	100	100
EBITDA	1,065.0	935.1	718.2	750.3	1,371.0	Pay-out ratio (%)	64	92	-107	-135	65
Working capital change	227.0	245.0	0	0	0						
Interest & tax paid	(183.0)	(135.0)	7.6	(9.9)	(175.6)	Operating Performance	2018A	2019A	2020E	2021E	2022E
Other	(78.0)	(59.1)	(1,215.4)	373.4	97.9						
Operating cash flow	1,031.0	986.0	(489.6)	1,113.7	1,293.3	Available Seat Km (ASK)					
Capital expenditure	(809.0)	(821.0)	(700.0)	(450.0)	(570.0)	Domestic	6,905	7,104	5,896	5,778	7,000
(Acquisitions)/divestments	33.0	13.0	40.0	40.0	40.0	Tasman and Pacific	12,964	13,640	10,912	10,694	14,000
Other	(2.0)	(75.0)	25.8	26.6	27.4	Long-haul	24,406	25,285	20,481	20,071	25,000
Funding available/(required)	253.0	103.0	(1,123.8)	730.3	790.7	Total	44,275	46,029	37,289	36,543	46,000
Dividends paid	(260.0)	(260.0)	(260.0)	(123.5)	(123.5)	Change (%)	5.0	4.0	-19.0	-2.0	25.9
Equity raised/(returned)	(17.0)	(14.0)	0	0	0						
(Increase)/decrease in net debt	(24.0)	(171.0)	(1,383.8)	606.7	667.2	RASK (cents per ASK)					
						Domestic	22.0	22.5	23.1	22.6	23.1
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Tasman and Pacific	9.6	9.6	9.4	9.4	9.8
Working capital	89.0	60.0	66.5	66.9	63.1	Long-haul	7.9	8.1	7.8	7.6	8.0
Fixed assets	5,035.0	5,268.0	3,838.0	3,619.6	3,539.9	Total	10.6	10.8	10.7	10.5	10.8
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	Costs					
Other assets	647.0	602.0	602.0	602.0	602.0	Ave. jet fuel price (US\$/bbl)	68.6	82.0	75.8	60.0	64.5
Total funds employed	5,941.0	6,116.0	7,151.5	6,933.5	6,850.0	Fuel supply chain (US\$/bbl)	10.0	11.4	11.0	11.0	11.0
Net debt/(cash)	1,391.0	1,542.0	1,825.8	1,219.0	551.8	Jet fuel cost (US\$/bbl)	78.6	93.4	86.8	71.0	75.5
Lease liability	0	0	2,186.0	2,186.0	2,186.0	Jet fuel volume (bbl in millions)	9.0	9.1	7.3	7.3	9.1
Other liabilities	2,374.0	2,485.0	1,570.2	2,192.1	2,534.4	Ave. NZDUSD rate	0.72	0.67	0.64	0.66	0.67
Shareholder's funds	2,176.0	2,089.0	1,569.5	1,336.4	1,577.8	Jet fuel (NZ\$m)	987	1,271	993	792	1,029
Minority interests	0	0	0	0	0	Unit fuel (cents/ASK)	2.2	2.8	2.7	2.2	2.2
Total funding sources	5,941.0	6,116.0	7,151.5	6,933.5	6,850.0	CASK ex-fuel/forex (cents/ASK)	7.2	7.4	8.4	8.6	7.7

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

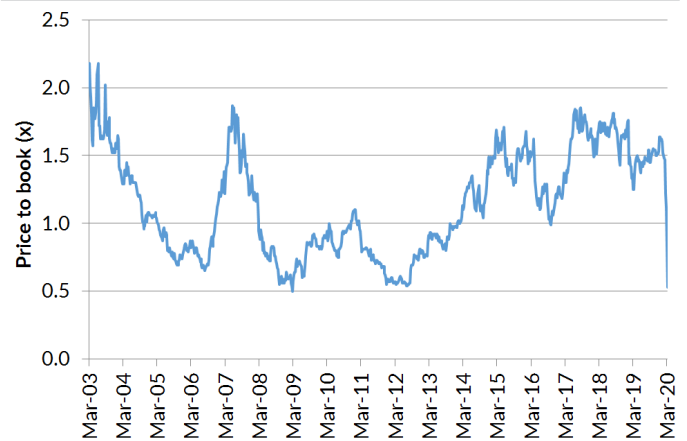
Valuation

Figure 1. AIR's net tangible assets (NZ\$m)

	FY19
Total equity	2,089
Less: Intangibles	(186)
NTA at 30 June 2019	1,903
Projected NTA change: FY20	(519)
Projected NTA change: FY21	(237)
Adjusted NTA	1,147
Shares on issue (m)	1,129.0
NTA per share (NZ\$ per share)	1.02

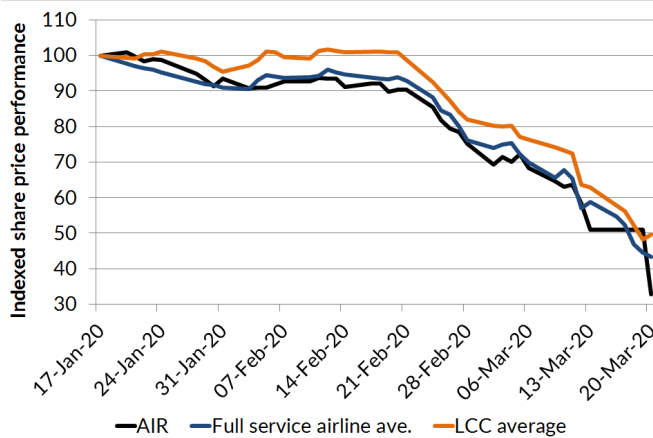
Source: Forsyth Barr analysis

Figure 2. Price to book has collapsed



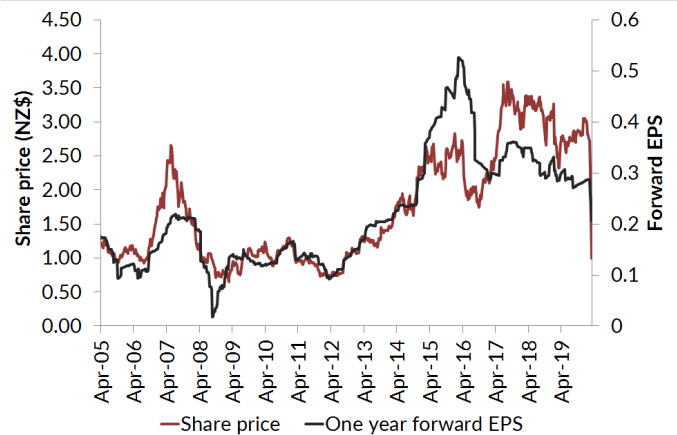
Source: Datastream, Forsyth Barr analysis

Figure 3. Share price performance: AIR vs other listed airlines



Source: Eikon, Forsyth Barr analysis

Figure 4. Near term earnings are now unforecastable



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. 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 structural 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 secular 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).

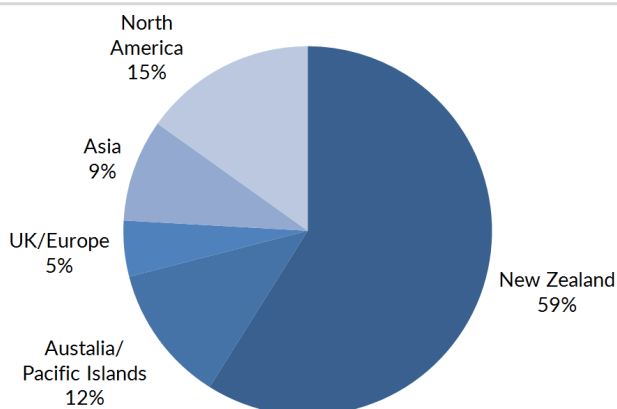
Financial structure

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

Risk factors

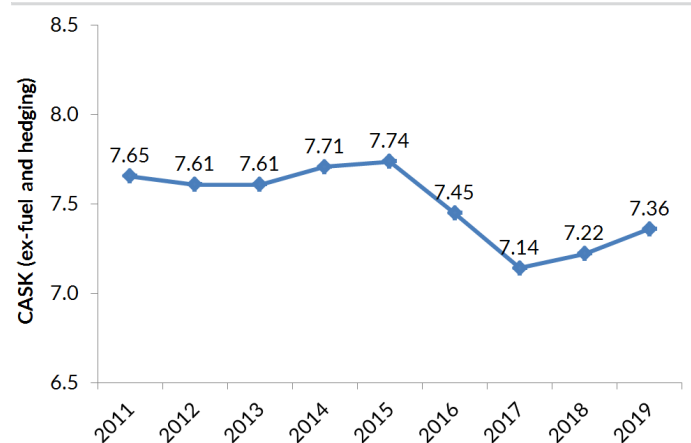
- **Left field events:** Disease outbreak (for example COVID-19), volcanic ash clouds, terrorism events.
- **Macro:** Volatility in exchange rates and global oil prices can have a dramatic impact on profitability.
- **Safety:** Any blip on AIR's good safety record could impact passenger confidence in the airline.

Figure 5. Geographic exposure mix in FY19

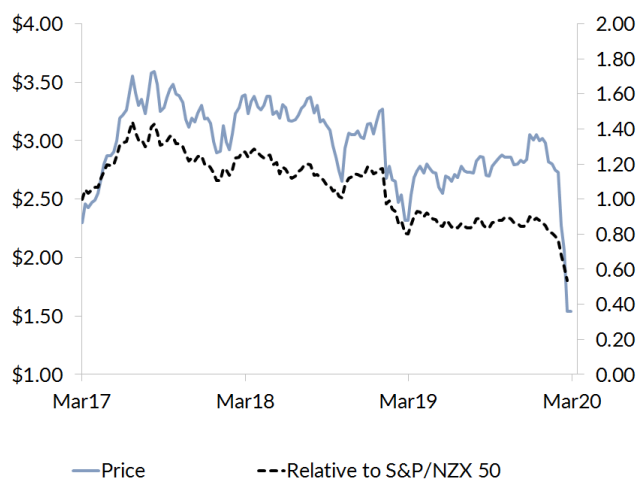


Source: Forsyth Barr analysis

Figure 6. Cost per ASK under control (cents per ASK)



Source: Forsyth Barr analysis

Figure 7. Price performance


Source: Forsyth Barr analysis

Figure 8. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	52.5%

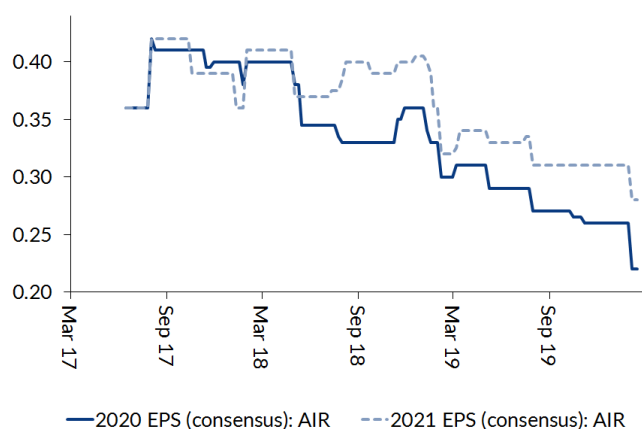
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 9. International valuation comparisons

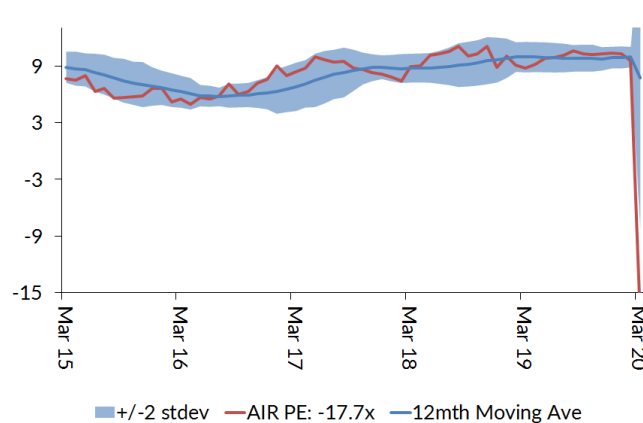
Company	Code	Price	Mkt Cap (m)	PE 2020E	PE 2021E	EV/EBITDA 2020E	EV/EBITDA 2021E	EV/EBIT 2020E	EV/EBIT 2021E	Cash Yld 2021E
(metrics re-weighted to reflect AIR's balance date - June)										
Air New Zealand	AIR NZ	NZ\$0.99	NZ\$1,112	<0x	<0x	3.7x	3.5x	<0x	<0x	11.1%
DEUTSCHE LUFTHANSA-REG	LHA GY	€8.97	€4,288	4.5x	4.0x	1.9x	1.8x	5.5x	4.7x	8.7%
AIR FRANCE-KLM	AF FP	€4.55	€1,950	5.0x	2.9x	2.2x	2.0x	7.9x	6.4x	0.0%
SINGAPORE AIRLINES	SIA SP	S\$6.12	S\$7,253	16.1x	12.1x	5.6x	5.2x	18.3x	17.1x	4.3%
CATHAY PACIFIC AIRWAYS	293 HK	HK\$8.16	HK\$32,100	5.3x	2.4x	7.7x	7.4x	<0x	<0x	1.9%
QANTAS AIRWAYS	QAN AT	A\$2.14	A\$3,190	13.0x	6.1x	3.5x	3.0x	15.5x	10.1x	10.5%
VIRGIN AUSTRALIA HOLDINGS LT	VAH AT	A\$0.06	A\$490	<0x	<0x	6.2x	7.9x	<0x	16.3x	n/a
AMERICAN AIRLINES GROUP INC	AAL US	US\$10.41	US\$4,440	11.2x	11.0x	6.9x	7.6x	20.6x	19.6x	3.6%
UNITED AIRLINES HOLDINGS INC	UAL US	US\$23.18	US\$5,745	2.9x	2.9x	3.9x	3.9x	6.8x	6.8x	0.0%
Compco Average:				8.3x	5.9x	4.7x	4.8x	12.4x	11.6x	4.1%
AIR Relative:				n/a	n/a	-22%	-27%	n/a	n/a	168%

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 10. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 11. One year forward PE (x)


Source: Forsyth Barr analysis

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OUTPERFORM	NEUTRAL	UNDERPERFORM
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