

Air New Zealand

NAVigating to FY20

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UNDERPERFORM

Air New Zealand's (AIR) reinstated FY20 earnings guidance highlights the severity of COVID-19 on its profitability, with the company pointing to a material 2H20 underlying loss, albeit at a lower level than we were expecting. New underlying PBT guidance is for a loss up to -NZ\$120m, which incorporates a sharp contraction of revenue through the fourth quarter, lower costs given a high variable component, and the government's wage subsidy (~NZ\$80m). The company's ~30% downsizing only kicks in from July 2020, helping to mitigate FY21 losses. In addition to the underlying guidance, there are a number of significant items that will impact the FY20 reported result, and importantly, the net asset value (NAV) at balance sheet date. We now expect NAV to fall to ~NZ\$1.05 per share at 30 June 2020, and NZ\$0.80 per share at 30 June 2021. We retain an UNDERPERFORM rating given the share price trades at a material premium to expected asset value.

NZX Code	AIR	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$1.56	NPAT* (NZ\$m)	270.1	-83.4	-255.1	22.7	EV/EBITDA	3.4	4.4	7.8	4.1
Target price	NZ\$0.80	EPS* (NZc)	23.9	-7.4	-22.6	2.0	EV/EBIT	8.7	n/a	n/a	n/a
Risk rating	High	EPS growth* (%)	-30.4	n/a	n/a	n/a	PE	6.5	n/a	n/a	n/a
Issued shares	1123.0m	DPS (NZc)	22.0	0.0	0.0	0.0	Price / NTA	0.9	1.8	2.4	2.4
Market cap	NZ\$1,752m	Imputation (%)	100	100	100	100	Cash div yld (%)	14.1	0.0	0.0	0.0
Avg daily turnover	2,122k (NZ\$3,572k)	*Based on normalised profits					Gross div yld (%)	19.6	0.0	0.0	0.0

What's changed?

- **Earnings:** Reduced profit before tax (PBT) loss estimates in both FY20 and FY21
- **Target price:** Increased from 70c to 80c in light of higher NAV assessment at year end FY21

Losses likely to continue into FY21; uncertainty persists

AIR's reinstated guidance provides clarity on the scale of losses endured during 4Q20, when airline capacity had been cut dramatically, albeit cushioned by government wage subsidy support and continued air freight revenues. Despite the business downsizing to reduce fixed overheads, and in particular labour by ~30% by FY20 year end and a further -NZ\$150m thereafter, we expect losses to continue into FY21. While we provide revised earnings forecasts for FY21 and FY22 we recognise the wide margin for error given the range of potential outcomes.

Significant 'significant items'

AIR has already signalled a number of material one-off or significant items that will impact reported profits in FY20. In aggregate these now total a loss of ~-NZ\$600m, which now also incorporate an ~NZ\$70m gain from the revaluation of unhedged foreign currency debt. Other items include a non-cash charge from aircraft impairments (NZ\$350m-NZ\$450m), reorganisation costs (NZ\$140m-NZ\$160m), and the cost of de-designating fuel hedges (NZ\$85m-NZ\$105m).

Asset value improves

Our assessment of NAV at both year end FY20 and FY21 improves (by 10c) in light of the guidance update. FY20 NAV of ~NZ\$1.05 implies a decline of -75c from Dec 2019. In FY21 we estimate that NAV will fall a further 25c to NZ\$0.80.

Air New Zealand Ltd (AIR)

Priced as at 18 Jun 2020 (NZ\$)

1.56

12-month target price (NZ\$)*						Spot valuations (NZ\$)					
Expected share price return						1. Net asset value				0.80	
Net dividend yield						2. n/a				n/a	
Estimated 12-month return						3. n/a				n/a	
Key WACC assumptions						DCF valuation summary (NZ\$m)					
Risk free rate						Total firm value				5,503	
Equity beta						(Net debt)/cash				(1,537)	
WACC						Less: Capitalised operating leases				(2,821)	
Terminal growth						Value of equity				1,145	
Profit and Loss Account (NZ\$m)						Valuation Ratios					
Sales revenue	2018A	2019A	2020E	2021E	2022E	EV/EBITDA (x)	2018A	2019A	2020E	2021E	2022E
Normalised EBITDA	5,485.0	5,785.1	4,616.9	2,277.8	3,808.4	EV/EBIT (x)	2.8	3.4	4.4	7.8	4.1
Depreciation and amortisation	1,065.0	935.1	742.3	411.5	773.1	PE (x)	5.6	8.7	n/a	n/a	50.4
Normalised EBIT	(525.0)	(567.0)	(820.8)	(730.6)	(709.7)	Price/NTA (x)	4.5	6.5	n/a	n/a	77.4
Net interest	540.0	368.1	(78.6)	(319.1)	63.4	Free cash flow yield (%)	0.9	0.9	1.8	2.4	2.4
Associate income	(33.0)	(31.0)	(72.3)	(70.3)	(66.8)	Net dividend yield (%)	12.7	9.4	-45.9	-1.3	7.5
Tax	33.0	37.0	35.0	35.0	35.0	Gross dividend yield (%)	14.1	14.1	0.0	0.0	0.0
Minority interests	(150.0)	(104.0)	32.4	99.2	(8.8)		19.6	19.6	0.0	0.0	0.0
Normalised NPAT	0	0	0	0	0						
Abnormals/other	390.0	270.1	(83.4)	(255.1)	22.7	Capital Structure					
Reported NPAT	0	0	537.3	0	0	Interest cover EBIT (x)	2018A	2019A	2020E	2021E	2022E
Normalised EPS (cps)	390.0	270.1	(620.7)	(255.1)	22.7	Interest cover EBITDA (x)	16.4	11.9	n/a	n/a	0.9
DPS (cps)	34.4	23.9	(7.4)	(22.6)	2.0	Net debt/ND+E (%)	32.3	30.2	10.3	5.9	11.6
	22.0	22.0	0	0	0	Net debt/EBITDA (x)	39.0	42.5	55.1	60.8	57.0
							1.3	1.6	1.9	3.4	1.6
Growth Rates						Key Ratios					
Revenue (%)	2018A	2019A	2020E	2021E	2022E	Return on assets (%)	2018A	2019A	2020E	2021E	2022E
EBITDA (%)	7.4	5.5	-20.2	-50.7	67.2	Return on equity (%)	6.9	4.7	-1.0	-4.4	0.9
EBIT (%)	2.9	-12.2	-20.6	-44.6	87.9	Return on funds employed (%)	17.9	12.9	-7.1	-28.1	2.5
Normalised NPAT (%)	-0.4	-31.8	n/a	n/a	n/a	EBITDA margin (%)	n/a	n/a	n/a	n/a	n/a
Normalised EPS (%)	2.9	-30.8	n/a	n/a	n/a	EBIT margin (%)	19.4	16.2	16.1	18.1	20.3
Ordinary DPS (%)	3.4	-30.4	n/a	n/a	n/a	Capex to sales (%)	9.8	6.4	-1.7	-14.0	1.7
	4.8	0.0	-100.0	n/a	n/a	Capex to depreciation (%)	14.7	14.2	13.0	15.4	9.2
						Imputation (%)	154	145	73	48	49
						Pay-out ratio (%)	100	100	100	100	100
							64	92	0	0	0
Cash Flow (NZ\$m)						Operating Performance					
EBITDA	2018A	2019A	2020E	2021E	2022E	Available Seat Km (ASK)	2018A	2019A	2020E	2021E	2022E
Working capital change	1,065.0	935.1	742.3	411.5	773.1	Domestic	6,905	7,104	5,648	4,262	5,683
Interest & tax paid	227.0	245.0	0	(0.0)	0	Tasman and Pacific	12,964	13,640	10,298	8,184	11,594
Other	(183.0)	(135.0)	50.4	56.5	(48.1)	Long-haul	24,406	25,285	20,481	2,529	12,643
Operating cash flow	(78.0)	(59.1)	(996.1)	(140.6)	(243.5)	Total	44,275	46,029	36,427	14,975	29,920
Capital expenditure	1,031.0	986.0	(203.4)	327.4	481.4	Change (%)	5.0	4.0	-20.9	-58.9	99.8
(Acquisitions)/divestments	(809.0)	(821.0)	(600.0)	(350.0)	(350.0)						
Other	33.0	13.0	40.0	40.0	40.0	RASK (cents per ASK)					
Funding available/(required)	253.0	103.0	(742.4)	38.4	192.4	Domestic	2020E	2021E	2022E		
Dividends paid	(260.0)	(260.0)	(260.0)	0	0	Tasman and Pacific	22.0	22.5	22.7	20.3	20.8
Equity raised/(returned)	(17.0)	(14.0)	0	0	0	Long-haul	9.6	9.6	9.3	8.7	8.9
(Increase)/decrease in net debt	(24.0)	(171.0)	(1,002.4)	38.4	192.4	Total	10.6	10.8	10.5	11.7	10.6
						Costs					
Balance Sheet (NZ\$m)						Ave. jet fuel price (US\$/bbl)	68.6	82.0	75.8	49.5	59.0
Working capital	2018A	2019A	2020E	2021E	2022E	Fuel supply chain (US\$/bbl)	10.0	11.4	11.0	12.0	12.0
Fixed assets	89.0	60.0	67.1	74.2	69.6	Jet fuel cost (US\$/bbl)	78.6	93.4	86.8	61.5	71.0
Intangibles	5,035.0	5,268.0	3,438.0	3,238.0	3,058.9	Jet fuel volume (bbl in millions)	9.0	9.1	7.2	3.6	6.8
Right of use asset	170.0	186.0	186.0	186.0	186.0	Ave. NZDUSD rate	0.72	0.67	0.63	0.63	0.65
Other assets	0	0	2,459.0	2,459.0	2,459.0	Jet fuel (NZ\$m)	987	1,271	978	350	747
Other assets	647.0	602.0	602.0	602.0	602.0	Unit fuel (cents/ASK)	2.2	2.8	2.7	2.3	2.5
Total funds employed	5,941.0	6,116.0	6,752.1	6,559.2	6,375.5	CASK ex-fuel/forex (cents/ASK)	7.2	7.4	10.6	12.5	10.1
Net debt/(cash)	1,391.0	1,542.0	1,444.4	1,406.0	1,213.6						
Lease liability	0	0	2,186.0	2,186.0	2,186.0						
Other liabilities	2,374.0	2,485.0	1,944.2	2,058.8	2,058.8						
Shareholder's funds	2,176.0	2,089.0	1,177.5	908.4	917.1						
Minority interests	0	0	0	0	0						
Total funding sources	5,941.0	6,116.0	6,752.1	6,559.2	6,375.5						

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

Earnings and valuation

AIR's earnings guidance update leads us to change both our earnings estimates and target price. The high level of uncertainty over the near, medium and long term outlook for aviation, international and to a lesser extent domestically, mean that our forecasts have a wide margin for error.

Earnings revisions

We upgrade our earnings forecasts for FY20–FY22 as summarised in Figure 1. Our revised FY20 underlying PBT estimate of -NZ\$116m is consistent with the new guidance and implies a second half loss of -NZ\$334m (prior to -NZ\$572m of net significant/one-off items). We continue to expect a material loss in FY21, despite the potential for international flying to resume, with Tasman and Pacific Islands services recommencing. Our FY22 forecasts assume long haul flights resume and consequently AIR returns to break-even/low levels of profitability.

Figure 1. Earnings revisions (NZ\$m)

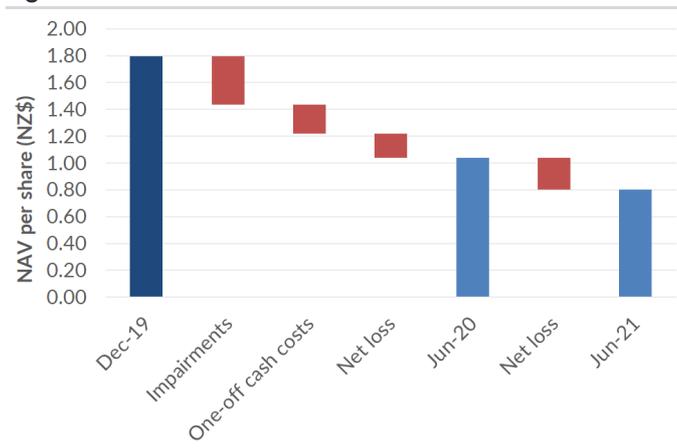
	FY20E			FY21E			FY22E		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Group RASK growth	-2.6%	-2.6%	-4 bps	11.8%	11.8%	2 bps	-9.9%	-9.9%	1 bps
Group ASK growth	-20.9%	-20.9%	4 bps	-58.9%	-58.9%	1 bps	99.8%	99.8%	0 bps
Total fuel cost (ex forex hedging)	977	979	2	363	363	0	770	770	(0)
Sales revenue	4,572	4,617	1%	2,276	2,278	0%	3,799	3,808	0%
Underlying PBT	(316)	(116)	63%	(381)	(354)	7%	(8)	32	495%
Underlying NPAT	(115)	(83)	27%	(274)	(255)	7%	(6)	23	479%
Underlying EPS (cents)	(10.2)	(7.4)	28%	(24.3)	(22.6)	7%	(0.5)	2.0	503%
DPS (cents)	0.0	0.0	n/a	0.0	0.0	n/a	0.0	0.0	n/a

Source: Forsyth Barr analysis

Valuation/target price lift

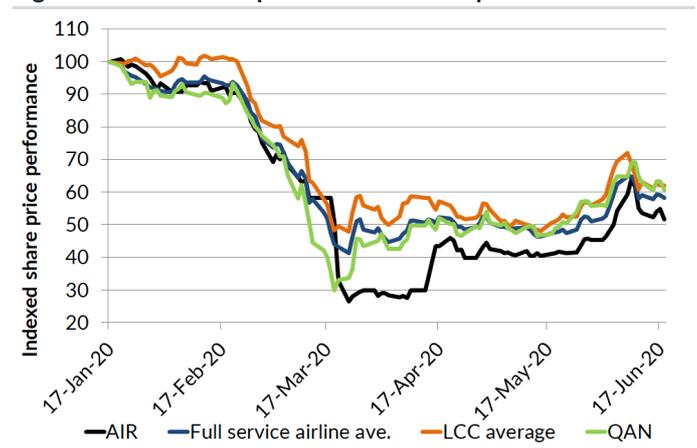
Our revised earnings estimates drive an uplift in our NAV estimates at the end of FY20 (now ~NZ\$1.05) and FY21 (~NZ\$80c). We continue to base our target price on NAV at 30 June 2021, given the uncertainty that AIR will be able to generate a return on capital in excess of WACC over the foreseeable future. We recognise that AIR trades at a material premium to forward NAV but has still underperformed its global airline peers over recent months, as shown in Figure 3.

Figure 2. NAV falls in both FY21 and FY22



Source: AIR, Forsyth Barr analysis

Figure 3. AIR has underperformed its airline peers



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 foreseeable future. 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).

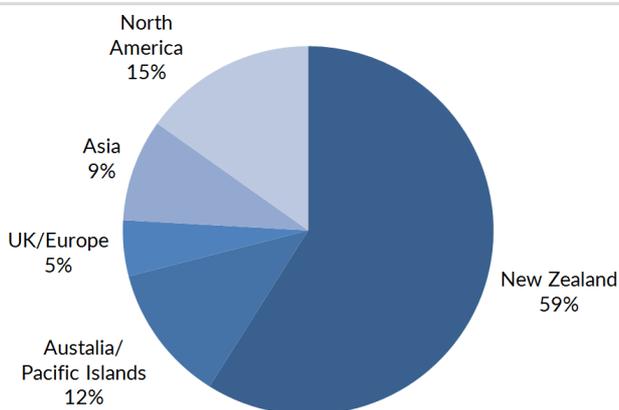
Financial structure

- **Balance sheet:** Gearing was at the top end of management’s 45%–55% target band at June 2019. 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

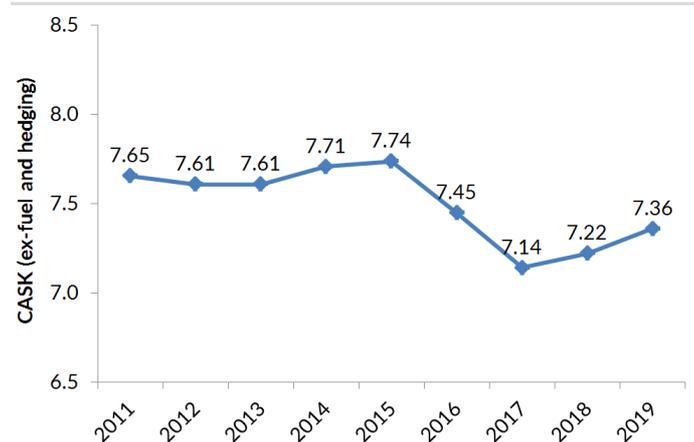
- **Left field events:** Disease outbreak (for example COVID-19), volcanic ash clouds, terrorism events.
- **Macro:** Volatility in exchange rates and global oil prices can have a dramatic impact on profitability.
- **Safety:** Any blip on AIR’s good safety record could impact passenger confidence in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

Figure 4. Geographic exposure mix in FY19

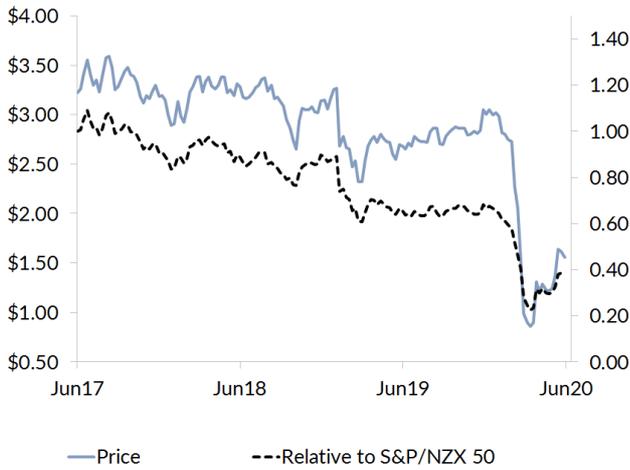


Source: Forsyth Barr analysis

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%

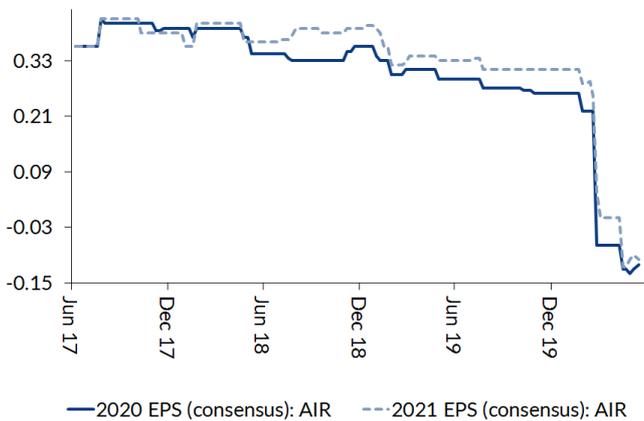
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 8. International valuation comparisons

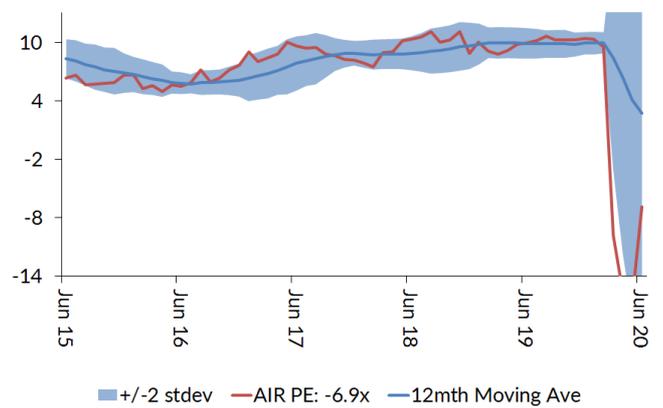
Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
Air New Zealand	AIR NZ	NZ\$1.56	NZ\$1,752	<0x	<0x	4.4x	8.0x	<0x	<0x	0.0%
DEUTSCHE LUFTHANSA-REG	LHA GY	€10.28	€4,916	1.3x	<0x	<0x	<0x	2.3x	7.3x	0.6%
AIR FRANCE-KLM	AF FP	€4.68	€2,004	3.2x	<0x	<0x	<0x	3.5x	<0x	0.0%
SINGAPORE AIRLINES	SIA SP	S\$4.13	S\$12,236	<0x	8.6x	16.1x	29.9x	>75x	<0x	1.8%
CATHAY PACIFIC AIRWAYS	293 HK	HK\$8.12	HK\$31,943	7.9x	13.9x	14.3x	14.1x	10.4x	10.4x	0.9%
QANTAS AIRWAYS	QAN AT	A\$4.52	A\$6,738	<0x	>50x	5.8x	5.4x	>75x	46.3x	1.4%
VIRGIN AUSTRALIA HOLDINGS LT	VAH AT	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
AMERICAN AIRLINES GROUP INC	AAL US	US\$16.79	US\$7,098	1.7x	<0x	<0x	2.0x	3.9x	29.3x	0.3%
UNITED AIRLINES HOLDINGS INC	UAL US	US\$38.91	US\$11,301	0.8x	21.6x	<0x	1.8x	1.5x	10.7x	0.0%
Compcpo Average:				3.0x	14.7x	12.1x	10.7x	4.3x	20.8x	0.7%
AIR Relative:				n/a	n/a	-63%	-25%	n/a	n/a	-100%

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 9. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)


Source: Forsyth Barr analysis

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