

Air New Zealand

Gaining Height at Low Altitude

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UNDERPERFORM

Air New Zealand's (AIR) June operating statistics imply that passenger revenue declined by around -21% during FY20, reflective of the significant COVID-19 impact through the last four months. The data shows improving domestic passenger flows and a broad recovery in pricing. International passengers remain a rounding error (skeleton services are being supported by the Government sponsored cargo initiative) and will likely continue to be until 2021. We take a more positive view on passenger yields and cargo revenue generation for the year ahead and upgrade earnings forecasts, which erode but not fully, anticipated losses. The adverse impact of operating losses on AIR's net asset value (NAV) is less severe than previously assumed, which leads us to lift our target price to NZ\$0.90 from NZ\$0.80. However, a valuation gap to the share price persists; UNDERPERFORM.

| NZX Code | AIR | Financials: Jun/ | 19A | 20E | 21E | 22E | Valuation (x) | 19A | 20E | 21E | 22E |
|--------------------|---------------------|------------------------------|-------|-------|--------|------|-------------------|------|-----|-----|------|
| Share price | NZ\$1.32 | NPAT* (NZ\$m) | 270.1 | -68.1 | -151.7 | 10.7 | EV/EBITDA | 3.2 | 3.9 | 5.2 | 3.8 |
| Target price | NZ\$0.90 | EPS* (NZc) | 23.9 | -6.0 | -13.4 | 0.9 | EV/EBIT | 8.0 | n/a | n/a | 60.4 |
| Risk rating | High | EPS growth* (%) | -30.4 | n/a | n/a | n/a | PE | 5.5 | n/a | n/a | n/a |
| Issued shares | 1123.0m | DPS (NZc) | 22.0 | 0.0 | 0.0 | 0.0 | Price / NTA | 0.8 | 1.5 | 1.8 | 1.8 |
| Market cap | NZ\$1,482m | Imputation (%) | 100 | 100 | 100 | 100 | Cash div yld (%) | 16.7 | 0.0 | 0.0 | 0.0 |
| Avg daily turnover | 2,328k (NZ\$3,772k) | *Based on normalised profits | | | | | Gross div yld (%) | 23.1 | 0.0 | 0.0 | 0.0 |

What's changed?

- **Profit before tax:** FY20 upgraded to loss of -NZ\$95m; FY21 to loss of -NZ\$211m
- **Target price:** Lifted from NZ\$0.80 to NZ\$0.90 due to a better NAV outlook

Passenger revenue recovery from low floor

We calculate that June passenger revenue was down ~-80% compared to the prior year, an improvement from the ~-90% decline in May, as the domestic recovery takes hold. July will be even better given the impact of domestic school holidays, in our opinion. AIR appears to be applying its revenue management strengths by lifting domestic capacity and optimising yield/RASK (revenue per available seat km). The June data suggests that FY20 passenger revenue declined -21%.

Solid domestic momentum

Domestic demand appears robust considering the lack of international connectivity, which typically accounts for 15%-20% of passengers. AIR plans to have ~70% of pre COVID-19 capacity in August, with a further school holiday boosted lift in October. Demand is being led by leisure traffic, albeit business demand is also recovering. Business customers typically account for ~50% of domestic revenue and ~40% of bookings. We understand that domestic business demand is back to ~65% of pre COVID-19 levels.

Valuation anchored to NAV

AIR's share price continues to closely track its international full-service airline peers, yet it trades at a ~+35% premium to our estimate of its NAV as at June 2020. In light of the challenges facing AIR and the global airline industry, NAV remains the most appropriate valuation benchmark, in our opinion.

Air New Zealand Ltd (AIR)

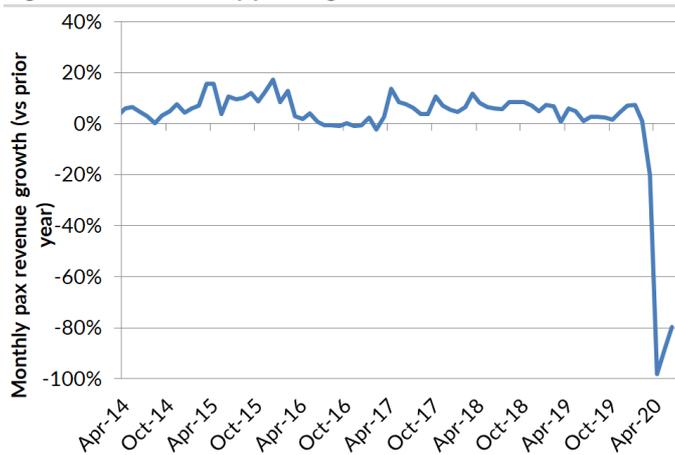
| | | | | | | | | | | | | |
|--|----------------|----------------|----------------|----------------|----------------|--------------------------------------|------------------------------------|---------------|---------------|---------------|---------------|---------|
| Priced as at 28 Jul 2020 (NZ\$) | | | | | | 1.32 | | | | | | |
| 12-month target price (NZ\$)* | | | | | | 0.90 | Spot valuations (NZ\$) | | | | | |
| Expected share price return | | | | | | -31.8% | 1. Net asset value | | | | | 0.90 |
| Net dividend yield | | | | | | 0.0% | 2. n/a | | | | | n/a |
| Estimated 12-month return | | | | | | -31.8% | 3. n/a | | | | | n/a |
| Key WACC assumptions | | | | | | DCF valuation summary (NZ\$m) | | | | | | |
| Risk free rate | | | | | | 2.00% | Total firm value | | | | | 5,639 |
| Equity beta | | | | | | 1.40 | (Net debt)/cash | | | | | (1,553) |
| WACC | | | | | | 9.8% | Less: Capitalised operating leases | | | | | (2,821) |
| Terminal growth | | | | | | 1.5% | Value of equity | | | | | 1,266 |
| Profit and Loss Account (NZ\$m) | | | | | | Valuation Ratios | | | | | | |
| | 2018A | 2019A | 2020E | 2021E | 2022E | | 2018A | 2019A | 2020E | 2021E | 2022E | |
| Sales revenue | 5,485.0 | 5,785.1 | 4,831.8 | 2,569.8 | 3,962.1 | EV/EBITDA (x) | 2.6 | 3.2 | 3.9 | 5.2 | 3.8 | |
| Normalised EBITDA | 1,065.0 | 935.1 | 763.4 | 558.1 | 757.9 | EV/EBIT (x) | 5.1 | 8.0 | n/a | n/a | 60.4 | |
| Depreciation and amortisation | (525.0) | (567.0) | (820.8) | (730.6) | (709.7) | PE (x) | 3.8 | 5.5 | n/a | n/a | >100x | |
| Normalised EBIT | 540.0 | 368.1 | (57.5) | (172.5) | 48.2 | Price/NTA (x) | 0.7 | 0.8 | 1.5 | 1.8 | 1.8 | |
| Net interest | (33.0) | (31.0) | (72.1) | (68.2) | (63.3) | Free cash flow yield (%) | 15.0 | 11.1 | -53.1 | 5.8 | 8.4 | |
| Associate income | 33.0 | 37.0 | 35.0 | 30.0 | 30.0 | Net dividend yield (%) | 16.7 | 16.7 | 0.0 | 0.0 | 0.0 | |
| Tax | (150.0) | (104.0) | 26.5 | 59.0 | (4.2) | Gross dividend yield (%) | 23.1 | 23.1 | 0.0 | 0.0 | 0.0 | |
| Minority interests | 0 | 0 | 0 | 0 | 0 | Capital Structure | | | | | | |
| Normalised NPAT | 390.0 | 270.1 | (68.1) | (151.7) | 10.7 | Interest cover EBIT (x) | 16.4 | 11.9 | n/a | n/a | 0.8 | |
| Abnormals/other | 0 | 0 | 537.3 | 0 | 0 | Interest cover EBITDA (x) | 32.3 | 30.2 | 10.6 | 8.2 | 12.0 | |
| Reported NPAT | 390.0 | 270.1 | (605.4) | (151.7) | 10.7 | Net debt/ND+E (%) | 39.0 | 42.5 | 54.5 | 55.5 | 51.7 | |
| Normalised EPS (cps) | 34.4 | 23.9 | (6.0) | (13.4) | 0.9 | Net debt/EBITDA (x) | 1.3 | 1.6 | 1.9 | 2.3 | 1.5 | |
| DPS (cps) | 22.0 | 22.0 | 0 | 0 | 0 | Key Ratios | | | | | | |
| Growth Rates | | | | | | 2018A | 2019A | 2020E | 2021E | 2022E | | |
| Revenue (%) | 7.4 | 5.5 | -16.5 | -46.8 | 54.2 | Return on assets (%) | 6.9 | 4.7 | -0.7 | -2.4 | 0.7 | |
| EBITDA (%) | 2.9 | -12.2 | -18.4 | -26.9 | 35.8 | Return on equity (%) | 17.9 | 12.9 | -5.7 | -14.7 | 1.0 | |
| 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 | 15.8 | 21.7 | 19.1 | |
| Normalised EPS (%) | 3.4 | -30.4 | n/a | n/a | n/a | EBIT margin (%) | 9.8 | 6.4 | -1.2 | -6.7 | 1.2 | |
| Ordinary DPS (%) | 4.8 | 0.0 | -100.0 | n/a | n/a | Capex to sales (%) | 14.7 | 14.2 | 12.4 | 13.6 | 8.8 | |
| Cash Flow (NZ\$m) | | | | | | 2018A | 2019A | 2020E | 2021E | 2022E | | |
| EBITDA | 1,065.0 | 935.1 | 763.4 | 558.1 | 757.9 | Capex to depreciation (%) | 154 | 145 | 73 | 48 | 49 | |
| Working capital change | 227.0 | 245.0 | 0 | 0 | 0 | Imputation (%) | 100 | 100 | 100 | 100 | 100 | |
| Interest & tax paid | (183.0) | (135.0) | 44.6 | 18.3 | (40.0) | Pay-out ratio (%) | 64 | 92 | 0 | 0 | 0 | |
| Other | (78.0) | (59.1) | (995.4) | (140.3) | (243.9) | Operating Performance | | | | | | |
| Operating cash flow | 1,031.0 | 986.0 | (187.4) | 436.1 | 474.0 | 2018A | 2019A | 2020E | 2021E | 2022E | | |
| Capital expenditure | (809.0) | (821.0) | (600.0) | (350.0) | (350.0) | Available Seat Km (ASK) | | | | | | |
| (Acquisitions)/divestments | 33.0 | 13.0 | 40.0 | 40.0 | 40.0 | Domestic | 6,905 | 7,104 | 5,619 | 4,973 | 5,683 | |
| Other | (2.0) | (75.0) | 21.0 | 18.0 | 18.0 | Tasman and Pacific | 12,964 | 13,640 | 10,366 | 5,456 | 11,594 | |
| Funding available/(required) | 253.0 | 103.0 | (726.4) | 144.1 | 182.0 | Long-haul | 24,406 | 25,285 | 20,354 | 1,264 | 10,114 | |
| Dividends paid | (260.0) | (260.0) | (260.0) | 0 | 0 | Total | 44,275 | 46,029 | 36,340 | 11,693 | 27,391 | |
| Equity raised/(returned) | (17.0) | (14.0) | 0 | 0 | 0 | Change (%) | 5.0 | 4.0 | -21.0 | -67.8 | 134.3 | |
| (Increase)/decrease in net debt | (24.0) | (171.0) | (986.4) | 144.1 | 182.0 | RASK (cents per ASK) | | | | | | |
| Balance Sheet (NZ\$m) | | | | | | 2018A | 2019A | 2020E | 2021E | 2022E | | |
| Working capital | 89.0 | 60.0 | 66.5 | 73.3 | 69.1 | Domestic | 22.0 | 22.5 | 23.4 | 21.4 | 21.4 | |
| Fixed assets | 5,035.0 | 5,268.0 | 3,438.0 | 3,238.0 | 3,058.9 | Tasman and Pacific | 9.6 | 9.6 | 9.5 | 9.1 | 9.4 | |
| Intangibles | 170.0 | 186.0 | 186.0 | 186.0 | 186.0 | Long-haul | 7.9 | 8.1 | 8.0 | 7.7 | 7.9 | |
| Right of use asset | 0 | 0 | 2,459.0 | 2,459.0 | 2,459.0 | Total | 10.6 | 10.8 | 10.8 | 14.2 | 11.3 | |
| Other assets | 647.0 | 602.0 | 602.0 | 602.0 | 602.0 | Costs | | | | | | |
| Total funds employed | 5,941.0 | 6,116.0 | 6,751.5 | 6,558.3 | 6,375.0 | Ave. jet fuel price (US\$/bbl) | 68.6 | 82.0 | 77.8 | 53.0 | 59.0 | |
| Net debt/(cash) | 1,391.0 | 1,542.0 | 1,428.4 | 1,284.4 | 1,102.4 | Fuel supply chain (US\$/bbl) | 10.0 | 11.4 | 12.0 | 12.0 | 12.0 | |
| Lease liability | 0 | 0 | 2,186.0 | 2,186.0 | 2,186.0 | Jet fuel cost (US\$/bbl) | 78.6 | 93.4 | 89.8 | 65.0 | 71.0 | |
| Other liabilities | 2,374.0 | 2,485.0 | 1,944.2 | 2,058.8 | 2,058.8 | Jet fuel volume (bbl in millions) | 9.0 | 9.1 | 7.4 | 3.1 | 6.3 | |
| Shareholder's funds | 2,176.0 | 2,089.0 | 1,192.9 | 1,029.2 | 1,027.9 | Ave. NZDUSD rate | 0.72 | 0.67 | 0.63 | 0.64 | 0.65 | |
| Minority interests | 0 | 0 | 0 | 0 | 0 | Jet fuel (NZ\$m) | 987 | 1,271 | 1,040 | 317 | 683 | |
| Total funding sources | 5,941.0 | 6,116.0 | 6,751.5 | 6,558.3 | 6,375.0 | Unit fuel (cents/ASK) | 2.2 | 2.8 | 2.9 | 2.7 | 2.5 | |
| | | | | | | CASK ex-fuel/forex (cents/ASK) | 7.2 | 7.4 | 11.2 | 17.2 | 11.7 | |

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

Valuation gap persists; UNDERPERFORM

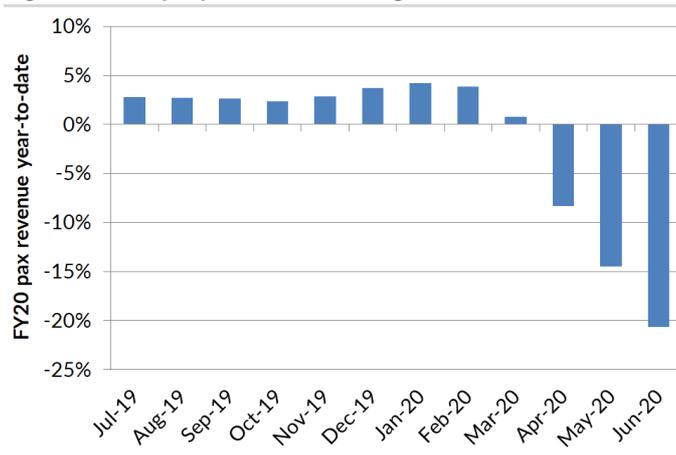
The June 2020 operating statistics round out AIR's FY20 monthly data and highlight a -20.5% decline in passenger revenue for the year. While annual capacity declined -21.2%, revenue per available seat km (RASK) held up despite the COVID-19 impact in recent months (+0.7% for the year), assisted by the positive mix influence of the recovery in higher RASK domestic and reduced lower RASK international services.

Figure 1. AIR's monthly passenger review



Source: AIR, Forsyth Barr analysis

Figure 2. AIR's ytd pax revenue through FY20



Source: AIR, Forsyth Barr analysis

Earnings revisions

We lift our FY20 and FY21 earnings forecasts as shown in Figure 3. Our FY20 PBT forecast of -NZ\$95m, aligns with management's guidance for a loss of up to -NZ\$120m. We continue to expect AIR to be loss-making in FY21, albeit higher cargo revenue and passenger RASK assumptions lift our estimates. Our recovery track has AIR's overall capacity at ~60% of pre COVID-19 in FY22 and ~80% in FY23.

Our cost forecasts assume that (1) ~55% of AIR's FY19 EBITDRA (EBITDA before lease rentals) cost base ex-fuel was variable, and (2) its unit costs (or CASK) is influenced by mix, given the higher CASK nature of domestic services relative to international services.

AIR is due to report its FY20 result on 27 August 2020.

Figure 3. Earnings revisions (NZ\$m)

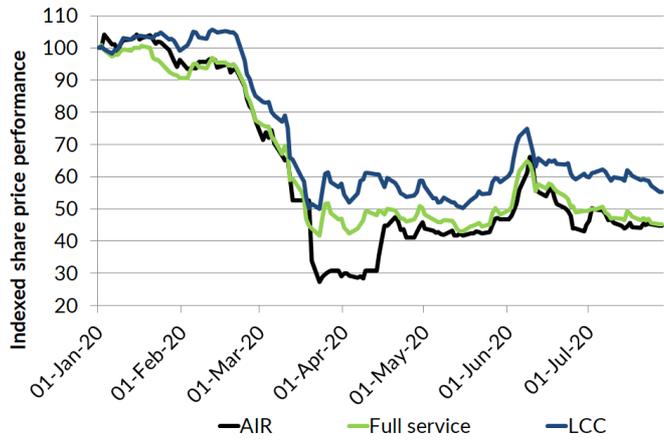
| | FY20E | | | FY21E | | | FY22E | | |
|------------------------------------|--------------|-------------|------------|--------------|--------------|------------|-----------|-----------|-------------|
| | Old | New | Chg | Old | New | Chg | Old | New | Chg |
| Group RASK growth | -2.6% | 0.7% | 326 bps | 11.8% | 30.9% | 1906 bps | -9.9% | -20.2% | -1032 bps |
| Group ASK growth | -20.9% | -21.0% | -15 bps | -58.9% | -67.8% | -892 bps | 99.8% | 134.3% | 3445 bps |
| Total fuel cost (ex forex hedging) | 979 | 1,040 | 61 | 363 | 317 | (46) | 770 | 683 | (87) |
| Sales revenue | 4,617 | 4,832 | 5% | 2,278 | 2,570 | 13% | 3,808 | 3,962 | 4% |
| Underlying PBT | (116) | (95) | 18% | (354) | (211) | 40% | 32 | 15 | -54% |
| Underlying NPAT | (83) | (68) | 18% | (255) | (152) | 41% | 23 | 11 | -53% |
| Underlying EPS (cents) | (7.4) | (6.0) | 19% | (22.6) | (13.4) | 41% | 2.0 | 0.9 | -53% |
| DPS (cents) | 0.0 | 0.0 | n/a | 0.0 | 0.0 | n/a | 0.0 | 0.0 | n/a |

Source: Forsyth Barr analysis

Target price lifted to NZ\$0.90

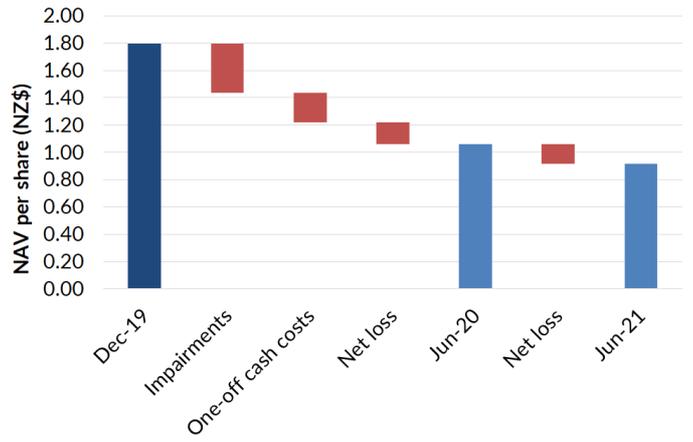
AIR continues to trade in close correlation to its global full service airline peers. Other New Zealand stocks are trading in a similar fashion to their respective international peers, we suspect this is a function of the inherent difficulty in valuing companies with highly uncertain outlooks currently. However, AIR's asset base provides a key valuation benchmark. Its net asset value (NAV) was ~NZ\$1.80 at year end FY19. We expect it to fall to ~NZ\$1.00 at FY20 and ~NZ\$0.90 at FY21, which reflects the basis of our target price. Previously we expected NAV to fall to ~NZ\$0.80 in FY21.

Figure 4. AIR's share price mirrors full service peers



Source: Eikon, Forsyth Barr analysis

Figure 5. NAV hit in FY20 and FY21



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 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).

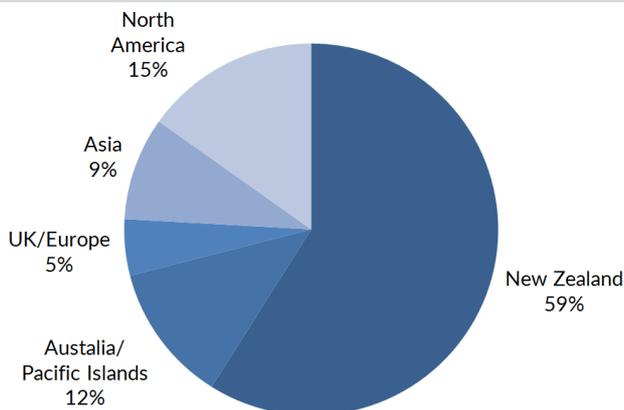
Financial structure

- **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 a capital raise would help 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 6. Geographic exposure mix in FY19

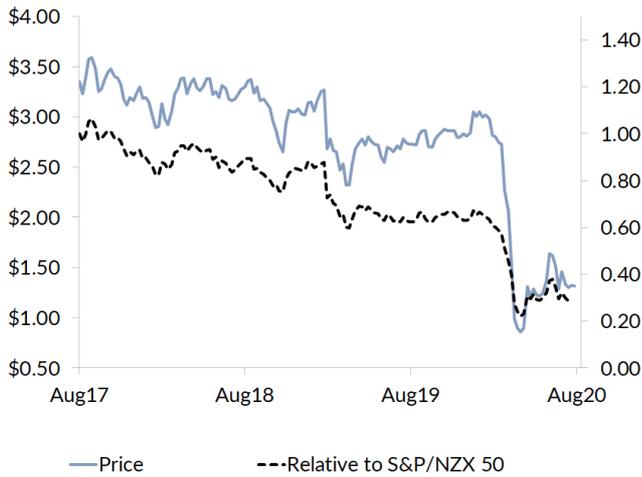


Source: Forsyth Barr analysis

Figure 7. Cost per ASK under control (cents per ASK)



Source: Forsyth Barr analysis

Figure 8. Price performance


Source: Forsyth Barr analysis

Figure 9. Substantial shareholders

| Shareholder | Latest Holding |
|-------------|----------------|
| NZ Govt | 52.5% |

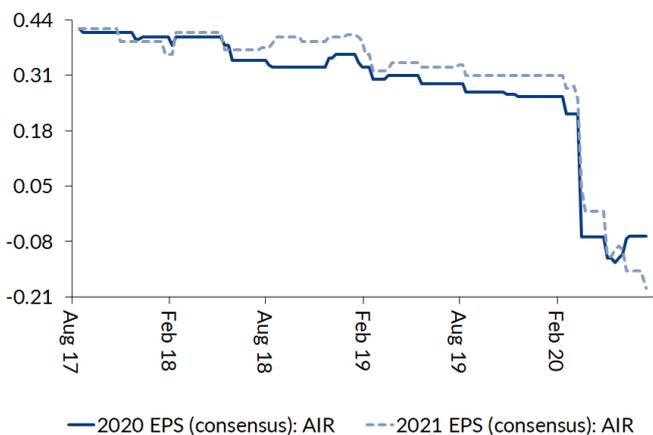
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 10. International valuation comparisons

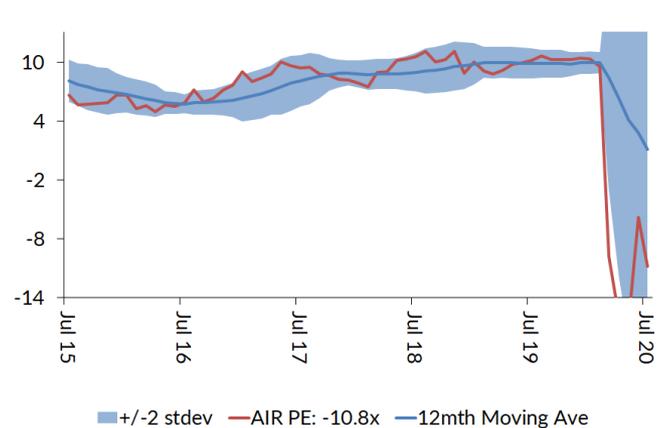
| Company | Code | Price | Mkt Cap (m) | PE | | EV/EBITDA | | EV/EBIT | | Cash Yld 2021E |
|------------------------------|---------------|-----------------|------------------|---------------|---------------|--------------|--------------|---------------|---------------|----------------|
| | | | | 2020E | 2021E | 2020E | 2021E | 2020E | 2021E | |
| Air New Zealand | AIR NZ | NZ\$1.32 | NZ\$1,482 | <0x | <0x | 4.0x | 5.4x | <0x | <0x | 0.0% |
| QANTAS AIRWAYS | QAN AT | A\$3.65 | A\$6,802 | <0x | <0x | 5.6x | 6.1x | 45.8x | 38.4x | 1.2% |
| CATHAY PACIFIC AIRWAYS | 293 HK | HK\$5.62 | HK\$36,177 | 6.3x | 13.5x | 16.5x | 16.7x | 11.7x | 31.9x | 1.1% |
| SINGAPORE AIRLINES | SIA SP | S\$3.61 | \$10,702 | <0x | 20.1x | 27.7x | 66.1x | >75x | 0.6x | 1.8% |
| DEUTSCHE LUFTHANSA-REG | LHA GY | €7.81 | €4,668 | 1.1x | <0x | <0x | <0x | 2.3x | 16.2x | 0.6% |
| AIR FRANCE-KLM | AF FP | €3.79 | €1,622 | 2.6x | <0x | <0x | <0x | 3.4x | <0x | 0.0% |
| AMERICAN AIRLINES GROUP INC | AAL US | US\$11.39 | US\$5,793 | 1.2x | <0x | <0x | 4.7x | 4.0x | <0x | 0.8% |
| UNITED AIRLINES HOLDINGS INC | UAL US | US\$32.42 | US\$9,416 | 0.7x | <0x | <0x | 1.2x | 1.3x | 59.6x | 0.0% |
| Compcop Average: | | | | 2.4x | 16.8x | 16.6x | 19.0x | 11.4x | 29.3x | 0.8% |
| AIR Relative: | | | | n/a | n/a | -76% | -71% | n/a | n/a | -100% |

EV = Current Market Cap + Actual Net Debt

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

Figure 11. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 12. One year forward PE (x)


Source: Forsyth Barr analysis

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