NEW ZEALAND EQUITY RESEARCH | TRANSPORT | INTERNATIONAL AIRLINE
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Air New Zealand
FY20 — Viral Load Factor

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UNDERPERFORM

Air New Zealand (AIR) is a major casualty of COVID-19 having posted its first annual loss in 18 years and remains in a cash burn situation. The company reported a pre-tax FY20 underlying loss of -NZ$87m, with a significant decline through 2H20. Border closures and social distancing will remain key headwinds. Cash burn is through the worst, given major cost cutting and scope for recovery, particularly domestically, but will likely continue until borders reopen, in our view. The government has confirmed that it will remain a majority shareholder, and therefore will support a potential recapitalisation, which we believe is necessary given elevated gearing. Net asset value (NAV) falls to NZ$1.17 per share, a better outcome than we were anticipating, though we expect it to fall further in FY21 given ongoing losses. NAV remains our anchor for valuation purposes, and in light of the share price trading at a material premium to it, we retain an UNDERPERFORM rating.

NZX Code	AIR
Share price	NZ$1.42
Target price	NZ$1.00
Risk rating	High
Issued shares	1123.0m
Market cap	NZ$1,589m
Avg daily turnover	2,396k (NZ$3,770k)

Financials: Jun/	20A	21E	22E	23E
NPAT* (NZ$m)	-64.2	-216.6	15.8	80.9
EPS* (NZc)	-5.7	-19.3	1.4	7.2
EPS growth* (%)	n/a	n/a	n/a	n/a
DPS (NZc)	0.0	0.0	0.0	10.0
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	20A	21E	22E	23E
EV/EBITDA	3.7	5.4	3.5	3.1
EV/EBIT	n/a	n/a	51.3	19.6
PE	n/a	n/a	n/a	19.6
Price / NTA	1.4	1.8	1.7	1.7
Cash div yld (%)	0.0	0.0	0.0	7.1
Gross div yld (%)	0.0	0.0	0.0	9.8

What's changed?

- **Earnings:** Increase in FY21 pre-tax loss given assumed slower international recovery; wider margin for error in outer years
- **Target price:** Increased to NZ$1.00 from 90c based on higher forward NAV estimate

Uncertain outlook

AIR has experienced the worst operating conditions through 4Q20 in its history and has responded appropriately by cutting costs and limiting cash burn. The recovery path will likely be lengthy and may encompass temporary setbacks (like during the past few weeks). It's difficult to predict timeframes though we expect a recovery to FY19 demand levels within 3–5 years. In light of this, we believe the only appropriate means of valuing AIR currently is using an asset backed approach.

Cash burn reduced; accounting losses to deepen in FY21

The business appears close to operating cashflow breakeven before accounting for capex and capital repayments of aircraft secured debt. AIR suggests that monthly cash burn (assuming domestic at ~70% of pre COVID-19 levels, no social distancing requirements, and international airfreight only) will be NZ$65m–NZ$85m, down from NZ$175m in 4Q20. In accounting terms this still means meaningful losses, particularly given depreciation is significantly larger than capex. We expect FY21 pre-tax underlying losses to be bigger then FY20, but sequentially improving half on half in 1H21 and 2H21 respectively.

Crown committed to resolving capital structure

AIR has yet to dip into the government's NZ$900m funding facility, but expects to over the coming days. It currently has ~NZ$245m of cash in hand. Gearing is now at 69% and likely to deteriorate further through FY21, given ongoing cash burn, in the absence of an equity recapitalisation. AIR says "*The Government has recently reaffirmed the Crown's long-standing commitment to maintaining its majority shareholding ....* [AIR] *is engaging constructively with the Crown as it continues to assess its capital structure and funding needs*".

Air New Zealand Ltd (AIR)

Priced as at 27 Aug 2020 (NZ$)	1.42

12-month target price (NZ$)*	1.00
Expected share price return	-29.6%
Net dividend yield	0.0%
Estimated 12-month return	-29.6%

Spot valuations (NZ$)	
1. Net asset value	1.00
2. n/a	n/a
3. n/a	n/a

Key WACC assumptions	
Risk free rate	1.30%
Equity beta	1.40
WACC	8.9%
Terminal growth	1.0%

DCF valuation summary (NZ$m)	
Total firm value	n/a
(Net debt)/cash	n/a
Less: Capitalised operating leases	n/a
Value of equity	n/a

Profit and Loss Account (NZ$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	5,785.1	4,836.2	2,333.3	3,635.3	4,656.3
Normalised EBITDA	**935.1**	**784.2**	**501.6**	**807.9**	**922.6**
Depreciation and amortisation	(567.0)	(841.0)	(754.4)	(753.1)	(778.9)
Normalised EBIT	**368.1**	**(56.8)**	**(252.8)**	**54.8**	**143.6**
Net interest	(31.0)	(69.0)	(102.1)	(71.9)	(70.3)
Associate income	37.0	39.0	39.0	39.0	39.0
Tax	(104.0)	22.5	99.4	(6.1)	(31.5)
Minority interests	0	0	0	0	0
Normalised NPAT	**270.1**	**(64.2)**	**(216.6)**	**15.8**	**80.9**
Abnormals/other	0	389.5	0	0	0
Reported NPAT	**270.1**	**(453.8)**	**(216.6)**	**15.8**	**80.9**
Normalised EPS (cps)	23.9	(5.7)	(19.3)	1.4	7.2
DPS (cps)	22.0	0	0	0	10.0

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	3.3	3.7	5.4	3.5	3.1
EV/EBIT (x)	8.3	n/a	n/a	51.4	19.6
PE (x)	5.9	n/a	n/a	>100x	19.7
Price/NTA (x)	0.8	1.4	1.8	1.7	1.7
Free cash flow yield (%)	10.3	-24.1	-8.7	24.1	20.3
Net dividend yield (%)	15.5	0.0	0.0	0.0	7.0
Gross dividend yield (%)	21.5	0.0	0.0	0.0	9.8

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	11.9	n/a	n/a	0.8	2.0
Interest cover EBITDA (x)	30.2	11.4	4.9	11.2	13.1
Net debt/ND+E (%)	42.5	43.7	53.0	44.6	40.6
Net debt/EBITDA (x)	1.6	1.3	2.4	1.1	0.8

Growth Rates	2019A	2020A	2021E	2022E	2023E
Revenue (%)	5.5	-16.4	-51.8	55.8	28.1
EBITDA (%)	-12.2	-16.1	-36.0	61.1	14.2
EBIT (%)	-31.8	n/a	n/a	n/a	>100
Normalised NPAT (%)	-30.8	n/a	n/a	n/a	>100
Normalised EPS (%)	-30.4	n/a	n/a	n/a	>100
Ordinary DPS (%)	0.0	-100.0	n/a	n/a	n/a

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	4.7	-0.8	-3.4	0.7	1.8
Return on equity (%)	12.9	-4.9	-19.9	1.4	7.3
Return on funds employed (%)	n/a	n/a	n/a	n/a	n/a
EBITDA margin (%)	16.2	16.2	21.5	22.2	19.8
EBIT margin (%)	6.4	-1.2	-10.8	1.5	3.1
Capex to sales (%)	14.2	12.7	12.9	15.1	17.2
Capex to depreciation (%)	145	73	40	73	103
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	92	0	0	0	139

Cash Flow (NZ$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	**935.1**	**784.2**	**501.6**	**807.9**	**922.6**
Working capital change	245.0	0	0	0	0
Interest & tax paid	(135.0)	134.0	31.8	(38.1)	(56.3)
Other	(59.1)	(688.2)	(372.6)	163.9	257.6
Operating cash flow	**986.0**	**230.0**	**160.8**	**933.7**	**1,123.9**
Capital expenditure	(821.0)	(615.0)	(300.0)	(550.0)	(800.0)
(Acquisitions)/divestments	13.0	109.0	40.0	40.0	40.0
Other	(75.0)	30.0	23.0	23.4	23.4
Funding available/(required)	**103.0**	**(246.0)**	**(76.2)**	**447.1**	**387.3**
Dividends paid	(260.0)	(130.0)	0	0	(112.3)
Equity raised/(returned)	(14.0)	0	0	0	0
(Increase)/decrease in net debt	**(171.0)**	**(501.0)**	**(201.2)**	**322.1**	**150.0**

Operating Performance	2019A	2020A	2021E	2022E	2023E
Available Seat Km (ASK)					
Domestic	7,104	5,619	4,618	5,683	6,394
Tasman and Pacific	13,640	10,367	4,092	10,912	12,276
Long-haul	25,285	20,349	2,529	7,586	17,700
Total	**46,029**	**36,335**	**11,238**	**24,181**	**36,369**
Change (%)	4.0	-21.1	-69.1	115.2	50.4
RASK (cents per ASK)					
Domestic	22.5	23.6	22.0	22.0	21.8
Tasman and Pacific	9.6	9.4	7.5	9.2	9.1
Long-haul	8.1	8.1	5.8	7.4	7.6
Total	**10.8**	**10.8**	**13.1**	**11.6**	**10.6**
Costs					
Jet fuel (NZ$m)	1,271	1,022	275	696	931
Unit fuel (cents/ASK)	2.8	2.8	2.4	2.9	2.6
CASK ex-fuel/forex (cents/ASK)	7.4	8.4	16.3	11.7	10.3
Normalised EBIT	368.1	(56.8)	(252.8)	54.8	143.6
Net interest	(31.0)	(69.0)	(102.1)	(71.9)	(70.3)
Associate income	37.0	39.0	39.0	39.0	39.0
Normalised PBT	**374.1**	**(86.8)**	**(315.9)**	**21.9**	**112.4**

Balance Sheet (NZ$m)	2019A	2020A	2021E	2022E	2023E
Working capital	60.0	89.0	99.0	95.1	92.0
Fixed assets	5,268.0	3,336.0	3,056.7	3,044.8	3,270.2
Intangibles	186.0	186.0	186.0	186.0	186.0
Right of use asset	0	2,357.0	2,430.0	2,514.9	2,583.7
Other assets	602.0	815.0	831.0	846.6	862.2
Total funds employed	**6,116.0**	**6,783.0**	**6,602.7**	**6,687.4**	**6,994.1**
Net debt/(cash)	1,542.0	1,025.0	1,226.2	904.0	754.0
Lease liability	0	2,238.0	2,413.0	2,588.0	2,763.0
Other liabilities	2,485.0	2,202.0	1,874.0	2,074.0	2,374.0
Shareholder's funds	2,089.0	1,318.0	1,089.5	1,121.4	1,103.1
Minority interests	0	0	0	0	0
Total funding sources	**6,116.0**	**6,783.0**	**6,602.7**	**6,687.4**	**6,994.1**

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

Losses set to continue; UNDERPERFORM

AIR reported a heavily COVID-19 impacted FY20 result with its first underlying loss since 2002. 2H20 losses were material given the seismic impact of border closures and other government restrictions. Losses will continue through FY21, with management suggesting that even its most optimistic scenario for the year ahead has it generating an underlying loss. The company needs commercial international air travel to resume, before it can be profitable, in our view. There remains a significant amount of uncertainty as to when this will happen.

There are two other key areas of uncertainty — (1) capital structure given elevated gearing, and (2) the strategy refinement that will be presented at the annual Shareholder Meeting on 29 September 2020, which will explore opportunities within loyalty, digital and sustainability.

Forward earnings multiples are irrelevant for AIR and its peers currently. The balance sheet provides the best benchmark for valuation, in our opinion. Consequently, our target price is NAV based, and despite lifting it to NZ$1.00, it remains materially lower the current share price. We retain an UNDERPERFORM rating.

Result summary

AIR reported a pre-tax loss before significant items of -NZ$87m, compared to guidance of a loss of up to -NZ$120m. The 2H20 underlying pre-tax loss amounted to -NZ$285m. Passenger revenue declined -45% in 2H20; in contrast cargo, which overtook passengers as a bigger source of income temporarily, grew +44% in the half.

The balance sheet is in better shape than we anticipated with net asset value (NAV) per share down to NZ$1.17 from NZ$1.86. No dividend will be paid and no guidance provided for FY21 in light of the level of forward uncertainty.

Figure 1. Result summary (NZ$m)

	FY19	FY20	Change	Forbar
Sales revenue	5,785	4,836	-16.4%	4,832
EBITDRA	1,180	784	-33.5%	763
Underlying PBT	**380**	**(87)**	**-122.8%**	**(95)**
Reported NPAT	270	(454)	-268.0%	(605)
Underlying NPAT	270	(64)	-123.8%	(68)
Underlying EPS (cents)	23.9	(5.7)	-123.9%	(6.0)
Final DPS (cents)	11.0	0.0	-100.0%	0.0
NAV per share (NZ$)	1.86	1.17	-37.1%	1.06

Source: AIR, Forsyth Barr analysis

Figure 2. Revenue split (NZ$m)

	FY19	FY220	Change
Domestic	1,600	1,324	-17.3%
Tasman & Pacific Islands	1,312	970	-26.0%
International	2,048	1,648	-19.5%
Passenger revenue	**4,960**	**3,942**	**-20.5%**
Cargo	390	449	15.1%
Contract services	197	216	9.6%
Other	238	229	-3.8%
Total revenue	**5,785**	**4,836**	**-16.4%**

Source: AIR, Forsyth Barr analysis

Earnings revisions

We summarise the changes to our earnings forecasts in Figure 3. We now expect AIR's pre-tax losses to be bigger in FY21 than our previous forecast, due to (1) a later resumption of international travel in 2H21, (2) lower revenue per ASK (RASK) given the continuation of freight predominant flying, reduced outbound repatriation flow and finite border entry numbers. We recognise that there remains a wide margin for error in all of our earnings forecasts.

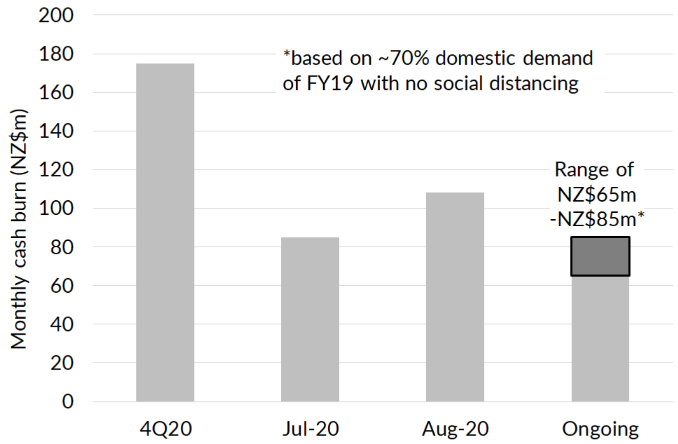
Figure 3. Earnings revisions (NZ$m)

	FY21E			FY22E			FY23E		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
Group RASK growth	30.9%	20.5%	-1035 bps	-20.2%	-10.9%	927 bps	n/a	-8.9%	n/a
Group ASK growth	-67.8%	-69.1%	-125 bps	134.3%	115.2%	-1908 bps	n/a	50.4%	n/a
Total fuel cost (ex forex hedging)	317	275	(42)	683	696	13	n/a	931	n/a
Sales revenue	2,570	2,333	-9%	3,962	3,635	-8%	n/a	4,656	n/a
Underlying PBT	**(211)**	**(316)**	**-50%**	**15**	**22**	**47%**	**n/a**	**112**	**n/a**
Underlying NPAT	(152)	(217)	-43%	11	16	47%	n/a	81	n/a
Underlying EPS (cents)	(13.4)	(19.3)	-44%	0.9	1.4	48%	n/a	7.2	n/a
DPS (cents)	0.0	0.0	n/a	0.0	0.0	n/a	n/a	10.0	n/a

Source: Forsyth Barr analysis

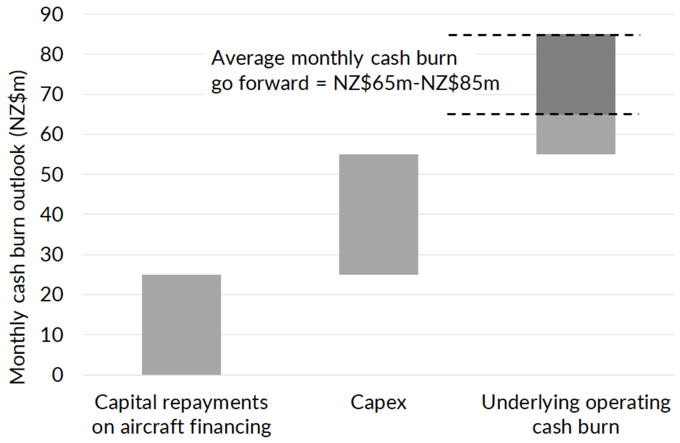
Key charts from FY20 result

Figure 4. Cash burn has improved but remains a drag on the balance sheet with border closures. August impacted by Alert Levels shift



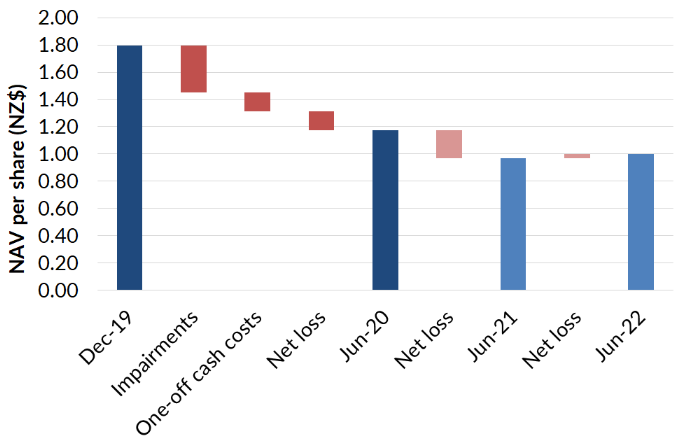
Source: Forsyth Barr analysis

Figure 5. Monthly cash burn includes capex of ~NZ$30m, aircraft finance capital repayments of ~NZ$25m and close to break-even underlying operating cash flows



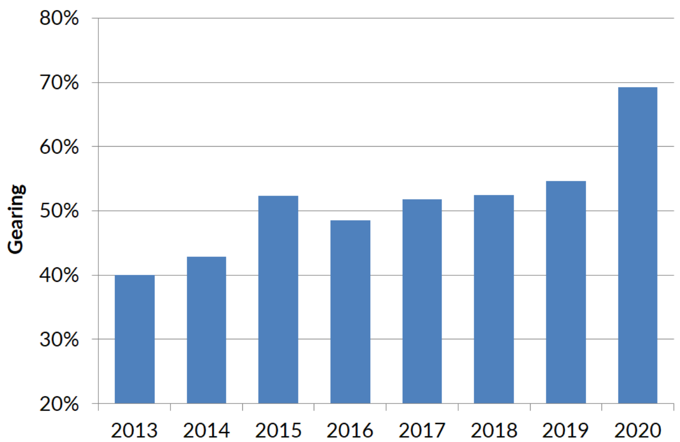
Source: Forsyth Barr analysis

Figure 6. NAV per share has fallen 69c over the past six months to NZ$1.17. We expect a further decline to ~NZ$0.97 in FY21 and a small gain to ~NZ$1.00 in FY22



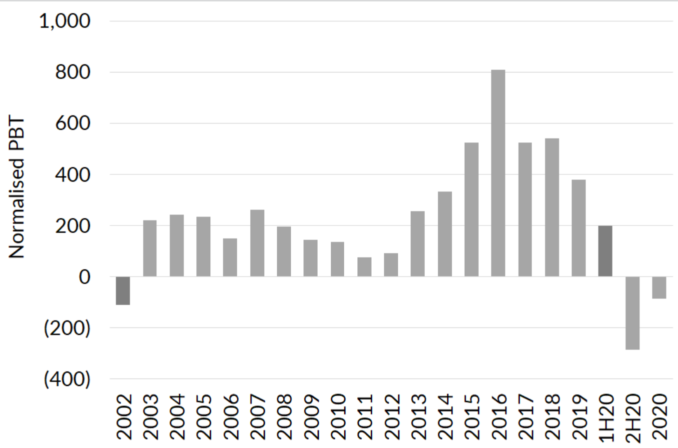
Source: Forsyth Barr analysis

Figure 7. Gearing is now beyond AIR's 45%–55% target band, which implies a capital raising is increasingly likely, though near term liquidity is provided for by the gov't funding facility



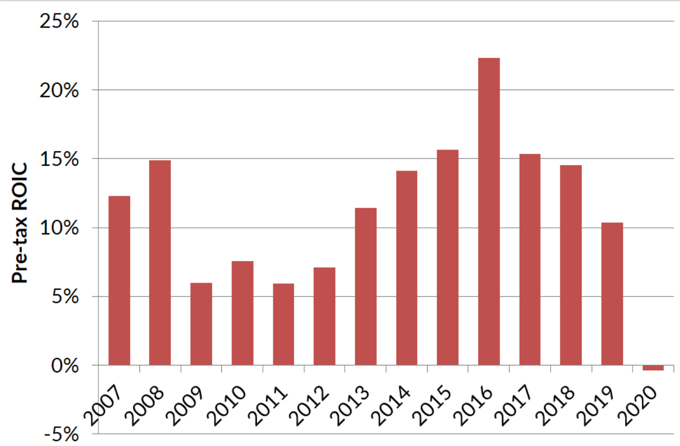
Source: Forsyth Barr analysis

Figure 8. AIR reported its first pre-tax loss in 18 years with an underlying loss of -NZ$87m in FY20



Source: AIR, Forsyth Barr analysis

Figure 9. We expect AIR to review its pre-ROIC objectives as part of its strategy refinement process (prev. target = 10%-15%)



Source: Forsyth Barr analysis

Results analysis

Figure 10. Result analysis (NZ$m)

	FY19	FY20	Change	Comments
Profit and loss account				
Domestic	1,600	1,324	-17.3%	Pax down -23%, ASK down -21%, RASK up +5%
Tasman & Pacific Islands	1,312	970	-26.0%	Pax down -26%, ASK down -24%, RASK down -2%
International	2,048	1,648	-19.5%	Pax down -22%, ASK down -20%, RASK down -1%
Passenger revenue	4,960	3,942	-20.5%	Reduction of -24% in passenger numbers and RASK flat
Cargo	390	449	15.1%	Boosted by government's International Airfreight Capacity Scheme
Contract services (& other)	197	216	9.6%	Includes gas turbines business, helped by ongoing US NAVY contracts
Other revenue	238	229	-3.8%	Reduced ancillary and lounge rev partially offset by private charters and repatriation flights
Sales revenue	5,785	4,836	-16.4%	
EBITDRA	**1,180**	**784**	**-33.5%**	
Rentals	(245)	0	n/a	IFRS 16 means lease operating expenses are now included within depreciation and interest
Depreciation and amortisation	(567)	(841)	-48.3%	Includes lease depreciation (not disclosed separately)
Interest expense	(31)	(69)	-122.6%	Includes lease interest (not disclosed separately)
Associates	37	39	5.4%	
Profit before tax	**374**	**(87)**	**-123.2%**	**AIR's best case scenario still sees an FY21 PBT loss**
Taxation	(104)	23	121.7%	Our estimate of underlying tax
Underlying NPAT	**270**	**(64)**	**-123.8%**	**AIR's first underlying loss since 2002**
Abnormals (post tax)	0	(390)	n/a	Aircraft impairment charge, reorganisation costs and de-designation of hedges
Reported NPAT	270	(454)	-268.0%	
Underlying EPS (cents)	24.0	(5.7)	-123.8%	Weighted average number of shares on issue of 1,123m
Interim DPS (cents)	22.0	0.0	-100.0%	First time AIR hasn't paid a dividend since 2005
Cashflow and net debt				
Operating cashflow	986	230	-76.7%	
Maintenance capex = depreciation	(567)	(841)	-48.3%	Deferral or cancellation of ~NZ$700m of expected capex through to December 2022
Disposals	13	109	738.5%	
Free cash flow	432	(502)	n/a	
(Acquisitions)/divestments	0	0	n/a	
Net debt/(cash)	(1,542)	(1,025)	33.5%	No longer includes debt related to finance leases (FY19: NZ$1,088m). Gearing at 69.2% outside of 45%–55% target band
Key statistics				
Total RASK	2.0%	0.7%	n/a	
Total ASK growth	4.0%	-21.1%	n/a	
Passenger revenue	6.0%	-20.5%	n/a	
Cost per ASK growth by segment (cents)				
Labour	2.94	3.29	12.2%	~-4,000 employees reduction (benefit in FY21); wage subsidy savings of NZ$75m
Fuel at hedged price translated at prevailing forex rate	2.76	2.81	1.9%	Reduced volume and decline in jet fuel price (-15%)
Maintenance	0.87	1.21	40.0%	Reduced capacity partially offset by increased maintenance activity for third parties
Aircraft operations	1.47	1.58	7.4%	
Passenger services	0.69	0.71	2.5%	
Sales & Marketing	0.76	0.70	-8.4%	
Forex hedging	(0.12)	(0.05)	57.0%	
Other	0.63	0.89	41.5%	
Pre-abnormals	**10.00**	**11.15**	**11.5%**	**Mainly driven by diseconomies of scale given fixed cost base**

Source: AIR, 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 forseeable 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 typically represents 25%–30% 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).

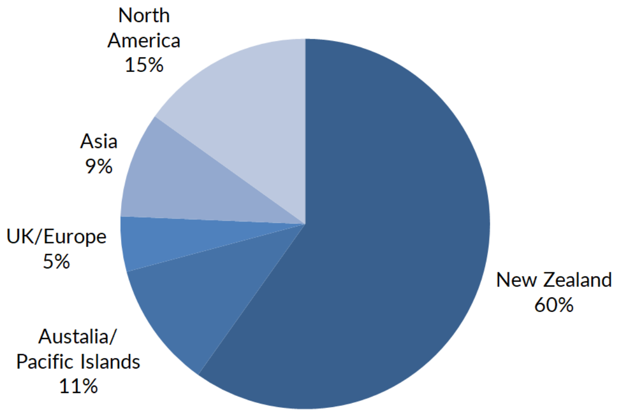
Financial structure

- **Balance sheet**: Gearing was outside of management's 45%–55% target band at June 2020. Gearing has been 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

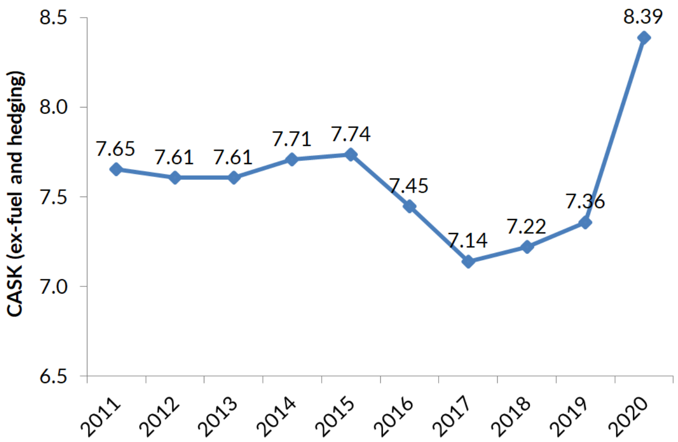
- **Left field events**: Disease outbreak (for example COVID-19), volcanic ash clouds, terrorism events.
- **Macro**: Volatility in exchange rates and global oil prices can have a dramatic impact on profitability.
- **Safety**: Any blip on AIR's good safety record could impact passenger confidence in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

Figure 11. Geographic exposure mix in FY20



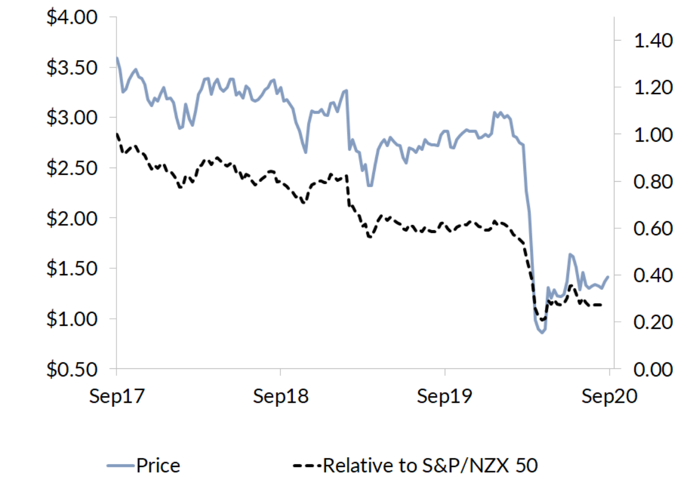
Source: Forsyth Barr analysis

Figure 12. Cost per ASK (cents per ASK)



Source: Forsyth Barr analysis

Figure 13. Price performance



Source: Forsyth Barr analysis

Figure 14. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	52.5%

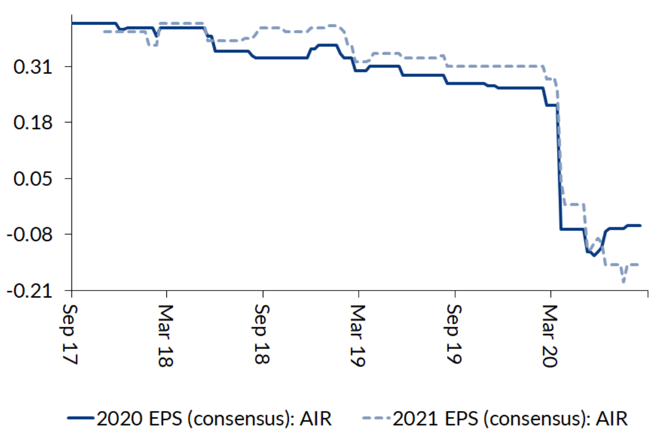
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 15. 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)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Air New Zealand	**AIR NZ**	**NZ$1.42**	**NZ$1,589**	**<0x**	**>50x**	**5.2x**	**3.2x**	**<0x**	**47.7x**	**0.0%**
QANTAS AIRWAYS	QAN AT	A$3.83	A$7,224	<0x	14.5x	13.7x	4.3x	<0x	12.3x	2.0%
CATHAY PACIFIC AIRWAYS	293 HK	HK$6.14	HK$39,524	<0x	<0x	>75x	8.2x	>75x	>75x	1.5%
SINGAPORE AIRLINES	SIA SP	S$3.66	S$10,851	<0x	<0x	<0x	7.6x	73.5x	>75x	1.3%
DEUTSCHE LUFTHANSA-REG	LHA GY	€8.77	€5,240	<0x	<0x	<0x	4.2x	<0x	4.8x	1.0%
AIR FRANCE-KLM	AF FP	€3.82	€1,639	<0x	18.0x	<0x	3.7x	<0x	<0x	0.0%
AMERICAN AIRLINES GROUP INC	AAL US	US$12.79	US$6,502	<0x	0.5x	4.2x	10.2x	<0x	<0x	0.5%
UNITED AIRLINES HOLDINGS INC	UAL US	US$34.25	US$9,948	>50x	>50x	0.5x	7.0x	<0x	<0x	0.0%
			Compco Average:	**n/a**	**11.0x**	**6.2x**	**6.5x**	**73.5x**	**8.6x**	**0.9%**
EV = Current Market Cap + Actual Net Debt			**AIR Relative:**	**n/a**	**n/a**	**-15%**	**-50%**	**n/a**	**457%**	**-100%**

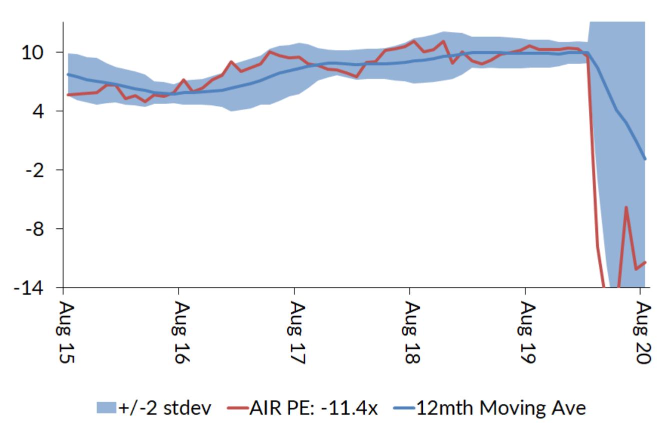
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (AIR) companies fiscal year end

Figure 16. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 17. One year forward PE (x)



Source: Forsyth Barr analysis

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