FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | TRANSPORT | INTERNATIONAL AIRLINE
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Air New Zealand
Valuing Loyalty — Upgrade to NEUTRAL

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NEUTRAL

Vaccine news and related positive sentiment aside, the recovery profile for Air New Zealand (AIR) is likely to be uneven and long dated. AIR's asset value continues to be an appropriate valuation benchmark while the business is loss-making or generating sub-WACC returns, in our opinion. However, this valuation anchor inconveniently ignores Airpoints, its loyalty scheme. Airpoints is scalable, asset-light and generates relatively stable earnings. We believe it is a higher multiple business than AIR's aviation business and contributes a material part of AIR's current share price. This may sound fanciful, yet a number of US airlines have recently used their loyalty schemes as collateral in recent funding events. We recognise AIR still requires a capital raise to mend its balance sheet, though this will be made easier with a more positive vaccine outlook. We upgrade our rating to NEUTRAL after applying a value to Airpoints as part of our revised net asset value (NAV) approach.

NZX Code	AIR
Share price	NZ$1.62
Target price	NZ$1.60
Risk rating	High
Issued shares	1123.0m
Market cap	NZ$1,819m
Avg daily turnover	2,566k (NZ$3,801k)

Financials: Jun/	20A	21E	22E	23E
NPAT* (NZ$m)	-64.2	-218.1	23.7	91.4
EPS* (NZc)	-5.7	-19.4	2.1	8.1
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
PE	n/a	n/a	76.9	19.9
EV/EBIT	n/a	n/a	46.4	19.3
EV/EBITDA	4.0	5.9	3.7	3.3
Price / NTA	1.6	2.0	1.9	1.9
Cash div yld (%)	0.0	0.0	0.0	6.2
Gross div yld (%)	0.0	0.0	0.0	8.6

What's changed?

- **Target price:** Lifted to NZ$1.60 having assigned value to AIR's loyalty programme Airpoints
- **Rating:** Upgraded to NEUTRAL from UNDERPERFORM

Strategic priority

New CEO Greg Foran has made loyalty a key strategic priority for AIR. At its recent Annual Shareholder Meeting he outlined the intention to "*strengthen loyalty to create a second growth engine*". Key sources of external loyalty revenue include banking partners through Airpoints aligned credit card schemes and various retailers. Airpoints has a highly engaged member base representing a high proportion of New Zealand adults.

Direct value in loyalty

Listed US airlines Delta (DAL.N), United (UAL.O), American (AAL.O), and Spirit (SAVE.K) have all used their respective loyalty schemes as collateral for funding rounds through COVID-19. Financial information provided by Delta and United highlights the material earnings generation of their respective schemes. For prolonged periods through COIVD-19 third party valuations of their loyalty programmes suggest they are worth more than the market cap of each airline (this is still the case for UAL.O and AAL.O).

Asset light and defensive

In normal operating conditions loyalty represents just another earnings stream for an airline. It can be valued as part of the overall profit base of the company within an earnings multiple or cash flow based valuation. However, when the aviation business is generating significant losses, the loyalty income stream which is typically defensive, can easily be lost, particularly if its not split out. Book value approaches to airline valuations ignore the asset light nature of loyalty schemes that generate income from third parties (credit card companies and retailers) irrespective of whether aircraft are flying.

Air New Zealand Ltd (AIR)

Priced as at 10 Nov 2020 (NZ$)	**1.62**

12-month target price (NZ$)*	**1.60**
Expected share price return	-1.2%
Net dividend yield	0.0%
Estimated 12-month return	-1.2%

Spot valuations (NZ$)	
1. Net asset value plus loyalty	1.60
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**	**499.4**	**818.8**	**936.8**
Depreciation and amortisation	(567.0)	(841.0)	(754.4)	(753.1)	(778.9)
Normalised EBIT	**368.1**	**(56.8)**	**(255.0)**	**65.7**	**157.9**
Net interest	(31.0)	(69.0)	(102.1)	(71.9)	(69.9)
Associate income	37.0	39.0	39.0	39.0	39.0
Tax	(104.0)	22.5	100.0	(9.2)	(35.6)
Minority interests	0	0	0	0	0
Normalised NPAT	**270.1**	**(64.2)**	**(218.1)**	**23.7**	**91.4**
Abnormals/other	0	389.5	0	0	0
Reported NPAT	**270.1**	**(453.8)**	**(218.1)**	**23.7**	**91.4**
Normalised EPS (cps)	23.9	(5.7)	(19.4)	2.1	8.1
DPS (cps)	22.0	0	0	0	10.0

Valuation Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EV/EBITDA (x)	3.5	4.0	5.9	3.7	3.3
EV/EBIT (x)	8.9	n/a	n/a	46.4	19.3
PE (x)	6.8	n/a	n/a	76.9	19.9
Price/NTA (x)	1.0	1.6	2.0	1.9	1.9
Free cash flow yield (%)	9.1	-21.2	-7.7	21.5	18.4
Net dividend yield (%)	13.6	0.0	0.0	0.0	6.2
Gross dividend yield (%)	18.9	0.0	0.0	0.0	8.6

Capital Structure	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Interest cover EBIT (x)	11.9	n/a	n/a	0.9	2.3
Interest cover EBITDA (x)	30.2	11.4	4.9	11.4	13.4
Net debt/ND+E (%)	42.5	43.7	53.0	44.3	39.7
Net debt/EBITDA (x)	1.6	1.3	2.5	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	-36.3	64.0	14.4
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	-3.5	0.9	2.0
Return on equity (%)	12.9	-4.9	-20.1	2.1	8.2
Return on funds employed (%)	n/a	n/a	n/a	n/a	n/a
EBITDA margin (%)	16.2	16.2	21.4	22.5	20.1
EBIT margin (%)	6.4	-1.2	-10.9	1.8	3.4
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	123

Cash Flow (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EBITDA	**935.1**	**784.2**	**499.4**	**818.8**	**936.8**
Working capital change	245.0	0	0.0	0	0
Interest & tax paid	(135.0)	134.0	32.4	(41.1)	(60.1)
Other	(59.1)	(688.2)	(372.6)	163.9	257.6
Operating cash flow	**986.0**	**230.0**	**159.3**	**941.6**	**1,134.4**
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)**	**(77.7)**	**455.0**	**397.8**
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)**	**(202.7)**	**330.0**	**160.5**

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	270	687	915
Unit fuel (cents/ASK)	2.8	2.8	2.4	2.8	2.5
CASK ex-fuel/forex (cents/ASK)	7.4	8.4	16.3	11.6	10.2
Normalised EBIT	368.1	(56.8)	(255.0)	65.7	157.9
Net interest	(31.0)	(69.0)	(102.1)	(71.9)	(69.9)
Associate income	37.0	39.0	39.0	39.0	39.0
Normalised PBT	**374.1**	**(86.8)**	**(318.1)**	**32.9**	**127.0**

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	1,227.7	897.7	737.2
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	1,087.9	1,127.7	1,119.9
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

Key valuation questions

We have simplistically used book value, or NAV (net asset value), as the sole basis for our valuation of Air New Zealand (AIR) since the onset of COVID-19 in March 2020. Only briefly has AIR's share price traded below book value. We recognise that the ongoing use of this basic approach must consider two key valuation questions:

- Should we ascribe value to loyalty, as loyalty has no book value?
- Is book value a fair representation of AIR's asset base?

Structural change in valuation

We believe the answer to both questions is yes. In addressing them we alter our approach to valuing AIR. In particular, we add a specific value for AIR's Airpoints loyalty scheme. Our revised valuation and target price is NZ$1.60 reflecting NZ$1.00 for net asset value (NAV) and NZ$0.60 for loyalty.

Figure 1. Valuation breakdown (rounded to NZ$1.60)

Valuation component	Comments	Value (NZ$m)	Shares on issue (m)	Value per share (NZ$)
Net asset value	NAV was NZ$1.17 per share at 30 June 2020. We expect a further decline to ~NZ$1.00 as at 30 June 2021.	1,098		
Loyalty	Discounted by -15% from mid-point pre COVID-19 range of NZ$700m–NZ$1bn	725		
Total		**1,823**	**1,123**	**1.62**

Source: Forsyth Barr analysis

Should we ascribe value to loyalty?

We have previously conveniently ignored loyalty at AIR given its limited financial visibility. However, airline loyalty schemes offer more attractive investment characteristics than the airlines they are connected to, in our opinion. They are scalable, asset-light, generate relatively stable earnings and are data driven. They provide airlines defensive earnings streams and scope to create deeper, more valuable and longer lasting customer relationships.

Yet, airline loyalty schemes detract rather than add to an airline's book value. This reflects the deferred revenue liability of airmiles/points that have yet to be redeemed (ignoring the cash received in respect of those points). A book value approach ignores the underlying value that may exist within a loyalty scheme; a loyalty scheme premium should be applied to book value if it is the sole means of valuing an airline.

We think there are two significant sources of value from Airpoints:

- **Direct value:** the value of the earnings stream generated by the scheme from non-aviation partners and from its own (online) Airpoints retail store.
- **Indirect value:** the deeper engagement with customers that drives loyalty/willingness to a pay a premium for flights, increase frequency of flights and choose AIR over competitors. This is effectively the competitive advantage that the scheme creates. AIR uses its tiered approach (Silver, Gold and Gold Elite) to drive loyalty as members attempt to retain or gain higher membership tiers.

Direct and indirect value can be complimentary although the balance between them may differ materially by scheme. For example, we believe the structure and currency of Airpoints helps lift its indirect value, but adversely impacts its direct value, due to the relative transparency on the value of each Airpoints Dollar. The indirect value is helpful to the success of the airline but is extremely difficult to value. Our valuation for Airpoints only considers the direct value of the scheme.

Strategic focus

AIR's new five pronged strategy as outlined at its September 2020 annual shareholder meeting includes "*Lifting Loyalty: Strengthening loyalty to create a second growth engine*". The company says that it will bring more opportunities to earn and use Airpoints Dollars, while creating innovative new products and services. This appears to be following the route taken by more advanced loyalty schemes at other airlines, including Qantas, and highlights the scope/need for a loyalty valuation separate to the aviation business.

Is book value a fair representation of AIR's asset base?

AIR's balance sheet is dominated by aircraft. Excluding cash, aircraft (owned and leased) account for ~77% of total assets as at 30 June 2020. Aircraft values are tested for impairment annually. As a result of COVID-19 AIR decided to ground its B777-200ER fleet (eight aircraft, of which four are leased) for an indefinite period. It consequently wrote-down the value of these aircraft by NZ$335m in its FY20 result. It made no other impairment provisions for other aircraft.

Aircraft valuations have fallen as a result of COVID-19 but not significantly for AIR

The B777-200ER impairment amounted to a -6% decline in AIR's total aircraft book value (including both owned and leased aircraft). This compares to an -11% decline in its weighted market value of aircraft based on Cirium (an aircraft valuer) data between January 2020 and September 2020 (refer to our summarised analysis in Appendix 4 on page 16). We determine that AIR's market value of aircraft has held up comparatively well compared to other airlines given the relatively young age of its fleet and limited exposure (in value terms) to older aircraft technology. For example, the market value of its largest aircraft asset, the B787-9, has only fallen between 0% and -5% according to Cirium, compared to the market value decline for A320-200s of between -20% and -40%.

The impact of COVID-19 on AIR's aircraft market values also needs to be considered in the context of its annual depreciation burden, which between January 2020 and September 2020 will have amounted to around 8% of its aircraft book value. Consequently, we believe AIR's impairment approach to-date more than reflects the diminution in aircraft market values at a fleet level.

Equity dilution from ongoing cash burn

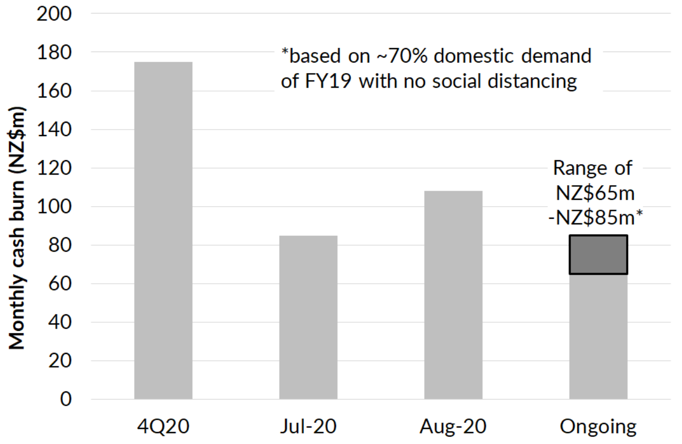
We assume monthly post-tax losses of -NZ$30m to -NZ$50m currently in the absence of commercial international services as shown in Figure 2, which is based on monthly cash burn of NZ$65 to NZ$85m. This equates to 2c–3c per share monthly NAV diminution and is consistent with our NAV estimate of ~NZ$1.00 as at 30 June 2021 assuming borders begin to reopen during 2H21.

Figure 2. Reconciliation between monthly cash burn guidance and P&L impact

	Monthly amount (NZ$m)	Per share (cents)
Cash burn	(65)-(85)	
Capex	30	
Capital on aircraft financing	25	
Operating cashflow	**(10)-(35)**	
Working capital	25	
Depreciation	(45)	
Monthly P&L pre-tax loss	**(30)-(50)**	**(2.7)-(4.5)**
Monhtly P&L post-tax loss	(22)-(36)	(1.9)-(3.2)

Source: Forsyth Barr analysis

Figure 3. AIR's cash burn through COVID-19

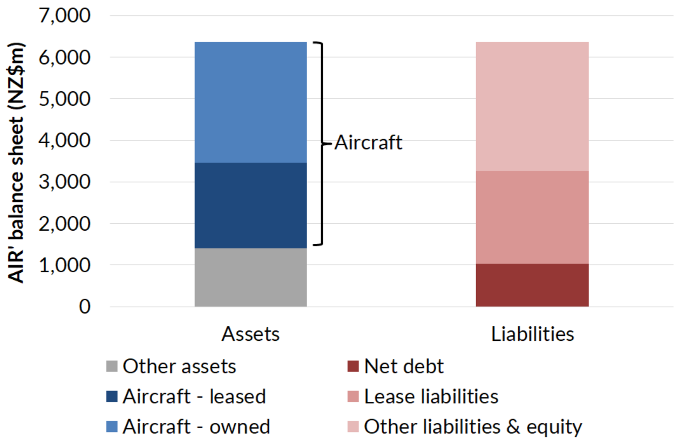


Source: AIR, Forsyth Barr analysis

AIR has enjoyed a book value premium in recent years

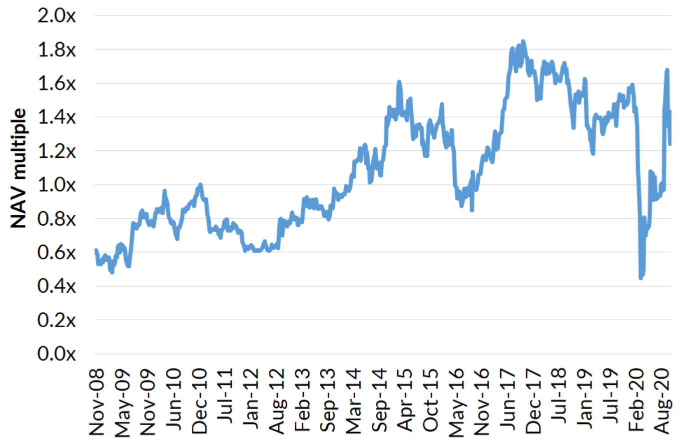
Over the past 12 years AIR has traded at an average +8% premium to NAV (Figure 5); this premium has strengthened in more recent years. Over the past four years, which admittedly coincide with more elevated levels of profitability, the premium has averaged +41%.

Figure 4. AIR's balance sheet is dominated by aircraft (FY20)



Source: AIR, Forsyth Barr analysis

Figure 5. AIR has traded at a premium to NAV in recent years

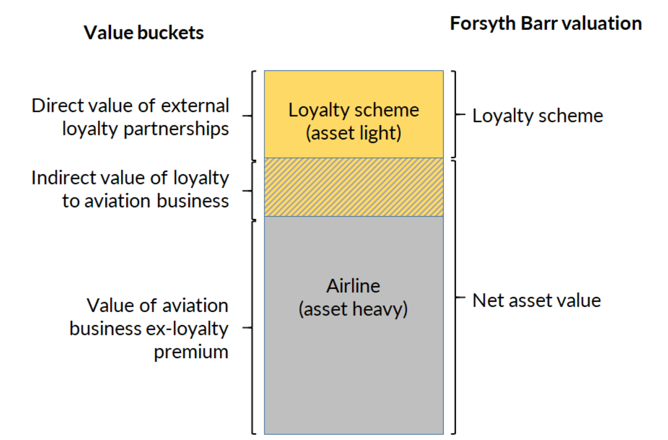


Source: Datastream, Forsyth Barr analysis

The value of loyalty

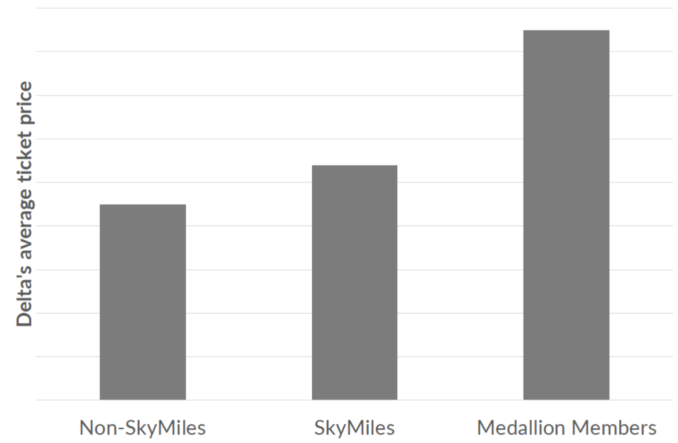
The value of AIR's loyalty scheme Airpoints would ordinarily be reflected in an earnings multiple or DCF valuation. However, in a COVID-19 world we disregard both of these valuation techniques given the uncertainty surrounding the earnings recovery path and current losses. Instead we use a balance sheet approach, which largely reflects aircraft values, but ignores any valuation for the asset light loyalty scheme. Airline loyalty schemes are intrinsically linked to an airline's ability, and the aspiration of its members to fly; therefore, any value ascribed to Airpoints assumes that AIR is a going concern, which is reasonable given assurances from the New Zealand Government. We, therefore, believe it is appropriate to provide some value to loyalty schemes separately to NAV.

Figure 6. The value attached to a loyalty scheme is incremental to the hard assets of an airline



Source: Forsyth Barr analysis

Figure 7. Loyalty schemes provide ticket revenue premium to airlines



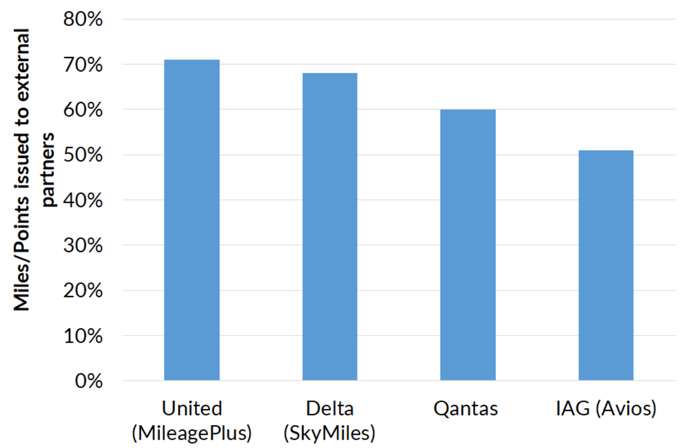
Source: Delta Airlines, Forsyth Barr analysis

Key benefits of loyalty programmes

There are a number of key benefits that strong loyalty schemes provide airlines. In particular they:

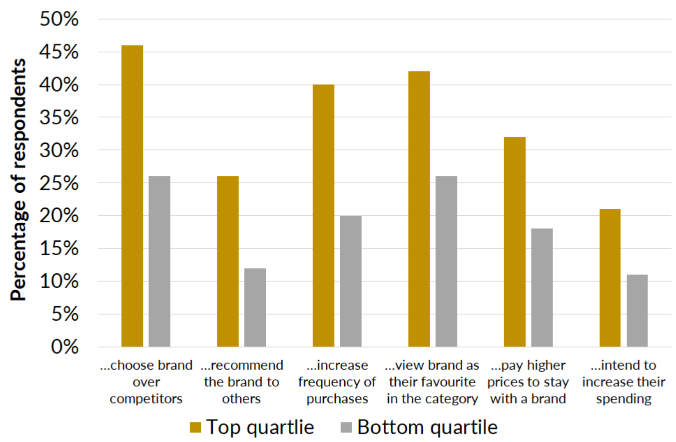
- **Create loyalty** — AIR is able to charge a premium to customers because of its loyalty as many customers are 'locked in' to the scheme tiers (Silver, Gold and Gold Elite) and will use AIR more than other airlines. This is particularly the case for business travellers, which generate Airpoints for themselves (as a perk of travelling) at their company/organisation/government's cost.
- **Big data** — AIR has as much consumer related data as any organisation in New Zealand for a large proportion of the population. This data provides it with the opportunity to personalise its service, undertake data-driven marketing, and generate offers based on buying habits.
- **Offer more comprehensive service** — Lounge access and other benefits through own services and alliances (AIR does this through status points).

Figure 8. Third party relationships are key drivers of growing loyalty scheme value



Source: United Airlines, Delta Airlines, Qantas, IAG, Forsyth Barr analysis

Figure 9. Members of top performing loyalty schemes are significantly more likely to....



Source: McKinsey, Forsyth Barr analysis

- **Generate incremental revenue** — Through selling points/airmiles to third parties including credit card companies. Many schemes issue a greater proportion of points to third parties than to their own airline. Refer to Figure 8.

Limited loyalty scheme data available

Few airlines (including AIR) provide frequent flyer loyalty scheme financial data. However, the use of loyalty schemes as collateral for funding rounds among US airlines due to COVID-19 balance sheet pressures has provided more insight into schemes at United Airlines (MileagePlus) and Delta Airlines (SkyMiles). Qantas (Qantas Frequent Flyer), Virgin Australia (Velocity) and Aeromexico (Club Premier via its JV ownership vehicle PLM) have also historically provided useful financial insight into their respective schemes.

AIR's Airpoints loyalty scheme

AIR's Airpoints loyalty scheme, similar to other airlines programmes combines an airmiles reward programme with a status point/tier structure. Airpoints is unique in the airline loyalty world with a direct conversion between Airpoints Dollars to NZ Dollars. This provides a high level of transparency and redemption options for members, greater churn of points, but less flexibility for AIR in the pricing of units.

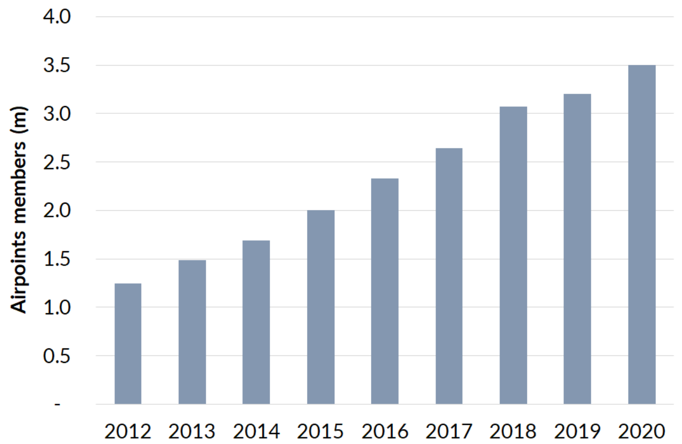
Members can earn Airpoints Dollars by (1) flying on Air New Zealand, (2) flying on Star Alliance/other partner airlines, and (3) spending with retailers/hotels/car hire/real estate agents/banks/insurance companies that have partnered with Airpoints.

There are now >60 Airpoints partners (including American Express, ANZ, Kiwibank, Westpac, New World, Mitre 10 Mega, Mercury, Z Energy, Caltex, Harvey Norman, Tower Insurance and Spark) that members can earn points from.

Airpoints can be spent/redeemed on almost any Air New Zealand flights (this is unusual in loyalty schemes, which typically restrict flights/seats available for redemptions) and upgrades, the Airpoints store, at Mitre 10, at the Air New Zealand wine store, and on car rental and travel insurance through Air New Zealand.

AIR has 3.5m members currently, having grown from 1.2m in 2012; representing an impressive compound average growth rate (CAGR) of +14% over eight years. AIR has never provided any financial detail on its Airpoints scheme beyond the annual accrued 'revenue in advance' related to loyalty in its balance sheet.

Figure 10. Airpoints membership has grown significantly



Source: AIR, Forsyth Barr analysis

Figure 11. Airpoints partners include ...

Source: AIR, Forsyth Barr analysis

Scope for more growth

AIR has various means of extracting more direct economic value from its Airpoints loyalty scheme:

- **Growing its membership base:** The vast majority of the current 3.5m Airpoints members (~90%) are New Zealanders. Therefore, scope to continue to grow the membership base is limited by its historic success and the New Zealand population.
- **Growing its proportion of active members:** Those highly engaged members that are often in higher scheme tiers that purchase higher value tickets than other travellers.
- **Expanding the scheme to include more partners:** This is a key opportunity for AIR, in our opinion. We expect Airpoints to expand the depth and breadth of its retailer/financial services relationships, to white label its own credit cards as other airlines have done successfully, and expand its Airpoints store for redemption options.

- **Generating better margins from selling Airpoints to external partners:** By this we mean the amount of income AIR generate for every NZ$1 spent by a member with an Airpoints partner. For example: if 'John' spends NZ$75 on his Airpoints credit card, he may receive one Airpoint Dollar, which costs the credit card company 90c. The Airpoints margin on the member spend is 90c / NZ$75 = 1.2%.

The last point is topical given the decision by ANZ to recently reduce the value provided to its Airpoints Platinum credit card members, who will now have to spend NZ$85 for each Airpoints Dollar, compared to NZ$75 previously.

Figure 12. Comparison with key alternative airline loyalty schemes

Airline	Loyalty scheme	Airmile unit	Total members	Active members	No. of partners	Key bank/credit card partners
AIR	Airpoints	Airpoint (1 = NZ$1)	3.2m	n/a	60+	American Express, Kiwi Bank, ANZ, Westpac
Qantas	Frequent Flyer	Frequent flyer point	13m	n/a	450+	American Express, NAB, Wesptac, Bankwest, St George, HSBC, ANZ, Macquarie, Bank of Melbourne, Bank SA, BOQ, Bendigo Bank, Qudos
Virgin Australia	Velocity	Velocity point	10m	n/a	400+	American Express, ANZ, Westpac, Suncorp, St George, NAB, BOQ, Bank SA, Bank of Melbourne, HSBC, Commonwealth Bank, Citi, Virgin Money
IAG	Avios	Avios	34m	9m	930+	American Express, HSBC, Barclays, Tesco bank, Asda money, RBS, white labels (BA, Iberia, Aer Lingus, IHG)
United	MileagePlus	Mileageplus point	100m+	n/a	110+	JP Morgan Chase
Delta	SkyMiles	Skymile	100m+	n/a	65+	American Express
American	AAdvantage	AAdvantage point	n/a	n/a	n/a	Citi
Air Canada	Aeroplan	Aeroplan mile	n/a	5m	150+	TD (Toronto Dominion Bank)
Aeromexico	Club Premier	Premier point	6.7m	n/a	90+	American Express, Citi, Capital One, Barclays, Hana Bank, Livelo, HSBC, Esfera

Source: Company data, Forsyth Barr analysis

The perceived vs. actual value of an Airpoints Dollar

Despite the seemingly transparent nature of the value of one Airpoints Dollar (= NZ$1) to Airpoint scheme members, we are unsure of the actual value applied to Airpoints Dollars by AIR. Airpoints Dollars represent a currency for members, but members have no ability to exchange Airpoints Dollars to other currencies. The perceived value of an Airpoints Dollar to a member likely overstates its actual value. For example if a member was given the choice of receiving NZ$1,000 in cash or 1,000 Airpoints Dollars, we'd expect the member to take the cash 100% of time. The cash has greater actual value as it can be used far more freely than Airpoints Dollars. The answer may be different if the member was given the option of receiving NZ$900 in cash or 1,000 Airpoints Dollars.

We carried out a survey of Airpoints members and found that when offered the choice of NZ$900 in cash or 1,000 Airpoints Dollars, 63% of respondents opted for the cash. Taking this further we found that respondents appeared indifferent when offered NZ$780 cash or 1,000 Airpoints Dollars. We recognise the value of an Airpoints Dollar may have fallen through COVID-19 given less scope for flight redemptions, though we also recognise that even in pre COVID-19 times there would still have been a value difference.

Ultimately, we believe that the real AIR value of an Airpoints Dollar is less than NZ$1. This means that for internal transfer pricing one Airpoints Dollar will equal less than NZ$1. This may not seem intuitive, but reflects several factors including (1) AIR sells Airpoints Dollars to third parties at, or below, face value (the perceived value), (2) the captive nature of a member's Airpoints Dollars balance as most Airpoints are redeemed through flying, (3) an Airpoints Dollars booked flight has lower overhead cost (for example sales and marketing) than the average ticket sold, and (4) breakage when Airpoints Dollars expire and therefore can no longer be redeemed.

Breakage

Industry estimates point to 15%–30% of all airline miles ending up unspent and thus expiring. This 'breakage' is booked directly as profit to the airline. This may sound like a good thing, but in reality it reflects a lost opportunity to engage with customers.

AIR has previously stated that its breakage is comparatively low, which we believe reflects the (1) the simplicity/transparency of Airpoints, and (2) the engaged/active nature of its membership base. Its relatively low level of breakage is consistent with an engaged membership base as evidenced in its comparatively low level of unused Airpoints liability.

How much is Airpoints worth?

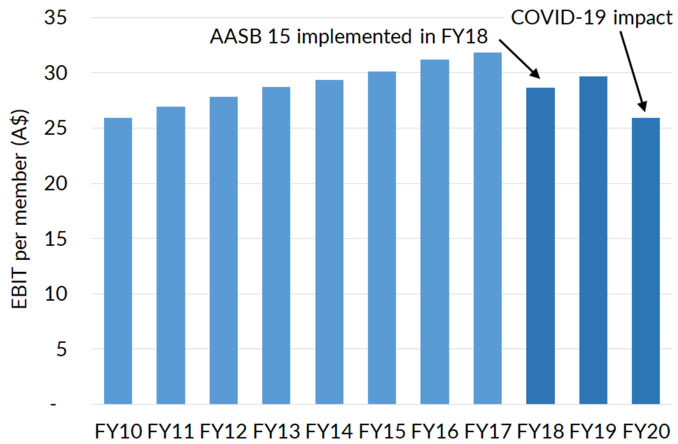
AIR does not provide any financial detail on its Airpoints scheme beyond the balance sheet disclosure for 'revenue in advance' related to loyalty. This liability reflects the amount of Airpoints dollars outstanding among members. This lack of disclosure (like most airlines) makes AIR's Airpoints scheme difficult to value. The difficulty is magnified by COIVD-19.

Nonetheless, there are a number of valuation approaches available together with comparative airline loyalty scheme financial information, which allows us to estimate, recognising a reasonable margin for error, the value of Airpoints. Based on our assessment of recent loyalty scheme transaction values, third party loyalty valuations and listed loyalty scheme providers we value Airpoints at ~NZ$725m or ~60c per share. This appears significant in the context of AIR's current share price, but represents only ~15% of its pre COVID-19 (31 December 2019) enterprise value (EV).

Higher multiple businesses than associated airline

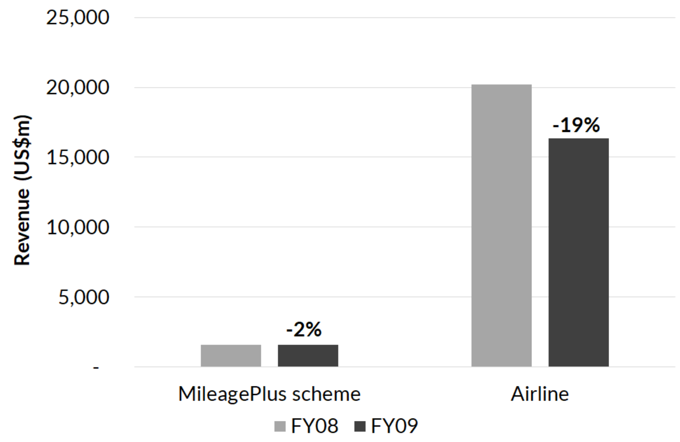
Loyalty schemes typically generate far more defensive earnings streams than their associated airlines. By way of example we highlight the steady growth generated by Qantas Loyalty over the past 10 years in Figure 13. While COVID-19 impacted its profitability in FY20, the earnings decline was modest in relation to the significant losses incurred by the airline's aviation business. Loyalty resilience is further highlighted in Figure 14, which shows the revenue impact of the global financial crisis (GFC) on United Airlines compared to its MileagePlus loyalty programme.

Figure 13. QAN's loyalty unit EBIT growth has been consistent



Source: QAN, Forsyth Barr analysis

Figure 14. Relative resilience through GFC at United Airlines



Source: United Airlines, Forsyth Barr analysis

What does the loyalty valuation constitute?

The balance sheet accounting of a loyalty scheme includes a large liability (deferred revenue) for unexpired points/airmiles issued. The corresponding asset is reflected in the airlines cash (or net debt) balance. When these points/miles are redeemed the balance sheet liability is drawn down as revenue. For Airpoints we assume the scheme NAV is equal to zero. Therefore, any value that we attach to Airpoints is 100% incremental to NAV.

Airpoints' earnings

AIR does not provide profit & loss or cash flow information on its Airpoints loyalty scheme. Our profitability assumption is based on comparative loyalty scheme information. We believe Airpoints generates loyalty revenue from five principal sources:

- **Selling Airpoints Dollars to third parties** — it sells Airpoint Dollars at or below face value to third parties, which generates a margin given the selling price will still be higher than the (actual) cost of each Airpoint Dollar assigned by AIR.
- **Selling Status Points/lounge passes/other benefits to third parties** — for example it sells Status Points to credit card companies. The cost associated with status points reflects tier benefits including lounge access, Star Alliance benefit related costs, valet parking vouchers etc.
- **Selling products through its Airpoints store** — it sells products and services through its Airpoints store in exchange for Airpoints Dollar redemptions. AIR says that over 90% of redemptions have typically been undertaken through its Airpoints store, albeit this may have increased as a result of COVID-19 travel restrictions.

- **Selling Koru memberships** — the Airpoints business unit manages AIR's lounge network and sells Koru membership separately to its airpoints scheme.
- **Commissions on redemptions through third parties** — for example members can use Airpoints Dollars to buy Mitre 10 evouchers in its Airpoints store or use Airpoints Dollars at Mitre 10 stores for in-store purchases.

We assume that AIR generates a loyalty margin from each of these revenue streams. It also generates a margin from "breakage", when unredeemed Airpoints Dollars expire.

Our EBIT estimate for Airpoints

We estimate that Airpoints contributes (or at least has the ability to contribute) NZ$70–100m of EBIT annually on pre COVID-19 assumptions based on the profitability of other schemes. This suggests that the EBIT generated per member would be ~NZ$20–28, which is below that of Qantas but above Virgin Australia (Figure 16). We acknowledge that COVID-19 will have had an impact on loyalty scheme earnings and adjust accordingly in our valuation as discussed and summarised below.

Figure 15. Estimating Airpoints EBIT

	Denominator	Denominator	Assumption	EBIT (NZ$m)
EBIT per member	Members in millions (current)	3.5	NZ$20	70
Loyalty EBIT margin of Group revenue (refer Figure 17)	Group revenue (FY19, NZ$m)	5,785	1.7%	98
Average				**84**

Source: Forsyth Barr analysis

Profitability of other schemes

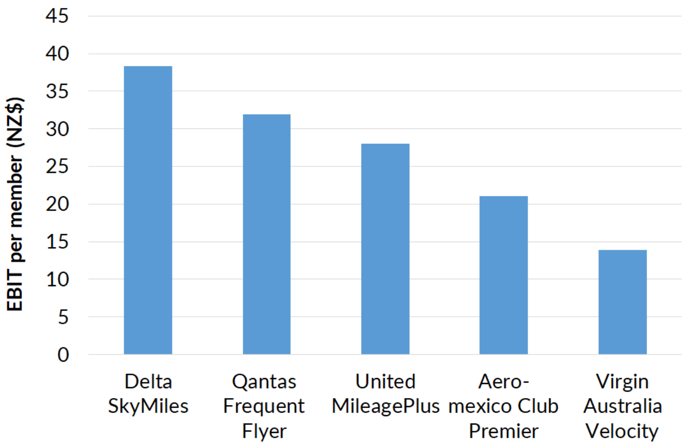
The range of EBIT per member generated by other airline loyalty schemes is wide as shown in Figure 16. However, we are wary of the inconsistencies between schemes with regards to how they each manage internal transfer pricing of points. For example, Qantas Loyalty reports earnings that do not include any margin on Qantas issued points or flight redemptions. In contrast, United Airlines buys miles from its MileagePlus scheme that guarantees a minimum EBITDA margin of 20% on United related revenue. Virgin Australia's Velocity scheme also generates a margin on points issued from the airline.

Notwithstanding internal transfer pricing, the majority of partner related income for a scheme typically stems from credit card relationships. For example, Delta's relationship with AMEX contributes ~97% of its non-air partner revenue and ~64% of the total. This is consistent with anecdotal evidence for the Airpoints scheme given the number of Airpoints Dollars generated from different partners at a member level.

In Figure 17 we suggest that there is a relationship between the EBIT generated by a scheme as a proportion of total airline revenue and the domestic split of that revenue. This is intuitive. Domestic airline revenue is more likely to be frequent flyer generated, either through cash sales, which generate points, or redemption flights which may have been paid for by credit card usage. However, this arguably penalises AIR given the relatively attractive structural positions (i.e. less competitive) of its international routes. We exclude Virgin Australia's Velocity scheme from the best fit line for three reasons (1) Virgin's scheme will be a secondary rather than primary scheme for many of its members, (2) it generates substantially lower profits per member than Qantas, reflective of the latter's superior third party revenues, and (3) it is an outlier.

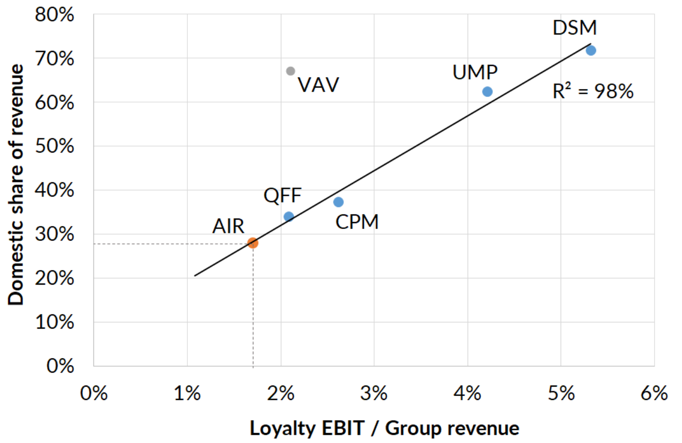
It may be prudent to apply a discount to comparative scheme profitability when applying to AIR, given the greater transparency with its points, which may hinder its ability to generate the same level of third party margin as other schemes do.

Figure 16. EBIT per member differs materially by loyalty scheme



Source: United Airlines, Delta Airlines, Qantas, Virgin Australia, PLM, Forsyth Barr analysis

Figure 17. Scheme EBIT as a proportion of group revenue and the domestic split of the airline



Source: Forsyth Barr analysis DSM = Delta SkyMiles, UMP = United MileagePlus, CPM = Club Premier, QFF = Qantas Frequent Flyer, VAV = Virgin Australia Velocity

Valuation of Airpoints

Our three valuation approaches provide a wide range of outcomes as shown in Figure 18, from NZ$639m to NZ$1.3bn. We take a conservative approach and err to the lower end of this range as (1) Airpoints provides no cashflow or profitability disclosures, (2) we only value the third party income related to the scheme (some schemes generate profit from internally issued points), and (3) we believe the Airpoints scheme has historically been more weighted to member experience/loyalty than as a revenue/margin generating business unit. Consequently, we value Airpoints on a pre COIVD-19 basis between NZ$700m and NZ$1bn, the mid-point being NZ$850m.

We use three different approaches to value Airpoints:

- #1: Transaction values for recent loyalty scheme M&A
- #2: Third party valuations
- #3: Applying listed loyalty scheme company earnings multiples

Figure 18. Comparative valuation approaches considered in valuing Airpoints

Valuation approach	Details	Valuation (NZ$m)	Value per share (NZ$)
Transaction values			
- Virgin Australia (2019): EBIT multiple	16x EBIT multiple x NZ$84m estimated EBIT	1,344	1.20
- Virgin Australia (2019): value per member	A$200 x 1.07 (NZDAUD) x 3.5m members	749	0.67
- Air Canada Aeroplan (2019): value per active member	C$600 x 1.15 (NZDCAD) x 34/9 (total to active member ratio from IAG) x 3.5m members	639	0.57
On Point Loyalty	US$791m x 1.53 (NZDUSD)	1,217	1.08
Listed comps	14x historic average PE multiple x NZ$84m x (1- 28%) post tax	847	0.75

Source: Forsyth Barr analysis

A pre COVID-19 valuation

Our valuation analysis has been undertaken on a pre COVID-19 basis. COVID-19 has had an impact on the relative attractiveness of loyalty schemes for several reasons:

- Credit cards experienced a sharp decline in spending through April and May 2020 in light of government imposed lockdowns
- The value of airline loyalty scheme points to members will have fallen in our view, as members have less ability to redeem points given significant flight capacity reductions
- Airline loyalty schemes only exist in tandem with the associated airline. Most associated airlines have come under significant financial strain as a result of COVID-19 with the very survival of many still a key risk. This isn't a risk for AIR specifically given the government's commitment to its going concern nature
- The broader economic consequences on, and attractiveness of, air travel impact the desirability of membership

Adjusting for the impact of COVID-19 we apply a discount of ~-15% and accept this is an arbitrary deduction. There is limited information concerning the performance of airline loyalty schemes through COVID-19, albeit their performance has held up significantly better than their associated airlines (Qantas Loyalty for example experienced a -28% decline in EBIT in the six months to June 2020, compared to a decline into loss-making territory for Qantas' airline assets).

Valuation approach #1: Transaction values

There have been two notable airline loyalty scheme transactions over the past two years:

- **Virgin Australia** (VAH.AX) acquired the ~35% minority stake in its **Velocity** scheme from Affinity Equity Partners late last year for A$700m, having sold the stake in 2014 for A$336m. On a value per member basis, this values Velocity at ~A$200/member (or ~US$140/member) and at ~16x trailing EBIT multiple.
- **Air Canada** (AC.TO) bought back its **Aeroplan** scheme from Aimia (AIM.TO) in early 2019 for C$517m plus the net scheme liabilities. In total this amounted to C$3.1bn. On a value per member (active members only) basis this values Aeroplan at ~C$600/ member (or ~US$460/member). Air Canada does not disclose Aeroplan earnings.

While these transactions provide valuation benchmarks, they represent a relatively crude measure as (1) they take no account of the quality or profitability of each scheme (for example Velocity is far less profitable per member, despite generating a margin from internally issued points, than other schemes [Figure 19]), and (2) we are uncertain how comparable the membership numbers are between the schemes. For example Velocity publishes total members whereas Aeroplan publishes active members.

Applying the same proportion of active to total provided by IAG's Avios scheme (9m active of 34m total) suggests the valuations per member may not be too different between Velocity and Aeroplan (its has ~5m active members, but could have ~19m members [= 5m x 34 / 9] in total).

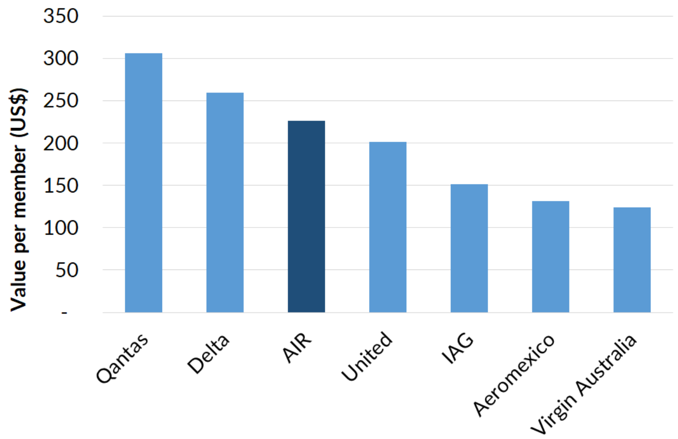
Virgin Australia publishes Velocity divisional earnings, which allows us to determine that the transaction value represented a ~16x EBIT multiple. This is a useful valuation benchmark despite the fact that AIR doesn't publish profitability data for its Airpoints scheme, as we have already estimated its EBIT contribution based on comparative programmes.

Valuation approach #2: On Point Loyalty valuations

On Point Loyalty, an external loyalty focussed consultancy and investment firm estimates (in its January 2020 report Top 100 Most Valuable Airline Loyalty Schemes) the value of AIR's Airpoints at US$791m (or NZ$1.2bn). This amounts to ~NZ$1.08/share (~70% of current share price) or ~US$225/member. We take this valuation with an element of scepticism. On Point's valuation is based on a minority stake of the programme and would likely include profits generated from points issued (as a result of favourable transfer pricing) by the airline to scheme members.

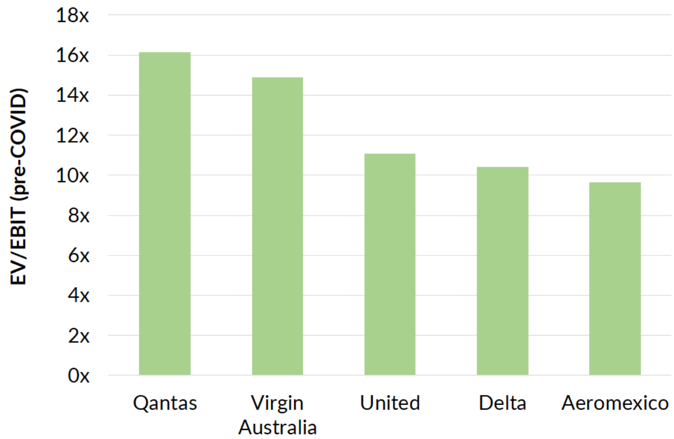
As a crude benchmark for On Point Loyalty the valuations applied to the loyalty schemes of United (US$20.2bn) and American (US$23.4bn) are broadly consistent with the internally assigned valuations by both airlines (US$21.9bn and US$18–30bn) respectively.

Figure 19. Loyalty scheme valuations per member (selected schemes only) based on On Point Loyalty valuations



Source: On Point Loyalty, Company data, Forsyth Barr analysis

Figure 20. Loyalty scheme earnings multiples (selected schemes only) based on On Point Loyalty valuations



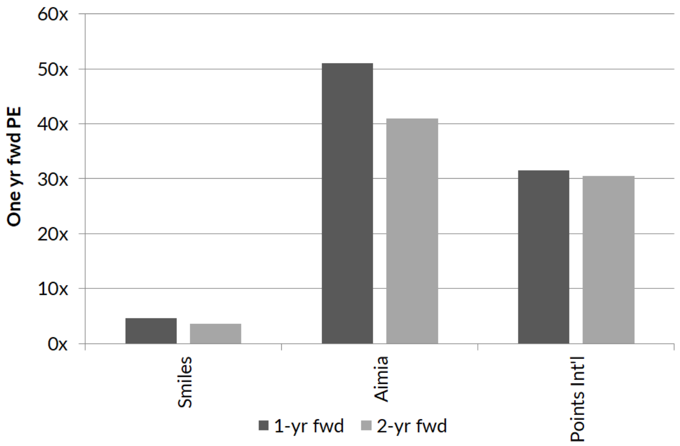
Source: On Point Loyalty, Forsyth Barr analysis

Valuation approach #3: Listed loyalty scheme players

There are several listed loyalty scheme players including Smiles (Brazilian carrier GOL's scheme), Aimia (JV partner of Club Premier/ Aeromexico and BIG Loyalty/ AirAsia and loyalty solutions services; previous owner of Air Canada's Aeroplan) and Points International (loyalty solution platform to >60 schemes globally). Multiplus (Chilean airline LATAM's scheme) delisted in 2019.

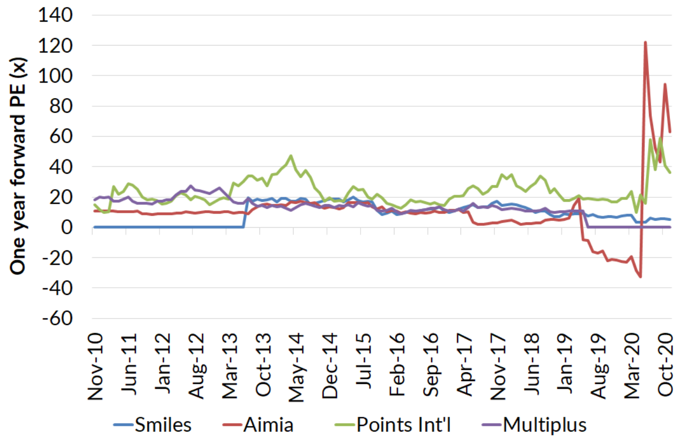
The use of these listed loyalty players for valuation purposes is limited given the high standard deviation of their forward valuation multiples. The wide range reflects the low cost carrier nature of several of the associated airlines, the acquisitions and divestments undertaken (particularly Aimia) and the differences between loyalty scheme owners and service providers. However, notwithstanding the wide dispersion of current and historic multiples, we calculate that the median multiple over the past 10 years is ~14x. We use this as a further valuation benchmark.

Figure 21. Wide range of multiples from listed loyalty comps



Source: Datastream, Forsyth Barr analysis

Figure 22. History of listed loyalty multiples



Source: Datastream, Forsyth Barr analysis

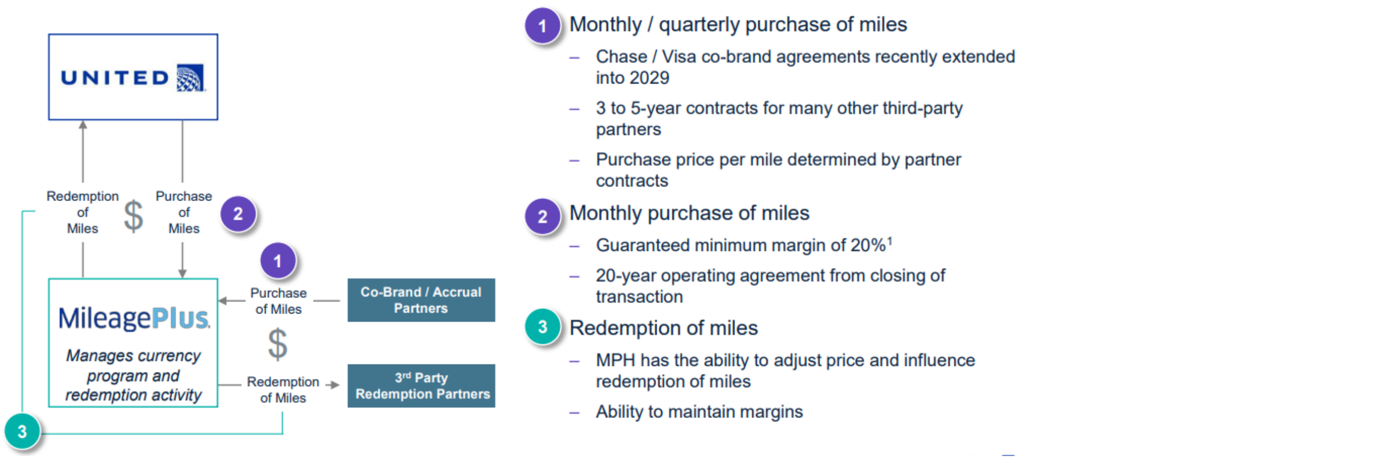
Appendices

Appendix 1: How do airline loyalty schemes work?

Airline loyalty schemes are typically encompassed within the broader airline business (like Airpoints is within AIR). However, some schemes are treated at an arm's length due to ownership requirements, funding arrangements, or reporting frameworks. Regardless of whether a scheme is internalised or externalised they share common traits:

- **Sales of points:** Schemes sell (issue) points to the airline and third parties (scheme partners).
- **Points issued to members:** The airline and scheme partners issue points/airmiles to scheme members as an incentive to purchase flights, products and other services.
- **Members redeem points/airmiles:** Members are able to redeem points earned by booking flights or via third party redemption partners. Flights typically account for the majority of redemptions. According to AIR more than 90% of redeemed Airpoints Dollars on flights. At Qantas it is around 80%. At United it is 97%, of which 20% are redeemed on partner airlines.

Figure 23. United's MileagePlus scheme



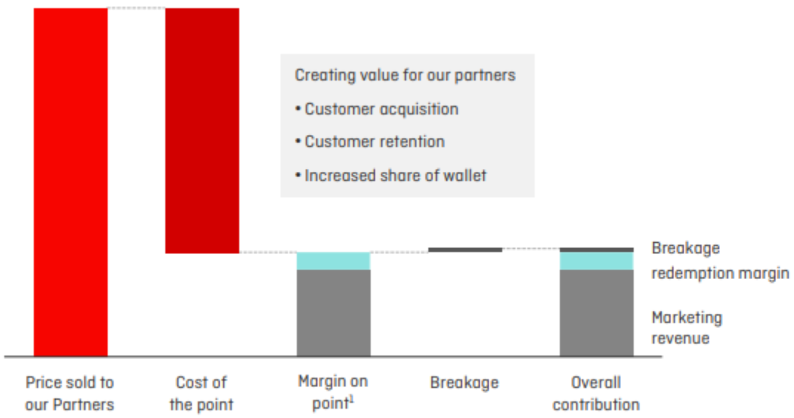
Source: United Airlines, Forsyth Barr analysis

Accounting for loyalty schemes

Airline loyalty schemes generate margin from three primary areas (as demonstrated by QAN in Figure 24):

- **Sale of points:** Airlines sell points to third party partners (banks, retailer etc.) above their 'fair value' or cost. These points are then issued by the partner to scheme members (for example ANZ will issue Airpoints Dollars to its credit card customers monthly depending on monthly card usage).
- **Breakage:** Some points that are sold to third parties and issued to members expire. The value of the point is lost to the member and given there is no cost in redemption, breakage margins are 100%.
- **Redemption of points:** When members redeem points either through flight bookings, upgrades, gift purchases, or via partners, the scheme typically generates a further margin.

Figure 24. QAN generates three types of loyalty margin — marketing, breakage and redemption



Source: Qantas (Investor Day presentation 2019), Forsyth Barr analysis 1. Recognition is split across time of issuance and time of redemption.

Loyalty schemes can also generate a margin from the sale of points to the airline. This is typically done when the scheme is not wholly owned by the airline and therefore an arms length relationship needs to exist. United Airlines' MileagePlus programme generates a guaranteed minimum EBITDA margin of 20% from United related points.

Loyalty accounting policies at AIR

Revenue recognition: Revenues associated with the award of Airpoints Dollars to Airpoints members as part of the initial sales transaction is determined by reference to the relative standalone selling prices. These revenues as well as consideration received in respect of sales of Airpoints Dollars to third parties is deferred to revenue in advance (net of estimated expiry) until such time as the Airpoints member has redeemed their points. The estimate of expiry is based upon historical experience, assessments of changes in customer behaviour and availability of redemption opportunities (such as international air operating capacity) and is recognised in net passenger revenue in proportion to the pattern of rights exercised by the customer.

Revenue in advance creditor: Loyalty programme revenue in advance includes revenues associated with both the award of Airpoints Dollars to Airpoints members as part of the initial sales transaction and with sales of Airpoints Dollars to third parties, net of estimated expiry (non-redeemed Airpoints Dollars), in respect of which the Airpoints member has not yet redeemed their points.

Appendix 2: Loyalty liability

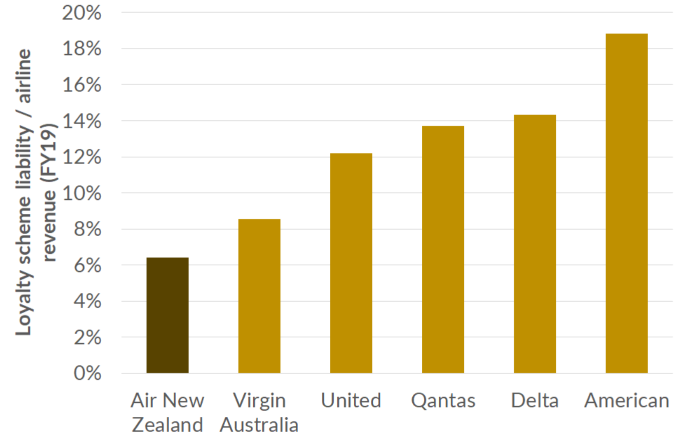
While most airlines provide very little loyalty disclosure, they do typically report their loyalty liability as part of their balance sheet accounting. AIR's loyalty liability relative to other airlines tells us:

- The churn rate of Airpoints Dollars is high given the value transparency and ease of redemption
- Group revenue has grown more slowly than membership growth
- Membership has expanded beyond frequent flyers

Figure 25. AIR's loyalty liability

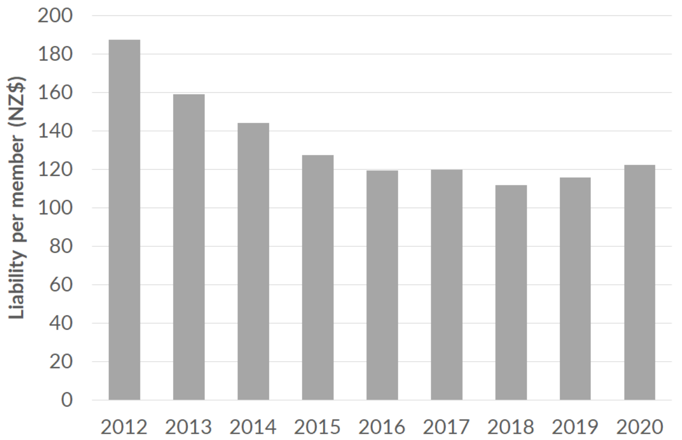
Source: AIR, Forsyth Barr analysis

Figure 26. Loyalty liability across different schemes



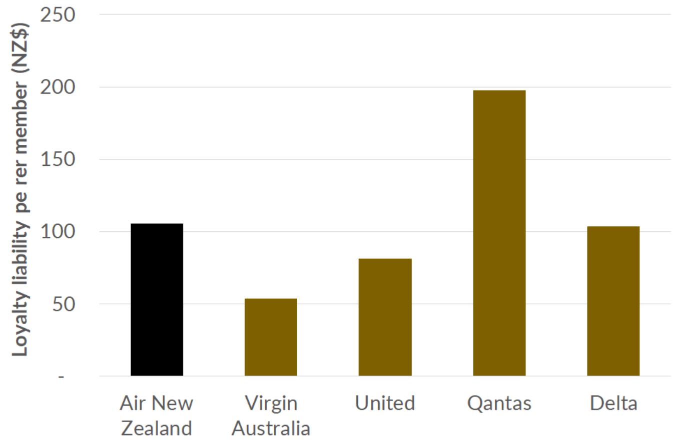
Source: Forsyth Barr analysis

Figure 27. AIR's liability per member steady in recent years



Source: AIR, Forsyth Barr analysis

Figure 28. Loyalty liability per member across different schemes

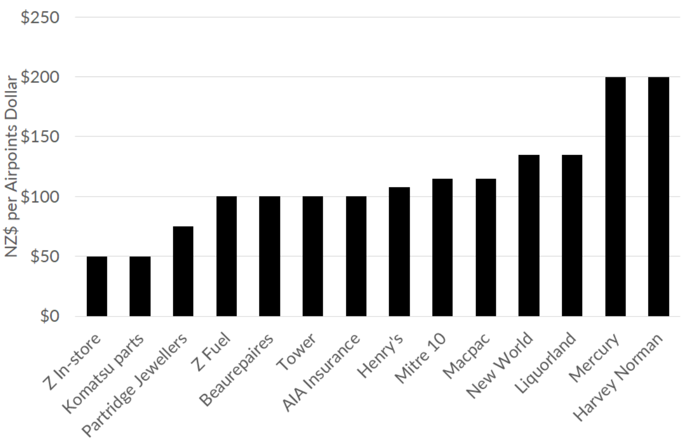


Source: Forsyth Barr analysis

Appendix 3: Member spend to earn one Airpoints Dollar with scheme partners

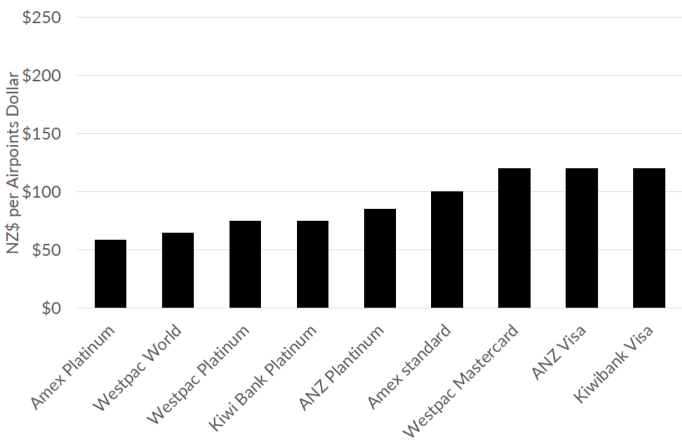
The amount members must spend with Airpoints partners in order to earn one Airpoints Dollar differs materially as shown in Figures 29 and 30.

Figure 29. Required spend to earn one Airpoints Dollar — retail partners



Source: AIR, Forsyth Barr analysis

Figure 30. Required spend to earn one Airpoints Dollar — credit card partners



Source: AIR, Company websites, Forsyth Barr analysis Note: Each credit card also charges an annual member fee — Amex Platinum: NZ$195, Westpac World: NZ$390, Westpac Platinum: NZ$150, Kiwi Bank Platinum: NZ$150, ANZ Platinum: NZ$150, Amex standard: no fee, Westpac Mastercard: NZ$55, ANZ Visa NZ$65, Kiwibank Visa: NZ$65

Appendix 4: Aircraft valuation impact from COVID-19

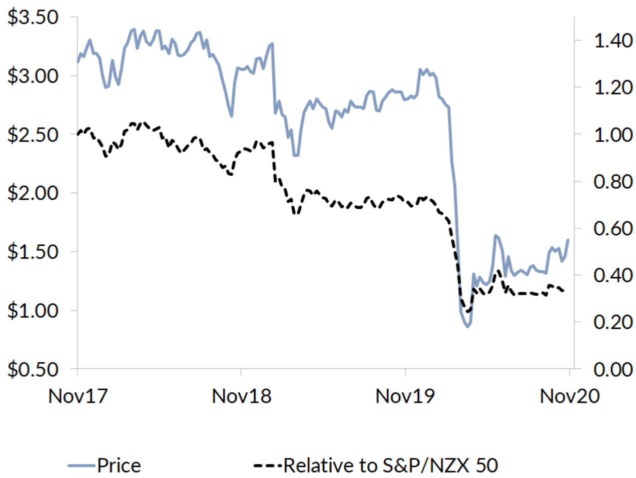
Our analysis in Figure 31 of AIR's aircraft book value decline is based on our understanding of its fleet mix and estimated pre COVID-19 net book value. We use Cirium estimates for the impact of COVID-19 on aircraft valuations, which averages at -11% for AIR's fleet.

Figure 31. The book value decline of AIR's fleet from pre COVID-19 to now is ~NZ$575m

Aircraft type	In Service	Parked	Total	Current list price per aircraft (US$m)	Estimated pre-COVID-19 net book value (NZ$m)	MV changes since Jan 2020	Impact (NZ$m)
ATR 72-600	28		28	26	448	-20%	(90)
Airbus A320-200	19	3	22	101	673	-30%	(202)
Airbus A320neo	3	1	4	111	325	-3%	(10)
Airbus A321neo	5	2	7	130	658	-2%	(13)
Boeing 777-200		8	8	307	264	-13%	(34)
Boeing 777-300		7	7	376	790	-21%	(166)
Boeing 787-9 Dreamliner	12	2	14	293	2,080	-2%	(42)
De Havilland Canada DHC-8-300	22	1	23	20	58	-30%	(17)
Total	**89**	**24**	**113**		**5,296**	**-11%**	**(574)**

Source: Cirium, Forsyth Barr analysis

Figure 32. Price performance



Source: Forsyth Barr analysis

Figure 33. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	52.5%

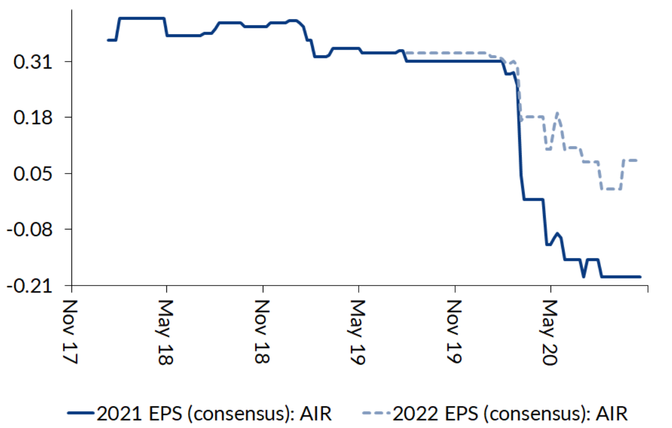
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 34. 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$1.62**	**NZ$1,819**	**<0x**	**>50x**	**5.7x**	**3.5x**	**<0x**	**43.3x**	**0.0%**
QANTAS AIRWAYS	QAN AT	A$4.63	A$8,723	<0x	13.0x	13.6x	4.6x	<0x	12.4x	1.6%
CATHAY PACIFIC AIRWAYS	293 HK	HK$5.72	HK$36,821	<0x	<0x	>75x	8.2x	>75x	>75x	1.7%
SINGAPORE AIRLINES	SIA SP	S$3.45	S$10,229	<0x	<0x	<0x	5.7x	<0x	<0x	1.2%
DEUTSCHE LUFTHANSA-REG	LHA GY	€7.44	€4,445	<0x	2.7x	1.1x	5.5x	<0x	<0x	1.0%
AIR FRANCE-KLM	AF FP	€3.08	€1,318	<0x	>50x	0.2x	5.6x	<0x	5.3x	0.0%
AMERICAN AIRLINES GROUP INC	AAL US	US$11.46	US$5,829	<0x	22.9x	45.2x	52.2x	<0x	3.6x	0.4%
UNITED AIRLINES HOLDINGS INC	UAL US	US$34.68	US$10,092	<0x	0.2x	5.6x	10.7x	<0x	<0x	0.0%
			Compco Average:	**n/a**	**9.7x**	**13.1x**	**13.2x**	**n/a**	**7.1x**	**0.9%**
EV = Current Market Cap + Actual Net Debt			**AIR Relative:**	**n/a**	**n/a**	**-57%**	**-74%**	**n/a**	**511%**	**-100%**

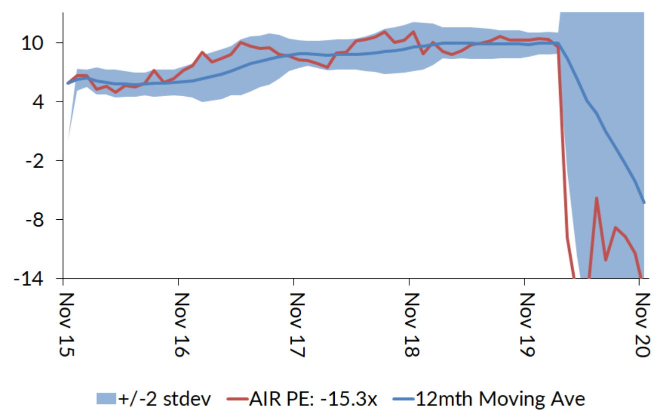
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (AIR) companies fiscal year end

Figure 35. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 36. One year forward PE (x)



Source: Forsyth Barr analysis

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