FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH
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Transport Sector
Long Haul for Aviation Recovery

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

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

The aviation sector's recovery remains highly uncertain; the slope is primarily dependant on the timing of Government restrictions being lifted, while the magnitude and growth thereafter is a function of the unknown new norm of consumer demand. In the meantime, airlines and airports continue to burn cash, the former more than the latter. Domestic aviation in New Zealand has begun the tentative steps to recovery with easing restrictions at Alert Level 2. The real recovery only begins at Alert Level 1, with scope existing for the opening of some borders. We prefer Auckland Airport (AIA; NEUTRAL) to Air New Zealand (AIR; UNDERPERFORM) as (1) its balance sheet is no longer an issue and has minimal cash burn, (2) it will likely benefit more from a trans-Tasman/Pacific Islands bubble, and (3) it should return to profitability quicker.

Tentative recovery steps

The shift from Alert Level 3 to 2 provided the first step to aviation recovery. It was a small step, with domestic capacity only at ~20% and international capacity reliant on repatriation flights and freight services. A shift to Alert Level 1 will be more meaningful. This will remove most domestic restrictions on consumers and allow scope for borders to reopen. Domestic aviation demand will increase materially. However, we believe it will remain below pre COVID-19 levels given (1) the lack of international connectivity, (2) a lower level of business travel, (3) consumer apathy to air travel, and (4) the economic consequences of COVID-19 on consumer confidence.

Trans-Tasman and Pacific Islands bubble potential

At Alert Level 1 we expect some borders may be able to reopen. However, the New Zealand Government will be cautious. Its elimination strategy has come at a huge economic cost. Any risk of re-emergence of COVID-19 would be mitigated by borders remaining closed. Therefore, borders are only likely to reopen with countries at the equivalent Alert Level (i.e. domestic elimination). The obvious contenders are the Pacific Islands and Australia. The trans-Tasman bubble has received lots of attention by politicians and the travel/tourism industry. A bubble could lead to more Australians visiting New Zealand, and vice versa, than pre COVID-19.

Auckland Airport (NEUTRAL)
Under Alert Levels 4 and 3 we believe AIA was close to EBITDA break-even. Its profit recovery begins at Alert Level 2 and it only becomes profit-making on an NPAT basis at Alert Level 1. It would be a key beneficiary of trans-Tasman and Pacific Island bubbles, as these markets made up more than 50% of its pre COVID-19 international capacity. If these bubbles were to eventuate we estimate AIA would return to ~70% of CY19 EBITDA on an annualised basis. On CY19 EBITDA AIA is currently trading at ~15x. This appears reasonable relative to historic trading patterns and considering the current bond yield environment. However, it's likely to be at least three years (our forecasts assume 4.5 years) before AIA returns to that level of profitability. While we consider AIA neither cheap, nor expensive, we retain a NEUTRAL rating.

Air New Zealand (UNDERPERFORM)
AIR's recovery profile is longer and less certain than that of AIA. We forecast the company will be loss-making until COVID-19 is no longer an issue internationally (all border restrictions are removed), or the airline rationalises its asset and employee base materially to lower its fixed cost burden. AIR is trading at a -27% discount to its FY19 NTA (net tangible assets; NZ$1.68/share). However, its NTA is falling by around -NZ$5m per day (or ~13c/share per month) at the moment given the ongoing cash burn, which will continue for the foreseeable future. A trans-Tasman and Pacific Islands bubble would assist its recovery by reducing losses and limiting the cash burn, but the business will remain challenged and a recapitalisation is still necessary, in our opinion. Given the level of uncertainty surrounding AIR's near term outlook, we retain an UNDERPERFORM rating.

Alert to more freedom in the air

The re-opening of air travel markets in New Zealand is reliant on a number of different factors which largely come down to the Government's approach to Alert Levels and border controls. Airlines will fly if they are provided free access to operate without burdensome and costly protocols (i.e. earlier check-in, health tests pre-boarding, physical distancing on-board). Heavy restrictions will mean less demand and higher airfares. We focus this report on the Government's Alert system and how this may play out for Auckland Airport (AIA) and Air New Zealand (AIR).

Implications for companies

AIA's profitability will likely recover far quicker than AIR's, in our opinion. While AIR has historically generated a greater proportion of its profitability from the domestic market, AIA has a higher exposure to the Tasman and Pacific Island markets. We expect these markets to reopen ahead of other borders given their respective COVID-19 situations.

While we expect AIA to return to profit-making when New Zealand enters Alert Level 1 (and even before potential border re-openings), our modelling suggests that AIR's loss making will end only when the Alert Levels are removed entirely, subject to any significant reductions in its employee and asset base in the meantime.

Given the uncertain outlooks, point valuations for AIA and AIR currently have high margins for error. While it's difficult enough plotting the near to medium term outlooks for both companies, the longer term outlook is also questionable. We retain an UNDERPERFORM rating on AIR given (1) its balance sheet challenges given the on-going cash burn and recapitalisation need, (2) a long duration recovery, and (3) excess industry capacity, which may cap recovery margins. Our rating on AIA is NEUTRAL.

The Alert Level system and air travel

The timing of the recovery in aviation will be influenced predominantly by Alert Level changes and specific border arrangements at Alert Level 1, in our opinion. We outline the current travel guidance from the Government for each Alert Level in Figure 1. The different restrictions imposed at each Alert Level mean any changes from one to another can have a step change in aviation capacity and demand, particularly between Alert Levels 3, 2, 1 and 0 (this is our definition of when the Alert Level system is withdrawn).

Figure 1. Current Alert level guidance

Alert Level	Current COVID-19 guidance from New Zealand government
4	► Travel is severely limited. ► People instructed to stay at home (in their bubble) other than for essential personal movement.
3	► Inter-regional travel is highly limited to, for example, essential workers, with limited exemptions for others. ► Physical distancing of two metres outside home (including on public transport), or one metre in controlled environments like schools and workplaces.
2	► You can travel, but do it in a safe way. ► Appropriate physical distancing and other risk mitigating measures in place on public transport and aircraft as agreed by relevant agencies.
1	► Border entry measures to minimise risk of importing COVID-19 cases. ► No restrictions on domestic transport, avoid public transport or travel if you're sick.
0*	► No restrictions.

Source: NZ Government, Forsyth Barr analysis * We recognise that there is no Alert Level 0. This is illustrative

Timing of Alert Level changes critical to aviation recovery

Alert Level reductions are as much political and economic decisions as they are public health decisions. The Government needs to balance the needs of these key influences. While there was a quick progression from Alert Level 3 to 2, we expect a lengthier progression from Alert Level 2 to 1. Coming out of COVID-19 is a far more difficult balancing act, particularly given the re emergence of cases in China and South Korea. While we were in Alert Level 4 for 4.5 weeks and Alert Level 3 for 2.5 weeks, we expect to be in Alert Level 2 for longer. A shift to Alert Level 1 is only likely once New Zealand has eliminated COVID-19, which means at least 28 days of no new infections (this is the definition that the Government uses to determine whether or not a cluster can be closed).

Alert Level 1 measures are limited largely to just border closures. While a superior contact tracing system may assist at all levels (lowering the R_0, or reproductive rate), we believe the Government would only remove all restrictions on domestic activity when the country has been successful in its eradication strategy. The best case scenario would likely be a shift to Alert Level 1 during the week beginning 22 June.

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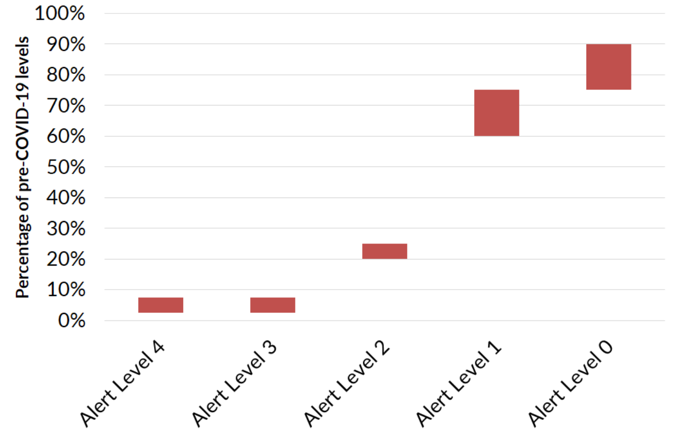
Recovery pathway

Domestic aviation's recovery path will lead that of international, though given the connectivity provided by international services, domestic will only fully recover when international bounces back. Under Alert Levels 4 and 3 AIR was operating at around ~5% of previous capacity.

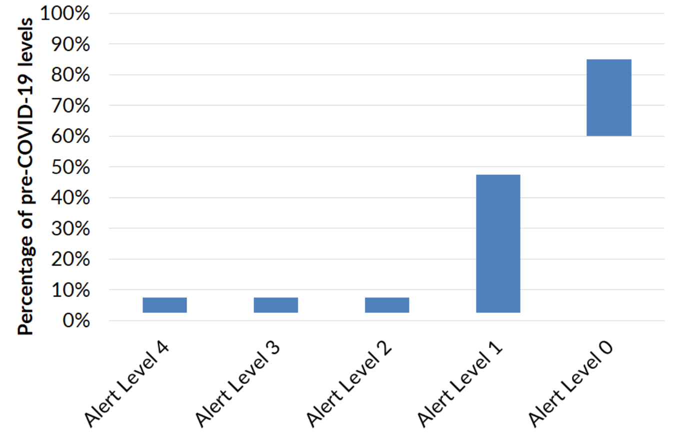
In Figures 2 and 3 we provide illustrations of the potential seat capacity bounce-back for domestic and international services. The wide-variety of potential outcomes at Alert Level 1 for international reflects scope for some borders to reopen.

Figure 2. Domestic capacity recovery illustration



Source: Forsyth Barr analysis

Figure 3. International capacity recovery illustration



Source: Forsyth Barr analysis NOTE: Alert Level 1 includes potential for some borders to reopen, including the Australian and Pacific Island markets

Domestic travel recovery begins now, but long dated

Airlines can only really recommence commercial domestic schedules at Alert Level 1. Physical distancing at Alert Level 2 on aircraft means that capacity is significantly reduced. For example, one-metre social distancing requirements means AIR will only sell just under 50% of seats on a turboprop aircraft (ATR72s and Q300s) and just ~65% on an A320. Therefore, it will be operating 30%–40% of usual domestic aircraft capacity to get to ~20% of available seat capacity.

AIR at one fifth of usual capacity at Alert Level 2

AIR has said that it will operate to the majority of its domestic airports under Alert Level 2 but will only provide ~20% of usual domestic capacity. AIR may be assisted by a slow resumption by Jetstar in recommencing its domestic operations. Its domestic schedule currently recommences on 1 July 2020.

Aviation recovery really starts at Alert Level 1

Physical distancing measures will no longer be required at Alert Level 1, allowing airlines to operate each aircraft more efficiently with greater load factors. This will assist demand as airlines will be able to offer more attractive lead in fares. While there will be an element of pent up demand we expect domestic passenger demand to be impacted by:

- A general ***apathy to travel*** particularly among older age groups given perceived fear of infection.
- Anyone who is ***sick*** may not be allowed to travel.
- Lower ***consumer confidence*** given rising unemployment.
- ***Business travel*** will be impacted by a partial structural shift to digital meetings. We now know that non-essential face-to-face interaction can be done effectively via digital means.
- A lack of ***international connectivity***, which previously accounted for ~20% of domestic pax. While a trans-Tasman bubble will provide some connectivity, the majority of connections are for long-haul, given the point-to-point nature of many trans-Tasman journeys.

Consequently, we believe that under Alert Level 1 domestic aviation capacity will return to 60%–75% of pre COVID-19 levels.

International travel bubbles and border reopening

All Alert Levels incorporate border entry measures. This will impact the recovery of international aviation. It is impractical to open the borders and apply quarantine measures on all arrivals. In addition, the lack of evidence of consistent antibody related immunity from previously COVID-19 infected people means that free travel to, or from, New Zealand is only likely when the Alert Level system is removed. This will be dependant on (1) a cure or vaccine, or other health related measures that reduce mortality/reproduction rates, (2) at Alert Level 1 with other countries that are at a similar level of control/elimination, or (3) an ultimate acceptance by Governments that COVID-19 is in global circulation and the economic cost of restrictions is greater than the toll on health services.

For the time being we can discount (3). We think this is an unlikely scenario at least over the next 12 months, particularly if New Zealand is successful in eradicating COVID-19. Therefore, in the absence of (1), which will, even in the best case scenario, only be a medium term solution, Governments, including our own, will want to be absolutely certain about future exposure and domestic economic risks should border openings allow COVID-19 to re-enter the country.

We see two realistic areas where the Government may open the borders during Alert Level 1:

1. Australia — the trans-Tasman bubble
2. The Pacific Islands

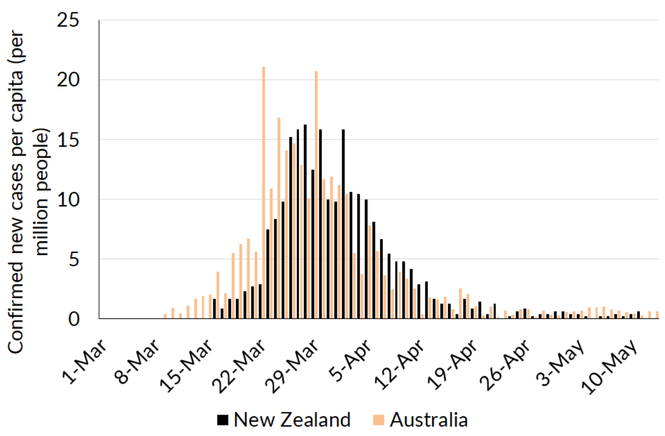
1. Trans-Tasman bubble

Politicians on both sides of the Tasman have talked to varying degrees of a desire for trans-Tasman borders to reopen. Both Governments have endorsed the idea and the industry is working on making it a reality.

An unrestricted bubble could only really work both health-wise and politically when New Zealand reaches Alert Level 1 (the disease is eliminated) and Australia, the equivalent. While the New Zealand government appears most keen, and has more to gain from a trans-Tasman bubble, we also expect it to be the critical factor in agreeing to the bubble given the more relaxed approach taken by Australia, which is publicly pursuing a containment rather than an elimination strategy.

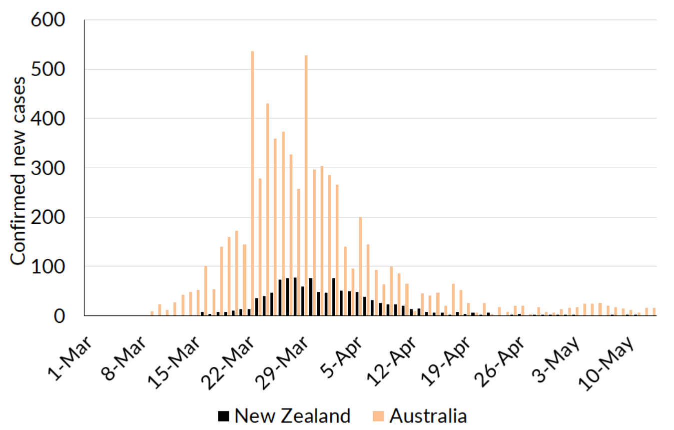
The state border restrictions in place in Australia provide insight into progression of international borders opening. We expect both countries to be more cautious with international borders than with internal domestic travel.

Figure 4. COVID-19 per capita in New Zealand and Australia



Source: WHO, Forsyth Barr analysis

Figure 5. COVID-19 in New Zealand and Australia



Source: WHO, Forsyth Barr analysis

New Zealand has had five days in the past 10 days with no new confirmed cases. In contrast, Australia still has a trickle of cases and is easing restrictions. Consequently, we believe Australia is at least two weeks behind New Zealand towards eradication.

States first in Australia

The Australian Government's plan to assist the recovery of passenger travel has a number of stages, is ultimately dependant on the discretion of each state and territory government, with some expected to move more quickly than others.

- **Stage 1**: Intrastate travel opens back up — limited leisure and business travel for people exploring their own state or territory first. For example, under current Queensland restrictions, people can venture up to 50km from their home for non-essential purposes. From 16 May, that radius is widened to 150km for day trips.

- **Stage 2**: Some interstate travel resumes. The timing of this is at the discretion of each state/territory government subject to advice from the National Cabinet.
- **Stage 3**: All interstate travel resumes, some international travel possible. This would entail no mandatory self-isolation for 14 days. Moving to this stage would again be at the advice of National Cabinet but the discretion of each state, and would be at least three weeks after progressing to Stage 2. Stage 3 could involve a trans-Tasman bubble.

The final stage of recovery would be an opening up of all borders.

Airline capacity

Prior to COVID-19 there were seven airlines flying across the Tasman. Three (AIR, Qantas/Jetstar and Virgin Australia) accounted for ~94% of capacity. The other four were fifth freedom carriers (those that carry passengers between two foreign countries as a part of services connecting the airline's own country) — LAN, Singapore, Emirates and China Airlines.

The biggest question around future Tasman capacity is whether Virgin Australia (VAH), which is currently in administration, resumes operations. VAH closed its New Zealand based operations in late March. Therefore, any resumption of Tasman activity would likely be Australian based. Media reports suggest that a management plan put to potential buyers included a return of international services, including New Zealand destinations.

Potential demand for trans-Tasman travel

In 2019, ~1.5m Australian residents visited New Zealand, out of a total of ~9.9m overseas trips by Australians. They represented ~39% of all visitors to New Zealand. Going the other way there were ~1.3m trips by New Zealand residents to Australia, out of ~3.1m overseas trips, representing ~16% of all visitors to Australia.

Figure 6. New Zealand inbound/outbound

	New Zealand
Australian inbound visitors (m)	1.5
Total inbound visitors (m)	3.9
Tasman share of total inbound	38%
Australian inbound tourism spend (NZ$bn)	2.7
Total inbound tourism spend (NZ$bn)	11.3
Tasman share of total inbound tourism spend	24%
Total outbound trips (m)	3.1
Tasman share of total outbound trips	45%
Total outbound tourism spend (NZ$bn)	6.5

Source: NZ Stats, ABS, TRA, MBIE, Forsyth Barr analysis

Figure 7. Australia inbound/outbound

	Australia
NZ inbound visitors (m)	1.4
Total inbound visitors (m)	9.5
Tasman share of total inbound	15%
NZ inbound tourism spend (A$bn)	2.6
Total inbound tourism spend (A$bn)	45.4
Tasman share of total inbound tourism spend	6%
Total outbound trips (m)	9.9
Tasman share of total outbound trips	15%
Total outbound tourism spend (A$bn)	58.3

Source: NZ Stats, ABS, TRA, Forsyth Barr analysis

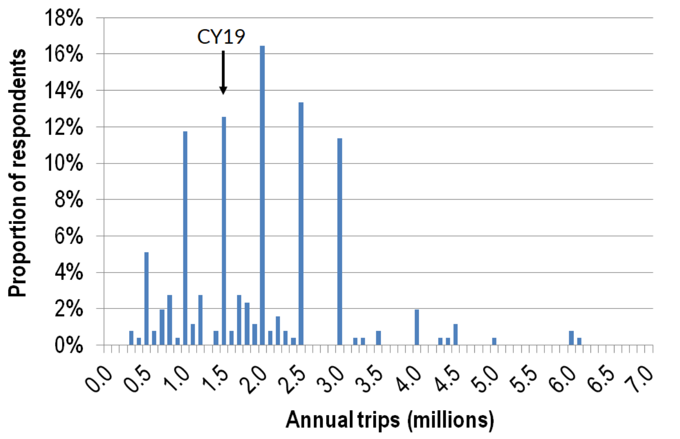
Question: How many Australians will visit New Zealand, and vice versa, if they have no other locations to visit? This is very difficult to answer and the range of sensible responses are wide. We recognise there are a variety of drivers of travel which will influence the ultimate outcome including:

- Affordability
- Safety/health
- Insurance
- Friends and family
- Activities/purpose/type of holiday
- Weather
- Other options

We didn't know the answer; so we ran a survey

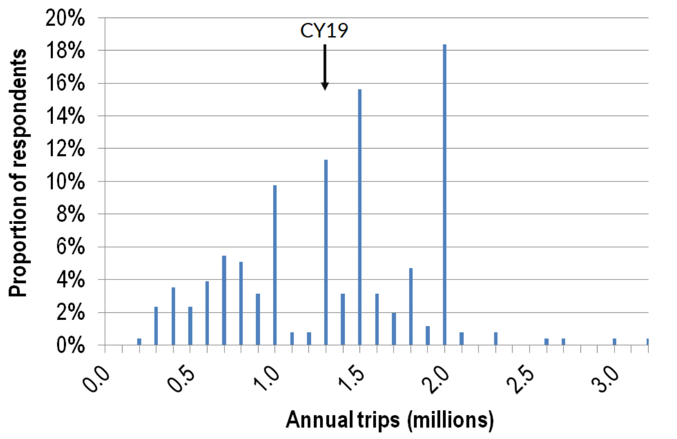
In light of the difficulty in forecasting trans-Tasman bubble passenger flows, we decided to undertake a "*wisdom of the crowd*" experiment and conduct a survey, which many of our readers will have participated in (in total we had >250 responses from both sides of the Tasman). The survey confirmed what we had already gauged; that it was very difficult to forecast. The range of responses was wide as shown in Figures 8 and 9.

Figure 8. Survey responses — Aussies to NZ...



Source: Forsyth Barr analysis

Figure 9. ...and Kiwis to Aussie



Source: Forsyth Barr analysis

Taking averages our survey feedback suggests the trans-Tasman bubble will create more demand than pre COVID-19:

- **More Australians travelling to NZ**: The mean number of Australians travelling to NZ would be ~1.95m, up almost +30% on the pre COVID-19 level. There was little difference between the mean of Australian (~2.03m) and New Zealand (~1.93m) domiciled feedback to this question, albeit Australians were slightly more optimistic. The justification for a higher number of visitors than previously was centred around (1) lack of other options, (2) an attractive destination, and (3) perceived to be safe/COVID-19 free, but partially mitigated by the economic impacts of COVID-19 and increasing domestic travel.
- **Similar number of Kiwis travelling to Australia as before COVID-19**: The mean number of Kiwis travelling to Australia would be ~1.34m, up marginally on the pre COVID-19 level. Very similar justifications were provided for New Zealanders venturing across the Tasman as above, albeit the relatively small uplift reflects the greater economic consequences and lower spending power of Kiwis. New Zealanders (~1.36m) were marginally more optimistic about travelling the Tasman than Australians (~1.32m) think they would be.

More Australians, more Kiwis, but fewer overall

Our survey result suggests that if the tran-Tasman bubble opened in isolation then the level of traffic among Australians and New Zealanders would be larger than what it was pre COVID-19. However, there would be no travellers/or very few from other countries and no Australasian transit passengers. This would mean that overall Tasman demand would fall by ~-16% as shown in Figure 10.

Figure 10. Tasman demand would be ~84% of pre COVID-19 levels according to our survey

	Australians visiting NZ	Kiwis visiting Australia	Other nationalities/transit	Total
CY19	3.0	2.6	1.7	7.9
Trans-Tasman bubble	3.9	2.7	0.0	6.6
Change	30%	3%	-100%	-16%

Source: Forsyth Barr analysis NOTE: The numbers above highlight return trips so reflect 1.5m Australians visiting NZ in CY19

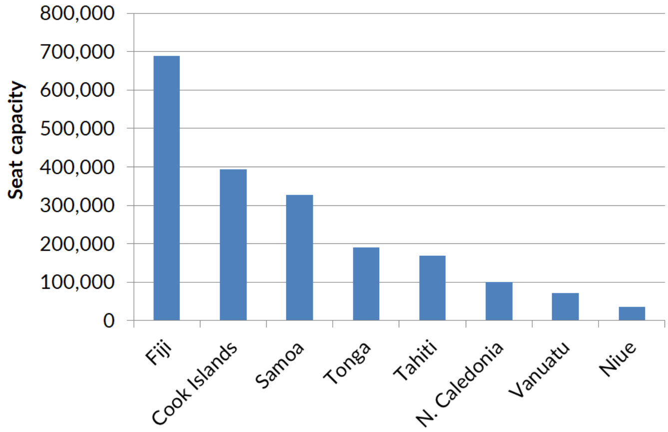
2. Pacific Islands bubble likely before Tasman

The Pacific Islands have been largely spared the problems that have beset other countries from COVID-19 thanks to early border closures. Fiji and New Caledonia have been the worst impacted with a total of 18 cases each, but have now been clear of new cases for 25 and 43 days respectively.

The prospect of Pacific Island borders opening before the Tasman is likely, in our opinion. At this stage Nadi Airport is closed until the end of May. However, Fiji is only likely to reopen borders on a country by country basis. The limiting factor will likely be New Zealand's elimination of COVID-19. We'd anticipate the borders reopening soon after New Zealand moved to Alert Level 1.

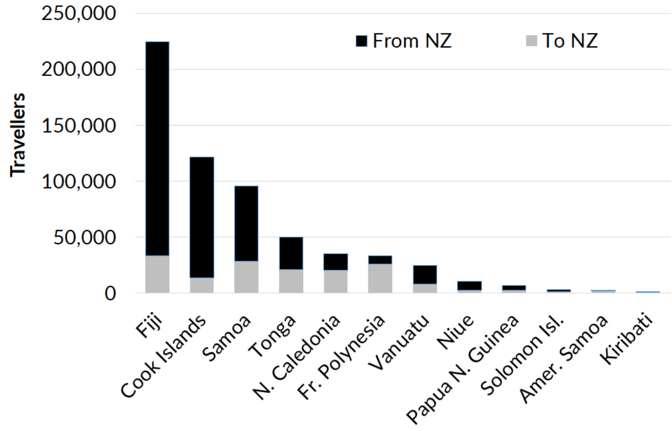
The re-opening of the Pacific Island borders would benefit the islands more than New Zealand. Around ~75% of passengers on these routes are New Zealanders as shown in Figure 12.

Figure 11. New Zealand's capacity with Pacific Islands (2019)



Source: OAG, Forsyth Barr analysis

Figure 12. Passenger flows are dominated by Kiwis (2019)



Source: Stats NZ, Forsyth Barr analysis

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Implications for companies

The level of uncertainty around key near/medium term drivers of air travel for Air New Zealand (AIR) and Auckland Airport (AIA) means providing forecasts remains extremely difficult and incorporates a large helping of guess-work. Key drivers include:

- Timing of Alert Level 1 and potential border expansion bubbles
- The potential and timing of a vaccine/cure/medical solution
- Consumer demand given likely apathy to air travel and economic headwinds
- The structural change to business travel

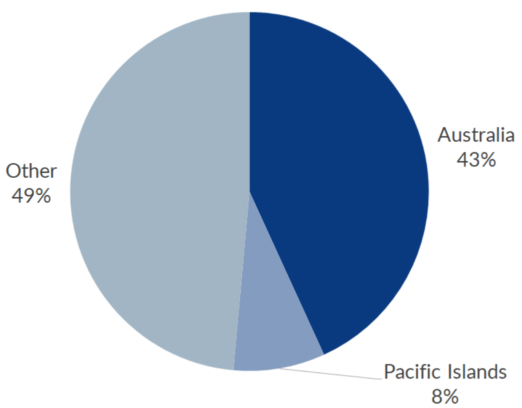
Generating meaningful earnings forecasts in this environment is very difficult given the number of variables and the range of possibilities within these variables. We focus our company specific efforts in this report on AIA and AIR's respective levels of profitability at each Alert Level and various border reopening scenarios at Alert Level 1.

Auckland Airport (AIA) —returns to profitability at Alert Level 1

AIA's profitability is highly leveraged to passengers and in particular, international passengers. Despite this, we expect it can return to profit-making once New Zealand enters Alert Level 1 with all borders still closed. It generates some aeronautical and material car parking income from domestic passengers.

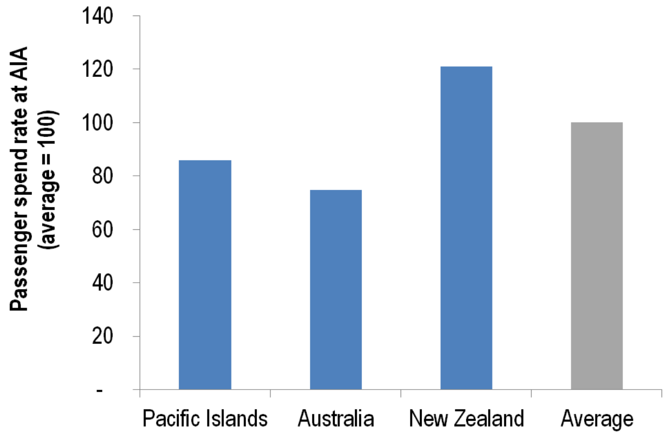
The Tasman and Pacific Islands previously accounted for over half of all international passengers. Therefore, the emergence of bubbles for either market would be beneficial for AIA.

Figure 13. AIA's prior int'l exposure to Australia and Pacific Is



Source: OAG, Forsyth Barr analysis

Figure 14. Passenger spend rates at AIA (2013)



Source: AIA, Forsyth Barr analysis

Profitable at Alert Level 1

In Figure 15 we summarise an analysis of AIA's profit and loss account at the various Alert Levels on an annualised basis. We assume that at Alert Level 1, AIA's NPAT will recover to ~30% of pre COVID-19 levels. However, if a trans-Tasman and Pacific Islands bubble emerges we believe NPAT could return to ~60% of pre COVID-19 levels. At an EPS level both of these recovery percentages are diluted in light of the NZ$1.2bn equity raise.

The interest cost assumption applied in analysis is higher than applied in our current earnings forecasts as until AIA is able to resolve its impending USPP covenant breaches, it is holding excess cash earning little or no interest.

Figure 15. The pro-forma recovery profile for AIA (pax in millions, otherwise NZ$m)

	Domestic pax	Int'l pax (incl. trans)	Pax linked revenue	Rental/ other revenue	Revenue	Opex	EBITDA	EBIT	NPAT
CY19	**9.5**	**10.5**	**597**	**151**	**748**	**(191)**	**557**	**449**	**277**
Alert Level 4	0.3	0.1	16	113	129	(124)	5	(107)	(130)
Alert Level 3	0.3	0.1	16	113	129	(124)	5	(107)	(130)
Alert Level 2	1.7	0.1	87	136	223	(124)	99	(13)	(60)
Alert Level 1	5.7	0.1	287	140	427	(140)	287	175	79
Alert level 1 - PI	5.9	1.1	307	143	450	(162)	288	176	80
Alert level 1 - Tasman	6.5	5.5	391	145	536	(167)	369	257	140
Alert level 1 - Tasman + PI	6.6	6.0	400	148	548	(171)	377	265	145
Alert Level 0	7.9	8.7	496	151	647	(175)	472	360	216

Source: Forsyth Barr analysis

Cash burn

We estimate that AIA was EBITDA break-even during Alert Levels 4 and 3. However, interest costs would have meant an operational cash burn of NZ$6–7m per month.

This would have been exacerbated by its capex profile. The company has outlined that it is likely to spend capex of ~NZ$275m between April 2020 and December 2021, or ~NZ$13m per month on average. However, we recognise this will be front loaded, therefore, capex related cash outflows will be larger over the coming months (~NZ$20m per month).

The company's NZ$1.2bn equity raise last month has settled any balance sheet concerns for the time being given the covenant waivers received for the next 18 months.

Valuation

AIA's valuation is principally driven by (1) bond yields (see Figure 17), (2) passenger growth rates, and (3) the base level of EBITDA. Bond yields have fallen to new record lows, while passenger growth rates and EBITDA have been materially impacted by COVID-19. Passenger growth rates for the foreseeable future will be distorted by COVID-19's downturn and ongoing recovery. Moreover, AIA is unlikely to return to pre COVID-19 levels of EBITDA in the near future as both passenger levels and yields from retail/car-parking operations are likely to be lower than before.

However, pre COVID-19 EBITDA is as good as any measure to benchmark AIA's current valuation against. In CY19 AIA generated EBITDA of NZ$557m, implying an EV/CY19 EBITDA of ~15x. This seems reasonable value in the context of how AIA has traded historically relative to bond rates (Figure 18). However, it is on the proviso that AIA's profitability returns to pre COVID-19 levels. While we think this is likely at some stage, we are unsure on the time frame.

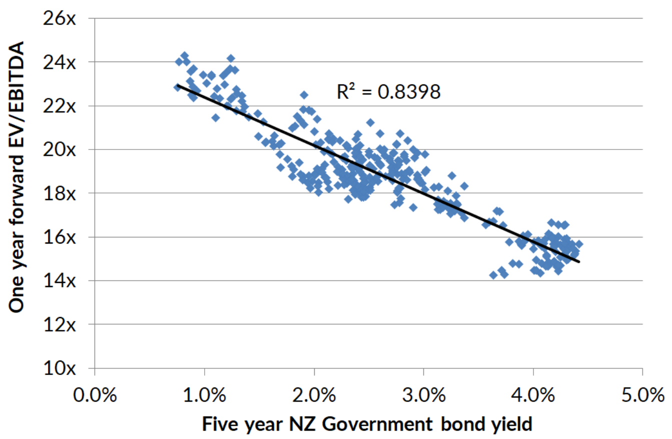
In the meantime, if we assume that a trans-Tasman and Pacific Islands bubble is possible within the next 12 months, AIA's EBITDA should improve to an annualised run-rate of ~NZ$375m. This would imply a forward multiple of ~23x. Not cheap, but similarly not expensive relative to how AIA has traded historically (see Figure 17).

Figure 16. AIA trades at ~15x CY19 EBITDA

Item	CY19	AL1 + Tasman + PI
CY19 EBITDA	**557**	**377***
Market cap at NZ$5.70 per share	8,380	
Net debt at 31 Dec 2019	2,238	
Equity raise proceeds	(1,200)	
Associates	(155)	
Land bank	(377)	
LHFU (Northern runway)	(345)	
Adjusted EV	**8,541**	**8,541**
Adjusted EV/EBITDA	15.3x	22.7x

Source: Forsyth Barr analysis * refer Figure 15

Figure 17. Bond rates have been a driver of AIA's multiple



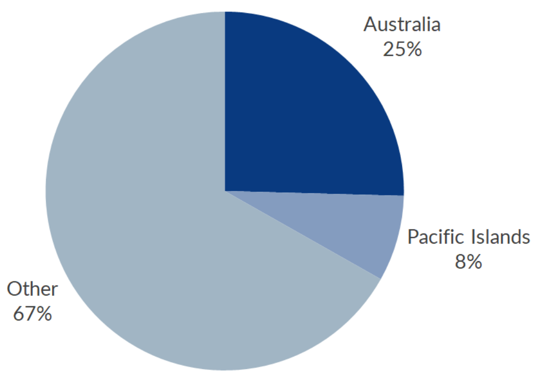
Source: Eikon, Forsyth Barr analysis NOTE: weekly observations based on consensus data since 2013 up until January 2020. Excludes recent observations given impact of COVID-19

We currently apply an asset beta of 0.6 in our WACC calculation for AIA. In light of the less defensive nature of the business relative to expectations pre COVID-19 we believe this risk to this asset beta estimate is to the upside. We don't address this risk attribute in this report but recognise the valuation consequences of a higher asset beta and that the historical relationship between bond yields and valuation multiples may have a different path in future to that historically. For example, if we increase our asset beta estimate from 0.6 to 0.7, our WACC increases from 6.2% to 7.0% and our DCF calculation falls by -6% (note: our aeronautical and property valuations within our DCF framework for AIA reflect RAB (regulatory asset base) and NTA (net tangible assets) approaches and are not directly linked to WACC).

Air New Zealand (AIR) — returns to profitability at Alert Level 0

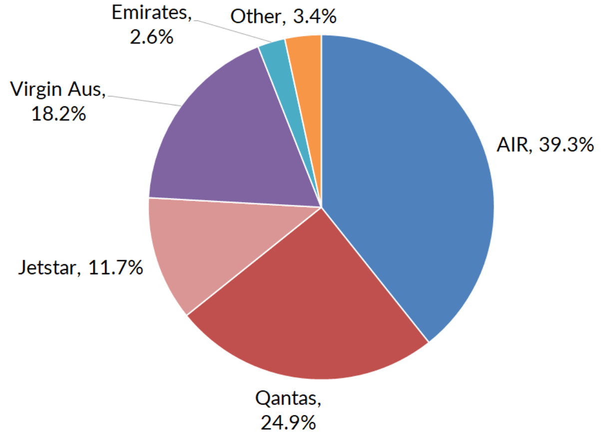
Modelling the profitability impact for AIR is far harder given the competitive dynamics at play in all of its markets and the variability of its fuel costs. The company's opex cash burn at the moment is high (we estimate >NZ$150m per month). While its positioning domestically will assist in achieving an acceptable margin, the return of trans-Tasman flying could see a race to the bottom-line given endless international capacity from competitors Qantas/Jetstar and Virgin Australia (if it returns). In the absence of alternative routes, airlines would prefer to return to the skies and generate an incremental dollar contribution at low margin than play rationally for a 'full' pre COVID-19 margin.

Figure 18. AIR's prior exposure to Australia and Pacific Islands



Source: OAG, Forsyth Barr analysis

Figure 19. AIR share of Tasman market



Source: BITRE, Forsyth Barr analysis

Longer dated return to being profitable

In attempting to model the profitability impact on AIR at each Alert Level we make a number of key assumptions, with the emphasis on keeping the analysis as simple as possible. These include:

- RASK down -10% vs CY19 once commercial flying recommences to reflect (1) less business traffic, and (2) a structurally lower fuel price. Prior to commercial flying (for example international at Alert Level 2) RASK decline is greater. Larger RASK declines at Alert Levels 4, 3 and 2.
- Fuel cost at 1.6c/ASK for international and 2.0c/ASK for domestic — based on a Brent crude oil price of US$40/bbl.
- Opex (excluding fuel and leases) split 50% variable and 50% fixed. Fixed cost savings of ~15% commence at Alert Level 1

The analysis suggests that AIR will only return to profit-making at Alert Level 0. It is currently undertaking a ~-30% reduction in the size of its employee base, which we attempt to adjust for via the variable percentage of its cost base. A further reduction in its asset or employee base, may mean that it is profitable at Alert Level 1 with Tasman and Pacific Island borders open.

Figure 20. The pro-forma recovery profile for AIR (NZ$m)

	Domestic capacity (ASK '000)	Tasman/PI capacity (ASK '000)	Long haul capacity (ASK '000)	Total revenue	Fuel: ave price (NZc/ ASK)	Fuel	Other costs	Total costs	PBT
CY19	**7,019**	**13,661**	**25,563**	**5,873**	**(2.8)**	**(1,278)**	**(4,240)**	**(5,518)**	**355**
Alert Level 4	351	683	1,278	567	(1.7)	(38)	(2,615)	(2,653)	(2,086)
Alert Level 3	351	683	1,278	567	(1.7)	(38)	(2,615)	(2,653)	(2,086)
Alert Level 2	1,404	683	1,278	797	(1.8)	(59)	(2,654)	(2,713)	(1,916)
Alert Level 1	4,913	683	1,278	1,570	(1.9)	(130)	(2,527)	(2,656)	(1,086)
Alert level 1 - PI	5,479	4,283	1,278	2,069	(1.8)	(199)	(2,681)	(2,879)	(811)
Alert level 1 - Tasman	5,641	7,780	1,278	2,545	(1.8)	(258)	(2,816)	(3,074)	(529)
Alert level 1 - Tasman + PI	5,787	10,929	1,278	2,863	(1.7)	(311)	(2,938)	(3,249)	(386)
Alert Level 0	5,951	10,246	16,616	4,109	(1.7)	(549)	(3,487)	(4,035)	73

Source: Forsyth Barr analysis

Cash burn

We estimate AIR's current cash burn is ~NZ$150m per month (derived from our PBT estimates in Figure 20 adjusted for depreciation /capex, ongoing refunds, and fuel hedging losses). The cash burn will continue, albeit at incrementally lower rates as (1) AIR utilises more of its capacity and generates revenue, and/or (2) it undertakes major capacity rationalisation through aircraft retirement, concurrently with job cuts.

In light of this cash burn and the shape of AIR's balance sheet heading into COVID-19, we expect a recapitalisation of AIR over the next 6–12 months.

Valuation

We base our current valuation of AIR on its net tangible assets (NTA) as at 30 June 2019, adjusted for anticipated NTA changes in both FY20 and FY21 given the ongoing cash burn, but not for any potential aircraft impairments. We make no changes to our valuation/target price in this report, but recognise the duration that New Zealand is at each Alert Level may have material implications for AIR's valuation in light of the cash burn.

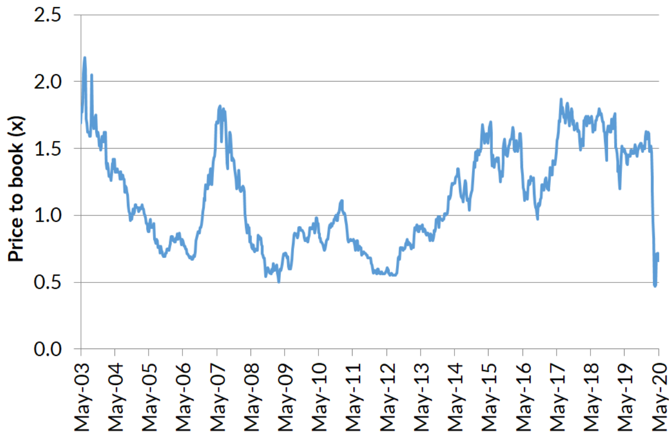
In the absence of a cure/vaccine/medical solution to COVID-19, we believe there is downside risk to our valuation.

Figure 21. AIR's net tangible assets (NZ$m)

	FY19
Total equity	2,089
Less: Intangibles	(186)
NTA at 30 June 2019	**1,903**
Projected NTA change: FY20	(519)
Projected NTA change: FY21	(237)
Adjusted NTA	1,147
Shares on issue (m)	1,129
NTA per share (NZ$ per share)	**1.02**

Source: Forsyth Barr analysis

Figure 22. AIR's price to book has collapsed

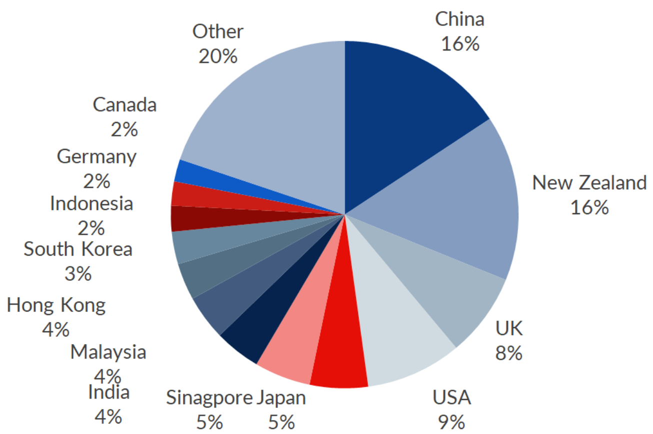


Source: Datastream, Forsyth Barr analysis

Appendices

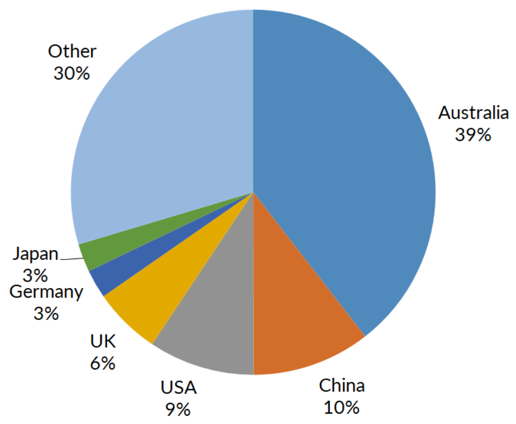
Appendix 1: Australia and New Zealand travel markets

Figure 23. Australian inbound trips by origin



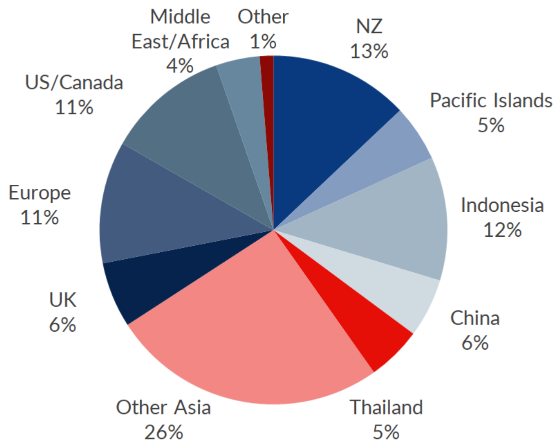
Source: Forsyth Barr analysis

Figure 24. New Zealand inbound trips by origin



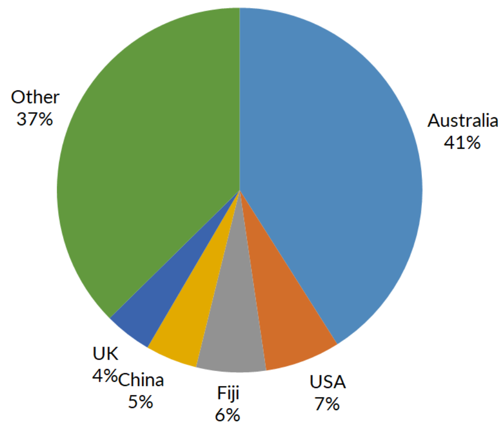
Source: Forsyth Barr analysis

Figure 25. Australian outbound trips by destination in 2018–19



Source: TRA, Forsyth Barr analysis

Figure 26. New Zealand outbound trips by destination



Source: Stats NZ, Forsyth Barr analysis

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