FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | TRANSPORT | INTERNATIONAL AIRLINE
26 MAY 2020

Air New Zealand
Commencing the Journey to Safety

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

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

UNDERPERFORM

Air New Zealand's (AIR) liquidity and earnings update (1) highlighted the dramatic changes to its business as a result of COVID-19, (2) confirmed it will be loss making in FY20, and (3) provided some insight into the impending impact to its NTA (net tangible assets) at year end FY20. Ongoing cash burn and flagged impairment charges will have a material impact on NTA as at 30 June 2020, in our opinion. Almost NZ$700m of expected capex has either been cancelled or deferred, which together with labour cost reductions has helped to lower the cash burn by NZ$50m–NZ$60m per month. AIR has short term liquidity of NZ$640m (prior to accessing its NZ$900m Government loan facility) and no debt covenants, which buys it time for a potential balance sheet recapitalisation. However, with its recovery profile very uncertain and NTA in decline, we retain an UNDERPERFORM rating.

NZX Code	AIR
Share price	NZ$1.32
Target price	NZ$1.00
Risk rating	High
Issued shares	1123.0m
Market cap	NZ$1,482m
Avg daily turnover	1,796k (NZ$3,096k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	270.1	-115.9	-91.7	379.5
EPS* (NZc)	23.9	-10.3	-8.1	33.6
EPS growth* (%)	-30.4	n/a	20.9	n/a
DPS (NZc)	22.0	0.0	0.0	22.0
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	3.2	4.6	4.9	2.6
EV/EBIT	8.0	n/a	n/a	6.4
PE	5.5	n/a	n/a	3.9
Price / NTA	0.8	1.9	2.2	1.6
Cash div yld (%)	16.7	0.0	0.0	16.7
Gross div yld (%)	23.1	0.0	0.0	23.1

A smaller airline

AIR continues to focus on being 30% smaller than its pre COVID-19 size in two years time. Significant labour reductions (accounting for 4,000 employees) will deliver annualised savings of NZ$350m–NZ$400m. Domestic and short haul international are likely to have quicker recovery profiles than long haul, in our opinion. Consequently, we expect long haul fleet rationalisation over the next 12 months, with management (1) suggesting it has early termination options on several B777-300 aircraft and (2) largely writing down the book value of its B777-200 fleet.

Earnings and cash burn

In the absence of a cure, vaccine or medical treatment solution to COVID-19, the earnings outlook remains extremely uncertain for aviation and tourism related companies. AIR acknowledges that it will be loss making in FY20 (we forecast an unchanged NPAT loss of -NZ$116m) but refrains from providing guidance at this time. We estimate its monthly pre-capex cash burn will be ~NZ$100m from early FY21, which we believe could halve when New Zealand moves to Alert Level 1, given the additional demand for domestic services and less restrictions on airlines around social distancing. Thereafter, the prospect of some borders reopening (i.e. a trans-Tasman bubble) will further assist its cash burn outlook. However, its decision yesterday to maintain current depleted international schedules to 31 August 2020, suggests that it's not optimistic of an imminent return to international flying.

Impact on NTA

In light of (1) the impairment of its B777-200 and some B777-300 aircraft (NZ$350m–NZ$450m), (2) significant cash costs (de-designation of fuel and forex hedges, and reorganisation costs totalling NZ$225m–NZ$265m), and (3) an underlying loss in FY20, we expect a meaningful drop in NTA. Excluding other balance sheet movements, we estimate these items will lower NTA to ~NZ$1.00 from NZ$1.68 (as at 30 June 2019).

FORSYTH BARR

Air New Zealand Ltd (AIR)

Priced as at 26 May 2020 (NZ$)	1.32

12-month target price (NZ$)*	1.00
Expected share price return	-24.2%
Net dividend yield	0.0%
Estimated 12-month return	-24.2%

Spot valuations (NZ$)	
1. Price to book	1.00
2. n/a	n/a
3. n/a	n/a

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	1.40
WACC	9.8%
Terminal growth	1.5%

DCF valuation summary (NZ$m)	
Total firm value	6,445
(Net debt)/cash	(1,528)
Less: Capitalised operating leases	(2,821)
Value of equity	2,096

Profit and Loss Account (NZ$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	5,485.0	5,785.1	4,837.1	4,707.2	5,966.8
Normalised EBITDA	**1,065.0**	**935.1**	**704.0**	**718.6**	**1,334.3**
Depreciation and amortisation	(525.0)	(567.0)	(820.8)	(801.9)	(788.8)
Normalised EBIT	**540.0**	**368.1**	**(116.8)**	**(83.2)**	**545.5**
Net interest	(33.0)	(31.0)	(81.1)	(78.1)	(58.5)
Associate income	33.0	37.0	37.0	34.0	40.0
Tax	(150.0)	(104.0)	45.1	35.7	(147.6)
Minority interests	0	0	0	0	0
Normalised NPAT	**390.0**	**270.1**	**(115.9)**	**(91.7)**	**379.5**
Abnormals/other	0	0	504.7	0	0
Reported NPAT	**390.0**	**270.1**	**(620.6)**	**(91.7)**	**379.5**
Normalised EPS (cps)	34.4	23.9	(10.3)	(8.1)	33.6
DPS (cps)	22.0	22.0	0	0	22.0

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	2.6	3.2	4.6	4.9	2.6
EV/EBIT (x)	5.1	8.0	n/a	n/a	6.4
PE (x)	3.8	5.5	n/a	n/a	3.9
Price/NTA (x)	0.7	0.8	1.9	2.2	1.6
Free cash flow yield (%)	15.0	11.1	-93.8	42.3	46.1
Net dividend yield (%)	16.7	16.7	0.0	0.0	16.7
Gross dividend yield (%)	23.1	23.1	0.0	0.0	23.1

Capital Structure	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	16.4	11.9	n/a	n/a	9.3
Interest cover EBITDA (x)	32.3	30.2	8.7	9.2	22.8
Net debt/ND+E (%)	39.0	42.5	67.8	61.0	39.5
Net debt/EBITDA (x)	1.3	1.6	2.9	1.9	0.5

Growth Rates	2018A	2019A	2020E	2021E	2022E
Revenue (%)	7.4	5.5	-16.4	-2.7	26.8
EBITDA (%)	2.9	-12.2	-24.7	2.1	85.7
EBIT (%)	-0.4	-31.8	n/a	n/a	n/a
Normalised NPAT (%)	2.9	-30.8	n/a	n/a	n/a
Normalised EPS (%)	3.4	-30.4	n/a	n/a	n/a
Ordinary DPS (%)	4.8	0.0	-100.0	n/a	n/a

Key Ratios	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	6.9	4.7	-1.4	-1.0	6.6
Return on equity (%)	17.9	12.9	-12.0	-10.7	34.5
Return on funds employed (%)	n/a	n/a	n/a	n/a	n/a
EBITDA margin (%)	19.4	16.2	14.6	15.3	22.4
EBIT margin (%)	9.8	6.4	-2.4	-1.8	9.1
Capex to sales (%)	14.7	14.2	14.5	9.6	9.6
Capex to depreciation (%)	154	145	85	56	72
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	64	92	0	0	65

Cash Flow (NZ$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	**1,065.0**	**935.1**	**704.0**	**718.6**	**1,334.3**
Working capital change	227.0	245.0	(0.0)	0	0
Interest & tax paid	(183.0)	(135.0)	187.8	(14.9)	(178.5)
Other	(78.0)	(59.1)	(1,582.4)	373.4	97.9
Operating cash flow	**1,031.0**	**986.0**	**(690.6)**	**1,077.1**	**1,253.7**
Capital expenditure	(809.0)	(821.0)	(700.0)	(450.0)	(570.0)
(Acquisitions)/divestments	33.0	13.0	40.0	40.0	40.0
Other	(2.0)	(75.0)	22.2	20.4	24.0
Funding available/(required)	**253.0**	**103.0**	**(1,328.4)**	**687.5**	**747.7**
Dividends paid	(260.0)	(260.0)	(260.0)	0	(123.5)
Equity raised/(returned)	(17.0)	(14.0)	0	0	0
(Increase)/decrease in net debt	**(24.0)**	**(171.0)**	**(1,588.4)**	**687.5**	**624.2**

Operating Performance	2018A	2019A	2020E	2021E	2022E
Available Seat Km (ASK)					
Domestic	6,905	7,104	5,896	5,778	7,000
Tasman and Pacific	12,964	13,640	10,912	10,694	14,000
Long-haul	24,406	25,285	20,481	20,071	25,000
Total	**44,275**	**46,029**	**37,289**	**36,543**	**46,000**
Change (%)	5.0	4.0	-19.0	-2.0	25.9
RASK (cents per ASK)					
Domestic	22.0	22.5	23.1	22.6	23.1
Tasman and Pacific	9.6	9.6	9.4	9.4	9.8
Long-haul	7.9	8.1	7.8	7.6	8.0
Total	**10.6**	**10.8**	**10.7**	**10.5**	**10.8**
Costs					
Ave. jet fuel price (US$/bbl)	68.6	82.0	75.8	60.0	64.5
Fuel supply chain (US$/bbl)	10.0	11.4	11.0	12.0	12.0
Jet fuel cost (US$/bbl)	78.6	93.4	86.8	72.0	76.5
Jet fuel volume (bbl in millions)	9.0	9.1	7.3	7.3	9.1
Ave. NZDUSD rate	0.72	0.67	0.64	0.66	0.67
Jet fuel (NZ$m)	**987**	**1,271**	**993**	**803**	**1,043**
Unit fuel (cents/ASK)	2.2	2.8	2.7	2.2	2.3
CASK ex-fuel/forex (cents/ASK)	7.2	7.4	8.5	8.7	7.8

Balance Sheet (NZ$m)	2018A	2019A	2020E	2021E	2022E
Working capital	89.0	60.0	66.5	66.9	63.1
Fixed assets	5,035.0	5,268.0	3,438.0	3,266.7	3,228.5
Intangibles	170.0	186.0	186.0	186.0	186.0
Right of use asset	0	0	2,459.0	2,459.0	2,459.0
Other assets	647.0	602.0	602.0	602.0	602.0
Total funds employed	**5,941.0**	**6,116.0**	**6,751.5**	**6,580.6**	**6,538.6**
Net debt/(cash)	1,391.0	1,542.0	2,030.4	1,342.9	718.8
Lease liability	0	0	2,186.0	2,186.0	2,186.0
Other liabilities	2,374.0	2,485.0	1,570.2	2,192.1	2,534.4
Shareholder's funds	2,176.0	2,089.0	964.8	859.5	1,099.5
Minority interests	0	0	0	0	0
Total funding sources	**5,941.0**	**6,116.0**	**6,751.5**	**6,580.6**	**6,538.6**

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

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 represents ~25% of the cost base at AIR and can have a significant impact on company profitability from period to period. AIR hedges forward most of its exposure, which offers near term certainty.
- **Passenger demand**: Rising secular demand both domestically and from offshore markets is supportive to yields and load factors.
- **Cost control**: Management believes cost control measures can more than offset inflationary pressures to lower CASK (cost per available seat km).

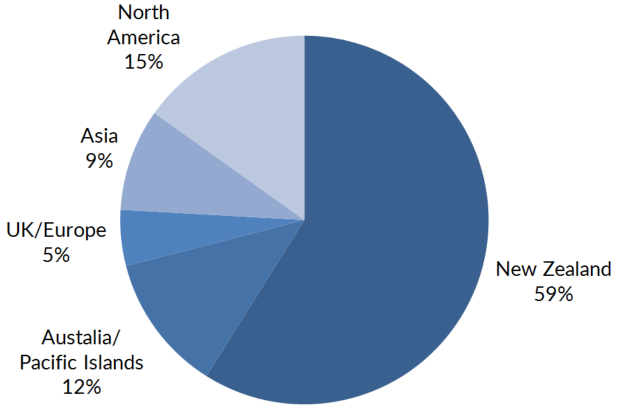
Financial structure

- **Balance sheet**: Gearing was at the top end of management's 45%–55% target band at June 2019. This position will be exacerbated by the COVID-19 demand impact.
- **Capital raise**: In light of the severe demand implications of COVID-19 we believe a capital raise is likely to provide liquidity and protect the balance sheet.

Risk factors

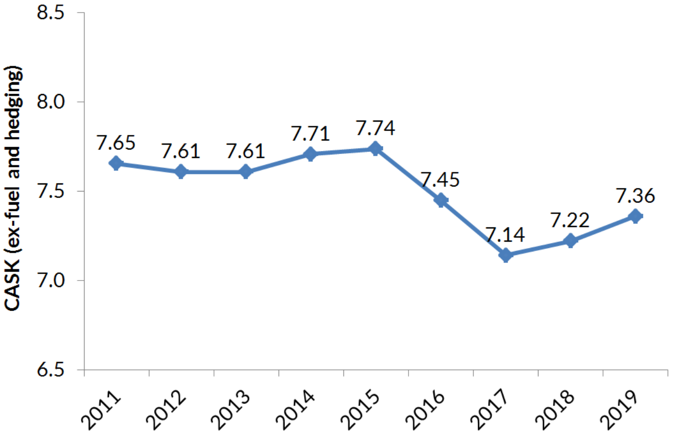
- **Left field events**: Disease outbreak (for example COVID-19), volcanic ash clouds, terrorism events.
- **Macro**: Volatility in exchange rates and global oil prices can have a dramatic impact on profitability.
- **Safety**: Any blip on AIR's good safety record could impact passenger confidence in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

Figure 1. Geographic exposure mix in FY19



Source: Forsyth Barr analysis

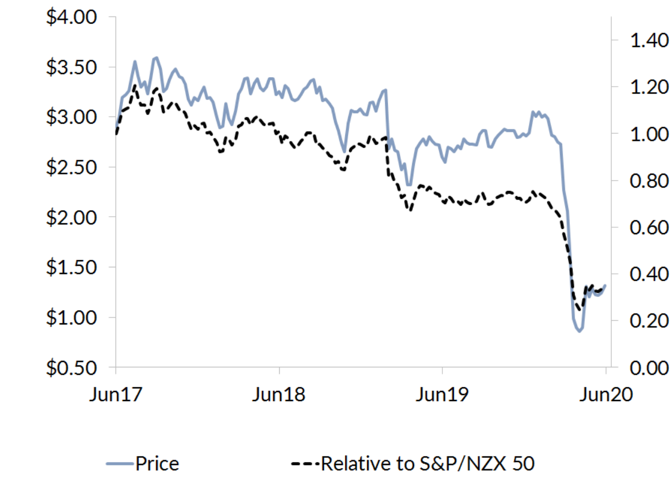
Figure 2. Cost per ASK under control (cents per ASK)



Source: Forsyth Barr analysis

FORSYTH BARR

Figure 3. Price performance



Source: Forsyth Barr analysis

Figure 4. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	52.5%

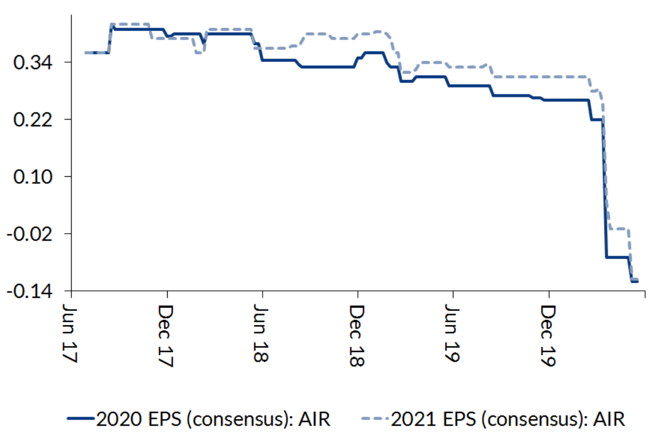
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 5. 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)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Air New Zealand	**AIR NZ**	**NZ$1.32**	**NZ$1,482**	**<0x**	**<0x**	**4.3x**	**4.2x**	**<0x**	**<0x**	**0.0%**
DEUTSCHE LUFTHANSA-REG	LHA GY	€8.04	€3,844	1.0x	2.9x	<0x	<0x	1.9x	2.8x	2.3%
AIR FRANCE-KLM	AF FP	€3.60	€1,545	2.4x	<0x	<0x	<0x	3.2x	14.1x	0.0%
SINGAPORE AIRLINES	SIA SP	S$3.63	S$5,280	<0x	5.2x	10.8x	20.1x	>75x	<0x	1.8%
CATHAY PACIFIC AIRWAYS	293 HK	HK$8.11	HK$31,903	7.6x	8.5x	9.5x	9.1x	5.7x	2.5x	1.2%
QANTAS AIRWAYS	QAN AT	A$3.60	A$5,367	<0x	>50x	5.5x	4.9x	<0x	72.9x	1.6%
VIRGIN AUSTRALIA HOLDINGS LT	VAH AT	n/a	A$726	n/a	n/a	12.7x	8.8x	<0x	26.4x	n/a
AMERICAN AIRLINES GROUP INC	AAL US	US$9.70	US$4,102	1.0x	<0x	<0x	1.5x	3.6x	28.0x	0.6%
UNITED AIRLINES HOLDINGS INC	UAL US	US$25.40	US$7,378	0.5x	10.9x	<0x	1.5x	1.3x	6.3x	0.0%
			Compco Average:	**2.5x**	**6.9x**	**9.6x**	**7.7x**	**3.1x**	**21.9x**	**1.1%**
EV = Current Market Cap + Actual Net Debt			**AIR Relative:**	**n/a**	**n/a**	**-55%**	**-45%**	**n/a**	**n/a**	**-100%**

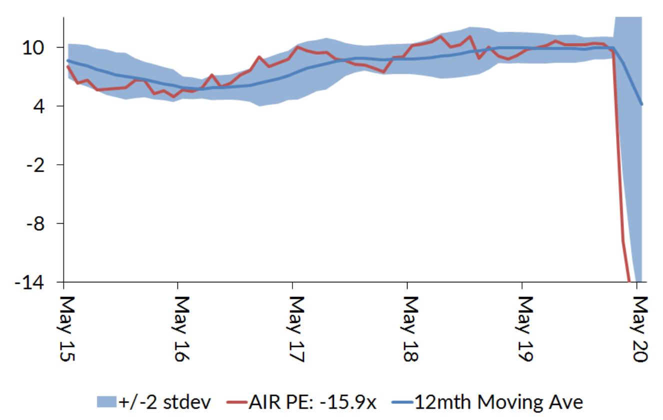
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (AIR) companies fiscal year end

Figure 6. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 7. One year forward PE (x)



Source: Forsyth Barr analysis

Analyst certification: The research analyst(s) primarily responsible for the preparation and content of this publication ("**Analysts**") are named on the first page of this publication. Each such Analyst certifies (other than in relation to content or views expressly attributed to another analyst) that (i) the views expressed in this publication accurately reflect their personal views about each issuer and financial product referenced and were prepared in an independent manner, including with respect to Forsyth Barr Limited and its related companies; and (ii) no part of the Analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that Analyst in this report.

Analyst holdings: The following Analyst(s) have a threshold interest in the financial products referred to in this publication: N/A. For these purposes, a threshold interest is defined as being a holder of more than $50,000 in value or 1% of the financial products on issue, whichever is the lesser.

Ratings distributions: As at 25 May 2020, Forsyth Barr's research ratings were distributed as follows:

OUTPERFORM	NEUTRAL	UNDERPERFORM
49.0%	36.7%	14.3%

Forsyth Barr's research ratings are OUTPERFORM, NEUTRAL, and UNDERPERFORM. The ratings are relative to our other equity security recommendations across our New Zealand market coverage and are based on risk-adjusted Estimated Total Returns for the securities in question. Risk-adjusted Estimated Total Returns are calculated from our assessment of the risk profile, expected dividends and target price for the relevant security.

Disclosure: Forsyth Barr Limited and its related companies (and their respective directors, officers, agents and employees) ("Forsyth Barr") may have long or short positions or otherwise have interests in the financial products referred to in this publication, and may be directors or officers of, and/or provide (or be intending to provide) investment banking or other services to, the issuer of those financial products (and may receive fees for so acting). Forsyth Barr is not a registered bank within the meaning of the Reserve Bank of New Zealand Act 1989. Forsyth Barr may buy or sell financial products as principal or agent, and in doing so may undertake transactions that are not consistent with any recommendations contained in this publication. Other Forsyth Barr business units may hold views different from those in this publication; any such views will generally not be brought to your attention. Forsyth Barr confirms no inducement has been accepted from the issuer(s) that are the subject of this publication, whether pecuniary or otherwise, in connection with making any recommendation contained in this publication. In preparing this publication, non-financial assistance (for example, access to staff or information) may have been provided by the issuer(s) being researched.

Investment banking engagements: Other than confidential engagements, Forsyth Barr has within the past 12 months been engaged to provide investment banking services to the following issuers that are the subject of this publication: FRE

Not personalised financial advice: The recommendations and opinions in this publication do not take into account your personal financial situation or investment goals. The financial products referred to in this publication may not be suitable for you. If you wish to receive personalised financial advice, please contact your Forsyth Barr Investment Adviser. The value of financial products may go up and down and investors may not get back the full (or any) amount invested. Past performance is not necessarily indicative of future performance. Disclosure statements for Forsyth Barr Investment Advisers are available on request and free of charge.

Disclaimer: This publication has been prepared in good faith based on information obtained from sources believed to be reliable and accurate. However, that information has not been independently verified or investigated by Forsyth Barr. Forsyth Barr does not make any representation or warranty (express or implied) that the information in this publication is accurate or complete, and, to the maximum extent permitted by law, excludes and disclaims any liability (including in negligence) for any loss which may be incurred by any person acting or relying upon any information, analysis, opinion or recommendation in this publication. Forsyth Barr does not undertake to keep current this publication; any opinions or recommendations may change without notice to you. Any analyses or valuations will typically be based on numerous assumptions; different assumptions may yield materially different results. Nothing in this publication should be construed as a solicitation to buy or sell any financial product, or to engage in or refrain from doing so, or to engage in any other transaction. This publication is not intended to be distributed or made available to any person in any jurisdiction where doing so would constitute a breach of any applicable laws or regulations or would subject Forsyth Barr to any registration or licensing requirement within such jurisdiction.