FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | TRANSPORT | INTERNATIONAL AIRLINE
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Air New Zealand
FY20 Preview — Balance Sheet in Focus

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UNDERPERFORM

In the aftermath of Ansett, the then Chair of Air New Zealand (AIR) John Palmer said in his 2003 annual review, "*I have come to believe that the only real competitive advantage that a company can have in the airline industry is the ability to prepare for and manage change*". While other key areas of competitive advantage have evolved over the past 17 years, particularly for AIR, these words resonate strongly in the midst of COVID-19 challenges (on 27 August 2020, we expect AIR to report its first annual underlying loss since 2002). While AIR is, and has been, well equipped to manage the significant operational challenges as COVID-19 took hold, its revenue rapidly collapsed as a result of apathy to travel and government restrictions. Its cost base was unable to keep up. The company's reinstated earnings guidance for FY20 is for an underlying profit before tax (PBT) loss of up to -NZ$120m, implying a PBT loss of up to -NZ$318m in 2H20. With material losses, significant impairments and current operating conditions providing little insight as to the future, the more important aspect of this result will be the shape of the balance sheet, in our opinion.

NZX Code	AIR
Share price	NZ$1.34
Target price	NZ$0.90
Risk rating	High
Issued shares	1123.0m
Market cap	NZ$1,505m
Avg daily turnover	2,389k (NZ$3,797k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	270.1	-68.1	-151.7	10.7
EPS* (NZc)	23.9	-6.0	-13.4	0.9
EPS growth* (%)	-30.4	n/a	n/a	n/a
DPS (NZc)	22.0	0.0	0.0	0.0
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	3.2	3.9	5.3	3.9
EV/EBIT	8.1	n/a	n/a	60.8
PE	5.6	n/a	n/a	n/a
Price / NTA	0.8	1.5	1.8	1.8
Cash div yld (%)	16.4	0.0	0.0	0.0
Gross div yld (%)	22.8	0.0	0.0	0.0

Key things to look out for in AIR's FY20 result

- **Cash burn/net debt:** With a significant reduction in revenue and a high fixed cost base, AIR has endured cash burn since March. We expect the company is close to dipping into the government's NZ$900m lending facility.
- **Net asset value (NAV):** The combination of asset impairments, reorganisation costs, hedging losses, and 2H20 cash burn will dilute AIR's NAV significantly. We estimate AIR's NAV as at June 2020 is ~NZ$1.06 per share.
- **Opex:** AIR has undertaken a significant reduction in costs (a ~30% downsizing) as a result of COVID-19. However, much of this was effective for the beginning of FY21. Therefore, its cost burden as outlined in FY20 will be substantially higher than the run-rate, albeit partially offset by wage subsidy receipts (~NZ$75m).
- **Airfreight:** AIR's current international schedule is almost exclusively being operated for airfreight purposes, given its pivotal role in the government sponsored airfreight initiative. A significant lift in airfreight yields will likely drive a material jump in airfreight revenue through 2H20.

Figure 1. Summary of FY20 forecasts (NZ$m)

	FY19	FY20E	Change	Consensus
Sales revenue	5,785	4,832	-16.5%	4,637
EBITDRA	1,180	763	-35.3%	n/a
Underlying PBT	**374**	**(95)**	**-125.3%**	**(101)**
Reported NPAT	270	(605)	-324.1%	n/a
Underlying NPAT	270	(68)	-125.2%	(61)
Underlying EPS (cents)	23.9	(6.0)	-125.2%	(5.4)
Final DPS (cents)	11.0	0.0	-100.0%	0.0

Source: Refinitiv, Forsyth Barr analysis

Figure 2. Breakdown by region/business unit

	FY19	FY20E	Change
Domestic	1,600	1,317	-17.7%
Tasman & Pacific Islands	1,312	987	-24.8%
International	2,048	1,637	-20.1%
Passenger revenue	4,960	3,942	-20.5%
Cargo	390	430	10.3%
Contract and other	435	460	5.7%
Total revenue	**5,785**	**4,832**	**-16.5%**

Source: Forsyth Barr analysis

Air New Zealand Ltd (AIR)

Priced as at 20 Aug 2020 (NZ$)	**1.34**

12-month target price (NZ$)*	**0.90**
Expected share price return	-32.8%
Net dividend yield	0.0%
Estimated 12-month return	-32.8%

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

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	5,485.0	5,785.1	4,831.8	2,569.8	3,962.1
Normalised EBITDA	**1,065.0**	**935.1**	**763.4**	**558.1**	**757.9**
Depreciation and amortisation	(525.0)	(567.0)	(820.8)	(730.6)	(709.7)
Normalised EBIT	**540.0**	**368.1**	**(57.5)**	**(172.5)**	**48.2**
Net interest	(33.0)	(31.0)	(72.1)	(68.2)	(63.3)
Associate income	33.0	37.0	35.0	30.0	30.0
Tax	(150.0)	(104.0)	26.5	59.0	(4.2)
Minority interests	0	0	0	0	0
Normalised NPAT	**390.0**	**270.1**	**(68.1)**	**(151.7)**	**10.7**
Abnormals/other	0	0	537.3	0	0
Reported NPAT	**390.0**	**270.1**	**(605.4)**	**(151.7)**	**10.7**
Normalised EPS (cps)	34.4	23.9	(6.0)	(13.4)	0.9
DPS (cps)	22.0	22.0	0	0	0

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	7.4	5.5	-16.5	-46.8	54.2
EBITDA (%)	2.9	-12.2	-18.4	-26.9	35.8
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

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**1,065.0**	**935.1**	**763.4**	**558.1**	**757.9**
Working capital change	227.0	245.0	0	0	0
Interest & tax paid	(183.0)	(135.0)	44.6	18.3	(40.0)
Other	(78.0)	(59.1)	(995.4)	(140.3)	(243.9)
Operating cash flow	**1,031.0**	**986.0**	**(187.4)**	**436.1**	**474.0**
Capital expenditure	(809.0)	(821.0)	(600.0)	(350.0)	(350.0)
(Acquisitions)/divestments	33.0	13.0	40.0	40.0	40.0
Other	(2.0)	(75.0)	21.0	18.0	18.0
Funding available/(required)	**253.0**	**103.0**	**(726.4)**	**144.1**	**182.0**
Dividends paid	(260.0)	(260.0)	(260.0)	0	0
Equity raised/(returned)	(17.0)	(14.0)	0	0	0
(Increase)/decrease in net debt	**(24.0)**	**(171.0)**	**(986.4)**	**144.1**	**182.0**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	89.0	60.0	66.5	73.3	69.1
Fixed assets	5,035.0	5,268.0	3,438.0	3,238.0	3,058.9
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**	**6,558.3**	**6,375.0**
Net debt/(cash)	1,391.0	1,542.0	1,428.4	1,284.4	1,102.4
Lease liability	0	0	2,186.0	2,186.0	2,186.0
Other liabilities	2,374.0	2,485.0	1,944.2	2,058.8	2,058.8
Shareholder's funds	2,176.0	2,089.0	1,192.9	1,029.2	1,027.9
Minority interests	0	0	0	0	0
Total funding sources	**5,941.0**	**6,116.0**	**6,751.5**	**6,558.3**	**6,375.0**

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

Spot valuations (NZ$)	
1. Net asset value	0.90
2. n/a	n/a
3. n/a	n/a

DCF valuation summary (NZ$m)	
Total firm value	5,671
(Net debt)/cash	(1,562)
Less: Capitalised operating leases	(2,821)
Value of equity	1,288

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	2.6	3.2	3.9	5.3	3.9
EV/EBIT (x)	5.1	8.1	n/a	n/a	60.8
PE (x)	3.9	5.6	n/a	n/a	>100x
Price/NTA (x)	0.8	0.8	1.5	1.8	1.8
Free cash flow yield (%)	14.8	11.0	-52.3	5.7	8.2
Net dividend yield (%)	16.4	16.4	0.0	0.0	0.0
Gross dividend yield (%)	22.8	22.8	0.0	0.0	0.0

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	16.4	11.9	n/a	n/a	0.8
Interest cover EBITDA (x)	32.3	30.2	10.6	8.2	12.0
Net debt/ND+E (%)	39.0	42.5	54.5	55.5	51.7
Net debt/EBITDA (x)	1.3	1.6	1.9	2.3	1.5

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	6.9	4.7	-0.7	-2.4	0.7
Return on equity (%)	17.9	12.9	-5.7	-14.7	1.0
Return on funds employed (%)	n/a	n/a	n/a	n/a	n/a
EBITDA margin (%)	19.4	16.2	15.8	21.7	19.1
EBIT margin (%)	9.8	6.4	-1.2	-6.7	1.2
Capex to sales (%)	14.7	14.2	12.4	13.6	8.8
Capex to depreciation (%)	154	145	73	48	49
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	64	92	0	0	0

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Available Seat Km (ASK)					
Domestic	6,905	7,104	5,619	4,973	5,683
Tasman and Pacific	12,964	13,640	10,366	5,456	11,594
Long-haul	24,406	25,285	20,354	1,264	10,114
Total	**44,275**	**46,029**	**36,340**	**11,693**	**27,391**
Change (%)	5.0	4.0	-21.0	-67.8	134.3
RASK (cents per ASK)					
Domestic	22.0	22.5	23.4	21.4	21.4
Tasman and Pacific	9.6	9.6	9.5	9.1	9.4
Long-haul	7.9	8.1	8.0	7.7	7.9
Total	**10.6**	**10.8**	**10.8**	**14.2**	**11.3**
Costs					
Ave. jet fuel price (US$/bbl)	68.6	82.0	77.8	53.0	59.0
Fuel supply chain (US$/bbl)	10.0	11.4	12.0	12.0	12.0
Jet fuel cost (US$/bbl)	78.6	93.4	89.8	65.0	71.0
Jet fuel volume (bbl in millions)	9.0	9.1	7.4	3.1	6.3
Ave. NZDUSD rate	0.72	0.67	0.63	0.64	0.65
Jet fuel (NZ$m)	**987**	**1,271**	**1,040**	**317**	**683**
Unit fuel (cents/ASK)	2.2	2.8	2.9	2.7	2.5
CASK ex-fuel/forex (cents/ASK)	7.2	7.4	11.2	17.2	11.7

Forecast summary

Figure 3. Summary of our earnings forecasts (NZ$m)

	1H19	2H19	FY19	1H20	2H20E	FY20E	1H20 chg	2H20 chg	FY20 chg
Domestic	807	793	1,600	851	467	1,317	5.5%	-41.2%	-17.7%
Tasman & Pacific Islands	697	616	1,312	688	299	987	-1.2%	-51.4%	-24.8%
Short-haul	1,503	1,409	2,912	1,539	766	2,305	2.4%	-45.6%	-20.9%
International	994	1,054	2,048	1,038	600	1,637	4.4%	-43.1%	-20.1%
Passenger revenue	**2,497**	**2,463**	**4,960**	**2,576**	**1,366**	**3,942**	**3.2%**	**-44.6%**	**-20.5%**
Cargo	213	177	390	195	235	430	-8.5%	32.8%	10.3%
Contract services (& other)	92	105	197	117	113	230	27.2%	7.6%	16.8%
Other revenue	125	113	238	127	103	230	1.6%	-8.8%	-3.4%
Sales revenue	**2,927**	**2,858**	**5,785**	**3,015**	**1,817**	**4,832**	**3.0%**	**-36.4%**	**-16.5%**
EBITDRA	609	571	1,180	615	148	763	1.0%	-74.0%	-35.3%
Rentals	(122)	(123)	(245)	0	0	0	100.0%	100.0%	100.0%
Depreciation and amortisation	(272)	(295)	(567)	(412)	(409)	(821)	-51.5%	-38.6%	-44.8%
Interest expense	(17)	(14)	(31)	(28)	(44)	(72)	-64.7%	-214.9%	-132.5%
Associates	19	18	37	23	12	35	21.1%	-33.3%	-5.4%
PBT	**217**	**157**	**374**	**198**	**(293)**	**(95)**	**-8.7%**	**-286.3%**	**-125.3%**
Taxation	(61)	(43)	(104)	(54)	81	26	11.3%	n/a	n/a
Underlying NPAT	156	114	270	144	(212)	(68)	-7.7%	-285.9%	-125.3%
Abnormals (post tax)	0	0	0	(43)	(494)	(537)	n/a	n/a	n/a
Reported NPAT	156	114	270	101	(706)	(605)	-35.2%	-719.3%	-324.1%
Underlying EPS (cents)	13.9	10.1	24.0	12.8	(18.9)	(6.1)	-7.7%	-286.3%	-125.2%
DPS (cents)	11.0	11.0	22.0	0.0	0.0	0.0	-100.0%	-100.0%	-100.0%

Source: AIA, Forsyth Barr analysis

Investment Summary

Air New Zealand (AIR) offers one of the most favourable structural positions for any airline globally. A dominant domestic business with ~80% market share and an international business that has mitigated competitive threats through JVs, lower cost capacity, and its brand positioning among higher yielding NZ travellers. Management is pursuing a rational value accretive strategy of optimising revenues through yield and capacity initiatives, and keeping a lid on costs. However, the dramatic impact of COVID-19 on demand through consumer behaviour and government intervention is likely to shift AIR well into loss-making territory for the forseeable future. A substantial drop in oil prices provides some respite to profitability over the medium term, but that seems a long way off. UNDERPERFORM.

Business quality

- **Strong structural position in tough industry**: AIR operates in an intensely competitive industry. It benefits from a duopoly industry structure in NZ.
- **Fleet investment**: AIR continues to invest in new lower cost capacity, which provides scope for growth and a more competitive fleet.

Earnings and cashflow outlook

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

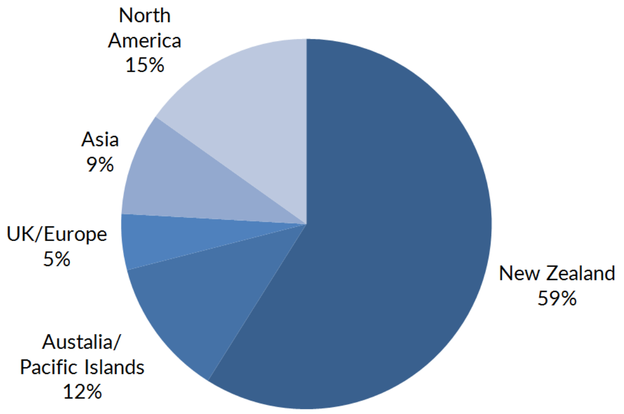
Financial structure

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

Risk factors

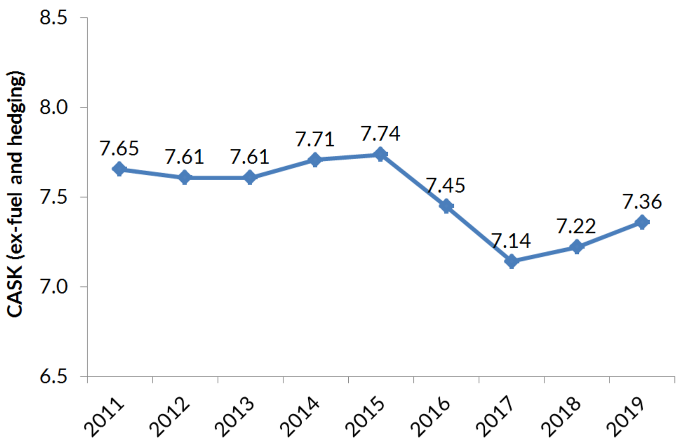
- **Left field events**: Disease outbreak (for example COVID-19), volcanic ash clouds, terrorism events.
- **Macro**: Volatility in exchange rates and global oil prices can have a dramatic impact on profitability.
- **Safety**: Any blip on AIR's good safety record could impact passenger confidence in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

Figure 4. Geographic exposure mix in FY19



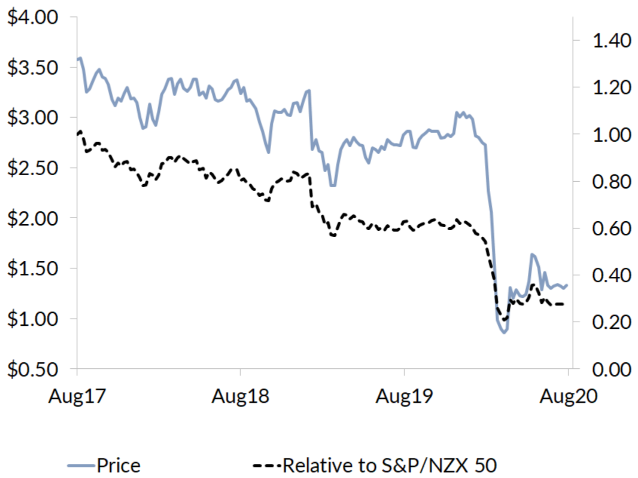
Source: Forsyth Barr analysis

Figure 5. Cost per ASK under control (cents per ASK)



Source: Forsyth Barr analysis

Figure 6. Price performance



Source: Forsyth Barr analysis

Figure 7. Substantial shareholders

Shareholder	Latest Holding
NZ Govt	52.5%

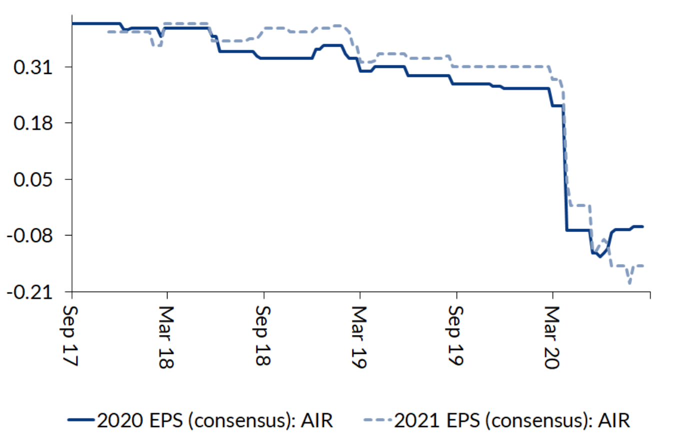
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 8. 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$1.34**	**NZ$1,505**	**<0x**	**<0x**	**4.0x**	**5.5x**	**<0x**	**<0x**	**0.0%**
QANTAS AIRWAYS	QAN AT	A$3.76	A$7,092	<0x	<0x	5.7x	6.6x	43.7x	53.9x	1.1%
CATHAY PACIFIC AIRWAYS	293 HK	HK$5.45	HK$35,083	6.4x	<0x	>75x	>75x	14.3x	>75x	0.7%
SINGAPORE AIRLINES	SIA SP	S$3.62	S$10,732	<0x	<0x	<0x	<0x	>75x	73.1x	1.2%
DEUTSCHE LUFTHANSA-REG	LHA GY	€8.70	€5,200	1.2x	<0x	<0x	<0x	2.7x	<0x	0.3%
AIR FRANCE-KLM	AF FP	€3.75	€1,608	2.6x	<0x	<0x	<0x	4.0x	<0x	0.0%
AMERICAN AIRLINES GROUP INC	AAL US	US$12.77	US$6,503	1.3x	<0x	<0x	4.2x	4.1x	<0x	0.8%
UNITED AIRLINES HOLDINGS INC	UAL US	US$34.77	US$10,108	0.7x	<0x	<0x	1.5x	1.3x	61.1x	0.0%
			Compco Average:	**2.5x**	**n/a**	**5.7x**	**4.1x**	**11.7x**	**62.7x**	**0.6%**
EV = Current Market Cap + Actual Net Debt			**AIR Relative:**	**n/a**	**n/a**	**-29%**	**34%**	**n/a**	**n/a**	**-100%**

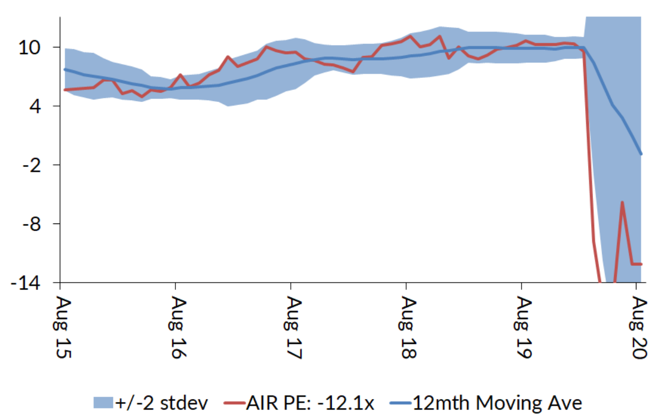
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (AIR) companies fiscal year end

Figure 9. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)



Source: Forsyth Barr analysis

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