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Air New Zealand (ANZFF)–Update on FY 2019 Results Maintain BUY

We are maintaining our BUY recommendation on Air New Zealand (ANZFF). The company reported lower earnings largely based on higher fuel costs essentially offsetting higher revenues. At the same time, the additional labor costs, passenger service costs, and operations costs of dealing with several of its B-787 aircraft being grounded due to problems with the Rolls-Royce engines all increased. Those issues were known when we first made the recommendation and there is evidence that all of those issues are largely resolved at this point.

The stock still yields 7.6% has been successfully reducing operating costs. It dominates its domestic market and has found cheaper ways to team with foreign partners to share revenues on international routes and maximize aircraft utilization. It still has a very liquid balance sheet and several years coming where capital spending on new aircraft will decline as the company's revenue and income rise based on rising passenger growth and lower costs per passenger. It still is at the high end its cash target of $700 million-$1 billion with over $1 billion now.

- **We still believe that fuel is a wildcard, and the company buys that in US dollars.** Oil prices began the last fiscal year at $70 in July 2018, falling to $46 in December, rising to $64 in April and remaining the mid-$50s since. **Fuel costs could be a positive change in fiscal 2020.**

- **The first reason to expect fuel costs to decline going forward are the 787s are coming back.** Air NZ has had as many as 5 of these new planes being repaired at the same time during the fiscal year ended June 2019. **This issue is essentially over in September 2019 and the 787 burns 25% less fuel than the 777 doing the same route.** There were 3 leased 777s used to replace the 787s under repair.

- **The second reason is Air NZ is forecasting and hedging oil at $75/barrel in US dollars for fiscal 2020. At that price, fuel costs would be $1.3b in NZ dollars. Every $10 move in oil prices would change the fuel costs by $80-$100 million. They are nearly through the first quarter and oil has not been above $60 yet. Fuel costs could come in 7%-10% lower than forecast if that holds up.**

- **Air NZ is still very comfortable that it can reduce costs by $60 million with much of that coming in fiscal 2020.** Without the Rolls Royce engine issues on the 787 and the need to rebook passengers, re-juggle crew schedules, lease extra 777's (all of which added to costs in fiscal 2019) – **CASK (Cost per Available Seat Kilometer) already fell in 2019 by 1.2% or $50 million.**

- **The company can quantify about $41 million from the Rolls Royce problems that will not recur – that will be much of the $60 million forecast. Other aspects of cutting CASK is simply replacing older Airbus planes with new A320/321 NEO models. These carry more passengers at very little incremental cost and that also pushes down CASK.** Last year only had a partial year with some of those planes and more will arrive this year.

- **The company has seen growth return after weakness last fall. It is forecasting 5% growth in fiscal 2020 as more capacity in long International routes is added. Also, the domestic market and business travel has been stronger.**

Overview of 2019 results:

Capacity grew at a slower rate than recent years as the disruption of repairing engines on 787s hit last year and the company opted to defer some new capacity additions on domestic routes when bookings slowed last fall:

Capacity	2019	2018	2017	2016
Domestic Seat KMs	7,104	6,905	6,597	6,065
Domestic Growth	2.9%	4.7%	8.8%	8.5%
Intl Seat KM	38,925	37,369	35,572	33,619
Intl Growth	4.2%	5.1%	5.8%	12.0%

This led to higher load factors as passenger growth exceeded capacity growth for two years in a row. It also leads to better pricing:

Passengers	2019	2018	2017	2016
Domestic	5,957	5,719	5,311	4,887
Domestic Growth	4.2%	7.7%	8.7%	7.1%
International	32,616	30,943	29,503	28,336
Intl Growth	5.4%	4.9%	4.1%	11.7%

Per km stats in cents	2019	2018	2017	2016
Passenger Rev/seat km	12.9	12.8	12.6	13.5
Load Factor	83.8%	82.8%	82.6%	83.7%
Revenue/Seat km	10.8	10.6	10.4	11.3
Cost per seat km	10.0	9.5	9.1	9.3

Looking at total passenger revenue grow0074h it was up NZ$264 million. That was with all the disruptions with the 787s being grounded for repairs. It is worth noting that any passengers who did not make into New Zealand as a result of rescheduling issues – likely also did not fly on a domestic flight while in-country as well.

What jumps out is the spread between revenue per available seat km and cost per available seat km. It was down to 0.8 cents vs. 1.1 cents in 2018 and 1.3 cents in 2017. The largest reasons for that narrowing were fuel costs being higher by $284 million. That is a function of using more fuel overall with less efficient aircraft and higher prices than the year before. The price of fuel is a wildcard, the fuel usage is something actively being addressed by Air NZ. Higher fuel was 0.43 cents of the increase in CASK (Cost per Available Seat Km). On top of that, the disruptions of having the 787s out of service was another 0.09 cents. Those two items alone are the difference in having a spread of 1.3 cents vs. 0.8 cents. That is nearly a $200 million negative swing in cash flow. As it was, cash flow before working capital was only down $100 million. Also, with future bookings being higher with passenger growth – that was a key in keeping cash flow nearly flat at NZ$986 million vs. NZ$1.03 billion y/y.

It may also be worth considering that the 787 issues and rescheduling of many passengers may have made it impossible for some passengers to fly at all. The long-haul routes to Asia, Europe, North America carried 2.2 million people last year. The average flight is 9,800km or about NZ$1,200 per flight. Every 1% of potential passengers lost with the disruptions would be about NZ$27 million in revenue with minimal incremental cost.

The Cash Flow Statement Looks Tight for the Dividend, Due to Higher than Normal Capital Spending which Is Ending

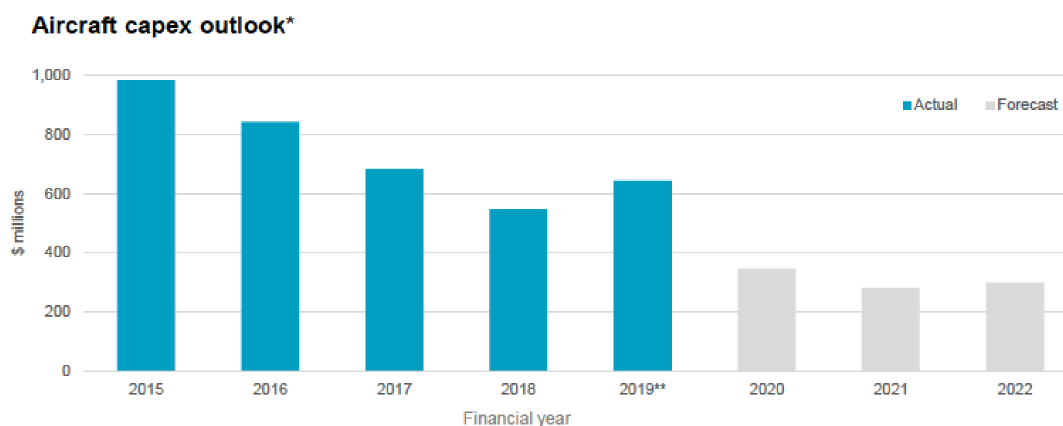
Cash Flow	2019	2018	2017	2016
CFO	$986	$1,031	$904	$1,074
CapX	$821	$809	$853	$998
Free Cash	$165	$222	$51	$76
Ordinary dividend	$260	$260	$236	$230

The company has been generating essentially $1 billion in cash flow for several years. During that time, it has invested over $2 billion in new aircraft. Some of that is money spent before the new planes arrive. Some of those airplane purchases are financed too. The graph below lays out the amount of spending that has been in Cap-Ex for new planes. The fair view of airplane investments is the last three years has been about $600 million and that is about to fall to $300-$400 million for fiscal 2020-22. Simply adding back $200-$300 million to free cash flow shows that the company covers the dividend over time with solid coverage. In addition, the company's earnings plus depreciation can show ample dividend coverage too:

Earnings in cents	2019	2018	2017	2016
Dividend/Shr.	$22.0	$22.0	$21.0	$20.0
EPS	$23.9	$34.4	$33.5	$40.8
Post Tax Depr.	$36.3	$33.4	$31.3	$28.6
Cash flow/Shr	$60.2	$67.8	$64.8	$69.4

The dividend is normally about 65% of EPS and about 33% of EPS + Depreciation. The growth Cap-Ex is skewing the free cash flow figure down and when looked at in the light of upcoming Cap-Ex for aircraft, the company still has ample room for the dividend.

We see a substantial reduction in aircraft capex from 2020 to 2022 compared to recent years



* Per 28 March 2019 disclosure to NZX and ASX; assumes NZD/USD = 0.67, includes progress payments on aircraft. Does not include widebody replacement aircraft.
** Based on estimate of 2019 aircraft capital expenditure.

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Management has talked frequently about its dividend and coverage and points toward the longer time horizon to periods when capital spending is not so high:

- *2019 Annual Results Conference Call -* ***we're coming into a lower-CapEx period, higher free cash flow and the gearing is tracking down. So those will be in our minds as we look at it [fiscal 20 dividend.]*** *The only other point I'd make actually is if you kind of think back a couple of years, we would have said back then that with the wide-body replacement program coming up in -- from 2023 that we'd targeted gearing below the [target]range as we contemplated that. Now that we've made the CapEx deferral that Christopher alluded to a second ago, that's no longer the case. The CapEx is quite evenly spread. It's quite sort of BAU-like [Business As Usual] almost as we go through that wide-body program. So,* ***we no longer need to get gearing below the range as we contemplate that. So, it's another thing that we'll factor into the consideration when we look at the dividends*** *for FY '20.*

- *2019 Investor Day - So first thing to note is we remain committed to consistently paying a sustainable level of ordinary dividend. And we're really proud that we have been able to pay $2.2 billion in dividends over the past 14 years. The thing I wanted to point out, though, is that when we talk to investors, and I talked about that at the beginning, particularly offshore investors, they sort of want to know what we mean*

by consistent and sustainable. So, when we publish this new framework, we will actually conclude definitions of those terms.

*So firstly, by consistently pay, we mean -- what we mean by that is simply that we seek to pay a dividend every year**. By sustainable, what we mean by that is that the amount of that dividend is not a short-term focus thing. It's looking at our medium-term financial projections of earnings, CapEx and gearing. And so, it's not based on a payout ratio of the earnings in a given year.***

- *2018 Annual Results Conference Call - Well we are not really in a position to provide dividend guidance. I mean we would sort of reiterate our policy of providing our consistent and sustainable dividends.* ***As you know we are getting towards a period, or getting closer to the period, where we have got a lower level of CapEx and an elevated level of free cashflow, so we continue to see that the Board will have an opportunity there to consider further distributions.***

- *2017 Investor Day - One point I made at this forum last year where I said when you think about our dividend, do not think about FY '16. That year is unique. What we know about in front of us [heavy Cap-Ex], that's what's hitting our dividend. And so, I was surprised -- people were surprised we kept $0.10 at February.* ***That should not have been a surprise given what we had said. So how we think about it is very much looking at those peaks and troughs and trying to sort of project that in a medium-term basis and as I say, sustainable.***

Unit Costs Should Decline Going Forward and Income Growth Should also Be Helped by Revenue Growth

There are several areas where CASK (cost per available seat kilometer) should decline going forward. We already talked above how the price of fuel is lower than the annual forecast and below fiscal 2019 levels. In addition to that, Air NZ has the following tailwinds for unit cost reductions:

- 787 aircraft will be in wider use in fiscal 2020 and fiscal 2021. Those burn about 25% less fuel per similar segment flown by the current 777 aircraft that Air NZ brought in to bridge the maintenance issues. Lower fuel usage should help lower CASK regardless of fuel prices.

- The new A320/321 NEO versions are replacing older planes. These offer more seats to sell, more room for cargo, but operating costs are essentially the same. The seat increase per plane is 27%. Simply dividing the same cost by more seats, lowers the CASK. Air NZ had only a partial year impact of these new planes in FY2019. Planes that arrived later in FY 2019 will have a full impact this year in FY 2020 and 9 more of these planes will arrive between FY20-22 boosting the total from 4 to 13.

- The absence of the Rolls Royce engine issues will cut costs by $41 million, as discussed above. It should also mean better scheduling of crews and other labor and some ancillary costs can decline further.

- The company has been active in reducing costs over time. They see gaining some efficiencies by looking at many areas of ordering, training, electronic communications and ticketing with customers as areas where they can continue to improve. They essentially hope to find about $25 million per year in cost savings. These costs were already down 0.28 cents per km in 2019 before being offset by commodity cost increases.

- Management's view is that they have a $3.4 billion cost structure to continually examine in terms of wages, training, supplies, ordering parts, passenger services. They think they can pull $25 million out of that $3.4 billion per year for a while, which is only 0.7%. If they can compound that as basically a decline in fixed costs, it should help offset variables like FX and fuel price swings and also bolster underlying profitability.

At the same time, revenue should also have some tailwinds:

- The company is forecasting 5% capacity growth in FY20 and essentially 3% for the following two years. That gives them a reasonable growth path to keep supply and demand more in balance. With the lower capacity growth, Air NZ has seen stronger pricing for the last two years already as shown in the first tables above.

- That capacity growth would compound to be 11% higher over the next three years at the same time the unit costs are lower from the fleet changes. Areas like the NEO

models adding more seats without adding flights are a good example of this. The incremental seat revenue should flow largely to the bottom line.

- The company is also targeting more International flight potential for areas that are underserved to New Zealand and offer the potential to bring in premium paying visitors. They are opening Seoul, South Korea this year. There are plans to expand service to Singapore and Taipei. Air NZ also noted it is looking at New York and Sao Paulo in Brazil.

- Some of the competition from Virgin between Australia and New Zealand has been reduced as well.

As we noted above, any combination of higher revenue and lower costs per available seat km totaling 0.5 cents – which is where the company has already been in FY 2018 – would be a $200 million positive to operating earnings vs. $1.2 billion posted in FY19.

Weakness in Bookings Has Recovered

As the company noted on the earnings call, there was a bit of big event/lack of event timing – but bookings have improved since the slow-down from last fall –

> *"We started to gain some momentum in terms of the revenue result, especially with strong close-in bookings in the May and June months, which drove a slightly better overall performance than we had expected when we reaffirmed guidance at our Investor Day in May. Areas that demonstrated the strength included domestic as we saw capacity reductions and pricing adjustments start to drive a stronger RASK result. We also saw a good inbound traffic from North America as well as solid performance from the Pacific Islands as we experienced a significant amount of bookings over the April school holidays, which you may remember had Easter and Anzac Day falling on the same week and was considered something of a super holiday for travel. Now that influx of travel demand also meant that the recent July school holidays had less demand, which is reflected in the recent operating stats we released to the market earlier this week."*

They continued talking about domestic demand – they are still getting positive growth and strong corporate demand:

“So, although when we look at the domestic demand at the moment, it's very much in line with what we indicated back in January. We haven't really seen that change much. We're seeing strong corporate booking, still strong unit revenue growth from that segment. Leisure still softer, but growing -- but still positive growth, so broadly, that's in line with what we expected.“

Y/Y Chg	Total Pass.	Dom. Pass	Tas. Pass	Total Load	Dom Load	Tas. Load
19-Jul	2.4%	1.7%	1.8%	0.4	0.9	-0.9
19-Jun	4.0%	4.3%	2.0%	2.2	3.1	2.9
19-May	3.4%	3.2%	2.8%	2.8	3.9	0.9
19-Apr	3.4%	3.0%	1.8%	1.6	0.4	-1.5
19-Mar	4.7%	4.7%	6.1%	-1.3	0.3	-0.4
19-Feb	5.8%	4.7%	10.7%	0.5	-0.9	1
19-Jan	4.1%	1.5%	8.9%	1.7	-0.4	0.2
18-Dec	4.5%	3.2%	6.9%	0.1	-0.7	0
18-Nov	4.2%	3.3%	8.9%	-0.7	0.3	-0.1
18-Oct	4.4%	3.4%	7.5%	0.6	1.1	0.6
18-Sep	6.0%	6.2%	7.5%	1.5	3.9	0.6
18-Aug	5.3%	4.3%	8.5%	2.7	2.3	0.6
18-Jul	4.7%	3.4%	7.0%	0.8	-0.7	-0.1
18-Jun	5.2%	4.0%	8.3%	0.4	2.1	-4.8
18-May	6.3%	5.6%	8.7%	0.3	1.9	-1.2
18-Apr	7.8%	7.7%	9.2%	-0.8	4.1	1
18-Mar	8.6%	7.9%	9.6%	3.5	2.4	2.1
18-Feb	5.3%	4.4%	8.3%	1.5	2.6	2.5

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