China / Hong Kong Industry Focus

Chinese Airlines Sector

Refer to important disclosures at the end of this report

DBS Group Research . Equity 26 Apr 2022

Wings clipped by more frequent lockdowns and jet fuel prices

- **Omicron and jet fuel prices are significant headwinds for the Chinese airline sector**
- **Another year of substantial losses for the Chinese airlines could lead to raising of more equity capital**
- **Downgrade Air China and CEA to HOLD with lower TPs; maintain BUY on CSA with lower TP**

Slashing FY22/23F earnings estimates. We expect the Chinese airlines to post significant losses again in FY22F before finally returning to the black in early FY23F. FY22F will be a particularly challenging year, given the confluence of headwinds in the form of the blazing rally in jet fuel prices (especially since all three airlines are completely unhedged) and limited improvement in passenger traffic, as international borders will likely remain closed until 2023 and more infectious variants like Omicron will lead to a higher rate of lockdowns of Chinese cities.

The Chinese flag carriers might need to raise more equity capital. Credit metrics for the three Chinese airlines could become unsustainable after another year of substantial losses. China Southern Airlines (CSA) has already announced plans to raise more equity capital, while Air China and China Eastern Airlines (CEA) could follow suit shortly. Air China, in particular, has not raised equity capital since the pandemic began, and appears to be in need of equity capital to bolster its battered balance sheet.

Turning neutral on Chinese airlines; CSA is our only BUY call at this juncture. We are downgrading Air China and CEA to HOLD with lower TPs of HK$5.20 and HK$2.80, respectively, but keeping a BUY call on CSA, though with a lower TP of HK$5.10. We are less positive about Air China, given its relatively higher exposure to the international travel market, and sluggish turnaround at key associate Cathay Pacific. Although the temporary grounding of CEA's B737-800 aircraft is not a serious issue, we believe that the airline's recent aviation accident could cause some reputational damage and lead to consumers avoiding CEA for a while. Finally, we believe that CSA will perform better than its peers again in FY22F because of its commanding position in the domestic market and tighter cost control.

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Recommendation & valuation

	Price HK$	A+H Mkt Cap US$m	12-mth Target Price HK$	Performance (%) 3 mth	Performance (%) 12 mth	Rating
China Southern Airlines (1055 HK)	4.23	16,062	5.10	(16)	(22)	BUY
Air China (753 HK)	5.22	17,266	5.20	(12)	(18)	HOLD
China Eastern Airlines (670 HK)	2.58	9,399	2.80	(17)	(27)	HOLD

Source: Bloomberg Finance L.P., DBS Bank (Hong Kong) Limited ("DBS HK")

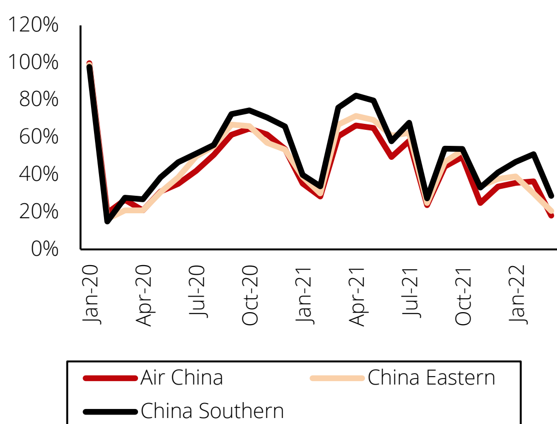
Closing price as of 25 Apr 2022

Turning neutral on the Chinese airlines

Air travel demand is likely to be much weaker than initially anticipated in FY22F. China is experiencing its worst spike in Covid-19 cases since the onset of the pandemic in Wuhan back in early 2020. Domestic air travel activity has been hit hard, with the three Chinese flag carriers reporting a steep 60%-70% y-o-y drop in domestic passenger traffic in March 22 as the country was thrown into lockdowns due to challenges in containing the spread of the highly transmissible Omicron variant. We believe that Omicron and the potential emergence of new problematic variants (that will likely be even more infectious) will translate into a higher frequency of domestic lockdowns in China in 2022.

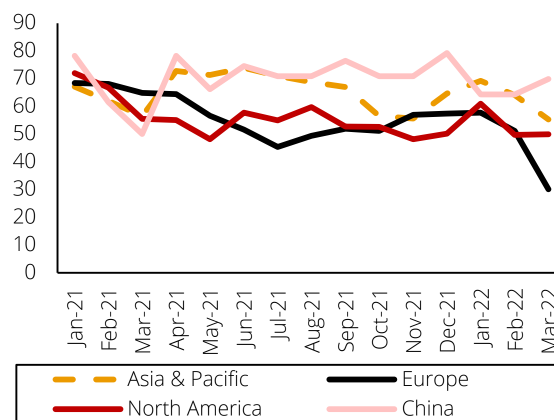
Furthermore, slower economic growth and rising unemployment will likely constrain discretionary consumer spending on air travel. Additionally, the recent aviation accident in China involving a B737-800 aircraft operated by China Eastern Airlines could exacerbate the issue, and lead to a temporary shift in demand to other modes of transportation like high-speed rail. Hence, our base case for the three Chinese airlines points to domestic air traffic reaching around 80% of pre-crisis levels in FY22, up moderately from 70%-75% in FY21. Assuming the pandemic is largely under control in 2023, we should see domestic travel activity surpassing pre-pandemic levels.

Historical passenger traffic (2019 = base)



Source: Bloomberg Finance L.P, DBS HK

Covid-19 Stringency Index

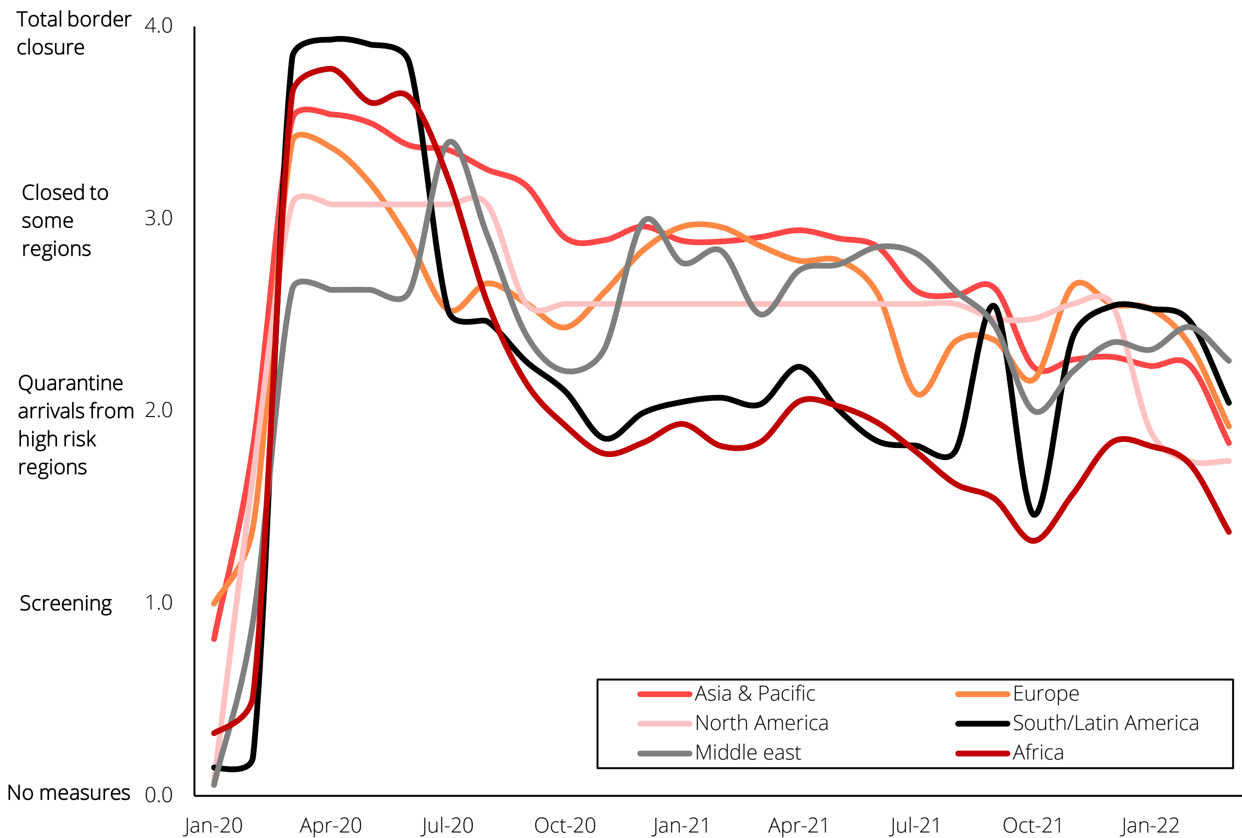


Source: OurWorldinData, DBS HK

There continues to be considerable uncertainty on when international travel will resume. International air travel cannot restart if the government sustains its current Covid-zero stance. Unfortunately, we believe that it will be an arduous task for the country to transit to living with Covid-19, suggesting that China could remain closed off to the rest of the world for a protracted period of time. Firstly, multiple research studies have demonstrated that Chinese vaccines provide less protection against the Omicron variant, and this will likely be the case for new variants of concern as well. Secondly, China's success in keeping the virus in check over the past two years means that natural immunity amongst the Chinese population is generally low, suggesting that the country is more vulnerable to Omicron. Finally, vaccination rates amongst the elderly in China are relatively poorer compared to other major economies, and this further complicates the reopening equation.

mRNA vaccines are currently being developed by several Chinese pharmaceutical companies, but success is not guaranteed, and it will still be a major undertaking to ramp up production and disseminate vaccines to China's massive population. The government has somewhat softened its stance by adopting more targeted responses and approving Pfizer's antiviral pills for emergency treatment. However, there are still many hurdles to overcome before international travel restrictions are sufficiently relaxed for a meaningful rebound in air travel activity, in our view. Hence, we only expect international travel restrictions to be loosened in early 2023, which is in line with the Chinese Government's five-year plan for the aviation sector. On a positive note, a key factor that will propel the recovery of international passenger traffic is sustained momentum on the reopening front across the world, which means that the ball is in China's court.

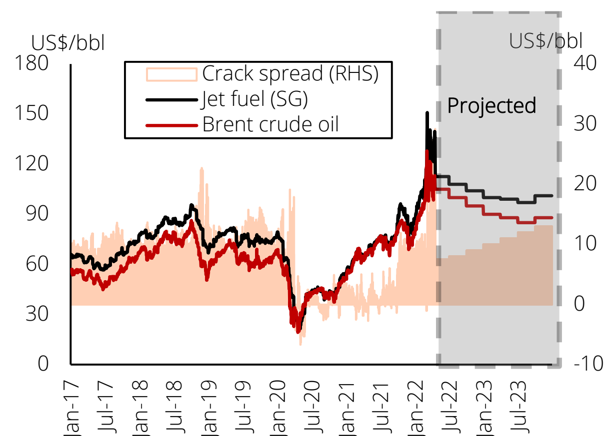
International travel restrictions (weighted by population) are starting to trend down again



Source: OurWorldinData, DBS HK

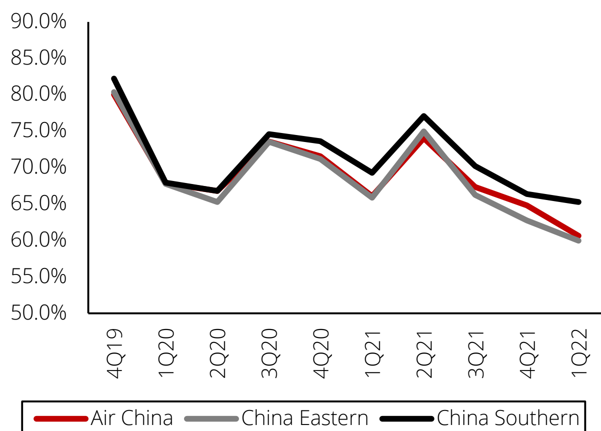
Inflation and buoyant jet fuel prices will have a considerable impact on operating margins. Unit costs among the Chinese airlines are likely to increase in FY22F, given limited improvement in passenger load factors and rising operational costs. Jet fuel prices are currently considerably higher than pre-pandemic levels (jet fuel prices averaged US$107.5/bbl in 1Q22, up 29.2% from 4Q19) and will likely stay at elevated levels for some time. Contrarily, passenger traffic has been averaging 55%-60% over the past six months and should struggle to surpass pre-pandemic levels for the next quarter at least. Apart from jet fuel prices, rising wages and the resumption of civil aviation levies will erode profitability. Accordingly, we estimate total unit costs to increase by 5%-8% in FY22F, before declining by around 8%-10% in FY23F on the back of higher passenger load factors.

Historical and projected crude oil/jet fuel prices



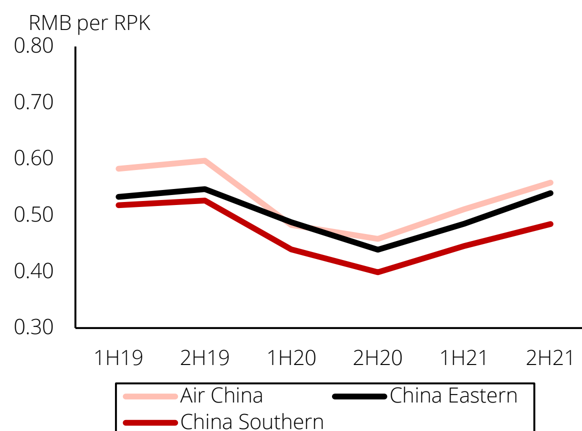
Source: Bloomberg Finance L.P., DBS HK

Historical passenger load factors



Source: Companies, DBS HK

Historical domestic passenger yield



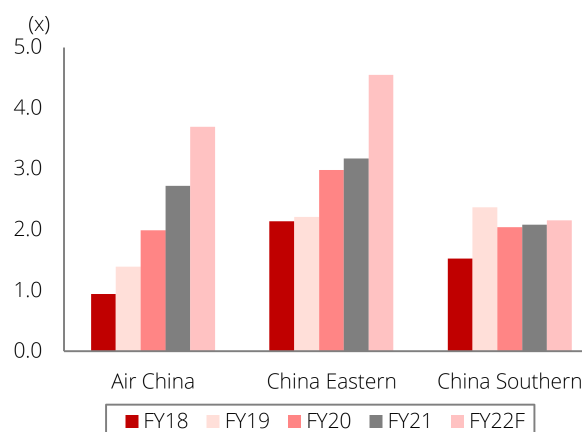
Source: Companies, DBS HK

Uptick in passenger yields could be insufficient to mitigate margin pressures. Domestic passenger yields staged a solid rebound in FY22F to around 90%-95% of pre-crisis levels in 2H21. Looking forward, however, we believe that the Chinese airlines have limited headroom to boost yields, as they lack bargaining power to further raise air fares in light of lacklustre demand. According to data by Qunar, ticket prices recorded for the recent Qingming Festival holidays were down nearly 20% compared to last year, largely a function of the surge in new Covid-19 cases and the plane crash in late March. Although airlines recently doubled fuel surcharges (fuel surcharges were reinstated last November, and will increase to RMB50 per pax for flights shorter than 800km, and RMB100 for flights exceeding 800km), we believe that fierce competition will force them to keep ticket prices affordable. Our base case currently factors in an 8%-10% increase in passenger yields in FY22F, slightly above the increase in total unit costs, as we still envisage a bounce in air travel demand in 2H22, but it will not be enough for the Chinese airlines to breakeven.

Continued deterioration in credit metrics could lead to equity being raised. Net gearing for CSA, CEA, and Air China were at 2.1x, 3.2x, and 2.5x as of Dec 21, respectively, still fairly in line with the industry average, but noticeably higher than pre-pandemic levels. Air China's net gearing ratio rose the most over the period (to 2.5x from 1.3x in FY19) as unlike its peers, the airline did not raise new equity capital since the pandemic began.

As FY22F will likely be another year of substantial losses for the Chinese carriers, financial leverage will likely rise again. CSA has already announced plans to raise more funds from the equity markets. Air China might turn to the equity markets to raise capital, as gearing levels could become uncomfortably elevated if it opts to finance its fleet expansion plans with debt again, given its weak operating cash flow generation. CEA could also return to the equity markets again after having raised around RMB10.8bn in FY21, given that the airline's net gearing is projected to surpass 4.5x in FY22F, which is much higher than the pre-pandemic levels of 2-3x.

Historical and projected net gearing ratio



Source: Companies, DBS HK

Cut FY22/23F earnings across the board. We now expect all three airlines to post deeper net losses in FY22F than before, due to softer passenger traffic and the fierce rally in crude oil/jet fuel prices. Our revised estimates point to the three airlines still turning profitable in FY23F on the assumption that border restrictions will be gradually lifted from early 2023, with international traffic hitting 40%-50% of pre-crisis levels for full-year FY23F. Current consensus estimates are too optimistic in our view, and we believe that there are downside risks to our FY23F earnings estimates, given the lack of visibility on China's reopening trajectory.

Old vs. new net profit estimates

	FY22F (old)	FY23F (old)	FY22F (new)	FY23F (new)	FY22F % change	FY23F % change
CSA	-2,100	2,003	-10,382	1,752	nm	-13%
Air China	-3,977	2,490	-14,005	1.968	nm	-13%
CEA	-2,936	1,633	-14,568	418	nm	-74%

Source: Companies, DBS Bank HK

Downgrade Air China and CEA to HOLD; maintain BUY on CSA. We are downgrading our recommendations on Air China and CEA to HOLD, with lower TPs of HK$5.20 and HK$2.80, respectively, to reflect our negative earnings revisions and share dilution risks. CSA is now our only BUY call in the sector, albeit with a lower TP of HK$5.10, primarily because of its dominant position in the domestic market, and relatively stronger cost control. Current valuations for Air China and CEA are fairly in tune with their relatively dimmer recovery prospects compared to regional and global peers, at around 1.1-1.3x P/BV (FY22F), and around +1.0 standard deviation above their five-year means. Meanwhile, CSA is priced more attractively at 1.0x P/BV (FY22F), which is in-line with its five-year average. Aircraft lessors are our preferred plays on the reopening theme at this juncture, given that they are not directly exposed to volatile commodity prices and tailwinds should propel a shift to aircraft leasing over the medium term.

Old vs. new target prices (HK$) and recommendation

	New TP	New Rcmd	Old TP	Old Rcmd	Current share price	% upside
CSA	5.10	BUY	5.70	BUY	4,24	20.2%
Air China	5.20	HOLD	6.30	BUY	5.24	-0.1%
CEA	2.80	HOLD	4.00	BUY	2.58	8.5%

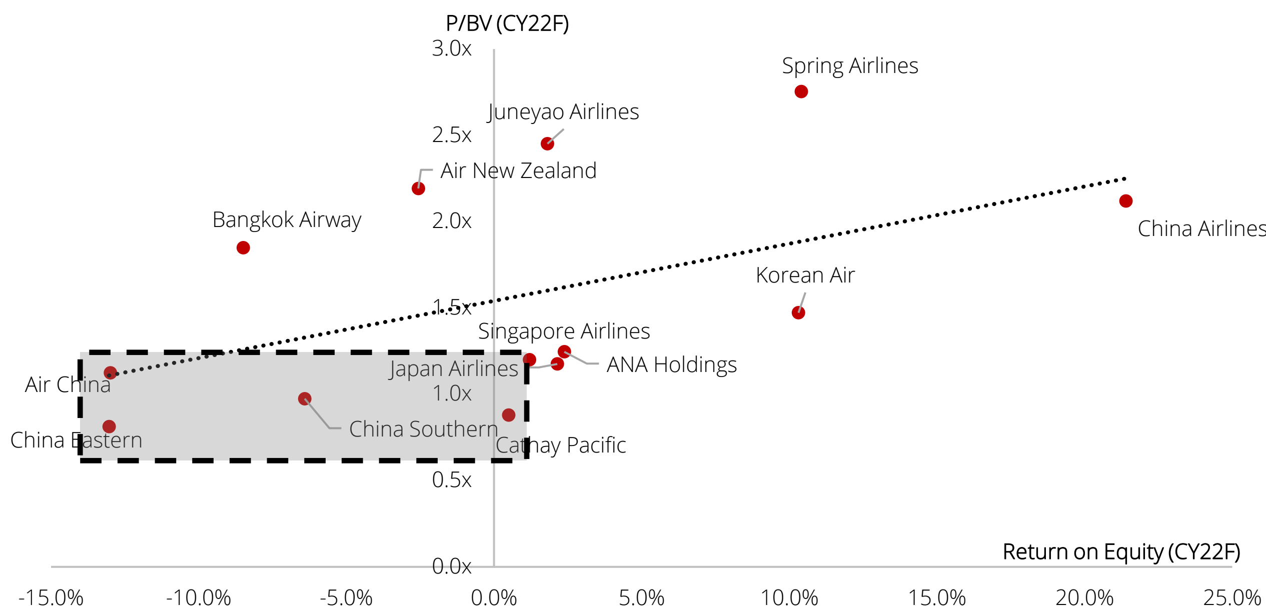
Source: Companies, DBS Bank HK

Regional airlines peer comparison

Company	Market cap (US$m)	P/E CY22F	P/E CY23F	EV-to-EBITDA CY22F	EV-to-EBITDA CY23F	P/BV CY22F	P/BV CY23F	ROE (%) CY22F	ROE (%) CY23F
Air China	17,266	nm	16.3x	18.0x	8.5x	1.1x	1.1x	-13.0%	5.2%
China Southern	16,062	nm	21.2x	14.7x	8.5x	1.0x	0.9x	-6.4%	4.8%
Singapore Airlines	12,033	394.3x	30.8x	8.1x	6.1x	1.6x	1.3x	0.1%	4.1%
China Eastern	9,399	nm	24.4x	14.5x	7.6x	0.8x	0.8x	-13.0%	6.4%
ANA Holdings	9,384	64.8x	13.5x	9.7x	6.6x	1.2x	1.1x	2.4%	9.3%
Korean Air	8,950	14.9x	15.6x	6.0x	6.1x	1.5x	1.4x	10.3%	7.7%
Japan Airlines	7,466	93.4x	12.5x	6.4x	4.1x	1.2x	1.1x	2.1%	9.8%
Spring Airlines	6,744	82.8x	24.1x	14.9x	9.9x	2.8x	2.4x	10.4%	14.1%
China Airlines	6,443	12.5x	22.1x	4.8x	5.2x	2.0x	1.9x	16.9%	13.6%
Cathay Pacific	6,048	nm	19.3x	9.1x	6.1x	0.8x	0.7x	-6.8%	4.3%
Qantas Airways	5,853	10.4x	18.0x	4.3x	4.2x	2.1x	2.0x	21.4%	17.3%
Juneyao Airlines	4,139	85.3x	17.7x	15.3x	8.3x	2.5x	2.2x	1.8%	11.9%
Air New Zealand	1,627	nm	14.0x	5.1x	3.4x	2.2x	1.9x	-2.6%	15.6%
Asiana Airlines	1,276	nm	nm	6.9x	6.8x	4.1x	4.5x	-13.2%	-2.5%
	Sector Median	73.8x	18.0x	8.6x	6.4x	1.5x	1.3x	1.0%	8.5%

Source: Bloomberg Finance L.P, DBS Bank HK

Price-to-book (CY22F) against return on equity (CY22F) of Asia Pacific airlines



Source: Bloomberg Finance L.P, DBS Bank HK

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BUY (>15% total return over the next 12 months for small caps, >10% for large caps)
HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)
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**Share price appreciation + dividends*

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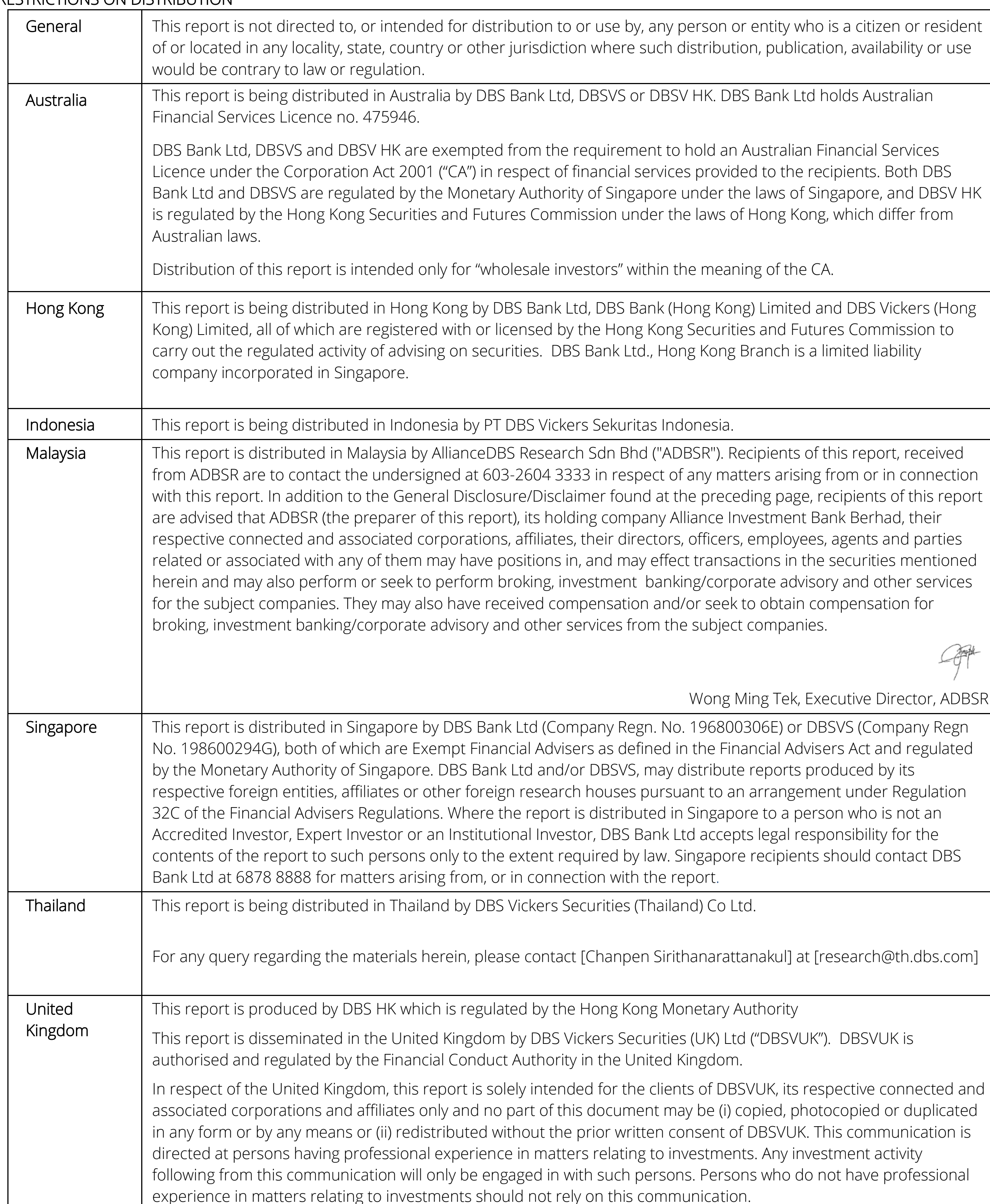

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