SECTOR UPDATE

Aviation – Singapore

Recovery On Track But Outlook Not All Rosy; Interest Hikes Weigh On Valuations

The May 22 operation data of SIA reaffirms the sector's strong recovery momentum in the near term. However, beyond the near-term optimism, high fuel costs and uncertainties of COVID-19 policies in China may limit the extent of the sector's recovery. The aggressive rate hikes by the Fed and the resultant higher risk-free rates would weigh on companies' valuations. Maintain MARKET WEIGHT and lower our DCF-based target prices for SIA Engineering and SATS.

- **Strong May air traffic statistics underscore strong near-term recovery momentum.** National carrier Singapore Airlines (SIA) saw its pax load (RPK) rising 15.1% mom in May 22, on the back of a 7.0% mom increase in pax capacity (ASK) and a 5.5ppt mom improvement in pax load factor (May 22: 78.2%, drawing close to its pre-pandemic levels of over 80%). SIA's pax capacity and pax load in May 22 were at 61.0% and 56.4% of their respective pre-pandemic levels.

MAY 22 OPERATION DATA OF SIA

	May-22	Apr-22	*Change mom*	May-21	*Change yoy*
Singapore Airlines					
ASK ('m)	9,656	9,022	*+7.0%*	4,266	*+126.3%*
RPK ('m)	7,546	6,558	*+15.1%*	610	*+1137.3%*
Pax Load Factor	78.2%	72.7%	*+5.5ppt*	14.3%	*+63.9ppt*

Source: SIA

- **High jet fuel prices may dampen long-term travel demand.** On the back of global inflationary pressures and the supply concerns due to Russia-Ukraine War, crude oil prices have been on a sharply rising trend. Fuelled by a widened crack spread, the increase in jet fuel price was even steeper, now standing at over US$180/bbl and matching the historical high last seen in 2008. The high jet fuel prices are expected to lead airfares to stabilise at a higher equilibrium level. While we believe that the strong pent-up air travel demand being fulfilled currently and in the upcoming months would be relatively more inelastic to higher airfares, a sustained high jet fuel price (and the resultant high airfares) may eventually dampen the air travel demand in the longer term.

JET FUEL PRICE NEAR HISTORICAL HIGH

Source: S&P Global, Refinitiv Eikon, International Air Transport Association (IATA)

- **Northeast Asia remains a drag.** Based on SIA's statistics, the air traffic recovery in the recent months has been mainly driven by the Americas, Europe and Southwest Pacific routes, but we note that for air travel in Singapore to recover to its full potential, traffic from/to Northeast Asia is required (China, Taiwan and Japan collectively formed about 20% of Changi airport throughput in 2019). China, sticking to its "Dynamic Zero-COVID" policies, is still in a largely locked down state today. Japan and Taiwan are gradually opening up their borders but at a cautious pace. Japan has reopened its borders to travellers on guided tours from 10 Jun 22, but remains closed to individual travellers. Taiwan has also loosened its border control recently, allowing entry by international

MARKET WEIGHT

(Maintained)

SECTOR PICKS

Company	Rec	Current Price	Target Price New (Old)	Upside
SIA Engineering	BUY	S$2.37	S$2.70 (S$2.90)	+13.9%
SATS	BUY	S$3.97	S$4.20 (S$4.75)	+5.8%
Singapore Airlines	HOLD	S$5.12	S$4.88 (S$4.88)	-4.7%

Source: UOB Kay Hian

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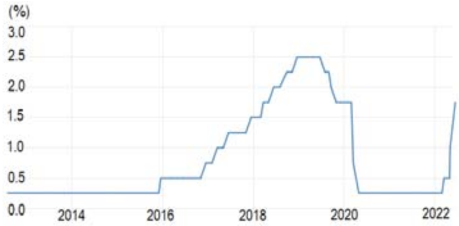
travellers from 15 Jun 22, but with a cap of 25,000 visitors per week. Pre-departure and on-arrival tests, as well as quarantines (though shortened), are still required.

- **Rising interest rates…** Since the start of 2022, the US Fed has conducted three rate hikes totalling 150 bps (the most recent one announced on 16 Jun 22 was a hike of 75 bps), raising the federal funds rate to 1.5-1.75%. The central bank also guided to raise the benchmark rate further to 3.25-3.50% by end-22, implying additional hikes totalling 175 bps in the remaining four Fed meetings of 2022. The interest rate hikes by the Fed are driving up borrowing costs in all open economies globally.

- **… have limited impacts on earnings…** Fortunately, for all the three Singapore aviation plays under our coverage, their direct earnings exposure to the rising interest rate is rather limited. First and foremost, all three companies were in net cash positions as of Mar 22, meaning they can easily pay off their outstanding debts with their cash position (or liquid investments) on their balance sheet. Second, out of the gross amount of debts outstanding, a substantial portion, if not all, is based on fixed interest rates. Lastly, for the part of gross debts on fixed interest rates, only a limited portion or none are due for repayment (refinancing) in 2022-24. As such, we expect the rising interest rates to have very limited impact on the earnings of the three aviation plays in the next three years.

FED FUNDS RATES HIKED TO 1.5-1.75% IN JUN-22, EXPECTING ANOTHER 175 BPS HIKES BY END-22



Source: Trading Economics

SINGAPORE AVIATION PLAYS' EXPOSURE TO RISING INTEREST RATES

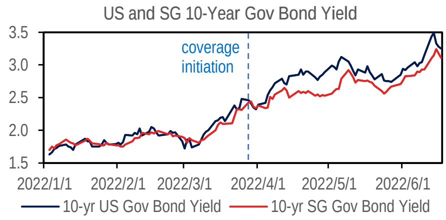
S$m	Net debt / (cash)	Debt gearing	Cash and liquid investments	Gross debt	% gross debt on floating rates	% gross debt on fixed-rates and due in 2022-24
SIA*	-2,157	n.m.	14,169	12,012	<1%	~23%
SATS	-275	n.m.	786	511	~40%	0%
SIA Engineering	-623	n.m.	625	3	n.m.	n.m.

** Debt calculation for SIA does not include mandatory convertible bonds (MCBs), which are also of fixed financing costs in nature.*
Source: Company Reports, UOB Kay Hian

- **…but still weigh on valuations.** Despite the very limited earnings impact, the rate hikes (leading to higher risk-free rates and discount rates, ie WACC) would still have negative implications on the valuation of aviation plays. Since our initiation on the Singapore aviation sector in end-Mar 22, the yield of the US government's 10-year bond has increased from 2.46% (as of 28 Mar 22) to 3.25% (as of 17 Jun 22) and the yield of the Singapore government's 10-year bond has increased from 2.43% (as of 28 Mar 22) to 3.11% (as of 17 Jun 22).

- The table below shows the sensitivity of DCF-based fair values of the three aviation companies by hiking their respective WACC by the same absolute quantum (50 or 100 bps) while holding other factors constant. Among the three, fair value of SIA (the lowest WACC implied by our current target price) is the most susceptible to rate hikes, followed by SATS. Fair value of SIA Engineering is the least sensitive, as the previous 8.5% WACC applied was already on a high base (the highest among the three).

RISING RISK-FREE RATES WEIGHING ON VALUATION OF AVIATION COMPANIES



Source: MAS, US Department of Treasury

SENSTIVITIES OF DCF-BASED FAIR VALUE OF THE THREE SINGAPORE AVAITION PLAYS

	--------------- SIA ---------------		--------------- SATS ---------------		------- SIA Engineering -------	
	WACC	DCF value**	WACC	DCF value	WACC	DCF value
Previous TP (implied) basis	6.5%	S$4.88	7.0%	S$4.75	8.5%	S$2.90
WACC hiked by 50 bps	7.0%	S$3.83	7.5%	S$4.20	9.0%	S$2.70
WACC hiked by 100 bps	7.5%	S$3.01	8.0%	S$3.77	9.5%	S$2.52

** Terminal growth of 3.0% has been applied across all three aviation companies.*
*** DCF valuation for SIA is included for illustration purposes only as we have switched to P/B as the primary valuation method for SIA.*
Source: UOB Kay Hian

EARNINGS REVISION

- No change.

RECOMMENDATION

- **Maintain MARKET WEIGHT on the Singapore aviation sector.** We have retained the respective ratings for the three individual stocks while lowering the target prices for SIA Engineering and SATS.

- **SIA Engineering (top pick) – BUY with lower target price of S$2.70 (from S$2.90).** Our DCF-based target price for SIA Engineering has been adjusted lower as we have hiked the WACC applied on SIA Engineering by 50 bps to 9.0% (previously 8.5%). SIA Engineering is our sector top pick. We like it for: a) the good visibility of business volume recovery (directly geared to increasing flight activities at Changi airport), b) its strong balance sheet (net cash position of S$623m at end-Mar 22 is equivalent to 23.2% of its market cap), and c) already cheap valuation (and hence the lowest valuation sensitivity to interest rate hikes) – current price of S$2.37 implies an FY25F (normalised year) PE of 14.2x (10.9x if excluding net cash), 2.4SD below its average of 23.2x during the pre-pandemic years of FY14-19.

- **SATS – BUY with lower target price of S$4.20 (from S$4.75).** Our DCF-based target price for SATS has been adjusted lower as we have hiked the WACC applied on SATS by 50 bps to 7.5% (previously 7.0%). SATS would benefit from the regional air travel recovery but its near-term earnings performance is expected to be weighed down by the keener cost pressure from: a) headcount build-up ahead of the business volume recovery, and b) inflationary pressure on labour and raw material costs. Current price of S$3.97 implies an FY25F (normalised year) PE of 16.6x, 1.1SD below its average of 19.9x during the pre-pandemic years of FY14-19.
- **SIA – HOLD with unchanged target price of S$4.88.** As illustrated earlier, theoretically, SIA's fair value (if using DCF valuation) would be the most sensitive to interest rate hikes. However, we note the speculative sentiment towards SIA could be high in the near term and we do not rule out the possibility of SIA trading higher on positive sentiments triggered by the likely exceptionally strong earnings in the next two quarters. As such, we see SIA as a trading play and hence have applied the P/B valuation method which is more short-term based in nature and offers a better sense on SIA's trading price relative to its historical trading range. Our target price of S$4.88 is pegged to 1.12x FY23F P/B (we estimate SIA's adjusted book value per share at S$4.36 at end-FY23), 2.0SD above its historical average of 0.96x during the pre-pandemic years. We recommend investors to offload SIA into share price strengths.

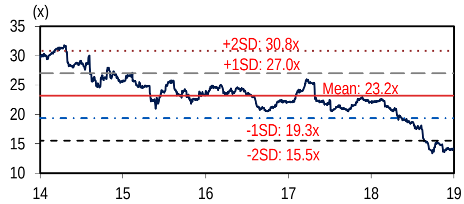
SECTOR CATALYSTS

- Key sector catalysts include: a) positive news flow of Singapore air travel recovery, b) faster pace of border measure relaxations in Japan and Taiwan, and c) possible shifts in stance on treating COVD-19 by China.

RISKS

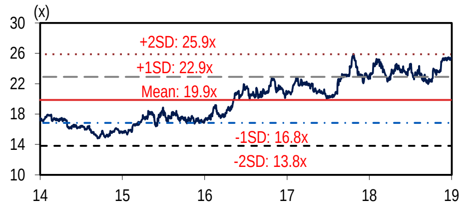
- Key risks include: a) inflationary cost pressures weighing on aviation companies' earnings recovery, b) a possible recession impacting air travel demand, and c) a more infectious/fatal COVID-19 variant leading to rollback of the global economic reopening.

SIA ENGINEERING HISTORICAL PE BAND IN PRE-PANDEMIC YEARS



Source: Bloomberg, UOB Kay Hian

SATS HISTORICAL PE BAND IN PRE-PANDEMIC YEARS

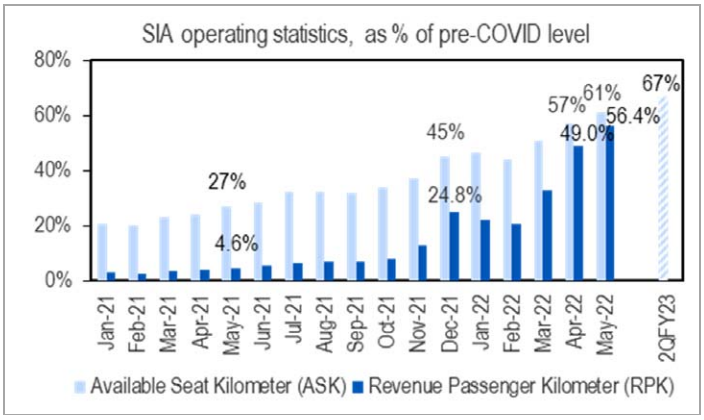


Source: Bloomberg, UOB Kay Hian

SIA HISTORICAL P/B BAND IN PRE-PANDEMIC YEARS

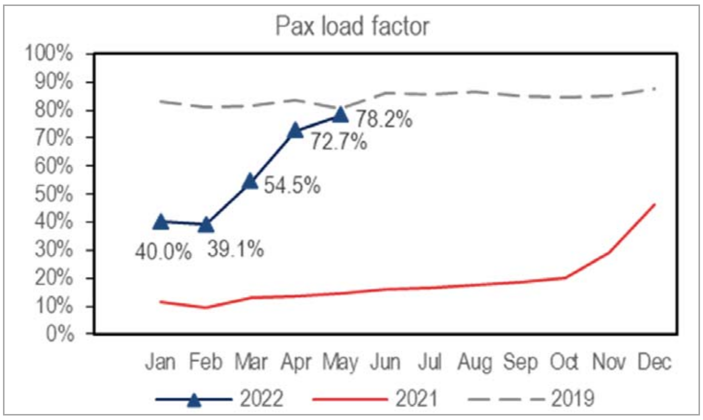
Source: Bloomberg, UOB Kay Hian

SIA'S PAX CAPACITY AND LOAD ON THE RECOVERY TRACK



Source: SIA, UOB Kay Hian

SIA'S PAX LOAD FACTOR ROSE TO 78.2% IN MAY-22



Source: SIA, UOB Kay Hian

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