China / Hong Kong Industry Focus

Chinese Airlines Sector

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DBS Group Research . Equity

14 Sep 2022

Long way to normal

- 1H22 results were much worse than expected; sector could stay unprofitable in FY23F
- Expect to see more red ink in 2H22 due to domestic lockdowns and travel restrictions; strict border controls will hamper international traffic in FY23F
- More equity raising could be on the cards given airlines poor liquidity and damage inflicted on their balance sheet
- Downgrade CSA to HOLD, Air China to FULLY VALUED with lower TPs; maintain HOLD on CEA with a lower TP

Cutting FY22/23F earnings estimates. We are now projecting the Chinese airlines to report deeper net losses in FY22F and remain in the red in FY23F. This is primarily driven by our expectations of higher frequency of domestic lockdowns, on-off implementation of travel restrictions, and gradual easing of international border controls.

Chinese airlines may need to raise more equity capital despite recent fund-raising. The credit metrics of all three airlines have deteriorated drastically over the course of the pandemic. Air China and China Eastern Airlines (CEA) in particular, might need to rely on their respective parents and the equity markets again for more capital to replenish their working capital and finance their fleet expansion plans, as sustained losses continue to take a toll on their balance sheets.

Turning more bearish on the sector; downgrade CSA to HOLD and Air China to SELL. We now have a HOLD recommendation on CSA and CEA with lower TPs of HK$4.40 and HK$2.50 respectively, and a SELL recommendation on Air China with a lower TP of HK$4.00. We have turned negative on Air China as its current valuation is too rich, given that its share price has outperformed the broader airline sector index this year despite its relatively bleak earnings prospects and risk of more equity dilution. Meanwhile, the current valuations of CEA and CSA also appear unattractive at greater than two standard deviations above their five-year averages, but we are neutral on them given that their valuation is in line with their fundamentals. Consensus estimates for the sector are too optimistic, and we expect to see more negative earnings revisions in the near-term.

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Recommendation & valuation

	Price	Mkt Cap	12-mth Target Price	Performance (%)		
	HK$	US$m	HK$	3 mth	12 mth	Rating
Air China	6.20	3,604	4.20	16.1	12.9	FULLY VALUED
China Eastern Airlines	2.72	1,614	2.60	2.6	(17.1)	HOLD
China Southern Airlines	4.23	1,976	4.50	5.5	(10.8)	HOLD

Source: Thomson Reuters, DBS Bank (Hong Kong) Limited ("DBS HK")

Air China : Air China is the flag carrier of China and one of its largest airlines

China Eastern Airlines : China Eastern Airline is a major airline company in China, mainly engagiing in passenger and cargo service.

China Southern Airlines : Provides air passenger and cargo services, with main hub in Guangzhou

Risks are still skewed to the downside; valuations appear stretched at this juncture

1H22 results were notably worse than our expectations. Net losses incurred by the three Chinese airlines in 1H22 were dramatic, to say the least – net losses during the period were equivalent to three-four years of their respective net earnings prior to the pandemic and more than double the net losses in 1H21. Deeper net losses during the period were largely driven by an acute decline in passenger traffic due to a higher frequency of domestic lockdowns, and buoyant jet fuel prices and steep FX losses. CSA fared the best among the three flag carriers – CSA saw a relatively smaller increase in net losses and was the only airline to report positive EBITDA in 1H22.

Historical net losses (in RMB billions)

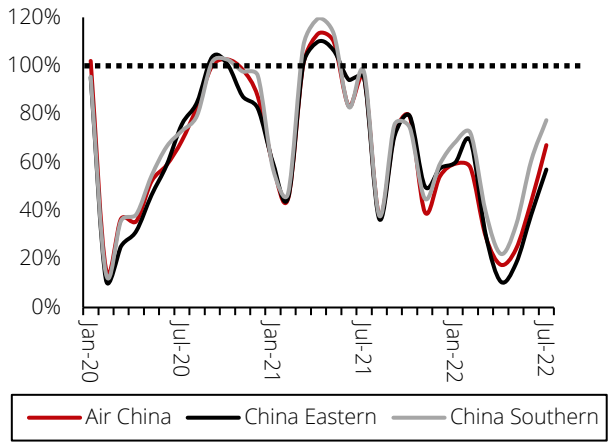
	1H20	2H20	1H21	2H21	1H22	y-o-y change (absolute)
Air China	-9.4	-5.0	-6.8	-9.9	-19.4	-12.7
CEA	-8.5	-3.3	-5.2	-7.0	-18.7	-13.5
CSA	-8.2	-2.7	-4.7	-7.4	-11.5	-6.8

Source: Companies, DBS Bank HK

Recovery in domestic passenger traffic will continue to be bumpy in 2H22; return to normalcy in FY23F is unlikely if China maintains its strict zero-tolerance stance. Domestic air travel activity was severely depressed (below 30% of pre-pandemic levels) between March to May-22 as multiple cities, including key hubs like Shanghai and Beijing were thrown into partial or complete lockdowns to curb the spread of the Omicron variant. CEA saw the steepest decline in passenger volumes owing to the temporary grounding of its B737 aircraft and a two-month lockdown of its primary hub, Shanghai. While domestic air traffic rapidly regained lost ground to 65-70% of pre-pandemic levels in July-22, the recovery remains fragile as snap lockdowns continue to be the tool of choice to suppress new cases. Chengdu, one of China's largest cities with a population of 21.2 million people entered lockdown in the first week of September, and more recently, Shenzhen was also placed in lockdown. Additionally, the government also intensified domestic restrictions for domestic travel and group gatherings until the end of October, dampening travel demand during the peak Golden Week holiday period in October.

History suggests that domestic air travel will quickly bounce back when the pandemic situation stabilises, but it is difficult to plot the course of China's domestic air traffic in FY23F under a COVID-zero framework given the sheer transmissibility of Omicron and potential emergence of new variants which will likely prove even more challenging to contain. Consequently, our current assumptions point to domestic air travel activity reaching 85-90% of pre-COVID19 levels in FY23F, up from 45-55% in FY22F.

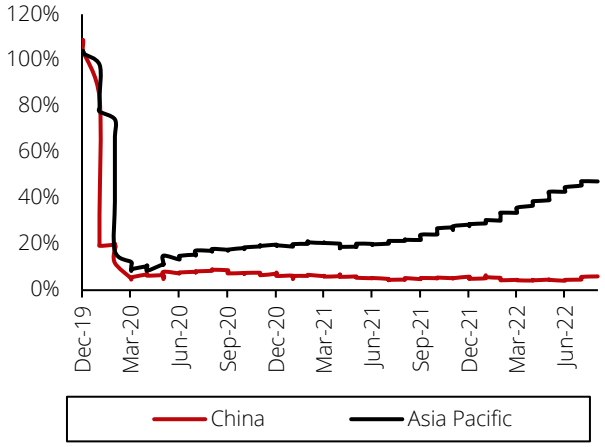
Domestic passenger traffic (2019 = base)



Source: Companies, DBS HK

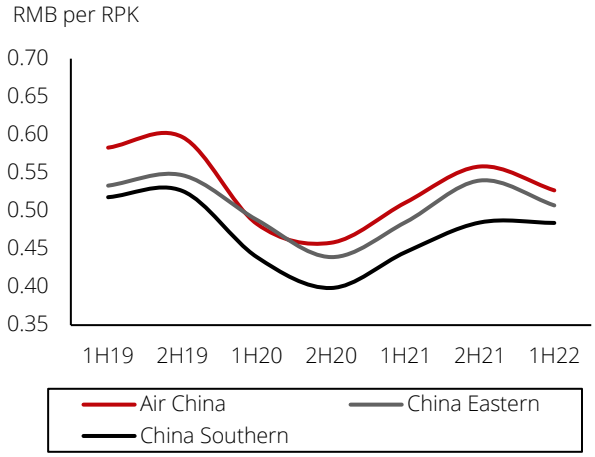
Easing of travel restrictions unlikely to translate into a meaningful increase in international travel; turnaround in FY23F is constrained by uncertainty on reopening timeline. During May to June-22, China loosened business travel and work visa restrictions and cut the number of mandatory quarantine days by half for inbound travellers to seven days (with three days of home-based monitoring). While these developments are certainly a step in the right direction, China's border controls continue to be among the most onerous in the world, with quarantine-free travel already a reality in most parts of Asia. Hong Kong officials expressed their intent to end hotel quarantine in November, but the Chinese government has been doubling down on COVID-zero and offers little clue on how they intend to exit COVID-zero. Although we currently anticipate China to progressively ease international border controls in the near-term, we do not believe it will move the needle as it is likely to take an extended period of time for travel measures to be sufficiently loosened to spur a rebound in international air travel. Accordingly, we only anticipate international air traffic to reach 25-30% of 2019's level in FY23F.

International passenger capacity (2019 = base)



Source: CAPA, DBS HK

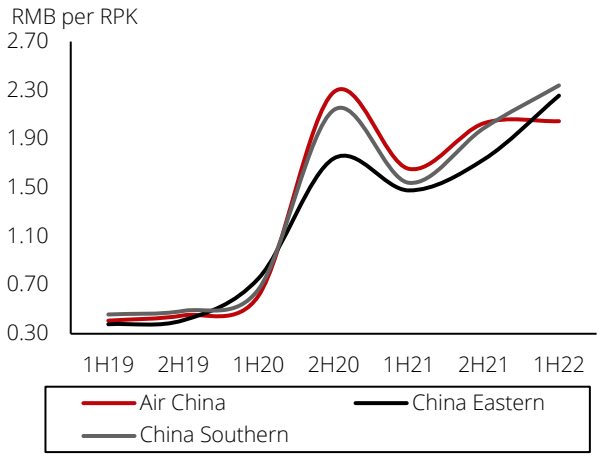
Domestic passenger yields



Source: Companies, DBS HK

Domestic passenger yields should strengthen on demand rebound; elevated international passenger yields should trend lower as airlines reinstate more flights. Passenger yields in the domestic market softened sequentially in 1H22 due to the drastic drop in demand. Looking ahead, domestic air fares should climb in 2H22 with the return of demand, but weaker economic growth and higher unemployment in China, coupled with the prolonged closure of international borders (capacity will remain abundant with the Chinese airlines focusing on deploying capacity in the domestic market) will impede yields from normalising to pre-pandemic levels. Meanwhile, international passenger yields broke new records in 1H22 because of an extremely low frequency of international flights, but they should rapidly fall when more international flights resume. Nonetheless, we expect international air fares to hold above pre-pandemic levels when China's borders reopen given significant pent-up demand for international travel.

International passenger yields

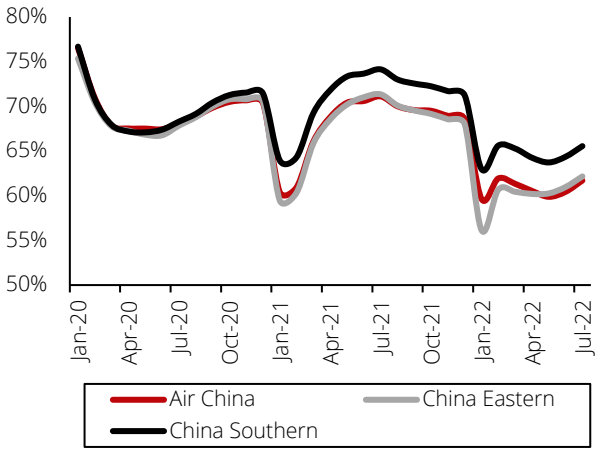


Source: Companies, DBS HK

Cost headwinds will persist in the near-term; strong USD will weigh on operating margins and bottom line of the Chinese airlines. Unit costs among the three airlines rose sharply among the three airlines in 1H22 amid limited government support and weaker passenger load factors, with CEA seeing the most sizeable increase in unit cost due to the relatively larger decline in its total capacity. Unit cost is unlikely to fall by much in 2H22 but should trend lower in FY23F and beyond as overall load factors rise, though any improvement will be hampered by higher jet fuel prices (SG Jet fuel prices averaged US$142.2/bbl in 2Q22, up 32.2% from 1Q22 and 70.9% from 4Q19), which we expect to remain buoyant over the next two years. A strong USD will also have an adverse impact on operating margins as a fair

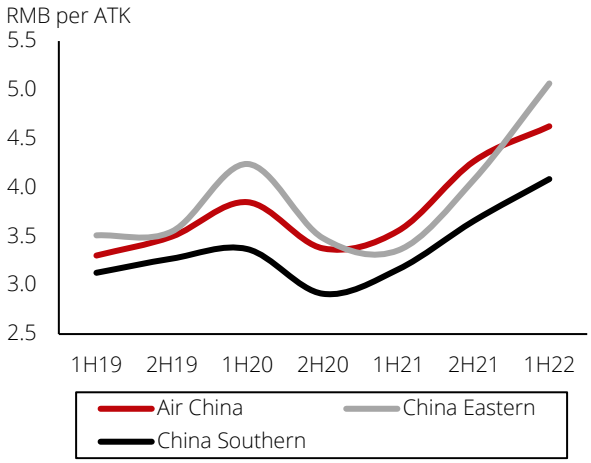
proportion of operating costs is denominated in USD. Additionally, the Chinese carriers will see additional FX losses in 2H22 if the USD continues to appreciate against the RMB. Even though the three airlines have been moderating their exposure to USD-denominated debt, they still incurred considerable FX losses of RMB1.4-2.2bn in 1H22.

Overall passenger load factors



Source: Companies, DBS HK

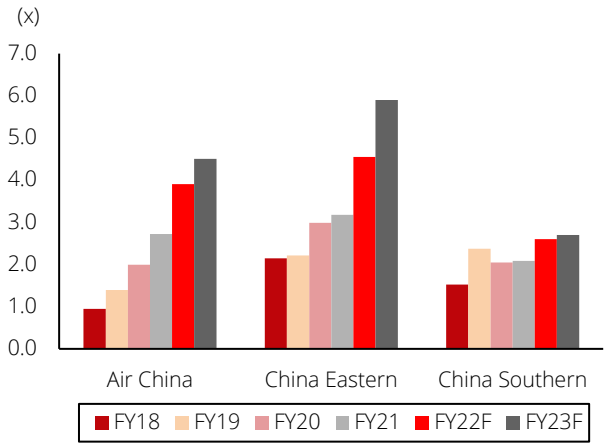
Overall unit costs



Source: Companies, DBS HK

The Chinese airlines may need to raise more equity capital given the severe deterioration in their financial health. CEA and Air China recorded negative cash flows from operations of RMB4.4bn and RMB10.0bn in 1H22 respectively, while CSA saw a significant decline in operating cash flow to RMB1.6bn (-40% h-o-h, -67% y-o-y). Net gearing ratios of Air China, CEA and CSA climbed to 4.2x, 5.1x and 2.6x in 1H22 from 2.6x, 3.2x and 2.1x in 2H21 respectively. All three airlines have announced plans to raise equity capital in 2022 thus far to bolster their liquidity positions and finance their fleet expansion plans, but we believe they may need to raise more capital if their operational performance continues to be lackluster. This will consequently be EPS dilutive over the longer-term even after the Chinese airlines emerge from the crisis.

Historical and projected net gearing ratio



Source: Companies, DBS HK

Project Chinese airlines to post more substantial losses in FY22F; profitability in FY23F will be elusive if air travel demand is curtailed by lockdowns or international borders take longer than expected to reopen. We now expect the three Chinese airlines to report wider net losses in FY22F and remain in the red in FY23F as we lower our air traffic assumptions. Our current earnings estimates are still predicated on China reopening in mid-2023, with international traffic hitting 25-30% of 2019's level for full-year FY23F. The street is still overly bullish on the three Chinese airlines, in our view, particularly on the extent of recovery of international air traffic in FY23F.

Old vs. new net profit estimates (in RMB billions)

	FY22F (old)	FY23F (old)	FY22F (new)	FY23F (new)	FY22F % change	FY23F % change
CSA	-10.4	1.9	-18.1	-1.4	-74.0%	nm
Air China	-14.0	2.0	-29.1	-5.2	-107.8%	nm
CEA	-14.5	0.4	-28.4	-5.7	-95.8%	nm

Source: Companies, DBS Bank HK

Valuations of the three Chinese airlines are misaligned with their extended recovery trajectory. We downgrade our recommendations on CSA to HOLD with a lower TP of HK$4.40 and Air China to FULLY VALUED with a lower TP of HK$4.00. Meanwhile, we are maintaining our HOLD call on CEA with a lower TP of HK$2.50. We believe that the risk-to-reward set up for Air China is unfavourable given the stark divergence in its share price performance and fundamentals. Overall, current valuations for the three Chinese airlines are greater than two standard deviations above their respective five-year averages, which is expensive, when considering their lackluster near-term recovery prospects and potential share dilution. Additionally, they are trading at considerably higher multiples than regional airline peers with stronger credit metrics and more promising earnings profile. While the longer-term outlook for the Chinese airlines remains bright, we believe that it is not the right time to accumulate their shares yet.

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

	New TP	New Rcmd	Old TP	Old Rcmd	Current share price	% upside
CSA	4.50	HOLD	5.10	BUY	4.23	6.4%
Air China	4.20	FV	5.20	HOLD	6.20	-32.3%
CEA	2.60	HOLD	2.80	HOLD	2.72	-4.4%

Source: Companies, DBS Bank HK

Peer comparison table

Company	Market cap (US$m)	P/E		EV-to-EBITDA		P/BV		ROE (%)	
		CY22F	CY23F	CY22F	CY23F	CY22F	CY23F	CY22F	CY23F
Air China	18,656	nm	27.1x	254.8x	9.8x	1.9x	1.7x	-48.5%	8.3%
China Southern	14,520	nm	30.4x	43.6x	9.7x	1.2x	1.1x	-24.2%	4.2%
China Eastern	11,662	nm	nm	59.0x	9.1x	1.2x	1.2x	-49.5%	0.9%
Singapore Airlines	11,499	16.2x	14.8x	5.3x	5.0x	1.2x	1.1x	5.1%	6.3%
ANA Holdings	9,191	37.6x	15.3x	9.5x	7.0x	1.5x	1.4x	3.7%	9.2%
Japan Airlines	7,983	38.8x	14.0x	7.0x	5.1x	1.4x	1.3x	3.5%	9.3%
Korean Air	6,784	5.9x	10.2x	3.6x	3.8x	1.1x	1.0x	20.5%	10.2%
Spring Airlines	6,522	nm	30.6x	119.8x	11.0x	3.5x	3.1x	-8.3%	11.3%
EVA Airways	6,863	12.0x	7.1x	4.2x	3.3x	82.5x	14.4x	876.3%	198.1%
China Airlines	5,805	17.7x	11.2x	5.4x	4.6x	2.0x	1.7x	10.5%	12.7%
Qantas Airways	4,347	16.6x	13.5x	5.4x	4.1x	1.8x	1.7x	10.6%	11.0%
Cathay Pacific	6,857	nm	21.0x	9.0x	6.4x	0.9x	0.9x	-6.6%	5.3%
Juneyao Airlines	5,006	nm	29.1x	nm	12.2x	3.6x	3.2x	-21.6%	11.5%
Air New Zealand	1,399	56.3x	9.1x	3.7x	2.8x	1.3x	1.1x	1.6%	12.9%
Asiana Airlines	767	nm	76.9x	nm	nm	2.6x	1.5x	-13.5%	2.0%
	Sector Median	17.7x	15.3x	8.0x	6.4x	1.5x	1.4x	1.6%	9.3%

Source: Bloomberg Finance L.P, DBS Bank HK

DBS HK recommendations are based on an Absolute Total Return* Rating system, defined as follows:

STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

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)

FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)

SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

**Share price appreciation + dividends*

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