Malaysia Aviation

Hitting all the right spots

Positive dynamics to continue
1Q16 financial results were spectacular for a few reasons. First, all four carriers were profitable which is a rarity. Second, the industry’s average load factor was >80%, which is a record for 1Q performance. Third, the profits margin achieved by AirAsia was a global record for the period. Things have never been this good for the sector. Given that the dynamics are unchanged in 2Q16 and perhaps 3Q16, we expect airlines to deliver supernormal profits in the subsequent quarters. We favour AirAsia.

Benefitting from industry consolidation
The stellar performance can be attributed to the industry consolidation as Malaysia Airlines (MAB) has cut significant capacity since Sep 2015. We have said for a long time that consolidation is good for the market but 1Q16 results however, overwhelmed us. Currently, the market is short of supply and we think this situation will persist until late 2016 as there has been only one (1) addition of aircraft deployed in Malaysia YTD.

The party will continue for 1-2 more quarters
The combination of buoyant passenger demand, short of supply and low fuel prices are the stuff of dreams for airlines. 1Q16 supernormal profits manifest the net result of this virtuous combination. Given that the dynamics are unchanged in 2Q16 and perhaps 3Q16 as well, we expect airlines to deliver supernormal profits in the subsequent quarters. Things will normalise when the industry deploys more aircraft, which should be the case in late 2016 and 2017.

Maintain Positive
The short-term outlook is exceptionally strong, perhaps the best in the entire Asian region. We favour AirAsia (AIRA MK, BUY, TP: MYR2.90) as it is the best positioned to benefit from the current industry landscape. Neutral on AirAsia X (AAX MK, HOLD, TP: MYR0.36) as we feel the risk-reward is not justified for an upgrade. Neutral on MAHB (MAHB MK, HOLD, TP: MYR7.10) as passenger traffic growth remains below its historical average and its Turkish airport has yet to turnaround.
1Q16 in summary

Net profit for Malaysian based carriers

<table>
<thead>
<tr>
<th>Airline name</th>
<th>1Q16</th>
<th>1Q15</th>
<th>YoY (%)</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>figures in MYR m</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia Airlines</td>
<td>14</td>
<td>n.a</td>
<td>n.a</td>
<td>First profit since 2010</td>
</tr>
<tr>
<td>AirAsia (M’sia operations)</td>
<td>403</td>
<td>(182)</td>
<td>n.a</td>
<td>Record quarterly profit in its history</td>
</tr>
<tr>
<td>AirAsia X</td>
<td>74</td>
<td>(33)</td>
<td>n.a</td>
<td>Turnaround since 2012</td>
</tr>
<tr>
<td>Malindo</td>
<td>Profitable</td>
<td>Loss making</td>
<td>n.a</td>
<td>Market sources revealed that Malindo had a reasonably good 1Q16 performance</td>
</tr>
<tr>
<td>Grand total</td>
<td>491</td>
<td>&gt;(215)</td>
<td></td>
<td>The industry’s best 1Q16 performance in history</td>
</tr>
</tbody>
</table>

Sources: Respective companies, Maybank KE

Load factor soared to new record

MAB has cut significant capacity back in Sep 2015 and in Jan 2016. We estimate the industry capacity has shrunk by 5% YoY in 1Q16 due to MAB capacity cuts and given that the other airlines have not added much new capacity. The lower supply coupled with demand growth has pushed load factors up significantly YoY. AirAsia has achieved a record load factor of 85.4% and AirAsia X has also recorded a respectable load factor of 81.7%. Both MAB and Malindo do not reveal their operating statistics but we gather from industry sources that both have recorded strong load factors as well — MAB at high 70% and Malindo at >80%.

Everyone was profitable

AirAsia, AirAsia X and MAB all have achieved YoY yield growth in 1Q16. This is a stark contrast against the average 8% yield decline for Asia Pacific carriers. Malaysia and Thailand were the only countries that achieved positive yield growth in the quarter. AirAsia delivered quarterly record profits, AirAsia X has firmly turnaround, MAB delivered a modest profit, and we were reliably informed that Malindo Air also recorded good profits. This is the first time since 2007 that all the main carriers are profitable.

MAB was the root cause

Whether the other carriers want to admit it or not, the biggest reason of this blowout 1Q16 performance has hinged on MAB’s restructuring which drove industry consolidation. Due to MAB’s capacity cuts and other carriers did not grow their fleet, it has caused a capacity crunch which ultimately provided substantial pricing power to the airlines. The industry would have recorded profit growth in 1Q16 even if MAB did not cut capacity as fuel prices fell 38% YoY, but the quantum would have been much less.
Short-term outlook remains positive

Supply shortage to persist in the short term

The table below shows the number of aircraft in the fleet for all the Malaysia carriers. Based on initial fleet plans, the fleet size should maintain flat in 2016. But, what we have seen YTD is that the total fleet size has shrunk by 10 aircraft or down by 4.2% compared to 2015. This explains the capacity crunch issue that affected the sector in 1Q16.

Thus far YTD, there has only been one net addition of aircraft in 2Q16, which infers that the industry will remain to be short in supply in 2Q16. MAB, Firefly, AirAsia and AirAsia X are all being consistent with their initial plans. However, Malindo fleet deployment plans seems to have hit a snag, we hear market whispers that many of its planned new routes are still waiting for approvals. This delay in route approvals has caused a changed in its original aircraft deployment plans.

Rayani Air’s adventures have come to an end as the Malaysian Aviation Commission (MAVCOM) has revoked its operating license on 13 Jun. It has ceased its operations indefinitely and this again will add to further capacity shortage to the industry.

Net fleet growth for Malaysia 2014-16F

<table>
<thead>
<tr>
<th>Airline name</th>
<th>2014A</th>
<th>2015A</th>
<th>2016F</th>
<th>Actual YTD</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malaysia Airlines</td>
<td>99</td>
<td>92</td>
<td>82*</td>
<td>82*</td>
<td>Many aircraft are sitting idle</td>
</tr>
<tr>
<td>Firefly</td>
<td>16</td>
<td>19</td>
<td>21</td>
<td>20</td>
<td>Took first delivery on 28 Apr</td>
</tr>
<tr>
<td>AirAsia</td>
<td>81</td>
<td>80</td>
<td>82</td>
<td>80</td>
<td>Not taking any aircraft this year, latest input by the CEO</td>
</tr>
<tr>
<td>AirAsia X</td>
<td>19</td>
<td>20</td>
<td>20</td>
<td>21</td>
<td>One aircraft in transition to be returned to lessor</td>
</tr>
<tr>
<td>Malindo</td>
<td>19</td>
<td>27</td>
<td>32</td>
<td>27</td>
<td>No new aircraft has been deployed yet</td>
</tr>
<tr>
<td>Rayani</td>
<td>-</td>
<td>2</td>
<td>3</td>
<td>Discontinued</td>
<td>Lost its ATL and has ceased operations</td>
</tr>
<tr>
<td>Grand total</td>
<td>234</td>
<td>240</td>
<td>240</td>
<td>230</td>
<td></td>
</tr>
</tbody>
</table>

* some aircraft are sitting idle
Sources: Respective companies, Maybank KE

Profit outlook remains positive

This demand-supply mismatch should be supportive for load and yield growth into 2Q16. 2Q is seasonally a soft quarter for the industry due to limited public and school holidays, and the overlap of the Ramadhan fasting month. Therefore, the absolute 2Q16 profit number will trail that of 1Q16’s, but it will still deliver exceptionally strong YoY growth, we believe.

How long will this super-normal profit last?

One shouldn’t expect the strong profits achieved in 1Q16 to sustain. As explained earlier, it was a combination of supply shortage coupled with steady demand and low fuel prices. Any one of these variables can move the other way and shift the equilibrium very quickly in the future.

At this juncture, 2Q16 seems to be another quarter of super-normal profits and perhaps so will 3Q16 too. We believe it is just a matter of timing before more capacity is injected into the system and the supply-demand margin will narrow. We think this may happen at the end of 3Q-4Q16 and onwards till 2017. This will inevitably rebalance the loads and yields and ultimately eat into the net margins.
AirAsia (AIRA MK): BUY, TP: MYR2.90

AirAsia 1-yr forward PER

- Reiterate BUY rating. Main beneficiary of MAB capacity cuts. Hedged 55% of 2016 fuel and about 42% of USD liabilities, thus mitigating some cost fluctuation.
- Strong core earnings outlook in 2016 of +323% YoY.
- Management intends to subscribe to 10% of new shares. This will add MYR1b of capital to the Company and reduce gearing level to <1x from the current 1.84x.
- TP of MYR2.90 based on FY16 8x PER, which represents the bottom of the airline cycle as we think earnings will peak in 2016.

Sources: Bloomberg, Maybank KE

AirAsia X (AAX MK): HOLD, TP: MYR0.36

AirAsia X 1-yr forward P/BV

- Post turnaround in 2016, we forecast earnings to soar in 2017.
- Risk-reward not attractive given the unproven business model and it has a very thin capital base.
- We are concerned that the business seems to only do well when jet fuel prices are in middle ground. Otherwise, when fuel is too high and too low, AirAsia X loses its advantage.
- TP of MYR0.36 based on FY17 1x P/BV as the business have yet to achieve a turnaround.

Sources: Bloomberg, Maybank KE

Malaysia Airports (MAHB MK): HOLD, TP: MYR7.10

MAHB 1-yr forward P/BV

- Reiterate HOLD rating. Net loser from MAS capacity cuts.
- Passenger traffic growth forecast of 4-5% in 2016 is uninspiring, well below the pre-2014 traffic growth of 8-10%.
- New CFO has been putting in a big effort to improve transparency and rationalisation of cost.
- Most cost fluctuation has stabilised and the Company is progressively obtaining better productivity.
- Turkish airport is performing much stronger than initial forecasts. Will breakeven in 2016.
- TP of MYR7.10 based on DCF (WACC: 9.6%, terminal growth: 2.0%).

Sources: Bloomberg, Maybank KE
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<td>Return is expected to be above 10% in the next 12 months (excluding dividends)</td>
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<tr>
<td>HOLD</td>
<td>Return is expected to be between -10% to +10% in the next 12 months (excluding dividends)</td>
</tr>
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<td>Return is expected to be below -10% in the next 12 months (excluding dividends)</td>
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