Waiting for the industry rebound patiently

Cathay Pacific (293.HK)

5.2% in revenue of HKD 98.406 billion in 2011, up 9.9% yoy, profit attributable to parent company declining by 60.8% yoy to HKD 5.501 billion (or 50.1% ex one-offs), EPS HKD1.4.

In 2011, the passenger business performed well with passenger income increased by 14.2% to HKD 67.778 billion while the cargo demand income increased by 0.3% yoy to HKD 25.98 billion. The yield of passenger and cargo grew by 8.7% and 3.9% yoy. The overall P/L/F (passenger load factor) and freight load factor (F/L/F) fell by 3 ppts and 8.5 ppts respectively to 80.4% and 67.2%.

The operating expenditure increased by 17.9%. The combined cost per ATK (with fuel) increased from HK$3.16 to HK$3.45. This is mainly due to higher average fuel prices. Ignoring the effect of fuel hedging, the company’s gross fuel costs in 2011 increased by 44.1% yoy. The company’s balance sheet remains stable. In August 2011, the company established a mid-term note programme to provide an additional source of funding and allows CX to issue debt in a range of currencies.

CX carried 7.017 million passengers in the first three months of 2012, up by 9.0% yoy. CX’s passenger traffic grew by 8.8% yoy. P/L/F stood at 78.8%, up 0.2 percentages. Cargo demand was still slack, Q1 cargo and mails carried by the company declined by 10.5%. F/L/F stood at 64.8%, down 4.2 percentages.

We are cautiously optimistic for Asia-Pacific area passenger demand in 2012 but pessimistic for the global air cargo demand recovery in the near term. In valuation, we prudentely adopt 1.08-time P/B level (5% below CX’s average valuation since 2002), in relation to expected BVPS at the end of 2012, and 12-month target price is HKD16.5. Buy rating.

Summary

Cathay Pacific
Rating
1.00 Buy
Target Price (HKD)
15.5
Previous Rating
2.00 Accumulate
Target Price (HKD)
20.6
Expected Capital Gains (%)
26.5%
Expected Dividend Yield (%)
5.2%
Expected Total Return (%)
31.8%
Raw Beta (Past 2yrs w weekly data)
0.87
Market Cap. (HKD bn)
51.297
Enterprise Value (HKD mn)
80.848
52 week range (HKD)
11.8 - 20.15
Closing Price in 52 w week range

Key Financial Summary
FYE
12/10 12/11 12/12F 12/13F
Revenue (RMB mn)
89524 98406 105819 115872
Net Profit, adj. (RMB mn)
14048 5501 4397 6033
EPS, adj. (RMB)
3.57 1.40 1.12 1.53
P/E(X), adj.
3.0 7.6 9.4 6.8
BVPS (RMB)
13.80 14.19 15.30 16.29
P/B (X)
0.8 0.7 0.7 0.6
Div. Yield (%)
10.5% 4.9% 3.8% 5.2%

Source: Bloomberg, PSR est.

*All multiples & yields based on current market price

Valuation Method
PB

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FY2011 net profit hit 5.5 billion, down 61%, EPS HKD1.4
Affected by slowdown of the passenger demand, slack cargo demand and the high fuel price, CX reported its revenue of HKD98.406 billion in 2011, increasing by 9.9% over 2010, profit attributable to parent company declining by 60.8% yoy to HKD 5.501 billion, EPS HKD1.4, down by 60.9%. The management suggests distributing dividends of HKD0.34 per share. In additional to interim dividend of HKD0.18, full year dividend is HKD0.52 per share. CX recorded HKD10.45 billion profits in 2010, including HKD3.333 billion proceeds of selling Hong Kong Air Cargo Terminals and HAECO to major shareholder Tai Koo. Core profits declined by 50.1% in 2011 over 2010. Contribution from associated company Air China accounted for 31.1% of pre-tax profit.

Passenger transport business has ideal performances
The income of the passenger business increased by 14.2% yoy to HKD 67.778 billion, which made up around 70% of total revenue. Available seat kilometres increased by 9.2% yoy, passengers carried amounted to 27.60 million up by 2.9% yoy. P L/F declined by 3 percentages to 80.4%. Passenger yield increased by 8.7% to 0.665, partly attributable to fuel surcharge increase.

Fig 1. Passenger Load Factor of Cathay

Driven by robust business demand in Asia and other short-distance routes, CX’s premium class demand was ideal in 2011 as premium class income increased by 16.5%, P L/F rose by 0.2 percentages to 66.9%. North America and Southeast Asia routes were relatively strong in economy class, but yield of long-distance economy class somewhat declined, mainly due to the Japan earthquake and tsunami in March and Thailand severe floods in October. Economy class income increased by 13.1%, but P L/F declined by 3.7 percentages to 82.7%.

Cargo business plunged
Cargo freight was affected by Euro debt crisis and slack international trade. The air cargo market drastically turned weak from 2011Q2, especially Hong Kong and China’s mainland, the two major markets, experienced sustained slack cargo demand since April. CX’s cargo income grew slightly by 0.3% yoy to 25.98 billion. Thanks to increased fuel surcharge, CX cargo yield rose by 3.9% to HKD2.42, while available ton kilometers increased by 6.9%, which was offset by the drastic decline of 8.5 percentages to 67.2% in F L/F.

The company started new cargo service in 2011 to Bangalore in India, Zaragoza in Spain and Chongqing and Chengdu in West China.

Operating cost up by 17.9%
In 2011 the company operating expenditure increased by 17.9% to HKD93.65 billion, among which the staff cost rose by 6.7%, and landing expense increased by 16%, with aircraft maintenance up by 19.7% to 8.468 billion. The combined cost per ATK (with fuel) increased from HK$3.16 to HK$3.45. This principally reflected higher average fuel prices. High fuel cost constituted major effect on the company’s operating performance as fuel average purchase price rose by 37.7% to $129/bbl and fuel consumption increased by 4.4%. Ignoring the effect of fuel hedging, the company’s gross fuel costs in 2011 increased by 44.1% yoy. The company realized a profit of HKD1.813 billion from fuel hedging activities with unrealized mark-to-market profit of HKD436 million. The company fuel cost stood at 38.877 billion, which accounted for more than 40% of total operating cost.

Fig 2. Total operating expenses

Balance Sheet remains stable
The company borrowings rose by 9.4% to HKD43.335 billion at the end of 2011, with 69% currently at fixed rates after taking into account derivative transaction. Liquid funds declined by 19% to HKD19.597 billion. The net debt/equity ratio increased from 0.28 times to 0.43 times.

The company’s balance sheet remains stable. In August 2011, the company established a mid-term note programme to provide an additional source of funding and allows CX to issue debt in a range of currencies. The first issue of notes of HKD658 million under the programme took place in October 2011 and further notes were issued in January and February 2012.
The company took delivery of 13 new aircrafts in 2011, including 9 passenger planes (6 Boeing 777—300ERs and 3 Airbus A330-300s) and 4 Boeing 747 — 8F freighters. Dragonair received two new Airbus A320-200s. Year-round available seat-km increased by 2.9% and available ton-km rose by 7.9%. So far, there were 96 new aircrafts in total on order, for delivery up to 2019, and during the period the company will arrange retirement of 32 older aircrafts. Due to a cautious outlook in 2012 especially the cargo market, the company cut its guidance for passenger and cargo capacity growth for 2012 to 6% and 7% respectively. A total of 19 new aircrafts will be delivered in 2012, including two operating leased aircrafts. We believe capacity growth slowdown is favorable news as it is positive to the yield.

Q1 2012 traffic: passenger better than cargo
CX carried 7.017 million passengers in the first three months of 2012, up by 9.0% yoy. Driven by the robust demand from China’s mainland and North America routes, CX’s passenger traffic grew by 8.8% yoy. In European routes, the demand took a recovering trend somewhat under capacity cut. P L/F stood at 78.8%, up 0.2 percentages. Cargo demand was still slack, even benefiting from mainland’s electronic product order recovery, while Q1 cargoes and mails carried by the company declined by 10.5% to 378000 tons. F L/F stood at 64.8%, down 4.2 percentages.

Oil price hikes are biggest challenge
As for oil price trend of 2011, prices remained low in early year but climbed rapidly subsequently. 2011Q1 saw relatively low prices and subsequent three quarters encountered higher prices. The international crude oil prices rose by about 20% in 2011. Driven by the Middle East conflicts and sound Q1 data for US economy, the international oil prices rose. We believe due to the staggering recovery of global economy and the Euro debt crisis, the foundation of international oil price hikes is not solid in 2012. We believe overall oil price growth will be less than 2011’s. The company guided that its fuel hedge proportion is between 20-25% this year and pledged to speed up phasing-out of older planes and replace them with models of high fuel efficiency to reduce the company’s overall fuel cost pressure. Recently, the company received approval to raise fuel surcharge. Short-distance flights to rise from HKD248 to HKD253, up 2%; long-distance flights to rise from HKD1132 to HKD1164, up 3%, which are expected to cover part of oil cost increase.

Valuation
Based on IATA prediction, compared with other global areas, Asia-Pacific region strong economy will drive faster growth of air transport demand in 2012, and Asia-Pacific airlines will benefit undoubtedly. Air demand in crisis-stricken areas such as Europe will have to wait for better supply-demand conditions.
In cargo market, we believe the catalyst for an obvious demand increase is not in sight in the near term, and obvious recovery of air cargo transport is not expected soon. In valuation, we refer to CX P/B trend in recent ten years; the reasonable interval of stable growth is between 0.9-1.4 times. Good location and strong competitiveness of CX deserve certain premium. We prudently adopt 1.08-time P/B, in relation to expected BVPS at the end of 2012. This gives us 12-month target price of HKD16.5, 27% and Buy rating.

Risk
Deepening economic recession might lead to drastic decline of aviation demand;
Industrial price war;
Oil price hikes;
Fuel hedge loss;
War, terrorist incidents, epidemic diseases and other emergencies
### Fig 5. Peer Comparison

<table>
<thead>
<tr>
<th>Ticker</th>
<th>BEst P/E</th>
<th>BEst P/E (Y+1)</th>
<th>BEst P/E (Y+2)</th>
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<th>BEst P/B</th>
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<td>LUV</td>
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Source: Bloomberg, Phillip Securities
### Valuation Ratios

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<tr>
<th>Ratios</th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12F</th>
<th>FY13F</th>
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</thead>
<tbody>
<tr>
<td>P/E (X), adj.</td>
<td>8.9</td>
<td>3.0</td>
<td>7.6</td>
<td>9.4</td>
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<tr>
<td>P/B (X)</td>
<td>1.0</td>
<td>0.8</td>
<td>0.7</td>
<td>0.7</td>
<td>0.6</td>
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<tr>
<td>Dividend Yield (%)</td>
<td>0.9%</td>
<td>10.5%</td>
<td>4.9%</td>
<td>3.8%</td>
<td>5.2%</td>
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### Per share data (RMB)

<table>
<thead>
<tr>
<th>Data</th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12F</th>
<th>FY13F</th>
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</thead>
<tbody>
<tr>
<td>EPS, reported</td>
<td>1.19</td>
<td>3.57</td>
<td>1.40</td>
<td>1.12</td>
<td>1.53</td>
</tr>
<tr>
<td>EPS, adj.</td>
<td>1.19</td>
<td>3.57</td>
<td>1.40</td>
<td>1.12</td>
<td>1.53</td>
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<td>DPS</td>
<td>0.10</td>
<td>1.11</td>
<td>0.52</td>
<td>0.40</td>
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<tr>
<td>BVPS</td>
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<td>13.80</td>
<td>14.18</td>
<td>15.30</td>
<td>16.29</td>
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### Growth & Margins (%)

<table>
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<tr>
<th>Growth</th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12F</th>
<th>FY13F</th>
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</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>3.6%</td>
<td>33.7%</td>
<td>9.9%</td>
<td>7.5%</td>
<td>9.5%</td>
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<tr>
<td>EBIT</td>
<td>NA</td>
<td>187.8%</td>
<td>-47.1%</td>
<td>-17.9%</td>
<td>33.9%</td>
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<tr>
<td>Net Income, adj.</td>
<td>NA</td>
<td>199.3%</td>
<td>-60.8%</td>
<td>-20.1%</td>
<td>37.2%</td>
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<table>
<thead>
<tr>
<th>Margins</th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12F</th>
<th>FY13F</th>
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<tbody>
<tr>
<td>EBIT margin</td>
<td>7.1%</td>
<td>15.2%</td>
<td>7.3%</td>
<td>5.6%</td>
<td>6.9%</td>
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<tr>
<td>Net Profit Margin</td>
<td>7.0%</td>
<td>15.7%</td>
<td>5.6%</td>
<td>4.2%</td>
<td>5.2%</td>
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### Key Ratios

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<tr>
<th>ROE (%)</th>
<th>FY09</th>
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<th>FY11</th>
<th>FY12F</th>
<th>FY13F</th>
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<tbody>
<tr>
<td></td>
<td>11.89%</td>
<td>29.11%</td>
<td>9.99%</td>
<td>7.58%</td>
<td>9.72%</td>
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<table>
<thead>
<tr>
<th>ROA (%)</th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12F</th>
<th>FY13F</th>
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<tr>
<td></td>
<td>6.9%</td>
<td>15.8%</td>
<td>6.3%</td>
<td>3.6%</td>
<td>4.3%</td>
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### Income Statement (RMB mn)

<table>
<thead>
<tr>
<th>Revenue</th>
<th>66,978</th>
<th>89,524</th>
<th>98,406</th>
<th>105,819</th>
<th>115,872</th>
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<tbody>
<tr>
<td>Operating expenses</td>
<td>(62,499)</td>
<td>(78,471)</td>
<td>(92,906)</td>
<td>(101,123)</td>
<td>(109,520)</td>
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<tr>
<td>- Jet fuel cost</td>
<td>(17,349)</td>
<td>(28,276)</td>
<td>(38,877)</td>
<td>(44,501)</td>
<td>(50,223)</td>
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<tr>
<td>Profit from operations</td>
<td>4,479</td>
<td>11,053</td>
<td>5,500</td>
<td>4,696</td>
<td>6,452</td>
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<tr>
<td>Financial costs</td>
<td>(847)</td>
<td>(978)</td>
<td>(744)</td>
<td>(975)</td>
<td>(1,338)</td>
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<tr>
<td>Share of profits and losses of associates</td>
<td>261</td>
<td>2,587</td>
<td>1,717</td>
<td>1,231</td>
<td>1,486</td>
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<tr>
<td>Profit before tax</td>
<td>5,147</td>
<td>15,693</td>
<td>6,473</td>
<td>4,952</td>
<td>7,031</td>
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<tr>
<td>Tax</td>
<td>(283)</td>
<td>(1,462)</td>
<td>(803)</td>
<td>(461)</td>
<td>(844)</td>
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<tr>
<td>Profit for the period</td>
<td>4,864</td>
<td>14,233</td>
<td>5,670</td>
<td>4,491</td>
<td>6,187</td>
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<tr>
<td>Minority interests</td>
<td>(170)</td>
<td>(185)</td>
<td>(169)</td>
<td>(94)</td>
<td>(155)</td>
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<tr>
<td>Net profit</td>
<td>4,694</td>
<td>14,048</td>
<td>5,501</td>
<td>4,397</td>
<td>6,033</td>
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Source: PSR

### Balance Sheet (HKD mn)

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<th>FYE DEC</th>
<th>FY09</th>
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<th>FY11</th>
<th>FY12F</th>
<th>FY13F</th>
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<td>Total Current Assets</td>
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<td>37,197</td>
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<td>32,636</td>
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<td>Total Long-Term Assets</td>
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<td>96,711</td>
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<td>124,975</td>
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<td>133,908</td>
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<td>Total Current Liabilities</td>
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<td>39,185</td>
<td>43,819</td>
<td>44,095</td>
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<td>Total Long-Term Liabilities</td>
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<td>40,294</td>
<td>43,048</td>
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<td>Total Liabilities</td>
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<td>79,479</td>
<td>86,867</td>
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<td>Total Shareholders’ Equity</td>
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<td>55,944</td>
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<td>Shares Outstanding</td>
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</table>

Source: PSR
Cathay Pacific (293.HK)
Hong Kong Equities Research
25 April 2012

Ratings History

<table>
<thead>
<tr>
<th>PSR Rating System</th>
<th>Recommendation</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Returns</td>
<td></td>
<td></td>
</tr>
<tr>
<td>&gt;+20%</td>
<td>Buy</td>
<td>1</td>
</tr>
<tr>
<td>+5% to +20%</td>
<td>Accumulate</td>
<td>2</td>
</tr>
<tr>
<td>-5% to +5%</td>
<td>Neutral</td>
<td>3</td>
</tr>
<tr>
<td>-5% to -20%</td>
<td>Reduce</td>
<td>4</td>
</tr>
<tr>
<td>&lt;-20%</td>
<td>Sell</td>
<td>5</td>
</tr>
</tbody>
</table>

Remarks
We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation.
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