

Air sector Supply and demand gap will narrow

Phillip Securities Research
China
4 Jan. 2012

Neutral

I. 2011 Review

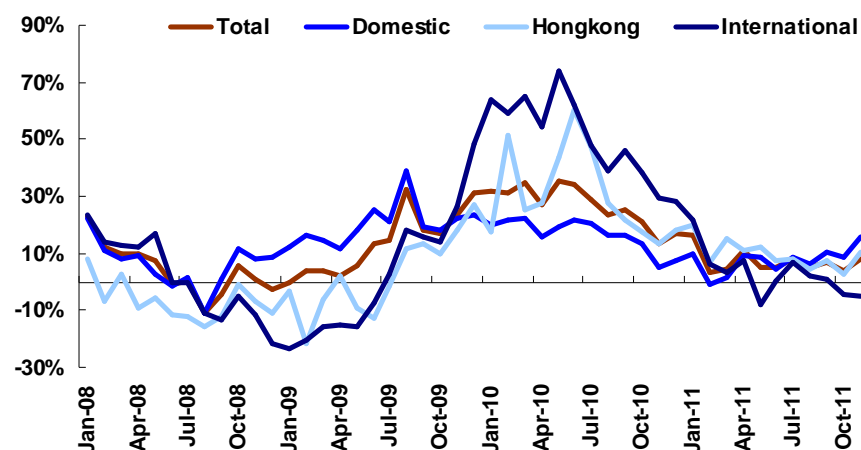
1) The growth ratio flattens out gradually after a steep rise

In 2011, the global economy was on the recession stage with regional conflicts and Japan Earthquake, which matched with the sluggish demand on the international air market. During the first three quarters of 2011 the global aviation passenger load factor decreased by 0.8 ppts yoy, and the hit-hard global air cargo market by the European debt crisis and worsening global trade market saw a 5% drop in air cargo volumes for the third quarter of 2011 over the first quarter.

As we expected before, China still remains the strongest aviation of the world. After a prosperous 2010, the boom of China's aviation industry continued in 2011, but growth ratio narrowed infected by the economic slow-down, high basement from 2010 Shanghai Expo and Japan Earthquake. Segment differed much more significantly and the growth ratio flattened out after 2010's steep rise.

The RTK of China in the first eleven months of 2011 grew by 6.7%, 9.7%, 1.2% and 9.0% (Vs 2010's 26.4%, 16.6%, 49.4% and 30.4%) for total, domestic routes, international routes and regional routes respectively to 52.6, 34.8, 17.8 and 1.15 billion ton-km.

Figure 1 Monthly growth of RTK by routes



Data source: CEIC, Phillip Securities

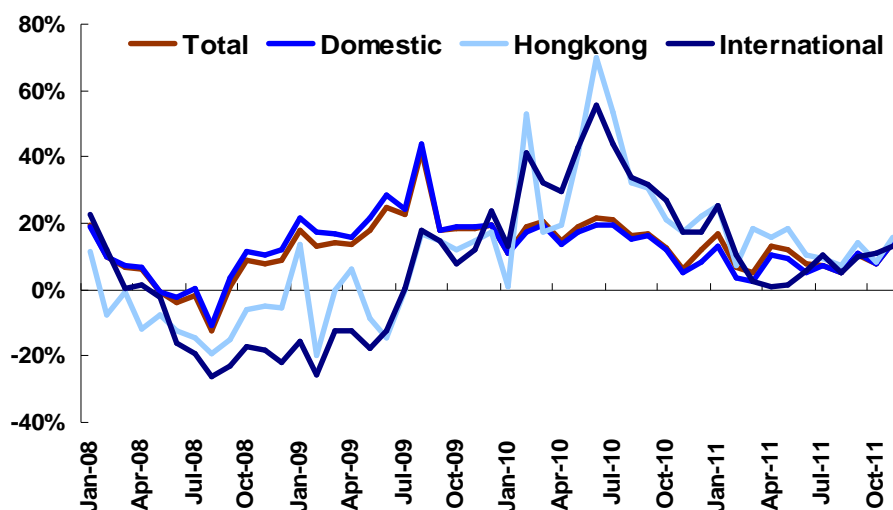
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MICA (P) 004/01/2011
Ref No: HK2012_0001

2) Passenger business: strong domestic routes and chilly international routes

The number of passengers carried grew by 9.1%, 9.2%, 8.7% and 12.7% for total, domestic routes, international routes and regional routes respectively to 269.19, 249.93, 19.26 and 6.9 million in the first 11 months of 2011.

Figure 2 Monthly growth of number of passengers



Data source: CEIC, Phillip Securities

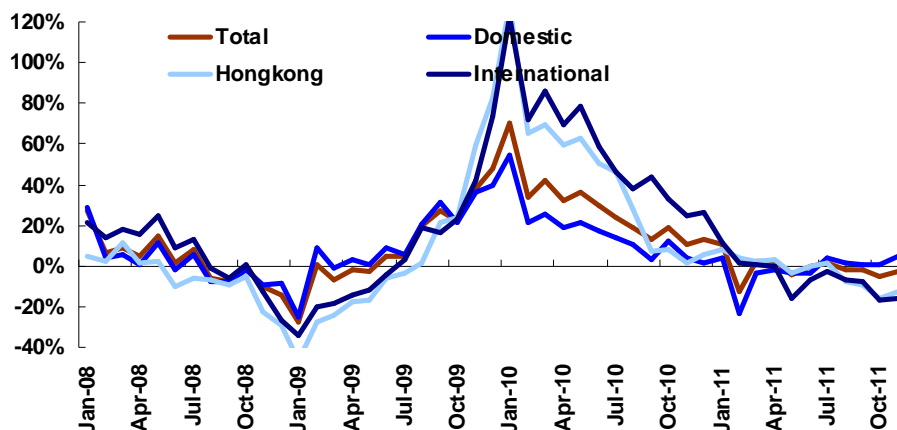
Despite the high basement last year, the boom of China's domestic air passenger market continued in 2011 due to the relatively more stable economy and the upgrading of consumption structure. During the first 11 months, the domestic air passenger traffic volume increased by 9% yoy, compared to 2010's 15.1%, 2009's 22% and 2008's 5%.

For the international market, air passenger demand slow down apparently from the 2010's blow out due to the high base and the European debt crisis. On the other hand, China's big three carriers increase aircraft supply on the international market remarkably, further adding to the embarrassing oversupply.

3) Cargo business: still weak

The cargo tonnes carried grew by -1.7%, 1.3%, -7.4% and -3.0% for total, domestic routes, international routes and regional routes respectively to 5.03, 3.40, 1.62 and 0.191 million ton in the first 11 months of 2011.

The decline of international air cargo market is greater than that of air passenger market as the former had highest ability in predicting global economy. Due to the deteriorating global economy and international trade, the international air cargo demand suffered heavy losses and returned to the freezing point from 2010H's strong rebound. As the ratio of international air cargo in China cargo business has exceeded 70%, the cargo volumes fell by 1.7% yoy in the first 11 months of 2011.

Figure 3 Monthly growth of total cargo tonnes

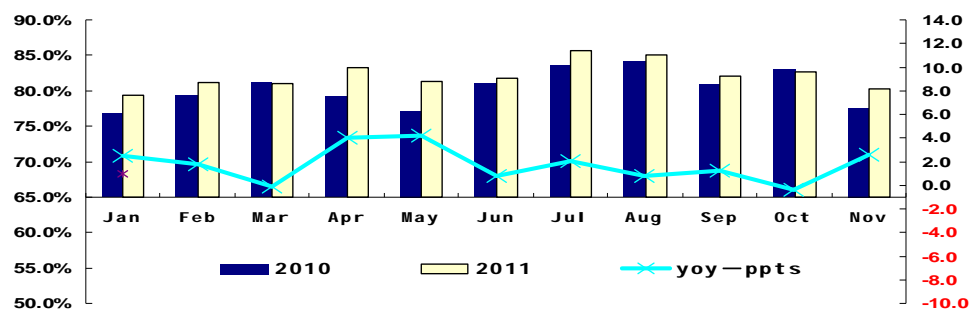
Data source: CEIC, Phillip Securities

4) Passenger Load Factor hit record high because of the short-supply

Since the “8.24 air crash” in 2010, the civil aviation authority of China slowed down the aircrafts delivery to enhance margin of safety. In the first three quarters of 2011, the civil aviation aircrafts increased only 7.1% yoy, lower than the market expected.

At the same time, in response to high-speed railway competition, growth ratio for the introduction of aircrafts also slowed. In the first 11 months of 2011, industry growth rate of total ASK only reached 9.4%, less than the 11.8% of passenger turnover.

In the first eleven months of 2011, China civil aviation passenger load factor (P L/F) climbed 1.9 pts from the same period last year to 82.2% and 0.9 pts from 2011H. On a closer look, the domestic market grew and the international market fell because of the different supply strategy.

Figure 4 PRC Aviation Monthly Passenger Load Factor (%)

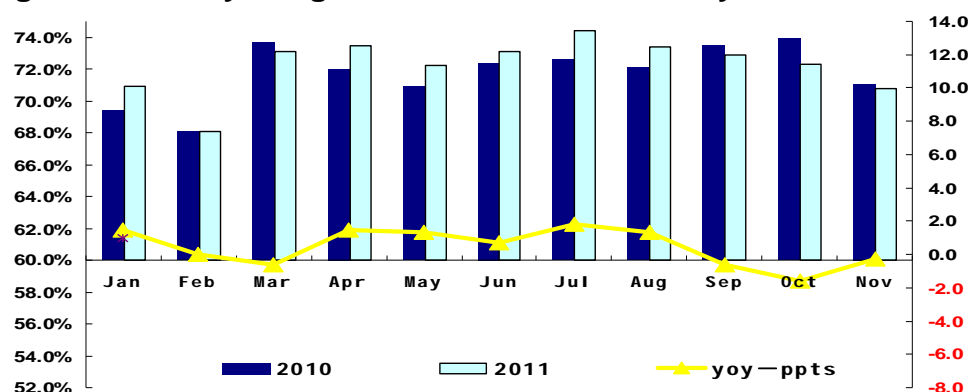
Data source: CEIC, Phillip Securities

Figure 5 The Three Big Carriers' Passenger Load Factor by routes

	Domestic Passenger Load Factor							International Passenger Load Factor						
	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11
AC	77.0%	78.9%	83.1%	81.8%	81.4%	83.6%	86.3%	82.3%	81.1%	83.5%	76.0%	76.6%	81.3%	83.5%
CEA	76.0%	78.3%	83.2%	78.5%	79.1%	80.8%	82.8%	71.9%	73.0%	79.4%	72.5%	73.1%	75.0%	79.0%
CSA	79.0%	77.9%	82.1%	81.0%	81.6%	83.0%	84.7%	73.6%	75.4%	77.8%	72.5%	72.7%	73.9%	77.2%

Data source: Phillip Securities

The freight load factor (F L/F) improved 0.8 pts yoy to 72.3%. Aircraft daily utilization reached average 9.3 hours, 0.1 hour lower than same period last year.

Figure 6 Monthly Freight L/F of China air industry

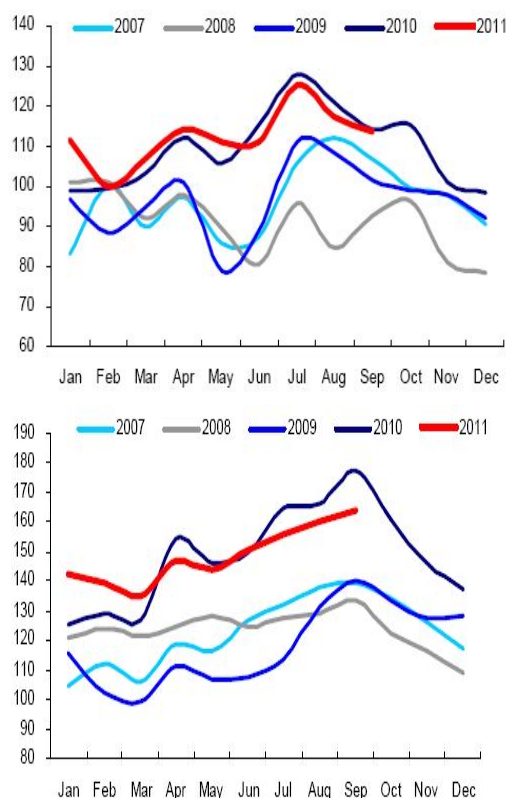
Data source: CEIC, Phillip Securities

5) Integrated fare remain high but with a less improvement

Since 2010, ticket prices remained the clear upward trend. During 2011, the high ticket prices continued thanks to the short-supply especially the domestic market.

While the growth ratio of ticket prices showed unilateral downward trend. The domestic ticket price grew 5.43%, 0.69% and -1.93% QoQ in the three quarters of 2011 and the international grew 9.52%, -1.93% and -5.49% QoQ.

Figure 7-8 China Domestic (left) and International (right) Aviation Fare index



Data source: CEIC, Phillip Securities

6) More expansive fuel cost and high exchange gains

Rising international crude oil price shocks this year, and the airline's fuel costs proportion has rose by more than 30% yoy, accounting for around 40% of operating costs. China released in Nov.2009 a linkage mechanism between fuel surcharges on domestic routes and international oil price, which help to offset part of cost if the oil prices surge.

The range of appreciation of RMB/USD reached 5.1% during 2011, already exceeding last year's level. According to the three quarterly financial reports, despite the high base, the profit of China aviation industry during the first three quarters is still high excluded the exchange gains, non-operating net income, changes in fair value and assets impairment.

On specific airliners, the company with a higher proportion of international line suffered much more. Among the three big carriers, Air China with the highest proportion of international line market received the worst semi-annual earnings and China Southern Airlines which enjoyed the highest share of the domestic air passenger share saw relatively stable earnings.

II、 2012 outlook: Supply and demand gap will narrow

1). Supply and demand gap will narrow

We expect China's civil aviation industry will enter a period of adjustment from 2012 given the current uncertain economic forecast

and the high base effect due to the rapid development of the last two years. Thanks to the business, visiting and tourism demand, domestic air passenger demand will keep steady growth, while there's a still downside risk for the international routes due to a substantial expansion of capacity and the slow recovery of global economy. Overall passenger traffic in 2012 is expected to increase by 11% yoy.

For the supply, according to the airlines' 2012 schemes, Air China plans a net increase of 31 aircrafts or an increase of 8% yoy, China Southern Airlines plans to introduce 45 net or an increase of 11%, and China Eastern Airlines is expected a net increase of 39, or 10%. The aircraft industry as a whole is expected to increase the fleet by 11.1% yoy, higher than 2011. What's more, taking into account long-range wide-body models have introduced (about 30), the high passenger load factor, aircraft utilization, and fare levels in 2012 are expected to be dampened.

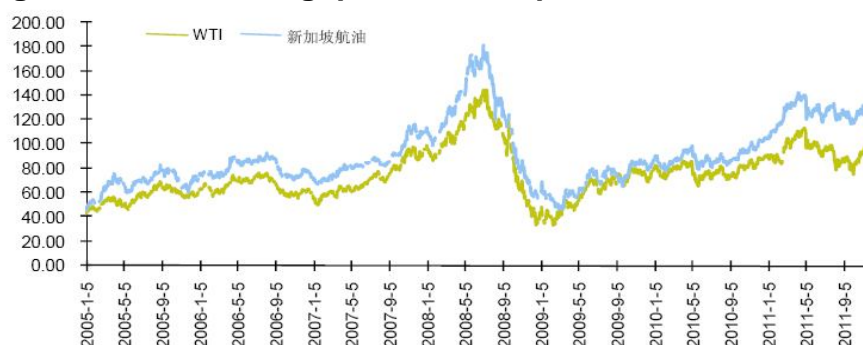
So the supply (ASK) and demand(RPK) of 2012 are expected to be 11%, the gap will narrowed to a balance.

2) Gradually increased operating cost

In 2012, the aviation industry will continue to be challenged by the slow economic growth, lower aircraft utilization, as well as stagnations of RMB appreciation and rising fuel costs, the airline's profitability will be squeezed when things are at their worst.

Oil prices will remain the most uncertainty for airlines as the current price jumped over USD100/barrel. We believe that the airlines could face higher oil prices for long-term. China released in Nov.2009 a linkage mechanism between fuel surcharges on domestic routes and international oil price, which help to offset 80% of cost if the oil prices surge while the airlines still need to carry the remaining 20%.

Figure 9 WTI and Singapore Jet fuel price



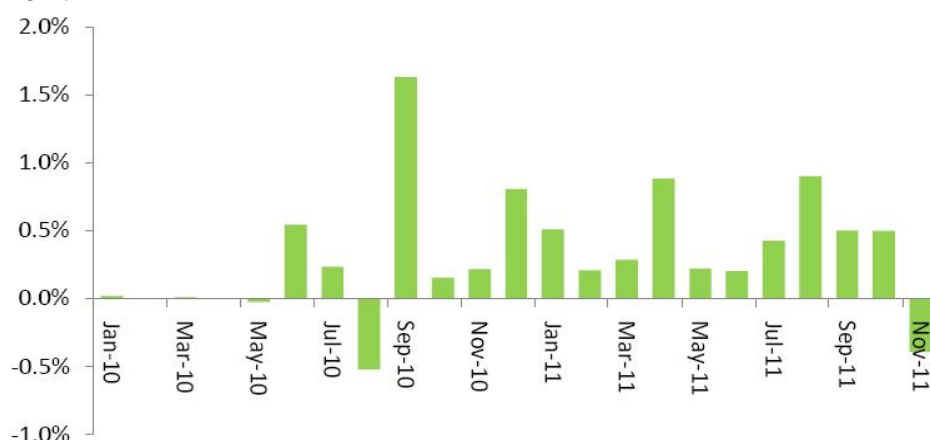
Data source: Bloomberg, Phillip Securities

Figure 10 Impact of fuel RMB 100/ton rise on aviation companies

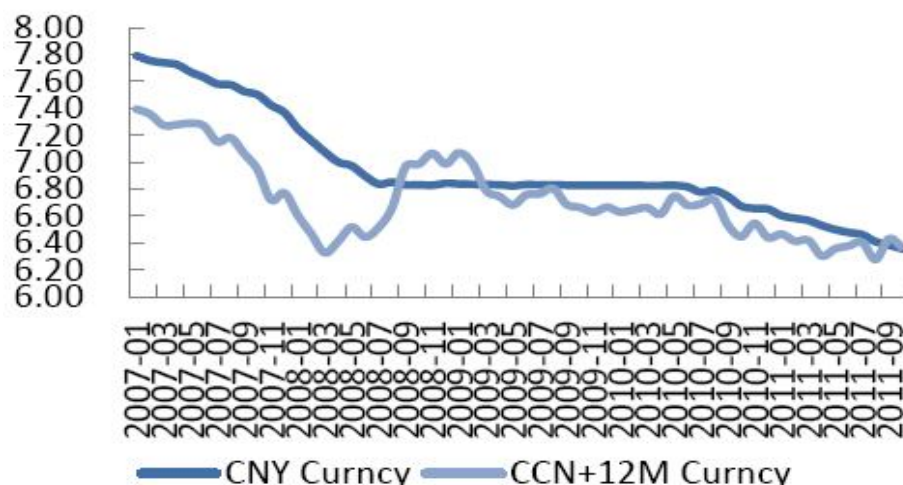
	EPS impact (Rmb)
Air China	0.01
China Southern Airlines	0.03
(New)China Eastern Airlines	0.02

Data source: Phillip Securities

RMB appreciation mainly influences aviation companies' profitability on two aspects, both positively: Firstly, procurement costs on airplane and aviation equipments from European counties and USA will be reduced; secondly, exchange gains generated by US dollar liability. In the forward foreign exchange market, the expectation of unilateral appreciation of the RMB has changed to devaluation. If the appreciation of the RMB changed in the future, sharp fluctuations in foreign exchange gains will reoccur. According to our estimates, every 1% appreciation of RMB, will increase Air China, China Southern Airlines, China Eastern Airlines' EPS by 0.034, 0.04, 0.025 yuan.

Figure 11 the percent of RMB appreciation against the USD per month

Data source: Reuters, Phillip Securities

Figure 12 RMB currency trend

Data source: Bloomberg, Phillip Securities

3. China's civil aviation industry is still in a good developing period in the long term

We are still optimistic about China's aviation demand for long-term, because of China's low level of average flight frequency per year and aviation consumer affordability. In addition, the supply limitation from the industry control and resource bottleneck will exist in the long and medium term.

We believe that the stable develop of economic and consumption upgrades caused by the increase of national income are the main force causing air demand. We expected that China's civil aviation industry will continue to maintain double-digit growth as the increase of residential disposable income in the future.

After the financial crisis, China's aviation industry once suffered a lot. The Chinese government implements a series of stimulus bailout to support the industry, for example, cut and delay the order of aircraft to avoid oversupply (China's civil aviation industry introduced less aircrafts in 2010 and 2011 than the original schedule), release preferential tax and lift the industry barrier. In addition, the slowing down the construction of high-speed rail helped to weaken the diversion effects further.

III Sector Neutral rating

1. 2012 sector rating

Under the expectation of narrowed gap between supply and demand and increased operating costs, there is little probability for aviation sector to outperform the market in the first half of next year. But chance may emerge if the world economy improved, or the floating exchange earnings base disappeared from the second half of next year to 2013.

We believe that the China's aviation industry will reach to a balance in 2012 after a low 2008, a recovered 2009, a prosperous 2010 and a steady 2011 and the growth ratio will keep shrink. We estimate that

passenger traffic in 2012 industry will fall to the 11% growth ratio. The rising fuel price and high-speed rail diversion are the main risk of the airliners, thus giving the "neutral" rating.

2. Recommendation

In the investment order of the air stock selection, we recommend China Southern Airlines first, and then Air China, paying close attention to the China Eastern Southern Airlines.

With a huge domestic route net, the prosperous domestic aviation market is real good to China Southern Airlines for long term.

As a leading company with a strong control of the market, Air China is the first to benefit from the rebound in international aviation demand. It remains our first choice. After merger of Shenzhen Airlines, its network layout becomes more optimized.

Synergistic effect becomes increasingly clear after China Eastern Airline's merger of Shanghai Airlines. If successfully introduce a strategic investor, China Eastern Airline's development would be further widened.

Figure 13 Peer Comparison

TICKER	P/E	EV/EBITDA								P/B			
		10A	11E	12E	13E	10A	11E	12E	13E	10A	11E	12E	13E
293 HK	3.9	8.5	8.6	7.4	5.0	6.1	5.8	5.2	1.0	1.0	0.9	0.8	
SIA SP	12.0	23.8	17.0	11.9	3.0	4.0	3.5	3.0	1.0	1.0	1.0	0.9	
9202 JP	25.1	27.3	n.a.	15.9	6.8	6.2	5.5	5.2	1.1	1.1	1.1	1.0	
003490 KS	6.3	9.5	7.7	4.4	7.1	7.9	6.6	5.9	0.8	1.0	0.8	0.7	
2610 TT	6.1	157.3	14.2	14.7	6.9	15.3	11.2	9.5	1.3	1.2	1.2	1.1	
2618 TT	5.4	18.8	12.3	10.0	5.1	9.5	7.4	6.4	1.6	1.6	1.5	1.4	
QAN AU	14.4	9.8	6.8	5.4	3.1	3.1	2.6	2.3	0.6	0.6	0.5	0.5	
THAI TB	2.2	22.9	8.2	5.9	5.1	6.0	4.9	4.5	0.6	0.5	0.5	0.5	
MAS MK	19.3	n.m.	463.3	11.0	16.1	n.m.	6.8	4.3	1.7	1.6	1.6	1.4	
	10.5	34.7	67.3	9.6	6.5	7.3	6.0	5.1	1.1	1.1	1.0	0.9	
	6.3	20.7	10.4	10.0	5.1	6.1	5.8	5.2	1.0	1.0	1.0	0.9	
IAG LN	9.3	10.5	5.9	n.a.	5.4	4.0	4.0	3.3	0.8	0.6	0.5	0.5	
LHA GR	3.8	12.6	16.4	8.0	2.2	2.5	2.5	2.1	0.5	0.5	0.5	0.5	
AF FP	2.3	n.m.	12.0	5.1	4.7	4.4	3.6	3.1	0.2	0.2	0.2	0.2	
	5.2	11.6	11.4	6.5	4.1	3.6	3.4	2.9	0.5	0.4	0.4	0.4	
	4.5	11.6	11.7	6.5	4.4	3.8	3.5	3.0	0.5	0.5	0.5	0.5	
753 HK	6.0	6.6	7.1	6.4	8.3	8.0	7.4	6.0	1.7	1.4	1.1	1.0	
1055 HK	5.8	4.7	5.1	4.7	7.4	6.9	6.6	5.7	1.3	1.0	0.8	0.7	
670 HK	5.7	4.3	4.7	4.1	7.4	6.7	6.2	5.0	1.9	1.3	1.0	0.8	
	5.9	5.2	5.6	5.1	7.7	7.2	6.7	5.6	1.6	1.2	1.0	0.8	
	5.8	4.7	5.1	4.7	7.4	6.9	6.6	5.7	1.7	1.3	1.0	0.8	
801111 CH	8.4	9.8	10.9	9.9	9.6	8.3	7.6	6.4	2.5	2.0	1.7	1.5	
800029 CH	10.5	8.9	10.1	9.3	8.3	7.6	7.7	6.2	2.3	1.8	1.5	1.3	
800115 CH	9.9	8.5	9.6	8.4	9.3	8.0	7.5	6.1	3.4	2.4	1.9	1.6	
800221 CH	8.2	8.8	8.5	7.2	7.0	6.4	5.6	5.0	2.0	1.6	1.2	1.0	
	9.3	9.0	9.8	8.7	8.6	7.6	7.1	5.9	2.5	2.0	1.6	1.3	
	9.1	8.9	9.9	8.8	8.8	7.8	7.6	6.2	2.4	1.9	1.6	1.4	

Data source: CICC, Phillip Securities

Figure 14 the Three Big carriers' main market map

Data source: CAAC, Phillip Securities

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