

SECTOR UPDATE

Aviation – China

Airlines: Expecting A Turnaround In 3Q24; Overcapacity A Medium-term Risk

The three major airlines were still loss-making in 1H24, with CSA's net profit standing at the lower end of its guided loss range, while Air China and CEA were near the mid-point. The three airlines should make a turnaround in the seasonally strong 3Q24, helped by the recent fuel price weaknesses. However, overcapacity remains a medium-term challenge and is not helpful for the airlines' balance sheet repayments. Maintain UNDERWEIGHT. Top pick: CSA.

1H24 FINANCIAL AND OPERATING HIGHLIGHTS

	1H24	1H23	yoy	1H19	1H24 vs 1H19	UOBKH's 2024F proj.	1H24 vs 2024F
Air China							
Revenue (Rmbm)	82,771	63,683	+30%	67,245	+23%	176,877	47%
Net profit (Rmbm)	-2,779	-3,447	n.a.	3,144	n.a.	4,874	n.a.
ASK (m)	171,791	128,800	+33%	163,600	+5%	349,066	49%
RPK (m)	136,214	90,835	+50%	133,158	+2%	281,850	48%
Pax load factor	79.3%	70.5%	+8.8ppt	81.4%	-2.1ppt	80.7%	-1.5ppt
Pax yield (Rmb/RSK)	0.54	0.61	-12%	0.52	+3%	0.56	96%
Non-fuel cost (Rmb/ATK)	2.62	2.88	-9%	2.34	+12%	2.60	101%
Fuel cost (Rmb/ATK)	1.26	1.23	+2%	0.96	+31%	1.19	105%
CSA							
Revenue	84,790	71,830	+18%	72,939	+16%	190,256	45%
Net profit	-1,054	-2,877	n.a.	1,682	n.a.	3,954	n.a.
ASK (m)	175,321	144,031	+22%	166,037	+6%	371,224	47%
RPK (m)	145,637	109,128	+33%	137,231	+6%	307,972	47%
Pax load factor	83.1%	75.8%	+7.3ppt	82.7%	+0.4ppt	83.0%	+0.1ppt
Pax yield (Rmb/RSK)	0.49	0.56	-12%	0.48	+3%	0.54	92%
Non-fuel cost (Rmb/ATK)	2.29	2.41	-5%	2.20	+4%	2.32	99%
Fuel cost (Rmb/ATK)	1.13	1.11	+1%	0.92	+23%	1.13	100%
CEA							
Revenue	64,199	49,425	+30%	58,859	+9%	148,044	43%
Net profit	-2,768	-6,249	n.a.	1,941	n.a.	3,352	n.a.
ASK (m)	144,252	108,605	+33%	131,567	+10%	298,201	48%
RPK (m)	117,143	77,935	+50%	108,854	+8%	243,710	48%
Pax load factor	81.2%	71.8%	+9.4ppt	82.7%	-1.5ppt	81.7%	-0.5ppt
Pax yield (Rmb/RSK)	0.53	0.60	-13%	0.51	+3%	0.58	91%
Non-fuel cost (Rmb/ATK)	2.48	2.88	-14%	2.49	-0%	2.48	100%
Fuel cost (Rmb/ATK)	1.31	1.35	-3%	1.02	+28%	1.32	100%

Source: Respective companies, UOB Kay Hian

RESULTS

• 1H24 results in line with guidance, three major airlines still loss-making at the bottom line. Air China, China Southern Airlines (CSA) and China Eastern Airlines (CEA) recorded net losses of Rmb2.78b, Rmb1.05b and Rmb2.77b respectively in 1H24. CSA's net loss stood at the lower end of its guided loss range, while Air China and CEA were near the mid-points of their respective guided ranges. Air China's revenue rose 30% yoy to Rmb67.2b, forming 47% of our full-year projection; CSA's revenue rose 18% yoy to Rmb72.9b, at 45% of our full-year projection; CEA's revenue rose 30% yoy to Rmb58.9b, at 43% of our full-year projection. 1H24 revenues of Air China, CSA and CEA were 23%, 16% and 9% higher than their respective 1H19 revenues (pre-pandemic levels).

PEER COMPARISON

Company	Ticker	Rec	Price @ 3 Sep 24 (HK\$)	Target Price (HK\$)	Upside To TP (%)	Market Cap (US\$m)	PE*			EV/EBIT			P/B	Yield 24-26F (%)	Net Gearing End-1H24 (%)
							23 (x)	24F (x)	25F (x)	23 (x)	24F (x)	25F (x)			
Air China	753 HK	HOLD	3.27	3.50	7.2	6,957	n.a.	259.9	12.9	31.4	27.7	14.0	1.1	0.0	392
China Southern Airlines	1055 HK	BUY	2.71	3.00	10.7	6,296	n.a.	36.6	12.5	n.a.	15.9	12.5	1.2	0.0	207
China Eastern Airlines	670 HK	HOLD	1.98	1.80	(9.0)	5,659	n.a.	na	15.2	n.a.	42.2	15.8	1.9	0.0	671
Average							n.a.	148.2	13.5	31.4	28.6	14.1	1.4	0.0	424

*PE estimates were adjusted for potential dilutions from new equity raisings
Source: Bloomberg, UOB Kay Hian

UNDERWEIGHT
(Maintained)

SECTOR PICKS

Company	Ticker	Rec	Share Price (HK\$)	Target Price (HK\$)
Air China	753 HK	HOLD (D/G)	3.27	3.50
China Southern Airlines	1055 HK	BUY (U/G)	2.71	3.00
China Eastern Airlines	670 HK	HOLD	1.98	1.80

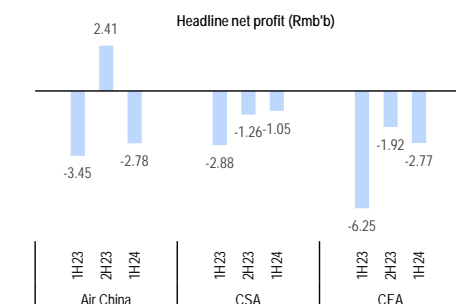
Source: Bloomberg, UOB Kay Hian

THREE AIRLINES' ACTUAL RESULTS VS GUIDED RANGES BASED ON PRELIMINARY ESTIMATES

Rmb'b	1H24					
	Air China		CSA		CEA	
Preliminary earnings guidance	-2.3	-3.0	-1.06	-1.58	-2.4	-2.9
Actual earnings	-2.78		-1.05		-2.77	

Source: Respective companies

THREE AIRLINES STILL LOSS-MAKING IN 1H24, THOUGH THEIR LOSSES NARROWED YOY



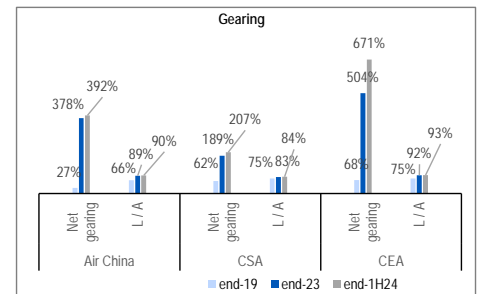
Source: Respective companies, UOB Kay Hian

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- Overall pax factor below pre-pandemic levels, despite sub-optimal aircraft utilisation.** CSA's pax load factor stood at 83.1% in 1H24, 0.4ppt higher than in 1H19 (pre-pandemic levels), but Air China's and CEA's pax load factors of 79.3% and 81.2% were below 1H19 levels by 1.7ppt and 1.5ppt, respectively. On a collective basis, the three airlines' 1H24 load factor was 81.2%, 1ppt below pre-pandemic levels, even though sector-wide average daily aircraft utilisation was 8.75 hours, 6% lower than 1H19's 9.30 hours. This is a reflection of the airline sector's oversupply situation.
- Overall pax yields missed our projections.** 1H24 pax yields of the three airlines were 4-9% below our projected full-year average levels. The miss was likely attributable to the sector's capacity oversupply situation, as airlines cut prices to compete for pax traffic.
- Lofty gearings.** As they remained in still loss-making positions, net gearings of the three airlines rose further in 1H24, standing at 392%, 207% and 571% for Air China, CSA and CEA, respectively, as at end-1H24 (end-23: 378%, 189% and 504%). CSA's net gearing was lower than the other two, mainly because it raised the most equity during the pandemic. Before the pandemic, net gearings of the three airlines ranged between 27-68%.

LOFTY GEARINGS OF THE THREE AIRLINES

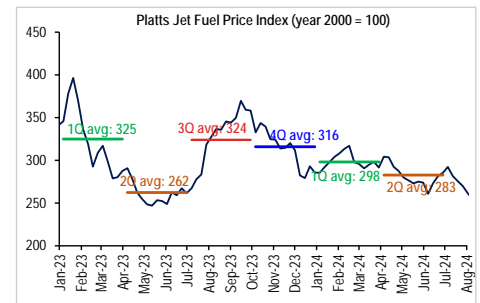


* The net gearing estimates here have excluded lease liabilities, which, if included, would make the three airlines' net gearing even higher. Source: Respective companies, UOB Kay Hian

STOCK IMPACT

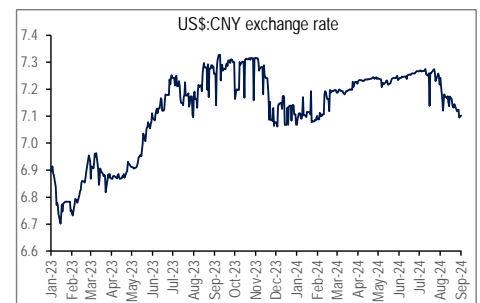
- Expect a turnaround in the seasonally strong 3Q24.** We expect all three airlines to make a turnaround into profitability in the seasonally strong 3Q24, driven by strong demand (July and August are the school holiday season which will see plenty of students travelling) and the airlines' high operating leverage. According to airline sector data platform Umetrip, the Chinese airline sector transported a total of 140m travellers during the summer peak period, or 2.28m per day; this represented a 12% yoy growth and a 18% growth vs the same period in 2019. We note that the remarkable air traffic growth during the summer peak was achieved at the sacrifice of airfare levels, which is likely to have seen a double-digit decline based on various news media. All in all, we still expect the three airlines to report yoy increases in revenue and earnings in 3Q24.
- Favourable jet fuel prices and forex impact for 3Q24.** The three airlines' 3Q24 earnings should be also helped by: a) weaknesses in jet fuel prices, which have dropped by about 11% since end-Jun 24, and b) the recent appreciation of the renminbi against the US dollar, which would lead the three airlines to each recognise several hundreds of millions of forex translation gains in renminbi terms (one-off nature). Among the three airlines, we expect CSA to record the strongest 3Q24 performance, given its overall strongest fundamentals (lowest gearing among the three) and its healthy Jul 24 operating data.

JET FUEL PRICE DROPPED 11% SINCE END-JUN 24



Source: S&P Global

RENMINBI STRENGTHENED 2.3% AGAINST US DOLLAR SINCE END-JUN 24



Source: Bloomberg

JUL 24 PAX OPERATION DATA OF THE THREE MAJOR CHINESE AIRLINES

	Overall			Domestic			International & Regional		
	Air China	CSA	CEA	Air China	CSA	CEA	Air China	CSA	CEA
Pax capacity (m seat-km)	33,238	34,263	27,675	23,628	25,909	18,770	9,610	8,353	8,906
mom change	+15.7%	+17.5%	+15.9%	+18.5%	+18.0%	+16.1%	+9.2%	+15.9%	+15.4%
as % of pre-pandemic	114%	110%	116%	130%	122%	123%	88%	84%	103%
% recovery mom change	+8.3ppt	+3.6ppt	+7.3ppt	+9.0ppt	+3.7ppt	+6.9ppt	+4.7ppt	+2.9ppt	+7.7ppt
Pax load (m pax-km)	26,653	28,702	23,019	19,171	21,713	15,922	7,482	6,989	7,097
mom change	+16.0%	+18.0%	+15.5%	+17.6%	+18.1%	+16.4%	+12.0%	+17.9%	+13.7%
as % of pre-pandemic	112%	111%	117%	127%	123%	126%	87%	84%	102%
recovery % mom change	+7.7ppt	+3.9ppt	+8.2ppt	+6.4ppt	+4.1ppt	+7.9ppt	+6.8ppt	+3.4ppt	+8.1ppt
Pax load factors	80.2%	83.8%	83.2%	81.1%	83.8%	84.8%	77.9%	83.7%	79.7%
mom change	+0.2ppt	+0.4ppt	-0.3ppt	-0.7ppt	+0.1ppt	+0.2ppt	+1.9ppt	+1.5ppt	-1.2ppt
diff. vs pre-pandemic	-1.4ppt	+0.7ppt	+1.2ppt	-2.4ppt	+0.8ppt	+2.1ppt	-0.6ppt	+0.3ppt	-0.8ppt

Source: Respective companies, UOB Kay Hian

- Cautioning a change in demand pattern.** Despite the strong summer peak travel data, we caution that the airlines sector has demonstrated stronger seasonal fluctuations in air travel demand in the post-pandemic period, ie air travel demand in the seasonally strong months of the post-pandemic years appears even stronger than that in pre-pandemic years, but demand in seasonally weak months tends to be weaker than that in pre-pandemic years. We expect this change in seasonal pattern to remain in the near-to-medium term. Hence, after a likely decent performance in the seasonally strong 3Q24, airlines' earnings outlook for the seasonally weaker 4Q24 remains uncertain. According to several news media, airfare levels have already seen a meaningful retreat after the summer peak.

• **Overcapacity likely a medium-term challenge.** While peak season aircraft utilisation and pax load factors appear largely adequate, we expect airlines to face challenges in managing their capacity utilisation once demand ebbs in the seasonally slower months. Based on our rough estimate, currently the sector's latent supply may exceed demand by 5-8%; the excess capacity may take another 1-2 years to be absorbed, depending on the speed of demand growth and airlines' fleet retirement.

EARNINGS REVISION

• **Lower earnings forecasts.** Our updated earnings projections for the three airlines are summarised in the table below. Although we expect the three airlines to achieve a turnaround in 3Q/2H24, our 2024 earnings estimates for the three airlines have been significantly lowered as we incorporated their 1H24 loss-making positions. We now expect CSA to be profitable in 2024, Air China to largely break even, and CEA to be loss-making for full-year 2024. We have also trimmed our 2025-26 earnings forecasts for Air China and CEA, as we have fine-tuned our pax yield and cost projections.

We caution that our earnings forecasts for airlines are subject to high margins of error. Due to airlines' very high operating leverage, a small swing in pax yield levels will lead to significant fluctuation in airlines' earnings levels.

UPDATED EARNINGS FORECASTS FOR THE THREE AIRLINES

Rmb'b	Air China			CSA			CEA		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
2024F earnings	4.87	0.24	-95.0%	3.95	1.52	-61.4%	3.35	-1.51	-144.9%
2025F earnings	6.34	5.13	-19.1%	4.47	4.47	-	4.01	3.78	-5.7%
2026F earnings	6.79	6.79	-	4.84	4.85	-	4.34	3.99	-8.0%

Source: UOB Kay Hian

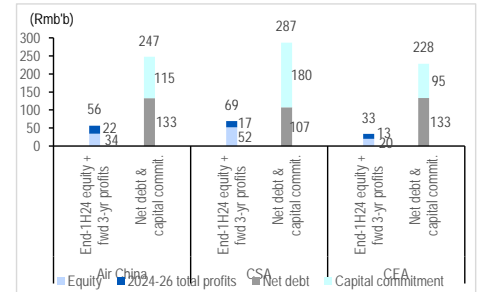
ACTION

- **Maintain UNDERWEIGHT on high gearing and overcapacity concerns.** We maintain a fundamental UNDERWEIGHT rating as we do not like the three major airlines' sky-high gearings and note that the sector's current overcapacity situation, leading to only moderate earnings recovery, is not good enough for the three airlines to pare down their debts and rebuild balance sheet strength. We see no hope for dividends in the medium term as organic earnings in the next few years are likely not enough to even make up for the three airlines' huge negative earnings reserves. In addition, the airlines' significant capex commitment may further stress their balance sheets, and hence more equity raisings are likely on the cards.
- **Possible trading opportunities, with CSA a preferred pick.** Despite our unfavourable fundamental view towards the airlines, we note there might be still opportunities to trade the 3Q24 earnings turnaround. CSA is our preferred pick, given its healthy operating data and likely stronger earnings turnaround prospect for 3Q24.
- **CSA (1055 HK/BUY/Target: HK\$3.00).** Our target price for CSA remains unchanged at HK\$3.00, based on a 13.8x 2025F PE (pegged to sector historical mean), factoring in a 20% dilution factor to provide for more potential equity raising. We upgrade CSA to BUY after its recent share price decline.
- **Air China (753 HK/HOLD/Target: HK\$3.50),** Our target price for Air China is lowered to HK\$3.50 (previously HK\$4.33), as we apply the same 13.8x 2025F PE (with a 25% dilution factor) on a lowered 2025F earnings estimate. We downgrade Air China to HOLD given its weaker-than-expected operating data ytd as well as relatively higher exposure to the US route, the recovery prospect of which remains uncertain.
- **CEA (670 HK/HOLD/Target: HK\$1.80).** Our target price for CEA is lowered to HK\$1.80, also based on a 13.8x 2025F PE, with the highest dilution factor of 30% due to its most devastated balance sheet. Maintain HOLD on CEA.

RISKS

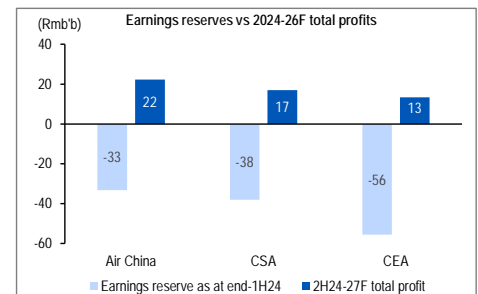
- a) Overcapacity situation lasting longer than expected; b) weak macroeconomy dampening air travel, c) unfavourable fluctuation of fuel cost, d) renminbi weakening (rendering overseas travel more expensive for the Chinese), and e) EPS-dilutive equity-raisings.

AIRLINES' VERY ELEVATED CAPEX PLANS VS ALREADY HIGHLY-GEARED EQUITY BASES



Source: Respective companies, UOB Kay Hian

2H24-27 EARNINGS NOT ENOUGH TO MAKE UP FOR NEGATIVE EARNINGS RESERVES



Source: Respective companies, UOB Kay Hian

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