



1H17 post-results conference call takeaways

Air China hosted a 1H17 post-results conference call on 31 August. Key takeaways are as follows:

- 1H17 review and FY17 outlook: In 1H17, Air China saw an increase in both load factors and yield, thanks to improved demand/supply situation in the domestic market on a strong economy. Front cabin load factor improved by 9% for domestic routes and 8% for international routes to around 60% for both. And revenue from front cabin increased 15% YoY. According to management, there is still room to further increase front cabin load factor by optimizing fleet and improving services.
- Ticket pricing: Air China's strategy to increase ticket prices has been successfully implemented. In 1H17, passenger yield increased by 1.4% and cargo yield surged 12.7% by reducing the ratio of cargo space available for pre-sale. Going forward, Air China will stick to the strategy of raising ticket prices for the rest of the year.
- Fuel cost: Air China's net profit declined 60% in 1H17 mainly due to a high YoY increase in fuel price. Management still has no fuel hedging plans for this year.
- Capacity: In 1H17, Air China's 5% ASK growth was lower than planned due to the maintenance of the central runway and traffic disruption during the One Belt and One Road Forum. In 2H17, Air China plans to expand ASK by 11%, with domestic ASK likely to increase by 9-10% and international ASK to increase by 12%.
- Investment loss: Management confirmed that the investment loss in 1H17 was mainly attributable to losses at Cathay Pacific (0293.HK, HKD11.62, Sell). Air China remains hopeful of a near-term turnaround in Cathay Pacific operations.
- Strategic JV with Lufthansa (LHAG.DE, EUR20.34, Hold): The cooperation started in April is operating smoothly. The two parties are improving services (e.g. sharing VIP lounges); offering more transit flights and providing a more diversified range of products (e.g. increased products from 3 cabins to 5 cabins).
- USD debt: Air China further reduced its USD debt ratio to 44% at the end of June 2017 from 46% at the end of 2016 by replacing USD debt with RMB debt and repaying USD debt in advance. The airline will stick to its original plan to further reduce the ratio to c.35% by year-end FY17 in order to control FX risk. Yet, given a steady interest rate for USD debt at the moment, the airline will strive to dynamically maintain an optimal balance of foreign debt ratio.

Deutsche Bank's view - stable core business masked by CX weakness.

We believe that Air China's core business looks solid with decent air passenger demand and good yield management. However, we are still concerned about Cathay Pacific's earnings outlook given the hedging loss and uncertainty of its ongoing restructuring. Therefore, we maintain a Hold on Air China's H-shares. Meanwhile, we have a Sell rating on its A-shares, given their significant valuation premium over the H-shares.

Deutsche Bank AG/Hong Kong

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Focus stocks

Air China (0753.HK),HKD6.96 Hold Price Target HKD7.70
Air China-A (601111.SS),CNY9.27 Sell Price Target CNY7.00

Source: Deutsche Bank

Our target price for Air China is based on 1.1x FY18E P/BV, at par with its mid-cycle valuation since 2011. We believe the valuation benchmark is still prudent, given 11% FY18E core ROE, which is in line with the historical average since 2011. Key downside risks include excessive new capacity on international routes, and the Cathay Pacific earnings contribution disappointment. Key upside risks are the reverse of the aforementioned points.