

21 November 2012 | 10 pages

Airlines (GICS) | Airlines (Citi)
Asia Pacific | Malaysia

AirAsia (AIRA.KL)

Alert: Large Capacity Push a Loud Battle Cry against Malindo

■ **Reiterate Sell on AirAsia; Buy MAHB** – We reiterate our contrarian Sell on AirAsia. Negatives: *i)* 3Q12 results missed Street estimates; *ii)* significant downside to consensus estimates; *iii)* accelerated capacity expansion, especially in Malaysia, may exert downward pressure on yields and load factors; *iv)* valuations may de-rate as Malindo progresses from concept to reality. We prefer Asia Aviation (AAV.BK; holding company of Thai AirAsia) as its profits enter a fast-growth zone with limited direct competition, though valuations cause us to rate it Neutral with TP Bt4.80. We also reiterate our Buy rating on MAHB.KL with TP RM6.10 as it may benefit from more LCC traffic being stimulated by aggressively expanding AirAsia and Malindo.

■ **Capacity flood goes beyond growth optimism** – We were surprised by AirAsia's announcement today that it will further accelerate its fleet growth plans, adding 35 aircraft in 2013 (Malaysia +10, Thailand +9, Indonesia +9, Philippines +3 and Japan +4/5). We recall that back in May 2012 AirAsia had planned to expand 2013 fleet by 15 aircraft, and raised this to 21 aircraft in Aug 2012 due to strong demand outlook. Today's announcement to raise the 2013 fleet addition from 21 to 35 aircraft is more than just growth optimism – in our view, it is an aggressive tactic to flood the market with capacity in anticipation of Malindo's entry into the Malaysian market in 2013.

■ **Two confident competitors = irrational competition?** – Lion Air (49% owner of Malindo) CEO Mr. Rusdi Kirana gave a detailed interview to *The Star* newspaper last weekend reiterating its commitment to enter the Malaysia market in March 2013 (2 months earlier than planned), sticking to its strategy of operating a hybrid "some-frills" LCC business model while offering competitive fares "same or lower than competition". The CEOs of AirAsia and Lion Air sound equally confident of their strategies in Malaysia. We fear this exuberance may lean on the side of irrationality.

■ **Does Malaysia need so many aircraft?** – We question the wisdom of AirAsia's plans to accelerate fleet growth in 2013. In our view, Malindo's entry is inevitable; even without today's announcement by AirAsia to accelerate its fleet growth, the Malaysian market would be saturated with capacity. We expect the LCC demand in Malaysia to grow by around 10% per year under normal circumstances (AirAsia's passenger volume grew 8-12% over the past 5 quarters). In the event of a major price war, new demand will be stimulated and the LCC market may grow by around 15%. However, the combined fleet of narrow body aircraft between Malindo and AirAsia will grow by 22 aircraft in 2013 (AirAsia +10; Malindo +12) from a base of 61 aircraft at end-2012 (all operated by AirAsia). Clearly, capacity growth will be more than double demand growth, and we fear AirAsia may not be able to achieve its 85% load factor (by itself an ambitious target from current load factor of 80%).

■ **Continue to Page 2 for our further thoughts.**

■ Company Update

Sell	3
Price (21 Nov 12)	RM2.85
Target price	RM2.30
Expected share price return	-19.3%
Expected dividend yield	0.0%
Expected total return	-19.3%
Market Cap	RM7,923M
	US\$2,590M

Price Performance (RIC: AIRA.KL, BB: AIRA MK)



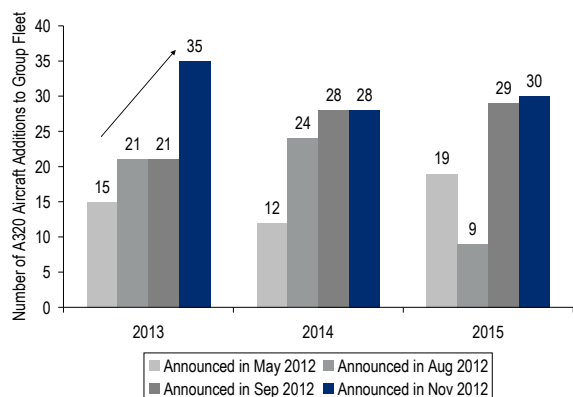
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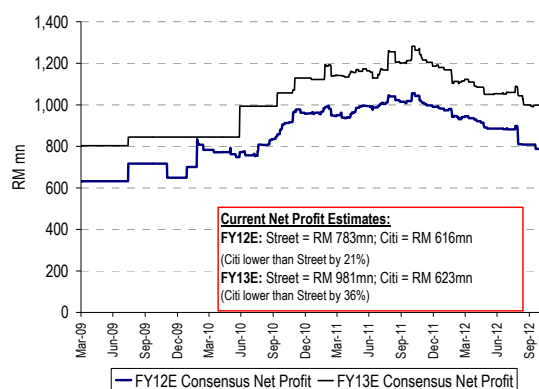
- **Unnecessarily rapid expansion in Thailand and Indonesia** – AirAsia also announced that Thai AirAsia and Indo AirAsia will each add 9 aircraft in 2013, up from previous plan of +5-6 aircraft each, so their capacities will grow 33% and 41% respectively in 2013. We are unsure how firm these plans are, especially for Thai AirAsia as AAV (holding company of Thai AirAsia) had just reiterated its 2013 fleet growth plan of six aircraft a week ago when it reported 3Q12 results. In our view, accelerated fleet expansion of Thai AirAsia and Indo AirAsia beyond their original plan of 20-25% is not only unnecessarily aggressive but also incomprehensible as the outlook in these markets had not changed from a quarter ago when the original plan was presented. We would rather see these associates grow sustainably.
- **3Q12 results below Street expectations** – Core net profit of RM164mn was within our expectations but below Street's (9M12 core net profit RM422mn vs. Street FY12 estimate of RM783mn). Average fares in Malaysia were lifted to RM191 in 3Q12 vs. RM180 in 3Q11 but the positive effect was offset by higher maintenance costs (more routine checks), higher user charges (higher airport fees and less incentives), and higher branding costs. Thai AirAsia's profits (and AAV's, which reported results last week) were lighter than expected, due to front-loading of expenses related to the move to Don Mueang from Suvarnabhumi on 1-Oct (higher selling and admin expenses). Indo AirAsia posted an encouraging turnaround in profitability (core net profit +205% to Rp83bn) outperforming our expectations, though we are unsure whether the profit improvement is sustainable given the airline's renewed push into the domestic market where it had previously failed to successfully penetrate.
- **Significant downside to Street estimates** – We expect further downgrades to Street estimates on the back of 3Q12 results announcement which came in below expectations, accelerated capacity expansion plans of AirAsia which may further depress yields and load factors, and entry of Malindo Airways in Mar-2013 which may lead to an aggressive price war and hurt both airlines' profitability. Our FY13E net profit estimate of RM623mn is subject to significant uncertainty in light of current market competitive dynamics, but we think further risks lie to the downside. Street FY12E and FY13E profit estimates appear high relative to our estimates.
- **Buy MAHB; Neutral on AAV** – We like Asia Aviation (AAV.BK; holding company of Thai AirAsia) as its profits enter a fast-growth zone (assuming the airline does not pursue the more aggressive expansion plan in 2013 announced today) with limited direct competition, though valuations cause us to rate it Neutral with TP Bt4.80. We also reiterate our Buy rating on MAHB.KL with TP RM6.10 as it may benefit from more LCC traffic being stimulated by aggressively expanding AirAsia and Malindo.

Figure 1. AirAsia – Announcement of Planned Fleet Addition



Source: Company Reports

Figure 2. AirAsia – Downward Revision of Consensus Net Profit



Source: Bloomberg Consensus Estimates; Citi Research Estimates

AirAsia

Valuation

Our RM2.30 target price is based on 7x average of FY12-13E Adj. EV/EBITDAR, and adjusted for unrecognized share of losses from Indonesia AirAsia. Our 7x Adj. EV/EBITDAR target multiple is pegged at a ~15% premium to peers valuation, justified by AirAsia's Pan-Asia presence and market dominance. We use an earnings-based valuation methodology as we believe that the share price will be driven by earnings growth going forward as gearing issues are addressed.

Risks

Key upside risk is a sharp decline in jet fuel costs and less-than-expected competition from Malindo Airways. Other upside risks include a stronger-than-expected operating environment especially in the Philippines, and a faster-than-expected ramp-up of ancillary service offerings and revenue stream. Any of these risk factors could keep the stock above our target price.

Asia Aviation

(AAV.BK; Bt4.22; 2)

Valuation

Our target price of Bt4.80 is based on 8.0x FY13E Adj. EV/EBITDAR, 15% above peers, justified by Thai AirAsia's superior earnings growth. Adjusted EV/EBITDAR is a common valuation method for airlines which adjusts for differences in capital structure between airlines. We think this method is appropriate to value Asia Aviation as its share price is likely to be driven by investors' expectations of its earnings growth.

Risks

Upside risks: Stronger than expected LCC market growth, ability to raise ancillary prices further. **Downside risks:** Irrational pricing by competitors such as THAI, THAI Smile, Nok, USD appreciation, or spike in jet fuel costs. Any of these risk factors could cause the shares to deviate from our target price.

Malaysia Airports Holdings Bhd

(MAHB.KL; RM5.60; 1)

Valuation

Our RM6.10 target price is derived using a sum-of-the-parts approach. We value the core Malaysian business using DCF, which in our view is most appropriate given it is a highly cashflow generative business with relatively stable and visible cash flows. Our DCF valuation of the core Malaysian business is RM4.71, calculated using a WACC of 8.85% from a 10.1% equity discount rate (4.5% risk-free, 7.5%

equity risk premium and beta of 0.75), and a 3.75% net cost of debt. We value MAHB's overseas investments at book, contributing RM0.28 to our target price. We ascribe a value of RM1.11/share for MAHB's 20% stake in Istanbul's Sabiha Gokcen International Airport (ISGIA). Our ISGIA valuation is DCF-derived and is based on a three-year passenger CAGR of 18%, and a WACC of 8.14% (5% risk-free, 3.7% equity risk premium, beta of 1.15, 6% cost of debt).

Risks

Downside risks that could impede the stock from reaching our target price include: *i)* weaker-than-expected passenger growth, particularly from anchor tenants MAS and AirAsia; *ii)* higher-than-expected capex and/or cost overruns at KLIA2; *iii)* a slower-than-expected turnaround from ISGIA; *iv)* expensive overseas investments; *v)* longer-than-expected delay in implementing higher passenger service charges.

Appendix A-1

Analyst Certification

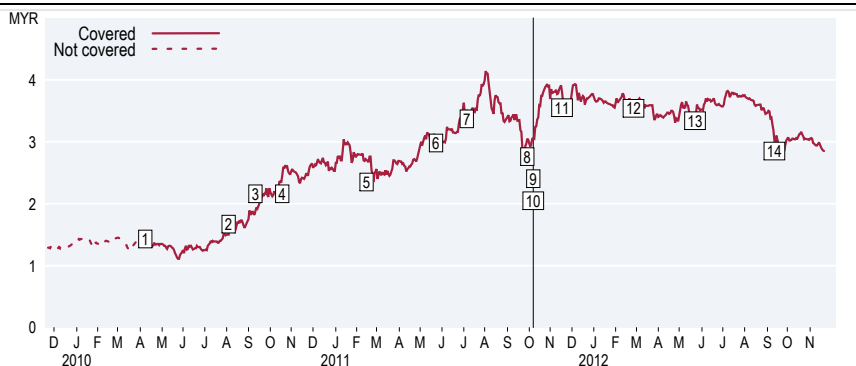
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Ratings and Target Price History Fundamental Research

Analyst: Rigan Wong, CFA
Covered since June 29 2011



	Date	Rating	Target Price	Closing Price
1	8-Apr-10	*3M	*1.10	1.35
2	4-Aug-10	*1M	*2.10	1.50
3	10-Sep-10	*1L	*2.50	1.82
4	19-Oct-10	1L	*2.85	2.45
5	15-Feb-11	1L	*3.25	2.72

	Date	Rating	Target Price	Closing Price
6	24-May-11	1L	*3.70	3.06
7	6-Jul-11	*3M	3.70	3.50
8	29-Sep-11	*1L	*3.60	3.05
9	7-Oct-11	Stock rating system changed		
10	7-Oct-11	*1	3.60	3.06

	Date	Rating	Target Price	Closing Price
11	17-Nov-11	*3	3.60	3.80
12	27-Feb-12	3	*2.80	3.61
13	23-May-12	3	*2.85	3.39
14	12-Sep-12	3	*2.30	3.02

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

AirAsia (AIRA.KL)

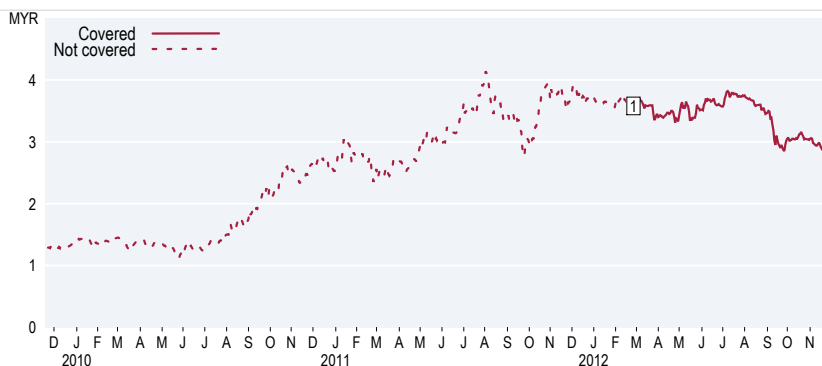
Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Rigan Wong, CFA

Covered since June 29 2011



	Date	Rating	Target Price	Closing Price
1	27-Feb-12	*ADD LP	-	3.61

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

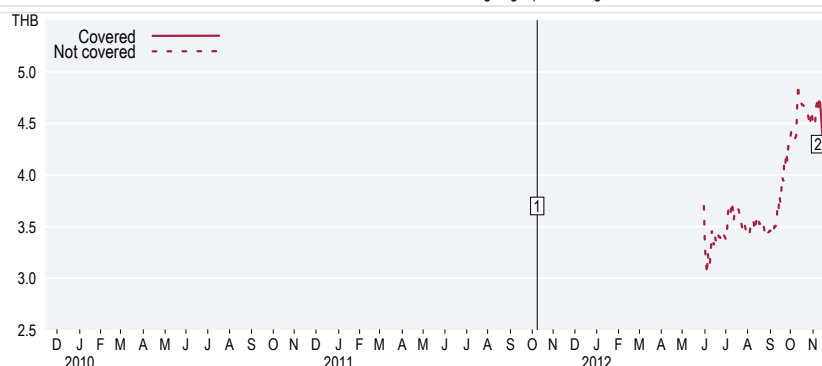
Asia Aviation (AAV.BK)

Ratings and Target Price History

Fundamental Research

Analyst: Rigan Wong, CFA

Covered since November 8 2012



	Date	Rating	Target Price	Closing Price
1	8-Oct-11	Stock rating system changed	-	-

* Indicates change

	Date	Rating	Target Price	Closing Price
2	8-Nov-12	*2	*4.80	4.66

Rating/target price changes above reflect Eastern Standard Time

Asia Aviation (AAV.BK)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Rigan Wong, CFA

Covered since November 8 2012



* Indicates change

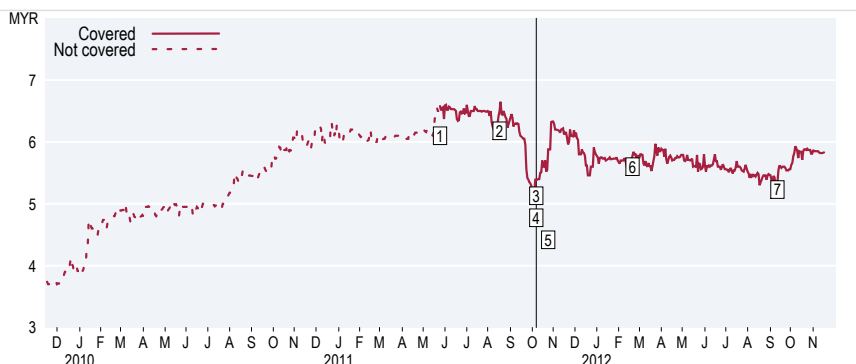
Rating/target price changes above reflect Eastern Standard Time

Malaysia Airports Holdings Bhd (MAHB.KL)

Ratings and Target Price History

Fundamental Research

Analyst: Rigan Wong, CFA
Covered since June 29 2011



	Date	Rating	Target Price	Closing Price
1	25-May-11	3L	*6.00	6.58
2	17-Aug-11	*1L	*7.40	6.50
3	7-Oct-11	Stock rating system changed		

* Indicates change

	Date	Rating	Target Price	Closing Price
4	7-Oct-11	*1	7.40	5.39
5	25-Oct-11	1	*7.20	5.88
6	21-Feb-12	1	*6.75	5.78

	Date	Rating	Target Price	Closing Price
7	12-Sep-12	1	*6.10	5.33

Rating/target price changes above reflect Eastern Standard Time

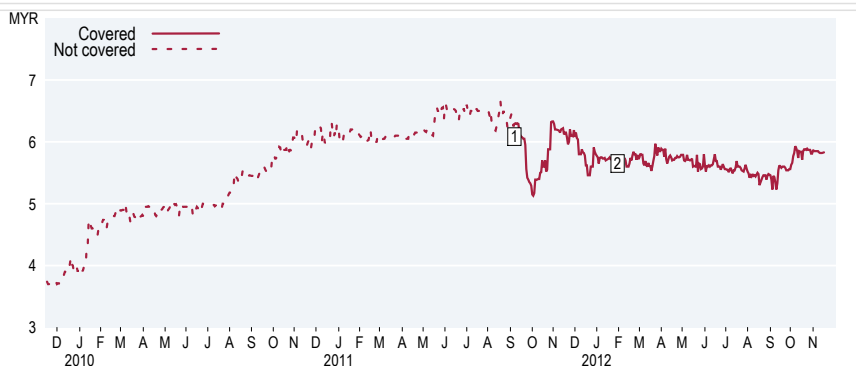
Malaysia Airports Holdings Bhd (MAHB.KL)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Rigan Wong, CFA
Covered since June 29 2011



	Date	Rating	Target Price	Closing Price
1	7-Sep-11	*ADD MP	-	6.29

* Indicates change

	Date	Rating	Target Price	Closing Price
2	31-Jan-12	*REM MP	-	5.70

Rating/target price changes above reflect Eastern Standard Time

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12 Month Rating			Relative Rating		
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51%	38%	11%	7%	85%	7%
50%	47%	45%	59%	47%	50%

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