

Market Commentary

NZFUNDS

AIR NEW ZEALAND - READY FOR TAKEOFF?

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The airline industry is a notoriously difficult place to consistently show profitability and, as a result, investors are frequently the ones who suffer. But Air New Zealand has come through a very tough environment with flying colours and is poised to benefit from a recovering global airline environment.

Airlines are extremely cyclical businesses. They are heavily impacted by factors largely beyond their control, principally the global economic cycle and the impact that has on travel demand and the price of oil. The airline industry is characterised by relatively low margins with large fixed costs so if demand collapses they can lose large amounts of money very quickly.

However, the reverse is also true. If demand picks up, profitability can soar. History illustrates the variability of airline shares as they fluctuate with investors moving from one forecasting scenario to the other. However, as we know all too well, forecasting the future is fraught with difficulty. In the face of uncertainty how do we decide whether a company like Air New Zealand's current value is appropriate, too high or too low?

There are a number of ways we can approach this problem. The first is to accept that while our ability to exactly predict passenger trends in the future is very limited, we can nevertheless make some assumptions about what some kind of normalised level is. From there we can assess what a normalised earnings number is, what that means for valuation and compare it to the current value.

Another way is to look at a variation of the price-to-book ratio. Often, price-to-book is an unrealistic valuation tool, because either the book value of the assets is highly inaccurate or the assets are not practically liquid. Airline assets are mainly their planes and these can easily be sold. So an appropriate measure is the value of the company compared to the sale value of its fleet of aircraft.

Finally, we can overlay an assessment of the very near term cycle and see if that offers a catalyst for the stock's performance in the near future. In the case of Air New Zealand a combination of these three approaches suggests it presents significant value at these levels.

The present enterprise value of around \$1.1b is only around 5x its earnings before interest and tax (EBIT) value which is \$230m. This is a reasonable mid-cycle figure. At current prices the airline is approximately only 0.8x the estimated value of its airline fleet.

Recent trends in global and domestic passenger growth suggest demand is returning. If the market was to re-rate Air New Zealand so it was priced in line with Qantas, which is priced on an around 9x then it would be valued at nearly double today's price of \$1.30.

While we don't necessarily expect the stock to double in the short term, Air New Zealand's share price clearly has potential to climb to a higher altitude.

AIR NEW ZEALAND PRICE



AIR NEW ZEALAND RELATIVE TO NZ SHARES



For further information please contact:



Michael Lang Ph: 09 377 2277
Chief Investment Officer
New Zealand Funds Management

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