AVIATION
Brace for impact

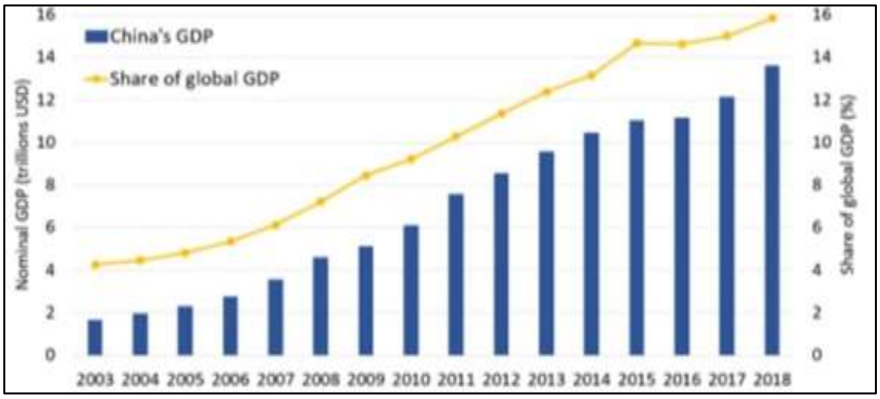
Downgrade to NEUTRAL
From POSITIVE

KEY INVESTMENT HIGHLIGHTS

- **Significance of China travel demand to exert stronger impact from Covid-19 on tourism compared to SARS**
- **Airlines have been scrambling to cut capacity amidst the waning travel demands and travel bans imposed by more than 50 countries**
- **Passenger load factors for local airlines (AAGB and AAX) will drop below 80.0% in the coming quarters**
- **Effect of lower fuel prices insufficient to offset impact from lower travelling demand**
- **Downgrade the aviation sector from POSITIVE to NEUTRAL**
- **MAHB (BUY;TP:RM7.83) is our top pick for the sector as we foresee a rebound in passenger traffic in FY21 assuming the Covid-19 will be contained this year**

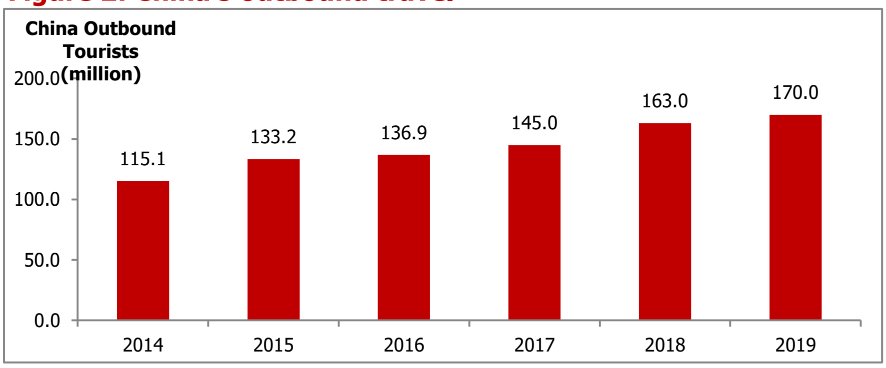
China outbound travel has increased in the past few years. China's exposure to the global economy has evolved tremendously over the past 17 years, growing from the world's sixth largest economy to the second biggest today behind the U.S. Its share of global trade has more than doubled, to 12.8% in 2019 from 5.3% in 2003, according to Oxford Economics. The result of China's economic growth coupled with relaxation of visa policies for Chinese citizens has spurred travel demand for outbound travel from the country. Outbound China travel has increased in the past few years, increasing from 115.1m tourists in 2014 to 170.0m in 2019, representing a nearly 50% growth. In fact, China was the world's largest outbound tourism market in terms of spending in 2018 whereby tourism spending rose by +8%yoy to USD277.0b.

Figure 1: China's economic growth from 2003 to 2017



Source: World Bank, OECD

Figure 2: China's outbound travel



Source: Bloomberg Intelligence

COMPANY IN FOCUS

Malaysia Airports Holding Berhad
Maintain **BUY |** Unchanged Target price: RM7.83
Price @ 9th March 2020: RM5.76

- Shift in pattern towards more passengers from India which currently has a manageable number of Covid-10 cases
- Growth factors include the roll out of MAHB's biometric identification process for international departing passengers which by June 2020
- Expect passenger traffic to normalize in FY21

Share price chart

AirAsia Group Berhad
Maintain **NEUTRAL |** Revised Target price: RM1.03
Price @ 9th March 2020: RM0.99

- Capacity slashes have taken place for MAA and TAA
- Passenger load factor could drop below 75.0% if Covid-19 outbreaks continues beyond 1HFY20
- Alleged bribery involving AAGB executives and Airbus will remain a sentiment drag

Share price chart

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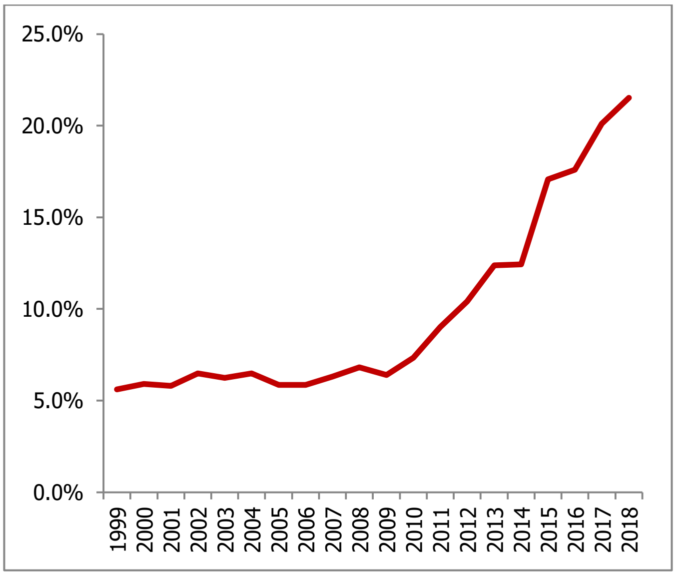
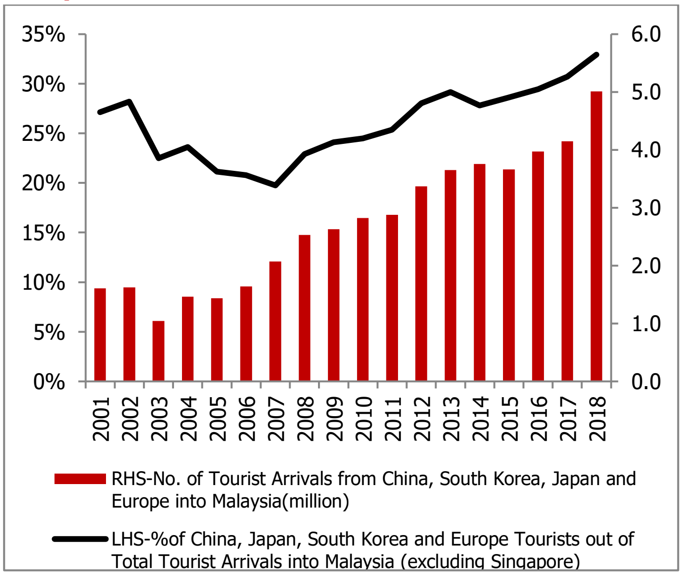
Significance of China travel demand means stronger impact from Covid-19 on tourism compared to SARS. With regard to the Covid-19 outbreak, we opine that there will be a bigger compact on ASEAN tourism compared to the SARS outbreak in 2003. Recall that the number of visitor arrivals to ASEAN from China dropped by -15.6%yoy in 2003 due to the SARS outbreak before staging a +32.9% recovery in the following year. Similarly, international passenger traffic growth from China to ASEAN nations such as Malaysia showed a -10.7%yoy drop at the KLIA Main Terminal in 2003 which was then followed by a whopping +75.8%yoy growth in 2004. Notwithstanding this, the significance of Chinese tourists towards ASEAN has been rapidly increasing since the SARS outbreak. For instance, we found that the percentage of Chinese tourists out of total tourist arrivals in ASEAN stood at just 6.2% in 2003 and has increased to 21.5% in 2018. As Japan, South Korea, Germany and France are some of the countries with the highest number of Covid-19 cases outside of China, the downward pressure towards the tourism and aviation sector of ASEAN nations such as Malaysia will be amplified. The reason being is that, the proportion of tourists arrivals from China, Japan, South Korea and Europe breached the 30.0% mark in 2017 and 2018 after remaining in the range of 20-29% from 2003 to 2016.

Figure 3: Percentage of Chinese tourists out of total tourist arrivals in ASEAN



Source: China Tourism Academy

Figure 4: Percentage of Chinese, Japan, South Korea and Europe tourist arrival out of total tourist arrivals in Malaysia



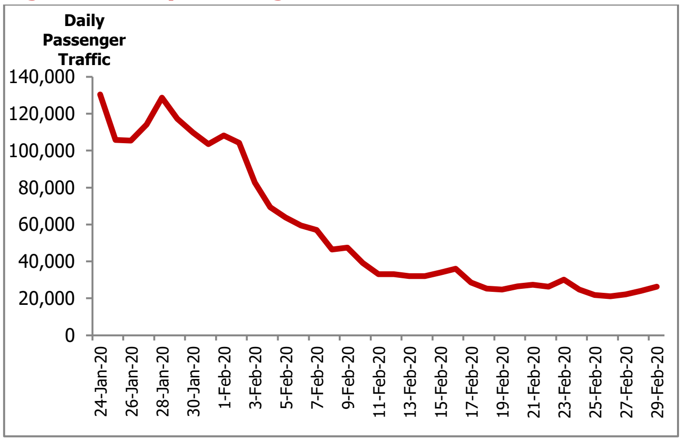
Source: ASEAN Data Portal

What impact have we seen so far on travel demand. Following the Covid-19 outbreak, airlines have been scrambling to cut capacity amidst the waning travel demands and travel bans imposed by more than 50 countries. According to Centre for Asia Pacific Aviation, China's international seat numbers are already down by nearly 80% compared to last year, with domestic seat numbers down nearly 60%. Meanwhile, Hong Kong's flagship carrier Cathay Pacific is among the hardest-hit airlines in Asia due to its high exposure to the Chinese market, with about one-fifth of all Cathay flights serving the mainland. Due to the sharp -80% drop in daily passenger traffic in Hong Kong International Airport (HKIA) from 24 January 2020 to 29 February 2020, Cathay has scrapped over three-quarters of its weekly flights in March, more than the 40% cut in capacity the airline had previously planned.

Figure 5: Travel bans imposed around the world

Source: Bloomberg Intelligence

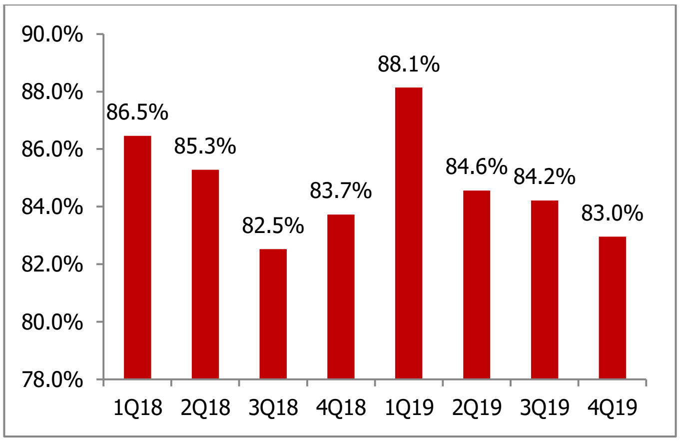
Figure 6: Daily Passenger Traffic at HKIA



Source: Immigration Department, The Government of Hong Kong

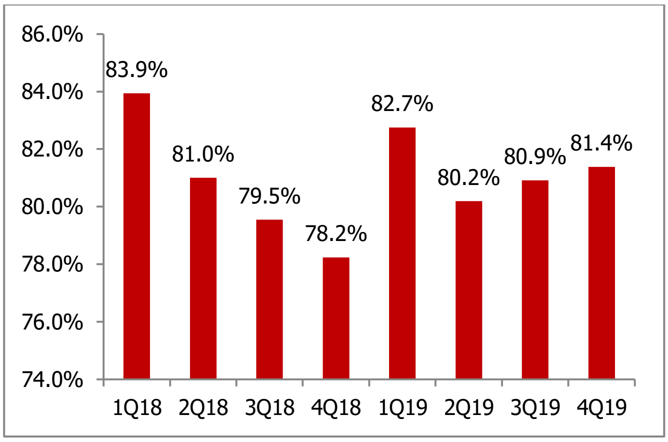
Load factor to witness a drop in the coming quarters for local carriers. Closer to home, AirAsia Group Berhad (AAGB) and its long-haul affiliate, AirAsia X Berhad (AAX) have been actively reducing capacity to international routes. The capacity in terms of Available Seat Kilometres (ASK) catered for destinations in China by AAGB make up around 13.0% of AirAsia Malaysia's (MAA) total capacity. Overall in 1Q20, AAGB has slashed overall capacity for MAA and AirAsia Thailand (TAA) by -10% and -23% respectively in light of the Covid-19 outbreak. As for AAX, the ASK attributable to China make up between 25% and 45% of AAX's overall ASK. We understand passengers flying to or from destination in mainland China with AAX and AAGB are given an option for a credit account or full refund except for Wuhan which has been temporarily cancelled. Meanwhile, South Korea and Japan combined makes up around 40% of AAX's total capacity and only Thai AAX has cancelled flights to South Korea from March 6 to March 27 due to the Covid-19 outbreak. In order to deal with the Covid-19 outbreak, AAX has planned the cancellation of non-profitable routes such as Tianjin, Lanzhou and Jaipur. Management also guided that more than 600 flights will be cancelled in March 2020, covering eight destinations. Although capacity cuts have been planned out, we believe the dampened global travel sentiment will give additional downward pressure on Revenue Passenger Kilometre (RPK). As a result, the passenger load factors for both airlines will drop below 80.0% in the coming quarters. Assuming a worst case scenario whereby the Covid-19 would prolong beyond FY20, load factors will remain depressed, possibly reaching below 70.0% for both airlines and drag AAGB to a second year of loss while stretching AAX's losing streak for the third year running.

Figure 7: Quarterly Load Factor of AAGB



Source: AAGB

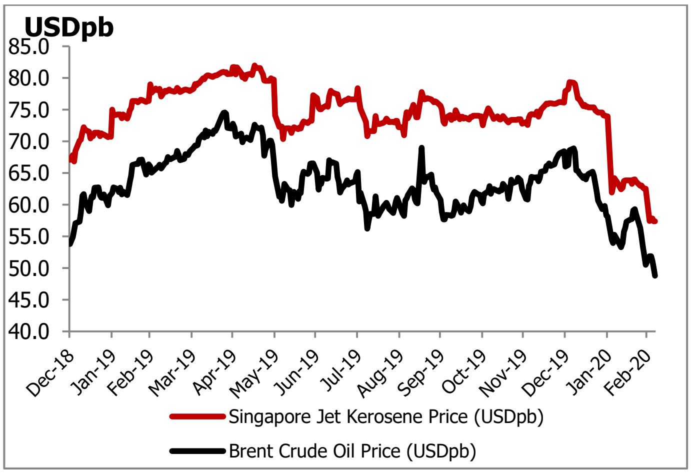
Figure 8: Quarterly Load Factor of AAX



Source: AAX

Effect of lower fuel prices insufficient to offset lower travelling demand. For FY19, AAGB saw a +12.8%yoy rise in opex, partly attributable to the +7.5%yoy increase in aircraft fuel expenses amidst capacity expansion. Nevertheless, the increase was not as profound in FY18 when fuel expenses increased by +39.5%yoy. The lower magnitude of increase in aircraft fuel expenses occurred despite the 14.9% rise in Singapore jet kerosene during FY19; and (ii) the 15.5%yoy increase in the number of flights for the same period. This indicates that AAGB's conservative hedging strategy came to fruition. In light of low oil prices, AAGB (including AAX) has started to implement 7-39% crack hedges from 1QFY20 to 4QFY20 (averaging around 25%), ranging from USD8-12pb. Usual crack spreads range from USD13.00-15.00pb. The recent chain of events involving Russia resisting further output cuts beyond and Saudi Arabia slashing its pricing for crude oil has further dragged Brent crude oil prices below USD40pb. Notwithstanding this, our analysis finds that the total hedge cost post-revision of our average Brent crude oil price forecast for 2020 to be only -5.4% lower. The effect of lower jet fuel expense is marginal for AAGB as its FY20 earnings will increase only by around +1.0% while AAX's net losses in FY20 will be lowered by approximately the same quantum. As such, no changes are made to our earnings forecasts for both airlines.

Figure 9: Singapore Jet Kerosene Price (USDpb) vs Brent Crude Oil Price



Source: Bloomberg

Figure 10: AAGB's Fuel Cost Estimates

Period	FY20F (Previous)	FY20F (Revised)
Hedge Ratio on Brent (%)	73.8	73.8
Hedge Ratio on Crack (%)	19.5	0.0
Average Hedge Cost (USDpb)	59.7	59.7
Average Brent Crude oil price assumption	64.0	51.0
Estimated Average Jet Fuel Price (USDpb)	75.0	61.0
Estimated Total Fuel Cost (RM'm)	3,024.0	2,861.3

Source: AAGB

The case for airports in Malaysia. Similarly for airports, MAHB has witnessed a -10-18%yoy drop in passenger traffic for the month of February 2020. In addition to the increasing proportion of tourist arrivals from Japan, South Korea and China mentioned earlier, more than 20% of international passengers flying to and from KLIA Main Terminal comprise of North East Asian passengers (Japan, South Korea and China). Due to the significance of North East Asian passengers in KLIA Main Terminal combined with the prevalence of Covid-19 cases in these countries, we deduce that overall passenger traffic growth for MAHB's airports in Malaysia will decline in FY20. Assuming a worst-case scenario whereby the Covid-19 outbreak will continue beyond 1HCY20, the drop in passenger traffic at MAHB's Malaysian airports could widen by more than the -2.5%yoy drop we forecasted. It was also notable MAHB's wholly-owned Istanbul Sabiha Gokcen Airport (ISGA) in Turkey remained resilient in the wake of the MERS-CoV in 2012. Nevertheless, the surge in cases around Europe especially in Italy, France and Germany will adversely impact passenger traffic at the airport as Europe has a 73% market share in ISGA.

Figure 11: International Passenger Movements by Sectors at Kuala Lumpur International Airport

Sectors	No. of int'l passengers in FY18 (million)	Percentage of total int'l passengers (%)
ASEAN	20.7	47.5
North East Asia	10.6	24.5
Southwest Pacific	2.6	6.0
South Asia	5.4	12.4
Central Asia	0.1	0.2
Africa	0.1	0.2
North America (Honolulu)	0.0	0.1
Middle East	3.1	7.1
Europe	0.9	2.1
Total	**43.5**	

Source: MAHB

Figure 12: International passenger movements by region at ISGA in 2018

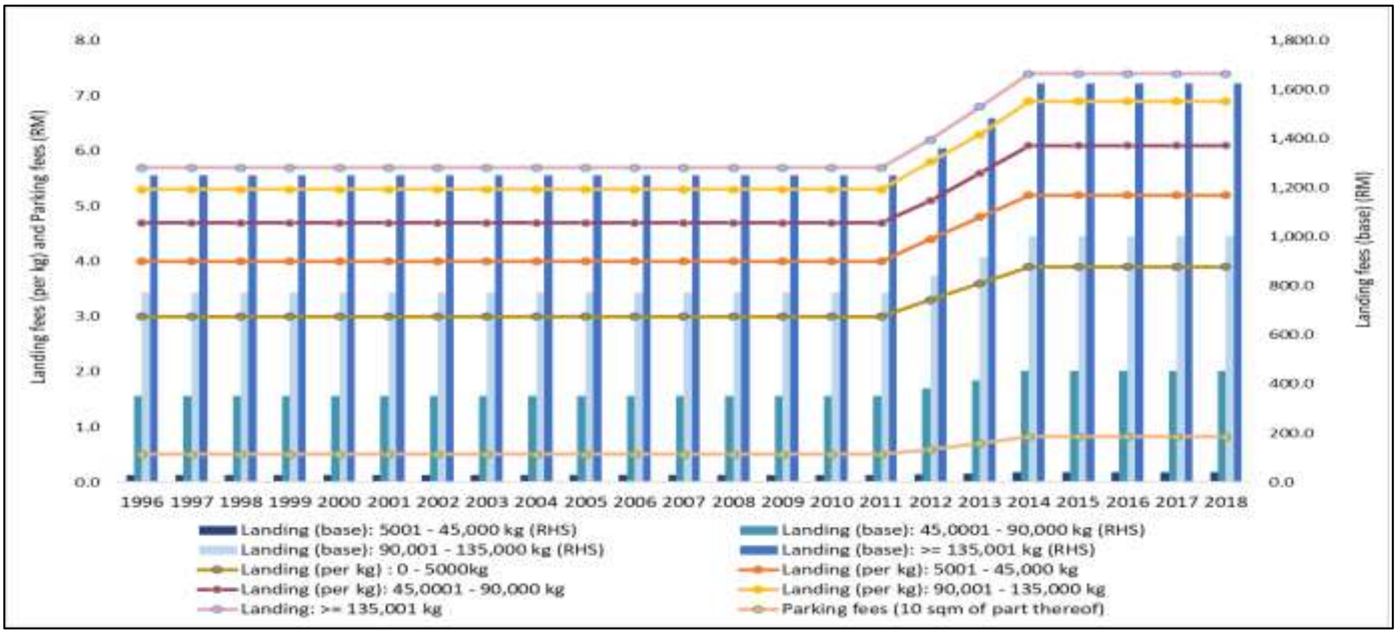
Region	Total International Passengers	Market Share (%)
Europe	8.52	73.0
Middle East	2.92	25.0
Africa	0.23	2.0
Total	**11.67**	**100**

Source: MAHB

Stimulus package, slightly good for airlines but the opposite for MAHB. In response to the Covid-19 outbreak, the Government of Malaysia announced a stimulus package which called for rebates on rental of premises and landing and parking fees for aircraft by MAHB. Details of the rebates have not yet been announced at the time of writing. Back in April 2003 during the SARS outbreak, the Government of Malaysia slashed landing and parking charges at KLIA Main Terminal by half for a one year period. As for the rental rates, tenants at Changi Airport will receive a 50% rental rebate for a period of six months. Therefore, we do not discount the possibility that the discount rate applied on the landing and parking fees and rental will be of a similar quantum. Landing and parking charges contribute around 17.0% annually to MAHB's aeronautical revenue while rental revenues make up around 30.0% of MAHB's non-aeronautical revenue in Malaysia. Assuming that both landing, parking and rental fees will be halved, total revenue of MAHB could potentially decline by more than 10.0% annually. However, the rebate on rental coincides well with its commercial reset strategy. The commercial reset strategy is aimed at changing the travel retail landscape at its airports with an injection of new brands, high-end fashion retailers and a refreshed shopping experience. As such, rebates could attract premises to extend their contracts for existing one while inviting new tenants at MAHB's airports, partially offsetting the decline seen in the aero-nautical segment. On the flip side, the rebate will be in favour for airlines as it will decrease their operating costs. Based on data from MAVCOM, low cost carriers such as AAGB and AAX are currently paying around RM400 per aircraft for landing fees (base) while parking fees are very minimal. A rebate on these fees give some leeway to airlines to manage their fares better as less cost will need to be passed to customers albeit by a measurable magnitude.

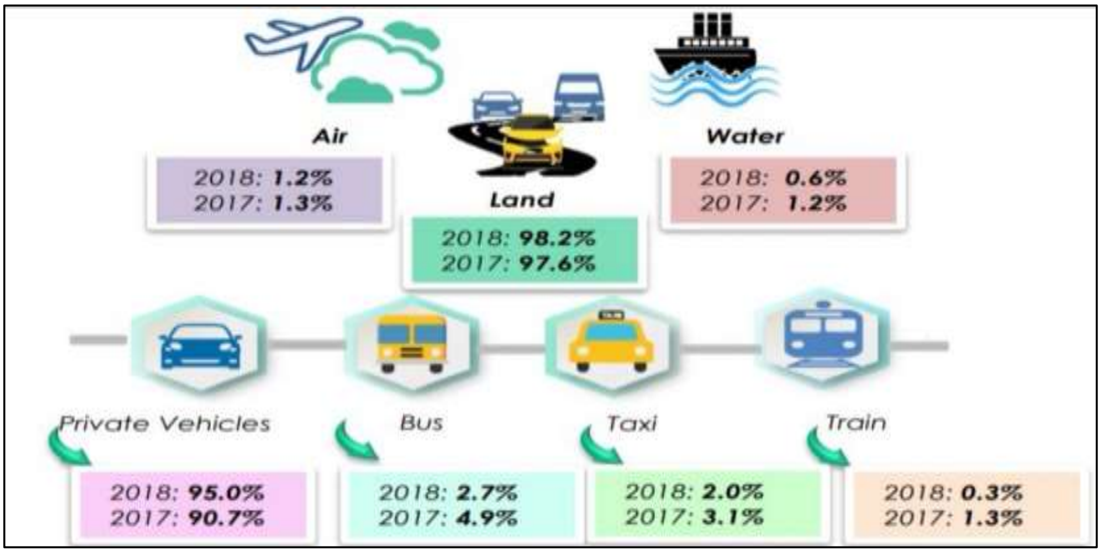
Domestic tourism and aggressive sales to act as buffer? Other reliefs provided under the latest stimulus package by the government is the i) personal income tax relief of up to RM1,000 on expenditure related to domestic tourism and ii) Malaysian will be eligible to digital vouchers for domestic tourism of up to RM100 per person for domestic flights, rails and hotel accommodations for all Malaysians. We opine that this will bode well for AAGB which recently had a RM12 sale on Malaysian domestic flight whereby Malaysians will take the opportunity to travel domestically rather than overseas to prevent risk of the Covid-19 infection. Nevertheless, fears of travelling via airports may still linger and therefore prompt many travellers to opt for other alternatives such as railways and highways. In 2017 and 2018, land transport made up more than 95.0% of the mode of transport by domestic visitors.

Figure 13: Historical landing and parking fees in Malaysia



Source: MAVCOM

Figure 14: Percentage share of trips of domestic visitors by mode of transports in 2017 and 2018



Source: Department of Statistics Malaysia

Revision on valuation for airlines. In the wake of the further spread of the Covid-19 outbreak outside of China especially in Malaysia and Singapore which has reached 99 and 150 cases respectively as at the time of writing, we opine that sentiment on global travelling will remain low at least until the end of 1HCY2020. As such, we opine that share prices of airlines will remain depressed. Taking into account of this mild challenging and volatile environment, we are ascribing: (i) a lower target PER of 9.0x (from 10.0x) pegged to the FY21F EPS for AAGB and; (ii) a revised target PBV of 1.2x or-1SD of the five-year historical PBV (from 1.6x) pegged to the FY21F book value per share for AAX. We have now arrived at a revised TP of: (i) **RM1.03 per share** (previously RM1.14) for **AAGB** and; (ii) **RM0.06 per share** (previously RM0.08) for **AAX**.

Downgrade aviation sector to NEUTRAL from POSITIVE. The current environment is the most challenging we have seen for a long time. Airlines have no choice but to slash capacity amidst waning travel demand amidst the Covid-19 outbreak. In addition to the capacity reduction, airlines have offered huge discounts for fares in hope to lure passengers to fly with them. For instance, Malaysia Airlines and Singapore Airlines have cut routes and offered discounts but we believe these initiatives may not be able to strongly boost ASK. AAGB's AOCs such as Indonesia is also expected to face headwinds from the regional weakness in travelling sentiment despite its limited exposure to routes to China. Even with the stimulus package by the interim Government of Malaysia, the positive impact will not be immediate. As such, yields will remain depressed and margins will be tight for airlines in the next few months. Therefore, we are downgrading the aviation sector from POSITIVE to **NEUTRAL**.

Our top pick for the aviation sector is **MAHB (BUY; TP: RM7.83).** Assuming that the coronavirus outbreak would last in the next two to four months, we could still expect traction from other countries namely India, which so far has only 39 confirmed cases of coronavirus as of late, a manageable figure so far amongst Asian nations. The 15-day visa free travel had been extended for Indian nationals for the whole of 2020, coinciding with the Visit Malaysia Year campaign. Moreover, tourist arrivals from India in Malaysia reached 0.6m in FY18, almost comparable to South Korea and 52.2% higher than Japan. Other growth factors would include the roll out of MAHB's biometric identification process for international departing passengers by June 2020. We opine that the fears over the Covid-19 will subside by then. Henceforth, we still believe that MAHB passenger numbers can meet the 102.6m mark in 2020 at the current juncture, representing a growth rate of -2.5%yoy. Meanwhile we maintain our **NEUTRAL** and **Trading SELL** call on **AAGB** and **AAX** respectively as we believe the compiling headwinds will remain a sentiment drag.

PEER COMPARISON TABLE

Stock	FYE	Recommendation	Price @ 9-Mar-20	Target Price (RM)	EPS (sen)		PER (x)		Net DPS (sen)		Net Divd Yield (%)	
					FY20E	FY21F	FY20E	FY21F	FY20E	FY21F	FY20E	FY21F
MAHB	Dec	BUY	5.76	7.83	33.8	40.1	17.1	14.4	14.0	14.0	2.4	2.4
AAGB	Dec	NEUTRAL	0.99	1.03	7.3	11.4	13.5	8.7	0.0	2.0	0.0	2.0
AAX	Dec	Trading SELL	0.08	0.06	-4.6	-1.9	-1.7	-4.1	0.0	0.0	0.0	0.0

Source: Company, MIDFR

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DISCLOSURES AND DISCLAIMER

MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <10% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >10% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.