Sector Update | Tuesday, 21 January 2020

AVIATION

***Maintain* POSITIVE**

Mirror mirror on the wall, who is the worthiest of them all?

KEY INVESTMENT HIGHLIGHTS

- **AAGB and JAL frontrunners in bid to takeover MAB**
- **JAL's turnaround experience and recent financial performance supports its bid**
- **Moreover, the deal with JAL will result in only one overlap of routes, the KL-Tokyo route**
- **AAGB (BUY; TP:RM2.04) should focus on further strengthening its non-airline business. Besides, there seems to be more duplications in the routes and airline operations**
- **Nevertheless, AAGB remains our top pick for the sector, being one of the major beneficiaries of VMY2020**
- **Maintain POSITIVE on the aviation sector**

AAGB and JAL frontrunners in bid to takeover MAB. From media reports, we understand that there are five proposals to take over the debt-laden Malaysia Airlines Berhad (MAB). Meanwhile, according to Focus Malaysia there are two frontrunners for the bid; AirAsia Group Berhad (AAGB) and Japan Airlines Co Ltd (JAL). The involvement of AAGB in the process comes as a surprise to us. Earlier reports mentioned that it was the low cost carrier's long haul arm, AirAsia X that could possibly merge with MAB.

The JAL case. The proposed deal brought forward by JAL entails a RM1.12b price tag for a 25% equity stake in MAB. In terms of financial performance, JAL saw an +11.4%yoy growth in earnings for the financial year ended 31 March 2019. JAL has also been showing commendable profit trends, recording an average PAT margin of 11.0% in the past five years. Meanwhile, JAL has been in a net cash position during the same period range, indicating that the airline will face lesser financial risks in financing the takeover of MAB, its operations and possibly debt post-takeover. Recall that MAB has been in the red since 2011 with its loss after tax (for FY18) of –RM791.7m.

JAL's turnaround experience. Another compelling point for JAL to be considered as a bidder for MAB is its turnaround experience. Recall that JAL filed for USD25.0b bankruptcy in January 2010 amidst the burden of large jets and unprofitable routes, and was delisted from its stock exchange. Notwithstanding this, JAL made a roaring comeback to the public equity space with the world's second largest IPO in 2012 worth USD8.5b, after Facebook's USD16.0b IPO. The Enterprise Turnaround Initiative Corporation of Japan, a state-backed fund that injected USD4.4b into JAL in 2010, sold its entire 96.5% stake in the IPO, generating around $4 billion profit. The revival of JAL made possible through changes by its then chairman, Kazuo Inamori who introduced the 'amoeba' management system. Instead of top-down decisions always being taken, the airline's workforce was divided into small units under the 'amoeba' system, each with a leader given a degree of freedom. As such, JAL's revival serves as a valuable experience in helping to turnaround MAB.

COMPANY IN FOCUS

Malaysia Airports Holding Berhad
Maintain **BUY |** Revised Target price: RM8.98
Price @ 20th January 2020: RM7.01

- Total passenger traffic exceeded estimates in FY19
- VMY2020 and visa-free entry for China and India tourists to lend support to passenger growth
- Expecting passenger traffic to reach 110.8m passengers in 2020

Share price chart

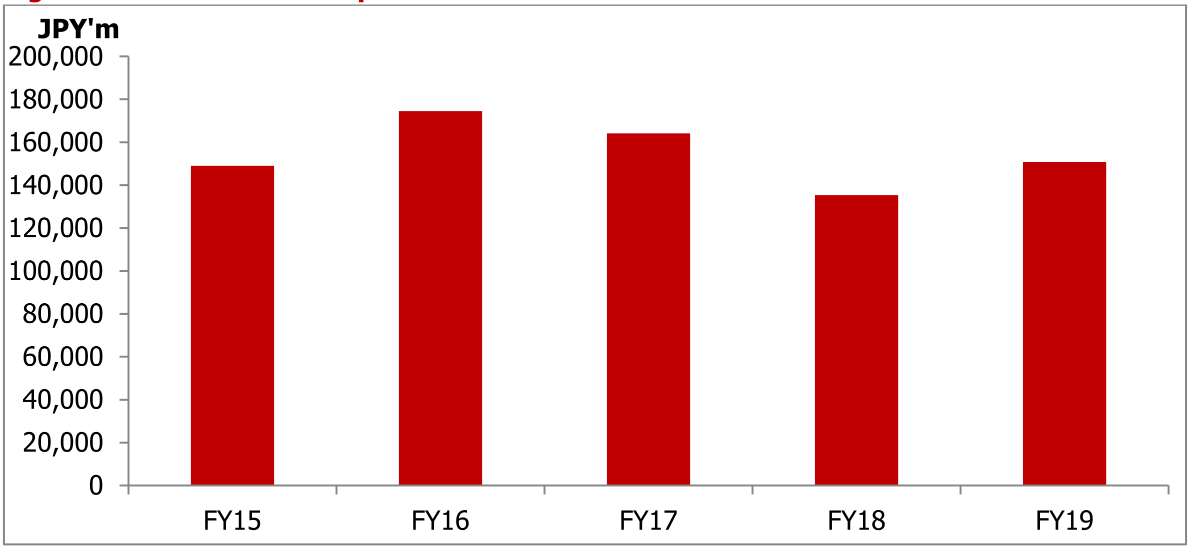
AirAsia Group Berhad
Maintain **BUY |** Unchanged Target price: RM2.04
Price @ 20th January 2020: RM1.63

- Prudent hedging policy to shield AAGB from any volatility in Brent crude oil price
- Expected to gain from lower amount of interest beyond the fifth year of the lease term.
- Passenger load factor to remain intact despite the departure levy

Share price chart

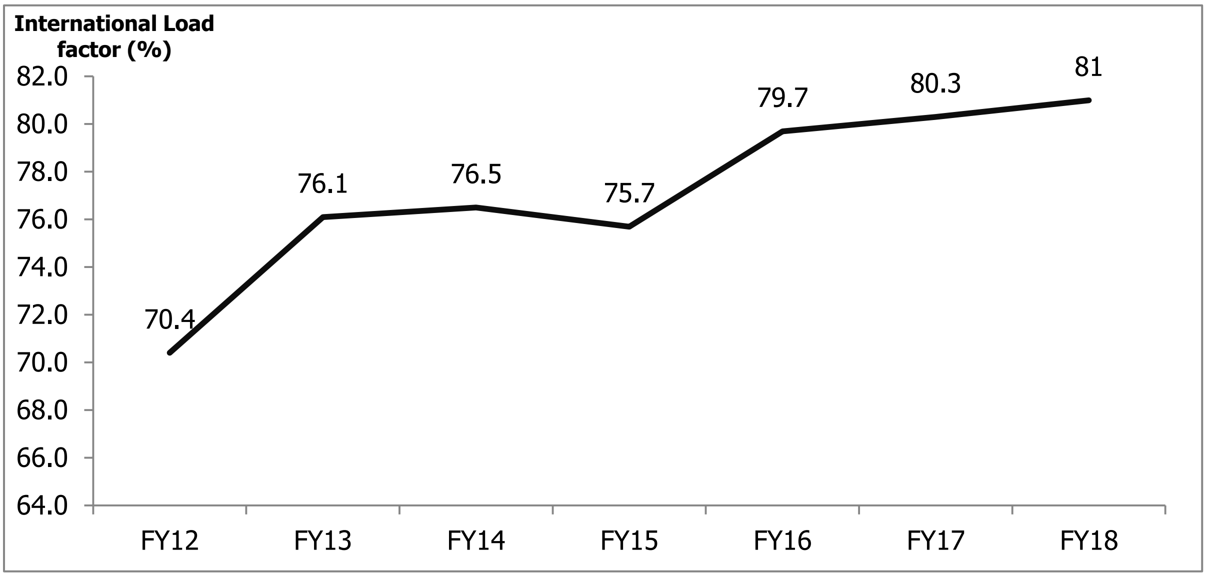
ANALYST (S)
ADAM Mohamed Rahim
adam.mrahim@midf.com.my
03 -2772 1686

Figure 1: JAL's annual net profit



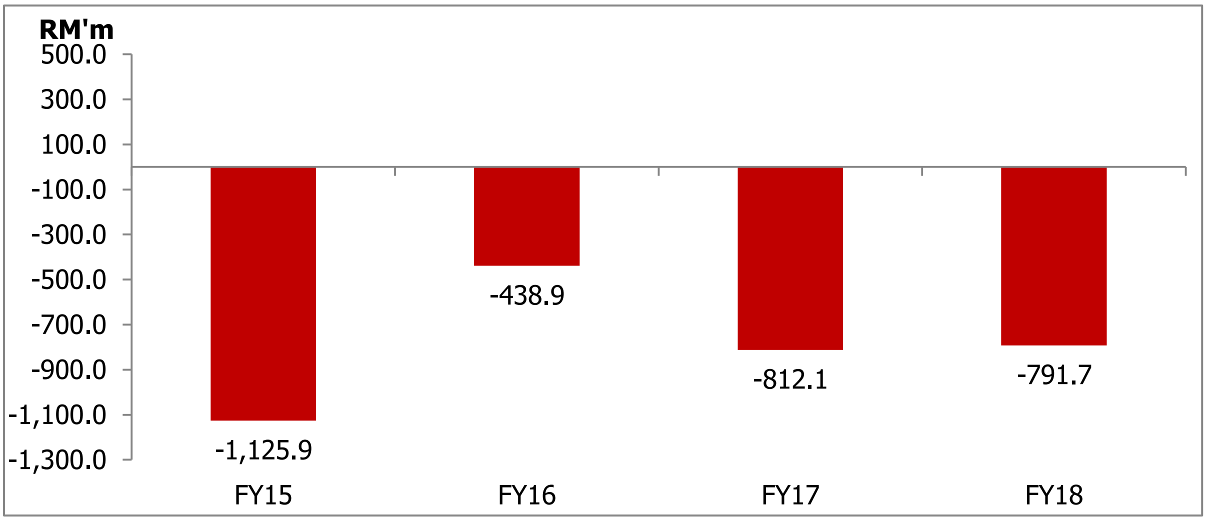
Source: JAL

Figure 2: JAL's international passenger load factor



Source: JAL

Figure 3: MAB's past financial performance (Profit After Tax)



Source: CCM

Precedence of Japanese airlines venturing into ASEAN. If JAL won the bid for MAB, this will not be the first time a Japanese airline ventures into an ASEAN airline. For example, JAL's main competitor, All Nippon Air (ANA) owns 8.8% and 9.5% stake in both Vietnam Airlines and Philippines Airlines respectively. Vietnamese Airlines chose ANA for its ability to share demand for business travel between Vietnam and the Americas and elsewhere via Japan, demand that is likely to surge after the Trans-Pacific Partnership economic pact took effect in 2016. Relating to the case of JAL having a 25% stake in MAB, we found that there will be no major overlapping of routes except for the Kuala Lumpur-Tokyo route. Plans to transform KLIA into a hub for JAL would not just benefit JAL in the competition with its Japanese peer, but could possibly expand MAB's network. A hub in KLIA Main Terminal could connect people in Malaysia not only to other parts of Japan, but also other points that are not in reach by MAB, namely North America and Europe (excluding the U.K). According to data from MAHB, the percentage of international passenger movements from North America and Europe at KLIA Main Terminal in 2018 is very small at less than 2.5%. Likewise, the international passenger movements from Tokyo Narita and Tokyo Haneda at KLIA Main Terminal are also small at 2.2% from total. Hence, this presents an opportunity for JAL to increase it via the proposed hub in KLIA Main Terminal which will eventually boost the passenger traffic, benefitting MAHB.

Table 1: International Passenger Movements by Sectors at Kuala Lumpur International Airport

Sectors	**No. of passengers in FY18 (million)**	**Percentage of total international 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 (excluding Amman, Baghdad, Basra and Tehran)	3.1	7.1
Europe (including Istanbul)	0.9	2.1
Total	**43.5**	

Source: MAHB, MIDFR

Table 2: Absolute increase/decrease in annual passenger traffic at MAHB's airport in Malaysia (million)

Airport	**FY17**	**FY18**	**FY19**
KLIA Main Terminal	2.8	-0.2	1.1
KLIA2	3.1	1.6	1.3
MASB	1.7	1.0	3.7
Total absolute change in annual passenger traffic	7.7	2.5	6.1

Souce: MAHB

The case for AAGB. Meanwhile, from the media report, it seems that Khazanah Nasional Berhad's (KNB) management favours a merger between MAB, AAGB and AAX, leading to a single listed entity. It views that the consolidation as the best way forward in resolving domestic industry capacity, thus placing MAB on a more financially sustainable path. Moreover, the merger has been estimated to result in a synergy worth RM1.45b per year. However, we understand the proposal lacks details such as; (i) comprehensive proposal on the valuation of MAB's stake and (ii) any mention of revenue management measures.

Table 3: Salient points of AAGB's initial proposal to KNB

Details	Remarks
AAGB is in the process of consolidating AirAsia Berhad (AAB) with AAX into one airline operation	IATA code 'D7' for AAX will be retired and absorbed under 'AK' code
MAB to be placed under Asia Investment Ltd (AAIL) which is 100% owned by AAGB	IATA code 'MH' for MAB will be replaced by 'MY' code targetting premium segment of domestic and international markets
KNB will not have any golden shares in MAB	AAGB demanding complete control of management
KNB to bear staff layoff and settle RM2.5b sukuk	AAGB wants full discretion of hiring despite layoff via MSS or VSS to be settled by KNB
AAGB to seek clearance from Malaysian Competition Commission	Merged entity expected to trigger anti-competition problems
AAGB to cancel, exclude and retire some MH planes	KNB to dispose 6 Airbus A380 and bear the RM5.4b financing gap KNB to cancel 25 Boeing 737 Max 8 orders and bear any penalties AAGB to retire 6 Airbus A330-200 which are around 10 to 14 years old
Firefly given two alternatives post-merger	Options include excluding Firefly from merger or keep it as a separate company from MAB and not subsidiary of MAB
Plans for MAS Wings	Propose takeover of MASwings by Sabah and Sarawak government to operate Rural Air Services routes
Acquisition of Brahim by AAGB	To streamline in-flight catering operations to ensure cost efficiency and operations

Source: Focus Malaysia

Our view on AAGB's proposal to merge with MAB. From Table 3, AAGB is planning to acquire AAX via AAB into one airline operation before absorbing MAB under AAIL, leading to a single listed entity. AAGB and AAX will target the low cost segment while MAB will focus on the premium segment for both domestic and international market. While this move may serve to solve the issue of overcapacity in the nation's aviation sector, it is important to note that the merger would lead to redundancy of many routes offered, as compared to just one route overlap under the proposal for JAL to take over MAB. In brief, we believe the initial plans of AAX to be the one merging with MAB is more plausible due to the existing long haul nature of service for both airlines. With a huge existing orderbook backlog that AAX has with Airbus (30 Airbus A321XLRs and 78 Airbus A330-900s), short haul flights under MAB could be reduced and AAX's incoming fleet could be well utilised under MAB's long haul services. Moreover, the proposal by AAGB would be done at the expense of KNB, whereby the fund will have to fork out more than RM8.0b to bear the RM5.4b financing gap and also forego its golden share in the airline.

Apt for AAGB to beef up its non-airline business. At this juncture, we opine that it would be apt for AAGB to focus on strengthening its non-airline business which as a lot of potential. For 9MFY19, total revenue of AAGB's non-airline ancillary segments more than quadrupled to RM475.2m compared to a year ago. Most of the contribution for non-airline ancillary revenue came from Teleport at 70.2% and we expect it will reach its target of RM400m given the revenue recorded of RM333.5m in 1HFY19. Moving forward, performance of Teleport will be enhanced by: (i) the launch of 'teleport.social', a platform enabling sellers on social media to integrate with Teleport's logistics infrastructure; (ii) joint investment with Gobi Partners in EasyParcel; and (iii) direct interline agreement with Lufthansa Cargo. Another non-airline ancillary component to focus on is AirAsia.com which offers flights (also for destinations not served by AAGB), hotels, holiday packages, insurance and duty free. Its gross booking value stood at RM5.1b (+20%yoy) in 3QFY19The integrated platform effectively intensifies competition with other Online Travel Agents (OTAs), enabling AAGB to cut OTAs which it was previously listed on. Meanwhile, AAGB's BigPay launched a fully digital remittance product in 3QFY19, enabling users to send money directly from Malaysia to bank accounts in Singapore, Thailand, Indonesia and the Philippines.

It currently has a user base of around 500,000 people with 62% being active users. We opine that the percentage of active users should increase further once AAGB obtains its e-money license to operate in Singapore. Quarterly capital spending for these businesses especially in terms of manpower is expected to remain high at circa RM50m in the coming quarters before normalising in 3QFY20.

Table 4: Revenue breakdown of AAGB's non-airline business (Teleport, Airasia.com, BigPay, Red Beat Ventures)

Non-airline business revenue (RM'm)	9MFY18	9MFY19	% change
Teleport, AirAsia.com, BigPay, Red Beat Ventures	138.4	475.2	243.4%

Source: AAGB

Maintain POSITIVE on the sector. Overall, we believe that the Government of Malaysia would continue exercising their prudence and objectivity in determining the most suitable party to take over MAB. The decision to finalise the winning bidder is expected to take place in April 2020. Notwithstanding this decision, **AAGB (BUY; TP:RM2.04**) remains our top pick for the aviation sector as it is set to be one of the major beneficiaries of Visit Malaysia Year 2020 with RM1.1b allocated by the Government of Malaysia (GoM) for the tourism ministry including RM960m to drive awareness and promotion programmes. Furthermore, the GoM's initiative for a 15-day visa free travel for tourists from China and India in 2020 will further support the overall passenger traffic growth as these travellers made up more than 20.0% of passengers in 2019. In the past Visit Malaysia Years, the international traffic growth had been commendable, and the international traffic is likely to get a similar boost from the VMY2020 activities. We also continue to like Air Asia as the company continues enhance its cost structure, along with its efforts of rationalising revenue and cost via digitalisation efforts. Our positive outlook on the AAGB also hinges on: 1) its more prudent hedging policy 2) stable operations with added capacity and 3) continuous improvement to drive its non-airline ancillary business. Meanwhile, the adoption MFRS 16 will be a headwind in the next coming years as the majority of AAGB's fleet are leased. Nonetheless, AAGB is expected to gain from lower amount of interest beyond the fifth year of the lease term. We opine that passenger growth in Malaysia to remain intact despite the departure levy which took effect in September 2019 as the levies gazetted are lower than regional peers such as Thailand and Hong Kong.

PEER COMPARISON TABLE

Stock	FYE	Recommendation	Price @ 20-Jan-20	Target Price (RM)	EPS (sen)		PER (x)		Net DPS (sen)		Net Divd Yield (%)	
					FY19E	FY20F	FY19E	FY20F	FY19E	FY20F	FY19E	FY20F
MAHB	Dec	BUY	7.01	8.98	34.4	38.6	20.4	18.2	14.0	14.0	2.0	2.0
AAGB	Dec	BUY	1.63	2.04	6.0	13.6	27.3	12.0	102.0*	12.0	62.6	7.4
AAX	Dec	NEUTRAL	0.16	0.17	-5	1.1	-3.1	14.1	0.0	0.0	0.0	0.0

Source: Company MIDFR

**-Special dividend*

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.