03 July 2014 | Sector Update

Aviation Sector

Yield to recover in 2H14

Maintain **NEUTRAL**

INVESTMENT HIGHLIGHTS

- **Expect yield to recover modestly by 3-5%yoy in 2H14 due to slower capacity expansion and possible route rationalization exercise.**
- **We have selective BUY call on AirAsia and AirAsia X; NEUTRAL on MAHB and SELL stance on MAS.**
- **Maintain NEUTRAL overall stance on the aviation sector as there is no strong sector catalyst in the horizon.**

Overcapacity dragged down yield. The aviation sector has experienced a steep decline in market yield as a result of the robust capacity expansion of +20%yoy since 2H13. Consequently, the earnings base of the local carriers has been eroded. In addition, the sector also faces other challenges such as the recent fuel price hike due to the situation in Iraq crisis and sluggish demand from China tourists following the MH370 incident.

Airlines turning conservative for the rest of FY14. In order to weather market uncertainties, the majority of the domestic airlines have gone into more conservative approach to maintain their cash levels. Among the strategies deployed by these carriers include delaying fleet deliveries plan, disposal of older aircrafts, aircraft sale and leaseback financing term and possible route rationalization exercise.

Yield may recover modestly in 2H14 due to slower expansion. AirAsia decelerated its expansion pace and lowered the ASK capacity growth from double-digit previously to 3.2%yoy (figure 1) in 1Q14. Its FY14 net delivery of aircrafts will be lower at four aircrafts as compared to last year's eight. MAS still recorded an aggressive expansion of 18.8%yoy (figure 1) in 1Q14 which, in our opinion, is unsustainable in the long run. However, we note that the yield base has shown a sign of stabilizing in 1Q14 (figure 2).

All considered, we now expect the industry's yield to recover modestly by 3-5%yoy in 2H14.

AirAsia (BUY; TP: RM3.14)

The strongest fundamentals. AirAsia appears to have the strongest fundamentals as compared to other local aviation players. The LCC advantages are characterized by its efficient cost structure and innovative ancillary products such as upcoming onboard Wi-Fi service and inflight duty free product sale. The operation of the overseas associates in Indonesia and Philippines, which dragged down its 1Q14 performance, may further improve if the business turnaround plan is successfully carried out.

Reiterate BUY stance. AirAsia stands to benefit from the possible route rationalization from MAS as it give the former more bargaining power to raise its yield base. While most of other LCCs suffered from the negative yield trend and some even faced with closure of operation such as Mandala Tiger but AirAsia is still prevail. Hence, we maintain our BUY AirAsia with unchanged TP of RM3.14. Our valuation is based on 10x PER of FY15.

AirAsia X (BUY; TP: RM0.96)

Launch of Bangkok-Seoul with full load. Thai AirAsia X launched its inaugural flight from Bangkok to Seoul with full load on June 17. The strong market demand suggests that the earnings digestion period may be shorter than expected due to the developed market presence of these two countries. The second destination to be added into the portfolio will be Tokyo.

Maintain BUY stance. Even though AirAsia X started with numerous challenges normally faced by the long haul LCC player, investors should not overlook its long term potential from its superior cost structure and the move towards market yield normalcy. The Australian routes are now its largest source of leakage because of the swelling of capacity by >50%yoy in 1Q14. Nonetheless, it should be able to pare down the losses if MAS decided to rationalize its Australian routes. Hence, we maintain BUY on AirAsia X with unchanged TP unchanged TP of RM0.96. Our valuation is derived from 10x PER of FY15, which is the average of LCC peers.

MAHB (NEUTRAL; TP: RM8.40)

Slowdown in passenger growth in May. MAHB's passenger movement growth was not spared from the MH370 impact and the slowdown in capacity expansion by the domestic carriers. The early signal was evident by the flattening growth of May passenger movement, which was a mere +2%yoy against the double digit growth achieved since February 2013.

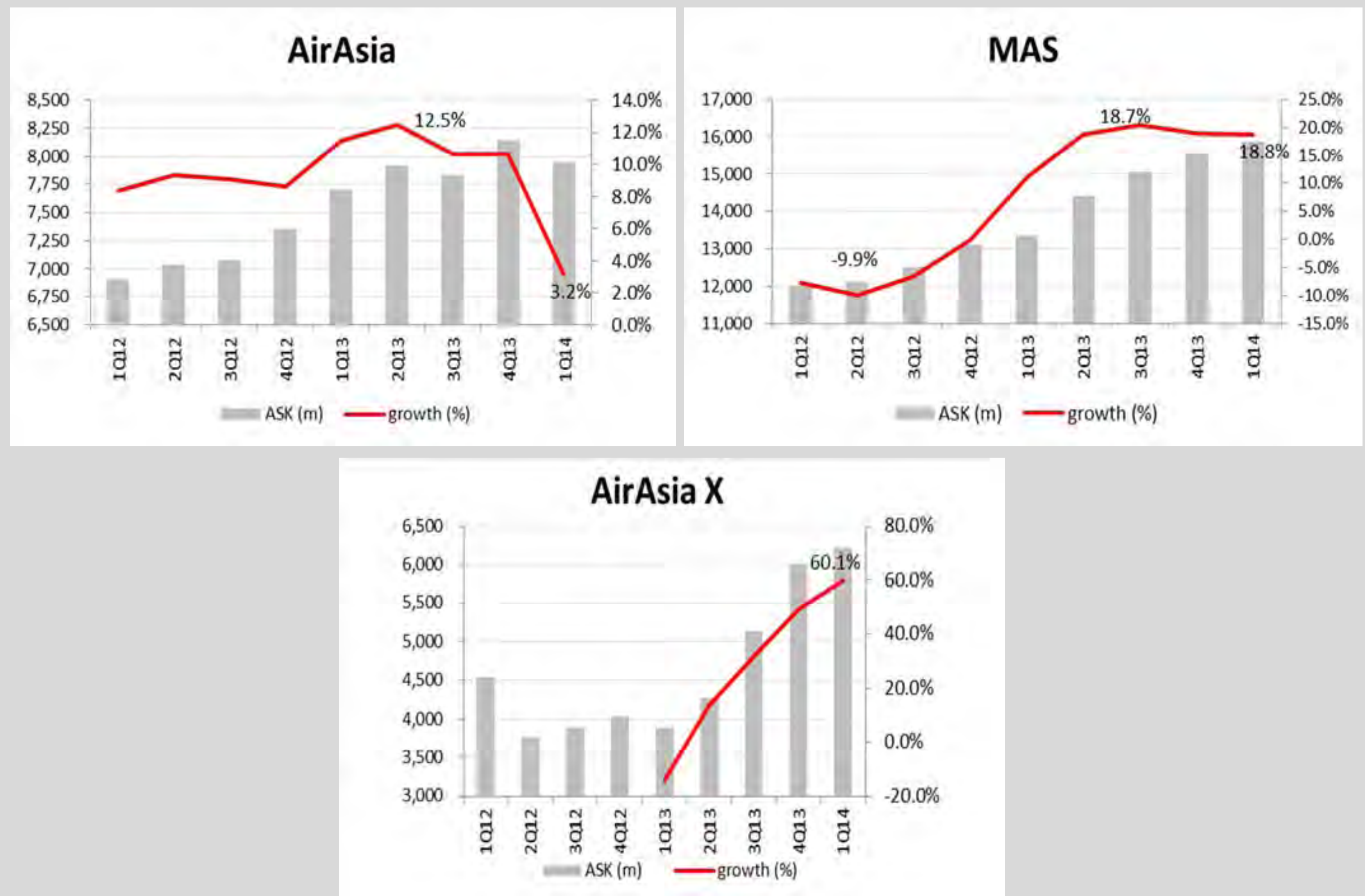
Maintain NEUTRAL stance. The higher operation expenditure upon KLIA2 opening will not be fully covered by the incremental earnings of the operation due to the lower than optimal utilization during the initial years. Its aeronautical revenue is also vulnerable to potential route rationalization by MAS. Hence, we reiterate our NEUTRAL on MAHB with unchanged TP of RM8.40, derived from DCF method with 7.0% of WACC.

MAS (SELL; TP: RM0.18)

Loss may widen. MAS's May monthly operating statistics revealed a sharp decline in international load factor by -10ppt, suggesting the adverse impact of MH370. We believe that its net core loss will rise from 1Q14's RM342m to RM400-500m for the next few quarters.

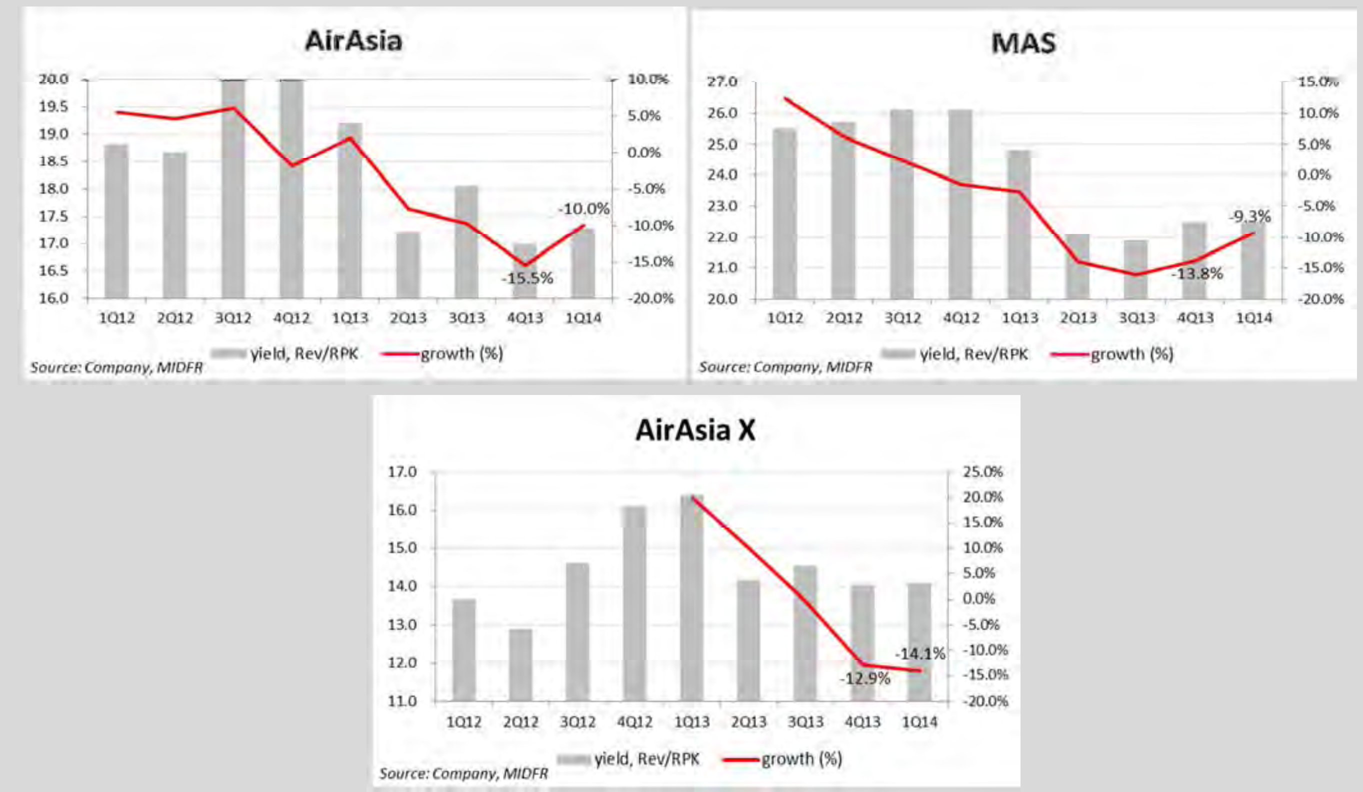
Maintain SELL stance. We believe that the management is looking at other measures to complement its "yield-passive, load-active" approach in managing its mounting losses. It is likely that sweeping changes of the MAS business structure and route rationalization exercise are on the cards. Until the future is clearer, we reiterate our SELL on MAS with unchanged TP of RM0.18, based on 0.9x FY14-P/BV.

Figure 1: Capacity ASK growth



Source: Companies, MIDFR

Figure 2: Yield trend, Rev/RPK



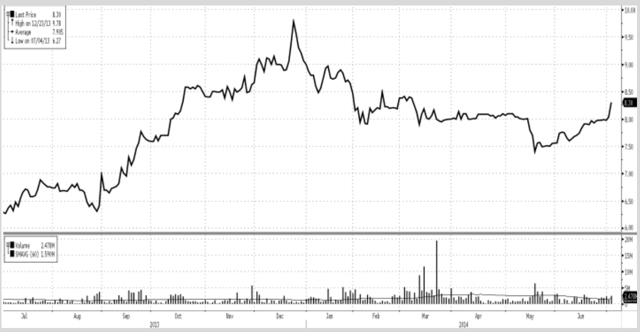
Source: Companies, MIDFR

DAILY PRICE CHART

AirAsia

AirAsia X

MAHB



MAS

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STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	*Negative* total return is expected to be -15% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% 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.