

Analyst: Kelvin Li

**AIR CHINA LIMITED** (中國國航)

Sector	: Transportation	Acting Chairman	: KONG Dong
Stock Code	: 0753	President	: CAI Jianjiang
Market Price	: HK\$5.24 (18/03/2008)		
HSI	: 21,384.61 (18/03/2008)		
H Shares Issued	: 4,405.683 million		
H-share Market Cap	: HK\$23,085.78 million		
52-week Hi / Lo	: HK\$12.72 / HK\$5.10		

**SUMMARY OF THE FINAL RESULTS FOR THE YEAR ENDED 31<sup>ST</sup> DECEMBER 2007**
**Final Results Highlights**

	FY2007	FY2006	Change
	RMB million	RMB million	
• Turnover	51,331	44,937	+14.2%
• Operating expenses	(47,496)	(42,419)	+12.0%
• Operating profit	3,834	2,518	+52.3%
• Net finance gain/ (charge)	407	(699)	-158.3%
• Gain from the disposal of an associate	-	1,593	-100.0%
• Share of profits of associated companies	1,365	518	+163.7%
• <b>Profit attributable to shareholders</b>	<b>4,229</b>	<b>2,688</b>	<b>+57.3%</b>
• EPS – Basic	RMB0.3560	RMB0.2620	+35.9%
• Final DPS	RMB0.0684	RMB0.0492	+39.0%
• Total DPS	RMB0.0684	RMB0.0492	+39.0%
<b>Traffic (Air China Group)</b>			
• Revenue passenger kilometres (RPK)	70,026 million	N/A*	+10.5%
• Passengers carried – <i>Air China Ltd.</i>	34.8 million	31.5 million	+10.6%
• Revenue freight tonne kilometres (RFTK)	3,880 million	N/A*	+11.4%
• Freight carried (tonnes) – <i>Air China Ltd. &amp; Air China Cargo</i>	934,000	N/A	+10.6%
• Freight carried (tonnes) – <i>Air China Cargo</i>	274,000	238,000	+15.3%
<b>Capacity (Air China Group)</b>			
• Available seat kilometres (ASK)	89,234 million	83,492 million	+6.9%
• Passenger load factor	78.47%	75.89%	+2.59 pct pts
• Passenger yield	RMB0.62	RMB0.59	+5.1%
• Available freight tonne kilometres (AFTK)	6,868 million	6,404 million	+7.2%
• Freight load factor	56.4%	54.3%	+2.13 pct pts
• Freight yield	RMB1.98	RMB2.16	-8.3%
• Available tonne kilometres (ATK)	14,939 million	N/A*	+7.0%

Remark: (\*) Air China did not provide the actual FY06 operational figures for Air China Group (Air Macau &amp; Air China Cargo inclusive)

- Air China Group (including also Air Macau, Air China Cargo and other subsidiaries) reported a robust 57.3% y-o-y rise in net profit to RMB4.23 billion for FY07 despite the absence of a disposal gain, thanks to strong passenger traffic growth, profit from its 17.5%-owned Cathay Pacific Airways (HKEx: 0293) and foreign exchange gain.

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- Turnover of Air China grew 14.2% y-o-y to RMB51.3 billion in FY07, driven by a 16.2% rise in passenger service revenue to RMB43.6 billion.
- Operating expenses rose 12.0% y-o-y to RMB47.5 billion, mainly driven by a surge in jet fuel expenses and employee compensation costs. Jet fuel costs rose a contained 9.4% y-o-y in FY07 and accounted for 36.2% of total operating expenses, down from 37.0% in FY06. However, due to a 20.8% rise in employee-related costs and a 33.7% jump in selling & marketing expenses, the Group's unit cost per ATK inched up to RMB3.18 in FY07 from RMB3.04 in FY06.
- All in all, operating profit rose a sharp 52.3% y-o-y to RMB3.8 billion, while its operating margin increased by 1.87 percentage points to 7.47% in FY07 from 5.60% a year earlier.
- EPS for FY07 was RMB0.356, up 35.9% y-o-y from RMB0.262 a year earlier. A final dividend of RMB0.0684 was proposed (FY06: RMB0.0492), bringing the payout ratio at 19.2% (FY06: 18.8%).
- According to Air China, price impact accounted for a RMB383 million rise in jet fuel costs and the remaining RMB1.1 billion was due to volume growth. The Group reported a jet fuel hedging gain of RMB235.9 million in FY07, up 108.4% from RMB113.2 million in FY06. Along with a passenger jet fuel surcharge of RMB4.2 billion (Domestic: RMB2.2 billion, International & regional: RMB2.0 billion) (FY06: RMB3.6 billion), the jet fuel hedging measures has worked effectively to protect the Group from rising energy prices.
- As at 31/12/2007, the Group had total debts of RMB43.1 billion (31/12/2006: RMB37.4 billion). Along with RMB4.0 billion (31/12/2006: RMB5.4 billion) cash on hand, net debt-to-equity ratio of Air China surged to 137.2% as at the end of FY07 from 125.3% as of 31/12/2006. Overall, 68.5% of Air China's debt and other financial obligations were denominated in US dollars as at the end of FY07.

### **Business Highlights**

- **Passenger revenue breakdown by geographical segments:**

<i>(RMB million)</i>	FY2007	%	FY2006	%	Change
Domestic	23,486	53.8%	20,051	53.4%	+17.1%
Hong Kong & Macau	2,289	5.2%	2,239	6.0%	+2.2%
Europe	6,438	14.8%	5,146	13.7%	+25.1%
North America	3,680	8.4%	2,786	7.4%	+32.1%
Japan & Korea	4,174	9.6%	3,891	10.4%	+7.3%
Other Regions in Asia	3,565	8.2%	3,452	9.2%	+3.3%
<b>Total</b>	<b>43,632</b>	<b>100.0%</b>	<b>37,565</b>	<b>100.0%</b>	<b>+16.2%</b>

- Revenue from **passenger services** increased 16.2% y-o-y to RMB43.6 billion, thanks to a 10.5% jump in passenger traffic in terms of RPK and a 5.1% y-o-y rise in passenger yield to RMB0.62. Passenger load factor was 78.47%, up 2.59 percentage points from FY06. The number of passengers carried by Air China grew 10.6% y-o-y to 34.8 million.
- Revenue from **cargo and mail services** rose a tepid 1.1% to RMB4.1 billion in FY07, accounting for 8.0% (FY06: 9.0%) of the Group's total. In fact, due to intensifying competition in the Mainland, the Group's cargo yield dropped 8.3% y-o-y to RMB1.98 in FY07 but improved from RMB1.84 in 1H07. Volume growth remained healthy with its RFTK up by 11.4% y-o-y to 3.9 billion tonne km.
- In geographical terms, the **domestic** segment continued to grow favourably, with revenue up 17.1% y-o-y to RMB23.5 billion, accounting for 53.8% (FY06: 53.4%) of the Group's total. Revenue from the **international** segment grew a robust 16.9% y-o-y to RMB17.9 billion, accounting for 40.9% (FY06: 40.7%) of the Group's total, mainly driven by strong growth in the Europe and the Northern America markets. Revenue from the **regional** segment (Hong Kong and Macau) reported an unexciting 2.2% y-o-y increase to RMB2.3 billion. Overall, passenger load factors for the three regions (domestic, international & regional) were up by 3.3 ppts, 1.8 ppts and 1.9 ppts to 80.2%, 77.1% and 72.1%, respectively, last year.



## Outlook & Prospect

- **Jet fuel hedging measures proved effective** Air China has been engaged in jet fuel hedging since 2001. The Group's FY07 results showed once again that its hedging measures (financial derivatives hedging and jet fuel surcharges) have worked effectively in offsetting rising jet fuel costs.
- **Rising employee-related expenses raises concerns** Financial hedging and jet fuel surcharge helped maintain healthy profit margins of Air China despite rising crude oil prices. Nonetheless, employee compensation costs kept rising over the last couple of years due to a rise in general salary level and competition among airlines for staff recruitment. Nonetheless, we see it as a normal part of Air China operations, as passenger load factor and yield continue to improve amid robust air traffic demand and pursuit of better service quality.
- **Selling & marketing expenses seen retreating in FY08** Selling and marketing expenses surged a high 33.7% y-o-y in FY07. The Group management said most of which was related to the joining of Star Alliance, and it is expected to return to normal level in FY08.
- **Joining Star Alliance** Air China has joined Star Alliance, the world's largest airline alliance, in late 2007. The Group is expected to benefit from the expanded international coverage and the enhanced exposure to larger corporate clients and frequent flyers worldwide. According to management, Air China saw a good contribution from the Star Alliance membership in January-February 2008, and it expects the membership should help boost passenger revenue by at least RMB900 million this year (about 5% of the FY07 international passenger revenue). Leveraging on the Star Alliance platform, the Group hopes to further strengthen its international business in coming years.
- **Growing premier class business** In order to enhance passenger yield and revenue, Air China has been putting efforts in developing its premier (First & Business) class business. For FY07, revenue from the First and the Business classes amounted to RMB5.07 billion, up a sharp 33.8% from FY06 and accounting for 11.6% (FY06: 10.1%) of the Group's total passenger revenue. The premier class business is expected to keep growing fast in the next couple of years, as demand for better service is seen growing further amid a robust Mainland economy.
- **Long-haul routes (Europe & N. Americas) turns profitable** Air China revealed that efforts in adjusting routes and resources in the European and the North American markets have paid off last year, and the overall business from the two long-haul markets turned profitable in FY07.
- **Raising stake in Air China Cargo** Despite the weak performance of the cargo segment, the Group said it is still keen on buying additional stake in Air China Cargo. Earlier this year, Air China completed the purchase of a 25% interest in Air China Cargo from CITIC Pacific, raising its holding in Air China Cargo to 76%. Management reveals that Air China is in talks with Beijing Capital International Airport to buy out the remaining 24% equity interest. Meanwhile, the Company's chairman Mr. Kong Dong reveals that Air China plans to move its cargo hub to Shanghai from Beijing, paving way for the set-up of a cargo joint venture with Cathay Pacific. Kong also sees better future development in its cargo segment to be based in Shanghai.
- **Higher capex for FY08** The Group has earmarked a capital expenditure of RMB18.0 billion, up 17.5% from FY07. About two-third of which would be used for aircraft purchase and the remaining for other plans like investment in the Terminal 3 of Beijing Capital International Airport. Air China plans to order 24 aircraft in 2008 and another 40 in 2009-2010, and it will focus on the A320 and the B737 models. Proceeds from the planned A-share issue (no more than 400 million A shares) this year would be used for partly funding the aircraft purchase.
- **Effective fuel hedging & strong business outlook – BUY** Air China delivered a set of strong results in its FY07 final results. A possible recession in the US has drawn some concerns over a slowdown in Air China's international segment. However, the fact is that traffic in Air China's international routes stayed robust in Jan-Feb 2008. Trading at 11.7x FY08E P/E and 10.2x FY09E P/E, the counter's valuation has become more attractive after recent share price weakness. Accordingly, we recommend a "BUY" on the counter.

## **Recommendation: BUY**



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