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HONG KONG RESEARCH
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AIR CHINA LIMITED (中國國航)

Sector	:	Transportation	Chairman	:	LI Jiaxiang
Stock Code	:	0753			
Market Price	:	HK$9.06 (29/08/2007)	President	:	CAI Jianjiang
HSI	:	23,020.60 (29/08/2007)			
H Shares Issued	:	4,405.683 million			
H-share Market Cap	:	HK$39,915.5 million			
52-week Hi / Lo	:	HK$9.20 / HK$2.69			

SUMMARY OF THE INTERIM RESULTS FOR THE SIX MONTHS ENDED 30TH JUNE 2007

Interim Results Highlights

	1H2007 RMB million	1H2006 RMB million	*Change*
• Turnover	23,353	19,931	*+17.2%*
• Operating expenses	(21,986)	(19,038)	*+15.5%*
• Operating profit	1,367	893	*+53.0%*
• Net finance gain/ (charge)	227	(341)	*-166.6%*
• Share of profits of associated companies	479	108	*+344.1%*
• **Profit attributable to shareholders**	**1,569**	**458**	***+242.5%***
• EPS – Basic	RMB0.1320	RMB0.0490	*+169.4%*
• Interim DPS	-	-	*N/A*
Traffic (Air China Group)			
• Revenue passenger kilometres (RPK)	33,286 million	N/A*	*14.4%*
• Passengers carried	17.9 million	N/A*	*13.7%*
• Revenue freight tonne kilometres (RFTK)	1,867 million	N/A*	*19.2%*
• Freight carried (tonnes)	535,717	N/A*	*15.3%*
Capacity (Air China Group)			
• Available seat kilometres (ASK)	43,891 million	N/A*	*11.3%*
• Passenger load factor	75.84%	N/A*	*2.04 pct pts*
• Passenger yield	RMB0.59	N/A*	*4.7%*
• Available freight tonne kilometres (AFTK)	3,515 million	N/A*	*22.4%*
• Freight load factor	52.5%	N/A*	*-1.5 pct pts*
• Freight yield	RMB1.84	N/A*	*-12.6%*
• Available tonne kilometres (ATK)	7,485 million	N/A*	*16.2%*

Remark: (*) Air China did not provide with the actual 1H06 operational figures for Air China Group (Air Macau & Air China Cargo inclusive).

- Air China Group (including also Air Macau, Air China Cargo and other subsidiaries) reported a stunning 242.5% y-o-y rise in net profit to RMB1.57 billion for 1H200, thanks to strong passenger traffic growth, profit contribution from its 17.5%-owned Cathay Pacific Airways (HKEx: 0293) and foreign exchange gain. EPS for 1H07 was RMB0.132, up 169.4% y-o-y from RMB0.049 a year earlier, being diluted by the Group's A-share issue in August 2006.

- Turnover grew 17.2% y-o-y to RMB23.4 billion in 1H07, driven by a 19.8% rise in service revenue from passenger traffic to RMB19.8 billion.

- The Group's operating expenses rose 15.5% y-o-y to RMB22.0 billion in the first half, mainly driven by a surge in jet fuel expenses amid a strong traffic volume growth. In fact, jet fuel costs rose a contained 13.9% y-o-y during 1H07, which helped bring down the unit cost per ATK to RMB2.94 from RMB3.04 in FY06. As a result, operating profit rose a sharp 53.0% y-o-y to RMB1.37 billion, while its operating margin increased by 1.37 percentage points to 5.85% in 1H07 from 4.48% a year earlier.

- The Group reported a jet fuel hedging gain of RMB304.6 million during the first half, down 9.9% from RMB338.1 million a year earlier. Along with a jet fuel surcharge of RMB2.85 billion (Domestic: RMB1.1 billion, International: RMB1.5 billion & Regional: RMB35 million) during the first half, the jet fuel hedging measures has worked effectively to protect the Group from rising energy prices.

- As at 30/06/2007, the Group had total debts of RMB40.7 billion (31/12/2006: RMB37.4 billion). Along with RMB4.2 billion (31/12/2006: RMB5.4 billion) cash on hand, net debt-to-equity ratio of Air China surged to 139.4% as at the end of 1H07 from 125.3% as of 31/12/2006.

Business Highlights

- **Turnover breakdown by geographical segments**:

	1H2007		1H2006		
	RMB million	%	RMB million	%	Change
Domestic	12,497	53.5%	10,759	54.0%	*+16.2%*
Hong Kong & Macau	1,317	5.6%	1,285	6.4%	*+2.5%*
Europe	3,224	13.8%	2,477	12.4%	*+30.2%*
North America	2,154	9.2%	1,595	8.0%	*+35.1%*
Japan & Korea	2,199	9.4%	2,116	10.6%	*+3.9%*
Other Regions in Asia	1,962	8.4%	1,698	8.5%	*+15.5%*
Total	**23,353**	**100.0%**	**19,931**	**100.0%**	***+17.2%***

- Revenue from **passenger services** increased 19.8% y-o-y to RMB19.8 billion in 1H07, thanks to a 14.4% jump in passenger traffic in terms of RPK and a 4.7% y-o-y rise in passenger yield to RMB0.59. Passenger load factor was 75.84%, up 2.04 percentage points from a year earlier. In 1H07, Air China carried 17.9 million passengers, up 13.7% from a year earlier.

- Revenue from **cargo and mail services** rose a tepid 1.2% y-o-y to RMB1.9 billion in 1H07, accounting for 8.8% of the Group's air traffic revenue and 8.2% of the total, down from 10.3% and 9.5% in 1H06, respectively. In fact, due to intensifying competition in air cargo business in the Mainland, the Group's cargo yield dropped a sharp 12.6% y-o-y in 1H07 to RMB1.84. Volume growth remained healthy during the first half, with its RFTK up by 19.2% y-o-y to 1,867 million tonne km.

- In geographical terms, the **domestic** segment continued to grow favourably, with revenue up 16.2% y-o-y to RMB12.5 billion, accounting for 53.5% (1H06: 54.0%) of the Group's total. Revenue from the **international** segment (N. America, Europe, Korea, Japan and other SE Asia regions) grew a robust 20.9% y-o-y to RMB9.5 billion in 1H07, accounting for 40.8% (1H06: 39.6%) 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 2.5% y-o-y increase to RMB1.3 billion in 1H07, amid sluggish passenger volume growth and take-up. It may be partly due to the fact that some of the clients have moved to sister airlines like Cathay and Dragonair. Overall, passenger load factors for the three regions (domestic, international & regional) were up by 2.2, 2.0 and down 0.2 ppts to 77.8%, 74.1% and 66.8% respectively in the first half.

Outlook & Prospect

- ***Effective hedging measures help contain threat from volatile oil prices*** The Group has been engaged in jet fuel hedging since 2001. During the last couple of years, the Group's results showed that its hedging measures (financial derivatives hedging and jet fuel surcharges) have worked effectively in offsetting rising prices on the overall jet fuel costs. For the time being, we see jet fuel cost no longer a major threat to the Group's operations.

- ***Strict cost control to bring down unit cost further*** Strict cost control during the first half also helped contain the Group's unit cost despite rising jet fuel expenses. In the first half of 2007, cost per ATK was RMB2.94, down from RMB3.04 in FY06. For the second half, Management of the Group expects the unit cost ex jet fuel expense would fall further, amid continued efforts in cost control. Meanwhile, higher traffic volume and increased capacity should also bring in cost synergies and drive down the unit cost.

- ***Government's traffic control at Beijing Airport has minimal negative impact*** The General Administration of Civil Aviation of China (CAAC) ordered airlines to cut the number of flights taking off from the Beijing Capital International Airport, the home base of Air China, as an attempt to boost industry efficiency and ease traffic congestion in the airport. Air China revealed that it has been ordered to cut 10 flights a day from the airport, but the overall impact has been positive from the latest control measures. First, it strengthened efficiency and service quality by reducing air traffic congestion. Besides, it also boosted passenger yield, as travellers' demand remained strong. The Group said, since the implementation of the government control in mid-August, its passenger yield per RPK has grown by 5%-10%.

- ***Passenger yield seen further improving amid strong demand for better service*** The Group's passenger yield improved by a solid 4.7% y-o-y during the first half, driven by a 9.3% jump in the yield of international routes. In fact, the Group's encouraging yield enhancement in 1H07 was also supported by rising demand for premium-class passenger service. For the first half, revenue from business and first classes grew 34.7% y-o-y to RMB2.24 billion, accounting for 11.3% (1H06: 8.5%) of the Group's passenger revenue. Given a booming Mainland economy and rising business tie with other international destinations, we should see persistent growth in the demand for premium class services, which should further boost the Group's passenger yield in the future.

- ***Cargo segment – the only weak point*** Volume growth in Air China Cargo was strong in the first half. However, due to lower yields on severe industry competition, contribution from the segment was not satisfactory and it was still making losses in 1H07. To overcome this, the Group plans to sell oil cargo aircraft (with age of over 20 years) to enhance operational efficiency. Besides, it will also strengthen yield management via the set-up of a cargo yield department and route optimisation. For instance, the Group has cut three US cargo flights and reallocated capacity to Europe and other regions. The Group expects cargo business in both markets to break even by the end of this year.

- ***July operational figures show resilience*** The passenger segment of Air China performed strongly in July. Despite a 4.7% y-o-y rise in passenger capacity, Air China's passenger load factor surged to 81.5% in July 07, which helped lift the accumulative load factor for Jan-Jul 2007 by 1.8 percentage points y-o-y to 76.7%. Besides, the national flag air carrier carried a total of 3.2 million passengers during the month, setting a new monthly passenger traffic record.

- ***Still a long-time winner in Mainland's aviation industry*** Air China's first-half results demonstrated once again its strong competitive edge and leading position in the Mainland aviation industry. We expect a better full-year result, as its operation is proceeding well during its peak season (July-October) in the second half. Trading at 31x FY07E P/E and 26x FY08E P/E, the counter's valuation has largely priced in the strong set of interim results. However, we expect the operational figures in the next couple of months to stay robust, like those in July 07, which should continue to support its share prices. Accordingly, we recommend a "Hold" on the counter.

Recommendation: HOLD

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