

**BEA securities**

EAST ASIA SECURITIES COMPANY LIMITED

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**HONG KONG RESEARCH****3<sup>rd</sup> December 2004**

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**Main Board Listing - Research**

中國國際航空股份有限公司  
Air China Limited [Stock Code: 0753]

**Joint Global Coordinators, Joint Bookrunners, Joint Lead Managers and Joint Sponsors** : China International Capital Corporation Limited (CICC) Merrill Lynch Far East Limited

**Sector** : Airlines**Business** : Air passenger, air cargo and airline-related services provider

<b>Total share offer:</b> <u>2,805,680,000</u> H shares <b>(31% of the enlarged share capital)</b>  <b>Public Offer:</b> 280,568,000 H shares (10%) <b>Placing:</b> 2,525,112,000 H shares (90%)  <b>Greenshoe:</b> 420,852,000 H shares	<b><u>Business of Air China</u></b>  The Group is the national flag carrier of China and a leading provider of air passenger, air cargo and airline-related services in China. Air China is based in Beijing, with the largest share of air transportation business at the country's busiest Beijing Capital International Airport.  According to data from the General Administration of Civil Aviation of China (CAAC), the Group is the largest commercial airline company in China in terms of RTKs flown (30.4% of the total in the industry in 2003) and the largest air cargo services provider in terms of RFTKs flown (38.1% of the total in the industry in 2003).  As of 30 <sup>th</sup> June 2004, the Group operated a fleet of 136 aircraft, of which 130 were passenger aircraft, 5 freighters and 1 corporate jet aircraft, serving 69 domestic and 34 international and regional destinations. For the six months ended 30 <sup>th</sup> June 2004, revenue from domestic routes (including HK and Macau) accounted for 57% of the total while that from international and regional service accounted for the remaining 43%.  Besides its core business, the Group has also equity interests in various airlines and airline-related businesses, including Air China Cargo, Air Macau, Dragonair, Shandong Airlines, Shenzhen Airlines, etc.
<b>Price:</b> HK\$2.35 – HK\$3.10 per share <b>Market Cap.:</b> HK\$21.269 billion – HK\$28.057 billion  <b>Forecast FY2004 P/E:</b> 9.8x – 12.9x (Pro forma fully diluted)  <b>Adjusted NTA per share:</b> HK\$1.56 – HK\$1.76  <b>Staffing:</b> 26,935 (as of 30 <sup>th</sup> June 2004)	
<b>HK Public Offer period:</b> 3 <sup>rd</sup> December 2004 - 8 <sup>th</sup> December 2004  <b>Receiving bank:</b> HSBC Standard Chartered Bank ICBC (Asia)  <b>Share registrar:</b> Computershare Hong Kong Investor Service Limited  <b>Listing date:</b> 15 <sup>th</sup> December 2004	

**Major Shareholders after Listing** (Assuming the over-allotment option is not exercised)

China National Aviation Holding Company (CNAHC)	53.65%
China National Aviation Corporation (Group) Limited (CNACG)	15.35%
Cathay Pacific Airways Limited (HKEx: 0293)*	10.00%
	<u>79.00%</u>

\*Cathay Pacific Airways, as the Strategic Investor, will subscribe 905,061,818 H shares or 10% of the total issued share capital immediately following the completion of the offering.

*This report has been prepared solely for information purposes and we are not soliciting any action based upon it. Neither this document nor its contents shall be construed as an offer, invitation, advertisement, inducement or representation of any kind or form whatsoever. The information is based upon information, which we consider reliable, but accuracy or completeness is not guaranteed. Opinions expressed herein are subject to change without notice. At time of this report, East Asia Securities Company Limited has no position in securities of the company or companies mentioned herein.*

### Use of Proceeds

Net proceeds from the offer are estimated to be HK\$6,522 million

(Assuming the over-allotment option is not exercised, and at an issue price of HK\$2.725 each, which is the mid-point of the indicative price range)

	RMB million
To acquire ten Airbus 319 aircraft and four Boeing 737-700 aircraft	4,800
To repay debts that will mature in one year and to supplement the Group's cash flow	1,722

### Financial Highlights

	Year ended 31 <sup>st</sup> December			6 months ended
	2001	2002	2003	30 <sup>th</sup> June 2004
	RMB in million	RMB in million	RMB in million	RMB in million
Revenue	22,736	24,984	24,641	15,311
Operating profit / (loss)	3,286	3,284	2,284	1,827
Net profit / (loss)	948	500	160	788
EPS - Basic	RMB0.146	RMB0.077	RMB0.025	RMB0.121

### Breakdown of Revenue by Business Segments

	Year ended 31 <sup>st</sup> December						6 months ended	
	2001		2002		2003		30 <sup>th</sup> June 2004	
	RMB in million	%	RMB in million	%	RMB in million	%	RMB in million	%
Airline operations	22,217	97.7	24,436	97.8	23,910	97.0	14,949	97.6
Engineering services	605	2.7	705	2.8	772	3.1	443	2.9
Airport terminal services	162	0.7	180	0.7	251	1.0	130	0.8
Others	285	1.3	352	1.4	321	1.3	174	1.1
Eliminations	(532)	(2.3)	(689)	(2.8)	(613)	(2.5)	(385)	(2.5)
Revenue	<u>22,736</u>	100.0	<u>24,984</u>	100.0	<u>24,641</u>	100.0	<u>15,311</u>	100.0

### Breakdown of Revenue by Geographical Segments

	Year ended 31 <sup>st</sup> December						6 months ended	
	2001		2002		2003		30 <sup>th</sup> June 2004	
	RMB in million	%	RMB in million	%	RMB in million	%	RMB in million	%
Domestic	11,609	51.1	11,867	47.5	12,926	52.5	7,865	51.4
HK/Macau	1,992	8.8	2,018	8.1	1,573	6.4	893	5.8
Europe	2,511	11.0	3,486	14.0	3,548	14.4	2,032	13.3
North America	1,491	6.6	2,254	9.0	2,336	9.5	1,505	9.8
Japan/Korea	3,020	13.3	3,081	12.3	2,287	9.3	1,566	10.2
Asia Pacific, others	2,112	9.3	2,277	9.1	1,971	8.0	1,450	9.5
Revenue	<u>22,736</u>	100.0	<u>24,984</u>	100.0	<u>24,641</u>	100.0	<u>15,311</u>	100.0

**Strengths/Opportunities**

- ✓ Beijing Capital International Airport, where the Group based in, is the busiest airport in China. In 2003, there were 233,776 landings or takeoffs from the Beijing Capital International Airport. It accounted for 11.0% of the country total in that year, outweighing Guangzhou Baiyun International Airport in the second place with a share of 6.7%. In terms of passenger throughput, Beijing Capital International Airport is also the industry leader with a share of 13.9% of the total. Leveraging the leading status of the airport, Air China is well positioned to capture business opportunities arising from the fast-growing air travel market in China as well as to maintain its leadership in the aviation industry.
- ✓ The Group has a diversified route network, with about 50%-60% of total revenue derived from the PRC (including HK and Macau) and the remaining portion from international destinations.
- ✓ In 2003, the Group became the first and so far the only major Chinese airline group to complete its operational integration under the government's plan to consolidate the aviation industry in 2002. Business integration helped promote the Group operational efficiency as well as capability to counteract adverse market changes. For instance, the Group managed to stay in profit in 2003, when SARS had dampened the sector and caused other major Chinese airlines to run into operational losses.
- ✓ The Group achieved sound results in the last couple of years, not only in terms of basic operational figures like the number of passengers carried and the distance travelled, but also in terms of efficiency and profitability. The Group's passenger load factor has been growing steadily from 61.9% in 2001 to 68.6% in 1H2004. Besides, the Group also achieved higher-than-average operating margins during the last three years. The figure dropped below 10% only in 2003 when margins of other major peers even tumbled below 3%, showing relative strength of the Group.
- ✓ Beijing city will host the Olympic Games in 2008. This international event should further enhance Beijing as a major air transportation hub in China and strengthen the brand name of Air China.
- ✓ Shares of Air China are priced at 10x-12x FY2004E P/E, of which the valuations are not demanding relative to the peers (China Southern Airlines (HKEx: 1055): 23x FY2004E P/E; China Eastern Airlines (HKEx: 0670): 13x FY2004E P/E).

**Weaknesses/Threats**

- × As of 30<sup>th</sup> June 2004, about 22% of the Group's total debt was short-term debt, which is exposed to prevailing market interest rates. Any further rate hike in China may increase the Group's finance cost.
- × As of 30<sup>th</sup> June 2004, the Group had total outstanding debt of RMB34.8 billion, implying a debt-to-equity ratio of 3.4 times. The ratio is significantly higher than China Southern Airlines' 1.8 times but more or less similar to that of China Eastern Airlines' 3.4 times. The Group plans to use HK\$1.722 billion raised from the offer to repay short-term debt. However, the total debt would only be slightly reduced and the Group's debt-to-equity ratio would remain close to 3 times at the end of current year.
- × The Group budgeted capital expenditure of RMB18.697 billion through 2006, which may reduce free cash flows and accordingly the amount of dividend paid. Nonetheless, the Group's management planned to set the dividend payout ratio at about 10-15% in the future.
- × Jet fuel cost accounts for nearly 25% of operating expense of the group. Fuel price and supply scarcity should keep posing threats to the Group and the overall aviation industry. However, the threat of high energy cost seemed to lessen a bit after a sharp fall in international crude oil prices in early December.

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