

Malaysia Aviation

NEUTRAL

 (Unchanged)

It gets serious

- MAS' second capacity cuts will create a new equilibrium to the market supply-demand.
- Expect industry load factor and yields to rise significantly from Aug 2015 onwards.
- Maintain BUY on AirAsia; sector recovery is well underway.

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What's New

Malaysia Airlines (MAS) is believed to have launched the second wave of route and capacity cuts, based on our channel checks. These changes are expected to take effect from Aug 2015.

What's Our View

The first wave of route cuts (Kuala Lumpur to Frankfurt, Krabi, Kochi and Kunming) was immaterial and has no noticeable impact on AirAsia and Malindo Air.

However, the impact of the upcoming second wave should be more pronounced with frequency reductions on several regional routes and termination of two routes (Kuala Lumpur to Brisbane and Male). As this will take place in Aug, we believe that yields will quickly move up from thereon.

We believe MAS will have to announce even more route cuts and capacity reduction due to its extensive headcount reduction which involves 6,000 employees by end-Aug 2015. This will benefit the industry to weed out excess capacity, cut wastages, boost load factor and reverse the declining yield trend.

The biggest beneficiary is AirAsia (AIRA MK, BUY) as it has the most route overlap with MAS, followed by Malindo Air (Not Rated), AirAsia X (AAX MK, HOLD) and to a lesser extend Cebu Pacific (CEB PM, BUY). For Malaysia Airports (MAHB MK, HOLD) however, this development is not positive as it will reduce its traffic volume.

Media sector - Peer valuation summary

Stock	Rec	Shr px MYR	Mkt cap MYR m	TP MYR	PER (x)			P/BV (x)		ROE (%)		Net yield (%) CY15F
					CY14A	CY15F	CY16F	CY14A	CY15F	CY14A	CY15F	
AirAsia	Buy	1.60	4,452.8	2.45	11.0	5.9	6.3	1.0	0.8	8.9	13.5	0.0
AirAsia X	Hold	0.23	933.3	0.30	n.a.	6.1	3.9	0.8	0.6	(58.3)	9.9	0.0
MAHB	Hold	6.20	10,287.0	6.75	55.9	64.6	32.6	1.1	1.0	2.0	1.5	0.6

Source: Maybank KE

MAS' capacity cuts will shift the equilibrium

The airline industry is a very competitive industry. Any changes in the number of flights will quickly shift the supply-demand dynamics and greatly impact on overall load factor and yields. There is a fine equilibrium and it will quickly shift whenever any of the variables have been altered.

First wave of route cuts was immaterial

MAS has already cancelled four flights in 2Q15 as shown in the table below. The overall impact wasn't meaningful as these are thin routes with only a handful of players. Nonetheless, AirAsia and Malindo Air did benefit slightly from this first wave.

MAS first wave capacity cuts

Routes	Effective date	Frequency	Impact
Kuala Lumpur to Frankfurt	29-May-2015	7x week	Positive for Lufthansa
Kuala Lumpur to Kunming	30-Apr-2015	4x week	No impact, exclusive to MAS
Kuala Lumpur to Krabi	6-May-2015	14x week	Positive for AirAsia
Kuala Lumpur to Kochi	1-Jun-2015	7x week	Positive for AirAsia and Malindo Air

Sources: MAS, Maybank KE

Second wave of route cuts gets more serious

The second wave of route cuts is more directed towards the regional and Australian routes. This intersects with AirAsia, AirAsia X and Malindo Air's portfolios directly. Thus, we believe there will be a shift in market equilibrium and load factor and yields are likely to rise for the three carriers. The quantum of impact will vary according to how big and how well served the route is.

MAS second wave capacity cuts

Routes	Effective date	Action	Impact
Kuala Lumpur to Brisbane	9-Aug-2015	Terminate	Positive for AirAsia X's Gold Coast flight
Kuala Lumpur to Guangzhou	15-Aug-2015	Reduce frequency (2x to 1x daily)	Positive for AirAsia and China Southern
Kuala Lumpur to Ho Chi Minh	15-Aug-2015	Reduce frequency (4x to 3x daily)	Slight positive for AirAsia and Vietnam Air, very dense market
Kuala Lumpur to Hong Kong	15-Aug-2015	Reduce frequency (4x to 3x daily)	Slight positive for AirAsia and Cathay Pacific, very dense market
Kuala Lumpur to Male	23-Aug-2015	Terminate	Nobody flies direct to Male after this
Kuala Lumpur to Manila	15-Aug-2015	Reduce frequency (5x to 4x daily)	Slight positive to AirAsia and Cebu Pacific, very dense market
Kuala Lumpur to Perth	15-Aug-2015	Reduce frequency (12x to 7x weekly)	Neutral, Malindo Air will launch new daily services to Perth and therefore negating any positive impact from MAS's cut.
Kuala Lumpur to Siem Reap	17-Aug-2015	Reduce frequency (7x to 5x weekly)	Very positive for AirAsia, only two airlines serving this route.
Kuala Lumpur to Taipei	15-Aug-2015	Reduce frequency (2x to 1x daily)	Slight positive for AirAsia X and EVA Air
Kuala Lumpur to Yangon	18-Aug-2015	Reduce frequency (14x to 11x weekly)	Positive for AirAsia and Myanmar Airways

Sources: MAS, Maybank KE

There will be more

We think there will be more route cuts to be announced in the coming months because the vast headcount cut at MAS will necessitate further capacity cuts. As a rule of thumb, MAS needs roughly 45-55 employees per flight. We estimate that the second wave of capacity cuts will only involve 800-1,000 employees. Given that roughly 6,000 employees have been / will be terminated, MAS will inevitably announce more route cuts.

We list down in the table below for routes that we deem have the potential to be terminated or cut in capacity. Note that this is based on our forecast only, and the Company has not given any indication.

MAS potential capacity cuts

Routes	Action	Note
Kuala Lumpur to Amsterdam	Terminate	Demand dried up after MH17, MAS can transfer passengers to AirFrance-KLM via its code share
Kuala Lumpur to Paris	Terminate or downsize aircraft	MAS is unable to fill its Airbus A380 aircraft
Kuala Lumpur to Istanbul	Terminate	No chance to compete with Turkish Air
Kuala Lumpur to Dubai	Terminate	No business case to fly this route
Kuala Lumpur to Darwin	Terminate	No business case to fly this route
Kuala Lumpur to Osaka	Terminate or reduce frequency	Seasonal route
Kuala Lumpur to Adelaide	Terminate or reduce frequency	Seasonal route
Kuala Lumpur to Sydney	Reduce frequency	Currently 3x day, should be only 2x day
Kuala Lumpur to Melbourne	Reduce frequency	Currently 3x day, should be only 2x day
Kuala Lumpur to Singapore	Reduce frequency	Too much capacity, no differentiation factor
Kuala Lumpur to Bangkok	Reduce frequency	Too much capacity, more leisure centric
Kuala Lumpur to Jakarta	Reduce frequency	Over-served market
Kuala Lumpur to Bali	Reduce frequency	Leisure centric market
Kuala Lumpur to Kota Kinabalu	Reduce frequency	Over-served market, too much competition
Kuala Lumpur to Kuching	Reduce frequency	Over-served market, too much competition
Kuala Lumpur to Penang	Reduce frequency	New train service will shift market share
Kuala Lumpur to Langkawi	Reduce frequency	Over-served market
Kuala Lumpur to Kuantan	Terminate	Traffic is spotty, sometimes full but empty on most accounts

Sources: MAS, Maybank KE

The next two months will be packed with announcements

We think the next two months (Jul-Aug) will be packed with announcements by MAS. MAS has to provide 2-3 months forward notice before it can terminate routes in order to manage its customers' booking schedule and therefore this is the applicable window time. This material newsflow could potentially provide a rerating to the sector, in our view.

Recommendation

AirAsia: BUY MYR2.45 TP

AirAsia is clearly the biggest beneficiary of MAS' route restructuring because it has the highest route overlap with MAS. This should enable AirAsia to enjoy better load factors with higher yields as the reduced supply from the market will not fester the market demand. We have mentioned in our earlier reports that AirAsia will likely see a year of two halves in 2015, and we think the 2H15 will be one with very convincing performance. **BUY**; the stock is trading superbly cheap at only 5.9x FY15 PER.

AirAsia X: HOLD MYR0.30 TP

On face cover, MAS' capacity cuts to Brisbane, Perth and Taipei will benefit AirAsia X in terms of better load factors and higher yields. However, Malindo Air is adding new services to these routes and it will nullify any benefits of MAS' capacity cuts. Furthermore, we think Malindo could potentially steal market share away from AirAsia X given its superior cabin products and services. We maintain our HOLD call and TP for AirAsia X for now pending a management visit as we seek greater clarity on their growth plans.

Malaysia Airports Holdings: HOLD MYR6.75 TP

These developments by MAS are not positive for MAHB, but nonetheless it is expected. Our base forecast for MAHB has largely prized in the risk of capacity cuts by MAS and therefore we retain our earnings forecasts and HOLD recommendation.

Malindo Air: Not Listed

Malindo Air is very lucky as its new route launches to Taipei and Australia coincide with MAS cutting capacity on these destinations. This will help it to spool up demand and reduce the need to provide deeply cheap promotional tickets in the start-up stage. We are impressed with Malindo Air's growth strategy thus far and we believe it could add another layer of competition to the Malaysian aviation industry in the next one to two years.

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