AirAsia – Buy or Die?

17 Sep 2020

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Disclaimer:

- This analysis is still a work-in-progress. It is not a recommendation to buy, but simply a sharing of my research so far. Please build on my analysis rather than take it at face value.
- I own Airasia shares.

30,000 feet view

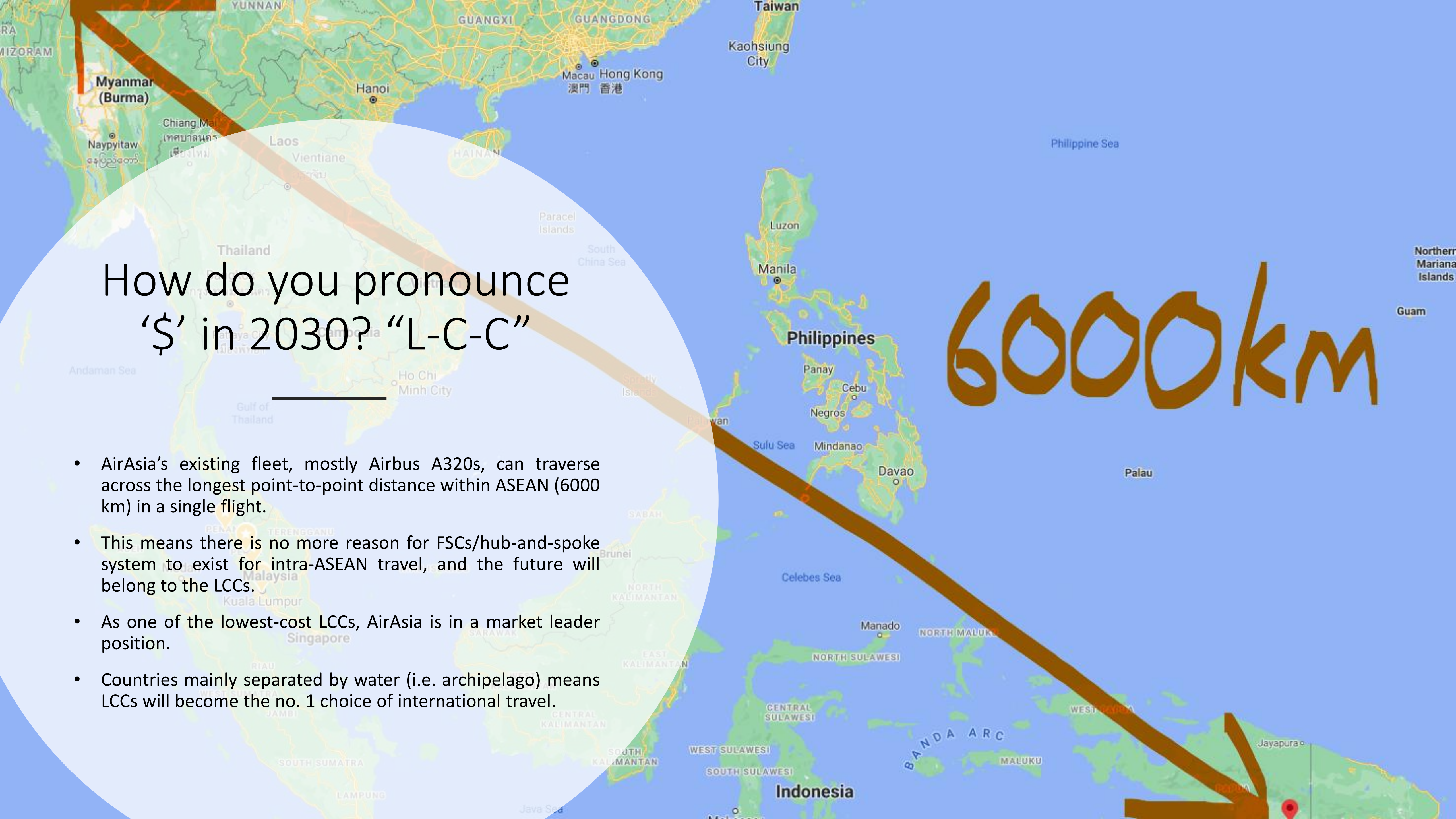
- AirAsia has the lowest unit cost among ASEAN airlines, as of 2018. This may change post sale-and-leaseback beyond 2019, but it shouldn't alter significantly.
    - AirAsia: 2018 CASK US$0.0367; 2019 CASK US$0.0362
    - 2019 CASK: Ryanair US$0.04; Southwest US$0.077; Spirit US$0.05
    - 2019 CASK (ASEAN LCC): Nok Air US$0.07; Garuda US$ 0.065; VietJet US$ 0.039
- In a commodity business like airlines, lowest cost wins because they can offer the lowest price and grab market share consistently over time by underpricing competitors. This was both Southwest's and Ryanair's playbook in their early days.

ASEAN Growth Story – AirAsia's market (TAM)

- ASEAN is poised to become the next China, due to:
  - China's labour costs increasing
  - Close proximity to China
  - Relatively stable political regime vs other developing economies
  - 4.8% GDP growth (US 2.3%, EU 1.5%, China 6.1%), young median age (29 years)
- Burgeoning middle-class with improving disposable income = more future LCC flyers
- It is not unreasonable to expect regional GDP to grow 10x over the next 30 years (8% CAGR), which broadly speaking translates to >10x disposable income.

How do you pronounce ‘$’ in 2030? “L-C-C”

- AirAsia’s existing fleet, mostly Airbus A320s, can traverse across the longest point-to-point distance within ASEAN (6000 km) in a single flight.
- This means there is no more reason for FSCs/hub-and-spoke system to exist for intra-ASEAN travel, and the future will belong to the LCCs.
- As one of the lowest-cost LCCs, AirAsia is in a market leader position.
- Countries mainly separated by water (i.e. archipelago) means LCCs will become the no. 1 choice of international travel.

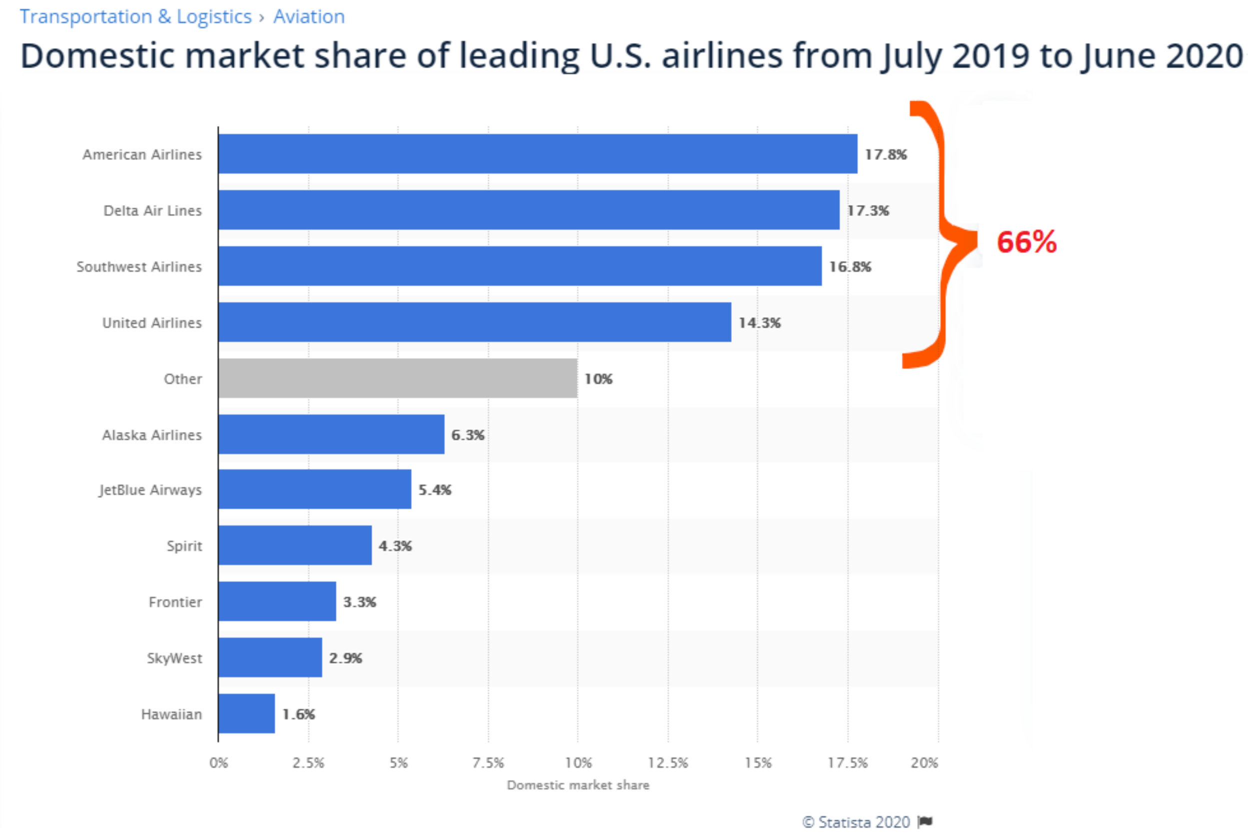


- In 5 years time*, AirAsia’s new Airbus A321 neo’s will be able to compete on this part of the prized “Kangaroo Route”.
- Dubai is the ‘airline hub of the world’, given its central location on the globe. If AirAsia can penetrate this market, the potential TAM will increase by an order of magnitude.

*The reason why AirAsia is not already in this market, despite the similar 6000 km distance across ASEAN, is because its current fleet of A320’s cannot regularly fly their theoretical maximum range of 6150 km. Whereas the upcoming A321 neo’s will have a theoretical maximum range of 7400 km.

Why did Warren Buffett buy the Big 4 US airlines in 2016?

- US airline market share had consolidated between the Big 4 airlines
  - i.e. the industry had become an oligopoly, & these airlines would soon have **pricing power***
  - unfortunately, the pandemic upended this thesis, which was why he sold them
- The same industry consolidation will happen to ASEAN airlines in 30 years, with the largest airlines having pricing power, rapidly improving ROE & valuations.
- As the lowest-cost airline in ASEAN, AirAsia is likely to end up as one of the survivors; or be acquired by one of them at fair value.

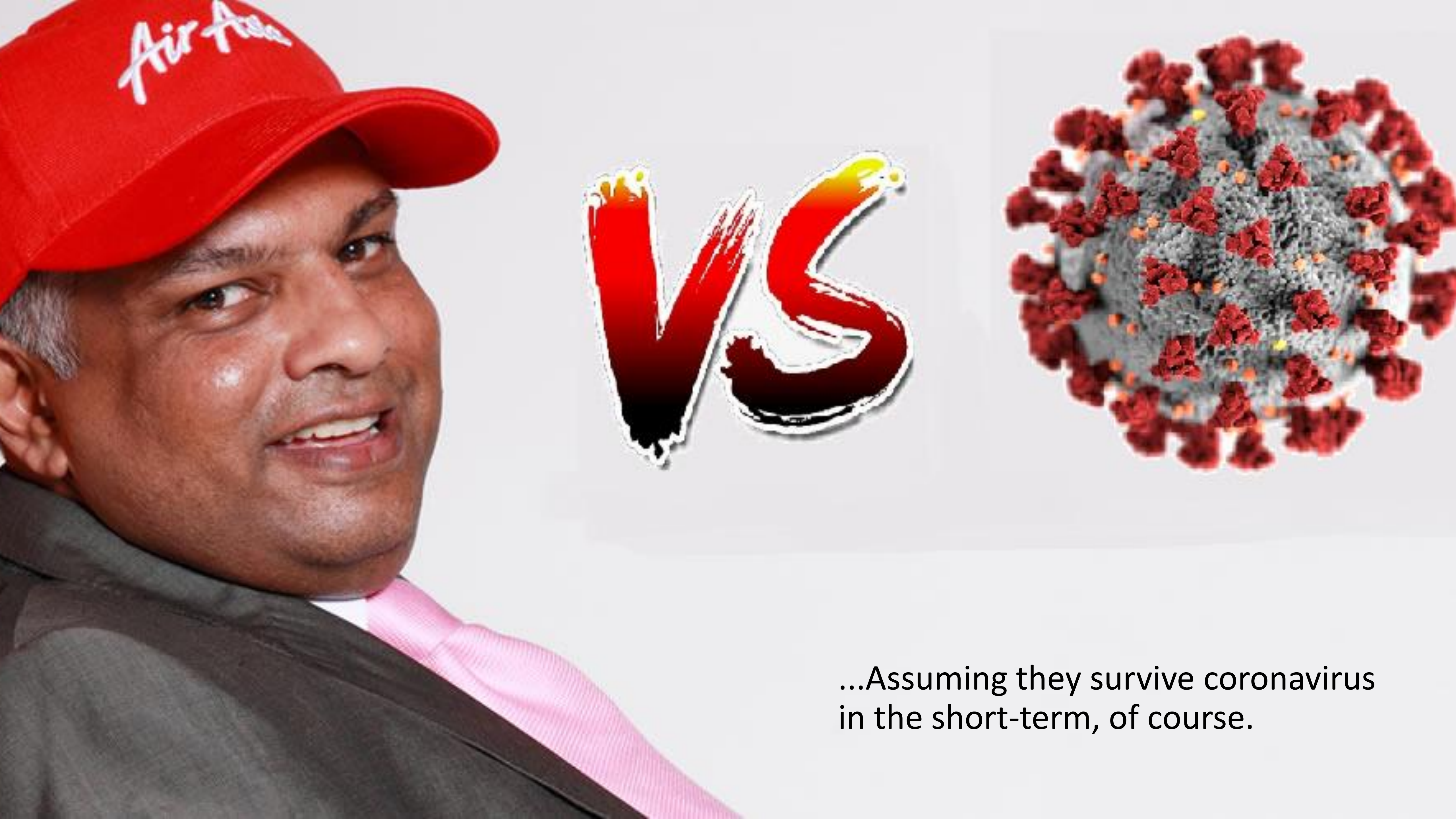


* *"The single-most important decision in evaluating a business is **pricing power**. If you've got the power to raise prices without losing business to a competitor, you've got a very good business". - Warren Buffett*

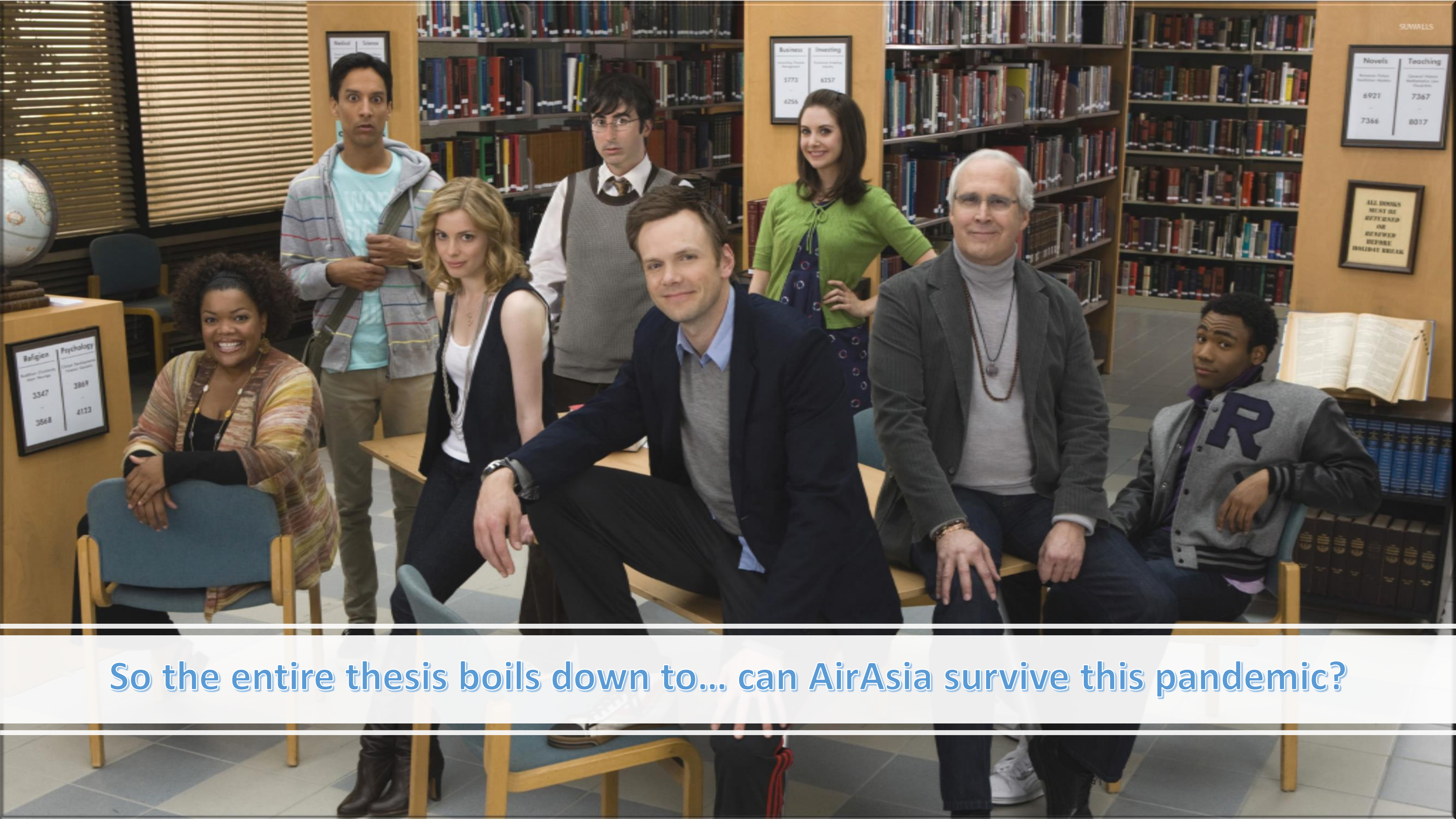
AirAsia Bull-Case Summary:

- Lowest-cost airline in a commodity industry (where lowest cost wins)
- Huge TAM amidst burgeoning middle-class population:
  - Rapid ASEAN GDP & disposable income growth (guaranteed 2-3x TAM increase);
  - Potential 10x incremental TAM from Kangaroo Route
- Future industry consolidation = market leaders gain pricing power = improved ROE & valuations.
- Summary: Lady Luck is on your side.

Long-term upside?
15% CAGR, easy.



...Assuming they survive coronavirus
in the short-term, of course.



So the entire thesis boils down to… can AirAsia survive this pandemic?

Key assumptions

- Economic impact of pandemic on airlines will end by end-2021 (The Economist interview with Bill Gates on the pandemic).
- If AirAsia can survive until end-2021, this bull thesis has a chance to unfold.
- If AirAsia cannot survive until then, bankruptcy or punishing dilution is possible.
- Maximum 70% equity dilution before end-2021.
- Another implied risk is that if the pandemic stretches to 2022 and beyond, then this thesis is moot.

Let’s begin.

How Do We Analyse Whether AirAsia Can Survive Until End-2021? Current Liabilities.

	reported	reported		adjusted	adjusted
AIRASIA 2Q20 QR	30/6/2020	31/3/2020		30/6/2020	31/3/2020
	RM '000	**RM '000**		**RM '000**	**RM '000**
ASSETS					
Receivables and prepayments (NCA)	3,710,104	3,604,900			
Receivables and prepayments (CA)	780,426	1,170,346			
Deposits, bank and cash balances	996,121	1,607,317			
CURRENT LIABILITIES					
Trade and other payables	2,923,189	2,470,445		2,142,763	-
Aircraft maintenance provisions and liabilities	594,978	665,206		594,978	665,206
Sales in advance	950,752	711,923			
Amounts due to associates	40,844	55,037			
Amounts due to related parties	3,832	36,618			
Borrowings	464,757	486,693		464,757	486,693
Lease liabilities	2,196,657	2,223,295	50%	1,098,329	1,111,648
Derivative financial instruments	1,087,317	1,750,927	50%	543,659	875,464
Provision of taxation	21,702	58,937		21,702	58,937
TOTAL CURRENT LIABILITIES	**8,284,028**	**8,459,081**		**4,866,187**	**3,197,947**

AirAsia's 2Q20 quarterly balance sheet:

- They have RM 8.284B of current liabilities (i.e. cash outflows over next 12 months)
- However, many of them are controllable (i.e. not actually likely cash outflows)
    - e.g. Sales in advance, Amounts due to associates/related parties
- >50% of Plane Leases & Oil Hedges have been re-negotiated to beyond June 2021, as reported both in media & sell-side reports.
- 'Trade and Other Payables' adjusted from RM 2.923B to RM 2.142B, after netting off Current 'Receivables and Prepayments' of RM 780M.
    - i.e. RM 2.923B – RM 780M = RM 2.142B
- Hence, their actual likely cash outflows over next 12 months (red) are only RM 4.866B.

Liquidity FY20

	30/6/2020	31/3/2020
12M LIQUIDITY from 6M20	**RM '000**	**RM '000**
Cash Current Liabilities	4,866,187	3,197,947
Deposits, bank and cash balances	996,121	1,607,317
Loan	1,000,000	1,000,000
Cash Shortfall for FY20	**2,870,066**	**590,630**
FY19 Revenue	11,860,403	11,860,403
Malaysia FY19 Revenue	7,699,365	7,699,365
Assume 50% drop in passenger numbers (50% normalized rev)	5,930,202	5,930,202
FCF-to-revenue ratio	48%	10%

- Hence, they need about RM 4.866B* to make it through the next 12 months.
- They currently have about RM 2B of liquidity on-hand:
  - RM 996M of cash and cash equivalents
  - RM 1B bank loan approved
- Hence, they have a cash shortfall of RM 2.87B, which needs to be addressed in order to survive the next 12 months.
  - i.e. they need to raise FCF of RM 2.87B to survive for the next 12 months

- In FY19, Group revenue was RM 11.86B; while Malaysia revenue was RM 7.699B.
  - Domestic routes in all of AirAsia's operating countries have since reopened.
  - Assuming a 50% drop in FY20 passenger numbers vs FY19, they would be able to raise RM 5.93B of FY20 revenue.
  - Hence, about 48% (=2.87/5.93) of that FY20 revenue would need to translate into FCF (not profit!) for them to survive under these assumptions. In my view, that's reasonable.

- Conclusion:
  - A case can reasonably be made for AirAsia's survival over the next 12 months.

*based on currently available information, and all else being equal

AirAsia has not simply been resting on its laurels & resigned to its fate:

- They have been aggressively offering promotions for domestic flights, presumably in order to raise cash flow.
- While these promotions are likely to lead to net losses for FY20, it achieves its goal of raising cash flow
  - This gives AirAsia more breathing room, and they can keep doing this until the pandemic ends to survive if necessary.
- Anecdotal research from friends who travelled by AirAsia for holidays, revealed a load factor of >50%:
  - the KL-Penang flight was >50% full
  - the KL-Kota Kinabalu flight was >70% full

Valuation

AirAsia Valuation	
Share price at 16/9/2020 (RM)	0.65
Assume equity funding of RM 1.5B raised (RM 'm)	1,500
No. of shares to be issued to raise RM 1.5B at RM 0.65	2,307,692,308
Current existing no. of shares	3,341,974,000
Implied no. of shares post-dilution	5,649,666,308
Implied equity dilution	69%
Market cap at 16/9/2020 (RM'm)	2,172
Implied share price, post 69% dilution (RM)	1.10
Implied market cap, post 69% dilution (RM 'm)	3,672
10-year average Net Profit (2010-2019) (RM 'm)	799
Implied post-dilution normalized historical PE (x)	4.6

Net Profit	RM 'm
2010	1061
2011	555
2012	790
2013	362
2014	83
2015	541
2016	1,619
2017	1,571
2018	1,695
2019	-283
10-yr Average	799

AirAsia.com

- The most pressing concern to equity investors today would be potentially huge dilution.
- AirAsia's CEO, Tony Fernandes, has gone on record saying that raising RM 2B - 2.5B in funding would be "more than enough" to weather the pandemic until end-2021.
  - Conservatively assuming the highest amount of that range, i.e. RM 2.5B would be raised:
    - RM 1B has already been funded via debt
    - Thus, the remainder of RM 1.5B would still need to be funded via equity
- At the current share price of RM 0.65, raising RM 1.5B would entail 69% equity dilution:
  - However, assuming that Net Profit can and does return to historical levels over the next 30 years, normalized PE would be 4.6x *post-dilution*.
  - Even applying a 50% margin of safety, the implied long-run PE would still be only 9.2x. (i.e. <10x)
- Conservative assumptions:
  - The above calculation assumes zero-growth to normalized historical profits. If the discussed bull-case scenario materializes, implied PE would be even lower.
    - e.g. if they can grow normalized net profit by 5x in 15 years (11% CAGR), then the implied 2035 forward PE is only… 1x.
    - This is how Warren Buffett gets his incredible compounding streak… by earning back 100% of his early investment outlay in annual profits *every year*.
  - This valuation ignores any potential contributions from all other AirAsia non-airline ventures, e.g. Teleport (logistics), BigPay (e-wallet), AirAsia.com (interline), etc.

Positioning

- Risk: The potential for AirAsia to go bankrupt is non-zero
- Reward: If they don't go bankrupt, the returns would be more than satisfactory
- Risk:reward is excellent, possibly up to 1:10 if they survive & the discussed bull case thesis materializes
- Make it a small portion of your overall portfolio. Heads you win, tails you don't lose much.

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