

### Airlines & Airports Sector (OUTPERFORM): Aircraft accident won't change the upbeat climate, and government guidance accelerates reform of the sector

- ❖ Operating profitability of airlines improved in Jul 10. We estimate that Jul 10 profits of China's civil aviation sector will come in at Rmb5.5bn, up 12x YoY (1.3x over the same period in 2007) and up 1.4x MoM. Additionally, the gross margin of the sector is estimated to be 29%, up 14ppts YoY (up 5ppts over the same period in 2007 and up 9ppts MoM). Profits in Jul 10 hit a record monthly high and we predict that the figure in Aug 10 will exceed that in Jul 10.
- ❖ Domestic air traffic is booming. In Jul 10, RTK of overall, domestic, international and regional routes in China's civil aviation sector grew 28.2%, 20.0%, 47.7% and 47.7% YoY, respectively, and 10.0%, 13.5%, 3.8% and 16.7% MoM, respectively. The number of passengers on total, domestic, international and regional routes grew 21.1%, 19.6%, 43.9% and 53.1% YoY, respectively, and 16.6%, 16.9%, 12.9% and 23.7% MoM, respectively.
- ❖ Air transport capacity increased during the peak season. As at end-Jul 2010, there were 1,519 civil aircraft operating in China's aviation sector, up 14.2% YoY and 1.4% MoM. The daily utilization rate of aircraft stood at 9.8 hours, up 0.2 and 0.6 hours on a YoY and MoM basis, respectively. ATK came in at ~6.57bn tonne-kilometres, up 18.3% YoY and 9.7% MoM. Seats available stood at ~30.46m, up 11.2% YoY and 13.0% MoM. Airlines increased capacity in the peak season.
- ❖ Operating efficiency of airlines hit a record monthly high. In Jul 200, the PLF of overall, domestic, international and regional routes in China's aviation sector came in at 83.6%, 84.3%, 80.5% and 80.9%, respectively, up 6.8, 6.4, 8.9 and 11.4ppts YoY and 2.6, 2.9, 1.4 and 5.4ppts MoM. We estimate that Jul 10 RPK will come in at Rmb0.69 (up 19.0% YoY and 11.3% MoM) and that RTK will stand at Rmb5.99 (up 19.1% YoY and 13.0% MoM). PLF and airfares continued rising concurrently.
- ❖ Recommend hub airports. Airports have benefitted from the continually upbeat climate, gradually rising utilization rate and steady growth of business volume and results. We recommend hub airports with fair valuations, no major CAPEX, and exposure to recovering international routes (implying huge elasticity in business results).
- ❖ Risks associated with investing in the sector: (i) Systematic risks for the A-share market; (ii) competition from high-speed railways as a substitute; (iii) sharp swing in international oil prices; (iv) FX rate risk; (v) outbreak of irrational price war in the sector; and (vi) sudden outbreak of epidemics or disasters, etc.
- ❖ Reiterate OUTPERFORM sector rating. We still believe that air travel remains one of the safest modes of transport. The aircraft accident that has happened will not have a material impact on: (i) the trend of the airline sector; (ii) performance of the airline sector index; or (iii) demand for air traffic. Nor will it change the upbeat climate for China's aviation sector. We reiterate our OUTPERFORM rating for the airport and airline sector. Investors are advised to keep a close watch on the accelerating M&A and restructuring in the sector, the tremendous changes in competitive landscape and the slowdown in capacity growth. We advise investors to watch out for the short-term negative impact of the aircraft accident on investors' sentiment, as well as the possible pressure on prices of airline stocks on the secondary market due to the recent private placement by China Southern Airlines.

#### Peers' comparisons – China Aviation Industry

Company	Price (HK\$)	PER (x)			PEG (x) 09-11E	P/B (x) 10E	Yield (%) 10E	RoE (%) 10E
		09	10E	11E				
<b>Hong Kong airlines - average</b>		<b>106</b>	<b>6</b>	<b>6</b>	<b>0.3</b>	<b>3.0</b>	<b>0.1</b>	<b>78</b>
China South Air (01055.HK)	3.78	70	5	7	0.3	1.4	0.2	38
China East Air (00670.HK)	4.20	141	7	6	0.4	4.6	0.0	118
<b>Hong Kong airports - average</b>		<b>34</b>	<b>25</b>	<b>18</b>	<b>1.0</b>	<b>1.4</b>	<b>1.9</b>	<b>7</b>
Beijing Airport (00694.HK)	3.88	49	34	21	0.9	1.1	1.4	3
Meilan Airport (00357.HK)	8.40	19	16	14	1.2	1.7	2.5	11

Source: Respective companies, Bloomberg, CSI

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## Investment rating system

Performance of stock or sector relative to MSCI-China Index over next 6 months after research publications

	Rating	Remark
Stock rating	Buy	Relative performance over MSCI-China Index >20%
	Overweight	Relative performance over MSCI-China Index 5% ~ 20%
	Hold	Relative performance over MSCI-China Index -10% ~ 5%
	Sell	Relative performance over MSCI-China Index > -10%
	NR	Not rated
Sector rating	Outperform	Relative performance over MSCI-China Index >10%
	Neutral	Relative performance over MSCI-China Index -10% ~10%
	Underperform	Relative performance over MSCI-China Index > -10%

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