Asia Credit Research

OCBC Bank

Singapore Airlines Ltd: Credit Update

Tuesday, 12 September 2017

Changing its game

- **SIA Group focuses on the growing Asia Pacific region but core airline business is undergoing multi-pronged capacity challenges from low cost carriers ("LCC"), Gulf carriers, Chinese carriers and other airlines.**
- **We do not expect supply-demand balance in airline capacity to occur in the next six to twelve months.**
- **SIA Group is in the midst of a major business transformation review with the aim to improve efficiency and identify additional revenue generation opportunities. Expect Singapore Airlines ("SQ") to remain premium while simultaneously build-out other businesses.**
- **Decline in SQ yields means other income streams are crucial to profitability and future growth (eg: wholesale of KrisFlyer miles, non-scheduled services and other fees)**
- **Cashflow from operations insufficient to fund fleet renewal, expect further bond supply and gearing to rise.**
- **Recommendation:** SIA Group's current credit position is commendable. Nonetheless, the company is going through a challenging and transformative period and we expect further credit deterioration. We are however maintaining our **Neutral** issuer profile on SIA Group and may relook this should conditions deteriorate beyond our expectations. We see valuation of Singapore Telecommunications' bonds as an upper bound to the SIASP curve. On a fair value basis, we see the SIASP curve at 25-40 bps wider than STSP (rated at A+/A1/A+ by credit rating agencies). Both these issuers share a common major shareholder in Temasek, though we see STSP's credit as stronger and hold the issuer profile at Positive. We are underweight the SIASP '27s, SIASP '26s and SIASP '24s, and see fair value at 25-40bps wider than where they are trading at. We are neutral the SIASP '25s. At the shorter end of the curve, we are underweight the SIASP '20s and SIASP '21s and see fair value at 15-25 bps wider.

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A) Background

Singapore Airlines has released its 1QFY2018 financial results. We have analysed the 1QFY2018 financial results and considered the updated developments in our credit update.

Singapore Airlines Group ("SIA Group") is listed on the Singapore Stock Exchange ("SGX") with a market cap of SGD12.3bn as at 12 September 2017. SIA Group's key business is its flagship full service carrier, SQ. Additionally, the company operates other airlines and businesses, including SIA Engineering Company, SIA Cargo, Silk Air and Budget Aviation Holdings (which holds Scoot and Tiger Airways). The company traces its history to the birth of Malayan Airways Limited in May 1947. SIA Group's first flight in its own name took place on 1 October 1972. SIA Group's main hub is Singapore's Changi Airport and it is building out a multi-hub strategy via its associated companies in India and Thailand. The company is in the midst of a major business transformation review with the aim to improve efficiency and identify additional revenue generation opportunities.

Currently, SIA Group is ~56% owned by Temasek while the remaining shareholding is dispersed across institutional investors. As part of Air Service Agreements ("ASAs") signed between the Government of Singapore and governments of other countries, SIA Group must at all times be effectively controlled and substantially owned by Singapore nationals under most of the ASA terms during the duration of the ASAs.

The Minister for Finance holds one non-tradable Special Share in SIA Group. In line with other Temasek-owned companies, strategic decision-making and day-to-day operations are left to a professional board and management team. The Singapore government though in 2003 had intervened when industrial relations between SIA Group's labor union and management soured significantly.

Figure 1: SIA SGD Bonds

Issue	Maturity / First Call Date	Outstanding Amount (SGDm)	Ask Price	Ask YTW (%)	I-Spread	Bond Rating
SIASP 3.13% '27	23 Aug 2027	700	101.60	2.94	78	NR/NR/NR
SIASP 3.13% '26	17 Nov 2026	430	102.35	2.84	73	NR/NR/NR
SIASP 3.035% '25	11 Apr 2025	700	102.10	2.73	75	NR/NR/NR
SIASP 3.75% '24	8 Apr 2024	300	107.80	2.46	58	NR/NR/NR
SIASP 3.145% '21	8 Apr 2021	200	104.60	1.81	29	NR/NR/NR
SIASP 3.22% '20	9 July 2020	500	104.00	1.76	35	NR/NR/NR

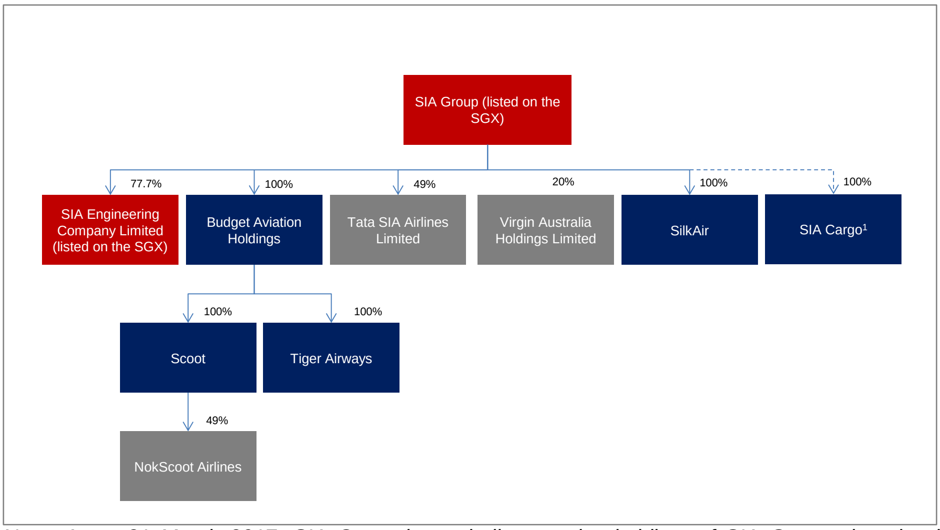
Note: (1) Indicative prices as at 12 September 2017

B) Recent Performance

- **1QFY2018 reported profits have declined y/y though overall operating profit excluding one-off improved:** SIA Group saw its revenue increase 5.6% to SGD3.9bn in 1QFY2018. Passenger flown revenue was up 4.3% (by SGD121mn), driven by higher passenger flow traffic (up 7.6%), which more than offset the decline in passenger yields. Improvements in cargo revenue, driven by a 6.9% increase in freight carriage and better cargo yields also helped boost the top line. We include fuel, aircraft maintenance and overhaul costs, handling charges and rentals on leased aircrafts as COGS. In 1QFY2018, COGS increased by 5.3% to SGD1.7bn, in part driven by higher jet fuel prices and expanded operations of SilkAir and BAH. Whilst SIA Group recorded significant operating profits of SGD280.8mn in 1QFY2018 and SGD193.2mn in 1QFY2017, these were boosted by one-off items. Adjusting for one-off items identified by the company, operating profit would have increased to SGD108mn in 1QFY2018 (up SGD66mn y/y). 1QFY2017 operating profit was boosted by a one-off up-front recognition of revenue from unutilised tickets of SGD151mn. In 1QFY2018, SGD173mn of one-off items were recognised from (1) KrisFlyer adjustments as SIA Group reviewed the actual expiry against expected breakage rates; and (2) compensation for changes in aircraft delivery slots. Joint ventures and associates had turned marginally positive at SGD0.8mn, improving from the SGD43.9mn loss in 1QFY2017. SIA Group ended the quarter with a reported profit before tax of SGD292.9mn (1QFY2017: SGD341.3mn), down SGD48.4mn. Book value equity was relatively unchanged as at 30 June 2017 at SGD13.5bn versus end-March 2017 as SIA Group reported another comprehensive loss of SGD197.7mn mainly from losses on cash flow hedges.

- **SQ continues to be main operating income driver in 1QFY2018:** Despite SIA Group's on-going efforts to diversify into other businesses, SQ continues to dominate operating income. Excluding one-off items, SQ generated SGD68mn in 1QFY2018 representing 63% of operating income, followed by SIA Engineering ("SIAEC") at 17%, SilkAir and SIA Cargo at 6% each and BAH (combined Scoot and Tiger) at 3%. Contributions from SilkAir and BAH was led by increase in capacity (which entailed higher capex and operational costs). In 1QFY2018, SilkAir reported a SGD20mn decline in operating income (down SGD14mn excluding one-off), despite the 13.8% growth in passenger volumes as yields fell by 8.6%. Expenditure increased by 11.6% following higher maintenance and fuel costs. As at 31 March 2016, SilkAir operated 29 planes, by 31 March 2017, this had increased to 30 and the company expects to buy four more fuel-efficient 737 MAX 8 by 31 March 2018. BAH also saw a decline of SGD6.0mn in operating income despite the 18.2% growth in passenger carriage. Expenditure increased by 18.3%, driven by capacity growth of 16.5%. Over the year to FY2017, BAH saw a net addition of two planes.

Figure 2: Simplified Corporate Structure



Note: As at 31 March 2017. SIA Cargo is a wholly-owned subsidiary of SIA Group, though will be re-integrated back as a division within SQ (expected to be completed in the first half of 2018)

C) Current Competitive Landscape

- **Geographical Concentration on East Asia Group:** SIA Group is reliant on the East Asia region. By area of original sale, East Asia made up 61% of airline operations revenue in FY2017 (excluding non-scheduled services and incidental revenue). This concentration is in line with SIA Group's strong brand recognition among customers and established route presence in the region. 14% of revenue is derived from South West Pacific (includes Australia, New Zealand) and 13% is from Europe. Airbus Global Market Forecast projects that demand for passenger aircraft (above 100 seats) for intra-regional and domestic traffic in the Asia-Pacific region will grow at a CAGR of 6.0% p.a in 2016 – 2036. While SIA Group is dominant in a region with solid growth prospects, the region is characterized by overcapacity. The International Air Transport Association ("IATA") had forecast demand for air travel to grow slower than capacity expansion in 2017. Capacity offered by carriers in the Asia-Pacific region is forecasted to grow by 7.6% vis-à-vis forecast in demand growth of 7.0%.

- **Threat of Gulf Carriers, Turkish Airlines in SIA Group's core long-haul premium segment:** Emirates, Etihad Airways, and Qatar Airways have expanded aggressively to dominate Asia-Europe air routes while Turkish Airlines had capitalised its Istanbul hub as a connector for Asia-Europe-Middle East-Africa. For leisure passengers, and business travellers facing increasingly tighter corporate budgets, these full-service carriers provide services of comparable quality (at four stars or better versus SQ's five per SKYTRAX, an aviation consultant) and at competitive prices, making these airlines a strong substitute in long-haul travel. According to management consultancy firm, McKinsey & Company, these airlines collectively doubled the number of European airports served (from 44 to 81) and quadrupled the number of seats (from 7mn to 27mn) over the past decade. Nonetheless, with recent financial strains reported (eg: Emirates saw a 82.5% decrease y/y in net profit for FY2017) capacity growth by Gulf Carriers could be curtailed, providing SQ some respite in the near-term.

- **Capacity growth among Chinese airlines:** While service standards have not reached the level of the Gulf Carriers and Turkish Airways, Chinese airlines (including second-tier airlines) have been growing their presence in international routes, particularly between (1) China-Southeast Asia (2) China-Australia (3) China-USA and (4) China-Europe routes. In the first half of calendar year 2017 ("1H2017"), the Big Three state-owned Chinese airlines grew international capacity by 10% y/y, though pace of growth had decline from the 28% reported between 1H2016 and 1H2015. These numbers exclude capacity for Hong Kong, Macau and Taiwan. The three smaller listed airline companies, namely Hainan Airlines, Juneyao Airlines and Spring Airlines collectively saw international capacity increase 54% in 1H2017, in line with the increase in 1H2016. We find the international capacity of these six airlines in aggregate to have grown 15% y/y in 1H2017 (1H2016 growth of 30%). In other words, Chinese airlines have been growing where their customers are going. While SIA Group is able to benefit from broad-based growth in Chinese outbound travel, the potential may be capped in our view, as customers can increasingly choose to travel from point-to-point.

- **Qantas Airways upping its game in Asia-Pacific:** On 30 August 2017, Qantas announced that it was returning to Changi Airport as a stopover for its popular Sydney-London A380 flights. This announcement comes after a five year hiatus. As part of a global partnership entered into with Emirates back in 2012, Qantas opted to use Dubai as a hub for its European flights. Qantas has signalled its intention to fly direct from Australia to Europe within five years, with the Perth-London non-stop flight (starting in 2018) announced in December 2016. This would have made Dubai as a stopover less relevant over time. We think an important reason for Qantas' return to Changi Airport is to intensify its presence in the Asia-Pacific region, especially now that Qantas has turned around from its losses in 2012. Changi Airport announced that this would mean (1) Additional 5.5% of one-way seats on Singapore-Australia routes weekly and (2) Additional 18.3% of one-way seats on Singapore-UK routes weekly. Our colleagues at OCBC Investment Research expect SIA Group to face increased competition from Qantas for Singapore-based passengers and the most direct impact would be on yields on the Singapore-London/Sydney/Melbourne routes.

D) Reviewing the Segments

- **Decline in SQ passenger yields and utilisation; other revenue streams increasingly important**: Passenger yields, which are derived from passenger revenue from scheduled services over revenue passenger-km (product of number of passengers carried and distance flown) measures average fare paid per km. We saw fares declining to 10.2 cents/pkm in FY2017, levels lower than that seen in FY2010 (a period covering the aftermath of the global financial crisis which saw a significant demand slump in air travel demand). Despite lower air fares charged, SQ's passenger load factor was also slightly lower at 79.0% in FY2017 (down from 79.6% in FY2016). In 1QFY2018, passenger yield was 10.1 cents/pkm, down from 10.3 cents/pkm in 1QFY2017. With the decline in spreads between passenger yield and per unit costs, break-even load factors (a theoretical measure of capacity which allows operating expenditure to be recouped via passenger revenue) have increased above 79% in the past five years (82.2% in 1QFY2018). This has persisted even in a low-fuel cost environment since end-2014. The decline in air fares and reduction in utilisation reflects the intense competition from Gulf carriers, Turkish Airways and Chinese airlines as these emerged as significant operators in the Asia-Pacific region only in the past 15 years. Despite not breaking-even on seats for scheduled services, SQ still managed to generate an operating profit for FY2017 and 1QFY2018. We infer that other revenue were important contributors, chiefly, the KrisFlyer loyalty program which allows miles to be sold on a wholesale basis, charter services and other revenue (such as service fees, inflight sales, additional baggage fees etc). Encouragingly in July 2017, passenger load factors was 84.0% (1.6 pts higher y/y), though yields are likely to be still low given the significant promotions that have been carried out.

Figure 3: SQ Passenger Load Factor and Breakeven Load Factor (%)

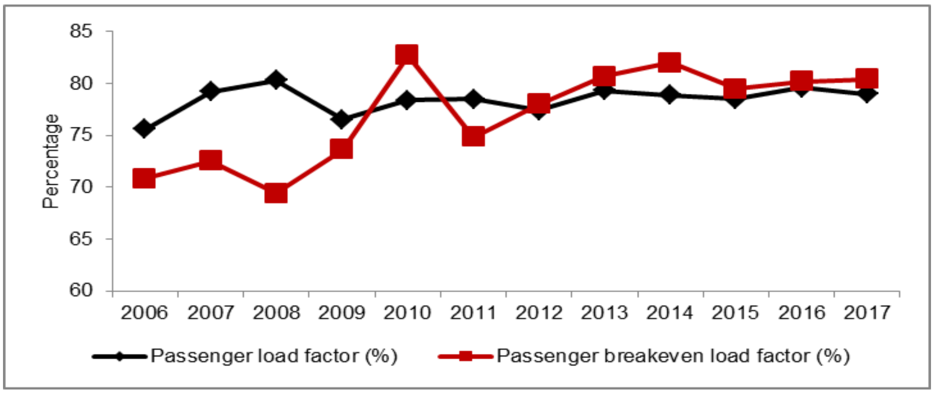
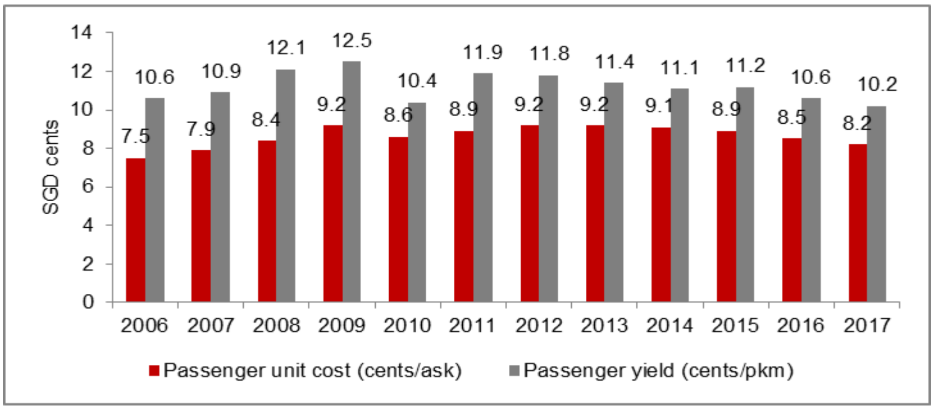


Figure 4: Passenger unit cost and passenger yield



- **Yields too have fallen but SilkAir still making money from seats**: SilkAir is positioned as a premium short-to-medium haul regional carrier (only one in the Asia-Pacific region), with its network fully integrated with SQ. Despite being a lesser known brand, SilkAir, in contrast to SQ has been able to generate sufficient passenger loads above its break-even levels. Break-even load factors are lower for SilkAir at 66-70% in the past five years versus SQ's 79-82%. While passenger yields have declined to 12.5 cents/pkm in FY2017 from 13.5 cents/pkm in FY2016, SilkAir was still generating a positive spread above unit cost. As of May 2017, SilkAir flies to 53 destinations in 15 countries, among which, SilkAir is the main carrier for SIA Group for the high-traffic Singapore-Kuala Lumpur route. Other main routes include Singapore-Denpasar/Male/Penang/Cebu/Phuket, plying a significant proportion of transit passengers from Changi Airport to tourist destinations regionally. In July 2017, SilkAir reported a passenger load factor of 76.6% (up 4.5 pts y/y), a positive momentum in our view as this was on the back of a 12.7% increase in capacity. SQ is expected to dedicate more capacity to SilkAir.

- **Low Cost Carriers ("LCC") changed dynamics:** Asia's first LCC was AirAsia, established in 1993 by DRB-Hicom but later bought out by Tune Air Sdn Bhd in December 2001. The success of LCCs changed the competitive landscape of the airline industry, forcing many legacy, full-service carriers to revisit their strategies and product offering. Between 2001-2004, other regional LCCs such as Jetstar, Lion Air and Nok Air were also quick to enter the market to fulfil consumers' demand for low-cost air travel. Around the same time, Tigerair was also set up, initially 49%-owned by SIA Group. Other early shareholders include the founders of Ryanair, Indigo (an investment fund) and Temasek. At this point LCCs catered to short-haul flights. In 2011, SIA Group founded Scoot as a wholly-owned brand to provide medium-to-long haul air travel at low prices to consumers. According to Centre of Asia Pacific Aviation ("CAPA"), an aviation market intelligence outfit, Southeast Asia's LCC fleet passed the 600 aircraft mark in end-2015, with 70 aircrafts added in 2015 alone. This also represented a 50% increase in fleet size over a three year period. While SQ and SilkAir's cachet continues to attract a segment of customers who demand a premium product offering, air travel to an extent is seen as an increasingly commoditized product. This is particularly true for short haul, non-time sensitive travel. We think sector-wide declines in yield are a reflection of strong price competition from LCCs and newer full-service airlines, amidst the rapidly expanding capacity in the region.

- **Trying to get LCC strategy right**: Unlike Qantas Airways who decided early to develop its dual-brands (ie: Qantas and Jetstar) cohesively to avoid cannibalisation, SIA Group's initial involvement in Tigerair was as a financial investor. There were neither commercial cooperation agreements nor coordination of routes between Tigerair and SIA Group. We believe route overlaps (between Tigerair, Scoot and SilkAir) and the lack of scale benefits weighed down on profits, in addition to brand confusion among customers. In January 2016, SIA Group succeeded in its takeover bid for Tigerair, paying SGD458mn to acquire the remaining stake it did not already own. The acquisition intends to provide SIA Group with a new growth avenue while being financially optimal for Tigerair. Tigerair was then facing severe competition from other LCCs and was loss-making (1HFY2016 standalone net loss of SGD14.4mn). In FY2017, SIA Group took a SGD98.2mn write-off on brands and trademarks in relation to Tigerair, having decided that "Scoot" was its LCC brand going forward. SIA Group set up BAH as a holding company in May 2016 to own, manage and integrate Scoot and Tigerair. Scoot and Tigerair completed their integration in July 2017 after a year of integrating reservation systems, flight schedules, conditions of carriage and back-end services. The LCC now operates under a single Air Operator's Certificate with a combined network of 60 destinations across 17 countries. The company is in the midst of optimizing its routes as part of its review and in July 2017 it was announced that two of SilkAir routes would be transferred to Scoot. While SIA Group is a latecomer in the LCC segment, the company is still strategizing to grow BAH's importance as an income driver for the group. We take some comfort that BAH is profitable.

- **Still waiting for associates and joint ventures to deliver:** SIA Group has entered into joint venture agreements with companies in markets it sees as strategic. In 1QFY2018, share of profits of joint venture companies and share of losses of associate companies was collectively SGD0.8mn, narrowing from a significant loss of SGD43.9mn in 1QFY2017. Significant joint venture and associates include:

Figure 5: Major joint ventures and associates

Joint venture and Associate	Percentage stake held by SIA Group	Brief Description
Vistara India	49%	• Part of SIA Group's multi-hub strategy • Joint venture airline with Tata Sons Limited ("Tata") in India, a conglomerate. Tata also owns a 49%-stake in AirAsia India • Vistara commenced operations in January 2015 as a full service airline and serves the domestic Indian market. Management is in the midst of developing Vistara's international routes • SQ and SilkAir has signed an agreement to codeshare on Indian domestic flights operated by Vistara • The Business Standard reported that Vistara's management only expects the airline to be cash positive by FY2018-2019 • We expect SIA Group to still periodically pump in funds in support of its Indian growth strategy • In July 2017, there were media reports that Tata is interested in pursuing a stake in Air India (the national carrier of India). There is still policy uncertainty as to whether SIA Group (as a foreign investor) will be allowed to participate in a joint bid with Tata
NokScoot Thailand	49%	• Part of SIA Group's multi-hub strategy • Joint venture with Thailand's NokAir, a domestic LCC • Commenced operations in May 2015, focusing on medium and long-haul routes • Per the Bangkok Post, NokScoot recorded a net loss of THB117.5mn (SGD4.8mn) in 1H2017 • Key routes include Bangkok-Tokyo/Osaka (on Scoot), Bangkok-Taipei/Nanjing/Qingdao/Dalian/Tianjin/ Shenyang • Targeting eventual expansion for Bangkok-South Korea • As at 31 March 2017, SIA Group has provided a guarantee of THB600mn (SGD24.3mn) on borrowings at NokScoot
Virgin Australia Holdings ("VAH") Australia	20%	• VAH focuses on the domestic Australian market, characterized by a duopoly with Qantas • SIA Group purchased a 10%-stake in VAH as part of a broader strategic alliance for the Australian and Pacific markets in October 2012. Stake was increased to 20% in April 2013 • Post-electing to physically settle a series of equity swaps it had entered into with a counter-party, SIA Group's shareholding increased to 23.1% in April 2016 • VAH privately placed new shares to Hainan Airlines in June 2016. SIA Group's stake in VAH was diluted to 20%, behind the largest shareholder Etihad Airways with 20.9% • When the opportunity arose in mid-2016, SIA Group did not opt to become majority stakeholder of VAH. We expect SIA Group to continue holding its stake as a minority shareholder • As at 31 March 2017, the book value of SIA Group's 20%-stake in VAH was SGD490.1mn As at 5 September 2017, the market value of SIA Group's 20%-stake in VAH amounts to AUD321mn (SGD346.4mn) • SIA Group has yet to take any impairment charges on

		this equity stake • In FYE June 2017, VHA reported a net loss of SGD185.8mn, mainly due to restructuring charges

- **SIA Cargo to be re-integrated as a division within SQ after years of gradual scale-down:** SIA Cargo's fleet is made up of seven Boeing 747-400 freighters in addition to managing the belly hold space on passenger aircrafts for SQ, SilkAir and Scoot. In FY2017, SIA Cargo recorded its first operating profit in six years of SGD3.1mn (FY2016: operating loss of SGD49.7mn). Encouragingly, SIA Cargo recorded SGD6.0mn in operating profit in 1QFY2018 (operating loss of SGD34mn in 1QFY2017), on the back of freight carriage growth of 6.9% and improvement in cargo yield by 4.8%. Cargo load factor (measures capacity utilization) improved 3.7%, as the increase in freight carriage superseded capacity expansion. In May 2017, SIA Group announced that SIA Cargo will be re-integrated as a division within SQ from the first half of 2018. SIA Cargo was spun out as a separate subsidiary when SIA Group decided to manage SIA Cargo as a dedicated air cargo business. Then, SIA Cargo was in a midst of business and fleet expansion to 17 freighters (from nine freighters in 2001). In FY2006, SIA Cargo, together with Temasek and Great Wall Industry Corporation set up Great Wall Airlines ("GWA"). In FY2011, SIA Cargo invested in a 16%-stake in China Cargo Airlines, for ~SGD63.5mn and GWA was merged into this entity. In line with changing market dynamics of weakening demand and overcapacity, growth plans for SIA Cargo was pulled back gradually, with fleet sold and returned to lessors. As a result of persistent losses, SIA Group also fully wrote-down its investment in China Cargo Airlines in FY2015.

- **SIAEC is the second largest profit contributor:** SIAEC, listed on the SGX is ~78%-owned by SIA Group. With its base in Changi Airport, SIAEC provides repair and overhaul and line maintenance services to group and also third party aircrafts. The business's line maintenance networks covers 36 airports across seven countries. This is the key profit driver for SIAEC and the business services more than 50 airlines passing through Singapore. SIAEC reported SGD18mn in operating profit in 1QFY2018, making up 6% of consolidated operating profit at SIA Group.

E) Planning the Next Steps

- **Timely business transformation plan underway:** In May 2017, SIA Group announced that it would be undergoing a business transformation plan which would entail a review of all of its business divisions and processes. A Business Transformation unit has been specifically set up to work on this review. SIA Group has emphasised that the transformation would not just be a cost-cutting exercise but would include looking at new areas of growth. A holistic approach to network and product planning across the whole group would be undertaken. No comprehensive plan has been released yet though news on certain changes to routes, partnerships and operations has been trickling in. In August 2017, SIA Group stated that it was offering voluntary unpaid leave for three months (starting September 2017) to cabin crew in an effort to stem costs amidst a challenging operating environment. In 1QFY2018, staff cost amounted to SGD650mn, being the second largest cost contributor at 18% of operating expenses. On 29 August 2017, SIA Group announced that certain SQ and SilkAir finance functions have been combined for efficiency gains, though an outright merger is not currently in the works.

- **Large capex commitment due to fleet renewal:** As at 31 March 2017, SIA Group has indicated capex commitment amounting to SGD30.1bn for the next five years (97% attributable to aircraft capex). This number is high versus historical levels on a five year rolling-basis. Bulk of the capex commitments relate to firm orders for Airbus A350-900s and Boeing 787-10s, both models which cater for long range travel efficiently. Some A350-900s would be deployed for non-stop flights between Singapore-USA. SIA Group's fleet is still relatively young versus other full service airlines though it has crept up steadily since FY2012. As at 31 March 2017, SIA Group's fleet average age was 6.7 years while SQ's fleet had an average age of 7.7 years, as such the fleet renewal in our view is aimed at (1) Renewing aircraft into more efficient longer-haul aircraft while SIA Group is still able to recoup some second-hand value from older aircrafts; and (2) Capacity expansion of SilkAir and BAH. SQ is steadfastly keeping its market positioning as a premium airline with an on-going commitment to keeping a young fleet. Furthermore, SIA Group is aiming to take on competition by offering non-stop ultra-long haul flights. Eg: SQ is restarting a non-stop flight between Singapore-New York in 2018 (19 hours flight versus 24-30 hours currently), targeted to business travellers.

Figure 6: Fleet Development

		SQ	SilkAir	BAH	SIA Cargo
Operating fleet as at 31 March 2017		106	30	35	7
In:					
A380-800	Range: 15,700 km Typical seating: 525 Superjumbo. Hub-to-hub connections on high-yielding routes	+2			
A350-900	Range: 15,000 km Typical seating: 325 Medium, long and ultra-long haul eg: point-to-point. Cornerstone of SIA Group's fleet renewal plans	+10			
737 MAX 8	Range: 6,150 km Typical seating: 178 Fuel efficient, short-medium haul aircraft		+4		
787-8	Range: 13,620 km Typical seating: 242 Fuel efficient medium-to-long-haul aircraft			+4	
A320	Range: 6,850km Typical seating: 150 Single aisle, short-medium haul aircraft			+3 (returned by lessee)	
Out:					
A380-800	Range: 15,700 km Typical seating: 525 Superjumbo. Hub-to-hub connections on high-yielding routes. To be replaced by newer A380s	-4			
A330-300	Range: 11,750 km Typical seating: 277 Medium-to-long haul aircraft. To be replaced by A350s	-2			
777-200	Range: 9,700 km Typical seating: 305 Older aircrafts to be replaced by A350s	-2			
777-200ER	Range: 14,305 km Typical seating: 301 Older aircrafts to be replaced by A350s	-1			
A320	Range: 6,850 km Typical seating: 150 Single aisle, short-medium haul aircraft			-2	
Expected operating fleet as at 31 March 2018		**109**	**34**	**40**	**7**

Note: Typical seating per aircraft provided by aircraft manufacture
Source: SIA Group presentation, Boeing and Airbus website

Figure 6: SIA Group Projected Capex FY2018 to FY2022

FYE March (SGDmn)	2018	2019	2020	2021	2022
Aircraft	5,300	6,400	6,100	6,200	5,300
Other Assets	180	140	180	130	170
Total	**5,480**	**6,540**	**6,280**	**6,330**	**5,470**
Proportion of five year accumulated projected capex	18%	22%	21%	21%	18%

Note: As at 31 March 2017
Source: Company presentation

- **Cash flow from operations unlikely to keep up with investments:** In 1QFY2018, including cash received from sales in advance of carriage of SGD299mn, SIA Group reported SGD776.2mn in cash flow from operations (before interest, tax and payment of fines). During the quarter, the company paid SGD139mn in fines after the European Commission re-imposed fines on SQ and SIA Cargo for alleged anti-competitive behaviour. Net CFO was hence lower at SGD644.2mn (1QFY2017: SGD759mn). During the quarter, SIA Group paid SGD18.6mn in interest, rendering Net CFO/Interest paid of 34.6x, still very healthy even though interest paid had increased by 72%. Total net cash outflows for investing amounted to SGD1.7bn in 1QFY2018 and the cash gap at the company was funded via SGD700mn in proceeds from a new bond (issued in April 2017) and a SGD424.9mn drawdown of beginning cash balance. We expect some contribution from disposed fleet proceeds, though do not think this would be a significant source of capex funding.

- **Gearing expected to rise:** As at 30 June 2017, headline gross gearing at SIA Group was 0.19x while the company was in a cash surplus position of -0.03x on a net-basis. While still low, it has crept up from 31 March 2017 (0.14x and -0.11x respectively). We expect SIA Group to turn net debt by FY2018, with net gearing reaching ~0.12x-0.18x and going higher in the following years. Rather than issuing new equity, we assume additional debt is taken to fund the gap between operating cash flow and capex. In August 2017, SIA Group had issued a further SGD700mn in bonds. As at 31 March 2017, non-cancellable operating leases where SIA Group was a lessor was SGD4.1bn. Assuming this was unchanged as at 30 June 2017 and adjusting these non-cancellable operating leases as debt, we find adjusted gross gearing and adjusted net gearing to be 0.50x and 0.28x respectively, a better reflection of SIA Group's gearing levels in our view. SIA Group reported a cash balance of SGD2.9bn as at 30 June 2017, though sales in advance of carriage (a current liability item) were SGD1.9bn. This is a common line item across airlines as tickets are sold prior to trips (up to one year in advance). We are of the view though that this cash needs to be kept as part of day-to-day operations. If used, this cash would need to be replaced (eg: from new debt or continuous pre-sales) to allow the business to function without disruptions.

- **Recommendation:** We are maintaining a **Neutral** issuer profile on SIA Group and may relook this should operating conditions or credit standing deteriorate beyond our expectations. We see valuation of Singapore Telecommunications' bonds as an upper bound to the SIASP curve. On a fair value basis, we see the SIASP curve at 25-40 bps wider than STSP (rated at A+/A1/A+). Both these issuers share a common major shareholder in Temasek though we hold STSP's issuer profile at Positive. We are underweight the SIASP '27s, SIASP '26s and SIASP '24s, and see fair value at 25-40bps wider than where they are now trading at. We are neutral the SIASP '25s. At the shorter end of the curve, we are underweight the SIASP '20s and SIASP '21s and see fair value at 15-25 bps wider.

  We have considered the following:

A) Adjusting for maturity, there is little-to-no spread differential between an implied-SGD STSP against SIASP '27s, SIASP '26s and SIASP '24s. In our view, the credit risks on these SIASP bonds are under-priced. We see SIASP's fair value at 25-40bps wider versus the ST SP. In addition to higher credit risk, in our view SIASP is susceptible to further supply risk. We currently hold STSP's issuer profile at Positive.
B) The STSP '20s is trading at a spread of 23bps, while the SIASP '20s is trading at 35bps spread (only 12bps apart)

C) Within the investment grade airline sector, we use Qantas Airways (QANAU, rated at BBB-/Baa2/NR) and Southwest (LUV, rated at BBB+/A3/BBB+) as the closest comparable to SIASP (unrated). Both the QANAU and LUV curves have tightened since July 2017, providing only fair value against the SIASP. We do not cover QANAU and LUV.

Singapore Airlines Ltd

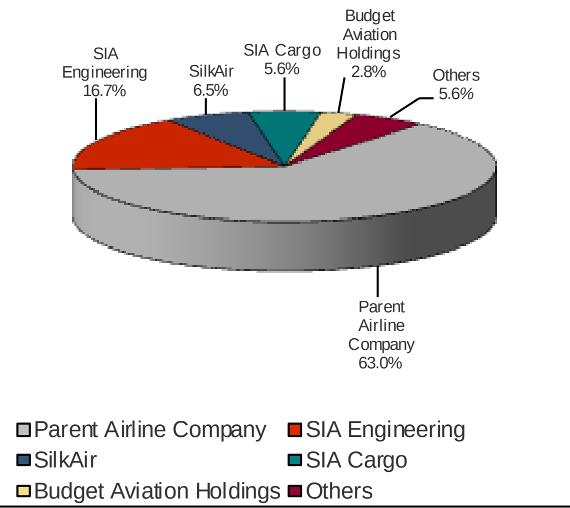
Table 1: Summary Financials

Year End 31st Mar	FY2016	FY2017	1Q2018
Income Statement (SGD'mn)			
Revenue	15,238.7	14,868.5	3,864.2
EBITDA	2,256.9	2,214.7	691.3
EBIT	681.2	622.8	280.8
Gross interest expense	50.3	46.1	20.1
Profit Before Tax	972.4	518.6	292.9
Net profit	804.4	360.4	235.1
Balance Sheet (SGD'mn)			
Cash and bank deposits	3,972.4	3,380.5	2,935.9
Total assets	23,769.7	24,720.0	25,424.4
Gross debt	1,347.5	1,836.7	2,596.9
Net debt	-2,624.9	-1,543.8	-339.0
Shareholders' equity	13,132.9	13,470.2	13,515.6
Total capitalization	14,480.4	15,306.9	16,112.5
Net capitalization	10,508.0	11,926.4	13,176.6
Cash Flow (SGD'mn)			
Funds from operations (FFO)	2,380.1	1,952.3	645.6
* CFO	3,005.5	2,532.9	644.2
Capex	2,909.0	3,944.7	1,751.0
Acquisitions	130.3	225.3	21.3
Disposals	664.0	1,640.0	360.1
Dividend	359.0	558.9	0.8
Free Cash Flow (FCF)	96.5	-1,411.8	-1,106.8
* FCF adjusted	271.2	-556.0	-768.8
Key Ratios			
EBITDA margin (%)	14.8	14.9	17.9
Net margin (%)	5.3	2.4	6.1
Gross debt to EBITDA (x)	0.6	0.8	0.9
Net debt to EBITDA (x)	-1.2	-0.7	-0.1
Gross Debt to Equity (x)	0.10	0.14	0.19
Net Debt to Equity (x)	-0.20	-0.11	-0.03
Gross debt/total capitalisation (%)	9.3	12.0	16.1
Net debt/net capitalisation (%)	-25.0	-12.9	-2.6
Cash/current borrowings (x)	18.7	80.5	76.5
EBITDA/Total Interest (x)	44.9	48.0	34.4

Source: Company, OCBC estimates

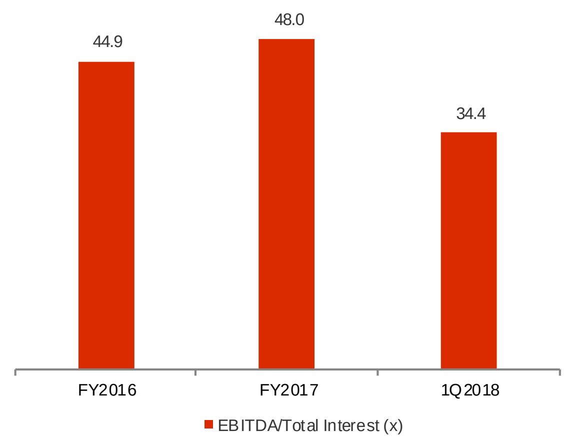
**FCF Adjusted = FCF - Acquisitions - Dividends + Disposals | *CFO before deducting interest expense*

Figure 1: EBIT breakdown by Segment - 1Q2018



Source: Company | Excludes Inter-segment Eliminations and one-off items

Figure 2: EBITDA/Total Interest (x)



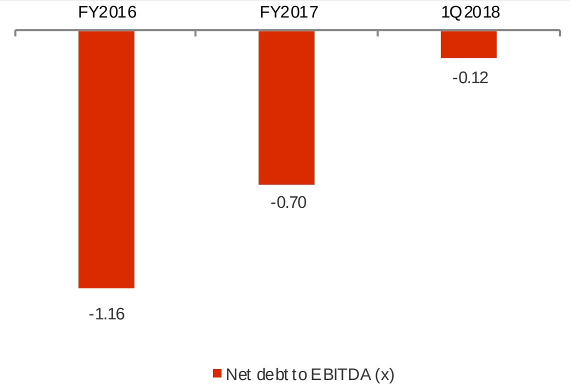
Source: Company

Figure 3: Debt Maturity Profile

Amounts in (SGD'mn)	As at 31/03/2017	% of debt
Amount repayable in one year or less, or on demand		
Secured	31.9	1.4%
Unsecured	6.5	0.3%
	38.4	**1.7%**
Amount repayable after a year		
Secured	70.4	3.1%
Unsecured	2,150.7	95.2%
	2,221.1	**98.3%**
Total	**2,259.5**	**100.0%**

Source: Company

Figure 4: Net debt to EBITDA (x)



Source: Company, OCBC estimates

The credit research team would like to acknowledge and give due credit to the contributions of Yeo Jin Peng.