OCBC Bank

Ticker:
CATHAY

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Cathay Pacific Airways Ltd ("Cathay")

OCBC Credit Research does not cover Cathay. We present this paper as a special interest commentary.

Key considerations

- **Airlines reasserting their strategic role at times of crisis:** Globally, airlines are one of the hardest hit sectors by COVID-19 (along with hospitality) on the back of restricted movement of people and social distancing measures. Airlines without a hinterland such as Cathay is likely to face a slower recovery versus those serving domestic routes given the complexity in negotiations for international re-opening of borders and divergence in virus recovery rates across countries. Given the high uncertainty and airlines focusing on survival mode, Cathay has understandably not provided its updated sector or company outlook but has instead pointed towards the International Air Transport Association ("IATA")'s guidance that air travel would not return to pre-crisis levels before 2023. Major airlines have been in a binary situation of either entering into a debt restructuring or receiving some form of state backed support (ranging from minimal support through waiver of fees and levies to government bail-outs). On 9 June 2020, Cathay announced a HKD39bn recapitalization plan which would see the HKSAR government funding 70% of this capital raising transaction. Assuming the conversion of warrants into common equity, another HKD1.95bn would be raised, with the HKSAR government owning a ~6.0%-stake in Cathay's enlarged share capital.

- **Immediate liquidity needs tackled:** Due to COVID-19, Cathay announced an unaudited loss of HKD4.5bn in 4M2020 for the flagship airline Cathay Pacific ("CX") and regional airline Cathay Dragon combined, setting back two consecutive years where Cathay managed to report net profits (HKD1.7bn in 2019 and HKD2.8bn in 2018). It was also disclosed that cash burn per month was between HKD2.5bn to HKD3.0bn. Assuming HKD3.0bn cash burn per month, this implies HKD18.0bn cash will be burnt through 1H2020 versus its cash balance of HKD8.9bn in end-2019 and HKD11.1bn of liquid funds that includes committed undrawn facilities and debt securities managed by investment managers (excluding pledged liquid funds). In our view, Cathay benefited from a strong cargo business while cuts in staff costs helped conserve cash, given other operating expenses are relatively fixed. Per the company, the cash burn also included front-loaded refunds on air tickets which points towards lower cash burn in 2H2020. Cathay did not specifically break down the use of net proceeds from its recapitalization proposal of HKD38.9bn although at end-2019, it faced HKD20.8bn of short term debt (representing 21% of total debt). While Cathay did not share how much capital expenditure is needed for 2020, we assume that it will be difficult to push back on near term aircraft deliveries. On average, Cathay made HKD14.1bn in capex in the past two years. Assuming part of the proceeds go towards capex and the short term debt gets refinanced (rather than paid down), the remaining HKD24.8bn in net proceeds would be sufficient to cover around eight months of cash burn. With HKD2.0bn liquidity remaining from end-2019, a new SGD175mn (~HKD973mn) of bonds raised in January 2020, a private bond placement of HKD400nn also in January 2020 and USD703.8mn (~HKD5.5bn) from sales and leaseback in March 2020, this stretches cash burn coverage by an additional three months.

- **Mainland China market an important and concentrated source of revenue:** Cathay is heavily reliant on sales from HKSAR and Mainland China, with HKSAR and Mainland China consistently taking up around 50% of CATHAY's total revenue by origin of sale since 2013. 2019 revenue was down 4% y/y though based on our calculation, revenue for 2H2019 was down 8% y/y (compared to +13% y/y from 2H2017 to 2H2018). The weaker performance in 2H2019 came on the back of social unrest in HKSAR which also saw the performance of the travel and hospitality industry being dragged. In 1H2019, 34.9 million visitors visited HKSAR but this had fallen to 21.0 million in 2H2019 (down 40% h/h and 39% y/y). While Cathay's operations are global and Cathay is an international brand, to its core geographical markets, the brand is quintessentially linked to developments in HKSAR, including the current political climate, with 2019 seeing a knock on impact on its operations. The company also faces heightened competition from Chinese airlines, which in recent years, have grown faster and now account for more than half of total international seat capacity in China. In our view, rather than passengers arriving into an international hub to catch a connecting flight, increased international seat capacity in China means increased options for passengers to either fly point-to-point or via a Chinese hub (eg: via Beijing, Shanghai, Guangzhou) instead.

- **Air Hong Kong, Asia Miles and associate stakes important to profits:** In 2019, Cathay reported HKD2.8bn of earnings before interest and tax ("EBIT") on HKD103.3bn of revenue for its CX, Cathay Dragon and HK Express businesses (collectively, we group it as the Airline business), although within the Airline business, there is no further breakdown of contribution between passenger and cargo services (from the belly hold of passenger aircraft and CX operated freighters). Based on our estimation, combined revenues from its passenger and cargo services within Airline) would have been insufficient to cover costs, suggesting that Asia Miles is a main contributor to Airline business EBIT. Asia Miles, Cathay's reward programme, is a market leading programme in Asia, which has seen its membership base grow from more than 8 million in 2015 to nearly 12 million in 2019. In 2019, Air Hong Kong (a solely cargo focused airline) contributed HKD797mn in EBIT. Air Hong Kong has a block space arrangement with DHL International that we think is likely to come with stable revenue. For 2019, Cathay's other businesses (eg: catering, cargo terminal, ground handling) reported a loss of HKD111mn in 2019. Cathay's key associates are its ~18%-equity stake in Air China Limited ("Air China") and stake in Air China Cargo Co. Ltd ("Air China Cargo"), a leading air cargo provider in China. Cathay has an ~18%-equity stake in Air China Cargo but a ~35% economic interest in this business. At HKD1.6bn, share of associates was 77% of total profit before tax in 2019.

- **Susceptible to jet fuel price with hedging decisions impacting bottom line:** Cathay is susceptible to fuel cost with fuel making up ~29% of total operating expenses in 2019. While hedging provides stability to an airlines' forecasted income, being locked into high fuel price contracts amidst weakening fuel prices means that the airline is still obliged to pay higher fuel price even if the market price has fallen. Cathay has in the past reported significant fuel hedging losses though this had narrowed to HKD101mn in 2019 (2018: HKD1.4bn). Since its transformation plan that begun in early 2017, the company had changed its hedging strategy where fuel needs are hedged no longer than two years out with no more than a 50% exposure to expected total fuel needs. As at end-2019, ~40% of 2020 fuel needs were hedged at an average strike price of ~USD61 to ~USD65 (Brent per bbl). With capacity cut severely (CX and Cathay Dragon combined passenger capacity down 59.5% y/y for 5M2020), actual fuel needs have declined though the forward fuel hedges still persist. Per company, assuming USD40 Brent per bbl, this may mean ~HKD250mn per month of fuel hedging losses.

- **More levered with thinner interest coverage versus other airlines we cover:** In 2019, EBITDA (based on our calculation) was HKD17.5bn, higher by 28% y/y. In-line with lower revenue, fuel costs were also lower. Interest expense was HKD3.3bn, with resultant EBITDA/Interest of 5.4x. Cathay is a relatively levered issuer in our view, with an unadjusted gross gearing of 1.55x as at 31 December 2019 while gross debt-to-EBITDA was 5.5x in 2019 (2018: 5.5x), higher versus Singapore Airlines Ltd (Issuer profile: Neutral (5)). That said EBITDA/Interest coverage is unlikely to be meaningful for 2020, with Cathay anticipating a substantial loss for 1H2020. We pay closer attention to gross gearing (rather than net gearing) for airlines given very significant revenue is received in advance of services provided, especially more so amidst dampening demand which has led to customer refunds (and thereby dwindling its cash balance).

Background

- Founded in 1946, Cathay is the flagship carrier of the HKSAR, serving Hong Kong International Airport. The company is listed on the Hong Kong Stock Exchange ("HKEX") with a market cap of HKD31.9bn (~USD4.1bn) as at 17 June 2020.
- Cathay's key businesses are divided into four segments: (1) CX and Cathay Dragon comprising passenger services and cargo services within the bellyhold and CX freighters (2) HK Express, low cost passenger airline bought in July 2019 from HNA (3) Air Hong Kong, dedicated cargo freighter business (4) Airline services comprising catering, cargo terminal operations, ground handling services and commercial laundry operations.
- Geographically, the majority of Cathay's total revenue by area of original sale was from North Asia – with 51% of total revenue from HKSAR and Mainland China, and 9% of total revenue from Japan, Korea and Taiwan. Meanwhile, the Americas contributed 13% to total revenue, Europe contributed 10%, Southeast Asia 7%, Southwest Pacific 5% and lastly, South Asia, Middle East and Africa contributed 5% to total revenue.

Ownership and Management

Swire Pacific Limited ("Swire"), the largest shareholder of Cathay is listed on the Hong Kong Stock Exchange and New York (via American Depository Receipts) with a market cap of HKD62.8bn (~USD8.1bn) as at 17 June 2020. Swire, which bought a stake in Cathay's flagship airline in 1948, originated from an import-export company founded in 1816. Over the years, Swire's growth and expansion was interlinked with Hong Kong's early history under British rule. Today, Swire is a conglomerate with businesses spanning aviation, property, beverages, and marine services, trading and industrial. John Swire & Sons Limited (controlled by members of the Swire family) holds the single largest voting block of Swire across its dual-class share structure.

The second largest shareholder of Cathay holding a ~29.99%-stake is Air China, its strategic partner. Cathay has a cross-holding in Air China with a 18%-stake in Air China. Air China is listed on both the HKEX and the Shanghai Stock Exchange and is indirectly majority controlled by the Chinese state via China National Aviation Holding Company Limited ("CNAHC"). Headquartered in Beijing, Air China's flagship airline, along with China Southern and China Eastern form the "Big Three" Chinese airlines. Collectively, Swire and Air China holds a 74.99%-stake in Cathay. A shareholder's agreement (eg: covering take-over matters and board rights) governs their relationship.

Qatar Airways, the state-owned airline of the Qatari government holds 9.99% stake in Cathay, While both are part of the Oneworld airline alliance, pre-COVID-19, there appears little influence by Qatar Airways over CATHAY's operations and Qatar Airways has no representation on CATHAY's board. Qatar Airway's stake in Cathay is considered as public float.

Figure 1: Major Shareholders as at 9 June 2020

Unitholder	Shares	Deemed interest
Swire Pacific Limited	1,770,238,000	45.00%
Air China Ltd	1,179,759,987	29.99%
Qatar Airways	392,991,000	9.99%
Other public investors	590,855,585	15.02%

Source: Bloomberg, Company

A recapitalisation plan for times in need

On 9 June 2020, Cathay announced a recapitalisation plan that will raise HKD39bn of new cash infusion via preference shares with warrants, rights issue of common equity and a bridge loan. The HKSAR government via Aviation 2020 Limited ("Aviation 2020"), a company wholly-owned by the Financial Secretary Incorporated would provide 70% of the funding for the HKD39bn recapitalization plan. The investment is being carried out with the aim of upholding HKSAR's status as an international aviation hub and generating a return for the government. Similar to Singapore, the aviation sector is seen as a strategic component of economic development.

Another HKD1.95bn will also be raised from Aviation 2020 if it opts to exercise warrants into common equity of Cathay. Per Cathay, it plans to repay the government over three to five years.

The HKSAR government does not intend to be involved in the company's day-to-day management and would not have board seats on Cathay's board of directors despite the large capital outlay. The HKSAR government though would have two board observer seats, which allows the observers access to management and information. Swire Pacific, which is currently the single largest shareholder of Cathay has also undertaken that it will remain a controlling shareholder of Cathay as long as the HKSAR government remains a holder of outstanding preference shares or bridge loans. Cathay has a relatively complex shareholding structure that involves a cross-ownership with Air China, a shareholder's agreement and a framework agreement (covering operational matters) governs their relationship. In our view, the undertaking by Swire Pacific elegantly removes the uncertainty over Cathay's ownership during this period given long existing speculation that Swire Pacific may sell its stake to other parties such as Air China.

A review of Cathay's business model will be undertaken over the next few months. Management will present a recommendation to the board with regards to the company's size and shape in 4Q2020. There is no obligation on maintaining the company's neither staff strength nor scale as part of the recapitalisation funding.

Preference shares with equity warrants

(a) Aviation 2020 to subscribe for HKD19.5bn of cumulative preference shares issued by Cathay.
(b) The preference shares are not redeemable at the option of Aviation 2020, with Cathay holding the redemption option to redeem all or some of the preference shares at any time.
(c) Rank senior to common equity in a liquidation scenario.
(d) Preference dividend rate of 3.0% p.a from issue date to year three.
(e) Preference dividend rate of 5.0% p.a from year three to year four.
(f) Preference dividend rate of 7.0% p.a from year four to year five.
(g) Preference dividend rate of 9.0% p.a from year five onwards.
(h) No voting rights except in specific circumstances such as amendment to articles of association that adversely modify rights of the preference shares or the winding up of Cathay.
(i) Aviation 2020 will receive ~416.7mn warrants. These warrants are exercisable into Cathay common equity at HKD4.68 per share, subject to adjustments, within five years from issue date of the preference shares and warrants. Assuming these are exercised, Cathay will raise an additional HKD1.95bn and the HKSAR government will own a ~6.0%-stake in the company on a fully diluted basis (assuming completion of the Rights Shares).

Rights Shares leading to upfront expansion of equity base

(a) Rights issue to raise common equity ("Rights Share") amounting to ~HKD11.7bn. Seven rights share for every 11 existing shares held at a subscription price of HKD4.68 per share.
(b) The subscription price represents a 46.9% discount to the closing price on the last trading day before the announcement and 35.0% discount to theoretical ex-rights

price.

(c) Cathay's major shareholders Swire Pacific, Air China and Qatar Airways, collectively holding ~85%-stake in the company has irrevocably undertaken to subscribe for their pro-rata share of the Rights Shares.
(d) In the event the remaining 15% is not subscribed by minority investors, this would be underwritten by four banks.
(e) Shareholder approval for the Rights Shares is expected to take place at an Extraordinary General Meeting in July 2020 with completion expected in August 2020.

Bridge loans

(a) HKD7.8bn of bridge loans will be provided by Aviation 2020 to Cathay.
(b) The bridge loan is available for drawdown in one or more drawdowns for 12 months from the date of the bridge loan agreement. Each loan matures 18 months from date of drawdown.
(c) Security will be granted over certain aircraft and related insurances in favour of Aviation 2020.
(d) The interest cost for the bridge loans are at HIBOR + 1.5% (excluding upfront fees) which per Cathay are its market rates pre-COVID-19

How would the gross proceeds be used

Expenses in relation to the recapitalisation proposal are estimated at ~HKD100mn, with net proceeds of HKD38.9bn. The company intends to use net proceeds for general corporate purposes.

What the transactions mean for CATHAY bondholders:

- **Support from shareholders and the HKSAR government:** The Cathay transaction has taken some time to stich up, presumably so as it involves multiple stakeholders. This is an unprecedented move for the HKSAR government to invest directly into an entity that is owned by private companies, signifying the strategic role that Cathay plays for HKSAR. The strategic uplift would cover the tenor of the SGD-denominated CATHAY 3.375% '23s given it matures in January 2023 and other HKD issuances currently outstanding. Over the longer term, it is worth re-iterating that the intention is for Cathay to repay the HKSAR government's investment over three to five years. In our view, any strategic uplift of Cathay beyond five years would need to be taken into context of future development of the aviation industry of HKSAR and the Greater Bay Area, which houses increasingly internationalized airports. The substantial shareholders holding a collective ~85%-stake has undertaken to subscribe to their pro-rata stake.

- **Remaining unencumbered assets can still be used to raise funds:** Aircraft and related equipment comprise 57% of the HKD214.5bn of total assets as at 31 December 2019 (ie: HKD122.3bn of aircraft and related equipment). This implies gross debt-to-total aircraft and related equipment of ~80%. As at 31 December 2019, HKD54.5bn of aircraft and related equipment were pledged as security for secured bank loans, leaving HKD67.8bn unpledged. Security will be granted over certain aircraft and related insurances in favour of the lender of the HKD7.8bn bridge loan under the recapitalising proposal. While the quantum of the security was not provided, we do not expect this to be higher than the amount outstanding on the bridge loan. Earlier in March 2020, six Boeing 777-300ER aircraft were sold under a sale-and-leaseback arrangement, with a disclosed net asset value attributable of HKD5.3bn (asset value could be higher debt was taken on these aircraft, although this was undisclosed). In our view, while debtholders (including the SGD bondholders) would have less asset coverage, there is at least another HKD33.9bn in unpledged aircraft and related equipment and in the optimistic scenario, HKD54.6bn of assets that can generate liquidity if required.

- **Full equity treatment for the preference shares and enlarged equity base:** The preference shares of HKD19.5bn would be fully recognised as equity in the books of Cathay. While there is a distribution rate step-up (akin to corporate perpetuals), the preference shares can remain outstanding into perpetuity as Aviation 2020 has no right to call the preference shares and/or force redemption. Taken together with the new common equity to be raised via the Rights Shares and possibly more if the equity warrants are exercised, book value equity at Cathay may rise from HKD62.8bn as at 31 December 2019 to HKD95.9bn. Adding the two bonds that were raised in January 2023 and the new bridge loan, gross debt would increase by HKD9.2bn. Also adding HKD5.5bn of lease liabilities from the sale and leaseback arrangement gross gearing may fall to 0.95x (before factoring equity erosion from 2020 losses) versus 1.55x as at 31 December 2019. With the external support and stronger post-transaction balance sheet, Cathay aims to restore its access to funding markets.

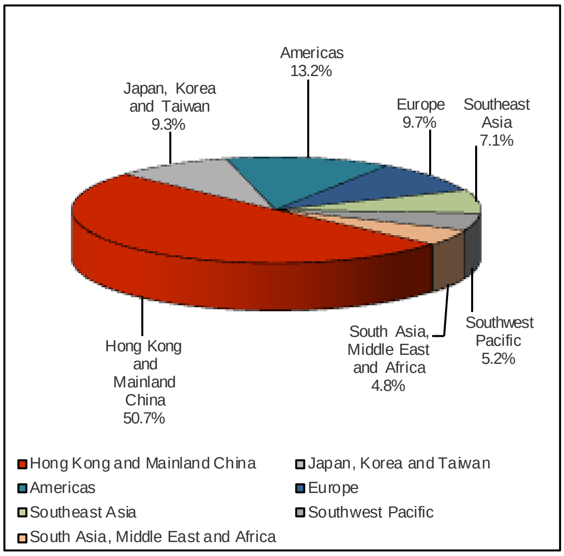
Cathay Pacific Airways Limited

Table 1: Summary Financials

Year End 31st Dec	FY2017	FY2018	FY2019
Income Statement (HKD'mn)	HKD'mn	HKD'mn	HKD'mn
Revenue	97,284.0	111,060.0	106,973.0
EBITDA	7,075.0	13,397.0	17,549.0
EBIT	-2,279.0	3,595.0	3,327.0
Gross interest expense	2,223.0	2,457.0	3,276.0
Profit Before Tax	-580.0	3,243.0	2,145.0
Net profit	-888.0	2,777.0	1,691.0
Balance Sheet (HKD'mn)			
Cash and bank deposits	6,914.0	7,672.0	8,881.0
Total assets	188,378.0	190,294.0	214,516.0
Short term debt	8,888.0	13,713.0	20,752.0
Gross debt	78,394.0	73,896.0	97,260.0
Net debt	71,480.0	66,224.0	88,379.0
Shareholders' equity	61,272.0	63,939.0	62,776.0
Cash Flow (HKD'mn)			
CFO	5,632.0	16,233.0	18,173.0
Capex	16,926.0	15,991.0	12,171.0
Acquisitions	0.0	0.0	1,697.0
Disposals	2,016.0	1,132.0	134.0
Dividend	453.0	1,154.0	1,496.0
Free Cash Flow (FCF)	-11,294.0	242.0	6,002.0
Key Ratios			
EBITDA margin (%)	7.27	12.06	16.41
Net margin (%)	-0.91	2.50	1.58
Gross debt to EBITDA (x)	11.08	5.52	5.54
Net debt to EBITDA (x)	10.10	4.94	5.04
Gross Debt to Equity (x)	1.28	1.16	1.55
Net Debt to Equity (x)	1.17	1.04	1.41
Gross debt/total assets (x)	0.42	0.39	0.45
Net debt/total assets (x)	0.38	0.35	0.41
Cash/current borrowings (x)	0.78	0.56	0.43
EBITDA/Total Interest (x)	3.18	5.45	5.36

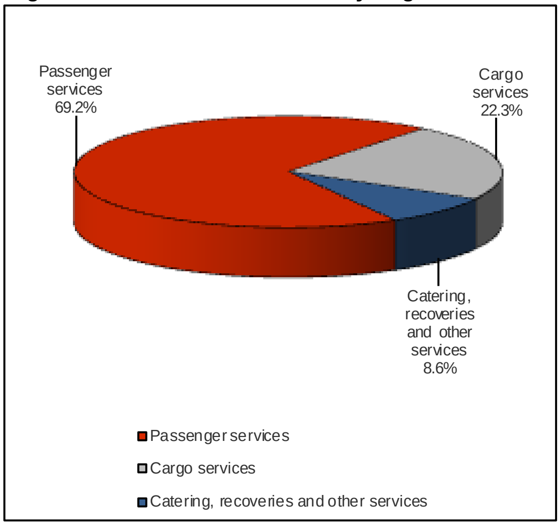
Source: Company, OCBC estimates

Figure 1: Revenue breakdown by Geography* - FY2019



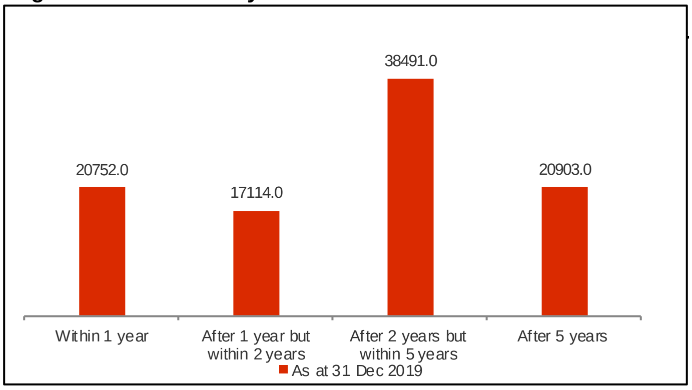
*Source: Company | *by origin of sale*

Figure 2: Revenue breakdown by Segment - FY2019



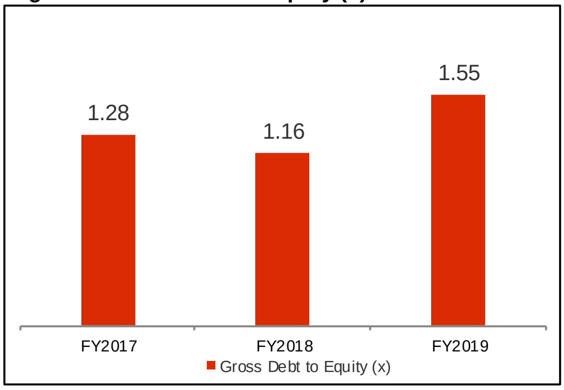
Source: Company

Figure 3: Debt Maturity Profile



Source: Company, OCBC estimates | Excludes lease liabilities

Figure 4: Gross Debt to Equity (x)



Source: Company

Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Please note that Bond Recommendations are dependent on a bond's price, underlying risk free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

Explanation of Bond Recommendation

Overweight ("OW") – The bond represents **better relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Neutral ("N") – The bond represents **fair relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Underweight ("UW") – The bond represents **weaker relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

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The credit research team would like to acknowledge and give due credit to the contributions of Lin Guixin.

Analyst Declaration
The analyst(s) who wrote this report and/or her or his respective connected persons did not hold financial interests in the above-mentioned issuer or company as at the time of the publication of this report.