

Industrials
Airlines
Equity – Hong Kong

Overweight

| | |
|-----------------------------|-------|
| Target price (HKD) | 21.10 |
| Share price (HKD) | 17.04 |
| Forecast dividend yield (%) | 2.1 |
| Potential return (%) | 25.9 |

Note: Potential return equals the percentage difference between the current share price and the target price, plus the forecast dividend yield

| Performance | 1M | 3M | 12M |
|---------------------------|------|------|------|
| Absolute (%) | -0.5 | 1.2 | 14.2 |
| Relative ^A (%) | 3.2 | -4.4 | 2.6 |

Index^A HANG SENG INDEX

RIC 0293.HK
Bloomberg 293 HK

Market cap (USDm) 8,633
Market cap (HKDm) 67,033

Enterprise value (HKDm) 113821
Free float (%) 25

Note: (V) = volatile (please see disclosure appendix)

Cathay Pacific (293 HK)

OW: Remains on track for a robust 2015 rebound

- ▶ **2014 profit HKD3.15bn, up 20% y-o-y but 20% below our forecast due to fuel hedging losses; traffic revenues in line**
- ▶ **Strong passenger bookings, continued cargo recovery and fuel cost savings suggest robust earnings rebound in 2015**
- ▶ **Stay OW, TP lowered slightly to HKD21.1 (from HKD21.5); value compelling and share price drivers are positive**

2014 net profit was HKD3.15bn, up 20% y-o-y but 20% below our forecast. Passenger revenues were better than expected but cargo was slightly worse (annual cargo contracts mean that most of the recent pick-up in the spot cargo yield will be enjoyed only in 2015). However, operating costs were 2% higher than expected due to fuel hedging losses (HKD0.9bn loss vs forecast of HKD0.4bn gain) – this explains the difference to our profit forecast.

Cathay has extended fuel hedging to 2018. The airline has 61% of 2015e fuel needs hedged at Brent of USD95/bl, and 60% of 2016 at Brent of USD85/bl. The hedging book was marked to market at year-end 2014, generating unrealised losses of HKD14.3bn, (there were also unrealised currency hedging gains of HKD1.8bn). HKD6.7bn of the fuel loss should reverse in 2015. Associates Air China and Air China Cargo have no fuel hedging

Management's guidance was bullish, largely driven by the good position Cathay now finds itself in rather than a strong pick-up in the overall market. Passenger demand is very strong, although yields are under pressure, and cargo continues to rebound. Most of the benefits of the recent fall in fuel prices will be felt in 1Q15 as Cathay buys fuel about 1.5 months in advance and much of the fuel surcharge income in early 2015 was set at higher fuel prices. We also believe that Cathay will boost underlying yields to help offset the fall in surcharges. In addition, despite hedging, Cathay estimates it will enjoy net fuel savings of HKD5bn in 2015 if Brent is at USD60/bl. We forecast a strong rebound in earnings and make no material change to our 2015 forecast which is 17% above consensus.

OW rating, TP lowered slightly to HKD21.1 (from HKD21.5). Since 2000, Cathay Pacific has traded at an average one-year forward book value of 1.25x and, given our forecast of normalising ROE, we believe Cathay's PB level should return to this average. Hence we derive our target price of HKD21.1 from this level (the decline is caused by a slightly lower 1-year forward book value, which is impacted by unrealised hedging losses). Earnings momentum – a key share price driver – remains positive; the key downside risk is US dollar strength.

18 March 2015

Mark Webb*

Analyst
The Hongkong and Shanghai Banking Corporation Limited
+852 2996 6574
markwebb@hsbc.com.hk

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Financials & valuation

Financial statements

| Year to | 12/2014a | 12/2015e | 12/2016e | 12/2017e |
|---|----------|----------|----------|----------|
| Profit & loss summary (HKDm) | | | | |
| Revenue | 105,991 | 110,261 | 116,180 | 121,918 |
| EBITDA | 13,029 | 16,914 | 20,026 | 20,514 |
| Depreciation & amortisation | -8,594 | -8,537 | -9,006 | -9,428 |
| Operating profit/EBIT | 4,435 | 8,378 | 11,019 | 11,087 |
| Net interest | -1,158 | -1,408 | -1,429 | -1,143 |
| PBT | 4,049 | 8,483 | 11,533 | 11,887 |
| HSBC PBT | 4,049 | 8,483 | 11,533 | 11,887 |
| Taxation | -599 | -1,045 | -1,439 | -1,492 |
| Net profit | 3,150 | 7,115 | 9,747 | 10,019 |
| HSBC net profit | 3,150 | 7,115 | 9,747 | 10,019 |

Cash flow summary (HKDm)

| Year to | 12/2014a | 12/2015e | 12/2016e | 12/2017e |
|---------------------------|----------|----------|----------|----------|
| Cash flow from operations | 23,984 | 6,490 | 15,522 | 17,875 |
| Capex | -12,130 | -12,100 | -7,100 | -10,100 |
| Cash flow from investment | -16,123 | -12,100 | -7,100 | -10,100 |
| Dividends | -1,418 | -2,988 | -4,240 | -4,258 |
| Change in net debt | 4,801 | 655 | -8,934 | -5,102 |
| FCF equity | 4,449 | -2,871 | 11,008 | 8,700 |

Balance sheet summary (HKDm)

| Year to | 12/2014a | 12/2015e | 12/2016e | 12/2017e |
|-----------------------|----------|----------|----------|----------|
| Tangible fixed assets | 98,471 | 102,034 | 100,128 | 100,800 |
| Current assets | 33,467 | 32,776 | 42,372 | 48,541 |
| Cash & others | 21,098 | 20,443 | 29,376 | 34,903 |
| Total assets | 171,974 | 175,945 | 185,055 | 193,318 |
| Operating liabilities | 35,980 | 31,560 | 33,564 | 35,179 |
| Gross debt* | 89,529 | 89,529 | 89,529 | 89,954 |
| Net debt* | 68,431 | 69,086 | 60,153 | 55,051 |
| Shareholders funds | 51,722 | 63,791 | 74,049 | 81,821 |
| Invested capital* | 90,994 | 102,942 | 103,193 | 104,818 |

*Includes capitalised operating leases

Ratio, growth and per share analysis

| Year to | 12/2014a | 12/2015e | 12/2016e | 12/2017e |
|-----------------------|----------|----------|----------|----------|
| Y-o-y % change | | | | |
| Revenue | 5.5 | 4.0 | 5.4 | 4.9 |
| EBITDA | 14.9 | 29.8 | 18.4 | 2.4 |
| Operating profit | 18.0 | 88.9 | 31.5 | 0.6 |
| PBT | 13.1 | 109.5 | 36.0 | 3.1 |
| HSBC EPS | 20.2 | 125.9 | 37.0 | 2.8 |

Ratios (%)

| Year to | 12/2014a | 12/2015e | 12/2016e | 12/2017e |
|-----------------------------|----------|----------|----------|----------|
| Revenue/IC (x) | 1.1 | 1.1 | 1.1 | 1.2 |
| ROIC | 5.4 | 9.0 | 10.7 | 10.7 |
| ROE | 5.5 | 12.3 | 14.1 | 12.9 |
| ROA | 2.6 | 5.0 | 6.3 | 6.0 |
| EBITDA margin | 12.3 | 15.3 | 17.2 | 16.8 |
| Operating profit margin | 4.2 | 7.6 | 9.5 | 9.1 |
| EBITDA/net interest (x) | 11.3 | 12.0 | 14.0 | 17.9 |
| Net debt/equity | 132.0 | 107.5 | 80.4 | 66.3 |
| Net debt/EBITDA (x) | 5.3 | 4.1 | 3.0 | 2.7 |
| CF from operations/net debt | 35.0 | 9.4 | 25.8 | 32.5 |

Per share data (HKD)

| Year to | 12/2014a | 12/2015e | 12/2016e | 12/2017e |
|------------------------------|----------|----------|----------|----------|
| EPS reported (fully diluted) | 0.80 | 1.81 | 2.48 | 2.55 |
| HSBC EPS (fully diluted) | 0.80 | 1.81 | 2.48 | 2.55 |
| DPS | 0.36 | 0.76 | 1.08 | 1.08 |
| Book value | 13.15 | 16.22 | 18.82 | 20.80 |

Key forecast drivers

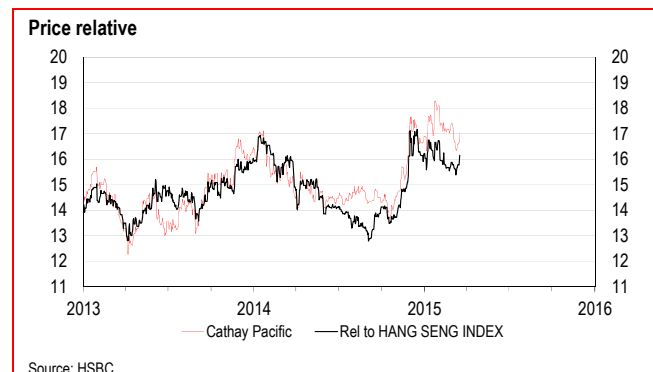
| Year to | 12/2014a | 12/2015e | 12/2016e | 12/2017e |
|--------------------------------|----------|----------|----------|----------|
| Capacity growth (ATK) %, y-o-y | 8 | 9 | 5 | 5 |
| Traffic (RTK) %, y-o-y | 10 | 9 | 6 | 5 |
| Overall load factor | 72.9 | 73.5 | 74.2 | 74.2 |
| Change in overall yield %, y-o | -3.5 | -6.0 | -0.8 | -0.4 |
| Change in unit costs per ATK % | -2.6 | -8.1 | -1.9 | 0.3 |
| Spot jet fuel price (USD/bbl) | 117 | 80 | 80 | 80 |

Valuation data

| Year to | 12/2014a | 12/2015e | 12/2016e | 12/2017e |
|--------------------|----------|----------|----------|----------|
| EV/sales | 1.1 | 1.0 | 0.9 | 0.8 |
| EV/EBITDAR | 7.1 | 5.7 | 4.5 | 4.1 |
| EV/IC | 1.2 | 1.2 | 1.0 | 0.9 |
| PE* | 21.3 | 9.4 | 6.9 | 6.7 |
| P/NAV | 1.3 | 1.1 | 0.9 | 0.8 |
| REP** | 1.6 | 1.0 | 0.7 | 0.7 |
| Dividend yield (%) | 2.1 | 4.5 | 6.3 | 6.4 |

Note: * = Based on HSBC EPS (fully diluted)

** REP = EV/IC divided by ROIC/WACC



Note: price at close of 17 Mar 2015

1. 2014 result versus prior year and HSBC forecast

| YE Dec (HKDm) | 2014 | 2013 | Chge % | HSBC 2014e | Diff % | 2H14 | 2H13 | Chge % | HSBC 2H14e | Diff % |
|--------------------------|----------------|----------------|-------------|----------------|----------------|---------------|---------------|-------------|---------------|-------------|
| Passenger | 75,549 | 71,631 | 5% | 74,370 | 2% | 39,029 | 36,756 | 6% | 37,850 | 3% |
| Cargo | 21,997 | 20,300 | 8% | 22,440 | -2% | 11,966 | 10,690 | 12% | 12,409 | -4% |
| Other | 8,445 | 8,553 | -1% | 9,194 | -8% | 4,156 | 4,453 | -7% | 4,905 | -15% |
| Total revenue | 105,991 | 100,484 | 5% | 106,004 | 0% | 55,151 | 51,900 | 6% | 55,164 | 0% |
| Fuel | 39,473 | 37,264 | 6% | 38,375 | 3% | 20,969 | 19,019 | 10% | 19,871 | 6% |
| Non fuel unit costs | 59,050 | 55,828 | 6% | 58,430 | 1% | 29,806 | 28,402 | 5% | 29,186 | 2% |
| Traffic op costs | 98,523 | 93,092 | 6% | 96,805 | 2% | 50,775 | 47,421 | 7% | 49,057 | 4% |
| Traffic EBIT | -977 | -1,161 | -16% | 5 | -21790% | 220 | 26 | 758% | 1,202 | -82% |
| Traffic EBIT margin | -0.9% | -1.2% | 0.2% | 0.0% | -1% | 0.4% | 0.0% | 0.3% | 2.2% | -2% |
| Other EBIT | 5,412 | 4,921 | 10% | 5,516 | -2% | 2,639 | 2,699 | -2% | 2,743 | -4% |
| EBIT | 4,435 | 3,760 | 18% | 5,521 | -20% | 2,859 | 2,725 | 5% | 3,945 | -28% |
| Net finance | 1,158 | 1,019 | 14% | 1,255 | -8% | 537 | 477 | 13% | 634 | -15% |
| Associates/JCE | 772 | 838 | na | 617 | 25% | 1,037 | 993 | na | 882 | 18% |
| Profit before tax | 4,049 | 3,579 | 13% | 4,883 | -17% | 3,359 | 3,241 | 4% | 4,193 | -20% |
| Taxation | 599 | 675 | -11% | 640 | -6% | 403 | 502 | -20% | 444 | -9% |
| Minorities | 300 | 284 | 6% | 303 | -1% | 153 | 143 | 7% | 156 | -2% |
| Net Profit | 3,150 | 2,620 | 20% | 3,940 | -20% | 2,803 | 2,596 | 8% | 3,593 | -22% |
| EPS (HKD) | 0.80 | 0.67 | 20% | 1.00 | -20% | 0.71 | 0.66 | 8% | 0.91 | -22% |
| DPS (HKD) | 0.36 | 0.22 | 64% | 0.40 | -10% | 0.26 | 0.16 | 63% | 0.30 | -14% |

Source: Company and HSBC estimates

Valuation and risks

Reiterate OW with a target price of HKD21.1 (from HKD21.5)

Our target price of HKD21.1 is based on a 1.25x one-year forward book value which is the average since 2000. Given our forecast of normalising ROE, we believe Cathay's PB level should return to this average. The decline in TP is caused by a slightly lower forecast book value, which is impacted by unrealised fuel hedging losses. We argue that Cathay Pacific's strong home base – which we believe is the best-positioned gateway into Southern China – and its greater exposure to North America mean that the carrier has a stronger medium-term outlook than its Asian competitors.

2. Key operating data

| HKD | 2014 | 2013 | Change % | 2014e | Diff % | 2H14 | 2H13 | Change % | HSBC 2H14e | Diff % |
|------------------------------|------|------|----------|-------|--------|------|------|----------|------------|--------|
| Revenue/ATK | 3.43 | 3.50 | -2% | 3.40 | 1% | 3.42 | 3.45 | -1% | 3.37 | 2% |
| Revenue/RTK | 4.71 | 4.88 | -3% | 4.67 | 1% | 4.68 | 4.78 | -2% | 4.61 | 1% |
| Passenger yields(\$/RPK) | 0.67 | 0.69 | -2% | 0.66 | 2% | 0.68 | 0.68 | 0% | 0.66 | 3% |
| Cargo yield (\$/km) | 2.19 | 2.32 | -6% | 2.23 | -2% | 2.21 | 2.31 | -5% | 2.29 | -4% |
| Unit costs per ATK | 3.46 | 3.55 | -2% | 3.40 | 2% | 3.41 | 3.45 | -1% | 3.29 | 4% |
| Unit costs per ATK (ex fuel) | 2.08 | 2.13 | -2% | 2.05 | 1% | 2.00 | 2.07 | -3% | 1.95 | 2% |

Source: Company and HSBC estimates

Under our research model, for stocks without a volatility indicator, the Neutral band is 5ppts above and below the hurdle rate for Hong Kong stocks of 8.5%. Our target price implies a potential return (including the forecast dividend yield of 2.1%) of 26%, which is above the Neutral band; therefore, we maintain our Overweight rating. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Key downside risks to our rating and forecasts include lower-than-expected Asian and global GDP growth, a sharp decline in business confidence, and a further material strengthening of the US dollar.

Disclosure appendix

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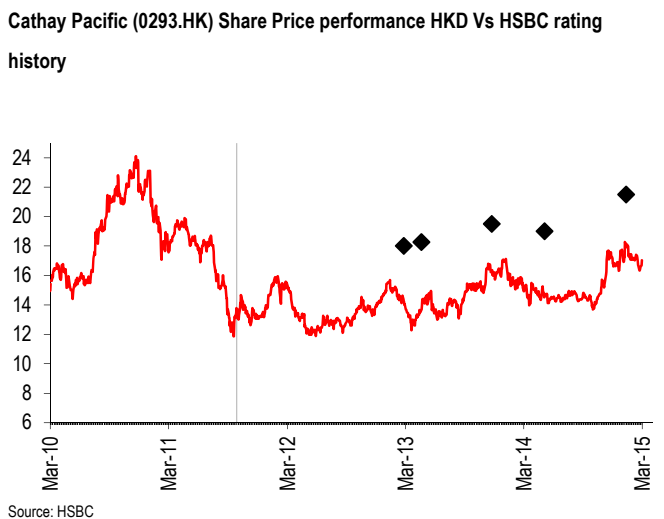
*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

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As of 18 March 2015, the distribution of all ratings published is as follows:

| | | |
|---------------------------|-----|--|
| Overweight (Buy) | 41% | (30% of these provided with Investment Banking Services) |
| Neutral (Hold) | 39% | (28% of these provided with Investment Banking Services) |
| Underweight (Sell) | 20% | (20% of these provided with Investment Banking Services) |

Share price and rating changes for long-term investment opportunities



Recommendation & price target history

| From | To | Date |
|--------------|------------|------------------|
| Neutral | Overweight | 14 October 2011 |
| Target Price | Value | Date |
| Price 1 | 18.00 | 13 March 2013 |
| Price 2 | 18.25 | 06 May 2013 |
| Price 3 | 19.50 | 09 December 2013 |
| Price 4 | 19.00 | 21 May 2014 |
| Price 5 | 21.50 | 28 January 2015 |

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

| Company | Ticker | Recent price | Price Date | Disclosure |
|----------------|---------|--------------|-------------|------------|
| CATHAY PACIFIC | 0293.HK | 17.04 | 17-Mar-2015 | 6, 7 |

Source: HSBC

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Issuer of report

The Hongkong and Shanghai Banking Corporation Limited

Level 19, 1 Queen's Road Central
Hong Kong SAR
Telephone: +852 2843 9111
Fax: +852 2596 0200
Website: www.research.hsbc.com

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