



Air China - H

Headline/recurring earnings beat expectations;
outlook positive; stays our top pick

Air China remains our top pick in the Chinese airline sector given its strong organic growth prospects driven by rising outbound Chinese traffic (Chinese air travel penetration remains low and has strong growth potential as incomes rise), premium and transit passenger market share gains, helped by its Star Alliance membership and 29%:20% cross-shareholding with Cathay Pacific, leverage to the growing West China market given its second hub in Chengdu, and lowest exposure to high-speed rail competition. Valuations look attractive with P/BV at a 15% discount to its historical average valuation and an EPS CAGR of 26% over 2015-17E.

- **Headline results beat our and market expectations; recurring earnings improved markedly:** 2H14 net profit rose 56% y/y, 548% h/h, to Rmb3.3B. This raised full year 2014 net profit to Rmb3.8B, 17% higher y/y with net margin of 3.6%. **Recurring profit was c.Rmb4.1B in 2014, 249% higher y/y. Core profit margin was 3.9%** and core ROE was 7.7%. Dec-14 BV/shr rose 1% h/h to c.Rmb4.4 while net debt-equity rose to c.1.94x from 1.79x. DPS was Rmb0.05 (15% higher y/y), implying an 18% payout ratio and yield of 1.0%.
- **Key 2H14 highlights – stronger traffic and cost efficiency:** Revenue rose 7% y/y, 12% h/h. Group pax traffic rose 8% y/y while yield was steady y/y at c.Rmb0.62. Group cargo traffic rose 18% y/y while yield fell 1% y/y to c.Rmb1.54. **2014 revenue breakdown by business segment:** Pax 88%, cargo 8% and other 4%. Unit cost/Unit cost ex-fuel fell 9%/7% y/y. OP rose 83% y/y, 110% h/h to Rmb4.9B with OP margin at 8.8%, 4ppts higher y/y, h/h.

Overweight

0753.HK, 753 HK

Price: HK\$6.85

Price Target: HK\$8.30

Hong Kong Airlines

Corrine Png^{AC}

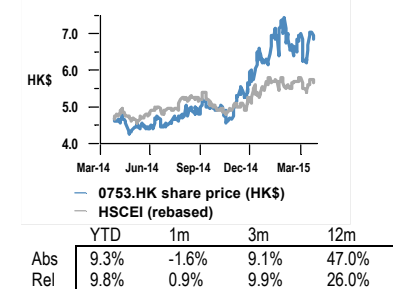
(65) 6882-1514

corrine.ht.png@jpmorgan.com

Bloomberg JPMA PNG <GO>

J.P. Morgan Securities (Asia Pacific) Limited

Price Performance



Air China - H (Reuters: 0753.HK, Bloomberg: 753 HK)

Rmb in mn, year-end Dec	FY12A	FY13A	FY14A	FY15E	FY16E
Revenue (Rmb mn)	99,473	98,181	105,884	107,078	119,223
Net Profit (Rmb mn)	4,816	3,264	3,817	5,912	7,041
Recurring Net Profit (Rmb mn)	4,697	1,326	4,178	6,212	7,041
EPS (Rmb)	0.40	0.27	0.31	0.45	0.54
Recurring EPS (Rmb)	0.39	0.11	0.34	0.47	0.54
DPS (Rmb)	0.06	0.05	0.06	0.08	0.09
Revenue growth (%)	1.1%	(1.3%)	7.8%	1.1%	11.3%
Recurring Net Profit growth	18.5%	(71.8%)	215.1%	48.7%	13.4%
EPS growth (%)	(31.9%)	(33.1%)	17.0%	45.5%	19.1%
Recurring EPS growth	18.7%	(72.1%)	215.1%	39.7%	13.4%
ROCE	4.6%	2.1%	3.7%	4.5%	4.8%
ROE	10.0%	6.3%	7.1%	10.4%	11.3%
P/E (x)	13.8	20.7	17.7	12.1	10.2
P/BV (x)	1.3	1.3	1.3	1.2	1.1
EV/EBITDA (x)	9.9	12.9	10.9	9.3	8.2
Dividend Yield	1.2%	0.9%	1.0%	1.4%	1.6%

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data	
Shares O/S (mn)	12,294
Market Cap (Rmb mn)	67,471
Market Cap (\$ mn)	10,860
Price (HK\$)	6.85
Date Of Price	26 Mar 15
Free Float(%)	26.0%
3M - Avg daily vol (mn)	13.90
3M - Avg daily val (HK\$ mn)	94.41
3M - Avg daily val (\$ mn)	12.2
HSCEI	11,919.69
Exchange Rate	7.75
Fiscal Year End	Dec

See page 12 for analyst certification and important disclosures, including non-US analyst disclosures.

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<p>Key catalysts for the stock price:</p> <p>Rising travel penetration in China, yield improvement from increased premium traffic, increased traffic feed from Star Alliance partners, more synergies from tie-up with Cathay Pacific, further liberalization of China's air links, falling fuel prices, industry M&A.</p>	<p>Upside risks to our view:</p> <p>Air traffic growth accelerates, falling fuel prices, Rmb rebounds, industry alliances/consolidation.</p>	<p>Downside risks to our view:</p> <p>China's growth stalls, resulting in industry oversupply, rising competition from high-speed rail expansion, volatile fuel prices, weaker-than-expected earnings contribution from Cathay Pacific and other associates.</p>
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Key financial metrics	FY14A	FY15E	FY16E	FY17E
Revenues (LC)	105,884	107,078	119,223	130,676
Revenue growth (%)	7.8%	1.1%	11.3%	9.6%
EBITDA (LC)	18,585	22,617	25,007	26,912
EBITDA margin (%)	17.6%	21.1%	21.0%	20.6%
Tax rate (%)	15%	15%	15%	15%
Net profit (LC)	3,817	5,912	7,041	8,170
EPS (LC)	0.310	0.452	0.538	0.624
EPS growth (%)	17.0%	45.5%	19.1%	16.0%
DPS (LC)	0.06	0.08	0.09	0.10
BVPS (LC)	4.39	4.52	4.97	5.49
Operating cash flow (LC mn)	14,064	19,059	22,162	23,944
Free cash flow (LC mn)	3,751	(6,096)	7,008	8,790
Interest cover (x)	6	8	9	10
Net margin (%)	3.6%	5.5%	5.9%	6.3%
Sales/assets (X)	0.51	0.49	0.52	0.56
Debt/equity (%)	193.4%	189.7%	166.3%	144.9%
Net debt/equity (%)	193.8%	188.3%	162.3%	136.5%
ROE (%)	7%	10%	11%	12%
Key model assumptions	FY14A	FY15E	FY16E	FY17E
Passenger traffic growth	9.0%	9.4%	8.3%	7.4%
Passenger yield growth	-3.0%	-8.4%	2.7%	1.8%
Jet fuel price (US\$/bbl)	141.0	93.0	101.0	105.0
CNY/USD	6.16	6.25	6.25	6.25

Source: Bloomberg, Company and J.P. Morgan estimates.

Sensitivity analysis	EBITDA	EPS
Sensitivity to 1% change in	FY15E	FY15E
Passenger traffic growth	+/-4%	+/-10%
Passenger yield growth	+/-4%	+/-12%
Jet fuel price (US\$/bbl)	-/+1%	-/+2%
CNY/USD	-/+1%	-/+5%

Source: J.P. Morgan estimates. *Large earnings sensitivity due to small profit base.

Comparative metrics	CMP	Mkt Cap	P/E (x)		P/BV (x)		ROE (%)		YTD Stock perf.
	LC	\$MM	FY15E	FY16E	FY15E	FY16E	FY15E	FY16E	
Air China – H	6.85	10,860	12.1	10.2	1.2	1.1	10.4%	11.3%	9.3%
China Eastern – H	4.18	11,942	10.5	9.3	1.2	1.1	12.4%	12.2%	12.4%
China Southern – H	4.73	10,819	10.8	9.5	1.0	0.9	9.4%	9.8%	28.2%
Average			16.7	11.0	1.5	1.3	9.3%	10.8%	8.5%

Source: Bloomberg, J.P. Morgan estimates. Prices are as of 26th March, 2015.

Valuation and price target basis

Our Dec-15 H-share price target of HK\$8.3 is based on 1.4x P/BV, in line with Air China H-share's historical average P/B valuation since listing (excluding the M&A speculation period).

P/BV trading range since listing



Source: Bloomberg, J.P. Morgan estimates.

JPM change in estimates and vs Consensus

EPS (LC)	FY15E	FY16E
JPMe old	0.51	0.59
JPMe new	0.45	0.54
% chg	-12%	-8%
Consensus	0.54	0.64

Source: Bloomberg, J.P. Morgan.

2H14 Results Review

2014 headline results ahead of our and consensus expectations; recurring earnings also improved markedly

2H14 net profit rose 56% y/y, 548% h/h, to Rmb3.3B with a net profit margin of 5.9%, 2ppts higher y/y, 5ppts higher h/h. This resulted in full year 2014 net profit of Rmb3.8B, 17% higher y/y, with a net margin of 3.6%. Cathay Pacific contributed Rmb590MM profit in 2014 (or 12% of Air China's pre-tax profit) vs a profit of Rmb423MM in 2013 (or 9% of pre-tax profit).

Excluding Rmb360MM in FX losses (due to CNY depreciation) and Rmb40MM disposal gains, Air China reported a recurring profit of c.Rmb4.1B in 2014, 249% higher y/y. Core profit margin was 3.9% and core ROE was 7.7%. Dec-14 BV/shr rose 1% h/h to c.Rmb4.4 while net debt-equity rose to c.1.94x vs 1.79x at the end of 2013. DPS of Rmb0.05/share (15% higher y/y) implying a payout ratio of 18% and yield of 1.0%.

Total capital commitments rose 21% h/h to Rmb139.8B in end Dec-14 while operating lease commitment rose 23% h/h to Rmb35.3B.

Key 2H14 highlights

Revenue rose 7% y/y, 12% h/h, mainly driven by higher traffic as yields were flat to slightly lower y/y. Other revenue rose 3% y/y but fell 14% h/h.

Group passenger traffic rose 8% y/y, 6% h/h in 2H14. Group pax load factor (PLF) was 79%, 1ppt lower y/y, h/h. Group passenger yield was flat y/y but rose 7% h/h to c.Rmb0.62.

Group cargo traffic rose 18% y/y, 22% h/h. Group cargo load factor (CLF) fell 1ppt y/y but rose 4ppts h/h to 58%. Group cargo yield fell 1% y/y and was flat h/h at c.Rmb1.54.

2014 passenger & cargo revenue breakdown: Mainland China 64% (-1ppt y/y), HK/Macau/Taiwan 6% (flat), Europe 11% (flat), North America 9% (+1ppt), Japan & Korea 5% (flat), Asia Pacific & Others 5% (flat).

2014 revenue breakdown by business segment: Pax 88%, cargo 8% and other 4%.

Operating costs rose 3% y/y, 7% h/h in 2H14 and lower than revenue growth y/y which is positive, Higher operating costs y/y was mainly due to higher aircraft maintenance, repair and overhaul costs (+22% y/y due to expansion of fleet size), aircraft and engine operating lease expenses (+14%), other flight operation expenses (+11%), employee compensation costs (+8% due to higher number of employees and adjustment in compensation level) and takeoff, landing and depot charges (+8% due to increase in number of takeoff and landings). Unit cost fell 9% y/y, 2% h/h while Unit cost ex-fuel fell 7% y/y and rose 1% h/h. Operating profit rose 83% y/y, 110% h/h to Rmb4.9B with OP margin at 8.8%, 4ppts higher y/y, h/h. Finance costs rose 179% y/y to Rmb1.0B in 2H14 mainly due to F/X losses in 2H14 vs F/X gains in 2H13.

In 2014, Air China added 67 new aircraft and retired 24 planes, lowering the average fleet age to 6.08 years – one of the youngest fleets among the Asian full-service airlines.

Operating outlook

Management commented that “in 2015, although the Company faces challenges from the industry’s changing landscape and intensifying competition inside or outside the industry, the global aviation industry is on a positive trend. As China’s economy maintains its growth at a high to moderate rate under the “new normal”, the increase of consumption level of Chinese consumers and the change of their consumption structure will provide a new dimension and a new strategic opportunity for the development of China’s aviation industry. (Air China) Group will proactively adjust to the new normal and new industry characteristics, and continue to pursue (their) goal of “building a large network airline with international competitiveness”. (They) will move forward prudently, strive to increase our profitability, operating management capability and administrative ability, fortify (their) advantages, and seek new drivers under the new normal, thereby providing a better return to (their) shareholders and the society”.

Trimming estimates to factor in weaker Rmb and higher fuel price

We trim our FY15-16 earnings forecasts slightly, mainly to factor in the weaker Rmb and higher fuel prices.

Our Dec-15 H-share price target of HK\$8.3 is based on 1.4x P/BV, in line with Air China’s historical average valuation since listing (excluding the M&A speculation period).

Notwithstanding China’s slowing economic growth, we remain bullish on the LT growth prospects of the airline sector given China’s low travel penetration (at 0.2x trips per capita vs 2.0x for developed markets) and expect China’s air traffic to grow 1.5x China’s real GDP growth going forward, in line with the sector average multiplier.

Industry demand-supply growth will come into balance from 2015 with potential supply shortage longer term as aircraft deliveries moderate and imply a fleet growth of only c.10% in 2015E, c.4% in 2016E and c.3% in 2017E, before taking into account aircraft retirement. This should help lift the sector and Air China’s earnings growth next year, driving a re-rating.

Our top pick in the Chinese airline sector is Air China in the longer term, given its strong organic growth prospects driven by rising outbound Chinese traffic (Chinese air travel penetration remains low and has strong growth potential as incomes rise), premium and transit passenger market share gains, helped by its Star Alliance membership and 29%:20% cross shareholding with Cathay Pacific, leverage to growing West China market given its second hub in Chengdu, and lowest exposure to high-speed rail competition. Valuations also look attractive with current P/BV at a 15% discount to its historical average valuation, with an average ROE of 11% and an EPS CAGR of 26% over 2015-17E.

Key downside risks: 1) China's growth stalls, resulting in industry oversupply, 2) rising competition from high-speed rail expansion, 3) volatile fuel prices, and 4) Cathay Pacific's 2015E EPS falls short of our below-consensus forecast of HK\$1.59.

Table 1: Air China: 2H14 & 2014 Results At A Glance

Rmb MM	2H14	2H13	Y/Y Chg	1H14	H/H Chg	2014	2013	Y/Y Chg
Air traffic revenue	53,874	50,138	7%	47,511	13%	101,385	94,603	7%
Other operating revenue	2,078	2,024	3%	2,421	-14%	4,499	3,578	26%
Total Revenues	55,952	52,162	7%	49,932	12%	105,884	98,181	8%
Jet fuel costs	(17,354)	(17,350)	0%	(17,189)	1%	(34,542)	(33,722)	2%
Take-off, landing and depot charges	(5,520)	(5,132)	8%	(5,046)	9%	(10,566)	(9,585)	10%
Depreciation	(5,784)	(5,674)	2%	(5,539)	4%	(11,323)	(10,937)	4%
Aircraft maintenance, repair and overhaul costs	(1,891)	(1,544)	22%	(1,697)	11%	(3,588)	(3,064)	17%
Employee compensation costs	(8,443)	(7,825)	8%	(7,070)	19%	(15,513)	(14,024)	11%
Air catering charges	(1,410)	(1,414)	0%	(1,346)	5%	(2,756)	(2,572)	7%
Aircraft and engine operating lease expenses	(2,342)	(2,057)	14%	(2,194)	7%	(4,537)	(4,006)	13%
Other operating lease expenses	(453)	(511)	-11%	(487)	-7%	(941)	(915)	3%
Other flight operation expenses	(4,783)	(4,296)	11%	(3,607)	33%	(8,390)	(8,257)	2%
Selling and marketing expenses	(3,025)	(3,006)	1%	(2,875)	5%	(5,900)	(5,760)	2%
General and administrative expenses	(29)	(661)	-96%	(540)	-95%	(568)	(1,221)	-53%
Total Operating expenses	(51,034)	(49,470)	3%	(47,589)	7%	(98,623)	(94,063)	5%
Profit/(Loss) from operations	4,918	2,691	83%	2,344	110%	7,262	4,118	76%
Operating profit margin	8.8%	5.2%	3.6ppt	4.7%	4.1ppt	6.9%	4.2%	2.7ppt
Finance revenue	123	1,020	-88%	107	15%	230	2,265	-90%
Finance costs	(1,165)	(1,394)	-16%	(2,135)	-45%	(3,301)	(2,688)	23%
Share of profits and losses of associates and joint ventures	629	654	-4%	245	157%	874	823	6%
Profit/(Loss) before tax	4,505	2,972	52%	560	705%	5,065	4,518	12%
Tax	(678)	(508)	33%	(102)	563%	(780)	(903)	-14%
Effective tax rate	15.0%	17.1%	-2.1ppt	18.3%	-3.2ppt	15.4%	20.0%	-4.6ppt
Profit/(Loss) for the year	3,828	2,464	55%	458	736%	4,285	3,615	19%
Attributable to:								
Equity holders of the Company	3,307	2,119	56%	510	548%	3,817	3,264	17%
Net profit margin	5.9%	4.1%	1.8ppt	1.0%	4.9ppt	3.6%	3.3%	0.3ppt
Minority interests	520	345	51%	(53)	nm	468	351	33%
EPS - Basic and Diluted (cents)	26.9	17.2	56%	4.2	548%	31.1	26.6	17%

Source: Company reports.

Table 2: Air China: 2H14 & 2014 Operating Statistics

	2H14	2H13	Y/Y Chg	1H14	H/H Chg	2014	2013	Y/Y Chg
Traffic								
RPK(million)								
Domestic	51,089	48,438	5%	49,010	4%	100,100	94,344	6%
Regional	3,557	3,165	12%	3,432	4%	6,989	6,115	14%
International	24,984	22,458	11%	22,611	10%	47,595	41,531	15%
Total	79,630	74,061	8%	75,053	6%	154,683	141,990	9%
RFTK(million)								
Domestic	759	735	3%	698	9%	1,457	1,423	2%
Regional	65	51	28%	54	20%	118	96	23%
International	2,304	1,868	23%	1,811	27%	4,116	3,497	18%
Total	3,128	2,653	18%	2,563	22%	5,691	5,015	13%
RTK(million)								
Domestic	5,279	5,027	#REF!	5,046	5%	10,326	9,797	5%
Regional	392	343	#REF!	370	6%	762	660	16%
International	4,524	3,866	#REF!	3,825	18%	8,349	7,192	16%
Total	10,196	9,236	10%	9,242	10%	19,437	17,648	10%
Capacity								
ASK(million)								
Domestic	63,434	59,709	6%	59,685	6%	123,119	115,388	7%
Regional	4,844	4,283	13%	4,664	4%	9,508	8,385	13%
International	32,225	28,048	15%	28,780	12%	61,005	51,904	18%
Total	100,503	92,040	9%	93,129	8%	193,631	175,677	10%
AFTK(million)								
Domestic	1,509	1,405	7%	1,550	-3%	3,058	2,806	9%
Regional	170	137	24%	163	4%	333	271	23%
International	3,719	2,979	25%	3,038	22%	6,756	5,587	21%
Total	5,397	4,521	19%	4,750	14%	10,148	8,664	17%
ATK(million)								
Domestic	7,213	6,774	6%	6,916	4%	14,129	13,180	7%
Regional	624	539	16%	601	4%	1,225	1,057	16%
International	6,624	5,509	20%	5,635	18%	12,258	10,267	19%
Total	14,461	12,823	13%	13,152	10%	27,613	24,504	13%
Load factors								
Pax load factors								
Domestic	80.5%	81.1%	-0.6ppt	82.1%	-1.6ppt	81.3%	81.8%	-0.5ppt
Regional	73.4%	73.9%	-0.5ppt	73.6%	-0.2ppt	73.5%	72.9%	0.6ppt
International	77.5%	80.1%	-2.5ppt	78.6%	-1.0ppt	78.0%	80.0%	-2.0ppt
Total	79.2%	80.5%	-1.2ppt	80.6%	-1.4ppt	79.9%	80.8%	-0.9ppt
Cargo load factors								
Domestic	50.3%	52.3%	-2.0ppt	45.0%	5.3ppt	47.6%	50.7%	-3.1ppt
Regional	38.0%	36.9%	1.1ppt	33.0%	5.0ppt	35.6%	35.4%	0.1ppt
International	62.0%	62.7%	-0.7ppt	59.6%	2.3ppt	60.9%	62.6%	-1.7ppt
Total	58.0%	58.7%	-0.7ppt	53.9%	4.0ppt	56.1%	57.9%	-1.8ppt
Overall load factors								
Domestic	73.2%	74.2%	-1.0ppt	73.0%	0.2ppt	73.1%	74.3%	-1.2ppt
Regional	62.8%	63.6%	-0.7ppt	61.6%	1.3ppt	62.2%	62.4%	-0.2ppt
International	68.3%	70.2%	-1.9ppt	67.9%	0.4ppt	68.1%	70.0%	-1.9ppt
Total	70.5%	72.0%	-1.5ppt	70.3%	0.2ppt	70.4%	72.0%	-1.6ppt

Source: Company reports.

Table 3: Air China: 2H14 & 2014 Financials And Operating Statistics Comparison

RMB million	2H14	2H13	Y/Y Chg	1H14	H/H Chg	2014	2013	Y/Y Chg
Air traffic revenue	53,874	50,138	7%	47,511	13%	101,385	94,603	7%
Other operating revenue	2,078	2,024	3%	2,421	-14%	4,499	3,578	26%
Total revenue	55,952	52,162	7%	49,932	12%	105,884	98,181	8%
Operating Expenses	51,034	49,470	3%	47,589	7%	98,623	94,063	5%
Profit/(Loss) from operations	4,918	2,691	83%	2,344	110%	7,262	4,118	76%
Operating profit margin	8.8%	5.2%	3.6ppt	4.7%	4.1ppt	6.9%	4.2%	2.7ppt
Finance revenue	123	1,020	-88%	107	15%	230	2,265	-90%
Finance costs	(1,165)	(1,394)	-16%	(2,135)	-45%	(3,301)	(2,688)	23%
Gain on disposal	-	-	-	-	-	-	-	-
Share of profits and losses of associates	629	654	-4%	245	157%	874	823	6%
Others	-	-	-	-	-	-	-	-
Profit/(Loss) before tax	4,505	2,971	52%	560	705%	5,065	4,518	12%
Tax	(678)	(508)	33%	(102)	563%	(780)	(903)	-14%
Effective tax rate	15.0%	17.1%	-2.1ppt	18.3%	-3.2ppt	15.4%	20.0%	-4.6ppt
Profit/(Loss) for the year	3,827	2,464	55%	458	737%	4,285	3,615	19%
Attributable to:								
Equity holders of the Company	3,307	2,119	56%	510	548%	3,817	3,264	17%
Net profit margin	5.9%	4.1%	1.8ppt	1.0%	4.9ppt	3.6%	3.3%	0.3ppt
Minority interests	520	345	51%	(53)	nm	468	351	33%
Operating Statistics:								
Traffic								
Passenger (RPK)	79,630	74,059	8%	75,054	6%	154,683	141,964	9%
Cargo (FTK)	3,128	2,649	18%	2,563	22%	5,691	5,016	13%
Capacity								
Passenger (ASK)	100,503	91,958	9%	93,129	8%	193,631	175,677	10%
Cargo (AFTK)	5,397	4,531	19%	4,750	14%	10,148	8,664	17%
Load factor								
Passenger (%)	79%	81%	-1.3ppt	81%	-1.4ppt	80%	81%	-0.9ppt
Cargo (%)	58%	58%	-0.5ppt	54%	4.0ppt	56%	58%	-1.8ppt
Yield								
Passenger (RMB/RPK)	0.62	0.62	0%	0.58	7%	0.60	0.61	-2%
Cargo (RMB/FTK)	1.54	1.56	-1%	1.54	0%	1.54	1.57	-2%

Source: Company reports.

Table 4: Air China: 2014 Revenue Breakdown By Route Region

Rmb MM				% Contribution		
	2014	2013	Y/Y Chg	2014	2013	Y/Y Chg
China	68,003	64,387	5.6%	64.2%	65.6%	-1.4ppt
HK, Macau, Taiwan	6,186	5,492	12.7%	5.8%	5.6%	0.2ppt
Europe	11,304	10,153	11.3%	10.7%	10.3%	0.3ppt
North America	9,339	7,929	17.8%	8.8%	8.1%	0.7ppt
Japan and Korea	5,453	5,023	8.6%	5.1%	5.1%	0.0ppt
Asia Pacific and Others	5,599	5,197	7.7%	5.3%	5.3%	0.0ppt
Total	105,884	98,181	7.8%	100.0%	100.0%	

Source: Company reports.

Table 5: Air China: FY15-17 Earnings Estimate Revisions

	Old			New			% chg		
	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Net profit (RMB mn)	6,726	7,669	-	5,912	7,041	8,170	-12%	-8%	-
EPS (RMB)	0.51	0.59	-	0.45	0.54	0.62	-12%	-8%	-

Source: J.P. Morgan estimates.

Figure 1: Air China - H: P/BV Trading Range Since Listing



Source: Company reports, Bloomberg, J.P. Morgan estimates.

Figure 2: Air China - A: P/BV Trading Range Since Listing



Source: Company reports, Bloomberg, J.P. Morgan estimates.

Investment Thesis, Valuation and Risks

Air China - H (*Overweight; Price Target: HK\$8.30*)

Investment Thesis

Air China is our top pick in the Chinese airline sector, given its strong organic growth prospects, driven by rising outbound Chinese traffic (Chinese air travel penetration remains low and has strong growth potential as incomes rise), premium and transit passenger market share gains helped by its Star Alliance membership and 29%:20% cross-shareholding with Cathay Pacific, leverage to the growing West China market given its second hub in Chengdu, and lowest exposure to high-speed rail competition.

Valuation

Our Dec-15 H-share price target of HK\$8.3 is based on 1.4x P/BV, in line with Air China H-share's historical average P/B valuation since listing (excluding the M&A speculation period).

Risks to Rating and Price Target

Key downside risks: (1) Stall in China growth, resulting in industry oversupply; (2) rising competition from high-speed rail expansion; (3) volatile fuel prices; and (4) Cathay Pacific's earnings falling below our expectations.

Air China - H: Summary of Financials

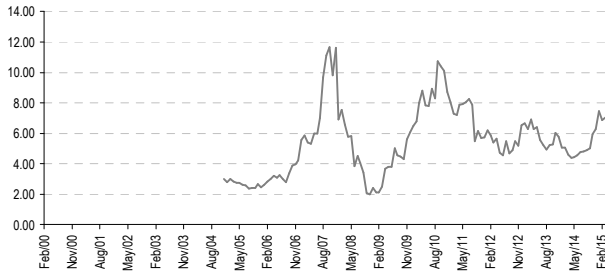
Income Statement						Cash flow statement					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Revenues	98,181	105,884	107,078	119,223	130,676	EBIT	4,118	7,262	9,292	10,483	11,486
% change Y/Y	(1.3%)	7.8%	1.1%	11.3%	9.6%	Depr. & amortization	10,937	11,323	13,324	14,524	15,426
EBITDA	15,055	18,585	22,617	25,007	26,912	Change in working capital	1,399	(1,021)	137	1,392	1,313
% change Y/Y	(19.6%)	23.4%	21.7%	10.6%	7.6%	Taxes	(565)	(780)	(1,208)	(1,438)	(1,669)
EBIT	4,118	7,262	9,292	10,483	11,486	Cash flow from operations	14,608	14,064	19,059	22,162	23,944
% change Y/Y	(51.0%)	76.3%	28.0%	12.8%	9.6%	Capex	(17,915)	(15,220)	(25,155)	(15,155)	(15,155)
EBIT Margin	4.2%	6.9%	8.7%	8.8%	8.8%	Disposal/(purchase)	676	0	0	0	0
Net Interest	(423)	(3,071)	(2,787)	(2,793)	(2,612)	Net Interest	(423)	(3,071)	(2,787)	(2,793)	(2,612)
Earnings before tax	4,518	5,065	7,844	9,342	10,840	Other	(3,399)	4,907	0	0	0
% change Y/Y	(34.6%)	12.1%	54.9%	19.1%	16.0%	Free cash flow	(6,030)	3,751	(6,096)	7,008	8,790
Tax	(903)	(780)	(1,208)	(1,438)	(1,669)	Equity raised/(repaid)	-	-	-	-	-
as % of EBT	20.0%	15.4%	15.4%	15.4%	15.4%	Debt raised/(repaid)	12,182	2,707	9,000	(4,000)	(4,000)
Net income (reported)	3,264	3,817	5,912	7,041	8,170	Other	(2,345)	(11,548)	300	0	0
% change Y/Y	(32.2%)	17.0%	54.9%	19.1%	16.0%	Dividends paid	(890)	(683)	(1,016)	(1,152)	(1,336)
Recurring Net income	1,326	4,178	6,212	7,041	8,170	Beginning cash	12,591	15,508	9,735	11,922	13,778
% change Y/Y	(71.8%)	215.1%	48.7%	13.4%	16.0%	Ending cash	15,508	9,735	11,922	13,778	17,231
Shares outstanding	12,294	12,295	13,085	13,085	13,085	DPS	0.05	0.06	0.08	0.09	0.10
EPS (reported)	0.27	0.31	0.45	0.54	0.62						
% change Y/Y	(33.1%)	17.0%	45.5%	19.1%	16.0%						
Recurring EPS	0.11	0.34	0.47	0.54	0.62						
% change Y/Y	(72.1%)	215.1%	39.7%	13.4%	16.0%						
Balance sheet						Ratio Analysis					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Cash and cash equivalents	15,508	9,735	11,922	13,778	17,231	EBITDA margin	15.3%	17.6%	21.1%	21.0%	20.6%
Accounts receivable	6,780	7,085	7,164	7,977	8,743	Operating margin	4.2%	6.9%	8.7%	8.8%	8.8%
Inventories	1,045	1,100	1,113	1,239	1,358	Net margin	1.4%	3.9%	5.8%	5.9%	6.3%
Others	2,486	3,134	3,134	3,134	3,134	Sales per share growth	(2.6%)	7.8%	(5.0%)	11.3%	9.6%
Current assets	25,817	21,053	23,333	26,128	30,466	Sales growth	(1.3%)	7.8%	1.1%	11.3%	9.6%
LT investments	-	-	-	-	-	Net profit growth	(32.2%)	17.0%	54.9%	19.1%	16.0%
Net fixed assets	132,806	148,180	160,010	160,641	160,369	EPS growth	(33.1%)	17.0%	45.5%	19.1%	16.0%
Total Assets	205,083	209,311	224,760	229,838	235,871	Interest coverage (x)	35.6	6.1	8.1	9.0	10.3
Liabilities						Net debt to equity	178.9%	193.8%	188.3%	162.3%	136.5%
Short-term loans	43,362	34,044	34,044	34,044	34,044	Sales/assets	0.5	0.5	0.5	0.5	0.6
Payables	21,135	20,475	20,704	23,035	25,234	Assets/equity	376.4%	384.6%	383.6%	365.9%	340.0%
Others	5,577	6,324	6,324	6,319	6,319	ROE	6.3%	7.1%	10.4%	11.3%	11.9%
Total current liabilities	70,074	60,843	61,073	63,398	65,597	ROCE	2.1%	3.7%	4.5%	4.8%	5.2%
Long-term debt	68,332	80,302	89,302	85,302	81,302						
Other liabilities	5,812	5,673	5,973	5,973	5,973						
Total Liabilities	147,537	150,201	159,730	158,056	156,255						
Shareholder's equity	57,546	59,110	65,030	71,782	79,616						
BVPS (Rmb)	4.37	4.39	4.52	4.97	5.49						

Source: Company reports and J.P. Morgan estimates.

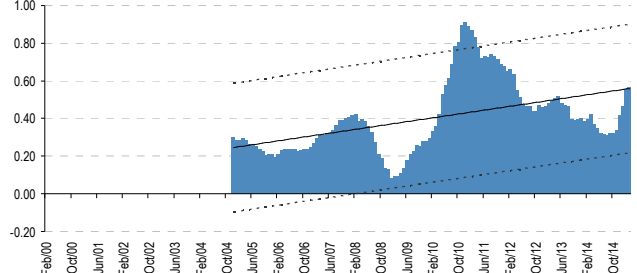
JPM Q-Profile
Air China Limited Class H (CHINA / Industrials)
 As Of: 23-Mar-2015

Global Equity Quantitative Analysis

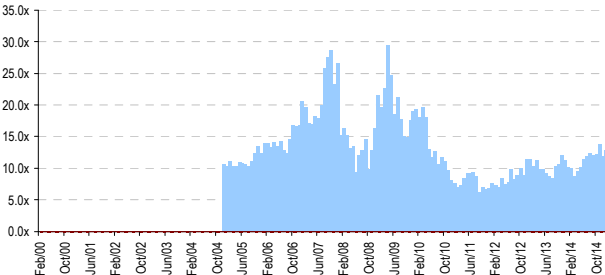
Local Share Price **Current: 7.03**



12 Mth Forward EPS **Current: 0.56**



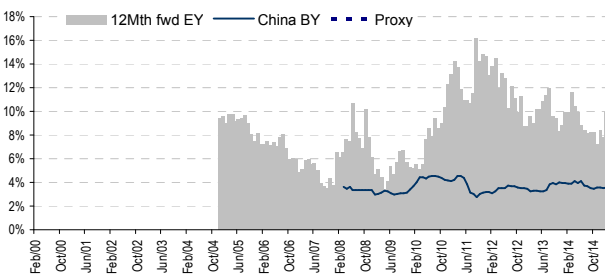
PE (1Yr Forward) **Current: 10.0x**



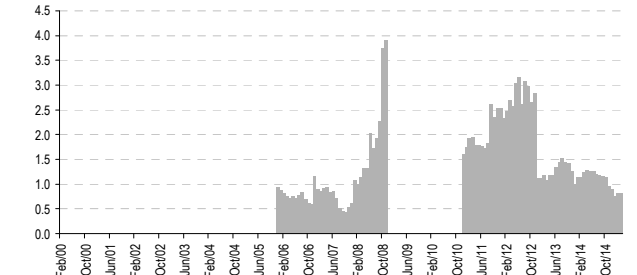
P/E Relative to China Index **Current: 1.03**



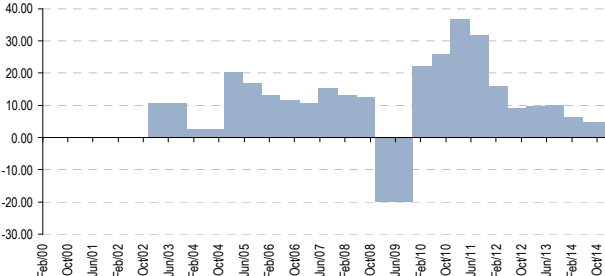
Earnings Yield (& Local Bond Yield) **Current: 10%**



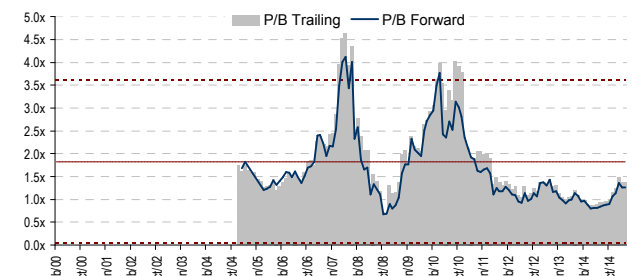
Dividend Yield (Trailing) **Current: 0.81**



ROE (Trailing) **Current: 5.02**



Price/Book (Value) **Current: 1.4x**



Summary

Air China Limited Class H		TICKER 753 HK		As Of: 23-Mar-15							
CHINA				Local Price: 7.03							
Industrials				EPS: 0.56							
	Latest	Min	Max	Median	Average	2 S.D.+	2 S.D. -	% to Min	% to Max	% to Med	% to Avg
12mth Forward PE	9.97x				1.82	3.61	0.04	-50%	244%	6%	33%
P/BV (Trailing)	1.37	0.69	4.73	1.46	1.04	2.94	-0.85	-100%	381%	13%	28%
Dividend Yield (Trailing)	0.81x	0.00	3.92	0.92	11.26	36.09	-13.56	-499%	632%	115%	124%
ROE (Trailing)	5.02	-20.04	36.74	10.79							

Source: Bloomberg, Reuters Global Fundamentals, IBES CONSENSUS, JPMorgan Quantitative & Derivative Strategy

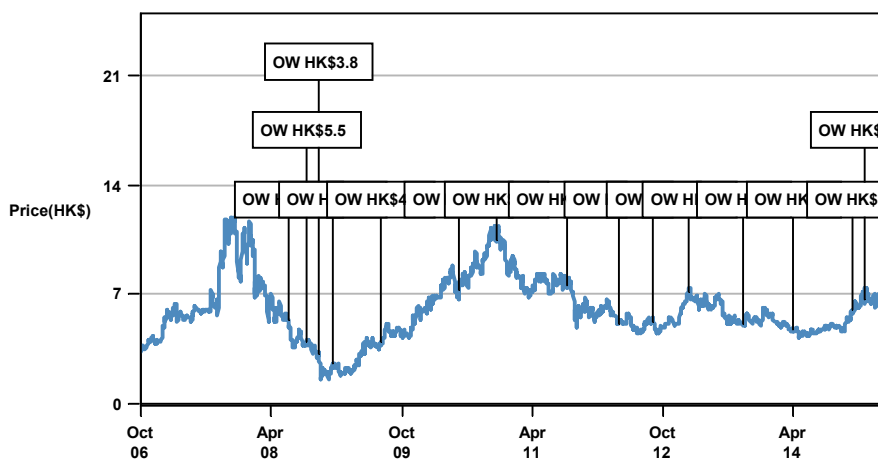
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Air China - H (0753.HK, 753 HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
09-Jun-08	OW	5.36	6.60
27-Aug-08	OW	4.02	5.50
16-Oct-08	OW	3.20	3.80
12-Dec-08	OW	2.53	3.50
07-Jul-09	OW	3.92	4.50
23-May-10	OW	7.32	7.80
29-Oct-10	OW	10.46	12.00
26-Aug-11	OW	7.58	10.50
28-Mar-12	OW	5.08	8.50
21-Aug-12	OW	5.25	7.00
15-Jan-13	OW	7.21	8.00
28-Aug-13	OW	5.15	7.00
26-Mar-14	OW	4.78	6.00
02-Dec-14	OW	5.98	7.00
22-Jan-15	OW	6.66	8.30

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Jun 09, 2008.

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