Media Release:

Outlook On China Airlines Revised To Negative On Uncertain Cash Flow Recovery; 'twBBB+/twA-2' Ratings Affirmed

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Rating Action Overview

- We expect CAL's cash flow to weaken significantly over the next few months due to the widening impact of COVID-19 and high uncertainty over the time frame for recovery in cash flow.
- CAL's ratio of FFO to debt could weaken to 7%-11% in 2020 as a result of pressured cash flow and high capital expenditure, despite the benefit of lower fuel price and cost saving initiatives.
- On March 16, 2020, Taiwan Ratings Corp. revised its rating outlook on CAL to negative from stable. At the same time, we affirmed the 'twBBB+' long-term and 'twA-2' short-term issuer credit ratings on CAL.
- The negative outlook reflects our view of the elevated risk that CAL may take longer than we currently predict to restore its cash flow and lift the ratio of FFO to debt to above 12%, given a likely prolonged industry downturn over the next few quarters.

Rating Action Rationale

Substantial flight cuts and weak load factor could materially pressure CAL's cash flow in 2020.

The deep slump in passenger air traffic demand with highly uncertain prospects of a recovery could sustain at least over the next several months. **China Airlines Corp.** (CAL) has suffered an immediate hit at the beginning of the novel coronavirus (COVID-19) outbreak, given the airline's most profitable routes which include flights to China and Japan, were the first to be affected by the virus spread. With COVID-19 now spreading to other continents including Europe and America, we believe that passengers will avoid or postpone all but essential travel until confidence fully restores. This will inevitably lead CAL to further cut its flights over the coming few quarters from an already-low base, along with a weaker load factor on operating flights.

We anticipate the ratio of FFO to debt will weaken to 7%-11% in 2020, given a likely prolonged industry-wide downturn.

Our current forecast indicates that if CAL's cash flow generation remains very weak beyond the first half of 2020, the company's funds from operations (FFO) could fall by 40%-55% annually, compared with that in 2019. At the same time, CAL's planned capital expenditure for its fleet renewal program could further elevate debt leverage over the next several quarters. The airline estimates the upgrade program to cost New Taiwan dollar (NT$) 18 billion-NT$21 billion in 2020, mainly for the pre deliver payment on six 777F freighter and eleven A321neo passenger jets. As a result, CAL's ratio of FFO to debt is likely to shrink materially to 7%-11% in 2020, down from our estimate of 16%-19% in 2019. This could leave CAL with limited rating headroom if the duration and impact of COVID-19 are worse than our current expectation, resulting in a longer period before CAL's earnings recover.

Lower fuel price, cost saving initiatives, and a potential government subsidy could partially lessen CAL's cost burden.
We expect the jet fuel price to weaken materially in 2020 due to the intense price war ignited between Russia and OPEC recently. This combined with lower fuel usage could save CAL 25%-30% in fuel cost compared with 2019. In addition, CAL's initiatives to reduce its cost base by trimming its selling, general and administrative expense, labor cost, and airport charges could partly offset its margin pressure. We also expect the Taiwan government's plan to subsidize airline landing and airport facilities costs could further alleviate the company's cost pressure when the plan comes into effect.

More resilient cargo operation could help CAL weather its overall weak performance in 2020.
In our view, the economic impact of COVID-19 on air cargo business is more manageable, supported by tight market supply due to the cancellation of a large number of passenger flights that used to provide belly space for air cargo. We believe CAL is better able to flexibly adjusting its routes and flight frequency to drive up cargo yield and load factor because it has the largest freighter capacity in the domestic market. These measures are likely to partly offset the negative impact from lower capacity, in our view. Lower fuel costs could also support the profitability of CAL's cargo business.

Our current base case assumes cash flow could improve in the second half of 2020 and fully recover in 2021, but the timescale remains unclear.
At this stage, we expect the bulk of the COVID-19 fallout to occur in the first two quarters of 2020. This means the carrier's business conditions should gradually recover from the second half of 2020 before its operation fully normalizes in 2021. Under our base case scenario, we expect CAL's revenue momentum and load factor to improve to a healthy level in 2021 as the turbulence caused by the outbreak fades. This is also based on our view that CAL's leadership in Taiwan's aviation market through its extensive flight network will remain solid for the next couple of years. Nonetheless, there are no signs that governments will contain the rapid spread of COVID-19 any time soon. Therefore, there is an elevated risk that the detrimental impact of the outbreak could sustain longer than we currently expect and prevents the company from restoring its cash flow protection measures in the next few quarters.

Outlook

The negative outlook reflects our view that CAL will experience significant deterioration in its operating performance in 2020 due to the outbreak of COVID-19. We currently expect CAL's ratio of FFO to debt to weaken to 7%-11% in 2020, from 16%-19% in 2019, but to recover to above 15% in 2021. That's based on our base-case assumption that the global epidemic will subside during the second quarter of 2020. However, we recognize the high uncertainty as to when the epidemic spread could be contained and the airline's operating recovery could begin.

We believe there is an elevated risk that a more significant and prolonged negative impact from the epidemic could hinder the company from restoring its cash flow generation per our expectation.

Downward scenario

We could lower the long-term rating if industry conditions worsen beyond our current expectations and it takes longer for passengers to restore their confidence, resulting in a faster decline in CAL's cash flow for a longer period, such that we expect the company's ratio of FFO to debt to remain weak at below 12% in 2021. This would occur if passenger demand remains very weak and shows no signs of recovery in the coming few quarters. It could also occur if CAL maintains its aggressive growth strategy through fleet expansion during the industry downturn.

Upward scenario

We may revise the outlook back to stable if we believe CAL's operations show clear signs of recovery, such that improved profitability and operating cash flow support sustainable recovery in the ratio of FFO to debt to above 12% over the next few quarters. This could result from the normalization of operations, particularly on its earnings-driving routes including China and Northeast Asia routes, in the coming few quarters. CAL's more prudent capital expenditure and more effective cost controls could also support such improvement in its credit metrics.

Our Base-Case Scenario

- We expect economic growth to slow in 2020 as a result of the COVID-19 outbreak. S&P Global Rating has revised down its forecast for Asia Pacific real GDP growth of 4.0% in 2020 and 5.5% in 2021, for Taiwan at 1.9% in 2020 and 2.8% in 2021, and for China 4.8% in 2020 and 6.6% in 2021.
- Air traffic demand to drop substantially in the first half of 2020, as most passengers will defer their travel to avoid potential viral infection. Slowing economic activity could further pressure passenger demand, although we expect this to gradually recover in the third quarter of 2020, based on our assumption that the epidemic is likely to subside in the second quarter.
- Weak demand on all routes could lower the average passenger load factor to below 50% in the first two quarters of 2020, before operations gradually normalize from the third quarter. We expect CAL's average load factor to decline to 63%-67% in 2020 from about 80% in 2019. We also expect passenger yield to decline by mid-to-high single digit in 2020.
- A likely moderate negative impact on cargo revenue in 2020. We expect tight market demand due to reduced supply from large number of passenger flight cancellations could support an improvement in load factor and cargo yield.
- TigerAir Taiwan's operation could also undergo significant downward pressure in 2020 due to the carrier's high revenue and profit concentration on Northeast Asia routes. We also expect TigerAir Taiwan's load factor to weaken to a similar level as that of CAL.
- Fuel cost to decrease by 25%-30% in 2020 due to lower jet fuel price and lower usage volume. Our jet fuel price assumptions are US$60 per barrel (bbl)-US$70/bbl in 2020 and US$70/bbl-US$80/bbl in 2020.

- Other operating costs are likely to decline and correspond with lower traffic volume, particularly regarding airport charges and labor cost.
- Despite a pessimistic outlook on the company's earnings profile in 2020, we expect its revenue and profitability to largely recover in 2021 when market turbulence related to the outbreak fades.
- Capital expenditure of NT$18 billion-NT$21 billion in 2020, mainly for the pre delivery payment for six 777F and eleven A321neo aircraft, declining to NT$11 billion-NT$15 billion in 2021.

Based on these assumptions, we arrive at the following credit measures:

- EBITDA margin of 15%-18% in 2020, and 19%-23% in 2021.
- Ratio of FFO to debt to fall to 7%-11% in 2020 from 16%-19% in 2019, but to recover to 15%-18% in 2021.
- FFO cash interest coverage of 4x-6x in 2020 and 9x-13x in 2021.

Liquidity

The short-term issuer credit rating is 'twA-2'. We believe CAL has adequate liquidity to meet its needs over the next 12 months, which reflects our view that the ratio of liquidity sources to liquidity uses will be 1.2x-1.3x over the same period and that liquidity sources will continue to exceed uses, even if CAL's EBITDA were to decline by 30%. We also believe CAL has a generally satisfactory standing in credit markets and good bank relationships, supported by its government-owned status and its capability to tap various financing markets, including syndication loans, corporate bond, and convertible bond. In our view, CAL faces very limited risk rolling over its short-term debt based on the company's track record. CAL does not have any covenants placed on its debt.

Principal liquidity sources

- Cash and short-term investments: about NT$30 billion at the end of September 2019.
- Cash flow from operations: NT$11 billion-NT$15 billion in the 12 months ending September 2020.

Principal liquidity uses

- Debt maturity: NT$29 billion-NT$31 billion in the 12 months ending September 2020.
- Capital expenditure: NT$2 billion-NT$4 billion for maintenance.
- Dividend: NT$150 million-NT$300 million in 2020.

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com - June 26, 2018
- General Criteria: Methodology For National And Regional Scale Credit Ratings - June 25, 2018
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings - March 28, 2018
- General Criteria: Group Rating Methodology - July 01, 2019

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - April 01, 2019
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Transportation Cyclical Industry - February 12, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria | Corporates | General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities - November 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

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Ratings List

Ratings Affirmed; Outlook Action

	To	From
China Airlines Ltd.		
Issuer Credit Rating	twBBB+/Negative/twA-2	twBBB+/Stable/twA-2

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.taiwanratings.com for further information. Complete ratings information is available to subscribers of Rating Research Service at rrs.taiwanratings.com.tw. All ratings affected by this rating action can be found on Taiwan Ratings' public website at www.taiwanratings.com.