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Media Release:

Outlook On China Airlines Revised To Stable On Solid Air Cargo Prospects; 'twBBB+/twA-2' Ratings Affirmed

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Overview

- Taiwan-based **China Airlines Ltd.** is the largest air service operator for passengers and cargo in Taiwan, with EBITDA of NT$33.6 billion in 2020.
- Air cargo demand will likely remain elevated amid strong global trade growth and clogged seaborn transportation. The resulting tight freight capacity could sustain solid air freight rates into 2022.
- Passenger traffic in Asia is likely to recover in 2022 and accelerate in 2023 with easing travel restrictions, lessening the operating burden on China Airlines' passenger segment.
- We have revised our rating outlook on China Airlines to stable from negative. At the same time, we affirmed the 'twBBB+' long-term and 'twA-2' short-term issuer credit ratings on China Airlines.
- The stable rating outlook reflects our view that robust air cargo demand and gradually recovering passenger volume will sustain China Airlines' operating cash flow generation and keep its ratio of FFO to debt above 12% in 2021 and 2022.

Rating Action Rationale

Strong cargo performance could extend for another year before normalizing. Robust consumer demand in the U.S. and Europe could continue to support trade volume growth into 2022. In addition, ongoing supply chain disruptions due to factors such as the reimposition of lockdowns or delays on transport, make the speed provided by air freight highly valuable. Taiwan's favorable geographic location in Asia also supports air cargo demand for China Airlines over the next 12 months, in our view. Meanwhile, recovery in air cargo capacity could remain stagnant due to still-subdued international travel. This limits belly cargo carriage available due to the lower frequency of passenger flights. Ongoing tight air cargo capacity should sustain China Airlines' cargo load factors above pre-pandemic levels as well as sustaining the elevated air freight rates seen in 2020-2021.

Nonetheless, booming air cargo demand could soften in 2023 and 2024 when the easing of supply chain disruptions could shift goods transportation back to container shipping. Restocking demand in developed countries could also recede after inventory-to-sales ratios return to adequate levels from the currently historical lows. Furthermore, a likely more rapid recovery in international travel will restore belly cargo capacities that will increase competitive pressure and cast downward pressure on air cargo yields.

Passenger traffic to pick up from 2022 after a quiet year in 2021. We see clearer signs of the reopening to international travel among Asian countries that could facilitate passenger traffic recovery for China Airlines in 2022. While we anticipate limited improvement on passenger traffic for the airline over the next one to two quarters due to border curbs and quarantine requirements still in place, many governments are planning to ease their restrictions after vaccination rates reach sufficient levels. We view the declines in daily new cases and fast rising vaccination rates in the region provide a firm ground for reopening. Passenger traffic could accelerate further in 2023 with faster returning demand from leisure and business travel as the risk related to COVID abates. This could mitigate the impact of a possible decline in cargo revenue and support China Airlines' operating cash flow generation. Intra-Asia flights were the biggest revenue contributor to the airline before the pandemic, constituting around 70% of the airline's passenger revenue.

Ratio of funds from operations (FFO) to debt to remain above 12% with debt kept in check over the next two years. We anticipate China Airlines' adjusted debt to decline to new Taiwan dollar (NT$) 178 billion-NT$182 billion by the end of 2021, down from NT$191 billion at the end of 2020. A surge in air cargo freight rates along with an increase in cargo volume will inflate the carrier's EBITDA to pre-pandemic levels in 2021. China Airline's control over capital expenditure (capex) in 2021 also provides capacity for debt reduction. Lease debt could climb by NT$14 billion-NT$18 billion in 2022, mainly for the scheduled delivery of A321neo aircraft. Nonetheless, we forecast China Airlines' debt to remain steady with lower capex and adequate operating cash flow generation sufficient to mitigate the impact of the carrier's single-aisle fleet replacement plan.

Outlook

The stable rating outlook reflects our view that robust air cargo demand and gradually recovering passenger volume will sustain China Airlines' operating cash flow generation and keep its ratio of FFO to debt above 12% in 2021 and 2022. Our view is supported by strong global trade volume, still-congested global supply chain, lower schedule reliability of seaborn transportation, and tight air freight capacity with belly capacity of passenger flights yet to meaningfully return. Meanwhile, declining new pandemic cases and rising vaccination rates in Asia will likely drive ease of current travel curbs and support a recovery in passenger traffic in the region in 2022 and 2023.

Downward scenario

We could lower the rating if the company's ratio of FFO to debt declines to below 12% without signs of recovery. The possible scenarios for this could be:

- If industry conditions worsen beyond our current expectation, possibly due to a delayed recovery of passenger demand along with a weakening in air cargo demand, or a material rise in jet fuel price without proper reflection in yields; or
- If the company pursues an aggressive growth strategy through fleet expansion during the industry downturn.

Upward scenario

We may raise the rating if China Airlines could improve its ratio of FFO to debt consistently above 20%, possibly driven by enhancement in its profitability or debt reduction. Factors potentially leading to this include:

- Strong demand in air traffic that turns into a high load factor and unit yield, along with a lower fuel cost; or
- Controlled capex without large-scale aircraft procurement that could gradually reduce the airline's debt. However, we expect China Airlines' debt appetite to remain high due to on-going fleet renewal needs and the industry's high capital intensity nature.

Our Base-Case Scenario

- S&P Global Ratings forecast of Taiwan's real GDP to grow 5.5% in 2021 and 2.9% in 2022, Asia Pacific GDP to grow 6.7% in 2021 and 5.2% in 2022, and the U.S. to grow 5.7% in 2021 and 4.1% in 2022. The high level of GDP growth will continue to underpin global trade and air cargo demand.
- China Airlines' passenger revenue to decline by 75%-80% in 2021 as passenger air traffic in Asia remains muted with tight border controls. We forecast passenger revenue to approach the 2020 level only in 2022 when revenue passenger kilometers (RPK) will recover to 8%-13% of the level in 2019 following the easing of control measures. We forecast passenger revenue to more than double in 2023, reflecting RPK reaching around 30% of the 2019 level with quarantine requirements being further lifted.
- Subdued demand will result in a low load factor of 15%-20% on its passenger business in 2021. Load factors could rebound to 30%-40% in 2022 and 50%-60% in 2023.
- Passenger yield to double in 2021 as travelers with rigid demands are willing to accept higher prices. Passenger yield to decline by 8%-12% in 2022 and 25%-30% in 2023, albeit remaining much higher than normal levels before the pandemic.
- China Airlines' cargo revenue to soar by 30%-36% in 2021, reflecting 15%-20% growth in freight ton kilometers (FTK) and 11%-16% increase in freight yield. We forecast cargo revenue for 2022 to decline by 8%-12%. While FTK could remain largely flat in 2022, freight yield could decline by 8%-12% as supply chain congestion improves and belly capacity of passenger flights returns. We forecast cargo revenue to decline further by 25%-35% in 2023, mostly brought by yield decline as the air cargo market normalizes.
- Cargo load factor to remain above 71% in 2021-2023, but in a declining trend from a peak of around 75% in 2021.
- Fuel cost to increase by 35%-40% in 2021 due to higher jet fuel price. Fuel cost to increase by a further 10%-15% in 2022 as usage volume increases.
- Non-fuel expenses to decrease by 4%-6% in 2021 for cost savings in airport charges, selling and service expense, and labor cost, as well as government's subsidies. None-fuel expenses to grow by mid-single-digits in 2022 and 2023 with rebound in passenger flights.
- Capex of NT$11 billion-NT$14 billion in 2021, and NT$8 billion-NT$11 billion in 2022 and 2023, mainly for Boeing 777F freighters and pre delivery payment for Airbus A321neo aircraft.
- Asset sales of about NT$2.8 billion in 2021 due to sales-and-leaseback transactions for Airbus A330-300 aircraft.

- Zero or very limited cash dividends for the next two to three years.

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

- EBITDA margin of 27%-31% in 2021, and 22%-26% in 2022 versus 29.1% in 2020.
- Ratio of FFO to debt of 17%-20% in 2021 and 14%-18% in 2022 versus 15.8% in 2020.
- FFO cash interest coverage of 12x-15x in 2021 and 2022 versus 10.2x in 2020.

Liquidity

The short-term issuer credit rating is 'twA-2'. We believe China Airlines has adequate liquidity to meet its needs over the next 12 months, which reflects our view that the airline's ratio of liquidity sources to liquidity uses will be 1.4x-1.6x over the same period and that liquidity sources will continue to exceed uses, even if EBITDA were to decline by 30%. We also believe China Airlines 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 bonds. The company does not have any covenants placed on its debt.

Principal liquidity sources

- Cash and short-term investments of about NT$32.1 billion at the end of June 2021.
- Cash flow from operations of NT$34 billion-NT$38 billion in the 12 months ending June 2022.
- Asset sales of NT$1.4 billion-NT$1.6 billion in in the 12 months ending June 2022.

Principal liquidity uses

- Debt maturity and short-term leasing liabilities of NT$30 billion-NT$34 billion in the 12 months ending June 2022.
- Capex of NT$10 billion-NT$13 billion in the 12 months ending June 2022.
- Working capital outflow of NT$1.5 billion-NT$3.5 billion in the 12 months ending June 2022.
- No dividend payout in 2021.

Ratings Score Snapshot

Issuer Credit Rating: twBBB+/Stable/twA-2

Note: The descriptors below are on a global scale.

Business Risk: Weak

- Country risk: Intermediate
- Industry risk: High
- Competitive position: Fair

Financial Risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: twbbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: twbbb

Issuer credit rating on Taiwan: AA (unsolicited, rated by S&P Global Ratings)

Likelihood of government support: Moderate (+1 notch from SACP)

Related Criteria & Research

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Methodology For National And Regional Scale Credit Ratings - June 25, 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
- 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: Principles Of Credit Ratings - February 16, 2011
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings - October 10, 2021

Related Research

- Taiwan Ratings' Ratings Definitions – August 10, 2020

(Unless otherwise stated, these articles are published on www.taiwanratings.com)

Ratings List

Ratings Affirmed; Outlook Action

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