Media Release:

China Airlines Ltd. Upgraded To 'twA-/twA-2' On Improved Debt Leverage; Outlook Stable

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Rating Action Overview

- Taiwan-based **China Airlines Ltd.** is the largest air service operator for passengers and cargo in Taiwan, with EBITDA of NT$41 billion in 2023.
- The carrier's passenger traffic has recovered more strongly than competing airlines which we expect to help China Airlines sustain a relatively higher passenger yield in 2024-2025. Meanwhile, rebounding air cargo demand, especially on transpacific routes, provided uplift for the airline's cargo yield.
- We forecast stronger operating cash flow generation and profitability will lift the ratio of funds from operations (FFO) to debt consistently above 20% in 2024 and 2025. As a result, we have raised our assessment of China Airlines' financial risk.
- We therefore raised our long-term issuer credit rating on China Airlines to 'twA-' from 'twBBB+'. At the same time, we affirmed the short-term rating on the company at 'twA-2'.
- The rating outlook is stable to reflect our view that the airline will maintain improved debt leverage in 2024 and 2025. This is despite rising capex needs for fleet renewal over the period.

Rating Action Rationale

The upgrade reflects a sustained higher performance on major routes. Operating profit on the airline's North-east Asia routes has risen two to threefold and reduced its high reliance on cross-strait routes. The increasing move of manufacturing bases to South-east Asia has raised cargo and passenger demand on China Airlines' America and South-east Asia routes as well. The airline's improved performance also reflects its ability to secure airport service capacity for its major routes in the early post-pandemic period.

However, the gradual recovery in capacity by competing airlines, especially regional and global carriers with a larger operating scale, could intensify competition and challenge China Airlines' profitability if passenger growth does not follow the same speed over the next two years.

Higher passenger yield can sustain China Airlines' EBITDA margin and cash flow generation in 2024-2025. The airline's passenger yield is stronger than we previously forecast, supported by limited capacity restoration by competing carriers and strong outbound demand from Taiwan. Many airlines have faced difficulty restoring aircraft schedules after laying off staff during the pandemic while airports globally also face difficulty recruiting enough staff to meet rising demand. China Airlines has fared better than its peers in this respect. Meanwhile, manufacturing supply issues could delay new aircraft deliveries and the repair of existing airplanes for many airlines. This would further slow capacity restoration and benefit China Airlines on its major routes.

Meanwhile, total passenger volume through Taiwan airports in the first seven month of 2024 recovered to 83% of the 2019 level. At the same time, outbound passenger volume restored to just 3% below the 2019 level over the period. This strong recovery in outbound demand further supported China Airlines' performance over the same period. We expect the airline's passenger volume to continue growth in 2024 and 2025, albeit at a slower pace in 2025, given the higher base in 2024 and slow recovery in inbound visitors amid fewer cross-strait routes. We forecast China Airlines could improve its operating cash flow to around new Taiwan dollar (NT$) 39 billion-NT$42 billion in 2024-2025, which is 4%-11% higher than 2019 level. We also anticipate the airline will maintain its EBITDA margin at 21.0%-22.5% over the same period, compared to 21.3% in 2019.

Rising demand from e-commerce and electronic products to underpin cargo business in 2024-2025. Geo-political tension has reshaped part of the air cargo market in Taiwan. With limited non-stop flights between China and the U.S., an increasing amount of e-commerce now transits through Taiwan between the two nations. Meanwhile, surging demand from high technology hardware sectors has also uplifted cargo yield so far in 2024. We expect air cargo demand to continue to grow over the long-term and support China Airlines' cargo business as production bases in Asia Pacific become more diversified. As a result, we expect its cargo yield business to stay at NT$10.7-NT$11.0 per freight ton kilometer in 2024-2025, up from NT$8.2 per freight ton kilometer in 2019.

Nonetheless, part of the airline's cargo demand relies on a favorable political environment overseas to support air cargo volume transiting through Taiwan. Rapid changes in customers' preferences for e-commerce products and the sustainability of AI server investments are further uncertainties for air cargo demand over the next few years. In addition, other Taiwan-based air carriers are likely to expand their cargo fleet, which will increase supply and competition if the air cargo market declines significantly.

Strong cash flow generation supports deleveraging before higher capital expenditure resumes in 2026. The strong recovery in demand boosted China Airlines' ability to use cash flow generation to fund debt repayments. This brought the company's outstanding debt down to NT$138.7 billion at the end of 2023, from NT$159.0 billion at the end of 2022. We believe China Airlines will continue to deleverage in 2024-2025, given a delay in the delivery of new aircraft will postpone the peak of its upcoming capital expenditure (capex) needs to 2026 from 2025.

We anticipate China Airlines' annual capex will stay above NT$30 billion in 2024 and 2025 before climbing to NT$65 billion in 2026. This compares with NT$29 billion in 2023. As a result, we believe the airline has more time to enhance its financial buffer through cash flow generation and a potentially lower cash dividend payout over the next two years. Accordingly, we expect China Airlines' ratio of FFO to debt to improve to 28%-30% in 2024-2025 from 25.9% in 2023.

Outlook

The stable rating outlook reflects our view that a relatively high yield for passenger and cargo sectors could sustain China Airlines improved profitability over the next one to two years. This is supported by sturdy growth in passenger traffic with slower competing capacity recovery. Meanwhile, sustainable cash flow generation and increased cash on hand should be sufficient to cover the airline's rising capex needs and support the ratio of FFO to debt at close to 30% in 2024 and 2025. This is despite increasing debt risk from 2026 when the airline enters its peak capex period for fleet renewal.

Downward scenario

We could lower the rating on China Airlines if the ratio of FFO to debt drops to below 20% for an extended period without improvement. The possible scenarios for this are:

- Deteriorating profitability amid intensifying competition that weighs on passenger yield, weaker demand for air cargo services due to a weakening global economy, or a material rise in jet fuel price without proper reflection in yields; or
- The company fails to prudently control capex for fleet expansion, or it executes another round of fleet renewal with debt funding higher than our current forecast.

Upward scenario

We may raise the rating if China Airlines could sustain the ratio of FFO to debt consistently above 40%, possibly driven by improving profitability or a reduction in debt. Potential factors support this include:

- Strong air traffic demand that supports a high load factor and unit yield, along with a lower fuel cost; or
- A limited rise in debt after the airlines completes capex for large-scale aircraft procurement, supported by strong operating cash flow generation with lower debt usage.

Our Base Case Scenario

- S&P Global Ratings forecast of Taiwan's real GDP to grow 4.2% in 2024 and 2.1% in 2025, Asia Pacific GDP to grow 4.4% in 2024 and 2025, and U.S. GDP to grow 2.7 % in 2024 and 1.8% in 2025. Slowing economic growth will constrain the increase in global trade and air cargo demand.
- China Airlines' passenger revenue to increase 12%-16% in 2024, reflecting continuous recovery in passenger traffic, but growth to slow to 1%-4% in 2025, given the higher base in 2024. Revenue growth is mainly supported by continuous growth in revenue passenger kilometers, which we forecast to reach 90%-95% of the 2019 level in 2024.
- Load factor on its passenger business to maintain at 79%-81% in 2024 and 2025 due to solid travel demand with a limited increase in available seat kilometers.
- Passenger yield to decline by 0.5%-2.0% in 2024 and 2025 as the passenger market gradually normalizes, but it still moderately higher than the level before 2020.
- China Airlines' cargo revenue to decline by 1%-4% in 2024, reflecting 2.5%-5.5% a decline in freight ton kilometers but freight yield to increase 1%-2% because of both increased shipping supply and higher demand for timely delivery for e-commerce and electronic products. Cargo revenue for 2025 to decline 3%-5% with freight ton kilometers down by 1%-3% and freight yield declining 1%-3% due to increasing supply from both shipping and airlines.
- Cargo load factor to sustain at 67%-69% in 2024 and 2025.
- Fuel cost to largely remain stable in 2024 but decline slightly by 1%-2% in 2025, given stable consumption volume with a minor price downward revision. This also reflects the fuel saving effect of new cargo aircraft.
- Non-fuel expenses to increase by 13%-15% in 2024 mainly for an increase in work force, airport charges, and passenger services. Non-fuel expenses to grow 2%-4% in 2025 along with an increase in passenger flights.
- Capital expenditure of NT$30 billion-NT$34 billion in 2024, and NT$38 billion-NT$42 billion in 2025, mainly for the purchase of Boeing 777F freighters, Airbus A321neo aircraft, and pre delivery payments for Boeing 787 aircraft.

- Cash dividend of NT$4.3 billion in 2024. Payout ratio to remain at 55%-60% for 2025.
- Disposal of cargo aircrafts at NT$5.5 billion-NT$6.5 billion in 2024.
- Proceeds from share disposals of NT$1.97 billion in 2024from its low-cost carrier, Tigerair Taiwan Co. Ltd.

China Airlines Ltd. – Taiwan Ratings Corp. Forecast Summary

Industry sector: Transportation cyclical

(Mil. NT$)	2021a	2022a	2023a	2024e	2025f	2026f
Revenue	138,841	150,722	184,817	201,356	201,472	198,379
EBITDA (reported)	44,918	32,912	40,814	44,840	42,624	37,791
Plus/(less): Other	13	64	147	118	118	118
EBITDA	44,931	32,976	40,962	44,958	42,742	37,909
Less: Cash interest paid	(2,432)	(2,857)	(3,322)	(3,197)	(3,193)	(3,306)
Less: Cash taxes paid	(284)	(4,623)	(1,744)	(1,834)	(2,878)	(2,419)
Funds from operations (FFO)	42,214	25,496	35,896	39,927	36,671	32,184
Cash flow from operations (CFO)	49,724	46,635	55,518	41,822	39,280	34,359
Capex	14,684	26,786	28,792	32,107	40,607	65,757
Free operating cash flow (FOCF)	35,039	19,849	26,726	9,715	(1,327)	(31,398)
Dividends	125	5,201	3,025	4,335	6,799	5,715
Discretionary cash flow (DCF)	34,915	14,648	23,701	5,379	(8,126)	(37,113)
Debt (reported)	156,068	140,573	119,547	118,804	108,034	135,955
Plus: Lease liabilities debt	15,292	18,467	19,148	19,854	20,586	21,345
Debt	171,360	159,040	138,695	138,658	128,620	157,300
Cash and short-term investments (reported)	62,088	45,556	45,237	58,088	39,192	30,000
Adjusted ratios						
Debt/EBITDA (x)	3.8	4.8	3.4	3.1	3.0	4.1
FFO/debt (%)	24.6	16.0	25.9	28.8	28.5	20.5
DCF/debt (%)	20.4	9.2	17.1	3.9	(6.3)	(23.6)
Annual revenue growth (%)	20.5	8.6	22.6	8.9	0.1	(1.5)
EBITDA margin (%)	32.4	21.9	22.2	22.3	21.2	19.1

All figures are adjusted by Taiwan Ratings Corp., unless stated as reported. Figures for the forecast period are based on Taiwan Ratings Corp.'s base-case scenario. a--Actual. e--Estimate. f--Forecast. NT$--new Taiwan dollar. N.M.--Not meaningful.

Liquidity: Adequate

The short-term issuer credit rating is 'twA-2'. We assess China Airlines has adequate liquidity to meet its needs over the next 12 months. This reflects our estimate that the airline's ratio of liquidity sources to liquidity uses will be 1.2x-1.3x over the same period, while liquidity sources will continue to exceed uses, even if EBITDA were to decline by 30%. In addition, we 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$45.2 billion as of June 30, 2024.
- Cash flow from operations of NT$38 billion-NT$42 billion in the 12 months ending June 30, 2025.
- Working capital inflow of below NT$1 billion in the 12 months ending June 30, 2025.
- Disposal of cargo aircrafts of NT$3 billion-NT$4 billion ending June 30, 2025.

Principal liquidity uses:

- Debt maturity and short-term leasing liabilities of NT$28 billion-NT$36 billion in the 12 months as of June 30, 2025.
- Capex of NT$34.5 billion-NT$38.5 billion in the 12 months ending June 30, 2025.
- Cash dividend of NT$4.3 billion in 2024.

Ratings Score Snapshot

China Airlines Ltd.		
	To	**From**
Issuer Credit Rating	twA-/Stable/twA-2	twBBB+/Stable/twA-2
Business risk	Weak	Weak
Country risk	Intermediate	Intermediate
Industry risk	High	High
Competitive position	Fair	Fair
Financial risk	Significant	Aggressive
Cash flow/Leverage	Significant	Aggressive
Anchor	twbbb	twbbb-
Modifiers		
Diversification/Portfolio effect	Neutral (no impact)	Neutral (no impact)
Capital structure	Neutral (no impact)	Neutral (no impact)
Financial policy	Neutral (no impact)	Neutral (no impact)
Liquidity	Adequate (no impact)	Adequate (no impact)
Management and governance	Neutral (no impact)	Neutral (no impact)
Comparable ratings analysis	Positive (+1 notch)	Positive (+1 notch)
Stand-alone credit profile (SACP)	twbbb+	twbbb
Issuer credit rating on Taiwan (unsolicited, rated by S&P Global Ratings)	AA+	
Likelihood of government support	Moderate (+1 notch from SACP)	Moderate (+1 notch from SACP)
Note: The descriptors are on a global scale.		

Related Criteria & Research

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology - April 04, 2024
- Criteria | Corporates | General: Corporate Methodology - January 07, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities - January 07, 2024
- General Criteria: National And Regional Scale Credit Ratings Methodology - June 08, 2023
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings - October 10, 2021
- General Criteria: Group Rating Methodology - July 01, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments - April 01, 2019

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- 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
- General Criteria: Principles Of Credit Ratings - February 16, 2011

Related Research

- Taiwan Ratings' Ratings Definitions – November 11, 2021

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

Ratings List

Upgraded

	To	From
China Airlines Ltd.		
Issuer Credit Rating	twA-/Stable/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.