Aviation

MAVCOM Proposes to Maintain Airport Tariffs

NEUTRAL

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Downgrade the aviation sector from OVERWEIGHT to NEUTRAL. Malaysian Aviation Commission (MAVCOM), in its newly released (on 10 Aug 2022) *First Consultation Paper on the Long-Term Framework for the Regulation of Aviation Services Charges*, proposes to keep airport tariffs status quo (as in 2021), held constant in real terms by inflating charges each year using CPI. It proposes this to be applied during Regulatory Period 1 (RP1) (2023-2025), which appears to be less favorable vs. the proposal back in 2019 based on a WACC of 10.88%. We are concerned as this could work against MAHB's ability to generate enough cash flow for capex purposes, particularly for airport expansion and maintenance. While MAVCOM also proposes mechanism for MAHB to recoup losses incurred during RP1 in RP2, we are concerned over MAHB's cash flow over RP1. While the proposals in this MAVCOM consultation paper are not cast in stone, they do significantly raise MAHB's earnings risk over the short to medium term, prompting us to downgrade our rating on MAHB and the aviation sector.

MAVCOM proposes to keep airport tariffs status quo. Malaysian Aviation Commission (MAVCOM), in its newly released (on 10 Aug 2022) *First Consultation Paper on the Long-Term Framework for the Regulation of Aviation Services Charges*, proposes to keep tariffs status quo (as in 2021), held constant in real terms by inflating charges each year using CPI to be applied during Regulatory Period 1 (RP1) that is to run from 1 Jan 2023 to 31 Dec 2025 which is less favourable as compared with the one proposed back in 2019 with a WACC of 10.88%. However, this is just a first consultation framework and not cast in stone as the Commission is also seeking feedback from stakeholders. MAVCOM's view that cost-based approaches to setting tariffs would be impractical for RP1 when demand is low and uncertain as the sector continues its slow recovery, hence demand over the course of RP1 will continue to be below pre-pandemic trends, meaning that average costs will likely be higher than those seen prior to the pandemic. As such, there is a significant risk of understating or overstating MAHB's average costs. This could result in a significant increase in tariffs. We believe the framework is to ensure that the airport operator does not take advantage of its dominant market position to either offer substandard service quality or charge exorbitant tariffs. Nevertheless, in our view, MAVCOM has to set a reasonable tariff rate given the urgency for airport expansion and maintenance capex in Malaysia to enable MAHB to accumulate the required cash for capex purposes.

Loss accumulation and recovery mechanisms explained MAHB cash flow back-load. In anticipation that MAHB is expected to incur losses following the slow recovery for air travel post pandemic, if tariff remains status quo under RPI, MAVCOM proposed two mechanisms. Under RP1, a 'loss accumulation mechanism' proposes to keep track of the financial losses made by MAHB over the regulatory period and allows for claw back under RP2 (Regulatory Period 2 from 1 Jan 2026 to 31 Dec 2028). Under RP2 and beyond, MAHB will start recovering losses incurred in RP1 over a ten-year period starting in Year 1 of RP2. In our view, MAHB's earnings and cash flows are back-loaded which are needed for airport capex plans. As suggested in the consultation paper, MAVCOM will bear 90% of the cumulative losses and MAHB the remaining 10%. MAHB will be able to recover the 90% of the loss over time starting from Year 1 of RP2. Similarly, MAHB will forego 90% of the profits achieved in RP1 which would be returned to customers in the form of lower airport charges in the future, and only retain the remaining 10%.

Rebalance ASEAN, Non-ASEAN PSCs, and potentially higher domestic PSC. Presently, the PSC for passengers departing to ASEAN destinations is RM35/pax or 52% lower than that for passengers departing to non-ASEAN destinations at RM73/pax. This differentiation could be removed and the charges equalised. For illustration purposes, this might involve an increase in the PSC for ASEAN destinations and a decrease in the PSC for non-ASEAN destinations. Note that ASEAN destinations account for 17% of total passengers. Similarly, the PSC for domestic passengers at RM11/pax is around two-thirds lower than that for ASEAN passengers, and >80% lower than that for non-ASEAN destinations. As the sector recovers, the Commission is expecting domestic traffic to represent a higher share of traffic overall / international traffic to represent a lower share overall. To overcome this relative shortfall in international traffic, the domestic PSC could be adjusted relative to the international PSC.

Illustration of cost-based approach suggests a significant increase in tariffs. With COVID-19, it is likely that demand in RP1 will continue to be possibly below pre-pandemic levels, suggesting that average costs will likely be higher than those seen prior to the pandemic. Therefore, a cost-based approach to setting tariffs could very well result in a significant increase in tariffs. For illustrative purposes, based on inputs from the Commission's previous Aeronautical Charges Framework Review of June 2019 (this data is out-of-date but the Commission suggest that it is sufficient for the purposes of this illustrative analysis). The date is then compared against a passenger weighted average of current PSC, where the weights were based on passenger forecasts provided by MAHB. The analysis indicates that the average PSC under a RAB framework is likely to be 2 to 3 times higher than current PSC rising between a weighted average of RM26-30/pax to RM71-86/pax between 2023-2025.

Downgrade MAHB from OP to MP. We cut MAHB FY23F net profit by 10% as we lowered down our passenger numbers from 108m to 100m. Correspondingly, we downgrade our TP from RM7.65 to RM6.05 based on 22x FY23F EPS, from previously 25x due to higher downside earnings risk or at 40% discount to closest peer Airport of Thailand due to its smaller market capitalisation. Note that Thailand's tourism revenue is 3x larger than Malaysia.

Peer Comparison

Name	Last Price	Market Cap	Shariah Compliant	Current	Revenue Growth		Core Earnings Growth		PER (x) - Core Earnings			PBV (x)		ROE (%)	Net Div.Yld.\ (%)	Target	Rating
	(RM)	(RM'm)		FYE	1-Yr. Fwd.	2-Yr. Fwd.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	1-Yr. Fwd.	1-Yr. Fwd.	Price (RM)	
AVIATION UNDER COVERAGE																	
CAPITAL A BHD	0.650	2,704.7	Y	12/2022	347.0%	31.7%	-125.0%	-73.4%	N.A.	N.A.	14.1	(0.9)	(0.7)	21.4%	-	0.650	MP
MALAYSIA AIRPORTS HOLDINGS BHD	6.25	10,370.0	N	12/2022	77.8%	17.5%	-65.1%	70.1%	N.A.	38.7	22.8	1.4	1.4	3.7%	1%	6.05	MP

Source: Bloomberg, Kenanga Research

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Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10%
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10%
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than -5%

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

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