

TUESDAY, 11 SEPTEMBER 2012

Company Update

CEBU AIR, INC. (CEB) Downgrading on negative airline industry outlook

We are downgrading our rating on CEB from BUY to HOLD and reducing our FV estimate to Php68.50/sh. Although CEB's share price has declined by over 8.72% for the year to date period, we still do not find the stock cheap given the negative impact of stubbornly high oil price and intensifying competition on CEB's profitability.

- **A turnaround that did not materialize.** We previously thought that CEB's profits would bottom in 2011. This was due to our expectation that oil prices would decline to more reasonable levels due to the global economic slowdown. We also expected operating costs (per available seat kilometer or ASK) to drop due to economies of scale and improvement in cost structure.

However, based on CEB's earnings performance during 1H12, the turnaround did not materialize. Jet fuel prices remain elevated. Intense competition resulted to higher overhead expenses and costs per ASK, negating the positive impact of economies of scale. As a result, operating profits during 1H12 continued to drop, falling by 28.3% to Php1.53Bil.

- **Airline sector – a tough industry.** Valuations of companies in the airline industry have deteriorated in the past few years. Although each airline faces various risks, the most common challenge right now is increasing oil prices. From US\$54.14/barrel in 2009, oil price is now US\$133.55/barrel. During the same period, average EV/EBITDA multiple declined from 11.7X to 6.4X.
- **Rising operating costs also hamper profits.** We previously expected improvements in cost management effort and economies of scale to lead to lower cost per ASK, softening the impact of higher oil prices. However, during 1H12, total expenses excluding fuel increased by 23.0% to Php8.98Bil, faster than the 17.8% increase in available seat kilometer. According to CEB, intense competition led to higher pilot sourcing and training costs, while repairs and maintenance increased due to additional costs associated to the return of two aircrafts in the second quarter.
- **Threat from intensifying competition.** The number of aircraft operating in the country is expected to grow four times to 260+. CEB is estimated to double its planes to 60 by 2016 while Philippine Airlines disclosed plans to purchase 100 aircrafts over the next 3-5 years through its US\$7.0 Bil re-fleeting program. Air Asia also plans to purchase 20 aircrafts while Zest Air and Seair disclosed plans to embark on a major expansion program.

Forecast Summary (PhpMil)

Year to Dec. 31	2010	2011	2012E	2013E
Revenues	29,089	33,935	38,568	47,587
% change y/y	24.8	16.7	13.7	23.4
EBIT	6,451	3,528	3,330	3,664
% change y/y	103.9	-45.3	-5.6	10.0
EBIT Margin (%)	22.2	10.4	8.6	7.7
EBITDA	8,552	6,160	6,369	7,172
% change y/y	68.3	-28.0	3.4	12.6
EBITDA Margin (%)	29.4	18.2	16.5	15.1
Core Net Profits	5,739	3,198	2,324	2,465
% change y/y	76.2	-44.3	-27.3	6.1
NPM (%)	19.7	9.4	6.0	5.2
EPS (cents)	11.78	5.93	3.84	4.07
% change y/y	110.7	-49.7	-35.3	6.1
RELATIVE VALUE				
P/E(X)	5.1	10.0	15.5	14.6
P/BV(X)	2.0	1.9	1.7	1.5
ROE (%)	32.1	16.7	10.8	10.3
Dividend Yield (%)	0.0	5.1	0.0	0.0

*Source: CEB, CiticOnline estimates

SHARE DATA

Rating	HOLD
Ticker	CEB
Fair Value (Php)	68.50
Current Price	59.50
Upside (%)	15.13

SHARE PRICE MOVEMENT



ABSOLUTE PERFORMANCE

	1M	3M	YTD
CEB	-13.27	-12.37	-8.72
PSEI	-1.47	2.17	18.62

MARKET DATA

Market Cap	35,842.14Mil
Outstanding Shares	605.25Mil
52 Wk Range	58.15 - 82.50
3Mo Ave Daily T/O	35.21Mil

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A turnaround that did not materialize

We previously thought that CEB's profits would bottom in 2011. This was due to our expectation that oil prices would decline to more reasonable levels due to the global economic slowdown. We also expected operating costs (per available seat kilometer or ASK) to drop due to economies of scale and improvement in cost structure. Recall that although revenues grew by 16.7% in 2011, profits declined by 47.6% to Php3.6Bil, while net margins decreased by more than half from 23.8% to 10.7% due to high fuel cost.

However, based on CEB's earnings performance during 1H12, the turnaround did not materialize. Jet fuel prices remain elevated. Intense competition resulted to higher overhead expenses and costs per ASK, negating the positive impact of economies of scale. As a result, operating profits during 1H12 continued to drop, falling by 28.3% to Php1.53Bil.

The outlook for the airline industry has also worsened. Although high fuel cost and rising operating expenses negatively affected CEB's profitability, revenues were still very strong due to strong growth in demand. However, this could change due to aggressive expansion plans of competitors (domestic and international players) and capacity constraints in the Manila airport which could negatively affect CEB's passenger yield and ability to increase flights.

As a result, we are reducing our core net profit forecast for FY12 by 48.7% to Php2.32 Bil and for FY13 by 45.4% to Php2.46Bil. We also reduced our FV estimate on CEB by 36.7% to Php68.10/sh, which is based on a 7.0X 2013E EV/EBITDA target multiple. We believe that valuing CEB using a relative valuation approach instead of a DCF approach would be more appropriate given the difficulty in forecasting long term oil prices and to make it more comparable to global peers.

Exhibit 1: Summary of changes in forecast

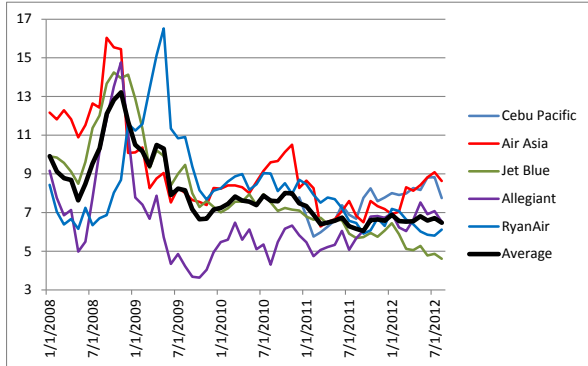
in PhpMil	2012E			2013E		
	Old	New	%Change	Old	New	%Change
Forecast:						
Revenues	38,191	38,568	1.0	44,950	47,587	5.9
EBIT	5,221	3,330	-36.2	5,995	3,664	-38.9
EBITDA	8,098	6,369	-21.4	9,354	7,172	-23.3
Core Net Income	4,530	2,324	-48.7	4,512	2,465	-45.4
Fair value estimate	107.50	68.57	-36.2			

Source: COL estimates

Airline sector – a tough industry

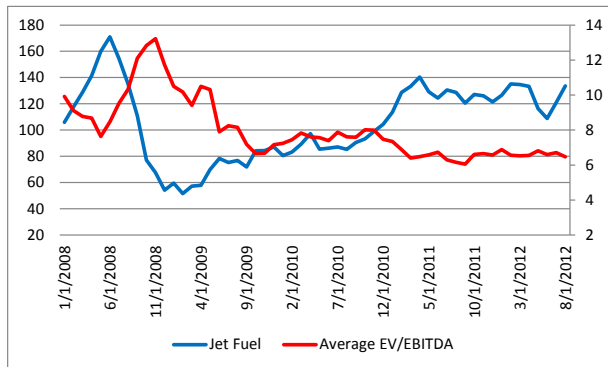
Valuations of companies in the airline industry have deteriorated in the past few years. Although each airline faces various risks, the most common challenge right now is increasing oil prices. From US\$54.14/barrel in 2009, oil price is now US\$133.55/barrel. During the same period, average EV/EBITDA multiple declined from 11.7X to 6.4X.

Exhibit 2: Historical EV/EBITDA of Low-Cost Carriers (LCC)



Source: Bloomberg

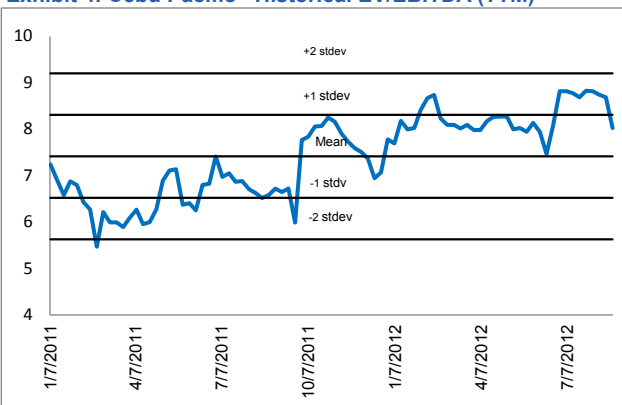
Exhibit 3: Industry Average EV/EBITDA vs Jet Fuel Prices



Source: Bloomberg

Although CEB's share price has fallen significantly during the year to date period, the company is trading above its historical average EV/EBITDA given the more substantial decline in its profitability. Cebu Pacific is currently trading at 8.0X EV/EBITDA, higher than its historical average of 7.4X.

Exhibit 4: Cebu Pacific - Historical EV/EBITDA (TTM)



Source: Bloomberg

Rising operating costs also hamper profits

We previously expected improvements in cost management effort and economies of scale to lead to lower cost per ASK, softening the impact of higher oil prices. However, during 1H12, total expenses excluding fuel increased by 23.0% to Php8.98Bil, faster than the 17.8% increase in available seat kilometer. According to CEB, intense competition led to higher pilot sourcing and training costs, while repairs and maintenance increased due to additional costs associated to the return of two aircrafts in the second quarter.

We increased our assumption on cost per available seat kilometer (ASK) by 9.6% from Php1.13 to Php1.24, in line with CEB's cost per ASK during 1H12.

Exhibit 5: Cost per ASK

In Php	2009	2010	2011	1H12
Flying operations (exc. Fuel)	1,497	1,610	2,129	1,297
Aircraft and traffic servicing	2,632	2,462	2,991	1,732
Repairs and maintenance	2,569	2,290	2,519	1,487
Depreciation and amortization	1,918	2,101	2,632	1,619
Aircraft and engine lease	1,724	1,605	1,718	1,079
Others	2,448	2,763	3,197	1,766
Cost per ASK (exc. Fuel)	1.36	1.24	1.23	1.25

Source: CEB

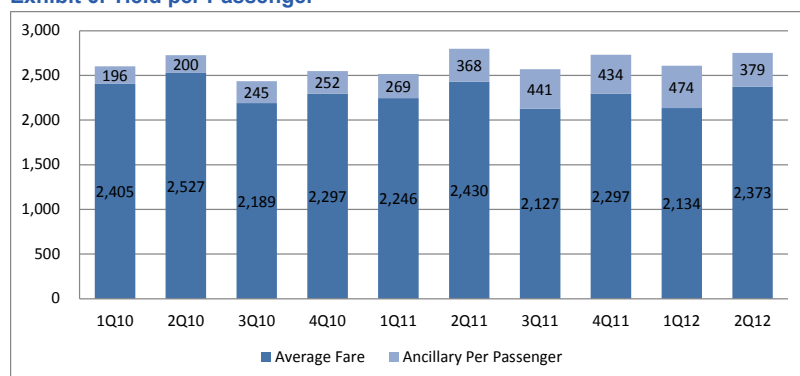
Threat from intensifying competition

The strong growth of passenger volume has attracted more competition in the domestic airline industry. From 66 in 2011, the number of aircrafts in the whole industry is estimated to increase to 91 by the end of this year. Not surprisingly, CEB's average fares during 1H12 declined by 3.6% to Php2,257/ticket. Total yield, meanwhile, was flat at Php2,682/ticket as CEB managed to boost ancillary revenues per passenger (ex., baggage charges, revenues from sale of food on deck). Nevertheless, the increase is not enough to offset the impact of rising costs.

We don't expect yields to improve in the near term given plans of industry players to significantly increase their seat capacities. Based on the press releases of various players in the industry, the number of aircraft operating in the country is expected to grow four times to 260+. CEB is estimated to double its planes to 60 by 2016 while Philippine Airlines disclosed plans to purchase 100 aircrafts over the next 3-5 years through its US\$7.0 Bil re-fleeting program. Air Asia also plans to purchase 20 aircrafts while Zest Air and Seair disclosed plans to embark on a major expansion program.

Another potential threat is airlines' ability to secure additional flights out of Manila given the capacity constraint of the airport. The increase in number of flights from Manila is already resulting to a growing number of delayed flights. The average number of flights per hour during the peak season jumped to 50 trips compared to the normal average of 40 trips. Although the government has coordinated with International Air Transport Association (IATA) on improvements on the runway, the long-term supply is still a major concern.

Exhibit 6: Yield per Passenger



Source: CEB

Exhibit 7: Expansion Plans

In Php	2010	2011	2012E	2016E
Cebu Pacific	24	29	33	60+
PAL / AirPhil Express	25	24	31	140+
Zest Air	5	9	19	31+
Seair	2	2	4	12+
AirAsia Philippines	0	2	4	20+
Total	56	66	91	263

Source: Company news

Upside risk largely dependent on oil prices. Further improvements in CEB's profitability and share price are largely dependent on the direction of oil prices. We have provided a sensitivity analysis showing CEB's profitability and fair value estimates given different oil price assumptions. Our base case assumption is that oil would stay at US\$126/barrel which is 6.7% lower than the current price of US\$135/barrel.

Exhibit 8: Sensitivity Analysis (Oil price vs. EV/EBITDA)

		Oil Price					
		110	120	126	130	140	150
EV/EBITDA	5.5	76.5	60.4	50.8	44.4	28.4	12.3
	6.0	84.7	67.2	56.7	49.7	32.2	14.7
	6.5	93.0	74.0	62.7	55.1	36.1	17.2
	7.0	101.2	80.8	68.6	60.4	40.0	19.6
	7.5	109.5	87.6	74.5	65.7	43.9	22.0

Source: COL estimates

INVESTMENT RATING DEFINITIONS

BUY	HOLD	SELL
Over the next six to twelve months, we expect the share price to increase by 15% or more.	Over the next six to twelve months, we expect the share price move within a range of +/- 15%.	Over the next six to twelve months, we expect the share price to decline by more than 15%.

TOP PICK DEFINITION

A stock that is included in our "Top Pick" list has to meet the following criteria: 1.) It must belong to a sector with neutral to positive outlook; 2.) It must have double digit earnings growth for the current and the succeeding fiscal year; 3.) Its share price appreciation potential must be above 15% as of the date it was included in the list; and 4.) It must have an upward intermediate term trend.

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