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AIR.NZ - Full Year 2017 Air New Zealand Ltd Earnings Call

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PRESENTATION

Operator

Thank you for standing by, and welcome to the Air New Zealand 2017 annual results investor briefing conference call. (Operator Instructions). With that, I will turn the call over to Air New Zealand's Head of Investor Relations, Leila Peters.

Leila Peters - *Air New Zealand - Head of Investor Relations*

Thank you and good morning everyone. Today's call is being recorded and will be accessible for future playback on our investor centre website, which you can find at www.airnewzealand.co.nz\investor. Also on the website you can find our annual results presentation, financial report, media release and relevant Stock Exchange disclosures.

Speaking on the call today will be Chief Executive Officer, Christopher Luxon, and Chief Financial Officer, Rob McDonald. I would like to remind you that our comments today will include certain forward-looking statements regarding our future expectation which may differ from actual result. We ask that you read through the forward-looking cautionary statement provided on slide 2 of the presentation.

With that, I will turn the call over to Christopher.

Christopher Luxon - *Air New Zealand - CEO*

Thank you Leila. Kia ora and a very good morning to everyone. Thank you for joining us on the call. We had a strong performance for 2017, delivering our second highest annual result in a year that we knew would be challenging as we faced an unprecedented amount of new international competition in the New Zealand market.

Now, before getting into the details of the year, I'd like to first thank all the Air New Zealanders for their enthusiasm and hard work. Our people are the airline's differentiator, and I want to acknowledge everyone for their contribution to this great performance.

Now, this morning we'll go through the key drivers of the result, spending some time on the revenue environment and delving into the cost performance and capital program. We will also give some insight into our views on current market dynamics and how we are positioned to perform in the year ahead.

In the back of the presentation are a number of supplementary slides which provide key financial and operational details. I do recommend that you do take the time to review that information as well.

Now, touching on the headline financial results, we delivered the second highest profit in Air New Zealand's history, with earnings before taxation of $527 million. That's in line with the updated guidance we provided back in June, in which we stated we were targeting earnings before taxation to exceed $525 million. Now, that guidance did not include the $10 million provision for the Australian cargo case or the further impairment on the Beach aircraft. Net profit after tax was $382 million. Operating cash flow generation continues to be strong at $904 million, and our pre-tax return on invested capital was 15.3%.

Now looking at the key drivers of the result, passenger revenue declined half a percentage point and RASK declined by 6.4%, reflecting the challenging competitive environment. However, the second half of the year saw a significant improvement to the rate of RASK decline compared to the first half and was driven by a stabilization of competitive capacity, as well strength in our domestic and Pacific Islands network.

As I've said before, despite the decline in RASK our entire network continues to be profitable. Cargo was impacted by the same competitive dynamics as the passenger business, and cargo revenue was down 0.6% for the year. Helping to partially offset the impact of competitive capacity on our revenue was a very impressive unit cost performance.

As Rob will expand on shortly, our unit costs excluding the impact of foreign exchange improved 2.3%. This year we've seen improvements come from increased long haul flying and the benefits of exiting from legacy fleets such as the Beach and 767 aircraft. These efficiencies are driving significant incremental savings. This year our efficiencies drove savings of $158 million.

Lastly, the fuel costs excluding foreign exchange increased 4.6% for the year, but this was below the rate of capacity growth due to the benefit of fuel price reductions, including hedging. In the supplementary slides we've provided details on the movements and fuel costs.

Now turning to revenue performance, the external environment and our internal outlook certainly improved as we progressed through the second half of 2017 and started to see the market adjust to the additional capacity. As you can see from the quarterly bar chart, the rate of overall RASK declined, improved in the third quarter and then turned positive in the last quarter of the year as we lacked weakness from the prior period and experienced very strong demand, specifically in the short haul market.

The table on the right summarizes how RASK in the various markets performed against our own expectations when we last reported our interim results in late February. Now, while our market saw improvement in RASK as we progressed through the year, the pace and magnitude of the momentum varied by sector.

The domestic network was the most resilient to the additional capacity that we put into the market, reflecting strong underlying demand that supported our growth of approximately 10% in the second half. As we said last year and at the interim result, about half of that growth was driven by Queenstown, which continues to be highly sought after as a leisure destination by both international, inbound and domestic tourists.

Events held in New Zealand in the second half also stimulated demand, thus helping to improve our RASK. However, even adjusting for those events, the underlying performance of the domestic network was robust.

The trans-Tasman market was very challenged for about a year due to a number of market dynamics such as increased competitive capacity and a decline in connecting passengers, resulting from the new direct services to New Zealand. That resulted in a weak first half for the sector. However, we experienced substantial improvement as we went through the back half of the year. The improved RASK was related to lapping the impact of some direct services as well as improving underlying demand.

I can move to the Pacific Islands, which always tends to be a strong performer for us based on the strong New Zealand outbound tourism driving those markets. In the first half of the year we saw some moderate RASK declines as a result of some aggressive competition on Rarotonga. However, this market turned positive in the second half with strong demand for destinations such as Honolulu, Bali, Fiji and Samoa.

Asia experienced weakness during the year, primarily based on a significant amount of competition coming from the new Chinese and Middle Eastern hub carriers starting up direct services to New Zealand. This clearly impacted our Shanghai and Hong Kong routes and, to a lesser extent, Singapore.

Japan had a very different dynamic, however, and the strong demand for inbound New Zealand traffic coming from this region was impacted by the Kaikoura earthquake which occurred in November 2016 and softened demand from Japan for a period of time. While all our Asian markets experienced less RASK decline in the second half, the softness resulted in unit revenue levels that were below our expectations.

Finally, the RASK impact felt in the Americas region resulted from a full year of US carriers bringing about 30% of additional capacity to New Zealand. North America is a significant market for us, comprising about half of our long haul network. The impact of introductory pricing for new services in the first half of the year started to stabilize into 2017 and we saw demand and pricing improve, which helped reduce the rate of RASK decline in the second half.

To briefly wrap up my observations about this year's performance, 2017 was a challenging year and one we did not take lightly. We knew there would be an impact as we moved very quickly from a relatively benign competitive environment to one that was filled with a number of new carriers. In that context, I'm extremely pleased with how we responded to that competition and the moment we saw towards the end of the year.

Looking at the year from the perspective of our financial framework, I would say that our focus on profitable growth continues. We seek to grow our network broadly in line with tourism demand and we also have a very disciplined approach to ensuring that the growth we are adding to our network is achieving the returns that we require. To support this growth we've continued to drive underlying cost efficiencies and economies of scale. You can clearly see those benefits in our 2017 result.

Regarding our capital structure, we continue to have a stable investment grade credit rating and appropriate gearing levels which allow us to finance aircraft at very attractive rates to deliver our growth. Our ultimate goal is providing sustainable strong returns for our shareholders over the long term, and I think you've seen us do that again this year.

Sitting where we are today we continue to benefit from the rational capacity decisions we've observed within the market over the past four to six months, and I have a lot of confidence in the work our team is doing with regard to market development. Based on that, there are areas where you'll see us adding targeted growth, and I will come back later to provide some insight into those plans.

Now, let me hand it over to Rob.

Rob McDonald - *Air New Zealand - CFO*

Thanks Christopher. Kia ora and good morning. I will walk through the key movements which affected our performance during the year. Please note that these numbers isolate the impact of foreign exchange to help provide a better understanding of the dynamics of each major component.

Starting with revenue, there was a decline of $19 million which was drive by a reduction in RASK of $247 million. Partially offsetting this was a capacity growth of $225 million and a $3 million increase from cargo and other revenue. Labour costs increased $44 million due to the combination of activity and rate increases, which was partially offset by improving productivity and reduced incentive provisions, including the Company performance bonus. On capacity growth of 6.3% our total labour cost excluding the effects increased only 3.6% and our head count increased 3.4%, which is an excellent result.

Fuel increased $39 million, while the average fuel price increased by 12%. This was offset by the benefit of hedging movements. In total fuel price savings were $13 million. These savings were partially offset by $52 million relating to increased fuel consumption. Maintenance, aircraft operations and passenger service costs increased by $43 million. We saw good improvements in maintenance costs across the fleet and started to enjoy the benefits from the exit of the 767 and Beach fleets.

Offsetting those improvements were higher passenger services and operating costs associated with increased flying. Sales and marketing, other expenses and share of associates increased by $13 million, relating to higher travel agency commissions, increased loyalty activity and digital expenses. Also included are the earnings from our investment in the Christchurch engine centre, which grew to $26 million compared to $23 million in the prior year.

Ownership costs increased by $25 million due to the depreciation expense related to the delivery of new aircraft and lounge refurbishments. The impact of the strengthening New Zealand dollar again foreign currencies on our revenue and costs had a positive effect of $19 million. However, that benefit was more than offset by the impact of hedge movements.

In the prior year we realized a gain of $112 million, while the current hedging resulted in a modest loss of $6 million. After taking into account the unfavourable impact of $118 million of hedging, overall foreign exchange had a $99 million impact on earnings. The positive movement in other significant items was $146 million, consisting of a $3 million gain compared to the prior year loss of $143 million. The net result of these movements is an incremental decrease in earnings before taxation of $136 million.

CASK improvement and scale economies are integral to our growth strategy as we regularly review the ability of each route to contribute possible growth to our network by ensuring we optimize deployment of our aircraft and keep our fixed costs stable, we can achieve growth at a higher relative return. CASK excluding FX improved 2.3%.

Fuel price and foreign exchange movements had relatively minor impacts and offset each other, resulting in an underlying CASK improvement of 1.9%. The reduction in CASK was driven by efficiencies of $158 million and economies of scale related to the benefits of fleet simplification, productivity and other cost saving initiatives that more than offset the impact of inflation.

Turning to cargo. While this continues to be a very strong business for us cargo was also impacted by the same competitive trends that impacted passenger revenue. Competition from carriers in North America and Asian drove a yield decline of 8.7% which was partially offset by strong volume growth of 8.1%. The growth came from new routes to the Americas, up-gauging of our flights and additional frequency on the Tasman and Pacific Islands.

Issues with the Los Angeles airport taxi ways and runways, which are still under construction, continue to have an adverse impact on our ability to drive additional volume which impacted cargo revenues by almost 2% in the year. Lastly, our domestic cargo performed well driven by good yield growth underpinned by a strong New Zealand economy.

Operating cashflow while impacted by the decline in earnings continued to be strong at $904 million. Included in the operating cashflow was an outflow of $58 million relating to a one-time restructuring of an engine maintenance agreement, which we also mentioned during the interim result. We ended the period with cash on hand at $1.4 billion and there was some key movements to highlight. Related to the divestment of Virgin Australia we also received $45 million as net proceeds from the sale of our remaining interest. We also received from Virgin the repayment of a shareholder loan in August 2016 of $137 million.

Finally, there was a $530 million outflow from the payment of ordinary and special dividends. Our liquidity ratio at the end of the year was 30% of revenue, down from 36% in the prior year. As we enter the final stages of our current fleet replacement program, we're looking at our options to reduce our cash balance through aircraft acquisition and paying down debt.

Our gearing at the end of the year was 51.8%, an increase of 3.2 percentage points from last June. The level of CapEx primarily drove the increase as well as the payment of the 2016 special dividend. We continue to maintain an investment grade rating of Baa2 from Moody's with a stable outlook. As a result of an operating performance that ranks the second best in our history the airline's financial strength and capital commitments over the next few years, as well as the trading environment, the Board was pleased to announce a fully imputed final dividend of $0.11 per share. This is a 10% increase from the prior year and speaks to our confidence going forward. That brings our total imputed ordinary dividends for the year to $0.21 per share.

Moving onto our fleet. During the first half of 2017 we received delivery of three Dreamliners, one A320 and two ATR turboprops. We also acquired two A320 Tasman aircraft that were previously on operating lease. During the June investor day presentation we provided an update on the delivery schedule relating to the A320 and the A321 NEOs.

One of the benefits from the delay is that we will receive the new configuration for the A321 which will be released in September 2018 and that will provide five more seats than the previous version. The other benefit to the delay is that it will smooth out our capital expenditure profile. Based on our current forecast we expect CapEx relating to aircraft and associated assets over the next four years to be $1.5 billion.

Now looking forward to 2018. I wanted to provide an update on our fuel hedging. We have mitigated the risk from increased fuel prices with some additional hedging. Last Friday we disclosed our latest hedging portfolio which showed an increase volume of hedges particularly in the second half of the year. The drop in oil prices in June enabled us to lock in lower pricing for the first half of the year.

At the same time we increased the volume of hedges for the second half. Our collar structure allows us to participate should oil prices fall lower, while also ensuring that we have a high level of price protection in place should there be a material spike in fuel. Fuel represents our largest US dollar exposure and for 2018 we are 80% hedged at $0.718.

Based on current prices fuel costs will be about $50 million higher in 2018. To be helpful we have provided an outlook of estimated fuel costs using a fuel price of USD60 per barrel. The increase reflects the impact of hedging movements and additional volume, partially offset by a favourable foreign exchange.

Based on the makeup of our hedges we have also provided an estimate of how movements up or down in fuel prices would impact our fuel costs in New Zealand dollars. I would note that while this estimate assumes an FX rate of $0.725 movements in the exchange rate, it would have a minimal impact on our bottom line as those movements are offset by FX hedging. Assuming that average fuel price for the year remained at USD60 per barrel, our approximate fuel costs would be $880 million.

Now let me turn the call back to Christopher to discuss the outlook for 2018.

Christopher Luxon - *Air New Zealand - CEO*

Well thanks Rob. I'll briefly touch on our view of current market dynamics to provide some context for our growth plans in the year ahead. Looking at our short haul markets we continue to see strong underlying demand in both the domestic and Pacific Island regions.

On the domestic routes we're targeting growth to be in line with demand stimulated by tourism, as well as supported by the strong economic climate. We will continue to grow our domestic jet routes into key city centres, with the largest part of that growth again coming from Queenstown.

Growing the regional New Zealand market remains core to our strategy and while our competitor has recently reduced capacity to the regions this remains an important part of our domestic growth in 2018. We plan to add over 60,000 extra seats to our regional schedule alone over the summer months across then network, which includes additional services in Napier and Nelson.

We continue to be pleased with the performance of our Pacific Island routes which overall are showing robust demand from outbound New Zealand travel. The Pacific Islands are an incredibly popular destination and in the past 12 months kiwi outbound travel grew almost 12% with the Pacific Islands comprising also one third of that growth.

Following the successful deployment of the Dreamliner on Honolulu and an improved schedule we're continuing to see strong demand, particularly from premium traffic driving good yield performance and we're getting a positive market response to the additional growth. So we will be continuing to add frequencies over the peak periods to service this continued demand.

Our growth of the Bali route is another example of building up strong customer demand over time. We will be increasing our service frequency per week and we'll be lengthening the season which allows us to tap into the kiwi demand for Bali that had historically been travelling via Australia.

Now shifting to the Trans-Tasman market, we have seen recent signs of some rationalization in competitive capacity and we are seeing improved revenue dynamics begin to emerge, albeit from a low base. This year we plan to up-gauge certain routes such as Adelaide to the Dreamliner to benefit from the aircraft economics, while also stimulating more premium traffic with our business and premium economy offerings.

This growth also supports our new A Better Way To Fly campaign featuring Dave the Goose as part of our North and South American growth strategy. Overall, we're optimistic on the revenue momentum on the Trans-Tasman after a year of excess capacity impacting pricing.

Now looking further abroad international long-haul clearly was the sector most impacted by the influx of new competition last year. I can turn first to North America. We continue to see strong demand out of these routes even after 30% growth in capacity last year from other carriers.

We have seen our partner United Airlines remove its capacity during the New Zealand winter season and they will do that again for next year's winter as well. Additionally, our competitor out of Los Angeles just recently announced they will suspend services to Auckland from April to September of 2018. Those capacity changes continue to support a stronger revenue environment as we look ahead.

Our Houston route continues to perform strong, especially with connecting customers to the South-East, Mid-West and North Atlantic parts of the US. As we continue to strengthen our Houston route this year we will be adding frequencies and deploying the new Code 2 787 Dreamliner.

With 275 seats it has fewer economy seats and adds 21 additional premium seats to capture the demand in that market. In the first quarter of this year we will also be launching a new marketing campaign targeted to key catchment areas in the US to drive increased brand awareness.

Over the peak season we will also be growing Vancouver by extending our daily peak season and adding an additional service per week from March to June. Our Vancouver service enjoys good flows from both inbound and outbound traffic and we expect a good customer response from the additional growth.

Now turning to Asia. The challenging competitive environment we've seen throughout 2017 will start lapping towards the end of the first half of 2018. We expect the revenue environment in the second half to improve as we absorb the growth and industry capacity specifically with regards to Hong Kong.

We continue to be optimistic regarding the demand dynamics for Singapore which remains a popular destination serving as a gateway to South-East Asia, India and Europe, for both inbound and outbound travel in cooperation with our alliance partner Singapore Airlines.

Now in Japan we continue to have a strong focus on strategically growing this market. It has been really encouraging to see the latest economic reports showing Japan's GDP has grown for six consecutive quarters, which is the longest streak in more than a decade and it demonstrates our confidence that demand will ultimately follow our market development.

We were very pleased to have launched our Haneda service last month to complement our existing Narita route. Haneda is much closer to the centre of Tokyo and offers better domestic connections with our codeshare partner ANA. We are now operating three flights a week into Haneda as well as maintaining our daily service into Narita and we will be working to grow demand for both services over the next few years.

We have provided a breakdown of our estimated capacity plans for the year which I think is fairly self-explanatory. This plan does represent an increase from an earlier estimate of 3% to 4% growth that we provided at the June investor day presentation. I wanted to highlight that the additional capacity is solely based on increased utilization of the existing fleet already planned for 2018, so this is very capital efficient growth.

As we have continued to see and benefit from improving market dynamics our team have targeted specific opportunities for growth which are reflected in the current plan outlined here. Putting it all together we anticipate capacity growth between 4% to 6% for the Group in 2018.

Now turning to the outlook for the year. Our 2017 earnings provide us with a sustainable platform for future performance. As we look forward to the year ahead we're optimistic about the overall market dynamics. Based on the current market conditions and assuming fuel prices remain at USD60 per barrel, which represents the average over the past two months, we are aiming to improve upon 2017 earnings.

Well, thank you for listening. Now Operator, please open the line up for any questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Your first question comes from Andy Bowley from Forsyth Barr. Please go ahead.

Andy Bowley - *Forsyth Barr - Analyst*

Thanks Operator, and good morning Christopher, Rob and Leila. I've got a couple of questions here, but the first one's around the cost base. The cost improvement is clearly very impressive through the year, albeit the second half cost benefits are a lot lower than the first half. I suspect there's some mix impact in there. But can you kind of give us a bit of a guide as to where or how we should be thinking about costs now going forward, given some of the step changes, particularly around maintenance, over the last 12 months?

Rob McDonald - *Air New Zealand - CFO*

Kia ora and good morning Andy. So just on the second growth was slower than the first half growth, so that's just impacted the scale economies that we got in the second half.

Also, which is really a positive, we were paying higher commissions in the second half as we started to see that revenue momentum pickup beyond February. So as I say, that's a good thing.

Then also we had some marketing campaigns coming in the current year and the production costs of those were in the last quarter. So that's why you saw that sales and marketing costs have come up a bit in that second half as well. But again that spend, that is really investment for the coming year.

Christopher Luxon - *Air New Zealand - CEO*

In thinking forward Rob, in terms of...

Rob McDonald - *Air New Zealand - CFO*

On maintenance -- the maintenance has been a good trend now for a couple of years. We'll get some more benefit as the full year of the 767s is out. But then we'll go into a more orderly sort of power by the hour being the core part of the engines. So it will become a bit more stable in coming years, and just more tied to volume growth.

Also the longer sectors that we're flying continue to help in 2018.

Andy Bowley - *Forsyth Barr - Analyst*

So on a unit cost basis should we expect further reductions in the year ahead given the kind of greater capacity expansion than we were anticipating previously? Can we offset the inflationary pressures?

Rob McDonald - *Air New Zealand - CFO*

Yes, that is certainly the aim.

Andy Bowley - *Forsyth Barr - Analyst*

Okay, but I assume, is it getting harder now or are the scale benefits still providing that?

Christopher Luxon - *Air New Zealand - CEO*

Hi Andy, Chris here. Listen as we discussed at the investor day, just ongoing CASK reduction is just built into how we do the business. It'll be -- that's very driven by how much capacity we've got coming through. Some of that targeted capacity deployment that we've got will certain help us, particularly as we go into the second half next year.

Andy Bowley - *Forsyth Barr - Analyst*

Great, thanks Christopher and Rob. Now second question, just around CapEx. So the total CapEx for the year was a little bit higher than I think I was anticipating, but clearly there's a fair bit of non-aircraft CapEx being spent currently. Can you give us a flavour for the kind of the magnitude of some of the key projects around the CapEx, together with what we can expect over the next couple of years?

Christopher Luxon - *Air New Zealand - CEO*

Yes, Andy, I mean the aircraft piece is pretty self-explanatory. The other pieces that are really non-aircraft related is really lounge investment. We're partway through a $120 million lounge upgrade program across our network.

The second piece would be good targeted investment in digital technology. We've talked a lot about our vision for how we want to use digital to transform the company operationally for customers, and commercially. There's some investments going into that space.

Andy Bowley - *Forsyth Barr - Analyst*

So I guess just to clarify in terms of looking ahead to the year ahead, we've got aircraft CapEx as outlined in the slide. What should we be thinking about non-aircraft CapEx?

Rob McDonald - *Air New Zealand - CFO*

Generally -- Andy, it's Rob here -- if you're around $100 million other, sort of a run rate you could accept, see in the next couple of years. The lounge program is probably on its part of the back hill part, although clearly with the growth we're doing at the moment that's an area that is now becoming a more business as usual. That we've just got to keep on top of it all the time, we can't let it run backwards.

Andy Bowley - *Forsyth Barr - Analyst*

Great, thanks guys.

Operator

Thank you. Your next question comes from Andrew Steele from First NZ Capital. Please go ahead.

Andrew Steele - *First NZ Capital - Analyst*

Good morning. Just one point of, I guess, clarification on CASK looking forward to next year. You've given the strong level of profitability recorded in FY17, I mean how do we -- shall we think about I guess performance or incentive pay for staff for 2017 flowing through into the 2018 year?

Rob McDonald - *Air New Zealand - CFO*

So assuming we achieve improved earnings then you would expect the sort of both short-term incentive payments, and also the Company performance bonus to obviously improve if that was the case. Obviously that's what we're aiming at, so that would be a good cap outcome for everyone.

Andrew Steele - *First NZ Capital - Analyst*

Okay, but you in terms of the FY17 year's profitability, there's no sort of material impact as into labour costs for FY18?

Rob McDonald - *Air New Zealand - CFO*

No.

Andrew Steele - *First NZ Capital - Analyst*

Great. Just in terms of the lookout for cargo dynamics for FY18, I guess we saw, going from first half into second half, a moderation in cargo yield decline. What are your expectations for this going forward into FY18?

Christopher Luxon - *Air New Zealand - CEO*

Hi Andrew, it's Chris here. Listen, yes, I mean cargo dynamics actually for the first time in this last year have actually mirrored passenger revenue dynamics, which we've -- which is unusual actually over the last decade or so.

As we go forward we're expecting an improving revenue situation to happen in cargo as well. In part, also because you would have noticed the recent announcement of withdrawal of capacity from the New Zealand market by American, and going into peak summer seasonal services only. So that creates an opportunity for our North American cargo part of our business.

So we expect cargo improving along the similar lines and philosophy as what we're seeing in the passenger part of the business.

Andrew Steele - *First NZ Capital - Analyst*

That's great. That's all from me, thank you very much.

Operator

Thank you. Your next question comes from Owen Birrell from Goldman Sachs. Please go ahead.

Owen Birrell - *Goldman Sachs - Analyst*

Hi guys, and thanks for the result today and the call. Look, I just wanted to -- I had a few questions around I guess the Trans-Tasman international legs that you guys are running with the new Dreamliners. First, I just wanted to confirm that you said you had three that you received this year.

I just wanted to get a better understanding of which destinations in Australia you're connecting those to. Then is it only onward to Houston on the US side, or is it actually going to LA as well?

Christopher Luxon - *Air New Zealand - CEO*

Hey Owen, listen on the Tasman obviously we've been putting increasingly wide-bodied capacity, you're right, we had three new aircraft come this last year. I think we've got two coming next year -- this year, I mean in FY18.

Really our focus is on making sure that we actually can serve the corporate market incredibly well with wide-bodies going over in the morning and the evening for the major cities on the Eastern Seaboard.

The increasingly you will have seen us start up a 787 service out of Adelaide to actually bring that strategy to life of bringing Australians through New Zealand into North America and South America. That's really the big increase in capacity that's going into the Australian market.

Leila Peters - *Air New Zealand - Head of Investor Relations*

Sorry, Owen, this is Leila. In terms of the use of the Dreamliner, that will start in 2018, this year, around peak season where we'll be introducing the new Code 2 aircraft that we talked about earlier. Which is the increased premium economy seats going to Houston.

Owen Birrell - *Goldman Sachs - Analyst*

So those three Dreamliners are only going Trans-Tasman, or are they actually going over to the US as well?

Rob McDonald - *Air New Zealand - CFO*

I wouldn't say -- we've been doing (inaudible) and so it's a continuation of flying that we've done for decades. But it's certainly, as you've seen in the last couple of years now, a return to a very focused strategy around that and using Auckland as a hub to North American, given that we now fly to Houston. We've grown Vancouver, we've now got Buenos Aires as well.

So certainly if I go back a decade, we started to push more into narrow bodies, that's re-weighting a bit back into wide-bodies and ensuring, as Christopher said, those more business connections for wide-bodies are there as well.

Christopher Luxon - *Air New Zealand - CEO*

I think the other thing, Owen, would be the recent rationalisation of competitive capacity out of Sydney is just meaning that we think we will see improving revenue dynamics on the Tasman, along with that wide-bodied capacity going into targeted places to connect Australians through to North America and South America.

Owen Birrell - *Goldman Sachs - Analyst*

Can I just ask, in the connection through to the US, is that -- so that's currently going to LA on those Dreamliners?

Christopher Luxon - *Air New Zealand - CEO*

No, it goes all over the place. So it actually at different times it will go across -- the connections from Australia are actually going into Vancouver, LA, San Francisco, Houston, Buenos Aires. I mean Buenos Aires, as we've said, is in excess of 20% to 25% Australian traffic now -- or actually 40%, actually Houston is in excess of 25%. We're hoping to get it closer to 30%. So that strategy is working very well.

Owen Birrell - *Goldman Sachs - Analyst*

Sorry, that's with the Dreamliner though?

Rob McDonald - *Air New Zealand - CFO*

Flight to -- and they are evening flights to North America are over a two-and-a-half period. So the Australian [bank] comes into that. So it doesn't really matter where the plane goes beyond, the connections are available.

Owen Birrell - *Goldman Sachs - Analyst*

Right, okay. That's great, thanks guys.

Operator

Thank you. (Operator Instructions) Your next question comes from Marcus Curley from UBS Investment Bank. Please go ahead.

Marcus Curley - *UBS Investment Bank - Analyst*

Good morning guys. Just a few from me. Sorry to labour the cost discussion, but can you give a little bit of colour of what you're thinking around labour costs this year. Obviously it was a pretty impressive labour cost performance in 2017 against the backdrop of all that capacity growth. Is the possibility of leveraging labour to the same degree there in 2018?

Rob McDonald - *Air New Zealand - CFO*

It's Rob here. I think we've held the pilot complement after 767s have left for the planes that are coming in this year, and they will be more productive than the 76s obviously. So that's a bit of an opportunity for us on the labour side.

But generally we're still seeing a sort of CPI settlements occurring, which is good. So I think we still certainly, and are aiming for, to capture the scale growth for labour. But clearly operationally as we grow, and we're talking about 4% to 6%, then you will see operational labour numbers grow.

That said, on the rest of the labour base very focused on ensuring that that stays buttoned down.

Marcus Curley - *UBS Investment Bank - Analyst*

Okay, secondly I just wondered whether you can give some sort of directional comments on what you think RASK does across the major sectors this year. Obviously there's a flavour of that in the outlook, but I suppose more specifically in terms of the long haul market?

Christopher Luxon - *Air New Zealand - CEO*

Yes. I think, we won't give specific RASK guidance obviously, but as we go forward, we've just seen continuing stabilization of RASK as you would have seen in the first half last year was minus 9%. We ended up in Q4, I think, at plus 2%.

I think the July operating were at 4.3%. So we've just seen that in that improving RASK environment. Obviously we've got targeted capacity improvements going -- capacity growth going in.

It's very good rationale for that capacity growth that we've got going on. It makes sense and it's all profitable growth. So as we go through the year, we would expect a pretty stable international RASK situation.

Marcus Curley - *UBS Investment Bank - Analyst*

Christopher, would you give some comments in terms of whether Asia versus the US, in terms of whether either of those markets is more challenging at the moment?

Christopher Luxon - *Air New Zealand - CEO*

Yes. So in terms of challenging, I mean -- and since we spoke to you guys at Investor Day and certainly at the interim result, I mean, we've -- we would say that most of the theatres have met our expectations or surpassed our expectations. North America is an area that surpassed our expectations obviously.

Asia has met and remain to be challenging. So certainly with some of the rational competitor decisions that we've seen with United now only in the summer peak as our alliance partner, American only now in the summer peak, we see good opportunity in the US. To give you a feel for it, US visitor numbers from the US into New Zealand were up about 24% this last year. So there's still a lot of good growth prospects there.

Marcus Curley - *UBS Investment Bank - Analyst*

As part of that Asian challenge, how do you think about Chinese visitor [rolls]? Do you think that's a blip or something that you're having to just think about adjusting in terms of a slower demand out of that market?

Christopher Luxon - *Air New Zealand - CEO*

Yes. Well, we look at Asia sort of into -- I think you've got to look at it through three dimensions. One is South East Asia and its connectivity to South America. In particular, we're seeing good opportunities there and South East Asia and the Singapore anchor that we've got there is a good place.

Tokyo, we can talk more about, but as -- that's where two-thirds of our international capacity growth will come, and is very good economic stats and growth out of Tokyo. We're seeing very good increase in visitor numbers and we also have a big strategic play to secure slots at Haneda Airport, which we think is for the long-term future in Japan very important. The real challenge, as you identified, is really in Hong Kong and China, because of the capacity coming out of direct Chinese carriers.

What I'd say about that is we're a little bit inoculated by that. Total Chinese visitors to New Zealand in the last year was at 0 to 0.1 -- minus 0.4% from memory, so it's pretty stable. Within that, what we've got to understand is we're at Shanghai.

We're fixated on Shanghai and that catchment area. 80% of the people coming on our planes, our services -- are there for -- in New Zealand for eight days as free and independent travellers. So we have a wealthier dynamic.

I think what's happened and what you're seeing in some of those stats is certainly the group large, low value, bulk group travel from China to New Zealand has struggled to get access to hotel rooms at competitive rates, all those sorts of issues. Whereas the free and independent travellers, who are spending significant amounts of money daily in the country is a much more valuable niche for us to go after.

We talked a lot about -- you might remember in past conversations how we're focused on different segments of the Chinese market exclusively; wealthy 30-year-old couples, wealthy upper middle-class families and that's stood us in good stead. So I think we're a bit inoculated from it to some degree.

Marcus Curley - *UBS Investment Bank - Analyst*

Then finally, it looks from the announcement so far that your competitive capacity has probably peaked. Are you seeing or hearing anything that would concern you in terms of renewed competitive capacity coming into New Zealand and over the summer period?

Christopher Luxon - *Air New Zealand - CEO*

You can never say never, but the bottom line is that, yes, you're right. We've seen some - we're very encouraged. From where I sat a year ago talking to you guys on this call to where we sit today, we're in a very different place.

I think we look at this 2017 result and we say it's a fantastic result, because not only did we see off 10 new competitors in 12 months, who subsequently have gone on to rationalize a lot of that capacity, and we were highly competitive and the investments we've made stood us in good stead, we delivered $500,000,000 doing that.

At the same time we had a whole bunch of commercial highs in terms of total shareholder return, ROIC. We had a whole bunch of customer highs in terms of number 1 corporate reputations in Australia and New Zealand. A whole bunch of cultural highs as well in terms of how we look at the business.

So the health of the business is in fantastic shape and so, yes, as we go forward, we can see that we think the macro environment and the revenue environment is positive and it's improving and that's why you've seen us obviously come through feeling very confident about the platform that we've created with the 2017 result. We have a positive, I think, outlook statement. The third thing I'd say to think about is that the dividend increase also underscores our confidence as we go forward as well.

Rob McDonald - *Air New Zealand - CFO*

Marcus, the only comments I'd make on that is clearly we're late August now. Anything in the high season is getting very late to get a booking profile going, so even the recent announcement we've seen are actually about the season after that, and that was obviously American pulling out. The only thing you've heard of in recent weeks is the Philippines flying direct from Manila.

We look at that and say that's not a bad thing for us, because they're out of Cairns, so that's more good stuff for the Tasman.

Christopher Luxon - *Air New Zealand - CEO*

It is probably important just to register some of that rational competitor capacity decisions that are taking place. I mean, you have -- you've had Emirates pull off from there.

You've had China Airlines come off the Trans-Tasman. Philippines obviously come out of Cairns/Auckland and go direct. United and American both in summer peaks and obviously Jetstar cutting some 15% regional capacity as well.

So they're encouraging signs that give us -- partly give us confidence, why our confidence is there for the coming year.

Marcus Curley - *UBS Investment Bank - Analyst*

Okay. Thank you very much.

Operator

Thank you. Your next question comes from Steve Creedy from Airline Ratings. Please go ahead.

Steve Creedy - *Airline Ratings - Media*

Hi, guys. I was just wondering about the 787-9 Code 2s. How many of -- what proportion of the fleet is going to be the Code 2 and I think somebody said that they're due to be introduced when they come into Houston. Is there any -- are there any plans to retrofit the rest of the fleet?

Christopher Luxon - *Air New Zealand - CEO*

Yes, Steve. I think we've got four coming, two next year, and net of our fleet is about 13 is what we've got. So -- and as you know, that Code 2 comes as a 275-seater.

I think from memory you've got 21 extra premium seats and so that's just a great configuration for us. I mean, one of the real strengths of us is we're in a simplified fleet and not only that, but we've got the aircraft personally configured for the New Zealand market. What we're identifying is as we grow and build these markets, we are going to put different aircraft on at different times as we see the mix of customers change and evolve and become more premium ultimately.

So for the Code 2s, yes, we felt we wanted more premium seats and there's some opportunities in the number of places around the world, which we won't get into today, but -- that we want to deploy them to. It gives us an ability to extend range obviously with a lot less economy passengers on board.

Steve Creedy - *Airline Ratings - Media*

Sure. Okay. All right. Thanks.

Operator

Thank you. Your next question comes from Jason Familton from Accident Compensation Corporation. Please go ahead.

Jason Familton - *Accident Compensation Corporation - Media*

Good morning. Sorry to come back to the cost questions, but if you look at what you've guided yesterday around nominal CASK in 2018 to be stable on 2017? Obviously today you announced capacity growth ahead of [year fall back then]. So do you know anticipate CASK, nominal CASK, to go backwards?

Rob McDonald - *Air New Zealand - CFO*

I don't know why nominal CASK would go backwards. If anything, it should be a touch beneficial (multiple speakers).

Jason Familton - *Accident Compensation Corporation - Media*

Yes. Beneficial, sorry. Full. Yes.

Rob McDonald - *Air New Zealand - CFO*

One of the things about the growth from taking it where we were at the Investor Day to where we are now is that it's really just playing into the utilization of the aircrafts and so that's always very (inaudible) when it comes to helping CASK along. So, yes, I would look at that additional set of growth as beneficial to keep the CASK pressures downwards.

Leila Peters - *Air New Zealand - Head of Investor Relations*

Jason, it's Leila. Also additionally if you look at some of the additions to the capacity growth for 2018 that we outlayed -- that we laid out today versus June, you've got Bali, you've got Vancouver, you've got Honolulu, Houston, Buenos Aires. These are all some of our longest sector routes, which as we increase that flying, we'll definitely have some improvement at the CASK level. We have to consider where the capacity adds are going as well.

Christopher Luxon - *Air New Zealand - CEO*

Yes. Many of those additions are to existing services. That just makes -- when we grow them from the existing service, it just plays to efficiency of crews and things like that.

Jason Familton - *Accident Compensation Corporation - Media*

Okay. That sounds good. So it's an improvement on that guidance. That's good.

The second one, I don't think you made any comments around the frequent flyer program. I'm wondering how your membership has grown over the last six months and secondly how revenue from your partners may have grown over the last six months.

Christopher Luxon - *Air New Zealand - CEO*

Yes. So we're up 16%. We're over 2.5 million air points members now, which is pretty phenomenal.

We've obviously, I think, added 15 new coalition partners in the year as well to get over 60 coalition partners now. That's going incredibly well. As we talked a bit about at the Investor Day, that just continues to go from strength to strength and we've got a fantastic ecosystem that I think is very supportive of certainly our domestic, regional and outbound travel for New Zealanders.

Jason Familton - *Accident Compensation Corporation - Media*

Okay. That's all from me. Thanks, guys.

Operator

Thank you. There are currently no further questions at this time. I'll now hand back for closing remarks.

Christopher Luxon - *Air New Zealand - CEO*

Well, can I just say a very big thank you to everyone for listening on the call, certainly for your time and your interest and support of Air New Zealand. If you do want to schedule a call, as you know, always, please reach out to Leila and our Investor Relations team, who are very happy to take any questions or help clarify anything for you as you digest the results.

But, again, for us, we're really proud of the performance, proud of the result and it's onward and upwards. Thanks.
