

## **Start of Transcript**

Operator: Welcome to Air New Zealand 2019 Interim Results call. During the presentation your phone lines will be placed on listen-only until the question and answer session. If you could please refrain from asking questions until that time.

With that I will turn the call over to Air New Zealand's Head of Investor Relations Leila Peters.

Leila Peters: Thank you and good morning everyone. Today's all 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-centre](http://www.airnewzealand.co.nz/investor-centre).

Also on the website you can find our Interim 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 Jeff McDowall.

I would like to remind you that our comments today will include certain forward looking statements regarding our future expectations, which may differ from actual results. We ask that you read through the forward looking cautionary statement provided on Slide 2 of the presentation.

In addition, the Appendix of the presentation has a number of slides that we will not be specifically speaking to which provide key financial and operational details. We recommend that you take the time to review that information.

With that I will turn the call over to Christopher.

Christopher Luxon: Thank you Leila. Kia ora and good morning everyone, and thanks so much for joining us on today's call.

Earlier this morning, as you've seen, we have released to the market our financial results for the first half of 2019 financial year. Those results were solid, with \$211 million in earnings before taxation achieved despite what I think is a very challenging operational and cost environment.

We experienced strong demand levels across our network particularly in our domestic market for the majority of the period. That demand, in conjunction with our targeted capacity growth and pricing actions taken across parts of our network, drive high single-digit revenue growth. Which helped partially offset the headwinds of fuel and higher

operational costs.

However as we saw with the results of our December revenue and looked into the remaining peak months of the year we identified softer levels of demand that indicated revenue growth in the second half of this year will be slower than what we saw in the first half.

Now the areas where the change in demand is most visible from a forward bookings perspective is domestic leisure travel within New Zealand. Although we continue to see robust demand for corporate and business traffic.

To a lesser extent we're also seeing some impact to our inbound long-haul network which is seeing slowing rates of tourism growth compared to recent years. But to provide some context, in the 2018 calendar year New Zealand inbound tourism growth was 3.5%, which is in line with our own long-haul growth this year.

However it is much slower than the average visitor growth over the previous five years of approximately 8%. We are closely monitoring our other markets and various distribution channels for additional changes in demand. But we have not seen a notable shift.

As a result of the revised revenue forecast the updated earnings outlook provided at the end of January was necessary. Although it is disappointing not to be able to deliver on the financial commitment we made to our shareholders earlier this year.

Now in light of the demand levels we are observing I announced in late-January that the airline has commenced a review to determine what adjustments need to be made across our network, across our fleet, and ultimately our cost base.

It is clear that some aspects of our business that made sense in a high-growth environment will need to be reconsidered and adjusted as we enter a period of lower growth.

Now Air New Zealand has a rich history of being able to adapt quickly to changing market dynamics. Whether that be natural disasters, significant shifts in the competitive landscape, right through to demand slow-downs. This time will be no different.

Agility is really embedded in the DNA of this airline and its people. I think it is one of the core competitive advantages we have as a smaller airline that enables us to effectively compete with some of the largest airlines in the world.

Now the review is making good progress, but the work is ongoing. We expect to be in a

position to provide an update in due course.

I am confident that the actions we are taking, along with the continued dedication and focus of our phenomenal people, will support a return to earnings growth and ROIC improvement in this lower revenue growth environment.

Now going into a bit more detail as to what we are seeing in the domestic market I thought it would make sense to provide some more context.

For the past year our domestic network has experienced average revenue growth of around 8%. Over that period revenue has grown either as a result of high levels of capacity growth, stronger yields, or a combination of the two.

Supporting that growth has been really robust underlying demand. As we mentioned on our 2018 Annual Results call in August, that growth has come from a combination of strong business travel, really good inbound tourism - which as you know results in additional domestic travel once tourists arrive in New Zealand. Lastly domestic leisure demand from New Zealanders choosing to travel throughout the country.

As I already mentioned, our December revenue results for the domestic segment came in a bit softer than our expectations had been. As you can see in the chart on the right-hand side of this slide, the January growth is also softer.

Now as we progress month to month through the end of the year I would expect to see some variability in the rate of domestic revenue growth as it relates to the prior comparable period.

But we believe the trend will continue to demonstrate low-to-mid single-digit revenue growth. Which is a good result although it's much slower than the high single-digit growth that we had previously been experiencing.

Even though we are expecting a slower rate of growth going forward it is important I think to point out that our domestic network is extremely strong, with a market share position that has grown in the past 12 months.

Over the years we have built up this business to have tremendous resilience, with significant investments both on the ground and in the air. We will continue to do so now.

You will have seen that we announced earlier this year that we would be investing \$60 million in our domestic and regional lounges throughout New Zealand over the next two years. We have made some exciting progress on this, opening up our new Tauranga

lounge in December.

We know there is huge demand for our lounges. It is that sort of investment that really enhances our customer experience before they have even boarded the plane.

Now last June we held our Investor Day in an environment of rising fuel prices. I spoke about the playbook that we follow and the levers we would pull in this part of the cycle. Similarly we have a huge amount of institutional knowledge and we know what levers we need to pull to address the slower growth environment we are seeing.

Now the first step is adjusting our supply to be more in line with demand. That is through reductions in capacity growth across the network. We have made a series of changes to our schedule, the net result of which has brought our capacity plan down to around 4%. Compared to our original plan of 4% to 6% growth for the year.

The second step is transforming our domestic fare structure. You will have seen earlier this week we announced the biggest overhaul of the Airline's domestic pricing structure in over a decade.

We are now offering lower entry level fares, or lead-in fares as we call them, to make domestic travel more affordable than ever. Our customers will now be able to find domestic fares for as low as \$39 each way.

We believe simplifying the fare structure will help stimulate domestic travel for New Zealanders and international visitors. While this may result in some impacts to load factors for average fares, we will continue to focus on maximising total revenue.

Finally, with the first two components right size we are working on driving increased interest in travel and stimulating demand for a series of market development activities which differ market to market.

This includes utilising our data analytics capability to driver more targeted offerings to our customers. Increasing the update on our various ancillary product offerings, as well as specific marketing campaigns aimed to stimulate new visitors to the country.

For example, we continue to partner with Tourism New Zealand to drive increased awareness of New Zealand for international travellers in Asia over the low season, which is going really well.

Then if I can I would like to remind you of our core purpose as an airline which continues to be, to supercharge New Zealand's success. That is our mission, and that's what

motivates me and my management team every day.

Part of that mission is to economically supercharge New Zealand by promoting tourism and trade. We will continue to significantly contribute to these industries.

Our focus will be always on profitably connecting the world to New Zealand through our Pacific Rim network, and connecting New Zealanders to each other through our powerful domestic network.

Now our decision six or seven years ago to redesign our network around the growth potential that we saw, and continue to see in our major long-haul markets, has stood us in tremendously good stead through changing macro environments.

We are well positioned with increased scale across a diversified set of markets. Importantly we have built skills and ability in each of those markets. We have also been able to partner with other outstanding airlines to offer greater connectivity around the globe for New Zealanders.

To put it simply, we have some tremendous competitive advantages. We will leverage them to the best of our ability to continue driving value for our customers, our staff and our shareholders.

Now I will hand over to Jeff who will discuss the details of the result.

Jeff McDowall: Thanks very much Christopher, and kia ora to everyone on the call. I'll start by walking you through some of our key financial highlights for the [unclear] period.

Our operating revenues were \$2.9 billion. That's an increase of 7.1% on the prior period. It's a strong result against the backdrop of some tough operational conditions that we have faced so far this year as Christopher has already touched on.

We delivered earnings before taxation of \$211 million. Although this is a decline of 35% you will see shortly that this is largely the result of a significant increase in fuel prices.

Net profit after tax for the period was \$152 million. We maintained a strong operating cash flow of \$475 million.

Now as mentioned earlier, revenue for the period was strong. That was driven by really good levels of demand across the network, as well as the targeted capacity and pricing actions that we have undertaken.

If we look at passenger revenue in particular we saw an underlying increase of 5.1%. Reflecting higher capacity as well as unit revenue growth.

Despite this earnings were hugely impacted by a \$131 million headwind from increased fuel prices. That \$131 million net impact was driven by \$146 million, or a 31% increase in the average price of jet fuel from USD67 to USD87 per barrel. Which was then partially offset by an additional \$15 million in gains from our fuel hedging program.

To put the size of the fuel increase into context the net impact of \$131 million for the first six months of this financial year compares to a full year impact in 2018 of \$135 million. So we really have seen a significant jump this year.

So if we were to look at our 2019 versus 2018 first half earnings on a comparable fuel basis we actually delivered a 10% increase in earnings.

There is a detailed waterfall in the Appendix which shows the breakdown of each component contributing to the overall \$179 million net increase in the fuel cost line in our P&L. But you can see that it really is driven by those couple of points that I just mentioned.

If we move now to Slide 11, this provides further details on both revenue and cost side of our business. As I already mentioned, passenger revenue increased 5.1%. This reflects increased demand as well as unit revenue growth, particularly on the North America and domestic routes.

Demand was up 5.3% on capacity growth of 4.3%. Risk increase by 0.8%.

Our cargo business also delivered strong volume growth and good yields resulting in a 5.1% increase in revenues.

This growth is moderated somewhat compared to previous periods, including the operational disruptions that we've experienced with our Trent 1000 engines. However, we have still seen good volumes and revenue from North America, Europe and Japan, and strong yields from an improved product mix.

Turning now to our operating costs CASK adjusted for the impact of fuel price, FX and third-party maintenance, grew 1.6%. This growth reflected price increases and cost incurred in the period to ensure greater operational resilience, which is partially offset by economies of scale and deficiencies.

In the first half we saw lower economies of scale and efficiencies than we've reported in the past, due to inefficiencies around our network schedule as well as timing related to setting up new routes and the entry of newer aircraft into service. Looking forward, we expect a stronger underlying CASK performance in the second half of the year.

We've generated strong operating cashflows again in this period, of \$475 million. We know this is largely flat compared to the prior period, but reflects strong working capital cashflow offset by lower earnings. The timing of tax payments also had a positive impact on cashflow.

The airline continues to maintain a stable investment grade credit rating from Moody's of Baa2. Gearing was 56.4%, slightly above the announced target range and an increase from 52.4% at the end of the 2018 financial year, reflecting investment in our fleet as the current fleet program nears completion.

Going forward, we expect gearing levels to return to our previously communicated target range of 45% to 55%.

Finally, our strong balance sheet has helped us to deliver sustainable, ordinary dividends to our shareholders. The Board was pleased to announce the fully imputed interim dividend of \$0.11 per share, reflecting the Board's commitment to its distribution policy. It looks through short-term earnings volatility to provide a consistent and sustainable ordinary dividend.

In the chart on slide 14, you can see the phasing of our updated aircraft capital expenditures through to 2022, which total approximately \$1.2 billion based on an exchange rate of \$0.67. The figure includes the commitments that we made last financial year for the domestic A321 NEOs, but does not include any assumptions on CapEx rating to the Boeing 777-200 replacement program, as aircraft selection is still in progress. As a reminder, we are still expecting to announce our selection before the end of the current financial year.

Turning finally to fuel and our outlook for the remainder of the financial year, based on our hedging profile. To be helpful we've provided an outlook of estimated fuel costs for the second half of the year, with some assumption of average jet fuel at US\$75 per barrel. Based on the make up of our hedges, we've also provided an approximation of how moves up or down of fuel price would impact our fuel costs for the second half of the year.

At US\$75 per barrel for jet fuel, our fuel costs in the second half would be approximately NZ\$596 million, which would bring our full-year fuel cost to approximately \$1.2 billion.

Now let me turn the call back to Christopher to discuss the outlook for the rest of the year.

Christopher Luxon: Thanks Geoff, and turning to slide 17, I'll briefly provide some perspective on expected capacity and revenue dynamics, looking out to the rest of the

financial year.

As I spoke about earlier, we believe that there are signs of significant shift in demand and we are now moving to a period of more moderated revenue growth from the high levels that we've been experiencing over the last few years.

The table on this slide shows you our capacity growth for the first half, and where we see further growth opportunities across the remainder of the financial year. You can see to the far right the initial expectations that we had when we announced the 2018 annual results in August last year. There's definitely been a shift in our expectations, so we want to be really clear here. We believe that there are still growth opportunities for us to pursue, and that this new environment brings us more in line with what our global peers are seeing in their home markets.

Now, turning to the outlook for the remainder of the financial year, as indicated in late January, we have started to see a slower rate of demand growth from previous years. This in turn will result in revenue growth and profit that is lower than we had originally anticipated at the beginning of the financial year. This is true, even though jet fuel prices have come back a bit compared to what we experienced in the first half.

We do, however, continue to see demands and growth opportunities, and based on this and current market conditions, we are reaffirming the full year guidance that we provided to you at the end of January 2019. That is, assuming an average jet fuel price of \$75 per barrel for the second half of the financial year, 2019 earnings before taxation is expected to be in the range of \$340 million to \$400 million. This assumes an average jet fuel price of \$81 per barrel for the 2019 financial year as a whole.

What we really want to communicate to you all today is that the airline is still fundamentally strong, but the rate of growth in the New Zealand market is slowing compared to previous years. That is in fact more in line with other developed markets, such as the US.

We realise that we need to adapt and we need to use the agility that we as Air New Zealand, pride ourselves on, to continue to supercharge New Zealand success, and to provide the strongest possible return to our investors. Accordingly, we're in the process of undertaking a review to ensure that our network, our fleet and our cost base are better optimised to reflect the new environment that we are now operating in. We will be updating you and the market on those plans in due course.

So, can I say thank you so much for listening, and we know you'll have lots of questions, so operator please open up the line for questions that you have.

Operator: Thank you. If you wish to ask a question, please press star-one on your telephone and wait for your name to be announced. If you wish to cancel your request, please press star-two. If you are on a speaker phone, please pick up the handset to ask your question.

Your first question comes from Andy Bowley from Forsyth Barr. Please go ahead.

Andy Bowley: (Forsyth Barr, Analyst) Thanks moderator, and good morning Christopher, Jeff and Leila. I've got a couple of questions, so I'll kick off firstly with the dividend. Christopher, maybe you can speak on behalf of the Board here. I'm conscious that a number of issues will impact your ability to sustain or even grow the current dividend.

We've got gearing now towards or above the top ends of the target band, we've got a CapEx holiday in a couple of years for a couple of years. But can you talk about what you would need to - or what would need to change for you, to require you to cut the dividend relative to the current forward expectations that you have for the business?

Christopher Luxon: First of all, good morning Andy, good to hear from you. On the dividend front, look, you've seen us maintain a stable dividend here. That's us, as we've said before. We're looking through into the medium term, and we feel incredibly confident with where we are as a business, and as a result, that's what we've - why we've reaffirmed the dividend as where we are.

You know how we think about - I think we've been pretty transparent about how we think about this, but I think we feel very confident going forward around our ability to pay the dividend.

Jeff, would you have anything else to add?

Jeff McDowall: The only thing I'd say, Andy, is that as you have probably heard from our remarks, we're not satisfied with the earnings, of where they are, so we're very focused on earning - restoring earnings growth in the Company. So, yes on that basis and knowing what our dividend policy is, we're very comfortable that the dividend's sustainable.

Leila Peters: Andy, it's Leila, just a note, in the last 15 years there's only been two times where we've cut the dividends, and that's been the Christchurch earthquake and the GFC. So clearly, we're not forecasting anything like that looking forward, we're just looking at a slower growth environment. We're still pretty strong. That's all I've got.

Andy Bowley: (Forsyth Barr, Analyst) Great, thanks. So, the second question around the cost base, unit cost growth in this period of 1.6%, that compares to what you talked about at the investor day last year where you suggested you'd be able to negate unit cost increases given economies of scale. I recognise that there hasn't been as much capacity growth as maybe you would have expected, and there's been a fair bit of indirect cost growth given the network disruption during the period, but were there any other cost base issues at play in the first half, and what cost levers do you have in second half, notwithstanding your comments Jeff, around being a better CASK outcome in the second half relative to the first half?

Jeff McDowall: Hi, Andy. The main thing really is the operational difficulties that we've faced in the past half year. As you said, the growth rate's down a little bit, but - that's a contributor, but it's really the both direct and indirect consequences of the operating environment that we've had. There's some direct costs associated with the Rolls Royce issue that we talked about in the guidance in August. To a significant extent we've been able to mitigate those. There are still quite significant indirect or hidden costs that are spread throughout our both cost schemes and revenue line associated with, for example, making changes in aircraft type late in the planning cycle, which is really inefficient.

Some of it's consequential. Some of it's actually proactive, where we've actively held more staff, for example, so that we can make the schedule more resilient and provide our customers with a better level of support when they're seeing disruption. All of those impacts will start to ease as the Rolls Royce situation improves, which is now - which is what we're now seeing. So, we're expecting that to be a better picture as we look forward.

Andy Bowley: (Forsyth Barr, Analyst) [Okay]

Christopher Luxon: Maybe if I can give you some confidence around that Andy, around the Rolls Royce situation. Through this half that we're reporting on - we had up to five aircraft on the ground. Currently, we have two aircraft on the ground. From 1 April, we expect that to be one. By 1 September we expect to be fully resolved. So, we are expecting to start to work our way through those additional and direct costs that were a part of the first half result, as we go through the second half and certainly into 2020.

Andy Bowley: (Forsyth Barr, Analyst) In terms of your comment Jeff, that we'd see a better CASK outcome through the second half, is that really a reflection just of Rolls Royce, or are there any other issues at play? I guess you've got your broader cost and network and fleet review ongoing, but I'd imagine the benefits of that will flow more through fiscal

2020 than fiscal 2019 second half.

Jeff McDowall: Yes, that's right. Yes, the main difference in the second half will be the easing of those operational disruption issues.

Andy Bowley: (Forsyth Barr, Analyst) Great, thank you.

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 the first one for me is on the domestic slow-down. From your assessment, would you say this is largely a consumer cycle-driven effect, or are there competitive or company-specific issues that are related to that? I guess also, what are you seeing in the forward data which gives you confidence that January is the low point for this growth profile?

Christopher Luxon: Yes, well firstly good morning. You are right. What we're seeing is - and it's a difficult situation because we, as a business, are actually living in the future and we are obviously seeing six months out, and we are, in fact, I think a leading indicator for what's going on.

There's two big bits of it. We're seeing lower growth, driven firstly by lower levels of inbound tourism. So, if you think about recent years, inbound tourism to New Zealand has been growing around 8%. The last 12 months ending December, it's about 3.5%. That's across the board. That clearly is linked to a global slow-down.

The second piece we're seeing is obviously domestic leisure travel. That manifests itself in lower site visits to our sites, which typically tends to be leisure travellers, and even some small, medium enterprises.

What I'd say is that our corporate and our government and our business traffic is holding up incredibly well, and is in a good, stable position. What we're talking about here is moving to a lower level of growth of around 4%, which is still pretty - fundamentally pretty good levels of growth.

Certainly, as we came through at the end of the January, and we reviewed the close-out period, and then we looked at our forward projections, we saw softness in that leisure travel component. As we have gone through January, we're seeing some stabilisation of that.

Andrew Steele: (First NZ Capital, Analyst) Okay, great. Thank you.

Jeff McDowall: Can I add to that, Andrew, is that the booking trends that we've seen in the past four weeks or so, since we updated the guidance, are very much in line with what we expected when we provided that update. Yes, based on what we're seeing at the moment, that would put us pretty much in the midpoint of the range that we talked about.

Christopher Luxon: The other thing Andrew, I know from some of the commentary is that there's no doubt about it, this is a market issue. I can reassure you, we are not losing market share to our competitor. In fact, we've gained market share over the last year. So this is something happening, an underlying demand with leisure travellers.

Andrew Steele: (First NZ Capital, Analyst) That's great, thank you very much. Just the next one from me is in terms of thinking about your previous guidance on the impact that Rolls Royce has had on earnings.

How should we think about the normalisation of that impact looking forward into really, I guess, the FY20 year given the updated demand profile and in particular, I guess, the capacity changes that you've put through into the Tasman and Pacific Island markets?

Jeff McDowall: Just specifically in terms of the Rolls issue, Andrew, as you said, we indicated the range of \$30 million to \$40 million in August. We now have been able to mitigate that. So if you are thinking ahead to next year and just thinking of those direct costs, I couldn't give you a precise number but sort of in the low double digits. But that's not the full story.

As I was talking to the other guys about, there is quite significant hidden costs as well which are the key reason why our efficiencies are lower this half. So there's that direct cost that goes away next year but there's also those indirect costs that go away next year.

Andrew Steele: (First NZ Capital, Analyst) Thank you.

Leila Peters: I didn't understand the second part of your question related to the Tasman capacity. Could you repeat that again?

Andrew Steele: (First NZ Capital, Analyst) I guess given that there's a reasonably material shift in the Tasman and Pacific Island capacity guidance for this year, factoring in I guess there's probably a lower run rate in that market going into '20, should we be thinking about I guess a lower benefit from Rolls Royce normalisation going into '20 as well?

Jeff McDowall: That wouldn't be a significant driver for that market. A different point I'd point out is that a lot of the growth that we're seeing in the fourth quarter and heading into the first quarter of next year, is going to be the additional seats on the AC21s coming

into the fleet which come in at a very low incremental cost.

Andrew Steele: (First NZ Capital, Analyst) Great. Just the last one from me is given the change of capacity to Tasman and Pacific Island, can you just provide a few comments on what you're seeing which has really driven that pull back?

Christopher Luxon: Yes, I mean maybe - I just take the Tasman, it's certainly a bit [forcey] at the moment, but that's to be expected post the withdrawal of our alliance with Virgin. But what I'd say to you is we still look at that dynamic and say that's a lot better than when Emirates was in the market.

Certainly we've seen Virgin struggling big time in terms of adding lots of capacity, lowering prices, have low levels of load factors. I think none of you have probably had a hamburger served to you while you've been doing that. But on the Pacific Island, it's really been we've put a lot of growth in over the recent 18 month period. It's just making sure we get that moderated and right.

Leila Peters: Really just a lapping and moderation of the shoulder season capacity on the Pacific Islands and the Tasman. The Tasman capacity, really, it's still an increase. I think we're up 7% for a northern summer season. So it's still quite a lot. But in targeted areas that play well to our strengths.

Andrew Steele: (First NZ Capital, Analyst) Great. That's all from me, thank you.

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

Owen Birrell: (Goldman Sachs, Analyst) Hey guys. Just a couple of questions from me. Just drawing on that Tasman and Pacific Island capacity again. It's a big reduction in that second half of '19. I'm wondering if you could split the difference between what you're doing on the Tasman versus Pacific Island?

Christopher Luxon: Yes, sure. So the Tasman is still growing. The rate is 7% or 8% I think in the second half of the year. As I was mentioning to Andrew, a big chunk of that comes from the extra seats on the AC21. So that, as I said, comes at a really low cost. We're actually seeing pretty healthy revenue growth against that capacity backdrop.

So you know, that's looking pretty good, notwithstanding the fact of the highly competitive market. As Leila kind of eluded to, the Pacific Islands, we're actually reducing capacity year over year. Having said that, we had extremely high capacity growth this time last year.

We saw an opportunity with the part of the year that's typically off peak for the rest of our network meant that we had aircraft available that we could deploy into the Pacific Islands to build on the strong growth that we saw at a low incremental cost. We still see that opportunity this year but we are dialling it back a bit. It was 20% to 30% growth this time last year and we're just dialling that back a bit.

Owen Birrell: (Goldman Sachs, Analyst) So there's actually a contraction in the capacity overall for the second half in the Pacific Islands? Well there has to be. I mean if...

[Over speaking]

Leila Peters: There's contraction in the longer sector Pacific Island market. So Hawaii and Bali are clearly the longest sectors and that's where we put about that 20% to 25% growth in last year. So that's where you're seeing the proportionality impact on Tasman and PI, Owen. The other Pacific markets are growing, most of them. It's the mix factor of the length.

Owen Birrell: (Goldman Sachs, Analyst) I was going to say is it because passenger demand hasn't grown in line with your expectations? Or are you removing capacity to improve your RASK on those routes?

Jeff McDowall: Really removing capacity to better match supply and demand to ultimately give a better RASK result.

Owen Birrell: (Goldman Sachs, Analyst) Can I ask also then I guess on other international market, you're adding some new routes on those and sort of drawing on a couple of - I think it was a San Francisco and LA routes. I'm just wondering what gives you confidence that the new routes that you're putting on are going to be incrementally for the broader international platform? Given that they are very new.

Jeff McDowall: We think both of them. But Taipei and Chicago that I think you're referring to. We've seen both of them perform extremely well. Actually, better than we had anticipated in our internal business cases for them. If you take Chicago - I mean Taipei was always going to be incremental. We took very little traffic via other gateways in our network from Taipei in the past.

So that is genuinely incremental traffic for us. I mean Chicago, there was always the chance that some of that demand would come from our other gateways in the US, whether it be particularly Houston and San Francisco. We're actually seeing that perform a lot better than we thought from that perspective. We're seeing the vast bulk of the traffic

originating in the US coming from the surrounds of Chicago itself without any connecting flights. Which leads you to the view that that is us tapping into new pools of demand there rather than stretching our existing demand base.

Owen Birrell: (Goldman Sachs, Analyst) Okay. Just one final question from me on the relationship between how we should look at domestic growth versus international. I mean obviously international is a big driver of the domestic market but do you have a rough rule of thumb as how you look at that? You know, if international is growing at 5%, what incrementally does that add to the domestic market?

Jeff McDowall: Ballpark, for international visitors coming from a long haul destination, i.e. excluding Australia, there's roughly two domestic trips for every passenger. So you see that flow straight through to our domestic business. So that gives you kind of a rough rule of thumb.

You know, the guts of that is that as a consequence, 20% to 25% of our domestic passengers have originated offshore. Whether they're directly connecting or they've bought a ticket locally but are here on a vacation.

Owen Birrell: (Goldman Sachs, Analyst) That's good. That's useful. Thank you.

Operator: Thank you. Once again, if you wish to ask a question, please press star one on your telephone and wait for your name to be announced. Your next question comes from Wade Gardiner from Craigs Investment Partners. Please go ahead.

Wade Gardiner: (Craigs Investment Partners, Analyst) Hi guys. Going all the way back to the very first question on the dividend. You know, you've got a target gearing of 45% to 55% and you're sitting at 56% at the moment. You're paying out sort of \$250 million in dividends per year. I've always assumed that as we head into the 777 replacement cycle that you're going to want to get that gearing down towards the bottom end of that range.

Is that a fluid target? Given that if we have a protracted or a greater downturn here and your earnings are potentially lower for longer, how comfortable are you that you can continue to pay out that dividend? How flexible is that gearing target?

Jeff McDowall: We've always said that the gearing target is a target rather than a straight jacket and we always expected at this point in time, which is the end of the peak CapEx period, that it was going to be at the top of the range. In fact, two or three years ago, we thought it would be past the top of the range.

So relative to what we expected, that's pretty good. Having said that, financial resilience is

always going to be our key number one priority when we start considering distributions. But we look at that, we look at our resolve on improving earnings growth. We're very comfortable with where the dividend policy sits and as you know, there's a significant period of CapEx reduction coming up. So we're very confident about where that's sitting.

Wade Gardiner: (Craigs Investment Partners, Analyst) Okay. So if we did have a period of lower earnings, you'd be quite happy for that - for gearing to come in in that upper band as we go into that 777 replacement cycle, if that's what was needed?

Jeff McDowall: Look, you know, like I say, we're very resolved on not having a period of lower earnings. But we certainly do want to make sure that we've got plenty of capacity to get through that next CapEx cycle in good shape. But you know, the gearing range is not a straight jacket. Financial resilience is always our core point. But we do still see potential there. Particularly given our focus on restoring earnings growth.

One point I'd just illustrate, as you pointed out, the earnings at the half year was - sorry, the gearing was 56.4%. There was a movement there, if you look at the movement from where the gearing was six months ago to now, there was a movement there of just over a percentage point which was driven by the fuel price at balance date being very low. It was in the low 50s.

That meant that there was a change in our head reserves which reduced equity and brought gearing back up a bit. That was purely to do with fuel being at a really low point at that balance date.

[Over speaking]

Leila Peters: ...adjust it for that way, we'd be sort of just above 55%. So right in that target range anyway.

Wade Gardiner: (Craigs Investment Partners, Analyst) Okay. Another question. Your first half was done 35% and the guidance that you've given implies that the second half is going to be down, you know, the midpoint, by a similar sort of level. Yet, when you changed your guidance in January, from the discussions that we had at that point, it seemed to me that you didn't really see the fall off in demand until December.

So I was therefore expecting a first half that would be better and a second half would be - the implied second half would be a lot weaker. Can you just give me a bit of colour in trying to reconcile that sort of where you had your guidance prior to when you actually saw the decline? Therefore why we should expect a second half that is a similar sort of down

to the first half?

Jeff McDowall: I mean there's a bunch of moving parts there, Wade. So for example, as I was saying earlier, we expect the operational costs disruption to be less impactful in the second half. You'll see in the fuel analysis that the year over year fuel headwind's lesser in the second half. But the rate of revenue growth is lower as well.

So there's a number of moving parts that drive the relative performance of the two halves.

Leila Peters: Right. So stronger revenue in the first half offset by inefficiencies in the cost space which Jeff has already spoken to you. In the second half, those costs inefficiencies will alleviate. Fuel will alleviate on a year on year basis but revenue will come in a bit softer. That's really what's driving the first half/second half mix there.

Wade Gardiner: (Craigs Investment Partners, Analyst) Okay, that's all from me.

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

Marcus Curley: (UBS Investment Bank, Analyst) Good morning, team. Just a few from me. I just wondered whether you're able to actually call out the magnitude of the, I suppose improvement in the 787 disruption issue into the second half. Obviously, it underpins your belief in improved cost performance. Could you give us any colour of what you think that is in terms of number?

Jeff McDowall: I can't give you a precise number. I mean, one thing we've been focussed on is that there is a slide in the pack that shows the efficiency year-over-year in the CASK space and you compare that with that same slide from this point last year. The [unclear] a big chunk of that is due to the operational cost disruptions that we're seeing. I know it's not a precise answer, but that does give you a sense of the magnitude of the impact.

Marcus Curley: (UBS Investment Bank, Analyst) So you're confident these quite large increases in aircraft operating costs and passenger costs relate to that issue as opposed to other issues, which could be longer lasting?

Jeff McDowall: Yes. That is the biggest single driver that we can point to. There are a couple of other things I was talking about earlier in the remarks which relate to things like the one-off costs associated with the new routes that we entered in that period, one-off costs associated with the entry of the A320neos for example, our A320neos. So those contributed to the picture as well. So the operational efficiency is not the only thing, but the predominant thing.

Marcus Curley: (UBS Investment Bank, Analyst) Okay and then just a couple of questions on airfares. Within your guidance it doesn't look like you're incorporating any yield impact from the lower entry level fares on the domestic in the second half.

Jeff McDowall: Yes, so that is an accurate analysis Marcus. The - that set of fare changes is really designed to stimulate leisure travel. So we are confident that that will be a positive move for us from a revenue and commercial perspective and as well as stimulating leisure travel, it also gives our revenue management team a better set of tools to use to manage the performance of flights.

Marcus Curley: (UBS Investment Bank, Analyst) Okay and I just wondered if you could comment on what you're seeing in airfares post the Chinese New Year on the Asian routes and also more recently on the Tasman - it doesn't sound like you've seen any signs of the economic slowdown impacting traffic post the peak season.

Jeff McDowall: From a time perspective, yes Chinese New Year was a couple of weeks earlier this year. You saw the - so you see a little bit of the strength associated with it come into January this year versus it all being in February last year. But to answer your question about once you go through that peak period have we seen a softening in bookings that's greater than we saw before. Not really. You would have heard a lot about tourism from China being weaker.

If you - and we certainly do see that, but if you look at our Shanghai route, for example, we do compete in a slightly different way than other airlines fly into China. We've got a more premium niche that we target at the Shanghai end and we've got a much bigger market share ex-New Zealand, which includes a good premium market share. So if you look at the performance of our flights, we are seeing really strong performance in our premium cabins.

We are seeing a little bit of softness in the economy cabin, which is consistent with what we're seeing in in-bound tourism arrivals. But overall the flight is doing pretty well, because we compete in a slightly different market than most of the carriers.

Marcus Curley: (UBS Investment Bank, Analyst) And on the Tasman. More recently, as we enter the off season, any signs of weakness there?

Jeff McDowall: Well the growth rate is - has moderated a bit. We're seeing more competitive intensity which Christopher referred to. But actually, despite all that, the revenue growth we're seeing is quite solid. There is a - it's a little bit difficult to unwind

because there is a lot of different dynamics going on. We've got some additional capacity, so we're getting a bigger market share as a consequence of that.

We've got Virgin competing independently and having quite low factors and then you've got what's going on with the underlying market demand the being the third factor that impacts performance. But - so it's quite difficult to unwind each of those individually. You saw inbound tourism from Australia is 1-ish% in the last month, so not that high. But the sum of those three factors - and I think helped by our product proposition, the way we compete with [unclear] service and low cost carriers and the capacity growth we're putting in there, has actually given us a pretty good revenue result.

Marcus Curley: (UBS Investment Bank, Analyst) My question was on yields. Have you seen airfares starting to fall or are they remaining up?

Jeff McDowall: They are not falling significantly. We focus more on RASK than yield, to be honest, because we see yield and [low factors] as ingredients to the RASK outcome that we're looking to maximise. When there is capacity up in the market, which is up a little bit, 3% I think, you wouldn't expect to see - you would be surprised to see flights flattening and yields but it's nothing pronounced.

Leila Peters: And Marcus, this is a reminder. We'll be - we lapse through the Emirates' exit from Melbourne and Brisbane right around now, March or so. So we would expect to see some variability on the month to month offsets on there. But overall, Jeff's comment it holds completely true. It's quite resilient levels so far.

Christopher Luxon: Yes, you will see choppiness in the offsets with Chinese New Year being a bit earlier, but also, we've got the period in April when Easter Monday and ANZAC Day fall on the same week, which will drive a really strong period for demand in April, which will bring some demand that was previously in March in to April. So you'll see some volatility month-on-month there.

Marcus Curley: (UBS Investment Bank, Analyst) And then just on the labour costs. Could you give us a breakdown in terms of what your wage freights are up verses stuff numbers and what to expect going forward? Is there any initiatives to limit the growth in staff numbers?

Jeff McDowall: If you look at the - where is the breakdown - page 21, I think, in the supplementary slides, the labour cost is up \$36 million for the half. If that had been driven purely by rate increases and volume, it would have been up \$42 million. So there were

some efficiencies there.

That number understates the efficiencies, because we do see good economies of scale, for example, albeit with lower growth in our overhead base, holding overheads cost while we grow. Offset by those operational [disrupt] costs in labour costs that we talked about before. As those roll out, we expect that efficiency picture to improve.

Marcus Curley: (UBS Investment Bank, Analyst) And what was the level of rate increases?

Leila Peters: 2-ish%.

Marcus Curley: (UBS Investment Bank, Analyst) And do you have to hand the level of the number of people that have gone in, what the rate of increase of that is?

Christopher Luxon: Yes, we've had about a 6.3% increase in FTEs across the business. I think it's an extra 690 people. A large part of that has been into cabin crew, airports and in regional airlines as well.

Marcus Curley: (UBS Investment Bank, Analyst) So that's 6.3%?

Leila Peters: Yes, around that, exactly.

Christopher Luxon: Yes.

Marcus Curley: (UBS Investment Bank, Analyst) Is - that seems a fairly large number, given what we've seen recently out of the business. So that was - do you think that there is some step-ups, one-off step-ups in that? Or is that a bit of a catch up or how would you think about the 6%?

Jeff McDowall: A lot of it is - well, a chunk of it - yes, [unclear] growth 4.3%. So to the extent that it's higher than that. There is two main drivers. I think the bigger one is that we have deliberately kept larger work groups to give us more flexibility as we've gone through a period of scheduled disruption.

Typically we run a very disciplined focused rostering cost base, where we don't have a lot of [fat] in the schedule, which is great for efficiency, but it means in a period of operational uncertainty, it reduced our level of resilience and so we have added labour to improve resilience, knowing that there is more operational uncertainty. Then there are some one-offs associated with, for example, the AC-21 [Neo] entry.

Leila Peters: And we had something similar in, I believe, it was 2014 or 2015, with the introduction of the Dreamliners market, where we had a little bit of a bubble that then smoothed out as we got the aircraft into service and started operating.

Marcus Curley: (UBS Investment Bank, Analyst) Okay and then finally from me, just the timing on the 777-200 replacement. Is it still 2023 and beyond or is it possibly going to be brought forward?

Christopher Luxon: No. The plant hasn't changed at this point. We are still looking at FY23, so calendar late 2022 and we're looking - as we've indicated before, we're looking to make an announcement this half of the year.

Marcus Curley: (UBS Investment Bank, Analyst) Okay, thank you.

Operator: Thank you. Your next question comes from Nick Mah from Macquarie Group. Please go ahead.

Nick Mah: (Macquarie Group, Analyst) Hi guys, most of my questions have been asked, just a couple of other ones. The Air Canada announcement today, what's your kind of thoughts around that and plans around any kind of - or the level of JV on that route?

Christopher Luxon: Yes, so - from our point of view Nick, it's a positive thing. I think it will stimulate a lot of traffic between Canada and New Zealand. We've obviously known Air Canada for a long period of time. We've been aware of them and this intention. We've signed an MOU with them to explore a JV. Obviously that will need regulatory blessing at both ends of the market and we'll work our way through that in the coming months.

But I think if you think about North America and say an American entry, this is a very, very different experience here. So we're very comfortable, very relaxed about that.

Nick Mah: (Macquarie Group, Analyst) And is the intention to take it all the way through to a similar kind of revenue share, as you have with some of your other partners?

Christopher Luxon: That's what we'll try and work through in the coming months and obviously have to work through with regulators as well.

Nick Mah: (Macquarie Group, Analyst) That's great and then just on the domestic pricing restructure. How much of that was accelerated by the kind of slowdown you saw versus something that you'd had in the works for a while? Then I guess what gives you confidence in the new pricing being the right one? Obviously you have a lot of data there. Can you talk about how you formulated those levels to balance [giving away] yield versus demand?

Christopher Luxon: Yes, sure. Look, we - really it just came out of our responses. We looked at our closing results and our forward projections at the end of January and really

what this is designed is purely about simulating leisure travel. So it's all about lowering the lead-in fares at our lowest - our fares that we have in the marketplace and we think fundamentally that will stimulate travel.

If you think about it, there are - other sectors or other business often when they're faced with lowering growth or lowering demand, they actually take their prices up and actually end up getting into a negative cycle. We've learnt through the GFC, we've learnt from the past, that we actually are better to [unclear] go out and actually simulate the market. What I'd say already within the first days, is that we've seen a doubling of people onto our website, so just to give you a feel for how well we think it is actually working.

So it's a very simple equation. We plan to simulate demand for leisure travellers and get them moving. I think it seems to be working.

Nick Mah: (Macquarie Group, Analyst) Sure and those prices are - how different is the overall optimisation equation from what you are doing previously, which is obviously every single day you do similar things, but obviously the lead-in fares are slightly lower. Is it drastically different overall?

Jeff McDowall: Well, as you say, the lead-in fares are lower, so that will give us the ability to improve low factors and performance of the lower demand flights. There is also a more sensible - it's all behind the scenes, but there is a more sensible set of [buy-ups], as you go through the fare structure which, as Christopher was talking about, a lot of our demand is from small, medium size enterprises.

So having moderate buy-ups allow us to cater to that group a bit more effectively with more moderate fares. So it's just a better set of tools, more consistency to buy-ups to maximise performance across the overall network.

Nick Mah: (Macquarie Group, Analyst) Great, thanks a lot.

Operator: Thank you. Your next question is a follow-up question from Owen Birrell from Goldman Sachs. Please go ahead.

Owen Birrell: (Goldman Sachs, Analyst) I just wanted to I guess follow up on that domestic fare pricing a little bit further. You've obviously lowered the domestic fares for the lowest bucket of seats.

I'm just wondering is there any offsetting increase in the higher level buckets? [Plus] that your RASK is probably less than...

Christopher Luxon: No.

Owen Birrell: (Goldman Sachs, Analyst) No? Did you have any offset in CASK...

Christopher Luxon: I said no [too].

Owen Birrell: (Goldman Sachs, Analyst) ...coming through?

Jeff McDowall: Sorry, I missed the second part of the question. But sorry just for the first part, the...

Owen Birrell: (Goldman Sachs, Analyst) I'm just wondering if there's any...

Christopher Luxon: ...the short answer is, no, we haven't increased there at the top end of the scale. As I mentioned though, from the way we manage flights is using two price components. One is the fares and the other is the revenue management system.

So the team will use the new set of fare structure to optimise performance, while making sure we take full advantage of the ability to stimulate leisure demands.

Owen Birrell: (Goldman Sachs, Analyst) I was just going to maybe...

Christopher Luxon: Sorry, I missed the second, is around CASK?

Owen Birrell: (Goldman Sachs, Analyst) Yes, is there offset in CASK benefits coming through such that your spread on each of those individual routes is actually fairly stable?

Christopher Luxon: I mean there's the opportunity to drive our load factors up a bit, particularly on the lower demand flights. Middle of the day type flights, and get to a point that the load factors are a bit more consistent across the day.

So it's not so much a CASK thing, but it's a cost per passenger thing if you know what I mean.

Owen Birrell: (Goldman Sachs, Analyst) Yes.

Christopher Luxon: As we look forward we do have the benefit that will be provided next year when the AC21 domestic aircraft start to come into the fleet.

Owen Birrell: (Goldman Sachs, Analyst) I note your domestic load factors are around about sort of 83% at the moment. I mean that seems quite high for a network, from a network perspective.

Some of these flights that you're discounting can you give us a sense of what your load factors on those flights are at the moment?

Christopher Luxon: Oh, it is quite variable. I mean to get an 83% load factor you've got some 100s in there and some 55s in there. So it's - part of it is about consistency of load factor, yes.

So there's quite a - I couldn't give you precise numbers. I mean the range of load factors is quite broad. Less broad than it has been, because we've over time become better and better at managing that.

But I can tell you there's opportunities within individual flights to drive load factors up.

Owen Birrell: (Goldman Sachs, Analyst) Sure. So broadly we should see the domestic network load factors improve on the back of this, RASK aside.

Christopher Luxon: Yes, that's right.

Owen Birrell: (Goldman Sachs, Analyst) Thank you.

Operator: Thank you. Your next question is a follow-up question from Andy Bowley from Forsyth Barr. Please go ahead.

Andy Bowley: (Forsyth Barr, Analyst) Thanks. Hi again guys. So just another question around the domestic leisure situation, and more broadly domestic travel. In New Zealand we already have a very high propensity to fly.

I'm keen to hear your thoughts with regards to what kind of feeling is there to that propensity to fly in terms of the modelling that you do? To what extent you do modelling in terms of how much more we can fly each year? Because there's a limit to how much I want to fly, and I'm sure that's the same for many people in New Zealand.

Christopher Luxon: Yes, I think, Andy, I mean it's an interesting part of this fare restructure is also to actually attract some people who are actually currently driving. So you can start to imagine that we are competing the customers who are driving to the destinations they want to go to. So there will be market growth off the back of that as well.

Andy Bowley: (Forsyth Barr, Analyst) So plenty of scope for further growth in propensity to fly.

Christopher Luxon: Yes, I mean I think so. I think there's lots of opportunity to keep growing the market, yes.

Andy Bowley: (Forsyth Barr, Analyst) Okay, thank you.

Operator: Thank you. There are no further questions at this time. I will now hand back for

closing remarks.

Christopher Luxon: Well, can I just say to everyone on the call, thank you so much for joining us this morning and giving us your time. Thanks again for the interest and for the variety of questions.

If you are an investor or an analyst and you do want to schedule a call or a meeting, or any follow-up questions that you may have, can I ask that you just direct those questions through to Leila and our Investor Relations team. Certainly Jeff and I are happy to participate with you and her as well.

If you've got a media-related question can I ask that you just fire those through to Marie Hosking in the Communications team.

Thanks again, and thanks for your time. Have a great day.

**End of Transcript**