THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

AIR.NZ - Interim 2017 Air New Zealand Ltd Earnings Call

EVENT DATE/TIME: FEBRUARY 22, 2017 / 10:00PM GMT

CORPORATE PARTICIPANTS

Leila Peters *Air New Zealand - Head of IR*

Christopher Luxon *Air New Zealand - CEO*

Rob McDonald *Air New Zealand Limited - CFO*

CONFERENCE CALL PARTICIPANTS

Nick Mar *Macquarie - Analyst*

Andy Bowley *Forsyth Barr - Analyst*

Owen Birrell *Goldman Sachs - Analyst*

Matt Peek *Craigs Investment Partners - Analyst*

Andrew Steele *FNZC - Analyst*

Marcus Curley *UBS - Analyst*

PRESENTATION

Leila Peters *- Air New Zealand - Head of IR*

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 interim results presentation, shareholder review, 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 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. With that I will turn the call over to Christopher.

Christopher Luxon *- Air New Zealand - CEO*

Well thanks Leila and Kia Ora and good morning everyone and also thanks for joining us on this call. A very strong performance I think for the first six months of 2017 in a period that we knew would be challenging as we face an unprecedented new amount of new international competition in the New Zealand market. Before I start I'd like to personally thank all Air New Zealanders for their continued dedication and hard work. Even more important is the enthusiasm and the energy that our team demonstrates every day which I think differentiates us in the eyes of our customers.

Culture is strongly linked to performance and our culture has proven itself time and time again to be agile and to be effective in making our airline as competitive as possible. This time it's no different and I do want to acknowledge our people for their contribution to this great performance.

I'm going to talk a little bit about the environment this morning, about what we saw in our market since we reported in August and how that has tracked against our expectations. Our teams have made great strides to increase productivity in response to the more challenging environment and that is clear when you look at our cost improvement for the period. I'll also give some insight into what we're seeing as we focus on the rest of this year. I'll then turn it over to Rob who will provide more details on the financial results and how we are tracking with regard to our capital program, our key financial metrics and hedging. Finally, I'll provide some comments on the full year outlook before opening up the call for questions.

Now touching briefly on the financial highlights of the first six months, we recorded our second best interim result in Air New Zealand's history with earnings before taxation of NZD349 million. This is a great achievement in the face of the strong competition we saw this period and this result includes a NZD22 million gain related to the divestment of our remaining interest in Virgin Australia. Net profit after taxation was NZD256 million. Operating revenue was NZD2.6 billion, a decrease of 3% excluding foreign exchange. And lastly, our operating cashflow generation continues to be very robust at NZD376 million.

Now turning to slide 5, competitive capacity from new carriers certainly impacted revenue with eight new carriers entering the New Zealand market resulting in a passenger revenue decline of 3.1% in the period. Demand slightly lagged the capacity growth of 7.1% and market yields declined. While we saw our RASK excluding foreign exchange decline 9.3%, this growth continues to be positive to our earnings and our entire network continues to be profitable.

Cargo revenue was impacted by the same competitive dynamics and was down 4.3% excluding foreign exchange. The decline in revenues was expected and helping to partially offset the impact to our profitability was the quick response by our team. There's been a real focus internally on managing our costs, specifically making sure we are doing everything we can to leverage efficiencies from our fleet and ramping up our own productivity.

As Rob will touch on later, our unit costs improved 8.5% with efficiencies driving a significant portion of that improvement. When we exclude the impact of fuel price and foreign exchange our per unit cost still improved I think an incredibly impressive 3.6%. Air New Zealand has demonstrated steady unit cost improvement now for several years and I'm incredibly proud of the progress our teams have made on this front, resulting in savings of NZD113 million in the period. Lastly, fuel was a tailwind with our cost of fuel declining 18%.

Turning to the broader market it is obvious that we have had to adjust to a new revenue department. Compared to the prior period when the competition was fairly benign in some regions, our year on year RASK decreased. However, these declines occurred at varying levels across our market and for varying reasons. RASK fell as expected on the domestic network reflecting the annualization impact of Jetstar entering a number of our regional markets. RASK was also impacted on a number of sectors where we grew capacity at a relatively fast rate as part of our overall strategy of up gauging to larger aircraft and stimulating demand through lower prices. However, this capacity growth and larger aircraft are also driving strong improvements in our cost base.

We've also grown faster in markets that are traditionally more leisure based such as Queenstown which is resulting in a mixed impact. Queenstown is a great example of growing profitably. We increased domestic capacity to this market about 25% but there was really strong inbound tourism and domestic demand to justify that growth and we filled those additional seats.

The New Zealand market is a key part of our business and it continues to show healthy demand, both from the strength in the domestic economy, as well as inbound tourism. And looking to the second half of the year we expect an improvement in the year on year RASK decline compared to the first half. On a month to month basis however there is likely to be fluctuations in the RASK as we finish the year which are related to the timing of events or holidays.

There are certainly some highly anticipated events planned for the second half which will also bring stronger demand to domestic travel such as a number of concerts, the World's Masters Games in April and the Lions tour at the end of June and the beginning of July. We expect these events as well as underlying strong demand to make the domestic market our strongest sector in terms of RASK performance for the second half of the year.

Now moving to the Tasman and the Pacific Islands where we saw the industry capacity grow about 10%. I'd like to touch briefly on some of the dynamics in both the Tasman and the Pacific markets which are quite different. Now the Trans-Tasman market is always a competitive sector and this period we lived in a challenging pricing environment. This was mainly the result of capacity additions and the seat numbers now available in the point to point market due to direct long haul services from other carriers. Looking to the remainder of the year we expect similar levels of performance on the Tasman.

I would say however there are pockets of optimism in this sector as we look ahead. For example this period we launched a new brand campaign in Australia that we call a better way to fly featuring Dave the goose. While still in the early months this has been extremely successful in educating the Australian market that we don't just fly across the Tasman but we also fly to five different destinations in North and South America. And building this awareness across the ditch has been a critical pillar of our strategy to leverage Australasia flows to the Americas and vice versa. You can expect continued focus on market development such as this campaign as we go through this year and beyond.

We also continue to be pleased with the performance of our Pacific Island routes which overall are showing strong customer demand due to an increase in outbound New Zealand travel. In exiting from the 767 aircraft we have up gauged several of these destinations to the 787 Dreamliner and have received a great customer response as well as strong improvement on the economics of these routes with the new aircraft. As we look to the second half of this year we expect this market will continue to perform.

Finally, international long haul clearly was the sector most impacted by the influx of new international carriers and to provide some perspective, overall industry capacity across our entire long haul market increased about 30% in the first half of the year. North American routes initially experienced the impact of a new competitor and introductory pricing over the low season which then improved as we moved into the peak summer season. And this region actually performed slightly better than we had expected in the beginning of the year due to strong demand.

Looking ahead we're optimistic about both North and South America. Our Houston route is performing very well and is diversifying our reach into the United States beyond the traditional West Coast markets and on into the East Coast and Mid-West. And over the peak season we increased frequency from five times a week to daily and will continue to develop and build that route as part of our North American strategy.

Bueno Aires has also performed ahead of our expectations in its first year and it's seeing strong demand from all three points of sale, across Australia and New Zealand as well as Argentina. I think these routes are a great example of the benefits of developing a diversified network which has made our airline much more resilient.

Our alliance partner United Airlines will suspend operations over the low season on the San Francisco route. Air New Zealand therefore will pick up some of the flying over that period to maintain a daily service and that will result in some capacity coming off that market in our fourth quarter.

Turning to Asia we certainly experienced weaker performance than we had hoped in the period. Overall the new capacity introduced by carriers in China and Hong Kong was just too much for the market to absorb and we saw this manifest itself in RASK declines in the first half.

Additionally the Kaikoura earthquake which impacted New Zealand in November had a roll in softening demand in the Japanese market. After the earthquake we experienced some cancellations from Japanese visitors and this weakness continues to persist early in the second half, but we do see this as a temporary setback only. I can tell you our sales teams in Japan are very focused on stimulating this market and looking beyond 2017 we will be increasing our capacity to Japan and will begin splitting our services between Narita and Haneda airports in July. We currently only fly to Narita airport and the ability to get a slot at Haneda, which is much closer to Tokyo and offers better domestic connections, is a key part of our strategy to grow the Japanese market.

So I guess I'd say despite the tough environment currently in Asia there are encouraging signals as we look ahead to the end of the year. Some Chinese carriers appear to be taking steps to reduce frequency to New Zealand in our low season and this has the potential to help our international long haul RASK when looking beyond 2017.

So in summary there are some moving parts but we feel better where we stand today looking out than we did six months ago. And that doesn't mean that our teams get complacent. We still are facing a significant amount of competition and it will still be very challenging but you can expect that our teams will be very focused on execution regardless of the environment.

Now broadening the scope beyond the revenue environment, if I can briefly touch on the key tailwinds and headwinds facing the business for the remainder of the year. A number of these will be familiar. Inbound tourism grew 12% for the 2016 calendar year and this positively impacts our international network and provides a flow-on benefit to our domestic network. Also performing well was outbound tourism of Kiwis traveling abroad, which grew at almost 9% in 2016 compared to 6% in the prior year. Air New Zealand gets a disproportionate share of the outbound international traffic and our robust economy suggests we can expect continued strong outbound growth this year as well.

I've already touched on the moderated capacity plans we are seeing from other international carriers as well as the New Zealand economy and upcoming events, so I'll move next to the cost tailwinds that we project for the rest of the year. We will see a positive impact coming from the additional ATRs we received in the period, and we also received delivery of three additional Dreamliners to our fleet in the first half, bringing the total to nine.

And with those aircraft, we expect to see a step-up in efficiencies, especially as we exit the remaining two 767 aircraft from our fleet in March. At that point we will be operating just three different jet aircraft groups across the entire network.

And then you can expect the strong productivity that we demonstrated in the first half to continue into the second half. That will be across the cost structure as we work hard to drive good economies of scale from our growth as well as effectively manage our fixed costs.

Now, I've already commented at length about all of the points and the revenue headwinds, so I'll move to the cost headwind in the second half, which is really about fuel price. When we started the year, we based our initial outlook range on $55 jet fuel, and it has clearly tracked higher in recent months. And while fuel was a tailwind in the first half, it will be a headwind in the second half at the $65 level we are seeing today. And I know Rob will go into this in greater details shortly and provide some pretty good clarity as to how we see fuel impacting our second half costs.

So to wrap things up, we knew this year would be a really challenging environment, but I'm incredibly pleased with the way we've performed in the first half. We delivered our second-best interim result by achieving some really strong cost efficiencies and productivity gains, and we are also working incredibly hard on market development to drive profitable growth. We are fundamentally feeling good about some of the capacity decisions we have seen from other carriers, especially as we go into our low season, and we have decent foresight into the revenue outlook for the rest of the year and we expect the year-on-year RASK decline to improve compared to the first half.

Now, those are the short-term initiatives that we implemented in the beginning of the year. Then there are the longer-term strategic initiatives and investments that we've been working on for the past five years, namely the continued diversification of our network across the Pacific Rim region, investing where it matters to our customers in areas such as fleet, lounges, airport kiosks, loyalty, digital and so forth.

And finally, all the work we continue to do with our people to keep them engaged, to ensure their wellbeing and to help them develop their careers. It really is those investments that are now bearing fruit and holding us in tremendous stead as we face this competition.

So now let me hand it over to Rob.

Rob McDonald - *Air New Zealand Limited - CFO*

Thanks, Christopher. Kia Ora and good morning. I will walk through the key movements which affected our performance during the period. Please note that these numbers isolate the impact of foreign exchange.

As Christopher discussed earlier, operating revenue was the largest driver of the decline in profitability. Revenue, excluding FX, decreased by NZD81 million. Capacity growth increased passenger revenue by NZD98 million, which was offset by a reduction in RASK of NZD170 million. Cargo and other revenue contributed a further NZD9 million to the decline.

Labour costs were relatively flat, increasing by just NZD7 million as activity and rate increases were mostly offset by improved productivity and reduced incentive provisions. Our total labour cost, excluding FX, increased 1.1% on capacity growth of 7.1%, which is a great outcome.

Fuel costs declined NZD62 million. Our average cost of fuel decreased by 18%. This included the benefit of hedging gains in the current year compared to hedging losses that were realized in the previous period. Fuel price related savings were NZD92 million. These savings were partially offset by NZD30 million relating to increased fuel consumption.

Maintenance, aircraft operations and passenger service costs were NZD14 million higher. We saw good improvements in maintenance costs across the fleet, with benefits from the exit of the 767 and the additional new aircraft. Offsetting those improvements were higher passenger services and operating costs from increased flying. Sales and marketing was flat and other expenses increased by NZD7 million, primarily related to a lower gain on sale from fixed assets as well as an increase in digital expenditure.

Ownership costs were NZD11 million higher due to increased depreciation expense relating to the delivery of new aircraft. We realized a NZD22 million benefit related to the divestment of the remaining interest in Virgin Australia. That benefit was partially offset by the equity earnings which we recorded last period. The net result was a NZD7 million improvement.

Foreign exchange hedging movements offset the net positive impact of currency movements on the revenue and costs resulting in a NZD57 million negative impact to profitability. The net result of all these movements is an incremental decrease in earnings before taxation of NZD108 million.

Going a bit deeper into the operations, our unit cost performance improved 8.5%. that was helped by an 18% reduction in our cost of fuel, which more than offset adverse changes in foreign exchange. What is impressive is our efficiencies were the largest driver of the improvement in unit cost, driving NZD113 million in savings. Even when offset by the minor increases in pricing, our underlying cost still improved 3.6%.

Christopher touched on this a bit, but I wanted to expand a little on where those savings are coming from. We see them coming from the transition away from the 767s and our wide-body fleet and replacing those aircraft with larger, more modern and efficient Dreamliners.

We see it in the regional fleet following the exit of the Beech aircraft and investing in the larger ATR turboprop. We also see it coming from good management of overhead costs. So it is quite simply across the board.

Our domestic network continued to perform well this period. As Christopher mentioned, capacity grew at 7.3% due to increased services on the Auckland-Queenstown route, as well as the main trunk routes. Transitioning to the larger ATR turboprops in the regional routes also contributed to the growth. RASK, excluding FX, decreased 5.3% with load factors remaining relatively stable.

We completed the rollout of our new network schedule, which was an effort that had spanned about six months, and involved completely redesigning the regional and jet schedule. There are many customer and commercial benefits of the new schedule, which is significantly less complex. The schedule now maximizes capacity and frequency where there is strong demand, therefore driving stronger returns, and it provides better intra-regional connections within New Zealand as well as better regional to international connections for our customers.

Moving on to the Tasman and Pacific Islands, capacity grew at 4%, reflecting growth on several Pacific Island routes, Perth and the up-gauging to larger aircraft. RASK, excluding FX, decreased 7.7% due to the pressures from the competitors that Christopher touched on earlier. We are seeing good demand for our Pacific Island destinations, and on these routes we have been replacing older 767s with Dreamliners and seeing customer satisfaction increase notably.

Turning to international, capacity grew 8.8% in the period, reflecting annualization of Houston and Buenos Aires routes. Due to the entry of a number of new international competitors, RASK, excluding FX, decreased 13.2%.

Turning to cargo. While this continues to be a very strong business for us, cargo was clearly impacted by similar competitive trends that we experienced in passenger revenue. Competition from carriers in North America and Asia drove a yield decline of 12.8%, which was partially offset by a strong volume growth of 8.5% coming from new routes to the Americas and up-gauging of our flights.

We have developed a new inter-line relationship with United Airlines for cargo, which is providing good connectivity throughout the United States and on to Europe. We think there is good opportunity to develop these markets further as we look forward.

Issues with the Los Angeles airport taxiways and runways, which are under reconstruction, have had an adverse impact on our ability to drive additional volume which impacted cargo revenues by approximately 1 percentage point. Lastly, our domestic cargo business performed well, driven by good yield growth and demand from a strong New Zealand economy.

Moving on to our fleet update, in the first half of this year we received delivery of three Dreamliners, one Airbus A320 and two ATR turboprops. We also acquired two Airbus A320 Tasman aircraft that were previously on operating lease.

The CapEx for this year is substantially complete and as you can see from the chart on this slide, we only have two more years of the current fleet replacement to go, after which the level of spend is expected to decline significantly. Based on our current forecasts, we expect CapEx related to aircraft and associated assets over the next 4.5 years to be approximately NZD1.6 billion.

Just touching briefly on operating leases, we recently entered into an agreement with Air Lease Corporation to take one additional 787 aircraft on operating lease, with the delivery in the 2019 financial year. This is reflected in the table at the bottom of the slide and will bring the total 787 to 13.

We generated a solid cash flow of NZD376 million and we ended the period with net cash on hand of NZD1.3 billion compared to the balance of NZD1.6 billion at the end of June. There were some key movements to highlight from a cash perspective.

Firstly, there was an outflow of NZD58 million relating to a onetime restructuring of an engine maintenance agreement. This decision has a short-term impact on the operating cash flow but will yield cost reductions over the next three years.

Then we had a NZD182 million net inflow resulting from the repayment of the shareholder loan we made to Virgin Australia as well as the net proceeds from the sale of our remaining interest. Lastly, there was a NZD412 million outflow from the payment of the 2016 final and special dividends.

Our gearing was 55.9% at the end of the period, increasing 7.3 percentage points from the end of June. The level of CapEx in the period primarily drove the increase as well as the payment of the 2016 special dividend.

While our target gearing is 45% to 55% as we near the completion of our fleet program in 2018 and 2019, it is expected it will sit around the upper end of this range. We are comfortable with that level given our consistent focus on financial discipline and management of the balance sheet, as well as the drop-off in CapEx that is forecasted after 2019. We continue to maintain a credit rating Baa2 from Moody's with a stable outlook.

In October, we issued a new NZD50 million unsecured, unsubordinated fixed-rate bond which matures in 2022 and partially replaced the NZD150 million bond that matured in November. As a result of an operating performance that ranks as our second-best in 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 announced a fully-imputed interim dividend of NZD0.10 per share which is consistent with the prior year.

Turning finally to fuel and our outlook for the remainder of the year, given the hedging profile. To be helpful, we've provided an outlook of estimated fuel costs for the second half of the year based upon an assumption of jet fuel at $65 a barrel. Based on the makeup of our collars, we have also provided an approximation of how moves up or down of fuel price would impact our fuel cost for the second half of the year.

At $65 for jet fuel per barrel, our fuel costs in the second half would be approximately NZD430 million, which would bring our full year fuel costs to about NZD820 million. As you can see from the first half and the second half breakdown in the chart on the left hand side of slide 18, while fuel was a tailwind in the earnings in the first half, it will reverse into a headwind for the second half.

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

Christopher Luxon - *Air New Zealand - CEO*

Well thanks Rob and turning to slide 20, we have provided a breakdown of our capacity forecast for the second half and the full year. I think it's fairly self-explanatory but what you'll notice is a large decline on the international long haul capacity growth in the second half as the annualisation from Houston and Buenos Aires laps itself. Our domestic capacity plans for the rest of the year include growth to capture the demand strength we're seeing and includes more frequency in the jet market, specifically Queenstown but also in Christchurch, Dunedin and Wellington. Also reflected in the domestic growth is the continued impact of our up-gauging to larger aircraft across our regional network and total capacity growth planned for the Group will be about 5% in the second half of the year, bringing our full year capacity growth to about 6%.

Turning now to the outlook for the year. As we look to the end of the financial year, we expect the revenue environment will improve from the first half of the year. However higher fuel prices will be a headwind in the second half. So based on the current market environment and our expectations for the average jet fuel price in the second half of the year of US$65 per barrel, we are targeting 2017 earnings before taxation to be in the range of NZD475 million to NZD525 million. This target includes the NZD22 million gain related to the divestment of our remaining interests in Virgin Australia as well as our share of earnings in associates.

So can I say thank you for listening and now Operator, please open up the line for any questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Your first question comes from Nick Mar of Macquarie. Please go ahead.

Nick Mar - *Macquarie - Analyst*

Hey guys. Just a couple of quick ones from me. Firstly on the maintenance costs, how much of that decline was related to timing versus the more efficient fleet?

Rob McDonald - *Air New Zealand Limited - CFO*

Hi Nick. It's Rob here. It's a bit of both. So there's some timing in that period but also we really are starting to see the benefits of that growing 787 fleet and the departure of the 767 fleet and obviously the last two out next month.

Nick Mar - *Macquarie - Analyst*

So just kind of on a full year basis, last year was kind of NZD350 million. Where would you see it landing this year?

Rob McDonald - *Air New Zealand Limited - CFO*

That's very much in the region we expect.

Nick Mar - *Macquarie - Analyst*

Thank you and just secondly, on the guidance, just to clarify, the guidance provided earlier, the NZD400 million to NZD600 million, was that including any assumption around that kind of significant item or the gain on the sale of the Virgin stake?

Christopher Luxon - *Air New Zealand - CEO*

No it wasn't, Nick.

Nick Mar - *Macquarie - Analyst*

Okay, no that's good.

Christopher Luxon - *Air New Zealand - CEO*

We didn't know at the time to be honest that the investment -- whether we'd be able to sell it and for how much we'd be able to sell it for.

Nick Mar - *Macquarie - Analyst*

Great, thanks guys.

Christopher Luxon - *Air New Zealand - CEO*

Thank you.

Operator

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

Andy Bowley - *Forsyth Barr - Analyst*

Thanks very much and good morning Christopher. First question here around costs. Really impressive cost result here and you mentioned in your presentation a real focus on cost during the period. I guess in terms of my question here, two subcomponents. To what extent did your cost focus change during the first half in light of the fact that RASK probably deteriorated more than you would have anticipated six months ago and then the second component of the question, if we continue to grow capacity which, given the aircraft deliveries over the next few years suggests that we will, can we continue to keep labour costs similar to current levels, which is what you've done pretty successfully over the last six months?

Christopher Luxon - *Air New Zealand - CEO*

Yes, hi Andy. Look I mean the cost control was really a good standout here as you know, down 8.5% including fuel but stripping that out, down 3.6%. That is a really impressive result. When I go around and look at every other airline at this part of the cycle, they've all got cost inflation going on at the unit cost level. So it's a really good outcome.

As to what changed, I mean I've said this to you guys before, but we are trying to run it like a business and we do it quarter by quarter. So we were at the beginning in August 1, we were seeing revenue pressure as we talked to you about. We said it would be choppy, we said it would be transition, it would be adjusting supply to demand and equilibrizing that. The business -- we get -- need to make sure we've got the cost tension that's sitting alongside that revenue tension. So that's all we've done and we got onto that. We could see it coming. We got onto it really early and we executed it very, very well. I mean it's an outstanding result.

Second question, part of your question mate was around -- just remind me again?

Andy Bowley - *Forsyth Barr - Analyst*

The labour component of cost which is, you know, a sizeable proportion of the overall. To what extent should we expect that to increase in light of capacity increases going forward?

Rob McDonald - *Air New Zealand Limited - CFO*

Hi Andy, it's Rob here. Just on the labour cost, there's a couple of aspects to that one. One we do highlight in the report which is that the incentive payments are obviously lower this year than they were last year, given the level of profitability last year.

So that is accounted for and that will run obviously through to the end of the year as well. There are a couple of features in the labour cost. One is the 76s are going out, so that's a good opportunity for us in respect of a fleet type moving out. That'll occur this half, so we'll -- as we look forward into subsequent years, we really become quite efficient at gathering or growing capacity because we're just going to be adding 320s or 787s for the foreseeable future. So I think there still remains good opportunity in the labour cost to ensure that we're capturing the scale available in growth.

Andy Bowley - *Forsyth Barr - Analyst*

Okay, great. Thanks Rob. So the second question around capacity growth, if we go back six months to capacity growth outlined for this year, you gave some ranges. Capacity growth for the second half and therefore full year was right at the top end of those ranges for each of domestic, Tasman and international long haul. Can you kind of give us a sense of what -- why the range six months ago or I guess more importantly, why are we at the top of the range now, particularly given the broader competitive environment in the industry has probably become more challenging than what you thought back then and then any kind of capacity expectations that you can give us that are beyond the end of the second half?

Christopher Luxon - *Air New Zealand - CEO*

Yes, so I mean we're well -- we're within the range that we thought, but as I said to you before, is that all our capacity adjustments are sensible. They're really smart and are profitable. If you are other airlines, you often have loss making routes, right, and we don't. So when we're adding capacity, we know exactly what we're doing. It's not mindless growth or profitless growth whatsoever. So that's been really important.

I mean if we just go around it, I mean domestic is incredibly strong. We're seeing really good growth obviously with inbound tourism being dispersed across the country. We're seeing really big growth into quite a few big ports across New Zealand and obviously that's been a big part of it and there's been some annualisation or some up-gauging benefits as we've gone into larger regional aircraft with those ATRs, et cetera. So -- but domestically, New Zealand's in strong shape in terms of economically, tourism growth's robust and there's a truckload of events coming through in the next six to nine months that will continue to make that be a good place for us to be.

In international, what we're seeing is increasingly -- you know, we're starting to see some of that competition moderate its capacity, but again the capacity growth that we're putting in is profitable growth. So we're going to see -- we're going to continue to take opportunities where we see it because if you look at domestic, we've got our best RASK performance despite a lot of capacity going in there and it's been a very smart move. So yes, so I'm very comfortable with the settings that we've got. We're not -- as I said to you -- we just think differently about route profitability. We don't just add routes for the sake of it. We do it purposefully, intentionally and in a very smart and make sure it's all profitable growth.

Andy Bowley - *Forsyth Barr - Analyst*

Great. Good to hear. Thanks Christopher and Rob.

Operator

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

Owen Birrell - *Goldman Sachs - Analyst*

Hi guys. Just a quick question on the Trans-Tasman routes. You were talking about ongoing competition in that space and obviously RASK fell quite significantly during this half. Your outlook for flat RASK into the second half, I'm just -- what gives you your confidence there? Is there the potential for increasing capacity to continue to place pressure on that?

Christopher Luxon - *Air New Zealand - CEO*

Yes, so I think the Tasman has been without doubt probably the toughest market sell that we see across the network at the moment. Obviously a big part of that to be honest, the big driver is really the direct services from Auckland into the Middle East and that capacity staying in on the Tasman has been probably the real challenge that we face there.

Having said all that, there are some really bright sparks for us. So this whole connecting Australia through New Zealand to the Americas north and south has been very, very successful, much more successful than we anticipated and we continue to want to build that out over time as well. So again, the Tasman is challenging. The Pacific Islands piece of that is a very big piece of strength. I mean outbound travel out of New Zealand has been up about 9% and demand for those Pacific Island destinations has been very, very strong. So within Tasman PI you sort of have to differentiate it and overall I think we've got very similar RASK in the second half as we had in the first half.

Owen Birrell - *Goldman Sachs - Analyst*

Can I just ask, on an internal accounting question, when you book a ticket from say Sydney through to LA via Auckland, how do you allocate the revenue side of that ticket between the Trans-Tasman and the international route?

Rob McDonald - *Air New Zealand Limited - CFO*

Owen, it's Rob here. So we'll do it essentially based on what we call a pro rate agreement. So largely they're determined by mileage but there will be other factors that we might bring into play, but it will end up in the Tasman route, the portion of that flight that's the sector on the Tasman and then obviously the rest onto a long haul Pacific, but it generally sort of starts at a mileage base and then there can be some factors we bring in.

Owen Birrell - *Goldman Sachs - Analyst*

Just finally on the domestic environment, you said it's obviously very supportive with tourist in flows and a lot of events that you're seeing in the next coming six months. I'm just wondering how the competitive landscape against say Jetstar is going in New Zealand?

Christopher Luxon - *Air New Zealand - CEO*

It's going very well for us is the short answer. It's been really good. I mean if you look at markets like say Auckland and Queenstown, we've had 25% more capacity go into that market in the last year and it's been completely sold through really well and cleanly. So it's a very good result. So we're very, very confident about our position in domestic New Zealand.

Rob McDonald - *Air New Zealand Limited - CFO*

I might just add in the turboprop market, that's a year on from Jetstar's entry into that market and we do feel it's sort of settled down now and has turned out exactly as we expected and now we're bringing -- we're now on this long journey for over a year of bringing the ATRs and that's working very well for us.

Christopher Luxon - *Air New Zealand - CEO*

Yes, I can think of many regional ports across the company where we've had a big influx of demand. Lower prices due to lower cost aircraft and then really robust sustainable services being built out. So it's actually been -- that whole strategy as we talked about for regional New Zealand, our response to Jetstar's entry, has all played out exactly as we expected.

Owen Birrell - *Goldman Sachs - Analyst*

So if things are settling down can we expect to see I guess rising load factors and more stable yields over the next six to 12 months.

Christopher Luxon - *Air New Zealand - CEO*

Yes, well I think the revenue environment for us in the next six months gets much improves and then it improves again I suspect in the first half of next year as we lap the American entry in particular. But it's really going to be about how the market absorbs the supply with the demand and yes, I think we're feeling -- we might be -- we probably think we're at the high water tide mark of new competitors coming into the market place and in fact we're really encouraged by the fact that some of our competition is already starting to adjust capacity downwards. I mean you can look at what's happening with United in our own JV and alliance. On North America you can look at what's happening with the Chinese carriers as well.

So look, yes, I mean we know it's still going to be tough but we are feeling good and we are feeling that the revenue environment will improve at least in the next six months and then again the following six months after that.

Owen Birrell - *Goldman Sachs - Analyst*

Great, thanks guys.

Operator

Your next question comes from Andrew Steele of FNZC. Please go ahead.

Andrew Steele - *FNZC - Analyst*

Good morning Christopher and Rob. Just wondering if you could provide a little bit more colour on your thinking on the international yield trends through the second half. I guess in particular I mean there would be a benefit from the Masters Games and the Lion tour. I mean how do you view I guess an underlying trend excluding those events?

Christopher Luxon - *Air New Zealand - CEO*

Yes. So pretty stable to be honest. I think that's pretty stable would be my key takeaway.

Rob McDonald - *Air New Zealand Limited - CFO*

Yes, I'm just adding, the Lions tour and the Masters Games are probably as much around Trans-Tasman and domestic as anything else. But as we look forward to the fourth quarter there, as Christopher mentioned just previously, there are some encouraging capacity adjustments occurring. Then we go into the first half of next year and we see pretty well lapped just about everything and particularly the American entry and the additional United capacity, which has now obviously shifted out to the end of that first half. So just a number of things happening that probably give us a sense of a feeling of stability.

Andrew Steele - *FNZC - Analyst*

Okay, great and just one final one on unit cost trends. I guess on a ex fuel FX basis would you expect a similar decline that we saw in the first half? I guess how sustainable are these gains that we saw?

Rob McDonald - *Air New Zealand Limited - CFO*

Yes, it's Rob here. Well I can't obviously give you an exact number that we're thinking about but the answer generally is yes. (technical difficulty) without, yes, excluding fuel.

Andrew Steele - *FNZC - Analyst*

Thanks very much.

Operator

Your next question comes from Marcus Curley of UBS Investment Bank. Please go ahead.

Marcus Curley - *UBS - Analyst*

Good morning guys. A couple from me. I wasn't across the Chinese capacity changes which you were referring to, could you provide a little bit more detail in terms of what's happening there?

Christopher Luxon - *Air New Zealand - CEO*

Yes, it's a -- so I can. I'm trying to think what it actually is that they've done. It's China Southern and China Eastern have both made changes in the margins. China Southern I think has gone from 14 down to 10 services a week and China Eastern has also made adjustments as well and that's encouraging because you know we had some challenges with the capacity of those competitors last year as well, staying in over that low part of the season. So that's some more rationale behaviour which we're encouraged by.

Marcus Curley - *UBS - Analyst*

Great and just on new services from yourself. I suppose the only one that was previously flagged was Manila. Is that still on the cards for this year?

Christopher Luxon - *Air New Zealand - CEO*

Something we're watching and still in the frame but no real intention to move forward with that in the short term.

Marcus Curley - *UBS - Analyst*

Okay and just secondly, Rob I'm not sure if you've got this to hand but do you have the fuel usage in the first half and can you quantify the efficiency savings that you got from the new fleet in that first half result.

Rob McDonald - *Air New Zealand Limited - CFO*

If you give me about 10 seconds. I think it was in the order of a per cent. Yes, so the volume increase of fuel was around 6%. So I guess given the capacity increase of 7% we're talking about a percentage increase in fuel efficiency. That's sort of the trend we've enjoyed now for many periods.

Marcus Curley - *UBS - Analyst*

Great and then just finally guys, when you look at the full year guidance it implies I suppose at the midpoint about NZD150 million pre-tax for the second half. If that's sort of the base level of profitability with all the competition in the market and fuel prices at $65, is there an easy way of annualizing that? I was thinking if I could times that by three to get an annualized seasonally adjusted number so in other words at the end of the financial year the business is producing an annualized profitability around NZD450 million. Is [EO] against that setting? Is that a reasonable assumption?

Rob McDonald - *Air New Zealand Limited - CFO*

That's a heroic attempt at getting a 2018 forecast out of me but what I have said consistently, but it's always masked by what happens with fuel or other things, is that the first half is stronger than the second half. And so from that perspective it's really difficult at this point.

Christopher Luxon - *Air New Zealand - CEO*

We've got a lot to work forward to on the second half to execute really well in order to do what we want to do in 2017, so I'm sure at the investor day we'll have more visibility over that.

Marcus Curley - *UBS - Analyst*

Okay, thanks guys.

Christopher Luxon - *Air New Zealand - CEO*

Thanks Marcus.

Operator

Your next question comes from Matt Peek of Craigs Investment Partners. Please go ahead.

Matt Peek - *Craigs Investment Partners - Analyst*

Hi guys and congratulations on a strong result in trying circumstances. In particular on the costs side I'm just trying to understand some of -- the permanence of some of these savings that you've made. Looking on a 7[%] ASK basis some of the items in the first half compared to both first half last year and second half sales and marketing looks like there's been about a 10% saving on PCP on an ASK basis. Then a lot of the other categories are sort of down as well.

Is the run rate into the second half going to be in line with first half? Are you seeing continued benefits or in some of these categories were there savings that you made in the first half that won't flow into second half? I know you've addressed things like maintenance and labour costs, but in some of the other categories can you just allude to whether you're going to see those costs stay at these levels?

Rob McDonald - *Air New Zealand Limited - CFO*

Matt it's Rob here. So I did talk about labour and mentioned yes, we did expect that to go through and also maintenance. So just to touch on sales and marketing, the previous year was a big year for sales and marketing. It had a number of route launches as well as a very big campaign in New Zealand which was our first master brand for a number of years, so that was expected we'd dial back that, particularly on media. So we will see that sort of -- that's -- what you're seeing is by and large pretty well a new level for the sales and marketing. So in summary, yes, we think it will travel through to the second half.

Matt Peek - *Craigs Investment Partners - Analyst*

Okay, thank you.

Operator

(Operator instructions). Your next question is a follow up question from Owen Birrell of Goldman Sachs. Please go ahead.

Owen Birrell - *Goldman Sachs - Analyst*

Hi guys. Just on the China New Zealand route, I'm just interested by those comments about China Southern and China East and lowering capacity. Can you give us a sense of what yields did on that route over the last half and what do you expect to see into the next half?

Christopher Luxon - *Air New Zealand - CEO*

No, we're not probably prepared to do that but yes, I mean suffice to say on the way we're thinking about China is -- one is that obviously our business into Shanghai has been over the last three years all about trying to get more premium travellers onto services. And we've been doing that through different marketing campaigns with different trade partners. 80% of our customers actually are free and independent travellers that are spending eight days or more in New Zealand.

So we focus very much on Shanghai so there is some Chinese activity or competitive activity that don't impact us so much and we really are very fixated on free and independent travellers rather than group travel which is lower yielding obviously for a lot of our competitors.

Owen Birrell - *Goldman Sachs - Analyst*

I take from that comment that yield would have been substantially compressed over the past six to 12 months.

Rob McDonald - *Air New Zealand Limited - CFO*

Matt it's Rob here. I mean well clearly with that much influx of capacity that we certainly have seen lower yields without a doubt. But it's fair to say we have a, as Christopher mentioned -- sorry, Owen -- as Christopher mentioned that both our makeup from China but also our portion of outbound from New Zealand is higher than most. So we certainly haven't suffered what we've seen general fares from other carriers do.

The other point I would make about them adjusting themselves in the fourth quarter of this year and it will flow through to the first quarter next year, is that is entirely sensible given the low season nature. And the surprise to us a year ago was they didn't do it and that made it pretty tough a year ago, so we're much more encouraged now that we'll see a more sensible capacity environment in the low season.

Christopher Luxon - *Air New Zealand - CEO*

And still relatively a small part of our overall flying ASKs and part of our network really, while strategically important, still relatively small.

Owen Birrell - *Goldman Sachs - Analyst*

Thanks guys.

Operator

Your next question is a follow up question from Nick Mar of Macquarie. Please go ahead.

Nick Mar - *Macquarie - Analyst*

Just one more. I guess at a very high level what kind of changes to the backdrop around competition and fuel prices and everything would you need to see to be in a position to start growing yield again?

Christopher Luxon - *Air New Zealand - CEO*

Well I think we are feeling better now than we did at the beginning of the year around the revenue environment in general. We think the competition is probably as much as it's been. There might be some new things coming in on the margins but at the end of the day it's sort of hitting that high tide water mark. I think we're feeling each six month period it improves for us and we'll see a step up in long haul I think in the first half of 2018 which is with the -- once we start to lap the American entry in July and August.

So I think for us we are positive. We are feeling good about it. We think each six month period it will get better for us. But we've got a lot of work to do to make sure we execute incredibly well.

Nick Mar - *Macquarie - Analyst*

So would you say that given where fuel prices have risen to and the kind of profitability hit that is starting to come through, that's enough for people to start looking to try and push prices up at the moment?

Rob McDonald - *Air New Zealand Limited - CFO*

Nick, it's Rob here. I think at an industry level that move is significant enough to certainly put people on their back heels as far as capacity growth goes as we look into subsequent years and certainly we're seeing that in the wide-body order market, and people deferring.

But from areas we've seen growth from, from China, the Middle East, it's hard to understand where they're going sometimes with capacity. And things like ultra-long-haul flying, it's questionable how you make money on that anyway.

Nick Mar - *Macquarie - Analyst*

Thanks. Thanks, guys.

Operator

Your next question is a follow-up question from Matt Peek of Craigs Investment Partners. Please go ahead.

Matt Peek - *Craigs Investment Partners - Analyst*

Hi, guys, again. I appreciate that ultimately it's a Board decision but can you provide some insights as to how the Board is thinking about the current level of dividends based on I guess the current run-rate profitability and going into FY18, I think we're looking at a circa 70% payout ratio. Do you think that there's comfort that profitability is at a level where the current dividend can be maintained and then grown over time?

Rob McDonald - *Air New Zealand Limited - CFO*

Matt, it's Rob here. So just a couple of things. Last year we talked about consistent and sustainable, and I think -- and on numerous occasions we talked about the dividend setting being something that was done but looked completely through 2016 as an abnormal year, and that's important.

We've had a very strong first half from our perspective and then we look in the medium term as we head towards the end of this fleet reinvestment and now we're down to increments of growth, and so from that perspective the fleet CapEx falls off and in a period that really starts in 2019 and beyond we start to go into a stronger free cash flow environment. So there are a number of things we think about and look at, but each time we'll make the decision then, so I can't really give you any crystal ball into the future on it.

Matt Peek - *Craigs Investment Partners - Analyst*

Thanks.

Operator

There are no further questions at this time. I'll now hand back to Mr. Luxon for closing remarks.

Christopher Luxon - *Air New Zealand - CEO*

Well guys, if I can just thanks so much for everyone taking the time to get on the call and listening to our story today. Again, as you know, if you'd like to schedule a call or to have a meeting with any of thus, please direct those requests through the investor relations team and to Leila.

And operator, that concludes our call. Thank you.
