

Aeroflot Group

Aeroflot Group 6M and Q2 2019 IFRS Financial Results

Conference call held on 30 August 2019 at 12:00 PM MSK

Edited Transcript

Speakers:

- Andrey Napolnov, Head of IR
- Andrey Panov, Deputy CEO for Strategy, Service and Marketing
- Ivan Batanov, Head of Revenue Management
- Andrey Chikhanchin, Deputy CEO for Commerce and Finance
- Artem Glaznev, Head of IFRS Reporting

Participants asking questions:

- Matvey Tayts, Sova Capital
- Alexey Ryabushko, Sberbank CIB
- Ivan Postevoy, VTB Capital
- Igor Goncharov, Gazprombank

Operator: Ladies and gentlemen, welcome to Aeroflot Group 6M 2019 IFRS Financial Results conference call. I want now to hand you over to your host, Mr Andrey Napolnov, Head of IR. Sir, please, go ahead.

Andrey Napolnov: Good afternoon, ladies and gentlemen. Thank you for joining us for the call. We will discuss 6M and Q2 2019 financial results. Today, we have the following speakers on the call: Deputy CEO for Commerce and Finance Andrey Chikhanchin, Deputy CEO for Strategy, Service and Marketing Andrey Panov, Director of Revenue Management and Network Planning Department Ivan Batanov, Head of IFRS Reporting Artem Glaznev, and myself. As usual I would like to remind that press release and IFRS statements are available at our website in the Investor Relations section. Also, before we start, I would like to draw your attention to the disclaimer statement that some information on the call may contain forward-looking statements and actual results may differ materially from those expressed or implied in the statements made during the conference call due to known and unknown facts and events.

We begin our presentation with the key semi-annual highlights to be discussed in details during the presentation. First of all, operational growth has been quite strong with capacity and passenger number increase of 14.9% and 13.4%, respectively. The high pace of Q1 2019 growth has started to normalise according to our plan and the announced guidance in Q2 2019. Positive yield amid high capacity expansion proves that the market has been digesting our expansion strategy this year. At the same time, the World Cup base effect, currency trends, and competition on international routes have defined Q2 2019 results and may have some impact going forward. To discuss these operational trends, I would like to pass the floor to Andrey Panov, Deputy CEO for Strategy, Service and Marketing.

Andrey Panov: Hello everyone. I will spend several minutes on the market update and the overall situation with our competition.

The Russian market continued to grow at quite an impressive rate – an almost 9% growth in 1H 2019 is above our 6–7% expectations for the overall year, and we understand that with the current trends it looks like that this growth will continue approximately at 8–10%.

Both domestic and international segments post high single-digit growth, and we do not see any material differences in growth trends between Q1 and Q2 2019. However, some important aspects of the growth have changed and we would like to draw your attention to that.

First of all, what we see is the different dynamics between Russian and foreign carriers. We saw it in Q1 2019, but now it really looks quite significant. Foreign carriers started to reduce capacity and lost 9% of combined traffic and 2.5 p.p. of the market share, and the overall competition decreased. Yet, CIS and Asian airlines are growing their presence in the Russian market.

We see that in June, foreign carriers reduced traffic by over 20%. Of course, we understand that this is the result of the base effect of the World Cup we had last year, but still, it is really significant. In our opinion, the situation is that foreign carriers cannot compete with Russian airlines on a cost base and the prices and fares they can afford. Despite very rational approach to the domestic market, domestic carriers have accelerated their growth on international routes with the traffic rights received during the last 12 months, which resulted in the overcapacity in the segment on some selected routes.

We also see that there is some acceleration in regional expansion. We can name S7, with their expansion in Novosibirsk's hub outpacing the expansion in Domodedovo, and Ural Airlines, which focused on Zhukovsky and Yekaterinburg airports. Utair returned to the growth mostly in the non-scheduled segment.

In general, Aeroflot Group was growing above the market in 1H 2019 and in Q2 2019. Above the market growth was secured primarily by Pobeda. The calculated share of Aeroflot Group is now seen at 40.3% based on a "pure O&D market".

So let us go to the next slide. Once again, we have seen the growth in all our key brands: Aeroflot passenger growth was approximately 10%, Pobeda – 45%, Aurora, more or less stable – 2%, Rossiya airlines – 7%. So it is obvious that the most growth we have is from Aeroflot and Pobeda and we can predict that next years Pobeda will bring us the most passengers.

Aeroflot airline concentrated its growth on international routes, including Europe-to-Asia transfer. I will speak about it a bit later. Pobeda passenger growth came mainly from the domestic market.

What is also important, Rossiya airline's scheduled network was moved to the Sheremetyevo airport from Vnukovo, and continued to show improved efficiency and connectivity to a larger Aeroflot network, which translated into better results.

Let us go to the next slide. Now I will speak about our transit flows. As you may remember, we have quite ambitious targets for the international transit in the long-term strategy, and we want the Group to have 10–15 million passengers in 2023. The number of international-to-international transit PAX in 1H 2019 increased by 21% on the back of continuing further connectivity improvement. I think that is quite impressive. Thanks to the transfer of Rossiya's scheduled flights to the Sheremetyevo Airport in Moscow on top of 2.5 million transit passengers of Aeroflot airlines, more than 100,000 additional transit international passengers were generated by Rossiya.

Rossiya showed the biggest contribution in our network in the domestic-to-domestic segment where it generated almost 400,000 additional PAX on top of Aeroflot's 1.8 million PAX. We expect that the consolidation of Rossiya's scheduled flights in Sheremetyevo will continue to yield higher PLFs and boost connectivity of the Group's route network, reflecting positively on our financial results.

And a bit about Pobeda. During the last 12 months, the airline received 10 aircraft, increasing total fleet to 30 planes. It obviously allowed the airline to grow quite fast (+45% and 4.5 million passengers) in 1H 2019.

The network of the airline in the Summer season comprises over 100 routes and half of them are unique for the Group, which is also quite important for us. Next year, we are planning to launch a new pilot project. We hope that we will be able to do that, and we think about deploying some of new Pobeda aircraft in Sheremetyevo to connect with Aeroflot's network. Pobeda will not leave Vnukovo. We speak only about pilot project, and we think that it could bring some synergies when we establish code-sharing between Aeroflot and Pobeda from Sheremetyevo. I think that Pobeda, with its CASK and RASK, is a perfect affordable product for some markets.

Of course, there are some challenges for Pobeda as well as for the aviation industry in general. I am talking about 737 MAX. We hope that this aircraft will start flying. We are considering various options for the future development of the fleet at LCC as other companies of the Group also operate the aircraft type currently used by Pobeda.

So that is it about the market update and now Ivan Batanov will continue with the network and schedule overview.

Ivan Batanov: Thank you. Let me start with the Group network update. In 2019, we have continued to improve network quality by focusing on frequencies and connectivity, and expanding to new markets with high point-to-point and transfer potential. The total number of the Group's flights expanded by 9.6% in 6M 2019 y-o-y with Asia, and Middle East and Africa being the two most actively growing regions, supported by additional destinations opening and flight frequency increases.

Accelerated growth in a number of flights to Asia is explained by new destinations to Colombo and Denpasar as well as higher frequencies to Seoul vs the Summer season the year before. Middle East and Africa region expanded on the back of growing frequency between Moscow and Dubai, Cairo and Istanbul.

North and Central America has seen lower flight frequency between Moscow and New York: two flights per day in the last Winter season vs three flights per day in Winter 2017/2018. In Summer 2019 schedule, we have three frequencies between Moscow and New York, and we are going to keep this frequency for the future.

Higher average scheduled flight frequency per route expansion was mostly driven by the domestic segment, (about +16%), with new destinations in the southern part of Russia launched last autumn as well as higher frequency on the number of the existing routes. Overall expansion of our route network is aimed at supporting our international-to-international transit strategy.

Now let us move on to the unit revenues. A 2.2% increase the Group's yields in 1H 2019 was driven by the domestic segment while international yields have been slightly down on Q2 2019 trends, where international yields declined by 3.7% during the recent quarter.

What are the key factors that impacted Q2 2019 yield dynamics? First of all, it is fuel surcharge impact that provided for the most of the domestic yields increase (6.1%) and positively contributed to selected international routes where we adjusted the surcharge. Fuel surcharge was for the first time introduced in the CIS segment, resulting in a 4% increase in yields for the segment in roubles. Another round of fuel surcharge increase is effective from July 2019 and covers mainly the domestic and CIS segments.

The second factor is pressure from the increased competition of Russian carriers on international routes, including indirect competition from the charter segment where we have limited presence as a Group. This competition is quite visible on European routes, and I would not say that we are significantly impacted by soft trends on the intra-European routes – maybe to some extent indirectly via transfer offering of biggest

European carriers, but I would not exaggerate the importance of this factor. Competition from domestic players on European routes is definitely noticeable. Our yields for Europe are down by around 5% in roubles, which also includes currency factor as rouble strengthened 2% vs euro.

Exchange rate dynamics. As I have mentioned, euro lost 2% vs rouble, which is positive for demand but affects our yields reported in roubles, transfer yields and inbound traffic.

Among other factors, we have also active development of ancillary and load factor trend with implication for the sales mix, and last but not least – abnormally high base because of the World Cup 2018.

Base effect is well illustrated by the following slide on Aeroflot airline's monthly yield growth y-o-y. In June 2018, the yields growth spiked at 17%, driven by a 23% increase in the international and 8% in the domestic yields – well above low single-digit domestic yield and mid-to-high single-digit international yield growth before.

With this high base of June 2018, we managed to post a 5.8% yield decrease in June 2019, driven by an 11% decline in international yields and moderate deceleration of domestic yield growth.

June was the Group's stage of the World Cup, that is why the effect is so pronounced. It partially lingers in the first half of July, mostly in the international segment, due to the schedule of the championship, but to a less extent than in June according to our estimates. Just to remind you that July 2018 y-o-y yield was up by 8% driven by a 13% increase in the international segment.

Let me pass the floor to Andrey Chikhanchin.

Andrey Chikhanchin: Thank you, Ivan. Hello everyone. The next slide is "Aeroflot Group fleet breakdown." As of 30 June 2019, the Group had 365 aircraft in the fleet deployed in operation by the airlines of the Group. Even though the fleet is not increasing year-to-date, the average fleet size is up by almost 20 aircraft vs the fleet we operated in 2018. We do not have any sizable addition to the aircraft fleet in 2019, but rather focus on increasing flight hours for the existing aircraft, which contributes to higher efficiency of the fleet.

The next slide is "The Fleet Expansion Strategy." In 6M 2019, the Group has been expanding its capacity by nine aircraft including two wide bodies and seven narrow bodies in the medium-haul segment. In Q2 2019, however, our capacity has decreased by six aircraft, including the scheduled phase-out of seven aircraft of Airbus 320 family. In 2H 2019, we expect a net increase in our fleet by five narrow bodies as well as a phase-out of three wide bodies.

With respect to the MAXes, which are currently grounded by the regulators, we expect joint solution of Boeing and regulators and are ready to introduce MAX in our fleet only when its safety is confirmed. Three Airbus A330 aircraft will be leaving the fleet in the very end of the current year, followed by a phase-out of four additional Airbus A330 aircraft in 2020, according to our schedule. Airbus A330 will be replaced by brand new Airbus A350 aircraft, we expect eleven aircraft to enter the fleet next year.

Now let us move to the consolidated financial results for 6M and Q2 2019.

2019 began with an over 10% increase in fuel price and material rouble depreciation vs dollar and euro, which resulted in soft Q1 2019 results. At the same time, despite competition headwinds, we have been successful at increasing the yields. As we were moving through Q2 2019, we saw a number of changes in the macro trends. First and most important, jet price has been gradually improving. Rouble appreciated vs dollar, but was still 4.5% weaker in Q2 2019 and 10% weaker in 6M 2019 y-o-y. Euro/dollar trends resulted in pressure both on revenues and costs, as euro continues to trade at 1.12x. On top of that, we faced extremely high base in June as we had to deliver on the back of the group stage of the World Cup held last year. Additional pressure came from the closure of Pakistan skies.

I should also mention that we present restated numbers for 6M 2018 under IFRS 16, and we would like to highlight that the restated net income is the result of currency effect on capitalised operating lease. We apply hedge accounting for lease previously classified as operating since 1 January 2019 and absorb all currency effect in equity like we do for finance lease since 2014.

On the next slide we can see that during 6M 2019, the Group's revenue grew by 17.2% y-o-y and amounted to RUB 311 bn led by the expansion of scheduled operations, which generated additional revenue of RUB 39 bn.

We have been able to realise a positive currency effect of RUB 11 bn due to a weaker currency and RUB 3 bn on pricing due to an increase of fares and fuel surcharges. An additional contribution to revenue was generated by ancillary revenue projects, showing positive reception of our passengers, such as upgrade to business and comfort class, and seat selection for lower booking classes. We see further perspective with our ex-baggage fares.

On the next slide we can see our operating costs. Substantial growth in OPEX in 6M 2019 was mainly driven by a 15% increase in capacity. Fuel remained one of the key contributors to OPEX growth mainly due to volume growth as well as further rouble devaluation. FX trend is also an explanation for the key lines with an FX component. In addition to the volume and FX factors, a number of key P&L lines were affected by accounting and operational factors. One of them was aircraft and passenger servicing cost which was additionally inflated by higher fares in domestic regional airports. The second factor was lease, amortisation, maintenance and other lines which were affected by IFRS 16. We discussed it in detail on a special call several months ago. Another important factor influencing operating expenses, as mentioned earlier, were additional costs stemming from flying around the India and Pakistan conflict zone in 6M 2019. In Q2, growth in ASK amounted to 13%, so a 15% increase in OPEX is mostly linked to the volume factor with an additional influence of the same factors as described for the 6M 2019 y-o-y dynamics.

Going forward Group's management remains an apologist of strict cost control measures as pressures from fuel price persist and it is important to become even more cost-efficient to protect the margins.

Let us talk about Group unit costs. We may conclude that CASK increased by 4% in 6M and just by 2% in Q2. Around 50% of the costs are denominated in hard currencies, mostly in US dollar, which gained about 10% in 6M 2019 and 4% in Q2 2019. On top of that, we have seen continued growth in fares in the regional airports, an increase in LIBOR by 0.5 p.p. in 6M 2019 and other minor factors. It is worth mentioning that in Q2 2019, the spread between the CASK and RASK significantly narrowed as Total CASK grew by 1.9% and Blended RASK decreased by 0.1% (a 2.0 p.p. spread). This compares with a 8.9 p.p. CASK-RASK spread in Q4 2018.

The fuel price remained elevated for the most of 6M 2019, but it reached the base of 2018 by May and, as you see from the chart on the slide, the two lines have crossed. In June 2019, we benefited from a 7% y-o-y decline in the fuel price and the trend continued in July. At the same time, I would like to highlight that in June and July, we faced a high base effect of FIFA. This means that we benefit on the cost side, while having tough comps on the revenue side. We have hedge instruments for the 70% consumption of Aeroflot standalone for 2H 2019. We believe we secured attractive levels at very attractive prices. The introduction of the damper mechanism is for sure a positive development for airlines. In other words, it is better to have it in place than not. At the same time, the levels approved are relevant mostly to the worst-case-scenario. It is our opinion. The question of protecting the margins up to the damper level remains important for airlines of the Group.

The next slide is the EBITDA evolution. In 6M 2019, we generated RUB 68 bn in EBITDA, up by 15.7% y-o-y. The key drivers of changes in EBITDA are as follows: a positive volume and price effect on revenue amounting to RUB 35 bn, which outpaced growth in costs by RUB 30 bn, which implies that the volume growth was not dilutive for our business on the operational level; and a positive net FX effect on revenue and costs in the amount of RUB 4 bn resulting from a weaker rouble vs US dollar and euro.

Let us move to an important slide about Pobeda's financial results. This is additional information to what Andrey Panov has mentioned about Pobeda's operating results. An active expansion of Pobeda in 6M 2019 and an addition of 47% in ASKs y-o-y did not dilute RASK, which grew by an impressive 6.5% y-o-y amid a 92.5% load factor. Pobeda's operating growth allowed to increase operating profit by 44% in Q2 to RUB 1.4 bn. I would like to remind that net income contains FX revaluation of the lease portfolio of RUB 2.9 bn for 1H 2019. In the future, this adjustment will be made on a company basis to make bottom-line figures representative.

Leverage and liquidity. Net debt as of 30 June 2019 decreased by 12% (presented on a comparable basis) on the back of revaluation of lease liabilities due to the rouble appreciation during 6M 2019 and the growth in cash position.

The last slide is Adoption of IFRS 16 – lease liabilities revaluation. I would like to pass the floor to Artem Glaznev, Head of the IFRS Division.

Artem Glaznev: Hello, everybody. Aeroflot has adopted IFRS 16 starting from 1 January 2019 using a fully retrospective approach. As a result, the 2018 figures were restated. Before that, hedge accounting was applied to finance lease liabilities from 30 September 2014. IFRS 9 prohibits the retrospective adoption of hedge rules and therefore the requirements of this standard at the transition to IFRS 16 were applied prospectively from 1 January 2019. If the Group had reflected the hedge accounting of lease liabilities in respect of liabilities recognised as a result of applying IFRS 16 from 1 January 2018, then the positive effect on the financial result for 6M ending on 30 June 2018 would have amounted to about RUB 28 bn, reducing the loss for the period to RUB 2.9 bn. The graph on the slide explains a 6M 2018 rouble devaluation of 9% vs US dollar since the beginning of the year which resulted in a 28 billion RUB paper loss on FX. That is all about IFRS 16 and hedge accounting.

Operator: Our first question comes from Matvey Tayts, Sova Capital. Please go ahead.

Matvey Tayts: Hello. Thank you for this opportunity to ask you questions. My first question is about other operating income, which increased quite substantially in Q2 2019. Can you please suggest if we will have similar dynamics in 2H 2019 comparing to what you have in 1H 2019. The second one is about RPK yields. The line was not good. Can you please repeat your statements regarding the RPK yields in July? What have you seen so far? Just to have an idea of what the RPK yields for Q3 will be like for international and domestic lines, if possible. Also, my last question is about the third runway which will be launched in Sheremetyevo. Can you please explain how it will impact your plans and how it will contribute to your growth. Thank you very much.

Andrey Chikhanchin: Thank you for your questions. Let us start with other operating income. There are some figures available and the most impressive and biggest one is excise reimbursement. These are regulated payments which we received during the years from 2015. I think it is the biggest part of other expenses/income. I should also mention some income from selling our assets and some adjustments in maintenance reserves, which are nothing unpredictable and nothing unusual.

Speaking about the third runway in Sheremetyevo, of course, it is in line with our strategy. Our aim is to have 90–100 million passengers by 2023. The third runway will help us improve our operations in our domestic hub in Moscow.

Regarding RPK, I will pass the floor to Ivan.

Ivan Batanov: Let me comment on the question regarding the Q3 yields – what we have seen so far. So we have already mentioned that this year we will feel the base effect of the World Cup that Russia hosted last year. Most of the championship impact relates to June as June was the group stage of the championship, but July is also affected. It means that the July yields are not strong enough mainly due to the performance of the international yields. Last July we posted over 8% growth backed by a 12% increase in the international segment y-o-y. Base effect is exacerbated by a 3.4% y-o-y decline in EUR. It is the currency effect that affected yields reported in roubles. As a result, we expect a decline in international yields for July but more moderate vs June, which will be offset by an ongoing positive trend in domestic yields which are back to the average growth we posted before. The result is a low single-digit yield for the scheduled operations. If we look at the August yield trends, they are better than those in July and our very preliminary indication is from 2 to 3% increase y-o-y.

Matvey Tayts: Thank you. A 2 to 3% increase in rouble terms. Is that correct?

Ivan Batanov: Yes, that is true.

Matvey Tayts: OK, thank you.

Operator: Our next question comes from Alexey Ryabushko, Sberbank CIB. Sir, please go ahead.

Alexey Ryabushko: Hi. A couple of questions from me. The first is regarding your seat load factors. Since the start of the year we have seen a steady decline in y-o-y terms. Can you comment on what we should expect from 2H 2019? Should we project the same decline in seat load factors y-o-y or not, or maybe they will even increase? My second question is regarding your fleet expansion plans, in particular SSJs and MC-21s. As far as I understand, you have reached a principle agreement to order more planes but have not signed the hard contract. Can you please elaborate on the process, at what stage you are now, when we should expect the signature of this contract. Thanks.

Ivan Batanov: Let me first comment on the load factors. It is important to note that according to the 2019 budget, the Group's overall capacity will increase from 9 to 10% in terms of ASK. It means that a slight decline in the load factor that we have mentioned so far is something we consider OK. Due to the competition that we can see on the international market and obviously excess capacities, Aeroflot commented several times that we definitely can see overcapacity in the international market. But in terms of the year, we expect the load factor to be at the level of 82%.

Andrey Chikhanchin: I will answer the question about the fleet, SSJ and MC-21. Yes, you are right. We have a preliminary contract for SSJ 100. We are having a lot of discussion about this contract. However, I think we are at the final stage. By the end of the year, we are ready to receive ten aircraft. Now, we are in the process of receiving necessary corporate decisions following corporate procedures.

Regarding MC-21, yes, we have a firm contract. As you may have read in the news, the delivery of the first aircraft has moved from 2020 to 2021. So we are still in this contract and waiting for this aircraft.

Alexey Ryabushko: Just to clarify, regarding SSJs, as far as I understand, you expect some corporate actions until the end of the year

Andrey Chikhanchin: Yes.

Alexey Ryabushko: And regarding MC-21, I was talking about the extra 35 planes that, as I read, the corporation expected you to sign until Q1 2020, not about those 50 you have already signed.

Andrey Chikhanchin: I understand. Yes, it is the extra 35 aircrafts, we have a preliminary memorandum of understanding for receiving these aircraft, and we are still in the process of negotiations for these 35 aircraft.

Alexey Ryabushko: Ok, thank you.

Operator: We have a question from Mr Ivan Postevoy from VTB Capital. Sir, please go ahead.

Ivan Postevoy: Hi. Thank you for the presentation. I have three questions. First one: as we see that maintenance grew by 30% in Q2 and by 50% in Q1, what dynamics should we expect for the rest of the year? My second question is about the staff costs line. It grew only by 11% vs the 6% growth in Q1. Don't you see a shortage of pilots in the industry and don't you think there will be further growth in this cost line? And my last question is regarding the Pobeda code-sharing. Don't you think this may give rise to complaints to or by FAS (Russian Federal Antimonopoly Service), given the recent claims to Pobeda and Aeroflot? Thank you.

Andrey Chikhanchin: Ok, we will start with the maintenance. The main factor influencing the change is, of course, the volume accounting for more than 20%, which is a big portion of 38%. The second factor is FX. It is not something extraordinary, it correlates with our growth and the FX factors. I think it will be on the same level for the next period. And speaking of staff costs, there was some impact from reducing bonuses cancelled in Q1, so in this case the growth in this P&L line was not so high. And I will pass the question about the code-sharing to Andrey Panov.

Andrey Panov: We cannot comment on any FAS claims to us, but we think that by implementing code-sharing for Pobeda and Aeroflot we will increase the opportunities for people of the Russian Federation to travel across the country. And I don't think there is something wrong with what we are doing. Once again, I should repeat that it will only be a pilot project: we will do some code-sharing, because anyway we have some bases where Pobeda and other airlines are flying now, for instance, in Saint Petersburg. Regarding Moscow, we will see it happen next year or later, especially because of the question with new MAXes which Pobeda will need to have to increase operations next year.

Ivan Postevoy: Ok, thank you.

Operator: We have a question from Igor Goncharov, Gazprombank. Sir, please go ahead.

Igor Goncharov: Thank you very much. I have a question on the fuel costs. You showed on the slide that in July you saw a y-o-y decline in the level of fuel cost in rouble terms. Can you comment on how this trend continues into August? Thank you.

Andrey Chikhanchin: Thank you for your question. The trend is the same as in July, maybe with a little further decline, so it is a high single-digit decline in August.

Igor Goncharov: Ok, thank you.

Andrey Napolnov: Thank you very much for participating in the call. If you have any follow-up questions, we will be happy to answer them. See you at the next call, and have a good day. Thank you.