

Qantas

12/08/2014 FAT-AUS-685

QAN

AUD \$1.310

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**HIGH****B**

## Emerging from the turbulence

When debating the subject of airlines as stock market investment, the minds of many will flash back to the movie Wall Street. In the well-known tale of greed, the central plot involves a battle between a semi-fictional corporate raider Gordon Gekko and his protégé Bud Fox over the plans for Bluestar airlines. Bud recommends Bluestar's stock to impress Gekko as he knows through his father who works there that the airline is about to win a court case regarding an accident, that was not the airlines fault.

Fast forward towards the end of the 80's blockbuster film and Gekko does an about face on helping to turn the airline around. Instead he is intent on breaking the airline up and selling the parts, which he believes are worth more separately.

So why the big movie recap? We believe it is relevant, re-introducing as we are an airline stock to the portfolio in the form of Qantas (ASX, QAN). We believe that the airline is on the comeback trail on the back of a significant cost cutting program, abating capacity pressures domestically, and also through the relaxation of ownership rules for the national carrier.

We also believe there is the prospect of significant additional restructuring initiatives when full year results are released at the end of this month. Whilst not extreme as Mr Gekko's plans, this may indeed include a split of the airline or asset sales. We believe such moves would provide further fuel for the share price re-rating seen this year.

**We are therefore recommending Qantas as a Buy to Members with a high appetite for risk, and a medium term investment horizon.**



## Chequered past

Qantas does have a past in the Fat Prophets portfolio. Indeed we exited the stock almost a decade ago at \$3.31. A key part of our logic for exiting was that oil prices were set to go higher, with knock on impacts to jet fuel and costs. Oil prices were around \$41 a barrel at the time, and this of course proved to be a valid fear, with oil prices hitting peak levels of around \$150 a barrel pre-GFC.

We were also wary about increasing domestic competition, and this also proved a valid concern with Virgin in particular making its presence felt in the market, along with the rise of budget carriers. Accordingly, Qantas lost its monopoly position.

We also cited (in September 2011 and again in mid-2012) that Qantas was a 'landmine stock' to avoid. We noted the challenges of high fuel prices, and the fact the further profit downgrades were on the cards. We noted that the international airline had been the epicentre of Qantas's problems and questioned whether the company could achieve profitability here by FY14.

Our general caution towards the company has proven well founded with the shares losing around 70 percent since it exited the portfolio, and around 40 percent since we flagged it as a 'landmine' stock, when measured against the lows of around 95 cents last December.

Sentiment towards the embattled carrier has however improved significantly in 2014, and we believe there are clear foundations for an upward re-rating having much further to continue.

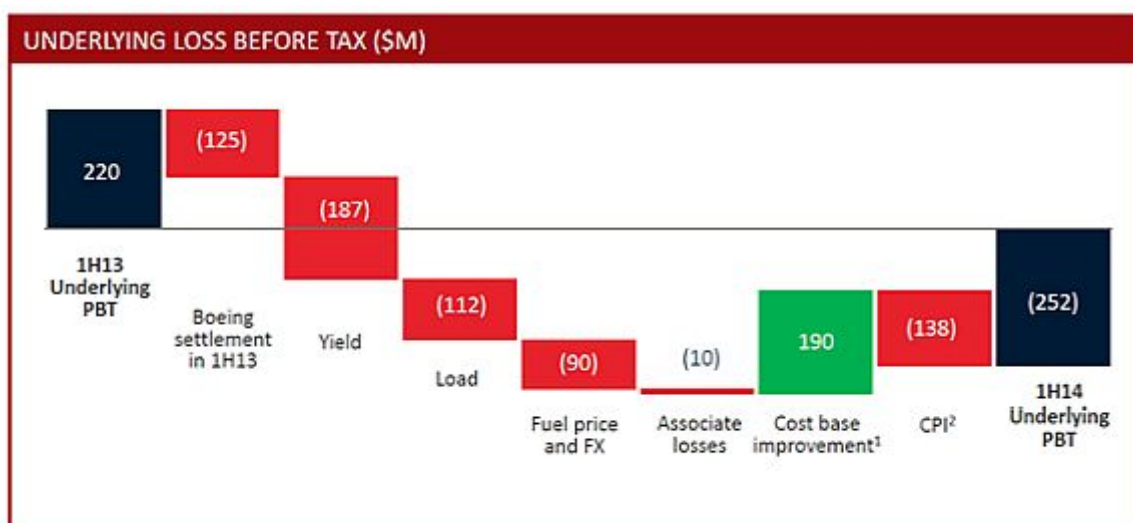
We believe that the carrier is in a much better position to offset the still high costs of jet fuel with a cost reduction program set to deliver substantial savings. We also believe that drivers of margin pressures within

the domestic business are abating.

Furthermore, recent changes to ownership rules also open up the prospect of a key stake being taken by an overseas carrier. The prospect of a major restructuring initiative is also on the cards when full year results are announced at the end of August. This could take the dramatic form of a split of the company's international and domestic businesses or a part or full sale of Jetstar and/or the frequent flyer unit. Such moves would provide further catalysts for a re-rating in our view.

## Half year results

A look back at the half year results to 31 December 2013, released in February provides a key insight into the earnings pressures that Qantas has faced. Revenue fell 4 percent to \$7.9 billion. The company also reported a first half loss of \$252 million, which compared to an underlying profit before tax of \$220 million in the 2013 half year.



Source: Qantas Half year results Presentation

## Underlying Income Statement Summary

\$M	1H14 <sup>1</sup>	1H13 <sup>1,3</sup>	VLY %	
Net passenger revenue <sup>2</sup>	6,786	7,042	(4)	Sustained aggressive competitor activity impacting yield and load
Net freight revenue	500	475	5	Consolidation of Australian air Express <sup>4</sup> ; reduced international capacity
Other revenue <sup>2</sup>	617	725	(15)	1H13 Boeing settlement \$125m
<b>Revenue</b>	<b>7,903</b>	<b>8,242</b>	<b>(4)</b>	
Operating expenses (excluding fuel)	4,797	4,770	(1)	Qantas Transformation initiatives; 0.7% capacity growth
Fuel	2,255	2,181	(3)	9% increase in average AUD fuel price before hedging; offset by 3% fuel efficiency <sup>3</sup> improvements
Depreciation and amortisation	746	719	(4)	Net increase of 7 owned aircraft
Non-cancellable aircraft operating lease rentals	261	265	2	Net reduction of 2 aircraft leases
<b>Underlying EBIT</b>	<b>(156)</b>	<b>307</b>	<b>&gt;(100)</b>	
Underlying net finance costs	(96)	(87)	(10)	Increase in net debt
<b>Underlying PBT<sup>1</sup></b>	<b>(252)</b>	<b>220</b>	<b>&gt;(100)</b>	

Source: Qantas Half year results Presentation

CEO Alan Joyce said the result came was 'unacceptable' and came on the back of the 'the toughest conditions Qantas has ever seen.' Much of the pressure stemmed from a wave of international airline capacity, with a 46 percent increase since 2009.

Management have also claimed that the Australian domestic market was not a level playing field with Virgin Australia majority-owned by three foreign government-backed airlines, yet having access to 'Australian bilateral flying rights'. A \$300 million investment in Virgin has allowed the company to increase domestic capacity whilst losses are growing. These grumblings do have some legitimacy, and recent law changes could see the situation addressed.

Drilling down on the half year results, earnings pressure has occurred consistently across the domestic and international units. **Whilst the competitive nature of the landscape has not diminished significantly in recent months, there are growing foundations for a bottom line recovery from a number of angles.**

#### Qantas Domestic

The company's domestic operations saw underlying profits of \$57 million in the first six months, down from \$218 million the year before. A challenging economy, along with capacity increases, have put pressure on 'yields' (passenger revenue divided by, passengers carried times kilometres flown) and passenger loads. Management notes that the domestic 'profit pool' has shrunk from more than \$700 million in FY12 to less than \$100 million in 1H14. ASK (total number of seats available for passengers, multiplied by the number of kilometres flown) meanwhile held fairly flat, another reflection of the headwinds facing the broader economy.

		1H14	1H13	VLY %
Revenue	\$M	3,086	3,220	(4)
Underlying EBIT	\$M	57	218	(74)
ASKs	M	19,227	19,187	0.2
Seat factor	%	74.9	76.9	(2.0)pts

Source: Qantas Half year results Presentation

We believe there are some clear signs that margin pressure within the domestic business is set to improve. Qantas has refrained from adding to capacity and Virgin is set to follow suit. With the economy also showing some signs of improvement this should tip the demand/supply balance more favourably. A weakening in the AUD, which we expect to happen as the RBA finally throws the towel in on rates should also help here.

Certainly Qantas stands in good stead to maintain, if not increase market share as well. The company remains the most punctual major domestic airline, whilst it has also continued to invest in the quality of its fleet. Qantas also retains around 80 percent of the higher margin corporate market.

Meanwhile the repeal of carbon taxes should have limited impact to ticket margins. Qantas has now removed the itemised 'surcharge' from fares, but a competitive landscape meant it hadn't pushed these on through price increases.

#### Qantas International

The company's international division was a clear laggard, reporting an underlying EBIT loss of \$262 million in 1H14, compared with a loss of \$91 million in 1H13. Again the key features were intense competition and growing capacity.

This unit sees fuel costs rise in line with a weaker Australian dollar, making careful control of costs here even more paramount if a downward trend were to gain pace here.

		1H14	1H13	VLY %
Revenue	\$M	2,621	2,818	(7)
Underlying EBIT	\$M	(262)	(91)	>(100)
ASKs	M	29,863	29,625	0.8
Seat factor	%	80.8	82.7	(1.9)pts

Source: Qantas Half year results Presentation

The prospect of a split of the international business from the domestic operations (which we go into further below) could however greatly improve the competitiveness of this unit, as will a significant cost-stripping exercise.

#### Jetstar

The company's Jetstar business also saw a lot of red ink in the first half with an underlying EBIT loss of \$16 million, down from an underlying EBIT profit of \$128 million in 1H13. Again the business saw significant pressure on yields, particularly in Asia, and a \$29 million share of start-up losses from the launch of Jetstar-branded airlines through Asia.

More encouragingly though, Jetstar's domestic operations in Australia remained profitable (in fact it has been so every year since 2004). A low cost-carrier model continues to prove its worth in Australia, and the company further reduced costs by another 2 percent at the half year. Jetstar has also shown success at driving ancillary revenues per passenger, on top of four percent growth in passenger numbers. This unit could attract significant interest if Qantas were to consider a sale or part thereof.

		1H14	1H13	VLY %
Revenue	\$M	1,671	1,757	(5)
Underlying EBIT	\$M	(16)	128	>(100)
ASKs	M	22,754	22,562	0.9
Seat factor	%	78.5	79.0	(0.5)pts

Source: Qantas Half year results Presentation

#### Qantas Loyalty

Qantas meanwhile continues to leverage its loyalty program to good effect. The unit reported record underlying EBIT of \$146 million, up from \$137 million in 1H13. The company currently has 9.8 million frequent flyers and looks set to take this to 10 million by the the full year end. This would also garner much attention if Qantas were to put part of this business up for sale.

		1H14	1H13	VLY %
Underlying EBIT	\$M	146	137	7
Billings	\$M	662	607	9
Deferred Revenue Growth <sup>5</sup>	\$M	59	45	31
Members	M	9.7	9.0	8

Source: Qantas Half year results Presentation

The company's freight business meanwhile reported underlying EBIT of \$11 million, down from \$22 million in 1H13, with a weak global cargo market being the key driver.

#### Costs in focus

Qantas has certainly been buffeted by headwinds in recent years, but still the half year result was far from palatable as far as management was concerned. Costs have already been in focus under a transformation



program, with comparable unit costs down 19 percent in four years but the company clearly needs to put on the afterburners.

**The company has now set about accelerating the transformation program to achieve \$2 billion in cost reductions by full year 2016/2017. Qantas is planning to implement no less than 250 initiatives as part of this.** The plans include rationalisation of the company's fleet, with some models retired and further exits of under-performing routes. There will also be a headcount trimming of around 5,000 jobs. Capital expenditure is set to be culled by \$1 billion across financial years 2014/2015 and 2015/2016.

The company believes that these initiatives will also able it to close the cost gap to domestic competition, whilst also obtaining a competitive cost base versus international competitors.

Qantas is also taking strategic decisions to better optimise the portfolio. This includes returning the Brisbane airport terminal lease to Brisbane Airport Corporation together with related assets for \$112 million.

Discussions are meanwhile continuing on the Sydney and Melbourne terminals.

Meanwhile pressures on the jet fuel side have also been mitigated. The company has hedged around 98% of its fuel costs for the second half of 2014. Qantas has also insured against FX movements with around 88 percent of its exposure hedged.

2H14 EXPOSURE <sup>3</sup>	% HEDGED
Fuel costs	98
Operating foreign exchange	88

Source: Company Presentation

### Capital and Asset Position

Qantas is clearly going through some major changes and has more on the horizon, but a robust capital position affords it some flexibility to do so. Despite negative free cash flow during the half year, **the company finished the period with \$3.0 billion of liquidity, comprising \$2.4 billion in cash and \$630 million in undrawn debt facilities.**

Added to this is the fact that around 30 percent of the Qantas Group's passenger fleet is debt free. The company has added 31 new unencumbered aircraft in the past three years, and added seven in the first six months of the current financial year. A further 49 mid-life aircraft are to become unencumbered through to FY17. Meanwhile, the Group's average passenger fleet age is 7.6 years, the youngest in two decades. This also helps to ensures that a high quality experience is in place for customers.

## FLEET AGE<sup>2</sup> (YRS)



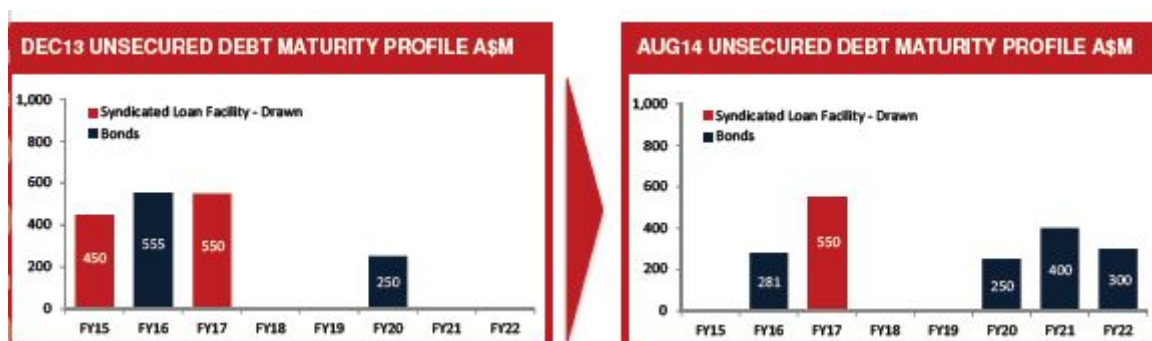
Source: Company Presentation

The company's debt rating remains solid, although looks likely to remain (just) short of investment grade while the transformation plan is worked through. Gearing at last count sits just under 50%.

DEBT POSITION AND GEARING			
	1H14	2H13 <sup>4</sup>	VLY%
Net on balance sheet debt <sup>2</sup> (\$M)	3,829	3,226	(19)
Gearing ratio <sup>3</sup>	49:51	46:54	(3)pts

Source: Company Presentation

More recently the company has further improved its debt profile, repaying \$450 million of senior unsecured bank debt eight months ahead of schedule. More than half the company's debt isn't due now till post 2019, which alleviates financial pressure somewhat.



Source: Company Announcement

## Outlook

Whilst it would be naïve to suggest that earnings for Qantas have reached their low point, we do believe that the foundations are being set in place for a recovery over the medium term.



The company has not guided on full year earnings (which are reported at the end of this month), but it is likely the bottom line loss for the second half will be significantly higher than that seen in the first six months of the year. Expectations are for the pre-tax earnings to come into the red to the tune of \$600 million to \$1 billion for the full year. Management meanwhile expect the company to deliver positive free cash flow by 2015.

There are however signs that competitive pressures domestically at least, are on the cusp of abating. In May the company announced that total domestic capacity growth (comprising Qantas Domestic, QantasLink and Jetstar Domestic) will be zero in each of the first three months of financial year 2015 compared to the prior corresponding periods. This is a key inflection point, particularly as Virgin also looks to be following suit. A tacit agreement not to increase capacity will bode better for margins being held in a still challenging environment.

With the supply ring fenced, this leaves Qantas more upside exposure as the domestic economy improves, and should see an ultimate lift in revenue per seat, and thereby earnings.

### **Structural Changes Afoot**

Sentiment towards Qantas has improved in recent months with the company's cost transformation program being stepped up and domestic margin pressures potentially thawing. However, with the prospect of a still hefty loss for the full year on the table we believe further major initiatives may be announced which could unlock further value for the airline.

One mooted option is for Qantas to split its domestic and international arms. We have seen other companies pursue such an action already this year (e.g Westfield) and such a move may be best to ensure capital is allocated more optimally.

Firstly it would allow the company to potentially attract more foreign investment, and level up the playing field more. Virgin split the ownership of its domestic and international businesses in 2012. It would also allow Qantas to participate (should it be appropriate) in the global industry consolidation which has been taking place.

Foreign investment restrictions in Qantas though have already been alleviated by recent changes to the Qantas Sale Act. Ownership restrictions on a foreign investor (25 percent) and foreign airlines (35 percent) have been lifted to 49 percent.

Qantas will need to remain 51 percent Australian owned, but it now leaves another 11 percent of the register (around 38 percent is already foreign owed) up for grabs by an offshore party. This may prove particularly attractive as costs are being taken out, and as domestic capacity pressures may be alleviating to some extent.

Meanwhile the split of Qantas would open up the remit all the much more. It is also understood that the government is unlikely to contest such a move. Management have suggested the split could take just 6 to 9 months to put into effect.

Also potentially on the cards are asset sales. With this in mind, Jetstar, which has a strong record of profitability, could be in the frame. Another possibility is the partial sale of the company's frequent flyer business. A part sale of the latter (the most profitable unit) could generate north of \$1 billion on its own.

Meanwhile progress on the company's key targets below would further bolster investor appetite.

		Target		PROGRESS TO DATE As at 1 May 2014
		Metric	Timeframe	
ACHIEVING OUR TARGETS	COST SAVINGS	\$2b gross savings	FY17	Initiatives in implementation phase = \$800m
		>10% ex-fuel expenditure reduction <sup>1</sup>		
	DELEVERAGE BALANCE SHEET	5,000 FTE reduction	FY17	FTEs reduced by 2,200 by end FY14
		>\$1b debt reduction	FY15	Focus on cash generation in FY15
	CASH FLOW	Gross Debt / Adj. EBITDA <sup>2</sup> <4.0x	FY17	Gross Debt / Adj. EBITDA <sup>2</sup> to peak FY14
		Positive free cash flow	FY15 onwards	FY15 & FY16 net capex reduced by \$1.2b since Aug-13
FLEET SIMPLIFICATION	11 fleet types to 7	FY16	1 x B747 retired since Dec-13 2 x B767 retired since Dec-13 All remaining B734s retired	
CUSTOMER & BRAND	Customer satisfaction (6 month rolling average): Improving / Stable / Declining	Ongoing	Improving	
	Most on-time domestic carrier: Qantas Domestic	Ongoing	9 out of 9 months (FY14)	

Source: Company Presentation

Turning to the charts the technical outlook for QAN has also improved recently and bodes well for higher levels over the medium term. Prior to 2012 the company's shares were in a strong downtrend, however this has been broken by the formation of a double bottom. Also positive is a bullish crossover of the daily averages (see daily chart above). With prices successfully bouncing off the 200-day moving average and the RSI reading almost neutral, we expect the share price to continue strengthening.



Summary

Qantas has endured a number of tumultuous years but we believe the company's fortunes are set for a significant turnaround. The company's cost transformation program will deliver significant gains to the bottom line over the medium term. Meanwhile the prospect of a capacity war abating in the domestic market could prove a tailwind with the economy also getting back on the up. The latter would also of course be significantly aided by a RBA-induced fall in the Australian dollar.

Whilst no given, the potential split of the international and domestic business seems to be gaining in favour. This could significantly improve access to capital by these respective businesses and also level the playing field from an international perspective. Other asset sales meanwhile will further improve the company's capital position.

**We are therefore recommending Qantas as a Buy to Members with a high appetite for risk, and a medium term investment horizon.**

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## Snapshot QAN

**Qantas**

**Latest Closing Price: \$1.310**

**Market Capitalisation: \$2.88b**

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	<b>FY1</b>	<b>FY2</b>
Price to Earnings	-5.3	-20.2
Price to Book	0.57	0.60
Return on Equity (%)	-10.5	-3.0

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