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HD **Investors wary of Qantas risk**

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As 2014 shapes up as the year of whether Alan Joyce will survive as Qantas's chief executive, institutional investors are privately questioning why they would want to own shares in the airline's frequent flyer business.

A public offering of the frequent flyer business had been mooted with a speculated price tag that ranges wildly between $1.5 **billion** and $3 **billion**.

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A partial **sale** of that business is a more likely option.

This was what Qantas explored back in 2008 before the global financial crisis shelved the idea.

In 2008, Qantas hired UBS, Macquarie and Citigroup to advise it on that partial IPO and institutional investors were desperate for a slice of the frequent flyer business.

Frequent flyer businesses have become money-spinners for airlines because essentially points are a currency.

A credit card **company**, a retailer or hire car **company** that has partnered with an airline's frequent flyer program pays the airline a fee.

At some point in the future the consumer accumulates enough points to claim a seat, but invariably there are extra charges, taxes, fuel surcharges, and more cash to ensure you get the ticket you want.

The quandary for institutional investors is not whether the frequent flyer business is an attractive business. It is.

It's how to price the frequent flyer business when there's a risk, even though a small one, that Qantas could collapse.Lessons from Ansett collapse

For those who say a Qantas financial collapse is impossible, the federal government would never let the national carrier go under, it's worth recalling Ansett.

It too had a valuable frequent flyer program, known as Global Rewards, which became worthless when the airline was put into liquidation in 2002.

Qantas remains in negotiation with the federal government on the provision of a standby debt facility with a government guarantee that Qantas could access for a fee.

This guarantee would bolster the airline's credit rating and could lessen its need to sell key assets such as a **stake** in its frequent flyer business.

In the past year there has been enormous volatility in the earnings outlook for Qantas and there remains doubt around Joyce's leadership.

Qantas expects to report a first-half loss of as much as $300 million. Its credit rating has been downgraded to junk.

The latter kicked off speculation that a sell-off of the frequent flyer business was back on the cards and then Joyce declared "all options are on the table".

While institutions might be trying to price the risk side of a potential frequent flyer business sale there's no doubt it's also in their interest to try to talk down a sale price.

Another option Qantas is exploring is a partial sale of Jetstar to a third party. Qantas has pushed Jetstar, a low-cost carrier, which was seen as the airline's future. Now that's looking less and less like a sure bet.

Many other mainline airlines such as United Airlines, Delta Air Lines, British Airways and Air New Zealand have ditched their low-cost carriers, realising it leads to a lot of duplication in costs, cannibalisation of the main airline and is a management distraction.Hating head office

Some analysts argue the rise of Jetstar has meant Joyce has taken his eye off fixing Qantas and there's certainly plenty of resentment within Qantas towards Jetstar.

Indeed, Qantas remains very much an organisation of tribes where the only alignment is that head office is hated.

For any organisation to be successful you've got to align you people behind you across all the business.

Joyce, who's been in the chief executive's role since November 2008, is smart.

He has some hard choices to make on Jetstar, the frequent flyer business, as well as Qantas, and that is all forming part of a strategic review now. But is what the airline really needs as part of its strategic overhaul a fresh set of eyes?

Billionaire investors such as George Soros are again warning that China is on a very dangerous path in terms of the rate of credit growth in that country and the rapid increase in leverage by Chinese corporation in particular. However, this has been the case for a couple of years, with many China watchers calling a bubble, both in China's real banking system and shadow banking system, and that crash hasn't yet happened.

No doubt the domestic credit growth is worrying for China's financial system's stability.

To add to this concern is data dug up by CLSA Asia-Pacific Markets equity strategist Chris Wood, which highlights China's rising offshore credit risk.

He's noted (see chart below) that the Hong Kong banking system's claims on China banks have surged from $HK60 billion at the end of 2009 to a record $HK1.935 trillion at the end of October last year.

Wood also noted the explosion in offshore issuance of international debt securities by Chinese borrowers, the biggest of which are Chinese financial corporations.

China's international debt securities outstanding rose five-fold from $US46.5 billion at the end of 2009 to $US239.7 billion (see chart).

This tremendous credit growth in debt securities is consistent with growth in the issuance of corporate bonds in the offshore RMB market that really took off in 2011-12.

Historically Chinese banks and corporations only issued bonds domestically.

Even so the growth in those charts seems off the charts.

The small comfort is that those Chinese banks issuing debt are government-backed.

It's unlikely they're going to be allowed to fail as the Chinese government has shown little appetite to date in allowing state-owned enterprises to fold.

A decade ago, China was well through the process of recapitalising its banks and in the middle of a really decisive upswing in the economy led by an investment boom, which was only facilitated because of a clean-up in the country's banking sector.

Now it needs to kick-start its next stage of economic growth by writing off bad loans, over investment and recapitalising its banks again, which will **lead** to a rebalancing and resetting of the economy.

Reform on this front has been slow and second guessing the **Chinese** government on what it might do or when it might act is a fool's game.

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