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HD **Qantas International throttles to beat death spiral**

BY Jamie Freed
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Airlines The Shrinking Kangaroo may now be a more suitable name.

As Qantas International boss Simon Hickey celebrated the opening of the airline's new lounge in **Hong Kong** to much fanfare on Thursday, he was keen to emphasise that the airline remained committed to the Asian port even though it shifted its European hub to Dubai last year as part of its partnership with Emirates.

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"**Hong Kong** is a key entry point both direct into **Hong Kong** and into mainland **China**," he told The Australian Financial Review. "We are really focused on the customer in things like the lounge."

But the investment is coming at a time when customer numbers at Qantas International are falling as the business contracts and cuts services. It no longer offers international flights on a permanent basis from Perth or Adelaide.

For those who remember the airline's glory days, the network is a shadow of its former self. Until Qantas bought Trans Australia Airlines in 1992, it was solely an international carrier, which trumpeted Brand Australia to the world in ports that once included now almost inconceivable destinations such as Tehran, Tel Aviv, Rangoon, Harare and Sapporo.

Now, the national carrier might better be described as the Shrinking Kangaroo.

Of course, Qantas hasn't been shy about stating publicly that its loss-making international business faces serious issues as it attempts to compete with rivals that have a much lower cost base.

The airline last year pushed the competition regulator to approve the Emirates alliance to "arrest the terminal decline" of its international business.

But with its fuel bill at a record high and international airlines including Emirates continuing to pour capacity into Australia, it remains to be seen whether that deal will benefit Qantas financially.

In February, Qantas chief executive Alan Joyce abandoned a high-profile target of returning the international division to a break-even position by the 2014-15 financial year after revealing first-half losses had more than doubled to $262 **million** despite the Emirates deal.

The obvious question for investors – and the travelling public – is whether Qantas International has entered an irreversible death spiral or if there is still hope of returning it to growth.

There are two key factors for any a potential turnaround: the contribution of the Emirates partnership and future decisions about the Qantas fleet.The problem with Emirates

Qantas this week celebrated the first anniversary of its alliance with Emirates. However, given Qantas International's growing losses, the financial benefits are unclear.

Hickey says the Emirates deal was meant to help the airline to keep customers who preferred a one-stop flight to dozens of destinations across Europe rather than transiting in London for a third flight under its old alliance with British Airways.

"It was about providing a network for our customers so that we could keep our customers with us," he says. "It wasn't about finding a pot of **gold** where there previously wasn't one."

The investment community was under a different impression. When the alliance was announced, analysts were told the full benefits would flow to the bottom line this financial year. Macquarie Equities forecast a $130 **million** improvement.

Now, when management is asked about the financial implications of the Emirates deal, there is radio silence.

The chief analyst of StrategicAero Research, Saj Ahmad, says the only winner from the partnership is Emirates, as it no longer has to compete against Qantas and now generates more traffic at its Dubai hub.

"This is not a deal of equals," Ahmad says. "Emirates operates the youngest, most modern fleet of jets and is arguably the world's fastest-growing airline. Qantas is in reverse mode."

Hickey says the Emirates deal does not allow Qantas to veto the Gulf carrier adding more capacity into the Australian market. Emirates has been one of the fastest-growing airlines in this market and its expansion lowers returns from fares for all players, including its partner. Contrary to popular belief, the alliance would allow Qantas to reinstate flights from Singapore to London if it felt there was demand – although Hickey says Dubai is so popular with customers that there is no need to do so.

There has been industry speculation that Qantas has looked to renegotiate some of the terms of the Emirates deal. Hickey won't deny that is a possibility. "As these things evolve, there are always things you can go back and revisit," he says. "That is part of partnerships."

The benefit or otherwise of the Emirates partnership is only one of the serious issues facing the international business. Another major concern is whether the airline will be able to invest in newer, more fuel-efficient planes to better compete against rivals.A puzzling fleet

Qantas has trimmed its route network to the point where its services generate positive cash flow. The international division reported earnings before interest, tax, depreciation and amortisation of $86 **million** in the first half.

But as Joyce noted at a Senate inquiry last month, the business is currently unable to cover its $800 **million** to $900 **million** of annual non-cash depreciation charges and is therefore in "terminal decline".

"When the business is not covering the depreciation of those assets, it is a business that cannot afford to replace those assets into the future," he said.

Rivals are buying fuel-efficient Boeing 787s and Airbus A350s to add to fleets that often also contain the twin-engine 777s Qantas overlooked in favour of four-engine A380s.

This means the Australian carrier is saddled with ageing aircraft at a time when most peers have put them out to pasture.

Newer aircraft are more fuel-efficient and require less maintenance, which gives their operators the ability to turn a profit from offering fares that undercut Qantas.

Qantas has begun taking delivery of 787-8s but has allocated them to the international division of its budget carrier Jetstar rather than the mainline business.

That decision has puzzled some analysts, who wonder why Qantas mainline isn't running the mid-haul range aircraft on transcontinental services to beat Virgin Australia's rival product and to better compete on flights to Asia and Hawaii.

"I think the logical home [for those aircraft] is Qantas mainline," one analyst said.

Instead, Qantas is taking Jetstar's old A330s as the budget carrier receives its 787-8s and a cabin upgrade won't start until the end of this year.

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Hickey argues his division doesn't need the 787-8s. Instead, it is focused on returning to profitability so it can obtain the stretch version of the Dreamliner, the 787-9, which has enough range to fly to ports like Los Angeles, Dubai and perhaps even Dallas.

"I don't want to get aircraft which are ultimately not the ones we want to get," he says of the 787-8s.

Qantas has options and **purchase** rights over 50 787-9s which would ideally allow the airline to restore services to thinner routes like San Francisco and Frankfurt or even add new services to places such as Mumbai and Chicago.

CAPA Centre for Aviation executive director Peter Harbison recalls that the 787-9 was once viewed as the "salvation" of Qantas, as it would allow the airline to service routes point to point, bypassing hubs in Asia and the Middle East.

But the problem is that Qantas no longer has **firm** order for 787-9s. The options and **purchase** rights can be exercised from 2016 to 2025 ,but Joyce has ruled out doing so until the international business returns to break-even.

Qantas International was last profitable in 2008, just before the global financial crisis and the introduction of more competition on the trans-Pacific route that broke its long-standing duopoly with United Airlines.

Hickey thinks he will be able to return the international business to profitability even with the current fleet, particularly as the ageing 747s are phased out over the next two years. He says buying new aircraft wouldn't necessarily be a financial panacea because of the capital cost and future depreciation issues.

Qantas is focusing on flying its existing aircraft for more hours to help reduce its fixed cost base.

But with the target of returning the international division to break-even by 2014-15 now abandoned, Hickey will not outline a new goal.

"It depends on headwinds and tailwinds," he says. "It is pretty hard to predict what is going to happen to capacity next year and the year after, what is going to happen with fuel prices – none of which I can personally control."

Harbison is not optimistic about the future of Qantas International. He believes the best move available is to become almost a "virtual" airline with a few niche routes, just as Virgin has done through its alliances with Air New Zealand, Etihad and Singapore Airlines.

"In pure practical terms, that is by far the best way to operate as an international carrier, situated where we are [in a remote location with a high cost base]," he says. "My ideal for the international aviation industry is you have just a small number of airlines providing the pipes and everyone else just rents space on them."

It is possible that will be the best eventual financial outcome for Qantas and its investors. But for passengers who still remember the airline's global glory days, getting used to that idea will take quite an adjustment.

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