"A High-Stakes Journey: Evaluating Virgin Australia's Financial Health, Funding Alternatives, and Merger Feasibility"

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**Introduction**

Over 65.5 million jobs have been created by the Air transport sector, which contributes around 2.7 trillion dollars to the economy (Aviation Beyond Borders, 2018). This industry can be considered a revenue-generation machine, However, the systemic or unsystematic risks can strike and bring these big companies to the verge of bankruptcy. In this essay, Firstly, we are going to calculate the return on capital and return on equity given the latest information we have received in the statement of profit and loss. After calculating these figures, we will assess whether these changes affect Virgin Australia’s debt and equity arrangements and what is the most optimal financing option for this organization. The second part of the essay will elaborate on whether Virgin Australia are in a position to merge with one of its industry peers; what the risks of a merger are; how to mitigate them; and what will happen if the risk are not mitigated.

**Part one: Assessing return on capital and equity**

Return on equity calculates a company’s earnings as a percentage of the total value of all of its ownership interests (Mitchell, 2023). An analyst could utilize a variety of figures from the income statement and balance sheet to obtain a somewhat different ROE. It is typical to take the net income from the income statement and divide it by the entire shareholder ownership on the balance sheet (Mitchell, 2023). The percentage return of profitability that a business generates using the capital provided by equity and debt providers is measured by the Return on Capital. Because the continual development of positive value is viewed favorably as a necessary trait of a successful business, Return on Capital is commonly employed in practice to assess the effectiveness at which capital is allocated (Wallstreetprep, 2023).

Table 1.1 summarizes the data and calculates the return on equity and capital

Table 1.1



The return on equity ratio shows that Virgin Australia has generated more than 46 percent profit for shareholders which indicates that it is a very profitable company. This metric can also be used to show that Virgin Australia is more profitable in comparison to its industry peers as the return on equity for Virgin Australia exceeds the industry average.

The return on capital is also aligned with the return on equity. It shows more than 14 percent profit. From this, we can conclude that Virgin Australia is a profitable company and is doing a good job.

**Assessing Debt and equity arrangements**

To determine whether Virgin Australia can pay its short-term and long-term debts, liquidity and solvency analysis is used.

**Liquidity Analysis**

We can determine whether the corporation can meet its short-term obligations using the liquidity analysis.

Table 1.2 summarizes the data and calculates the current and quick ratio of virgin Australia.

Table 1.2



As observed in the aforementioned table, Virgin Australia’s current and quick ratios were both below 1 from 2017 to 2019, indicating that the company wasn’t only functioning poorly during the pandemic but also throughout the years of 2017 and 2018. We can see that in 2019, the quick ratio is less than 0.1, indicating that the corporation can only afford to pay 10% of its short-term debt.

**Solvency Analysis**

To Determine whether the corporation can pay its long-term obligations, we can use solvency analysis. I used the debt-to-assets ratio and debt-to-equity ratio for this purpose.

Table 1.3 summarizes the debt-to-asset and debt-to-equity ratios.

Table 1.3



The table demonstrates how heavily reliant on leverage Virgin Australia is. In 2019, the debt-to-assets ratio climbed from 75% to over 90%. This suggests that this business is heavily dependent on debt financing and as a result is at a high risk of suffering serious consequences and going bankrupt. The debt-to-equity ratio went from 3.03 in 2017 to roughly 9.5 in 2019, which indicates that Virgin Australia has 9 times more debt than equity invested in the company.

**Financing Options: Using more debt, Selling stocks, reinvesting the earnings, Using more leases, or considering a merger**

Virgin Australia has issues with liquidity as well as solvency, as seen by the company’s poor current, quick, debt-to-asset, and debt-to-equity ratios. We may readily conclude that a company is in financial distress as it is highly leveraged to the point that its debt is nine times more than its equity. In his essay, Morais (2013) claims that heavily leveraged businesses that are unable to take on further debt tend to turn to leasing, while businesses that are nearing bankruptcy find leasing to be more alluring (p.443). From these figures, we can conclude that Virgin Australia cannot borrow more money despite the new information revealing that they have made a profit instead of a loss in 2019. However, Their profitability ratios seem to be adequate as they have positive returns on equity, return on capital, and return on assets. In light of this new information, new opportunities can arise such as reinvesting the earnings, using more leases or even considering a merger. Selling the the equity in the market to finance the operations is an option as well, however, this option will dilute the stocks of the shareholders and the company will further deviate from its optimal capital structure. Largest airline firms with the most effective use of capital to produce returns with the least amount of fixed assets. In these businesses, the capital contributed by shareholders accounts for at least 40% of total funding. By simplifying the analysis, it could be observed that by examining companies’ debt levels and return on assets, it is possible to determine which ones are the most and least efficient. A significant majority of businesses are taking steps to lower their amount of debt and increase their returns over time (Capobianco & Fernandes, 2004).

After deducting dividend payments, a company’s retained earnings are its total net earnings or profits. The term “retained” refers to a crucial idea in accounting that describes how earnings were held by the corporation rather than distributed to shareholders as dividends. Because of this, retained earnings go down when a business experiences a loss or pays dividends and go up when new profits are generated (Fernando, 2023). As per the new information, virgin Australia made a profit, therefore, they should reinvest this money into the business and avoid paying money to the shareholders in the form of dividends. This will increase their current assets and improve working capital. The other financing option is to consider leases as they will not affect the debt ratios in the balance sheet and over time can improve Virgin Australia’s liquidity and solvency ratios as they will be paying back the debt over time. The other viable option for Virgin Australia is to pursue a merger, as the financial resources of Virgin Australia are limited, by joining forces with another organization, the combined firm will have access to more financial resources to support prospects for economic expansion. The second part of the essay will dive deeper into the possibility of a merger for Virgin Australia.

**Part two: assessing the feasibility of the merger, its risks, and how to mitigate it**

**Merger feasibility**

As we have examined the current, debt-to-equity and debt-to-assets ratios, we have realized that Virgin Australia is facing financial distress. The current ratio shows that Virgin Australia has a liquidity problem as it will not be able to pay its short-term obligations. The debt-to-equity ratio shows that the amount of debt in Virgin Australia’s balance sheet is nine times higher than the equity invested in the company. Also, the debt-to-asset ratio is 0.9 which indicates that Virgin Australia has a very high level of debt relative to its assets. However, as a last resort, the assets can cover the cost of debt which can be seen as decent. In this position, pursuing a merger can be a feasible option for Virgin Australia. For this purpose, they can engage in a horizontal merger which is merging with a direct competitor which can lead to increased market power and share, economies of scale, and merger synergies can be exploited from the deal. A merger is synergy is the concept the two organizations can perform better together and will be more valuable if they operate together. The merger can save money due to operational efficiencies, pave the way for the organization to enter new markets, and improve its research and development capabilities.

China Eastern Airlines and Shanghai Airlines were facing significant losses and were fighting for survival amid the global financial crisis when China Eastern Airlines and Shanghai Airlines merged in 2009. Examining the costs for China Eastern's seven domestic routes that originate in Shanghai reveals that, on departure days, average fares have climbed by 22% since the merger. Due to the concurrent nature of this acquisition, it appears that the 2009 merger gave China Eastern enormous market strength. As a result, a record profit was announced in 2010 (Zhang, 2015). This can be an important factor as more earnings can help Virgin Australia overcome its financial distress once they merge. An airline merger can also have "scale" and "synergy" effects that enhance the merged airline's worldwide competitiveness, as evidenced by a rising market share at the route level. The scale effect results from greater operational efficiency as a result of the economies of scale on both local and international markets following the merger, but the synergy effect is caused by a better-coordinated hub functioning to service international transfer passengers (Ma et al., 2023). Although more international competition and deregulation make these benefits less tempting, a merged airline may profit from increased market power over specific routes and hubs following the merger as well as enhanced contract structure and negotiating power in operations (Nolan et al., 2014). The market power in the post-merger can lead to increased levels of earnings which can be good for companies such as Virgin Australia as they will be able to elevate their financial position. Hüschelrath and Müller (2014) in their research on Market Power, efficiencies, and entry evidence from an airline merger outlined that A merger may result in price hikes of roughly 11% on overlapping routes and about 10% on routes where the operating carrier changed as a result of the merger. However, over a longer time frame, our estimation outcomes are in line with the idea that post-merger entry by competitors and merger efficiencies together started a downward price trend, leaving customers with a modest net price rise of roughly 3% on the impacted routes (p.1).

**Risks of merger**

When a company wants to merge, it should consider the risk that comes with the merger or it will face severe consequences as the data shows that most mergers lead to failure 90 percent of the time (Lewis, 2021). The main risk for the merger is unsystematic risk, as when two companies merge, it mitigates and decreases the systemic risk (Evripidou, 2012). The following are the most common risks associated with mergers:

**Unexpected costs**

The cost of a deal typically includes advisor, investment banking, and legal fees, but it also includes due diligence (such as the per-page pricing models some practitioners still use) and integration practices (such as employee training, rebranding, and new salaries).

**Failure to capture synergies**

As can be seen, a merger can result in several synergies, but it's crucial to recognize that these benefits typically take time to materialize. When the organizations merge, the expenses to the organization can even rise in the short term. Up to three years may pass before the synergies are completely realized.

**Overestimating synergies**

Most of the time when a merger fails is due to the fact the analyst overestimates the synergies. This can be a result of many things such as weak due diligence and inaccurate.

**integration shortfall**

The majority of merger and acquisition professionals believe that post-merger integration is the trickiest aspect of any deal. Several difficulties need to be resolved, ranging from internal management audits to the integration of sales forces, posing serious risks such as employee discontent, inability to realize synergies, and ultimately value loss.

**Weak due diligence**

According to Financier Worldwide (2023), Failures in M&A can result from weak due diligence during mergers, due diligence must be done in both a "hard" and "soft" manner to avoid this. With the assistance of legal and financial advisors, "hard" due diligence entails acquiring and confirming factual information. While this is going on, "soft" due diligence examines the cultures, leadership, and alignment of merging organizations.

**How to mitigate risks of merger**

**Unexpected costs**

For each sort of fee, early planning and estimation are essential. All team members must also adopt the perspective that it is crucial to reduce costs at every stage of the process and by doing this the risk can be reduced (Lewis, 2021).

**Failure to capture synergies**

To mitigate the risk of failing to capture synergies in a merger, consider these key practices. Start by targeting the "low-hanging fruit" – the easiest synergies that align with your overarching goal. Adopt an Agile approach to stay adaptable and focused. Retain key employees to preserve knowledge and success factors. Lastly, analyze your customer base for revenue opportunities by identifying unmet needs. These steps will help ensure a smoother integration process and increase the likelihood of synergy realization (Lewis, 2021).

**Overestimating synergies**

According to Christofferson et al. (2004), “Overestimation can be attributed to elements such as a lack of access to crucial target firm data, insufficient due diligence, and irrational expectations for pricing, market share, and revenue growth. Reduce top-line synergy estimates, acknowledge revenue dis-synergies, increase one-time cost estimates, compare projections with market realities, use external benchmarks for cost synergies, and have reasonable expectations about the timing of synergy capture are just a few practical steps that can be taken to avoid this curse. It is also advised to include line managers in estimating and codifying previous M&A experiences for ongoing improvement. For a proper synergy estimate, access to credible data and industry benchmarks is essential.”

**integration shortfall**

Improving integration practices starts with incorporating due diligence team members into the integration team for seamless information transfer and reduced redundancy. The integration team should comprise individuals skilled in value creation, project management, and organizational development within HR. This approach allows for proactive integration planning as insights about the target company emerge during the diligence process (Lewis, 2021).

**Weak Due diligence**

To prevent integration challenges and guarantee long-term M&A success, it is crucial to conduct cultural due diligence early in the process, align senior leadership on cultural traits, and effectively communicate with employees. Any M&A deal must have proper due diligence. The buyer must begin the process early with a knowledgeable team that combines business, legal, and financial know-how with an understanding of the sector. So that the acquirer can ask the right questions during the process, that team must produce a master list of due diligence requests (riskOptics, 2022).

To conclude, If these risks are not mitigated, the merger will fail and Virgin Australia will be in more serious trouble than today. For a successful merger, the aforementioned risks should be taken into consideration, and dive deeper into how to mitigate these risks, otherwise, the consequences are going to be unbearable.

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