# Report and Analysis of Qantas Airlines Limited

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Please note that throughout this report all monetary figures in Australian dollars will be denoted by the '$' symbol, unless otherwise stated.

## Company Overview

Qantas is an Australian airline group engaged in both short-haul and long-haul operations. Qantas is a well-established player in international air travel, being the third oldest airline in existence. However, as with many older "legacy" carriers, Qantas is facing many challenges in a rapidly changing market environment. The rise of the middle class, combined with the changing needs of consumers has been the stimulus for a new wave of "low-cost carriers" who have taken market share away from their older competitors. Another development in the market that has had a major impact on Qantas and other carriers in the Asia-Pacific region has been the growth of the "ME3" group. This term refers to the 3 Middle Eastern carriers that have transformed the landscape of international travel. The group consists of Qatar Airways, Etihad and Emirates. Therefore, despite the market as a whole growing, increased competition has created a lot of problems for Qantas. The performance of the company over recent years has been poor however an underlying profit before tax of $945 million for the 2015 financial year was recorded earlier this year, which is in stark contrast to the $2.8 billion loss of 2014. It is evident that Qantas is now dedicated to returning to stable profitability and a recent upturn in the value of their shares reflects the increased optimism about the company's future.

## Market Perception

Throughout its history, Qantas has maintained a reputation as a premium, reliable and safe airline. Particularly in its native Australia the "flying kangaroo" is synonymous with a high-quality service. 70% of Australians prefer to use Qantas group brands for domestic travel while 46% prefer them for international travel. Qantas has famously had no fatalities associated with its operations during the jet era and regularly tops rankings of global airlines based on safety. For example a 2015 study by AirlineRatings.com placed Qantas ahead of 448 other airlines[1]. However, some developments in recent years have eroded the reputation of the Qantas brand. For example a 2011 union-organised strike by workers which grounded all of Qantas' planes caused major embarrassment and some to question the reliability of the airline. Airlines are dependent on customer loyalty - particularly regular business travellers who often select one airline as their regular choice for flights. Therefore, a weakening of the airlines brand which causes customers to switch loyalties can have a major impact on the business. Jetstar Airways is a wholly owned subsidiary of Qantas. It allows Qantas to compete with the wave of low-cost carriers that have emerged in recent decades without weakening its own premium brand. This "dual-brand" strategy allows customers to choose between a full-service premium flight or a cheaper basic flight, enabling Qantas to target two very different market segments. Qantas has differentiated itself from its competitors in both its low-cost and premium service. Even throughout the recent cuts to costs across Qantas, investments in customer products remained stable in order to ensure the brand was not permanently weakened. Qantas utilises the Net Promoter Score to gauge customer loyalty. The Net Promoter Score is a modern alternative to traditional customer satisfaction research and has been found to be correlated with revenue growth. Qantas regularly surveys customers on their experience. A panel of approximately 25000 frequent flyers record their NPS every time they fly. In November 2014, following feedback, Qantas launched the "Feels Like Home" campaign in order to emotionally reconnect with Australians. The campaign can be considered a success as 66%

[1] http://www.abc.net.au/news/2015-01-07/qantas-tops-airline-safety-rankings/6005074

of Australians who watched the TV commercial felt more positively about Qantas afterwards. Qantas uses its customers' insights to improve the service it provides and guide progress of its dual-brand strategy. Since 2008 Qantas has further built on its customer image with 2015 ratings for domestic experience, service & product focus and safety at the highest level seen since surveying began. Customers also feel more strongly than ever that Qantas international provides exceptional customer service and a competitive product and that it is a premium full-service airline. On the other hand, the public felt that Jetstar was the leading low-cost carrier and leads its competitors strongly when Net Promoter Scores are compared. Qantas recognises the value of its loyal customers and priority is given to them in instances such as flight disruption. The company has recognised digital media as an increasingly more important way to reach out to consumers. Nearly half of the groups marketing spend is now used for digital channels.

## Business strategy

***Jetstar***

Qantas has capitalised on the growth of the low-cost airline market by the creation of the Jetstar brand. Jetstar is a subsidiary of Qantas. Jetstar has been a successful example of the model, expanding beyond its domestic roots to begin short- and long-haul operations as well as forming partnerships in Asia. This a market with huge potential and Jetstar has wisely selected cost-sensitive markets in Asia in which it believes it can take a share of the market and has partnered with local shareholders. These investments have not involved a large amount of capital investment but have huge potential. While this branch did not return its cost of capital in the first half of the financial year CEO Alan Joyce strongly believes that these capital-light investments will reap the benefits as the Asian airline market grows and, if Joyce is to be believed, becomes the most profitable in the world. The Vietnam and Singapore-based branches are expected to become profitable in the second half of this financial year.

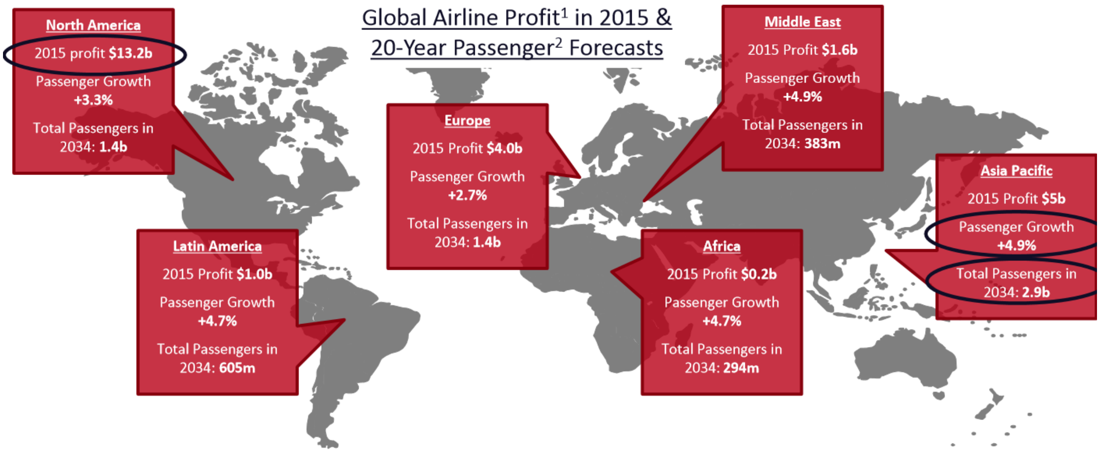
***Asian Market***

Over the coming 20 years analysts expect to see the most growth in passenger numbers in the already important Asia-Pacific market as well as in the more modest South American, African and Middle Eastern markets. This is good news for Qantas which operates primarily in the Asia-Pacific region. GDP growth over the next 20 years in the Asia-Pacific region is forecast to be 290%[2]. This incredible growth will spur an increase in demand for air travel. One recent development that could benefit Qantas is the introduction of a 10-year multiple-entry visa for Chinese tourists wishing to travel to Australia. China is already the greatest source of inbound tourists to Australia and this new visa, coupled with a growing middle class could see many more deciding to visit. If Qantas can convince some of these tourists to travel with them, it would be a boon for the airline[3]. However there have been some negative signs in 2015 which could spell bad news for the Asia-Pacific market. A slowdown in the Chinese economy, upon which many other Asian economies are dependant, has caused the growth of the middle-class to decelerate. This problem is exacerbated by the oversupply of capacity in Southeast Asia which will force airlines to slash fares to compete.

[2] http://www.airbus.com/company/market/forecast/
[3] http://www.abc.net.au/news/2015-06-19/chinese-enthused-about-10-year-visas-for-tourists/6560184

The gulf carriers continue to eat into legacy carrier's market share on long-haul routes in Asia. Etihad's long-haul capacity in Asia (excluding China) increased by a massive 39.7% year-on-year in 2014 and the impressive growth of the ME3 as well as Turkish Airways looks set to continue. As can be seen, the Asian market has great potential and possibilities for Qantas but is also fraught with uncertainty and intense competition.

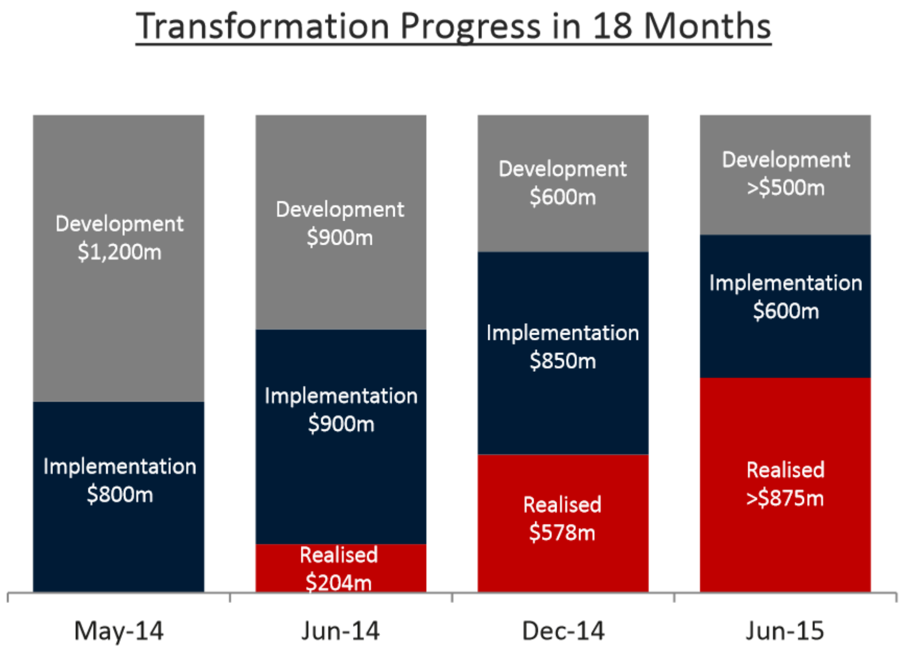
**Figure 1**




## The Qantas Transformation Program

Qantas is currently engaged in a transformative period which involves consolidating the business. Thus far, the scheme has been very successful with the first 18 months seeing a return to profitability. All targets have so far been met or exceeded. This period saw a focus on productivity and consolidation improvements. Consolidation involved a reduction in the size of its workforce by 5000 and the centralisation of operations in one campus. As well as cutting 16% of its workforce, an 18-month pay freeze was also introduced to further curb annual the annual wages bill. In the coming months, the transformation scheme will see a greater shift towards right-sizing and the utilisation of technology such as the "Spend Aware" supplier spend program which aims to reduce the number of suppliers and bring about $30 million worth of benefits by 2017. Other measures included the sale or deferral of purchase of 50 planes and the ditching of life rafts on overland flights to reduce fuel costs. An example of this scheme in action is the Q Catering service. Prior to the transformation, the service had a >10% cost gap in comparison to domestic competitors. The actions taken by Qantas have included matching labour supply to demand, waste reduction, redesigning meals and removing trays. As a result, there is now a 0% cost gap and customer satisfaction of catering services has in fact simultaneously increased by 2.5%. However these early measures are just the start and over the next 3 years, Qantas hopes to have achieved 2 billion dollars in benefits.

**Figure 2**




## Partnerships

Qantas is a founding member of the Oneworld airline alliance. Alliance membership is associated with a number of advantages and pitfalls for carriers. The cooperation between international airlines from different countries enables an expanded network for each member through code-sharing as well as reduced costs as a result of the ability to "share" facilities and staff at airports. Flying with an airline which is a member of an alliance also has numerous perceived advantages for consumers. Miles earned with any Oneworld member can be redeemed with other members and a smoother travel experience can be expected for connecting flights between members. However despite its continued membership of Oneworld, Qantas has in recent years weakened ties with some of its fellow members for strategic reasons. The Australia-Europe market was once dominated by British Airways who connected London and Australia using cities in Asia such as Singapore as stop-offs. However this market has drastically changed since the emergence of the three major Middle Eastern carriers: Emirates, Qatar and Etihad. Qantas has recognised this massive shift in the market and reacted accordingly. Qantas has cancelled its former deal with Oneworld member British Airways and instead turned to Emirates to tap into this market. The advantages are obvious. Whereas, previously, travellers would fly to London, stopping off in Southeast Asia, and then continue on to their desired destination in Europe, people can now fly with Qantas to Dubai and then fly on to a multitude of other destinations in Europe and Africa. The deal helped Qantas to half its large losses on its international routes to $246 million. In October of this year, Qantas confirmed that it was looking at ways to expand its partnership with Emirates such as opening more destinations in Australia up to Emirates and providing them with use of two slots at London Heathrow that will revert to Qantas from British Airways in 2017[1].

Qantas has responded to the changing needs of its clients as conditions change. The once-booming resources industry in Australia has hit a downturn which is expected to last for the coming years. In response, Qantas is now using smaller aircraft on routes serving the mining industry and utilises the larger, more expensive planes on routes serving Singapore and Western Australia, where the performance of the financial and infrastructure industries respectively is stronger[4].

## Fleet Renewal

As a result of its strong recent performance, Qantas has renewed expansions plans which have involved the airline exercising its option to buy 8 Boeing 787 Dreamliners. These aircraft have a very large range and their improved fuel-efficiency will help to reduce Qantas' fuel bill on long-haul flights such as the Melbourne to Dallas route which is currently the longest in the world of any airline. Plans to purchase these dreamliners has been postponed as part of cost-cutting measures but they will now join the fleet in 2017. Furthermore they have another 15 options on 787s from 2017 and 30 purchase rights. The planes will be used to replace older Boeing 747s on routes to South Africa and North and South America. The new planes increased range opens up the possibility of direct flights to European destinations from Western Australia and more flights to north America that don't need to stop in Los Angeles. Qantas is considering this as potentially a long-term plan and will exercise options on more planes if a case can be made for new routes[5].

**Figure 3**


4 http://www.reuters.com/article/2015/10/08/qantas-emiratesairline-idUSL8N1281D620151008#vmtTfkHk3rutDFWK.97
5 http://australianaviation.com.au/2015/08/joyce-says-787-9-represents-hugely-exciting-opportunities-for-qantas/

## Qantas Loyalty

Qantas has a well-regarded frequent flyer programme. This part of its operations is non-cyclical and generates a lot of cash. The programme currently has 10.7 million members. In 2014 the “Aquire” loyalty program for Australian small and medium enterprises was established. This allows business owners and employees to earn rewards for their business as well as for themselves. Points can be earned and redeemed with Qantas as well as a number of partners including Westpac bank and Deloitte. The long history of Qantas’ frequent flyer programme together with the customer information that is gathered in the process has enabled Qantas to set up its new “Red Planet” service. Qantas now realises the value of the detailed customer records it holds to businesses that wish to understand customer behaviour. Over 27 years, Qantas has amassed billions of customer records and transactions which can be overlaid on behavioural data from the online world and give them a unique understanding of their current and potential customers. Businesses can take advantages of Red Planets’ services to target the most suitable customers. It also offers expert analytics and research assistance to companies that require it. Earlier this year Qantas Loyalty also acquired Taylor Fry, an Australian firm that that offers analytics, actuarial, statistical and policy advice to business and government. Qantas Loyalty offers a bespoke service to other businesses to build their own loyalty programmes. The experience they’ve amassed over the years makes Qantas an expert in the field of commercialising loyalty and creating employee reward and recognition schemes. One option suggested by some following major losses was the sale of the loyalty programme as it was valued by some at $3 billion at the time, more than the $2.7 billion market value of the airline[6].

## Industry Comparison

Qantas’ involvement in a number of varied markets ensures that it competes with many other airlines. The Qantas group offers both short-haul and long-haul flights to customers, seeking low-cost or full-service air travel through its dual-brand strategy. In the domestic Australian market, the largest competitor to Qantas is Virgin Australia. There are many similarities between the two companies: Virgin offers short- and long-haul flights and also has a low-cost subsidiary called Tiger Airways. One important distinction between Qantas and Virgin is ownership. As the flag carrier of Australia, Qantas is restricted from having more than 49% foreign ownership. This limit is actually an increase on the previous limit of 25% for a single foreign investor or 35% for another airline. The increase was a compromise between leaving the limits as they were and shelving restrictions completely. Qantas has always maintained that this legislation has disadvantaged it against competitors which can be backed by wealthy foreign investors. Virgin’s main shareholders are Etihad, Air New Zealand and Singapore airways – all of which are government backed. While the government in Australia recognises Qantas’ strategic importance to the nation, it has not always acted in the airlines interest. In 2014 the government rejected Qantas’ plea to guarantee its debt following bad losses. Qantas is also obligated to maintain some aspects of operations, such as maintenance in Australia where labour is costly.  This type of government apathy is in stark contrast to the conditions in which Middle Eastern airlines operate. The governments of the United Arab Emirates and Qatar have acted proactively to

[6] http://www.irishtimes.com/business/transport-and-tourism/slashing-jobs-and-jets-qantas-makes-plea-for-state-aid-1.1706642

stimulate airline growth. They have allowed the airlines to expand and develop their hub airports as they wish and provided them with cheap oil and labour. As earlier noted when discussing the Emirates partnership, the Middle Eastern airlines also have a geographical advantage by being located at the crossroads of Europe, Asia and Africa, a perfect location for the hub-and-spoke long-haul model which they follow.

## Management Criticisms

***Industrial Disputes (2011)***

With the high level Australian wages, Qantas was struggling to limit sizeable expenses in 2011. Qantas announced indeterminate job cuts as a result of rising fuel costs and natural disasters, and refused to negotiate terms with 9000 workers (including long-haul pilots, engineers, baggage handlers, check-in crew, and cleaning staff) who ready to strike for a 4% pay increase as the Transport Workers' Union (TWU) stated[7]. At first, baggage handlers and ground staff walked off the job, with 39 flights delayed by up to an hour and two flights cancelled. However, the damage did not stop there. This eventually resulted in the striking of more than 4000 ground staff, culminating in the decision by Qantas, on 29 October 2011, to lock out those employees (with the consequence that the entire Qantas mainline fleet would be grounded). Qantas said the strike action resulted in at least 80,000 passengers being affected, more than 600 flights cancelled and seven aircraft grounded. The fleet grounding impacted 108 planes at 22 airports, domestically and internationally. The Australian government then intervened, as then Prime Minister, Julia Gillard, requested an urgent meeting at a Fair Work Australia tribunal: "As a result of the dramatic escalation of that dispute the government has taken a rare decision to make application to Fair Work Australia to have the industrial action terminated and have Fair Work Australia deal with this dispute"[8]. Thus, an application by the Federal Minister for Workplace Relations, Fair Work Australia, terminated the industrial action 2 days later. Qantas' rival airlines responded positively to the fleet grounding. Virgin Australia offered stranded passengers a discount on flight fares. Virgin also announced that it would provide an additional 43,000 seats to accommodate Qantas passengers. AirAsia X offered discounted fares for passengers holding a valid Qantas ticket to any AirAsia X destination. According to Qantas, the industrial action by the three labour unions cost the airline $194 million. While this expedited a resolution to the immediate strike action, it did not produce the major workplace reforms Qantas had hoped to achieve. Nor did it impress customers. This weakened the brand of Qantas, as even loyal customers were lost to rival airlines with many questioning the reliability of the carrier, and the competencies of the carrier’s senior management.

***Waiting Times (2013)***

Although, as previously mentioned, Qantas prides itself on customer satisfaction and adhering to its customers’ requests, the company and management was subject to much criticism after a schedule issue caused huge uproar among even loyal customers of the airline. Qantas made a decision to abandon its traditional route from Australia to Europe via Singapore in favour of stopping off in Dubai's International Airport instead, as part of the new Qantas/Emirates alliance, in March of 2013. This decision led to many travellers left

[7] http://www.afr.com/news/policy/industrial-relations/fedtimeline-of-qantas-industrial-dispute-20111031-j3v00
[8] https://en.wikipedia.org/wiki/2011_Qantas_industrial_disputes

waiting for a connection in Dubai for up to 10 hours. A dilemma for Qantas was that its flights from Sydney and Melbourne arrived in Dubai about midnight, but most Emirates flights from Dubai to Europe departed between 7am and 10am. Passengers faced a stark choice: either fly on a Qantas aircraft and wait in Dubai for several hours, or take the Emirates flights that depart Melbourne and Sydney in the evening and arrive in Dubai around 5am, with a shorter layover time before connecting. This second proposition, which seems to make more sense, threatened to erode Qantas's slice of the Australia-Dubai pie. In order to soften the blow for its passengers who faced long delays between connecting flights, Qantas introduced "Dubai Connect", a service that had already been offered by Emirates[9]. If an economy or premium economy passenger faces a delay of eight to 24 hours in Dubai, Qantas will provide complimentary hotel accommodation, transfers, meals and visa fees (and for business- class and first-class passengers, the figures are six to 24 hours). However, this did not solve the problem. A source from a rival carrier said that more and more travellers were switching to Gulf airlines because of the convenience of transiting through Dubai, Abu Dhabi and Qatar. The extent of customers' frustration with the operation can be seen in the 1.2/5 star rating (on 81 reviews) this particular service received on the review website consumeraffairs.com[10]. Qantas has slightly improved the efficiency of this operation since, slashing the layover time. However, both customers, and investors alike had much unrest regarding management's slow reaction to this evident issue.

### *Qantas' Credit Problem (2014)*

In June of last year, Qantas was facing serious financial difficulties, as it laid off 5,000 Qantas employees with the company looking for $2 billion in savings. Qantas CEO Alan Joyce complained that Qantas was under pressure in the domestic travel market from foreign "government-backed" competitor Virgin Australia[11]. It is fair to say the company was and still is at a disadvantage to Virgin Australia, in the way that it cannot wholly benefit from wealthy foreign investors that would provide financing even when profits are low, especially in a capital-intensive airline industry. The reason for this being the restriction that foreign investors cannot own more than 49% of the company's shares. However, Mr. Joyce sought a debt guarantee which would provide the airline with millions of dollars' worth of tangible benefits by way of cheaper credit, simultaneously putting billions of dollars of taxpayers' money potentially at risk. Founder of the Virgin group, Richard Branson stated that "Qantas has gone to its shareholders on numerous occasions over the last few years to wage its capacity war against us. Now that shareholders have turned that tap off, the company is turning to the Australian taxpayer to try and bail it out." In response, the government maintained that if the taxpayers of Singapore, New Zealand, and the United Arab Emirates want to continue to subsidise the airfares of Australian consumers, frankly that is a matter for them. Australian consumers had been the beneficiaries of this increased competition. Ultimately, the government dashed Qantas' pleas since the trouble with any bailout package is that it discourages companies from being competitive by rewarding inefficiency and loss-making behaviour. In the long run, companies become dependent on corporate welfare, and the vicious cycle continues until eventually a decision is made to turn off life support. This lead to the wide criticism of company's senior management, directed at the carrier's poor strategy and subsequent calls for the Australian government to solve its credit problems.

[9] http://www.traveller.com.au/qantas-travellers-could-be-left-waiting-in-the-wings-2ewrc
[10] http://www.consumeraffairs.com/travel/qantas.html
[11] http://www.theguardian.com/commentisfree/2014/feb/28/qantas-needs-to-grow-up-a-bailout-wont-solve-its-problems

## Carbon Tax

Despite having one of the highest per-capita greenhouse gas emission rates in the world[12], Australia's Senate voted to repeal the carbon tax in an effort to boost the economy's activity, and cut energy prices. This was a levy on the biggest polluters passed by the previous Labour government. As an airline, the tax bill from this levy was huge. Thus, Qantas said the repeal of the carbon tax was significant factor in the underlying profit result in 2015, adding $59 million[13] of the total underlying profit ($367 million). This can be seen to some degree in the marked decrease of the company's effective tax rate from 81.8% in 2013 to 29% in 2015, despite EBITDA increasing by only 26% over that same period.

## Fuel Costs

The second largest cost for the carrier (after human capital) is fuel costs. Many investors have cited the remarkable decline in global oil prices as the reason for Qantas' return to profitability in for the 2015 financial year. Fuel costs decreased from $4.5 billion in 2014 to $3.9 billion in 2015, and yet still accounted for 30% of operating costs.

**Figure 4**

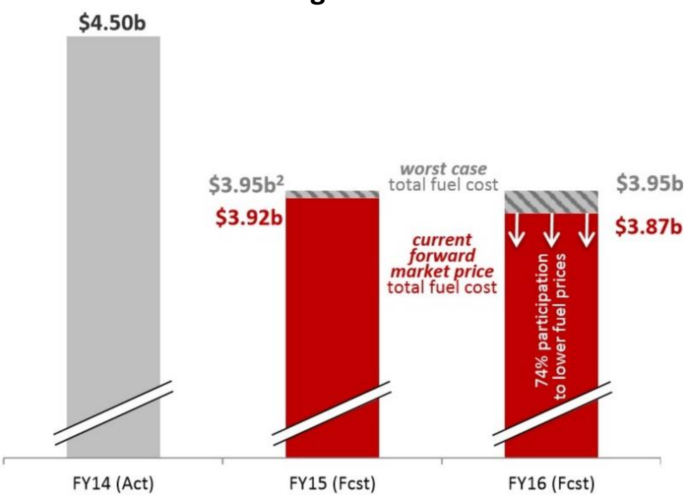

The price of a barrel of oil has been cut roughly in half since June 2014 (see Figure 4), reaching levels last seen during the depths of the 2009 recession. Prices have recovered a few times this year, but executives think it will be years before oil returns to US$90 or US$100 a barrel[14], which were roughly the average prices over the last decade. Why has oil prices plummeted? Well, save for the intrinsic volatility of the oil market, it boils down to the simple economics of supply and demand. Every major producer that has been able to up production has done just that, with several hitting record output levels. United States domestic production has nearly doubled over the last six years, leasing to lessening oil imports. Saudi, Nigerian and Algerian oil that once was sold in the United States is suddenly competing for Asian markets, and the producers are forced to drop prices. Canadian and Iraqi oil production and exports are rising year after year. Even Russia, with all their economic problems, manage to keep pumping. On the demand side, the economies of

[12] http://www.bbc.com/news/world-asia-28339663
[13] http://www.sbs.com.au/news/article/2015/02/26/axed-carbon-tax-aids-qantas-profits
[14] http://www.nytimes.com/interactive/2015/business/energy-environment/oil-prices.html?_r=0

Europe and developing countries are weakening and vehicles are becoming more energy-efficient. So the demand for fuel is slightly lagging. China's recent devaluation of its currency suggests the economy of the world's biggest oil importer may be worse off than expected. A big reason why oil prices are plummeting (according to analysts) is the continuing unwillingness of OPEC, a cartel of oil producers, to intervene to stabilize markets that are widely viewed as oversupplied. Will the worm ever turn?  Yes, this is a commodity market, after all, and oil is a classic boom-and-bust industry, but the general consensus is clear: fuel prices will remain relatively low for the next year or two, since oil production is not declining fast enough in an oversupplied market.

Conversely, the company has protected itself against the possible revival of oil prices. Qantas has hedged through options 98% of their fuel costs for the 2016 financial year which provide a cap should oil prices rise (see Figure 5). They also have a participation rate of 72% for the 2016 financial year, since they can opt out of these contracts to reap benefits from falling oil prices, if such is the case. (As we can see in Figure 5, the company have cited its worst case fuel cost for 2016, given such hedging, to be $3.95 billion, which is on par with the fuel costs of the 2015 financial year, and so is promising.)

**Figure 5**




Also, the company has been putting a huge focus on improving fuel usage efficiency with its Qantas Group Fuel Optimisation Program, which reduced fuel consumption by 38 million tonnes in the last year.

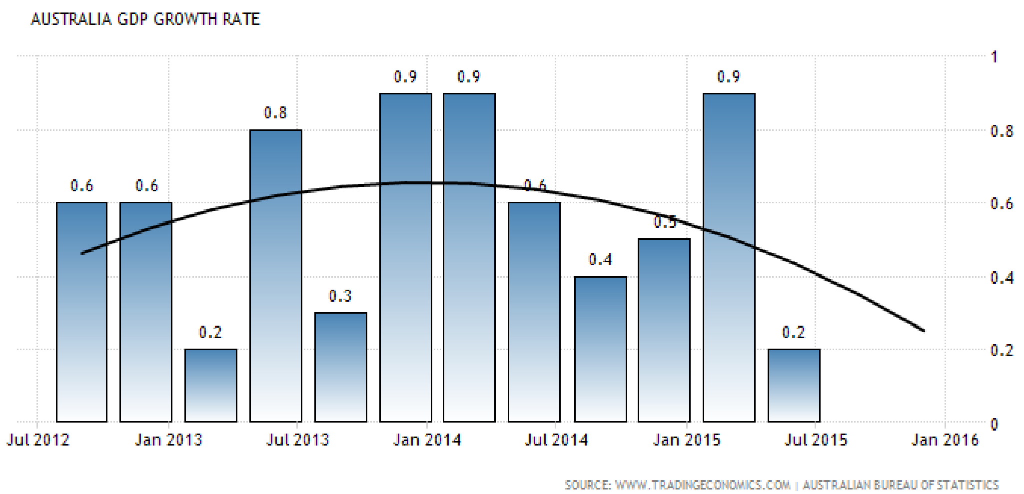
Finally, we note that since the 2009 financial year, Qantas has had more than 140 new aircraft while retiring more than 80. This has brought the average age of its fleet down to 7.7 years - the lowest it’s been for more than 20 years and significantly younger than the averages in North America, Europe or Asia Pacific. Furthermore, over the next 10 years, Qantas has committed capital investment worth around US$17 billion in next generation aircraft, such as the Airbus A380, Boeing 787 Dreamliner and Airbus A320 neo. This fleet renewal will offer the benefits to fuel efficiency in the immediate future and in the long run, with newer models of aircraft much less taxing on fuel usage. What’s more, the carrier has recently been prioritising aircraft fuel efficiency over capacity, purchasing aircraft with smaller capacity per plane but longer operating ranges and lower operating costs. An example of this being the taking over of many routes by the smaller Boeing 737s. (In fact, fuel efficiency is improving so much so that in November of this year Qantas revealed it was considering launching nonstop flights between Australia and Europe by 2017, including a Perth-to-London route, using the eight new Boeing 787-9 aircraft it has ordered to replace its 747s. )

Recently, Qantas has said it expects fuel costs for the six months to December of this year to be $1.76 billion, down almost 20% on the $2.16 billion for the previous half. The full year's fuel bill is expected to be between $3.61 billion[15]. This bodes well for the near future of Qantas' operating profits and operating cash flows. These are needed to service the company's long-term debt of $5.56 billion, and to finance the company's high capital costs (as fleets need to be continually upgraded and planes need to be maintained). Furthermore, increased cash flows enhances the carrier's ability to pay dividends to its shareholders.

## Economic Outlook

Many have cited the reasons to the $1.6 billion turnaround in Qantas' underlying earnings (in the 2015 financial year) to be related to a number of external factors such as lower fuel prices and the removal of the carbon tax, alongside the airline's cost-cutting program. However, some, including CEO, Alan Joyce have mentioned the performance of the Australian Dollar and Australian economy as a contributing factor.

**Figure 6**

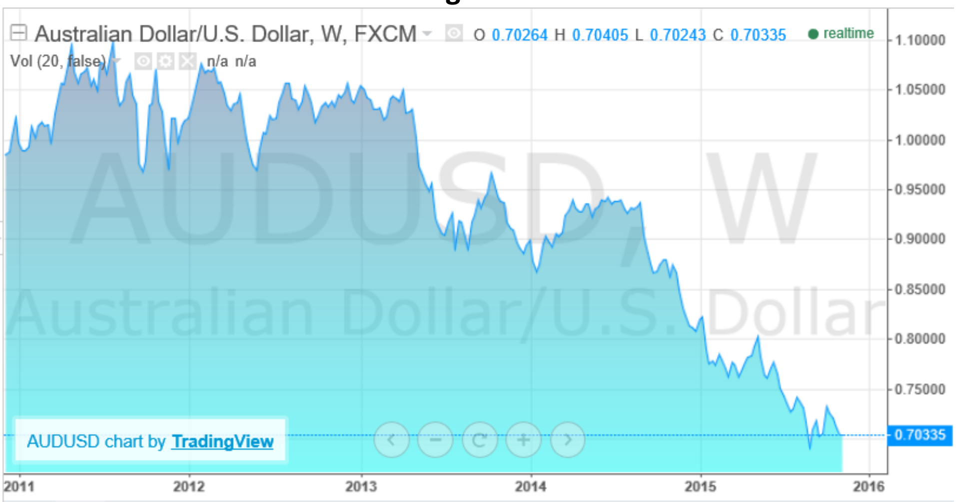



The Australian economy performed adequately over the 2015 which lead to more domestic business as Australians were keen on holidays given the expendable income. Although, the Australian economy is slowing. Australia's GDP grew at feeble 0.2 % in the second quarter of this year, the slowest rate in more than two years, and is expected to further decline (see Figure 6). Real net disposable income slid 1.2% in the biggest drop in standards of living since the global financial crisis[16]. Poor productivity, low profits and the largest fall in trade in 50 years are some of the many reasons for this performance. In particular, the contraction

[15] http://www.fool.com.au/2015/10/23/qantas-airways-limited-shareholders-will-go-nuts-over-this/
[16] http://www.news.com.au/finance/economy/australias-economy-has-slowed-to-a-crawl-prompting-fears-we-may-be-slipping-into-a-recession/story-fnu2pwk8-1227511065914

in retail sales in July, sharp declines in equity markets and a tightening in financial conditions do not bode well for the immediate future of the economy. Australia's dependence on China (as its largest export market) has left the country in a vulnerable place. China's underperforming economy has led to a sharp decline in its demand for Australia's minerals. This can be seen in Australia's terms of trade — which measures export prices against import prices — as it fell 10.6% over the last financial year[17]. With the fastest-growing net debt in the developed world and a shrinking federal budget, the outlook for the economy is dim, especially when considering the government's limited responses – given that interest rates are already at record low levels. In fact, according to respected economist and former Reserve Bank board member Warwick Mc Kibbin, there is a 50% chance Australia will slide into recession in the coming year[18], despite going the last 25 years without one. While investment bank, Goldman Sachs is warning that Australia faces a one-in-three chance of a recession in the coming year[19]. This does not auger well for Qantas' domestic market, as its Australian customer base may switch to the lower-cost carriers, given their depleted expendable income. With Qantas Domestic reported a $480 million underlying EBIT for the 2015 financial year, the most of all its segments, this threatens Qantas in an area where it derives so much of its profits.

**Figure 7**




Also, as Figure 7 shows, during the period from June 2014 to June 2015, the value of the Australian dollar declined immensely. This helped Qantas' 2015 profits, since a lower dollar made Australia more affordable for overseas visitors, leading to an increase in inbound passengers. The Australian Dollar is forecasted to decline further in the next year or two, in order to increase exports, to help support the economy in its downturn. This bodes well for Qantas, since the value of its domestic currency affects the costs associated with major inputs such as fuel, revenues generated in foreign currency, and the value of its asset base. Also, this is comforting news for Qantas' international efforts, which has been by the far the least profitable segment of its group, with tough competition coming from the 3 Middle Eastern airline powers. (Qantas international reported losses of $497 million for the 2014 financial year, the most of all segments.)

[17] http://www.tradingeconomics.com/australia/terms-of-trade
[18] http://www.smh.com.au/business/the-economy/economist-warwick-mckibbin-puts-risk-of-recession-at-50-per-cent-20150904-gjffwv
[19] http://www.abc.net.au/news/2015-09-11/goldman-sachs-warns-of-recesssion/6769186

## Profitability

**Figure 8**

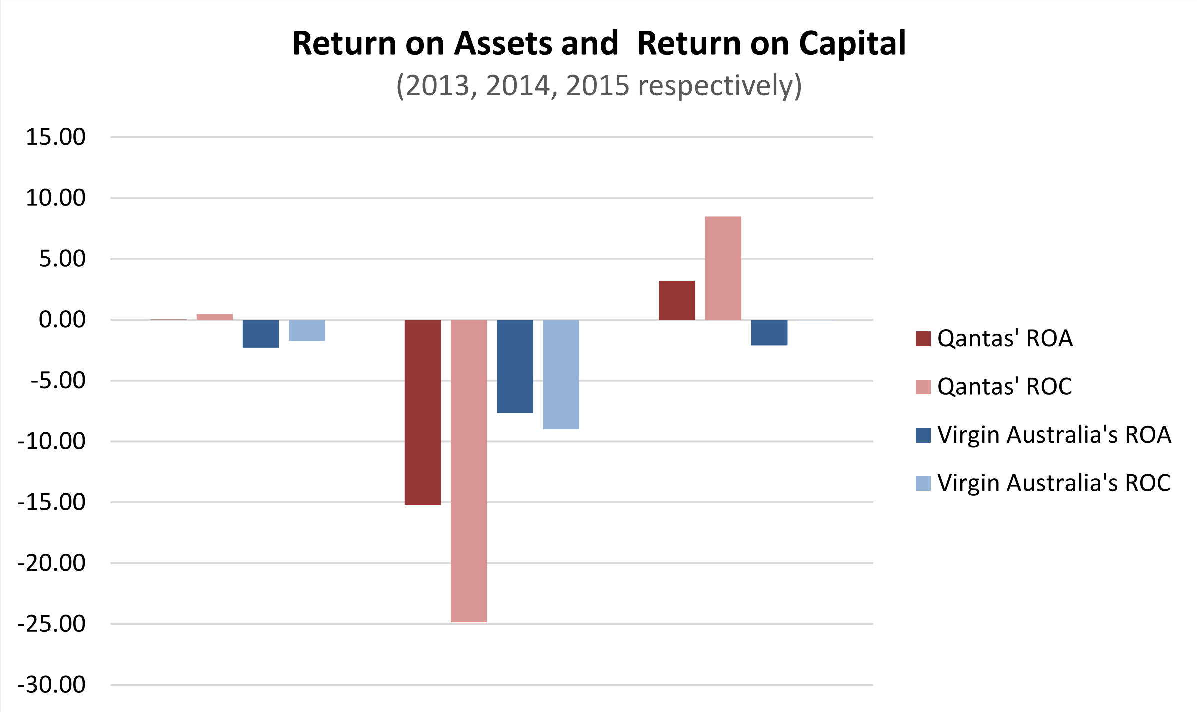
| Qantas | | | Profitability Ratios[20] | Virgin Australia | | | Cathay | | |
|---|---|---|---|---|---|---|---|---|---|
| 2013 | 2014 | 2015 | | 2013 | 2014 | 2015 | 2013 | 2014 | 2015 |
| 14.6m | 14.2m | 14.6m | Revenue ($) | 4.0m | 4.3m | 4.7m | 13.4m | 15.2m | 16.4m |
| 2.41 | -5.35 | 8.07 | Operating Margin (%) | -4.11 | -6.80 | -1.10 | 5.19 | 4.92 | 5.41 |
| 0.46 | -24.85 | 8.47 | Return on Capital (%) | -1.74 | -8.99 | -0.02 | 3.01 | 3.53 | 4.71 |
| 0.08 | -64.53 | 17.67 | Return on Equity (%) | - | - | - | 4.36 | 5.5 | 8.26 |
| 0.00 | -15.22 | 3.20 | Return on Assets (%) | -2.30 | -7.67 | -2.12 | 1.58 | 1.82 | 2.80 |

Profitability is of primary concern to investors as an indicator of the allocation and management of financial resources within the company to achieve the intention of serving the vested interests of shareholders. Since all of Qantas' probability figures given in the table in Figure 8 follow a similar trend (see Figure 9), we will address this in general. The trend is that all of the figures have increased since 2013 (most by a substantial margin), and experience a considerable dip in 2014 (where all the profitability ratios are negative). There are many reasons for this dip. Qantas' got dragged into a domestic price and capacity war with Virgin Australia, which left both battered and bruised in the balance sheet. This explains a lot of the $400 million fall in revenue, driven by a 3% decline in net passenger revenue and an 11% in other revenue. Also, Qantas' operated on many unprofitable routes where some planes flying practically empty. Furthermore, Qantas' international exploits were unimpressive as it recorded underlying losses of $497 million, as the airline lost business to the middle-eastern powers. Its subsidiary Jetstar performed poorly with an underlying loss of $116 million, as it bled money on both its domestic and international operations, and was failing to keep pace with innovations in the low cost sector, particularly given the intense competitive environment in both domestic Australia and South East Asia. As well as that, an increase in fuel prices from 2013 to 2014 cost the carrier an extra $253 million (6% increase from previous year). Finally, Qantas wrote down the value of its international fleet by $2.6 billion.

However, as we know, things improved mightily. What were the reasons for this? Firstly, oil prices remarkably halved in price, which paired with the airline's range most fuel efficient aircraft improved the carrier's fuel costs by $600 million. A lower Australian dollar helped Qantas' struggling international business. A strong Australian economy improved Qantas' domestic exploits. A domestic revival was helped through an unwritten truce between Qantas and Virgin Australia, where Virgin Australia have now "up-market" by providing "complimentary" in-flight entertainment and meals, and thus, operating on Qantas' terms. The repeal of the carbon tax had a difference of $59 million, and finally, the CEO implemented the start of the famous "transformation program." This was where the airline cut 16% of its workforce (5000 employees), and engaged in a pay-freeze to curb high Australian wages. This is projected to accumulate savings of at least $2 billion in total upon completion in 6 months.

[20] Figures for Qantas and Virgin Australia are for the financial year ending 31/06/13, 31/06/14 and 31/06/15 whereas figures for Cathay are for the financial year ending 31/12/13, 31/12/14 and the trailing 12 months from 31/06/12

**Figure 9**




Now that we have explained the trend, let's analyse the current profitability of the airline. Evidently, despite Qantas' operating profit margin being healthier than Virgin Australia's and Cathay's, at 8.07%, it is more than half the industry average (19.45%). This does not bode well for the retention of profits. Subsequently, as a healthy operating profit is of pivotal importance in ensuring the ability of the company to repay interest and associated debt expenses it is not desirable for the operating margin to continue at this level, particularly when the company is engaged in a capital-intensive industry and has $5.56 billion in debts on the books, which will exert more pressure.

Conversely, both potential and existing investors would be certainly pleased with Qantas' return on equity and return on capital for 2015, at 17.67% and 8.47% respectively, towering over that of Virgin Australia's dire profitability returns. This indicates that management have employed equity and capital (to a much lesser extent) efficiently in operations. The return on assets at 3.2% is above those of Virgin Australia's and Cathay's, however, lies below the industry average of 4%. Although, we must note that payment of $1 billion in debt had an effect on this. With that said, we would suggest that Qantas review their strategic asset employment policy to maximise efficiency in the utilisation of company assets.

## Liquidity

**Figure 10**

| Qantas | | | Liquidity Ratios[21] | Virgin Australia | | | Cathay | | |
|---|---|---|---|---|---|---|---|---|---|
| 2013 | 2014 | 2015 | | 2013 | 2014 | 2015 | 2013 | 2014 | 2015 |
| 0.75 | 0.66 | 0.68 | Current Ratio | 0.54 | 0.64 | 0.69 | 0.85 | 0.73 | 0.69 |
| 0.56 | 0.50 | 0.48 | Quick Ratio | 0.40 | 0.49 | 0.52 | 0.70 | 0.58 | 0.51 |
| 0.43 | 0.40 | 0.39 | Cash Ratio | 0.32 | 0.41 | 0.45 | 0.59 | 0.46 | 0.39 |

In short, liquidity is a measure of the extent to which a company has cash to meet its immediate and short-term obligations, or assets that can be quickly converted to do this. Therefore, it is of upmost importance to investors, as even highly profitable companies can fall into much difficulty if they do not position themselves to be able to meet any short-term obligations that may fall due. This is particularly the case in the airline industry, where carriers are subject to huge costs, including human capital and fuel, yet simultaneously require huge amounts of capital to provide constant investment to upgrade and maintain fleet.

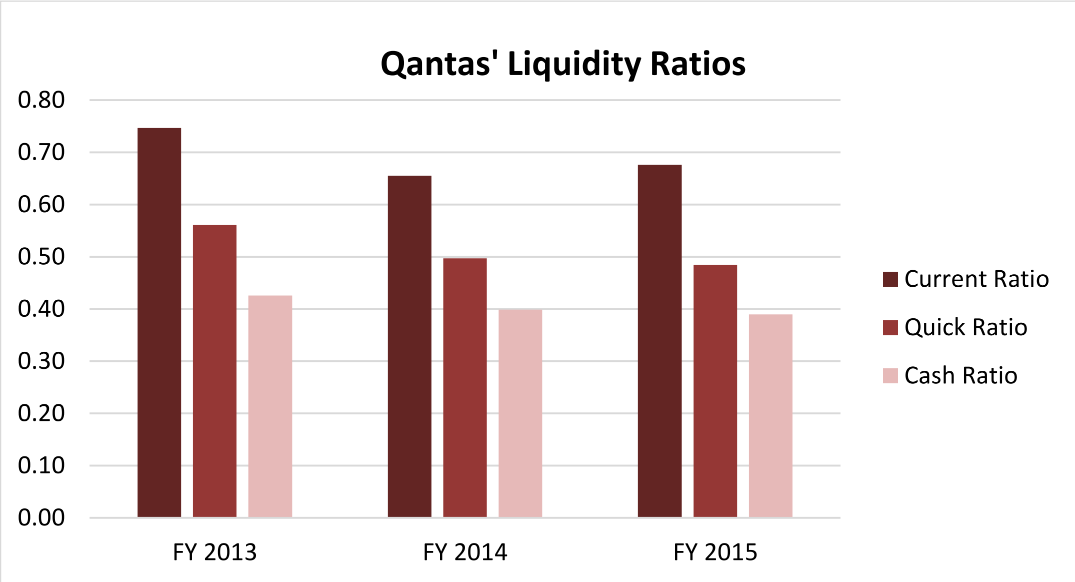
Due to the nature of the airline industry and the predominantly tertiary nature of the undertakings in the sector, retention of large volumes of inventories or many trade receivables tends not to be of considerable magnitude in these carriers. Consequently, as observed in Figure 10, there is rarely a significant difference between the current, quick and cash ratio for the airlines, whose primary inputs are centred about human capital (pilots, baggage carriers, cabin crew, engineers, service desk, cleaners, and so on).

Both the current and quick ratios demonstrate disimprovements over the period under examination indicating that cash resource allocation within the operation is trending away from optimal. The current ratio considerably deviates from the ideal 2:1 in 2015, at 0.68. Equally, whilst the quick ratio is slightly outperforming the airline average of 0.34, at 0.48, it is considerably behind the benchmark 1:1. What is more concerning is the clear downward trend since 2013, where the current ratio, quick ratio, and cash ratio have all declined by 9%, 12.5% and 9% respectively (see Figure 11). We understand that the carrier has recently used its extra cash flows to finance the purchase of new fleet members, return $505 million in dividends to shareholders, and most of all, pay $1 billion in net debts, over the last year. However, we note that the carrier's unavoidable liquidity problems in 2014 forced a cut in its capital expenditure to the value of $1 billion, which some attribute as a major reason why the company's had so much extra cash flows in 2015. These problems also sparked the company's plea to the Australian government for a debt guarantee, along with the 5000 job cuts that Qantas endured in order to provide a much needed influx of cashflow to service its operating activities. We appreciate the company's positive approach to cash resource allocation that ensure excessive cash balances are not being retained by the company at the expense of expansion. However, the carrier should really tread carefully in finding a balance whereby there is enough investment for expansion, but also enough liquid assets available to pay any short term obligations that fall due – even if the airline, or industry were to descend into a period of unprofitability. The airline industry is intertwined with risk, with the

[21] Figures for Qantas and Virgin Australia are for the financial year ending 31/06/13, 31/06/14 and 31/06/15 whereas figures for Cathay are for the financial year ending 31/12/13, 31/12/14 and the trailing 12 months from 31/06/12

possibility of natural disasters, terrorist attacks and accidents never far away. This, combined with the volatility of fuel prices and the pressure of high Australian wages (relative to its international competitors) indicate the importance for Qantas to keep liquid assets at hand to protect itself for unfortunate circumstances. We consider too the $5.56 billion in debt that burdens the company with substantial annual interest payments. Therefore, should the decreasing trend in liquidity ratios persist, Qantas will have difficulty making repayments as they fall due in the short term, which will in turn, endanger the carrier’s ability to pay dividends to its shareholders, and the company’s profitability situation going forward.

**Figure 11**




The liquidation situation of Qantas, mirrors that of its international counterparts, with many airlines ploughing its cash flows into more fuel efficient aircraft to be able to combat and counteract the high oil prices when they return. Cathay is an example of this, as its current ratio, quick ratio and cash ratio have all declined since 2013 by 19%, 29% and 34%, to around the same marks as Qantas in 2015. In an ultra-competitive industry, most carriers employ an aggressive approach to expansion, as they are desperate to improve quicker so as to catch a share of the market.

With that said, we consider Virgin Australia’s liquidity situation. In contrast, despite efforts to upgrade its fleet, the carrier’s liquidity position has been enhanced. The company has achieved this through a better cash resource allocation strategy and mainly by raising $350 million in capital in 2013 to boost its cash flows. This combined with the benefits from downturn in oil prices and repeal of the carbon tax, have culminated in an advantageous liquidity position. The carrier’s current ratio, quick ratio and cash ratio have all improved by 26%, 30% and 41% from 2013. They have landed on marks similar to Qantas, even with these remarkable inclines, which highlight the difficulty for an airline to maintain a comfortable liquidity situation given the competitiveness of the industry.

# Efficiency

**Figure 12**

| Qantas | | | **Efficiency Ratios**[22] | Virgin Australia | | | Cathay | | |
|---|---|---|---|---|---|---|---|---|---|
| 2013 | 2014 | 2015 | | 2013 | 2014 | 2015 | 2013 | 2014 | 2015 |
| 29.23 | 31.70 | 25.32 | Receivables Days | 15.77 | 17.52 | 17.80 | 27.87 | 18.85 | 19.86 |
| 32.86 | 30.44 | 29.71 | Payables Days | 172.63 | 179.81 | 200.42 | 130.71 | 87.92 | 144.49 |
| - | - | - | Inventory Days | - | - | - | - | - | - |

The efficiency metrics are indicative of the management of resources within the company, and are a reflection of management efficiency in the allocation and supervision of resources employed. Despite receivables days in 2015 being more than the industry average (of 16 days) at 25.32 days, this has successful improved by 13.4% from 2013 and 20.1% in the last 12 months. This ratio indicates a successful credit policy implementation ensuring timely collection of debtors amounts outstanding and thus, simultaneously avoiding sustained periods of credit extension where no interest is being earned. In addition, payables days have decreased 0.73 days in the last 12 months and 3.15 days since 2013. At 29.71 days, this is below the industry average. Although, this is somewhat counteracted by the fact that Qantas' trade payables decreased by 10.3% in the last 12 months. Yet, this signals Qantas' ability to remunerate creditors quickly, thus giving suppliers confidence in commercial transactions with the corporation. However, given that the receivables days are less than the payables days by 4.39 days, investors should have slight concerns in the company collecting enough off its debtors to meet its creditors' obligations, and thus inhibiting the carrier's ability to pay dividends to its shareholders. Moreover, this is especially the case as Qantas does not have a perfect liquidity standing at present. Hence, going forward it would be advisable to curtail this decreasing payables collection period moderately, or preferably, seek to decrease their receivables collection period, by shortening their credit period with customers.

Also, we can see that Qantas' is taking longer to collect off its debtors than its domestic rival Virgin Australia. Despite its improvement, Virgin Australia's liquidity position has not been comfortable. It is, thus, not surprising than Virgin Australia's trade payables days are nearly 7 times that of Qantas' and have declined by 16.1% since 2013. This indicates that the company is struggling to remunerate its creditors. The implication of this is positive for Qantas. This problem could culminate in depleting Virgin Australia's cash flows, and subsequently diminishing its ability for capital expenditure. In this, a capital-intensive industry, Qantas would then occupy a dominant position in its domestic market. Additionally, the situation is very similar, but to a lesser extent, when considering Qantas' international rival, Cathay. Although Qantas' international competition is strong, and the company would prefer to further improve its efficiency, this is certainly a positive sign going forward.

[22] Figures for Qantas and Virgin Australia are for the financial year ending 31/06/13, 31/06/14 and 31/06/15 whereas figures for Cathay are for the financial year ending 31/12/13, 31/12/14 and the trailing 12 months from 31/06/12

## Gearing

**Figure 13**

| Qantas | | | Gearing Ratios[23] | Virgin Australia | | | Cathay | | |
|---|---|---|---|---|---|---|---|---|---|
| 2013 | 2014 | 2015 | | 2013 | 2014 | 2015 | 2013 | 2014 | 2015 |
| 0.88 | 1.84 | 1.39 | Debt-Equity Ratio | 1.46 | 1.52 | 2.16 | 0.9 | 1.07 | 0.96 |
| 46.8 | 64.8 | 53.2 | Debt-Equity Percentage (%) | 59.3 | 60.3 | 68.4 | 47.4 | 51.7 | 49.0 |
| 1.06 | 12.90 | 3.26 | Interest Cover | -1.29 | -3.04 | -0.23 | 4.24 | 4.5 | 6.71 |

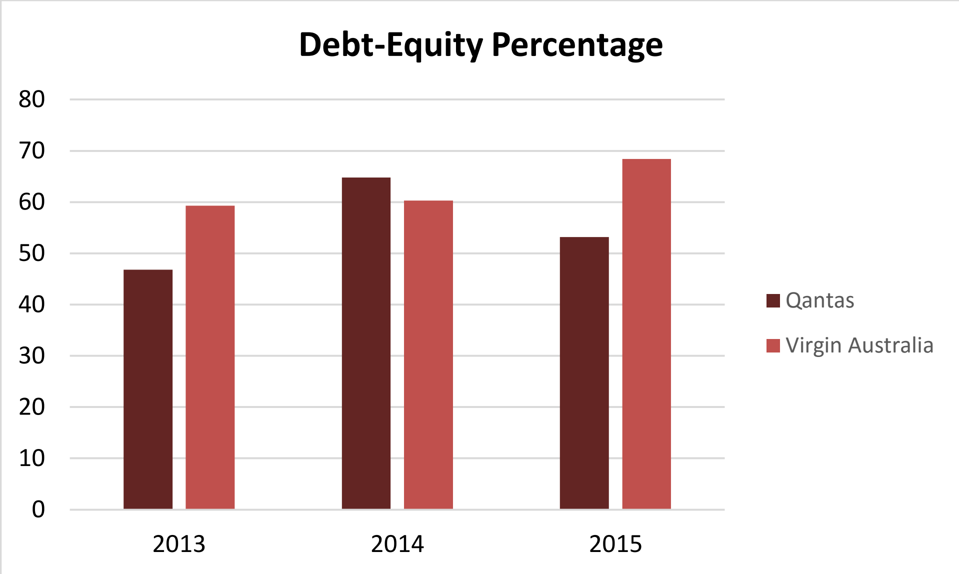
Gearing is a measure of a company's financial leverage and shows the extent to which its operations are funded by lenders versus shareholders. In general, a company with excessive leverage, as demonstrated by its high gearing ratio, may be more vulnerable to economic downturns. This is because it has to make interest payments and service its debt through cash flows that may be significantly lower due to the downturn. The flipside of this argument is that leverage works well during good times, since all the excess cash flows accrue to shareholders once the debt service payments have been made[24].

Qantas have $4.71 billion in long term debt, which accounts for 84.7% of the $5.56 billion in total debt the airline have incurred. The debt-equity percentage was inflated to 64.8% in 2014 (see Figure 14), after the carrier had to raise $400 million in debt, in order to provide an injection of cash flow that would help keep its liquidity situation afloat amongst underlying losses of $273 million. However, the airline's interest cover shot up by 1220% to 12.90, from 2013 to 2014. This reveals that the carrier's probability situation wasn't as bad as it had initially seemed. In fact, despite a net loss of $2.843 billion, the carrier had wrote down the value of its international fleet by $2.6 billion. Subsequently the debt-equity percentage has improved significantly (by 11.6 percentage points) over the last 12 months because Qantas has paid off $1 billion in debt using its improved net free cash flows (which amounted to $1.1 billion). (These free cash flows stemmed from the company's decision to cut capital expenditure by $1 billion and upturn in financial performance.) This remarkable decline highlights Qantas' strategic approach to credit management and their efficient utilization of revenue generated from operations to offset debt obligations. Qantas' debt-equity percentage is below the industry average (55%), and in particular, is much more favourable than domestic rival, Virgin Australia's (with a difference of 15.2 percentage points). However, Qantas has incurred significantly more debt than Virgin Australia, with 3.3 times as much in 2014 and over 2 times as much currently. This heightens the importance of the interest cover ratio. Worryingly, the interest cover dropped by 74.7% to 3.26, which is concerning despite interest payments increasing by 24.8% due to the $400 million raised in 2014. With $5.56 billion in debt, the interest payments are substantial and thus, it would be preferable if Qantas could improve on its interest coverage. This will be made easier with an expected decrease in interest payments next year (as a result of the $1 billion in debt paid off this year). However, if Qantas' interest cover slips more, the company runs the risk of its interest payments sapping much of its operating profits, which in turn endangers the airline's liquidity position and ability to pay dividends. This is especially perturbing for

[23] Figures for Qantas and Virgin Australia are for the financial year ending 31/06/13, 31/06/14 and 31/06/15 whereas figures for Cathay are for the financial year ending 31/12/13, 31/12/14 and the trailing 12 months from 31/06/12
[24] http://www.investopedia.com/terms/g/gearing.asp

investors when considering the dim outlook of the Australian economy, and the conceivable possibility of a recession.

**Figure 14**



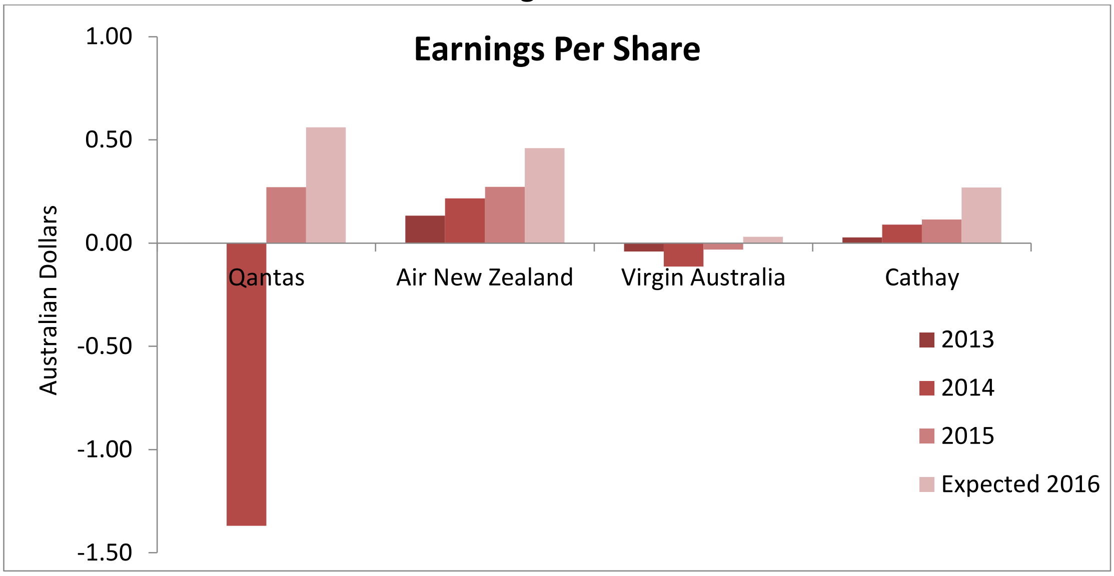

In comparison with its rivals, Qantas' debt-equity percentage is measures well. In what is a capital-intensive industry, airlines have to often raise huge amounts of debt, especially if they do not have the benefit of wealthy foreign investors. This makes Qantas' percentage all the more impressive. We note that Virgin Australia's debt-equity percentage climbed by 8.1 percentage points to 68.4%. This is as a result of the carrier's decision to raise US$300 million through unsecured notes issue, as it scrambled for liquidity coverage following the price and capacity war with Qantas. (The company also raised $350 million through a capital raising supported by three of its alliance partners Singapore Airlines, Air New Zealand and Etihad Airways. Add to this the $336 million the carrier also received from the sale of its 35 per cent stake in the Velocity frequent flyer program to Affinity Partners[25]). Also, despite an improvement of 92.4%, Virgin Australia's interest cover ratio is alarming, at -0.23. If Virgin Australia continues in this vain, then interest payments will diminish any operating profits, and consequently weaken the carrier's ability to compete with Qantas, in all facets, especially prices.

Qantas' credit rating is Ba1 positive outlook by Moody's and BB+ stable by Standard and Poor's, who said that was not likely to be raised for at least the next 12 to 18 months. "We don't forecast a demand-led recovery," S&P credit analyst Graeme Ferguson said. "However we do believe that lower fuel prices, the more benign domestic market conditions and the lower Australian dollar should translate into improved metrics for the airline."

[25] http://Australianaviation.com.au/2014/11/virgin-raises-us300-million-through-us-notes-issue/

## Investment Ratios

**Figure 15**




Earnings per Share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock, and serves as an indicator of a company's profitability. If we look at Qantas' EPS, considering that they are the largest airline in Australia, they haven't done too well. Qantas made a considerable loss in 2014, prompting Alan Joyce (Qantas CEO) to take action in order to turn the company's fortunes around, with the transformation program. For the 2015 financial year, the airline did quite well with an EPS on par with Air New Zealand at 27 Australian cents per share. With profits expected to increase, we can see that Qantas has high expectations for EPS for the 2016 financial year. Qantas has clearly set its sights on overtaking its regional rivals. If the shareholders continue incur a cost of equity of 8.8% then Qantas must increase its EPS.

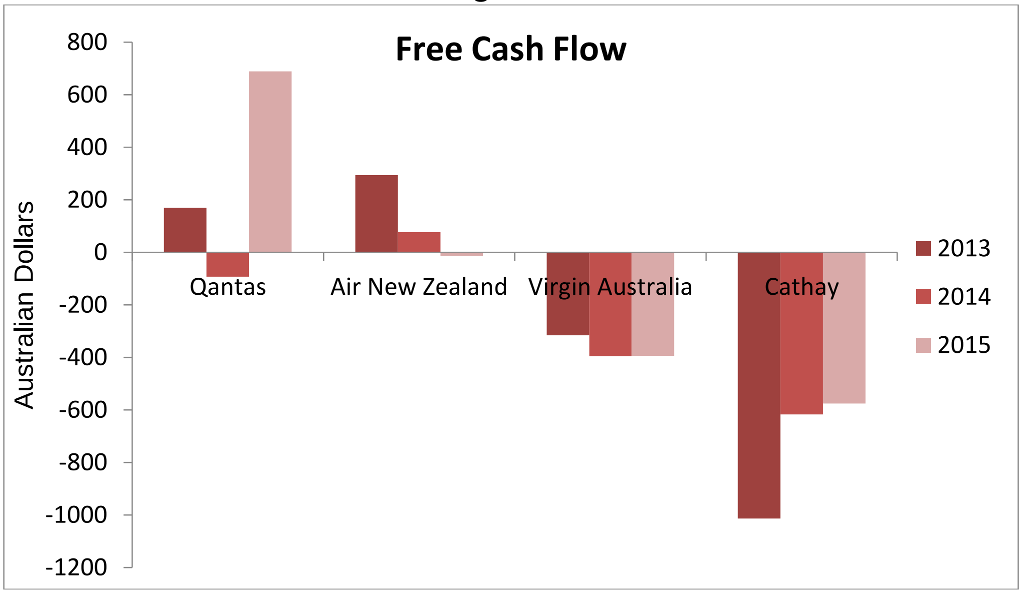
**Figure 16**

| | Qantas | Air New Zealand | Virgin | Cathay |
|---|---|---|---|---|
| ***P/E Ratio*** | 13.77 | 9.73 | 11.88 | 12.62 |

The price earnings ratio indicates how many years (financial periods) it would take for the company to return the monetary amount an investor has invested in the company, given that earnings remain at the same level. A low price earnings ratio low P/E can indicate either that a company may currently be undervalued or that the company is doing exceptionally well relative to its past trends. Above is the price earnings ratio (P/E) for Qantas, Air New Zealand, Virgin and Cathay for the last 12 months. Although Qantas has a P/E ratio greater than that of the others, this P/E ratio is still less than the industry average of 15.23
This is all well and good, but one may ask if the EPS and P/E ratios really give us a penetrative insight into whether Qantas is a profitable investment for our money or not. These ratios have shortfalls including in the way a company can manipulate its earnings using certain accounting methods. However, the airline industry bears huge emphasis on capital investment, and these ratios do not take this account. For instance, a carrier that chooses not to invest in upgrading and maintaining fleet, could make significant earnings. Therefore its EPS and P/E could be quite promising, yet the airline's prospects for the future

could be gloomy if it ignores the need to constantly re-invest. That is why we turn to Free Cash Flow. Free Cash Flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. Free cash flow represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base. Free cash flow is important because it allows a company to pursue opportunities that enhances shareholder value.

**Figure 17**




As we can see above, these results are very positive for Qantas. The free cash flows in 2015 largely stemmed from an upturn in financial performance along with the decision to cut capital expenditure by $1 billion. Having a positive free cash flow is promising for investors as it means Qantas have extra cash to invest in opportunities. On the other hand, if company has a negative free cash flow, this is not necessarily a bad thing. If a company is making large investments from which it expects to yield significant returns in the future, then having a negative free cash flow is certainly acceptable. Although, in Qantas' case, having such a positive free cash flow is very enticing for investors and the extent of negative free cash flows for their competitors is not pretty however way you look at it.

# Airline Ratios

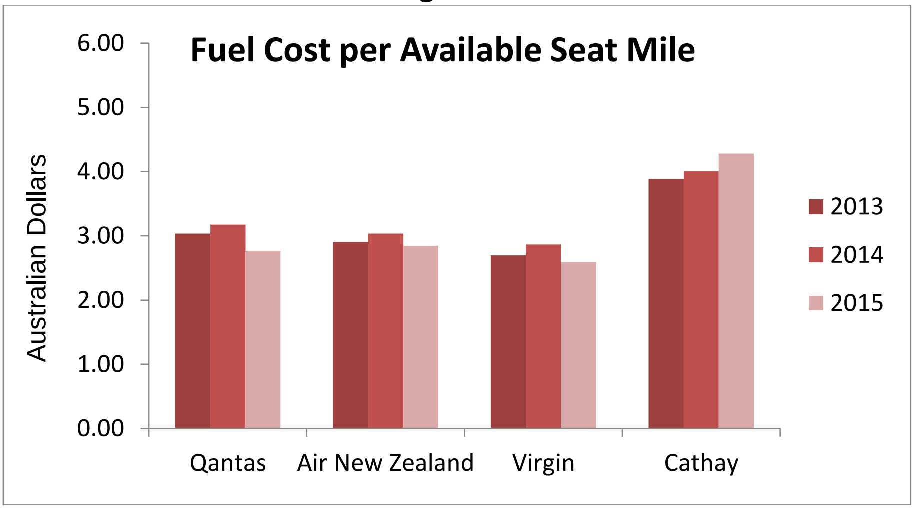
The main airline ratios we are interested in are the following:

***Fuel cost per available seat mile*** – which provides an insight into how efficient the airline is with its fuel. It is essentially the cost of fuel for one seat mile. Clearly, it would preferable to have this figure as low as possible so as to maximise profits, especially considering the high proportion that fuel costs are of any airline's expenses.

***Revenue per employee*** – which supplies an insight into the productivity of the company. A high revenue per employee indicates that an airline's operations utilise its human capital efficiently.

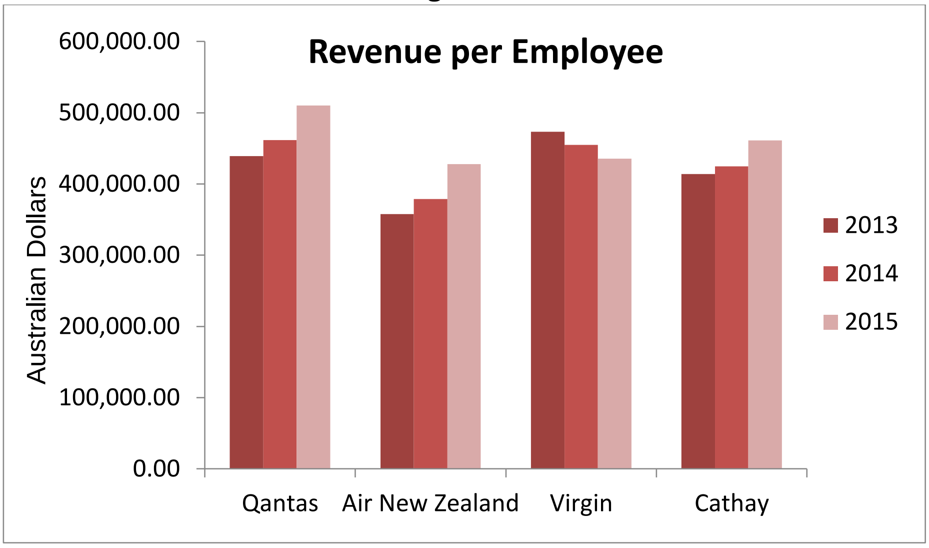
***Breakeven load factor*** – which is probably the most important airline ratio. This is the total percentage of seats on an aircraft that need to be purchased by customers so that revenues equal expenses, assuming that revenue per passenger mile and expenses remain constant. It is important that this figure is less than 100%, otherwise it becomes much more difficult for the airline to make a profit in that year. In particular, a lower figure means that the airline does not have to fill up its planes as much to break even with expenses. Essentially, if this figure is low and is consistently low, it is a great sign to investors that this airline is and can be profitable.

**Figure 18**



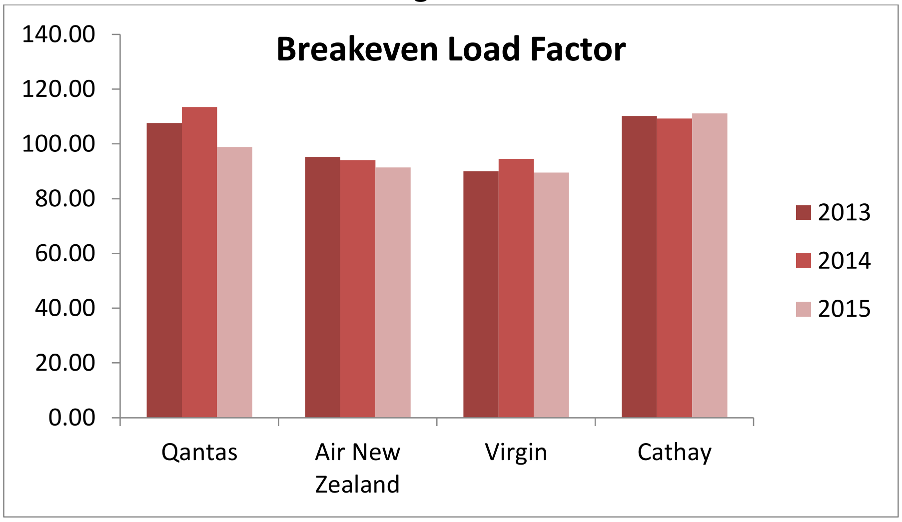

We can see here that Qantas has not fared too badly in relation to fuel cost per available seat mile. They are on par with their regional competitors. Virgin are leading the way when it comes to fuel efficiency, however with Qantas' recent purchase of new Boeing 787-9s and through the help of the Fuel Optimisation Program, their fuel efficiency should improve and contend with Virgin.

**Figure 19**




We can see on the graph that Qantas in the last three years has overtaken Virgin when it comes to Revenue per employee. We know that Alan Joyce has put steps into place to reduce the workforce by 5000. So perhaps here we can see the evidence that those extra employees weren't adding much in a marginal sense to profits. Qantas is leading the way for efficiency now which is always a promising sign for investors.

**Figure 20**




We can see here that over the last three years, Qantas has not had an ideal breakeven load factor, only dipping below 100% in 2015. Qantas is not doing well in comparison with Air New Zealand and Virgin who have set impressive standards for the Breakeven Load factor. Having a Breakeven Load Factor like Virgin had for 2015 (of 89.55), ensures profitability is a very realistic target, and although Virgin have struggled in the past few years, this ratio would be very propitious result for investors. From Qantas' point of view, it is encouraging that this ratio is decreasing and is expected to decrease to 95.5% in 2016, but Qantas needs to catch up with its competitors to entice investors.

## Risk

Airlines are notoriously volatile businesses. The famous advice from the founder of the Virgin Group, Richard Branson, should be a warning to all investors – "*If you want to be a millionaire, start with a billion dollars and launch a new airline*[26]*.*" With that said, as with any carrier, Qantas is subject to a number of external and internal risk factors which may affect company prospects and the desirability of the company securities in the market. With a beta of 1.38, Qantas has a relatively unfavourable risk profile based on the connotations of this metric. With a high beta, the company shares are more responsive to fluctuations in the market and, as such, would be considered more volatile stocks as a potential investment. This is because there are a number of contributing risk factors associated with Qantas' operations which have a considerable influence on the profitability of the carrier. In general, Qantas is exposed to four main types of risk, namely:

***Competition risk*** – The threat to competitive advantage and market share posed by fellow sector participants and their corporate strategies is of considerable note in this industry. Domestic rivals Virgin Australia are seeking to undercut Qantas' market share by now moving "up market" by providing "complimentary" in-flight entertainment and meals[27], for example. While, low-cost carriers such as Tiger Airways could further undercut Qantas' low cost carrier Jetstar prices in catering for the value-orientated customers – especially as Australia's economy slips into a downturn, with real net disposable income, as previously mentioned, sliding by 1.2%. This is compounded by the ability of passengers to lock in the cheapest possible airfares through the internet and comparison websites, such as webjet.com.au, skyscanner.com.au and flightcentre.com.au, and so on. Furthermore, the ME3 players (excluding Emirates) with vast customer bases and government funding may be better placed to target Qantas customers and offer them deals that Qantas can't compete with.

***Market risk*** – As suggested above, the airline industry is one of the riskiest industries there are. Fuel costs are intrinsically volatile, which have a significant bearing on the costs incurred by airlines. One of the main reasons why Qantas had a remarkable $1.6 billion turnaround is the fall in global oil prices. Economies and currency values are similarly unpredictable, and also bear a considerable influence on profitability. This can be seen in the way Qantas cited a lower Australian Dollar and a strong economy as major factors in the company's return to profitability. If Australia's economy does fall into a recession, this could have damning effects on Qantas' balance sheet. Yet the risks don't end there. Weather is always unpredictable, can cause delays and disruption, which have huge financial implications. As recent as July of this year ash-clouds grounded many planes, including Jetstar's. Grounding of aircraft in these circumstances can easily cost Qantas in excess of $20 million a day. Travel scares, such as the threat of contagious diseases, can halt an airline's operations and destroy its revenue. Take for example Ebola, which still hasn't been eradicated. As recent as October 2014, Ebola panic sent British Airways market price falling by 7% - knocking £500 million off its market value[28]. Many other airlines' market price was shattered. For similar reasons, a terrorist attack can also have damning implications for

[26] https://en.wikiquote.org/wiki/Richard_Branson
[27] http://theconversation.com/qantas-turnaround-delivers-some-useful-market-lessons-46524
[28] http://www.dailymail.co.uk/news/article-2783947/Ebola-panic-hits-airlines-travel-carriers-millions-knocked-share-prices-Spanish-case-deadly-virus.html

carriers. As a result of the terror attack in New York, on September 11, 2001, the global airline industry recorded losses of $13 billion[29]. Equally, wars and the like can also have a profoundly devastating effect on an airlines financial performance. Even if the airline you invest in has sheltered itself from such problems, it still seems to be severely affected. Also, we haven't even mentioned the possibility of accidents. In 2014, Malaysia Airlines lost two aircraft—Flight 370 and Flight 17—which dismantled the carrier's financial performance and led to the renationalization of the airline. Prior to 2014, Malaysia Airlines had one of the world's best safety records just like Qantas—only two fatal accidents in 68 years of operation[30]. However, just two accidents later, and the airline has been severely struggling to make ends meet.

***Regulatory risk*** – As the airline service provision is a regulated area, certain Qantas operations may be subject to constraints and regulations imposed by the Australian government, who enforce the 1992 Qantas Sale Act which imposes a 49% cap on the total foreign ownership of Qantas, for example. This puts Qantas at a disadvantage since it cannot benefit from wealthy foreign investors, who would provide cash flows even if the carrier's profitability was waning. In general, these regulations are often restrictive. An example of this is that Jetstar have been trying to open a Hong Kong base for a year now with no success. This is because of the strict regulations of the Chinese government that have greatly hindered the process. Add to that the inception and imposition of the (recently repealed) Carbon Tax. This was introduced to combat climate change as Australia has one of the highest per-capita greenhouse gas emission rates in the world. It cost the airline $59 million a year. Consequently, the company's financial performance is subject to the risk associated with unforeseen changes to regulatory frameworks and their varied implications for service provision across the diverse range of Qantas' operations.

***Carrier-specific risk*** – The main internal risks associated with Qantas are those scrutinised in the subsequent financial analysis section which are linked to the financial viability of the company in terms of leverage, profitability, liquidity and the internal management of credit policy, continual employee training and cash flow requirements. Essentially, these risks are associated with management efficiency and the strategic organisation of company operations.

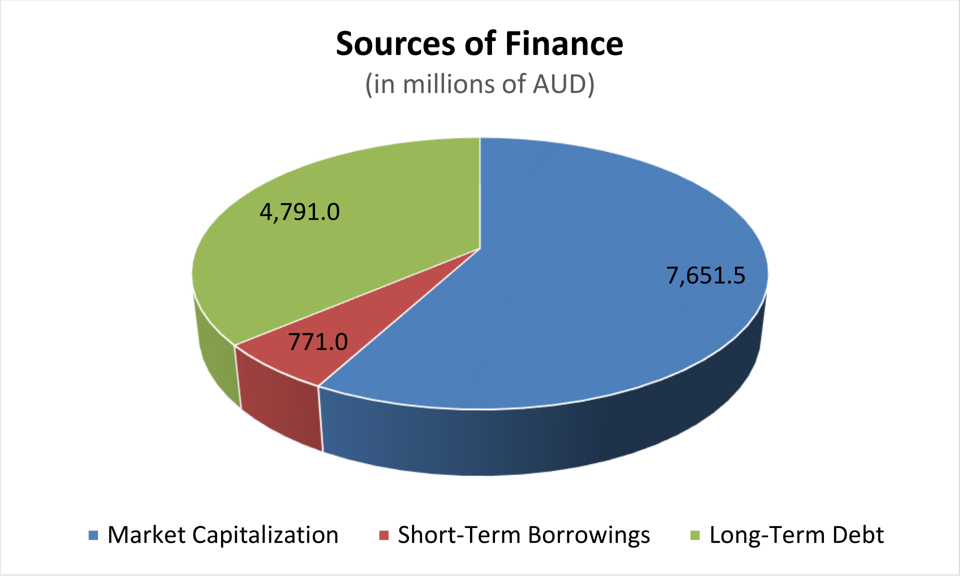
In consequence, it seems fitting that the company has a high beta of 1.38. (A beta greater than one suggests the proportional rise of the market results in a greater than proportional rise in Qantas' stock price.) Many investors purposely avoid investing in the airline industry for the reasons outlined above. Given that employees are overpaid, labour unions are obstinate, airplanes are expensive, fuel costs are volatile, competition is unrelenting, regulations are restrictive, natural disasters and accidents ruin business, the risks that are associated with the industry pose mighty threats to the already pressured profitability of companies within industry.

[29] http://www.iata.org/pressroom/Documents/impact-9-11-aviation.pdf
[30] https://en.wikipedia.org/wiki/Malaysia_Airlines

# Funding

As it has been mentioned previously in this report, Qantas raised $400 million in debt at the end of the 2014 financial year to keep its liquidity afloat. In fact, at that time, debt holders had 84% more claim than equity holders. Since then the airline has paid off $1 billion in debt due to a remarkable return to profitability. Currently, debt holders have 39% more claim in Qantas than equity holders have, so for the last two years Qantas have relied much more on debt capital rather than equity. Management say the carrier have now reached its optimal capital structure.

**Figure 21**




# Capital Expenditure

Capital expenditure for Qantas like most airlines is of huge importance. Qantas' current fleet totals 299 aircraft. For the 2015 financial year, Qantas has had a net cash capital expenditure of $1.359 million, in which it has purchased 11 aircraft and leased one aircraft:

Qantas – five B737-800s, one Bombardier Q400 and one Fokker100
Jetstar – four B787-8s and one A320-200[31]

Qantas will also acquire eight Boeing 787-9 aircraft, to be delivered from calendar year 2017 and gradually replace five older Boeing 747s. "New aircraft types have always unlocked opportunities for Qantas," Mr Joyce said. "When our red tail Dreamliners start arriving in two years' time, their incredible range and fuel-efficiency will create new possibilities for our network." For customers, the Qantas Dreamliner's improved cabin pressure, larger windows and technology to reduce turbulence will deliver the world's best travel experience"[32]. This expenditure has also been used for customer experience initiatives such as airport lounges and cabin reconfigurations for the Airbus A330. This sort of fleet investment is crucial for improved customer satisfaction, environmental outcomes, operational efficiencies and cost reductions.

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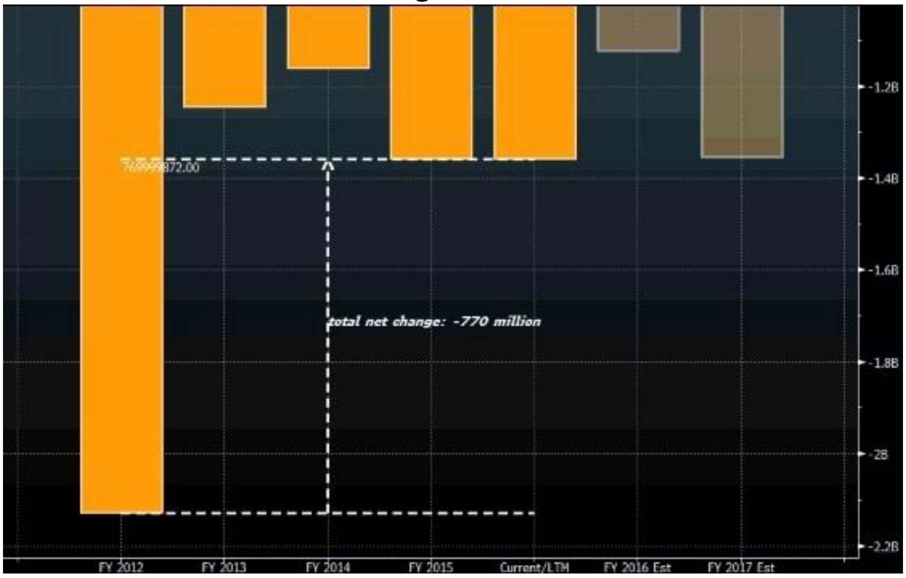
[31] http://www.qantas.com.au/infodetail/about/investors/mediaReleaseResults15.pdf
[32] http://www.qantas.com.au/infodetail/about/investors/mediaReleaseResults15.pdf

The group has become dedicated over the past few years to use capital investment more strategically and to avoid unnecessary and inefficient spending. Qantas have reduced capital expenditure, which has gone from 2.129 billion (for the 2012 financial year) to 1.359 million (for 2015 financial year). This is a decrease of approximately 770 million in just three years.[33]

**Figure 22**




This reduction is a result in the company turning their aims on reducing debt. This tactic of reducing capital expenditure has allowed Qantas to reduce net debt by $1 billion recently and has resulted in a large free cash flow which enabled them to reward there shareholders with a $505 capital return. Despite their reduced levels of capital expenditure their targeted investments in their products, service and training resulted in record customer satisfaction as measured by Net Promoter Scores.

As a result of historical high capital expenditure which was directed at renewing their fleet their current average aircraft age is 7.7 years which is under the targeted 8-10 year range[34]. This puts Qantas in a good position going forward with no immediate need for large amounts of capital expenditure in the next few years to renew their fleet. This can be seen in its forecasted capital expenditure, which is expected to be $1.12 billion for the 2016 financial year and $1.35 billion for 2017 financial year[35]. These expenditures will be funded through the continued benefits from the cost reduction program implemented in 2014, and asset sales (i.e. old aircraft). Qantas continues to target positive free cash, with capital expenditure aligned to financial performance.

[33] Bloomberg Terminal
[34] http://www.qantas.com.au/infodetail/about/investors/mediaReleaseResults15.pdf
[35] Figures and graph form Bloomberg Terminal

## Cost of Capital

Cost of Capital is defined as the expected return on a portfolio of a firm's existing securities. The portfolio usually consists of debt and equity; hence the cost of capital is estimated as a blend of the cost of debt (interest rate) and the cost of equity, which is the expected rate of return demanded by investors in the firm's stock. This is often called the weighted average cost of capital (WACC). It's worth noting that the cost of debt is cheaper than equity, due to the reduced risk exposure to the debt holders.

When it comes to cost of capital and in particular WACC, Qantas is far superior in comparison with its rivals. Qantas has a very competitive WACC at 6.3%. The WACC represents the minimum rate of return (risk adjusted) of 6.3% at which a company produces value for its investors. Thus, Qantas' blend of cost of equity and cost of debt is lower than its direct competitors, and as a result, investment in the airline will be regarded as "less risky" than investment in its peers.

Moreover, Qantas' is separating itself from its competitors with its ROIC (return on invested capital) which currently stands at 12.52%. This figure is well above (more than double) the airline's WACC and much higher than the carrier's competitors' ROIC, indicating how profitable Qantas is at the moment. Precisely, this means that the airline has created more than six cents of value for every dollar that it invests in capital. Qantas has set targets to reduce its current long term debt by a further $1 billion in 2017, which has the implication of possibly driving up Qantas' WACC because the cost of equity is higher than the cost for debt. However, if Qantas can keep a WACC of less than 10% as they aim to do, then with their current ROIC they will remain profitable in the years ahead. It is important that Qantas invest well in the growing Asia markets to maintain and even increase their ROIC. Qantas have marked the Asian market as a big opportunity for the airline as the number of passengers from the continent grows exponentially each year. A big part of that will be down to Qantas' low cost brand Jetstar. See below how Qantas currently compares to its rivals:

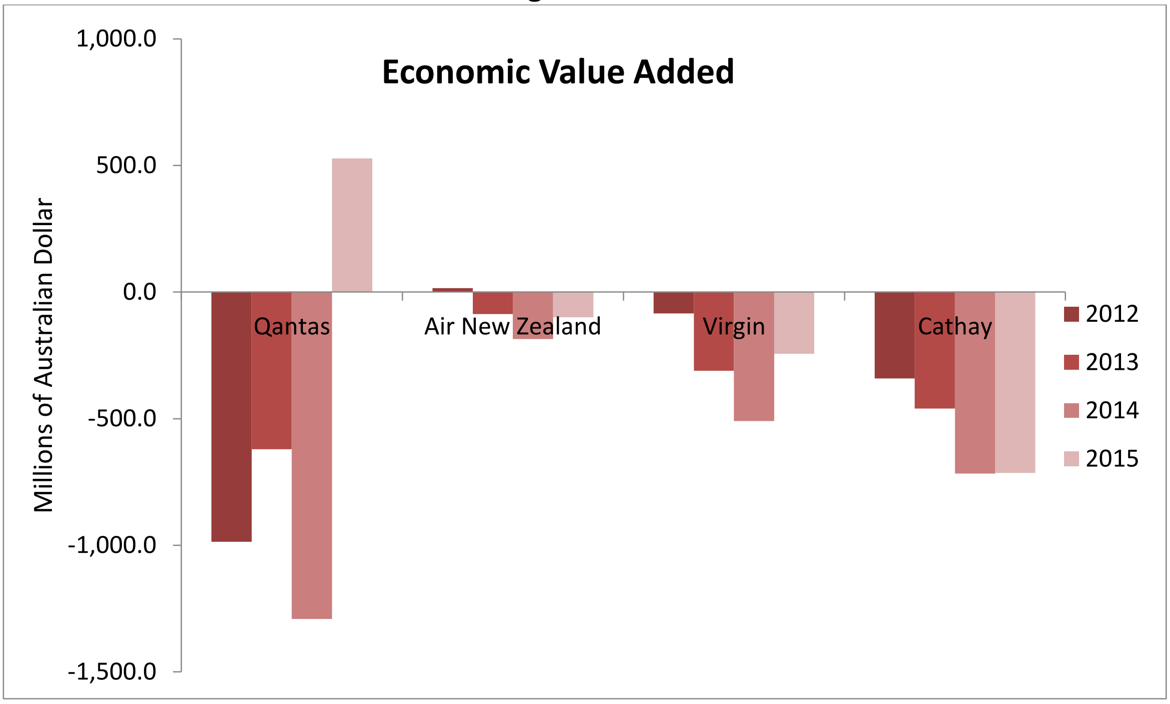
**Figure 23**

| | Cost of Debt (%) | Cost of Equity (%) | WACC (%) | ROIC (%) |
|---|---|---|---|---|
| Qantas | 2.8 | 8.8 | 6.3 | 12.52 |
| Air New Zealand | 3.2 | 10.4 | 7.2 | 7.14 |
| Cathay | 1.6 | 11.4 | 6.9 | 3.67 |
| Virgin | 4.3 | 5.2 | 4.6 | -1.46 |

Qantas has recently announced that it is to purchase 5 Boeing 787-9s. These planes will give Qantas the ability to compete on some of the longest routes possible e.g. Melbourne to Dallas, while also being fuel efficient, and thus reducing fuel costs, as previously mentioned. This purchase is clearly possible because of a recent surge up in profits and market capitalisation, as Qantas' share price continues to soar.

As was mentioned earlier, the global airline industry has become highly competitive especially with the emergence of Emirates, Qatar and Etihad as big name players in the industry. This combined with the fact that when economic times are tough, one of the first industries affected is the airline one, as people tend to decrease flying costs. In the last few years "Oceanic" airlines like Qantas, Cathay, Virgin and Air New Zealand have struggled to stay in the black. Qantas is the first airline in the region to drastically change things around and increase its Economic Value Added (EVA), which is essentially an estimate of the carrier's true economic profit. If we look at Qantas' EVA in comparison with its regional competitors we can clearly see how Qantas have successfully turned things around in recent years.

**Figure 24**




We can see that Qantas is the only one among its close peers to turn with a true economic profit in 2015 which is remarkable after the 3 years they had before, especially in 2014 when they made significant losses (primarily because of devaluation of their fleet). Like most airlines, if Qantas can keep ROIC greater than their WACC, there is no reason why the carrier can't continue to keep their EVA in the black.

## Dividend Policy

Qantas paid dividends to the value of $505 million in 2015. With the shareholders' approval, they did this as a capital return through a stock split (in the ratio 0.939:1) which reduced the number of shares outstanding to 2.059 million. This is equivalent to 23 cents per share. This dividend was agreed as management wanted to reward shareholders who have been loyal despite the recent crisis. This was possible due to the $1.1 billion the airline had in free cash flows, which originated from the carrier's decision to slash capital expenditures by $1 billion, and Qantas' recent upturn in financial performance.

For existing investors this was obviously good news. However, one does have to question whether this was the right time for the airline to pay a dividend of over half a billion Australian dollars. Given that fuel prices are low now, perhaps it would have been wiser to use that money to upgrade Qantas' fleet further, instead of deferring the purchase of some aircraft to 2017. This would have given Qantas a better chance of withstanding the capacity war that has been ongoing on all fronts.

Before this Qantas had not paid out any dividends since 2009, when it paid 6 cents per share fully franked. It has been made clear all along that management had every intention to pay regular dividends to shareholders when possible. "We are serious about repaying dividends," announced Qantas Airway's chairman Leigh Clifford in 2012 at the company's AGM[36]. However, the capital-intensive nature of the airline industry sapped the carrier's ability to pay dividends. Qantas' management were also always seeking to achieve their "optimal capital structure," which they have finally reached, in order to lower the airline's WACC.

Offering a dividend has displayed a lot of confidence by Qantas' management in the airline's ability to sustain these new levels of return. If these levels are not sustained, no doubt it will have a negative effect on the company's share price and shareholder's newfound confidence in management.

[36] http://www.news.com.au/finance/business/qantas-aims-to-return-to-paying-dividends/story-fnda1bsz-1226509042243

## Share Price

The following table shows the weekly Highs, Lows and Closing Share Price for Qantas over the past ten years:

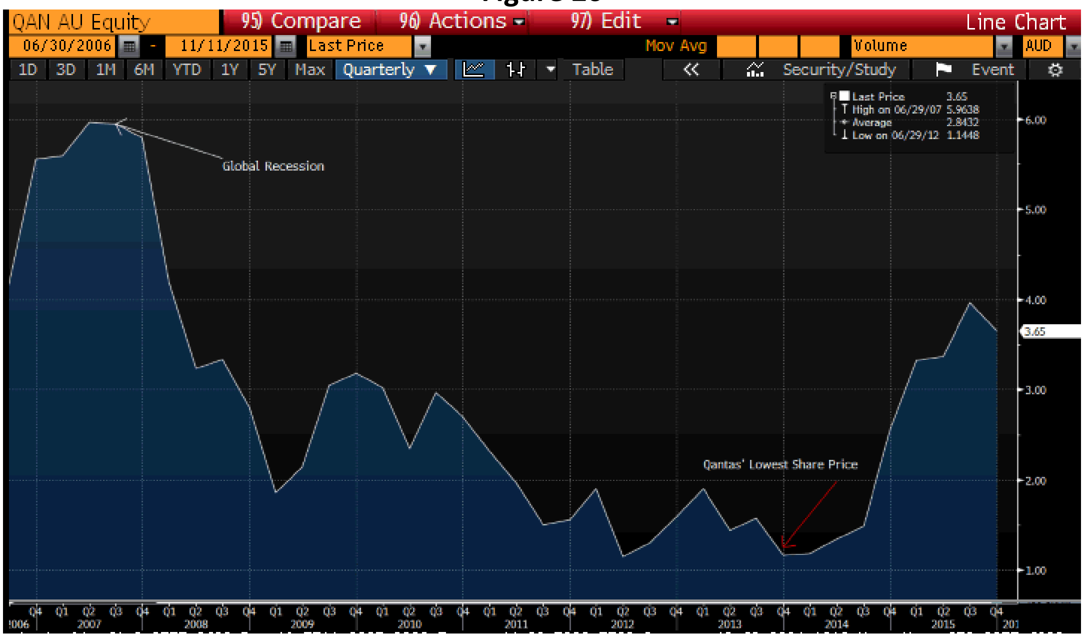
**Figure 25**

| Year | 52 Week High | 52 Week Low | Close On Year | % Change from Close On Year |
|---|---|---|---|---|
| 2015 | 4.03 | 1.28 | 3.65 | 172.39% |
| 2014 | 1.65 | 1.01 | 1.34 | -4.97% |
| 2013 | 2.02 | 1.05 | 1.41 | 20.51% |
| 2012 | 2.16 | 1.02 | 1.17 | -40.61% |
| 2011 | 3.16 | 1.90 | 1.97 | -15.09% |
| 2010 | 3.26 | 1.97 | 2.32 | 10.48% |
| 2009 | 3.99 | 1.47 | 2.10 | -37.5% |
| 2008 | 6.45 | 3.13 | 3.36 | -43.72% |
| 2007 | 6.22 | 3.10 | 5.97 | 87.74% |
| 2006 | 4.57 | 3.10 | 3.18 | -11.42%** |

*Year end 11-November **2005 closing price 3.59

The Stock Price for Qantas has changed very little from its close price of $3.59 in 2005 to the price of $3.65 as of November 11th, an increase of just 1.67%:

**Figure 26**




Qantas saw significant growth between the close price in 2006 and 2007 with a staggering increase of 87.74%. Over the 2007 financial year, Qantas reported recorded breaking profits of $1.032 billion, as it expanded its network connecting regional Australia to city capitals. Even as oil prices neared US$100 a barrel, Qantas had hedged 79% of their crude oil needs for that financial year and after only two years in operation, Jetstar was named the world's best low cost airline by Skytrax[37]. All of these factors led to all-time peak of Qantas' stock price of $6.22 in 2007.

The 2008 financial year saw a massive drop in the share price of Qantas with both years seeing a negative year on year change. Qantas saw a fall in profits and its dividends per share decreased. Qantas' and Jetstar's rankings in the world dropped, the price of a barrel oil increased to US$129.58 and the world welcomed a global economic crash.

The 2010 financial year saw an increase in Qantas' share price of 10.48%. Qantas' international business improved despite the global economic uncertainty and the impact on airlines caused by the volcanic ash disruptions. Jetstar achieved a record profit and the price of a barrel of oil dropped significantly to US$75.77.

Late 2010-Early 2012 saw a series of disputes between Qantas and a number of Trade Unions. Over this period, Qantas endured a drop in share price by a staggering 15.09% and 40.61%.

December of 2013 was when Qantas' share price reached its lowest on record at $1.05. Virgin Australia was more competitive due to its reduced costs. The price of a barrel of oil increased to roughly US$129.17 a barrel. Qantas had to increase its fuel charges across the board. Qantas reported a loss of $646 million before tax. Thus, all these things culminated in massive decrease in share price.

With a reduction in costs of over $2 billion, and a historical partnership with Emirates, the company has seemed more attractable and this has led to a 172.39% increase in share price[38] where it currently trades at $3.65 AUS Dollars as at 11/11/2015.

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[37] http://www.jetstar.com/au/en/about-us/our-awards
[38] http://www.fool.com.au/2015/11/04/qantas-airways-limited-why-the-share-price-is-up-300/?source=aptyholnk3030003
Oil Prices: http://inflationdata.com/Inflation/Inflation_Rate/Historical_Oil_Prices_Table.asp
Profits/losses: http://investor.qantas.com/investors/?page=asx-announcements

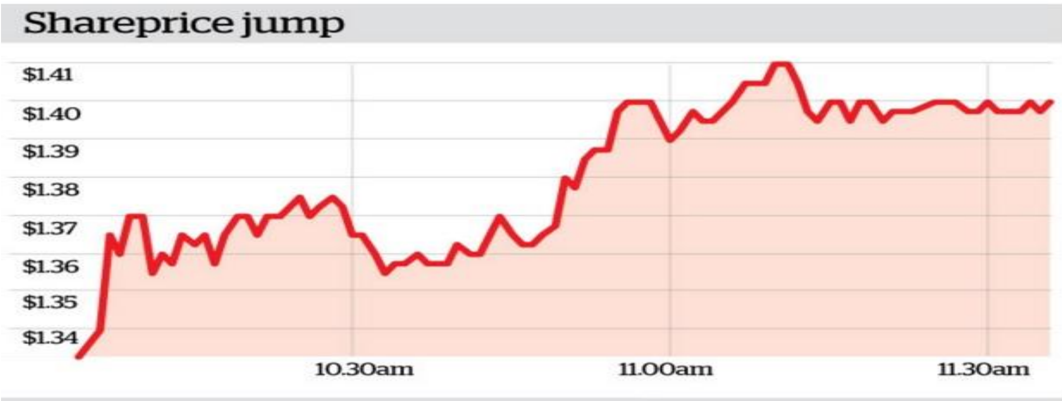
***Qantas Share Price Over The Last 12 Months:***

**Figure 27**


Qantas' share price had reached an all-time low at the end of 2013/early 2014 because of a revenue drop and an increase in oil prices. Qantas had announced a management's reform agenda; this relied on falling fuel prices and a lower Australian Dollar.

August 28th 2014 saw a soar in share price for Qantas[39], the first time in months. Qantas reported a net loss of $2.8 billion, yet wrote down the value of its fleet by $2.6 Billion. This left Qantas with just an underlying $646 million loss, and because investors thought the airline had incurred some greater loss than there was, the share price actually increased (see Figure 28).

**Figure 28**




2015 has seen Qantas achieving its best result since the Global Financial Crisis in 2008 with its highest stock price over the year $4.03. A profit before tax of $975 million was reported. Qantas' reform agenda has made rapid progress leading the way to a $1.6 Billion turnaround on its 2014 low and the company has also hedged its fuel exposure effectively. Therefore, it comes as no surprise that Qantas' share price has improved by 172.39%.

[39] http://www.smh.com.au/business/aviation/qantas-28-billion-loss-explained-20140828-109h8q.html

## Discounted Cash Flow Valuation

| Figure 25[40] | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | Year 5 |
|---|---|---|---|---|---|---|---|
| **Future Free Cash Flows** | **1407** | **1136** | **893** | **1008** | **1091** | **1311** | **1171** |
| % Margin | 9% | 7% | 5% | 6% | 6% | 7% | |
| % Growth YoY | 57% | -19% | -21% | 13% | 8% | 20% | |
| | | | | | | | |
| % of FCF to be Discounted | 64% | 100% | 100% | 100% | 100% | 36% | |
| Discount Factor WACC @ 6.3% | 0.98 | 0.93 | 0.88 | 0.83 | 0.78 | 0.75 | |
| **PV of Cash Flow** | **878** | **1060** | **784** | **832** | **847** | **355** | |

| **Perpetuity Growth Method – Value Per Share** | | |
|---|---|---|
| Free Cash Flow at Year 5 | | 1,171 |
| WACC | | 6.3% |
| Perpetuity Growth Rate | | 4.4% |
| Perpetuity Value at End of Year 5 | | 64,495 |
| | | |
| Present Value of Perpetuity (@ 6.3% WACC) | | 47,529 |
| (+) Present Value of Free Cash Flows (@ 6.3% WACC) | | 4,756 |
| | | |
| **(=) Current Enterprise Value** | **52,285** | |
| | | |
| Short Term Debt | | 771 |
| (+) Long Term Debt | | 4,791 |
| (-) Cash and Marketable Securities | | 2,908 |
| (-) Current Net Debt | | 2,654 |
| (-) Current Preferred and Minority Interest | | 5 |
| (=) Equity Value | | 49,626 |
| | | |
| Shares outstanding | | 2059 |
| **Estimated Value per Share (AUD)** | | **24.10** |
| Current Price (AUD) @ Nov 10th 2015 | | 3.71 |
| **Estimated Upside** | | **549.6%** |

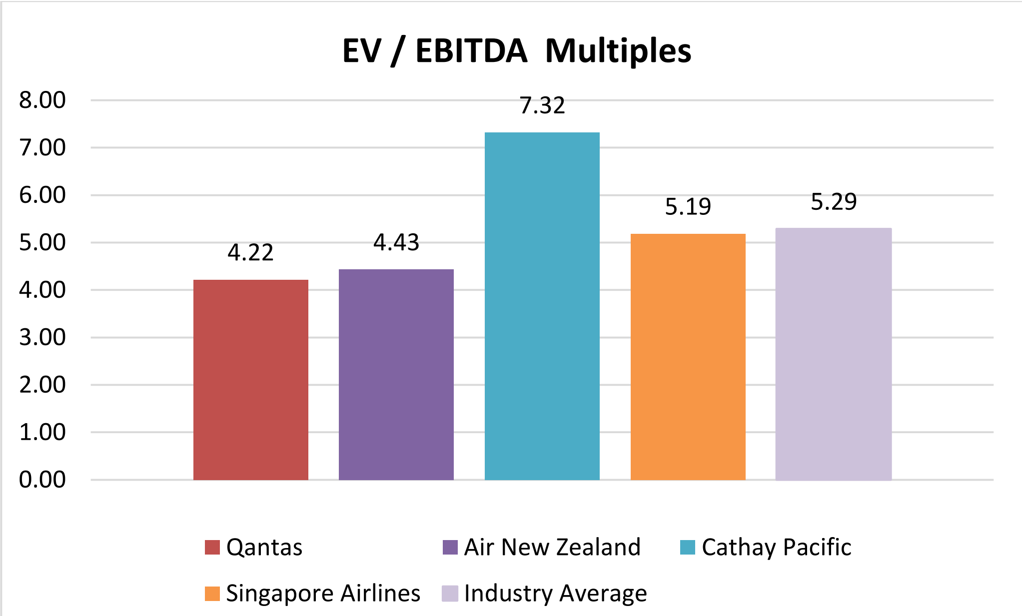
The discounted cash flow valuations can be a very powerful tool, especially considering that accounting scandals and inappropriate calculation of revenues and capital expenses have led to concerns over the quality and reliability of standard valuation metrics like the P/E ratio. However, we urge potential investors to take caution. This is because the basis for this valuation has many shortfalls: small changes in inputs can result in large changes in the value of a company and the assumptions are quite susceptible to error.

[40] All values are in millions of AUD, except for per share or percentage amounts

With that said, we credit Bloomberg for the valuation. In the above discounted cash flow valuation, we assume that the value of a company can be calculated as the sum of the present values of the cash flows it produces in the future. To get the present value of each year's estimated cash flow, we used a WACC of 6.3% after-tax. From the above model, there is a significant difference between the current trading price ($3.71 per share) and the estimated share price of $24.10 per share, an upside of 549.6%. If Bloomberg's estimate for long-term growth (2%) is correct, then Qantas' stock is intrinsically undervalued. If the assumptions of the model were true, then this means that Qantas' stock has the potential for attaining larger gains than its rivals, and there also is less of a risk of the stock plummeting in value[41] relatively.

## EV/EBITDA Analysis

**Figure 29**




EV/EBITDA analysis is powerful tool, for similar reasons as outlined before for that of discounted cash flow valuation. This is commonly used, and its purpose is to determine if a company's stock is undervalued or overvalued. As we can see in Figure 29, Qantas' EV/EBITDA multiple is the lowest out of the five companies and 2.87 points lower than the industry average (which is calculated in respect to Qantas, Air New Zealand, Cathay Pacific, and Singapore Airlines). Note that Virgin Australia (which has a current EV/EBITDA of 14.29) is part of a holding company and therefore, it was not included for selection. This would suggest a distinct undervaluation of Qantas relative to its competitors. A low EV/EBITDA multiple suggests Qantas yields a higher level of operating profit relative to its market value than its competitors and demonstrates the strength of Qantas' cash flows. In addition, the average industry market capitalization is $8.35 billion and the average shareholders is 2.071 million, and thus, we have a rough estimate of the share price: $4.03 rounded to two decimal places. This estimate with respect to its implied market average EV/EBITDA multiple represents an estimated upside of 8.63% compared to its current trading price, $3.71[42].

[41] http://www3.nd.edu/~scorwin/fin70610/Common%20DCF%20Errors_LeggMason.pdf
[42] Values as of November 10th 2015

## Investor Recommendation

Our recommendation to investors is a medium to long term sell. Despite Qantas' remarkable return to profitability, we think that this may be short lived. In a capital-intensive industry, with a decreasing profit margin, we doubt the airline's ability to be competitive internationally. The three major middle-eastern powers loom as huge threats (despite Emirates partnership with Qantas) to the carrier's international exploits, given their vast and loyal customer base, ideal location, and government backing. Qantas does not have the benefit of a government that will make sure its regulations are helpful rather than restrictive. Qantas cannot benefit nearly as much from wealthy foreign investors like these airlines due to a 49% restriction on foreign ownership. We also have doubts regarding its domestic performance. We understand that Qantas has many advantages of its domestic counterpart, including far superior profitability and gearing standings. Virgin Australia have realised this too, with their move away from direct competition with Qantas. However, a major downturn in the Australian economy is threatening, with a real possibility of a recession. This will inevitably drive away even loyal customers of the carrier, when the premium service will be unfavourable to many customers, given their largely diminished disposable incomes. Many passengers will turn to the low-cost carriers. In this case, Jetstar's importance to the group will be heightened. Yet, we have severe concerns about its prospects. In spite of passengers in the Asia-Pacific market growing exponentially each year, Jetstar is encountering many difficulties both domestically and internationally. Worryingly, the airline is struggling to keep up with innovations in order to set the lowest prices, which was the sole reason for its inception. Moreover, despite the low fuel prices, and the fact that they are projected to remain relatively low for the next year or so, they will eventually return to high prices as they always do, with the oil industry a classic boom-or-bust one. When this happens, we feel that the enormous fuel costs will devour Qantas' already narrow profit margins. This is regardless of how fuel efficient Qantas' aircraft have become or how much they have hedged in fuel costs. Furthermore, all these reasons are compounded when we consider the risk associated with the stock, especially given that we are slightly more risk averse than average investors. With a beta of 1.38, the stock exhibits a substantial amount of risk. Amongst many other things, contagious diseases, wars, terrorist attacks, natural disasters and accidents can all cripple Qantas' profitability, if not take the airline out of business entirely.

However, despite our recommendation of a medium to long term sell to investors, we understand that Qantas could be profitable in the short term. The carrier is already profitable, providing satisfactory returns, especially in comparison to most of its competitors. The losses in 2014 could be largely attributed to the $2.6 billion it wrote off in a revaluation of its fleet.  Qantas' ROIC is more than double its WACC. Also, the airline's EVA indicates a true economic profit of $500 million. These are both impressive in comparison to its close rivals. Furthermore, Qantas' liquidity situation is healthy when compared to the industry. Though a better quick ratio would be preferable, we acknowledge that Qantas paid off $1 billion in debt last year. This also had a positive effect on the carrier's gearing, which is below the industry average. The airline paid $505 million in dividends, with management citing the airline reaching its optimal capital structure as a reason why, which bodes well for dividends payments in the immediate future. Also, in spite of its extreme and intrinsic volatility, fuel prices should remain relatively low for the next year or so. The airline has outlined its worst case scenario for 2016 fuel costs at just $3.95 billion, which is on par with the 2015 financial year, as a result of hedging. Even so it's worth noting that the airline reported expected fuel costs for the first six months of the 2016 financial year (July – December) as down 20% from the previous half to $1.76 billion, which would amount to a full year cost of $3.52 billion – if prices remained at the same level. As well as that, we recognise that in the short term, Australia's economy could remain strong in the face of an economic downturn, as it has done in the past. Finally, we accept that the DCF valuation and EV/EBITDA analysis have indicated that the stock is intrinsically and relatively undervalued.

Thus, in summary, we believe that Qantas' prospects in the medium to long term are unpromising. While we admit that Qantas could be profitable in the short term, we think that this is subject to a large amount of risk.

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