Qantas - it's the long haul that matters

antares

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There has been no shortage of news flow around Qantas (QAN) in recent weeks. Most of it negative – the ACCC instigated charges around selling cancelled flights, the loss in the High Court on the legality of outsourcing its baggage handling, executive bonuses of seemingly large proportion in the face of a great deal of negative publicity and apparently critical opposition to a proposal from a rival, Qatar, to fly more regularly into Australia which is seen as anticompetitive. Finally, the Federal government has indicated it may review the process for landing and departure slots at Sydney Airport, which has the potential to introduce new competition.

Yet despite this negativity, Antares believes that QAN is one of the most attractive investments currently on the ASX on a 3 year view. Our conviction stems from the industry structure, licence to operate, valuation and finally, demand (As per the trading update issued on Monday 25th September, demand remains the same as it was in the June quarter 2023). Put simply, people are still just as keen to travel with Qantas despite the headlines. This paper explains why we have come to our view.

Airfares

There has been a great deal of noise regarding airfares post the full re-opening of state and federal borders in Australia. There are two points to note. This effect is not unique to Australia. For instance, leading US carrier Delta has seen unit revenues increase by over 7.0% pa since 2019, which compares to 8.6% for QAN. The table below shows similar price hikes for all major airlines over the same time period.

Table 1: Major airline unit revenue

Unit Revenue	2019	2023	% CAGR
IAG Group (EUR c)	6.6	9.1	9.6%
Singapore Airlines (S$c)	8.2	10.6	7.6%
Scoot (S$c)	4.8	6.3	8.1%
Delta (USc/M)	16.2	21.7	7.6%
Ryan Air (EUR)	54	63.9	4.3%
United (USc / m)	15.2	19.3	7.0%
Average			7.4%
Qantas	8.9	12.3	8.6%

Source: Company Accounts and Antares Equities; September 2023

Why has this occurred? The short answer is capacity. With the re-opening of international travel, demand has exceeded expectations materially. Further, it has exceeded supply, which has been constrained (We discuss the reasons below.) As seats on a given flight are limited, and the number of flights are also limited by aircraft supply, in an open market prices will rise to match demand to supply.

Service

One area of concern to us is costs, and this is where some of the criticism levelled at QAN has some validity in our opinion. As table 2 highlights, QAN has amongst the lowest increases in unit costs of the major airlines. When compared to the price rises, we see that profit margins have expanded. We believe QAN should have spent more on service, especially given the disruptions incurred due to constraints lingering from COVID.

Table 2: Major airline unit costs (ex fuel)

Unit Costs ex Fuel	2019	2023	% CAGR
IAG Group (EUR c)	4.8	5.7	5.2%
Singapore Airlines (S$c)	5.3	6.6	6.5%
Scoot (S$c)	5.3	6.6	6.5%
Delta (USc/M)	10.6	13.0	5.3%
Ryan Air (EUR)	29	38.4	7.3%
United (USc / m)	10.2	11.6	3.8%
Average			5.8%
Qantas	4.3	4.9	3.2%

Source: Company Accounts and Antares Equities; September 2023

However, the amount QAN might need to spend is not huge. For example, if we grew QAN's unit costs excluding fuel at the same level as their major peers, led by DAL, we would see the cost base lift by around $350m. One a cost base of $10.2bn (excluding fuel and depreciation) this is a relatively small number and would have little impact on valuation.

High Court Ruling

We are not experts on this matter, but note that the High Court merely observed the law which under the Fairwork Act stated that the decision to outsource must be made in such a way that there was never any intent to deny workers their rights to collective bargaining. This is an almost impossible test to pass as it requires proving motivation was NOT driven by a particular factor, regardless of how compelling the commercial logic is in its own right. We also observe that we are not aware of any major airline in the world that handles its own baggage – it is all outsourced to firms such as Suisse Port or DNata. We also note the High Court did not mandate the re-instatement of these workers. Merely that a settlement on compensation be reached. This is therefore a one-off cost, not an ongoing drag.

ACCC

We will not comment on whether QAN has sold fares on flights that were cancelled as this is a live ACCC investigation. We have provided for a negative outcome in terms of fines in our valuation methodology.

Qatar

The furore around Qatar is somewhat surprising to us. QAN was asked as a stakeholder (like many others) on its opinion of additional slots being made available to Qatar as the world re-opened post the pandemic. QAN's opinion was that it would be best to wait to see how much supply actually returns before making any structural changes to international supply into Australia. The Federal Government then made its own decision. QAN acted in an entirely logical fashion to defend its interest via a legal framework provided by the Commonwealth. It is, to us, not at all a QAN issue. We would also note that travelling through Qatar has been challenging at times for Australians with requests for ongoing investigation to certain events.

Landing Slots

Much discussion has centred around slots at Sydney airport. In Australia, as in every other major aviation market, airport landing slots are allocated on the 80/20 rule. Simply this means that an airline needs to use its allocated slots 80% of the time or risk losing them. This global practice was recently re-endorsed by the peak aviation body, IATA (https://airlines.iata.org/2022/08/29/preserving-networks-stronger-recovery).

The argument for a change comes from airports, predominantly, that want to be able to generate more slot revenue from reselling slots that are subject to tighter rules. As IATA makes clear, the current system works very well in other capacity constrained markets such as Changi or Heathrow.

Should the government implement a change, there is then the question of whether any airline would seek to enter the local market. This is unlikely in our view. As will be discusses below, aircraft are in short supply globally, and will remain so for the rest of the decade. Secondly, several foreign carriers have already attempted to enter the domestic flight market and all have lost significant sums of money, most recently Air New Zealand, Singapore Airlines (for a second time) and Etihad. Finally, aviation is a network business. A few slots at Sydney won't help you create the network you require to drive (scarce) asset utilisation and achieve necessary returns.

Capacity

We recently visited Airbus in Toulouse to discuss QAN's recent aircraft orders including the market leading Project Sunrise and the domestic fleet replacement, Project Winton. The most startling fact which emerged from our trip was that an aircraft ordered today would not be ready for delivery until the end of the decade – some 6 years. The

reasons are that aircraft supply chains are complicated and complex – a commercial airliner has around 340,000 parts. These require skill and precision to manufacture and even more experience to assemble into a safe aeroplane.

COVID interrupted labour supply to the industry and its suppliers. Training new staff takes many years. Airbus has promised its shareholders that it could restore around 75% of its pre COVID capacity by 2025. We have had similar conversations with Boeing and the story is the same.

Why is this important? A number of reasons. COVID saw many older aircraft parked in secure locations. Renewing their air-worthy certification is a long term project as that industry relies on the same labour force as that which builds new aircraft. Further, new aircraft, such as Qantas' A321Neo and A220 are around 25% more fuel efficient per seat than older aircraft. In a world of higher fuel costs and possible sustainable aviation fuels (which cost 2-3x ordinary aviation fuel per litre) this is important.

We also learned from Airbus that QAN is considered a marquee client – a leader and innovator in global aviation. As such its orders are prioritised and QAN has been receiving a new aircraft from Airbus once every three weeks for the past nine months. While some is for international, much of this is for QAN's domestic fleet replacement which will take another two years to complete on our estimates.

We believe this is a significant competitive advantage for QAN. By placing orders during the pandemic and being a marquee client, QAN will have secured new, far more efficient aircraft than nearly all its rivals, both domestic and international. With the delay in receiving new planes ongoing, its rivals will be years behind. And old aircraft re-furbished from semi-retirement will be outdated.

On our estimates, QAN will have a fleet operating cost advantage over its competitors of around 8%. In an industry where this is the profit margin on average over time, the significance of this cannot be underestimated.

Demand

With much of the noise around QAN, it is understandable that people might think nobody will choose to fly with them. This is simply not true. QAN has the largest loyalty programme in Australia via its Qantas Frequent Flyers with over 15m members. QAN is adding Classic Rewards flights to ensure the programme retains its prestige - we would suggest it is an area that suffered post pandemic (partly due to a lack of capacity). This will add some cost back to QAN (included in our assessment above) but it is not material and the programme has shown its success for years.

We also draw the analogy from the outcome of the Medibank and Optus data breaches. In both cases the companies experienced a sea of bad publicity for an extended time. Yet with the incidents now 6-12 months in the past, both companies are again growing policy holder or subscriber numbers as appropriate. We also note the opinion of respected marketing professional, Professor Mark Ritson who notes that established brands such as Qantas have significant heritage and resilience. (https://www.theaustralian.com.au/business/growth-agenda/brand-qantas-will-survive-and-thrive/news-story/2c66b624b444f6f850f42046b3f5ea13)

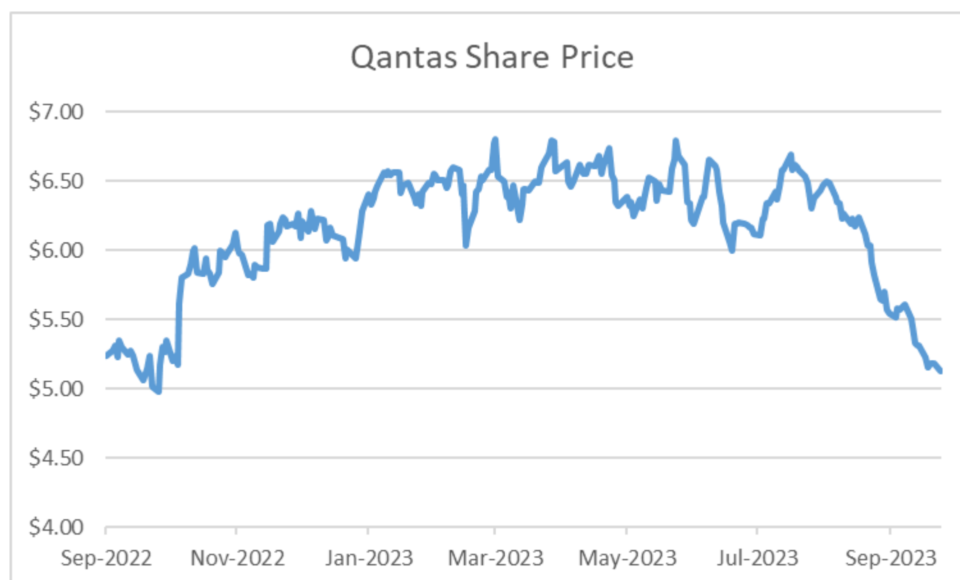
So we see the current media furore as akin to noise when it comes to demand. Aviation is essential in Australia and aircraft are in short supply. We believe QAN should invest in service to lift its game and benefit its longer term health. But as our analysis above highlights, and QAN's announcements on service initiatives show, this is not a material cost.

Valuation

We see QAN as having a privileged and defendable industry position. Its domestic rival, Virgin (VAH), is owned by private equity group Bain, who will be thinking about how it exits its investment in line with its process. It is interested in profitability. And if, as planned, VAH is sold via IPO, investors will demand the same. It can be very lucrative to be a profitable number 2 player. Internationally, Sydney airport's constraints make new entry difficult at times people want to fly, while longer term, Project Sunrise will overfly hubs such as Singapore and Doha, rendering them less attractive options.

Yet QAN has been trading at a discount to international peers. And in the past few weeks as the noise enveloping QAN has becoming deafening, the stock price has fallen yet further.

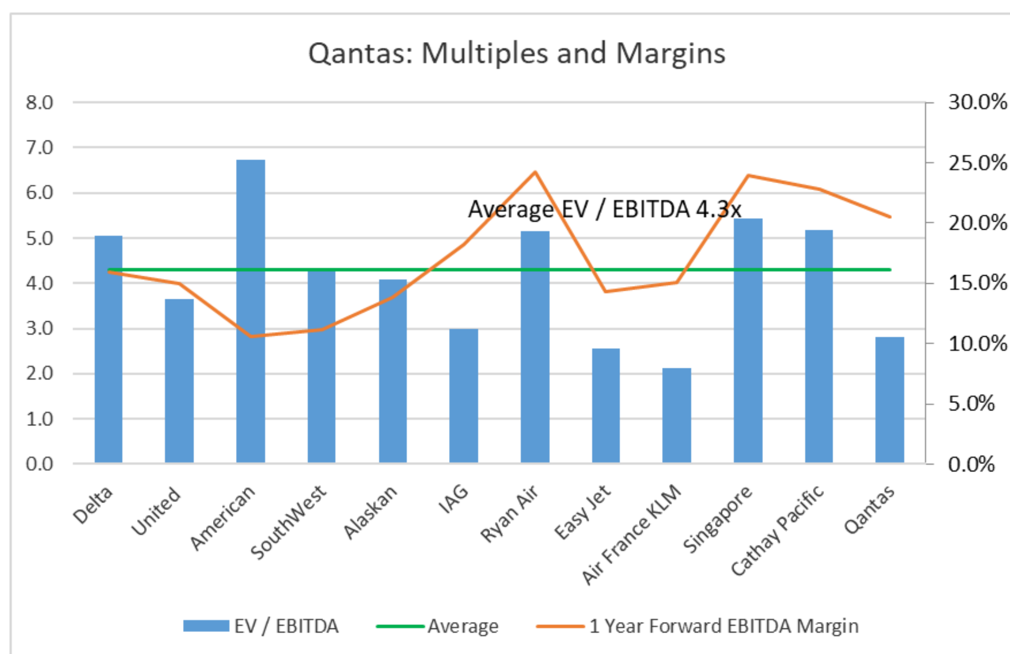
Figure 1: Qantas share price



Source: Bloomberg; October 2023

The following figure provides a selection of peer airlines globally that are akin in some ways to QAN. We have provided consensus earnings and margins for comparison to the market's financial forecast for QAN.

Figure 2: Earnings multiples (x) and margins (%) QAN vs other airlines



Source: Bloomberg; October 2023

As Figure 2 shows, QAN is trading at a material discount to these peers. We would further argue that none of these peers are as high quality an operation as QAN. None are the leading player in a domestic duopoly with a private equity owned rival and none own two brands that own both the premium (Qantas Airways) and discount fare (Jetstar) space. None have QAN's second to none safety record and none have a frequent flyer programme that captures 60% of Australia's population with a significant grounding in wealthier demographics (the so-called "A & B Demographics"). Finally, QAN is one of the few airlines globally to have an investment grade credit rating from Moodys.

This valuation gap is compelling and provides for significant potential valuation upside to the QAN share price, if and when QAN regains the market's trust.

As investors who focus on the fundamentals and take a longer term view, we view QAN as a premium airline that does not warrant a 50% trading discount to its rivals.

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