Qantas airways ltd: analysis and valuation

Environment, Air

market price or not. The report doesn’t directly suggesting an existing investor’s about offloading his/her investment in the company or keep sticking to it.

The report has employed top-down approach to share valuation – it starts with economic analysis, proceeds to industry analysis and finishes at fundamental or company analysis followed by the limitations of the analysis and recommendations. Economic analysis is suggestive of a slowing down in the Australian economy due to rising inflation and food prices. Interest rates are expected to stay the same in the current year amid fears of serious economic slump. Overall, Australian economy is still well placed as compared to its western counterparts and is expected to be resilient on the back of commodities export to China and India. Australian air transport industry has been fiercely competing after the advent of so called budget airlines and the deregulation which started in early 1990s. Qantas is still the leading player but is facing intense competition from Virgin Blue on the domestic front and Air New Zealand, Emirates and Singaporean Airlines.

The competition is expected to further escalate and would result in an increasing number of people travelling by air than the conventional modes of transport. The report has employed dividend valuation model and price-earnings approach to the valuation. Dividend valuation model’s constant growth version has been used in the report whereas simple P/E multiples approach has been used to add credibility to the dividend valuation model’s results. For dividend valuation model, we have used the historical financial data from the company’s annual reports for 2005, 2006 and 2007.

Capital Asset Pricing Model (CAPM) has been employed to calculate the expected rate of return of the company which is then used in constant growth dividend model to calculate the intrinsic value and ascertain whether the share is overvalued r undervalued in the market. Fundamental analysis suggests that the company is one of the top brands of Australia and is facing an intense competition from the low cost carriers like Virgin Blue and Tiger Airways. It has tried to compete with these budget airlines in their own territory by establishing a low cost carrier subsidiary JetStar. The company has been over reliant on debt and has taken on high financial risk in order to produce good results for the shareholders and it might be in trouble if it is unable to maintain its strategic advantage over the rivals. Based on our analysis, we have concluded that the company’s share has been over valued by the market. Therefore, we recommend to risk-averse investors to stay away from company as long as it’s market price is above the intrinsic value calculated by us.

2. 0 OBJECTIVES The primary objective of this report is to analyse and value the share of Qantas Airways Limited with an intention to invest or not to invest in the company. The report will serve as a guide to a potential investor who wants to make an investment in the said company. Therefore, the report also gives a recommendation about whether or not to invest in the company.

Moreover, this report has been prepared to fulfil the passing criteria of HBC618 Personal Investment. 3. 0 ECONOMIC ANALYSIS The world economies depend on one another immensely as they are connected through trade, migration and investment. Presently, global economy has

slowed down as a result of the credit market turmoil and tightening of financial conditions in the developed countries especially in US.

On the other hand this has not affected the economic growth in Asian countries such as India and China which still has been strong. This has been one of the major factors for Australian economy to be in a strong position, as China and India are one of the biggest consumers of Australian exports. In the year 2008 Australia has seen an increase in its cash rate (also known as Interest rate) twice by 25 basis points. At present the cash rate is 7. 25 percent. One of the major reasons for such a tightening of monetary policy is the rising inflation in Australia.

Presently Australia is experiencing an inflation rate of 4. 2 (Figure 1) percent which is above the Reserve Bank target of 2 to 3 percent. In addition to this, Australian dollar is strengthening against many currencies which has resulted in an improved terms of trade for Australia i. e. the price of exports is more than the price of imports. This has put a further upward pressure on domestic demand and inflation rate.

On the other hand, food prices are going up in Australia and especially in the world which has helped put brakes on the surging inflation. Therefore, Recently Reserve bank of Australia has decided to keep the cash rate unchanged at 7. 25 percent even though there haves been some signs of inflation. This decision was taken as a result of the economic slowdown. Presently RBA has increased its bench mark rate of inflation to 4. 5 percent (RBA tipped to stay put).

Figure 1 Key Economic Indicators According to the ANZ Australian Economics Weekly, domestic economy is slowing down due to decline in business and consumer confidence. Therefore, interest rates are going to stay the same throughout 2008. Australian Stock Exchange (ASX) was at its four months high in the last week and is expected to bounce further back after Westpac Bank has announced a another record performance amid global credit crunch. . 0 INDUSTRY ANALYSIS Historically, Australian Domestic airline industry was confined to a two carriers –Qantas and Australian Airlines (formerly Trans-Australian Airlines) – until early 1990s. They were fully government-owned from 1947 to 1993 when the government sold 25 percent of its shares in Qantas to British Airways for $665 million.

At the same time, it was decided to deregulate the pricing structure and government control over new entrants in the industry. That policy has now culminated in Australia having 3 airlines i. e. Qantas (including JetStar), Virgin Blue and Tiger Airways. In a survey conducted by Roy Morgan, it was established that Virgin Blue and Jetstar have the potential to improve their market shares (Figure 2). However, the leader is Qantas as 72 percent say that they would consider flying Qantas for their business trip (Jetstar stalls growth of Virgin Blue).

In recent times Qantas faces competition from the new low cost airline Tiger airways which began their services since November 2007. Domestically Tiger airways have given a big competition to the existing airlines by providing air fare of less than $100 Australian dollars on over 90% of the tickets. As Tiger airways have started recently it is difficult to inform its market share.

However in the first week of its flight about 91 percent of its seats that is tickets were sold (Tiger roars with order for 20 planes). Airlines compete on the basis of product differentiation and cost leadership strategies in order to survive for a long term as there is a low level of switching costs involved in an airline industry.

Therefore, airlines keep coming up with strategies like frequent flyer programs. This program gives the passengers points as and when they fly using the particular airline on a regular basis. Using these points' customers can get free flights or can upgrade it to a higher class. This enables an airline to attract a customer who has already flown using the particular airline. This becomes a barrier for the new entrants (Airline choice, switching costs and frequent flyer programs).

Figure 2 Low-Cost airlines' product and labor market strategic choices: Australian perspective In an airline industry the substitute for an airline can be beaten on the cost whereas on considering the time taken for travelling airlines will always have an upper hand against its substitutes. A substitute for an airline industry will be automobiles or train. If a customer decides to travel by bus transport between Melbourne and Sydney he will be paying $79 per head for an adult while the same passenger flying through Jetstar will have to pay $89 to travel the same distance. A customer who wants to travel on a specific low budget will choose bus transport as it's less costly whereas a customer who has to reach the destination on a tight time schedule will prefer Jetstar. According to the study conducted by Roy Morgan, article Jetstar stalls growth of Virgin Blue proposes that in Australia

there has been a decline in the passengers travelling in car with an increase in fuel prices and there has been a steady increase over the last few years in airline transport (Figure 3).

Airline industry is very capital intensive and with the launch of low cast carrier Tiger Airways the competition is going to increase which will bring the margins down. Another threat to industry is rising oil prices in the world. Therefore, this industry is characterised with significant risk and one should make its investment decision after giving considerable thought to all these factors. Figure 3 Preferred Mode of Transport 5. 0 COMPANY PROFILE – QANTAS AIRWAYS LTD Qantas is the largest airline in Australia and is considered a symbol of national pride by many Australians. It started its operations in Queensland on 16 November 1920 as the Queensland and Northern Territory Aerial Services Limited (QANTAS).

Today, Qantas is widely regarded as the world’s leading long distance airline and one of the strongest brand names in Australia. The airline basically covers nearly 140 destinations in 37 countries carrying more than 36. 4 million passengers (Media release – Qantas Announces Record Profit for the Half-Year Ended 31 December 2007). On the domestic front Qantas is clearly the market leader and its main competitor is Virgin Blue which began providing service since August 2000 (Figure 4).

Figure 4 Australian Domestic Market Share (Source: IBISWorld Report) Major PlayerMarket Share Range Qantas Airways Limited66. 90% (2007) Virgin Blue Holdings Limited29. 00% – 32. 00% (2007) Other1.

10% – 4. 10% (2007)As for as international passenger and freight to and from Australia is concerned, Qantas airline is a market leader but is facing a stiff competition from Air New Zealand, Emirates, Singapore and Malaysian Airlines (Figure 5). Figure 5 Australian International Market Share (Source: IBISWorld Report) Major PlayerMarket Share Range Qantas Airways Limited30. 00% (2007) Air New Zealand Limited8. 00% (2007) Other62.

00% (2007) Qantas annual report throws light upon many facts and figures indicating it has experienced a growth in profits by 53. 8 percent, which is earning a profit before tax of $1, 032. million for the year ended June 2007. The new brand of Qantas ‘ Jetstar’ has been providing service since May 2004 which focuses on the cost differentiation (Jetstar Media release). This strategy of Qantas enables them to meet the changing customer demand, compete with other low budget airlines and to capture wider market.

Qantas has provided its customers with new generation cabins and seating and a new premium economy will be introduced on international B747-400 services. Jetstar has been providing services at reduced costs by having new aircraft carriers and providing exceptional customer service (Qantas Annual report 2007). For more information on the airline, please refer to Appendix 1 at the end of the report. 5. 1 Key Financial Ratios Qantas has been the market leader in the air transport sector and is one of the very well-recognised airlines around the globe.

The company’s success can be credited to the high level of gearing which it uses to create superior returns for its shareholders but not everybody would like this much financial risk. Here is a brief interpretation of the six key ratios

contained in Table 1 below (for details calculations, refer to Appendix 2 Ratio Calculations at the end of the report): ? Net profit margin has increased from 3. 51% in 2006 to 4. 74% in 2007. This means that company is now generating 4. 74 cents in net profit from each dollar of sales which is much better performance than the last year.

? Return on assets has also improved from the last year and indicates that management is using company assets more efficiently this year as compared to the previous year. ? Current ratio indicates the liquidity position of a firm. It has deteriorated from 0. 93 to 0. 87.

It tells us that the company has 87 cents in assets for each dollar in liability. For an airline, the ratio is ok as it normally generates a lot of cash in the short run from ticket sales. Table 1 Key Ratios Ratio20062007 Net Profit Margin3. 51%4. 74% Return on Assets2. 55%3.

69% Current0. 930. 87 Quick0. 870. 80 Gearing2. 162.

17 Interest Cover3. 834. 93 ? Quick or acid test ratio gives a much better picture of the liquidity position of a company as it doesn’t take non-cash current assets into account. It has also gone down but is in line with the current ratio as it dropped by 7 cents only from the past year. ? Gearing is an indicator of the level of debt employed by a company in its capital structure.

As we can see, gearing ratio has been almost unchanged from 2006 to 2007 but it is very excessive which highlights the enormous amount of debt employed by the company. It tells us that the company has 2. 17 dollars in debt for each dollar of equity. ? Given the high level of gearing, the interest

coverage ratio becomes very important as it elucidate the ability of the company to generate enough profits to easily pay back the interest on its debts.

The ratio has improved which is a positive sign and is suggesting that the company earned almost 4. 93 times more profits before tax than its interest rate commitments on the debt. Overall, we can say that the company is doing OK but it is employing very high financial leverage. Given the current level of industry which is characterized by high fuel costs and intense price competition, the company can be in trouble if it is unable to maintain its revenues. 6. 0 VALUATIONS We have used two different approaches to calculate the intrinsic value of Qantas' shares.

The intrinsic value is then compared to the current market price of company share in order to determine whether the share is currently overpriced or underpriced. The two methods we adopted are the Dividend Valuation model and the Price / Earnings (P/E) model. . 1 DIVIDEND VALUATION MODEL In the process of valuation, the intrinsic value of any investment is equal to the present value of the expected cash benefits. In the case of shares, this amount is the cash dividends received each year plus the future sale price (capital gains) of the share.

The Dividend valuation model (DVM) values a share on the basis of the future dividend stream it is expected to produce. Its three versions are zero growth, constant growth and variable growth. We have used the constant growth model to calculate the intrinsic value of Qantas' share as follows: Value of a share (V) = next year's dividends (D1) required rate – constant

rate of of return (k) growth in dividends (g) D1 = annual dividends expected to be paid next year (the first year in the forecast period) k = the discount rate or capitalisation rate (which defines the required rate of return on the investment) g = the annual rate of growth in dividends, which is expected to hold constant to infinity. Calculation of intrinsic value of Qantas' share in current year 2007-2008 YearIntrinsic value of share V= D1 -gCurrent year's dividend D0Next year's dividend D1Required rate of return (k)Risk free rate (rf)Share beta ? Expected market return (rm)" Growth rate (g)Return on equity (ROE)NPATSH EquityRetention Rate (rr)Dividend payout ratio (DPR)Dividend per share (DPS)Earnings per share (EPS) D1= Do(1+g)k= rf+? (rm -rf) (g= ROE X rr) NPAT SH Eqty$M$Mrr = 1- DPRDPS/EPS 19980. 120. 0510.

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824$0. 300$0. 364 Average0. 1420. 045 Intrinsic value of Qantas' share in current year 2007-2008 = $2. 85 (As per above calculations) Market Price of Qantas's share as on 15/05/08 = $3.

5 (Source: http://www. asx. com. au/asx/markets/PriceResults. jsp? method= get&template= F1001&ASXCodes= QAN) Note: i. Growth rate is calculated as an average of the last 10 year growth rates of Qantas financial figures.

ii. Expected market return (rm) is calculated as an average of the last 10 years market returns in the Australia share market. iii. The Company Beta (?) is 1.

17 (source: http://money. ninemsn. com. au/shares-and-funds/research-a-company/results. aspx? inforeq= mainview§ionid= 2338§ionname= sharesAndFunds⊂sectionid= 4071⊂sectionname= Researchacompany_Statistics&code= QAN iv.

The risk free rate (rf) is 6. 29% p. a. (10 year govt bond rate) (source: http://www.

rba. gov. au/Statistics/Bulletin/index. html) 6. 2 PRICE-EARNINGS(P/E) MODEL According to this approach, the share's P/E is equal to its market price divided by the share's EPS (forecast for the coming year).

Using this approach, Qantas' share price is calculated as follows: Share price = EPS1 X P/E ratio Share Price(2008) = $0. 53 X 7. 19 = $3. 80 Table 2 Earnings and Dividends forecasts Key StatisticsCurrentForecast Forecast 20082009 EPS$0.

36$0. 53$0. 40 DPS$0. 15$0. 36$0. 34 P/E Ratio7.

19 Source: http://money. ninemsn. com. au/shares-and-funds/research-a-company/results.

aspx? inforeq= mainview§ionid= 2338§ionname= sharesAndFunds⊂sectionid= 4071⊂sectionname= Researchacompany_Statistics&code= QAN) 7. 0 LIMITATIONS Although we have come up with the intrinsic value of the share but how right or wrong it is depends upon the health of our numbers and the assumptions which work behind those numbers. A basic assumption of the DVM is that k must be

greater than g for the model to hold. This requirement is predicated on the practical limitation that a stock’s price must be non-negative. Similarly, k must be greater than g since equivalence would result in an infinite value.

However, it is quite difficult to understand how the relationship between k and g affects the estimate of the stock’s intrinsic value. DVM expected returns are not generally predictive and sometimes negatively correlated with actual returns. Hickman and Petry (1990) find that dividend discount approaches produce errors averaging 88% of the actual price, and 4. 21 times those of price-earnings methods. In addition, a high degree of error in growth and required return estimates is found irrespective of specific modelling assumptions. Gehr (1992), noting that price estimation bias in the DVM is the result of required return and growth prediction error, proposes application of a probability weighted range of the parameter estimates.

Finally, Good (1989) points out that, since the next period dividend is largely a known quantity, the reliability of the DVM is mostly dependent on the estimation of required return and growth rates. The goal of valuation analysis is to estimate a reasonable range for the intrinsic value of a share price, rather than a single point estimate. Besides, the company had reverse growth in certain years and we have had incidents like nine eleven which really brought the airlines profits down in 2002. These numbers also have the limitations of formal accounting procedures used to collect them. 8. 0 RECOMMENDATIONS Based on our calculations from both the models above, we have concluded that the Qantas’s share has been overvalued by the market.

Therefore, we’ll recommend a wait and see approach to the potential investor until the price is at or below the calculated intrinsic value before putting money on the company. Additionally, the company is also operating with a very high financial leverage and in a very competitive industry. Therefore, risk-averse investors should be even more cautious while deciding to make a decision to invest in the company. 9. 0 LIST OF REFERENCES

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164/cpu_au_std/131/11/21/index. html APPENDIX 1 QANTAS AIRWAYS LTD – KEY FACTS ASX CodeQAN Official Listing Date31 July, 1995 GICS Industry GroupTransportation Exempt Foreign? No Internet Addresshttp://www. qantas. com Registered Office AddressQantas Centre , Level 9, Building A , 203 Coward Street , MASCOT , NSW, AUSTRALIA, 2020 Head Office Telephone(02) 9691 3636Head Office Fax(02) 9691 3339 Share RegistryQANTAS SHARE REGISTRY. LEVEL 12 , 680 GEORGE STREET , SYDNEY , NSW, AUSTRALIA, 2000 Share Registry Telephone(02) 8280 7111 Directors / Senior Management Mr Leigh Clifford (Chairman) Mr Geoff Dixon

(Executive Director, CEO) Mr Peter Gregg (Executive Director, CFO) Mr Mike Codd, AC (Non Exec.

Director) Retired General Peter Cosgrove, AC MC (Non Exec. Director) Mrs Patricia Cross (Non Exec. Director) Mr Garry Hounsell (Non Exec. Director) Dr John Schubert (Non Exec.

Director) Mr James Strong, AO (Non Exec. Director) Ms Jane Boyle (Investor Relations)Company SecretaryMrs Cassandra Hamlin Principal ActivitiesThe operation of international and domestic air transportation services, the sale of worldwide and domestic holiday tours and associated support activities including catering, information technology, ground handling and engineering and maintenance. 2 RATIO CALCULATIONS RatioFormula20062007 Net Profit Margin= Net Profit after Tax / Total Revenues= $479. 5m / $13, 646.

7m = 3. 51%= $719. 40m / $15, 165. 7m = 4. 74% Return on Assets(ROA)= Net Profit after Tax / Avg.

Total Assets= $479. 5m / (($19, 183. 3m+$18, 390. 4m)/2) = 2. 5%= $719.

4m / (($19, 605. 7+$19, 183. 3)/2) = 3. 69% Current= Current Assets ? Current Liabilities (CL)= $5, 052. 8m / $5, 429. 7m = 0.

93= $5, 634. 0m / $6, 504. 0m = 0. 87 Quick= (Cash Assets + Receivables) ? CL= ($2, 902m+$1, 228.

7m+$604. 8m)/ $5, 429. 7m = 0. 87%= ($3,, 362. 9m+$1, 376. 8m+$476.

7m)/ $6, 504. 0m = 0. 80% Gearing= Total Liabilities ? Total Equity= $13, 102. 2m /$6, 189. 10m = 2. 16= $13, 410.

7m /$6, 076. 20m = 2. 17 Interest Cover= Net Profit before Tax ? Interest Expense= ($671. 2m+$163. 3m)/$217.

9m = 3. 83= ($1032. 1m+$244. 0m)/$258. 9m = 4. 93 3 TECHNICAL ANALYSISTechnical analysis is the study of any market that used price and volume information only in order to forecast future price movement and trends (Stevens 2002).

It is often used as an aid to the fundamental analysis by the expert investors in order to determine when to get in the market and when to get out. It is strongly recommended not to use technical analysis in isolation. It is normally used to complement fundamental analysis. Technical analysis can be of different types such as relative strength index (RSI), charting, moving averages and trendlines.

We’ll try to do some basic technical analysis for QAN below. We have prepared this chart at www. bigcharts. com by using daily prices for one year of Qantas. Lower panel is showing the RSI i. e. the ratio of the average price change on up days to the average price change on down days during the same period – in our case one year. The RSI ranges between 0 and 100. Most RSIs range between 30 and 70. Generally, RSI values above 70-80 indicate an overbought condition (the stock has been bought strongly although its fundamentals are not that strong) which may signal that a reversal of the overbought situation is possible. On the other hand, RIS values below 30

indicate an oversold condition (more people have sold the stocks despite strong fundamentals) which may point to reversal of the downward trend. When the RSI crosses these ranges, it indicates a possible reversal of the trend (Gitman 2004). As we can see from the figure, RSI is moving around 50 throughout the year but has never touched the 20 mark. It was at or very close to 30 three times and close to 70 twice. Right now, it is just under 70. We can employ either of the two strategies using this chart: 1– We can buy the stock when RSI moves above 70; and – We can sell when it starts coming below 70. These are very basic strategies and have their demerits such as when you buy it above 70 with an intention to sell it when it starts dropping; it mightn’t drop and keep going up etc. Therefore, as the Qantas is approaching 70, there is an indication that its in an overbought condition. Hence, there is a possibility of a decline in the price. As a potential long term investor, we should not invest in the stock as it will drop in value. We should rather but it when it RSI has dropped well below 50 and is close to 30. This conclusion is in harmony with our fundamental analysis.