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Qantas – Flying Below Global Peers

Our weekly view on Australian equities.

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Soaring to New Heights

Qantas (QAN) is currently trading at a discount relative to its US peers. We make a case that QAN should be trading at a premium, based on factors including post-pandemic airline industry dynamics, overly conservative earnings estimates for the company, and upside potential to the share price with a possible rerate and further earnings upgrades.

Key Points

- Qantas (QAN) is at a discount relative to US peers (at a 23% discount on a CY24 basis).
- QAN should trade on a premium based on the current market dynamics post-pandemic.
- QAN earnings growth looks too conservative.
- We think there is still upside to the share price with potential for a rerate and further earnings upgrades.
- Risks persist on recession and elevated demand but, overall, risks remain to the upside, in our view.

Qantas (QAN) Still an Opportunity

We have held QAN in the Focus Portfolio to provide leverage to the travel reopening that we have seen globally over the past 12 months.

QAN has performed strongly over the past 6-7 months, with gains of around 50% since the June 22 lows. Despite this, we still believe that QAN presents a well-priced investment opportunity due to its current discounted valuation relative to US peers, while earnings still have the potential to surprise to the upside.

Discount to US Peers Is Unjustified

The discount may be partially explained by the view that US airlines will continue to recover and grow earnings after CY23. In contrast, consensus expects QAN to effectively reach its earnings peak by FY23. However, when looking at the company's valuation metrics in CY2024 - after the global travel recovery is expected to be largely complete - the discount on QAN's stock price still persists and seems unjustified, in our view.

Figure 1: QAN traded above 4x EV/EBITDA pre-COVID and now trades below its pre-COVID average

Source: Refinitiv, Wilsons.

Figure 2: QAN looks cheap relative to US peers

Ticker	Company	EV/EBITDA CY2023	EV/EBITDA CY2024
QAN.AX	Qantas Airways Ltd	3.3	3.2
AAL.O	American Airlines Group Inc	7.1	6.0
DAL	Delta Air Lines Inc	5.1	4.5
UAL.O	United Airlines Holdings Inc	4.2	3.7
LUV	Southwest Airlines Co	4.1	3.4
	US Peer Average	**5.1**	**4.4**
	QAN discount	***-36%***	***-28%***

Source: Refinitiv, Wilsons.

Qantas and the Australian air travel industry have undergone structural change since the pandemic. We think the discount is illogical given:

1. **Reduced competition** – The exit of Tiger during the pandemic left Qantas Group (including Jetstar) and Virgin as an effective duopoly.
2. **A more rational market** – The potential IPO of Virgin has created a more rational pricing environment as Virgin presents their IPO credentials to the market.
3. **QAN cost-out** – Resulting in higher profit and higher return on invested capital (ROIC). Qantas stripped ~$1bn of costs out of the business since the onset of the pandemic. This has led to a structural increase in earnings in the post-pandemic world.

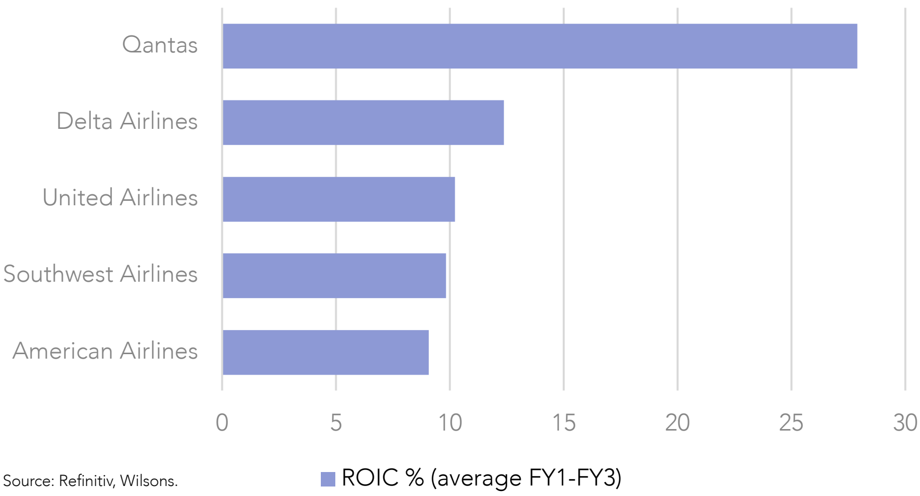
Based on these factors, QAN should command a premium over its US peers rather than a discount, especially considering the US airline industry is highly competitive, and the large US airlines will operate on considerably lower ROICs than QAN.

Earnings yet to Peak

QAN earnings are forecast to grow at 2.6% in FY24. This estimate looks too conservative, in our view. We do not believe earnings have peaked, contrary to consensus, and see upside to current earnings estimates for FY23 and FY24. This view is based on:

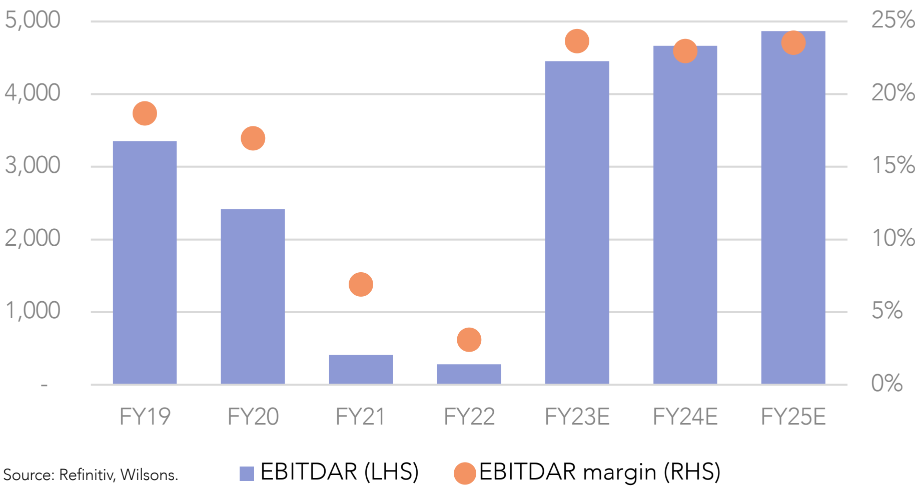
- Revenue to stay elevated – Market still underestimates the pent-up demand for travel, which we believe will keep prices and passenger numbers elevated; the November 2022 trading update supported this view.
- International still to reopen – The change in the international airline composition has led to Qantas taking a higher market share (30% in CY22 vs 25% pre-COVID) and this should equate to higher margins. The recovery in international travel for QAN is ongoing, which should be supportive of higher revenues.
- Capital management – better than expected cash flow and net debt balances in HY23 and FY23 should lead to further capital management via buybacks. This would provide further upside to earnings per share (EPS) numbers for FY24.

Figure 3: QAN forecast ROIC (average FY1-FY3) is well above US peers – a good indicator for a valuation premium.



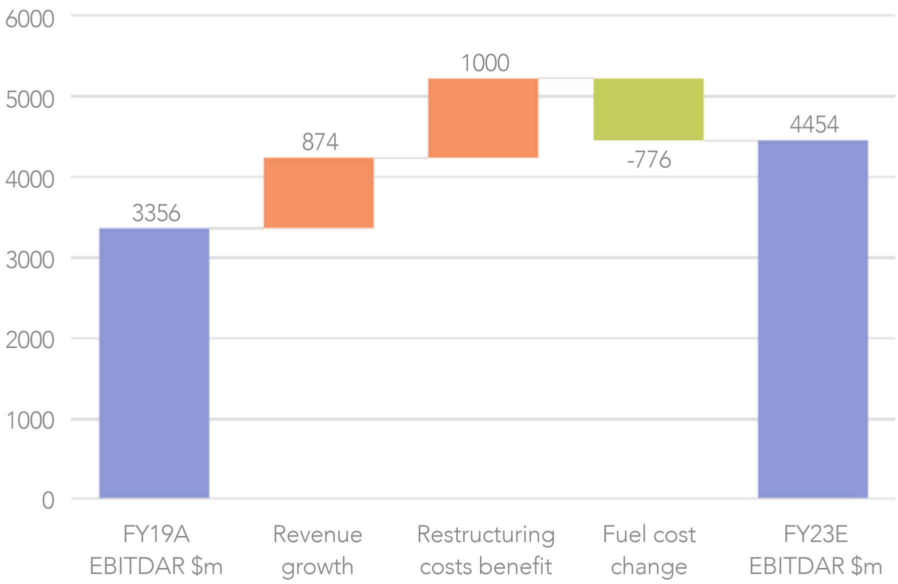
Source: Refinitiv, Wilsons.

Figure 4: EBITDAR earnings growth looks conservative



Source: Refinitiv, Wilsons.

Figure 5: QAN's cost out has led to structurally higher earnings; revenue and fuel costs could provide earnings upside to QAN in FY24



Source: Refinitiv, QAN company filings, Wilsons.

Valuation Sensitivity – Room for Upside

As figure 6 shows, putting QAN's consensus EBITDA (earnings before interest, taxes, depreciation and amortization) for FY24 on a multiple of 4.0x (vs the FY24 US peer average at 4.4x) implies a valuation of $8.57 per share – or ~31% upside to QAN's current share price.

Alternatively, if we are more conservative and assume QAN should be valued at 3.5x consensus FY24 EBITDA – still well below its 10-year pre-pandemic multiple of 3.7x – it implies a fair value of $7.34 – or ~12% upside.

On top of this, we believe current consensus forecasts for QAN's earnings in FY23-FY25 are still too conservative, and that more upgrades are plausible over the next 12 months, which would translate to additional valuation upside.

Therefore, using reasonable assumptions we continue to see material upside to QAN's share price, given the potential for its multiple to re-rate closer to peers and considering the likelihood of further earnings revisions.

Figure 6: Conservative sensitivity analysis still presents upside for QAN

QAN per share valuation scenario analysis

EV/EBITDA x	- 10% 4,012.2	- 5% 4,235.1	Consensus EBITDA 4,458.0	+ 5% 4,680.9	+ 10% 4,903.8
3x	5.35	5.73	6.10	6.47	6.84
3.5x	6.47	6.90	7.34	7.77	8.20
4x	7.58	8.08	8.57	9.07	9.56
4.5x	8.70	9.25	9.81	10.37	10.93
5x	9.81	10.43	11.05	11.67	12.29

Implied valuation upside by scenario

EV/EBITDA x	- 10% 4,012.2	- 5% 4,235.1	Consensus EBITDA 4,458.0	+ 5% 4,680.9	+ 10% 4,903.8
3x	-18.3%	-12.7%	-7.0%	-1.3%	4.3%
3.5x	-1.3%	5.3%	11.9%	18.5%	25.1%
4x	15.7%	23.2%	30.8%	38.3%	45.9%
4.5x	32.7%	41.2%	49.7%	58.2%	66.7%
5x	49.7%	59.1%	68.6%	78.0%	87.5%

*Data as of 23/01/2023.
Source: Refinitiv, Wilsons.

Cyclical Risks Overdone

As cyclical businesses, airlines are inherently exposed to the ebbs and flows of the economic cycle.

Therefore, the key threat facing QAN at this juncture is that an economic slowdown or recession, coupled with ongoing cost of living pressures, could see households curtail their expenditure on non-discretionary items like travel.

However, notwithstanding the cyclical risks, we remain constructive on QAN given:

- Our base case scenario is that Australia will avoid a recession in CY2023.
- The Australian consumer has been resilient to date despite elevated inflation and the Reserve Bank of Australia's (RBA) interest rate hikes.
- Pent-up demand for travel remains significant with both domestic and international passenger numbers still below pre-pandemic levels, and consumers have continued to prioritize travel ahead of other spending categories.
- QAN's growing loyalty segment, which represents ~17% of forecast EBIT for FY23 is relatively defensive, helping to insulate QAN's earnings from a cyclical slowdown.

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