



# Cross Check

A Study of Qantas' Financial Health

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Financial Analysis of

# **Qantas Airlines**

With Virgin Australia as benchmark

(for the year 2011)

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## Summary

The objective of the report is to analyse Qantas financial health using Virgin Australia as a benchmark. The two companies are competitors in the Australian sky and are leading airlines in the industry. According to 'Porter's Five forces', industry is shaped by five forces such as competition in the industry, potential new entry into the industry, power of suppliers, power of customers and threat of substitute products. Qantas and Virgin operate under this circumstance.

Financial health of Qantas is analysed based on profitability, liquidity, efficiency, market performance and capital structure ratios. The debt ratios show that Qantas would need to raise money through issue of debt or equity instruments to service its liability obligations. The debt coverage ratio is high and may require 5-6 years before it can cover its current debt. Negative free cash flow means Qantas is in disadvantaged position to grab market opportunities.

Three analytical methods are used to analyse the financial situation of the company: Horizontal and Vertical Analysis, Trend Analysis and Ratio Analysis.

## Introduction

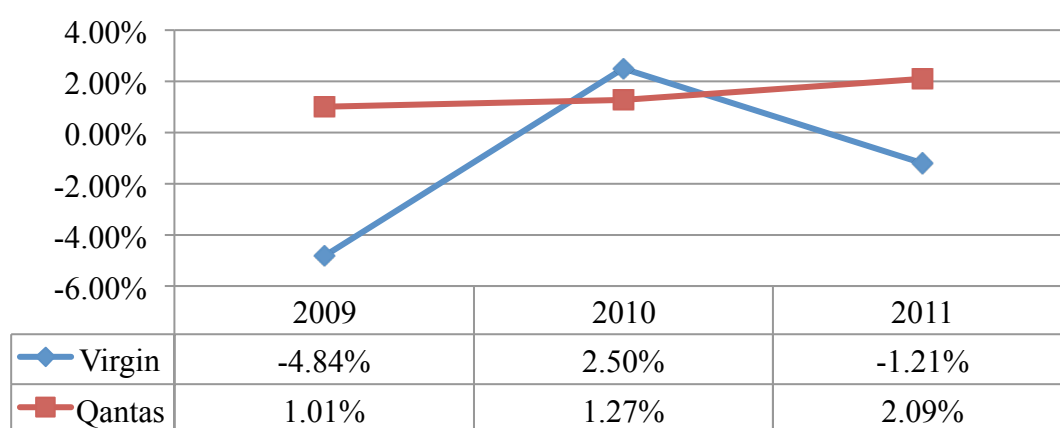
The paper makes an in-depth study of the financial health of Australian flagship airlines, Qantas through a critical analysis of the financial statements from 2009 to 2011 comparing to Virgin Australia during the same period.

Established in 1920, Queensland and Northern Territory Air Services (abbreviated QANTAS) is the front-liner in Australian aviation industry. From a regional air service company, Qantas grew to meet the increasing demands of the fast expanding market. Now, the company provides service to more than 142 destinations in 42 countries around the world with around 250 aircrafts.

## Ratio Analysis

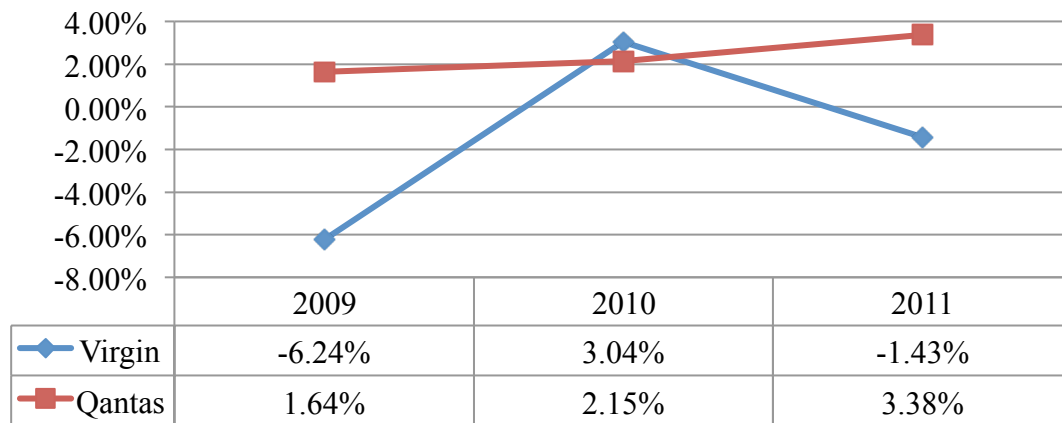
### Profitability Ratios

#### Return on Asset (ROA)



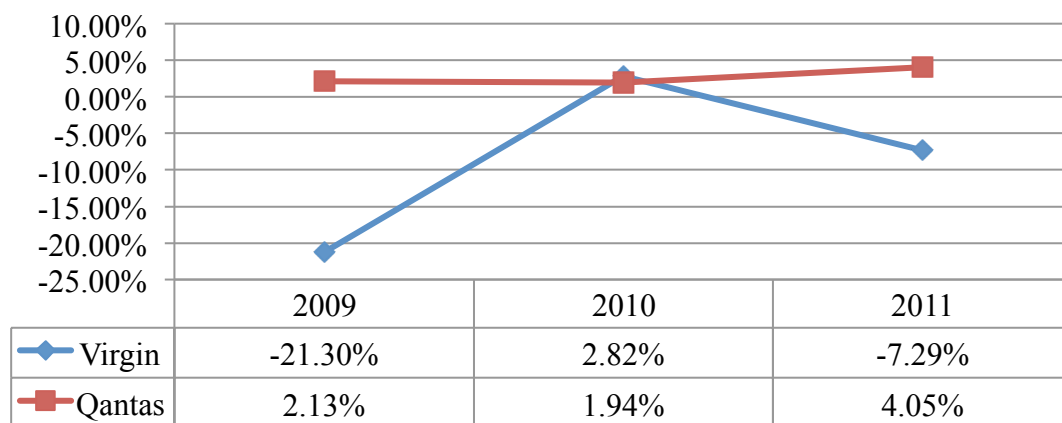
Return on asset is in increasing trend in Qantas whereas Virgin is not. Despite slight progress in 2010 compared to 2009, the company's return on assets dropped in 2011 again. This shows Qantas is better utilising its assets than Virgin to generate more sales and ultimately profits.

#### Profit margin ratio



International Civil Aviation Organisation (2012) states the average profit margin ratio for the airline industry would be around 5%. Despite increasing net profit, Qantas is still below the set criteria or average industry indicator. This will have negative impact on its competitive ability with other companies in the industry. Again, Qantas is leading in 2011 while Virgin had won the race in 2010. Profit margin for Virgin for the year 2011 has dropped to negative and this will have negative consequences to the company's future. It shows Qantas has better control over its costs compared to Virgin.

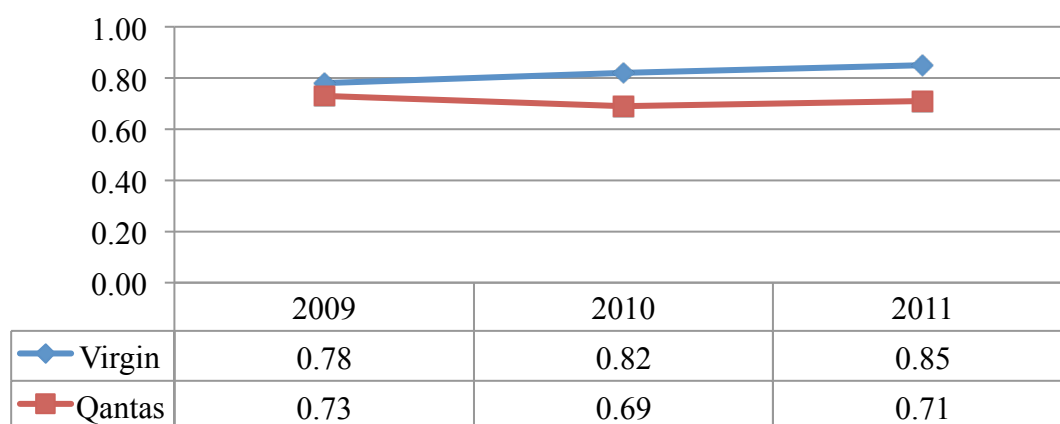
### Return on Equity (ROE)



Return on equity is in increasing trend in Qantas. Upward trend in ROE is advantageous for companies but that invites more competitors into the industry. The status of the Virgin remains fluctuating over the review period. Virgin emerged efficient in 2010 while Qantas has beaten Virgin in 2009 and 2011.

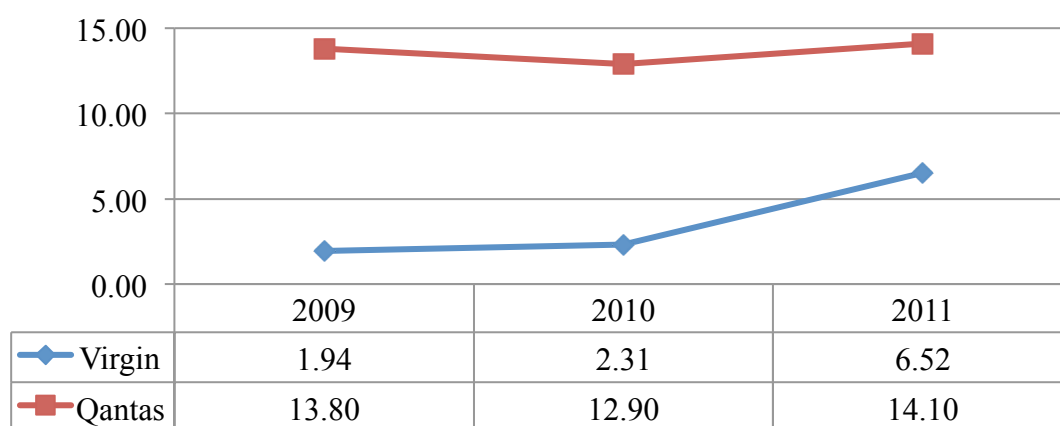
## Efficiency Ratios

### Asset turnover ratio



Qantas' efficiency at using its assets in generating sales/revenue in 2010 dropped compared to 2009 but regained in 2011. Qantas remain behind Virgin in all three years in terms of asset turnover. That means Qantas is less efficient than Virgin in using its assets to generate sales and revenue.

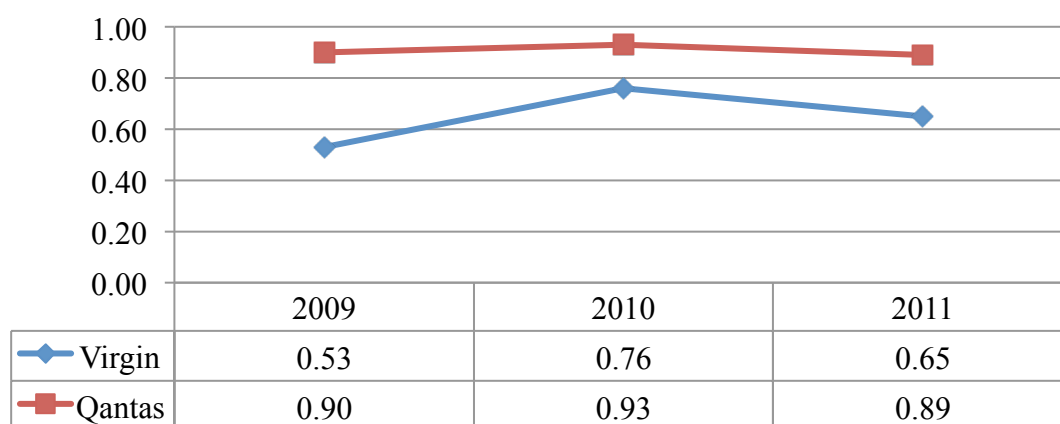
### Times debtors turnover



The trend remains unstable in Qantas whereas that of Virgin has made a smooth progress. However, Qantas always remained ahead of Virgin in converting its inventory and accounts receivable into cash. It is important to remember here, however, that the appropriateness of the days debtors turnover depends on credit terms offered by the entity.

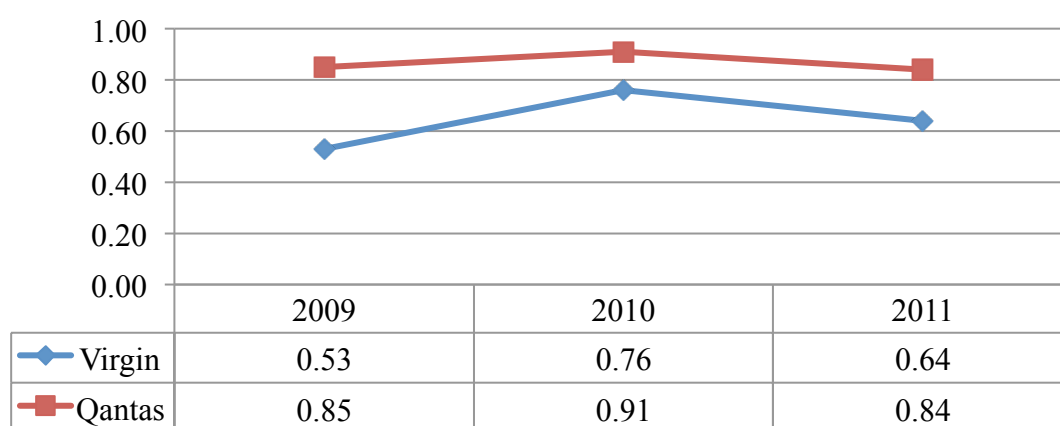
## Liquidity Ratios

### Current ratio



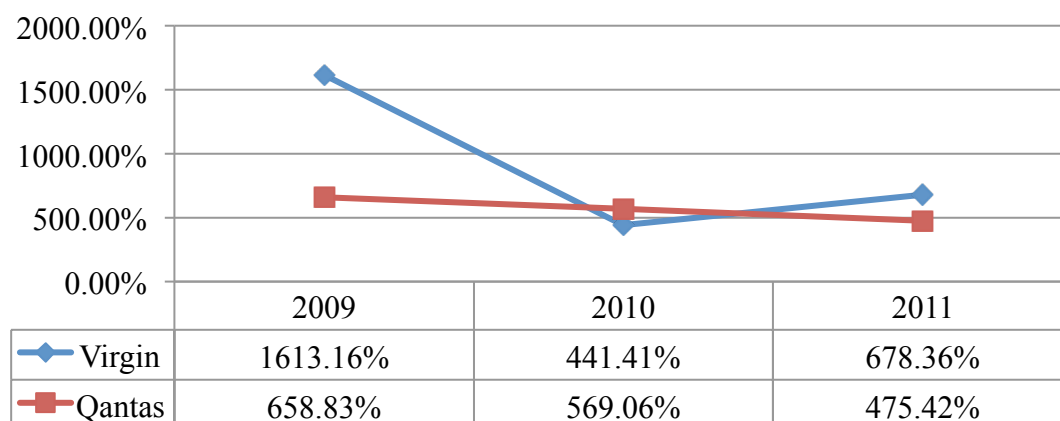
A generally acceptable current ratio would be 2:1 or 1:1 also can be accepted. (Lincoln, 2010) however, Qantas has constantly maintained the 0.9:1, which is quite low ratio. It indicates Qantas might have trouble paying the current debts. Yet compared to Virgin, Qantas is faring well.

### Quick asset ratio



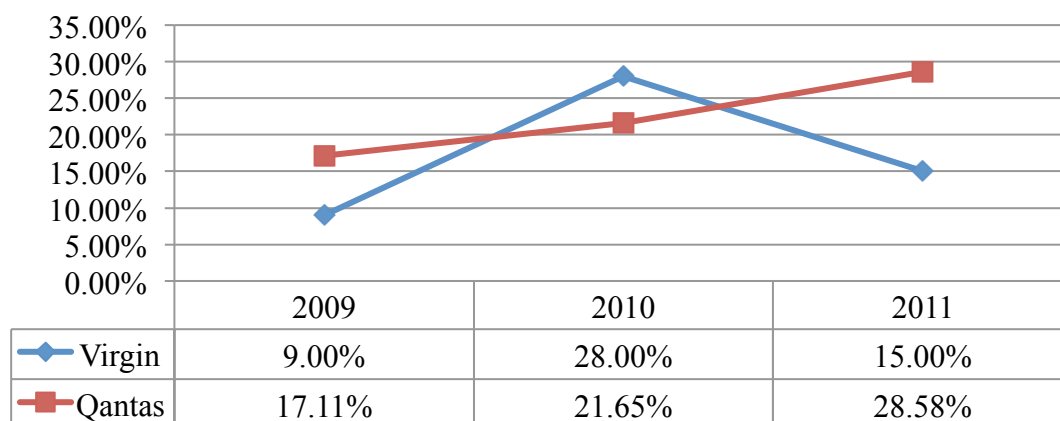
Qantas has not achieved the acceptable quick asset ratio of 1:1. It stays at around 0.85:1. Low quick asset ratio means Qantas has weaker position to generate profit and pay off current obligation. On the other hand, Virgin is weaker than Qantas in terms of meeting its liabilities obligations.

## Debt Coverage ratio



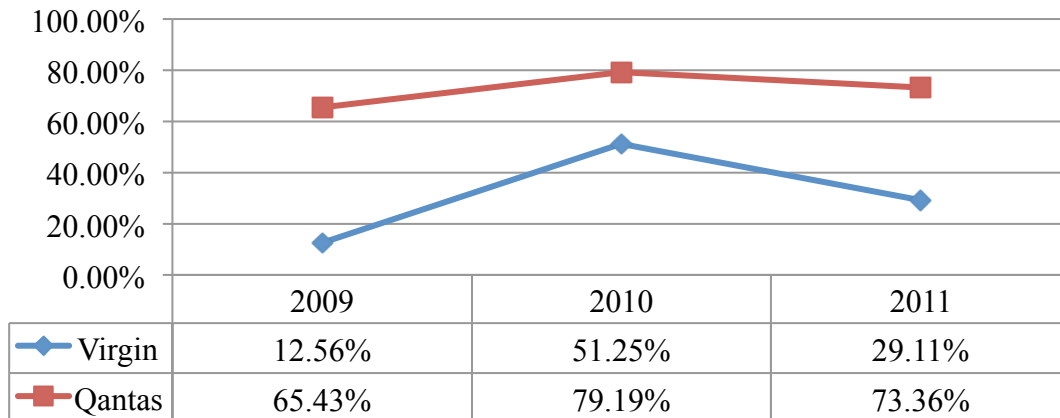
The debt coverage ratio of Qantas is decreasing (from 658 % in 2009 to 475% in 2011). This is a positive indication that the company might be able to cover its current debt from the operational earnings. Virgin shrunk in 2010 and has recovered in 2011 and is well ahead of Qantas.

## Cash flow ratio



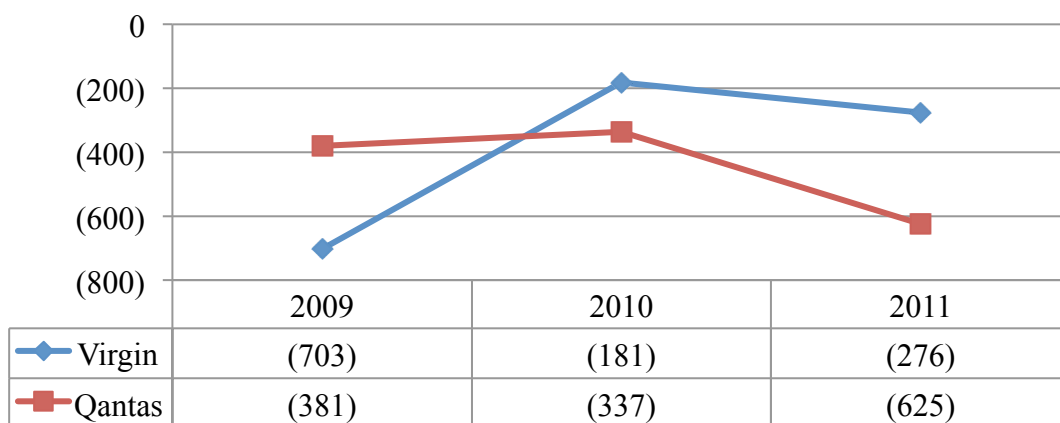
Through 2009 to 2011, the cash flow ratio of Qantas remained approximately at 20%. This level is not adequate to pay off its short-term liabilities but there is still hope of doing better as the figures are in increasing trend. Virgin had more cash in hand in 2010 but has slipped down in 2011. Qantas, which remained behind Virgin in 2010, has remained ahead of Virgin in 2011.

### Cash adequacy ratio



Cash adequacy ratio shows Company's ability to cover its capital expense and dividend attribute to shareholders. Qantas's cash adequacy ratios from 2009-2011 are quite higher compare with its competitor Virgin.

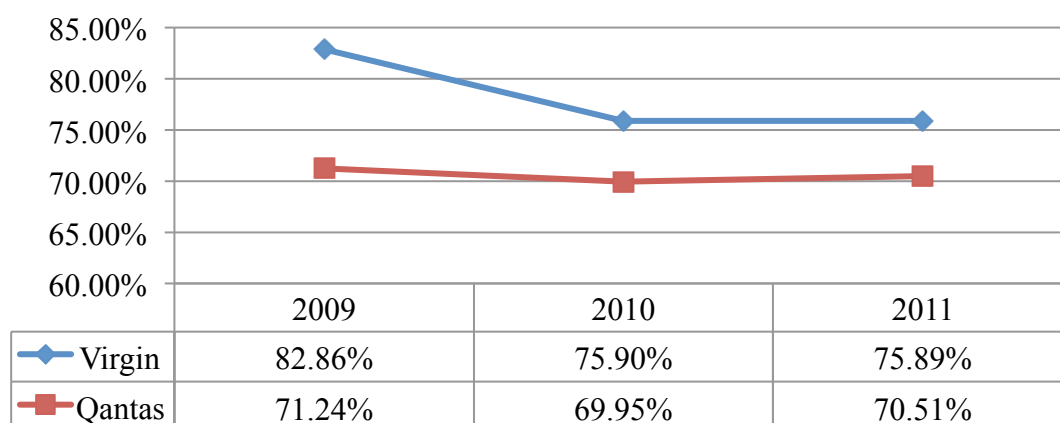
### Free Cash Flow



Qantas has a decreasing free cash flow trend. This will affect the company for immediate capital investments in bigger scale. This is unlikely that the company will acquire new company. One indication was seen in 2010 October when Qantas group sold its one of the company Travel group. The decreasing trend will also affect Qantas in introducing new products. Virgin has less negative cash flow compared to Qantas – meaning Qantas is faring worse than its competitor.

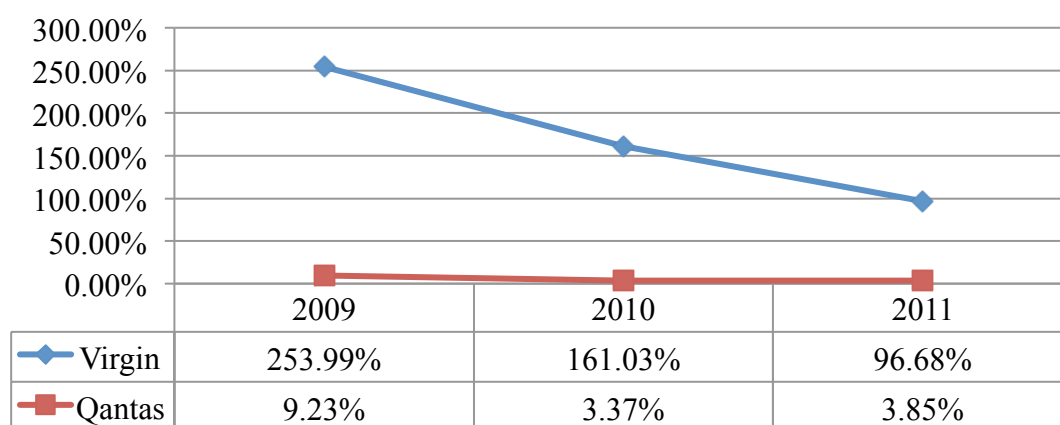
## Capital structure ratios

### Debt ratio



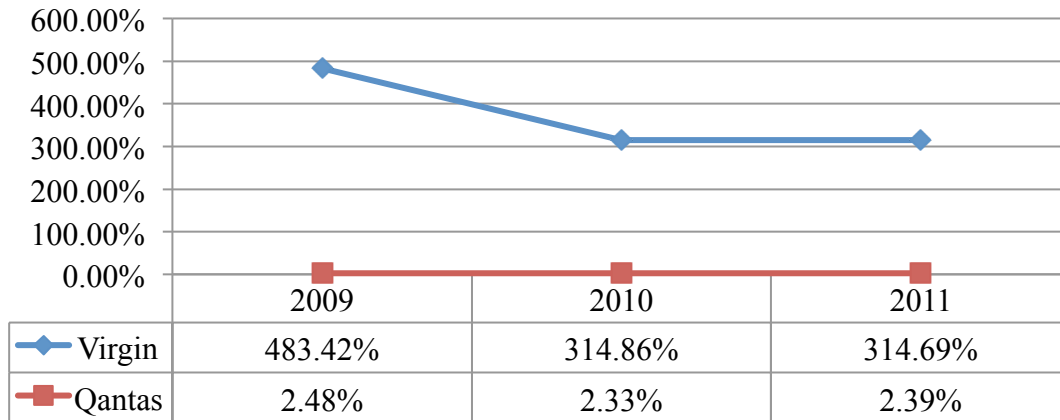
Qantas has an average of 70% debt ratio over the three years which means Qantas is operating in debt. It is but less debt ridden compared to its competitor Virgin in the reviewed period.

### Interest coverage ratio



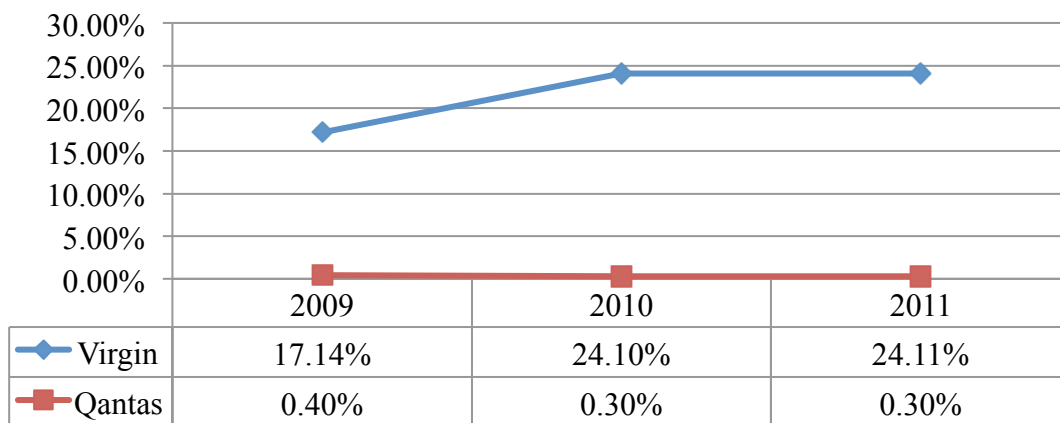
Qantas is more inclined to its debt for operation compared to Virgin. In all three years, Qantas has heavily relied on its debts for operational activities. However, the ratio is above the questionable level. If the ratio is below 1.5, the ability of the company to meet the interest expenses is questioned.

### Debt to equity ratio



The above figure shows that Qantas has lower debt-to-equity ratios (fluctuate within 2.3% to 2.5%) way ahead than Virgin's (above 300%). It means that Qantas using less leverage than Virgin. Whereas from the equity position's point of view, Qantas is more resilient than Virgin.

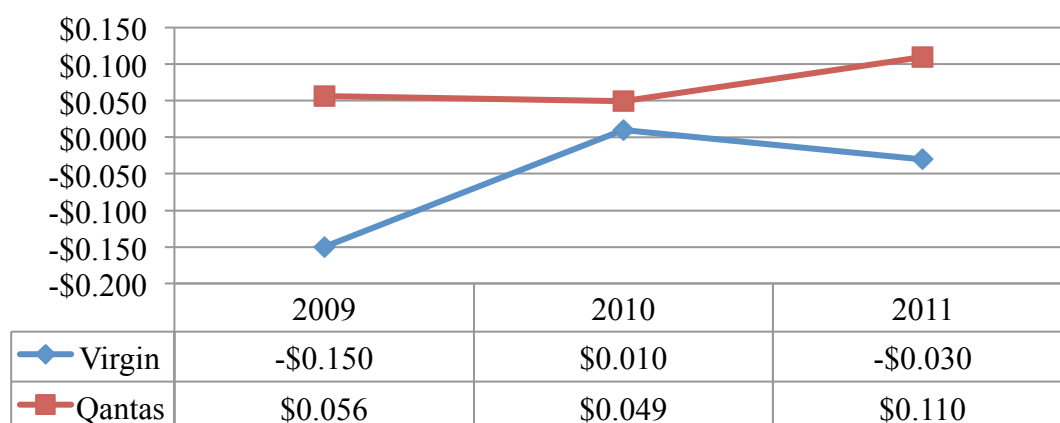
### Equity ratio



From the above chart, Qantas shows a lower Equity ratio than Virgin, which means that Qantas does not rely on its shareholder to expand and rely more on debt funding, even though it is still a minute compare to its total asset. All in all, the equity ratio and the debt-to-equity ratio of Qantas suggest that Qantas is growing in a modest way, while Virgin as a new player in the field must compensate the growth with heavy burden on debt that put shareholders' trust a little bit away from investing in this company.

## Market performance ratios

### Earnings per share (EPS)



Qantas is not able to give back a good return to investors/share holders while Virgin has gone negative in earning its share. That is why the company has not issued any dividends in the reviewed period (2009-2011).

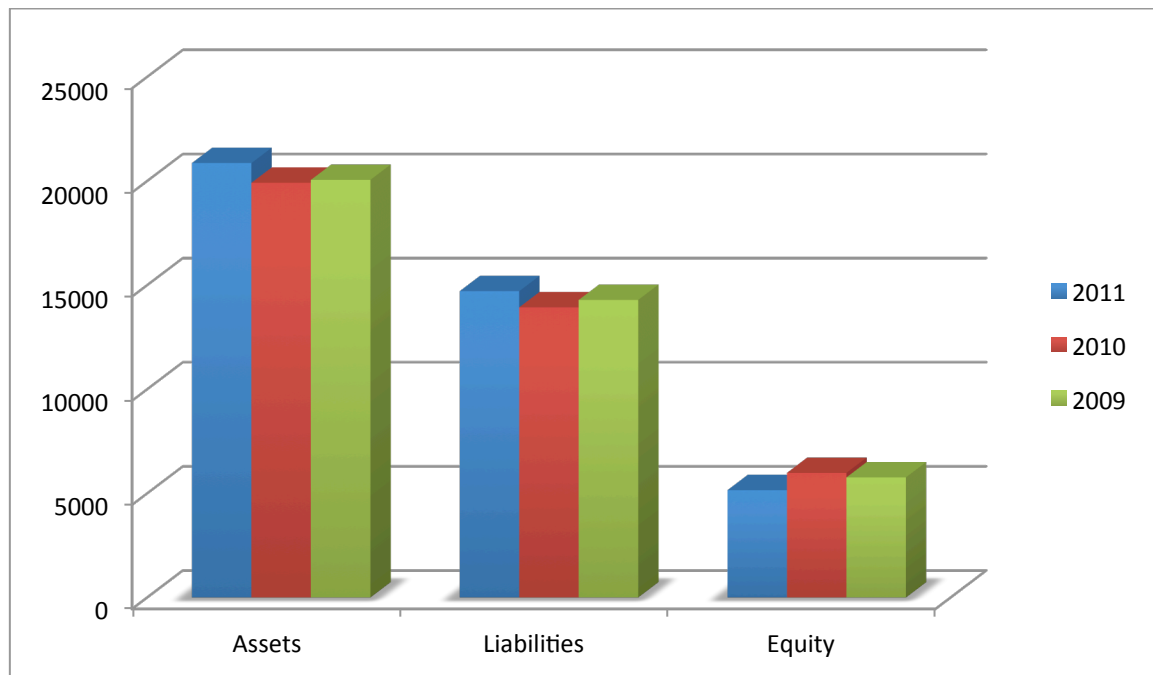
## Trend Analysis- Qantas

### Balance sheet

*Assets:* There's slight increase in the total assets of the company though current assets decreased slightly in 2011 compared to 2010. In terms of total assets, the company fared negative on 2010 compared to the previous year but that has been recovered in 2011. In all three years, non current assets occupy bigger proportion. Under current assets, the company has highest increases inventories and under non current assets, the company's 'investments accounted for using the equity method'.

*Liabilities:* Its liabilities remain fluctuating over the period of review (2009-2011). The current liabilities are decreasing (100% - 92.87%) signalling a good sign. However, its non-current liabilities pushed the total liabilities up in 2011 compared to 2010. Total liabilities in 2011 surpassed that of 2009 as well. This is because of the major increase in other financial liabilities (100% - 183.96%). This is in indication of the airlines company being highly leveraged.

*Equity:* Equity is little more than half of the liabilities in 2011 while its almost one-third in 2009. The cause behind might be that Qantas uses debt over capital raising equity to finance its assets. But the company has hefty increase in retained earnings (100% - 134.71%) in 2011 compared to 2009. Late issue of dividends or re-investment facilities for shareholders might have resulted this.



### Income statement

Qantas income statement reveals, the company had performed badly in the year 2010. In all areas, the company went downward trend. Qantas has shown an increase in revenue from 100%, 94.26% and 104% during the review period. Similarly, the company's EBIT had a large increase of 100%, 98.34%, and 178%.

The statutory profit of Qantas increased from 100% to 202%. Sales volume and revenue have increased at a greater scale than operating and financing activities of the company.

## Cash flow

The Qantas reports mention that both net cash inflow from operating activities and cash outflow from investing activities have increased each year over the review period. However, cash flow from financing activities has decreased. Fluctuating net cash flow for the period 2009 and 2010 shows weak liquidity in the company in need of emergency. Cash and cash equivalent at the end of the year was quite stable during the review period.

## Qantas and Virgin Airlines compared

### Balance Sheet

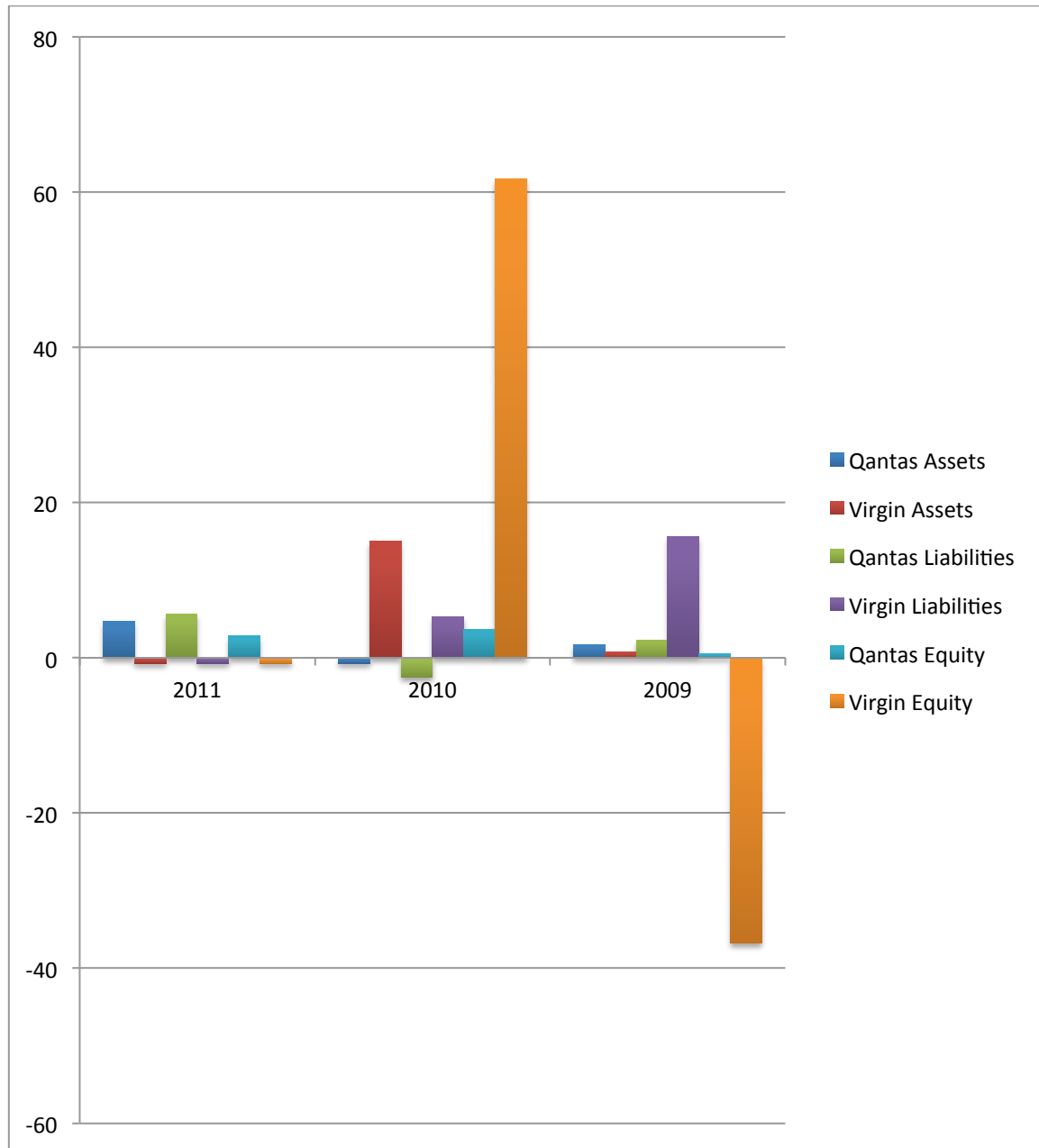
*Assets:* Both Qantas and virgin airlines experienced a growth in their total asset, but virgin increased significantly compared to Qantas. For Qantas the highest increase in current asset is their inventory where as for Virgin the greatest increase is their liquid cash. Virgin is ahead of Qantas in terms of managing its liquidity.

Both companies have shown an increase their non-current asset showing growth in their investing decision. It indicates that both companies invested in their long term assets.”

*Liabilities:* Overall Qantas had an increase in liability compared to Virgin. It indicates that the company is heavily relying on borrowings compared to equity. That is to say that Qantas is increasing its obligations to their creditors. Though the company is being highly leveraged the highest increase in liability is with their other financial liabilities. They must make sure they have enough cash-flow to service their debts (make interest payments). For Virgin airlines their total liability increased by only around 5%. This shows that they are very conservative with their financing decisions. So we can conclude though both companies increased their liabilities, Virgin is preferably doing better compared to Qantas.

*Equity:* For Qantas while their equity increases from one third compared to liability in 2009 to almost half in 2011. This shows they are getting investors from the market and people did actually increased their investments with the company. We should also note that their liability also increased over the period, so this increase in equity might be the result of not paying dividends to the share holders. While for Virgin the equity increased by more than 60% over

the years, this shows a growing investor confidence with the company. But during 2010-2011 periods as Virgin lost a lot of money their equity fell from \$933m to \$926m.



#### Income Statement:

For Qantas though their Revenue fluctuated during the years the company did manage to secure profits significantly from \$100m to \$522m. This performance indicator shows that the

company was very profitable during the period. Whereas for Virgin airlines though their revenue shows an all time increase trend, their expense had also increased significantly which lowered their profit and they reported a loss in 2011. That year was bad for the company as they failed to control their expense compared to their revenue.

#### Cash Flow Statement:

For Qantas the cash flow from both investing activities and operating activities increased which indicates that whatever money they made from their operations, they reinvested that in their assets. And the decline of cash flow from financing activities shows that their investments were heavily dependent on their retained earnings as they decreased their financing through loans. They also showed fluctuating cash flow during the period which raises a question on their liquidity. Whereas for Virgin both their operating and investing cash flow increased from 2009 to 2010 but declined in 2011. The decline may be due to the fact that they made a loss in 2011 and limited their investing decisions. The net cash flow declined significantly in 2011, which made it a very unattractive company to invest in. Virgin should be more careful to control its expense otherwise if the trend continues they will face the problem of liquidity and they will default on their debt servicing.

#### Qantas Vs Aviation Industry

Besides ratios analysis and comparative performance analysis between Qantas and Virgin, this section compares Qantas with the average industry figures.

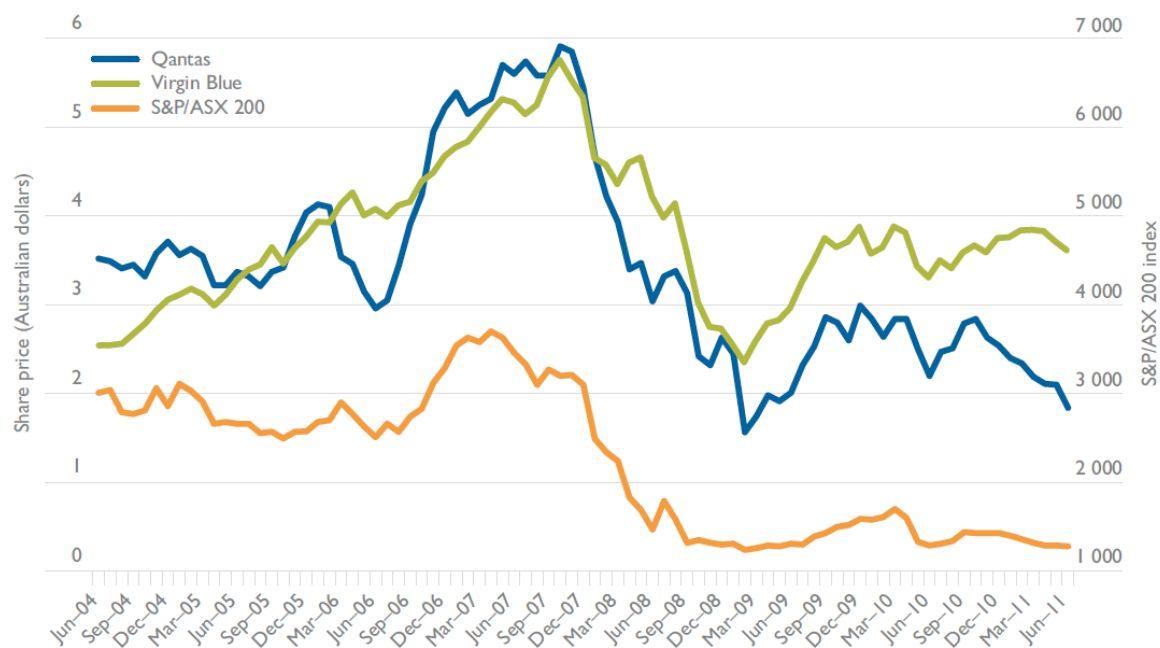
Of the total of 81.7m passengers movement during the year, Qantas carried more than half of them. In 2010-11 Qantas carried 44.5m passengers and earned \$12,042m in revenue. This is 81% of its total revenue.

Overall, the airlines industry in Australia posted 0.5% increase in revenue over the last five years (PRWEB, November 2011), Qantas has posted negative 1% growth in average in the same period. From freight Qantas earned \$842m and forms 6% of its total revenue.

Sydney continued to be Australia's busiest airport with nearly 36.0 m passenger movements in 2010–11. Canberra was the only airport of the ten major airports to record a decrease in passenger movements compared to 2009–10 (0.5% decline). Perth Airport experienced the highest growth in total passenger movements (9.0%), followed by Cairns (8.7%), Melbourne (7.9%) and Darwin (7.1%).

Both Qantas Airways and Virgin Australia stocks lost value in 2010-2011 in comparison to the S&P/ASX 200 Price Index. Qantas Airways stocks lost 16.4 per cent and Virgin Australia stocks lost 3.4 per cent despite S&P/ASX 200 Price Index gaining 7.1% in June 2011 compared to June 2010.

Qantas also lost race with Virgin in share prices as well. During the year 2010-11, Qantas' share price declined from \$2.47 in July 2010, to \$1.84 in June 2011 (25% decline). Against this, Virgin Australia's share price increased from \$0.31 in July 2010 to \$0.44 in September 2010 (29.5% increase) but fell to \$0.28 in June 2011 (9.6% decline).



Graph source:

*Aviation: Avline 2010-11, Statical Report, Bureau of Infrastructure, Transport and Regional Economics, Department of Infrastructure and Development, Australian Government*

## Horizontal Analysis

Qantas' total assets had increased during FY 2011 for about 5% from \$19.9m to \$20.86m. The increase composed of 3% in decrease of the Current Assets and 8% increase of the Non-Current Assets. In details, there were increased values of Current Other Financial Assets (36%), Inventories (17%), Non-Current Receivables (4%), Investments accounted for using the equity method (26%), and Property, Plant, and Equipment (9%). Although the changed percentage portion for Property, Plant and Equipment was quite modest, it accounted for the biggest part of Qantas' assets, i.e. AUD 1.14 billion. On the other hand, there were decreased values of Cash and cash equivalent (-6%), Current Receivables (-6%), Assets classified as held for sale (-78%), Non-Current Other Financial Assets (-31%), Intangible Assets (-11%), and Other Non-Current Assets (-57%). The biggest decrease in value was in Cash and cash equivalent, i.e. \$208m.

From that figures, in general it can be argued that Qantas laid more assets in the long term than the short term. In particular, in FY 2011 Qantas did not holding much cash even though it has sold its majority of Assets classified as held for sale, and probably has cashed-in some of its Non-Current Other financial assets, Intangible assets, and Other Non-Current Assets as well. It can be argued that Qantas using its cash to buy Other financial assets in the short run, to finance new Property, Plant, and Equipment, and to increasing its investment in its associate companies (in equity method). From the notes to the Financial Statement, Qantas explains that some of its cash were used to buy Short-term money market securities and put it as collateral for its financing activities (p.68). Other factors that could contribute to less cash in Qantas were the increasing value of debtors or customers in the long term than in the short term and the increasing value of Property, Plant, and Equipment. The major cause for the decrease in Current Receivables and the increase in Non-Current Receivables was the sundry debtors that traded with Qantas infrequently (p.69), while the major cause for increasing value of Property, Plant, and Equipment was Qantas decision to add their airline and flight through lease (p.87).

On the other side of the balance sheet, Qantas' liabilities increase for 6% or almost \$778m in value. The increasing liabilities consisted of 0.1% decrease in Current Liabilities and 10% increase in Non-Current Liabilities. The biggest percentage of increase was coming from the

Non-Current Other Financial Liabilities (113%), followed by the Current Other Financial Liabilities (64%). However, the biggest increasing value was Non-Current Interest Bearing Liabilities (\$339m), followed by the Non-Current Other Financial Liabilities (\$262m) and Current Other Financial Liabilities (\$155m). The increases in all liabilities account were dominated by management decision to procure more aircrafts, engines, and maintenances through short term and long term financing (p.79). Some liabilities that were planned to dispose in 2010 (amounting \$4m) have all been realised in 2011 (p.86).

As for the Equity, it increased by 3% or equal to approximately \$170m. Qantas did not issue any capital in this fiscal year, increased the Treasury shares by 33% and the Retained earnings by 22%. Having said that, Qantas also lost its Reserves by 22%, thus made the Equity attributable to the members of Qantas increased by 4%. As for the Non-Controlling interests was decreased by 90%. Reading that figures, it seems that Qantas did not want to burden the owners or shareholders in order to expand its business, but put its confidence in its operational capacity as shown in its decision to use leased aircrafts.

## Vertical Analysis

### Balance sheet

Total assets in 2011 and 2010 are \$20,858m and \$19,910m respectively. Therefore, each caption in the statement of financial position is divided by these total assets and then multiplied by 100.

**Assets:** Non-current assets in 2011 represent more than 70% of its total assets as a result of property, plant and equipment. It covers approximately 65% of total assets as a result of acquisition of aircraft and engines amounting to \$542m and transfer of aircraft and engines from aircraft deposits amounting to \$1541m, which offsets depreciation of \$996m during the year (p.75). Current assets in 2011 show only 27% of total assets. However, the largest proportion arrives from cash and cash equivalent which take up almost 17% of total assets. It is also critical to notice that there was a decline in cash and cash equivalent of 2% comparing to 2010.

**Liabilities:** In 2011, Qantas relied on debt to finance its assets more than equity. It represents about 70% of liabilities and owner's equity. Moreover, it is clearly seen that interest-bearing liabilities caption shows the highest percentage in non-current liabilities which is 37%.

**Equity:** Equity represents 29%-30% of total liabilities and owner's equity in 2010-11. We observed no change in issued capital but significant change in non-controlling interest, which represent 0.07% and 0.70% in 2011 and 2010 respectively. It is also interesting to note that as a result of good financial performance in 2011, retained earnings increased from 19% to 23%. Moreover, even though equity attributable to the members of Qantas in 2011 seems to increase significantly, there is almost no change in proportion which still represents 99% - 100% in both years.

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