



WILSONS

Does Omicron Quarantine the Recovery in Travel Stocks?

Our weekly view on Australian equities.

02 December 2021

Assessing the Threat of Omicron to the Travel Recovery

Australian travel stocks have been beaten up over the past month over concerns around the pace of reopening and rising energy prices. The emergence of COVID variant Omicron as a potential threat to the travel recovery over the past week has taken the retreat in travel stocks to around 20% since mid-October.

At this stage, it's difficult to be too definitive around the ultimate impacts of Omicron on economies and economic reopening until more data is available - likely mid-December. As a result, travel-related stocks will remain price sensitive to news flow surrounding the Omicron threat.

Our positive thesis on QANTAS (QAN - Wilsons Australian Focus List member) is based not so much around the international border reopening, but on domestic activity resuming.

This is in contrast to travel peers Corporate Travel (CTD), Flight Centre (FLT), and Webjet (WEB) where the real value they create for clients is primarily attached to more complex forms of travel like overseas travel.

Whilst the recovery in travel will take some time, we outline how QAN can get back to earning >80% of pre-COVID earnings without any contribution from the international business.

QAN domestic and Loyalty are the key generators of income for the airline and are likely to remain so. If the international business were to reach QAN's internal targets post COVID it would present >20% upside to consensus numbers in 2024/25. We continue to see the medium to long-term risk/reward of QAN skewed 2:1 to the upside.

Performance of Australian Travel Stocks

Travel stocks are now trading at similar share price levels as 12 months ago when news broke of effective vaccines.

After rallying through much of 2021 on reopening optimism, travel stocks have fallen back by ~20% since mid-October. We suggest several reasons behind the recent weakness:

- Prospects of northern hemisphere winter and the potential for re-emergence of travel restrictions
- Higher energy prices impacting airline stocks.
- Stalling of vaccination rates, with an emerging push for vaccination boosters
- The slow pace of borders reopening domestically, but also into popular international destinations like Asia and NZ

Since mid-October, the underperformance of Australian travel stocks vs the US Global Jets EFT (JETS.US) - a collection of global airlines - looks like an anomaly in our view, given the likelihood of further border reopening in Australia in the coming months.

Exhibit 1: Australian travel stocks have underperformed global airlines since mid-October



*Rebased to 100 at Nov 2020

Source: Refinitiv, Wilsons.

Travel Agents are Overweight International Travel

Since the equity market bottomed in March 2020 investors have lumped travel stocks into a single basket with a similar performance, bar Corporate Travel (CTD) which has outperformed considerably following a large acquisition. Over the past six months the performance between all four travel stocks has been similar.

As the recovery emerges, share prices are going to show greater divergence as the actual recovery takes place at different speeds, impacting each company differently.

We see QAN as being differentiated from the travel agent stocks for the simple reason that QAN can return to profitability without the need for international borders to open. We estimate that >70% of the QAN profitability is derived from domestic activities. This is important as we see the domestic pathway for reopening as being clearer, nearer and without the complications that international travel is likely to contain well into 2022.

Exhibit 2: Australian travel companies vs global airlines

Name	Ticker	International Exposure	EBITDA Growth FY23e-24e (%)	EV/EBITDA Average FY15-19 (x)	EV/EBITDA FY23e (x)
Qantas Airways	QAN	<30%	18%	5.3	4.6
Flight Centre	FLT	>90%	33%	8.4	9.5
Webjet	WEB	>80%	33%	n/a	14.2
Corporate Travel	CTD	>80%	15%	35.6	14.0

Source: Refinitiv, Wilsons Estimates.

Travel agents earn most of their income from international travel, which has a higher degree of complexity in terms of booking (i.e. travel which is multi-destination, multi-modal, and or an all-inclusive package). We see this style of travel as taking longer to return to normal than simple domestic aviation. The likely reopening of the QLD border in December 2021 will open up the highly profitable 'gold triangle' of the Brisbane, Sydney, Melbourne corridor for QAN.

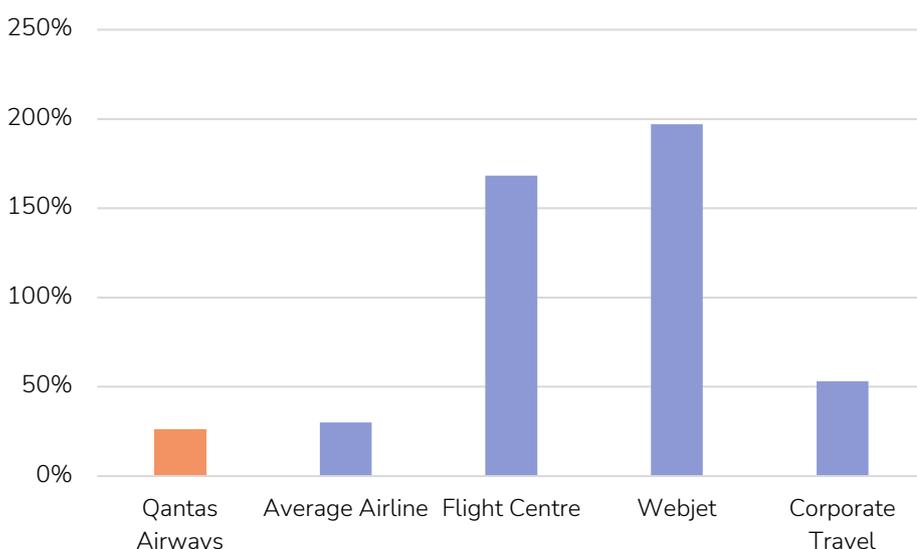
In contrast, we estimate more than 80% of travel agent revenue is linked to high complexity/international travel.

Earnings can Recover but will EPS?

To date, the market has not differentiated on the ability of travel stocks to return to pre-COVID levels of earnings-per-share (EPS). We see this as short-sighted given the significant dilution both Flight Centre (FLT) and Webjet (WEB) have undertaken to survive.

For FLT, the dilution could be significantly higher than what we show, depending on what price the \$800m of convertible notes are converted into equity. For QAN, the share dilution is just 26%. We can see a pathway to where QAN is generating enough free cash flow (FCF) to consider a share buy-back. Between 2009-2019 QAN bought back over 30% of its outstanding shares. We expect QAN will look to do the same once earnings normalise.

Exhibit 3: Share dilution has been significant for the travel agents and less so for Airlines*

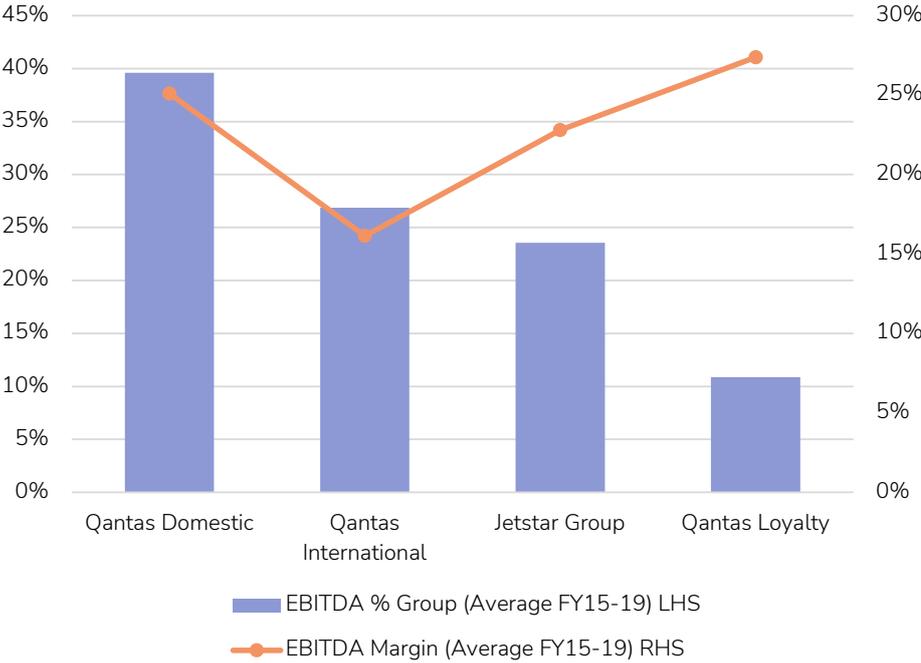


*Full service global airlines. FLT dilution excludes \$800m of convertible notes due in.

Source: Refinitiv, Wilsons Estimates.

QAN Divisional Earnings

Exhibit 4: QAN's highly profitable domestic business and Loyalty business underpin its earnings base



Source: Refinitiv, Wilsons Estimates.

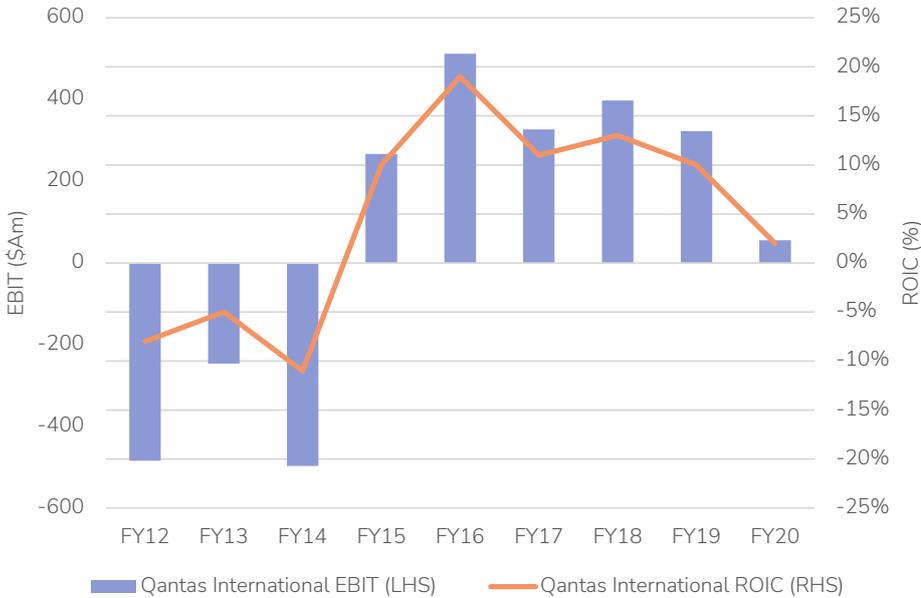
We expect the domestic aviation business to continue to be the core earnings driver for QAN into the recovery. With >70% market share, generating a 25% margin, the premium domestic business is strong and has proven itself to have the ability to withstand concerted attempts of new competition. Normalised profitability is likely to be higher with a scaled-down Virgin Australia (VAH) (post private equity ownership) and with a manage-for-profit pricing mentality.

Jetstar is the fast-growing low-cost airline wholly owned by QAN. Pre-COVID, Jetstar represented almost 25% of group earnings. Post-COVID, the earnings prospects are unlikely to have been diminished.

Combined with the Loyalty business, we estimate these three businesses can return QAN earnings to around 80% of pre-COVID levels.

QANTAS International - COVID Presents a Pathway to Reset

Exhibit 5: QAN International earnings and returns have been variable. QAN targeting 10% ROIC post-COVID-19



Source: Refinitiv, Wilsons.

QAN runs a premium international airline. Full-service international long-haul businesses typically destroy capital. This is a function of government-owned airlines with ultra-low-cost of capital.

QAN is using the lull in international travel to reset the cost and capital base (fewer planes) of the international division. Removing unprofitable routes and scaling down some of the international operations will decrease revenue, but have a much smaller impact on overall profitability.

Partnerships, rather than ownerships of planes, will ensure an end-to-end customer experience. QAN is targeting a 10% return on capital by FY24.



Valuation

Historically QAN has traded at a ~25% discount to its full-service Asian and US full-service airline peers (both EV/EBITDA and PER). QAN's track record on capital discipline, high margin domestic business, and Loyalty are overlooked, with QAN's relatively small scale and long-haul aspect ultimately counting against it in the view of investors.

At present, QAN's relative pricing is not too different to history. Investors are paying around the long-term average on an FY23E basis (i.e. a 'normalised' year of earnings) at 4-5x EV/EBITDA or 10x PER. In the absence of a global airline re-rate, share price upside resides primarily through earnings recovery.

QAN valuation sensitivity

Putting aside high growth, QAN currently has the highest operating leverage of any company in the Focus List. The investment appeal of QAN is that future normalised earnings could be considerably higher than pre-COVID earnings by FY24/25E – which would present considerable upside to market estimates.

Bull case

Assumes a faster recovery from COVID-19. In FY23, domestic revenue is higher than in FY19, but international revenue will still be lower. Profit margins expand further than consensus is expecting after a successful cost-out program and less competition.

Base case

Our base case assumes a slower recovery in passenger demand, in line with what we have seen globally. In FY23, domestic revenue equals FY19 levels, and international capacity is down by 40% compared to FY19. Profit margins are expected to improve after the cost-out program and less competition.

Exhibit 6: QAN historically traded a discount to global full-service peer airlines

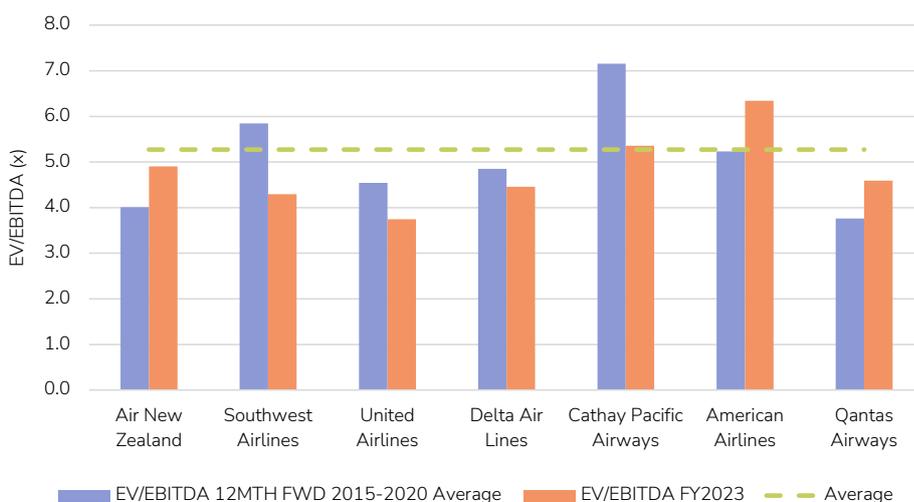


Exhibit 7: QAN bull and bear case scenario points to 2:1 upside/downside potential

	Bear Case	Base Case	Bull Case
Earnings as % of FY19	67%	93%	127%
EV (A\$m)	11,589	16,034	21,851
5x EV/EBTIDA FY23 multiple			
Market Cap (A\$m)	5,789	10,234	16,051
Implied Share Price (\$A)	3.16	5.59	8.77
Current Share Price (30/11/21) (\$A)	5.06		
Implied Share price upside (\$A)	-37%	11%	73%
EPS (cps)	0.35	0.49	0.66
Implied PER (x)*	14.4	10.4	7.6

* PER at scenario EPS level.

Source: Refinitiv, Wilsons

Bear case

Assumes a significant delay to travel restrictions being lifted, potentially from the Omicron variant. Travel demand declines for both the corporate and leisure markets leading to a longer recovery profile. Fuel costs increase, and profit margins do not increase as much as expectations – the cost-out program is relatively ineffective.

The >\$400m pa of earnings is valued by the mark on QAN group multiple.

QAN Loyalty: cash generative growth business

QAN Loyalty or Frequent Flyer rewards program is the largest customer reward programs in the country with >12m members, capable of generating >\$1.6bn in revenue per year.

Loyalty business is not only highly strategic for QAN, but is extremely valuable generating ~15% QAN earnings in normalised periods. Importantly, the Loyalty earnings are somewhat immune from the aviation cycle, providing QAN with a counter cyclical earnings stream. In 2021, Loyalty was the only division to generate income.

The Loyalty business generates most of its income by selling frequent flyer points to partner providers (>650 companies) which are incorporated into their own reward programs. QAN sells these points at a margin above costs.

Over the years, QAN has looked at alternative ownership structures for the Loyalty business. The >\$400m pa of earnings is valued by the mark on QAN group multiple. Loyalty as a standalone could attract an earnings multiple double that of the airline business given its growth profile and highly cash generative nature irrespective of the economic cycle.

With listed loyalty programs now largely owned by investment firms or financial sponsors, valuation reference points are more challenging. We see QAN Loyalty was being an integral part of QAN earnings going forward.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

Disclaimer

All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

Wilsons Australian Equity Focus List (Focus List) is a weighted list of the Investment Strategy Group's (ISG) preferred companies. The Focus List can hold up to 25 companies, largely taken from the S&P/ASX 300. Stocks may be substituted at any time at the discretion of the ISG. Performance numbers around the Focus List are unaudited, and should be used only as a guide to indicate returns if investors were to follow the Focus List. For further information please contact your Wilsons Advisor.

This document has been prepared by Wilsons Advisory and Stockbroking Limited (AFSL 238375, ABN 68 010 529 665) ("Wilsons") and its authors without consultation with any third parties, nor is Wilsons authorised to provide any information or make any representation or warranty on behalf of such parties. Any opinions contained in this document are subject to change and do not necessarily reflect the views of Wilsons. This document has not been prepared or reviewed by Wilsons' Research Department and does not constitute investment research. Wilsons makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and opinions contained therein, and no reliance should be placed on this document in making any investment decision. Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of Wilsons and therefore may not be realised in the future. Past performance is not an indication of future performance.

In preparing the information in this document Wilsons did not take into consideration the investment objectives, financial situation or particular needs of any particular investor. Any advice contained in this document is general advice only. Before making any investment decision, you should consider your own investment needs and objectives and should seek financial advice. You should consider the Product Disclosure Statement or prospectus in deciding whether to acquire a product. The Product Disclosure Statement or Prospectus is available through your financial adviser.

Wilsons Corporate Finance Limited ACN 057 547 323, AFSL 238 383 may have participated in some capacity with regard to capital raisings for some of the companies mentioned in this article. To manage any conflicts of interest with Wilsons Research, full disclosure on any relevant corporate transaction may be found on our website.

Wilsons contact

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au