Geoff Dixon
Chief Executive Officer
Qantas Airways Limited

Operating Environment

Operating Environment

- International environment
- Australian domestic environment

- With around 75 percent of our aircraft asset base deployed in the international market, Qantas is obviously not immune from these difficult conditions. There are, however, offsetting positives for us which, if we exploit successfully, should provide us with profitable growth over the coming years.
- It is important we remember that the international aviation industry was already in decline before the events of September 11 greatly exacerbated the situation.
- In Australia during this period we also faced a very competitive domestic market, with a level of discounting that had driven domestic fares to an all time and, ultimately, unsustainable low.
- This intense competition, which had already seen one airline, Impulse, taken over by Qantas, finally resulted in Ansett, our major domestic competitor, with around 40 percent of the market, collapsing two days after September 11.
- Demand in our international markets following the terrorist attacks fell by an average of 20 percent, with the United States, our most profitable market, experiencing a decline of some 30 percent. To meet this situation we reduced capacity by an average of 13 percent on an annualised basis.
- To produce cash Qantas, along with most international carriers, has been discounting in most markets. This has helped to maintain our load factors at levels comparable with the prior year. However the impact of the discounting has been felt In our international yield, which was down 2.1 percent, excluding exchange, for the six months.
- Currently our leisure demand is strong, but we are yet to see a sustained recovery in premium demand. As a result we expect it may take up to two years for our international operations to return to the levels of profitability seen in the 2000 year, a year which benefited from the Sydney Olympics.

[slide commentary continued over]

Operating Environment

- International environment
- Australian domestic environment

- In the domestic market we moved very quickly following Ansett's collapse, and increased capacity by over 40 percent, which represented around 80 percent of the market they previously served. While some of this capacity increase was made possible by the redeployment of aircraft from our international operations, thus insulating us somewhat from the international problems, much of the increase was funded by costly short term wet-leased aircraft.
- We did this for two reasons:
  - Firstly, to prevent possible severe economic harm to business in general and the tourism and travel markets in particular, and
  - Secondly and unashamedly to take advantage of the unprecedented opportunity to grow our domestic market share.
- All these events make a comparison with the prior corresponding period difficult. Nevertheless I will take you through a quick summary of our results.

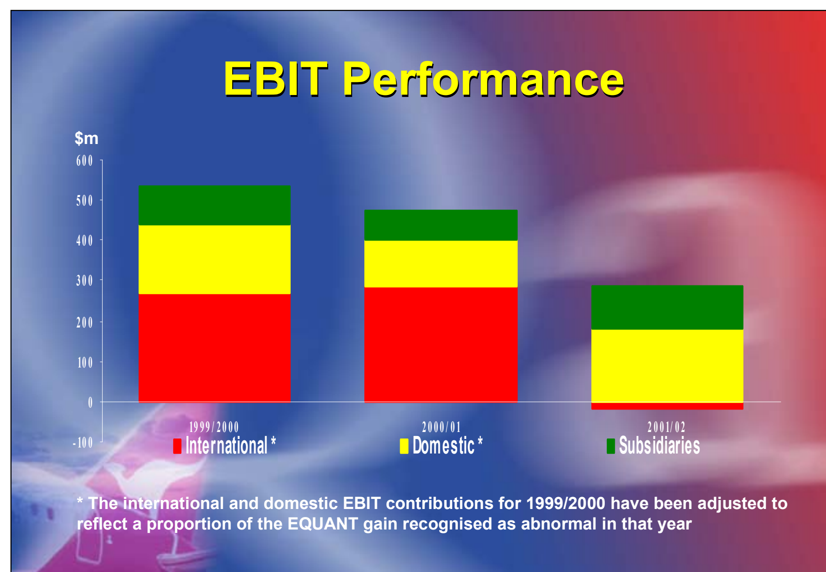
Financial Results

Highlights

		Dec 2001	Dec 2000	% increase (decrease)
Sales and operating revenue	$m	5,664.6	5,098.9	11.1
Expenditure	$m	5,394.1	4,628.4	16.5
Earnings before interest and tax	$m	270.5	470.5	(42.5)
Profit before tax	$m	231.3	416.4	(44.5)
Profit after tax	$m	153.5	262.9	(41.6)
Earnings per share	¢	11.1	21.5	(48.4)

- Sales and operating revenue increased by 11.1 percent to $5.7 billion, reflecting higher domestic traffic and yields, offset by lower traffic and yields internationally.
- Expenditure rose by 16.5 percent to $5.4 billion, mainly due to an overall capacity increase of 5.4 percent, but also due to:
  - The cost of wet-leased aircraft used to fund the domestic capacity increase;
  - Higher aircraft maintenance costs as our fleet aged tTo an average of just over 11 years;
  - Higher fuel costs of $224 million; and
  - The continued weakness of the Australian Dollar.
- Earnings before interest and tax decreased by 42.5 percent to $270.5 million.
- Profit before tax of $231.3 million was 44.5 percent lower than the prior year.
- Net profit after tax was $153.5 million, down 41.6 percent.

Divisional Performance and
Strategic Response



- This graph shows our current year earnings by division compared with the prior two half-years.
- You can see the impact of the prevailing operating environment on our current earnings before interest and tax, which fell by 42.5 percent, from $470.5 million to $270.5 million.
- The contribution from domestic operations, shown in yellow, increased from $118.1 million in the 2000 half to $180.1 million in the current year.
- However, at the same time, the contribution from international operations fell from a positive contribution of $285.9 million to negative $15.5 million.
- Collectively, subsidiaries contributed $105.9 million, compared with $66.5 million in the prior year.

Strategic Response

- Segmentation
- Grow non-passenger businesses
- Labour cost base
- Fleet upgrade and expansion program
- Capital management
- Qantas Sale Act

- Qantas had already put in place a number of strategic initiatives to combat the difficulties created by the economic slowdown prior to September 11. We accelerated these initiatives following these events.
- Broadly these strategies are:
- To align the revenue base of our various markets with an appropriate cost base to ensure acceptable returns and justification for continued investment. The result of this is the segmentation of our flying into four different categories.
- To aggressively grow those parts of our group that provide a return above that of the flying business. Flight catering, wholesale tours, domestic freight, regional airlines and our frequent flyer program. These companies are dependent on the airline, have been growing steadily and profitably, and since the collapse of Ansett have been provided with additional benefits of scale.
- To continue to work with our unions and our people to gain greater labour productivity;
- To upgrade and expand our fleet to take advantage of our new domestic environment and the changed international environment;
- To retain the strength and flexibility in our balance sheet as we move through this cycle of higher capital expenditure; and finally
- To seek the repeal of the Qantas Sale Act which restricts the level of foreign ownership in Qantas.
- I will now take you through each of these issues in more detail.

Strategic Response

- **International**
- Pursue strategy of market segmentation:
  - Three-class product for long haul flying
  - Ten two-class B747-400s to serve markets not requiring first class

- The segmentation of our international flying will see us more closely align our product, and therefore our cost base, with the yields available in each of our markets. We will remain a fully-fledged premium carrier, committed to our three class product for long haul 747-400 and later A380 flying to the United States, Europe, Hong Kong, South Africa and key intermediate ports such as Singapore and Bangkok.
- We will introduce a fleet of ten two class 747-400s to serve markets not requiring first class but where a profitable mix of business and economy demand exists. The business and economy class offerings on these aircraft will be identical to that of our three class 747 service. The reconfiguration will provide an extra 50 economy seats in each aircraft, the equivalent of 1.5 747-400 aircraft.

Strategic Response

- **International**
- Continue to invest in international product:
  - Refurbishment of B747-300 and 400 fleets, including in-flight entertainment in all classes
  - Evaluation of business class sleeper seat

- We will also proceed with major investment in our product despite the current difficult conditions.
- The first of our refurbished three class 747-400s commenced flying during last year, with new interiors in all classes, including personal video screens in every seat. This program is being accelerated and will be extended in a two-class configuration to our 747-300 fleet. We have a new business class sleeper seat under design and will review our plans for this product in the next few months.

Strategic Response

- **International**
- Launch of Australian Airlines:
  - Will operate independently of Qantas, on routes not serviced by Qantas
  - Low cost, but not low service offering

- Part of our international strategy has been to grow profitable markets while progressively withdrawing from unprofitable ones. We are now looking for more growth opportunities by returning to those previously unprofitable routes with a different product.
- That product is a new airline called Australian, which will be a wholly-owned subsidiary operating independently of Qantas, and only on routes not serviced by Qantas.
- Australian will commence flying in September from Cairns, a northern Australian tourist centre and gateway to the Barrier Reef, to Osaka, Nagoya and Fukuoka in Japan and to Singapore, Taipei and Hong Kong. Other routes will be added in 2003.
- Australian will be a low cost, but not low service airline, and is aiming for around 30 percent lower discretionary costs than Qantas through a single class seating configuration, savings on labour and an innovative service regime. Our modelling indicates that the airline can break even within its first 12 months of operation. However, it will only commence when the 30 percent lower cost target is achieved.

Strategic Response

- **Domestic**
- Pursue strategy of market segmentation:
  - CityFlyer super shuttle on key business routes
  - B747-400 and B767 aircraft for long-haul domestic flying

- As in our international operation, we are segmenting our domestic market to align our costs more closely with the revenue. Within those segments we are providing different flying products, but with a uniform standard of service.
- At the premium end we have introduced CityFlyer, a two-class super shuttle, which now services Sydney, Melbourne and Brisbane, offering half hourly departures, mostly widebody aircraft, and a range of dedicated facilities. The product is drawing enormous support from business travellers in those key centres.
- We have 747-400 aircraft, as well as the usual 767 aircraft, for long haul flying between Sydney and Perth, and Sydney and Cairns. The 400s domestically are extremely popular and more economically productive than we first anticipated.

Strategic Response

- **Domestic**
- Pursue strategy of market segmentation:
  - Introduction of B737-800 aircraft in all-economy configuration
  - Reconfiguration of existing B737 aircraft to all-economy class
  - QantasLink to service regional Australia

- Finally for our premium domestic operation we bought immediately after the Ansett collapse 15 new 737-800 aircraft, with a further 60 options. These aircraft have 25 percent lower unit operating costs than existing narrowbody capacity, will have new slimline seating in an all economy configuration and will seat 180 passengers.
- A number of our existing 737 aircraft will also be reconfigured to create a fleet of 40 all economy class aircraft, for deployment on trunk routes where there is a business market but no business class market.
- Our fourth segment is an existing regional operation called QantasLink, which services regional or non-trunk routes throughout Australia. This operation, following the collapse of many smaller airlines in Australia, now comprises 67 aircraft, operates 2,800 flights per week and carries six million passengers a year. It is a growing business with discretionary costs more than 25 percent lower than for the mainline.

Strategic Response

- **Qantas value chain**
- Subsidiaries:
  - QantasLink
  - Qantas Flight Catering
  - Qantas Holidays

- Along with QantasLink, a number of other subsidiaries form part of what we call the Qantas value chain….. And as I said earlier, each of these subsidiaries has seen a significant scale benefit since Ansett's collapse.
- Qantas Flight Catering is the largest airline catering operation in Australia….. Earning around 70 percent of its revenue from Qantas and having the majority of all the other airline business in the country. While it has had some industrial problems in its Sydney centre, the opening of a new production facility near Brisbane in Queensland, called Snapfresh, will allow it to increase its penetration into the institutional catering market, including hospitals and correctional facilities.
- Qantas Holidays is the largest leisure travel and tour wholesaler in the southern hemisphere, headquartered in Sydney but with valuable subsidiaries in key Asian cities. It remains a vital strategic asset, acting as a distribution channel for Qantas, protecting a considerable amount of revenue, and earning good margins on an extensive fully-integrated package holiday business.

Strategic Response

- **Qantas value chain**
- Other businesses:
  - Australian Air Express
  - Frequent Flyer Program

- Australian Air Express is a joint venture between Qantas and Australia Post under which Qantas carries express mail freight in the cargo hold of its domestic fleet. It was growing and profitable before last September, and the increase in domestic capacity over the last six months will directly translate into more saleable freight capacity and better growth prospects.
- We also include our frequent flyer program as an important component of the Qantas value chain. The program is an offensive rather than defensive product, generating extensive revenue as well as loyalty. We now have agreements with all credit card providers, and have seen a step-up in membership growth to over three million, with almost one in every six Australians now being a member.

Strategic Response

- **Other strategies**
- Labour cost base
- Fleet upgrade and expansion program
- Capital management
- Qantas Sale Act

- The wage pause has been accepted by approximately 85 percent of our workforce, and was offered and accepted in return for an incentive scheme that will provide a lump sum payment equivalent to three percent of an employee's base salary if Qantas achieves a profit before tax of $550 million for the current financial year. The concept of incentive payments to align some part of remuneration more closely to the company's performance will be ongoing in our labour relations.
- I would now like to say a few words about two closely related issues. Our major fleet upgrade and expansion program and our capital management strategy.
- The aircraft orders in our ten year fleet program were placed prior to September 11, but they remain just as relevant today, and with the purchase prices still highly competitive.
- We take delivery of the first of 13 A330 aircraft in November, with a further three A330 aircraft and six 747 ER aircraft being delivered throughout next year. The 747ER has been built by Boeing exclusively for Qantas and will be capable of flying non-stop between Sydney and Melbourne and Los Angeles with a full passenger and freight load; currently not possible on this route because of seasonal headwinds.
- Significant flexibility has been built into the fleet plan in the form of slide rights that enables us to move delivery dates to match our capacity requirements. Our decision to defer delivery of three A330s demonstrates this flexibility in practice.
- We also retain the flexibility to move the retirement dates of our older aircraft, ensuring we operate the optimum level of capacity for the prevailing conditions. This flexibility has also been demonstrated in practice with our recent decision to accelerate the retirement of four 747-200 aircraft from late this year, one 747SP aircraft last November, and another SP this month.

[slide commentary continued over]

Strategic Response

- **Other strategies**
- Labour cost base
- Fleet upgrade and expansion program
- Capital management
- Qantas Sale Act

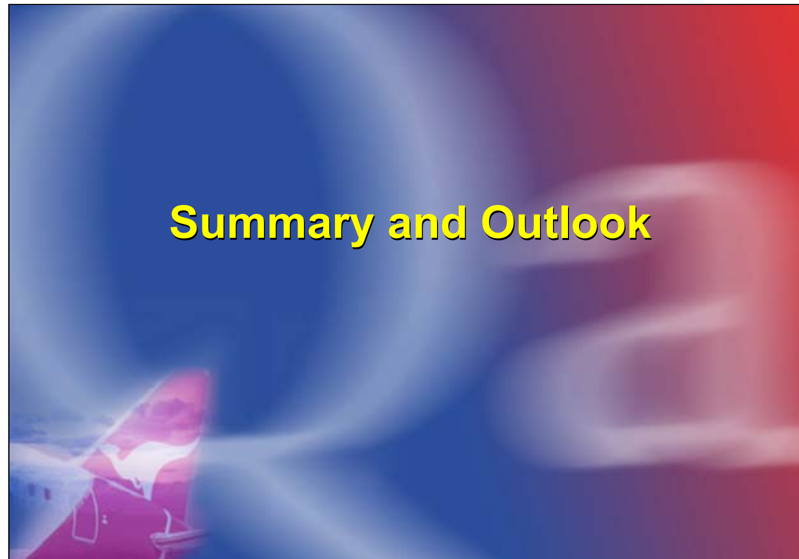
- The retirement of these aircraft will provide a step change in our cost base, cutting significant heavy maintenance costs and the cost of spares specific to these aircraft types.
- Our fleet program will provide Qantas with a very strong platform for the future. With large widebody aircraft supported by new generation narrowbody aircraft in our domestic market, and with 747-400s, and in 2006 the A380 aircraft in our international operation, each of which are ideal for the specific nature of Qantas' international flying.
- This program, while hugely significant in Qantas' terms, is underpinned by our capital management strategy.
- To successfully compete both internationally and domestically against lower cost operators we continue to work to drive down costs overall, and as labour comprises 25 percent of our total cost base, it is an important part of this strategy.
- Wage and salary cost increases were contained to 1.5 percent for the six months to December 2001; made possible by a combination of a 12 month wage pause, staff reductions and changed work practices.
- Since our privatisation in 1995, we have worked hard to provide a strong balance sheet; a strategy made more necessary in light of recent events. Market observers maintain that only those airlines with robust balance sheets can prosper in the current operating climate, a proposition with which we at Qantas wholeheartedly agree.
- We also believe that shareholder value is maximised with an investment grade credit rating. So we remain committed to maintaining our book gearing between 50 and 60 percent, including off balance sheet debt.

[Slide commentary continued over]

Strategic Response

- **Other strategies**
- Labour cost base
- Fleet upgrade and expansion program
- Capital management
- Qantas Sale Act

- Our recent $663 million equity raising will ensure that we remain within this range, with book gearing, including off balance sheet debt, for the 2002 financial year currently forecast to be slightly over 55 percent, a significant achievement given capital expenditure is forecast at $2.5 billion.
- With respect to our dividend policy, it is the board's current intention that the annual dividend payout ratio will be about 60 percent. In line with this we declared a fully franked interim dividend of eight cents a share for the six months to December 2001.
- Before concluding with our outlook, I would like to explain our stance with respect to special government legislation called the Qantas Sale Act.
- The Qantas Sale Act is legislation enacted by the Australian Government during our privatisation, requiring Qantas to be 51 percent Australian owned, and which restricts ownership by a single foreign investor to 25 percent and by multiple airlines to a maximum of 35 percent.
- For some time now Qantas has petitioned the Australian Government to repeal the Act. We believe the Act places an unnecessary restriction on Qantas' ability to access the international capital markets and, to date, has resulted in our exclusion from benchmark free-float international indices such as the MSCI.
- While we have no agreement on removal of the act to date, both the government and the major opposition political party in Australia have indicated our arguments have some validity in the current environment. We are confident our request for the act to be repealed will be given every consideration sometime this year.



- To sum up, September 11 irrevocably changed the airline industry, both in Australia and globally.
- There are now signs of increased demand for international travel. However, markets are being stimulated by heavy discounting, which is impacting yields.
- In Australia, while a more rational domestic environment represents a positive for Qantas. However, Virgin Blue, their new partner, and any of the other rumoured competitors will all act to maintain a healthy degree of competition.
- We believe that the products we will offer in each of our markets, a continuing focus on costs, a strong portfolio of non-flying companies and the strength of our balance sheet, provides us with a solid platform for success.
- We also believe that while the low-cost carriers are the “flavour of the month” as they say, and rightly so, the events of September have strengthened the position of carriers with strong operational records, a cost conscious culture and a premium product….. Qantas is one of these carriers.
- In terms of profitability for 2001/02, I can reaffirm our target remains a profit before tax of $550 million.