

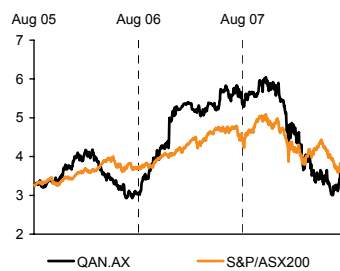
1 August 2008

Produced and issued by: ABN AMRO Equities Australia Ltd

Change of forecast

HoldTarget price
A\$3.20Price
A\$3.32Short term (0-60 days)
n/a**Price performance**

	(1M)	(3M)	(12M)
Price (A\$)	3.04	3.40	5.74
Absolute %	9.2	-2.4	-42.2
Rel market %	14.4	9.8	-28.6
Rel sector %	12.2	11.8	-35.0

Market capitalisation
A\$6.38bn (US\$6.04bn)Average (12 mth) daily turnover
A\$56.94m (US\$51.44m)RIC: QAN.AX, QAN AU
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Qantas Airways

What price for loyalty?

We value the Qantas Frequent Flyer program at A\$1.8bn-2.0bn and believe the QAN board will give the go-ahead for the IPO at the FY08 result this month. However, we expect movements in the oil price to remain the near-term driver of the share price. **Hold.**

Key forecasts

	FY06A	FY07A	FY08F	FY09F	FY10F
EBITDA (A\$m)	2067.8	2608.2	3248.3	2095.4	2269.7
Reported net profit (A\$m)	479.5	719.3	971.2	376.7	410.8
Normalised net profit (A\$m) ¹	544.0	858.3	1234.2	376.7	410.8
Normalised EPS (c) ¹	27.4	43.6	63.6	19.9	21.7
Normalised EPS growth (%)	-16.8	58.7	46.0	-68.8	9.05
Dividend per share (c)	22.0	30.0	36.0	20.0	20.0
Dividend yield (%)	6.63	9.04	10.8	6.02	6.02
Normalised PE (x)	12.1	7.62	5.22	16.7	15.3
EV/EBITDA (x)	4.48	3.10	2.58	4.54	4.61
Price/net oper. CF (x)	3.25	2.77	2.37	3.52	3.39
ROIC (%)	5.69	9.03	14.2	4.13	4.73

1. Pre non-recurring items and post preference dividends
Accounting Standard: IFRS
Source: Company data, ABN AMRO forecasts

year to Jun, fully diluted

Qantas Frequent Flyer float looks ready to go...

The QAN board is to announce at the FY08 result on 21 August its decision on whether it will proceed with the planned spin-off of the Qantas Frequent Flyer (QFF) program. Although there is some possibility of a delay due to weaker market conditions, we expect QAN to press ahead with the float of about 40% of the business by the end of CY08. We value QFF at A\$1.8bn-2.0bn and estimate the market cap at A\$1.1bn-1.2bn (implying a free-float of A\$430m-480m). We view the planned spin-off as positive for QAN given QFF is likely to trade on a higher multiple (if the experience of its listed peer, Aeroplan, holds). However, in the near term, we see movements in the oil price as being the near-term driver of the QAN share price.

... with recent enhancements introduced

QAN introduced enhancements to the program on 1 July, with the major change being a second-tier redemption option ('any seat') in addition to the 'classic' award system giving customers more flexibility (at a higher price) in using their points. Our analysis suggests points required under the 'any seat' option remain similar on domestic flights to the classic system, while points for international flights appear more expensive. Overall, we expect the increased ability to redeem points to shorten the life of a QFF point from 2.2 years to around 1.5-2.0 years (potentially offsetting this though is an increase in point issuance). The impact will be to bring forward earnings into earlier years as earnings are recognised on point redemption.

Credit card spending to support earnings growth

According to the RBA, about 7.2m Australians have credit card accounts, representing 1.72 cards each on average. There are around 5m QFF members, which suggests 60-70% of credit card holders are QFF members. Since 1995, annual credit card purchases have increased 12.6% pa, which we believe will help underpin earnings growth within the business. On an active membership base of 3.5m (active in the past three years) and given estimated annual net membership growth of 180k, we forecast adjusted EBITDA growth for QFF of 12.1% in FY09 to A\$206m.

Important disclosures can be found in the Disclosures Appendix.

Qantas Frequent Flyers: loyalty program or profit centre?

Prepare for spin-off

We value Qantas's Frequent Flyer (QFF) operations at A\$1.8bn-2bn. In our view, the frequent flyer operations are most closely comparable to Aeroplan, the only listed loyalty program. We think the business could handle debt of A\$720m-800m (40% gearing), implying QAN could raise A\$430m-480m from the potential IPO, assuming it retains a 60% equity stake. This would provide a small, but welcome source of cash in the current difficult operating environment.

Table 1 : Estimated cash raised from QFF IPO*

(A\$m)	Enterprise value					
	1,400	1,600	1,800	2,000	2,200	2,400
25%	420	480	540	600	660	720
33%	375	429	482	536	590	643
40%	336	384	432	480	528	576
50%	280	320	360	400	440	480
60%	224	256	288	320	352	384

* Assumes QAN sells 40% of QFF through an IPO.
Source: ABN AMRO estimates

In our view, the spin-off should be positive for QAN given QFF is likely to trade on a higher multiple. To date, (largely due to the impact of a higher oil price) we don't think QAN has benefited from any re-rating potential following increased disclosure of QFF earnings at the 1H08 result. We believe separate trading of QFF will reinforce the value contribution it makes to the QAN group.

QAN management appears intent on moving ahead with a partial divestment of QFF. Given the turmoil in the global markets we think there is a small chance the board will decide in August to delay the divestment for 6-12 months until a more stable investment environment returns. However, with record oil prices negatively impacting the business in the lead-up to a significant capex program, a divestment by the end of the year could come at a good time for QAN to provide it with an extra cash buffer. We therefore think it is most likely QAN will press ahead with the divestment by the end of CY08.

We forecast FY08 EBITDA of A\$121m for QFF. This would represent 3.8% of QAN group EBITDA (or 5.7% on an adjusted EBITDA basis). We anticipate revenue growth of 6% pa during the next two years, reflecting continued strong credit card growth, offset by a potential slowdown in travel. Longer term, we anticipate points allocation will grow at 8-10% pa, reflecting continued high single-digit credit card growth.

Table 2 : QFF indicative financials

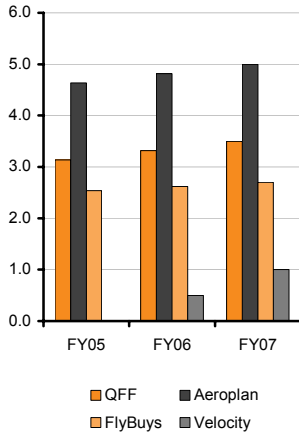
(A\$m)	FY07E	1H08A	2H08F	FY08F	FY09F	FY10F	Comments
Reported revenue	776	399	405	804	852	903	Includes points-related revenue + fees and ancillary revenue
Growth rate				3.6%	6.0%	6.0%	
Costs	654	337	346.1	683	719	762	Redemption costs of points
Reported EBITDA	122	62	58.9	121	133	142	Accounting EBITDA impacted by time lags
Adjusted earnings:							
Gross billings	913	479	498	977.2	1046	1119	Proceeds from the sale of FF points
Growth rate				7.0%	7.0%	7.0%	
Points-related revenue	-756	-391	-397	-788	-832	-883	Revenue recognised due to points redemption + breakage estimate
Change in future redemption costs	-115	-56	-70	-126	-140	-150	Provision against cashflow to recognise increase in points balance
Adjusted EBITDA	164	94	90	184	206	227	Exp profitability from sale of points during period (eliminates time lag)
Implied growth				12.3%	12.1%	10.0%	

Source: Company data, ABN AMRO forecasts

Program overview

The Qantas Frequent Flyer (QFF) program has evolved from a pure loyalty reward for frequent flyers to a business in its own right, which we value at A\$1.8bn-2bn. The program began in 1987 as a loyalty program for Qantas passengers. While rewarding loyalty remains a significant driver of the program, we believe it has extended from purely airline passenger loyalty, through partner-customer loyalty towards a business model in its own right.

Chart 1 : Frequent Flyer membership (millions)



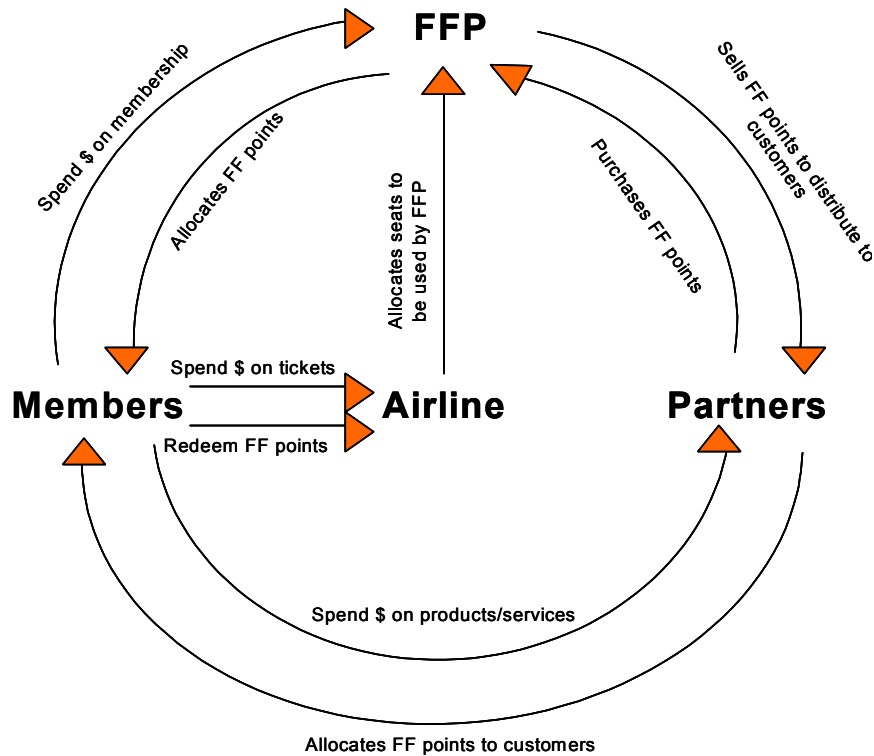
*For QFF and Aeroplan, based on estimated "active" members in a three-year period.
Source: Company data, ABN AMRO estimates

The program presently has more than 5m members and accumulates about 1,000 new ones every day. We estimate that around 50% of total members (2.5m) have been active in the past 12 months and 70% (3.5m) active in the past three years. As such, QFF is Australia's largest loyalty program, about 30% larger than FlyBuys® and 70% of the size of the Canadian-listed loyalty scheme, Aeroplan [AER.CA, C\$14.92, NR].

The dynamics of a frequent flyer program

The basis of the QFF program is earning points for flights, although it has now evolved into a broader program of earning capabilities. Points can be earned from Qantas and affiliated airlines for travelling with those airlines as a loyalty incentive and from non-airline partners for transacting with those partners. In this respect, while the loyalty relationship is primarily between the partner and the customer, Qantas also benefits from the association through the frequent flyer points. The loyalty relationship enables QAN to manage load factors effectively and is a key factor in QAN maintaining its market share.

Chart 2 : Frequent flyer dynamics



Source: ABN AMRO

Table 3 : QFF partners

	Earn	Redeem
Qantas group	3	3
One World	9	9
Partner airlines	14	14
Credit cards	14	
Other financial institutions	7	
Hotel/hotel chains	280	12
Car hire	4	2
Other travel	6	
Qantas affiliated businesses	4	
Other	14	
Total	355	40

Source: Company website, ABN AMRO

Not surprisingly, most benefits accrue to the most loyal customers

While the program is a substantial business in its own right, we believe there is still a sizeable element of loyalty generation associated with it. In addition to status credits, which we believe influence a member's ability to receive free upgrades as well as accelerating points-earning capability, the 'value' associated with redeeming the points can also generate loyalty.

We believe Qantas sells the points for 1-1.5c each to its external partners, with financial institutions likely to pay towards the lower end. Based on key flights, Sydney-Melbourne and Sydney-LA-Toronto, we believe members can derive up to 10.8c per point of value. The table below indicates that for members, greatest value can be derived from using points to pay for longer flights (ie, international) and more premium service (ie, business class).

Table 4 : Comparison of member benefits from classic loyalty programs

	Qantas FF	Aeroplan ¹	Velocity	Flybuys
Revenue (FY07, A\$)	798	1058		
Estimated "active" members – three-year period (m)	3.5	5.0	1.0	2.7
Revenue/member (A\$)	228	212		
Adjusted EBITDA (FY07, A\$m)	188	280		
Adjusted EBITDA/member (A\$)	53.7	56.0		
Indicative points required				
Domestic				
Sydney/Melbourne (including taxes)	28,000	15,000 ²	13,800	22,000
Credit card A\$ spend to achieve	28,000	16,667	27,600	110,000
Implied benefit of points (c/point)	0.8	1.6	0.7	0.2
Premium credit card A\$ spend to achieve	14,000	12,346	13,800	na
Implied benefit of points (c/point)	1.5	2.1	1.3	na
International				
Sydney/LA/Toronto (excluding taxes)	132,000	75,000	121,000	na
Basic credit card A\$ spend to achieve	132,000	83,333	62,667	na
Implied benefit of points (c/point)	1.9	3.1	3.0	na
Premium credit card A\$ spend to achieve	66,000	55,556	47,000	na
Implied benefit of points (c/point)	3.9	4.6	4.1	na
Sydney/LA/Toronto business class	264,000	100,000	188,000	na
Credit card A\$ spend to achieve	264,000	111,111	125,333	na
Implied benefit of points (c/point)	5.4	12.4	10.0	na
Premium credit card A\$ spend to achieve	132,000	74,074	94,000	na
Implied benefit of points (c/point)	10.8	18.7	13.3	na

1. Conversion rate of A\$1.00 = C\$0.90.

2. Aeroplan equivalent of Toronto/Montreal.

Source: Company websites, ABN AMRO

Frequent flyers generate greater benefits from using points to pay for international flights and business class tickets

Further analysis (on similar routes used above) confirms that frequent flyers generate greater benefits from using points to pay for international flights and business class tickets. Table 5 shows that an international flight from Sydney-LA-Toronto can cost 14.5x more (in dollar terms) than a domestic flight from Sydney-Melbourne, but it only requires 4.7x as many frequent flyer points. Likewise, a business class ticket can cost 5.0x more than an economy ticket but requires only 2.0x as many frequent flyer points.

Table 5 : Differential of using points vs dollar cost

	Economy class	Business class
A\$ cost – international vs domestic	14.5x	14.1x
QFF points required – international vs domestic	4.7x	4.7x
	Domestic* route	International* route
A\$ cost – business class vs economy class	5.0x	4.9x
QFF points required – business class vs economy class	2.0x	2.0x

Example of how to read table – in economy class, the cost of an international ticket is 14.5x more expensive than a domestic ticket.
 * International – Sydney-LA-Toronto; Domestic – Sydney-Melbourne.
 Source: QAN/Aeroplan websites, ABN AMRO

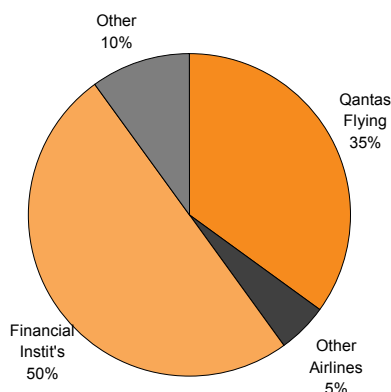
Earning and redeeming points is getting easier

The Qantas FF program has over 350 partners, primarily Qantas/Oneworld affiliated airlines, hotels and financial institutions. The vast majority of the partners allocate Qantas frequent flyer points, which can then be redeemed for flights (both on Qantas airlines and One World airlines), accommodation and car hire.

Our analysis suggests QFF allocated in excess of 150bn points to members in FY07, with about 62bn (40%) from flying on Qantas and partner airlines. We estimate points earned through financial institutions, primarily from using credit cards, represents about 50% of points allocated, with the balance from hotel, car hire and other services.

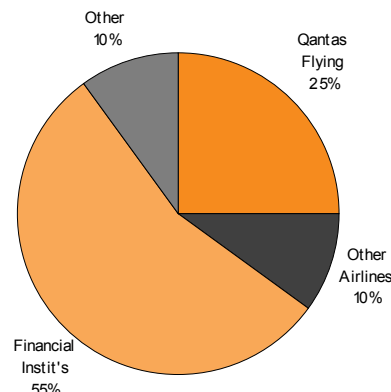
About 50% of QFF points are allocated to credit card companies

Chart 3 : QFF points allocation



Source: ABN AMRO estimates

Chart 4 : QFF revenue sources



Source: ABN AMRO estimates

The points allocated by the airlines retain the characteristics of a loyalty program, with a base level of one point being earned per kilometre flown. This rate of allocation increases with cabin level, with first class earning 1.5 points per kilometre flown. With additional points also being earned based on status levels (which in turn depend on frequency of flying and distance travelled during the membership year) the program does retain key elements of a loyalty scheme for Qantas.

Table 5 : QFF program partner points earning summary

	Points earned per A\$1 spend	Other points earning criteria	Indicative limit on points	Indicative partners
Financial institutions				
Basic credit cards	0.67		36,000-50,000 pa	ANZ, NAB, Westpac
Premium credit cards	1.0		unlimited	CBA, NAB, ANZ, Westpac, Amex, Diners, Citibank, St George, Suncorp
Super-earner credit cards	1.5		Unlimited	Amex, Diners,
Loans	0.05-.07	25k per A\$100k		ANZ, Macquarie
Term deposits	0.167		A\$10,000 min for 6 mths	Macquarie
Online trading	.33		1,000 per calendar month	E*Trade
Car hire – domestic	3			Avis, Hertz, Budget, Thrifty
Car hire – overseas		700/rental		
Hotels – domestic				
Hotels – domestic	3	1000/stay		Conrad, Hilton, Hyatt, Sofitel, Choice, Medina, Vibe
Hotels – overseas		600-1000/stay		Various
Holidays - Qantas related	2			Qantas Holidays
SkiMax		1000-2000/holiday		SkiMax
Other holidays	1-1.5			Wildlife Safari, Cruiseco
Telecoms – mobile	3		24-month mobile plan	Optus
Telecoms – calling card	4		calling card only	Telstra
Services		200,000/sale		Volvo, LJ Hooker, Trivett
Goods/other	1			Snap Printing, Cellarmaster, Nuance, Fletcher Jones

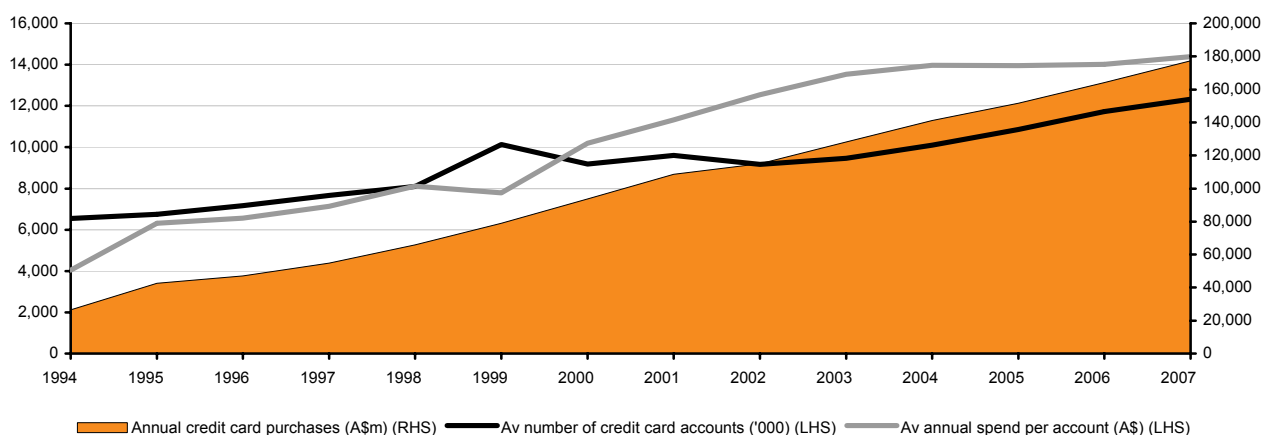
Source: ABN AMRO, Company website

As indicated in the previous table, credit card spend is the largest single method of earning QFF points. Effectively credit card providers (primarily NAB, ANZ, Commonwealth, Westpac, American Express and Diners Club) buy points from Qantas to allocate to their credit card holders when those holders 'swap' credit card points for frequent-flyer points.

We estimate 60% of credit card holders are QFF members

In 2007, there was an average of 12.3m credit card accounts in Australia (excluding charge cards). This suggests each Australian between 15 and 65 has a credit card. In reality, we believe a smaller proportion of the population holds more than one card. According to the RBA, about 7.2m Australians have credit card accounts, representing 1.72 cards (excluding supplementary cards) each on average. With around 5m QFF members (the vast majority of whom would be Australian domiciled), it suggests 60-70% of credit card holders are QFF members.

Chart 5 : Annual Australian credit card spend and average spend per card member



Source: RBA, ABN AMRO

We estimate 75-100bn points are allocated annually to cover credit card spend

In 2007, the average spend on credit cards in Australia was A\$14,383. We estimate a higher socio-demographic mix for QFFs, suggesting they would spend more than average on credit cards. Assuming A\$20,000 pa spend per frequent flyer member credit card, and taking in to account caps on points allocation and the fact that not all points earners on credit cards will redeem them for QFF points, we estimate 50bn-60bn QFF points would likely be allocated pa to cover credit card spend. We believe financial institutions pay 1-1.2c per point, with scale discounts

likely to apply. Therefore, we estimate the program generates A\$500m-700m in gross billings from financial institutions.

Frequent-flyer members use their points, primarily for flights, but also to pay for accommodation and car hire. With Qantas indicating 99% of redemptions were for flights and that, in FY07, there were 3.45m reward flights, we estimate QFF members redeemed about 120bn points last year. With around 150bn points accrued and 120bn redeemed, we estimate the increase in Qantas's liability for points increased 30bn increase in FY07.

Recent program improvements to allow more flexibility

Qantas has made changes to the program, which took effect 1 July 2008. These are intended to improve the appeal of the frequent flyer program with the potential for a partial float. Qantas has also announced that a decision on the ownership structure of the program is to be made in August and announced at the FY08 result on 21 August.

Effective 1 July QFF members have three different options for obtaining rewards seats:

- Qantas and Partner classic awards (existing system) whereby the availability of frequent flyer seats is limited (although over 3.5m seats pa) and are often allocated months before the flight, particularly at peak periods. This system suits those travellers with more flexibility in their itineraries and generally reflects discount economy fares.
- Points plus pay whereby QFF members can now use a combination of points and a credit/charge card payment for Qantas and Jetstar any seat awards and in the QFF store.
- Qantas and Jetstar any seats awards, whereby frequent-flyer points can be redeemed for any seat (including taxes and surcharges) on any Qantas or Jetstar flight. Under this system, the number of points required for the seat reflects both the class the seat is in and the market value of the seat based on demand. Under this system, members will pay more for the benefit of guaranteeing a seat on the day they wish to travel. We note, however, that the system doesn't extend to code-share partners, limiting the flexibility to some degree.

The points required for a 'classic' award seat (ie, the 3.5m) will not change from the original system and dynamic redemption ('any seat') will apply to incremental seats. In our view, this will have the effect of utilising more points, assisting Qantas with load management. We believe it will also reduce the time between point allocation and redemption, potentially reducing Qantas's cashflow advantage and breakage.

International award seats appear to 'cost' more, while domestic seats have a similar cost

We note from an examination of point redemption that domestic flights require a similar amount of points to the 'classic' system, while international flights have generally become more expensive, particularly when booking in a shorter time-frame. We think this disparity is likely due to the competition faced domestically by Virgin Blue's Velocity program, which tends to offer redemption opportunities at a 15-20% discount to QFF.

Table 6 : Comparative point redemption requirements

Origin	Destination	Qantas classic points	Tax (A\$)	Points needed to pay taxes ¹	All-inclusive classic points	Qantas any seat points ²	Jetstar any seat points ²	Virgin Blue - rewards ³	Virgin Blue any seat ³
2 months advance booking (September 2008)									
Sydney	Melbourne	16,000	80.56	12,000	28,000	26,792	23,953	12,300	18,800
Sydney	Perth	36,000	81.09	12,000	48,000	48,422	n/a	29,000	42,400
Sydney	Los Angeles	96,000	457.42	68,136	164,136	255,137	n/a	n/e	n/a
Sydney	London	128,000	797.08	118,731	246,731	284,938	n/a	n/e	n/a
Sydney	Hong Kong	66,000	327.07	48,719	114,719	147,498	n/a	n/e	n/a
7 months advance booking (February 2009)									
Sydney	Melbourne	16,000	80.56	12,000	28,000	26,792	24,429	13,800	18,800
Sydney	Perth	36,000	81.09	12,000	48,000	48,422	n/a	32,600	42,400
Sydney	Los Angeles	96,000	447.48	66,655	162,655	197,695	n/a	n/e	n/a
Sydney	London	128,000	754.48	112,385	240,385	221,049	n/a	n/e	n/a
Sydney	Hong Kong	60,000	330.30	49,201	109,201	97,870	n/a	n/e	n/a

1. Assumes 149 points per \$ of tax.

2. Inclusive of taxes.

3. Excludes taxes of about A\$88.

Source: Company data, ABN AMRO

Presently, 99% of QFF points are redeemed for flights, vs 85% for Aeroplan

Qantas has also announced expansion of travel award options, including a greater array of hotels, car hire and packaged holidays, which will assist point redemption. Although unlikely to benefit Qantas airlines, it should improve QFF profit (as revenue is reported when points are redeemed) and keep the points liability under control. Presently 99% of points redeemed are for flights. This is significantly higher than the 85% rate experienced by loyalty programs such as Aeroplan that has broadened its redemption options since its separation from Air Canada. We believe QFF's expanded range of redemption opportunities will bring the proportion of flight redemptions more into line with Aeroplan.

Finally, Qantas has also announced an expanded QFF Store from 1 August 2008 and introduced additional program partners, which will likely enhance value for members and, by implication, existing partners. This could potentially allow Qantas to increase the price charged per point to partners.

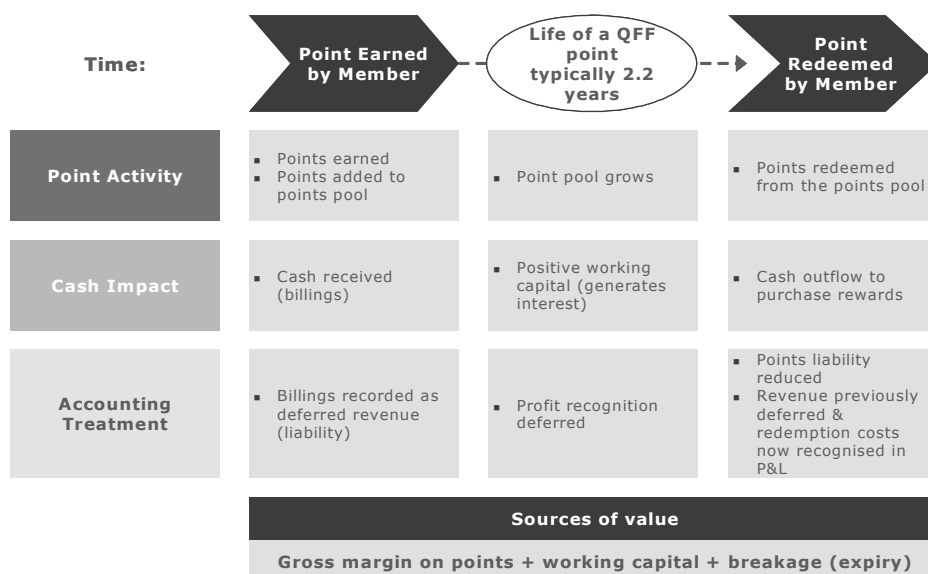
Accounting for frequent flyer points

Qantas's accounting treatment for frequent flyer transactions changed in FY07 from recognising revenue when points are sold to third parties to recognising the revenue when points are redeemed. Qantas recognises the revenue associated with points sold by partners that statistically will not be redeemed (referred to as breakage) at the time of the sale of the points.

Points accumulated by frequent flyers for travelling on qualifying flights are expensed when earned, net of an estimate of points which are likely to expire unredeemed. The expense for these points is based on the marginal incremental direct cost to Qantas, primarily meals and associated expenses.

Since 1 July, Qantas has been required (under IFRIC 13) to allocate part of the revenue received for a flight ticket sold to the frequent-flyer points accrued. While we are unable to estimate the impact on Qantas's annual profit, the company noted the impact on 1 July 2006 retained earnings would be A\$297m.

Figure 1 : Profit cycle of a loyalty program point



Source: QAN 1H08 result presentation

Point life to become shorter

We estimate the average life of a QFF point could decline from 2.2 years to 1.5-2.0 years as redemption opportunities increase.

At present, the average life of a QFF point is 2.2 years. With the proposed changes outlined above, we would anticipate a shorter time period between earning and redemption, reflecting the significant increase in award-seat availability and increased number of redemption partners. Potentially offsetting this though are measures designed to drive an increase in QFF point issuance (eg, credit card companies issuing QFF points directly to customers rather than generic reward points that can be later converted into QFF points). In our view, the average life of a QFF point is likely to decline, potentially to around 1.5-2.0 years. We believe this will benefit frequent flyer and Qantas profit, although we note the impact is likely to be immaterial to group operating profit. The example below shows the impacts of a shortened redemption window on QAN's financials – greater amount of profit is generated in earlier years, the deferred revenue liability balance is lowered, while the cash flow advantage is reduced.

Table 7 : Illustrative impact of shortened redemption window

	2-year points redemption assumption				1.5-year points redemption assumption			
	FY0	FY1	FY2	FY3	FY0	FY1	FY2	FY3
Points sold to QFF partner for customers	100,000	100,000	0	0	100,000	100,000	0	0
Revenue per point (c)	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
QFF cash inflow for points sold (A\$)	1,500	1,500	0	0	1,500	1,500	0	0
Points redeemed by customer	0	0	100,000	100,000	0	50,000	100,000	50,000
Breakage	10%	10%	10%	10%	10%	10%	10%	10%
QFF revenue recognised (A\$)	150	150	1,350	1,350	150	825	1,350	675
Cost per point (c)	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75
QFF costs recognised (A\$)	0	0	-750	-750	0	-375	-750	-375
QFF EBITDA impact (A\$)	150	150	600	600	150	450	600	300
Balance sheet deferred revenue (A\$)	1,350	2,700	1,350	0	1,350	2,025	675	0
Cash flow impact (A\$)	1,500	1,500	-750	-750	1,500	1,125	-750	-375

Source: ABN AMRO assumptions

Financials

1H08F represented the first time Qantas separately disclosed QFF financials. While it has previously disclosed revenue and EBIT, the separation of the business within Qantas has resulted in slightly increased disclosure.

Table 8 : 1H08A financials

(A\$m)	1H07	1H08	% chg
Revenue	388	399	2.8%
Costs	327	317	-3.1%
EBITDA	60.8	61.9	34.4%
Points related revenue	-381	-391	2.6%
Billings	444	479	7.9%
Change in future redemption costs	-43	-56	30.2%
Adjusted EBITDA	81	94	16.0%

Source: Company data

QFF reported A\$61.9m EBIT in 1H08 on revenue of A\$399m. Reflecting the nature of the business, there is minimal depreciation, therefore effectively EBITDA reflects EBIT. Qantas has not allocated interest expense to the program in 1H08, resulting in a reported PBT for the division of A\$61.9m. In our view the frequent flyer business is likely to be cashflow positive, reflecting the sale of points before revenue is recognised. Therefore on a true 'stand alone' perspective, PBT is likely to be higher than that reported by Qantas, although the impact is likely to be influenced by the quantum of debt allocated to the division.

We understand the seasonality of the frequent flyer business is fairly limited. We therefore forecast FY08 EBITDA of A\$121m (2H08 slightly below 1H08 due program enhancement costs). This would represent 3.7% of group EBITDA. With limited data provided, forecasting QFF financials is difficult and subjective. However, to assist in valuing the business, we provide indicative forecasts. We anticipate revenue growth of 6% p.a. during the next two years, reflecting continued strong credit card growth continuing to grow strongly, offset by a potential slowdown in travel. Longer term, we anticipate points allocation will grow at c.8-10% p.a., reflecting continued high single-digit credit card growth.

Table 9 : QFF indicative financials

(A\$m)	FY07E	1H08A	2H08F	FY08F	FY09F	FY10F	Comments
Reported revenue	776	399	405	804	852	903	Includes points related revenue + fees and ancillary revenue
<i>Growth rate</i>				3.6%	6.0%	6.0%	
Costs	654	337	346.1	683	719	762	Redemption costs of points
Reported EBITDA	122	62	58.9	121	133	142	Accounting EBITDA impacted by time lags
Adjusted earnings:							
Gross billings	913	479	498	977.2	1046	1119	Proceeds from the sale of FF points
<i>Growth rate</i>				7.0%	7.0%	7.0%	
Points related revenue	-756	-391	-397	-788	-832	-883	Revenue recognised due to point redemption + breakage estimate
Change in future redemption costs	-115	-56	-70	-126	-140	-150	Provision against cashflow to recognise increase in points balance
Adjusted EBITDA	164	94	90	184	206	227	Exp profitability from sale of points during period (eliminates time lag)
<i>Implied growth</i>				12.3%	12.1%	10.0%	

Source: Company data, ABN AMRO forecasts

The table below shows the impact on our QAN group FY10 forecasts when QFF is stripped out. On an ex-QFF basis (100%), QAN's EBIT would fall by 21.7% from A\$653m to A\$511m. Under the assumption that QAN retains a 60% holding in QFF, consolidation would result in QAN group financials being unaffected until the minorities and NPAT line. However, on a proportionately consolidated basis a 60% holding would reduce EBIT by 8.7% to A\$596m.

Table 10 : QAN group financials ex QFF

(A\$m)	QAN group	QFF	QAN group ex-100% FF	QAN group prop con 60% FF
	2010F	2010F	2010F	2010F
Total revenue	16,526.0	903.4	15,622.6	16,164.6
Operating costs	13,860.5	761.6	13,098.9	13,555.8
Operating EBITDAR	2,665.5	141.8	2,523.7	2,608.8
Non-cancellable operating leases	395.8	0.0	395.8	395.8
Operating EBITDA	2,269.7	141.8	2,127.9	2,213.0
Depreciation & amortisation	1,617.0	0.0	1,617.0	1,617.0
Operating EBIT	652.7	141.8	510.9	596.0

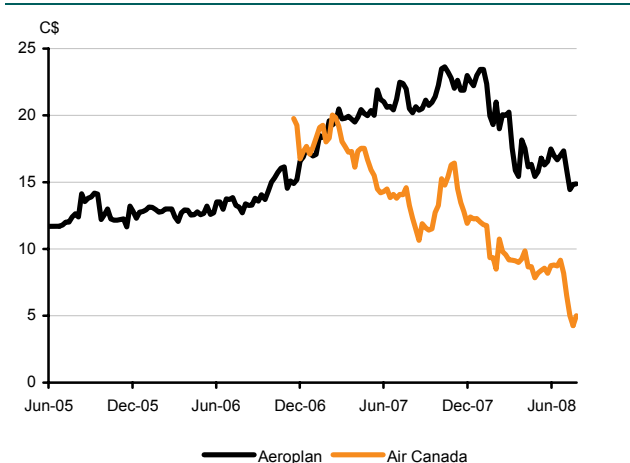
Source: ABN AMRO forecasts

QFF's only peer, Aeroplan, has had a solid trading history

Aeroplan was spun-out of Air Canada in 2005 when Air Canada was experiencing financial difficulties. It originally listed with a market cap of C\$2.0bn with a current market cap around C\$3.0bn. Notably it is now 6x the size of Air Canada's market cap. Since its spin-off Aeroplan has broadened its partner base so customers can earn and burn their points on a number of different products (Air Canada flights now represent around 85% of redeemed points vs 99% for QAN). Recently, Aeroplan acquired Loyalty Management Group (LMG) – owner of the Nectar brand in the UK – further broadening its reward base business and providing a platform for international growth.

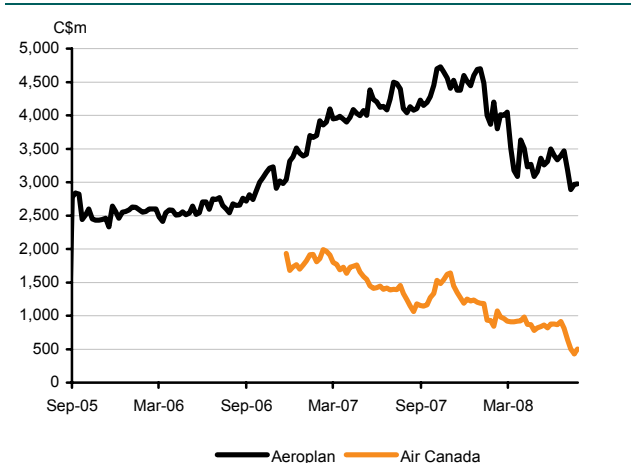
Aeroplan has been a strong share-market performer since listing in 2005 and although has not been immune to the general market sell-off since the credit crisis hit, it has out-performed Air Canada since Air Canada re-listed in 2006.

Chart 6 : Share price – Aeroplan vs Air Canada



Source: Bloomberg

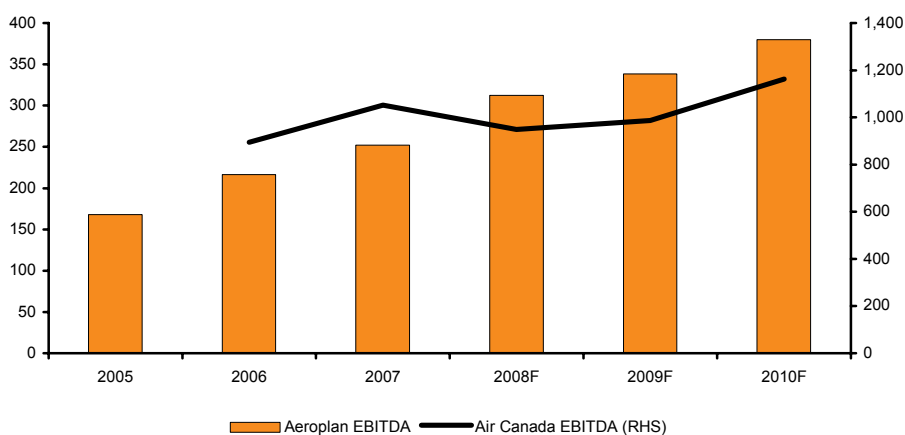
Chart 7 : Market capitalisation – Aeroplan vs Air Canada



Source: Bloomberg

On an earnings basis, Aeroplan has seen a consistent rise in EBITDA and Bloomberg consensus suggests this is likely to continue growing at a three-year CAGR of 14.7%. Conversely, Air Canada's exposure to the more volatile airline industry limits its three-year CAGR to 3.4% (according to Bloomberg consensus). We forecast a similar situation for QFF, with a three-year (adjusted) EBITDA CAGR of 11.4% vs QAN group's -4.5%.

Chart 8 : EBITDA comparison of Aeroplan vs Air Canada (C\$)



Source: Aeroplan, Bloomberg

We value QFF at A\$1.8bn-2.0bn

Table 11 : Qantas FF implied valuation

A\$m	FY08	FY09
Aeroplan (x)	9.7	8.9
Mastercard (x)	17.1	13.8
Visa (x)	23.4	19.0
Average (x)	16.7	13.9
QFF based on EBITDA	2,021	1,850
QFF based on Adj EBITDA	3,073	2,863

Source: Bloomberg (Aeroplan, Mastercard, Visa), ABN AMRO

We value Qantas's frequent-flyer operations at A\$1.8bn-2bn. Reflecting the limited financial information available, we believe a multiple valuation basis is appropriate. In our view, the frequent-flyer operations are most closely comparable to Aeroplan, the Air Canada affiliated (and the only) listed loyalty program, and to a lesser extent those of Mastercard [MA US, US\$270.73, NR] and Visa [V US, US\$78.45, NR]. While Mastercard and Visa may seem unusual, they are more processors of financial information and transactions rather than vanilla credit card companies. With limited available peers we have included them in our average peer multiples.

We think the business could handle debt of A\$720m-800m (40% gearing), implying QAN could raise A\$430m-480m from the potential IPO, assuming it retains a 60% equity stake. This would provide a small, but welcome source of cash in the current difficult operating environment.

Table 12 : Estimated cash raised from QFF IPO*

Debt level	Enterprise Value					
	1,400	1,600	1,800	2,000	2,200	2,400
25%	420	480	540	600	660	720
33%	375	429	482	536	590	643
40%	336	384	432	480	528	576
50%	280	320	360	400	440	480
60%	224	256	288	320	352	384

*Assumes QAN sells 40% of QFF through an IPO
Source: ABN AMRO estimates

Partial divestment likely by end of CY08

QAN management appears intent on moving ahead with a partial divestment of QAN Frequent Flyer, particularly as increased transparency alone seems to have fallen short of expectations regarding value realisation. Given the turmoil in global markets, we think there is a small chance the board will decide in August to delay the divestment for 6-12 months until a more stable investment environment returns. However, with record oil prices negatively impacting the business in the lead-up to a significant capex program, a divestment by the end of the year could come at a good time for QAN to provide it with an extra cash buffer. We, therefore, think it is most likely QAN will press ahead with the divestment by the end of CY08.

Spin-off the most likely option

While a demerger of QAN Frequent Flyer could provide an opportunity for shareholders to gain CGT rollover relief, QAN would need to retain a stake in the business of 20% or less. Given management has consistently indicated QAN will retain a majority stake (we estimate 60%) this option looks unlikely. A demerger also wouldn't result in any cash generation, an outcome we believe is less attractive to QAN given an additional source of cash would be welcome in the current environment of sustained higher oil prices.

Spin-offs are generally undertaken when a company wishes to access cash. Twelve months ago QAN didn't have a strong need for cash given its strong balance sheet and favourable operating environment. But with oil prices having risen about 90% over that time, coupled with a softening demand outlook, an injection of cash would provide an additional buffer against the cost demands of the business. However, QAN may be subject to CGT assuming the offer price is greater than the cost base of QFF.

Investors typically take comfort from there being a sizeable strategic investor in such transactions, and on this basis Qantas's retention of a 60% ownership stake in such a vehicle could find support. For this to successfully realise greater value, in our view, investors would need to be convinced of the new entity's independence, particularly its ability to pursue growth opportunities relatively unhindered. Offsetting this is Qantas's desire to retain control over the strategic direction of the business, as well as to the benefits enjoyed as a result of the Frequent Flyer customer profiling database.

The likelihood is increasing of a QFF IPO by year- end

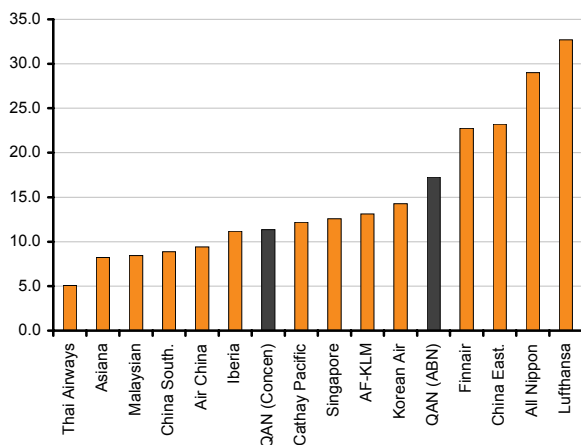
A spin-off would provide an extra cash buffer for QAN in the current environment

We keep our valuation and target price unchanged

We maintain our A\$2.75 DCF valuation and A\$3.20 target price for QAN. We think the stock will continue to trade near its traditional support levels of 1.0x P/B (currently 1.1x) unless the oil price takes another step up through US\$150-160/bbl.

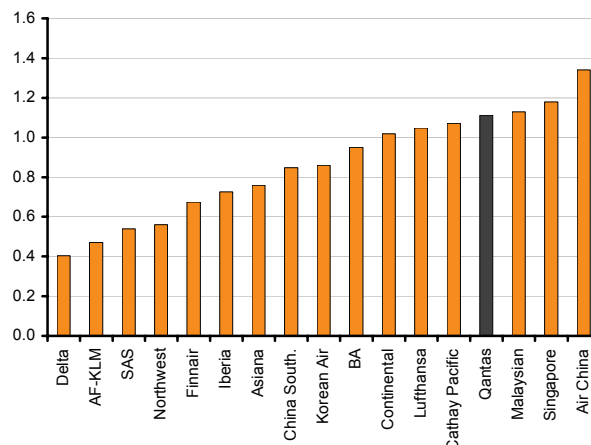
QAN is trading towards the higher end of the range against its global peers (full-service carriers). We think this is partly justified given the relative strength of QAN as an airline. We also note the number of airlines trading below QAN's traditional support level of 1.0x P/B. We think this indicates QAN may not be immune from a similar occurrence should oil prices continue to track higher.

Chart 9 : 1 year forward Price-to-Earnings



*As of 29 July 2008
 Source: ABN AMRO (China Southern, Air China, Iberia, QAN, Air France-KLM, Finnair, China Eastern, Lufthansa); Bloomberg (All others)

Chart 10 : 1 year forward Price-to-Book



*As of 29 July 2008
 Source: ABN AMRO (China Southern, Air China, Iberia, QAN, Air France-KLM, Finnair, China Eastern, Lufthansa); Bloomberg (All others)

Table 13 : QAN financial summary

Year to 30 Jun (A\$m)	AIFRS 2006A	AIFRS 2007A	AIFRS 2008F	AIFRS 2009F	AIFRS 2010F	Closing price (A\$)	3.32	Price target (A\$)	3.20	
Income statement						Valuation metrics				
Divisional sales	13542.7	15068.0	16417.7	16394.9	16526.0	Preferred methodology	DCF	Val'n (A\$)	\$ 2.75	
Total revenue	13542.7	15068.0	16417.7	16394.9	16526.0	DCF valuation inputs				
EBITDA	2067.8	2608.2	3248.3	2095.4	2269.7	Rf	6.50%	10-year rate	6.50%	
Depreciation	-1249.8	-1362.7	-1506.3	-1584.0	-1617.0	Rm-Rf	4.50%	Margin	2.0%	
EBITA	818.0	1245.5	1742.0	511.4	652.7	Beta	2.03	Kd	8.50%	
Amortisation/impairment	0.0	0.0	0.0	0.0	0.0	CAPM (Rf+Beta(Rm-Rf))	15.6%	Ke	15.6%	
EBIT	818.0	1245.5	1742.0	511.4	652.7	E/EV*Ke+D/EV*Kd(1-t)		NPV cash flow (A\$m)	6950.7	
Associate income	0.0	0.0	0.0	0.0	0.0	Equity (E/EV)	45.0%	Minority interest (A\$m)	5.9	
EBIT(incl associate profit)	818.0	1245.5	1742.0	511.4	652.7	Debt (D/EV)	55.0%	Net debt (A\$m)	1990.4	
Net interest expense	-54.6	-14.9	20.9	26.7	-65.9	Interest rate	8.50%	Investments (A\$m)	375.7	
Pre-tax profit	763.4	1230.6	1762.9	538.1	586.8	Tax rate (t)	30.0%	Equity market value (A\$m)	5330.1	
Income tax expense	-218.9	-372.1	-528.7	-161.4	-176.0	WACC	10.3%	Diluted no. of shares (m)	1939.7	
After-tax profit	544.5	858.5	1234.2	376.7	410.8			DCF valuation (A\$)	2.75	
Minority interests	-0.5	-0.2	0.0	0.0	0.0					
NPAT	544.0	858.3	1234.2	376.7	410.8	Multiples	2007A	2008F	2009F	2010F
Significant items	-64.5	-139.0	-263.0	0.0	0.0	Enterprise value (A\$m)	8190.5	8469.2	9614.9	10554.3
NPAT post abnormals	479.5	719.3	971.2	376.7	410.8	EV/Sales (x)	0.5	0.5	0.6	0.6
						EV/EBITDA (x)	3.1	2.6	4.6	4.7
Cash flow statement	2006A	2007A	2008F	2009F	2010F	EV/EBIT (x)	6.6	4.9	18.8	16.2
EBITDA	2067.8	2608.2	3248.3	2095.4	2269.7	PE (normalised) (x)	7.7	5.3	16.9	15.5
Change in working capital	443.8	115.0	40.2	-0.7	3.9	PEG (normalised) (x)	-0.7	-0.5	-1.5	-1.4
Net interest (pd)/rec	-322.9	-194.9	-103.4	-148.8	-242.2					
Taxes paid	-162.7	-166.4	-468.7	-161.4	-176.0	At target price	2007A	2008F	2009F	2010F
Other oper cash items	0.0	0.0	0.0	0.0	0.0	EV/EBITDA (x)	3.0	2.5	4.4	4.5
Cash flow from ops (1)	2026.0	2361.9	2716.4	1784.5	1855.4	PE (normalised) (x)	7.3	5.0	16.1	14.8
Capex (2)	-1527.1	-1235.9	-1835.7	-2399.7	-2415.9					
Disposals/acquisitions)	637.5	15.7	0.0	0.0	0.0	Comparable company data (x)	2008F	2009F	2010F	
Other investing cash flow	0.0	0.0	0.0	0.0	0.0	Virgin Blue Holdings	EV/EBITDA	5.8	9.7	7.4
Cash flow from invest (3)	-889.6	-1220.2	-1835.7	-2399.7	-2415.9	Year to 30 Jun	EV/EBIT	9.1	23.8	14.6
Incr/(decr) in equity	0.0	0.0	-504.4	0.0	0.0		PE	6.7	423.1	19.4
Incr/(decr) in debt	73.9	-257.6	0.0	0.0	500.0	British Airways	PEG	-0.2	-11.1	-0.5
Ordinary dividend paid	-212.1	-414.7	-655.0	-530.4	-378.9	Year to 31 Mar	EV/EBITDA	2.8	5.1	4.4
Preferred dividends (4)	0.0	0.0	0.0	0.0	0.0		EV/EBIT	5.0	29.4	19.0
Other financing cash flow	0.0	0.0	0.0	0.0	0.0		PE	4.6	51.2	25.4
Cash flow from fin (5)	-138.2	-672.3	-1159.5	-530.4	121.1		PEG	0.2	1.7	0.8
Forex and disc ops (6)	0.0	0.0	0.0	0.0	0.0					
Incr/(decr) cash (1+3+5+6)	998.2	469.4	-278.7	-1145.7	-439.4	Per share data	2007A	2008F	2009F	2010F
Equity FCF (1+2+4)	498.9	1126.0	880.7	-615.2	-560.5	No. shares	1985.0	1894.4	1894.4	1894.4
						EPS (cps)	36.5	50.1	19.9	21.7
Balance sheet	2006A	2007A	2008F	2009F	2010F	EPS (normalised) (c)	43.6	63.6	19.9	21.7
Cash & deposits	2902.0	3362.9	3084.2	1938.5	1499.1	Dividend per share (c)	30.0	36.0	20.0	20.0
Trade debtors	1466.3	1376.8	1500.1	1498.0	1510.0	Dividend payout ratio (%)	68.9	56.6	100.6	92.2
Inventory	334.8	180.3	196.5	196.2	197.7	Dividend yield (%)	9.0	10.8	6.0	6.0
Investments										
Goodwill	311.7	365.9	365.9	365.9	365.9	Growth ratios	2007A	2008F	2009F	2010F
Other intangible assets	0.0	0.3	0.3	0.3	0.3	Sales growth	11.3%	9.0%	-0.1%	0.8%
Fixed assets	12375.0	12308.3	12755.5	13789.4	14807.5	Operating cost growth	8.6%	5.7%	8.6%	-0.3%
Other assets	1793.5	2011.2	2011.2	2011.2	2011.2	EBITDA growth	26.1%	24.5%	-35.5%	8.3%
Total assets	19183.3	19605.7	19913.7	19799.6	20391.8	EBITA growth	52.3%	39.9%	-70.6%	27.6%
Short-term borrowings	440.8	863.7	863.7	863.7	863.7	EBIT growth	52.3%	39.9%	-70.6%	27.6%
Trade payables	1988.0	2005.7	2185.4	2182.3	2199.8	NPAT growth	57.8%	43.8%	-69.5%	9.1%
Long-term borrowings	5334.8	4210.9	4210.9	4210.9	4710.9	Pre-goodwill NPAT growth	57.8%	43.8%	-69.5%	9.1%
Provisions	701.2	675.6	675.6	675.6	675.6	Normalised EPS growth	58.7%	46.0%	-68.8%	9.1%
Other liabilities	4637.4	5654.8	5971.4	6014.1	6057.0					
Total liabilities	13102.2	13410.7	13907.0	13946.6	14507.0	Operating performance	2007A	2008F	2009F	2010F
Preference shares						Asset turnover (%)	19.4	20.8	20.6	20.6
Hybrid equity						EBITDA margin (%)	17.3	19.8	12.8	13.7
Share capital	4382.2	4481.2	3976.8	3976.8	3976.8	EBIT margin (%)	8.3	10.6	3.1	3.9
Other reserves	329.3	148.2	148.2	148.2	148.2	Net profit margin (%)	5.7	7.5	2.3	2.5
FCTR						Return on net assets (%)	20.1	29.0	8.7	11.1
Unrealised gains/losses						Net debt (A\$m)	1711.7	1990.4	3136.1	4075.5
Retained earnings	1388.5	1592.3	1908.5	1754.7	1786.5	Net debt/equity (%)	27.6	33.1	53.6	69.3
Other equity	-23.8	-32.6	-32.6	-32.6	-32.6	Net interest/EBIT cover (x)	83.6	-83.5	-19.2	9.9
Total equity	6076.2	6189.1	6000.8	5847.0	5878.9	ROIC (%)	9.0	14.2	4.1	4.7
Minority interest	4.9	5.9	5.9	5.9	5.9					
Total shareholders' equity	6081.1	6195.0	6006.7	5852.9	5884.8	Internal liquidity	2007A	2008F	2009F	2010F
Total liabilities & SE	19183.3	19605.7	19913.7	19799.6	20391.8	Current ratio (x)	0.9	0.8	0.6	0.6
						Receivables turnover (x)	10.6	11.4	10.9	11.0
						Payables turnover (x)	6.2	6.3	6.5	6.5

Source: Company data, ABN AMRO forecasts

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For UK Small/Mid-Cap Analysis a Buy/Sell implies upside/downside of 10% or more, an Add/Reduce 5-10% and a Hold less than 5%. For UK-based Investment Funds research the recommendation structure is not based on upside/downside to the target price. Rather it is the subjective view of the analyst based on an assessment of the resources and track record of the fund management company. For listed property trusts (LPT) or real estate investment trusts (REIT) the recommendation is based upon the target price plus the dividend yield, ie total return.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months. Sector relative to market: The sector view relative to the market is the responsibility of the strategy team. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside. Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Distribution of recommendations

The tables below show the distribution of ABN AMRO's recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where ABN AMRO has an investment banking relationship.

Long Term recommendations (as at 31 Jul 2008)		
	Global total (IB%)	Asia Pacific total (IB%)
Buy	540 (4)	378 (1)
Add	0 (0)	0 (0)
Hold	373 (2)	214 (0)
Reduce	0 (0)	0 (0)
Sell	90 (0)	54 (0)
Total (IB%)	1003 (3)	646 (0)

Source: ABN AMRO

Trading recommendations (as at 31 Jul 2008)		
	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	8 (0)	8 (0)
Trading Sell	1 (0)	1 (0)
Total (IB%)	9 (0)	9 (0)

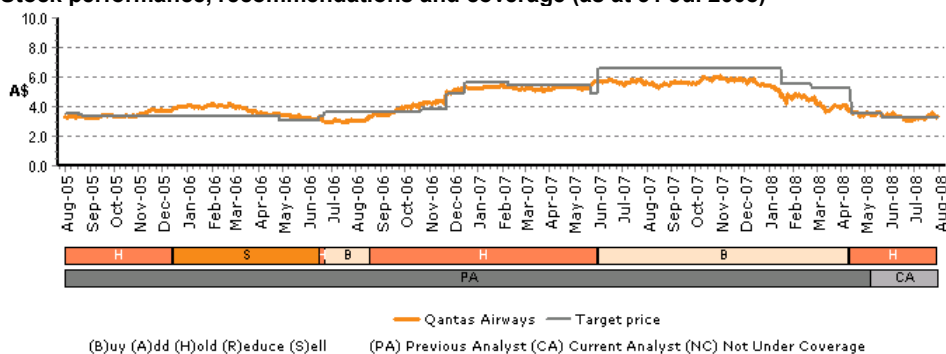
Source: ABN AMRO

Valuation and risks to target price

Qantas Airways (RIC: QAN.AX, Rec: Hold, CP: A\$3.32, TP: A\$3.20): We value Qantas using a DCF methodology. We are basing our target price on the P/B levels at which QAN traditionally finds support. Downside risks are a deterioration in global economic conditions, increased domestic competition, accelerated yield decline, higher jet fuel prices and inability to fund the incoming fleet capacity. Upside risks are continued strong demand (which we do not expect) and an unexpected drop in jet fuel prices.

Qantas Airways coverage data

Stock performance, recommendations and coverage (as at 31 Jul 2008)



Trading recommendation history (as at 01 Aug 2008)

Date	Rec	Analyst
	n/a	

Source: ABN AMRO

Mark Williams started covering this stock on 7 May 08
 New recommendation structure from 7 November 2005
 Source: ABN AMRO

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