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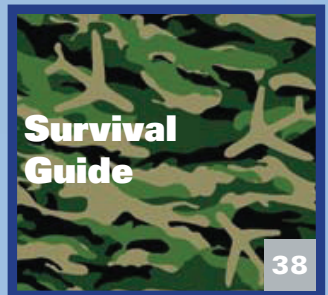
Taking your airline to new heights

## A Clear Vision

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# Capital Uplifting

*An industry downturn has left many airlines struggling to raise capital in a credit-tight environment, but three basic options exist for those that need capital.*

■ By Shane Batt | *Ascend* Contributor

October 2007 was the last month when the global economy was growing. Because the airline industry is the first to notice a downturn, it has just completed one of the most difficult calendar years in history of commercial aviation.

Last year, the aviation industry suffered during the first two-thirds of the year from skyrocketing fuel prices, only to succumb to a sharp reduction in demand as soon as fuel prices began to ease. Now, airline executives increasingly worry about capital availability and its effect on the survival — not just the growth — of their companies.

During these times of uncertainty, there are things airlines can do to raise capital to secure their future, but first it's necessary to examine the financial crisis and its effect on commercial aviation as well as the ways in which airlines are raising capital under the new financial reality. To begin this examination, it is first necessary to look back at the relatively happy days of 2007.

In retrospect, and despite severe structural difficulties, 2007 was a better year for commercial aviation than most years. Fuel prices were high, but crude oil prices had not yet passed US\$100 a barrel, as they did last year, and the average jet fuel price for 2007 was less than US\$75 a barrel. Share prices were high, and there was substantial investment interest in the aviation sector from a wide variety of sources.

2007 will be remembered (among other ways) as the year in which private equity made many inroads into the aviation sector. Because airlines were attractive to investors, banks also courted airlines by providing a high availability of credit facilities. At one point during 2007, a government-owned airline that had never published profits attracted bids for privatization that were more than 60 times the airline's earnings before interest, taxation, depreciation and amortization, or EBITDA.

By comparison today, airlines are attracting on average four to five times EBITDA for privatization, but only if they have a history of profitability. During 2007, capital was substantially available from a variety of sources, and airlines employed these sources to go on an aircraft shopping spree.



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The collapse of several major financial institutions last year, including Northern Rock, had a large impact on airlines', whose asset values rapidly dropped, and they began to look less attractive for new credit or extensions of existing credit.

Boeing achieved record sales of 1,413 aircraft during 2007, and Airbus was just behind in record new sales with 1,364 aircraft. This was more than 800 aircraft higher than the combined (Boeing plus Airbus) orders for new aircraft in 2006, the previous record year, and about 1,600 more aircraft orders than the average sales year this decade.

Massive orders for aircraft were agreed upon by China, India, the Middle East and South American airlines. Additionally, future delivery slots for aircraft were valuable, so credit was readily available from financial institutions to fund the manufacturer-required pre-delivery payments, or PDPs. While the manufacturers provided substantial discounts on new aircraft in consideration of the vast individual orders, PDP percentages were paid off the list price of aircraft. For example, if an aircraft's list price was US\$100 million, it might be sold for as low as US\$60 million as part of a bulk purchase. Nevertheless, the PDPs of around 40 percent needed to be paid on the list price so airlines would need to find US\$40 million to cover the PDPs of that single unit instead of US\$24 million.

Despite the huge capital commitments that were being agreed upon, airlines purchased aircraft with confidence because capital was widely available. By the end of 2007, however, early signs of trouble in the capital markets arose. Late that year, there were concerns about the stability of over-extended banks. In August 2007, BNP Paribas, the largest bank in France, discontinued three investment funds it had set up based on selling mortgage debt from U.S. mortgage lenders. The BNP Paribas funds had invested in collateralized debt obligations, or CDOs, which are complex financial instruments designed to take advantage of high-asset growth rates that produce increasing equity for asset owners.

Simply put, mortgage companies in the United States and United Kingdom were increasingly offering credit-debt swaps that allowed mortgage holders to trade equity in their homes for credit facilities they could use to pay off credit cards or finance other lifestyle improvements. These credit-debt swaps, along with new mortgages and other debt facilities, were then put into structured CDOs that, in theory, had a very low default rate. In fact, the default rates of the CDOs were so low that the default rates could only be predicted. There was no actual data on the default rate for CDOs. Financial institutions throughout the world invested in these high-yielding CDOs believing that their default rate was very low.

Then, in mid-September 2007, there was a bank run on Northern Rock, the fifth-largest mortgage lender in the United Kingdom. Collapse of Northern Rock was only narrowly averted by the end of 2007 through injections of funds by the Bank of England. Equity markets around the world began a downturn as concerns over bank liquidity began to surface. The downturn was just beginning, however.

Then 2008 dawned with increasingly bad financial news. Stock markets around the world began to see downturns and struggling banks

began to fail. Defaults of CDOs provided real data on the default rate, and banks soon found that their exposure with these facilities was very significant. Banks have governance rules that do not allow them to risk high levels of exposure on bad debts. Unfortunately, investments in CDOs greatly increased the exposure of banks and, when it became clear that the default rate was much higher than expected on CDOs, banks had to immediately curtail providing new loans until they could reduce their exposure.

Last year, several major banks failed including Northern Rock, Bear Stearns, Washington Mutual, IndyMac, First Integrity Bank, ANB Financial, Hume Bank, Douglas National Bank, First Heritage Bank and First National Bank

#### HIGHLIGHT

## Airlines that own their aircraft, facilities and other assets are more attractive to financial institutions because they have real assets that might be attached by the lenders in the event of default.

of Nevada. Many more large banks, such as Citibank, Morgan Stanley, Barclays Bank, Bradford and Bingley, HBOS, Royal Bank of Scotland and Corus Financial, required huge bailouts to keep from collapsing. The U.S. Government promised US\$700 billion in bank bailouts and even began to distribute these funds.

Airlines were caught in the middle of this increasingly deep banking crisis. First, asset values dropped rapidly, and this meant that their balance sheets suffered, and airlines began to look less attractive for new credit or even the extension of existing credit lines. Banks that had tightened their credit policies in light of the CDO impact found that their liquidity was greatly affected. The poor liquidity in the financial system meant that many existing revolving credit facilities could not be serviced. All of this occurred at a time when airlines needed cash the most.

At the same time, crude oil prices hit a record US\$147 a barrel last July, meaning that JetKero was selling for more than US\$220 a barrel. Airlines needed to protect themselves with

fuel and currency hedging, but capital availability became increasingly restrictive just as those PDPs began to come due. As a result, more than 30 airlines failed worldwide last year.

Typically, airlines do not fail due to losses of profit; they fail because of an absence of cash to pay their obligations. By the end of 2008, it became clear that the world was in a global financial crisis, and demand for air travel plummeted as both individual consumers and companies cut back on travel to save on expenses. As airlines stumbled into 2009, the full impact of the financial crisis was beginning to be factored in the real economy as companies worldwide began massive layoffs.

So during the first quarter of the year, airlines find themselves in a precarious situation. First, there are virtually no credit facilities available to airlines under the current financial conditions. Airlines with very strong cash equity are still able to acquire credit, but these carriers are limited to a few fairly elite examples. Reduced demand for air travel that was increasingly apparent during the first quarter of 2009 is further putting pressure on cash management by airlines. Quite simply, most airlines lack cash. Furthermore, all of the purchases made in 2007 require PDP payments during 2009, and many airlines don't have the capital to pay these obligations.

The manufacturers, which had all increased production quotas, are beginning to see order cancellations because the airlines cannot pay their PDPs. Order cancellations and deferrals are expected to increase through the year. Therefore, the manufacturers will be required to slow production and reduce the number of planned deliveries for this year and into next year. This reduction in production quotas will be reflected in layoffs by the largest manufacturers, which will further exacerbate the financial crisis.

To survive and also address their obligations, airlines desperately need to raise capital. How does an airline raise capital, however, under these current financial circumstances? They have three basic options for raising capital under the new financial reality that is expected to continue for some time, including:

- Equity injections — Take on additional owners or obtain more funds from existing owners,
- Debt facilities — Take on additional debt in ways that solve the airline's capital requirements without increasing its survival risks,
- Asset liquidation — Existing assets of airlines can be liquidated to increase cash availability.

Each of these methods of raising capital produces its own opportunities and challenges.

#### Equity Injections

Equity injections are increasingly becoming the preferred choice of airlines to raise capital under the current financial crisis. Earlier this year, Qantas Airways and SAS Scandinavian Airlines announced their intentions to perform a "rights issue" to increase their common shares. Many companies retain the right from their owners to issue additional shares — up to an agreed upon percentage of the

outstanding existing shares — to address their immediate capital requirements. Essentially, the owners have pre-granted the right to the airlines to dilute the owners' percentage of ownership to solicit additional investors that will bring in much-needed capital. While this looks like a good way of raising capital, it is also fraught with risk.

For example, Qantas Airways had to suspend trading of its shares in advance of announcing its rights issue due to rapidly declining share values (shares fell more than 10 percent over two consecutive trading days). Investors became aware of rumors that the carrier would be making its rights issue to financial investors at US\$2 a share — a substantial reduction over the then-selling price. Qantas Airways made the rights issue to the financial institutions at the lower price to quickly raise necessary capital, but its existing shareholders felt that their own share value would drop under these conditions and, therefore, decided to sell before the rights issue could be announced. This produced the requirement to suspend share trading, which further undermines investor confidence.

A different way of obtaining capital through equity is to court private equity where a public company can actively look for private equity and then take the company "private" by de-listing it from its associated stock exchange. While there is much less private equity available in the marketplace compared to 2007, there is still availability — especially from Sovereign Funds set up by the richest oil-producing states that made massive profits during 2007 and 2008.

The problem with private equity, however, is that it often violates foreign ownership maximums. Aeroflot Russian Airlines recently announced that it is interested in investing in CSA, the Czech national airline. European Union regulations, however, only allow a maximum of 49 percent ownership by non-European owners. So, a private equity investor who would like to invest in an airline has to consider ownership restrictions and control issues before making investments that can, especially under the current financial conditions, be considered risky. While increasing cash equity is a popular way of addressing an airline's capital requirements, these types of transactions should be carefully considered.

### Debt Facilities

The second method of raising capital is through debt facilities, which can include taking on additional loans or through the issuance of corporate bonds. Most airlines have a very difficult time today convincing banks to increase their credit facilities. This is not true, however, in some cases. Many banks are still interested in lending to airlines that show substantial credit worthiness. One of the ways of

demonstrating credit worthiness is to have a low debt/equity ratio because the airline is asset rich. Airlines that own their aircraft, facilities and other assets are more attractive to financial institutions because they have real assets that might be attached by the lenders in the event of default.

Similarly, some airlines can obtain sovereign guarantees from their government owners that will back the loans. Sovereign guarantees are often even better than assets to attract loans from financial institutions. Corporate bonds are a fall-back approach to raising capital through debt facilities. When an airline issues corporate bonds, it is essentially going to investors instead of banks to obtain a loan. The airline must provide an extremely attractive interest rate to the purchasers of the corporate bonds, or the investors would not be attracted. This means that the cost of corporate bonds for airlines is probably greater than other types of loans.

There is also the matter of collateral associated with corporate bonds. To attract substantial funds through corporate bonds today, airlines have to provide substantial security. This means that the bonds have to be backed by assets that can be easily liquidated in the event of default or the bonds need to be "convertible" into equity. That is, airlines can sell "convertible bonds" that, under certain circumstances (such as default), can be converted into an equity ownership in the business. Despite the high cost of corporate bonds to airlines, it is expected that this form of raising capital will be popular this year because of the credit crunch affecting banks that traditionally provide loans to the aviation sector.

### Asset Liquidation

The final method of raising capital under the current economic climate is through asset liquidation, where an airline essentially converts an asset into cash to fund its ongoing capital requirements. Airlines that own their aircraft can sell them to a leasing company and then lease back the same aircraft after receiving the cash value from the sale. Similarly, airlines can sell buildings, slots, non-core businesses and other assets to raise capital. Many carriers selected leasing instead of purchasing of aircraft throughout the last decade, meaning airlines don't have aircraft to sell and lease back.

Increasingly, therefore, airlines are selling other assets such as their headquarter buildings, hangars and similar "hard" assets to fund their cash requirements. Similarly, airlines are liquidating non-core businesses. For example, airlines are selling their maintenance facilities, catering facilities, airport ground handling companies and even distribution companies to generate cash resources. Ultimately, the sale of assets can reduce

the value of the airline's balance sheet and may make the airline even less attractive to lenders in the future. Furthermore, assets today have a lower value than in many years. Because there is a lack of liquidity, assets are selling for rates that are much below their notional value. So, an airline that liquidates assets today may, in fact, be selling these assets for very little compared to their intrinsic value. This means that asset liquidation is pretty much the last resort for most airlines for raising capital. Nonetheless, as airlines "go to the wall," they will increasingly sell assets throughout 2009 to fund their immediate capital needs.

The industry outlook for capital-hungry airlines doesn't appear to look very promising. The current economic crisis, which airlines can't control, is affecting capital availability, and airlines are struggling to meet their obligations. There is some good news inherent in this situation, however.

First, the carriers that restructure to become leaner organizations will solve many of their long-term structural issues and ensure that their unit costs are low enough to compete effectively. The survivors are going to be much stronger and more resilient than what is currently observed throughout the industry. The survivors will arise from this financial quagmire stronger, more profitable and better able to weather future economic downturns. More importantly, however, these survivors won't have to wait very long.

Airlines are the first businesses to feel the impact of an economic downturn. They are also, however, the first businesses to improve and lead the way out of a recession. This is because airlines are an economic enabler. Companies that have tightened all discretionary costs then have to turn to their revenue performance. To increase their revenues, most businesses have to travel to meet existing and new clients. Therefore, travel picks up ahead of most other industries.

In the past, airlines have typically demonstrated recovery two calendar quarters before most other business sectors. Renewed growth in the aviation sector will allow more capital availability to airlines, which will then further stimulate the recovery of the real economy. While this will be another challenging year, airlines worldwide will likely experience relief from this financial crisis by the end of the year. ■