FIRST NZ CAPITAL

COMMERCIAL SECRET

Memorandum

To	Kirsty Flannagan The Treasury
From	First NZ Capital
Date	12 December 2002
Subject	Project Vanilla – Potential Withdrawal of Qantas

1. Introduction

We refer to your email dated 9 December 2002. This memorandum addresses the matters raised in your email, which for ease of reference, are repeated below:

1. assess a new counterfactual scenario against the JAO Base Case. The new scenario involves Qantas withdrawing from the New Zealand market;

2. analyse the prospect of Qantas withdrawing from New Zealand; and

3. analyse the risks and benefits of a Strategic Alliance Agreement ("SAA") that did not involve Qantas subscribing for equity in Air NZ.

2. Modelling of Qantas exiting the New Zealand domestic market

Scenario assumptions

Air NZ has developed a new counterfactual scenario (referred to as the Qantas Exit scenario) that models the impact if Qantas withdrew its New Zealand domestic operations. For the purposes of the analysis a number of assumptions have been made regarding flying by Qantas on other routes where it competes with Air NZ, and the likely behaviour of a potential VBA entrant. Key assumptions include:

- Qantas ceases New Zealand domestic operations in FY2004;
- Qantas' trans-Tasman ASKs increase at a CAGR of 8.6% per annum between FY2003 and FY2006;
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- Qantas continues flying the Auckland – Los Angeles route with a total of 10 flights per week; and
- VBA begins flying on the trans-Tasman and enters the New Zealand domestic market with six aircraft.

We believe that the assumption that Qantas increases capacity on the trans-Tasman and Auckland – Los Angeles routes errs on the side of conservatism. We would assume that the withdrawal of

Qantas' New Zealand domestic services would reduce feeder traffic and negatively affect load factors on Qantas' remaining routes that connect with New Zealand.

Air NZ has assumed that a VBA would operate on the trans-Tasman and New Zealand domestic routes if Qantas withdrew its domestic New Zealand operations. We regard this assumption as being reasonable. First, there are many public comments by Virgin Blue that it wishes to begin operating international flights. Second, a competitor is likely to be attracted to the New Zealand market if Air NZ was operating as the sole provider of capacity on the main trunk routes.

Comparison to JAO and stand-alone Base Case scenarios

Key points to note in the analysis include:

- Air NZ's EBITDRA under the Qantas Exit scenario is less than the JAO Base Case in each of the projected years. As outlined in section six of our report, the JAO is expected to stimulate demand (increase load factors) through, for instance, better scheduling and connectivity. The JAO is also projected to result in lower relative operating costs from better aircraft utilisation;

- Air NZ's NPBT under the JAO Base Case scenario is significantly higher than under the Qantas Exit scenario as a result of improved earnings and a reduced interest expense due to a lower net debt position following the placement of approximately $543 million of Air NZ equity to Qantas;

- Under the Qantas Exit scenario, Air NZ's trans-Tasman profitability improves significantly compared to the stand-alone Base Case. Qantas' lower procurement of capacity relative to the stand-alone Base Case, results in improved load factors for Air NZ;

- Increased competition, irrespective of whether it is Qantas operating 8 aircraft or a VBA operating 6 aircraft, has a material effect on Air NZ's domestic operating yields and load factors. The competitive threat that a VBA poses to Air NZ's domestic operations, despite flying fewer aircraft than Qantas, is due to greater aircraft utilisation. For example it is assumed that daily departures by VBA, aircraft average , as compared to for Qantas. Additionally, it is assumed that Qantas' aircraft hold fewer seats than those of a VBA. For these reasons, despite flying two fewer aircraft than Qantas, the VBA is assumed to operate more ASKs on an annual basis. In our view, higher frequency and greater seat numbers per plane is consistent with the VBA business model;

- Under the Qantas Exit scenario, Air NZ's profitability on New Zealand domestic routes is similar to the stand-alone Base Case scenario due to the assumption of a VBA entrant competing on these routes;

- The most significant improvement in Air NZ's profitability under the Qantas Exit scenario is on the Auckland – Los Angeles route. This is largely attributable to the capacity provided by Qantas in FY2006 being approximately half that assumed under the stand-alone Base Case scenario.

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Figure 1.3 shows Air NZ's ROCE under the JAO and stand-alone Base Case scenarios and compares them to the Qantas Exit scenario. The chart illustrates that Air NZ's projected ROCE under the Qantas Exit scenario is significantly above the stand-alone Base Case scenario, but is less than the JAO Base Case scenario in each of the forecast years.

3. Prospect of Qantas exiting the New Zealand domestic aviation market

Overview

As detailed in section 3.3 of our December 2002 report, in our view, Qantas' current position in the New Zealand market is unsustainable and in the event that the proposed SAA does not proceed, one of two outcomes is expected:

- Qantas increases capacity on routes where it competes with Air NZ to gain market share and weaken Air NZ's position; or

- Qantas reduces competition and exits routes where it generates inadequate returns.

In our view, Qantas is unlikely to withdraw from New Zealand for a number of reasons. First, Qantas is a natural competitor in the New Zealand market given the similar cultures between New Zealand and Australia and Qantas' existing brand recognition in New Zealand. Second, Air NZ's strategic move to the VBA+ model has resulted in Qantas being the only full service airline ("FSA") operating in domestic New Zealand. Third, Qantas is currently in a relatively strong financial position, with an unprecedented market share in its domestic market following the collapse of Ansett. It therefore has the financial resources to invest in penetrating this market. In aggregate, given the current volatile international aviation market, Qantas' position as one of the world's strongest airlines and the change in Air NZ's domestic strategy, an opportunity is created for Qantas to increase its presence, rather than withdraw from New Zealand. This conclusion holds irrespective of whether or not the SAA and JAO proceed.

Logical market for expansion

With an estimated share of approximately 80% of the Australian domestic market, Qantas has reasonably limited growth opportunities domestically. If Qantas is to continue to expand and achieve further economies of scale, it must look for growth through its international operations. New Zealand represents a logical market for Qantas to expand into and establish itself as the major carrier. Reasons for this include:

- New Zealand's close geographic proximity to Australia provides Qantas with improved aircraft utilisation through co-ordination with its Australian fleet;

- New Zealand is an important destination for Australian passengers, accounting for 20% of all outbound traffic (and providing feed to Qantas' New Zealand network);

- Qantas has made a significant commitment to its brand and terminal facilities in New Zealand; and

- the launch of NZ Express has created an opportunity for a full service airline to operate on New Zealand's major domestic trunk routes.

Defensive move to protect its Australian domestic position

In FY2002, Qantas had an EBIT of A$690 million, of which approximately 44% was generated by its domestic operations. Due to the significant contribution that Qantas' domestic operations make to its earnings, it can be expected to actively defend this market position.

In the event that Qantas exited the New Zealand domestic market there is a reasonable possibility that Virgin Blue or another VBA would enter the trans-Tasman market and begin operations on domestic main trunk routes within New Zealand. The expansion of Virgin Blue's operations to include New Zealand destinations is likely to strengthen its competitive position against Qantas on both trans-Tasman and domestic Australian routes. While Virgin Blue is unlikely to overturn Qantas' strong domestic position, it could place pressure on Qantas' yields and erode its profitability.

In the event that Qantas did exit the New Zealand market, Air NZ might seek to further expand its operations by initiating services on routes within Australia. If a Star Alliance partner such as Singapore Airlines supported Air NZ's entry, Qantas' important domestic profitability could be adversely affected.

Qantas is now New Zealand's only FSA

NZ Express, Air NZ's new short-haul airline, is potentially exposed to losing market share in the business passenger sector to a full service airline such as Qantas. In other international markets, VBAs have failed to gain more than 20 - 25% of total market share and full service airlines continue to account for the majority of total capacity provided. NZ Express has attempted to retain a number of key aspects of a full service model, in order to retain its higher yielding customers, but its business model remains untested. Key risks include the loss of high yielding customers that place greater value on the features of a full service airline and other passengers who may elect to fly with a full service airline for comparable prices. Qantas is likely to regard the introduction of Air NZ's revised short-haul strategy as an opportune time to exert greater competitive pressure.

Relatively weak financial position of Air NZ

Air NZ remains reasonably highly geared and has significant capital commitments over the medium to longer term. Without the support of the Crown, Air NZ's ability to raise substantial amounts of new equity may be limited.

Qantas is projected to be profitable in New Zealand in the medium term

The historically poor financial performance of Qantas' New Zealand operations is relatively insignificant when viewed in the context of Qantas' total profits. In FY2002, Qantas generated a NPAT of A$423 million on revenues in excess of A$11 billion. Qantas' profitability is expected to improve significantly over the short to medium term, with CSFB forecasting FY2005 NPAT of A$780 million. The strong financial performance of Qantas' other operations reduces the need for it to focus solely on maximising short-term profitability and increases the likelihood that it will give priority to the longer term strategic and competitive implications of changes to its network.

4. Qantas subscription for equity in Air NZ

The proposed JAO involves Qantas taking a 22.5% equity stake in Air NZ. However, it is possible that the JAO could proceed as a purely contractual arrangement with no Qantas equity contribution. You have asked for our assessment of the benefits and risks of such a transaction structure. We set out below the key issues for each of the relevant parties, - Air NZ, the Crown and Qantas.

Benefits and issues from Air NZ's perspective

From a management perspective, removing the equity subscription would not change Qantas' level of influence in the management of the JAO. The provisions setting out the role of the SAAG and the Qantas secondees are included in the SAA and we assume they would not be changed.

The key issue for Air NZ would be forgoing approximately $543 million of new equity. Without the new equity, Air NZ's ability to reduce its relatively high level of gearing would be adversely affected.

The second key issue for Air NZ relates to the heightened risk of a dispute in relation to the JAO's profit sharing mechanism. In holding a significant shareholding in Air NZ, Qantas indirectly benefits from any incremental profits Air NZ earns from the JAO. From this perspective, Air NZ's and Qantas' incentives are aligned to increase the value of Air NZ. If Qantas benefits only from its direct share of JAO earnings, there is greater risk that the profit sharing mechanism will be a cause of dispute over time.

Benefits and issues from the Crown's perspective

With no equity in Air NZ, Qantas would have reduced influence on Air NZ's board. Based on the terms of the transaction documents, rather than having the right to nominate up to two Air NZ directors, Qantas would be able to nominate only one director (the SAA director). The Crown may consider this to be a benefit.

A second benefit is that Qantas would not obtain "negative control" through a 22.5% shareholding (i.e. Qantas' ability to vote against special resolutions would be removed). Further, the Crown would continue to hold over 75% of Air NZ's voting shares.

A major disadvantage is that the likelihood of the Crown being required to inject new equity into Air NZ would increase significantly.

It is unlikely that the provisions relating to Qantas' right to terminate the SAA if another airline acquires a material stake would be altered. These provisions are set out in the SAA, not the equity subscription agreement. In our view, Qantas is unlikely to be willing to change these provisions since it would not wish to be involved in a strategic alliance that benefits a competing airline.

As noted in our report, we believe that Qantas' shareholding in Air NZ would not reduce the Crown's exit options because, in the short to medium term, it is unlikely that any other airline would be interested in a stake in Air NZ.

Benefits and issues from Qantas' perspective

Qantas' equity stake would preclude any other airline from acquiring a significant stake in Air NZ. With Qantas owning a 22.5% shareholding, an investment in Air NZ is unattractive to any other airline even if the Crown were willing to permit it.

In the absence of the equity investment, another airline could acquire up to 20% of Air NZ without shareholder approval (except from the Kiwi shareholder), but with Qantas holding 22.5%, in our view no other airline would want to pursue this option. The equity investment effectively blocks other partners and therefore protects Qantas' strategic position. The equity is important to encourage Qantas to make a long-term commitment to the SAA and JAO.

Secondary benefits accruing to Qantas include:

- the equity investment provides Qantas with the right to nominate two directors – one director can have limited influence, but two acting together can have disproportionately more influence;
- the establishment of the JAO should enable Qantas to earn a satisfactory return on its investment; and
- by sharing in Air NZ's returns, Qantas has a reduced incentive to maximise its returns from the JAO.

If there was no equity investment, the main benefit for Qantas would be the savings in capital of approximately $543 million.

In summary, while a SAA without an equity investment by Qantas would reduce Qantas' influence on the Air NZ board, it is unlikely to reduce its management influence and would heighten the risk of the SAA not being successful due to Air NZ and Qantas having more disparate financial incentives.

In our view, the strategic stake in Air NZ is a crucial element of the SAA from Qantas' point of view. First NZ Capital believes that Qantas would be unwilling to enter into the SAA if it were prevented from securing a strategic stake in Air NZ.

5. Key Conclusions

The key conclusions of this memo are as follows:

- although the removal of Qantas enhances the profitability of Air NZ's trans-Tasman and Los Angeles routes, the likely emergence of a VBA competitor on New Zealand domestic main trunk routes, does not result in any material increase in Air NZ's profitability on domestic main trunk routes. This is due to the assumption of greater aircraft utilisation and increased seat capacity by the VBA;
- the JAO Base Case is projected to be more profitable than the Qantas Exit scenario due to the JAO's projected ability to stimulate passenger demand and reduce operating costs;
- in our view, it is unlikely that Qantas would withdraw from the New Zealand domestic market; and

- from a financial and commercial perspective, a strategic alliance between Air NZ and Qantas that does not involve Qantas having an equity investment in Air NZ is significantly less attractive for Air NZ, the Crown and Qantas.