AIDE MEMOIRE: AIR NZ STRATEGIC PARTNERSHIP

This note has been prepared based primarily on public sources and knowledge of the aviation sector. However, public comments on this note could have a material impact on Air NZ's share price. Public comments should therefore be avoided.

Purpose

- The note provides some high-level rationale for potential strategic partnership proposals from Air NZ. However, it is not intended to provide any assessment of the specific contents of potential proposals.

Rationale for a strategic partner

- While Air NZ's performance has been improving and it is working on its competitive response to other airlines (eg Air NZ Express class), it is in **a weak competitive position:**

  - domestic routes are the only profitable part of its *flying* operations
  - the New Zealand market is small so there is limited opportunity for domestic growth
  - domestic routes are vulnerable to increased competition from Qantas and the possible entry of Virgin Blue or other value-based airline
  - domestic profitability is used to support the loss-making international routes (*all,* , make losses)
  - internationally, Air NZ is subject to fierce competition and an over-supply of capacity overall.

- **Airlines worldwide face an uncertain operating environment**. As well as being highly capital intensive, airlines are vulnerable to oil prices, world economic conditions, and the prospect of war. Air NZ is also vulnerable to exchange rate movements.

- A good strategic partner could offer **improved profitability and service for both airlines** through economies of scale. This includes cost reductions from removing duplication, increased revenue from increased loads (fewer empty seats), and better scheduling (more frequency, more non-stop destinations). This could be expected to improve Air NZ's position in both domestic and international markets – the extent of the benefit would depend on the detail of any proposal.

- Although Air NZ does probably need more capital, **the rationale for a strategic partner is not about more capital**: it is to place Air NZ in a strong strategic position for the future.

What Does the Ideal Strategic Partner Look Like?

- A good strategic partner would:

  - Be operating in the same market to **provide economies of scale and feeder traffic**

- **Have sufficient similarity** to allow for coordinated scheduling and cost reductions
- Be **financially strong** to allow it to buy in and to commit to a continuing partnership.

- **Options for strategic partners are limited.** A Singapore/Virgin Blue/Air NZ tie-up is talked of but the likelihood of this and the benefits are uncertain. Other international airlines are too far away and mostly financially weak. Air NZ is probably not attractive to them anyway being small, offering few hub benefits, and just starting to recover from a very poor financial position.

Without a Strategic Partner, What Happens?

- The alternatives are highly dependent on how Qantas responds to failure of partnership talks, as well as how Air NZ responds.

Qantas Response

- **Severe competition with Qantas** (currently competition may be viewed as benign while discussions continue on a strategic alliance). Qantas has the ability to compete on volume (increased capacity) and price (aggressive price discounting) and has the financial capacity to maintain cutthroat competition if it desired. Air NZ's balance sheet is likely to continue to require to support under this scenario which **would require a significant capital commitment** from the Govt to shore up Air NZ's finances.

- **Benign competition with Qantas**: continuing benign competition. The impact on Air NZ's profitability is uncertain at this stage and it may still require a significant capital commitment from the Govt.

- Under both these scenarios, Virgin Blue may enter the market. Air NZ would be at risk of being squeezed in the middle between Qantas's full service offering and VB's value-based offering.

Air New Zealand Response

- Air NZ would also need to consider how to improve profitability on its own. In particular this would likely involve considering its long-haul strategy, including the service offering, routes offered, and frequency.