

Treasury Report: Air New Zealand: Options

Date:	24 September 2001	Treasury Priority:	High
Security Level:	Commercial Sensitive	Report No:	T2001/1600

Action Sought

	Action Sought	Deadline
Treasurer/Minister of Finance	Note	Before a conference call with Ministers at 10am, Tuesday 25 September
Associate Minister of Finance (Hon Trevor Mallard)	Note	Before a conference call with Ministers at 10am, Tuesday 25 September
Associate Minister of Finance (Hon Paul Swain)	Note	Before a conference call with Ministers at 10am, Tuesday 25 September

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
John Wilson	Principal Adviser, International and Defence	471 5936 (wk)	✓
Linda Dixon	Senior Analyst, Commercial Markets Section	471 5079 (wk)	

Treasury Report: **Air New Zealand: Options**

Purpose of Report

This report advises you of the risks, costs and benefits of three options that are available for the future of Air New Zealand (Air NZ) being:

- Statutory management;
- Crown-led recapitalisation with other major shareholders;
- Crown-led recapitalisation on its own.

This report also discusses the merits of the Crown financing a deal to settle the Ansett claims against Air NZ at \$185 million for which a decision needs to be taken by Tuesday, 25 September 2001.

Analysis

Request for \$850 million Capital from the Crown

We understand the Board of Air NZ is likely to approach you on Tuesday 25 September to seek a commitment from the Government to inject \$850 million in capital into Air NZ before the completion of due diligence.

We recommend the Crown declines to inject capital into Air NZ before due diligence has been completed. The consequences of declining this request could be either the Board reconvenes to consider what other options it has available to it (eg shareholder financial support or statutory management).

We note that if the Crown injected capital without due diligence, there is no guarantee that it would be sufficient.

The information provided in support of the request is scant.

Deal with the Voluntary Administrator for Ansett

The Voluntary Administrator (VA) for Ansett has proposed a deal that would allow Air NZ to crystallise the Ansett liabilities at NZ\$185 million. This would be a full and final settlement and would be approved by the Australian courts. This would mean that no party could take any Ansett-related claims against Air NZ in the future. At the same time, Air NZ would relinquish its claims against Ansett.

The Australian courts are to consider the matter on Wednesday, 26 September. However, the Air NZ directors must have signed the deal before the courts will consider it. The Air NZ directors cannot sign the deal until they have certainty that it can be funded while leaving Air NZ solvent.

The directors have advised the Crown that neither Singapore Airlines (SQ) nor Brierley Investments (BIL) are able or willing to fund the deal before due diligence on Air NZ's business plans is complete. The directors have therefore informally sought the Crown's agreement to fund the NZ\$185 million deal (this would be part of the \$850 million capital

noted above). If the Crown chooses to provide this funding, it will put itself in the position of leading the Air NZ recapitalisation. If the deal to settle the Ansett claims is done with the Voluntary Administrator, statutory management becomes an unlikely proposition.

Benefits and Risks of the Ansett deal with the Voluntary Administrator

The benefits of the deal are:

- it limits Air NZ's exposure to Ansett claims to \$185 million (plus the value of any claim that may have been successfully taken against Ansett in the liquidation process);
- to the extent that it keeps Air NZ solvent, it avoids liquidation or statutory management options;
- the Australian government would probably welcome the measure and this may improve relations between Australia and New Zealand.

It should be noted that many of the benefits accrue first to shareholders in Air NZ. However, to the extent that the Crown elects to take a significant equity stake in Air NZ following due diligence, the deal protects value for the Crown also.

The key risks with the deal are that once the Crown has committed capital:

- it will be difficult for the Crown to act in any way that leads to statutory management of Air NZ (ie the Crown would be unlikely to recoup its \$185 million if Air NZ was in statutory management); and
- it will be difficult for the Crown to decline to contribute capital following due diligence regardless of the capital requirements identified as part of that process; and
- it is possible that there will be more calls for interim capital before the due diligence exercise is complete (expected to be December).

In addition, the Crown will come under pressure from SQ and BIL for the capital injection to take the form of debt rather than equity. This is because, at \$185 million, on present pricing the Crown will become the majority shareholder.

It is probable that SQ in particular will resist the proposal for a Crown-led recapitalisation. Its incentives are to avoid having its 25% shareholding diluted. SQ desires as great a say in the boardroom as it can achieve while limiting its capital contribution to \$150 million. The result of this action would be to stop the Ansett deal proceeding, the consequences being that:

- an unknown level and value of claims would be brought against Air NZ in the future;
- the independent directors will probably resign from the Board; and
- Air NZ will probably meander towards liquidation or statutory management.

Options

The options available for Ministers' consideration, and their potential fiscal consequences for the Crown, are shown in the table below and discussed thereafter. A table presenting the key differences between Statutory Management and Crown-led recapitalisation is appended to this report.

Option	Fiscal Consequences for the Crown
Statutory Management	Crown provides guarantee of credit to Statutory Manager; Crown ranks as priority debt in the case of liquidation
Crown-led recapitalisation with major shareholders	Crown injects \$185 million immediately, to be followed by up to \$335 million after due diligence (excluding any contribution that may come from minority shareholders)
Crown-led recapitalisation on its own	Crown injects \$185 million immediately, to be followed by up to \$615 million after due diligence (excluding any contribution that may come from minority shareholders)

Note that until due diligence has been completed, the recapitalisation costs are unknown and have been roughly estimated by advisers to Air NZ at \$850 million.

1. Statutory Management (No Ansett Deal with the Voluntary Administrator)

It would be difficult for the Government itself to put Air NZ into statutory management. The directors of the company are responsible for seeking statutory management. The Securities Commission would have difficulty assessing the merits of an application for Statutory Management if the entire Board were not unified on the matter.

As we understand it, the SQ directors would not support an application for statutory management. It is likely the Securities Commission would test the solvency of the company in reaching its decision. If it is found to be solvent (and it probably would be), then it is likely that the application for statutory management would be unsuccessful. This notwithstanding the company may be in distress.

The process to statutory management would involve the Government declining to provide Air NZ with any funding prior to completion of the due diligence exercise. However, there would be no guarantees that the eventual outcome would be statutory management. It could, for example, be liquidation. In the case of the latter, it is possible that the SQ directors would do a deal with the banks to continue operating the company but with a view to the banks winding out from their exposures through selling down the assets over time.

The upshot of this is that if and when Air NZ reached statutory management, it could be in far worse shape than it is today.

The ongoing operating regime would be solely at the discretion of the statutory manager and would not be open to influence or control by the Crown.

The Crown would be responsible for guaranteeing access to credit for the Statutory Manager and indemnifying him or her for any personal liabilities accrued as a result of his/her actions as Statutory Manager.

If the process of statutory management led to the separation of Air NZ's profitable operations from its unprofitable ones (eg the Ansett liabilities), the Crown may be able to, if it wished, take an equity stake at that time (which could be in several years time). At that time, there would be clearer views as to the value of the firm and the risks in the future.

2. Crown-led Recapitalisation including current majority shareholders

While the Crown would provide the immediate financing of \$185 million to meet the VA's deal regarding Ansett, the remainder of the recapitalisation requirements would be met in part by the Crown and in part by BIL and SQ.

We note the following:

- It is highly unlikely that BIL will be able to meet its commitment to provide \$150 million when needed (as a result of the adverse consequences to its tourism interests as a result of the recent terrorist attack in the USA). It is likely any default by BIL would increase the Crown's contribution;
- SQ is likely to resist the Crown's contribution being equity since equity would significantly dilute SQ's holding and therefore level of influence in the business:
 - if the Crown was to concede this point, then SQ would be the majority shareholder with a \$150 million contribution whereas the Crown would contribute potentially in excess of \$500 million and would be subject to outcomes arising from SQ's influence;
 - if the Crown was to insist upon its contribution being equity (and in fact the capital structure of Air NZ is likely to lead to a conclusion that only equity can be sustained), SQ may either be forced to increase its contribution to maintain influence (if it is able, and we are told that it can contribute no more than \$150 million) or walk away entirely without contributing any further equity (discussed further below).

3. *Crown-led Recapitalisation without current majority shareholders*

In this option, the Crown would recapitalise Air NZ by itself. It would do this by underwriting a share issue to current shareholders including BIL and SQ. It would take up all unsubscribed shares.

The benefits of this option are:

- the current shareholders that did not wish to participate in recapitalising the airline would be diluted away so as to have little or no influence;
- the Crown would effectively control the company and could address governance issues.

The key risk is the Crown has a high fiscal exposure, possibly around \$1 billion (subject to due diligence determining the precise capital requirements). It may be possible for the Crown to shed the risk by backing the purchase with a sale transaction (ie finding a suitable equity partner). However, it may not be possible in the short time available to 'back to back' the transaction. If the Crown could not immediately on-sell the shares, it would face the following fiscal risks:

- business risks of airline ownership into the future;
- opportunity cost of capital that may have a higher rate of return when invested in schools and hospitals;
- price risk if the Crown decided to sell its shares at a later date (ie the risk that the price on divestment is lower than the price on acquisition);

- it may find it difficult to divest the shares in the near term due to the present aviation and business environment.

It is possible that this option would lead to adverse consequences for the New Zealand/Singapore relationship since the actions of the Government serve to dilute Singapore Airlines investment.

Recommendations

It is recommended that you:

- a **note** the content of this report; and
- b **refer** a copy of this report to members of the ad hoc Ministerial group, being the Prime Minister, Deputy Prime Minister, Minister of Transport, Minister of Commerce, Minister of Tourism before your scheduled 10am conference call.

John Wilson
for Secretary to the Treasury

Comparison of Crown-led Recapitalisation with Statutory Management

Area of Impact	Crown-led Recapitalisation	Statutory Management
Air NZ viability	<ul style="list-style-type: none"> The short-term viability of Air NZ will be assured, but its medium to long term viability is dependent on the Government providing an open-ended commitment to financially support the airline. 	<ul style="list-style-type: none"> Air NZ's operations are likely to continue in the short-term, with this being assisted by the (1) moratorium on all debts and claims against Air NZ, (2) a Crown guarantee of the statutory manager's credit lines, and (3) the statutory indemnity enjoyed by the manager. The medium term options available to the statutory manager are: <ol style="list-style-type: none"> restructure the company and hand it back to its shareholders; restructure and sell the business(es) and return the proceeds to Air NZ for meeting the company's liabilities; or liquidate the company, if he/she determines that it is not profitable. The decision of the manager will be influenced by his/her judgement about the viability of the business(es) going forward.
Crown fiscal impact	<ul style="list-style-type: none"> High exposure – this will be substantial, and there is a risk that the crown will be unable to exit its investment in the short term. The costs over the next twelve months are estimated to be up to \$1 billion. This represents a significant opportunity cost for other capital spending priorities. 	<ul style="list-style-type: none"> Limited exposure – costs would only be incurred if the sale of Air NZ's business operations failed to produce sufficient funds to cover the statutory manager's costs (which are paid out first from any sale proceeds). If the statutory manager sells the business(es) in due course the Crown will face pressure to be an equity partner.
Shareholder & creditor reaction	<ul style="list-style-type: none"> This is likely to be positively received, as their positions are preserved (though shareholdings will be diluted). 	<ul style="list-style-type: none"> This is likely to be poorly received (in comparison with a Crown-led recapitalisation) particularly by unsecured creditors and shareholders whose rights are frozen by the moratorium. The simultaneous appointment of an advisory committee of creditors/shareholders under section 60 of the Act to advise the statutory manager will assist in managing this reaction

International market reaction	<ul style="list-style-type: none"> • Any negative reaction is likely to be muted, as: <ol style="list-style-type: none"> 1. it does not interfere with the rights of shareholders and creditors (though their shareholding will be diluted); 2. a number of governments are expected to be under pressure to bail out their national airlines in the near future; 3. airlines are generally regarded as ‘essential infrastructure’ justifying extraordinary intervention in times of distress. 	<ul style="list-style-type: none"> • A negative reaction to the moratorium is expected, which may, in turn, adversely impact on NZ’s reputation as a reliable destination for foreign direct investment. This reaction may be tempered, however, by the global downturn in aviation, as a number of airlines may be placed into similar arrangements (eg, “Chapter 11” type arrangements). Air NZ is unlikely to be the only airline in this position.
Australian reaction	<ul style="list-style-type: none"> • There may be a favourable reaction, as this will either preserve existing claims against Air NZ or allow Ansett’s voluntary administrator to reach a settlement with the Air NZ Board. 	<ul style="list-style-type: none"> • The current adverse political, union and consumer reaction may be sharply exacerbated by a perception that Air NZ is taking further steps to quarantine itself from Ansett’s liabilities.
Competition	<ul style="list-style-type: none"> • There are unlikely to be any short term changes in competition 	<ul style="list-style-type: none"> • There are unlikely to be any short-term changes in competition.
Consumer reaction	<ul style="list-style-type: none"> • This option is expected to quickly restore consumer confidence. 	<ul style="list-style-type: none"> • There is likely to be some adverse impact, particularly where consumers are uncertain about the implications of statutory management, and this leads them to using Air NZ as an airline of last resort.
Air traffic rights	<ul style="list-style-type: none"> • These rights will be protected, though questions will re-emerge if/when the Crown on-sells any equity stake it acquires. In this event, the Government will still be able to regulate to protect the rights. 	<ul style="list-style-type: none"> • These rights will be protected, though questions will re-emerge if/when the manager sells the business undertaking of the company. In this event, the Government will still be able to regulate to protect the rights.
Risks	<ul style="list-style-type: none"> • Even with an ‘exit strategy’ the Crown may have to hold on to its equity stake for a considerable time period, and expose itself to commercial risk (including the lion’s share of any future capital calls). • There may be sensitivity about the nature of any restructuring Air NZ can undertake, and possible criticism directed to the Government if the company makes job and capacity reductions. 	<ul style="list-style-type: none"> • Implementation of this option is doubtful if an application to the Securities Commission is contested by Air NZ’s major shareholders – this is currently a high risk. • There may be some risk of offshore assets being seized, but this should be manageable if the manager quickly negotiates compromise agreements for key contracts (eg, aircraft leases). • The Government will have little control over the future shape of the national airline.