

Treasury Report: Air New Zealand: Convertibility of Interest on Crown Loan

Date:	7 December 2001	Treasury Priority:	Statutory Deadline
Security Level:	C-S	Report No:	T2001/2038

Action Sought

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Treasurer/Minister of Finance	Sign attached letter varying the Heads of Agreement between the Crown and Air NZ	Monday 10 December 2001
Associate Minister of Finance (Hon Trevor Mallard)	Note	Nil
Associate Minister of Finance (Hon Paul Swain)	Note	Nil

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Linda Dixon	Senior Analyst	471 5079 (wk)	✓
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Enclosure: Yes

7 December 2001

GD-44-5

Treasury Report: **Air New Zealand: Convertibility of Interest on Crown Loan**

Purpose of Report

1. This report seeks your agreement to vary the Heads of Agreement between the Crown and Air New Zealand to provide that, in the event the allotment of the Crown's shares in Air NZ is extended beyond 18 January 2002, the accrual of interest on the Tranche A loan will be paid in cash, rather than converted into shares.
2. A letter, signed by Air NZ, is attached for your signature executing the proposed variation to the Heads of Agreement. The letter is a faxed copy that is acceptable for signing.

Analysis

Heads of Agreement

3. Under the Heads of Agreement, the Crown advanced loan monies as Tranche A funding to Air NZ of \$300 million on 15 October. That loan plus interest is repayable or convertible to Convertible Preference Shares in Air NZ on either 31 January 2002 or the date on which the Crown subscribes for Convertible Preference Shares in Air NZ.

Conversion of Tranche A Loan to Convertible Preference Shares

4. As the Crown has elected to subscribe for shares in Air New Zealand, the loan will convert to Convertible Preference Shares at the time the shares are allotted. The Heads of Agreement provides that the Crown will subscribe for shares 15 working days after shareholders have passed resolutions in favour of the Crown's recapitalisation package, being 18 January 2002.
5. The conversion of the loan to convertible preference shares will be as follows:
 - \$300 million loan principal will convert at 24 cents per share to 1.25 billion shares; and
 - interest on the principal from 15 October (when the loan was advanced) until 18 January of \$7.2 million will convert at 24 cents per share to 30 million shares.

Takeovers Act Requirements

6. The Takeovers Code requires Air NZ to state the precise number of shares that will be issued to the Crown in its Notice of Meeting to shareholders. To leave the issue open would have required an exemption from the Takeovers Panel, for which there was insufficient time available to obtain one.
7. The risk is that if the shares are not allotted to the Crown on 18 January, the Tranche A loan will not convert to shares and interest will continue to accrue on the loan until

conversion. This would then require Air NZ to pay that interest in cash because an issue of additional shares would require further shareholder resolutions.

8. Events that could stall settlement are the non-satisfaction of conditions precedent to the Crown subscribing for shares such as:
 - shareholder resolutions not being passed at the AGM; and
 - more than 2% of the aggregate of Air NZ's A and B shares being the subject of notices under the Companies Act requiring Air NZ to buy back those shares.
9. While the likelihood of conditions being unsatisfied is low, it cannot be discounted.
10. The Heads of Agreement anticipated an exemption would be obtained from the Takeovers Panel to allow full conversion of interest to shares. In the absence of the exemption, it is proposed that the Heads of Agreement is varied to provide for any residual interest to be paid in cash. Attached is a letter, signed by Air NZ, for your signature effecting this variation.
11. On the loan of \$300 million, interest at 9.18 percent accrues at a rate of around \$75,000 per day.

Other Relevant Information

Air New Zealand's Banking Arrangements

12. Air New Zealand has been in negotiation with its unsecured lenders to agree new credit facilities for the next two years. Those negotiations are ongoing but are not critical to the Air NZ workout, given it will have significant cash resources after the Crown's recapitalisation package is provided. Therefore, unsecured banking arrangements have become 'business as usual' issues.

Independent Fairness Report

13. In accordance with its obligations under the New Zealand Stock Exchange Listing Rules and the Takeovers Code, the Board of Air NZ commissioned an independent assessment of the fairness of the proposed recapitalisation package.
14. The report by Grant Samuel (GS) was provided to shareholders yesterday along with other documentation relevant to matters to be discussed at the Air NZ AGM on 19 December.
15. The key finding in the Fairness Report is that the proposed recapitalisation is fair and reasonable. The findings are underpinned by the following:
 - the pricing of the share placement is fair, falling within GS's range of 15-37 cents per share;
 - Air NZ will not be in a financial position, after recapitalisation, to sustain any further material extended downturn in business or other adverse impact;
 - shareholders have virtually no choice, with Air NZ facing likely statutory management or possibly legislated nationalisation without the Crown's

recapitalisation from which shareholders would almost certainly realise no value for their shares;

- shareholders would have arguably been better off if the Crown had underwritten a pro rata rights issue.

16.

Monitoring and Communications Protocols

17. As noted to you in a recent report, we are engaging with the Chair of the Board towards agreeing monitoring and communications proposals for your consideration in January 2002.

Indemnification of Board Members

18. As part of the October Heads of Agreement, you provided indemnities to the directors of Air NZ against costs and liabilities arising from their continued participation on the Board over the period in which it was uncertain as to whether Air NZ would be recapitalised.
19. The indemnities are terminated at the earlier of the time at which the term of the director ends or on the allotment date of shares to the Crown (being 18 January 2002).

Recommended Action

20. It is recommended that you **sign** the attached letter formally varying the Heads of Agreement between the Crown and Air New Zealand to allow for any interest accruing on the Crown's Tranche A loan after 18 January to be settled in cash.

David Taylor
Manager, Commercial Investments
for Secretary to the Treasury

Hon Dr Michael Cullen
Treasurer/Minister of Finance