

Aircraft Financing – how things have changed

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I still get a bit of a cold shiver, I think, when Dermot mentions the collapse of Qantas New Zealand. It is never nice to hear your name associated with any collapse, but also a little bit nervous, I guess, about appearing in public with New Zealand lawyers at this point in time. There is obviously a little bit of speculation going on there.

I just really want to give a bit of an overview, I guess, of, I guess, the Qantas experience in relation to aircraft financing markets, particularly over the last 12 months. You certainly don't have to be an aviation analyst to realise, as Dermot indicated, that the last year has been one of total upheaval, particularly in this Australasian region, I think. It is a bit of a microcosm, I guess, of what's slowly starting to happen around the world.

September 11, I guess, was a major blow to an industry that was already really struggling with rising fuel prices. You had a slowing world economy and fierce competition from a lot of the new start-up carriers, the low-cost carriers that have again proven their resilience over the last six months. In Australasia, in particular, it is probably deregulation more than terrorism that created the change but nonetheless you can see those trends are going to continue around the world.

I thought I might just firstly touch on a few subjects that, I guess, have helped shape the environment and get us to where we are today, and give you a bit of background as well later on; on Qantas's own financing policy, and then move on, I guess, from there to some documentation issues. I guess if you are keen to get out and have a swim, I can summarise it - I mean, the Qantas experience has actually been fairly favourable over the last six months. We've probably sat in a fairly unique situation in that the collapse of Ansett opened up a lot of possibilities for us so that, instead of grounding aircraft like a lot of airlines, we had exactly the opposite problem, and we are still struggling to cope with the growth that we've had to generate to meet that increased demand.

I guess, given all of the events that have taken place over the last 12 months, it is a credit to the legal system within Australia that, from what we see, financiers still have a lot of confidence in this region and are still willing to put a lot of money into this part of the world. If aviation is to survive down here, then we need to maintain and improve the legal and regulatory system to keep the area attractive for them.

Deregulation has probably been a major factor in shaping where the industry sits today. I guess, historically, the aviation industry has been viewed as a special market segment by governments around the world. I guess a lot of governments see airlines as vital to national psyches and we

probably, looking selfishly from Qantas's point of view, we think it is very important that Australia maintain a strong aviation industry. I know we had a bit of discussion with Dermot last night. Obviously, New Zealand feel exactly the same as to most countries.

Over time, though, the substantial costs involved in owning airlines and in growing those airlines has seen governments slowly move to privatise carriers and deregulate aviation markets. Our own privatisation in 1995 was part of an ongoing liberalisation of aviation policy within Australia. The aim there obviously is to drive down airfares and, particularly, I think, a huge push towards tourism. The last 12 months, you know, virtually every state government in Australia has been pumping money into airlines and, in some cases, have shown themselves pretty keen to own airlines. The Victorian Government, I think, was very interested in trying to revive Ansett. Obviously, up here, Virgin has a strong presence within Queensland. Again, it just shows the importance of tourism, I guess, to the state economies and, from their point of view, obviously want to see airfares lower.

I guess, from Qantas's perspective, this liberalisation has seen a level of domestic and international competition that is probably not experienced by a lot of our competitors with the exception of the EEC. Australia is the only country in the world where a domestic airline can be 100 per cent foreign owned.

At the moment, there is considerable debate about the future of the aviation industry here in Australia. The human and financial costs of the Ansett collapse were a fairly stark reminder, I think, of the rapid change - the impacts, I guess, of rapid change on an industry. I guess, despite what's happened in the last year, it seems reasonable to assume that, over time, bilateral arrangements will continue to break down and the skies will be open to more and more competition. We obviously understand the need for deregulation and we've benefited from that but we also need to ensure that I think change that takes place takes place at a steady place.

I just wanted to touch also, I guess, on the tax system within that, I guess, deregulation field. From Qantas's perspective, we have been hamstrung over the years by the fact that we have a very small domestic capital market. Airlines, by their nature, have huge capital requirements. You know, we've got, at the moment, \$10 billion-worth of aircraft on order coming up over the next few years. You just can't fund that sort of money domestically. To face a situation - where you're getting penalised for trying to raise funds off-shore by having to pay withholding tax - is clearly a big impediment to growth within the airline and we've been having a lot of discussions over the last 12 months with the Tax Office here in Australia to try and free up some of those impediments.

I guess the good news is that slowly we're making progress there. A revised Tax Treaty obviously with the US has been announced and, hopefully, that will spread to other countries which will help us on that side. There has also been a lot of debate over across-water leasing and where that goes within the country. That has been going for I don't know how many years, John, but I think John will probably touch a little bit on that later on as well. Again, we are slowly making progress but it is difficult. If we look at our major competitors, you know, the Cathays, the Singapores and so on, they virtually have unfettered access to any financial market they choose to take to. At Qantas there is a lot more work involved in structuring around the various regulations and so on to get to desired outcomes.

Along with deregulation, consolidation has probably been the major catchphrase within the aviation industry in recent years. As airfares have been forced down around the world, I guess many people, including ourselves, thought that consolidation would really start to accelerate as airlines try and find better ways to, I guess, pool assets and make better use of what they have.

September 11 has had a bit of a surprising impact, I guess, on consolidation and its progress forward. At a time when you think it would be necessary for airlines to consolidate and thus ensure survival, we've seen pretty much the reverse occur. Many governments have moved to assist or re-nationalise their airlines. We've seen that obviously in this region. The US Government has obviously given substantial aid to their carriers, a fair, I guess, special case there, but also the Swiss Government again and Malaysia have both moved to protect their own airlines rather than remove impediments, I guess, to further consolidation.

There is a huge list of airlines out there at the moment in dire difficulty, but, to date, there's only been four airlines collapse. So you can see that the change is going to occur slowly. It is a bit of perverse situation, I guess, where governments are deregulating to try and bring through change but, at the same time, when an airline does start to hit a bit of trouble, they turn around and try and protect it.

Longer term, I think, we believe that competitive pressures will continue to drive airfares lower. As a result, airlines will continue to search for ways to create the scale necessary to ensure long-term profitability.

I don't think anyone can really predict what shape airlines will take in the future. In the long term, I guess, we believe that this push to reduce costs will lead to a lot more sharing of aircraft, better co-ordination of schedules between airlines. We've had a long-standing arrangement now with British Airways, for example, where we have co-ordinated scheduling between Australia and Europe and I don't think that's been at any detriment to competition, given there's up to 50-odd carriers flying that particular route. But from the point of view of both airlines, it's been a major cost saver.

The fact that BA, I guess, have held their shareholding in Qantas through all the difficulties that they've had, particularly in the last six months, is probably an indication of how important that relationship is. Again, that has been done with a shareholding that now stands at around 22 per cent. You don't have to hold 100 per cent of another carrier to bring through these benefits. In other areas we have arrangements with American Airlines, for example, and Japan Airlines again, mainly through code sharing, no equity investment required. Again, it just helps you to co-ordinate schedules, get much better feeder traffic which is essential to airlines, and Air New Zealand have been struggling with that. Virgin this week announced obviously the tie-up with United to try and improve their situation but feeder traffic is a huge issue.

From a documentation perspective, I guess issues arise when airlines do start to move beyond the traditional subleasing and pooling arrangements. There is no reason why, in the future, a Qantas 747 that might otherwise be parked in Heathrow overnight couldn't be used by a partner airline of Qantas to do a return, say, to Moscow, for example. The idea is the assets are sitting there. You're paying for them. You might as well work them as hard as you can. The extension of the Qantas flights from Los Angeles over to New York is another example of that where, again, quite often we have to

overnight aircraft there because of scheduling requirements, curfews back in Sydney and so on. So you might as well keep the aircraft flying, even if it is not full. It is sort of a marginal cost type argument.

If I could just move on, I guess, to September 11. There probably have been permanent impacts, I think, on aircraft finance markets. IATA recently reported that the fall in demand for air travel as a result of the terrorist attack led to the grounding of over 1000 aircraft between September 2001 and March 2002. The combined losses of airlines worldwide during 2001 totalled over \$20 billion. I've heard estimates of between 20 and 30 billion. The outlook for 2002 is not a whole lot better. Most estimates are guessing that airlines will lose another \$10 billion around the world this year.

That is a big question when we're looking at huge CAPEX requirements going forward. How do you get investor confidence to come back into your industry? Historically, returns on airlines have never been very impressive.

One of the main impacts of September 11 has been that aircraft financiers have been quickly forced to revisit many of their long-held assumptions about the industry. A year ago, most insurance models would have predicted that a worst-case accident scenario would probably involve two aircraft colliding over a major population centre and you'd have some collateral damage on the ground below but you would never predict the type of third party liability claims that are arising out of what happened in September. That has again flow-on effects through the insurance markets and so on and we will touch on those a little later.

Again, no liquidity model used by a financier would have ever predicted that the entire US airline industry would be grounded for four days. I guess no financier would ever consider that they would have been trying to dispose of a repossessed aircraft into a market where there were 1000 aircraft grounded at a point in time. So I think you really have seen a quantum shift in terms of the assumptions that people have to make as to the risks involved in aircraft financing.

If I just touch on the rating agency response. I saw a quote in a paper earlier this week. The Director-General of IATA said:

"In retrospect and looking at the deteriorating situation even before September 11, we would be forced to concede that this industry was ill-prepared to successfully weather even a fairly mild regular economic cycle."

The rating agencies in hindsight clearly seem to agree with this statement. Shortly after September 11, S and P downgraded nine airlines on the basis of their high ratio of secured debt to total assets. More downgrades followed as traffic started to slow and losses mounted.

If you look around the airline industry, British Airways, for example, two years ago was rated single A as were Swissair. British Airways is now sub-investment grade at BB+, I think, the equivalent by Moodies. Swissair, of course, are no longer around. The American carriers, similarly, Delta and American Airlines were both rated BBB flat which again is an investment grade carrier two years back; today, they are lucky to hang onto a BB rating. Again, that all has flow-through implications for trying to raise finance to fund your airline.

Looking forward, the agencies are definitely placing a lot more importance on the liquidity of airlines and the availability of unencumbered assets as security for unsecured creditors. Airlines traditionally operate a negative working capital position; which means that we fund ourselves, in part, I guess, by the cash that we receive from tickets sold in advance and that all works fine until you have an event such as September 11 or, perhaps, a major pilots strike like we have seen here in Australia where, all of a sudden, you stop flying and you have to start refunding those tickets, and that's why having liquidity backup is so important for airlines.

We've always maintained significant standby facilities to guard certainly against the pilots strike scenario. I don't think we'd ever thought that something like September 11 could occur. So we were probably fortunate that, you know, going into September, we did have quite a significant amount of liquidity behind us.

I think, going forward, the other thing rating agencies will continue to look at - and we've had some feedback from them already - are things like the material on adverse change clauses within documents, downgrade triggers and so on. Again, just looking at the sort of risk profile.

In terms of the reaction of financiers to all these events: surprisingly muted is probably the best I can say at the moment. A large number of air finance banks have cut back and, in some cases, stopped lending while they re-evaluate the risk on their portfolios. The spread of airlines to whom they will lend has definitely narrowed. Fortunately, we've stayed within that pool, but a lot of banks will now say that they really do only have a core group of airlines that they will lend to. As always, though, there's always new entrants, new lenders, coming into the markets. Through the early '90s, it was the Japanese banks that really, I guess, carried Qantas through its last major expansion phase. In the late '90s we probably saw the Landes banks out of Germany and, today, the Chinese banks, in particular, are very hungry to make loans. So supply is still there.

I guess on the negative side, spreads have widened. We are probably seeing an increase of between .2 and .3 per cent to the cost of a 112-year loan, but, given the all-in level of interest rates, global rates at the moment, it is not really a major impact for us. Unsecured borrowing is definitely more difficult. Our spreads blew out significantly, basically doubled, after September 11, but those spreads have now come back in to levels probably as low as they've been for several years. Again, to some extent, that is Qantas specific but there have been other successful airlines out there. South-West in the US recently did a major issue. They've been another success story of the last 12 months.

In addition to the impact on margins, the grounding of such a large number of aircraft has had a significant impact on the price of second-hand aircraft. As a result, forecast residuals have declined in some cases by as much as 20 per cent. We are therefore finding that financiers are looking a lot harder at loan-to-value ratios and so on when they come to Qantas with proposals. They are also focusing more on the type of aircraft. There's definitely a trend towards narrow bodies, which are more readily saleable within the market. The 747s that Qantas relies on the long-haul market are definitely not as attractive as they once were because there's a limited resale market there.

Longer term, I guess it will be interesting to see whether market forces will bring pricing back to pre-September 11 levels, or whether there has been a permanent shift in the way that banks assess the

risk on aircraft. If I was a betting man, I think market forces will probably bring it back. I am constantly surprised in the last six months in particular at how quickly markets are able to rebound from shocks.

With commercial margins increasing, however, and loan-to-value ratios falling, the attractiveness of export credit agency debt has also increased. We recently tapped that market to finance the acquisition of 15 737-800 which were an order cancelled by American Airlines to help pick up the growth here in our domestic market.

I will just touch quickly on our financing strategy and I guess why we believe it has been of such value over the last 12 months. We undertook a major capital management review in early 2001 and the key finding of that review was that shareholder value is maximised by Qantas maintaining an investment grade rating. If you look at the US airline model, for example, there is really only one investment grade airline being South-West but then those airlines have access to the deepest capital market in the world. They are all registered in the US. They can tap things like the securitised markets, the EETC-type structures. Qantas doesn't have that same benefit and, therefore, we believe it is important to keep our rating high so that we can maximise our choice with respect to financing options.

In May 2001 we put together a \$2.1 billion syndicated bank facility. As I mentioned before, this liquidity was vital going into September last year. This assisted investor confidence and, again, it helped us with our equity raising which we were able to get away in November last year where we pulled together about \$600 million to again help with this start-up of the 737-800 operation.

We also believe there is benefits from diversification both in our root structure and within our subsidiary businesses. Many airlines around the world have spent the last few years selling a lot of their operations off - their catering, their engineering, even their aircraft themselves. Swissair was a very good example of that. There wasn't a real lot left in the core airline at the end of the day. I haven't looked closely at the situation but we've never really been able to understand that. At the end of the day when there's a shock and you have such an impact on your revenue, you need to have something behind you to back it up. If you've sold off all your assets and you don't have cash flows coming in from other areas, then it makes it very difficult to ride through cycles.

The last thing I wanted to touch on today is, I guess, just documentation, the fascinating topic. To some extent, I think the jury is still out on the issues arising out of September 11 and Ansett. Again, our experience is probably a little more favourable than that encountered by many airlines, but we feel that we've worked pretty hard over the years to, you know, earn that confidence with the investment community. Insurance is clearly now a major focus and I think that will be touched on some more shortly. Liability issues, you know, are gaining a great deal of attention. In the Australian context, obviously, there is a renewed focus of the implications of the Damage by Aircraft Act. I am sure that topic will continue to receive a lot of debate going forward.

In responding to a lot of queries, I guess we've, in talking to financiers, tried to give them confidence that, at the end of the day, we're a public-listed company and we're not going to put our shareholders' funds at risk. You know, the board are clearly very aware of the situation out there and there's no way that Qantas would ever be flying if we didn't have appropriate cover in place. Fortunately, the governments were able to step in quickly - the Australian Government in our case - after September

11 and help us when war-risk insurance, in particular, was withdrawn. We are slowly seeing a recovery in that market. Our war-risk cover now we have, I think, got up to about 600 or 650 million US dollars, but, again, we are still getting a top up beyond that from the government and I think that situation will stay for a little while longer.

In terms of the rest of the documents, we done quite a few financings recently. Not a lot has changed. There may well be developments, I think, as the implications of Ansett sweep through but, at this point, we haven't seen a lot of evidence of that. At the end of the day, I think the events of the last 12 months have made it clear that a financier shouldn't just look at the asset when providing funding to an airline. They must have some faith in the ability of the airline to meet their obligations going forward. During the 12 years of your average financing, aircraft are going to suffer bird strikes, they'll receive hail damage, they'll be hit by catering trucks or run off the end of runways and end up in golf courses, they'll be subleased to other airlines, they'll make emergency landings in strange countries, they'll be re-configured, reconditioned, repainted, re-registered and repaired many times over. If I've learnt anything over the last few years in the role I guess it is that no document is ever going to cover the range of potential issues that are going to come up over your average financing.

Looking forward, I guess, from our perspective, you hope the governments will continue to relax the grip on the aviation industry but allow this change at a controlled pace. Challenges are going to continue to arise and we obviously want to make sure that we maintain a significant presence within the Australasian region.

Thanks very much.