

Not a vintage year

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As the anniversary of Swissair's bankruptcy approaches, Michael Conolly, CFO of Transportes Aereos Portugueses, is sounding out new potential equity investors. However, his top priority is to make the Portuguese carrier profitable again.

Swissair was set to buy a 34% equity stake for E155 million (\$153 million) in Portugal's flag carrier and without that injection Conolly has been busy finding other sources of finance.

"As part of our financing needs, last year we started to work on a couple of options, and we were defining what our needs would be, and looking at which of the options we would go for, when September 11 struck," says Conolly, who joined TAP from Varig in 2000 along with Fernando Pinto, the Portuguese carrier's chief executive officer.

Bids from Bank of Tokyo Mitsubishi (BTM), Santander Central Hispano and Merrill Lynch/Banco Comercial Portugues were short-listed but put on hold after the terrorist attacks on the US.

At the beginning of 2002, TAP approached the market again and, in June, the airline closed a E100 million loan with GE Capital Aviation Services subsidiary PK Airfinance. Secured on three A340s which were delivered to TAP in 1994 and 1995 Conolly says that the pricing was competitive. "The pricing is reflective of current times, but it was reasonable, and lower than the market in general expected. PK Airfinance also had the advantage that it was a simple structure, a straight loan, so it was quicker and cheaper," he adds.

BTM advised TAP on the deal, with the Japanese bank also a lender to TAP. In February 2001, TAP was facing a shortfall after Swissair pulled out so BTM extended a E40 million loan for a period of two years. This loan is able to be repaid, with proceeds either from the new PK Finance loan or other facilities that TAP hopes to have in place by year end.

"Basically, the loan is for working capital or cash-deficit needs. At this point we still need to refinance about a quarter of our debt service principal and interest that matures this year, and the PK Finance loan is part of that effort," says Conolly. "We hope to be cash-positive next year."

After posting heavy losses in 1999 and 2000, for the financial year to December 31, 2001, TAP had an operating profit of E20 million on turnover of E1.218 billion. But with other financials included, the airline had a net loss of E44 million. The results for the first quarter of 2002 were slightly ahead of the same period in 2001, in spite of the difficulties in the industry, which shows that the cost cutting and profitability drive at TAP is having a positive effect.

"We established a very aggressive budget for this year, because we basically maintained the objective that we had in the plan we had set out at the end of 2000," says Conolly. "This year's budget basically confirmed those targets, so it is really a pre-September 11 target that we maintained, and it was very aggressive in that respect."

Conolly expected the first half of 2002 to be below budget, but the results are slightly up on 2001. "We have to find a way to recuperate what we lack in terms of the budget to try to meet the full-year target, which is a net loss of E5 million, whereas last year we lost E44 million. So our plan is very aggressive under current circumstances."

TAP hopes to achieve a cash surplus by 2004 reducing its need for external cash. "We are on track," adds Conolly. "We were able to achieve our cash-deficit goals last year, even with the downward changes in economic growth, and September 11, and this year things are going well. We have very strict cash management."

At operational level, TAP is redesigning its network, and hopes to make better use of its fleet, reposition in key markets such as Brazil in order to target higher yield segments and cut costs, including labour costs through staff layoffs.

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TAP timed its fleet renewal well, with the start of the downturn coming after new aircraft had been delivered. The airline placed a major A320 family order with Airbus in 1997, to replace 737-300s. "Obviously commonality is an advantage, and our fleet is not big enough to have two different makes of the same group of aircraft, and the fleet is working well," says Conolly.

The airline took delivery of its last A321 in June and does not have any outstanding orders or options. Conolly adds: "Obviously this would be a good time to discuss pricing with the manufacturers, but we feel that we have to consolidate our operations."

TAP's fleet comprises four A340s, five A310s, three A321s, eight A320s and 16 A319s. The carrier has eight aircraft on operating leases from lessors including ILFC, GATX and Bavaria, and has also used a variety of finance leases and Export Credit Agency loans to finance its aircraft acquisitions. Four aircraft have just reached the end of their lease terms on Japanese leveraged leases dating back to 1989 and 1990, and TAP closed two Japanese operating leases in 2000. Last year the carrier also looked at the possibility of doing a Portuguese leveraged lease, but the deal was not closed.

The June A321 was delivered on an operating lease, and Conolly thinks that the current mix of operating lease versus owned aircraft is a reasonable one at about 20%, although he feels that owning aircraft is generally preferable, allowing a carrier to benefit from any residual value when an aircraft is eventually sold.

The airline has looked at financing alternatives such as European enhanced equipment trust certificates (EEETCs). "EEETCs are an interesting structure but still not very common in Europe and we need to do a few more to make people feel comfortable," says Conolly. "You have all the issues of repossession and different local legislation, so there is still some work to be done there."

As TAP is still reliant on the bank loans rather than bonds, the airline is not planning to get a public credit rating. "One of the options that we were looking at last year was a deal in which we would have gone to a rating agency, but only as a need for that specific transaction," says Conolly. "I think at this point we have to finish restructuring and improve our financials before we look at getting rated."

Going public

The airline is still completely state owned and Swissair's bankruptcy has cost it valuable time. TAP was one of the founders of the Qualiflyer group in 1998, and the SAirGroup strategy always envisaged that an equity stake would follow, with a sale approved by the Portuguese government in Decree Law 122/1998 and Decree Law 34/2000.

In March 2000, it was agreed that SAirGroup would acquire 34% of TAP, but the Swiss airline was already running into difficulties, something which became known to the outside world early in 2001, at which point SAirGroup informed TAP management and the Portuguese government that it would not be proceeding with this plan.

"Obviously the effects of events at Swissair were very damaging, first of all because they were contractually supposed to make a capital increase which didn't happen, and subsequently because with their bankruptcy we lost a strong feeder into our network," says Conolly. "The same thing happened with Sabena. Our flights were feeding Sabena beyond Brussels, and Swissair beyond Zurich, and vice versa, so losing that was very damaging. On the other hand, we tried as much as possible to occupy the space left by Sabena and Swissair."

He adds: "We continued with the privatization effort in 2001, after Swissair informed us that they would not be taking an equity stake. We started to find other investors, and our preference was to tap into Portuguese investors first. We initiated a roadshow last year, but that was also impacted by the September events. There was great uncertainty, not only about the airline sector but also potential investors were uncertain about their businesses, and the economy in general."

Then there was an unforeseen change in government in Portugal, with elections being called, and everything put on hold because potential investors wanted to find out about the intentions of the new government. The new administration has since confirmed that it wants to see Tap privatized. "We are now getting ready to restart discussions with potential Portuguese private investors," says Conolly. "It is our preference not to go to another airline - obviously it will depend on what presents itself, but we are not seeking that right now."

Searching for the right partner

The unravelling of the Qualiflyer alliance also left TAP looking for new alliances, and this year TAP and Iberia signed a cooperation agreement,

allowing them to offer better connections by coordinating their timetables on codeshare flights. Codeshare routes include Lisbon to Madrid and Barcelona; and Porto to Madrid and Barcelona. There are no plans to join any of the big global alliances. "We have a number of codeshare agreements, and we continue working on those agreements," says Conolly.

He adds: "We feel that, at this stage, it is probably more advantageous for Air Portugal to go into different commercial agreements in the different geographic regions, rather than looking at one major alliance."

TAP also has commercial agreements with carriers including American Airlines, bmi british midland, Finnair and Olympic. TAP flies into both Newark and JFK, where it feeds passengers on to American Airlines flights, and vice versa.

TAP is also quite strong serving the Brazilian market, and flies into Fortaleza, Recife, Salvador, Rio de Janeiro and São Paulo. It also operates to a number of destinations in Africa, such as Dakar, Bissau, São Tome, Luanda, Maputo and Johannesburg.

The airline is watching the growth of low-cost airlines, although Conolly believes that the long tradition of cheap charter flights into Portugal as a holiday destination means there will be less of an impact on the Portuguese market than some other countries.

"If you take Lisbon and Porto, for example I don't believe there is the density of traffic to justify the presence of the low-cost carriers, and if you take the leisure market further south in the Algarve region, there you already have an enormous amount of charter activity which works very well. So I don't know if there is much of an attraction for the low-cost carriers," he argues.

He adds: "Obviously we get indirectly the effects of them because as people get nervous and start competing on fares, that eventually effects our markets. But at this point there is no direct attraction in this market for the low-cost carriers."

In the charter market, TAP owns 49% in YES- Linhas Aereas Charter, which it set up in 2000 together with Portugal's largest tour operator, Viagens Abreu. TAP is also a shareholder in Air Macau, which flies out of Macau, the former Portuguese colony which was returned to Chinese sovereignty in 1999. TAP owns 75% of Seap, which, in turn, owns 20% of Air Macau. The balance of Seap shares is held by Portuguese bank Caixa Geral de Depositos,

Clearly, 2002 is going to be a difficult year for the airline industry but, having cut its cost base, TAP is managing to reduce its losses. From January to March 2002, it carried 3% more passengers than in the same period the previous year, and improved its load factor by 1.1%.

The management hopes that the target of profitability that has eluded TAP for several years will finally become a reality in the 2003 financial year.

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