The return of the state-owned carrier?

The COVID-19 crisis is posing the most significant challenge to airlines in history. State aid in one or multiple forms will likely be required by most if not all carriers – and can be immensely beneficial, if provided intelligently.

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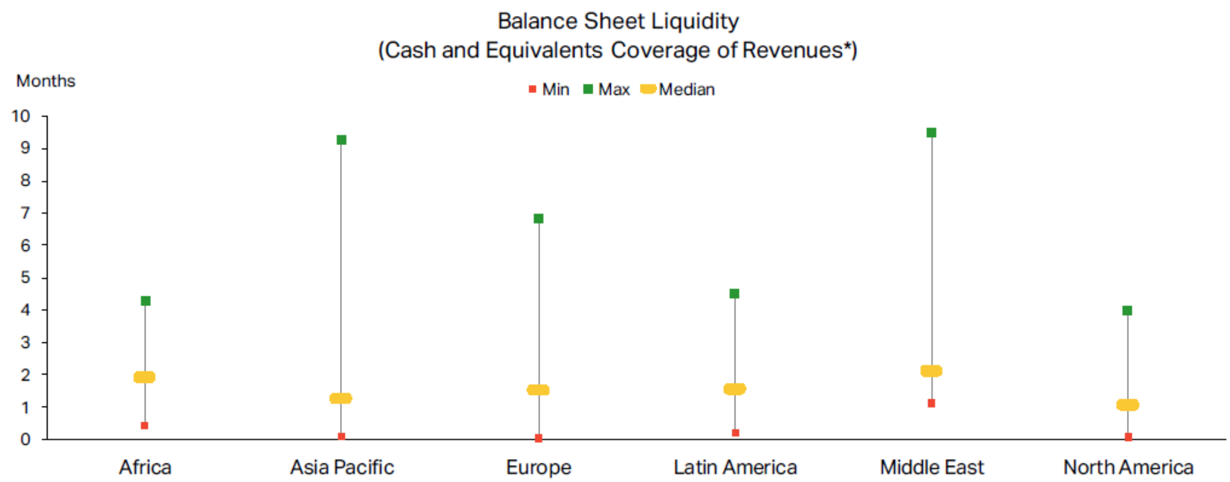
By Henrik Mädler, et al. of the Solution Group Organization, Strategy and Finance

Airlines in crisis

IATA Director General and CEO Alexandre de Juniac warned already in March: “Airlines are fighting for survival. [...] Millions of jobs are at stake. Airlines need urgent government action if they are to emerge from this in a fit state to help the world recover, once COVID-19 is beaten.”

This is because global airline balance sheets are liquidity-strapped. IATA analysis suggests that the median global airline had cash reserves for only two months at the end of 2019.



Note: IATA Economist based on data from Airline Analyst

A bleak outlook

A market rebound – while likely in the long-run – is not in clear sight. Capacity in Europe has been down nearly 90% compared to the previous year and first announcements to “restart” have included only the cautious resumption of (some) routes. The restriction of movement has been a key instrument in fighting the spread of the virus. Border closures for non-essential travel are being lifted within Europe, but the picture is less clear on a world-wide scale.

Domestic capacity is likely to return first once country-level lockdowns are lifted. Indeed, China has returned to ~80% of pre-crisis levels on the domestic market. International capacity will follow, depending on where, when and how travel restrictions are removed. Questions remain as to how much the following economic recession will depress demand and to what extent people might be afraid to fly until medical solutions to SARS-CoV-2 are found and widely available - distancing measures, masks, and industry-grade air filtration notwithstanding. IATA as well as individual airlines now forecast a return to (and growth beyond) the 2019 capacity baseline only in 2023.

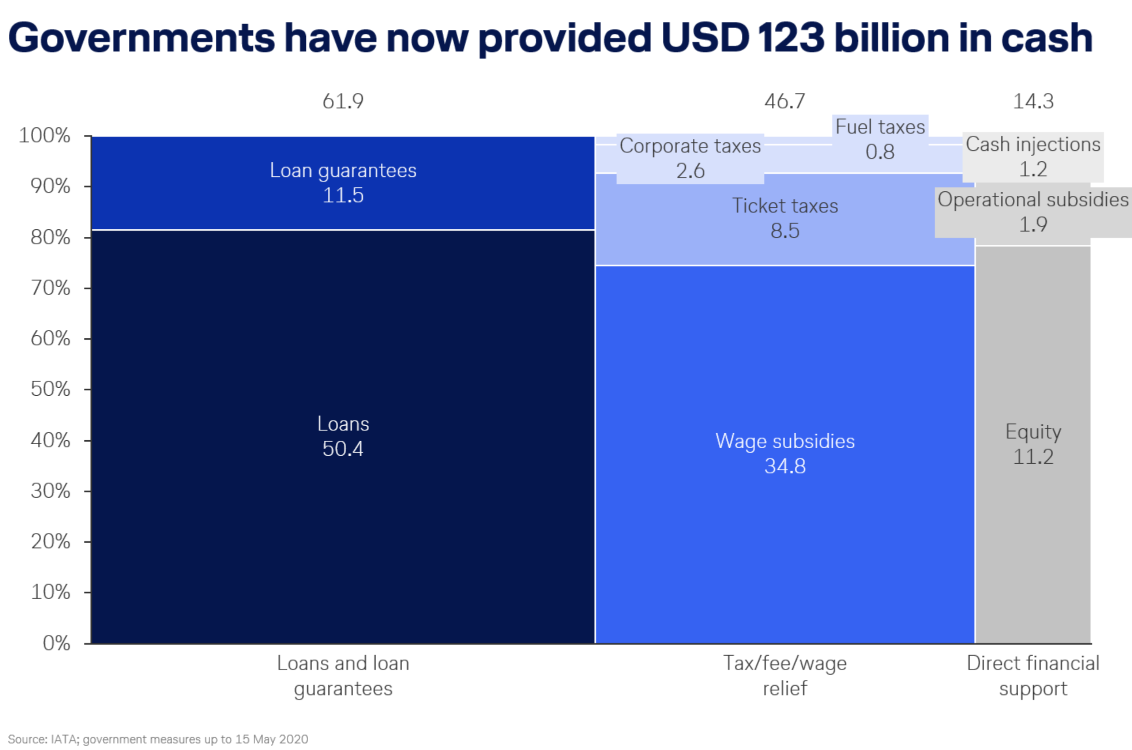
Governments to the rescue

Governments have long recognized the importance of airlines to economic development and global connectedness. 65 million jobs globally depend on the air transport industry, its wider supply chain, flow-on impacts and jobs in tourism.

Consequently, airlines have started to engage governments as helpers of the last resort. So far, USD 123 billion of government aid has been made available, from three key sources:

- Loans/loan guarantees – loan with potentially favorable terms, from or backed by governmental development institutions, possibly convertible into equity
- Tax/fee/wage relief – waivers or deferrals of taxes, air traffic management fees, security fees etc., state funds to pay for (parts of) salaries while staff are furloughed
- Direct financial support – cash infusion of state money to stabilize the airline, e.g. grants, equity raise

Beyond that, the most extreme option is a government take-over – full nationalization of the carrier with assumption of management control.



[Figure 2 – Types and volume of total governmental stabilization actions up to 15 May 2020, per IATA]

One of Europe's largest airline groups, Air France-KLM, received a EUR 4 billion state-backed bank loan and a EUR 3 billion direct shareholders loan from the French government. The Dutch government is willing to provide another EUR 2-4 billion. Both governments are already shareholders at 14% each.

The United States federal government has made airlines (and indeed, the entire aviation sector) a priority in the USD 2 trillion-strong Coronavirus Aid, Relief and Economic Security (CARES) Act. For carriers, it includes USD 25 billion in loans and loan guarantees, USD 25 billion in payroll grants and federal excise tax relief.

In Asia, the government of Singapore has meanwhile designed comprehensive measures to help its aviation sector as part of its SGD 48 billion economic stimulus package. These include funding up to 75% of aviation workers' pay and forgiving SGD 350 million in fees for airlines. Temasek, the Singapore government-owned holding company that owns a majority stake in Singapore Airlines, is backing efforts by the airline to raise SGD 5.3 billion in new equity and up to SGD 9.7 billion in convertible bonds. Meanwhile, Singaporean DBS Bank is providing an SGD 4 billion bridging loan facility to SQ.

Strings attached

Yet government assistance can come with some significant strings attached.

Government loans are usually expensive, as they are only extended after all avenues on capital markets have been exhausted and often come with provisions ensuring convertibility into equity in case loans cannot be repaid. For example, the NZD 900 million loan recently offered to Air New Zealand by the NZ government comes with interest rates up to 9% and potentially higher should the loan be needed for more than two years, and is convertible. Experience suggests that favorable lending terms can work out well for governments, and by extension, the taxpayers to whom they are ultimately accountable, even if an airline still goes under: Of the EUR 200 million bridging loan that was extended to ultimately-failed Air Berlin by the German government in 2017, every cent was paid back including interest, due to preferential treatment of the loan in the liquidation process.

More troublingly, national interest (i.e. not spending tax dollars abroad) constrains aid, especially for multinational airline groups. The French and the Dutch governments, for instance, emphasize that their tax payers' money will only benefit their "own" airline, Air France and KLM respectively. While inefficient in the worst case, this makes a strong case for airline groups to engage each one of their national stakeholders as a work-around of sorts.

Job guarantees may be another consideration. The US CARES package mandates that no staff be laid off, furloughed or have their pay cut through 30 September. However, executives from the major US carriers have indicated that they will need to shrink their workforces by 30% come October, for unfortunate but sound reason: If the market is only fully to recover by 2023, airlines will have to restructure and shrink in the short-term before returning to growth. This is paramount to the financial health of the companies, especially now that their balance sheets are laden with additional debt.

More creatively, environmental concerns may also enter the fray. The French government has attached provisions to its aid to Air France relating to carbon efficiency, especially through the elimination of domestic flights, fleet renewal and increased use of biofuels. In the pursuit of a valuable goal in principle, environmental objectives should be set at the industry-level, ensuring a level playing field for all airlines, rather than at the level of individual companies. This would be ultimately in the interest of both competitiveness and environmental protection.

Governance, not government

Yet again, it is best if the attached strings are financial rather than political. Even with state aid in place, politics (and politicians) should stay away from the day-to-day running of an airline and ensure that international-standard corporate governance is in place, management is professional and industry-trained, and financial management is disciplined, transparent and clearly accountable.

A prime example, Temasek has always managed Singapore Airlines on a commercial basis. The airline has consequently turned a profit every year of its existence, except once (in the Global Financial Crisis), at the same time topping the World's Best Airline rankings four times.

In 2001, when 9/11 upset global aviation and the much larger Ansett (that it wholly owned) collapsed, Air New Zealand had to be re-nationalized to secure its survival. Yet Air NZ achieved an exemplary turn-around, transforming its legacy business model in the process. The NZ government reduced its stake relatively quietly from 76% to 53% in 2013 at a handsome profit and has been holding on to the remaining share majority ever since.

Ethiopian Airlines also makes for a success story, as the only profitable airline in Africa. It is 100% state-owned but managed without any interference by the government. Ethiopian Airlines has become "The Best Airline in Africa", as evaluated by Skytrax, three times in a row (2017- 2019).

While examples how not to do it abound, one cautionary tale shall suffice: Alitalia most recently entered extraordinary administration in May 2017 and was injected with cash from the Italian government repeatedly while talks with potential buyers or investors were underway. Deadlines for the sale kept passing as interested parties often emphasized that they would make their investment contingent on a restructuring, including the reduction of fleet and staff sizes. All deals fell through, and so the Italian government re-nationalized Alitalia to the tune of an EUR 3 billion capital injection in May 2020 – announcing that it would reduce the "new Alitalia" to the same size suggested by bidders earlier. Chances are, the restructuring will now be more disruptive than it could have been.

As we can see, state-owned airlines are not per se doomed. Despite all the cautionary tales of government interference in management decision processes leading to long term competitive disadvantages, there are shining examples of how state-owned carriers can prosper: As long as the government can manage to keep politics out of the daily business and act as an economically-oriented investor, states will actually reap respectable returns on their investment in the long run.

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