Airline project

Summary of the Operation Performance Evaluation Review (February 2005)

THE PROJECT

The international airline ("the Company") was established in the early 1990s as a joint venture between the government (the country's State Association of Civil Aviation) and a Western aviation leasing group. The government brought in 20 exclusive route rights valid until 2010 and the aviation leasing group invested several million US dollars in equity. The Company was created as a greenfield project with its management team, consisting of nationals from the country of operation, expatriate executives and led by a former vice president of a Western airline. It was one of the first businesses after the collapse of the former Soviet Union to attract foreign direct investment. It began operating scheduled flights to Western Europe by acquiring two new B737-400 aircraft operated by well-trained pilots, engineers and cabin crews.

The Company's shares were evenly split between two leading Western airlines ("the Sponsors") via a jointly owned special purpose vehicle. Through this strategic partnership, fresh capital was injected into the Company, and in 1998, it increased its stake by obtaining half of the aviation leasing group's holdings. This strategic partnership, apart from providing urgently needed additional finance, reputation, and stability, more importantly induced considerable transition impact potential and management support. These factors are believed to have been crucial in the Company's survival during the 1998 Russian Crisis.

At the end of November 2000, the Bank approved the subscription of a substantial portion of preference shares in the Company, representing about 10 per cent of the Company's capital. The preference shares carry the right to a preferred dividend payable annually at a fixed rate on the nominal value of the preference shares (portage equity). The appraised exit strategy envisaged an exit in five years through the put and call options agreement with the Sponsors. Alternatively, the Bank could exit by converting the preference shares into ordinary shares for a market exit sale. Whilst the Bank's investment was principally for financing the Company's ordinary business activities, the provided freedom to make distribution changes within the cost budget resulted in the equity proceeds being utilised to finance spare-parts and aircraft maintenance, aircraft purchase advance payments and repayment of short-term debt.

PROJECT RATIONALE

Despite limited funding to cover start-up costs and its rapid expansion, the Company managed to start generating operating profits after only two years of operation (by 1994). This helped attract the Sponsors' investment in 1996. However, increased interest costs (start-up losses were financed using expensive short-term debt) and difficult economic conditions linked to the Russian Crisis (adversely affecting the Company's profitability) called for the Bank's support for re-capitalisation and strengthening of its balance sheet in 1997.

ACHIEVEMENT OF OBJECTIVES

The assumed main objective was: "to attract strong investors to the privatisation and initial public offer (IPO) of the Company by consolidating the commercial success of the Sponsors with better financial results through the Bank's financial support". In the Company's 1999 privatisation plan, it targeted a "private majority by the end of 2001 and a public offering on the local stock exchange by the end of 2004". The Bank's equity injection was expected to benefit the Company's transition impact.

The achievement of objectives was assessed against:

- (i) progress towards privatisation and IPO
- (ii) financial and commercial performance of the Company
- (iii) increased involvement of the Sponsors both financially and in terms of the transfer of management expertise or cooperation in marketing the business of the Company
- (iv) strengthening of the Company as a commercially viable leading airline carrier.

The achievement of the objectives is rather mixed. The main strategic objective (privatisation) has yet to be achieved. The Company's financial and commercial performance is positive, but remains fragile. There is an upward trend with an action plan in place that thoroughly monitors cost, revenues, and cash flow developments. The Sponsors provided substantive support to the Company in the form of shareholder loans, pro-active management support, and staff training in various forms (including training for pilots, crew staff, maintenance engineers). The Company established itself as the country's leading carrier for international air travel, adhering to the highest standards of trade. Its operational success is documented by steep increases in passenger numbers. In terms of aircraft maintenance it is noteworthy that the Company obtained the required qualifications to carry out related works for other (domestic and foreign) airlines.

OVERALL ASSESSMENT

The Evaluation Department (EvD) gave this project an overall rating of *Successful*. While the operation was instrumental in re-capitalising the Company and strengthening its balance sheet at a critical juncture, it ultimately failed to deliver on the main strategic objective. It did not foster privatisation by selling-down the State Property Fund's majority stake in the Company to local investors thereby ensuring the private sector became the majority shareholders. However, the EvD believes that, given the unfavourable business environment in the country, this strategic objective lacked appraisal realism. Had the Bank assumed a less ambitious strategic objective, for instance the operational, financial and institutional strengthening of the Company and deferred privatisation to a later phase, then this operation would have achieved all of its expected outcomes. However, in view of this, the achievement of the objectives was rated *Satisfactory*. The rating of the Company's financial performance, albeit not impressive, was rated *Satisfactory*. The Bank's investment performance has not been rated since the (portage) equity has not yet been exited. However, the interest gained from the (interest bearing) preference shares was regarded *Satisfactory*, comfortably covering the Bank's transaction cost and contributing to its net profit. Transition impact was rated *Satisfactory,* based on the project's market expansion, corporate governance and business conduct. Substantial improvements have materialised, many of them, however, are seen as not attributable to the Bank, which basically provided justifiable re-financing (financial additionality) in 2000, long after privatisation had taken place in 1992 (and the strategic sponsors' involvement in 1996/1997). The Bank's additionality was *Verified in all respects* mainly on the grounds that no long-term financing from commercial banks was available at this time and that the strategic sponsors' were reluctant to inject further capital. The extent of environmental change was rated *Some* (reduction of noise and air emissions), and environmental performance was rated *Good* (environmental analysis was carried out satisfactorily). Bank Handling was rated *Good*.

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

During the project's appraisal, the Office of the Chief Economist (OCE) gave it a potential transition impact rating of *Good* and identified the privatisation of the Company as a key transition challenge with a *High* risk. The EvD assigned a *Satisfactory* rating for transition impact (TI) generated from this investment, associated with a *Medium* risk for future yet to materialise transition impacts. It should be noted, however, that whilst there was little progress on the privatisation agenda, this rating paid particular tribute to other remarkable TI achievements obtained in a most difficult business environment. The EvD moreover believes that the privatisation agenda presented at appraisal was far too optimistic and, in fact, unrealistic. A phased-approach striving for a more gradual reduction of the government's stake in the Company was warranted instead.

BANK HANDLING

The Bank's appraisal for this project included the commissioning of a study by a renowned air consultant group, which confirmed the rationale for the investment. The design covered all relevant aspects and factors, but seems to lack support for the Bank's main strategic objective. The reporting by the Company was regular and satisfactory, and the Bank's monitoring was as expected. The Bank's project representatives were both located in the Bank's Resident Office, hence allowing close follow-up and interventions when required. Procurement was in line with the Bank's Procurement Policies & Rules for private sector operations and operation risks were adequately identified. The relationship between the Bank, the Company and the Sponsors was very good, and the Bank's representatives visited the Company regularly. The Bank's performance was rated *Good*.

MAIN OPER ISSUES AND LESSONS LEARNED

Incongruence of stakeholder interests

The Bank became involved at a time when financial assistance was needed, but when the Company structure was already firmly in place. While coming in late considerably reduced the Bank's risk of the investment going astray (since it mainly acted as a re-financier), it left little room for the Bank to help shape the operation (an absence of "design additionality"). Where the Bank was to 'put its stamp' on the deal, namely to implement the main strategic objective, it failed to do so until now. This raises the question of whether the strategic objective was over-optimistic or whether the Bank should have secured more leverage at the operation design stage with the State Property Fund and the Sponsors.

<u>*Lesson learned*</u>

Design additionality is an important ingredient. Thorough analysis of stakeholder interests in an existing operation in which the Bank wishes to invest is essential. This will assist in determining whether a Bank-induced operational strategic objective is achievable, the nature and type of leverages required to support or enforce progress on the Bank's agenda, and whether some technical cooperation input is necessary to pursue such a strategic objective. This is particularly relevant where the main objective of the Bank's intervention is privatisation.

Government interference

The Company was established to service international air routes, mainly connecting the country (its capital in particular) with Western Europe. The country's State Department of Aviation Transport guaranteed to the Company, until 2010, exclusive rights for servicing 20 international routes (12 clearly identified routes to Western European capitals, and an additional 8 routes which did not have an appointed carrier). Although these rights seem unconditional, together with equally granted benefits concerning airport charges and tax exemptions, they are regarded by the Company to be linked to service agreements for certain domestic routes. Similar arrangements, reportedly, exist with other airlines in the country. The ticket prices for these domestic routes are administered and at levels comparable to corresponding railway travel. For the Company these tariffs are not cost-recovering, but the Company's management argued that, balancing costs and benefits (including opportunity costs), this arrangement is a 'net-net' non-loss provider. The Company operates its domestic network with a mixed fleet of aircrafts, including technically outdated models. This raises two principle issues of concern: government interference per se, and the Company's reputational risk from its domestic operations for the international business.

<u>*Lesson learned*</u>
Transparency on tariff cross-subsidisations helps to build investor and client confidence. If non-transparent relationships exist between public sector authorities and private sector entities and translate into unclear cost structures, the private sector will be reluctant to invest. Equally, differentiation between service standards (for domestic and international routes) without adequate reflection in price structures is not conducive to attracting new customers or to maintaining the loyalty of existing ones. Both are related to the virtues of trust and confidence by outsiders (clients, business partners) as the integrity of the company is at stake and this needs to be treasured as a corporate governance objective. In this project the domestic flight activities should have been better integrated into the overall airline business concept and culture.