
Clerk to Joint Committee on Transport
Leinster House
Kildare Street
Dublin 2

Tuesday, 11 April 2006

Dear Sir

I refer to your request for submissions relating to the possible privatisation of Aer Lingus.

This submission is being made because of my concern that privatisation may not be appropriate or necessary for Aer Lingus at this juncture.

In this submission, I cover two matters as follows:

1. "Base case" financial projections for the airline for the five years 2006-2010 to serve as a basis of discussion.
2. Discussion on points arising from the projections and related strategic matters.

1. "Base Case" Projections

One of PlanWare's most basic software packages has been used to help set the scene for this submission by establishing "base case" financial projections for Aer Lingus for the five years commencing January 2006. To do this, I have drawn on the Annual Report for 2004 and results statement for 2005 and used material reported in the media.

The following financial assumptions were made:

1. No increase in revenues and no change in operating margins over the five years from those achieved in 2005, namely, annual revenues of €883 million and a net margin on sales of 8.2%.
2. No capital expenditure and no asset disposals during the five years.
3. No capital injections, no debt repayments and no cash movements other than those arising in the course of normal operations.

Based on these assumptions, we projected Aer Lingus' pro-forma accounts forward for the five years 2006-2010. These "base case" projections are summarised in the following three tables which (in order) cover P&L, cashflow and balance sheet projections:

Table 1 - Aer Lingus: "Base Case" Profit & Loss Projections (2006-10)

Years ending Dec	Year 1	Year 2	Year 3	Year 4	Year 5
	2006	2007	2008	2009	2010
	Proj	Proj	Proj	Proj	Proj
	€Mln	€Mln	€Mln	€Mln	€Mln
Sales	883.0	883.0	883.0	883.0	883.0
Cost of sales	<u>641.7</u>	<u>641.7</u>	<u>641.7</u>	<u>641.7</u>	<u>641.7</u>
Gross profit	241.3	241.3	241.3	241.3	241.3
Overheads	<u>92.6</u>	<u>92.6</u>	<u>92.6</u>	<u>92.6</u>	<u>92.6</u>
Trading profit	148.7	148.7	148.7	148.7	148.7
Depn., interest etc.	<u>(66.3)</u>	<u>(60.6)</u>	<u>(54.7)</u>	<u>(48.6)</u>	<u>(42.3)</u>
Net profit before tax	82.4	88.1	94.0	100.1	106.4
Corporation tax	<u>10.3</u>	<u>11.0</u>	<u>11.8</u>	<u>12.5</u>	<u>13.3</u>
Profit after tax	72.1	77.1	82.3	87.6	93.1
Dividends declared					
To reserves	72.1	77.1	82.3	87.6	93.1

Table 2 - Aer Lingus: "Base Case" Cash Flow Projections (2006-10)

Cashflows	Year 1	Year 2	Year 3	Year 4	Year 5
	2006	2007	2008	2009	2010
	Proj	Proj	Proj	Proj	Proj
	€Mln	€Mln	€Mln	€Mln	€Mln
Total cash receipts	918.2	925.3	931.2	937.3	943.6
Total cash payments	<u>771.5</u>	<u>771.9</u>	<u>772.6</u>	<u>773.4</u>	<u>774.2</u>
Net cashflow	146.7	153.4	158.6	163.9	169.5
Opening					
Closing surplus (defic	877.6	1,024.3	1,177.8	1,336.4	1,669.8

Table 3 - Aer Lingus: "Base Case" Projected Balance Sheets (2006-10)

Years ending Dec	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
	2005	2006	2007	2008	2009	2010
	Actual	Proj	Proj	Proj	Proj	Proj
	€Mln	€Mln	€Mln	€Mln	€Mln	€Mln
Fixed & intang assets	598.3	522.0	445.6	369.3	292.9	216.6
Current assets:						
Cash	877.6	1,024.3	1,177.8	1,336.4	1,500.3	1,669.8
Other	<u>60.2</u>	<u>61.6</u>	<u>61.6</u>	<u>61.6</u>	<u>61.6</u>	<u>61.6</u>
Total Current Assets	937.8	1,085.9	1,239.3	1,398.0	1,561.9	1,731.4
Current liabilities:						
Overdraft						
Other	<u>421.3</u>	<u>420.9</u>	<u>420.9</u>	<u>420.9</u>	<u>420.9</u>	<u>420.9</u>
Total Current Liabilities	421.3	420.9	420.9	420.9	420.9	420.9
Net current assets	516.5	665.0	818.4	977.0	1,141.0	1,310.4
Creditors after one year	<u>673.0</u>	<u>673.0</u>	<u>673.0</u>	<u>673.0</u>	<u>673.0</u>	<u>673.0</u>
Capital employed	441.8	513.9	591.0	673.3	760.9	854.0
Share capital	369.0	369.0	369.0	369.0	369.0	369.0
Reserves	<u>72.8</u>	<u>144.9</u>	<u>222.0</u>	<u>304.3</u>	<u>391.9</u>	<u>485.0</u>
Total shareholders' fu	441.8	513.9	591.0	673.3	760.9	854.0

We would be very willing to make the software package along with more detailed information on the projections available to the Joint Committee (and Aer Lingus) if it could assist its deliberations.

These simple, high-level “base-case” projections highlight the following:

1. Net profits will rise each year, as a consequence of additional interest earned on increasing cash balances, from €72 million profit in 2006 (same as reported for 2005) to €93 million in 2010. Ref: Table 1.
2. The opening cash balance of €877 million will increase to €1,668 million by 2010 as a result of cash inflows from operations (including estimated annual depreciation of €76 million a year). Ref: Table 2.
3. Shareholders’ funds will almost double from €441 million (end 2005) to €854 million by end 2010. Ref: Table 3.
4. If cash balances (ignoring the restricted cash and any debt component within short-term creditors) are offset by long term creditors, net cash will increase from €204 million at end 2005 to €996 million by 2010. Ref: Table 3.
5. The airline will generate an initial annual return on shareholders’ funds of 14% in 2006. This will decline over the five years to 11% p.a. as the return on the expanding cash balances is constrained by interest rates. Ref: Table 3.

These projections presume the following:

1. Reasonably stable global economic environment with no significant disruption to established air traffic patterns and no major interest rate, fuel cost or exchange rate shocks.
2. Operating margins to be maintained by a gradual reduction in variable operating costs and a rise in seat sales and aircraft utilisation to counter reductions in seat prices.
3. No significant new routes introduced and no changes to the fleet. Planned additions in 2006 and 2007 have been ignored in the balance sheet and operating profit projections.

Of course, Aer Lingus will, in reality, seek to expand and strengthen its operations. We estimate that in the “base case” scenario, it could undertake a significant investment programme funded as follows:

- By eliminating long-term debt and reducing cash balances to €300 million, it could free up about €700 million for investment over the five years.
- By restoring long-term borrowings but limiting net debt to 40% of shareholders’ funds. This would permit borrowings of about €600 million.

On this basis, Aer Lingus could prudently invest €1.3 billion before taking account of the sale of any surplus aircraft.

2. Discussion

I wish to raise the following points about these projections and their implications:

1. The projections, even though they are very rough, show that the net proceeds of any privatisation (e.g. €200+ million after contributing to the pension deficit) are “small beer” in the context of the airline’s existing capacity to finance growth.
2. The cost of privatisation will be significant (e.g. €40 million based on 10% of gross proceeds of €400 million). This equates to about six months profits. In addition, substantial ongoing listing and compliance fees will eat into the airline’s future profitability. As a consequence, Aer Lingus will incur substantial front-end and ongoing expenses to raise about €200 million net. The Joint Committee should pursue these matters in order to get a full picture of privatisation costs and, as part of this process, it should also examine dilution resulting from the possible granting of share options to incentivise management of the newly privatised business.
3. Management speaks of a €2 billion investment programme. In assessing this programme, we believe that the Joint Committee should seek to dissect this investment in terms of new and replacement capacity divided between short- and long-haul. It should also seek insights in the timing, incremental profitability and risks associated with these four distinctive investment categories. As part of this process, the Joint Committee should review the airline’s consolidated 5-year projections to assess their realism and viability.
4. Much store is being placed on expansion plans into new traffic corridors to the Americas, Middle/Far East and Africa. What proportion of the proposed capital expenditure programme is related to these and, in the event of them not being pursued, could the balance the programme be sustained without an IPO? If the programme could be sustained, why is privatisation being pursued to facilitate this untried and uncertain expansion strategy? Bear in mind that other than for the North Atlantic route, Aer Lingus has few commercial or logistical strengths on which to build long-haul traffic and it would face many major threats from well-established and larger operators. As it would have no natural customer base, little brand recognition and minimal economies of scales when plying these routes, what value proposition or unique selling proposition could it offer in the face of such competition?
5. The proposed investment programme of €2 billion is massive and would treble the initial cost of tangible assets in the Aer Lingus balance sheet. Based on our projections, this level of investment would not be prudent and could push Aer Lingus into very high borrowings relative to its size. If the airline were to encounter serious problems, this borrowing might not be manageable without recourse to rescue finance or asset sales.
6. If the Government and management judges that the proposed investment level is prudent, the question needs to be raised as to why Aer Lingus has to be privatised to raise a mere €200 million from an IPO. Furthermore, if the stock market is being used to raise further funds at a later date, what are the implications for the

Government's residual stake? For example, if Aer Lingus were to subsequently raise, say, €400 million in rights issues, the State would be obliged to subscribe €100 million to maintain a 25% stake. This equates to half its net proceeds from the IPO !

7. What is the basis for valuing Aer Lingus at, say, €800 million? Is this value pre- or post-IPO? Let's assume that the business is valued at €1 billion post-IPO. Based on its 2005 balance sheet, the net asset value of the business would be about €640 million (including net cash of €200 million arising from the IPO). Exactly how will its market capitalisation of a billion be sustained given the premium to its shareholders' funds, the cyclic nature of the airline business and the (apparent) intention not to pay any dividends?
8. If dividends were to be paid post-IPO, they would need to amount to about €20 million a year to give a modest 2% yield to shareholders. This is equivalent to about a quarter of current annual profits and would amount to €100 million of cash lost to the airline over the next five years. That's equivalent to half the net proceeds of the IPO ! Bear in mind that if Aer Lingus cannot sustain an attractive face to the stock market, it could be obliged to raise any future funds on very disadvantageous terms which would entail a heavily discounted rights issue with implications for State and staff shareholdings.
9. Can the EU be invited to offer a definitive view on the scope for the State to invest in Aer Lingus so that this issue can be resolved once and for all? Of course, if the State invested in Aer Lingus instead of privatising it and everything went *pear shaped* for reasons outside the control of the business, the State would be unable, under EU rules, to provide rescue finance. If the same thing happened to the privatised airline, it would still be in trouble as its fund-raising capability on the stock market would be greatly diminished. One way or the other, the airline would be in serious trouble. If there is any significant prospect (e.g. one-in-three over the next five years) of major disruption, then the correct strategy for Aer Lingus would be to stay in State ownership, suspend all significant investment and expansion, cut costs to the bone and maintain as conservative a balance sheet as possible. Of course, no one can have 20/20 vision of the future. It is only mentioned here to emphasise the importance of prudence.
10. What assurances should (or can) the State secure to ensure that Aer Lingus is not subject to assets stripping or a hostile takeover or poor management. For example, if the planned investment programme is not followed through (for whatever reason) what will have been the point of the IPO and loss of State ownership? Given that part-privatisation is the Government's preferred option, what would prevent another airline or a financial institution building a stake with a view to outright purchase? In the event of the latter occurring, the preferred option would lead to the previously rejected option of a trade sale.

All other things being equal, the future of Aer Lingus must be viewed positively. Otherwise, why is the airline, with Governmental support, proposing to raise €2 billion? This begs the question as to why the State, while endorsing this programme, is selling off a majority stake

in a profitable business when this is not necessary and, as we have shown, could be fraught with downstream problems?

Overall, it is hard to explain, let alone justify, the proposed privatisation of Aer Lingus and I would urge the Joint Committee to recommend against this proposal.