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Keeping the kite flying

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NATIONAL air carrier Malaysia Airlines has gone through a lot in its three decades of existence. It would not be wrong to say that the company's flight path has been fraught with all kinds of turbulence.

The last few years have been one of the most trying for the carrier as it fought to get back on its feet via a massive restructuring. Burdened with heavy losses, ownership has reverted back to the Government.

With the decision to separate its international and domestic operations, the listed entity, Malaysian Airline System Bhd (MAS), is looking to reporting profits next year. If all goes well, a foreign party may also acquire a stake in the company.

THE BIG PLAN

Datuk Malek Merican, a member of MAS' first board of directors in 1972, says when the new management line-up was announced in February 2001 under the stewardship of Datuk Md Nor Md Yusof, 'He knew he had to come out with a radical solution'.

Peter Negline, regional airline analyst with JP Morgan in Hong Kong, says, 'In August 2001, as the first critical step, MAS increased its domestic fares by 51.8 per cent within Peninsular Malaysia.' (Incidentally, the last fare increase - of 16 per cent - was in 1992.)

Still, why fares to Sabah and Sarawak were not increased is not clear, says Tan Sri Abdul Aziz Abdul Rahman, MAS' former managing director.

One obvious reason would be to maintain integration between the peninsula and the two states.

'Still, it may have been a good social reason but bad business decision as flights between the peninsula and the two states are profitable,' notes a local analyst. 'As such, the impact on revenue was not there. Then Sept 11 came, smearing ink on an already smudged balance sheet.'

Md Nor then crafted an unorthodox financial plan in July this year. Under it, MAS' planes and liabilities would be transferred to a new government entity, Penerbangan Malaysia Bhd (PMB).

Notes Ann Lim, investment analyst at Daiwa Institute of Research in Singapore, 'This move would make it Asia's first debt-free airline.' The plan, scheduled for completion by Sept 30, would essentially strip MAS of its assets and liabilities.

'Essentially, 73 planes will be transferred from MAS' balance sheet to PMB at a book value of RM5.11 billion and leased back. Another RM6.96 billion of liabilities will be taken over by PMB,' says an analyst with Mayban Securities Sdn Bhd.

'All MAS needs to do now is to own and operate the international routes, and run the domestic routes for the Government for three years in the interim,' adds Negline.

This exercise should generate cash flow for MAS. Cost savings are projected to amount to RM293 million. On top of that, it would get cash proceeds of RM93.78 million, according to net book value, for its headquarters in Kuala Lumpur, RM363.20 million for its complex in Subang, RM111.04 million for its Kelana Jaya Complex and RM932.20 million for its Kuala Lumpur International Airport (KLIA) complex.

MAS should also get to pocket RM175 million from its sale of a 70 per cent stake in wholly owned MAS Catering Sdn Bhd. The sale is to a consortium consisting of Fahim Capital Sdn Bhd, Advent Group Management Sdn Bhd and LSG SkyChefs (a subsidiary of Deutsche Lufthansa AG, Cologne).

LSG holds a 40 per cent stake in the group.

Lim of Daiwa feels this divestment is a good move to raise working capital. But the plan also has its detractors.

Aziz and Tan Sri Saw Huat Lye, MAS' founding general manager, feel MAS should have a bigger stake in MAS Catering in order to have better control over quality and prices. 'Otherwise it could be at the mercy of others,' notes Saw.

Md Nor declined to be interviewed for this article.

MAS chairman Tan Sri Azizan Zainul Abidin tells Malaysian Business: 'I am confident that MAS would be able to overcome the current challenges and forge ahead to resume its position as one of the world's highly regarded airlines.

'The problems faced by MAS were brought about by a combination of factors including its rapid expansion and the impact of the Asian financial crisis.'

Azizan admits they were also due to 'certain serious internal weaknesses'. Having said that, he feels the corporate restructuring announced recently would place MAS in a better position to work out its recovery.

While the restructuring plan may be revolutionary when fully implemented, it has yet to address over-staffing. The airline currently has 21,438 on its payroll. Is there a need to offer a voluntary separation scheme?

Azizan does not seem to think so. As he states in the 2001/2002 Annual Report, 'As MAS would operate the domestic sector on behalf of PMB, splitting personnel between the two entities (international and domestic) would be unnecessary, allaying staff anxieties.'

In August last year, MAS undertook the MAS Gemilang programme to enhance the airline's long-term performance. This programme managed to save the airline RM10 million in 2001 alone. In fact, MAS and its wholly owned subsidiary MASKargo are beginning to hire more personnel. Staff morale has also improved.

According to Azizan, 'Today there is a pervasive sense of pride among the general body of the staff ... given us a cause for optimism.'

In any event, the anticipated return to profitability would be a great achievement for MAS. Given its status and obligation to do 'national duty', maximising profits has never been easy, from the day it was established.

THE BIG SPLIT

When MAS was formed 30 years, it was for the sake of national interest. But not many know of the events that led to its formation, which came about after it separated from its predecessor, Malaysia-Singapore Airlines (MSA).

MSA was then a viable company. Its Singapore-to-Kuala Lumpur route alone ferried more than 250,000 passengers between 1970 and 1971. MSA's pre-tax profit in 1971 was \$55 million (Singapore dollar).

One theory for the separation is that MSA was not particularly interested in the unprofitable domestic routes. Apparently, more than half of its profits was generated by its international service. Also, all flights from Kota Kinabalu in Sabah and Kuching in Sarawak flew into Singapore, bypassing Kuala Lumpur.

There were various attempts to integrate Sabah and Sarawak with the peninsula but they were futile. 'So began the saga of assembling a totally new airline in 18 months,' notes Tan Sri G K Rama Iyer, MAS' founding chairman.

DISMANTLING MSA

'We had to be no different from MSA in terms of safety and service and

we had a limited number of aircraft,' says Aziz. 'Our immediate task was to create a new corporate identity which would meld precisely with the inherited part of the old company (MSA), creating a harmonious whole. People were sceptical about us in the beginning.'

What ensued was a series of high-level meetings on how to separate equitably. According to a 33-page Scheme for Reconstruction of MSA, both the Malaysian and Singapore governments agreed that MSA's total assets were to be valued at \$245.4 million.

'Unfortunately, Singapore benefited more than us,' notes Tan Sri Azman Hashim, a founding director. Singapore landed with assets worth \$202.9 million while Malaysia got \$42.5 million. Singapore paid Malaysia in cash worth \$80.2 million. All other shareholders of MSA, namely British Overseas Airlines Corporation (now British Airways), Qantas, Straits Steamship and Ocean Steamship, collectively holding 14.42 per cent, were bought out.

'Singapore inherited the entire Boeing fleet (five 707's and seven 737's) and two of the 11 Friendships,' adds Aziz. 'Apart from that, the \$15 million MSA headquarters building and \$14 million computerised booking system went to Singapore,' remarks Malek.

Starting with an authorised capital of \$100 million and a paid-up capital of \$65 million, building of the MAS brand began. Its logo was a stylised version of a wau or kite.

'The Sabah and Sarawak state governments, which had received \$3 million each for their stake in MSA, used their proceeds to invest in MAS,' says Rama. The three shareholders of the nascent airline were the Central Government (90.8 per cent) and the Sabah and Sarawak state governments with 4.6 per cent each.

'International bankers provided the loan to purchase seven Boeing 737's worth \$47 million,' adds Malek. The deal was 40 per cent-financed by the American Export-Import Bank, 20 per cent by the First National City Bank of New York, and 20 per cent by the New York office of BCI, an Italian bank. The rest originated from MAS' own resources.

'Initially we focused on the domestic and regional routes. In fact, domestic services claimed much of our attention,' says Rama. One of MAS' policies then was not to allow its separated counterpart, Singapore Airlines, to fly into East Malaysia.

'Not that we wanted a monopoly. We merely wanted to redress the integration issue,' contends Rama. 'We however allowed competition between Kuala Lumpur and Singapore.'

Over the years, MAS continued to build its reputation as a good airline, winning accolades in the process. 'It was a new learning curve for all of us,' says Rama. 'We had to learn about break-even analysis, aviation insurance and creating a presence regionally. Somehow or rather, we achieved it.'

A NEW ERA

After taking MAS to a successful level, the Government decided privatising the company was the answer to further growth. In fact, MAS was the first state-held entity to do so under the country's privatisation programme initiated by Prime Minister Datuk Seri Dr Mahathir Mohamad. MAS was listed on the Kuala Lumpur Stock Exchange on Dec 16, 1985.

Substantial shareholders were Bank Negara Malaysia (BNM) with 43 per cent, Brunei Investment Agency, 10 per cent, Sekim Amanah Saham Nasional, 5.4 per cent, Finance Secretariat of Sarawak, five per cent and Finance Secretariat of Sabah, five per cent.

In fact, Malek was a strong proponent of what he called 'broad privatisation'. Under it, people from the right government departments like the Ministry of Transport would take over as chiefs rather than

outright business people who had no experience in the area. 'I felt this would make the airline more efficient,' he says.

During the early privatised days, MAS was profitable. For financial year ended March 31, 1992 (FY92), after-tax profit was RM112.9 million, for FY93 it was RM145.6 million and for FY94, RM8.43 million.

Then in June 1994, a more vigorous form of privatisation took form. RZ Equities Sdn Bhd (RZE), a company owned by Tan Sri Tajudin Ramli, acquired 32 per cent from BNM's 43.56 per cent stake in MAS, for RM1.79 billion cash. RZE was then wholly taken over by Malaysia Helicopter Services Bhd (now known as Naluri Bhd). The balance of 11.56 per cent of BNM's stake was sold to Kumpulan Wang Amanah Pencen.

Tajudin 'ran MAS the best way as he knew it', notes a local analyst. Tajudin once said he would carve out a bigger market share for MAS by improving its route structure, and ultimately increase its turnover five-fold by the turn of the century. 'The financial crisis of 1997, among others, stopped short this plan,' adds the analyst.

Leasing and paying for fuel in US dollar while earning revenue mainly in ringgit, MAS was locked into foreign currency debt. For three consecutive years, it reported pre-tax losses - RM225.36 million in FY98, RM669.73 million in FY99 and RM236.90 million in FY00. They included losses in its MASKargo operations.

Alleged MASKargo irregularities between 1994 and 2000 are currently being investigated. On Dec 20, 2000, the Government decided to re-purchase MAS from Naluri

Bhd. The move caused ripples in business circles as the Government, via the Ministry of Finance Inc, bought back a controlling stake of 29.09 per cent for RM1.79 billion or RM8 per share, the same price it was originally sold. Closing price of the shares a day before was RM3.68. Net tangible assets during that period was RM1.74.

'I was surprised,' notes Malek.

FRESH START

With the purchase, the Government also inherited huge debts. As of FY00, MAS borrowings stood at RM9.38 billion - more than the RM9 billion it cost to build the KLIA in Sepang.

On top of that, there were continuing pre-tax losses amounting to RM1.30 billion in FY01 and RM846.49 million in FY02. Since then, the Government was under immense pressure to turn around the carrier.

External factors like fuel costs play a big role in airline companies. A transport analyst in Singapore says, 'If airlines like MAS or Thai International do not hedge their requirements, uncertainties in the Middle East will always pose a problem.'

MAS's domestic revenue in FY02 was RM2.0 billion. MIDF Sisma Securities Sdn Bhd estimates domestic losses to be in the region of RM300 million a year. Dr Mahathir was even reported to have admitted at a Press conference in April 2001 that domestic routes basically lost money.

What causes this perennial bleed for domestic routes?

'The answer lies in fuel consumption,' says Kenneth Yuen, an aircraft engineer. 'Our domestic routes are less than 45 minutes long. A fully loaded (140 passengers) Boeing 737 uses quite an amount of fuel when it takes off against gravity. Just as it gets to cruise on optimal fuel consumption, it is required to land again. Coupled with fairly low fares, this would definitely bleed any airline. That is why international routes are always more profitable.'

Does the answer lie in more fuel-efficient aircraft?

'It's easier said than done,' adds Yuen. 'We need more than that. The problem is not the type of aircraft but geographical location of our towns. Some are just too near each other.'

THE FUTURE

Today MAS has come full circle. 'From government ownership to privatised company to government ownership again,' says Malek.

An analyst with a foreign research house notes, 'While the problem of bridging Sabah and Sarawak has been solved, the question of the profitability of the domestic routes is still being wrangled over.'

However, 'this is no longer a problem as MAS is only operating (the domestic routes) for the Government,' says an analyst with MIDF Sisma. 'Stipulated conditions and benchmarks apply, otherwise MAS has to foot a certain amount of the cost incurred by PMB.'

All considered, things seemed to be fine and dandy for MAS - until Air Asia got into the picture. 'When Air Asia got rave reviews for its low fares, MAS initially watched,' remarks an analyst. 'Then out came the dagger - in the form of 50 per cent discounts on 14,000 seats per week.'

Some argue MAS was competing with Air Asia on a non-equal footing. 'MAS is asset-free while this not the case for Air Asia. Why did MAS not think of offering deep discounts with low fares in the first place?' argues an industry observer.

Negline acknowledges this issue as 'detrimental to the concept of free markets' but feels that 'fair competition is good for the consumer'.

In any case, competition, mergers, liberalisation and no-frills are the name of the game. 'After Sept 11, airline management is not an easy industry to be in,' notes Negline. 'Even carriers like Japan Airlines and Japan Air System have merged, making the new entity, Japan Airlines System, the world's six largest carrier.'

Will having two airlines be beneficial for Malaysia in the long run?

Aziz has his reservations. 'Our population is small. Only six per cent actually fly,' he says.

Industry observers feel a better solution would be to allow Air Asia to run the domestic service, thereby complementing MAS in its international routes.

'They (Air Asia) should be able to pull through because of the volume generated. Moreover, unlike MAS which needs a passenger load factor of 70 per cent to break even, Air Asia only needs 56 per cent,' they say.

Already, Air Asia has reported an unaudited operating profit of RM2 million a month on a passenger load factor of 70 per cent.

Still, there will always be a section of business travellers who will eschew budget travel, even domestically.

'Air Asia could perhaps introduce a service like US-based JetBlue, a low-fare but high-frills airline,' notes an industry observer. 'It could even compliment MAS on certain dedicated regional routes. After all, it did say the key success factor is innovation. MAS could then operate like Singapore Airlines, focusing on international and cargo operations.'

Can MAS stand alone as an international carrier? What happened to its earlier plans to get foreign equity? Some of the foreign airlines reported to have been interested in MAS were Qantas and Swiss Air.

'But Swiss Air is out of the equation (the company went bust) now,' says an analyst. Negline says, 'Many of the European airlines have their own problems at home, so these airlines will not think of foreign stakes for the time being.'

Azizan is of the same opinion. Still, he says, finding a foreign equity partner that could satisfy the aspirations of MAS as a business entity and as a national airline would certainly be good. 'We will keep a watch on the business landscape and keep the option open.'

Will airline alliances, which are fast becoming the norm, help?

'They should, as long they're win-win situations,' notes Aziz.

Of the alliances available like Star Alliance, One World and Wings, MAS

seems slanted towards Wings, led by KLM Dutch Airlines and Northwest of the US. It has not announced any decision so far.

MAS is also looking to its charter service to boost revenue. Currently, charter services contribute 0.69 per cent to revenue. 'This comes mainly from its haj charter flights,' says Negline. Saw also sees charter as a good potential for MAS and 'a natural way of expanding its service'.

In 2001, tourism brought in RM39.1 billion or 11 per cent of the country's gross domestic product. Malaysia hopes to get about 20 million tourists to visit the country by 2010. Statistics by the International Air Transport Association also support this. MAS can only benefit from this development.

Industry observers believe there is also potential in the cargo sector. But MAS has to buck up. In FY01, its MASKargo reported pre-tax losses of RM170.02 million and in FY02, RM242.85 million. 'Over the last three years, accumulated pre-tax losses easily amounted to RM1 billion,' notes a local analyst.

With regard to investment in IT, a foreign analyst suggests that MAS look into ticketless travel. 'This will save on administration cost and increase efficiency,' he says. Aziz, however, feels 'our travellers may not be fully ready'.

As for MAS' Engineering & Maintenance division, 'There is not much problem. It just needs a little oiling and re-engineering itself', remarks a Singapore analyst. While the division reported pre-tax losses of RM6.39 million in FY01, a rationalisation exercise produced a pre-tax profit of RM2.29 million for the following year.

Still, as Azman says, 'Managing an airline is a most difficult job as many factors are beyond one's control.' But insofar as direction and profitability are concerned, things look bright for MAS. While for the first three months of FY02/03, it reported a group pre-tax loss of RM77.58 million, it is projecting a net profit of RM94.2 million for the full financial year.

Lim of Daiwa is more conservative, expecting MAS to be profitable earliest by FY04.

Interestingly, MAS has been granted tax exemption on income including dividend and interest till 2005.

Some say being a national carrier, MAS' umbilical cord with the government and country will never be cut.

While that may be true, the carrier still needs to prove its worth - like it did when it first started in 1972, when the founding directors pumped a lot of energy and 'emotional investment' into the project.