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Malaysian Airline System Bhd
and
AirAsia Bhd: Share Swap

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Malaysian Airline System Bhd and AirAsia Bhd: Share Swap

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Case Study

Malaysian Airline System Bhd and AirAsia Bhd: Share Swap (A)

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1. *How had the fortunes of Malaysia Airlines and Air Asia compared since 2002? Why?*
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3. *Why were so many different groups opposed to the share swap?*

On August 9, 2011, Malaysian Airline System Bhd (“Malaysia Airlines” or “MAS”) and AirAsia Bhd (“AirAsia”) announced an agreement to swap shares of their commons stock and begin collaborating in the highly competitive Asian airline industry. The two airlines’ fortunes had been quite different over the preceding 10 years and the move was viewed by many analysts as the latest in a series of moves by the government to make MAS more competitive.

The swap and its details were immediately controversial. Over the next five months, the deal went through ups and downs as constituents in both the business and political communities weighed in with their views.

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Malaysia Airlines

Malayan Airways Limited, the predecessor to Malaysia Airlines, got its start by flying government servants between Penang and Singapore in 1937. Over the next 35 years the company grew, adding flights around the Malayan Peninsula and to and from international destinations like Perth, Taipei, Rome, and London. In 1965, with Singapore's separation from Malaysia, the company changed its name to Malaysia-Singapore Airlines. Then, in 1972, the company split, beginning a long-lived competition between two rivals: Singapore International Airways and Malaysian Airline System, or MAS as it is frequently called.[1]

The ownership and capital structure of MAS went through significant changes over the next three decades. Originally state-owned[2], the Malaysian government listed 48% of the company on the Kuala Lumpur Stock Exchange in 1985. It sold an additional 32% for RM1.8 billion in 1994 to Malaysian businessman Tajudin Ramli, who owned one of Malaysia's telecommunications companies and a helicopter service. Tajudin became MAS's chairman, though the government retained effective control of MAS through a so-called "golden

[1] Source: http://malaysiaairlines.com/my/en/corporate-info/our-story.html

[2] Over the years, even as the government divested its ownership, MAS was frequently referred to as Malaysia's "national carrier" in a region where most countries had a similarly designated airline. Deemed an essential industry for Malaysia despite airline overcapacity region-wide, the government essentially allowed no other domestic airlines to compete with MAS on lucrative international routes. In exchange, MAS agreed to provide service on a wide range of domestic routes, even unprofitable ones.

share," which gave it certain control rights and a liquidation preference in the event of a winding up of the company.[3]

Tajudin's focus was on expanding MAS's international routes and fleet, in particular expanding capacity on the growing Kuala Lumpur-London route, which he planned to double. Air travel around Asia was growing along with national economies through the mid-1990s, and Tajudin moved to position the company to take advantage of the growth. One piece of this strategy was to replace leased aircraft with company-owned aircraft, which MAS implemented by entering into agreements to take ownership of 25 new jets by 2000.[4]

The Asian financial crisis grounded these plans. Between 1997 and 2000, air traffic around Asia and between Asia and destinations in Western Europe and the Unites States declined substantially. Although MAS continued to increase its revenues, currency depreciation wreaked havoc on dollar-denominated fuel costs and caused a string of operating losses at the company. The weakened ringgit also caused a RM2.3 billion currency exchange loss on the company's recently executed aircraft purchase contracts. From 1997 through 2000, MAS lost RM1.2 billion. During the same period, shareholders' equity declined from RM4.5 billion to RM3.2 billion and debt approached RM10 billion.[5] Deciding drastic action was required, the government repurchased Tajudin's shares in early 2001, returning the RM1.8 billion he had paid in 1994. The repurchase price was controversial; companies controlled by Tajudin had defaulted on bonds[6] and RM8 per share was more than double the current MAS share price at the time. Malaysia's finance minister, Daim Zainuddin, explained that the price, approximately USD2.11 per share, looked "attractive" however when compared to Cathay Pacific's HKD13.80 (RM6.76) and Singapore Airlines' SGD16.50 (RM35.97) per share.[7]

In 2001 and 2002, MAS sustained operating losses of an additional RM1.2 billion which, combined with the return of Tajudin's equity, resulted in unsustainable financial leverage. In 2002, through Penerbangan Malaysia Berhad, the Ministry of Finance established a special purpose vehicle, Aircraft Business Malaysia Sdn Bhd ("ABM"), to take MAS's fleet of jets and approximately RM7 billion in debt off of MAS's balance sheet. The exercise was called "Widespread Asset Unbundling," and included ABM taking ownership of the money-losing domestic routes that MAS operated. Under the transfer, ABM reimbursed MAS for all costs incurred flying domestic routes; in return, MAS paid ABM all revenues it collected.[8]

An objective of the balance sheet restructuring and transfer of the money-losing domestic routes was to relieve the pressure on the company from operating under financial distress

[3] "Malaysia Airlines (A)," Harvard Business School case 9-209-024, November 17, 2008

[4] Ibid

[5] Ibid

[6] TRI gets court protection, *New Straits Times*, December 18, 1999; and "Cover up? Decide for yourselves, Dr M tells public," *Malaysia Kini*, February 25, 2012 (http://www.themalaysianinsider.com/malaysia/article/cover-up-decide-for-yourselves-dr-m-tells-public)

[7] "Government stake in MAS vital," *New Straits Times*, January 19, 2001

[8] "AirAsia: Flying Low-Cost with High Hopes," The University of Hong Kong Asia Case Research Centre, case #HKU833, 2009.

and allow MAS management to focus on operations instead of finances. For the next few years, the strategy worked. MAS increased its revenues from RM8.6 billion to RM11.4 billion between 2002 and 2005 and accumulated profits of approximately RM 1.1 billion. The company's annual report for the year ended March 31, 2005, included plenty of smiling faces.

It wasn't to last. In the fiscal period ending December 31, 2005, shortened to just nine months by a change in accounting year end, the company gave it all back, incurring a loss of RM 1.3 billion. By early 2006, MAS had a new management team and a much-publicized Business Turnaround Plan in place. In his statement accompanying the year's financials, new chairman Dato' Dr Mohd Munir bin Abdul Majid was frank about the failure of the turnaround:

> *The Widespread Asset Unbundling (WAU) exercise that was completed on 5 November 2002 was not followed through with the full operational transformation of the company, as envisaged, and the subsequent better financial results, largely the outcome of balance sheet transformation and of significant contribution from non-operating income, lulled the company into a false sense of security and achievement. Thus, when the sources of non-operating income dried up, with no compensating strong income from operations, which were further undermined by the sharp rise in the price of jet fuel, the true nature of the company's situation became all too painfully evident. There was shock and disbelief. The general perception was that the company had turned the corner and recovered. The reality of still unsatisfactory operating performance and of poor quality of income was obscured by the stronger balance sheet and non-operating contribution. This perception was as true of internal as of external stakeholders. The shock and disbelief turned into a search to apportion blame, which further obstructed understanding of the true situation.*[9]

Summary financial statements for MAS are shown at **Exhibit 1**.

As MAS's fortunes gyrated, at first struggling to regain its footing after the Asian financial crisis, seeming to do so, then turning down again, AirAsia and a growing list of other regional low-cost airlines were expanding in the market, changing the dynamics of air travel all around Asia. Consumers loved the competition. In 2007, MAS joined the low-cost segment itself, launching subsidiary FireFly, a turbo-prop service connecting Subang Airport with Penang. That put MAS in head-to-head competition with AirAsia on one of Malaysia's most heavily-travelled domestic routes.

[9] Source: Malaysian Airline System Berhad, Annual Report 2005.

AirAsia

AirAsia, MAS's first Malaysia-based competitor, was founded in 1993 by HICOM Holdings Bhd ("HICOM"), a Malaysian government-linked conglomerate, and began operating in 1996. Although it offered modestly lower prices than MAS, it wasn't operated as a "low-cost carrier," as the model was understood in the United States and Europe. Its strategy was to offer full service on regional flights at slightly lower prices to both attract some of MAS's existing customer base and stimulate new fliers. It did neither in numbers large enough to be profitable.

Like MAS, AirAsia flew into turbulence with the onset of the Asian Financial Crisis in mid-1997, which reduced air travel in the region and increased dollar-denominated fuel and debt costs dramatically as local currencies depreciated. HICOM spent the next few years restructuring the varied group of businesses under its umbrella. It sold Kedah Cement Holdings Bhd and found new investors for auto manufacturers Proton ("Perusahaan Otomobil Nasional Bhd") and EON ("Edaran Otomobil Nasional Bhd"). By late 2001, flying just two aircraft over six routes and suffering continual losses, HICOM had reached the end with AirAsia. It sold the struggling airline to Tune Air Sdn Bhd ("Tune Air") for RM1 and assumption of approximately USD11 million in debt (RM40 million), which was about half of AirAsia's total debt.

Tune Air's founders, Tony Fernandes, Kamarudin Meranun, and Aziz Bakar, were music industry executives with no experience in running an airline; they had, however, a keen understanding of what the Malaysian public wanted and how to sell it to them. To complement their team, they partnered with airline industry executive Conor McCarthy, who invested in Tune Air and joined the team as a director and chief operating officer. McCarthy was an aviation industry veteran from Ireland, joining Aer Lingus at 16 before moving to RyanAir 18 years later, where he was Director of Group Operations of one of Europe's most successful low-cost carriers for four years.[10]

Their timing was right, despite the recent decline in global air traffic caused by the events of September 11, 2001, and an economic downturn in the United States. Malaysia had managed its way through the Asian financial crisis in relatively good shape compared to some of its neighbours and Malaysians were beginning to spend – and fly – again. Experienced airline staff were available to help AirAsia grow and aircraft acquisition costs were low as a result of the industry-wide downturn in demand.

AirAsia's strategy was simple: cut costs, cut prices, and rebrand as a low-cost carrier. The strategy had proved successful in the West and was ripe for execution in Asia. AirAsia, rescued from near-death and unburdened by unions or other high-cost structural elements, was an ideal foundation on which to build.

Being a low-cost carrier had several major components:

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[10] Source: investing.businessweek.com/research/stocks/people/person.asp?personId=25228682&ticker=AIRA:MK

- **High fixed asset utilization** meant keeping aircraft in the air earning revenue and increasing the number of arrivals and departures at airport gates. Fast turnarounds at gates was a primary driver of this, which also meant AirAsia could offer more flights, an important convenience factor when attracting customers. By 2011, AirAsia claimed its average turnaround time of 25 minutes[11] was the fastest in the region.
- **No-frills flights** meant offering low fares and not offering "free" in-flight meals, frequent flyer programs, or airport lounges. Passengers who wanted low prices more than anything else, didn't mind. If they wanted to eat on board, they could buy meals, snacks, and drinks sold by cabin staff. They believed low fares more than offset frequent flyer miles. And many of AirAsia's customers, who were new to flying, had little use for airport lounges and no reason to miss them.
- In fact, no free food or airport lounges fit operationally with AirAsia's **point-to-point short-haul flights**. Asking passengers to pay for food on flights of a few hours or less was perceived as a reasonable trade-off for lower fares. Flying point-to-point instead of using a hub-and-spoke flight system reduced the cost of building and staffing airport lounges and could be done using narrow-body, fuel efficient jets instead of the wide-body, long-haul jets that were favoured by regional competitors. It also meant no waits between flights, the *raison d'être* of airport lounges.
- Operating a **uniform, cost-efficient fleet** meant flying a single type of aircraft. When Tune Air purchased AirAsia the company, like low-cost U.S. pioneer Southwest Airlines, was flying only Boeing 737s. Fleet uniformity provided cost savings through reduced training for flight crews, ground crews, and mechanics, and rationalization of investment in spare parts. As the company grew over the next three years, it added 15 more used B-737s to its fleet. In December 2004 however, AirAsia announced it was switching to Airbus A320s, which offered higher capacity and better fuel efficiency than the aging 737s. By 2011, 86 of its 90 aircraft were A320s, including all jets based in Malaysia[12]. It was a large, high-profile move.

An equally-important component of AirAsia's low-cost model, perhaps less-touted by the company, were the **low labour costs** it enjoyed by having a non-union, low-paid workforce. By 2011, revenue per employee was RM875,000 and staff costs per employee approximately RM94,000, significantly better metrics than those of MAS.[13] Unburdened by union work rules, AirAsia often assigned employees multiple jobs in boarding, serving aboard, and deplaning passengers, which resulted in more productivity per employee.

An additional component of AirAsia's low-cost strategy was selling tickets on-line, which helped lower the high costs of ticketing offices and travel agents' commissions. AirAsia's

[11] Source: http://www.airasia.com/my/en/about-us/ir-about-airasia.page

[12] Four B737s were based in Indonesia and scheduled to be phased out in 2012.

[13] MAS's comparable numbers were RM679,000 and RM115,000, respectively. Sources: AirAsia and MAS 2012 Annual Reports.

website was the most popular on-line shopping site in Malaysia the year after it was launched and remained at or near the top through 2011.[14]

AirAsia grew rapidly following its takeover by Tune Air and by 2011 had surpassed RM4 billion in annual revenue. In late 2007, it launched AirAsia X, a long-haul carrier flying from Kuala Lumpur to Australia's Gold Coast. By 2011, AirAsia X was flying to more than a dozen markets in Oceania, Asia, and Europe.

Summary financial statements for AirAsia are shown at **Exhibit 2**. Selected comparisons between MAS and AirAsia are shown at **Exhibit 3**.

Despite its low-cost advantage, or perhaps because of it, AirAsia was both feeling the heat of increased competition in the region and finding itself unwelcomed at times when seeking access to landing rights in neighbouring countries. Low-cost competitors had sprung up around Asia since Tune took over AirAsia's operations, and by 2011, most countries in the region had one or more airlines competing using a model similar to that of AirAsia. When expanding to new markets in the region, AirAsia's management found it lacked one advantage that MAS typically had: ready government connections to assist when acquiring landing rights.

The Asian Airline Industry

The years leading up to 2011 saw rapid growth in the airline industry in Asia, driven by both passenger demand and airline supply. Even including the downturn from the 2008 financial crisis, average annual passenger growth within Southeast Asia over the six years ended 2011 was 8.8%, as per **Exhibit 4**. The demand was met by an influx of new carriers; by 2011, the industry was awash with competition from low-cost and full-service carriers alike. A list of major carriers based in East Asia and selected operating information is included at **Exhibit 5**. In long-haul service into and out of major cities around the region, Asian airlines also competed with carriers from around the globe, many of whom operated substantially larger fleets. A list of major airlines from the U.S., Europe and the Middle East, and selected operating information is included at **Exhibit 6**.

Like elsewhere around the world, most growth in airline travel in Asia was driven by the introduction of low-cost carriers, non-unionized airlines based in a region where labour costs were already among the lowest in the world, coming online to serve a growing middle class who would happily substitute air travel for bus travel on overland routes (e.g., Kuala Lumpur – Singapore) or simply increase travel to destinations that were previously too expensive for them to visit often. Deregulation had spurred a similar growth in competition in the United States in the early 1980s and had wreaked havoc on the U.S. airline industry,

[14] "AirAsia: Flying Low-Cost with High Hopes," ibid. By 2011, AirAsia was still Malaysia's second most visited domestic on-line shopping site, following only Lelong.com.my in Alexa rankings of top internet sites in Malaysia.

leading to a prolonged period of bankruptcy filings, mergers, and corporate restructurings among the major airlines. Unlike the United States however, governments around Asia were loath to let their national carriers fail.

Still, recognizing that air travel drives economic growth, ASEAN Transport Ministers in October 2003 agreed to an open-skies policy beginning in 2015,[15] effectively imposing deregulation in their own region. Such a regional policy was considered generally successful after its introduction in Europe and had been expanded to an EU-US agreement in 2007. The global trend was clearly toward freer competition in the airline industry. In theory, competition would provide substantial economic benefits to many players:

> *Ultimately, the gains from Open Sky will come about from greater airline productivity, better targeting of markets, and from improved operational flexibility for the airlines. Opening up routes to competition, and allowing more scope for ASEAN airlines to serve particular routes will drive improvements in productivity. Competition will put pressure on airlines to lower costs, and to pass cost savings on to passengers. Additional flexibility in operations and route development will enable airlines to reduce costs. It is likely that low cost carriers will become more prominent in a liberalised environment. These airlines will provide a stimulus for serving more markets, and they will put pressure on existing airlines to perform well.*[16]

These benefits held great appeal, but at least one industry observer believed they would not be easy to realize. The Sydney-based Centre for Aviation wrote: "The popular media, together with aviation observers, airlines and even aircraft manufacturers, tends to get excited about the prospects for unlimited air passenger travel within ASEAN. Yet, the reality is more complex – the single market is unlikely to be realised in substance, certainly not by 2015."[17]

Increased competition was inevitable, the Malaysian government realized, and MAS had to pick up its game.

The proposed share swap

The announcement of the proposed share swap between the major shareholders of MAS and AirAsia took analysts by surprise. Under the announced terms of the deal, Khazanah Nasional Bhd ("Khazanah") and Tune Air would swap existing shares from their investments in MAS and AirAsia respectively. Before the swap, Khazanah owned 69.5% of MAS and Tune Air owned 23% of AirAsia.[18] After the swap, Khazanah would own 10% of

[15] "Preparing ASEAN for Open Sky," *Final Report*, Monash International Pty Ltd, February 2004.

[16] Ibid, "Preparing ASEAN for Open Sky"

[17] "ASEAN's Single Aviation Market: Many Miles To Go," Centre for Aviation, March 13, 2013 (http://centreforaviation.com/analysis/aseans-single-aviation-market-many-miles-to-go-100831)

[18] "Airline alliance takes off" *The Edge Financial Daily*, 10 August 2011

AirAsia's equity interest and Tune would own 20.5% of MAS's equity interest.[19] Pre- and post-swap shareholdings are shown at **Exhibit 8**.

A "sweetener" for minority shareholders was also to be added to the deal: "To strengthen the collaboration and to establish a mutuality of interest, MAS and AirAsia are issuing free warrants to each other's shareholders… A MAS shareholder will be granted approximately one warrant in AirAsia for every 30 MAS shares held. An AirAsia shareholder will be granted approximately one MAS warrant for every 10 AirAsia shares held."[20]

The justification for the swap seemed simple. "The deal between state-run Malaysian Airline System Bhd. and budget carrier AirAsia Bhd. has the potential to increase earnings for both carriers. The agreement also could help cement the country's role as one of the region's most important transportation hubs. Under the agreement, resources for Malaysian Airline System's low-cost carrier, Firefly, will be refocused toward full, regional service, reducing competition for AirAsia. The share swap also adds government support to AirAsia, which could help the budget carrier acquire more lucrative flight routes." [21]

"Full-service carriers such as Malaysia Airlines, as the brand is known, have been struggling with rising fuel costs, which analysts expect will continue to cripple margins and crimp demand for air travel as airlines increase ticket prices. Malaysian Airline System in May reported a first-quarter net loss of 242.3 million ringgit ($79.9 million) compared with a net profit of 320.3 million ringgit a year earlier, hurt by rising fuel costs and the ringgit's gains against the U.S. dollar."[22]

As later summarized by a reporter, the tie-up between the two airlines "was especially crucial for the loss-making MAS, whose product quality had slipped over the years and whose yield factor, the aviation industry's success barometer, was paltry compared with regional rivals such as Singapore Airlines, Garuda Indonesia and Thai Airways."[23]

Along with the share swap came proposed changes in oversight:

> *Under the partnership deal, Fernandes and group deputy CEO Datuk Kamaruddin Meranun have been appointed non-independent non-executive directors of MAS effective Aug 11.*
>
> *Meanwhile, other appointments on MAS's board include Tan Sri Wan Azmi Wan Hamzah, Tan Sri Krishnan Tan, Datuk Rohana Rozhan and David Lau Nair Pek as independent non-executive directors. The partnership also entails the establishment of an executive committee (exco), to be chaired by MAS's current chairman Tan Sri Md Nor Yusof, which will comprise Datuk Mohamed Azman Yahya, Mohamed Rashdan Mohd Yusof, Fernandes and Kamaruddin.*

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[19] The Collaboration Agreement is included at **Exhibit 7**.

[20] See **Exhibit 9** for share swap press release.

[21] "Malaysia Airlines, AirAsia Agree on Share Swap," *Wall Street Journal Online*, 10 August 2011

[22] Ibid.

[23] "MAS-AirAsia deal: How its wings were clipped," 6 May 2012, *Straits Times*

> *The exco will oversee the management of MAS until the latter appoints a new managing director to replace Tengku Datuk Azmil Zahruddin, who will be joining Khazanah as executive director of investments effective Sept 12.*[24]

And the agreement included the proposed transformation of FireFly, MAS's turbo-prop service based in Subang, into a "regional, full-service carrier,"[25] effectively ending its head-to-head competition with AirAsia.

Reactions to the proposal

Investors spoke loudly and clearly about the proposed swap. Following three days of heavy volume the week before, trading in the shares of both companies was suspended on Monday, August 8, pending "an announcement to be made by both companies."[26] When trading resumed on Wednesday, August 10, investors drove up MAS's share price 7.4% and drove down AirAsia's share price 10.4% by the end of the day. Sceptics called it a "bailout" of MAS. "Many see the MAS-AirAsia partnership as a way to help stop MAS from plunging further into the red," *The Edge* reported.[27]

> *Khazanah managing director Tan Sri Azman Mokhtar denied the tie-up was a form of bailout for the national carrier, which has recently suffered massive losses.*
>
> *"This is a growth-driven strategy. Khazanah is still firmly behind Malaysia Airlines.*
>
> *"There's no bailout. There's no government money in this deal. They remain distinct companies, with different P&L (profit and loss account), different balance sheet," he said after the signing of the collaboration and shareholders agreement between Khazanah and Tune Air yesterday. Khazanah will remain as MAS's single largest shareholder with a 49% stake. Azman said the transaction has been pragmatically structured in that the business models, brands, boards, governance structures and cultures will remain distinct and separate, but is now complemented by the comprehensive collaboration frame (CCF) work.*
>
> *"They (the two airlines) are not combining, but competing in some cases and collaborating in some cases. Can you imagine the power of MAS's 13 million passengers and AirAsia's 39 million* [sic] *passengers a year. This is a very powerful combination.*
>
> *"We don't have time anymore to look at petty things and differences. It's time to go forward," he added. In addition, Khazanah also proposed to acquire 10% of AirAsia X on terms and at a*

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[24] "Airline alliance takes off," *The Edge Financial Daily*, 10 August 2011

[25] Ibid.

[26] "Malaysia Airlines to benefit more from share swap deal," *Bernama Daily Malaysian News*, 8 August 2011.

[27] "Airline alliance takes off," Ibid

price to be mutually agreed later. Azman said this would be done "quickly", adding that its investment in the aviation sector currently accounts for about 3% of its portfolio.

"This collaboration is both synergistic and pragmatic. It will sharpen the focus on core competencies, deliver better products and ultimately greater value for all stakeholders. Aviation has a very high economic multiplier, estimated at 12 times," added Azman.

Although AirAsia and MAS officials said it is too early to estimate synergy gains as a result of the partnership; it is estimated that the tie-up can potentially save both airlines as much as RM1 billion annually.

Maybank Investment Bank Research in a recent note said by realigning capacity to match market demand, both airlines can save as much as RM300 million to RM400 million annually. It estimated that roughly 70% of the combined capacity of MAS and AirAsia group currently is deployed in overlapping routes, which undermines yields, load factor and ultimately profitability.[28]

AirAsia's shareholders had an unlikely ally: MAS's unions. The cultures, work rules, and compensation of the two airlines couldn't have been more different. It was no secret that MAS's employees worked less and were paid more than their counterparts at AirAsia. With a long history in the West of what airline mergers meant to existing labour forces – more and harder work for less pay – it wasn't difficult to envision what a tie-up with AirAsia meant for MAS's people.

On Saturday, August 13, the president of the Malaysian Airlines System Employees Union ("MASEU"), Alias Aziz, told Bernama that the union had "Asked its new management to consider all staff-related issues before making any significant change in the administration of Malaysia Airlines." He said, "The share swap between MAS and low-cost carrier AirAsia Bhd had raised concerns that the strategic alliance could lead to retrenchments, [though] the employees were relieved to receive the assurance of Prime Minister Datuk Seri Najib Tun Razak that there would be no retrenchments."[29]

Alias said the union was worried that the new management would not provide any benefits to about 20,000 MAS employees worldwide.

"We do not want a situation where 30 to 40 new faces are brought in by the new management, causing no promotion for existing employees," he told reporters at his office in Subang Jaya. He hoped that new managers would be chosen from among MAS employees who know the airline and understand the industry. "MAS has the world's best cabin crew while AirAsia is good in business strategies. I hope they can work together for the good of the national airline industry," he added.[30]

[28] Ibid.

[29] "Union hopes MAS new team consider staff first," Bernama Daily Malaysian News, 13 August, 2011

[30] Ibid, Bernama

Others around Kuala Lumpur opposed the tie-up for different reasons, citing more emotion than economics in their reasoning.

> *Malay Chamber of Commerce Malaysia (DPMM) President Syed Ali Al Attas said selling and swapping shares are not the best way to see the growth of a strategic entity of the country. He also expressed concern that such a transaction would become a trend in regard to government-linked companies.*
>
> *"We view seriously a transaction where shares held by the government on behalf of the people in general will end up in the hands of outsiders," he told reporters in reaction to the swap involving Malaysia Airlines (MAS) and AirAsia shares recently.*
>
> *Syed Ali said MAS, as a "flag carrier" for the country and Malaysian citizens, holds greater value, far higher than the market value.*
>
> *He said the main solution should be a management change to ensure continued growth of a strategic entity of the government.*
>
> *"We have many intellectuals out there who can helm MAS. We also have many intellectuals whose views can be obtained before a decision like this is made," he said. "MAS has grown for over 80 years with hundreds of aircraft and routes, and thousands of local manpower. It has produced many pilots and engineers, and provided training for outside parties."*
>
> *"MAS is in a class of its own and should be properly guarded by a management team who understands the objective of establishing this national airline," he said.*
>
> *When asked what should be done now that the share swap had taken place, Syed Ali said: "Malaysia has seen the building of a crooked bridge cancelled halfway. What more with this just a share transaction."*[31]

Within a month, leaders of three of MAS's unions, MASEU, the Airline Workers Union of Sarawak, and the Air Transport Workers Union of Sabah, were making plans to protest the tie-up by picketing. The three unions represented approximately 15,000 of MAS's 20,000 employees. Apparently not mollified by the prime minister's assurances about retrenchment, Alias expressed new concerns to the media.

> *Union representatives told reporters today that they felt the deal would not benefit MAS, and that they believed the carrier's new management team was planning the creation of a new brand within the airline as part of a union-busting move.*
>
> *"We do not agree with the collaboration or the move to establish the new airline Sapphire (under the deal)," said MAS Employees' Union (Maseu) president Alias Aziz.*

[31] "Share swapping not the way for strategic entity – DPMM," *Bernama Daily Malaysian News*, 11 August 2011

> *"What we saw from the collaboration will benefit AirAsia and also there is a rumour that a new airline company will be set up from the collaboration."*
>
> *"We already have MASwings, Firefly and MAS. So, what is the purpose of wanting to establish a new airline company," he told reporters during news conference at Maseu office in Subang Jaya, here, today.* [32]

The airline workers in Sarawak and Sabah weren't the only ones in the two East Malaysian states not pleased with the proposed tie-up. Comprising more geographic area than all eleven peninsular Malaysia states combined,[33] much of a jungle land unserved by roads or railways, Sarawak and Sabah had long depended on the airlines both to ferry their people around and to fuel their economies through tourism in the normal travel of Malaysian business people. Any diminution of travel schedules or increase in fares, both distinct possibilities under a tie-up designed to improve the competitiveness and financial results of the two airlines, could have adverse economic effects on the two states. An official from each state had long served on the MAS board. Under the new structure and board composition proposed by the tie up, both would be out.[34]

Former MAS Managing Director and CEO, Abdul Aziz Abdul Rahman, expressed the view that the tie-up was "unnecessary," and wouldn't solve MAS's underlying problems. Abdul Aziz joined MAS as an in-house lawyer in 1971, worked his way up, and headed the airline for 10 years before he retired in 1991. He was blunt in his assessment, delivered on the radio talk show *Kerusi Panas* (Hot Seat) in mid-September.

> *"Firstly, it was due to lack of good management over the past 15 years and secondly, it may be caused by the government's failure to have an orderly air transport policy… As far as I am concerned, AirAsia was initially approved on the ground that it travels to international routes not taken by MAS instead of what happened later, the frills-free airline was also involved in domestic routes… Under such circumstances, both airlines are not cooperating but rather competing with each other in which MAS will ultimately lose out as it relies heavily on premium air travel service," he said.* [35]

Supporting an independent MAS, he continued, "This move is unnecessary as MAS already has its own edge to compete globally such as quality services although it is still lacking in terms of a strong marketing strategy compared to the airlines in the Middle East."[36] Nevertheless, he appeared to imply that MAS should be more like AirAsia. "For the future,

[32] "MAS unions to hold picket over Air Asia deal," *Bernama Daily Malaysian News*, 8 September 2011

[33] 200,565 square kilometres vs 131,598 square kilometres

[34] "Sabah, Sarawak feel chill wind of airlines' move," *New Straits Times*, 19 August 2011

[35] "Ex-MD expresses caution over MAS-AirAsia share-swap deal," *Bernama Daily Malaysian News*, 14 September 2011

[36] Ibid.

Aziz suggested that MAS changed [sic] its way of handling flights, such as introducing low-cost seats within its fleet of aircraft in order to stay competitive.[37]

AirAsia Chairman Tony Fernandes was adamant that AirAsia changing to be more like MAS was not in the plans. "AirAsia started as a low-cost carrier and we will stay a low-cost carrier. There will be no benefit to us if fares are increased," Fernandes said after speaking at Tunku Abdul Rahman College on October 1.[38]

In an apparent contradiction to earlier claims that the share swap was not a bailout, Deputy Finance Minister Awang Adek Hussein told Parliament on October 5 that, while MAS was "moderately successful" it "needed a boost to face new challenges."[39]

"We had no choice. If it makes more losses, the government will have to inject funds and we will face more anger," he said, further explaining that the share swap was based on the guiding principle that both parties would benefit. He said AirAsia had proven to be a success in other developing countries such as Thailand and Indonesia. "MAS can learn from their experience to move forward."[40]

Even the simple act of trading the shares of the two airlines seemed to cause controversy, when an independent member of Parliament raised allegation of insider-trading ahead of the announcement of the tie-up in August.[41] Deputy Finance Minister Awang told lawmakers that both Bursa Malaysia and the Securities Commission had opened investigations into the matter.

As 2011 closed, yet another issue came into view. Preparing for the enactment of the Competition Act (2010) on January 1, 2012, the CEO of the Malaysia Competition Commission, Shila Dorai Raj, told reporters that the commission had "received complaints from consumers urging it to look into the deal and whether it would reduce competition and result in expensive airfares."[42] Given that the birth of AirAsia was catalysed in part by a desire to provide competition to Malaysia Airlines in the 1990s, consumer complaints about possible backtracking on the issue could not be wholly discounted.

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The leaders of each airline had to decide how best to communicate the *raison d' etre* for the share swap to bring it to a successful close. Shareholders, employees, passengers, politicians,

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[37] Ibid

[38] "No hike in fare, says AirAsia chief," *Bernama Daily Malaysian News*, 1 October 2011

[39] "Ministry: MAS, AirAsia share swap only option," *New Straits Times*, 5 October 2011

[40] Ibid

[41] "Ministers clear the air over allegations," *New Straits Times*, 5 November 2011. Selected share trading data in the days leading up to the announcement are shown at **Exhibit 10**.

[42] "Eventful 2011 for aviation, more headwinds await in 2012," *Bernama Daily Malaysian News*, 1 October 2011

and the public all seemed interested but did not have completely aligned interests at stake. Satisfying everyone seemed like a large challenge.

Malaysian Airline System Bhd and AirAsia Bhd: Share Swap (B)

"Airlines collaborate all the time without a share swap."[43]

Questions:

1. *What's the long-term solution to the problems facing Malaysia Airlines?*
2. *What are the ramifications of finding ways to avoid confronting them?*
3. *What are the pros and cons of propping up MAS indefinitely?*

The new year brought little relief to the architects of the Malaysia Airline System Bhd ("Malaysia Airlines" or "MAS")/AirAsia Bhd ("AirAsia") share swap. In early January 2012, the Malaysia Competition Commission ("MyCC") requested documents and additional information from the two airlines so it could study whether the proposed share swap "could potentially put air travelers at a disadvantage."[44] Two weeks later, the airlines had not responded.

> *Malaysia Competition Commission (MyCC), which has asked Malaysia Airlines (MAS) and AirAsia to produce documents and collaboration agreement on the share swap deal, is still awaiting response. It has taken the initiative on its own accord to study if there was a breach of "anti-competitive behaviour" and abuse of dominant position in the deal following the brouhaha surrounding the share swap and collaboration agreement, signed between the two airlines, its chairman Tan Sri Siti Norma Yaakob said at the MyCC 2012 work plan media briefing today. MyCC had written to both parties following concerns by many quarters that the deal could possibly weigh on air travelers with expensive airfares in the absence of competition.*
>
> *"It's not an investigation and since it is the first case for the agency, we didn't provide a timeframe. However, we hope to receive a reply by end-January.*
>
> *"We want to look into the deal and maybe there's nothing in it," she said.*
>
> *MyCC is empowered to act if both parties do not respond.*[45]

Meanwhile, the MAS Employees Union ("MASEU") kept up their campaign to undo the swap. On February 14 2012, MASEU president Alias Aziz met with Prime Minister Najib

[43] Brendan Sobie, Chief Analyst at Centre for Asia Pacific Aviation, "CAPA Supports Malaysia Airlines-Airasia Collaboration", *Bernama Daily Malaysian News*, 3 May 2012,

[44] "Press Digest – Malaysia," *Reuters*, 4 January 2012.

[45] MyCC still waiting for response from mas & airasia on share swap deal, *Bernama Daily Malaysian News*, 19 January 2012. Undeterred by the termination of the deal in May 2012, MyCC continued its investigation. On March 14, 2014, it announced that AirAsia and MAS had infringed Malaysia's Competition Act of 2010, by agreeing to "share the market." It imposed a fine of RM10 million on each airline.

Razak to discuss the issue for the second time since the swap was announced the preceding August.

> *SEVEN months down the road, Malaysia Airlines's employees are no closer to buying in to the Khazanah Nasional Bhd-Tan Sri Tony Fernandes share swap than when it was first announced.*
>
> *According to Malaysian Airline System Employees' Union (Maseu) president Alias Aziz, staff morale is the worst he has seen since he joined the company some 20 years ago.*
>
> *"During Datuk Seri Idris Jala's time, the staff were okay. We were involved in turning around the company. Now we have no idea what is going on," he told Business Times.*
>
> *Idris's first order of business as managing director and chief executive officer of MAS was to have a town hall session with staff to reassure them of his commitment to the airline.*
>
> *Representatives from all eight of MAS' unions and associations met up with Prime Minister Datuk Seri Najib Razak last Tuesday to voice the growing discontent among MAS employees.*
>
> *"We don't want any AirAsia people in MAS, we want to see the share swap between Khazanah and AirAsia Bhd's founders undone. We don't mind working together with AirAsia but the share swap is not necessary," Alias said.*
>
> *He has also requested that the government do an independent audit on Malaysia Airlines to uncover losses in the national carrier.*
>
> *The unions in MAS have received their fair share of flack from staff too, with many voicing their disdain for its inactivity on the world wide web.*
>
> *Another meeting with the Prime Minister is expected in two weeks' time.*
>
> *Analysts are, however, unimpressed by the unions' and associations' demands, saying that it is unlikely the government will backtrack.*[46]

Indeed, it was difficult to see how MAS could carry on with business as usual. On February 23 2012, MAS CEO Ahmad Jauhari Yahya spoke with reporters at Bernama about MAS's deep-rooted problems:

> *The top priority for Malaysia Airlines now is to stem its huge losses and a return to profitability soon, besides striving to regain its stature as a preferred premium airline with better services and newer aircraft, its Group Chief Executive Officer (CEO), Ahmad Jauhari*

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[46] "Press Digest – Malaysia," *Reuters*, 44 February 2012. Casewriter's note: The full text of the article from Malaysia's Business Times was no longer on-line in July 2014. The excerpts above were taken from http://news.kliq.my/?p=588 .

Yahya, said today. Its recent senior management shake-up and drastic route cuts are among the many strategies being taken to put the national airline back on track towards profitability from the 2013-14 financial year onwards, he said. He also said it was imperative that solutions be found to address issues at the national carrier, as the Malaysia Airlines name, invoked much pride among Malaysians. For the nine months ended Sept 30, 2011, Malaysia Airlines incurred RM1.209 billion in pre-tax losses as compared to a RM23.73 million profit for the same period in 2010. It is scheduled to release its full year financial result next week.

To avoid "rivers of red ink" for a considerable period if nothing drastic is done, major shareholders of Malaysia Airlines decided to undertake a top management change, as well as a landmark share swap deal late last year between Malaysia Airlines and its closest local rival, AirAsia.

Under the deal, AirAsia's major shareholder, Tune Air Sdn Bhd, took a 20.5 per cent share in Malaysia Airlines while Khazanah Nasional Bhd got 10 per cent of the low budget airline.

As part of the revamp, Ahmad Jauhari, 57, an engineer by training and a corporate figure who had made his mark at Malaysian Resources Corporation Bhd and Malakoff Bhd, was appointed CEO last September. "We have to stem losses first before moving forward. So, the first thing we did was to review all the "bleeding" routes, then on managing costs and finally, relooking our network."…

… As to the possibility of Malaysia Airlines being forced to offer a voluntary employee separation scheme following the route cuts, Ahmad Jauhari said the management would look at seconding its skilled workforce to other airlines first, if there was a surplus.

"Secondment means these skilled workers would be gainfully employed until such time when the situation improves and Malaysia Airlines could then fully utilise them again," he added.

He said the highly trained cabin crew, pilots and technical personal of Malaysia Airlines were much sought after in the industry. "If we have more than necessary, we can send them on secondment. This is also a norm in the industry. We helped start India's Jet Airways (in that way), as they used our cabin crew, pilots and planes," he disclosed. He stressed that the management would ensure that its work force would be "usefully employed." Asked what he meant by "usefully employed", Ahmad Jauhari explained that they would have to undertake tasks to help boost the national airline's current turnaround and ensure future profitability.[47]

When MAS released its full-year results on February 29 2012, they shocked analysts. The company booked another RM1.2 billion in losses for the fourth quarter, bringing its total loss for the year to RM2.5 billion on revenues of RM13.9 billion.[48]

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[47] "Malaysia airlines' top priority to stem losses," *Bernama Daily Malaysian News*, 23 February 2012

[48] Comparable results for 2012 were Q4 net income of RM226 million; full-year net income of RM237 million; and full-year revenues of RM13.6 billion

Opposition to the swap only grew more vociferous however, and it reached into the highest echelon of Malaysian politics. On March 3, former Prime Minister Tun Dr Mahathir Mohamad "urged Malaysia Airlines to study AirAsia's cost-cutting measures and management structure for it to return to the black."

> *Now was the best chance to understudy and see why the national carrier had plunged into a deep fiscal crisis while the budget airline was making [profits] the former prime minister told Bernama.*
>
> *The swap deal between Khazanah Nasional and key shareholder of AirAsia should tie them together, he said. In August last year, MAS and AirAsia entered into a collaboration agreement that was strengthened by Tune Air and Khazanah -- the major shareholders of AirAsia and MAS respectively -- swapping their shares.*
>
> *This resulted in Tune Air holding 20.5 per cent equity interest in MAS and Khazanah owning 10.0 per cent of AirAsia, and also Tune Air founder and co-founder Tan Sri Tony Fernandes and Datuk Kamarudin Meranun joining MAS' board.*
>
> *"Given that both the airlines operate from the same country, there is no reason for MAS to fail. They have to team up with AirAsia," Dr Mahathir said. "AirAsia is making plenty of money. They are making profit even though their fares are very low."*
>
> *"So there is something MAS can learn from AirAsia in terms of management, cutting down costs and therefore, making profit," he said.*[49]

But the swap seemed to be unraveling. On March 13 2012, Bernama reported that "Transport Minister Datuk Seri Kong Cho Ha is unaware of any cancellation of the deal, involving the share swap between Malaysia Airlines and Air Asia. It was reported that stiff resistance from MAS employees to the share swap had prompted Prime Minister Datuk Seri Najib Tun Razak to consider the option of unraveling the deal. Kong said any decision on the issue would have to be made by the concerned parties together with Khazanah."[50]

A week later, the *Wall Street Journal* ran a story that highlighted the issue.

> *Abdul Malek Ariff, the secretary-general of Malaysia Airlines' union, said last week that Prime Minister Najib Razak had promised to review the $364 million share swap, which is close to being concluded. But he said the union hasn't heard back from Mr. Najib.*
>
> *A government spokesman declined to comment. AirAsia officials couldn't be reached.*

(Source:http://announcements.bursamalaysia.com/edms%5Cedmswebh.nsf/LsvAllByID/8F0949F537E02232482579C4005FE5B0?OpenDocument)

[49] "Learn from AirAsia, Dr Mahathir tells Malaysia Airlines, *Bernama Daily Malaysian News*, 3 March 2012

[50] Transport ministry unaware of reported cancellation of MAS-AirAsia share swap," Bernama Daily Malaysian News, 13 March 2012

Since February, the tone of the dispute has become increasingly political. The opposition alliance led by Anwar Ibrahim has pledged to look again at the share swap if voted to power in elections expected by next March, and market speculation has increased that the deal could be under pressure.

In an unusual statement issued Friday, Malaysia Airlines' top management said the share swap with AirAsia's founders would help the airline get back on a more stable footing, stating that the rivals can cooperate in several areas to reduce costs.

"Already, we are in the process of setting up joint-venture companies for procurement and training and potential maintenance services provided by Malaysia Airlines Engineering for the AirAsia fleet," Malaysia Airlines Chairman Nor Yusof said in the written statement. He said the company supports Chief Executive Ahmad Jauhari Yahya.

"I am writing in such a forthright manner because I have noted that our business plan has not been accepted by all of our stakeholders and has in fact met with turbulence in some sectors," Mr. Nor said. "This turbulence has the potential to distract the attention of Malaysia Airlines' management team and its 20,000 staff from the very crucial task at hand. That task is our top priority. It is the economic recovery and sustained future performance of Malaysia Airlines.[51]

After the close of trading on Bursa Malaysia on Tuesday, May 1 2012, MAS and AirAsia announced a one-day suspension of trading in their shares the following day.[52] On Wednesday, Khazanah announced that the share swap had been terminated. At the same time, it "[reemphasized] its support for greater collaboration between Malaysia Airline System Berhad, AirAsia Berhad and AirAsia X Sdn. Bhd. as part of a broader turnaround plan for MAS." MAS and AirAsia issued complementary announcements. (Khazanah's announcement is at **Exhibit 11**, MAS's at **Exhibit 12**, and AirAsia's at **Exhibit 13**. A timeline of key events is at **Exhibit 14**.)

In the end, MAS's union leaders got what they demanded, though, as the *Wall Street Journal* later opined, may have "shot themselves in the foot."

Malaysia Air's main union leaned on the country's politicians to squash the share swap because of concerns about cost cuts. Those fears were well-founded. Malaysia Air has been bleeding losses because of rising competition and soaring fuel prices. The tie-up was meant to reduce overlap between the two Malaysia-based carriers on some routes, cut expenses and help shore up Malaysia Air's balance sheet.

Now the share swap is history, however, Malaysia Air's employees could find they face even deeper cuts. The deal was a key to reviving "a very sick patient," said the airline's chairman,

[51] "Malaysia Airlines Seeks More Time To Set AirAsia Deal," *The Wall Street Journal Asia*, 20 March 2012

[52] http://announcements.bursamalaysia.com/edms%5Cedmswebh.nsf/LsvAllByID/4F035688984F05F048257A03006030BD?OpenDocument

Tan Sri Nor Yusof, in March. Without AirAsia on board, uncompetitive routes will still have to go and other cost-cutting measures will have to be found.[53]

The *Journal* also opined that AirAsia "dodged [a] bullet."[54]

Reactions in the press were consistent with positions taken earlier. "Tune Air Director, Kamarudin said since the CCF[55] was launched, there had been good progress in furthering the collaboration. 'Although the share swap has to be unwound, the collaboration over the past eight months has brought MAS and AirAsia closer. Ten years of non-collaboration and an unnecessary struggle between us, has come to an end and we are now able to focus on our markets and core competencies."[56]

Speaking at a media conference on May 3 2012, former Malaysian Prime Minister Mahathir Mohamad said the two airlines should continue to cooperate, "as there is much that MAS can learn from AirAsia. (AirAsia) Fares are very cheap, sometimes free, but it has been able to provide the service for the past 10 years. Logically, the company should be bankrupt, while MAS, which has received government aid of up to RM3 billion, is still losing money every year."[57]

And "[in] a telephone interview with the New Straits Times, MASEU president Alias Aziz said the reversal of the share deal and the resignation of AirAsia owners Tan Sri Tony Fernandes and Datuk Kamarudin Meranun were what the union had wanted.

"We are happy and satisfied and we thank the prime minister for listening to MAS employees. We salute you, Mr Prime Minister."

He said the decision was important as the union felt MAS might suffer losses if the AirAsia bosses were allowed to sit on MAS's board.

"For example, MAS may want to submit a tender to bring Malaysians to perform haj for RM1,000 but AirAsia will offer a cheaper price. This will affect MAS's business."

He said the AirAsia bosses might also influence MAS's business deals and demand to accommodate AirAsia in future businesses and routes.

"Other than these two issues, we are willing to work with AirAsia for the benefit of the airline industry in the country."

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[53] "AirAsia Flies Better Without Flag Carrier," *Wall Street Journal*, May 2, 2012

[54] Ibid, "AirAsia Flies Better Without Flag Carrier,"

[55] "CCF" (Comprehensive Collaboration Framework)

[56] "Share Swap Deal Between MAS-AirAsia Is Officially Off, Says Khazanah," 2 May 2012, *Bernama Daily Malaysian News*

[57] "MAS-AirAsia Cooperation Should Be Continued - Dr Mahathir," 3 May 2012, *Bernama Daily Malaysian News*

"This Labour Day is a double bonus for us, with the minimum wage and the share swap reversal."[58]

On May 22 2012, MAS announced that it had lost RM171 million for the first quarter of 2012 and announced it was raising RM9 billion in new capital. A week later, the chief economist of Rating Agency Malaysia Holdings discussed the issue.

The RM9 billion fund raising proposal announced by Malaysia Airlines last week is a vote of confidence by Malaysia's financial system in the airline's future, a prominent economist said today.

Dr Yeah Kim Leng, Group Chief Economist of RAM Holdings Bhd, said MAS would not have problems in getting the funding because both Malaysia's banking and capital markets were actually flushed with liquidity.

He said Malaysia had surplus liquidity and high savings and both the government and the private sector currently did not face problems raising funds in the market.

"What we notice here, projects which are viable or bankable projects normally would not face any problems.

In fact, we are short of good projects in order to raise private investment value."

"Because of Malaysia's surplus liquidity and a strong banking system, the credit risk spreads as well as the amount of funds, the cost of financing still remained relatively low, especially for projects having good credit quality.

"The other positive thing we notice here is that other international issuers are also coming to Malaysia to raise funding," he revealed.

The RM9 billion financing plan is made up of three components -- the issuance of up to RM2.5 billion Islamic sukuk by June this year, the government setting up a special purpose vehicle to raise RM5.3 billion to pay for eight aircrafts, including six A380 superjumbo, which will then be leased back to Malaysia Airlines, and RM1.2 billion for the remaining wide-bodied aircraft purchases this year, funded by a loan facility to be wrapped up very soon.

Dr Yeah said the market was also quite comforted by the fact that Malaysia Airlines' chief executive officer Ahmad Jauhari Yahya had laid out his restructuring plans and come out with a Turnaround Plan.

The plan entails structural cost cutting, improvements to its operational efficiency, rationalising all its contracts and ensuring that its staff force is of the right size as well as starting a Voluntary Separation Scheme (VSS).

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[58] "MAS union happy share swap is off," 3 May 2012, New Straits Times

"I think if you look at it and given sufficient time, perhaps over two years, if it can undertake all these structural reforms, then it will be placed on a very sound footing and the rest will be up to the impact on how the airline industry will pan out over the next few years." [59]

[59] "RM9bil Financing, A Vote of Confidence to Malaysia Airlines," 29 May 2012, *Bernama Daily Malaysian News*