cash management
CASE STUDY

Turbulent times

TOM MILLIGAN, GROUP TREASURER OF AIRLINE BMI, TOLD A RECENT ACT CASH MANAGEMENT CONFERENCE HOW HE MANAGES THE TREASURY FUNCTION FOR A BUSINESS IN A SUPREMELY VOLATILE INDUSTRY. **GRAHAM BUCK** CAUGHT UP WITH HIM BEFORE HIS PRESENTATION.

Resurgent fuel prices, freezing winter weather and unrest in the Middle East, all occurring against an uncertain economic backdrop, have made cashflow forecasting even more of a challenge for airline businesses in recent months. The combination has even proved too much for successful low-cost carriers such as easyJet and Ryanair, whose most recent results showed a dive into the red.

Tom Milligan, group treasurer for British Midland International, outlined how the airline was coping with an uncertain environment in a presentation at the ACT's annual cash management conference in February.

BMI's owner Lufthansa is aiming to achieve combined cost savings and synergies of £100m. It has instigated such measures as job cuts, a wages freeze, the closure of routes suffering the heaviest losses, and the abandonment of some Heathrow slots. In January, the group announced plans to add flights from Heathrow to Basel, Bergen, Casablanca, Marrakesh and Stavanger, while ending its loss-making service from London to Glasgow, following a rise of more than 50% in domestic passenger charges imposed by Heathrow's owner BAA.

In a changing and uncertain environment for the airline industry, cash is all-important and airlines generally hold substantial cash balances at times of adverse market conditions, says Milligan. There is an increased emphasis on accurate cash forecasting in a "cash burn" environment, and encouragement for imaginative solutions and a flexible approach to cash generation. However, these efforts require shareholder support and solidarity if a treasurer's efforts to sustain liquidity in a business are to be most effective.

A successful airline treasurer will also be knowledgeable about the business model and key metrics. The timing of cashflow is determined by a number of factors. Heading these are its revenue sources, with agents still important despite the growing use of the internet for booking online. Another is the widespread use of codeshare agreements, whereby two airlines share the same flight so that passengers purchasing a ticket from one airline will travel on a flight operated by a co-operating airline under a different flight number. Codeshare helps to keep excess capacity to a minimum. BMI has built on its codeshare agreements with Virgin Atlantic, and most recently signed a codeshare with Croatia Airlines late last year.

The timing of aircraft and engine maintenance also influences revenue, especially if it can be scheduled for less busy periods without compromising safety. Proactive airlines will add new routes in response to growing markets and passenger demand to open up new revenue sources, and cancel less popular routes that have become unprofitable.

"Growing an airline business actually generates cash from advanced sales," says Milligan, as a high percentage of tickets are typically paid for well ahead of their use by the customer.

Knowing your customers and the suppliers of data is another major element in growing the business. This involves clearly communicating treasury requirements throughout the business, clearly identifying who the key suppliers of cashflow data are, educating the business on the importance of cash and simultaneously increasing awareness of cash sensitivity.

THERE IS AN INCREASED EMPHASIS ON ACCURATE CASH FORECASTING IN A "CASH BURN" ENVIRONMENT, AND ENCOURAGEMENT FOR IMAGINATIVE SOLUTIONS.

Knowing the balance sheet entails the treasurer focusing on four key areas, which are:

- working capital cycle;
- addressing credit terms;
- identifying unencumbered assets with a sale and leaseback value within the company; and
- identifying recoverable restricted cash balances.

Once this groundwork has been completed, the treasurer will be equipped to proceed to the next stage, which is the creation of a flexible forecasting model and the application of sensitivity analysis.

Here there are three major components. The first is contingency planning; this will consider a range of potential events, such as the Icelandic volcanic ash cloud that played havoc with airline schedules last April, and consider the most appropriate response.

The second is aligning the cashflow model to reflect any changes in operations by the group. In the case of an airline, this may entail regular revisions.

Third is overlaying the impact of the group's hedging activities, which in BMI's case is focused on jet fuel and foreign exchange. At the time of writing, jet fuel spot prices have soared to $890 a ton, so effective hedging offers substantial cashflow benefits. The preferred hedge product will be determined by the company's risk appetite, which in the current economic climate may well be fairly restricted.

The final main area in BMI's cashflow forecasting is measuring accuracy and continuous process improvement. Again, this is broken down into three main components. The first is comparing period-end reporting/trading performance causal track analysis against both the budget forecast and the prior year. The second is regular reporting to the board. And the third is improving automated processes so that reliable and timely information from the various business units provides an accurate picture.

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The BMI story

For just over a year, the BMI group has been wholly owned by Germany's flagship carrier Lufthansa. Before that it was a private company held 50% plus one share by founding chairman, Sir Michael Bishop; Lufthansa's holding was 30% minus one share and the remainder was owned by Scandinavian Airlines (SAS).

The German airline initially acquired a 20% stake for £91.4m back in 1999, which was subsequently increased, and at the same time signed an agreement, running for 10 years, with Sir Michael.

The deal gave him a put option to sell his controlling stake to Lufthansa at a later date. It was a relatively straightforward agreement, but the intervening period was marked by the onset of global recession, the banking crisis and the steady escalation of fuel costs. Other airlines such as Virgin and British Airways were also mooted as potential buyers of BMI, and there were reports that a merger might be engineered with Abu Dhabi-based carrier Etihad.

However, in October 2008 Sir Michael confirmed he would exercise his option to sell his majority stake to Lufthansa for £300m. The ensuing months saw negotiations to forge an acceptable deal that took the effects of recession, financial crisis and rising fuel costs into account. The shareholders simultaneously endeavoured to agree a dispute over the company's sale price.

By July 2009, the price of Sir Michael's stake had been pared back to a mutually acceptable £223m and Lufthansa's stake rose to 80%. The following October it agreed a £38m deal with SAS to acquire the other 20% and take full control.

Today, BMI serves 69 destinations in 32 countries through three main businesses. BMI Mainline runs 800 flights a week to and from London Heathrow; BMI Regional serves Aberdeen, Bradford, Glasgow, Leeds, Manchester and East Midlands; and BMI Baby is a low-cost operation.

The new owner has offered reassurance that Lufthansa intends to make BMI a "valuable asset" for the group and has no plans to break up and divest any of the businesses.

BMI's fleet of 60 aircraft includes two large-capacity Airbus A330s and seven Airbus A321s. BMI Baby operates 14 Boeing 737s, with smaller aircraft down to four Embraer ERJ-135s making up the remainder.