CLEARED FOR TAKE-OFF

THE ABILITY TO RESPOND SWIFTLY AND EFFECTIVELY TO A CHANGING WORLD HAS BECOME A KEY DIFFERENTIATOR FOR FINANCE AND TREASURY FUNCTIONS IN EU COMPANIES. **ROB RUIJTER** OF KLM TALKS TO SHEELAGH KILLEN ABOUT HOW THE AIRLINE'S FINANCE TEAM IS COPING WITH AN ENVIRONMENT IN FLUX.

It is fair to say that, in the two years or so that Rob Ruijter has been in charge at KLM Royal Dutch Airlines, the resilience of the KLM finance function in the face of change has been well and truly tested. As the CFO of the Dutch airline says: "Volatility, in all its forms, is perhaps the greatest challenge we are facing."

SHORT, SHARP SHOCKS. First, his team has had to respond to the global shocks caused by 11 September 2001, the Iraq crisis and the outbreak of the Sars virus. The effects of the terrorist attacks of 11 September on global air travel have been well-documented. Faced with falling passenger numbers and security concerns following the tragedy, airlines had to find new models for managing their day-to-day operations. "Airlines have traditionally been technocratic- rather than finance-driven organisations," says Ruijter. "Suddenly, we needed to manage our business on totally different parameters." Post-11 September, the KLM finance function began monitoring their cash position on a daily basis and preparing detailed analysis of key performance indicators, such as bookings and actual passenger traffic. Treasury was also tasked with "mitigating cash outflows as far as possible".

"You are faced with having to throw out your management information overnight and develop new things on a daily basis," comments Ruijter. Yet despite these difficulties, the provision of such timely decision-making support paid dividends for the business. "We played a major role in providing all parts of the business with the right kind of information to steer the business. Also, by managing the company on a cash basis, by realising that cash is king, we managed to come out cash positive in the quarter following those events," Ruijter explains.

The development of this new high-level financial 'dashboard' also stood the finance function in good stead to deal with other external threats to the airline industry. During the potential Sars epidemic, which hit air traffic hard, particularly in the Asian Pacific region, KLM was able to respond with some of the techniques for "flexible and active management of capacity", which it had developed in the period following 11 September.

FINANCIAL RISKS. Volatility in demand for air travel was also accompanied by significant price fluctuations of inputs to the business. Fuel accounts for some 15%-20% of the average airline's cost base and, with hostilities in the Middle East and other global uncertainties, the price of oil experienced a number of peaks and troughs. KLM's exposure to fuel prices is managed in treasury and, with the advantage of his oil company background at BP, Ruijter worked closely with his treasury staff to mitigate these exposures efficiently.

ROB RUIJTER'S **CAREER OVERVIEW**

Source: Capital Photos for KLM©

1970-1983
Qualified as a CPA with Ernst & Young.
Accounting roles in the US and the Netherlands.

1983-1993
Finance roles at BP.
Managing Director and CEO of BP Sweden.

1993-1996
Joined Philips Group as Director of Finance.

1996-2000
Appointed Chief Financial Officer and Executive Vice President of Philips Lighting.
Appointed MCT.

2000
Appointed Chief Financial Officer and Executive Vice President of Baan Company NV.

2001
Joined KLM in March 2001.
Appointed Managing Director and CFO in July 2001.

This task was made all the more onerous as a result of severe movements in the foreign exchange (FX) markets, particularly in the value of the US dollar against KLM's base currency of the euro. Over the past year, the dollar has moved from being at a 10% premium over the euro to being at a 15% discount. This potentially has a huge impact on KLM's business. The dollar is not only a key cost driver, as it is the currency in which fuel prices are denominated, but is also a significant revenue currency (both in its own right on North Atlantic routes and as a component of the value of many Asian currencies). Accordingly, the KLM treasury has had a vital role to play in mitigating financial risks during this period of economic and political upheaval.

BUYING BIG. As well as helping KLM to weather uncertain demand in the immediate wake of world events, the finance functions are now starting to deal with some of the longer-term consequences of these impacts. This has been particularly noticeable for treasury in setting up asset finance structures to fund aircraft acquisition. Following 11 September, the lending community has begun, in some cases, to take a different view of aircraft valuation.

Cashflow valuations are largely based on expected revenue which can be generated from an aircraft during its life and, with fears of excess aircraft capacity resulting from more conservative projections of passenger numbers, the value of aircraft as collateral for borrowing has undergone substantial adjustment. Pre-11 September, KLM was able to use its position as an innovative, blue-chip borrower and the quality of its fleet collateral to finance its aircraft at sub-Libor rates. Therefore, it tended to utilise specialist funding structures with banking partners rather than issue into the capital markets. In recent days, this has proved more problematic, although the group has recently secured a deal to finance two new passenger aircraft through the US export finance agency at an all-in cost of Libor+50.

One especially challenging issue to resolve has been the re-financing of older elements of the fleet. Specialist finance structures were often put in place for new aircraft over a 12-year period. On maturity, it was previously possible to roll over this financing for a further 12-year period.

Now lenders are more reluctant to accept such aircraft as good collateral and more innovative financing structures are required. KLM has been exploring some of the available options but is reluctant to pay the spreads borne by other, less creditworthy airlines, which can be as high as 200bp.

THE ROAD IS LONG. However, despite the obviously testing nature of the past 24 months, KLM has not just had to respond to short-term crises. The group is also faced with the more enduring challenge of adapting to the new business model which is emerging in the global airline industry.

The success of new operators in the low-cost segment has put pressure on all European airlines to reduce overheads. This impetus, coupled with over-capacity in the European airspace and the end of governmental subsidies for some European state airlines, is driving rationalisation of the industry and encouraging the formation of code-sharing and strategic alliances.

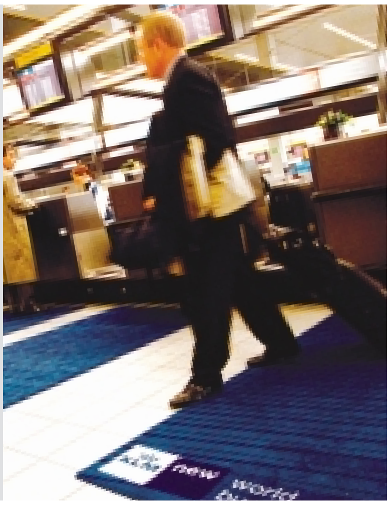
KLM, which has been free of state subsidies for some decades, welcomes the establishment of a "level playing field" for pan-European competition, but is also alive to the pressures on its cost base. The group is keen to build a platform for a competitive future and has been working constantly on a comprehensive programme of measures to ensure that the company is "managing costs down on a continuing basis and providing a clear product proposition into the market."

There are still issues to be addressed, however. For example, Ruijter mentions the difficulty of re-negotiating landing fees and air traffic control tariffs with principal city or "primary" airports, many of which may be wholly or partly state-controlled.

As there is little impetus to cut wages and other costs in these enterprises, lower levels of traffic merely result in the same cost base being allocated over a smaller number of flights, pushing up unit costs for every landing. This makes it increasingly difficult for network airlines obliged to use these mainstream airports to compete with low-cost operators which often utilise 'secondary' airports with more flexible financial arrangements.

LOOKING INWARD. This drive for efficiency on the commercial side of KLM's business has also extended into the back office functions of the organisation, including the finance areas. For the past three or four years, the team's management has been looking at ways of centralising key functions and increasing automation to reduce personnel costs and other expenses.

KLM CORPORATE OVERVIEW



Source: Capital Photos for KLM©

- KLM Royal Dutch Airlines (KLM) is a network airline operating worldwide from its home base at Amsterdam's Schiphol Airport.
- The KLM fleet numbers 219 aircraft and KLM and partner airlines link more than 350 cities in 73 countries on six continents. KLM Cargo serves 250 destinations.
- In 2003, KLM Group had approximately 33,000 full-time employees worldwide, 4,850 outside the Netherlands, with 9,900 deployed as flight crew.
- During the 2002/2003 fiscal year, 23.4 million passengers and 489,000 tons of cargo and post were carried.
- KLM's turnover during the 2002/2003 fiscal year amounted to €6,485bn.
- KLM shares are listed on the Amsterdam and New York stock exchanges.
- KLM has interests in KLM UK/Cityhopper (100%), Transavia Airlines (100%), Martinair Holland (50%), and Kenya Airways (26%).

Centralisation of finance has been aided in part by the fact that the structure of airlines means that some 80% of its business takes place at or near the airline's hub, which for KLM is in Amsterdam. However, further opportunities have been identified to share services between separate business units within the group, such as between the cargo business, engineering and maintenance, Transavia (the low-cost and charter arm of KLM), Kenya Airways (in which KLM has an equity investment) and the main airline finance and accounting. Staff numbers have been reduced from more than 1,300 to less than 1,100, and, ultimately, it is hoped that efficiencies will allow the workforce to be reduced to between 800 and 900 worldwide.

As part of these initiatives, KLM has set up a centralised accounting centre in Budapest, Hungary, which, it is hoped, will reduce the number of locations where finance tasks are carried out in the group. However, internal and financial controllers are, as a matter of policy, kept in place at all remote business units to ensure that all procedures are properly adhered to and that information is fed back effectively to the centre. Treasury has also been largely centralised and cash pooling and cash management arrangements are in place so that balances are controlled out of the corporate centre rather than on a country-by-country basis. Business units are, according to Ruijter, "not allowed to carry out any treasury transactions or to speak to any bankers outside the treasury function."

PURE AND SIMPLE. Hand in hand with centralisation plans, Ruijter is also looking to drive down costs by simplifying both the inputs and outputs of the finance function. He recognises the danger of data overload, whereby a mass of statistics can be generated that do not have a significant informational content in terms of directing the strategy of the business. "Network airlines are necessarily complex organisations, but complexity also results in slower reactions and higher costs. We are aiming for clarity and simplification – with real objectives for finance and truly meaningful information," he says. For this reason, the finance group is also exploring the use of non-financial, as well as financial, measures and has recently implemented the balanced business scorecard.

PLAYING BY THE RULES. While coping with the transformations taking place in both the airline industry and the internal mechanisms at KLM, the finance team has also, of course, not escaped the pressures faced by many of their colleagues across the EU in dealing with frequent and extensive regulatory changes. These include EU initiatives for the creation of a single European market, especially the transition to International Financial Reporting Standards (IFRS) and the introduction of the Sarbanes-Oxley Act 2002 (which impacts KLM through its New York listing).

ACCOUNTING MEASURES. Ruijter is concerned about some aspects of the proposed IFRS regime. KLM has already implemented fair value accounting for derivative transactions according to FAS 133 as part of its parallel reporting under US GAAP. With IAS 39 incorporating similar provisions, despite being "all for transparency", Ruijter is keen that "economic reality continues to prevail". He says: "To continue to do things which make economic sense, we have to bend over backwards to abide by the rules of FAS 133 and to qualify for hedge accounting – to avoid fluctuation in the profit and loss (P&L) account which cannot be easily explained to investors."

The demands of derivatives accounting which result in linked transactions being reported separately, rather than being netted off, has already resulted in a substantial gross-up of the KLM balance sheet, which has had to be managed with investors, particularly in relation to analysis of return on capital employed.

Another impact has been on the utilisation of credit lines with financial institutions. Where previously netted transactions are now reported separately, this has also affected apparent gross counterparty exposures.

Another potential area of debate is the IFRS pension standard IAS 19. This is presently being updated and may resemble the UK FRS 17 standard once it is finally revised. If it were to do so, this would bring under- or over-funding of company pension funds on to the balance sheet. In Ruijter's opinion, in the Dutch scenario, this is a distortion of economic and legal reality. Under Netherlands law, the pension fund is entirely independent of the corporate. KLM's reporting under US GAAP currently reflects this disparity. Under Dutch GAAP, the net asset value (NAV) of the KLM group is roughly €1.5bn (or €33 per share), against nearer €2.8bn (or €63) under US GAAP. The difference is the over-funding of the KLM pension fund, an asset which is "value the company cannot get at". Although KLM has the advantage of being one of the few entities with such a healthy pensions surplus, and the company "has no significant liability in the pensions arena", this does not alter the argument that to include pension assets in the balance sheet would, for a Dutch legal entity, seem to be "entirely misleading."

ROB RUIJTER'S **PORTFOLIO AT KLM**

Source: Capital Photos for KLM©

ALL FOR ONE, AND ONE FOR ALL. Ruijter also has mixed feelings about some aspects of the regulatory process. As he is involved in managing a multi-national business, he is highly supportive of "commonality" and the creation of universal standards at global level. However, in a number of instances, the greatest difficulties for business arise where areas of national difference are yet to be resolved. For example, while the introduction of the euro has been extremely beneficial to KLM (and, indeed, would prove more so if the UK was to enter the single currency), the delay in harmonising fiscal policy along similar lines to monetary policy is hampering the ability of companies to truly manage their businesses across European national borders. Likewise, on the issue of corporate governance, Ruijter would be more convinced by the development of a global standard rather than by the EU moving to introduce their own legislation on the back of the US Sarbanes-Oxley Act. He would also be wary of European regulators adopting the rules-based "form over substance" approach that has characterised many US regulatory controls, fearing that "history does not support" a link between such legislation and improved standards of business behaviour.

UP CLOSE AND PERSONAL. Yet whatever form regulatory and commercial developments might take, it seems that the need for finance functions to be sufficiently flexible to deal with constant and far-reaching change is likely to persist for some years to come. This can only mean more challenges ahead for the KLM finance team and for Ruijter. So what keeps him motivated?

The variety and scope of responsibility are clearly important factors. "Airlines are both a capital- and people-intensive business, which I like. The complexity means there is always something new," says Ruijter. "In my previous role as Group Treasurer of Philips, I only saw that aspect of the business, and as CFO of the lighting division there, I also did not have the full portfolio which I have now as CFO of a publicly quoted company like KLM. That was why it was my ambition to become CFO of such a company."

The breadth of his remit (see ***Figure 3***) does not, however, prevent him from continuing to take a hands-on interest in treasury activity. Ruijter admits that his treasury background "has an influence" on aspects of his relationship with the firm's Group Treasurer. He regards his interactions with treasury as "quite intensive" and believes his experience of treasury work makes him a more effective "sparring partner" when agreeing strategy.

There are, of course, attendant pressures in holding such a broad ranging and high-profile role. "Sometimes, it is a bit like working in a glasshouse. Even though at Philips and BP I was working with products that people come across in everyday life, with airlines, it's different. Everybody has an opinion and they don't hesitate to share them," says Ruijter.

Yet Ruijter's varied background in accounting, financial control and treasury has clearly prepared him to withstand what the airline world has to throw at him. Moreover, he believes that other treasurers have a great opportunity to move into the most senior finance roles. "In many ways, treasurers are better prepared than pure accountants in the nature of their experience in dealing with the outside world and in how they approach things," he explains. "However, my advice to treasurers is to broaden themselves, preferably at an early stage in their careers, and to be aware of business controls. That is where they need to seek exposure. If they can master the issues of control, treasurers have a lot to offer at Board level."

Rob Ruijter is CFO of Dutch airline KLM.
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