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For discussion
on 18 July 2006

**Legislative Council Panel on Economic Services**

# Government's Views on the Proposed Acquisition of Dragonair by Cathay Pacific

## Introduction

At the Panel's invitation, this paper sets out the Government's views on the proposed change of shareholding structure between Cathay Pacific and Dragonair, its possible implications on the development of Hong Kong's aviation and tourism industries, and whether any competition issues would be involved.

## Background

*The Proposed Shareholding Change*

2. On 9 June 2006, the major shareholders of Cathay Pacific and Dragonair announced that, as part of an agreement to realign their shareholding structures and create one of the world's strongest airline groupings, Dragonair will become a wholly owned subsidiary of Cathay Pacific. More information about the proposed transaction and the benefits envisaged by the parties to this transaction is set out at the note provided by Cathay Pacific at **Annex**.

## Government's Views on the Possible Implications of the Proposal

3. Transaction of this nature is a commercial matter between the two airlines concerned and among their shareholders; and does not require the Government's approval. The Government plays no role in the transaction. In any event, the transaction has yet to be completed, subject to approvals of the shareholders of the companies involved.

4. On a more general note, Hong Kong is facing fierce competition from many other major airports in the region. If the proposal could, as envisaged by the parties to the transaction, better integrate Cathay Pacific's international network with Dragonair's Mainland network and create maximum synergy between the two airlines, it would facilitate the connection of international passengers into the Mainland and vice versa via Hong Kong. This would enhance the competitiveness of Hong Kong as a transit hub into the Mainland market and further strengthen our status as an international aviation centre. A vibrant and competitive aviation industry would also facilitate more convenient air travel to and from Hong Kong, which would contribute positively to the tourism industry.

5. On competition, it is worth noting that the global aviation industry is a highly competitive one. Over the past few years, the Government has been proactively liberalising our air services arrangements with both the Mainland and other parts of the world to remove restrictions and promote competition. At present, Hong Kong's aviation market is highly liberal. There are 80 airlines operating scheduled services from Hong Kong. On almost all important routes Hong Kong airlines face keen competition from Mainland and foreign airlines. Even on less mature routes, there are ample traffic rights available for additional airlines to enter the market as and when they perceive the demand. Besides, Cathay Pacific and Dragonair serve very distinct markets with very limited overlap between their respective network. We therefore do not consider that the changes in shareholding under the current proposal would raise substantive concerns on competition. The Government will continue to proactively pursue liberalisation with the 60 existing and many more prospective aviation partners to create an operating environment that facilitates competition.

Economic Development and Labour Bureau
12 July 2006

**Annex**

**Hong Kong Strengthens Its Role as the Premier Asia-Pacific Regional Aviation Hub under Shareholding Realignment**
***(Information provided by Cathay Pacific Airways[1])***

## Introduction

Cathay Pacific, Swire Pacific, Air China, CNAC and CITIC Pacific have reached an agreement to change the shareholder structure of Cathay Pacific, Dragonair and Air China. The new structure will offer significant benefits for airline customers and for Hong Kong and Beijing as gateways to China.

Under the agreement, which is subject to shareholder approvals, Dragonair will be wholly owned by Cathay Pacific. Air China will acquire a 17.5% stake in Cathay Pacific, and Cathay Pacific will double its shareholding in Air China to 20%.

Swire will remain the principal, long-term shareholder in Cathay Pacific. Dragonair will continue to operate under its own brand, but under Cathay Pacific management.

Cathay Pacific and Air China will continue to develop closer cooperation on many fronts, including establishing an air cargo joint venture in Shanghai.

## Benefits across the board

The agreement will produce far-reaching benefits across the board for customers, shareholders, employees and the Hong Kong economy. It will:

- Enable Cathay Pacific to connect its international network with Dragonair's short-haul services to Mainland China and secondary regional destinations.

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[1] The proposed shareholding alignment announced on 9 June 2006 is subject to necessary regulatory and shareholders approval. Details of the proposed shareholding alignment are documented in a circular to shareholders dated 6 July 2006. All details relating to the shareholding alignment are determined and governed by information set out in the circular.

- Produce efficiencies and operational streamlining that will result in a wider network for the two airlines, more destinations, wider choice and greater convenience for customers.
- Reinforce Hong Kong’s position as the premier aviation hub in the Asia Pacific region and provide a platform for the growth and expansion for Hong Kong’s home carriers into the Mainland and the region.
- Further the development of Beijing Capital International Airport and Hong Kong International Airport as gateways to and hubs for Mainland China by enabling Air China and Cathay Pacific to increase business and operational cooperation, increase traffic and load factors and enhance flight connectivity between all three airlines.
- Deliver more jobs and career opportunities in the aviation sector and related industries in Hong Kong over a long-term period of growth.
- Give Cathay Pacific shareholders a stake in a larger, growth-driven company with a formidable international, regional and Mainland network.
- Create one of the world’s strongest airline groupings - Cathay Pacific, Dragonair and Air China.

**Background**

Cathay Pacific and Dragonair are natural partners. Cathay Pacific part-owned and managed Dragonair between 1990 and 1996 before its current ownership structure came into effect. Economic and aviation circumstances have since changed dramatically, particularly in Mainland China, and so too has the world in which Cathay Pacific and Dragonair and Hong Kong must now compete.

Hong Kong’s future prosperity hinges to a large extent on its development as a gateway to the Chinese Mainland and as a hub for the movement of people and goods around the globe. As Hong Kong’s home carrier, Cathay Pacific has a shared interest in and commitment to the welfare of Hong Kong and its people.

Yet neither Cathay Pacific nor Dragonair separately can serve all Hong Kong’s needs adequately. Dragonair lacks an international network. Cathay Pacific has a comprehensive international network hub is not yet able to offer the access consumers want to the Chinese Mainland, the world’s fastest growing economy and Hong Kong’s natural hinterland.

Given the urgency of competition Hong Kong faces from other regional hubs, there is not enough time for either carrier to evolve organically in order to fill these gaps. This agreement meets this pressing need.

Cathay Pacific and Dragonair are, in effect, like two separated halves of a whole: their networks and capabilities complement each other. Reunited, the whole will be greater than the sum of the parts. Hong Kong, the Hong Kong aviation hub, consumers, staff and shareholders will enjoy the benefits.

**Dragonair will become a wholly owned subsidiary of Cathay Pacific**

- Cathay Pacific has offered to acquire the remaining 82.21% shareholding in Dragonair that it does not already own for HK$8.22 billion, turning it into a wholly owned subsidiary.
- The consideration for the Dragonair shares will be a combination of the issue of new Cathay Pacific shares at HK$13.50 each and cash.
- Reflecting its confidence in the benefits and synergies from acquiring Dragonair, Cathay Pacific has agreed to pay a special dividend of HK$0.32 per share upon completion of the transaction.

**What it means for Hong Kong and the hub**

The aviation industry is a major contributor to the Hong Kong economy, generating close to 10% of the SAR’s GDP in 2005, according to the Aviation Policy and Research Centre of the Chinese University of Hong Kong. The Cathay Pacific Group is one of Hong Kong’s largest employers, with a payroll of more than 23,000 people. This agreement means that the Hong Kong economy as a whole and the aviation industry in particular will benefit from the growth it represents.

Hub strength comes from flight frequency, connectivity and the ability of airlines to offer competitive fares. Cathay Pacific and Dragonair under single ownership and working towards a common management goal – to draw more traffic to and through Hong Kong from the Mainland and the rest of the world – would deliver on all three counts.

Close cooperation between Cathay Pacific and Dragonair has been difficult because Dragonair has not been able to offer competitive fares to our connecting passengers.

Customers flying from Sydney to Shanghai, say, have been offered more attractive prices on single-carrier services connecting in Bangkok and Singapore than Cathay Pacific has been able to offer in collaboration with Dragonair. Hong Kong is the loser as Mainland traffic flows through competing regional hubs.

Seamless operations between Cathay Pacific and Dragonair – which can only be achieved through common ownership – would lead to the coordination of services and schedules, create faster and more frequent connections and strengthen Hong Kong as a hub.

A stronger hub creates a virtuous circle for consumers: increased traffic leads to more services, which leads to increased traffic and more choices and so on.

**What it means for customers**

Cathay Pacific and Dragonair's combined networks and capabilities have the potential to deliver more destinations, greater travel choice, enhanced convenience and, therefore, better value for its customers.

The acquisition will be a boost for the consumer. Hong Kong will benefit from an aviation industry better able to compete in a global marketplace. Hong Kong people will share the benefits of such growth.

Greater international traffic flows through Hong Kong unlocked by the deal will enable Dragonair to operate with greater frequency to cities it now serves and to mount new services to destinations it does not – creating more competition and choice.

Hong Kong has a population of only 7 million people. With such a small domestic market, many of the flights now available to Hong Kong people would not exist were it not for the international traffic funneled through the Hong Kong hub. About half of Cathay Pacific's passengers transit Hong Kong.

Cathay Pacific would not, for example, be able to operate daily to Bali and Colombo without the support of passenger and cargo traffic drawn from across its network. The fare on a less frequent service sustained only by Hong Kong travelers would be higher as well.

With great volumes of traffic fed from the Cathay Pacific network, infrequent and even daily services operated by Dragonair would be improved and new routes opened. Similarly, Cathay Pacific would be able to mount more services and offer greater customer value with support from Dragonair's Mainland network.

The two airlines' fleet structures will help such growth. With a fleet comprised entirely of large aircraft, Cathay Pacific cannot operate economically to smaller Mainland and regional cities. Dragonair with its fleet of small, short-range aircraft can. Yet it needs the support of international traffic from Cathay Pacific to profitably do so.

**What it means for shareholders**

Cathay Pacific shareholders will be owners of a much larger and stronger company, better placed to compete and maintain profitable future growth by capturing the complementary brands, network and operational attributes of Hong Kong's two largest airlines.

Cathay Pacific's ownership of Dragonair will create a company able to fully exploit the dual strengths of both airlines: Cathay Pacific as a full-service global network carrier and Dragonair as regional airline with predominantly mid-size short-haul fleet and established network focused on the Chinese Mainland and some secondary regional destinations.

The seamless integration of both airlines' operations will generate hitherto unobtainable opportunities for Cathay Pacific to increase efficiency, create new and stronger streams of revenue, expand both its network and market share and further strengthen Hong Kong's strategic position as a global aviation hub and gateway to the Chinese Mainland.

**What it means for staff**

Cathay Pacific, over many years, has developed an impressive and profitable passenger and cargo network throughout Asia and to Europe, North America, Australasia, the Middle East and South Africa.  However, the glaring gap in this network is the company's very hinterland, Mainland China. It was intended some years ago that Dragonair would fill this gap, but for several reasons this plan has not worked in practice. The agreement now changes all this.

Common ownership will create opportunities for growth and expansion, thus creating more job and career opportunities over the longer term. The enlarged company will, of course, maintain the rigorous standards of productivity, cost management and efficiencies that have underpinned Cathay Pacific's remarkable success in the past.

Cathay Pacific Airways
July 2006