For information
9 June 2020

Legislative Council Panel on Financial Affairs
Legislative Council Panel on Economic Development

Government's Investment in Cathay Pacific Airways Limited under the Land Fund to Uphold Hong Kong's Status as an International Aviation Hub

Purpose

This note informs Members of the Government's decision to invest in Cathay Pacific Airways Limited ("Cathay Group") in a bid to uphold Hong Kong's status as an international aviation hub amidst the threat arising from COVID-19.

Importance of the aviation industry

2. Hong Kong is an international aviation hub with a comprehensive international air network that underpins the development of a wide spectrum of economic activities, notably trading and logistics, tourism and financial services. Strategically located in the region and having one of the best airport infrastructure in the world, Hong Kong's aviation industry has brought tremendous economic benefits to Hong Kong over the years. In 2012, the economic contribution of the Hong Kong International Airport ("HKIA") (including direct, indirect and induced contribution) amounted to some $94 billion, representing 4.6% of Hong Kong's gross domestic product. Prior to COVID-19, about 78,000 people worked in the HKIA.

3. Our international aviation status is premised on, among others, the comprehensive network operated by our local airlines, in particular our flag carrier – the Cathay Group. As a home-based carrier underpinning our hub status, the Cathay Group links us to the rest of the world. Many foreign airlines choose to come to the HKIA in order to tap into the Cathay Group's comprehensive network linking the Mainland and the rest of the world. Before the outbreak of COVID-19, the Cathay Group accounted for some 57% and 41% of the overall passengers and freight carried at the HKIA. The Cathay Group's high frequency of passenger flights and comprehensive network have also contributed very significantly to the HKIA's development as the world's number one air cargo hub for nine consecutive years, complementing the all-cargo services in capturing the rapidly flourishing e-commerce businesses which look for speed.

Impact of COVID-19 on the aviation industry

4. However, the sustainability and competitiveness of our flag carrier is now under severe stress in the face of the COVID-19 pandemic. In April 2020, the International Air Transport Association ("IATA") projected that the annual airline passenger revenues around the world would suffer a year-on-year drop by 55% due to the economic shock of COVID-19 and the imposition of travel restrictions. In Hong Kong, the Cathay Group's flights have been drastically cut by 97% in recent months, as compared to its pre-COVID-19 operation. Hong Kong Express (being part of the Cathay Group) has also suspended all flight operations since 23 March 2020. The Cathay Group has seen its passenger traffic plunged by over 99% from its normal 100,000 daily passenger volume to less than 1,000 only.

5. At this unprecedented time, many major international airlines (e.g. Singapore Airlines, British Airways, Air France, KLM, Qantas, SAS, and Lufthansa) have turned to their governments / state funds for support. Such support takes various forms, including government-backed commercial loans, government loans, direct equity investment, etc. In view of the sheer size of the financial support needed and the prevailing economic situation, we cannot afford leaving the viability of our aviation hub status, contributed significantly by the Cathay Group, to market force alone. The International Transport Workers' Federation and IATA published a joint statement earlier in April, calling for governments, among others, to provide immediate financial support to protect jobs and ensure that air services can be maintained.

6. To safeguard Hong Kong's status as an international aviation hub, the Government considers it necessary and justified to take measures commensurate with the strategic importance of the issue at stake.

Why the Government's investment

7. About two months ago, the Cathay Group and the Government started the discussion about the case for the Government to support the aviation sector through an investment in the Cathay Group against the above macro and operational backdrop. While pledging their commitment to the aviation business, the management and the major shareholders of the Cathay Group highlighted the huge challenges of sustaining operation by relying purely on market forces and the Cathay Group's own efforts when the COVID-19 pandemic has brought the whole industry to a standstill globally.

8. In fact, the operation of the aviation industry is unique, involving traffic rights and slots at different airports. To the HKIA, the failure of the Cathay Group to sustain its operation would mean an immediate loss of the precious network that it has established through the airline group over decades. Such network included 49 passenger points and 14 all-cargo points served by the Cathay Group exclusively

pre-COVID-19. Without the air connectivity, the demand for the HKIA's transit / transfer services, which contributed 29% of the HKIA's passengers in 2019, is expected to drop significantly. In the absence of a well-established home-based flag carrier, reliance on non-local carriers will not be sustainable for the long-term development of the HKIA, as the bases and foci of these carriers may not be in alignment with the best longer term interests of Hong Kong.

9. Given the unprecedented impact of COVID-19 on our local aviation industry and the Cathay Group, and having regard to the actions taken by other governments to sustain their own aviation industries, the Financial Secretary considers it imperative and justifiable to support the Cathay Group as an essential player in the Hong Kong aviation industry, with the prime objective of upholding and maintaining Hong Kong's status as an international aviation hub amidst the huge challenges and uncertainties brought about by the pandemic.

10. The Government's investment in the Cathay Group (see paragraphs 14-16 below), coupled with the financial contribution by the shareholders of the Group, is expected to recapitalise the Group and help tie it over this extremely difficult period. The investment would also enable the Group to compete on par with other airlines receiving respective government support in the upcoming recovery of air services, thereby reinforcing Hong Kong's strengths as an international aviation hub. More importantly, it will preserve the necessary conditions and provide impetus to the much-needed post-COVID-19 revival of the Hong Kong economy.

Authority for making the investment under the Land Fund

11. The decision to authorize the investment in the Cathay Group was made by the Financial Secretary in exercising his authority under a resolution made under the Public Finance Ordinance (Cap. 2). Paragraph 7 of the Resolution of the Provisional Legislative Council on Land Fund (Cap. 2O) provides that the Financial Secretary may, in his discretion, authorize and direct the investment of any assets of the Land Fund which are not immediately required to meet expenses in respect of the Land Fund at any time in such manner as he may determine.

12. The Land Fund, totaling about $220 billion, is currently placed (via Future Fund) with the Exchange Fund for investment. At present, around 40% of the Land Fund is allocated to the Investment Portfolio of the Exchange Fund. Other parts of the Land Fund is committed to longer-term investments. The capital required for the investment in the Cathay Group will be drawn from the Investment Portfolio.

13. When making this decision, the Financial Secretary has taken into account the policy advice of the Secretary for Transport and Housing and the Secretary for Financial Services and the Treasury. The Hong Kong Monetary Authority ("HKMA") has been tasked to provide professional assistance in the evaluation of the commercial viability of the investment.

Highlights of the investment

14. The current recapitalisation plan of the Cathay Group involves $39 billion (US$5 billion), including rights issue to existing shareholders and the Government's investment. The two major shareholders of the Cathay Group, namely Swire Pacific Limited and Air China Limited, have undertaken to subscribe to their pro-rata share in the rights issue. The portion beyond the pro-rata allocation of the two major shareholders will be underwritten by the banker engaged by the Cathay Group.

15. Meanwhile, the Government will invest in preference shares (with detachable warrants) to be issued by the Cathay Group, and extend a bridge loan to the Group. The Government's total commitment amounts to $27.3 billion (US$3.5 billion). Based on the assessment of the external financial consultant engaged by the HKMA, the projected return in terms of internal rate of return is expected to be in the range of 4.0% - 7.5%, higher than the 6-year moving average return of 3.7% of the IP as at 2020. The key commercial terms of the aforesaid recapitalisation plan are set out at **Annex**.

16. To safeguard the best interests of the Government, we have included as a pre-condition of making the investment that the Government will have the right to appoint two observers to the Cathay Group's Board of Directors, and that such right will remain before Cathay Group repays the Government in full the drawn bridge loan and interest, and before Cathay Group redeems all preference shares from the Government, whichever is later ("Applicable Period"). Swire Pacific Limited has also undertaken to remain as the controlling shareholder of the Cathay Group throughout the Applicable Period.

Administrative arrangements

17. The Government's investment will be held by a dedicated company wholly-owned by the Financial Secretary Incorporated as established under the Financial Secretary Incorporation Ordinance (Cap. 1015). While the HKMA will be entrusted to manage the investment, the Financial Secretary will continue to give steers towards the investment under Cap. 2O.

Way forward

18. The Cathay Group is a listed company on the Stock Exchange of Hong Kong. It will seek the necessary approval for the relevant parts of its recapitalisation plan at its extraordinary general meeting to be arranged. Details of the aforesaid recapitalisation plan has been announced by the Cathay Group in accordance with relevant regulatory requirements.

Financial Secretary's Office
Financial Services and the Treasury Bureau
Transport and Housing Bureau
June 2020

Annex

Highlights of the Cathay Group's Recapitalisation Plan

<table>
<tr><th rowspan="2"></th><th colspan="2"><u>Investment from</u>
($ billion)</th><th rowspan="2"><u>Remarks</u></th></tr>
<tr><th>Existing shareholders</th><th>Government</th></tr>
<tr><td>- Rights issue</td><td>11.7</td><td>-</td><td>● The two major shareholders of the Cathay Group (namely, Swire Pacific Limited and Air China Limited) have undertaken to subscribe to their pro-rata share in the rights issue
● Subscription price: $4.68 per share</td></tr>
<tr><td>- Preference shares with detachable warrants</td><td>-</td><td>19.5</td><td>● Step-up coupon (3% for year 1 to year 3; 5% for year 4; 7% for year 5; 9% for remaining years)
● Warrant coverage ratio: 10%
● Warrant strike price: same as rights issue price</td></tr>
<tr><td>- Bridge loan</td><td>-</td><td>7.8</td><td>● Coupon: HIBOR + 150bps, plus drawdown fee
● Allows drawdowns within 12 months of the loan establishment
● Repayment within 18 months of respective drawdowns</td></tr>
<tr><td>Sub-total</td><td>11.7</td><td>27.3</td><td rowspan="2"></td></tr>
<tr><td>Grand total</td><td colspan="2">39</td></tr>
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