



## Murky financial transactions tarnish the credit outlook for AirAsia

by [Dexter Tan](#)

The shares of one of the world's top budget carriers, AirAsia, tumbled sharply last week as investors questioned the airline's credibility and earnings ability. A report by GMT Research highlighted problems with the company's accounting practices and raised concerns regarding the firm's cash flows, leverage and group structure. The report has a press embargo until Jun 24 but is made available to paying subscribers. The market cap of the carrier has declined significantly, falling 45% from MYR 8.2bn in Dec 2014 to MYR 4.5bn on Jun 19. The RMI 1-year probability of default (PD) for AirAsia has soared in tandem with the drop in its market value, reflecting concerns about the firm's credit profile.



Figure 1: RMI 1-year PD for AirAsia vs market capitalization. Source: Risk Management Institute, Bloomberg

AirAsia is the largest budget airline in Asia in terms of fleet size and passenger load. The carrier covers 199 travel routes with an extensive network spanning across 98 destinations. Last Tuesday, the carrier was [voted](#) the world's best low cost airline for the seventh consecutive year based on Skytrax's surveys. AirAsia X, the long haul affiliate of AirAsia, was voted the world's best low cost airline premium cabin and world's best low cost airline premium seat.

On Jun 10, GMT Research, a Hong Kong based research firm, [questioned](#) AirAsia's accounting methods and accused the carrier of using related party transactions (RPTs) to boost its bottom line. GMT said that RPTs increased from MYR 13mn in 2004 to MYR 1.7bn in 2014, and the company would have recorded substantial losses over the past years if not for the RPTs. AirAsia denied the accusations by GMT, saying that the financial reports had been prepared in line with accounting standards and audited by PricewaterhouseCoopers (PWC). The conglomerate also [blamed](#) aviation regulations for preventing the airline from consolidating the accounts of its foreign associates and from becoming more transparent.

GMT Research may have some grounds for its opinion. Even though AirAsia claimed that PWC was the company's external auditor in 2014, PWC did not audit a number of AirAsia's subsidiaries such as AirAsia (Mauritius) Ltd and Asia Aviation Capital Ltd, which were formed in Sep 2014 to provide aircraft leasing services. In the CEO's note to shareholders, AirAsia said that setting up Asia Aviation Capital and separating the leasing business into a different entity would provide a number of benefits such as a more efficient tax management process. Setting up a subsidiary in Mauritius, an offshore center, to provide aircraft leasing facilities to Thai AirAsia, would appear incredulous. Keeping the operating and aircraft leases in an offshore center does raise suspicion about the company's financial figures, especially if they are not audited. The airline may have deliberately segregated its leasing business as an off balance sheet item for reasons associated with higher borrowing ratios and lower borrowing limits.

In 2009, AirAsia discontinued recognition of its share of further losses made by Thai AirAsia (TAA) as interest in the jointly controlled entity had been reduced to zero. Yet the carrier booked MYR 175mn of operating lease income from TAA during the year. Likewise in 2010, the company booked MYR 223mn of operating lease income from TAA even though it had zero interest in the jointly controlled entity. In 2012, the holding company of TAA listed on the Thai stock exchange. The IPO helped AirAsia recognize a net gain of MYR 120mn as fair value of the equity interest in TAA increased to MYR 1.04bn. The company said that the gains were made in accordance to MFRS131, an accounting standard for interests in joint ventures.

Recently, AirAsia expressed similar plans for Indonesia AirAsia (IAA) and AirAsia Philippines (PAA). Similar to TAA, the group did not recognize losses in both jointly controlled entities but continued to book leasing incomes from the firms in 2014. Last Wednesday, AirAsia [revealed](#) more details about the outstanding amounts owed by IAA and PAA. Total receivables owed amounted to MYR 2.4bn, which management expects to be paid in three to five years from internally generated cash flows. Furthermore, IAA and PAA will [issue](#) MYR 1.12bn in convertible bonds and raise share capital via IPOs as repayments. Management expects an IPO valuation of MYR 2.61bn and MYR 2.24bn for IAA and PAA respectively, 20% of which will be floated on the exchange. However, AirAsia is likely to recognize further losses of the two associates on its financial statements once they recapitalize as the reception of the convertible bond issuance and share offering is likely to be tepid. This will likely deteriorate earnings and weigh on AirAsia's overall future credit profile.

Besides the issue of fraudulent accounts, bondholders of AirAsia would have to contend with other headwinds such as a weakening MYR relative to the USD. During 2014, AirAsia recorded nearly twice the amount of forex losses on USD denominated borrowings compared to 2013. The firm recorded a 13% increase in USD liabilities to MYR 10bn, but forex losses nearly doubled from MYR 353mn in 2013 to MYR 609mn in 2014. The continued depreciation of the MYR against the USD this year could weigh on the credit profile of the firm in Q2 2015.

	Mar 2014	Jun 2014	Sep 2014	Dec 2014	Mar 2015
EBIT / Int. expense	1.98X	1.71X	1.49X	1.29X	1.27X
Retained cash flow / Net debt	-1.36%	1.80%	1.33%	1.63%	2.83%
Total debt / EBITDA	6.89X	7.84X	8.29X	9.08X	9.03X

Table 1: Financial metrics indicating the coverage and leverage ratios of AirAsia. Income statement and cash flow figures are adjusted to a trailing 12 month basis. Source: *Bloomberg*

AirAsia's ability to cover the cost of its borrowed capital has declined over 2014, falling to 1.27X in Q1 2015. Operating expenses have increased in 2014 backed by elevated labor costs, a 9% higher landing charge for airplanes in Malaysia and higher depreciation expense from an expanded fleet size to 172 planes. The proportion of retained cash flows to net debt improved a little, although a sub 3% ratio suggests a relatively high debt burden. AirAsia's debt to EBITDA continued an upward trend in 2014, rising above 9X in Dec 2014 and Mar 2015 as a result of the consolidation of Asia Aviation Capital.

A potential wildcard for AirAsia is the price of jet kerosene, which accounts for 49% of AirAsia's overall costs. Last year, AirAsia hedged 54% of its jet fuel requirements at an average of USD 88 per barrel for 2015. This is more than what they had done in the past. For example, in 2013 the company hedged only 7% of its 2014 fuel requirements. In addition, AirAsia's practice is different from other carriers as they have [reportedly](#) downsized their fuel hedges significantly. While hedging protects the firm against large and fast moving fuel prices, it would not be beneficial if jet kerosene prices stagnate, or move within a relatively tight band.

It has been an unfortunate series of events for the Southeast aviation industry. A number of fatal flight accidents have damaged the reputations of two prominent airlines. Sales at the airlines have been badly affected as some consumers booked seats at other airlines because of safety concerns. The newly appointed CEO of Malaysian Airlines said that the legacy carrier was technically bankrupt and the business would undergo a major restructuring to restore confidence in the firm. Earlier in the year, Garuda Indonesia [outlined](#) plans to restructure the business to cut costs. Meanwhile, AirAsia ended 2014 on a bad note but soon found itself embroiled in another PR nightmare as the firm defends itself against allegations that it misrepresented its accounts.

## Credit News

### Greece spells out terms for debt crisis 'breakthrough'

**Jun 23.** Greece's economy minister has spelled out the terms of new proposals to end the standoff of its debt crisis, amid hopes a deal can be struck this week. The new proposal includes new taxes on business and the wealthy. Before this, the negotiation had been in a deadlock for five months, and the ECB and IMF were unwilling to unlock the bailout funds Greece desperately needed to repay its debts unless the country agreed to economic reforms. Greece is required to pay a EUR 1.6bn IMF loan by the end of this month. The European leaders met on Monday evening to discuss Greece's proposal at an emergency summit in Brussels. ([BBC](#))

### DBS sells first ever AAA-rated covered bond

**Jun 19.** DBS has started selling USD 10bn of covered bonds to investors in Asia, Europe and the United States. This is the first test of the demand for AAA rated debt that is backed by mortgage loans out of Singapore, a closely regulated and unique property market. Such debt instruments are most comparable to mortgage-backed securities. Banks can package assets such as mortgages into securities that yield a cash payment, which are then sold to investors. The yield would reflect the credit quality of the underlying assets. ([Asiaone](#))

### Heta sees insolvency risk after USD 7.9bn hole emerges

**Jun 18.** Heta Asset Resolution AG, the remnant of nationalized Hypo-Alpe-Adria Bank International AG, warned that insolvency may be the only way to shut down the company. The firm recognized EUR 7.9bn of write downs, leaving it with EUR 16.55bn of liabilities and EUR 9.6bn of assets. Regulators imposed a debt moratorium on the Austrian bank, forcing senior bond holders to share losses for the first time in the euro area. This extent of losses on bondholders will be determined by Austria's Financial Market Authority. Heta is the first European bank to be wound down under the European's Bank Recovery and Resolution Directive, a new regulation designed to protect taxpayers from the cost of bank failures. ([Bloomberg](#))

### Yellen points to gradual rate rises

**Jun 17.** Janet Yellen declared that the Federal Reserve will only increase short-term interest rates cautiously in upcoming years. Despite evidence of recovery in the US economy, Ms Yellen claimed that better concrete evidence of the magnitude of the US economy recovery is required, before the Fed will take action. The Fed officials were unable to come to a common consensus on the appropriate times to hike interest rates by this year, although a chart of interest rate predictions from the Fed officials pointed to two. Equities rose and bond yields fell, after the Fed moved away from obvious signs of raising interest rates by September. However, Ms Yellen claimed that the timely implementation of tighter monetary policy is necessary, given the time-lag in the implementation of monetary policy. ([FT](#))

### Consumer debt defaults hit new lows

**Jun 16.** The latest S&P / Experian Consumer Credit Default Indices have shown that American households have been making improvements in controlling their debts, as defaults on consumer loans continue to hit new lows. The data also show the impact of general improvement in the housing market for most states in the US. Consumers were able to better control their monthly debt payments due to the strong job market and historically low interest rates. ([CNBC](#))

**Surge in local government debt issuance threatens China central bank's easing efforts** ([BT](#))

**OeVAG said to get conditional approval for capital plan** ([Bloomberg](#))

**Hercules Offshore plans for bankruptcy** ([Bloomberg](#))

### Regulatory Updates

#### Europe's banks head to Asia amid USD 1tn capital shortfall

**Jun 19.** European banks are increasingly moving towards Asia for capital, with the new regulations that banks in Europe are required to sell more than USD 1tn of equity and subordinated debt to increase loss buffers. Asia provides them with sufficient cash to purchase large amounts, and the pricing is also favorable. The move East is poised to accelerate as banks still need to issue about four times the amount of subordinated debt in either dollars or euros since 2008. By going to Asian currencies, banks are also diversifying their pool of investors and able to tap on wealthy Asian individuals. ([Bloomberg](#))

#### Sovereign debt needs international supervision

**Jun 16.** The present-day sovereign debt restructuring framework lacks the emphasis on fair resolution and often leads to inequitable and inefficient outcomes as a result of bargaining among unequals. While virtually every government in the world enacts local bankruptcy laws to provide the ground rules for creditor-debtor negotiations domestically, the absence of its equivalent in the international stage leaves much to be desired given the complexity of sovereign debts. A full global bankruptcy code may be impossible but at the minimum, a baseline framework needs to be constructed to limit disruptive intents and the extent to which one democratic government can bind its successors. ([Guardian](#))

#### India's new rules on debt restructuring are credit positive for banks

**Jun 15.** The Reserve Bank of India has introduced new guidelines for the restructuring of corporate loans, aimed at improving the ability of Indian banks to resolve bad loans. The new rules will allow creditors to gain a majority stake in the debtor company when it fails to meet debt servicing obligations. The move is seen to be highly favorable to the banks as it entails an attractive debt to equity conversion price, in addition to an exemption on making an open offer after acquisition. Furthermore, the value of the acquired stakes need not be marked to market for a period of 18 months. ([Business Standards](#))

**Basel Committee finalizes Net Stable Funding Ratio disclosure standards** ([Reuters](#))

**US banks to unveil stress test findings** ([Oilprice](#))

**IOSCO seeks to temper 'systemic risk' proposals for asset managers** ([IPE](#))