Thomas Cook: another solution was possible

The rescue of Thomas Cook could have been cheaper than the cost of repatriation

Thomas Cook’s bankruptcy had been in the air for several months. The successive revisions of the recapitalisation plan were a clear sign of the lack of a simple solution. Initially, the plan was based on a strategic review of the airline as a condition for the release of an additional £300m funding by the banks. The plan was abandoned and replaced by a solution where:

• Fosun contributed to £450m of new money to the Group and acquired at least 75% of the equity of the Group Tour Operator (subject to the receipt of anti trust approvals) and 25% of the Group Airline
• The Group’s core lending banks and noteholders provided an aggregate £450m of new money to the Group and converted their existing debt into approximately 75% of the equity of the Group Airline and up to 25% of new equity in the Group Tour Operator.
• Fosun’s control of the Tour Operator would have required the airline to be separated in order to respect the conditions of ownership of airlines in Europe by non-European players.

According to the Thomas Cook Group (TCG), the only alternative to this scheme was insolvency.

At the end of September according to insolvency documents filed by the company, TCG was left with just £956,670 in group cash reserves and £31.2m in bank accounts. This led chief executive Peter Fankhauser to conclude that the “company will run out of cash by 4 October 2019 and probably earlier” (Financial times). Thomas Cook had a balance sheet deficit of £3.1bn, with £1.9bn of debt, on top of £1bn of inter-company payables and amounts owed to third parties.

The scenario of an unplanned insolvency had been was analysed by Alixpartners. On a total of £1.9bn debt, the creditors would recover between £138m and £210m. Alixpartners, performed this entity priority analysis on the behalf of TCG, and are now one of the special managers for the tour operator and the airline.

One would then expect that the price tag for a bailout of TCG could have been as low as £138m. For that price, according to Alixpartners, the main creditors could have been wiped out and TCG left with a clean balance sheet and only current liabilities. This was at the end of August. At the end of September, given the deteriorated cash position, the price could have been even lower. The bailout would have been cheaper than the costs of repatriation with Fosun undoubtedly interested in paying a significant premium for a business with a clean balance sheet.

In 2019, like-for-like revenue for the year to July 2019 (as at 23 August 2019) was £183m behind for the year. Over the same period, the Group’s liquidity position had continued to worsen resulting in a deterioration of approximately £530m in the Group’s liquidity as at 31 July 2019 (as reviewed on 23 August 2019) compared...
to the position at 31 July 2018. As a result of lower profitability and a negative working capital position, the Group’s net debt position as at 31 July 2019 was approximately £1.43 billion, a like for like increase of £815 million from 31 July 2018.

Airlines: Viable businesses which were victims of a vulture strategy

Contrary to the government and media narratives the group’s airline was not only profitable but had one of the most competitive cost bases amongst UK operators. In FY 18, TCG airlines had an EBITDAR margin of 13%, where by comparison easyJet and Lufthansa had a margin of 16%. Thomas Cook was not the most profitable airline in Europe, but was a sound and stable and viable business. In H1 2019, Thomas Cook airlines (UK) had a revenue of £1.2bn and an EBITDAR of -£98m. During the same period, Easyjet had a revenue of £2.3bn for an EBITDAR of -£16m. Thomas Cook cost per ASK was lower than Easyjet and BA in H1 2019. Ironically, the main problem of the group’s airline was the profitability of Condor.

The impact of the restructuring of Condor initiated in 2017 had significantly improved the performance of the group’s airline. The sale of seats to third parties and directly to customers was increasing rapidly. Between 60 and 70% of the seats sold by Thomas Cook airlines in the UK were not to Thomas Cook holiday makers, and as a result although the failure of the tour operator would have been a significant challenge for the airline, it could also have reviewed it’s network and re-allocated resources to the most profitable routes for the airline itself.

The impairment test carried out in March 2019 had confirmed the positive prospect for the Group Airline. The future cash flow of the group airline was expected to be sufficient to confirm the value of the goodwill of £881m. The goodwill for the UK tour operator has been totally written off (£1,038m).

Condor (including its subsidiary TC Balearics) is the biggest airline within the group. As at the 22/09/2019, Condor had a fleet of 42 aircraft (86% leased) and Thomas Cook Airline (UK) had a fleet of 34 aircraft (all leased). Condor has a capacity of over 10m seats and TC Airline (UK) flew 8.1m passengers in 2018. In 2018/19, the UK airline turnover increased by 14%.

The company delivered £129m profit before taxation, offsetting adverse economic headwinds by a strong hedging strategy on fuel and currency. Since 2004, the UK company has only experienced two year ends which resulted in a loss a loss. This happened with the crisis in 2008/2009 and 2016/2017 following the Brexit vote and resultant impact on the currency markets.

At September 2018, TC airlines (UK) had a total retained profit of £421m and total reserve of £532m (with the issued capital). The UK airline was the cash cow of the group with a net financing position at the end of September 2018 of £773m (£1091m owed by the group and £318m owed to the group). The amount owed by the group is unsecured and repayable on demand. 70% of the amount was interest bearing and non-trade related. 97% of the amount owed to the group was trade related. Given the seasonality of the business, September is not the highest point in terms of cash position.

Despite this, the balance sheet of the airline can be regarded as strong. The weakness of the airline was the cash pooling procedure at the group level. The airline had almost no directly accessible cash. Therefore, with a net position which could be in excess of £800m, the UK airline is surely one the main creditors of the group. At the end of September 2018, the Group had £1,038m of cash, of which £773m came from the UK airline.

The liquidation of TCG effectively immediately condemned the TC airline. The company, despite being profitable, had been left with no means to continue trading.

The only real assets of the company were the slots, the employees, the brand and the contracts. Based on previous summer operations, the value of the enterprise could have been above £1bn. However given its profile (dependence to the group, age of leased aircraft, leisure profile, etc) the airline valuation
must be discounted. An enterprise value of £300m to £500m (at a discounted 3 to 3.5 X EBITDAR) seems more reasonable. The slots are the main assets (TCG had 200 slots per week in Gatwick and 350 in Manchester, and a lot more in the UK and at leisure destinations) with the 15 pairs of daily slots in the summer at Gatwick alone being worth as much as £30m.

**The separation of the airline from the rest of the group**

This separation was part of the recapitalisation scheme in order to avoid Fosun controlling the airline. When TCG put the airline up for sale, it received several offers. Unfortunately, none of these offers were high enough to allow the group to raise enough cash to complete the required capitalisation of the Group as a whole.

We estimate that TCG was looking for £500m to £600m for the airlines. A business model for the airlines separate from the group was therefore viable. At least several players in the industry shared this view.

The contrast in fortunes of Thomas Cook Airlines UK and Condor is stark. The latter filed for the so-called "protective screen" (Schutzschirmverfahren), a procedure in the German insolvency law shielding German entities from the liquidation of foreign related companies. The German Carrier rapidly secured a bridging loan from the German government amounting to EUR380m (USD415m). Condor, which was in a similar stable financial position to Thomas Cook Airlines UK, required the loan to survive through the low winter season as all its financial reserves were tied to the bankrupt holding company.

The loan could also have provided a lifeline to Thomas Cook Airlines, Thomas Cook Balearics and Thomas Cook Aviation which operated exclusively on behalf of Condor. This all was part of the procedure related to the state loan.

The same procedure could have been implemented in the case of the UK airline. Thomas Cook airlines could have continued to fly, saving hundreds of millions of pounds of public money spent on repatriation, and allowing time for the sale of an on-going business with all its employees. Exactly like Condor, the UK airline was a sound business with literally no debt beyond trading payables and lease obligations. The only problem of the airline was that all its cash was tied up with the Group.

The group airlines could have survived even with the loss of a significant part of the group’s long-term loans but needed access to working capital to carry on its business as usual. The airlines were in a situation similar to having their bank accounts frozen. Based on the working capital during September 2018, the trend of the current market and the time of the year (just at the beginning of the winter period), we estimate that a bridging loan of c. £250m would have been sufficient to support the business.

The loan could have been secured against the slots (at least in part) as has been done by Norwegian, which provided Gatwick slots as a guarantee to its lenders. With an interest rate comparable to the (high) rate of 7%, currently charged by the group to the UK airlines for the interest bearing borrowings, the costs of such a loan would have been of £17.5m for the airlines, an amount which it would have had no problem in paying. The loan would have been reimbursed with the proceeds of the sale which could have been a quick process. This is what will happen at Condor, with some parties having already expressed interest.

The problem for the UK airline was that no one party had an interest in keeping the business alive (apart from the customers and the employees).

The UK insolvency law was not necessarily an obstacle in finding alternative solutions. However the lack of clear procedures with a simple principle of saving potential viable businesses, which operated in conjunction with the absence of stakeholder voices at the table, has again caused an undoubtedly viable business to cease trading.

There was no risk in keeping the airline flying. The greatest risk for a bankrupted airline is to see its aircraft seized by creditors (notably the airports). This
has even happened with leased aircraft with notable precedents being set notably in Italy.

With a bridging loan, the UK airlines would not have been insolvent and would have been able to pay suppliers, exactly in the way Condor has done. The receiver could have acted in a similar way as it did with British Steel. Both Thomas Cook and British Steel went through compulsory liquidation without any prior administration. We do not have yet the publication of the judgement regarding Thomas Cook but in the case of British Steel it appears clearly that the liquidation was decided on the basis that none of the usual insolvency practitioners were ready to become administrators with all the risk attached (and the prospect of a payment of only £600,000 if they failed to find a solution creating more value as none of the creditors were ready to pick up the bill).

All companies refused to become administrators, but Ernst and Young accepted the job of “special managers”, were paid by the taxpayer (the official receiver) for an undisclosed amount, to do exactly what an administrator would have done; run the business and try and find a long-term solution. In this case it was a sale of a business, which seemed to have had a good prospect of success.

The government could have provided the business with the necessary funding to continue its operation. A similar scheme to that of British Steel could have been put in place for Thomas Cook.

One of the key differences between TCG and British Steel was the level of information given to the unions. In the case of BS, the unions were instrumental in helping to find a solution based on a comprehensive and detailed knowledge of the situation before it became public knowledge.

When Unite, in July 2019, requested Syndex assess the situation of the UK airline the management of TC refused on the basis that it was “premature” and “unnecessary”. The employees had no say and neither did customers (who also became the victims of the bankruptcy of TCG).

On the publication of the compulsory winding-up order, the employees’ contracts of service were terminated as the order is regarded as a notice of dismissal. The employees will be paid a remuneration (up to £800 under Schedule 6 of the Insolvency Proceedings Monetary Limits) and leave entitlements (up to six weeks) outstanding as well as redundancy payments by the Insolvency Service which will claim them, in turn, in the winding up process. The money that will be paid to the employees will be at the end less than half of the fees paid to lawyer’s and banker’s days before the bankruptcy... it could even be less than the fees paid to the special managers.

If the government had invested money in TC airline, it would have certainly required that it be first in line for the proceeds of any sales (of the whole or part of the business). The creditors would have lost a source of recovery of part of their loss, notably though the potential sales of the slots. However employees, airports, suppliers and customers would all have retained and secured work, and any competitor airline or new investor would have paid a premium for a business that had value, when it was trading. Now they will simply compete for the slots.