KLM Restructuring Plan

Draft summary findings
For discussion with the Dutch Ministry of Finance

Final Draft – 22nd October 2020

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Glossary

- A/C - Aircraft
- AF - Air France S.A.
- ASK - Available Seat Kilometre
- ATK - Available Tonne Kilometre
- BA - British Airways
- BH - Block Hour
- BoMD - Board of Management/Directors
- BSA – Blocked Space Agreement
- CASK - Cost per Available Seat Kilometre
- CAGR – Compound Annual Growth Rate
- CLA - Collective Labour Agreement
- COI - Current Operating Income
- CORSIA - Carbon Offsetting and Reduction Scheme for International Aviation
- EASA – European Union Aviation Safety Agency
- E&M - Engineering & Maintenance
- ETS – European Emission Trading System
- FA - Framework Agreement
- FTE - Fulltime Equivalent
- HV - Transavia
- IAG – International Airlines Group
- ICAO – International Civil Aviation Organisation
- KLC - KLM Cityhopper
- KLM - Koninklijke Luchtvaart Maatschappij (Royal Dutch Airlines)
- LH(G) - Lufthansa (Group)
- LVNL - Luchtverkeersleiding Nederland
- NL - Netherlands
- NOx – Nitrogen Oxides
- OEM – Original Equipment Manufacturers
- P&L – Profit and Loss account
- RASK - Revenue per Available Seat Kilometre
- RP - Restructuring Plan
- RSG – Royal Schiphol Group
- SAF - Sustainable Aviation Fuel
- TU - Trade Union
- UFP – Ultra Fine Particles

PA Consulting – our brief

Scope of work

The Dutch Government, KLM and Air France S.A. have each executed the Hexagone Framework Agreement (the "FA"), which *"sets out the overarching terms and conditions pursuant to which the Dutch Support Package is provided by the Dutch State to KLM."*

Within the Framework Agreement, KLM has committed to *"draw up a Restructuring Plan by no later than 1st October 2020 and shall have a duration until 31st December 2025"* and the PA Nyras aviation team within PA Consulting has been engaged as an external adviser by the Dutch State to review the Restructuring Plan (the "RP").

Objectives

10.1.c, 10.2.g

The objective of this report is to advise the Dutch State of the adequacy of the RP's compliance with the Covenants, and to advise the Dutch State of areas of concern and also potential areas where we believe further improvements could be made.

Approach

During the assignment, we have reviewed the RP in detail and have engaged a core team of aviation specialists and subject area experts to work closely with KLM management in order to complete a detailed review and challenge of the RP and to complete the objectives as set out above.

We have reported back to the Dutch Government each week to advise on progress and have also maintained ongoing dialogue throughout with the Dutch Government to ensure that any concerns have been addressed. Following such discussions with the Dutch Government we have then worked closely with our core team and subject matter experts to evolve our report and where necessary to raise further review questions with KLM to improve our understanding of details within the RP.

Following this approach, this report outlines our findings relating to the objectives set out above.

Foreword

- We acknowledge the significant work undertaken by KLM in completing the Restructuring Plan ("RP"), management's openness and availability to explain the details of the RP throughout the assignment. We particularly appreciate the fact that management has made this time available to us in parallel with managing the airline's response to the reality of a second wave of COVID-19, and the ongoing negotiations with Trade Unions and suppliers to ensure delivery of certain requirements of the RP.
- As our team is composed of former airline executives who have dealt with other industry crises in the past, we can comprehend the pressures to execute a forward-looking rethink such as the RP while simultaneously navigating these unprecedented events and engaging with multiple stakeholders in a fluid environment. While we may have differences of views on certain points, we do not underestimate the efforts made to get the RP to this point.
- Prior to the Covid crisis, KLM had delivered a strong financial performance over the five years to FY19, 10.1.c 10.1.c However, the impact of Covid has been enormously challenging for KLM and the entire global airline sector with the situation continuing to evolve. 10.1.c 10.1.c

Summary of main findings (1 of 2)

Key Findings

- We have sought during our review to confirm KLM Group's compliance with the loan conditions as contained in the Framework Agreement (FA). Our report covers each loan condition in detail with supporting analysis and commentary.
- We have assessed 17 of the loan conditions that are within the Covenants and our scope for our review and, based on KLM's interpretation of the FA, management has presented a Restructuring Plan (RP) that complies with these loan conditions.
- There are, however, a number of key requirements in the FA that were not clearly defined, on which KLM has therefore had to make its own interpretation of the specific clauses. The most prominent ones are as follows:
  - 10.2.b
- We believe that KLM's interpretations on each of the points above are reasonable. However, it would also be possible to have reached an alternative interpretation. For example:
  - The RP delivers a 10.1.c improvement in profit margin 10.1.c by FY25, which could be argued is not significant *(slide 26)*;
  - Manageable costs are assumed to be 50% of group operating costs. While this seems reasonable for FY21 and FY22, we believe that ~70% would seem more appropriate for FY23 to FY25 after pre-COVID levels of production and demand return *(slides 27 and 28)*.
  - Furthermore, materially all cost savings in the RP are delivered in FY21 and FY22, 10.1.c 10.1.c 10.1.c may be deemed not to be a "sufficient improvement of KLM's competitive position" (slides 34-39)
- We have further explained each of the above during this presentation and where applicable offered benchmarks that help inform our alternatives views. The net impact of interpreting each of the above differently would, in our view, lead to an increase in the cost efficiency and profit improvement challenge for KLM Group.
- The new CLAs, which run to the end of FY22 (Mar-22 for Cockpit), do not extend to the assumed date of the loan repayment in FY25. However, in the event that the TUs do not sign a new CLA to be effective from FY23 (Mar-22 for Cockpit), we understand that under Dutch Labour Law the existing CLAs will remain in place *(slides 13-15)*.
- 10.2.g

Summary of main findings (2 of 2)

Key Findings (continued)

- 10.1.c
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- If it is accepted that manageable costs are 70% of total group operating costs, then further annualised savings o 10.1.c would be required by FY25 *(slide 28)*.
- Notwithstanding all of above we acknowledge that KLM management have many ideas on how to improve cost and productivity efficiency in the RP. Indeed, there are procurement initiatives underway to deliver additional savings that are not reflected in the RP and there are plans in place to negotiate changes to the CLA that will improve productivity and underlying cost competitiveness in FY23 to FY25 *(slide 24)*.
- 10.2.b

Conclusion

- KLM considers the requirements of the Framework Agreement ("FA") to be a contractual commitment and has prepared a comprehensive RP to ensure delivery of those requirements.
- It would be normal within an airline restructuring plan for near term opportunities to be developed in detail and also for the plan to contain higher level actions and value/cost estimates during later years. Those higher level actions and value/cost estimates would then be further refined and developed in detail, and prepared for implementation as the plan evolves.
- KLM has already taken decisive action to deliver key aspects of the RP with immediate effect from October 2020 onwards, and through detailed action plans fully expects to deliver (and in some areas exceed) the RP and meet the requirements of the FA during the first two years.
- During the final three years, further cost saving/revenue opportunities exist, some of which have already been identified by management but are not included within the RP. These further opportunities could be developed and included within the final three years of the RP in order to fully deliver the requirements of the FA.

KLM Restructuring Plan
Summary Findings - for KLM Management

1. **Requirements under Framework Agreement**
2. Labour – TU Negotiations
3. Labour – Productivity
4. Restructuring Plan to FY25 (1st October 2020)
5. Competitor Benchmarking
6. Liveability and Sustainability

Appendices:

A. KLM Restructuring Plan to FY25

B. Subject Matter Expert (SME) Observations