CATHAY PACIFIC TO GROW THE HONG KONG CARGO HUB

Introduction
Cathay Pacific Airways has played a key role in building Hong Kong into one of the world’s leading international air-cargo hubs. The carrier operates one of the world’s biggest freighter fleets and has developed a worldwide network that enables it to carry around 1.3 million tonnes of freight annually through Hong Kong International Airport.

Cathay Pacific is firmly committed to the further development of the Hong Kong aviation hub and is investing some HK$20 billion in new freighters and doubling its freight capacity within the next five years - probably the largest confirmed financial commitment of any airline to its cargo business in the world at present. The airline has also resumed the development process of the HK$5.5 billion new cargo terminal in Hong Kong which is scheduled to come into operation in 2013.

In a bid to further strengthen its cargo operation, Cathay Pacific on 25 February 2010 signed a Framework Agreement with Air China for the establishment of a jointly-owned and managed cargo airline.

Both Air China and Cathay Pacific will use an existing cargo airline, Air China’s wholly owned subsidiary Air China Cargo Co Ltd (ACC), as the platform for the joint venture. ACC currently operates international services from Beijing and Shanghai and the joint venture plans to expand its operations from this strong base.

Summary of the joint venture
According to the Framework Agreement, Cathay Pacific’s interest in ACC will comprise a 25% equity interest held by a wholly owned subsidiary, Cathay Pacific China Cargo, and a 24% economic interest through the returns on a loan provided by Cathay Pacific Group to an offshore trust.

Cathay Pacific Group plans to fund its RMB 1,669 million investment in the joint venture with the injection of four Cathay Pacific Boeing 747-400 Converted Freighters (BCFs) and two spare engines. The jointly owned cargo airline is expected to become operational in the summer of 2010. (Summary in Annex on P.4)

How the joint venture will benefit Hong Kong
The joint venture airline will not only be good for customers, it will also be good for the trade, generating more business and new opportunities in Hong Kong and Shanghai. A strong home-based cargo airline with a firm foothold in the YRD will ensure an efficient capture of cargo movements that may otherwise divert to rival hubs in the region. It makes sense for Cathay Pacific and Air China to team up for this joint venture because the airlines’ complementary strengths in products, services, network and expertise will enable the joint venture to offer very competitive
services to customers in northern and eastern China. The objective is that this joint venture will grow to become the strong home-based carrier in Pudong and Beijing, just as Cathay Pacific is at HKIA.

The YRD will continue to grow rapidly, as will the PRD. The joint venture will help ensure that both hubs will remain competitive relative to other export zones elsewhere in the world. The PRD remains the largest export-orientated manufacturing area in the Mainland - and indeed the world - and is the primary reason why HKIA has become the world’s largest international cargo hub.

The joint venture carrier’s primary focus will be channelling export cargoes originating from the YRD area and northern China through Shanghai and Beijing, fully complementing Cathay Pacific’s cargo strengths in Hong Kong and the PRD.

**Growth potential in the YRD and PRD markets**

Both the YRD and PRD had a significant cargo throughput in 2007, taking a 38% and 30% share respectively in terms of the international trade value between China and the rest of the world. In real terms, Hong Kong’s annual air-freight throughput still exceeded Shanghai’s by some 1 million tonnes, but the gap is narrowing.

Cathay Pacific continues to have great faith in China’s continued economic development and we believe it will occupy the role of the world’s manufacturing centre for some time to come.

**Competition – and co-operation**

Cathay Pacific is not creating a brand new airline - it is buying into an existing airline that already has seven freighters flying and will have a total of 12 freighters by the end of next year.

The joint venture and Cathay Pacific Cargo are completely separate and will compete. They also have the chance to work together, within the normal anti-trust parameters, to create, through interline arrangements, something of mutual value that neither could achieve working on its own. The conduits between HKG and PRC are clearly critical to this end and both parties have agreed that over the next four years they will discuss further the possibility of future arrangements on Cathay Pacific freighter services within the PRC to strengthen their competitive positions in this respect.

The joint venture needs additional aircraft to grow and its geographical location means that the four BCFs from Cathay Pacific are well suited to the task. The Cathay Pacific Cargo freighter fleet will continue to grow, not diminish, with 10 new and larger Boeing 747-8 freighters being delivered from early 2011. This translates in to double digit capacity growth levels in 2011 and 2012, even after the 4 aircraft have left the Cathay Pacific fleet and joined the joint venture fleet. Hong Kong will certainly benefit from this growth.
At present Cathay Pacific Cargo operates 15-16 freighter services per week between Shanghai and Hong Kong, successfully “hubbing” export and import cargoes to and from North America and Europe through HKIA. Cathay Pacific is able to do this because Shanghai lacks a strong, home-based carrier that is able to offer a more cost-effective and superior direct service than that provided by Cathay Pacific and other indirect operators.

**Competitive realities**

As and when a strong home carrier in the YRD is created, Cathay Pacific Cargo’s ability to compete in this market will inevitably diminish. The competitive advantage of Cathay Pacific and HKIA with respect to capturing transhipment traffic to and from Shanghai will be further threatened by the likelihood that Taiwanese carriers will soon be granted permission to transship PRC-originating traffic to and from Europe and North America over their Taipei hub.

Given these competitive realities it makes strategic and commercial sense for Cathay Pacific to join its strategic partner, Air China, in forming a joint venture cargo airline that has the potential to become the strong home-based carrier that the Shanghai market needs and can support. It is likely that the joint venture will forge strong inter-line arrangements with Cathay Pacific Cargo.

The aim is to develop and grow the joint venture carrier into the pre-eminent home-based all-cargo carrier in eastern and northern China, having the fleet size, market share and service quality to provide competitive direct services to Europe and North America, and also Asian destinations such as Japan, Korea and Taiwan. Cathay Pacific Cargo will be well placed to compete effectively in both hinterlands.

It must be assumed that a strong home based carrier will emerge in the Shanghai market. Cathay Pacific and Air China are not alone in aspiring to fill this role. If Cathay Pacific were not involved in such a development, then it can be reasonably assumed that our ability to compete would be diminished as outlined above. This would be bad news for Cathay Pacific and bad news for HKIA as against other regional hubs. If however the joint venture is successful, then Cathay Pacific will have a partner with whom it can cooperate with as well as compete.

The most likely form of co-operation would be through interline and block space arrangements to destinations that the other party doesn’t serve. In this sense both carriers might complement each other’s network and would be incentivized to do so by the strategic partnership that exists between Air China and Cathay Pacific. Given the competitive realities that are likely to unfold as Shanghai develops this is clearly the best potential outcome for HKIA as it suggests that traffic that might otherwise flow over alternate hubs and on rival carriers will instead continue to flow over Hong Kong.
Conclusion

The cargo joint venture marks another important milestone for the strategic partnership between Cathay Pacific and Air China which was established in June 2006. The partnership has since been instrumental in reinforcing Hong Kong’s position as the premier aviation hub in the Asia Pacific region and providing a platform for the growth and expansion for Hong Kong’s home carriers into the Mainland and the region.

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. Cathay Pacific’s partnership with Air China has equipped Hong Kong’s home carriers with a formidable international, regional and Mainland network to the benefit of the Hong Kong hub and the Hong Kong economy.

Appendix:

**Air China and Cathay Pacific establish cargo airline joint venture**

**Deal Summary**

According to the Framework Agreement, Cathay Pacific’s interest in ACC will comprise a 25% equity interest held by a wholly owned subsidiary Cathay Pacific China Cargo Holdings and a 24% economic interest through the returns on a loan provided by Cathay Pacific to an offshore trust. The relevant transactions involve:

- Cathay Pacific China Cargo Holdings will subscribe a 25% equity interest in ACC for RMB852 million, and a further capital contribution of RMB238 million by Fine Star in ACC.

- Cathay Pacific Group will fund a RMB817 million loan to an offshore trust to acquire Fine Star from CNAC, which will allow the trust to own 24% of ACC. Cathay Pacific Group has no equity or beneficial interest in the offshore trust.

- The offshore trust’s equity interest in Fine Star will be pledged to Cathay Pacific Group. The returns on the loan will be equal to the dividend returns on the 24% effective shareholding in ACC through its ownership of Fine Star.

- The sale of four Boeing converted freighters and two spare engines by Cathay Pacific Group to ACC for RMB1,924 million.