The MAS Way:
Business Turnaround Plan

A Letter from the Managing Director

There is no question that MAS is in crisis within the increasingly challenging Asian airline industry. Today, we have a cash and profit crisis. On current business assumptions, course and speed, we will surely fail unless we radically change the way we run our business.

I am convinced that with decisive action, MAS can be a success and emerge as a winner. We have a plan—*The MAS Way*—a plan that will turnaround the business in 2 years. There are already promising early results and a groundswell of energy that give me confidence that we will realise an all-time high profit for MAS in 2008 of RM 500 million. In my first three months as MD/CEO of Malaysia Airlines, we have been working very hard to prepare a robust Business Turnaround Plan. It is our roadmap going forward.

This will be a long, winding and difficult journey and it will require unleashing the talents of all our employees and the support of all our stakeholders. We will win this together.

The GLC Transformation Program launched by the Government in 2004 has gone a long way to making this possible. It has provided the necessary 'air-cover' and acts as the spearhead for our business turnaround. We will continue to work within the guidelines prescribed by the GLC Transformation Manual.

I am fully aware that our stakeholders particularly in Malaysia are very interested in the affairs of MAS. Whilst this document is aimed primarily at communicating the Business Turnaround Plan to our staff, we felt that it should be made available to selected external stakeholders. My team and I have decided to be as transparent as possible about our problems and how we intend to address them, without disclosing confidential and competitive information. What we are definitely NOT disclosing is how precisely we are going to implement the plan. The key to success is indeed in the execution of this plan and that is our secret.

Over the next three years, look for regular updates on our progress and the impact of our actions. Much lies ahead of us, but we will succeed.

Idris Jala
Managing Director
Malaysia Airlines
27 February 2006

The MAS Way:
Business Turnaround Plan

Executive Summary

The global airline industry is in a state of turmoil and it is increasingly clear that the survivors—and most certainly the winners—will have to make radical changes to adapt to the new environment.

For the FY 2005[1], Malaysia Airline System (MAS) reported a loss of over RM1.3 billion. This announcement came at the same time as some of our regional competitors reported strong profits. This result is unacceptable.

A real business turnaround is an imperative for MAS. The new environment will continue to hit MAS hard. The projections for MAS for 2006 look dismal. *In fact, on its current business assumptions, course and speed, MAS will likely fail*, running out of cash in April 2006, and reporting a RM1.7 billion loss for 2006.

The management team, and our staff, however, believes strongly in our ability to transform the business and, indeed, to go beyond expectations. MAS has done much to improve its performance over the last 5 years, and indeed last year. We have much to be proud of, and this work will form the foundation of our success.

With hard work, radical changes and some tough decisions, MAS can certainly be a survivor and a winner. Since early December 2005, the management team has dedicated itself to the development of a plan that builds off the actions taken by the Board in 2005 to begin the turnaround. This turnaround plan will not only reverse the loss and return MAS to profitability, but also transform the company into a strong and vibrant institution—one that is capable of withstanding external shocks and aggressively tackling new opportunities.

Our Business Turnaround Plan has been developed using the GLC Transformation Manual as a guide. It takes into account the recommendations in the manual and adapts these for implementation in MAS in the context of the business turnaround. The plan, outlined in this document, has five central thrusts, each symbolised by a tail of the venerable MAS symbol (Exhibit A). This plan will enable MAS to realise a net income of RM500 million in 2008—an all-time high profit for MAS—and to be well positioned to improve its net income even further.

[1] 9 months from April-December 2005

Exhibit A: ***The MAS Way***

The MAS Way provides the framework for our Business Turnaround Plan:

1. **Flying to win customers**—we will reconfigure our network and our product portfolio to ensure that we have the tools and capabilities to be a top-tier player in each of the markets we serve, or we will leave.

2. **Mastering operational excellence**—we will build a unique operating capability unmatched by our peers. This capability will be reflected not only in improved operational reliability, but also in higher productivity and greater precision in everything that we do.

3. **Financing and aligning the business on P&L**—we will relentlessly increase profits with the support of a world-class Finance function that ensures true financial accountability, transparency and performance orientation in our business.

4. **Unleashing talents and capabilities**—we are committed to our people. We strongly believe that the MAS employees and managers have both the passion and talent to achieve whatever goals we set for ourselves. We will work together with our employees to ensure that they have a working environment in which their talents can thrive.

5. **Winning coalitions**—we know that we cannot achieve our goals alone. MAS needs the resolute support of the Government, its employees, managers, customers, suppliers, agents and investors. It is only with the support of these stakeholders that MAS can have the mandate it needs to make the changes that will ensure our long-term success.

This Business Turnaround Plan has been carefully sequenced over the next 3 years to deliver cash, profitability and growth—in that order of intensity and focus. At the same time, we will continue to foster an environment that allows the talents of our people to be unleashed and to flourish.

In 2006, we are already undertaking a series of measures to raise RM4 billion in cash through internal and external sources to tide us through our current cash crisis. We are also tackling the biggest immediate profitability challenge for MAS: low yield. MAS has award-winning products and services, a competitive cost base, and a load factor that is only slightly below average, but we are still losing money because our yields are lower than those of our competitors.

In 2007, our plan will focus on improving efficiency and capabilities. In 2008, we will focus on new growth opportunities.

We are dedicated to the creation of a company that will be a source of pride and admiration for its employees and indeed all its stakeholders. The MAS of tomorrow will maintain its five-star product, have a competitive cost structure in the region, be renowned as being one of the best places to work in Malaysia, have closed much of the revenue performance gap to our peers and will return to profitability in 2007. We can do this, and we will.

Contents

Section		Page
A.	Impact of the MAS Business Turnaround Plan	1
B.	Current Environment for the Airline Industry	3
C.	MAS will Fail without a Business Transformation	15
D.	Transforming the Business—*The MAS Way*	23
E.	How We Will Do It: Our Business Turnaround Plan	31
F.	Execution of Our Plan is Under Way to Ensure Lasting Success	41


golden
PAS MASUK

Impact of the MAS Business Turnaround Plan

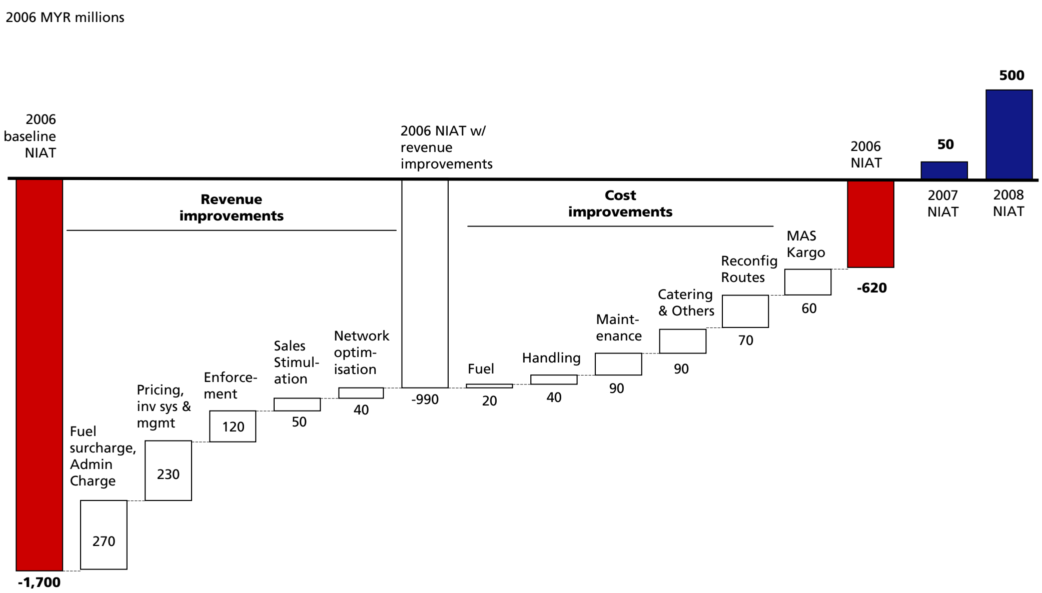
The Business Turnaround Plan will turnaround MAS in 2 years, following a series of specific cost and revenue actions, which will result in a profit of RM500 million in 2008—an all-time high profit for MAS—and position MAS to improve its net income even further

Starting today from a base forecast loss of RM1.7 billion, the forecast result for 2006 will be a loss of RM620 million—an improvement of RM1.1 billion. For 2007, the plan forecasts a further improvement of about RM670 million, resulting in a RM50 million profit (Exhibit B).

While MAS has award-winning products and services, competitive cost base, and only slightly below average load factors, our yields are dramatically lower than our competitors. Even though we currently have a competitive cost structure, our costs are rising and our productivity is low. Therefore, our immediate problem is one of low cash and low yield and, in the medium term, we will face a cost challenge.

For these reasons, the Business Turnaround Plan focuses on revenue and yield improvements in 2006, followed by cost reduction, network optimisation and growth. In the course of 2006, the groundwork for launching aggressive cost reduction and network review will be conducted and the impact on the P&L will be realised in 2007 and beyond.

Exhibit B: Profit turnaround—RM1.1 Billion Improvement in 2006



Current Environment for the Airline Industry

The MAS Business Turnaround Plan proposes bold actions, which together will drive significant improvements against a dismal base. Embracing these actions as necessary, rather than radical, requires an understanding of the industry environment that MAS faces.

ASIA AT THE FOREFRONT OF THE STORM, FACING INTENSE COMPETITION

The cold reality is that the airline industry is a tough business. Most markets eventually mature into intensely competitive arenas where very few players are able to earn consistent profits. Asian airlines have enjoyed a few years of excellent returns, reflecting relatively light competition, but the signs of deepening competition and worsening market conditions are now evident in Asia.

Indeed, the following is true of the current environment for the airline industry:

- Recent trends are leading to the worst global crisis the industry has ever seen.
- Airlines are radically restructuring their operations to survive—and clear winners will emerge.
- Asian carriers have been protected to date, but not for much longer.

Recent trends are leading to the worst global crisis the industry has ever seen

While the industry's structural dynamics virtually guarantee eventual crisis, a number of forces have conspired to bring on the deepest and longest downturn that the industry has ever seen. The collective impact of these forces is tremendous. Since 2001, the global airline industry has lost over USD36 billion[2]. This is of the same order of magnitude as the sum of its profits over the last 50 years.

The five main forces at work in the industry are as follows:

There has been a slowing of global Revenue Passenger Kilometre (RPK) growth

Airlines (and aircraft manufacturers) have traditionally based their forecasts on assumptions of relatively large ratios between RPK growth and GDP growth. For several decades, airline growth significantly outstripped economic growth. However, since the 1990s, airline growth in most parts of the world has become

[2] Source: International Air Transport Association (IATA)

more closely aligned with the economic growth. Nearly all additional growth in Europe, for example, has come from the Low Cost Carrier (LCC) segment. Unfortunately, several experts believe that RPK growth is slowing. Much of the growth of the last 40 years has been driven by price declines and increases in access (that is, a new service that makes it much easier to get between two points). Both of these drivers are reaching natural limits. Prices cannot go below zero—or are not likely to—and virtually every point in the world can be reached from another in less than 24 hours. Growth has masked many of the problems associated with rising factor costs. As growth slows, many previously buried problems have surfaced to add fuel to the fire.

An increase in pricing transparency is leading to commoditisation

In few industries are buyers as empowered as they are in the airline industry. First of all, buyers have nearly perfect information. Online search engines and the Global Distribution System (GDS) display all possible options and prices for a market pair, with price emerging as the central determinant of display priority—for example, the order in which options are displayed on a computer screen. Second, as the industry has relied on year-on-year price decreases to fund growth, the proportion of discretionary traffic has increased. Recent research suggests that as many as 70% of airline passengers are making trips that they don't need to make and are motivated by price alone. This has contributed to a paradox that perplexes casual observers: full planes and low fares. Despite the fact that planes are full, airlines are finding it increasingly difficult to raise prices as they fear that even a small price increase could significantly reduce demand.

Factor costs—particularly fuel—have increased

Between mid 2002 and late 2005, fuel prices increased by over 168%. The increase in fuel prices alone has added nearly USD64 billion to the industry cost structure.

Low cost competition is on the rise

In nearly every market we now see low cost (or at least low fare) competitors hoping to stimulate demand by dumping large numbers of very low price seats in core markets. These airlines are attempting to generate new pools of discretionary traffic. Even though these airlines do not explicitly target the business passengers from which mainline carriers make their living, they create a devastating residual effect. When low cost carriers drop leisure fares, they also typically remove restrictions such as advance purchase requirements or minimum stay. Because of this, mainline carriers are faced with a choice: either match these fares and conditions and lose valuable premiums from business passengers, who now have access to these lower fares, or continue to take premium fares from business passengers and risk losing significant market share in the leisure segment. Research shows that following the entry of a low cost carrier on a route, the profits of the incumbent carriers on that route decline by an average of 31%.

The frequency and impact from global demand shocks is increasing

The events of September 11, the SARS outbreak and the Gulf War have had devastating effects on the industry—in some regions, for example, demand over the short term has fallen by more than 30%. While it is arguable whether such tragedies are increasing in frequency, it is clear that when they do happen, these events will have greater and greater impact on our industry—especially as today as much as 70% of travel is purely discretionary. Simply put, many of our customers do not *need* to travel. In addition, with the current transparency and immediacy of global media, we end up with increasingly volatile demand. Airlines used to plan for demand shocks of up to 5 to 10%. Today, we need to have the flexibility and agility to react to demand shocks of up to 30% or more.

Airlines are radically restructuring their operations to survive—and clear winners will emerge

Airlines that are being hit by the crisis are faced with a choice: either radically transform the business or wallow in continued crisis. Those that have attempted incremental changes have floundered only to eventually find themselves being restructured by the courts as part of a bankruptcy proceeding. In the US, more than 50% of the industry capacity is operating under bankruptcy protection, including, for example, Delta Airlines and Northwest. In 2005 alone, United Airlines reported losses of US$21 billion. Those airlines that survive and win will have radically restructured themselves, leaving no assumption untested and no opportunity uncaptured. The good news from all this turmoil is that those who successfully manage the transformation will be positioned to dramatically outperform the rest.

Those who will emerge as winners will share the following four characteristics:

Winners will make dramatic staff cuts fueled by massive increases in labour productivity

Since 2001, airlines in the US have collectively cut staff by over 28%[3] while growing at 6%[4]. This implies a productivity increase of over 34%. Airlines in Europe have cut staff by similar orders of magnitude. These airlines are not simply asking staff to work harder; they have literally redesigned every process, looking for ways to eliminate waste. At Delta Airlines, for example, a narrow-body aircraft is now deplaned and boarded by less than one single gate-agent (one agent greets the plane, then moves onto another task; another agent arrives 30 minutes before departure to manage the boarding process). The use of lean manufacturing techniques in areas such as maintenance have allowed airlines to increase unit productivity by over 30% by redesigning how basic tasks are done. These changes have been hard to achieve, but ultimately result in leaner and healthier airlines.

Winners will make across-the-board wage cuts

Since 2001, airlines in the US have reduced employee wage and benefit costs by over 35%[5]. In addition, they have dramatically altered the mix of full-time, part-

3. Source: BTS
4. Source: Form 41
5. Source: Herald Tribune

time and temporary employees. The goal is not just to reduce wages one time, but to create an employment structure that is capable of holding costs constant over time. It is clear that in an industry where prices decline by 2% year-on-year on a real basis, continuously rising labour costs—through both wage increases and the natural aging of the workforce—is unsustainable.

Winners will adopt widespread automation and outsourcing

Airlines have embraced technology, automation and outsourcing with vigour, looking to automate non-value activities such as check-ins and outsource non-core activities such as maintenance and call-centres. British Airways is in the process of rolling out web-based check-in for the entire system, with the goal of virtually eliminating the airport check-in process (and queues!) over time. Delta Airlines is outsourcing its maintenance, call-centres (to India), and certain ground handling tasks in an effort to reduce costs and increase accountability.

Winners make the tough choices about strategy

In the past, this has been an industry characterised by a near complete disconnect between product and network investment and return. Marketing departments have designed product specifications based on what they believed customers wanted and network structures based on where they believed customers wanted to fly. In recent years, airlines have been forced to take a much sharper line on these investments. Airlines in the US and Europe have been forced to recognise, for instance, that however much passengers might appreciate food on board, it does not influence the purchase decision for short-haul flights—and therefore can be seen as an investment with a negative return. Several mainline airlines now charge for food. Similarly, these airlines have rationalised their networks, focusing on destinations where they can earn acceptable returns, and looking to alliance partners to fill the void left by canceled routes. British Airways, for example, reduced its available seat departures by 7.4% over the course of the last 5 years while increasing its operating margin by 4.7 percentage points[6].

Asian carriers have been protected to date, but not for much longer

Many in the industry have recently pointed to Asia as a bright spot on the aviation horizon. Planes are full, many carriers have returned to profitability, and the aircraft manufacturer order books are filled with new planes to refresh the Asian fleet. Indeed many Asian carriers have recently enjoyed record profits: Singapore Airlines, Thai Airways and Cathay Pacific are all enjoying some of their best years.

However, it is increasingly clear that the factors that have lifted the performance of Asian carriers are transient, and that the ills that have affected airlines in the US and Europe are just around the corner.

The reason for this is because, while these airlines have certainly had to work hard to be resilient in the wake of the September 11 and SARS eras, much of their good fortune surely comes from the environment and, in particular, from the following four factors:

6. Source: British Airways' company reports

A dramatic rise in demand in most markets has outstripped supply growth

Demand from and to Asia from North America and Europe has grown rapidly—by 6% and 11%[7] respectively—since 2002, dramatically outstripping supply growth. Intra-Asian demand has increased by 40%[8] in the same period. The Asian economic recovery has been fast and full, leaving airlines to profit from excess demand.

Constrained capacity for growth in supply has kept that demand strong

In most markets, such an increase in demand would have been rapidly followed by supply growth. Asian markets have benefited from two constraints on supply. First, manufacturers' order books have been largely full. The wait for new aircraft ranges from 2 to 5 years, depending on the type. Over the next few years, significant capacity is expected to enter Asia. Second, many airports are still single-runway and slot constrained. These factors have combined to ensure that capacity growth has been relatively slow.

There are tight controls on competition

Most Asian markets (particularly North Asia) have tightly controlled competition. There has been, and will be, increasing liberalisation in Asia.

Asian countries have 'pro-business' labour laws compared with other regions

While many Asian countries have strong unions, the labour law construct allows businesses much more flexibility in doing what they need to do to ensure their viability. The use of contract flight crews, tenure limits on customer service staff, and limits on labour flexibility (the ability to move from one job to another) are all freedoms that would not likely be possible in the West. The labour law construct in Asia (except, perhaps, in Japan) has allowed airlines to keep cost growth in check as revenues have grown.

HOW MAS WILL BE AFFECTED

Many of the factors that have eroded profits in the West are emerging in Asia with some effect already felt. MAS, in particular, has been, and will continue to be, affected in the following ways:

There will be massive increases in capacity

Asian carriers (and carriers playing in Asian markets) have ordered massive amounts of long-haul capacity. The A380s and 777s ordered by Singapore, Emirates, Qantas and others will need homes quickly and will find them in the core routes across the region. Research suggests that the combined effect of this capacity could result in yield declines by as much as 7% in core markets by the end of 2008.

7. Based on passenger volume 2002-05. Source: International Air Travel Association (IATA)
8. Based on passenger volume 2002-05. Source: International Air Travel Association (IATA)

New markets will open

With the emergence of multi-national bargaining units and increased prevalence of open-skies agreements, governments around the region have been forced to adopt a much more open stance to foreign and local competition. The ASEAN open market, for instance, will yield new opportunities for small sub-scale carriers, as well as foreign flags, to operate point-to-point services over and around the hubs of the already crowded set of incumbents.

There will be increasingly difficult competition from foreign carriers now made much stronger by tough fights at home

US, European and Australasian carriers—never 'easy' competitors—have been forced to become much leaner by intense competition on their home turf. These carriers, with their lower cost structures, leaner processes and faster decision cycles will prove to be much tougher competitors than their former selves. As they look for new growth opportunities, they will look to the as-yet-untroubled skies of Asia as a prime target. In the late 1990s and early 2000s, many European and US airlines dropped service to Malaysia as their cost structures did not allow adequate returns in what has historically been a low yield market. When these carriers become leaner, they will be back.

There is intense low-cost competition at the regional level

New low-cost entrants are already eroding yields in regional markets, but the combination of excess investment funds interested in the space and the gradual opening of markets will lead to further proliferation and yield destruction. As we have seen in the US and Europe, not all of these new entrants will have rational or viable strategies. Some will choose to take on incumbents in core business markets and, perhaps, even long-haul. While low-cost players might not succeed in these markets, the more relevant fact for incumbents is that they will try. The fight will be long and hard, with devastating effects on business yields. Clearly, with the growth of Air Asia, MAS has been an early victim. But as Air Asia's fleet grows and it looks for new market opportunities, we can expect to see it attempt to enter MAS' core markets.

Economic growth will lead to increases in labour costs

The good news behind the Asian economic recovery is that it has fueled strong traffic growth. The bad news is that it has put pressure on cost of living and labour factor costs. MAS' labour costs have risen by 25% since 2003 with further increases requested by both suppliers and labour.

Maintenance and capital costs will rise as fleets age

Many Asian carriers have benefited from relatively new fleets. Significant fleet investment in the mid-1990s filled fleets with the then state-of-the-art Airbuses and Boeings. Unfortunately, those aircraft are now entering a more maintenance-intensive phase. MAS' fleet, for instance, is an average age of 7 to 8 years, which has resulted in a 10% increase in the number of annual heavy maintenance visits since 2001.

MAS is not alone in its exposure to these factors—to some extent, they will affect all of our regional peers, with some already being affected. To the south, Garuda has already entered crisis; it has recently stopped paying back debt and has signalled the need for radical structuring to be able to survive. To the north, Japan Airlines continues to struggle despite relatively healthy economic conditions at home (the airline reported a loss of approximately USD193 million for the 9 months to 31 December 2005). The combination of rising factor costs and a tough competitive environment has challenged its ability to earn profits. As large debt payments become due, Japan Airlines, too, will face difficult choices.

INDUSTRY PERSPECTIVE FROM THE CEO OF THE INTERNATIONAL AIR TRANSPORT ASSOCIATION

The future of the air transport industry is promising. Over 1.8 billion passengers travelled in 2004, with international passenger and cargo expected to grow at an annual rate of 6% until 2008. But the road ahead is challenging as air transport experiences its most difficult period. Following on losses exceeding USD30 bilion since Sept 11, soaring fuel prices will drive industry losses of at least another USD6 billion in 2005. For 2006, we expect to add another USD4.3 billion of red ink. With continuous cost reduction and efficiency gains, we may see USD6 billion profit in 2007.

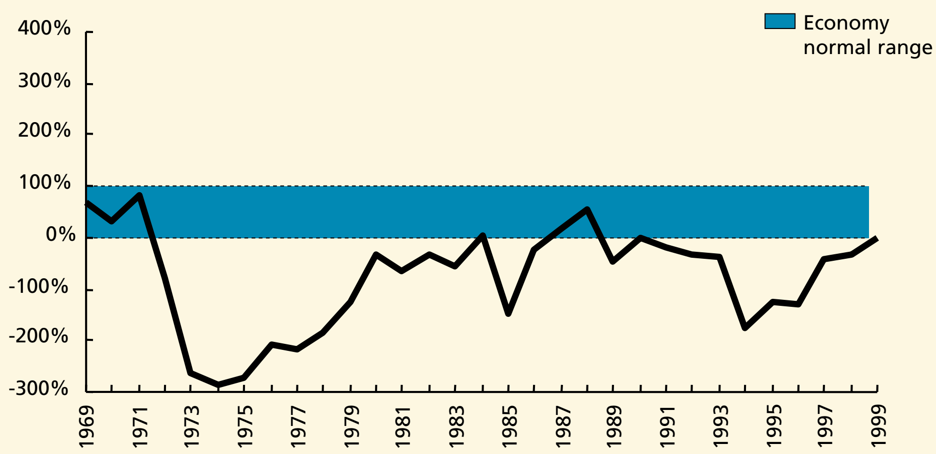
Mr Giovanni Bisignani
Director General and CEO
International Air Transport Association (IATA)

Airline Market Phases

MAS' current situation—urgent and grave—is, to a great extent, an outcome of the natural maturation of the airline industry in Asia. The airline industry is characterised by extremely poor returns over the course of its history (Exhibit C), with most markets eventually reaching a stage where radical restructuring is required in order for players to survive.

Exhibit C: Only airlines consistently underperform

7-year rolling normalised indexed Total Returns to Shareholders (TRS): US airline industry vs. economy



Source: Industry financial data

Many industry experts break-down the natural evolution of airline markets into four distinct phases (Exhibit D), each characterised by differing regulatory environments, competitive landscapes and customer behaviour. Economic performance, naturally, is an outcome of these market characteristics.

This four-phases framework helps provide critical context behind MAS' turnaround plan as it focuses us on the inescapable conclusion that MAS must radically transform itself in order to win in the current market environment.

Exhibit D: Airline market phases

	Phase 1: Limited competition	Phase 2: Emerging competition	Phase 3: Traditional competition	Phase 4: Intense traditional and non-traditional competition
Environment	Regulated	Deregulating	Deregulated	Highly deregulated
Supply & Demand	Supply < Demand	Supply = Demand	Supply > Demand	Supply >>>Demand
Customers	Loyal to the brand	Brand loyalty has to be bought	Shop around (lowest price, etc)	Highly choosy
Cost to serve	High	Medium	Competitive	Low
Price/ margin	High	Medium	Low	Very low
Profitability	Profitable	Breakeven/some profitable	Many unprofitable	Mostly unprofitable
	History	**Asia/ME**	**Europe**	**US**

Phase 1. In the early years of the airline industry, most markets were highly regulated. Governments dictated both pricing and supply on nearly every route. Most regulators had a similar objective: *to ensure profitability*. The consensus was that a healthy and profitable national airline was a critical component of national security and sovereignty. Regulators carefully allocated supply to ensure that prices remained high; that customers, facing few choices, remained loyal to the brand; and that, despite relatively little attention to costs, airlines earned profits. This so-called 'Phase 1 market' is now history as nearly every country and region has been forced to open its doors to competition.

Phase 2. While the regulatory policies associated with Phase 1 markets ensured healthy airlines, they constrained demand. Customers complained of high prices, and would-be competitors—eager to enter markets—complained of favouritism. The first action most regulators took to increase competition was to allow new entrants to compete on key routes. Capacity and, in some cases, pricing were still strictly controlled, but customers now had choices. In this second phase of airline market development, airlines needed to compete for customer favour through product and service features. The frequent-flyer program, business-class service, and plush lounges are all inventions of this phase. Despite increased competition and relatively high costs, most airlines in Phase 2 markets are able to earn reasonable returns as the regulatory control over market capacity ensures reasonably high prices. Most experts consider Asia to be in the late stages of this phase, with less-than-free competitive access to most markets and the competitive battlefield being played out along brand and product lines rather than cost lines.

Phase 3. In the early 1980s, the US began a complete deregulation of its airline market, with free access to nearly all markets and a complete release of pricing controls. Europe followed in the late 1990s/early 2000s. The US experience in the early 1980s is the archetype for this third phase. Multiple new players entered the market and supply quickly outstripped demand. The advent of the global distribution system (GDS) allowed customers the opportunity to shop around for the lowest price and the best schedule. The advent of price and schedule as key purchase drivers quickly turned the competitive battlefield into a size and cost game. That is, the airlines with the most flights and lowest costs were able to sustain themselves in a price- and schedule-shopped environment and outlast the competition. Europe is largely in Phase 3, with incumbents closely controlling costs while pursuing consolidation to maintain scale.

Phase 4. Unfortunately, it is now clear that the deregulated environment of Phase 3 leads to a natural end: new entrants proliferate—some free of the legacy costs (pensions, old-debt, etc.) that plague incumbents—and low-cost supply dramatically outstrips demand. To keep planes full, all players radically reduce price, and the resulting customer base, with its high mix of discretionary travellers becomes nearly 100 percent influenced by price. In this final, fourth market phase, it is only the player with the lowest cost that is able to make money. The only avenue to sustainable price increases is collaboration among the players to increase load factors through joint capacity reduction. It is clear that consolidation through mergers and acquisitions is a strategy that many winners will have to pursue.

As markets evolve through these four phases, the number of profitable airlines shrinks rapidly, with losses in Phase 4 easily outstripping profits in the first three phases of market growth (Exhibit E).

Exhibit E: Airline industry rapidly approaching highly unprofitable Phase 4

Phase 4

2004: -USD9.1 billion
2005: -USD10 billion

Example
- Delta and North West file for bankcruptcy protection (Chapter 11)
- United Airlines posted loss of $21 billion in 2005

Phase 3

2004: USD0.6 billion
2005: USD1.3 billion

Example
- Alitalia,Swiss, SAS, Malev posted losses

Phase 2

2004: USD3.2 billion
2005: USD1.5 billion

Example
- MAS, Japan Airlines, Thai Airways have posted losses
- SIA, Qantas and AirAsia profitable

'The industry will not see black ink until at least 2007',
IATA Director General, Giovanni Bisignani

Source: IATA

It is clear to us that Asia—and Malaysia in particular—is rapidly progressing towards Phase 4. The liberalisation of the ASEAN market has driven a huge explosion in local competitors while waves of new foreign capacity heads our way in international markets. Our pricing environment, already challenged, will only get worse. Given the clear pattern behind the scenarios playing out for other airlines around the world, we would be naïve to assume that MAS is immune from the storm. We must take bold, quick action to ensure our survival and our success.

MAS Will Fail without a Business Transformation

Clearly, we need to give credit to the hard work that has been done at MAS over the last few years, without which the crisis would likely have come sooner and been even more serious. In particular, the widespread asset unbundling program (WAU) in 2002 was able to trim the balance sheet to fix cash-flow problems and free up MAS to focus on core operations. In addition, as soon as MAS reported losses in the first half of 2005, the Board was quick to establish an Exco and launch a series of quick-win revenue initiatives. There are also many strengths to build on. But without a full business transformation, they will not be enough to weather the tough airline industry environment. Indeed, left to its current course and speed, MAS will fail.

A LOT HAS BEEN DONE—AND WE HAVE MANY STRENGTHS TO BUILD ON

MAS has several core strengths that can form the foundation of a vibrant strategy. These include the following:

MAS is a five-star brand

Our focus on service quality has earned the company the status of a top-tier global brand. In 2004, SkyTrax, the preeminent airline quality monitor, awarded MAS ‘Five-Star’ status—and MAS is one of only four airlines across the globe to have achieved this rating. This recognition follows four consecutive years of winning the 'best cabin crew' (also from SkyTrax). These SkyTrax awards are not anomalies. In 2005, TTG designated MAS as the ‘Best Airline to Asia’, and in January 2006, Travel Weekly, a UK-based travel periodical, awarded MAS the same status. Our employees continue to deliver outstanding service and the world is watching.

MAS has a loyal and captive customer base

As we interview our customers, particularly Malaysians, we are encouraged by the extent to which they are passionately loyal to MAS. This is not a luxury that all national carriers enjoy. In many cases the market power held by a local carrier results in animosity and frustration.

We have very strong technical skills and highly trained cabin crew

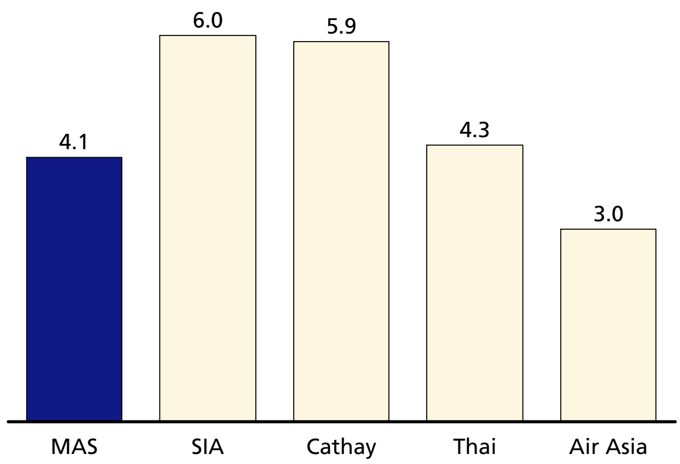
MAS' maintenance staff, flight operations staff and ground crew are world-class in their technical skills. Our strong safety record has much to do with our staff and crews' attention and capabilities. These skills are not just a source of strength for MAS, but also a potential source of revenue as MAS looks to broaden its business activities. Our cabin crew are highly trained and committed to excellent service—and our five-star rating owes much to their grace and professionalism.

We have some of the lowest labour costs in the region

The fact that we have low labour costs, a function of a comparatively low cost of living in Malaysia, is perhaps the most important 'building block' and something that we must strive to maintain (Exhibit F). Malaysia does not have the large base of business traffic enjoyed by our neighbours to the south and therefore it will be difficult to match them on absolute revenue performance. To be competitive, we must maintain a cost advantage.

Exhibit F: MAS is cost competitive

Cost/ASK, US cents



Source: ICAD, Annual reports

OUR STRENGTHS ARE NOT ENOUGH TO WEATHER THE COMING STORM

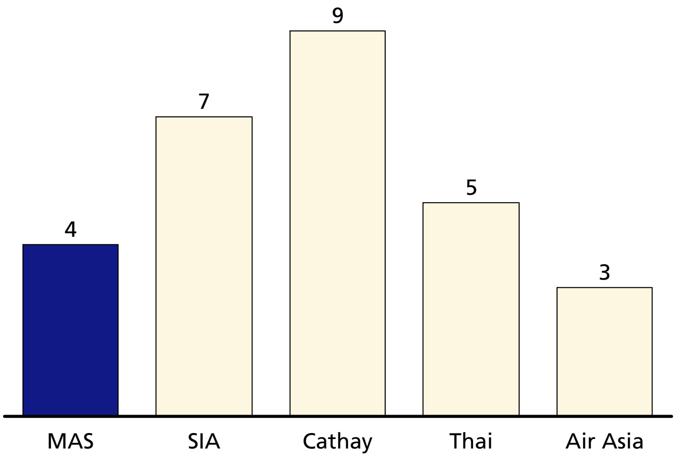
Despite the hard work that has been done to date, it is clear that MAS is not equipped to weather the coming 'storm'. MAS is currently in a much weaker position than our regional peers. There are five main reasons for this:

Our pricing power significantly lags the industry

MAS substantially lags its peers on yield—and this is our central issue (Exhibit G). Some of this gap is due to differences in traffic mix (less business traffic to and from Malaysia than to and from Singapore), but much of it is due to weaknesses in our pricing and revenue management, sales and distribution, brand presence in foreign markets, and alliance base.

Exhibit G: MAS has a real revenue disadvantage

Revenue/ASK, 2004, US cents



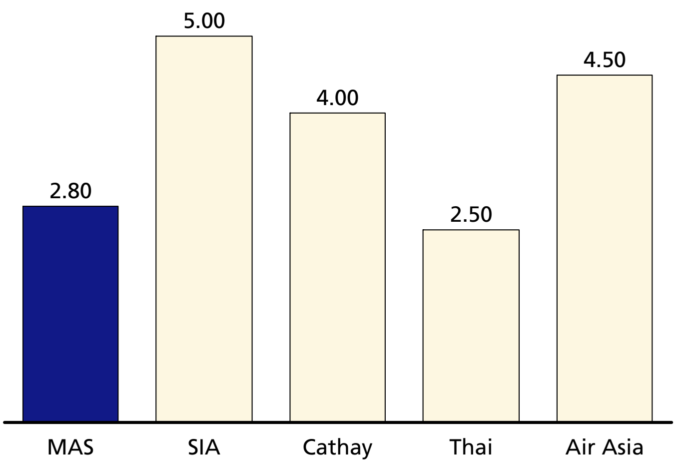
Source: ICAO, companies' annual reports

Our costs have risen out of control

Despite a low starting point, MAS' costs have risen by over 20% in the last year and show no signs of flattening. Furthermore, our productivity is at the low end of our peer group (Exhibit H).

Exhibit H: Labour productivity is low

ASK million/Number of personnel, 2004



Source: ICAO

We need to have much higher productivity than our peers to be able to survive and prosper in our smaller revenue environment. As our factor costs rise, we will see a disproportionate increase in costs unless we can become much more efficient with our resources. Of particular concern is our fixed cost base. MAS has millions of ringgit invested in some real estate and equipment through its offices around the world that do not directly contribute to revenue production.

Our current, and future, fleet and product are poorly matched to MAS' strategic realities

The markets in and out of, and around, Malaysia are relatively small. However, the MAS fleet is predominantly made up of some of the largest aircraft in their class, putting it in the league of the leading international airlines. In addition, we have produced one of the world's most attractive products by upgrading our cabins—generous seat pitch in economy and business, and a flat bed in first class. Unfortunately, our higher costs have not been offset by stronger yields or loads. Given the limited business traffic, we are more dependent on low yield connecting traffic, and as our aircraft have relatively few seats in them, this drives up unit costs. A MAS 777-200 has only 247 seats in economy, compared with 293 in Singapore Airlines.

MAS lacks a disciplined performance culture

Discussions with our managers and employees have made it clear that today MAS does not have the leadership, accountability or teamwork needed to survive and prosper in this more challenging environment. One external analysis suggests that MAS needs approximately 300 more leaders. Potential leadership talent definitely exists lower in the organisation but it has not been unleashed through the right opportunities. We are also a company with relatively little experience with accountability. Based on our internal employee survey last year, our employees report little confidence in the management team and our managers report that they do not feel that there are any repercussions for staff who miss targets and deadlines or who do not meet key performance indicators (which have recently been adopted). Further, our people tend to be jealous of success, rather than being inspired by it. Simply put, MAS will require a significant organisational overhaul to be able to survive in the new world.

There are significant social and political obligations

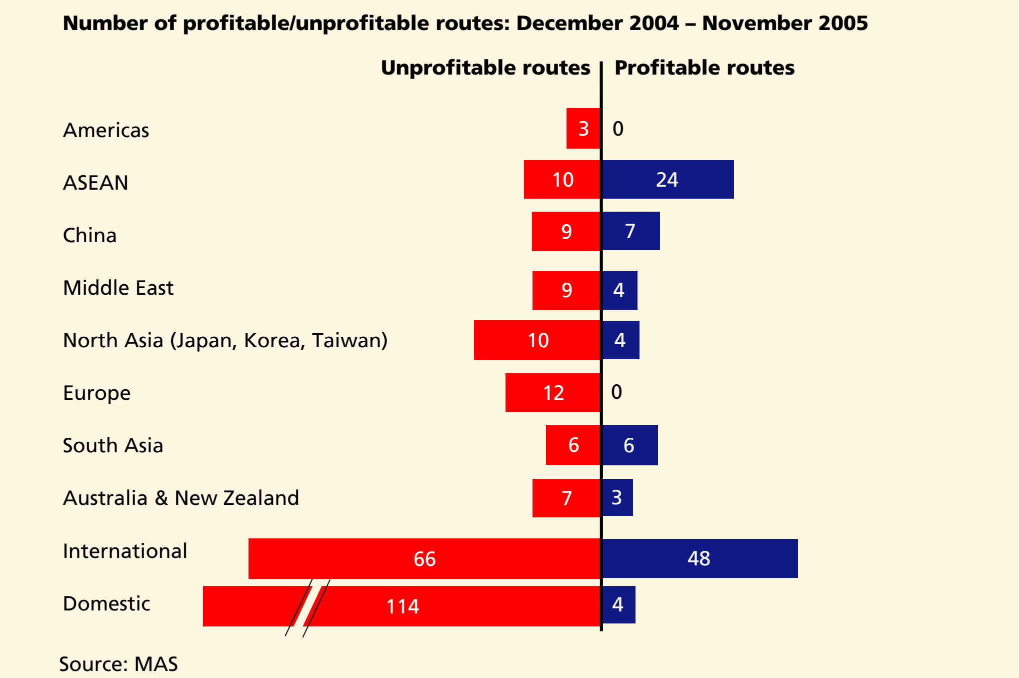
The pundits are of the view that political and social obligations present the most overwhelming and significant constraints to our ability to transform the business. As a largely state-controlled airline in a regulated industry, it is argued that MAS does not always have the freedom to act according to pure market principles. MAS is constrained from freely changing destinations, routes and pricing within its domestic sector. And even though there are no explicit constraints on the international routes, MAS might not have full flexibility to make changes to destinations, schedules or pricing. For example, flying to Vienna costs MAS approximately RM30 million per annum[1] in losses and it is

1. Based on October 2004 to September 2005 figures

MOST ROUTES ARE LOSING MONEY

Our poor pricing, rising cost structure, mismatched fleet, weak operational performance, low-intensity performance culture, and social obligations all contribute to our dismal financial performance across most routes we fly. We estimate that about 60% of our routes are not profitable on a fully cost allocated basis (Exhibit I). While most airlines have a mix of profitable and developmental routes, MAS loses money on the bulk of its network. Most importantly, this means that we lack the core 'profit engine' that can help to fuel experimentation and expansion into new frontiers.

Exhibit I: Most routes are losing money



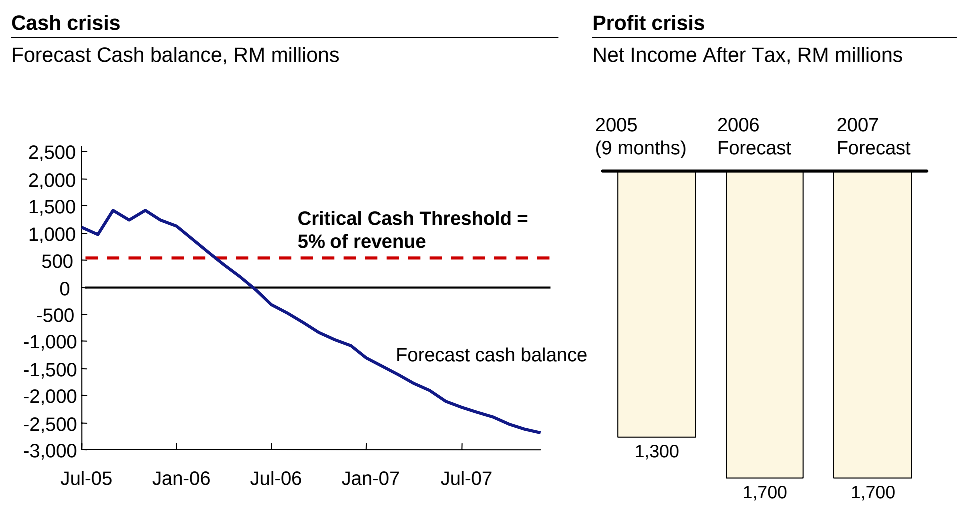
unclear if MAS can simply exit this route. We are committed to serving the nation and enhancing the country's economic prosperity, and serving the market as we do today certainly meets the national interest, but it does not necessarily fulfil our commercial interests. In moving forward, both the Government and MAS need to establish a workable mechanism to ensure that both the social objectives of the Government and the commercial objectives of MAS are catered for. To this end, the interests of MAS and the Government will be guided by the principles laid out in the GLC Transformation Manual issued by the Putrajaya Committee for GLC High Performance.

ON ITS CURRENT COURSE AND SPEED, MAS WILL LIKELY FAIL

In early December 2005, the MAS management team engaged in a comprehensive forecast exercise. We did not try to paint a picture that was either worse or more rose-coloured than the most likely forecast. We did lay out our known obligations over the next 3 years against a number of reasonable 'revenue scenarios'.

This exercise clearly demonstrated to us that MAS is not just 'having a bad year', but that in fact it is in a fast descent towards insolvency (Exhibit J).

Exhibit J: Under current course and speed MAS will fail



Source : Team Analysis

Under reasonable business assumptions—MAS' traffic growth in line with industry, stable yield in most markets, fuel at USD78/bbl, and further cost increases—and based on MAS' current course and speed without any business turnaround, we forecast the following results:

Losses will amount to RM1.7 billion by 2006

Without strong and decisive action, MAS' losses will continue to grow. Natural factor cost growth and new obligations such as new aircraft, facilities and product enhancement, combined with the effect of new regional capacity on revenue, will cause costs to continue to increase sharply while unit revenue continues to fall.

We will run out of cash by April 2006

Under current course and speed, the airline would have hit a critical cash threshold of 5% of revenue by April 2006. (As part of the Business Turnaround Plan, however, we have already taken steps to avert this cash crisis.)

We will enter a downward spiral from which we are not likely to recover

Should these losses and cash drain continue, MAS would enter a downward spiral from which it would not likely recover. As suppliers become nervous about our ability to pay bills on time, they will cut us off or require pre-payment, exacerbating the cash problem. Continued losses will further damage our credit rating and cripple our balance sheet, eliminating our ability to invest in new products, talent, aircrafts and markets. Our customers, also nervous about our ability to deliver against commitments, will seek other alternatives.

The Prime Minister has clearly said that the 'Government is committed to MAS', but he has also been clear, and right, in stating that the 'Government will not bail MAS out'. The Prime Minister has stated that MAS has to first demonstrate that it is doing all it can to turnaround the airline; MAS has to work towards maximising internal generation of cash and improve its profits drastically. The Government would then provide appropriate assistance to raise any shortfall with financial structure and tenure that would be 'win-win' for both the Government and MAS.

Transforming the Business 'The MAS Way'

MAS' mission is to be a profitable airline. Make no mistake about this: our primary obligation to the Government and all other shareholders is to drive top-tier financial performance. Everything we do must be designed to achieve that objective. We also have a responsibility to the country to help promote national growth and development, and to do this we must first be profitable. A healthy profitable national carrier is an important part of a country's economic prosperity. Business people, tourists, students and workers alike require frequent, non-stop access to the rest of the world to be able to expand their markets and their horizons.

MAS' vision remains the same: Going Beyond Expectations—particularly, the expectations of our customers, shareholders and employees. Our cost-base, talent-base, and service reputation will be our core competitive strengths as we seek to connect customers around the world to and from Asia and beyond.

To achieve our mission and our vision, MAS will transform the company along each of the five thrusts of *The MAS Way* and MAS will 'look and feel' very different to what it does today (Exhibit K).

Exhibit K: ***The MAS Way***

1. FLYING TO WIN CUSTOMERS

As we work on this thrust, we will construct a focused commercial platform that is capable of consistently winning in the marketplace. Due to the small size of our home market, MAS will not likely reach the scale of our neighbours to the north and to the south. What we lack in size we must make up for in agility. We will build a market-facing capability that allows us to out-manoeuvre our peers in the markets in which we choose to compete. Customers will choose MAS because of its products and services, flight timings, prices and promotions, not because it is the only game in town.

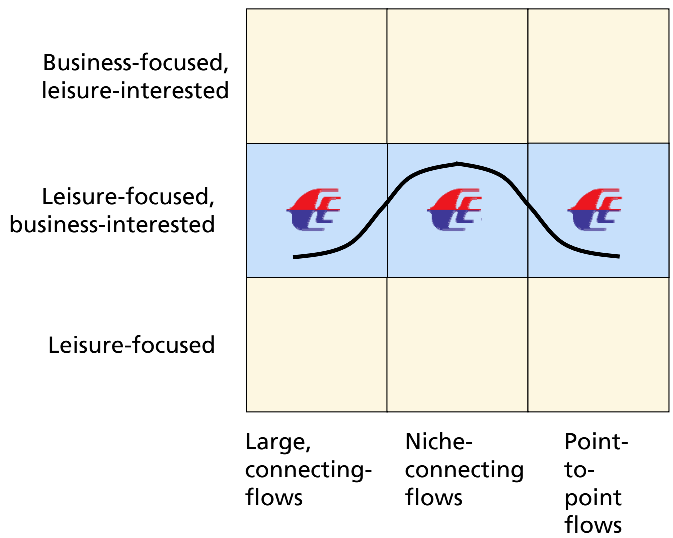
For MAS to 'fly to win customers' we will fundamentally change our customer focus and our network configuration in four ways.

From 'business-focused' to 'leisure-focused *and* business-interested'

Our recent investments in large aircraft with low seating-density and top-range products implicitly suggest a focus on large, business point-to-point connecting flows. The reality is that Malaysia's premium traffic to and from Malaysia is too small to fund this investment. For example, the European business traffic to and from Malaysia is less than half of that to and from Singapore or Bangkok.

Given our existing fleet and market realities, MAS must increase its competitiveness in key connecting flows and re-embrace leisure traffic (Exhibit L). This does not mean that we will compromise the quality of our business offering. On the contrary, we will maintain and improve the quality of those products over time. But it does mean that we recognise that our competitiveness in the leisure segment will emerge as the key driver of our profitability. We will fly only where there are large attractive flows of leisure customers. The premium cabins will provide us with much needed 'gravy', but they will not carry the day.

Exhibit L: Not all options are viable for MAS



From a 'largely point-to-point carrier' to a 'world-class connecting carrier with a major hub in KLIA'

The proximity of Singapore and Bangkok to Kuala Lumpur makes it difficult for MAS to carve out connecting flows in the regional and key markets that our competitors cannot match. Still, to increase our ability to fill our aircraft, we must ensure that we are playing in markets large and broad enough to fill our seats. We will concentrate on markets that we can win, with some reinvestment from those that we cannot. We will also adjust the structure of our schedule in KLIA to ensure that we can connect as many core markets together as possible.

For long haul routes, we will shift from a 'point-to-point' network towards a 'hub and spoke' connecting network. This transition will be done only after we have negotiated bilateral/code share arrangements with other airlines feeding a few MAS foreign hubs. In doing this, we will be able to intensify flight frequencies on our chosen trunk routes. We should be able to increase connecting traffic flows into these foreign hubs from other airlines as feeders into our trunk routes. In this way, we will reduce our variable and station costs while increasing our reach.

From 'lightly-configured large aircraft' to 'densely-configured smaller aircraft'

To win in the leisure-focused, business-interested space, we will decrease the size of premium cabins, increase the density in economy cabins, and eventually reduce the average aircraft size. Our future fleet will comprise aircrafts that are smaller and more fuel efficient. This will allow us to provide regular services to those destinations that we choose to serve.

From 'high product spend and distribution cost' to 'lean product cost and distribution cost'

Much of the economy class market across Southeast Asia is price-sensitive. In addition to our service being impeccable, our schedule convenient, and our operations reliable, we must also cut back on extra services that our customers are not willing to pay for. Furthermore, current trends show that customers increasingly use the internet and call-centre channels to buy airline tickets, so it will be important that MAS positions itself well in these distribution channels.

2. MASTERING OPERATIONAL EXCELLENCE

This thrust reflects our belief that MAS must have a superior operating capability to out-operate and out-last our peers. This capability will consistently deliver excellence in everything that we do, and be reflected in four fundamental shifts in our operating performance and efficiency.

From 'highly variable operations ' to 'precise low-error operations'

As we grow, we will deliver more consistency, more quality and more precision than anyone else. Flying MAS must 'feel' different. Everything we do will be on time, according to specifications and to cost. We will reflect this precision not only in our operating performance—better on-time arrivals, fewer lost bags—but also in our customer experience—shorter lines, greater consistency. We will treat every task, from checking-in a passenger to unloading a bag, with the same discipline and with a goal of eliminating waste, variability and error.

From 'year-on-year cost increases' to 'ruthless, year-on-year, cost efficiencies'

We firmly believe that the only way MAS can strategically differentiate itself in the region is to maintain a cost-advantage over our competitors. Increased capacity in the region from Emirates, Etihad, Qantas, Singapore Airlines and others will further lower prices and put pressure on MAS' operating margins. Furthermore, as our factor costs rise, we will offset those increases with even greater increases in productivity to continue to maintain our regional cost advantage. This must come from stronger cost controls, superior labour and asset productivity and more efficient processes.

From 'over staffed and low productivity' to 'leaner workforce and high productivity'

As our labour productivity is lower than competitors, we will need to be leaner to reach our goal of increasing employee productivity. In the future, MAS will definitely be run with fewer employees per unit of capacity. We will work with the Government to find ways to smooth the transition to become leaner and more efficient.

We recognise the pain that staff rightsizing can inflict and will view this only when:

- Government has completed its review of the domestic aviation policy
- MAS has completed its route profitability initiatives and has exhausted all avenues to turnaround its unprofitable routes.

Depending on the above, we envisage that we will be in a position to make a firm decision about this matter from 2007 onwards.

From 'entitled suppliers' to 'sharing both the risks and rewards'

Suppliers who look to MAS as a cash-cow will find themselves out of a contract. We will build a supplier base that is aligned with our aspirations, well integrated with our operations, and willing to partner us in seeking continuous improvement for mutual benefits.

3. FINANCING AND ALIGNING THE BUSINESS ON THE P&L

This thrust reflects our need to ensure that MAS has the balance sheet, cash reserves and financial structure to be able to withstand any market shock and that it is able to tackle new opportunities. To achieve this, we will focus all our people on single-mindedly increasing profits with the support of a world-class Finance function.

From 'focused on image' to 'focused on profit'

Our decisions must be anchored on the company's profit—not political favour, not our image, not the latest aircraft and technologies, and not our stature in the international community. If it does not help us make more money, we will not do it. You can expect that we will re-focus on routes, businesses and activities where we can make money. If we need to, we will shrink, as we will limit our reach to where we can win. We will make every effort to turnaround each part of our business and we simply will not operate where we cannot make money.

From 'reviewing operational performance' to 'intense business performance management'

Historically, MAS has focused on monitoring operational performance—and this is important to maintain, but it is not enough. Going forward, the leaders of MAS will be made accountable for specific financial targets, and performance against targets will be transparently reported and challenged every month by the Managing Director and the leaders of MAS. Any shortfalls will be scrutinised immediately and early corrective action will be taken.

From 'Accounting' to 'a world-class Finance Function'

We need a world-class Finance function to ensure that all our people and our decisions are anchored on the P&L. The Finance function will consistently deliver proactive target-setting based on external benchmarks; insightful, intense and transparent daily/weekly/monthly monitoring of key performance indicators; reliable forecasting; rigorous financial evaluations of major decisions; active management of cash and working capital; and commercial management of fuel-hedging and risk.

From 'unprofitable' to 'sustainable profits'

MAS cannot remain unprofitable if it is to succeed within the increasingly challenging Asian airline industry. We will return MAS to profitability over 2 years, and ensure it is in a position to sustain profits.

4. UNLEASHING TALENTS AND CAPABILITIES

We strongly believe that our employees represent our most important asset. As we talk to our employees and managers we consistently see passion, energy and drive. In this thrust, we will make four fundamental changes in our working environment so that we can harness and direct this passion and drive and so that our people can thrive.

From 'administrators' to 'leaders'

We do not want 'administrators' to take up leadership positions. We want only leaders who *deliver breakthrough performance* such as turning around an unprofitable route, substantially increasing yield, dramatically improving on-time performance, or significantly improving fuel efficiency. There could be these types of leaders at every level of MAS today, and we will create more room for this exceptional talent to step-up and deliver breakthrough results—regardless of their seniority, education or background.

From 'entitled employees' to 'real accountability and performance culture'

MAS will no longer be just a nice place to work, but also an intense and dynamic one where only performance and high values/integrity matter. We will generously and immediately reward those who perform and success will be celebrated, without jealousy. MAS will not offer a 'job for life' because we will ask those who do not perform to leave.

From 'silos' to 'cross-functional teamwork'

Silos are typical in complex network businesses like MAS, where most decisions involve the input of many functions. But a silo culture is also the reason why many airlines fail. We will work increasingly in cross-functional teams and hold people accountable for cross-functional results. For example, we will hold people accountable for route profitability—an opportunity that cuts across the Sales, Pricing, Network and Operations functions.

From 'opaqueness' to 'transparency'

We will be transparent with our people. In turn, our people will behave with real integrity, and be transparent in their interactions with each other and our stakeholders.

5. WINNING COALITIONS

We know that we cannot achieve our goals alone. MAS needs the resolute support of the partners, government, its employees, managers, customers, suppliers, agents and investors. This thrust is focused on fundamentally transforming how we work with stakeholders to ensure that national and community needs are met while still providing MAS with the room required to operate profitably.

From 'flying solo' to 'winning partnerships'

We will cooperate much more closely with Air Asia domestically (for example, by sharing maintenance facilities); with international airlines (for example, through alliances); and with Malaysian business partners (for example, through joint loyalty programs with other government-linked companies).

From 'reactive' to 'proactive engagement with stakeholders'

We will proactively engage with all our stakeholders about our results, our issues, our plans, and about what we do and why. We will also demand that all our stakeholders do the same for us.

How We Will Do It:
Our Business Turnaround Plan

MAS cannot achieve is strategic vision without first executing a fast and sustainable turnaround. Over the past 3 months, the MAS management team has developed a comprehensive and actionable plan to return the company to profitability and create a company that exceeds the expectations of its customers, employees and shareholders.

In developing this plan, we built upon the Board's recent turnaround initiatives and we interviewed hundreds of employees, managers and customers to clarify our priorities, identify our constraints and understand what it will take to succeed. We also studied external case examples of airline turnarounds for insight into their key success factors. Learning from those discussions, we have designed a plan that is:

Fast and decisive

Our employees will focus on clear P&L results, not just activities. There is no time for projects with long lead-times that only pay off years down the track. We will build capabilities while we work, but we must focus on actions that will deliver quick and fast results.

We will also be expeditious in our decision making. In any turnaround, there will be tough, and sometimes painful, decisions to make. We are prepared to make those decisions quickly, with an adequate and reasonable level of analysis. In our review of failed airline turnarounds, it was procrastination, more than anything, that got in the way of creating impact.

Focused

There are, no doubt, hundreds of new and existing opportunities that MAS could exploit; however, we will focus on what will deliver results.

We have also carefully sequenced the turnaround plan over the next 3 years to deliver cash, profitability and growth—in that order of intensity and focus. The initial initiatives will focus on quick, high-impact changes that drive immediate improvements in cash flow and yield with minimal investment. This focus reflects the fact that MAS is in a cash and P&L crisis. Simply put, we need to stabilise the patient before surgery. This will take up to 12 months through to the end of 2006. Once the airline is stabilised and the financial crisis is behind us, more intensity and focus will be given to profit turnaround and capability building. Thereafter, we will begin to aggressively tackle growth through new opportunities.

Fully supported by management

We are aligned as a management team, both among ourselves and with our stakeholders, as to the direction and implications of the plan and the risks we are taking. The plan will be clear and transparent to our employees and stakeholders. Every action must be led, guided and communicated in context of one of the plan's five thrusts.

Consistent with GLC Transformation guidelines

The MAS Business Turnaround Plan has been developed using the GLC Transformation Manual as a guide. It takes into account the recommendations in the manual and adapts these for implementation in MAS in the context of the business turnaround.

Our Business Turnaround Plan—*The MAS Way*—is built on five main thrusts. Over the coming years you will see perhaps hundreds of actions, but the five thrusts will not change—we will remain focused and structured in our actions. Below are the main actions for each of the five thrusts.

* * *

1. FLYING TO WIN CUSTOMERS

Over the next 3 years, we will fundamentally change our customer focus, our products, our pricing, and our network configuration to fly profitably. Actions under this thrust will focus initially on tactical marketing efforts to raise revenue quickly and to address our financial crisis. In year 2, we will selectively build our revenue management capabilities to squeeze every last ringgit of opportunity from the marketplace and redefine our products and services. Finally, in year 3, with the support of alliance partners and investment in new aircraft, we will launch new products and new destinations.

	Business Turnaround		Growth
Thrust	**Actions for months 0-12: cash and revenue**	**Actions for months 9-24: costs and building capability**	**Actions for months 24-36: new opportunities**
Flying to Win Customers	Overhaul Pricing and Revenue Management to drive increased revenue performance from our current network	Renegotiate selected code-share and Sale Purchase Agreements (SPAs) to ensure that MAS gets its fair share of partnership revenues	Join an international airline alliance
	Launch route turnaround labs to drive accountability and action in foreign points-of-sale	Build a 'bond-trader'-like capability in our Revenue Management group	Launch new branded fares to help sustain yield premiums
	Launched a focused effort to improve consistency in the customer experience	Redefine product and service features to further build our brand and align cost with value	Launch new products and services to maintain our competitive position in the region
	Re-optimise the current network and fleet portfolio with a focus on ensuring the right aircraft is going to the right market at the right time	Launch new frequencies to existing markets	Launch new destinations to begin expanding the network
	Reconfigure aircraft to ensure optimal mix of classes (economy, business, first)	Rationalise the fleet (retire older aircraft), further refine configuration	Order new aircraft
	Launch tactical campaigns to drive increased agency sales	Accelerate direct bookings (internet, call-centre)	
	Enhance fee-based revenue streams (admin-fees, excess baggage collection)		

FLYING TO WIN—CARGO BUSINESS

MASKargo was initially forecasted to generate RM47 million in profit in 2006. A lot of work has been done in the last few years to improve the profitability and performance of the cargo business in MAS. But no area of MAS is without additional opportunity, and the Business Turnaround Plan targets a profit of RM107 million for cargo in 2006.

About half of the RM60 million increase in profit in 2006 will come from improving yield and revenue. We will optimise capacity and enhance peak-period pricing, launch limited Express products (restricted to prime sectors), and increase the domestic freight rates and introduce fuel surcharges.

From 2007, we will implement a 'fix, sell, close' strategy for MASKargo. We have conducted initial profitability analysis of each cargo route. We will quickly act to apply all profit improvement levers to each route. Routes that can be saved will be. Routes which cannot will be sold or closed.

2. MASTERING OPERATIONAL EXCELLENCE

Over the next 3 years, we will significantly improve our productivity and fundamentally improve the way we do everything. In year 1, the actions under this thrust will allow us to get a grip on our costs by containing the cost budgets while aggressively renegotiating supplier contracts and driving fuel efficiency. In year 2, we will focus on fundamentally redesigning our core processes in operations and the corporate centre, while building a distinctive 'lean manufacturing' operations capability that delivers high productivity levels across MAS. In year 3, we will focus on partnerships with staff and in-sourcing arrangements with other airlines.

	Business Turnaround		Growth
Thrust	**Actions for months 0-12: cash and revenue**	**Actions for months 9-24: costs and building capability**	**Actions for months 24-36: new opportunities**
Mastering operational excellence	Renegotiate key supplier contracts	Implement 'lean manufacturing' principles in Maintenance to increase productivity and shorten turnaround times	Explore in-sourcing opportunities
	Drive fuel-efficiency through changes to load-planning, flight-planning and crew practices	Redesign crew work-rules for improved productivity and lifestyle	Engage in risk-reward sharing partnerships with flight-crews to drive increased performance and collaboration
	Launch exercise to force quick reductions in budgeted expense across all areas	Redesign key airport processes to reduce staff requirements, shorten lines and improve customer experience	
	Launch operational precision effort to improve focus on on-time performance, safety and reliability	Redesign the aircraft turnaround process to enable shortened turn-around times and increased aircraft utilisation	
	Launch focused effort to improve baggage delivery	Optimise corporate and central overhead structures to reduce staff requirement, speed decision-making processes and increase accountability	

3. FINANCING AND ALIGNING THE BUSINESS ON THE P&L

Over the next 3 years, we will anchor everything we do on the P&L. Initially, we will focus on cash-generation, including the disposal of key non-core assets such as property, and ensure we have a substantial cash infusion to be able to successfully execute the plan. In year 2, we will revamp the Finance function and optimise our business portfolio, creating bona-fide business units, with P&Ls out of our services businesses and 'spinning off' those that might perform better in the hands of others. In year 3, we will look for new sources of financing, making strategic investments and further optimising the business portfolio.

	Business Turnaround		Growth
Thrust	**Actions for months 0-12: cash and revenue**	**Actions for months 9-24: costs and building capability**	**Actions for months 24-36: new opportunities**
Financing and aligning the business on the P&L	Form robust program-management office, hard-wired to the P&L	Revamp the Finance function to improve transparency, formalise performance management and drive increased accountability	Spin-off/monetisation of non-core businesses
	Take near-term cash survival actions — Working capital — Non-core assets — Capex rationalisation — External financing	Redesign revenue-accounting function, consider outsourcing	Secure strategic investments in new businesses to strengthen the balance sheet and reduce cash-flow volatility
	Improve cash-flow and P&L reporting	Create separate visibility around business-unit P&Ls	

4. UNLEASHING TALENTS AND CAPABILITIES

We will transform the way we work together over the next 3 years. In year 1, we will establish a new leadership team and get basic people policies, processes and agreements in place. Year 2 will primarily be about streamlining our workforce while revamping the HR function to deliver succession planning, and an intensified performance management approach that ensures that our top employees are rewarded handsomely for their efforts. Finally, in year 3, we will develop innovative leadership development programs and new work rules to improve both productivity and employee lifestyle.

	Business Turnaround		Growth
Thrust	**Actions for months 0-12: cash and revenue**	**Actions for months 9-24: costs and building capability**	**Actions for months 24-36: new opportunities**
Unleashing talents and capabilities	Establish new leadership team	Rightsize manpower (depending on Government's decision on domestic aviation policy and route profitability initiatives)	Implement new job designs, and employment constructs
	Launch rough and ready performance management of top leadership and front-line, with meaningful rewards and consequences	Revamp HR function and implement new HR system	Formalise empowerment down to the front-line
	Move head office to create single, coordinated space for all decision-making	Redesign training programs	Formalise leadership development program
	Launch clear whistle-blower policy to bring immediate transparency to fraud	Ensure clear succession plans for all key positions	
	Sign new collective bargaining agreement with all unions	Launch Employee Share Option Scheme (ESOS)	
	Launch new staff intranet to improve communications		

5. WINNING COALITIONS

We will work with partners, the Government and other stakeholders to ensure that national and community needs are met while providing MAS with the room required to operate profitably. Actions under this thrust will include our efforts to redesign the domestic aviation policy with a goal of either fully compensating MAS for loss-making routes or sharing or transferring the responsibility to others in the market who have a cost structure better suited to the task. We will also take an active role in regional discussions around the opening of markets and we will work with our unions to ensure delivery of success.

	Business Turnaround		Growth
Thrust	**Actions for months 0-12: cash and revenue**	**Actions for months 9-24: costs and building capability**	**Actions for months 24-36: new opportunities**
Winning coalitions	Work with Khazanah to manage social obligations	Engage in active management of the regional regulatory agenda	Partnerships with regional/international airlines
	Work with the Government to redefine domestic aviation policy	Engage with unions	
	Leverage GLC relationships for new JVs, business opportunities	Launch affinity/co-branded cards with Telcos, Banks	

RADICALLY RESTRUCTURING THE DOMESTIC SECTOR

Under the current WAU regime, Penerbangan Malaysia Berhad (PMB) owns the profit and loss (P&L) statement for the domestic sector and MAS operates the sector on behalf of PMB. PMB and MAS agreed upfront on an annual budget with projected revenues, costs and income. When MAS succeeds in outperforming the agreed annual budget, it receives an incentive: 20% of the incremental business values generated. In 2005, PMB has incurred financial losses for the domestic sector.

Against this background, the Government is currently reviewing its Domestic Aviation Policy. There are three options:

1. Maintain status quo—MAS continues to operate and run the domestic aviation sector on behalf of PMB.
2. Air Asia takes over the domestic sector from MAS and the two companies agree to collaborate on route connectivity—a prerequisite for this is that Air Asia will have to radically restructure the domestic sector operation handed over from MAS.
3. MAS takes over the P&L responsibility from PMB and operates the domestic sector—for this to happen, MAS has to radically restructure its business to make it profitable.

Various discussions have taken place between the Government, Khazanah, MAS and Air Asia. The Government does not prefer Option 1 because of the financial burden that this entails. Consequently, MAS has decided through these discussions that it would pursue Option 3.

MAS could take over the P&L responsibility for the domestic sector from PMB from 1 January 2007. To do this, MAS would require the prior agreement of the Government to the following conditions:

1. MAS has the same freedom as Air Asia in determining the destinations, schedules and fares for its routes, and consequently the size of its network, fleet choice and seat configuration.
2. The Government gives MAS a free hand in restructuring its business and restructuring costs are paid by the Government.
3. The Government continues to provide financial support for Rural Air Services and Fokker 50 routes. The Government also provides financial support on any other social routes that they mandate.

It should be noted that if Air Asia take over the domestic sector from MAS, they have confirmed in our discussion with them that they would require conditions 2 and 3 above.

In 2006, with the consent of the Government, MAS will increase domestic prices for the first time in 13 years, implement an Administration Fee (RM14 per person) in line with Air Asia's practice, and pursue cost reduction programs. These initiatives will help to defray the losses incurred by PMB in 2006. At the same time, MAS might radically restructure its domestic sector operation so that it is in a position to take over the P&L responsibility on 1 January 2007.


golden club

Execution of Our Plan is Already Under Way to Ensure Lasting Success

It is important to note that as we communicate this plan, our effort is already several months under way. We are managing the execution of the plan for quick impact and lasting success. This goes well beyond posters and fancy words—it must be evident in everything we do.

Our quick wins and initial work are an important part of our lasting success. In addition to improving our situation, they help set the momentum and energy required for the long haul because this turnaround will not happen overnight—it will take time and the full support of all our stakeholders.

OUR QUICK WINS AND RECENT SUCCESSES

We have realised quick wins and recent successes since early December 2005 in each of the plan's five main thrusts.

1. Flying to win customers

It is understandable that, given our cash and profit crisis, our initial focus would be on our commercial activities. Our recent successes under this thrust include the following:

We have launched the Route Profitability Project.

To ensure that our actions are as close to the market as possible, we have organised our early efforts around eight route-cluster 'labs'. These labs are designed to turnaround our unprofitable routes by driving real accountability and quick decision making without getting lost in cross-functional infighting. Our country managers, our revenue management analysts and our sales leaders are working closely together to turn key routes around.

Early analysis and results suggest few routes are beyond saving; and we will fight hard to win each one. The European route lab, for instance, identified a number of initiatives and immediately began to implement quick turnaround actions at the end of 2005. Sales stimulation and selected revenue management techniques helped leverage revenue opportunities during the Christmas peak, increasing load factors by five percentage points. More structural changes have been implemented since January 2006 that focus more holistically on cost, traffic and yield improvements.

We have implemented a Revenue Enhancement Project (REP).

This project, which began in September 2005, has raised our yield on flights from Kuala Lumpur to bring it in line with competitors' pricing, which will have an estimated annual net-income after-tax (NIAT) impact of RM70 million. In addition, various surcharges and administrative fees in line with the rest of the market have been introduced to align revenue with costs, resulting in overall annual NIAT impact of RM310 million.

We have launched 'Travel Fair 2006'.

We have launched 'Travel Fair 2006', where we rewarded our customers by selling 5 million seats at up to 70% discount. Most importantly, these tickets were sold through multiple channels: more than 500 leading agents, a call centre and the internet. We expect to raise RM150 million from the Travel Fair.

We have boosted the collection of excess baggage fees.

By introducing an incentive bonus for check-in staff in January 2006, the excess baggage fee collection doubled during the month.

We have prepared the ground for launching e-ticketing.

E-ticketing is a critical success factor as customers increasingly demand purchase of tickets via the Internet. In response to this, MAS will launch e-ticketing for customers in the domestic sector in the first week of March 2006.

2. Mastering operational excellence

Our recent successes under this thrust include the following:

We have established a process to track, and report, on-time departures and arrivals daily.

This information is reported to the full leadership team.

We have established a Fuel Efficiency Task Force.

The purpose of this task force is to implement measures to reduce fuel consumption.

3. Financing and aligning the business on the P&L

Our recent successes under this thrust include the following:

We have secured short-term financing.

On top of RM1 billion to be raised internally, we have secured RM1 billion in short-term external financing.

We have established a Program Management Office (PMO).

The primary purpose of this office is to drive transparency and discipline of action. The PMO oversees each initiative, tracks actions, measures impact, intervenes with corrective actions, and manages communications. The PMO also works closely with Finance to produce daily cash reports, weekly financial reports and monthly progress reports to the Board.

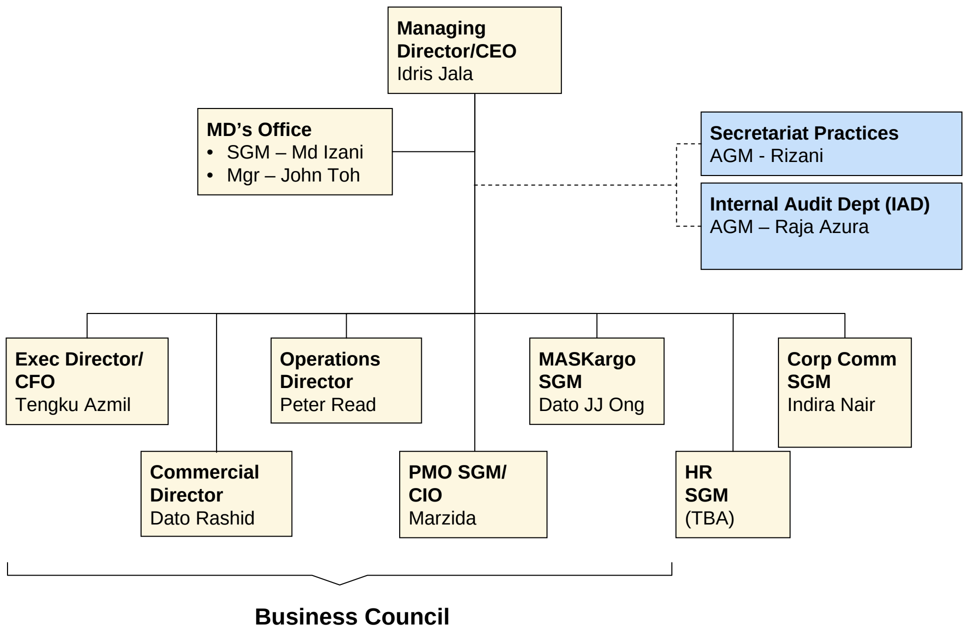
4. Unleashing talents and capabilities

Our recent successes under this thrust include the following:

We have engaged our people around the turnaround plan.
Since launching our business turnaround at the beginning of December 2005, there has been growing management commitment and a groundswell of staff support to implement the plan. A lot of 'transparent' syndication and engagement work has taken place through meetings and 'turun-padang'.

We have established a new Leadership Team and a Business Council to ensure fast decision making.
To help turnaround the business, and in addition to the existing MAS leaders, we have brought in relevant expertise from British Airways, Air Asia, Petronas, Shell, Ogilvy and PwC. Apart from the traditional management team structure, a Business Council has been set up with cross-functional representations from Commercial, Operations and MASKargo. This council also has representation from pivotal leaders two levels down in the organisation. The Council will fully review the facts, consider the alternatives and the implications and then drive action. The Leadership Team and the Business Council are well prepared to take risks and fight tough battles for what is right (Exhibit M).

Exhibit M: Leadership Team



Source: MAS

We have launched a robust set of Key Performance Indicators (KPIs) to track impact and measure our success.

We have instituted a cross-company set of KPIs that will allow us to measure our progress on an ongoing basis. The performance of the company as well as the Managing Director and Leadership Team will be assessed using a KPI scorecard (Exhibit N).

Exhibit N: 2006 Scorecard

PRELIMINARY

KPI	Unit	Weighting	Threshold	On target	Exceeding	Outstanding
1. Net Income	RM Million	60%	-700	-600	-300	0
2. Cash Surplus	RM Billion	5%	0.8	1.0	1.3	1.5
3. International Awards e.g.Skytrax	Number	3%	1	2	3	4
4. On Time Performance	%	4%	75%	80%	90%	95%
5. System-wide aircraft utilisation	% of usable hours	4%	85%	88%	91%	95%
6. Baggage delivery	% Improvement over previous year	4%	20%	30%	40%	50%
7. Safety Record	Incident per month of operation	10%	Not More than 4	Not more than 3	Not more than 2	Not more than 1
8. HR (8 Collective Agreements)	Signed within mandate from start of negotiation	5%	Within 4 months from mandate	Within 3 months from mandate	Within 2 months from mandate	Within 1 month from mandate
9. HR (Performance Management Systems	Percent of employees who are performance managed	5%	60%	70%	80%	90%+
OVERALL SCORES		***100%***				

We have moved our head office to Subang.

The reason for this move is not only to generate cash (through the disposal of the KL head office), but also to achieve greater efficiencies in terms of reduced travelling between offices to attend meetings and reduced building maintenance and other support costs. Clearly, this also helps to unleash talents and promote greater teamwork.

We have instituted a 'whistle-blower policy'.

This policy provides a safe and acceptable way for employees to raise concerns about malpractices, irregularities and negligence affecting MAS without fear of adverse repercussions—and with the assurance of protecting the confidentiality of both the information and the identity of the whistleblower. Employees welcomed its introduction and many have responded since its launch on 26 January 2006.

5. Winning coalitions

Our recent successes under this thrust include the following:

We are holding discussions on the sharing of assets.

We are in advanced discussions with various airlines and suppliers to share or finance assets (such as the hangar and equipment in KLIA).

We have concluded the negotiation with unions and associations and signed the collective agreements.

New deals have been concluded which include performance-related salary increases. This is a major breakthrough for MAS in its efforts to link staff performance with pay.

We are working with other GLCs.

We are working with a number of GLCs as 'willing partners' to collaborate and achieve mutual benefits.

THE FULL EXECUTION OF THE PLAN WILL TAKE 3 YEARS —AND CONTINUE BEYOND

We believe strongly that *The MAS Way* will restore MAS to profitability and achieve our vision of going beyond expectations—but it will not happen overnight and it will not be easy. A turnaround is not just a series of quick actions, it is also a multi-year program designed to create an organisation that can adapt to whatever the market will throw our way. And it is important to note that lasting airline turnarounds take years of concerted action. Consider the journeys of Continental, Aer Lingus and Air Canada.

We fully understand the magnitude of this change and recognise that much of this takes time.

We expect that there will be setbacks along the way; although we will do all we can to manage these. The nature of quick and decisive decision making is that we might make mistakes. Many of our pricing changes, for example, will increase revenue, but some could result in losses in market share. Some new markets will be a success; some will prove a struggle. And while we hope that we will reach common ground with our unions and suppliers, there could be difficult discussions, and we cannot ensure that there will not be interruptions to service along the way. When we make tough decisions, we will strive to understand the possible outcomes of those decisions and have back-up plans in place to correct them if they arise. When there are unacceptable consequences from our actions, we will recognise them, own them, and then quickly adapt to accommodate.

We do know for sure that we cannot reach our goals without taking risks.

WE NEED THE COMMITMENT OF OUR STAKEHOLDERS—AND THERE ARE BENEFITS IN RETURN

When MAS succeeds, our stakeholders succeed. If MAS fails, it will be detrimental to the interests of all our stakeholders. No airline has ever turned itself around without full commitment from its stakeholders. And in giving this commitment and support, each group earns the right to share our success and reap the benefits.

Our employees

When MAS succeeds, our employees will have their pride restored, be inspired by renewed leadership and be generously rewarded for performance. To succeed, it is critical that we maintain our labour cost advantage and our employees must be among the most productive in the industry.

Our management

As MAS succeeds, our high performing managers will be given exciting new opportunities and generous rewards. For those who have looked at MAS as a source of guaranteed employment and relatively generous perks, this could be a painful process. We will ask our managers to put real 'skin in the game'. Those that are willing to take on real accountability and deliver results will be rewarded. Those who are not will be asked to leave.

Our customers

Customers can look forward to higher service levels as we master operational excellence, as well as improved products and services that they will be willing to pay for. However, in order to be profitable, MAS will need to charge premium, but competitive, prices.

Our agents

We have deep appreciation for the value that our agents add to our business and to their customers. For this reason, agents will continue to be a critical channel for MAS. The agents that help MAS succeed can look forward to attractive support and incentives. However, we simply must reduce our cost of distribution and respond to customer preferences from specific segments to deal directly by phone or the internet. We will work with our agents to ensure that they can earn a fair living from a partnership with MAS while ensuring a reasonable return on that investment.

Our suppliers

As MAS succeeds, we can expect our suppliers to grow and develop with us. Those suppliers who offer the highest value for money can also look forward to increased transparency and merit-based decisions. However, we cannot survive and prosper with imbalances in risk and rewards with our suppliers. We will negotiate with our suppliers until we are convinced that we share equitably in the risks and rewards from the marketplace. If we cannot do that, we will replace them with those who can.

The Government

MAS will continue to carry the flag for Malaysia. The aviation sector has a high economic multiplier effect—based on preliminary analysis, the economic multiplier effect in Malaysia is 12. For every ringgit invested in the aviation sector, there is a positive spin-off of 12 ringgit to the Malaysian economy in terms of tourism, infrastructure and logistics development. Furthermore, we will do our part to deliver on the Government's GLC Transformation Program.

Given this, we expect Malaysia to develop with MAS' success. To succeed, we ask that we are given a fair regulatory framework, the freedom to act as a business and be compensated for any social obligations we must fulfil.

Our investors

As MAS returns to profitability, all our investors can expect attractive investment returns. In return, we ask for patience—the road back to profitability will be a long, winding and challenging one.

We are dedicated to the creation of a company that will be a source of pride and admiration for its employees and indeed all its stakeholders. The MAS of tomorrow will maintain its five-star product, have a competitive cost structure in the region, be renowned as being one of the best places to work in Malaysia, have closed much of the revenue performance gap to our peers and will return to profitability in 2007. We can do this, and we will.

malaysia
AIRLINES