# WHITE PAPER
on the Malév Heritage

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# TABLE OF CONTENTS

## INTRODUCTION

### Dear Reader,

By 2011, the national airline that has a great past and was once among Hungary's most successful companies has been put into a critical situation. For several years Malév has been making a loss and accumulating enormous debts, which have translated into a competitive disadvantage against other airlines. The company closed last year with a loss of EUR 80 million[1] and a debt amounting to several tens of billion forints.

The company's past ten years were characterised by fast changing ownership and executive structures and a business practice endeavouring to make prompt profit and patch up the system without any kind of a long-term strategic thinking. The wrong decisions made by Malév's former executives, the hasty and disadvantageous contracts, the sale off of the company's valuable assets, the irresponsible privatisation of 2007 and the prodigal renationalisation performed during the previous government's term resulted in a company full of unsolved problems and grave losses, inherited by the government in 2010.

As a result of the events detailed below, the incumbent government was forced on an inescapable path in solving Malév's problem. Seeking a solution is an extraordinary challenge for the affected parties, as in addition to strategic planning; prompt damage control is also required.

## PURPOSE OF THIS WHITE PAPER

The purpose of this document is to present accurately how and why one of Hungary's most significant and internationally known companies has been put into so difficult a situation that its very operation is at risk. This White Paper gives a chronological summary of the important events and abortive decisions of the past decade in order to interpret the government's efforts made at understanding and consolidating the current situation.

The White Paper endeavours to give a comprehensive picture. As, however, information is scanty and difficult to access, and due to the limited disclosure of the data constituting business secrets, this picture is far from being complete. It is not the task and purpose of this document to undertake a deeper analysis of the damages caused and calling the responsible persons to account. It is merely meant to shed light on the facts that have, in our opinion, an impact on the company's present and future.

[1] Exchange rate: 1 EUR = 300 HUF

# I. SITUATION ANALYSIS

## I./A WHY IS A NATIONAL AIRLINE NEEDED?

**Currently, the Malév group employs about 2600 people. It ensures orders for more than 500 domestic businesses and pays more than EUR 20 million to small and medium-sized companies.**

The annual amount of tax paid by the company is nearly EUR 33 million, and its aggregate direct and indirect positive impact on fiscal revenues amount to EUR 233 million. As the overwhelming majority of the company's sales revenues, nearly EUR 200 million come from exports, Malév Zrt. is also listed among the thirty most significant exporters of the country.

The company transports nearly 3 million passengers on 23,000 pairs of flights per year, and flies planes directly to 45 destinations. More than half of Malév's passenger turnover comprises point-to-point[2] passengers, significantly improving tourism incoming to Hungary.

Malév is one of the most significant partners of Budapest Airport Zrt., contributing approximately 40% of its turnover. Approximately EUR 50 million is paid annually under the title air service revenues and real estate and retail rental fees. For lack of Malév, the airport operator's budget may be deprived of a considerable part of this amount, and under Budapest Airport's privatisation agreement, its operation may even become impossible. Thus the state would be required to promptly pay a single amount of approximately EUR 1.5 billion, which would, in turn, have grave consequences on the maintenance of the budget deficit target. Such an enormous lump sum would also impose a heavy burden.

Thanks to Malév's revenues, HungaroControl[3] can also obtain a considerable amount of sales revenues. Malév ensures 10% of the company's total annual sales revenues, which was more than EUR 9 million in 2010. If HungaroControl lost Malév as a partner, either the Hungarian State as 100% owner should make up for the profit missed, or the company's services would become considerably more expensive. If Malév is removed, the company would be unable to continue financing the costs of the control centre ANS III, being built within the framework of a EUR 27 million project supported by the European Union.

In addition, Hungary benefits from Malév in several ways that are difficult to quantify. The company's services are the very first momentum to expose tourists to Hungarian hospitality, wines, brandies and brochures of popular tourist attractions. In a certain sense, Malév is a gate to Hungary, a gate we can proudly show the world. Access to and leaving of the given country within one day is a factor taken into consideration when project and investment decisions are made by foreign companies. Thus the lack of a national airline would mean a considerable competitive drawback to Hungary. Moreover, Malév also operates as a responsible Hungarian company: when the need arises, it returns fellow citizens in difficulties abroad, cooperates with charity organisations or provides opportunity for poor children to enjoy the joy of summer holidays.

**The significance of Malév Magyar Légiközlekedési Zrt. (Hungarian Airlines Ltd) in the national economy goes beyond the company's maintenance and operation, as the company's operation is clearly justified by macro-economic factors, and for this reason, and also in view of the company's unique role in the national infrastructure, in the Hungarian Government's opinion a national airline is required.**

[2] Direct passenger traffic, i.e. passengers with Hungary as their destination instead of being transit passengers.

[3] The national air traffic controller.

## I./B MALÉV GRIPPED IN COMPETITION AND WRONG GOVERNMENT DECISIONS

For the above-mentioned reasons, the Orbán government has always supported Malév. Following Hungary's accession to the European Union in 2004, the conditions of state support changed under the Community regulation, which considerably restricts the government's elbowroom.

**Based on a report made in late 2010 by WizzAir, operating under the control of one-time general manager of Malév, József Váradi, in its decision dated 21 December 2010, the European Commission opened a formal investigation into Hungarian support measures alleged to be in conflict with the EU's state aid rules.**

The decision starting the procedure presumed that the proprietary loans granted and capital increase made by the state as owner and other financial measured taken between 2007 and 2010 might constitute prohibited state aid under the EU laws.

If this is confirmed in a final and binding decision, and the European Commission orders a repayment obligation, the granted aid must be reclaimed from the company with a compound interest. According to preliminary calculations, as a result of the wrong state, proprietary and corporate decisions made during the period under review, approximately EUR 333 million should be repaid by the company on its own, all kinds of state aid or support excluded.

**The incumbent government makes efforts at finding a solution by winning a financially stable strategic investor round, while maintaining a minority ownership, rolling the burdensome heritage of the past over and forward, undertaking all its political and financial difficulties involved.**

## I./C WRONG DECISIONS OF THE PAST 10 YEARS

The narrow-minded and prodigal decisions made during the past ten years without any kind of a long-term strategic thinking contributed significantly to the unsolved problems and grave indebtedness Malév faces in 2011.

It is highly expressive that while between 1945 and 1990, i.e. in 36 years, Malév only had five general managers, between 1990 and 2011 about twenty different people were appointed to manage Malév. Frequently, all professional considerations were disregarded and solely political loyalty was taken into account. Thus in the overwhelming majority of the cases the appointed persons had no experience whatsoever in aviation business management. For the most part the successive general managers had nothing but short-term plans, and regularly acted against the decisions made and strategies applied by their predecessors.

During the first few years following the change of regime, efficiency was not demanded as unlimited state aid was granted. For lack of stability, predictability and long-term planning, the adopted decisions pushed the airline, which had already been grappling with serious problems, to the brink of collapse.

## I./D PROBLEMS RELATED TO THE FLEET

In the early 2000's, Malév's fleet was still fairly diversified. In addition to several Boeing 737, Boeing 767, Fokker 70 and Bombardier CRJ-200 planes also flew under the colours of Malév. The ill-advised restructuring of the fleet started in this period.

The leasing contracts under which the planes currently comprising the backbone (more than 80%) of Malév's fleet, namely 18 Boeing-737 NG aircraft were concluded between 2001 and 2003[4], under the control of **József Váradi**, current general manager of WizzAir.

As a result of the negotiations, seemingly favourable leasing fees were achieved, but actually the agreement imposed a heavy burden on Malév already in that period, and so in the year 2000, the company made a loss of EUR 31 million. The question arises if the replacement of the complete fleet was really necessary or not, as the previous contracts could also have been renegotiated under considerably more favourable conditions than those fixed in the new leasing contracts.

Although in the short run the contractual conditions might have seemed to be advantageous, they impose heavy costs on the company up to this very date. As a result of the extensive fleet replacement, major obligatory and highly expensive maintenance, repairs and overhauls usually fall due simultaneously. Characteristically, the managements in office made insufficient maintenance reserves as it would have deteriorated the company's balance sheet. For this reason, by now the reserve deficit has reached USD 120 million.

It is also important to highlight that the leasing contract concluded by Váradi included highly disadvantageous conditions and hamstrung Malév for long years to come. It speaks for itself that, for instance, each engine overhaul obligatorily required in the contract costs USD 3-4 million irrespectively of their wear-and-tear, or that under the leasing contract the machines can only be returned to their owners in their original condition when the contract expires, which means that billions of dollars must be spent on them. As a result of the leasing contract, Malév is forced to spend a considerable part of its revenues on leasing fees, which has contributed to the company's losses over the long term. Meanwhile, Váradi-managed WizzAir and other competitors could rely on Malév's ever increasing financial and management crisis.

Simultaneously with Malév's leasing contracts (2002-2003), Malév purchased four Bombardier CRJ 200 aircraft (for USD 70 million), 30% from the company's own contribution and 70% on a loan. Two of these planes were purchased with government support, and two other were financed from loans granted by Kereskedelmi and Hitelbank Rt., KBC Finance Ireland and Magyar Export-Import Bank Rt.

The process of fleet replacement continued between 2003 and 2009, however, as there was no coordination between the acquisition of regional aircraft and leasing Boeing NG aircraft, the composition of the resulting Boeing fleet was disadvantageous for operational purposes (Boeing 737-800, 737-700, 737-600) and unsuitable in many other respects e.g. aircraft replacement and capacity optimisation.

[4] József Váradi (current general manager of WizzAir) acted as general manager of Malév between July 2001 and February 2003.

Between 2007-2008[5] the owner (at that time AirBridge Zrt.) decided to withdraw Fokkers and CRJ 200 aircraft from circulation and purchase Bombardier Q400 instead. The reason why the replacement of the regional fleet was a wrong decision is that the CRJ aircraft could only be sold below cost price (one of them is still waiting for being sold), whereas the Fokkers' overhaul before return cost an enormous amount (approximately EUR 10.3 million). As no reserve had been made to cover these costs, they added to the company's financial burdens. Moreover, the technical conditions of the purchased four second-hand Q400 aircraft were uncertain, and its grave consequences are most manifest these days.

Although the cancellation of long-distance flights was a necessary strategic decision, as they had generated heavy losses for several years, the decision itself was rash and inconsiderate. This is evidenced by the fact that similarly to CRJ, the last Boeing 767 aircraft is still waiting for sale; in other words, the current management completely disregarded the conditions of sale and the demand of the time.

Sale is made even more difficult by the fact that with permission from **János Gönci**, "double" mortgage was registered on the plane (a direct and an indirect one, the latter through pledging the shares of the owner company as collateral), as Gönci failed to report the mortgage already registered to the benefit of CIB Bank. This is how MFB's mortgage right could also be registered. In this case MNV Zrt. (Magyar Nemzeti Vagyonkezelő Zrt., i.e. Hungarian State Property Management Ltd.) made a criminal report, however, the proceedings was terminated for lack of evidence for causing damage, as Malév did pay the due interest and repayment instalments of the loans.

The planes that cannot be sold impose a heavy financial burden on Malév in the amount exceeding EUR 1,1 million per year.

**As a result of the short-sighted, inconsistent decisions of the past decade, which completely disregarded costs and Malév's current financial situation, now Malév leases 18 Boeing-737 and has four used Bombardiers in its fleet. The expiry date of the first leasing contract is approaching very fast, and in the next one or two years nearly all the contracts will have to be renewed for the fleet or the aircraft must be returned in the condition determined in the contracts. This will require the payment of several millions of dollars per aircraft and serious strategic decisions of the current management and the owners.**

[5] Under the management of Péter Leonov (14 September 2007 - 10 February 2009)

## I./E FINANCIAL DECISIONS ALLOWING FOR SINGLE SHORT-TERM REVENUES: SALE OFF OF MALÉV'S ASSETS

In its difficult situation and due to the problematic financing opportunities, Malév sold its assets and, improperly, used the income for covering its current operating costs, thus completely dissipating and run through its own equity.

### Sale of the ownership in Hyatt Regency

Malév sold its 50 percent share in Hyatt Regency (previously Atrium Hyatt) at the end of 2001 to Pannónia Hotels Rt.. A tender was invited for the ownership share, but as it was closed unsuccessfully, one of the owners with an option, Pannónia Hotels was allowed to make an offer, which was far below the price that could have been achieved in a competition. Sale of the shareholding was an erroneous decision, among others, because the real property had a considerable profit generating potential. In addition to isolation, the move performed in 2003 also required considerable extra cost payable over several years, as for a long time Malév was unable to sell the office in Hyatt and it had to pay rental fees for the premises found at the airport.

### Sale of the Heathrow slot

Slots have a very high value, as they provide airlines with the right to land and take off and they are available in decreasing numbers on overcrowded airports. For this reason with clever strategy and utilisation, an enormous capital can be accumulated from them on airports suitable for this purpose, like Heathrow. Malév sold its slot on Heathrow already before the start of slot trade, in 2006 (despite the fact that it was among those most in demand in the slot market) to British Airways, and thus it had to make do with the secondary Gatwick airport. In return for a single approximately EUR 6,6 million , this sale-off put Malév to a clear competitive disadvantage over the longer term. In addition, under the current market conditions, repurchase can be ruled out.

### Sale of the fuel supply business to the airport

In 2005[6] Malév sold its valuable fuel filling business for EUR 16 million cash and the charge-off of its EUR 8,6 million debt to Budapest Airport Rt., operator of the Budapest airport. Although the transaction provided Malév with a single revenue, which was, indeed, a great help in the short run for the company suffering of serious losses and heavy debts, in the long term this step caused considerable damages. Malév's fuel service was the largest fuel supply service at Ferihegy airport, generating several millions of euro per year. In addition to losing this income, the company became dependent as a result of this transaction, which resulted in clearly worse conditions in prices as well as service quality.

**As a result of these short-term decisions yielding a single revenue, Malév had been deprived of practically all of its assets already by 2007. In addition to depriving the company of long-term revenues and resources, the sale of the assets and businesses of profitable and strategic significance also reduced the company's goodwill.**

[6] Under the control of Dr János Gönci (14 February 2005 - 10 July 2007)

## I./F IRRESPONSIBLE PRIVATISATION

By the end of 2006 the airline had been driven to the brink of bankruptcy, and the government was no longer capable of financing it. However, the government in office refused to undertake the political and economic consequences of Malév's eventual bankruptcy. The only aim they had was to get rid of the company at all costs within the shortest time possible. Malév with its characteristic features of that time, its financial standing, organisational and operating problems was not an attractive investment target for professional strategic investors. Finally, a single privatisation applicant remained: AirBridge Zrt., the empty holding company of **Boris Abramovich** and his Hungarian strawpersons (**Magdolna Költő** and **Kálmán Kiss**). In an ardent intention to privatise at all costs, the government made one blunder after another during the procedure.

They failed to perform an authentic verification and request a certificate of the buyer AirBridge Zrt.'s professional competence and financial standing. In the privatisation contract, it failed to provide for the long-term viability of the national airline, appropriately fix the financial conditions of its long-term financing or the collateral restrictions for the avoidance of disastrous indebtedness.

Malév Zrt.'s privatisation contract was concluded on the basis of the government resolution setting forth expectations related to tender invitation and sale. Under the contract, the investor had to make an offer for the purchase price, the required completion of Malév Zrt.'s capital and final repayment or redemption of the loans guaranteed by the state (EUR 76 million provided by MFB, a commercial loan granted by K&H in the amount of EUR 9.5 million, and a commercial loan granted by EIB in the amount of EUR 37 million) with the guarantees offered by the buyer. The privatisation contract was signed on 23 February 2007 by and between ÁPV Zrt., on the one hand, and AirBridge Zrt., represented by **Boris Abramovich** and his two Hungarian strawpersons, on the other.

### The contract included the following essential elements:

- ✈ The purchase price offered by the buyer was merely EUR 666,6 thousand.

- ✈ As a precondition to the effect of the contract, the buyer undertook to increase the capital of Malév Zrt. by EUR 16,6 million (in cash), and contribute an additional total sum of EUR 30 million to the capital, allowed to be made in the form of a proprietary loan.

- ✈ The buyer undertook to prepay the commercial loans by 31.12.2007 (K&H, EIB).

- ✈ The buyer undertook repayment of the interest and principal of the MFB loan to expire on 31 December 2017 as regulated in detail in Annex 8 to the contract. Based on this, Malév Vagyonkezelő Kft. (MAVA) was established with 100% government ownership. This company assumed Magyar Fejlesztési Bank's EUR 66,6 million loan from Malév using Malév's brand name; Malco LLC, the owner of a Boeing-767 aircraft, and the section of the Százhalombatta-Ferihegy kerosene pipe, excluding the section falling on the territory of the airport, as collateral.
  Malév pays rental and use fees for the assets pledged as collateral.

- ✈ The buyer undertook to uphold the national character of the airline for at least ten years following the acquisition of the shares.

The Hungarian State undertook unconditional guarantee for the loans presented in Sections 3 and 4. In addition, EIB's commercial loan was also secured by four CRJ planes in the company's ownership.

For the purpose of performing its commitments, the buyer was granted a credit and guarantee limit by the Russian Vneshekonombank (hereinafter: VEB) in the amount of EUR 102 million. This limit comprised four parts: a loan in the amount of EUR 22 million, to finance the purchase price and the first EUR 16,6 million capital increase; a loan in the amount of EUR 18 million, which should have been transferred for financing the daily operation of Malév; an unconditional bank guarantee in the amount of EUR 30 million required by the privatisation contract for additional capital increase; and a bank guarantee in the amount of EUR 32 million to secure repayment of the loans granted to Malév.

Following the April 2007 effective date of the privatisation contract, on 18 May 2007, Malév Zrt. and VEB concluded a framework guarantee agreement for the amount of EUR 102 million, in which Malév Zrt. as guarantor undertook to perform AirBridge Zrt.'s obligation if the latter failed to perform such obligations vis-a-vis VEB.

**In other words, in the course of this privatisation the buyer practically did not invest or risk any money of his own, while he ultimately redebited all repayment obligations to Malév.**

Based on the inspection initiated by MNV Zrt. it can be established that the Company's Board of Directors did not approve the EUR 102 million guarantee contract. For and on behalf of Malév Zrt., the contract was signed by **Boris Abramovich**, president of the Board of Directors at that time, as far as we know, without appropriate legal authorisation and decision-making powers. The members of the Board of Directors were not aware of the contract or even its existence, they only learnt of it during its modification in August 2008. At that time the Board of Directors approved of the modification, but MNV Zrt. was again left uninformed. It is important to note that this guarantee contract was governed by Anglo-Saxon law. According to the opinion of an international law office asked by the Ministry of National Development, on account of the governing law, a legal procedure initiating nullity and voidness would have been doomed to failure and would have cost the Company a large amount.

In agreement with its obligations undertaken in the privatisation contract, AirBridge Zrt. increased Malév's subscribed capital by EUR 16,6 million cash, and contributed additional EUR 30 million in the form of a proprietary loan amounting to EUR 30 million, paid in two instalments. In consideration of this, as **Miklós Tátrai**, general manager of Magyar Nemzeti Vagyonkezelő Zrt. at that time, also admitted to MTI in late 2008, the Russian bank was given mortgage right to Malév's shares. This was not completely in agreement with the privatisation contract, as admitted by **Miklós Tátrai**, who added that the opportunity of registering a mortgage was a deficiency of the privatisation contract.

Thus VEB granted a loan to AirBridge Zrt., which was transferred to Malév in the form of a loan and principal.

It is important to note that AirBridge Zrt. had been an empty company, which financed the Malév privatisation completely from the loan obtained from VEB, including the purchase price of the shares. **He did not risk his own money. All this was done in a way that the loan granted by VEB was re-guaranteed by Malév, which actually meant that the VEB loan was secured by Malév itself and the proceeds earned from Malév's activities, moreover, in a way that the interest charged on the proprietary loans transferred to the airline exceeded the interest payable by AirBridge Zrt. to VEB.**

The carefully engineered money withdrawal techniques is thus clear even for an amateur, and can be tracked in the conditions of proprietary credit limits and contracts forced on Malév by AirBridge Zrt.

**The most serious offences in the privatisation transaction include the facts that, on the one hand, proprietary loan should not have been accepted as contribution capital, and on the other, neither Malév nor its profit-making capacity should have been pledged. What practically happened was that Malév actually purchased itself under a Russian umbrella, and moreover, it simultaneously lost its money as well as control over itself, and became completely dependent.**

By 2009, the situation had deteriorated to the point where AirBridge Zrt. was incapable of meeting its payment obligations, and for this reason, in order to secure its claims, VEB obtained a minority ownership in AirBridge Zrt. At this moment, Malév owed EUR 30 million to AirBridge Zrt. In the interest of maintaining the company as a going concern, between April and September 2009, VEB granted further EUR 50 million to the airline.

In addition to operation, AirBridge Zrt. also had obligations under the privatisation contract, including repayment of the loans granted to Malév prior to the privatisation. VEB granted a loan redemption bank guarantee for this purpose in the amount of EUR 32 million. Naturally, the loan was not paid. Although Magyar Nemzeti Vagyonkezelő made several attempts at drawing down the bank guarantee, VEB refused to pay despite repeated attempts. On account of VEB's failure to meet its payment obligation arising from the guarantee, MNV Zrt. wished to start court action; however, it was prevented by a founder's resolution of the Ministry of Finance under the control of János Veres. The guarantee was drawn down only in the spring of 2010, shortly before the change of government, in the framework of a renationalisation agreement. The state drew down the bank guarantee form VEB, and in turn, VEB drew down the counter-guarantee from Malév, as back in 2007 it had undertaken a counter-guarantee. As Malév was unable to pay, VEB elegantly granted the airline a loan in the amount equivalent to the counter-guarantee for the sole purpose of meeting its payment obligation under the counter guarantee.

**This is how the bank guarantee was turned into a loan repayable with interest. By 2010, Malév's debt to VEB had increased to EUR 112 million.**

The disadvantageous privatisation, the fraudulently concluded financing contracts and the ruthless exploitation carried on for three years completely destroyed Malév's finances and had rendered independent operation impossible.

VEB funded AirBridge Zrt. presumably on a political basis, as the financing conditions were set in a way unfamiliar to the market. Moreover, compliance with some of the required indicators had been impossible right at the moment of contract execution. In relation to this highly irresponsible privatisation procedure causing damages to Malév, the political and criminal responsibility of the Hungarian government of the day arises. Serious blunders were made during the determination and performance of the contractual conditions, and as a result of the failure to check operation during the Russian period.

During the period of private ownership, with the assistance of the government of the time, Malév practically ran into extreme debt and was driven to the brink of bankruptcy.

## I./G OPERATION DURING THE BORIS ABRAMOVICH PERIOD (between 12 July 2007 and 6 January 2009)

These nearly two years marked a drastic deterioration and destruction in the company's business, as clearly traceable in its figures. Lifted by socialist into the owner's position practically free of charge, but currently a wanted person in Russia, **Boris Abramovich** managed the Hungarian airline he had been given on the nod not simply irresponsibly but he obviously embezzled its assets. In conflict with the company's interests, this period was characterised by the enforcement of the owners' private financial interest, with a general manager[7] assisting and a state constantly turning a blind eye to the events.

In this period the earnings before interest, taxes, depreciation and amortization (EBITDA) changed from EUR 18,3 million to more than EUR -33,3 million, while the profit before taxes dropped to EUR -80 million. In the very same period, the equity fell from EUR +8 million to a record low: EUR -136,6 million.

The Russian businessman arrived without capital, and Malév was an investment he made without risking his own funds. The airline received all funds at high interest rates and high additional costs. However, the capital did not serve long-term development. The exclusive role assigned to it was to settle the debt service on the capital commitment received only on the face of it. The VEB loan agreement contained biased conditions that were unfavourable for Malév and impossible to meet already at the moment they were signed by the airline management, who could not choose but sign them, with the government's assistance, despite the specialists' opinions.

During this period the owner's money pump worked at full blast through the contractual conditions of the credit limits made available for Malév in a way that these proprietary credit limit contracts lacked any kind of financial coverage at AirBridge Zrt. Thus high amounts could be transferred to AirBridge Zrt and its owners due to unrealistically high interest rates, commitment fees and other charges, the generation of which was, naturally, required of the airline.

Here is an example to demonstrate the money pump operated by the Russian owner: AirBridge Zrt. concluded a credit limit contract with its subsidiary, Malév Zrt. for the amount of EUR 102 million. Malév was permitted to draw down EUR 18 million of this amount, and this way AirBridge Zrt. met its Malév financing obligation undertaken vis-à-vis VEB. Malév was practically prevented from drawing down the remaining EUR 84 million of the credit limit, however, a so-called commitment fee was charged at 4% for the undrawn amount of the credit limit, i.e. EUR 84 million.

**Through this transaction EUR 3.4 million was withdrawn by the owners from the company annually. The absurdity of the case is that AirBridge Zrt. actually did not have the funds promised as a credit limit to Malév, they were offered exclusively as a means of cash withdrawal presented as a legitimate transaction.**

During 2007-2008, the company accumulated accounts payable in the additional amount of about EUR 8,3 million for the realisation of a few unrealistic expansion plans. The approach and immoral attitude of the Russian businessman is clearly demonstrated by projects like the extension of Areoplex services to KrasAir airline, one of Abramovich's participations at that time. The total annual costs of opening a base in Russia amounted to more than a billion forints; however, the licence to perform activities in Russia was never issued.

[7] Péter Leonov's term (14 September 2007 - 10 February 2009)

Abramovich concluded numerous false advisor's contracts with the offshore company Charter Corporation, also among his participations, through which he had nearly EUR 3,3 million transferred, presumably to himself, without any service or product provided in recompense. **Martin Gauss**, Malév's general manager of the time reported the case to the police after the change of government.

In addition to serving his own interests, Abramovich also endeavoured to serve his clients. This can be perhaps best demonstrated by the catering contract, concluded with Budapest Aeroservice Szolgáltató Kft., another offshore company presumably within the scope of interest of a previous Malév general manager, **Péter Leonov**, for five years. The contract is still valid (2008-2013), cannot be terminated and is highly unfavourable for Malév, thus causing additional billion-forint losses to the company.

## I./H RESPONSIBILITY OF THE PREVIOUS GOVERNMENT - RENATIONALISATION

As a result of the ruinous exploitation and amuck run by “to manager” **Péter Leonov**, by the second half of 2009, Malév’s financial standing had turned critical again. During the period in private ownership, Malév sank into extreme debts. By the end of 2009, the company’s doom had been sealed to the extent that the owners turned to the Hungarian Government for help.

The previous government had to face a grave decision and undertake an enormous business and political responsibility: renationalisation or bankruptcy and building a new national airline - these were the options available for the socialist-liberal coalition. Following a six-month series of negotiations, the Bajnai Government adopted a decision in favour of renationalisation. With this step the government officials seriously debited the country’s budget, while shifting the pressure of long-term problem solution to the next government. This was done in a way that set funding on an inescapable path, as the new government could have allowed the airline to go bankrupt only if simultaneously it gives its blessing to wasting the billions of taxpayers’ forints spent on renationalisation. **It is important to highlight that several new airlines could have been established from the billions of forints spent under pressure on Malév during renationalisation and since then.**

Based on Government Decree 1051/2010. (II. 26.) on the acquisition of ownership by the Hungarian State, on 26 February 2010, AirBridge Zrt., VEB, MALÉV Zrt. and MNV Zrt concluded an agreement regulating the conditions of ownership roles and cooperation between the parties, countersigned by the Finance Ministry (hereinafter: Five-party Agreement).

Pursuant to the Five-Party Agreement, by making approximately EUR 83,3 million available, the Hungarian State increased the capital of the Company and compounded the overdue and unpaid interests on the proprietary loans granted by AirBridge Zrt. during privatisation in the amount of approximately EUR 5 million. In this scheme the Bajnai Government recovered nearly 95% of the shares, and assumed the burdens and obligations that had paralysed the company and overshadowed its future.

VEB’s positions were confirmed in the Five-Party Agreement. The agreement set up a system of guarantees that deprived the government of all effective means and provided disproportionate control to the minority owner. The agreement comprised the following main elements:

- VEB was entitled to make remarks on Malév Zrt.’s restructuring plan, add recommendations to and start negotiations on it,

- AirBridge Zrt. was entitled to transfer the principal amount of its accounts receivable to VEB (and naturally, it did so, and thus the bank became Malév’s direct creditor),

- so long as Malév had overdue and unpaid obligations to VEB, the latter was entitled to delegate two persons to Malév Zrt.’s Board of Directors, could send a permanent observer to the Supervisory Board, and was entitled to appoint the Deputy General Manager of Malév Zrt. Naturally, these positions are filled by VEB’s delegates, thus generating additional costs amounting to millions of forints for the airline,

- so long as Malév Zrt. has outstanding debts to VEB or AirBridge Zrt., VEB’s preliminary approval is required for reducing MNV Zrt.’s voting rights below 25%+1 vote;

- AirBridge Zrt. was allowed to freely transfer its business share in Malév Zrt. to VEB on notification of the parties and the Finance Ministry;

- ✈ **the sale of Malév Zrt.'s tangible assets was prohibited, provided that their value exceeded EUR 166,6 thousand, and no encumbrance was allowed on them without the preliminary written approval of VEB;**

- ✈ **increase or decrease in Malév Zrt.'s subscribed capital, decision on starting dissolution or bankruptcy proceedings against the company and the sale of tangible assets worth more than EUR 166,6 thousand were made subject to VEB's preliminary written approval.**

Although under the Five-Party Agreement VEB finally paid the EUR 32 million loan repayment bank guarantee undertaken in the privatisation contract under two different titles[8], this was done by granting a new loan to Malév Zrt. in the amount of EUR 32 million, and debited the company with its repayment.

**To sum up the above, it can be stated that serious mistakes were made during Malév Zrt.'s renationalisation by the previous government, as at that time, the company had already been practically incapable of independent operation, and its re-acquisition and sustention consumed enormous amounts of money.**

The reason for renationalisation was that the previous government refused to undertake the inconvenience of liquidation. This responsibility was shifted to the next government, despite the fact that it was aware of the opportunity, as it had engaged (in April 2010) a renowned international law office to make a study of Malév Zrt.'s guided bankruptcy. The Five-Party Agreement concluded by the Bajnai Government during renationalisation also deprived the next government of all efficient means to save Malév, in other words, in consideration for a lot of money, the company's bankruptcy was essentially postponed and the political responsibility was shifted on to the current government.

[8] (i) EIB loan and (ii) the annual charge payable for using the MALÉV brand name

## II. INESCAPABLE PATH - WHAT HAS BEEN DONE SO FAR?

In this situation, the incumbent government has two choices. Either it allows the airline to go bankrupt, which would have been an irresponsible dissipation of the approximately EUR 83,3 million spent of the taxpayers' money on renationalisation, and would have led to the national airline's termination, with all the adverse economic and moral effects of the latter. The other solution is the opportunity to deliberate on the potential inherent in the company, reasonable business and the benefits that are immeasurable by money, act with due care and try to keep the company above the water until a strategic investor is found who is ready to buy Malév or operate a new national airline instead of the bankrupt Malév. Naturally, the Government has chosen the latter, with the aim to operate a new national airline, if possible already from the next morning following the bankruptcy of the airline if its sale fails.

**Just as in other fields, the work of the second Orbán Government with Malév started by damage assessment. In the course of several months of analysis, all anomalies, partly described above, were revealed. It is noted here that the meshes of scandals and anomalies are so extensive that part of certain elements have remained mysteries up to this very date.**

Then the Government's task was to decide, in view of the accurate situation, if it was worth standing up for maintaining a national airline. By now it has become clear that both the obvious benefits immeasurable by money and economic rationale require the operation of a national airline. According to macro-economic analyses, for lack of Malév, 13 pairs of flights would be totally lost, as the competitors would replace these services by infrequent flights or not at all. No new parties would undertake to fly to 23 of Malév's current 45 destinations, and consequently direct access to 19 cities located in priority areas for Hungarian investor relations (including the Balkan, Transylvania, the Middle East and various Scandinavian destinations) would be terminated. Already a low-key 20% drop in point-to-point[9] passenger traffic would deprive Hungarian hotels of nearly 500,000 guest nights, causing a direct cut of at least EUR 13-16 million and a similar volume of indirect reduction in the revenues. It is no side-issue that currently Malév employs more than 2600 people, and spends more than EUR 20 million for purchasing the products and services of about 500 Hungarian businesses, let alone the approximately EUR 33 million the company pays to the central budget as taxes on an annual basis. All these factors clearly justify the efforts made by the Government in the interest of maintaining Malév, even if it makes a loss.

**After the Government was convinced of the justification of the existence of a national airline, the next objective to set was the identification of a strategic investor who has the required experience in this field.**

Up to this date, negotiations have been held with several significant interested parties, perhaps the best known being the Chinese Hainan airline. The strategic partner of Hainan was a company hallmarked by the name of Sándor Demján, who negotiated with the Hungarian State about the Hungarian national airline as a syndicate. The two private investor circles signed a cooperation agreement during the Chinese prime minister's visit to Hungary in June 2011, with Malév intended to be involved as a flagship, and should an agreement have been reached, the Hungarian State would have joined. It should be highlighted that in order to comply with the EU's regulations and Hungary's effective bilateral aviation contracts, it is important to enforce the principle of maintaining the majority ownership of EU Member States, and more specifically Hungarian owners, in the corporate structure after inclusion of the investor. In the course of negotiations conducted with the airline, it turned out that despite unbroken theoretical interest in the Hungarian national

[9] Direct, non-transit passenger traffic

airline, Hainan considered the schemes that had been discussed with the company in Demján's interest feasible no longer. They informed both the Hungarian Government and Sándor Demján of this fact.

In addition to the Chinese airline, significant European participants in aviation also indicated their interest in the operation of the national airline. Due to the ongoing negotiations their identity cannot be revealed at this stage.

In addition to seeking an investor, the other task of the Government is to handle the European Union's procedure and minimise the potential losses arising as a result. Although the actions of the Gyurcsány and Bajnai governments affecting Malév ensured that with the assistance of a former Malév general manager, WizzAir managed tap the national airline, so far the Commission's final decision has been postponed, and valuable months have been given for the identification of a new investor.

Last, but not least, it fell to the Government to ensure Malév's maintenance until a new investor is found. It is in our fundamental interest to cut the time as short as possible between Malév's termination and the foundation of a new national airline, which would also reduce the social and business losses caused by the termination of flights.

All these have been achieved by the Government through state financing and simultaneous improvement in Malév's efficiency. The fact that the latter is possible indeed is evidenced by Malév's last quarter, when approximately EUR 23,3 million additional revenues were raised on a year earlier. Utilisation of the flights exceeded 75%, above the European average.

## III. CONCLUSIONS

In May 2010 the newly elected Government inherited a company full of unresolved problems, heavy losses, debts and risks. There was no rational long-term plan for the company's recovery. By that time Malév's valuable assets had been sold off, and consequently its goodwill had dropped considerably. The company felt the evil effects of disadvantageous contracts, repayable loans and debts. Difficult strategic decisions, prompt and focussed efforts were (and actually have been) needed for the incumbent Government to prevent the crisis from deepening.

The Hungarian Government is aware of Malév's business and financial position, operating conditions and the fact that despite the efforts made so far, developments in the external environment have fundamental impacts on the future of the airline.

It is in the fundamental interest of the Hungarian economy to be accessible by air. For lack of a national airline centred in Budapest, our economy would suffer an irreparable loss already in the medium term. For this reason, the second Orbán Government does its best to ensure aviation relations for the country.

However, the Government is gripped in an inescapable path, as in the current structure, Maglev's operation is unsustainable. Regular financial injections are required to maintain the company in the service of the national economy. If as a result of its investigation of state aid, the European Commission eventually issues a decision ordering repayment of the aid, the company would be driven to bankruptcy.

The structural and cultural problems of corporate operation have grown so extensively that the funds and energy required for their restoration would be waste to spend. The various networks of closely interwoven internal and external interests practically hamstring the corporate management.

**The recently taken state measures affecting the airline were all aimed at making the Hungarian market a more favourable target for potential strategic investors in aviation. The results achieved in the past few months prove that these efforts were successful. We continue making efforts at finding the appropriate investors.**

**The government's priority aim is invariably to have a national airline run in Hungary, centred in Budapest, to enforce national economic and strategic interests.**

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