Financial Policy

Financial Policy

The objectives of LAN's financial policy are as follows:

- Maintain cash balances that are adequate for operating levels.
- Maintain medium-term and long-term debt at levels that are in reasonable proportion to growth in operations, and which will preserve the company's "Investment Grade" credit rating
- Carry no short-term debt except for certain specific operations.
- Make appropriate investments that maximize future cash flows and facilitate efficient operations.
- Invest cash surpluses in financial instruments in accordance with policies established by the Board of Directors
- Respond effectively to external conditions beyond the company's control in order to maintain stable cash flows and protect LAN from market risks such as exchange rate, fuel price and interest rate fluctuations
- Maintain adequate credit lines with Chilean and foreign banks.
- Maintain an appropriate risk rating through ongoing control of the distribution of risk among countries and businesses.

Liquidity

In 2006 LAN continued its policy of maintaining a significant degree of liquidity to guard against possible external shocks. Thus, at year end the company held US$218 million in cash balances and highly liquid securities. While remaining committed to this policy LAN has nevertheless sought alternatives for making the best use of these resources, and last year continued to internally finance the great majority of pre-delivery payments on future aircraft acquisitions from Boeing and Airbus. In order to maintain its solid liquidity position LAN obtained committed credit lines totaling US$62 million as of December 2006.

Investment and Financing

The great majority of LAN's investments are concentrated in its fleet acquisition programs, which are generally financed through a combination of long-term financial debt and the company's own resources.

Boeing 767 Program

Between 2004 and 2005 LAN ordered twelve Boeing 767-300s for delivery between 2005 and 2008. Although the plan specifies the purchase of seven Boeing 767-300ER passenger planes and five Boeing 767-300F freighters, there is a certain margin of flexibility regarding aircraft types. In 2004 LAN structured a new syndicated loan for US$250 million to finance the entire cost of the two Boeing 767s received in 2005 and the first delivery in 2006. This loan is guaranteed by Ex-Im Bank for 85% of the amount with a term of 12 years.

In 2005 LAN finalized two new syndicated loans to finance the Boeing 767-300ERs slated for delivery between 2006 and 2008. Both loans are backed by Ex-Im Bank guarantees with 12-year terms and below-LIBOR interest rates. The first loan, which is for US$280 million, covers 85% of the last four deliveries in 2006, while the second will finance 85% of the five final deliveries scheduled for 2007 and 2008 under conditions similar to those for the previous one.

In December 2006 LAN ordered three Boeing 767-300s for delivery during the last quarter of 2009, but has yet to solicit financing for the purchase. Also in December LAN refinanced certain pre-delivery payments for three aircraft to be received in 2007-2008. Three Boeing 767-300s remain to be delivered during 2007, with five more of the same model earmarked for arrival in 2008 and a further three in 2009.

Airbus A320 Family and Airbus A340 Programs

In 1998 and 1999 LAN signed purchase orders for a total of twenty aircraft of the Airbus A320 family and seven Airbus A340-300s. This package, later changed to twenty-three A320s and six A340s, was financed through a syndicated loan of US$ 1,311 million from a group of European banks led by Credit Lyonnais. Backed by guarantees from the European Export Credit Agencies for 85% of the value of each plane, the loan has a payment profile of up to eighteen years. It may also be used to structure other types of financing such as tax leases. Between 2000 and 2005 LAN made use of this loan to support the acquisition of fourteen Airbus A320s, seven Airbus A319s and four Airbus A340-300s. Still to come as of December 2005 were two Airbus A319s scheduled for delivery in 2006, plus five more for reception between 2007 and 2008 whose purchase options were exercised in 2001 and which were not included in the original credit arrangement.

This delivery program was modified as a result of a new purchase order for twenty-five planes from the A320 family agreed in October 2005. With the two orders together LAN now expects to receive twenty Airbus A318s, eight Airbus A319s and four Airbus A320s between 2006 and 2008. Negotiations to finance the planes scheduled for reception between 2006 and 2008 via a new syndicated loan were finalized early in 2006. Under the program as it currently stands, a total of five A318s and two A320s will be received in 2007, with fifteen A318s and two A320s to be delivered in 2008.

Hedging of Financial Risk

The main financial risks facing firms in the airline industry are posed by foreign exchange rates, interest rates and the price of fuel.

As regards exchanges rates, the nature of LAN's operations constitute a natural hedge given that approximately 85% of revenues and 76% of costs are denominated in dollars. In the case of interest rates, LAN has used swaps and calls to reduce floating rate risk. Thus, 95.8% of its current exposure was covered as of December 2006, and the interest rates for the financing of the Boeing aircraft to be delivered in 2006, 2007 and 2008 have already been set.

To reduce exposure to fuel price fluctuations, LAN resorts to various mechanisms including cost pass-through to customers and financial instruments such as swaps, calls and zero-cost collars. In 2006 the company hedged approximately 40% of its fuel needs.