Credit Ratings and Cash Reserves: How They Influence the Borrowing Costs of Airports:

An Industry White Paper

Prepared For the:
ACI-NA Finance Committee

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The Start

Reducing Airport Costs

Facing the 'brutal facts'
There are some red flags

1. Rates by ordinance.
2. Difference in credit ratings between airlines and airports.
3. Airline cost changes occurring more rapidly than airports.
4. Cost premiums for airport projects.
5. Pre-funding of major capital projects.
6. Tension between airports/airlines on capital projects.

The Airline Viewpoint

ACI-NA Economic and Finance Conference, April 7, 2009

Purpose of the White Paper

- Investigate why there is a difference in the credit ratings of airports and the airlines.
- Investigate how the rating agencies view cash reserves in the rating process
- Investigate how the use of cash influences the borrowing costs of airports
- Promote a dialog between airports and the airlines regarding ratings and cash reserves, and the importance of each related to borrowing costs.

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The White Paper did not……

- Seek to establish "Best Practices" regarding the amount and use of airport cash reserves
- Examine the cost of holding cash
  - To the airport
  - To the airlines
    - The paper does recognize that such costs may exist

"Cash is a bad investment over time…" but,

"You always want to have enough that nobody else can determine your future."

--- Warren Buffett, CEO, Berkshire Hathaway, Inc.

Source: CNBC, "Warren Buffett and Bill Gates: Keeping America Great"
Original air date November 12, 2009

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The Paper does…

- Demonstrate that higher ratings and the use of cash result in lower borrowing costs for airports
- Promote the concept that airports should develop a policy regarding the maintenance of cash reserves and liquidity
  - Airports should clearly communicate this policy and its rationale to both the airlines and the rating agencies

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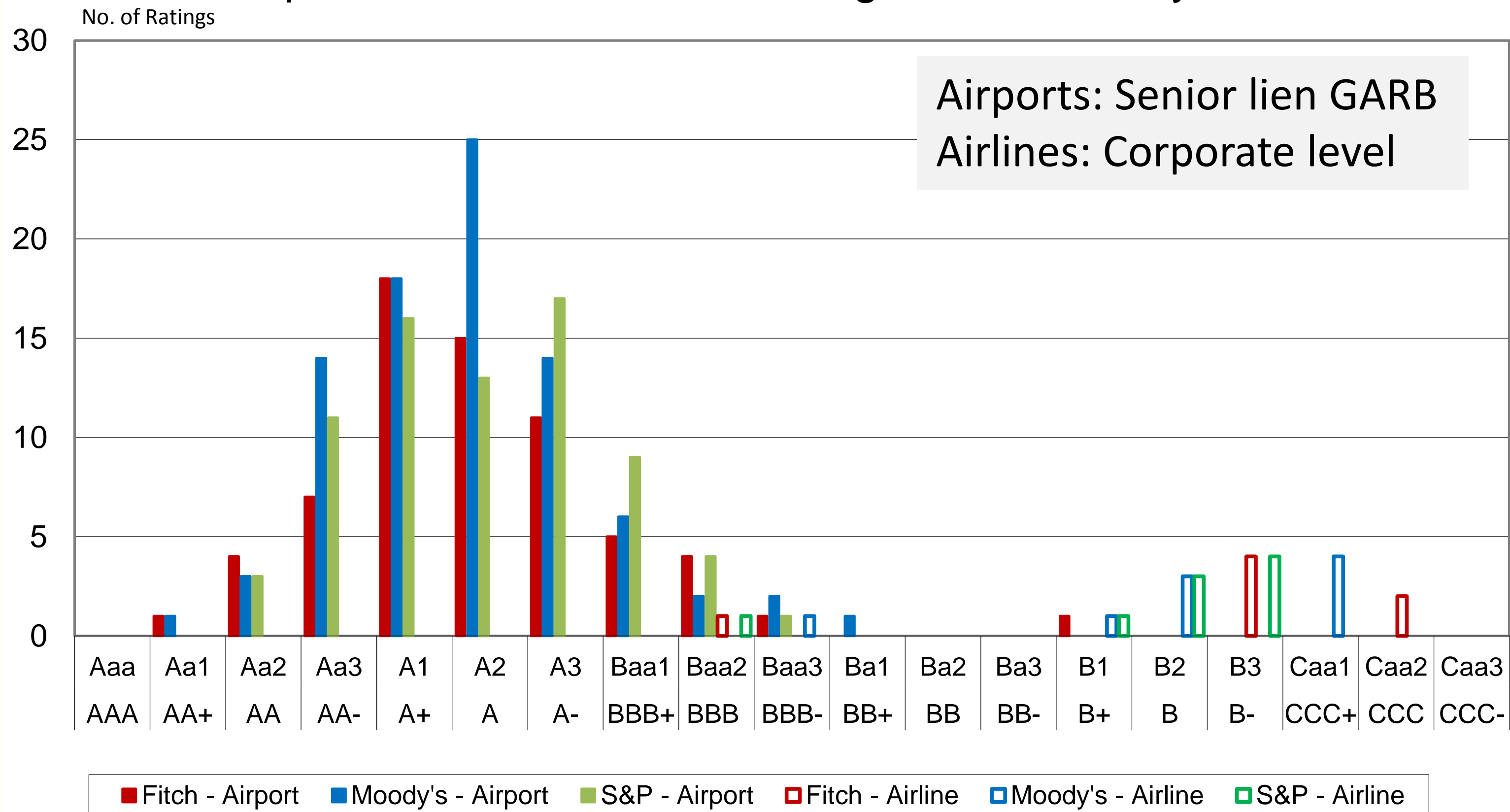
The Issues

- Airports seek high ratings to:
  - Reduce borrowing costs
  - Maintain access to the municipal bond market
- Airports seek to maintain liquidity and coverage to:
  - Support their bond ratings
  - Provide a source of internal capital funds
  - Provide reserves to protect against decline in enplanements / revenues
- Airlines view excessive liquidity and coverage as adding to their costs
  - They are unsure what level of liquidity and coverage are truly necessary for the maintenance of airport credit ratings
    - Believe excess generation of cash and coverage add to rates and charges
    - Believe excess generation of cash and coverage achieves lower return than alternative uses

The Difference In Credit Ratings



Sources: Fitch Ratings, Moody's Investor Service; Standard & Poor's Rating Service; as compiled by Ricondo & Associates, Inc. (December 2010 and January 2011
Prepared by: Ricondo & Associates, Inc. (March 2011)

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Airline Credit Characteristics

- Extremely competitive industry
- Influenced by economic cycles
  - Sensitive to event risk
- Limited barriers to entry
- Arguably strong barriers to exit – esp. for large carriers
- Limited control over major expenses, notably fuel
- Highly leveraged
- ATA 'unofficial list' - 185 airline bankruptcies since 1978

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Airport Credit Characteristics

- Market facilitating function
  - Open to all airlines
  - Limited commercial risk
- Demand driven by strength of local service area
- Significant barriers to entry
- Non-profit, cost-recovery nature of operations
  - Nature of the use and lease agreement with the airlines
- Federal oversight of rates and charges
  - Airport revenues restricted to airport uses
- No record of default for a major commercial airport

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Airline Rating Criteria

- Ratings cited are at the corporate level
  - Individual transactions are rated based on security pledged
    - Secured – mortgage, deed of trust, security agreement
    - Unsecured - bondholders do not have collateral or priority rights
      - Generally issued for general corporate purposes, not a specific project
      - Generally structured as non-amortizing, interest only (“bullet bonds”)
- Rating agencies focus on:
  - Industry risks
  - Market position and cost structure
  - Leverage
  - Cash flow
  - Liquidity

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Airport Rating Criteria

- Ratings cited are for senior lien general revenue bonds
  - Secured by a first lien on net revenues
    - Generally issued for a specific project
    - Generally structured as long-term fixed rate fully amortizing bonds
- Rating agencies focus on:
  - The economic base of the air trade area
  - Traffic composition
  - Competition from other airports
  - Passenger trends and provision of air service by the airlines
  - Airline market share
  - The business agreement (use and lease, ordinance, etc.)
  - Capital program
  - Debt
  - Finances

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Differing Need for Liquidity – Airlines

- Seek to maximize returns
- Maintain liquidity to:
  - Manage short-term events / changes in business conditions
  - Maintain market access
    - Typical corporate debt structure introduces refinance risk
- Sources of liquidity
  - Cash on hand
  - Sale of stock
  - Sale of unencumbered financial assets (e.g. miles, aircraft)
  - Sale of nonstrategic assets (e.g. regional airline)
  - Revolving line of credit
  - Issuance of debt
  - Support from outside vendors or lessors

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Differing Needs for Liquidity – Airports

- Operations structured to recover costs
- Manage short-term events / changes in business conditions
- Maintain access to municipal bond market
  - Typical airport debt structure places analytical focus on coverage and liquidity metrics
- Source of internal capital funds
- Sources of liquidity
  - Cash on hand
- Debt – commercial paper, short-term, long-term
- Rating agencies do not have established targets
- Rating agencies favor airports with higher liquidity / coverage to their peers

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Why Airports Focus on Liquidity and Coverage

- Short-term risk to airports:
  - Increased volatility of the airline industry
  - Shortened length of use and lease agreements
  - Rising debt levels
  - Compensatory use and lease agreements
    - Cost-recovery mechanism remains
      - Annual rate adjustments / extraordinary coverage provisions
- Airports gain greater control over facilities through:
  - Ability to accumulate cash reserves / internal capital
  - Incentives to maximize non-airline revenues
  - Diminished MII provisions
  - Ability to reallocate gates / accommodate new carriers

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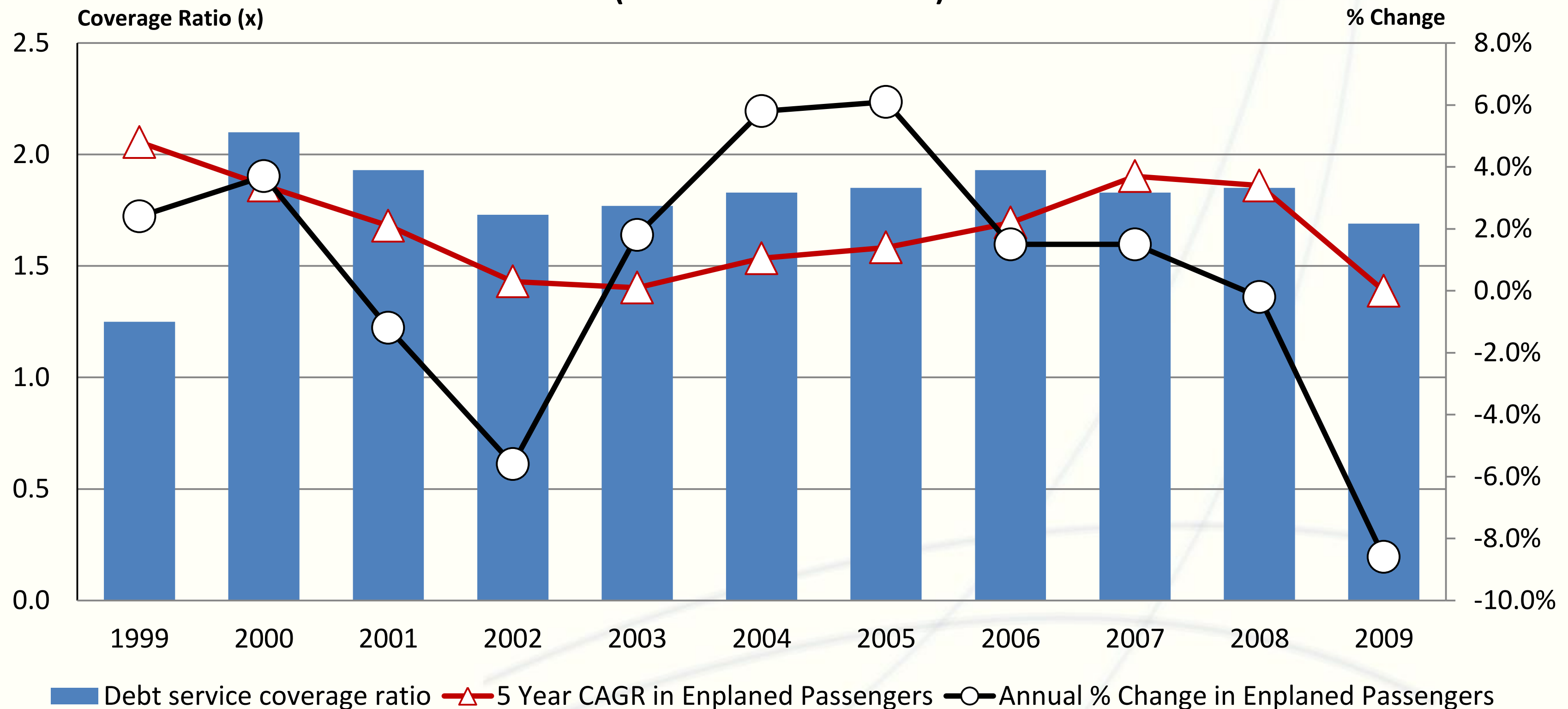
Rating Agencies on Liquidity and Coverage



Source: Moody's Investor Service, *U.S. Airport Medians for FY 2009*, December 16, 2010

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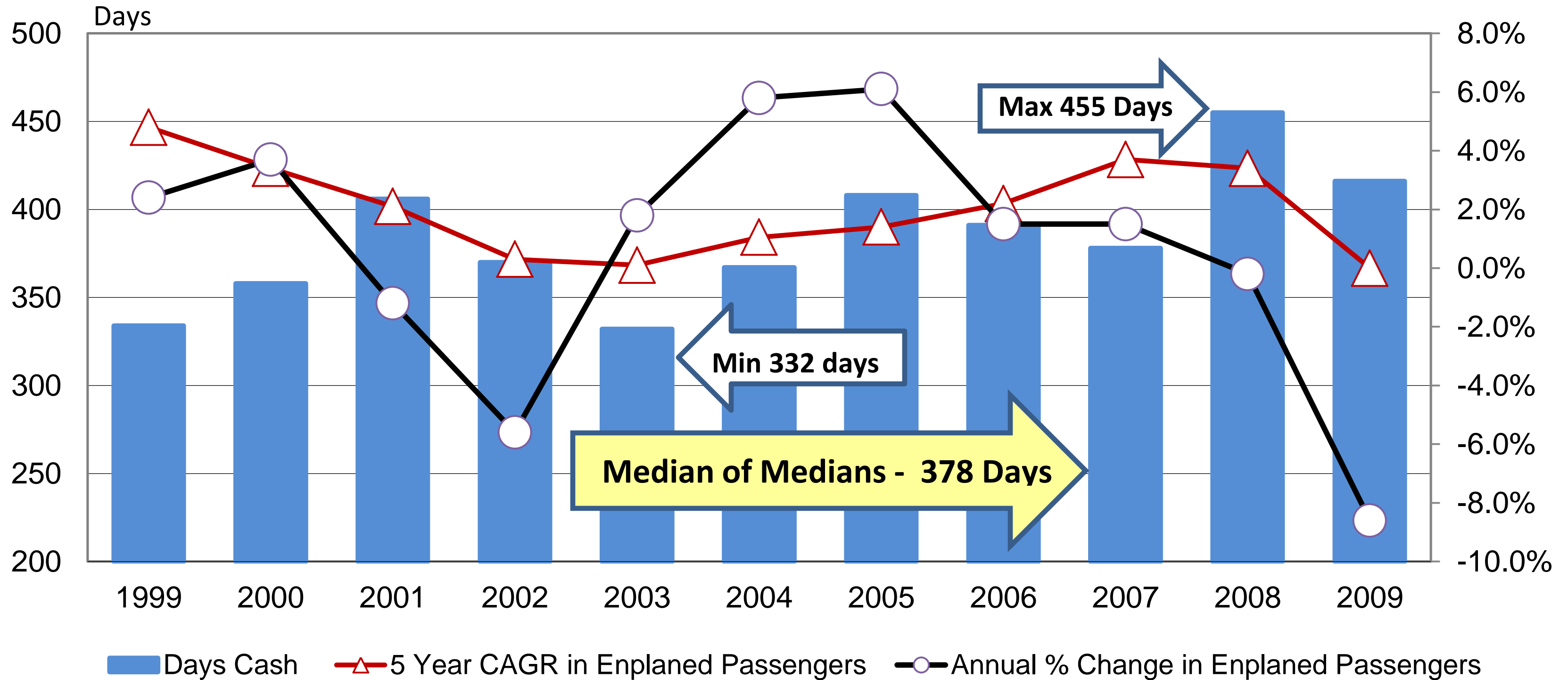
Rating Agencies on Liquidity and Coverage



Source: Moody's Investor Service, *U.S. Airport Medians for FY 2009*, December 16, 2010

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Rating Agencies on Liquidity and Coverage

Fitch on coverage and liquidity….

“Highly rated airports are expected to maintain consistently positive operating margins, which, over time, should also result in a healthy if not strong balance sheet.”

“An important part of (Fitch’s) analysis focuses on unrestricted liquidity as the airport sector is susceptible to adverse conditions, whether they come from carrier actions, macro events, or economic cycles. With healthy reserves, airports can use unencumbered funds in several ways, including weathering a likely airline bankruptcy, terrorist/health incident, or natural disaster, and also the cash funding of capital improvements or lowering the cost burden passed to the airlines or passengers.”

- Fitch “Indicative” ‘A’ category financial performance for a large hub/gateway airport

Debt to O&D Enplanements: $125 - $250

Debt Service Coverage Ratio: 1.25x – 1.5x

Net Debt to CFADS: 7.0x – 10.0

Days cash on Hand: 250 – 350

Source: Fitch Ratings, *Rating Criteria for Airports*, November29, 2010

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Why Ratings Matter to Airports

- Lower interest cost
  - Loss of bond insurance industry
- Political / Headline Risk
  - Ratings followed by press – viewed as a reflection of management
  - Loss of public support, political will to undertake projects
- Risk loss of market access
  - Limited options to raise capital other than the bond market
- Lack of non-investment grade market
  - Significantly higher interest rates

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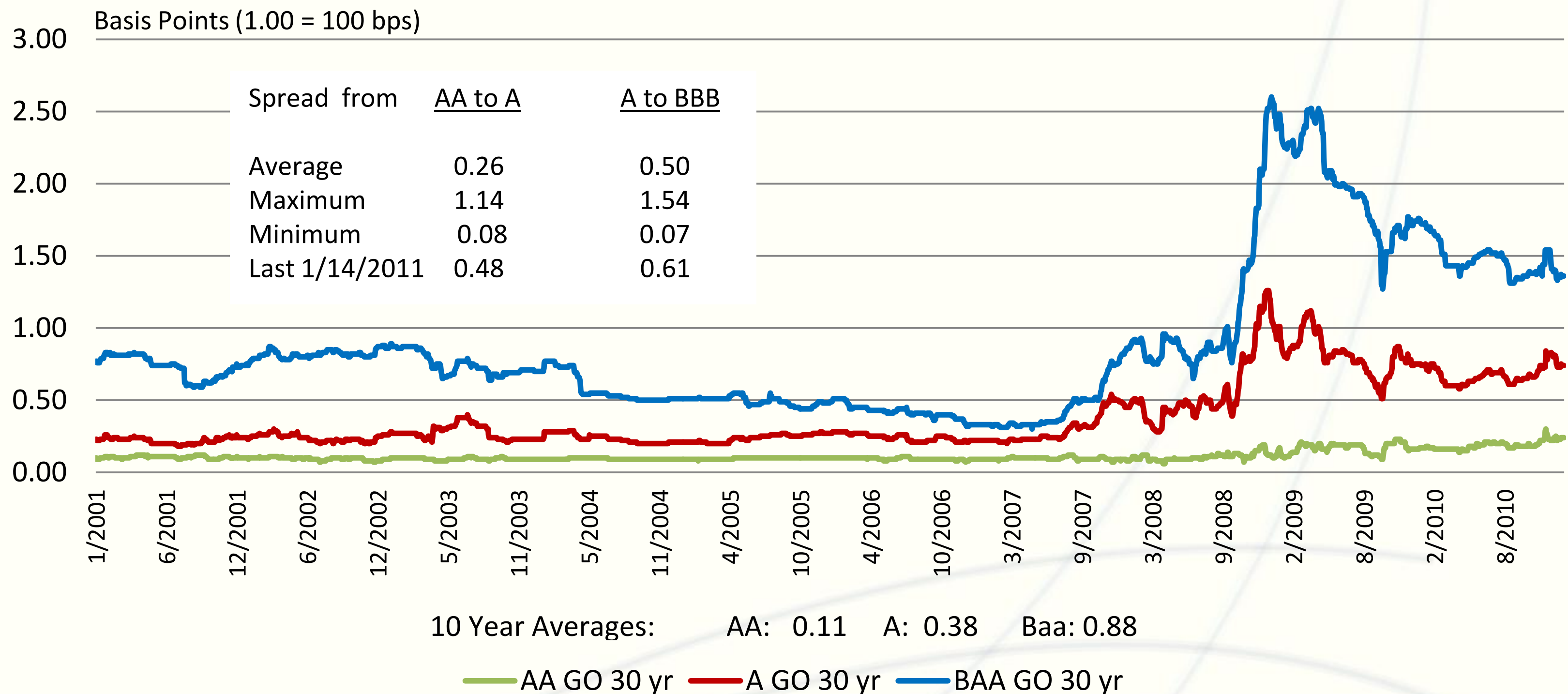
Ratings and Interest Rate Spreads



Source: Municipal Market Data provided by Piper Jaffray & Co. (April 2010)
Prepared by: Ricondo & Associates, Inc., April 2010

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Ratings and Borrowing Costs

- $200 million base amount
- Level debt service, calculated on ‘mortgage style’ basis
- 30-year term, 20-year rates used for average cost
  - Municipal Market Data General Obligation Scale - revenue bond spreads likely differ
  - Source: The Bond Buyer September 14, 2010
- Airport serves 4.0 million annual enplanements (PIT, MKE, SAT, IND)

Rating Category	AA	A	BBB
Base amount	$200,000,000	$200,000,000	$200,000,000
Interest rate	3.52%	4.11%	4.80%
P&I	$10,901,532	$11,720,990	$12,715,188
CPE	**$2.73**	**$2.93**	**$3.18**
Total interest cost	$127,045,958	$151,629,711	$181,455,653

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Ratings and Total Borrowing Costs

				Difference Between	
Rating Category	AA	A	BBB	AA and A	A and BBB
Interest rate	3.52%	4.11%	4.80%	0.59%	0.69%
Proceeds	$200,000,000	$200,000,000	$200,000,000		
Capitalized interest	$16,509,095	$19,641,040	$23,462,440	$3,131,945	$3,821,400
Capitalized interest period (mos.)	24	24	24		
Debt service reserve	$13,305,098	$14,522,054	$16,049,973	$1,216,956	$1,527,920
Other borrowing costs	$4,690,000	$4,779,000	$4,888,000	$89,000	$109,000
Total Par of Bonds	$234,504,193	$238,942,094	$244,400,413	$4,437,900	$5,458,319
Annual P&I	$13,305,098	$14,522,054	$16,049,973	$1,216,956	$1,527,920
CPE	$3.33	$3.63	$4.01	$0.30	$0.38
Total interest cost	$148,964,050	$181,153,603	$221,739,182	$32,189,553	$40,585,580

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Applying Cash and Total Borrowing Costs

				Difference between	
Rating Category	AA	A	BBB	AA and A	A and BBB
Interest rate	3.52%	4.11%	4.80%	0.59%	0.69%
Capital program requirement	$200,000,000	$200,000,000	$200,000,000		
Cash applied	$50,000,000	$50,000,000	$50,000,000		
Bond proceeds required	$150,000,000	$150,000,000	$150,000,000		
Capitalized interest	$12,381,862	$14,730,756	$17,596,830	$2,348,894.37	$2,866,073.62
Capitalized interest period (mos.)	24	24	24		
Debt service reserve	$9,978,856	$10,891,522	$12,037,480	$912,666.47	$1,145,957.42
Other borrowing costs	$3,518,000	$3,584,000	$3,666,000	$66,000	$82,000
Total Par of Bonds	$175,878,718	$179,206,278	$183,300,310	$3,327,561	$4,094,031
Annual P&I	$9,978,856	$10,891,522	$12,037,480	$912,666	$1,145,957
Total interest cost	$111,723,401	$135,864,981	$166,304,387	$24,141,580	$30,439,406
Amortization	$2,725,383	$2,930,248	$3,178,797	$204,865	$248,550
Annual capital charge (P&I + amort)	$12,704,239	$13,821,770	$15,216,277	$1,117,531	$1,394,507
CPE	$3.18	$3.46	$3.80	$0.28	$0.35
Difference With Use of Cash					
Total Par of Bonds	$58,625,475	$59,735,815	$61,100,103	$1,110,340	$1,364,288
Total resources (bonds & cash)	$8,625,475	$9,735,815	$11,100,103	$1,110,340	$1,364,288
Annual capital charge (P&I + amort)	$600,859	$700,284	$833,696	$99,425	$133,413
Total capital charges	$369,363,608	$402,978,687	$444,968,609	$33,615,078	$41,989,923
CPE	$0.15	$0.18	$0.21	$0.02	$0.03

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Observations and Recommendations:

- The disparity in airport and airline ratings reflect:
  - Differences in the industries
  - Differences in bond structures and risks
- Higher ratings and application of cash can reduce borrowing costs
  - Maintenance of higher ratings and cash reserves do impose costs
  - Market conditions will affect the magnitude of the savings achieved
- Airports should work to develop policies / goals regarding cash reserves
  - Factors to consider:
    - Seasonal cash flow variances
    - Level of financial exposure to any one carrier or group of airlines
    - Effect of a 10% - 15% decline in enplanements on revenues
    - Annual debt service and other fixed obligations
    - Amount of variable rate debt and interest rate exposure
    - Pending capital needs
    - Potential alternative uses of cash assets
    - Ramifications on airline rates and charges
- Airports should maintain a continuing dialog with the airlines on these issues
  - Communicate its policies and goals with the airlines and the rating agencies

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Thank You

- Questions

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