UNLOCKING VALUE IN THE AIRPORT-AIRLINE ECOSYSTEM

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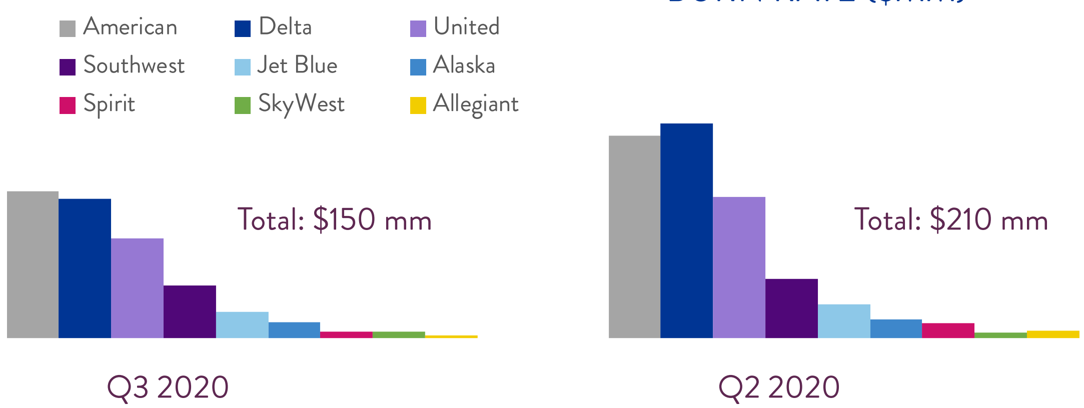
PJ SOLOMON
unrivaled wisdom

TWENTY-TWENTY WAS A YEAR OF AIRLINES CHASING LIQUIDITY AS THEY SOUGHT TO SURVIVE THIS UNPRECEDENTED DOWNTURN IN PASSENGER TRAFFIC.

During this time, they pursued all the common ways of raising capital: sale leasebacks of aircraft, collateralizing frequent flier programs, updating branded credit card relationships, and various other forms of debt and equity issuances. In addition, governments stepped in. The United States government has provided direct funds and loan programs to supplement what airlines have been able to achieve in the public and private markets. US-flagged airlines raised close to $70bn[1] last year with similar situations occurring throughout the world. The much-publicized liquidity needs of the airlines are of course symptomatic of all stakeholders within the airline-airport ecosystem. In the United States, **those stakeholders are missing significant opportunities to unlock value in the existing system.**

Nearly all commercial service airports in the US operate financially independent of their governmental sponsors, with profits from airport operations staying on airport and all costs carried by those using the airport. It is a closed financial system resulting from decades of federal law and practices between airlines and airport operators. Furthermore, the system as currently constructed supports stakeholder decision-making authority and control, over financial efficiencies.

AVERAGE DAILY CASH BURN RATE ($MM)



2020 highlighted pressures that have existed for quite a while. The system fails to incentivize business strategies that seek to deliver the full variety of what passengers want the most—and on which they are willing to spend money. Strong airport management teams across the United States recognize this, yet are hampered by the inability to nimbly manage their offerings due to inefficient procurement processes, lack of flexibility in credit-raising, and the bureaucracies that often come from a system with a large and not-always-directly-aligned set of stakeholders.

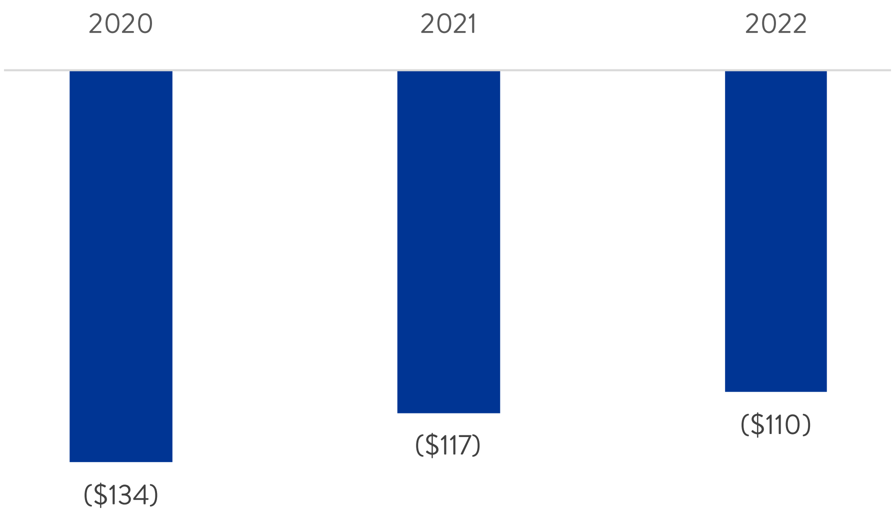
Inefficiencies exist on the spending side as well, with many US airports realizing annual increases in operations and maintenance costs at multiples of inflation[2]. These conditions are not new, and they have generally been viewed as acceptable tradeoffs. The pandemic and the associated downturn in passenger traffic have shined a light on the other side of these tradeoffs.

As examples of O&M cost growth, United Airlines' five largest airports experienced 2015-2019 CAGR of 2.5% - 11.2%, and Southwest Airlines' five largest airports experienced 1.9% - 7.7% over the same period.

AT PJ SOLOMON WE HAVE THE BENEFIT OF REGULAR COMMUNICATIONS WITH BOTH AIRLINE AND AIRPORT STAKEHOLDERS. Perhaps the most common theme discussed over the past several months is around risk allocation. In a closed system, there is a limitation on who may hold risk.

One could simplify most US airport systems and say there are essentially three parties that hold significant financial risk: debt holders, airport sponsors and airlines. The majority of airport debt is raised through the municipal bond market, and these bond holders conceivably hold risk. However, defaults on US municipal commercial airport bonds are very rare, historically isolated to bonds issued over 20 years ago where the sole obligor was an airline that entered bankruptcy[3]. Nonetheless, these bonds are ill-suited for providing short-term flexibility during a year like 2020. In other words, there is no substantial current risk being borne by these bond holders. That effectively leaves two parties – airport sponsors and airlines.

PROJECTED COVID RELATED REVENUE LOSS FOR CITIES, TOWNS AND VILLAGES ($BN)



Airport sponsors are the governmental entities that own and operate these facilities. Many of them are able to raise funds through taxes independent of the airport. In very few instances, however, has a city's corporate fund been used as a guarantor for its airport. These same governmental entities are now facing other unprecedented financial pressures, making this an even less viable financial backstop in today's environment. That leaves airlines to hold most of the risk at an airport.

In other words: if there will not be a default on an airport bond (and there has not been), the city sponsoring the airport will not redirect tax revenues to cover airport shortfalls (given so many other budgetary pressures), then airlines will be expected to ensure financial viability. **It does not have to be this way.**

Private sources of capital exist to take these types of risks, and the availability of such capital, along with the associated investor appetite, continues to grow. As we look at this year, we at PJ SOLOMON expect to see these critical discussions of risk allocation turn to actions that seek to remedy this issue.

The Federal Aviation Administration's Airport Investment Partnership Program (AIPP)[4] is one option for substantially changing the risk allocation at an airport. It provides an avenue for airlines to obtain cost security and predictability, and it is uniquely the only mechanism for an airport sponsor to realize substantial financial benefits that may be used outside of the airport environment. Updates to the program in 2018 included allowing current airport sponsors to continue to hold a partial equity interest in an airport lessee.

Writer Joseph Guinto examined why cities may look to airport transaction proceeds to deal with budgetary gaps in the 18 August 2020 issue of The Atlantic.

With these changes, a minority level of private investment could open the traditionally closed structure, while the government retains significant control and involvement in operations. A strong, existing airport management team could be maintained and supplemented by best practices and scale-efficiencies brought through a partnership. There may be a role for an airport sponsor's pension fund to also join the equity structure—and further align short- and long-term interests of all involved. We expect these opportunities to be increasingly attractive to airport sponsors facing non-airport budgetary issues[5], and there is an opportunity for airport management teams and airlines to use the FAA's program to also achieve their objectives.

Yet there are other structures outside of the FAA's AIPP that may be a quicker and better fit for other situations. We see these structures to be of interest to airlines and airport management teams as they change risk allocation and obtain cost and revenue efficiencies in simpler ways.

For example, major operating and maintenance expenses can be restructured as an availability-payment system. Heating, refrigeration and other utility systems are among prime candidates for consideration. Additional major revenue areas include in-terminal retail/food & beverage and car parking. The vision for restructuring these transactions is different than what has been pursued in the past by outsourcing janitorial contracts, master concessionaires and parking operators.

At least two distinct elements are critical. The first is ensuring that passenger traffic risk is offloaded to the private source of capital— likely the best to price and accommodate this risk. This ensures the airlines are holding less of the passenger risk that they will always hold on the airplane through their core business. The second is related to the financial strength of the private source of capital. It is important to ensure the capital provider has sufficient strength and the transaction is structured in a manner that requires them to maintain responsibility in the future. That airport retailers and food and beverage providers require permanent cancellation (or temporary deferments that will very likely eventually lead to cancellations) of contractual obligations[6] has illustrated the importance of financial strength of airport service providers.

Sustainability Partners is providing modernized infrastructure through a financial model that passes along substantial operational cost savings in ways that are easy to engage and terminate. They have successfully deploying solutions across more than 13 public agencies in at least 9 states within the US.

TCR provides turnkey full service operating lease solutions for the full range of GSE types, along with similar provisions for a variety of other airport/airline equipment across more than 140 global airports.

These value-producing transactions can be structured to optimize the timing of savings or revenue increases. Immediate cost relief may be a priority, and therefore an upfront payment to the airport may be useful. In other situations, it may be preferable to take the savings each year in the future. Alternatively, a situation may benefit from a mix of single-event and over-time realizations. We believe these situations also allow for enhancement of other important considerations, such as the participation of Minority- and Woman-Owned businesses and labor relations, when structured correctly.

We anticipate the future of commercial aviation will be more dynamic. Airlines are expected to be nimbler in making short-term allocations of seat capacity, as an example, with airports needing to in-turn access more flexible sources of capital. New ventures have been created to specialize in this area of flexible infrastructure management.

As an example, there are solutions that effectively convert the provision of essential infrastructure into a utility service[7]. This can be done to provide immediate environmental and operational efficiencies through system upgrades and at a fixed, reliable cost. Innovative solutions also exist in the areas of airport ground service equipment, on-airport buses, and other such movable equipment[8]. Airports and airlines may benefit from sale-leaseback opportunities that can provide immediate balance sheet benefits. Alternatively, equipment pooling with shared usage and a single-sourced maintenance provision may provide cost and operational benefits. These solutions need not take many months or years to realize – there are proven ventures that can deploy solutions in a matter of weeks with a variety of contractual options, including some as short as one month. The private sector is producing impressive innovations, and we expect to see these increasingly deployed across the US airport sector.

A key to success in realizing many of these opportunities comes through a thoughtful review of risk allocation. An understanding of the risks involved in managing an airport and an airline is critical, as well as an understanding of what options may exist in the private sector to provide viable risk transfer. Successful execution of these transactions requires both this sector knowledge and a broader capability in infrastructure investments.

We are confident the airline and airport industry will continue to evolve, benefiting from the lessons learned through this unprecedented period. What may come out of this is a system that better aligns the objectives of all stakeholders through flexible capital solutions and optimal allocation of risks. An airport management team's ability to manage nimbly through this period of upheaval has the potential to strengthen alignment of interests with the airlines they hope to serve. We believe this is increasingly important in an evermore competitive environment.

FOOTNOTES

1 Calculated based on increases in long-term debt as per Q3-2020 financials and equity stock issuances throughout 2020 from all U.S-based publicly traded commercial airlines listed on the NASDAQ and NYSE

2 United Airlines' five largest airports experienced 2015-2019 CAGR of 2.5% - 11.2%, and Southwest Airlines' five largest airports experienced 1.9% - 7.7% over the same period.

3 Bloomberg database search on all municipal bonds which are indicated to be "is-defaulted"

4 https://www.faa.gov/news/fact_sheets/news_story.cfm?newsId=24114

5 https://www.theatlantic.com/ideas/archive/2020/08/sell-airports/615331/

6 https://www.icf.com/insights/transportation/airport-concession-fees-covid-19

7 https://www.sustainability.partners/p3-as-a-utility-p3u-2/

8 https://tcr-manager.net/corporate/wp-content/uploads/sites/3/20201109-Aviationpros-TCR-Establishes-North-American-Presence.pdf

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ABOUT PJ SOLOMON'S AIRPORT & AVIATION BUSINESS SERVICES ADVISORY GROUP

PJ SOLOMON has established a specialized, airport focused practice within its Infrastructure, Power & Renewables Group. Comprised of individuals with global experience and sector-specific expertise, the Airport coverage practice helps our clients to originate and execute global airport and aviation-business related opportunities. For more information, contact Tim Bath (tbath@pjsolomon.com) or Shawn Kinder (skinder@pjsolomon.com) and visit www.pjsolomon.com.