Rating Methodology - Airport Companies

[In supersession of "Rating Methodology - Airport Companies" issued in June 2017]

Industry landscape: India has a total of 125 airports managed by Airport Authority of India (AAI) (of which 81 are domestic, 11 are international, 8 customs airport and 25 civil enclaves at defence airfields) which handled total passenger traffic of 308.75 million in FY18 (refers to the period April 01 to March 31) representing a growth of 16.5% over FY17. While most of the airports are operated by Government of India (GoI) through the Ministry of Civil Aviation (MoCA) controlled Airports Authority of India (AAI), five of the country's biggest airports namely Delhi, Mumbai, Hyderabad, Bangalore, Nagpur and Cochin are managed through Public Private Partnership (PPP) model. These airports handled around 55.5% of the total passenger traffic movement during FY18. With the expected growth in passenger traffic to 452 million by 2021 according to CAPA India, the country would need significant investments in developing the aviation infrastructure (mainly airports) to cope with the increase in the passenger traffic. In addition to this efforts have been made to revive defunct airports and develop greenfield airports as well.

This rating methodology provides insight into CARE Ratings' detailed approach on the rating of airports. This methodology is prepared to work as a reference tool for issuers, investors and other market participants to help them understand the various factors considered by CARE Ratings while rating the airport companies. The rating methodology identifies four key rating factors that drive credit rating of the airport operating companies. The first three factors and their sub-factors focus on the business risk profile and management's assessment while the fourth factor concentrates on the analysis of the financial risk associated with the company.

1. Regulatory environment

Revenues of an airport operating company fall into two broad categories a) aeronautical revenues (charges levied on the passengers and the airline operators for using the airport infrastructure viz. passenger fee, user development fee, landing and parking charges, fuel farm etc.) and b) non-aeronautical revenues (rental on food and beverage outlets and retail outlets, duty free shops, advertisements, car parking, leasing of space within terminal to third parties viz. tour and hotel operators and airline check-in counters). An airport operating company usually enters into agreement with third party to provide these services and earns a fixed rental and/or a fixed share of the revenue earned by the third party.

Airports are natural monopolies given that development of new airports is in general a rare event as most of the existing airports go for brownfield expansion to serve increasing passenger traffic. In a developing economy like India, the replacement of an existing airport with a new and bigger one at a different location is a more likely event.

Hence, the number of airports is not likely to increase rapidly in a short span of time leading to monopolistic business environment. As a result, airport companies are under purview of certain economic regulations wherein the regulatory body uses various methods to estimate the revenue requirements of the airport operators and accordingly fixes the charges for various aeronautical services. While analyzing the regulatory environment encompassing the airport companies, CARE Ratings considers the following:

The approach to determine the aeronautical charges

The approach of determining the tariffs may or may not be defined in the concession agreement. In case, the approach is not defined in the concession agreement, then the regulator in consultation and interaction with company management and other stakeholders viz. passengers, Government bodies and airlines, may use the most suitable approach. The final tariff decision is made by the regulator in line with the concession document.

There are broadly three approaches to arrive at aeronautical charges “Single Till”, “Dual Till” and “Hybrid Till”. Under 'Single Till' approach, revenues from both aeronautical and non-aeronautical activities are taken into account to determine the passenger fees.

However, under the “Dual Till” approach only aeronautical activities are taken into consideration. Hence, airport charges derived using the single till approach is lower than they would under a dual till as non-aeronautical revenues are fully subsidized under single till. Third is the mixed approach for determination on airport charges known as “Hybrid Till” approach. Under this approach the regulator subsidizes only a part (usually 25-30%) of non-aeronautical activities while determining the charges. From cash flow perspective, an airport operating under dual till mechanism would be better off as compared to an airport operating under single till mechanism.

In addition to the selection of till, the regulator also determines the “Regulatory Asset Base (RAB)” on which the operator is entitled to earn a fair rate of return (mainly cost of capital).

Generally, all the airport assets are covered under RAB. However, in case of any cost overrun, the regulator may use its discretion to determine allowable project cost. Hence, it is important to review the project capex plan and determine if any cost overrun has occurred. The cost overruns on account of extraneous factors could be considered by the regulator. However, in case cost overrun is on account of poor planning and execution, then it may lead to RAB being lesser than the actual capex which can affect the returns of the airport operator. In conjunction with the till, CARE Ratings also analyses airport operator’s revenue-sharing arrangement with the government, the commercial rights to develop the land near airport etc. The essence of this analysis is to ascertain the predictability and volatility of the earnings which would be used to service the debt.

Regulatory evolution and policies

Regulations and policies tend to evolve and develop over a long period of time and therefore a regulator’s track record plays a key role in any sector that it governs. Consequently, CARE Ratings favorably factors in an established and transparent framework of economic regulations allowing a fair rate of return to the airport operator on its investments. Whereas a regulatory framework with no track record and lack of robust policies may hamper the business risk profile of an airport operator.

Flexibility in rate setting

Rate setting model of one airport can be significantly different from another airport. Given that aeronautical charges determined by the regulator are based on certain assumptions such as projected passenger growth forecasts and air traffic movements, any adverse variation in the actual traffic vis-à-vis estimates could lead to economic losses for an operator. Though the airport operator is exposed to the traffic risk, provisions to pass-through such risks through truing up mechanism would help in removing the uncertainties associated with the traffic risk and also help the operator achieve fair rate of return over long term. CARE Ratings would view such pass-through arrangements by an economic regulator positively.

2. Market position and passenger base

Passenger traffic is the key revenue driver for airport and the number of passengers using the airport would determine the revenues it could generate. Hence, CARE Ratings evaluates various factors that have a direct relation with the passenger traffic such as location of the airport, population of the region, service area, region's economic base and competition from other airports. Additionally, credit profile of the major airlines operating at the airport is also evaluated to gauge counterparty risk. These factors help in determining the earning potential of an airport over a longer period of time. An airport that can maintain healthy traffic levels through economic downturn as well consistent growth in growth periods is viewed more favourably than an airport with fluctuating traffic.

Population:

Population of the area to be served is the most appropriate measure given that passenger volumes are the key revenue driver for any airport. CARE Ratings believes that there is a good correlation between population of the service area and the likelihood of airport usage.

Location:

Airport's location is important as it boosts the potential of airport to become a hub for major airlines and a geographically well-located airport would get much higher transfer traffic as compared to origin and destination airport. Location that provides better connectivity also attracts more number of airlines which automatically leads to higher passenger traffic leading to better earning profile.

Region's economic base:

Region's economic strength has significant implications on the passenger traffic. Therefore, CARE Ratings carefully analyses region's per capita gross domestic product (GDP) and income levels, economic diversity (presence of multiple industries), employment rate etc. Region with important business districts and tourist destinations would be better positioned as compared to a region which is highly dependent on particular economic activity which makes it more susceptible to the economic cycles. Also, an airport in a location attracting a lot of tourist traffic from various cities across country / world will be less dependent on local economy.

Service area:

Determining the area to be served is somewhat complex and subjective. A major international airport of the country which is considered one of the gateways to the country would have a larger service area as compared to a small regional airport which would be able to serve a limited region. CARE Ratings views an airport with larger area to be served with no competition from other major airport in vicinity favorably as compared to a regional airport with limited service area.

Airline's financial profile:

The airport operator not only collects the landing and parking charges from an airline but also the passenger and user development fees, which is usually built into the ticket price. This exposes an airport operator to counterparty risk. Therefore, CARE Ratings critically examines the financial profile of the major airlines operating in the region. Airport serving profitable airlines with sound financial profile would have better track record in collecting the due aeronautical charges and passenger fees in timely manner. However, if the region has large number of financially-weak airlines or if the entire airline sector is going through a trough then it would have negative implications on the airport operator due to high counter-party risk. A structured payment mechanism to directly remit passenger and user development fees collected by airlines into dedicated escrow accounts of the airport operator would be considered positively by CARE Ratings as it would help mitigate counterparty risk to an extent.

Competition:

Airports are generally less susceptible to competition due to capital-intensive nature coupled with regulatory hurdles of public utility type entity. This creates strong entry barriers. However, these projects remain exposed to competition from new airports that may be allowed and developed by MoCA/AAI in the nearby vicinity. CARE Ratings evaluates the competitive position of the airport by reviewing the concession documents to understand if the concession agreement provides immunity from any new airport for a sufficiently long period of time so that there is no threat to the earning potential of an airport especially during the tenor of the loan. Presence of such anti-competitive clauses provides monopolistic features to the airports thus increase the earning potential.

3. Promoters/sponsors and management track record

Airports can be characterized by wide range of ownership from being a PPP to a fully government-owned and operated. Promoters/sponsors experience and capabilities play a key role in running airport operations. Hence, sponsors experience and resourcefulness are given utmost importance while evaluating management competency, commitment and quality.

Experience:

For seamless airport operations, an airport operator is required to handle multiple functions such as aeronautical operations, cargo handling, terminal operations, airport retail and commercial operations effectively. Hence, assessment of airport operator's experience is very crucial. Inability to manage the operations may lead to higher-than-projected operating and maintenance costs which may deplete the cash flows or may also result in non conformity to laid out service quality standards by the regulator. Hence, CARE Ratings believes that an experienced airport operator tends to benefit when it comes to managing the airport operations. This also helps in mitigating the operational risks. To evaluate management's experience CARE Ratings looks into the promoters previous involvement in similar project that have been operated successfully. Sponsor with significant experience of similar business with successful track record is viewed favorably.

Financial strength and commitment:

Considering the capital-intensive nature of business, a company with financially strong promoters enjoys an advantage over others as their ability to infuse and/or raise funds in a timely manner is the key rating criteria. Further, the strong group presence / parentage would result in enhanced financial flexibility. CARE Ratings looks for evidence of the promoters‟ commitment towards the company. Promoters having significant resources, time and money invested in the company is factored in favorably. Conversely, promoters with limited or low operational and financial resources would not provide any strength to the rating.

Key credit metrics

As described in the beginning of this methodology, the first three factors and their sub-factors aim to capture the fundamental strengths and weaknesses of an airport operator, while the key credit metrics covers the financial risk profile of the company. For evaluating credit metrics, CARE Ratings follows its standard ratio analysis methodology in order to assess the financial risk of companies (refer to CARE‟s Rating Methodology for Manufacturing Companies for this section).

If the company is implementing the airport project then besides the parameters discussed in the methodology CARE Ratings would give due consideration to implementation stage of the *project, achievement of financial closure, availability of land and requisite clearances and track record of project executing agencies.*

Conclusion

The rating outcome is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CARE Ratings analyses each of the above factors and their linkages to arrive at the overall assessment of credit quality of an issuer.

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