CARE Ratings
Professional Risk Opinion

Rating Methodology - Airport Companies

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Industry landscape: India has a total of 137 airports managed by Airport Authority of India (AAI) (Operational -109 and Non Operational-28) (of which 55 are domestic, 21 are international, 6 customs airport and 27 civil enclaves at defence airfields) which handled total passenger traffic of 340.94 million in FY20 (as against 344.67 million in FY19) (refers to the period April 01 to March 31), representing a marginal decline of 1.08% over FY19. 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 and Cochin are managed through Public Private Partnership (PPP) model. These airports handled around 51.86% of the total passenger traffic movement during FY20.

India's aviation industry is largely untapped with huge growth opportunities, considering that air transport is still expensive for majority of the country's population, of which nearly 40% is the upwardly mobile middle class.

Rating Methodology

This rating methodology provides 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 companies involved in operations, management and development of both greenfield and brownfield airports. CARE Ratings looks at a time horizon over the life of the debt instrument being rated and covers the following areas while rating airports.

1. Business Risk Assessment

Contractual Structures

The development, operations and management of airports under PPP entails involvement of many stakeholders such as Airports Authority of India (Authority), MoCA, Airports Economic

Regulatory Authority (Regulator, AERA), GOI-designated agencies, State Government and the Airport Developer/ Concessionaire.

The concession agreement between Authority and airport developer provides the framework within which the airports operate, develop and manage under PPP, and such framework is implemented through Special Purpose Vehicles (SPVs).

CARE examines whether the risks are identified and allocated appropriately among the stakeholders. The contracts entered between SPV and the stakeholders are assessed which defines the allocation of risks. Furthermore, the contracts are assessed for their comprehensiveness, clarity and enforceability.

Revenue Risk

An airport is primarily exposed to the risks associated with revenue generation. An airport generates revenue from providing aeronautical services and revenues from services other than aeronautical services.

Aeronautical Revenue:

Aeronautical charges are levied on the aircraft and passenger for providing services and infrastructure at the airport. Aeronautical charges are regulated by AERA (Regulator). A high degree of certainty in tariff determination makes cash flows of airport operators more predictable and viewed positively.

Non-Aeronautical Revenue:

Non-Aeronautical revenue stream includes revenue from lease of commercial space at airports, advertisements, baggage handling, fuel-farms, food and beverage outlets and revenue from development of real-estate around the airports. Non-aeronautical revenues are not regulated and therefore provides scope for growth potential, wherein the operator enters with contractual agreements with the third party for offering the services. Against the established airport, Greenfield airport faces uncertainty over generation of non-aeronautical revenues as marketability of various streams of revenue is not tested.

Regulatory Environment

Typically, the aeronautical revenues are regulated, largely to counter the monopolistic nature of airports. It is important to assess the concession framework of economic regulation within which the airport operates.

Determination of aeronautical charges

AERA is the designated Regulator by GoI for determination of Aeronautical charges [including user development fee (UDF)[1]] for the airport as per Airports Economic Regulatory Authority (Terms and Conditions for Determination of Tariff for Airport Operators) Guidelines, 2011. The aeronautical charges are reviewed by the Regulator once in 5 years (Control Period). The first control period was from 2011 to 2014 and thereafter every five years.

The GOI has, through the National Civil Aviation Policy dated June 15, 2016, approved, (Shared-Till or Hybrid Till) the 30% of the non-aeronautical revenues to be used in shared-till framework for the determination and regulation of the aeronautical charges for all airports in India and the same shall be considered by Regulator for the purpose of the determination of the Fees/ Aeronautical Charges.

GOI has proposed a new concession structure for Greenfield projects called NextGen Airports for Bharat Nirman 2018. As per the guidelines in the NABH Nirman scheme, the 'Maximum Blended Aeronautical Yield' (MBAY) in terms of INR per passenger shall be pre-determined by the Concession Authority at the beginning of the Concession Period. The total annual allowable aeronautical revenue for the Concessionaire shall be the MBAY multiplied by the annual number of passengers at that airport. Once in five years, the Concessionaire shall submit its proposed tariff card and projected tariff for five-year period to the Regulator. The tariff card shall be developed in such a way that the projected aeronautical yield during the five-year period is less than or equal to the MBAY on a present value basis.

CARE assesses the transparent framework in deriving the aeronautical charges for firmer future estimations.

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[1] *User Development Fee (UDF) and Airport Development Fee (ADF) are levied on passengers but they are conceptually different. ADF is used to fund ongoing modernization of airport assets, while UDF is levied to bridge any revenue shortfall so that the airport operator is able to get fair rate of return on investment.*

<u>Flexibility in rate revision</u>

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 cash flow disruptions till truing up is undertaken and approved for recovery by the Regulator. Thus, the frequency of tariff revision, and the timeliness of implementation of tariff revisions are important to lend predictability to future revenue generation at an airport.

<u>Revenue Sharing Structure with Authority:</u>

So far, share of gross revenue of the airport operator has been the bid parameter in Greenfield airports. There are many challenges, however, in monitoring and finalizing the 'gross revenue' and hence the share thereof payable to the Concession Authority. The intrusive accounting process, controversies and legal disputes lead to wastage of time, effort and money for all parties involved with limited positive outcome. The new model under NABH Nirman 2018 Scheme address the same with simple per passenger fee metric as the sole criteria for appointment of the selected bidders and Concession Fee payment to the Authority. Furthermore, the annual revision in Per Passenger Fee shall be revised taking into account CPI (IW).

CARE views more predictable nature of cash flows positively while assessing the risk.

Operating Risk

An airport operator has to adhere to the performance indicators and service levels set forth in the concession agreement for various services offered including operating aeronautical assets such as runways, taxiways, aprons and approach area, etc, permitting safe, smooth and uninterrupted movement of users and flow of traffic, terminal building, vehicle parking, cargo facilities, ground handling services, aircraft fueling services, check-in Services, VIP lounges, immigrations, customs and safety requirements, etc. The airport operator shall confirm to the standards set out by International Civil Aviation Organization (ICAO) for operating aeronautical assets. Furthermore, the airport operator has to engage with various agencies such as Bureau of Civil Aviation Security of India (BCAS), Air Traffic Control (ATC), Ministry of External Affairs of India, Central Industrial Security Force (CISF) and other designated agencies of GOI for smooth operations of an airport.

On account of increased maintenance standards and service quality levels in managing the next generation airports, airport operator will incur higher O&M expenses. Further, if an airport operator fails to execute O&M obligations as per the provisions set out in the concession agreement; penalties levied by the Authority may lead to higher O&M expenses.

Hence, the assessment of airport operator having established track record in managing airports are viewed credit positively compared to the airport operators with limited track record.

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:

An important indicator is the size of the population in an airport's area to be served and is the most appropriate measure given that passenger volumes are the key revenue drivers 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.

Traffic Pattern & Volatility:

An established track record of passenger/cargo growth and its volatility plays an important role in assessment of future cash flows of the airport. Hence, an airport with stable growth rate historically coupled with less volatility are viewed credit positive.

Counterparty risk:

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.

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 the 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.

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 due 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 or the appointed operator's track record involvement in airports of similar capacity have been operated successfully. Sponsor or an operator 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. Furthermore, the strong group presence / parentage would result in enhanced financial flexibility. Since the infrastructure projects are financed generally on a project finance basis, CARE Ratings looks for evidence of the promoters' commitment to provide support beyond the risk capital that is already factored in.

For detailed note on evaluation of management risk: Refer to CARE's Rating Methodology-Infrastructure Sector Ratings (ISR) on our website www.careratings.com

4. Financial Risk Analysis

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 detailed credit metrics, CARE Ratings follows its standard ratio analysis methodology in order to assess the financial risk of companies (please refer to CARE's Financial Ratios- Non Financial Sector on our website www.careratings.com).

Other Aspects:

Foreign Currency fluctuation risk: Though airports have moderate share of income in foreign currency denominations (revenue from duty-free sales or any tariff levied on international passengers), which is exposed to fluctuations in foreign currency. Airport entities importing equipment, spare parts and having External Commercial Borrowings are exposed to fluctuation in foreign currency. Thus, the entity's hedging policy needs to be assessed for cash flow impact.

Refinancing Risk: Debt from banks/FIs for funding expansion plan for airports are available for a tenor of 3/5/7/10 years; it is exposed to the refinancing risk for varying degrees. So, while refinancing risk is in general considered as negative from a ratings perspective, the income generation ability of an airport project is considered while assessing refinancing risk. As such, the impact of this risk on the credit profile of an airport will differ on a case-to-case basis.

5. Project Risk Analysis

If the company is implementing the greenfield/expansion airport project, then besides the parameters discussed in the methodology above, CARE Ratings would give due consideration to implementation risk.

For evaluating detailed project implementation risk, CARE Ratings follows its standard methodology in order to assess the project implementation (please refer to CARE's Rating Methodology - Infrastructure Sector Ratings (ISR) on our website www.careratings.com).

Conclusion

The rating outcome is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CARE's Rating Committee analyses each of the above factors and their linkages to arrive at the overall assessment of credit quality of an issuer based on its holistic judgement.

[For previous version please refer 'Rating Methodology - Airport Companies' issued in September 2019]

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