Airports: the next risky bet of infrastructure funds

A primer on the Airport industry in Europe

This second part on the air transport industry reaction to the COVID-19 pandemic (part one here) will focus on the infrastructure investment business revolving around airport ownership.

Airports are a significant piece of infrastructure that enables air travel. As we saw in part one of this analysis, air travel has large upstream and downstream economic impacts. Also, airports directly benefit regional economies. For example, it favors the development of business through facilitated transport and opens the gate to international tourism. Because of this central role in a country's economy, governments are usually heavily involved in the development of these infrastructure projects. Indeed, most Airports are operated by regional governments or government-owned corporations.

Airports have two major sources of operational revenue: aeronautical and non-aeronautical activities. Aeronautical revenues are generated by fees connected to the main activities of the airport, which include passengers transport, landing, terminal usage fees and any other charges directly related to the operation of the airport. Non-aeronautical revenues come from commercial activities done on the areas belonging to airports. These include parking, concessions for restaurants, advertising, and rent. In 2015 the global Airport revenue accounted for $152bn. 56% came from aeronautical services, while 40% were generated by the other commercial revenue streams. The remaining 4% are non-operating revenues which often are constituted by government grants & others.

Ownership Structure

Historically, airports worldwide are mainly owned and operated by regional or national governments. The upfront investment and the amount of land needed would be hard to obtain without the help of the public. Nevertheless, most airports are no longer directly managed by governments, instead, they are incorporated as enterprises, and they are exposed to the same incentives to create value as regular businesses. Since the liberalization of the aviation industry in the 1990s and the creation of the single market in the EU, we saw the rise of strong competitive forces amongst airports. The need for innovation and investment opened the door for private investors into the industry.

Thus, many governments have ongoing privatization programs. In the past decade, private investment in airports rose very quickly. In 2010, 78% of the airports were fully owned by the public, while in 2016 only 59% were fully publicly owned. Especially larger and well-known airports attract private investors. Thus, while airports with at least some private shareholders make up for only 41% of all airports, they constitute over 80% of the annual passenger traffic.

The privatization of airports is at a much further stage in Europe than it is in the US. In Europe, 15.8% of the Airports are fully privately owned, while there is only one fully privately-owned airport in the US. The difference is caused by a different approach to privatization. While Europeans started the privatization with their largest airports, in the US they started with smaller and less profitable ones.

Because of their importance to a country's economy, governments never cede full control. Usually, the government continues to own the land of the airport and writes out licenses and concessions of various lengths to different operators. The terms of such concessions vary widely across airports and countries.

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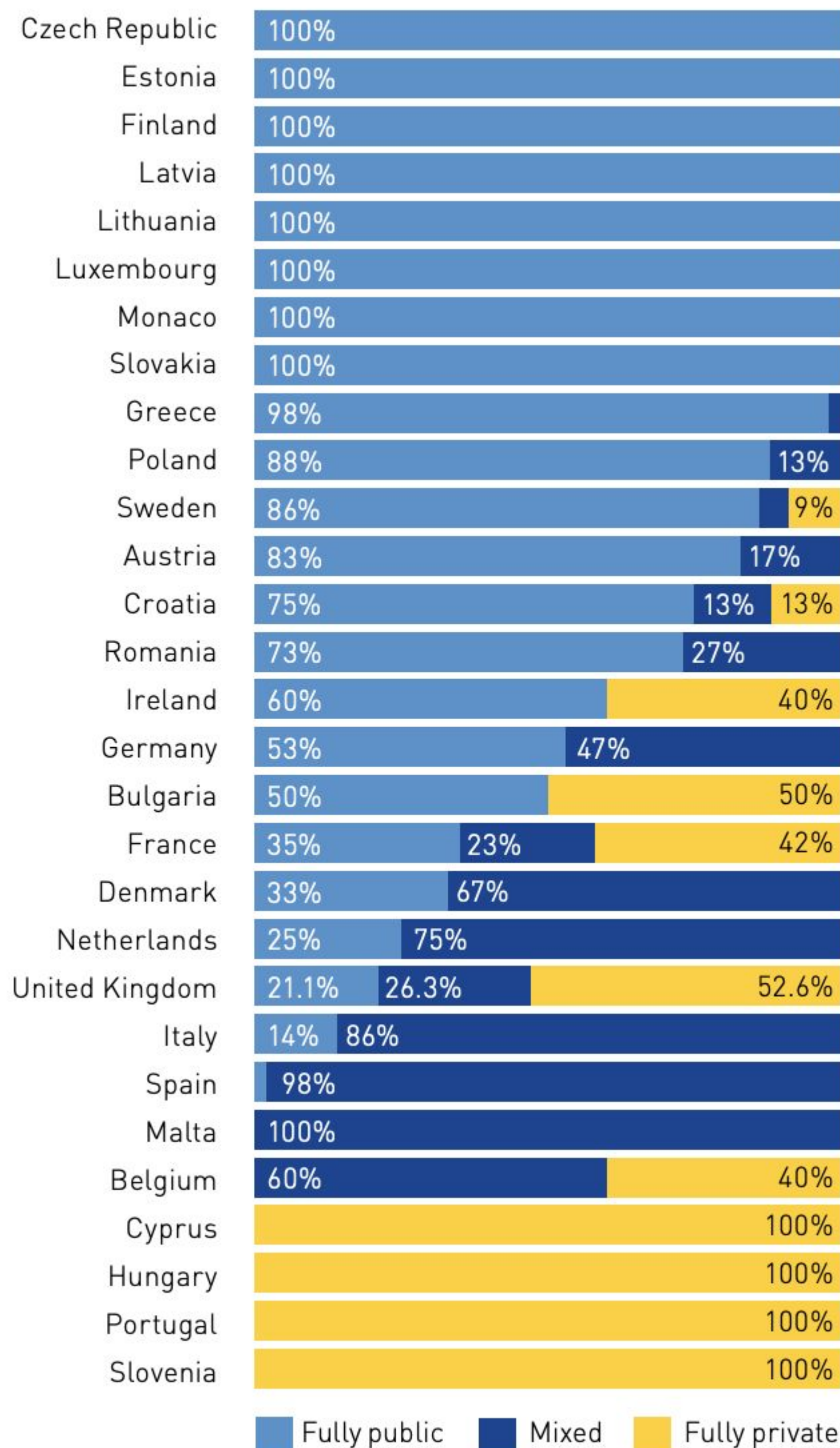

Source: 2016 Airport Council International Ownership Report

Capacity Management

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Before the Pandemic, the Airport Council International (ACI) reported that there was a gap between needed and actual investment into European airport capacity of €12.3bn from 2019 to 2023. According to ACI the average flight fare increased by 26% over the past decade due to capacity constraints. Indeed, many airports in Europe are categorized as coordination level 3. This means that the demand from airlines for the airport outweighs its capacity.

Airports are generally classified based on demand by airlines. The unit which is used to measure the capacity is slots. A slot is a time required for a passenger jet to land, perform all the necessary operations to fly again, and depart. Level 1 airports have enough supply for all the airlines' requests. Level 2 airports do have a minor capacity constraint which usually can be resolved through cooperation amongst airlines. Level 3 airports have such a big demand that they need an outside coordinator to decide who gets to land and who does not. Airports usually divide their slots into winter season (22 weeks) and summer season (30 weeks) and the coordination level is assigned separately to each season (e.g. Some airports are level 2 for the winter season but level 3 for the summer season).

Usually, incumbent players have an advantage in securing slots. According to EU law, an airline is granted to maintain its allocated slots if it uses at least 80% of them. If they do not efficiently use the capacity allocated to them, the slots will be reassigned the following season to other requesting airlines. To enhance competition, 50% of the slots in the reassignment pool have to be allocated first to airlines that do not operate yet in the airport.

These slots are often considered to be one of the most important assets of airlines, nevertheless, the sale of landing rights is prohibited by EU law. Instead, airlines are only allowed to trade slots from different airports on a 1-to-1 basis. Airlines have been requesting that the regulator allows a transparent secondary market for slots. Proponents say that this would optimize the usage of Airport resources and capacity.

The airlines' reliance on slots explains the event of "ghost flights" we saw at the beginning of the Covid-19 pandemic. If they would not use at least 80% of the slots, they would be reassigned to other airlines. Thus, they preferred to fly empty planes rather than losing their slots. Because these "ghost flights" had a disastrous impact on the environment and on the economy, the 80/20 rule was suspended by EU lawmakers on April 1st. While this change benefitted airlines, airports could no longer rely on the revenue stream from constant departures. At the current moment when this article is being written, the 80/20 rule is suspended until the end of the winter season that ends March 27th 2021. Major airport operators are requesting to reinstate the 80/20 rule for the 2021 Summer season. According to them, this would increase competition amongst airlines to bring capacity back to pre-pandemic levels as soon as possible.

The Impact of the Pandemic

As for the wider air transport industry, the Covid-19 pandemic was disastrous for airport operators as well. With most fleets grounded, and no passengers going through them, their revenues declined by almost 75%. At the same time, their cost base, as for most infrastructure assets managers, is mainly fixed. This leaves them little room to navigate in a situation like this. Thus, Airports had to tap into capital markets to finance their operations. One popular way of financing they are recurring to are Promissory Notes. Luckily the demand for such debt instruments is quite high—this October, the Frankfurt Airport even increased its offering from €150m to €250m because it was heavily oversubscribed. Nevertheless, it remains unclear for how long airports can access debt markets in a sustainable way. According to ACI if the situation does not improve soon, 193 Airports across Europe could face insolvency in the coming months.

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Governments are likely to step in and rescue airports, as they facilitate 277 thousand jobs across the EU, and they constitute, without considering all the externalities, €12.4bn of the European GDP. Also, airport closures would cause major disruptions within the European transport system. Alternatively, governments could rely on selling equity of the operating companies. As airports are desperate for liquidity, infrastructure funds could seize the opportunity to acquire major stakes within such companies. Air travel is likely to recover in the midterm future, and infrastructure funds with longer investment horizons might seize the opportunity and invest in such assets. We already saw two deals playing out in Europe. In August, Columbia Threadneedle Investments bought non-core assets from the Manchester Airport Group, who operates three airports in the UK, for £340m. Then in October we saw the F2i infrastructure investment fund acquiring an 80% stake in the Olbia Costa Smeralda Airport in Sardinia.

Conclusion

The Covid-19 pandemic is a seismic event for the whole air traffic industry. Passenger numbers are down significantly year over year, but most industry experts agree that in the medium term we will go back to the pre-pandemic demand for air travel. The situation in the short run, on the other hand, is hard to predict. We do not know yet how long the Covid-19 pandemic and the wave of deglobalization it caused will last. Thus, there is a lot of uncertainty around how long the liquidity crunch for airlines will go on. With investment funds ready to step in, the circumstances of the pandemic could be an accelerating factor in the privatization of European airports.

TAGS: Airlines, Transportation, Industrials, COVID-19, Pandemic, industry analysis, Airports, Infrastructure, Public-Private partnerships

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