Credit Update on the U.S. Airport Sector

Air travel serves as a primary means of medium to long distance travel in the U.S. As a result, domestic airports play a critical role in the national transportation network. Airports are capital intensive and have significant need for ongoing investment. While the federal government provides capital resources to airports through the Federal Aviation Administration's Airport Improvement Program, the majority of capital development projects are funded through the capital markets. An airport's location, size, accessibility, and strength and size of its service area are important credit components, as they are the driving force in the crucial number of airport enplanements.

MTAM expects flat or nominal traffic growth for most airports in 2012. The sector faces challenges in the form of carriers restraining capacity, security costs, and macroeconomic pressures. Some are dealing with the last operational changes attributable to the mergers between United and Continental and Southwest and Airtran. Still others may feel the impact of American Airlines' restructuring and route changes. Some traffic increases could occur in selected domestic airports served by the growing market share of low-cost carriers, particularly as they expand into large hub markets and backfill service abandoned by legacy carriers.

U.S. airlines have signaled that 2012 scheduled capacity growth will remain constrained or even reduced in the face of high jet fuel costs, and the potential for sluggish air travel demand growth in an uncertain macroenvironment. The American Airlines bankruptcy is likely to drive additional capacity discipline, as underperforming routes are cut and the carrier's fleet is rationalized in Chapter 11.

The operational changes brought on by recent merger participants will also present some challenges. Secondary hubs such as Cleveland's Hopkins International could suffer if their respective anchor carriers reduce or reallocate direct service to other primary hubs such as Atlanta or Chicago. There are also a number of upcoming slot revisions in the Washington and New York markets caused by mergers. However, their impact remains to be seen.

AMR Bankruptcy

AMR Corp.'s bankruptcy filing on November 29, 2011 should not necessarily affect the ratings on U.S. airports. AMR Corp., the parent of American Airlines Inc., filed voluntary petitions for Chapter 11 reorganization, but announced that it is operating normal flight schedules and expects to continue to conduct business as usual.

American Airlines has a large presence, including hubbing activities at:

-- Dallas-Fort Worth International Airport (84% of enplanements);
-- Miami International Airport (63%);

-- Chicago O'Hare International Airport (35%);
-- New York JFK Airport (14%); and
-- Los Angeles International Airport (15%).

With American Airlines' stated intention of conducting normal business operations and flying a normal schedule, we do not anticipate an impact on airport ratings at this time. We will continue to monitor enplanement levels at airports served by American Airlines for any changes in activity levels. A material change in traffic at American's hub airports could affect the ratings on those airports. Elimination or reduction of service by American at other airports that puts pressure on financial metrics could also lead to lower ratings on those airports.

Global airport sector credit quality has performed relatively well in the past 10 years -- a period that was one of the most volatile in the history of aviation. This period included: numerous airline bankruptcies; airline consolidation; a global recession; the severe acute respiratory syndrome pandemic; natural disasters such as hurricanes, earthquakes, volcanic eruptions, and tornadoes; high fuel prices; and the far-reaching effects of the September 11, 2001 terrorist attacks. We have observed that airport credit quality, in most cases, has remained stable or changed only modestly despite these events.

American has said that it filed to reduce labor costs and its debt load. It is the last major airline to seek to restructure its business. It avoided bankruptcy in the past decade, unlike its major competitors. United filed in 2002 and Delta and Northwest in 2005. Their lower cost structure hurt American's competitive edge and ability to earn a profit. American's board decided that it was necessary to take this step to restore the company's profitability, operating flexibility, and financial strength. The bankruptcy filing gives the carrier the edge in labor talks, and it plans to reduce its fuel bills by introducing new, more efficient aircraft.

Airports where the airline has a significant presence face fewer operating risks given their importance to American's network, whereas smaller airports are at greater risk of losing service. American operates hubs at LAX, JFK, DFW, O'Hare and Miami International Airports, with a significant presence at more than a dozen airports.

The bankruptcy filing comes as Dallas-Fort Worth International Airport is embarking on a $3.1 billion capital improvement program that includes the remodeling of its four original terminals through bonds backed by airport revenues. DFW is American's largest hub and is near the airline's headquarters southwest of the airport. American accounts for 84% of enplanements with more than 700 daily departures. Officials said they are confident operations will continue as normal for the time being. In Miami, the airline and its affiliates account for 63% of passengers. American Airlines was the largest source of revenue for MIA in fiscal 2010, paying $232 million. American accounts for 35% of passenger traffic at O'Hare in Chicago. The City anticipates minimal immediate or long-term negative impacts as a result. American has signed off on the next round of projects that are part of an $8 billion expansion, but will need airline support for future plans. American has held the top market share at LAX for the past two years. The airline's market share from January through October 2011 was 15%, representing 7.35 million passengers.

As is common in the early stages of the bankruptcy process, American is expected to operate its full schedule and will need to fulfill obligations of its use and lease agreements at the various airports where it operates, though there may be some small amounts of pre-petition rents owed. This would expose airports with inadequate liquid reserves. As bankruptcy courts generally allow an airline to continue making payments to the airports it serves, MTAM expects airports will continue to receive payments from American on a timely basis for the near term. However, an airline bankruptcy filing may allow for rejection of use and lease agreements at individual airports or result in changes through negotiations.

The New Federal Aviation Administration Bill

MTAM believes the new FAA bill, expected to be signed into law by President Obama, includes several provisions that airports will find underwhelming. The history of this bill, similar to other transportation-related bills, has been a sore point for airports and the industry. The bill covers federal fiscal years 2012-2015, and is the first multiyear reauthorization since the last one expired on September 30, 2007. During subsequent years, Congress approved 23 short-term extensions to maintain continuity. A brief interruption of the FAA authorization took place in mid-2011.

MTAM expects airports to be somewhat dissatisfied with the bill because its annual funding allocation provides less money than drawn in recent years. While the allocation of $3.35 billion annually is higher than that of previous versions of the bill, MTAM believes that this reduction is significant enough for airports to seek alternative funding sources for capital spending.

We expect some airports to be put under pressure by the cap on the passenger facility charge (PFC). This airport revenue source is a ticket surcharge levied and collected by the carriers, and is viewed as part of the airfare price. The bill will hold the PFC at $4.50 per segment of traffic. Some airports with improvement needs will be unable to increase it to raise their financing capacity for capital projects, even though construction needs are likely to increase.

The bill allocates $11 billion intended to modernize the air traffic system. The deadline to develop new arrival procedures at the country's 35 busiest airports is now June 2015. Some of those airports will find this change positive, as it provides a path and investment in a process that will make their operation more efficient.

MTAM expects to see little credit impact on airport ratings from the adoption of the FAA bill. While federal grants can be a primary funding source for capital programs, particularly for the medium- and small-hub airports, MTAM does not expect many airports to make material revisions to their spending levels and financings during the life of this bill.

Conclusion

MTAM has some concerns around the highly cyclical nature of the aviation industry. However, most of the industry's exposure to the economic cycle is shifted from the air*ports* to the air*lines*. Thus, the airport sector does not have credit risk so much as it has concentration risk. We favor large airports with low customer concentration and regional competition, as well as lean cost structures, manageable leverage, and strong demographics. Many airports do not serve as hubs, and are more origination and destination airports, so the performance is more tied to the local economy than a given airline.

The bankruptcy of AMR could be challenging for some airports. The impact on American's hubs is still unfolding, and MTAM will continue to assess it. However, American has a dominant market share position in a notable handful of regional airports. One is the Northwest Arkansas Regional Airport, where American represents 40% of enplanements. Most of the other O&D airports have exposures to American of less than 30%. In many such smaller markets, American extensively utilizes commuter and regional jets, where excess capacity can be a concern. Should the carrier decide to rationalize or pare down this fleet while in bankruptcy, some smaller cities could lose service. The O&D nature of traffic in many of these markets does, however, increase the probability that another carrier or carriers may enter the market and provide service previously offered by American. No detail on the significance of this can be gleaned until American's route changes become clear in the bankruptcy proceeding. Credit concerns may increase during the course of American's bankruptcy proceedings should the reorganization process lead to operating decisions that significantly reduce or reallocate the carrier's schedule.