FitchRatings

Fitch Affirms Philadelphia International Airport Revs at 'A'; Outlook Stable

Fitch Ratings-New York-05 October 2017: Fitch Ratings has affirmed the 'A' rating on approximately $1.06 billion in outstanding airport revenue bonds issued by the City of Philadelphia, Pennsylvania on behalf of Philadelphia International Airport (PHL or the airport). The Rating Outlook is Stable.

KEY RATING DRIVERS

Summary: The rating reflects PHL's role as the main air service provider to a large and stable market of nearly 15 million enplanements, which is offset by American Airline's (rated
'BB-'/Stable Outlook) elevated degree of carrier concentration and some connecting traffic exposure. The rating also reflects PHL's strong residual airline agreement, which provides for full recovery of operating expenses and debt service costs, though the agreement also lends to narrow coverage and liquidity levels. PHL's leverage levels are expected to remain elevated at 10x to 11x over the medium term as additional capital-related borrowing comes on line, though Fitch views the airport's levered position as consistent with the current rating level given PHL's franchise strength. Moreover, while airline costs are expected to continue to rise, signatory carriers have approved the airport's capital plan, signalling their ongoing commitment to the airport.

Revenue Risk - Volume: Midrange.
Sizable, Stable American Airlines Hub: PHL serves as one of American Airlines' leading connecting hubs, which lends to sizable carrier concentration of roughly 70% and some connecting traffic exposure at about 33%. Service reduction risk is partially mitigated by American Airline's long-standing presence at the airport, which Fitch expects to persist. Fitch also views PHL's low historical traffic volatility positively; the airport has experienced a minimal 6% peak-to-trough decline despite having some connecting traffic exposure, representative of stable American Airlines operations and the sound

Philadelphia MSA.

Revenue Risk - Price: Stronger.
Strong Cost-Recovery Framework: The airport benefits from a five-year residual use and lease agreement (AUL) through fiscal (ended June 30.) 2020, which effectively provides for 100% recovery of operating expenses and debt service costs. PHL's rising cost per enplaned passenger (CPE) level, which Fitch believes could increase to nearly $20 by FY2022 under rating case conditions, is viewed as mitigated by the airport's franchise strength and airline support to fund additional capital costs.

Infrastructure Development and Renewal: Midrange.
Largely Debt-Funded Capital Plan: The airport's seven to 10-year Capital Development Program (CDP) is sizable at nearly $2 billion, and focuses primarily on airfield improvements, terminal redevelopment and expansion, and ground transportation-related enhancements. The airport is reasonably maintained and will require some debt funding for priority capital improvements. The CDP is expected to be roughly 74% financed with commercial paper or future long-term debt; however, the plan's projects and associated sources of funding are need-driven and subject to change over time.

Debt Structure: Stronger.
Sound Debt Structure: PHL benefits from all senior, fully amortizing debt with no material exposure to variable interest rates as all debt is either fixed or synthetically fixed. The debt's structural features are considered adequate, including a partially cash-funded debt service reserve. The airport's leverage position is expected to remain relatively stable at roughly 10x to 11x over the next five years as PHL issues additional debt.

Adequate Financial Metrics: The airport has historically managed to debt service coverage levels (excluding fund balances) of around 1x and liquidity levels ranging 100-150 DCOH (including operating expenses and interdepartmental charges); these metrics are considered narrow relative to large hub peers yet adequate for airports with residual AULs as the agreement limits bottom-line cash flow volatility. Fitch expects FY 2017 leverage to be roughly 8x, and increase to the 10x to 11x range as additional capital-related borrowings come online.

PEER GROUP

Philadelphia's similarly sized hub airport peers include Miami (rated 'A'; Stable Outlook) and Charlotte (rated 'AA-'; Stable Outlook), which share comparable exposure to carrier concentration and connecting traffic. Charlotte's higher rating reflects much lower projected leverage levels of 3x to 4x, while Miami is able to achieve the same rating level with slightly higher leverage due to its stronger traffic base anchored by international operations.

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action:
--A material reduction in, or elimination of, American's hubbing activity, which reduces financial flexibility.
--Inability to maintain a minimum of 1x net revenue debt service coverage and inability to maintain leverage levels at or below 10x to 11x on a sustained basis

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action:
--Upward rating movement is unlikely over the near-term given PHL's single carrier concentration and sizable expected capital-related borrowings

CREDIT UPDATE

Performance Update

Enplanements declined by 5.6% in FY 2017, due to the restructuring of American's hubbing activity at PHL. Specifically, American eliminated two of its eight connecting banks to enhance efficiency, resulting in fewer departing seats to domestic destinations, and simultaneously reduced international service to London, Frankfurt, Zurich, Barcelona, Venice and Cancun.

Though FY2017, enplanement performance was worse than Fitch's base case expectations, which anticipated a 2% decline, the decline did not exceed the cumulative 9.5% shock assumed in Fitch's rating case. Furthermore, published schedules show a departing seat increase of 3.5% in FY2018, mostly due to American launching new service and increasing capacity. As a result, Fitch expects flat to modest growth in enplanements for FY2018. Additionally, the restructuring has allowed the PHL's traffic base to reach its highest percentage of O&D traffic since FY 2000, at 67.3% compared to 70%, which should provide for continued traffic stability at PHL.

Despite worse than expected traffic performance in 2017, currently estimated financial performance has generally exceeded Fitch's expectations. Airline revenues are estimated to be slightly lower than originally expected due to postponement of a new money issuance and lower than budgeted expenses. Non-airline revenues are estimated to be higher, primarily due to legalization of ridesharing companies in Philadelphia, which has allowed PHL to collect fees on pick-up and drop-offs. The aforementioned developments should result in net revenues which are notably higher than expectations as well as healthier cash balances, translating into a stronger DSCR (excluding fund balances) of 1.13x compared to 1.02x and lower leverage of 8x compared to 13x.

Since Fitch's last review, PHL has shifted its capital-related priorities from airfield capacity to terminal, landside, and cargo development due to observed decreases in aircraft operations over the past decade. The new CDP is expected to be slightly longer in nature (seven to 10 years) than PHL's previous capital plans and is larger as a result. The plan contains a higher percentage of future debt-funding than those in the past, at 74% compared to 54%. This has translated into an additional $270 million in new money being considered within Fitch's financial analysis. However, the additional debt is not currently expected to be detrimental to credit quality as financial metrics remain broadly consistent with past expectations even after the additional debt is considered, mostly as a result of PHL's strong residual AUL and better than expected non-airline revenue performance in recent years.

Fitch Cases

Fitch's base case assumes a slow recovery of 2017's enplanement declines through fiscal 2022, while operating expenses increase at above inflationary rates of roughly 3.5%-4.5%. In this case, DSCR (including interdepartmental charges and excluding fund balances) remains at an average of 1.07x, in line with historical performance, while leverage ranges from 10x to 11x and CPE grows to $19.15 by FY2022. Fitch's rating case incorporates an additional 4% enplanement drop in FY 2018 with a partial recovery thereafter and higher costs. In this case, CPE is slightly higher at $19.53 by FY2022, while coverage and leverage remains in a similar range as the base case due to the airport's cost recovery framework.

In comparison to Fitch's Rating Criteria for Airports, PHL's leverage levels of 10x to 11x are higher than the indicative guidance range of 4x to 8x for an airport with a High Midrange revenue risk profile. However, in comparison to other relevant High Midrange peers, PHL's volume profile is stronger as it benefits from lower carrier concentration, lower historical volatility, less connecting traffic exposure, and a higher percentage of international traffic. While PHL's revenue risk profile is not viewed as commensurate with Stronger revenue risk peers, which generally benefit from larger, growing traffic bases, the airport's aforementioned volume strengths and amortizing debt structure are considered mitigants against somewhat elevated leverage levels, making PHL's credit commensurate with an 'A' rating.

SECURITY

The bonds are secured by the net revenues generated through the operations of the airport. In addition, the airport may pledge certain passenger facility charge (PFC) revenues for eligible projects.

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Applicable Criteria
Rating Criteria for Airports (pub. 14 Dec 2016) (https://www.fitchratings.com/site/re/891804)
Rating Criteria for Infrastructure and Project Finance (pub. 24 Aug 2017) (https://www.fitchratings.com/site/re/902689)

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