Research Update:

Irish Airport Operator daa PLC Downgraded To 'A-' Due To Protracted Recovery In Traffic Volumes; Outlook Negative

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PRIMARY CREDIT ANALYST

Tania Tsoneva, CFA
Dublin
+353 1 568 0611
tania.tsoneva
@spglobal.com

SECONDARY CONTACT

Beata Sperling-Tyler
London
(44) 20-7176-3687
beata.sperling-tyler
@spglobal.com

ADDITIONAL CONTACT

Industrial Ratings Europe
Corporate_Admin_London
@spglobal.com

Rating Action Overview

- We expect that global travel restrictions, weak economic conditions, and social distancing measures related to the COVID-19 pandemic will lead to approximately 70% fewer passengers at Dublin Airport in 2020 compared to 2019. This is a steeper reduction than we anticipated, and we now think the recovery to pre-pandemic levels could take until at least 2024.
- We expect that Irish airport operator daa PLC's weighted-average funds from operations to debt will decline to 15%-16% on average over 2021-2022 compared to 58.1% in 2019. This is despite daa's plan to significantly resize its operations, and the flexibility of its €2.25 billion approved capital expenditure for 2020-2024.
- As we announced on July 14, 2020, we lowered our long-term issuer credit rating on daa to 'A-' from 'A' to reflect a one-notch downward revision of its stand-alone credit profile to 'bbb+' from 'a-'. We assess the likelihood of the Irish government providing support to daa, when needed, as moderately high.
- The negative outlook reflects the risk of a one-in-three chance of a further downgrade of at least one notch if the consequences of the pandemic for passenger traffic and retail revenues are worse than we expect, resulting in weighted-average FFO to debt below 13%.

Rating Action Rationale

COVID-19-related global travel restrictions, weak economic conditions, and social distancing measures will lead to approximately 70% fewer passengers at Dublin Airport in 2020 than in 2019. We believe that daa's passenger traffic volumes in 2020 might be affected more than its European and some of its global counterparts. This is due to Dublin Airport's very limited share of domestic traffic, which we expect to start picking up earlier than nondomestic traffic, and the future capacity schedules announced by daa's two main airlines, Ryanair and Aer Lingus (see "Airports Face A Long Haul To Recovery," published May 28, 2020).

The sharp economic contraction that we forecast for Ireland in 2020, coupled with high unemployment, could further reduce disposable incomes and the ability to travel. In the medium term, we think daa will likely recover at a similar speed to other European airports due to its relatively young passenger base and significant share of passengers travelling for leisure purposes and to visit friends and relatives. We expect these passengers to be more resilient to the accelerated trends of virtual meetings and remote working than business travelers.

Assuming that traffic returns to 2019 levels by 2024, and subject to the implementation of mitigating actions, we expect that daa's weighted-average funds from operations (FFO) to debt will be 15%-16% over 2021-2022, down from 58.1% in 2019. We do not think that traffic volumes in 2020 are representative of the airports' long-term credit quality. Although the COVID-19 pandemic will likely transform air travel, daa is an essential infrastructure asset for Ireland, with a strong market position and regulated earnings. Therefore, in our ratio calculations, we look beyond the short-term ratios and place more emphasis on 2021 and 2022.

We forecast that all daa's revenue streams will suffer over the next two-to-three years. Compared with 2019, we forecast that daa's total revenues will be 70% lower in 2020, 30%-35% lower in 2021, and about 15%-20% lower in 2022. Aeronautical income will depend on traffic volumes and charges per passenger. We expect these charges to stay flat until the completion of the North Runway due in 2023. We do not factor in any tariff increases in the event of a readjustment of the regulatory package to account for the significant disturbance in daa's operating environment. This is because it may take some time for the regulator to opine on the future tariffs, and any increases could prove challenging given the economic difficulties airlines will continue facing.

A further complicating factor is daa's reliance on two main airlines--Aer Lingus and Ryanair--with the latter in particular seeking a reduction in charges to drive a recovery in traffic. Nonaeronautical income, excluding international activities, corresponds to about 40% of daa's total income in a normal year. Nonaeronautical income could drop due to the potential deferral of commercial income, that is concession payments, relief or pauses in tenancy payments, the possible closure of some retail or food and beverage outlets, and lower consumer spending.

While airports' operating costs are inherently fixed, daa has a significant advantage as more than 50% of its €2.25 billion capital investment program for 2020-2024 is not committed. daa's cost base is largely fixed, with more than one-third of costs attributable to staff. However, as daa had experience of a significant traffic decline during the sovereign debt crisis of 2010-2013, its management is more proactive in resizing the operations and using capex as a way of managing cash burn in line with the recovery in traffic. The Irish government's wage subsidy schemes will alleviate cash leakage in 2020, but we understand that daa is pursuing a permanent cut in its 3,500-strong workforce through a voluntary severance scheme. We also factor in about a 25% decline from 2019 in maintenance expenditure on work dependent on traffic volumes, such as security and cleaning.

Regarding capex, daa is only committed to two major projects--the construction of the North Runway and the baggage holding system--amounting to €320 million over 2020-2024. While daa has considerable ability to defer up to 50% of its investments approved by the regulator, its revised capex is still relatively high, driving negative discretionary cash flows over 2020-2024.

One of daa's credit strengths is its robust liquidity position, bolstered by an increase in its revolving credit facility (RCF) to €450 million from €300 million. The relatively small amount of upcoming debt maturities, coupled with the heavy capex and dividend cuts, should ensure that daa's liquidity sources are sufficient to absorb the losses we estimate from the pandemic over the next two years.

As a state owned airport, daa could benefit from extraordinary state support from its 100% owner, the Irish state. So far, the Irish state has cancelled the payment of the 2019 dividend and is not planning any dividends in the near term.

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Environmental, social and governance (ESG) factors relevant to the rating action: Social – Health and safety management factors.

Outlook

The negative outlook on daa reflects the uncertainties about the extent of the drop in traffic volumes and the pace and shape of the recovery due to COVID-19-related mobility restrictions. Further negative consequences for passenger traffic and retail revenues could arise from the pandemic's impact on Ireland's macroeconomic environment, given the correlation between disposable incomes and leisure travel.

In our base case, we expect daa to maintain weighted-average adjusted FFO to debt of about 15% in 2021-2022. The credit metrics will be constrained by the lower aeronautical charges approved for the 2020-2024 price control period, and daa's completion of significant investments. Additional negative effects could occur because 30% of daa's passengers come from the U.K., which is still suffering from uncertainties related to Brexit, and because of the headwinds facing the airline industry, including overcapacity in the low-cost segment.

Downside scenario

We could lower the rating by at least one notch if we expected a further weakening of daa's credit metrics, in particular if daa failed to maintain weighted-average FFO to debt sustainably above 13%. We think this could occur if:

- The economic recovery is slower or more prolonged than we anticipate, or there are long-lasting effects on air travel from the recessionary macroeconomic backdrop;
- The company does not execute its planned mitigating actions in good time; or
- There are unfavorable changes to the liberalized air service agreements or economic regulation in the Common Travel Area as a result of Brexit.

We could also lower the ratings if daa's competitive position weakens, for instance due to higher volatility of cash flows or profit margins below 30% in normal times. All else being equal, a one-notch downgrade of Ireland will not change the rating on daa.

Upside scenario

We could revise the outlook to stable if traffic starts to recover in a strong and sustainable way and the risk of a further spike in infections falls. There could be some rating upside from a potential tariff reset by the regulator to compensate for the drop in traffic, although we believe this could take more than 12-18 months to negotiate.

Company Description

daa operates Dublin and Cork Airports in Ireland and is involved in all related activities, from retail activities within the airports to managing the airports' car parks. It is a 100% state-owned company but is financed and managed independently of the government. Through its wholly-owned subsidiary, Aer Rianta International, daa also owns and operates airport retail businesses in the Middle East, the Americas, New Zealand, and Cyprus, and holds stakes in other airports, namely, 20% in Dusseldorf Airport in Germany and 11% in Paphos and Lanarca Airports in Cyprus.

Dublin Airport is regulated on the basis of a single-till approach, whereby the airport's costs are covered by both aeronautical charges and commercial revenues. The current regulatory contract covers the period between 2020 and 2024. Cork Airport is unregulated. In 2019, Dublin and Cork Airports saw a 4.7% increase in passengers to 35.5 million and generated 88% of daa's EBITDA.

Our Base-Case Scenario

- A drop in traffic of about 70% in 2020, as a result of the significant decline in passengers due to lockdown measures in daa's Irish and international markets. We anticipate a protracted rebound in traffic, with passenger numbers remaining about 30% below 2019 levels in 2021 and 18% below 2019 levels in 2022. We do not expect traffic to return to 2019 levels until 2024.
- Negative adjusted EBITDA margins in 2020 because we do not expect cost-cutting measures and government-support initiatives such as furlough schemes to fully offset the decline in revenues, since daa's cost base is largely fixed, with about one-third of costs being staff expenses. Mitigating actions in the next two years include voluntary redundancies of up to one-third of daa's 3,500-strong workforce.
- Total capex of about €200 million-€250 million for 2020, and remaining at about €200 million in the following two years. A return to the amount of capex allowed by the regulator of about €400 million-€450 million annually in 2023 and beyond depends on the shape and pace of the recovery in traffic.
- No dividend distributions to the Irish government.

Key metrics

	2019	2020	2021	2022
FFO to debt (%)	58.1	N.M.	15-Oct	15-20
EBITDA margin (%)	34.4	N.M.	20-25	25-30

N.M.--Not meaningful.

Liquidity

We view daa's liquidity as strong. We estimate that sources of liquidity in the 12 months to March 30, 2021, will exceed uses by more than 1.5x, and that liquidity coverage in the following 12 months will be more than 1.0x.

In our view, daa should be able to withstand substantially adverse market conditions over the next 24 months, while still having sufficient liquidity to meet its obligations. This view is supported by our expectation that sources of cash will exceed uses even if forecast EBITDA declines by 30%, and that the company will be able to absorb high-impact, low-probability events without refinancing.

In our view, management exercises prudent risk management, and has ensured the maintenance of strong liquidity, particularly ahead of the construction of the North Runway. daa has a high standing in the credit markets, and its debt documents remain favorable, with limited covenant protections, including a change-of-control clause.

We expect that daa's principal liquidity sources for the 12 months to March 30, 2021, will include:

- Surplus cash and liquid investments of about €280 million;
- Availability of €450 million under an RCF that expires in March 2025; and
- A €350 million European Investment Bank (EIB) loan signed in June 2019, available to June 2022.

We expect that principal liquidity uses over the same period will include:

- Negative cash flows from operations of about €100 million.
- Debt maturities of about €40 million-€50 million;
- Capex of about €200 million-€250 million; and
- No dividends on 2019 profits.

Government Influence

We view daa as a government-related entity. It is 100% owned by the Irish government and is a strategic asset for the Republic of Ireland (AA-/Stable/A-1+). In our view, there is a moderately high likelihood that the Irish government would provide timely and sufficient extraordinary support to daa in the event of financial distress. This reflects our assessment of daa's:

- Important role for Ireland, owing to the company's strategic role in relation to air travel, absent any land connections to other countries, and general economic development in Ireland.
- Strong link with the Irish government. We understand that the Irish government is no longer considering privatizing Dublin Airport due to its strategic value to the government. Nevertheless, we anticipate that the independent regulatory regime, established under the Aviation Regulation Act 2001, would be the primary source of financial support to daa. It is government policy that daa should operate on a commercial basis.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of December 2019, daa held bank loans of about €171 million. DAA Finance PLC, the subsidiary, holds the remainder of the financial debt, which includes about €400 million of unsecured notes listed on the Irish Stock Exchange and about €189 million in loans from the EIB. daa guarantees this debt.

Analytical conclusions

The issue ratings on the €400 million of unsecured debt issued by DAA Finance PLC and the €450 million RCF available to both DAA Finance and daa are the same as the long-term issuer credit rating on daa. This is because there are no priority liabilities and DAA Finance's debt benefits from a parental guarantee.

Ratings Score Snapshot

Issuer Credit Rating: A-/Negative/A-2

Business risk: Strong

- Country risk: Low
- Industry risk: Low
- Competitive position: Strong

Financial risk: Intermediate

- Cash flow/Leverage: Intermediate

Anchor: bbb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb+

Government support:

- Sovereign rating: AA-/Stable/A-1+
- Likelihood of government support: Moderately high (+1 notch)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Industrials: Key Credit Factors For The Transportation Infrastructure Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009