Holding pattern

01/09/2008

Airports in Central & Eastern Europe continue to be viewed favourably by equity investors, and upcoming privatisations are expected to generate heavy bidding interest, in spite of debt funding costs that have widened out by 100bp over the past twelve months.

In the more mature economies such as the UK, France or Germany there are concerns about passenger numbers as a result of airlines' high fuel costs, rising ticket prices, and the overall effects of possible recession on consumer demand. In the UK some airlines have already announced reductions in their winter timetable frequencies.

But in the CEE region the picture is different. Smaller countries such as the Czech Republic or Slovakia have the kind of rapid economic growth typically associated with emerging markets, and appreciating currencies, which are generating more domestic demand for foreign travel. With their less mature aviation markets they represent solid prospects for passenger growth. As an oil-based economy, Russia is a major beneficiary of high oil prices, and growing wealth means that both business and leisure passenger growth is buoyant.

Thus upcoming CEE concessions or sales are expected to generate a high level of interest from airport operators, infrastructure funds, and construction conglomerates with concession/PPP divisions, as well as banks looking for equity participation. "We do expect airport privatisations to move forward, and we would generally expect there to be quite a bit of equity looking to invest in the airport sector," comments Andrew Blease, senior vice-president at Moody's Investors Service in London.

"Debt will also be available, though clearly not on the same terms as a year ago, but the impact of the current difficult conditions on financial markets is likely to be on price rather than whether transactions happen," says Blease. "Governments will have to decide whether they find bids acceptable, and that will be a decision that varies from country to country. But though asset prices may be lower than one or two years ago, they are still probably high by historical standards, so governments selling airports may still find bids reasonable."

Pulkovo pulls ahead

The deal currently causing most of the excitement in the market involves Pulkovo Airport in St Petersburg, which is being structured as a PPP-style concession running for 30 years, involving the development, reconstruction and operation of the airport. This project is being realised not under the Federal concession law, but instead as a build-own-operate-transfer structure under general civil law and the specific regional PPP law in St Petersburg. At least $1 billion will be needed in capital investment. The adviser to the City of St Petersburg is Citigroup.

In mid August the authorities announced the results of the pre-qualification process. A total of seven of the nine pre-qualification bidders, who submitted proposals on 31 July, made it onto the official list of bidders. The next stage involves the submission of binds to the tender committee no later than 5 February 2009. The successful bidder is expected to be announced in mid-March 2009.

The long list of airport operators, banks and infrastructure funds as consortium members is confirmation that airports are still viewed as a very attractive asset class.

A consortium comprising VTB Bank, Fraport, and Horizon Air Investment (a subsidiary of Copelouzos Group of Greece) has established a special purpose company incorporated in Russia, Northern Capital Gateway. VTB Europe's infrastructure capital department was set up to raise VTB's profile in developing and financing PPP projects in Russia and the CIS, including transportation, energy, utilities and social infrastructure.

The operators of Changi Airport in Singapore are bidding in conjunction with Oleg Deripaska's Basic Element. Maquarie has teamed up with Rennaissance Capital. Hochtief has joined forces with Viktor Vekselberg's Renova group, which already owns the Ural airport Koltsovo. And Vienna Airport have teamed up with Gazprombank.

Two bidders did not have any Russian partner, and are considered outside bets. One is TAV Airports of Turkey, while the other is GMR Infrastructure of India. The two bidders eliminated were local Russian groups. It is possible that the bidding groups may now re-align themselves, so some of the consortiums could yet merge to present a stronger bid.

The winner will upgrade the airport to handle 22 million passengers annually, from six million at present. Total capex requirements will not be known until the authorities complete an assessment in the autumn, though as of earlier this year a figure of R35 billion ($1.42 billion) was being discussed.

"In spite of the current difficult market conditions, many governments appear to be moving ahead with airport privatisations, which indicates that their financial advisers continue to believe that there will be healthy investor appetite for these assets," says Robert Franklin, a project finance partner at Denton Wilde Sapte in London.

"However, the consequences of the general global economic slowdown and the effect of high oil prices on the aviation industry are bound to impact traffic forecasts and valuations in the airport infrastructure asset class," he adds. "But it will vary from country to country, and in Russia the outlook may be more positive, since high oil prices in a producer economy are a driver of economic growth."

"Russia currently has a different story from the rest of Europe, and remains popular with investors, so the government is moving ahead with a number of concession projects involving airports and other assets such as toll roads," adds Anna Otkina, a partner in Denton Wilde Sapte's aviation group in Moscow. "For example, major airport operators and infrastructure funds are present in the seven consortia which pre-qualified as official bidders for Pulkovo Airport."

Investing in appreciation

Elsewhere, the long awaited privatisation of the main Ruzyne airport in Prague, probably via a concession, is moving forward again and could close in 2009. Estimates of its value vary between Eu3 billion ($4.4 billion) and Eu4 billion.

As one of the prime tourist destinations in Europe, Prague is viewed as a highly attractive asset. And domestic demand is also growing. Economic growth is forecast by the Czech National Bank to run at 4.1% in 2008, which is down from 6.6% in 2007, but still very respectable at a time when some Western European economies are sliding towards recession.

In addition, the dramatic appreciation of the Czech Crown against the Dollar and Euro over the past twelve months, when it has risen by roughly 25%, means that demand for air travel from Czech citizens is rising to offset any potential drop in the numbers of tourists flying into Prague.

The privatisation of Ruzyne forms part of a wider programme being implemented by the Czech government. National carrier Czech Airlines (CSA) is also up for privatisation, and this should be completed ahead of the airport deal.

And in Macedonia a group of four airports will be bundled together under a 20-year concession to expand and operate the facilities. They include Alexander the Great Airport in Skopje.

Lowballs and liftings

But Pulkovo and Prague are generating most of the interest. "I think there will b a lot of infrastructure funds bidding for these assets, and also corporate entities with interests in infrastructure concessions like Ferrovial," says an analyst. "The question is who will be prepared to accept the lowest equity internal rate of return in conjunction with how aggressive their base case is. But generally speaking, the equity returns that many investors have been able to live with on infrastructure assets have been quite modest."

Airport deals move slowly, so the market has to wait for benchmarks to come along. The Eu1.52 billion financing for Budapest Airport closed last year in spite of the credit crunch, at margins ranging from 95bp to 120bp over Euribor. In 2008 the market has seen the syndication of the Eu600 million loan for Antalya Airport Terminal, led by Garanti Bank, WestLB and HVB, which was heavily oversubscribed in spite of the dire conditions in the credit markets during the first half of 2008. But Antalya's pricing of 250bp over Libor may have gone some way to assisting its progress.

The most recent clue as to where pricing has shifted to comes from Germany, with Berlin Brandenburg International. Building work officially began in July on what is the biggest infrastructure project in the former East Germany. The terminal will be able to handle 25 million passengers per year.

In spring 2007 project bankers were falling over themselves to offer financing at around the 50bp level. But by summer 2008 they were talking more like 150bp. There has also been the usual pushing and shoving between borrower and bank lenders about market flex provisions.

This extra 100bp of interest on very long-term debt was too much for the sponsors, which are moving to have fully guarantee all the BBI project debt, where previously they were guaranteeing 80%, with a 20% commercial debt tranche. "Last year there were a couple of banks who told BBI that they would underwrite the whole thing," comments a banker. Instead the Eu2.4 billion debt package is being rewritten, with banks now looking at a very fine margin on guaranteed debt. Extra guarantees have to be approved by the Berlin Senate, and Brandenburg Senate, which are both states under the Federal umbrella, as well as the Federal Government.

Neither Brandenburg nor Antalya offers perfect guidance for pricing on the forthcoming Eastern European financings. Turkish banks' funding costs are risen so sharply that Antalya might be priced at 350bp today. And the governments privatising Russian, Czech and Macedonian airports will not be as willing to prop up lenders as Brandenburg's was. But a spike in margins is unavoidable, say lenders familiar with the sector, with unpredictable results for valuations.

In addition to more expensive debt and gloomier passenger forecasts, sponsors also have to look at regulatory and political risk, as well as the very long delays in privatisation processes. While CEE auctions have suffered delays, Western Europe has challenges too. The sale of a stake in Amsterdam Schiphol has been on and off for almost a decade, and is currently off the agenda, after it was blocked by its major shareholder, the city of Amsterdam.

And in the UK the events surrounding the Competition Commission's review of BAA's ownership of multiple airports have caused consternation among bank lenders. The CC has recommended that BAA's owner, Ferrovial, sell two of its London airports and one of its Scottish assets, just as BAA completed a long-awaited refinancing of its regulated portfolio.

But analysts feel that the the action is highly unusual, and will not lead to bidders being scared off from wanting to buy airports elsewhere in Europe because of regulatory risk. "It is common across Europe for one company to own the entire airport system in a major city, which is what BAA does with three London airports," comments one analyst. "No other government has a policy like the one being followed by the UK government, which wants to have competition among airports serving one city."

Many project bankers have been tied up with the BAA refinancing, which finally lined up agreement from lending banks in August, rather than looking at new loans. But new deals at prominent airports with solid growth prospects are still expected to be viewed favourably at project lenders. "The debt market is still there for good projects with strong sponsors, though debt pricing has clearly increased," says a banker. "I don't see any problem getting funding."