

Russian roulette

01/10/1999

Russia's airport sector is a mess. The number of airports has nearly halved since 1991, according to the Russian aviation authorities.

But there are still 640 airports, including 300 civil airports. Out of that, 63 have federal status. They account for more than 80% of all domestic and 95% of all international traffic in Russia.

After the downturn in the national economy and aviation industry, airport operations dwindled across the board. This took a heavy toll on revenue streams and, accordingly, on cash allocations for airport maintenance and development.

Signs of recovery and sustainable growth in Russian aviation still remain mixed. Interest rates on bank loans continue to be prohibitively high for borrowers, given the uncertain industry growth forecast. Banks have cut investment in development projects to the minimum, pending the results of the upcoming parliamentary and presidential elections.

Chances to arrange financing for even a modest project are slim, laments Viktor Gorbachev, who heads the association of Russia's airports. A cash-strapped government effectively ceased funding airport infrastructure. The private sector is either unwilling, or unable, to embark on projects requiring long-term expenditure commitments.

All this, in turn, discourages potential foreign investors.

Since 1991, capital spending on the development of airports has decreased seven times. As a result, they typically have only 60% of the required ground facilities while their equipment is increasingly wiped out by wear and tear. Airports in Siberia, East Asia and in the northern territories are particularly under-equipped and worn out.

The situation is better in the Moscow region.

The reason is simple, explains Gorbachev. The Moscow airport network plays a key role in the country's aviation industry and traditionally has been more developed. Apart from a dozen general aviation and paramilitary airfields, the system comprises four civil airports, including Sheremetyevo, Russia's leading international gateway, Vnukovo, Domodedovo and Bykovo.

Among them Domodedovo stands out as having the highest potential for growth. The airport, opened in 1964, serves mainly long-haul routes to Siberia, the Asia-Pacific region and Central Asia. With two runways in operation, it handled more than eight million passengers a year at the peak of its activity in the late 1980s.

At that time, British Airways was considering an expansion plan for Domodedovo with a view to using it as a landing site on routes to Asia. The venture, called Air Russia, envisaged financial backing from a Barclays-led consortium. However, the project flopped after the break-up of the Soviet Union and the subsequent economic and political turmoil in Russia.

Traffic volumes at Domodedovo have declined sharply since then. But despite the lean times for domestic aviation, the airport retains its valuable niche. It handles 11% of Russia's air traffic and 30% of that in the Moscow region, ranking first in domestic passenger numbers and fourth in terms of international traffic.

Overall, Russia's traffic volumes fell by as much as 25% in the wake of last August's rouble devaluation. Strange as it may seem, Domodedovo went unscathed. "We have not seen a slump in aircraft departures since 1997," says airport director Sergei Rudakov. "Year-on-year, passenger traffic remains on the same level as in the pre-crisis times while cargo traffic is on the rise. This is in contrast to our major rival, Sheremetyevo."

Meanwhile, only three years ago the Moscow regional government, which owns the airport, considered declaring it bankrupt. Today, according to Anatoly Savinov, the transport minister, capital investment in its upgrade exceeds that for the rest of Russia's airports. "Last year, they received \$38 million while Domodedovo alone got \$40million," he says. "This year, the figures are likely to be \$20 million and \$60 million, respectively."

The airport owes the turnaround in its fortunes solely to East Line Group – a private holding company that entered into a contract to manage it under a long-term lease agreement with the government. The group embraces 12 companies working in the air transportation and tourism industries, centring on East Line Airlines (ELA).

Since its launch in 1995, ELA has rapidly developed into one of Russia's largest cargo carriers. It claims to account for more than a half of airlifted imports to Russia from China and Italy, 29% from the UAE and 27% from Turkey.

Servicing the shuttle traders' consumer goods sector, as well as a booming tourist business, brought in a quick profit that allowed East Line to increase its fleet to 29 aircraft and diversify into other lucrative markets. The range of activities also expanded to embrace charter passenger flights. Work is underway to launch scheduled services and set up a business aviation facility.

Airline and tourist business aside, the group's soaring profits are channelled in the development of Domodedovo, serving as the hub for ELA and other East Line operations. Over the past four years, \$140 million has been ploughed back in airport improvements. This included a \$20 million construction of the international cargo terminal, a \$4 million overhaul of the catering facility producing 25,000 meals a day, as well as a massive facelift for the air traveller hotel. This year will see a major upgrade of the passenger terminal worth a total of \$70 million.

Rudakov points out that all this expenditure comes exclusively from the group's own funds. "We act as both operator and investor, providing financing for the entire project. We have never seen financial support from the state in any form."

Before the rouble devaluation last August, the group negotiated with several Russian and foreign banks on their participation in the airport development programme. "Various schemes, including long-term syndicated facilities, were under consideration," says Rudakov. "We hoped to secure at least \$60 million in loans from the EBRD and came close to the deal. However, these plans had to be shelved because of the currency crash."

Initially, the modernization programme envisaged the construction of a new passenger terminal with an estimated cost of between \$100 million to \$120 million. "Had the half of it come from the EBRD loan, we would have managed to pull in the remainder from internal sources," says Rudakov. With this in mind, a mandate to build the terminal went to the group of bidders, including Hochtief, La Mayer of Germany, ABB and GiproKon/Aeroproject of Russia. After the financial crisis, East Line was forced to opt for only upgrading the existing facility.

Dmitry Kamenschik, the group's board chairman, is confident that the most viable way to get around the current credit squeeze in Russia is taking an "invest-as-you-earn" approach. "Revenues from particular operations should meet financing requirements for developing relevant facilities," he says. "At this stage, we want all units in the group to act as

profit centres capable of funding modernization works on their own. Ideally, the cargo terminal should rely on cargo-handling fees and the pump-fuelling system on fuelling charges, for example.?

This strategy implies an ability to upgrade the operational system with negligible disturbance to airport activities. ?We need to secure the functionality of the existing facilities which are in use most of the time,? says Kamenschik. ?

Technically, it is a much more difficult task than just building a new facility. On the other hand, this allows us to recover investment and break even much earlier.?

According to Rudakov, East Line does not have to overcome financial obstacles typical for Russia's airports. He believes the major reason is that corporatization of Domodedovo avoided the usual pattern. ?By and large, components of airports' infrastructure attained their identity as separate legal entities,? he explains. ?As a result, airport facilities are often owned and run by independent companies. In contrast, East Line secured the right to manage the airport in its entirety and single-handedly.?

Services are provided by eight joint stock companies in which East Line holds a controlling stake. It also has a 75-year leasehold on the airport's fixed assets.

Within the group, Airport Management Company (AMC) handles cash flows generated by operational divisions. It is tasked with consolidating revenue streams from all airport activities and putting them to better use in the interests of the whole group rather than individual units.

?Currently, our priority is the expansion of the air terminal,? says Rudakov. ?Therefore, AMC channels the bulk of earnings into this project. There is an understanding that other operations will benefit from increased passenger numbers once it is completed. In addition, revenues from non-aviation sources at the terminal will make up between 30% and 40% of total revenue.?

Services at Domodedovo are on average cheaper than in other Moscow airports. Users enjoy cost and time savings as they deal directly only with East Line Handling. The company was set up as a general groundhandling agent supervising provision of services to each aircraft individually. Besides, there is a system of discounts designed to encourage carriers to expand their operations out of Domodedovo.

In another move to entice users, AMC ruled that operational units should pay a \$10 fine to airlines for each minute of delay in providing services. As a result, the customer base and, accordingly, revenue potential has increased substantially over the past few years and comprises 57 regular airlines. Last October, Vnukovo Airlines, Russia's second-largest carrier, relocated from its Vnukovo hub to Domodedovo after a fuel price increase at Vnukovo.

Buoyed by a growth in incomes, the operator wants to develop the airport into a major international hub in Russia and upgrade it to the International Civil Aviation Organization category one. Strategically, the argument goes, Domodedovo is perfectly positioned to compete with other Moscow airports.

Located at a greater distance from the city than Sheremetyevo or Vnukovo, it faces less environmental constraints on expansion. The airport currently covers 1,200 hectares. In addition, local authorities have allocated 1,540 hectares for its future development.

This is sufficient to build two new runways with a view to tripling airport capacity. In June, East Line came up with the development programme for Domodedovo until 2003. Under it, the share of international flights operated out of Domodedovo is expected to increase to 50% from 20%. It is estimated that, in 2003, the gateway will account for 70% of cargo traffic in the Moscow region, 50% of Russia's passenger numbers and 30% of intra-CIS passenger traffic.

The programme, approved by Russia's civil aviation authority and Moscow regional administration, envisages capital

spending in excess of \$286 million. Out of that, \$152.6 million is to come from East Line's resources.

The group is undertaking the finance of all airside and landside improvements at the airport. The rest of the investment is earmarked for infrastructure projects in its environs, supposedly to be funded by investors interested in the airport expansion.

This approach complies with that advocated by the federal programme for developing the country's airport system until 2010. According to it, budget allocations will account for only 6% of the funding requirements. The bulk of the required funds should come from airport incomes with the remainder attracted from all available sources.

Financial backing for expansion plans at Domodedovo has come from its major tenants and the local government, which is keen to beef up one of the largest employers and taxpayers in the region. Moscow Railway Company has committed to upgrade rail links to the city with a view to launching express services eventually.

As for the investment in airport modernization, Rudakov says that, at this stage, the group plans to get by on its own. ? But if need be, we'll consider raising money through debt and bond issues.?

Putting up a new passenger terminal is the case in point. ?The original plan to build it was only put off and is still valid,? says Rudakov. ?Expanding the existing terminal provides for the increase in throughput to seven million passengers a year. Before long, this may become insufficient and we'll have to seek funds for a new facility, no matter how difficult this might be.?

Thank you for printing this article from IJGlobal.

As the leading online publication serving the infrastructure investment market, IJGlobal is read daily by decision-makers within investment banks, international law firms, advisory firms, institutional investors and governments.

If you have been given this article by a subscriber, you can contact us through www.ijglobal.com/sign-in, or call our London office on +44 (0)20 7779 8870 to discuss our subscription options.