AIRPORT SALES TAKE OFF WITH LMM

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On February 27 2013, the Puerto Rico Ports Authority (PRPA) transferred the operation of the Luis Muñoz Marin (LMM) Airport in San Juan, Puerto Rico to Aerostar Airport Holdings in the first successful privatisation of a hub airport under the FAA's Airport Pilot Privatization Program.

This landmark transaction, more than four years in the making, was a significant success for all stakeholders – the PRPA was able to retire a significant amount of debt; airlines saw rates lowered versus the status quo; passengers can look forward to improved facilities; and Aerostar was able to capture a significant opportunity to bring value to its shareholders, infrastructure fund Highstar Capital IV and Mexican airport operator ASUR.

In the broader context, especially in light of the clear need for renewal of US transportation infrastructure, the transaction shows that there is appetite and demand for airport transactions in the United States among private operators, and that public airport authority sponsors have a lot to gain from a public-private partnership (PPP). In light of the success of the transaction, here are a few lessons that can be applied in future airport PPPs:

Early engagement with airline customers is key

Under the FAA's Airport Privatization Pilot Program, no privatisation transaction can occur without the support of airlines representing 65% of the number of carriers serving the airport and 65% of the passenger traffic at the airport. While some public authority sponsors or private operators might see this as the basis for a divide-and-conquer strategy, in practice the airlines at LMM tended to function as a fairly tight-knit group. The number of major commercial airlines in the US is small, and key airlines serving LMM recognised that the positives far outweighed any apprehension about a new operator coming in to manage the airport.

It is important to recognise the diversity of viewpoints among airlines. Most airlines at LMM were clearly focused on tariffs: the new rate structure at LMM caps aggregate fees at US$62m per year (escalated by inflation after the fifth year). This represents a significant departure from the tariff structure at many other public airports around the world, which is based on a per-passenger or aircraft unit rate.

The willingness of airlines to accept an aggregate fee structure showed their optimism about air traffic at LMM after declines in recent years – as the number of passengers rises, the rate per passenger effectively decreases. Some airlines, however, were equally focused on the crumbling infrastructure at LMM – a number of airlines demanded specific fixes to facilities, ranging from large passenger-facing equipment (antiquated jet bridges) to minor quality-of-life issues (faulty air-conditioning units in offices). Others were focused on space allocations and the ability to maintain their existing locations at the airport, particularly when faced with proposals to turn the airport into a common use terminal equipment (CUTE) facility.

Aerostar successfully managed this process by engaging with the airlines early on – it was able to leverage ASUR's positive relationships with airlines at its Cancun airport, as well as the relationships that employees hired from the airline industry brought. However, an important lesson learned is that airport operators in the US have a long history of interacting with airport customers in a manner that may be different from airports in other jurisdictions where private participation in the airport sector is more prevalent. Successful engagement requires both public airport authority sponsors and private operators alike to understand the complex dynamics among airline customers and to ensure that they understand the primary objectives of each airline, which may differ within the group.

Not necessarily structured as a typical PF

One of the key challenges for Aerostar in the LMM transaction was to obtain financing on terms that permitted it to operate the airport, meet its obligations under the Lease and Airport Use agreements and respond to the dynamic air travel market, where customer preferences, technologies and pricing structures are constantly changing. The initial response of Aerostar's lenders was to look at the transaction as a typical project financing, with a strict cashflow waterfall, lockbox accounts and completion certificates for capital expenditures. Viewed strictly through the prism of aeronautical revenues, there is some support for this notion: much like a power business or a ports business, the aeronautical revenue side of the LMM transaction has predictable revenue streams, long-term contracts and, at least initially, well-defined capital expenditure programmes that are reviewed and approved by the FAA.

However, after further engagement with the project, Aerostar was able to show its lenders that the traditional project finance model had serious limitations at commercial airports whose operations are far more dynamic than other infrastructure facilities such as, for example, toll roads. Airline and airport technology is constantly changing – whereas self check-in terminals were barely on the radar screen just 15 years ago, today they are the norm and in some cases are the only options for passenger check-in. Ten years ago, charging passengers for baggage would have been nothing short of heresy, whereas today all but a select group of elite passengers will pay beginning with the first piece of luggage at most airlines. Aerostar needed a financing structure that permitted it the flexibility to respond quickly to the needs of its airline and passenger customers.

More importantly, one of the most attractive revenue streams for private operators in airport PPPs is not passenger charges or other forms of aeronautical revenue but, rather, the revenues that are generated by leasing space to commercial tenants seeking to serve passenger needs, such as food and beverage concessionaires, parking operators or fixed-base operations (FBO) tenants. To take an example, ASUR's commercial revenues grew from 8.1% of its total non-construction revenues in 1999, when the Mexican airports were privatised, to 31.7% in 2012. Given that aeronautical revenues at LMM are capped at US$62m per year (adjusted for inflation), commercial revenues were even more crucial to Aerostar – and it was even more critical for Aerostar to have a financing structure that afforded it the flexibility needed to attract and retain tenants.

Aerostar's financing structure successfully balanced the protection of lenders' interests with the flexibility necessary for a dynamic operating business. While Aerostar's revenues do go into a pledged account, Aerostar has broad flexibility to use funds to operate its business. Aerostar's capital expenditures are limited by a budget (plus a cushion for contingencies), but the budget is not subject to lender approval. In light of the commercial opportunities that exist at most major public airports in the US, future private operators would be well-advised to seek similar flexibility in their financing structures.

Maintain stakeholder support

Nearly all PPP infrastructure transactions take a long time to develop – taking many months or even years – because of the nature of infrastructure assets and public bidding processes. Airport PPPs in the US, however, have the added complexity of regulatory requirements that are not applicable to the operator of a toll road or even a power plant. Any private operator of an airport must apply for and receive a Part 139 Operating Certificate from the FAA, a process that can take many months, even for operators such as Aerostar whose shareholders comprise existing public airport operators and investors. In addition, newly-minted airport operators must receive security clearances to be able to view TSA security plans, and if an airport operator's shareholders are located outside of the US, it may be prudent to file an application with the Commission on Foreign Investment in the United States (CFIUS). In total, the closing of the LMM transaction took over seven months from the date that the lease agreement with the PRPA was signed.

Adding to the challenge of the long periods to negotiate and close an airport PPP transaction, maintaining stakeholder support for airport PPP transactions during these periods is crucial. Unlike ports or energy sector PPP transactions, large portions of the population have some amount of regular contact with an airport, whether they are air travellers or merely picking up visiting friends and relatives. Airports are also frequently significant generators of public employment in a community. Finally, airports are considered by many politicians to be a gateway to a community. As a result, even small changes in airport operations are often put under a microscope. This was certainly true in the PPP transaction at LMM airport, where support or opposition to the transaction was voiced early and often by politicians, labour unions and community groups.

In this regard, a few lessons can be learned from Aerostar's experience with LMM Airport. First, it is important to build in contractual incentives – both positive and negative – for community support. The Lease Agreement for LMM Airport provides not only for a large initial up-front payment, but also a fixed annual payment of US$2.5m in the first five years of the transaction, followed by payments of 5% of gross revenues for each of the next 25 years and 10% of gross revenues in each of the final 10 years.

From the PRPA's perspective, the large up-front payment allowed it to retire all of its airport-related debt and still have enough left over for other ongoing obligations. Further, the ongoing payments ensured a revenue stream that would be able to continue to pay for the PRPA's oversight of Aerostar as well as help fund the regional airports for which the PRPA remained responsible, which were a key issue in community discussions on the transaction.

Ongoing payments also helped the PRPA to build political consensus for the transaction by allowing it to highlight that it would share in the project's success down the road. On the other hand, the contract provided for reimbursement by the PRPA of up to US$8m in bidder expenses if the PRPA walked away without justification. Both the ongoing revenue-sharing and the costs for abandoning the privatisation were invoked in a speech given by Governor Garcia Padilla the night before the closing of the transaction took place.

Second, it is important that the bidding process be as efficient and transparent as possible, consistent with achieving the public airport sponsor's objectives for the transaction. Bidding processes that drag on for substantial periods of time can often weaken public support by making it seem as if there are doubts about whether the transaction will move forward and allowing opponents additional time to mobilise support. In the LMM Airport PPP, Aerostar was selected from an initial pool of six bidders. This pool was wisely reduced to two by the PRPA before a final bid, which gave both sponsors a greater incentive to spend the diligence dollars necessary to complete the transaction.

Unlike many public procurement processes, in which bids are based on a final form of agreement, the PRPA submitted draft Lease and Use Agreements to all bidders and asked for comments in three separate rounds. This process produced some benefits – it resulted in bidders obtaining a number of value-enhancing changes to the agreement, which, insofar as they translated into a higher upfront payment, was a key objective of the PRPA in light of its stated goal of using the proceeds to deleverage. Although each airport PPP will obviously be somewhat different, now that there is a form of agreement that has been accepted by market participants, future airports may be able to use that form as a base for their negotiations with prospective private operators.

Finally, having a deep bench of industry experts and advisers, both during contract negotiations and the closing process, is essential to success. Aerostar engaged experienced transaction counsel as well as special FAA counsel, who were essential to ensuring that there was a constant line of communication open between Aerostar and its regulators. Aerostar's shareholder ASUR seconded a number of key personnel for a transitional period, all of whom brought years of experience from the operation of ASUR's airports in Mexico to discussions with airlines and commercial tenants, while shareholder Highstar Capital IV fielded a team of financial experts who had extensive experience with public infrastructure projects, including Highstar's investment in London City Airport and the Seagirt Marine Terminal in Baltimore. Finally, Aerostar hired a US airport industry expert to both advise on US airport practices during contract negotiations and to facilitate a smooth transition with key airport stakeholders, such as airlines, technical staff and cargo carriers. Having this team in place meant that Aerostar could quickly respond to changes in agreements during negotiations and assure that they were correctly implemented during the closing process.

Look at an airport as a blank canvas

Because of the very limited history of private participation in airport operation in the US, most major public airports have historically been operated as akin to utilities or public works – and it shows. Compared with many of their peer airports in Latin America, Asia and Europe, US airports have far more limited commercial offerings, less advertising and fewer sources of revenue. LMM Airport was no different: LMM Airport had declining traffic for many years – from 2007 to 2011 enplanements had declined by approximately 20%, and one of the Airport's key airline customers – American Airlines – was about to file for Chapter 11 bankruptcy and begin reducing capacity. LMM Airport was in severe need of remedial maintenance and the PRPA was running low on cash and faced upcoming debt maturities. The commercial tenants at the airport had a poor history of paying rent and many of them had abandoned their spaces.

For many of the bidders, this situation represented a daunting challenge: how could you unlock the value at an airport that, by all accounts, was substantially under-utilised?

Adding to the difficulties faced by bidders at LMM Airport was the fact that, under the tariff structure, aeronautical revenues were fixed independently of passenger traffic – so a private operator couldn't generate additional aeronautical revenues by promoting additional flights to the airport. One of the key strategic decisions that Aerostar made early in the bidding process was to make a relatively radical suggestion: rather than propose to build out and increase the size of the airport, which is the basis for many PPP transactions, Aerostar actually proposed to consolidate the airport into a smaller footprint that was more consistent with its current usage, and then reserve two entire concourses to be for future growth.

Although Aerostar's proposal was initially met with scepticism by the PRPA and resistance by airlines concerned about its operational impact, both constituencies grew to see the plan – which was called the Capacity Enhancement Plan, or CEP – as beneficial.

The PRPA recognised that, by allowing a bidder to eliminate the fixed costs of operating terminals that were barely used, that could translate into a higher up-front payment. In addition, in order to implement the CEP, Aerostar would have to make significant capital improvements to two of the other three remaining concourses, which would result in an improved travel experience for passengers and better functionality for airlines.

After a significant period of engagement between Aerostar and the airlines, the airlines and the PRPA grew to recognise that the CEP would provide for a better passenger experience and would result in a number of long-overdue construction projects being accelerated. For Aerostar, the CEP was key to obtaining financing and meeting the financial goals set by its shareholders.

The lesson for future bidders in airport PPPs is that it isn't necessarily the case that the airport has to be taken as it stands. Although there are certainly restrictions imposed by regulators as well as the inherent limitations that arise from operating a space where planes take off and land at all hours, airports are, in many ways, an ideal commercial opportunity waiting in the wings – with captive consumers, existing infrastructure and limited competition.

Conclusion

The LMM Airport PPP transaction was the first successful PPP transaction in the US airport sector since the fizzled out Stewart Airport privatisation attempt in the 1990s. It shouldn't be the last. There are many opportunities to be gained by public airport authorities and private operators alike – improved operations, enhanced passenger experiences, and at a time of state and municipal fiscal austerity, an opportunity to participate in the success of a PPP transaction.