Research Update:

Flughafen Zurich 'A+' Ratings Affirmed On Traffic Recovery Expectations; Outlook Negative

February 17, 2022

Rating Action Overview

- S&P Global Ratings expects passenger volumes for Zurich Airport (FZ)--the main asset of Flughafen Zurich AG (FZAG)--will recover slower than previously anticipated, with traffic likely at about 60% of 2019 levels in 2022 and about 80% in 2023, with a full recovery unlikely before 2025. We believe consumers' ability and willingness to travel and the risk of potential new COVID-19 variants will be key to FZ's recovery path.
- We believe that FZAG's adjusted funds from operations (FFO) to debt will remain weak for the current rating in 2022 at about 16%-18%, but recover toward 30% by 2023. This is supported by about 15%-20% of total revenue coming from leasing and rental cash flows that are not exposed to traffic volumes, sustained cost management, and continued financial discipline.
- We have therefore affirmed our 'A+' long-term issuer credit rating on FZAG, and our 'A+' issue rating on its debt.
- The negative outlook on FZAG reflects uncertainty in its traffic recovery path, which could mean that the company might not return its weighted average S&P Global Ratings-adjusted FFO to debt above 30% over 2022-2024, if not mitigated.

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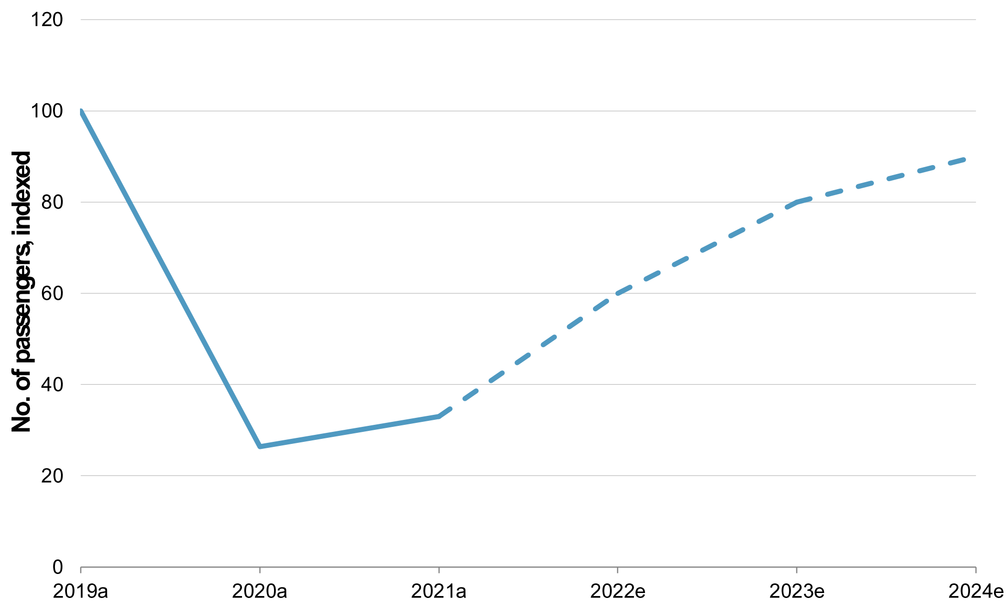
Rating Action Rationale

We expect FZ's recovery will be slower than previously anticipated, in the face of evolving new COVID-19 variants and inherent pandemic uncertainties and given its exposure to business and long-haul traffic. We now project that the FZ's passenger volumes will be about 60% of 2019 levels in 2022, before rising to about 80% in 2023 and about 90% in 2024. This is because we anticipate that the recovery path will continue to be volatile and depend on consumers' ability and willingness to travel amid the risk of potential new COVID-19 variants. We also consider FZ's dependence on business travel and long-distance routes (27% and 26% of 2019 traffic, respectively), which we believe will recover more slowly than airports with higher exposure to domestic and short-haul routes.

Chart 1

Flughafen Zurich Passenger Number Recovery Path
Number of passengers, Indexed 2019=100



e--Estimate. Source: S&P Global Ratings.

In our view, there is the potential that COVID-19 flare-ups and variants could further dampen our current forecast, although in our base case we assume that current vaccines will continue significantly protecting against severe illness. For further information on our view on our rated European airports, see "A Volatile Recovery Ahead For European Airports ," published on Jan. 24, 2022.

We believe that FZAG will have limited flexibility in capital spending, which could make the airport less able to mitigate the impact of potential traffic recovery delays (beyond our base-case assumptions) on its credit ratios. At the airport's Zurich operations, we note that the group already reduced spending by close to 50% from 2019 levels to Swiss franc (CHF) 232 million in 2020. Over the next two-to-three years, we expect that the company's capital expenditure (capex) at its Zurich operations will be about CHF200 million per year, including essential maintenance spending of approximately CHF100 million-CHF150 million a year.

The company's international activities, particularly for its investment in Noida International Airport in Jewar, India, will also have limited flexibility, given the greenfield nature of the project that requires milestone construction targets to be met to avoid penalties under its concession agreement. We expect that the construction of this project will total about CHF650 million, spread over the next three-to-four years.

Given FZAG's slower passenger recovery and high committed spending, we forecast FZAG's leverage, as measured by FFO to debt, will be elevated in 2022 but should recover to levels commensurate with the current rating level by 2023. With the delay in passenger recovery, we expect that the company's FFO to debt will be below our downgrade threshold in 2022, but recover to more than 30% in 2023, as the recovery unfolds. We anticipate that this will be complemented by the group's stability in leasing income and increasing contributions from its international investments where traffic has also been recovering faster.

We believe that FZAG will prioritize deleveraging over growth opportunities over the next two-to-three years. As the recovery unfolds, we expect management will remain committed to its net financial debt-to-EBITDA target of less than 3x and will maintain adjusted weighted average FFO to senior debt above 30%, managing its spending and distributions in line with this target.

We expect that FZAG's cash flows will be supported by the increased revenue contribution from its rental income (15%-20% of total revenues in 2022), providing a buffer against traffic volume-exposed revenue lines amid pandemic uncertainty. We expect that the Circle, the airport's new multi-use commercial real estate project, that opened in November 2020, will increase FZAG's real estate rental and facility management revenue to about 15%-20% of FZAG's total revenue in 2022 from about 10% in 2019. We view this as a strength in comparison to peers, because these cash flows are largely fixed under long-term retail price index-linked contracts and will mitigate passenger volume risks. Like existing rental contracts, the Circle will also benefit from minimum annual revenue guarantees (MAGs) incorporated in contracts with the airport's commercial tenants. Under MAGs, about 80% of rent from commercial (retail as well as food and beverage) partners is fixed and payable regardless of footfall and the tenants' revenue. The opening of the Circle will support an increase in the airport's commercial revenue by about 10% in 2021, and 15%-20% in 2022.

To date, the occupation rate is about 85%, comprising high-quality tenants, including Microsoft, Hyatt, and SAP. The Circle will add to FZAG's Priora real estate portfolio purchased in 2019, which also benefits from long-term fixed rental contracts. The added stability in FZAG's cash flows as a result of the airport's real estate and leasing investments can be seen in 2020. Despite a 74% drop in traffic in 2020, the company's revenue dropped by only 49%.

While the MAGs were suspended during the government-imposed lockdowns in 2020 and thus did not provide the full expected protection, MAG terms are largely unchanged. We also anticipate limited re-negotiation of rental contracts, because there are limited contract expiries in the next two years.

We believe that there is a moderate likelihood of timely and sufficient support from the Canton of Zurich, FZAG's largest single shareholder. We continue to believe that FZAG has an important role for the Canton of Zurich, as the country's largest airport that plays a key role in meeting economic and public policy objectives. Aviation is part of the country's critical infrastructure, supporting over one-third of Switzerland's exports and one-sixth of imports. Zurich airport, as one of the three national airports but the only hub, connects Switzerland with the world, supporting tourism and business travel. That said, we believe FZ's default would have an important, rather than significant systemic impact on the local economy.

In our view, FZAG has a limited link with the Canton of Zurich, given its relatively low shareholding in the company of only 33.3% (plus one share). The canton's obligation to hold more than one-third of FZAG's shares, and hence to maintain its influence over FZAG as a shareholder, is stated in the Airport Act. However, there is no legal base for providing extraordinary support above CHF6 million without going through parliament (and potentially a referendum), which implies the support may not be provided in a timely manner should it be required.

Ultimately, FZAG's moderate likelihood of government support translates into one notch of uplift that we apply to the company's stand-alone credit profile of 'a', resulting in an issuer credit rating of 'A+'.

The recent rapid spread of the omicron variant highlights the inherent uncertainties of the pandemic as well as the importance and benefits of vaccines. While the risk of new, more severe variants displacing omicron and evading existing immunity cannot be ruled out, our current base case assumes that existing vaccines can continue to provide significant protection against severe illness. Furthermore, many governments, businesses, and households around the world are tailoring policies to limit the adverse economic impact of recurring COVID-19 waves. Consequently, we do not expect a repeat of the sharp global economic contraction of second-quarter 2020. Meanwhile, we continue to assess how well each issuer adapts to new waves in its geography or industry.

Outlook

The negative outlook indicates that we could lower the rating should the traffic disruption due to the pandemic last longer than we expect, amid already lower rating headroom, leading S&P Global Ratings-adjusted FFO to senior debt over 2022-2024 to fall below 30% on average.

The recovery of passenger volumes could take longer than we anticipate, due to further variants and COVID-19 flare-ups that could materially dampen travel demand. We could lower the rating, if passenger numbers lag our assumption of 60% of 2019 levels for the first half of 2022 and FZAG's credit ratios are not adequately protected by mitigating efforts, such as the lowering distributions, reduction of operating costs, and delay of uncommitted capex.

Upside scenario

We could revise the outlook to stable if traffic improved continuously and the risk of further mobility restrictions eased, leading to a more stable operating environment. An outlook revision to stable would also require visibility on the company's ability to manage its costs, investments, and dividends, such that weighted average FFO to debt is sustainably above 30%.

Company Description

FZAG is the owner and operator of FZ, Switzerland's largest airport, with a license to operate the airport until 2051. In 2019, the airport handled 31.5 million passengers.

The company's airports are well diversified, with 45% of total revenue in 2019 generated from commercial, real estate, and service activities, and international investments in Latin America, mainly in Brazil and Chile. In October 2020, FZ signed a concession agreement for a greenfield investment in Noida International Airport in Delhi, which is expected to start contributing EBITDA from 2025. In 2019, revenue from international investments corresponded to about 10% of FZAG's total.

Our Base-Case Scenario

Assumptions

Our base-case assumptions for 2022-2024 are as follows:

- Passenger traffic will be about 60% of 2019 levels in 2022, about 80% in 2023, and approximately 90% in 2024.
- Aeronautical revenue in line with traffic performance. The 10% discount on the aeronautical tariff ended in December 2021, returning to its full tariff level.
- Retail (airside and landside) revenue will continue benefiting from MAGs.
- An increase of about 10% in commercial revenue in 2021 due to the opening of the Circle in November 2020, with growth of about 15%-20% in 2022. This will also be supported by traffic recovery.
- EBITDA margins to recover to about 45% in 2022 and toward 55% thereafter, supported by sustained cost savings.
- Total annual capex of about CHF400 million in 2022-2024. Construction of Noida airport during 2022-2024 at the total cost of about CHF650 million.
- No distributions until 2023. Later, dividends and acquisitions set at the level corresponding to the company's mid-term target leverage of net financial debt to EBITDA of below 3x.

Key metrics

Table 1

Flughafen Zurich --Key Metrics*

	--Fiscal year ended Dec. 31--				
	2019a	**2020a**	**2021e**	**2022f**	**2023f**
(Mil. CHF)					
Revenues	1,113.90	591.1	650.0-660.0	890.0-900.0	1,050.0-1,070.0
EBITDA	633.5	194.7	280.0-290.0	430.0-440.0	580.0-590.0
EBITDA margin (%)	56.9	32.9	40.0-45.0	45.0-50.0	About 55.0
FFO to debt (%)§	40.6	9.6	16.0-18.0	25.0-27.0	About 35.0

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast. FFO--Funds from operations. CHF--Swiss francs. §We adjust debt by adding lease liabilities, pension liabilities, and deducting surplus cash.

Liquidity

We believe that FZAG has strong liquidity and note its proactive liquidity management during the pandemic. This includes its ability to reduce shareholder distributions if necessary. FZAG's strong relationships with banks and good standing in capital markets have also allowed it access to relatively low-priced liquidity during the pandemic. We expect liquidity sources will exceed uses by more than 1.5x in the 12 months to Dec. 31, 2022, and by more than 1x in the subsequent 12 months to Dec. 31, 2023.

We estimate the following liquidity sources for the 12 months to Dec. 31, 2022:

Unrestricted cash and fixed-term deposits of CHF510 million. We exclude the cash held in the Airport of Zurich Noise Fund of CHF3.9 million;

Availability of about CHF290 million under a committed credit line increased in February 2021 and expiring in 2025; and

Cash FFO of CHF420 million-CHF450 million under our base-case scenario.

We estimate major liquidity uses for the 12 months to Dec. 31, 2022, comprise:

No debt maturities in the next 12 months, although the company's CHF400 million bond is due in 2023;

Expected capex of about CHF400 million for the upgrade and maintenance of FZ, as well as investments in India and Brazil; and

Estimated working capital outflows of about CHF30 million.

Issue Ratings - Subordination Risk Analysis

Capital structure

FZ's capital structure primarily comprises approximately CHF1.65 billion in senior unsecured debentures, plus unsecured bank loans issued by the Chilean subsidiary A-port S.A. and Florianopolis airport in Brazil. FZ's total gross debt, excluding lease liabilities, stood at CHF1.81 billion as of June 30, 2021.

Analytical conclusions

We rate the senior unsecured debt issued by FZAG at 'A+', the same as the issuer credit rating, reflecting the company's modest financial risk profile. We consider that FZAG has low enough leverage to limit the possibility of any lenders being significantly disadvantaged relative to other lenders.

Ratings Score Snapshot

Issuer Credit Rating: A+/Negative/--

Business risk: Strong

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

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: a

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: a

- Likelihood of government support: Moderate (+1 notch from SACP)

ESG credit indicators: E-2, S-4, G-2

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- A Volatile Recovery Ahead For European Airports, Jan. 24, 2022
- ESG Credit Indicator Report Card: Transportation Infrastructure, Dec. 13, 2021
- Flughafen Zurich AG, May 6, 2021

- Flughafen Zurich AG Ratings Lowered To 'A+' On Protracted Passenger Traffic Recovery; Outlook Negative, July 22, 2020

Ratings List

Ratings Affirmed	
Flughafen Zurich AG	
Issuer Credit Rating	A+/Negative/--
Senior Unsecured	A+