Research Update:

Flughafen Zurich AG Outlook Revised To Stable On Recovering Air Traffic And Financial Performance; 'A+' Ratings Affirmed

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Rating Action Overview

- Higher visibility on passenger recovery path and its positive impact on non-aviation business lines should increase Flughafen Zurich AG's (FZAG's) earnings and cash flows, supporting the long-term sustainability of the credit metrics in line with the rating, notably adjusted funds from operations (FFO) to debt comfortably above 30% over 2023-2025.
- We also think that the continuous cost discipline to manage higher energy costs and general inflationary effect on expenses should support healthy EBITDA margin at around 55% over the next three years.
- We anticipate that committed investments in the Noida greenfield airport project in India will likely bring execution and financial challenges, which in our view is balanced by the experienced management team and forecast credit metrics providing rating headroom for potential cost overruns.
- We have therefore revised our outlook on FZAG to stable from negative and affirmed our 'A+' long-term issuer credit and issue ratings.
- The stable outlook reflects our expectation of continued traffic recovery, and that FZAG will effectively manage its capital spending (capex) and cost base, such that its ratio of S&P Global Ratings-adjusted FFO to debt will remain above 30%.

Rating Action Rationale

We anticipate FZAG's air traffic will recover to just above 80% of 2019 levels in 2023 and to about 90% in 2024, with a full recovery in 2025-2026. We understand the recovery path has been slower than that of rated peers and this is mainly driven by the combination of:

- Airlines' operational constraints in the upturn of activities following the pandemic;
- Delays in deliveries of new aircraft and spare parts that are limiting capacity, particularly in

2023, and

- Swiss Air's decision to deploy about 80%-85% of its capacity at the airport in 2023 instead of 100%.

Swiss Air is part of Lufthansa Group's (BB/Positive/B) airline business, and carried about two-thirds of total passengers at FZAG before COVID and we consider the airport's reliance on Lufthansa to be significant.

Having said that, we expect Switzerland's higher disposable incomes to be less sensitive to macroeconomic headwinds, which offsets the risks of affordability concerns and sustainability of demand within an environment of high ticket prices. We also expect the increase in leisure passengers to partially offset the potential permanent loss of some business travel (26% share of total traffic in 2019). This could be advantageous for the airport, given leisure passengers tend to spend more time taking advantage of retail shops and restaurants in the airport. That said, we do expect spending per passenger to return to pre-pandemic levels of around Swiss franc (CHF) 22 per departing passenger from the peaks seen during the last three years of CHF24-CHF25 per passenger as operations resume normal activities and waiting times at the airport reduce.

Although aeronautical tariffs will remain flat until 2026, the business lines allow for inflation pass-through Real estate income generated by the Circle and Priora portfolios will continue to represent around 15%-20% (16% as of end-2022) of total revenue thanks to long-term index-linked contracts. On top of this, the retail business benefits from minimum annual revenue guarantees (MAGs) that limit the exposure to footfall and tenants' revenues. We view this as a strength compared with peers' and the cash flow protection seen during the pandemic kept the drop in commercial revenue to a maximum of about 35% versus 2019 levels.

The above would contribute to offsetting inflation-linked costs. We expect operating costs to continue rising in 2023 owing to high energy prices, salaries growing in line with inflation, and additional security costs following traffic recovery. From 2024 we expect growth to decelerate accounting for the company's cost discipline and business efficiencies and contribute to maintaining EBITDA margins at about 55%. That said, additional capacity coming from the Circle portfolio and recently acquired Priora portfolio, together with traffic recovery, should further boost non-aviation income. Once volumes return to pre-pandemic levels by 2025-2026, we foresee non-aviation revenue allowing FZAG to reach higher levels of profitability above 55% EBITDA margin.

Improved operating environment and deleveraging efforts will balance the financial risk profile considering the ongoing capital investments in India. We expect FZAG to make a cash payment of its upcoming bond maturity of CHF400 million on April 17, 2023, and at least half of the CHF300 million bond due in May 2024. This will leave room for new leverage for the ongoing construction of Noida International Airport in Jewar, India, which has a revised budget of CHF750 million. The project started construction in the second quarter of 2022 and is expected to be operational by the end of 2024. Financing was secured at the time of the closure of the concession agreement in 2021 with State Bank of India for Indian rupee 37.25 billion (about CHF415 million) to be repaid over a 20-year period, leaving the remaining portion to be made through equity contribution.

Given the complexity and size of the project, we think FZAG faces a significant execution risk with no flexibility in terms of timing, given the concession agreement requires milestone constructions to be met to avoid penalties. This could potentially place further pressures on the strong liquidity position. Nevertheless, as the recovery unfolds, we expect adjusted weighted average FFO to senior debt to remain above 30% and provide rating headroom for potential cost overruns.

Aviation charges will be negotiated during 2025 and unlikely to be implemented before 2026. So far, we have no visibility on potential changes and recent history has been somewhat inconsistent. Pre-pandemic charges were heading toward a 15%-20% reduction mandated by the Federal Office of Civil Aviation (FOCA) due to higher-than-expected returns in the 2016-2020 regulatory period, when growth in the passenger numbers led to an 8.8% instead of 5.9% maximum allowed return (weighted average cost of capital) on aviation business. In fact, it attempted to claw back the overperformance by lowering aeronautical charges and increasing cross-subsidy of aeronautical charges by FZAG's non-aeronautical revenue. However, none of the above materialized.

As the pandemic eased, FZAG quickly managed to reach an agreement with airlines and FOCA to provide a 10% discount on tariffs for the nine months following April 2021. Thereafter, tariffs remained flat until 2025, placing FZAG in a much better position than peers struggling to meet regulatory revisions.

For the next regulatory period, we will monitor the discussion among the market participants to understand the future implications to FZAG.

Outlook

The stable outlook on FZAG reflects our expectation that, underpinned by the recovery in air traffic, the company will effectively manage its cost base and committed capex program in India while maintaining credit metrics commensurate with its current credit quality. Specifically, we expect its adjusted FFO to debt will remain above 30% in 2023-2025.

Downside scenario

We could lower the rating if financial performance deteriorates, specifically if FFO to debt falls below 30%. This could happen in the short term if traffic volumes take significantly longer to recover, or FZAG's investments are greater than we assume in our base case. The latter would become likely if the Noida project were to go over time or over budget. Tariff cuts in the next regulatory period starting in 2026 could meaningfully harm credit metrics and put pressure on the rating, as could higher-than-expected dividends. Finally, all else being equal, a one-notch downgrade of the Canton of Zurich may result in a similar action on FZAG.

Upside scenario

We see an upgrade as limited at this stage while traffic recovers and the construction of the Noida project is ongoing. For a one-notch upgrade to the rating, we expect FFO to debt to be consistently above 35% and free operating cash flow (FOCF) to debt to be above 10%.

Company Description

FZAG is the owner and operator of Flughafen Zurich, 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, FZAG was awarded with 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 2023-2025 are as follows:

- Passenger traffic will be about 80% of 2019 levels in 2023, about 90% in 2024, and about 95%-100% in 2025. We assume growth in line with GDP thereafter. We do not include revenues from the operations in India from 2025.
- Aeronautical revenue in line with traffic performance and tariffs flat.
- An increase of about 6%-7% in commercial revenue in 2023 and about 4%-5% in 2024 and 2025, supported by traffic recovery, retail line (airside and landside) benefiting from MARGs, and available capacity of the Circle portfolio.
- Operating cost growing at around 12% in 2023 considering the increase in personnel expenses of 3% based on past inflation, as well as an expected increase of 50% in energy and waste costs, driven by high energy prices in Europe. We expect costs to continue growing at a lower pace of around 3%-5% in the following two years.
- EBITDA margins to decline marginally to about 53% in 2023 and remain around 55% thereafter, sustained by efficiencies gain with the ramp-up of operations and passenger recovery.
- Committed capex for the construction of Noida airport during 2022-2024 at the total cost of about CHF750 million. We are accounting for potential cost overruns of CHF150 million in 2024, by which time the airport needs to be delivered. Maintenance capex for the Zurich site to remain around CHF250 million–CHF300 million in the next three years.
- Cash repayment of CHF400 million notes coming due on April 17, 2023, and partially repayment of CHF300 million notes due in May 2024.
- Dividend policy in line with the company's expectations of 40% of net income. We don't account for a potential pay-out of remaining capital contribution held in reserves.

Key metrics

Flughafen Zurich AG--Key Metrics*

Mil. CHF	2019a	2020a	2021a	2022a	2023e	2024f	2025f
% of 2019 passenger numbers	N/A	26.4	32.3	71.5	About 80.0	About 90.0	90.0- 100.0
Revenue	1,113.90	591.1	662.8	994.5	1,100.0-1,200.0	1150.0-1250.0	1250.0-1350.0
EBITDA	633.5	194.7	296.9	555.7	580.0-600.0	640.0-660.0	710.0-730.0
EBITDA margin (%)	56.9	32.9	44.8	55.9	50.0-55.0	About 55	About 55
Funds from operations (FFO)	526.1	148	282.8	534	540.0-580.0	580.0-620.0	620.0-660.0
Capital expenditure	774.0	398.5	206.3	235.3	650.0-700.0	750.0-800.0	About 500

Flughafen Zurich AG--Key Metrics* (cont.)

Mil. CHF	2019a	2020a	2021a	2022a	2023e	2024f	2025f
Debt to EBITDA (x)	2.0	8.0	4.9	2.3	2.5-2.7	2.7-3.0	2.7-3.0
FFO to debt (%)	40.6	9.6	19.5	41.0	34.0-37.0	32.0-35.0	32.0-35.0

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast. N/A--Not applicable.

We assume partial repayment of the CHF300 million bond due in 2024 and drawdown of about CHF415 million of the loan with the State Bank of India Ongoing de-leveraging efforts will contribute to balance FZAG's financial profile. We assume CHF150 million of the total CHF300 million due in May 2024 will be refinanced at a higher interest rate of 2.0%-2.5%. In the context of macro volatility and rising interest rates, we assume coupon will be about 30% higher than the existing 1.7%. Secured financing with the State Bank of India will start to be repaid one year after construction is complete and operations ramp up in 2025, thanks to the moratorium agreed in the financing. Concession fees benefit from a grace period of six years after the start of operations.

Liquidity

FZAG benefits from strong relationships with banks and a good standing in capital markets, which allowed it to access relatively low-priced liquidity during the pandemic. However, we believe the cash position could come under pressure because of delayed traffic recovery, resumption of dividend distribution, and more importantly, committed capex investments taking place in a complex greenfield project in India. Therefore, we don't believe the company will be able to absorb contingencies or high-impact events while maintaining a strong liquidity position.

That said, we acknowledge FZAG's proactive liquidity management during the pandemic, its flexibility to defer small investments and capex, and its ability to reduce shareholder distributions if necessary. We do not anticipate changes to the rating based on our liquidity assessment.

Liquidity sources exceeded uses by more than 1.5x in the 12 months to March 31, 2023, and we expect they will exceed uses by more than 1x in the subsequent 12 months to March 31, 2024.

Principal liquidity sources

We estimate the following liquidity sources for the 12 months to Dec. 31, 2023:

- Unrestricted cash of CHF600 million. We exclude the cash held in the Airport of Zurich Noise Fund and in subsidiaries.
- CHF290 million available under a committed credit line due in 2025.
- Cash FFO of CHF558 million-CHF450 million under our base-case scenario.
- State Bank of India loan for about CHF415 million.

Principal liquidity uses

We estimate major liquidity uses for the same 12 months comprise:

- Debt maturities of CHF400 million bond in April 2023.

- Expected maintenance capex of about CHF250 million for the upgrade and maintenance of Zurich airport, an additional CHF300 million investments in India, and Latin America; we do not include any cost overruns in our liquidity assessment.
- Estimated working capital outflows of about CHF35 million.
- Dividend distribution of just above CHF100 million considering dividend policy of 40% of net income.

Covenants

FZAG's bonds and facilities are not subject to financial covenants.

Environmental, Social, And Governance

ESG credit indicators: To E-2, S-3, G-2, From E-2, S-4, G-2

We revised our social factors score to 'S-3' from 'S-4' because, even though we have gained visibility on the recovery path, FZAG still operates in what we consider to be a moderately negative environment and consideration in our credit analysis. Travel restrictions were lifted worldwide as China reopened its borders, which should contribute to an increase in long-haul passengers at Flughafen Zurich. However, airlines have not deployed their full capacity and there are some delays on deliveries of airplanes, which would ultimately affect passenger volumes regardless of the existing demand.

Group Influence

We add one notch of uplift to FZAG's stand-alone credit profile (SACP) to reflect what we see as a moderate likelihood of timely and sufficient extraordinary support from the Canton of Zurich, FZAG's largest single shareholder. We base our view on our assessment of FZAG's:

- Important role for the Canton of Zurich given the company's function in meeting economic and public policy objectives. Aviation is part of the country's critical infrastructure; it supports over one-third of Switzerland's exports and one-sixth of imports. Flughafen Zurich, 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 FZAG's default would have an important, rather than significant, systemic impact on the local economy.
- 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.

Issue Ratings - Subordination Risk Analysis

Capital structure

FZAG's capital structure primarily comprises approximately CHF1.6 billion senior unsecured debentures, plus unsecured bank loans issued by the Chilean subsidiary A-port S.A. and Florianopolis airport in Brazil. FZAG's total gross debt, excluding lease liabilities, stood at CHF1.77 billion as of December 2022.

Analytical conclusions

We rate the senior unsecured debt issued by FZAG at 'A+', the level of 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+/Stable

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-3, G-2

Environmental, social, and governance (ESG) credit factors for this change in credit rating/outlook and/or CreditWatch status:

- Health and safety

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
- 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

Related Research

- Industry Top Trends 2023: Transportation; Jan. 23, 2023
- Industry Top Trends 2023: Transportation Infrastructure; Jan. 23, 2023
- Research Update: Deutsche Lufthansa AG Upgraded To 'BB' On Air Traffic Recovery And Reduced Financial Leverage; Outlook Positive; Nov. 30, 2022.

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Flughafen Zurich AG		
Issuer Credit Rating	A+/Stable/--	A+/Negative/--
Senior Unsecured	A+	A+