

LEVERAGING THE PRIVATE SECTOR TO IMPROVE AIRPORT INFRASTRUCTURE

UPSIDES AND RISKS OF AIRPORT PRIVATISATION

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As passenger volumes continue to grow and airlines worldwide expand their fleets, airport infrastructure is fast becoming a growth bottleneck.

Privatisation has an important role to play in eliminating this barrier to growth, and its execution around the world has evolved significantly over the past 25 years. During that time, key lessons have been learned from successful transactions:

- Clear objectives are required to guide scope and transaction design
- Well-defined governance structures are needed, to ensure the initial strategy is followed
- Regulatory frameworks need to be established before privatisation is launched
- Transparent communication with stakeholders is required to build public support

This paper examines those issues and outlines what can be done, by governments and potential investors, to ensure successful airport privatisations.

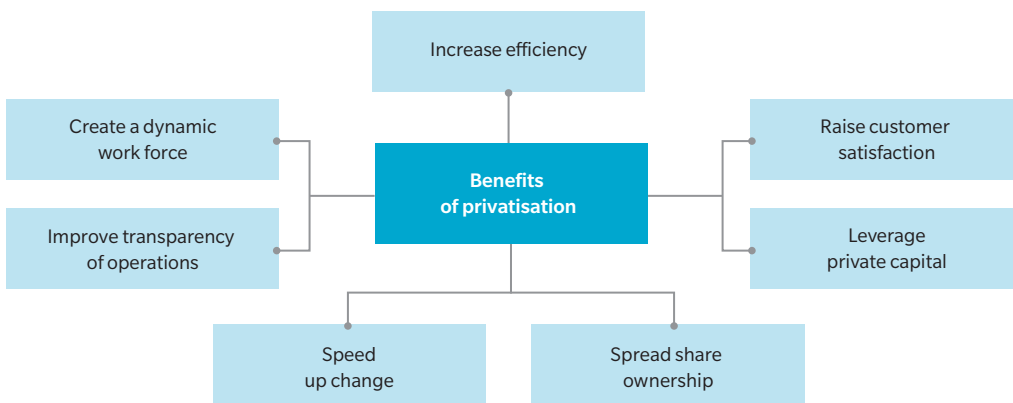
INTRODUCTION

In 1987, the UK government founded BAA plc¹, now known as Heathrow Airport Holdings Ltd, to raise funds as part of a wider effort to monetise government-owned assets. Since then, the business of airport privatisation has grown, matured and diversified to meet the objectives of governments and investors around the world.

After a lull, airport privatisations became particularly active again, between 2012 and 2015, with the most substantial activity seen in South America, the Middle East and Europe. The predicted exponential growth in passenger volumes worldwide² will require improvements and expansions of aviation infrastructures for many years to come. Privatisation will be a key tool in securing funding for these types of projects.

The benefits of airport privatisation, if managed diligently, can be significant.

Exhibit 1: Benefits of privatisation



Three elements are of particular relevance to the privatisation of airports:

- **Leverage private capital:** the private sector can provide the tremendous amount of capital required to build new infrastructure, reducing investment burdens for governments. Private capital is generally allocated more efficiently, and the money saved can be invested in alternative public services, such as education or healthcare
- **Raise customer satisfaction:** most airports operated by public entities do not focus on the customer experience. Privatisation can allow for better adjustments to market changes and will often provide more innovative solutions to customers, resulting in improved outcomes for all
- **Create a dynamic workforce:** privatisation goes hand in hand with extensive training of airport staff. International operators play a key role, bringing best practices to the respective operations

This report highlights lessons learned from our extensive experience with airport privatisations and other airport business-improvement projects. It is designed to help sellers and buyers navigate the privatisation process and effectively manage its upsides and risks.

1. British Airport Authority

2. IATA 20 Years Passenger Forecast, IATA Press Release No 59, 2016

AIRPORT PRIVATISATION MODELS

The following three examples illustrate the history of privatisation and how the business has evolved and diversified. These are:

- 100% private ownership
- Privatisation through a long-term concession
- The sale of less than full ownership of an airport

Even though some models are more conventional than others, there is no optimal model that fits all government needs. Each option requires a detailed analysis of public priorities to allow a government to select the most appropriate model.

Exhibit 2: Airport privatisation models

Full Private Ownership

- Government fully transfers ownership of the airport to the private sector

Long-term Concession

- Airport operator receives long term concession (25+ years) to operate the airport, often on a revenue share basis

Partial Privatisation

- Privatisation of the airport, but the government keeps a significant ownership stake



Sector Policy and Regulation

- Aviation sector policy needs to be clarified
- Airport operator and regulatory functions need to be separated

1. Full private ownership

British Airports Authority (BAA)

The evolution of BAA aptly illustrates how airports have attracted a range of investors over time, as well as signifying the critical impact of regulatory intervention on airport investors.

Initially 100% privatised³ BAA was then acquired in 2006 by a consortium led by the Spanish conglomerate Ferrovial. It was then taken private and its shares delisted. Two years later, UK regulators acted to increase airport competition in the London and Glasgow/Edinburgh areas, by ordering BAA to divest Gatwick, Stansted and either Glasgow or Edinburgh⁴. BAA had transferred all but London Heathrow through trade sales by the end of 2014. Throughout this period, the 100% private ownership model remained intact.

A recurrent concern with the full private ownership model is that strategic infrastructure assets are handed over to private sector operators. Politicians struggle to find common ground, often running into fierce opposition over deals.

3. In 1987, when its shares were first listed on the London Stock Exchange

4. Originally the BAA portfolio contained seven UK airports

2. Long-term concession

International Airport Group (Jordan)

A fundamental government concern about airport privatisation is the potential loss of control over essential facilities used by the public. In a number of privatisations, governments have maintained a high degree of involvement and control by retaining a substantial minority stake with special rights in the concession (as in the case of Brazil) or a majority stake (as with the privatisation of Aena in Spain).

In the example of Jordan, the government invited six international consortiums to bid for the construction of a new hall and the upgrade and expansion of Amman-Queen Alia International Airport, via a build-operate-transfer contract (BOT). In these types of concessions, the private sector builds the enterprise, exploits and operates it for a specific period of time, and then transfers it back.

The International Airport Group (IAG), an Aéroports de Paris-led consortium, won the BOT contract in 2007. The government and IAG signed a 25-year agreement, which stated that the government would receive 54.5% of revenues during the concession period.

A key enabler for the success of this privatisation process was the setup of aviation policy and regulation. This began in 1994, with the recommendation of the Civil Aviation Authority⁵ to run the airport on purely commercial lines. A revised civil aviation law was issued in 2006, enacting the separation of airport management and operations from regulatory activities, which prepared the ground for privatisation.

5. Civil Aviation Regulatory Commission (CARC) since 2007

3. Partial privatisation

Aena (Spain)

In 2014, the Government of Spain moved ahead with the privatisation of 49% of Aena, the Spanish airport operator that manages 46 airports in Spain, serving more than 207 million passengers⁶.

The privatisation model designed by the government was divided into two stages, with the objective to maximise value creation and allow citizens to participate, by investing in their society.

In September 2014, the government began with a conditional sale of up to 21% of Aena's equity, offered to stable core shareholders through a public tender process⁷. Next, an initial public offering on the Madrid Stock Exchange, in February 2015, transferred a further 28% of Aena's shares for a total of 49%. The strong demand generated by this privatisation enabled the government to set the IPO price at the maximum of the range suggested by banks.

This generated an enterprise value of €8.7 billion, far beyond initial expectations⁸. Among the factors that led to this healthy valuation, two key reasons should be highlighted:

- The strong results achieved by Aena through a transformation programme it completed, prior to privatisation
- The economic regulatory framework that enabled the owners to capture the upsides of non-aeronautical businesses⁹

Based on the strong valuation of Aena's shares, investors now recognise the potential for continued value creation, which will benefit both the government and private investors.

6. Aena also participates in the management of 15 airports in Mexico, Colombia and the UK

7. The tender terms included the important condition that if the government realised a higher price in the subsequent IPO than the price previously offered by the core shareholders, their offers would not be considered

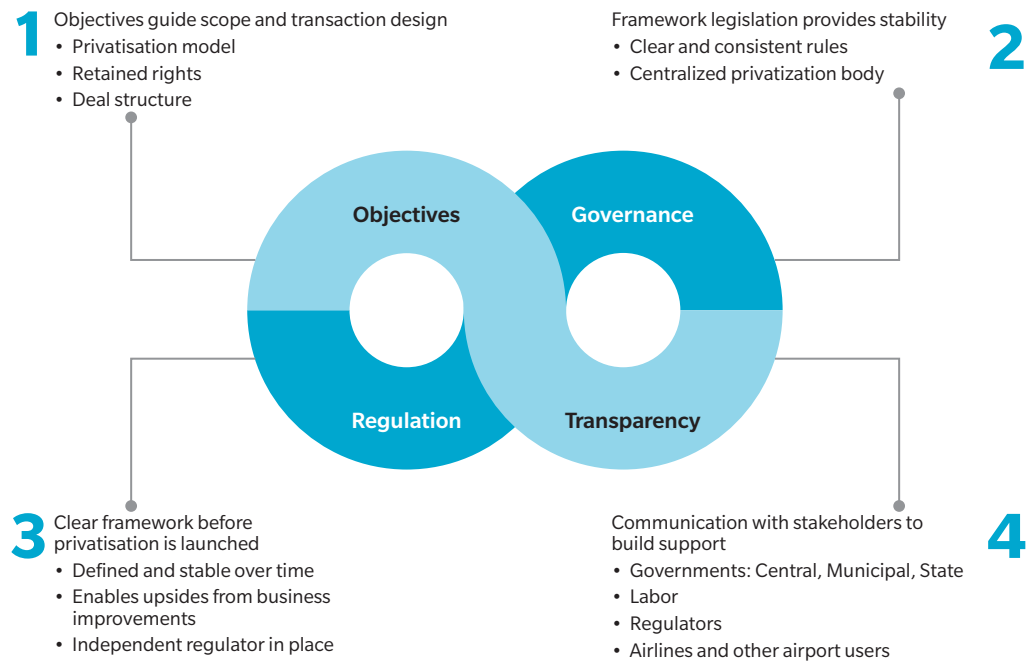
8. Under the terms of the earlier conditional sale, the core shareholder group received no shares, because the price offered by the group was lower than the IPO price. This led to the entire 49% of Aena's shares being sold in the IPO

9. Aena is currently going through a gradual evolution to a dual-till model by 2018, along with a freeze on airport charges until 2025, to facilitate traffic growth

KEY SUCCESS FACTORS FOR AIRPORT PRIVATISATION

There are many ways to structure airport privatisations depending on the government's objectives and its assessment of how best to achieve them. In analysing past privatisations, we have identified four key success factors for both investors and governments, as illustrated in the exhibit below.

Exhibit 3: Four dimensions of effective privatisation



Well-designed privatisation transactions that take advantage of these key success factors reduce uncertainty for both investors and governments. In turn, the lower risk attracts more-patient investors with lower return expectations.

1. Objectives

Clear objectives guide scope and transaction design

A well-designed privatisation transaction will meet the criteria of airport investors, while also accomplishing the government's objectives. This can be realised using a wide range of models.

Governments need to understand the pros and cons of different deal structures and define clear objectives before starting the privatisation process. For example:

- Full privatisation through a direct sale to an airport operator transfers all decision-making authority to the new owner. If that shift of control is not acceptable to a government, it should decide that before finalising the privatisation structure.
- Although not optimal in terms of facilitating rapid business improvement, the government's retention of a substantial stake in the privatised entity enables it to continue to influence airport strategy.

Furthermore, past transactions show that the perception of the success of a privatisation process will be directly linked to a proper communication of the objectives and benefits of the chosen model. The government needs to develop a clear, unified communication strategy and focus on the long-term benefits of the transaction. It should engage all stakeholder groups, increase transparency and align actors with seemingly conflicting agendas.

2. Governance

Framework legislation and a central privatisation body ensure continuity and consistency

To ensure the effective governance of privatisation, the government needs to put in place laws to guide the process and create a central body to steer it:

- Putting in place framework legislation provides three primary benefits
 - Increases transparency of the process, with clear rules for all participants
 - Provides consistency in the process, which is important to attract investors
 - Ensures that the money from the sale of the assets is only used to meet the goals of the programme
- Creating a central body to drive the process will ensure:
 - Co-ordination of strategy
 - Precise, strong guidance and appropriate transfer of knowledge to all entities involved in the process




The benefits of these measures will be especially important for countries without any history of privatisation, since their introduction will create synergies, generate confidence in investors and become the institutional memory for how to enact privatisation successfully.

3. Regulation

Regulatory framework needs to be clear before privatisation is started

There is no perfect economic regulatory framework from the perspective of either governments or investors. However, the development of a clear and coherent framework is critical. The best regulatory frameworks keep competitive aeronautical charges to encourage air-service development and protect airlines, while offering airport investors the ability to benefit from commercial performance improvements (generally meaning dual-till approaches). A balanced airport economic regulatory framework should also provide clear rules for operators regarding asset disposal, required investment, and other issues.

Exhibit 4: Key features of regulatory framework design

1	 Keep competitive aeronautical charges	<ul style="list-style-type: none">• Keep competitive aeronautical charges to encourage air service development and airlines' growth
2	 Liberalise non-aeronautical charges	<ul style="list-style-type: none">• Offer airport investors the ability to benefit from commercial performance improvements (i.e. dual-till approaches)
3	 Set clear rules	<ul style="list-style-type: none">• Provide clear rules regarding asset disposal, required investments, and other issues

In the case of the privatisation of Aena, the regulatory framework provided for the transition to a dual-till system over a four-year period, to allow the privatised entity to capture the upsides of non-aeronautical business, while at the same time freezing aeronautical tariffs for 11 years to facilitate air-traffic growth.

Without some form of price protection for airlines, or at least strong input from them into the tariff-setting process, their role as stakeholders may become increasingly contentious over time. For example, some airlines are dissatisfied with the type of light-touch regulation that prevails in Australia, because they feel the airport-tariff threshold for government intervention has been set too high.

Government roles and responsibilities need to be clearly defined. In many cases, the role of the regulator will need to be expanded, to enable effective monitoring and enforcement of the new regulatory requirements. This is not an easy task, as budget limitations may hinder the regulator's ability to develop the required capabilities.

Also, in some cases, oversight roles are split among different government entities, further complicating co-ordination. For example, transport ministries may have responsibility for service quality and infrastructure investment requirements, while other ministries may have responsibility for aeronautical tariff review and approval.

Another important issue arises where a government serves as both the economic/safety regulator and the airport operator. Having the government retain a substantial stake in the privatised entity may provide some comfort to investors that the government's economic regulations will be reasonable, but the far better approach is to separate the government's regulatory responsibilities from any role in airport operations.

4. Transparency

Communication with key stakeholders builds support for the transaction

Transparency should be on a government's agenda from the beginning of the privatisation process. One possible solution is to have the programme regularly monitored and audited by a well-financed, independent agency reporting to the parliament or to a similar ultimate authority.

The privatisation model selected will largely determine the potential participants in the process. During the early stages of the process, therefore, it is important to identify the parties to be targeted as potential participants.

Exhibit 5: Transparency with key stakeholders

PROSPECTIVE STAKEHOLDERS



ROLE OF ENTITY IN CHARGE OF PRIVATISATION

- The entity in charge of the privatisation should involve key stakeholders to gain their support
- The underlying rationale for the privatisation should be presented carefully, highlighting:
 - Key characteristics of the privatisation process/model
 - Value creation story
 - Levers for value growth, the characteristics of the economic regulation model, economic impact of the airport in the region/country, etc.

The entity in charge of privatisation should involve key stakeholders to gain their support for the privatisation (or at least to determine how to deal with their opposition). These stakeholders include, but are not limited to, unions, airlines and other tenants, regional and local governments, tourism authorities, and business groups.

From the beginning, the underlying rationale for the privatisation should be presented carefully, highlighting the key characteristics of the privatisation process and model; the value creation story and the levers for value growth; the characteristics of the economic regulation model; and other issues.

The exhibit below lists several privatisations along with some lessons learned from each.

Exhibit 6: Lessons learned from recent transactions

AIRPORT	YEAR	PRIVATISATION TYPE	LESSONS LEARNED
Aena	2015	Partial privatisation (49%)	<ul style="list-style-type: none"> • Partial privatisation through an IPO allows government and management team to retain control and preserve the airport network model and strategy • Transformation of Spanish airports operator to increase equity value was done prior to the privatisation • Balanced regulatory framework, providing clear incentives to airport operator (dual-till) while at the same time freezing airport charges to facilitate airlines' growth • Potential upsides left for the benefit of private investors (and government) • Requires a redefinition of roles of supervisor and regulator and the reinforcement of their capabilities
ANA	2013	Concession and full privatisation	<ul style="list-style-type: none"> • Transformation of Portuguese airports operator to increase equity value was enacted prior to privatisation • Clear regulatory framework allows for significant increase in airport charges if traffic grows • Potential upsides left for private investors • Need to reinforce the role of the regulator
Five Brazil airports	2012/2013	51% concession	<ul style="list-style-type: none"> • Series of individual airport privatisations allowed the government to improve the transaction requirements • Government retention of 49% stake ensured important decision-making role • Concession terms set at different lengths for different airports depending on investment required
San Juan	2014	Full concession	<ul style="list-style-type: none"> • Provided for retirement of \$500 million in debt; airport investment; percentage revenue payment to government (increasing over time); and airline fee discipline • Total annual aggregate airline fees capped at fixed price for first five years, then allowed to increase at CPI

Source: Oliver Wyman analysis

ASSESSING THE FEASIBILITY OF AIRPORT PRIVATISATION

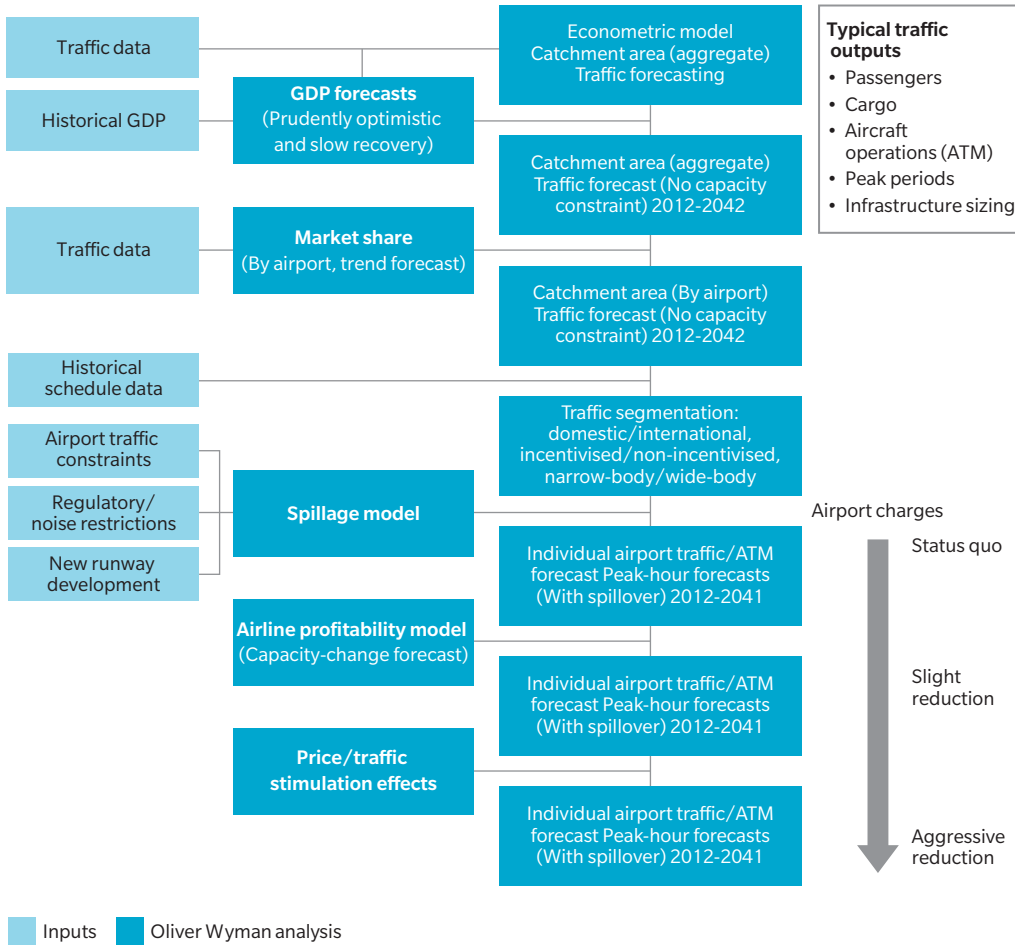
Governments should carefully consider their privatisation objectives. By emphasising specific objectives such as value maximisation, preservation of decision-making and creation of a strong private operator, governments are implicitly affecting the overall valuation. By clearly recognising the potential upsides and risks of the privatised airport, and how those upsides and risks are allocated, both parties can better accomplish their transaction goals. A thorough feasibility study is an essential first step.

To obtain the maximum value in an airport privatisation the seller must make sure that the levers for value creation are clearly understood. Although different bidders may assess the potential for value creation differently, there should be general agreement on the primary sources of value in any airport privatisation, specifically including:

- Reasonable returns on aeronautical investments
- Non-aeronautical revenue opportunities
- Operating efficiencies
- CAPEX requirements and returns

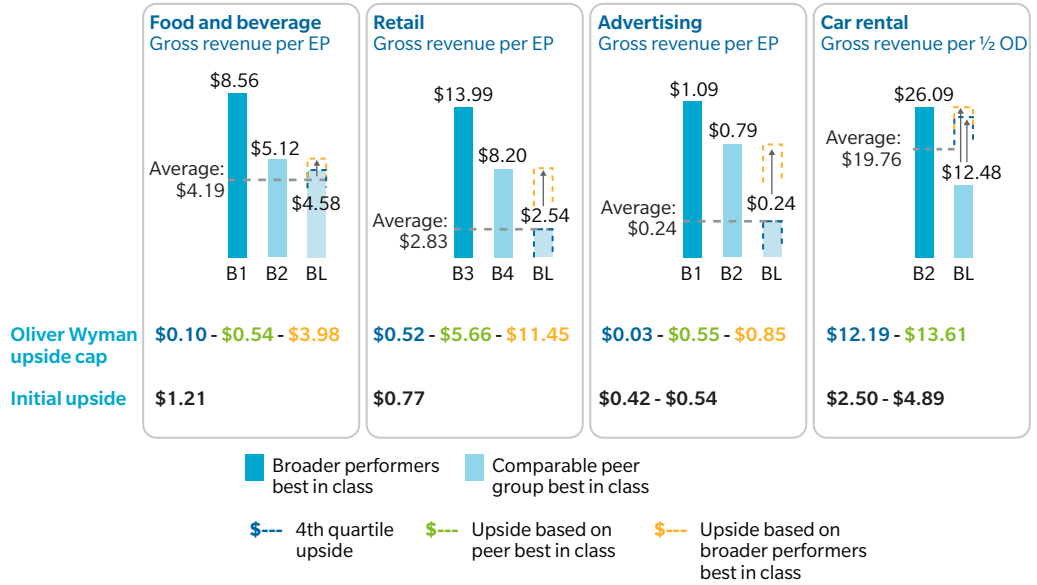
Expectations regarding volume growth as a driver will be very different in mature versus developing markets. Future projections should be based on solid traffic forecasts, recognising the cyclical nature of air-travel demand and the competitive dynamics of the airline industry. The exhibit below provides an example of the methodology used to forecast traffic in a large multi-airport metropolitan area.

Exhibit 7: Example of traffic-forecast methodology



In particular, the upside potential on non-aeronautical revenues is significant, as these are often neglected by public sector-operated airports. The exhibit below illustrates the differences in non-aeronautical revenues across some airports as highlighted in a recent Oliver Wyman study.

Exhibit 8: Upsides in non-aeronautical business

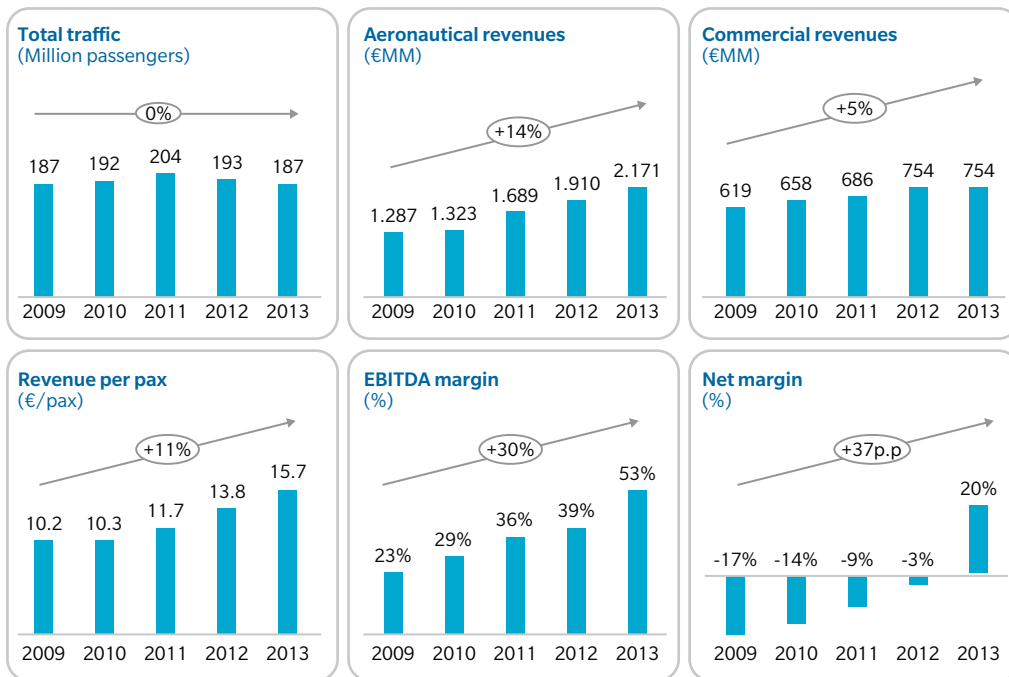


Past performance should demonstrate the potential for the privatised airport to grow revenues through the development of air services and increasing commercial activities, while at the same time optimising operational costs and CAPEX. Without a prior history of performance improvement, the source of airport value shifts increasingly to the abilities of new management to make a difference.

The exhibit below shows the results obtained by Aena in Spain during the years prior to the privatisation process.

Exhibit 9: Aena performance improvements before privatisation

KEY ECONOMIC AND FINANCIAL INDICATORS 2009-2013



In determining the potential value of the airport, a comprehensive risk assessment should be conducted. Typical strategic risks to be evaluated are listed in the exhibit below.

Exhibit 10: Comprehensive risk assessment

1	Airports competition	Competition between the privatised airport and other hubs or regional airports may result in substantial reallocation of air service among the airports
2	Airline-specific risk	Airline-specific risk, such as the failure of a network carrier, or a decision to abandon its hub, may impact the connectivity and overall demand of a hub airport
3	Low-cost carriers' decisions	The decisions of major low-cost carriers operating at regional/secondary airports regarding their current bases, may impact the overall demand of these airports
4	Inability to realise planned capacity	Inability to realise planned usable capacity increases, due to environmental, air-traffic system, security, or other constraints
5	Drop in passenger demand	Risk of general drop in passenger demand, due to cost increases (fuel) or other events (terrorism, pandemic, safety-related)
6	Changes to economic regulatory model	Changes to the economic regulatory model that may limit the return to investors, or may provide insufficient certainty about future revenues, or may not lead to the most efficient and sustainable allocation of key risks
7	Lack of regulatory enforcement	Lack of experience, capabilities and independence of the regulator to monitor economic regulation of airport charges could generate pressure from airlines, politicians or other stakeholders

DEFINING AN OPTIMAL TRANSACTION PROCESS

Following a careful feasibility assessment, defining an optimal transaction process requires time, and alignment between stakeholders. It ought to be designed in a way that incorporates all the objectives previously defined, ensuring that the initial strategy is respected.

Factors that should be considered in scoping and designing an airport privatisation transaction include value creation, control and the selection of strategic investors in the airport.

Exhibit 11: Objectives and transaction design





Value creation	<ul style="list-style-type: none">• The EBITDA multipliers that drive valuation will most likely be higher in the case of full privatisation
Control	<ul style="list-style-type: none">• In the case of partial privatisation, the government will be able to retain important rights, which could increase the likelihood that key stakeholders will support the privatisation• At the same time, it is also important that the government's retained rights not be so extensive as to substantially diminish the attractiveness of the privatisation for investors
Investor selection	<ul style="list-style-type: none">• A direct sale may be the most attractive model for airport operators while an IPO may be more attractive for financial investors• Creating a core shareholder group or a strategic partner may be an effective model that attracts private operators and subsequently facilitates the success of an IPO

Some other aspects of transaction design that have led to successful privatisations relate to the timing and bundling of airport privatisations. For example:

- Privatisation in waves of airports allows the government to establish a track record and build investor confidence, and enables both the government and investors to capitalise on the lessons learned in the previous waves
- Bundling a number of airports as part of a single concession creates scale and reduces risk

Additionally, throughout the process, continuous process-management is required to guarantee that the strategy is followed. There are many aspects of strong transaction process-management, including the most obvious ones, such as having clear rules regarding the transaction along with establishing markers to ensure the government is following the rules it has set.

Exhibit 12: Best practice in transaction process management

1		Establishing markers to ensure the set rules are followed by the different stakeholders
2		Defining well-structured strategic partner requirements to satisfy high competence level
3		Ensuring expertise of participants (e.g. requiring international airport management experience and local business experience) to ensure professional management of airport and significant local stakeholder involvement
4		Requiring publication and adherence to a strict transaction timetable to limit delays and overall uncertainty

Two important lessons learned from the management of past transactions are:

- Well-structured strategic partner requirements are likely to increase the competence and expertise of the participants – for example, requiring both international airport management experience and local business experience helps to ensure that the airports will be managed professionally and with significant local stakeholder involvement
- Although it may seem obvious, publication and adherence to a strict transaction timetable produces better results for both governments and investors. Too many privatisations suffer long delays and periods of uncertainty, almost as a matter of course

WHY NOW?

Given the aviation industry’s strategic importance for modern economies and the need to improve and expand infrastructure to respond to the expected increase in air traffic, airport privatisation presents itself as a viable solution.

Experience shows how privatisation can bring benefits not only to local economies and governments (in terms of budget control or knowledge transfer), but how it also positively affects individuals, as it is usually linked to improvements in efficiency and customer satisfaction. However, privatisation takes time, and many arduous steps are required to achieve a robust outcome. The exhibit below shows two examples of past failed transactions that illustrate the importance of following the best practices highlighted in this report.

Exhibit 13: Past failed transactions

AIRPORT	MODEL	REASONS FOR FAILURE	LESSONS LEARNED
Chicago Midway International Airport (MDW)	<ul style="list-style-type: none"> First attempt: lease agreement to private operators for 99 years Second attempt: lease agreement to private operators for less than 40 years 	<ul style="list-style-type: none"> First attempt (2009) <ul style="list-style-type: none"> The winning consortium was not able to secure the required financing Second attempt (2013) <ul style="list-style-type: none"> One of the two final bidders dropped out, pushing the City to decide to suspend the lease of MDW 	<ul style="list-style-type: none"> Need to have realistic, attractive and feasible terms for maximizing the number of bidders and solid offers Need to choose the appropriate timing for privatisation (e.g. avoid periods of crisis on financial markets) Need to have rigorous selection criteria and process Need to have contingency plans
Madrid (MAD) and Barcelona (BAR) Airports	<ul style="list-style-type: none"> Concession of Madrid and Barcelona airports to private operators for 20+5 years Included the creation of Aena Airports S.A. (airport operator) and Aena E.P.E. (air navigation services provider) 	<ul style="list-style-type: none"> First attempt (2011) <ul style="list-style-type: none"> Lack of a shared vision and alignment on the concession model from the different stakeholders Opposition created from the different stakeholders The new appointed government in 2011 decided to cancel the concession and to initiate a transformation program to improve the profitability and competitiveness of Aena before starting its privatisation 	<ul style="list-style-type: none"> Need to have a clear privatisation model Need to gain the alignment of relevant stakeholders Need to define a model that maximizes airport valuation

Source: Oliver Wyman analysis

If governments consider airport privatisations as the answer to funding the improvement and expansion of airports, they need to start acting now. An eventual rush in the future to speed up the process could compromise the success of transactions.

If traffic levels continue to rise as projected, acting too late could mean falling behind other countries. This would create a gap that is difficult to close. Our recommendation is to start now to assess the needs of a privatisation process, and to prepare for the challenges in the years to come.

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