Sydney Airport: through turbulence and terror

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It was a time of turbulence in the aviation industry, the 9/11 terror attacks had left the market stagnant and airlines were in trouble. The international insurance market, in respect of the coverage of airports, went through a virtual breakdown. Even as the international market slowly lifted the Australian market still looked grim with the collapse of Ansett Airlines, one of two major airlines operating in Australia.

Then came the big news, the long-awaited sale of Sydney's Kingsford Smith Airport (Sydney Airport). The winning bidder, Southern Cross Airports Corp (Southern Cross), paid A$5.58 billion (US$3.68 billion) for the 99-year lease to operate Sydney's international airport. The price paid for the airport raised eyebrows, being at the high end of the expected price for such a privatisation.

Background

Sydney Airport is Australia's busiest passenger and cargo airport and major international gateway airport. In December 2000, following the successful privatisation of the majority of major city airports in Australia in 1997 and 1998, the Government announced its intention to privatise the Sydney basin airports, with Sydney Airport to be sold separately followed by the remaining three airports (Bankstown, Camden and Hoxton Park). After conducting a scoping study, on 29 March 2001 the Government and its advisers, Salomon Smith Barney, announced it had decided to sell Sydney Airport by a 100 per cent trade sale, and established the following sale objectives:

- Optimise sale proceeds within the context of the broader Government sales and policy objectives; - minimise the Commonwealth's exposure to residual risks and liabilities; - ensure that the airport lessee has the necessary financial and managerial capabilities to operate and provide timely investment in environmentally appropriate aviation infrastructure at Sydney (Kingsford Smith) Airport; - ensure the sale outcome is consistent with relevant airport legislative, regulatory and policy requirements, including environmental, foreign investment, competition, access and pricing policies; - ensure fair and equitable treatment of employees of Sydney Airports Corporation including the preservation of accrued entitlements; and - ensure the airport lessee demonstrates a commitment to the effective development of airport services, consistent with Australia's international obligations.

The proceeds from the sale of Sydney Airport were to be applied both to finance maturing debt and invested in deposits with the Reserve Bank of Australia. This approach is estimated to have resulted in a return of 5.17 per cent in 2002–03, or some A$219 million. Interest savings in future years will reflect the course of market interest rates going forward, amongst other considerations.

Tender Process

At each stage of the tender process, participating bidders were advised in advance of the evaluation criteria that would be applied. The Expressions of Interest stage was necessarily a less demanding stage because no price indications were given so that more general financial strength, airport management experience and regulatory compliance aspects were the focus. In the Request for Indicative Bids, six evaluation criteria were specified, consistent with the sale objectives.

The Request for Binding Bids specified eight criteria, drafted to more closely mirror the sale objectives than those applied to the Indicative Bids. As the evaluation criteria other than sale proceeds were qualitative in nature, the Binding Bid Evaluation Committee considered it was not appropriate to apply a pre-specified and mechanistic weighting system in the ranking of bids. Instead, the Request for Binding Bids included a statement weighting the criteria as follows: 'The Commonwealth aims to maximise net sale proceeds on a risk adjusted basis while achieving optimal outcomes in relation to the other criteria'.

The assessment of Binding Bids required the effective coordination of input from a multi-disciplinary evaluation team within a tight time scale. To assist with evaluation, following recommencement of the tender process, the procedure and method of evaluating Binding Bids was set out in an evaluation plan that was approved in advance of the receipt of Binding Bids. Evaluation against the Binding Bid evaluation criteria was carried out based on a series of schedules. This approach enabled an assessment to be made and clearly documented of whether each bidder had fully responded to and addressed the specifications in the Request for Binding Bids. A systematic application of the criteria to each consortium and full documentation of that process, and an assessment of the level of coverage, both qualitatively and quantitatively.

Three bids were received on 12 June 2002;- Connect – ABN Amro, National Australia Bank, Vancouver Airport and Babcock & Brown- Gateway – Westpac, AMP, Deutsche Bank and BAA- Southern Cross Airport Corp – Macquarie Bank, HOCTIEF AirPort, a specialist airport owner and manager subsidiary of German construction group HOCHTIEF, and the Commonwealth Bank of Australia.

The three bids were evaluated against the specified criteria. The successful bid offered a significantly higher purchase price for the shares than the next highest bid and was assessed as equal to, or higher than, both other bids on all remaining criteria. On this basis, the Evaluation Committee unanimously concluded that the bid lodged by the Southern Cross Airports Corporation best met the aim of maximising net sale proceeds on a risk-adjusted basis, while achieving optimal outcomes in relation to the other criteria. The sale agreement was signed and the selection decision announced on 25 June 2002, with financial completion occurring on 28 June 2002.

Acquisition Chronology

- 29 March 2001 Commonwealth Government announces its decision to sell Sydney Airport by way of a 100 per cent trade sale.
- 14 May 2001 Southern Cross lodges expression of interest.
- 1 June 2001 Southern Cross admitted to proceed to phase 2 of the sale process.
- 17 July 2001 Southern Cross lodges indicative bid.
- 2 August 2001 Commonwealth Government announces that indicative bids had been received and evaluated. Final and binding bids were to be received on 17 September 2001. This was deferred until 26 September 2001 following the terrorist attacks on the World Trade Center in the US.
- 24 September 2001 Commonwealth Government announces that the sale of Sydney Airport be deferred until early 2002.
- 11 March 2002 Commonwealth Government announces the recommencement of the sale process.
- 19 April 2002 Sale process recommences.
- 25 June 2002 Commonwealth Government announces the sale of Sydney Airport to Southern Cross.
- 28 June 2002 Southern Cross achieves financial close and all required funds transferred to the Commonwealth Government.

The Australian National Audit Office reviewed the deal and found the sale proceeds represent a very good financial outcome for the Commonwealth. The purchase price paid by the successful bidder was more than A$600 million higher than the next highest bid, with the highest bid also assessed as equal to, or higher than, both other bids on all remaining evaluation criteria. The ANAO also viewed that the financial return from the sale compared very favourably to Scoping Study and Budget estimates of likely sale proceeds, to current market valuations of previous privatisations of other international airports world-wide, and to the returns achieved from the Phase 1 and Phase 2 sales.

Risk mitigation

The tender approach addressed the Commonwealth's post-sale risk exposure by issuing draft sale documentation to shortlisted bidders on a broadly non-negotiable basis; tenders were required to be clear and certain; and any proposed increased risk allocation, cost or liability was assessed as part of the tender evaluation process. In this latter respect, the successful tender was rated equal to, or higher than, the other two tenders in relation to the risk-related criteria.

The major sale documentation comprised a Share Sale Agreement and a Tripartite Deed. Competitive tension through the tender process enabled various changes requested by bidders to the sale documentation to be resisted. In addition, the final signed Sale Agreement contains a number of measures designed to minimise the Commonwealth's post-sale risks and liabilities. The potential liability of the Commonwealth under the Tripartite Deed is significant. It extends to a risk that, in the event the lease is terminated by the Commonwealth and not re-sold, the Commonwealth is required to obtain a valuation of the airport site that would set the basis for a repayment of financier's loans by the Commonwealth, subject to higher ranking claims being met first.

Regulation and Policy

Historically, the provision of air services has been heavily regulated. Regulators could control routes operated, frequency, capacity, the number of airlines and the fares charged. In certain markets these controls have been reduced or removed to the extent that the only constraints are those controlling safety and security. The US effectively pioneered domestic deregulation from 1978. Other markets have followed, most notably the European Union from 1997. A number of US-to-Europe markets have also been deregulated with bi-lateral agreements, which control the entry of new carriers, frequencies and services, replaced with more liberal "open-skies" policies. The effects of deregulation are still developing in Europe and are expected to have a positive impact on traffic growth for some years.

Consistency with relevant airport legislative, regulatory and policy requirements was explicitly assessed as part of the tender process. Each bid was assessed to meet the evaluation criteria relating to this sale objective, with the successful bidder considered by the Evaluation Committee to display a sound understanding of, and consistency with, all relevant legislative, regulatory and policy requirements surrounding Sydney Airport.

The sale objective of ensuring fair and equitable treatment of employees of SACL was addressed through the introduction of executive remuneration arrangements intended to retain top management throughout the sale process. Bids were evaluated in terms of this objective, and redundancy protections for staff were included in the Sale Agreement. This was set at a term of 12 months that has recently passed sparking the news that Sydney airport is to make about 40 per cent of its full-time staff redundant in a restructuring aimed at increasing its competitiveness. About 160 jobs would be lost at the airport through a combination of forced and voluntary redundancies that will cost about A$6.5million (US$4.3million). The organisational revamp will be across the board, with redundancies in management, maintenance, and baggage handling. Non-core functions will be contracted out, greater operational efficiency will be required of retained core functions, and intellectual capital will be fostered in key business development functions. The long-awaited restructuring was spurred on by the difficult aviation market, which had come under increased pressure from the outbreak of Sars in the airport's key growth markets.

One of the Binding Bid evaluation criteria addressed the Government's sale objective of ensuring the airport lessee demonstrates a commitment to the effective development of airport services, consistent with Australia's international obligations. Southern Cross was assessed to fully meet this criterion, including a proposed capital expenditure programme of A$2.1 billion over 20 years. The complex and shifting regulatory environment for Sydney Airport and large Australian airports in general created very substantial changes in the regulatory regime that continued to occur during the bidding process.

Difficulties were also imposed by the need to ensure that at all times Sydney Airport would be majority-owned by

Australians. The consequent requirement was that in the context of a competitive bidding process in which two other consortia were endeavouring to raise equivalent amounts of Australian equity. In a limited market for infrastructure assets, firm commitments had to be obtained from a large number of institutional investors and underwriters

Commercial Structure

Airports generate revenue from two main sources, aeronautical revenue, 45 per cent, and commercial revenue, 55 per cent (see Figure 1 below). Aeronautical revenues are derived from charges applying to a range of aviation activities. The main charges are an international Passenger Services Charge, a runway charge and an aircraft parking charge. Pro forma aeronautical revenues (including aeronautical security recovery revenue) increased by 57.4 per cent from A$130.8 million in the 2001 financial year to A$206 million in the 2002 financial year. This increase resulted largely from changes to aeropricing introduced in May 2001 and enhanced security requirements.

Non-aeronautical revenue comprises retail revenue, property revenue and commercial trading revenue. Retail revenue was marginally lower by 1.5 percent. However, this represents an increase in revenue per passenger from A$4.44 to A$4.84 due to higher spend rates. Sydney Airports Corporation manages a total lettable area of 963,000m2. In the 2002 financial year, total property revenues were A$71.5 million, representing a 5.4 per cent increase over the previous year. The main commercial trading activities of Sydney Airport include car parking, car rental, external advertising and licenses and management of commercial ground transportation. Commercial trading revenue, including car parking and car rental revenue, was stable at A$58.6 million in the 2002 financial year, as compared to the previous year.In 2000 Sydney Airport had handled over 25 million passengers, of which nearly nine million passengers were international and the remaining 16 million were domestic. Over the last 15 years international and domestic traffic has grown by an average of 7.5 and 6.4 per cent per annum respectively. Recent reports from BAA suggest that air passenger numbers are expected to continue to rise steadily. Sydney airport, being the gateway airport has the largest share of both the international and domestic passengers (see figure 2 below).

The key drivers of air traffic growth are:

- GDP growth: GDP growth tends to stimulate leisure traffic growth as the disposable income of individuals increases. In addition, business traffic tends to increase as economic activity stimulates trade and the resulting need to travel for business purposes. The relationship between historical growth in revenue passenger kilometres and GDP varies between regions, but has historically averaged more than twice GDP growth and has also been relatively resilient to economic downturns.

- Air fares: Air traffic has tended to increase as air fares have become more affordable. Growth in leisure traffic tends to be more sensitive to changes in air fares than growth in business traffic. In the US, for example, real air fares (per seat kilometre) have declined by an average of 2.2 per cent per annum between 1970 and 1999. The fall in real airfares worldwide is mainly due to reductions in airline costs caused by technological improvements and increased levels of operational efficiency. Industry sources expect that both air fares and airline costs worldwide will continue to decline in real terms, albeit more slowly than in the past. The decrease in airline costs is expected to be partially offset by an increase in security costs following the events of 11 September 2001.

- Airline deregulation: Deregulation tends to stimulate traffic growth in three ways. Firstly conventional carriers can increase frequencies and introduce new routes, thereby increasing service levels and the level of competition. Secondly, low cost scheduled carriers, such as Virgin Blue in Australia, Southwest in the US and EasyJet in the UK, can enter the market, further increasing competition and services provided. Lastly, airlines can introduce differential fares to maximise revenues and load factors.

Financing

The Sydney Airport deal was the largest trade sale of an airport in the world and involved A$6.565 billion that was raised on behalf of Southern Cross to acquire all share SACL. The equity investors were Macquarie, HOCHTIEF AirPort, Ferrovial

Aeropuertos, Abbey National Treasury Services, Ontario Teachers' Pension Plan Board, and the Motor Traders Association of Australia Superannuation Fund. In its role as equity arranger to Southern Cross, Macquarie utilised its global network to arrange $1,715 million equity for the bid that included the equity contributed from all of the equity investors apart from Hochtief AirPort.

To finance the SACL acquisition, the successful bidder adopted a relatively aggressive financial structure, with one ratings agency noting that this meant there is little room for under-performance in any key operating metric and that any deviation in underlying cash flow expectations or financial accommodation could adversely affect its rating of the entity. Financial strength and managerial capabilities of bidders were explicitly addressed in the tender process, with the successful bidder assessed by the Evaluation Committee to have a very strong financial and management expertise. The tender process also addressed the strength and structure of the financing arrangements backing the bid with the Evaluation Committee concluding that the successful bidder's capital structure and financial coverage ratios (including gearing levels) were reasonable for an infrastructure asset financing.

FLIERS

The large amount of capital included A$2.02 billion in equity and a further A$600 million in Australian Stock Exchange-listed hybrid security known as FLIERS (Floating IPO Exchangeable Reset Securities). Institutional and retail investors were invited to invest in the FLIERS through an issue of units by the Southern Cross FLIERS Trust in a prospectus lodged shortly after the acquisition of SACL was completed. The public offering closed in early August and was significantly over subscribed. The units were listed on the Australian Stock Exchange on 13 August. The FLIERS were jointly underwritten by Macquarie Equity Capital Markets and UBS Warburg, and were rated BBB- and Baa3 by S&P and Moody's respectively. This represents a one notch rating differential from the senior debt. Colin Atkinson, the Analyst working on the project for Standard and Poors, remarked that the rating given to the fliers was a distinctive feature of the deal. The issue of FLIERS represented the first structure of its type and one of the largest hybrid deals ever in the Australian market. The innovative nature of their structure (based on the terms of the relevant Australian federal legislation) enabled the FLIERS to be counted as Australian equity in the acquisition of SACL and assisted Southern Cross in comfortably satisfying the government's requirement of 51 per cent of the equity being Australian. This requirement that the airport remain majority Australian owned was a key issue faced by bidders given the size of the asset in the context of the Australian unlisted equity investor market.

Debt

At the time the senior secured debt arranged by Macquarie of A$3.95billion represented the largest senior debt package ever arranged for an Australian borrower. The facilities include A$3.75billion used to fund the acquisition of SACL by Southern Cross and a further A$200million facility to fund ongoing capital expenditure. These facilities were jointly underwritten by Barclays, Commonwealth Bank of Australia, RBS Australia and SG Australia.

The syndication of A$2.45billion of the senior secured facilities was very well received by the market and successfully closed in July 2002, over subscribed, without requiring a general syndication phase. This was the largest ever debt syndication in the Australian market. The syndicated debt facilities was rated BBB by S&P and Baa2 by Moodys.

In October 2002 Southern Cross refinanced A$1.5billion of the remaining senior secured debt facilities through a credit-wrapped capital markets issue which represented the largest bond issue in Australia to date in the 2002/03 financial year. Southern Cross issued AAA/Aaa rated credit wrapped securities in tenors of 5 and 10 years with these maturities offering both fixed and floating rate tranches. The capital market issue was credit-wrapped by MBIA Insurance Corp.

Series	Volume	Margin
5 years fixed	A$600 million	57 bps
5 years floating	A$620 million	57 bps
10 years fixed	A$40 million	65 bps

10 year floating	A$240 million	65 bps

The Senior Debt Documentation allowed Senior Lenders to adjust the pricing of Senior Debt, after consultation with Southern Cross, in order to ensure the Senior Lenders reach their required hold levels in the syndicated debt markets. The Senior Lenders were entitled to adjust the pricing of Senior Debt by:

- an increase in arranging and underwriting fees by adding up to 1.2 per cent
- an increase in margins by adding up to 0.3 per cent per annum
- or a combination of increases in fees and margins, which together do not exceed 1.2 per cent flat calculatedon the amount of the Senior Facilities – assuming an average life of four years.

The right of Senior Lenders to adjust the pricing of Senior Debt expired, on the earlier of, the six months after 28 June 2002 and the date on which Senior Lenders reach their required hold levels in the syndicated debt markets. Senior Debt includes a A$1.5 billion 364 day bridge facility refinanced in October 2002 through a credit wrapped capital markets issue. Pursuant to the Senior Debt Documentation, there is a risk that should the bridge finance not be refinanced in an acceptable manner within this period that Southern Cross Holdings will not have funds available to pay FLIERS dividends. Southern Cross has sought to minimise this risk by progressing the capital markets takeout by obtaining investment grade credit ratings from Standard & Poor’s and Moody’s and commencing discussions with three monoline insurers. The remaining senior debt facilities have bullet maturities with terms of three and five years respectively.

Future

In April this year Sydney Airport announced an consolidated profit of A$285.5 million for the first nine months of financial year to April 2003. This EBITDA result compares with the corresponding SACL first nine months of financial year 2002 result of $A244.1 million. EBITDA, excluding specific non-recurring expenses, increased by 13 per cent to $A286.7 million compared to the corresponding period in financial year 2002.

International traffic had been on a downwards tend since January and year-on-year growth was negative in March 2003, before the full impact of SARS on key Asian source markets. Domestic traffic has been subdued but it is likely that there will be some increased growth over the next quarter. The combined effects of the Iraq war and SARS would mean that trading conditions for the airport in the final quarter would be difficult. Sydney Airport has had a series of cost containment measures in place since January which have resulted in a substantial reduction in trend operating cost as well as the recent employee restructuring.

Sydney Airport was a very significant closure in the Australian market. The innovative aspect of the financing through the use of FLIERS also made it an outstanding deal. The transaction was structured during a time of turbulence, and consequently seems to be built to withstand the recent and future instability. What at first seemed a surprisingly large price was in fact not an amount out of touch with the market, but a reflection of the stable growth apparent in the future of the aviation market. IJ