

Research Update:

Royal Schiphol 'A/A-1' Ratings Affirmed On Resilient Ratios Despite Slower Recovery; Outlook Negative

January 28, 2022

Rating Action Overview

- The recent omicron variant highlights the volatility in recovery for European airports. The potential for travel disruptions and/or renewed border restrictions will drag on the recovery path for European airports, given that the emergence of new, more dangerous variants cannot be excluded.
- As such, we expect a slower passenger number recovery for Schiphol airport, with traffic now likely to be 60%-65% of 2019 levels for 2022, rising to 80% in 2023, with a full recovery unlikely to occur before 2025.
- We expect that the effects of a slower traffic recovery will be offset by the company's expected tariff increases starting in April 2022 for its next regulatory period, as well as flexibility in the company's capital expenditure (capex). Consequently, we forecast that Schiphol's weighted-average adjusted funds from operations (FFO) to debt will be 7.5%-8.0%, on average, over 2022-2024, commensurate with the current rating.
- We therefore affirmed our 'A/A-1' long- and short-term issuer credit ratings on Royal Schiphol Group N.V. (Schiphol) and our 'A' issue rating on its debt.
- The negative outlook reflects the ongoing emergence of new coronavirus variants, effectiveness of vaccines, and possible mobility restrictions and social measures that will affect passengers' confidence and willingness to travel, amid already reduced rating headroom. The negative outlook also incorporates the uncertainty over the airport's tariff implementation for the next regulatory period, which could result in lower charge increases than we currently expect.

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Rating Action Rationale

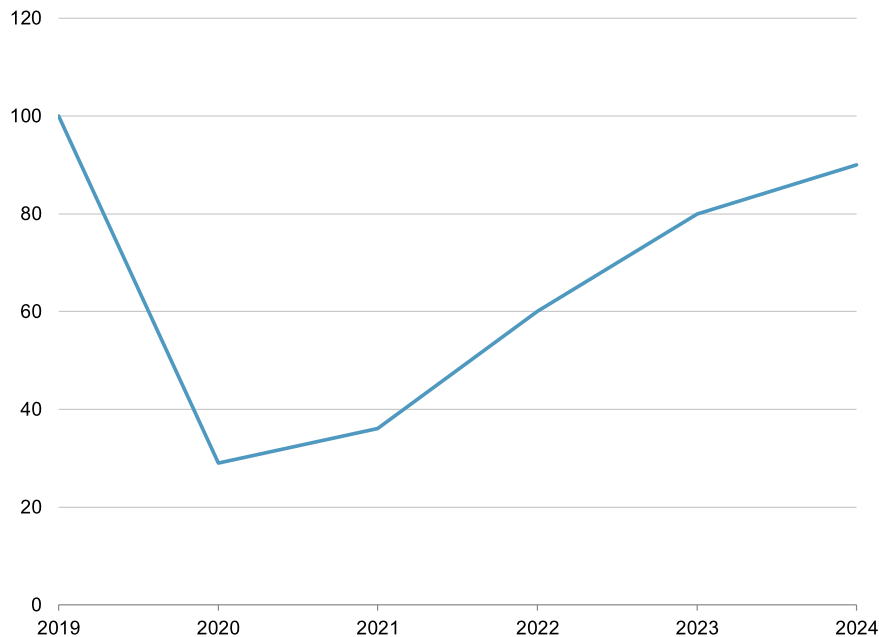
We forecast Schiphol's recovery path will be slower than previously expected, in the face of new variants, the efficacy of current vaccines, and varying cross-border restrictions. Eased cross-border eurozone travel due to the EU digital COVID pass in the summer of 2021, and the opening of U.S. borders in November 2021, supported the start of what seemed like a promising recovery for European airport traffic. However, this was somewhat interrupted by omicron, with

many European countries reimposing travel restrictions over the holiday period, weighing on the recovery for the region's airports. We believe the recovery in air passenger numbers will remain volatile and as such, we anticipate a more modest recovery trajectory for Schiphol. Although mobility restrictions have not been as severe as what we saw in 2020, we view the response to omicron and moreover, the uncertainty of further variants and efficacy of current vaccines, will severely weaken consumer confidence to travel. Combined with a lack of a domestic market, and reliance on long-distance routes, we believe that Schiphol will not be able to fully recover its 2019 traffic levels before 2025. For further information on our view on our rated European airports, see our report "A Volatile Recovery Ahead For European Airports," published Jan. 24, 2022, on RatingsDirect.

Schiphol's traffic volumes in 2021 were similar to 2020 levels, at around 35% of 2019 passenger traffic volumes. We project Schiphol's passenger volumes as a proportion of 2019 levels will be 60%-65% in 2022, around 80% in 2023, and around 90% in 2024. With the likelihood of variants emerging even after omicron, the recovery path is still uncertain and will depend on the extent of mobility restrictions and vaccine response to new variants. There is the potential that further COVID-19 flare-ups and variants could further negatively affect our current view.

Chart 1

Schiphol Passenger Number Recovery Path
Number of Passengers, Indexed 2019=100



Source: S&P Global estimates

We expect Schiphol's cash flows to be supported by the implementation of a higher regulatory tariff for 2022-2024. Our rating incorporates our belief that Schiphol will benefit from its strong and supportive regulatory framework, that allows a timely adjustment to tariffs in the face of cost pressures and allows Schiphol to recover past investments. It is also one of the few European airports to benefit from a traffic sharing mechanism. As such, we anticipate that the company should be entitled to compensation for lost revenue due to lower pandemic-related traffic volumes, as well as for its past investments. In light of this and following the airport's formal tariff proposal in October 2021 and the regulator's announcement of a timely implementation in January 2022, we expect tariff increases of 9% in 2022 and a 12% increase in 2023 and 2024 for the next regulatory period 2022-2024. We believe this will be implemented on time on April 1, 2022. This partially incorporates settlements for the lower-than-expected traffic volumes in 2020, which will be delayed by one year to 2023 in order to reconcile the impact of a higher tariff and a better operating environment. We don't expect Schiphol's competitive position will be affected by the tariff increases, given that its aeronautical tariffs will remain below that of other international hub airports.

However, there could be further downside to the rating in the event of material unfavorable regulatory developments. Although the regulator, the Authority for Consumers and Markets (ACM), has announced that Schiphol's tariff increases will be implemented on April 1, 2022, we understand that ACM will continue to review complaints raised during the consultation period. We expect that ACM will conclude the review by March 24, 2024, although this could be extended by two months. The weak financial position of airlines casts some doubt over the current magnitude of the charge increases. Unfavorable regulatory developments could include the tariff being revised materially below our expectations. We understand that this could happen if ACM concludes that the charges and conditions of Schiphol's new tariffs are in violation of law. In this case, we expect that Schiphol would have to set new charges, which would apply retrospectively from April 1, 2022. That said, we note that there is no track record of the regulator disagreeing with Schiphol's tariff proposals.

Slower passenger recovery due to the pandemic and ongoing capex commitments will likely keep leverage elevated at Schiphol over the next two years. We believe that Schiphol will proceed cautiously in reducing investments, given long-standing requirements to increase terminal and associated infrastructure capacity. Consequently, despite some scaling down of capex in 2020 and 2021 as a result of COVID-19 precautions, we expect that the company will still spend around €650 million-€800 million in 2022 to remove capacity bottlenecks and to create sustainable efficiencies. However, our wide range for estimated capex reflects the company's flexibility in investment levels depending on the passenger recovery.

Given Schiphol's weaker operating environment and high committed capex, we forecast FFO to debt will be below our downgrade threshold in 2022. However, with the bulk of traffic recovery now likely to take place in 2023, supported by more established measures to manage the pandemic, combined with the expected tariff increases, we believe FFO to debt will recover above 8% in 2023, commensurate with the current rating. This contrasts to the group's FFO to debt of 19% in 2019.

Our base case does not consider the impact of the expected orderly sale of the 8% cross-shareholding held by Royal Schiphol Group and Aeroport de Paris (ADP). Following the expiration of Schiphol Group's co-operation agreement with Groupe ADP on Nov. 30, 2021, the parties are in the process of unwinding the cross-shareholding. Royal Schiphol is due to sell its

8% stake in ADP, but the proceeds are not incorporated into our credit metrics. This is because we lack visibility on the amount of proceeds and the timing of the transaction. However, we believe that there will be a positive financial impact as a result of the unwinding. According to the wind-up mechanism agreed in 2008 when the industrial cooperation between the two airports was set up, the disposal should be completed by May 30, 2023.

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 on Schiphol reflects uncertainty over the ongoing emergence of new variants, effectiveness of vaccines, and the extent of mobility restrictions and social measures that will all affect passengers' confidence and willingness to travel. These factors drive our assumption of a generally lengthier recovery amid already reduced rating headroom for Schiphol, which could be further exacerbated by further COVID-19 flare-ups that are inadequately mitigated by existing vaccines. The negative outlook also incorporates the uncertainty over the airport's tariff implementation for the next regulatory period, which could incorporate a lower charge increase than expected or be delayed. In our base case, we expect Schiphol's weighted average FFO to debt to be 7.5%-8.0% over 2022-2024.

Downside scenario

We could lower the rating by at least one notch if we expected a further weakening of Schiphol's credit metrics, in particular if Schiphol failed to improve FFO to debt above 8% by 2023. We think this could occur if:

- The charges for the next regulatory period for 2022-2024 are incorporate a significantly lower charge increase than we expect or are implemented with a delay. This could also lead us to re-assess our view on Schiphol's regulatory framework and how this could affect the company's earnings profile.
- The passenger recovery path is slower or more prolonged than we anticipate, due to further new variants and COVID-19 flare-ups that are not mitigated by existing vaccines materially dampening consumer confidence to travel. Passenger numbers lagging our assumption of 60% of 2019 levels for the first half of 2022, could lead us to lower the rating.

All else being equal, a one-notch downgrade of the Netherlands would not change the rating on Schiphol.

Upside scenario

We could revise the outlook to stable if traffic starts to recover in a strong and sustainable way. There could also be some rating upside from further potential tariff settlements for 2021 for example, to compensate for the drop in traffic.

Company Description

Schiphol Group owns and operates the largest of the Dutch airports, Amsterdam Airport Schiphol, which is one of Air France-KLM's two major hubs. In 2019, Amsterdam Airport Schiphol catered for almost 72 million passengers and was the third-largest airport in Europe by number of passengers and fourth-largest airport in terms of cargo volumes. The airport has a virtual monopoly on air travel originating and ending in The Netherlands and continues to be a major driver of the Dutch economy.

The group is 70% owned by the state of The Netherlands--a fact that supports the rating--20% by the Municipality of Amsterdam, 2% by the Municipality of Rotterdam, and 8% by Groupe ADP.

In addition to its operations in Amsterdam, a major capital city in Europe, Schiphol also owns and operates Lelystad Airport and Rotterdam Airport, and holds a 51% stake in Eindhoven Airport. Its international operations include an 8% stake in Groupe ADP, a 19.61% stake in Brisbane Airport, and a management contract for Terminal 4 of JFK Airport in New York.

Our Base-Case Scenario

Assumptions

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

- Passenger traffic as a proportion of 2019 levels will be about 60%-65% in 2022, around 80% in 2023, and about 90% in 2024.
- An increase in airport charges of about 9% in 2022, followed by a 12% increase in both 2023 and 2024.
- EBITDA margins improving to about 20% in 2022, supported by sustained cost savings and recovery of passenger numbers.
- Annual capex of about €650 million in 2022, under the assumption of a 60%-65% passenger recovery. However, we anticipate that this could increase to up to €800 million with a better recovery path. Spending in 2023 and 2024 to be around €900 million-€950 million.
- No dividend distributions to shareholders.

Key metrics

Based on these assumptions, we arrive at adjusted FFO to debt of below 8% in 2022, 8.0%-8.5% in 2023, and 11.5%-12.5% in 2024.

Liquidity

We assess Schiphol Group's liquidity as adequate, based on our expectation that liquidity sources will cover uses by more than 1.2x for the 12 months to Dec. 31, 2022. In our view, management exercises prudent risk management, has a high standing in the credit markets, and its debt documentation remains favorable, with limited covenant protections.

Our estimates of Schiphol Group's principal liquidity sources and uses for the next 12 months are as follows.

Principal liquidity sources:

- Unrestricted cash and cash equivalents of about €919 million.
- Undrawn and committed credit facility that mature beyond 12 months of about €675 million.
- Estimated cash FFO of about €170 million.

Principal liquidity uses:

- Debt maturities of about €9 million over the next 12 months.
- Capex of about €800 million. This includes some growth capex, but we note that the company has some flexibility to manage growth capex by up to 20%.
- No dividends.

Covenants

Schiphol Group's loan agreements with the European Investment Bank (EIB) include an own-funds-to-total-assets covenant calculated as equity as a percentage of the total balance sheet. This ratio is tested annually and must remain higher than 30%. As of Dec. 31, 2021, the company was compliant with this covenant, with an on-funds-to-total-assets ratio of 38%.

Environmental, Social, And Governance

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

Social factors are a negative consideration in our rating analysis for Schiphol. Passenger traffic decreased significantly by 71% in 2020 because of COVID-19-related mobility restrictions. With high concentration on business and long-haul traffic (30% and 29% in 2019, respectively), we do not expect a recovery to pre-pandemic levels until 2025, at the earliest, which will weigh on the airport's cash flow. We also note the company's exposure to noise pollution and the subsequent regulatory constraints that have limited airport capacity, resulting in congestion and tighter margins. Consequently, the company faces higher capex requirements to alleviate capacity constraints than other airports, amid a weak operating environment. Potentially offsetting this, however, are the airport's supportive regulations allowing a traffic-risk sharing mechanism, which should entitle the company to compensation for lost revenue due to lower traffic volumes during the pandemic, as well as for past investments.

Issue Ratings--Subordination Risk Analysis

Capital structure

Schiphol Group's capital structure consists primarily of €3.9 billion of senior unsecured notes under its euro medium-term note program, plus unsecured bank loans of about €954 million. The group's total gross debt amounted to €4.8 billion as of Dec. 31, 2020.

Analytical conclusions

We rate the unsecured debt issued by Schiphol Group at 'A', the same as its issuer credit rating, reflecting that priority liabilities in the form of secured loans are significantly less than 50%.

Ratings Score Snapshot

Issuer Credit Rating: A/Negative/A-1

Business risk: Excellent

- Country risk: Very Low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+

- Related government rating: AAA
- Likelihood of government support: Moderately high (+2 notches from SACP)

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: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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
- Dutch Airport Operator Royal Schiphol Group Downgraded To 'A' On Protracted Traffic-Volume Recovery; Outlook Negative, July 15, 2020

Ratings List

Ratings Affirmed

Royal Schiphol Group N.V.

Schiphol Nederland B.V.

Issuer Credit Rating A/Negative/A-1

Royal Schiphol Group N.V.

Senior Unsecured A

Schiphol Nederland B.V.

Senior Unsecured A

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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