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Research Update:

Norway-Based Avinor AS Ratings Affirmed; Outlook Remains Negative

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Overview

- The Norwegian Ministry of Transport recently announced its intention to dispose of Avinor's air navigation subsidiary by 2021, which implies that our view on the likelihood of extraordinary support from the government could weaken.
- We expect Avinor's investment requirements to be high through 2022 and its funds from operations to debt to deteriorate in 2017 due to various one-off events. This will constrain its financial headroom.
- Although we are affirming our 'AA-/A-1+' ratings on the company, the outlook remains negative.
- The negative outlook indicates the uncertainty related to the disposal plans and the possibility that we may lower the ratings if Avinor is unable to steadily improve its profitability and maintain credit measures commensurate with the rating.

Rating Action

On Sept. 27, 2017, S&P Global Ratings affirmed its 'AA-/A-1+' long- and short-term corporate credit ratings on Norway-based airport network operator and air navigation services provider Avinor AS. The outlook remains negative.

At the same time, we affirmed our 'AA-' issue rating on the company's unsecured debt.

Rationale

The negative outlook reflects the uncertainty caused by the government's decision to dispose of a subsidiary controlled by the Avinor Group by 2021. The subsidiary currently operates the air navigation service. Given that the air navigation service has an obligation to provide a critical civil and military service with high safety implications, the completion of this transaction could cause us to view Avinor's role as being of lesser importance than previously.

Under our base-case scenario, we forecast that one-off expenses related to pensions and compensation costs will cause Avinor's ratio performance to be tight for the rating in 2017. That said, we anticipate that the company will be able to improve its credit metrics from 2018 onward and so sustain a weighted-average ratio of funds from operations (FFO) to debt for 2017-2019 above 13%, which we consider to be commensurate with its current financial risk profile. The company may perform below our expectations, especially if passenger volumes fail to sustain its growth and commercial operations fail to expand at the rate predicted by 2018. This would result in credit measures falling sustainably short of our rating guidelines.

Avinor has a near-monopoly position as an integrated airport network operator in a wealthy country and is the sole air traffic controller over Norwegian airspace, which implies a much larger scope of operations than other rated European airports. Avinor's business risk profile also reflects its strong competitive position, based on its high (about 85%) share of origin and destination traffic, which we consider to be generally less susceptible to passenger choice and airline performance than transfer traffic.

Our assessment also reflects Avinor's fairly resilient S&P Global Ratings-adjusted EBITDA margins, which we forecast at 33%-35% in 2017-2019. The group's solid operating performance in the large airports and expanding commercial activities underpins its profitability; for example, Oslo Gardermoen accounts for about two-thirds of the group's earnings and generates EBITDA margins that are among the highest of the European airports we rate. Avinor also has a history of managing operating costs well. However, we anticipate that the group's loss-making local and regional airports will continue to constrain its consolidated profitability. Avinor operates these airports as part of its public service obligation and it has a limited ability to dispose of these unprofitable operations. That said, operating these unprofitable airports without state subsidies strengthens Avinor's importance to the government.

Our assessment of Avinor's financial risk profile is based on:

- Avinor's ample operating cash flows supported by its protected market position and high EBITDA-to-operating cash flow conversion rate.
- Our expectation of increasing financial leverage and deteriorating credit measures, due to the accelerated and partly debt-funded capital investments needed to expand and enhance the airports' infrastructure.
- Some flexibility and discretion over the magnitude and timing of uncommitted capital expenditure (capex).

Our base-case scenario assumes:

- Real GDP growth in Norway of 1.1% in 2017, and 1.3% in 2018.
- Estimated annual passenger volume growth of 1.5%-2.0% in 2017 and 1%-2% growth in 2018. We typically see a relationship between GDP growth rates, passenger numbers at the airport, and retail spending.
- Revenues rising at a higher pace than traffic in 2017-2018 because of steadily improving and expanding commercial operations, and average tariffs increasing broadly in line with the consumer price index of Norway.
- Average adjusted EBITDA margin of about 33%-35% in 2017-2019 thanks to a cost control policy. The margin expansion is likely to be further accelerated as higher-margin commercial sales increase following the openings of new terminals in Oslo and Bergen.
- Annual capex to Norwegian krone (NOK) NOK3.0 billion-NOK4.0 billion in 2017-2019.

- Distribution of dividends at a constant payout ratio of 50% (capped at NOK500 million annually until 2018).

In accordance with our criteria for government-related entities, our view of a very high likelihood of government support is based on our assessment of Avinor's:

- Very important role as the operator of nearly all of Norway's airports and the sole provider of air navigation services for both civilian and military flights within Norwegian airspace. Due to Norway's unique topography and geography, combined with its high dependency on foreign trade, we consider that the integrated airport system constitutes essential infrastructure for the country to meet its key economic, social, and political objectives.
- Very strong link with the Norwegian government, based on the state's 100% ownership, the government's role in appointing Avinor's board members, its close oversight of the group's strategies, and its track record of financial support. We don't expect Avinor to be fully privatized in the next 24 months but the air navigation service could be sold off by 2021, which might trigger a revision of our opinion on the likelihood of government support for Avinor.

Liquidity

We consider that Avinor's strong liquidity profile is supported by its liquidity sources (such as the undrawn long-term revolving credit facility [RCF] and available cash holding), ability to generate solid operating cash flows, and demonstrated access to capital markets. These sources compare favorably with its liquidity uses, particularly mandatory debt repayments and high capex.

Our base-case liquidity assessment for the 12 months from June 30, 2017, reflects the following factors and assumptions:

- We expect the group's liquidity sources will exceed liquidity uses by at least 1.5x in the next 12 months. Even when measured over the next 24 months, the ratio remains above 1.0x.
- Liquidity sources will continue to exceed uses, even if EBITDA declines by 30%.
- We understand that Avinor complies with its financial covenant and we expect the group to be able to manage the covenant tests. The group's loan documentation includes one maintenance covenant; a ratio of equity to equity plus interest bearing debt of at least 30%. As of year-end 2016, Avinor's equity ratio was about 42%, which implies comfortable headroom.
- The group appears to have well-established, solid relationships with banks and a generally high standing in credit markets. Furthermore, Avinor has demonstrated uninterrupted access to commercial paper and loan markets.
- Avinor likely has the ability to absorb high-impact, low-probability events without refinancing, given its capability to reduce capex or increase tariffs in times of stress.

Principal sources of liquidity over the 12 months from June 30, 2017, include:

- Available cash and cash equivalents of about NOK1.82 billion;
- A fully available NOK4 billion RCF due in June 2020; and
- Forecast operating cash flows of about NOK2.9 billion.

Principal uses of liquidity over the same period include:

- Short-term debt of about NOK634 million;
- Expansionary (and to some extent discretionary) and maintenance capex of approximately NOK3.5 billion-NOK4.0 billion; and
- Discretionary dividends of NOK400 million-NOK500 million.

Outlook

The negative outlook indicates the possibility that we could lower the ratings if we considered the state less likely than before to support Avinor in extraordinary circumstances, or that its credit quality had deteriorated as a result of either the disposal of the air navigation services or its partly debt-funded expansionary capex. We will assess the implications of the plan on the government's willingness to support Avinor in extraordinary circumstances once the timeline for the disposal of the subsidiary has been clarified and the final format defined.

We expect financial leverage to remain elevated for the next few years because Avinor is expanding and upgrading the infrastructure of its airports. This weighs on its credit metrics, which are at the low end of its rating category.

Downside scenario

We could lower the ratings if Avinor's EBITDA and leverage materially deviates from our base case, resulting in its weighted-average FFO to debt falling below 13%. This is likely to happen if Avinor's sizable expansionary investments to expand and enhance its airports' infrastructure are not sufficiently mitigated, for example, if passenger volumes fail to continue showing recovery. This would also likely lead to the commercial business underperforming.

We could also lower the ratings if greater clarity regarding the final shape of the privatization of the air navigation services caused us to revise down our view of likelihood that the Norwegian government would offer Avinor extraordinary support in case of need.

A downgrade might also be triggered if the group's profitability deteriorated, such that the EBITDA margin fell sustainably below 30%, leading us to lower our assessment of the company's business risk profile.

Upside scenario

We could revise the outlook back to stable if we perceived that Avinor's role had not changed as a result of the privatization, for instance, if Avinor proves difficult to replace when it comes to critical activities for airport safety. In addition, we could revise the outlook if Avinor's financial performance appeared to be strengthening from 2018 onward. This would most likely occur thanks to a combination of increasing operating cash flow, robust and expanding passenger volumes and retail business, and gradually declining debt once capital investments slow, leading to a ratio of adjusted FFO to debt of well above 13% on a sustainable basis.

Issue Ratings

Subordination risk analysis

Capital structure
Avinor's capital structures mostly consist of senior unsecured debt issued at parent level.

Analytical conclusions
Avinor's debt is rated 'AA-', the same as the corporate credit rating, because no significant elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

Corporate Credit Rating: AA-/Negative/A-1+

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

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: bbb+

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb+
- Likelihood of government support: Very high (+4 notches from SACP)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 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
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Transportation Infrastructure Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Avinor AS	
Corporate Credit Rating	AA-/Negative/A-1+
Senior Unsecured	AA-

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