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FIXED INCOME ANALYSIS

# KINGSTON AIRPORT REVENUE FINANCE LIMITED (KING AIR)

Barita Investments Limited
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## Company Overview

| | |
|---|---|
| Industry: | Transportation Services |
| Security Name | KINAIR 6.75% 12/15/36 |
| Credit Rating (Moody's)/Outlook | Ba3/Stable |
| Maturity | December 15th, 2036 |
| Issue Size | US$480 Mn |
| Rank | Senior Secured |
| Current Price (Oct 1, 2024) Source: Bloomberg | US$103.70/US$103.91 |
| Yield to Maturity (Bid/Ask) | 6.28%/6.26% |
| Yield to Worst (@maturity) | 6.29% |
| Recommendation | **OVERWEIGHT** |

Kingston Airport Revenue Finance Limited (King Air) is a Cayman-based special purpose vehicle (SPV) which will be assigned the Airports Authority of Jamaica's (AAJ) economic right to receive 53.22% of the gross revenues of Norman Manley International Airport (NMIA). AAJ was established in 1974 under the *Airports Authority Act* as an independent statutory body, with initial responsibility (ownership and management) for the nation's international airports. AAJ would later assume additional responsibility for the country's domestic aerodromes (Tinson Pen located in Kingston, and others) in 1990. On October 10, 2018, the AAJ and PAC Kingston Airport Limited (PACKAL), a wholly owned subsidiary of Grupo Aeroportuario del Pacífico (GAP), entered into a 25-year Concession Agreement for the operation of the Norman Manley International Airport (NMIA). This agreement would see to it that the Mexican airport operator, Grupo Aeroportuario del Pacifico (GAP), maintained the rights to 46.88% of NMIA's gross airport revenues, along with the obligation to operate and sustain NMIA with those revenues. Exactly one year later, on October 10, 2019, PACKAL officially began operating and maintaining NMIA. King Air will use AAJ's portion of NMIA's revenue to service the senior secured bond which will have a 6.75% coupon rate and mature on December 15, 2036.

## Executive Summary

The King Air 6.75% 2036 note exposes investors to the aeronautical industry through the management of airports in a public-private partnership. The 12-year bond was upsized to US$480 million from an initial offer of US$440 million, reflecting the strong demand for the bond as international investors rushed to buy into the offer less than a week after its announcement. High demand for the offer underscores the perceived credit quality the Government of Jamaica (GoJ) enjoys, as international investors look to gain greater exposure to GoJ-backed bonds. The structure of the Concession Agreement also ensures that AAJ, and by extension, investors in the King Air bond, face limited exposure of business risk to PACKAL, while also providing investors with an implicit 'government guarantee' on coupon payments over the life of the bond.

### *Concession Agreement*

While NMIA remains under the ownership of AAJ for the life of the Concession Agreement, PACKAL, as Airport operator, assumes full responsibility for the operation of NMIA. The scope of their responsibility not only includes the maintenance of the airport but also encompasses improving operational efficiency (both airside and landside) of NMIA. PACKAL is also tasked with financing and completing the modernization and expansion of the airport, as well as overseeing the design and construction of all other capital works projects. The structure of the Agreement **provides AAJ with the majority of the**

**Airport's gross revenues**, while also limiting the entity's exposure to PACKAL's business risk. Additionally, the agreement incentivizes PACKAL to operate efficiently and increase passenger traffic, thereby maintaining profitability and keeping agency costs low.

In accordance with the Concession Agreement, AAJ retains 53.22% of gross revenues generated by NMIA and the authority to set rental rates for third-party entities, such as food and beverage services, advertising, general retailing and duty-free services. This ensures that NMIA, and by extension AAJ, receives a minimum commission on all sales made by vendors using airport facilities.

Notably, AAJ collected US$41.3 million or J$6.34 billion in concession fees during 2023 from PACKAL, and US$34.7 million or J$5.27 billion during 2022. It should also be noted that the 53.22% concession fee charged by AAJ, is paid on the 25th of each month for gross revenues accrued during the month prior.

*Use of Proceeds*

The issuer, King Air, intends to use the proceeds of the offer to pay transaction fees and expenses, fund a six-month debt service reserve account, fund a revenue account, and to **make a one-time payment to AAJ for the true sale of revenue rights**. This action corresponds with the GoJ's Privatization and Public-Private Partnership (PPP) Program, which serves to facilitate and secure private sector investment and participation in the Jamaican economy through the ownership, expansion or operation of state-owned assets/enterprises and the provision of public infrastructure and services. The Government of Jamaica will also use some of the proceeds to pay principal and interest on certain outstanding debt obligations and fund other budgetary purposes. The most notable of which will be the financing of certain infrastructure projects within Jamaica, including the modernization and rehabilitation of more than 2,000 roads island-wide under the J$40-billion Shared Prosperity Through Accelerated Improvement to our Road Network (SPARK) program.

## Investment Rationale

**Attractive Yield:** The King Air bond offer has an implicit government guarantee over the life of the bond that greatly reduces the default risk borne by the investor. As such, the Jamaican government's commitment to covering any revenue shortfalls allows the King Air note to be treated as a quasi-sovereign bond. In comparing the yield on the King Air note to US-denominated Jaman bonds of close maturities, we note that the King Air bond is attractively priced considering its ask yield-to-maturity (YTM) of 6.256%. This yield compares to a YTM of 5.502% for the JAMAN 8% 03/15/2039 bond, which represents a spread of 75.4 basis points. As such, we believe the King Air bond provides investors with superior value relative to plain vanilla, GoJ bonds.

**Stable Passenger Traffic:** Almost all of the relevant inter-continental routes pass through NMIA and SIA, underscoring the importance of Jamaica's airport network to international connectivity. Notably, NMIA's commercial passenger traffic for 2023 amounted to 1.74 million, below the pre-pandemic level of 1.86 million reported in 2019. ALG Global (a leading global consultancy team with more than 30 years of professional experience in the transport sector) projects NMIA to surpass its pre-pandemic level of passenger traffic by year-end 2025. ALG has also projected that total passenger traffic for the 2025-2030 period will grow by a compound annual growth rate (CAGR) of 2.5% before slowing to a CAGR of 1.8% for the 2030-2042 period. Using ALG's projections as a baseline, NMIA's growing passenger traffic should support stable revenue growth, allowing King Air to service its coupon payments over the life of the bond.

**Operational Improvements to Meet Growing Traffic:** In line with this, PACKAL, as mandated by the Concession Agreement, is currently undertaking several capital projects that will not only improve safety at the Airport but also enhance operational efficiency of NMIA, allowing them to serve a growing number of passengers. These projects include upgrades to the departure lounge and improvements to the terminal and runway.

**Against this backdrop, we believe that the King Air bond is best suited for investors seeking consistent interest payments with a medium- to longer-term investment horizon and a moderate to aggressive risk profile.**

## Kingston Airport Revenue Credit Rating

### Credit Assessment

**Rating Summary:** On September 17, 2024, Moody's Ratings assigned a Ba3 rating to Kingston Airport Revenue Finance Limited ("KingAir") for its issuance of up to $440 million in senior secured notes due 2036, maintaining a stable outlook. The rating reflects the steady passenger traffic at NMIA driven largely by visiting friends and relatives, along with a diversified airline base and a favourable regulatory framework for aeronautical changes.

**Key Rating Drivers:**

<u>Credit and Business Risk</u>

The Ba3 rating faces challenges primarily due to refinancing risk linked to a substantial balloon payment, which represents roughly 77% of the total issued debt due in 2036. However, the rating incorporates an assumption that the revenue-sharing structure will remain intact following the concession renewal period, which extends beyond 2044, enabling refinancing and full amortization of the balloon payment within an extended concession framework.

Transfer risks may pose a challenge due to the operator's responsibility for collecting revenue and ensuring timely monthly remittances of the issuer's share to offshore accounts for creditors. This setup raises concerns about potential disruptions in cash flow stability, which could compromise the issuer's financial health. Additionally, the airport's location in the Caribbean



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hurricane belt exposes it to significant physical climate risks, with the threat of hurricanes and tropical storms potentially impacting passenger traffic and operational continuity.

Government Influence on Risk

The rating is anchored by the Jamaican government's first-priority rights to receive 53.22% of the revenue from NMIA which acts as security for noteholders. King Air benefits from this partial government backing, **with the Jamaican government providing reliable cash flow from the operations of NMIA and its obligation to cover any revenue shortfalls, thereby reducing default risk for investors**. The assigned cash flows will be managed by an independent trustee in special purpose accounts that follow well-defined waterfall rules. The potential oversight quality from the Government of Jamaica (B1 positive) is expected to enhance the credit profile, introducing a layer of institutional stability. The mitigation of foreign currency risk is another significant factor supporting the credit quality. Given that cash flows from airport operations align directly with debt obligations, there is a natural hedge against fluctuations in exchange rates. Additionally, King Air's diversified revenue base from international passengers helps stabilize cash flows and enhances resilience against economic downturns or shifts in travel behavior. Another crucial element of its financial structure is the cash-funded six-month debt service reserve account, which serves as a liquidity buffer against revenue volatility.

Conditions for Rating Modification

The rating has the potential for an upgrade if King Air achieves a notable increase in passenger traffic, which would contribute to a lasting improvement in key financial metrics. Specifically, consistent ratios of (Funds from Operations (FFO)+ interest expense/interest expense) above 1.8x and FFO/Debt exceeding 7% would be favorable indicators. Additionally, an upgrade in the credit rating of the Government of Jamaica would positively influence the rating.

Conversely, the rating would face downward pressure if the Government of Jamaica's credit rating is lowered. Weaker-than-anticipated passenger traffic or tariff adjustments falling short of baseline projections could also trigger a downgrade, especially if (FFO + interest expense/interest expense) and FFO/Debt fall below 1.20x and 3%, respectively. A sustained Debt Service Coverage Ratio (DSCR) below 1.30x, as calculated by the trustee, would further indicate financial challenges. Additionally, any disruptions in cash flow transfers from the operator to the issuer would heighten downgrade risks.

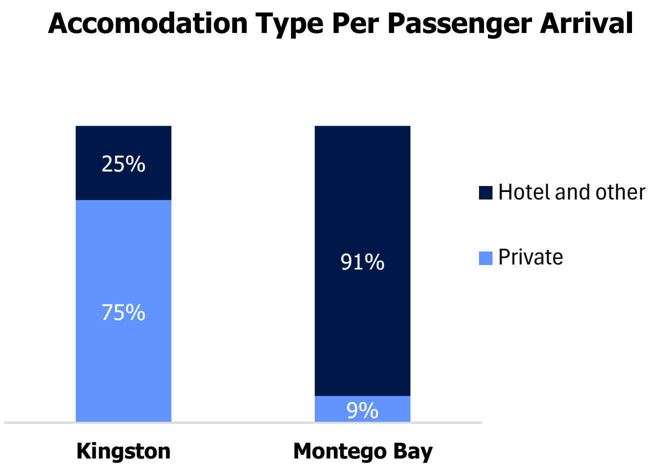
## Industry Analysis – Airport Operators

Airport operators represent a diverse group of companies differentiated by scale, market position and geographic service area. Airport operators range from companies that operate all the airports of a large sovereign nation to those that operate a small regional airport. As such, service areas range from very large to relatively small. Nevertheless, in most cases, the airports managed by such operators would be considered essential assets within the economic regions they serve. While airports may face competition from other airports or, to a lesser extent, other modes of transportation, the largest airports and systems serving major economic hubs typically have strong monopoly power. Relatively low business risk is generally coupled with high leverage that often stems from significant capital expenditure to accommodate passenger growth and the optimization of the capital structure to reduce the cost of capital. Credit quality in the sector varies between regions and is affected by the economic health and activity of the respective service area.

The publicly owned and operated model is fundamentally different from that of privately managed airports. In the former, airport operators do not have a profit maximization objective but are operated for the public benefit of the municipal entity or entities that own them. Financing is raised solely to meet the expenditure required to fulfil the airport's development needs. In contrast, privately managed airports, driven by profit maximization, exhibit a stronger relationship between credit strength and financial metrics.

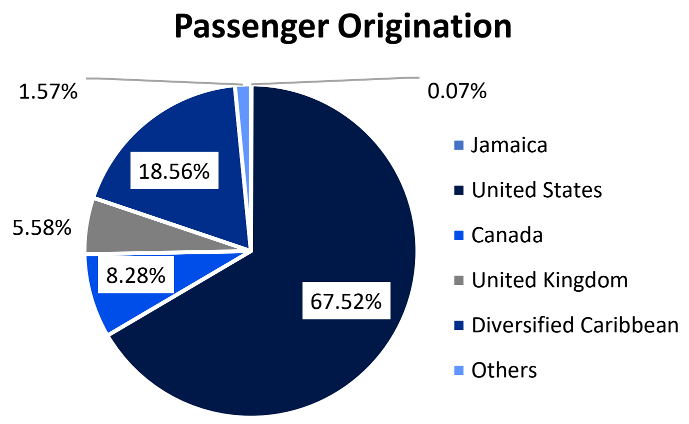
## NMIA – The Business

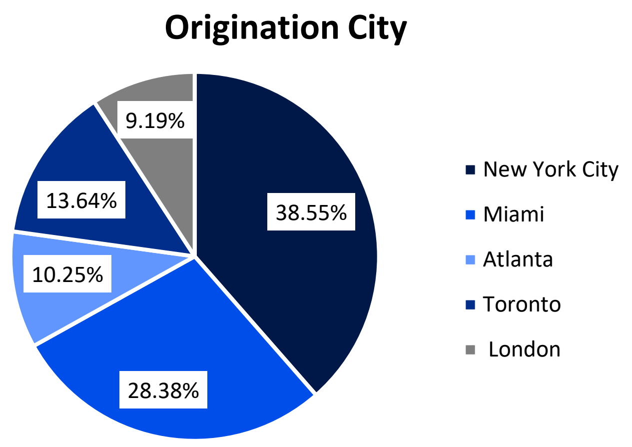
NMIA is designated as an international airport under Jamaican law, which indicates that it is equipped to receive international flights and handle customs and immigration processes. NMIA hosts over 13 passenger airlines that connect Kingston to domestic and international destinations across Latin America, North America and Europe. Specifically, airlines operating at NMIA reach at least 17 destinations, including several major international routes such as New York, Fort Lauderdale, Miami and Toronto, which in 2024, are ranked among the busiest international destinations from NMIA by total number of passengers. International airlines such as JetBlue, American Airlines, Caribbean Airlines and Spirit operate frequent flights from NMIA, while British Airways offers transatlantic flights from Kingston to London. Caribbean Airlines, a domestic carrier operates the most departures to the most destinations, including destinations in Central and South America.




NMIA is the only material non-tourist international airport in Jamaica. Sangster International Airport (SIA), on the other hand, primarily serves foreign tourist passenger traffic, accommodating 5.3 million passengers in 2023. For the same year, NMIA had 1.7 million passengers, serving primarily non-tourist Passenger Traffic. NMIA mainly serves the domestic population of Jamaica (76.4% of whom live in the Kingston metropolitan area) and the Jamaican diaspora returning for visits. Additionally, NMIA handles 76.3% of the country's air cargo, consistent with NMIA's role as the primary airport transporting goods in Jamaica. Jamaica has a large diaspora of non-resident Jamaican citizens and descendants of Jamaicans who live primarily in the United States, Canada, and the United Kingdom.

The Jamaican diaspora is heavily concentrated in major metropolitan cities within these countries. In the United States, they are concentrated in the North-East (New York, New Jersey, Connecticut, and Maryland), the Atlanta area, and southern Florida. In Canada, the diaspora is concentrated in the province of Ontario (Toronto), and to a lesser extent Alberta, Quebec, and British Columbia. In the United Kingdom, the diaspora is primarily concentrated in London, Birmingham, and the Midlands (Manchester, Nottingham, and Wolverhampton). A smaller portion of the Jamaican diaspora is spread across the Caribbean (approx. 30% of the population of the Cayman Islands is part of the Jamaican diaspora). According to a 2018 study by the International Organization for Migration ("IOM"), Jamaicans abroad relate and maintain connections to their homeland in through volunteerism, remittances to support family, contributions to health and welfare in specific communities, purchasing Jamaican goods and participating in marketing Jamaican culture, particularly music and visiting Jamaica. **The diaspora community exhibits greater air traffic pattern stability than other groups during times of exogenous stress, demonstrating less of a decline and a faster recovery than average.** As a result, NMIA is less susceptible to downturns in source markets than its north-coast counterparts.




Notwithstanding, NMIA's business remains subject to seasonal fluctuations, with demand for air travel generally higher during the summer months and during the winter holiday season, particularly in international markets. NMIA's results of operations generally reflect this seasonality but have also been impacted by numerous other factors that are not necessarily seasonal. Some of these factors include economic, security and health concerns, war or threat of war, weather, air traffic control delays and general economic conditions. As a result, NMIA's operating results for a quarterly period are not necessarily indicative of operating results for an entire year, and historical operating results are not necessarily indicative of future operating results.

It should be noted that upgrades to NMIA were delayed for over two years due to a significant drop in traffic during the COVID-19 pandemic. With the easing of pandemic-related restrictions however, NMIA has since seen an improvement in passenger arrivals, with approximately 1,979,700 million passengers recorded between July 2022 to July 2023, an increase of 570,700 passengers over the previous year and a rise of 637,783 passengers from 2020. As a result, PACKAL has taken, and is in the process of implementing, several investments that are integral to the operational improvement and safety of NMIA. These investments are currently underway in 2024, with PACKAL expected to undertake several projects until 2028 to fulfil its obligations under the Concession Agreement. These projects include (i) a departure lounge upgrade and expansion, which is expected to be completed in 2025; (ii) upgrades to the pumps, valves pipes and flow meters; and (iii) upgrades and improvements to the terminal and taxiway in order to keep up with traffic demand, expected to be completed between 2026 and 2028.

## Other Factors to Consider

**Approximately 67.5% of the 1.74 million passengers served by NMIA during 2023 originated from the United States.** As such, NMIA's revenues are closely linked to the overall health of its biggest source market, with macroeconomic conditions in the US likely affecting travel demand for Jamaica's diaspora.

While several factors influence consumption patterns in the U.S., consumer sentiment indexes can be useful tools for gauging consumer expectations, and by extension, their willingness to spend on non-essentials such as leisure and travel. Notably, the University of Michigan's Consumer Sentiment Index (CSI) improved to 70.1 in September 2024 from 67.9 in August, suggesting improving economic conditions for U.S. households. Similarly, the Consumer Expectations Index (CEI) advanced to 74.4 from 72.1 for the previous month, marking a substantial increase of 13.2% from the 65.7 reported for September 2023. This improvement reflects an increasingly positive outlook for economic conditions for U.S. households, coinciding with ongoing disinflationary pressures as headline inflation approaches the Federal Reserve's 2% target. Low, stable inflation will likely contribute to reduced economic uncertainty and further improve consumer confidence. This is expected to positively influence discretionary spending, such as travel, directly impacting arrivals at NMIA and, ultimately, revenues.

Headline inflation for the 12 months ended January 2024 was reported to be 3.1%, with point-to-point inflation falling to 2.5% as of August 2024. Additionally, from August 2023 to August 2024, real average hourly earnings increased by 1.5%, while the average workweek decreased by 0.3%. Consequently, the change in real average hourly earnings combined with the decrease in the average workweek resulted in a 1.3% increase in real average weekly earnings over this period. The unemployment rate averaged approximately 3.7% over the past year, with an outturn of 4.3% in July 2024 and 4.2% in August 2024. As labour market conditions in the US ease relative to the tightness during the Covid-19 pandemic, hourly wage growth is expected to moderate, returning to pre-pandemic levels. The normalization of wage growth will further support price stability in the U.S.

In summary, while some economic uncertainty remains, positive shifts in consumer sentiment and expectations, combined with slowing inflation and stable employment conditions suggest a favourable outlook for arrivals at NMIA. Recent



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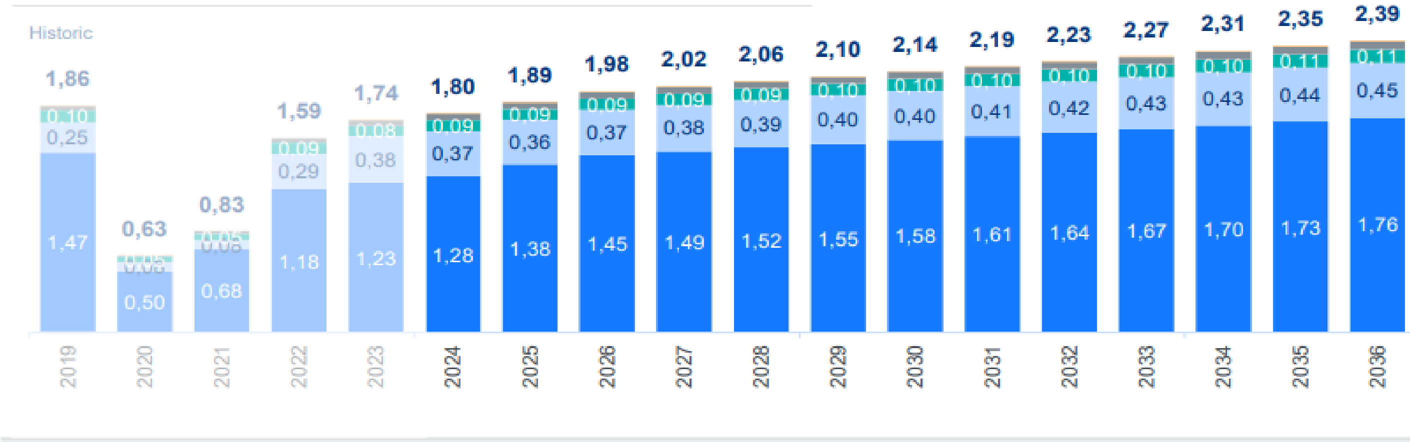
improvements in consumer confidence coupled with real wage growth could potentially increase spending on travel, further supporting growth in revenues. However, a negative shift in consumer sentiment may adversely impact travel demand and ultimately passenger traffic at NMIA, particularly if we see a material increase in unemployment.

*Passenger Traffic Projections*

NMIA has seen passenger traffic generally increase over the last five years, despite the disruption between 2020 and 2021 due to the COVID-19 pandemic. While numbers are yet to recover to pre-pandemic levels, ALG Global (a leading global consultancy team with more than 30 years of professional experience in the transport sector) has forecasted that passenger traffic will likely surpass 2019 levels by year-end 2025. In forecasting passenger arrivals over the 2024 to 2044 period, ALG employed the use of regression models to extrapolate the relationship between passenger traffic and macroeconomic variables on Jamaica's biggest source markets. The projections for these variables, provided by Oxford Economics, were used to model passenger arrivals over the forecast period. The chart below shows the forecasts for passenger arrivals over the 2024-2036 period, which coincides with the life of the bond.

According to ALG's analysis, NMIA's total passenger traffic for the 2025-2030 period is projected to grow at a compound annual growth rate (CAGR) of 2.5%, before slowing to a CAGR of 1.8% for the 2030-2042 period. This forecast puts NMIA, and by extension, King Air, in a favorable position, with the airport projected to experience stable growth in passenger traffic over the life of the bond.

| | CAGR '19-'25 | CAGR '25-'30 | CAGR '30-'42 | CAGR '19-'42 |
|---|---|---|---|---|
| **Domestic** | **-27.4%** | **1.9%** | **1.7%** | **-6.8%** |
| **International** | **0.3%** | **2.5%** | **1.8%** | **1.6%** |
| North America | -1.0% | 2.7% | 1.8% | 1.3% |
| Caribbean | 6.8% | 2.1% | 1.8% | 3.1% |
| Europe | -2.1% | 2.1% | 1.8% | 0.8% |
| Other | 6.3% | 2.1% | 1.8% | 3.0% |
| **General Aviation** | **12.8%** | **0.6%** | **0.6%** | **3.6%** |
| **Total** | **0.3%** | **2.5%** | **1.8%** | **1.6%** |




Source: OAG, CAPA, Analysis ALG

## Conclusion and Recommendation

The King Air bond presents an attractive investment opportunity, giving investors exposure to the local aeronautical industry. The bond has an implicit government guarantee that reduces default risk, while also offering a competitive yield above U.S. dollar denominated GoJ bonds with similar maturities. Notably, NMIA's projected recovery in passenger traffic, which is expected to surpass pre-pandemic levels by 2025, supports a positive revenue outlook. Additionally, Packal's ongoing operational improvements at NMIA are expected to enhance safety and efficiency, further strengthening NMIA's ability to serve a growing passenger base, and ultimately, King Air's ability to service its coupon payments. As such, we recommend investors **OVERWEIGHT** this offer in their portfolio, particularly those with a moderate to aggressive risk profile seeking consistent interest payments with a medium- to longer-term investment horizon.



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