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Summary:

Philadelphia, Pennsylvania Philadelphia International Airport; Airport; Joint Criteria

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Summary:

Philadelphia, Pennsylvania
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Credit Profile		
US$96.835 mil arpt rev rfdg bnds ser 2015A		
Long Term Rating	A/Stable	New
Philadelphia, Pennsylvania		
Philadelphia International Airport, Pennsylvania		
Philadelphia (Philadelphia Intl Arpt)		
Unenhanced Rating	A(SPUR)/Stable	Downgraded
Long Term Rating	A/Stable	Downgraded

Rationale

Standard & Poor's Ratings Services has lowered its underlying rating (SPUR) on Philadelphia, Pa.'s airport revenue bonds issued for Philadelphia International Airport (PHL) to 'A' from 'A+'. At the same time, Standard & Poor's assigned its 'A' long-term rating to the proposed series 2015A airport revenue refunding bonds. The outlook is stable.

The downgrade reflects our assessments of PHL's additional borrowing plans; high carrier concentration; moderately high exposure to connecting traffic; marginal Standard & Poor's-adjusted debt service coverage (DSC); and relatively weak liquidity position, and moderately high airline cost structure. Although the airport has executed a new five-year airline use and lease agreement and has obtained approval for $173 million in additional projects these developments, in our view, were not enough to offset the factors detailed above. The downgrade also reflects our assessment of the airport's weak Standard & Poor's-adjusted DSC levels from 2013 to 2015 and our expectation that Standard & Poor's-adjusted DSC will stay near 1x. Furthermore, the rating action reflects our expectation that liquidity will stay at levels we consider weak to contain increases to its airline cost structure. We consider PHL's airline cost structure moderately high, which could be higher than forecast if enplanements trend lower than forecast or if the cost of PHL's capital program exceed current estimates. Nevertheless, we believe the airport will manage the added debt given its large origin and destination (O&D) passenger base. Overall, we believe these factors and risks are more consistent with an 'A' rating.

At the same time, Standard & Poor's affirmed its 'AAA/A-1+' rating on the airport's parity variable-rate demand bonds series 2005C, of which approximately $131.2 million is outstanding. The 'AAA/A-1+' rating reflects the application of joint criteria (assuming low correlation) of Standard & Poor's underlying rating (SPUR) on the airport and the direct-pay, irrevocable letters of credit (LOC) from TD Bank N.A. and by Royal Bank of Canada. The stated expiration dates are Dec. 22, 2017, for the Royal Bank of Canada LOC and Dec. 23, 2019, for the TD Bank LOC.

The 'A' SPUR reflects our view of the airport's:

- Relatively large O&D market, with a diverse service area economy that provides a good base for local air travel demand;
- Good level of aeronautical activity, with total enplanements averaging 15.3 million from fiscal years 2010-2014 and an estimated 15.3 for fiscal 2015, which we expect to hover near this level due to PHL's large O&D base and role as a key transatlantic connecting point for American Airlines Inc.; and
- Debt burden we expect to increase, but remain manageable and consistent for the rating.

We believe offsetting these credit strengths are the airport's:

- Relatively high air carrier concentration (the new American Airlines resulting from the merger of American and US Airways Inc., and their regional affiliates handle approximately 77% of fiscal 2014 enplaned passengers and nearly all connecting traffic) and a moderately high exposure to connecting passengers (43% of fiscal 2014 total enplaned passengers);
- Significant additional borrowing plans that could increase PHL's airline cost structure (which we already consider above-average) and reduce its financial flexibility should demand remain flat or decline or capital costs exceed current estimates; and
- Marginal Standard & Poor's-adjusted DSC levels and weak liquidity position that we expect to continue.

Bond proceeds will be used to currently refund all of the city's outstanding series 2005A airport revenue bonds for level savings.

Securing the bonds are net project revenues; amounts payable to the city under a qualified swap; and all amounts on deposit in, or credited to, some aviation funds. Project revenues include all revenues from system occupants and users. Net project revenues are net of net operating and maintenance expenses. Net operating and maintenance expenses are net of interdepartmental charges, which we include in our adjusted DSC calculations although they are subordinate to debt service under the general airport revenue bond ordinance. A portion of passenger facility charges (PFCs) is pledged to pay debt service for the airport's series 1998B, 2010D, and 2011A bonds.

Philadelphia operates PHL and the Northeast Philadelphia Airport, a small general aviation airport that operates at a loss. They constitute the airport system. According to Airports Council International-North America data, in 2014, PHL ranked 19th in terms of total passengers in the U.S. It is a major hub in the northeast for American, which merged with US Airways in December 2013. The new American Airlines, along with their affiliated commuter carriers, accounted for approximately 76.9% of fiscal 2014 total enplanements, followed by Southwest Airlines Co. (including AirTran Airways) at 7.3% and Delta Air Lines Inc. at 7.1%.

PHL, in our opinion, benefits from serving a large O&D market, supported by a relatively stable economy that spans 11 counties across Pennsylvania, New Jersey, Delaware, and Maryland. We believe it provides a good base for local air travel demand with 8.7 million O&D enplaned passengers (or approximately 57% of the 15.3 million total) at fiscal year-end 2014 (June 30). In addition, it has a competitive position we consider good because of limited competition from other major airports and the presence, although limited, of low-cost carrier service. We believe these factors have contributed to the airport's generally good level of aeronautical activity. Although its total and O&D enplanement levels remain below those before the Great Recession, demand has been relatively stable. PHL's fiscal 2014 O&D and total enplanements were nearly 85% and 97% of fiscal 2007 levels, respectively, while connecting enplanements were

117% of fiscal 2007 levels. From fiscal years 2010 to 2014, total enplanements averaged 15.3 million, hovering near 15.2 million to 15.3 million from fiscal years 2012-2014, while O&D enplanements have averaged nearly 8.7 million from 2010-2014 and ranged from about 8.6 million to 8.7 million from 2012-2014. Estimated total enplanements for fiscal 2015 were flat, at 15.3 million. We expect demand for the airport will be generally stable.

We consider PHL's carrier concentration high and its exposure to connecting passengers moderately high. Now that the airport is part of the new American network, we expect its activity will remain near current levels given its role and importance within the airline's route network as a major transatlantic connecting point and its large O&D market. Within American's route system, PHL ranks as the largest gateway airport to Europe and the Middle East and the third-largest international gateway overall behind Miami International Airport and Dallas Fort Worth International Airport.

The current airline use and lease agreement took effect July 1, 2015. This agreement has a five-year term with two one-year extensions. The agreement's financial terms are consistent with those of the previous one. In addition to the $173.25 million of newly approved projects, the airlines, by the end of 2016, must approve one or more of the following projects: terminal modernization program with an additional investment of $100 million to $250 million and one of a new $200 million air traffic control tower or up-to-$300 million for a runway extension and related airfield and terminal improvements. American, however, is the only signatory under the new agreement to date. We expect the other primary airlines to sign shortly. Airlines that do not sign are subject to a city regulation that would require them to pay more than the signatory airlines. Pursuant to the airport rates and charges regulation (effective June 29, 2015), nonsignatory airlines must pay amounts equal to 115% of the calculated signatory airline landing fee rate, terminal rentals, international common use area fees, and domestic common use area fees.

PHL's capital program totals $1.6 billion in airline-approved projects, consisting of $1.1 billion in projects related to its long-range capacity enhancement program (CEP) and $483 million in near-term, ongoing capital improvement program (CIP) projects. We consider the CEP a very complex capital program. More specifically, major CEP elements include expanding and reconfiguring the existing terminal complex; a new runway; two runway extensions; taxiway improvements; relocating several off-airport facilities to facilitate airfield improvements; a ground transportation center which includes a consolidated rental car facility; cargo facility development; constructing an automated people mover; and parking expansion and roadway improvements. Capital projects in the CIP complement the CEP's framework and the airport's ultimate development. Major CIP projects include an expansion of Terminal F; completion of Terminals D/E checked baggage inspection system; and on-going rehabilitation and repair projects. Anticipated Expected funding sources include approximately $719 million from general airport revenue bonds or commercial paper, $314 million from customer facility charge (CFC) revenues, $213 million from grant or PFC revenues, and $171 million from prior bond issues. PHL may also issue bonds solely backed by CFC revenue.

We consider the airport's debt burden manageable at recent activity levels (as of June 30, 2015), at about $89 debt per enplaned passenger. However, adding $709 million to PHL's $1.4 billion in debt outstanding now (including CP outstanding), debt per enplanement increases to $135, which we still view as manageable for the rating. Given the CEP's size and scope, we believe it could cost more than current estimates and potentially disrupt operations.

PHL's Standard & Poor's-adjusted DSC levels are weak for a large-hub residual airport, in our opinion. Adjusted

coverage based on historical results has averaged 1.03x from fiscal years 2010-2014. For fiscal 2014, DSC was 0.95x, and is 1.01x based on estimated fiscal 2015 figures. Our DSC calculations include the portion of PFC revenues on which the city has pledged to pay debt service on bonds issued to finance PFC-eligible projects and exclude transfers from the previous year or available cash balances. DSC as defined under the airport's general airport revenue bond ordinance (GARBO) has exceeded 1.0x and 1.5x (excluding interdepartmental charges) rate covenants from fiscal years 2010-2014, and we expect this to continue. More specifically, including interdepartmental charges, transfers and previous year or available cash balances, DSC per GARBO for fiscal 2014 was 1.54x and averaged 1.66x from fiscals 2010-2014. Based on fiscal 2015 estimated figures DSC per GARBO is 1.45x. In addition, Standard & Poor's-adjusted DSC based on forecast figures done in connection with this proposed bond issue is slightly above 1.0x for fiscal years 2016 to 2020; and no less than 1.6x DSC per GARBO.

PHL's fiscal 2016 budgeted figures shows an airline cost structure of $14.71 based on 15.6 million enplanements, assuming enplanements increase 2.1% from fiscal 2015. The airport's airline cost structure is $12.81 per passenger based on estimated 2015 results. This is above-average compared with that of other large-hub airports we rate in the 'A' category. A forecast done in connection with this bond issue, which assumed enplanements increasing 2.1% to 15.6 million in fiscal 2016 followed by modest annual growth of about 1% from fiscal years 2017 to 2020, shows PHL's airline cost per enplanement gradually increase to $16.15 in fiscal 2020 from $14.72 in fiscal 2016. The forecast assumes the airport will fund near-term capital program with commercial paper up to $350 million capacity, then taking out with GARBs. This assumed added debt service from the airport issuing general airport revenue bonds in 2017 and 2019 of $535 million and $370 million, respectively. The forecast assumes PHL will not use PFCs to pay a portion of the debt service for these future bonds, although it could. We think the enplanement forecast might be moderately aggressive given the airport's generally flat enplanement trends over the past few years. As a result, we expect PHL's airline cost structure will remain above-average, unless it experiences notable and sustainable increases in demand and less reliance on airline revenues.

We consider the airport's liquidity position weak, which we expect to continue given the residual nature of its airline agreements and low DSC (per our adjustments). PHL's fiscal year-end unrestricted cash balance has declined gradually, to about $58.3 million (about 90 days' cash on hand) from about $118.4 million (245 days) from fiscal years 2010 to 2014. Management attributes the most recent liquidity decline from mitigating impacts to airline rates and charges by using its cash reserves to cover increased costs for fringe benefits, (specifically pensions and health care, labor settlements), and added snow removal costs from severe winter weather. Based on projections, we expect PHL's cash to stay at levels we still consider weak. Management reports an unaudited unrestricted cash balance of $65.6 million (102 days) as of June 30, 2015. In addition, the prepared forecast shows airport's unrestricted cash reserves ranging from about $66 million (95 days) to $98 million (126 days) from fiscal years 2016 to 2020. Such forecast assumes, as agreed by the airlines, that the airlines will gradually replenish PHL's cash reserves used to mitigate fiscal years 2014 and 2015 rate and charges from fiscal years 2016-2018. The rating could face stress if the airport's liquidity is not consistently maintained near this range.

PHL has one floating-to-fixed-rate swap with JPMorgan Chase Bank, N.A. The swap synthetically fixes 100% of the airport's 2005C bonds, resulting in a net variable-rate percentage of 0%. The 2005C bonds, with a total principal of $131.2 million, represents the only variable-rate debt PHL has outstanding. As of June 15, 2015, the mark to market

value for the swap was approximately $16.0 million, not in the airport's favor. We consider the contingent liquidity risk low for the swap given the rating differential between the rating on the swap insurer and rating triggers that would require PHL to post a material amount of collateral or make a termination payment. The airport has no direct purchase obligations outstanding.

We consider PHL's GARBO provisions relatively weak. They include a rate covenant and projected additional bonds test that incorporate unlimited rolling tests, allowing the airport flexibility to achieve rate covenant compliance or incur additional debt, despite producing low coverage based on pledged operating revenues net of all fixed charges.

Outlook

The stable outlook reflects our expectation that demand will hover near recent levels; that Standard & Poor's-adjusted DSC will stay near 1x; and liquidity will improve but remain at levels we consider weak, despite the airport's significant additional debt plans. We could lower the rating within the two year outlook period if our adjusted DSC calculations are consistently below 1x or PHL's liquidity position materially erodes. We don't expect to raise the rating within the two-year outlook period given the airport's significant additional debt needs and moderately high airline cost structure. A higher rating could result long term if the airport experiences notable increases in demand that we believe are sustainable and that will boost Standard & Poor's adjusted DSC and liquidity to levels we believe are also sustainable and consistent for a higher rating.

Related Criteria And Research

Related Criteria

- Criteria: Airport Revenue Bonds In The U.S. And Canada, Nov. 15, 2013
- USPF Criteria: Contingent Liquidity Risks, March 5, 2012
- Criteria: Methodology And Assumptions: Approach To Evaluating Letter Of Credit-Supported Debt, Feb. 20, 2015
- USPF Criteria: Municipal Applications For Joint Support Criteria, June 25, 2007
- Criteria: Joint Support Criteria Update, April 22, 2009
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Methodology Applied To Bank Branch-Supported Transactions, Oct. 14, 2013
- Criteria Update: Joint-Support Criteria Refined, Feb. 3, 2006
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Ratings Detail (As Of August 10, 2015)		
Philadelphia, Pennsylvania		
Philadelphia International Airport, Pennsylvania		
Philadelphia (Philadelphia International Airport) arpt (BAM)		
Unenhanced Rating	A(SPUR)/Stable	Downgraded
Philadelphia (Philadelphia Intl Arpt)		
Unenhanced Rating	A(SPUR)/Stable	Downgraded
Long Term Rating	AAA/A-1+	Affirmed

Ratings Detail (As Of August 10, 2015) (cont.)		
Philadelphia Auth for Indl Dev, Pennsylvania		
Philadelphia International Airport, Pennsylvania		
Philadelphia Auth for Indl Dev (Philadelphia Arpt Sys)		
Unenhanced Rating	A(SPUR)/Stable	Downgraded
Many issues are enhanced by bond insurance.		

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