MOODY'S
INVESTORS SERVICE

Rating Update: Moody's downgrades the Alaska Airport System's revenue bonds to A1; Outlook revised to stable

Global Credit Research - 30 Jul 2013

The system has $553.2 million in outstanding debt

ALASKA (STATE OF)
Airports
AK

Opinion

NEW YORK, July 30, 2013 --Moody's Investors Service has downgraded to A1 from Aa3 the rating on the outstanding State of Alaska Airports System's revenue bonds totaling $553.2 million. The Alaska International Airport System (AIAS) includes the Ted Stevens Anchorage International Airport and the Fairbanks International Airport.

SUMMARY RATING RATIONALE

The downgrade is based on the change in the airport system's market position due primarily to the slowdown in global air cargo trends. Given the airport system's relatively high leverage, its financial strength has remained constrained by the marked reduction in air freight activity at the airport and a more robust recovery does not appear likely in the near term. The A1 rating reflects the airport system's strong market position as a major air cargo activity point, air transportation hub for the state, and key transportation asset for the State of Alaska (GO rated Aaa) and Municipality of Anchorage (GO rated Aa2).

LEGAL SECURITY: Net revenues of the airport. The debt service reserve has $24.9 million of cash toward the approximately $47 million requirement, in addition to sureties of $2.0 million from Ambac Assurance (ratings withdrawn) and $29.2 million from National Public Finance Guarantee Corp.(rated Baa1, positive outlook).

INTEREST RATE DERIVATIVES: None

STRENGTHS

* Role of air transportation in state economy gives system near-monopoly status of a highly essential transportation service

* Substantial cargo revenues limit exposure to passenger airlines; largest tenant, Alaska Airlines, accounts for only 17% of operating revenues with no other tenant accounting for more than 9%

* Solid liquidity position provides for significant financial flexibility

*Future debt requirements are limited for at least the next five years

CHALLENGES

* Concentration in Alaska Airlines for passenger enplanements

* Above average debt level and airline cost per enplanement due to recent large capital expenditures

* Enplanement levels and cargo traffic have been more volatile than previously expected

* The system's debt service reserve fund is funded with $24.9 million in cash and $31.2 million in sureties from National Public Finance Guarantee Corp. ($29.2M) and AMBAC ($2.0M), but the system intends to contribute $2 million annually to fully cash fund the reserve

DETAILED RATING RATIONALE:

Cargo activity remains well below pre-recession levels and there is little evidence to suggest that will change in the medium term. Unlike most other rated airports, cargo revenues represent the bulk of aviation revenues at Anchorage, accounting for approximately two-thirds of airline derived revenues and over 50% of total operating revenues. Total certified maximum gross take-off weight (CMGTW) at the airport declined 22.1% in FY 2009 then rebounded somewhat in fiscal years 2010 and 2011 with 12.1% and 5.1% growth, respectively. However declines of 9.6% and 5.0% in fiscal years 2012 and 2013 demonstrate that full recovery is not imminent. The fact that these declines come despite improving global economic conditions show how persistent lower air cargo growth is likely to remain at Anchorage. Our negative outlook included, in part, a belief that economic growth would remain stagnant. While global economic growth has outperformed our expectations, recovery in landed weight at the airports has not followed suit. We note that this condition is not unique to Anchorage and that it has generally maintained its market share of US domestic air cargo.

Looking forward we expect air cargo growth will remain below average in the near term due to a number of factors. While economic growth has been resilient, trade between North America and Asia is likely to be pressured as China's growth rate slows and on-shoring/near-shoring trends marginally reduce global shipping. Moody's Global Risk Perspectives publication expects China's GDP to grow at 7% to 7.5% in 2013 to 2014, still robust but lower than recent growth rates including 9.3% in 2011. Air cargo demand has been affected by excess capacity in sea-borne trade since the downturn which has lowered shipping rates. Long-term we expect growth to return to historic levels, but Anchorage's competitive position may be also be reduced as aircraft range increases.

The current rating recognizes that the airport system's finances are quite stable, but that they have stabilized at a lower overall level and with limited expectation of strong improvement. Passenger enplanement levels have shown stability in recent years with a CAGR of 2.8% over the past five years and a slight retreat in FY2013 decreasing 0.7%. Since the economic downturn the airport has been deliberate in using excess reserves to reinforce the funding of the debt service reserve fund and to reduce debt service requirements. As a result, the debt service reserve now has $24.9 million of cash toward the approximately $47 million requirement, in addition to sureties of $2.0 million from Ambac Assurance (ratings withdrawn) and $29.2 million from National Public Finance Guarantee Corp.(rated Baa1, positive outlook). The improving credit strength of National Public Finance Guarantee Corp. also adds strength to this reserve.

Through amortization and the use of cash to pay down additional debt and fund the debt service reserve, leverage has declined markedly. Total debt outstanding has fallen from $644.7 million in 2006 to $553.2 million currently resulting in debt per O&D enplanement, which uses debt net of the debt service reserve amount, decreasing from $246 to $187 in that time. System leverage remains well-above average as a result of large debt taken on in 2006 for the terminal redevelopment project, but with no additional debt planned in the next five years and low long-term capital needs we expect these metrics will continue to improve.

The use of cash to pay debt service has kept cost per enplanement low, but we expect costs to remain elevated. Annual debt service requirements remain fairly level through 2028, but operating expenses have increased by 12.2% and 10.5% in FY 2011 and FY2012, respectively, due to higher costs for deicing materials and higher expenditures for snow removal. Cost per enplanement for passenger airlines has remained below $10, but this is in part due to the airport's use of cash to reduce annual debt service requirements since 2009. While Moody's considered prudent the system's use of excess construction funds to pay debt service, it has masked the system's elevated cost structure. As the system's cash position continues to decrease and it discontinues this practice, cost per enplanement will likely rise to over $10. Without the benefit of this cash use, airline cost per enplanement would have increased approximately $1.10 in 2012 and charges to the cargo carriers would have also been higher. Rising costs would pressure both cargo and passenger activity levels down, further impacting the airport's market position.

Available financial reserves have remained fairly stable, but operating expense increases have eroded their relative strength. Days cash on hand has steadily declined over the past decade from over 800 days to 602 in FY 2012. This, along with management's goal of establishing a relatively lower minimum level of cash reserves to approximately one year's operating expenses following completion of Anchorage's major capital projects leads us to expect lower liquidity ratios in the future. At this time financial reserves remain well above average and represent a key credit strength, the value of which has been demonstrated by the airport's use of reserves to maintain airline costs over the past few years. Our rating incorporates the expectation that management will continue to move toward a level of days cash on hand closer to 400 days, which will somewhat limit its financial flexibility.

The airport has reached a new ten-year operating agreement with the airlines which adds to the stability of the airport's revenues. The agreement began on July 1, 2013 and keeps the current residual rate-setting methodology in place. The agreement allows for mid- and end-year rate adjustments to allow the airport to meet its financial obligations and limits capital spending by including an affirmative majority-in-interest provision that 50% of the signatory airlines must approve any projects that total more than $500 million or that have over $100 million of funding from the rate base.

The new agreement pre-approves $414 million of capital projects in the ten year period, including the system's $197.2 million 2013 to 2018 capital plan (CIP). The five-year CIP is 66% funded by FAA Airport Improvement Program grants and includes no additional debt. This light spending program is heavily focused on pavement maintenance with $134.9 million, or 69% of the total plan, scheduled for pavement reconstruction at Anchorage. The remainder includes smaller expenditures on equipment and annual improvement projects.

Outlook

The stable outlook is based on the airport system's stable enplanement levels, relatively stable operating revenues, and management's proactive steps to use financial resources to reinforce the debt service reserve fund and to manage airline costs.

What Could Change the Rating - UP

Substantial and sustained increase in air cargo activity levels that returns cost per enplanement to near median levels while maintaining current levels of financial liquidity.

What Could Change the Rating - DOWN

Failure to maintain liquidity above the US airport median levels by Moody's calculation, a weakening of the debt service reserve fund, or a sharp reduction in passenger or cargo activity levels that pressures airport costs further.

METHODOLOGY SCORECARD FACTORS:

Factor 1 - Market Position- Total Enplanements: Baa

Factor 1 - Market Position- Size of Service Area: Baa

Factor 1 - Market Position- Economic Strength/Diversity of Area: Aa

Factor 1 - Market Position- Competition for Travel: Aaa

Factor 2 - Service Offering- Carrier Base (Primary): Baa

Factor 2 - Service Offering- Enplanement 5-year CAGR: A

Factor 2 - Service Offering- O&D Passenger Mix: Aa

Factor 3 - Capacity and Capital- Growth & Operational Restrictions: Aa

Factor 3 - Capacity and Capital- Construction Risk: Aa

Factor 4 - Financial Metrics - Airline Cost per Enplanement: Aa

Factor 4 - Financial Metrics - Debt Service Coverage: Baa

Factor 4 - Financial Metrics - Debt per O&D Passenger: Baa

Notching: 1 Notch Change for Liquidity, -1 Notch Discretionary Reserves; 1 Notch Increase for Revenue Diversity

Scorecard Indicated Rating: A1

KEY INDICATORS

Type of Airport:O&D

Rate-making methodology:Residual

FY 2013 System-wide Enplanements: 2.942 million

5-Year Enplanement CAGR 2008-2013:2.8%

FY 2013 vs. FY 2012 Enplanement growth:-0.7%

FY 2013 vs. FY 2012 Cert. Max. Gross T/O Weight growth:-5.0%

% O&D vs. Connecting, FY 2013:95%

Largest Carrier by Enplanements, FY 2012 (share):Alaska (62%)

Airline Cost per Enplaned Passenger, FY 2012:$9.50

Debt per Enplaned Passenger, FY 2012 :$187

Debt Service Coverage, FY 2012:1.33x

RATED DEBT

Series 1999A,B&C Airport System Revenue Bonds, $13.94 million

Series 2003A&B Airport System Revenue Bonds, $62.64 million

Series 2006A,B&D Airport System Revenue Bonds, $259.79 million

Series 2009A Airport System VRD Revenue Refunding Bonds, $50.0 million

Series 2010A,B,C&D Airport System Revenue Bonds, $166.8 million

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The principal methodology used in this rating was Airports with Unregulated Rate Setting published in July 2011. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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