Monetizing Slots, Gates and Routes

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BRIEF:

IN THIS EDITION OF MORTEN BEYER & AGNEW'S INSIGHT SERIES, THE BUSINESS VALUATION & ECONOMIC ANALYSIS TEAM DEFINES AND ASSESSES THE UNTAPPED POTENTIAL OF USING SGR ASSETS AS CAPITAL BY ANALYZING A SECTION OF THE MARKET, IDENTIFYING REGULATORY IMPACTS AND COMPARING THE ENFORCEABILITY AND TRANSFERABILITY OF SGR ASSETS.

Key Concepts:

- *SGR secured debt represents a minority share of an airline's overall debt funding and remains a relatively new concept among airlines outside of North America.*
- *The regulatory environment can have a significant impact on the value of SGR assets.*
- *The long-term nature of these assets means their value is less susceptible to short term fluctuations in the economic environment.*
- *Large-scale monetization of slots, gates and routes outside of North America remains a significant source of untapped capital.*

Slots, Gates and Routes – Monetizing Intangible Assets

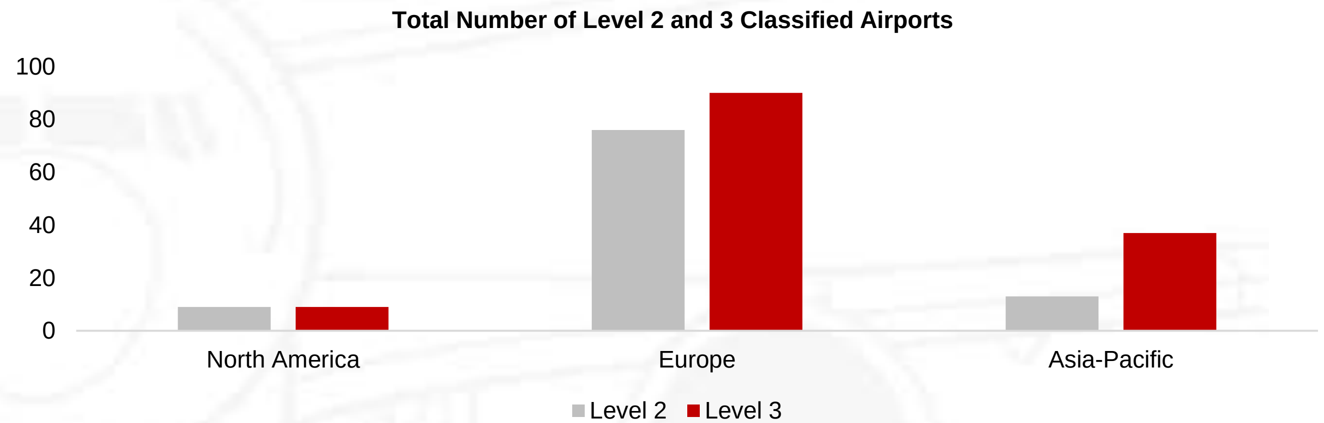
Slots, Gates and Routes (SGR) are immensely valuable assets for airlines, referred to commonly as "intangible" assets for valuation and collateralization. For operators, SGR assets represent strategic long-term competitive advantages and their value helps to raise additional capital for airlines, predominantly based in North America. mba estimates that close to $8.0bn US of debt was outstanding as of December 2016 utilizing slots, gates and routes as collateral. Despite the numbers, large-scale collateralization of SGR to raise capital remains largely untapped in non-US markets.

The use of SGR as collateral for funding purposes relies primarily on lenders' and investors' confidence in the enforceability of the asset; concern is focused on such enforceability in the event of default, as well as maintaining contractually agreed-upon loan-to-value (LTV) ratios. Detailed in the contracts, an independent initial request to provide the appraised asset value serves the joint purposes of calculating initial LTV ratios and subsequent calculations of maintenance of these ratios.

SGR Defined – What Falls Into the Asset Class?

Slots

Generally speaking, the term airport slot covers the range of actions and access an operator may have at a given airport, including land and takeoff and use of related facilities on a schedule basis. The term slot is interchangeable with slot-pair as the use includes time scheduled to land and depart. The International Air Transport Association (IATA) defines an airport slot as "a permission given by a coordinator for a planned operation to use the full range of airport infrastructure necessary to arrive or depart at a Level 3 airport on a specific date and time.[i]" Airports are classified by IATA as a Level 1, Level 2 or Level 3 based on the capacity of the facilities and the demand for access or use. Level 1 airports' capacity generally meet the demand at all times whereas a Level 3 airport's demand for slots significantly exceeds the capacity at the airport and therefore slot allocation requires a coordinator out of necessity. Although most airports in the U.S. are categorized as Level 1 airports under the IATA Worldwide Slot Guidelines (WSG), the Federal Aviation Administration (FAA) has imposed Level 3 slot controls by rule at John F Kennedy International Airport (JFK), LaGuardia Airport (LGA), and Ronald Reagan Washington National Airport (DCA).



Source: IATA, FAA

[i] https://www.hamburg-convention.com/en/hamburg/stories/iata-slots-conference/

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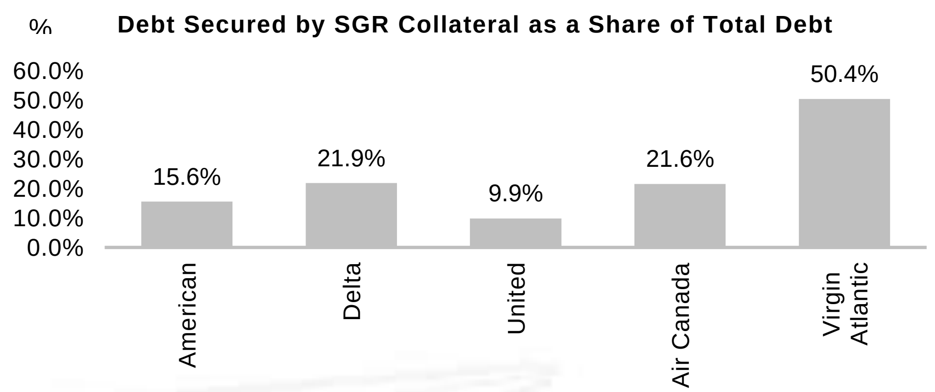
Routes

Routes are defined as the right to operate scheduled air service between specified airports. The route authority is governed by multilateral agreements between countries, and are subject to capacity restrictions at each airport and also between countries. In the United States, the Department of Transportation (DOT) processes requests by U.S. airlines for authority to serve foreign markets. If more carriers seek frequencies than are available, the DOT must allocate the frequencies among the U.S. carriers using comparative selection procedures.

A Brief Look at the Market

A vast majority of outstanding SGR secured debt consists of bank loans between airline and a lending bank. Although the use of slots, gates and routes as collateral in debt financing is common among large North American airlines, it still represents a minority share of total debt financing for these airlines, with the exception of Virgin Atlantic.



Source: Companies' Financial Statements

In December 2015, Virgin Atlantic used its slots at London Heathrow Airport (LHR) as collateral for a private placement bond, raising £225 million ($260 million US) of debt financing, the largest non-bank related debt financing arrangement with SGR as collateral, with proceeds used to finance new aircraft orders. In January 2017, Virgin Atlantic announced it had secured another £32 million ($40 million) of financing on the back off the same slot portfolio. The Virgin Atlantic deal represented the first, and (to this date) only, funding deal where slots outside of US airports were used as collateral in non-bank lending, although British Airways' parent IAG previously attempted in 2012, but proved unsuccessful due to the timing issues, and that transaction's specific complexity.

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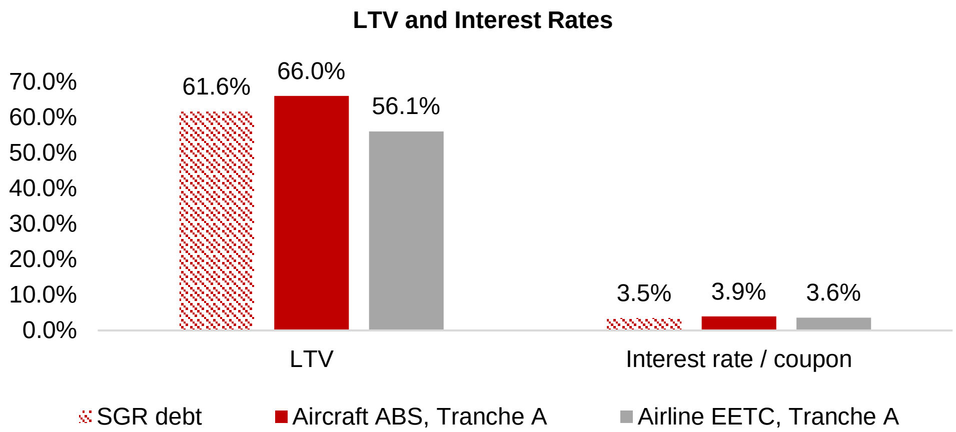
In addition to providing an additional source of funding for airlines and thereby diversifying the funding base, the cost of SGR related debt is relatively beneficial compared with other common sources of aviation financing. The chart below depicts the average publicly disclosed interest rates on debt facilities secured by SGR collateral and the average LTV for the same facilities, in comparison to recent aircraft ABS and airline EETC transactions. On average, interest rates on SGR secured debt facilities are comparable to A-tranches in aircraft ABS and EETCs.



Source: Companies' Financial Statements, Rating Agencies

Regulatory Impact on SGR Assets

While investor confidence to enforceability plays a large role in arranging SGR debt financing, the regulatory environment in various jurisdictions often dictates the starting point for valuing SGR assets. Changes in regulations can have a significant impact on the value of these assets.

In the US, the Department of Justice (DOJ) can mandate divestitures when there are competition concerns as a result of mergers between airlines. Following their merger in 2013, US Airways and American divested a total of 17 slot pairs at LGA and 52 slot pairs at DCA to gain DOJ approval. Private auctions for these slots at LGA and DCA, respectively, were limited to Low-Cost Carriers. Ultimately, at DCA, Southwest Airlines won six pairs plus five pairs it was already leasing from American, while Virgin America won bids for six slot pairs. At DCA, Southwest Airlines won 28 pairs, JetBlue Airways won 12 pairs, plus eight they were already leasing, and Virgin America won four pairs.

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The US Department of Transportation (DOT) also plays a role in the management of SGR. It granted antitrust immunity in 2016 for the proposed alliance agreements submitted by Delta Air Lines and Aeroméxico. This was on the condition that the carriers divest takeoff and landing slots to support 24 new daily transborder services from Mexico City and four new daily transborder services from New York JFK, to be operated by competing airlines. The American and Delta examples above illustrate the impact regulatory actions have on competitive environment and SGR values.

Beyond North America, regulation can, in addition to evaluating slots for competition, impact the distribution of trans-ocean routes. In December 2016, the DOT finalized its decision to award American Airlines route authority between Los Angeles and Beijing. Delta Airlines had also filed an application, however the DOT determined that American Airlines' superior connectivity (resulting in a higher number of U.S. travelers benefitting from one-stop connections over Los Angeles) was significant enough of a factor to award the route to American.

Asset Enforceability and Transferability

As SGR is considered an intangible asset, establishing parties' legal rights and generally market interests are together the center piece to demonstrate discernable value for the parties transacting, the relatively small number of completed sales transactions make benchmarking difficult, and attracting investment using these assets is complicated by lack of information. However, there are indicators of the inherent value, enforceability and transferability of the asset worth reviewing.

Although sales of SGR assets occur less frequently, several examples of slots and routes transactions are notable. The table below contains slot sales at London Heathrow Airport, LaGuardia Airport, and Ronald Reagan Washington National Airport over the past decade, their value being shown in the market demand.

Sale Year	Airport	Asset	Buyer	Seller
2006	LHR	1 slot pair	British Airways	BWIA
2008	LGA	7 slot pairs	Southwest Airlines	ATA Airlines
2011	DCA	8 slot pairs	JetBlue	US Airways
2016	LHR	1 slot pair, morning peak	Oman Air	Air France-KLM
2017	LHR	1 slot pair	Delta	Croatia Airlines

Sales of routes occur less frequently than slots, however multiple transactions between 1982 and 1992 are informative to value and opportunity. Approximately $3.0bn worth of route transactions occurred during this period as shown in the following table. A majority of these sales were a result of bankruptcy proceedings.

Sale Year	Asset	Buyer	Seller
1989	Latin American routes	American Airlines	Eastern Airlines
1990	Seattle - Tokyo route	American Airlines	Continental Airlines
1991	3 London - U.S. routes	American Airlines	TWA
1991	PHL, BWI - London route	USAir	Trans World
1991	Latin America routes*	United Airlines	Pan Am. World Airways

**Included slots in New York, Washington and Chicago. Source: The New York Times, Chicago Tribune*

The legal view of SGR collateral is equally up to benchmarking the asset value in the market, and the use of slots, gates and routes as collateral has been supported by several US courts. In the American Airlines bankruptcy case, the route authorities and gate leaseholds that had been used as collateral in certain of its lending agreements were deemed as valid. Ultimately, American Airlines prepaid these loans early and the creditors received full payout, with no impairment of their security interest. Another example where the validity of SGR assets was upheld in court is the case of Monarch versus Airport Coordination Limited. The court ruled that Monarch in fact had the right to its slots for the 2018 summer season at London Gatwick airport, despite having had its Air Operator Certificate revoked (see: How Monarch Monetized Gatwick Slots Post-Collapse). The right to sell an asset out of Bankruptcy as ruled by the court in the Monarch case provides further validity to the use of SGR assets as collateral.

Finally, even in instances where sales of SGR are prohibited by regulation and transferability of the asset cannot take place, there is inherent intangible value in the asset. This is because airlines can lease the asset to a partner airline rather than sell it in order to obtain long term rights to the slot. In fact, slot leasing is more common than slot sales as airlines prefer to retain the long term rights to the asset. Therefore, where sales are prohibited, it is possible to generate a return on the asset while maintaining long term ownership rights.

Conclusion

Large North American Airlines have successfully monetized their slots, gates and routes to raise financing. That said, SGR secured debt still represents a minority share of an airline's overall debt funding and remains a relatively new concept among airlines outside of North America. The regulatory environment can have a significant impact on the value of SGR assets, as illustrated above. However, regulation tends to change infrequently and the long term nature of these assets means their value is less susceptible to short term fluctuations in the economic environment. Moreover, the validity of slots, gates, and routes as collateral has been upheld in several court cases predominantly in North America, but also more recently in the UK. While the Monarch ruling should improve investor confidence in SGR assets, large-scale monetization of slots, gates and routes outside of North America remains a significant source of untapped capital.