Memorandum

CITY OF DALLAS

DATE October 30, 2020

TO Honorable Mayor and Members of the City Council

SUBJECT **S&P Global Ratings Downgrades Love Field Airport Modernization Corp. General Airport Revenue Bonds Due to COVID-19 Pandemic – RATING ACTION**

Today, S&P Global Ratings (S&P) lowered its long-term rating to ‘A-’ from ‘A’ on the Love Field Airport Modernization Corp. (LFAMC) General Airport Revenue Bonds (GARBs) issued for Dallas Love Field Airport (DAL). The outlook remains negative.

This downgrade follows a review by S&P at the end of March of this year in which the outlook was deemed negative and, “DAL, along with many other U.S. airport ratings, was placed on CreditWatch to reflect the material negative impact of the COVID-19 pandemic on traffic levels, expected financial performance metrics, and overall credit quality.” S&P’s rating decision reflects the expectation that, “activity levels at DAL will be depressed, unpredictable, or demonstrate anemic growth due to the COVID-19 pandemic and associated effects outside of management's control,” further based on their belief that, “a high degree of uncertainty exists regarding the trajectory of a recovery in aviation activity, complicating financial planning and increasing operational challenges”.

The report from S&P notes that DAL entered the pandemic operationally and financially strong, with enplanements at an all-time peak, historically strong debt service coverage levels and good liquidity, however, “the enplaned passenger levels declined 39.1% to 5.06 million in fiscal 2020 (ended Sept. 30) from 8.31 million in fiscal 2019, following depressed activity levels since March.” According to S&P, “enplanements improved from the most severe declines experienced in April and May, but remain materially depressed.” In spite of these challenges, S&P notes DAL’s credit strengths as an “important provider of air service in the expanding Dallas-Fort Worth-Arlington MSA,” in a “good liquidity position,” with a “very strong management and governance, reflecting an effective and experienced management team that has sufficiently managed risks and operations.”

S&P’s assessment follows the assumption “among health experts,” that “the pandemic may now be at, or near, its peak in some regions but will remain a threat until a vaccine or effective treatment is widely available, which might not occur until the second half of 2021.” As such, S&P “could revise the outlook to stable in the next two years with improved clarity on the trajectory of DAL's enplanement recovery and stabilization of activity levels,” evaluating if the airport's “ability to maintain financial metrics is achievable, sustainable, and consistent with the rating.”

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Please find attached the report provided by S&P today. If you have any questions or need further information, please do not hesitate to contact me.

M. Elizabeth Reich

M. Elizabeth Reich
Chief Financial Officer

Attachment

c: T.C. Broadnax, City Manager
Chris Caso, City Attorney
Mark Swann, City Auditor
Bilierae Johnson, City Secretary
Preston Robinson, Administrative Judge
Kimberly Bizor Tolbert, Chief of Staff to the City Manager
Majed A. Al-Ghafry, Assistant City Manager
Jon Fortune, Assistant City Manager
Joey Zapata, Assistant City Manager
Dr. Eric A. Johnson, Chief of Economic Development & Neighborhood Services
M. Elizabeth (Liz) Cedillo-Pereira, Chief of Equity and Inclusion
Directors and Assistant Directors

S&P Global
Ratings

RatingsDirect®

Summary:

Love Field Airport Modernization Corp., Texas; Airport

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Table Of Contents

Summary:

Love Field Airport Modernization Corp., Texas; Airport

Credit Profile		
Love Field Airport Modernization Corp AIRPORTS		
Long Term Rating	A-/Negative	Downgraded, Removed from CreditWatch

Rating Action

S&P Global Ratings lowered its long-term rating to 'A-' from 'A' on Love Field Airport Modernization Corp. (LFAMC), Texas' general airport revenue bonds (GARBs) issued for Dallas Love Field Airport (DAL), and removed the rating from CreditWatch, where it had been placed with negative implications Aug. 7, 2020. The outlook is negative.

DAL, along with many other U.S. airport ratings, was placed on CreditWatch to reflect the material negative impact of the COVID-19 pandemic on traffic levels, expected financial performance metrics, and overall credit quality. For more information, see "U.S. Airport Ratings Placed On CreditWatch Negative On Severe Passenger Declines And Weakening Credit Metrics," published Aug. 7, 2020, on RatingsDirect.

Net airport system revenues, as made available by the city under a project financing agreement with the LFAMC, secure the bonds. A debt service reserve fund funded to the lesser of the IRS maximum provides additional security to bondholders. A rate covenant (1.25x debt service coverage [DSC] based on average annual debt service) is in effect, as is an additional bonds test requiring that historical net revenues provide at least 1.1x DSC or projected net revenues provide at least 1.25x DSC, respectively. We consider the bond provisions credit neutral.

As of October 2020, DAL had approximately $625.5 million in total debt outstanding, which includes $213.97 million in general airport revenue bonds (GARBs), $407.46 million in Southwest bonds (revenue credit agreement), and $4.07 million in pension obligation bonds. All debt is fixed rate with no swaps or variable-rate debt outstanding.

Credit overview

The rating action and negative outlook reflect our expectation that activity levels at DAL will be depressed, unpredictable, or demonstrate anemic growth due to the COVID-19 pandemic and associated effects outside of management's control. In our view, the severe drop in demand has diminished DAL's overall credit quality and will likely pressure financial metrics relative to historical levels. We view this precipitous decline not as a temporary disruption with a relatively rapid recovery, but as a backdrop for what we believe will be a period of sluggish air travel demand that could extend beyond our rating outlook horizon.

DAL entered the pandemic operationally and financially strong with enplanements at an all-time peak (8.31 million enplaned passengers in fiscal 2019), historically strong DSC levels, and good liquidity. However, enplaned passenger levels declined 39.1% to 5.06 million in fiscal 2020 (ended Sept. 30) from 8.31 million in fiscal 2019, following depressed activity levels since March. Enplanements improved from the most severe declines experienced in April and May, but remain materially depressed; August and September enplanements declined about 58% and 56%, respectively, compared with 2019. In addition, we believe a high degree of uncertainty exists regarding the trajectory of a recovery in aviation activity, complicating financial planning and increasing operational challenges. For additional information, see "This Time Is Different: An Anemic And Uncertain Passenger Recovery Will Challenge U.S. Airports' Credit Quality," Aug. 7, 2020, and "Activity Estimates For U.S Transportation Infrastructure Show Public Transit And Airports Most Vulnerable To Near-Term Rating Pressure," June 4, 2020.

The rating reflects DAL's adequate enterprise risk profile and strong financial risk profile. Our forward-looking view resulted from a weakening of DAL's market position assessment due to effects related to COVID-19, which in turn lowered our enterprise risk profile assessment to adequate from strong. Under our criteria, market position is a primary credit factor that incorporates activity level trends; passenger volatility; rate-setting flexibility; and additional considerations outside of the operator's control, including health scares. Within our overall enterprise risk profile, market position assessment is the highest-weighted factor (60%), followed by industry risk (20%), economic fundamentals (10%), and management and governance (10%). Within our overall financial risk profile, we consider such factors as financial performance (55% weight), debt and liabilities capacity (35%), and liquidity and financial flexibility (10%). For additional information regarding our criteria, see "U.S. And Canadian Not-For-Profit Transportation Infrastructure Enterprises: Methodologies And Assumptions," March 12, 2018.

Our revised market position assessment for DAL results in a lower-but-still-adequate overall enterprise risk profile. This reflects our view of the airport's role as an important provider of air service within the region with strong historic enplanement growth, as well as its position as a key component of Southwest Airlines Co.'s route system, supported by a growing demand base, centered on the Dallas-Fort Worth-Arlington metropolitan statistical area (MSA). Tempering our assessment is significant air carrier concentration, with Southwest at 94% of total enplanements in fiscal 2019; local competition from Dallas Fort-Worth International Airport (DFW); and moderate exposure to connecting traffic (about 32% of total enplanements). The financial risk profile is unchanged at strong overall, as we continue to evaluate management's strategy and the shape of the traffic recovery along with the anticipated impact on financial metrics. Our financial risk profile incorporates DAL's strong financial performance, with DSC of 1.85x in fiscal 2019 (S&P Global Ratings-calculated; 5.57x GARB indenture coverage in fiscal 2019); moderate cost and debt structure ($10.27 cost per enplanement S&P Global Ratings-calculated; $77 debt per enplanement--all for 2019); debt-to-net revenues of 8.3x in fiscal 2019, with a manageable capital improvement plan and no additional near-term debt needs; and good liquidity (estimated $42.9 million in unrestricted reserves in fiscal 2020) equal to 171 days' cash and 6.7% liquidity to debt using 2019 expenditure and debt figures.

We anticipate financial performance (DSC) in fiscal years 2020 (based on preliminary estimates) and 2021 will be lower than in recent years. Existing liquidity in concert with mitigation measures taken thus far to reduce expenditures, and the $53.8 million in Coronavirus Aid, Recovery, and Economic Security (CARES) Act funding will allow DAL to weather the near-term activity declines. Management applied $24 million of CARES Act money in fiscal 2020 with $4 million allocated to capital projects, $10 million to debt service requirements, and $10 million to operations and maintenance (O&M). The remaining balance will be used in fiscal 2021 to offset revenues losses from COVID-19 and is expected to be applied to debt service requirements and O&M. In response to COVID-19, DAL provided concessionaires relief with contracts adjusted to a percentage of rent, and also provided three months of rent abatement to rental car providers that did not receive any federal aid. Furthermore, DAL's skilled management team continues to implement measures to reduce expenses, defer capital spending, and manage rental car and concessionaire relief. Although estimated revenue impacts to DAL appear to be manageable at this time, the projected effects on future key financial metrics are subject to considerable uncertainty, in our view. We could weaken the financial risk profile if enplanements remain depressed for an extended period, further pressuring financial metrics, including DSC (S&P Global Ratings-calculated) and debt-to-net revenue.

Key credit strengths, in our opinion, are DAL's:

- Role as an important provider of air service in the expanding Dallas-Fort Worth-Arlington MSA, along with its position as a key component of Southwest's route system with strong historical enplanement growth prior to the COVID-19 pandemic. Tempering our assessment is significant air carrier concentration, competition from DFW, and moderate exposure to connecting traffic;
- Good liquidity position, with $42.9 million in estimated unrestricted reserves in fiscal 2020 (unaudited) providing 171 days' cash on hand and 6.7% liquidity to debt based on 2019 figures, bolstered by an infusion of CARES Act funds that DAL expects to deplete in fiscal 2021;
- Large and economically vibrant service area, which encompasses the Dallas-Fort Worth-Arlington MSA (fourth-largest MSA in the U.S.), supported by a large and growing population base, good economic activity as measured by GDP per capita, and ample employment opportunities despite the spike in unemployment resulting from COVID-19; and
- Very strong management and governance, reflecting an effective and experienced management team that has sufficiently managed risks and operations, as demonstrated by steady financial and operational performance during periods of significant growth.

Key credit weaknesses, in our opinion, are DAL's:

- Exposure to potentially prolonged weak or unpredictable enplanement levels as a result of COVID-19 outbreaks and lingering associated effects (such as the pandemic-induced recession, shifts in travel restrictions, stay-at-home and social distancing restrictions, or behavioral changes with respect to air travel), making effective financial budgeting and planning challenging;
- Constrained cash flow generation ability as a result of severe enplanement declines related to factors outside of management's control, pressuring financial metrics; and
- Significant airline concentration, with Southwest (BBB/Negative), its largest carrier, accounting for approximately 94% of total enplanements in fiscal 2019.

Environmental, social, and governance (ESG) factors

Our rating action reflects health and safety risks posed by the COVID-19 pandemic and its impact on passenger activity due to mobility restrictions and behavioral changes related to travel, which we view as a social factor within our ESG factors, resulting in significant operating and financial pressures for the airport. We analyzed DAL's risks related to environmental and governance factors, and consider them to be in line with our view of the standard for the airport sector. We will continue to evaluate these risks as the situation evolves.

Negative Outlook

Downside scenario

We could lower the rating if we come to believe that DAL's enplanements will remain materially depressed for longer than we expect, negatively affecting financial metrics for an extended period.

Return to stable scenario

We could revise the outlook to stable in the next two years with improved clarity on the trajectory of DAL's enplanement recovery and stabilization of activity levels. When making this assessment, we will evaluate if the airport's ability to maintain financial metrics is achievable, sustainable, and consistent with the rating.

Credit Opinion

S&P Global Ratings acknowledges a high degree of uncertainty about the evolution of the pandemic and its effect on the economy and air travel. The consensus among health experts is that the pandemic may now be at, or near, its peak in some regions but will remain a threat until a vaccine or effective treatment is widely available, which might not occur until the second half of 2021. We are using this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

The U.S. economy has begun what looks to be a long, difficult journey to recover from its pandemic-induced slump. With consumer spending proving largely resilient through the summer of 2020 (helped by federal fiscal stimulus) and unemployment--while still notably high--softening a bit more than S&P Global Economics had forecast, third-quarter GDP is poised for a steeper rebound than many market participants expected. S&P Global Economics expects a 29.5% bounce in third-quarter U.S. GDP (6.7% annualized rate), although that will only partially offset the massive losses in the first half of the year. Our current economic forecasts anticipate ending 2020 at a negative 4.0% real GDP growth rate in 2020 and rebounding to a slower growth phase heading into 2021 with 3.9% estimated for next year, down from 5.2% in June's economic forecast and weaker than our previous 2021 estimate of 6.2%. The unemployment rate declined to 8.4% in August from its post-1947 record high of 14.75% (in April 2020); however, S&P Global Economics doesn't expect the unemployment rate to reach its pre-pandemic level until mid-2024. Our economic forecasts and macro credit implications associated with the pandemic assume a vaccine or effective treatment is widely available in the second half of 2021. As this sluggish recovery unfolds, three big risks remain: no coronavirus vaccine yet available as the country heads into flu season, a lack of new fiscal stimulus, and trade tensions with China on the rise. (See "Economic Research: The US Economy Reboots, With Obstacles Ahead," Sept. 24, 2020.)

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.