

NEXT STEP IPO?

Investment in the airline services and handling industry has come thick and fast; it has also come from many and varied sources. Today, enthusiasm for investment in this sector continues. Jo Murray surveys the scene, identifies key deals and asks the experts where the pockets of opportunity lie

Deal after deal for investment in airline services and handling companies has been announced over the last decade. We have seen private equity participation, industry consolidation as well as investors working with handling company management to steer growth in a business that can only continue to burgeon.

If there have been any surprises, perhaps it is the extent to which private equity has been keen to participate in a service industry which – perhaps – remains hard to fathom for those operating outside it. But the examples of private equity interest in this service business litter the aviation landscape and continue to accrue.

EQUITY EVOLUTION

Investment from private equity participation has been particularly noteworthy for the sums involved; but also for the swift exits following significant achievement and further consolidation. Let us remember that Candover invested €393 million in Swissport in February 2002 only to exit three years later when Candover sold the Swiss handler to Ferrovia. Candover, at the time, acknowledged that Swissport was well positioned to drive consolidation in the market and, indeed, it did.

Further back, similar timescales were at play when Castle Harlan acquired Worldwide Flight Service in April 1999 from AMR – American Airlines parent – in a deal that almost set the stage for the later Swissport acquisition. By September 2001, Castle Harlan exited the investment by selling for \$295 million to Vinci SA, having grown the US based handler through acquisition. Of course WFS is now owned by LBO France, the French private equity company.

More recently we have seen private equity participation from 3i which has

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Clive Dolman,
Managing Director, Candover

shown itself to be a significant supporter of aviation industry acquisition; witness the investment in low cost airline Go Fly and aircraft maintainer SR Technics. In July 2005, 3i bought airlines services

business Aviapartner for a reported £160 million. The private equity participant works in partnership with Aviapartner management to pursue international expansion, both organically and through acquisition.

Another private equity fan of aviation company investment is the Carlyle Group which has companies such as aircraft repairer Aviall and engine module builder Avio SpA in its portfolio. Although the equity participant has not bought into a handler, it has bought a major provider of transportation communications and

PRIVATE EQUITY PARTICIPATION: SEEKING REVENUE AND EARNINGS GROWTH THROUGH MARKET GROWTH AND PENETRATION AS WELL AS CONSOLIDATION OPPORTUNITIES

Candover practices a philosophy of investing in companies with strong management and then backing management to build the businesses both organically and through investment in target companies with a view to an exit within a three to five year timeframe. The private equity partnership believes management's full involvement is crucial to the success of its deals.

Candover has invested in a number of sectors over the past 25 years, including the support services sector. Clive Dolman is a Managing Director at Candover and formerly Chief Financial Officer of Swissport, a company providing a variety of different services to the airline industry including baggage, passenger and cargo handling, security, cleaning and maintenance services. The Candover 2001 Fund that invested in Swissport in 2002, also invested across a whole range of industries – not just airline-related businesses.

All the service companies in which Candover has invested are exposed to potential growth as a result of the continuing trend towards outsourcing across the globe. At Candover, the quest is for strong earnings growth potential and for businesses that can potentially gain greater market share both through additional services and market consolidation.

"As a private equity investor, the biggest source of value creation is through growing the top line. Inevitably there will always be some cost cutting, but this is not the main value driver," he says. "In the case of Swissport, we acquired Cargo Service Centre, which gave us an additional leg to the business and added top line growth. We also bought Groundstar, which specialised in the low cost/charter airline segment and so created a new opportunity within our existing business which, until then, had been primarily involved in servicing the scheduled airlines."

In terms of when to exit and realise a private equity investment, Dolman comments: "This tends to be market driven. In the case of Swissport, we were approached by Ferrovia, amongst others, who offered an attractive price based on what they believed they could add to the business in taking it to the next level".

Dolman explains that the 2001 Candover Fund (€1.5 billion) was followed by the 2005 Candover Fund (€3.5 billion). The private equity partnership – in keeping with a number of other private equity players – raises a new fund every three to four years and will continue to seek to generate value in whichever businesses, be they services or otherwise, offer the best potential going forward.

systems provider - ARINC - which is working with airports and airlines to implement CUSS passenger handling technologies amongst others.

UNLOCKING VALUE

So why the interest in investment in aviation services; what is driving this trend? Peter Bluth is a Partner in Corfina - a corporate finance partnership in Frankfurt, Germany, and was previously associated with Lufthansa and its airport service subsidiary, GlobeGround, which was acquired by Penauille Polyservice from Lufthansa. He comments: "The ground handling industry is interesting because it's a growth market. There are three growth factors. First there is the growth in aviation which is about 5-6% globally per annum. If air traffic grows at that rate then the request for handling services will grow at a similar rate."

Bluth continues: "The second issue, especially in Europe, is ongoing market liberalisation which has been instigated by the European Commission whereby handling monopolies have to be opened up to at least two licensees. A new Directive is in preparation whereby airports where there are 20 million passengers per year might be requested to allow three handling agents to operate. This brings further market liberalisation and the opportunity for handling companies to grow their businesses."

The final factor is, of course, airline outsourcing potential. "Many airlines have already outsourced part of their handling business - primarily ramp handling - although in many cases airlines still pursue their own passenger handling. Some of the carriers still provide ramp handling services in their own countries. In North America, especially, many carriers are still undertaking complete handling services at many airports. In our opinion there is a huge potential for independent ground handling companies one day to take over



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these businesses from the airlines," comments Bluth.

But it is not just acquisitions from airlines that are being sought; divestments from handling companies are also being pursued. Ludwig Bertsch heads up Equilog Management which - along with Zurich-based Afinum Management - led a consortium of investors who acquired a majority shareholding in Unitpool from Swissport in autumn 2007. Unitpool is an airline service company which, for strategic reasons, no longer fitted into the Swissport portfolio. In acquiring this shareholding, Bertsch's Equilog Management and the Afinum Group laid a sound foundation for additional joint acquisitions worldwide in the aviation services and aviation-related logistics fields. The partners now aim to engage in further investments in this market.

When asked why invest in this sector, Bertsch responds: "Aviation and logistics are still fast growing industries and benefit from the mega trend of globalisation. Even so, a lot of consolidation has taken place already; but there are still some very fragmented parts of the industry with some smaller to medium sized local players or niche services who so far have not been on the radar screen of players active in industry consolidation."

Bertsch continues: "Unitpool is an example of a small industry niche with big growth potential and also a business model which should benefit from any industry downturn as cost pressure

will force the consideration of outsourcing even smaller functions, such as ULD management. Some security services might be other examples as are many more niche services currently performed around airports and still in an early stage of consolidation."

When investing in an aviation services company, what are the guiding principles for Bertsch? "We are looking for attractive niche services with proven business models and good growth potential. Those services might currently be offered only locally and have the potential to be rolled out nationally or even internationally. The current management or owners might not have the skills or means to undertake an international roll out and need growth capital."

Bertsch also sees an opportunity for spin-offs from the larger established players who might want to concentrate on core business and might not want to fund all activities within their portfolio of services. "We have seen some areas which might not be attractive for the big players anymore, as those activities cannot carry the overhead burden of big corporations, but show healthy profits if managed lean outside a big structure. In general, we plan to follow a buy and build strategy so, by acquiring several smaller players within a given sector, we will try to build some critical mass around specific niche services. Therefore the business models need to be scalable."

Last but not least, Bertsch expects that airlines might consider spinning off certain services which currently are performed in house and have the potential to become stand alone businesses.

In the final analysis, what can Equilog and Afinum - or indeed any private equity investor - bring to the table to add value to an airline services operation? "In general, private equity can offer the growth capital to develop a business to the next stage, be it international expan-



This may be the cycle that brings businesses out of private equity ownership

Philip Harnden,
Executive Vice President,
Commercial, Menzies Aviation

sion, the introduction of new services or investment in new technology. It also has the capabilities to support an M&A strategy which might not have been feasible without access to capital and M&A know-how," responds Bertsch.

Also, he reminds us, private equity, in many cases, helps to achieve the most from the balance sheet by smart financial engineering; usually this is not the focus of smaller owner managed businesses. "Private equity is also able to facilitate the strategic planning process and help a business focus on delivery of its chosen strategy by providing the tools, techniques and processes to deliver," he comments.

SECTOR SPECIFIC INVESTMENT

It might well be that aviation services and handling companies breathe a sigh

of relief when private equity companies show an interest in this sector and buy into market growth potential, but an understanding of the shape and scope of the handling industry, the dynamics and its shortcomings must surely be desirable too.

In some sectors of the aviation industry, ownership by private equity investors has been observed with caution for fear that time horizons will be

short. Witness Dubai Aerospace Enterprise's (DAE's) acquisition of Standard Aero (which was first owned by Doughty Hanson and then the Carlyle Group) and Landmark Aviation (which was owned by the Carlyle Group). New ownership by an aerospace conglomerate means that Standard Aero and Landmark Aviation – as a combined entity under the DAE banner – are no longer guardians of private equity; now the merged companies are playing the long game and focusing on delivering technology driven results.

For a services company – like an airline handling organisation – the imperatives of developing new aviation technologies over a long timeframe are not present and therefore sorely needed investment, the opportunity to grow in a consolidating market and the ability to

INVESTMENT FROM WITHIN: MENZIES AVIATION KEEPS ON INVESTING IN HANDLING

Menzies Aviation is a subsidiary of a public limited company (PLC) and has a history of investment in airline services businesses; but Philip Harnden, Executive Vice President, Commercial at Menzies Aviation, insists that being the subsidiary of a PLC makes no difference to Menzies Aviation's investment strategy.

"Because we are part of a public company, what we do has a visibility that we might not have if we were privately owned. Our parent company has to publish six-monthly results and performance statistics; but in terms of the actual investment criteria, they do not change at all as a result of our shareholding. We have to deliver shareholder value as any organisation would."

For Menzies, investment in airline services businesses is a long game. "Our objective is to be a long term sustainable business," Harnden states firmly. He is unfazed by the actions of other investors in this market and their imperatives. "We are just interested in doing what is right for our business, our customers and our shareholders"

When asked further about the criteria

upon which Menzies' investment strategy is built, Harnden responds: "We have our 'attractiveness strategy' where we aim to build businesses which will add value for our customers – and we have a core group of customers with whom we aim to expand. There are also certain airports in the world that are attractive for us to enter; perhaps airports at which handling has been very restricted for a number of years, where we consider handling companies to be inefficient, or where there is some opportunity for us to do something for our customer base – or the market as a whole – that will enable us to create value."

For Menzies, any investment has to achieve certain expectations in terms of return on investment and wise use of capital. There is also consideration paid to the appropriate use of internal resources. "We need to use management on the projects that are going to deliver maximum value, deliver strategic value and not spend time on marginal projects," he emphasises.

Harnden sees the aviation down cycles as

an opportunity for further consolidation in the handling market but, investors must have robust businesses that can withstand both the impact of the investment on capital and the impact of the down cycle. Less robust businesses will suffer disproportionately in a downturn and that very suffering becomes an opportunity for further consolidation. "This may be the cycle that brings businesses out of private equity ownership," he comments.

As to the future shape of the airline handling industry, Harnden sees lots of shades of grey. "Ground handling is not a perfect market. There are a lot of parts of the world where there are still restrictions on ownership and licences. There are also many of elements that work to stymie competition in this sector. A lot of businesses are protected in this way and so they become relatively immune to normal market pressures on quality, service and pricing," says Harnden. "Most airlines would argue for the open market philosophy as we are also vigorous in doing."



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Ludwig Bertsch,
Head of Equilog Management

explore market liberalisation are being welcomed. But sector specific knowledge surely helps.

"So far, most private equity funds are multi-sector funds and this means that they invest in many industries and sectors," says Bertsch. "Even though private equity managers are very good at understanding different industries; usually none of them is a real expert in one industry. So private equity tends to judge and manage a business based more on the financials and overall sector trends."

He continues: "We also see that many private equity firms are raising increasingly large funds so that, in many cases, the potential targets are becoming increasingly too small as the preferred transaction sizes of the established players become bigger. A fund which might have considered a €50 million transaction in 2005 might not consider anything below €100 million currently. On the other hand, those funds which invest in small to medium sized transactions mostly have a geographic focus and might not be allowed to invest outside their geographic area."

Bertsch sees the Equilog and Afinum's USP as a focus on small to medium sized deals, without geographic limitations, combined with industry know-how and the hands-on support of Equilog. "In our case, Afinum brings its vast experience of buy outs of small to medium businesses; many of them family owned and managed. Equilog brings industry sector knowledge and contacts as well as the management capabilities which some of the players in our target segment might have been missing," he says.

"In general, we aim to be long-term partners; even so it is in the nature of our business that we want to realise our investment after we have achieved what we aimed for with the business," comments Bertsch.

CYCLES AND MORE CYCLES

If there is one sure thing about the aviation industry it is that its cycles will continue to roll, bringing with them good times and bad times.

Not only that, pressure in the established airline market is becoming intense with low cost airlines having gained market share, fuel price increases and fleet replacement programmes making demands on capital. One method for coping with the high cost environment being discussed in airline boardrooms is to visit suppliers – and these include ground handlers – to ask for reduced rates. "This has the positive effect on handlers that they have to make their operations as efficient as possible and it also supports the consolidation process of the handling industry," comments Bluth. "The result is networks, synergies and a larger handling volume to offer to airlines. In the future, airlines will have more and more network contracts through which they can participate in the synergies."

Before networks can be formed, investors have to become comfortable with the cycles: "Indeed it is the nature of this industry to be cyclical," comments Bertsch. "You have to be able to manage and run a tight ship during the downturn and benefit from the upturn."

He reminds us that many businesses in aviation services are not as subject to the huge yield and volume changes as the airlines themselves and, if properly managed, can show sustainable profits even in a downturn." Bertsch remarks:

"As we seem to be heading into a downturn right now and during the next two years, we see investment opportunities to invest anti-cyclically and to use those investment opportunities to position the businesses to our benefit once the cycle goes upwards again."

Bluth agrees that, despite this period of reorganisation, consolidation and downward pressure on pricing, investors remain interested in this very changeable industry. "Ground handlers usually still achieve an EBIT [earnings before interest and taxation] margin of 4-5%. Some who are not as efficient and who do not have a substantial network may have more problems and do not achieve these reasonable margins," comments Bluth. "Investors are interested in any case in a growth industry. With consolidation, you reduce the negative effect of competition and therefore margins at around 5% of EBIT are still seen as reasonable."

M&A CYNICISM DASHED

We have all read the reports on how M&As do not work over the long term because of culture clashes, the cost of integration and wrong assumptions, but Bluth is convinced that in the airline services and handling industry, M&As succeed. "Of course there is the cultural element but then you have the benefit that you can streamline the administration, substantially reduce the overhead and you have better key account management," he says. "These deals are also to the benefit of the acquired company."

Bluth sees the consolidation in the market driven by investors as being a very positive move in that it will create a strong, stand alone handling sector in its own right.

"In some years to come I think a leading ground handling company might be ready for an IPO," he concludes. ☺