

Review of the business

The Group, branded London City Airport, operates London City Airport (“LCY”). LCY is primarily a business airport serving over 40 destinations across the UK and Europe and connections to the rest of the world through major European hubs. LCY offers passengers a time saving proposition and its location means it is 15 minutes by road to Canary Wharf and 23 minutes to the City by Docklands Light Railway. We pride ourselves in enabling the vast majority of passengers to pass through our facility in 10 minutes for arrivals and 20 minutes for departures and we offer everyone a business class experience.

Business traffic was hit hard by the recession. Between 2007 and 2010, business traffic at UK airports fell 29% (20% for leisure traffic). After almost continuous decline since early 2007, business traffic started to grow again in 2011 and continued to grow in 2012. Pertinently for LCY, the UK market which had seen strong growth in business travel and foreign residents visiting for business purposes was negatively affected due to the 2012 London Olympics.

LCY handled 3 million passengers in 2012 (growth of 1% on 2011) reflecting strong underlying demand for its route network.

LCY’s top 10 destinations continue to remain stable, accounting for c72% of passengers in 2012. This is not expected to change significantly in 2013. Collectively, the three main airline alliances of Oneworld (British Airways), Star Alliance (Lufthansa and Swiss) and SkyTeam (Air France-KLM/Cityjet) account for c92% of scheduled LCY traffic. The “sunshine” destinations that were added to compliment the regular business focussed routes will continue in 2013.

Key performance indicators

	Year ended 31/12/2012	Year ended 31/12/2011
Total passengers (000's)	3,017	2,993
Aircraft movements (scheduled & general)	70,523	68,203

Retail and other income

Commercial income will continue to build on 2012 as passenger numbers grow and retail and food and beverage outlets continue to fine tune their offer to maximise income on the back of strong contracts in place. In addition, our recently recruited Director of Non Aero income will focus on new business opportunities driving incremental revenue streams.

Business aviation

The Corporate Aviation market has been challenging, suffering a significant reduction in traffic whilst key customers in the financial services sector continue to look for ways to reduce costs. In order to combat these challenges, a Director of Business Aviation was recruited towards the end of 2012, with aims of reviewing the proposition in 2013.

Costs

We continue to focus on minimising cost inflation and delivering improved productivity. A business improvement group was established in 2012 in relation to this.

Capital expenditure

There are no major projects planned in 2013, however, we continue to invest in the airport for passengers, airlines, and to meet our S106 planning obligations

Planning

In July 2009, the London Borough of Newham (LBN) approved the airport’s planning application, increasing the number of permitted flight movements from 80,000 to 120,000 per annum.

LCY’s ‘Master Plan’ can be read at www.londoncityairport.com/index.php?mode=pages&action=masterplan and sets out the long term objectives for the airport. It is likely that the overall Master Plan will be delivered in a number of phases focussed on enhancing the capacity of the runway, taxiways and to provide additional aircraft stand capacity. Planning permission is being applied for in 2013.

Environmental

Managing the impact our operation has on the local and global environment, and local communities, is a priority for our business. We work closely with our neighbours and stakeholders to maximise the positive impacts the Airport brings to the local and UK economies, while delivering our wide ranging environmental programmes to ensure we can operate and grow in a sustainable way.

Key environmental priorities at LCY include noise, air quality, waste management, energy consumption, water management and sustainable transport. We are the leading UK airport for surface access via public transport, with more than 60% of our passengers arriving at our site via rail, bus or licenced black taxi. During 2011, we launched our upgraded sound insulation scheme for local homes and public buildings, providing glazing, ventilation and grants to mitigate the impact of noise for local residents and this has continued in to 2012. The noise level which triggers entitlement to this scheme is the lowest daytime level of any UK airport. During 2012, we invested in a new noise monitoring system which furthers our commitment to the environment and community.

Social and community

Since opening in 1987 London City Airport has developed a wealth of relationships with local communities and contributed significantly to the regeneration of the Docklands area. Through regular and voluntary interaction with community partners – residents, schools, colleges, charities, local businesses, landowners, developers and other stakeholders, as well as local boroughs – the airport works towards accomplishing its goal – to maintain constructive relationships with its neighbours and support local initiatives, whilst at the same time developing its business.

The airport has developed and implemented a comprehensive community relations programme that focuses primarily on local education and employment initiatives, but also includes staff volunteering and health and fitness programmes. A hands-on approach is taken alongside sponsorship to ensure that the knowledge, expertise and experience of airport staff at all levels contribute to the further development of the local area.

Efforts to employ the long-term unemployed have continued through LCY's award-winning into-work training programme "Take off into Work" which has now supported over 300 local residents into jobs since March 2009. Nearly 40% of the workforce at LCY live in the borough of Newham, where the airport is situated.

The airport's communities are encouraged to take an active interest in the operation. It is realised that neighbours are interested in the impact the airport's operation has on their lives and so communication and consultation with them is a priority. In addition to an active Consultative Committee, LCY delivers a quarterly community newsletter to more than 33,000 local homes to ensure local people are able to keep abreast of airport developments. This is also available on the Group's website.

Health and safety matters

It is the policy of the Group to seek to prevent all personal injuries, dangerous occurrences and damage to property. The Group seeks to achieve this by ensuring that the Board and management recognise their commitment to the safety of LCY employees, and those who may be affected by operations under the Group's control.

It is also the Group's policy to ensure that all employees are aware that they have a legal and moral responsibility, for their own safety, for the safety of those who might be affected by their actions, and to co-operate with their employer in Health and Safety matters.

In order to monitor the Group's Health and Safety policy, data is collected and monitored on the number, types and frequency of accidents and incidents in the workplace. Accident investigation is undertaken in the event of loss or damage to property and injury to persons to ensure root cause and corrective action is identified.

Regular internal audits, inspections and validations are undertaken of the airport's facilities, infrastructure and operating equipment together with periodic audits and inspections from external regulatory bodies.

Employees

The Group encourages the involvement of employees in its performance through regular communication from its managers to all employees providing up to date information on business matters and results. Also, where possible, employees' remuneration contains an element linked to business performance to give an opportunity for employees to participate in the success of the business.

The Group regularly reviews employment practices to ensure good working relations and equal opportunity based on fairness, equality and inclusiveness. The Group is committed to ensuring that people with disabilities are supported and encouraged to apply for employment with the Group and to achieve progress through the Group. Every reasonable effort will be made to enable disabled persons to be retained in the employment of the Group by investigating the possibility of making reasonable adjustments to the job, and to enable them to perform work identified as appropriate to their aptitudes and abilities.

The Group continues to invest in training to ensure that employees have the necessary management, technical and commercial skills to provide the best possible service to our customers and passengers. Both internal and external training opportunities will be provided where they are appropriate to an employee's current role and/or development. Suitable arrangements can be made either with regard to the structure or format of the event to enable employees with disabilities to participate.

The Group continues to maintain a positive relationship with all of its employees and actively encourages communication through a variety of channels. In addition, a consultative committee comprising of staff representatives meets on a regular basis to discuss issues of importance to the staff they represent. This structure and regular management and team briefings form a major part of the communication channel with employees.

Additionally the regular Chronicle staff newsletter and a dedicated intranet site play important roles in our communications with employees. The Group continues to recruit locally, with over 60% of staff living within 5 miles of the site, providing socio-economic benefits in a deprived part of London.

Significant contractual and other relationships

The Group has a number of important relationships with its customers, suppliers and bankers. These relationships are managed by key managers and directors of the individual businesses. The two primary areas of concentration of key relationships are;

- a) Revenue - Scheduled aviation revenue is principally derived from the three major airline alliances in Europe, namely Sky Team (Air France- KLM/Cityjet), oneworld (British Airways) and Star Alliance (Lufthansa/Swiss).
- b) Debt finance - The Group has arranged its debt finance through a syndicate of banks to access the level of funding required for its leveraged structure.

Principal risks and uncertainties

Safety risks

Health and safety is a core value of the business and the Group operates a safety management system built around risk assessment, inspection, asset stewardship, governance and assurance.

Risk assessment is undertaken for all activities entailing significant risk and proportionate control measures employed to safeguard everyone impacted by our business. The Group also operates robust asset selection and inspection and maintenance programmes to ensure property and equipment remain safe. Governance, led by the Board, and assurance processes are used to ensure the aforementioned remain effective and to encourage continuous improvement.

Security risks

Security risks are regarded as critical risks to manage within the business. The Group mitigates these risks by adopting and enforcing rigorous policies and procedures supported by professional training and by investment in leading-edge security technology. The Group has adopted the recommendations of the Airports Security Planning Guidance, as issued by the Department for Transport in January 2010. The Group works closely with government agencies, including the police and UK Border Agency, building a framework to establish joint accountabilities for airport security and shared ownership of risk, thus ensuring security measures remain both flexible and proportionate to the prevailing threat environment.

Competitive risks

The key competitive risks are derived from;

- a) Passenger switching to other airports – Passengers can opt to fly from other London airports that serve similar destinations to LCY.
- b) Airline operators switching to other airports – Airline operators may choose to move operations to other airports, subject to operating slot availability at other locations.

Operational disruption risks

There are a number of circumstances that can pose short-term risks to the normal operations of the airport, particularly adverse weather conditions. Where possible, the Group seeks to anticipate the effects of these events on its operations and also maintains contingency plans to minimise disruption wherever possible.

Legislative and planning risks

Specific legislative risks exist in areas covering the operations of the business from a health and safety, passenger screening and security and aerodrome operations perspective. Robust compliance and legal monitoring controls promote best practice throughout the organisation and minimise the Group's exposure to non-compliance. The key bodies that regulate the operation of the airport are the Civil Aviation Authority and the Department for Transport.

Additionally, planning risks exist in relation to the ability of the airport to secure planning permissions to facilitate future growth. Changes to the planning legislation, national aviation policy and the impact of anti-aviation pressure groups could impact the airport's ability to deliver the growth vision set out in its 2006 Master Plan. With its planning experience and resources, LCY is well placed to respond to these risks.

Financial risks

The Group has established financial management control processes whose objective is to monitor the Group's financial performance and risks and to ensure sufficient working capital exists.

a) Risk relating to leverage - As at 31 December 2012 the Group had external debt of £436.3 million (2011: £440.0 million) and is exposed to interest rate risk, liquidity risk and cash flow risk in respect of these borrowings. Throughout 2012 the Group was compliant with its various financial agreements and maintained comfortable headroom over all financial covenant ratios. This debt was refinanced on 2nd April 2013, further details of which are provided in note 20 to the financial statements.

The Group is exposed to interest rate risk on its debt which bears interest at variable rates. Increases in these rates result in increased interest expense and increased interest payment. The Group controls these interest rate risks through the use of derivatives, specifically interest rate swaps.

The application of these derivatives economically converts the hedged portions of variable-interest debt from variable to fixed interest. As at 31 December 2012, 79% (2011: 78%) of the corporate borrowings were hedged.

Liquidity risk is the risk that an entity may encounter difficulties in meeting obligations associated with financial liabilities. The Group aims to mitigate liquidity risk by having a strong positive cash flow and has undrawn overdraft facilities to manage liquidity risk.

Cash flow risk is the risk of exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability such as future interest payments. The Group manages this risk through regular cash flow forecasts, monitoring and strict management of its working capital and planning for known significant cash flow movements.

b) **Exposure to credit risk** - Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. Group policies are aimed at minimising such a risk by conducting credit checks where appropriate and by other established credit control procedures.

c) **Other risk** - The Group places all its insurance with leading insurance companies. Obligatory insurances are placed as necessary at competitive rates. All other risks are assessed and identified and where appropriate, insurance cover is purchased, where available, to mitigate these risks. Insurances are reviewed, assessed and renewed on an annual basis.

Corporate governance

The Board is comprised of a non-executive Chairman, seven non-executive Directors and two Executive Directors from the Company, being the Chief Executive Officer and Chief Finance Officer.

The Board meets regularly, normally monthly, and in addition, separate strategic discussions take place. Matters of significance are reserved for confirmation by the full Board. Matters not reserved for the Board may be delegated to senior management within clearly defined financial parameters.

The Company has an Audit Committee which is comprised of one Non Executive director from each shareholder and the non-executive Chairman, who is appointed as Chairman. The Committee normally meets once a year. External auditors are invited to attend the meeting. The Committee has the authority to examine any matters relating to the financial affairs and internal controls of the group.

Group internal controls are monitored at management reviews which cover all operational and health and safety aspects of the Company, independent audits, monthly business reviews, monthly reporting with performance measured against budgets and a comprehensive annual budget process which requires Board and business approval. In addition to the annual budget, a long term plan is continuously updated to reflect current performance and strategic aspirations.

In November 2008 the Walker Report was published, following a request by the British Venture Capital Association and certain major private equity firms. This report provided 'best practice' disclosure guidelines in the annual report and financial statements for those companies defined as UK portfolio companies and private equity firms. The Company meets the definition of a UK portfolio company and therefore the directors have adopted the disclosure recommendations in the annual report and financial statements.