Has the trend line shifted?

The impact on airport valuations

Romil Radia, Funminiyi Oduko, and Robert Behan

Executive summary

The last year has continued to see transactions taking place in the UK airports' sector, including OTPP increasing its shareholding in Bristol Airport to 100% and Heathrow Airport Holdings (HAL) announcing the sale of its interests in Glasgow, Aberdeen, and Southampton airports. This followed an active 2013, which saw Manchester Airport Group's (MAG) acquisition of Stansted Airport and other transactions in UK regional airports. In addition, there have been numerous European airport transactions, namely the sale of Hochtief's airport division to PSP Investments and TAV Airports' acquisition of a stake in Sabiha Gokcen (Istanbul) from Limak Group. These transactions and other anticipated transactions across Europe in the near term demonstrate that there is strong ongoing interest in the airport sector. Understanding individual airport value drivers and associated risks remains key to securing a good deal.

Airports are a unique class of asset. While they have historically enjoyed a moderate degree of cash flow certainty, they have also offered greater potential for growth than more traditional infrastructure assets.

A unique asset class

In the mid to late 2000s, against a backdrop of greater availability of credit and sustained passenger traffic growth, we saw enterprise value to earnings before interest, tax, depreciation, and amortisation ('EV/EBITDA') transaction multiples for European airports at or above 25x. Passenger traffic growth forecasts at the time of these transactions indicated expectations for continued traffic growth from an all-time high.

But unlike more traditional infrastructure assets, airports serve airlines as their primary clients and therefore share in the fortunes and woes of a highly cyclical industry. Airport valuations are predicated on expected future cash flows, which are in turn underpinned by passenger demand for travel.

Despite the resilience of airport cash flows in the previous economic downturns, the onset of the global financial crisis led to lower passenger traffic and revised growth expectations. Downside valuation risks for airports became apparent. These risks were subsequently borne out by airport transaction multiples observed since 2008, which, on average, declined in line with traffic growth expectations.

This article explores the trends in UK passenger growth and the movement in EV/EBITDA transaction multiples for airports over time. It also highlights airport valuation drivers and risks. Finally, we identify considerations important for investors to take into account when valuing airports.

Today's market is characterised by modest growth expectations and significant short-term uncertainties.

Today's market is characterised by modest growth expectations and significant short-term uncertainties. For this reason, we do not for the moment expect to see a sustained return to EV/EBITDA transaction multiples of more than 20x for European airports last observed in the mid to late 2000s.

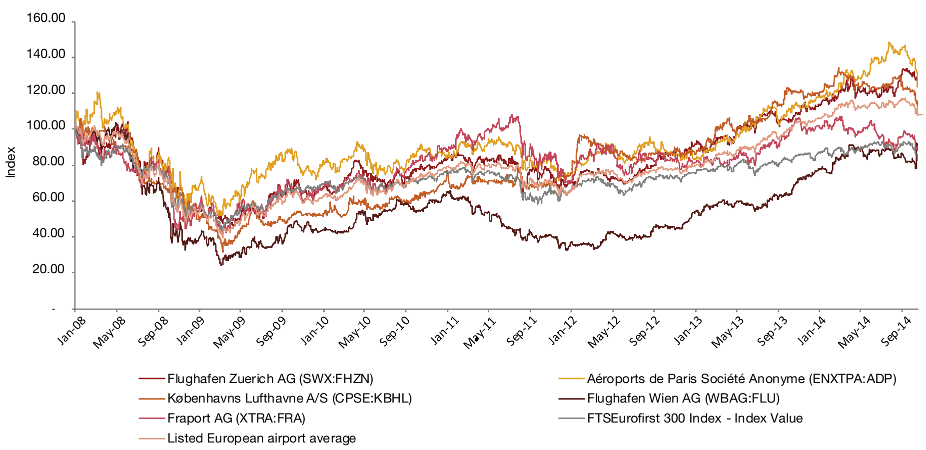
Instead, airport transactions in the past five years indicate that regional airports with higher traffic growth transact within a range of between 14 to 18 times EV/EBITDA, and larger, more mature airports transact within a range of 10 to 14 times EV/EBITDA. To date, apart from transactions characterised by government or local authority intervention, there has been limited evidence of transactions in underperforming airport assets.

For airports that would currently fall within the respective 10 to 14 times and 14 to 18 times EV/EBITDA ranges, once there is greater visibility around the strength and pace of traffic recovery, nothing precludes observing the higher level of multiples again in the medium term, if there are asset-specific reasons to justify this.

Airports: a very current valuation topic

Airport transactions continue to hit the headlines: MAG acquired Stansted concurrently with Australian infrastructure fund IFM's purchase of a minority stake in MAG in January 2013; Canadian pension fund PSP acquired the airport portfolio from Hochtief group in the third quarter of 2013. In addition, the Spanish public body Aena acquired Luton Airport from Abertis in August 2013. Deal activity is likely to continue in the UK (witness HAL's recent announcement of the sale of its interests in Glasgow, Aberdeen, and Southampton airports) and European markets into 2015.

Figure 1: Listed European airport share price performance



Source: S&P Capital IQ

Given current sovereign debt burdens across Europe and the need for investments in key transport infrastructure in the emerging markets, partial or full privatisation of state-owned airports may remain popular (examples include the partial privatisation of AENA and sale of a number of Greek airports, both likely to be completed by 2014/early 2015). Furthermore, the uncertainty in economic outlook across the world makes airports a relatively attractive asset class to invest in.

Uniquely appealing assets

Many investors see airports as relatively safe assets. That is because airports typically offer stable cash flows with the potential to realise significant capital gains on disposal. Indeed, having at times enjoyed traffic growth rates in excess of two times GDP growth, listed European airports, on average, have continued to outperform the Eurofirst 300 index over the last six years. (See Figure 1.)

Even when air traffic falls during economic slowdowns, airports can still deliver growing dividends to investors through the deferral of operating costs and rescheduling or reducing capital expenditure.

Airport investors

Financial investors in airports such as infrastructure or pension funds are interested in the stable cash flows airports offer. And they often invest with their eye on the long term. Many focus on the internal rate of return (IRR). They also try to enhance value by implementing optimal financing structures.

Trade buyers (such as other airport operators) try to improve operational efficiencies; for example, by increasing commercial yields and by expanding the airport's route network. We are observing an increasing trend of airport operators forming consortia with financial investors with the aim of boosting value through operational and financial structuring improvements.

In the case of airports, a primary driver of earnings growth potential is passenger growth.

The key messages arising from this paper are relevant and applicable to both trade and financial investors.

UK traffic: Reversion to trend?

Tracking growth against the trend

Figure 2 shows UK terminal passenger traffic ('pax') since 1976, with the long-term passenger growth trend superimposed.

The graph shows that, up until 2008, it typically took 4-6 years for traffic to return to the long-term passenger growth trend following a recession or other economic shock.

Thanks to these patterns, it has often become conventional wisdom that traffic growth and associated airport cash flows will revert to the long-term trend after a shock rather than grow at a similar rate from a lower base. Indeed, between the late 1990s and mid 2000s, UK traffic saw significant growth above the long-term trend. This was fuelled by a sustained period of economic growth, greater availability of credit, and the emergence of low-cost carriers (LCCs).

Growth expectations and transactions

Figure 3 shows actual UK passenger traffic alongside UK traffic expectations in 2007, the last full year prior to the global economic crisis.

In 2007, the expectation was that UK airport traffic would continue growing from its 2007 peak at a rate broadly in line with the long-term growth trend. With hindsight, it is clear that 2007 passenger growth expectations did not materialise.

Take a look at the EV/EBITDA multiples between 2000 and 2014 for European airports in Figure 3.[10] Of course, there are obvious challenges in comparing transaction multiples between airports owing to each airport's specific operations and individual growth potential. However, it is fair to say that, on average, airport transaction multiples rose in the early to mid 2000s, peaking around 2007 and, on average, have fallen since.

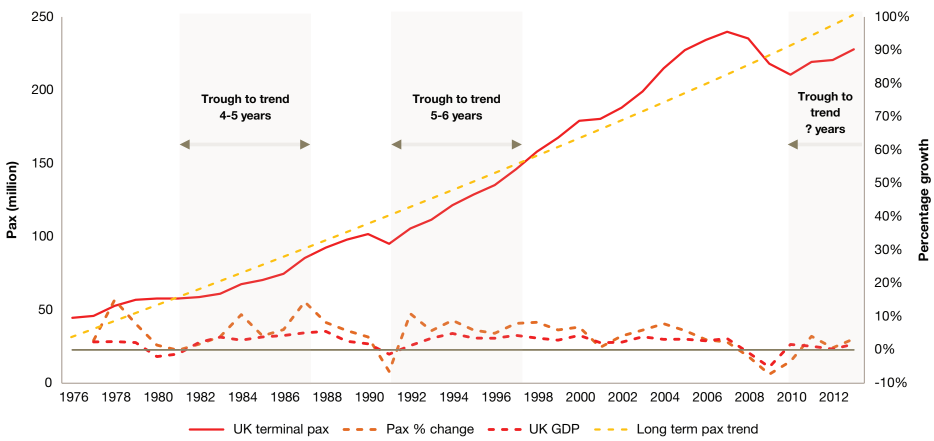
Perhaps unsurprisingly, passenger numbers in the UK have seen a similar pattern. The upshot of this analysis is relatively straightforward: at a basic level, transaction multiples are a function of current earnings and expectations for future earnings growth, with the simple relationship being that the greater the growth potential, the higher the multiple.

In the case of airports, a primary driver of earnings growth potential is passenger growth.

Back in 2006-2008, observers expected long-term passenger traffic to keep growing at the rates seen in the immediate preceding years rather than revert to the long-term trend. Put another way, they anticipated a one-off upward shift in the long-term traffic trend.

These expectations were reflected in increasingly higher transaction multiples paid over that period. In effect, investors in airports were willing to pay high sums for the future growth they anticipated in 2007. Once investors realised that the expected growth wasn't going to materialise – and once credit markets tightened – transaction multiples declined.

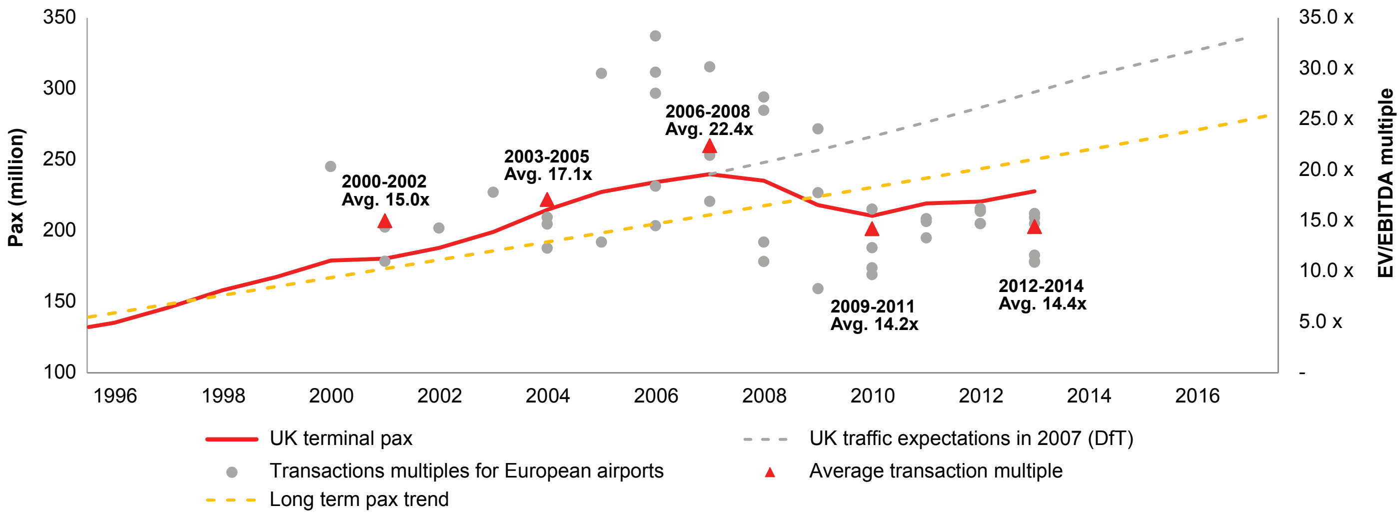
Figure 2: UK airport traffic and GDP growth



Source: CAA, PwC analysis

[10] The HAL transaction announced in Oct-14 is due to complete in Jan-15. The implied EV/EBITDA transaction multiple based on 2013 historic EBITDA is circa 16x.

Figure 3: UK airport traffic and European transactions



Source: CAA, DfT, PwC analysis, Press

Over the past three years, we have seen average transaction multiples stabilise at around 15 to 16 times EV/EBITDA. The latest UK traffic data (for the full year 2013 and for the eight months to August 2014) suggests that future terminal passenger growth may follow this revised long-term traffic trend.

Furthermore, there have been recent encouraging signs on the UK economic front: based on the latest data released in October 2014, IMF has upgraded its UK GDP forecasts since October 2013 by over a full percentage point for 2014 (1.9% to 3.2%) and by over half a percentage point for 2015 (2.0% to 2.7%). Therefore, downside risk to the sustainability of future UK traffic growth has lessened in the past year. However, Eurozone GDP forecasts have remained broadly unchanged over the period, and economic sentiment in the region has deteriorated in recent weeks as a result of deflationary fears and slowing growth in Germany's economy.

Despite the improved UK economic outlook, smaller regional UK airports remain vulnerable to risks given the shift in the balance of power to LCCs, who are increasingly mobile and can relocate their operations at short notice. Cardiff Airport and Glasgow Prestwick Airport were re-nationalised recently after failing to attract buyers, while Manston Airport (Kent) closed in May 2014 and Blackpool Airport closed to commercial operations in October 2014. These developments demonstrate that the divide in growth prospects for UK regional airports continues to widen. The key for smaller regional airports is to ensure a healthy balance in airline customer dependence such that the traffic growth expectation is sustainable.

Note: The transactions we are talking about here relate to European as well as UK airports. We believe that the two airport markets are sufficiently developed and similar to draw consistent insights from the data.

What influences an airport's value?

Discounted cash flow analysis. While transaction multiples provide useful valuation benchmarks, typically the discounted cash flow ('DCF') valuation methodology is used as the primary approach to value airports. This is because airports generally have long-term projections that offer cash flow visibility. The DCF approach is also more appropriate for differentiating between an airport's revenue streams (aviation, retail, real estate, external operations) and the various regulatory mechanisms under which airports operate.

Airport transaction multiples. There are clear challenges in comparing transaction multiples between airports. This is due to each airport's specific operations and individual growth prospects. In addition to market factors and competitive bidding conditions at sale, key factors affecting airport value and transaction multiples include the following:

- **Maturity of the airport**. Most large, mature airports have less potential to increase traffic than smaller regional airports and may trade at a lower multiple. For a small regional airport starting from a low passenger base, attracting two or three new airlines can transform the business – a prospect that is often reflected in transaction multiples. Conversely, larger airports tend to have a broader airline base, so they are less vulnerable to customer concentration risk and volatility.
- **Potential for yield improvements.** Airports with non-aeronautical revenues that are lower than those of comparable airports can boost their earnings by improving their retail offerings, increasing parking fees, and making other similar enhancements. This potential for better earnings can also be reflected in transaction multiples. However, to benefit from an enhanced non-aeronautical revenue stream, can require significant capital expenditure investment.
- **Regulatory environment.** Airports are typically subject to regulation when regulators see them as holding substantial market power. Regulated airports' risk/reward profile differs from those of unregulated airports – for example, investors see regulated airports as more vulnerable to changes in regulatory regimes, which translates into regulatory risk. Airports are also subject to different regulatory environments in different jurisdictions. In the UK, for instance, regulated airports are allowed to earn a return on their regulated asset base (RAB). RAB is therefore a key valuation metric, and the market places significant emphasis on enterprise value to RAB multiples in assessing the value of regulated airports.
- **Catchment area penetration.** The extent to which an airport has penetrated its primary and secondary catchment areas affects its passenger growth potential.
- **Capacity constraints.** Runway or terminal capacity constraints tend to depress an airport's traffic growth potential. Alleviating these constraints may require significant capital expenditure as well as planning and regulatory approval.
- **Airport traffic mix.** The make-up of an airport's traffic – the mix of short – and long-haul as well as business, leisure, charter, and low-cost traffic – affects airport earnings. For example, traffic mix can strongly determine an airport's commercial revenue spend per passenger. Domestic passenger retail spending will tend to be lower than that of leisure travellers (such as charter), owing to shorter airside dwell time. Business traffic is a lucrative revenue stream, given it will likely stay steady during an economic slowdown, compared to other traffic types such as charter.
- **Airline customer dependence.** The degree of airline concentration at an airport will affect value. If an airport is highly dependent on one or two key airline customers, a reduction in aircraft capacity (due, for example, to reallocation of aircraft capacity across an airline's network or airline bankruptcy) will have a material impact on the airport. Further, airports typically have to renegotiate tariff increases on a frequent basis with their main carriers, and single airline dominance at an airport will affect the balance of negotiating power in favour of the airline.
- **'Stickiness' of airlines.** The extent to which an airline has the option to relocate operations to another airport that serves the same catchment area will determine the stickiness of an airline to a particular airport and will affect value. Stickiness subsequently determines the balance of negotiating power in tariff negotiations (the extent to which tariffs can be increased without significant adverse effects of the airline moving its operations away from the airport). It is difficult to isolate the impact of airline stickiness in a transaction multiple. However, we have observed adverse impacts through the suppressed EBITDA margin of airports that do not have strong power in price negotiations with airlines.
- **Dividends.** The history that an airport has demonstrated in paying regular dividends and the potential capacity to continue paying these regular dividends will affect value. Given that airport investors often invest with their eye on the long term, the prospect of regular dividend payments will cause investors to see the investment as more liquid. Airports also offer the flexibility of being able to support dividend payments during a slowdown through the deferral of operating costs and rescheduling or reducing of capital expenditure.

Given the number of circumstances affecting an airport's value, investors need to carefully assess airports' comparability and adjust transaction multiples where appropriate.

Where do we go from here?

The picture is continuing to improve for certain advanced economies. But emerging economies like India, Indonesia, Turkey, South Africa, and Brazil have run into trouble over the past year as capital has begun flowing back to the advanced economies. While this situation appears to have subsequently stabilised, the pace of European economic growth remains uncertain and the economic impact of the Fed ceasing its quantitative easing programme and raising interest rates is unclear.

After generally disappointing growth in 2011 and 2012, the UK economy showed signs of recovery in 2013 and GDP forecasts have continued to be upgraded throughout 2014. Consumer spending growth is projected to follow a slightly more optimistic GDP growth rate in the UK. Yet downside risks to growth remain, albeit to a lesser extent than in 2013, owing to the possibility that the current relative calm in the Eurozone may not last.

The speed at which traffic may return to the long-term trend line hinges on the pace of economic recovery. Figure 4 sets out current passenger number expectations for the UK aviation market, but also projects a range of potential passenger growth profiles based on forecast UK GDP growth and a range of income elasticities.

In Figure 2, we saw that in the early 1980s and 1990s, it took four to six years for traffic to revert to the long-term trend after an economic slowdown.

The patterns in Figure 4 suggest that even in a high-growth scenario, passenger numbers are unlikely to revert to the trend line before 2022-2024.

Given that the drop in UK passenger traffic since 2007 has been markedly sharper than that observed in previous periods of economic recession, a 10-12 year period for reversion to the long-term trend does not appear unlikely. Indeed, if one were to focus on lower passenger growth profiles, it could be argued that the long-term trend line is shifting downwards and that the premise that traffic always reverts to long-term historical trends must be questioned.

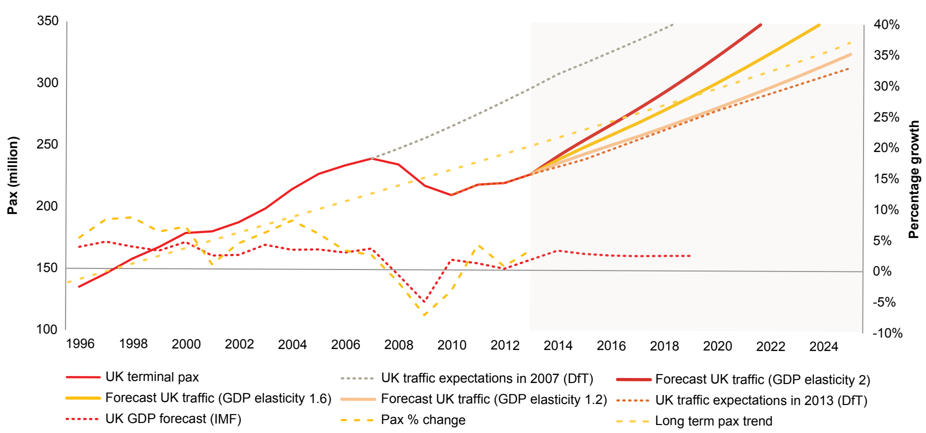
Looking at current growth expectations and market uncertainties, we do not expect to see a sustained return to the 20+ times transaction multiples observed in the mid-2000s in the short term.

However, once there is greater visibility into the strength and pace of traffic recovery, nothing precludes seeing this level of multiples in the medium term if there are asset-specific reasons to justify this. As can be seen in Figure 3, airport transaction multiples are perhaps stabilising.

Given current market evidence, we would continue to expect higher growth regional airports to transact within a range of 14 to 18 times EV/EBITDA, and larger more mature airports in the range of 10 to 14 times EV/EBITDA.

There is certainly significant interest in the airport assets coming up for sale, and competitive tensions may increase transaction multiples observed.

Figure 4: UK airport traffic – reversion to trend



Source: CAA, DfT, IMF, PwC analysis

About the authors: Funminiyi Oduko and Robert Behan are airport valuation professionals at PwC UK. Romil Radia leads the PwC airport valuations team in London.

Key contact for Valuations: Romil Radia, Partner, PwC UK, London (romil.radia@uk.pwc.com, +44 (0)20 7804 7899).

If you're thinking about investing

1

Cyclicality should be built into long-term cash flow projections

When assessing the value of an airport, it is essential to recognise the cyclicality of the industry, consider where we currently sit in the economic cycle, and build sensitivities into cash flow projections to reflect economic downturns and other risks. Recent evidence suggests that airport performance is not as immune to wider market volatility as perhaps once thought.

2

Airport transaction multiples are unlikely to reach pre-recession levels in the short term

Given current growth expectations and market uncertainty, we do not expect to see a sustained return to the +20x EV/EBITDA transaction multiples for European airports in the short term. However, once there is greater visibility around the strength and pace of traffic recovery, there is nothing to preclude observing this level of multiples again in the medium term, if there are asset-specific reasons to justify this.

3

A comprehensive assessment of comparable transaction multiples is required if used as valuation benchmarks

While airport transactions clearly provide useful valuation benchmarks, it is imperative to undertake a comprehensive assessment of the comparability of transactions and make appropriate adjustments if it becomes apparent that they are incorporating different, or even unrealistic, growth expectations.

4

Reversion to the long-term passenger traffic trend will take several years

An assessment of historical UK passenger traffic suggests that growth rates are not constant. With potentially a 10-12 year period before traffic reverts to historical passenger growth trends, it seems timely to revisit the premise that traffic always reverts to long-term trends.

5

Airport operators and financial investors are increasingly joining forces to deliver airport value improvements

We see an increase in airport operators forming consortia with financial investors with the aim of delivering value enhancement through operational and financial structuring improvements. The key messages arising from this paper are relevant to both trade and financial investors.