
Has the trend line shifted? The impact on airport valuations.

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Executive summary

2013 has seen Manchester Airport Group's (MAG) acquisition of Stansted Airport, followed by various European airport transactions, namely the sale of Hochtief's airport division to PSP Investments. Both these transactions demonstrate that there is still strong 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.

European airports at or above 25 times EV/EBITDA. Passenger traffic growth forecasts at the time of these transactions indicated expectations were 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.

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

Airports are a unique class of asset.

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

Airport transactions continue to hit the headlines.

For this reason, we do not for the moment expect to see a 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.

However, 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.

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.

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 third quarter of 2013. More recently, the Spanish public body Aena acquired Luton Airport from Abertis in August 2013.

Given the continuing Eurozone crisis and the need for investments in key transport infrastructure in the emerging markets, partial or full privatisation of state-owned airports may remain popular. Furthermore, the

increasing uncertainty in economic outlook across the world makes airports a relatively attractive asset class to invest in.

Airports are 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 gross domestic product (GDP) growth, listed European airports, on average, have continued to outperform the FTSEurofirst 300 index over the last five 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 of capital expenditure.

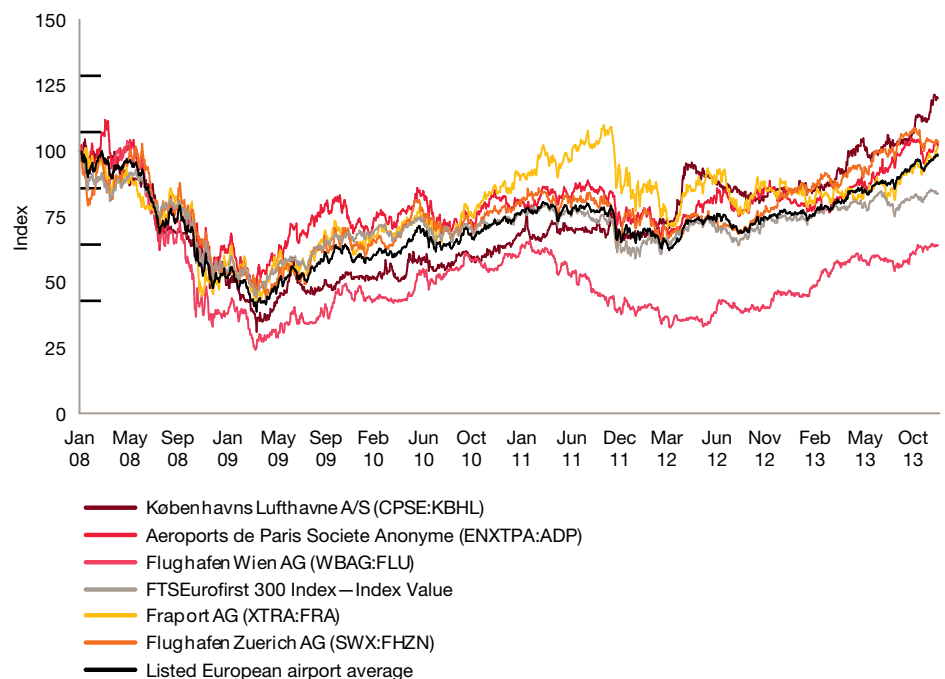
Airport investors

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.

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

Figure 1: Listed European airport share price performance



Source: Datastream and Capital IQ

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 four to six 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).

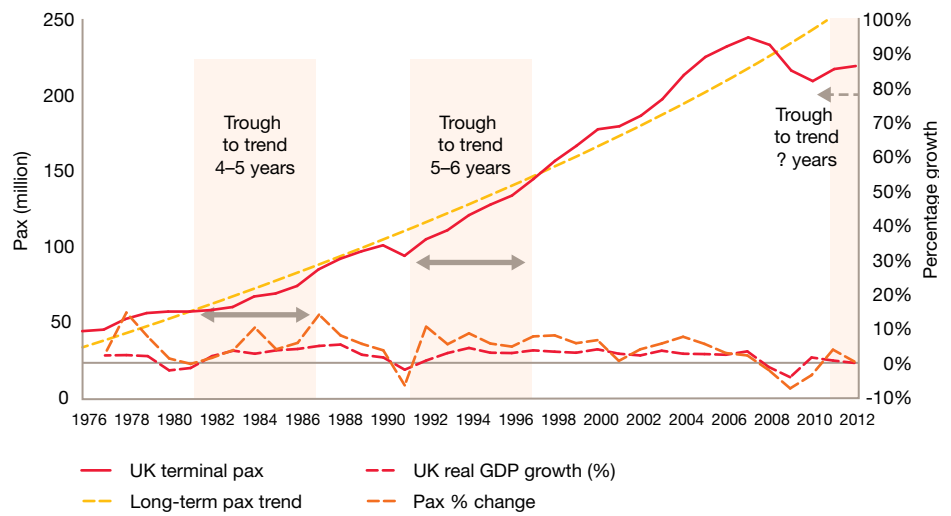
Growth expectations and transactions

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.

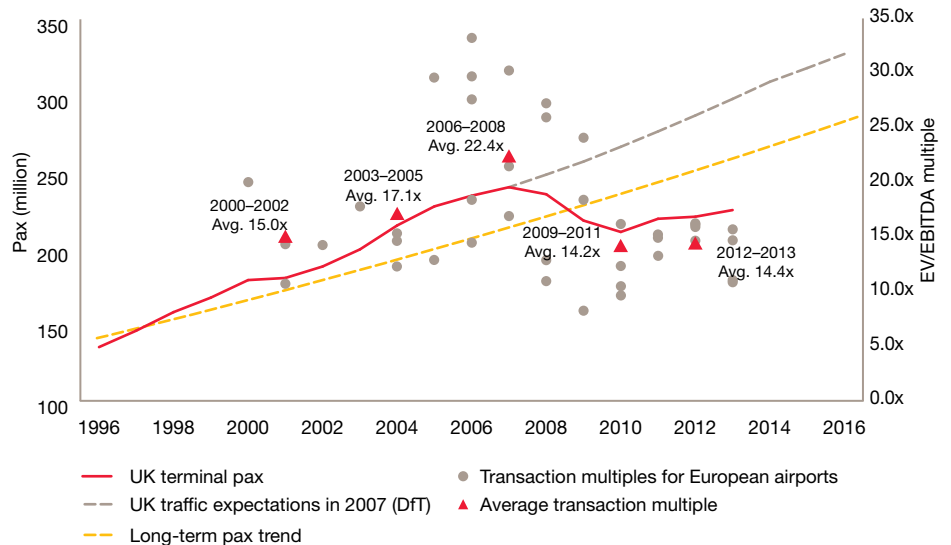
Take a look at the EV/EBITDA multiples between 2000 and 2013 for European airports in Figure 3. Whilst there are obvious challenges in comparing transaction multiples between airports due to each airport’s specific operations and individual growth potential, it is fair to say that, on average, airport transactions multiples rose in early to mid 2000s,

Figure 2: UK airport traffic and GDP growth



Source: CAA, IMF, PwC analysis

Figure 3: UK airport traffic and European transactions



Source: CAA, DfT projections, PwC analysis

Note: The graph above combines European transaction and UK traffic data as European traffic information dating back to 1976 was not available

peaking in 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.

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 impacting 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.
- **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 i.e. 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 (capex) spend 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 other leisure and business travellers, due to shorter airside dwell time. Also, business traffic 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 impact 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 impact negotiating power.

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

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.

Over the past year we have seen average transaction multiples stabilise at around 14 to 14.5 times EV/EBITDA. The latest UK traffic data (to July 2013) seems to suggest future terminal passenger growth may follow the revised long-term traffic trend.

However, caution should be exercised: Based on the latest data released in October 2013, IMF revised its global and Eurozone GDP forecast down by around 1% from the first half of 2012, whilst UK forecast growth remains unchanged. Therefore some downside risk to the sustainability of future traffic growth still remains. Indeed, smaller regional airports are even more vulnerable given the shift in the balance of power to low cost carriers 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. The key for these airports is to ensure there is a healthy balance in airline customer dependence such that the traffic growth expectation is sustainable.

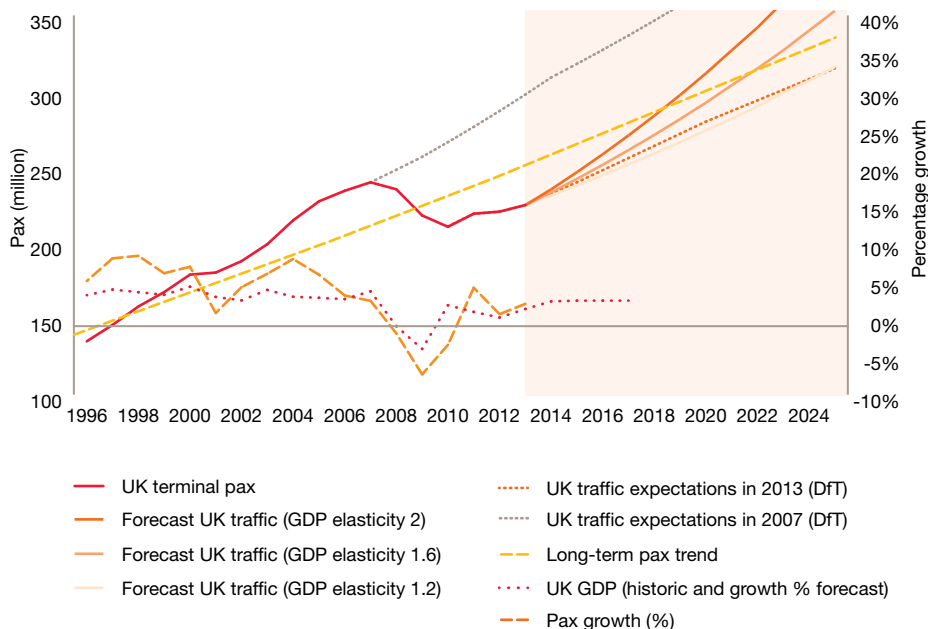
Note: The transactions we are talking about here relate to European as well as UK airports. We believe that the two airport markets are sufficiently developed and similar to draw consistent insights from the data.

Where do we go from here?

An improving picture is slowly developing for the advanced economies, albeit from lower expectations than the first half of 2012. But emerging economies like India, Indonesia, Turkey, South Africa and Brazil have run into trouble as capital has started to flow back to the advanced economies. Moreover, the pace of European economic growth remains uncertain and the impact of the Fed's inevitable decision to taper quantitative easing looms.

After a period of generally disappointing growth in 2011 and 2012, the UK economy has shown signs of recovery in the first half of 2013. Consumer spending growth is projected to follow a slightly more optimistic UK GDP growth rate. But again risks to growth remain weighted to the downside, due in particular to the possibility that the current relative calm in the Eurozone may not last.

Figure 4: UK airport traffic and GDP growth



Source: CAA, DfT, IMF, PwC analysis

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 1, 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 ten to twelve 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 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.

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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 return to the 20+ times 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 are observing an increasing trend of airport operators forming consortia with financial investors with the aim of delivering value enhancement through both operational and financial structuring improvements. The key messages arising from this paper are relevant to both trade and financial investors.