MORNINGSTAR®

**Stock Research | 05 Jun 2013**

Click the print icon in your browser to print this report

# Auckland International Airport Limited AIA

05 Jun 2013 | Commerce Commission's ruling lessens regulatory risk, valuation raised

Recommendation: **Hold**

▼ 2.48

| BUY | ACCUM | HOLD | REDUCE | SELL |
|---|---|---|---|---|
| $ | 1.75 | 2.25 | 2.75 | 3.35 |

Note: marker indicates price of $2.48 at publication date

| **Risk Rating** | |
|---|---|
| Fair Value ($) | 2.48 |
| Uncertainty Rating | Medium |
| Moat Rating | Wide |

**Earnings** Morningstar Analyst numbers at the time of publication

| | 06/11(a) | 06/12(a) | 06/13(e) | 06/14(e) |
|---|---|---|---|---|
| NPAT ($m) | 96.4 | 111.2 | 123.5 | 129.1 |
| EPS (c) | 7.3 | 8.4 | 9.4 | 9.8 |
| EPS Change (%) | 7.8 | 15.4 | 11.0 | 4.5 |
| Div Payout Ratio % | 92.1 | 86.6 | 93.9 | 98.0 |
| DPS (c) | 6.7 | 7.3 | 8.8 | 9.6 |
| Franking (%) | 0.0 | 0.0 | 0.0 | 0.0 |
| Grossed-Up DPS (c) | 6.7 | 7.3 | 8.8 | 9.6 |
| Grossed-Up Yield % | 4.1 | 3.9 | 3.5 | 3.9 |
| Dividend Yield % | 4.1 | 3.9 | 3.5 | 3.9 |
| PE Ratio (x) | 22.4 | 22.1 | 26.5 | 25.3 |
| Avg. Price/Price ($) | 1.64 | 1.87 | 2.48 | 2.48 |

Source: Morningstar

## Investment Perspective

AIA owns and operates the Auckland International Airport, NZ's largest and busiest airport for aircraft and passenger activity. Around 70% of international visitors travel through Auckland Airport, a testament to the airport's dominant position as the gateway to New Zealand. AIA's fortunes are inextricably linked to tourist arrivals in NZ, the longer term outlook for which remains sanguine. The airport also owns 1500hectares of land presenting it with a huge opportunity for commercial and retail property development. Over the longer term, the attitude of regulators, which so far has been favorable, will have a bearing on valuation.

## Analyst Note

We are lifting our valuation for Auckland Airport from NZD 2.60 per share to NZD 3.00 per share mainly reflecting a reduction in our weighted average cost of capital (WACC) from 8.5% to 7.5%. We think a lower cost of capital is justified given Auckland Airport's defensive earnings characteristics. Our revised fair value implies fiscal 2014 price/adjusted earnings of 24.5 times, enterprise value/adjusted EBITDA of 13.5 times and free cash flow yield of 3%. The stock now appears fairly priced compared to our revised intrinsic value. We continue to believe the firm is well-placed to capitalise on expected strong growth in tourist arrivals from Asia in the long term. We think the firm deserves a wide moat because it is a monopoly operating in a favourable regulatory environment with reasonably strong returns on capital.

In our view the regulatory risk for the business has lessened following the Commerce Commission's favourable assessment of Auckland Airport's aeronautical charges. The commission concluded that the airport's targeted return for the period 2013-2017 of 8% on average is appropriate and consistent with the commission's WACC. The commissions' returns however include leased activities which, while part of the aeronautical asset base, are not included for price setting purposes. Excluding revenues from leased activities raises airport aeronautical returns to approximately 8.5% based on 2.8% compound annual growth rate (CAGR) in international passengers. However we believe this is conservative considering our expectation of a continued strong growth in arrivals from Asia, Latin America and Australia. Our forecast assumes a 4.2% CAGR in international passenger movements from 2013 to 2017. Consequently we anticipate aeronautical returns to be above 8.5% over the next five years.

International passenger movements (excluding transits) were up 1.3% relative to the prior comparable period in the first ten months of fiscal 2013 with New Zealand (resident arrivals) and China being notably strong. Overall 2013 was affected by strong based period comps because of the Rugby World Cup in the previous year but we expect a pick up in passenger volumes in 2014. As a result we are projecting international passenger movements (excluding transits) to rise by 5% in fiscal 2014 assuming stable global economic conditions. We believe that new services/increased frequency will continue to underpin traffic growth with airlines committing nearly 200,000 additional seats to and from Auckland since December 2012. The domestic business continued to perform strongly and is up 8.2% year-to-date as competitive fares on mainline routes seems to have stimulated demand for domestic travel. We forecast 8% growth in domestic passengers in fiscal 2013 but only a modest increase in 2014 due to stronger base period comps. Overall our NPAT forecast for 2013 and 2014 remains unchanged at NZD 150 million and NZD 161 million respectively.

## Thesis

Auckland Airport is the largest airport in New Zealand, meaning most visitors must pass through its assets. It handles 7.8m international passengers and around 6m domestic passengers on a yearly basis and has been voted as the 8th best airport in the world and the best in the Australia/Pacific region in a survey conducted by Skytrax. We think the firm deserves a wide moat because it is a monopoly operating in a favorable regulatory environment with reasonably strong returns on capital. Risks to returns are minimal but include a slowdown in tourism, as was evident during the SAARS epidemic several years ago and lately by the global financial crisis. On balance though, Auckland Airport benefits from substantial competitive advantages.

The firm derives its revenues from aeronautical and non aeronautical/commercial operations. The non aeronautical business consisting of retail, car park, property development and utilities constitutes 55% of revenues. Retail is the biggest part of the non-aeronautical business with revenues of NZD 121 million in fiscal 2012. The business is highly leveraged to growth in international passenger traffic which can exhibit volatility in the short to medium term. The property business is half the size of the retail business but has been a steady performer historically. Auckland Airport generally scouts for blue chip tenants with agreements typically spanning ten years and develops the land once a tenant is secured. Revenue growth is driven by new developments and rent reviews. On the aeronautical side of the business landing fees and development charges account for the vast majority of revenues. Landing fees are charged on the weight of each aircraft and reviewed every five years in consultation with the airlines. Historically they have increased at or above inflation.

The firm enjoys one of the highest EBITDA margins compared to airports globally reflecting a light handed regulatory environment and a greater mix of international passengers versus domestic passengers. The aeronautical business is not regulated and can set prices to cover its cost of capital. In comparison the vast majority of airports around the world have a regulated structure. This means that in most instances the commercial arm of the airport, namely retail, tends to subsidize the aeronautical business. Furthermore international passengers make up 57% of the overall passengers at the Auckland Airport compared to around 32% in Sydney and approximately 21% in Melbourne. On a per passenger basis the amount spent by international passengers far outstrips domestic passengers resulting in significantly higher margins for the airport. The company�s EBITDA margins have historically hovered around the 75-77% mark and we expect this to continue.

We see good opportunities for Auckland Airport to grow its commercial property portfolio by taking advantage of its massive land bank. Pent up demand from multinational firms involved in freight, logistics and transportation businesses should spur developmental activity and in turn drive rental growth. On the retail front, a significant increase in the number of high spending Asian tourists and their desire to visit duty free retail stores is likely to provide a significant lift to retail revenues overtime. The route development strategy embarked upon by management last year has already boosted seat capacity into and out of Auckland by more than 1m passengers. This bodes well for both aeronautical and retail income going forward. Management sees immense opportunities from Asia, particularly China and India, and is wooing airlines to commence new services to Auckland.

We think the medium-term growth outlook for the company is sanguine. We are anticipating earnings to grow by 8% in fiscal 2013 underpinned by reasonably strong growth in the non-aeronautical businesses and continued growth in associates. We think passenger growth will likely be muted following the Rugby World Cup last year. A lot will therefore depend upon new capacity coming through from October which is expected to materially increase seat capacity to and from Auckland this year.

## Bull Points

- Seat capacity from Auckland has increased by approximately 1.3m driven by a plethora of new services announced by different carriers, equating to 16% of international passenger movements. This should propel international passenger growth.
- The outlook for the property business seems promising with a good pipeline of projects on the horizon.
- The company should be able to maintain dividend growth in line with profit growth despite elevated capital expenditure levels..

## Bear Points

- Global economic conditions continue to remain challenging which could affect tourist inflows into NZ.
- The NZ market could face a prolonged period of tepid passenger growth given high consumer debt levels.
- The firm�s bottom line is somewhat sensitive to interest rates which could increase considering that they are at an all time low.

## Valuation

We are lifting our fair value estimate for Auckland Airport to NZD 3.00 per share from NZD 2.60 per share. This implies forward price/earnings of 24.5x, enterprise value/EBITDA of 13.5x and free cash flow yield of 3%. Our intrinsic value is also consistent with the firm's historical enterprise value/EBITDA multiple of between 13x and 14x. Our DCF valuation assumes a weighted average cost of capital (WACC) of 7.5%.

## Risk

AIA is vulnerable to a slowdown in international passenger traffic emanating from factors that could destabilize tourist travel such as SAARS, terrorism (9/11) etc. In addition a strong NZD would drive tourists away from NZ to cheaper destinations. An economic recession or a slowdown in NZ would affect outbound travel. Higher fuel prices might be passed on to passengers in the form of a fuel surcharge which might dampen air travel as well. Domestic retail and car park income will be affected if people cut back on domestic travel. Property revenue is linked to rental demand which in turn could be affected by an economic recession. Persistent complaints from airlines like Air New Zealand (the company�s biggest customer) regarding excessive landing charges could prompt the government to regulate the aeronautical business. This would reduce the appeal of that business from a returns perspective. However the possibility of this scenario playing out is remote in our view.

## Financial Health

Auckland Airport is in reasonable financial health. Total debt/capital is 31%and underlying EBITDA covers interest 4.8 times. The company will be embarking on a massive capital expenditure program aimed at constructing another domestic terminal adjacent to the existing terminal. This project will cost NZD 250 million and will take approximately five years to build. Another NZD 15 million to NZD 20 million will be spent in freeing up capacity at the current terminal.

**Air NZ**

**Contact Addresses for Contractual Notices**

Manager Operations Support
Air New Zealand Limited
PO Box 92007
Auckland

Ph. 09 256 3879
Fax 09 256 3518

E-Mail bob.fletcher@airnz.co.nz

**Contact Address for Operational Matters**

Duty Operations Control Centre
Air New Zealand Limited
Auckland
(24 hours availability)

Ph. 09 256 4600
Fax 09 256 4612

E-Mail intops@airnz.co.nz
(Mon to Fri 0800-1700)