FORSYTH BARR

Auckland Airport

UNDERPERFORM

Lower Aero Flight Plan

The profile of Auckland Airport's (AIA) aeronautical earnings through its next regulated pricing period has reduced due to lower bond rates, capex delays and an increasingly likely deferral of its runway land charge. While aeronautical prices will still be on an upwards curve from FY23, the slope of the curve will be far more gentle than previously expected. Moreover, international passenger growth will remain subdued through FY20, having declined -1% in July 2019. With consensus earnings risk weighted to the downside for FY21 and FY22, and valuation stretched at ~41x one year forward PE, ~23x EV/EBITDA, we reiterate an UNDERPERFORM rating.

What's changed?

- **Earnings:** FY20 unchanged. FY21 and FY22 EPS cut by -7% and -6% respectively to reflect deferral of runway land charge. EPS CAGR to FY22 of ~-1%
- **Target Price:** Reduced to NZ$7.90 from NZ$8.25 to reflect lower aeronautical valuation

Aeronautical earnings outlook has weakened

AIA's aeronautical earnings outlook is supported by a rising regulatory asset base. However, the rate of growth is slowing due to:

- **Lower bond yields** — lower bond yields have provided a major benefit to AIA's valuation but will also lower AIA's future aeronautical pricing.
- **Northern runway deferral** — the potential deferral of the delivery date for the Northern runway at the investor day in November 2019 may also mean a delay in the introduction of the runway land charge from FY21 to a later date, in our opinion.
- **Capex spend lower than intended** — AIA's recent FY19 result further highlighted its capex under-spend thus far through its current regulated pricing period (FY18–FY22) relative to the budget on which its current pricing was based (provided in 2017).
- **ComCom still to review other regulated services** — in its review of AIA and Christchurch Airport's PSE3 pricing the ComCom deferred its decision on non-pricing assets. These represent only 8% of AIA's aeronautical revenues but generate a return materially in excess of WACC.

Balance sheet pressures ease

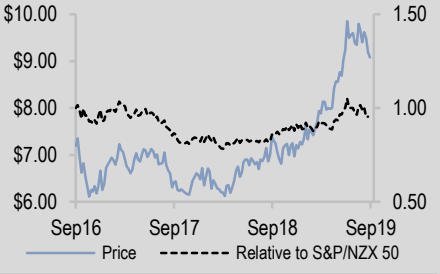
A deferral of the Northern runway construction and later delivery of the domestic jet terminal puts less stress on AIA's balance sheet over the medium term. As a result AIA will now remain comfortably within its 'A-' S&P credit rating parameters, on our estimates.

Investment View

AIA is well positioned given its control of New Zealand's major gateway, its hub positioning for Air New Zealand and the country's positive longer term tourism outlook. It is a high quality infrastructure asset providing structural growth and sustainable dividends. The company is in the midst of a multi-year capex programme. AIA is sensitive to bond yield movements and international pax growth. In combination these no longer support current valuation levels and therefore our rating is UNDERPERFORM.

NZX Code	AIA
Share price	NZ$9.08
Target price	NZ$7.90
Risk rating	Low
Issued shares	1207.0m
Market cap	NZ$10,960m
Average daily turnover	1,130k (NZ$9,121k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ$m)	274.7	271.0	268.8	271.8
EPS* (NZc)	22.8	22.3	22.0	22.1
EPS growth* (%)	3.6	-2.0	-1.4	0.5
DPS (NZc)	22.3	22.3	22.0	22.1
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	23.3	23.6	23.1	22.0
EV/EBIT	28.5	29.4	29.7	29.2
PE	39.9	40.7	41.3	41.1
Price / NTA	1.8	1.8	1.8	n/a
Cash dividend yield (%)	2.5	2.5	2.4	2.4
Gross dividend yield (%)	3.4	3.4	3.4	3.4

*Historic and forecast numbers based on underlying profits

Andy Bowley
andy.bowley@forsythbarr.co.nz
+64 4 495 8246

Auckland International Airport Ltd (AIA) Priced as at 18 Sep 2019: NZ$9.08 June year end

Forsyth Barr valuation										
Valuation methodology		Average of DCF and sum-of-the-parts								
12-month target price (NZ$)*	**7.90**	**Spot valuations (NZ$)**								
Expected share price return	-13.0%	1. DCF			6.30					
Net dividend yield	2.4%	2. Sum of the parts			8.75					
Estimated 12-month return	-10.5%	3. n/a			n/a					
Key WACC assumptions		**DCF valuation summary (NZ$m)**								
Risk free rate	2.00%	Total firm value			9,783					
Equity beta	0.80	(Net debt)/cash			(2,182)					
WACC	6.4%	Value of equity			7,601					
Terminal growth	2.0%	Shares (m)			1,207					

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	684	743	752	782	820
Normalised EBITDA	**506**	**555**	**558**	**576**	**605**
Depreciation and amortisation	(89)	(102)	(111)	(128)	(150)
Normalised EBIT	**418**	**453**	**447**	**448**	**455**
Net interest	(77)	(79)	(79)	(84)	(88)
Associate income	9	8	9	9	10
Tax	(218)	(109)	(105)	(105)	(106)
Minority interests	-	-	-	-	-
Normalised NPAT	**263**	**275**	**271**	**269**	**272**
Abnormals/other	(387)	(249)	-	-	-
Reported NPAT	**650**	**524**	**271**	**269**	**272**
Normalised EPS (cps)	22.0	22.8	22.3	22.0	22.1
DPS (cps)	21.8	22.3	22.3	22.0	22.1

Growth Rates	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Revenue (%)	8.7	8.7	1.1	4.0	4.9
EBITDA (%)	7.0	9.6	0.6	3.3	5.0
EBIT (%)	5.6	8.4	-1.2	0.2	1.6
Normalised NPAT (%)	6.2	4.4	-1.3	-0.8	1.1
Normalised EPS (%)	5.6	3.6	-2.0	-1.4	0.5
DPS (%)	6.1	2.3	0.3	-1.4	0.5

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**506**	**555**	**558**	**576**	**605**
Working capital change	4	(40)	-	-	-
Interest & tax paid	(295)	(188)	(185)	(188)	(193)
Other	105	49	-	-	-
Operating cash flow	**321**	**376**	**373**	**388**	**412**
Capital expenditure	(387)	(320)	(488)	(640)	(640)
(Acquisitions)/divestments	347	(1)	-	-	-
Other	(9)	(7)	(7)	(12)	(15)
Funding available/(required)	**272**	**48**	**(122)**	**(265)**	**(243)**
Dividends paid	(183)	(192)	(195)	(192)	20
Equity raised/(returned)	-	-	-	-	-
Increase/(decrease) in net debt	**(90)**	**144**	**317**	**457**	**223**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	(76)	(33)	(120)	(124)	(130)
Fixed assets	6,378	6,577	6,814	7,226	7,616
Intangibles	-	-	-	-	-
Other assets	1,640	2,014	2,162	2,272	2,381
Total funds employed	**7,942**	**8,557**	**8,857**	**9,373**	**9,867**
Net debt/(cash)	1,954	2,153	2,470	2,927	3,150
Other non current liabilities	306	371	371	371	371
Shareholder's funds	5,682	6,033	6,016	6,075	6,346
Minority interests	-	-	-	-	-
Total funding sources	**7,942**	**8,557**	**8,857**	**9,373**	**9,867**

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	25.3	23.3	23.6	23.1	22.0
EV/EBIT (x)	30.7	28.5	29.4	29.7	29.2
PE (x)	41.3	39.9	40.7	41.3	41.1
Price/NTA (x)	1.9	1.8	1.8	1.8	1.8
Free cash flow yield (%)	-0.6	0.5	-1.0	-2.3	-2.1
Net dividend yield (%)	2.4	2.5	2.5	2.4	2.4
Gross dividend yield (%)	3.3	3.4	3.4	3.4	3.4
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	99	98	100	100	100

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	5.4	5.8	5.6	5.3	5.2
Interest cover EBITDA (x)	6.6	7.1	7.0	6.9	6.9
Net debt/ND+E (%)	25.6	26.3	29.1	32.5	33.2
Net debt/EBITDA (x)	3.9	3.9	4.4	5.1	5.2

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	5.1	5.2	4.9	4.7	4.5
Return on equity (%)	4.6	4.6	4.5	4.4	4.3
Return on funds employed (%)	12.3	11.0	9.6	8.6	7.7
EBITDA margin (%)	74.0	74.6	74.2	73.7	73.8
EBIT margin (%)	61.0	60.9	59.5	57.3	55.5
Capex to sales (%)	56.6	43.1	64.9	81.9	78.0
Capex to depreciation (%)	436	313	441	499	427

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Aeronautical	329	342	334	348	367
Consumer	263	301	309	319	333
Property	86	95	103	110	115
Other	6	5	5	5	6
Total sales revenue	**684**	**743**	**752**	**782**	**820**
Aeronautical	222	233	226	236	249
Consumer	219	250	252	256	267
Property	66	72	80	85	89
Total EBITDAFI	**506**	**555**	**558**	**576**	**605**

Key drivers					
International pax ('000)	10,203	10,507	10,612	10,824	11,203
Transits ('000)	1,064	1,011	860	877	908
Total international pax ('000)	11,266	11,518	11,471	11,701	12,110
Domestic pax ('000)	9,264	9,594	9,402	9,684	9,974
International pax growth (%)	4.7	3.0	1.0	2.0	3.5
Transits (%)	-1.2	-1.2	-15.0	2.0	3.5
Total international pax growth (%)	4.7	3.0	1.0	2.0	3.5
Domestic pax growth (%)	7.7	3.6	-2.0	3.0	3.0
International aircraft numbers	55,693	57,082	56,293	56,861	58,284
Domestic aircraft numbers	118,583	121,689	117,761	119,794	121,880
International MCTOW (KT)	5,798	5,894	5,841	5,928	6,106
Domestic MCTOW (KT)	2,342	2,372	2,365	2,478	2,596
Aeronautical income per pax (NZ$)	16.0	16.2	16.0	16.3	16.6
Change (%)	n/a	1.3	-1.2	1.6	2.0
Retail sales per int'l pax (NZ$)	17.8	20.5	21.1	21.3	21.5
Change (%)	n/a	15.5	3.0	1.0	1.0
Car park income per pax (NZ$)	3.2	3.1	3.1	3.2	3.0
Change (%)	n/a	-4.5	2.3	1.8	-6.9
Yield on property book value (%)	7.4	6.8	6.6	6.5	6.4

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Reduced aero earnings growth outlook

In this report we consider the near to medium term outlook for AIA's aeronautical earnings profile in light of (1) a decline in bond rates, which feed its allowable aeronautical return when prices are reset; (2) the likelihood of a lower for longer capex programme; and (3) slower pax growth in light of a more subdued demand environment.

Investor day to reset capex

AIA will host an investor day on 21 November 2019. We expect investors to be particularly focussed on the capex backdrop. We believe it is likely to provide a revised infrastructure development programme relative to its PSE3 (FY18–FY22) price setting assumptions, which in our opinion will mean:

- Lower gross capex but a similar level of assets commissioned in PSE3
- A deferral of the Northern runway delivery timetable into the 2030s
- At least a three year delay to the domestic jet terminal project

There will be no impact on already assessed PSE3 aeronautical pricing, however, we expect AIA to delay the implementation of the NZ$1.19 per pax, runway land charge, which was due to commence in FY21.

The timing of asset commissioning in PSE4 (FY23–FY27) will be later than envisioned, which will reduce the rate of aeronautical pricing growth through the next price setting period.

Earnings revisions

We reduce our FY21 and FY22 earnings forecasts as summarised in Figure 1 to primarily reflect the deferral of the runway land charge introduction. Other changes to our near term earnings estimates are immaterial. We expect aeronautical pricing growth in PSE4 (FY23–FY27) to average ~+4% pa (refer to page 11 for more detail).

Figure 1. Earnings revisions (NZ$m)

	FY20E			FY21E			FY22E		
	Old	New	Chg	Old	New	Chg	Old	New	Chg
International pax growth	1.0%	1.0%	0 bps	2.0%	2.0%	0 bps	3.5%	3.5%	0 bps
Retail per int'l pax	21.12	21.12	0.0%	21.33	21.33	0.0%	21.54	21.54	0.0%
Sales revenue	751.3	751.7	0.1%	805.3	781.7	-2.9%	843.9	820.0	-2.8%
EBITDAFI	556.6	557.9	0.2%	598.7	576.3	-3.7%	626.7	605.2	-3.4%
Underlying NPAT	**269.7**	**271.0**	**0.5%**	**288.8**	**268.8**	**-6.9%**	**290.4**	**271.8**	**-6.4%**
Underlying EPS (cents)	22.2	22.3	0.5%	23.6	22.0	-6.8%	23.6	22.1	-6.3%
DPS (cents)	22.2	22.3	0.5%	23.6	22.0	-6.8%	23.6	22.1	-6.3%

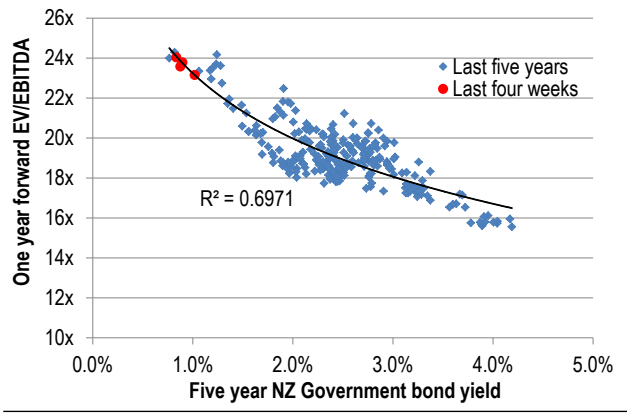
Source: Forsyth Barr analysis

Valuation

We cut our target price to NZ$7.90 from NZ$8.25 reflective of a lower aeronautical valuation. As discussed on page 11 of this report we now apply a RAB multiple of ~1.4x, reflective of (1) a lower bond rate, but (2) a lower growth outlook.

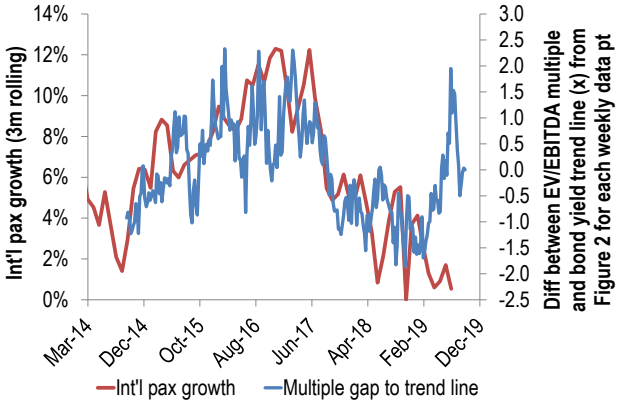
Our analysis of the relationship between AIA's forward valuation multiple, bond rates and international pax (Figures 2–3), suggest it remains over-valued. While its EV/IC and ROIC in Figure 4 are close to the best fit line of other infrastructure stocks, we expect AIA's ROIC to fall in future given its significant investment in lower returning aeronautical assets. Moreover, AIA trades at a material premium to Australasian sector peer Sydney Airport (SYD.AX) as shown in Figure 5.

Figure 2. AIA valuation relation to bond yields



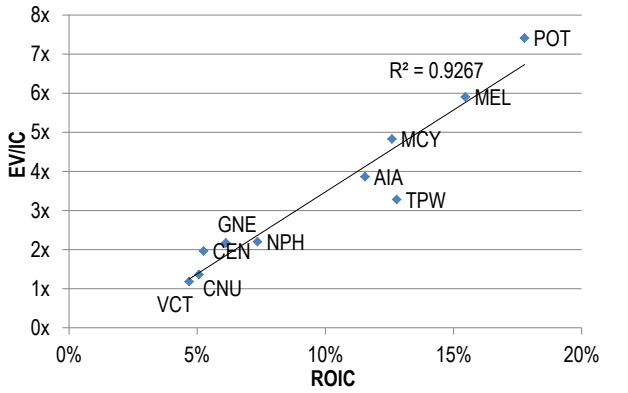
Source: Eikon, Forsyth Barr analysis NOTE: based on consensus earnings

Figure 3. Deviation from best fit explained by pax growth



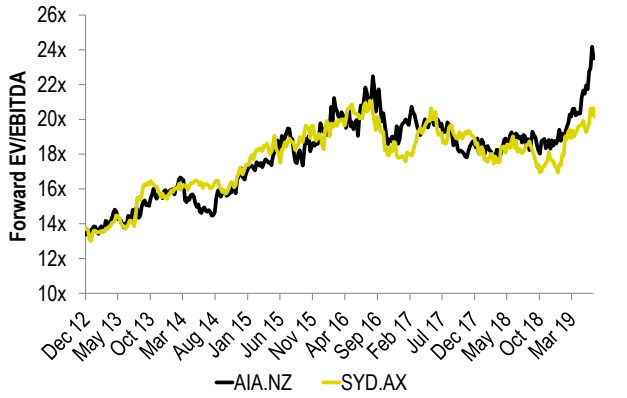
Source: Eikon, AIA, Forsyth Barr analysis NOTE: based on consensus earnings

Figure 4. Strong relationship between EV/IC and ROIC



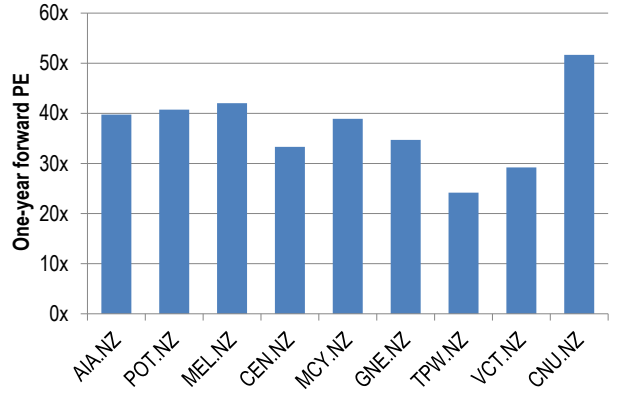
Source: Eikon, company reports, Forsyth Barr analysis NOTE: based on consensus earnings

Figure 5. AIA vs. SYD.AX



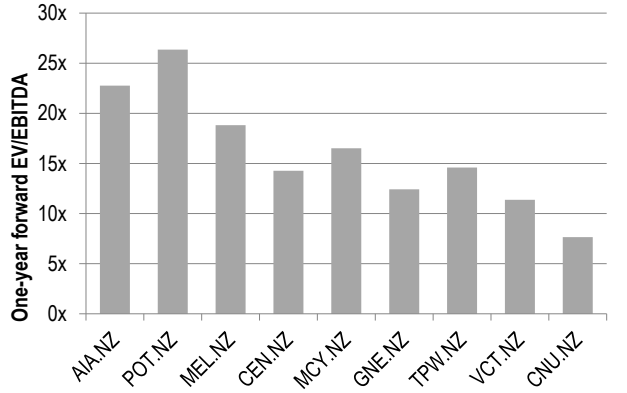
Source: Eikon, Forsyth Barr analysis NOTE: based on consensus earnings

Figure 6. One year forward PE



Source: Eikon, Forsyth Barr analysis NOTE: based on consensus earnings

Figure 7. One year forward EV/EBITDA

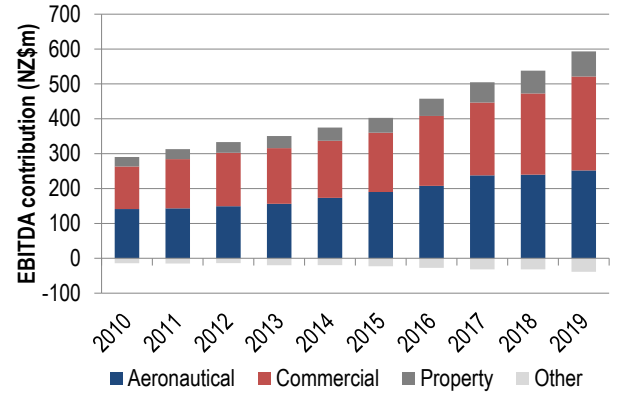


Source: Forsyth Barr analysis NOTE: based on consensus earnings

Lower WACC = lower targeted return

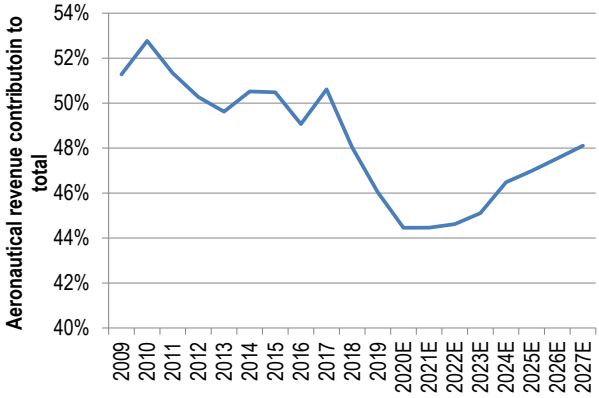
AIA is very reliant on its aeronautical earnings stream. In FY20 we estimate it will account for ~49% of group EBITDA and ~44% of group revenue. Aeronautical earnings are largely a function of a five year price setting framework. AIA is currently halfway through its current five regulated pricing year period, which began on 1 July 2017.

Figure 8. EBITDA history by operational area



Source: AIA, Forsyth Barr analysis

Figure 9. Aeronautical revenue's growing contribution



Source: AIA, Forsyth Barr analysis

Once set aeronautical prices are assessed by the Commerce Commission (ComCom). ComCom assessments are undertaken using an internal rate of return (IRR) calculation on AIA's regulatory asset base (RAB) and benchmarked against a WACC estimate derived from previously defined input methodologies. The five year Government bond rate is a key driver of its WACC estimate and therefore the ultimate allowable return.

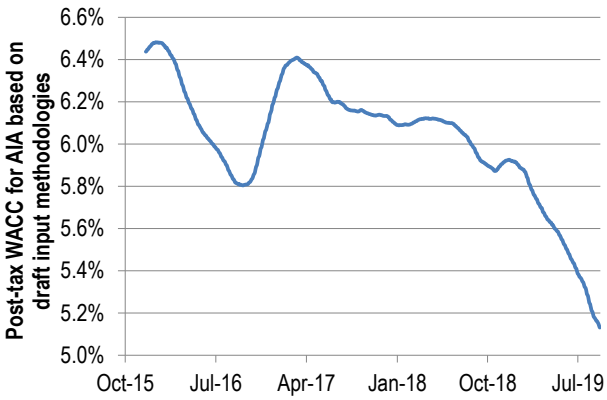
Lower bond rates will pressure allowable return

As a result of falling bond rates, AIA's allowable return in the next five year period beginning FY23 (PSE4) could fall materially from the current period (PSE3: FY18–FY22). **A lower allowable return will mean lower aeronautical earnings, and therefore lower aeronautical prices.** We estimate that based on the current five year Government bond rate, AIA's allowable return for its pricing assets will fall from 6.62% in PSE3 to 5.26% as shown in Figure 11.

Figure 10. Falling bond rates

Source: Bloomberg, Forsyth Barr analysis

Figure 11. WACC declines given falling bond rates



Source: Bloomberg, Forsyth Barr analysis

Pricing vs. non-pricing assets

AIA's regulatory assets include pricing and non-pricing assets (or priced services and other regulated services). Pricing assets are those assets that the five year price setting process imposes charges for. Non-pricing assets are those that are charged for on normal commercial terms and include aeronautical property leases. The ComCom has

outlined that it will likely review non-pricing assets as part of a broader ex-post review of airport performance in 2019–2020. In its December 2018 report on AIA's PSE3 aeronautical prices the ComCom said that it believed AIA has not "*sufficiently justified its expected return of 7.9% on its other regulated services".*

We estimate that this difference in returns between pricing and non-pricing assets equates to additional aeronautical revenue of ~NZ$35m in PSE4.

120bps fall in targeted return

We show in Figure 12 that assuming there is no change to the return on non-pricing assets that AIA's overall allowable return would fall to 5.51% from 6.73%.

Figure 12. AIA's implied WACC for PSE4 has fallen materially

	50% percentile PSE3 WACC#	AIA targeted PSE3 return after price cut	Current
Risk free rate	2.8%	2.8%	1.00%
Debt premium	1.45%	1.45%	1.10%
Debt issuance costs	0.2%	0.2%	0.2%
Investor tax rate	28.0%	28.0%	28.0%
Corporate tax rate	28.0%	28.0%	28.0%
Market risk premium	7.0%	7.0%	7.0%
Leverage	19.0%	19.0%	19.0%
Asset beta	0.60	0.63*	0.63
Equity beta	0.74	0.78	0.78
Cost of debt	4.41%	4.41%	2.30%
Cost of equity	7.17%	7.43%	6.16%
WACC	**6.41%**	**6.62%**	**5.31%**
Pricing assets		92%	92%
Non-pricing		8%	8%
Overall	**100%**	**100%**	**100%**
Targeted return			
Pricing assets		6.62%	5.31%
Non-pricing assets		7.90%	7.90%
Overall	**6.41%**	**6.73%**	**5.51%**

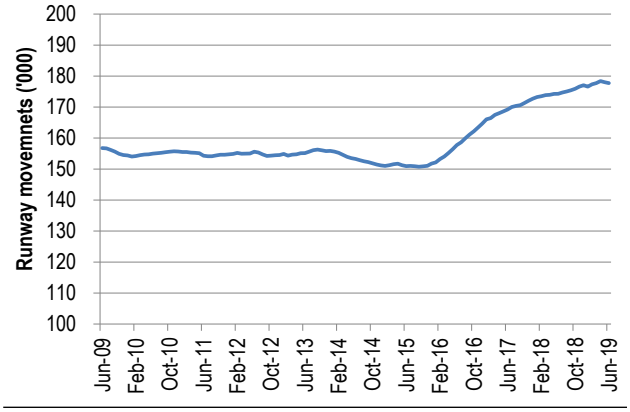
Source: Commerce Commission, Eikon, Bloomberg, Forsyth Barr analysis *higher than input methodologies at 0.60 reflecting AIA's higher level of operating leverage given its elevated capex profile. # based on input methodologies.

Northern runway to be pushed out

AIA's proposed Northern runway development will cost more than NZ$1.4bn and will take 5–8 years to complete. The company's current mid-point delivery timing is 2028. We expect this date to be pushed out at the November 2019 investor day to beyond 2030 due to (1) a slowing of pax growth, (2) further up-gauging of aircraft particularly in Air New Zealand's domestic fleet, and (3) technology advances which will increase AIA's maximum limit on runway movements to 50/hr by 2022, from 42 at the beginning of FY19.

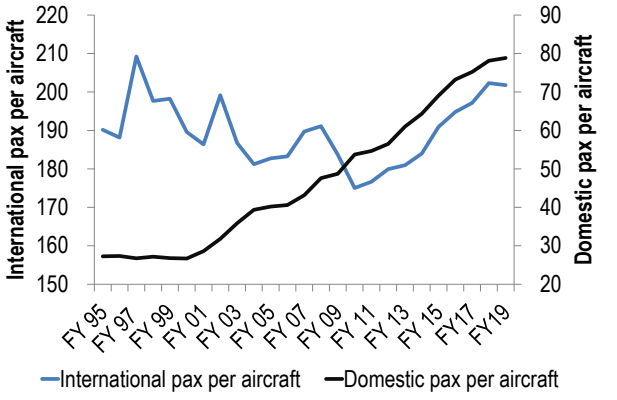
Runway capacity limitations only apply at peak times. During off-peak times AIA is comfortably within its operational limits. However, at peak times in the morning and evening for domestic services, capacity limits are an issue.

Figure 13. Runway movements have levelled off after growth spurt



Source: AIA, Forsyth Barr analysis

Figure 14. The up-gauging trend across domestic has been relentless



Source: AIA, Forsyth Barr analysis

Deferral of the 'runway land charge'

In order to trigger the runway land charge AIA needs (1) to spend NZ$50m on pre-construction activities, and (2) its Board to decide to proceed with runway construction. While we expect the first of these conditions to be fulfilled by the beginning of FY21, we are less certain that the Board will commit to the capex in the same timeframe in light of:

- The delivery timetable for the Northern runway is likely to be pushed out, as referenced above.
- Whenuapai Airport was recently raised by Air New Zealand as an alternative to Auckland Airport for passenger services (it's currently NZ's largest air force base). While we think the commercialisation of Whenuapai into a passenger airport is very unlikely to go ahead, the issue will question the timing and cost of AIA's infrastructure development pipeline, and may influence the Board to defer a decision around commencing construction of the Northern runway.

Runways take 5–8 years to build

It would be extremely difficult for AIA to justify the commencement of construction of the Northern runway ~12 years ahead of likely delivery. Other new runway developments have taken far shorter periods:

- **Brisbane Airport's** new 3.3km runway will take eight years to construct (2012–2020) of which five have been focussed on ground works to (1) raise the ground level by 3m, and (2) strengthen the previously unstable ground.
- **Dublin Airport's** new 3.1km runway will take less than five years to build. Construction commenced in late 2016 and will be completed in 2021.

Capex under spend

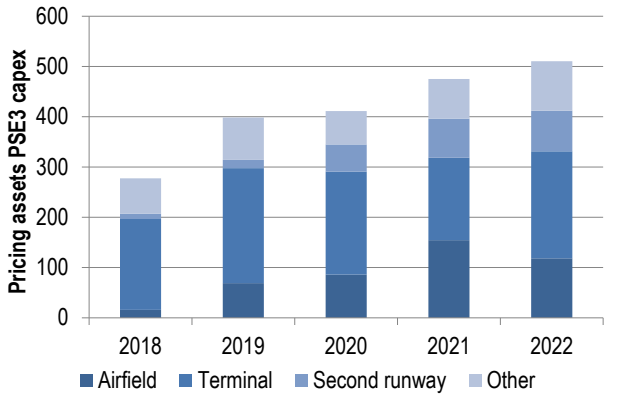
AIA is due to spend ~NZ$2.2bn (pricing asset capex of NZ$2.1bn plus NZ$0.1bn of non-pricing asset capex) of gross aeronautical capex in PSE3 (FY18–FY22) according to its 2017 pricing disclosures.

Of this and including brought forward work-in-progress, total commissioned assets amount to ~NZ$1.6bn. The difference between the two reflects the domestic jet terminal, which will only be commissioned in PSE4 (FY23–FY27) — at the time of pricing the terminal was due to be commissioned at the beginning of PSE4 but now is likely mid-PSE4, in our opinion.

Commissioned assets are key to price setting

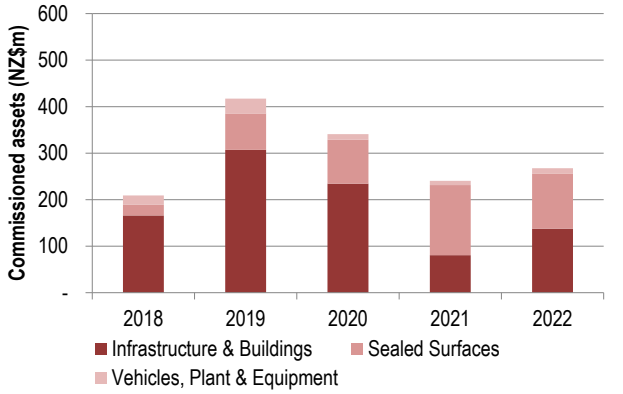
The level of commissioned assets is the more important amount for regulatory purposes as this is what pricing setting is based on. Note that assets only enter the regulatory asset base (RAB) when they are commissioned. As a general rule AIA is unable to generate income on non-commissioned assets (the exception being its proposed runway land charge).

Figure 15. Total gross PSE3 pricing assets capex = NZ$2.1bn



Source: AIA, Forsyth Barr analysis

Figure 16. Commissioned assets through PSE3 (FY18-FY22)

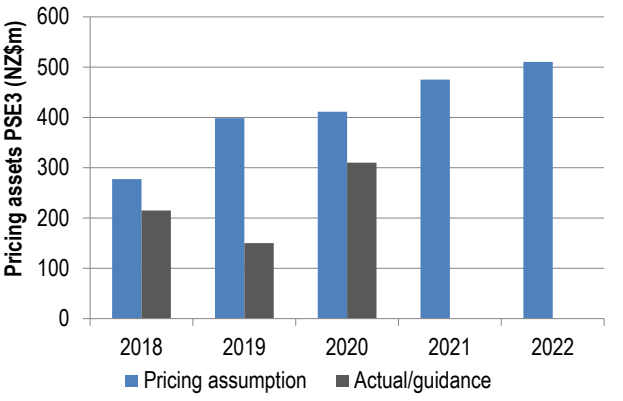


Source: AIA, Forsyth Barr analysis

Gross capex falling behind budget

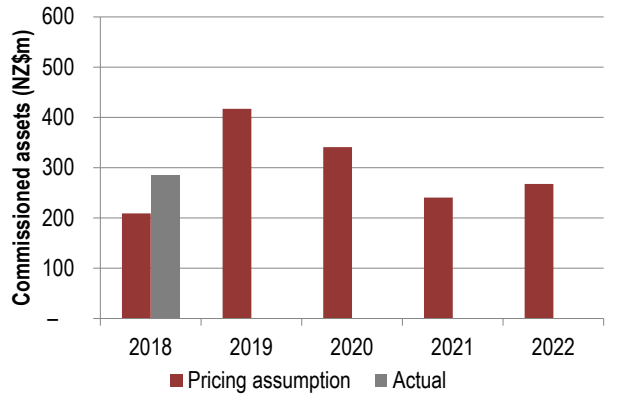
Thus far through PSE3 AIA has materially under-shot its gross capex assumptions. It spent ~NZ$365m in FY18 and FY19 combined compared to its pricing assumption of ~NZ$735m. Moreover, its FY20 capex guidance suggests aeronautical capex will create a further ~NZ$130m shortfall. Therefore, after the first three years of PSE3 it would be behind by ~NZ$500m, with only two years to catch-up.

Figure 17. Ramp up in capex in FY21 and FY22 necessary



Source: AIA, Forsyth Barr analysis

Figure 18. Commissioned capex over-shot in FY18



Source: AIA, Forsyth Barr analysis

In contrast to gross capex, commissioned assets were higher in FY18 than AIA's pricing assumptions. However, when AIA releases its next annual regulatory filing later this year we expect it to show a short-fall of commissioned assets for FY19, given the lower level of actual gross capex in FY19. Commissioned assets assumptions are less onerous over the next several years (Figure 16) and therefore we expect AIA will broadly meet its cumulative PSE3 commissioned assets pricing assumptions.

Scope to over-earn

The timing of the commissioning of assets later in the pricing period than assumed at the time of price setting will enhance the overall actual internal rate of return (IRR) relative to the targeted return, and potentially allowing AIA to over-earn relative to its price setting assumptions. .

AIA unlikely to catch-up with gross capex short-fall

Management suggests that it will largely make up for the short-fall in gross capex through the remainder of PSE3. We think this is unlikely given:

- AIA's ability to physically spend the money
- Its projects keep getting pushed out given extended planning/consultation
- The construction industry is at capacity with a strong pipeline of activity with limited resourcing
- To make up the shortfall it will need to spend more than double it has ever spent on aeronautical capex in any one year in both FY21 and FY22.

Under-spending gross capex in PSE3 will have little impact from a regulatory perspective as the IRR for the period is based on commissioned assets. However, **lower capex will mean less of a RAB uplift in the next pricing period (i.e. PSE4) and therefore lower aeronautical income, all else being equal.**

Ability to physically spend the money

The New Zealand construction industry is close to full capacity. Availability of labour to complete major projects is limited by the number and size of other horizontal and vertical construction projects being undertaken or planned to commence.

In addition, we question AIA's ability to manage a wide range of different projects simultaneously over an extended period of time, given the operational complexity that this would create. This is not a reflection of AIA's capability, more the significant challenge of what it would like to do.

Projects keep getting pushed out

AIA has under-invested in capacity over the past 5–10 years, in part driven by seemingly slow decision making and its ability to sweat older assets more. Its track record suggests that projects will continue to get pushed out.

- **Domestic jet terminal:** The new domestic jet terminal was originally due for completion in 2019, this year. PSE3 pricing documentation suggested it would be completed mid-2022. However, further delays mean it will unlikely be completed before mid-2024 at the earliest. Therefore, it would only enter the RAB mid-way through PSE4.
- **Northern runway:** As discussed above we believe the Northern runway project is likely to be deferred for a delivery date beyond 2028.

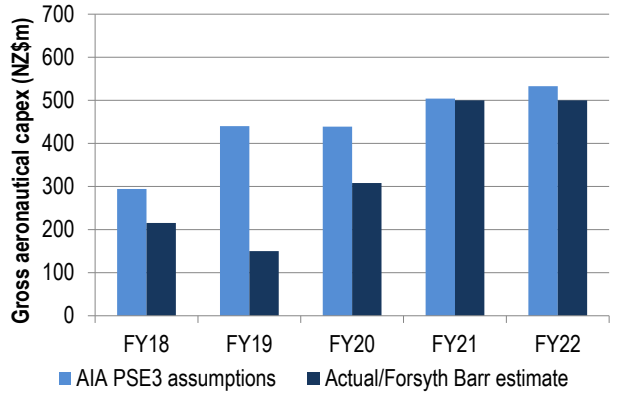
Capex profile

Our revised earnings estimates reflect updated aeronautical capex assumptions:

- Northern runway construction capex is deferred by three years; now commencing in FY24 rather than FY21
- Gross aeronautical capex capped at NZ$500m in FY21 and FY22
- Gross aeronautical capex ex-Northern runway remains at NZ$1.4bn through PSE4 but more evenly split on year on year basis. Delivery of the new domestic jet terminal is in FY26 (previously early FY23).

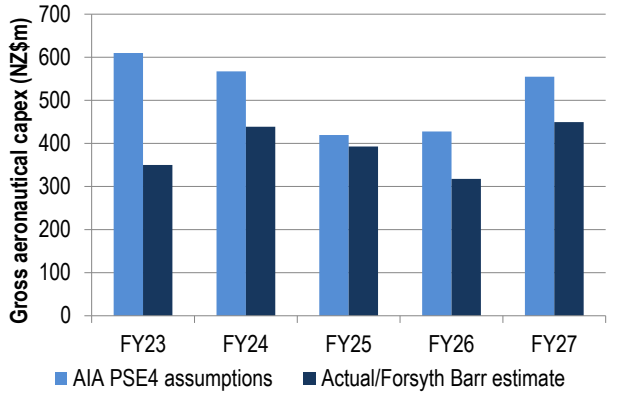
We highlight our revised aeronautical capex forecasts in Figures 19–24.

Figure 19. PSE3 gross aeronautical capex



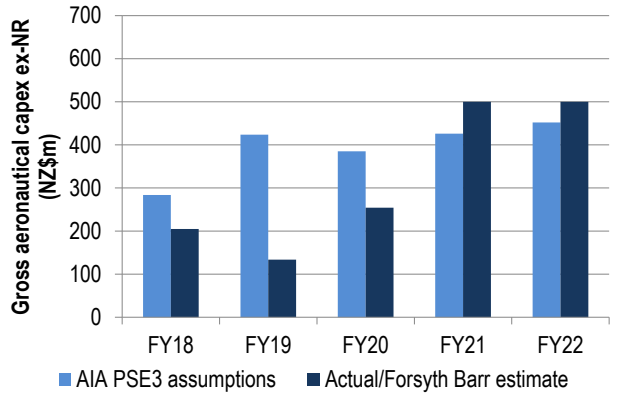
Source: AIA, Forsyth Barr analysis

Figure 20. PSE4 gross aeronautical capex



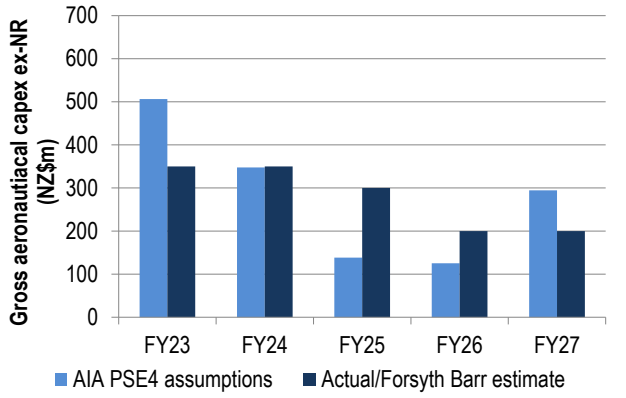
Source: AIA, Forsyth Barr analysis

Figure 21. PSE3 gross aeronautical capex ex-Northern runway



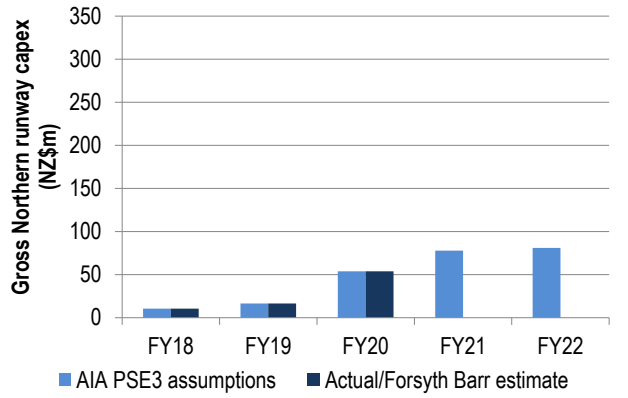
Source: AIA, Forsyth Barr analysis

Figure 22. PSE4 gross aeronautical capex ex-Northern runway



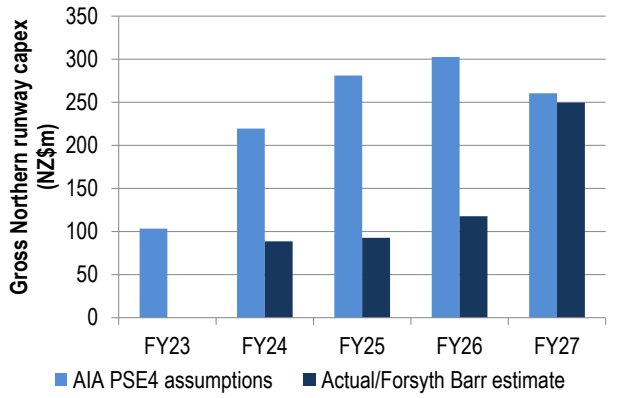
Source: AIA, Forsyth Barr analysis

Figure 23. PSE3 gross Northern runway capex



Source: AIA, Forsyth Barr analysis

Figure 24. PSE4 gross Northern runway capex



Source: AIA, Forsyth Barr analysis

Aeronautical earnings growth outlook

The short to medium term outlook for aeronautical income has deteriorated for two reasons:

- Aeronautical price increases in PSE4 will be at a lower rate than previously anticipated. Our revised modelling based on the current 5-year Government bond rate assumes that aeronautical pricing (excluding the runway land charge) grows at ~+4% pa from FY23. This, in combination with a recovery of pax growth to ~+3.5%, still provides an attractive aeronautical revenue growth stream of ~+8% during each year of PSE4.

Figure 25. Estimated aeronautical pricing growth through PSE4 at different risk free rates

Risk free rate = Five year Government bond	0.0%	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%
Pricing WACC estimate	4.59%	4.95%	5.31%	5.67%	6.03%	6.39%	6.75%
Overall WACC estimate	4.85%	5.18%	5.51%	5.85%	6.18%	6.51%	6.84%
PSE4 aeronautical pricing growth pa	**2.2%**	**3.2%**	**4.1%**	**5.0%**	**5.9%**	**6.8%**	**7.7%**

Source: Forsyth Barr analysis

- We expect the implementation of the runway land charge to be delayed from FY21 to a later date in PSE4 (probably FY24) given the likely deferral of the Northern runway project. The year of implementation of charge would benefit from a step up in profit growth.

Implications for valuation

Our RAB multiple approach to valuing AIA's aeronautical assets means that changes to underlying earnings have little impact on our calculation. However, our RAB multiple is dynamic to changes in the underlying assumptions that it is reliant on, in particular:

- **5-year Government bond rate** — the benchmark rate has fallen to ~1.0% from ~1.7% when we last adjusted our RAB multiple. This lowers the implied mid-point WACC and therefore target return that AIA is able to earn on its regulated assets.
- **Assessment of long term aeronautical growth** — we previously applied a terminal growth rate (from today) of +5%. We lower this to +4% in this report in light of slower near term growth outlook and lower bond yields which will hamper profit growth progression.
- **AIA's ability to over-earn** — AIA is able to earn a higher return than the ComCom's mid-point WACC due to (1) its use of an asset beta of 0.63 rather than 0.60 as prescribed by input methodologies; and (2) the ComCom has yet to determine the appropriate return or assessment approach for non-pricing assets/other regulated services, which currently generate returns well in excess of the mid-point WACC (~7.9% in pSE3 vs. 6.41%). This provides a risk to AIA's regulatory returns in future, but in the meantime allows AIA to over-earn relative to the mid-point.
- **AIA's capex profile over the medium term** — which influences our calculation of its RAB. We consider the forward growth in RAB and discount back to present value, therefore, providing the full benefit of future regulatory capex.

As a result of these changes our RAB multiple falls to ~1.4x from ~1.6x and our regulatory asset valuation now amounts to ~NZ$3.2bn.

Figure 26. Revised RAB multiple assumption

	PSE3 pricing assumptions	Old: 5 Mar 2019 estimate	New: 18 Sep 2019 estimate
Five year Government bond rate (risk free rate)	2.76%	1.70%	1.00%
Targeted return (ROIC)*	6.73%	6.02%	5.51%
WACC mid-point estimate (based on ComCom inputs and risk free rate)	6.41%	5.65%	5.10%
Growth (g)	5.0%	5.0%	4.0%
RAB	~1.2x	~1.6x	~1.4x

Source: Forsyth Barr analysis

Figure 27. Valuation summary (NZ$m)

	Comments	DCF	Sum-of-the-parts
Aeronautical	RAB multiple of ~1.4x		3,167
Commercial	SYD.AX commercial valuation		8,348
Property	10% premium to NTA		1,422
Other			(904)
Enterprise value		**9,103**	**12,033**
Associates		227	227
Land bank	Includes 10% property development margin	453	453
Net debt		(2,182)	(2,153)
Implied market cap		7,588	10,560
Shares on issue (m)		1,207	1,207
Implied valuation per share (NZ$)		**6.30**	**8.75**

Source: Forsyth Barr analysis

Investment summary

Auckland Airport (AIA) is New Zealand's premier airport and provides Air New Zealand with a domestic and international hub. It is very profitable given strong concession based commercial assets. It is part way through a major 10-year plus capex programme, which will facilitate longer term growth. Despite the support from attractive return on capital in AIA's non-regulated commercial assets and low prevailing Government bond rates, its valuation is stretched. Moreover earnings risk is to the downside, in our opinion. UNDERPERFORM.

Business quality

- **Hub-airport:** AIA is New Zealand's key international gateway and accounts for ~90% of all long-haul passengers (pax) arriving in New Zealand. Its available land provides scope to increase capacity over the next 30+ years.
- **Multi-pronged strategy:** AIA has three key income streams — (i) aeronautical (regulated); (ii) commercial, which incorporates retail and car parking; and (iii) development property.
- **Track record:** AIA has created value in recent years through route development activities, expanding its retail footprint to optimise passenger spend and concession rates, and developing property.

Earnings and cash flow outlook

- **Slower phase of earnings:** The growth outlook for the next three years is impacted by subdued aeronautical income and reversion to mean for pax growth after a recent boom. Earnings growth should accelerate from FY23.
- **Aeronautical income:** AIA resets its aeronautical prices every five years which are subject to regulatory oversight from the Commerce Commission (ComCom). The current price path prescribes subdued aeronautical income growth through to FY22.

Financial structure

- **Balance sheet:** AIA is in the midst of a major capex bulge given the need to build capacity. AIA expects to spend ~NZ$3.0bn over the next five years.
- **Dividends:** It has a 100% dividend pay-out rate and has a dividend reinvestment plan in place.

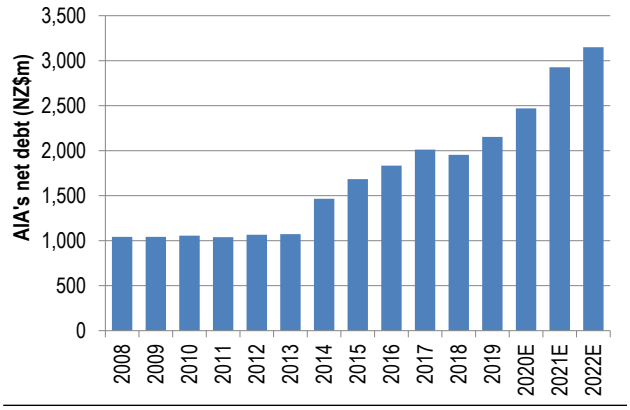
Risks factors

- **Rising bond yields:** AIA trades as a bond proxy. Its valuation holds a very strong inverse relationship with bond yields.
- **Regulatory risk:** We expect AIA to lower current aeronautical prices to ease any regulatory pressure given its mixed ComCom report last year.

Company description

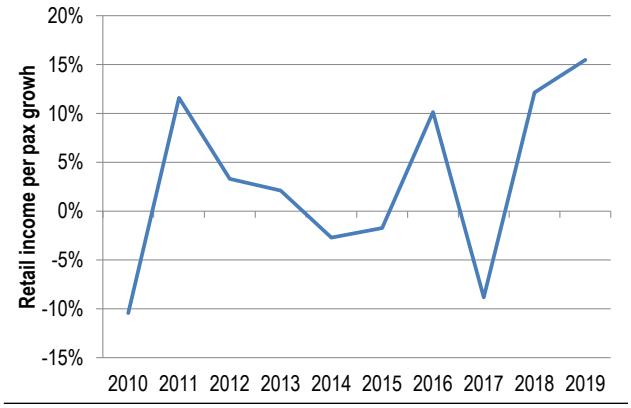
AIA was listed in July 1998 following the Government selling its majority stake. The current major shareholder, the Auckland Council, owns 22.4%. Auckland is the largest airport in New Zealand and has around a 70% share of international passenger traffic. Its share of long haul traffic is in excess of 90%. The company generates income from three core areas - regulated aeronautical, consumer activities, and investment property. AIA also has minority stake in Queenstown airport.

Figure 28. Increasing debt burden at AIA



Source: Company reports, Forsyth Barr analysis

Figure 29. Retail income per international pax growth



Source: Company reports, Forsyth Barr analysis

Figure 30. Substantial Shareholders

Shareholder	Latest Holding
Auckland City Council	22.1%
BlackRock Investment Management	5.0%

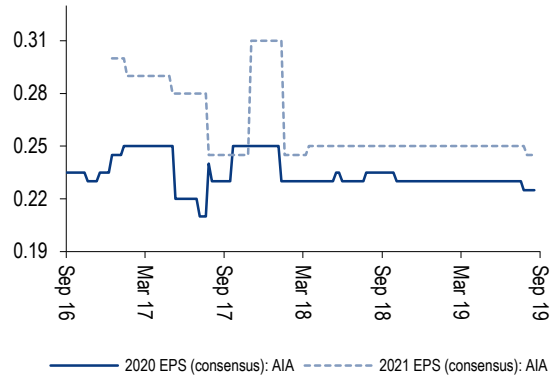
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 31. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect AIA's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Auckland Airport	**AIA NZ**	**NZ$9.08**	**NZ$10,960**	**40.7x**	**41.3x**	**23.5x**	**22.8x**	**29.3x**	**29.3x**	**2.4%**
Sydney Airport	SYD AT	A$8.01	A$18,091	45.2x	40.7x	20.1x	19.0x	29.6x	27.5x	5.2%
Malaysia Airports Holdings Bhd	MAHB MK	RM8.56	RM14,203	24.3x	21.1x	8.3x	7.8x	13.3x	12.8x	2.7%
Flughafen Wien AG	FLU AV	€38.80	€3,259	19.7x	18.9x	9.2x	8.9x	13.9x	13.3x	3.3%
Flughafen Zurich AG	FHZN SW	CHF177.70	CHF5,456	18.1x	19.8x	9.5x	9.8x	15.2x	16.3x	3.1%
Fraport AG Frankfurt Airport Services Worlc	FRA GY	€74.58	€6,896	15.5x	14.6x	9.1x	8.8x	14.9x	14.2x	3.0%
Airports of Thailand PCL	AOT TB	THB73.50	THB1,049,999	37.5x	29.4x	24.2x	19.0x	28.5x	22.6x	2.0%
Beijing Capital International Airport Co	694 HK	CN¥7.14	CN¥30,923	16.2x	20.5x	7.9x	9.4x	12.1x	15.9x	2.1%
			Compco Average:	**25.2x**	**23.6x**	**12.6x**	**11.8x**	**18.2x**	**17.5x**	**3.0%**
EV = Current Market Cap + Actual Net Debt			**AIA Relative:**	**+62%**	**+75%**	**+86%**	**+93%**	**+61%**	**+67%**	**-21%**

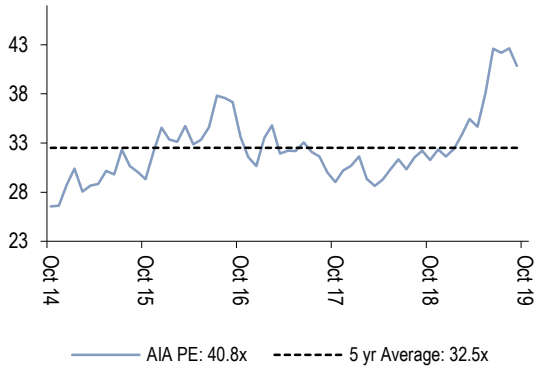
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (AIA) companies fiscal year end

Figure 32. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 3328. 12 Month Forward PE



Source: Forsyth Barr analysis