

# Auckland Airport

## Twists and Turns on Runway to Recovery

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**NEUTRAL** 

The outlook for Auckland Airport's (AIA) passenger and profit recovery remains uncertain, yet deconstructing the current share price relative to pre COVID-19 levels suggest our recovery profile is broadly consistent with implied market expectations. The rising number of domestic passengers (pax) represents the first recovery steps, which is positive for business momentum, yet profitability is more leveraged to international pax. It typically generates 4.5x the income from an international pax than a domestic pax. Apathy to travel, border closures, medical solutions, and the economic implications of COVID-19 will all influence the timing and slope of the recovery in international pax. We expect AIA to get back to FY19 international levels in FY25, though we recognise the high margin for error in this forecast. Through COVID-19 AIA's share price has closely tracked those of its international airport peers. We expect it to continue to be influenced by aviation recovery sentiment in the absence of any certainty around the cash flow outlook. We raise our target price to NZ\$5.70 to reflect a marginally more positive view on medium term retail concession yields and retain a NEUTRAL rating.

NZX Code	AIA	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$6.44	NPAT* (NZ\$m)	274.7	165.5	-6.2	167.2	EV/EBITDA	20.6	28.1	77.9	28.3
Target price	NZ\$5.70	EPS* (NZc)	22.8	13.1	-0.4	11.4	EV/EBIT	25.2	38.8	n/a	40.1
Risk rating	Low	EPS growth* (%)	3.6	-42.5	n/a	n/a	PE	28.3	49.2	n/a	56.6
Issued shares	1470.2m	DPS (NZc)	22.3	0.0	0.0	4.6	Price / NTA	1.3	1.1	1.3	1.3
Market cap	NZ\$9,468m	Imputation (%)	100	100	100	100	Cash div yld (%)	3.5	0.0	0.0	0.7
Avg daily turnover	2,047k (NZ\$14,254k)	*Based on normalised profits					Gross div yld (%)	4.8	0.0	0.0	1.0

### AIA is tracking global airports

Since the start of 2020, AIA's share price has exhibited a ~95% correlation (r-squared) to its global listed airport peers. This compares to a ~37% correlation for the prior two years. Airport share prices appear to be performing as a pack given the inherent difficulty in valuing them currently. Asset bases provide a valuation benchmark for some airports and some airport assets but in AIA's case are of limited use, given the valuation of its 'second till' commercial assets are linked to forward earnings potential. Earnings multiples and dividend yields have little relevance given the lack of earnings generation with reduced passenger flows.

### Pax recovery and retail uncertainty; aeronautical and investment property stability

The largest margin for error in assessing the longer term outlook for AIA is profiling the passenger recovery. The timing, slope and longer term passenger growth rate are all key uncertainties and have a material impact on value. In addition, concession yields in retailing will likely change (downwards) in light of the impact on the future risk appetite among travel retailers. In contrast, the cashflow/earnings from aeronautical (from FY23 when prices are reset) and investment property (stable cap rates) should be largely unchanged as a result of COVID-19.

### COVID-19 valuation hit fair

COVID-19 has removed almost NZ\$2.5bn from AIA's enterprise value (EV = market capitalisation + net debt). This value reduction is largely concentrated in its commercial activities. Our analysis suggests the company's commercial value has fallen by ~30% since pre COVID-19. This is broadly consistent with the revisions over the same period to our modelling of AIA's commercial income stream.

**Auckland International Airport Ltd (AIA)**

Priced as at 21 Jul 2020 (NZ\$)						<b>6.44</b>									
<b>12-month target price (NZ\$)*</b>						<b>5.70</b>	<b>Spot valuations (NZ\$)</b>								
Expected share price return						-11.5%	1. DCF					5.25			
Net dividend yield						0.1%	2. n/a					n/a			
Estimated 12-month return						-11.4%	3. n/a					n/a			
<b>Key WACC assumptions</b>						<b>DCF valuation summary (NZ\$m)</b>									
Risk free rate						2.00%	Total firm value					10,013			
Equity beta						0.80	(Net debt)/cash					(2,294)			
WACC						6.2%	Less: Capitalised operating leases					0			
Terminal growth						2.0%	Value of equity					7,719			
<b>Profit and Loss Account (NZ\$m)</b>						<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>					
Sales revenue	683.9	743.4	565.2	282.3	551.2										
<b>Normalised EBITDA</b>	<b>506.4</b>	<b>554.8</b>	<b>393.3</b>	<b>135.6</b>	<b>373.7</b>										
Depreciation and amortisation	(88.9)	(102.2)	(108.5)	(107.7)	(110.4)										
<b>Normalised EBIT</b>	<b>417.5</b>	<b>452.6</b>	<b>284.8</b>	<b>27.9</b>	<b>263.2</b>										
Net interest	(77.2)	(78.5)	(65.3)	(36.4)	(35.9)										
Associate income	8.5	8.2	6.0	0	5.0										
Tax	(217.7)	(109.2)	(9.3)	2.4	(65.0)										
Minority interests	0	0	0	0	0										
<b>Normalised NPAT</b>	<b>263.1</b>	<b>274.7</b>	<b>165.5</b>	<b>(6.2)</b>	<b>167.2</b>										
Abnormals/other	(387.0)	(248.8)	(32.5)	0	0										
<b>Reported NPAT</b>	<b>650.1</b>	<b>523.5</b>	<b>198.0</b>	<b>(6.2)</b>	<b>167.2</b>										
Normalised EPS (cps)	22.0	22.8	13.1	(0.4)	11.4										
DPS (cps)	21.8	22.3	0	0	4.6										
<b>Growth Rates</b>						<b>2018A</b>	<b>2019A</b>	<b>2020A</b>	<b>2021A</b>	<b>2022A</b>					
Revenue (%)	8.7	8.7	-24.0	-50.1	95.3										
EBITDA (%)	7.0	9.6	-29.1	-65.5	>100										
EBIT (%)	5.6	8.4	-37.1	-90.2	>100										
Normalised NPAT (%)	6.2	4.4	-39.8	n/a	n/a										
Normalised EPS (%)	5.6	3.6	-42.5	n/a	n/a										
Ordinary DPS (%)	6.1	2.3	-100.0	n/a	n/a										
<b>Cash Flow (NZ\$m)</b>						<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>					
<b>EBITDA</b>	<b>506.4</b>	<b>554.8</b>	<b>393.3</b>	<b>135.6</b>	<b>373.7</b>										
Working capital change	(12.3)	(48.6)	(6.0)	0	(5.0)										
Interest & tax paid	(294.9)	(187.7)	(74.7)	(34.0)	(101.0)										
Other	122.0	57.4	(105.2)	0	5.0										
<b>Operating cash flow</b>	<b>321.2</b>	<b>375.9</b>	<b>207.4</b>	<b>101.5</b>	<b>272.7</b>										
Capital expenditure	(387.4)	(320.1)	(350.0)	(160.0)	(340.0)										
(Acquisitions)/divestments	347.3	(0.8)	0	0	0										
Other	(8.8)	(7.0)	(11.9)	(10.9)	(9.7)										
<b>Funding available/(required)</b>	<b>272.3</b>	<b>48.0</b>	<b>(154.5)</b>	<b>(69.3)</b>	<b>(77.1)</b>										
Dividends paid	(182.8)	(192.4)	(98.0)	0	(28.4)										
Equity raised/(returned)	0	0	1,200.0	0	0										
<b>(Increase)/decrease in net debt</b>	<b>89.5</b>	<b>(144.4)</b>	<b>947.5</b>	<b>(69.3)</b>	<b>(105.5)</b>										
<b>Balance Sheet (NZ\$m)</b>						<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>					
Working capital	(76.3)	(33.4)	(89.9)	(44.9)	(87.6)										
Fixed assets	6,378.0	6,577.1	6,658.6	6,620.9	6,760.5										
Intangibles	0	0	0	0	0										
Right of use asset	0	0	0	0	0										
Other assets	1,640.4	2,013.7	2,179.7	2,269.7	2,364.7										
<b>Total funds employed</b>	<b>7,942.1</b>	<b>8,557.4</b>	<b>8,748.4</b>	<b>8,845.7</b>	<b>9,037.5</b>										
Net debt/(cash)	1,953.6	2,153.1	1,205.6	1,274.9	1,380.4										
Lease liability	0	0	0	0	0										
Other liabilities	306.4	371.4	371.4	371.4	371.4										
Shareholder's funds	5,682.1	6,032.9	7,171.5	7,199.4	7,285.7										
Minority interests	0	0	0	0	0										
<b>Total funding sources</b>	<b>7,942.1</b>	<b>8,557.4</b>	<b>8,748.4</b>	<b>8,845.7</b>	<b>9,037.5</b>										
						<b>Valuation Ratios</b>					<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
						EV/EBITDA (x)					22.3	20.6	28.1	77.9	28.3
						EV/EBIT (x)					27.1	25.2	38.8	>100x	40.1
						PE (x)					29.3	28.3	49.2	n/a	56.6
						Price/NTA (x)					1.4	1.3	1.1	1.3	1.3
						Free cash flow yield (%)					-0.7	0.6	-1.5	-0.6	-0.7
						Net dividend yield (%)					3.4	3.5	0.0	0.0	0.7
						Gross dividend yield (%)					4.7	4.8	0.0	0.0	1.0
						<b>Capital Structure</b>					<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
						Interest cover EBIT (x)					5.4	5.8	4.4	0.8	7.3
						Interest cover EBITDA (x)					6.6	7.1	6.0	3.7	10.4
						Net debt/ND+E (%)					25.6	26.3	14.4	15.0	15.9
						Net debt/EBITDA (x)					3.9	3.9	3.1	9.4	3.7
						<b>Key Ratios</b>					<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
						Return on assets (%)					5.1	5.2	3.2	0.3	2.8
						Return on equity (%)					4.6	4.6	2.3	-0.1	2.3
						Return on funds employed (%)					12.3	11.0	7.0	0.4	5.2
						EBITDA margin (%)					74.0	74.6	69.6	48.0	67.8
						EBIT margin (%)					61.0	60.9	50.4	9.9	47.7
						Capex to sales (%)					56.6	43.1	61.9	56.7	61.7
						Capex to depreciation (%)					436	313	323	149	308
						Imputation (%)					100	100	100	100	100
						Pay-out ratio (%)					99	98	0	0	40
						<b>Operating Performance</b>					<b>2018A</b>	<b>2019A</b>	<b>2020E</b>	<b>2021E</b>	<b>2022E</b>
						Aeronautical					328.5	342.2	257.3	116.6	256.2
						Consumer					263.0	301.3	213.2	72.9	201.3
						Property					86.1	94.7	89.4	87.4	88.2
						Other					6.3	5.2	5.3	5.4	5.5
						<b>Total sales revenue</b>					<b>683.9</b>	<b>743.4</b>	<b>565.2</b>	<b>282.3</b>	<b>551.2</b>
						Aeronautical					239.9	252.1	175.3	46.6	174.2
						Consumer					232.6	269.0	185.2	46.9	173.3
						Property					65.5	72.2	69.7	68.2	67.9
						<b>Total EBITDAFI</b>					<b>506.4</b>	<b>554.8</b>	<b>393.3</b>	<b>135.6</b>	<b>373.7</b>
						International pax growth (%)					4.7	3.0	-26.3	-72.8	250.0
						Transits (%)					-1.2	-1.2	-1.2	-93.5	1,380.6
						Total int'l pax growth (%)					4.7	3.0	-26.3	-72.8	250.0
						Domestic pax growth (%)					7.7	3.6	-26.5	-31.9	50.0
						Aero income per pax change					-2.4	1.3	2.8	3.1	3.6
						Retail sales per int'l pax change					12.1	15.5	-8.0	0.0	0.0
						Car park income per pax change					1.6	1.8	0.0	0.0	3.0
						Yield on property BV (%)					7.4	6.8	5.6	5.0	4.7
						Int'l aircraft numbers ('000)					55.7	57.1	41.6	10.4	38.8
						Domestic aircraft numbers ('000)					118.6	121.7	90.3	64.0	94.7

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

## Share price within 'ball park'

The level of uncertainty prevailing in the aviation world means having strong conviction on the value of AIA is not possible. There remains a wide range of potential cashflow outcomes over the near, medium and long term, given the high margin for error in forecasting passenger numbers. There are more unknowns than knowns. Consequently, there are few aspects of the AIA investment case that we currently have a strong degree of certainty over.

**Figure 1. High margin for error in passenger recovery profile**

Key driver	Our view	Margin for error
<b>Passenger recovery</b>		
International pax over near/medium term	FY21: 20% of FY19; FY22: 70%; FY23: 80%; FY24: 90%; FY25: 100%	High
Passenger growth longer term	More likely to be lower than higher. We assume no change	Modest
<b>Retail</b>		
Concession yields	Lower as a result of COVID-19, partly mitigated by single duty free operator	Modest
Passenger spend rates	Reflects pax mix in international terminal. Assume no change	Low
<b>Aeronautical</b>		
Regulatory asset base (RAB)	Forward profile of RAB will be lower. Current RAB used in valuation unchanged	Modest
Aeronautical earnings	Less steep forward profile given lower targeted return/WACC and RAB	Modest
<b>Investment property</b>		
Net tangible assets	Largely unchanged given stable cap rate	Low

Source: Forsyth Barr analysis

Our near term earnings for AIA are largely unchanged in this report. However, we modestly lift our medium term retail income per passenger to NZ\$19 from NZ\$18 in FY23 to reflect a marginally more optimistic view on AIA's ability to mitigate the downside impact on its concession yields from COVID-19 through its next duty free tender process. Our target price rises from NZ\$5.50 to NZ\$5.70 as a result.

## Valuation

Valuing AIA is difficult currently in light of an uncertain cash flow outlook. While we can look to AIA's asset base to form a valuation basis for its aeronautical and investment property businesses, its higher returning (and ordinarily higher multiple) commercial business requires a view on future cashflows. The use of near term forward earnings multiples are challenging given the lack of earnings. This problem is not solely an AIA problem. Global airports face the same challenges. The predicament for investors is encapsulated in share trading patterns through COVID-19.

### Airports trading as a bunch

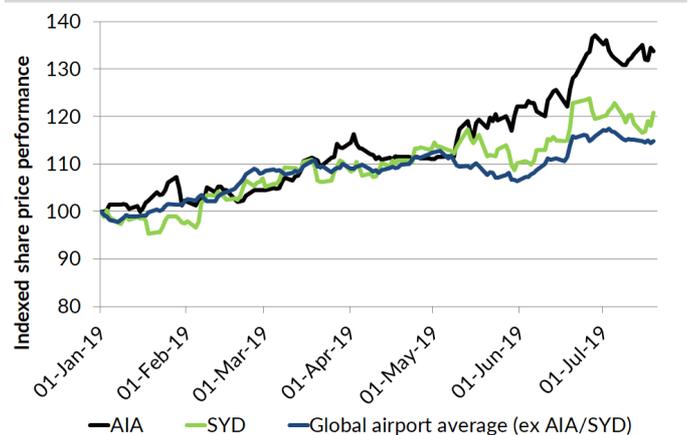
Since the beginning of 2020 AIA's share price has been highly correlated to its international airport peers (Figure 2). The r-squared coefficient is 95% using daily share prices. This is unusually high relative to AIA's historical trading patterns. During the same period in 2019 the r-squared was 67% (Figure 3) and 37% over the past two years.

**Figure 2. Airport share price performance in 2020**



Source: Eikon, Forsyth Barr analysis NOTE: Global peers include MAHB.KL, FHZNS, VIEV.VI, ADP.PA, FRAG.DE, AOT.BK, AENA.MC, 600009.SS, SATS.SI, 9706.T, 000089.SZ, 0694.HK

**Figure 3. Same period during 2019**



Source: Forsyth Barr analysis

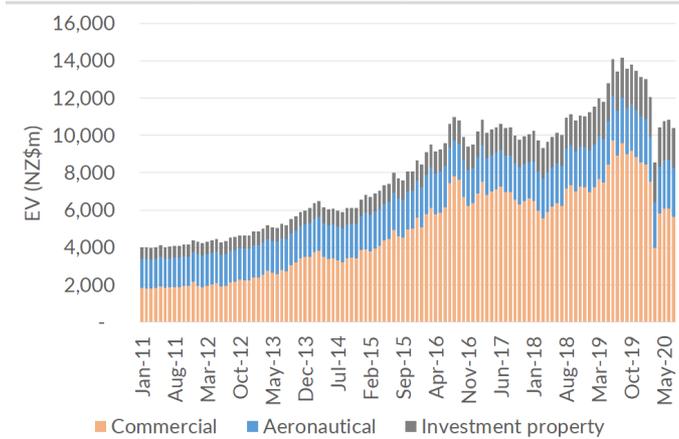
**What is the current share price telling us?**

The mid-point nature of a DCF or sum-of-the-parts valuation calculation provides a degree of accuracy, which is impossible to have any conviction over currently. We retain these approaches to drive our target price, but caution investors from taking them too definitively as to what valuation is currently appropriate for AIA. Instead we work backwards from the current share price to reverse engineer what it is telling us. In Figure 4 we show a breakdown of AIA's enterprise value (EV = market cap + net debt) since 2011, split between its three core segments – aeronautical, investment property and commercial. Of these, aeronautical and investment property are both asset backed and therefore relatively easy to compute.

- The **aeronautical** value is applied as a RAB multiple based on the last published RAB (adjusted to include land held for future use and assets under construction). We apply a premium to RAB based on the equation  $([ROIC - g] / [WACC - g])$  where ROIC is assumed to be +50 bps better than WACC (AIA's ability to over-earn relative to the mid-point being recognised given its asset beta adjustment for operating leverage and the higher return generated on non-pricing assets) and g is assumed to be consistent with long term international pax growth of ~+3.5%.
- The **investment property** multiple is calculated using historic NTA with a constant +10% premium applied.
- The **commercial** value is what is left after subtracting the above two segments from AIA's EV.

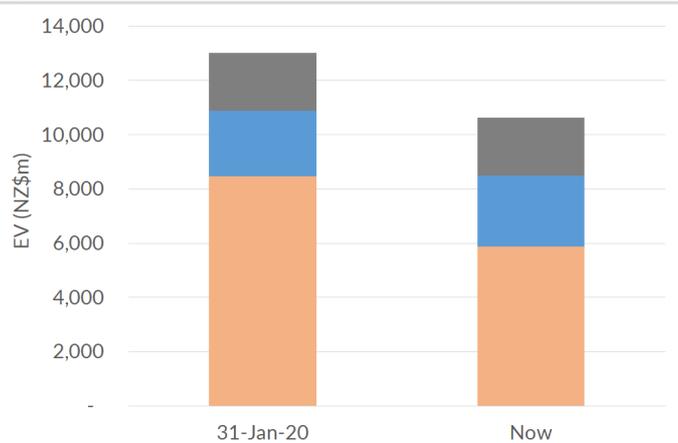
The analysis tells us that AIA's commercial EV has fallen by ~40% from its peak in mid-2019, and ~30% from early 2020 (pre COVID-19) when New Zealand Government bond rates (the risk free rate ) were only marginally higher than they are now. Is this reasonable?

**Figure 4. Deducing the commercial segment's value**



Source: Eikon, Forsyth Barr analysis

**Figure 5. Pre COVID-19 and now**



Source: Eikon, Forsyth Barr analysis NOTE: we make no adjustment in this assessment for the near term loss of aeronautical earnings vs pricing expectations. We estimate this could be NZ \$100m-NZ\$200m loss of value relative to our RAB based approach, which is relatively immaterial in scheme of our overall analysis.

We think it is reasonable. A -30% reduction in the commercial value, all else being equal, reflects an underlying ~30% reduction in free cash flows. This is the equivalent to:

- Seven years of lost commercial earnings then reverting back to the previous earnings trajectory (unlikely, but possible); or
- Four years of lost commercial earnings then reverting back to pre COVID-19 levels of commercial earnings on prior growth trajectory; or
- Two years of lost commercial earnings and a -20% drop in commercial earnings from pre COVID-19 levels then growing on same trajectory as previously but from a lower base. This implies a permanent reduction in the commercial segment's return on capital.

In contrast, our commercial segment 10 year cashflow forecasts have also fallen by ~30% since pre COVID-19 with earlier cashflows more impacted than later cashflows.

On a pre COVID-19 earnings base, AIA's higher return on capital commercial assets trade at a ~22x EBITDA multiple, compared to the company as a whole on ~19x. This is far from cheap, particularly given the EBITDA decline post COVID-19, but similarly we don't believe it's excessively expensive when compared to the pre COVID-19 implied multiple of ~32x using the same methodology, particularly given the valuation benefit from bond yield compression.

## Pax recovery path; high margin for error

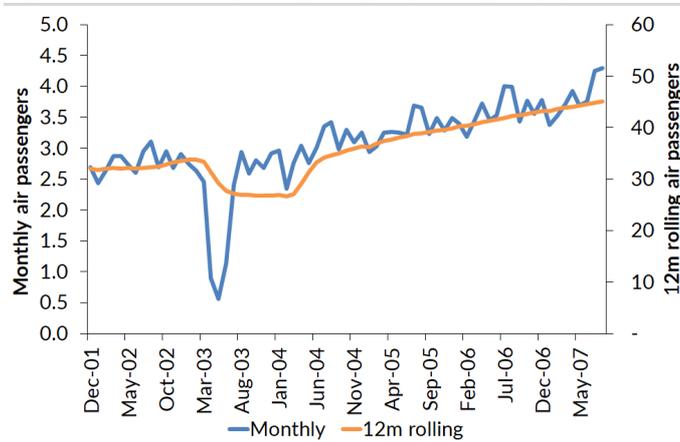
Our forecasts assume that AIA's recovery will be long-dated with international pax recovering to FY19 levels in FY25 and domestic a year earlier. We have no inside knowledge or historic play book to fall back on in deriving these forecasts. We acknowledge the high margin for error in these forecasts. However, we are not alone when considering a long dated recovery. The owner of airports in Paris, Groupe ADP, recently said "It turns out now that the **traffic recovery will be very gradual, with a return to the 2019 level expected between 2024 and 2027**".

### Comparison to other events

COVID-19 has turned into the worst event to impact the aviation world since the second world war. The impact on passengers is broadly threefold: (1) the propensity to fly during the pandemic as a result of the virus, (2) border restrictions in place globally, and (3) the economic impact of COVID-19 on disposable incomes and affordability of travel. We've previously looked at other events such as SARS, the GFC and Swine flu to gain an understanding of how quickly travel markets recover. We revisit these recovery profiles in Figures 6-8 and plot all three against our COVID-19 passenger recovery path for AIA in Figure 9.

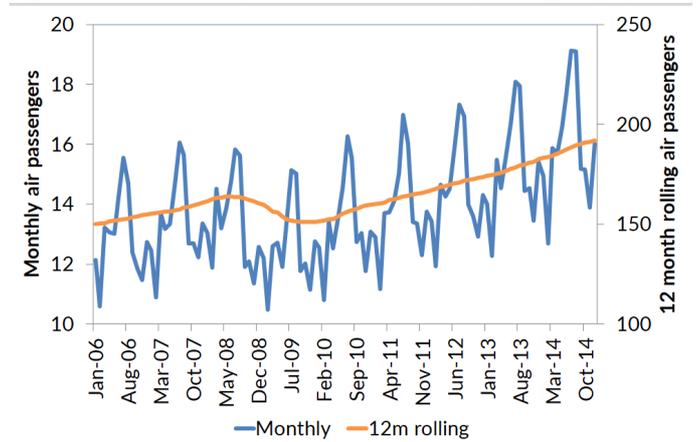
There is a strong possibility that these passenger forecasts will be wrong, and materially so.

**Figure 6. SAR recovery: Hong Kong air passengers (m)**



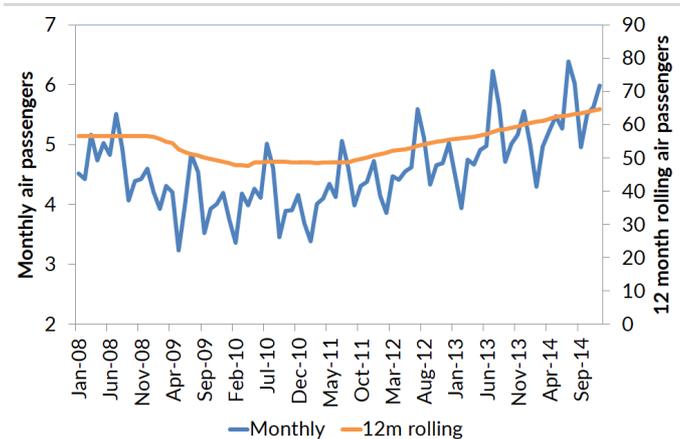
Source: Civil Aviation Dept (Hong Kong), Forsyth Barr analysis

**Figure 7. GFC recovery: US international air passengers (m)**



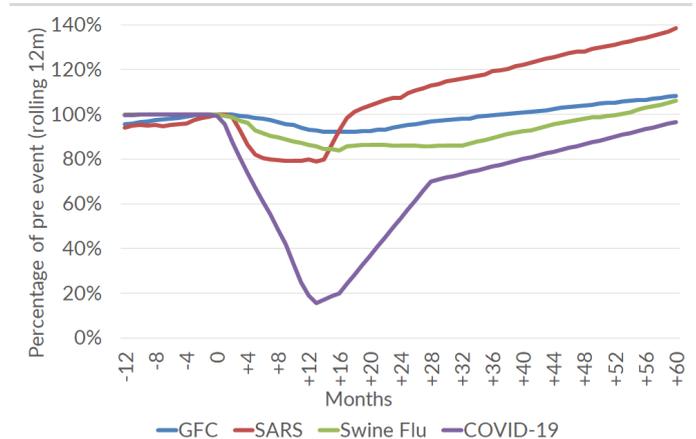
Source: Bureau of Transportation (US), Forsyth Barr analysis

**Figure 8. Swine flu recovery: Mexican air passengers (m)**



Source: CEIC, Forsyth Barr analysis

**Figure 9. Our forecasts vs other recovery profiles**



Source: Forsyth Barr analysis

## Retail uncertainty

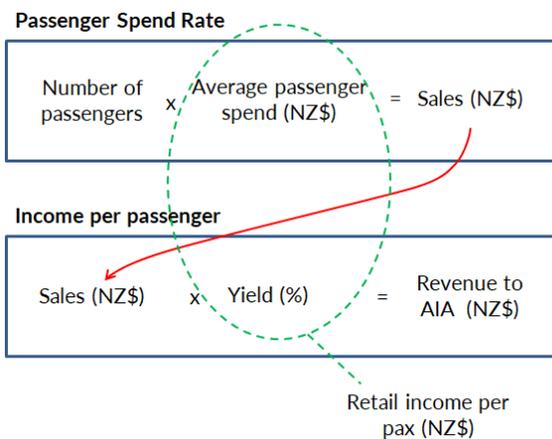
Retail is the core of AIA's commercial activities, which have generated high margins and super-returns (ROIC) in recent years, providing the basis for high implied valuations. Retail has been hard hit by COVID-19, as despite retailers being subject to minimum annual guarantees (MAGs), these have been largely removed by AIA to ensure retail tenants remain solvent. We expect to remain absent for the foreseeable future.

AIA's retail income is simplistically a function of three drivers (1) the number of passengers, (2) passenger spend rates (PSR), and (3) the average concession yield, as shown in Figure 10. The lasting impact of COVID-19 on each of these drivers is uncertain. We explored (1) above; (2) and (3) are more difficult to gauge.

### Passenger spend rates (PSR)

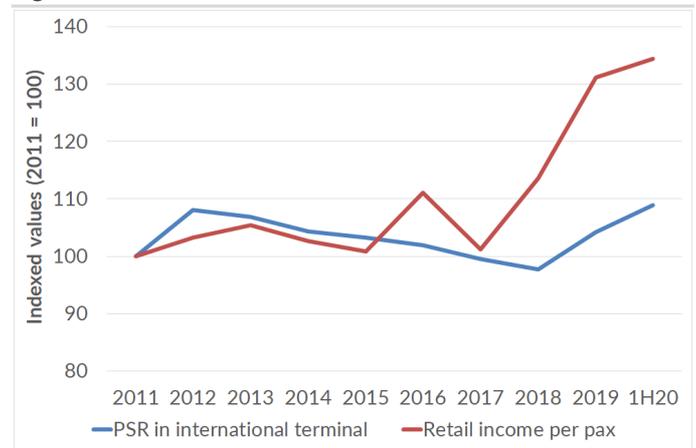
PSR at AIA has increased following the completion of the international departures area, which encompassed significant retail space expansion. Greater retail space allows for a larger range of products thereby meeting more passenger needs. However, PSR at AIA declined successively from 2012 through 2018 (Figure 11). This was due to a number of factors including (1) tobacco rule changes, (2) disruption from the retail expansion, (3) increasing competition from online retail, and (4) increasing competition with other ports, particularly China as new inbound duty free stores opened.

**Figure 10. PSR x yield = retail income per pax**



Source: Forsyth Barr analysis

**Figure 11. PSR has increased at AIA**



Source: AIA, Forsyth Barr analysis

We expect PSR to return to pre COVID-19 levels once international air travel resumes en masse. We do not expect any meaningful change in dwell times or traveller spending capacity. While cyclical economic factors will impact air travel, we expect this will impact the pax recovery profile more than PSR.

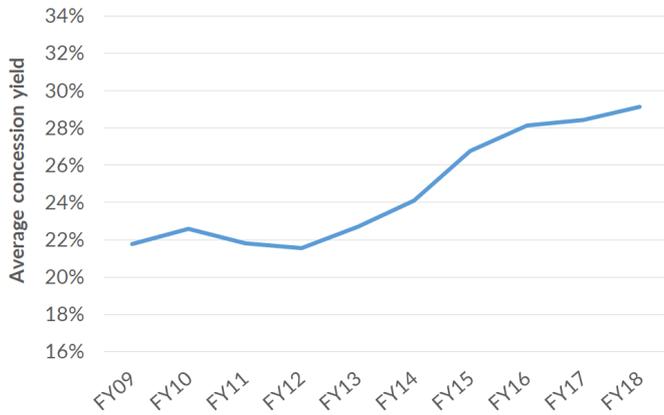
### Concession yields

Concession yields have been rising for airports globally as highlighted by the average concession yield paid by the global leader in travel retailer, Dufry (refer to Figure 12). While not disclosed it is apparent through (1) our analysis of the concession payments of its duty free retailers in Figure 13, and (2) discussions with management historically, that AIA's average concession yields have been rising also. Rising concession yields reflect increasing airport sophistication in managing retail concessions and a fragmented travel retail industry globally.

However, we believe there will be an adverse impact from COVID-19 on the risk appetite of retailers to bid-up in airport tenders and likely industry consolidation as weakened balance sheets look for support.

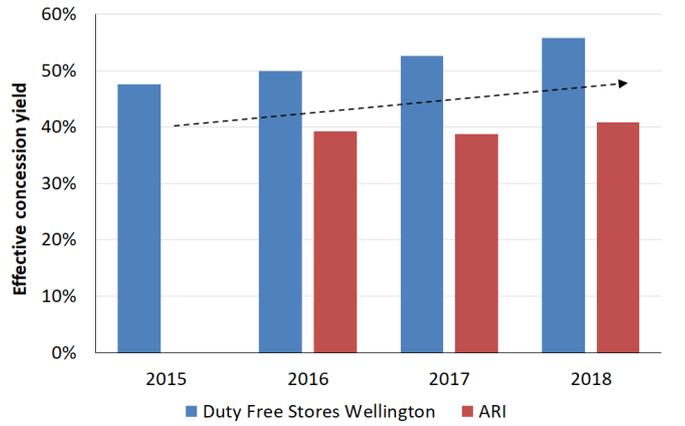
Consequently, we don't expect AIA's retail income per pax to return to CY19 levels in the foreseeable future. However, a mitigating factor for AIA will be the prospect of it moving to a single duty free operator model at its next tender. Refer to our report *Auckland Airport: Duty Free to Fly Solo*, dated 29 January 2020 for more insight.

**Figure 12. Dufry's concession yields have risen in recent years**



Source: Dufry, Forsyth Barr analysis NOTE: based on reported concession payments as a proportion of group net sales

**Figure 13. Auckland Airport retailer concession yields**



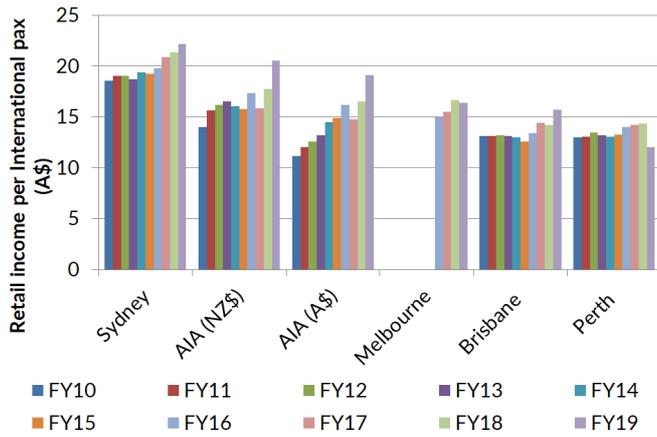
Source: Companies Office, Forsyth Barr analysis

**Retail income per pax**

The multiplication of PSR and average concession yield produces average retail income per pax, which is a critical retail metric for AIA. In light of rising concession yields and more latterly PSR, retail income per pax at AIA has grown over the longer term. In CY19 we calculate it was ~NZ\$20.75 compared to ~NZ\$16.25 in CY12.

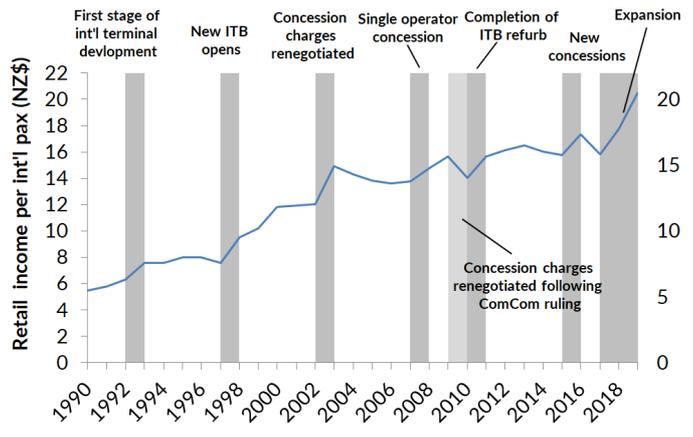
AIA's advancing retail income per pax has been impressive relative to other larger airports in Australasia as shown in Figure 14. The comparison between AIA and other Australasian airports uses available reported figures but we acknowledge that the disclosure of 'retail' income by airport may differ. For example AIA incorporates car rental income in its retail income but other Australasian airports include it in ground transport revenue. Therefore, this analysis must be considered with a 'pinch of salt'.

**Figure 14. Retail income per pax at different airports**



Source: Company reports, BITRE, Forsyth Barr analysis NOTE: Melbourne Airport data prior to FY16 not comparable as includes all ground transport and car parking income

**Figure 15. Retail income per pax progression at AIA**



Source: AIA, Forsyth Barr analysis

While we expect PSR to be largely un-impacted by COVID-19 when international travel returns, we believe concession yields are at risk, given the likely more risk averse nature of travel retail concession tenders in future. Consequently we expect retail income per pax to find a new (lower) base of ~NZ\$19.00 in FY23 when the pax recovery is in full swing.

## Aeronautical re-pricing boost

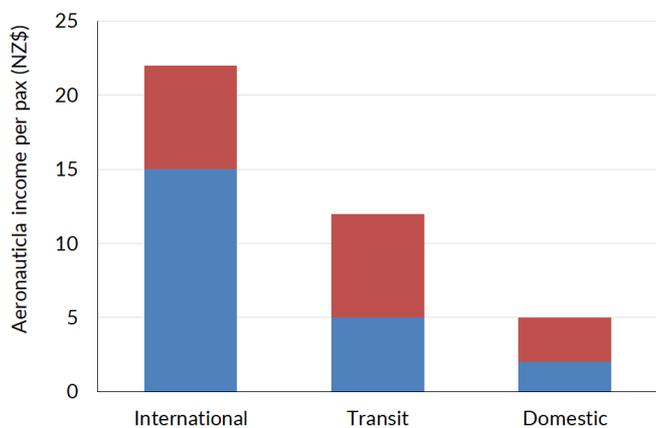
AIA is due to re-price its aeronautical charges in July 2022. Historically, the company has weighted its pricing towards international traffic/passengers as shown in Figure 16. In light of the longer dated nature of international pax recovery the company may decide to change its pricing approach. This will ultimately be dependant on the pax growth assumptions used in its calculations and shouldn't matter to investors given the aeronautical income generated will be the same regardless. More important is (1) the targeted return (based on the 50th percentile WACC as calculated using the ComCom's input methodologies), and (2) the regulatory asset base (RAB).

### Regulatory asset base

AIA's aeronautical development pipeline has been cut significantly and successively over the past 12 months given (1) a slow down in international pax growth in recent years, (2) the exit of Jetstar from regional services in late 2019, and (3) the impact of COVID-19 on pax demand. AIA's RAB was assumed to grow by ~NZ\$1.2bn through its current pricing period PSE3 (FY18-FY22), but instead we now expect it to grow by just ~NZ\$500m.

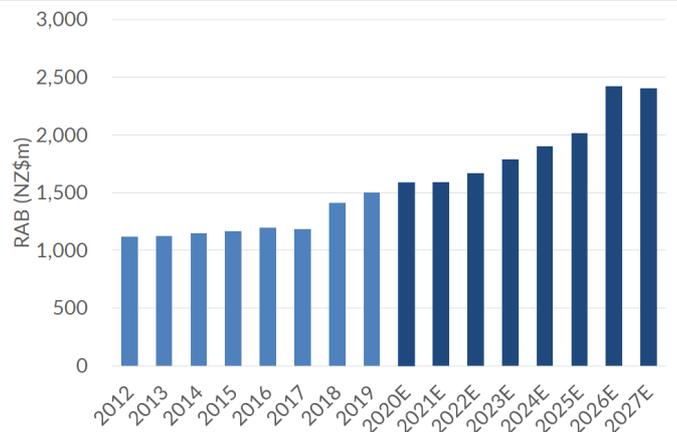
Lower RAB growth will have a consequence on future aeronautical prices (i.e. they will be lower than previously anticipated), though we recognise that RAB growth in itself is a positive driver of pricing. We now assume that AIA will commission assets totalling NZ \$800m in PSE3 and NZ\$1.2bn in PSE4 (FY23-FY27). This compares to its pricing assumptions of NZ\$1.5bn in PSE3 and NZ\$2.1bn in PSE4.

**Figure 16. Average aeronautical price per ticket in FY20**



Source: Forsyth Barr analysis

**Figure 17. RAB growth history and our forecast outlook**



Source: AIA, Forsyth Barr analysis

### Targeted return

When AIA set prices for PSE3 in 2017, the mid-point (50th percentile) WACC as calculated by the ComCom was 6.4%. Adjusting for an up-to-date risk free rate and debt premium we determine that the mid-point WACC has fallen to 4.7%. Assuming that AIA continues to argue that its asset beta should be higher (approximating to the 55th percentile) in light of its elevated operating leverage, then we estimate this would increase to 4.9% (Figure 18). However, we are conscious that a number of key WACC inputs may change prior to AIA's price setting.

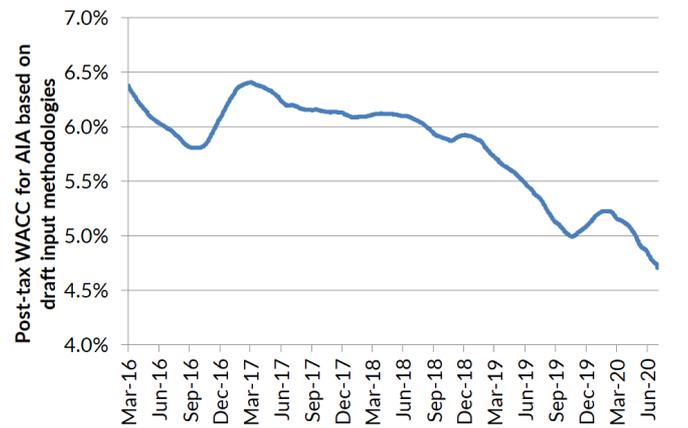
- **Risk free rate:** The five year government bond has fallen significantly over the past few years. The 30 day average is now 0.4%.
- **Market risk premium:** The Commerce Commission has suggested that the tax-adjusted market risk premium for the New Zealand market may increase to 7.5% from 7.0%.
- **Asset beta:** The ComCom applies a global airport comparator based asset beta of 0.60. This may increase as a result of COVID-19.
- **Leverage:** The ComCom applies a comparator based leverage factor of 19%. In light of the changing capital structures this may change also.

The ComCom has still to undertake its review of AIA's current non-aeronautical returns, which have historically been higher than 'pricing' returns. The result of this review could have a negative impact on AIA's future aeronautical returns.

**Figure 18. Key inputs into ComCom WACC estimate**

	PSE3	Now
Risk free rate	2.76%	0.38%
Debt premium	1.45%	1.55%
Leverage	19%	19%
Asset beta	0.6	0.6
Tax adjusted MRP	7%	7%
<b>Post-tax WACC</b>	<b>6.41%</b>	<b>4.71%</b>
Targeted percentile	55th	55th
<b>Targeted return</b>	<b>6.62%</b>	<b>4.89%</b>

Source: Forsyth Barr analysis

**Figure 19. 50th percentile WACC**


Source: Bloomberg, Forsyth Barr analysis

### Implications for aeronautical pricing

Actual aeronautical prices will be dependant on both the RAB, target returns, and other key inputs including passenger and opex assumptions. In particular, as already noted in this report, there is a great level of uncertainty around the passenger outlook. A lower level of passengers will mean higher unit prices and vice versa.

## 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, albeit this is now on hold in light of COVID-19 disruption. Ordinarily it generates attractive return on capital in its non-regulated commercial assets and valuation benefits from low prevailing government bond rates. However, COVID-19 has had a material impact on its operations and we expect recovery will take years given border closures, consumer apathy to travel and the impact on the travel retail sector. NEUTRAL.

### 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 cashflow outlook

- **COVID-19 implications:** AIA will be hard hit by COVID-19. We expect air travel to recover in FY21, albeit only slowly over a number of years.
- **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.

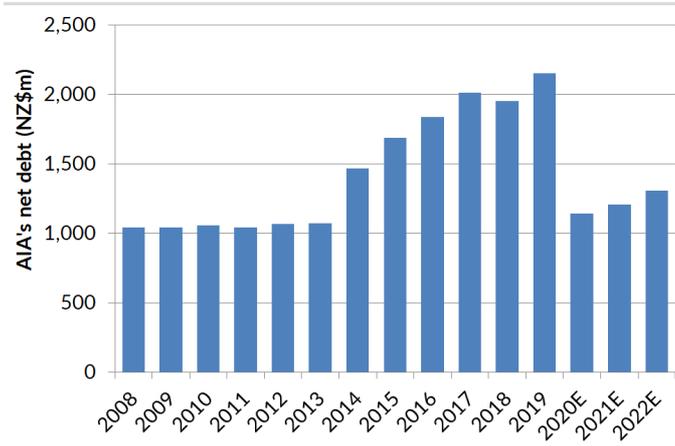
### Financial structure

- **Balance sheet:** AIA is in the midst of a major capex bulge given the need to build capacity, albeit this is now on hold in light of COVID-19.
- **Dividends:** It has a 100% dividend pay-out rate and has a dividend reinvestment plan in place, albeit won't be paying any dividends until FY23 given its agreement with lenders.

### Risk factors

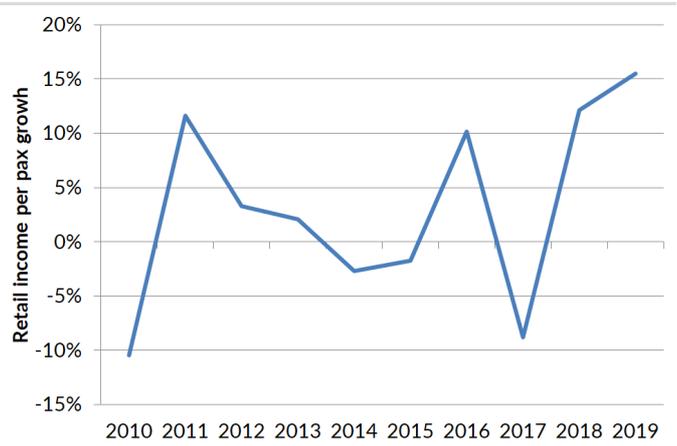
- **Rising bond yields:** AIA trades as a bond proxy. Its valuation holds a very strong inverse relationship with bond yields.
- **Regulatory risk:** We expect AIA to lower current aeronautical prices to ease any regulatory pressure given its mixed ComCom report last year.

Figure 20. Debt burden at AIA helped by capital raise



Source: AIA, Forsyth Barr analysis

Figure 21. Retail income per international pax growth



Source: AIA, Forsyth Barr analysis

**Figure 22. Price performance**


Source: Forsyth Barr analysis

**Figure 23. Substantial shareholders**

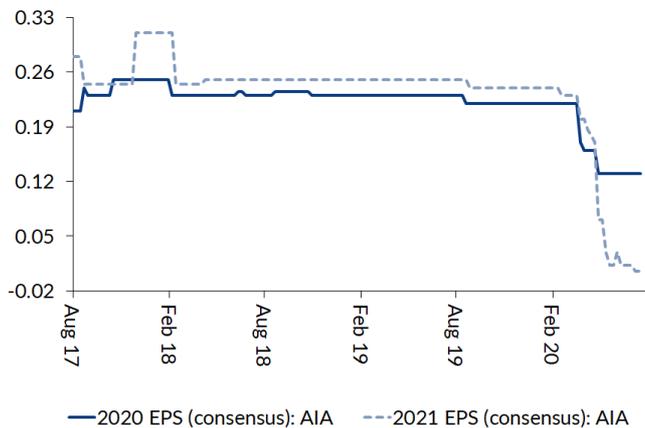
Shareholder	Latest Holding
Auckland City Council	22.1%
BlackRock Investment Management	5.0%

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

**Figure 24. International valuation comparisons**

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
(metrics re-weighted to reflect AIA's balance date - June)										
<b>Auckland Airport</b>	<b>AIA NZ</b>	<b>NZ\$6.44</b>	<b>NZ\$9,468</b>	<b>49.2x</b>	<b>&lt;0x</b>	<b>29.5x</b>	<b>&gt;75x</b>	<b>40.8x</b>	<b>&gt;75x</b>	<b>0.0%</b>
SYDNEY AIRPORT	SYDAT	A\$5.52	A\$12,474	<0x	15.2x	27.2x	30.5x	>75x	>75x	2.1%
MALAYSIA AIRPORTS HLDGS BHD	MAHB MK	RM5.09	RM8,445	<0x	<0x	8.7x	9.3x	28.7x	31.0x	1.6%
FLUGHAFEN WIEN AG	FLU AV	€25.50	€2,142	<0x	<0x	13.0x	14.1x	<0x	<0x	2.4%
FLUGHAFEN ZURICH AG-REG	FHZN SW	CHF126.20	CHF3,875	<0x	<0x	14.3x	15.5x	<0x	<0x	3.0%
FRAPORT AG FRANKFURT AIRPORT	FRA GY	€37.60	€3,477	<0x	3.7x	15.6x	17.0x	<0x	<0x	1.8%
AIRPORTS OF THAILAND PCL	AOT TB	THB56.25	THB807,142	>50x	>50x	48.1x	45.4x	>75x	>75x	0.8%
BEIJING CAPITAL INTL AIRPO-H	694 HK	CN¥5.39	CN¥24,682	36.2x	43.2x	9.2x	11.0x	22.2x	27.9x	1.9%
<b>Compc Average:</b>				<b>36.2x</b>	<b>20.7x</b>	<b>19.4x</b>	<b>20.4x</b>	<b>25.4x</b>	<b>29.4x</b>	<b>1.9%</b>
<b>EV = Current Market Cap + Actual Net Debt</b>				<b>AIA Relative:</b>	<b>36%</b>	<b>n/a</b>	<b>52%</b>	<b>n/a</b>	<b>60%</b>	<b>n/a</b>

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

**Figure 25. Consensus EPS momentum (NZ\$)**


Source: Forsyth Barr analysis

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