European Airports (02/01/2014)

We are attracted to airports due to the monopoly (or near monopoly) characteristics of the aeronautical operations, the opportunity to take advantage of unregulated retail, real estate and other operations, and the ongoing propensity for travel. However, these characteristics are generally well understood by many investors and create little opportunity for us. Nevertheless, from time to time there are genuine company specific factors that can create opportunities.

During the year the fund had investments in three European airport companies. Below we have outlined the general characteristics and investment tenet for two of these opportunities.

Flughafen Wein AG

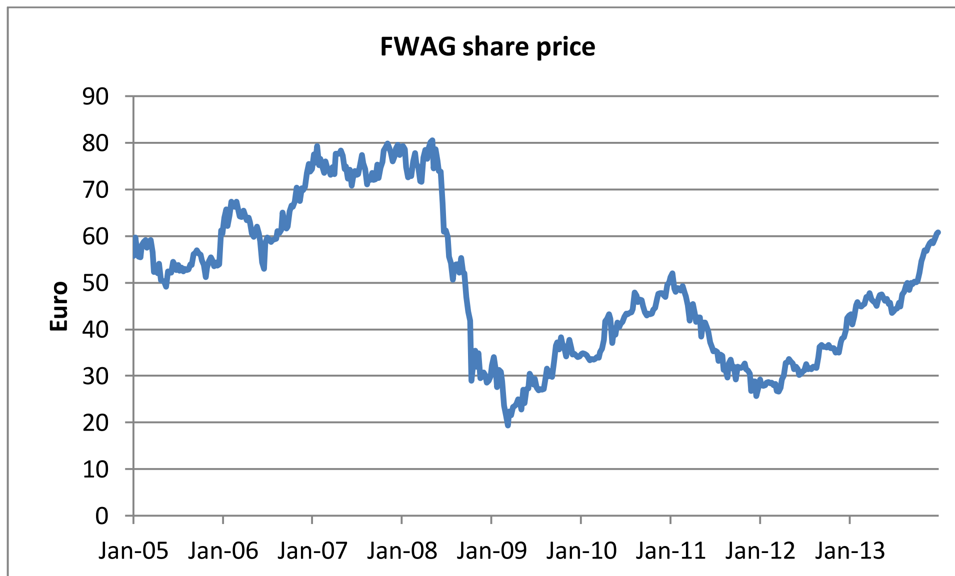
The fund currently holds a position in Flughafen Wein AG (FWAG) which it acquired in March 2012 at an average price of E27.38. In November 2013 the fund trimmed the position from 6% to around 3.5% at a price above E57. FWAG is currently trading around E60 per share. The investment has delivered an annualised internal rate of return of 60% to date.

FWAG is the owner and operator of Vienna airport. It is responsible for the aeronautical, retail, real estate and handling operations. The aeronautical operations account for around 50% of operating profit, retail and properties 35% and handling / other 15%.

Vienna airport operates under a dual till regulatory environment. The regulated aeronautical charges are indexed to inflation less a portion of passenger growth using an approach established in 2004. There is no regulated asset base or allowed returns mechanism. The retail, property, handling and other revenues are unregulated.

FWAG's ownership of Vienna airport is not subject to a concession arrangement; that is, FWAG own the airport and associated facilities outright. Vienna airport is a relatively large facility with a history of growth - passenger traffic grew by approximately 5% pa on average from 2004 to over 22m passengers in 2012.

FWAG has endured a fairly tough period after getting itself into trouble between 2005 and 2010 when it decided to significantly expand its airport terminal capacity with the construction of Skylink. During construction it became apparent that there were some significant issues, including major cost over runs, delays and serious allegations of mismanagement. This led to a lengthy halt in construction and a government audit. In the end the project cost over E700m compared to the original expectation of around E400m and was delivered three years late, finally opening in 2012. Moreover, the expansion increased FWAG's net debt significantly from around E100m to over E700m - this occurred at the same time as the global financial crisis and an 8% decline in passenger numbers (2009). As a result, FWAG's share price fell from a pre-financial crisis E80 to below E30 in late 2011 / early 2012 (initially hit by the financial crisis and then by the concerns over Skylink).



Our FWAG investment tenet was that the project issues were being resolved and there was significant value in Skylink. In particular:

- A new management team was put in place in late 2011 which oversaw the completion of Skylink and brought a better focus to growing revenue, cost control and debt reduction;
- The project was nearing completion and the worst case capital cost was being progressively revised down as the final milestones were met;
- Skylink made significant operational improvements to the airport, especially in relation to the layout of the retail operations and new retail floor space; and
- We were patient to allow the returns to accumulate over time (rather than step up more immediately as per a regulated asset base approach).

We also viewed the debt load as manageable.

When we acquired the investment we thought about the numbers as summarised in the table below. We prepared 2013 estimates in order to capture the first full year of the Skylink operations and derived a pre tax ungeared yield of 10.0%.

Simplified investment summary[(1)]	
Shares on issue	21m
Our average buy price	E27.38 per share
Implied market capitalisation	E575m
Estimated net debt	E725m
Estimated enterprise value	E1,300m
Estimated pre tax ungeared coupon	E130m (2013 estimate)
Estimated pre tax ungeared yield	10.0%

Notes: (1) This is a simplified valuation which does not consider equity interests and other assets, pension and other liabilities, etc.

The successful opening of Skylink in mid 2012 removed significant uncertainty and provided improved financial results, helping to move the share price from around E30 to around E60 at December 2013.

Vienna airport's financial performance has been better than our initial expectations and we now expect the 2013 coupon to be around E150m. Based on the current share price of E60, the implied enterprise value is approximately E1.9b and ungeared pre tax yield is approximately 8%.

FWAG has performed very well over the past two years and from here we think gains will be more incremental, reflecting refinements to Skylink's retail operations, passenger traffic growth and other factors. We have trimmed the position from 6% to around 3.5% to reflect this.

Save SpA

The fund initially acquired a 4% position in Save SpA (Save) around mid 2011 and added to it opportunistically up until January 2013. After a strong move in the share price in early 2013 the position size reached 7.5% from which we progressively sold down the position. The average entry price was E7.24 and average exit E12.53. The investment delivered an annualised internal rate of return of 40%.

Save is the operator of Venice Marco Polo and Treviso airports in Italy. These two airports account for around 75% of Save's EBITDA (Venice Marco Polo is the majority). The balance is from passenger railway station property, airport / toll road retailing and other businesses.

The opportunity we saw in Save relates to its Venice Marco Polo (Venice) airport operations – this is the focus of the discussion below.

While Venice airport has a long history, the airport terminal and runway facilities are relatively new. It is also well located with only a short drive from the airport to Venice (Treviso by comparison is a hour away). Venice is one of three major international airports in Italy (the others being Rome and Milan) and has experienced passenger growth of 4% pa on average from 2004 to over 8m passengers in 2012.

The challenge for Venice airport has been the lack of an economic regulatory regime which has severely limited its ability to increase aeronautical charges over time (i.e. passenger and landing fees for use of run way, terminals, etc). Any increase in these charges needs to be approved by the regulator and the government and there was no framework in place to facilitate such an increase. While Venice airport was able to increase its earnings from unregulated areas such as the retail, property and car parking, the lack of progress on the aeronautical side of the business limited its value.

Our work on Save suggested limited downside to the share price if the status quo was maintained. It was a nice business with a strong balance sheet, good management and was trading on an ungeared pre tax yield of around 9.8% (prior to any uplift from a new regulatory regime). The enterprise value of less than E500m also looked low compared to other similar size and favourably positioned airports around the world (refer table below).

Simplified investment summary[(1)]	
Shares on issue	53m
Our average buy price	E7.24 per share
Implied market capitalisation	E384m
Estimated net debt	E76m
Estimated enterprise value	E460m
Estimated pre tax ungeared coupon	E45m (2011 estimate pre any new regulatory regime)
Estimated pre tax ungeared yield	9.8%

Notes: (1) This is a simplified valuation which does not consider equity interests and other assets, pension and other liabilities, etc.

Our Save investment tenet related to the progress being made on implementation of a regulatory regime for aeronautical charges. We saw this in a number of areas, including:

- The high level agreement concluded in 2007/2008 provided a basic structure that we viewed favourably (although significant time had elapsed since);
- The regulator was progressively approving Venice airport's capital expenditure, environmental, traffic and other plans that formed part of its regulatory proposal;
- Venice, Rome and Milan airports were all being considered by the government as a priority for a new regulatory regime;[1]
- The government, recognising the absence of any price increase since 2000, allowed small price increases from 2009-11;
- The regulator approved a fee increase of up to E3 per passenger, which needed Ministerial approval. This suggested to us that the regulatory body was endorsing the higher fees and putting more pressure on the government to act;
- Milan airport concluded its regulatory agreement with the government on what we viewed as very favourable terms; and
- A deadline of December 2012 was put in place (although these often slip).

Moreover, we are familiar with the workings and how the regulatory regimes for the Italian energy infrastructure and toll road sectors have evolved. The progress of Venice airport appeared consistent with this history.

As part of our work we prepared our own estimates of the key regulatory financial parameters, including the regulated asset base (RAB), allowed returns, operating expenditure and depreciation – from this we could see the earnings potential of a new regulatory arrangement.

In December 2012 the new economic regulatory arrangement for Venice airport was approved by the government. Overall, it was better than we expected.[2] The arrangement included a dual till

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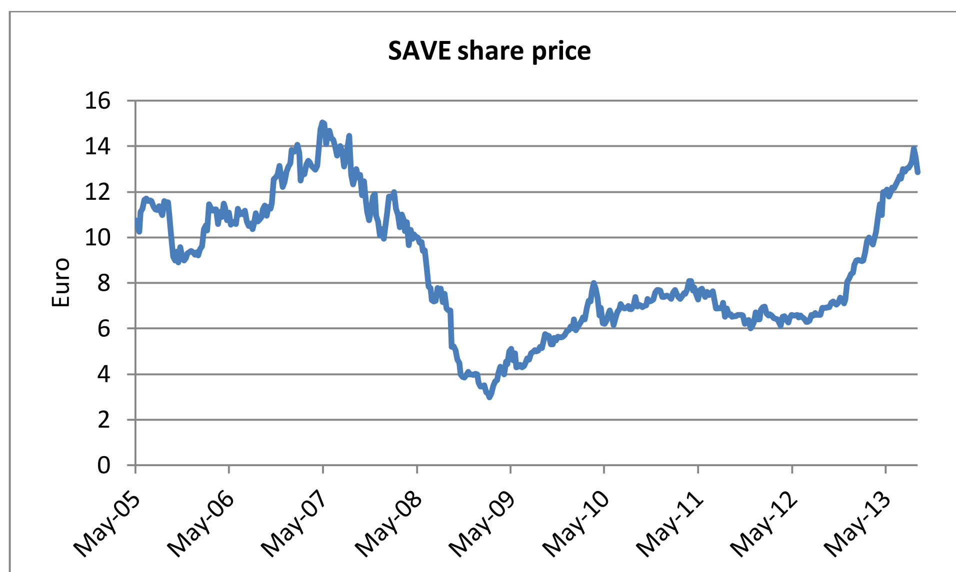
[1] While progress was slow we could see that Rome airport was under significant financial pressure – it was highly leveraged and faced a significant capital expenditure program, which we doubted could be funded in the absence of a favourable regulatory regime. While Venice was not under financial pressure, it could leverage off the position of Rome airport in getting a favourable decision from the government.

[2] The RAB was lower but the allowed return was higher than our expectations. We also thought there was a risk that unregulated earnings may be subject to some type of sharing arrangement above a certain level but this was not the case.

regulatory framework, a defined RAB (around E150m at 2012)[3] and an allowed return of 12.51% real pre tax WACC, with "strategic investments" receiving an additional return of 2-3%. In broad terms, the decision would increase operating profit for the airport segment[4] by 25% from the 2012 level. In addition, it provided a framework for future investment in the airport – given the attractive allowed return, Venice airport is strongly incentivised to roll out its capital expenditure plan.



With the announcement of the new regulatory regime the share price moved fairly quickly to E12-14 where we progressively exited, selling the last of our holding around E13.50. At E13.50 the enterprise value had increased to around E800m and the ungeared pre tax yield was less than 7%. In addition, the share price implied that the regulated airport business was priced at a meaningful premium to its regulated asset base (reflecting the high allowed return). We see some risk in this as ultimately we think that the allowed return of 12.51% (real pre tax WACC) may prove too generous and come under regulatory pressure.

[3] We think the RAB of around E150m is very low given the existing aeronautical assets (terminal, runway, etc). We suspect this amount may have been influenced by the high allowed WACC such that the implied tariff increase was up to E3 per passenger. We would have preferred a higher RAB and a lower (more reasonable) allowed return to get to the same result.

[4] This segment is much broader than the regulated activities of Venice airport. It also includes Treviso airport (which was not part of the regulatory decision) and the unregulated airport retail, property, car parking etc operations.

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