

Airport Infrastructure

Connecting the World



Chris Hillsdon
Investment Analyst

Airport Infrastructure, and the airlines they serve, play a vital role in facilitating economic growth and connecting communities around the world.

Today, airport demand and passenger volumes continue to increase globally, fueled by rising incomes, falling airfare prices and growing air freight volumes. In this edition, Chris Hillsdon explores the Airport thematic detailing the nature of these infrastructure assets.

Q. Why are airports considered infrastructure?

Airports are considered infrastructure as they exhibit the following characteristics:

1. **They are essential to the proper functioning of society.** Imagine life without air travel!

As air travel has become more ubiquitous, airports have become essential to the functioning of societies and facilitate:

- ✦ Business interactions
- ✦ Tourism
- ✦ Visiting family and friends
- ✦ Movement of cargo and freight

2. **Cash flows are predictable**, typically as a result of inelastic demand combined with pricing power **within a strong legal framework**. Additionally, airports generally face minimal competition, either within their catchment area, as most cities only have one major airport, or from other modes of transport, such as travelling by rail or road.

As such, airports typically have:

- ✦ **Strong pricing power** given the lack of competition and high barriers to entry, namely regulation, safety and large capital investment.
- ✦ **Relatively inelastic demand** given they provide an essential function with little competition.

Q. How do Airports derive their income?

Airport operations and the services they provide can be best understood by considering their various revenue streams. Airport revenues can be split into two main revenue streams:

1. **Aeronautical revenues:** This revenue stream is typically earned as a fee per passenger and aircraft size for the use of the runways, terminals and associated infrastructure.

2. **Commercial, non-aeronautical revenues:** This revenue stream is collected by the airport owing to their status as landlord across various activities such as:

- ✦ shop rentals
- ✦ car parking operations
- ✦ building rentals, including car rental, cargo, office space and catering operations.

Q. What are the key risks airports face?

Passenger shocks such as health epidemics (SARS), terrorism, actions, environmental obstruction (volcanic ash clouds), airline bankruptcy, regulatory changes and increased competition are typically the major risks that airports face.

As it relates to competition, not all airports are equal, with a key consideration being what proportion of passengers are Origin & Destination (O&D), versus transfer passengers. Some airports are predominantly used by

transfer passengers and are more exposed to the risk of an airline moving its hub operations to another airport. For example, at Frankfurt airport approximately 60% of its passengers are transfer passengers whereas virtually all Sydney Airport passengers are O&D.

Q. How are airports regulated?

As airports have monopolistic characteristics, they tend to be subject to economic regulation to ensure prices are not excessive.

In general, economic regulation applies to either:

- ✦ **Aeronautical and commercial activities.** This is referred to as “**single till**” regulation and limits the ability for the airport to earn excess returns or benefit significantly from strong passenger growth. In this case, airport prices and the resulting returns are driven by the allowed return on capital set by the regulator and the size of the asset base.
- ✦ **Aeronautical activities only.** This is referred to as “**dual till**” where one till is regulated (aeronautical) and the other till is non-regulated (commercial). This enables airports to earn higher return on the non-regulated portion of the business and to capture economic benefits of strong passenger growth. Conversely, dual till operations are also more exposed to the risk of passenger shocks.

Economic regulation is defined by each country and often applies only to the largest airports within the country. However, economic regulation tends to be similar across regions, with predominant regional regulatory approaches being:

- ✦ **Australia / NZ:** Dual till and light-handed. For instance, aeronautical prices are monitored but not controlled.

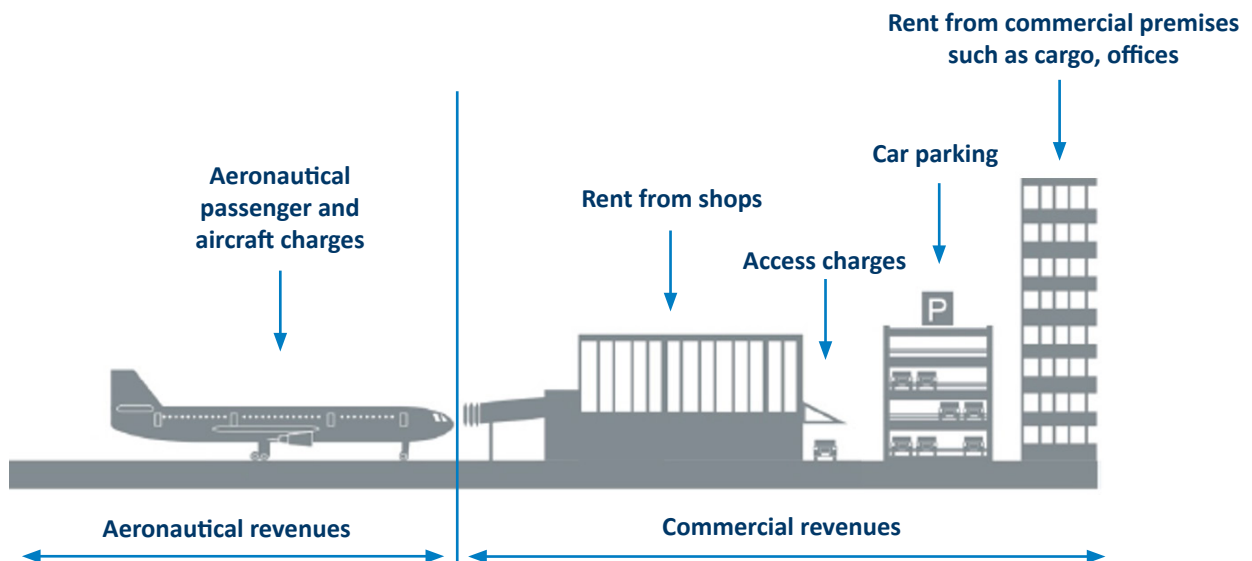
- ✦ **Asia:** Dual till with quasi-government regulation.
- ✦ **Europe:** Semi-dual till. For instance, some commercial revenue streams such as car parking are included in the regulation.
- ✦ **UK:** Heathrow is single till regulated. For instance, all activities are subject to economic regulation.

Q. What are the key investment attributes of airports?

The key favourable investment characteristics of the airport sector include:

- ✦ **Growing passenger numbers** supported by growing population, lower airfares and increasing middle class.
- ✦ **Operating leverage.** Revenues tend to increase with inflation and passenger numbers whilst operating costs typically increase at a lower rate. This results in growing margins and cash flows to investors. Dual-till airports, in particular, can capture the benefits of operating leverage in their commercial operations.
- ✦ **Regulation.** The type of regulation (single vs dual till) and its predictability is an important consideration in airport investment.

Airport Infrastructure | Revenue streams



Source: Image courtesy of Fraport

Q. How can investors access this thematic?

At RARE, we focus exclusively on publically traded infrastructure securities from around the world. Listed infrastructure investors can enjoy the attractive characteristics of the infrastructure asset class which includes: long-term stable cash flows, lower correlation and beta to other asset classes and inflation protection while enjoying the added benefits of listed markets such as liquidity and lower fees.

Importantly, investing in the listed markets provides us with the flexibility to take advantage of market movements and to invest where we, as active managers, see value.

Geographical coverage of global listed airports contained in RARE's investible universe include airports in the cities of Sydney, Auckland, Paris, Zurich, Madrid, and Frankfurt, as well as companies that operate airports in the following countries: Greece, Turkey, Brazil, Argentina, Mexico, Thailand, Malaysia and China. Refer to the adjacent table for examples of listed infrastructure airport assets.

Examples of Listed Infrastructure Airport Assets

Listed Airport Operator	Key Airport Asset	Location of Asset
Groupe ADP	Paris Charles de Gaulle	Paris, France
AENA S.A	Madrid-Barajas Airport	Madrid, Spain
Sydney Airport	Sydney Airport	Sydney, Australia
Fraport	Frankfurt Airport	Frankfurt, Germany
Malaysia Airports	KLIA	Kuala Lumpur, Malaysia
Beijing Capital International Airport	Beijing Airport	Beijing, China
Auckland Airport	Auckland International Airport	Auckland, New Zealand
Airports of Thailand	Bangkok Airport	Bangkok, Thailand
Grupo Aeroportuario del Sureste	Cancún International Airport	Cancún, Mexico

Source: RARE Infrastructure

While the information contained in this document has been prepared with all reasonable care, the RARE Infrastructure Group does not accept any responsibility or liability for any errors, omissions or misstatements however caused. This information is not personal advice. This material has been prepared for investment professionals, qualified investors and investment advisors only. This material is not suitable for retail investors and RARE Infrastructure does not authorise the provision of this material to retail investors.

Investors should be aware that any views expressed in this material are given as of the date of publication and such views are subject to change at any time. Where an investment product is mentioned, potential investors should seek independent advice as to the suitability of the product to their investment needs. Reference to shares in a particular company, is not a recommendation to buy, sell or hold that stock.

Any prospective PE ratios and dividend yields or forecasts referred to in this material constitute estimates which have been calculated by the RARE Infrastructure investment team based on RARE's investment processes and research.

The distribution of this document may be restricted in your jurisdiction. This document does not constitute an offer or solicitation in any jurisdiction in which to make such an offer or solicitation would be unlawful. It is your responsibility to ensure that any such product, security, service or investment outlined is available in your jurisdiction.

Issued and approved outside Canada, United States of America and EU/EEA by RARE Infrastructure Limited ("RIL"), registered office Level 13, 35 Clarence Street, Sydney, NSW 2000, Australia (ACN 84119339052; AFSL307727).

In Canada and the United States of America, issued and approved by RARE Infrastructure (North America) Pty Ltd ("RINA"), registered office Level 13, 35 Clarence Street, Sydney, NSW 2000, Australia (ACN 138069191). Neither RIL nor RINA are registered as a dealer in any province in Canada. RIL and RINA are not offering the securities of any investment fund that may be described in the materials in Canada or the United States. This material has not been approved or verified by the SEC or the OSC.

RARE Infrastructure operates in the EU/EEA from the UK through Legg Mason Investments (Europe) Limited, which is Authorised & Regulated by the Financial Conduct Authority, registered office 201 Bishopsgate, London EC2M 3AB. Legg Mason Investments (Europe) Limited is registered in England and Wales with Company No. 7970290. This material is issued in the EU/EEA by Legg Mason Investments (Europe) Limited.

RARE Infrastructure is an affiliate of Legg Mason.

ESSENTIAL FOR SOCIETY, ESSENTIAL FOR YOUR PORTFOLIO

Please visit www.RAREinfrastructure.com

