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# Sydney Airport: in the lounge, waiting for final call

Our weekly view on Australian Equities

8 July 2021

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# Sydney Airport's cash takeover

We think Sydney Airport's (SYD) $8.25 cash takeover proposal, from an IFM Investors-led consortium of infrastructure specialists, has room to move higher. The IFM bid benefits from its industry member super fund members having deep pockets, rich asset level experience, and arguably one of the lowest costs of capital in the market.

In our view, the price offered looks too low. The implied control premium does not reflect SYD's unique position in the region, which has delivered 8.2% CAGR EBITDA growth over 2013-2019. SYD is in a great position to benefit from the return of international passenger volumes and strong Asian passenger growth over the medium term.

We see room for IFM to lift the current bid into the $8.50-$9.00 range. This range implies an earnings multiple towards the top end of historic global airport M&A transactions. It is not unreasonable for an iconic gateway airport asset and one of the last publicly listed international airports.

Since adding SYD to the Wilsons Australian Equity Focus list in March 2021, SYD has returned 31%, ahead of the S&P/ASX 200 total return of 9% over the same period. We continue to hold SYD at a 3% weight, given the prospects for a revised higher offer.

**Exhibit 1: SYD current bid is ~10% below the all-time high**

*Source: Refinitiv, Wilsons*

## SYD security price was 35% below pre-COVID levels

SYD security price has languished since COVID-19 struck in the early first quarter of FY20. The closure of international borders resulted in international traffic falling by over 95% and cutting free cash flow, necessitating distribution cuts and a $A2bn equity capital raising to deleverage the balance sheet in the last quarter of FY21.

SYD's equity raising in 2020 was far less dilutionary at 20% than for other travel-related stocks like QANTAS (QAN) at 27% and Flight Centre (FLT) at close to 100%.

The market has been cautious around building too much 'recovery' into travel companies share prices, as the domestic pathway for international border reopening remains unclear. Both QAN and FLT share prices are now well below the early 2021 highs, while the SYD price tracked sideways this year.

The opening of international borders is crucial for the SYD security price. The operating leverage of SYD is heavily dependent on international passengers, given they are 3-4x more valuable to the airport than domestic passengers in revenue dollar terms.

Before COVID-19, SYD's security price was trading around all-time highs at just under $9.00. If we adjusted for the capital raising last year, the all-time high is $6.42, given almost 20% additional shares on issue. This suggests that the $8.25 bid is at least competitive.

But as SYD pointed out in its release to the ASX on Monday, "indicative price is below where Sydney Airport's security price traded before the pandemic". Suggesting in our view, the SYD Board will be looking for a higher price from IFM.

## Earnings should be 2-3x higher ex-COVID

To better understand why we think the implied multiple for SYD is too low, we need to look more closely at where SYD earnings currently sit.

Market consensus is expecting SYD to earn $550m of EBITDA in FY21E. In the two years before COVID, SYD was making ~$1,300m per year. The 6-year pre-COVID EBITDA growth was 8.2%, demonstrating the earnings growth potential of SYD.

There is no reason to think SYD cannot return to those levels (and pretty quickly) once international borders reopen, given pent-up consumer demand. Many of the cost reductions SYD has put in place are likely to be permanent.

Meanwhile, Western Sydney Airport (WSA) is not scheduled to open until 2025/26, and any impact is unlikely to be felt until much closer to the end of the decade.

While public market investors are asking the question as to just how quickly those earnings can return to pre-COVID-19 (currently estimated by FY23/24), they could well be losing sight of the bigger picture.

IFM is arguably more focused on the medium and longer-term earnings outlook rather than the shape of the near-term earnings recovery. The SYD concession length - rights to operate the airport from the Commonwealth Government - stretch out to 2097.

### Longer-term drivers of value for SYD include:

- Growing SYD's capacity
- Competition from WSA
- Aeronautical agreements which dictate landing charges
- Changing consumer preferences
- Whether the aviation's historical passenger growth above GDP growth rates can continue

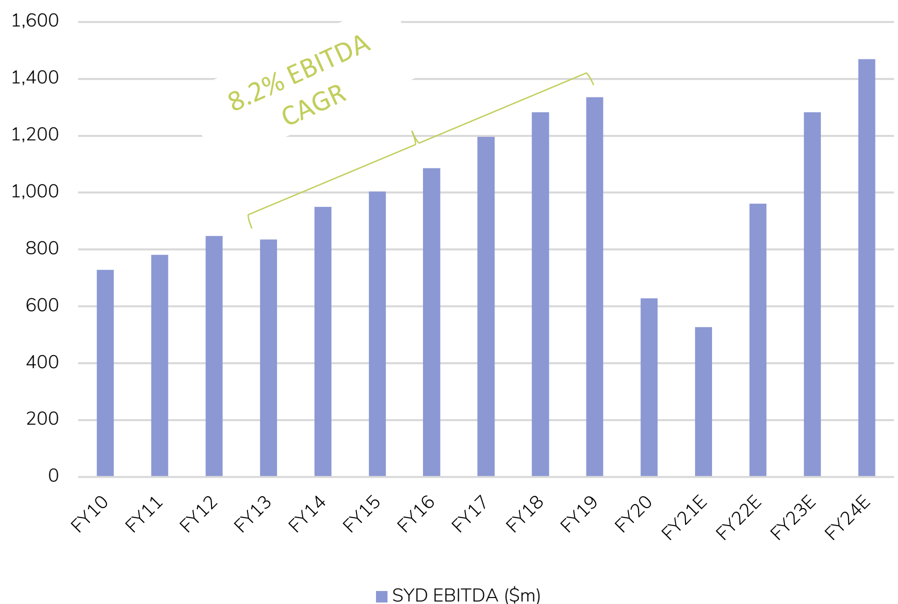
## New private owners could fast track distributions

SYD cancelled distributions at the onset of COVID-19, so until international travel/and earnings are restored, it's unlikely SYD will resume distribution payments (market assuming 2H22E).

The $A2bn equity raising in 2020 delevered SYD's balance sheet. It's not unreasonable to think the SYD gearing ratio (Net Debt/EBITDA) could fall from the 5-6x today to ~3x as earnings are restored through FY23E. This would leave SYD looking very under-geared (historically, it's been as high as 7-8x).

A regearing of the balance sheet could happen much earlier under private ownership versus public market – where there is less appetite for higher gearing levels. Regearing SYD could accelerate the resumption of distributions/capital returns for new owners.

**Exhibit 2: Historically, SYD earnings have grown at +8.2% CAGR 2013-2019**




*Source: Refinitiv, Wilsons*

## Valuation multiples

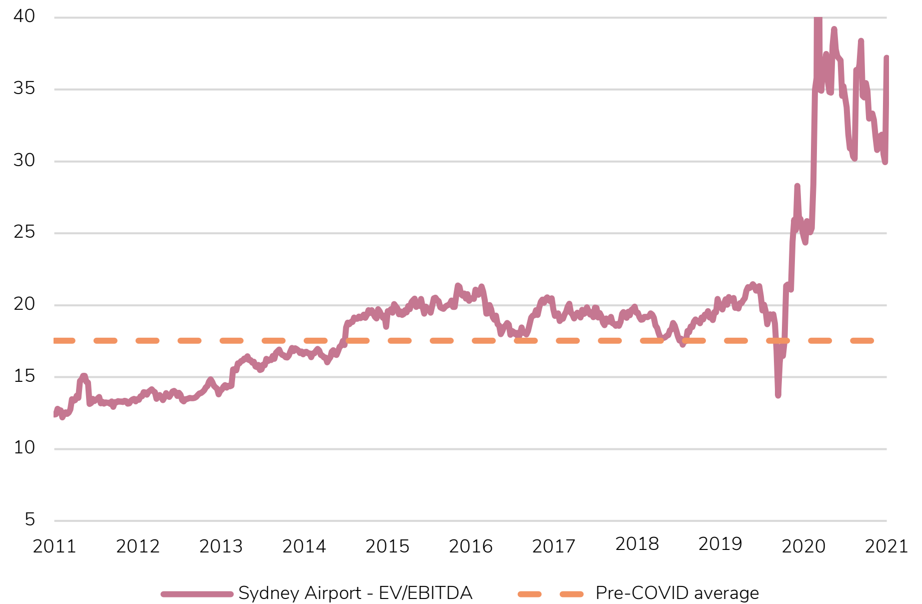
Using market consensus FY22E earnings, the $8.25 offer implies an EV/ EBITDA multiple of 30x, well clear of SYD's long term average of 18x. This falls to 23x using FY19A, pre-COVID earnings.

Airport M&A in recent years, particularly for Tier 1 airport assets, has averaged around 23x. Australian regional airports in North Queensland (2019) and Hobart International (2018) have transacted on premium multiples, often when less than 100% of the asset changes ownership. This is one reason why we think an implied 23x FY19A multiple for SYD is too low.

SYD is a Tier 1 asset with a high degree of earnings certainty. It's an iconic gateway airport operating under a light regulatory framework, better duty-free allowances (vs peer airports), with exposure to long-term Asian passenger growth dynamics. Australia's multicultural population and higher propensity to travel - particularly offshore - also needs to be recognised.

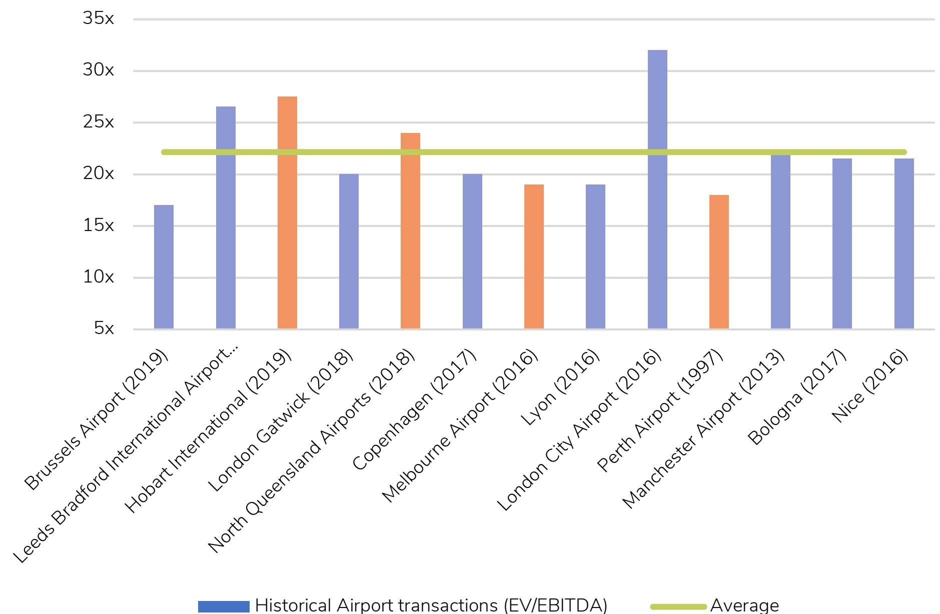
We suspect the David Gonski-chaired SYD Board will attempt to drive a higher offer or demonstrate a pathway for SYD on its own to create additional value along these lines over the coming weeks.

**Exhibit 3: SYD has traded on an 18x EV/EBITDA up until COVID.**




*Source: Refinitiv, Wilsons. 12mth fwd EV/EBITDA. Pre-COVID 2011- Jan 2020*

**Exhibit 4: Selected M&A transaction multiples for airports have been +23x EV/EBITDA**




*Source: Refinitiv, Wilsons. Australian Airports in green.*

## Areas of hidden value

Valuing long-dated assets like airports on a single year of earnings is fraught with danger. There can be many hidden areas of asset monetisation/optionality that are not captured in a single earnings period.

We have identified several for SYD, and estimated the potential value they could have in the hands of new owners.

Combining the bottom end of our estimates – excluding bond yield adjustment (which is not specific to SYD) - there is ~$1.00-1.50 of hidden value in our view. In the coming weeks, we would expect SYD to highlight some of these areas in more detail.

## SYD could be worth $A8.50-9.00 per share

A revised offer for SYD in the $A8.50-9.00 range, we think, would be seriously considered by the board. This offer represents a 24-25x FY19A multiple. In our view, a 24-25x multiple acknowledges that the path to earnings recovery is still uncertain over coming years.

There are other risk factors over the coming years. The key aeronautical agreements which set landing charges with the airlines expired in late 2019, with reviews suspended until post-COVID.

There is no certainty that SYD, under any new agreement, receives the same value uplift historic agreements have provided.

The opening of WSA in 2025/26 also provides an element of uncertainty. Given the prospects for a revised offer, we continue to hold SYD at a 3% weighting in the Focus List.

**Exhibit 5: SYD potential areas of hidden value**

| Item | Estimate | Comment |
|---|---|---|
| Franking Credits | $1.00-$1.20 per share* | Likely to be more valuable to IFM's largely underlying Australian owners than SYD currently 50/50 local/international share register |
| Land Bank | $0.25-$0.50 per share | Optimising SYD current land footprint. We have seen elements of this in recent years with motor dealerships/hotels added to the mix |
| Development | $0.25-$0.50 per share | Fast tracking planned development, particularly in the non-aeronautical areas. There is an arugment that SYD has underinvested, with SYD's capital base not growing since 2015. Deprecretion has exceeded CAPEX in every year since 2015. |
| Re-gearing | $0.30-$0.40 per share | SYD balance sheet will de-lever quickly after traffic returns. FY24/25 leverage perhaps x3. Historically 6-8x. Targeting 5x in FY22E could all $0.40 per share. |
| Low Bond Rates | $1.00-$2.00 per share | How low do you take long-term bond yield assumptions. Market is valuing SYD using 10YR bond of ~2.5-3.0%. Dropping the 10YR to ~1.5% will add almost $2 per share. |

*Source: Company Data, Wilsons* Full value of the franking credits*

## Impediments to a takeover

The offer at this stage is an unsolicited, indicative, conditional, and non-binding acquisition proposal. We are very early in the process, and there no certainty that our thesis around a higher bid emerging will eventuate.

**Impediments to a full-takeover of SYD by IFM include:**

- If SYD aggressively rebuts the IFM proposal on valuation grounds, leaving IFM unable to conduct Due Diligence (DD).
- If IFM is unwilling to increase its offer.
- UniSuper (largest SYD shareholder at 15%) decides it no longer wants ownership of an unlisted SYD.
- FIRB/ACCC approval is not reached.

Transurban (TLC) and APA Group (APA) – similar assets to SYD - have received takeover offers in recent years that failed to eventuate. Santos (STO), with energy infrastructure assets, also ultimately saw it rebuke its acquirer. IFM may be the difference here, given the underlying super fund members.

Could a contested bid emerge for SYD? In our view, a likelihood exists, primarily as those with the lowest cost of capital, the industry super funds, are on board via IFM. A Macquarie and or AMP backed consortium could get involved, but at A$30bn enterprise value, we think it's difficult for other players to enter the fray.

**Exhibit 6: Infrastructure like assets and M&A**

| Company | Wilsons Comment | Recent M&A Interest | Acquirer | Reason for failure |
|---|---|---|---|---|
| **APA Group (APA)** | Emerging valuation discount. Key debates; 1) are gas pipelines a risk of being 'stranded assets' post ~2035; 2) APA US growth ambitions 3) recent mngt changes + strategy direction; UniSuper largest shareholder 15% | 2018/19 $11 cash offer | Hong Kong based CKI Group | FIRB rejection |
| **Atlas Arteria (ALX)** | Emerging valuation discount. Key Debates 1) when can ALX's US toll roads begin to pay dividends; 2) expansion plans for EU roads; 3) traffic volume recovery. Open share register. | 2018/2019 Internalisation of manger | ALX from MQG | n/a |
| **Transurban Group (TCL)** | No large valuation discount. Key debates are around 1) global growth ambitions; 2) +4% toll road escalators in a low inflation environment; 3) are incremental returns on capital falling. UniSuper largest shareholder 15% | 2010 $5.57 cash offer | Canadian consortium of TCL three largest shareholders at the time | TCL Board rejection on valuation grounds |
| **Spark Infrastructure Group (SKI)** | Low growth assets, with significant regulatory intervention. Its not clear if FCF growth can exceed core inflation over the long-term, making the assets less appealing for Industry Super funds. Key shareholder Lazard 13%. | | | |
| **AusNet Services (AST)** | Low growth assets, with significant regulatory intervention. Its not clear if FCF growth can exceed core inflation over the long-term, making the assets less appealing for Industry Super funds. Key shareholder Singapore Power at 31% | | | |
| **Macquarie Group (MQG)** | Whilst unlikely an M&A target itself, the current M&A cycle is tailwind for driving advisory fees, potential revaluation gains in peer assets. | | | |

*Source: Company Data, Wilsons* Full value of the franking credits*

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