Mexican Airports? Surely you Can't be Serious. I am, and Don't Call me Shirley!

by David Wagner, CFA

MARKET OVERVIEW

Keeping with our approach of exploring value wherever we may find it, the Driehaus Value team has been focusing on a much less efficiently priced area within air travel that the market has appeared to overlook, publicly-traded Mexican airport operators.

If you are thinking to yourself that you have never heard of a publicly-traded airport, well they are large buildings where people go to fly on planes, but that's not important right now. Mexican airports have not always been publicly-traded as it was not until 1998 when Mexico's state-owned airport operator Aeropuertos y Servicios Auxiliares ("ASA") identified 35 of the country's 58 principal airports as being suitable candidates for privatized investment. The 35 airports were separated to be run by four different operators; three of the four operators are publicly-traded.

Not only have these stocks consistently outperformed domestic major airline operators over the last five years, but they have significantly outperformed their home market of Mexico in almost every trailing period. (Exhibit 1)

Exhibit 1:
Performance of Mexican Airport Operators

	1-Month	3-Month	6-Month	1-Year	2-Year	3-Year	5-Year	10-Year
Mexican Operator 1	8.2%	21.5%	41.6%	29.5%	31.9%	27.2%	173.7%	702.6%
Mexican Operator 2	5.3%	5.7%	15.6%	6.2%	-5.9%	19.5%	108.2%	627.6%
Mexican Operator 3	8.5%	18.5%	40.4%	21.6%	19.8%	25.6%	179.1%	688.3%
Mexican Airport Operator Peer Avg.	7.3%	15.2%	32.5%	19.1%	15.3%	24.1%	153.7%	672.8%
MSCI ACWI Ex-US	0.3%	2.7%	8.4%	-4.5%	5.5%	25.9%	7.4%	63.4%
MSCI Mexico	0.1%	6.3%	10.8%	1.5%	-12.5%	-3.4%	-27.1%	41.6%

Source: Factset

The performance of airport stocks should not come as a surprise. After all, they are as close to a monopoly as any company can be. The Economist wrote in 2015:

> "Imagine owning a shopping center that your customers are forced to stay in for several hours. Better yet, everyone who visits is relatively rich, and many are in a giddy holiday mood. Now imagine that the number of these special shopping centers is strictly regulated, giving you a near-monopoly. On top of this you get paid a fee per visitor. No wonder buying airports has become something of an investment fad."

It is difficult to think of many other industries that are so economically essential, command tremendous pricing power, and face such little competition.

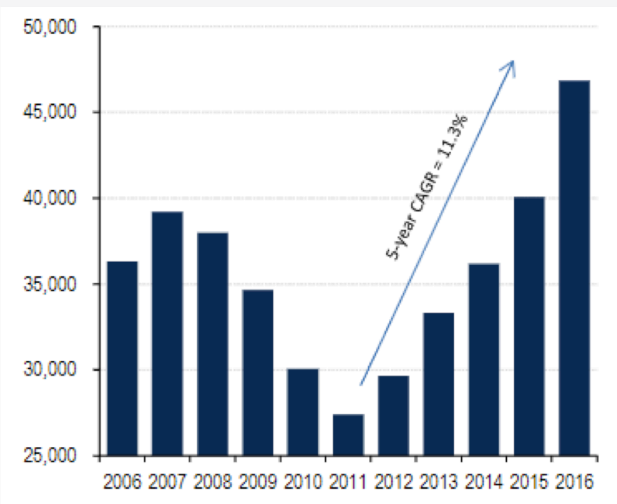
BACKGROUND

Very much like airline companies, airport operators earn revenues from seat traffic, which is called aeronautical revenues. But, the differentiating factor between airport operators and airliners is that the former also earns revenue from non-aeronautical sales. While aeronautical revenues are driven by seat volumes and gate fees, non-aeronautical sales are derived from a plethora of items such as leasing of commercial space to retail tenants all the way to ground transportation and visitor parking.

With much of the costs incorporated in running an airport being fixed, it is necessary for an airport to increase the variable portion of their revenues, ultimately leveraging their operating income, which, at times, can result in EBITDA growth twice that of revenue growth.

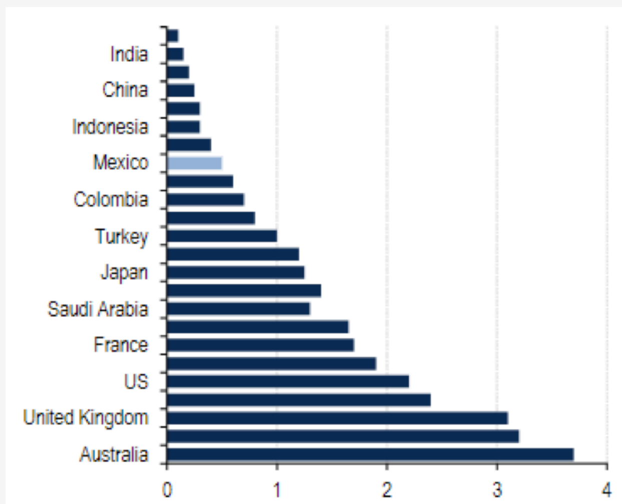
Through movements of each company's multiple, success has been measured by how well these operators can manage operating leverage. To be effective in this, the easiest and quickest way for operators to leverage income is through expanding its aeronautical sales, i.e., adding new routes, increasing seats, adding gate capacity, and/or increasing air travel penetration. (Exhibits 2 and 3) This runway of growth appears to be quite long as there has been forecasted strength in this industry. For example, Mexican airlines have invested to increase the size of their fleets and total available seats, which has already expanded by over 10% annually since 2011, setting up airport operators for future success.

Exhibit 2:
MX airlines have invested to increase their fleets and total available seats



Source: BofA Merrill Lynch Global Research with Ministry of Communications and Transportation data

Exhibit 3:
Mexican air industry low penetration (propensity to fly: number of trips per capita)



Source: IATA/Tourism Economics Ait Passenger Forecasts, Sept 2016

The second avenue of sales growth is through non-aeronautical revenue. While aeronautical revenue is highly-regulated, majority of the non-aeronautical revenue is not, allowing operators to have more control in their capital allocation process. Investors may not see variable income spike as quickly in this segment as they would in aeronautical sales, but operators have continued to do everything in their power to increase margins. Given the nature of business, operators generate strong cash flow, which has allowed these operators to reinvest in the airports through terminal expansion, remodeling commercial retail space, and modernization improvements. All of which, have yielded higher margins through increased tenant leasing rates. This has allowed operators to grow the non-aeronautical segment at a faster rate than aeronautical revenue, delivering an 11-year compound annual growth rate (CAGR) of 18.5%. (Exhibit 4) Not surprisingly with this growth, Mexican operators, on average, now derive close to 40% of their revenues from this segment. (Exhibit 5)

Exhibit 4:
Top line growth driven by non-aeronautical revenue

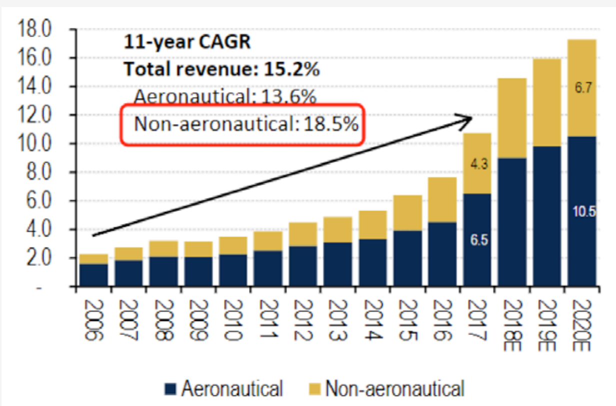
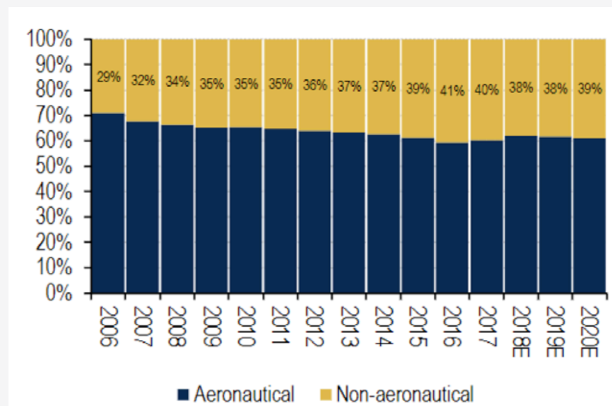


Exhibit 5:
Non-aeronautical revenue (majority is non-regulated) should stabilize at around 39% for the next three years



Source: BofA Merrill Lynch Global Research estimates

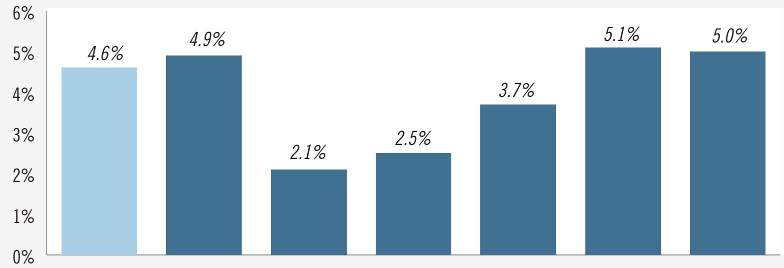
INDUSTRY

Unlike The Economist, we would not go as far as saying that Mexican airport operators have a monopoly, but they do have sole authorized control over key infrastructure gateways to geographic locations, plus significant barriers to entry, making it difficult for competition to enter the space. There are several regulatory and investment restrictions on developing new airports in any given Mexican region, so the market has not seen any increased competition from the private sector. Not to mention, Mexico's new progressive leader, Andres Manuel Lopez Obrador ("AMLO"), putting the kibosh on Mexico City's new airport in October, which was 70% completed, making the likelihood of any new airport project occurring minimal.

The industry has seen very strong traffic growth over the past few years, albeit slightly slowing, and it may not all be from the assumed catalyst, the appreciation of the U.S. Dollar. While a strengthening dollar has bolstered travel into Mexico from the United States, material growth has also come from homegrown traffic demand. The Mexican economy is highly tied to the success of the U.S., and with increasing U.S. consumer sentiment and a ten-year bull market, Mexico has become a very integrated and more stable emerging market.

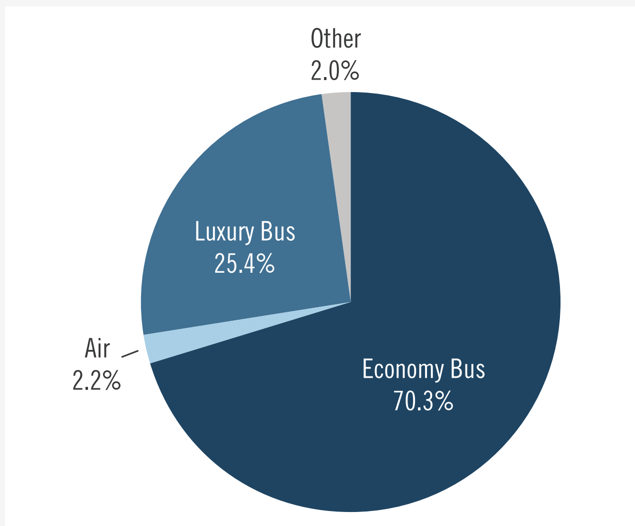
Operators have seen most of their growth come from increased domestic travel, which has grown annually by over 10% the last few years. Increased demand from Mexico's middle-class and, most importantly, a structural shift from road to air travel has boosted traffic volumes. (Exhibit 7) An influx of lower-cost carriers infiltrating the market has helped reduce prices for travelers. With this shift, the annual estimated growth in domestic air travel from 2016-2035 in Mexico is expected to average +4.6%. (Exhibit 6)

Exhibit 6:
Annual estimated growth in domestic air travel, 2016-2035



Source: KeyBanc

Exhibit 7:
Modes of Transportation in Mexico



Source: KeyBanc

Though boat travel is not plausible for domestic trips, there continues to be a titanic opportunity as we have just seen the tip of the iceberg for domestic Mexican air travel, which has a long runway to continue outsized growth. Currently, bus travel is the main means of transportation for Mexicans, accounting for 95.7% of travel, while air travel is only utilized 2.2% of the time. With the recent influx of low-cost carriers into Mexico, we will see more domestic travelers choose air travel as a means for transportation, increasing Mexico's already low penetration rate.

VALUATIONS

Even though the dynamics of these operators are the same, the differentiating factor between all of them is geographical location and the type of travel that they see within their regions. For example, one airport operator owns airports in locations that have higher tourist traffic, i.e., Cancun. On the other hand, another operator tends to own airports that have a focus on trade and manufacturing. This operator's crown jewel is the airport in Monterrey, an industrial-focused city, which generates around 50% of its highly-concentrated revenues. When you look at the valuations between these two Mexican airport operators, the latter tends to yield a lower valuation, partially due to investors assuming significant trade barriers may arise between the U.S. and Mexico, while the former has been granted a higher valuation with tourist travel expected to increase as the dollar appreciates.

Exhibit 8:

Exhibit 8: Valuation of International Airport Operators

Company	Median	Average	Mexican Airport Operator 1	Mexican Airport Operator 2	Mexican Airport Operator 3	Beijing Airport Operator	New Zealand Airport Operator	Australia Airport Operator	Austria Airport Operator
P/E (LTM)	22.5	22.6	16.3	19.0	22.5	8.6	39.2	29.0	23.9
P/E (NTM)	17.3	23.1	14.6	17.3	20.0	12.9	36.2	44.2	16.8
EV/EBITDA (LTM)	11.8	14.0	10.5	11.8	13.2	5.1	25.0	21.5	10.7
EV/EBITDA (NTM)	11.4	13.1	9.4	11.4	11.7	6.3	22.6	20.3	9.8
P/Book	3.0	3.2	5.3	3.1	4.8	1.1	1.8	-	2.8
Dividend Yield	3.3%	3.4%	3.3%	2.1%	3.8%	4.5%	2.6%	5.0%	2.2%
FCF Yield	5.2%	5.0%	5.7%	6.1%	3.7%	-	-	-	4.6%
ROE	15.4%	19.0%	35.8%	17.3%	22.7%	13.0%	13.4%	-	11.9%
ROIC	11.3%	12.1%	23.0%	11.3%	13.7%	11.3%	9.8%	6.2%	9.2%
LT EPS Growth	5.7%	3.3%	5.7%	6.7%	8.8%	-20.2%	11.9%	5.3%	4.8%
Market Cap	$ 4,842.00	$ 5,638.71	$ 2,438	$ 4,842	$ 5,698	$ 3,676	$ 7,024	$ 12,031	$ 3,762
Debt-to-Capital	32.1%	39.2%	35.2%	32.1%	39.6%	17.3%	26.6%	99.2%	24.5%

Source: Factset

When compared to other airport operators around the world, Mexican operators are expected to see higher growth over the next five years and tend to have a higher dividend yield, higher return on capital, and a healthier balance sheet. The only other operator to see anything close to this kind of growth is the airport in Auckland, which commands a multiple that is quite full, given its paltry return on invested capital. Though, it does appear that airport operators in developed nations, New Zealand, Australia, and Austria, yield a higher multiple than airport operators in emerging markets. Albeit Beijing is a problem child from a growth perspective. When compared to other Mexican stocks, these operators trade at a premium, given the fact that they tend to sport a lower Mexican market beta. (Exhibit 8)

Lately, valuations for the Mexican airport operators have compressed due to trade tension between the United States and Mexico. But, more importantly, valuations have come in due to the unknowns of the new populist lead by the AMLO regime, which has depressed sentiment in the space. Now, every Mexican airport operator is trading one standard deviation below its five-year average, though still at a home market premium. Given their healthy balance sheets, coupled with strong expected growth in the future, we believe that these securities may be undervalued.

CONCLUSION

Mexican airport operators are positioned to grow well above GDP in Mexico as they see benefits not only from an increase in U.S. travel, but also from increasing domestic traffic. This structural shift in domestic travel will provide a tailwind for earnings growth over the next decade, while they can continue to leverage growth in the current environment.

The DCM Value Equities Team has a common tenet to find lower valued, higher-quality companies that have superior growth prospects. For these higher-quality and highly-valued stocks relative to its home economy, we believe that price is what you pay, and value is what you get. We continually monitor our investment thesis for all of the stocks in our portfolios, especially those prone to geopolitical woes, as we won't put investments on autopilot.

About the Author

David Wagner, CFA, is a senior analyst on the Driehaus Small Cap Value strategy. He is responsible for conducting in-depth fundamental research, idea generation and making relevant buy/sell recommendations. Prior to joining Driehaus, Mr. Wagner was a research analyst at Opus Capital Management where he conducted research on the firm's smaller capitalization strategies. Mr. Wagner is a CFA charterholder and a member of the CFA Society of Cincinnati. Mr. Wagner earned his B.S. in Accounting and B.B.A. in Finance from the University of Kentucky. He also earned his MBA in Finance from Xavier University.

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