



# Assessment of potential valuation of Gatwick Airport

Summary Report prepared for easyJet, Virgin Atlantic and Tui Travel

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## Summary: Valuation of Gatwick Airport

easyJet, Virgin Atlantic and Tui Travel asked Frontier to assess the potential valuation of Gatwick Airport. This report provides a high level summary of the valuation. More detail on the analysis is provided in the full report dated 8 December.

The results presented in this report are based on a regulatory approach to the valuation of Gatwick. We believe that this is an appropriate methodology to apply to Gatwick Airport, because of its status as a designated airport.

- As a designated airport Gatwick Airport is subject to price regulation. De-designation will only occur when there is sufficient evidence of effective competition between airports in the London catchment.
- The valuation of Gatwick under a scenario of effective competition would be likely to be similar to the outcome under a system of effective regulation. Effective competition will deliver further downward pressure on prices and, to compensate, Gatwick will need to achieve additional efficiencies and service improvements.

We have developed a range for the valuation based on reasonable assumptions for low case and high case scenarios.

- **Low case valuation:** Value of £1,333 million (07/08 prices)
- **High case valuation:** Value of £1,734 million (07/08 prices)

Valuation of Gatwick Airport		
07/08 prices	Low case	High case
Valuation (£mn)	1,333	1,734
Current RAB (£mn)	1,524	1,524
Valuation as % of RAB	87.5%	113.8%

Source: Frontier Economics

This gives a range relative to the current Regulatory Asset Base (RAB) of 88% to 114%. This suggests that a reasonable valuation is centred around the current RAB with roughly the same degree of upside and downside risk. This result is supported by financial market evidence (EBITDA multiples) for a sample of quoted airport operators.

## Summary: Valuation of Gatwick Airport based on RAB and potential outperformance

The valuation model is based on the existing regulatory framework, assumptions about the regulator's expectations and actual performance against those expectations. The cash flow impact of under or out-performance is valued as a discount or premium relative to the RAB.

The model covers the next four price review periods – from Q5 to Q8. The main drivers of under or out-performance are: opex and capex; commercial revenues and passenger volumes; and financing costs.

The Table below shows that the biggest potential for under or out-performance lies in financing costs and in commercial revenue.

£mn	Low case	High case
RAB in 2008/09	£1,524	£1,524
NPV of financing and terminal value	-£59	£73
NPV of capex over/under performance	-£36	£26
NPV of opex over/under performance	-£24	£28
NPV of commercial (& other) revenue over/under performance	-£61	£75
NPV of variations in passenger volumes	-£10	£9
NPV impact of rebates and bonus payments	£0	£0
<b>Total valuation (£m in 07/08 prices)</b>	<b>£1,333</b>	<b>£1,734</b>
<b>Premium of value over RAB</b>	<b>-12.5%</b>	<b>13.8%</b>

A description of the main drivers in the valuation model is provided below, together with a summary of the cross-check based on financial market evidence.

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## Valuation methodology and Regulatory Asset Base

The valuation model is based on the existing regulatory framework and takes a “building block” approach to the RAB. The cash flow impact of out or under-performance against regulator’s expectations is explicitly valued as a premium or discount relative to the RAB. The main features of the model are as follows.

- The model covers the next four price review periods – from Q5 to Q8.
- The valuation is based on the current RAB as a starting point.
- Plus potential for outperformance or underperformance on: Opex, Capex, Revenues and Passenger volumes
- The model also includes a valuation of variance in financing costs relative to the regulated allowed return.

The CAA’s final decision on the price controls for Gatwick airport is contained in its March 2008 determination (for control period Q5). Data from this determination has been used in defining the start point for the valuation model. The opening RAB for 2008/09 is £1,524 million in 2007/08 prices, as determined by the CAA. The value of the RAB has been questioned in the context of the currently on-going judicial review of the CAA’s Gatwick determination. While it seems certain that the value of the RAB will not increase above this value, there must be a possibility, subject to the outcome of the Judicial Review, that this value may be reduced. We have, however, made no such assumption in our modelling.

## Opex and Capex: scope for out and under-performance

The model assumes that opex under or out-performance is removed by the regulator at the start of the next control period. This corresponds to the current CAA approach.

To assess a plausible range for opex performance, we used the CC's Working Paper on "benchmarking operating performance". This showed that Gatwick was c.30% less efficient (opex per PAX) than the average airport. We assessed possible out and under performance scenarios as follows:

- **Out-performance scope:** Regulator assumes constant real terms total opex in each regulatory period. Scenario assumes Gatwick actually reduces opex per PAX such that over 15 years, 50% of the current efficiency gap is closed.
- **Under-performance scope:** Regulator assumes reduced opex per PAX such that over 15 years, 50% of the current efficiency gap to the averagely efficient airport is closed. Scenario assumes that Gatwick delivers constant real opex.

The under-performance scenario reflects a regulatory approach where the regulator sets opex targets based on benchmarking across airports. This approach is more likely to be implemented following the divestment of Gatwick and potentially Stansted. It also replicates the expected outcome in a competitive and de-regulated environment.

For capex the model adopts current practice by excluding any clawback within regulatory periods (model assumes that projects are delivered on schedule and therefore there are no trigger payments). The baseline capex programme for Q6 reflects Gatwick's forecasts and for Q7&8 reflects an average of allowed Q5 capex and forecast Q6 capex.

The valuation model assumes the following scenarios:

- **Out-performance:** Gatwick is able to out perform by 10% (i.e. deliver the required capex 10% under budget)
- **Under-performance:** Gatwick under-performs with regard to capex by 15%

This assumed asymmetry in our assessment of the scope of over and under performance reflects the fact that capital projects are more likely to over run against allowed costs (in terms of pure efficiency per development delivered).

## Regulated and commercial revenues – out and under-performance

The model includes potential out or under-perform aeronautical revenues with regard to passenger volumes. In order to model revenue variance, we considered (i) the regulator's expectation of passenger volume projections and (ii) the scope for actual volume variation. We have therefore modelled the following.

- **Assumed passenger growth:** We have therefore assumed – as a baseline – that passenger volumes will increase by a constant percentage from Q6 such that, by 2030, there would be 45m passengers (the limit with existing capacity).
- **Scope for variance from forecast passenger numbers:** Over the medium-term, it is unlikely that actual volumes would systematically vary from the regulator's expectation by a material degree. We have therefore assumed that actual passenger volumes could be **+/-2% of the regulator's expectations**.

In addition to variance in regulated revenues, it is possible to out or under-perform in commercial revenues. Gatwick would benefit from out-performance in commercial revenues but only within a regulatory period. At the start of each subsequent period, the regulator should reset its expectations of commercial revenues to reflect the revenues actually earned.

To model commercial revenue variance we used the CC's benchmarking working paper. This showed that (i) Heathrow generates some 20% more commercial revenue than Gatwick on a per PAX basis; and (ii) Stansted generates some 36% less commercial revenue than Gatwick on a per PAX basis. Given this, we have assessed:

- **Out-performance scope:** Assumes that Gatwick could increase commercial revenues per PAX to close 20% of the gap to Heathrow over 15 years.
- **Under-performance scope:** Assumes that Gatwick could face a decrease in commercial revenues per PAX such that it closed 10% of the gap down to Stansted's current levels over 15 years.

The assumed asymmetry between the scope for over and under performance reflects a view that it is more likely that Gatwick will be able to achieve growth in revenue per PAX than face a significant decline.

We have not included any impact of rebates or bonus payments in the scenarios. Bonus payments for exceeding service quality levels are limited to 2.24% of revenue and penalties for poor performance are limited to 7% of revenue. This suggests there is more downside risk from the inclusion of these factors. In fact Gatwick's current performance leads to rebates to airlines.

## Financing performance against regulatory allowance

The regulatory price control allows Gatwick to earn a pre-tax rate return on the RAB. Financing out-performance occurs when regulator sets allowed rate of return above the actual pre-tax cost of capital. Our modelling of financing out-performance takes account of the following:

- The credit crunch has increased the cost of capital for Q5 above the allowed rate of return
- For Q6-8 the regulator is more likely to set a rate of return slightly above the cost of capital.

The estimated current cost of capital is c.1% higher than the figure allowed in the CAA decision. In determining the scale of the underperformance the main question is – how long will it take for market rates to return to more ‘normal conditions’?

- In our **high valuation scenario**, we have assumed that the under-performance for Q5 as a whole is 0.25% - this implies that the market conditions will revert to normal after about a year
- In our **low valuation scenario**, we have assumed that the under-performance will be 0.5% - which implies that the conditions will last for around two years.

In modelling the financing performance in Q6-8, we recognise that regulators tend to allow rates of return that are above the mid-point estimate of the cost of capital. The reason typically given for this is that regulators consider that the risks from setting the cost of capital too low are greater than the risks from setting it too high. Our assumptions for financing performance for Q6-8 are:

- **Out-performance scope:** The allowed rate of return will be 0.5% higher than the cost of capital.
- **Under-performance scope:** The allowed rate of return will be equal to the cost of capital.

It should be noted that the development of competition and the move towards de-regulation will reduce or remove the need for regulators to incentivise investment through the rate of return. This would make the low valuation scenario presented here the more likely outcome.

## Results of valuation modelling – summary and sensitivities

The results above indicate that the appropriate range for the valuation is £1,333m to £1,734m (2007/08 prices). This represents a range of 88% to 114% of the current RAB. This valuation has been built on a regulatory methodology that assumes the current system of regulation will be maintained or will evolve gradually.

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These results are reasonably robust to variations in the main assumptions

- Varying the proportion of opex that is fixed by 10% (i.e. from 60% to 50%) reduces the high case and increases the low case valuation by less than 0.5%
- Reducing the percentage of out/under performance of capex by 5% (i.e. from 10% to 5% in high case and 15% to 10% in the low case) reduces the high case valuation by 0.75% and increases the low case valuation by 0.9%
- Changing the capex profile to reflect the forecast level of expenditure in Q6 for both the Q7 & Q8 period (rather than the average of Q5 and Q6) reduces the high case valuation and increases the low case valuation by 1.1%
- Increasing the variation in passenger volumes from 2-2.5% increases the high case valuation and decreases the low case valuation by approximately 0.6%.

## Financial market data can be used as a cross-check on the valuation

The results presented in the previous section are based on a regulatory methodology. We believe that this is the appropriate methodology, but it is useful to cross-check these valuation results against financial market evidence. A common metric used to value business is the ratio of enterprise value (EV) to a measure of operating surplus (EBITDA).

The results from our valuation model for the current earnings multiple (based on 2008/09 earnings) are in the range 8.2 – 9.0x.

The Table below shows the multiple for a sample of quoted European airport operators. This shows that the multiple has been around 11x in recent years. The EV/EBITDA multiple based on prospective earnings for 2009 is lower at 8x earnings. For comparability the valuation model gives a prospective earnings multiple (based on 2009/10 earnings) for Gatwick of 7.4 – 8.7x.

The current projected multiples for these quoted airport operators are in line with the multiples implied by our valuation model and support our results. It should be recognised that the characteristics of these airports may differ from Gatwick in terms of: system of regulation, investment requirements, extent of competition and potential to expand.

Airport operators	EV/EBITDA				
	2006	2007	2008E	latest	2009E
Fraport	9.5	9.9	10.6	10.1	7.9
ADP	15.3	14	12.5	12.3	7.7
Flughafen Wien	10.3	10	8.9	10.4	8.2
Flughafen Zurich	10.6	10	9.2	9.4	7.0
Kobenhavns Lufthavne	13.7	12.2	11.5	11.4	9.5
Aeroporto di Firenze	20.6	14.6	12.9	14.3	-
<b>Average</b>	<b>13.3</b>	<b>11.8</b>	<b>10.9</b>	<b>11.3</b>	<b>8.1</b>

Source: 2006 to 2008E Mediobanca Securities, June 2007, latest in Reuters, 2009E Deutsche Bank October 2008.

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