Positives

(1) **FCF generation:** Aena has historically heavily over invested in modern facilities. Capacity utilisation is only c60% and investment needs are now low. In 2015 we estimate operating FCF of €1.5n, capex of €400m and FCF of €1.1bn, equating to a 9.8% FCF yield (Figure 1). Although, we forecast capex/ depreciation to rise from 0.42x in 2014 to 1.1x in 2025 we still see continued strong FCF.

(2) **Traffic growth:** We expect international traffic to continue grow strongly driven by LCCs and Spanish traffic to continue its GDP led recovery. We forecast traffic growth of 3.8% in 2015, 3.2% in 2016 and 2.7% in 2016-21 (Figure 2).

(3) **A country wide monopoly:** Aena operates 46 airports including all the major airports in Spain, thus airlines have no other realistic options. Other airport operators in our universe only dominate individual cities.

(4) **Regulated returns reached with tariff declines:** A forecast declining RAB means moderate EBIT growth leads to rapidly improving returns on RAB. This is despite tariffs set by the Direccion General de Aviacion every 5 years can't increase until 2027 and we estimate will actually fall by an average -2.0% pa in 2017-26 and then remain flat in 2026-50, so our estimated allowed regulatory return is not exceeded (Figure 3). Thus we see less pressure from airlines than for other European airports.

(5) **Increasing tariff competitiveness:** Although tariffs are currently relatively high, particularly at Madrid and Barcelona, they will become increasingly competitive versus other European airports.

(6) **High profitability:** We expect that EBITDA margins increased from 36.2% in 2011 to 58.3% in 2014, driven by aeronautical prices, commercial revenues and efficiency. Margins are significantly above peers such as Fraport's 31.0% or ADP's 40.7% in 2014E (Figure 4)

(7) **Efficiency:** Recent efficiency initiatives focused particularly on employee costs means Aena is significantly more efficient than its European peers. Opex per ATM of €740, compares to Frankfurt €2,900 and ADP €2,400 in 2013, although this is partly due to mix given numerous smaller aircraft at Aena's smaller airports.

(8) **Evolving dual till:** It was agreed by Royal Decree (2014) that Commercial activities will leave the RAB at 20% pa in 2014-18 at their RAB value, well below their estimated market value, allowing Aena to benefit from improving performance without a negative impact on returns in Aeronautical.

(9) **Dividends:** Management have indicated a 50% payout ratio in 2015 rising to 60% by 2020 resulting in a dividend yield of 3.3% in 2016 and 5.1% in 2020. We see upside potential if dividend growth is preferred over significant overseas acquisitions.

(10) **Management record:** In our view over the last 3 years management has successfully commercialised Aena having significantly reduced debt, improved efficiency and increased FCF.

(11) **Retail improvement:** Most retail contracts have been renegotiated with space remodelled and income guaranteed. The Madrid and Barcelona WDF contracts became based on guarantees rather then revenues at end 2014 due to below expected spend. Some 35-39% of revenues are guaranteed until 2020, although we expect a c€100m fall in revenue in 2021 post their expiry (Figure 5).

(12) **Strong EBITDA growth in 2014:** 9M EBITDA grew 15%, driven by efficiency improvements and Commercial (+22%) on top of 48% EBITDA growth in 2013.

Risks

(1) **Upcoming regulatory review:** The Royal Decree August 2014 established regulatory principals and a transition to dual till but the main regulatory document (DORA 1) with the assumptions and allowed return for 2017-21 is not approved until September 2016. The Spanish election will be before 20 December 2015 and could be won by radical left wing party Podemos.

(2) **Lack of regulatory history:** The other airports in our universe have more regulatory history. Hence, given this and election risk we apply a 0.25 supplement to our standard European airport asset beta of 0.65, leading to a Ke of 7.8%.

(3) **Low regulatory return:** Aena's current aeronautical pre-tax allowed return is 6.2% (post-tax 4.3% (Figure 6), the lowest of the regulated airports in our universe. Although many European airports currently earn significantly less than their aeronautical allowed returns, that are in reality cross subsidised by more profitable retail activities, partly due to pressure from airlines.

(4) **Potential reduction in allowed return:** We estimate a post-tax return of 4.3% for 2017-21 with a lowered long term bond yield assumption of 3.0% partially offset by a higher proportion of equity, likely to change from book value to market value and a higher cost of debt as Enaire's government backed debt expires. We see a risk the regulator uses a RFR closer to current yields.

(5) **Declining RAB:** As capex is currently significantly below depreciation and the RAB doesn't inflate we forecast it will decline 15% in 2013-20 and then fall slightly in 2021-50 as capex closes the gap with depreciation. As the allowed return is a percentage of the RAB we expect the nominal allowed regulatory EBIT to decline particularly in 2017-26.

(6) **Potential cost transfer out of RAB:** The CNMC in December 2014 recommended transferring €100m of Aeronautical costs into Commercial, where they would be no longer compensated through tariffs. The regulator disagrees but the outcome is uncertain. ADP in France has adopted a similar transfer in its regulatory proposal for 2016-20. We deduct €4 a share in our SOTP based on a 60% probability weighting.

(7) **Low spending traffic:** Low cost carriers account for 55% of passengers with 49% of flying through tourist airports and 93% are European. We expect retail income per passenger of €3.22 in 2014 compared to Fraport €3.21, ADP €4.29 and Heathrow €7.75. Given Aena's low proportion of higher spending intercontinental traffic we expect its retail revenues will remain structurally low.

(8) **Rising cost of debt:** Upcoming amortisations of the government Enaire backed debt are c€900m pa or 9% of end 2014E net debt of €10.4bn. We expect an increase in the current interest cost of 2.1%, which is 89% variable/ revisable but not renewable. We estimate refinanced debt at 10-year Spanish yields +250bps equating to 3.9%, above Aena's peers given higher leverage.

(9) **Sensitivity to operating assumptions:** Given long duration we estimate our DDM changes by 21% for a 100bps change in tariffs, 17% for 100bps change in traffic, 13% for a 0.10 change in the regulatory risk premium on our asset beta and 11% for a 100bps change in Commercial revenues beyond 2021.

(10) **Risk of rising bond yields:** We mark to market historically low current 10 year Spanish bond yields of only 1.64% in our WACC and each 100bps increase reduces our DDM by 6%.