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Shanghai Int'l Airport: Munger's Way of Investing in China's Growth

Sid Choraria, an Asian Equities Portfolio Manager, presented his in-depth investment thesis on Shanghai International Airport Co. (China: 600009) at Best Ideas 2019.

Jon Xu, analyst at Amiral Gestion in Singapore, joined Sid for this session.

The following transcript has been edited for space and clarity.

Sid Choraria: My philosophy is to invest intelligently in high-quality businesses across Asia, where Mr. Market is often excessively fearful or excessively greedy. I primarily fish in China, India, Japan, and some of the high demographic markets in Southeast Asia. You can adapt very well the time-tested principles of Benjamin Graham, Charlie Munger, and Warren Buffett in Asia.

The subject of this presentation, Shanghai Airport, is an idea Jon Xu, our Chinese equities analyst, and I copied from Charlie Munger. He spoke about this in an interview almost a year ago, and we came across it when the stock was trading at much lower prices – it was down nearly 30% in 2018. Charlie Munger said, "Always look for durable competitive advantages. One of the things we got into was the Shanghai Airport, the main airport in China, with no debt net. How can you lose with the main airport of China?"

The thesis is fairly simple. It's a $14 billion market cap company, with a current enterprise value of about $12.8 billion. It's consistently net cash. From a valuation perspective, it has a free cash flow yield of 6% to 7% and price to earnings ex-cash of about 15x to 18x. This is a large liquid idea offering a highly defensible investment proposition in a market which is said to be volatile over the next few years. The key with Shanghai Airport is that the revenue is more predictable as the company has a minimum guarantee from the duty-free concession it signed in 2018. Also, there's a very long growth runway over the next 20 years as Chinese consumers are just getting started with travel.

Munger's interview inspired us to look further into the idea. One thing that makes Shanghai Airport worthy of attention is its moat: we have the "location, location, location" benefit, pricing power levers (because of the duty-free concession which carries a minimum guarantee for the next six to seven years and provides a highly predictable revenue stream), and 70 million passengers a year.

Secondly, there is a long growth runway. Only 4% of Chinese people hold passports, but this should rise to 12% to 15% by 2025. The structural trend also makes it a no-brainer. The retail spend per passenger is just 1/3 of what we have in Hong Kong, Singapore, and Paris.

The most important thing when you look for a forecast of revenues and profits is predictability. Shanghai Airport has grown its revenues every year since 1999, except probably in one year. This annual growth will continue in the foreseeable future. Combined with rising incomes and GDP per capita, it's almost certain we can have a high degree of predictability in the revenues and profits of this company. In terms of the shareholder structure, it has a strong SOE backing and solid alignment with the minority shareholders. The cost of capital is also low given the backing.

With regard to passenger volumes, Shanghai Airport has risen from below 30th position in the rankings in 2000, 2005, and 2009 to enter the top ten. We forecast passenger numbers to increase to about 100 million in the next five to six years and reach 160 million by 2040, which is more than double the current levels. There's a much longer time horizon with this idea, and investors should take advantage of China's Mr. Market – which is going to be excessively fearful or excessively exuberant – to enter Shanghai Airport at prices they feel have a high margin of safety.

When it comes to the number of take-offs and landings, Shanghai Airport has also risen from obscurity, moving from below 30th in rank to the top 10. A similar pattern is observed in cargo traffic, where Shanghai Airport entered the top 10 in 2005 and has been in the top 3 since 2009.

In the matter of company financials, a key point is its predictable and high earnings power through various economic cycles. The first thing to note is that aeronautical revenues accounted for about 46% of the total in 2017, down from as high as 65% ten years ago. It will continue to trend lower in the next five to six years from now, sliding to mid-30s. Since this is a lower-margin business, as the mix changes, EBIT margins have improved and will continue to do so. The second revenue segment is called non-aero and accounts for about 37%. Within that, some 70% is related to commercial rental, which is primarily concession agreements with leading Chinese duty-free operators. In 2017, a regulatory change allowed Shanghai Airport to sign a highly attractive agreement with one of the operators, Sunrise, securing a minimum guarantee of revenue over the next ten years.

In terms of the assets, the company operates two terminals with four runways. It also has Satellite 1 and 2 terminals in construction, which will be operational in the second half of 2019.

Where aeronautical revenues are concerned, the key thing to note is that they grow with enplanement and overall passenger growth. The contribution of this segment has been coming down because of the growth in non-aero revenues, which are becoming increasingly more important for the underlying intrinsic value of Shanghai Airport. We think aeronautical revenues should decline from 46% in 2018 to as low as 30% by 2025. The key here is that this is a lower-margin business (10% to 20% operating margin), so as the revenue mix changes, the EBIT margin will go up.

On the non-aero side, the revenue contribution has gone up over time. It remains quite low compared to international peers, where the share is as high as 70% to 80%. The key driver here is commercial rental revenue, most notably the portion derived from the duty-free concession agreement. The contribution of commercial rental revenue to the non-aero segment was 49% in 2008, rising to 69% in 2017. We model this to grow to 87% by 2025. The duty-free contribution to commercial rental revenue is approximately 80% to 85%, and there is a minimum guarantee and variable component to it. Pre-2017, both the minimum guarantee and the variable component were low. However, the regulatory change that year allowed for an open tender where both parameters have increased for the next ten years and provide significant visibility to the minority investor.

Outside of this duty-free component, there are commercial rental revenue drivers which have to do with shops and F&B-related revenue. The mix is changing for the better, so the margins are going higher, and there is predictability because of the duty-free concession signed in 2018. Those are the key points for new investors trying to understand Shanghai Airport.

The operating margins of the company have improved over the last few years, primarily as a result of the mix change. The main costs are D&A and labor. We model them to be largely consistent with the past, but the margin should improve as a result of the revenue mix.

John Xu: Shanghai Airport has seen revenue growth since its listing, as early as 1998. We have a 14% top-line CAGR from 2000 to 2017, underpinned by consistent passenger input. The number of domestic passengers has tripled during this period, and international passenger volume has doubled. Going forward, we forecast low- to mid-double digits.

In terms of net profits, Shanghai Airport has been profitable in all of the past 18 years. Since the financial crisis of 2008, the bottom line has quadrupled due to the larger share of non-aero revenues. We also expect low- to mid-teens net profit growth in the decade ahead.

The duty-free concession business contributes about 80% of commercial rental revenues, which is the key driver for non-aero revenues. The pivotal change occurred when the long-term duty-free concession signed around 2007-2008 between Shanghai Airport and Sunrise Duty Free expired. It had low minimum guarantee and revenue share as the parties didn't foresee the degree to which international traffic would increase. The new contract signed in 2018 includes the so-called minimum guarantee, which will go from RMB 3.5 billion in 2019 to RMB 8 billion in 2025 – 15% CAGR in the seven-year period. We believe this provides a very predictable and high-margin business for Shanghai Airport.

As for the Satellite terminal set to open in the second half of 2019, it is expected to bring an additional 60% passenger capacity and, most importantly, double of the current duty-free rental of 7,800 square meters.

To sum up, Shanghai Airport has got a long operating history with predictable earnings power, an ability to deliver strong profitability through cycles, high barriers to entry, and a respected management team, all of which are reflected in robust financials characterized by strong FCF generation.

Choraria: Let me proceed with some benchmarking analysis. I tend to devote most of my time to a watchlist of 60 to 80 high-quality businesses in Asia. I also spend some time on less liquid, lower market cap securities, which represent probably 15%-20% of my portfolio. But as portfolio sizes grew, we decided to look for a larger liquid company, and Charlie Munger's interview inspired us to go for Shanghai Airport.

Compared to peers, Shanghai Airport has among the highest operating and net profitability. Furthermore, it's one of only two net cash companies. It should be noted that the Paris, Sydney, and Frankfurt operators fund their dividends through the issuance of debt and equity, not solely by free cash flow. This is not the case with Shanghai Airport, which has a net cash balance sheet. It has paid down debt previously and generates significant cash flow. As we expect non-aero revenues to rise at 15% CAGR through 2025, we're quite comfortable with our free cash flow assumptions looking out three, five, or ten years from now.

Shanghai Airport ranks highly not just in terms of having a favorable margin profile but also in terms of its growth profile, which is essential when investing in Asia. Paris Airport, for example, has net debt, slow revenue growth, and lower margins but still trades at 25x to 30x PE, while Shanghai Airport, on a forward one- to two-year basis, trades at just 15x to 18x cash. Sydney Airport also has net debt and lower growth. Moreover, it is highly dependent on Chinese outbound passengers and funds its dividend through debt, but it still trades at 40x PE, which is quite egregious. The situation is similar at the Frankfurt and Zurich airport

operators.

The following are excerpts of the Q&A session with Sid Choraria:

John Mihaljevic: Could you comment a bit more on how the Chinese government or the regulators might affect returns to shareholders over the long term? What are the potential risks there, if any?

Jon Xu: On this front, we've got to understand how the Chinese government thinks about the incentives. Shanghai Airport is 53% owned by the Shanghai Airport Authority, which is in turn owned by the Shanghai municipal government. We believe the incentives of the local government are aligned with those of the shareholders. Both the local and national governments care about increasing passenger throughput and the status of Shanghai Airport as an international aviation hub. From that perspective, we believe solid government support is key for Shanghai Airport to have strong, stable growth in the foreseeable future.

Choraria: With investing in China, you think they're going to screw minority shareholders, but in the case of Shanghai Airport and some other companies we invest in, we feel that the price, predictability, growth runway, track record, and capital allocation we've seen over the last 10 years does not warrant undue concern.

Mihaljevic: I'm wondering how these business models work over the very long term. It seems that a few airports globally, maybe in Thailand or other places, have multiple airports. How would that kind of growth strategy work in such cases? Could that be realistic at some point?

Choraria: I haven't looked closely at Thailand Airport, but its operator does own a number of airports across the country, whereas it's just Pudong International Airport for Shanghai Airport. I think Thailand has something like 20-plus airports, which is ridiculous. An airport in Thailand has 3x the market cap of Shanghai.

In terms of the business model, it's fairly simple. The company has its assets (the terminals and the runways), very strong SOE backing, and low cost of capital. There are two main revenue streams: the aero side, which is a low-margin business, and the non-aero side.

One of the reasons we picked this idea for presentation is the inspiration provided by Charlie Munger. Secondly, we have the game changer for Shanghai Airport in the form of the renegotiated duty-free concession, which provides visibility for the next ten years. We like this predictability. Also, the long-term structural trend is undeniable. Even Japanese companies we find interesting are fueled by Chinese consumer demand.

In terms of differences between the airports, there certainly are some. I don't know a lot about the airports in Thailand, but I still see no reason why they should have 2x or 3x the market cap of Shanghai Airport. We bought the stock at much lower prices than the current ones, but we think it's very interesting given the predictability of the duty-free concession.

Mihaljevic: Some major cities around the world, such as New York and London, have more than one airport. Do you see any risk of such competition coming to Shanghai at some point?

Xu: We spoke to the company, and right now, no one knows for sure. What they told us was that Pudong Airport is a very strategic airport, and it's highly likely there will be no third airport in the region [ed. note: Shanghai has another airport, domestic travel-focused Hongqiao, which is also owned by the Shanghai Airport Authority]. Right now, it's not set in

stone, but our research gives us the impression that the competition risk is very low for Shanghai Airport compared to, say, Beijing, where a second airport is set to open in 2019.

Choraria: Our research suggests that Shanghai Airport is a very high strategic priority for China, so the competitive risk is very low. Every business has competition, but as Charlie Munger said, we need to look for durable competitive advantages, and we think this one has them. In our opinion, the idea deserves a place on a core China watchlist. Since Mr. Market in China is very greedy or fearful, a prudent long-term value investor who understands the predictability of the earnings can take advantage. That's set in stone because of the duty-free concession agreement, so you can understand the normalized profitability over time. We think the catalyst in 2018 made the idea quite compelling.

About the instructor:

Sid Choraria is an Asian Equities Portfolio Manager focused on identifying exceptional businesses, cultures and CEOs/management teams to invest like a business owner, preferably for 10 years or longer.

The typical company Sid prefers is a business that can endure the risk of impermanence over decades. His research indicates that over 98% of investable companies fail the test. The culture must be unquestionably superior. Such companies are customer obsessed and have strong non-transactional relationships with constituents. Sid prefers early-stage pricing power that is not discovered. The universe is limited to exceptional Asian businesses and great global companies with significant revenue and cash flow from Asia very material to shareholder value.

In Aug 2013, Sid elicited a rare response from legendary Warren Buffett with a letter and thesis on an under-followed, 135-year-old Japanese company. The company, Kobayashi Pharmaceutical (4967 JP) founded in 1886 is as old as Coca Cola and Wrigley's chewing gum but with poor coverage when Sid discovered it. He presented the idea on MOI in 2013. Since the letter, business value has quadrupled compounding roughly 26% outperforming the S&P, NASDAQ and respective Asian indices. The inversion lessons influenced Sid's journey to focus on less followed companies, great cultures and businesses that can endure the test of time.

Sid enjoys mentoring young talent and giving back knowledge by speaking at the world's top universities like Harvard, Princeton, Columbia Business School, NYU Stern, LBS, USC and Brown. From 2014-2016, he consistently won a few research awards for probing research on Asian companies judged by over 70 judges. His contributions have featured in Goldman Sachs Alumni Network, CNBC, Sydney Morning Herald, Alpha Ideas India, Value Spain, Intel and GIC.

Sid has worked in Asia for 15 years and grew up in the region. Previously, he has served in senior investment roles in Asia, at multi-billion long-only and long-short funds. He worked at Goldman Sachs technology investment banking in Asia. These experiences taught him the significant importance of teams, culture and incentives.

Sid received his MBA from New York University Stern School in 2011 and was recipient of the Harvey Beker Scholarship. During his MBA, Sid worked at Bandera Partners, a fund focused on small mid cap activism, run by Jeff Gramm, Author of "Dear Chairman", Greg Bylinsky and Andy Shpiz.