

*This article is authored by MOI Global instructor Luis Garcia Alvarez, Equity Portfolio Manager at MAPFRE AM. The article previews Luis' in-depth idea presentation on Ferrovial (Spain: FER) at Wide-Moat Investing Summit 2018.*

Ferrovial is a multinational infrastructure, services and construction group headquartered in Madrid, Spain. It owns significant stakes in Canada's 407 ETR toll road (43% equity) and Heathrow airport (25% equity), plus four "managed lane" projects in the United States (of which two are currently operational). The company has a portfolio of mature assets generating predictable cash flows that the construction division deploys to develop new concession projects.

Ferrovial was founded in 1952 by Rafael del Pino y Moreno. Today, the del Pino family still owns a significant stake in the company. Rafael del Pino Calvo-Sotelo, the current Chairman, owns a 20% stake. His sister María del Pino owns an 8% stake and his brother Leopoldo del Pino owns 5%. Unlike other companies exposed to construction, infrastructure and services in Spain during the last decades, Ferrovial followed a conservative approach with respect to financial leverage and possesses a solid balance sheet with net cash at the parent company level.

Ferrovial's valuation in terms of accounting multiples is distorted by the fact that the assets that contribute the most to the valuation (ETR, LHR) are integrated by the equity method without contribution to sales or EBITDA. The company has also started reporting its accounts proportionally to better reflect its economic and business reality.

During recent quarters, adverse market conditions in the Services activities in the United Kingdom and a lower contribution from projects in Construction, together with a couple of loss-making projects, have compressed the company's operating margins on the contracting side. Additionally, political uncertainty in Spain has increased investors' pessimism about Spanish stocks in general.

These factors combined have led to significant weakness in Ferrovial's share price, which has decreased from EUR20 per share in mid-2017 to approximately EUR17 per share in May 2018. However, we think that this is a case in which investors are simply not focused on the right issues and misunderstand the relative weight of the various segments and geographies in Ferrovial's valuation.

First, political uncertainty in Spain has very limited impact on the company's cash-flow generation as the bulk of its operating cash flow currently comes from outside its home country.

Second, although the competitive environment remains tough for the UK Services division, we believe that the worst is likely over. Operating margins should start to recover going forward as the negative impact of the challenging Birmingham project fades away. We further believe that the provisions that the company has already made regarding this project, which we subtract from our valuation, appropriately account for the negative

impact. In any case, even if we were wrong regarding this view, our estimated valuation for the entire UK Services division is a minor component of the company's total equity value, posing limited downside risk.

Finally, the most important asset in terms of equity value for the company - the Canadian 407 ETR toll road (close to 50% of our estimated intrinsic value for Ferrovial) - has continued to report very solid results in recent quarters, generating strong cash flow and outperforming analysts' estimates on both tariff increases and traffic growth.

It is precisely the exceptional terms and performance of the 407 ETR concession that cause us to consider Ferrovial a Wide-Moat company. The 407 ETR is located in Toronto, Ontario (Canada) and runs parallel to the first city ring road, the 401, one of North America's most congested highways. Currently, 108 km of the 407 ETR are operational. The concession was awarded to Ferrovial in 1999 as part of a consortium (in which it has a 43% stake) and runs until 2099 (more than 80 years remaining!). In our view, this is one of the best infrastructure assets in the world for the reasons we will explain below.

The 407 ETR is the world's first all-electronic, barrier-free toll highway, which means the toll system does not require drivers to stop at the entry or exit tollbooths. Instead, it detects the vehicle, calculates the route to be covered and manages billing automatically. Most importantly for Ferrovial, toll charges can be varied freely provided that traffic remains above a certain threshold. This means that drivers pay according to the value (i.e., timesaving) that the highway provides at any given time.

From our point of view, the operative question and main value driver for this motorway (and, hence, for Ferrovial as a whole) is the price sensitivity of demand to changes in tariffs. Logically, increases in tariffs reduce expected traffic volume. However, despite 9% annual growth in tariffs over the past ten years, price elasticity has proven to be low (EBITDA grew 10.5% annually during this period). We see potential for continued low levels of elasticity into the medium term with significant implications for long-term value creation given the concession's remarkable duration.

Ferrovial has been managing the 407 ETR successfully for almost 20 years. This constitutes, in our view, a key component of the company's sustainable competitive advantage: proprietary expertise. For two decades the company has tested the elasticity of demand to changes in tariffs, which is the primary driver of cash flow for largely fixed-cost assets like toll roads. Hence, Ferrovial has access to a priceless set of data on how traffic reacts to changes in prices.

Other infrastructure competitors simply do not have comparable data, especially considering the uniqueness of the 407 Toll Road. This creates an advantage for Ferrovial and enables the company to design more compelling and competitive offers when bidding for projects where this information is crucial. For example, Ferrovial's data capabilities were crucial to its success in winning the four "managed lanes" awards in the United States, projects that represent significant long-term value creation potential for shareholders.

