Insight: Is it business as usual for airports in 2023 and beyond?

Ofer Karliner, Portfolio Manager, provides insight into the outlook for airports and what other challenges and opportunities face this sector.

How has the post-pandemic recovery played out and have there been any unexpected deviations from this recovery?

Overall, the recovery's gone a bit better than we expected. Looking at the key structural themes, they have been as expected; during the depths of the covid crisis we talked about how leisure travel would come back before for business, domestic over international, short-haul over long-haul, and low-cost carriers over legacy carriers, that's what we're seeing play out. Leisure travel is largely recovered, business travel, depending on who you talk to, but broadly speaking, is about 70% recovered. Those marginal trips just don't happen anymore, people are doing video conferencing, for example. European companies are more focused on climate change and the impact of air travel, so we've seen some of those trips not come back, however, as expected. Domestic has recovered much faster, the July IATA numbers had global domestic travel about 8.3% above 2019 levels, where international was 11.3% behind. Short-haul's come back over long-haul for various reasons, including cost.

Finally, the legacy carriers have not ramped up capacity as quickly. Traffic hasn't recovered as quickly, and we can see that in the numbers. For the June quarter, for example, Ryanair had traffic 15% above 2019 levels, where IAG Group, (who own BA, Iberia, and other airlines), was about 5% behind. Ryanair has accelerated from there, with August numbers around 25% ahead of 2019 levels, so they're really ramped up capacity as we've seen.

The key deviation has been around the recovery in Asia, it's been slower than expected. The IATA numbers have July international travel out of Asia, at about 26% behind 2019 levels. That's really been driven by China, to a lesser extent Korea and Japan.

There's a couple of idiosyncratic factors to consider. All those countries were late to reopen, so they're taking long to recover, but Chinese domestic demand has replaced some of the international demand. Chinese domestic travel was up 22.5% in July against 2019 levels, well ahead of what it was prior to COVID, and that's probably eating into international travel. Part of that reflects group travel, it hasn't come back the same way, it's a big component of overall Chinese travel demand. We had a number of markets shut or closed off to group travel until very recently. That'll take time to re-establish itself, but it will over time.

One of the other things that is also impacting demand at the moment is availability of air routes to Europe being affected by geopolitical factors. A lot of bilateral air rights were being utilised prior to COVID. Because of the Ukraine war, Russian airspace is closed to European carriers. As a consequence, some of the European governments are pushing back on re-establishing the air rights to China as the Chinese airlines have a competitive advantage because it's a shorter flight, and they use less fuel, so governments trying to protect their local airlines. It's impacting demand, but probably impacting at the margin a bit.

What impact does lower airline capacity impacting pricing have on the airports?

It depends on the airport, obviously leisure airports are less impacted. We're seeing capacity put into those particularly, because there's such strong leisure demand. However, if it is long-haul or business-focused airports, then it's being more impacted.

Let's step back and look at why we're seeing the capacity constraints. Airlines retired a number of planes during COVID, large parts of the fleet were put into storage or the desert, with the intention of never bringing them back in many cases. As demand came roaring back, they've tried to pull these aircrafts out of storage, get them re-certified, safety checked and that takes time and there simply isn't the capacity to do all that quickly. One airline executive put to me that every airport hanger in the world that does maintenance is full, and there's a big backlog.

To give an example, Lufthansa announced at the end of June last year they were bringing back their A380s they retired during COVID. They got their first one back in service in June this year, so it'll take time to re-establish that capacity. The aircraft manufacturers slowed production during COVID. As they came out of COVID, they try to re-accelerate production, but there are

supply chain issues affecting that. They've got hundreds, if not thousands of secondary suppliers all feeding into the production of aircraft, it takes time to get that re-established and build up the fleets.

Finally, there's probably a shorter-term factor, there's an issue with Pratt and Whitney engines that are affecting the A380 Neos. We're seeing some of those out of service, where they're getting inspected more regularly and if they do have a problem with them, they have to be taken out of service. Supply chain constraints means there's not enough spare parts to fix them all, that's also impacting demand at the margin. Overall, it's probably 2026/2027 before we're back to normal capacity levels.

There's a regular report into the airline industry by a consulting company called Oliver Wyman, which estimated pre-COVID, that at the start of 2024, there'd be 32,000 working planes in the sky. The current estimate is for 28,000, that means a 12.5% reduction in the available capacity, a big impact to our overall capacity.

What does it mean? Well, for low-cost carrier driven airports, so for Magellan, that's Aena, our biggest airport position, and ANA owned by Vinci, another company in portfolio, they're less impacted. We're seeing demand, leisure demand, very strong, so the low-cost carriers in particular are putting capacity in those markets, but ticket prices are up everywhere. If you're a low-cost carrier and you're flying from Luton to Málaga in the UK or from Germany to Spain, the ticket price going from 20 pounds to 30 pounds, isn't that impactful. If you're a long-haul airport or a business airport, the person who's spending $2,000 on tickets, is now spending $3,000, and if you're a family of four, all of a sudden that's meaningful. We're seeing that impact demand for those longer haul destinations.

With the issues that the sector is faced with, and the additional issue around recessionary risk in Europe, how do you overlay that when you are thinking about investing in this sector?

Recessions are bad for airports, travel by its nature is discretionary. You don't have to travel - to the where people worry about their jobs, or don't have jobs, they tend to pull back on discretionary spending. Now, the reports coming out of Europe, and there's a few surveys suggesting the one area of discretionary spending that's not being cut is travel. Will that survive a deep recession? Probably not. We'll probably see some pullback, but you also have to think about the starting point of where we are now.

Looking at our portfolio, we can manage this in two ways. We can manage through position sizing and through the stocks we invest in. In terms of position sizing, we're about 9% in airports, pure play airports, and probably another 3- 4% underlying exposure through companies like Vinci and Ferrovial, who are in airports as well.

We are conscious of this recession risk in Europe. Airports as a whole, look reasonably good value to us but we're just conscious that if economic conditions worsen, they'll react to that at a share price level. In terms of the airports, we invest in, though, Aena is our biggest position. We also have a big position in Vinci, which owns ANA airports, they are largely low-cost carrier airports. What we see happen, is that people pull back in their spending initially and then they say, "Well, actually, I still want to go on holiday. What will I do? Well, I won't take that long-haul flight somewhere to a remote island. I'll go somewhere cheap, and local, like Spain or Portugal." Again, travelling by cheaper low-cost carriers.

We saw this in 2009 in Spain, international travel dropped 10% in 2009 during the deep GFC-driven recession. By 2010, international passengers were back at 2008 levels, as people want to travel. They simply substitute a cheaper destination, trade down the holiday to a cheaper destination. Where we are now, we think that'll probably be more mooted as well. In a recession, impact would likely be more mooted ascurrently, demand is far outstrip supply. Prior to COVID, we were growing at 4-5% per annum, underlying traffic demand globally. Even if we adjust for structural changes in the market, including business travel, even if we are being really conservative, we're 10% behind where we should be in traffic terms. If we get a recession, ticket prices will probably come off. Will there be a reaction initially? Probably there will be one, but I doubt it will be as big as what we saw during the GFC.

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