Airports

What the Productivity Commission missed

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On 22 October the Government released the Productivity Commission's final report on airports.

The Productivity Commission draft report on airports had said their investigation showed airport profits on the high side but were not high enough to warrant concern that they were abusing their monopoly power. Note that this preliminary conclusion was based not on an inspection of their financial reports but on questions put to the airports seeking profit and asset data on certain of their businesses such as those aeronautical operations.

The final report comes to the same general conclusions when it says for example

> On balance, most indicators of operational efficiency (including costs and service quality), aeronautical revenue and charges, and profitability are within reasonable bounds (p 2)

Further

> Overall, the evidence does not suggest that the monitored airports have systematically exercised their market power in aeronautical services to the detriment of the community. Some financial indicators could be consistent with the exercise of market power, when taken in isolation. In particular, the high international charges at Sydney and Brisbane airports, Sydney Airport's profitability, and the high operating costs at Perth Airport show that there is reason to remain vigilant (p 20).

These comments do not sit all that comfortably together. We observed that neither the draft or final report quotes financial data from annual reports of the various companies concerned. The four main airports; Sydney, Melbourne, Brisbane and Perth are all owned by companies that are virtually pure-plays in the airport industry; they have very few assets or operations other than their core airport operations. The only exception is Melbourne which is owned by *Australia Pacific Airports Corporation* which also operates the Launceston Airport.

In this brief we report on what those annual reports tell us about airport profitability.

Sydney airport

Sydney airport made a pre-tax profit of $665.3 million in 2018. Say it quickly and it does not sound like that much. Sydney airport is not structured like an ordinary company but is structured as a 'stapled security'. This 'stapled security' includes both a share in a trust and a share in a company for every security issued. The shareholder cannot disentangle them.

As the financial figures are presented in its financial report we calculate Sydney airport made a return on equity of 35.5 per cent. That is quite high but it gets worse. We summarise some interesting financial data in Table 1.

Table 1: Sydney Airport

	$m
Pre-tax profit	665.3
Assets	14,979.1
Liabilities	13,103.8
Equity	1,875.3
Intangibles	7,315.7

Source: Sydney Airport (2019) *Annual Report 2018*.

From Table 1 we can see that Sydney Airport is highly geared with total liabilities (excluding equity) at 87.5 per cent of assets.

Roughly half the assets are bogus or at least controversial with intangible assets of $7,315.7 million or 48.8 per cent of assets. The auditors have drawn attention to the valuation of the intangible assets. This is a way of saying they do not necessarily disagree the valuations with but others might question the underlying assumptions and might want to make up their own minds. A particular concern is an item in Sydney Airports accounts called 'Airport operator licence' worth $4,864.1 million. This seems to be no more than an estimate of the capitalised value of the future monopoly profit expected to be generated by the airport. There is a similar imputed valuation for the 'leasehold land' at $1,768.0 million. Finally, there is goodwill of $682.1 million. Goodwill is explained below but for now note that it represents the difference between what Sydney Airport paid for some assets and the book value of those assets.

> **Goodwill** arises when a company buys an asset such as another company, for something above the book value of the latter. The acquiring company may be willing to do that if the earnings potential of the purchased company is higher than its book value may suggest. In this case the goodwill arose through the privatisation of Sydney Airport with the buyer paying more than the intrinsic value of the property itself. Without the device of goodwill a company acquiring another at above the book value of the latter would have to write off the difference by declaring the difference as a loss in its operating statement.
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> The problem with intangible assets is that if, for example, a government were to control Sydney Airport's monopoly by capping its prices or profit, those intangibles could no longer be justified. An intangible asset valuation is not normally something that can be realised if a company gets into trouble. Moreover, imagine another company with the same net equity but no intangible assets. The present treatment of intangibles suggests they are somehow equal but clearly a company with a similar value of tangible assets should be treated as more solid than one with the intangible assets.

To return to the main argument, if we deduct intangibles then the net tangible equity in Sydney Airport is fairly large and negative. Put differently, the liabilities of Sydney Airport and much greater than the assets actually required to operate an airport. Meanwhile pre-tax profit was $665.3 million but the annual report reveals distributions to shareholders was $1,059.6 million. So effectively Sydney Airport was borrowing to pay shareholders. Aggressive management associated with some infrastructure funds that operate stapled securities has been compared with Ponzi schemes (see Davis 2017). Sydney airport revenues are sufficient to cover finance costs and generate huge profits for equity holders. But even those are supplemented by further borrowing which, in part, is used to pay for the capital distributions to shareholders.

Incidentally, there are 2,257,079,385 stapled securities in Sydney Airport with a market value of $18.1 billion. That market valuation is very high compared with its assets giving a price to book value of 225 and a price earnings ratio of 45.

Sydney airport profitability

We have already mentioned that on the face of it Sydney Airport is very profitable with pre-tax profit of $665.3 million or 35.5 per cent return on equity. However, even that understates its profitability. The use of items like Airport operator licence and leasehold land in the asset base is a way of capitalising future monopoly profits with the effect of making the return on assets look lower than they should be. This is shown in the numerical example.

Numerical example

Suppose you have a company with net assets of $1,000 million and profit of $100 million pa. the return on equity is a healthy but relatively modest 10 per cent.

Now take another company with net assets of $1,000 million and profit of $200 million – a return on equity of 20 per cent. However, what this company decides to do is declare that the profit is unusually high which it attributes to the value of the assets it has managed to control (Airport operator licence and leasehold land) even though these do not necessarily have intrinsic value and could not be transferred to another player. It therefore declares that there is intrinsic value in its assets. To put a value on the assets it discounts the unusually-high future profit at 10 per cent which is $1,000 million which it declares is the value of the assets. Now it apparently has an asset base of $2,000 million and so the return on equity appears to fall to a more modest 10 per cent.

This is a simplified example of the type of thing Sydney Airport has done.

As we hypothetically reduce the net equity in a company by ignoring intangible assets like goodwill and others so the estimated rate of return will increase. Hence if we exclude goodwill in Sydney Airport assets then the rate of return on equity would increase to 55.8 per cent. However, if we deduct all the intangible assets from Sydney Airport's asset base we end up with negative equity and the traditional calculation of return on equity makes no sense. We just note that Sydney Airport is so profitable that it can make a very large profit despite carrying substantially more debt than the value of its tangible assets.

By contrast to the assessment here the PC says

> Sydney Airport has relatively high returns, but this is less concerning in the context of land and regulatory constraints that have limited the growth of its asset base. Further, returns should be assessed over a reasonably long period of time. On that basis Sydney Airport's returns are not indicative of the systematic exercise of market power (p 147).

That seems a remarkable conclusion.

Melbourne Airport

Melbourne Airport is on the books of Australia Pacific Airports Corporation (APAC) which owns that and the Launceston Airport. Our comments here should be read as including the results of the much smaller Launceston Airport. The essential financial data appears in Table 2.

Table 2: Melbourne (and Launceston) Airport

	$m
Pre-tax profit	438.4
Assets	5,518.9
Liabilities	4,446.9
Equity	1,072.0
Intangibles	823.0

Source: APAC (2018) *Annual Report 2017-18*.

From Table 2 we can calculate that Melbourne Airport was very profitable with a pre-tax profit of $438.4 million which represented a return on equity of 40.9 per cent. However, included in the asset base is $671.9 million being the value of intangible assets which is wholly made up of goodwill. Without those the net equity falls to $400.1 and the return on tangible assets increases to a very high 110.4 per cent. Clearly Melbourne Airport is also very profitable. Each year Melbourne Airport receives pre-tax income greater than the value of the tangible assets it employs to operate the airport. Yet the Productivity Commission says:

> Melbourne Airport has relatively low costs and, on balance, good service quality compared with overseas airports but declining on-time performance. Its aeronautical charges are in line with overseas airports and its returns on aeronautical assets are not excessive (p 147).

Melbourne Airport's financial data suggests the airport is the epitome of excessive returns.

Brisbane Airport

Using the same format we present the essential financial magnitudes for the Brisbane Airport in Table 3.

Table 3: Brisbane Airport

	$m
Pre-tax profit	328.9
Assets	5,909.7
Liabilities	4,360.9
Equity	1,548.8
Intangibles	823.0

Source: Brisbane Airport Corporation (2018) *Annual Report 2018*.

The Brisbane Airport is also profitable with pre-tax profit of $328.9 million or a 21.2 per cent return on equity. However, if intangibles are excluded net tangible assets are $725.8 million which then implies a pre-tax rate of return on tangible assets of 45.3 per cent. This seems a very high rate of return albeit not quite as high as achieved by the bigger airports.

> Brisbane Airport has invested heavily in increasing international capacity. It has good service quality, low costs and low returns compared with the other monitored airports (p 147).

Perth

Table 4 follows the same format as for the other airports in the presentation of the financial data from Perth Airport.

Table 4: Perth Airport

	$m
Pre-tax profit	112.6
Assets	3,404.3
Liabilities	2,757.0
Equity	647.3
Intangibles	455.3

Source: Perth Airport Pty Ltd (2018) *Annual Report 2018*.

Perth Airport is also profitable. Pre-tax profit is $112.6 million which is a 17.4 per cent pre-tax return on equity. Eliminating intangibles and the return on equity increases to 58.6 per cent. While less than the Sydney and Melbourne airports examined here the profitability of Perth Airport remains high. The Productivity Commission again sees things differently and expressed their views in the following terms:

> Perth Airport invested in terminal expansions during the resources boom. Although these expansions were supported by airlines at the time, there is now excess capacity, which has led to high operating costs and falling returns (p 147).

General Comments

Any examination of the books of the airports examined here is going to show high returns to their investments. That is especially the case when intangibles are excluded as has been done in this brief. Sometimes companies report such things as intellectual property among their intangible assets. However, that is not the case here and invariably the intangibles we find are, in one way or another, the capitalisation of monopoly profits. 'Goodwill' for example arises when a company pays more for a business than its intrinsic or book value and, it usually only does that when the profitability in a business is greater than would normally be generated by assets of equivalent value.

The high return at Sydney Airport in particular is not admitted by the PC but just in case the reader does not believe them they add that '[w]hen capacity is constrained at an airport, it may be efficient to set aeronautical charges above the cost of existing infrastructure to manage congestion'. This of course is exactly what it means for a monopoly to exploit its power and make an income well above its average cost of production. There may well be an argument for congestion charges but not for a private company to collect them. This seems to be a contrived argument designed to justify Sydney Airport's high profit. However, it amounts to saying 'yes, companies with monopoly power will rip us off'.

References

Davis K (2017) ‘The case against stapled securities’, 4 August.