Indian Aviation

Caveat Emptor

- SpiceJet, a leading Indian Low Cost Carrier (LCC), has confirmed that a group of high quality investors is willing to inject up to US$100m into the company. Notwithstanding a recent push by the Government for rational behaviour within the industry, we see this latest news as delaying any near term sector rationalisation. Put another way, we feel that all major Indian airlines have raised sufficient cash to stay in the game arguably until the end of 2007. In our view, airfares are only likely to return to economic levels once weaker players exit the industry.

- We do not rate SpiceJet, but the company has taken a conservative approach to capacity expansion and containing financial losses. That said, Spicejet has started receiving up to 20 B737s, which raises the risk profile of the company in the face of excessive fare discounting and high oil prices. The investment arm of the Tata Group is expected to take a 7.5% stake in SpiceJet. We feel it is too premature to view Tata's potential investment as an endorsement of imminent industry consolidation, despite the group's deep knowledge of the industry.

- We have Underweight ratings on Jet Airways and Deccan Aviation. For Jet Airways, our June-07 price target of Rs550 is based on a 1.3x forward price-to-book value and 6.5x 2007E EV/EBITDA. For Deccan, our December 2007 price target of Rs50 is based on 11x FY07E EV/EBDRIT, in line with regional LCC peers and equal to the now-monetized value of their order book. The key risk to these price targets comes from faster-than-expected industry rationalization and fare increases.

Table 1: Indian Aviation - Key capacity data as at January and November 2006

	Jan-06	Nov-06	Pct Chg
Aircraft in operation	240	284	18%
Aircraft on order	400	397	-1%
Total future fleet	640	681	6%
Total aircraft seats in situ	39,841	44,502	12%
Economy seats in situ	24,444	27,827	14%
Total future seats	107,546	110,614	3%

Source: Company reports.

India
Airlines

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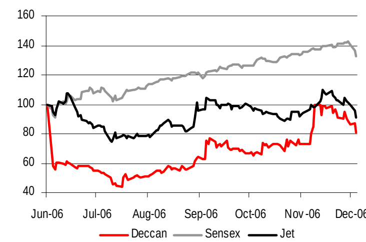
Figure 1: Share price chart



Source: Datastream.

Deccan: Performance & Market data

	1M	3M	IPO
Absolute (%)	10.6	28.1	-19.4
Relative (%)	12.7	16.6	-51.9
52-Wk Range (Rs)			148-64.65
Mkt Cap. (Rs MM)			12,643
Mkt Cap. (US$ MM)			283
Shares O/S (MM)			98.2
Free float (%)			50
Avg. Daily Volume			1.1MM
Liquidity (Rs MM)			143
Exchange rate (US$1)			Rs44.7
Index			12,995
Year-end			June

Source: Datastream, Bloomberg.

Jet Airways: Performance & Market data

	1M	3M	12M
Absolute (%)	-3.3	-5.2	-52.7
Relative (%)	-1.1	-17.7	-95.0
52-Wk Range (Rs)			1,268-491.8
Mkt Cap. (Rs MM)			54,416
Mkt Cap. (US$ MM)			1,218
Shares O/S (MM)			86.3
Free float (%)			100
Avg. Daily Volume			0.2MM
Liquidity (Rs MM)			133.1
Exchange rate (US$1)			Rs44.7
Year-end			March

Source: Datastream, Bloomberg.

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See page 5 for analyst certification and important disclosures, including investment banking relationships.
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The Tata group have a deep knowledge of Indian aviation, so we will watch their movements with some interest

The Tata Group established Air India in 1932 and ran the business until the Government nationalized the company in the early 1950s. The Tata family has a very deep knowledge of Indian aviation. In the early 1990s, the Tata group was thwarted in an attempt to establish an airline joint venture with Singapore Airlines. In 1997, the Tatas were blocked by the Government to start a wholly owned airline business.

SpiceJet has pursued a much lower risk profile than many competitors

It is, therefore, of quite some interest that the Tata Group are now investing in SpiceJet. In some regards, this is a confirmation that SpiceJet has built a reasonable presence in the Indian domestic market. The company has established this on relatively sound financial principles, in particular growing slower than many other new start-ups and containing its operating losses. But SpiceJet has just begun to take delivery of the first batch of 10 new B737s which it ordered in 2005. This extra capacity should increase the risk profile of the business ahead of any further liberalisation or policy initiatives by the Government.

India has defied precedents where rationalisation occurred after 9 months of brutal pricing

We have been negative on the Indian sector for some time on the grounds that it was overcrowded with new entrants, who were all trying to buy market share. We have been waiting for industry rationalisation for over 2 years now – that is, the Indian domestic market is in its 3rd year of brutal discounting, which is much more than the the 8 – 9 months that we saw in Australia and Singapore before weaker operators exited the market. Over these 3 years, the industry has been battered by an inability to pass on the impact of high oil prices – not to mention the added impact of India's onerous fuel taxes.

Indian carrier have benefited from inflated asset prices to unlock cash reserves and to fund further losses

The Indian sector has staved off financial disaster with nearly all airlines unlocking cash from inflated global aircraft prices or equity injections, such as announced by SpiceJet. We believe that the sector is getting towards the end of the line in this regard. To some extent, the raised concern from India's Aviation Minister confirms that the industry is reaching pain tolerance levels. Still, we fail to see which of the major players would quit the game right now.

Indian airlines have been great laggards relative to the Sensex, but there is a reason for everything in our view

As the Indian equity market has moved higher – excluding today's sharp decline – investors have been more attracted to the airline industry given its laggard status. While we see a potential handsome reward for any airline left standing after this game of russian roulette, we do not see which player is prepared to pay the inflated PB multiples to help remove a player from the market. The failed Jet Airways bid for Air Sahara does not bode well for industry consolidation.

There will be a big price to pay for investors being premature in our view

In short, we feel that investor anticipation or desire to back an early winner in any forthcoming industry rationalization is indeed the exact reason why the opportunity is actually being pushed further and further away. We also feel that there are some large vested interests in the Indian sector which are likely to prefer slow industry rationalisation. We are not convinced that even the popular aviation Minister will be able to overcome these powerful interests.

M&A in the Australian airline space is unfortunately unrelated to the Indian sector, in our view

We feel strongly that any private equity bid for Qantas should not be considered indicative of any imminent acquisition of an airline in India. We feel that valuations in the Australian market arising from the domestic duopoly gives airlines in that market a much lower risk profile than is possible in India

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Table 2: India - Aircraft fleet for all Indian registered airlines

Existing operators		Existing	Net Changes	Total	Sponsor / Main Shareholder	Market
Air India	A300/A310	19	-15	4	Government	Int'l
	B777s	3	23	26		
	B747s	16	-5	11		
	B787s		27	27		
Air India Express	B737s	4	18	22	Government	Int'l
Air Sahara	ATR/CRJ	7		7	Subrata Roy Sahara	Domestic + Int'l
	B737s	21	10	31		
	B767s	1		1		
Alliance Air	ATR/CRJ	4		4	Government	Domestic
	B737s	11	-11	0		
Indian Airlines	B737s	11	-11	0	Government	Domestic
	A319	6	13	19		
	A320s	48	4	52		
	A321s	0	20	20		
	A300/A310	3	-3	0		
Jet Airways	ATR/CRJ	8	0	8	Listed	Domestic + Int'l
	B737s	41	16	57		
	A340s	3	-3	0		
	A330	1	9	9		
	B777s		10	10		
Air Deccan	ATR/CRJ	22	30	52	Deccan Aviation	Domestic
	A320s	14	48	62		
Kingfisher Airlines	ATR/CRJ	2	33	35	UB Group	Regional
	A319	3	0	3		
	A320s	10	30	40		
	A321s	4	0	4		
	A330	1	5	5		
	A340		5	5		
	A350		5	5		
	A380		5	5		
SpiceJet	B737s	8	12	20	Royal Airways - Listed	Domestic
GoAir	A320s	6	10	16	Wadia family	Domestic
IndiGo Airlines	A320s	5	65	70	Interglobe Enterprises / Rakesh Gangwal	Domestic
	A321s		30	30		
Total		282	380	662		

Source: Company reports.

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Table 3: Indian Airlines - Analysis of seat capacity

	Present		Future		Seats
	Seats	Mkt Share	Seats	Mkt Share	Pct Chg
Total seats					
Air India Group	12,176	27%	24,608	22%	102%
IndiGo	900	2%	17,100	15%	1800%
Jet Airways	7,322	16%	13,832	12%	89%
Air Sahara	3,432	8%	4,804	4%	40%
Air Deccan	3,840	9%	14,280	13%	272%
Kingfisher Airlines	3,070	7%	16,054	14%	423%
Indian Airlines Grp	11,362	25%	13,776	12%	21%
Spice Jet	1,440	3%	3,600	3%	150%
GoAir	960	2%	2,560	2%	167%
Total	44,502	100%	110,614	100%	149%
Total Domestic					
IndiGo	900	3%	17,100	24%	1800%
Air Deccan	3,840	14%	14,280	20%	272%
Jet Airways	5,391	19%	7,295	10%	35%
Air Sahara	3,432	12%	4,804	7%	40%
Indian Airlines Grp	9,044	32%	11,265	16%	25%
Kingfisher Airlines	2,820	10%	9,804	14%	248%
Spice Jet	1,440	5%	3,600	5%	150%
GoAir	960	3%	2,560	4%	167%
Total	27,827	100%	70,709	100%	149%
Business class seats					
Indian Airlines Grp	960	40%	1,400	36%	46%
Jet Airways	1,040	43%	1,300	33%	25%
Kingfisher Airlines	150	6%	940	24%	527%
Air Sahara	252	10%	252	6%	0%
Total	2,402	50%	3,892	42%	62%
Economy class seats					
IndiGo	900	4%	17,100	25%	1800%
Air Deccan	3,840	15%	14,280	21%	272%
Kingfisher Airlines	2,670	10%	8,864	13%	232%
Jet Airways	4,351	17%	5,995	9%	38%
Air Sahara	3,180	12%	4,552	7%	43%
Indian Airlines Grp	8,084	32%	9,865	15%	22%
Spice Jet	1,440	6%	3,600	5%	150%
GoAir	960	4%	2,560	4%	167%
Total	25,425	100%	66,817	100%	163%

Source: Company reports.