kotak Institutional Equities

Aviation

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Good start – further reforms are needed. Government has allowed foreign carriers to take up to 49% stake in Indian carriers. While earlier also the FDI limit was 49%, investment by foreign carriers was not allowed. Even as the move is incrementally positive, we believe it is unlikely to solve problems of debt-laden Indian carriers (and Indian banks). SpiceJet could be a beneficiary as it is an attractive asset for a carrier given its ~18% share of the domestic market and an unimpaired balance sheet. More reforms are needed to rationalize taxes (on fuel) so as to make the sector operationally viable; in that case capital would have automatically come (even without the current regulation).

Government opens doors for foreign airlines – good start; more needs to be done

Government has allowed foreign carriers to take up to 49% stake in Indian carriers. While earlier also the FDI limit was 49%, investment by foreign carriers was not allowed. Even as the move is incrementally positive, we believe it is unlikely to solve problems of debt-laden carriers and the banks which have lent to these companies. In our view, investments by foreign carriers will go into airlines like SpiceJet which have relatively unimpaired balance sheets.

SpiceJet would be the biggest beneficiary

In our view, SpiceJet (or Go Air from unlisted space) would be the biggest beneficiary of the current move of the Government. The company could provide an attractive entry point for a foreign airline given (1) it has ~18% share of the domestic market and (2) relatively unimpaired balance sheet. Gross debt as of FY2012 was Rs10 bn; working capital debt (representative of cash losses) is only ~Rs4 bn; rest of the debt is on account of aircraft (Q-400s) acquisitions. Jet Airways won't gain as it is already in violation of FDI norms as the promoter (with 80% stake) is classified as an overseas corporate body (and hence comes under FDI). In our view, Kingfisher (because of large liabilities) and Indigo (foreign ownership is already 48% as per media articles) also won't gain.

More reforms needed – particularly to rationalize taxes on fuel

Government needs to introduce further reforms to rationalize taxes on fuel which make ATF 40% higher (versus international prices) on an average for Indian carriers. State sales tax on ATF (~25% on an average) is the largest component and needs to be rationalized. Either individual states need to be convinced to reduce taxes or ATF could be moved to 'declared goods' category so as to attract uniform 4% sales tax across the country. In our view, if implemented, this could be a game changer for the sector. Even as most of the gains on lower fuel (if implemented) costs would be passed on to the market, lower fares will give a major boost to passenger numbers.

More enthused by the return of pricing discipline in the sector

We are more enthused by the return of pricing discipline in the domestic market. As per our index which measures average one-week forward fares across eight metro routes, yields in 2QFY13 are up ~3.6% qoq. Recent increase in fuel surcharge (Rs150 for routes less than 1,000 km and Rs250 for routes greater than 1,000 km) has been fully passed on to the market. With domestic jet fuel prices at an all-time high and declining passenger numbers, there are no immediate benefits; nevertheless, pricing discipline means that profits can scale up quickly in the event of correction in oil prices or in case Rupee appreciates. We have a BUY rating on SpiceJet. High leverage makes us cautious on Jet Airways, hence SELL.

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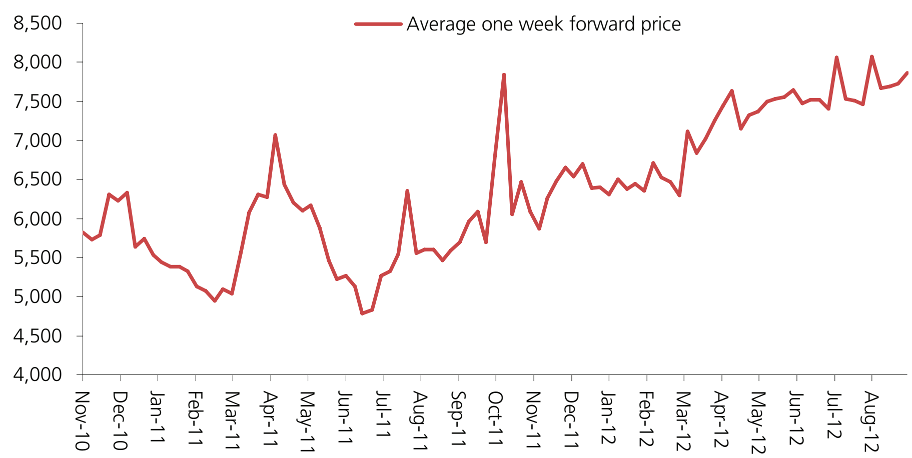
FDI in aviation – finer points

Until now foreign airlines were allowed to participate in the equity of companies operating cargo airlines, helicopter and seaplane services, but not in the equity of an air transport undertaking operating scheduled and non-scheduled air transport services. The Government has now permitted foreign airlines to invest in Indian airlines (scheduled carriers) up to the limit of 49 percent of their paid up capital. The 49 percent limit will subsume FDI and FII investments. The investments so made would need to comply with the relevant regulations of SEBI. Such an investment would be subject to these conditions:

A Scheduled Operator's Permit can be granted only to a company

- That is registered and has its principal place of business within India.
- The Chairman and at least two-thirds of the Directors are citizens of India.
- Substantial ownership and effective control is vested in Indian nationals.
- All foreign nationals likely to be associated with Indian Scheduled and Non-Scheduled air transport services, as a result of such investment, shall be cleared from security viewpoint before deployment.
- All technical equipment that might be imported into India, as a result of such investment, shall require clearance from the relevant authority in the Ministry of Civil Aviation.

Pricing discipline is back – yields are up in a seasonally weaker quarter
Kotak's proprietary index of one-week forward fares over eight routes (Rs)



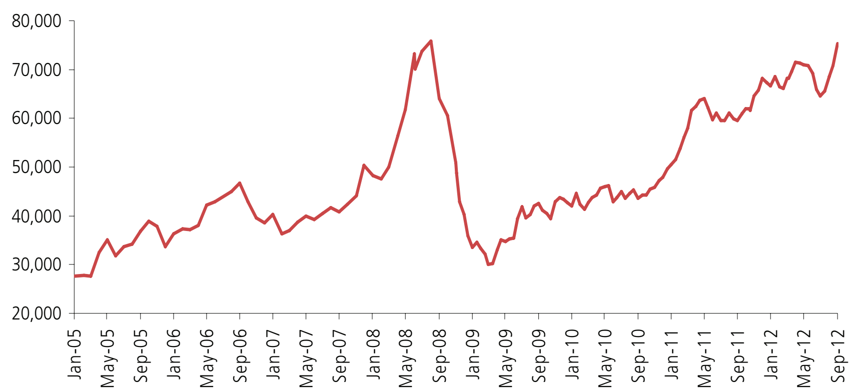
Source: Kotak Institutional Equities

Yields in 2QFY13 are up 3.6% qoq
Quarterly trend in Kotak's proprietary index (indicative of fares) in India (Rs)

Quarter	Average one-week forward price
4QFY11	5,332
1QFY12	5,969
2QFY12	5,506
3QFY12	6,426
4QFY12	6,519
1QFY13	7,417
2QFY13	7,683
% change over 1QFY13	**3.6%**

Source: Kotak Institutional Equities

Jet fuel prices have been increasing of late
Average Jet fuel price in four metros (Rs per KL)



Source: Kotak Institutional Equities

Passenger numbers have declined sharply yoy in July 2012
Monthly trend in passenger numbers in the domestic market (mn)

					Growth (% yoy)			
	CY2009	**CY2010**	**CY2011**	**CY2012**	**CY2009**	**CY2010**	**CY2011**	**CY2012**
January	3.33	4.09	4.9	5.3	(14.7)	22.8%	20.7%	8.0%
February	3.34	3.86	4.6	5.1	(6.9)	15.6%	18.5%	10.6%
March	3.16	3.9	4.8	4.9	(14.8)	23.4%	23.1%	1.5%
April	3.32	4.19	4.7	5.1	(14.8)	26.2%	11.5%	9.0%
May	3.93	4.79	5.5	5.4	(4.5)	21.9%	14.7%	-0.9%
June	3.69	4.5	5.3	5.1	5.4	22.0%	18.0%	-3.8%
July	3.6	4.08	5.0	4.5	23.0	13.3%	23.5%	-9.9%
August	3.63	3.99	4.8		26.0	9.9%	19.9%	
September	3.51	3.91	4.6		24.8	11.4%	18.1%	
October	3.97	4.62	5.4		29.9	16.4%	16.9%	
November	3.9	4.88	5.4		26.6	25.0%	11.1%	
December	4.49	5.21	5.6		35.0	16.1%	8.0%	
Total	**43.9**	**52.0**	**60.7**		**—**	**18.6%**	**16.6%**	**1.8%**

Source: DGCA, Kotak Institutional Equities

Valuations

Valuation summary for SpiceJet, March fiscal year-ends (Rs mn)

EBITDAR	10,863
EV EBITDAR multiple (X)	8.5
EV	92,336
Aircraft rentals capitalised at 7X	(61,142)
Cash	2,654
Gross Debt (a)	(11,730)
Implied equity value	22,118
Value per share (Rs)	46

Note: (a) Debt has been taken only for 12 Q-400 aircrafts.

Source: Kotak Institutional Equities

We value Jet Airways at Rs312

Valuation table for Jet Airways, one-year forward basis, March fiscal year-ends (Rs mn)

EBITDAR	32,575
EV/EBITDAR multiple (X)	7.8
EV	252,454
Aircraft lease rentals capitalised at 7X	(103,040)
Net Debt	(122,447)
Value of the equity	26,966
Value per share	312

Source: Kotak Institutional Equities

Summary financials: SpiceJet
Profit model, cash flow statement and balance sheet for SpiceJet, consolidated, March fiscal year-ends (Rs mn)

	2007	2008	2009	2010	2011	2012E	2013E	2014E
Profit model								
Net sales	**6,438**	**12,950**	**16,894**	**21,811**	**28,795**	**39,980**	**61,743**	**74,818**
EBITDAR	**(241)**	**6**	**(602)**	**4,297**	**4,957**	**835**	**9,310**	**12,416**
EBITDAR margin %	(4)	—	(4)	20	17	2	15	17
Aircraft rentals	(1,367)	(2,526)	(3,589)	(3,983)	(4,285)	(6,019)	(8,015)	(9,454)
EBITDA	**(1,608)**	**(2,520)**	**(4,192)**	**314**	**672**	**(5,184)**	**1,295**	**2,962**
EBITDA margin %	(25)	(19)	(25)	1	2	(13)	2	4
Depreciation & amortization	(58)	(78)	(73)	(76)	(89)	(310)	(643)	(946)
Net finance cost	(42)	(137)	(160)	(114)	(112)	(523)	(875)	(838)
Other income	1,045	1,436	1,241	610	811	211	353	379
Profit before tax	**(664)**	**(1,300)**	**(3,183)**	**734**	**1,282**	**(5,806)**	**129**	**1,557**
Exceptional items & prior period exp	(34)	(11)	(309)	(56)	0	(253)	—	—
Reported PBT	**(697)**	**(1,311)**	**(3,492)**	**678**	**1,282**	**(6,059)**	**129**	**1,557**
Taxes	(10)	(24)	33	(64)	(256)		(43)	(514)
Reported net profit	**(707)**	**(1,335)**	**(3,492)**	**615**	**1,025**	**(6,059)**	**87**	**1,043**
EPS (Rs)	(3)	(6)	(14)	3	3	(14)	0	2
Balance sheet								
Total shareholder equity	1,846	280	(4,295)	(3,422)	3,211	(1,587)	(1,501)	(458)
Total debt	4,322	5,401	4,888	4,383	858	9,640	12,290	9,440
Current liability and provisions	6,872	7,932	6,914	8,929	7,027	11,621	13,668	16,533
Total sources of funds	**13,039**	**13,613**	**7,508**	**9,891**	**11,096**	**19,674**	**24,457**	**25,516**
Cash and cash equivalents	3,510	6,081	3,080	4,506	1,922	2,328	2,442	2,866
Total current assets	2,101	1,892	1,900	1,464	2,192	8,841	7,643	8,874
Net fixed assets inc. CWIP	7,427	5,640	2,528	3,919	6,982	8,505	14,372	13,776
Total uses of funds	**13,039**	**13,613**	**7,508**	**9,891**	**11,096**	**19,674**	**24,457**	**25,516**

Source: Company, Kotak Institutional Equities

Summary financials: Jet Airways

Profit model, cash flow statement and balance sheet for Jet Airways, consolidated, March fiscal year-ends

	2008	2009	2010	2011	2012E	2013E	2014E
Profit model							
Income	**102,456**	**130,779**	**118,764**	**145,226**	**167,032**	**198,313**	**215,348**
Operating expenses							
Employee remuneration and benefits	(13,888)	(15,843)	(13,770)	(15,105)	(17,746)	(18,853)	(20,165)
Aircraft fuel expenses	(40,700)	(58,536)	(37,584)	(51,673)	(77,763)	(84,331)	(88,505)
Selling and distribution expenses	(11,137)	(12,040)	(10,977)	(13,714)	(14,962)	(18,109)	(19,700)
Other operating expenses	(30,144)	(42,519)	(34,219)	(37,589)	(44,776)	(47,375)	(51,474)
Operating expenses (exc rentals)	(95,870)	(128,937)	(96,550)	(118,082)	(155,247)	(168,667)	(179,844)
EBITDAR	**6,586**	**1,842**	**22,214**	**27,144**	**11,785**	**29,646**	**35,504**
Aircraft lease rentals	(8,216)	(10,429)	(11,591)	(11,452)	(12,050)	(14,709)	(14,731)
EBITDA	**(1,630)**	**(8,587)**	**10,623**	**15,692**	**(265)**	**14,937**	**20,773**
Depreciation	(8,018)	(9,021)	(9,691)	(9,186)	(9,446)	(9,774)	(9,804)
Interest and finance charges	(5,225)	(8,023)	(10,474)	(10,858)	(10,058)	(9,489)	(9,212)
Non-operating revenue	7,452	3,710	3,617	2,044	3,638	633	565
PBT before exceptional items	**(7,421)**	**(21,921)**	**(5,924)**	**(2,308)**	**(16,131)**	**(3,693)**	**2,322**
Exceptional items	(695)	11,651	1,826	1,824	1,732		
Reported PBT	**(8,115)**	**(10,270)**	**(4,098)**	**(484)**	**(14,399)**	**(3,693)**	**2,322**
Taxes	1,577	656	(104)	(374)	198	739	(464)
PAT	**(6,539)**	**(9,614)**	**(4,202)**	**(858)**	**(14,201)**	**(2,955)**	**1,858**
EPS							
Primary	(8)	(11)	(5)	(1)	(16)	(3)	2
Diluted	(8)	(11)	(5)	(1)	(16)	(3)	2
Margins %							
EBITDAR	6	1	19	19	7	15	16
EBITDA	(2)	(7)	9	11	(0)	8	10
Balance sheet							
Equity	863	863	863	863	863	863	863
Reserves and surplus	41,697	33,321	32,847	32,374	31,921	31,921	31,921
P&L balance	(1,052)	(12,213)	(16,415)	(17,273)	(31,475)	(34,429)	(32,572)
Net worth	**41,508**	**21,971**	**17,296**	**15,964**	**1,309**	**(1,646)**	**212**
Secured loans	17,530	50,364	43,066	46,605	110,244	110,244	110,244
Unsecured loans	104,523	115,976	99,738	90,199	22,572	18,572	12,572
Loan funds	**122,053**	**166,340**	**142,804**	**136,804**	**132,816**	**128,816**	**122,816**
Deferred payment liability	4,125	2,750	1,375	—	—	—	—
Deferred tax liability	1,602	—	—	336	0	0	0
Current liabilties and provisions	45,230	41,125	45,199	50,843	72,776	72,509	78,203
Total sources of funds	**214,519**	**232,186**	**206,674**	**203,947**	**206,901**	**199,680**	**201,231**
Assets							
Gross block	166,687	188,450	180,110	180,048	190,922	191,522	192,122
Less: depreciation	25,560	25,502	35,558	43,676	52,934	62,708	72,512
Net block	141,127	162,948	144,552	136,372	137,989	128,815	119,611
Capital work in progress	13,026	6,571	3,335	3,828	21	21	21
Fixed assets	**154,153**	**169,519**	**147,887**	**140,200**	**138,009**	**128,836**	**119,631**
Goodwill on consolidation	18,724	18,724	18,724	18,724	18,724	18,724	18,724
Investments	104	1,000	1,000	801	21	21	21
Inventories	6,044	6,963	6,975	8,252	8,584	11,410	12,390
Sundry debtors	13,990	8,075	8,765	10,254	13,577	14,670	15,930
Cash and bank balances	9,584	14,662	8,264	6,772	5,743	161	6,576
Other current assets				0	1,409	1,409	1,409
Loans and advances	11,921	13,243	15,059	18,944	20,834	24,450	26,550
Current assets	**41,538**	**42,943**	**39,063**	**44,223**	**50,147**	**52,100**	**62,855**
Total uses of funds	**214,519**	**232,186**	**206,674**	**203,947**	**206,901**	**199,680**	**201,231**
Free cash flow							
Operating cash flow excl. working capital	(6,846)	(14,803)	1,865	5,465	(7,101)	6,186	11,096
Working capital changes	4,919	1,728	4,638	(55)	17,780	(7,801)	1,353
Capital expenditure	(58,114)	354	(615)	(1,253)	1,637	(600)	(600)
Free cash flow	**(60,041)**	**(12,720)**	**5,889**	**4,158**	**12,315**	**(2,214)**	**11,850**

Source: Company, Kotak Institutional Equities