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India Research

Deccan Aviation

Avoid

Large Cap – Aviation

Surbhi Chawla

Tel : 022 – 4000 3600 Ext: 124

e-mail : surbhi.chawla@angeltrade.com

Issue Open: 18 May 2006

Issue Close: 23 May 2006

Issue Details

Pre-Issue Equity Share Capital :
Rs 73.64cr

Issue size:

Fresh issue:
24,546,000 equity shares of Rs 10 each

Post issue Equity Share Capital **:**
Rs 98.18cr

Price Band:
Rs 150-175

Post Issue Shareholding Pattern	
Promoters Group	75%
MF/Banks/Indian FIs/Public & Others	25%

IPO Note

Objects of the Issue

Particulars	**Amount (Rs cr)**
Setting up a training centre	65.67
Setting up a hanger facility for basic and medium-level maintenance checks at Chennai	40.02
Setting up infrastructure at airports	17.08
Market development initiatives	45.22
Debt repayment	132.75
Other expenses	67.26
Total	**368 - 429**

Air Deccan proposes to utilize the issue proceeds to repay debt leading to reduction in interest cost. It also intends to construct its own hanger space which would be operational by December 2007. This would result in lower maintenance expenses and would ensure timely availability of hanger space. The company also proposes to develop a training centre at Bangalore, which will include aircraft simulators for both ATRs and Airbus. On the anvil are plans to set up 50 ticketing offices in the major Indian cities by December 2006 as part of its growth strategy for market development and promotional activities.

Means of funding

The entire financing requirements would be met by the issue proceeds. The company proposes to raise Rs 368.19cr at the lower end of the price band and Rs 429.55cr at the higher end. This IPO would lead to an equity dilution of 25% for the company.

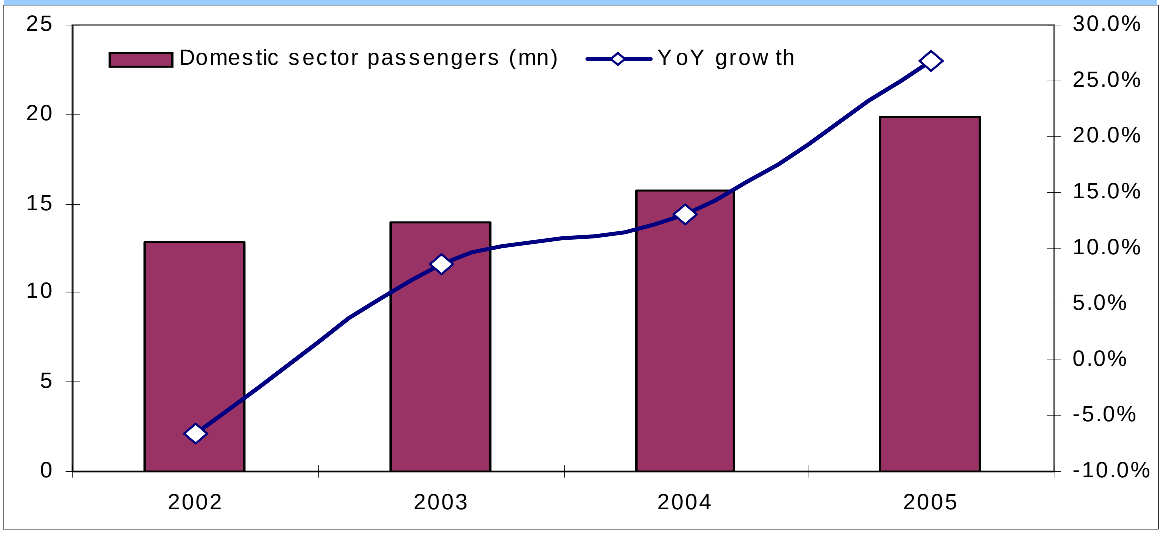
Background

Promoter Capt. Gopinath made his foray into aviation sector in 1996 with operations in India as a private helicopter and airplane chartering service. Capt. Gopinath then pioneered the concept of a no-frills, low-cost, scheduled commercial passenger airline in India with a single ATR turboprop aircraft in August 2003 flying a single route between Bangalore and Hubli. Since then, the company has aggressively increased its fleet size to 29 aircraft which is further proposed to be increased to 19 by 2007 and to 96 aircraft by 2013.

Air Deccan serves 56 domestic destinations as against just 43 destinations catered to by Indian Airlines and 44 by Jet Airways. Air Deccan has exclusivity in operations to 10-15 destinations. The company's market share as on February 2006 stood at 14.2% having increased from 11.6% in October 2005, a jump of 2.6% in just 4 months on the back of aggressive expansion.

Industry: On growth path
Rapidly growing Indian economy, rising consumerism and disposable income, growth in tourism and reduced air fares are giving a boost to the domestic aviation industry. Growth in domestic passenger has also been on a rise from 12.8mn in FY2002 to 19.9mn in FY2005 translating into a CAGR growth of 15.8% for the FY2002-05 period.

Exhibit 1: Growing Domestic sector



Source: DGCA, CMIE

LCC airlines revolutionizing Indian Aviation sector
As was witnessed in the US and Europe, low cost carriers (LCC) had created a revolution in the aviation sector in those countries. These airlines offer travel at lower cost by providing no-frills service. In India, Air Deccan started off as the country's first LCC in August 2003 followed by Spicejet, Kingfisher, Paramount and GoAir with news about more airlines following suit. The LCC segment in India is growing at almost 41% annually having captured around 1/3rd of total market share. Of the passengers traveling by LCC, nearly 40% are first time fliers. Seeking to take advantage of the growth in disposable income in India and the increasing need for geographic connectivity, increasingly carriers in India have sought to adopt the LCC model.

Air Deccan: Business Model
Air Deccan's business model entails high volumes at low fares. The airline stimulates demand by offering low fares which attracts leisure travelers, small business & corporate customers, Indian middle-class and cost-conscious segment of more well off classes all alike. Also, volume is driven by growing new markets for air travel in India by serving new destinations, increasing flight frequencies on existing routes, connecting new city pairs among destinations and by serving major urban cities with cost-effective fares.

The Airline also endeavours to reduce its cost of operations by outsourcing non-core business. Processes outsourced include in-flight food & drink, ticketing counters at airports, having manual rather than computerized flight check-in-system which simplifies operations and by adopting innovative distribution channels such as Internet, SMS which saves around 10-15% cost per passenger.

The company has consciously adopted 2 fleet strategy
- Airbus (A320 – 180 seater) to fly on its main or "trunk" routes connecting largest cities
- ATRs turboprop (ATR42- 48 seater, ATR72- 72seater) principally to serve regional airports which are small; to serve these small destinations is the company's adopted strategy.

Maximum utilisation of Aircraft warranted

Air Deccan has witnessed a growth of 546% in its domestic passengers flown from 152,910 in FY2004 to 987,104 in FY2005. In the eight months of FY2006, the passenger growth has already been more than 61% over FY2005. The expansion in its fleet size and its network would see more enhanced growth in the coming years. However, Air Deccan being a low-cost carrier and with expansion of services to the regional destinations on the anvil, it would find it difficult to maintain a profitable load factor. For an LCC to be profitable it would need to utilize its aircraft to maximum. The current PLF for the company is 73%. Currently, only around 40% of the routes of the company are profitable. The company is introducing new routes every year (around 60 new routes in FY2007), which would affect its load factor adversely and lower yields would be generated from these sectors.

Increasing fleet size would also result in higher cost of aircraft rentals in turn diminishing Operating Profits. EBITDAR margin, as a per cent to sales, for FY2005 is 10.2% whereas for domestic airlines like Jet Airways it is 33%, for international airline like Ryanair it is 34%.

Fluctuating Fuel (ATF) costs

The domestic aviation sector in India experiences high input costs in terms of government charges levied on fuel and airport related charges. The ATF cost was around 34% of operating cost for Air Deccan for FY2005 and 40% for eight months FY2006. ATF prices are affected by the crude oil prices which are surging at more than $ 72 a barrel. This would see the cost for ATF to increase in future affecting the profitability negatively and more so for low cost airlines.

Increasing Ancillary Revenues

The company plans to increase its ancillary revenues from 5% of total revenue in FY2005 to around 10% by FY2007. The company would do this by charging for food & drinks, selling advertising space on the interior & exterior of its aircraft, advertising on head-rest, baggage tag, etc.

Outlook and Valuation

The company is currently in expansion phase and proposes to tap the potential domestic traffic and increase its fleet size. The company would also be adding new routes which would however lower the load factor and yields. Also, the increasing un-hedged fuel costs and the infrastructure bottlenecks are some of the other challenges faced by the industry. Further, entry of new players in a short span of time and intentions of more joining the league, growth of the domestic aviation sector is expected to be hampered by shortage of enabling infrastructure such as airport facilities, parking bays, air traffic control facilities and takeoff and landing slots. Also, to capture a larger market share, the companies would have to reduce the fares.

In FY2005, Deccan Aviation incurred losses of Rs 35cr on Revenues of Rs 320cr and during the eight months period ended Nov 30 2005, it made a loss of Rs 118cr on Revenues of Rs 518cr. Overall, the company's profitability largely depends on the demand for low-cost airlines and successful implementation of its expansion plans. Nevertheless, we estimate the company to turn profitable in FY2008 post its restructuring and on-going fleet expansion. These growth prospects are however already factored in the stock price and hence the stock appears to be expensive when compared to its peers. **At the existing price band of Rs 150-175, we recommend investors to Avoid the issue.**

Financial Highlights

Y/E March (Rs cr)	FY2003	FY2004	FY2005	FY2006*
Net Sales	**23.4**	**62.9**	**305.6**	**478.3**
% chg	*0.2*	*1.7*	*3.9*	*0.6*
Total Expenditure	14.0	49.9	274.3	534.7
EBIDTAR	**9.4**	**13.1**	**31.3**	**(56.4)**
(% of Net Sales)	*0.4*	*0.2*	*0.1*	*(0.1)*
Aircraft/Engine lease rentals	5.7	10.6	45.1	80.7
EBIDTA	**3.7**	**2.4**	**(13.8)**	**(137.1)**
(% of Net Sales)	*0.2*	*0.0*	*(0.0)*	*(0.3)*
Other Income	0.1	4.4	14.7	39.9
Depreciation	0.3	1.1	3.1	4.8
Interest	1.5	3.9	10.2	11.4
Amortisation	0.8	1.0	5.7	8.3
PBT	**1.1**	**0.9**	**(18.1)**	**(121.6)**
(% of Net Sales)	*0.0*	*0.0*	*(0.1)*	*(0.3)*
Tax	0.5	0.3	(1.3)	2.2
(% of PBT)	*0.4*	*0.3*	*0.1*	*(0.0)*
PAT	**0.6**	**0.6**	**(16.8)**	**(123.9)**
% chg	*(0.4)*	*(0.0)*	*(29.1)*	*6.4*

Y/E March (Rs cr)	FY2003	FY2004	FY2005	FY2006*
SOURCES OF FUNDS				
Equity Share Capital	2.1	15.5	16.2	46.3
Reserves& Surplus	3.2	(1.4)	(28.6)	(161.7)
Shareholders Funds	5.3	14.1	(12.4)	(114.1)
Total Loans	11.2	34.9	284.5	470.7
Deferred Tax Liability	0.3	-	-	-
Total Liabilities	16.7	49.0	272.1	356.6
APPLICATION OF FUNDS				
Gross Block	11.2	27.1	55.2	309.8
Less: Acc. Depreciation	0.6	1.6	4.5	9.3
Net Block	10.5	25.5	50.7	300.5
Capital Work-in-Progress	0.1	1.2	153.1	142.9
Investments	-	-	0.4	0.4
Current Assets	13.5	48.1	176.0	190.6
Current liabilities	7.4	25.7	108.2	277.8
Net Current Assets	6.0	22.4	67.8	(87.2)
Total Assets	16.7	49.0	272.1	356.6

** 8 month ended 30th November, 2005 actuals*

Angel Broking Limited

Research Team Tel: 4000 3600 E-mail: research@angeltrade.com Website: www.angeltrade.com