Company Focus

5 March 2008 | 22 pages

Jet Airways (JET.BO)

Target price change
Estimate change

Sell: Clearer Skies, But Limited Upside – Revise Target to Rs765

- **Reiterate Sell (3M)** — Revise target price to Rs765 (from Rs716), but reiterate our Sell (3M) recommendation, given limited upside. Target price is based on 7x FY10E EV/EBITDAR (including capitalized leases). Our roll forward to FY10 from FY09 estimates is predicated on our view that FY09 will be a transition year for Jet – domestic operations will not reflect the benefits of a consolidating industry; international operations will also not reflect their inherent profitability, as routes to US markets, North Asia and the Middle East will mature in FY10E.
- **Earnings revised downward** — We forecast losses (pre-exceptional, excluding currency gains and sale and lease-back profits) of c.Rs6bn and Rs2.77bn in FY08-09E, respectively (vs. profit expectations of Rs1.2bn and Rs3.88bn in 08/09E), as we incorporate higher fuel prices and higher wage costs into our assumptions. We forecast Jet will return to profitability by FY10E – with international operations contributing meaningfully at both the revenue and EBITDAR level.
- **JetLite restructuring delayed** — We do not factor in JetLite into our current estimates, given that it remains in restructuring mode. Operational turnaround is taking longer than envisaged – turnaround is delayed into early FY09 (vs. 1HFY08) as Jet's management grapples with Air Sahara's legacy systems and strives to operationalize an inadequately maintained fleet.
- **Key risks** — Upside risks to our recommendation are a) lower fuel costs, b) faster than forecast turnaround of international routes and c) rapid rationalization of seat capacity in the domestic market.

Sell/Medium Risk	**3M**
Price (05 Mar 08)	Rs721.95
Target price	Rs765.00
from Rs716.00	
Expected share price return	6.0%
Expected dividend yield	1.1%
Expected total return	**7.1%**
Market Cap	Rs154,682M
	US$3,846M

Price Performance (RIC: JET.BO, BB: JETIN IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	2,240	25.94	-39.7	27.8	2.7	10.4	0.8
2007A	-1,414	-16.38	-163.1	nm	2.8	-6.2	0.8
2008E	-5,968	-69.13	na	-10.4	3.1	-28.0	0.8
2009E	-2,766	-25.87	62.6	nm	2.0	-9.5	0.8
2010E	4,876	45.61	276.3	15.8	1.7	11.5	1.1

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	27.8	nm	-10.4	nm	15.8
EV/EBITDA adjusted (x)	18.6	54.1	90.4	28.2	12.1
P/BV (x)	2.7	2.8	3.1	2.0	1.7
Dividend yield (%)	0.8	0.8	0.8	0.8	1.1
Per Share Data (Rs)					
EPS adjusted	25.94	-16.38	-69.13	-25.87	45.61
EPS reported	25.94	-16.38	-69.13	-25.87	45.61
BVPS	267.09	259.14	233.84	354.65	435.44
DPS	6.00	6.00	6.00	6.00	8.00
Profit & Loss (RsM)					
Net sales	56,937	70,578	85,878	124,584	143,637
Operating expenses	-51,716	-71,098	-90,512	-124,556	-133,351
EBIT	**5,221**	**-520**	**-4,634**	**29**	**10,286**
Net interest expense	-2,416	-2,402	-5,100	-4,829	-3,933
Non-operating/exceptionals	4,417	3,435	7,377	8,505	8,033
Pre-tax profit	**7,223**	**514**	**-2,356**	**3,705**	**14,385**
Tax	-2,702	-234	777	-1,222	-4,747
Extraord./Min.Int./Pref.div.	-2,281	-1,694	-4,389	-5,248	-4,763
Reported net income	**2,240**	**-1,414**	**-5,968**	**-2,766**	**4,876**
Adjusted earnings	2,240	-1,414	-5,968	-2,766	4,876
Adjusted EBITDA	9,285	3,621	2,597	8,973	19,800
Growth Rates (%)					
Sales	31.3	24.0	21.7	45.1	15.3
EBIT adjusted	-30.7	-110.0	-790.8	100.6	nm
EBITDA adjusted	-23.3	-61.0	-28.3	245.5	120.7
EPS adjusted	-39.7	-163.1	-322.0	62.6	276.3
Cash Flow (RsM)					
Operating cash flow	**2,510**	**7,279**	**4,303**	**16,643**	**23,647**
Depreciation/amortization	4,064	4,141	7,231	8,944	9,514
Net working capital	-7,333	2,755	-1,349	5,217	4,494
Investing cash flow	**-11,454**	**-27,997**	**-61,060**	**-7,650**	**-12,540**
Capital expenditure	-25,539	-29,180	-61,060	-7,650	-12,540
Acquisitions/disposals	14,085	1,183	0	0	0
Financing cash flow	**17,744**	**10,641**	**48,256**	**-10,458**	**-11,107**
Borrowings	19,308	11,607	48,862	-25,707	-10,106
Dividends paid	-591	-606	-606	-751	-1,001
Change in cash	**8,800**	**-10,076**	**-8,502**	**-1,465**	**0**
Balance Sheet (RsM)					
Total assets	**90,529**	**107,254**	**160,021**	**162,586**	**169,218**
Cash & cash equivalent	21,043	10,966	2,465	1,000	1,000
Accounts receivable	4,332	6,039	7,529	10,922	12,593
Net fixed assets	47,882	72,920	126,749	125,455	128,481
Total liabilities	**67,470**	**84,882**	**139,833**	**124,667**	**122,660**
Accounts payable	2,515	7,498	9,582	13,540	14,532
Total Debt	48,956	60,563	109,425	83,717	73,611
Shareholders' funds	**23,059**	**22,373**	**20,188**	**37,920**	**46,558**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	16.3	5.1	3.0	7.2	13.8
ROE adjusted	10.4	-6.2	-28.0	-9.5	11.5
ROIC adjusted	6.0	-1.1	-3.7	-0.9	4.2
Net debt to equity	121.1	221.7	529.8	218.1	156.0
Total debt to capital	68.0	73.0	84.4	68.8	61.3

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Investment Thesis

We reiterate our Sell (3M) recommendation on Jet Airways, highlighting the central issues below:

1 – Valuations – our target price of Rs765 (Revised up from Rs716) is based on 7x FY10E EV/EBITDAR. We reiterate our Sell (3M) recommendation, given the limited upside. We roll forward our estimates to FY10E as we believe that FY09E will be a transition year for Jet Airways – the profitability of its international operations will be fully reflected only in FY10E and the benefits of the consolidation of the domestic industry will start to meaningfully accrue only in FY10E. We believe that it is more accurate to assess Jet's viability and operations from a FY10E perspective, and hence our roll forward to FY10E. Our multiple of 7x remains unaltered.

2 - Our view on the 4 key issues on Jet is highlighted below:

A – Jet's Domestic Operations – will continue to be affected by competitive pressures into FY09. The supply overhang (in terms of seat capacity) in the industry persists, as consolidation has yet to bring about fleet rationalization. The expected improvement in FY08/09E is now deferred till FY10E, given the challenging environment and cost pressures from rising fuel costs.

B – Jet's International Operations - Have performed ahead of expectations in both operating and financial terms in FY08. FY09E will be a transition year as new routes added in FY08E stabilize (routes to the US will mature through FY09E, routes to the Middle East should break even relatively quickly (into 2HFY09E) while routes to Hong Kong, etc., should mature in FY10E. Margins expected to improve as new routes stabilize. Competitive pressures will continue – but Jet's track record thus far has been commendable.

C – JetLite – The turnaround has been delayed – management had indicated initially Oct07 – which is now deferred to early 1QFY09E. Competitive intensity impacts yields, JetLite's legacy systems continue to hamper the operational turnaround. We do not factor the costs/long-term benefits that might accrue into our current Jet forecasts, given relatively limited clarity.

D – Jet's Aggressive Capital Structure – Jet's balance sheet is extremely leveraged (debt–equity at end FY08 is forecast at almost 6x). Capital structure will remain high over the near term, but we are relatively sanguine as debt is backed by planes (liquid assets) – Jet can always effect sale–lease backs to bolster cash flows and pay down debt levels.

3 – We remain cautious on the domestic industry for the following reasons:

A – Consolidation in its current form has resulted in a sharp hike in fuel surcharges – but we view this as a meaningless development, as we believe that it will affect demand if fares continue to rise. What the industry requires is a deferment/reduction in capacity to remove the supply overhang – our thesis for the past 4 years has been that supply has created its own demand – and we believe the solution to sustained profitability is through reducing seats – not merely raising fares.

B – Drastic legislative measures are required – especially in the area of taxation on ATF – but given that it is a State subject, we believe that it will be a contentious issue. Certain states like AP have adopted progressive measures in

rationalizing sales tax, but given that each individual state government has to enact legislation separately, we believe that it will be difficult. We analyze these issues and more in the industry section.

Jet Airways – Revision in Key Parameters

Key Revisions:

1 - Domestic ASKs/RPKs – scaled down in-line with Jet's conservative capacity deployment plans. Load factors remain in-line with earlier forecasts

2 - International ASKs/RPKs – ASKs revised upward in-line with new route launches to Mid East/SE Asia. Upward revision in FY08/09E RPKs reflects impressive performance in FY08E – PLFs to improve into FY09E as routes mature, but stabilize on that base in FY10E as other private players launch international operations, and Air India continues to revamp operations

3 - Yields – Domestic yields revised upward (in-line with fuel hikes).

4 – International yields revised up to reflect better pricing that Jet enjoys – stable despite increasing stage length

5 - EBITDAR margins – domestic margins reflect impact of higher fuel costs, escalating wages defrayed over lower revenues

6 - International EBITDAR margins – Pared slightly - overall yield improvement, reduction in ex-fuel costs/ASK support margins despite higher fuel costs

Figure 1. Jet Airways- Revision in Key Parameters

		Old			New	
	FY08E	**FY09E**	**FY10E**	**FY08E**	**FY09E**	**FY10E**
ASKs						
Domestic	13,950	15,943	17,409	12,157	13,063	14,317
International	14,586	23,819	27,641	12,173	24,771	28,896
RPKs						
Domestic	10,044	11,479	12,534	8,510	9,405	10,452
International	9,408	16,189	19,231	8,214	17,213	20,050
PLFs (%)						
Domestic	72.0	72.0	72.0	70.0	72.0	73.0
International	64.5	68.0	69.6	67.5	69.5	69.4
Gross Yield (Rs)						
Domestic	6.2	6.0	5.8	6.2	6.3	6.4
International	3.0	3.0	3.0	3.2	3.2	3.2
EBITDAR Margins (%)						
Domestic	22.7	22.0	19.8	10.1	11.7	17.5
International	4.3	13.8	20.1	8.3	12.0	18.4
Fuel Prices Forecast (USD/bbl)	80	75	75	80	90	85
INR/USD Forecast	41.8	40.0	39.0	40.2	38.0	36.0
PAT (Rs mn)	**1,214**	**3,880**	**6,798**	**(5,968)**	**(2,766)**	**4,876**
Diluted EPS (Rs mn)	**11.4**	**36.3**	**63.6**	**(69.1)**	**(25.9)**	**45.6**
DPS (Rs mn)	**7.0**	**8.0**	**9.0**	**6.0**	**6.0**	**8.0**

Source: Citi Investment Research

Domestic Operations: Scaling Down Expectations

Jet's domestic operations have disappointed this fiscal – a confluence of continuing competition and higher fuel costs. Our revised operational metrics over FY08-09E (ASKs, RPKs) are almost 17-20% lower than previously forecast – in-line with Jet's strategy, which has been extremely conservative in deploying capacity in the domestic market.

Our gross yield assumptions are higher than previously forecast – essentially to partially absorb our higher fuel price assumptions (we now take FY09/10E average oil pricing at $90 and $85/barrel respectively – vs. previous forecasts of $75 in both FY09/10E). We forecast a yield improvement in FY10E – despite a Y/Y reduction in fuel prices – reflecting our belief that consolidation should positively affect the sector in the long run.

Because our revised revenues in Fy08-09E are ~16-18% lower than our previous revenues, we see domestic EBITDAR margins shrinking almost 12% over both FY08-09E – the compression arises primarily because of sticky wage costs and higher fuel costs. Our margin assumptions in FY10E are not meaningfully divergent – we forecast EBITDAR margins at around 18% in FY10E – vs. 20% earlier. This is significantly different from management's

expectations of EBITDAR margins at ~23-25%. We do not think this is possible – given that the industry structure in FY10E will have at least 5 players with meaningful capacity share – Jet-JetLite, Air India, Spice Jet, Indigo, Kingfisher – Air Deccan. In that scenario, if fuel prices decline, ~50% of the market which will be LCC will cut fares to stimulate growth. The FSCs-like Jet will follow – margins and returns will thus be capped structurally, and we don't think margins can trend back to the mid and high 20s (unless oil prices correct significantly). .

Figure 2. Jet Airways – Domestic Operations Assumptions

	FY07	FY08E	FY09E	FY10E
Average Trip Length (km)	862	875	884	893
Total block hours	190,911	192,238	211,119	238,581
ASKs (mn)	12,155	12,157	13,063	14,317
RPKs (mn)	8,538	8,510	9,405	10,452
PLF (%)	70.2	70.0	72.0	73.0
Gross Yield (Rs)	6.1	6.2	6.3	6.4
Cost/ASK (Rs)	4.3	4.5	4.6	4.5
Cost/ASK (ex fuel) (Rs)	2.7	2.9	2.9	2.8
Total Revenues	57,004	56,957	63,450	71,788
EBITDAR Margin (%)	16.0	10.1	11.7	17.5

Source: Citi Investment Research

Figure 3. Jet Airways: Domestic Operations – Profit and Loss Statement (Rs million)

Year Ended 31 March	**FY07**	**FY08E**	**FY09E**	**FY10E**
Total revenues	57,004	56,957	63,450	71,788
Operating Expenses				
Employee remuneration	8,194	9,850	10,484	11,774
% of total revenues	14%	17%	16%	17%
Lease rentals (variable component)	1,253	1,197	1,241	1,323
% of total revenues	2%	2%	2%	2%
Aircraft Insurance & Other Insurance	602	784	861	973
% of total revenues	1%	1%	1%	1%
Aircraft Maintenance (75% of total costs)	3,758	3,591	3,723	3,969
% of total revenues	7%	6%	6%	6%
Communication Costs	183	183	207	234
% of total revenues	0%	0%	0%	0%
Other SGA expenses	3,012	3,916	4,034	4,356
% of total revenues	5%	7%	6%	6%
Aircraft Fuel and Oil	18,878	19,630	22,925	23,180
% of total revenues	33%	34%	36%	33%
Landing, Navigation & Other Airport Charges	2,936	3,040	3,254	3,559
% of total revenues	5%	5%	5%	5%
Inflight & Other Pax Amenities	2,199	2,268	2,358	2,724
% of total revenues	4%	4%	4%	4%
Total Selling & Distribution Expenses	6,894	6,747	6,923	7,159
% of total revenues	12%	12%	11%	10%
Total Operating expenses	**47,909**	**51,207**	**56,009**	**59,251**
% of total revenues	84%	90%	88%	83%
EBITDAR	**9,095**	**5,750**	**7,441**	**12,537**
% of total revenues	16%	10%	12%	17%

Source: Citi Investment Research

International Operations: Steady Improvement

Jet’s international operations this fiscal have fared better than our expectations – not on operational metrics – but more so on financial metrics – notably yield assumptions – which has also translated into far better than forecast EBITDAR margins. Our revised yield forecasts for FY08 factor in an assumption of Rs3.2 (Rs3 earlier) – consequently EBITDAR margins have also been revised upward to 8.3% (earlier 4.3%). In retrospect, we were conservative also on load factors (now at 67.5% vs. 64.5%) – key routes to SE Asia are averaging >75%, while routes to the UK are in the high 60s. Very creditably, the Mumbai–New York route is also operating at ~69% loads, though the Delhi–New York route is averaging far lower load factors. We believe that yields have also been better than forecast due to better front-of-the-plane pricing (strong yields in business and first class) – but we don’t have data to support this hypothesis.

Overall, the trajectory of Jet's international operations is impressive – though we do add that the company has not been really tested by the key domestic competitor - Air India. We would be far more circumspect on Jet's international operations in both FY09/10E – we believe that Kingfisher (if it is permitted to fly on Air Deccan's rights) could prove an able competitor – especially on routes to the US and London. We continue to see Air India as a key competitor to Jet on the Middle East routes as well. We believe that FY09E remains a transition year for Jet as its new routes in the U.S. (which will be served from Europe and China), Canada (via Europe), South Africa and Middle East mature and turn profitable.

Our yield assumptions are fairly static over FY08-10E – this is a function of increasing stage length, rather than declining fares. The increase in the EBITDAR margins over both FY09-10E is on account of lower costs/ASK (again, on account of rising stage lengths). Our EBITDAR margin forecasts are lower than earlier envisaged primarily due to the higher fuel costs. Management has indicated that margins in FY10E could be around 20% levels – we are slightly lower at around 18% - the upside risk to our estimates is lower fuel costs – the downside risk is clearly yield compression – either due to stage–length adjustments (very difficult to forecast) or due to competitive pressures (which will manifest themselves in FY10E).

Figure 4. Jet Airways- Route Wise Load Factors on Key International Routes

	Q1 FY08	Q2 FY08	Q3 FY08	YTD 08
Mumbai-Singapore	78.2	73.6	80.1	77.3
Chennai- Malaysia	84.3	82.9	78.7	81.9
Chennai- Singapore	80.6	73.4	68.7	74.1
Delhi-Singapore	66.2	79.5	82.0	76.2
Delhi-Bangkok	73.2	73.2	85.7	77.4
Calcutta-Bangkok	44.7	48.7	77.6	57.1
Mumbai-London 1	67.6	68.0	65.5	67.0
Mumbai-London 2	58.8	59.8	57.0	58.5
Amritsar-London	54.6	57.5	52.9	55.0
Delhi-London	57.9	68.9	68.6	65.2
Mumbai-New York		65.5	71.0	68.9
Delhi-New York			57.3	57.3

Source: Jet Presentation

Figure 5. Jet Airways – International Operations Assumptions

	FY07	FY08E	FY09E	FY10E
Total block hours	36,238	72,534	142,204	163,909
ASKs (mn)	5,584	12,173	24,771	28,896
RPKs (mn)	3,771	8,214	17,213	20,050
PLF (%)	67.5	67.5	69.5	69.4
Gross Yield (Rs)	3.2	3.2	3.2	3.2
Cost/ASK (Rs)	2.7	2.3	2.2	2.1
Cost/ASK (ex fuel) (Rs)	1.7	1.3	1.2	1.1
Total Revenues	13,574	28,921	61,135	71,849
EBITDAR Margin (%)	7.2	8.3	12.0	18.4

Source: Citi Investment Research

Figure 6. Jet Airways: International Operations – Profit and Loss Statement (Rs million)

Year Ended 31 March	**FY06**	**FY07**	**FY08E**	**FY09E**	**FY10E**
Total revenue	**6,796**	**13,574**	**28,921**	**61,135**	**71,849**
Operating Expenses					
Employee remuneration	493	1,187	2,566	4,618	4,822
% of total revenues	7%	9%	9%	8%	7%
Lease rentals (variable component)	168	788	584	1,107	1,229
% of total revenues	2%	6%	2%	2%	2%
Aircraft Insurance & Other Insurance	61	121	383	625	725
% of total revenues	1%	1%	1%	1%	1%
Aircraft Maintenance (75% of total costs)	420	901	1,753	3,322	3,687
% of total revenues	6%	7%	6%	5%	5%
Communication Costs	19	30	130	271	316
% of total revenues	0%	0%	0%	0%	0%
Other SGA expenses	477	211	527	922	1,383
% of total revenues	7%	2%	2%	2%	2%
Aircraft Fuel and Oil	2,239	5,398	11,743	25,959	27,228
% of total revenues	33%	40%	41%	42%	38%
Landing, Navigation & Other Airport Charges	988	1,851	3,614	6,198	6,860
% of total revenues	15%	14%	12%	10%	10%
Inflight & Other Pax Amenities	363	988	2,218	4,820	5,414
% of total revenues	5%	7%	8%	8%	8%
Total Selling & Distribution Expenses	1,461	1,115	2,993	5,999	6,953
% of total revenues	21%	8%	10%	10%	10%
Total Operating expenses	**6,689**	**12,590**	**26,512**	**53,813**	**58,616**
% of total revenues	98%	93%	92%	88%	82%
EBITDAR	**107**	**984**	**2,409**	**7,322**	**13,234**
% of total revenues	2%	7%	8%	12%	18%

Source: Citi Investment Research

Figure 7. Sensitivity to Oil Prices

	+/- $1 change in oil prices	
Sensitivity (%)	**FY09**	**FY10**
EBITDAR	-/+ 3.7	-/+ 2.3
PAT	-/+ 13.2	-/+ 8.1

Source: Citi Investment Research

Figure 8. Jet Airways: Overall Profit and Loss Statement (Rs million)

Year Ended 31 March	FY06	FY07	FY08E	FY09E	FY10E
Total revenue	**56,937**	**70,578**	**85,878**	**124,584**	**143,637**
Operating Expenses					
Employee remuneration	5,672	9,381	12,416	15,103	16,596
% of total revenues	10%	13%	14%	12%	12%
Lease rentals (variable component)	1,241	2,041	1,782	2,348	2,552
% of total revenues	2%	3%	2%	2%	2%
Aircraft Insurance & Other Insurance	690	722	1,167	1,486	1,698
% of total revenues	1%	1%	1%	1%	1%
Aircraft Maintenance	3,109	4,659	5,345	7,045	7,656
% of total revenues	5%	7%	6%	6%	5%
Communication Costs	180	213	313	478	550
% of total revenues	0%	0%	0%	0%	0%
Other SGA expenses	2,241	3,223	4,443	4,956	5,740
% of total revenues	4%	5%	5%	4%	4%
Aircraft Fuel and Oil	16,789	24,276	31,373	48,885	50,408
% of total revenues	29%	34%	37%	39%	35%
Landing, Navigation & Other Airport Charges	3,505	4,787	6,654	9,452	10,419
% of total revenues	6%	7%	8%	8%	7%
Inflight & Other Pax Amenities	2,145	3,187	4,486	7,177	8,137
% of total revenues	4%	5%	5%	6%	6%
Total Selling & Distribution Expenses	7,740	8,009	9,740	12,892	14,111
% of total revenues	14%	11%	11%	10%	10%
Total Operating expenses	**43,312**	**60,499**	**77,719**	**109,822**	**117,867**
% of total revenues	**76%**	**86%**	**90%**	**88%**	**82%**
EBITDAR	**13,625**	**10,079**	**8,159**	**14,763**	**25,770**
% of total revenues	**24%**	**14%**	**10%**	**12%**	**18%**
Lease rentals	4,340	6,458	5,562	5,790	5,970
% of total revenues	8%	9%	6%	5%	4%
EBITDA	9,285	3,621	2,597	8,973	19,800
% of total revenues	16%	5%	3%	7%	14%
Other income	4,417	3,435	7,377	8,505	8,033
Interest and hire purchase costs	2,416	2,402	5,100	4,829	3,933
Depreciation	4,064	4,141	7,231	8,944	9,514
PBT	7,223	514	(2,356)	3,705	14,385
Tax	2702.2	234	(777)	1,222	4,747
PAT	4,520	279.4	(1,579)	2,483	9,639
Exceptionals	3,644	2,528	6,550	7,833	7,108
Pre - exceptional PAT	**2,240**	**(1,414)**	**(5,968)**	**(2,766)**	**4,876**

Source: Citi Investment Research

Jet Lite: Turnaround Delayed

Jet continues to turn around JetLite, though we note that targets are slipping – a turnaround that was initially envisaged in 3QFY08 has now been deferred to Mar–Apr 08, and given the competitive environment as also a scenario of rising fuel costs, we think the turnaround will be further delayed into 1/2QFY09. The competitive environment within the LCC space in India is extremely challenging – and players like SpiceJet and Indigo have a substantial headstart over JetLite as Jet attempts to convert the erstwhile Sahara into a value carrier.

The key positives appear to be the reduction in unit cost by around 28% (a function of increasing the number of seats in the planes by ~20% and slashing the headcount by ~50%). Market share is also trending up – 7.4% in Q3FY08 vs. 6.9% in 2QFY08 – but we believe that there will be some slippages ahead

as competition increases capacity at a faster pace than JetLite. The re-branding exercise is in progress, but anecdotally passengers do seem to be confused by the overall proposition, especially since it is strongly associated with the "Jet" brand – while quality and service levels appear to be far below Jet's exemplary service standards.

Figure 9. Jet Lite 9MFY08 Performance

Operational Data	
Block hours	56,863
ASKs	4,227
RPKs	3,011
PLF (%)	71.2
Passengers flown (mn)	2.5
Financial Results	
Operating Revenues	**11,519**
Employee Costs	1,470
Aircraft Fuel Expenses	5,857
S&D Expenses	1,206
Other Operating Expenses	3,597
Total Operating Expenses	**12,129**
Total Cost/ASK (Rs)	2.9
EBITDAR	**(610)**
Margin (%)	-5.3
Other Income	61
Aircraft Lease Rentals	2,028
Depreciation	62
Interest	144
Profit Before Tax	**(2,782)**

Source: Citi Investment Research

Balance Sheet – Aggressively Leveraged

Jet's current capital structure is extremely aggressive with an estimated debt–equity ratio of around 6x at end FY08E (we do not forecast fund infusion till early FY09E). We are somewhat concerned – but not unduly so – given that the planes are very liquid assets, and Jet could undertake sale and lease-backs to improve the capital structure.

That said, as we forecast into FY09/10E and beyond, we are cognizant of the risks of softening asset prices, as highlighted by our aerospace analysts George Shapiro and David Perry. In a scenario of a global recession – in which asset prices trend down, we believe that the Indian aviation industry's business model of the past 4 years – that of mortgaging the balance sheet to fund the P&L (engaging in sale and lease-back trades to prop up profits and cash flows) - will be challenged. Lenders and lessors will scale back their funding and in a scenario where credit risk continues to reprice upward, we believe that airlines will also have to bear higher credit costs.

Our forecasts for Jet factor in a $400m fund infusion (the rights issue), but we have yet to factor in the second round of fund raising (an incremental $400m) which management has stated that it might raise, if capital market conditions are conducive. Overall capital expenditure is almost complete – management stated that of the US$2.5bn capex plan, only around US$500m remains – which will be funded through a debt–equity mix of 4:1.

Fund raising for JetLite and its recapitalization remains an area of concern – as yet, we have little clarity on JetLite, its turnaround, and the impact it might have on Jet's balance sheet. If consolidated into the balance sheet at end FY08E, we estimate that it might adversely affect Jet's net worth by Rs3.6bn (essentially an annualization of 9mFY08 losses). There might also be a tax shield that Jet could benefit from – which would lower the cash tax outgo in FY09-10E.

Figure 10. Jet Airways – Profitability and Balance Sheet Ratios

Ratios	FY07	FY08E	FY09E	FY10E
Book Value (Rs)	259.1	233.8	354.6	435.4
Debt Equity (x) (incl Pref. Ex Reval.Res)	2.9	5.8	2.3	1.6
Debt Equity (x) (incl Pref. Ex Reval.Res, and capitalized leases)	5.0	7.9	3.4	2.6
ROE (%)	1%	-7%	9%	23%
ROCE (%)	0%	-3%	1%	9%
ROCE (%), incl. Capitalized operating leases	6%	1%	4%	10%

Source: Citi Investment Research

Industry Overview: India's Aviation Sector

We revisit 4 central themes in this section:

1 – Demand - Supply Dynamics – Is overcapacity still a concern?

2 – Relative Dearness of Fare – Are fare increases sustainable?

3 – Legislation and the Sector – Will taxes on ATF be cut?

4 – Civil Aviation Infrastructure – Are Concerns Overstated?

Demand – Supply Dynamics – Overcapacity will Continue into FY09e

After extremely rapid 37% growth in seat capacity over FY06-08E, we forecast capacity growth of 21% over FY08E-10E.

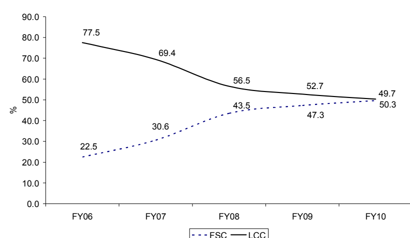
Thus far, the profitability of the Indian aviation industry has been dictated by supply-side dynamics. The rapid growth in capacity and the attendant need to fill seats has resulted in fares declining to irrational levels. It has been almost 9 months since the industry underwent its first round of consolidation, and as the optimism recedes, we re-examine the supply side. After extremely rapid 37% growth in seat capacity over FY06-08E, we forecast capacity growth of 21% over FY08E-10E. Some players have announced that capacity will be curtailed – the numbers depicted below incorporate these.

Figure 11. India Aviation Sector – Fleet Capacity Additions

Company	FY07	FY08E	FY09E	FY10E
Jet Airways	54	58	64	74
Indian Airlines + Alliance Air	53	55	57	59
Go Air	5	9	18	28
Indigo	9	19	29	39
Air Sahara	24	24	27	33
Paramount	5	10	15	18
Spicejet	11	19	23	27
Air Deccan	41	42	52	63
Kingfisher	28	37	46	56
Jagson Airlines	6	10	14	14
Total	**236**	**283**	**345**	**411**

Source: DGCA, Citi Investment Research, companies, press articles

Figure 12. FSC vs. LCC Capacity Share (%)



Source: DGCA, Companies, Citi Investment Research

Further analysis of the capacity indicates that low-cost carriers will contribute to most of the incremental growth, and would account for ~50% of overall capacity by 2010. Even assuming that airlines like Go, Indigo, Paramount and Jagson wind up/are dissolved, LCCs will account for around 39% of overall capacity by 2010.

With 40-50% of the market being catered to by low-cost carriers, we see 2 structural shifts emerging:

1 – Industry Becomes Far More Price Sensitive – The LCC market will be extremely price sensitive, given that it caters mostly to VFR (visiting friends and relatives) traffic. With VFR traffic forecast to account for around 51% of overall traffic by 2010, we think pricing will continue to play a far more important role in determining industry load factors than previously, when business passenger travel (relatively impervious to price movements) accounted for most of the passenger mix. Over the near term, this is not a very healthy trend, given that the industry is attempting to correct its supply-side excesses. Any attempt to increase fares rapidly could result in a sharp decline in load factors. Over Dec–Jan 08, we have seen passenger growth correct to ~15% (as per press reports, official DGCA data awaited) and while it is too early to determine if a new trend is forming, anecdotally we're also seeing airlines becoming cautious on fare increases – as they also believe that the market cannot absorb any hikes over the short–medium term.

Business traffic is forecast to grow at 14% CAGR over FY08-10E...

...Forecast VFR traffic will have to grow at ~30% CAGR to maintain an industry load factor of 66%

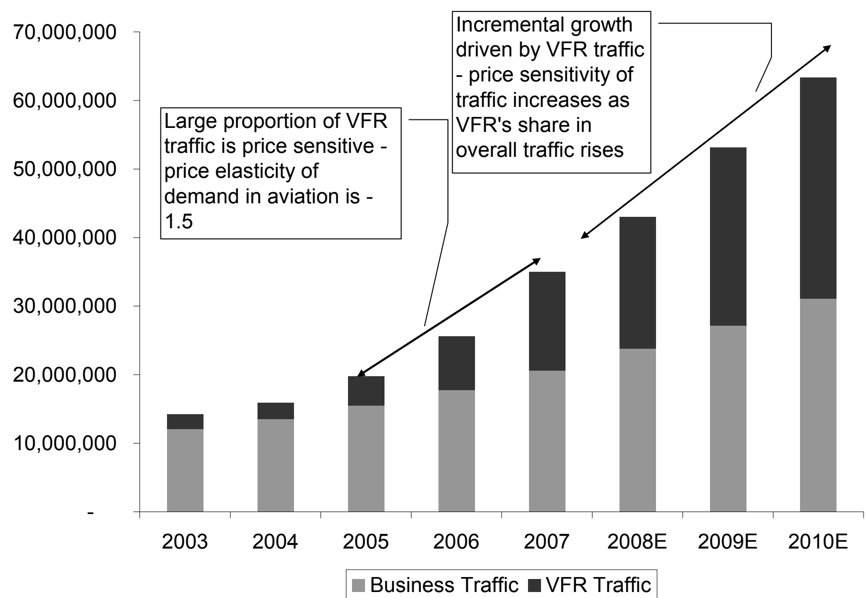
We reckon that the fabric of the entire industry has been stretched thin over the past 2 years, given the aggressive discounts that airlines offered. We now have a significant traffic base – the VFR traveler – who is far more price sensitive than the business traveler. In a scenario of rising fares, we see downside risks to our industry growth estimates – we forecast 80.5m seats in FY09E (we could be wrong, if players further defer capacity), and almost 96m seats in FY10E. We also assume an industry- wide load factor of around 66%. Given that business traffic is forecast to grow at 14% CAGR over this period (we assume a 1.5x multiple on services + industrial GDP growth), we forecast that VFR traffic will have to grow at ~30% CAGR (with the growth front-ended into FY09E) to maintain an overall industry load factor of 66% (marginally higher than what we expect in FY08).

2 – Pricing Power Determined by LCCs – Given that aviation is a commodity industry (especially in a short-haul market), we do not see the full service carriers being able to differentiate themselves meaningfully to earn a substantially higher yield over their low-cost peers (which will increasingly attract business traveler traffic as their on-time performance improves and infrastructural deficiencies are overcome). If 40-50% of the market is a low-cost market, it would structurally cap the upside in yields and profitability of FSCs. FSCs' pricing power would be restricted to business class traffic. Front of the plane dynamics will continue to dictate the profitability of carriers like Jet, Air India and Kingfisher Airways.

Analyzing Demand Side Dynamics

Incremental growth in this industry will come through VFR traffic – not business traffic, which we forecast will grow at around 14% CAGR over FY08-10E. Our base case estimate for the industry load factor is around 66% - in-line with current trends. At this load factor, VFR traffic will have to grow at 24-35% to sustain loads at current levels.

Figure 13. Business Traffic vs. VFR traffic Growth Trend- FY03-FY10E



Source: DGCA, Companies, Citi Investment Research

VFR traffic growth at 24-35% over FY09/10E will be difficult to sustain as ticket prices increase

In isolation, 24-35% growth does not appear very demanding, given that VFR traffic has grown at ~80-85% over FY05-07. But growth over this base – which is also largely due to declining ticket prices – will continue to pose a challenge to all carriers, in the backdrop of escalating oil prices. The negative elasticity of demand vs. price is well known – we have seen the impact of how demand was stimulated by lower prices, but we have yet to see the impact of higher prices on demand growth. Over the past 2 months, Y/Y growth has trended down to ~15% - 2 months is too early to call a trend (especially since the advance fares

in Oct, Nov exhibited irrational forward price curves) but this will have to be monitored very carefully, as a slump in the seasonally softer months will create further pressure on airlines to improve profitability in the peak seasons.

Relative Dearness of Air Fares

Every few months, we compare fares on popular LCC routes and compare them with both FSC fares, as also rail fares, to assess the relative dearness of air fares. We present the results of our 2nd survey (initially conducted in July 2007) below. To make the survey more inclusive, we have included Indigo within the survey (excluded previously)

Figure 14. Fare Comparison – Rail vs Air

		Price Differential		Difference in Average Fares	
From	To	Average FSC vs. LCC	Average LCC vs 2nd AC (Train)	FSC	LCC
Mumbai	Ahmedabad	2,545	3,315	1,500	1,634
Mumbai	Bangalore	2,515	2,410	450	1,602
Mumbai	Chennai	3,267	2,369	1,475	1,185
Mumbai	Goa	140	5,028	1,280	3,302
Mumbai	Hyderabad	2,875	2,659	1,675	702
Mumbai	Jaipur	3,970	2,214	1,075	827
Ahmedabad	Bangalore	7,081	2,753	2,140	651
Ahmedabad	Chennai	6,342	4,338	2,600	2,825
Ahmedabad	Delhi	3,470	2,429	2,300	1,002
Bangalore	Delhi	(379)	2,929	(3,080)	251
Bangalore	Hyderabad	3,170	2,130	1,665	2,340
Chennai	Bangalore	1,800	3,629	1,650	2,009
Chennai	Delhi	3,987	3,153	700	360
Chennai	Hyderabad	2,170	2,684	1,775	2,159
Chennai	Kolkata	3,945	4,078	1,005	1,702

Source: Company websites, Indian Railways

Note1: Numbers depicted in red indicate that the difference between FSC and LCC fares (and LCC vs. train fares) has narrowed, green indicates the spread has widened

Based on the data above, 3 clear trends emerge:

1 – Absolute Fares have increased – The absolute level of fares between July 07 and Jan 08 has increased on almost all routes, for both full service and low-cost carriers. This increase is attributed to some amount of seasonality (this is peak season) and also the surcharge that has been imposed fairly uniformly. Consolidation has thus resulted in an improvement in fares across the board, with the percentage improvement far greater for the LCCs than the FSCs. The expectation that the LCCs' profits will improve sharply (in-line with the improvement in yields) has also led to the sharp re-rating of players like Spice Jet, versus market leaders like Jet Airways.

2 - Differential between FSC and LCC Fares Has Narrowed - On 9 of the 15 routes we surveyed, the differential between FSC and LCC fares has narrowed, despite uniform fuel surcharge being imposed through the industry. In most instances, the LCCs have raised fares significantly, while the FSCs, while increasing surcharges, have reduced the base fares. This is a marketing tactic

employed by FSCs, which reduce the base fares (as commission to GSAs is paid on the base fares).

3 – Fares Rise Sharply vs. Train Fares - The differential in the average fares on LCCs vs trains has increased sharply on 13/15 routes. Train fares have remained static, while air fares have risen rapidly. As yet, data on air travel over 3QFY08 (Oct – Dec Q) is unavailable - which would provide the best insight into how elastic the demand has been, in the face of rising fares. The fares depicted above do not reflect the latest downward price revisions in the Railway Budget (which pared ticket prices by ~7%). Our next survey, which we expect to publish in Apr/May, should shed more light on pricing of railway tickets – but the downward trend in rail fares is clearly a negative for the domestic aviation sector.

Maintaining growth and profitability will be a challenge for the industry over FY09

We don't think the industry can absorb another meaningful round of fare hikes without demand contracting. Anecdotally, the managements of LCCs have stated that it would be difficult to pass through further hikes in fuel without it affecting demand. We believe that the near-term challenge (FY09) will be to maintain acceptable levels of growth without compromising significantly on profitability – but it will be a difficult balancing act in the backdrop of soaring fuel costs, escalating lease rentals, and wavering demand growth.

Legislation and the Aviation Industry

The current government's stance toward the aviation sector has been proactive. The industry has been liberalized, airport privatization has begun, but competitive dynamics have been brutal and severely affected profitability of the industry.

We estimate ATF sales and excise tax contribution would be around 8% and 2% respectively of the total sales and excise tax collection from oil products.

The tax structure on ATF has always been a contentious issue. The contribution of sales tax and excise duty on ATF to the total sales and excise tax collected by government is very low. We estimate ATF sales and excise tax contribution would be around 8% and 2% respectively of the total sales and excise tax collection from oil products. Thus far, select states like Andhra Pradesh have rationalized sales tax to 4% - but given that it is a state subject, it is very difficult to implement a uniform sales tax. We were surprised that the industry did not receive any benefits in the form of an excise reduction on ATF in the Budget – neither did ATF receive Declared Goods status, which would have resulted in a uniform sales tax rate of 4%.

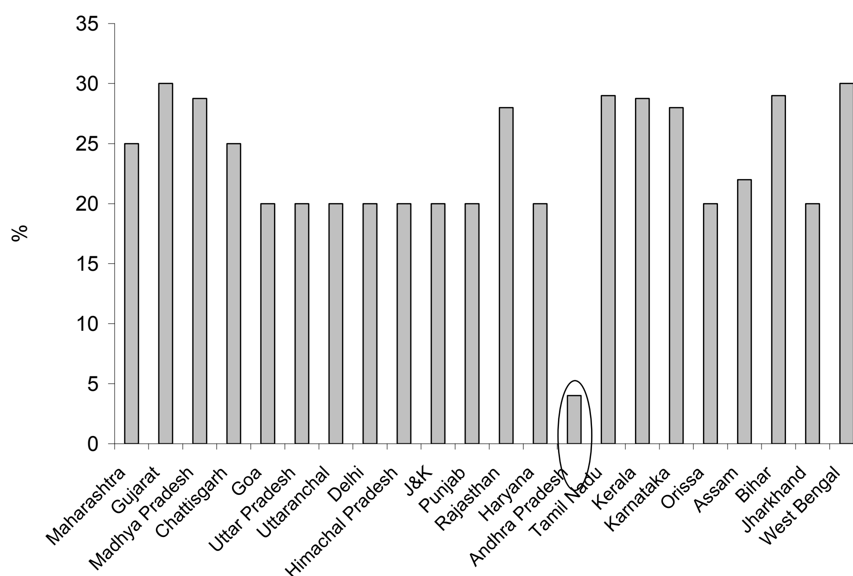
We believe that legislation will play an increasingly important role in the industry – given the skewed cost structure of the industry as a whole. The key upside risk to our Sell (3M) recommendation on Jet (other than a significant and sustained reduction in oil prices) is a positive legislative impact that might occur with the government cutting duties – but in the backdrop of a populist budget, we think any meaningful assistance from the government is still some time away. We believe legislation will become more supportive if industry growth tapers sharply and airlines start deferring fleet expansion in a significant manner. In that scenario, we would become extremely positive on Jet Airways, as we believe that it would be best positioned to benefit from the ensuing recovery.

Figure 10. Contribution of ATF in Sales and Excise Taxes

	Rs Bn
Sales Tax (Oil industry)	**536.5**
ATF Sales Tax	41.8
Contribution of ATF	7.8%
Excise Duty (Oil industry)	**589**
ATF Excise Tax	10.5
Contribution of ATF	1.8%

Source: Citi Investment Research estimates, Ministry of Petroleum

Figure 11. State Sales Tax Rates (%)



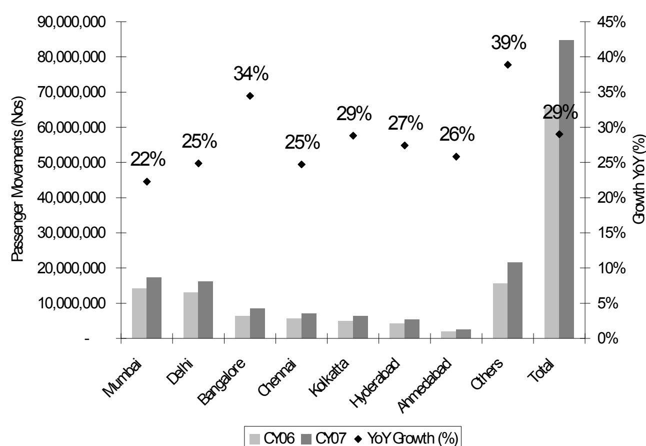
Source: Ministry of Petroleum

Aviation Infrastructure – Concerns Overstated

We believe the issue of aviation infrastructure and its impact on airlines is somewhat overstated. Infrastructure–related constraints (viz the lack of a 2nd operational runway/restricted movements per hour) are relevant only at the metro airports – and only at peak times at those locations – 6:30 am-9:30 am and 6pm-10pm. Moreover, this affects FSCs and LCCs whose business model is connecting same-day-return city pairs (very relevant for players like Jet, and also very relevant for airlines where the proportion of business travelers is far more than VFR traffic). Infrastructure at Mumbai was stretched as at end CY04 – yet aircraft movements have grown at 25% and 16% Y/Y in both CY06 and CY07, implying better utilization of the airport at non–peak times. Overall domestic aircraft movements at the 4 metro airports have grown at 16-29% Y/Y (CY07/06).

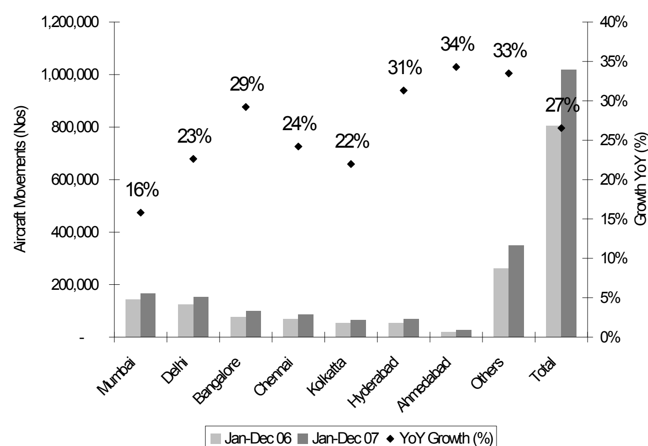
We believe that the congestion surcharge mechanism that is levied on every flight – regardless of the route and the time – mitigates the impact of congestion. Typically, a plane circles for a duration of 45 minutes – 1 hour on the destination leg at peak hours, and idles for around 15-30 minutes before take off – overall, an average of around 1 hour – we estimate this costs an incremental Rs.60,000 / return flight (based on a 737 / A320s fuel burn) – which, defrayed over 100 passengers, is a cost of Rs600 / passenger. Thus while the amount recovered is only ~50% of what is required, we believe that with the surcharge being imposed across all passengers, the airlines are recovering a very substantial amount of the fuel being burnt due to congestion.

Figure 12. Domestic Passenger Movements, Growth (%) – Key Airports



Source: AAI

Figure 13. Domestic Aircraft Movements, Growth (%) – Key Airports



Source: AAI

Conclusion

We continue to remain cautious on the domestic aviation industry, given that a) supply overhang continues, b) we see returns being structurally capped by the strong LCC presence in the sector, c) soaring fuel costs continue to affect the industry's break-even loads and profitability and d) no supporting legislative action that could provide some relief to the sector.

Jet Airways

Company description

Jet Airways is one of India's leading domestic airlines with around 22% market share (around 30% including Jet Lite). It has a very strong track record in the domestic market, and is now scaled up its international operations. It currently flies to several international destinations in the Asia Pacific region, as also to Europe, Middle East and North America. Jet has an aggressive fleet expansion plan, and it plans to increase its fleet to 97 planes at end FY11, from 62 planes at end FY07.

Investment strategy

We rate Jet Airways Sell/Medium Risk (3M) with a target price of Rs765. Jet is one of India's leading airlines with a market share of around 22% and arguably the best brand and service orientation. In the past, the domestic aviation sector grew at a sedate 6% and was characterized by low levels of competition and high airfares, accompanied by high costs due to regulation. But the situation has changed over the past few years. Economic growth and liberalization have stimulated demand for air travel, and the sector has been averaging growth of

over 25% over the past few years. Given the strong base effect over the past few years, we expect growth rates to moderate over the medium term. The government's policy of opening up international routes, albeit gradually and selectively, has opened up another substantial growth opportunity for local airlines such as Jet.

But deregulation has also resulted in a substantial increase in seat capacity, which we estimate to grow at a CAGR of at least 20-22% over FY08E-10E. The industry has come full circle, with consolidation commencing among key players. Given the supply overhang, the benefits of consolidation are yet to be reflected - we believe that airline P&Ls will remain under pressure unless they meaningfully scale back capacity induction. A rapidly consolidating industry should also discourage the entry of new players in the industry. It should also help the domestic market to return to profitability over the next 2 years. The 2 key imponderables at this juncture are a) soaring fuel costs (which raise overall industry break even load factors) and b) overall industry growth, given macro headwinds of decelerating economic growth.

The profitability of Jet's international operations is forecast to improve significantly, especially as routes mature over an 18–24 month period. We forecast profitability to improve substantially over FY09-10E, driven by expectations of relatively stable yields and declining costs/ASK (function of longer stage lengths and better asset utilization). Risks however remain on macro variables like oil prices, currency movements and also competitive intensity (both from well – entrenched international players, as also private domestic players).

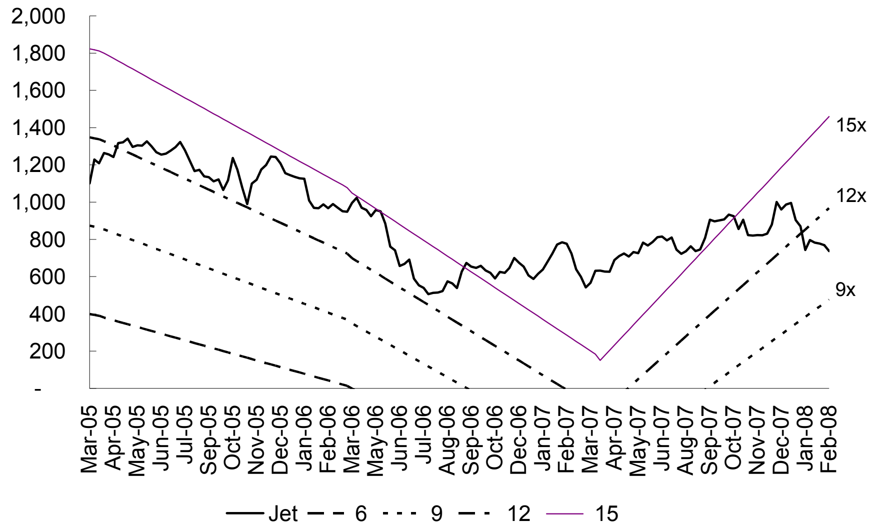
Valuation

Our target price of Rs765 is based on 7x FY10e EV /EBITDAR

Airlines are trading plays – given the cyclical nature of their business, high operational and financial leverage and an earnings profile that is excessively volatile and sensitive to macro variables like oil prices and currency movements. Given the excessive volatility in earnings of airlines, we prefer to utilize a more stable metric to value airlines. The price-to-book metric is a good fall-back measure for airlines, especially in times of distress, but it is not so appropriate for Jet Airways, which is entering a high growth phase, and wherein industry conditions (in the domestic market) are improving. We could also use a DCF valuation, but as India is a high growth market and new players are entering a transition phase, predicting cash flows over a longer term is quite difficult in our view. Hence we stick to our preferred method of EV/EBITDAR. We compare Jet with the major established full service carriers in our coverage universe. While Jet arguably has superior growth opportunities to most of these carriers, Jet has still to demonstrate its ability to deliver robust and consistent earnings over time, and strong sustainable market share in the face of aggressive competition. Nevertheless, Jet's market position within the domestic market is fairly well entrenched, and its international operations are proceeding at a satisfactory pace. We value Jet by rolling forward our EV/EBITDAR multiple to FY10E as we believe that FY09E is a transition year for Jet with the launch of new international routes. We retain our multiple of 7x as we roll forward. We agree that this is at a premium to other full service carriers – but we believe that the premium is merited – given Jet's stronger growth prospects over the long term. We accordingly assign a target price of Rs765 to

Jet Airways. We don't believe in utilizing trading bands for Jet Airways, given a) its relatively short trading history, and b) its volatile earnings profile over the past few years.

Figure 14. EV/EBITDAR Chart



Source: Citi Investment Research

Risks

Our Medium Risk rating on Jet Airways is in-line with the risk ratings on peers in our regional coverage universe. We believe that Jet merits a Medium risk rating, given: a) the competitive scenario in the domestic market; b) its international operations are still at a relatively embryonic phase and should take at least 2-3 years to stabilize; and c) turnaround of the Air Sahara acquisition. Key upside risks to our recommendation and target price are: a) Faster than anticipated capacity rationalization in the domestic airline industry; b) A sustained decline in ATF prices; c) Faster than anticipated ramp up, and greater than forecast profitability of international operations; and d) Rapid restructuring and turnaround of Jet Lite.

Appendix A-1

Analyst Certification

Each research analyst(s) principally responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

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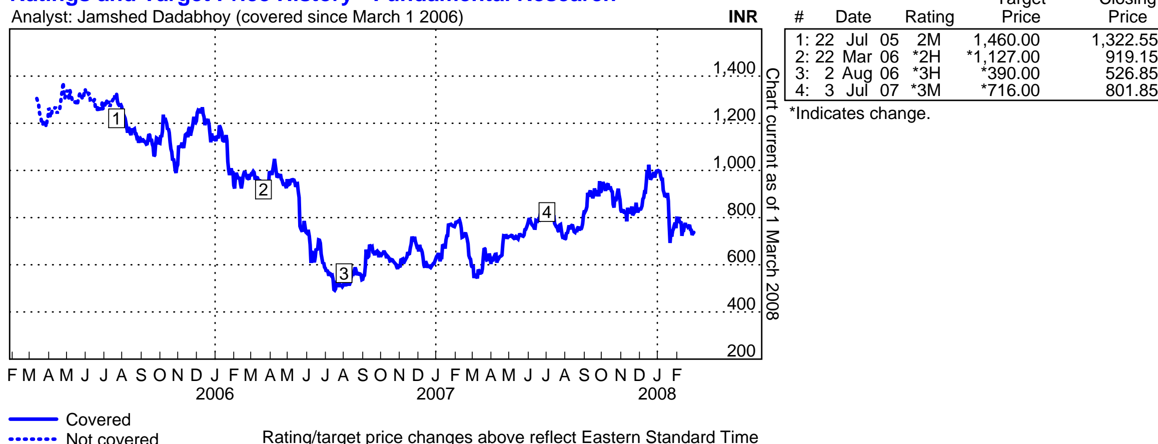

#	Date	Rating	Target Price	Closing Price
1:	22 Jul 05	2M	1,460.00	1,322.55
2:	22 Mar 06	*2H	*1,127.00	919.15
3:	2 Aug 06	*3H	*390.00	526.85
4:	3 Jul 07	*3M	*716.00	801.85

*Indicates change.

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For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings are: Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks,

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