

UPDATE

Share Data

| | |
|----------------------------------|---------|
| Reuters code | DECA.BO |
| Bloomberg code | DECA IN |
| Market cap. (US\$ mn) | 249 |
| 6M avg. daily turnover (US\$ mn) | 5.9 |
| Issued shares (mn) | 136 |
| Target price (Rs) | 38 |

| Performance (%) | 1M | 3M | 12M |
|-----------------|------|------|------|
| Absolute | (38) | (30) | (41) |
| Relative | (27) | (20) | (40) |

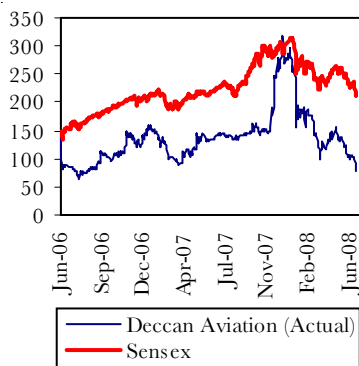
Valuation Ratios

| Yr to 30 Jun | FY09E | FY10E |
|---------------|--------|--------|
| EPS (Rs) | (52.5) | (21.0) |
| +/- (%) | NA | NA |
| PER (x) | NA | NA |
| PBV (x) | (0.9) | (0.7) |
| EV/Sales (x) | 0.6 | 0.5 |
| EV/EBITDA (x) | (3.5) | (16.2) |

Major shareholders (%)

| | |
|-----------------|----|
| Promoters | 67 |
| FII's | 1 |
| MF's | 10 |
| BFSI's | 1 |
| Public & Others | 20 |
| VC's | 1 |

Relative performance



Deccan Aviation

Downgrade to Sell

Price: Rs 79

BSE Index: 14,220

26 June 2008

Time to bail out

After the 3QFY08 results of Deccan Aviation (Deccan) we had put the rating of the stock Under Review. We were unable to value Deccan using relative valuations due to lack of comparable peers. Deccan has posted a loss on the EBITDA level since 2005 and we anticipate this trend to continue for FY09 and FY10.

Deccan does not own any of the aircraft in its fleet and a negative book value and lack of a trailing or forward PER make it unviable to use EV or profitability multiples to derive a value using a peer-group comparison. Moreover, the future uncertainties, because of its merger with Kingfisher (KF), further hinder the valuation process. We do not tend to value airline companies using the DCF model because of the unpredictable internal and external factors that govern the industry. Volatility in crude oil prices, irrational ticket pricing, domestic and international regulations and negative free cash flow, in the case of Deccan, will lead to an uncertain terminal value estimate.

Outstanding shares (o/s) post merger

| | |
|---|--------------------|
| Current o/s shares of Deccan | 135,762,603 |
| Current o/s shares of KF | 303,411,150 |
| Issue of Deccan shares at a ratio of 7:3 | 130,033,350 |
| O/s Shares of the combined airline | 265,795,953 |

Source: Company filing

For the purpose of valuation have taken into consideration the value of the airline's take-off and landing slots at Mumbai (India's most severely slot-constrained airport), and also the value in the A 320/A 330 order book.

Valuation of slots

For the slot-based valuation we have considered the acquisition of GB Airways by easyJet PLC. easyJet PLC acquired the entire issued share capital of GB Airways Ltd., excluding its slots at Heathrow Airport, from the Bland Group Limited, for a cash consideration of GBP 103.5 mn. Based upon its statutory accounts under UK GAAP, for the year ended 31 March 2007, GB Airways reported profit before tax of GBP 2.6 mn and EBITDAR of GBP 35 mn on revenues of GBP 250 mn; it carried 2.8 million passengers, had gross assets of GBP 182 mn and net assets of GBP 33 mn.

Mumbai vis-a-vis Gatwick

| | |
|---|------------|
| Premium of consideration over net assets (GBP mn) | 70 |
| Number of Gatwick/Manchester slots acquired | 34 |
| Implied Value per slot (GBP mn) | 2.05 |
| | ~US\$ 4 mn |
| Number of passengers Gatwick 2007 | 35 mn |
| Number of aircraft movements 2006 | 264,000 |
| Implied total slots | 20,000 |
| Number of passengers Mumbai 2007 estimated | 25 mn |
| Number of aircraft movements 2007 estimated | 284,000 |

Source: GB Airways filing & B&K Research

We use the implied value per slot at Gatwick to value the slots at Mumbai airport, which is also a very busy and slot-constrained single runway airport.

Slot valuation

| Particulars | Rs mn | Comments |
|------------------------------|-----------|---|
| Value/slot at Mumbai in 2011 | 112 | 30% less than the value of a 2007 Gatwick slot due to infrastructure constraints in India and uncertainty over prospects of slot trading. |
| Value of slots | 7,616 | Value of a Deccan and KF slot for the entire day. They currently have 68 slots in Mumbai between them. |
| Present value (PV) of slots | 5,722 | Present value calculated using a 10% discount rate and a time frame of 3 years. |
| Per share value (Rs) | 22 | PV slots/265.8 mn shares of the combined entity. |

In valuing the slots we have combined the slots of Deccan and KF. The share value has been calculated by dividing the present value of slots by the outstanding shares of the combined entity resulting from the merger.

The rationale for using Mumbai airport slots is that Mumbai is the busiest airport in India and the availability of only a single runway makes the slots even more valuable. (Technically, there are two runways, but since they overlap, and the air traffic control systems are unsophisticated, their combined capacity compares with a western single-runway airport.) The impact of the proposed Navi Mumbai Airport on the demand for slots by airlines at the existing airport post-2012 remains to be seen.

In India, slots are allocated by the government on a first-come, first-served basis and no secondary trading between airlines is permitted. The European Commission, which traditionally used administrative procedures to allocate slots to competing airlines, with the most important consideration being the 'grandfather rights' of existing carriers, recently permitted swapping of slots between airlines. A few months ago Alitalia sold three pairs of slots at London's Heathrow Airport for EUR 92 mn. The United States is also considering an effective slot trading mechanism. We have assumed that post-2011, India will permit the trading/sale of slots between airlines, even if it does not, the Mumbai slots held by the Deccan/Kingfisher airline will be a significant asset.

Valuation of order book

So far as order books are concerned, Deccan and Kingfisher have some 78 A320-class aircraft (50 Deccan and 28 KF) on order between them. The difference between the contracted prices of these aircraft and the current market prices for aircraft ordered in similar quantities is believed to be around US\$ 6 mn per aircraft. However, the value of Deccan's order book is lower. In 2006, Deccan entered into an arrangement with a European consortium to raise US\$ 100 mn. It assigned the purchase rights of its 60 Airbus aircrafts to a special purpose company, Southwest Trading Ltd. (STL), funded by two European banks, Investec Bank, UK and HSN Nord Bank AG, Germany. The US\$ 6 mn profit booked by Deccan on the sale and lease back of 2 Airbus A320 aircraft in the quarter ended March 2008 implies an equal profit-sharing of premium over the contracted price.

Kingfisher also has 15 A330, 10 A340-500, 5 A350 and 5 A380 wide-bodies on order. The A330's are each estimated to be worth US\$ 10 mn more than the contracted price, i.e. US\$ 150 mn (Rs 6 bn), but delivery slots for the other aircraft in the backlog do not command a premium at present. In particular, the A340-500 is designed to carry a modest number of premium passengers, vast distances. Singapore Airlines uses this type to fly a business-only configuration between Singapore and New York or Los Angeles. We do not believe that Kingfisher's plan to fly these aircraft non-stop between a variety of Indian and US destinations is viable at current fuel prices.

We estimate the value of the combined order book positions at US\$ 468 mn (Rs 18.7 bn), Rs 70 per share.

Order book valuation

| | Premium/Aircraft | US\$ mn | US\$ mn |
|--------------|------------------|---------|------------|
| Deccan | 50 Airbus A 320 | 3 | 150 |
| KF | 28 Airbus A 320 | 6 | 168 |
| KF | 15 Airbus A 330 | 10 | 150 |
| Total | | | 468 |

However, given the likelihood that:

- the value increment will be used to cover operating losses through sale and lease-back deals
- the deliveries will be spread over a decade
- the A340-500's will not be viable for some time and the orders may have to be reworked.

We do not think it would be prudent to recognise more than Rs 35 per share as the embedded present value of the order book.

Summary of B&K Asset Valuation

| | Rs |
|---|-----------|
| Value of slots, per share | 22 |
| Value of order book, per share | 35 |
| Accumulated losses of Deccan, per share | (19) |
| Value per share | 38 |
| Current market price | 79 |

In the above calculation we have not factored in the accumulated losses of KF and the brand value of KF airlines which we have treated as offsetting. Valuing brand Deccan is not logical as the UB group has indicated that Deccan as a brand will cease to exist after the merger. We are downgrading the stock to Sell with a revised target price of Rs 38.

Income Statement

| Yr end 30 Jun (Rs mn) | FY07 | FY08E | FY09E | FY10E |
|---|----------------|----------------|----------------|----------------|
| Net sales | 17,745 | 21,555 | 36,812 | 44,449 |
| Growth (%) | 86.2 | 21.5 | 70.8 | 20.7 |
| Operating expenses | (24,945) | (29,629) | (42,615) | (45,704) |
| Operating profit | (7,200) | (8,075) | (5,803) | (1,255) |
| Other operating income | 152 | 0 | 0 | 0 |
| EBITDA | (7,048) | (8,075) | (5,803) | (1,255) |
| Growth (%) | n/a | n/a | n/a | n/a |
| Depreciation | (437) | (497) | (458) | (502) |
| Other income | 782 | 406 | 450 | 475 |
| EBIT | (6,703) | (8,166) | (5,812) | (1,283) |
| Interest paid | (341) | (1,040) | (1,248) | (1,498) |
| Pre-tax profit | (7,045) | (9,206) | (7,060) | (2,780) |
| (before non-recurring) | | | | |
| Non-recurring items | 2,885 | 219 | 100 | 100 |
| Pre-tax profit | (4,160) | (8,987) | (6,960) | (2,680) |
| (after non-recurring) | | | | |
| Tax (current + deferred) | (34) | (47) | (55) | (65) |
| Net profit (before Minority Interest, Pref. Dividend, etc.) | (4,194) | (9,034) | (7,015) | (2,745) |
| Reported PAT | (4,194) | (9,034) | (7,015) | (2,745) |
| Adjusted net profit | (7,079) | (9,253) | (7,115) | (2,845) |
| Growth (%) | NA | NA | NA | NA |

Balance Sheet

| Yr end 30 Jun (Rs mn) | FY07 | FY08E | FY09E | FY10E |
|---------------------------------------|---------------|---------------|---------------|---------------|
| Cash & Marketable securities | 8,170 | 3,537 | 4,269 | 4,438 |
| Other current assets | 2,466 | 4,461 | 7,619 | 9,200 |
| Investments | 4 | 4 | 4 | 4 |
| Net fixed assets | 6,647 | 6,363 | 6,052 | 5,775 |
| Total assets | 17,287 | 14,365 | 17,944 | 19,417 |
| Current liabilities | 4,561 | 6,142 | 11,056 | 11,111 |
| Total debt | 9,167 | 13,127 | 18,639 | 22,560 |
| Other non-current liabilities | 110 | 228 | 303 | 455 |
| Total liabilities | 13,838 | 19,496 | 29,999 | 34,126 |
| Share capital | 1,355 | 1,355 | 1,355 | 1,355 |
| Reserves & surplus | 2,382 | (6,304) | (13,318) | (16,064) |
| Less: Misc. expenditure | (288) | (182) | (91) | 0 |
| Shareholders' funds | 3,449 | (5,131) | (12,055) | (14,709) |
| Total equity & liabilities | 17,287 | 14,365 | 17,944 | 19,417 |
| Capital employed | 12,727 | 8,224 | 6,888 | 8,306 |

Cash Flow Statement

| Yr end 30 Jun (Rs mn) | FY07 | FY08E | FY09E | FY10E |
|-----------------------------------|----------------|----------------|----------------|----------------|
| Pre-tax profit | (4,160) | (8,987) | (6,960) | (2,680) |
| Depreciation | 177 | 284 | 367 | 411 |
| Change in working capital | 753 | (297) | 1,832 | (1,374) |
| Total tax paid | (34) | (47) | (55) | (65) |
| Cash flow from oper. (a) | (3,265) | (9,047) | (4,815) | (3,708) |
| Capital expenditure | (1,645) | (0) | 0 | 0 |
| Others | 100 | 106 | 35 | (43) |
| Cash flow from inv. (b) | (1,545) | 106 | 35 | (43) |
| Free cash flow (a+b) | (4,810) | (8,942) | (4,781) | (3,751) |
| Equity raised/(repaid) | 5,767 | 0 | 0 | 0 |
| Debt raised/(repaid) | 4,650 | 3,960 | 5,512 | 3,920 |
| Cash flow from fin. (c) | 10,418 | 4,308 | 5,512 | 2,339 |
| Net change in cash (a+b+c) | 5,607 | (4,634) | 731 | (1,412) |

Key Ratios

| Yr end 30 Jun (%) | FY07 | FY08E | FY09E | FY10E |
|---------------------|--------|---------|---------|---------|
| Adjusted EPS (Rs) | (68.7) | (68.3) | (52.5) | (21.0) |
| Growth | NA | NA | NA | NA |
| Book NAV/share (Rs) | 33.5 | (37.9) | (89.0) | (108.6) |
| Tax | (0.8) | (0.5) | (0.8) | (2.4) |
| EBITDA margin | (39.4) | (37.5) | (15.8) | (2.8) |
| EBIT margin | (37.5) | (37.9) | (15.8) | (2.9) |
| RoCE | (70.2) | (78.0) | (76.9) | (16.9) |
| Net debt/Equity | 28.9 | (186.9) | (119.2) | (123.2) |

Valuations

| Yr end 30 Jun (x) | FY07 | FY08E | FY09E | FY10E |
|-------------------|-------|-------|-------|--------|
| PER | NA | NA | NA | NA |
| PCE | NA | NA | NA | NA |
| Price/Book | 2.4 | (2.1) | (0.9) | (0.7) |
| Yield (%) | 0.0 | 0.0 | 0.0 | 0.0 |
| EV/Net sales | 1.1 | 0.9 | 0.6 | 0.5 |
| EV/EBITDA | (2.9) | (2.5) | (3.5) | (16.2) |

Du Pont Analysis – ROE

| Yr end 30 Jun (x) | FY07 | FY08E | FY09E | FY10E |
|----------------------|---------|---------|--------|-------|
| Net margin (%) | (39.9) | (42.9) | (19.3) | (6.4) |
| Asset turnover | 1.3 | 1.4 | 2.3 | 2.4 |
| Leverage factor | 5.4 | (18.8) | (1.9) | (1.4) |
| Return on equity (%) | (271.0) | 1,100.4 | 82.8 | 21.3 |

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 2. **OUTPERFORMER:** 0 to +25%
 3. **UNDERPERFORMER:** 0 to -25%
 4. **SELL:** Potential downside of < -25% (absolute returns)
-

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