

**SpiceJet**  
BUY (Rs53)

**Jet Airways**  
HOLD (Rs653)

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## INDIA

## Indian Aviation Sector

## Set for a take-off

Reason for report: Initiating sector coverage

*"Flying may not be all plain sailing, but the fun of it is worth the price." – Amelia Earhart*

The aviation sector in India is set to jet underpinned by the introduction of low cost carriers (LCC) that promise to make use of the tremendous traffic potential (28.2% CAGR through FY09E) in the country. Further, surging tourism, expected conversion to air travel and upsides from regulatory and infrastructural changes would provide muscle to the imminent aviation J-curve. Apprehensions such as price wars, oversupply and lower load factors, too, seem overdone as fares have bottomed out, capacity is rationalised and tier II cities are emerging as next growth pockets. We initiate coverage on SpiceJet and Jet Airways with BUY & HOLD recommendations respectively.

- ▶ **Propelled into growth orbit.** We believe the aviation J-curve is about to unfold in India, traversing the same path as mobile telephony, small cars etc. Surely, there is a decided potential as India's per capita air trip/year is less than 25% that of China and 8% that of Mexico; lamentably, it is comparative to countries with poorer GDP such as Ethiopia and Nigeria. This is underpinned by the fact that air trips/capita in upper strata (US\$11,500+ annual income PPP unadjusted) is less than one.
- ▶ **Apprehensions seem overdone.** The era of price wars is almost passé – fares have bottomed out after having plummeted to near negative EBITDAR levels. Further, barring transient supply pressures due to announced fleet expansion and new entrants, we expect demand growth (28.2% CAGR) to exceed capacity addition (28.1% CAGR) by FY09E, leading to margin expansion. Exceptional growth from tier II cities (not factored in our estimates, but evident in retail buoyancy), expected regulatory changes (ATF tax reduction) and elimination of infrastructural constraints would further improve the outlook.
- ▶ **LCC model – Will it work in India?** Consider the best LCC in any country, and it has consistently delivered profits. In India, too, LCCs are expected to enhance their market share to 45% by FY09E and capture the bulk of exponential demand growth. Further, the competitive space is uncrowded and we expect just three dominant LCCs (>15 aircraft) with pan-India presence and four regional LCCs by FY09E as against more than 50 LCCs in Europe and 15 in the US at present. Cost per unit is also set to decline once critical mass of fleet is achieved, indicating profits for efficient LCCs. Watch for: i) lower-than-announced fleet expansion ii) improvement in average fare realisation during the upcoming lean season and iii) funding constraints for inefficient players – which would signal a turnaround.
- ▶ **Valuations – SpiceJet is our pick of the sector** as it is best positioned to benefit from the aviation J-curve on the back of high operational efficiency and sustained high load factor. We believe the worst is over for the LCC and it is set to script a turnaround by FY09E.

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## Investment summary

### Propelled into growth orbit

#### LCC – Next J-curve?

The Indian aviation sector is on the brink of a J-curve, emulating China's growth story – its aviation industry took off in 1998 from around 28mn passenger trips to 125mn passenger trips in '05 (at 24% CAGR), while growth in India has only started '02 onwards. India can grow significantly in a similar timeline.

The potential of the Indian consumer market has been demonstrated through repeated J-curves (mobile telephony, small cars etc) particularly as availability and affordability of the product/service across most sectors has been enhanced by reforms and competitive stimulus.

#### Air traffic at 54mn by FY09E will help script the J-curve

Our prognosis of domestic air passenger traffic increasing to 54mn by FY09E (in line with CAPA's estimate of 60mn domestic travellers by FY10E) is underpinned by a 35% growth to 25mn in FY06. Domestic traffic recorded a 19.4% CAGR through FY03-05 after LCCs entered India in '03, changing the face of aviation forever.

#### Key drivers

##### Conversion to air travel & surging tourism

The growth in air traffic is expected to come from a mix of rising conversion to air travel (19.4mn trips) from rail (49mn upper class trips) and surging tourism industry (domestic tourism growing at 20%). Lower air fares helped by lesser transport choices, given India's vast geography, would support air travel.

##### India's low per capita enplanement indicates growth potential

Surely, there is a decided potential as India's per capita air trip/year is less than 25% that of China and 8% that of Mexico; lamentably, it is comparative to countries with poorer GDP such as Ethiopia and Nigeria. This is underpinned by the fact that air trips/capita even in the upper income strata (US\$11,500+ annual income unadjusted for PPP) is less than one.

### Apprehensions seem overdone

#### Airfares have bottomed out

The era of price wars is passé – fares have bottomed out after having plummeted to near negative EBITDAR levels. Even though airfares increased more than Rs750/ticket mainly due to fuel surcharge since March '06, H1CY06 registered a record 50% rise in traffic as against H1CY05. Further, proposal to levy congestion surcharge and restriction of 'discount' tickets to less than 10% of inventory are signs of maturity and stability in the industry.

**Oversupply fears irrational**

Barring transient supply pressures due to announced fleet expansion and new entrants, we believe demand growth (28.2% CAGR) will outstrip capacity addition (28.1% CAGR), leading to improvement in industry load factor and consequently, margin expansion. Capacity addition beyond 60% of announced orders from new players is unlikely given the recent track record (deferral of capacity addition by existing players and repeated deferral in new launches). Exceptional growth from tier II cities (not factored in our estimates, but evident in retail buoyancy) would further improve the outlook.

**Upside from infrastructural and regulatory changes**

Progress on regulatory changes such as ATF price reforms & proposal to raise entry barriers to the industry as well as infrastructural developments such as construction of secondary airports & second runways at metros and addressing the shortage of pilots through mushrooming aviation academies would set stage for a seamless growth in the aviation sector.

**Crude price hike offset by fuel surcharge**

Airlines have finally passed on the ATF price hike in the form of fuel surcharge, which is unlikely to be significantly reduced in the short term. From here on, only potential upsides such as lower marketing margin and ATF tax reduction exist.

**LCC model – Will it work in India?****Pure LCCs have been profitable on a sustained basis**

Consider the best LCC in any country, and it has consistently delivered profits. Globally, LCCs such as AirAsia and RyanAir (RoE in excess of 15%; high EBITDA margin) have outperformed full service carriers (FSCs) on an operational level. We believe that this profitable growth story can be emulated in India if the model is followed in its entirety.

In India, LCCs are expected to enhance their market share to 45% by FY09E and capture the bulk of exponential demand growth. Further, the competitive space is uncrowded and we expect just three dominant LCCs (>15 aircraft) with pan-India presence and four regional LCCs by FY09E as against >50 in Europe and 15 in the US at present.

**Margin expansion will be helped by cost reduction**

Cost per unit is set to decline once critical mass of fleet is achieved, indicating profits for efficient LCCs. Fuel costs and airport charges, which are 40-50% higher in India (due to unfavourable regulatory policy), are expected to reduce the same way as in the mobile telephony market – licence fees were slashed post the opening up of the sector. Lower staff costs and increasing focus on ancillary revenue stream will further help margin expansion.

**Expected milestones**

Watch for: i) lower-than-announced fleet expansion ii) improvement in average fare realisation during the upcoming lean season and iii) funding constraints for inefficient players – which would signal a turnaround.

**Valuations – SpiceJet, our pick in the sector**

We believe SpiceJet is best positioned to benefit from the aviation J-curve on the back of demonstrated potential through high operational efficiency and sustained high load factor. The worst is already over for the company and it is set for a turnaround by FY09E. We initiate coverage on SpiceJet and Jet Airways with BUY and HOLD ratings respectively.

Our view is backed by the international trend, according to which LCCs command premium valuations over FSCs, as evidenced by higher EV/EBITDAR and market cap/sales multiples. Globally, LCCs trade at more than 100% premium to FSCs on market capitalisation/sales and EV/EBITDAR, though at a modest discount on EV/Fleet.

## Industry scenario

We envisage three different scenarios unfolding for aviation. In our base case scenario, we expect capacity growth to match or modestly exceed demand growth in the next 12-18 months, thereby impacting airline yields for some time. Nonetheless, yields have bottomed out at present and are likely to stage an up-tick from here on.

In the best-case scenario, capacity expansions by most carriers would be controlled, leading to substantial profitability and stabilisation of yields.

In the worst-case scenario, limited progress on capacity rationalisation would hinder survival of airlines with unmanageable network.

In all the scenarios, however, we note that carriers which maintain cost efficiency; expand in a phased manner and follow the true LCC model will benefit.

Chart 1: Industry scenarios

	<b>Scenarios</b>	<b>Industry impact</b>	<b>Beneficiary/survivor</b>
<b>Best case</b>	Withdrawal, consolidation, order cancellation and/or route rationalisation in the next six months. Infrastructural issues resolved faster than expected.	Check on capacity growth, return of pricing power, yield stabilisation – profitability for survivors. Cost effective carriers turn cash generators.	Carriers with scale and balance sheet strength can capitalise – primarily Jet Airways and SpiceJet.
<b>Base case</b>	Gradual withdrawals and route rationalisation in the next 12-18 months. Infrastructural issues ease a little, but airlines avoid head-on competition by choosing tier II destinations.	Capacity growth exceeds demand growth for 12-18 months; continued yield pressure in the interim but stabilises into FY09 – profitability and positive cash for cost efficient in 15-18 months.	Carriers avoid head-on collisions, lowest cost carrier with sound funding plan best placed to leverage from changing environment – SpiceJet.
<b>Worst case</b>	Limited progress towards route rationalisation, continued capacity additions leading to continued yield declines until inefficient carriers are forced to bankruptcy. Infrastructural problems worsen.	Easy availability of funds allow new entrants to continue to grow, pressurising both yields and margins – all airlines continue to bleed.	All airlines bleed heavily – FSCs and LCCs with scale (Air Deccan) would be the worst hit due to larger share. Carriers with limited destinations but chosen routes (SpiceJet) relatively less affected.

Source: i-SEC Research

Chart 2: Key carriers – Snapshot

Carrier	Load factor	Yields	Network	Fleet Order	On-time performance	Market share	Cost efficiency	Profitability	Funding status	i-SEC Outlook
Air Deccan										
Air India										
Air Sahara									*	
GoAir		*					*	*	*	
Indian										
IndiGo							*	*	*	
Jet Airways										
Kingfisher							*			
SpiceJet										
Paramount							*	*	*	

Note: Darker circles indicate better performance; \* indicate insufficient data to determine performance.  
Source: i-SEC Research

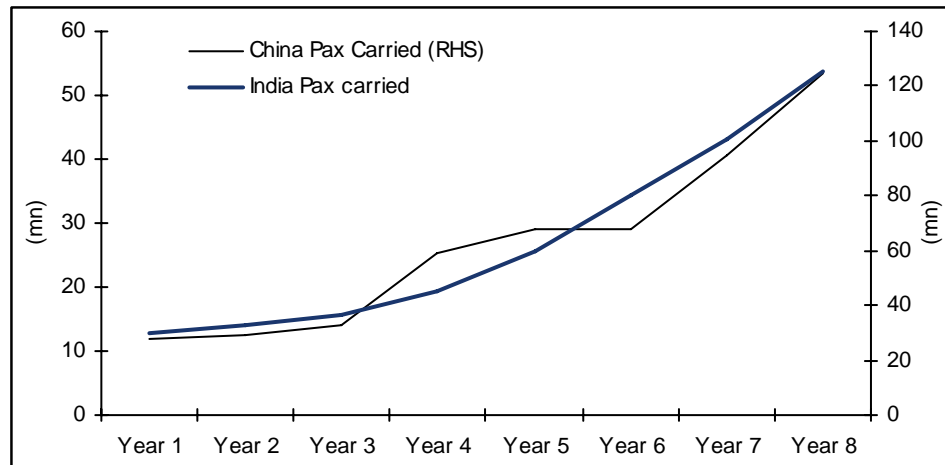
## Propelled into growth orbit

### LCCs – Next J-curve?

The Indian aviation space is on the brink of a J-curve, emulating China’s growth story (Chart 3) – its aviation industry took off in 1998 from around 28mn passenger trips to 125mn passenger trips in '05 (at 24% CAGR), while growth in India has only started '02 onwards. India can grow significantly in a similar timeline.

Further, India has demonstrated J-curves repeatedly, particularly as availability and affordability of the product/service across most sectors has been enhanced by reforms and competitive stimulus. With the advent of LCCs, we foresee a similar J-curve in aviation as mobile telephony and small cars (Charts 4 and 5).

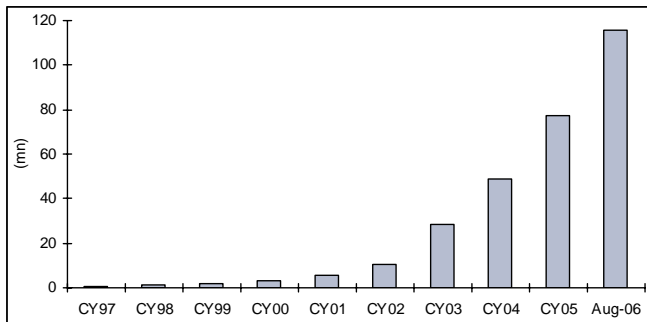
**Chart 3: Aviation J-curve – India going the China way**



China	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
India	FY02	FY03	FY04	FY05	FY06E	FY07E	FY08E	FY09E

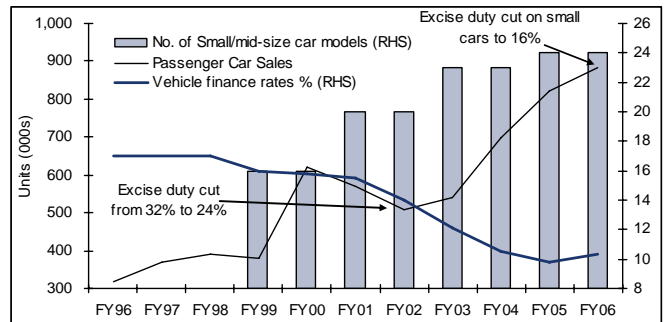
Source: i-SEC Research

**Chart 4: Surge in mobile subscribers...**



Source: TRAI

**Chart 5: ...and car sales**



Source: SIAM, Boston Consulting Group, FICCI, i-SEC Research

### Air traffic at 54mn by FY09E will help script the J-curve

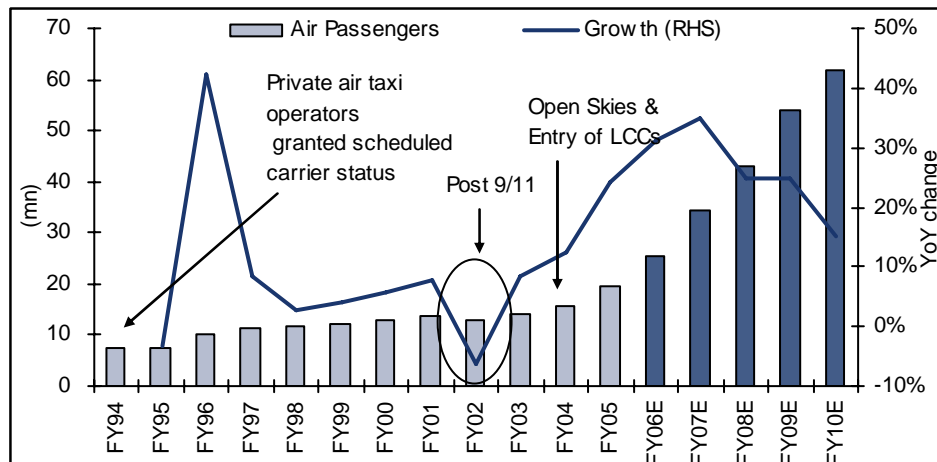
Our prognosis of domestic air passenger traffic increasing to 54mn by FY09E (Chart 6) is underpinned by a 35% growth to 25mn in FY06. Domestic traffic recorded a 19.4% CAGR through FY03-05 after LCCs entered India in '03 changing the face of aviation.



**Chart 6: Estimated air passenger traffic**

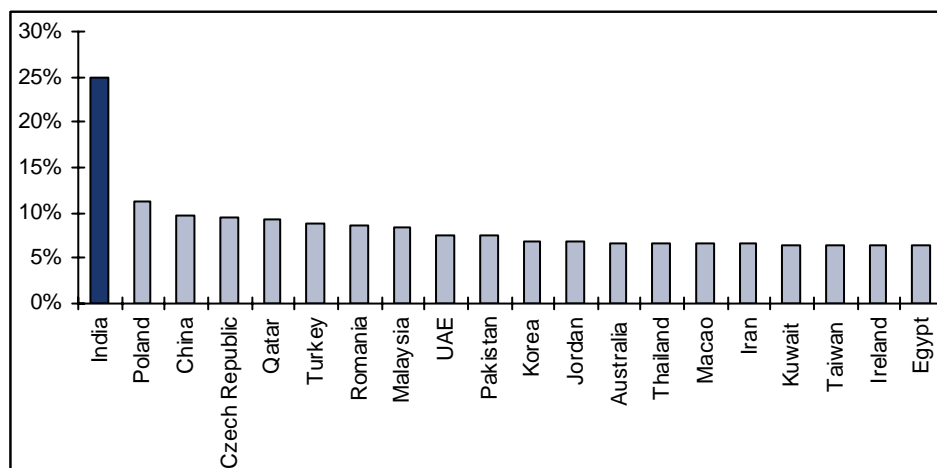
We expect FY07E to be an inflection point, registering more than 35% growth

H1CY06 growth at ~50% paves way for a new trajectory



Source: DGCA, i-SEC Research

**Chart 7: India – Fastest flyer**



Note: Growth in traffic over '05-09; India growth rate is an i-SEC estimate  
Source: IATA forecasts, i-SEC Research

**Traffic growth to outstrip capacity addition**

The consumer market in India is a multi-layered pyramid with critical mass at every stratum. In FY06E, the apex strata (super rich and sheer rich) consisted of 156,000 households and will likely grow at 26% CAGR over the next four years. The middle class (seekers, strivers and near rich) is at 350x the size of super rich and is expected to grow at 14% (Table 2). By FY10E, this will lead to an aggregate addressable base of 31mn households by FY10E. Assuming just four trips per household in a year, the potential traffic would be at 124mn by FY10E.

In comparison, as per our base-case scenario (Table 1), we estimate air traffic to reach 54mn by FY09E (28.2% CAGR as against 28.1% capacity CAGR). This translates into an industry-wide load factor of 66.0% by FY09E as against the FY06 load factor of 68.2% (Table 1). However, load factor in November '06 is estimated to have reduced to less than 60%.

**Table 1: Demand growth versus supply addition (base-case scenario)**

Industry statistics	FY05	FY06E	FY07E	FY08E	FY09E
Annual capacity (mn seats)	30	38	54	65	79
Estimated passenger traffic (mn)	19	26	34	43	54
Enplanement ratio	0.018	0.023	0.031	0.038	0.046
Industry Load Factor (%)	64.9	68.0	63.6	66.7	68.2

Source: i-SEC Research

**Table 2: The Great Indian middle class**

Consumer category	Income US\$ p/a (PPP unadjusted)	No of households ('000)				CAGR (%) '05-06 to '09-10
		'95-96	'01-02	'05-06E	'09-10E	
Deprived	<2,070	131,176	135,378	132,249	114,394	(3.6)
Aspirers	2,070-4,600	28,901	41,262	53,276	75,304	9.0
Seekers	4,600-11500	3,881	9,034	13,813	22,268	12.7
Strivers	11,500-22,990	651	1,712	3,212	6,173	17.7
Near rich	22,990-45,980	189	546	1,122	2,373	20.6
Clear rich	45,980-114,940	63	201	454	1,037	22.9
Sheer rich	114,940-229,890	11	40	103	255	25.4
Super rich	>229,890	5	20	53	141	28.1
<b>Total</b>		<b>164,877</b>	<b>188,193</b>	<b>204,282</b>	<b>221,945</b>	

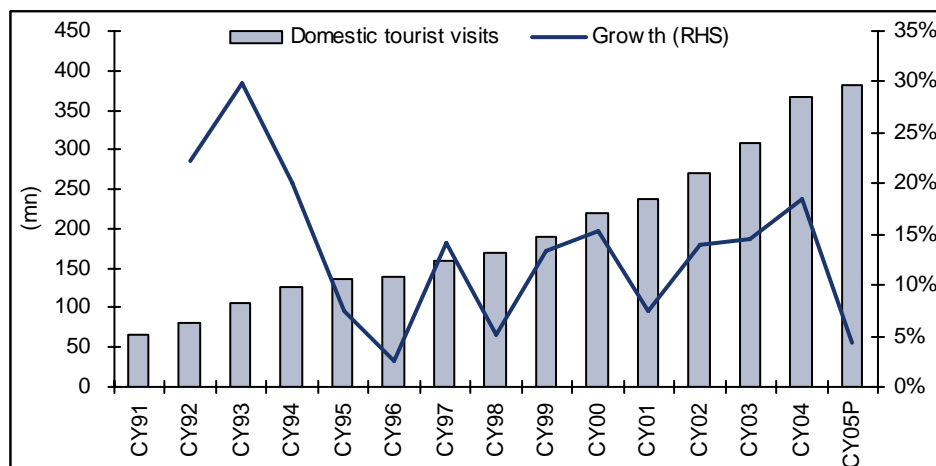
Source: NCAER, i-SEC Research

## Key drivers

### Surging tourism industry

Domestic tourism is growing at a rate higher than the GDP, having witnessed more than 382mn visits in CY05 (Chart 8). In comparison, number of air trips during the same year at 23mn was less than 7% of tourist visits (further, a majority of air trips was business travel). Hence, an immense opportunity exists in the form of converting domestic travel by car/rail/bus to air.

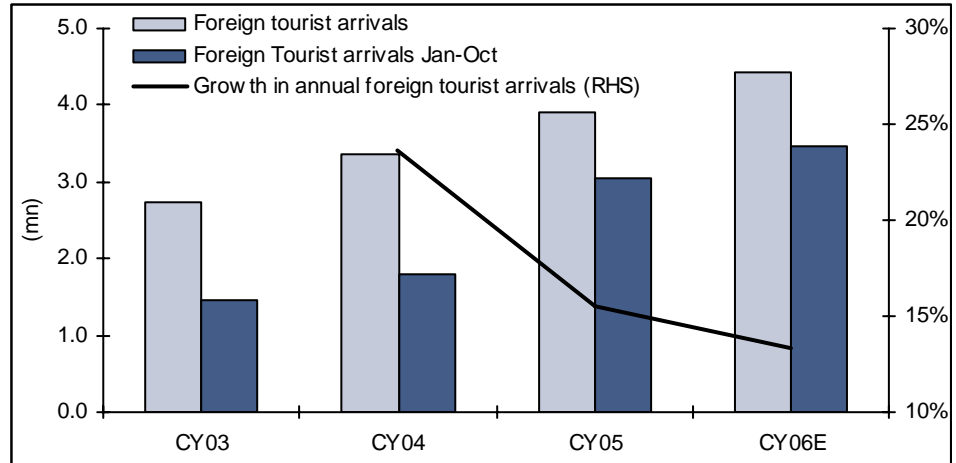
**Chart 8: Booming domestic tourism industry**



Source: Department of Tourism

Foreign tourist arrivals, too, registered a 14% growth through January-July '06 over the corresponding period last year (Chart 9) and are set to receive further impetus as global LCC players commence international operations in India. Surge in foreign tourists would create additional opportunity for Indian carriers in the form of onward connectivity within the country.

**Chart 9: Growth in foreign tourist arrival, another opportunity**



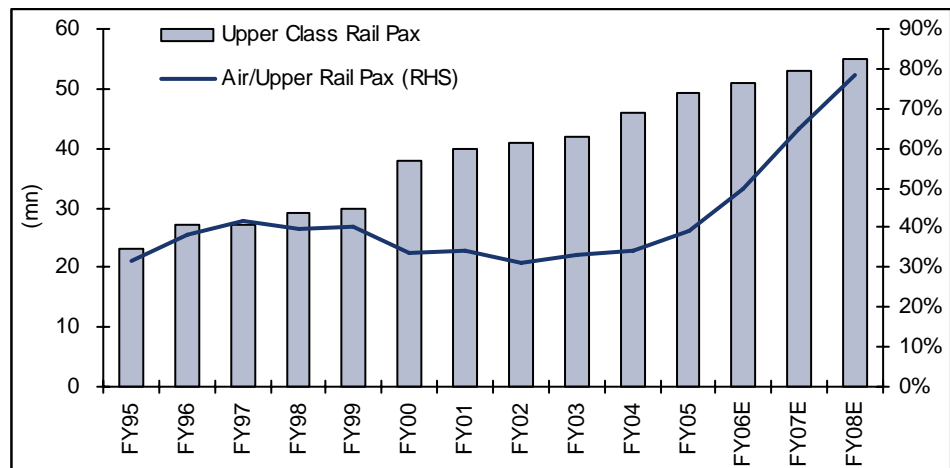
Source: Department of Tourism

**Conversion from upper class railway passengers**

LCCs plan to target the 49mn upper class rail trips as against 19.4mn air trips in FY06E, which compares poorly with 10mn car ownership base and almost a million new car sales per annum.

We estimate that by FY08E, the air-to-upper class rail passenger ratio will increase to more than 75% on account of conversion (Chart 10) as well as overall increase in air travel, which will largely be due to cheaper airfares. Table 3 presents a comparison between Indian Railways' upper class fares and the lowest available last day fares offered by the LCCs, which are comparable with AC I rail fares.

**Chart 10: Domestic air and upper class railway passengers in India**



Source: Indian Railways, DGCA, i-SEC Research

**Table 3: Fare comparison**

From	To	Train Fare (Rs)		Airfare (Rs)	AC I/Airfare (%)	AC II/Airfare (%)
		AC I	AC II			
Delhi	Jaipur	1,045	610	1,805	57.9	33.8
Chennai	Hyderabad	1,915	1,113	2,031	94.3	54.8
Mumbai	Goa	2,000	1,161	1,875	106.7	61.9
Hyderabad	Mumbai	2,030	1,178	1,975	102.8	59.6
Bangalore	Mumbai	2,500	1,439	2,711	92.2	53.1
Chennai	Mumbai	2,632	1,518	3,073	85.6	49.4
Delhi	Mumbai	2,747	1,583	3,310	83.0	47.8
Delhi	Kolkata	2,862	1,648	3,619	79.1	45.5
Chennai	Kolkata	3,120	1,794	3,835	81.4	46.8
Mumbai	Kolkata	3,465	1,989	4,335	79.9	45.9
Chennai	Delhi	3,609	2,071	4,547	79.4	45.5
				<b>Average</b>	88.4	51.0

Note: Airfares include fuel surcharge and taxes; cheapest available last-day fares on Nov 22, '06  
 Source: i-SEC Research

**India’s low per capita enplanement indicates growth potential**

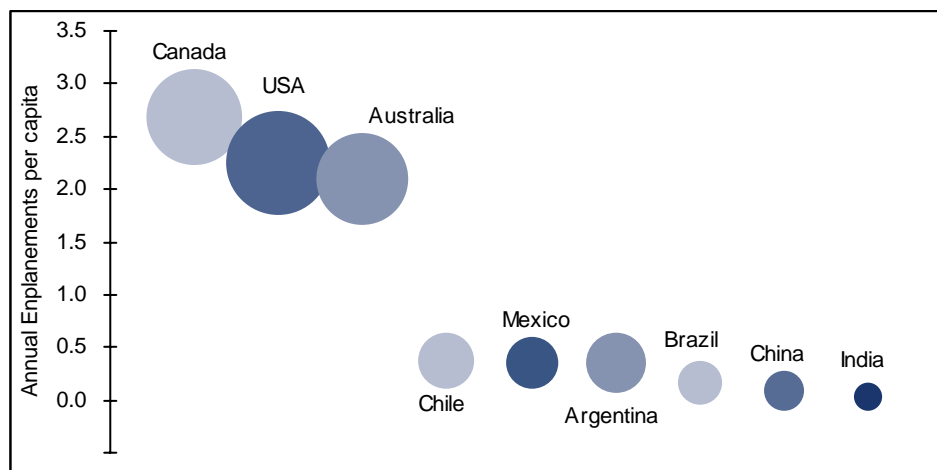
Air traffic potential is further highlighted from the fact that in spite of long distances, India’s per capita enplanement (air trip/year) at 0.027 is less than 25% that of China and 8% that of Mexico; lamentably, it is comparative to countries with poorer GDP such as Ethiopia and Nigeria. Table 4 compares the country’s geography, transport distance and time taken by different transport modes as against countries mentioned in Chart 11.

If we compare India’s per capita GDP (PPP adjusted) of US\$3,400 against China’s US\$6,800, assuming a linear relationship, the per capita enplanement will have to rise to 0.048 (equivalent to passenger traffic of 53mn) to catch up with China’s 0.096.

In a different vein, if we base our analysis on India’s per capita GDP forecasts of US\$5,400 by FY10E, we arrive at an estimated enplanement ratio of 0.043 or passenger traffic of 55mn (21% CAGR from FY06 traffic of 25mn).

On our base-case scenario, even if the air traffic grew at a CAGR of 28.2% till FY09E, per capita enplanement would remain low at 0.046 (assuming a 1.6% CAGR in population as per 1.65% population CAGR through FY01-06).

**Chart 11: Per capita enplanement**



Source: i-SEC Research  
 Note: Bubble size indicates the size of the economy

Average travel time in India is way higher than in other countries

**Table 4: Lesser choices in transport modes and vast geography**

	Area sq km ('000)	Max distance (Kms)		Benchmark rail travel time (hrs)*	Rail lines (kms)#	Rail Passenger kms (mn)#
		North-South	East-West			
Canada	9,976	2,414	4,827	7.7	49,422	1.0
USA	9,629	3,400	5,050	10.0	141,961	42.0
Australia	7,687	3,700	4,000	10.0	41,286	12.1
Chile	757	4,023	298	14.3	4,923	0.8
Mexico	1,973	3,100	2,000	12.5	26,656	2.0
Argentina	2,767	3,330	1,384	12.5	35,754	11.0
Brazil	8,512	4,023	4,183	11.1	30,403	0.1
China	9,597	2,993	2,446	9.1	60,627	490.0
<b>India</b>	<b>3,288</b>	<b>3,253</b>	<b>2,950</b>	<b>18.2</b>	<b>63,140</b>	<b>493.5</b>

\*For 1,000Kms distance; # Latest available year ('00-03)

Source: World Bank, Wikipedia, Expedia, Mapquest

## Liberalisation in aviation sector – A perspective

**Table 5: Evolution of the aviation sector in India**

Year	Passenger traffic (mn)	Carriers' mkt. share (%)		How has the sector unfolded over the period?
		National	Private	
FY91	7.5	NA	NA	Private airlines allowed in Indian skies as air taxi operators. Several players such as Jet Airways, East West, Modiluft and Air Sahara entered. However, national carriers dominated the market. Little impact on passengers and traffic figures
FY92	8.6	NA	NA	
FY93	7.7	NA	NA	
FY94	7.5	NA	NA	Private airlines granted scheduled status
FY95	7.3	64.6	33.6	Connectivity improved and passenger traffic started rising
FY96	10.4	59.2	37.5	However, several players such as Modiluft and East West went bankrupt and stopped operations by FY97/98, leaving just two private players, Jet and Sahara, by end-FY98
FY97	11.2	65.7	33.2	
FY98	11.5	67.1	31.3	FY98 & FY02 saw no new entrant
FY99	12.0	61.8	36.8	National carriers, Indian and Air India, however, faced threat from Jet and Sahara as their market share fell
FY00	12.7	56.3	41.9	
FY01	13.7	50.8	47.4	Overall traffic figure saw only a modest increase, while air fares remained prohibitive for the ordinary traveller
FY02	12.9	49.0	49.1	
FY03	14.0	43.9	54.1	Entry of LCCs – Air Deccan being the first
FY04	15.7	42.1	56.4	Period from FY02 to FY06 witnessed unprecedented rise in air traffic following cheap air fares and mushrooming LCCs
FY05	19.4	39.7	58.7	Several new players such as SpiceJet, GoAir, IndiGo, Paramount, Kingfisher entered the skies. At least half a dozen players are reportedly waiting to take off
FY06E	25.5	30.0	70.0	Relaxation in norms to allow up to 74% FDI in airlines
<b>What we expect further?</b>				Reduction in ATF taxes
				Easing of infrastructural constraints such as development of airports in tier II cities and secondary airports

Source: DGCA, i-SEC Research

## Apprehensions seem overdone

Despite soaring traffic and LCCs' increasing market share, airline stocks have evoked scepticism. We have addressed a few concerns below.

- **Pricing.** The era of price wars is passé – fares have bottomed out after having plummeted to near negative EBITDAR levels. Even though airfares increased more than Rs750/ticket after March '06, H1CY06 registered a record 50% rise in passenger traffic as against H1CY05. Further, proposal to levy congestion surcharge and restriction of 'discount' tickets to less than 10% of inventory are signs of maturity and stability in the industry.
- **Oversupply.** Barring transient supply pressures due to announced fleet expansion and new entrants, we believe demand growth (28.2% CAGR) will outstrip capacity addition (28.1% CAGR). Capacity addition beyond 60% of announced orders is unlikely given the recent track record (deferral of capacity addition by Air Deccan, repeated deferral of launch by IndiGo, Indus etc). Exceptional growth from tier II cities will further improve the outlook.
- **Rising crude prices.** Indian carriers have successfully passed on the ATF price hike in the form of fuel surcharge, which is unlikely to be significantly reduced in the short term. From here on, only potential upsides such as reduction in taxes on ATF and lower marketing margins with the entry of private players exist.

## Airfares have bottomed out

While low fares help increase air traffic – more so in India's case (30%+ YoY traffic growth in FY06) – we believe airfares have bottomed out after having plummeted to near negative EBITDAR levels.

That the airfares are already on the rise is evident from Table 6. Importantly, even as airfares increased more than Rs750/ticket after March '06, H1CY06 registered a record 50% rise in passenger traffic as against H1CY05.

**Table 6: Airfares on the rise**

From	To	Airfare		Change (%)
		July-06	Nov-06	
Chennai	Hyderabad	1,850	2,031	9.8
Hyderabad	Mumbai	1,950	1,975	1.3
Bangalore	Mumbai	2,625	2,711	3.3
Chennai	Mumbai	3,050	3,073	0.8
Delhi	Mumbai	3,025	3,310	9.4
Delhi	Kolkata	3,124	3,619	15.8
Chennai	Kolkata	3,775	3,835	1.6
Mumbai	Kolkata	3,850	4,335	12.6
Chennai	Delhi	3,723	4,547	22.1

Note: Airfares include fuel surcharge and taxes; cheapest available last day fares on July 15 and November 22, '06.

Source: i-SEC Research

## How much can airfares dip?

An analysis of the cost structure of a low cost airline – SpiceJet – shows that at peak fuel price of US\$76/Bbl, the airline's total cash cost is ~Rs2.80/ASKM, while variable cost is ~2.20/ASKM (Table 7). For an average sector length of 900Kms, airfares cannot go below average ticket price of Rs3,150 or Rs2,475 to cover cash & variable costs respectively.

Table 8 shows that most of the sector fares are close to break-even and hence further downside is unlikely.

**Table 7: SpiceJet – Cost structure**

	FY06	FY07E	FY08E	FY09E
Revenue/ASKM	2.30	2.58	2.80	2.96
Revenue/RPKM	2.69	3.07	3.45	3.60
Variable Costs/ASKM	1.97	2.08	2.22	2.21
Variable Costs ex fuel/ASKM	0.88	0.88	0.91	0.92
Cash Costs/ASKM	2.62	2.64	2.78	2.75
Cash costs ex fuel/ASKM	1.52	1.44	1.47	1.46

Source: Company data, i-SEC Research

**Table 8: Break-even ticket price**

B/E on cash cost	Rs	B/E on variable cost	Rs
Total cash cost (per ASKM)	2.80	Total variable cost	2.20
Load factor (%)	80	Load factor (%)	80
Break-even yield required (per RPKM)	3.50	Break-even yield required	2.75
Average sector length (Km)	900	Average sector length	900
Implied B/E tkt price on avg sector length	3,150	Implied B/E tkt price on avg sector length	2,475
Implied B/E tkt price on BOM-DEL	3,500	Implied B/E tkt price on BOM-DEL	2,750

Source: i-SEC Research

## Promotional fares boost load factor

While promotional offers such as Air Deccan's 3X3 scheme have generated huge concerns, globally LCCs offer a certain share of their seats at heavily discounted fares to fill up vacant seats and generate publicity.

We analyse that while Air Deccan has always offered a share of its overall seats on promotional fares, promotional offers do not significantly affect industry due to their insignificant share in total seats (Table 9).

Air Deccan's current spate of promotional offerings is unlike previous promotions as Rs750/ticket fuel surcharge and Rs50/ticket transaction fee are being charged extra. This helps the airline book higher fares via high fuel surcharge even as ATF prices have eased. Overall, if the earlier promotional offering from Air Deccan at Re1/ticket is compared with the recent offer and fuel surcharge is adjusted, net realisations will be higher.

**Table 9: Air Deccan – 3X3 scheme**

Air Deccan's seat capacity/day during the offer period	27,940
Total seats offered under promotional fares over 92 days	300,000
Seats/day offered by Air Deccan under promotional fares	3,261
Total promotional seats to Air Deccan's capacity (%)	11.7
<i>Of which</i>	
Share of seats on routes with no major competition (%)	40
Seats/day offered on comparable routes	1,957
Total LCC capacity incl. Air Deccan during the period	47,072
<b>Air Deccan's promotional seats on comparable routes to LCC capacity (%)</b>	<b>4.2</b>
Total Industry seat capacity/day (incl. FSCs) during the period	143,712
<b>Air Deccan's promotional seats on comparable routes to industry capacity (%)</b>	<b>1.4</b>

Source: Air Deccan website, i-SEC Research

## Oversupply fears irrational

Increased oversupply concerns have largely been addressed as only a few launches have materialised in the past few quarters and further, announced expansion plans have been curtailed. The following factors underpin our stance:

- Just three LCCs have actually started operations after Air Deccan, despite more than 15 airlines evincing interest. Rest have either indefinitely been deferred or cancelled.

**Table 10: Airlines that announced interest post the launch of Air Deccan**

Air One Feeder	Yamuna	Jagson
Magic Air	Air Dravid	Skylark
East West	IndiGo	Pioneer
Star Air	Go Air	Crescent
Indus Air	SpiceJet	Easy Air

Source: Media reports

- Expansion plans by existing players have been significantly revised following realisation that a phased expansion is more appropriate. Importantly, new LCC players (SpiceJet, GoAir and IndiGo) have added <20 aircraft between May '05 and October '06, while Air Deccan alone added >25 aircraft.
- Airlines have started rationalising routes – Air Deccan cut down on loss making sectors such as the Mumbai-Nasik. We believe such a rationalisation will prevail across the board and airlines will choose their expansion strategy with much care.
- Track record of airlines in the past 12-15 months suggests that only about 60% of announced fleet addition from new players will materialise as against existing players such as Jet and SpiceJet (they have already revised expansion plans). Based on the current standing of various airlines, we forecast an investment of about US\$4.2bn by FY09E (Table 11).

**Table 11: Expected purchase value of aircraft**

(US\$m)

Purchase value	FY07E	FY08E	FY09E	Total till FY14E	Announced Purchase Value
Indian	111	370	296	1,517	2,590
Jet Airways	77	270	193	539	539
Air Sahara	-	116	39	193	385
Air Deccan	75	250	125	900	1,500
Kingfisher	-	175	150	925	1,650
SpiceJet	77	308	231	924	1,001
Paramount	30	30	15	90	150
GoAir	39	116	116	385	655
East West	-	77	116	924	1,540
Easy Air	-	39	39	116	193
IndiGo	116	347	270	1,964	3,658
Indus	-	50	50	125	225
Jagson Airways	-	-	-	-	770
Star Air	-	-	-	-	-
<b>Total</b>	<b>524</b>	<b>2,146</b>	<b>1,637</b>	<b>8,601</b>	<b>14,855</b>

Source: Respective company data, i-SEC Research

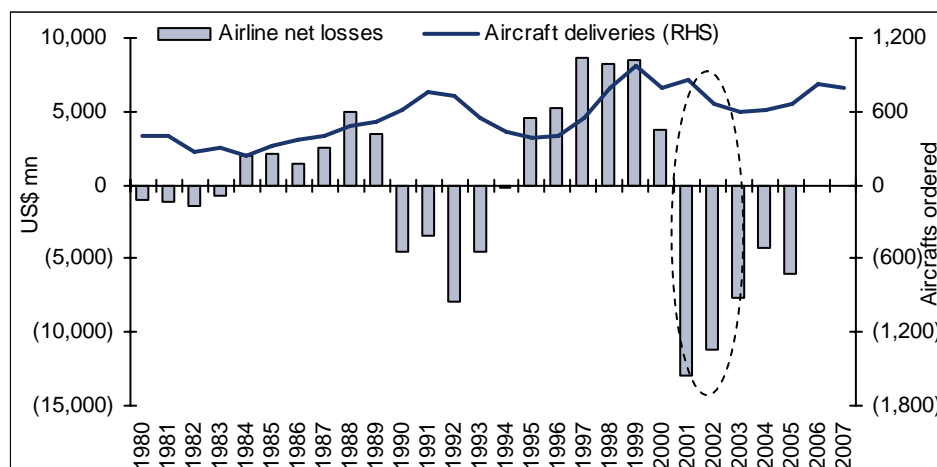
- CAPA estimates that almost 30% of the orders (across all carriers) will turn out to be replacement orders. We have conservatively assumed only 11% of the orders as replacement orders.
- Capacity might be diverted from domestic to international routes by players such as Air Deccan and IndiGo as the Government is considering relaxing restrictions



in international operations. At present, regulations prohibit airlines with less than five years experience to fly international.

- Similarly, optimisation will be achieved as airlines are planning to diversify into cargo operations using already ordered planes. Air Deccan and IndiGo have already announced plans to enter the cargo business; Jet Airways is also planning to follow suit.
- International experience shows that the impact of rising aircraft deliveries is transient on industry profitability (Chart 12). We anticipate a similar cycle in India, where the growth in aircraft deliveries is expected to peak in FY08E.

**Chart 12: Rising deliveries have transient impact on industry profitability**



Source: IATA

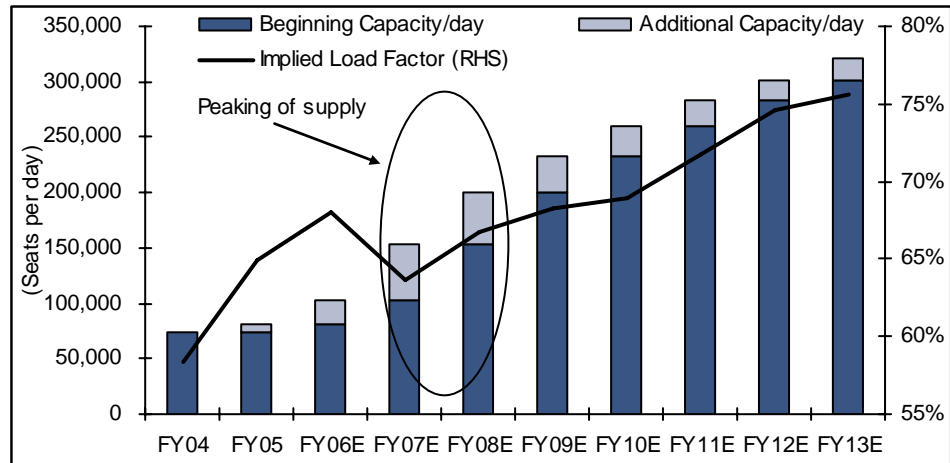
**Table 12: Fleet size of Indian carriers – Current & announced**

	Current Domestic Fleet	Announced aircraft orders	Total fleet post addition	Time frame	Expected Operations	Announced Purchase Value (US\$m)	Type
<b>Operating</b>							
Indian	52	70	122	2010	Operational	2,590	Airbus
Jet Airways	50	14	64	2010	Operational	539	Boeing
Air Sahara	22	10	32	2010	Operational	385	Boeing
Air Deccan	40	60	100	2014	Operational	1,500	Airbus/ATR
Kingfisher	21	66	87	2010	Operational	1,650	Airbus/ATR
SpiceJet	9	26	35	2011	Operational	1,001	Boeing
Paramount	3	10	13	2010	Operational	150	Embraer
GO Air	7	17	24	2009	Operational	655	Airbus
Indigo	5	95	100	2012	Operational	3,658	Airbus
Indus	1	9	10	2008	Operational	225	CRJ
<b>Yet to launch</b>							
East West	-	40	40	2010	2007	1,540	Airbus
Easy Air	-	5	5	2010	Apr-07	193	Airbus
Jagson Airways	3	20	23	NA	2007	770	Airbus
Star Air	-	NA	NA	NA	2007	-	Airbus
<b>Total</b>	<b>213</b>	<b>442</b>	<b>655</b>	<b>2014</b>		<b>14,855</b>	

\* Currently, operates as a non-scheduled operator

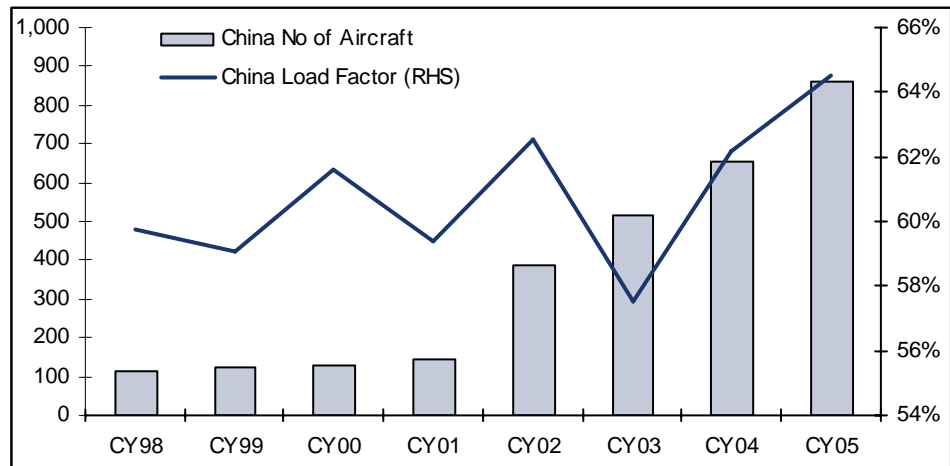
Source: Respective company data as of August '06, i-SEC Research

**Chart 13: Supply addition to peak in FY08**



Source: i-SEC Research

**Chart 14: China – Increasing load factor despite growing fleet**



Source: CAPA, Airbus, IATA, i-SEC Research

India's forecasted supply-load factor curve correlates with the curve witnessed in China

While China's fleet grew over 3.5x from less than 200 in 1998 to more than 900 by '05, the overall load factor also rose

**Table 13: China versus India – Per annum aircraft additions**

No. of aircraft	FY02	FY03	FY04	FY05
China	240	130	137	210
	FY07E	FY08E	FY09E	FY10E
India - Base case	12	53	36	31

Source: CAPA, Airbus, IATA, i-SEC Research

**Funding non-performers increasingly difficult**

While some players such as SpiceJet have successfully financed their expansion plans, other such as Jet, Air Deccan and Kingfisher are constantly exploring newer methods to generate cash. Increased scepticism for non-performers has also meant difficulty in financing from primary equity markets – Jet and Kingfisher indefinitely delayed their plans to tap equity/quasi equity market. While Jet had planned a US\$800mn offering, Kingfisher was aiming at a US\$200mn IPO.

As discussed earlier, 14 airlines, including the existing nine players, have announced plans to acquire ~500 aircraft in the next 7-8 years, of which the majority will come in the next three years. At announced purchase value level, this would require at least US\$15bn funding.

Even the referred sale and leaseback route has been used in plenty by existing and new carriers. Though lessors do not stand to loose as they can hold back the financed aircraft upon default, stable rental is the primary objective. Hence, as airlines continue to bleed, fund availability, both direct and indirect, has become increasingly difficult for non-efficient players. However, carriers that demonstrate optimal use of capital as well as lower cash-burn through rational pricing and cost efficiency would be the pick of the lot.

### Tier II cities to fuel next growth phase

Growth from tier II cities is expected to outpace the industry-wide growth at >28.2% CAGR in the next three years (Table 14 and 15). This exceptional growth will be further helped by capacity and infrastructure constraints at tier I airports.

The potential from tier II cities is not factored in the industry's rule of thumb that air traffic grows at 2x GDP (current rate of 8-9%). Since, the current infrastructure at tier I airports cannot sustain a traffic growth rate of more than 20% per annum, we expect smaller cities to fuel the next phase of growth.

Further, even as most carriers have expanded into top-10 airports (impressed by their stable 85% traffic share through FY99-FY06; Table 16) infrastructure development in these airports has lagged behind traffic and capacity growth (Annexure I), especially Delhi, Mumbai and Bangalore. The traffic congestion in metro routes is further highlighted in Table 17 that shows that almost 25% of the total domestic aircraft movement in the country is between top-6 metros.

**Table 14: Smaller cities growing faster than metros...**

Airports	CAGR (%) FY99/FY06	Airports	Growth (%) FY05/FY06
Amritsar	45.8	Pune	53.0
Chandigarh*	37.7	Ahmedabad	46.8
Raipur*	33.5	Coimbatore	46.7
Cochin	24.0	Raipur	42.1
Srinagar	22.1	Hyderabad	40.4
Hyderabad	16.7	Amritsar	40.0
Pune	16.6	Bangalore	37.5
Bangalore	16.0	Nagpur	35.5
Port Blair	15.8	Goa	32.2
Lucknow	14.6	Delhi	27.0
<b>Average</b>	<b>24.3</b>	<b>Average</b>	<b>40.1</b>

Note: \*Chandigarh's and Raipur's CAGRs are for FY03-06 & FY04-06 respectively.

Source: CAPA, AAI, Ministry of Civil Aviation, i-SEC Research

**Table 15: ...which is also reflected in mobile subscriber adds**

	# of subscribers Mar '00	Share in All India (Mar '00) (%)	# of subscribers Mar '06	Share in All India (Mar '06) (%)	CAGR FY01-06 (%)
Delhi	332,330	17.6	8,872,361	9.0	72.9
Mumbai	319,309	16.9	8,114,246	8.2	71.5
Chennai	54,256	2.9	3,296,988	3.3	98.3
Kolkata	90,036	4.8	3,538,200	3.6	84.4
All Metros	795,931	42.2	23,821,795	24.1	76.2
Non-Metros	1,088,380	57.8	74,989,672	75.9	102.5
A' Circle	585,653	31.1	34,845,555	35.3	97.6
B' Circle	460,094	24.4	32,282,985	32.7	103.1
C' Circle	42,633	2.3	7,861,132	8.0	138.6
All India	1,884,311	100.0	98,811,467	100.0	93.5

Source: TRAI

Mobile subscriber growth in non-metros has outpaced growth in metros over the past six years

**Table 16: ABC analysis points to traffic concentration in metros***Market share (%)*

Airports	FY99	FY05	FY06	CAGR
Top 5	72.84	70.33	70.20	9.7
Top 10	84.94	84.05	84.74	10.2
Top 25	94.51	93.52	94.06	10.1
Rest	5.49	6.48	5.94	10.3

Source: CAPA, AAI, Ministry of Civil Aviation, i-SEC Research

**Table 17: Top-six metros account for 25% of total departures**

# of flights	Mumbai	Delhi	Bangalore	Kolkata	Chennai	Hyderabad
Mumbai	-	54	26	15	19	13
Delhi	54	-	20	16	16	11
Bangalore	26	20	-	8	21	14
Kolkata	15	16	8	-	6	6
Chennai	19	16	21	6	-	13
Hyderabad	13	11	14	6	13	-
<b>Total</b>	<b>127</b>	<b>117</b>	<b>89</b>	<b>51</b>	<b>75</b>	<b>57</b>
Total daily domestic departures between six metros						516
Total daily domestic departures (country-wide)						2,097
Share of departures between six metros (%)						24.6

Source: Excel air service time table, i-SEC Research

## Upside from infrastructural & regulatory changes

**Secondary airports will help reduce costs for LCCs.** While traffic at key airports such as Mumbai, Delhi and Bangalore exceeds their rated capacity, upside will come from development of secondary airports. Industry sources point out that secondary airports for LCCs are planned in Delhi and Hyderabad, while an additional airport is coming up at Navi Mumbai.

**Table 18: Capacity crunch at the country's busiest airports***(mn)*

Airport	Traffic			FY06 Traffic/Capacity (x)
	FY05	FY06	Rated capacity*	
Mumbai	15.7	18.4	10.0	1.84
Delhi	12.8	16.2	8.4	1.93
Bangalore	4.1	5.7	3.6	1.57

\* Rated capacity is prior to privatisation of the airports.

Source: CAPA, Wikipedia, i-SEC Research

**Proposal to raise entry barriers.** The Ministry of Civil Aviation has hinted at raising the entry barriers for airlines. This will help ailing carriers. Notably, such a move will deter fly-by-night operators and benefit all committed players in the medium term by avoiding unwanted competition.

**Shortage of pilots, only an immediate concern.** Recent CAPA estimates show that India accounts for 23% of total pilot requirements (>11,000). At present, the airlines are sourcing bulk of their pilot needs from the US where there is no shortage of pilots willing to work in India. However, CAPA suggests that with mushrooming pilot training schools in the country, the situation is set to improve in coming years. This would also mean a reduction in the employee cost. As per industry sources, foreign pilots are paid more than twice their Indian counterparts.

## ATF price reforms

### High incidence of taxes – Rationalisation, a huge positive

The Government is considering proposals recommended by the Investment Commission (headed by Mr. Ratan Tata, Chairman, Tata Group) to lower taxes on ATF to international levels. The New Civil Aviation Policy (Annexure 1), which is proposed to be implemented soon also addresses high incidence of taxes on ATF.

At present, fuel prices in India are high mainly due to high incidence of ATF taxes. On an average, total taxes on ATF consumed for domestic operations is as high as 66%, while international airlines filling in India is taxed at just 8% (Table 19).

Amidst talks of proposed measures to ensure the industry's survival, we analyse how reduction in sales tax and customs rates could influence profitability. We expect 500bps & 200bps reduction in sales tax & customs rate respectively to save ~Rs45bn for the airline industry by FY09E (Annexure 3).

**Table 19: Tax structure on ATF**

	Amount (Rs/Kl)		Mark up as a % of base price	
	ATF (Domestic)	ATF (Intl)	ATF (Domestic)	ATF (Intl)
Base Price* (Rs/Kl)	23,711	23,711	23,711	23,711
Import Duty	2,418	2,418	8	8
Excise	2,143	-	9	0
Marketing Margin	5,654	5,654	24	24
Sales Tax & Surcharge	11,603	-	49	0
<b>Effective Total Taxes</b>	<b>16,164</b>	<b>2,418</b>	<b>66.2</b>	<b>8.2</b>
Retail Price (Rs/Kl)	45,529	31,784	45,529	31,784

Note: \*Based on international crude price at US\$76/Bbl and US\$/rupee rate of 46.30

Source: i-SEC Research

### ATF prices to reduce with the entry of private players

Entry of private players in ATF marketing is expected to reduce the high margins (in the range of 20-25%) charged by oil marketing companies at present. Airlines would benefit from discounts or negotiated bulk deals. Other indirect benefits could come as increased credit period, thus allowing them to enjoy cash float. While airlines expect marketing margins to fall 1,000bps by FY09E, calculations show that such a reduction would help neutralise crude price spike of up to US\$7/Bbl on our base case assumption of US\$76/Bbl.

In the initial stages, the Government plans to allow private players for marketing ATF at smaller airports. Reliance Industries has already received the approval. Due to infrastructure constraints, it would take some time before private players commence operations, but, we believe, marketing margins would reduce 500-1,000bps with the entry of private players.

### Prohibition on fuel hedging likely to be phased out

The Government of India recently allowed Indian carriers to hedge a fraction of their fuel requirements for international operations; prohibition on hedging for domestic operations still continues. Following the recent meeting with the Aviation Minister and the formation of Federation of Indian Airlines (FIA), the Government is now planning to remove restriction on hedging for domestic operations, too.

Benefits from fuel hedging have been evident as two of the best global LCCs have been profitable during the past few quarters mainly on account of gains from fuel hedging (Table 20). Further, but for fuel hedging, Southwest would have been a loss making company in the quarter ended September '06.

**Table 20: Profitability from hedging gains**

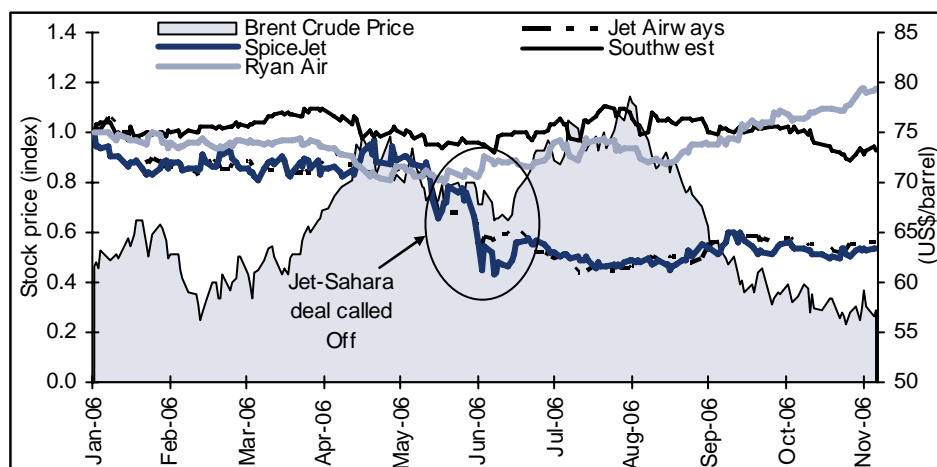
<b>Southwest</b>	<b>Jun-05</b>	<b>Sep-05</b>	<b>Mar-06</b>	<b>Jun-06</b>	<b>Sep-06</b>
Profit before Taxes	256	368	96	515	78
Hedging Gains	196	276	116	198	201
PBT ex. hedging gains	60	92	(20)	317	(123)
<b>Ryan Air</b>	<b>Sep-05</b>	<b>Dec-05</b>	<b>Mar-06</b>	<b>Jun-06</b>	<b>Sep-06</b>
Profit before Taxes	194	42	32	130	246
Hedging Gains	9	27	33	2	10
PBT ex. hedging gains	185	15	(0)	129	236

Source: Bloomberg, i-SEC Research

### Crude price hike offset by fuel surcharge

Market reaction to rising crude prices was exaggerated even as fuel surcharge at current levels offset the rise. While international carriers' stock prices recovered from the lows (following easing crude prices), Indian carriers improved just marginally.

**Chart 15: Domestic players – Exaggerated reaction to rising fuel prices**

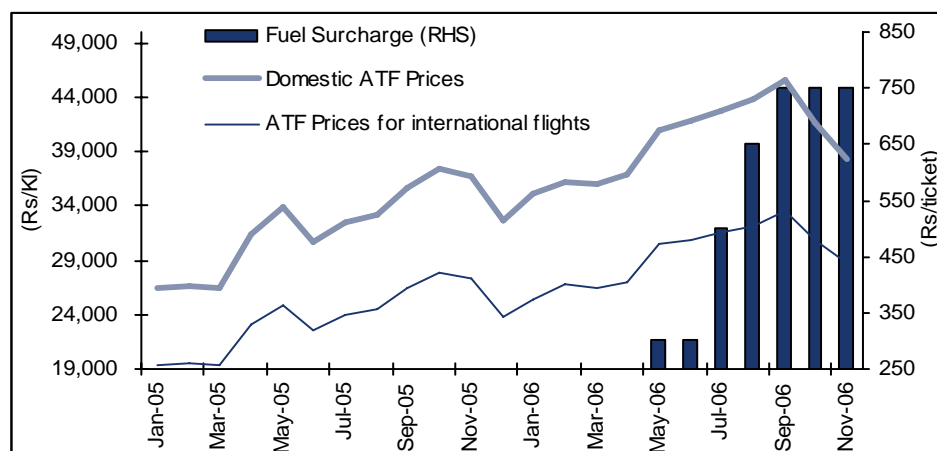


Source: Bloomberg, i-SEC Research

### Fuel surcharge – A tested way to pass on the ATF hike

Current levels of fuel surcharge (Rs750/ticket) more than offset the rise in crude prices from US\$40/Bbl in May '04 to US\$76/Bbl in September '06. We believe that fuel surcharge is now being used to increase the airline's average yield realisation, especially in the backdrop of intensifying competition, wherein a direct increase of the base fare is difficult.

Our sensitivity analysis (Table 21) suggests that crude price rise from US\$40/Bbl in should have led to a fuel surcharge of Rs550/ticket. However, most airlines levied fuel surcharge (Chart 16) only from March '06 (crude price at US\$62/Bbl), which rose to Rs750/ticket in September '06 (crude price at US\$76/Bbl).

**Chart 16: Fuel surcharge at current levels covers rise in ATF price**

Source: Indian Oil Corporation, Jet Airways

**Table 21: Fuel cost per passenger**

Average block hour per departure	1.7
Average fuel burn per block hour (Kl)	2.9
Total fuel consumption per departure (Kl)	4.93
Fuel cost per departure at crude price of US\$40/Bbl (Rs)	133,110
Fuel cost per passenger at US\$40/Bbl crude (Rs)	880
Fuel cost per departure at crude price of US\$76/Bbl (Rs)	216,920
Fuel cost per passenger at US\$76/Bbl crude (Rs)	1,435
Total increase in fuel cost per passenger (Rs)	554
Current fuel surcharge (Rs)	750
Aircraft seat capacity assumed	189
Load Factor assumed (%)	80
No. of passengers sharing fuel burden	151

Source: i-SEC Research

**Fuel surcharge likely to remain**

Despite the recent fall in crude prices, we believe that airlines would not cut fuel surcharge until crude prices stabilise below US\$60/Bbl for at least 4-5 months. Invariably, all carriers (both FSCs & LCCs) have resisted the temptation to reduce fuel surcharge despite falling ATF prices since October '06. Notably, OMCs have already cut ATF prices by 18% since October 1, '06.

Even if airlines eventually resort to price cut (in the form of lower fuel surcharge) post crude price stabilising at US\$60/Bbl level, it would be moderate due to the following reasons:

- Customers are accustomed to fuel surcharge at current levels (evidenced by ~50% passenger growth in H1CY06 despite fuel surcharge). Majority of decisions are taken on base fares offered by the airlines. Lower base fares help attract greater interest. Airlines forced to adopt innovative marketing strategies would hence keep their base fares lower and levy other surcharges such as fuel surcharge, transaction fee etc.
- LCCs usually plan their strategy in advance such as Air Deccan's recent scheme of offering tickets for base fares in the range of Rs3-9 plus fuel surcharge and taxes. However, like other forward sales, the fuel surcharge is payable to the airline in advance even if the actual fuel prices fall later. As discussed later, this is clearly a strategy to improve yields and substantiates our belief that fares have bottomed out.

- We estimate that the current fall in crude price (almost 15% from the peak of US\$76/Bbl corresponding to ATF price of ~Rs45,000/KL) would justify a ~Rs200/ticket reduction in fuel surcharge to sustain EBIT margin. This is based on an average stage length of 850Kms per departure and fuel cost (FY06) of Rs1.10/ASKM for SpiceJet and Rs1.36/ASKm for Jet Airways.

On the other hand, if crude prices were to increase to US\$80/Bbl, calculations based on above assumptions show that fuel cost per passenger would increase about Rs130-140/ticket. Given that airlines are already charging surcharge, which is higher than the actual increase in fuel price, we believe the current level of fuel surcharge would stay even at US\$80/Bbl. In our view, the LCC story remains intact even at higher crude prices of US\$80/Bbl.



## LCC model – Will it work in India?

### Pure LCCs have been profitable on a sustained basis

Globally, LCCs have outperformed FSCs (Annexure 2), both on operational parameters and RoE (which has been consistent and sustained). However, only companies following the pure LCC model – AirAsia, RyanAir – have delivered above-average returns. Table 22 shows that LCCs across the globe have delivered sustained profitability. Southwest and RyanAir – two of the world's best LCCs – have delivered RoE in excess of 15% on a sustained basis (Chart 17). While, Southwest saw a slight deterioration post 9/11, FY06 has been resurgent.

Such a profitable growth story can be emulated in India if the model is followed in its entirety. The main features of this concept are:

- Single aircraft type, which would help reduce maintenance as well as pilot costs
- Any service on board is chargeable; this is an additional revenue stream
- Point-to-point service with high frequencies
- No interline agreements or code-sharing arrangement
- Web-based reservation and distribution service
- Quick turnaround time for higher asset utilisation (25minutes)
- High asset utilisation; Brazil's GOL achieved 14 block hours/day
- Lean staffing and high employee productivity (multi-tasking)
- Alternate revenue streams such as hotel bookings, car rentals etc

**Table 22: Best LCCs have been profitable on a sustained basis**

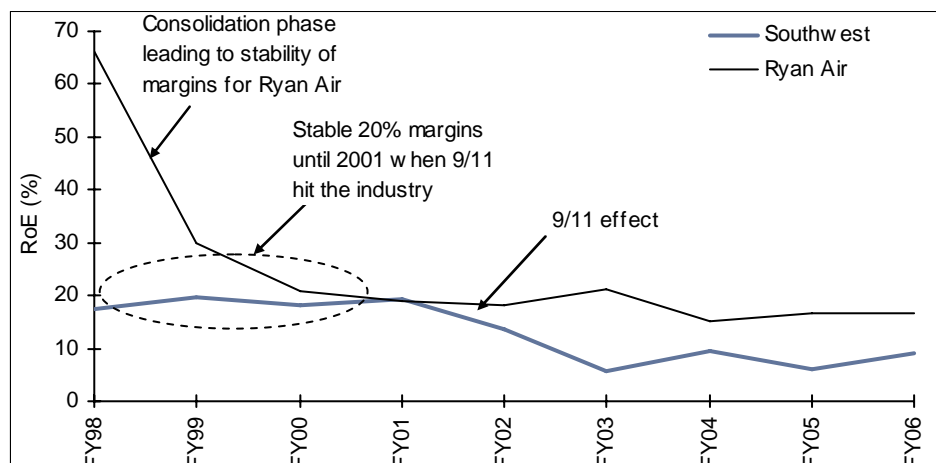
(All figures in %)

Southwest	FY04	FY05	FY06	Average	Comments
RoE	9.3	5.9	9.0	8.1	Though RoE shows a mixed trend, the airline has posted consistent double-digit RoE pre-9/11 (Chart 17). Margins have been resurgent in FY06
Load factor	66.8	69.5	70.7	69.0	
EBITDA Margin	14.6	15.1	17.0	15.6	
Net Margins	7.4	4.8	7.2	6.5	
<b>RyanAir</b>					
RoE	15.3	16.8	16.5	16.2	Stable RoE in excess of 15% and high EBITDA margin; boasts of the best load factor and highest net margin
Load factor	74.0	84.0	83.0	80.3	
EBITDA Margin	34.1	31.9	28.5	31.5	
Net Margins	19.2	20.0	18.1	19.1	
<b>AirAsia</b>					
RoE	49.2	20.2	12.4	27.3	Lowest cost operator in the industry; consistently high EBITDA margin. Exceptionally high RoE now stabilising to ~15%
Load factor	77.0	75.0	78.0	76.7	
EBITDA Margin	18.6	24.1	25.1	22.6	
Net Margins	12.5	16.7	14.8	14.7	
<b>Virgin Blue</b>					
RoE	40.4	24.0	12.2	25.5	Stable EBITDA margin, leader in the region. Has delivered exceptional RoE in the past and expects to maintain the momentum.
Load factor	82.6	76.8	77.0	78.8	
EBITDA Margin	19.5	14.2	14.6	16.1	
Net Margins	12.2	6.8	6.4	8.5	

Note: Fiscal year end-March for RyanAir & Virgin Blue, December for Southwest & June for Air Asia.

Source: Respective company filings, Bloomberg, i-SEC Research

**Chart 17: Double-digit returns for true LCCs**



Source: Bloomberg

**Profitability comparable between LCC and FSC**

For the purpose of illustration (Table 23), we present a hypothetical comparison between LCC and FSC models. We have assumed denser seating and higher load factor for LCC, while the average revenue per passenger is assumed to be 44% lower than that of the FSC. On the cost side, landing charges and maintenance costs are assumed to be constant at the absolute level. The LCC model has lower in-flight entertainment passenger costs, distribution costs as well as other costs (city office costs, loyalty programs, business lounges and staffing costs) as compared with the FSC. The LCC model, thus, by charging lower fares stimulates demand by cutting down on frills.

Notably, LCC match the overall profitability of an FSC with higher utilisation of aircraft on an annualised basis (Table 24), even as their absolute profits per departure are slightly lower than that of FSCs.

**Table 23: LCC model delivers similar profitability as FSC...**

	LCC		Full Service		% variance		Comments
	Total	Per seat	Total	Per seat	Total	Per seat	
Seats		189		154			For a typical Boeing 737-800
Loads %		80		70			Low fares stimulate higher load factor
Paid Seats		151		108			
Avg. Revenue (Rs)	468,720	3,100	592,900	5,500	(20.9)	(43.6)	Blended average of economy and business for FSC
Ancillary revenue (Rs)	46,872	310	41,503	385	12.9	(19.5)	10% of Pax revenue for LCC; 7% for FSC
Total revenue (Rs)	515,592	3,410	634,403	5,885	(18.7)	(42.1)	
Fuel (Rs)	212,148	1,403	200,070	1,856	6.0	(24.4)	LCCs can burn higher fuel because of higher load factor, which means higher weight carried.
Staff cost (Rs)	47,628	315	77,616	720	(38.6)	(56.3)	Lower staff count and higher utilisation.
Lease rental/Dep/Int (Rs)	96,957	641	96,957	899	-	(28.7)	
Inflight (Rs)	2,268	15	18,865	175	(88.0)	(91.4)	No frills in-flight service
Landing (Rs)	30,000	198	30,000	278	-	(28.7)	No difference when flying to same airport and same aircraft type
Maintenance (Rs)	41,998	278	41,998	390	-	(28.7)	No difference since cost depends on hours of usage
S&D Costs (Rs)	23,436	155	78,856	732	(70.3)	(78.8)	Lower marketing expense and higher share of online sales
Other Costs (Rs)	13,608	90	29,645	275	(54.1)	(67.3)	Lower administrative costs etc.
Total Costs (Rs)	468,043	3,096	574,007	5,325	(18.5)	(41.9)	
PBT (Rs)	47,549	314	60,396	560	(21.3)	(43.9)	
PBT Margin (%)	9.2	9.2	9.5	9.5	(3.1)	(3.1)	

Source: i-SEC Research

**Table 24: ...due to higher utilisation of aircraft**

	LCC		FSC	
	Annual	Daily	Annual	Daily
Total departures/per aircraft	2,639	7.2	2,135	5.8
PBT per aircraft (mn)	125	0.3	129	0.4
Revenue per aircraft (mn)	1,237	3.4	1,266	3.5
PBT Margin %	10.1	10.1	10.2	10.2

Source: i-SEC Research

## Margin expansion will be helped by cost reduction

### Costs set to reduce significantly as critical fleet size is achieved

Cost per unit is set to decline for efficient LCCs once critical fleet size is achieved with consequent margin expansion (Table 25). At present, LCCs in India are not profitable as they are ramping-up. They have smaller fleets and therefore rapid fleet addition puts substantial pressure on the profitability. In contrast, global airlines have been profitable due to their size. The case in point is Brazil's GOL, which in its very first year had a fleet size of 12 Boeing aircraft. As the fleet size of Indian LCCs increases, we expect them to reap benefits from economies-of-scale and spreading of overheads over a larger base of revenues.

Post the delivery of an aircraft, airlines have to take the necessary regulatory approvals until which the aircraft is grounded. Subsequently, they have to invest in route development, where the aircraft has to be deployed, apart from promotional expenses. Airlines also incur significant employee expenses (hiring in-flight crew, pilots and engineers) before fleet expansion. These start-up costs account for almost 8-10% of the total costs. Indian accounting standards do not allow amortisation of start-up costs and require charge-off in the same year as expensed.

**Table 25: Cost declines with an expanding fleet size**

SpiceJet	FY06	FY07E	FY08E	FY09E
Fleet at end of period (nos.)	6	11	19	25
Total Operating Cost ex Fuel (Rs/ASKM)	1.63	1.55	1.54	1.52
Break even Load Factor (%)	102	90	83	78
Cash Break even Load Factor (%)	97	86	80	76
	<b>SpiceJet</b>	<b>Air Deccan</b>	<b>Go Air</b>	<b>IndiGo</b>
Current load factor* (%)	86	75	60	77

Note: \* Latest fiscal year available; June '06 &amp; September '06 for Go Air &amp; IndiGo respectively

Source: DGCA, Company filings, Media reports for IndiGo, i-SEC Research

### Cost benefit from regulatory changes

Fuel costs, airport charges and maintenance costs are 40-50% higher in India than the global average, due to unfavourable regulatory policy. We expect these costs to come down (such as the mobile telephony market – regulatory fees such as licence fees were slashed after a lag, post the opening up of the sector). Remarkably, Indian carriers are at an advantageous position on costs other than these parameters such as staff costs due to the service advantages that India holds over global peers (Table 26).

**Table 26: India compares favourably as regards costs ex fuel**

Cost Pie (Rs/ASKM)	Spice Jet	Southwest	Jet Airways	British Airways
Salaries & Wages	0.44	0.97	0.43	1.29
Fuel	1.09	0.64	1.26	0.90
Maintenance MRO	0.19	0.15	0.23	0.26
Landing fees	0.19	0.16	0.26	0.63
Aircraft Financing charges (Depreciation, Rental, interest)	0.60	0.25	0.81	0.58
Other Opex	0.21	0.41	1.07	0.77
<b>Total Operating Cost</b>	<b>2.72</b>	<b>2.57</b>	<b>4.07</b>	<b>4.43</b>
<b>Total Operating Cost ex Fuel</b>	<b>1.63</b>	<b>1.93</b>	<b>2.81</b>	<b>3.53</b>

Source: Company filings, i-SEC Research

**Ancillary revenues to lower required break-even load factor**

While globally LCCs have supplemented their revenue stream from ancillary businesses such as online hotel booking, car rentals, insurance etc, Indian carriers are yet to take-off on this in a big way. We foresee a high focus on the ancillary revenue stream by the LCCs in the future as successful LCCs have been able to generate almost 15% of their revenues from such ancillary businesses (Table 27).

In India, ancillary revenue stream, such as online hotel booking, has been successfully tapped by portals – makemytrip.com and travelguru.com, suggesting tremendous scope for LCCs also. Importantly, these businesses offer high margins, while the investment is low and rather fixed in nature.

**Table 27: Sources of ancillary revenue**

	AirAsia	EasyJet	Southwest	RyanAir	SpiceJet FY06	SpiceJet FY09E
Ancillary Revenue (% of Pax revenues)	7.7	9.4	3.6	15.3	4.7	7.0
Courier	✓		✓	✓	✓	✓
Car Rentals	✓	✓		✓		✓
Hotel/Holiday Bookings	✓	✓		✓	✓	✓
Travel Insurance		✓		✓		
Sale of Food	✓	✓				
Web Gambling				✓		

Source: Company filings and websites

**Key milestones**

**Capacity rationalisation.** Lower-than-announced fleet expansion in the next two quarters will signal that capacity addition is slowing down and would match demand growth rather than outpace it. Entry into cargo and international operations by existing players such as Air Deccan and IndiGo will also imply capacity diversion from domestic operations. Overall, this will lead to improved load factors for the industry.

**Improvement in yields.** If the LCCs can register an improvement in average fare realisation during the upcoming lean season (quarter ending March '07) as against the worst quarter (ended September '06), it will clearly signal that the worst is over for the LCCs and that the fares have bottomed out.

**Constraints on funds availability.** Constraint on funding for inefficient carriers will ensure that unwanted competition would remain at bay, while serious carriers would continue to reap benefits from the sector growth.

## Valuations – SpiceJet, our pick in the sector

We initiate coverage on SpiceJet and Jet Airways with BUY and HOLD ratings respectively. SpiceJet stands out as it provides a play on the true LCC model. After correcting from a high of Rs84/share in May '06, the stock presents a buying opportunity at current market price of Rs53.

Globally, LCCs command premium valuation over FSCs as evidenced by higher EV/EBITDAR and market cap/sales multiples. LCCs trade at an average 2.8x market capitalisation/sales (actual), 15.2x EV/EBITDAR (actual) and US\$65mn EV/fleet, while FSCs trade on average multiples of 0.8x, 7.9x and US\$74mn respectively.

LCCs' premium valuations are justified because of the sustainability of the business model and greater reach among the masses. A comparison between SpiceJet (LCC) and Jet Airways (FSC) with global peers is presented in Table 28.

**Table 28: Global airline industry – Valuations**

Airline	Current Price	Current mkt. Cap (US\$mn)	Aircraft	EV/ Fleet (x)	EV/ EBITDAR (x)	Mkt. Cap / Sales (x)	EBITDAR Margin (%)	YTD Return (%)	% Return Since May 10, 2006
<b>LCCs</b>									
SpiceJet Limited	53.5	562	9	62.4	174.5	2.3	3.4	(52.1)	(47.9)
GOL	63.5	5,950	50	119.0	12.4	3.9	31.9	6.9	(14.3)
RyanAir	9.6	10,588	87	121.7	15.2	4.4	31.3	(3.6)	14.1
JetBlue	13.8	6,509	92	70.7	28.9	1.2	11.2	(24.8)	10.7
Southwest Airlines	15.6	12,478	445	28.0	8.7	1.5	17.6	9.1	8.2
AirAsia	1.5	1,224	41	29.8	18.9	4.3	28.3	(19.5)	(26.4)
easyJet	602.0	4,269	109	39.2	10.8	1.7	14.3	18.3	28.9
<b>Average</b>				<b>68.1</b>	<b>15.8</b>	<b>2.8</b>	<b>19.5</b>	<b>(2.3)</b>	<b>3.5</b>
<b>Full Service Carriers</b>									
Jet Airways	653.6	1,262	55	50.6	9.1	1.0	23.9	(55.2)	(47.0)
Singapore Airlines	15.8	12,651	90	154.6	7.6	1.5	21.3	2.4	(12.2)
Lufthansa	20.0	12,116	254	66.0	5.6	0.7	16.2	15.9	(3.3)
Cathay Pacific	18.7	9,440	95	135.6	10.2	1.4	19.3	1.6	2.4
British Airways	503.8	11,185	284	14.4	5.2	0.7	18.0	15.8	14.5
Qantas Airways	5.1	7,872	200	58.7	6.4	0.7	17.2	(25.1)	(10.6)
Air France-KLM	30.2	10,744	383	86.9	7.6	0.4	15.6	5.6	3.6
Air China Limited	3.9	6,718	176	74.0	10.4	1.5	27.5	19.6	(18.1)
Continental Airlines	42.0	3,783	360	50.4	14.2	0.3	11.4	30.7	(8.2)
<b>Average</b>				<b>80.1</b>	<b>8.4</b>	<b>0.9</b>	<b>17.0</b>	<b>5.1</b>	<b>(3.4)</b>

Source: Company filings, Bloomberg, i-SEC Research

**Table 29: Peer group trading multiples – LCCs**

	SpiceJet	Air Asia	EasyJet	GOL	JetBlue	RyanAir	Southwest	Average
Current Price (Local Currency)	53.5	1.5	602.0	63.5	13.8	9.6	15.6	
Enterprise Value (US\$ mn)	562	1,224	4,269	5,950	6,509	10,588	12,478	
CY07E EV/EBITDAR (x)	-	10.2	37.9	8.5	11.2	19.2	6.0	15.5
Implied 1-yr forward FY08E @ CMP	6.5							
Implied 1-yr forward FY08E @ Target price	7.5							

\* Last twelve reported months

Source: Respective company data, Bloomberg, i-SEC Research

**Table 30: Peer group trading multiples – FSCs**

	Jet Airways	SIA	Lufthansa	Cathay Pacific	British Airways	Qantas	Air France	Air China	Average
Current Price (Local Currency)	653.6	15.8	20.0	18.7	5.0	5.1	30.2	3.9	
Enterprise Value (US\$ mn)	2,783	13,918	16,775	12,878	4,087	11,737	33,295	13,029	
CY07E EV/EBITDAR (x)	-	6.3	8.5	7.5	4.5	3.4	11.1	7.8	8.2
Implied 1-yr forward FY08E @ CMP	7.5								
Implied 1-yr forward FY08E @ Target price	7.4								

Note: \* Last twelve reported months

Source: Respective company data, Bloomberg, i-SEC Research

## Annexure 1: Industry overview

The importance of civil aviation in the growth of the economy cannot be overemphasised. In value terms, 35% of the exports are transported by air and 97% of foreign tourists arrive in India by air. The International Civil Aviation Organisation (ICAO) estimated that every US\$100 spent on air transport produces benefits worth US\$325 for the economy; 100 additional jobs in air transport results in 610 new economy-wide jobs. The ICAO study attributes over 4.5% of global GDP to the air transport component of civil aviation. Another study (National economic Impact on Civil Aviation, July '02) on the impact of civil aviation on the US economy in '02, using a variety of economic multipliers encompassing the direct, indirect and induced effects on related industries for which civil aviation provides an enabling function, estimated a 9% share of civil aviation in GDP, amounting to about US\$900bn and 11mn jobs. Worldwide, tourism accounts for 10.2% of the GDP, while in India, it is just 4.8% as noted by the Naresh Chandra Committee report on Civil Aviation.

### Government and regulators

In India, the Ministry of Civil Aviation is responsible for the formulation of national policies and programmes for the development and regulation of Civil Aviation. The ministry along with important bodies – Bureau of Civil Aviation Security (BCAS) and Directorate General of Civil Aviation (DGCA) – is responsible for the enforcement of regulations. Another important body is the Airports Authority of India, which manages most operational airports.

India has 450 airports, of which all, except the Cochin International Airport, are administered by the central government – many are defence airfields, while some are non-functional. The Airports Authority of India owns and operates 125 airports – of these only 62 airports are operational for commercial airline routes.

### Early policy changes – Phase I

The history of Indian civil aviation dates back to 1953 when the Air Corporation Act was enforced and the industry was nationalised. The Tata Group-owned Air India was changed to Air India International and 11 private airlines were merged to form Indian Airlines (now 'Indian'). Air India's role was restricted to flying international routes and Indian Airlines was to serve domestically with no scope for competition. The aviation industry was liberalised in 1994, after the Air Corporation Act, 1953, was repealed, which allowed private operators to provide scheduled air transport services based on certain statutory requirements.

### Route dispersal guidelines

Similar to many other countries, India introduced route dispersal guidelines to ensure equitable development of air routes. The route dispersal guidelines classified air routes in three categories taking into account the need for air transport services across different regions of the country. Under the guidelines, each operator is required to offer at least 10% of its deployed capacity in Category-I routes for 'uneconomical' Category II routes, connecting stations in the North-Eastern region, J&K, Andaman & Nicobar and Lakshadweep. Furthermore, each operator should deploy 1% of the capacity exclusively within Category II stations and 50% of the capacity provided on Category I routes on Category III routes (routes not included in Categories I & II).

These route dispersal guidelines are, however, currently under review by the government. Plans are afloat to remove these restrictions and follow an auction mechanism for such routes. Routes for which no bidders would be interested shall remain under the current guidelines.

**Table 31: Classification of routes**

Category	Routes
Category I	1. Mumbai to Bangalore, Kolkata, Delhi, Hyderabad, Chennai, Trivandrum 2. Kolkata to Chennai and Bangalore 3. Delhi to Bangalore, Hyderabad and Chennai
Category II	North-eastern regions, J&K, Andaman Nicobar Islands and Lakshadweep
Category III	Consisted of routes other than those in category II and I

Source: DGCA

### Policy changes – Phase II

In 1997, the privatisation policy was further liberalised and foreign equity participation of up to 40% was allowed in the domestic airline sector; however, foreign airlines were not allowed to invest in domestic airline, directly or indirectly. With the liberalisation of the policy, as many as seven private airlines had started operation in 1994 but of them only two – Jet Airways and Air Sahara – are currently operating in India. In August '03, Air Deccan commenced operations taking the total number of private carriers operating in the domestic scheduled services to three. Since then SpiceJet, GoAir, Kingfisher Airlines, IndiGo, Paramount have taken to air while many other are in queue.

### Policy changes – Phase III, open skies

In '04, the government increased the foreign direct investment cap from 40% to 49%, but did not remove the restriction of allowing foreign airlines to pick up stake in the domestic aviation sector. It also decided to allow any country which has a civil aviation agreement with India to operate seven flights to any two of the twelve international airports in India subject to reciprocal rights for designated Indian carriers. The designated airlines from ASEAN countries have been allowed to operate daily flights to Chennai, Delhi, Kolkata, Mumbai and 18 tourist destinations in India, subject to the same reciprocal rights and commercial agreement.

Indian private carriers were permitted to fly to SAARC countries and the government also allowed private domestic carriers with a minimum fleet strength of 20 aircraft and five years of operations to fly to all international destinations except the Gulf.

The government scrapped the 15% inland travel tax and foreign air travel of Rs500, and also halved the excise duty on aviation fuel to 8% from 16%. The landing charges were reduced 15% for domestic flights and aircraft with seating capacity below 80 were exempted from landing charges. In a move to increase the penetration of air routes and to encourage airlines to fly smaller aircraft to smaller cities, the navigation charges, too, were reduced 20-40% based on the weight of the planes.

### New Civil Aviation Policy

The Government has been working on the New Civil Aviation Policy for over six years. The Bill, however, was tabled in the Parliament for discussion recently. The new policy is expected to be market friendly. Highlights are:

- FDI of up to 74% in domestic carriers to be allowed when the industry is stronger

- Route dispersal guidelines to be replaced with a subsidy-based system
- Minimum equity required to start a new airline to be raised from Rs300mn to Rs500mn
- Upper age limit for import or lease of aircraft to be reduced from 15 years to eight years
- Aviation Economic Regulatory Act (AERA) proposed to frame guidelines for mega-mergers such as Air India-Indian or Jet-Sahara. AERA to also lay down guidelines for sharing airport space and parking bays and providing a level-playing field to various operators
- AAI to undertake modernisation of 35 smaller airports; first phase to be completed by CY07
- Kolkata/Chennai airports to follow the JV route of PPP similar to Delhi/Mumbai airports
- Encouraging regional airlines to increase connectivity between non-metros and metros by incentives such as waiving of landing/parking charges for five years after commencement of operations

### **Airport infrastructure**

Over 40% of the passenger traffic is concentrated in the two main airports of Delhi and Mumbai. This along with limited terminal capacity, increased congestion, outdated infrastructure, inadequate ground handling systems and poor passenger amenities paints a very sorry picture.

The government, taking note of the inadequate infrastructure for the explosive growth in the aviation sector, has taken a number of steps to revamp and modernise existing airports and set-up greenfield airports. The government has started the process of revamping the Mumbai and Delhi airports through public-private partnership. The government has also initiated construction of state-of-the-art Bangalore and Hyderabad airports with similar public-private participation on lines of the Cochin International Airport. The government has initiated the process for building 35 designated smaller cities airports with public-private participation.

In addition, the government has decided to build a second airport at Navi Mumbai. This would go on auction in '07 and is expected to be ready in 5-7 years. For the Delhi airport, three additional runways are proposed in the same airport.

### **Parking bays**

The total number of parking bays available in the country is around 200 and the actual fleet size is 213. With the announced plans by the incumbents and new entrants in the Indian domestic airspace, the fleet size is expected to double by FY10. Clearly, there is shortage of parking bays at the airports and serious plans would have to be made and implemented at a rapid pace to accommodate the increase in the fleet. While work is underway to construct 60 new parking bays, there is a shortfall of over 250 parking bays in the domestic space itself.



**Table 32: Parking bays**

	Domestic	International	Total
Available	133	73	206
Occupied	136	58	194
Additional parking requirement	290	118	408
Additional parking announced			60

Source: Jet Airways presentation

### **Air traffic controllers**

At present, the number of air traffic controllers in India is grossly inadequate with only around 1,000 ATCs. The shortfall at major airports is as high as 40% and 50% in Delhi and Mumbai, respectively. At present, about 100 ATCs guide 500 planes over Delhi and Mumbai everyday. With the increase in the number of airlines and fleet size, the number of planes flying over metros is expected to rise to over 600 planes daily. In India, at key airports, ATCs guide planes through some 14-15 routes, 12 of which are major. There are two area radar controllers to guide planes through these 15 routes. According to the international norm, there should be one radar controller for every route – a radar controller for arrival and departure each, whereas, in India, a single ATC does both the jobs. Efforts are on to train more personnel in this highly stressful job, both in the government and private institutes. Other measures such as evenly scheduling of flights from peak times to non-peak times should help in countering the problem in the short term. However, both long-term and short-term measures are not enough to counter the shortage of ATCs.

### **Lack of secondary airports**

Internationally, LCCs have used secondary airports at major hubs for their operations. Use of secondary airports offers the availability of prime slots for take off and landing, which would have otherwise been used by legacy carriers at primary airports. Besides, airport charges are lower than primary airports. This fits in well with the concept of LCCs. In India, LCCs fly non-peak hours on the trunk routes due to unavailability of slots during the peak hours of the day. Thus, many airlines would loose out on the peak hours traffic. There is a case in India for the development of the secondary airports at key cities, given the current inadequate capacity resulting in congestion, flight delays, inconvenience to passengers and higher operating costs for the airlines.

### **Availability of trained personnel**

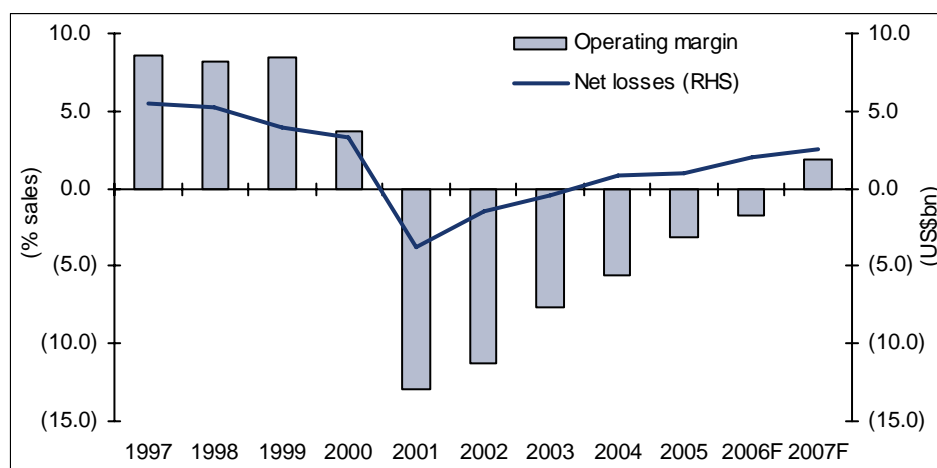
At present, there are over 1,800 pilots in India and around 213 aircraft. With the doubling of the aircraft fleet by '10 based on the announced fleet expansion by incumbents and new entrants, we believe that India will need additional 2,400 pilots. To counter this shortage, airlines are hiring expatriate pilots (who come at a higher cost). The investments in pilot training schools will have to be increased to have adequate number of pilots as the gestation period from a rookie to a commander is long. At the moment, there is a minimum requirement of 1,500 hrs of flying experience for a first officer to be eligible for an ALTP license, and further 4,000 hrs and five years experience as a first officer to be a commander; in addition, there are other internal processes for the final selection to be a commander. A similar extrapolation can be made for the availability of skilled engineers and cabin crew. We can safely assume that a similar shortage is going to there in these areas too.

## Annexure 2: Learnings from global airline industry

### Profitable outlook for CY07

Globally, airlines have been able to churn marginal operating profits over the past two years, though the bottomline still remained negative. IATA forecasts a further net loss of US\$1.7bn in CY06 though the industry is expected to post a net profit of US\$1.9bn in CY07E. IATA's improved outlook is based on anticipation of stronger revenue growth that would offset increase in fuel prices, while cost cutting would be the main profit driver.

**Chart 18: Global airline industry's profitability**



Source: IATA

Profitability would, however, be driven by LCCs and Asia-Pacific market. As per IATA estimates, LCCs earned the highest operating margins in CY05. Specifically, GOL, RyanAir and Air Asia were the margin leaders (operating margins in excess of 15%).

As per IATA, Asia-Pacific would witness the strongest growth in the next few years. Notably, of the US\$1.9bn profit forecasted for CY07E, about US\$1.2bn would come from airlines operating in Asia-Pacific as against no contribution from North America.

**Table 33: Industry net profits**

(US\$bn)

	CY04	CY05	CY06E	CY07E
<b>Global</b>	<b>(5.6)</b>	<b>(3.2)</b>	<b>(1.7)</b>	<b>1.9</b>
North America	(10.0)	(6.7)	(4.5)	-
Europe	1.1	1.6	1.8	1.5
Asia-Pacific	3.4	2.1	1.7	1.2
Middle East	0.2	0.2	0.1	0.1
Latin America	0.1	(0.1)	0.1	0.1
Africa	(0.3)	(0.4)	(0.8)	(0.9)

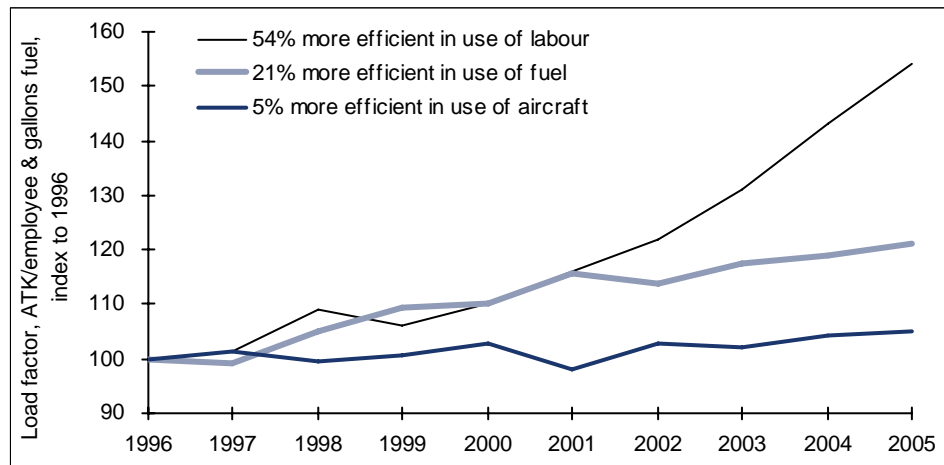
Source: ICAO, IATA

### Cost cutting leads global margin recovery

Among various initiatives taken by airlines to improve their bottomline, reduction in labour cost and distribution emerge as the most important contributors to margin recovery. As estimated by IATA, efficiency in labour usage went up 46% during 1994-2004, while load factor improved 4 percentage points. On the other hand, selling and distribution costs were cut 24% over '01-04.

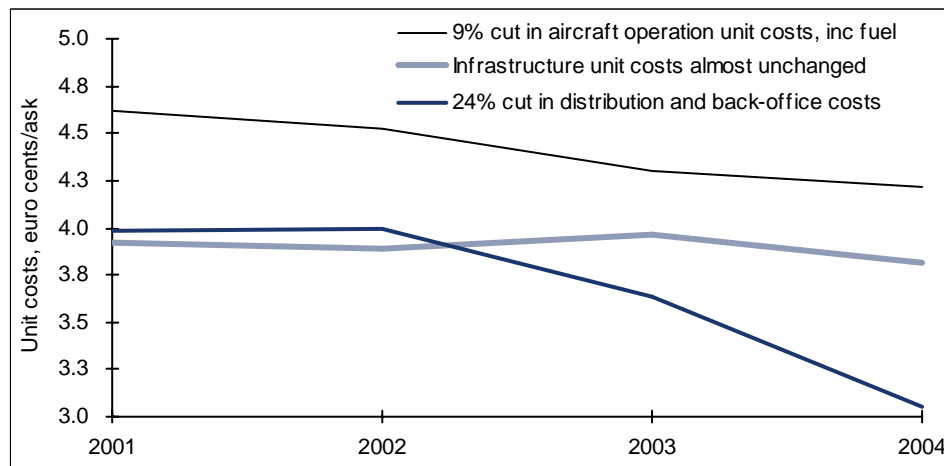
The learning is evident for Indian carriers – Efficient usage of labour and reduction in distribution costs are the key to long-term success.

**Chart 19: Factors driving margin improvement**



Source: ICAO, IATA

**Chart 20: Global airline industry's profitability**

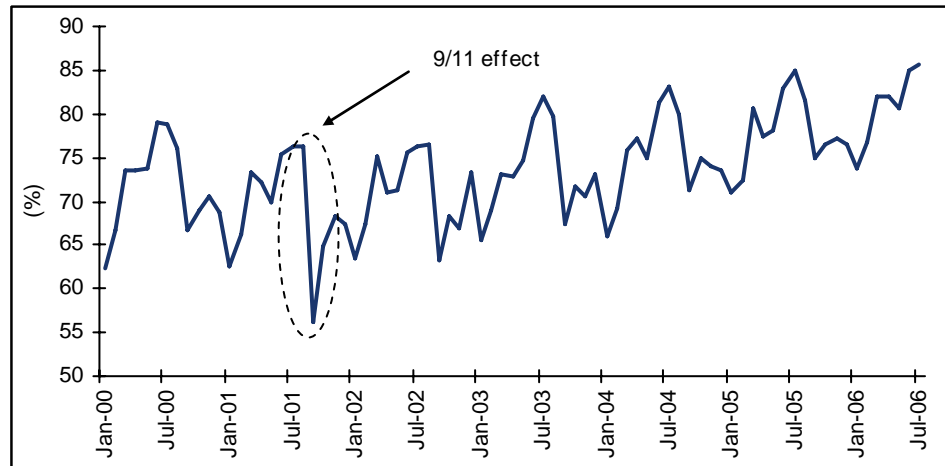


Source: ICAO, IATA

**Industry-wide load factor trend rising**

Contrary to the widespread market belief, demand for air travel is growing at a rate higher than the overall supply addition for the industry. As figures for the US show (Chart 21), industry-wide load factor has been rising continuously (except for seasonal downtrends).

**Chart 21: Positive trend in load factor**

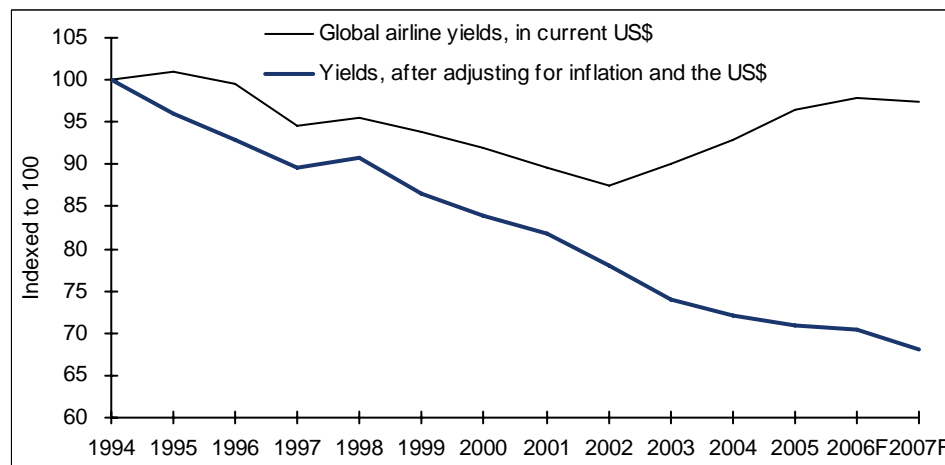


Source: Bloomberg

**Global yields down on real terms**

Though global airline yields have risen over the past few years, in real terms, the downward trend seems evident. Much of this is attributable to the advent of LCCs worldwide and the way they have captured market share. In turn, FSCs have been forced to offer discounted air fares, thus bringing down the overall yield for the industry.

**Chart 22: Falling yields attributable to LCCs**



Source: ICAO, IATA

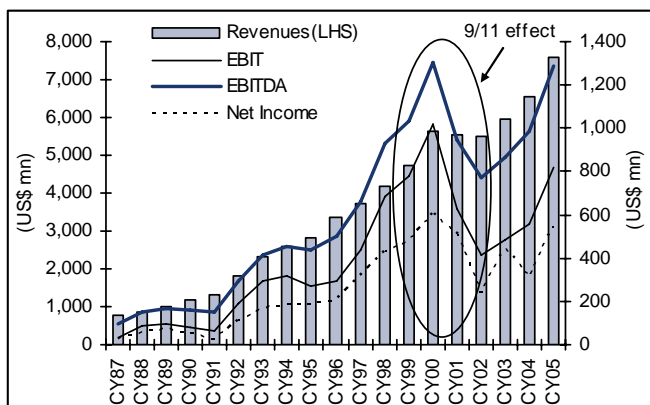
### Profitable track record of LCCs

Globally, LCCs have made air travel more affordable and hence not only gained substantial market share but also increased the overall market size. The Brazilian LCC, GOL, started operations in mid-'01 and in its very first year captured 4.6% market share. Since then, its market share has been increasing steadily and in four years it has captured an exceptional 25% market share. In the US, too, LCCs have gained market share from 7.3% in 1992 to 23.7% in '02.

Importantly, all leading LCCs are profitable. For instance, Southwest Airlines, which improved its market share from 7% in 1990 to 16.2% in '02, has consistently posted profits for more than 30 years. GOL boasts of among the highest margins in the industry across LCCs and FSCs. Similarly, Air Asia and RyanAir are among the margin leaders in their respective markets apart from being profitable.

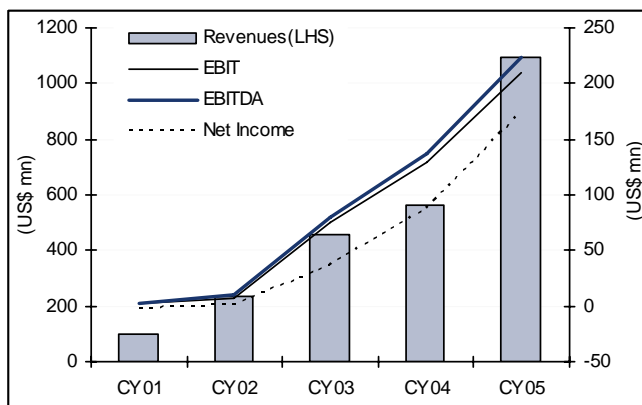
The oldest among the LCCs is Southwest Airlines of the US, which reported its 32<sup>nd</sup> annual profit in '04 in the backdrop of the airlines' industry reporting losses for the fourth consecutive year. Brazil's GOL is another notable LCC that has performed remarkably well since its launch and features among the most profitable airlines across the world. Air Asia boasts of being the lowest cost airline in the world with a cost/ASKM of less than Re1. Incidentally, all these airlines have been profitable even post-9/11, SARS threat, Iraq war and soaring crude prices. In contrast, the industry incurred cumulative losses of US\$36bn during '01-04.

Chart 23: Revenues and margins – Southwest



Source: Respective Company data

Chart 24: Revenues and margins – GOL

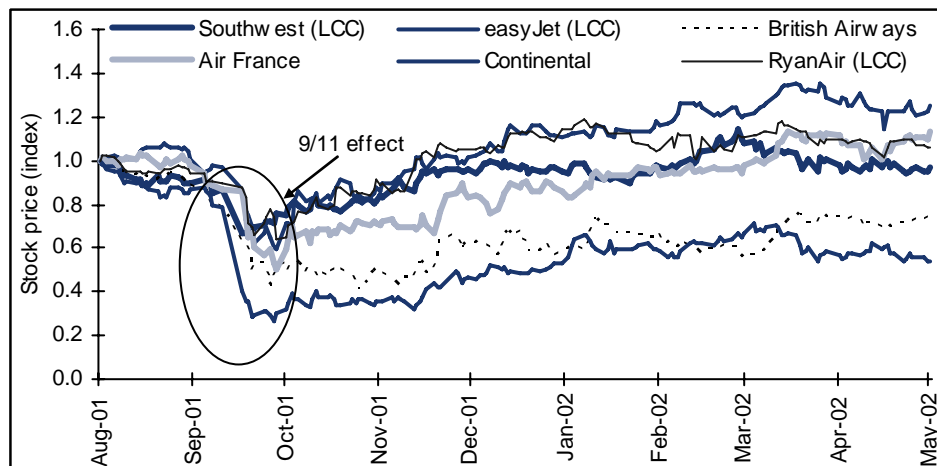


Source: Respective Company data

**LCCs react better to shocks than FSCs**

Globally, LCCs have outperformed FSCs; they have also fared better as regards exogenous shocks. LCC stocks with fundamentally sound business models were able to regain pre 9/11 levels within a span of three months, while even leading FSCs such as British Airways lagged behind until a year thereafter (Chart 25).

**Chart 25: LCCs react better to exogenous shocks such as 9/11**



Source: Bloomberg, i-SEC Research

### Annexure 3: Tax and fee reduction to save Rs45bn

Our estimates suggest that the impact of a 5% reduction in sales tax and 2% reduction in customs on ATF and a 10% reduction in landing charges would be as high Rs45bn by FY09E for the aviation industry (Tables 34 and 35).

Similar to the reduction in license fee in telecom that boosted the industry growth through lower costs, we foresee that reduction in charges can not only ensure survival of the industry but fuel growth to unprecedented levels. Accordingly, we estimate that the tax reductions will not impact the exchequer collection since the deficit will be more than met by increased volume.

Based on current rates, total taxes on ATF (customs, excise and sales tax) contributed Rs28bn in FY05, which can increase to Rs103bn by FY09E if the rates were maintained. Similarly, collection from Passenger Service Fee (PSF) and landing charges (charged for every departure) contributed Rs12bn in FY05, projected to increase to Rs30bn by FY09E.

As Table 35 shows, tax reduction will yield a total saving of Rs45bn by FY09E for the industry.

**Table 34: Estimated taxes and fees based on current rates**

Current scenario	FY05	FY06E	FY07E	FY08E	FY09E
No. of passengers (mn)	19	26	34	43	54
No. of departures p.a.	263,895	390,368	415,735	521,565	594,179
ATF excise (Rs mn)	4,552	10,033	13,095	17,602	20,053
ATF customs (Rs mn)	9,406	11,325	14,781	19,869	22,635
<b>Central exchequer collection (Rs mn)</b>	<b>13,958</b>	<b>21,358</b>	<b>27,876</b>	<b>37,471</b>	<b>42,688</b>
Growth (%)	-	53.0	30.5	34.4	13.9
<b>ATF sales tax (Rs mn)</b>	<b>13,815</b>	<b>30,449</b>	<b>39,742</b>	<b>53,420</b>	<b>60,857</b>
Growth (%)	-	120.4	30.5	34.4	13.9
PSF collection (Rs mn)	4,297	5,738	7,746	9,682	12,103
Landing Fee collection (Rs mn)	7,917	11,711	12,472	15,647	17,825
<b>Total AAI collection (Rs mn)</b>	<b>12,214</b>	<b>17,449</b>	<b>20,218</b>	<b>25,329</b>	<b>29,928</b>
Growth (%)	-	42.9	15.9	25.3	18.2
<b>Total govt. fees and taxes (Rs mn)</b>	<b>39,987</b>	<b>69,255</b>	<b>87,836</b>	<b>116,220</b>	<b>133,473</b>
Growth (%)	-	73.2	26.8	32.3	14.8

Source: Ministry of Petroleum and Natural Gas, i-SEC Research

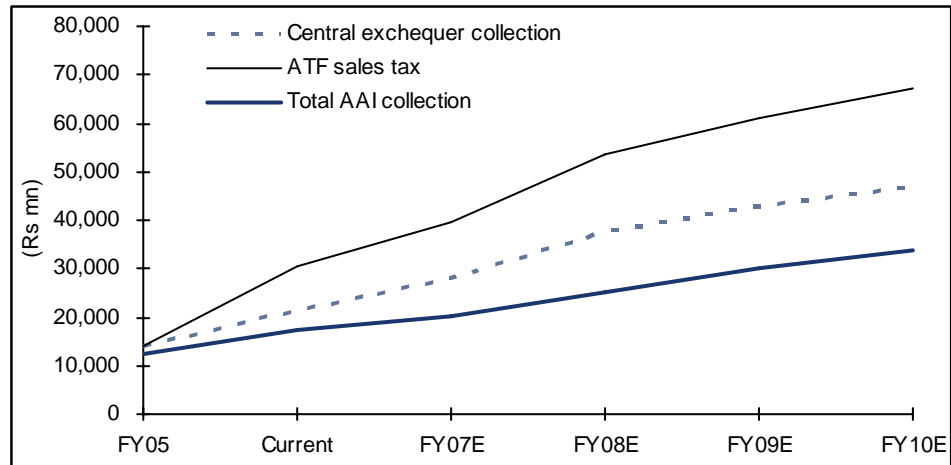
**Table 35: Estimated taxes and fees based on expected rates**

(Rs mn)

Expected scenario	FY05	FY06E	FY07E	FY08E	FY09E
ATF excise	4,552	10,033	13,095	17,283	19,689
ATF customs	9,406	11,325	14,781	15,973	18,197
<b>Central exchequer collection</b>	<b>13,958</b>	<b>21,358</b>	<b>27,876</b>	<b>33,255</b>	<b>37,885</b>
Growth (%)	-	53.0	30.5	19.3	13.9
<b>ATF sales tax</b>	<b>13,815</b>	<b>30,449</b>	<b>34,774</b>	<b>39,338</b>	<b>44,815</b>
Growth (%)	-	120.4	14.2	13.1	13.9
PSF collection	4,297	5,738	7,746	9,682	12,103
Landing Fee collection	7,917	11,711	11,848	14,082	16,043
<b>Total AAI collection</b>	<b>12,214</b>	<b>17,449</b>	<b>19,594</b>	<b>23,764</b>	<b>28,145</b>
Growth (%)	-	42.9	12.3	21.3	18.4
<b>Total govt. fees and taxes</b>	<b>39,987</b>	<b>69,255</b>	<b>82,245</b>	<b>96,358</b>	<b>110,846</b>
Growth (%)	-	73.2	18.8	17.2	15.0
<b>Total Industry Savings</b>	<b>-</b>	<b>-</b>	<b>5,591</b>	<b>19,862</b>	<b>22,627</b>

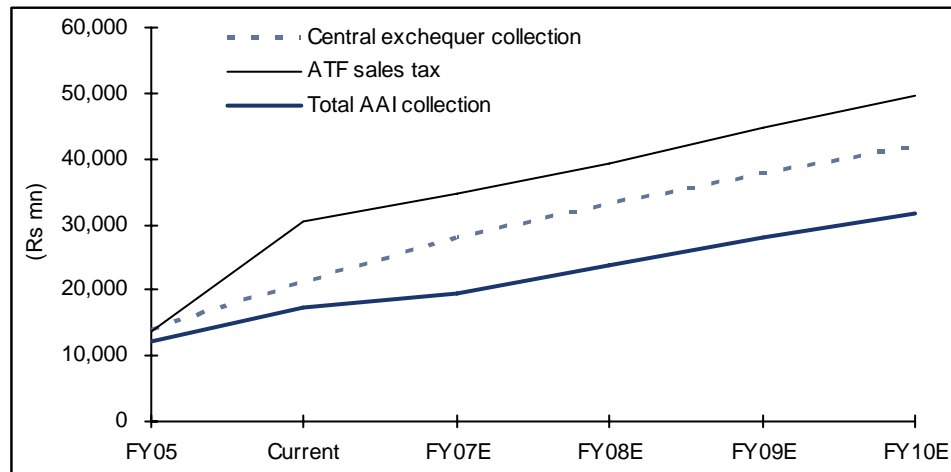
Source: Ministry of Petroleum and Natural Gas, i-SEC Research

**Chart 26: Contribution to exchequer based on current rates**



Source: i-SEC Research

**Chart 27: Contribution to exchequer based on expected rates**



Source: i-SEC Research



## Annexure 4: Key players in the Indian aviation

### Air Deccan

Air Deccan operates as a fully-owned subsidiary of Deccan Aviation promoted by Captain Gopinath, Captain Samuel and senior officers of the Indian Army Aviation. The company launched its charter helicopter services from its corporate base at Bangalore in September 1997. It operates a fleet of nine helicopters and two fixed-wing aircraft deployed across bases at Bangalore, Mumbai, Delhi, Ranchi, Hyderabad, Surat and Katra.

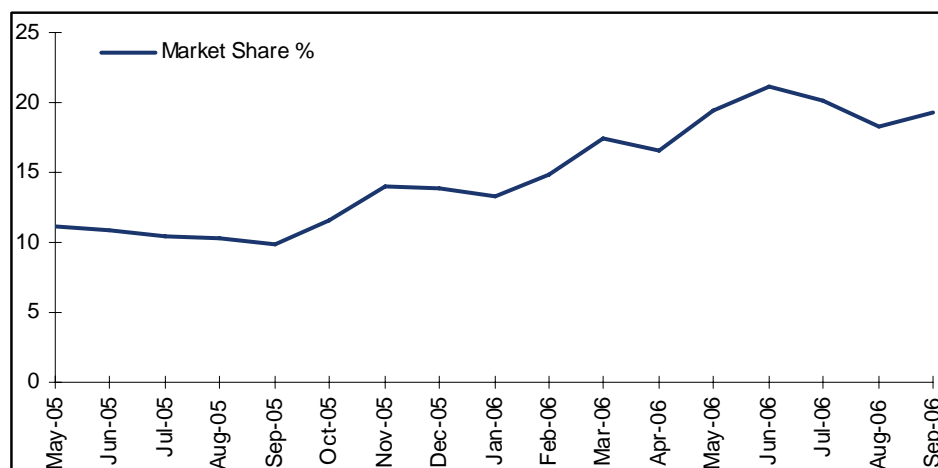
Air Deccan launched scheduled services in '03 with a single ATR 42-320 covering four sectors in South India. It is India's first LCC and has been instrumental in revolutionalising air travel in India. Today, Air Deccan has a fleet comprising 24 ATRs and 16 Airbus aircraft; it covers 60 airports with over 300 flights per day.

The airline can be credited with being the country's fastest growing airline and the third largest by way of market share as of September '06. It, however, posted record loss of Rs3.4bn for 15 months ended June '06. It further recorded a loss of Rs429mn (Rs2.17bn after adjusting for extraordinary gains) for the quarter ended September '06.

Air Deccan recently announced interest in starting a new cargo airline by converting five passenger planes to freighter aircraft.

Air Deccan is listed on the NSE and BSE with a market capitalisation of Rs12.25bn.

**Chart 28: Air Deccan's market share**



Source: DGCA

**Table 36: Announced expansion plans – Air Deccan**

Current Domestic Fleet	Planned Additions	Total planned fleet	Time frame
40	60	100	2014

Source: i-SEC Research

## Air India

Air India is India's national flag carrier that started as Tata Airlines in 1932. Tata Airlines was converted into a public company under the name of Air India in August 1946. From a total of three destinations during nationalisation, Air India's worldwide network today covers 44 destinations; it operates using its own aircraft and through code-shared flights.

Air India launched its subsidiary LCC, Air India Express, in April, '05. Air India Express, with three aircraft presently operates 38 flights per week from five points in India (Thiruvananthapuram, Kochi, Kozhikode, Mumbai and Delhi) to six destinations in the Gulf (Abu Dhabi, Dubai, Al Ain, Muscat, Salalah and Sharjah).

Air India has placed an order of 68 new aircraft scheduled to arrive between February '07 and '12. Of these, 18 aircraft are scheduled to be deployed for Air India's LCC, Air India Express. The 50 aircraft ordered for Air India will have all the modern on-board amenities.

Air India has been profitable in most years since its inception; it posted a net profit of Rs162.9mn in FY06 on a revenue base of Rs96.8bn.

**Chart 29: Air India's network**



Source: Air India website

## Air Sahara

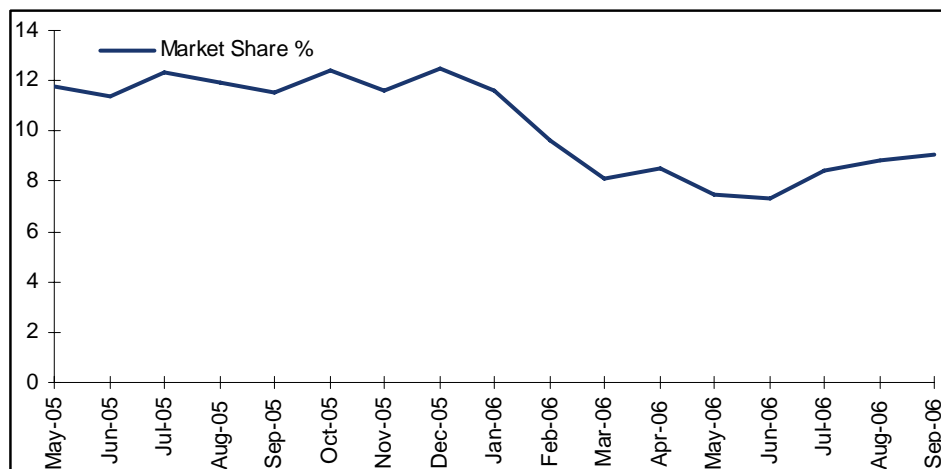
Air Sahara is a part of the Sahara India Group that also has interests in media & entertainment, housing, infrastructure, tourism, consumer products and information technology. Air Sahara began operations in December, 1993 following the Indian Government’s decision to open the sector to private players.

Air Sahara’s current fleet includes new generation Boeings 737s, Canadair regional jets and wide body 767-300 ER. The fleet also includes four helicopters (Dauphin and Ecureuil), which provide charter services. Air Sahara offers 134 daily flights and operates on both domestic and international routes.

Air Sahara was involved in a failed takeover attempt by Jet Airways (for US\$500mn) in early '06. According to Jet Airways, the deal failed due to non-receipt of regulatory approvals. On the other hand, Air Sahara blames Jet for last-minute cancellation.

Air Sahara is currently undergoing a complete overhaul and restructuring exercise. It has launched a major investment programme for the modernisation and enhancement of its fleet.

**Chart 30: Air Sahara’s market share**



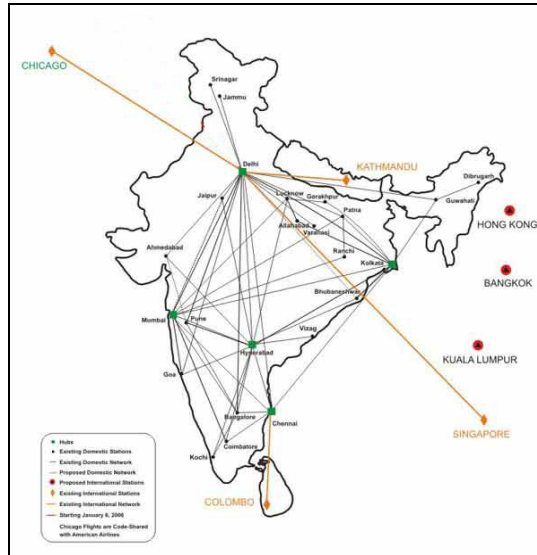
Source: DGCA

**Table 37: Announced expansion plans – Air Sahara**

Current Domestic Fleet	Planned Additions	Total planned fleet	Time frame
22	10	32	2010

Source: i-SEC Research

**Chart 31: Air Sahara's network**



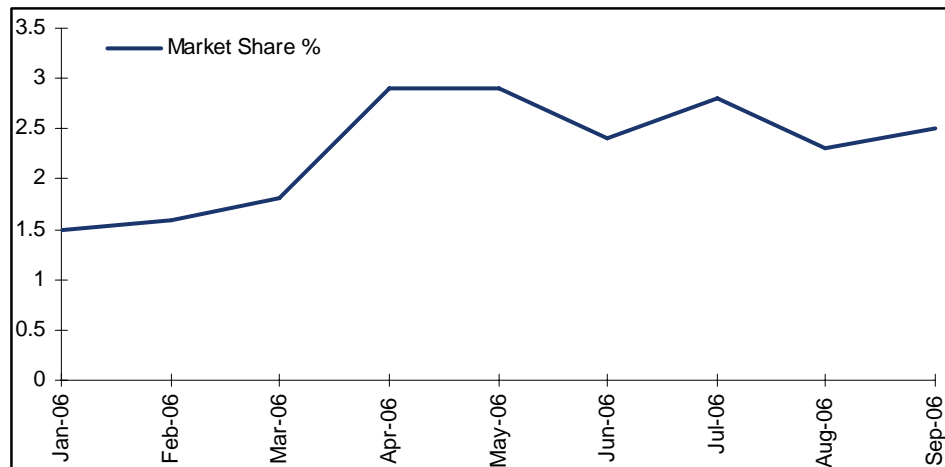
Source: Air Sahara website

**GoAir**

GoAir was launched in November '05 and is promoted by the Wadia Group that also owns Britannia and Bombay Dyeing. GoAir is projected as an LCC and flies seven new Airbus A320 aircraft.

GoAir services 13 cities with 37 flights daily. The airline's distribution policy is aimed at passengers who do not have credit or debit card or access to a computer. It enables booking tickets from several offline channels, which include GoTravel agents, GoTata Indicom outlets, GoInlott outlets, GoCyber café and GoPCOs.

**Chart 32: GoAir's market share**



Source: DGCA

**Table 38: Announced expansion plans – GoAir**

Current Domestic Fleet	Planned Additions	Total planned fleet	Time frame
7	17	24	2009

Source: i-SEC Research

## Indian

Indian (earlier Indian Airlines) was formed after the enactment of the Air Corporations Act 1953 and was entrusted with the responsibility of providing air transportation within the country as well as to the neighbouring countries. The airline was given the task to assimilate various dimensions of the eight private airlines, which were nationalised to provide well coordinated, adequate, safe, efficient and economical air services. The airlines began its operation on 1st August, 1953.

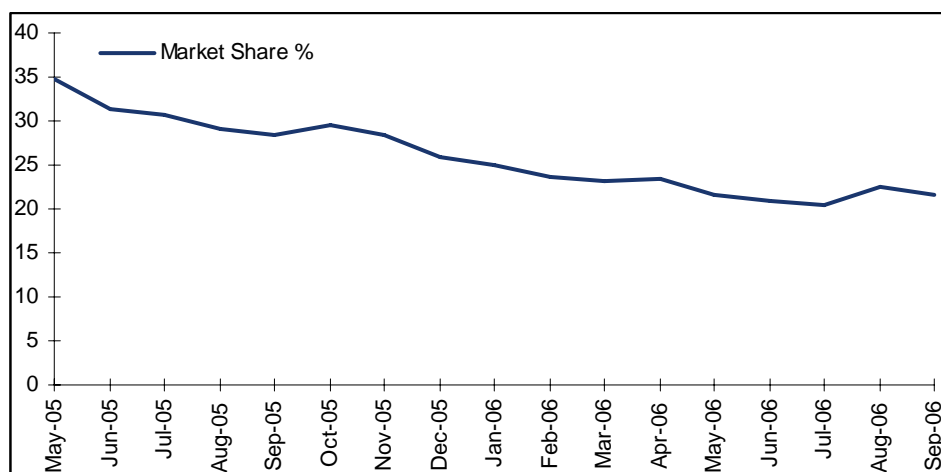
Indian, together with its fully-owned subsidiary Alliance Air, has a fleet of 70 aircraft (three wide bodied airbus A300s, 47 fly-by-wire airbus A320s, three Airbus A319s, 11 Boeing 737s, two Dornier Do-228 aircraft and four ATR-42. It has placed an order for 43 new aircraft. Indian's network covers 76 destinations (58 within India, 18 abroad).

At present, Indian is fully owned by the Government of India and has total employee strength of around 19,300 employees (including Alliance Air). Indian reported an annual turnover of Rs57.7bn in FY06 with net profit of Rs495mn. Indian expects revenues of Rs70bn in FY07E with accompanying net income of Rs750mn.

In a new development, the Government is planning to merge Air-India and Indian to create a mega-airline with domestic, international and cargo operations in one fold. An external consultant (Accenture) has been appointed to assist the merger. Sources suggest that the mega-airline to be formed is likely to adopt a de-centralised business model and will work under various departments such as full service airline, low-cost airline, ground handling, maintenance, repair and overhaul, cargo and other activities as independent profit centres.

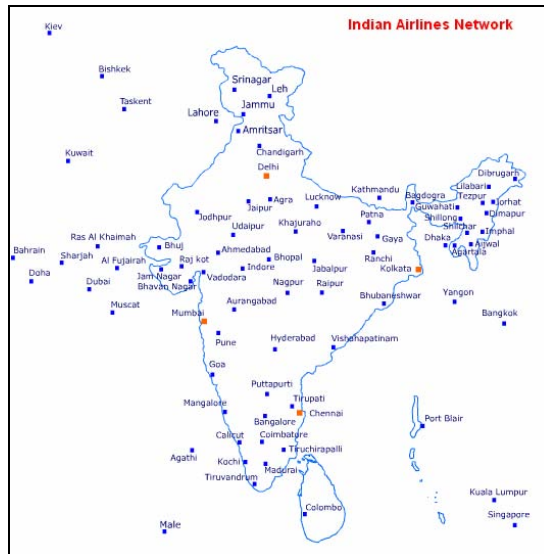
A separate CEO is planned for each department and all the CEOs would be represented in the Board of the merged entity. The Civil Aviation Ministry has also sought permission to carry forward unabsorbed depreciation so that the merged entity can set it off against future profits. Stamp duty waiver has also been sought for transfer of assets to the merged entity and the Finance Ministry is yet to take a call on this.

**Chart 33: Indian's market share**



Source: Indian

**Chart 34: Indian's network**



Source: Indian website

## IndiGo

IndiGo is the latest LCC entrant. It stunned the aviation market worldwide when it ordered 100 Airbus A320s, though they are scheduled to arrive until '14. Currently, the airline operates with four aircraft.

IndiGo boasts of a strong promoter group, InterGlobe Enterprises. Established in 1989, InterGlobe Enterprises enjoys a significant presence in aviation management, travel-related services, travel technology, travel distribution services and hotel development & management services. InterGlobe represents leading brands in the aviation industry and partners with global industry leaders (such as Galileo International, Accor Asia Pacific and Carnival Group) in the travel and tourism domain.

**Chart 35: IndiGo's network**



Source: IndiGo website

## Jet Airways

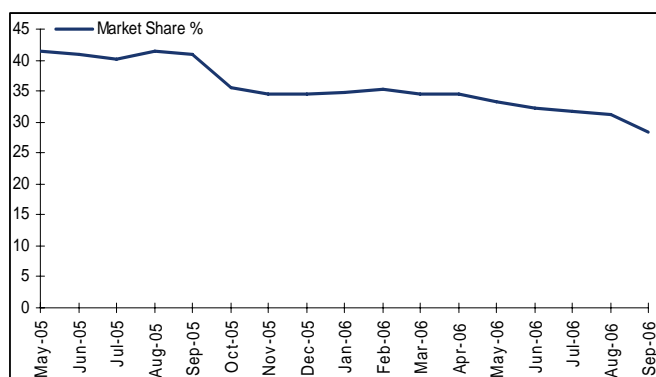
Jet Airways is India's largest carrier in the domestic airline industry with a market share of more than 30%. The company recently started operations on international routes with flights to Kuala Lumpur, Singapore, London and Colombo.

Jet Airways is promoted by Naresh Goyal and has acquired the 'Superbrand' status for continued excellence in the domestic aviation market. The airline remains as the preferred way of air travel for a majority of corporate travellers within the domestic circuit. Jet Airways, currently, has a market capitalisation of US\$1.22bn.

With the advent of LCCs, competitive pressures have made a dent in the airline's profitability. Jet Airways reported a loss of Rs1bn (Rs2.6bn after adjusting for extraordinary gains) in H1FY07.

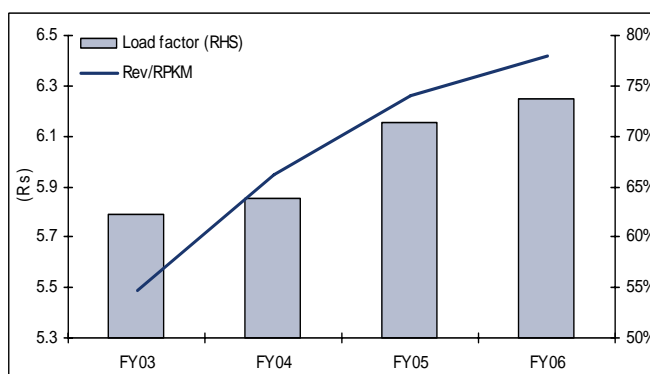
Jet Airways has sought permission to fly to the US and has ordered 10 Boeing 777-300ERs for deploying on its long haul international routes, including those to the US.

**Chart 36: Jet Airways' network**



Source: DGCA

**Chart 37: Jet Airways' load factor and Rev/RPKM**



Source: Jet Airways, i-SEC Research

**Table 39: Announced expansion plans – Jet Airways**

Current Domestic Fleet	Planned Additions	Total planned fleet	Time frame
50	14	64	2009
Current International Fleet			
7	15	22	2009
Current Total Fleet			
57	29	86	2009

Source: Jet Airways, i-SEC Research

## Kingfisher Airlines

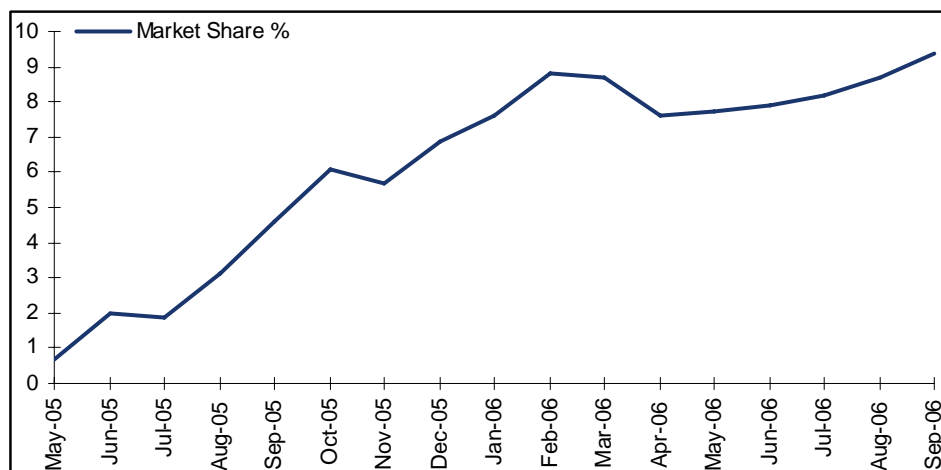
Kingfisher Airlines commenced operations in May, '05, offering full service at competitive fares. The airline promises an unparalleled experience to the Indian air traveller with extra-wide seats, spacious leg room, delicious gourmet meals, international-class cabin crew and a whole host of comforts and delights. The airline has received the 'Best New Airline of the Year' award in the Asia-Pacific and Middle East region from Centre for Asia Pacific Aviation.

Kingfisher Airlines is promoted by Dr. Vijay Mallya-owned UB Holdings, which is a holding company for several companies such as United Breweries, McDowell & Company, Herbertsons, Kingfisher Airlines among others. The Group through its subsidiaries is a dominant player in brewery, aviation, leather footwear exports etc.

Kingfisher Airlines reported a loss of Rs1.91bn at PBT levels for FY06 (operational for ~10 months). At EBITDA levels, the loss was Rs1.72bn. Kingfisher plans to start international operations beginning Q1CY08 with non-stop flights to the US, London and Hong Kong on Airbus A340 and A330.

Kingfisher has purchase orders for 34 A320s, 10 A330/340/350 family aircraft, 5 A380s and 35 ATRs with the deliveries scheduled until FY12. Kingfisher has a paid-up equity capital of over Rs4bn of which ~Rs1.8bn was eroded through cash losses for FY06. US\$35-40mn was recently raised by pledging the UB Group's entire minority holding in Aventis Pharma. Earlier, the Group had sold off its 10% stake in Bayer India and then exited South African brewing operations, United National Breweries (UNB), to fund the airline.

**Chart 38: Kingfisher's market share**



Source: DGCA

**Table 40: Announced expansion plans – Kingfisher Airlines**

Current Domestic Fleet	Planned Additions	Total planned fleet	Time frame
21	66	87	2010

Note: Planned additions include aircraft ordered for international operations

Source: Kingfisher, i-SEC Research

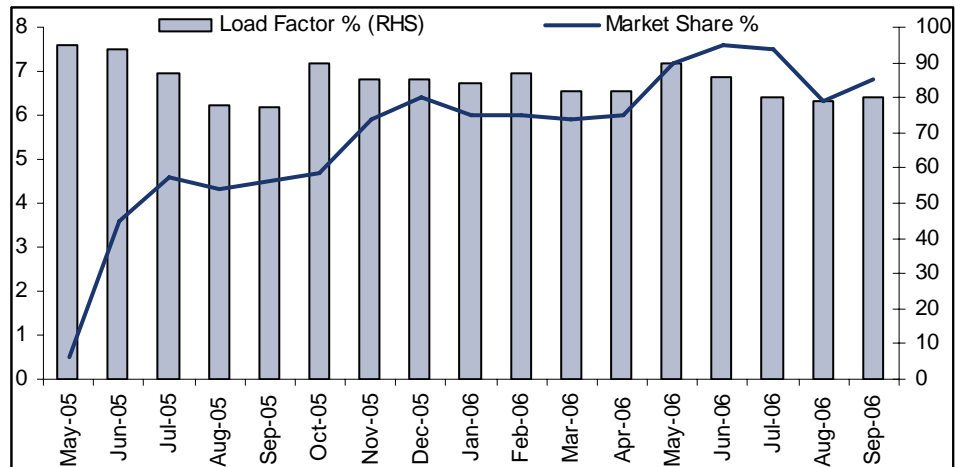


## SpiceJet

SpiceJet is the second-largest LCC in the domestic airline industry with a market share of ~7%. The company has recently added online hotel booking service through its website. Originally promoted by the SK Modi Group under the name Modiluft, SpiceJet was acquired by Royal Holding Services (Kansagra family) in '00. It re-started operations in May '05. Backed by strong management and significant experience in start-up airlines as well as the LCC industry, SpiceJet also has a maintenance support by KLM.

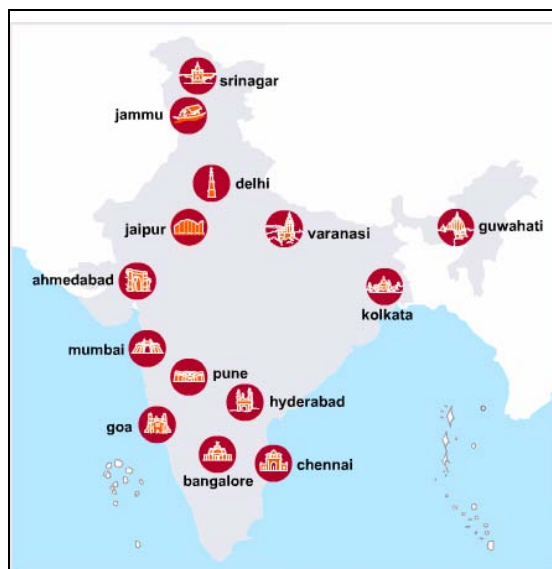
SpiceJet, currently, has a market capitalisation of US\$221mn. Barely 18 months into operations, SpiceJet is already EBITDA positive and operates on a fleet of nine Boeing 737-800 aircraft. It is expected to acquire 26 more aircraft, financing for which has already been tied up through sale and leaseback arrangement.

**Chart 39: SpiceJet's market share and load factor**



Source: DGCA and SpiceJet

**Chart 40: SpiceJet's network**



Source: SpiceJet

**Table 41: Announced expansion plans – SpiceJet**

Current Domestic Fleet	Planned Additions	Total planned fleet	Time frame
9	26	35	2011

Note: Planned additions include aircraft ordered for international operations  
 Source: SpiceJet, i-SEC Research

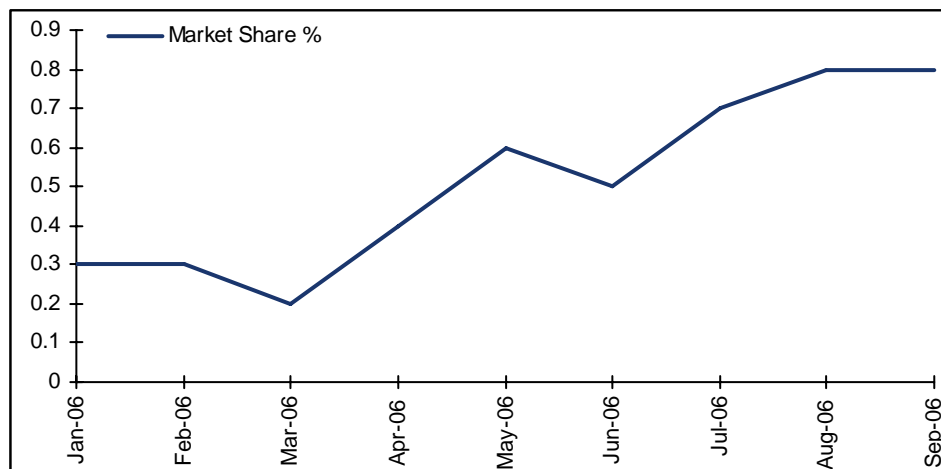
## Paramount Airways

Paramount Airways is the first airline in India to have launched the new generation Embraer 170/190 aircraft. The company has positioned itself as ‘value for money airline’, offering business class service at economy fares. It is promoted by Mr. Thiagarajan who is a Pilot and a keen aviation enthusiast. He hails from an illustrious industrial family from South India with experience the textile industry.

Paramount Airways plans to be a premium service airline offering competitive fares, and first-time direct services to commercial hubs in India, connecting these to metros.

Paramount, currently, operates with a fleet of three aircraft and plans to add another 10 by FY10E.

**Chart 41: Paramount’s market share**



Source: DGCA

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## SpiceJet

BUY

## Trailblaze

Rs53

Reason for report: Initiating coverage

**SpiceJet is best positioned to benefit from the imminent J-curve in aviation. Further, it has the capability to overcome the current overcast environment on the back of high operational efficiency, on-time performance and sustained high load factor. Following the globally tested pure LCC model, SpiceJet maintains a high focus on minimising costs and is set for a turnaround by FY09E. The airline is poised to expand its fleet significantly, targeting more than 20 high-growth destinations. We believe that the worst is already over for SpiceJet and recommend a BUY with a target price of Rs91/share.**

- ▶ **Demonstrated potential for performance.** SpiceJet has achieved the highest market share per aircraft, helped by highest asset utilisation and load factor in the industry ever since its launch. Exceptional growth from tier II cities will help the LCC sustain the growth momentum as it expands fleet from nine at present to 19 and 25 in FY08E and FY09E respectively. Importantly, SpiceJet has secured funding (sale & lease-back arrangement) to the tune of US\$1.1bn to finance the expansion.
- ▶ **At a cost advantage.** SpiceJet boasts of a lean cost structure that is comparable with the best globally. As the company expands and attains a critical mass of fleet (10-12 aircraft) by March '07, we estimate per unit cost (ex fuel) to reduce further from Rs1.63 in FY06 to Rs1.55 in FY07E and Rs1.52 by FY09E. Further, EBITDAR margin would expand 1,500bps backed by steady improvement in realisation.
- ▶ **Set to deliver returns.** Despite conservative assumptions (US\$76/Bbl crude price), we estimate SpiceJet to turn profitable by FY09E and EBITDA positive by FY08E, driven by over 85% revenue CAGR. Continued low fuel prices and earlier-than-expected improvement in competitive space could pose >10% upside to our FY08E EBITDAR estimate. Watch for: i) sustained above-average load factor and yield during the upcoming the lean season and ii) growth from tier II cities.
- ▶ **Attractive valuations.** Based on our deeply discounted DCF analysis, we arrive at a 12-month target price of Rs91/share that implies an FY09E EV/EBITDAR of 7.5x. This compares favourably with one-year forward CY07E EV/EBITDAR of 15.5x for global peers. We initiate coverage on SpiceJet with BUY.

Market Cap	Rs10bn/US\$221mn	Year to March	FY06	FY07E	FY08E	FY09E
Reuters/Bloomberg	SJET.BO/SJET IN	Revenue (Rs mn)	4,197	8,240	18,803	27,685
Shares Outstanding (mn)	184.3	Rec. Net Income (Rs mn)	(776)	(562)	(343)	1,332
52-week Range (Rs)	84/36	EPS (Rs)	(2.9)	(0.4)	0.2	8.4
Free Float (%)	83.1	% Chg YoY	NA	NA	NA	NA
FII (%)	17.0	P/E (x)	(18.2)	(120.3)	334.5	6.4
Daily Volume (US\$/'000)	1,200	CEPS (Rs)	(3.8)	(2.3)	(0.6)	8.0
Absolute Return 3m (%)	24.1	EV/EBITDAR (x)	132.7	29.7	12.7	6.6
Absolute Return 12m (%)	(21.9)	Dividend Yield (%)	-	-	-	-
Sensex Return 3m (%)	19.5	RoCE (%)	NA	1.2	5.4	11.5
Sensex Return 12m (%)	52.2	RoE (%)	NA	NA	NA	293.5

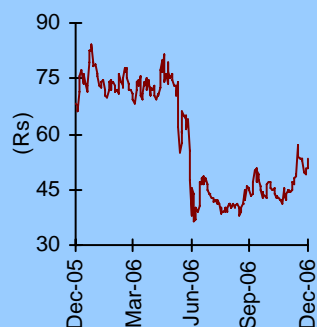
Please refer to important disclosures at the end of this report

## Aviation

## Shareholding pattern

	Mar '06	Jun '06	Sep '06
Promoters	17.3	16.9	16.9
Institutional investors	24.1	22.2	19.4
MFs and UTI	3.6	1.5	2.4
Insurance Cos.	0.1	0.1	0.1
FIs	20.4	20.7	17.0
Others	58.6	60.9	63.7

## Price chart



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## Best positioned to benefit from imminent J-curve

### Demonstrated potential for performance

#### Acquiring market share

SpiceJet, within a year, has already achieved ~7% market share as against the total LCC market share of ~30%. Remarkably, this was achieved with a fleet of just six aircraft as against a total LCC fleet of 45. The LCC has the highest market share per aircraft, suggesting optimal asset utilisation and load factor (Table 1). SpiceJet's market share has increased, despite the entry of new players such as IndiGo and GoAir (Chart 1).

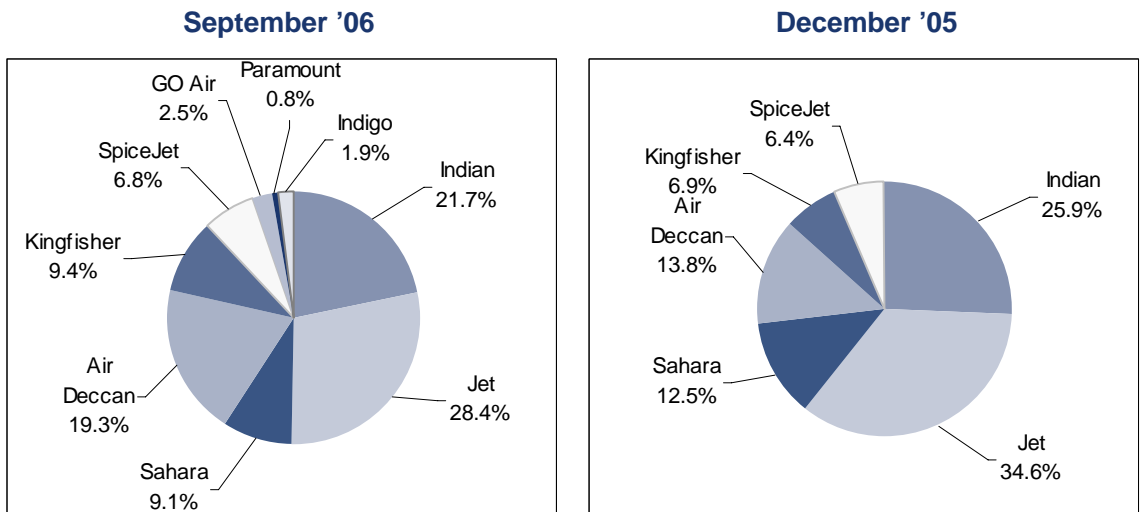
What is noteworthy is that SpiceJet grabbed market share by way of unique positioning – experimenting with new routes and off-peak timings – rather than plain fare dilution. This has helped it gain market share without sacrificing yield.

**Table 1: Highest market share per aircraft**

	Indian	Jet	Sahara	Deccan	Air Kingfisher	SpiceJet	GoAir	Paramount	IndiGo
Market share (%)	21.7	28.4	9.1	19.3	9.4	6.8	2.5	0.8	1.9
Average fleet size	52	50	22	36	17	6	4	3	3
Share per aircraft (%)	0.4	0.6	0.4	0.5	0.6	1.1	0.6	0.3	0.6

Source: DGCA, i-SEC Research

**Chart 1: Domestic market share**



Source: DGCA

#### Highest load factor in the industry

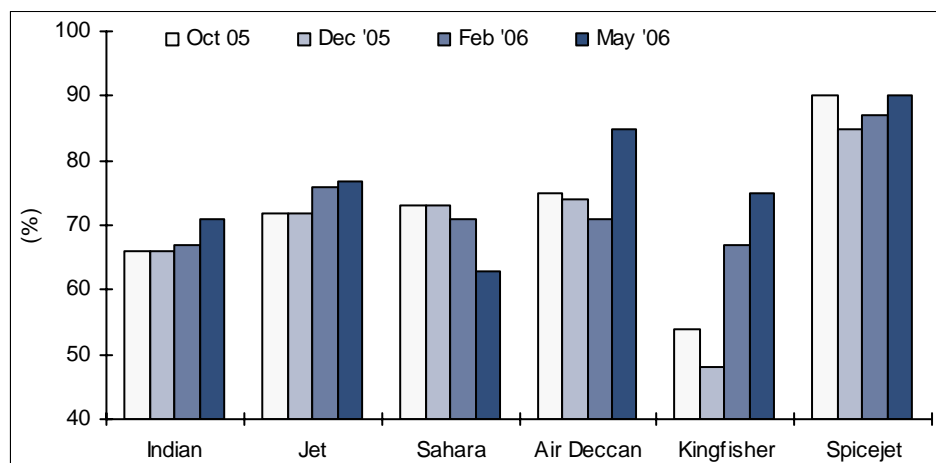
Ever since its launch, SpiceJet has maintained the highest load factor in the industry. This has directly added to the company's overall revenues and improved revenue/ASKM.

For fiscal year ending May '06, the airline reported a commendable average load factor of 86%. On the contrary, Air Deccan struggled to reach a load factor of even 80% (Chart 2).

**Chart 2: The best airline as regards load factor**

Highest load factor maintained in the industry since its launch

In contrast, network leader, Air Deccan, failed to reach even 80% load factor, despite following the LCC model



Source: SpiceJet

### Superior operational performance

SpiceJet's superior operational performance dispels the current market notion that LCCs offer cheap service. Globally, LCCs have never compromised on passenger safety, maintenance and on-time performance. In India, however, LCC industry's record might not be as favourable.

SpiceJet, however, has been an exception. The airline has successfully established itself in the industry due to high operational efficiency, on-time performance (over 90%) and flight completion record of 99.6% (better than overall average for Boeing).

### Expansion set to take wings

#### Phased capacity deployment

In line with its growth plan, SpiceJet will add 16 aircraft to its current fleet of nine. This will increase total seats to 10mn by FY09E from just 2mn at present.

**Table 2: SpiceJet's capacity expansion schedule**

Particulars	FY06	FY07E	FY08E	FY09E
Average Aircraft in Fleet	4	8	16	22
Total Aircraft	6	11	19	25
Total annual capacity (mn)	2	4	7	10
Total estimated Pax carried (mn)	2	3	6	8
Market share (%)	6.9	8.6	14.1	15.4

Source: Company data, i-SEC Research

SpiceJet also plans to induct Boeing 737-900 into its fleet, with 215 seating capacity as against 189 on 737-800 at present. The increase in seats (~13%) could reduce cost/ASKM by almost 10% since fixed costs would be distributed over a larger base.

#### Focus on limited airports saves substantial cost

Following a pure LCC model, SpiceJet's strategy is to focus on limited airports. Rather than spreading itself too thinly on many airports, the airline plans to maximise frequencies from few airports. This way it can amortise the fixed costs of setting up base in new airports over a larger base of available seats.

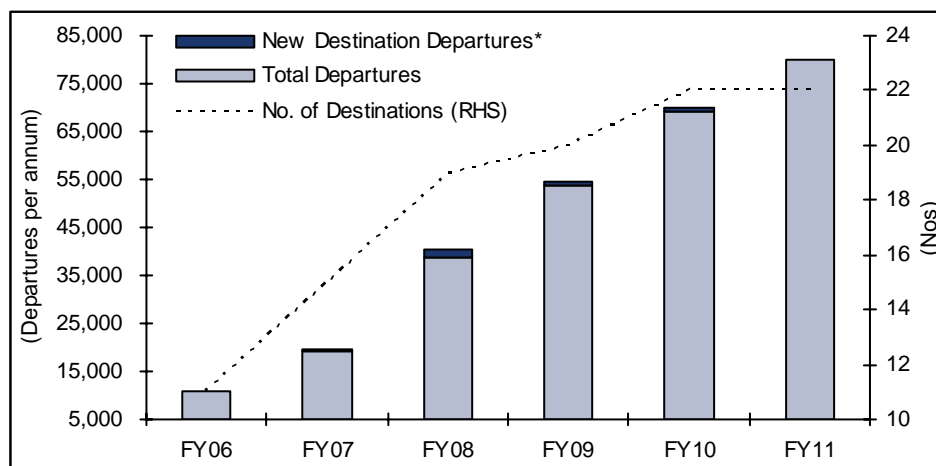


At present, the airline operates from 13 airports and plans to increase this to 20 by FY09. However, the connectivity within these airports is expected to be very strong, thus increasing the overall number of departures (Chart 3).

The potential for new destinations is even greater than the current ones (Tables 3 and 4). As highlighted in the sector note, connectivity to tier II cities will pave way for sustained growth in the sector. Accordingly, SpiceJet plans to target cities that offer potential to grow at a fast pace. Growth in these cities (seen in the context of two social benchmarks – literacy and population growth) exceeds that in metro destinations. Moreover, capacity addition on these destinations is slower than traffic growth.

**Chart 3: Airport connectivity versus departures**

Phased airport addition allows utilising the investment in airport infrastructure to the fullest



\* New destination factored only in the initial year

Source: i-SEC Research

**Table 3: New destinations offer great potential**

Destinations	Growth rate in population FY01/FY91	Literacy rate FY01	Capacity deployed FY06*	Capacity deployed FY05*	Capacity increase (bps)	Pax Traffic FY06*	Pax Traffic FY05*	Traffic increase (bps)
Existing	31.6	81.2	76.3	73.1	326	83.5	84.6	(108)
Planned#	39.1	84.2	7.9	7.8	5	6.6	6.3	35

Note: \* As percentage of total industry; # SpiceJet

Source: SpiceJet, Statistical Outline of India, AAI, i-SEC Research

**Table 4: Above-average traffic expected at new destinations**

Total potential traffic from served destinations to increase more than 75% by FY09E

Destination	FY06 traffic (mn)	FY09E traffic (mn)	CAGR FY09/06E
Ahmedabad	1.9	3.8	26.5
Bangalore	5.7	9.3	18.2
Chennai	6.8	13.2	25.0
Delhi	16.2	26.9	18.3
Goa	1.7	3.0	21.5
Guwahati	0.7	1.2	18.3
Hyderabad	4.0	8.4	28.2
Jammu	0.3	0.6	24.9
Kolkata	4.4	9.3	28.3
Mumbai	18.4	28.0	15.0
Pune	0.9	1.6	20.0
Srinagar	0.8	1.4	19.9
Varanasi	0.2	0.4	19.2
<b>Planned destinations</b>	<b>4.6</b>	<b>10.0</b>	<b>29.5</b>
<b>Total traffic</b>	<b>66.6</b>	<b>117.2</b>	<b>20.7</b>

Note: Traffic defined as total departures plus arrival, also includes international.

Source: AAI, i-SEC Research

**Expansion funding in place – Key positive**

Most importantly, the company has already secured financing arrangement for the next phase of its expansion. The financing involves sale and lease-back arrangement with Nomura Babcock & Brown for all 16 planes arriving till FY09. At current catalogue prices, the funding is reported to be at US\$1.1bn.

Even though there have been talks of huge expansion plans, almost all airlines have been restricted by fund availability. Though sale and lease-back are being used to avoid direct funding requirement, lessors are increasingly shying away from airlines with huge leverage and insecure business models.

In such a scenario, we believe SpiceJet's recent announcement regarding funding addresses any concern on the company's expansion ability and sustainability.

## Following the right model

### At a cost advantage

An airline can offer low fares only when it focusses on cost reduction. LCCs' focus on cutting down frills, sweating their assets, enhancing usage of technology and simplifying operations help them in containing costs as much as 33%. Low costs enable these carriers to provide fares at much lower rates than the legacy FSCs, which act as a price stimulation. Lower fares in turn help generate higher load factor thus boosting overall revenues.

Successful LCCs such as Southwest, RyanAir and easyJet have consistently been profitable due to their vicious cost-consciousness, despite oil price shocks. SpiceJet is an extremely cost-conscious airline (Table 5). Note that SpiceJet's current revenues are lower because the LCC market is still in a nascent stage in India. However, as the market matures and competition settles down, we expect revenues to increase substantially. Cost/ASKM is adversely affected because of higher domestic ATF prices as well as ban on fuel hedging. However, net of fuel expenses, SpiceJet's cost structure is comparable with the best globally. Further, as the carrier adds to its network and attains a fleet size of 12-15, the fixed costs are spread over a larger base, thereby lowering unit costs substantially.

SpiceJet is among the lowest cost airlines in the country, but its current operating costs, ex fuel (Rs1.63/ASKM), is already lower than Southwest (Rs2.13/ASKM) (Table 6). By FY09E, this is expected to reduce further by 9% to Rs1.52/ASKM.

**Table 5: Operating parameters – A comparison**

(Rs)	AirAsia	EasyJet	Southwest	RyanAir	SpiceJet
Fleet size (nos)	41	109	445	87	9
Revenue/RPKM	1.82	4.43	3.65	3.54	2.69
Revenue/ASKM	1.51	3.78	2.73	3.05	2.30
Cost/ASKM	1.07	3.47	2.81	2.09	2.73
Cost/ASKM ex fuel	0.68	2.57	2.13	1.39	1.64
Actual Load Factor (%)	80	82	75	84	86

Source: Company filings, i-SEC Research

SpiceJet is among the lowest cost airline (ex fuel), having the highest load factor

**Table 6: Cost comparison**

Southwest		Cost Description	SpiceJet	
Sep-05	Sep-06		FY06*	FY09E
0.90	0.92	Salaries & Wages	0.35	0.28
0.44	0.67	Fuel	1.09	1.29
0.14	0.14	Maintenance MRO	0.28	0.25
0.16	0.15	Landing fees	0.19	0.17
0.20	0.20	Financing charges (Interest, rentals, depreciation)	0.60	0.57
0.39	0.40	Other Opex	0.21	0.25
<b>2.22</b>	<b>2.47</b>	Total Operating Cost	<b>2.72</b>	<b>2.81</b>
<b>1.78</b>	<b>1.80</b>	Total Operating Cost ex Fuel	<b>1.63</b>	<b>1.52</b>

Source: Company filings, i-SEC research; \* Reclassified for comparison purposes

### Lower staff costs

SpiceJet saves cost mostly due to lower staff costs, which in turn is typical of the service advantage that India has over developed countries. Importantly, staff costs would reduce further as SpiceJet expands capacity.

**Table 7: SpiceJet's salary break-up***(Rs/ASKM)*

Salary break-up	FY06	FY09E	Comments
In-flight Expenses	0.02	0.03	Crew salaries – Variable and increasing due to market forces
Flight Operations	0.12	0.16	Pilot salaries – Variable and increasing due to market forces
Airport	0.05	0.03	Manpower/aircraft reducing from 100 in FY06 to 75 by FY09E; departures/airport employee increasing from 20 during the same period
Personnel cost	0.00	0.02	Corporate head office expenses amortised over expanded base.
Admin Exp.	0.18	0.05	Manpower per aircraft reducing from 16 in FY06 to 5.7 in FY09
<b>Total</b>	<b>0.35</b>	<b>0.28</b>	

Source: i-SEC Research

### Upside from reduction in fuel & maintenance costs

Fuel and maintenance costs push up the total costs. Fuel charges are particularly high in India because of the high incidence of taxes (refer sector report). Maintenance costs are high as there are few maintenance facilities in the country at present. Due to small size and no-frills model, LCCs typically outsource such services. At present, airlines send their aircraft to places such as Singapore or Middle East for higher level maintenance checks (C or D). This adds to the cost and renders the planes out of use for a long time. SpiceJet, for instance, incurs approximately 28paise/ASKM on maintenance and MRO as compared with just 15-17paise/ASKM for global LCCs such as Southwest, GOL and RyanAir.

However, aircraft manufacturing majors such as Airbus, Boeing and ATR have announced plans to invest huge amounts in setting up MRO facilities in the country. This would help reduce maintenance & MRO costs and align them with global levels. In fact, we envisage maintenance cost reductions to levels below international standards helped by India's cheap labour cost advantages.

### Financing & accounting choices affect depreciation and rentals

Cost incurred on lease rentals, interest and depreciation reflect the company's financing decisions, which are also affected by the adopted accounting treatments. For instance, Southwest depreciates its aircraft over 25-30 years using straight line method. On the other hand, Indian carriers are allowed to depreciate aircraft at a rate of 5.6% SLM or 16.2% WDV, which is much higher than the equivalent rate charged by global airlines. In effect, as airlines (such as SpiceJet) rapidly add aircraft, depreciation charges would be higher, but during the later years the charges would come down.

### Increasing ancillary revenues to reduce break-even factor

Globally, the ability of LCCs such as RyanAir, easyJet and AirAsia to offer low fares has been augmented by ancillary revenues (Table 8). In SpiceJet's case, ancillary revenues contributed 4.7% to total passenger revenues in FY06; this is expected to increase to 10% by FY09E. SpiceJet plans to augment its ancillary revenue stream by offering on-board courier services, hotel bookings, car rentals and holiday packages. Globally, ancillary revenues account for as much as 15% of passenger revenues. In line with this strategy, the company has already launched online hotel booking through its portal.

**Table 8: Ancillary revenue sources**

	AirAsia	EasyJet	Southwest	RyanAir	SpiceJet FY06	SpiceJet FY09E
Ancillary Revenue (% of Pax revenues)	7.7	9.4	3.6	15.3	4.7	10.0
Courier	✓		✓	✓	✓	✓
Car Rentals	✓	✓		✓		✓
Hotel/Holiday Bookings	✓	✓		✓	✓	✓
Travel Insurance		✓		✓		
Sale of Food	✓	✓				
Web Gambling				✓		

Source: Company filings and websites

## Tight working capital management

As per our estimates, SpiceJet is able to pre-sell tickets almost 75 days in advance on an average. This ability along with a credit facility on AAI charges and fuel purchases helped SpiceJet generate Rs663mn as cash float in FY06. Supported by online sale of 75% of its tickets, we believe SpiceJet will continue to generate cash float from forward sales.

While for most LCCs in India, ability to pre-sell tickets has depended on promotional fares, SpiceJet has followed a true dynamic pricing model – last day fares are higher than fares on tickets booked in advance. Forward sale of tickets generates cash float and helps develop future strategies, giving a better picture for demand.

Further, SpiceJet is among the few airlines that enjoy credit facility from ATF suppliers and AAI for airport-related charges. Some of the other airlines have been barred from credit on fuel purchase or airport charges and are forced to adopt the cash and carry model.

## Set to deliver returns

### How far is break-even?

We calculate that if the airline were to maintain its current average load factor of 86%, it would break-even at an average ticket price of Rs2,825 as against the current average ticket price of Rs2,500 (FY06). This implies a rise of Rs325/ticket or ~13% over current prices. Even if we assume that load factor would stabilise at 80% in the long-term, average realisation necessary to break-even would be Rs3,000/ticket. Importantly, we have assumed peak cycle crude oil price of US\$76/Bbl for above calculations. At current crude prices break-even will be even lower.

Notably, upside from ancillary revenues will lower the break-even ticket price further. Industry sources reveal that margins on online hotel bookings and car rentals are as high as 20-25%.

**Table 9: Break-even closer than anticipated**

<b>Scenario 1: Break-even at current load factor</b>	
Current average load factor (%)	86
Current average price/ticket (Rs)	2,500
Break-even average price/ticket (Rs)	2,825
Fare rise required to break-even from current levels (Rs)	325
<b>Scenario 2: Break-even at 80% load factor</b>	
Current average load factor (%)	86
Current average price/ticket (Rs)	2,500
Load factor assumed under scenario 2 (%)	80
Break-even average price/ticket (Rs)	3,000
Fare rise required to break-even from current levels (Rs)	500

Source: i-SEC Research

### Costs to reduce further

With its strong focus on cost control, SpiceJet has initiated several firsts in the country and supported by following initiatives, it is suitably placed to reduce its costs further.

- Maintains a new fleet that is fuel efficient (as much as 20% lower fuel consumption),
- Operates a single aircraft type that minimises spare parts and engineering costs,
- Operates on winglet aircraft that reduce fuel consumption up to 3% and
- Controls fuel cost by adopting international best practices such as centre of gravity based aircraft loading, optimum flying speed and altitude (reducing fuel consumption from 2.55KT/block hr to 2.31KT/block hr).

As discussed earlier, increasing interest in the airline MRO space presents further upside with the entry of organised players in the industry. Among key players set to enter the industry are GoAir (in a tie-up with Singapore Airlines), Taneja Aerospace (TAAL) and aircraft manufacturing majors such Airbus, Boeing and ATR. As competition in the MRO industry increases and more maintenance activities are provided within the country, overall maintenance charges are slated to come down. This could present an additional 40% saving in MRO costs.

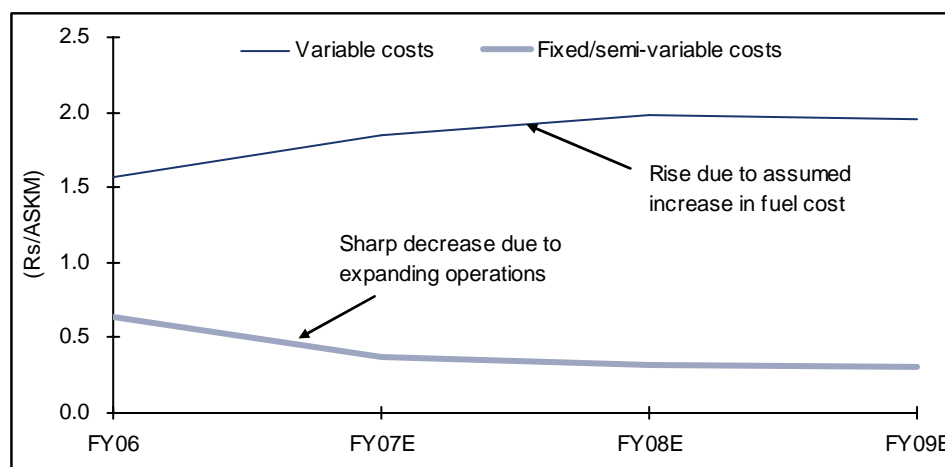
As discussed in our sector report, as operations expand, fixed costs are apportioned to a larger base, leading to a decrease in per unit costs. We estimate that fixed costs can come down as much as 50% for SpiceJet by FY09E (Table 10). Notably, fixed costs were 22% of total costs and 58% of total cost (ex fuel & financing costs) in FY06E.

**Table 10: Fixed costs to reduce more than 50% by FY09E**

Cost (Rs/ASKM)	FY06	FY07E	FY08E	FY09E	Comments
Fuel	1.09	1.20	1.31	1.29	Reducing on account of better fuel management techniques
Aircraft Maintenance	0.19	0.25	0.25	0.25	Potential upside from upcoming MRO facilities in India not yet factored in
Flight Operations Expenses	0.26	0.17	0.18	0.19	Reduces because initially pilots are trained and remain idle until operations start
Airports	-	0.06	0.06	0.05	Reduces because of spreading of resources over a larger base
Other	0.10	0.03	-	-	Several start-up costs are expensed in the same year
Personnel Cost	-	0.04	0.03	0.02	Fixed costs reduces as it is spread over expanded operations
Administrative & Other	0.27	0.07	0.05	0.05	Fixed costs reduces as it is spread over expanded operations
Variable costs	1.57	1.85	1.98	1.95	
Variable costs ex fuel	0.48	0.65	0.67	0.66	Increment in FY07E due to increased S&D activity and higher maintenance provision.
<b>Fixed/semi-variable costs</b>	<b>0.64</b>	<b>0.37</b>	<b>0.32</b>	<b>0.31</b>	<b>Substantial reduction due to expanded operations</b>
Financing costs	0.60	0.54	0.56	0.57	
Total Costs	2.82	2.76	2.86	2.83	Stays stable but has a potential upside from reduction in crude prices.

Source: i-SEC Research

**Chart 4: Upside from reducing fixed costs**



Source: i-SEC Research

## Recurring profits by FY09E despite conservative estimates

We assume fuel costs on the higher side at Rs45,000/KI (corresponding to peak crude price of US\$76/Bbl). Even though current ATF prices have reduced to ~37,500/KI, we have been conservative in our estimates.

Improvements in average FY07 yields have been assumed mainly on the back of the levy of fuel surcharge. On a conservative note, we have assumed marginal fare increment until FY09, expecting competitive pressures to continue. Load factors have been assumed to remain constant for FY07, though we expect it to dip in FY08 and FY09 as a result of industry-wide increase in capacity.

Despite conservative assumptions (Table 11), SpiceJet looks set to post profits by FY09E. On the back of an increase in fleet from nine aircraft to 25 in FY09E, we expect the airline to realise benefits of scale, and anticipate EBITDAR margin to

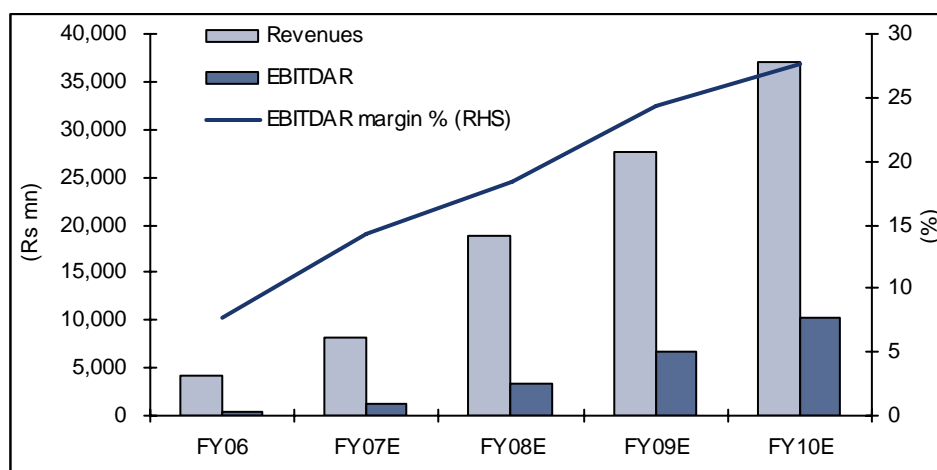
improve from 4% in FY06 to 23.8% in FY09E. Led by the expansion in EBITDAR, we expect the airline to report recurring profits of Rs1.3bn in FY09E and cash profits from FY07E.

**Table 11: Key assumptions**

	FY06E	FY07E	FY08E	FY09E
Avg revenue per Pax (Rs)	2,366	2,603	2,807	3,036
Ancillary revenue as % of revenues (%)	4.9	6.0	10.0	10.0
ASKM (mn)	1,822	3,196	6,709	9,357
RPKM (mn)	1,562	2,688	5,444	7,691
Revenue/RPKM (Rs)	2.69	3.07	3.45	3.60
Revenue/ASKM (Rs)	2.30	2.58	2.80	2.96
Cost/ASKM (Rs)	2.73	2.75	2.85	2.82
Cash Cost/ASKM (Rs)	2.62	2.64	2.78	2.75
Actual Load Factor (%)	86	84	81	82
Avg aircraft in Fleet	4	8	16	22
Avg Stage Length (Km)	882	904	896	930
Pax Carried (mn)	1.8	3.0	6.1	8.3
Fuel Rate (Rs/Kl)	37,000	42,298	45,000	45,000
Direct Engineering Cost/Block Hr (US\$)	750	550	550	550
Manpower per aircraft (Crew + Pilot)	46	43	40	38

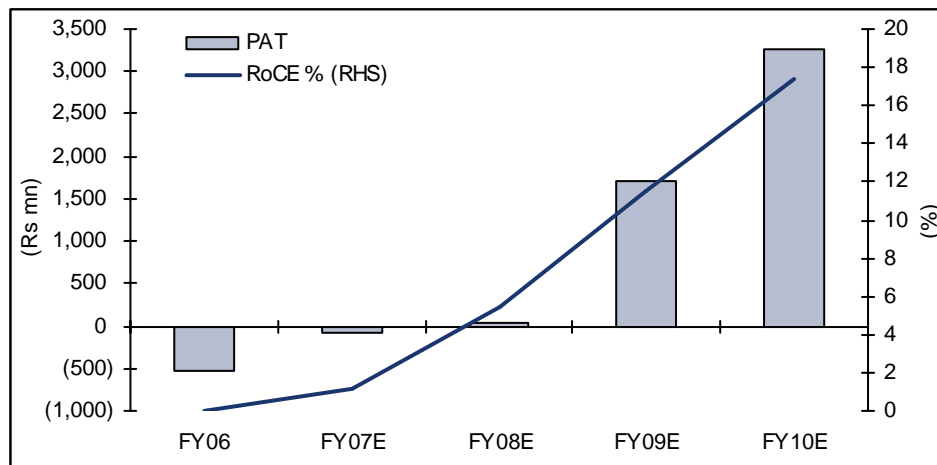
Source: i-SEC Research

**Chart 5: Exemplary growth in revenue and margins...**



Source: i-SEC Research

**Chart 6: ...will take SpiceJet to profitability**



Source: i-SEC Research



## Sensitivity analysis

While in our base-case estimate, we have assumed an ATF price of Rs45,000/Kl, we test the financial parameters for 10% change on either side. Notably, our base-case price corresponds to the peak crude price of US\$76/Bbl – given the recent fall in crude prices, ATF prices have reduced ~18% since October, '06.

However, the quantum of losses despite assuming ATF price of ~Rs49,500/Kl (as against current Rs38,000/Kl) is not very significant (Table 12). Upside in our load factor or yield assumption can offset the crude price increase. On the other hand, if ATF prices were to sustain at Rs40,500/Kl levels (still higher than current price), SpiceJet would break-even by FY08E.

Assuming a 5% sensitivity to load factors and yields (Tables 13 and 14), we estimate profitability to be delayed by a year in the adverse scenario. Similarly, the airline would be in the black in FY08E if the positive scenario sustains. Nevertheless, in line with the sector outlook, we do not expect such a severe slump in load or yields.

**Table 12: Sensitivity to ATF price**

	FY07E	FY08E	FY09E
<b>Base Estimates</b>			
EBITDAR (Rs mn)	1,147	3,403	6,595
EBITDAR Margin (%)	13.9	18.1	23.8
PAT (Rs mn)	(82)	29	1,708
DCF - NPV/Share (Rs)	107		
<b>ATF price increases by 10%</b>			
EBITDAR (Rs mn)	1,147	2,525	5,389
EBITDAR Margin (%)	13.9	13.4	19.5
PAT (Rs mn)	(82)	(849)	502
DCF - NPV/Share (Rs)	53		
<b>ATF price decreases by 10%</b>			
EBITDAR (Rs mn)	1,147	4,281	7,801
EBITDAR Margin (%)	13.9	22.8	28.2
PAT (Rs mn)	(82)	907	2,873
DCF - NPV/Share (Rs)	161		

Source: i-SEC Research

**Table 13: Sensitivity to load factors**

	FY07E	FY08E	FY09E
<b>Base Estimates</b>			
EBITDAR (Rs mn)	1,147	3,403	6,595
EBITDAR Margin (%)	13.9	18.1	23.8
PAT (Rs mn)	(82)	29	1,708
DCF - NPV/Share (Rs)	107		
<b>Load Factors rise by 5%</b>			
EBITDAR (Rs mn)	1,405	4,287	7,901
EBITDAR Margin (%)	16.5	21.7	27.2
PAT (Rs mn)	175	913	2,725
DCF - NPV/Share (Rs)	160		
<b>Load Factors fall by 5%</b>			
EBITDAR (Rs mn)	890	2,519	5,290
EBITDAR Margin (%)	11.2	14.1	20.1
PAT (Rs mn)	(339)	(854)	403
DCF - NPV/Share (Rs)	43		

Source: i-SEC Research

**Table 14: Sensitivity to yields**

	FY07E	FY08E	FY09E
<b>Base Estimates</b>			
EBITDAR (Rs mn)	1,147	3,403	6,595
EBITDAR Margin (%)	13.9	18.1	23.8
PAT (Rs mn)	(82)	29	1,708
DCF - NPV/Share (Rs)	107		
<b>Yields rise by 10%</b>			
EBITDAR (Rs mn)	1,594	4,306	7,926
EBITDAR Margin (%)	18.3	21.8	27.3
PAT (Rs mn)	365	932	2,673
DCF - NPV/Share (Rs)	161		
<b>Yields fall by 10%</b>			
EBITDAR (Rs mn)	722	2,500	5,264
EBITDAR Margin (%)	9.3	14.0	20.0
PAT (Rs mn)	(507)	(874)	377
DCF - NPV/Share (Rs)	41		

Source: i-SEC Research

## Valuations attractive despite the recent rally

### Attractive on DCF valuations – Target price Rs91/share

Based on DCF valuation, assuming a WACC of 12.7% and terminal FCF growth rate of 2%, we calculate an NPV of Rs107/share. Applying a further 15% discount to our DCF value, we arrive at a 12-month target price of Rs91/share.

Based on our target price, we have further tried to estimate implied forward multiple for FY08E (we expect the worst phase of competitive pressures to be over by then; refer sector report). Around the same time, SpiceJet will have achieved a fleet size of 18-20 aircraft, setting stage for a turnaround, driven by over 85% CAGR in revenues and >1,500bps margin expansion.

While SpiceJet at current market price of Rs53.45 trades at one-year forward FY08E EV/EBITDAR of 6.5x, on our target price of Rs91, it would trade at 7.5x, which still appears inexpensive as against global LCCs' peer group average one-year forward CY07/FY08E EV/EBITDAR of 15.5x.

**Table 15: Peer group trading multiples**

	SpiceJet	Air Asia	EasyJet	GOL	JetBlue	RyanAir	Southwest	Average
Current Price (Local Currency)	53.5	1.5	602.0	63.5	13.8	9.6	15.6	
Enterprise Value (US\$ mn)	562	1,224	4,269	5,950	6,509	10,588	12,478	
CY07E EV/EBITDAR (x)	-	10.2	37.9	8.5	11.2	19.2	6.0	15.5
Implied 1-yr forward FY08E @ CMP	6.5							
Implied 1-yr forward FY08E @ Target price	7.5							

Source: Respective company data, Bloomberg, i-SEC Research

**Table 16: FCFF calculation**

(Rs mn)

Particulars	FY07E	FY08E	FY09E	FY10E	FY11E	FY12E	FY13E	FY14E	FY15E	Terminal Value
Revenue	8,240	18,803	27,685	36,988	43,161	46,614	49,411	51,387	52,929	
Growth %	96.3	128.2	47.2	33.6	16.7	8.0	6.0	4.0	3.0	
Adj. EBIT	685	1,968	4,507	6,915	8,277	8,939	9,475	9,854	10,150	
Growth %		187.3	129.1	53.4	19.7	8.0	6.0	4.0	3.0	
Margin %	8.3	10.5	16.3	18.7	19.2	19.2	19.2	19.2	19.2	
Tax	25	52	70	295	568	1,574	2,050	2,164	2,252	
Effective Tax Rate					10.1	25.0	30.0	30.0	30.0	
Adj. EBIT (1-Tax)	660	1,916	4,437	6,621	7,709	7,365	7,425	7,691	7,898	
Add: Adj. Depreciation	943	1,808	2,464	3,102	3,662	3,932	4,016	4,075	4,121	
Add: Change in Working Capital	(102)	1,817	1,575	1,665	1,105	618	501	354	276	
Less: Total Capex and CWIP	9,374	17,152	12,735	7,380	7,481	1,865	1,976	2,055	2,117	
FCFF	(7,873)	(11,611)	(4,259)	4,008	4,995	10,050	9,965	10,064	10,178	97,366
Growth %					24.6	101.2	(0.8)	1.0	1.1	
PV of FCFF	(6,988)	(9,148)	(2,979)	2,488	2,752	4,915	4,326	3,877	3,481	29,555

Note: EBIT and depreciation adjusted for interest & depreciation portion in lease rentals; capex adjusted for leased assets

Source: i-SEC Research

**Table 17: DCF valuation**

WACC Calculations	(%)	DCF Valuation	(Rs mn)
Risk free rate	8.0	Terminal growth (%)	2.0
Market risk Premium	6.0	PV of FCF ('07-'15)	2,724
Sector risk Premium	3.0	PV of Terminal Value	29,555
Beta of the Stock (x)	1.3	Enterprise Value	32,279
Cost of equity	18.8	Less: Net Adjusted Debt*	12,546
Gross cost of debt	11.5	Value of Equity	19,733
Tax rate	33.6	No of equity shares	184
Net cost of Debt	7.6	<b>NPV/share (Rs)</b>	<b>107</b>
Target Debt to Capital ratio	55.0		
WACC	12.7	<b>Target price @ 15% discount to NPV (Rs)</b>	<b>91</b>

\* Includes off balance sheet liability – Leased aircraft

Source: i-SEC Research

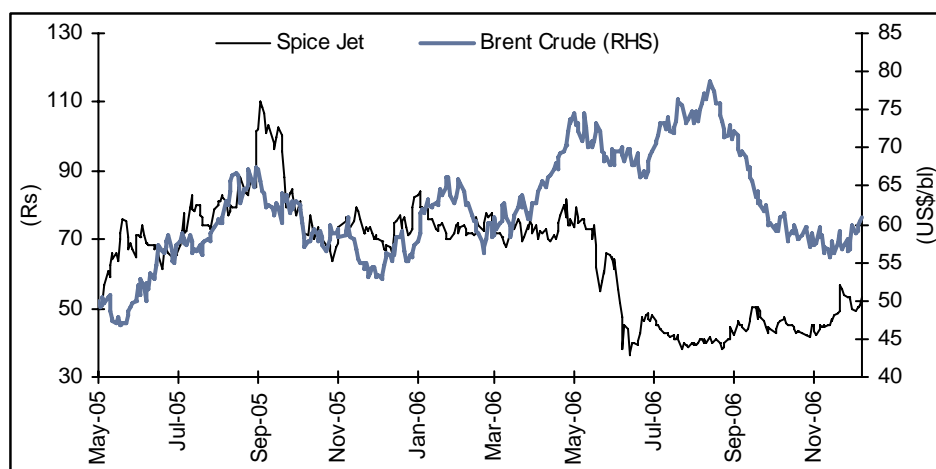
**Table 18: DCF sensitivity (Rs)**

Terminal growth rate / WACC	11.7%	12.7%	13.7%
1.0%	128	93	65
2.0%	146	<b>107</b>	76
3.0%	168	124	88

Source: i-SEC Research

### Recent rally driven by softening oil, industry rationalisation

We believe the recent rally in the stock price was driven partially by fall in crude prices and remaining by talks of increasing rationalisation (slower capacity addition and price increase). However, there is much steam left and current valuations do not reflect the true potential of the company.

**Chart 7: SpiceJet's share price versus Brent crude**

Source: Bloomberg

### Initiate coverage with BUY

SpiceJet is a success story waiting to unfold with potential value far exceeding the current market price. Following the globally tested pure LCC model, SpiceJet maintains a high focus on minimising costs and is set for a turnaround by FY09E. The airline is poised to expand its fleet significantly, targetting more than 20 high-growth destinations. We believe that the worst is already over for SpiceJet and recommend a BUY with a target price of Rs91/share.

## Key risks

### Shock from exogenous events such as terror attacks

We stress-tested SpiceJet's ability to sustain exogenous shocks such as terror attacks, air crash etc that could affect sentiments. In such an event, cashflow stream from forward sale of tickets would cease. Thus, the company would have to manage with cash in hand.

If SpiceJet's load factor were to crash to 50% from over 80% at present, the airline would have just enough cash to sustain losses for up to 30 days.

If we assume that market sentiments would be affected for about three months, SpiceJet would need an additional US\$22mn to meet cash losses for the period. Therefore, we believe that SpiceJet should maintain a cash chest of US\$25mn to meet such exogenous shocks without impacting its airline operations.

In such a scenario, the NPV/share (as per DCF analysis) would reduce from Rs107/share to Rs86/share.

### Operations focussed on congested airports

SpiceJet's focus on Delhi and Mumbai, the busiest airports (which are plagued by heavy congestion) might affect the airline in the medium term. Because of infrastructural constraints at these airports, airlines are forced to spend additional hours in sky thereby burning precious fuel. Additional flying hours also increase maintenance costs since it is directly linked to aircraft hours.

Fortunately, for SpiceJet, the airline operates most of its flights during off-peak hours, when the congestion is less, leading to lesser impact on the bottomline. Secondly, as part of the modernisation plan, a second runway is expected soon in the Delhi airport and a by-pass taxiing arrangement is underway in the Mumbai airport. This would lead to reduced congestion as well as help reduce block hours spent per flight and fuel costs.

### Risks from expanding operations

At present, the management team boasts of experienced professionals from the industry. However, increasing operations imply the need to strengthen operational management. The airline has recently been proactive on this front and has added professionals from global peers (Annexure 3).

## Annexure 1: Financials

**Table 19: Profit and loss account**

(Rs mn, year ending March 31)

	FY06*	FY07E*	FY08E	FY09E
<b>Gross Sales</b>	4,197	8,240	18,803	27,685
Less: Excise Duty	-	-	-	-
<b>Net Sales</b>	<b>4,197</b>	<b>8,240</b>	<b>18,803</b>	<b>27,685</b>
of which Export Sales	-	-	-	-
of which Domestic Sales	4,197	8,240	18,803	27,685
Other Operating Income	-	-	-	-
<b>Total Operating Income</b>	<b>4,197</b>	<b>8,240</b>	<b>18,803</b>	<b>27,685</b>
<b>Less:</b>				
Fuel	1,990	3,833	8,780	12,063
Landing & Other Airport Charges	339	747	1,557	2,056
Aircraft Maintenance	348	784	1,707	2,371
Aircraft Lease Rentals	772	1,314	3,096	4,471
Aircraft Insurance	112	143	289	377
Other Operating Costs	691	802	1,627	2,319
Selling & Distribution	63	439	916	1,284
Administrative & Other Expenses	485	345	524	620
<b>EBITDAR</b>	<b>169</b>	<b>1,147</b>	<b>3,403</b>	<b>6,595</b>
<b>EBITDA</b>	<b>(603)</b>	<b>(166)</b>	<b>307</b>	<b>2,124</b>
Depreciation & Amortisation	82	134	237	285
Other Income	157	35	46	144
Adj. Depreciation	82	134	237	285
<b>EBIT</b>	<b>(527)</b>	<b>(266)</b>	<b>116</b>	<b>1,983</b>
<b>Adj. EBIT</b>	<b>(527)</b>	<b>(266)</b>	<b>116</b>	<b>1,983</b>
Less: Gross Interest	236	272	407	580
<b>Pre-tax income</b>	<b>(763)</b>	<b>(538)</b>	<b>(291)</b>	<b>1,403</b>
<b>Recurring Pre-tax Income</b>	<b>(763)</b>	<b>(538)</b>	<b>(291)</b>	<b>1,403</b>
Add: Extraordinary Income	236	480	372	376
Less: Extraordinary Expenses				
Less: Taxation	13	25	52	70
--Current Tax	-	-	-	-
--Deferred Tax	-	-	-	-
--Fringe Benefit Tax	13	25	52	70
Adj. Taxation	13	25	52	70
<b>Net Income (Reported)</b>	<b>(540)</b>	<b>(82)</b>	<b>29</b>	<b>1,708</b>
<b>Recurring Net Income</b>	<b>(776)</b>	<b>(562)</b>	<b>(343)</b>	<b>1,332</b>
<b>Cash Profits</b>	<b>(852)</b>	<b>(463)</b>	<b>(152)</b>	<b>1,473</b>

\* Till FY06 year ends on May 31, FY07E for 10 months

Source: Company data, i-SEC Research

**Table 20: Balance sheet***(Rs mn, year ending March 31)*

	FY06*	FY07E*	FY08E	FY09E
<b>ASSETS</b>				
<b>Current Assets, Loans &amp; Advances</b>				
Cash & Bank balance	529	684	1,347	3,505
Inventory	34	46	66	81
Sundry Debtors	34	64	140	206
Other Current Assets	640	640	640	640
<b>Total Current Assets</b>	<b>1,237</b>	<b>1,434</b>	<b>2,194</b>	<b>4,433</b>
<b>Current Liabilities &amp; Provisions</b>	<b>1,650</b>	<b>1,591</b>	<b>3,504</b>	<b>5,161</b>
<b>Current Liabilities</b>	<b>1,508</b>	<b>1,591</b>	<b>3,504</b>	<b>5,161</b>
Sundry Creditors	1,508	1,591	3,504	5,161
Other Current Liabilities				
<b>Provisions</b>	<b>142</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Total Current Liabilities and Provisions</b>	<b>1,650</b>	<b>1,591</b>	<b>3,504</b>	<b>5,161</b>
<b>Net Current Assets</b>	<b>(413)</b>	<b>(156)</b>	<b>(1,310)</b>	<b>(728)</b>
<b>Deposits and Advances</b>				
Deposits and Advances	3,805	7,770	5,538	1,638
Deposits relating to leases and AAI	176	558	1,173	1,638
Sale/Leaseback Advances	3,629	7,212	4,364	-
<b>Total Deposits and Advances</b>	<b>3,805</b>	<b>7,770</b>	<b>5,538</b>	<b>1,638</b>
<b>Total Investments</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Fixed Assets</b>				
Gross Block	589	1,097	1,502	1,818
Less Accumulated Depreciation	98	232	469	754
Net Block	490	865	1,033	1,064
Add: Capital Work in Progress	-	-	2,409	3,960
Less: Revaluation Reserve				
<b>Total Fixed Assets</b>	<b>490</b>	<b>865</b>	<b>3,442</b>	<b>5,024</b>
<b>Off Balance Sheet Arrangements</b>				
Leased Aircraft	8,845	16,016	26,642	32,574
<b>Total Assets</b>	<b>12,728</b>	<b>24,495</b>	<b>34,312</b>	<b>38,508</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>				
<b>Borrowings</b>				
Short Term Debt	508	1,000	-	-
Secured Loans - FCCB	3,723	3,945	4,231	4,538
Aircraft Funding	-	3,964	3,838	89
<b>Total Borrowings</b>	<b>4,230</b>	<b>8,909</b>	<b>8,069</b>	<b>4,627</b>
<b>Off Balance Sheet Arrangements</b>				
Aircraft Lease Liability	8,845	16,016	26,642	32,574
<b>Share Capital</b>				
Paid up Equity Share Capital	1,843	1,843	1,843	1,843
No. of Shares outstanding (mn)	184	184	184	184
Face Value per share (Rs)	10	10	10	10
<b>Reserves &amp; Surplus</b>				
Share Premium	1,061	1,061	1,061	1,061
General & Other Reserve	(3,158)	(3,240)	(3,211)	(1,503)
Less: Misc. Exp. not written off	94	94	94	94
Less: Revaluation Reserve				
<b>Net Worth</b>	<b>(348)</b>	<b>(430)</b>	<b>(400)</b>	<b>1,308</b>
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b>12,728</b>	<b>24,495</b>	<b>34,312</b>	<b>38,508</b>

\* Till FY06 year end on May 31, FY07E for 10 months

Source: Company data, i-SEC Research

**Table 21: Cash flow statement***(Rs mn, year ending March 31)*

	<b>FY06*</b>	<b>FY07E*</b>	<b>FY08E</b>	<b>FY09E</b>
<b>Cash Flow from Operating Activities</b>				
Reported Net Income	(540)	(82)	29	1,708
<i>Add:</i>				
Depreciation & Amortisation	82	134	237	285
Provisions	126	222	287	307
Deferred Taxes	-	-	-	-
<i>Less:</i>				
Other Income	13	-	-	-
Net Extra-ordinary income	177	480	372	376
<b>Operating Cash Flow before Working Capital change (a)</b>	<b>(522)</b>	<b>(207)</b>	<b>181</b>	<b>1,924</b>
<b>Changes in Working Capital</b>				
(Increase) / Decrease in Inventories	(16)	(13)	(20)	(15)
(Increase) / Decrease in Sundry Debtors	(137)	(30)	(77)	(66)
(Increase) / Decrease in Other Current Assets	-	-	-	-
Increase / (Decrease) in Sundry Creditors	830	82	1,914	1,656
Increase / (Decrease) in Other Current Liabilities	(14)	(142)	-	-
<b>Working Capital Inflow / (Outflow) (b)</b>	<b>663</b>	<b>(102)</b>	<b>1,817</b>	<b>1,575</b>
<b>Net Cash flow from Operating Activities (a) + (b)</b>	<b>140</b>	<b>(309)</b>	<b>1,998</b>	<b>3,499</b>
<b>Change in Deposits/Advances</b>				
Change in Deposits against lease & AAI	-	(382)	(615)	(465)
Change in Advance paid to Boeing for Aircraft on lease	-	(3,583)	2,848	4,364
<b>Inflow / (Outflow) from Deposits/Advances (c)</b>	<b>-</b>	<b>(3,965)</b>	<b>2,232</b>	<b>3,899</b>
<b>Cash Flow from Capital commitments</b>				
Purchase of Fixed Assets	(391)	(508)	(405)	(316)
Purchase of Investments	-	-	-	-
Change in Capital Work in Progress	(3,153)	-	(2,409)	(1,552)
<b>Cash Inflow/(outflow) from capital commitments (d)</b>	<b>(3,544)</b>	<b>(508)</b>	<b>(2,814)</b>	<b>(1,867)</b>
<b>Free Cash flow after capital commitments (a) + (b) + (c) + (d)</b>	<b>(3,404)</b>	<b>(4,782)</b>	<b>1,417</b>	<b>5,531</b>
<b>Cash Flow from Investing Activities</b>				
Purchase of Marketable Investments	-	-	-	-
(Increase) / Decrease in Other Loans & Advances	-	-	-	-
Sale of Fixed Assets	-	-	-	-
Sale of Investments	-	-	-	-
Consideration received for sale of undertaking/division	-	-	-	-
Other Income	(84)	-	-	-
<b>Net Cash flow from Investing Activities (e)</b>	<b>(84)</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Cash Flow from Financing Activities</b>				
Issue of Share Capital during the year	589	-	-	-
Proceeds from FCCB	3,596	-	-	-
Aircraft funding	-	3,964	(126)	(3,749)
Other Borrowings	(636)	492	(1,000)	-
Buyback of Shares	-	-	-	-
Dividend paid including tax	-	-	-	-
<b>Net Cash flow from Financing Activities (f)</b>	<b>3,550</b>	<b>4,456</b>	<b>(1,126)</b>	<b>(3,749)</b>
<b>Net Extra-ordinary Income (g)</b>	<b>177</b>	<b>480</b>	<b>372</b>	<b>376</b>
<b>Total Increase / (Decrease) in Cash (a) + (b) + (c) + (d) + (e) + (f) + (g)</b>	<b>239</b>	<b>155</b>	<b>663</b>	<b>2,157</b>

\* Till FY06 year ends on May 31, FY07E for 10 months

Source: Company data, i-SEC Research



**Table 22: Key ratios***(Year ending March 31)*

	FY06*	FY07E*	FY08E	FY09E
<b>Per Share Data (Rs)</b>				
Diluted Recurring Earning per share (DEPS)	(4.2)	(3.1)	(1.9)	6.8
Diluted Earnings per share	(2.9)	(0.4)	0.2	8.4
Recurring Cash Earnings per share (CEPS)	(3.8)	(2.3)	(0.6)	8.0
Free Cashflow per share (FCPS-post capex)	(18.5)	(25.9)	7.7	30.0
Reported Book Value (BV)	(1.9)	(2.3)	(2.2)	7.1
Adjusted Book Value (ABV) **	(1.9)	(2.3)	(2.2)	7.1
Dividend per share	-	-	-	-
<b>Valuation Ratios (x)</b>				
Diluted Price Earning Ratio	(12.7)	(17.5)	(28.8)	7.9
Price to Recurring Cash Earnings per share	(14.2)	(23.0)	(93.3)	6.7
Price to Book Value	(28.3)	(22.9)	(24.6)	7.5
Price to Adjusted Book Value	(28.3)	(22.9)	(24.6)	7.5
Price to Sales Ratio	2.3	1.2	0.5	0.4
EV / EBITDAR	132.7	29.7	12.7	6.6
EV / Total Operating Income	5.3	4.1	2.3	1.6
EV / Operating Free Cash Flow (Pre-Capex)	159.7	NA	21.6	12.4
EV / Net Operating Free Cash Flow (Post-Capex)	NA	NA	30.5	7.9
Dividend Yield (%)	-	-	-	-
<b>Growth Ratios (% YoY)</b>				
Diluted Recurring EPS Growth	NA	NA	NA	NA
Diluted Recurring CEPS Growth	NA	NA	NA	(1,493.6)
Total Operating Income Growth	NA	96.3	128.2	47.2
EBITDAR Growth	NA	579.5	196.6	93.8
Recurring Net Income Growth	NA	NA	NA	NA
<b>Operating Ratios (%)</b>				
EBITDA Margins	(14.4)	(2.0)	1.6	7.7
EBITAR Margins	4.0	13.9	18.1	23.8
Recurring Pre-tax Income Margins	(17.5)	(6.5)	(1.5)	5.0
Recurring Net Income Margins	(17.8)	(6.8)	(1.8)	4.8
Fuel Consumed / Sales	47.4	46.5	46.7	43.6
Lease Rentals/Sales	18.4	15.9	16.5	16.2
SGA Expenses / Sales	13.1	9.5	7.7	6.9
Effective Tax Rate	NA	-	-	-
<b>Return / Profitability Ratios (%)</b>				
Return on Capital Employed (RoCE)-Overall	NA	1.2	5.4	11.5
Return on Invested Capital (RoIC)	2.1	7.6	12.0	19.4
Return on Net Worth (RoNW)	NA	NA	NA	293.5
Dividend Payout Ratio	-	-	-	-
<b>Solvency Ratios / Liquidity Ratios</b>				
Debt Equity Ratio (D/E) (x)	NA	NA	NA	28.4
Long Term Debt / Total Debt	1.0	1.0	1.0	1.0
Net Working Capital / Total Assets (%)	(7.4)	(3.4)	(7.7)	(11.0)
Interest Coverage Ratio-based on EBIT (x)	NA	(1.2)	0.3	3.4
Debt Servicing Capacity Ratio (DSCR) (x)	NA	(0.1)	0.2	1.7
Current Ratio (x)	0.57	0.55	0.63	0.86
Cash and cash equivalents / Total Assets (%)	4.2	2.8	3.9	9.1
<b>Turnover Ratios</b>				
Inventory Turnover Ratio (x)	89.9	137.7	185.7	195.1
Assets Turnover Ratio (x)	0.3	0.5	0.6	0.8
Working Capital Cycle (days)	(15.6)	(10.5)	(14.2)	(13.4)
Average Collection Period (days)	2.2	1.8	2.0	2.3

\* Till FY06 year ends on May 31, FY07E for 10 months

Source: Company data, i-SEC Research

## Annexure 2: Interim results

**Table 23: Quarterly results**

(Rs mn, year ending May\*)

	Aug-05	May-06	Aug-06
Net Sales	573	1,488	1,595
Total Operating Cost	754	1,647	1,947
Contribution	(181)	(160)	(352)
Interest	6	10	7
Depreciation	10	7	23
Other Income	90	52	19
Profit before Tax	(106)	(125)	(362)
Tax	2	5	5
Net Income before Extraordinary Items	(108)	(131)	(367)
Extraordinary Items	-	(5)	189
Reported Net Income	(108)	(135)	(178)
Contribution Margin (%)	(31.6)	(10.7)	(22.1)
Recurring PAT Margin (%)	(18.9)	(8.8)	(23.0)

\* Till FY06 year ends on May 31

Source: Company data

SpiceJet reported Rs1.59bn revenues and Rs178mn net loss for the quarter ended August '06. Adjusted for extraordinary gain in the form of write-back of time barred creditor claims, net loss was Rs367mn, while adjusted EBITDAR margin was at (3.8%) as compared with 9.6% for the quarter ended May '06. Results for the quarter were affected by lower yields and load factors due to the lean season. Non-availability of two aircraft for ~20 days during August further affected the available capacity.

Nevertheless, load factor for the quarter was comfortable at ~82% (the highest for the industry). Average ticket price was similar to FY06 levels at ~Rs2,350. Average fuel price for the quarter increased more than 8% to ~Rs42/litre from an average of Rs37/litre for fiscal ended May '06.

Non-availability of two aircraft (that were sent for C maintenance check for 20 days during August) impacted the seat availability for the month, thereby affecting the average aircraft availability in August (4.67 against six in June and July). We estimate the topline was affected almost Rs110mn, even as fixed charges such as depreciation, interest, lease rentals and semi-variable costs (staff expenses) continued to accrue on these aircraft.

SpiceJet expects yields to improve during the November quarter, which is generally a busy season.

## Annexure 3: Company profile

### Background

SpiceJet is the second-largest LCC in the domestic airline industry with a market share of ~7%. The airline recently added online hotel booking through its website to its portfolio. The company was originally promoted by the SK Modi Group under the name ModiLuft. It was acquired by Royal Holding Services (Kansagra family) in '00 and re-started operations in May '05. The company has a strong management team, which has significant experience in the LCC industry and start-up airlines. SpiceJet also has a maintenance support by KLM. The airline has a market cap of US\$221mn at present.

### Management

SpiceJet is controlled by the London-based Kansagra family that has significant business interest in fertilisers, ceramic ware, transportation, salts, horticulture and mixed farming spread over Kenya, Tanzania, Sudan and Nigeria.

### Key personnel

**Mr. Sidhanta Sharma, CEO.** Mr. Sharma has 25 years of experience and has set up a number of greenfield projects in India. His recent assignments include Allied Domecq India (CEO/Commercial Director) and Westmill Foods (Resident Representative).

**Mr. Jati Dhillon, EVP Flight Operations.** With over 32 years of aviation and management experience, Mr. Dhillon has worked as the Chief Pilot, Line Operations with Jet Airways.

**Capt. R.L. Kapur, Head Flight Safety.** A qualified examiner with over 25,000 flying hours, he has worked as Director Operations, Indian Airlines and MD, ModiLuft.

**Capt. John Curtis Ekl, Chief Pilot.** With 41 years of diverse aviation experience, John has previously held posts with Southwest Airlines as Director, Operations and Chief Pilot.

In line with its objective to handle the increasing size of its business, SpiceJet recently added the following seasoned airline professionals into the management team.

**Allen Marking, EVP Engineering.** He is an Aeronautical Engineer with over 35 years of experience with the likes of easyJet, World Airlines, Air Sahara, Gulf Air, etc.

Since January '05, Citigroup Inc., Isthitar, Deutsche Bank, HSBC and Standard Chartered have together acquired more than 20% stake in the company. IL&FS infused Rs153mn into the company by way of fully convertible debentures in March '05, which has been converted into equity at a price of Rs41.18/share. The company raised US\$92.5mn from international market through placement of equity (US\$12.5mn) and issue of FCCBs (US\$80mn). The FCCBs mature in '10 and are convertible at a strike price of Rs90.

**Table 24: Shareholding pattern**

(%)

	<b>Mar-06</b>	<b>Jun-06</b>	<b>Sep-06</b>
Promoters	17.3	16.9	16.9
- Indian	-	-	-
- Foreign*	17.3	16.9	16.9
Institutional investors	24.1	22.2	19.4
MFs and UTI	3.6	1.5	2.4
Insurance Cos.	0.1	0.1	0.1
FIIIs	20.4	20.7	17.0
Others	58.6	60.9	63.7

Source: BSE website

\*Stake owned by Kansagra family qualifies as foreign ownership since the Group is London based.

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## Jet Airways

HOLD

## Waiting for good times

Rs653

Reason for report: Initiating coverage

**Jet Airways' outlook is delicately poised due to medium-term pricing pressure on the back of growing clout of LCCs & 'value airlines' in domestic operations and high start-up costs in international operations. While margin pressure in the domestic market is expected to be offset by ongoing cost reduction, visibility on profits from international operations is restricted as footprint expansion would continue over the next 12-15 months. Even as domestic operations are expected to turnaround in H2FY07, competitive scenario in international routes from India remains challenging. At current market price of Rs653 the risk-reward ratio does not seem favourable. We initiate coverage on Jet Airways with a HOLD recommendation.**

- ▶ **Domestic operations to worsen before picking up.** Jet's domestic market share has already been impacted due to the advent of LCCs and 'value airlines', leading to pressure on yield-load factor balance and shrinkage in EBITDAR margin from 27% to 14.9% in FY07E. Ongoing cost reduction and seasonal pick-up in demand will likely lead to a turnaround in H2FY07.
- ▶ **International operations – A challenge.** We expect Jet to post cash losses from international operations until FY09E due to a four-fold increase in international fleet over the next 15 months. Unfavourable competitive scenario is likely to impact operations as new routes to the US and EU are rolled out. Expected entry of international LCCs will further impact competitive scenario and delay recovery.
- ▶ **Limited visibility on profits.** We expect Jet to be in the red until FY08E due to initial losses from international operations, which would offset the turnaround in the domestic operations. Accordingly, consolidated EBITDAR margin is expected to dip from 23.9% to 11.5% in FY07E before improving to 15% by FY09E. Watch for – i) yield and load factor improvements in the next two quarters and ii) funding of aircraft for international operations.
- ▶ **Initiate coverage with HOLD.** Based on our base-case DCF analysis with reasonable assumptions, we arrive at an NPV of Rs755/share, while replacement cost valuation (including brand valuation and partial litigation impact) yields a value of Rs530. Taking an average of the two approaches we arrive at a 12-month target price of Rs642.

Market Cap	Rs56bn/US\$1.3bn	<b>Year to March</b>	<b>FY06</b>	<b>FY07E</b>	<b>FY08E</b>	<b>FY09E</b>
Reuters/Bloomberg	JET.BO/JETIN IN	Revenue (Rs mn)	56,937	74,681	111,363	149,958
Shares Outstanding (mn)	86.3	Rec. Net Income (Rs mn)	1,402	(1,917)	(1,800)	421
52-week Range (Rs)	1,268/492	EPS (Rs)	16.2	(22.2)	(20.9)	4.9
Free Float (%)	20.0	% Chg YoY		NA	NA	NA
FII (%)	15.5	P/E (x)	40.2	(29.4)	(31.3)	134.0
Daily Volume (US\$/'000)	8,200	CEPS (Rs)	63.3	15.0	111.7	222.1
Absolute Return 3m (%)	3.4	EV/EBITDAR (x)	11.0	20.2	15.9	9.9
Absolute Return 12m (%)	(47.4)	Dividend Yield (%)	0.5	-	-	-
Sensex Return 3m (%)	19.5	RoCE (%)	4.2	1.6	2.3	4.5
Sensex Return 12m (%)	52.2	RoE (%)	13.0	(17.4)	(19.7)	6.7

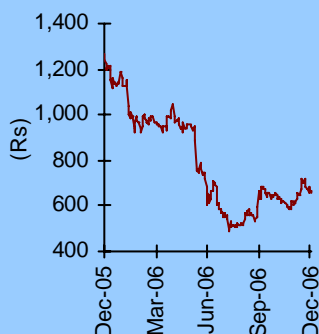
Please refer to important disclosures at the end of this report

## Aviation

## Shareholding pattern

	Mar '06	Jun '06	Sep '06
Promoters	80.0	80.0	80.0
Institutional investors	15.6	15.8	15.5
MFs and UTI	2.9	2.9	1.4
Insurance Cos.	2.2	3.2	4.3
FIs	10.5	9.6	9.8
Others	4.4	4.2	4.5

## Price chart



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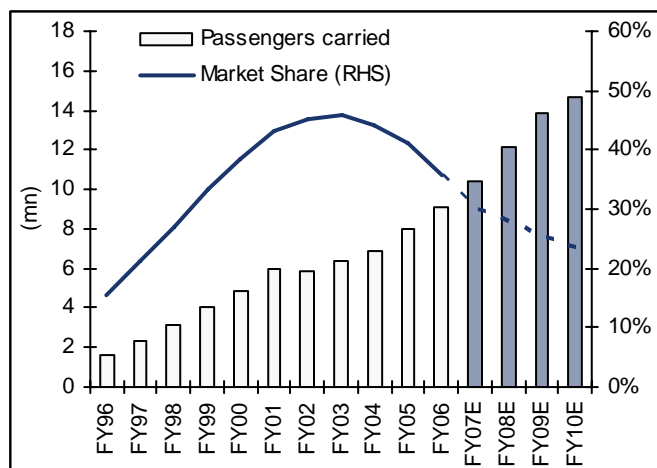
## Domestic operations to worsen before it improves

### Market share already impacted

In line with the aviation sector outlook, we expect industry-wide traffic to increase at a rapid pace. Even though Jet will benefit from this growth, we expect it to lag the industry growth. The trend has been visible since FY03 (which was the inflection point) when industry growth upstaged Jet's growth (Charts 1 and 2). We expect Jet's market share to reduce further to 23.7% by FY10E from the current 35.7% (FY06). In a scenario of losing market share, Jet will continue to experience pressure on yields and load factors.

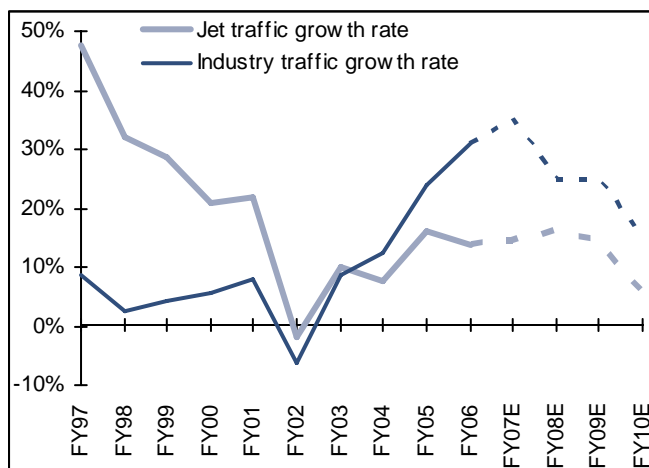
Importantly, while loss in market share and underperformance has been mainly due to the rise of LCCs, further deterioration is expected because of 'value airlines'.

**Chart 1: Loss in domestic market share to continue...**



Source: DGCA, i-SEC Research

**Chart 2: ...due to the inability to match industry growth**



Source: i-SEC Research

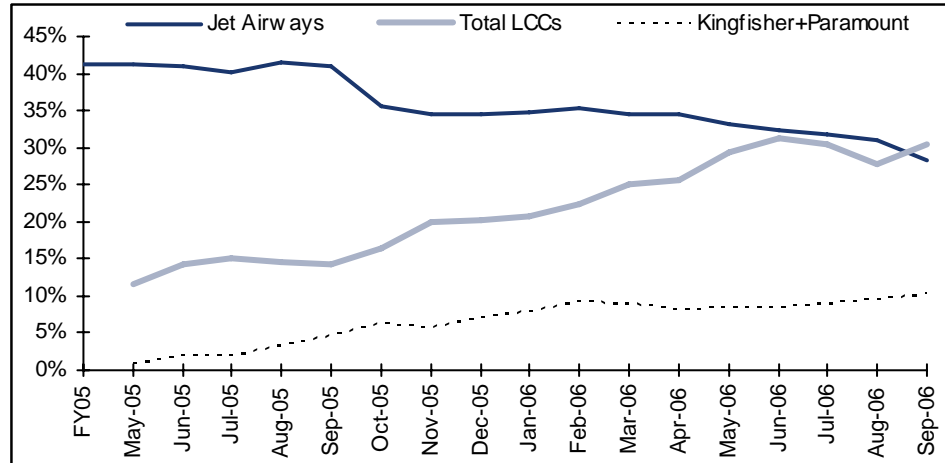
### Future threat from 'value airlines' – Kingfisher and Paramount

While the airline recently lost market share to LCCs, there is an increasing threat from the new breed of value airlines such as Kingfisher and Paramount. Both LCCs and value airlines (40.7%) have already surpassed Jet's total market share (28.4%) in September '06 (Chart 3).

In the coming quarters, Jet's domestic market share is expected to be under pressure from competitors such as Kingfisher and Paramount. As Kingfisher has already poached a fair share of Jet's business travellers, it is a serious future threat for the company because of comparable offering (if not better).

Planning to significantly expand its network, Kingfisher has also been able to acquire prime time departure slots in major metros, challenging Jet further.

**Chart 3: Losing market share to LCCs and value airlines**



Net of fuel charges, costs should reduce substantially by FY09E  
 Source: DGCA

**Turnaround to be led by ongoing cost reduction**

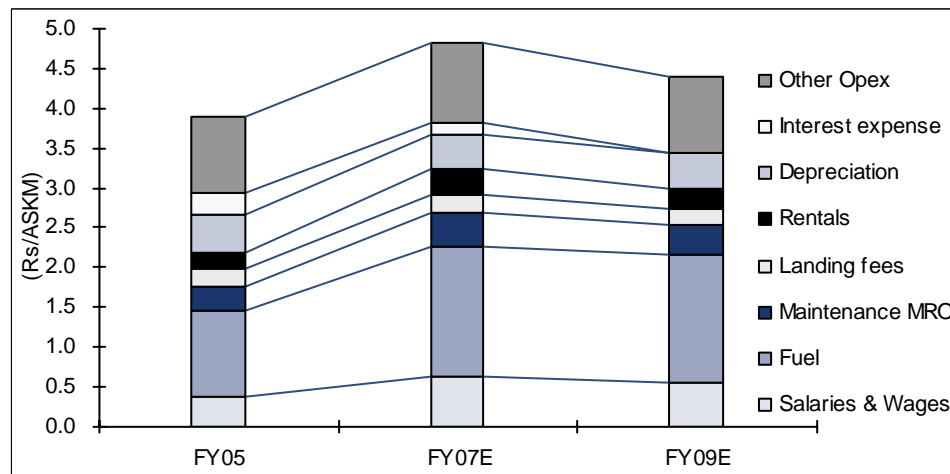
**Ongoing cost reduction**

Globally, FSCs have responded to the challenge from LCCs by reducing their costs. We foresee a similar story to unfold for Jet. Even as costs have piled since FY05, we expect it to rise in FY07E (mainly due to rising fuel prices) before decreasing substantially by FY09E (Chart 4).

On a per ASKM basis, Jet’s total cost ex fuel is expected to reduce to Rs2.56 by FY09E from Rs2.83 in FY05. Reduction in selling and distribution expenses and lower maintenance cost due to in-house hangar will help contain costs.

Notably, our base-case assumptions include fuel price of Rs45,000/Kl corresponding to peak cycle crude price of US\$76/Bbl. Sustained lower crude prices may help reduce costs further, signalling an earlier-than-expected turnaround.

**Chart 4: Efforts to reduce costs will yield results**



Note: Re-classified for comparison purpose  
 Source: Company data, i-SEC Research

**Medium term margin pressure from adverse yields load balance**

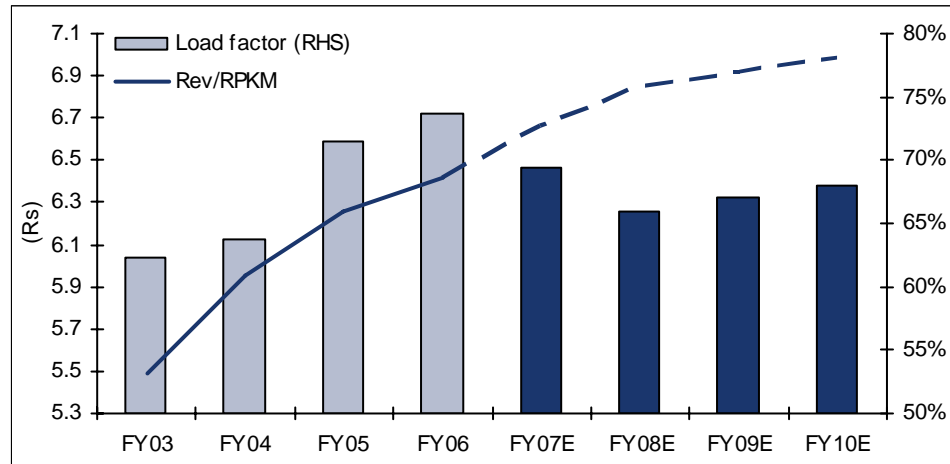
Competitive pressures from both LCCs and value airlines have reflected in lower yield/load factor for Jet. In its quest to maintain market share, the carrier has been forced to offer heavy discount in its regular fares. While this has temporarily boosted load factor, margins have shrunk dramatically. This is also reflected in consecutive quarterly losses in H1FY07.

However, we do not expect Jet to continue with its discounts over a long term in order to boost load factors (this is a strategy employed by LCCs). Hence, while we expect yields to recover from the current levels, load factors are expected to remain lower than historical highs. Chart 5 shows rising yield for FY07E on the back of fuel surcharge (net of fuel surcharge Rev/RPKM has actually declined 5% in H1FY07).

Full impact from the levy of fuel surcharge and seasonal pick up in demand are expected to boost yields in H2FY07E leading to a turnaround.

**Chart 5: Higher yields at the expense of lower load factor**

While fuel surcharge has boosted yields so far, future increase in yields would be at the cost of lower load factor



Source: Jet Airways, i-SEC Research

## International operations – A challenge

### Stiff competition on international routes

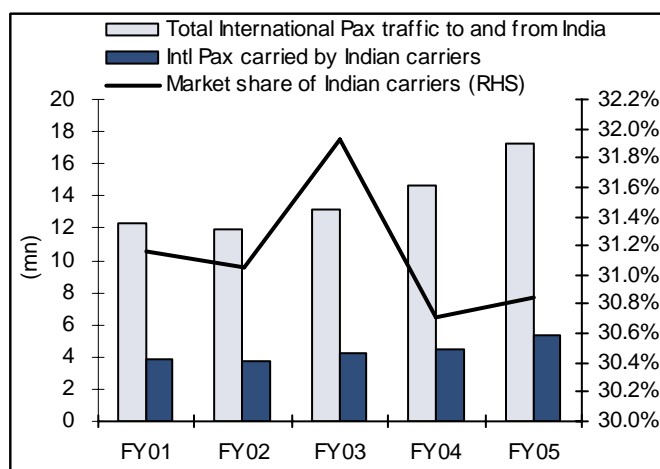
#### International players dominate international routes

Even as international traffic from India has grown in double digits (18% in FY05 over FY04) and reached 17.27mn passengers in FY05, the share of Indian carriers has remained low (Chart 6).

While Jet will compete with established foreign carriers such as Singapore Airlines (SIA), British Airways etc, which are strong on the balance sheet and brand image, foreign carriers use India only as a stop-over or extension destination. Thus, international players can substantially cut prices creating an unfair play for the Indian carriers.

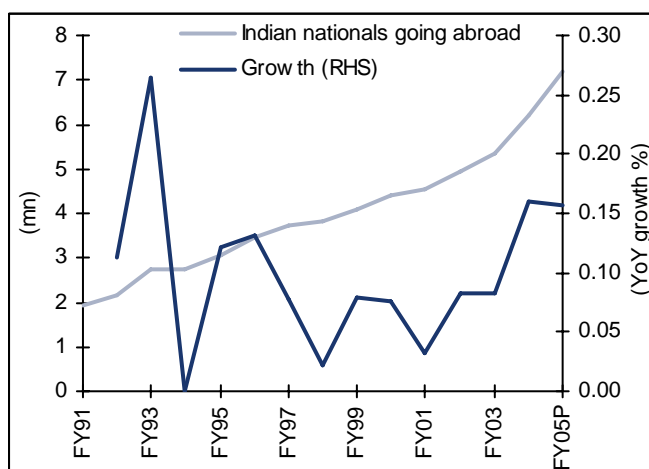
However, Jet can benefit from origin advantage as more and more Indians are taking to international travel (Chart 7).

**Chart 6: Though foreign carriers enjoy higher traffic share...**



Source: DGCA

**Chart 7: ..opportunities exist as more and more Indians are taking to international travel**



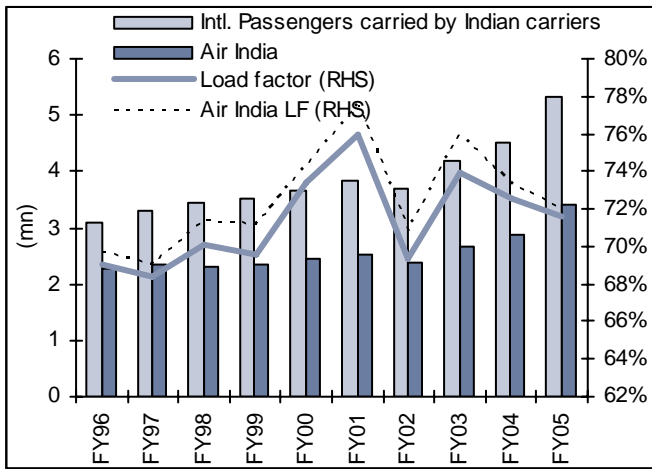
Source: Ministry of Tourism

#### Tough outlook reflected in Air India's performance

Air India has not been able to capitalise on the international opportunities and reeled under the dominance of foreign carriers on the international routes. The airline has rarely achieved break-even load factor on its international operations in the past 10 years (Charts 8 and 9). Nevertheless, Air India posted profits during the period due to cargo revenues.

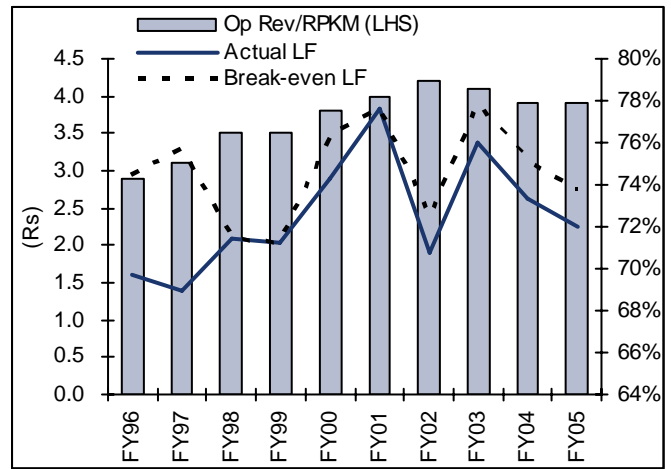
We expect Jet to perform better than Air India similar to its outperformance on the domestic routes as against Indian for the past several years. However, concerns on intensifying competition from foreign carriers will delay significant improvement in Jet's operational metrics.

**Chart 8: Though Air India has bulk of the traffic (among Indian carriers)...**



Source: DGCA

**Chart 9: ...it has not been able to break-even**



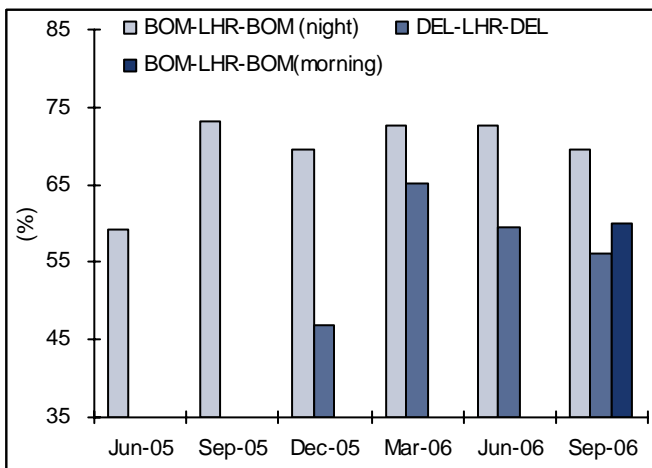
Source: DGCA

**Competitive scenario unfavourable**

**India-UK route plagued by excess capacity**

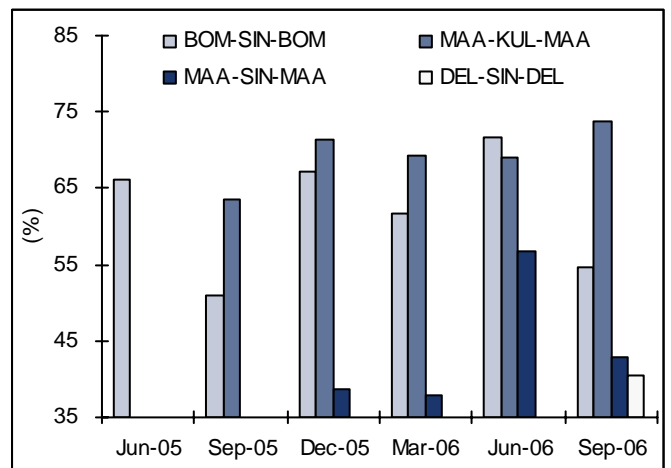
Jet has observed poor load factors on its London and South East Asian routes (Charts 10 and 11). Though traffic between India and the UK has been growing at over 15%, capacity deployment is far higher. As per DGCA, 0.88mn air trips were registered between India and the UK in FY05. We estimate that there are 8,000 daily seats (on an average) on offer (both ways) between India and the UK as against the demand of less than 5,000 seats; this translates into a load factor of just 60%.

**Chart 10: Poor load factor on the UK route...**



Source: Jet Airways

**Chart 11: ...similar to South East Asian routes**



Source: Jet Airways

International carriers can handle such lower load factors as India is used as an extension of main routes from where they already carry a bulk of their passengers. For example, SIA can operate Singapore-London flight via Mumbai with most of its seats taken in Singapore and only the balance on offer in Mumbai. Since Singapore already generates a sufficient load factor, Mumbai needs fewer seats for the flight to break-even or generate profits.

**Competition to intensify on US routes too**

The US accounts for close to 30% of tourist inflows to India (Chart 12). As such, India-US routes are on the priority list of most Indian carriers. However, capacity deployment on the India-US route is similar to that on the India-UK route as the passengers have an option of choosing from direct flights, or transit via London, the Middle East or other European destinations. Rough estimates (source: based on search from travel portals) suggest current capacity at 5mn seats per annum.

Current route load factor estimated at 72%

As per DGCA, traffic on India-US routes was at 0.55mn in FY05 (growing at 24%), but industry sources suggest that actual traffic could be ~15% of total international traffic from India (i.e. ~2.6mn passengers in FY05). The discrepancy arises because several passengers opt for hopping flights to the US via countries in Europe and the Middle East. Even if we assume a 25% growth rate on FY05 traffic (at 2.6mn), current traffic would be at 3.6mn passengers per annum. This translates into a load factor of ~72%.

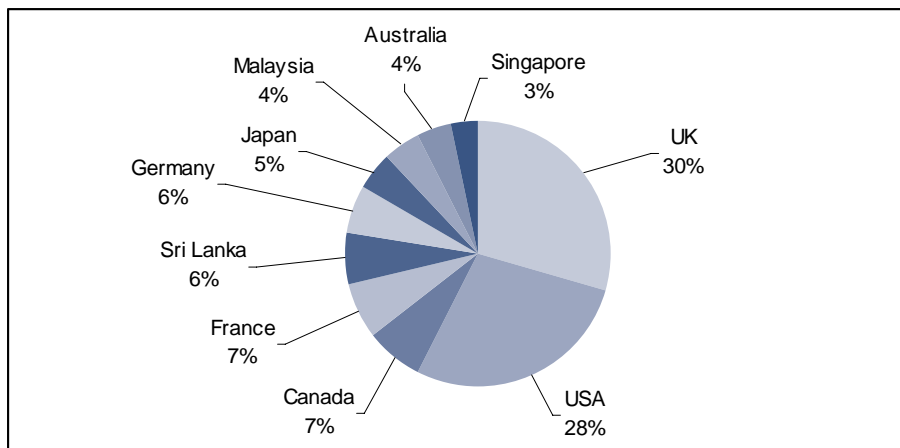
However, the situation is set to worsen with capacity augmentation planned by several players including Delta, Air India and Continental. These would primarily consist of non-stop flights between the two countries. This apart, the entry of Jet and Kingfisher Airlines (subject to the Government approval) would further worsen the demand-supply balance. Price war has already begun on US routes with Delta offering as low as Rs29,000 (plus taxes) on India-US return flights.

Jet plans to launch services to the US by June '07; it is expecting the formal approval from the US Department of Transport. Initially, Jet plans to start with flights on Mumbai-Brussels-Newark and Mumbai-Shanghai-San Francisco routes by deploying 5-6 Boeing 777s (of the total 10 on order) in a phased manner.

Positive EBITDAR contributions expected from US routes from FY09E

Based on our assumption of an average 65% load factor for FY08E and 70% for FY09E, we estimate US operations to be EBITDAR negative for FY08E and generate modest EBITDAR margin in FY09E. At the PAT level, US operations are likely to break-even in FY10E since Jet plans to finance its Boeing 777s through debt.

**Chart 12: UK and US generate maximum tourists for India**



Source: Ministry of Tourism

**Entry of LCCs on international routes to worsen situation**

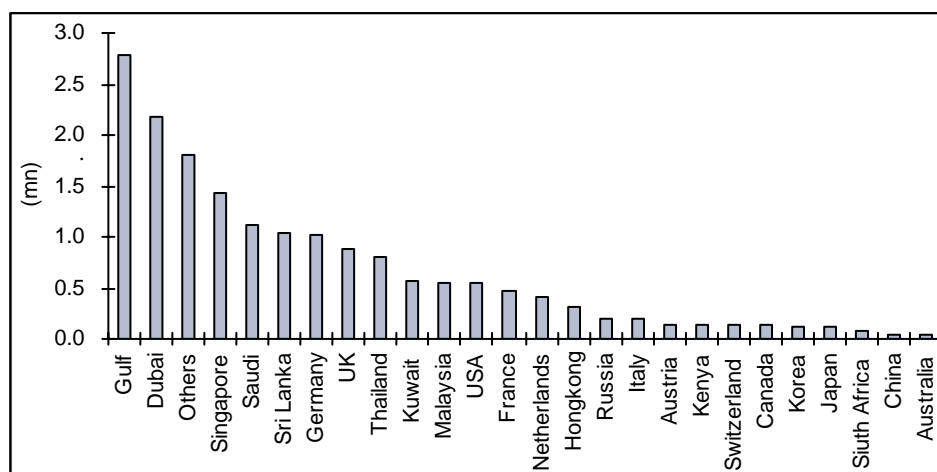
Expected entry of foreign LCCs such as AirAsia, Tiger Airways etc will further impact competitive scenario on the international routes. As these low cost airlines offer more options for short-haul destinations and further transit options to Europe and East Asia, FSCs will face pricing pressure similar to that experienced in the domestic market.

Though long-haul routes such as US are unlikely to be impacted, short-to-medium haul routes such as Gulf, South East Asia, East Asia, UK and other European cities will be affected. Notably, routes to UK and South East Asia are already very competitive and could aggravate with the entry of LCCs.

**But, lucrative Gulf market will offer opportunities**

Private Indian carriers are not allowed to operate in Gulf, which is at present reserved for National carriers (Indian and Air India), even as carriers from the Gulf can access India. Aviation Ministry has proposed to remove these barriers and allow Jet and Sahara on the lucrative Gulf route. We expect this to be a positive for Jet, since most of the international traffic to and fro from India consists of travel between India and Gulf (Chart 13). Specifically, Gulf countries together with Dubai, Kuwait and Saudi Arabia account for almost 40% of the total traffic.

**Chart 13: Gulf accounts for 40% of India’s international traffic**



Source: DGCA

**High start-up costs to impact margins in the medium term**

Jet’s current costs are loaded with high start-up costs that will reduce (on a per unit basis) as the operations stabilise. Costs are also impacted by Jet’s use of a WDV depreciation policy, while international carriers use an SLM method to depreciate aircraft. We have adjusted Jet’s financials for a like-to-like comparison (Table 1).

We expect Jet’s costs to reduce from Rs3.25/ASKM at present to Rs2.67/ASKM by FY09E (Table 1). Net of fuel costs, we expect Jet’s cost structure to approach SIA’s current cost structure by FY09E (Table 2).

**Table 1: Comparison on operating parameters – International**

(Rs)

	British Airways	SIA	Air China	Jet Airways FY06	Jet Airways FY09E
Revenue/RPKM	6.20	3.47	3.27	4.00	3.38
Revenue/ASKM	4.69	2.62	2.46	2.60	2.36
Cost/ASKM	4.43	2.48	2.50	3.25	2.67
Break even LF (%)	71	72	76	81	79
Actual Load Factor (%)	76	76	75	65	70

Source: Company data, i-SEC Research

Established carriers BA and SIA operate on thin margins – spread of 4-5% on actual versus break-even load

**Table 2: Cost comparison**

(Rs/ASKM)

Per unit cost reduces as stage length increases; hence, SIA is a good benchmark. Jet is unlikely to match a similar cost structure

SIA	British Airways	Cost Description	Jet Airways (FY09E)	
			Consolidated	International
0.40	1.29	Salaries & Wages	0.27	0.10
0.86	0.90	Fuel	1.24	1.02
0.12	0.26	Maintenance MRO	0.24	0.17
0.13	0.63	Landing fees	0.22	0.22
0.34	0.58	Financing charges (Rent, Depreciation, Interest)*	0.71	0.53
0.63	0.77	Other Opex	0.75	0.63
<b>2.48</b>	<b>4.43</b>	<b>Total Operating Cost</b>	<b>3.44</b>	<b>2.67</b>
<b>1.62</b>	<b>3.53</b>	<b>Total Operating Cost ex Fuel</b>	<b>2.20</b>	<b>1.65</b>
<b>4,900</b>	<b>3,000</b>	<b>Average stage length (Km)</b>	<b>1,851</b>	<b>5,750</b>

Source: Company filings, i-SEC Research; \* Adjusted depreciation for comparison purposes

### Lower staff costs

Staff costs are lower as Jet has outsourced several non-core processes at international airports (expenses related to these are in turn included under landing fees). Hence, a like-to-like comparison cannot be made. However, Jet is helped by lower staff costs due to the availability of cheap labour from India. Sharing of existing domestic manpower on international routes further reduces staff overhead.

### Fuel and landing fees damage competitiveness

Higher fuel and landing costs are among the key differences between the cost structure of Jet and SIA. The fuel charges are particularly high in India because of the high incidence of taxes (refer the sector piece). Further, Jet's current international operations are heavily dependent on costlier airports such as Heathrow that have higher landing fees. On the other hand, SIA's diverse mix of destination airports lowers its landing fees.

### Medium-term impact from expansion & maintenance costs

Jet's ambitious expansion plan on the international routes would impact its fund flow and cost structure during the initial years. Specifically, rental, depreciation and interest charges are expected to account for Rs0.53/ASKM for Jet (FY09E) as against just Rs0.34/ASKm for SIA. SIA has been operating on international routes for several years and has already funded its fleet.

Maintenance costs are high because currently there are few maintenance facilities in the country. At present, airlines send their aircraft to places such as Singapore or Middle East for higher level maintenance checks (C or D). This adds to their costs and renders the planes out of use for greater period. In comparison, MRO facilities in Singapore are world-class.

However, Jet has recently built its own hangar in Mumbai to carry out major & line maintenance checks for its fleet of Boeing and ATR aircraft. This hangar can accommodate two Boeing 737-series and one ATR aircraft at any given time. Set up at a cost of US\$15mn, the hangar is capable of undertaking C check as well as major maintenance work for Boeing 737-series aircraft and ATR aircraft. The hangar shall be eventually upgraded to provide D check, further reducing costs.



## Limited visibility on profits

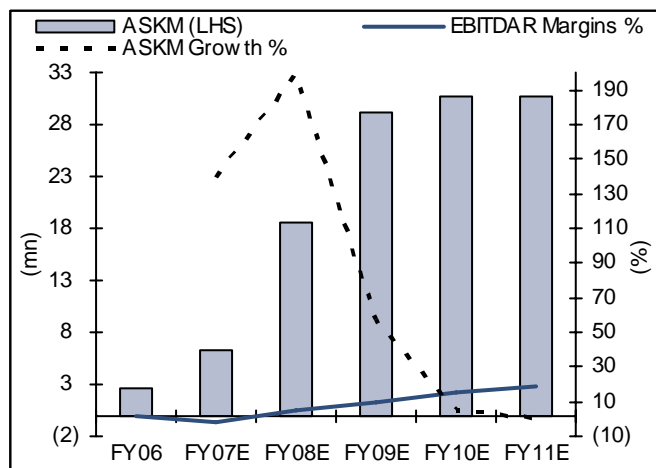
Losses from international operations to continue

### International operations to pull down group profits

Unfavourable competitive scenario is likely to impact international operations as new routes to US and Europe are rolled out. While the airline plans to expand its international operations at a rapid pace, EBITDAR contribution is expected only from FY08E (Chart 14) and cash profits from FY10E (Chart 16).

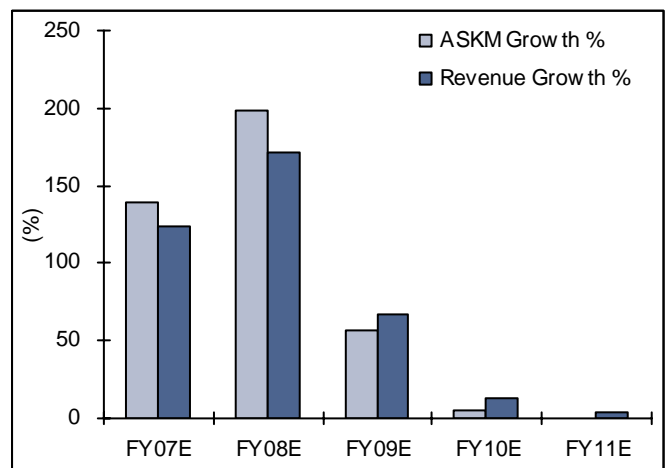
Overall, international operations international routes are expected to be a drain on the group's profitability until FY09E (Chart 16). While total capacity deployed on international routes (ASKM) is expected to exceed that on the domestic routes by FY09E, revenue and EBITDAR contribution from international operations are expected to lag behind.

**Chart 14: Profitability worst hit at the peak of capacity addition...**



Source: Company data, i-SEC Research

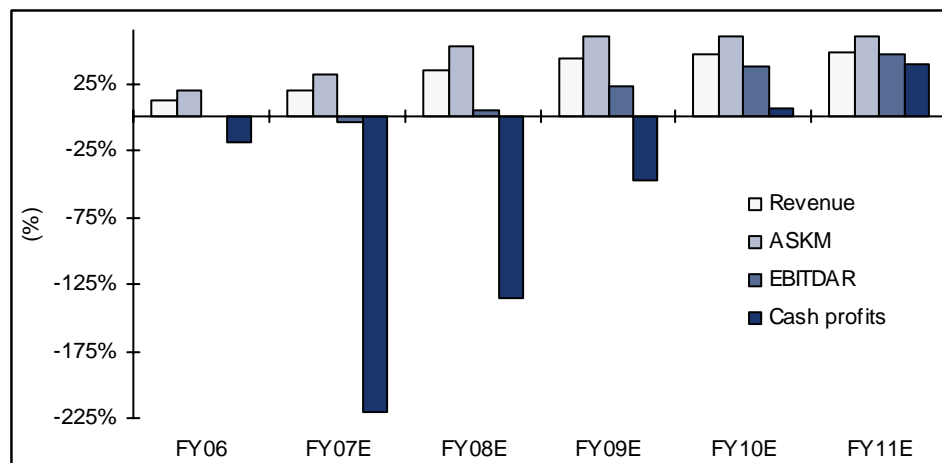
**Chart 15: ...even as topline grows at a rapid pace**



Source: i-SEC Research

**Chart 16: International operations as a percentage of consolidated numbers**

Overall international operations to make cash losses for initial years



Source: Company data, i-SEC Research

## Rapid fleet expansion to hurt profitability and gearing

We expect Jet to post cash losses from international operations until FY09E due to a four-fold increase in global fleet over the next 15 months. Jet Airways plans to increase its international fleet substantially from five at present to 22 in FY09 (Table 3), with an allocated spend of more than US\$2.5bn in the next five years. Of this, US\$2.15bn is for purchase of aircraft to be deployed on the international routes.

The rapid expansion will significantly impact leverage in the medium term (Table 4).

**Table 3: Jet Airways' capacity expansion schedule**

<b>Domestic</b>	<b>FY06</b>	<b>FY07E</b>	<b>FY08E</b>	<b>FY09E</b>
Fleet size	48	52	59	64
Aircraft added during the period	6	4	7	5
Total annual capacity (mn)	12.4	15.0	18.3	20.7
Total estimated Pax carried (mn)	9.1	10.4	12.1	13.9
Estimated load factor (%)	73.7	69.3	66.0	67.0
<b>International</b>				
Fleet size	5	9	20	22
Aircraft added during the period	5	4	11	2
Total annual capacity (mn)	0.7	1.4	3.6	5.1
Total estimated Pax carried (mn)	0.4	0.9	2.3	3.6
Estimated load factor (%)	65.0	64.2	65.0	70.0

Source: Company data, i-SEC Research

**Table 4: Worsening leverage**

	<b>FY06</b>	<b>FY07E</b>	<b>FY08E</b>	<b>FY09E</b>
D/E Ratio (x)	2.3	3.1	7.9	13.0
Adj. D/E Ratio* (x)	4.3	5.9	11.3	18.0

Note: \* Adjusted for off balance sheet liability of leased aircraft

Source: i-SEC Research

## Losses forecasted despite optimistic assumptions

We have factored in modest improvement in FY07E yields for Jet's domestic operations and also allowed for a rise in average yield on the international operations. Selling and distribution costs are also expected to reduce substantially with focus on e-ticketing.

However, we have taken fuel costs at Rs44,000/KI and Rs31,000/KI (on the higher side) for domestic and international operations respectively. Even though marketing companies have cut ATF prices by ~18% since the peak in September, we have been conservative in our fuel price assumptions for the sector.

Even after our optimistic assumptions (barring fuel price), Jet is expected to be in the red until FY08E due to initial losses from international operations, which would offset the turnaround in domestic operations.

**Table 5: Key assumptions**

	FY06	FY07E	FY08E	FY09E
<b>Domestic</b>				
ASKM (mn)	10,683	12,959	15,592	17,578
RPKM (mn)	7,875	8,987	10,291	11,777
No. of Passengers carried (mn)	9	10	12	14
Load Factor (%)	73.7	69.3	66.0	67.0
Avg. Yield (Rs)	5,165	5,317	5,400	5,450
Revenue/ASKM (Rs)	4.69	4.59	4.49	4.60
Revenue/RPKM (Rs)	6.37	6.62	6.80	6.87
Cost/ASKM (Rs)	4.27	4.43	4.14	4.05
Break-even factor (%)	67.1	67.0	60.9	59.0
Market Share (%)	35.7	30.3	28.1	25.8
<b>International</b>				
ASKM (mn)	2,617	6,253	18,656	29,209
RPKM (mn)	1,701	4,012	12,127	20,446
No. of Passengers carried (mn)	0.4	0.9	2.3	3.6
Load Factor (%)	65.0	64.2	65.0	70.0
Avg. Yield (Rs)	12,647	13,907	15,000	16,000
Revenue/ASKM (Rs)	2.60	2.43	2.22	2.36
Revenue/RPKM (Rs)	4.00	3.79	3.41	3.38
Cost/ASKM (Rs)	3.25	2.92	2.65	2.67
Break-even factor (%)	81.3	77.1	77.6	79.0
<b>Consolidated</b>				
ASKM (mn)	13,300	19,211	34,249	46,787
RPKM (mn)	9,576	12,999	22,418	32,223
No. of Passengers carried (mn)	10	11	14	17
Load Factor (%)	72.0	67.7	65.5	68.9
Avg. Yield (Rs)	5,637	6,088	7,054	7,728
Revenue/ASKM (Rs)	4.28	3.89	3.25	3.21
Revenue/RPKM (Rs)	5.95	5.75	4.97	4.65
Cost/ASKM (Rs)	4.18	3.98	3.25	3.13
Break-even factor (%)	70.2	69.2	65.4	67.2

Source: i-SEC Research

**Table 6: Domestic P&L***(Rs mn)*

	FY06	FY07E	FY08E	FY09E
Total Revenue	50,138	59,468	70,013	80,919
Total Operating Cost	39,227	54,667	62,180	69,543
Margin Before Overhead	10,911	4,801	7,833	11,376
Margin % Before Overhead	21.8	8.1	11.2	14.1
Adj. Depreciation	3,980	2,279	3,118	3,581
Finance Cost	2,416	2,067	978	-
Profit Before Taxation & Extra Ordinary Items	4,515	2,007	5,410	9,671
Profit on Sale & Lease Back	-	2,157	-	-
<b>Adj. Profit Before Taxation</b>	<b>4,515.2</b>	<b>4,163.5</b>	<b>5,410.4</b>	<b>9,670.9</b>
EBITDAR	13,515	8,880	12,230	15,820
EBITDAR Margin %	27.0	14.9	17.5	19.6
Cash Profits	8,495	4,286	8,528	13,252

Source: i-SEC Research

**Table 7: International P&L***(Rs mn)*

	FY06	FY07E	FY08E	FY09E
Total Revenue	6,800	15,213	41,351	69,040
Total Operating Cost	8,425	17,965	41,176	63,681
Margin Before Overhead	(1,625)	(2,752)	175	5,358
Margin % Before Overhead	(23.9)	(18.1)	0.4	7.8
Adj. Depreciation	84	322	2,654	5,463
Finance Cost	-	-	5,543	8,804
Profit Before Taxation & Extra Ordinary Items	(1,709)	(3,073)	(8,021)	(8,909)
Profit on Sale & Lease Back	-	-	-	-
<b>Adj. Profit Before Taxation</b>	<b>(1,709.0)</b>	<b>(3,073.2)</b>	<b>(8,021.2)</b>	<b>(8,908.5)</b>
EBITDAR	111	(325)	2,017	6,627
EBITDAR Margin %	1.6	-2.1	4.9	9.6
Cash Profits	(1,625)	(2,752)	(5,367)	(3,446)

Source: i-SEC Research

## Sensitivity analysis

While for our base case estimate, we have assumed an ATF price of Rs44,000/Kl, we have analysed financial parameters for 10% change on either side. Notably, our base case price corresponds to the peak crude price of US\$76/Bbl. Given the recent fall in crude prices, ATF prices have reduced ~18% since October, '06.

Profitability is heavily impacted due to movements in ATF prices (Table 8). Since we have already assumed high fuel price in our base case, any reduction in fuel price either by sustained crude prices at current levels or reduction in taxes will help Jet to recover earlier than expected.

Jet is highly sensitive to even 5% sensitivity on load factors and yields (Table 9 and 10). However, we expect Jet to maintain price leadership and sacrifice load factor to earn higher realisation.

**Table 8: Sensitivity to ATF price**

	FY07E	FY08E	FY09E
<b>Base Estimates</b>			
EBITDAR (Rs mn)	8,555	14,247	22,448
EBITDAR Margin (%)	11.5	12.8	15.0
PAT (Rs mn)	(1,917)	(1,800)	421
<b>ATF price increases by 10%</b>			
EBITDAR (Rs mn)	7,044	9,849	16,663
EBITDAR Margin (%)	9.4	8.8	11.1
PAT (Rs mn)	(2,919)	(4,718)	(3,416)
<b>ATF price decreases by 10%</b>			
EBITDAR (Rs mn)	10,066	18,644	28,232
EBITDAR Margin (%)	13.5	16.7	18.8
PAT (Rs mn)	(915)	1,117	4,258

Source: i-SEC Research

**Table 9: Sensitivity to load factors**

	FY07E	FY08E	FY09E
<b>Base Estimates</b>			
EBITDAR (Rs mn)	8,555	14,247	22,448
EBITDAR Margin (%)	11.5	12.8	15.0
PAT (Rs mn)	(1,917)	(1,800)	421
<b>Load Factors rise by 5%</b>			
EBITDAR (Rs mn)	10,178	18,376	28,074
EBITDAR Margin (%)	13.3	15.7	17.9
PAT (Rs mn)	(821)	983	4,204
<b>Load Factors fall by 5%</b>			
EBITDAR (Rs mn)	6,933	10,117	16,821
EBITDAR Margin (%)	9.6	9.5	11.8
PAT (Rs mn)	(3,014)	(4,583)	(3,362)

Source: i-SEC Research

**Table 10: Sensitivity to yields**

	FY07E	FY08E	FY09E
<b>Base Estimates</b>			
EBITDAR (Rs mn)	8,555	14,247	22,448
EBITDAR Margin (%)	11.5	12.8	15.0
PAT (Rs mn)	(1,917)	(1,800)	421
<b>Yields rise by 5%</b>			
EBITDAR (Rs mn)	10,283	18,670	28,492
EBITDAR Margin (%)	13.4	16.0	18.1
PAT (Rs mn)	(751)	1,177	4,481
<b>Yields fall by 5%</b>			
EBITDAR (Rs mn)	6,828	9,823	16,404
EBITDAR Margin (%)	9.4	9.3	11.5
PAT (Rs mn)	(3,083)	(4,778)	(3,639)

Source: i-SEC Research

## Valuations

### Replacement value below current price

Due to uncertainties associated with Jet's business, we believe a replacement cost valuation is necessary to arrive at a support price for the stock. Based on replacement cost valuation, our support price for the stock is Rs530/share (Table 11). We have included potential royalty value of 'Jet Airways' brand and partial impact of litigation with Air Sahara in the valuation. However, potential upsides from a positive change in macro-environment remain.

**Table 11: Replacement cost valuation**

Asset/Liability	Value (Rs mn)	Assumptions
Disposable value of fleet	32,826	21 owned Boeing 737 aircraft with average age of ~five years. Assumed disposable price: 737-700 @ US\$32mn 737-800 @ US\$36mn 737-900 @ US\$38mn
Net current assets	19,766	20% haircut on debtors; 1x market value of other current assets
Investments	736	1x market value
Capital works in Progress (cash with aircraft manufacturer)	29,940	1x reported figure
Gross value of landing rights	1,525	25% premium on cost
Other fixed assets at gross value	4,077	1x cost
Optional value of selling orderbook	10,679	Ordered aircraft: 9 A330-200s, 10 B777-300ER Assumed gain from selling order rights: A330-200 @ US\$10mn Boeing 777-300ER @ US\$20mn Discounted @WACC – deliveries till FY09E
<b>Gross asset value</b>	<b>99,547</b>	
<b>Brand Value (Rs mn)*</b>	<b>10,410</b>	*Brand Finance estimates
Less: Debt & deferred tax liability	62,030	1x market value
Less: Frequent Flier Program liability	164	1x reported figure as per company
Less: Liability on re-delivery of leased aircraft	193	1x reported figure as per company
Less: Expected liability from failed Air Sahara merger	1,800	Advance paid to Sahara shareholders only considered
<b>Net asset value</b>	<b>45,771</b>	
<b>NAV/share</b>	<b>530</b>	

Note: \*Brand Finance is a leading independent brand valuation and marketing metrics consultancy.

Source: Jet Airways Annual Report, Brand Finance, i-SEC Research

### DCF – NPV/share of Rs755/share

Based on our DCF analysis (with 11.6% WACC and 2% terminal growth rate), Jet's NPV/share comes to Rs755. Importantly, our WACC estimates are based on a beta of 1.05, in a similar range as peers such as SIA.

We arrive at our target price of Rs642/share for Jet Airways taking average of the DCF and replacement cost values. Based on current market price of Rs653 and our target price of Rs642, Jet trades at FY09E EV/EBITDAR of 7.5x and 7.4x respectively, which is in line with peer group average of 8.2x (though at a premium to SIA).

**Table 12: Peer group trading multiples**

	Jet Airways	SIA Lufthansa	Cathay Pacific	British Airways	Qantas	Air France	Air China	Average
Current Price (Local Currency)	653.6	15.8	20.0	18.7	5.0	5.1	30.2	3.9
Enterprise Value (US\$ mn)	2,783	13,918	16,775	12,878	4,087	11,737	33,295	13,029
CY07E EV/EBITDAR (x)	-	6.3	8.5	7.5	4.5	3.4	11.1	7.8
Implied 1-yr forward FY08E @ CMP	7.5							
Implied 1-yr forward FY08E @ Target price	7.4							

Source: Respective company data, Bloomberg, i-SEC Research

## Risk from adverse verdict in Sahara dispute

As discussed later, an adverse verdict from the Air Sahara dispute over the failed merger is a key risk. We have assumed that Jet will realise a loss of Rs1.8bn paid as advance to Sahara's shareholders. However, assuming a 50% liability from the remaining Rs20bn would mean an additional Rs116/share reduction in our DCF and replacement value estimates (Table 13).

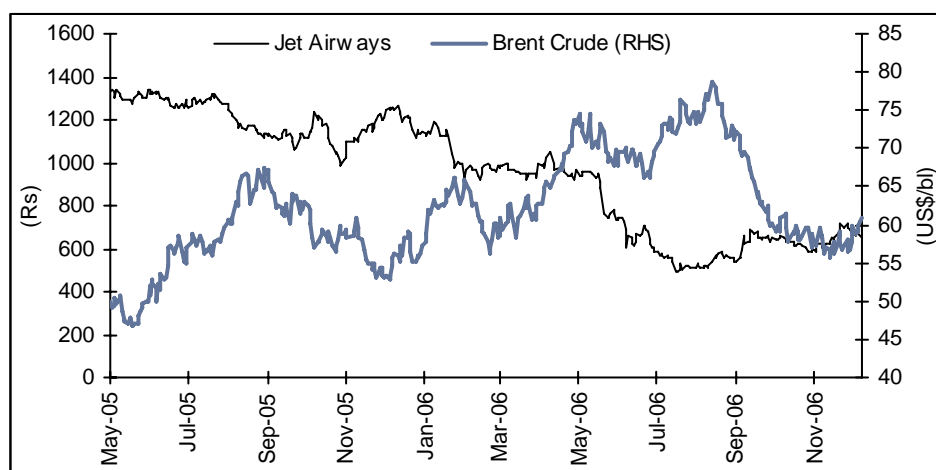
**Table 13: Valuations – Adverse impact from Sahara dispute**

	DCF (Rs mn)	Replacement cost value (Rs mn)
Implied equity value – base case	65,157	45,771
Less: Liability due to 50% probability of adverse verdict on Sahara dispute		10,000
Net asset value ex Sahara liability	55,157	35,771
<b>NPV/share (Rs)</b>	<b>639</b>	<b>414</b>

Source: i-SEC Research

## Recent rally driven by softening oil, industry rationalisation

We believe the recent rally in the stock price from ~Rs500/share was primarily driven by the fall in crude prices and talks of increasing rationalisation within the industry. However, macro environment for FSCs such as Jet remain hazy.

**Chart 17: Jet's share price versus Brent crude**

Source: Bloomberg

## We recommend HOLD

Based on the average of our base-case DCF analysis and replacement cost valuation we arrive at a 12-month target price of Rs642. At current market price of Rs653 the risk-reward ratio does not seem favourable. We recommend a HOLD.

## Investment risks

### Aircraft can be sub-leased temporarily to contain international losses

Given that international operations are expected to bleed the airline, especially because Jet plans to deploy all its 10 B777s within 10-11 months, we foresee that Jet might change its plans. In order to contain losses, Jet might sub-lease some of its planes until routes have matured for additional capacity infusion.

In such a case, there would be an upside to our estimates. However, the company currently maintains that it has no plans of sub-leasing these aircraft on a sustained basis, though it may sub-lease for short periods due to lack of approvals.

### Brand appeal and loyalty stronghold

Conferred the 'Superbrand' status in India, Jet is among the only two airlines holding this honour in the country. As the Superbrands council members say – obtaining the status puts the brand in an elite group that represents the best practices in brand management; ultimately it has won the Oscars for brands (Annexure 4).

Jet's frequent flier programme (FFP) under the name "Jet Privilege" is its stronghold and has been constantly innovated to attract maximum retention. FFP has been able to attract and retain corporate travellers at a time when no other airline in the country offered such a programme. Strong loyalty among executives with huge FFP points on the programme has helped Jet being the preferred airline. Among the laurels that Jet received for the FFP is 'Customer Service and Bonus Promotion at the 18th Freddie Awards'.

Other initiatives such as through check-in, interline and code share arrangements with leading global airlines have also helped traffic from international destinations for Jet. These tie-ups have ensured that Jet remains the most preferred domestic airline for tourists visiting the country.

### Stranded in Sahara

Jet Airways announced the acquisition of Air Sahara in January '06 for US\$500mn. While Air Sahara is a private unlisted company, market sources hint that the airline is making losses. At an EV of US\$500mn, the price is estimated to be at a premium to Sahara's assets. On the positive, Jet would have benefitted from Sahara's similar aircraft type (Boeing 737s) and international flying rights (current aviation policy requires five years of domestic flying experience for international license).

On the back of this deal, Jet probably ordered 10 Boeing 777s that would have allowed flights in the lucrative India-US sector. With Jet's own entry to the US being marred by controversy over trademark and linkages to unwanted agents, Air Sahara agreed to allow it to enter the India-US market using the Sahara tag.

But these benefits were accompanied by Sahara's unprofitable domestic operations (which would have severely dilute Jet's overall margins; Sahara is estimated to have utilised its assets for less than 7.5hrs/day), another set of smaller aircraft fleet (seven CRJ200s that would have further complicated Jet's mix of aircraft) and most importantly, a set of employees that Sahara has so far nourished as part of its *Sahara Pariwar*. It is believed that Jet would have to carry on with a large part of the Sahara pariwar even after picking and choosing from the balance. This would have significantly added to the employee cost apart from a culture clash – Sahara employees were treated as a family, while Jet follows a dynamic human resource policy. Sahara's crew would have needed a substantial re-vamp to switch from the *Saree* to Jet's 'western attire' – protests against which were already rising.

Overall, the deal was touted as being a mixed blessing for Jet and needed a gestation of 2-3 years before being termed either a success or failure. However, the deal was off in June '06, with Jet attributing it to non-receipt of legal approvals within the stipulated time. Sahara blamed it on Jet's intentional last-minute cancellation. The two parties filed suits against each other claiming Rs15bn that was put by Jet in an escrow account. This is apart from Rs5bn paid as advance on the personal guarantee of Sahara chief, Mr Subrata Roy and another Rs1.8bn that had already been paid to Sahara shareholders as advance.

While the court proceedings are still on, we believe that Jet would have to ultimately write-off the Rs1.8bn already paid, while the balance Rs20bn might be returned to Jet (if not 100%). On the positive, for the interim, Jet has been allowed to release the funds from the escrow against a bank guarantee of a similar amount.

We have assumed a hit of Rs1.8bn in FY07E for Jet from the failed transaction, while the balance Rs20bn have been assumed to stay as deposits and loans & advances in the balance sheet.



## Annexure 1: Financials

**Table 14: Profit and loss account**

(Rs mn, year ending March 31)

	<b>FY06</b>	<b>FY07E</b>	<b>FY08E</b>	<b>FY09E</b>
<b>Gross Sales</b>	56,937	74,681	111,363	149,958
Less: Excise Duty	-	-	-	-
<b>Net Sales</b>	<b>56,937</b>	<b>74,681</b>	<b>111,363</b>	<b>149,958</b>
of which International	6,800	15,213	41,351	69,040
of which Domestic	50,138	59,468	70,013	80,919
Other Operating Income				
<b>Total Operating Income</b>	<b>56,937</b>	<b>74,681</b>	<b>111,363</b>	<b>149,958</b>
<b>Less:</b>				
Employee Remuneration & Benefits	5,672	9,079	10,301	12,775
Fuel	16,789	27,758	43,974	57,844
Aircraft Lease Rental	4,340	6,506	6,238	5,713
Aircraft Insurance	690	1,117	1,159	1,450
Navigational & Other Airport Charges	3,505	4,913	7,847	10,313
Aircraft Maintenance	3,109	6,592	8,223	11,375
Inflight Expenses	2,145	2,580	4,431	6,737
Other	3,662	4,509	6,949	8,879
Selling & Distribution Costs	7,740	9,578	14,233	18,138
<b>EBITDAR</b>	<b>13,625</b>	<b>8,555</b>	<b>14,247</b>	<b>22,448</b>
<b>EBITDA</b>	<b>9,285</b>	<b>2,049</b>	<b>8,008</b>	<b>16,734</b>
Depreciation & Amortisation	4,064	3,211	11,444	18,751
Other Income	1,299	1,552	1,674	1,876
Adj. Depreciation	4,064	2,601	5,772	9,044
<b>EBIT</b>	<b>6,520</b>	<b>390</b>	<b>(1,762)</b>	<b>(141)</b>
<b>Adj. EBIT</b>	<b>6,520</b>	<b>1,001</b>	<b>3,910</b>	<b>9,567</b>
Less: Gross Interest	2,416	3,619	6,521	8,804
<b>Pre-tax Income</b>	<b>4,104</b>	<b>(3,229)</b>	<b>(8,283)</b>	<b>(8,945)</b>
<b>Recurring Pre-tax Income</b>	<b>4,104</b>	<b>(2,618)</b>	<b>(2,611)</b>	<b>762</b>
Add: Extraordinary Income	3,119	357	-	-
Less: Taxation	2,702	(906)	(2,720)	(2,926)
--Current Tax	1,341	-	-	-
--Deferred Tax	1,258	(997)	(2,823)	(3,054)
--Fringe Benefit Tax	104	91	103	128
Adj. Taxation	2,702	(701)	(810)	341
<b>Net Income (Reported)</b>	<b>4,520</b>	<b>(1,965)</b>	<b>(5,563)</b>	<b>(6,019)</b>
<b>Recurring Net Income</b>	<b>1,402</b>	<b>(1,917)</b>	<b>(1,800)</b>	<b>421</b>
<b>Cash Profits</b>	<b>5,466</b>	<b>684</b>	<b>3,972</b>	<b>9,465</b>

Source: Company data, i-SEC Research

**Table 15: Balance sheet***(Rs mn, year ending March 31)*

	FY06	FY07E	FY08E	FY09E
<b>ASSETS</b>				
<b>Current Assets, Loans &amp; Advances</b>				
Cash & Bank balance	2,278	4,751	6,799	9,111
Inventory	4,053	5,563	8,199	10,883
Sundry Debtors	4,332	2,781	4,099	5,441
Other Current Assets	2,065	2,065	2,065	2,065
<b>Total Current Assets</b>	<b>12,726</b>	<b>15,161</b>	<b>21,162</b>	<b>27,500</b>
<b>Current Liabilities &amp; Provisions</b>	<b>15,308</b>	<b>17,631</b>	<b>23,782</b>	<b>30,044</b>
<b>Current Liabilities</b>	<b>10,656</b>	<b>12,980</b>	<b>19,131</b>	<b>25,393</b>
Sundry Creditors	10,656	12,980	19,131	25,393
<b>Provisions</b>	<b>4,652</b>	<b>4,652</b>	<b>4,652</b>	<b>4,652</b>
<b>Total Current Liabilities and Provisions</b>	<b>15,308</b>	<b>17,631</b>	<b>23,782</b>	<b>30,044</b>
<b>Net Current Assets</b>	<b>(2,581)</b>	<b>(2,471)</b>	<b>(2,620)</b>	<b>(2,544)</b>
<b>Deposits and Advances</b>				
Deposits and Advances	8,233	5,348	5,248	5,198
Deposits relating to leases and AAI	4,553	5,348	5,248	5,198
Sale/Leaseback Advances	3,679	-	-	-
<b>Total Deposits and Advances</b>	<b>8,233</b>	<b>5,348</b>	<b>5,248</b>	<b>5,198</b>
<b>Investments</b>				
Other Marketable Investments	4,368	4,368	4,368	4,368
<b>Total Investments</b>	<b>4,368</b>	<b>4,368</b>	<b>4,368</b>	<b>4,368</b>
<b>Fixed Assets</b>				
Gross Block	43,721	48,774	137,262	160,203
Less Accumulated Depreciation	22,496	23,550	34,995	53,746
Net Block	21,225	25,224	102,267	106,457
Add: Capital Work in Progress	22,977	33,222	9,572	-
<b>Total Fixed Assets</b>	<b>44,202</b>	<b>58,446</b>	<b>111,839</b>	<b>106,457</b>
<b>Off Balance Sheet Arrangements</b>				
Leased Aircraft	46,275	59,001	52,762	47,049
Escrow Account & Loan to Sahara shareholders	21,000	20,000	20,000	20,000
<b>Total Assets</b>	<b>121,497</b>	<b>144,692</b>	<b>191,597</b>	<b>180,527</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>				
<b>Borrowings</b>				
Short Term Debt	14,668	12,000	10,000	2,000
Secured Loans	2,060	2,060	2,060	2,060
Aircraft Funding	32,228	48,328	111,858	123,574
<b>Total Borrowings</b>	<b>48,956</b>	<b>62,388</b>	<b>123,918</b>	<b>127,635</b>
<b>Off Balance Sheet Arrangemnets</b>				
Aircraft Lease Liability	46,275	59,001	52,762	47,049
<b>Deferred Tax Liability</b>	<b>3,207</b>	<b>2,209</b>	<b>(613)</b>	<b>(3,667)</b>
<b>Share Capital</b>				
Paid up Equity Share Capital	863	863	863	863
<i>No. of Shares outstanding (mn)</i>	86	86	86	86
<i>Face Value per share (Rs)</i>	10	10	10	10
<b>Reserves &amp; Surplus</b>	<b>22,196</b>	<b>20,230</b>	<b>14,667</b>	<b>8,648</b>
<b>Net Worth</b>	<b>23,059</b>	<b>21,093</b>	<b>15,530</b>	<b>9,511</b>
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b>121,497</b>	<b>144,692</b>	<b>191,597</b>	<b>180,527</b>

\*Details of conversions to be mentioned

Source: Company data, i-SEC Research

**Table 16: Cash flow statement***(Rs mn, year ending March 31)*

	<b>FY06</b>	<b>FY07E</b>	<b>FY08E</b>	<b>FY09E</b>
<b>Cash Flow from Operating Activities</b>				
Reported Net Income	4,520	(1,965)	(5,563)	(6,019)
Add:				
Depreciation & Amortisation	4,259	3,211	11,444	18,751
Provisions	109	1,000	-	-
Deferred Taxes	1,363	(997)	(2,823)	(3,054)
Less:				
Other Income	1,286	1,552	1,674	1,876
Net Extra-ordinary income	3,229	2,157	-	-
<b>Operating Cash Flow before Working Capital change (a)</b>	<b>5,737</b>	<b>(2,460)</b>	<b>1,384</b>	<b>7,802</b>
<b>Changes in Working Capital</b>				
(Increase) / Decrease in Inventories	(1,155)	(1,510)	(2,636)	(2,684)
(Increase) / Decrease in Sundry Debtors	(1,843)	1,550	(1,318)	(1,342)
(Increase) / Decrease in Other Current Assets	3,954	-	-	-
Increase / (Decrease) in Sundry Creditors	2,986	2,324	6,151	6,262
Increase / (Decrease) in Other Current Liabilities	-	-	-	-
<b>Working Capital Inflow / (Outflow) (b)</b>	<b>3,943</b>	<b>2,364</b>	<b>2,197</b>	<b>2,237</b>
<b>Net Cash flow from Operating Activities (a) + (b)</b>	<b>9,679</b>	<b>(97)</b>	<b>3,581</b>	<b>10,039</b>
<b>Change in Deposits/Advances</b>				
Change in Deposits against lease & AAI	(2,926)	(795)	100	50
Change in Advance paid to Boeing for Aircraft on lease	(3,679)	3,679	-	-
<b>Inflow / (Outflow) from Deposits/Advances (c)</b>	<b>(6,605)</b>	<b>2,885</b>	<b>100</b>	<b>50</b>
<b>Cash Flow from Capital commitments</b>				
Purchase of Fixed Assets	(27,946)	(9,653)	(88,488)	(22,940)
Purchase of Investments	-	-	-	-
Change in Capital Work in Progress	-	(10,245)	23,651	9,572
Consideration paid for acquisition of undertaking	(20,000)	-	-	-
<b>Cash Inflow/(outflow) from capital commitments (d)</b>	<b>(47,946)</b>	<b>(19,899)</b>	<b>(64,837)</b>	<b>(13,369)</b>
<b>Free Cash flow after capital commitments (a) + (b) + (c) + (d)</b>	<b>(44,871)</b>	<b>(17,111)</b>	<b>(61,156)</b>	<b>(3,280)</b>
<b>Cash Flow from Investing Activities</b>				
Purchase of Marketable Investments	(51,088)	-	-	-
(Increase) / Decrease in Other Loans & Advances	-	-	-	-
Sale of Fixed Assets	4,628	2,443	-	-
Sale of Investments	69,153	-	-	-
Consideration received for sale of undertaking/division	-	-	-	-
Other Income	537	1,552	1,674	1,876
<b>Net Cash flow from Investing Activities (e)</b>	<b>23,230</b>	<b>3,995</b>	<b>1,674</b>	<b>1,876</b>
<b>Cash Flow from Financing Activities</b>				
Issue of Share Capital during the year	-	-	-	-
Preference Shares repayment	-	-	-	-
Premium on redemption of Preference Shares	-	-	-	-
Increase/decrease in loans	19,174	13,432	61,530	3,716
Share Issue expenses paid	-	-	-	-
Dividend paid	(295)	-	-	-
<b>Net Cash flow from Financing Activities (f)</b>	<b>18,879</b>	<b>13,432</b>	<b>61,530</b>	<b>3,716</b>
<b>Net Extra-ordinary Income (g)</b>	<b>-</b>	<b>2,157</b>	<b>-</b>	<b>-</b>
<b>Total Increase / (Decrease) in Cash (a) + (b) + (c) + (d) + (e) + (f) + (g)</b>	<b>(2,762)</b>	<b>2,474</b>	<b>2,047</b>	<b>2,313</b>

Source: Company data, i-SEC Research

**Table 17: Key ratios***(Year ending March 31)*

	FY06	FY07E	FY08E	FY09E
<b>Per Share Data (Rs)</b>				
Diluted Recurring Earning per share (DEPS)	16.2	(22.2)	(20.9)	4.9
Diluted Earnings per share	52.4	(22.8)	(64.4)	(69.7)
Recurring Cash Earnings per share (CEPS)	63.3	15.0	111.7	222.1
Free Cashflow per share (FCPS-post capex)	(466.2)	(169.9)	(708.4)	(38.0)
Reported Book Value (BV)	267.1	244.3	179.9	110.2
Adjusted Book Value (ABV) **	267.1	244.3	179.9	110.2
Dividend per share	3.4	-	-	-
<b>Valuation Ratios (x)</b>				
Diluted Price Earning Ratio	40.2	(29.4)	(31.3)	134.0
Price to Recurring Cash Earnings per share	10.3	43.6	5.9	2.9
Price to Book Value	2.4	2.7	3.6	5.9
Price to Adjusted Book Value	2.4	2.7	3.6	5.9
Price to Sales Ratio	1.0	0.8	0.5	0.4
EV / EBITDAR	11.0	20.2	15.9	9.9
EV / Total Operating Income	2.6	2.3	2.0	1.5
EV / Operating Free Cash Flow (Pre-Capex)	15.4	NA	63.2	22.1
EV / Net Operating Free Cash Flow (Post-Capex)	6.2	NA	NA	NA
Dividend Yield (%)	0.5	-	-	-
<b>Growth Ratios (% YoY)</b>				
Diluted Recurring EPS Growth	(62.4)	(236.7)	NA	NA
Diluted Recurring CEPS Growth	(34.2)	(76.3)	645.2	98.8
Total Operating Income Growth	31.3	31.2	49.1	34.7
EBITDAR Growth	(3.3)	(37.2)	66.5	57.6
Recurring Net Income Growth	(62.4)	(236.7)	NA	NA
<b>Operating Ratios (%)</b>				
EBITDA Margins	16.3	2.7	7.2	11.2
EBITAR Margins	23.9	11.5	12.8	15.0
Recurring Pre-tax Income Margins	7.2	(3.5)	(2.3)	0.5
Recurring Net Income Margins	2.5	(2.6)	(1.6)	0.3
Fuel Consumed / Sales	29.5	37.2	39.5	38.6
Lease Rentals/Sales	7.6	8.7	5.6	3.8
SGA Expenses / Sales	20.0	18.9	19.0	18.0
Adj. Effective Tax Rate	36.0	35.0	35.0	28.0
<b>Return / Profitability Ratios (%)</b>				
Return on Capital Employed (RoCE)-Overall	4.2	1.6	2.3	4.5
Return on Invested Capital (RoIC)	9.5	1.6	4.9	9.4
Return on Net Worth (RoNW)	13.0	(17.4)	(19.7)	6.7
Dividend Payout Ratio	21.0	-	-	-
<b>Solvency Ratios / Liquidity Ratios</b>				
Debt Equity Ratio (D/E) (x)	2.3	3.1	7.9	13.0
Adj. Debt Equity Ratio (D/E) (x)	4.3	5.9	11.3	18.0
Long Term Debt / Total Debt	0.9	0.9	0.9	1.0
Net Working Capital / Total Assets	(4.0)	(5.0)	(4.9)	(6.5)
Interest Coverage Ratio-based on EBIT (x)	2.7	0.1	(0.3)	(0.0)
Debt Servicing Capacity Ratio (DSCR) (x)	0.4	0.1	0.4	0.8
Current Ratio (x)	0.42	0.51	0.63	0.86
Cash and cash equivalents / Total Assets	1.9	3.3	3.5	5.0
<b>Turnover Ratios</b>				
Inventory Turnover Ratio (x)	9.0	10.3	12.0	11.9
Assets Turnover Ratio (x)	0.5	0.6	0.7	0.8
Working Capital Cycle (days)	(6.7)	(12.3)	(8.3)	(6.3)
Average Collection Period (days)	22.0	17.4	11.3	11.6
Average Payment Period (days)	58.9	57.8	52.6	54.2

\*\*adjustments to be specified as footnote

Source: Company data, i-SEC Research

## Annexure 2: Interim results

**Table 18: Quarterly results**

(Rs mn, year ending March)

	Q2FY07	Q2FY06	YoY (%)	YTDFY07	YTDFY06	YoY (%)
Revenue	16,151	12,796	26.2	32,616	25,901	25.9
Staff Costs	2,246	1,241	81.0	4,537	2,351	93.0
Fuel Costs	6,792	3,996	70.0	12,651	7,474	69.3
Other expenses	4,694	2,978	57.6	8,887	5,781	53.7
S&D costs	2,085	1,297	60.8	4,145	3,370	23.0
EBITDAR	334	3,284	(89.8)	2,396	6,925	(65.4)
EBITDAR Margin (%)	2.1	25.7		7.3	26.7	
Rentals	1,576	1,087	45.0	3,027	1,937	56.3
EBITDA	(1,242)	2,197	(156.5)	(631)	4,988	(112.7)
EBITDA Margin (%)	(7.7)	17.2		(1.9)	19.3	
Depreciation	967	973	(0.6)	1,854	1,957	(5.3)
Finance cost	578	563	2.7	1,220	1,168	4.5
Other Income	445	446	(0.2)	767	794	(3.4)
Recurring PBT	(3,232)	215	(1,603.3)	(4,472)	1,069	(518.3)
Extraordinary items	1,617	-	NA	1,617	-	NA
Taxes	(173.8)	422.0	(141.2)	(319)	1,020	(131.3)
Net Income	(551.3)	685.0	(180.5)	(1,002)	1,637	(161.2)
Recurring PAT	(2,168.2)	685.0	(416.5)	(2,619.2)	1,637.0	(260.0)

Source: Company data

Jet Airways posted poor H1FY07 results. The airline lost Rs2.6bn YTDFY07 on recurring PAT levels. The losses were mainly due to lower realised yields and load factor. Jet reported a load factor of 66% & 59% for its domestic & international operations respectively in Q2FY07. Though Q2 is traditionally the weakest quarter due to seasonality, the decline in load factor this fiscal has been significant as against earlier years. This reflects the continued pressure on the airline from LCCs.

Higher fuel costs and rising losses from international operations have further added to Jet's woes. In Q2FY07, international operations lost Rs1.11bn at PBT levels, while domestic operations lost Rs1.23bn at recurring PBT levels. Higher profits booked on sales and lease-back transactions helped the company register modest profits on the domestic front. The company sold and leased back three aircraft in Q2FY07 at ~US\$25mn each for a profit over book value of US\$35.2mn. This is clearly a strategy to shore up book profits at a time when the operational profitability is strained.

Jet Airways started two new sectors on international routes during the quarter – Amritsar-London and Delhi-Singapore – while it added a second frequency on London-Mumbai route, which further affected the quarter's results.

Jet has not registered any loss from the failed merger with Sahara so far.

The company expects to face continued challenges in both domestic and international sectors and awaits price rationality in the market.

## Annexure 3: Company profile

### Background

Jet Airways is the largest carrier in the domestic airline industry with a market share of more than 30%. The company recently started operating on international routes with flights to Kuala Lumpur, Singapore, London and Colombo. The company is promoted by Naresh Goyal and has acquired the 'Superbrand' status for continued excellence in the domestic aviation market. The airline is the preferred way of air travel for a majority of corporate travellers within the domestic circuit. Jet Airways, currently, has a market capitalisation of US\$1.22bn.

### Management

Jet Airways is controlled by the London-based billionaire Naresh Goyal through his wholly-owned entity, Tail Winds, an Isle of the Man company.

Key personnel are:

**Mr. Wolfgang Prock-Schauer, CEO.** With a Master's degree in Economics and Business Administration from the University of Vienna, Mr. Prock-Schauer has been associated with the airline industry for over 23 years. He has previously worked as EVP, Alliance and Long Term Planning with Austrian Airlines and as Chairman, Star Alliance Management Board.

**Mr. Saroj K. Datta, Executive Director.** With a Master's degree in Economics from Delhi University, Mr. Datta has over 40 years of civil aviation experience. He has worked as Deputy Director, Planning and International Relations, Air India and held a senior position in Kuwait Airways.

**Mr. Garry Kingshott, Chief Commercial Officer.** With over 31 years experience in corporate and 10 years in the airline industry, Mr. Gary oversees key functions of marketing, airport services, in-flight, security, ISD, communications and customer service.

**Mr. Carl Saldanha, CFO.** With a Bachelor of Technology degree from IIT Mumbai and an MBA from the Asian Institute of Management, Philippines, Mr. Saldanha has worked with Chase Manhattan Bank and Deutsche Bank for more than 20 years.

**Mr. Raja Parthasarthy, EVP (Finance).** Mr. Parthasarthy was earlier an Executive Director with UBS Investment Bank, Hong Kong, where he was responsible for assisting Asian transport companies with their financing and strategic initiatives. At present, he is handling the overall responsibility of financial controls, financial reporting and investor relations. Mr. Parthasarthy has also worked with Goldman Sachs, Singapore and Lehman Brothers, New York, Hong Kong and London.

**Mr. Gaurang Shetty, Vice President (Marketing).** A science graduate from Bombay University, Mr. Shetty has worked with British Airways as Marketing Manager, South Asia and has a total of 16 years experience with British Airways in customer service, cargo and marketing. With Jet Airways, he is responsible for marketing, which includes brand management, interline, revenue & yield management systems, e-commerce and Jet Privilege Programme.

**Table 19: Shareholding pattern**

(%)

	<b>Mar-06</b>	<b>Jun-06</b>	<b>Sep-06</b>
Promoters	80.0	80.0	80.0
- Indian	0.0	0.0	0.0
- Foreign	80.0	80.0	80.0
Institutional investors	15.6	15.8	15.5
MFs and UTI	2.9	2.9	1.4
Insurance Cos.	2.2	3.2	4.3
FII's	10.5	9.6	9.8
Others	4.4	4.2	4.5

Source: NSE website

## Annexure 4: Jet Airways – The ‘Superbrand’

### Brand values

The core focus of the Jet Airways brand is to be a world-class airline. Towards this end, it offers a world-class product (best aircraft, world class in-flight service, business class product with international standards). The airline ensures that the customer can depend on the clockwork-like regularity of/efficiency of Jet Airways’ operations, delivering a professional and efficient brand experience (pre-flight, in-flight and post-flight).

Jet Airways has attained leadership, both in market share as well as brand name within a short span of just ten years. Customer satisfaction has always been high, reflected in customer loyalty through its rapidly growing Frequent Flyer Programme.

### Awards and recognitions

- Citibank Diners Blue Moon award for Service Excellence (1996)
- Rated as the ‘fastest growing passenger airline in the world’ by Air Transport World magazine (1999)
- Air Transport World Market Development award (’01)
- TTG award for Best Domestic Airline, Asia/Pacific (’02)
- Boeing company award for Best Technical Despatch Reliability (’02)
- India’s Most Respected Company in the Travel and Hospitality sector by Businessworld (’03)
- 3 Fe Business Traveller awards for Best Business Class, Best Economy Class and Best Service (Airport and In-flight) (’04)
- ‘Star of The Industry Award for Best Domestic Airline’ (’05)
- Hero Mindmine’s BML Munjal Award for ‘Excellence in Learning and Development’
- South Asia Travel and Tourism Exchange for being the ‘Indian Domestic Airline with Spectacular Growth’ and ‘India’s Most Popular Domestic Airline’ (’06)
- 3 Avion global awards by the World Airline Entertainment Association for Best Overall In-Flight Entertainment and Best Single In-Flight Audio Program (’06)
- Voted ‘India’s leading airline’ at the 13th Annual World Travel Awards (’06)
- ‘Best Domestic Airline’ at the 16th Annual Travel Awards (’02, ’04 and ’05)
- ‘Emerging Company of the Year at The Economic Times Award for Corporate Excellence’ (’05)
- ‘Industry Impact Award’ for the newly introduced Dynamic Tier Review programme (Jet Privilege) at the Freddie Awards
- Jet Privilege received ‘Best Customer Service’ and ‘Best Bonus Promotion’ for Japan, Pacific, Asia and Australia at the 18th Freddie Awards (’06)



## Successful frequent flier programme

As per industry sources, Jet Airways' frequent flier programme, Jet Privilege is comparable with the best in the world. Jet Privilege has many firsts to its credit in the Indian domestic airline market. It has the widest alliances with international airlines for earning and redemption of miles, including British Airways and KLM-Northwest, besides premium hotel chains, car rental services and financial services.

**Table 20: Frequent flyer programme partners**

<b>Airline Partners</b>	Austrian Airlines Gulf Air KLM Lufthansa Northwest Airlines Qantas SWISS THAI British Airways
<b>Domestic Hotel Partners</b>	ITC-WELCOMGROUP Leela Palaces and Resorts Oberoi Hotels and Resorts Radisson Hotels and Resorts The Park Hotels
<b>International Hotel Partners</b>	Hyatt Hotels and Resorts Hilton Hotels and Resorts Meritus Hotels and Resorts Raffles Hotels and Resorts Shangri-La Hotels and Resorts Swissôtel Hotels and Resorts
<b>Car Rental Partner</b>	AVIS Rent a Car HERTZ Car Rentals
<b>Telecommunication</b>	Matrix Cellular Services

Source: Jet Airways

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