



# Air Arabia

## Growth and turbulence in the desert

INVESTMENT RESEARCH

INITIATION OF COVERAGE | August 10, 2008

UNITED ARAB EMIRATES

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Last Price: AED 1.56

Price Target: AED 1.82

Sector: Transport

Stock Rating

**UNDERPRICED**

BLOOMBERG: AIRARABI

REUTERS: AIRA.DU

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# Air Arabia

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### Share Data

No of shares (m)	4,666.7
Daily vol (AEDm)	168.9
Daily vol (US\$m)	46.0
Free Float	55%
Mkt cap (AEDm)	7,280
Mkt cap ( US\$m )	1,982

Source: Reuters, Zawya

### GCC aviation is on a roll

Air Arabia signals a milestone for GCC aviation in that it is the first carrier of its kind in the region. It has set the precedent for low cost flying in a region where a large chunk of the population is from the Indian subcontinent. Middle Eastern airlines have been placing billions of dollars worth of aircraft orders. Meanwhile, all industry forecasts point at this particular region as the fastest growing. Fleet sizes, traffic and tourist numbers and finally airport sizes are growing every year.

### Air Arabia is the first

The first mover advantage in the GCC low cost industry gives Air Arabia a critical edge over its rivals. Competition is very nascent and there is no comparison in terms of statistics. Air Arabia is about two years ahead of its most mature competitor, Jazeera Airways of Kuwait. Air Arabia's example has triggered a proliferation of low cost carriers in the region which might not be sustainable. In an environment of rising fuel costs, a number of countries have turned to the low cost model, which sadly relies heavily on fuel.

### Fuel-sensitive target price of AED 1.82

We rate Air Arabia Underpriced with a target price of AED 1.82. We have used three valuation methodologies: DCF, peer valuation and dividend discount model. The company declared in its IPO prospectus that it planned to disburse 25% of its net profit to shareholders as cash dividends. We use this premise for DDM and assign a 50% weight to DCF and 50% to the other two methods. Fuel prices are the most important component of this valuation.

### Stock price performance



Source: Reuters

### Forecasts and Ratios

Yr to Dec	Revenue (AEDm)	EBITDA (AEDm)	Net Profit (AEDm)	P/E	EV/EBITDA
2007*	803.7	177.7	282.0	25.8	29.8
2008E	1,964.2	191.5	342.4	21.3	27.6
2009E	2,676.4	538.8	595.3	12.2	9.8
2010E	3,225.1	691.6	747.5	9.7	7.7

Source: TNI Investment Research

\*Figures for period since inception i.e. June 19

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## Investment Case

### **Air Arabia is the first LCC in the region**

Launched in 2005, Air Arabia is the GCC's first low cost carrier. It now has a strong brand name and a very strong but brief financial track record. Passenger numbers have been increasing at a CAGR of 70% in the last three years. The string of low cost airlines in the region are following Air Arabia's example. So far the airline has employed its first mover advantage to yield excellent results. As it expands its presence geographically, the future growth rates might be higher in the international skies.

### **The numbers speak for themselves**

Air Arabia currently maintains a fleet of fifteen aircraft. This number has been rising steadily since 2004, when it had just four aeroplanes. The airline has placed a firm order for 34 more of its preferred aircraft type, the Airbus A-320. These new planes are expected to be delivered between 2013 and 2016. With additions in the form of leased aircraft and those purchased outside of this order, Air Arabia is heading towards a path of inspiring growth. Along with the growth in fleet, passenger numbers have increased from just 0.6m in 2004 to 2.7m in 2007.

### **Fuel price is a major concern**

Jet fuel costs account for as much as 37% of total operating costs. We anticipate this number to rise significantly with the rise in fuel prices. The current rally in crude prices is making airlines around the world very miserable. If oil prices stay where they are, Air Arabia could easily turn into a 'high-cost carrier'. This is visible in the company's performance in the first two quarters of 2008. Margins have come under severe pressure and it is not easy to pass all the cost to passengers.

### **Middle Eastern airlines dominating the skies**

Globally, airlines are struggling to stay in the air and the entire business model of "all-business class" has fallen flat on its face. Business class travel has been falling during the last one year. Airlines have started charging for first or second bags and mergers are the next big thing in the industry. In this haze of burning and expensive jet fuel, the Middle East stands tall with an 18% RPK growth in 2007 compared to the industry growth rate of just 7.4%. Aircraft orders at the recent Farnborough air show were largely claimed by the likes of Etihad and FlyDubai.

### **A fuel-sensitive valuation at AED 1.82**

Assuming stable prices of US\$100 a barrel in our forecast horizon, we value Air Arabia at AED 1.82. This offers a 17% upside to the current price of AED 1.56. Any changes in the price of crude oil will alter the valuation very significantly. A booming Middle East aviation industry, the first mover advantage and strong potential for growth make Air Arabia an attractive stock. This growth rests heavily on stable oil prices.

## The troubled aviation industry

### Turbulence in the skies

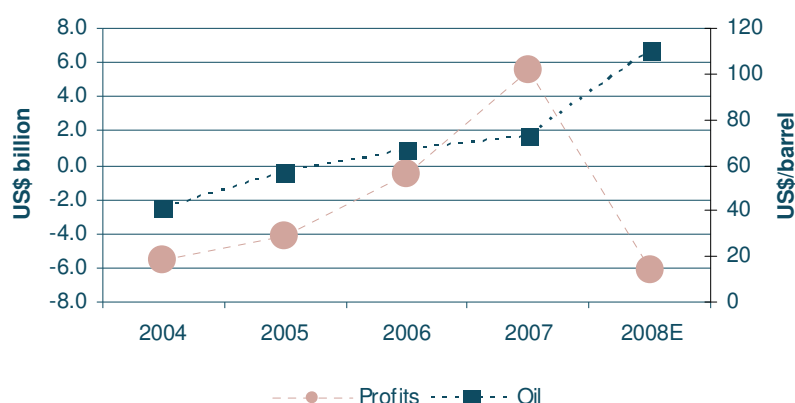
The airline industry has recently come face-to-face with its worst nightmare: unstoppable prices of crude oil. This has led to a meltdown in the global aviation industry in the form of a poor fundamental outlook. Moreover airline stocks around the world have been some of the worst performers lately. To make matters worse, the number of airlines stopping operations has been rising with the rising price of oil.

### IATA's grim outlook

The International Air Transport Association governs the aviation industry around the world and represents more than 230 airlines from 126 countries around the world. In its latest publication, the organization expects the global airline industry to post a loss of US\$ 6.1bn in 2008. This estimate is based on oil prices above US\$ 135 for the rest of the year. Moreover it compares to US\$ 5.6bn in net profits during 2007.

IATA expects airline losses to be as high as US\$6.1 billion in 2008

Chart 1: Airline industry net profits



Source: IATA, Reuters

The fuel bill is expected to rise by nearly 40% in 2008

Due to its huge share in the global aviation industry, the US is expected to contribute US\$ 4.2bn to this total loss of US\$ 6.1bn. The rest is spread almost equally between other regions of the world. Compared to last year's global airline fuel expense of US\$ 136bn, this year the fuel bill is expected to jump as high as US\$ 190bn. Last year the fuel bill rose by 23% while the average price of oil had risen by about 10%.

### The risks are critical

These mounting fuel bills are accompanied by other frightening statistics and their threat cannot be overstated. For example the global airline industry has over US\$ 190bn in debt and employs over 32 million people. Sustained high oil prices will influence all stakeholders extensively. In May 2008, cargo demand grew by just 1.3% compared to 4.3% for

## The troubled aviation industry

FY2007. Similarly, passenger traffic witnessed a 6% increase compared to 7.4% in 2007.

### Struggle for survival

With the hike in jet fuel prices, a number of airlines have stopped operations in 2008. Others have come together to merge and still others are framing plans for consolidation or downsizing. After significant rise in profitability in 2007, the industry is now headed towards the gloomiest situation in its history. The merger of Delta and Northwest was a consequence of rising energy costs. However such transactions also result in the grounding of fleet and other costs due to hub redundancy.

### Death of a business model

In December 2008 MAXjet Airways, an all-business class airline announced that it was suspending all operations. The company also suspended the trading of its shares however it announced a comeback in March, 2008. MAXjet is the polar opposite of an LCC, offering nothing but luxury travel to destinations in North America and Europe.

**EoS Airlines** was another business class airline which declared bankruptcy in April, 2008. The airline flew to destinations in Europe, North America and the Middle East. The company declared that it had insufficient cash to continue operations and ceased all flights on April 27.

**Silverjet** was a British airline catering to business class passengers only. Following a brief history of less than two years, the airline had to suspend operations in May, 2008. After struggling to find investors to inject cash, all employees became redundant on June 13.

With the collapse of these airlines, the major player in the “all business class” segment is now the French **L’Avion**. The airline calls itself a low fares business class carrier and flies between Paris and Newark in the USA. In July 2008, British Airways announced that it had agreed to buy L’Avion for £ 54m in order to expand its OpensSkies unit.

### Other victims of the oil plague

A number of airlines have declared bankruptcy in 2008 and there are bleak expectations about some more. Even low cost carriers are not immune to this dilemma afflicting the sector. Oasis Hong Kong declared bankruptcy in the second week of April and suspended all operations. The airline was a low cost carrier based in Hong Kong with a small fleet and a growing destination portfolio. Skybus was another low cost carrier which went defunct in the same week. Its “ultra low cost fare” model did not last in the face of rising fuel costs. At least six airlines have declared bankruptcy since the end of 2007.

The all-business class model seems to have failed miserably

The list of defunct airlines is growing every day

## The troubled aviation industry

### GCC flying high

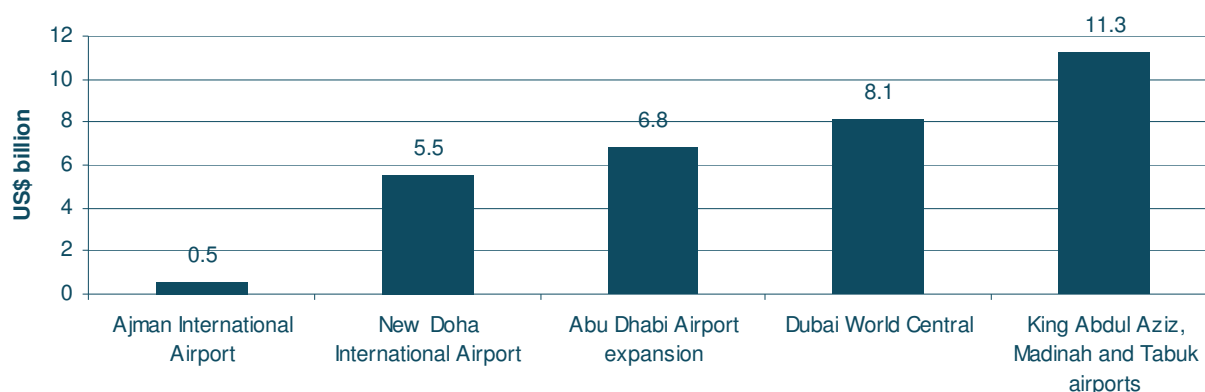
GCC airports are undergoing extensive development

Despite the trouble in the international airline industry, there has been a lot of growth in both demand and aviation infrastructure in the Middle East. Airports are being expanded all over the GCC and the total expected cost of these developments is estimated to be above US\$ 33bn. A fifth of this comes in the form of the expansion of Abu Dhabi International Airport at the cost of US\$ 6.8bn.

The UAE is leading the GCC aviation infrastructure boom

Ajman unveiled its plans for a US\$ 3.3bn international airport complex capable of handling one million passengers a year and 400,000 tonnes of cargo. Out of this, US\$ 545m is being spent on the airport itself while the rest is meant for commercial and residential buildings flanking the airport. Al Makhtoum International Airport in Dubai will be capable of handling a whopping 120m passengers upon its completion.

Chart 2: GCC airport expansion projects



Source: Press releases

These expansion projects will lead to a significant jump in capacities of regional airports and will facilitate growing tourism in the Middle East.

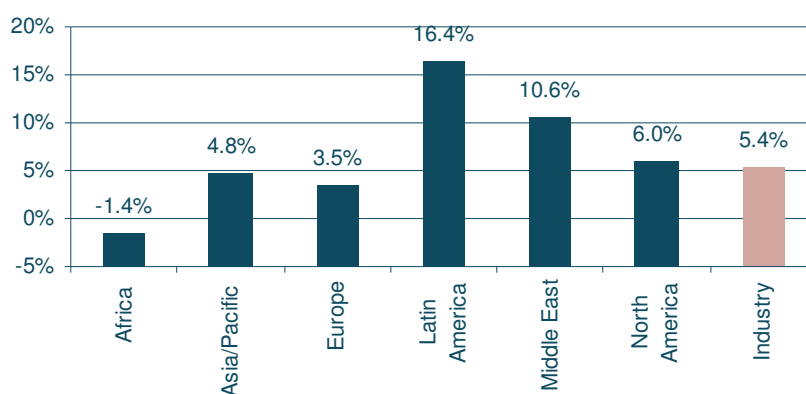
### Middle East leads global traffic growth in 2008

In the recent traffic statistics revealed by IATA, the Middle East overtakes most regions in YTD 2008 growth. The figures for June 2008 show a global growth rate of 5.4% in the first six months of the year. This compares to a growth rate of 10.6% in passenger demand in the Middle East. The region on top is Latin America, where the growth rate was an impressive 16.4%. Similarly the cargo traffic has also shown an impressive growth rate of about 12% in the Middle East compared to a global growth rate of just 2.4%.

## The troubled aviation industry

Revenue Passenger Kilometres are the measure of demand in the airline industry. The measure is calculated by multiplying number of passengers by the revenue and kilometres flown.

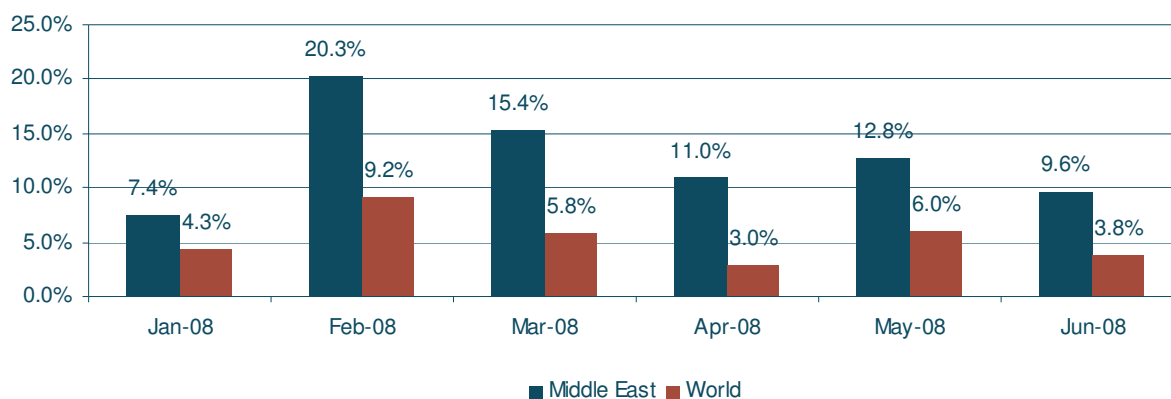
Chart 3: Revenue Passenger Kilometer growth in YTD 2008



Source: IATA

The Middle East has sustained this high growth rate so far in the year and is expected to continue with regional airlines targeting enormous expansion in the next few years.

Chart 4: RPK growth in 2008



Source: IATA

This trend is expected to be sustained with rising tourism to the region, favourable demographics and a booming economy due to rising oil prices. Competition is intensifying in both low cost and full service business models in the region. Moreover in the long-run, high oil prices will augment purchasing power in the region while it gets compromised elsewhere.

## The troubled aviation industry

### More than just airport expansion

Abu Dhabi Airports Company has shown interest in managing international airports

In the GCC, Abu Dhabi in particular has started focusing on all segments of the aviation industry. This includes rapid fleet expansion on the part of Etihad, the flag carrier. It also involves the US\$ 6.8bn Abu Dhabi Airport expansion overseen by the newly formed ADAC (Abu Dhabi Airports Company). ADAC is a rising arm of the UAE government that manages airports in the capital and has ambitious plans to manage airports around the world. The company recent announced that it will be building the region's first executive airport.

### From flying to manufacturing

Abu Dhabi Aircraft Technologies recently announced that they will be building a 96,000 ft<sup>2</sup> hangar, their sixth so far. Mubadala is planning to set up a manufacturing plant as an initiative of its dedicated aerospace and technology division. Mubadala recently signed a deal with EADS (European Aeronautic Defence and Space Company) for an aero structures plant in which the company plans to invest US\$ 161m initially.

Etihad and FlyDubai ordered US\$ 47bn worth of aircraft recently

### Big orders in daunting times

In the recent Farnborough air show, Middle East airlines placed huge orders for fleet expansion. These orders emphasize the latent growth in the Middle East aviation sector. Etihad led the way with an order for 100 aircraft with an option for another 105. This makes Etihad's order one of the largest in recent history. Currently, Etihad's fleet size is just 38 and the new order also includes ten models of the A-380 super-jumbo. Dubai's new low cost carrier, FlyDubai pitched in with an order for 54 Boeing 737-800s. Together, these orders amount to an impressive US\$ 47bn.

Airport traffic growth is overwhelming in the UAE

### Airport traffic growing rapidly

In the last three years, traffic in Sharjah International Airport has been growing at a CAGR of 38%. Abu Dhabi has been recording over 40% growth in the recent months over the previous year. Similarly Dubai International Airport has also experienced very high growth rates. Total traffic through the airport in 2008 is expected to hit 40m compared to 34.3m last year.

The outlook for the Middle East is positive

### The future looks bright

Despite grim expectations for airline profitability, IATA anticipates sustained growth in traffic. The industry has withstood oil shocks before and traffic has been growing gradually. In its latest statistics, IATA expects average growth rate for the next four years to be 5.1% globally. In these forecasts, the Middle East is expected to grow by 6.8%, which is the highest regional growth rate for the next four years.

## The troubled aviation industry

Table 1: Industry traffic forecasts

	International passengers		International cargo	
	2008	2007-11	2008	2007-11
Africa	5.7%	5.6%	4.8%	4.6%
Asia/Pacific	6.4%	5.9%	5.7%	5.4%
Europe	5.1%	5.0%	4.6%	4.3%
Latin America	4.6%	4.4%	4.3%	4.2%
<b>Middle East</b>	<b>7.2%</b>	<b>6.8%</b>	<b>5.4%</b>	<b>5.0%</b>
North America	4.4%	4.2%	4.0%	3.9%
Global	5.4%	5.1%	5.0%	4.8%

Source: IATA

The Middle East aviation industry is flying high at over 11% growth

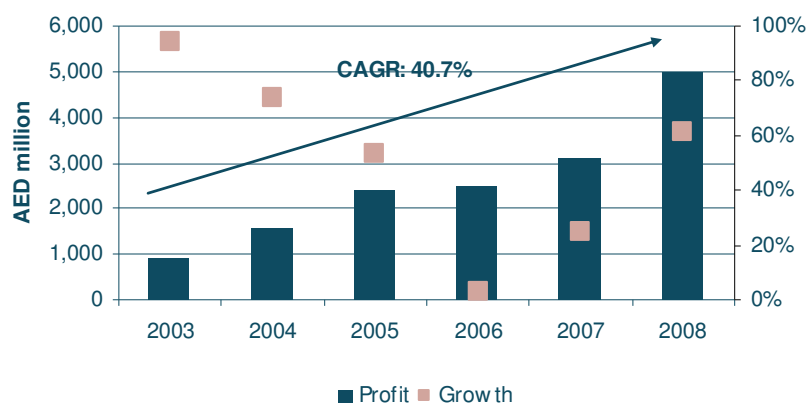
In terms of international cargo, Asia dominates with a four-year expected growth rate of 5.4%. According to the estimates published by Airbus, the fleet size of Middle East airlines is expected to more than treble in the next twenty years. Moreover between 2001 and 2006 traffic to, from and within the region has been rising at a CAGR of 11%. This is significantly higher than the global average of just 4.1%.

In 2008, Emirates reported a 60% growth in net profits

### Emerging Emirates

Another proxy of growth in Middle East aviation is Emirates, the largest airline of the UAE. In 2007, despite rising oil prices and a slowing global aviation sector, the airline reported 62% profit growth while passengers increased by about 21%. At the end of 2007, the airline had a total fleet size of 96 and catered to 17m passengers. This compares to 85 aircraft and 14.5m passengers in the previous year. Emirates has a very young fleet and the industry giant has grown fast with the UAE economy.

Chart 5: Emirates Airlines growth



Source: Emirates annual report

## The no-frills business

Pacific Southwest was the first low cost carrier

### The story of low cost flying

The beginnings of the low cost model are generally ascribed to Pacific Southwest Airlines, which was founded in 1949. The airline successfully implemented the low cost model within the USA. It operated a fleet of Boeing and Douglas aircraft and remained operational as an independent airline until its merger with US Airways in 1987. Following the success of Pacific Southwest, a number of airlines started low cost operations in both the US and Europe.

Since the first LCC was launched about six decades ago, a large number of no-frills airlines have come and gone. At times the sustainability of this model has come into question because of the low fares. However there are veterans in this industry which have been making profits every year for decades now. The threat posed by LCCs to legacy carriers is limited because of their narrow flying radius. Due to the four to five hour flying time, such airlines operate within a specific region or country.

### What is an LCC?

A low cost carrier is very different from full service carriers. We have listed the most important differences in this part. These differences are based on traditional low cost models however not all airlines adhere to such business models. In their attempt to differentiate themselves, they deviate from the textbook model by offering “non-LCC” services.

- Single cabin class
- A homogenous fleet (composed of one type of aircraft)
- Operations from secondary airports
- High utilization of aircraft for optimal operational performance
- Focus on ticket sales through the Internet
- No frequent flyer program
- No complimentary on-board services
- Multiple roles for employees
- Direct, point to point flights

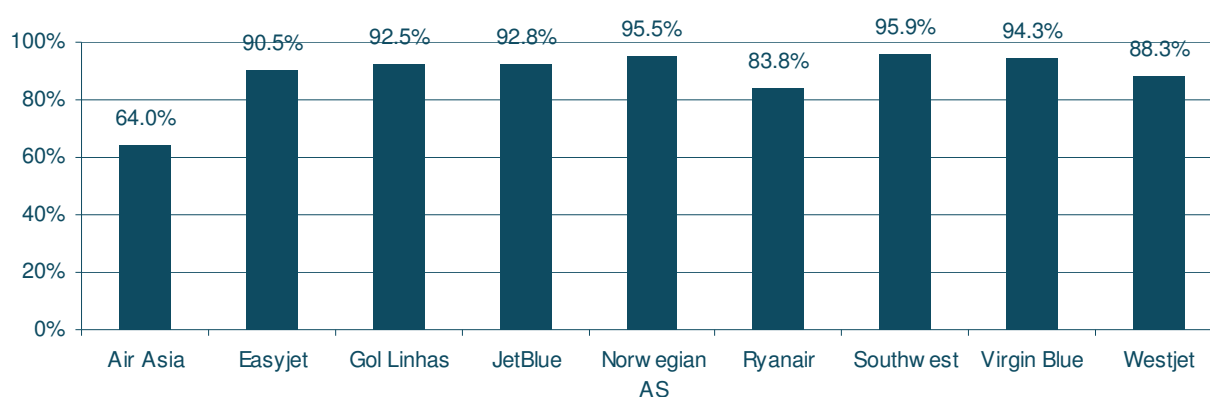
This contrasts with the model of a full service carrier, which offers on-board facilities and does not follow a point-to-point schedule. Moreover, full service carriers operate out of major airports. There is also no need for a homogeneous fleet in a major airline. These differences highlight the very definition of the low-cost model: keeping costs low. It is through these differences that such airlines manage to offer low fares.

## The no-frills business

### Ancillary revenues

Low cost airlines try to make the most of their ancillary services but conventionally, they form a very small proportion of their total revenues. Ancillary revenues include cargo, baggage and catering services among others. The revenue composition of nine major low cost carriers from different parts of the world is presented in the following chart.

Chart 6: Passenger revenue as a percentage of total revenue in 2007



Source: Company accounts

In most of the cases, passenger revenue accounts for over 90% of total sales. This implies that growth in this model is almost entirely dependant on passenger numbers. Traffic growth would in turn augment other revenue segments.

### Major players in the global LCC industry

The global LCC industry is composed of a very large number of airlines in all parts of the world. The most successful airline in this industry is Southwest Airlines, which has been profitable since 1973. Similarly, in Europe there are many low cost carriers which have successfully implemented the LCC model.

### Southwest Airlines

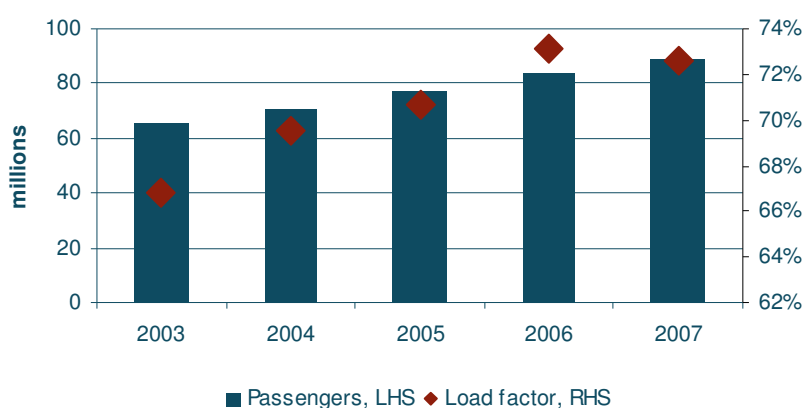
Southwest is an American low cost carrier based in the state of Texas. The airline is one of the largest in the world in terms of both its passenger numbers and fleet size. Currently the fleet stands at over 520 aircraft which is gigantic when compared to any airline in the Middle East. With nearly US\$10bn in 2007 annual revenues, it is one of the giants of the global aviation industry. Like Air Arabia, Southwest churned its first profit after two years of operations in 1973.

Southwest is a major player in the global aviation industry

## The no-frills business

In 2007, the airline carried more than 88.7m passengers; this is a very high number when compared to other large American LCCs. JetBlue for example managed 21.3m in the same period. Europe's giant Ryanair carried 42m with its much smaller fleet of 137 aircraft. Southwest prefers Boeing aircraft for its fleet.

Chart 7: Southwest Airlines: traffic and load factor



Source: Southwest Airlines

The company's net profit has been growing at a compounded annual growth rate of about 15% in the last four years. During the same time, revenues have grown by a CAGR of 13.5% while passenger growth has clocked a growth rate of 7.3%.

### Ryanair

Ryanair is an Irish low cost carrier which flies to destinations in Europe and Morocco through its numerous hubs. The airline was set up in 1985 and today flies to more than 120 cities. It operates a fleet of about 163 aircraft, all of them Boeing 737-800 models. The airline flew over 50m passengers in 2007-08 and registered over 20% growth in net profits. It is one of the top five airlines in Europe on the basis of its passenger numbers. Ryanair has managed to maintain high profit margins compared to LCCs in other parts of the world. Net profit margin for 2007 and 2008 stood at nearly 18%.

The company has been running into problems lately with the sharp rise in fuel costs. Recently there was an announcement by the management about temporarily grounding some of the airline's fleet due to rising airport charges. The airline is committed to not imposing any fuel surcharge and the management is convinced that they can break even at US\$130 a barrel.

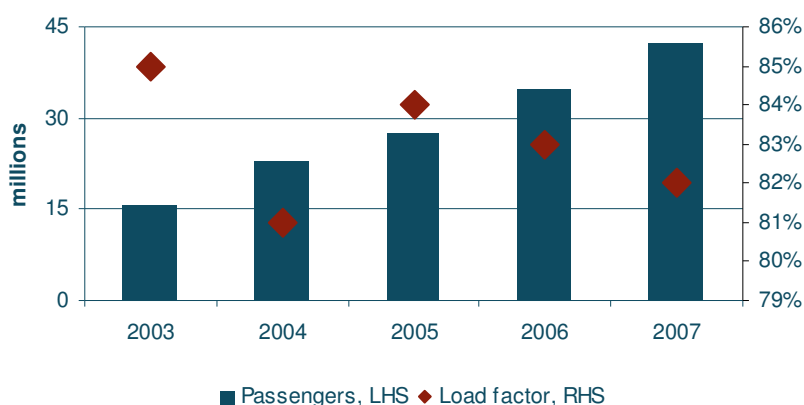
Ryanair is Europe's star LCC and grew by 20% in 2008

There are plans to ground some of the fleet due to soaring costs

## The no-frills business

Ryanair enjoys high profit margins and a very high load factor for a mature airline. There has been some decline in the load factor between 2005 and 2006 however in 2008 it remained stable at 82%.

Chart 8: Ryanair: traffic and load factor

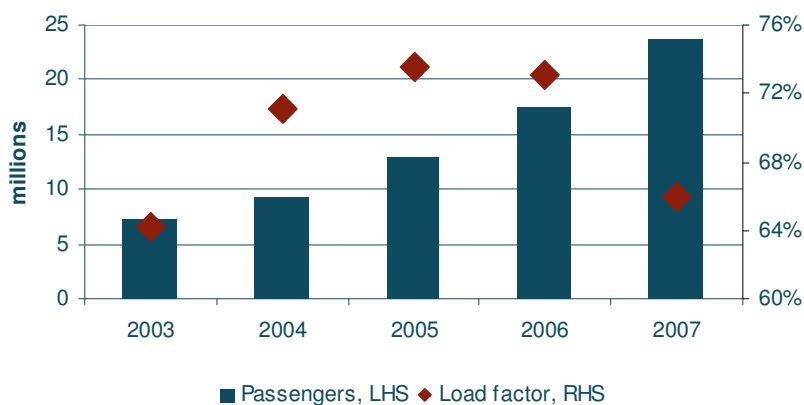


Source: Ryanair

## Gol Linhas

Gol is Brazil's low cost carrier and one of the largest airlines of the country. It operates a fleet of 111 aircraft and flies to 60 destinations in South America. It is one of those airlines which have been hit sharply by the rising cost of fuel. In the first quarter of 2008, the airline was hit by an 83% rise in energy costs while revenues grew by 54.3%. Unlike its European or American counterparts, Gol's load factor declined notably last year.

Chart 9: Gol Linhas: traffic and load factor



Source: Gol

## The no-frills business

Latin American passenger traffic is expected to increase by about 5% in 2008 according to IATA's forecasts. In the last four years, Gol has recorded a CAGR of 34% in its passenger numbers. Profit growth, however has not kept pace with the booming Latin American aviation industry. Net profits had been growing at a CAGR of 34% between 2003 and 2006 however there was an 81% fall in profits in 2007.

### The list is long

There are many other low cost carriers in India, North America and Europe. Compared to Southwest, all of them are small however they have ambitious plans for expansion. This can be gauged from the orders these airlines have placed with aircraft manufacturers. The price of aircraft has also been rising with rising transportation costs and booming demand.

Table 2: Other low cost carriers

As of FY2007	Fleet size	Load factor	Net profit in US\$m	Passengers (m)
Air Asia	66	80.0%	154.2	8.7
Easyjet	137	83.7%	303.1	37.2
JetBlue	134	80.7%	18.0	21.4
Norwegian AS	33	80.0%	16.7	6.9
Virgin Blue	59	81.2%	209.2	15.3

Source: Company websites and annual reports

## The no-frills business

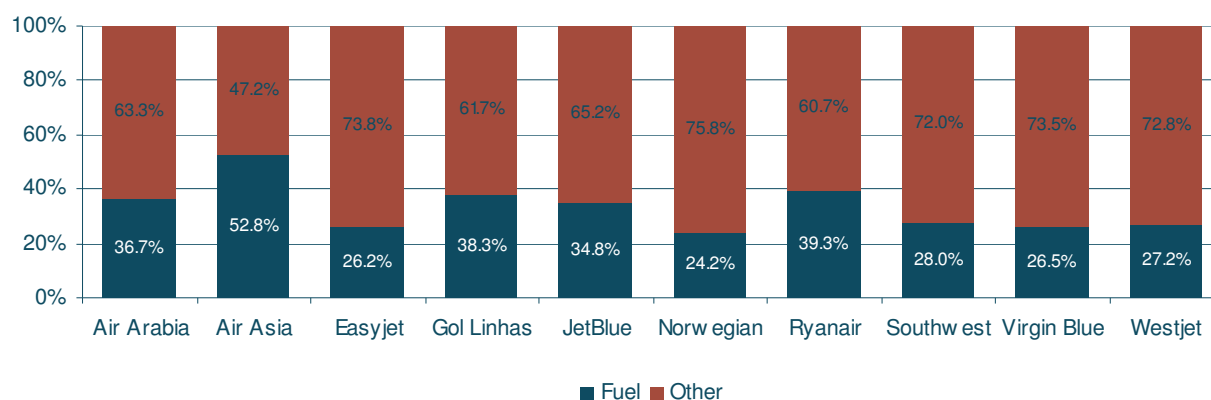
### Low cost industry with high numbers

In this section we present the financial statistics of different low cost carriers from around the world. Financial indicators have recently become very volatile for the aviation industry. This is a consequence of the skyrocketing price of jet fuel.

### Profit margins

Margins depend on growth in revenue and operating expenses, which in turn depend heavily on fuel costs. Presented below is the cost structure of different low cost carriers; it highlights the importance of fuel in the aviation industry. In all charts for the year 2007, Air Arabia's accounts are not for the entire fiscal year. The statistics reflect the "period from inception" with inception being June 19, 2007.

Chart 10: Operating cost structure for LCCs in 2007



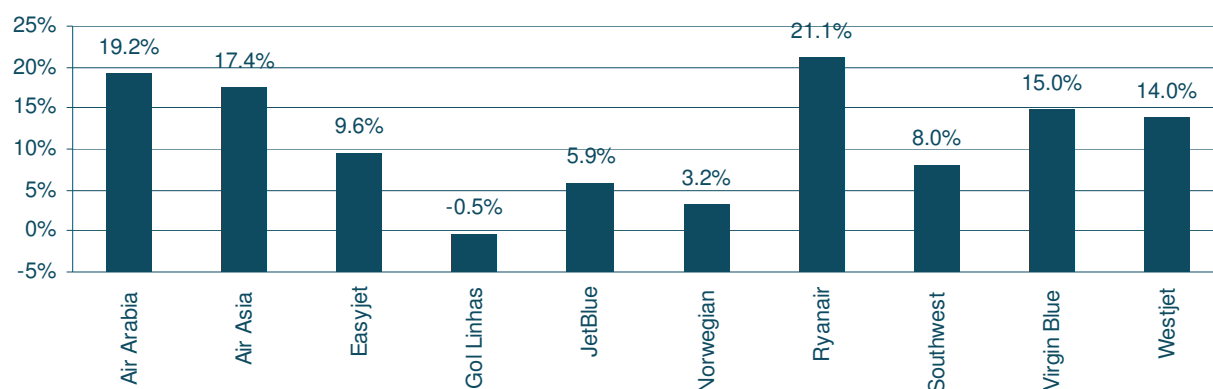
Source: Company annual reports

**On average fuel represents 34% of operating expenses**

On average, fuel costs account for 34% of total operating expenses. This number has been rising for most of the airlines as oil breaks new records. Moreover for Air Arabia, fuel costs accounted for 42% of total operating expenses in the first quarter of 2008. This number is expected to rise in the subsequent quarters if oil prices stay where they are.

## The no-frills business

Chart 11: EBIT margins of LCCs in 2007



Source: Company annual reports

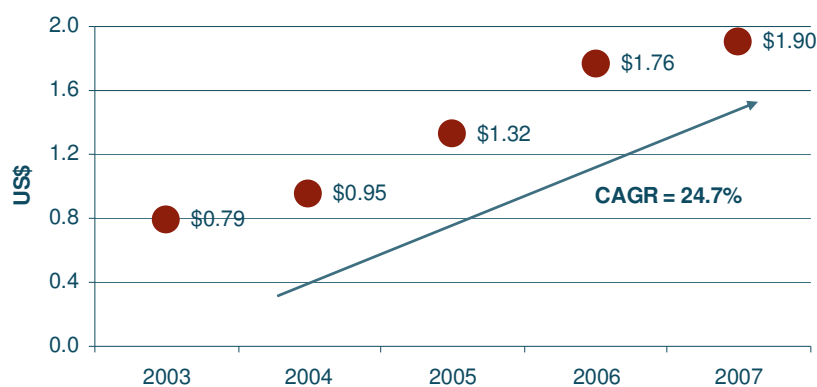
Average EBIT margin for the LCC industry is about 10%

Margins vary significantly across the LCC industry due to different fuel hedging policies exercised by the airlines. Moreover the fare structure leads to different levels of yield in different parts of the world. Ryanair for example enjoys a strong status in the European market however Southwest despite being the largest, is just one of many LCCs in the USA. Average operating margin in the industry stands at about 10% however expectations for 2008 are grim.

### Rising cost of fuel

We have taken the average price paid per gallon of jet fuel by two airlines and calculated a simple average for the five years of comparison. The price paid for jet fuel has increased at a phenomenal rate during the last few years.

Chart 12: Price of jet fuel/gallon



Source: Southwest and JetBlue

## The no-frills business

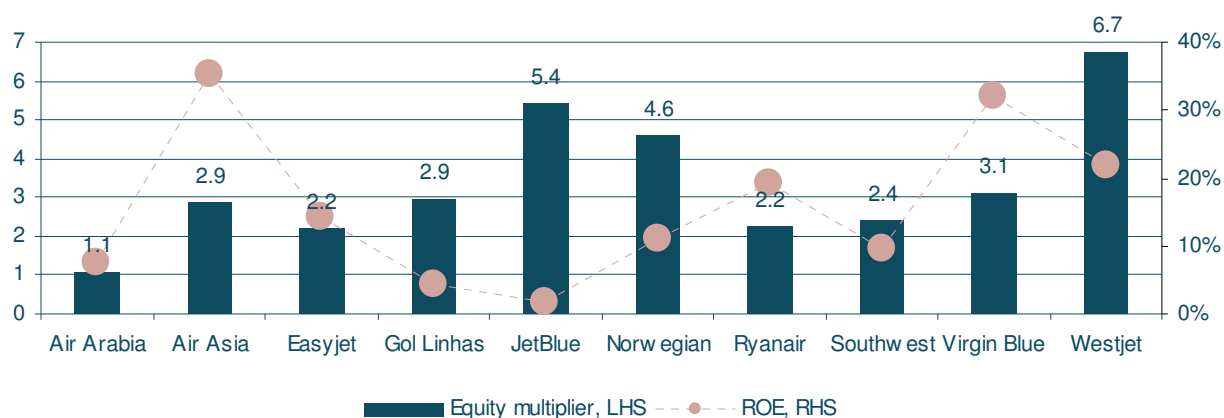
During the same time, passengers of the two airlines have grown at a CAGR of 10% while net profits have been very volatile. This is precisely why IATA has very pessimistic forecasts for the performance of the global aviation industry in 2008.

### High leverage, uneven returns

Due to its asset-heavy nature, the aviation industry is a highly leveraged one. We have presented the financial leverage index (equity multiplier) for ten different LCCs at the end of 2007. The equity multiplier is a very meaningful measure of financial leverage and is calculated by dividing total assets by total equity.

The aviation industry is a highly leveraged one

Chart 13: ROE and leverage



Source: Company annual reports

The capital structure in the industry is spread out around an average ratio of 70:30 (debt to equity). Air Arabia is an exception at this point in time because of its recent IPO. There is no debt in Air Arabia's balance sheet however that can be expected to change if and when the company decides to buy more aircraft.

### The future looks bright... if oil prices hold

The LCC model is gaining momentum in the regions where the aviation sector as a whole is growing at a fast pace. India's LCCs are placing orders with manufacturers to expand their fleet. FlyDubai rocked the Farnborough air show with its US\$ 4bn order for the first of its fleet. The market share of LCCs in Asia has grown from 5% in 2004 to 12% in 2007 in terms of available seats. In mature markets like North America and Europe this figure stands close to 30%. Middle East LCCs are poised to claim a large chunk of an expanding pie that is the regional aviation industry. More than anything else, this growth is dependant on crude oil prices.

Asia and Middle East are booming and so are regional LCCs

## Air Arabia: Falcon of the GCC skies

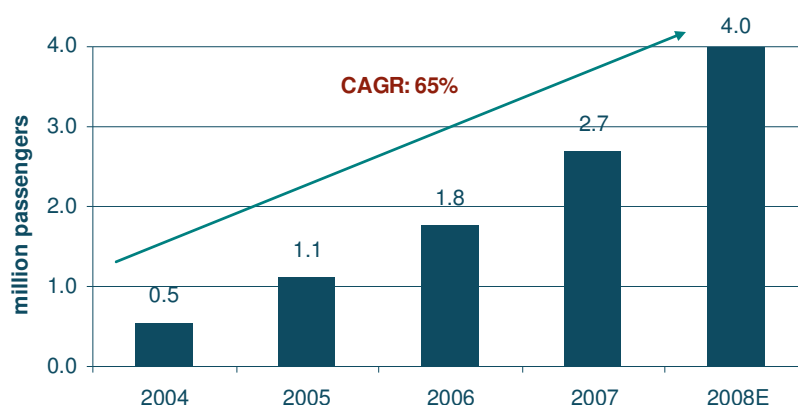
### The take-off

Air Arabia was established in 2003 through a decree issued by the Ruler of Sharjah. It started operations with a very small fleet of just two aircraft catering primarily to destinations within the GCC. The humble beginnings launched an aviation giant and by 2005, Air Arabia had made its first net profit amounting to AED 31.3m.

Passenger traffic growth has been phenomenal

From modest passenger numbers in 2003, traffic multiplied at very fast rates to cross the 1.6m mark in 2006. Between 2004 and 2007, Air Arabia's passenger traffic has been growing at a CAGR of 70% to reach 2.7m passengers in 2007. Air Arabia's performance has led to a number of awards including Low Cost Airline of the Year in 2006.

Chart 14: Number of passengers



Source: Air Arabia

Air Arabia is the pioneer of the low cost model in the GCC

The company has the distinction of being the first mover in the Low Cost Carrier industry of the Middle East. This first mover advantage continues to strengthen the brand of Air Arabia and to date in the UAE, its name is synonymous with budget travel. This is because the other three budget carriers in the UAE are at very early stages of their lives.

To finance its expansion plans, Air Arabia listed on the Dubai Financial Market in July, 2007. The IPO was 1.5 times over-subscribed, which was a poor response when compared to some of the other IPOs in the UAE. The IPO led to a huge cash surplus on the company's balance sheet, which has since been deployed in a number of channels.

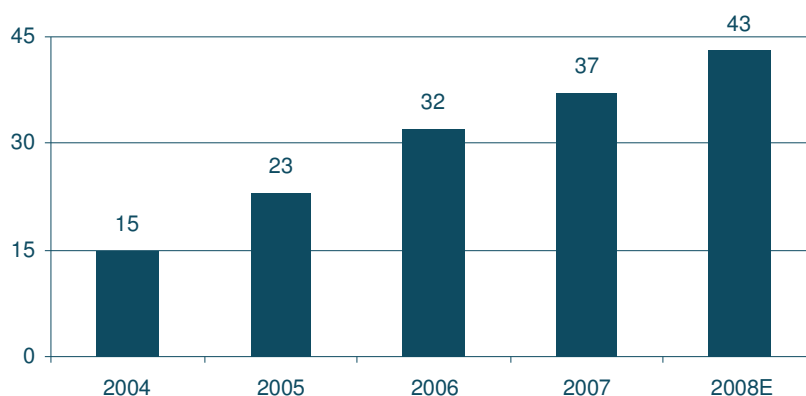
### Expanding destination portfolio

In its second year of operation, Air Arabia boasted just 15 destinations; this number has now nearly tripled to an impressive 41. The destinations of Air Arabia are spread across the Middle East, Asia, Africa and Europe.

## Air Arabia: Falcon of the GCC skies

This geographical split is based on the low cost model, which requires short flight times. The other factor is the demographic profile of the UAE's population. According to the CIA Factbook, half of the UAE population is originally from South Asia.

Chart 15: Air Arabia: number of destinations



Source: Air Arabia

In addition to the presence of Asians in white collar jobs, most of the construction labour is from South Asian countries. It is therefore not surprising that today, nearly half of the destinations are in countries like India, Bangladesh and Pakistan. With a targeted maximum flying time of five hours, this mix of destinations fits well with the company's strategy.

The recent additions to the airline's destination portfolio include Dhaka and Shiraz. The number of destinations in Asia continue to grow due to a large number of Asian residents in the United Arab Emirates.

### India is a key market

India is a very important market for Air Arabia and has seen significant growth over the years. Air Arabia travels to eleven Indian cities spread across the country. In the first quarter of 2008, YoY traffic growth to Indian destinations was an impressive 43%. Moreover, passengers flying to and from India accounted for an imposing 32% of Air Arabia's total traffic in the first quarter of 2008. The remarkable growth in Sharjah-India traffic easily surpasses the overall growth in Air Arabia's operations. Total traffic growth for all routes in 1Q/08 over the same period last year was 31%.

Last year, Sharjah-India routes accounted for 30% of total quarterly traffic. The load factor on Indian routes in the first quarter stood at an exciting 94%. This compares to an overall load factor of 85% across all routes. India itself has a strong LCC industry with players like Air Deccan and IndiGo Airlines. IndiGo Airlines placed an order for 100 Airbus A320s

In the first quarter of 2008, India-UAE routes accounted for 32% of total traffic

## Air Arabia: Falcon of the GCC skies

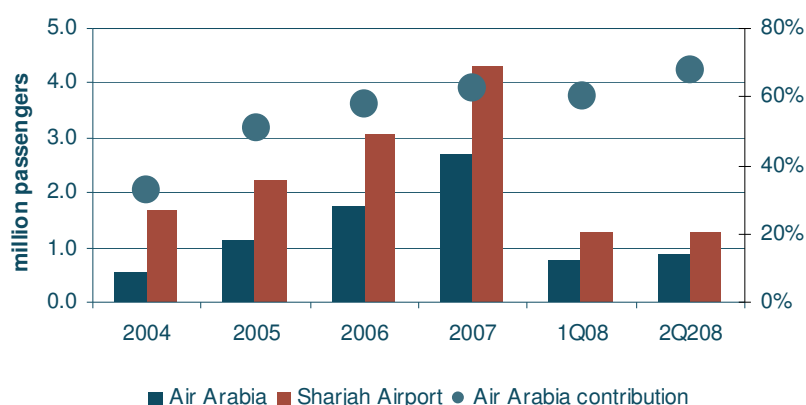
during the Paris Air Show in 2006, which is the largest order by an Indian Airline.

### Relationship with Sharjah Airport

Air Arabia enjoys a special relationship with Sharjah International Airport and accounts for 60% of traffic

Air Arabia enjoys a special relationship with Sharjah International Airport. The traffic at its home base has surged since the launch of Air Arabia. Compared to just a third of the total traffic in the airport in 2004, the new airline now accounts for over 60% of the traffic. We expect this number to stay strong in the future as Air Arabia expands its operations. Traffic at Sharjah International Airport has been growing at a CAGR of 20% since 1999.

Chart 16: Sharjah Airport passenger traffic



Source: Sharjah International Airport and Air Arabia

As more airlines fly through the airport, Air Arabia's share will be offset however the airline is expected to be the major contributor in the immediate future.

### Give us passengers, take concessions

Waivers from Sharjah Airport amounted to over AED 24m in 2007

Air Arabia gets a significant waiver off its parking and handling charges on Sharjah Airport. This enhances the financial performance of the company as it reduces costs. Until 2007, the airline was recognizing this benefit as other income however now it is being subtracted from operating costs as a discount. In 2007, benefits from this waiver amounted to over AED 24m for the entire year. We expect this treatment to continue in the foreseeable future and include it in our model across the forecast period.

### From Sharjah to the world

Sharjah Airport has recently embarked on ambitious expansion plans. Currently the airport has a capacity of 4 million passengers. Once the expansion project is completed, this number will rise to 8 million. This will help ease congestion and make further room for growth for Air Arabia.

## Air Arabia: Falcon of the GCC skies

### The Air Arabia way of flying

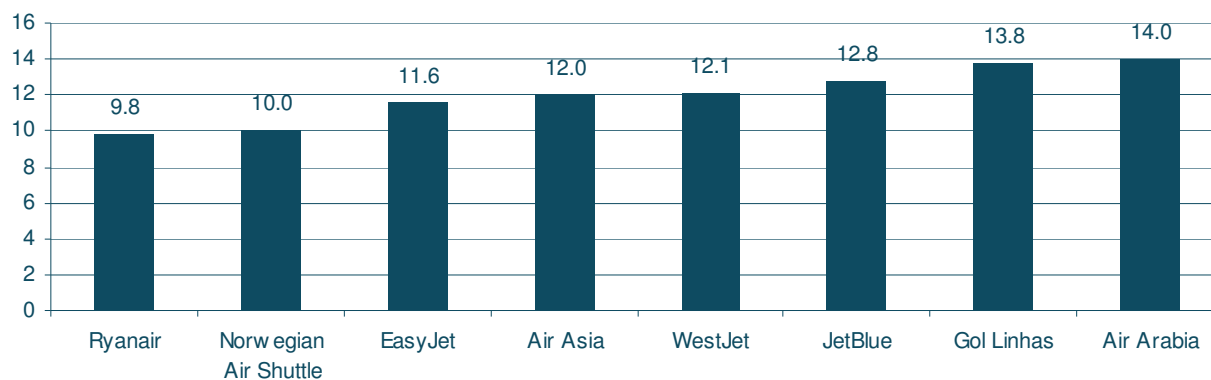
Air Arabia is in a strategically strong position due to a number of factors. The first mover advantage will continue to support its brand recognition across the region as setting up airlines takes time. Moreover some of the competitors have had to scale down their expansion plans due to the rising price of oil and aircraft. Lastly, Air Arabia has a unique business model in the region as it follows a text book example of an LCC. Other flyers in the region deviate somewhat from the traditional LCC model however Air Arabia uses it to distinguish itself.

### Focus on efficiency

Block hours for Air Arabia's fleet stood at 14.5 in 1Q/08

Air Arabia has a very high level of average block hours when compared to other low cost carriers. In FY 2007, the airline managed to clock 14 hours per day per aircraft. Generally, this figure stands close to 12 for other no-frills airlines. We expect the company to sustain this level in the forecast period. During the first quarter of 2008, the airline managed to best its own 2007 performance by achieving 14.5 block hours per aircraft.

Chart 17: LCC block hours for 2007



Source: Annual reports, company websites

### Number of aircraft

From a small fleet of just four aircraft at the end of 2004, Air Arabia is expected to reach 16 by the end of the current year. We expect that the airline will increase its fleet size by at least three aircraft per year. The crisis in global aviation will help the company achieve this objective. Struggling airlines will want to sell their aircraft at discounted rates as they battle rising costs. A firm order for 34 aircraft with an option for fifteen more will augment the fleet appreciably over the next ten years.

## Air Arabia: Falcon of the GCC skies

### Expansion into key markets

Air Arabia has recently tied up with Yeti Airlines of Nepal to form a joint venture named FlyYeti.com. Currently two aircraft serve this hub and traffic is expected to increase as the company applies its successful business model to more Asian routes. The collapse of regional carriers like Oasis Hong Kong gives the new venture an opportunity to strengthen its footing in Asia. In April 2008 the airline announced that FlyYeti would be flying to Kuala Lumpur with Air Arabia operating the Sharjah-Kathmandu half of the journey. Political unrest in Nepal has led to the grounding of fleet temporarily since July, 2008.

### Ancillary revenues

Currently, ancillary revenues constitute less than five percent of total revenues. This ratio is expected to remain stable going forward because of very strong growth in passenger revenues. However Air Arabia is focused on growing its ancillary revenues through a number of channels. These activities include cargo operations, plans to set up a ground handling company and even a hotel at Sharjah Airport. Between 2005 and 2007, ancillary revenues accounted for 2% of total revenues on average.

### Single aircraft type

Air Arabia prefers the Airbus A320 over other single-aisle aircraft. The aircraft is popular among other large low cost carriers like JetBlue, which had a total fleet size of 134 at the end of 2007. Out of these 104 were A320s. The decision to choose this aircraft is based on capacity and operating efficiency. Each Air Arabia aircraft accommodates 162 seats, which is greater than some other types. The fleet is very young as the airline's history spans less than a decade. Future orders for aircraft are significant in size (34) with the first expected in 2013.

### Going the IATA way; to a ticket-less world

Air Arabia has four channels for its ticket sales: sales agents, distribution shops, a call center and the internet. In 2006, sales through the internet accounted for 22% of total bookings. The objective is to elevate this figure to 50% in the next few years. This might be a challenge given that not all members of an LCC's target market will have access to credit cards. Increased bookings through the website will reduce the company's selling costs, which have averaged at about 3% of sales recently. This is quite low when compared to some other low cost carriers around the world.

### Focused on the pure LCC model

The first mover advantage coupled with the fact that Air Arabia tries to follow a pure low cost carrier model strengthens their brand name. Unlike other carriers which swerve from the traditional no-frills approach, Air Arabia is providing a single-class service. Some airlines provide an

Air Arabia has ambitious plans for its ancillary revenues

The Airbus A320 is Air Arabia's preferred aircraft

Paper tickets are now a thing of the past

## Air Arabia: Falcon of the GCC skies

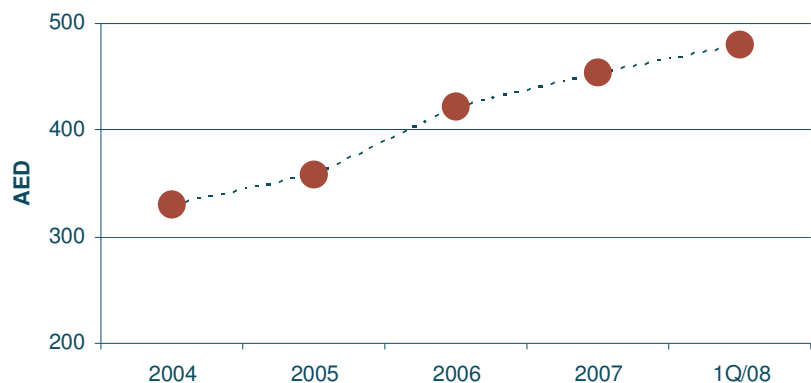
'economy plus' class in their aircraft, which is a deviation from the pure LCC model. Jazeera for example has two classes in its aircraft with the business class passengers getting preferential treatment. Air Arabia is the first mover, boasts high load factors and utilization and finally operates from a secondary airport.

Air Arabia lacks a formal fuel hedging policy

### No formal fuel hedging policy: from LCC to 'MCC'!

Air Arabia does not have a formal fuel hedging policy. The company's strategy is to analyze fuel prices and design a system of passing on the cost to customers. The average price of crude oil during 2007 was about US\$73.0. Air Arabia's average fare per passenger during the same year was about AED 454. In the first quarter of 2008, average fares went up to AED 479 while crude oil averaged at about US\$96. As oil prices continue rising, Air Arabia is expected to raise its fuel surcharges. This cannot go on endlessly as beyond certain fuel price levels, profitability will be uncertain.

Chart 18: Revenue/passenger



Source: Air Arabia

As of the second quarter of 2008, this figure has gone even higher due to the strong position of Air Arabia in the GCC market. The constantly rising fares seem to make Air Arabia transmute into a "medium cost carrier". Yield growth for Emirates has been in the region of 6% during the last two years.

## Air Arabia: Falcon of the GCC skies

### **Management**

Air Arabia has a very experienced management team which brings with it aviation experience from around the world. The Middle East aviation industry requires a blend of different business models due to its unique demographics. The management is instrumental in promoting the strong brand position of Air Arabia.

#### **Adel Ali – CEO**

With more than two decades of aviation and tourism experience under his belt, Mr. Ali is an important part of Air Arabia. He has extensive knowledge of the regional aviation industry and brings with him the important experience of working with Gulf Air. He is credited with being instrumental in the creation of Air Arabia.

#### **Paul Suckling – Director of Finance**

Mr. Suckling has significant experience in the low cost carrier industry and has previously worked for Ryanair. He has also been influential in setting up Euromanx Airways. His financial background is not confined to just airlines but also other areas of the aviation industry.

#### **Captain Mohamed Ahmed – Director of Operations**

Captain Ahmed has been with Air Arabia since the very beginning. He is responsible for the management of the fleet and ground operations among other functions. With his strong background and experience with the Airbus A320, he is well suited to an LCC like Air Arabia.

## Air Arabia: Falcon of the GCC skies

The LCC model is proliferating in the GCC

### Young and intensifying competition

Following the set up of Air Arabia, there has been a trend around the Middle East to set up low cost carriers. The most notable of these include Jazeera Airways, which has been up and running since 2005 now. This effectively gives Air Arabia a two-year lead over its oldest competitor. Others include Saudi's Sama, RAK Airways and Fujairah's Kang Pacific. In a booming and nascent industry, Dubai cannot be expected to stay behind. FlyDubai is the latest entrant into the Middle East LCC industry and is in the early stages of formation.

### Jazeera Airways

Jazeera is Kuwait's first low cost airline and operates from two hubs: Kuwait and Dubai. In this respect it might be considered somewhat of a threat to Air Arabia however the numbers say otherwise. Firstly the airline was set up in 2005, which is two years after Air Arabia. Secondly the fleet size constitutes a total of six aircraft compared to 15 for Air Arabia. Thirdly, total number of passengers for the Kuwaiti airline stood at 1.2m for 2007, which is less than half of Air Arabia's number. Lastly, Jazeera has shifted from a traditional LCC model by offering a "Jazeera Plus" cabin in their aircraft.

Like Air Arabia, Jazeera has a confirmed order for 34 new A320s, which is preferred by both airlines as the aircraft of choice. These new planes are expected to join the fleet in the next six years.

### Sama Air

Sama Air is a Saudi LCC set up in 2005 and operates out of Riyadh. The airline has a fleet size of seven which is composed of Boeing 737-300 aircraft. The destinations are mostly concentrated in the GCC region and according to the company's website, total number of destinations are just over twenty. Sama had aggressive expansion plans to increase its fleet and its destination portfolio. These plans were scaled back following the sharp rise in fuel costs.

### Nas Air

Nas Air is also a Saudi Airline and the first pure low cost carrier of the country. The airline was launched in February 2007 and therefore has little track record and a fresh fleet. Total number of destinations stands at twenty, most of them in Saudi Arabia. The main hub of the airline is King Khaled International Airport in Riyadh. The airline follows a pure LCC model offering only one cabin class in its A320s. There are seven aircraft in its fleet and with the prospect of international destinations, this number is expected to rise.

## Air Arabia: Falcon of the GCC skies

### **Bahrain Air**

Bahrain Air was set up in 2007 with a capital of US\$ 26.5m and flies to ten destinations in the GCC and the Indian sub-continent. Bahrain Air calls itself a “Premium Low Cost Airline” as it too offers two cabin classes. This is a deviation from the pure LCC model which requires a single class in all aircraft. The Airbus A320 is the popular choice among LCCs and Bahrain air is no exception. Their fleet size is just two at the moment but they have placed an order for three more to be delivered in 2009.

### **RAK Airways**

RAK Airways was launched in 2006 and operates a fleet of three leased aircraft. It has placed an order for another four scheduled to be delivered over the next four years. The destinations include Colombo, Beirut, Dhaka, Calicut and Sofia. Ras Al Khaimah has become very active in positioning itself as a tourist destination. Initiatives include the development of real estate projects like Marjan Island; RAK Airways is expected to compliment this effort.

### **Kang Pacific**

The official airline of the eastern emirate of Fujairah completed its maiden flight in the first week of June, 2008. At this stage it is not possible to say whether it will be a low cost carrier or not. The airline’s website mentions future destinations in Europe, which implies that it could be a full service carrier. Moreover with plans to have different types of aircraft, it seems Fujairah is aiming for the skies and not to compete in the LCC proliferation.

### **FlyDubai**

It would not be reasonable to expect Dubai to stay behind in any industry which is booming in the UAE. Dubai first announced its plans to set up an LCC back in March 2008. The airline is expected to take off sometime in late 2009. Dubai’s major carrier Emirates is involved in setting up this new airline however it is expected to be a separate and independent entity.

### **Flying bandwagons**

There have been statements from other airlines saying that they are contemplating setting up their own low cost carriers. The management of Qatar Airways hinted at setting up their own no-frills carrier. The management did not seem too excited about the prospect because they only want to do this to emulate others. With competition hopping into the LCC industry with a bandwagon philosophy, Air Arabia’s brand is expected to stay strong.

## Air Arabia: Falcon of the GCC skies

### SWOT analysis

Table 3: Air Arabia SWOT Analysis

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>• <b>First mover:</b> Air Arabia is the first low cost carrier in the GCC region. Given the huge investment required in setting up an airline, competition will need time to be a significant threat.</li> <li>• <b>Young fleet:</b> Air Arabia is a very young company and was set up in 2003. Resultantly, the aircraft fleet is very young with an average age of just over two years.</li> <li>• <b>Relationship with main hub:</b> Sharjah Airport gives significant waivers to Air Arabia in the form of landing and parking fees. In 2007, such waivers amounted to over AED 24m.</li> <li>• <b>Strong financial performance:</b> Despite a very young history, net profits have been increasing at a CAGR of over 200% since 2005. The company managed to generate its first net profit in 2005 after starting operations in late 2003.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Exposure to fuel prices:</b> Fuel prices account for roughly 38% of total operating costs for Air Arabia. The recent hike in crude oil prices is expected to continue affecting the airline. This was visible in the low margins in 1Q/08.</li> </ul>
Opportunities	Threats
<ul style="list-style-type: none"> <li>• <b>Geographical expansion:</b> With a firm order for 34 aircraft and an option for 15 more, Air Arabia is poised for growth. The airline is expected to add more destinations to its portfolio. The joint venture with FlyYeti.com is a step in that direction.</li> <li>• <b>Strengthening brand name:</b> Competition is still young when compared to Air Arabia which gives the company time to further solidify its positioning as a quality LCC.</li> <li>• <b>Economic and tourism boom:</b> The UAE and the GCC as a whole is focused on attracting tourists to the region. As the region grows with the rising price of oil, the accessible market for Air Arabia also expands in the long-term.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Price of crude oil:</b> Being the most significant component of operating costs, energy prices can seriously hamper Air Arabia's performance. Airlines around the world are struggling because of rising energy costs.</li> <li>• <b>Competition:</b> Low LCC penetration in the region makes the pie very large however new LCCs are on their way to make the division more diluted in the future. New LCCs include Sama, Nas, RAK Airways and FlyDubai.</li> <li>• <b>Delay in aircraft deliveries:</b> Due to limited choice in aircraft suppliers, airlines are sensitive to delivery schedules of aircraft. The delivery of the 34 ordered aircraft is originally meant to commence in 2013.</li> </ul>

Source: TNI Investment Research

### Competitive analysis

The following analysis shows how Air Arabia's first mover advantage has strengthened its position in the region's aviation industry. However airlines are showing very strong attraction to the LCC model.

#### **Bargaining power of suppliers (medium)**

Air Arabia relies on a single type of aircraft, the Airbus A-320, which is best suited to the LCC model. Delays in aircraft delivery are not an uncommon phenomenon in the industry. Middle Eastern airlines have placed orders for a very large number of aircraft already.

#### **Threat of new entrants (high)**

There are significant barriers to entry in the airline industry because of investment in fixed assets and landing rights. However the LCC model has gathered momentum in the region. The demographic profile of the GCC population and economic indicators support the LCC model.

#### **Bargaining power of customers (medium)**

Price is a very important factor for air travellers. It becomes even more important when travel is not adorned by any frills. As competition increases and customers have more choice, their bargaining power is set to rise.

#### **Threat of substitutes (low)**

There is no regional railway network in the GCC. In fact there is a noticeable absence of domestic railway networks within individual countries. Moreover, with a considerable portion of the UAE coming from the Indian Subcontinent, they have little choice in modes of transport.

#### **Rivalry in industry (medium)**

Air Arabia's competitors are very young but rivalry is on the rise. We expect competition to grow extensively in the future with more and more airlines venturing into the no-frills segment. Dubai's new LCC will add significantly to competition for Air Arabia.

## The financial story

Air Arabia's revenue has grown at a CAGR of 27% in the last three years

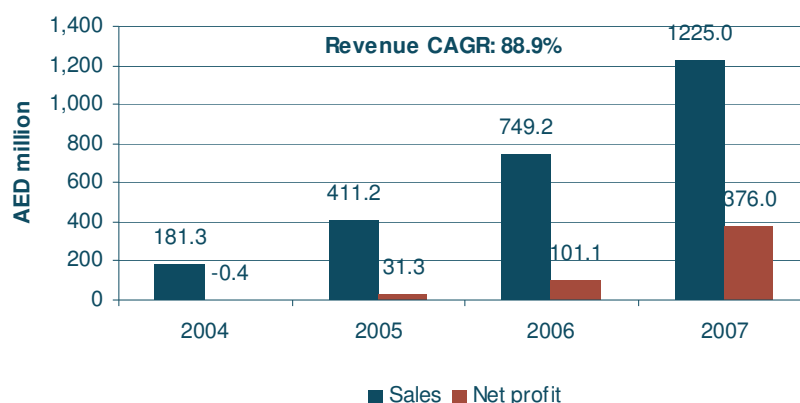
### Flying high but thunderstorms ahead

Air Arabia generated its first net profit in 2005, just two years into operations. Access to capital through an IPO, a strong brand name and the first mover advantage have all led to a revenue CAGR of 27% in the last three years. Margins have been expanding steadily and passenger numbers have seen tremendous growth. Lately however, oil prices have started taking their toll on the company.

### Blistering growth

Following its launch in 2003, Air Arabia launched into the skies with a profit of AED 31.3m in 2005. In 2007, the airline declared net profit of AED 376m with expanding margins and rising traffic statistics.

Chart 19: Air Arabia: Revenue and net profit growth



Source: Air Arabia

We are anticipating 20% revenue CAGR in the next ten years

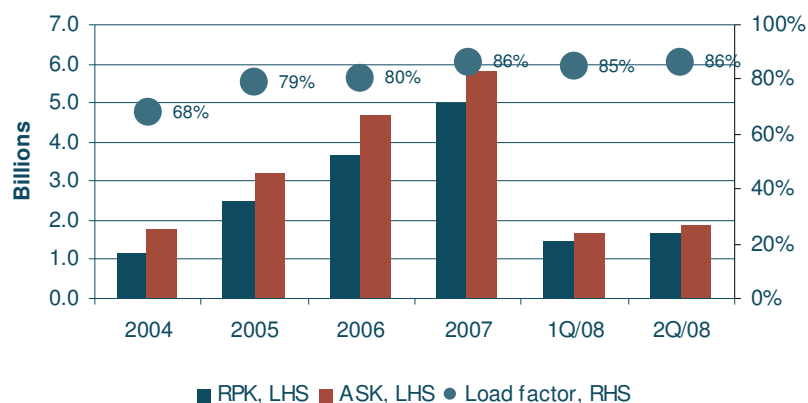
We expect Air Arabia's revenues to grow at about 21% CAGR in the next ten years however margins might stay under pressure depending on the oil prices. In the immediate future, revenue growth is expected to be phenomenal due to expansion in its fleet and destinations. In 2004, the airline was catering to just 15 destinations and that figure has now reached about 41.

### Growth expressed in airline lexicon

In terms of RPK and ASK, Air Arabia has shown tremendous growth as passenger traffic has been growing at a CAGR of about 70% in the last three years. The four-year CAGR including 2008 is expected to be close to 64% as passenger numbers approach 4.0m. There are issues with the company's JV in Nepal as the fleet was grounded in July due to political instability. This could bear on passenger and revenue growth in the current year.

## The financial story

Chart 20: Air Arabia: RPK, ASK and Load Factor



Source: Air Arabia

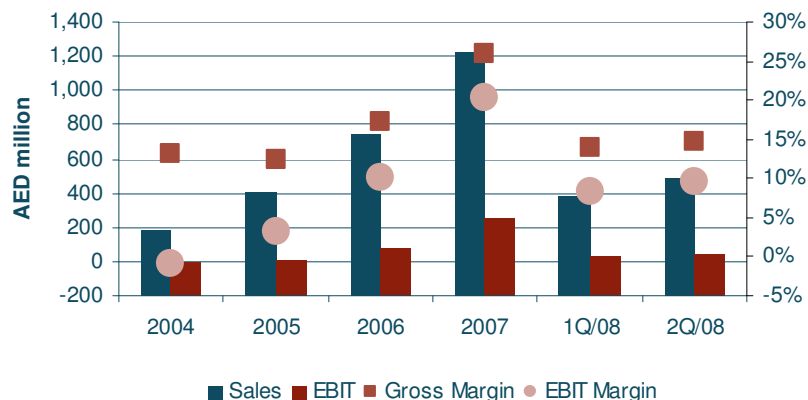
Air Arabia boasts high load factors of 85%

While RPK and ASK explain an airline's demand and capacity situation, the load factor demonstrates the proportion of seats that are occupied. Air Arabia has one of the highest load factors in the sector and it has managed to sustain it close to the 85% level. This is very impressive when compared to other young LCCs like the Spanish Vueling. The Barcelona-based airline managed a load factor of about 66% in the first quarter of 2008 along with operational losses.

### Profitability

After posting higher margins every year from 2004 to 2007, Air Arabia succumbed to higher fuel costs in 2008.

Chart 21: Air Arabia profitability



Source: Air Arabia

## The financial story

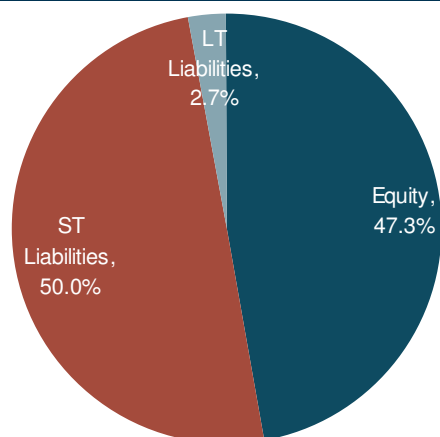
EBIT margins dropped to 8.3% in 1Q/08 from about 20% in 2007 as jet fuel prices impacted the company. We have assumed stable oil prices of US\$ 100 a barrel during the forecast period. A further blip in energy prices can be devastating for Air Arabia and the global airline industry as a whole.

### Capital structure and solvency

The capital structure is conservative and unique

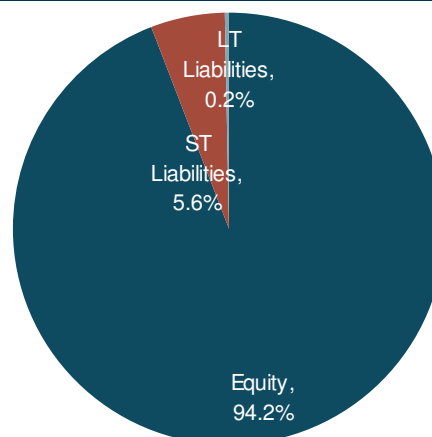
Following the AED 2.6bn IPO on the Dubai Financial Market, Air Arabia's capital structure is very conservative. There is absolutely no debt in the company and its strong net cash position enables it to increase its fleet conveniently depending on the availability of aircraft.

Chart 22: Air Arabia capital structure in 2006



Source: Air Arabia

Chart 23: Air Arabia capital structure in 2007



Source: Air Arabia

Given its ability to generate very strong cash flows, we believe Air Arabia will not need debt in the near future. This assumption again depends on stable load factors, a growing yield and most importantly steady oil prices. This capital structure is unique in the industry where on average, equity financing accounts for 35% of the capital.

Air Arabia has over AED 1.1bn in investments which will augment other income

### On the investing side...

Air Arabia purchased investments worth AED 1.1bn last year as a cushion against falling margins. We anticipate very moderate returns on this portfolio in our forecast period however when coupled with interest income, it yields significant addition to the bottom-line. The investments are fixed income instruments as the company does not seek stock market exposure.

## Valuation

### The nuts and bolts

We have used DCF, peer valuation and dividend discount model

We have used three different methodologies for Air Arabia's valuation. Firstly we employed a ten-year discounted cash flow model. The time horizon is important due to significant capital expenditures expected in the next ten years. The second method is a complex peer valuation technique in which we have used four major valuation multiples. The LCC industry is a large one with many players around the world, therefore peer comparison is meaningful. Lastly, Air Arabia declared in its prospectus that it will be paying 25% of its profits as cash dividends. We therefore discount the dividends during the next ten years for DDM valuation. We have assigned 50% weight to DCF and 50% to the other two methods.

### WACC and terminal growth rate

Due to absence of debt, we have only used the cost of equity as the discount rate

Our calculation of the weighted average cost of capital is based on the compounded annual returns on global emerging markets. The risk-free rate is the yield on the ten-year US Treasury bond. Air Arabia does not have any debt on its balance sheet and is not expected to have any in the near future. The WACC is therefore composed of the cost of equity and a beta of one. Air Arabia listed in July 2007 so trading data is brief which leads us to use the market beta of one.

We have used a terminal growth rate of 3.7% which is the IMF's estimate of global growth in 2008. This is conservative, considering that the same estimate for the Middle East is 6.1% and for Asia over eight percent. However we stick to the cautious global estimate of 3.7% in order to accommodate the very high risk of fuel prices.

### Crude oil prices

Oil prices are the most significant and erratic element of the Air Arabia story

The most important variable in Air Arabia's performance and valuation is the price of crude oil. Oil constitutes the largest cost for any airline and more so for low cost carriers. This cost has jumped YoY by over a hundred percent for Air Arabia in the first quarter of 2008. The rise in revenues, passenger traffic and profits is much smaller than that. Oil prices are the most integral and unpredictable component of the Air Arabia story.

### The story so far

The price of the OPEC basket of crudes has been rising at a precipitous pace for a long time now. Since 2001, the price of this basket has grown at a CAGR of 24.1%. The steepest rise was in the last three years when this price went from US\$50.6 to US\$104.5. There are conflicting views on whether this steep rise is a function of market forces of speculation. Major producers like Saudi Arabia have pledged to increase production marginally this summer to meet rising demand.

## Valuation

Chart 24: Crude oil prices 2000-08

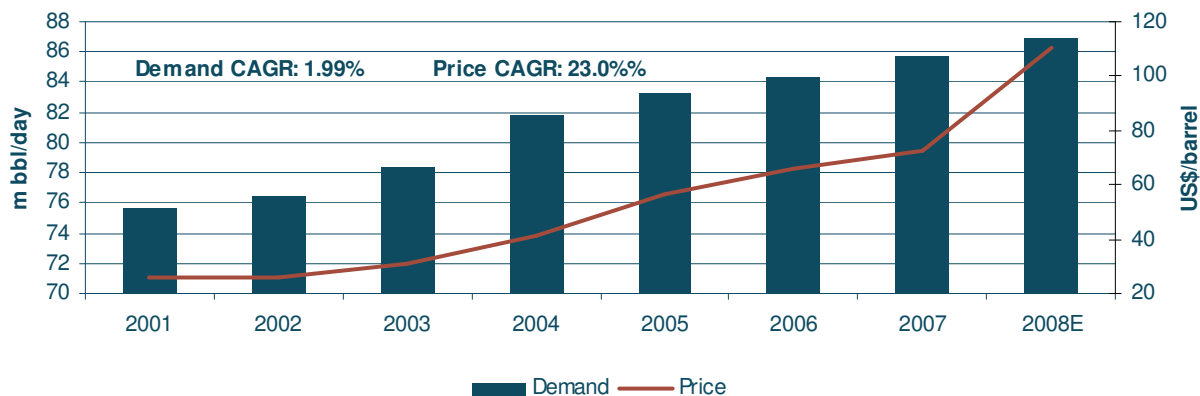


Source: Reuters

### A look at market forces

While the price has been rising at growth rates of more than 24% since 2001, demand growth was modest. China has been growing rapidly as a consumer of energy but the recent hike in prices of refined products there could slow down their tremendous growth. Supply has so far managed to meet demand successfully. There are now fears that crude oil supply will not meet the rising demand.

Chart 25: Demand for and price of crude



Source: OPEC and Reuters

OPEC is responsible for 37% of the world supply of oil. This means that out of about 87m barrels of oil produced every day, OPEC accounts for just over 31m barrels. Saudi Arabia is the largest producer with latest production figures of 9.3m bbl. Due to the disproportionate and steep rise in oil prices during stable demand growth, we foresee an era of stable crude prices in the medium-term.

## Valuation

We assume oil prices to stay at US\$100 a barrel in our forecast horizon. The recent pledge by Saudi Arabia to increase production, OPEC's firm stance on market forces, inconsistent price inflation, slowdown in demand and increased prices of refined products in China are the foundations of this assumption. We understand that this is a sensitive issue and the most important one and hence provide a sensitivity analysis of the valuation to crude prices.

### DCF valuation at AED 2.47

Strong growth in traffic, strong fundamentals of Middle East aviation and the first mover advantage make Air Arabia's cash flows significant. However sky-rocketing fuel prices have the opposite effect and depress margins significantly. For an LCC, jet fuel represents about one-third of its operating costs. This number rises significantly as the price of crude rises in the international market. Our estimates of capital expenditure are based primarily on the expected payments for the 34 ordered aircraft.

Table 4: Air Arabia: DCF valuation

All figures in AEDm	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E
EBIT	149.9	447.1	576.9	731.3	951.7	1,204.0	1,280.3	1,580.1	1,915.7	2,283.4
+Depreciation	41.6	91.7	114.7	132.9	154.3	179.1	207.5	239.6	275.8	321.5
-Capex	-860.2	-378.0	-399.9	-422.6	-448.1	-1,627.8	-1,701.7	-1,731.5	-1,763.0	-1,290.2
-Working capital Δ	-125.8	-25.9	-36.8	-27.1	-15.0	-6.0	-43.9	9.6	19.3	28.1
=Free cash flow	-542.9	186.8	328.5	468.8	672.9	-238.6	-170.0	78.5	409.2	1,286.5
xDiscount factor	0.96	0.87	0.79	0.72	0.66	0.60	0.54	0.49	0.45	0.41
=Discounted FCF	-520.2	162.7	260.3	337.7	440.8	-142.1	-92.1	38.7	183.2	523.8
Terminal value (TV)	20,518.9									
Sum of discounted FCF	1,192.9									
+Discounted TV	8,354.4									
<b>=Firm value</b>	<b>9,547.3</b>									
+Net cash (debt)	1,988.7									
<b>=Value of equity</b>	<b>11,536.0</b>									
÷Number of shares	4,666.7									
<b>=Fair value (AED)</b>	<b>2.47</b>									
Current price (AED)	1.56									
Upside/(downside)	58.3%									

Source: TNI Investment Research

## Valuation

Table 5: Sensitivity analysis of valuation

		Terminal growth rate				
		1.7%	2.7%	3.7%	4.7%	5.7%
WACC	7.97%	2.85	3.25	3.85	4.80	6.60
	8.97%	2.38	2.65	3.02	3.57	4.44
	9.97%	2.04	2.23	<b>2.47</b>	2.81	3.31
	10.97%	1.78	1.91	2.08	2.31	2.62
	11.97%	1.57	1.67	1.79	1.95	2.16

Source: TNI Investment Research

### Comparable valuation at AED 1.26

We have selected four different valuation multiples to provide a meaningful measure of Air Arabia's standing in relation to its peers. Being a very young airline and armed with the first mover advantage in a booming region, Air Arabia boasts high growth rates. Most of the listed low cost carriers around the world are mature companies. Our peer universe is composed of nine airlines. They represent Asia, Europe, North America and Australia. All multiples are based on 2009 forecasts.

Table 6: Air Arabia: Comparable valuation

All figures in AEDm	P/BV	P/E	P/S	EV/EBITDA
Air Asia	0.94	12.15	0.94	7.45
Easyjet	1.13	30.35	0.54	9.42
Gol Linhas	1.24	8.23	0.47	4.87
JetBlue	1.07	n/a	0.41	18.19
Norwegian	3.11	12.38	0.15	2.08
Ryanair	1.55	n/a	1.22	16.23
Southwest	1.73	38.82	1.00	6.81
Virgin Blue	1.05	14.66	0.34	5.53
Westjet	1.41	9.12	0.66	4.40
<b>Sector</b>	<b>1.47</b>	<b>17.96</b>	<b>0.64</b>	<b>8.33</b>
<b>Implied value</b>	<b>1.86</b>	<b>2.29</b>	<b>0.36</b>	<b>0.54</b>
<b>Fair value (AED)</b>	<b>1.26</b>			

Source: Bloomberg, TNI Investment Research

Compared to some of its mature counterparts around the world, Air Arabia looks expensive at current multiples. However Air Arabia has the promise of significant growth in the near future as it expands into other regions. At the same time, crude oil prices pose a strong downside risk.

## Valuation

### Dividend discount valuation at AED 1.09

We have discounted Air Arabia's forecasted dividends from 2008-2018 using the company's cost of equity. The dividend payments yield a value of just AED 1.09, significantly below the current price of AED 1.56.

Table 7: Air Arabia: DDM valuation

All figures in AEDm	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Dividends	0.0	85.6	148.8	186.9	232.3	296.0	370.1	389.8	465.6	553.2
Discounted dividends	0.0	74.6	117.9	134.6	152.2	176.3	200.4	192.0	208.5	225.2
Terminal value	8,823.3									
Sum of discounted Div	1,481.8									
+Discounted TV	3,592.5									
=Value of equity	5,074.3									
÷Number of shares	4,666.7									
=Fair value (AED)	<b>1.09</b>									

Source: TNI Investment Research

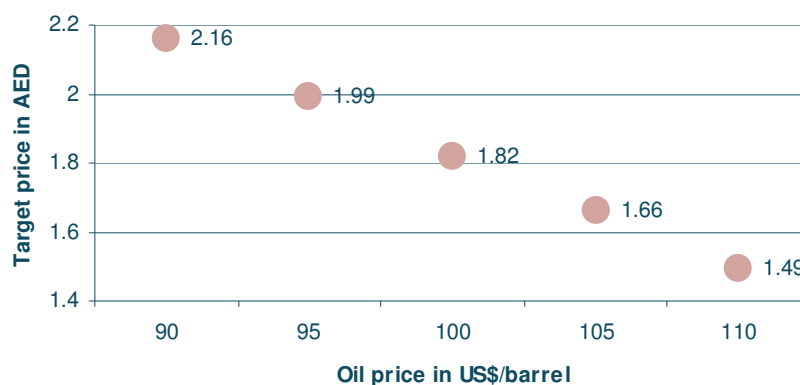
With high capital expenditures and rising fuel costs, dividend distribution will strain cash flows

We have assumed a payout ratio of 25%, as mentioned in the company's prospectus. Air Arabia might not fulfil this promise as it did not pay any dividends at the end of 2007. Moreover, with capital expenditures expected to stay high in the near future, we feel dividends are not in the best interest of the company. The rising fuel costs also make dividends an unpleasant addition to the cash flows.

### Weighted average valuation at AED 1.82

Our weighted average valuation for Air Arabia is AED 1.82, which is at a 17% upside to the current price of AED 1.56. We have presented below the sensitivity of the valuation to crude oil prices.

Chart 26: Sensitivity of valuation to crude prices



Source: TNI Investment Research

## Valuation

### Stock price performance

Air Arabia is a very young stock however it is one of the most liquid stocks on the DFM. On average it accounts for 11% of the daily traded value on the exchange. In absolute terms, its average traded value stands at US\$47m. After a very solid start in July last year, Air Arabia cooled down while the rest of the market continued going up.

Chart 27: Air Arabia stock price performance



Source: Reuters

**Air Arabia is strongly correlated with the market and not very news-elastic**

Since November 2007, the stock has been unable to breach and sustain the AED 2.00 level. Investors seem to have reservations about the sustainability of the company's growth. This is understandable as fuel costs are the largest component of an LCC's operating costs.

The stock is not very news-sensitive as the major result publications have not been followed by strong reactions. Following the announcement of the purchase order for 34 aircraft, the stock did rally. However this was also a consequence of the DFMGI registering strong growth in the same period. Air Arabia is strongly correlated with the market; daily returns show a correlation of 0.7 with the DFMGI.

Air Arabia has been declining since the beginning of June, 2008 in anticipation of poor second quarter results. This is because of rising price of crude oil which has led to the demise of many airlines in this year alone. Moreover, the market as a whole has been performing very badly and transport stocks have been at the forefront of this poor performance.

## Valuation

### Stock price catalysts

We believe in the immediate future, Air Arabia's stock price can potentially be impacted by the following factors.

#### Price of crude oil

This is the single-most important variable in any airline's operations. The higher this number goes, the lower the profitability in this business. A sharp rise in crude prices can be devastating for the stock. With oil accounting for over a third of the company's operating costs, we believe the stock price and valuation are very sensitive to such changes.

#### Third quarter results publication

The third quarter results are expected to be announced sometime in the second week of October. Air Arabia's growth is mostly priced in as shown by the high valuation multiples. Results publication is therefore expected to be less important than changes in crude oil prices. We expect significant QoQ growth in the third quarter if oil prices are stable. Passenger numbers have risen by 32% YoY in the first six months. We anticipate total traffic for the year to be 3.63m.

#### Addition of another hub

Air Arabia plans to expand its operations to Asia and Africa. A hub in Morocco is expected sometime next year. As and when the company announces solid plans to add another hub, the stock price can react. Such news will impact the company's performance as it gets exposed to new markets.

### Risks to the investment case

The airline industry is exposed to a number of important risks. We list here those which are most relevant to Air Arabia.

#### Price of crude oil

Due to the hyper-sensitivity of profitability to energy costs, this is the most important risk to Air Arabia. The airline will struggle to make profits if crude prices stay in the region of US\$140 a barrel. We have assumed oil prices to be constant at US\$100 a barrel in the forecast horizon.

#### Delay in aircraft delivery

Air Arabia's growth depends on the expansion of its fleet. The first of the 34 ordered aircraft are expected to be delivered in 2013. A delay in the delivery of these aircraft will hamper the airline's growth. The airline industry has always been beset with this problem.

#### Capacity of Sharjah airport

Air Arabia accounts for over 60% of traffic in Sharjah Airport. If the airline is unable to expand successfully to other hubs, its growth will be dependant entirely on Sharjah. Following the expansion plans, the capacity of Sharjah Airport is expected to reach eight million passengers.

## Valuation

### **Substitution risk**

Although a far-fetched possibility, alternative modes of transport might pose a risk in the long-run. Our valuation rests on a ten-year time horizon and a lot can change in a decade, specially in the GCC. There are already talks of a GCC-wide railway network. This could impact low cost carriers in the region significantly.

### **Economic risk**

It is certainly true that high oil prices mean rapid economic development for the region and hence enhanced purchasing power. However higher energy prices also imply high inflation and margin contraction for airlines. A slowdown in economic activity in the GCC region can impact Air Arabia's growth. Such long-term risk can alter the demographics of the GCC, which are crucial to the growth of airlines.

### **Beyond financial valuation**

Despite being a very young stock, Air Arabia is one of the most liquid companies on the DFM. There is little liquidity risk involved in the trading of the stock due to narrow spreads and high average turnover. In terms of its disclosure practice, it is better than the average Dubai-listed company.

According to our observations, the company's corporate communication is also at par with the standards of the DFM. Moreover in the transport sector as a whole in the GCC, it falls in the upper tier in terms of transparency and corporate communication. An informative website, regular analyst conference calls and detailed press releases with every result publication make Air Arabia better than the average UAE company in terms of transparency.

## Valuation

### Financial statements and ratios

Table 8: Air Arabia - Financials and ratios

Data in AED million	2007*	2008E	2009E	2010E	2011E	2012E
<b>Income statement</b>						
Revenues	803.7	1,964.2	2,676.4	3,225.1	3,792.2	4,429.9
Cost of Sales	(591.7)	(1,708.3)	(2,084.8)	(2,474.0)	(2,856.1)	(3,239.0)
Gross Profit	212.0	255.9	591.7	751.1	936.1	1,190.9
EBITDA	177.7	191.5	538.8	691.6	864.3	1,106.0
Net Income	282.0	342.4	595.3	747.5	929.2	1,184.1
<b>Balance sheet</b>						
Cash and cash equivalents	2,969.9	2,102.6	2,356.9	2,711.0	3,194.7	3,872.1
Net PPE	272.4	1,091.0	1,377.3	1,662.5	1,952.1	2,245.9
Total assets	5,337.6	6,033.0	6,690.7	7,420.2	8,286.8	9,362.9
Total debt	2.3	0.0	0.0	0.0	0.0	0.0
Shareholders funds	5,029.5	5,394.1	5,903.8	6,502.5	7,244.8	8,196.5
Total liabilities & equity	5,337.6	6,033.0	6,690.7	7,420.2	8,286.8	9,362.9
<b>Cash flow statement</b>						
Operating Cash Flow	98.0	183.6	470.1	622.4	769.4	977.3
CapEx	(206.4)	(860.2)	(378.0)	(399.9)	(422.6)	(448.1)
Investing Cash Flow	(594.8)	(1,054.7)	(135.2)	(123.3)	(102.8)	(72.0)
Proceeds/repayment of debt	0.0	(2.3)	0.0	0.0	0.0	0.0
Financing Cash Flow	3,266.7	3.8	(80.6)	(145.0)	(182.9)	(227.8)
Net Cash Flow	2,769.8	(867.3)	254.3	354.1	483.7	677.5
<b>Growth ratios</b>						
Revenues	7.3%	144.4%	36.3%	20.5%	17.6%	16.8%
Gross profit	63.6%	20.7%	131.2%	26.9%	24.6%	27.2%
EBIT	103.1%	-2.8%	198.3%	29.0%	26.8%	30.1%
Net profit	178.8%	21.4%	73.8%	25.6%	24.3%	27.4%
<b>Margins</b>						
Gross margin	26.4%	13.0%	22.1%	23.3%	24.7%	26.9%
EBIT margin	19.2%	7.6%	16.7%	17.9%	19.3%	21.5%
Net margin	35.1%	17.4%	22.2%	23.2%	24.5%	26.7%
<b>Valuation &amp; returns</b>						
P/E	25.8	21.3	12.2	9.7	7.8	6.1
EV/Revenue	6.6	2.7	2.0	1.6	1.4	1.2
EV/EBITDA	29.8	27.6	9.8	7.7	6.1	4.8
ROE	5.6%	6.6%	10.5%	12.1%	13.5%	15.3%

Source: Air Arabia, TNI Investment Research

\*The 2007 statements are for the "period since inception" i.e. June 19 to December 31

### **Ratings Definitions**

#### **Underpriced**

A stock is rated Underpriced when TNI Investment Research believes its fair value lies at 15% above the current market price and the stock is likely to reach such fair value within the next 12-18 months.

#### **Fairly Priced**

A stock is rated Fairly Priced when TNI Investment Research believes its fair value lies between -15% and +15% of the current market price and the stock is likely to stay within this range during the next 12-18 months.

#### **Overpriced**

A stock is rated Overpriced when TNI Investment Research believes its fair value lies at least 15% below the current market price and the stock is likely to reach such fair value within the next 12-18 months.

All stock market data refer to the closing prices of August 07, 2008



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