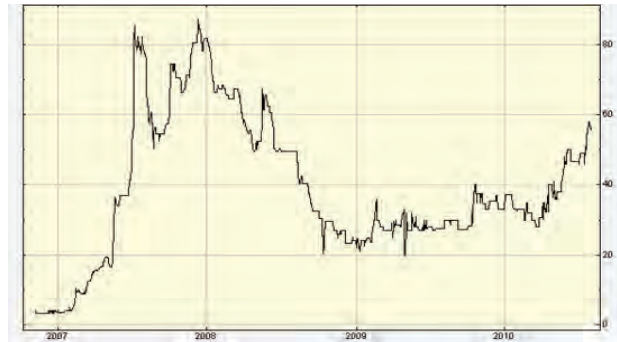


Research Note



Avation Market Capitalisation	£14.7m
Recent share price	56p
Listings	PLUS:AVAP,
Shares Issued / F.D. AVAP	26.2m / 28.9m
Group cash 31/12/09 ~£1.7m	P/E ~9x
Financial Y/E	30 June
<u>Significant S/holders in Avation:</u>	
Bennelong Asset Mgmt. LLP (via CFD)	13.82%
R. J. Chatfield	13.32%
UBS AG (London Branch)	7.77%
Silex Nominees Ltd.	7.63%
Credit Suisse Securities (Europe) Ltd.	6.64%
Harry Ansell	4.93%
Loeb Aron & Co. Ltd.	4.01%
Other directors and management	2.34%



Share price graph of – **AVAP** since admission to PLUS

25th August 2010

- **Avation Plc** (or “Avation”), the main subject of this note, is a PLUS quoted aircraft procurement and leasing company incorporated in England & Wales. The bulk of its balance sheet is comprised of aircraft, both held through 100% owned subsidiaries and through 51.2% owned AIM listed **Capital Lease Avation** (AIM:CLA) (“CLA”). Avation presents its accounts in consolidated form i.e. including the activities of CLA but recognising minority shareholders’ interests.
- Avation originally leased aircraft only to Skywest Airlines Ltd. (ASX:SXR, AIM:SKYW) from which it was spun out in 2006. In June 2007, Avation created CLA, a new subsidiary, to purchase and lease aircraft to a wider range of aircraft operators. CLA raised £11.4m of equity prior to admission to AIM in December 2007, diluting Avation’s interest to 51.2%. CLA has a current market capitalisation of approximately £15.4m.
- Avation owns and leases 12 aircraft, 6 100% owned and majority interests in a further 6 aircraft through subsidiary CLA, bringing the fleet size to 12. The book value of the fleet, after commercial asset valuation by an independent appraiser at year end, in the consolidated accounts was ~£85.6m at 31/12/2009. Cash and receivables add another £3.4m. Liabilities total ~£57.7m. The total market value of net assets (or “MVNA”) is thus ~£31.3m, with CLA minority interests of £11.5m accounted for, then Avation’s MVNA attributable to shareholders is ~£19.8m or 135% of market capitalisation.
- Group PBT (after stripping out asset revaluation gains and currency translation differences) was £1.53m for the 6-m period to 31/12/2009 again stripping out CLA minority interest of £542k would leave a core PBT for continuing operations of ~£0.99m for Avation for the six months.
- The published six months EPS (post tax) of 3.14p for Avation Plc for the 6 month period ending 31/12/2009 gives an annualised P/E ratio of ~9x in line with, or just ahead of, P/E ratios of established listed aircraft leasing companies in a sector due for re-rating as the aviation cycle turns upwards (Citigroup sectoral research note, 19/07/2010).
- Avation is a niche aircraft leasing player with ambitions to expand beyond dependence on a single customer, Skywest. This current dependence is two edged, in that the Avation group and Skywest share management through Jeff Chatfield (the Executive Chairman of all three companies), and thus there is a strong ongoing relationship with a profitable airline with surprises at lease renewal time unlikely.

As a small group, Avation have the opportunity to achieve significant growth rates. Guidance from the company for the full year results to 30th June 2010 is for solid results to equal or exceed those of the first half. Corporately, we believe that a move to the full list of the LSE (or other senior market) would be beneficial and management have confirmed that they are looking at this; a combination with CLA would also appear on the cards. We rate Avation a buy on the back of (i) expansion potential plus the possibility of listing on the main board of the London Stock Exchange, (ii) a moderate P/E and (iii) an overdue sectoral re-rating presaged by recent research from Citigroup. Our short term target is 70 – 75p, with 90p – 95p in 12 months.

This note reviews the operations of Avation plc, a company incorporated in England and Wales (Company number 5872328) with registered office at Georgian House, 63 Coleman Street, London EC2R 5BB. Operations are based primarily in Singapore. The Company website is www.avation.net. CLA's website is <http://www.capitalleaseaviation.com/>.

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1 INVESTMENT SUMMARY

- Avation lease out a total of 12 aircraft consisting of 8 Fokker 100's, 2 Airbus A320-200's and 2 Airbus A321-200's. Approximately 36% of the fleet by value is leased to Skywest Airlines, a Perth based regional airline serving the remote communities of West Australia, some of them under an exclusive licence deal with the government) and providing "fly-in fly-out" services to the mining industry. About 55% by value, the two Airbus A321-200's, is leased to Thomas Cook for use in Europe and Scandinavia and the remaining 9% by value, an Airbus A320-200, is leased to US Airways Inc.
- By revenue, Skywest is more dominant. This is because the F100 fleet attracts a higher lease rate than on the newer A320 Aircraft. Skywest is profitable and this is likely to continue as long as the Western Australian mining industry remains buoyant. US Airways Inc have recently announced a profitable quarter with a much improved outlook which is reflected in the recovery of its share price over the past nine months. Thomas Cook is one of the giants of the holiday business and has been through a tough three years with the effect of the volcanic ash cloud yet to be reported in results; nevertheless it has been able to refinance its debt at reasonable rates, is maintaining a dividend and is gradually improving financial performance. Compared to the situation of Avation two years ago, counterparty risks have been significantly diversified and reduced.
- Growth is brought about by increasing the number of aircraft under lease. This requires increased access to debt financing which must be matched by (about 20%) increase in equity contribution. The equity contribution will come primarily from retained after tax earnings and, if a suitable opportunity presents itself through further equity fundraisings. As a niche player, Avation currently has the capacity for greater fractional increases in business by identifying new opportunities and special situations and expanding to fill them. A doubling in the value of the fleet is quite possible over a 12 to 24 month period for Avation with a relatively modest capital raising; such rates of expansion are just not possible for the larger players.
- Avation's total revenue from operations increased from £5.0m to £16.2m (224%) between 2007-8 and 2008-9 due to the expansion of the fleet (11 compared to 5) made possible via the flotation of CLA on AIM and an £11.4m equity fundraising. Avation's total PBT (after stripping out asset revaluation gains and currency translation differences) was £1.53m for the 6 month period to 31/12/2009. The Avation market cap of £14.7m, gives an annualised group P/E of 9.14. This is just higher than the P/E ratios of major listed aircraft leasing companies in a sector due for re-rating as the aviation cycle turns upwards (Citigroup sectoral research note, July 2010) and in a company which has greater growth potential than larger groups.

Group fleet of 12 aircraft, to three customers to date.

Most of group revenue currently comes from Skywest.

Niche players, such as Avation, can have superior growth opportunities

P/E ratio of ~9X

- The book value of the fleet, after commercial asset valuation by an independent appraiser at year end, in the consolidated accounts was ~£85.6m at 31/12/2009. Cash and receivables added another £3.4m. Liabilities total ~£57.7m. The “market value of net assets” (or “MVNA”) is thus ~£31.3m which after deducting the CLA minority equity interest of £11.5m gives an Avation MVNA of £19.8m. The ratio of the market capitalisation to the MVNA is one of the valuation metrics commonly used by analysts of the aviation leasing sector. Avation’s P/MVNA is 74%. This is at the lower end of the range of ratios currently enjoyed by the major listed aircraft lease companies recently reviewed by Citigroup (AerCap 69%, Aircastle 96% and FLY 78%).
- Avation Group’s balance sheet is healthy with total liabilities significantly less than the realisable value of current and non-current assets. The value of the fleet is reassessed each year by an independent commercial appraiser. This revaluation enters the books each year (although legally required only every three years) on the balance sheet as a change in the value of “Property, plant and equipment” which is balanced by an entry known as the “Asset revaluation reserve” under “Equity attributable to shareholders”. Current appraisal trends are expected to show that the value of the Avation Group fleet is likely to remain constant or slightly increase over the current financial year.
- A major sectoral research note (19th July 2010, 96pp, covering listed aircraft leasing companies AerCap, Aircastle and Fly Leasing) has recently been issued by Citigroup. Their major sector wide conclusions, which should affect Avation as well as the larger players, are as follows:
 - a) Aircraft values and achievable lease rates have likely nearly reached their lows;
 - b) Most demand-side, supply-side and capital/lease market drivers support a recovery in values and lease rates;
 - c) Risk profiles continue to decline as the availability of debt finance improves and airline credit risks reduce.
 - d) For the major leasing companies, “deep value” remains as current share prices are factoring in further falls in aircraft value which Citigroup considers unlikely to happen.
- The major leasing companies are trading on P/E ratios in the range 6-7 and their share prices remain at about one third of all-time highs enjoyed back in 2006-2007. Avation broadly shares the P/MVNA ratios of these major lease companies, and the sectoral points made by Citigroup will also apply to Avation.
- Avation has a strong base “franchise” with Skywest Airlines which in turn is exposed to the booming Western Australian mining sector. Skywest’s most recent half yearly results for the period to 31/12/2009 report pre-tax profits of S\$10.1m (an improvement of some S\$12.6m on the previous periods losses) driven by 10% Y-o-Y revenue growth and elimination of the exceptional but short lived increase in fuel costs in mid-2008. One measure of the strength of the mining sector is the reinstatement in early 2010 of a regular Kalgoorlie-Melbourne service, Kalgoorlie being a major gold mining centre. Potential replacement of Skywest’s owner operated and aging Fokker F50 turboprop fleet with newer leased aircraft supplied via Avation is a major opportunity for the group in the near future.
- We believe Avation is a “buy” on the back of an anticipated sectoral revaluation in line with the aviation cycle, an undervalued P/E ratio, a strong franchise with a profitable customer likely to be looking to replace a significant portion of the owner operated fraction of its fleet, and an ability to expand operations significantly through filling new niches too small or specialised for other leasing companies. The announced intention to look into a listing on the main board of the London Stock Exchange also implies that a major equity fund-raising is on the cards; this also suggests that the opportunity to deploy that equity has already been identified by management.

P/MVNA ratio in line with those currently applied by the market to larger leasing companies.

Trends in residual values currently benign.

Major research note on the sector by Citigroup brings up to date background

Although revenue is concentrated with one customer, this is nevertheless a strong franchise with growth potential.

2 COMPANY HISTORY, DIRECTORS AND MANAGEMENT

Avation plc was incorporated on 11th July 2006 and acquired 99.96% of Avation.net Inc from Advent Air Ltd by way of the issue of new ordinary shares. These shares were then distributed as an *in specie* dividend to the shareholders of Advent Air on the basis of 1 Avation share for every 10 Advent Air shares held. Avation became quoted on the PLUS Market in November 2006. Advent Air Ltd. (renamed Skywest Airlines Limited from November 2007) owns 100% of Skywest Airlines, a West Australian based domestic airline.

Avation's initial business model was as a leasing company which sought only to service Skywest's ongoing needs for aircraft leasing. Avation's 100% owned fleet remains dedicated to Skywest. Recognising that client diversification gave access to debt finance at lower rates, a new subsidiary Capital Lease Aviation ("CLA") was incorporated in June 2007 to provide a vehicle to own and lease a portfolio of commercial jet aircraft to a wider base of regional and international airlines. In July 2007 CLA raised £11.378m at 24p per share diluting Avation's interest to 51.22%. CLA currently owns 6 new generation narrow bodied jets. This note examines Avation together with CLA in consolidated form, accounting for minority interests as appropriate.

Brief portraits of key directors and management from Avation and CLA are given below.

Jeff Chatfield (Executive Chairman of Avation Plc, Capital Lease Aviation Plc and Skywest Airlines Ltd aged 46)



Jeff Chatfield is the moving force behind Skywest and the Avation Group having taken control via a hotly contested takeover battle starting in 2004 with the final minorities mopped up in 2006. He has managed and been a director of a number of companies, the most high profile of which was perhaps formerly ASX-listed Data & Commerce Ltd into which he injected his Singapore based international media technology incubator Advent Television Ltd before raising A\$10m and taking over two Australian regional radio stations. Well publicised boardroom tussles between directors eventually removed Jeff from the MD's seat in 2003. For Aussie readers out there, he is an Old Haleian and a BE / MESC graduate of the University of Western Australia.

Soeren Ferre (Non-Executive Director of CLA aged 42)

Soeren Ferre is a valuable resource for CLA, having been granted special permission to join the board of Avation from his employer AerCap, a major listed aircraft leasing company. He has been the Head of Europe, Middle East, Africa & Asia/Pacific Region of AerCap since June 2006 having joined AerCap in September 2003 as Vice President of Marketing for the Asia/Pacific region. In addition to his regional responsibilities, he was appointed Chief Executive Officer of AerCap Group Services, B.V. in January 2008. Soeren started his career at Airbus in 1990 and was initially based in Toulouse, France later moving to China becoming head of the marketing team covering China, Hong Kong and Macau. In 2001, Soeren moved to Sydney to become the Director of Sales for the Pacific region for Airbus where he was in charge of the major airlines in that region. He holds a degree in Engineering from the Ecole Nationale de l'Aviation Civile.



Richard Sinclair (Chief Executive Officer and Finance Director of CLA aged 39)



Richard was briefly the Finance Director of Avation where in addition to having responsibility for the finance function he played an active role in securing aircraft purchases and in negotiating lease transactions. He previously worked in a finance role with Allco (Singapore) Ltd., a property portfolio management company part of the former ASX-listed Allco Finance Group conglomerate which was involved in real estate, aircraft and other capital assets. He has also worked at Westfield Ltd., a public company which is one of the world's largest owners of retail complexes. He has a B.Econ from the University of Adelaide and an Australian CPA.

3 FINANCIAL SUMMARY

3.1 Comprehensive Income Statement

Prior to 31st December 2009 the accounts were prepared to produce a “Consolidated Income Statement” – the two presentations have significant differences regarding the treatment of asset revaluation gains and currency translations. The 30th June 2009 figures have been restated to bring them into line with the subsequently adopted policy.

Currency: Sterling (£)

	6 months ended 31 December 2009 (unaudited)	12 months ended 30th June 2009 (audited, but partly reorganised for comparative purposes)
<u>Continuing Operations</u>		
Revenue	7,556,268	16,278,212
Cost of sales	(593,826)	(871,494)
Gross profit	6,962,442	15,406,718
Other operating income	2,686	57,528
Administrative expenses	(408,296)	(953,657)
Other operating expenses	(3,419,063)	(7,167,655)
Finance expense	(1,607,074)	(3,777,014)
Profit before tax	1,530,695	3,565,920
Income tax	(187,155)	(754,408)
Total profit	1,343,540	2,811,512
Other comprehensive income		
Revaluation gains on property, plant & eqpt (<i>Note 1</i>)	339,982	3,296,823
Foreign currency translation differences	2,339,896	1,420,401
	2,679,878	4,717,224
Total comprehensive income	4,023,418	7,528,736
Profit attributable to:		
Equity holder of the Company	801,941	1,644,894
Minority interest	541,599	1,166,618
	1,343,540	2,811,512
Total comprehensive income attributable to:		
Equity holder of the Company	2,458,990	5,150,823
Minority interest	1,564,428	2,377,913
	4,023,418	7,528,736
Weighted average number of shares in issue:	25,565,173	25,431,815
Earnings per share:	3.14p	6.47p

Note 1: All the revaluation gains are attributable to the 100% Avation owned aircraft. CLA has, probably marginally conservatively, not accounted for any asset revaluations on appraisal in FY 2008/9 or in H1 FY 2009/10. By analogy with the similar Avation owned fleet and reviewing general appraisal value tables, it would seem likely there may be some potential “hidden” value. Although largely standardised, aircraft appraisal is by no means an exact science and true realisable values under commercial conditions may differ substantially from appraised values.

3.2 Consolidated Statement of Financial Position

Currency: £ Sterling

	At 31 st December 2009 (unaudited)	As at 30th June 2009 (audited)
Assets		
Current assets:		
Cash and cash equivalents	1,737,101	1,039,321
Trade and other receivables	1,690,696	1,575,778
Inventories	512	493
Total current assets	<u>3,428,599</u>	<u>2,615,592</u>
Non-current assets		
Property, plant and equipment	85,631,466	83,053,926
Goodwill	1,324,541	1,324,541
Total non-current assets	<u>86,956,007</u>	<u>84,378,467</u>
Total assets	<u><u>90,384,606</u></u>	<u><u>86,994,059</u></u>
Liabilities and Equity		
Current liabilities:		
Trade and other payables	4,608,132	3,851,566
Provision for taxation	299,414	292,823
Loans and borrowings	8,000,510	8,521,911
Short-term provisions	1,695,889	1,088,555
Total current liabilities	<u>14,603,945</u>	<u>13,754,855</u>
Non-current liabilities:		
Trade and other payables	570,761	550,400
Loans and borrowings	38,384,142	40,253,227
Deferred tax liabilities	3,538,404	3,208,998
Total non-current liabilities	<u>42,493,307</u>	<u>44,012,625</u>
Equity attributable to shareholders:		
Share capital	256,190	255,555
Share premium	1,231,258	1,216,336
Reserves (Note 1)	9,585,449	7,928,400
Retained earnings	10,699,714	9,897,773
Total equity attributable to shareholders	<u>21,772,611</u>	<u>19,298,064</u>
Minority interest	11,514,743	9,928,515
Total equity	<u>33,287,354</u>	<u>29,226,579</u>
Total liabilities and equity	<u><u>90,384,606</u></u>	<u><u>86,994,059</u></u>

Note 1 Comprising: asset revaluation reserve, capital redemption reserve, foreign currency translation reserve, and share option reserve.

3.3 How the business works

The business model of an aircraft leasing company consists of (i) sourcing cheap debt with minimal equity support, (ii) purchasing aircraft as economically as possible, (iii) leasing them at decent rates to airlines who are (iv) reliable financial and operating counterparties and finally, (v) praying that the residual resale values of your aircraft on disposal are at least as high you hoped they were going to be. Investors should remember that the prayer bit is important, aircraft leasing companies being no more able to predict world economic conditions in, say, ten years time than are economists, politicians or research note writers.

*The four
commandments
and the fifth
prayer*

In the case of the Avation, debt has historically been available on an 80/20 DEBT/EQUITY ratio basis. Again, the lender will be looking at the diversification of the portfolio it lends against in terms of aircraft types, and operators as well as the financial position of the airlines lent to. A diverse portfolio will make a leasing company more attractive to lenders than lending to a single airline.

Avation was able to take advantage of the financial crisis by purchasing aircraft from leasing fleets part of larger banking operations that had come under severe financial pressure at “distressed rates”. Such opportunism can be an important part of success for smaller players.

Lease rates are expressed as a “monthly lease rate factor” (being the monthly lease rate expressed as a percentage of the market value of an aircraft). At present this is typically running at 0.9% - 1.0% for aircraft around 5 to 10 years old, but may be higher for older aircraft such as the Fokker F100 fleet for which a shorter remaining commercial life is factored in. Avation’s monthly lease rate factors are typical, save for the Fokker F100’s which because of their age attract higher lease factors – up to 2% - 2.5% - because of their fairly low remaining life.

When providing debt to an aircraft leasing company, a lender will take into account the financial stability of the leasing company as a whole (looking at the entire lease portfolio, P&L and the balance sheet), the nature of the particular asset being purchased (a new aircraft with a ready resale market or an older or more exotic aircraft with uncertain residual values), and the security offered. The life of a tranche of secured borrowing would typically be tailored to the lease arrangements of the aircraft offered as security. Thus, a typical leasing company would have many tranches of secured debt, with different maturity dates. These tranches are gradually paid down over the lease life of the secured asset, often with a residual level of debt at the estimated residual value of the asset. This debt might then be rolled over when the asset is re-leased.

The Avation has nine tranches of secured borrowing. Maturity dates range from 2012 to 2015, in line with the lease contract lives. One of the reasons that aircraft leasing companies keep their assets in obscure subsidiaries in tax efficient jurisdictions is so that the assets and shares of each subsidiary can be offered as security for debt.

*Well structured
maturities*

Avation’s cost of debt can be estimated by dividing annual financing costs by the total of loans and borrowings. For FY2008/9 this comes out at 7.7%. This is higher than the industry average, reflecting the relatively high average age of the fleet which comes out at about 12.5 years on a value weighted basis.

Apart from secured debt there is a small amount of unsecured borrowing and Avation also has had a mezzanine finance facility of US\$2m from CaptiveVision Capital Ltd, a subsidiary of Skywest Airlines. Unsecured debt facilities provide a leasing company with the flexibility in the case of mis-matched maturities between lower cost secured debt arrangements and the underlying leases and may also allow them to take advantage of brief opportunities to purchase aircraft at distressed asset rates without the delay of arranging secured debt facilities.

By the general standards of the leasing industry, Avation’s leases – which expire between 2012 and 2015 – are all relatively short term compared to an industry average weighted lease expiry of 4.5 – 5 years. Depending on where we are in the aviation “cycle” this may be an advantage or a disadvantage. If we follow Citigroup’s optimistic view, the short lease lives could be an advantage in that it gives Avation the near term opportunity to enter into new leases in a much tighter market at more advantageous rates.

Trends to look at include a decreasing DEBT/MVA (MVA = "Market Value of Assets") ratio – sometimes expressed as "increasing equity in the aircraft". This trend will be partly masked as the company takes on new aircraft which may have zero equity associated at the start of its lease life.

3.4 Outlook good, possibility of thunder storms receding

In recently published research all of Citigroup, JP Morgan, Goldman Sachs, Standard & Poors, Wells Fargo, and Barclays Capital have looked very positively on the (much larger) quoted aircraft leasing companies regarding them as being undervalued, and reporting a positive outlook on aircraft values. These conclusions rely on the following main points:

- Fears of collapsing demand for air travel have receded
- Fears of collapsing airlines have not been realised and those fears are receding
- Fears of disposals of aircraft portfolios from major leasing business as a consequence of parental problems have not materialised and have significantly receded
- Aircraft values have fallen significantly over the past two years, but are now stabilising
- Significant new money flowing into the sector, particularly from private equity.

Citigroup report compelling demand side drivers improving prospects, these include increasing demand returning for air travel and increasing airline profitability. Whilst a number of airlines failed in the recession, not least Japan Airlines, perhaps fewer failed than feared. Unlike banks, where failure is contagious since one bank is often exposed to another, each airline failure translates directly and immediately into opportunities for their competitors either to take over the profitable routes or to otherwise increase both traffic and yields.

We can simply follow the Boeing (NYSE: BA) stock price as a proxy for prospects

4 CONCLUSIONS

- With a P/E ratio of ~9x, then Avation is presently rated just ahead of listed peers such as AerCap, Aircastle and FLY (the "major listed peer group") which is consistent with its growth potential and lowish P/MVNA.
 - Avation's P/MVNA (market cap divided by market value of net assets) ratio of 74% is with the same as the ratio exhibited by AerCap, however considerably below that of Aircastle. This ratio historically has tended to be closer to 100% and a return to such valuations with a reappraisal of the sector would generate a significant increase in share price to approximately 81 pence.
 - Analysts for major investment banks believe that the aircraft leasing sector is undervalued and the outlook reasonable and improving.
 - Avation's management has indicated that they are looking into a listing on the main board of the LSE. Such a move would logically be accompanied by the raising of further equity allowing for access to further debt facilities. It would also be reasonable to speculate that Avation and Capital Lease Aviation might be merged as part of the process in order to reduce overheads, although this is by no means certain.
 - Avation and Capital Lease Aviation board and management, whilst possessed of talented individuals, will need deepening at both at the executive and non-executive levels in order to sustain significant expansion and a move to the main board of the LSE (and a hypothetical possible merger AVAP - CLA).
 - Our short term target is 70 – 75p, with 90p – 95p achievable in 12 months with a modest (and expected) sector wide re-rating. Possible replacement of the Skywest F50 fleet through Avation could add to this.
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LOEB ARON + CO.

Avation Plc

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