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Avation Plc* - Buy at 58p

On 26th July Avation Plc*, a PLUS market listed commercial jet aircraft owner and leasing provider, announced that it would consider proposals from advisers to move from PLUS to the Main Market of the London Stock Exchange and that it had appointed law firm Speechly Bircham LLP "to advise it with regard to the proposed move to LSE but at this stage is still considering the proposals and will continue to keep its options open".

The company has already delivered significant returns for shareholders - with the current 58p share price comparing to the 4p at which the shares commenced trading on PLUS on 7th November 2006 after being distributed to Advent Air Ltd shareholders as a special dividend. Since then the company has strongly developed contracted revenues and its asset base - so much so that we continue to see significant value in the shares at present levels. A blended price-earnings and fleet valuation approach suggests a share price of around 150p is not overly demanding - and it should be noted that this doesn't factor in further increases in the scale of the business or the valuation of the company-s most recently acquired aircraft, so we consider it appropriately conservative. At the current 58p the shares trade on a current year forecast price-earnings multiple of just 5.7, and with the added potential of a move to the main market to prove a significant catalyst for the shares as the story reaches a wider audience and a wider pool of investors are able to access it, the stance is **buy**.

Key Data	
EPIC	AVAP
Share Price	58p
Spread	56p - 60p
Total no of Shares	26 million
Market Cap	£15.2 million
12 Month Range	28.5p - 58p
Market	PLUS
Website	www.avation.net
Sector	Diversified Industrials
Contact	Jeff Chatfield (Chairman) Tel: +44 (0)7783 942 553

Forecasts Table

Year to 30 th June	Revenue (£ million)	Adjusted Pre-tax Profit (£ million)	Adjusted Earnings Per Share (p)	Price Earnings Ratio	Dividend Per Share (p)	Dividend Yield (%)
2007A	1.81	0.779	3.01	19.3	0.0	-
2008A	5.03	2.64	6.04	9.6	1.0	1.7
2009A	16.28	4.99	10.40	5.6	0.5	0.9
2010E	16.5	4.0	8.8	6.6	0.5	0.9
2011E	17.5	4.7	10.2	5.7	0.5	0.9

Background

Aircraft leasing company, Avation plc was formed as a spin-off from the former Advent Air Ltd (now Skywest Airlines Ltd*, an AIM-listed Australian airline). Following the company's late 2006 PLUS market listing it was swiftly able to secure a \$9.22 million debt finance facility *"provided by a subsidiary of a major commercial bank"* and acquire two 100-seat Fokker F100 aircraft leased to Skywest. This was followed in 2007 by the securing of further debt facilities of \$4.1 million and \$3.75 million and the acquisition of further Fokker F100 aircraft for \$4.1 million and \$4.9 million respectively. The first was again leased by Skywest and the second by *"a European airline"* - though this has since been re-leased to Skywest.

On 7th June 2007 Avation announced it had incorporated a wholly owned UK subsidiary called Capital Lease Aviation and in July of the same year Capital Lease raised £ 11.45 million through the issue of 47,708,339 new shares at 24p each. This left Avation with 50.1 million shares, equating to a 51.22% stake. Capital Lease was then able to secure a further \$55.57 million of debt finance before confirming the acquisition and leasing of its first two aircraft in September and October 2007. In December 2007 Capital Lease Aviation was then listed on AIM and followed this by securing a further \$12.20 of finance facilities and acquiring a further Fokker F100 aircraft for \$6.6 million as well as a first Airbus A320-200 for \$12.15 million - the latter *"leased until 2013 to a large domestic US carrier"*. There then followed a further step change in the scale of this business in June 2008 when the company was able to secure \$64.8 million of financing to help fund the \$70.75 million acquisition of two Airbus A321-200 aircraft which are under *"lease arrangements with a major European airline until February 2015"*.

Since the summer of 2007 Avation plc itself has not been idle. In August 2008 it announced it had obtained a \$5.12 million finance facility *"from an international equipment finance arm of a major British commercial bank"* and this was soon followed by confirmation of the \$6.4 million acquisition of another Fokker F100 which it has leased to Skywest. The following - and most recent - transaction was announced on 8th April this year, when the company reported it had completed acceptance of an \$8.6 million Airbus A320-200 aircraft which has also been successfully leased to Skywest Airlines.

Strategy

Both Avation and Capital Lease Aviation are focused on the continued growth of their aircraft leasing businesses. Capital Lease was de-merged from Avation as part of a strategy of it focusing on doing this by leasing a variety of types of aircraft to a wide range of airlines and enabling Avation to focus on servicing Skywest.

Both companies' acquisition and leasing strategy is to buy aircraft at half-life or better and place them on initial leases from which the revenues cover the price paid for the aircraft and still leaves the planes with significant usable and leasable life left. This aligning of finance for aircraft acquisitions to match the corresponding lease term of the aircrafts is a key differential from several other aircraft lessors. Additionally, as each aircraft acquired and leased increases asset base and revenues, it provides scope to further increase business scale.

Management

Jeff Chatfield - Executive Chairman.

Also the Chairman of Skywest and Capital Lease Aviation, Jeff Chatfield has management and directorship experience of a number of companies involved in the airline, investment, data distribution, electronics, manufacturing and broadcasting sectors. He is a member of the Australian Institute of Company Directors and the Singapore Institute of Directors.

Andrew Baudinette - Non-Executive Director.

Andrew Baudinette has significant management level experience in emerging technology and commercial media and has been involved with, and driven, start-up businesses in the travel, advertising, technology, and entertainment industries.

Bryant McLarty - Non-Executive Director.

A member of the Australian Institute of Company Directors, Bryant McLarty has strong knowledge of securities and equity markets with extensive experience in start-up and established companies, listed and unlisted, both as a Managing or Non-Executive director.

Significant Shareholdings

Avation's current issued share capital consists of 26,219,010 shares and there are 3,075,990 warrants outstanding. Significant shareholdings include:

Name	Shares	Percentage
Jeff Chatfield (Chairman)	4,400,000	16.78%
Andrew Baudinette (Non-Exec)	620,000	2.36%
Bryant McLarty (Non-Exec)	57,300	0.22%
<i>Directors</i>	<i>5,077,300</i>	<i>19.36%</i>
UBS	2,036,756	7.77%
Credit Suisse Securities (Europe) Ltd	1,583,244	6.04%
Harry Ansell	1,293,456	4.93%
Loeb Aron & Company Ltd	1,056,000	4.03%

Results, Balance Sheet & Cash Flow

Avation's P&L performance has demonstrated the profitable scalability of the company's aircraft leasing model ever since its PLUS Market listing and purchase and leasing of its first aircraft at the end of 2006.

Results Period	Revenue (£ million)	Post-tax Profit Attributable to Avation Shareholders (£)	Aircraft
11 th July 2006 - 30 th June 2007	1.81	547,585	2 for 7 ½ months 1 for 3 months
Year to 30 th June 2008	5.03	1.46 million	3 for 12 months 1 for 11 months <i>CLA: 2 for 9 months</i> <i>1 for 4 months</i> <i>1 for 3 months</i>
Year to 30 th June 2009	16.28	2.65 million	4 for 12 months 1 for 10 ½ months <i>CLA: 6 for 12 months</i>

Avation chairman Jeff Chatfield noted in the company's first full results statement that "*the Company will attempt to grow its asset base significantly and expects to take on more risk and debt to achieve this*" - and the balance sheet data below shows this is exactly what has been done. However, as debt has been added, net tangible asset backing has been being increased. At the most recent (31st December) balance sheet date £ 44.65 million of net debt compared to aircraft, stated to then currently be worth more than £ 85 million.

Date	Net Cash (Debt) £ million	Net current assets (liabilities) £ million	Net assets (liabilities) £ million
30 th June 2007	(5.48)	(0.298)	4.00 [^]
30 th June 2008	(42.61)	(7.77)	13.31 [^]
30 th June 2009	(47.74)	(11.14)	19.30 [^]
30 th December 2009	(44.65)	(11.18)	21.77 [^]

[^]includes £ 1.32 million of Goodwill.

The multi-year lease terms Avation and Capital Lease Aviation have shown themselves able to agree with good quality airlines provide reliable cash flows. In the most recent reported on six month period, Avation generated £ 6.48 million from operations and £ 4.86 million from operating activities (the latter after £ 1.50 million of interest payments and £ 130,155 of income tax). Thus the interest on its debt looks well covered.

Opportunities & Threats

Both Avation and its Capital Lease subsidiary look to have positive growth opportunities. Skywest Airlines continues to perform strongly and recently noted it *"would seek the opportunity to extend and increase the services and destinations in its network within the regulatory framework"*. Meanwhile historic and continuing uncertainty in the airline industry as a whole - with, for example, long-term growth forecasts led by emerging market demand juxtaposed with faltering Western economic growth and intense competition - enhances the attractiveness to airlines of "leasing-in" capacity rather than purchasing aircraft due to the operational leverage leasing offers.

A clear risk to Avation itself is its reliance on Skywest to provide aircraft leasing business. Though with Skywest profitable, having a strong balance sheet and continuing to grow robustly, we continue to regard it as a secure covenant for Avation. Capital Lease's more diverse customer base also provides Avation some diversified exposure.

However, there can be no doubt that this is currently a tough time for the airline industry - as some high profile failures have demonstrated. This is clearly not positive for aircraft demand and thus a potential threat to the execution of Capital Lease Aviation's customer diversification plans. However, in this situation, the unique position of Skywest at the heart of Western Australia's mining industry looks to offer some protection. There is also the threat to lessors with regard to credit worthiness of client companies. This is something Avation is acutely aware of - noting in its most recent results statement *"risk management on the airline lessees is critical. All of our airline clients are performing well in their businesses and are regularly monitored by your Board"*.

The challenging industry and wider economic backdrop also represent a threat to a key valuation parameter used for the aircraft leasing industry - the market value of a company's fleet - and a tight credit market may also be perceived as a significant threat to Avation's expansion plans as these rely on an ability to source finance on efficient terms. However, in its 2009 results statement Avation emphasised it *"believes that it can procure access to further funds for the purchase of aircraft"*, Capital Lease Aviation announced in October 2008 it had obtained a revolving \$100 million finance facility with a 5 year expiry term *"from a major European bank"*, with provision for a further \$50 million (since when it has not acquired any further aircraft suggesting it has significant expansion capital available to it) and opportunity is seen in the present situation.

This opportunity was noted in Capital Lease's 3rd March announced interim results statement; *"we anticipate that further growth will be available as aircraft valuations may become more attractive to operating lessors such as ourselves, as competitors such as financial institutions and banks leave the sector and release their aircraft into the market... Given recent signs of recovery in the global economy, particularly in the Asia Pacific region, we remain ready to take advantage of opportunities that may be available when demand in the aviation sector rebounds."* In this regard, it is notable that the aircraft purchase Avation has completed in 2010 was done so with the aid of *"attractive"* vendor finance of \$7.8 million.

Further risk factors include a heavy reliance upon the expertise of a small board of directors, usual aviation-related risks (including fuel costs) and exchange rate translations - Capital Lease has *"change(d) the currency in which it reports its financial results to US dollars to erase volatility due to currency fluctuations"*.

Valuation, Forecasts & Conclusion

Avation's results for the six months ended 31st December 2009 showed a pre-tax profit of £1.53 million on revenue down slightly on the corresponding six months in 2008 - to £7.56 million from £7.83 million - as no additional aircraft were purchased and leased out between the periods or during the six months to the end of 2009. However, the full-year numbers will include a contribution from the Airbus 320-200 aircraft the company announced it had completed acceptance for and successfully leased to Skywest on 8th April 2010. Therefore we presently anticipate £16.5 million of revenue for the year to 30th June 2010, rising to £17.5 million in the current year. The company noted in its interim results that *"maintenance reserve claims have increased during the period"* and we forecast pre-tax profit of £4 million for the year recently ended, rising to £4.7 million on the higher current year revenue estimate. We regard our current year numbers as conservative since we expect further increases in the scale of the business - the likely positive bottom-line effects of which are evident from the company's financial performance to this point as summarised in the table at the end of this section.

Aircraft leasing companies achieving full equity ownership of aircraft with significant usable life left have often been indicatively valued at the market value of their fleet. At its most recent balance sheet date Capital Lease Aviation's 'plant & equipment' totalled \$103.79 million (£66.5 million). This suggests the need to subtract £32.5 million from Avation's reported £ 85.6 million of 'property, plant & equipment' to reflect its current 51.18% stake in Capital Lease. This leaves £53.1 million, equating to 203p per share - and this is before including anything for the \$8.6 million plane Avation announced it had completed the acquisition of on 8th April 2010. As has been noted, there is a threat aircraft valuations may fall back from current levels given the challenging industry and wider economic backdrop but a multiple of 15x current year forecast earnings would, for example, suggest a share price of 153p; leaving more than a 25% fleet valuation decline factored into the share price. A main market move would likely prove a significant catalyst for these shares, which at the present 58p share price, trade on a current forecast p/e of a lowly 5.7. The stance is **buy**.

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