

Growth Equities & Company Research



Avation*

Buy at 25p – Target Price 187p

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20th November 2008

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Avation Plc, the commercial jet aircraft owner and lessor, announced results for the year ended 30th June 2008 on 3rd November. These show the company continuing to prosper despite a challenging economic and market backdrop and provide further evidence that, despite a 525% share price increase since joining PLUS Markets at 4p per share on 7th November 2006, the present £6.32 million market capitalisation significantly fails to reflect the value of the company's underlying business and the book value of its aircraft.

Our forecasts don't include further significant increases in the scale of Avation's business and thus are likely to prove conservative but even on these numbers the shares trade on a price earnings multiple of 1.9 and yield 7%. Valuing the company at what we regard as a conservative estimate of the market value of its aircraft fleet suggests a share price of 187p. That would put it on a price earnings multiple of 14.4 which looks far from excessive considering the growth on offer. Therefore, at the current 25p our stance is **buy**.



Key Data	
EPIC	AVAP
Share Price	25p
Spread	23p – 27p
Total no of shares	25,270,000
Market Cap	£6.32 million
12 Month Range	20.5p – 86.5p
Market	PLUS
Website	www.avation.net
Sector	Diversified Industrials
Contact	Jeff Chatfield (Chairman) 07783 942 553

Forecast Table:

Year to 30 th June	Sales (£ million)	Underlying Pre-tax Profit (£ million)	Underlying Earnings Per Share (p)	Price Earnings Ratio	Dividend Per Share (p)	Dividend Yield (%)
2007A	1.81	0.779	3.01	8.3	N/A	0
2008A	5.03	2.64	6.04	4.1	1.00	4.0
2009E	13.00	6.50	13.00	1.9	1.75	7.0

**Avation, Capital Lease Aviation and Skywest Airlines are corporate clients of Bishopsgate Communications, which is owned by Rivington Street Holdings, the ultimate owner of GE&CR. Skywest Airlines is also a research client of GE&CR.*

Background

Avation Plc is a commercial jet aircraft leasing provider, which also provides airline consumables and owns a legacy broadcasting services business. However, these latter two divisions are insignificant compared to the aircraft leasing business which is the overwhelming contributor to profits and driver of the company.

Avation Plc was formed after Avation.Net Inc was spun out of the former Advent Air Ltd (now Skywest Airlines Ltd* – an AIM listed Australian and South East Asia regional airline). The company's original 18,639,195 shares were distributed to Advent Air shareholders as a special dividend on the basis of 1 share in Avation for every 10 shares held in Advent Air. These shares were admitted to trading on the PLUS market on 7th November 2006 – with the 4p admission price capitalising the company at £745,568. It was intended that Avation Plc would become the aircraft leasing business for Skywest.

Operations

On its PLUS listing, Avation was principally a provider of procurement services and equipment to the broadcast industry, though with a stated goal of immediately expanding its business in the aviation industry.

The company straight away set about executing on this strategy – announcing little over 6 weeks after its shares commenced trading on PLUS that it had secured a \$9.22 million finance facility, provided by a subsidiary of a major commercial bank, and that it had entered into an agreement to acquire two 100-seat Fokker 100 Aircraft, leased and operated by Skywest Airlines. A wholly owned subsidiary, F100 Pty Ltd, was incorporated as a special purpose vehicle to own and maintain the leases of the aircraft.

Further finance facilities followed – with a \$4.1 million facility announced in March 2007 and a further \$3.75 million such arrangement revealed in May of the same year. These enabled the acquisition of two further Fokker 100 Aircraft, one leased to Skywest and the other to a German airline. More recently a further \$5.12 million new such facility was secured and used in conjunction with the company's own funds to acquire an additional Fokker 100 which has again been leased to Skywest. Additionally the aircraft leased to the German operator has been re-delivered and leased to Skywest.

Date Announced	Aircraft	Cost	Revenue (per year)	Lease Term	Lessee
12/01/2007 (effective 15/11/2006)	Fokker 100	\$4.425 million	\$0.9 million	72 months	Skywest Airlines
12/01/2007 (effective 15/11/2006)	Fokker 100	\$4.425 million	\$0.9 million	72 months	Skywest Airlines
11/04/2007 (effective 04/04/2007)	Fokker 100	\$4.1 million	\$1.08 million	66 months	Skywest Airlines
11/08/2008**	Fokker 100	\$4.9 million	\$1.08 million	72 months	Skywest Airlines
18/08/2008	Fokker 100	\$6.4 million	\$1.272 million	64 months	Skywest Airlines

***Acquisition of aircraft announced on 31/07/2007 and leased to a German airline until re-delivered and leased to Skywest.*

A summary of F100 Pty Ltd's aircraft leasing operations

As the above table shows Avation paid a total of \$24.25 million for the aircraft and is to generate \$30million of revenue plus certain maintenance reserves from their current leases. The financing for the purchase of these aircraft is fully amortising over their lease terms (some equity has also already been built up in the aircraft recently re-leased to Skywest from its prior lease period) whilst the aircraft have a useful life of over 25 years and have typically been bought at around half-life. This means the company will have full equity ownership of aircraft, which will at that point still have significant usable and leasable life left.

To facilitate the continuing growth of its aircraft leasing business, Avation incorporated an additional wholly owned subsidiary, Capital Lease Aviation*, on 6th June 2007. The next month 47,708,339 shares in the new subsidiary (48.78% of its enlarged share capital of 97,808,339 shares) were placed with investors at 24p each raising £11.45 million (gross of costs). This was followed on 23rd July 2007 with news that Capital Lease Aviation had secured a \$48 million finance facility from Avation's existing bankers and had entered into a letter of intent to purchase two Fokker 100 Aircraft. These cost \$5.9 million and \$4.63 million respectively and are both leased to Skywest for 5 year terms at \$1.18 million each per year plus maintenance reserves.

Following this commencement of operations, Capital Lease Aviation listed on AIM on 14th December 2007 at an admission price of 75p per share, capitalising the company at £73.36 million. This valued Avation's 50,100,000 share stake at £37.575 million.

Capital Lease Aviation has continued showing an ability to access capital in the midst of the 'credit crunch', announcing it had secured further \$7.57 million finance facilities in September and December 2007 and an additional \$4.63 million on 22nd May 2008. Another Fokker 100 was added to the fleet in March of this year and leased to Skywest on a five year term, whilst an Airbus A320 aircraft was purchased in the same month; this leased until 2013 to a large domestic US carrier. However, it was in July 2008 that Capital Lease first really demonstrated its market potential as it announced the purchase of two Airbus A321-200 aircraft for \$70.75 million – both of which are leased to a major European airline until February 2015 with each anticipated to generate a lease income of \$4.5 million per year. To enable this transaction Capital Lease was able to secure various financing facilities totalling \$64.8 million – with \$60 million provided by DVB Bank AG, a European bank specialising in the transportation sector, \$2 million from a vendor syndicate, \$2 million from CaptiveVision Capital Ltd (a subsidiary of Skywest) and \$800,000 from Avation itself.

Date Announced	Aircraft	Cost	Revenue (per year)	Lease Term	Lessee
28/09/2007	Fokker 100	\$5.9 million	\$1.18 million	60 months	Skywest Airlines
01/10/2007	Fokker 100	\$4.63 million	\$1.18 million	60 months	Skywest Airlines
03/03/2008 (lease announced 03/04/2008)	Fokker 100	\$6.6 million	\$1.2 million	60 months	Skywest Airlines
26/03/2008	Airbus A320	\$12.15 million	current market lease rates	until January 2013	large domestic US carrier
02/07/2008 (completed 30/06/2008)	Airbus A321-200	\$35.375 million	\$4.5 million	until February 2015	major European airline
02/07/2008 (completed 30/06/2008)	Airbus A321-200	\$35.375 million	\$4.5 million	until February 2015	major European airline

A summary of Capital Lease Aviation's aircraft leasing operations

As for F100 Pty, the lease terms Capital Lease Aviation has been able to achieve mean it should also develop full equity ownership of aircraft with significant usable life left. The two Airbus A321-200 aircraft, for example, were delivered brand new in 2003 and have 20–25 years of useful life left. Additionally, just last month, Capital Lease Aviation's potential for further expansion was significantly boosted by news that the company had secured a revolving \$100 million finance facility from a major European bank, with provision for a further \$50 million.

Strategy

Both Avation Plc and Capital Lease Aviation Plc are focused on the continued growth of their aircraft leasing businesses. Avation will seek to achieve this primarily by acquiring aircraft and leasing to a growing Skywest whilst Capital Lease Aviation's stated strategy is to lease to a broader range of airline clients.

The execution of strategy should be facilitated by the ongoing marked movement of airlines towards 'leasing-in' capacity rather than purchasing aircraft. In an airline industry which has proven to be, and remains, inherently uncertain – presently long-term growth forecasts led by emerging market demand are juxtaposed with a combination of oil price fears, faltering Western economic growth and intense competition – the operational leverage provided by leasing is seen as being particularly valuable. Additionally, leasing lowers the ownership risk to airlines since valuations of many are closely related to the resale values of the planes themselves. In a cyclical industry spinning off this risk should prove attractive.

As each aircraft Avation acquires and leases increases the company's asset base and revenues, it provides scope – via retained cash flow and access to debt financing - to further increase the scale of the business. Avation places a strong emphasis on maintaining an efficient capital structure and in line with this will continue to endeavour to place acquired aircraft on leases from which the revenues cover the price paid for the aircraft within five to six years. The company is to also maintain its cautious amortisation policy of fully amortising the financing of aircraft over this same time period (rather than aircrafts' usable life) which will see it achieving full equity ownership in aircraft which typically will still have significant usable life left.

A key plank of the company's capital structure strategy remains a staunch determination to avoid shareholder dilution. This shareholder focus – reinforced by directors' holdings representing 16.24% of the issued share capital – was recognised at the PLUS Investor Awards in April as the company won the best international company category.

Opportunities and Threats

Avation looks to have significant expansion opportunities as on a macro view the aircraft leasing market continues to grow and is presently highly fragmented and on a micro view Skywest Airlines is continuing to grow robustly. The cash flow being produced from the multiple year leases the company has demonstrated it is able to enter into further enhances this growth opportunity.

However, the company's strategy is not without risk. One remains a dependence on Skywest to provide aircraft leasing business. The continuing execution of Capital Lease Aviation's client diversification strategy provides some re-assurance on this score and with Skywest profitable, possessing a strong balance sheet and expanding robustly we regard it as a secure covenant for Avation. However, should, for example, Skywest's commodity sector activity decline significantly or competition become substantially more intense, its demand for aircraft would likely decrease.

The current credit market turmoil may also be perceived as a significant threat to Avation's expansion plans. However, we would note that both itself and Capital Lease Aviation have demonstrated an impressive ability to access capital for expansion and the latter's ability to recently purchase two Airbus A321-200 aircraft for \$70.75 million as well as secure a new \$100 million revolving finance facility just last month would suggest this threat is not particularly significant. Additionally, although the taking on of more debt and risk for expansion may concern some given the market conditions, the companies' proven ability to secure multi-year leases at the point of purchase which are closely aligned to the financing terms of aircraft acquisitions, mitigates this and is a key differential from some other aircraft lessors. This is demonstrated in Avation revealing in its results statement that despite debt market conditions, it and its subsidiaries have secured the bulk of their debt funding at a very competitive cost of around 6% per annum.

We have previously noted that the airline industry has proven to be, and remains, inherently uncertain. Therefore, although Skywest's unique position at the heart of the Western Australian resources industry means it is an exceptional case, cyclicalities means many airlines are facing an extremely challenging market climate. This has resulted in some high profile industry failures and highlights the threat presented to aircraft lessors by the credit worthiness of client companies. Furthermore, a prolonged downturn in the global aviation industry would almost certainly depress a key valuation parameter used for the aircraft leasing industry – the market value of a company's fleet - and may also hinder the execution of Capital Lease Aviation's client diversification strategy, although again we would note that against this sits the trend of airlines 'leasing-in' capacity rather than purchasing aircraft. Indeed Avation sees significant opportunity in the current market conditions, with aircraft valuations becoming increasingly favourable to buyers and offering the opportunity to purchase high quality, newer aircraft that are operated under lease by top tier airlines.

Further risk factors include a heavy reliance upon the expertise of a small board of directors, a plethora of specific aviation-related risks and exchange rate considerations – with the company operating from Singapore, usually executing business in US dollars but reporting in British pounds.

Management

Jeff Chatfield – Group Executive Chairman.

Chairman also of Skywest Airlines and Capital Lease Aviation, Chatfield has experience as a manager and director 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.

With significant management level experience in commercial media and emerging technology, Baudinette was appointed as CEO of Avation.Net Inc in 2003 and Managing Director in 2005. He has 25 years of media experience having held management positions in the radio, newspaper and television industries and manages the broadcast side of Avation's business.

Bryant McLarty – Non-Executive Director.

With extensive experience in start-up and established companies, both as a Managing and Non-Executive director, McLarty was appointed to the board of Avation as a Non-Executive Director in 2007. He has a practical working knowledge of Australian securities and equity markets and is a founding director of Pharmaust Ltd, an ASX listed company involved in pharmaceuticals.

Significant Shareholdings

Avations' issued share capital currently consists of 25,270,000 ordinary shares. Those holding more than 3% of the current issued share capital are:

Jeff Chatfield (Chairman)	13.81%
UBS AG London Branch	8.06%
Silex Nominees Ltd	7.91%
Credit Suisse Securities (Europe) Ltd	6.27%
Mellon Nominees Ltd	6.04%
W H Ireland Ltd – Phillip Haydn-Slater	4.93%
W H Ireland Ltd – discretionary clients	4.67%
Apollo Nominees Ltd	4.48%
W B Nominees Ltd	4.25%
Loeb Aron & Company Ltd	4.18%
W H Ireland Ltd – Harry Ansell	3.51%

Recent Results, Balance Sheet and Cash Flow

Avation announced its results for the year ended 30th June 2008 on 3rd November. These showed the significant bottom-line impact of a scaling up of aircraft leasing operations – with the company benefiting from a full years contribution from three leased aircraft and the leasing of a further five during the period (including four by Capital Lease Aviation) compared to having two aircraft leased out for less than eight months and one for less than three months in the year to 30th June 2007.

A pre-tax profit of £8.15 million, up from £779,399 for the previous year, was recorded as increased profit from continuing operations was supplemented by a £5.5 million exceptional gain resulting from the AIM listing of Capital Lease Aviation. However, even stripping this out leaves a post tax and minority interests profit of £1.46 million which compares favourably with the £547,585 achieved for the year to 30th June 2007. Revenue grew by 179% to £5.03 million and cash generated from operating activities by 439% to £5.90 million, as management signalled its confidence by declaring a further 0.5p per share dividend, payable from underlying earnings per share of 6.04p, up from 3.01p.

The balance sheet reflected a strengthened asset base as a result of the company's acquisitive approach to growth; with property, plant and equipment of £67.42 million comparing with £9.47 million at 30th June 2007 and loans and borrowings increasing to £43.86 million from £6.31 million. This helped the net asset value to increase to £21.22 million from £4 million.

Valuation, Forecasts and Conclusion

The continuing growth of Skywest Airlines together with exposure - via Capital Lease Aviation - to a presently fragmented aircraft leasing market which is benefiting from a movement of airlines towards leasing-in capacity, means Avation looks well placed to benefit from continuing increased demand. The multiple year leases the company has demonstrated it is able to enter into should continue to provide significant cash flow, as well as facilitating access to required levels of debt financing, and although some investors may be wary of companies increasing their financial leverage given the prevailing economic climate, Avation's strong and visible operating cash flows differentiate it from the crowd.

There are risks including a downturn in Skywest's business or the inherently uncertain airline industry hindering the execution of Capital Lease Aviation's client diversification strategy, but with both Skywest and Capital Lease Aviation confident in outlook, Avation looks set to benefit from a full years contribution from its newer leases and further growth in the year to 30th June 2009.

For this year, to June 30th 2009, we forecast pre-tax profits increasing to £6.5 million on turnover of £13 million. This should generate earnings per share of 13p, putting the shares on a lowly current year price earnings multiple of 1.9 and – on the basis of a 1.75p forecast dividend - yielding 7%. Moreover, we expect further significant increases in the scale of Avation's business, particularly through Capital Lease Aviation, to see these forecasts prove conservative.

Aircraft leasing companies achieving full equity ownership of aircraft with significant usable life left are often indicatively valued at the market value of their fleet. Using the prices at which the aircraft were bought suggests a value of £47.14 million for Avation (£15.14 million for its five aircraft fleet and £32 million for its 51.22% interest in Capital Lease Aviation's six aircraft fleet), which equates to 187p per share without including anything for the scope for further fleet expansion. Although aircraft prices now look to be weakening, they have risen significantly since Avation commenced aircraft leasing operations in November 2006 and the £67.42 million 30th June 2008 balance sheet value of the company's property, plant and equipment provides a clear indication of the conservativeness of our approach.

A share price of 187p equates to an earnings multiple of 14.4 which looks far from excessive considering the growth on offer. It is interesting to note that Avation's £6.32 million market capitalisation compares with a £33.82 million AIM market value for its 51.22% stake in Capital Lease Aviation and with Avation's shares at 25p, our stance is **buy**.

Forecast Table:

Year to 30 th June	Sales (£ million)	Underlying Pre-tax Profit (£ million)	Underlying Earnings Per Share (p)	Price Earnings Ratio	Dividend Per Share (p)	Dividend Yield (%)
2007A	1.81	0.779	3.01	8.3	N/A	0
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This research note cannot be regarded as impartial as GE&CR has been commissioned to produce it by Avation*

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