

# RUSSIA'S AIR WAR

Bloomberg:  
AFTL, AVSI,  
AVKA, TMAT

Reuters:  
AFTL, AVSI,  
AVKA, TMAT

## INITIATION OF COVERAGE

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Exhibit 1

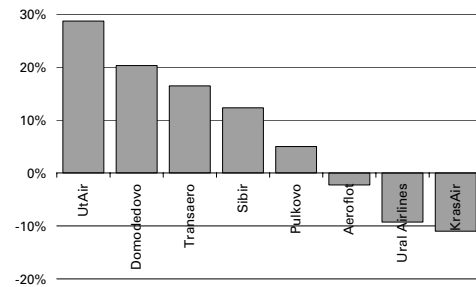
**Russian airlines' valuations and current value, \$/mn**

	Ticker	Free float	Target price	Current price	Upside	Rating
Aeroflot	AFLT	4%	1.35	1.83	-26%	SELL
Sibir Airlines	AVSI	12%	2,002	2,000	0%	HOLD
KrasAir	AVKA	21%	231	490	-53%	SELL
<b>UTAir</b>	<b>TMAT</b>	<b>24%</b>	<b>0.26</b>	0.205	29%	BUY

Source: company data, Bloomberg

Exhibit 2

**Passenger flow growth in 2005**



Source: company data, ABCentre

### UTAir sales up 46% in tough year

UTAir's revenues increased by 46% in 2005, with operating margins increasing from 4.4% to 6.2%. The increase was primarily driven by a 29% jump in passenger turnover during the period (Exhibit 2). Major competitors lost ground – KrasAir's passenger numbers fell by 11%, and Aeroflot's by 2%. We think UTAir's results are especially impressive, given that they were achieved in a year marked by much higher fuel prices.

### Varied business, UN chopper contract

About 23% of UNAir's sales come from its helicopter business, which has a major long-term contract with the United Nations. Sales to the UN amounted to \$53 million in 2005, up 97% from 2003.

### Fleet upgrade and expansion plans

UTAir is planning to replace some of its older, Russian-built planes with up to 15 foreign-built planes, which are deemed to be over twice as fuel-efficient. We think this upgrade, to be completed by the end of 2006, should help UTAir to realize its revenue goals. The company is planning to increase revenues by 47% in 2006, a goal we believe is realistic, since the company has consistently met its own revenue targets in the past.

### Initiate Buy on TMAT, neutral on the rest

UTAir has the lowest valuation ratios of the Russian airline sector, trading at 9 times 2005 earnings, and at 7 times expected 2006 earnings. We begin our coverage with a Buy recommendation, and a target price of \$0.26. We are negative or neutral on the remainder of the Russian air sector, especially Aeroflot, which we expect will soon lose a substantial percentage of its profits. We initiate coverage with a Sell on Aeroflot, a Sell on KrasAir, and a Hold recommendation on Sibir Airlines.

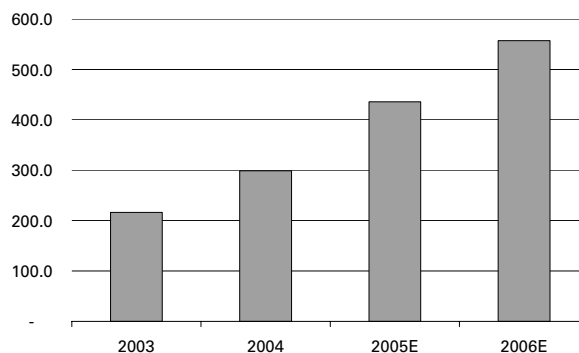
Exhibit 3

**UTAir's air fleet at the start of 2005**

Planes	Units	Helicopters	Units
Yak-40	17	Mi-26	19
Tu-154	12	Mi-10K	7
Tu-134	20	Mi-8	143
An-24	12		
An-2	44		
An-26	1		
Gulfstream	1		
<b>Total</b>	<b>107</b>	<b>Total</b>	<b>169</b>

Source: company data

Exhibit 4

**UTAir's revenue dynamics, \$ million, 2003-2006E**

Source: company data

**Discount to peers.** UTAir has the lowest valuation ratios in the sector, and also trades at a significant discount to its European peers. It trades at 9 times 2005 earnings, and at 7 times expected 2006 earnings. Its 2005 EV/Sales ratio is 0.6. We begin coverage on the stock with a BUY recommendation, and a target price of \$0.26, representing upside potential of 29% from the current share price.

**Revenue jump in 2005.** The company's revenues grew by 46% in 2005, while operating margins increased from 4.4% in 2004 to 6.2% in 2005. We attribute this relatively high growth to the acquisition in 2004 of regional airline Komiinteravia, which explains about 40% of the increase in passenger numbers. According to the company, about 200,000 passengers out of the total increase of 466,000 are likely to be explained by the acquisition. The remaining 60% of the increase is explained by organic growth, in our estimates.

**Fastest passenger numbers growth in 2005.** UTAir's passenger numbers increased by 29% in 2005, while KrasAir's passenger numbers fell by 11%, and Aeroflot's by 2%. While much of UTAir's increase can be explained by the acquisition of Komiinteravia, we think the remainder can be attributed to measures undertaken by management to stimulate organic growth. These include a new loyalty/bonus programme, new customer finance arrangements in conjunction with local banks, the introduction of new routes, and an improved docking system in Vnukovo airport.

**Fleet upgrade.** UTAir is planning to replace some of its An-24 and Yak-40 aircraft with about 15 ATR-42-320 planes, supplied by Continental Airlines and produced by EADS. According to the company, two of these aircraft entered service in December 2005, and five more are scheduled to enter service in the next year. In 2006, the company plans to lease 9 middle-distance Boeing-737 or A-320 air-

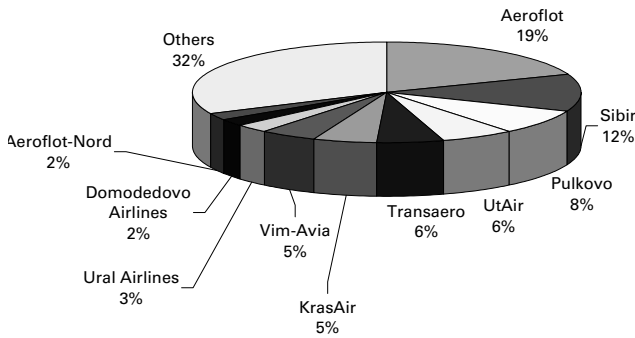
craft. We expect that the share of foreign planes in UTAir's fleet will increase to 20% in 2006.

**Revenue expansion plans.** We believe this fleet expansion, combined with promising foreign contracts in the company's helicopter division, will help UTAir achieve its revenue targets. According to the company, its 2006 business plan calls for a 47% increase in revenues. It plans to increase helicopter services by 25%, against 30% in 2005. We see this as plausible, given that the helicopter services division's main customer is the United Nations, which in 2005 spent \$53 million on helicopter services provided by UTAir. This was a 97% increase from 2003. We are also encouraged by the fact that UTAir has a track record of meeting its revenue targets.

**Foreign helicopter contracts.** UTAir is the largest helicopter transportation company in Russia, with 14% of the market. Revenues from the helicopter division amount to about 23% of total company sales. It has a number of blue-chip foreign clients, including the United Nations, which uses the helicopters for humanitarian missions throughout the world. UTAir owns a large helicopter fleet, including 143 Mi-8 and 7 Mi-10K helicopters, and 19 Mi-26T helicopters, which have the largest cargo capacity of any helicopter in the world. The fleet is equipped for transporting and installing oil and gas extraction equipment.

**Shareholding structure.** Surgutneftegas is the only major shareholder of UTAir. It controls 76% of the company through several affiliate companies. We see Surgutneftegas' involvement as a positive for minority shareholders, since it has significant financial resources.

Exhibit 5  
Market structure 2005



Source: ABCentre

Exhibit 6  
Macro dynamics

	2003	Change	2004	Change	2005
Passengers transported, th.people	29,415	14.9%	33,798	3.6%	35,015
<i>international</i>	12,117	23.0%	14,904	6.7%	15,903
<i>internal</i>	17,099	10.5%	18,894	1.2%	19,121
Passengers turnover, mn pass-km	71,115	16.7%	82,991	2.7%	85,232
<i>international</i>	35,456	23.3%	43,717	4.3%	45,597
<i>internal</i>	35,671	10.1%	39,274	1.0%	39,667
Seat occupancy	71%	-0.4%	70%	-	-
<i>international</i>	72%	-0.1%	72%	-	-
<i>internal</i>	69%	-0.8%	69%	-	-
Cargo transported, th.tonnes	621	5.5%	655	-4.7%	624
<i>international</i>	341	12.5%	384	-	-
<i>internal</i>	279	-3.1%	271	-	-
Cargo turnover, mn/tonnes-km	2,734	9.8%	3,002	-5.3%	2,843
<i>international</i>	1,813	17.8%	2,136	-	-
<i>internal</i>	923	-6.1%	867	-	-

Source: ABCentre

## MARKET SIZE AND GROWTH

**The sector is facing hard times.** This is due to significant changes caused by both internal and external factors.

- The steep increase in fuel prices has significantly changed the structure of airlines globally. According to figures from Bloomberg, jet fuel prices have increased in line with crude oil prices (Exhibit 7). Therefore, fuel now constitutes up to half of companies' costs. Airlines are trying to offset this cost by spending money on more fuel-efficient foreign aircraft, and by increasing air fares.
- Changes in consumer preferences are causing wider structural changes within the industry.
- Russian fleets are aging and need replacing, which requires large capital expenditures. We believe only the large companies can afford to finance such expenditure, forcing consolidation within the sector.

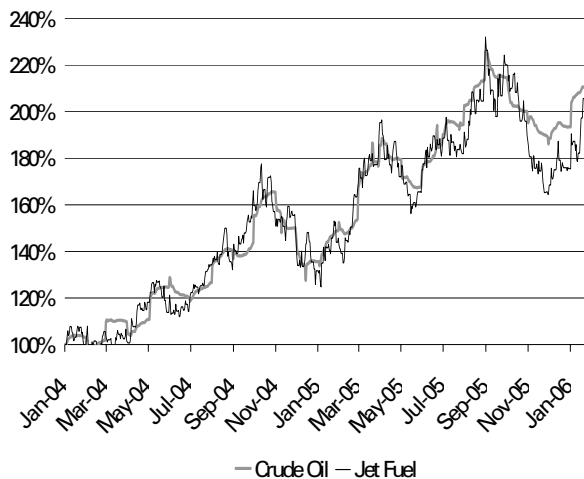
**Air fares are rising, but passenger numbers are still growing.** With air fares rising as a result of the fuel hikes, we have seen a drop-off in passenger turnover growth rates (Exhibit 6). In 2005, passenger traffic grew by only 3.6%, and cargo traffic decreased slightly. However, the fact that passenger numbers are still increasing, despite higher fares, is a positive, in our view. In 2006-2007, as passengers become accustomed to the higher fares, we expect the growth rates to climb back up. There is an historical trend for a country's air transportation to grow at a rate that is two or three times higher than the GDP growth rate. This would conservatively suggest growth in Russian passenger numbers of 12% in 2006-2007, assuming no further significant fuel price rises.

**Russian growth potential.** By the ratio of passenger traffic to the country's population, Russia ranks far below devel-

oped countries. For instance, in the USA, this ratio is about 1.65, while in Russia, it is only 0.24.

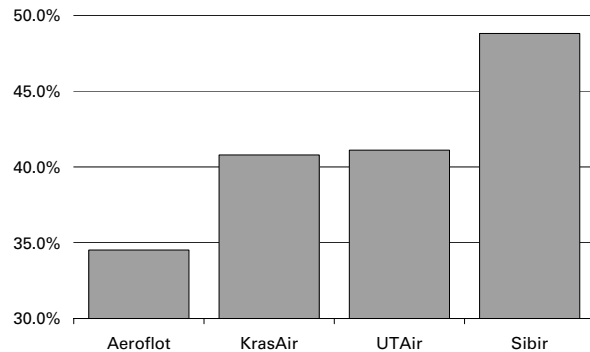
**Margins boost.** UTAir in 2005 reported the highest growth rates of the publicly traded sector, increasing its operating and net margins to 6.2% and 3% respectively. In contrast, Aeroflot decreased margins and Sibir Airlines continued to break even. Only KrasAir delivered high growth rates in 2005, but only because of low profitability previously – net profit grew to \$1.8 million, from \$0.3 million in 2004. We believe that Aeroflot's high margins can be explained by its role as the main collector of royalties from western airlines passing over Russian territory. This benefit was provided by the state, but will probably be eliminated in 3-4 years, due to pressure from European authorities, who have made the issue part of World Trade Organization accession negotiations.

Exhibit 7

**Changes in spot prices for crude oil and jet fuel**

Source: Bloomberg

Exhibit 8

**Share of jet fuel in cost of sales, 3Q2005**

Source: company data

**FUEL AND MARGINS**

**Fuel as a percentage of costs has risen.** Increased fuel prices have changed airlines' cost structures. In the 3Q2005, the share of fuel in airlines' costs totaled 50% for some companies (Exhibit 8), up from 30% previously. This led to increasing air fares, and a consequent drop in consumer demand. Nevertheless, different companies managed the situation differently. In our opinion, UTAir stayed within reasonable limits concerning fuel costs, which amount to about 41% of its total costs.

**Jet fuel prices should rise only slightly in 2006.** Prices on jet fuel rose by over 50% in 2005, to \$720 per tonne. Prices have come down slightly since, and we are not expecting any further significant rises.

**Change to fuel-efficient planes.** Using foreign-built aircraft can significantly cut down on fuel bills. Many major Russian air companies are planning to buy foreign aircraft, which are more fuel-efficient than Russian-built aircraft. For instance, the Tu-154 on average consumes almost twice the amount of the Airbus A-320, a European-built plane of roughly the same size. The Tu-154 consumes an estimated 4.8 tonnes of jet fuel per hour, while the Airbus A-320 consumes only 2.2 tonnes.

**Aeroflot to lose royalties.** According to the most recent financials available, a significant part of Aeroflot's profit is derived from royalties paid by foreign airlines for the right to fly through Russian airspace. This benefit was provided to Aeroflot by the Russian government, and is worth approximately \$100 million annually. Recently, the European Union has lobbied against the payment of these royalties to Aeroflot, calling it an unfair government subsidy. We believe it is likely that these royalties will be eliminated from Aeroflot's revenues by 2008, since the success of Russia's WTO accession may depend on it. Such a move would decrease Aeroflot's net profit by 50-60%, in our estimate.

**COMPETITION AND CONSOLIDATION**

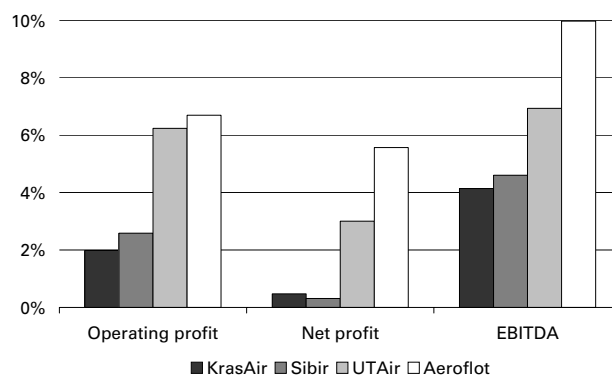
Aeroflot is Russia's largest airline company, with a 19% market share. It is controlled by the government (51%), Natsionalnaya Reseravnaya Korporatsiya (30%) and management, who control about 15%. According to company data, Aeroflot has a turnover of about 6.7 million passengers per year, equal to about 19% of the market, in our view. In 2005, Aeroflot decreased its turnover expectations for the year to 6.7 million. The company is also facing large CAPEX and custom duties for new planes in 2006-2007. Nevertheless, it remains the market leader, with 1.6 times the number of passengers than the second-largest airline company, Sibir. Another large player is AiRUnion Alliance, consisting of KrasAir, Domodedovo Airlines, Samara Airlines, Omskavia and Sibaviatrans, with a total turnover of about 3.5 million passengers, or about 10% of the market. UTAir, however, is probably the most rapidly growing company in the sector. It passed the 2005 fuel crisis with minimal damage, and significantly expanded its business at the same time.

**Regional acquisitions.** Almost all large companies are expanding by acquiring regional airlines. Aeroflot purchased Donskiye Airlines in 2003, renaming it Aeroflot-Don, and FGUP Arkhangelskiye Airlines in 2004, which is now called Aeroflot-Nord. It also purchased other charter airlines. There are many other regional companies owned by the state which may become acquisition targets. UTAir also purchased a regional airline company - Komi-interavia - in 2005.

**Airlines' performance**

	Margins			Growth		
	2003	2004	2005E	2004	2005E	2006E
<b>Aeroflot</b>						
Revenue	-	-	-	26%	19%	12%
Operating profit	7.3%	9.5%	6.7%	63%	-16%	n/a
Net profit	7.4%	8.0%	5.6%	36%	-17%	n/a
EBITDA	12.7%	13.8%	10.0%	37%	-15%	n/a
<b>Sibir Airlines</b>						
Revenue	-	-	-	44%	28%	n/a
Operating profit	4.9%	-2.8%	2.6%	neg	neg	n/a
Net profit	0.3%	-5.6%	0.3%	neg	neg	n/a
EBITDA	8.5%	-0.2%	4.6%	neg	neg	n/a
<b>KrasAir</b>						
Revenue	-	-	-	48%	30%	n/a
Operating profit	1.9%	1.1%	2.0%	-16%	143%	n/a
Net profit	0.2%	0.1%	0.5%	-4%	476%	n/a
EBITDA	2.9%	3.9%	4.1%	95%	39%	n/a
<b>UTAir</b>						
Revenue	-	-	-	38%	46%	28%
Operating profit	2.3%	4.4%	6.2%	168%	106%	n/a
Net profit	1.3%	1.2%	3.0%	37%	253%	7%
EBITDA	8.2%	7.0%	6.9%	18%	45%	n/a

Source: Company data, 2006

**Comparison of main airline companies' margins in 2005**

Source: company data

## FLEET RENEWAL AND FINANCIAL RESOURCES

Most Russian airlines in operation today inherited their current aircraft from Soviet state enterprises. These fleets have high maintenance costs and low fuel efficiency, with many obsolete aircraft. This factor is the main driver of sector consolidation, since only the large airlines are capable of funding new aircraft purchases or leases. Aeroflot has sufficient financial power to fund this CAPEX, but it also has other threats to its profitability through the loss of flyover revenue.

**UTAir fleet modernization.** UTAir's fleet consists mainly of Russian planes, including AN-2, AN-24, Tu-134, Tu-154, and Yak-40 variants. It also has 174 helicopters, primarily of the Mi-26 and Mi-8 variants. UTAir is planning to replace some of its An-24 and Yak-40 planes with 15 EADS-built ATR-42-320 aircraft, supplied through Continental Airlines. Two of these new planes entered service in December 2005, and five more are due in 2006. The company is also planning to lease 9 middle-distance Boeing-737 or A-320 class aircraft. After this, the share of foreign-built planes in the company's fleet will total about 20%.

**Debt multiples.** UTAir has a debt coverage ratio of 3.2. Other companies have worse values. KrasAir showed the worst coverage ratio – 1.6 (due to significant and expensive debt), while Sibir Airlines had a ratio of 2.0. Aeroflot reported the best debt coverage ratio, at 14.2. This company has low debt (Debt/Equity = 0.23). For European peers, EBITDA/Interest coverage is in the range from about 3 to 10, with the average value being 6.

Exhibit 11

**European airlines peers**

<b>Company name</b>	<b>P/E</b>	<b>EV/EBITDA</b>	<b>EV/Sales</b>
Air France	5.33	4.18	0.49
Austrian Airlines	n/a	13.37	0.84
Alitalia	n/a	n/a	0.68
British Airways	10.92	4.44	0.71
easyJet	n/a	8.08	0.51
Finnair	18.35	4.68	0.46
FL Group	13.37	6.87	0.62
Iberia Lineas Aereas de Espana	4.51	0.60	0.09
Deutsche Lufthansa	8.50	2.18	0.34
Norwegian Air Shuttle	n/a	n/a	0.07
Ryanair Holdings	19.25	10.19	3.14
SAS	n/a	n/a	0.39
Swiss International Air Lines	n/a	5.33	0.25
Turk Hava Yollari	18.67	n/a	0.78
<b>Average</b>	<b>12.36</b>	<b>5.99</b>	<b>0.67</b>

Source: Bloomberg

Exhibit 12

**Valuation results**

	<b>Sales</b>	<b>EBITDA</b>	<b>Net Income</b>	<b>Net Debt</b>	<b>Average MCap</b>	<b>Shares outstanding</b>	<b>Target price</b>	<b>Current price</b>	<b>Upside</b>	<b>Rating</b>
Aeroflot	2,844	261	149	409	1,498	1,111	1.35	1.83	-26%	SELL
Sibir Airlines	668	31	2	111	205	0.102	2,002	2,000	0%	HOLD
KrasAir	382	16	2	66	109	0.470	231	490	-53%	SELL
UTAir	557	30	13	130	152	577	0.26	0.205	29%	BUY
<b>Multiples of European peers</b>	<b>0.67</b>	<b>5.99</b>	<b>12.36</b>							

Source: companies' data, Bloomberg, IFC Metropol estimates

## 6

**VALUATION**

We used European companies' multiples as a benchmark to value Russian companies.

- The 2005 financials of Russian companies were taken. They are based on the companies' forecasts and our conservative estimates.
- As a final capitalisation value, the average of three estimates – by P/E, by EV/EBITDA and EV/Sales – was calculated.
- UTAir is the cheapest company in the Russian airline sector, and is also undervalued compared to its foreign peers. We estimate its upside potential at 29%, with a target price of \$0.26 per share.

# TMAT

# BUY

Price: \$0.205  
Target price: \$0.260

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The company was created in 1992 as JSC Tyumenaviatrans airlines. In 2002, it was renamed into UTAir. The company employs 5,000 people, and operates 107 aircraft and 169 helicopters. UTAir is the fourth-largest company in the world by volume of helicopter services.

UTAir owns and operates 5 airports – Noyabrsk airport, Berezovo airport, Igrim airport (Khanty-Mansiysk AO), Mys Kamenny airport and Tazovo airport (Yamal-Nentsk AO).

## INVESTMENT DRIVERS

- The company is the fourth-largest Russian air transportation company. Its business is highly diversified – while other airliners suffer from high fuel cost, UTAir continues to develop its other higher-margin segments.
- UTAir is the largest provider of helicopter transportation services in Russia. Its share of this market is 14%. More than a half of its helicopter division sales are provided abroad. The amount of revenue in this segment has been steadily increasing in recent years. The helicopter segment is very profitable, with net margins of 10-15%, compared to 2% for its plane passenger transportation business.
- Rapid growth due to both organic development and acquisitions
- The company's main shareholder is Surgutneftegas, which has significant financial resources that may be used to help UTAir in its development. It is also a major customer.
- Low debt, compared to Russian peers.
- It has the lowest earnings multiples in the sector

## INVESTMENT RISKS

- High competition
- UTAir will not be able to acquire regional airlines as easily as its bigger rivals. The process of consolidation will favour state-controlled companies, such as Aeroflot and AirUnion alliance.
- Non-transparent ownership structure of almost 25% of the company's shares.

7

TRANSPORT INITIATION OF COVERAGE

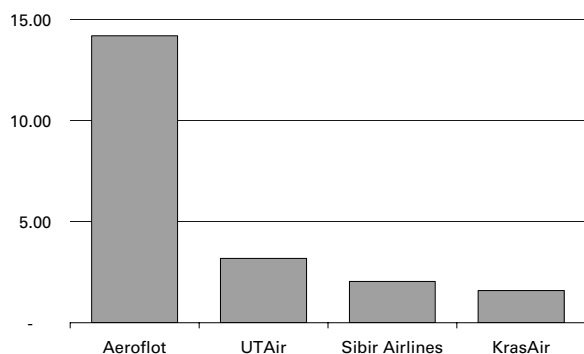
**TMAT Financial summary, 2003-2005E**

Balance Sheet, \$ million	2003	2004	2005E
<b>ASSETS</b>			
<b>Non-current assets</b>	40.8	44.8	48.8
<b>Current assets, incl.</b>	99.3	173.0	200.1
Cash and cash equivalents	0.8	0.7	1.4
<b>Total assets</b>	<b>140.1</b>	<b>217.8</b>	<b>248.9</b>
<b>LIABILITIES AND EQUITY</b>			
<b>Equity</b>	46.4	51.9	50.2
<b>Non-current liabilities, incl.</b>	39.3	73.2	102.8
Long-term debt	39.3	71.5	101.2
<b>Current liabilities, incl.</b>	54.4	92.7	95.8
Short term debt	18.4	36.6	29.7
<b>Total liabilities and equity</b>	<b>140.1</b>	<b>217.8</b>	<b>248.9</b>

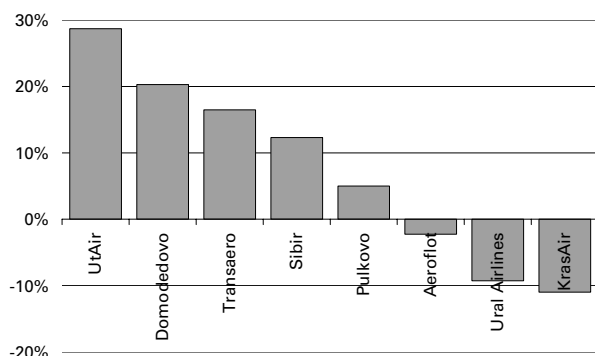
Income Statement, \$ million	2003	2004	2005E
Sales	216.2	298.8	436.0
CoS	(202.3)	(282.2)	(403.0)
<b>Gross profit</b>	<b>13.9</b>	<b>16.7</b>	<b>33.0</b>
<b>Operating income</b>	<b>4.9</b>	<b>13.2</b>	<b>27.2</b>
Interest expense	(5.1)	(6.4)	(9.5)
<b>Income before taxation</b>	<b>(0.2)</b>	<b>6.8</b>	<b>17.7</b>
Income tax expense	2.9	(3.1)	(4.6)
<b>Net profit</b>	<b>2.7</b>	<b>3.7</b>	<b>13.1</b>
<b>EBITDA</b>	<b>17.6</b>	<b>20.9</b>	<b>30.2</b>

Gross margin	6.4%	5.6%	7.6%
Operating margin	2.3%	4.4%	6.2%
Net margin	1.3%	1.2%	3.0%
EBITDA margin	8.2%	7.0%	6.9%
Revenue growth		38.2%	45.9%
Operating income growth		168.0%	106.3%
Net income growth		37.3%	252.8%
EBITDA growth		18.3%	45.0%

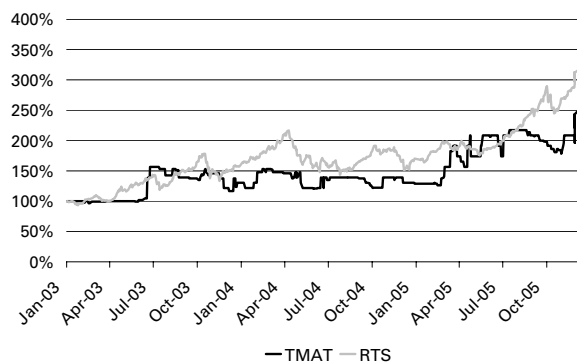
Source: company data

**EBITDA / Interest coverage, %**


Source: company data

**Passenger flow growth in 2005**


Source: company data

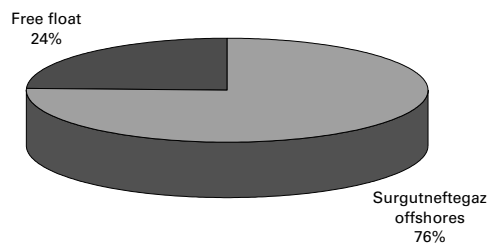
**TMAT: Shares Performance vs RTS Index, 2003-2006**


Source: Bloomberg

**TMAT: Shares and company data**

<b>Mcap (\$mn)</b>	118.33	<b>52w high (\$)</b>	0.18
<b>Share price (\$)</b>	0.205	<b>52w low (\$)</b>	0.07
<b>Shares out (mn)</b>	577.2	<b>Annual div.(\$)</b>	0.00194
<b>Free float (%)</b>	24%	<b>Div.yield (%)</b>	0.9%
<b>Free float (\$mn)</b>	28.84	<b>Pay-out (%)</b>	41.5%

Source: company data, RTS

**TMAT: Shareholder Structure**


Source: company data

**TMAT: valuation ratios, 2004-2005E**

Valuation ratios	2004	2005E
P/E	31.9	9.0
P/S	0.4	0.3
P/Book	2.3	2.4
EV/EBITDA	10.8	8.2
EV/S	0.8	0.6
Debt/Equity	0.9	1.1

Source: IFC Metropol estimates

**TMAT: Management and Headquarters**

<b>Address</b>	Khanty-Mansyisk airport, Tyumen region
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Source: company data





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