



KMEFIC Research Equity Analysis Report – Initiation of Coverage

Aviation Lease and Finance Company K.S.C.C.
[ALAFCO]

August
2010

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Executive Summary

Aviation Lease & Finance Company				
Listing:	Kuwait Stock Exchange-KSE	Ticker: ALAFCO	CMP (15 Aug-10):	KWD 0.184
Reuters:	ALAF.KW		Fair Value:	KWD 0.221
Sector:	Aviation - Aircraft Leasing		Upside/(Downside):	20%
			Opinion:	UNDERVALUED

This report is an initiation of coverage on **Aviation Lease and Finance Company (ALAFCO)**; we focused on the company's operations, activities and financial performance over a historical period of 7 years, along with relevant industry related variables in order to accurately forecast the company's financials over a five year horizon and reach an estimated fair value for the stock.

Aviation Lease and Finance Company ("ALAFCO", "The Company") was incorporated in Kuwait the year 2000. The Company is one of the few in the region engaged in business aircraft leasing and providing management, marketing, and consultancy services to aviation related businesses. ALAFCO operates its activities under a Shariah compliance umbrella. The company's main operations are the operating lease of aircrafts and other related equipment, sale and leaseback of aircrafts in addition to advisory services and aircraft lease management services.

Over the past six years, ALAFCO's revenue, comprised of operating lease, consultancy and finance lease income grew at a CAGR 18.8%, whilst Earnings before Interest & Tax (EBIT) grew at CAGR 27.9%. On average, net profit grew at an average of 11.0% between the years 2003-2008, excluding 2006 when net profit boomed by 136% from KWD 3.5 million to KWD 8.2 million, boosted by the hike in operating lease income which grew by 70.5% during the year. During 2009, net profit grew by a mere 1.3% as income from consultancy services shrank significantly from KWD 2.8 million in FY08 to KWD 0.5 million in FY09.

Financial Highlights (mil. KWD)	H1-09	H1-10
Total Assets	317.0	477.6
Current Assets	12.3	11.8
Current Liabilities	58.4	53.0
LT Loans	150.7	340.4
Total Equity	88.6	99.3
Net Profit	3.2	5.0

Over the 6 month period ending March 2010 ALAFCO's revenue grew by more than 50% compared to the first half of the preceding fiscal year, as operating lease income soared backed by its expanded fleet and the delivery of 10 Airbus aircrafts to multiple regional & European airlines. Likewise, net income also climbed by more than 57% in H1-2010, after recording a humble increase of 1.3% in FY09 when consultancy and managerial income slouched significantly. Furthermore, an infrequent income of KWD 3.17 million was recognized in FY09 as the company sold used aircrafts at gain, this have offset the plunge in managerial income.

On the 18th of July 2010, ALAFCO reported its financial results for the 9 month period ending 30 June 2010; the Company revealed a net profit for the period of KWD 7.75 million, versus the KWD 8.31 million recorded in the corresponding period of 2009. A slight dip in net income of 6.6% was recorded while earnings per share stood at fils¹ 10.45 (fils 11.19 in 9M-2009).

Our estimated target price of ALAFCO stock is based on discounting future cash flow valuation method as stipulated hereinafter in the report. Our conclusion is driven by Discounted Lease Payments (DLP). The relative valuation was inapplicable in the company's case as the Aircraft Leasing Industry in the region has a limited number of participants; hence, the weight was fully assigned to the discounting

¹ 1KWD=3.46US\$; there are 1000 fils per each Kuwaiti Dinar

lease payments method. **As on 15.08.10**, ALAFCO was trading at KWD 0.184, standing at a 20% discount to our estimated fair value. We therefore rate the stock as **"Undervalued"**.

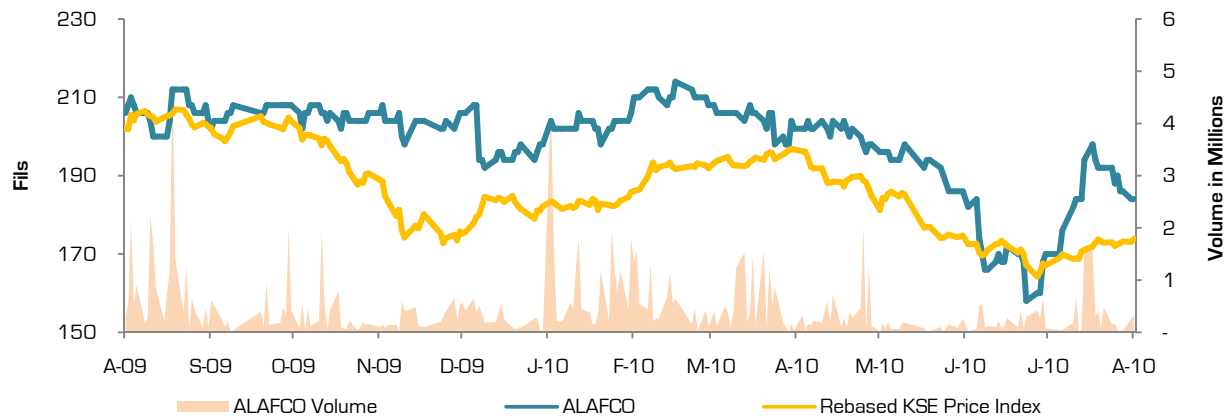
Table 1 - Key Performance Indicators

	FY07	FY08	H1-09	FY09	H1-10	FY10F
Revenue (million KWD)	26.8	27.3	12.2	26.9	18.6	47.9
Operating Profit (million KWD)	17.2	17.1	6.2	16.9	9.5	22.0
Net Profit (million KWD)	9.1	10.1	3.2	10.2	5.0	11.6
Operating Profit Margin	64%	63%	51%	63%	51%	46%
Net Profit Margin	34%	37%	26%	38%	27%	24%
EPS (KWD)	0.014	0.015	0.004	0.015	0.007	0.016
P/E	14.1	8.1	24.7	13.4	12.4	14.9
P/B	1.6	1.0	1.8	1.5	1.3	1.7
ROAE	12.1%	12.6%	7.5%	11.2%	10.7%	11.9%

Source: Company Filings & KMEFIC Research

ALAFCO, THE STOCK IN KSE

Figure 1 - ALAFCO, rebased to KSE Price Index (& Shares trading volume)



Source: KMEFIC Research & Kuwait Stock Exchange

We rebased ALAFCO's stock to Kuwait Stock Exchange Price Index over the past twelve months in order to test the stock's pattern relative to the index. The reading from *Figure 1* suggests that ALAFCO's stock returns were slightly volatile over the past 52 weeks; however the stock always outperformed KSE Price Index during the period. ALAFCO's share price averaged circa KWD 0.199 over the past year, reaching a maximum of KWD 0.214 in February 2010. Note that the stock reached a maximum of KWD 0.270 over the past 2 years in July 2008, right before the financial crisis weighed on the stock markets.

With the presence of two major shareholders blocking collectively around 63% of the company's shares, the remainder of ALAFCO shares are owned by the public, both GCC nationals and foreigners; ALAFCO's share turnover over the 12 month period reached 14.4% as the stock witnessed very low activity during the year. It is worth mentioning that the share's turnover during the previous year reached 64.9% (August-08 to August-09).

Business Profile

ALAFCO Aviation Lease and Finance Company was incorporated in Kuwait the year 2000. The Company is one of the few in the region engaged in business aircraft leasing and providing management, marketing, and consultancy services to aviation related businesses. ALAFCO operates its activities under a Shariah compliance umbrella. The company's main operations are the operating lease of aircrafts and other related equipment, sale and leaseback of aircrafts in addition to advisory services and aircraft lease management services.

As a matter of fact, ALAFCO currently is an aircraft-portfolio co-manager of the salient aircraft investment Islamic fund Millennium Aircraft Leasing Company (MALC). Moreover, ALAFCO has sales offices in the United States and France and aims further expansion to support its growing sales network around the globe.

The company has two major shareholders; Kuwait Finance House, which owns 52% stake in ALAFCO and Kuwait Airways Corporation, which owns circa 11%. The remaining shares are available to the public on Kuwait Stock Exchange.

Listen to the market

ALAFCO's adopted business strategy is to "Listen to the market"; the company embraced an edgy approach to aircraft leasing which a lot of airlines and aircraft leasing firms failed to adopt. Huge orders of 40 and 50 aircrafts are far from ALAFCO's approach, the company has always made sure to keep its options open, to listen and respond to the aviation market's demands and turns. What ALAFCO knows for sure is that by the end of December 2010, it will have a fleet of 59 aircrafts, between owned and managed, after that, market conditions and opportunities would take part of any future plans but is not expected to interfere with ALAFCO's long term target of a 100 aircraft fleet.

The company owns and plans to own a combination of wide and narrow bodied aircrafts from Boeing and Airbus consisting of single-aisle models such as Airbus-320 and Boeing 737NG and new technology twin-aisle Boeing 787 and Airbus 350XWB which will be delivered up to 2017.

Latest Deliveries

As mentioned previously, ALAFCO targets a fleet of 100 aircrafts between owned and managed; the table below exhibits aircraft deliveries since 2009 and up to date. In FY09, ALAFCO delivered a number of two aircrafts to Wataniya Airways, Sky Airlines of Turkey, GoAir of India and Olympic Airways of Greece, each, in addition to one aircraft delivered to Saudi Arabian Airlines. Meanwhile, during the current year and according to ALAFCO's Chief Executive Officer, the company delivered a total of 10 airlines by July 2010 of which 7 airlines were leased to Saudi Arabian Airlines, two to Olympic Air and one to Wataniya Airways.

Moreover, just recently, ALAFCO reached an agreement with all of Ethiopian Airways, OK Chinese Airways and Transaero Airlines for the lease of its aircrafts for a period of three years. The three aircrafts leased to the Ethiopian and Chinese Airways were Boeing B800-737 costing around USD 77 million each, whilst the one Aircraft leased to the Russian Airlines is a used B200-777 and is worth USD 60 million. By July 2010, and in **Farnborough International Air show for 2010**, ALAFCO announced converting its previous order of 12 Airbus A350-800 aircrafts placed a few years back into the most popular A350 Xtra Wide-Body (XWB) which is most efficient for medium- capacity long-range aircrafts.

"The A350-900 has a range of 8,300 nm / 15,400 km with a capacity of almost 40 additional seats to the 800 model. The A350 has three different passenger versions of the A350-800 which seats 270 passengers, the A350-900 which seats 314 and the A350-1000 which seats 350 passengers in a typical three class layout. (Centre for Asia Pacific Aviation)"

"Apparently, ALAFCO sells old, used aircrafts at a gain in order to maintain a healthy average age per aircraft and lower maintenance cost."

Industry: Overview and Outlook

Aviation Industry – Recovering Strong

Year 2009 hasn't been a ride-in-the-park for global airlines; the aviation industry experienced many turbulences over the past decade starting in 2001 with the September 11 attacks, SARS in 2003, Birds Flu and Swine Flu (H1N1) in 2008 and 2009, the global financial crisis and finally Iceland's "Eyjafjallajkull" volcano ash plume in April 2010; in addition to a rising frequency of employees strikes in this sector.

On traces of global safety and health concerns in addition to the financial squeeze, air traffic plunged severely during the past two years. The slump started in June 2008 when growth in international passenger traffic fell to 3.8%, the lowest growth rate seen in five years since SARS hit the industry in 2003. Passenger traffic started to recover in 2009 gradually, despite health concerns of the H1N1 virus; by June 2010 passenger traffic grew at an annualized rate of 6%, 13% above the recession trough and circa 2% higher than the pre-recession peak.

When it comes to profitability, the latter plunged along with passenger traffic over the period; According to IATA, aggregate net losses of global commercial airlines for 2008 widened to USD 16 billion, exceeding IATA's previous estimated loss of USD 10.4 billion for the industry by a hefty USD 6 billion. Likewise, forecasts of net loss of global commercial airlines for 2009 were revised from a net loss of USD 9 billion to USD 9.9 billion recently. Revenue-Passenger-Kilometer (RPK) underwent a wild flip from positive figures to negative and back to positive once again by June 2010. As of June 2008, the year-to-date RPK then reached 5.4% before dwindling to -7.6% in June 2009 and back to profit in June 2010 at 7.9%.

Table 2 – IATA Latest Data & Expectations

Net Profit in USD Bn, Global		June 2010 YTD	
2007	12.9	RPK (Revenue-Passenger-Kilometers)	7.90%
2008	-16	ASK (Available-Seat-Kilometers)	2%
2009E	-9.9	PLF (Passenger-Load-Factor)	77.1%
2010F	2.5	FTK (Freight-Tonne-Kilometers)	28.30%

Source: IATA

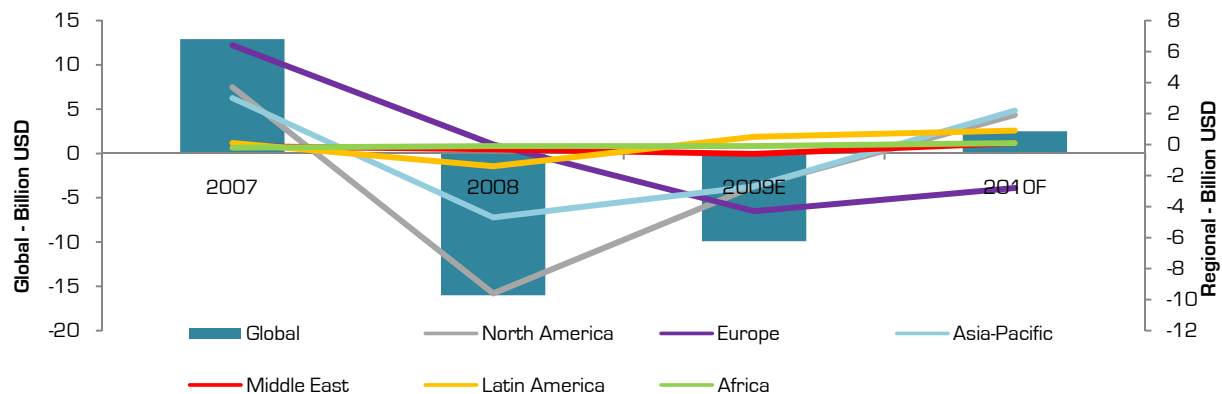
Building on IATA's forecast, revenue of international airlines that mounted along with RPKs, are expected to soar in 2010, flipping the estimated net loss of USD 9.9 billion in 2009 to a net profit of USD 2.5 billion; in fact, actual operating profit recorded for Q1-2010 for a sample of 46 international airlines reached USD 1.9 billion (excluding losses of 16 European airlines) and a net profit of USD 221 million (again, excluding losses of European Airlines amounting to USD 2.1 billion).

Middle Eastern & African Airlines Take the Lead

Middle Eastern air traffic and airlines revenue were boosting prior to the global financial mayhem, ahead of other regions; during the crisis and by June 2009, RPKs of the Middle Eastern aviation industry held on strong to a 7.1% growth whilst all other regions were smudged with negative growth rates. By June 2010, the aviation in the Middle East and Africa soared far beyond the recovery of other regions, with RPKs growing more than 20% and 13% respectively, while the industry grew at 7.9%.

Middle Eastern and African airlines are indeed experiencing strong traffic expansion as economic growth continues to solidify in the regions whilst additional long haul traffic being directed to their hubs. Despite maintaining positive growth rates during down times and outpacing global airlines in growth eras, both regions recorded operating losses over the past two years; however losses reported were the smallest in all regions of global commercial airline. Actual net loss of Middle Eastern airlines reached USD 300 million in 2008 whilst aggregate net loss of all regions totaled USD 16 billion. Again in 2009 estimated loss for the region is the second lowest after Africa. The IATA's forecast for 2010 results is net profit for both Middle Eastern and African airlines at USD 100 million per region.

Figure 2 - Net Profit in Global Commercial Airlines



Source: IATA

Fuel Costs

Fuel costs, which represented circa 32.3% of the industry's total operating cost in 2008, plunged sharply during the year, recovering partially in 2009 and 2010 by USD 40/b only to slip back again as a result of the Greek debt crisis in H1-2010. The slump in oil prices was for the interest of airline companies since fuel represents one of the main costs for the industry; nevertheless, airline companies were still unable to make profit with low fuel prices as load factors deteriorated due to lower air transport demand.

The IATA December forecast expects fuel prices to hike in 2010 but remain below 2008 levels ranging between USD 87 in 2010 and USD 90 in 2011.

Aircraft Leasing Industry – Rapidly Growing

The aircraft leasing market is a relatively young market underpinned mainly by the aviation industry and the success of airlines. This market emerged as a better solution for airlines than paying a lump sum of cash at the deliveries of aircrafts; instead, a lease would save airlines' from liquidity shortage and give them the option of eventually acquiring the leased asset.

Aircraft lease comes in two forms: **Wet Lease** and **Dry Lease**; a wet lease is the type of lease where

the lessor takes the responsibility of providing the airline with ACMI (Aircraft, crew, maintenance and insurance) in addition to fuel. This type of lease is common for individuals and small businesses. A **Damp Lease** is a kind of a Wet Lease that covers only ACMI excluding fuel. A Dry lease does not include ACMI and begins with a two years contract and is more common with big airlines.

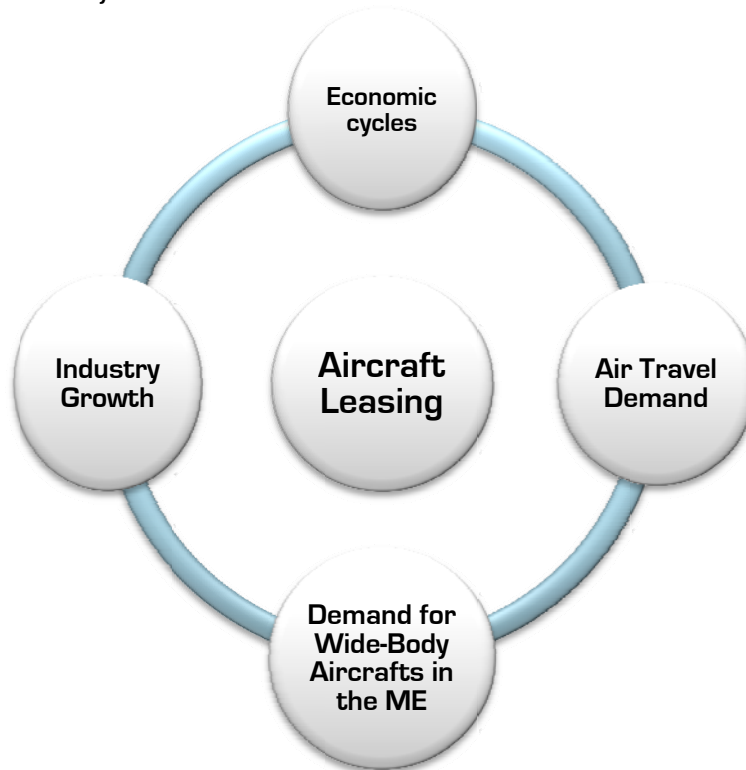
"A dry lease is a leasing arrangement in which a leasing company provides an aircraft without insurance, crew, ground staff, supporting equipment, maintenance, etc."

"A wet lease is a leasing arrangement in which the lessor provides an aircraft with complete crew, maintenance, and insurance to the lessee."

A dry lease can take two forms; airlines have the option of undergoing a financial lease where the aircraft is recorded on the airline's balance sheet as an asset, or undergoing an operational lease where the aircraft is not recorded as an asset and the future lease payments are off balance sheet obligations.

The profit or loss of players in the aircraft leasing industry is driven by a number of factors as displayed in the chart below.

Figure 3 – Aircraft Lease Industry



Industry Growth: The aircraft leasing industry has been growing rapidly in the past decade and in current economic conditions; airlines prefer holding on to their cash as profitability slumps with global misfortunes, favoring leasing their aircrafts. Leasing aircrafts instead of purchasing them is driven by cost cutting considerations and the rapid increase of the Low Cost Carriers airlines (LCC) which encourages the same.

Economic cycles: Aircraft Leasing is a typically cyclical industry correlated to global economic growth; according to A.T. Kearney, global management consultants, the aircraft leasing industry is highly cyclical with an up-cycle of 7-8 years, while its down-cycle ranges between 2-3 years. The fact that the

industry is cyclical is proved by the economic downturns we witnessed throughout the past decade which shackled airlines' profitability each time.

Demand for Wide-Body Aircrafts in the Middle East: The Middle East has become a famous destination and a busy hub for long haul traffic. Middle Eastern airlines have also put orders for more wide-body aircrafts from Boeing and Airbus to meet the increasing demand on air travel in the region which is driven by higher GDP per capita and a younger growing population.

Air Travel Demand: Demand on air travel increased noticeably over the past decade as disposable income for individuals grew at the same time LCCs invaded the airlines market, bringing lower fares which attracted more passengers. Furthermore, eased regulations and open skies agreements between different regions facilitated air travel and allowed airlines to adopt shorter routes (lower fuel consumption), save time and increase the frequency of the flights which led to higher profitability.

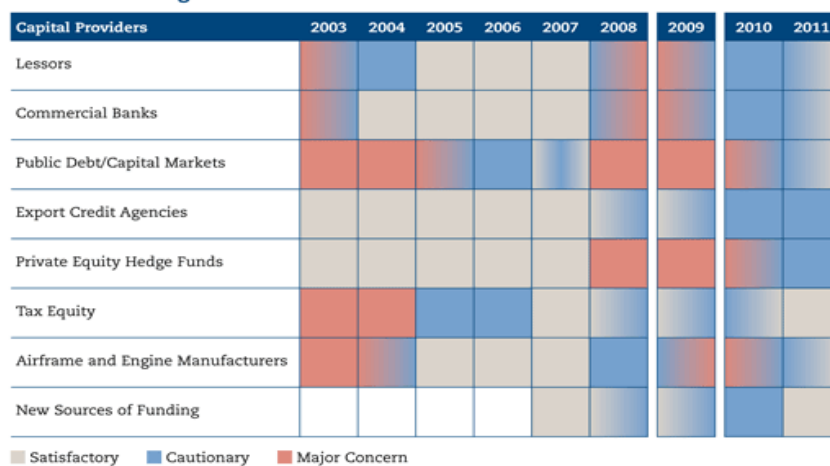
Aircraft Leasing – Outlook is Positive, However!

In coverage over this sector, the New York Times said that aircrafts leasing companies have their hands on almost one-third of the airliners in the sky while the paper quoted Ascend, an aviation consulting firm in London, stating that the industry grew from a niche market to a USD 150 billion one over the past 20 years. Ascend added these companies own or manage 34% of the circa 18,000 commercial airliners flying today.

In previous downturns, aircraft leasing companies benefited from airlines cost cutting strategies involving the cancellation of aircrafts orders versus a practical alternative, leasing aircrafts as a substitute. However, the latest financial crunch turned the tables and put aircraft leasing companies in the same bottleneck as airlines. The fact that aircraft leasing companies are 70-90% leveraged exposes these companies to aggressive hikes in finance cost due to tighter credit facilities conditions in addition to another obstacle represented by the scarcity of funds.

Figure 4 – Aircraft Financing

Aircraft financing environment



Copyright: MERCER. Source: MERCER, Boeing; Aircraft Finance update

The outlook for aircraft leasing firms remains positive and strong as airlines still prefer to lease aircrafts for a better financial position and more operational flexibility. One concern arises though after the latest financial crisis; higher cost of capital is expected to push lease rates and other fees upwards, which in return will force airlines to push the cost of flying upward. According to Aircastle Chief, aircraft leasing companies will grow their share in the aviation industry within 10 years to own almost half of the aircrafts in the airline industry.

Competition

The aircraft leasing industry is not an easy access one; it requires a great amount of capital and credibility, hence ALAFCO faces a relatively low competition in the region with only three main competitors: United Projects for Aviation Services Company in Kuwait, Abu Dhabi Aviation and Dubai Aerospace Enterprise. The former two are listed on their local stock exchanges while Dubai Aerospace is still a private firm.

United Projects for Aviation Services Company – UPAC

UPAC was established at the beginning of the new millennium 2000, for the purpose of providing airplane services, leasing out aircrafts, managing projects and investing surplus funds in investment portfolios; the company's shares became public later on in 2006 with a current market capitalization of KWD 29.7 million in August 2010.

Abu Dhabi Aviation Company – ADAVIATION

ADAVIATION was established in 1975 for providing aircraft and helicopters transportation services and leasing in addition to aircraft management and grounding. The company is based in Abu Dhabi and listed on Abu Dhabi Stock Exchange.

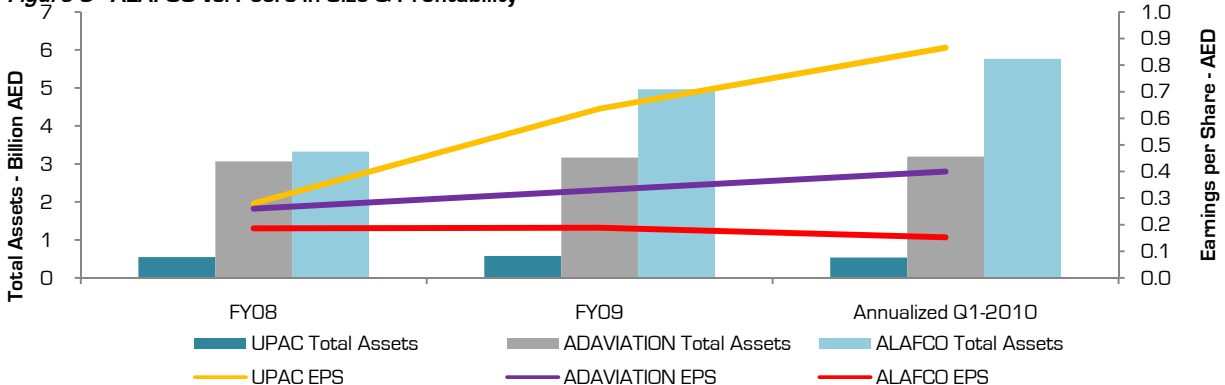
Dubai Aerospace Enterprise

The company is a privately held corporation established in 2006 in Dubai for the purpose of aircraft manufacturing, maintenance, leasing and financing in addition to airport development and management.

Financial Comparison

When comparing ALAFCO's financial position and performance with its peers, we concluded that FY09 was a good year for the 3 companies as Earnings per Share (EPS) hiked. The best performer amongst the three companies has been UPAC, recording higher EPS over the last interim and two fiscal years.

Figure 5 - ALAFCO vs. Peers in Size & Profitability



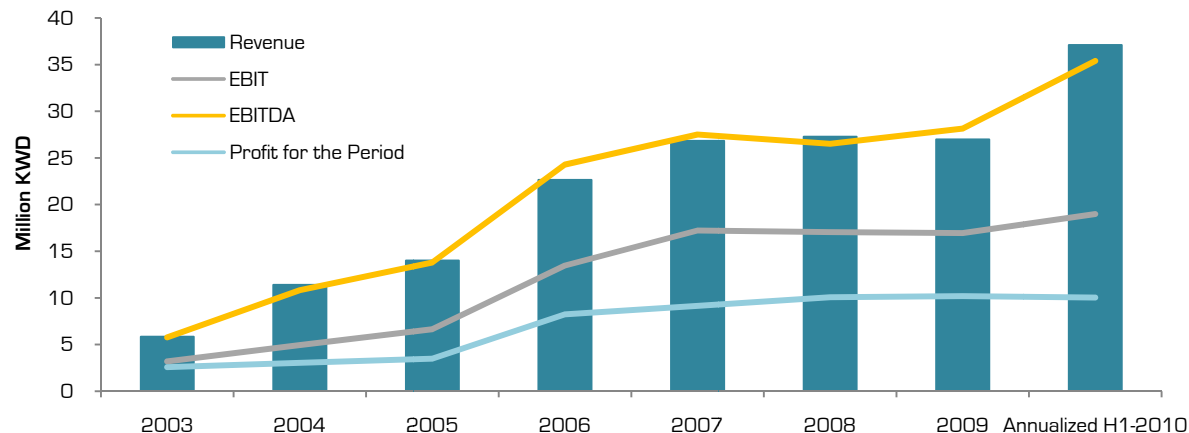
Source: Respective Companies Filings

The graph above ranks the competitors in terms of total assets, where ALAFCO ranks first, followed by ADAVIATION and UPAC. Albeit it may seem that UPAC is ALAFCO's main rival in the region, UPAC's operations and revenue are mainly from construction projects and projects under development; hence, real competition comes from ADAVIATION, which is smaller than ALAFCO in terms of total assets, and EPS. In conclusion, the aircraft leasing industry has high barriers to entry as it requires huge capital and financial backup; this puts ALAFCO in a good position with no threat of current or new competitors for the time being.

Financial performance

Smooth Sailing before September 2008

Figure 6- Revenue, EBIT, EBITDA and Net Profit Trend

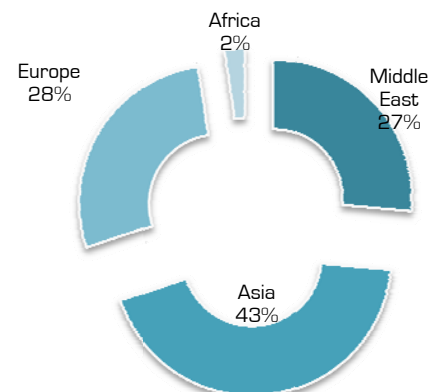


Source: Company Filings

ALAFCO Aviation Lease and Finance Company has demonstrated a firm commitment to its operations and a solid track record of continuous profit. Over the past 7 years, ALAFCO's revenue, constituting of operating lease payments, consultancy and service income and finance lease income, grew at a CAGR of 29%, tracked by net profit at a CAGR 25.8%.

By the end of 2008, ALAFCO's bottom line has been growing on an average of 13.5% over a period of five years, excluding FY06; In the fiscal year 2006 the company received aircrafts with a carrying value of KWD 162.58 million subject to finance lease, which carried ALAFCO's operating lease income (up by 70.5%) and net income (up by 136%) to a whole new level. Moreover, during the year, the company recorded gain from available for sale investment of KWD 2.51 million, contributing to the company's quantum leap in net income during that year. From FY06 and up till FY08, the company maintained a smooth sailing in terms of net income. Amid the financial mayhem, although operating lease income plunged by 7.8% as more airlines put leasing renewal plans on hold dreading the effect of the financial crisis on global airline traffic, an extraordinary income from consultancy services of KWD 2.84 million was recorded (versus KWD 0.47 million in FY07). The latter backed net income to end the year with a growth of 10.1% Y-o-Y basis.

Figure 7- Geographical distribution of revenue as of H1-2010



Source: Company Filings

Most of the company's operating lease income stems from Middle Eastern and Asian airlines; nevertheless, a different trend has been recorded recently as ALAFCO lays additional focus on Africa in 2009. During the financial periods FY09 and H1-2010, the percentage of operating lease income from the Middle East, Europe and Africa to total operating lease grew furthermore, while Asia's share shrank from around 50% to 40% by H1-2010.

Almost Still, But Still Green

In 2009, ALAFCO's operating lease income surged again by 8% compared to FY08, however, consultancy income had a very modest presence on the company's financial statements with a humble KWD 0.56 million. Nevertheless, net income was intact thanks to gain from sale of equipment reaching KWD 3.17 million, an infrequent source of revenue which the company does not expect to find often on its financial statements in the years to come. In other words, ALAFCO managed to record growth in net income of a mere 1.3%, reporting an almost still but green bottom line for FY09.

As mentioned previously in the report, H1-2010 recorded favorable figures for the company, with operating lease income growing circa 53% and net income by 57%; On the other hand, the 9 months 2010 initial result announcement reported sluggish growth in net income of KWD 7.75 million versus the KWD 8.31 million recorded in the comparable period of 2009.

Efficient Cost Control

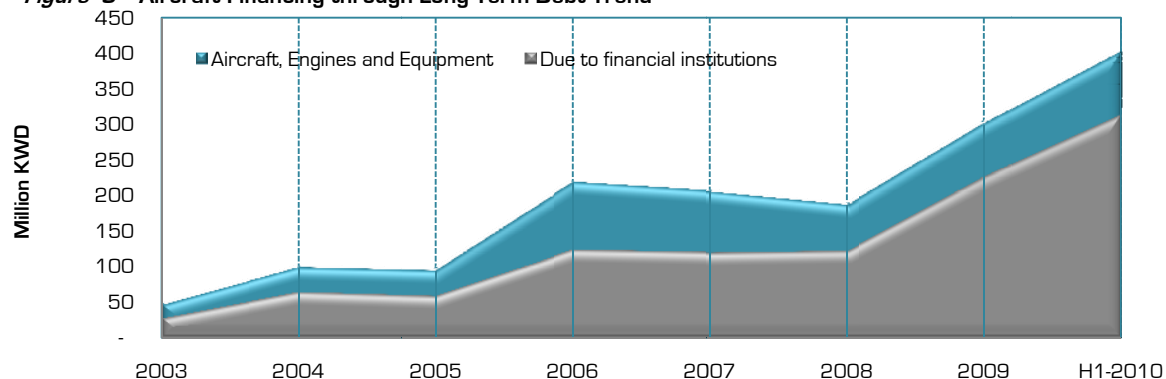
This favorable performance is a result of an efficient cost control strategy; depreciation expense is ALAFCO's main burden (60% of all expenses), a natural attribute to the aviation industry, which stems from the company's largest assets (more than 80% of total assets), aircrafts, engines and equipment. The second largest expense on ALAFCO's P&L statement is finance cost; contributing to circa 30% of this account each year.

Third in line comes the staff cost; ALAFCO's staff cost has been rather small compared to companies in the same domain. The reason for this low cost is the fact that ALAFCO adopts the Dry-Lease strategy rather than a Wet-Lease, which reduces the staff cost tremendously.

Financial Position

Aircrafts, engines and equipment represent more than 80% of total assets, whilst a relatively young asset on ALAFCO's balance sheet which occupies a significant weight is Capital Advances. The company started to book Capital Advances in 2006, representing advance payments with regards to commitments to buy aircrafts and engines which reached KWD 62.9 million out of a total commitment of KWD 934.7 million reported in H1-2010. The percentage of capital advances of ALAFCO's largest asset ranged from 34% in FY08 to 20% in FY09.

Figure 8- Aircraft Financing through Long Term Debt Trend



Source: Company Filings

Furthermore, during FY07 the company entered into a finance lease agreement for an aircraft with a total of KWD 3.05 million which is recorded at its present value on the balance sheet under finance lease receivables; the contract was for a 3 year period and is due to end in September 2010.

Meanwhile, although we would expect a company with ALAFCO's line of business to be heavily leveraged, the account "due to financial institutions" has and still contributes to more than 50% of total assets by H1-2010. Nevertheless, as the company receives new deliveries and plans for more, it is only natural for its debt exposure to widen. The Company's Debt to Asset ratio grew from 46.9% in H1-2009 to 65.4% in H1-2010, whilst aircrafts & engines recorded on the balance sheet grew by 78.7% over the same period. It is worth mentioning that ALAFCO's point of strength on its balance sheet is its long term loans; in fact, financing activities through short term loans is a fatal mistake for companies operating similar lines of business.

Another two liabilities recorded, however are hardly considered as future obligations on the company are "Security Deposits" and "Maintenance Deposits". The former is an amount paid by the lessee as a security in accordance with the lease agreement; whatever remains of the amount is returned to the lessee at the end of the lease agreement period. The latter on the other hand is paid by the lessee as an offset for any maintenance expenses occurring during the lease term; any amounts left by the end of the period are recognized as miscellaneous income on ALAFCO's income statement.

Note that during FY09, ALAFCO managed to secure a total financing of USD 460 million from Ex-Im, European Credit Agencies and other financial institutions. In addition, the company also received preliminary approvals for USD 625 million to finance the 16 aircraft expected to be delivered by the end of the fiscal year 2010.

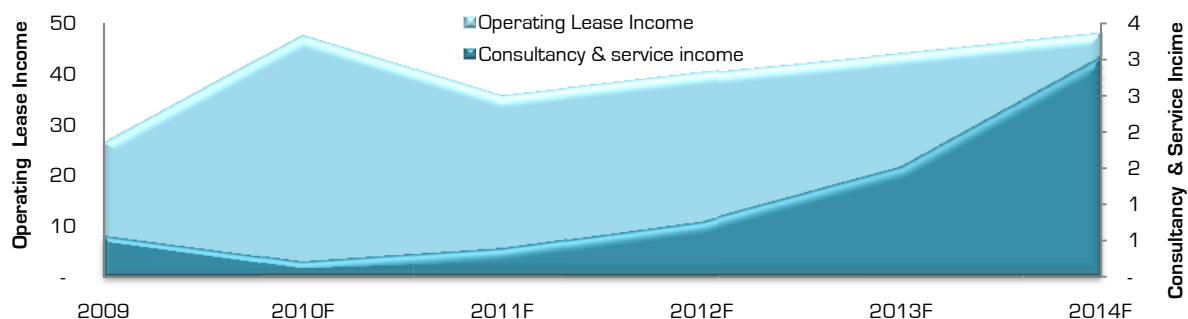
Forecasts

We forecasted ALAFCO's main revenue, income from lease payments, based on the correlation between the latter and the cost of goods sold, which in this case are depreciation expense and finance cost combined. In our forecast, operating lease income is expected to grow on an average of 17.5% over the next five years, whilst cost of goods sold shall grow at a faster pace by 18.2% on average. Earnings before interest, tax, depreciation and amortization are expected to grow on an average of 14.1% over the same period; meanwhile net income is expected to mount by 8.5% per annum over the next five years.

Consultancy Services in the Limelight – 2010

According to our forecasts, ALAFCO's bottom line is expected to grow on an average of 8.5% over the next 5 years, driven by the growth in both operating lease and consultancy services income. According to ALAFCO, the latter account is expected to grow at a faster pace in the foreseen future as compared to its growth in the previous years; we assumed an average growth rate exceeding 60% per annum for the account over the forecast period. Meanwhile, operating lease income is expected to continue to grow on an average of 17.5% over the next five years as mentioned previously and by 81.3% in FY10, Y-o-Y (53.1% in H1-2010).

Figure 9- Operating Lease Income vs. Consultancy & Service Income Forecast (In million KWD)



Source: Company Filings

Furthermore, depreciation expense and finance cost are expected to grow in correspondence with the growth in ALAFCO's aircrafts addition each year; both items are expected to grow at an average of 18.1% over the next five years. We expect ALAFCO to close its FY2010 books at an earnings per share (EPS) of KWD 15.6 versus the KWD 14.8 reported in FY09.

As for the geographical allocation of ALAFCO's revenue, we expect the bulk of revenue to stem from Middle Eastern and African airlines in the future; indeed, according to the IATA, Middle Eastern airlines were on the top of the passenger growth league with over 20% RPK, whilst African airlines saw a growth of 13% in June 2010, YTD.

Higher Liabilities for Higher Assets

ALAFCO is on the verge of a new era using a continuously renewed fleet with an average age of 4.7 years, with the intention of more concentration on consultancy and managerial services. Nevertheless, fixed assets are still expected to grow by an average of 26.6% over the next 5 years net of depreciation, tailed by loans from financial institutions at a rate of 34.1% on average. Forecasts for both accounts were based on ALAFCO's fleet addition per annum.

Moreover, assets and liabilities linked to the company's fixed assets are expected to follow the same trend; we reached our forecast for the items according to information from ALAFCO's management and the historical trend of capital advances and security & maintenance deposits in correspondence with fixed assets.

Valuation

We valued ALAFCO Aviation and Lease Company based on the discounting future cash flow, through discounting the future expected lease payments of the company based on the company's filings.

We dropped the Relative Valuation approach since the aviation market in the region is rather small, consisting of just a few public firms. In other words, the small universe of comparison and averaging the price multiples was a downside to the Relative Valuation approach.

Discounted Lease Payments

We used the company's expected fleet addition over the next five years to forecast the future lease payments for the fleet; furthermore we used a weighted average cost of capital of 5.41% and an expected growth rate of circa 2%. Discounting future lease payments for a 5 year horizon to their present value resulted in a fair value for the stock of KWD 0.221.

Table 3 - Sensitivity analysis in (KWD) to WACC and Growth

		WACC				
		5.21%	5.31%	5.41%	5.51%	5.61%
Growth	2.2%	0.457	0.388	0.324	0.264	0.207
	2.1%	0.396	0.332	0.271	0.214	0.160
	2.0%	0.339	0.278	0.221	0.167	0.116
	1.9%	0.285	0.228	0.174	0.122	0.074
	1.8%	0.235	0.180	0.129	0.080	0.034

Conclusion

Given the company's and the industry's nature, we granted the discounted cash flows approach the full weight in our valuation approach. We hence reached a value of KWD 0.221 for ALAFCO's share, representing a 20% upside from the current price level (as of 15 August 2010). We therefore believe that the current price does not reflect ALAFCO's growth prospects, which suggests an **"Undervalued"** rating, in our opinion.

Table 4 – ALAFCO Equity Valuation

in KWD	Value	Weight	Weighted Value
DLP	0.221	100%	0.221
Fair Value			0.221
Current price as of August 15, 2010			0.184
Potential upside/ (downside)			20.0%

APPENDICES

Balance sheet

KWD Million	FY09A	FY10F	FY11F	FY12F	FY13F	FY14F
Assets						
Aircraft, Engines and Equipment	299.52	527.05	614.89	707.12	801.55	898.17
Capital advances	59.54	72.00	84.00	96.60	109.50	122.70
receivables	1.65	1.22	1.43	1.64	1.86	2.09
finance lease receivables	1.82	-	-	-	-	-
Cash and balances with financial institutions & short term Murabahas	27.71	68.74	76.38	99.84	113.55	135.88
Total Assets	390.23	669.02	776.70	905.20	1,026.46	1,158.83
Liabilities						
Due to financial institutions	224.89	444.89	544.89	649.89	757.39	867.39
Security deposits	30.78	53.79	62.76	72.17	81.81	91.67
Maintenance reserve	7.03	14.06	16.41	18.87	21.39	23.97
Other Liabilities	33.97	54.95	48.77	53.98	49.73	49.66
Total Liabilities	296.67	567.69	672.82	794.90	910.31	1,032.68
Equity						
Share Capital	68.76	74.26	79.09	84.23	89.71	95.54
Share Premium	1.16	1.16	1.16	1.16	1.16	1.16
Statutory Reserve	4.80	6.00	6.92	8.01	9.27	10.76
Foreign currency translation reserve	0.18	1.88	0.37	1.46	0.73	2.19
Retained earnings	18.65	18.02	16.33	15.43	15.28	16.50
Total Equity	93.56	101.32	103.88	110.30	116.15	126.15
Total Equity and Liabilities	390.23	669.02	776.70	905.20	1,026.46	1,158.83

Income Statement

KWD Million	FY09A	FY10F	FY11F	FY12F	FY13F	FY14F
Operating Lease Income	26.29	47.67	35.67	40.20	44.06	48.00
Consultancy & service income	0.56	0.19	0.38	0.76	1.52	3.04
Finance lease income	0.14	-	-	-	-	-
Murabaha income	0.10	0.20	0.21	0.23	0.25	0.26
Gain on disposal of PPE	3.17	-	-	-	-	-
other income	0.13	0.02	-	-	-	-
Staff costs	(1.30)	(2.00)	(1.49)	(1.68)	(1.85)	(2.01)
Depreciation	(11.19)	(22.47)	(12.16)	(12.77)	(13.07)	(13.38)
Finance costs	(6.29)	(9.84)	(12.05)	(14.38)	(16.76)	(19.19)
Other operating expenses	(0.90)	(1.49)	(1.12)	(1.26)	(1.38)	(1.50)
Directors' fees	(0.06)	(0.12)	(0.09)	(0.10)	(0.11)	(0.12)
Profit before taxes	10.65	12.16	9.35	11.00	12.67	15.10
Contribution to KFAS	(0.11)	(0.11)	(0.08)	(0.10)	(0.11)	(0.14)
NLST	(0.10)	(0.17)	(0.13)	(0.16)	(0.18)	(0.22)
Zakat	(0.27)	(0.31)	(0.24)	(0.28)	(0.32)	(0.38)
Profit for the Period	10.18	11.57	8.89	10.47	12.06	14.37
Basic & diluted earnings per share (fils)	14.81	15.58	11.97	14.09	16.24	19.35

Ratios

	FY09A	FY10F	FY11F	FY12F	FY13F	FY14F
Current ratio	91.76%	127.33%	159.55%	188.00%	232.08%	277.80%
Receivables turnover	9.31	56.26	27.19	26.68	26.02	25.86
Days Sales Outstanding	39.19	6.49	13.43	13.68	14.03	14.11
Operating Profit margin	62.78%	45.98%	59.37%	61.96%	64.56%	67.19%
Net Profit margin	37.72%	24.18%	24.67%	25.55%	26.45%	28.16%
Return on total capital	3.20%	2.12%	1.37%	1.38%	1.38%	1.45%
Return on average equity	11.66%	11.88%	8.67%	9.77%	10.65%	11.86%
LT Debt to Equity ratio	2.40	4.39	5.25	5.89	6.52	6.88
Total Liabilities/ Equity ratio	3.17	5.60	6.48	7.21	7.84	8.19
EPS Growth	1.30%	5.23%	-23.16%	17.69%	15.20%	19.18%

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