

Konstantin Romanov, Senior analyst,
RomanovK@sovlink.ru

Aeroflot: moderately positive 3Q2011 IFRS results

Target price: -
Upside: -

Stock data

Ticker	AFLT	M.Cap, \$ mn	1 562
Shares Ords	1 110 616 299	EV, \$ mn	3 228
Shares Pref	-	Free Float	23.4%
Price, Ords, \$	1.41	Free Float, \$ mn	365

Market performance

		1 month	6 months
Absolute	Ords	-15.2%	-44.0%
Relative to RTSI	Ords	-6.4%	-16.6%
Price range, \$			
High	Ords	1.65	2.58
Low	Ords	1.39	1.39

Financials, USD mn

	2010	9M2011	2011E
Revenue	4 319	3 919	5 226
EBITDA	684	629	706
Operating income	499	464	487
Net income	253	384	402

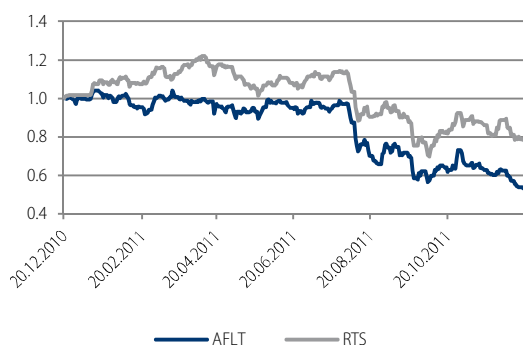
Margins

	2010	9M2011	2011E
EBITDA margin	15.8%	16.0%	13.5%
Operating margin	11.6%	11.8%	9.3%
Net margin	5.9%	9.8%	7.7%

Ratios

	2010	2011E
EV/S	0.75	0.62
EV/EBITDA	4.72	4.57
P/E	6.2	3.9

Relative performance



Source: RTS

AFLT

On December 20, 2011 Aeroflot published 3Q2011 IFRS results, which we see as moderately positive. Company's management also shared some information about strategy and current financial situation in 5 companies, which were acquired on November 15, 2011 from Rostekhnologii. We are still cautious about this acquisition, which will negatively affect Aeroflot financials in the short term, in our view. However, we do not expect this effect to be significant. The upcoming deconsolidation of Terminal D should be positively perceived by investors, in our opinion.

Among key positive factors we highlight the following:

- **Healthy business growth.** Aeroflot revenue surged by 24% y-o-y in 9M2011 due to both increase in passenger turnover and yields growth. The company managed to find the balance between these two rather contradictory goals. We also note that the growth of Aeroflot was not accompanied by significant increase in debt load, which remains at reasonable level (2.0 ND/EBITDA at September 30, 2011).

- **The results outperformed the consensus.** Actual EBITDA for 9M2011 was 20% better than expected, which should be positively perceived by investors. However, the actual net income was only 6% higher than consensus.

- **Acquisition of 5 companies will result in 50% growth in market share of the Group.** According to our estimated, Aeroflot market share will increase from current 24% to more than 35%, which will allow widen routes network, thus improve the quality of services. On some routes we also expect competition weakening.

- **Deconsolidation of Terminal D will allow to decrease company debt by USD 900 mn.** After a merger of all Sheremetyevo assets Aeroflot will get 8.7% stake in a large company, which is expected to be held in future in order to have veto right on key issues, specified in special agreement. However, we note that acquisition of 5 airlines will result in USD 760 mn increase in Aeroflot Group debt.

The factors, which could put pressure on Aeroflot, are the following:

- **High fuel prices.** In 9M2011 fuel cost of Aeroflot surged by 48% y-o-y due to increase in average price by 35% y-o-y to USD 863 per ton. We note that fuel costs account for 37% of all Aeroflot operating costs, thus the company's business is very sensitive to fuel costs increase. Consequently, EBITDA in 9M2011 grew by only 4.0% to USD 629 mn and EBITDA margin declined by 3.1 pp to 16.0% in 9M2011.

- **Acquired companies are loss-making even on EBITDA level.** Management shed some light on current financials of acquired 5 airlines. According to management accounts, the sum of their EBITDA is negative at USD -13 mn and total net loss is USD -12 mn. However, these figures do not look very significant compared to current Aeroflot financials. If we consolidate them, the Group EBITDA would decline by only 2% and net income by only 3%. We think that opportunities, provided by the acquisition, will fully cover the expected losses in the coming years, while these 5 companies will be restructuring.

Aeroflot has published moderately positive 3Q2011 results...

Revenue showed a healthy growth rate due to increase in passenger turnover...

In 9M2011 Aeroflot revenue was up by 24.0% y-o-y to USD 3.9 bn. due to growth in passenger turnover by 11.7% y-o-y and increase in yield per passenger-kilometer. Company's passenger turnover in 9M2011 grew almost in line with the Russian air transportation industry, which showed an increase of 13.6%. Aeroflot remained a market leader with 24% market share in 9M2011. We highlight that Aeroflot concentrated not only on growth in operation results, but also on efficiency: the yield per passenger-kilometer grew by 7% y-o-y in 9M2011, according to company data, and revenue per available seat-kilometer showed the same dynamics. Consequently, the passenger load factor remained at rather high level of 78% in 9M2011. In 3Q2011 revenue showed a growth of 20.7% y-o-y.

... however, operating costs increased quicker, than revenue...

Operating costs increased by 28.4% y-o-y in 9M2011 and by 32.0% y-o-y in 3Q2011. We point to quicker increase in staff costs, which grew by 32.3% in 9M2011. According to the management data, Aeroflot hired personnel in order to service increasing passenger turnover. However, we highlight that labor productivity increased. Passenger turnover per employee increased by 10% y-o-y in 9M2011 and revenue per employee grew by 22% y-o-y.

...due to upsurge in fuel costs by 48% y-o-y in 9M2011

The price for fuel increased significantly in 2011. According to company data, the average price grew by 35% from USD 641 per ton in 9M2010 to USD 863 per ton in 9M2011. The main reason behind this increase in fuel price is growth in oil price and deficit of jet fuel on the local market. The average oil price in 9M2011 was USD 111, which is 42% higher than USD 78 in 9M2010. The total flying time of Aeroflot planes increased by 19.5% y-o-y in 9M2011 to 291 300 hours, which also resulted in fuel costs growth.

Table 1. Key Aeroflot income statement indicators, USD mn

	9M2011	9M2010	Change	Consensus	Difference	3Q2011	3Q2010	Change
Revenue	3 919	3 160	24.0%	3 844	2.0%	1 576	1 306	20.7%
Operating costs	-3 455	-2 692	28.4%	-	-	-1 316	-997	32.0%
- Staff costs	-631	-477	32.3%	-	-	-211	-169	24.5%
- Fuel costs	-1 032	-697	48.1%	-	-	-415	-267	55.7%
Operating income	464	468	-0.8%	-	-	259	309	-16.0%
Operating margin	11.8%	14.8%	-3.0 pp	-	-	16.5%	23.6%	-7.1 pp
Depreciation and amortization	-165	-137	20.4%	-	-	-58	-45	27.2%
EBITDA	629	604	4.0%	523	20.2%	317	354	-10.5%
EBITDA margin	16.0%	19.1%	-3.1 pp	13.6%	+2.4 pp	20.1%	27.1%	-7.0 pp
Net financing costs	-92	-100	-7.9%	-	-	-30	-31	-
Foreign exchange gain (loss)	-88	-10	-	-	-	-186	42	-
Gain (loss) on disposal of investments	199	6	-	-	-	-1	5	-
Net income	384	281	36.6%	363	5.7%	7	263	-97.4%
Net margin	9.8%	8.9%	+0.9 pp	9.4%	+0.4 pp	0.4%	20.2%	-19.8 pp
Net income attributable to shareholders of the Company	396	302	31.0%	-	-	38	251	-84.9%

Source: Aeroflot, SOVLINK

Due to outrunning growth in operating costs, compared to revenue, Aeroflot margins declined to 16.0%

According to our estimates, EBITDA margin declined by 3.1 pp y-o-y from 19.1% in 9M2010 to 16.0% in 9M2011. However, EBITDA showed a moderate growth of 4.0% y-o-y to USD 629 mn. If we look at quarterly results, EBITDA margin dropped even more significantly by 7.0 pp from 27.1% in 3Q2010 to 20.1% in 3Q2011, and EBITDA declined by 10.5% y-o-y to USD 317. The main reason for this dynamics is that the sharpest increase in fuel costs occurred in 2Q and 3Q this year. Operating margin followed the same dynamics.

Foreign exchange loss in 3Q2011 reached USD 186 mn, which negatively affected Aeroflot net income; in 3Q2011 net income was only USD 7 mn, despite high season in summer

In 3Q2011 ruble depreciated dramatically. USDRUB rate increased by 13.5% in 3Q2011 and EURRUB rate grew by 7.5%. This increase in foreign currencies rates resulted in revaluation of all leasing contracts and loans, which are denominated in foreign currencies. We also note that approximately 50% of company's revenue is effectively nominated in euro, consequently, ruble depreciation resulted in revaluation of unearned transportation revenue on the balance sheet also. These revaluations resulted in foreign exchange loss of USD 186 mn in 3Q2011. Consequently, net income in 3Q2011 was only USD 7 mn due to this loss, despite high season in summer. However, in 9M2011 this effect was more than twice less (USD 88 mn) due to ruble appreciation in 1H2011.

Table 2. Key Aeroflot balance sheet indicators, USD mn

	30.09.2011	01.01.2011	Change YTD	30.06.2011	Change
Total assets	4 809	4 526	6.2%	5 347	-10.1%
Working capital	347	77	353%	-136	-
Total debt	2 212	2 047	8.1%	2 163	2.3%
Net debt	1 667	1 387	20.2%	1 287	29.5%
Net debt/EBITDA	2.0	1.7	15.6%	2.1	-3.7%

Source: Aeroflot, SOVLINK

Gain on disposal of investments, which was received in 1H2011, support net income in 9M2011

In 3Q2011 Aeroflot did not sell any assets, which could make any significant effect on its financial results. The net loss on investments in 3Q2011 was only 1 mn. However, we remind that in 1H2011 Aeroflot sold the following non-core assets:

- 100% of Insurance company Moscow;
- 100% in Nordavia;
- 31% in Sheremetyevo Fuel Company.

Nordavia was sold in order not to compete with Russia Airlines, which was acquired in mid-November 2011.

The sale of these 3 companies resulted in pre-tax gain on disposal of investments at USD 200 mn in 1H2011, which supports net income of Aeroflot in 9M2011, which grew by 36.6% y-o-y and reached USD 384 mn. However, if we make a correction for this one-off item, adjusted net income would be only USD 225 mn, which assumes 20% y-o-y decline in 9M2011. Adjusted net income margin in 9M2011 was 5.7%.

Debt load is stable and remains reasonable

Company's debt load looks rather stable: at September 30, 2011 net debt-to-EBITDA ratio was 2.0, which leaves enough room for further development and allows get loans and lease planes at attractive interest rate. According to company data, the average interest rate on finance lease obligations is only 2.9% in 9M2011. We included all financial lease obligations while calculating this ratio. Total debt, including financial lease obligations, grew by 8.1% YTD only in 9M2011.

9M2011 results are above the consensus

All key financials of Aeroflot are above the consensus, which should positively perceived by investors. Due to significant increase in yields, company's EBITDA considerably outperformed the consensus (by more than 20%). The market also anticipated a net loss USD -14 mn in 3Q2011, but larger than expected EBITDA allowed Aeroflot to get USD 7 mn net income. Revenue was almost in line with consensus: actual figure was only 2.0% higher, compared to expectations.

...and shed some light on 5 companies acquisition

On November 15, 2011 Aeroflot acquired 5 airlines from Rostekhnologii for 3.55% of its own shares

Aeroflot bought the following assets:

- Vladivostok Avia (52.2%);
- Russia Airlines (75% - 1 share);
- Saratov Airlines (51%);
- Sakhalin Airlines (100%);
- Orenburg Airlines (100%).

Consequently, all the balance sheet indicators of these companies will be fully consolidated in FY2011 results of Aeroflot Group. Income statement figure will be included only for second half of 4Q2011.

Aeroflot has a clear strategy for further development of these companies

Aeroflot standalone is expected to work in the premium segment of the Russian market and on the most of international airlines. All the subsidiaries will work as regional companies and their main goal will be to support Aeroflot business. All the tickets will be distributed through Aeroflot network only.

Vladivostok Avia is going to work in the Siberia and Far East region; Russia Airlines is expected to cover the North and North-West regions. This was also the reason for sale of Nordavia. Orenburg Airlines could be restructured and work as a charter company. Sakhalin Airlines and Saratov Airlines will become local companies, which operate propjet aircraft.

According to management data, it will take 3 years to make complete restructuring of 5 acquired companies.

Operating results of the Group should improve significantly, but a hard work on efficiency is ahead: the sum of EBITDA of acquired companies is negative

On the meeting with analysts management disclosed key current financials for 5 acquired companies.

According to 9M2011 data, the passenger turnover of Aeroflot Group should increase by 48% due to acquisition and number of passenger carried will increase even more, by 54%. Consequently, we expect the market share of Aeroflot Group to increase from 23.8% in 9M2011 to 35%. The larger market share will help the company to expand considerably its route network. On some routes the yields could improve due to competition weakening.

However, the acquired assets are loss-making even on EBITDA level. The sum of EBITDA of 5 acquired companies in 9M2011 is USD -13 mn, according to management accounting, which is however only 2% of Aeroflot Group EBITDA. We also note some positive dynamics: for comparison, in 9M2010 the EBITDA was USD -38 mn. The net loss in 9M2011 was USD -12 mn, which we expect to increase in 4Q2011 low season. In 9M2011 Aeroflot net income was USD 384 mn, so the current loss of 5 acquired companies accounts for only 3% of net income of the group.

Upcoming deconsolidation of Terminal D will allow to decrease debt load by almost USD 900 mn, but 5 acquired companies have a debt of USD 760 mn

According to the data provided by Aeroflot management on the meeting, the valuation of all assets for Sheremetyevo merger is approved by all the parties including authorities. According to management estimates, there is a chance that the deal could be closed till the end of this year. Aeroflot is expected to get 8.7% of new large company, which will be held in order to have veto right on key issues, specified in special agreement. Consequently, all the financials of Terminal D will be deconsolidated, including USD 900 mn of debt. Due to large debt Terminal D received a net loss of USD -50 mn in 9M2011, however, its operating income was positive and reached USD 52 mn. Now Aeroflot has 52.8% stake in Terminal D and uses consolidation method for accounting its financials.

Despite Aeroflot will be able to deconsolidate USD 900 mn of debt from Terminal D, we highlight that debt and financial leasing obligations of 5 acquired companies is USD 760 mn. Consequently, the net effect will be only USD 140 mn decrease in debt (8% decline in net debt).

Stock recommendations

STRONG BUY:	Upside over 25%; confidence level – high / upside over 100%; confidence level - low
BUY:	Upside between 15 and 25%; confidence level – high / upside between 25% and 100%; confidence level – low
HOLD:	Upside of less than 15%; confidence level – high / upside of less than 25%; confidence level – low
SELL:	Target price at or below current price levels

SOVLINK LLC

Tel.: +7 495 967-1300

Fax: + 7 495 967-1311

Kremlin embankment 1. bld. 2.

Moscow. 119019. Russia

www.sovlink.ru

research@sovlink.ru

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