JM JainMatrix Investments

A quality report by JainMatrix Investments

IndiGo – Spreading Wings but Oil Squeeze

- **Industry – Airlines**
- **Rs 58,000 cr. mkt cap**

- **Date: 09th May 2019**
- **CMP: Rs 1,575, Large Cap**
- **Advice: SELL**

- **Overview:** IndiGo is the market leader in Indian aviation with a low cost carrier model. It has a dominating domestic market share of 46.9%. The revenue and profit were Rs 23,967 crores and Rs 2,242 cr. resp. for FY18. The Income, EBITDA and profits have grown 31.6%, 26.6% and 21.3% CAGR over 8 years. The aggressive growth plans are in place for capacity addition. The Airline industry in India is going to see massive growth. With a big population, low penetration and weak railway sector, it should continue to grow at 15% over next few years. IGO has a strong brand and a leading domestic market share, consistent delivery and high growth. It has executed well on its LCC strategy. IGO has expanded the market with its growth. It will continue to dominate Indian skies due to network effect and good capacity additions. However there are several risks.
- **Key risks:** 1) crude price rise affects ATF prices leading to sharp profit falls 2) large sector capacity adds puts pressure on prices 3) The risk of an engine failure is still there
- **Opinion**: Today crude price is high given the global trade & tariff wars and we will see weak profits in Q4FY19 and the medium future. The IGO share is high due to market share gains, the Jet failure and Boeing grounding, inspite of high ATF prices. The price rise may not sustain due to high PE valuations. IGO is a SELL at current Rs 1,500+ levels. Any future fall below Rs 1,050 can be bought into.

- **On 30th May, 2017 we had published a report for subscribers for a HOLD call at Rs. 1,060 after sharp share price fall on account of a one-time event. The share price is up 49% since then. SIGN UP for the investment service subscription to gain exclusive access to high quality investment reports.**

Here is a note on the IndiGo Airways (IGO).

Description and Profile

- IndiGo is a low-cost carrier airline based in Gurgaon, India and in operation since 2006.
- IGO's revenue and profit were Rs 23,967 crores and Rs 2,242 cr. resp. for FY18.
- Market share based on passenger volume was 46.9% as of Mar 2019 for domestic market.
- Owned by InterGlobe Enterprises, IGO operates over 1,000 daily flights to 59 destinations, 48 in India and 11 abroad. Its base is IGI airport, Delhi. It has a fleet of 220 aircraft including 74 new generation A320 Neo, 130 A320 CEO, 1 A321 Neo 20 and 15 ATRs.
- IGO's domestic ASKs (Available Seat-Kilometer) increased from 5,461 cr. (FY17) to 6,370 cr. (FY18), growing 16.6%. It has an aggressive growth plan, with an order book of 400 A320neos and 125 Airbus A321 wide-body jets. The A321 is a stretched, longer version plane and will help in the international expansion. IGO's maintenance costs are the lowest among Indian carriers.
- Promoters are Rakesh Gangwal and Rahul Bhatia, through InterGlobe Enterprises Pvt Ltd 37.9%, R Gangwal 14.7%, Chinkerpoo Family Trust (Shobha Gangwal, JP Morgan) 13.6%, S Gangwal 8.41% and R Bhatia 0.01%. Shareholding in % is: Promoters 74.9, Institutions 20.1, NII Individual 1.8, others 3.2.

- Leadership team is Ronojoy Dutta (CEO), Wolfgang Prock-Schauer (COO), Riyaz Mohamed (Aircraft Acquisition/ Financing), and Rohit Philip (CFO) and M Damodaran (Chairman).

Business Notes, Strategies and Events

- IGO declared a final dividend of Rs 6/share for FY18 which has a dividend yield of 0.43%.
- IGO bought 12 ATR in Q3FY19 to feed its mainline network in a hub and spoke model, for flights under the GoI regional air connectivity scheme, UDAN (Ude Desh Ka Aam Naagrik).
- IGO reported Q3 profit fell by 75% YoY to Rs 191 cr. due to higher fuel prices and weak INR/USD.
- IGO launched on Delhi-Istanbul sector and will soon link China, Vietnam, UK, Myanmar and S Arabia.
- Aviation veteran Ronojoy Dutta was appointed CEO in Jan 2019 for 5 years. Aditya Ghosh who was CEO left in July 2018 followed a tumultuous year of crises like 1) his presiding over a decision to buy cheaper aircraft 2) inability to handle crisis of Pratt & Whitney engines. SEBI investigated a charge of insider trading for a sharp price fall during his exit but it was inconclusive.
- IGO promoters offloaded 3.2 million shares in Dec 2017 at a price of Rs.1,130 each.
- Pratt & Whitney disclosed a problem related to a "knife-edge seal" on certain engines in 2018, which may have caused several in-flight engine shutdowns. 7 planes of the IGO A320 fleet got grounded. P&W is addressing the problem and IGO should soon get the OK to resume flights.
- A passenger didn’t get entry to his flight inspite of clearing the security checks. The IGO flight was overbooked. This matter went to court and IGO had to pay Rs. 25,000 as compensation.
- IndiGo reported an incident of friction between ground staff and a passenger at Delhi airport. It was resolved after 23 days with an apology from IGO to passenger.
- JetAir had enjoyed market leadership with domestic passenger share of 44% in 2004 and 27.7% in 2007. But by Q1 FY18, Jet posted a first quarterly loss of Rs 1,323 cr. In Feb 2019, it dropped to #4 place with 10% share behind Indigo (43.4%), Spice Jet (13.7%) and AI (12.8%) per DGCA data. By Apr 2019, Jet suspended operations pending bankruptcy or revival processes.
- The global Boeing 737 Max grounding after 2 crashes over 2018-19 has also reduced airplane capacities in India. IGO is not affected but 13 aircraft of SpiceJet were grounded.
- Financial costs are likely to climb further for airlines in the near term, with new accounting standards on leases set to create "significant volatility" in P&L accounts. IndAS 116 came into effect from Apr 2019 and pertains to principles for recognition, presentation and disclosure of leases. The standard would have a quarterly impact in line with Rs/USD changes as IGO leases are priced in USD.
- Aircraft ownership cost comprising aircraft and engine rentals, depreciation and net interest expense increased by just 7.7% to Rs. 3,550 cr. in FY18 even as ASK increased 21.3%.

Indian Aviation Industry Review

- India is the world’s third largest aviation market. Total passenger traffic stood at 22.36 cr. in 2016 and there were 85 international airlines connecting India to over 40 countries.
- In terms of number of seats per capita, India is quite low with 0.1 domestic seats per capita, while Malaysia (1.04), China (0.41), Indonesia (0.49) and Thailand (0.66) are much higher. (FY18)
- Domestic passenger traffic expanded at a CAGR of 13.91% over 3 years.
- Anecdotal evidence shows that the sector is a destroyer of value. Many countries support their national carriers, even though there are losses, as it may be a matter of national prestige.

- IGO operations Fig 1a and Industry market shares are presented in Fig 1b. (Source DGCA).
- The Airline industry is a very tough globally, characterized by high airplane costs (the Airbus and Boeing duopoly), high fuel costs, parking, airport and maintenance charges. Costs are largely fixed. On the other hand, demand is cyclical and varies by season & economic cycle.

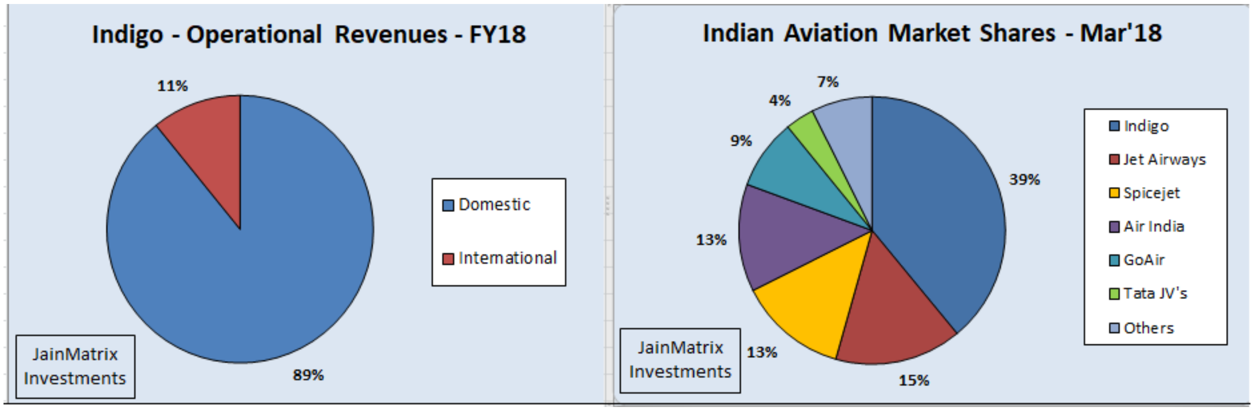


Fig 1a Industry Market Shares and Fig 1b - IGO Operational revenues

- The Indian aviation industry has been aided by the Indian Railways, which has been losing market share, weak capacity growth, poor passenger service levels and slow, obsolescent trains.
- The current fleet in Indian Aviation is 566 commercial aircraft. Indian carriers plan to increase their fleet to 1,300 aircrafts in 1-2 years. (Source: GoI/ Dept of Industrial Policy & Promotion).
- A number of foreign investors are present in India including Airbus, Boeing, AirAsia, Singapore Airlines, Rolls Royce, Frankfurt Airport Services, Honeywell Aerospace, Malaysia Airports Holdings, GE Aviation, Airports Company South Africa Global and Alcoa Fastening Systems Aerospace.
- Indian aviation is experiencing dramatic growth with the emergence of LCC, as well as new carriers, and a growing middle class ready to travel by air for business and leisure.
- Growth in airlines is causing demand growth for MRO (maintenance, repair and overhaul) facilities. Indian authorities plan to double the number of airports to 250 from 102 operating airports.
- The failure of Kingfisher Air indicates the market is not ready to pay prices of 2-3X of LCC tickets.

Stock Evaluation, Performance and Returns

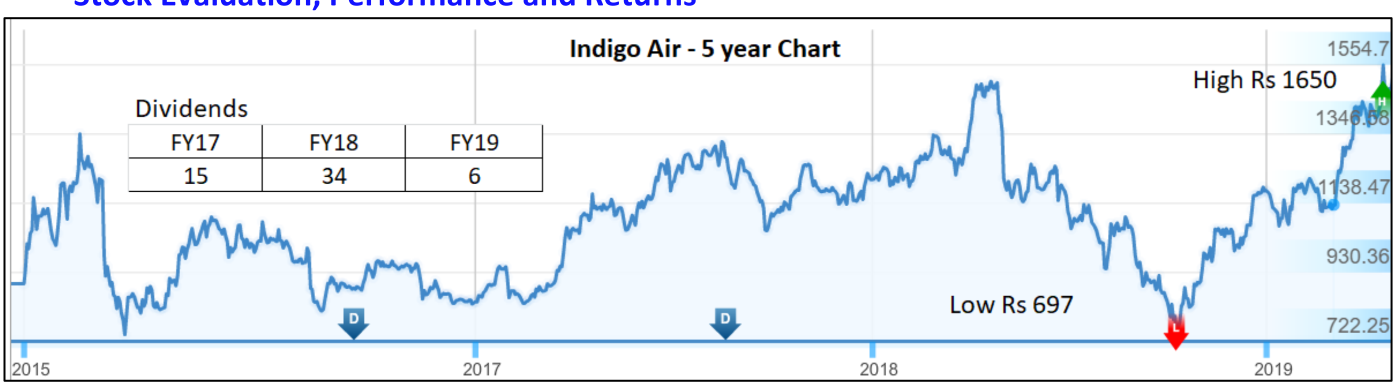


Fig 2 - Price History

- See IGO price history detailed in Fig 2. The IPO was in Nov 2016, at an issue price of Rs. 765, and the share price at Rs 1,515 has gained 116% - good returns. The share had a high of Rs 1,650 in April 2019 and a low of Rs. 697 in Oct 2018, so the share is 8% below the peak and 118% above the low.

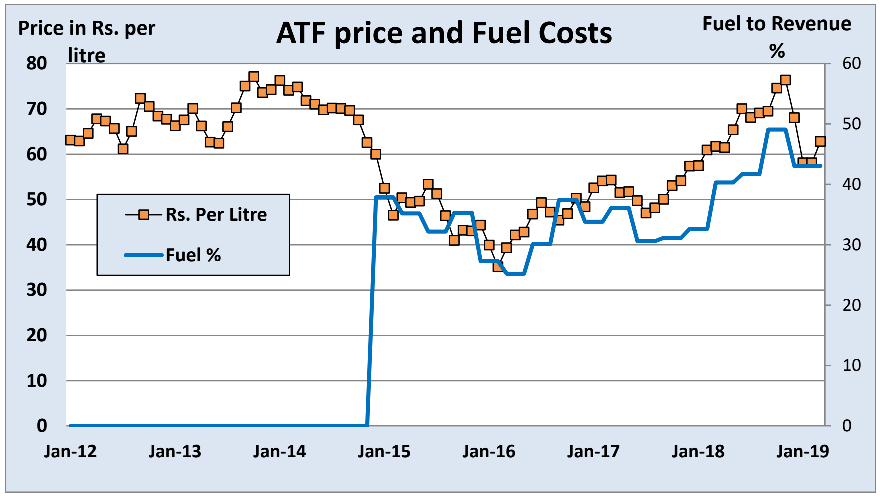


Fig 3a ATF prices

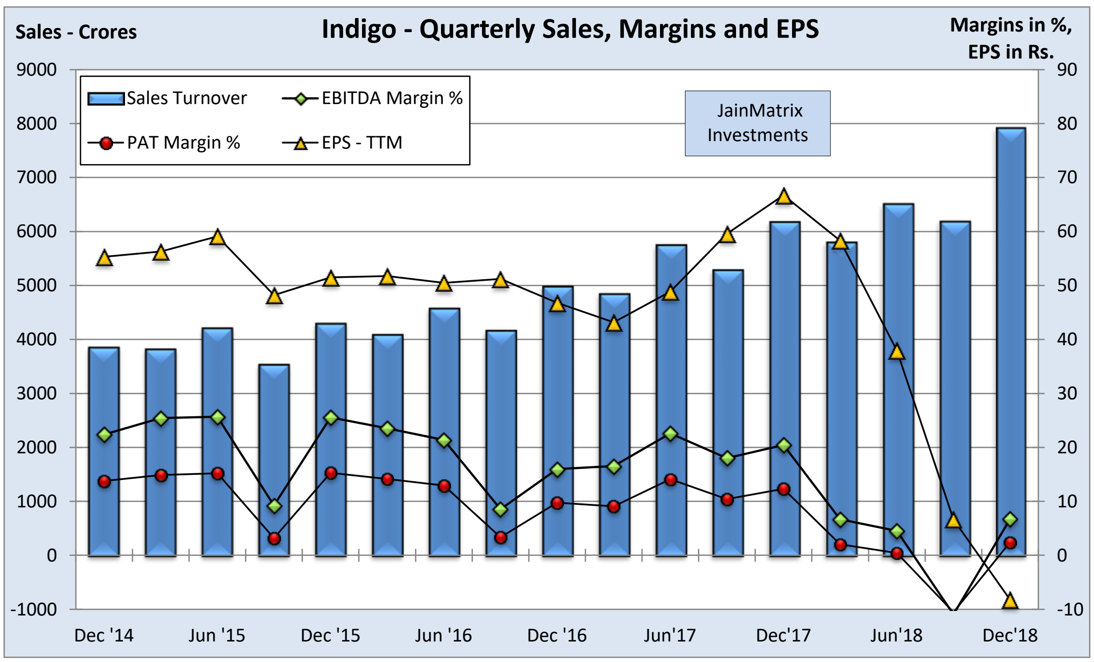
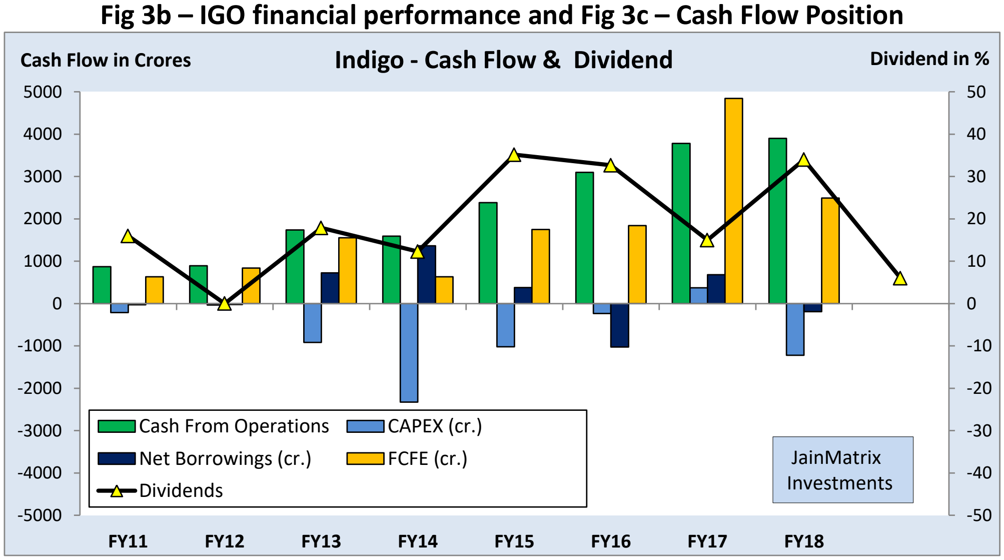


Fig 3b – IGO financial performance and Fig 3c – Cash Flow Position



- A key raw material for Indigo is ATF (Aviation Turbine Fuel), so we track these over 5 yrs., Fig 3a.
- ATF prices rose in CY18, and caused Fuel costs as a % of Revenues to rise, which squeezed margins.
- The quarterly financials of IGO in Fig 3b reveal a steady increase in revenues, but margins and PAT peaked in Dec 2017 then fell due to ATF prices, engine trouble and annual lease payments in Sept.
- The cash flow chart Fig 3c shows that cash flow has been positive with a high in FY17. Dividend peaked in FY17 and was lower in FY18.

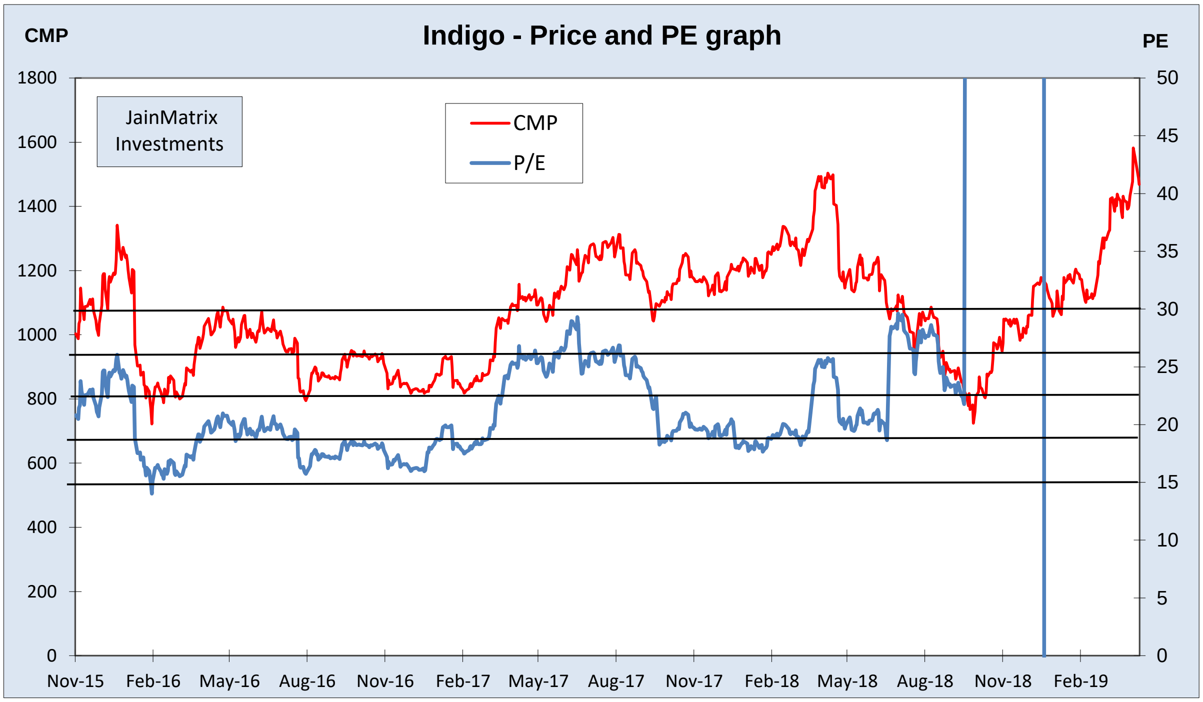
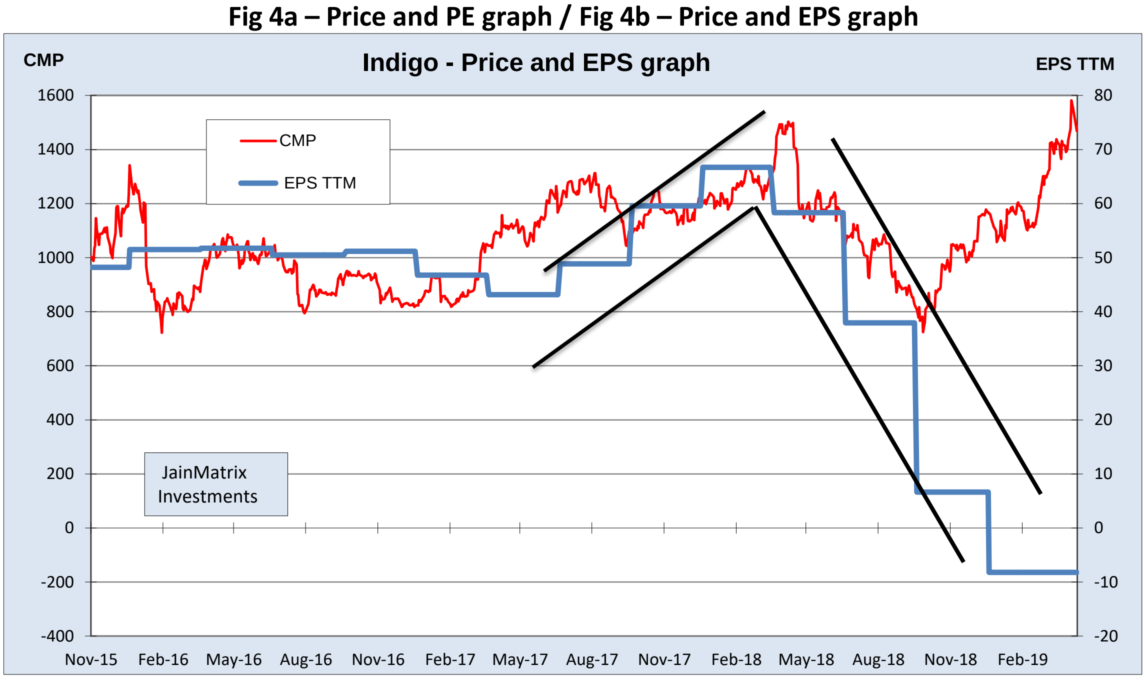


Fig 4a – Price and PE graph / Fig 4b – Price and EPS graph



- The Income, EBITDA and profits have grown 31.6%, 26.6% and 21.3% CAGR over 8 years till FY18.
- The total debt by end FY18 was Rs. 7,298 cr. and is aircraft related, there is no working capital debt.

- The D/E of the firm is at 0.32 times. In fact cash on books is good, and current ratio is 2:1. The margins are fair with Operating and Profit margins 16.3% and 9.4% for FY18.
- The historical PE is 22.5 since listing, see Fig 4a. With quarterly losses however the PE becomes meaningless. We can see that share price has risen anyway.
- The EPS TTM has fallen in the recent quarters, see Fig 4b. This is on account of fall in demand post demonetization (lower yields), higher fuel costs & engine rentals and greater competition.
- The Q2 results every year are weak, perhaps due to annual aircraft lease/ rental payments.
- In the airlines sector, fuel costs are a significant proportion of overall revenues. In this context, we can see IGO's ratio has been volatile and is high currently. See Fig 5a. The aircraft fuel expenses have risen in 2 years whereas engine rentals and the load factor have been flat.
- From the chart below we can see that the yield has fallen significantly over the last 8 quarters. However the management in confident of fast recovery in yields.
- With load factor mostly above 85%, IGO is performing impressively.

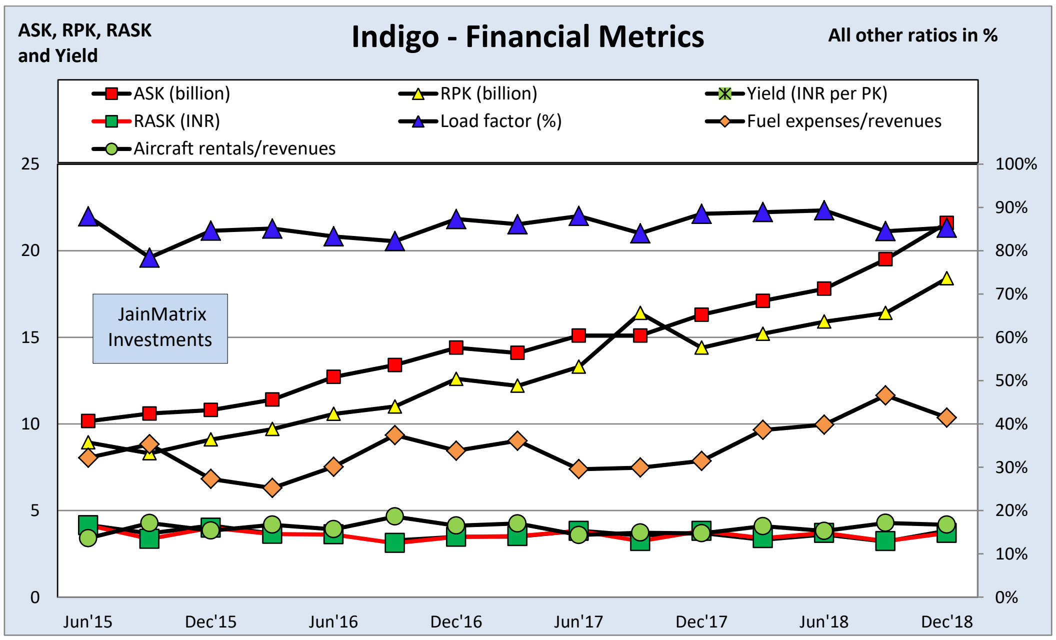


Fig 5a – Financial Metrics / Exhibit 5b – Definitions

Metric	Formulae	Meaning
RASK	Revenue net of finance income/Available Seat Kilometer	A unit of measurement that is used to compare the efficiency of various airlines. Generally, the higher the RASM, the more profitable the airline in question.
Load Factor	Revenue Passenger Kilometer/Available Seat Kilometer	Load Factor is the amount of (revenue) seats sold divided by the total number of seats.
Yield	Passenger Ticket Revenue / Revenue Passenger Kilometer	It's the amount of money paid for the ticket, divided by the distance. The yeild is the amount of money the flight makes.

Benchmarking

We benchmark IGO against listed peers and an Infra asset firm. Based on Exhibit 6, we conclude:

- Sales and PAT Growth has been impressive at IGO over the last 4 years.
- With much of the domestic industry in stress, the PE and returns numbers do not make sense.
- Margins are leading amongst the listed Indian peers.

Airlines are a stressed sector and the firms are not making money.

Partly this is due to high fuel costs and high Aircraft ownership cost. It is also due to capacity additions by players, in a rush for market share. So pricing power is weak. However this has changed in recent times due to the closure of Jet Air and grounding of a Boeing plane. There is a possibility of Jet being revived. It has lucrative international flying slots. However IGO is grabbing share with new planes.

Particulars	Indigo	Spicejet	Jet Airways	Southwest Airlines	Adani Ports
Sales (Rs. in Cr.)	23,967	7,728	25,177	146,128	8,141
EBITDA (Rs.in Cr.)	3,903	881	745	21,329	6,054
Net Profit (Rs. in Cr.)	2,242	557	-725	16,399	2,408
Market Cap (Rs crores)	54,738	5,865	3,021	190,868	78,986
PE (x)	0.00	-10.53	0.00	12.10	21.74
Price to Book Value (x)	7.73	Negative BV	Negative BV	2.91	3.72
3 Yr CAGR Sales (%)	18.67	-11.36	5.14	3.48	20.54
3 Yr CAGR Profit (%)	20.06	-207.23	-29.86	4.16	3.32
Debt to Equity Ratio (x)	0.32	-23.47	-0.73	0.00	1.07
EBITDA Margin (%)	16.29	11.41	2.98	14.60	92.65
Net Profit Margin (%)	9.36	7.26	-3.29	11.22	36.85
RoCE (%)	14.94	55.28	45.47	18.18	14.70
RoE (%)	31.68	-1318.73	10.59	24.31	13.29
Dividend Yield (%)	0.42	0.00	0.00	1.23	0.52

Exhibit 6 – Benchmarking

Positives of the firm

- Airlines have infrastructure characteristics. Once a critical network volume is achieved, financials turn positive. Debts can be easily paid off and incremental capacity is very profitable. IGO has this.
- IGO has joined UDAN, a regional connectivity initiative with new ATRs, to enhance its network.
- IGO has a large market share, high utilizations and ambitious growth plans in one of the largest & fastest growing aviation markets. It plans a 34% increase in ASKs in Q4FY19. With new planes, IGO will expand both domestic and lucrative global routes and grow market share further.
- It's a successful implementation of the LCC business model with virtually single aircraft type, high aircraft utilization, high reliability, no-frills product, and low distribution & maintenance costs.
- Indigo Airlines is a strong brand developed with good ads, marketing strategies and solid execution.
- By placing large Airbus aircraft orders, IGO has gained a structural cost advantage with favorable terms on aircraft, engines and components, and a young, modern and fuel-efficient fleet.
- On delivery, the aircrafts are sold and leased back. This arrangement is capital efficient as it converts fixed costs into variable. The asset light approach keeps capex under control.
- It has maintained consistent profitability and strong cash flow generation in the last 6 years.
- Experienced management with US airline background has executed well so far in the Indian context.
- A number of Airports have been newly constructed, improved or handed over by AAI to private parties for further improvement. This will improve airport capacities.
- A lethargic Indian Railways is slow to upgrade track capacity, trains and railway stations and offers weak competition. The roads are also a slower mode and only slowly improving for passengers.
- The Apr 2019 collapse of Jet has reduced ASKs of the industry by 13%.
- The Boeing grounding has also affected supply. So air ticket prices in May 2019 have risen as much as 100% in last 1 month.

Risks and Negatives

- Crude prices are volatile. In FY18 the ATF price rise pushed all airlines into losses. IGO does not hedge for fuel cost volatility. Hence if fuel costs rise further, it will affect financial performance.
- The quality issues with airplane engines may still not be fully resolved, just swept under a carpet. The risk of an engine failure is still there for IGO Pratt & Whitney engines.
- IGO, like other airlines, faces operational risks such as accidents and terrorism.
- Depreciation of the INR against USD will adversely effect IGO's operations and costs. This has worked in favor of IGO with rupee strength in last 1 year, but can easily reverse.
- With rapid addition of aircrafts by IGO, Spicejet and GoAir, we have already seen hyper-competition in the sector, which pushes down ticket prices and firms face losses, even though the market is growing fast. Jet Air collapse has provided a respite but this can be temporary.
- Airlines are a big cause of pollution due to large use of fossil fuels. There may be increasing pressure on airlines to reduce this in terms of fuel costs, capacity limitations or carbon credit requirements.
- There are high regulatory challenges for IGO including DGCA and AAI compliances, policies and execution and ATF taxes. However the business climate in India is improving.
- There are persistent rumors of corporate governance issues such as insider trading and news leaks.

Opinion, Outlook and Recommendation

- The Airline industry in India is going to see massive growth. With a big population, low penetration and weak railway sector, it should continue to grow at 15% over next few years. A bigger opportunity is in international travel from India. With Jet Air suspending operations, and Air India the only other Indian player, there is a vacuum that IGO can fill for Indians flying abroad.
- IGO has a strong brand and a leading domestic market share, consistent delivery and high growth.
- It has a good track record of execution, reliability, profitability and free cash flows. It will dominate Indian skies due to network effect, capacity additions and good execution on its LCC strategy.
- **Key risks:** 1) crude price rise affects ATF prices leading to sharp profit falls 2) large sector capacity adds puts pressure on prices 3) The risk of an engine failure is still there
- Today crude price is high given the global trade & tariff wars and we will see weak profits in Q4FY19 and the medium future. The IGO share is high due to market share gains, the Jet failure and Boeing grounding, inspite of high ATF prices. The price rise may not sustain due to very high PE valuations.
- IGO is a SELL at current Rs 1,500+ levels. Any future fall below Rs 1,050 can be bought into.

Disclaimer