CAPITAL STANDARDS
AN INDEPENDENT RATING AGENCY

Kuwait Passenger Airline Industry

Report Contents

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Summary

Middle East is emerging as a major aviation force driven by the regions strong economic growth, ambitious expansion plans, and favorable demographics. The majority population in the Middle East, particularly in the Gulf region is non-nationals, which form a sizeable travelling population, primarily to their countries of origin. This is further supported by a rising younger population with high disposable income. The financial crisis has negatively affected the economies of the GCC region, despite that the aviation sector maintained a healthy growth. The GCC countries are highly reliant on the oil sector and hence face major challenges in diversifying the economy. The governments are focusing on real estate, trade, tourism etc to diversify.

The lack of railway network in the GCC region, a vibrant young population, liberalization of aviation sector, and rising disposable income has contributed to the robust growth in air traffic leading to the development of airports, expansion of fleet capacity and entrance of new operators. The region's aviation sector has also been greatly helped by the global market liberalization, which were previously limited by restrictive controls. The major airlines in the region benefits from geographical location, young aircraft fleet, and low operating cost. Most of the airlines focus is on high quality and timeliness at reasonable prices.

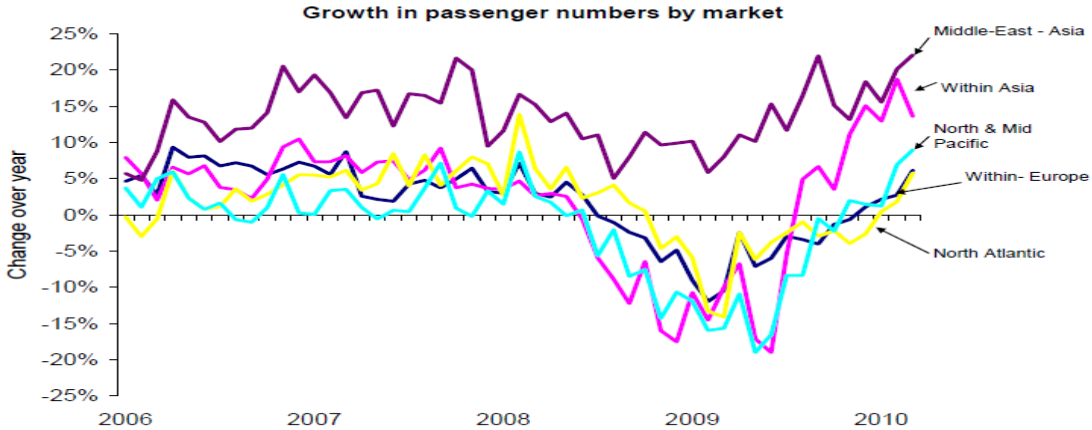
The outlook for aviation sector in GCC is likely to remain strong driven by continued demand for travel, developing infrastructure, and the objective to develop as an international travel hub.

Kuwait aviation sector experienced significant changes with the liberalization and launch of two new airline operators in 2005. This fostered the first private airline, 'Jazeera airways', in the Middle East (also the second low cost carrier), along with a premium service provider, 'Wataniya airways'. However the Kuwait aviation sector continues to remain plagued by its ailing flag carrier, 'Kuwait airways', which is rapidly losing market share, and is shackled with inefficiency.

Snapshot of Kuwait aviation sector

Airlines	Fleet	Established (Year)	PAX (passenger)		Destination
			2008	2009	
Kuwait Airways	19	1942	2.54m	2.59m	40
Wataniya Airways	4	2005	-	0.27m	13
Jazeera Airways	11	2005	1.4m	1.8m	19

Middle East Aviation Industry

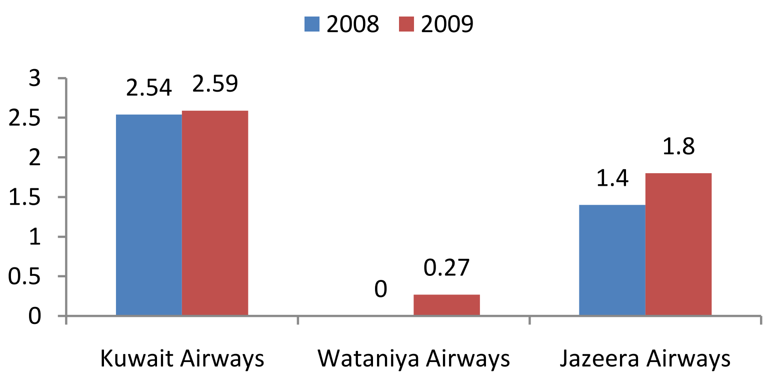


Source: IATA

According to IATA, Middle East outpaced the rest of world in passenger growth in 2009 growing up by 8.5%, and predicted to further grow by 15.2% in 2010. These gains result from Middle Eastern carriers taking a larger share of long-haul connecting traffic over their hubs. Middle East aviation sector is dominated by the big three, Emirates, Qatar and Etihad airways which flew 21.2mn, 8.9mn, and 6.0mn passenger in 2008. There primary objective is to develop as an international hub for passenger travelling across the world. The long haul expansion of Middle East is well established now, and there is an increasing focus towards connecting the region. It is worth noting that different restrictive access rules are still prevalent in many countries in the Middle East, which however is changing rapidly with increasing focus on sharing airspace. There are several factors affecting travel within the region, primary being liberalization, entry of new operators, fleet expansion, younger population and demand for reasonable ticket price. Given the rising disposable income in the Middle East, we expect increased passenger traffic growth in the near future.

Kuwait Airline Industry

Airline passenger traffic in millions



Kuwait's aviation sector is reflective of its economic development, assisted by a vibrant young population, and a large expatriate population travelling to countries of origin. As per IMF, Kuwait has a high GDP per head (USD 38,000), with a strong disposal income. In 2003 the government announced a plan to offer three new licenses to the public- two passenger airlines and one freight airline. The liberalization has significantly transformed the Kuwait aviation sector. In 2005 Jazeera airways was launched as a LCC (low cost carrier), while Wataniya airways started operations in 2009 as a premium airline. The introduction of these two airlines has resulted in:

- Fleet expansions: Jazeera and Wataniya airways introduced 11 and 4 aircraft respectively since starting operations, and have further ordered 32 more aircrafts, to be delivered and introduced in next few years.
- Increased destination connectivity in Middle East, North Africa, Europe and Asia; and
- Price rationalization resulting in increased passenger traffic

The rising demand for air travel has highly congested Kuwait airport, resulting in demand for a second terminal. Kuwait's Directorate General of Civil Aviation (DGCA) is contemplating a new terminal to increase its capacity to 20 mn passengers a year from 6 mn. The expansion project involves the construction of a new terminal building connected to the existing terminal building via a tunnel. The two existing runways will be extended up to 600 meters and a third runway will be constructed. The infrastructure is expected to be completed by 2012, while the overall project, is expected to be completed by 2016.

Intensifying competition: Jazeera and Kuwait Airways stand out as the main competitor in the Kuwait aviation sector, since there is a significant overlap in the networks of these airlines. The launch of Wataniya airways has further added to this competition. Wataniya and Jazeera airways benefit from a younger aircraft fleet and efficient operation. They have been able to exploit most of the weaknesses of Kuwait airways, which suffers from poor punctuality record, and an aging fleet of aircraft. Moreover the private airlines benefit from an efficient and robust management compared to Kuwait airways who suffers from extensive and slow bureaucracy. Competition is expected to intensify further given the focus on expansion, and the government's plan to privatize Kuwait airways. The private airlines are eagerly awaiting the privatization, since Kuwait airways, is expected to lose its competitive edge, driven by benefits from fuel subsidies, airport space rental subsidies, and carrier of government officials.

Kuwait Airways Privatization

Kuwait airways, privatization has been given a principal permission by the government under the Law 6/2008. The airline will be transformed into a private company, with a 35% stake to be sold at auction to foreign or local investors, 40% to be sold to Kuwaiti citizens in an initial public offering, while 20% will be reserved for state-run institutions and the remaining 5% will be distributed for free to the Kuwaiti employees. The airline has an ageing fleet of 19 aircraft which it bought in the early 1990s. The airline is currently involved in litigation with the Iraq government for a USD15 bn compensation for the theft of its fleet during Kuwait invasion. There is an ongoing investigation in the allegations of corruption in the carrier. The parliament rejected a motion to suspend privatization until the audit bureau had reported its findings. According to the minister Mohammed al-Baseeri, the investigation has been completed.

Privatization is a right beginning for Kuwait airways, although the time pressure for restructuring and financial consideration remains a major concern. Kuwait airways has been gradually losing market share and hence privatisation is necessary to compete with local and regional airlines. The airline has also lost resources in the past, given that other airlines have poached on its pilots, engineers and managers. It would be difficult for Kuwait airways to compete in the regional and local market even after privatization given their operational inefficiency, dilution in brand image, lack of clear strategy, and competition from local and regional airlines. The airline stands to lose the benefits of subsidized fuel, and landing facilities, which is almost nonexistent when compared to 25 KD per square meter being paid by private airlines. The airline would also cease to be the official carrier for all government and official trips, for which they receive special prices and benefits.

Airline operators in Kuwait

Kuwait Airways- The flag carrier in the path of being privatized

Kuwait Airways established in 1942 has long been the flag carrier and had a monopoly until the liberalization. Fully owned by the State of Kuwait, it has 16 Airbus aircraft and 3 Boeing, flying to 40 destinations. The airline operates a point-to-point network with both long-haul and short-haul flights. The airline has been rapidly losing market share given a bad record of punctuality, ageing fleet, and intensifying competition from the other two operators.

Financial snapshot

Kuwait parliament has approved the 2010-2011 budget of the airline with a projected deficit of USD180 mn, which is a necessary step towards privatization. The airline's revenue for the fiscal year ending March 31, 2011 is projected at USD853 mn, while expenditure is estimated at USD1.03 bn. The airline is estimated to have made losses of around USD190 mn during 2009-10. Kuwait airways, has posted a loss in all but one of the past 20 years, since the country was invaded by Iraq. This has led to accumulated losses of more than USD2.5 bn.

Kuwait National Airways (Wataniya Airways) - The premium carrier

Wataniya was awarded the second of the two commercial airline licenses offered by the government of Kuwait. The airline commenced operations in January 2009, and has 4 Airbus aircraft connecting 13 destinations from its hub at the Kuwait city airport. The airline would receive delivery of 3 more Airbus aircraft in 2010, and expected expansion plans for the airline are ongoing in the near future. The airline has an exclusive departure and arrival hub at Sheikh Saad terminal, and is primarily focused on providing premium flying experience. The airline currently employs 400 and was the second in the world to introduce an ‘On-Air’ service which allows passengers to use mobile phones and laptop computers in its flights. The airline operates A320 aircraft with only 122 seats, which provides more comfort and space for passengers compared to other airlines. Wataniya is the smallest and the newest player in the Kuwait aviation, and is positioning itself as a premium service provider to differentiate from other airlines.

Financial snapshot

In 2006 the airline completed public offering of 70% of its shares, which increased its capital to KD 50 mn. The airline has made financial losses in 2008 and 2009, given the high operating costs involved in the initial years of operations coupled by the global financial crisis. Wataniya airways has term loans from Commercial Bank of Kuwait (CBK), worth KD 2.1mn secured by financial assets worth KD2.9 mn, and is payable in 2014. The airline’s short term liabilities remain high at KD23.9 mn as of FY2009, and include KD 9.6 mn of term loans payable to CBK in year 2010. Wataniya airways reported 153% increase in operating profits for the quarter ending March 2010, reflecting increased passenger volumes. However, the airline continued to make net losses, on account of high administrative & distribution expenses, driven largely by fleet expansion, and other costs like addition of new destinations.

Jazeera Airways- The LCC

Established in 2004 Jazeera airways, was the first entirely private airline in the Middle East. The airline started operations in October 2005, and positioned itself as a LCC operator in Kuwait. Jazeera airways, has grown to become the second largest airline in Kuwait, and is highly popularizing the low-cost carriers in the Middle East. As per Kuwait DGCA, in July 2009 25% of the take-offs at Kuwait International Airport is a Jazeera airways aircraft taking-off, and also one of every four passengers traveling to- or- from Kuwait, has chosen Jazeera airways as their preferred airline. Jazeera airways have been gradually increasing its market share at the expense of the incumbent Kuwait airways. The airline used to operate from two hubs in Dubai and Kuwait, although they have restructured and now operates only from Kuwait hub, with the focus of gaining the largest market share in Kuwait. Jazeera airways operating model allows for significant cost reductions, which it passes to passengers in the form of lower fares, resulting in increased traffic demand in the operating routes.

Leading Market share: In 2009, the airline carried over 1.8 mn passengers, capturing over 22% of the market share, and becoming the largest operator at Kuwait Airport. Jazeera has gained leading market share among Kuwait-based airlines on the most competitive routes served from Kuwait. As per Kuwait DGCA, for the month of May 2010, Jazeera had a market share of 31% on the Kuwait-Beirut route, 49% on Sharm El Sheikh route, 19% on Kuwait-Dubai , 20% on Kuwait-Bahrain route, 34% on the Kuwait-Amman route, 46% on the Kuwait-Damascus route, and 55% market share on the Kuwait-Luxor route. This reflects the aggressive and competitive pricing of Jazeera airways on various routes along-with suitable connectivity, timeliness, and operational efficiency.

Financial snapshot

Jazeera reported operating losses in 2009, due to significant increase in lease rentals, ground handling & landing charges, and lease maintenance, though partly offset by lower fuel charges. The airline's revenue declined 5.5% to KD 46mn, and is reflective of the global financial crisis, H1N1 disease, and pricing pressure due to overcapacity in the market. The airlines average fare and RPK (Revenue per seat km) declined for 2009 while the ASK (Average seats per km) increased by 0.91 bn for the year ending 2009. Leverage continued to remain high at 140.8%, which is much higher than Wataniya and the ME airline average, and is primarily the result of fleet expansion. Although leverage ratio has historically been high, Capital Standards CSR is more concerned with the gradual shift toward short term debt, and a weak liquidity in the financial market.

Conclusion- The future looks promising

The Kuwait aviation sector benefits from favorable demographics with high disposable income, and hence, presents the potential for strong growth in the near future. The aviation industry is known to have high operating leverage, due to high fixed-cost structure. Hence minor changes in passenger traffic or fare structure could lead to fluctuations in operating results. Furthermore, LCC's like Jazeera airways is dependent on high passenger traffic, which is directly influenced by trade and tourism. It is worth noting that tourism activity is almost non-existent in Kuwait, which limits growth potentials. However Kuwait's geographic location, growing trade and regional tourism should stimulate the growth in the aviation sector.

List of Related Research

- Center for Asia Pacific Aviation (http://www.centreforaviation.com/)
- The Economist (http://www.economist.com/world/middle-east/)
- IATA (http://www.iata.org/WORLDWIDE/Pages/index.aspx)
- Zawya (http://zawya.com); Jazeera and Wataniya airways annual report

Appendix

Key financial information of the Kuwait airline sector

KD thousand	Kuwait Airways	Jazeera Airways	Wataniya Airways
Fleet size	19	11	4
Passenger traffic	2.6	1.8	0.3
Market share (as per passengers flying from Kuwait)	32%	22%	3%
Destination	40	19	13
Passenger Load factor	71.5	60.8	NA
Revenue per seat km (RPK)	7,687	2,439	NA
Average seat per km (ASK)	10,751	4,010	NA
Revenue	NA	46,009	22,195
Net profit	NA	(8,204)	(10,897)
Total assets	NA	73,738	79,201
Short term debt (inc. current portion of LT debt)	NA	13,710	10,771
Long term debt	NA	13,772	2,100
Paid-up capital	350,000	21,999	50,000
Shareholder equity	NA	19,521	38,639
Market capitalization	NL	220,000	491,420

Information on RPK, ASK, and Load factor is not available for Wataniya airways. Hence we could not compare the performance of the 3 airlines on these factors.

Peer comparison as of 2009

Percentage (%)	Jazeera Airways	Wataniya Airways	ME airlines average
Debt/Assets	37.3	16.3	26.5
Debt/Equity	140.8	33.3	72.6
Operating margin	(21.6)	(44.3)	1.4
Net margin	(17.8)	(49.1)	(0.4)
Return on equity	(42.0)	(28.2)	(1.0)

Note: The peer comparison of Kuwait airlines is limited due to the non-availability of Kuwait airways financials

Source: Zawya, Company reports, CSR analysis

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