



Yale School of Management

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AirTran Holdings, Inc (AAI)

October 28, 2002

Time Frame

12 Months

Recommendation

BUY

Recommendations:

Buy: >20% Undervalued

Hold: Fair Market Value

Sell: >20% Overvalued

As of close 10/25/02:

AAI \$3.97

% Change (TTM) 0.51%

Target Price \$6.32

Implied Return 59%

S&P 500 897.65

% Change (TTM) (18.40%)

Airline Index 37.83

% Change (TTM) (45.92%)

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“Riding Smoothly In Turbulence”

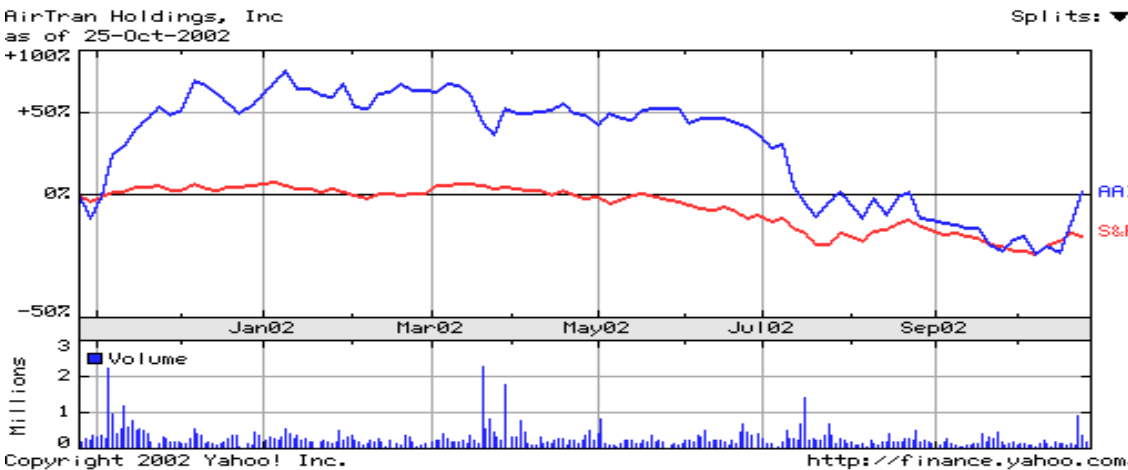
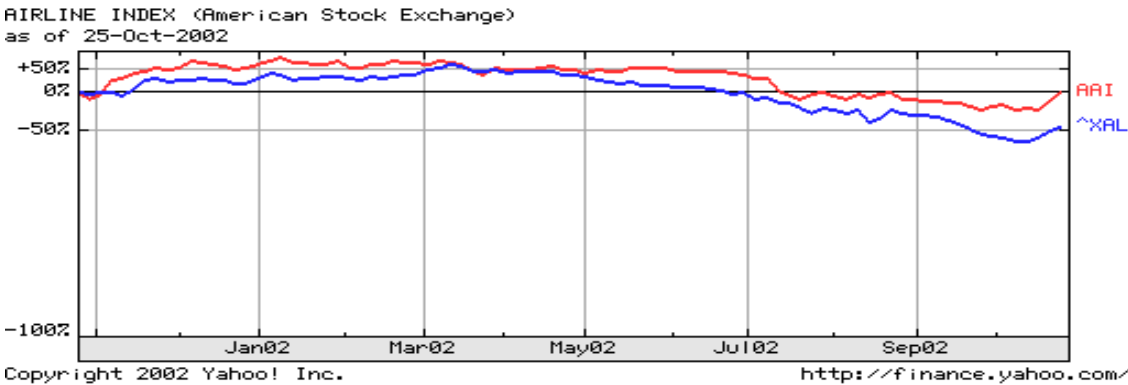
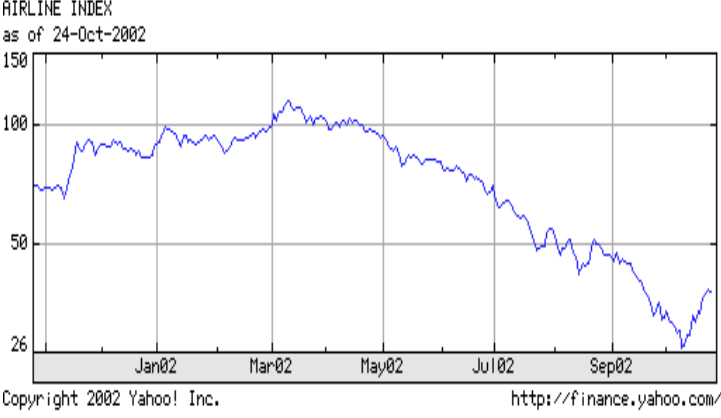
“We feel good about the fact that in probably the worst 12 month period in the history of aviation we’re standing stronger today than we were a year ago” - Robert Fornaro

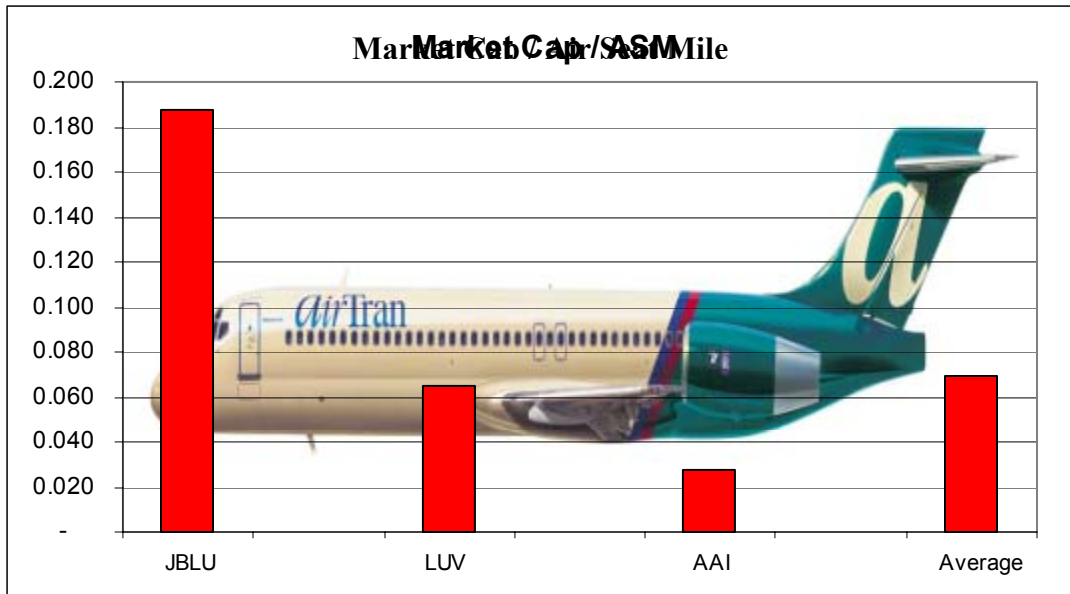
- Currently trading well below its immediate competitors despite its similar business strategy and recent impressive performance
- Cost structures estimated to drop considerably with fuel-efficient fleet replacement
- Inherent company risks include high leverage and dependence on Atlanta hub in face of Delta competition. But its arrangement with other feeder airlines will attract on-local traffic.
- At \$3.97 per share, AAI is a long term buy opportunity as it compares with its peers and exhibits favorable upside potential





Current Trading Statistics







Introduction and History

AirTran Holdings, a progression of the legacy ValuJet Airline, has had an interesting turn-around history. Airline veterans, Robert Priddy, Maurice Gallagher, and Timothy Flynn, founded ValuJet in 1992, basing it in Atlanta. By year-end, the company operated six aircraft on 34 daily flights to Fort Lauderdale, Jacksonville, Orlando, and Tampa, Florida. By late 1994, it flew 22 jets between 16 cities, mainly in the Southeast. ValuJet continued to expand, linking Washington, DC to Chicago and Montreal in 1995 and to New York in 1996.

In May 1996 a ValuJet DC-9 crashed in the Florida Everglades, killing all 110 people aboard. The FAA reviewed the company's safety and maintenance procedures after the crash, forcing the airline to shut down for 15 weeks. ValuJet resumed flights in September, offering \$19 one-way flights to lure back passengers. Turnaround specialist Joseph Corr, formerly of TWA and Continental Airlines, came aboard in November as CEO to help ValuJet change its course.¹

To recover passenger bookings, the airline joined the SABRE computer reservation system in 1997, sparking a 60% increase in SABRE bookings. That year ValuJet acquired AirTran Airways through its purchase of Airways Corporation, rebranded itself as AirTran Airlines, kicked off an advertising campaign to overhaul its image, and moved to Orlando. In 1999 Joseph Leonard, a former Eastern Airlines executive, succeeded Corr as CEO. That year AirTran began to replace aging aircraft by taking delivery of new Boeing 717 regional jets, becoming the first airline to use that new aircraft model.²

An industry-wide move to merge operations followed United Airline's announcement to buy US Airways in 2000 -- and AirTran was no exception. It began to circle ailing giant TWA, but talks between the two airlines ended shortly after they began. Also, during 2000, AirTran transferred to the American Stock Exchange from the NASDAQ.

In 2001, AirTran retired the last of its Boeing 737s as it continued to update its fleet with Boeing 717 jets. This will be discussed in more detail later in this report.

¹ Dow Jones Interactive. 10/25/2002.

² Wall Street Journal. "Airtran Swings to Third Quarter Profit." 10/24/2002.



Business Strategy

AirTran Holdings is determined to make air transportation cheaper and easier. The Orlando based holding company flies business and leisure passengers and focuses on those passengers with low fare requirements. With a fleet of 64 aircraft, the airline serves more than 35 US destinations (mostly eastern and Midwestern), originating mainly from its Atlanta hub. AirTran offers about 360 flights per day, which includes more than 145 daily departures from Atlanta, where it is the second-largest carrier (behind Delta, which handles most of the traffic at Hartsfield International Airport), the benefits of which will be mentioned in the next section.

The company tempts travelers with its low-fare, short-haul, and ticket-less service (but with assigned seating). AirTran is replacing its older jets with Boeing 717s; it was the first airline to use the new, fuel-efficient jets.³ The impact of this will be discussed in the valuation section of this report.

The airline has agreements with several major carriers, including United and Delta, for such services as ticketing and baggage handling for customers who fly outside AirTran's network. The airline is also considering establishing a second, smaller hub to reduce its heavy reliance on Atlanta.

Fleet

Commercial Jet Fleet

AirTran is currently in the process of converting its entire fleet to the Boeing 717 aircraft. In fact, AirTran was the initial launch customer for the Boeing 717, which is the newest commercial jet available and has significantly lower operating costs compared to the DC-9 (began flying in 1965). AirTran attributes much of its success in reducing unit costs and increasing aircraft utilization to the introduction of the 717. Some key points relating to the 717 are:

- AirTran realized \$4.4 million of total savings in fuel expense for the first six months of 2002. The 717 uses approximately 25% less fuel than the DC-9.⁴
- Maintenance, materials and repairs declined 27.3 percent from Q2 2001 to Q2 2002, and 37.8 percent for the first six months of 2002. Primary causes for the reductions in

³ Dow Jones Interactive. 10/25/2002.

⁴ Earnings Conference Call 2002 Q3.



maintenance expense are the reduced requirements associated with the Boeing 717 aircraft compared to the DC-9s, and fewer heavy maintenance checks than the older DC-9s.

- Currently flying forty-four 717s and twenty DC-9s. ASM Costs are \$.063 for the 717 compared to \$.09 for the DC-9
- All 717s are financed with operating leases which are not capitalized.
- By the end of 2003, AirTran should be completely converted to the 717 aircraft type.

New RJ Fleet

AirTran recently announced the beginning of a new feeder airline, called Jet Connect. Like the 717s, these regional jets (Brazilian ERJs) are known for their efficiency and maintainability. Utilizing RJ's for their thinner, shorter routes will allow AirTran to focus its 717 aircraft and crews to longer, denser routes. This will result in higher utilization per day and increased load factors.

Route Structure

AirTran's major hub of operations is Atlanta, GA. They fly primarily short haul routes, mostly in the north-south directions. Of the 388 daily departures, 152 originate from the Atlanta hub, flying to both leisure and business destinations. The plans for Q4 2002 include increasing the proportion of east-west flights. Delta Airlines also uses Atlanta as its major base of operations and has exerted significant competitive pressure in the past. At the current time, Delta and AirTran seem to be peacefully coexisting in Atlanta. (See AirTran's Route Map below.)





Competitive Landscape

Competition from Mainline Carriers

AirTran's most significant mainline competition comes from its Atlanta based rival, Delta. AirTran competes with Delta on every route AirTran serves. In AirTran's 2002 Q2 earnings conference call, the management team noted, "Delta is applying all the pressures that they know how and that's been pretty consistent. Our planning going forward considers that this won't change, it will remain immensely competitive." AirTran's core customers differ from those of mainline carriers in the quest for quality and the cheapest possible fare. AirTran is just now starting to implement frequent flyer programs to help them compete more effectively with other carriers who offer similar customer benefits. AirTran's significantly lower unit costs enable them to offer lower fares than any major carrier. Mainline carriers are currently unable to absorb the losses necessary to undercut AirTran's fares, as a result they will not be able to steal market share from AirTran.

Competition from Low Cost Carriers

AirTran competes directly with low fare carriers in many of their routes. JetBlue and Southwest are typical competitors. In the low fare arena, airlines compete not only at their specific airfield but all those fields within the reach of a short drive or public transportation. Management acknowledged, "As far as Southwest goes, we compete with Southwest in almost all of our markets but generally not directly. We go to Boston they go to Providence ... So we compete for the same flows but typically, not head-to-head in the same markets and we anticipate that situation will remain the same."⁵ At \$.0632 per seat mile, AirTran's cost structure is competitive with other low fare carriers. They are able to match prices with most any carrier they compete with.⁶ Unlike JetBlue and Southwest AirTran is launching "Jet Connect", a connector airline that will help feed the mainline operations out of Atlanta and fly smaller more efficient jets on their less popular routes and schedules. Jet Connect aircraft and flights will be owned and operated by Air Wisconsin.

⁵ AirTran Earnings Conference Call, 2002 Q2.

⁶ AirTran Earnings Conference Call, 2002 Q3.



Revenue Performance

Overview. AirTran Revenues increased 22% in Q3 2002 to \$183.2 million from \$150.7 million in Q3 2001. Q3 2002 net income is currently \$1.2 million, or 2 cents a share, taking advantage of lower costs and increased traffic. AirTran is continuing to expand service while its competitors are cutting back amid the worst financial crisis the industry has seen in many years. The airline is continuing to attract customers who focus on discounted fares. "We've done a good job of controlling costs," Leonard said. "We work diligently to keep the airline as simple as you can possibly keep it." "The resistance to paying \$1,000 (for airfare) is intense and permanent and we're benefiting from it,"⁷ he said.

- **Increased Capacity and Traffic.** AirTran said it increased capacity nearly 30% this year, helped by the addition of five new Boeing Co. (BA) 717 planes and the retirement of six older DC-9s. The company said traffic increased 29% to 1.43 billion revenue passenger miles from 1.11 billion a year earlier. AirTran also said it served a record 2.4 million customers in the quarter, noting that the third quarter of 2001 included the closing of U.S. air traffic control for several days immediately following the terrorist attacks⁸.
- **Improved Load Factors.** Load factor, or percentage of seats filled, was 58% for September, up from 55.1% a year earlier. Year-earlier traffic was hurt by the airline shutdown for several days following the Sept. 11th attacks and the decline in passenger demand for the rest of the month.
- **Exclusive Contracts.** AirTran Holdings Inc. (AAI) received a contract from the state of Georgia to be a preferred carrier for government-employee travel. The contract, awarded through a competitive bidding process, will allow the low-cost carrier to provide nonstop service between Atlanta and 18 domestic destinations for Georgia state employees.
- **Pricing Discounting and Structures.** AirTran Airways does not require a roundtrip purchase or Saturday night stay.

⁷ Wall Street Journal. "Airtran Swings to Third Quarter Profit." 10/24/2002.

⁸ Q3 2002 Airtran Earnings Call.



The airline offers affordable Business Class service, all-assigned seating, a frequent flier program, and a corporate program called A2B. Earlier this week, AirTran launched a one-day sale with new discounts on seven-day advance purchase tickets to and from Akron/Canton, Chicago (Midway), Greensboro/High Point/Winston-Salem, Minneapolis/St. Paul, Moline/Quad Cities, Newark, Newport News/Williamsburg, Philadelphia and Pittsburgh. These promotional fares are valid through February 10, 2003 and like all AirTran Airways fares, these promotional fares require neither a roundtrip purchase nor a Saturday night stay. Roundtrip fares range from \$88 - \$180, slightly below the industry average of \$180 per 1,000-mile trip⁹.

Cost Improvements

Overview. AirTran has taken advantage of lower costs, and as a result has reported Q3 2002 net income of \$1.2 million, or two cents a share. Company management said they expect to post a profit for the fourth quarter and all of 2002. The company's stock climbed 19% on the news. According to Leonard, it is the first airline that has improved its performance over the past year in the wake of a difficult industry environment. Operating costs per available seat mile declined 8.8% to 8.21 cents from a year earlier.¹⁰

- **Fleet Replacement.** AirTran Holdings Inc.'s (AAI) agreement to lease twenty-three 717s from Boeing Co. (BA) will help the discount carrier further cut costs and expand service. AirTran signed an agreement with Boeing Co. to take delivery of twenty-three 717-200 aircraft by the end of 2003. The move is part of the airline's plan to modernize its fleet by replacing older, gas-consuming DC-9s with larger, fuel-efficient Boeing 717s. During the third quarter 2002, AirTran said its unit costs, or cost per available seat mile, fell 8.4%, excluding fuel. Under the terms, the planes are scheduled to be delivered to AirTran in 2003¹¹. The deliveries include 22 used aircraft that AMR Corp. (AMR) acquired with its acquisition of Trans World Airlines and returned to Boeing. Boeing will reconfigure the planes for AirTran and offer them at

⁹ Business Wire. 10/24/02.

¹⁰ Q3 2002 Airtran Earnings Call.

¹¹ "Airtran Increases Boeing 717 Fleet by 23 Airplanes." Dow Jones News Service. 10/23/2002.



a lower lease rate. The oldest of these planes is 2 years old while the youngest ones have been painted but never flown. All of the leases will be expansible operating leases. The 717 has 11 more seats than its predecessor. The planes will aid in AirTran's recently announced strategy to begin a regional-jet service on Nov. 15th from its Atlanta hub. AirTran plans to use 50-seat regional jets to maintain or increase daily service on some short-distance routes. It plans to redeploy its Boeing 717s to longer-distance routes that attract more traffic.

- **Fleet Retirement.** AirTran said it increased capacity nearly 30%, helped by the addition of five new Boeing Co. (BA) 717 planes and the retirement of six older DC-9s. AirTran has retired aircraft through donation (tax-write-offs) and through secondary market resale. For example, last week, the carrier donated a McDonnell Douglas DC-9-32 to be used in the education of future certified aviation mechanics at Georgia Aviation & Technical College (GAVTC).¹²
- **Government Assistance.** The latest quarter's results, which include a credit of \$600,000 or a penny a share, related to government aid doled out to airlines directly after last year's terrorist attacks, compares with a net loss of \$10.6 million, or 15 cents a share, a year earlier.
- **Ticketing/Distribution.** In Q3 2002, total bookings via Internet were 53%, which reduced distribution expense to \$32.9 million compared with \$36.2 million in 3Q 2001. Through AirTran's sophisticated online systems, corporate and individual customers can now electronically book tickets, select and change seats and cancel ticket reservations online.¹³ Cost reductions associated with this advancement are discussed in the DCF analysis section of this report. This system is a low cost supplemental system to SABRE.

¹² "Airtran Airways Donates Ship 917". Business Wire. 10/24/2002.

¹³ Q3 2002 Earnings Call



Industry Risks

Despite AirTran's recent performance improvements and its positive future earnings potential, the overall industry outlook poses several risks:

- **Reduced Demand Due to a Faltering Economy.** Over short periods, airline travel can be erratic. Over the longer term, airline travel is very cyclical; it waxes and wanes together with consumer sentiment and disposable income levels. Given the current post-9/11 attack sentiment, economic climate, consumer confidence and unemployment levels, the airline traveler's willingness to pay has gone down even further since September 2001. In addition, airlines are plagued by weak demand for business and leisure travel: recent corporate downsizing has left leaner organizations, with fewer managers and executives authorized to travel and leisure travelers turning to ground transportation as a means to save money.
- **Convenience/Service Compromise.** AirTran, like most airlines, is subject to delays caused by factors beyond its control, such as air traffic congestion at airports, adverse weather conditions and heightened security measures. Delays frustrate passengers, reduce aircraft utilization and increase costs, all of which adversely affect profitability. AirTran competes for metropolitan passengers by offering priority check-in, expedited baggage handling, departure punctuality and in-flight amenities. The appeal of its strategy is to provide frequent flights, reliable on-time performance, and top safety records. In the wake of the September 11th attacks, the government recently federalized airport security and hired about 28,000 workers in an effort to alleviate security concerns. **The result: Airline travel has become less appealing amid new security requirements, frequent procedure changes, and a rush to get trained personnel in place.** Short-haul airline shuttle routes, traditionally profitable due to high proportions of business travel, are now being replaced by rental cars and regional rail, as a result of cumbersome airport checks and delays.
- **Labor.** In Q3 2002, labor costs for AirTran amounted to 29.3% of total operating expenses and 28.3% of revenue, while the industry's labor costs average 33% of total operating expenses, up from 28% in December of 2000. Although the industry had reacted promptly after



September 11th with lay-offs of more than 80,000 employees, the rise in labor costs can be explained by lower revenues, and by the normal time lag between employee layoffs and realization of cost savings.¹⁴ Airlines have traditionally suffered from exorbitant union contracts that we believe will be difficult to eradicate from the industry. AirTran recently unionized its FAA-employees, which increased its labor expenses by 34.7% in Q3 2002.¹⁵

- **Fuel Prices and Impending War with Iraq.** AirTran's annual operating cost per available seat mile dropped 8.8% in Q3 2002 to 8.21 cents despite a 0.9% increase in the year-over-year cost of fuel. Excluding the effect of higher fuel costs, AirTran Airways' unit costs are 6.32 cents per mile. Fuel, therefore, represents nearly 30% of AirTran's cost structure because of its inefficient DC-9s. Energy expenses depend on the fuel prices as well as the age of the aircraft and the average flight length.¹⁶ By moving to leasing a new fleet in 2003, AirTran will gain substantial efficiency in fuel consumption and in maintenance costs.

The Prospects of oil prices in 2002 do not look as positive as those in 2001. Fuel costs have risen approximately 50% (\$.25 per gallon) since January. We believe that the possibility of the US declaring war on Iraq will keep oil prices high during 2002, and a long conflict could lead to even higher prices through 2003. Hence, although AirTran has implemented a fuel-hedging program under which it enters into crude oil option contracts to protect against significant increases in fuel prices, the program may not be sufficient to cover material adverse effects on operating results as a consequence of an Iraqi invasion. Therefore, we prefer to stay cautious on this front due to the potential US invasion of Iraq.

¹⁴ Standard & Poor's, Industry Surveys, September 28, 2002.

¹⁵ AirTran Earnings Call Q3 2002.

¹⁶ Standard & Poor's, Industry Surveys, September 28, 2002.



Company Risks

Dependence on Atlanta

AirTran is highly dependent on its operations from Atlanta. If a competitor were able to penetrate that market with similarly low costs, profits would suffer.

Tainted Safety Record

AirTran's ValueJet heritage would have a negative impact on its ability to survive negative media coverage in the event of an accident or major safety incident. Small airlines have increased difficulty coping with public opinions of a "small time" poorly trained organization. Links to ValueJet would only make this worse.

Strong Bets on Boeing's 717 Program

The future of the 717 program is uncertain at this point. Currently, there are only 2 major customers for this aircraft, and Boeing has been grappling with shutting down the line for over three years now. Weak demand provides little incentive to develop new longer-range models, that AirTran has expressed interest in, to help them reach West Coast destinations from Atlanta. If the 717 program is canceled, obsolescence will make 717s more expensive to maintain and AirTran will be unable to grow their fleet with 717's. AirTran will once again be forced to operate multiple airframe types if they want to grow or reach more distant destinations. Multiple aircraft types would increase training and maintenance costs.

Highly leverage and low interest ratio in comparison to peers

The high levels of debt and constrains on sufficient liquidity, place a considerable risk on the company. From our DCF analysis (Exhibit 1), we see a critical cash flow position in 2003, since the free cash flows generated are not sufficient to cover the current levels of debt. Although we believe that this deficit can be compensated with the excess generated in 2002, we still believe that the tight liquidity position of the company represents a risk that investors should look at before investing.



Valuation

We used two main approaches to valuing the company: Comparable Companies Analysis and Discounted Cash Flow Analysis (DCF). Although the comparable companies set is reduced since most airlines have negative earnings, the comparable companies analysis provides an interesting insight into the valuation of AirTran. Further, since there has been no recent transaction activity in the airline industry, we did not include a precedent transaction analysis.

Comparable Companies Analysis

- **Forward P/E.** This method of valuation is the standard practice in the industry. Given the losses expected by most of the players in the industry in 2002, the comparison has to be reduced to the benchmarks provided by the companies producing positive results in 2003 (Southwest, JetBlue, AirTran, and Alaska). Although the set is reduced, it is representative since most of the airlines included have a similar business model, which makes the comparison more sensible. We look primarily at forward P/E ratios using projected earnings in 2003. AirTran's forward P/E amounts to 8x, a 62% discount over the industry median. If we estimate AirTran's share price based upon the median forward P/E of 22x, the resulting target price using our 2003 EPS estimate would be \$10.56. Hence, the comps analysis leads to the conclusion that AirTran stock is undervalued.

| Comparable Companies Analysis | | | | | | | | |
|--------------------------------|----------------------|---------|---------|---------|---------------------------|------------------------|-----------|-----------|
| Company | Price as of 10/25/02 | Q4E | 2002E | 2003E | Next Year Earnings Growth | 5-Year Earnings Growth | P/E 2002E | P/E 2003E |
| JBLU | 36.50 | 0.32 | 1.25 | 1.67 | 33.6% | 25.0% | 29 | 22 |
| ALK | 22.05 | (0.95) | (2.10) | 0.97 | -1.5% | 8.0% | NM | 23 |
| LUV | 15.65 | 0.04 | 0.22 | 0.48 | 118.2% | 14.5% | 71 | 33 |
| DAL | 10.80 | (2.41) | (8.44) | (3.77) | -55.3% | 8.0% | NM | NM |
| MEH | 6.65 | (0.55) | (1.20) | (0.31) | -74.2% | 12.0% | NM | NM |
| CAL | 6.50 | (1.90) | (4.91) | (1.71) | -65.2% | 8.5% | NM | NM |
| AMR | 5.24 | (3.77) | (13.36) | (8.49) | -36.5% | 10.0% | NM | NM |
| ATAH | 4.09 | (1.88) | (5.34) | (1.98) | -62.9% | NM | NM | NM |
| AAI | 3.97 | 0.02 | 0.02 | 0.49 | 2350.0% | 20.0% | 199 | 8 |
| UAL | 2.59 | (10.61) | (35.20) | (22.47) | -36.2% | 8.5% | NM | NM |
| Mean | | | | | | | 100 | 21 |
| Median | | | | | | | 71 | 22 |
| AAI Premium over Industry Mean | | | | | | | 99% | -62% |
| Source: Yahoo! Finance | | | | | | | | |

- **Historical Ratio Performance.** As shown below, the lowest P/E for the airline industry in the past five years was 15.4x. If we apply this lower benchmark to our estimated AirTran 2003 EPS of \$0.48, the resulting price would be \$7.49 per share, suggesting that the current share price is undervalued.

| RATIO COMPARISON | | | | |
|------------------------|---------|----------|--------|---------|
| Valuation Ratios | Company | Industry | Sector | S&P 500 |
| P/E Ratio (TTM) | NM | 39.83 | 26.48 | 24.74 |
| P/E High - Last 5 Yrs. | NA | 35.17 | 45.82 | 49.31 |
| P/E Low - Last 5 Yrs. | NA | 15.4 | 12.66 | 16.85 |



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| Dividends | Company | Industry | Sector | S & P 500 |
|-----------------------------|---------|----------|--------|-----------|
| Dividend Yield | 0 | 0.24 | 1.13 | 2.18 |
| Dividend Yield - 5 Yr. Avg. | 0 | 0.11 | 1.17 | 1.32 |
| Payout Ratio (TTM) | 0 | 2.55 | 22.18 | 28.29 |

| Growth Rates(%) | Company | Industry | Sector | S & P 500 |
|--------------------------------------|---------|----------|--------|-----------|
| Sales (MRQ) vs Qtr. 1 Yr. Ago | -7.35 | 11.53 | 3.64 | 6.17 |
| Sales (TTM) vs TTM 1 Yr. Ago | -10.53 | -7.15 | 0.59 | 2.56 |
| Sales - 5 Yr. Growth Rate | 24.81 | 10.46 | 7.95 | 11.42 |
| EPS (MRQ) vs Qtr. 1 Yr. Ago | -61.45 | -38.72 | 2.95 | 19.37 |
| Capital Spending - 5 Yr. Growth Rate | -24.54 | 15.46 | 3.77 | 10.57 |

| Financial Strength | Company | Industry | Sector | S & P 500 |
|----------------------------|---------|----------|--------|-----------|
| Quick Ratio (MRQ) | 0.41 | 1.35 | 1.11 | 1.1 |
| Current Ratio (MRQ) | 0.76 | 1.59 | 1.35 | 1.64 |
| LT Debt to Equity (MRQ) | 5.06 | 0.89 | 0.61 | 0.7 |
| Total Debt to Equity (MRQ) | 6.08 | 0.95 | 0.64 | 0.97 |
| Interest Coverage (TTM) | 0.14 | 2.77 | 12.24 | 10.04 |

| Profitability Ratios (%) | Company | Industry | Sector | S & P 500 |
|---|---------|----------|--------|-----------|
| Gross Margin (TTM) | 54.85 | 65.9 | 60.4 | 47.49 |
| Gross Margin - 5 Yr. Avg. | 54.37 | 69.69 | 76.28 | 48.57 |
| EBITD Margin (TTM) | 3.94 | 9.4 | 18.21 | 21.27 |
| EBITD - 5 Yr. Avg. Operating Margin (TTM) | -2.91 | 17 | 18.03 | 22.31 |
| Operating Margin - 5 Yr. Avg. | 0.71 | 3.35 | 11.1 | 18.28 |
| Operating Margin - 5 Yr. Avg. | -9.55 | 11.75 | 11.83 | 18.46 |
| Pre-Tax Margin (TTM) | -3.6 | 3.84 | 9.4 | 15.49 |
| Net Profit Margin (TTM) | -3.57 | 2.04 | 5.87 | 10.48 |
| Net Profit Margin - 5 Yr. Avg. | -13.34 | 7.28 | 5.9 | 11.42 |

| Management Effectiveness (%) | Company | Industry | Sector | S & P 500 |
|-----------------------------------|---------|----------|--------|-----------|
| Return On Assets (TTM) | -4.46 | 1.21 | 5.96 | 6.59 |
| Return On Assets - 5 Yr. Avg. | -9.48 | 7.22 | 6.42 | 8.06 |
| Return On Investment (TTM) | -7.25 | 1.09 | 7.6 | 10.48 |
| Return On Investment - 5 Yr. Avg. | -12.03 | 8.85 | 8.36 | 12.93 |
| Return On Equity (TTM) | -53.7 | -0.11 | 14.13 | 18.71 |
| Return On Equity - 5 Yr. Avg. | 112.58 | 16.77 | 15.11 | 21.96 |

| Efficiency | Company | Industry | Sector | S & P 500 |
|---------------------------|---------|----------|---------|-----------|
| Revenue/Employee (TTM) | 149,555 | 179,912 | 177,707 | 551,352 |
| Net Income/Employee (TTM) | NM | 9,999 | 10,657 | 79,802 |
| Receivable Turnover (TTM) | 37.66 | 37.21 | 13.64 | 9.43 |
| Inventory Turnover (TTM) | 35.07 | 25.26 | 19.2 | 10.79 |
| Asset Turnover (TTM) | 1.25 | 0.64 | 1.08 | 0.98 |



- Short Ratio.** Additional market data support the abovementioned conclusion. AirTran's short ratio (percentage of shares short in the market) of 3.90% versus an industry average of 5.38% suggests that the majority of the market does not expect the stock to go down in the future in relation to its peers. To further support this point insiders and 5%+ owners account for 21% of outstanding shares. Insiders are maintaining their ownership, showing their confidence in future prosperity.

| Short Ratio | |
|-----------------------|-------------|
| UAL (United) | 11.95 |
| JBLU (JetBlue) | 11.31 |
| LUV (Southwest) | 8.7 |
| NWAC (Northwest) | 7.85 |
| CAL (Continental) | 5.81 |
| FRNT (Frontier) | 5.69 |
| AWA (American West) | 4.96 |
| ALK (Alaska Air) | 4.18 |
| AAI (AirTran) | 3.90 |
| MEH (Midwest Express) | 3.32 |
| ATAH (ATA Holdings) | 3.28 |
| DAL (Delta) | 3.25 |
| AMR (AMR Corp.) | 2.99 |
| BA (British Airways) | 2.45 |
| ACAI (Atlantic Coast) | 1.01 |
| Average | 5.38 |



DCF Analysis

Key Assumptions. We have used the following assumptions in the DCF model to value AirTran:

1. The Revenue per aircraft will grow at about the inflation rate (3%), although we do not foresee any improvements in terms of load factors. This is a conservative assumption. This estimate will drive the revenue growth rates in the DCF model from 27% in 2003 to 22% in 2004, and 3% thereafter (see revenue section below).
2. Operating expenses and depreciation are projected as a percentage of revenues (see expense section below).
3. The capital expenditures estimates are based on the information given by the company during the 3Q/2002 earnings call. AirTran set the estimates of CAPEX for the 4Q/2002 between \$2 and \$3 million. We estimated CAPEX to decline over time. CAPEX are mostly currently used for maintenance of facilities and equipment. As the fleet average age goes from 12 years to 3 years in 2003, we believe the spare parts required to maintain the fleet will go down. Also, as the fleet transforms into an all-717 fleet, which requires less maintenance, CAPEX for spare parts will go down. Finally, since the new Boeing 717s are going to be financed through commercial leases, this expansion will not have any impact on the capital expenditures.
4. The target debt-to-equity structure is 95% is based on the target Long-Term Debt to Equity estimate for the Airline Industry (*Source: Multex Market Guide*). This figure does not include lease obligations, which are part of the operating expenses in our DCF model, since they are operating leases.
5. The levered beta for AirTran is 1.63 (*Source: Multex Market Guide*).
6. The risk-free rate is 4.092% (*Source: 10/26/02 WSJ Yield Curve for the 10-Year Treasury Note*).
7. The market premium is 8%, based on an average return of the US Stock Market of the past 75 years (*Source: Ibbotson & Associates*).
8. The cost of debt is 9.09%, the risk-free rate plus a 500 basis point spread for CCC-rated Bond. Although Moody's current bond rating for AirTran is B3¹⁷, we use a CCC-rating to reflect the additional risk that the off-balance sheet operating lease obligations (about \$1 billion as of 12/31/01) entail, as well as the fact that the AirTran is highly levered and it has a substantial low interest coverage ratio in comparison to its peers.
9. Expenses as a percentage of revenues are based on historical margins with appropriate adjustments for future trend projections.
10. Corporate income tax rate estimated at 40% for the projection period.
11. A terminal growth rate of 2%, which is a reasonable estimate of GDP growth based official estimates.¹⁸

¹⁷ Source: Bloomberg. Moody's B3 rating is equivalent to S&P B- rating.

¹⁸ The Bureau of Labor Statistics' projections for US real GDP growth by 2005 range from 1.6%-3%.



Revenue

We estimated a 27% revenue growth in 2003, based upon the aircraft acquisition plans mentioned in the 3Q/2002 conference call. According to the call, AirTran is planning to end 2002 with 50 aircrafts (all 50 Boeing 717), after the retirement of the rest of its DC-9 fleet, and increase its fleet to 73 aircrafts by the end of 2003, all of them Boeing 717. From 2003 on, we consider the fleet to stay at the same capacity of 73 aircrafts, net of retirement of older planes and acquisition of newer ones. This means growth of 22% in 2004, and afterwards we consider that revenues will grow at 3%, basically with inflation. The resulting five-year revenue CAGR is 10%.

Our methodology calculates the annual revenue as the product of the average number of aircrafts in the fleet for each projection year times the revenues per aircraft. Revenues per aircraft have been modeled to reflect the effects of quantities (Load Factors) and price increases (Inflation). We assume that load factors will stay at the current levels (65%) while prices will increase with inflation (3%), resulting in the abovementioned revenue growth when combined with number of existing aircrafts.

Operating Expenses (Exhibit 2a)

- Labor. We foresee salaries decreasing slightly as a percentage of revenues from the 2002 levels, which include recent increases in labor contracts. This is because we believe the flight crew will be more utilized in 2003 as aircraft difference training is completed and the fleet becomes 717 exclusively. However, as union contracts with several employee groups expire in the end of 2003, in 2004 and in 2005, we expect contract renegotiations to raise labor costs as a percentage of revenue after 2003. As a result of potential labor costs going up (both FAA and non-FAA contracts), we consider salaries to increase as a percentage of revenues in 2004 and 2005 by 1% in each year.
- Fuel. Despite uncertainty on fuel prices in the case of a war on Iraq, we do not expect fuel costs as a percentage of revenues to increase. First, AirTran is significantly hedged against changes in prices (about 40% of needs in 4Q/2002 and 1Q/2003). Second, as the airline completes the transition to an all-Boeing 717 fleet, fuel costs should decrease considerably as the 3Q/2002 results have proved (savings of approx. \$8.6 million YTD as of 3Q/2002).
- Maintenance. Maintenance costs should decline as a percentage of revenues to 5.7% in 2003 and 4.7% in 2004 as the age of the aircrafts drops from 12 years currently to 9 years at the end of 2002 and 3 years at the end of 2003, making AirTran's fleet the youngest in the industry.
- Aircraft Rentals. We expect aircraft rentals or lease payments to increase considerably in 2003 to 11.7% from 9.7% of revenues as a result of the values of the new aircrafts, increased liability insurance because of more passengers, \$1.25 war-risk insurance premium, and additional security costs required under the current environment. After 2003, we expect these costs to remain flat in absolute terms, since we do not consider in our model any further expansion for the airline.
- Depreciation & Amortization. Depreciation as a percentage of revenue will decrease as a result of the retirement of 14 owned DC-9 during 2003. Since the addition of 23 Boeing 717 will be financed through operating leases, there will be no impact on the depreciation expense (there will be an equivalent to depreciation of the new fleet that will be included in the abovementioned lease payments or aircraft rentals, but not in the depreciation expense position). Hence, we expect depreciation and amortization to amount to \$1.1 per year for the projection period.
- Rentals & Landing Fees. We assume these expenses will continue to go down as utilization of destination infrastructure increases.



- *Sales & Marketing.* We anticipate that this category of expenses will stay flat since continue at the current levels have proved to be quite satisfactory. AirTran's Internet bookings through its website were as high as 53%, considerably high compared to 10% for the industry. There is a big incentive for airlines to distribute tickets via the Internet since they can eliminate travel agent commissions. In 2001, these commissions cost the leading airlines some \$3.0 billion and accounted for about 3.9% of their expenses. According to United Airlines, electronic ticketing costs just 50 cents per ticket, versus \$8 for paper tickets, because it eliminates 14 accounting and processing procedures. Non-FAA labor costs amount to less than 15% of the electronic ticketing costs.
- *Interest Expense.* We expect interest expense to stay at the current levels as a percentage of revenues.

Conclusion

The resulting share price from the DCF analysis is \$6.32, which supports our buy recommendation. After looking at the sensitiveness of the model, we conclude that revenue growth was the variable whose changes had the most impact on the share price. Hence, we simulated a downside scenario based upon no price growth and worsened load factors during 2003 and 2004. The table below shows that even in a downside-case scenario, the stock should be priced above the current levels.

| Sensitivity Analysis | | | | | | | | | | |
|----------------------------|-----------|------|------|------|------|------------|------|------|------|------|
| | Base Case | | | | | Worst Case | | | | |
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2003 | 2004 | 2005 | 2006 | 2007 |
| Revenue | | | | | | | | | | |
| Load Factor | 65% | 65% | 65% | 65% | 65% | 65% | 58% | 58% | 65% | 65% |
| Price Growth | 3% | 3% | 3% | 3% | 3% | 0% | 0% | 0% | 0% | 0% |
| Terminal Value Growth Rate | 2.0% | | | | | 1.5% | | | | |
| Price/share | 6.32 | | | | | 4.88 | | | | |

In conclusion, provided the risks mentioned in early sections of this report, we believe AirTran represents a good long-term buy opportunity.

Exhibit 1. Discounted Cash-Flows Analysis

| | 2000A | 2001A | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|-------------------------------|--------|--------|---------|--------|--------|--------|--------|--------|
| Revenue Growth | 624.1 | 6.58% | 11.02% | 26.69% | 22.26% | 3.00% | 3.00% | 3.00% |
| Operating Expenses * | 83.30% | 90.40% | 94.53% | 91.03% | 89.60% | 90.82% | 90.55% | 90.55% |
| Depreciation & Amortization * | 3.70% | 4.23% | 2.32% | 0.11% | 0.09% | 0.09% | 0.09% | 0.09% |
| CAPEX * | 12.45% | 4.69% | 2.37% | 1.45% | 1.01% | 0.64% | 0.62% | 0.60% |
| %WCR * | -4.84% | -5.77% | -12.10% | -7.10% | -4.10% | -2.10% | -1.10% | -1.10% |

| | | | | | | | | |
|---|-----|-----|------|-----|-------|-------|-------|-------|
| Revenues | 624 | 665 | 738 | 936 | 1,144 | 1,178 | 1,213 | 1,250 |
| Operating expenses | 520 | 601 | 698 | 852 | 1,025 | 1,070 | 1,099 | 1,132 |
| Depreciation | 23 | 28 | 17 | 1 | 1 | 1 | 1 | 1 |
| EBIT | 81 | 36 | 23 | 83 | 118 | 107 | 114 | 117 |
| Taxes on EBIT | 0 | 3 | (1) | 33 | 47 | 43 | 45 | 47 |
| NOPLAT | 81 | 32 | 24 | 50 | 71 | 64 | 68 | 70 |
| Depreciation | 23 | 28 | 17 | 1 | 1 | 1 | 1 | 1 |
| Delta WCR | - | (8) | (51) | 23 | 20 | 22 | 11 | (0) |
| CAPEX | 78 | 31 | 18 | 14 | 12 | 8 | 8 | 8 |
| Adjustment for deposits on returned aircrafts | | | 15 | 5 | | | | |
| FCF | 27 | 38 | 90 | 19 | 41 | 36 | 50 | 64 |
| Continuation Value | | | | | | | | 693 |
| Discounted FCF | | | 90 | 17 | 33 | 26 | 33 | 441 |

| | |
|--------------------------------|-------------|
| PV(FCF) ** | 572 |
| Long Term Debt | 234 |
| Cash | 117 |
| Equity Value | 455 |
| # of Shares (million) | 72.03 |
| Price per Share in US\$ | 6.32 |

| WACC Calculation | | Terminal Value Growth Rate |
|---------------------|---------------|----------------------------|
| Target D/E | 1.0 | 2.00% |
| Levered Beta | 1.63 | |
| Market Risk Premium | 8.00% | |
| Cost of Equity | 17.13% | |
| Beta of Debt | 0.63 | |
| Cost of Debt | 9.09% | |
| Risk-free Rate | 4.09% | |
| Debt-to-Cap | 48.72% | |
| Equity-to-Cap | 51.28% | |
| WACC | 11.44% | |

* As a percentage of revenues

** Includes FCF for 4th quarter 2002

| | 2000A | 2001A | Q1-02 | Q2-02 | Q3-02E | Q4-02E | 2002E | 2003E | 2004E | 2005E | 2006E |
|----------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|---------------|---------------|---------------|
| Revenue | | | | | | | | | | | |
| Passenger | 604.8 | 648.5 | 156 | 186 | 178 | 200 | 719 | | | | |
| Other | 19.3 | 16.7 | 4 | 5 | 5 | 6 | 19.1 | | | | |
| TOTAL REVENUE | 624 | 665 | 159.3 | 191 | 183 | 206 | 738.4 | 935.5 | 1143.8 | 1178.1 | 1213.5 |
| % Growth Rate | | | | | | | | | | | |
| Operating Expenses | | | | | | | | | | | |
| Salaries & Benefits | 137.4 | 159.1 | 45.252 | 50.9 | 51.7 | 58.1 | 205.9 | 251.5 | 315.5 | 336.8 | 346.9 |
| Fuel | 140.4 | 139.4 | 33.805 | 39.0 | 40.7 | 45.7 | 159.2 | 201.7 | 246.6 | 254.0 | 261.6 |
| Maintenance | 73.2 | 68.7 | 10.563 | 15.1 | 9.4 | 10.6 | 45.6 | 48.4 | 59.2 | 61.0 | 62.8 |
| Aircraft Rentals | 12.6 | 35.4 | 13.758 | 16.4 | 19.6 | 22.0 | 71.8 | 109.6 | 109.6 | 109.6 | 109.6 |
| Rentals & Landing Fees | 28.8 | 35.7 | 10.01 | 10.7 | 10.0 | 11.2 | 41.9 | 43.8 | 53.5 | 61.0 | 62.9 |
| Depreciation and Amortization | 23.1 | 28.2 | 4.411 | 4.2 | 4.0 | 4.5 | 17.1 | 1.1 | 1.1 | 1.1 | 1.1 |
| Sales Marketing | 16.4 | 18.5 | 5.675 | 5.4 | 5.0 | 5.6 | 21.7 | 22.8 | 27.9 | 28.8 | 29.6 |
| Other | 111.0 | 144.7 | 38.8 | 36.7 | 36.0 | 40.4 | 151.9 | 173.7 | 212.4 | 218.8 | 225.4 |
| Total Operating Expenses | 542.9 | 629.5 | 162.2 | 178.5 | 176.4 | 198.1 | 715.2 | 852.7 | 1025.9 | 1071.0 | 1099.8 |
| OPERATING INCOME | 81.2 | 35.7 | (2.9) | 12.2 | 6.6 | 7.4 | 23.3 | 82.8 | 117.9 | 107.1 | 113.6 |
| Other (Income) Expense | | | | | | | | | | | |
| Interest Income & Other | 5.6 | 2.9 | 6.39 | 0.52 | 3.6 | 4.1 | 14.6 | 18.5 | 22.6 | 23.3 | 24.0 |
| Interest Expense | -39.3 | -37.4 | -7.5 | -7.4 | -9.1 | -10.2 | -34.1 | -43.2 | -58.5 | -66.1 | -74.2 |
| Total Other Income | -33.7 | -34.6 | -1.1 | -6.9 | -5.4 | -6.1 | -19.5 | -24.7 | -35.9 | -42.9 | -50.2 |
| Pretax Income | 47.4 | 1.1 | (4.0) | 5.3 | 1.2 | 1.3 | 3.8 | 58.2 | 82.0 | 64.2 | 63.4 |
| Income Taxes | | 3.2 | (1.0) | 0.2 | 0.0 | 0.0 | (0.8) | 23.3 | 32.8 | 25.7 | 25.4 |
| Income Tax rate | NM | 284% | 25% | 4% | 0% | 0% | 0% | 40% | 40% | 40% | 40% |
| NET INCOME | 47.4 | (2.8) | (3.0) | 5.1 | 1.2 | 1.3 | 4.6 | 34.9 | 49.2 | 38.5 | 38.0 |
| Fully Diluted # Shares (million) | 69.2 | 67.8 | 69.8 | 74.0 | 72.0 | 72.0 | 72.03 | 72.03 | 72.03 | 72.03 | 72.03 |
| EPS | 0.69 | -0.04 | -0.04 | 0.07 | 0.02 | 0.02 | 0.06 | 0.48 | 0.68 | 0.54 | 0.53 |

Source: Company Financials and Yale SOM Projections

| | | | | |
|--------------|------|------|------|------|
| Consensus es | 0.02 | 0.02 | 0.49 | 0.68 |
|--------------|------|------|------|------|

Exhibit 2a – Earnings Model Projections – Percentage Structure

| | 2000 | 2001 | Q1-02 | Q2-02 | Q3-02E | Q4-02E | 2002E | 2003 | 2004 | 2005 | 2006 |
|---------------------------------|--------------|--------------|---------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Revenue | | | | | | | | | | | |
| Passenger | | 7.2% | | | | | 10.9% | | | | |
| Other | | -13.4% | | | | | 14.4% | | | | |
| TOTAL REVENUE | | -6.2% | | | | | 25.3% | 27% | 22% | 3% | 3% |
| % Growth Rate | | | | | | | | | | | |
| Operating Expenses | | | | | | | | | | | |
| Salaries & Benefits | 22.0% | 23.9% | 28.4% | 26.7% | 28.3% | 28.3% | 27.9% | 26.9% | 27.6% | 28.6% | 28.6% |
| Fuel | 22.5% | 21.0% | 21.2% | 20.5% | 22.2% | 22.2% | 21.6% | 21.6% | 21.6% | 21.6% | 21.6% |
| Maintenance | 11.7% | 10.3% | 6.6% | 7.9% | 5.1% | 5.1% | 6.2% | 5.2% | 5.2% | 5.2% | 5.2% |
| Aircraft Rentals | 2.0% | 5.3% | 8.6% | 8.6% | 10.7% | 10.7% | 9.7% | 11.7% | 9.6% | 9.3% | 9.0% |
| Rentals & Landing Fees | 4.6% | 5.4% | 6.3% | 5.6% | 5.5% | 5.5% | 5.7% | 4.7% | 4.7% | 5.2% | 5.2% |
| Depreciation and Amortiz | 3.7% | 4.2% | 2.8% | 2.2% | 2.2% | 2.2% | 2.3% | 0.1% | 0.1% | 0.1% | 0.1% |
| Sales Marketing | 2.6% | 2.8% | 3.6% | 2.9% | 2.7% | 2.7% | 2.9% | 2.4% | 2.4% | 2.4% | 2.4% |
| Other | 17.8% | 21.8% | 24.3% | 19.3% | 19.7% | 19.7% | 20.6% | 18.6% | 18.6% | 18.6% | 18.6% |
| Total Operating Expenses | 87.0% | 94.6% | 101.8% | 93.6% | 96.4% | 96.4% | 96.8% | 91.1% | 89.7% | 90.9% | 90.6% |
| OPERATING INCOME | 13.0% | 5.4% | -1.8% | 6.4% | 3.6% | 3.6% | 3.2% | 8.9% | 10.3% | 9.1% | 9.4% |
| Other (Income) Expense | | | | | | | | | | | |
| Airline Stabilization Act C | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Interest Income & Other | 0.9% | 0.4% | 4.0% | 0.3% | 2.0% | 2.0% | 2.0% | 2.0% | 2.0% | 2.0% | 2.0% |
| Interest Expense | -6.3% | -5.6% | -4.7% | -3.9% | -4.9% | -4.9% | -4.6% | -4.6% | -5.1% | -5.6% | -6.1% |
| Total Other Income | -5.4% | -5.2% | -0.7% | -3.6% | -3.0% | -3.0% | -2.6% | -2.6% | -3.1% | -3.6% | -4.1% |
| Pretax Income | 7.6% | 0.2% | -2.5% | 2.8% | 0.6% | 0.6% | 0.5% | 6.2% | 7.2% | 5.5% | 5.2% |
| Income Taxes | 0.0% | | | | | | | | | | |
| Income Tax rate | NM | 284% | 25% | 4% | 0% | 0% | 0% | 40% | 40% | 40% | 40% |
| NET INCOME | 7.6% | -0.4% | -1.9% | 2.7% | 0.6% | 0.6% | 0.6% | 3.7% | 4.3% | 3.3% | 3.1% |

Source: Company Financials and Yale SOM projections

Exhibit 3. Revenue Projections

Revenue Growth

| | <u>2001</u> | <u>2002</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> |
|----------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Year End | 59 | 50 | 73 | 73 | 73 | 73 | 73 | 73 | 73 |
| Average | 59 | 54.5 | 61.5 | 73 | 73 | 73 | 73 | 73 | 73 |
| Revenues | 665 | 738 | 936 | 1,144 | 1,178 | 1,213 | 1,250 | 1,287 | 1,326 |
| Rev / Aircraft | 11.3 | 14.8 | 15.2 | 15.7 | 16.1 | 16.6 | 17.1 | 17.6 | 18.2 |
| Growth Rev/AC | | | 3% | 3% | 3% | 3% | 3% | 3% | 3% |
| "Q": Load Factor | 55% | 65% | 65% | 65% | 65% | 65% | 65% | 65% | 65% |
| Growth | | | 0% | 0% | 0% | 0% | 0% | 0% | 0% |
| "P": Prices | | | 3% | 3% | 3% | 3% | 3% | 3% | 3% |
| Revenue Growth Rate | | | 27% | 22% | 3% | 3% | 3% | 3% | 3% |
| 6-year CAGR | | | 10% | | | | | | |

Source: AirTran Financials, 3Q/2002 conference call, and Yale SOM Estimates

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