

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of AirAsia's financial condition and results of operations should be read in conjunction with the consolidated financial statements and the related notes for the two years ended March 31, 2001, the 15 months ended June 30, 2002 and the two years ended June 30, 2004 included elsewhere in this Prospectus. This discussion and analysis contains data derived from the audited consolidated financial statements of AirAsia and forward-looking statements that involve risks and uncertainties. AirAsia's actual results may differ significantly from those projected in the forward-looking statements. Factors that might cause future results to differ significantly from those projected in the forward-looking statements include, but are not limited to, those discussed below and elsewhere in this Prospectus, particularly in Section 5 "Risk Factors". Certain figures included in this Prospectus have been subject to rounding adjustments; accordingly, figures shown for the same category presented in different tables may vary slightly and figures shown as totals in certain tables may not be an arithmetic aggregation of the figures which precede them.

13.1 Overview

AirAsia is a leading low-cost carrier in Southeast Asia. The AirAsia Group focuses on providing high-frequency services on short-haul, point-to-point domestic and international routes. AirAsia began its operations in 1996 as Malaysia's second national carrier, but was unable to sustain profitability under a full-service airline model. In December 2001, Tune Air, a company controlled by certain members of the Company's current senior management, acquired the Company with the intention of transforming it into a profitable low-cost carrier.

Prior to the takeover by Tune Air, AirAsia operated between Kuala Lumpur and four destinations, namely Kota Kinabalu, Kuching, Langkawi and Labuan, in addition to providing charter flights (both on an ad-hoc and a scheduled basis). After the takeover, AirAsia's management increased frequencies on its inherited routes, added two new destinations to Penang and Kota Bahru, eliminated in-flight meals and other amenities, reduced fares to levels significantly below its competitors and began to adjust compensation for all staff, including pilots and flight attendants to emphasize productivity-based pay. AirAsia also expanded its fleet by leasing and purchasing used Boeing 737-300 aircraft. In addition, at the time of Tune Air's takeover, management renegotiated inherited leases for AirAsia's aircraft and reduced aircraft lease rates significantly. It also changed AirAsia's financial year-end from March 31 to June 30. During the 12 months following the change in AirAsia's business model, AirAsia introduced another two new destinations to Kuala Terengganu and Tawau and added frequencies on its existing routes.

Since AirAsia introduced its low-cost carrier business model in January 2002, its passenger volumes and passenger seat sales revenues have significantly increased as AirAsia substantially increased its capacity. AirAsia's passenger volume has increased from approximately 270,000 for the year ended March 31, 2000 to approximately 2.8 million for the year ended June 30, 2004.

Passenger seat sales revenues have increased from RM41.2 million for the year ended March 31, 2000 to RM348.0 million for the year ended June 30, 2004. AirAsia's RPK have increased from 339 million for the year ended March 31, 2000 to 2,771 million for the year ended June 30, 2004, due primarily to an increase in AirAsia's passenger load factor, fleet size, flight frequencies, and new destinations. Passenger load factor was 62% in each of the years ended March 31, 2000 and 2001, 66% for the 15 months ended June 30, 2002, 74% for the year ended June 30, 2003 and 77% for the year ended June 30, 2004. AirAsia's revenue per RPK has decreased from RM0.205 in the year ended March 31, 2000, to RM0.204 in the year ended March 31, 2001, RM0.184 for the 15 months ended June 30, 2002, RM0.151 for the year ended June 30, 2003 and to RM0.142 for the year ended June 30, 2004 due to the decrease in average fares.

The combination of expanding passenger volumes and capacity, increasing passenger load factors and disciplined cost management has enabled AirAsia to transform itself from a loss-making operation into one generating a profit before taxation for each of the years ended June 30, 2003 and 2004. AirAsia's financial results improved from losses before taxation of RM31.3 million for the year ended March 31, 2000, RM19.1 million for the year ended March 31, 2001 and RM1.6 million for the 15 months ended

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June 30, 2002, to profits before taxation of RM11.5 million for the year ended June 30, 2003 and RM58.1 million for the year ended June 30, 2004.

In November 2003, AAIL, then a company affiliated with AirAsia, entered into a joint venture with Shin Corporation to invest in and operate a low-cost carrier in Thailand. AAIL owns 49% of Thai AirAsia. Since December 2003, AirAsia has managed the operations of Thai AirAsia (which commenced operations in February 2004) for which it receives a monthly fee beginning April 2004. AirAsia has day-to-day financial as well as operational control of Thai AirAsia (please refer to Section 7.29 *"Thai AirAsia's Operations"*). Following the Company's acquisition of a 99.8% interest in AAIL effective July 1, 2004 for U.S.\$5.26 million (RM20.0 million), the Company obtained a 48.9% indirect interest in Thai AirAsia. As of July 1, 2004, AirAsia will account for its indirect interest in Thai AirAsia in its balance sheet under "Investment in Associates" and for its share of the net profits or losses of Thai AirAsia in its income statement under "Share of Results of Associate". Please refer to Section 7.3 *"Organization"*. Thai AirAsia's contribution is expected to have a material effect on AirAsia. Please refer to Section 13.2.7 *"Significant Factors Affecting AirAsia's Results of Operations—Results of Associate"*.

On August 30, 2004, AAIL entered into two conditional sale and purchase agreements to acquire a 49% aggregate shareholding interest in PT AWAir for total consideration of U.S.\$2.00. PT AWAir is an Indonesian company which has an Indonesian AOC and operated as a full service carrier before suspending operations in March 2002. Completion of the transaction is subject to various conditions including approval by various Indonesian regulatory authorities and further due diligence by AAIL. Assuming the transaction is completed, AirAsia will account for its indirect interest in PT AWAir in the same manner as it accounts for Thai AirAsia; however, the results of PT AWAir would not be expected to have a material impact on the results of AirAsia for the year ending June 30, 2005. Assuming the transaction is completed, AirAsia intends to adopt a low-cost carrier model and operate from a hub at Soekarno-Hatta International Airport in Jakarta. AirAsia could recommence PT AWAir's operations with two aircraft (in addition to the 36 aircraft the Group intends to operate by June 30, 2005) as early as December 2004. PT AWAir could also recommence operation independently prior to completion of the transaction.

On September 22, 2004, PT AWAir obtained the approval of the Badan Kordinasi Penanaman Modal (Indonesia) for certain proposed changes in its equity and human resource structures. The approval is one of the stated conditions for the completion of the transaction.

13.2 Significant Factors Affecting AirAsia's Results Of Operations

AirAsia's results of operations are affected by a number of factors, the most significant of which are described below.

13.2.1 Low operating expenses

AirAsia has low operating expenses primarily because it operates a single type of aircraft with a single class of service, uses a ticketless system and has low aircraft lease and maintenance expenses and a productive workforce. Strict management of AirAsia's costs and expenses is essential to keep AirAsia's fares low. The expenses of each flight do not vary significantly with the number of passengers carried and a relatively small change in the number of passengers or in AirAsia's pricing or traffic mix could have a disproportionate effect on AirAsia's revenues. Since AirAsia changed its business model, its cost per ASK has decreased from RM0.189 (U.S.\$0.050) for the year ended March 31, 2000, to RM0.160 (U.S.\$0.042) for the year ended March 31, 2001, RM0.128 (U.S.\$0.034) for the 15 months ended June 30, 2002, RM0.109 (U.S.\$ 0.029) for the year ended June 30, 2003 and to RM0.094 (U.S.\$0.025) for the year ended June 30, 2004. As its fleet expands, related fixed costs and variable costs, due to economies of scale, increase at a lower rate than does capacity. Therefore, AirAsia expects its cost per ASK to continue to decrease. Please refer to Section 13.2.3 *"Growth"*.

AirAsia's most significant costs include aircraft fuel expenses, maintenance and overhaul expenses, wages and benefits provided to its employees, aircraft operating lease expenses, airport facilities charges and insurance premiums. As AirAsia's aircraft age and as AirAsia expands its fleet,

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maintenance expenses are expected to increase significantly. AirAsia's cost of leasing and acquiring additional aircraft has declined during the two years ended June 30, 2004, due to new leases being negotiated at favorable rates and favorable market conditions caused in part by a large supply of used Boeing 737-300 aircraft, but could increase in the future depending upon market conditions.

In the event AirAsia elects to change its fleet type from the Boeing 737-300 aircraft, (please refer to Section 7.15 "*Business — Fleet-Future Plans*") AirAsia will incur transition costs (which may be higher if Airbus aircraft are acquired), including in connection with training its pilots cabin crew and engineers to operate and maintain a new aircraft type. On a longer term basis, operating costs of the new aircraft type may also be higher especially since the new aircraft type improved would likely be larger than the Boeing 737-300, resulting in higher landing and aeronautical charges, among other things. Expansion may lead to higher operating costs (resulting from higher lease expenses, increased consumption of jet fuel and higher labor and training expenses) in connection with operating a new aircraft type. However, AirAsia believes it will benefit from better fuel efficiency, higher passenger capacity and lower maintenance costs, which may offset any higher costs of operating the new aircraft type.

Some of AirAsia's expenses, such as aircraft operating leases and certain maintenance agreements, are fixed expenses or capped at certain levels. For example, AirAsia employs a "maintenance-by-the-hour" program for engine maintenance that obliges AirAsia to pay a fixed hourly rate to the contractor based on the number of flight hours of each aircraft. This program makes budgeting more predictable and simplified. Please refer to Section 7.4 "*Business - Competitive Strengths—Low Cost Operations*" and Section 7.17 "*Maintenance and Spare Parts*".

Other expenses, such as fuel, insurance, aeronautical charges and landing and parking expenses are variable depending upon market conditions. Fuel costs are extremely volatile, as they are subject to many global economic and geopolitical factors that can neither be controlled nor accurately predicted. AirAsia actively seeks to hedge its entire fuel supply requirements. However, AirAsia's ability to hedge its exposure to increases in the price of fuel is limited as its fuel hedging agreements contain various limitations, including limitations with respect to fuel price, volume and the duration of the agreements. In addition, AirAsia relies on Petronas for its jet fuel requirements. For the year ended June 30, 2004, 93% of AirAsia's aircraft fuel expenses were purchases of jet fuel from Petronas. AirAsia believes that comparable supply and support is available from other established suppliers. Nevertheless, AirAsia's operations could be adversely affected if it were unable to obtain an adequate supply of jet fuel in a timely manner or on commercial terms acceptable to AirAsia. AirAsia forecasts that its fuel expenses will increase to approximately 43% of its total cost of sales and operating expenses for the year ending June 30, 2005 (compared to 31% of its total cost of sales and operating expenses for the year ended June 30, 2004), due to higher fuel prices and higher consumption of fuel. AirAsia has not yet entered into jet fuel derivative contracts for the Group's expected fuel requirements for any period after June 30, 2005 (please refer to Section 13.11.1 "*Fuel price risk*", and Sections 7.18 and 7.28 "*Business - Fuel*" and "*Business - Major Suppliers*" respectively).

In addition, availability and cost of terminal space, landing Slots, aircraft parking, aircraft hangars and other airport facilities are fundamental to AirAsia's operations. Significant increases in the costs of any of these facilities could have a material adverse effect on AirAsia.

13.2.2 Passenger volumes

Attaining high passenger volumes is critical for AirAsia to maintain and increase its revenues from passenger seat sales. AirAsia's average fares have decreased from RM183 for the 15 months ended June 30, 2002 to RM131 for the year ended June 30, 2004, its revenue per RPK has decreased from RM0.184 for the 15 months ended June 30, 2002 to RM0.142 for the year ended June 30, 2004, and its average stage length has decreased from 1,128 kilometers for the 15 months ended June 30, 2002 to 967 kilometers for the year ended June 30, 2004. However, AirAsia's passenger volumes have increased from approximately 0.6 million for the 15 months ended June 30, 2002 to approximately 2.8 million for the year ended June 30, 2004, which has enabled AirAsia's revenues from passenger seat sales to increase from RM87.9 million for the 15 months ended June 30, 2002 to RM348.0 million for the year ended June 30, 2004.

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The economy in Malaysia and other countries in Southeast Asia

Passenger volumes and the prices at which AirAsia is able to sell seats are significantly affected by the amount of disposable income available to potential passengers. As a result, the state of Malaysia's economy, as well as the state of the economy in the Southeast Asia generally, has had and is likely to continue to have a material impact on AirAsia's results of operations. Please refer to Section 8 "Overview of the Aviation Industry". Strong economic performance in AirAsia's key customer markets boosts consumer disposable income and may increase passenger load factors and permit AirAsia to increase its fares. Conversely, poor economic performance in key customer markets is likely to reduce passenger load factors and/or require AirAsia to further reduce its fares and, as a result, have a material adverse effect on AirAsia's revenues.

13.2.3 Growth

AirAsia's growth strategy involves increasing the frequency of flights to markets that it currently serves and expanding its route network. Since the launch of its low-cost carrier business model in January 2002, AirAsia has increased its fleet from two aircraft to 17 aircraft as at June 30, 2004 including four aircraft leased to Thai AirAsia. AirAsia is also considering purchasing up to 80 new aircraft consisting of 40 purchase obligations and 40 purchase options from Airbus or Boeing. AirAsia expects that these aircraft would be delivered over a period of several years commencing as early as January 2006. In the short-term, expansion may lead to higher operating costs (resulting from the lease or purchase of additional aircraft, increased fuel costs, higher maintenance and labor expenses and higher training expenses in connection with learning how to operate a new aircraft type) without generating offsetting revenues. For example, AirAsia commonly offers highly discounted fares to stimulate demand on new routes. Expansion into geographic regions where AirAsia has limited operating experience may also have a material adverse effect on its results of operations as AirAsia may face operating, marketing, financial and legal challenges that are different than those it encounters in its existing markets. However, expansion is intended to have a long-term benefit on AirAsia's revenues and results of operations. AirAsia's expansion strategy, among other factors, has caused AirAsia's profitability to improve from a loss before taxation of RM1.6 million for the 15 months ended June 30, 2002 to a profit before taxation of RM58.1 million for the year ended June 30, 2004. With the expiration of the contract for charter services with LTH and Borneo Tours Sdn Bhd, substantially all of AirAsia's total revenue is expected to be derived from passenger seat sales going forward, while revenues from charter services are expected to decrease as a percentage of total revenue.

The success of AirAsia's growth strategy is contingent on various factors, many of which are outside AirAsia's control. Operational difficulties such as delays in the delivery and deployment of new aircraft, unexpected technical problems with AirAsia's aircraft, difficulties in hiring employees, particularly pilots, and/or the lack of flight simulator training capacity to train newly-hired pilots could have a material adverse effect on AirAsia. AirAsia expects to complete construction of its own flight simulator complex in the first quarter of 2005.

13.2.4 Terrorism and other significant events

Threats or perceived threats of terrorist activity (such as the attacks in the United States in 2001 and in Indonesia in 2002, 2003 and 2004), incidents of violence in Southeast Asia, the war in Iraq and other world events have had a negative impact on the airline and tourism industries in Asia. Industry-wide, both passenger volumes and air fares trended downwards while fuel expenses and insurance premiums have increased in response to these events. In addition, such events have resulted in several governments issuing travel advisories with respect to several of the AirAsia Group's destinations, including Thailand and Indonesia. Although these events have had an adverse effect on the passenger volumes of the airline industry generally, AirAsia is unable to specifically quantify the effect they have had on its revenues. AirAsia may lower its fares in an effort to maintain high passenger volumes in response to such events. Any future terrorist attacks or other significant events may have a material adverse effect on AirAsia.

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SARS and other similar outbreaks

In November 2002, the outbreak of SARS in the People's Republic of China, Hong Kong, Singapore, Taiwan, Vietnam and Canada resulted in substantial financial losses in the airline industry. Certain countries implemented immigration policies to restrict travelers coming to and from SARS-affected countries or regions and several airlines reduced flights to certain countries. AirAsia's average fares decreased from RM172 for December 2002 to RM121 for April 2003 primarily as a result of fare reductions introduced to maintain demand. Passenger volumes decreased, especially between March and April 2003 when monthly passenger volume decreased from approximately 147,000 to approximately 123,000. In response, AirAsia increased its advertising and offered promotional prices to stimulate demand for air travel. Passenger volumes increased to approximately 148,000 in May 2003.

Since the initial SARS outbreak, there have been new cases reported in Asia in January and April 2004. Any significant recurrence of SARS in the countries where AirAsia operates or elsewhere, or any similar outbreak of disease, could have a material adverse effect on demand for AirAsia's scheduled passenger services and its revenues.

13.2.5 Competition

At present, AirAsia is the only low-cost carrier operating out of KLIA that serves the Malaysian market. However, AirAsia competes with MAS on its domestic flights within Malaysia, as well as with other full-service airlines (such as Garuda and Singapore Airlines) and low-cost carriers that operate in Southeast Asia. Increased competition from any of these competitors or the entry of any new competitors could materially and adversely affect AirAsia. For example, increased competition could encourage deeper fare discounts, and may cause AirAsia to revise its cost structure and/or more aggressively develop new revenue streams. However, AirAsia believes that its strict adherence to its low-cost business model, which has enabled it to be profitable while offering low fares, is a significant competitive advantage.

Although AirAsia competes with full-service carriers, since air transportation has historically been affordable only to the higher income segment of Malaysia and other markets it serves, AirAsia believes that its low-cost, low-fare business model has the potential to increase the use of air transportation in Malaysia. Please refer to Section 7.22 "*Business - Competition*".

13.2.6 Regulation

AirAsia's financial performance is significantly affected by government regulation of the Malaysian domestic and international aviation industry. Substantially all aspects of AirAsia's domestic airline operations in Malaysia, including Slots allocation, granting of rights under Malaysia's ASAs and issuance of AOCs, are subject to regulation by DCA. Accordingly, AirAsia's operating and financial performance is significantly affected by government regulation of the Malaysian domestic and international aviation industry. Please refer to Section 9 "*Regulation of the Airline Industry in Malaysia*".

AirAsia's growth strategy involves both increasing the frequency of flights to markets that it currently serves and expanding the number of markets that it serves. Ultimately the success of this growth strategy depends upon obtaining additional traffic rights to suitable airports located in AirAsia's targeted geographic markets. Historically, AirAsia has been granted most of the air traffic rights it has requested and has not had any of its rights revoked, but this may not be the case in the future.

13.2.7 Results of significant associate

Effective July 1, 2004, the Company acquired a 99.8% interest in AAIL. As a result of this acquisition, the Company obtained a 48.9% indirect interest in Thai AirAsia. AirAsia will recognize its share of the net profits or losses of Thai AirAsia in a line item on AirAsia's income statement called "Share of profit/losses of an associated company".

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AirAsia manages Thai AirAsia and has day-to-day financial and operational control of Thai AirAsia. Thai AirAsia also follows the same low-cost carrier business model as AirAsia. As a result, Thai AirAsia's net profits are significantly affected by factors similar to the factors described above which affect AirAsia. Thai AirAsia competes with THAI on its domestic flights within Thailand, as well as with other full-service airlines. Low-cost carriers that will directly compete with Thai AirAsia on some of its routes include Nok Air (backed by THAI), Valuair, and Tiger Airways (a joint venture between Singapore Airlines and the founder of Ryanair). Most recently, Qantas Airways is working to establish a Singapore based low-cost carrier similar to its recently launched JetStar operation in Australia.

In addition, the following factors have affected and/or may have a material effect Thai AirAsia's results of operations, and as a result, AirAsia's profit before taxation:

- Thai AirAsia's ability to maintain high passenger volumes and low operating expenses;
- the economy in Thailand;
- any recurrence of SARS or a similar outbreak of disease;
- Thai AirAsia's ability to expand its operations;
- acts of terrorism and other significant events; and
- regulation by the Civil Aviation Board of Thailand.

AirAsia's expansion strategy includes replicating its joint venture model with partners in other regional markets. AirAsia expects that it would account for such investments similarly to its investment in Thai AirAsia, and that the results of operations of such associates would be affected by similar factors as those which currently affect AirAsia.

For a discussion of Thai AirAsia's business, please refer to Section 7.29 "*Business-Thai AirAsia's Operations*".

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13.3 Income Statement

The table below shows AirAsia's, income statement, the components of which are expressed as a percentage of total revenue, for the periods indicated.

	For the year ended March 31,			For the 15 months ended June 30,			For the year ended June 30,		
	2000			2002 ⁽¹⁾			2003		
	(RM thousands)	% of total revenue	(RM thousands)	(RM thousands)	% of total revenue	(RM thousands)	(RM thousands)	% of total revenue	(RM thousands)
Revenue:									
Passenger seat sales.....	41,181	27.6	44,041	87,856	40.4	195,864	347,971	59.3	347,971
Chartered flight revenue.....	105,844	70.9	118,409	123,179	56.7	123,061	24,514	37.3	24,514
Other revenue.....	2,260	1.5	5,299	6,386	2.9	11,115	20,205	3.4	20,205
Total	149,285	100.0	167,749	217,421	100.0	330,040	392,690	100.0	392,690
Cost of sales	(171,994)	(115.2)	(176,463)	(208,147)	(95.7)	(288,490)	(279,119)	(87.4)	(279,119)
Gross (loss)/profit	(22,709)	(15.2)	(8,714)	9,274	4.3	41,550	113,571	12.6	113,571
Sales and marketing expenses	(640)	(0.4)	(409)	(1,499)	(0.7)	(4,361)	(9,411)	(1.3)	(9,411)
Administration expenses	(2,862)	(1.9)	(3,523)	(7,936)	(3.6)	(23,061)	(34,351)	(7.0)	(34,351)
Other operating expenses	(2,573)	(1.8)	(2,048)	(1,445)	(0.7)	(3,758)	(13,054)	(1.1)	(13,054)
Other operating income.....	566	0.4	136	307	0.1	1,175	4,563	0.3	4,563
(Loss)/profit from operations	(28,218)	(18.9)	(14,558)	(1,299)	(0.6)	11,545	61,318	3.5	61,318
Finance costs	(3,075)	(2.1)	(4,559)	(308)	(0.1)	(84)	(3,131)	-	(3,131)
Share of losses of an associated company	-	-	-	-	-	-	(116)	-	(116)
(Loss)/profit before taxation	(31,293)	(21.0)	(19,117)	(1,607)	(0.7)	11,461	58,071	3.5	58,071
Taxation	(35)	-	(21)	(56)	-	7,375	(9,052)	2.2	(9,052)
(Loss)/profit after taxation.....	(31,328)	(21.0)	(19,138)	(1,663)	(0.7)	18,836	49,019	5.7	49,019
Minority interests	-	-	-	-	-	2	48	-	48
(Loss)/profit attributable to shareholders	(31,328)	(21.0)	(19,138)	(1,663)	(0.7)	18,838	49,067	5.7	49,067
Note:									

(1) In 2002, the Company changed its financial year-end from March 31 to June 30 to coincide with the financial year end of Tune Air.

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13.3.1 Revenue

AirAsia's revenue comprises revenue from passenger seat sales, chartered flight revenue and other revenue.

Passenger seat sales

Passenger seat sales revenue consists solely of revenues from seat sales related to AirAsia's scheduled air travel services. Revenues from this segment vary depending on AirAsia's passenger volume and the prices at which AirAsia sells each seat. Please refer to Section 12.1.5 "*Operating Data*" for operating data relating to AirAsia's passenger seat sales revenue.

Chartered flight revenue

Chartered flight revenue consists of revenues from AirAsia's provision of charter services. Most of the revenue from this segment comes from charter service contracts which apply to a two or three year period, such as the ATM contract with the Government for the provision of a minimum number of seats on specified routes to Angkatan Tentera Malaysia (the Malaysian armed forces). AirAsia provided scheduled chartered flights to LTH pursuant to the LTH contract which expired in June 2003 and to Borneo Tours Sdn Bhd pursuant to the Borneo Tours charter contract which expired in June 2004 (please refer to Section 7.6.2 "*AirAsia's Operations – Charter and contract services*"). Chartered flight revenue in any period depends upon the number and terms of the charter service contracts active in such period, and as a result revenue from this segment may fluctuate significantly in any period. AirAsia's expects its revenues from chartered flights to decrease next year as the Borneo Tours charter contract, which contributed RM4.5 million for the year ended June 30, 2004, expired in June 2004.

Other revenue

Other revenue includes fees for AirAsia's freight services, cancellation fees, excess baggage fees, sales of in-flight merchandise and food and any other items. Except for revenues from freight services, other revenue is primarily affected by AirAsia's passenger load factors.

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13.3.2 Cost of sales and operating expenses

The following table presents AirAsia's cost of sales and operating expenses, which are also expressed as a percentage of total cost of sales and operating expenses, for the periods indicated.

	For the year ended March 31,			For the 15 months ended June 30,			For the year ended June 30,		
	2000			2002 ⁽¹⁾			2003		
	RM thousands	% of total cost of sales and operating expenses	% of total cost of sales and operating expenses	RM thousands	% of total cost of sales and operating expenses	% of total cost of sales and operating expenses	RM thousands	% of total cost of sales and operating expenses	% of total cost of sales and operating expenses
Cost of sales and operating expenses									
Cost of sales									
Aircraft fuel expenses	34,477	19.4	22.7	63,980	29.2	29.3	93,581	29.3	30.6
Aircraft operating lease expenses	68,898	38.7	39.9	74,492	34.0	24.7	78,986	24.7	12.7
Maintenance and overhaul expenses	19,598	11.0	9.8	13,804	6.3	17.5	55,876	17.5	22.0
Staff costs	8,248	4.6	4.6	10,626	4.9	8.0	25,496	8.0	14.4
User charges and station expenses	23,287	13.1	10.2	24,071	11.0	6.7	21,837	6.7	2.9
Others	17,486	9.8	9.5	21,174	9.6	4.0	12,714	4.0	0.5
Total cost of sales	171,994	96.6	96.7	208,147	95.0	90.2	288,490	90.2	83.1
Operating expenses									
Sales and marketing expenses	640	0.4	0.2	1,499	0.7	1.4	4,361	1.4	2.8
Administration expenses	2,862	1.6	1.9	7,936	3.6	7.2	23,061	7.2	10.2
Other operating expenses	2,573	1.4	1.2	1,445	0.7	1.2	3,758	1.2	3.9
Total operating expenses	6,075	3.4	3.3	10,880	5.0	9.8	31,180	9.8	16.9
Total cost of sales and operating expenses	178,069	100.0	100.0	219,027	100.0	100.0	319,670	100.0	100.0

Note:

(1) In 2002, the Company changed its financial year-end from March 31 to June 30 to coincide with the financial year end of Tune Air.

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Cost of sales

Aircraft fuel expenses consist of the costs of fuel and oil that AirAsia purchases in connection with its scheduled and charter air travel services. (please refer to Section 13.11.1 "Fuel price risk" and Section 7.6 "AirAsia's Operations").

Aircraft operating lease expenses consist of the costs of leasing AirAsia's aircraft.

Maintenance and overhaul expenses primarily consist of all the costs of maintaining, repairing and overhauling all of AirAsia's aircraft and engines, technical handling fees in relation to pre-flight inspections and the costs of aircraft spare parts and other equipment.

Staff costs consist of salaries, performance-based bonuses, sector allowances, allowances for various technical certifications, medical reimbursements and employee provident fund and other mandatory contributions made to or on behalf of AirAsia's employees. This component of cost of sales does not include staff costs for AirAsia's administrative and sales and marketing employees, which is included under administration expenses.

User charges and station expenses primarily consist of ground handling fees, landing and parking charges, aeronautical charges and other airport charges.

Other cost of sales primarily consist of aviation insurance premiums, costs of meals, costs of merchandisc sold during AirAsia's scheduled air travel services, aircraft delivery costs, the fee for using OpenSkies by Navitaire, AirAsia's inventory and sales management system, credit card commissions, commissions to call center agents and retail outlets, costs related to AirAsia's flight planning and communicating system, and other flight operating costs. AirAsia partially offsets these costs by including within this expense item the monies it receives from passengers for an insurance surcharge (currently RM5 per passenger), an administrative surcharge (currently RM8 per passenger) and a charge for using the Nationwide Call Center (currently RM2 per passenger).

Operating expenses

Sales and marketing expenses primarily consist of print, radio and television advertising expenses as well as other marketing expenses.

Administration expenses include staff costs for administrative and sales and marketing staff, office rental expenses, telephone and printing costs, consultant and professional fees, travel and accommodation expenses, training expenses and other administration expenses.

Other operating expenses consist of expenses for depreciating AirAsia's aircraft and engineering parts and other furnishings, fittings and computer equipment as well as provision for doubtful debts.

13.3.3 Other operating income

Other operating income includes management fees AirAsia receives for managing Thai AirAsia's operations, interest income, gains on disposals of short-term investments, aircraft advertising income and, until December 2001, rental income from the lease of a lounge at KLIA.

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13.3.4 Taxation

Malaysia's corporate income tax rate is 28%. However, AirAsia has not paid any income tax since inception (except for tax on interest and rental income which is separately assessed for income tax purposes) as a result of losses it incurred from inception to June 30, 2002. To promote development and growth of certain industries, the Government may exempt identified businesses that qualify as Approved Service Projects under Section 127(3) of the Income Tax Act 1967 from corporate income tax. The Company was granted this incentive for five years ended December 31, 2002.

Under Malaysian law, tax losses and unutilized capital allowances can be carried forward indefinitely to offset future taxable income. AirAsia offsets all potential taxable income with its unused capital allowances in the two years ended June 30, 2004. As at June 30, 2004, subject to approval by the Inland Revenue Board, AirAsia had approximately RM36.9 million and RM39.4 million of unabsorbed tax losses and unutilized capital allowances, respectively, available to offset taxable income in future.

The Company has made an application to the Government for a tax exemption on the basis that AirAsia should continue to be considered an Approved Service Project. If the Company receives this exemption, it would not be subject to taxation for a period to be determined by the Government. It is unknown when or whether the exemption is likely to be approved. If the exemption were not obtained, AirAsia would be exposed to potential tax liability that it estimates would be approximately RM10.0 million for the year ending June 30, 2005.

13.4 Year Ended June 30, 2004 Compared to Year Ended June 30, 2003

13.4.1 Revenue

Revenue increased by 19.0% from RM330.0 million for the year ended June 30, 2003 to RM392.7 million for the year ended June 30, 2004. This increase was primarily attributable to an increase in revenue from passenger seat sales, which accounted for 88.6% of total revenues for the year ended June 30, 2004, which was partially offset by a decrease in revenue from chartered flight services.

Passenger seat sales

Passenger seat sales increased by 77.7% from RM195.9 million for the year ended June 30, 2003 to RM348.0 million for the year ended June 30, 2004. The total number of passengers increased from 1.5 million for the year ended June 30, 2003 to 2.8 million for the year ended June 30, 2004, resulting in an increase in passenger load factor from 74% for the year ended June 30, 2003 to 77% for the year ended June 30, 2004. The increase in passenger seat sales was primarily due to the increase in the frequency of scheduled flights (from 161 flights per week to 301 flights per week), number of destinations flown to (from 10 to 23 destinations), fleet size (from seven aircraft to 13 aircraft) and aircraft utilization. The increase in passenger volume more than offset a decrease in average fare price, from RM147 for the year ended June 30, 2003 to RM131 for the year ended June 30, 2004. However, because average stage length was also shorter, revenue per RPK decreased from RM0.151 for the year ended June 2003 to RM0.142 for the year ended June 30, 2004.

Chartered flight revenue

Chartered flight revenue decreased by 80.1% from RM123.1 million for the year ended June 30, 2003 to RM24.5 million for the year ended June 30, 2004. This decrease was due primarily to the expiration in June 2003 of the LTH contract, which generated revenues of RM97.8 million in the year ended June 30, 2003.

Other revenue

Other revenue increased by 81.8% from RM11.1 million for the year ended June 30, 2003 to RM20.2 million for the year ended June 30, 2004. This increase was mainly from a RM2.7 million increase in revenue from excess baggage charges and a RM2.7 million increase in revenue from freight services.

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (*Cont'd*)

Revenue from cancellation fees and sales of in-flight merchandise and food also increased during the year ended June 30, 2004.

13.4.2 Cost of sales

Cost of sales decreased by 3.3% from RM288.5 million for the year ended June 30, 2003 to RM279.1 million for the year ended June 30, 2004, while cost per ASK decreased from RM0.109 for the year ended June 30, 2003 to RM0.094 for the year ended June 30, 2004. This decrease was due to decreases in aircraft operating lease expenses, user charges and station expenses and other costs, which were partially offset by increases in aircraft fuel expenses, maintenance and overhaul expenses and staff costs.

Aircraft fuel expenses

Aircraft fuel expenses increased by 9.7% from RM93.6 million for the year ended June 30, 2003 to RM102.7 million for the year ended June 30, 2004. This increase was primarily attributable to a 80.6% increase in fuel consumption from increased scheduled flights in the year ended June 30, 2004 compared to the year ended June 30, 2003, partially offset by the reduction in fuel consumption for chartered flights resulting from the expiration of the LTH contract on June 30, 2003. In addition, average fuel prices increased from U.S.\$0.71 per gallon for the year ended June 30, 2003 to U.S.\$0.74 per gallon for the year ended June 30, 2004.

AirAsia's fuel expenses did not increase in proportion to the increase in the market price of fuel because all of its fuel requirements were hedged for the year ended June 30, 2003 while approximately 83% of its fuel requirements were hedged for the year ended June 30, 2004.

Aircraft operating lease expenses

Aircraft operating lease expenses decreased by 45.8% from RM79.0 million for the year ended June 30, 2003 to RM42.8 million for the year ended June 30, 2004. This decrease was primarily because lease expenses for a Boeing 747 aircraft used solely for charter flights to Mecca under the LTH contract were no longer incurred for the year ended June 30, 2004 since the LTH contract expired in June 2003. In addition, although AirAsia had six additional aircraft under lease in the year ended June 30, 2004 than in the year ended June 30, 2003, the impact was partially offset by the reduction of average lease rates as new leases were negotiated at more favorable rates.

Maintenance and overhaul expenses

Maintenance and overhaul expenses increased by 32.0% from RM55.9 million for the year ended June 30, 2003 to RM73.8 million for the year ended June 30, 2004. This increase was primarily due to the increase in AirAsia's fleet size from an average of five point five aircraft for the year ended June 30, 2003 to an average of nine point five aircraft for the year ended June 30, 2004. The impact of the larger fleet size was partially offset by economies of scale and the negotiation of maintenance contracts at more favorable rates, which resulted in a decrease in average maintenance and overhaul expenses per aircraft from RM10.2 million per aircraft for the year ended June 30, 2003 to RM7.8 million per aircraft for the year ended June 30, 2004. AirAsia's maintenance and overhaul expenses per ASK decreased from RM0.03 to RM0.02.

Staff costs

Staff costs increased by 89.8% from RM25.5 million for the year ended June 30, 2003 to RM48.4 million for the year ended June 30, 2004. This increase was primarily due to an increase in the number of employees and a 90% increase in salaries and performance-based bonuses paid out.

User charges and station expenses

User charges and station expenses decreased by 56.1% from RM21.8 million for the year ended June 30, 2003 to RM9.6 million for the year ended June 30, 2004. This decrease was primarily because

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (*Cont'd*)

RM5 million in user charges and outsourced ground handling expenses were not incurred for charter flights to Mecca in the year ended June 30, 2004 as the LTH contract expired in June 2003. In addition, other ground handling work was no longer outsourced in the year ended June 30, 2004.

Others

Other costs of sales decreased by 85.0% from RM12.7 million for the year ended June 30, 2003 to RM1.9 million for the year ended June 30, 2004. While credit card commissions increased by RM3.7 million as result of increased purchases made by credit cards, the increase was more than offset by an increase of RM14.0 million from fees derived from AirAsia's administrative and insurance surcharges.

13.4.3 Operating expenses

Sales and marketing expenses

Sales and marketing expenses increased significantly from RM4.4 million for the year ended June 30, 2003 to RM9.4 million for the year ended June 30, 2004. This increase was due to increased print, radio and television advertising expenses as a result of the expansion of AirAsia's operations.

Administration expenses

Administration expenses increased by 49.0% from RM23.1 million for the year ended June 30, 2003 to RM34.4 million for the year ended June 30, 2004. This increase was primarily due to increases in professional fees paid and expenses for pilot training, an increase in office rental expenses as a result of an increase in the number of offices and sales stations AirAsia operated, an increase in telephone charges and administrative staff costs.

Other operating expenses

Other operating expenses increased significantly from RM3.8 million for the year ended June 30, 2003 to RM13.1 million for the year ended June 30, 2004. This increase was primarily due to an increase in the depreciation expenses of aircraft and engineering parts as a result of the increase in AirAsia's fleet size as well as depreciation charge on owned aircraft purchased in 2004.

13.4.4 Other operating income

Other operating income increased significantly from RM1.2 million for the year ended June 30, 2003 to RM4.6 million for the year ended June 30, 2004. This increase was mainly due to increased interest income on short-term investments.

13.4.5 Finance costs

Finance costs increased significantly from approximately RM0.1 million for the year ended June 30, 2003 to RM3.1 million for the year ended June 30, 2004 primarily due to indebtedness incurred in the year ended June 30, 2004 to finance AirAsia's aircraft purchases.

13.4.6 Share of losses of an associated company

Share of losses of an associated company was RM116,000 for the year ended June 30, 2004 due to losses incurred by Thai Crunch Time, in which Crunchtime, a subsidiary of the Company, acquired a 49% stake in April 2004. Thai Crunch Time incurred losses primarily from pre-operating expenses.

13.4.7 Taxation

Taxation expense increased from a tax credit of RM7.4 million for the year ended June 30, 2003 to an expense of RM9.1 million for the year ended June 30, 2004. This increase was primarily the result of the reversal of the deferred tax asset of RM7.5 million arising from unutilized capital allowances recognized in the prior year and the recognition of deferred tax liability on AirAsia's newly acquired

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (*Cont'd*)

aircraft. The reversal of this deferred tax asset was attributable to profits recognized in the current year and the resulting utilization of the tax benefits previously recognized.

13.4.8 Loss/Profit after taxation

As a result of the foregoing, profit after taxation increased significantly from RM18.8 million for the year ended June 30, 2003 to RM49.0 million for the year ended June 30, 2004.

13.5 Year Ended June 30, 2003 Compared to 15 months Ended June 30, 2002

AirAsia changed its business model in January 2002. In addition, the financial year end was also changed from March 31, to June 30, in 2002 (please refer to Section 13.1 "*Management's Discussion and Analysis of Financial Condition and Results of Operations — Overview*"). As a result, AirAsia's results of operations between the 15 months ended June 30, 2002 and the year ended June 30, 2003 are not directly comparable.

13.5.1 Revenue

Revenue increased by 51.8% from RM217.4 million for the 15 months ended June 30, 2002 to RM330.0 million for the year ended June 30, 2003. This increase was primarily attributable to the increase in revenue from passenger seat sales, which accounted for 59.3% of total revenues for the year ended June 30, 2003.

Passenger seat sales

Passenger seat sales increased by 122.9% from RM87.9 million for the 15 months ended June 30, 2002 to RM195.9 million for the year ended June 30, 2003, despite a decrease in average fare price, from RM183 for the 15 months ended June 30, 2002 to RM147 for the year ended June 30, 2003. The total number of passengers increased from 610,738 for the 15 months ended June 30, 2002 to 1,481,097 for the year ended June 30, 2003, resulting in an increase in passenger load factor from 66% for the 15 months ended June 30, 2002 to 74% for the year ended June 30, 2003. The increase in passenger seat sales was primarily due to the change in AirAsia's business model in January 2002, as well as the increase in the frequency of scheduled flights (from 77 flights per week to 161 flights per week), number of destinations flown to (from six to 10 destinations), fleet size (from three aircraft to seven aircraft) and aircraft utilization. However, as a result of lower average fares and shorter average stage length, revenue per RPK decreased from RM0.184 for the 15 months ended June 30, 2002 to RM0.151 for the year ended June 30, 2003.

Chartered flight revenue

Chartered flight revenue decreased from RM123.2 million for the 15 months ended June 30, 2002 to RM123.1 million for the year ended June 30, 2003. Although revenues from the ATM contract decreased by approximately 16.0%, this decrease was offset by increases in revenues from other charter contracts, principally the LTH contract.

Other revenue

Other revenue increased by 74.1% from RM6.4 million for the 15 months ended June 30, 2002 to RM11.1 million for the year ended June 30, 2003. This increase was mainly because of a RM3.6 million increase in revenue from cancellation fees as a result of the increased number of scheduled flights. Revenues from freight services also increased.

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (*Cont'd*)

13.5.2 Cost of sales

Cost of sales increased by 38.6% from RM208.1 million for the 15 months ended June 30, 2002 to RM288.5 million for the year ended June 30, 2003, primarily due to increases in aircraft fuel expenses, maintenance and overhaul expenses and staff costs, which were partially offset by decreases in user charges and station expenses and other costs. However, cost per ASK decreased from RM0.128 for the 15 months ended June 30, 2002 to RM0.109 for the year ended June 30, 2003 due to AirAsia's change in business model.

Aircraft fuel expenses

Aircraft fuel expenses increased by 46.3% from RM64.0 million for the 15 months ended June 30, 2002 to RM93.6 million for the year ended June 30, 2003. This increase was primarily attributable to an increase in fuel consumption as a result of the increase in the number of scheduled flights for the year ended June 30, 2003 compared to the 15 months ended June 30, 2002, as well as in fuel consumption for chartered flight services (principally for the LTH contract).

Aircraft operating lease expenses

Aircraft operating lease expenses increased by 6.0% from RM74.5 million for the 15 months ended June 30, 2002 to RM79.0 million for the year ended June 30, 2003. This was due to the increase in AirAsia's fleet size from an average of 2.5 aircraft for the 15 months ended June 30, 2002 to an average of 5.5 aircraft for the year ended June 30, 2003, including an additional Boeing 747 aircraft used solely for charter flights under the LTH contract. AirAsia negotiated more favorable lease terms for all its aircraft, thus its per aircraft lease expense was lower.

Maintenance and overhaul expenses

Maintenance and overhaul expenses increased significantly from RM13.8 million for the 15 months ended June 30, 2002 to RM55.9 million for the year ended June 30, 2003. This increase was primarily due to the increase in AirAsia's fleet size from an average of 2.5 aircraft for the 15 months ended June 30, 2002 to an average of 5.5 aircraft for the year ended June 30, 2003 and the increase in AirAsia's aircraft utilization due to its change in business model. AirAsia's maintenance and overhaul expenses also increased from RM0.01 per ASK to RM0.03 per ASK.

Staff costs

Staff costs increased significantly from RM10.6 million for the 15 months ended June 30, 2002 to RM25.5 million for the year ended June 30, 2003. This increase was primarily due to an increase in the number of employees and a 140.6% increase in salaries and performance-based bonuses paid out.

User charges and station expenses

User charges and station expenses decreased by 9.5% from RM24.1 million for the 15 months ended June 30, 2002 to RM21.8 million for the year ended June 30, 2003. This decrease was primarily due to lower ground handling fees because AirAsia switched its service provider. This decrease was partially offset by an increase in landing and parking charges, transportation charges and aeronautical charges as a result of AirAsia's increased fleet size and utilization.

Others

Other costs of sales decreased by 40.0% from RM21.2 million for the 15 months ended June 30, 2002 to RM12.7 million for the year ended June 30, 2003. This decrease was mainly due to the receipt of RM13.5 million in offsetting fees derived from AirAsia's administrative and insurance surcharges, as well as a decrease in the cost of meals as a result of the cessation of providing free food on AirAsia's scheduled air travel services. This decrease was partially offset by an increase in AirAsia's aviation insurance premiums in connection with an increase in AirAsia's fleet size.

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont'd)

13.5.3 Operating expenses

Sales and marketing expenses

Sales and marketing expenses increased significantly from RM1.5 million for the 15 months ended June 30, 2002 to RM4.4 million for the year ended June 30, 2003. This increase was due to increased print, radio and television advertising expenses as a result of the expansion of AirAsia's operations.

Administration expenses

Administration expenses increased significantly from RM7.9 million for the 15 months ended June 30, 2002 to RM23.1 million for the year ended June 30, 2003. This increase was primarily due to increased headcount for administrative and sales and marketing staff, which accounted for an additional RM10.5 million, and an increase in office rental expenses because of an increase in the number of offices and sales stations AirAsia operated.

Other operating expenses

Other operating expenses increased significantly from RM1.4 million for the 15 months ended June 30, 2002 to RM3.8 million for the year ended June 30, 2003. This increase was primarily due to an increase in the depreciation expenses of engineering parts as a result of the increase in AirAsia's fleet size.

13.5.4 Other operating income

Other operating income increased from RM0.3 million for the 15 months ended June 30, 2002 to RM1.2 million for the year ended June 30, 2003. This increase was mainly due to a gain on disposals of short-term investments and advertising income received for the first time in 2003.

13.5.5 Finance costs

Repayment of certain loans contributed to a decrease in finance costs from RM0.3 million for the 15 months ended June 30, 2002 to approximately RM0.1 million for the year ended June 30, 2003.

13.5.6 Taxation

Taxation expense improved significantly from RM56,000 for the 15 months ended June 30, 2002 to a tax credit of RM7.4 million for the year ended June 30, 2003. This decrease was the result of AirAsia's recognition of a deferred tax asset of RM7.5 million arising from unutilized capital allowances. The credit primarily arising from the recognition of the deferred tax asset was slightly offset by the current tax expense of RM125,000 relating to interest and rental income.

13.5.7 Loss/profit after taxation

As a result of the foregoing, profit after taxation increased from a loss of RM1.7 million for the 15 months ended June 30, 2002 to a profit of RM18.8 million for the year ended June 30, 2003.

13.6 Year Ended June 30, 2002 Compared to Year Ended March 31, 2001

It is not meaningful to compare the 15 months ended June 30, 2002 against the 12 months ended March 31, 2001 as AirAsia was then under a different management and operating as a full service airline then until it was acquired by Tune Air in December 2001.

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (*Cont'd*)

13.7 Year Ended March 31, 2001 Compared to Year Ended March 31, 2000

It is not meaningful to compare the 12 months ended March 31, 2001 against the 12 months ended March 31, 2000 as AirAsia was then under a different management and operating as a full service airline then until it was acquired by Tune Air in December 2001.

13.8 Liquidity and Capital Resources

13.8.1 Cash flows

Year ended June 30, 2004 compared to year ended June 30, 2003

Net cash generated from operating activities increased by RM13.7 million from RM15.2 million for the year ended June 30, 2003 to RM28.9 million for the year ended June 30, 2004. This significant improvement in cash from operating activities was primarily due to a RM46.5 million increase in profit before taxation. This increase was partially offset by a RM29.1 million increase in deposits on aircraft operating leases as a result of the increase in AirAsia's fleet size and for jet fuel derivative contracts and a RM40.2 million increase in other receivables, which includes among other items RM17.0 million in expenses incurred and payments made on behalf of Thai AirAsia for its operations and RM20.0 million in advances to AAIL to establish the joint venture with Shin Corporation relating to Thai AirAsia.

Net cash used in investing activities increased by RM121.5 million from RM22.3 million for the year ended June 30, 2003 to RM143.8 million for the year ended June 30, 2004. The increase was primarily attributable to cash used to purchase four aircraft during the year.

Net cash generated from financing activities increased by RM115.2 million from RM25.8 million for the year ended June 30, 2003 to RM141.0 million for the year ended June 30, 2004. The increase was primarily due to indebtedness incurred in the year ended June 30, 2004 to finance aircraft purchased during the year as well as proceeds received for allotment of new shares.

Year ended June 30, 2003 compared to 15 months ended June 30, 2002

Net cash used in operating activities was RM12.0 million for the 15 months ended June 30, 2002, and net cash generated from operating activities was RM15.2 million for the year ended June 30, 2003. This significant improvement in cash from operating activities was primarily due to a RM24.8 million increase in trade and other payables as a result of the increase in AirAsia's fleet size, among other factors related to AirAsia's expansion and a RM13.1 million increase in profit before taxation. This increase was partially offset by a RM26.3 million increase in trade and other receivables, which was a result of increased deposits on new aircraft acquired under operating lease, and increased insurance prepayments as AirAsia's business continued to expand.

Net cash used in investing activities increased by RM15.7 million from RM6.6 million for the 15 months ended June 30, 2002 to RM22.3 million for the year ended June 30, 2003. The increase was primarily attributable to an increase in the purchase of engineering equipment and short-term investments.

Net cash used in financing activities was RM2.2 million for the 15 months ended June 30, 2002, and net cash generated from financing activities was RM25.8 million for the year ended June 30, 2003. The change was primarily due to the receipt of RM27.6 million in share application monies received in advance for shares which were subsequently issued in July 2003.

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont'd)

13.8.2 Working capital

AirAsia's principal source of liquidity is cash from operations. AirAsia also has certain surplus funds in short-term deposits that it may use for any unforeseen capital or other requirements. As at June 30, 2004, AirAsia had RM32.1 million in short-term deposits. In addition, as at June 30, 2004, AirAsia had an aggregate of RM13.4 million of available credit facilities.

As at June 30, 2002, 2003 and 2004, net working capital, defined as the difference between current assets and current liabilities, was a deficit of RM10.6 million, a surplus of RM7.9 million and a surplus of RM36.3 million, respectively. The Company's Board of Directors believes that after taking into consideration the expected cash generated from operations and proceeds from the issue of the Issue Shares and the banking facilities currently available to it, AirAsia has adequate liquidity and capital resources for its present requirements and the requirements for 12 months following the date hereof.

AirAsia incurs debt to finance its acquisition of aircraft. As at June 30, 2004, its total outstanding debt was RM95.5 million. Please refer to Section 14 *"Description of Material Indebtedness and Credit Facilities"* for a description of AirAsia's financing arrangements. AirAsia intends to use the outstanding balance of RM94.2 million of the proceeds from the issue of the Issue Shares to repay this indebtedness.

AirAsia may need to raise capital in the future if its cash flow from operations is not adequate to meet liquidity requirements or if AirAsia acquires additional aircraft or enters into new joint ventures. Depending on capital requirements, market conditions and other factors, AirAsia may raise additional funds through debt or equity offerings or through the sale of assets. In the event that such financing cannot be obtained, AirAsia may be compelled to scale back its plans for future business expansion.

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13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont'd)

13.9 Capital Expenditure

13.9.1 Historical capital expenditure

The table below presents AirAsia's capital expenditure for the periods indicated:

	Historical capital expenditure					
	Year ended March 31,		15 months ended June 30,	Year ended June 30,		
	2000	2001	2002	2003	2004	Total
	(RM thousands)					
Aircraft.....	-	-	-	-	102,120	102,120
Aircraft spare parts, fixtures and fittings	-	-	4,073	10,352	8,180	22,605
Office equipment and renovations.....	87	573	2,238	3,395	6,366	12,659
Aircraft and other assets not in operation ⁽¹⁾	-	-	-	1,246	30,408	31,654
Others ⁽²⁾	12	60	302	1,828	2,827	5,029
Total.....	99	633	6,613	16,821	149,901	174,067

Notes:

- (1) This item included aircraft and other assets which were not fully paid during the financial year and were not in operation.
- (2) Others includes furniture and fittings, motor vehicles, operating plant and ground equipment, kitchen equipment and hangar building

13.9.2 Planned capital expenditure

AirAsia's budgeted capital expenditure for the year ending June 30, 2005 are summarized in the following table:

	Budgeted capital expenditure for the year ended
	June 30, 2005
	(RM millions)
Aircraft ⁽¹⁾	68.7
Aircraft spare parts, fixtures and fittings.....	11.3
Office equipment and renovations.....	4.9
Construction of flight simulator complex	12.0
Others ⁽²⁾	3.1
Total.....	100.0

Notes:

- (1) AirAsia expects to purchase three additional aircraft during the year ended June 30, 2005. The first aircraft was delivered in October 2004, the second is expected to be delivered by January 2005 and the third is to be delivered by June 2005. This does not include potential expenditure related to the proposed acquisition of up to 80 aircraft as explained below.
- (2) Others includes furniture and fittings, motor vehicles, office equipment, office renovation, operating plant and ground equipment, kitchen equipment and hangar building

AirAsia expects to continue to incur substantial capital expenditure, primarily to expand the Group's fleet size to 36 aircraft by June 30, 2005 (please refer to Section 7.15 – "Fleet"). AirAsia's plans depend on a number of factors, including changes in economic, political or other conditions in the countries where it operates, or events that have a material adverse effect on the airline and the tourism industry. No assurance can be given that any of these acquisitions will be completed in the expected time frame or within the estimated budget. Please refer to Section 5.1.2 "Risks Relating to the Group – The Group may not be successful in implementing its growth strategy".

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont'd)

AirAsia is considering the proposed acquisition of up to 80 new aircraft, consisting of 40 purchase obligations and 40 purchase options from Airbus and Boeing ("Proposed Acquisition"). An agreement to purchase aircraft from either Airbus or Boeing could be reached as early as December 2004. In the event AirAsia enters into an agreement to purchase such aircraft (which would be in addition to the three aircraft AirAsia expects to acquire by June 30, 2005) costs associated with deposits and initial progress payments would be paid for with existing cash on hand which will include proceeds from the issue of the Issue Shares allocated to working capital. AirAsia plans to proceed with the Proposed Acquisition only if it believes that such a purchase would be likely to benefit its shareholders, taking into account, among other things, the economic benefits of any new aircraft type, the potential risks and operating difficulties of such aircraft type, whether AirAsia could maintain substantial unrestricted cash balances and whether it would be able to obtain debt or lease financing. AirAsia expects that these aircraft will be delivered over a period of several years, commencing as early as January 2006. Please refer to Section 7.15 "Business—Fleet" and Section 4.9 "Utilization of Proceeds".

AirAsia expects to continue to incur substantial capital expenditure, primarily to expand the Group's fleet size to 36 aircraft by June 30, 2005 (please refer to Section 7.15 "Business—Fleet"). AirAsia's plans depend on number factors, including changes in economic, political or other conditions in the countries where it operates, or events that have a material adverse effect on the airline and the tourism industry. No assurance can be given that any of these acquisitions will be completed in the expected time frame or within the estimated budget (please refer to Section 5.1.2 "Risks Factors — Risks Relating to the Group — the Group may not be successful in implementing its growth strategy").

13.10 Contractual Obligations and Contingent Liabilities

13.10.1 Contractual obligations and commitments

As at September 30, 2004, AirAsia had the following commitments:

	As at September 30, 2004	Payable within one year	Payable after one year but within three years	Payable after three years but within five years	Payable after five years
			(RM thousands)		
Aircraft.....	19,980	19,980	-	-	-
Property, plant and equipment.....	9,780	9,780	-	-	-
Aircraft operating lease expenses	387,665	75,193	142,903	99,814	69,755
Total	417,425	104,953	142,903	99,814	69,755

In the event AirAsia leases additional aircraft excluding the 16 additional aircraft the Group expects to lease during the year ending June 30, 2005, any costs associated with such leases would be paid for using proceeds from the Initial Public Offering currently allocated to working capital. Section 4.9 "Utilization of Proceeds".

13.10.2 Contingent Liabilities

As at September 30, 2004, AirAsia had the following liabilities which has not been provided for in AirAsia's audited consolidated financial accounts for the financial year ended June 30, 2004.

	RM millions
Liabilities for withholding tax.....	2.3

For further information, please refer to Section 14 "Material Indebtedness and Credit Facilities".

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (*Cont'd*)

13.11 Market Risk

AirAsia is exposed to market risk, including fuel price risk, foreign currency exchange rate risk and interest rate risk. Please refer to Section 20 "*Accountant's Report*" for a description of AirAsia's accounting policies and additional information.

13.11.1 Fuel price risk

Fuel costs, which represent a significant portion of AirAsia's expenses, have historically been subject to wide fluctuations as a result of actual or anticipated movements in supply and demand. AirAsia implements various fuel management strategies to manage the risk of rising fuel prices. These contracts fix the price of all of AirAsia's expected fuel requirements as long as the market price of jet fuel stays within a pre-determined range. In the event that the market price of jet fuel exceeds this range, AirAsia is required to pay a premium in addition to the fixed price.

For the year ended June 30, 2003, AirAsia was effectively 100% hedged because, with respect to all of its fuel purchases, the market price of jet fuel remained within the range prescribed under AirAsia's jet fuel derivative contract. However, during the six months ended June 30, 2004, the market price of jet fuel increased above the prescribed range so that AirAsia's fuel price hedge was no longer fully effective. For the year ended June 30, 2004, approximately 17% of AirAsia's fuel requirements were purchased at market prices.

AirAsia has entered into jet fuel derivative contracts for all of the Group's expected fuel requirements for the year ending June 30, 2005. In the event that fuel prices exceed the prescribed upper limits, approximately 30% of the Group's expected fuel requirements for the year ending June 30, 2005 will be exposed to full market prices. In the three months ended September 30, 2004, the market price of jet fuel has exceeded the prescribed upper limits of AirAsia's hedge such that AirAsia's fuel price hedge has not been fully effective. If the market price falls below the bottom of the fixed price range, AirAsia is required to pay a pre-determined minimum price. The contracts also contain volume, duration and other limitations.

Fuel prices have risen sharply since early December 2003 and AirAsia believes that these costs may increase further. AirAsia forecasts that its fuel cost will increase to approximately 43% of its total cost of sales and operating expenses for the year ending June 30, 2005, compared to approximately 31% of its total cost of sales and operating expenses for the year ended June 30, 2004. AirAsia has not yet entered into any jet fuel derivative contracts for the Group's expected fuel requirements for any period after June 30, 2005. Any increase in cost and/or decline in availability of adequate supplies of fuel could cause AirAsia to increase the fares it charges for air travel services, implement a fuel surcharge and/or have a material adverse effect on AirAsia. Please refer to Section 5.1.4 "Risk Factors - Risks Relating to the Group - the Group could be materially and adversely affected by the unavailability of sufficient quantities or cost of fuel", Section 13.2.1 "*Significant Factors Affecting AirAsia's Results of Operations - Low operating expenses*" and Section 7.18 "*Business - Fuel*".

13.11.2 Foreign currency exchange rate risk

Approximately 90% of AirAsia's revenues and 10% of its expenses were denominated in Malaysian Ringgit for the year ended June 30, 2004. AirAsia also receives revenues in Baht, Singapore dollars and Indonesian Rupiah but it does not enter into any hedging contracts to hedge fluctuations in exchange rates. Revenues, including credit card payments made through online bookings, that are denominated in Indonesian Rupiah and Macanese Patacas are converted immediately to U.S. dollars. The majority of AirAsia's costs, including fuel, aircraft lease expenses, maintenance expenses and insurance costs are denominated in U.S. dollars. However, because the Malaysian Ringgit is currently pegged to the U.S. dollar, AirAsia is not exposed to fluctuations between the two currencies. AirAsia may hedge its foreign currency exposure in the future, as it expands its services to additional international destinations.

In addition, Thai AirAsia is subject to fluctuations in the exchange rates between U.S. dollars and Baht as the majority of its revenues are denominated in Baht while most of its expenses are denominated in

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (*Cont'd*)

U.S. dollars. Where appropriate, Thai AirAsia intends to enter into hedging arrangements to minimize its risk to exposure to fluctuations between Baht and U.S. dollar.

13.11.3 Interest rate risk

Changes in interest rates affect AirAsia's interest expenses as all of its indebtedness is subject to floating interest rates. As at June 30, 2004, borrowings owed to banks amounted to an aggregate of RM95.5 million at effective interest rates ranging from 4.0% to 5.0%. Although AirAsia intends to use some of the proceeds from the Initial Public Offering to repay outstanding indebtedness, AirAsia is likely to incur additional floating rate indebtedness if it incurs debt financing in connection with the acquisition of additional aircraft.

13.11.4 Credit Risk

AirAsia's exposure to credit risks, or the risk of counterparties defaulting arises mainly from cash deposits and receivables. The maximum exposure to credit risks is represented by the total carrying amount of these financial assets in the balance sheet. Credit risks, or the risk of counterparties defaulting, are controlled by the application of credit approvals, limits and monitoring procedures. Credit risks are minimized by monitoring receivables regularly.

AirAsia generally has no concentration of credit risk except for a debt owned by two customers, which constituted approximately 83.4% of AirAsia's outstanding trade receivables as at June 30, 2004. However, the Directors are of the opinion that AirAsia's exposure to credit risk have been fully provided for.

13.11.5 Seasonality

AirAsia generally records higher revenue from November to January as festivals and school holidays in Malaysia increase AirAsia's passenger load factors. Accordingly, its revenue, operating profit and cash flow is usually lower between February and May and between July and September due to decreased travel during those months. Although Thai AirAsia did not commence operations until February 2004. The Company believes peak periods of demand in Thailand to be between November and January as well as in April due to increased leisure travel during those periods.

13.11.6 Inflation

AirAsia does not believe that inflation has had a material impact on its business, financial condition or results of operations. Inflation in Malaysia was 1.3% for the year ended December 31, 2003. If Malaysia were to experience significant inflation, AirAsia may not be able to fully offset the resulting higher costs through fare increases. AirAsia's failure or inability to do so could adversely affect its business, financial condition and results of operations.

13.12 Critical Accounting Policies and Estimates

In accounting for certain transactions and operations of its business, AirAsia's management establishes policies for the recognition of the revenue and expense, some of which require management to develop estimates and expectations regarding future events, including estimates for the useful lives of assets, the ability to generate revenue and the likelihood of receiving payments from third parties. The assumptions underlying these recognition standards are, of necessity, subjective in nature. The ability to effectively and accurately establish, monitor and adjust these standards may have a material impact on the accuracy and quality of the financial information reported by AirAsia. It is important to understand the underlying assumptions and policies adopted by AirAsia when analyzing AirAsia's financial conditions and results of the operations.

The Company's significant accounting policies are described in "Financial Statements and Independent Auditor's Report – Summary of Significant Accounting Policies". The preparation of financial statements requires the Company's management to make estimates and assumptions that affect the

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (*Cont'd*)

amounts reported in the consolidated financial statements and accompanying footnotes. AirAsia's estimates and assumptions are based on historical experiences, including changes in the business environment. However, actual results may differ from estimates under different conditions, sometimes materially. Critical accounting policies and estimates are those that are both most important to the portrayal of the Company's financial condition and results and require management's most subjective judgments. AirAsia's most critical accounting policies and estimates are described below.

Revenue recognition

Scheduled passenger flight and chartered flight income is recognized upon the rendering of transportation services and where applicable, net of discounts. The value of seats sold for which services have not been rendered is included in current liabilities as sales in advance.

As described in Note 2 to the Company's consolidated financial statements, seats sold and unused for passenger air travel are initially deferred as "Sales in advance". Sales in advance represents seats sold for future travel dates. Passenger revenue is recognized, and sales in advance is reduced, when the service is provided (i.e. when the flight takes place) AirAsia's terms and conditions of sale provide that seats sold but unused are void and are not refundable. The Company's sales in advance balance as at June 30, 2004 was RM33.1 million.

Amounts collected on behalf of governments or other regulatory bodies and direct per-passenger charges, are excluded from revenue as these amounts are not considered economic benefits which flow to AirAsia. Cargo, freight and other related revenue are recognized upon the completion of services rendered and where applicable, net of discounts.

Operating leases

Leases under which AirAsia assumes substantially the significant risk and benefits of ownership are classified as finance leases. Other leases are classified as operating leases.

All the aircraft lease agreements entered into by AirAsia are operating leases in compliance with MAAS. These agreements have the following key features which warrant the classification above:

- the lease does not transfer ownership of the aircraft to AirAsia by the end of the lease term;
- there is no option for AirAsia to purchase the aircraft at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised; and
- the lease term is not a major portion of the economic life of the related aircraft.

Payments made under operating leases (net of incentives received from the lessor) are charged to the income statement on a straight-line basis over the lease period.

Aircraft maintenance costs

Routine maintenance costs are expensed as incurred. This practice applies to both owned and leased aircraft and is distinct from major maintenance.

Provision is made for the estimated future cost of major overhaul and maintenance expenditure of leased airframes, engines and auxiliary power units by making charges to the income statement, calculated by reference to the number of hours or cycles operated during the period, as a result of aircraft rectification obligations placed on AirAsia by operating lease agreements. The cost of major overhaul and maintenance expenditure are written off against the provision when incurred.

AirAsia has certain aircraft for which the lease commenced during a major overhaul cycle and for which AirAsia is obligated under the terms of the lease to pay the full amount of the overhaul cost, although AirAsia only leases the aircraft for a portion of the relevant maintenance cycle. This element of the maintenance cost payable is recognized as a liability upon inception of the lease and an

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (*Cont'd*)

equivalent amount is accounted for as an asset (deferred expenditure). The deferred expenditure is amortized over the operating lease period. The liability is offset against the maintenance costs when such costs are actually incurred.

Major overhaul and maintenance expenditure on owned aircraft is capitalized as part of the carrying value of the aircraft as incurred and amortized over the period to the next scheduled heavy maintenance.

Property, plant and equipment

As of June 30, 2004, AirAsia had approximately RM158.5 million of property, plant and equipment, including RM144.2 million of flight equipment and related assets. In accounting for property, plant and equipment, AirAsia must make estimates about the expected useful lives of the assets, the expected residual values of the assets, and the potential for impairment based on the fair value of the assets and the cash flows they generate.

The following table shows a breakdown of AirAsia's key property, plant and equipment groups along with information about estimated useful lives and residual values of these groups:

	<u>Estimated Useful Life</u>
Aircraft and engines	7 years
Aircraft spares	10 years
Ground property and equipment	5 years

In estimating the lives and expected residual values of its aircraft, AirAsia has primarily relied upon actual and industry experience with the same or similar aircraft types and recommendations from Boeing Inc., the manufacturer of AirAsia's aircraft. Aircraft estimated useful lives are based on historical and anticipated future utilization of the aircraft. AirAsia evaluates its estimated useful lives, residual values and assumptions for each reporting period and when circumstances warranted, adjusts these estimates and assumptions. Generally, these adjustments are accounted for on a prospective basis through depreciation expenses as required by MAAS.

When appropriate, AirAsia evaluates its assets for impairment. Factors that would indicate potential impairment may include, but are not limited to, significant decreases in the market value of the asset(s), a significant change in the asset's physical condition, and operating or cash flow losses associated with the use of the asset. While the airline industry as a whole has experienced many of these indicators, AirAsia has continued to operate all of its aircraft and continues to experience positive cash flow. Consequently, AirAsia has not identified any impairment related to owned aircraft. AirAsia will continue to monitor its assets and the airline operating environment.

Derivatives

AirAsia uses certain derivative financial instruments to hedge its exposure to changes in jet fuel prices, and accounts for them under the Malaysian Accounting Standard Board, standard 24 "Financial Instruments : Disclosure and Presentation" ("MASB 24"). The Company is required to comply with restrictions on foreign ownership of its Shares, which may affect the voting rights, liquidity and market price of the Shares; Please refer to Section 13.11 "— Market Risk – Fuel price risk" for more information on these risk management activities. MASB 24 requires that where a financial instrument has been designated as a hedge for risk associated with anticipated future transactions, certain disclosures are required to be made. Gains or losses on the hedge arising up to the date of the anticipated transaction, together with any costs or gains arising at the time of entering the hedge, are only recognized or included in the measurement of income when it has occurred as designated i.e., on delivery of the related jet fuel. The fair value of AirAsia's financial derivative instruments not recognized in AirAsia's consolidated balance sheet at June 30, 2004, was RM28.0 million. Should the fair valuation be included in the financial statements, this would result in an increase in the Company's shareholders' funds. The Company does not purchase or hold any derivative instruments for trading purposes.

13. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Cont'd)

Where the anticipated transaction is no longer expected to occur as designated, the gains or losses relating to the hedged transaction are immediately recognized in the financial statements.

Income and deferred taxation

AirAsia has not historically paid significant amounts of corporate tax as only the interest and rental income has generated taxable profits, which have been presented as current tax.

Temporary taxable differences, the future reversal of which will give rise to taxable income, are provided for in full and are included as deferred tax liabilities in the financial statements.

AirAsia has significant amounts of brought forward capital allowances, other temporary deductible differences and unutilized tax losses. AirAsia assesses at each period end, whether there is sufficient convincing evidence that these potential credits are capable of reversal and utilization in future periods. Where it is probable that future taxable critical profit will be available against which the tax benefits can be utilized, AirAsia will recognize these benefits as deferred tax assets in the financial statements. As at 30 June 2004, AirAsia has a net deferred tax liability of RM1.1 million.

13.13 Audit Matters

The audited financial statements of the Company were not subject to any audit qualification for the years ended March 31, 2000, 2001, for the 15-month period ended June 30, 2002, and the years ended June 30, 2003 and 2004. The audited financial statements of Crunchtime were not subject to any audit qualification for the financial period from October 16, 2002 (Crunchtime's date of incorporation) to June 30, 2003 and for the year ended June 30, 2004.

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