

# AIR INDIA - THE ROAD AHEAD



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## PERSPECTIVE

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**As 2007 comes to an end, India's state-owned airlines can look back on what has been a momentous year in their history: notably, after nearly two decades of trying, which saw the merger of Air India and Indian Airlines. On paper, the combination of the international flag carrier, with one of the country's largest domestic airlines, has the potential to create a formidable carrier, with an extensive network and a fleet of over 120 aircraft.**

**There are strong drivers to support this merger, with potential benefits on both the cost and revenue sides of the ledger, and indeed both carriers faced a very tough existence if they continued independently. Merging the two airlines was undoubtedly an unavoidable decision. However, as we review in this perspective, merger is never an easy process and is particularly challenging in the current environment.**

#### **Leadership - or vacuum?**

The vision to merge Air India and Indian was shared by Minister of Civil Aviation, Praful Patel, and the heads of both carriers. It was only through this consensus that they were able to navigate a potentially difficult transaction, which faced a number of labour and political obstacles.

Throughout this process, the Chairman and Managing Director of Air India, Mr. V.Thulasidas, was a key driver who recognised that both airlines were becoming increasingly unviable in the rapidly liberalizing environment, as low cost airlines rapidly increased their market share, private carriers were permitted to expand overseas and foreign airlines were granted increasing access to India. His strong commitment to the merger and the positive message which he communicated has been critical to getting to this point, and he is the most suitable person to see the integration process through to its conclusion. However, Mr Thulasidas' tenure will come to an end on 31 March 2008. It remains to be seen what impact this will have on the direction of the merged airline.

This uncertainty will be compounded by the fact that a

number of key members of the senior management team are due to retire in coming months. There will still be several highly skilled and accomplished executives at senior levels, but there is a lack of depth at the middle management level, and it is these areas that are most impacted by the process of integrating two long-established and complex companies.

#### **Financial results take a wrong turn**

Air India posted a significant financial loss of USD112.5 for the twelve months to 31 March 2007. This result was achieved against a background of buoyant growth as international traffic to/from India grew by 15.1%. However, increased competition, declining yields and high fuel prices took their toll on the company's financial performance. The results for the current financial year are likely to show a further deterioration, as each of the contributing factors continue to intensify.

Furthermore, as the combined entity takes delivery of more of the 111 aircraft on order, the company's capital expenditure requirements become massive. As new payments fall due, the airline will face a significant interest and depreciation burden, in turn placing increased pressure on an already stretched balance sheet.

#### **... and cost pressures are mounting**

Labour productivity remains low, with Air India and Indian both having a much higher ratio of employees per aircraft than the private carriers. A new wage agreement is to be renegotiated in January 2008 and in light of the increasing shortage of skilled manpower in the Indian economy, wage inflation is being seen across many industries. Powerful unions can consequently be expected to press for increases - and perhaps significant ones.

The skills shortage is being faced most acutely in pilot recruitment, with Air India urgently requiring an additional 250 technical crew. One B777 is apparently currently grounded because of a lack of pilots. Meanwhile, fuel prices continue to strike new highs in excess of USD90 per gallon.

**... competition is intensifying**

The carrier's international operations have faced increased competition from European, Gulf and Asian carriers, as the government continues to open up the skies to facilitate trade and tourism. In 2008 Air India will face even greater competition from private Indian carriers. Jet Airways has been operating international routes since 2005, and from Jan-08 it will for the first time be permitted to launch services to the Gulf. The region had previously been reserved for the state-owned carriers, and had been one of their most lucrative markets.

The current regulation requiring private carriers to complete five years of domestic operations before being granted international access is also likely to be relaxed, and Kingfisher/Deccan plan to make their international debut in 2008/09, with others likely to follow. Kingfisher is scheduled to take delivery of ten A330/A340s by the end of 2008, with the USA and Europe being the network priorities, currently the highest revenue generators for Air India.

**... and management attention will be distracted from the core business**

At the very time when competition and the cost environment are becoming more challenging, Air India is however faced with the huge task of integrating two very different carriers. This process also involves developing a plan for a cargo operation, a low cost subsidiary, maintenance, ground handling, and pilot training. Fighting on multiple fronts is taking attention away from the core business, a situation compounded by the limited management capital available, and the internal struggles that inevitably arise during the merger of two companies.

This management bottleneck has impacted the basic operations of flying passengers, as evidenced by reports of recent delays and cancellations. Media can over-emphasise an issue, but there does appear to be a loss of focus on the people with a stake in the airline, be they passengers or employees, as attention is diverted to business strategy and equipment. In the long term, without the support of passengers and employees there is no business.

## **Fleet Expansion**

Air India is taking a long term view with respect to its fleet planning, and has indicated that it intends to place an order in the coming months for up to 150 aircraft. This order will be for deliveries beyond 2013 and is driven by the perceived need to secure positions in the strong order books of Airbus and Boeing, with delivery slots for some aircraft types sold out well into the next decade. There is a concern that if aircraft are not ordered soon, Air India may find itself unable to acquire the fleet required to meet expected long term market demand.

The manufacturers are currently in an enviable position, but with concern growing over the state of the global economy, the delivery position may well change over the next couple of years at possibly more favourable terms. Meanwhile, Air India might be better advised not to rush into placing an order just yet and instead focus on the major issue: the short term.

New orders would be better postponed until the integration process is further progressed, financial stability is restored, management is strengthened at all levels and the future direction of the carrier is clearer. The Ministry's recent directive to the airline's management "perform or perish" suggests that the situation is well understood.

## **Conclusion**

The merger of Air India and Indian is the most significant recent development for India's aviation sector. Managed correctly, the combined entity has huge potential as the largest airline in one of the world's largest and fastest growing economies. Global alliances will be attracted by its extensive network in an untapped part of the world (and indeed Star Alliance is due to vote on Air India's membership later this week).

However, the complexity of overseeing a merger taking place against such a challenging environment cannot be overstated, albeit there was no other option. Ultimately, Air India will need to be privatised over the next 3-5 years to introduce commercial disciplines. A partial IPO, scheduled for 2008/09 would be the first step, although the value that can be achieved will be highly dependent on the results from the integration process over the next 12-18 months. A heavily debt-laden ledger will not make that process easy, unless profitability is strong.

Introducing a strategic partner would ideally precede this first step, but would probably follow. Yet an Indian partner might raise competition concerns, and an overseas partner

would require changes in the regulations which currently prohibit foreign airlines from holding a stake in Indian carriers.

If Air India can successfully navigate through the next couple of years, it has the potential to become a major Asian airline, but 2008 will be critical.