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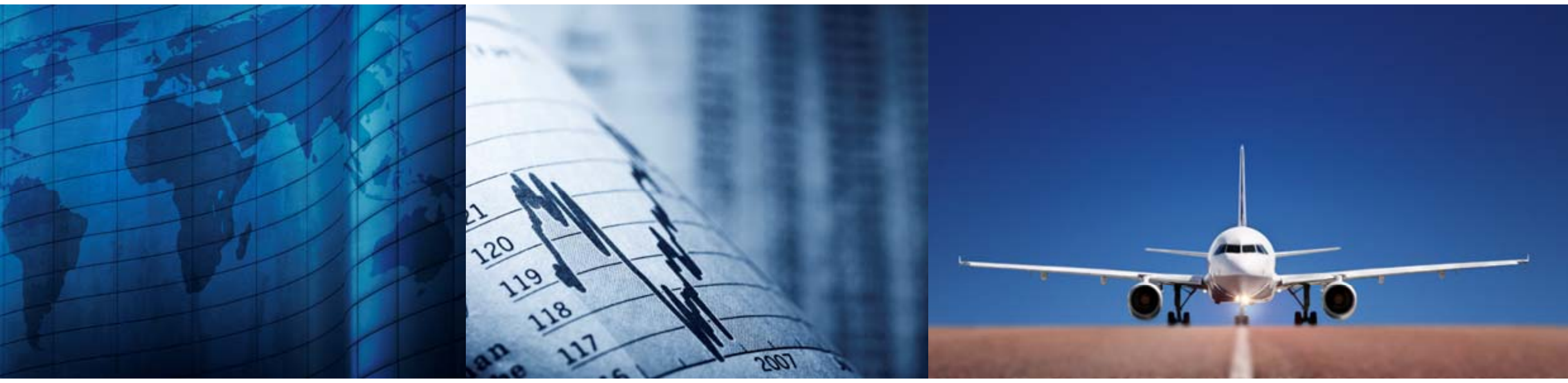
Indian Airlines Prepare for Consolidation Round Two



Centre for Asia Pacific Aviation

Market Research & Intelligence Unit

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Perspective

Indian Airlines Prepare for Consolidation Round Two

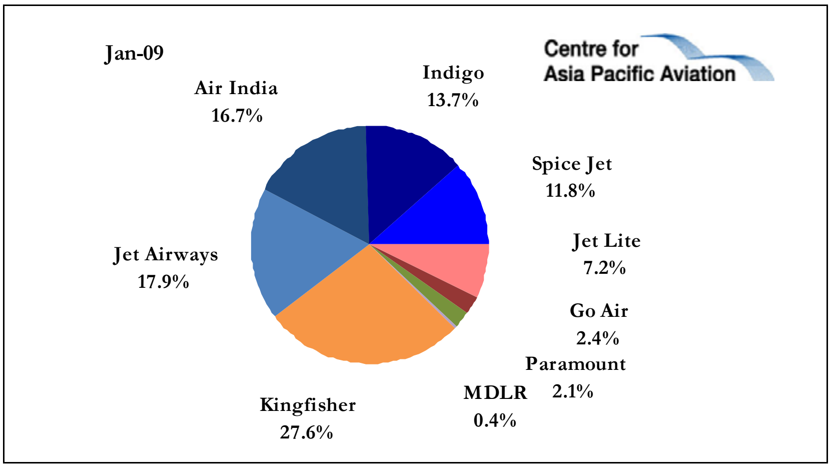
India's airline sector appears headed for another round of consolidation in 2009, as carriers seek to return the industry to profitability after a turbulent couple of years. Earlier attempts have not been particularly successful. But this appears to be the only option.

Since 2005, the financial performance of Indian carriers has been repeatedly battered by deep discounting, the fuel price spike, slowing demand and depreciation of the Indian rupee. With accumulated losses over the last 3-4 years estimated to be over USD4 billion, the industry is in need of restructuring. The problem: too many airlines, too few airports and passengers.

But, as airlines the world over have frequently found, mergers can bring along with them large amounts of baggage. These often outweigh the more obvious – or more apparent – benefits.

The immediate problem is that the airline market is highly fragmented, with too few routes to fly. And the train market has not yet taken to the air. Nine carriers are battling for a share of the market, operating largely similar route networks and offering limited differentiation in the customer proposition.

Indian domestic market share in Jan-09



Source: Centre for Asia Pacific Aviation, DGCA

To address the overcapacity in the market, Indian carriers recently attempted to stimulate demand with promotional pricing. In Jan-09 carriers cut fares by up to 50% across much of their inventory.

But with concentration on major inter-city (metro) routes, the mass leisure market has not yet been tempted to fly. The result was a marginal increase in traffic, but a dramatic decline in yields and consequently revenue for the month of Jan-09. Passenger loads for LCCs reportedly showed some improvements in Feb-09. However as up to 40% of these seats were sold during the promotional period, yields remained under pressure. With fares now increased again, traffic for March is expected to remain weak.

Demand is proving to be relatively unresponsive to price stimulation – at least at a level that is viable. This appears to be because the large discretionary market is still absent. In these circumstances, the only other solution is to reduce capacity. And the most effective way to achieve this is likely to involve consolidation through acquisition or market exit.

Consolidation Round 1: Disappointing Results

This is not the first time Indian aviation has witnessed restructuring of the market in recent years. The earlier phase of consolidation took place in 2007 with the acquisition of Air Sahara by Jet Airways, followed by Kingfisher taking a controlling stake and subsequently merging with Air Deccan, and the decision to merge Air India and Indian Airlines.

For Jet Airways and Kingfisher, the key driver of their decisions to acquire Air Sahara and Air Deccan, was to establish market leadership in order to be able to influence the direction of the industry and achieve pricing power.

Other anticipated benefits included network expansion, access to scarce airport slots and infrastructure, and costs savings through scale economies. At that time, the market was reporting growth of 25% year-on-year and the acquisition strategy appealed to investors.

But this consolidation, aimed at creating a more viable business model, took place against the background of an industry that was beginning to exhibit the first signs of distress.

- The bullish fleet orders placed by Indian carriers saw capacity being introduced at the rate of 6 to 6.5 aircraft a month, whereas the actual growth in demand was closer to 3 aircraft equivalents;
- Aside from the mis-match between supply and demand, the rate of growth was simply too great for the industry to handle from a management and capital perspective.
- In a fragmented market, with multiple start-ups chasing market share, loss-leader pricing was widespread and Air Deccan in particular was responsible for setting fares well below cost as it fought to retain its first mover market share;
- The rapid increase in capacity at a time when the airport modernisation program was yet to deliver upgraded infrastructure, meant that airports and airways were highly congested, increasing airline operating costs;
- With the inadequate surface access and airport (and airways) infrastructure, airlines were unable to secure a significant competitive edge over other means of travel, thereby excluding huge parts of the still-untapped leisure market;
- In a period of global boom, demand for skilled personnel such as pilots and engineers also outstripped supply leading to a sharp escalation in wages, and in some cases grounding of aircraft due a shortage of staff;
- Balance sheets were stretched as a result of the aggressive fleet induction programs, combined with the mounting operational losses.

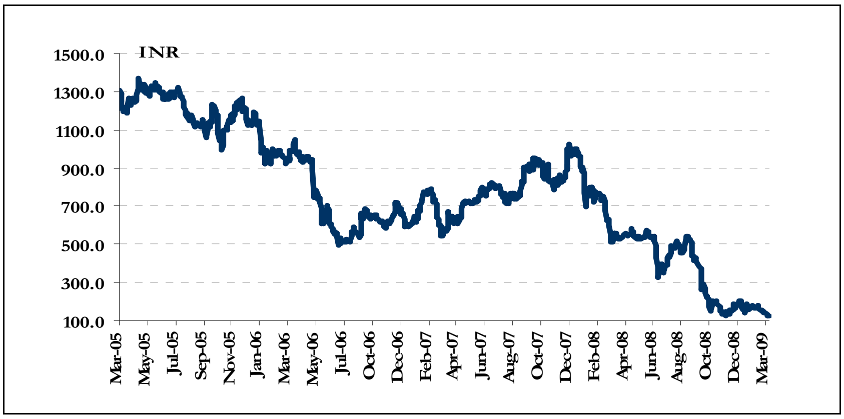
These early signs of growing pains were largely ignored and airlines continued to pursue aggressive but unachievable growth strategies. The flaws in this approach were exposed by the astronomical fuel prices in 2008 which created an impossible operating environment, not only for Indian airlines, but for the entire global industry.

Jet Airways-Air Sahara: a strategic mistake

The acquisition of Air Sahara by Jet Airways was arguably the carrier's first major strategic error (as CAPA observed at the time). Allowing Sahara to exit from the market would have resulted in a market correction that would have been to the benefit of all players. Jet incurred a high acquisition price and has been funding operating losses ever since. The process of integration has been difficult and costly and continues to negatively impact Jet Airways. It is reported that Jet Airways has yet to settle the full purchase price for the carrier, reflecting the state of its financial situation.

Jet Airways' bottom line has been further impacted by an aggressive international expansion which stretched the carrier's resources and damaged investor confidence.

Jet Airways share price: Mar-05 to 09-Mar-09



Source: Centre for Asia Pacific Aviation & Mumbai stock exchange

The airline has since been forced to cut a number of existing routes and halt new services as it consolidates its overseas network. To address the overcapacity in its longhaul fleet, Jet Airways has recently leased a number of widebody aircraft to Gulf Air and Oman Air.

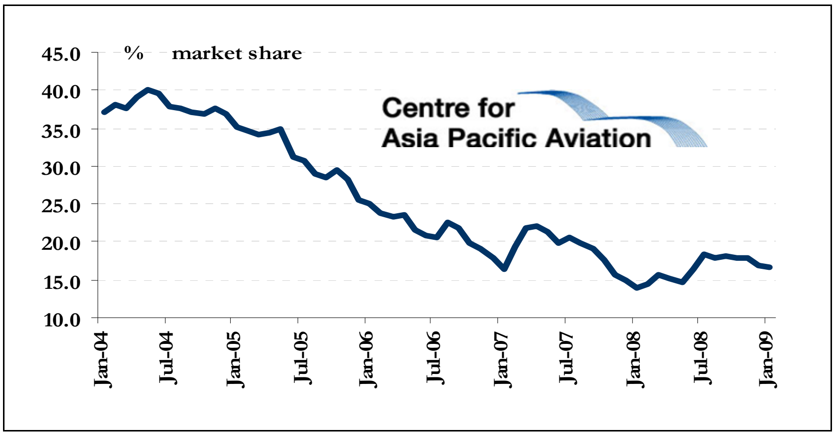
Air India-Indian Merger: Nice idea, poor execution

The merger between Air India and Indian Airlines made perfect sense on paper for over a decade. Their complementary networks, common ownership and need to generate greater efficiencies all pointed to the benefits of a merged entity. As it was, the merger coincided with a flurry of increased domestic and international competition, placing great pressure on management.

Successful implementation required robust guidance and a capable execution team to handle such a complex undertaking. Instead, the process moved ahead without first strengthening the management and organisation structure. More attention was devoted to discussion around non-core issues such as long term fleet acquisitions and establishing subsidiaries for ground handling and maintenance, than to addressing the state of the flying business.

Air India has continued to see its domestic market share decline.

Air India market share: Jan-04 to Jan-09



Source: Centre for Asia Pacific Aviation, DGCA

The situation was compounded by the cultural chasm between Air India and Indian Airlines, leading to an increase in internal politics, a potentially messy situation in an entity with 35,000 employees. A bloated workforce, unproductive work practices and political impediments to shedding staff made the creation of a viable business model extremely challenging.

Against this background, Air India's accession to the Star Alliance looks increasingly difficult. Technology integration between the two carriers and with Star, which is critical to membership, appears to be 18-24 months away. If Star Alliance begins to lose patience in its quest to induct an Indian member, this may create an opportunity for Jet Airways.

The situation calls for a depth of leadership across the organisation which still does not exist. This is reflected in the financial results, with an expected loss for the 12 months ending 31 March 2009 significantly higher than USD500 million. There appears to be no clear business plan to revive the carrier and effecting a turnaround now appears to be a herculean task. The new government, which will be elected in May 2009, will be faced with some tough decisions about Air India's future.

Kingfisher Airlines-Deccan: Not as easy as it sounded

The Kingfisher Airlines acquisition of Air Deccan is another case of underestimating the challenges of merging two carriers. It is a venture that has proved to be costly. Removing Air Deccan as an independent operator took out the airline that was most responsible for the irrational fares in the market place and, to this extent, it restored some pricing discipline which advantaged the entire industry.

However, integrating such different carriers (one, a classic low cost airline and the other a 5 star carrier), has proven to be extremely difficult. The huge combined network and distinct inflight products of the two carriers, has created duplication and confusion about the brand. This has been damaging to Kingfisher, with repercussions for its financial performance. The combined entity today has a large network and diverse operations that are proving to be hard to manage.

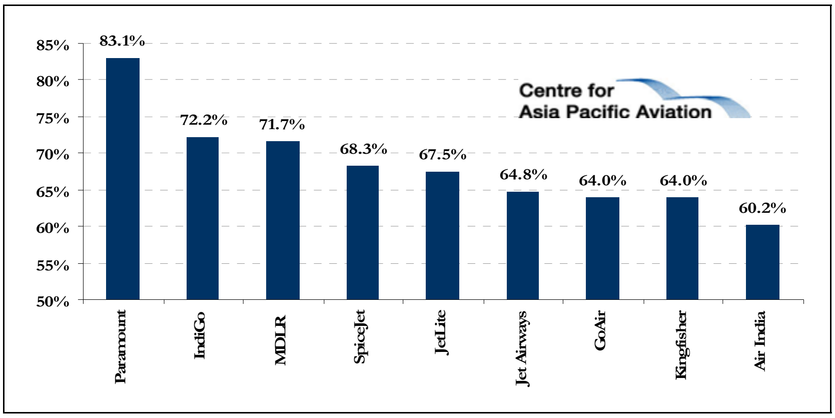
More consolidation now around the corner?

Where did this consolidation leave Indian aviation? Air Sahara, which should ideally have been left to fail and exit, continues to create problems for Jet

Airways. The Air India merger has been a non-starter because of a lack of leadership, while Kingfisher is still digesting Air Deccan.

So, even after this first round, the industry is still faced with over-capacity, especially in the full service category where passenger load factors remain below 65%. In India's high cost/low fare environment, it is simply not a sustainable strategy to keep flying with one in three seats empty.

Indian domestic passenger load factor in Jan-09

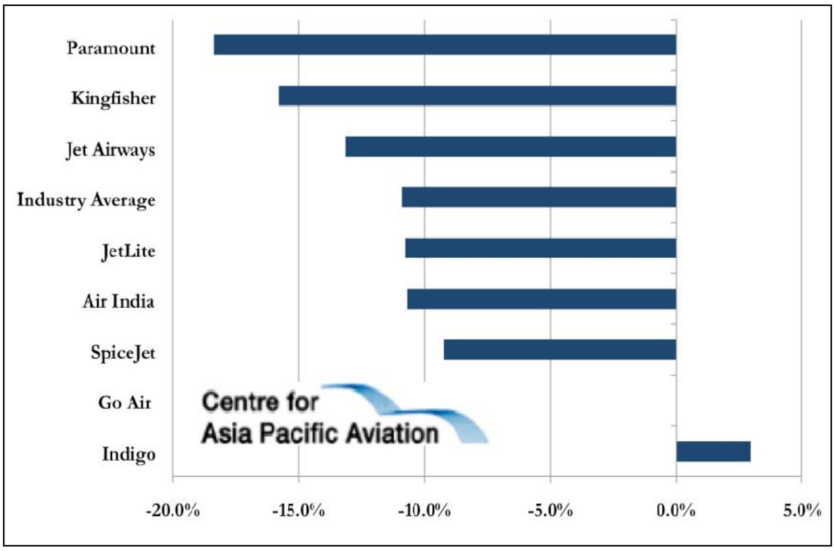


Source: Centre for Asia Pacific Aviation, DGCA

The full service model, particularly the operation of a premium class, has limited demand beyond the six major metros. And yet 120 aircraft - around half the domestic fleet - are operating with a full service cost structure For the major operators, this implies that recalibration of the inflight product offer in line with the realities of the market should be pursued.

And, despite the fact that carriers have reduced overall domestic capacity by around 10.9% over the last 10 months, there is now still a need to reduce available seats by a further 7-10%, the equivalent of grounding around 20 aircraft.

Domestic capacity adjustments by carrier: Feb-09 v May-09



Source: Centre for Asia Pacific Aviation, OAG

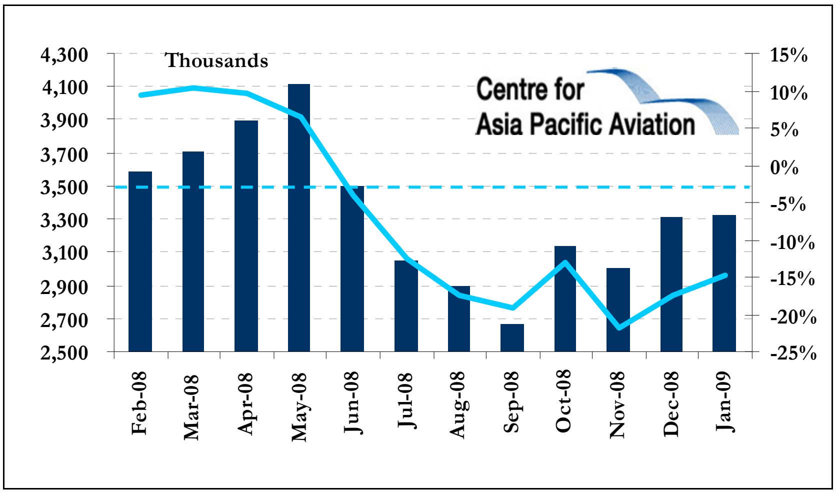
The Outlook: Round 2 for the New Indian Airline Industry

The three large airline groups have amassed huge losses over the last three years, a massive burden on their operations.

With demand expected to remain weak for at least the next two to three quarters at least, these carriers need to cut capacity, reduce costs and rationalise their networks in order to turn around in 2009/10.

Domestic traffic may start to resume growth from Q3 2009/10, allowing passenger numbers for 2009/10 to approach the levels achieved in 2007/08.

Indian domestic passenger numbers and passenger number growth: Feb-08 to Jan-09



Source: Centre for Asia Pacific Aviation, DGCA

LCCs such as IndiGo and SpiceJet also have significant capital requirements and will need further flows of funding. In the LCC space four carriers are operating very similar footprints. The next round of consolidation is therefore most likely to occur in the LCC sector, especially as the full service carriers do not have the balance sheets to engage in further acquisitions.

The next round of consolidation may be strategic in nature. SpiceJet, for example, has indicated that it would be interested in participating in such a development. The market and investors will support sensible consolidation which is designed to restore profitability rather than pursuing scale, and CAPA expects that activity will be seen on this front in H1 2009/10.

Foreign airlines appear unlikely to be able to participate in any consolidation opportunities in the short term though, as they barred from holding in equity in Indian carriers. The government had shortly been expected to permit foreign carriers to take a shareholding of up to 25%. However, with the dates for the general election having been announced, a major policy reform of this nature is unlikely. The new government, which will be formed in May 2009, is likely to take charge at a time when Indian aviation is re-shaping itself for survival.

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