CAPA
INDIA

Decisive action on Air India’s future assumes urgency in light of foreign airline investment

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CAPA Research & Market Analysis
February 2013

Published by

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CAPA INDIA

Executive Summary of Report on the Future of Air India

Current fiscal marked by improved operating performance

Air India has delivered a significant improvement in its operational and financial performance in FY13, partly due to improved market dynamics following Kingfisher's exit, but also as a result of a serious and committed approach by the management of Air India, new marketing initiatives and measures adopted to rationalise its network.

"Air India has delivered a significant improvement in its operational and financial performance in FY13, but deep structural issues remain."

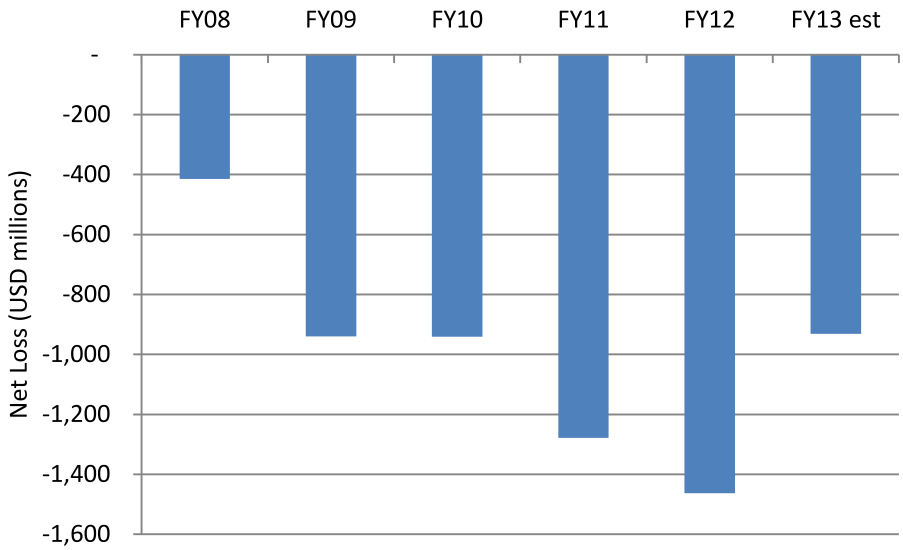
Pricing discipline is perhaps the most significant contributor to the improved performance. And over the last 12 months Air India's domestic market share has increased from approximately 14% to 20%. The carrier may even report a small operating profit for the current financial year ending 31 March 2013 subject to the impact of the B787 grounding and market conditions in Q4. However, the net result will remain significantly in the red.

Deep structural issues remain

But despite these improvements deep structural issues remain. As a result, in the five years from FY08 to FY12 inclusive Air India accumulated losses of close to USD5.25 billion, a figure which it is estimated will increase by a further USD950 million or more by the end of FY13.

Of the 189 routes that Air India operates only 12 meet total costs. A further 82 cover their cash costs but not their total costs and 95 routes, or just over half, do not even meet their cash costs. International routes are bleeding particularly badly and account for 80-90% of losses.

Air India Net Losses FY08 to FY13 estimated



Source: CAPA Research

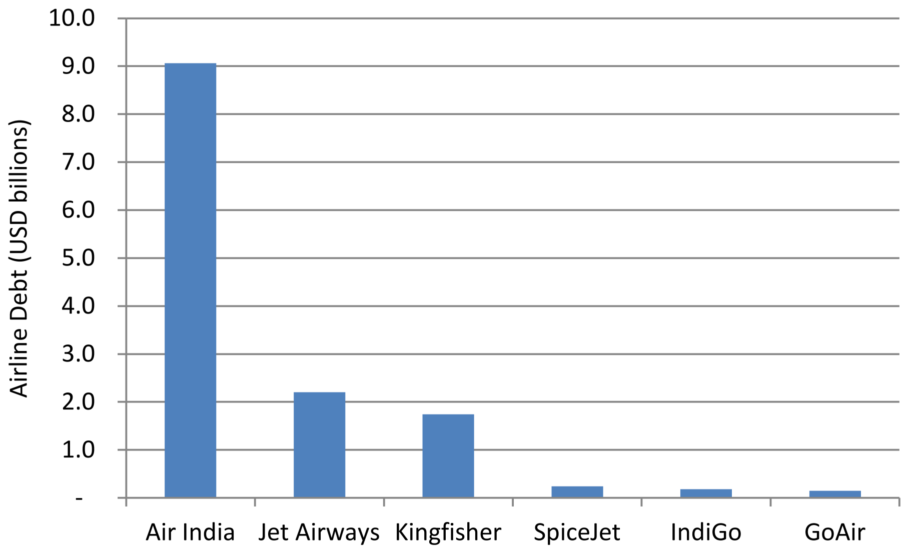
Piecemeal recapitalisation weakens turnaround efforts: The government has committed to fund the carrier's turnaround plan. However rather than infusing capital on a one-time basis, it is drip-fed in over an uncertain schedule. When each small tranche is received it is largely absorbed by overdue vendor and salary payments rather than being utilised to implement turnaround initiatives. As a result the recapitalisation efforts are not providing the strategic stability required.

"Piecemeal recapitalisation is not providing the strategic stability required, while its debt burden is approximately twice that of all other carriers combined."

Debt level imposes huge interest burden: Air India's bank loans and aircraft-related debt total approximately USD9 billion, in addition to which there are vendor-related liabilities e.g. to fuel suppliers and airport operators, in excess of USD1 billion. In fact Air India's debt is approximately twice that of all the other carriers combined.

The chart below highlights the fact that all of Air India's competitors are in a far better position. The three LCCs combined account for just 4-5% of total industry debt and this is largely aircraft-related. Even Jet Airways' position is improving, the carrier recently repaid over USD400 million of loans. The infusion of cash from the proposed stake sale to Etihad will be further used to reduce debt and interest obligations which in turn will improve its net profitability.

Indian Carrier Debt Levels FY12/13



Source: CAPA Research, Company Reports. Data for IndiGo and GoAir is as at 31 March 2012; Kingfisher and SpiceJet as at 30 September 2012; Air India (estimate) and Jet Airways as at 31 December 2012.

Sub-optimal aircraft utilisation: Air India's fleet utilisation is very poor with only around 100 operational aircraft out of a total registered fleet of 127 aircraft (including Air India Express). And even those aircraft in service have daily utilisation rates below the industry average.

"Turnaround efforts are hampered by poor asset utilisation and low labour productivity."

Recovery hampered by labour productivity: The productivity of Air India's bloated workforce continues to be a major challenge. And the airline carries the historical baggage of unresolved issues related to the integration of employees during the merger of Air India and the former Indian Airlines in 2007. The implementation of the recommendations of the Dharmadhikari Committee set-up to look into this issue is likely to face resistance.

The prospect of industrial action is always in the background, especially for licensed staff such as pilots and engineers, which could be triggered by the introduction of proposed wage restructuring initiatives.

Meanwhile, Air India continues to lose B777 pilots and other skilled personnel to foreign carriers, and Air India Express is facing a shortage of B737-800 pilots. A further exodus of licensed staff, particularly to the Gulf, is expected which will place added pressure on turnaround plans.

"Air India's fleet composition is poorly aligned with its mission requirements on both domestic and international routes. And the absence of a long term fleet strategy compromises any future business case."

Fleet issues impose strategic limitations: Air India also faces significant current and forward challenges with its fleet structure across its domestic and international operations:

1. The B777-200LR, B747-400 and the A319 aircraft are poorly matched with the mission requirements of its international and domestic routes;
2. The grounding of the B787, which was a cornerstone of the airline's turnaround strategy, is a major setback, especially as there is no clear timeline for the resumption of services;
3. The absence of a long term fleet strategy, with no pending narrowbody orders and no longhaul aircraft commitments beyond 2015 limits the future business case.

Business model needs to be reworked: Air India requires a comprehensive review of its business model. At present there are fundamental weaknesses in each of its key domains. On its longhaul routes for example it does not have the commercial strength to drive the necessary yields and premium traffic volumes. In the regional international market it is focusing on routes to/from Kerala but neglecting the significant opportunities elsewhere.

"A comprehensive review of the business model is required across domestic, regional international and longhaul operations as there are fundamental weaknesses in each of these domains."

While on the domestic front it faces a significant capacity crunch due to a limited fleet, which itself is dominated by an aircraft type that is not competitive on most of the routes which it operates. The absence of a domestic low cost operation or a clear regional strategy means that it is not participating in the fastest growing segments of the market.

Government intervention: In addition to these huge challenges, the management of Air India has to deal with excessive intervention by the Ministry of Civil Aviation and other ministries in the carrier's turnaround. This leaves little time or space to pursue strategic activities.

Internal challenges are compounded by a fast changing external environment

Concurrently with these massive internal challenges Air India is also faced with a fast changing external environment at several levels:

"Management is faced with huge internal challenges, a fast changing external environment and excessive government intervention."

1. **Indian market dynamics:** The market dynamics in India are being reshaped as a result of foreign airline investment. With up to three Indian carriers expected to secure strategic partners in early 2013, Air India will be faced with an increasingly strengthened set of competitors on domestic, regional international and longhaul routes.
2. **Shifting sands of global aviation:** The international aviation industry is adjusting to the impact of a number of emerging phenomena such as the growth of LCCs and the unfettered global ambitions of Middle East carriers. For example the three major Gulf carriers alone – Emirates,

Etihad and Qatar Airways - already have 311 wide body aircraft in service and a massive 418 on order. Recent developments (e.g. the Emirates/Qantas partnership, Etihad's network of equity investments and codeshare arrangements and oneworld's invitation to Qatar Airways to join the aliance) have also shaken the foundations of the global alliance structure. What were intended to be clearly distinct airline groupings have now become blurred. Airlines now cooperate with and invest in carriers across alliances. A new web of partnerships, deep codeshares and joint ventures is being created.

3. **Constant shocks:** And as always the aviation industry remains susceptible to "constant shocks" which range from economic downturns to fuel price spikes, health pandemics, natural disasters and terrorism.

"The pace of change in the market is so rapid that it puts into question the validity of the turnaround plan that has been developed for Air India. Meanwhile, many structural weaknesses in the Indian operating environment are not changing fast enough. "

Indeed the pace of change is so rapid that it puts into question the validity of the turnaround plan that has been developed for Air India.

Meanwhile, there are certain environmental features that are not changing fast enough, most notably the numerous structural challenges in Indian aviation which impact the overall viability of the sector. These include:

- Uncertain and unpredictable policy environment compounded by arbitrary distortions such as the 5 year/20 aircraft rule for international operations, route dispersal guidelines, and the regional airline policy which are not achieving their objectives;
- Weak regulatory framework;
- Micro-intervention by the regulator on commercial issues;
- Negative fiscal regime, particularly high sales taxation on fuel;
- Low productivity of airports and airspace;
- Shortage of skills and expertise;
- Absence of long-term vision for the sector.

Many of the above issues have remained unresolved since the sector was first deregulated in the early 1990s. In fact the frustration that airline leaders experience today with respect to operating in a non-enabling environment was shared by the founding father of Indian aviation, JRD Tata:

"Allowing foreign airline investment is a highly welcome development. But the government must strengthen the policy and regulatory framework to ensure that the competition, industry structure and consumer implications of such transactions are positive and in line with objectives."

"Government is of course free to pursue any policy however damaging it may be to the air transport industry, but I wish they would spare us, at the same time, obviously unrealisable assurances that they do not wish airlines to suffer losses," J.R.D. Tata, Founder, Air India, September 1949 (Source: Beyond the Last Blue Mountain, R.D. Lala)

As noted above, one of the most significant recent developments in the external environment is the approval of foreign airline investment up to 49% in Indian carriers. CAPA has welcomed this long overdue reform as a potentially game-changing decision.

However, we have also cautioned that the policy and regulatory framework may not be robust enough to understand the potential impact of foreign airline transactions on the industry structure, which includes the government's position with respect to the national carrier. Without a clear assessment of the impact of codeshares and alliances on competition and consumer issues, such transactions may not deliver the desired results.

CAPA INDIA

Jet Airways – Etihad deal will be the first test for the system

Etihad looks set to acquire a stake in Jet Airways, India's second largest international and domestic carrier, in the coming weeks. There is likely to be an extensive codesharing arrangement between the two new partners, network and scheduling coordination and integration of frequent flyer programmes. And at the backend various initiatives are expected to be pursued related to sharing of resources and joint purchasing and negotiations with suppliers, from aircraft manufacturers to GDS providers such as Sabre.

"The Jet Airways-Etihad deal has the potential to be a game-changing combination, bringing together one of the most successful airlines in India - a market expected to be the fastest growing in the world over the next 20 years - with a well-capitalised Gulf carrier with unfettered global ambitions."

The Jet Airways-Etihad deal has the potential to be a game-changing combination. It brings together one of the most successful airlines in India, a market expected to be the fastest growing in the world over the next 20 years, with a well-capitalised Gulf carrier with global ambitions, and its growing network of partners. Between the two airlines they have a fleet size in excess of 180 aircraft.

Critically for Jet this deal will provide it with the capital that it requires at this time. The airline has numerous positive attributes ranging from its brand equity, strong market presence, access to scare infrastructure and experienced management, but in recent times it has been starved of the capital it requires to be able to leverage its strengths.

Jet had been leaning towards membership of Star Alliance, but none of the large Star members was prepared to invest at this time. The interest from a major growth Gulf carrier with the ability to provide capital is therefore highly attractive. And with Air India currently weak, there is an opportunity for Jet Airways to use the partnership to strengthen its position in the international market.

Etihad has actively pursued a strategy of developing a diverse network of four equity investments, 41 codeshare partners and over 100 interline agreements. It has pioneered a new radial alliance constructed around strategic market access objectives for specific geographies. With Etihad at the centre of this self-selected alliance the carrier has a much greater incentive to progressively deepen its relationships, especially where an equity investment is involved and there is a strong reciprocal benefit to be achieved.

The carrier has strong ties with many of its codeshare partners involving reciprocal deals for baggage allowances, frequent flyer programmes and lounge access. This results in a large virtual network, providing behind gateway access that in some instances could not be achieved without scores of additional assets or markets too small to support direct services. Etihad operates to 86 passenger and cargo destinations with its own aircraft. With its partnerships it broadens this to 246 destinations worldwide. The carrier's partnership strategy is also a significant source of revenue. In 2012 partner carriers delivered 19% of the airline's total revenue.

Jet Airways will in due course probably also be able to leverage Etihad's partner networks on Air Berlin, Air France-KLM and Virgin Australia, and integrate with their frequent flyer programmes.

Etihad has also invested in ancillary activities, notably its acquisition of a majority stake in Air Berlin's frequent flyer programme to complement its 29.2% stake in the airline itself. The entity forms part of a new global loyalty management company established by Etihad Airways to target the fast growing and highly profitable loyalty management market. With Jet Airways evaluating the possibility of hiving off its loyalty programme, Jet Privilege, as a separate business, this may be a potential investment target for Etihad in future.

The market implications of a strategic investor are very different to a financial one and it is important that the government develops the expertise to understand these issues to ensure that the reform delivers the intended benefits.

"The combination of stronger Indian competitors as a result of foreign airline investment, the growth of LCCs, the opening up of the international market and the changing nature of global alliances will impact every aspect of Air India's operations."

A New World Order for India

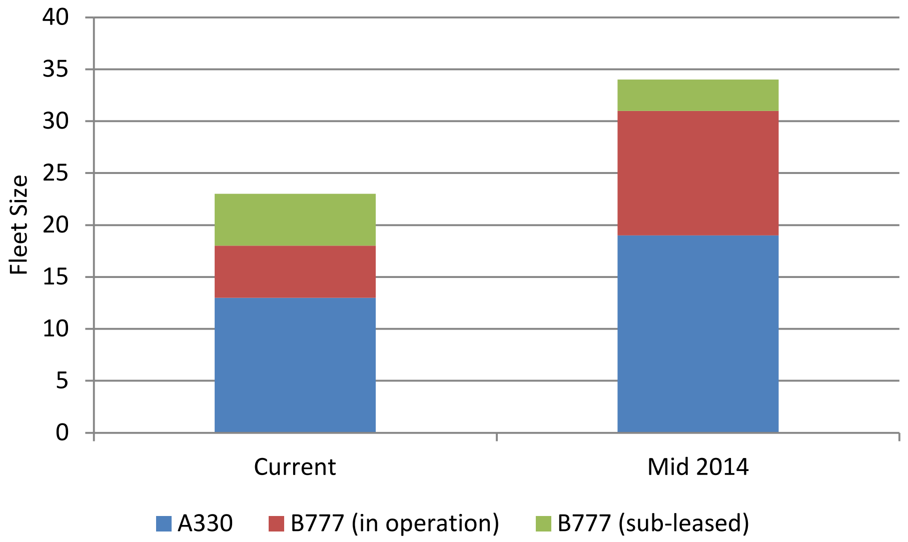
Air India as noted is faced with a fast changing environment. The combination of stronger Indian competitors as a result of foreign airline investment, the growth of LCCs, the opening up of the international market in the form of bilateral liberalisation and the changing nature of global alliances, will impact each of the three key areas of Air India's operations – namely longhaul international, regional international and domestic – each of which we will consider in turn below.

1. Key Issues for Air India's Longhaul Operations

Etihad investment expected to accelerate Jet Airways' international expansion

The infusion of cash from the deal will also likely accelerate Jet Airways' domestic and international expansion plans. Jet Airways currently has a widebody fleet of 23 aircraft (13 A330s and 10 B777-300ERs) of which five B777s have been sub-leased to Thai Airways, leaving an operational fleet of 18 aircraft.

Jet Airways Current and Projected 2014/15 Widebody Fleet Size



Source: CAPA Fleet Register

Over the next 12-18 months the widebody fleet is expected to increase from 18 operational aircraft to at least 30 aircraft, although this is largely dependent upon the new network plan to be developed upon conclusion of the Etihad transaction. This growth will be achieved as a result of:

- retaining at least two of the five sub-leased aircraft when they are returned at the end of their lease term later this year, with the balance three to possibly be re-leased;

- taking delivery of six new A330-300s (out of a total of ten to be taken on lease, of which four have already been inducted);
- induction of five or six B777-300ERs in 2014/15.

Meanwhile the carrier is likely to defer its order for 10 B787-800s (with 10 options) until after 2016 and possibly switch to the -900 variant. Jet Airways is also expected to evaluate the A350 as an option. The carrier will likely review its longhaul fleet strategy after developing a coordinated network plan in conjunction with Etihad.

Jet's international operations have stabilised financially, however the route network continues to evolve. In 2012 for example the carrier exited loss-making routes e.g. services to Johannesburg, Milan, New York JFK and Kuala Lumpur. Further changes can be expected in the short-term and a new network will emerge following the deal with Etihad, especially as the two carriers compete on Westbound routes from India.

For Etihad, a key rationale of the proposed investment is to provide greater feed from the Indian market to support its intercontinental services to Europe and the Americas which involves the development of Abu Dhabi as a hub. Jet Airways may in turn be used to develop Canada and other markets where Etihad faces challenges to securing bilateral entitlements.

Indian government expected to liberalise bilateral agreements with key markets

The Government of India's stance on bilaterals has lacked clarity and transparency which makes it virtually impossible for Indian carriers to plan their international strategy.

The rationale of India's bilateral strategy and the allocation of precious rights which are after all national assets, must be based on serving clearly defined national objectives – rather than the interests of any individual Indian or foreign carrier – to provide the necessary connectivity to support business, tourism, trade and social ties.

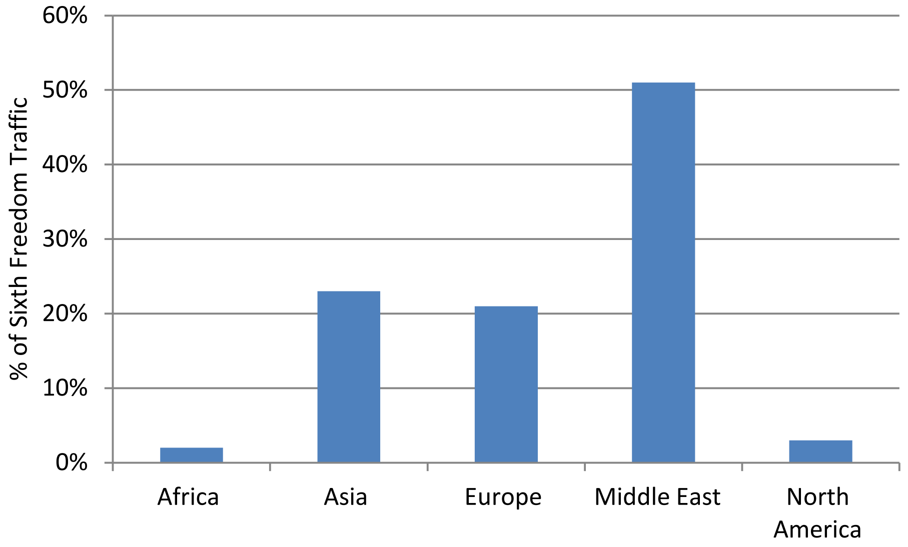
"India's approach to bilaterals has lacked clarity and transparency which makes it virtually impossible for Indian carriers to plan their international strategy. Entitlements are national assets and must be allocated in a manner which serves clearly defined national interests and objectives."

From 2004 the market was opened up rapidly, only for bilaterals to be frozen again from 2008 with a view to protecting Air India. In response to growing pressure from private carriers and Air India's inability to utilise the available bilaterals, several pending route applications were finally approved in early 2012 after significant delays.

One of the critical impacts of the Jet-Etihad deal is likely to be a liberalisation of the India-UAE bilateral. This will benefit not only these two carriers, but also Emirates, flyDubai and Air Arabia. Meanwhile Qatar Airways, Turkish Airlines and Singapore Airlines are all waiting in the wings seeking an expansion of bilaterals as they have exhausted their current entitlements.

Most of the airlines seeking additional rights are sixth freedom carriers which will place further competitive pressure on Air India's key routes. The historical weakness of international services by Indian carriers means that close to 40% of Indian international traffic travels to its final destination via an intermediate offshore airport, with Middle East hubs capturing just over half of such flows.

Location of Offshore Hubs for 6th Freedom Indian Traffic, 12 months to Nov-12



Source: CAPA, IATA AirportIS

Air India's longhaul operations compromised by widebody fleet issues

Air India, which is currently the largest international operator to/from India, will face increasing competition on overseas routes. However, the airline is poorly equipped to meet this challenge in terms of its fleet composition. Air India has a widebody fleet of 33 aircraft, with a further 21 (all B787s) on order. This relatively small fleet is spread across five different aircraft types adding complexity and cost.

"The B777-200LR and the B747-400 aircraft, representing more than 1/3 of Air India's longhaul fleet, are poorly suited to mission requirements leading to sub-optimal utilisation and significant losses."

And two of these types - representing 13 aircraft (eight B777-200LRs and five B747-400s) - do not have a good strategic fit with Air India's operations. The airline has not been able to generate the necessary traffic volumes and yields – particularly in premium cabins – to support the high trip costs of these large aircraft.

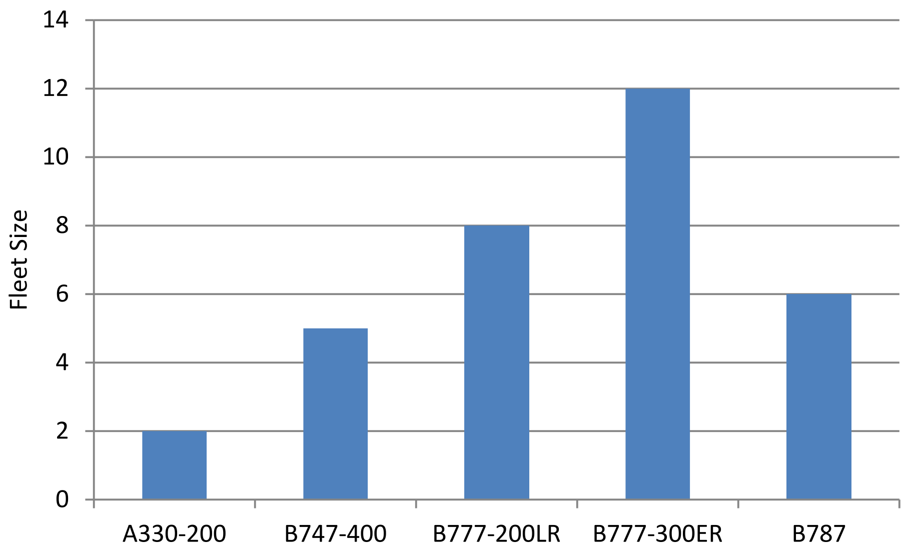
As a result, aircraft which are ideally suited to long range missions are instead being sub-optimally deployed on medium haul routes with relatively low utilisation. The airline has been trying to sell at least five of its B777-200LRs – and possibly all eight - but has not been successful to date. The B747-400s may be reconfigured for VIP operations and sold to the Government of India.

Until recently this left Air India with just the 12 B777-300ERs, supplemented by a couple of A330s, as the only widebody aircraft suited to its mission requirements.

For this reason the right-sized B787 with its superior seat mile costs was eagerly awaited and the aircraft was a cornerstone of Air India's turnaround plan. The strategy was proving effective with routes such as Delhi-Frankfurt turning to an operating profit within just a few weeks of deploying B787s.

But with the grounding of the Dreamliner and no clear timeline for the resumption of services, Air India will have to increasingly deploy its B777-200LRs which are poorly matched with the demand profile on its key longhaul routes.

Air India Current Widebody Fleet Size



Source: CAPA Research

As noted, Air India has a further 21 B787s on order, all of which were due to be delivered by 2015, although the schedule is now uncertain. And with B787 pilots sitting idle Air India may be forced to incur re-training costs on other types if the grounding is extended. At the same time B777 pilots – along with other skilled, licensed staff - are being poached by Gulf carriers and a continuing exodus is likely.

Membership of an alliance might strengthen Air India's commercial reach and feed and with Jet Airways now set to partner with Etihad, there may be a possibility that Star Alliance could resume discussions with Air India.

"With no committed longhaul fleet expansion beyond 2015, the prospect of significantly greater competition and weak commercial performance in premium cabins, Air India faces structural limitations to its longhaul business plan."

Beyond 2015 Air India has no committed fleet expansion which together with its commercial weakness, the opening up of bilaterals and the strengthened competition it will face from Indian and foreign carriers, LCCs and sixth freedom behemoths, imposes a structural limitation on its long term business plan. Air India is already bleeding badly on international routes which account for 80-90% of its total losses, and these developments will significantly weaken the business case.

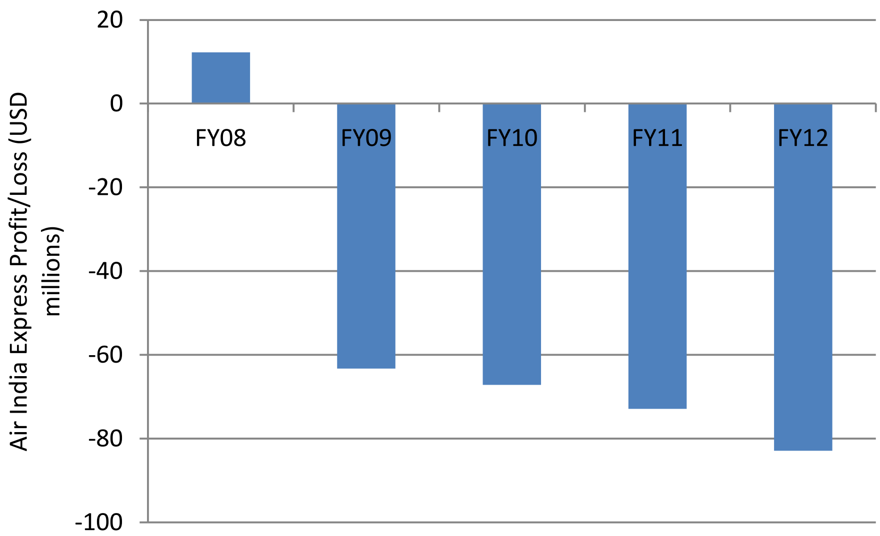
2. Key Issues for Air India's Regional International Operations

Air India's low cost international subsidiary, Air India Express, which operates primarily on routes to the Gulf and Southeast Asia, will also face increased competition. Firstly, Indian LCCs are expanding on shorthaul international routes. Secondly with the opening up of bilaterals, foreign carriers such as flyDubai and Air Arabia are also keen to increase their presence in India.

Air India Express has a fleet of 21 B737-800s, of which 17 are owned and the balance on lease. The carrier was earlier planning to increase its fleet size to 35 aircraft by 2015 and launch domestic operations. A combined domestic and international network would enable the carrier to increase its aircraft utilisation with a more flexible combination of sector lengths. However, with the airline facing a pilot shortage and under-utilising its current fleet, such a rate of expansion appears unlikely at this stage.

In addition to which Air India Express does not operate at a genuine arm's length from Air India and lacks a dedicated corporate structure. Air India's senior management is pre-occupied with the myriad challenges at the core business and have neglected the subsidiary. As a result, Air India Express has also seen its financial performance deteriorate since FY08.

Air India Express Net Profit/Loss FY08 to FY12



Source: CAPA Research

Air India Express is preparing to strengthen its base in the state of Kerala. However, this would appear to be a politically rather than commercially driven decision. Although the state accounts for the majority of the carrier's capacity today this may not always be the case going forward. If Air India Express truly wishes to be one of India's leading international LCCs there are route opportunities from airports right across the country, not just from Kerala.

Investing in developing a new base in a location which might not be the primary focus of the airline in future could result in an unnecessary duplication of resources. It would appear to be a strategic mistake to neglect other important markets and leave them open for Indian or foreign LCCs to develop their own fortresses.

"The decision to strengthen Air India Express' base in Kerala appears to be a politically rather than a commercially driven decision. It would be a strategic mistake to focus primarily on Kerala and neglect other important markets across India, leaving them open for Indian or foreign LCCs to develop their own fortresses."

And despite Air India Express making a commitment to Kerala, it is still not seen as being sufficient or in line with requirements by the state government, which is preparing to launch a competing low cost airline, Air Kerala. It is unfortunate that the one market which is receiving Air India Express' attention is seeking to undermine it.

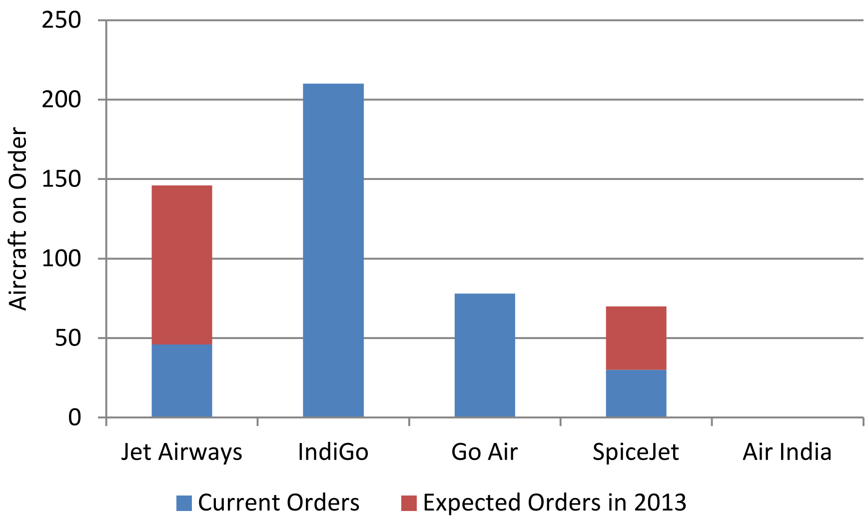
With the central government considering removing the regulation which requires domestic carriers to operate for at least 5 years and have a fleet of 20 aircraft before being granted permission to launch overseas routes, any new start-ups could in future also potentially compete with Air India Express on its key routes.

3. Key Issues for Air India's Regional Domestic Operations

Air India currently operates a domestic fleet of approximately 40 aircraft with no further equipment on order. However, around 60% of the fleet comprises A319s which have limitations in that they are not competitive against larger narrowbodies such as A320s and B737NGs as used by most Indian carriers, but are too large for regional routes. The airline has been seeking permission to lease up to 12 A320s to augment its domestic capacity however this continues to be held up.

There does not appear to be a clear domestic strategy and Air India has hesitated in launching a low cost subsidiary, partly for fear of cannibalising its parent operations. However this means that it is the only carrier which is not participating in the fastest growing segment of the market. And it has only a small regional fleet comprising a mix of regional jets and turboprops - several of which are dedicated to operations in the Northeast of the country - with no clear market proposition. Against this backdrop of capacity stagnation, Air India's competitors are set to expand aggressively.

Indian Carrier Narrowbody Current & Expected Orders



Source: CAPA Research

"Air India operates a domestic fleet of approximately 40 aircraft, of which around 60% are A319s, an aircraft type that is either too small or too large to be competitive in most of the key markets which Air India serves. Furthermore the airline has no narrowbody aircraft on order leaving it facing a looming capacity crunch. In contrast, India's private airlines could have up to 500 narrowbodies on order by the end of this year."

Jet Airways is expected to place an order in the coming months for up to 100 narrowbodies, which may consist of a mix of B737 MAXs for the full service operation and A320neos for JetKonnect. Meanwhile 46 B737-800s from an earlier order are still to be delivered. Following the conclusion of the Etihad transaction, Jet Airways is also expected to have the capital to implement a clearer market segmentation strategy, in particular the establishment of a strong hybrid model under the JetKonnect brand.

IndiGo has around 30 A320s from its 2005 order still to be delivered of which some will be used for replacement. However, from 2016/17 it will start to take delivery of the first of its 150 A320neos, as well as a further 30 A320s. As a launch customer placing what was at the time the largest civilian order by number of aircraft, IndiGo will have obtained very attractive pricing on its aircraft (as it did when it placed its original 100 aircraft order in 2005) providing it with a competitive cost base. IndiGo is also evaluating the possibility of placing an ATR order to establish a regional subsidiary.

SpiceJet has 30 B737-800s on order with deliveries set to commence from next year. A further narrowbody order may be finalised by early April 2013 after a new investor comes on board. The B737 MAX is the most likely equipment, particularly as there are no available A320 neo delivery slots within the required timeframe. SpiceJet remains undecided on whether to exercise its options for a further 15 Q400s, however CAPA expects that the carrier will increase its regional fleet in due course.

"There does not appear to be a clear domestic strategy. Air India has hesitated in launching a low cost subsidiary, partly for fear of cannibalising its parent operations. This means that it is the only carrier which is not participating in the fastest growing segment of the market."

GoAir will see its fleet size increase from 13 to around 20 aircraft over the next couple of years, to be followed by the first of its 72 A320neos on order from 2017. The airline is also considering inducting turboprops to serve Tier 2 and Tier 3 cities.

Between them, Air India's competitors could have 500 narrowbodies on order by the end of this year (over 360 narrowbodies currently on order, with up to a further 140 aircraft to possibly be ordered in the coming months).

And this is just the incumbents. There is no certainty at present regarding the approval of new licence applications for pan-India operators, but as and when the government decides to open up market access again there are 2-3 serious joint ventures in the pipeline. Although the Ministry may hold off granting permission to start-up national carriers for now, they will eventually launch. Meanwhile, regional airline licences will be approved and while new start-ups are likely to be small these new carriers will nibble away at Air India's operations in Tier 2 and Tier 3 cities.

Air India meanwhile has no current or impending orders and is expected to face a severe capacity crunch which will leave it unable to participate in domestic market growth.

Without decisive action Air India will continue to decline

As a result of management initiatives and improved market dynamics Air India could post a small operating profit this year. But at a net level losses are still expected to be close to USD1 billion, albeit 20-30% less than last year.

Against the backdrop of a fast-changing environment and strengthening competition the concern is that this could be as good as it gets. Air India generates 80-90% of its losses on international routes. The Jet Airways-Etihad deal and the opening of bilaterals will surely exacerbate this situation.

Meanwhile, in the domestic market where Air India performs relatively well the carrier is faced with a serious capacity constraint due to a lack of aircraft and the absence of a low cost arm to participate in the fastest growing segment of the market.

The likelihood is that despite the best intentions of Air India's management, the carrier has an almost insurmountable challenge. Its domestic competitors will be increasingly strengthened by foreign airline investment, overseas carriers are likely to be granted greater access to the Indian market and meanwhile Air India itself will be politically hamstrung with regard to taking the difficult restructuring decisions required to develop a competitive cost base or investing in new fleet.

Unthinkable funding requirements, fleet modernisation alone could require USD12-14 billion over ten years, let alone operating losses

In this scenario the government will be faced with having to drip feed billions of dollars over the next few years to finance deficits with no meaningful improvement in the carrier's situation. The government is already having trouble committing to the funding required.

This does not even take into account the investment that will be required in fleet modernisation and expansion over the next decade if the carrier is to maintain its share of traffic. CAPA estimates that the airline will need to order 240-280 aircraft for replacement and growth consisting of approximately:

- 40-50 turboprops or regional jets;
- 100-120 narrowbody aircraft for domestic operations;
- 50-60 narrowbody aircraft for regional international operations;
- 50 widebody aircraft for longhaul operations.

The cost of the above orders could conservatively be estimated at USD12-14 billion for which the government would need to extend a sovereign guarantee, something it is likely to be reluctant to provide at the current time. Air India as it stands today with all of its current challenges is not in a position to be able to take on such massive capital commitments.

One of the key economic challenges for the government today is to bring under control its large fiscal deficits. In this environment is unthinkable that the government can commit to the level of funding necessary to support Air India's capital requirements and operating losses, especially when there are multiple private operators willing and able to provide air transport service.

Scarce budgetary resources would surely be better diverted to supporting more important social objectives in health and education. Air India's estimated loss for this year will for example exceed the government's entire higher education budget.

"Without decisive - and in all probability painful – action the government could be faced with unthinkable funding requirements for Air India. Apart from drip feeding billions of dollars to finance operating deficits, fleet modernisation alone could require USD12-14 billion of funding over the next ten years."

"At a time when the government is under pressure to reduce its fiscal deficits surely scarce budgetary resources would be better diverted to supporting more important social objectives in health and education."

A solution requires transformational thinking, which has been sadly absent

If the carrier is to have any chance of success it must be radically restructured both financially and operationally. This will require a level of political will to take tough decisions, a feature which has been absent to date. Bold and pragmatic action is required to provide the airline with a fresh start and a fighting chance to compete. For the process to be successful it must be led by an MD that has the full-backing of the government to make the necessary cuts, as was the case at both Malaysia Airlines and Garuda Indonesia.

Turning around a national carrier is a difficult and painful process. It is arguably more difficult today than it was 10 years ago because the global environment has changed so dramatically as a result of liberalisation, the advent of LCCs and the rapid growth of Gulf carriers. But if the necessary commitment exists it can be achieved. In the case of Japan Airlines' bankruptcy in 2009 for example it was clear that incremental changes to the business would not deliver results and that radical surgery was required. The carrier took the following measures in order to reorganise:

"Turning around a national carrier today is more difficult than it was 10 years ago because the environment has changed so dramatically. But it is possible if the political will exists to take tough decisions, a feature which has been absent to date. "

- retired 103 aircraft out of a total fleet size of 258 aircraft;
- terminated more than 20% of its domestic and international routes;
- secured a debt waiver of USD6 billion and received an infusion of USD3bn;
- retrenched 16,000 employees representing 30% of its workforce;
- aggressively reviewed its business processes to improve efficiencies;
- upgraded its IT infrastructure to support process improvements;
- agreed to establish a low cost subsidiary in a joint venture with Jetstar.

"If Air India is financially and operationally restructured it should subsequently be granted a level playing field with respect to accessing foreign airline investment."

Japan Airlines emerged from the process and successfully conducted an IPO from which the capital infusion provided to the airline was recovered. A similarly aggressive approach is required at Air India. Sadly, a realistic assessment of the situation suggests that this is unlikely to happen.

However, if Air India was to take this path, pursuant to the restructuring it should be granted a level playing field with respect to access to foreign airline investment and be permitted to secure a strategic partner holding up to 49%. Over time the central government could reduce its stake to 26% with the balance 25% to be transferred to other public sector units.

"Restructuring is painful. In the case of Japan Airlines it involved retrenching 16,000 employees. With an election looming in 2014 the current administration will be reluctant to take such steps. But if decisive action is postponed – as we expect – the Indian taxpayer will bear an even greater cost."

If decisive action is postponed – as we expect – Indian taxpayers will bear the cost

With an election looming in 2014 the current administration may be reluctant to take such a bold step and prefer to leave it for the new government to deal with. But Air India cannot wait 18 months, by that stage it will be too late to recover.

Given the importance and sensitivity of this issue, CAPA recommends that a bipartisan approach is required with a committee to be established with multi-party consensus to oversee the financial and operational restructuring of the airline. Under a special administration, as was established for Satyam, Air India has the best chance of turning around.

A viable and long-term solution for Air India is imperative not only for the airline itself but for the industry at large because as long as it struggles under government ownership it will continue to drive distortions in policy. With Indian aviation set to receive close to USD100 billion of investment over the next decade, and given the potential for a vibrant aviation sector to play a critical role in enabling economic development, such distortions are not in the national interest.

"As long as Air India struggles under government ownership it will continue to drive distortions in policy, deterring valuable investment. Given the critical role that aviation plays in enabling economic development, such distortions are not in the national interest."

CAPA India Aviation Outlook Report: This analysis is an extract from the keenly anticipated 2013/14 edition of the annual CAPA India Aviation Outlook Report. The coming year will be a defining period for the long-term prospects of the Indian aviation market. In this complex environment, having access to up-to-date research and insights into the direction of the market is critical for any business with exposure to Indian aviation. For more information about CAPA India's research reports click here or contact bs@centreforaviation.com.

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