

Etihad's potential investment in Jet Airways to be a game-changer for India



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As Jet Airways and Etihad jointly conduct a series of meetings with key Indian Ministers and officials in New Delhi this week, the carriers appear to be seeking blessings for an impending wedding. If consummated this would be the first foreign airline investment transaction in Indian aviation since the long-awaited decision by the Indian Cabinet in Sep-2012 to permit up to 49% foreign investment in Indian airlines.

Allowing foreign airline investment is a vital step in establishing a more professional and corporatised sector in India. It offers the promise not only of introducing strategic capital and expertise into the market, but also delivers a much needed confidence factor for other institutional funding.

However, a big drawback remains the weakness of India's underlying regulatory framework and the structural challenges in Indian aviation. Until a host of typically Indian nit-picking bureaucratic and political issues are squared away, it remains a lottery investing into the country. That is a fundamental issue for any government serious about encouraging measures which will generate consumer (and corporate) benefits.

Etihad Airways has made partnerships a fundamental point of its business

Under CEO James Hogan's leadership, Etihad has from the start actively pursued a strategy of developing a diverse network of interline agreements and more than 30 codeshare and partnership agreements. The carrier has equity shareholdings in a range of carriers from Aer Lingus to Air Berlin, Air Seychelles and Virgin Australia. And more recently in Oct-12 it entered into an intra-European codeshare partnership between Air France, KLM and airberlin and a more sweeping alliance/partnership between Etihad and Air France-KLM. The investment in Jet Airways would extend this approach into the strategically important Indian market – at the same time introducing Jet to a range of new opportunities.

Etihad expected to acquire 24% at a valuation of USD1.3bn - 1.4bn

CAPA understands that in the first stage of the investment Etihad will acquire a stake of up to 24% in Jet Airways (just under the level at which an open offer would be triggered) at a valuation USD1.3 billion to USD1.4 billion. This represents a premium of around 35% on the current market capitalisation of the airline. Jet's share price has almost doubled since Nov-12 as a result of speculation about foreign airline interest and an improvement in market dynamics reflected in a sharp increase in yields.

Jet Airways Share Price (INR) last 12 months



Source: CAPA – Centre for Aviation, Rediff

The investment is expected to take place through the issue of preferential shares and warrants. At a later stage Etihad's stake could be increased to 49% at which time the de-listing of Jet Airways may be an option, as the promoters may find a private structure to be more suitable. Other opportunities include a potential investment in the carrier's loyalty programme, Jet Privilege, which could be hived-off as a separate business.

Etihad is expected to secure a seat on the Board of Jet Airways and have a say in the induction of some key executives, subject to obtaining the necessary regulatory and security clearances. As a result, Naresh Goyal, founding promoter and Chairman of Jet Airways, will for the first time relinquish exclusive control and influence over the airline and move to a shared management structure. This will bring a new set of skills to the business, a positive development for Jet Airways as it prepares for its next phase of growth.

Mr Goyal holds an 80% interest in Jet Airways through Tailwinds Limited, an Overseas Corporate Body (OCB) registered in the Isle of Man. OCBs are entities predominantly owned by non-resident Indians and such entities earlier used to be classified as having Indian nationality.

A subsequent change in regulations meant that Tailwinds was considered to be an overseas investor and technically in violation of the 49% foreign investment cap in the aviation sector. As the breach occurred due to a change in definitions, Jet Airways received a temporary dispensation and was granted time to restructure its shareholdings in order to comply. This issue will need to be resolved as part of the transaction, to comply with the requirement that Etihad and Tailwind's combined shareholding cannot exceed 49%.

Without key strategic mistakes Jet Airways might not have required a foreign airline investor

Aside from Tailwinds, the balance of 20% of shares in the airline are publicly held, since being listed on the exchange in 2005. The decision to float only 20% meant that an important capital raising opportunity was not fully leveraged. During what was a buoyant period in the sector which afforded a strong valuation, the airline could have raised additional funds which would have enabled it to implement its growth strategy more effectively.

In 2007, Jet Airways conducted its most significant strategic mistake, the acquisition of Air Sahara. Integration of the two carriers proved to be far more challenging than anticipated and drained capital which made the airline vulnerable. Air Sahara diverted management attention and precipitated the launch of a confused low cost strategy. The airline's organisation structure has also become increasingly top-heavy, which usually results in management becoming distant from the frontline and its passengers. As a result Jet Airways' customer proposition in terms of product and service delivery has been deteriorating, an unexpected outcome for an airline which until recently was remarkable for its high standards.

A long time opponent of foreign airline investment, Jet likely to again be the first beneficiary

Ironically, Jet Airways is likely to be first beneficiary of a foreign airline investment reform that it was instrumental in preventing for many years. Its long stated position was that Indian aviation did not require the support of foreign airlines – meaning mostly that Jet was happy with its dominant position and did not see value in creating more competition.

In reality, if the Etihad deal goes ahead, this would be the second time Jet Airways has been the recipient of foreign airline investment. In the 1990s when deregulation first allowed private carriers to enter domestic routes, initially as air taxis and subsequently as scheduled airlines, India permitted

up to 40% foreign direct investment, including by foreign airlines. Jet Airways at the time in fact leveraged this provision to the full, with both Gulf Air and Kuwait Airways holding a 20% stake each in the then-fledgling airline. This strategic investment undoubtedly provided Jet Airways with a number of benefits during the period 1993 to 1996, including access to expertise and international feed.

However, in 1996 the Government of India – with some encouragement from Jet - announced that foreign airline shareholdings were not in the interests of India's aviation sector and would no longer be permitted. Ostensibly this was because private carriers were still relatively small and the concern was that foreign airlines would control their development in such a way as to feed their offshore hubs, relegating the Indian carrier to the status of a regional carrier. But in reality it was a move designed to thwart the ambitions of the Tata Group and Singapore Airlines which were then planning a joint launch of a domestic carrier. As a result of this reversal of policy, Jet Airways had to buy back the shares from its Gulf investors. The outcome, among other things has been that India is critically short of quality senior management in the airline sector.

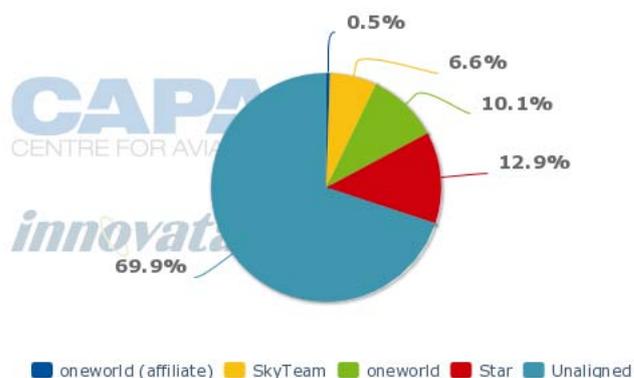
Jet Airways gains a much needed boost, while Etihad gains strategic entry into a long term growth market

The practical implications of the deal will unfold over the coming weeks but the outcome is likely to be changes at Jet Airways' senior management level, much deeper codesharing and schedule coordination between the two carriers and, probably, joint purchasing arrangements. It is not yet clear whether Jet Airways will establish a hub at Abu Dhabi, although this would certainly have merit in due course.

Some issues to resolve include alliance membership and utilisation of bilaterals. Jet Airways has been leaning towards membership of Star Alliance, but the airline needs capital – something that none of the large Star members was prepared to invest at this time. If it comes to a choice between membership of Star and a partnership with a major growth Gulf carrier, along with capital investment, the decision becomes much easier.

Etihad is unaligned, but has recently forged a partnership with Air France-KLM (one of the founding members of SkyTeam), at the same time as investing significantly in oneworld's airberlin. There is nothing technically that would prevent parallel membership, as this is an area that is evolving rapidly since last year's upheavals as Emirates moved to join oneworld's Qantas and Qatar Airways to join oneworld. At present, in the absence of any Indian carrier being an alliance member, almost 70% of international capacity in the Indian market is unaligned.

Share of Indian Weekly International Seat Capacity by Global Alliance (28-Jan to 3-Feb 2013)

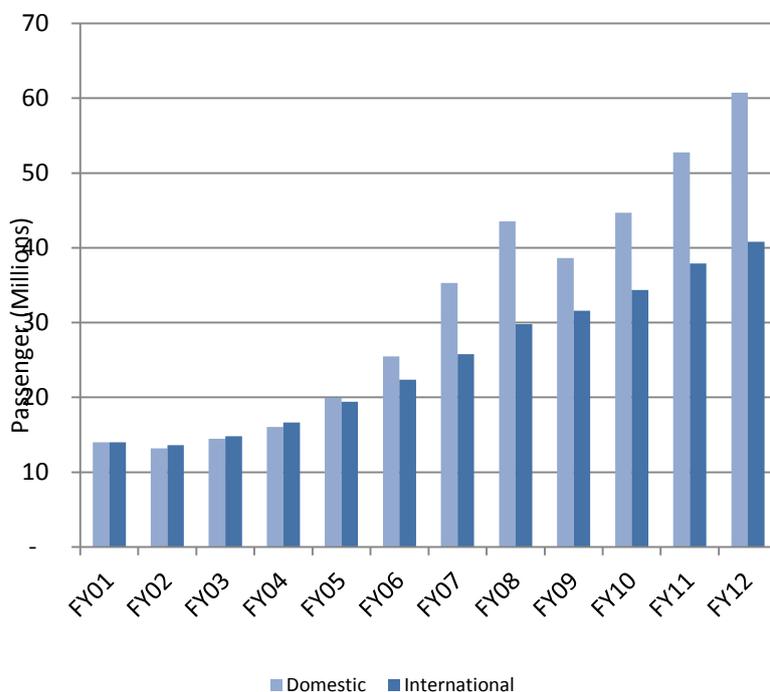


Source: CAPA – Centre for Aviation, Innovata

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Etihad, already an important operator into the Indian market, would gain access to India's potentially huge emerging demand. Since the market was opened up in 2004 domestic traffic has grown at a compound rate of 18.1% per annum, while international has expanded at 11.9% annually.

India Domestic & International Airline Passengers FY01 to FY12



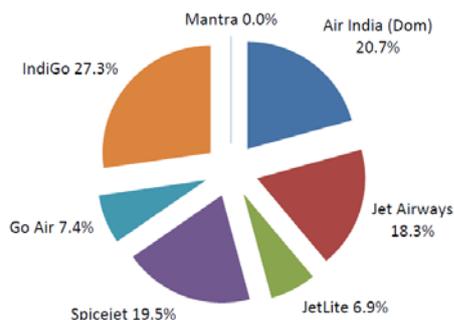
Source: CAPA – Centre for Aviation, Airports Authority of India

Despite recent challenges India is expected to be amongst the fastest growing in the world over the next two decades.

For Etihad, Jet Airways also offers:

- an airline with forecast consolidated group revenue in excess of USD3.4 billion in FY12/13;
- a combined Jet Airways/JetLite fleet size of 116 aircraft and almost 50 aircraft on order;
- domestic market share of 25.2% (Jet Airways combined with JetLite), and the second largest share of international traffic to/from India (likely to become the largest, given Air India's problems);
- a very strong and established brand;
- access to scarce infrastructure, particularly in the key premium market of Mumbai;
- operation of India's leading loyalty programme.

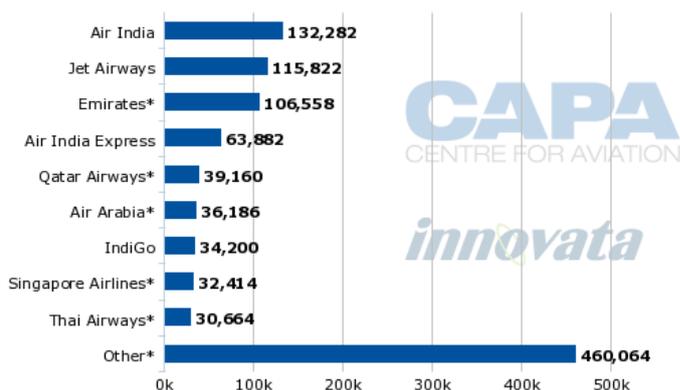
Indian Carrier Domestic Market Share Nov-12



Source: Directorate General of Civil Aviation

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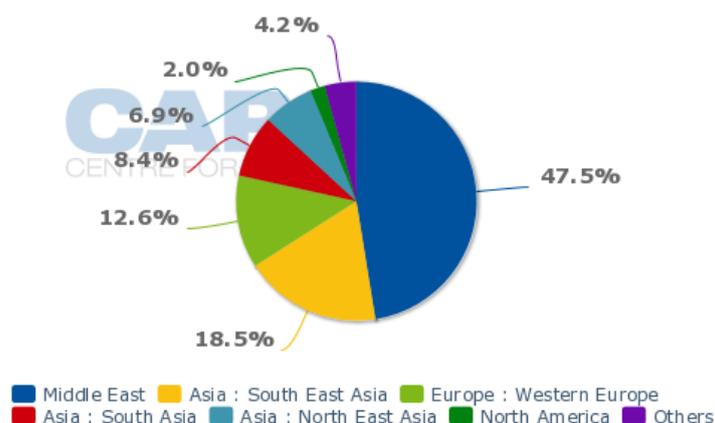
Weekly India International Seat Capacity by Leading Carriers (28-Jan to 3-Feb 2013)



Source: CAPA – Centre for Aviation, Innovata

As it is, the two airlines already have links that go back several years when several Jet Airways executives assisted in the setting up of the UAE carrier and, more recently, a successful codesharing arrangement. And the strong aviation links between India and the Gulf are clearly reflected in the fact that almost 50% of international seats to/from India are deployed on routes to the Middle East.

India Weekly International Seat Capacity by Region (28-Jan to 3-Feb 2013)



Source: CAPA – Centre for Aviation, Innovata

Although, at the prices being suggested, Etihad may be paying a premium on today's share price, that does not tell the whole story. Firstly, this valuation has been depressed by current structural weakness across the aviation sector – so, from a long-term perspective Etihad is counter-cyclically acquiring an important strategic asset at a very attractive level. More importantly, the sum of the parts here will by no means represent the real upside. Combining the almost symmetrically complementary operations of the two airlines promises a much more powerful overall entity.

From a broader perspective there are other benefits for Abu Dhabi - for example if Jet Airways were to make greater use of ADAT's maintenance services. And the emirate's aviation sector may be able to leverage its new footprint in India to recruit and train skilled resources to support its own growth. Jet Airways may also choose to directly import aviation turbine fuel from Abu Dhabi to circumvent the onerous sales taxation on local purchases, especially if the strength of Etihad can be leveraged to reduce the size of advance cash commitments that Jet has been unable to satisfy. If the infrastructure and logistics issues can be addressed and provided that Indian states do not adopt regressive entry taxes on imports, this channel could provide Jet Airways with an important cost advantage in the domestic market.

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For Jet Airways, the deal also provides multiple benefits, notably an infusion of cash for debt reduction and a basis for providing capital for growth. The Indian carrier gains access to a large global network, improved scale economies for procurement and – vitally - the ability to tap into a large pool of experienced management. In addition to the equity investment Etihad could potentially provide other financing support which may see Jet Airways accelerate its proposed order for 100 narrowbody aircraft.

In short, the partnership could see the rate of both domestic and international expansion rapidly scaled up.

SpiceJet and GoAir foreign airline investment deals are expected to follow soon

Further foreign airline investment may not be far behind. SpiceJet could be next off the block and is understood to be in quite advanced discussions with more than one party, including reportedly an aggressively expanding Southeast Asian LCC, as well as private equity funds. A deal could be announced before 31-Mar-2013.

GoAir is another potential candidate and it too is in discussions with foreign airlines. However, if it is unable to secure the valuation it seeks then it may instead consider an IPO in FY13/14.

The Indian Government is now faced with challenges in ensuring that investments can be implemented effectively

So often and in so many areas, positive policy moves by the Indian government are undermined by the complexity of putting them into effect. The various levels of government and the always-bureaucratically imposed hurdles to any change have proven extremely effective in putting off all but the bravest and most persistent investors. And introducing a relatively major change in the airline investment system seems likely to need a great deal of shepherding if it is to be implemented smoothly.

Minister Ajit Singh and the Government of India certainly deserve credit for permitting foreign airline investment, an issue long-mired in political complexity and whose benefits were only likely to be seen in the longer term. This was a reform that was pursued with strategic clarity and rigour in order to be able to overcome the numerous obstacles.

However, the policy and regulatory expertise in India may not be robust enough to understand the potential impact of foreign airline investment transactions on issues such as codesharing, alliances, bilaterals and competition, and to be able to respond quickly to the fast-changing environment.

Also, the decision to allow foreign airlines only to invest in incumbent carriers rather than to establish well-funded, professional start-ups means that the full range of potential airline investors are not being accessed. Global network carriers such as Etihad are primarily interested in feed and for them the incumbent operators provide ready market access. However, the leading LCCs such as AirAsia, Jetstar and Air Arabia, are more interested in launching cross-border joint venture start-ups without legacy issues and optimistically high valuations. This is the model which has applied in the rest of Asia, but India has rarely been adept at learning from the best practices of their neighbours, such are the inertial forces of vested interests.

AirAsia for example recently declared India as the non-ASEAN market “offering the most growth potential in terms of travel”, but for now the LCC is likely to be wary of investing under current regulations.

Air India is still an open question and will need resolving

As the investment process evolves, the government will also have to grapple with the implications for Air India, the airline which is likely to face the greatest strategic impact as a result of foreign airline investment. The national carrier has in the last six months shown a substantial improvement in financial and operational performance, but has suffered a major setback with the grounding of the B787 this month, an aircraft which was a key element of its turnaround plan. If there are lengthy delays to the resumption of Dreamliner operations this will impact the viability of its international operations, at the very same time that its competitors are being strengthened as a result of foreign tie-ups.

At present the government's position is that debt-laden Air India is not open to a strategic partnership with a foreign carrier. If this route is considered beneficial for private operators and is expected to strengthen them, denying Air India the same opportunity prevents any opportunity for a level playing field. However, the government will need to commit to a major financial restructuring of the flag carrier before such an option can be considered. With up to three foreign airline investment transactions expected in the private sector in 2013, calls to provide Air India with the same opportunity are likely to increase. One positive outcome is that this could – at last - act as the trigger for a decision Air India's future.

This is a defining moment in the development of Indian aviation, whatever the outcome

Indian aviation is (again) at a critical turning point and at such junctures the outcomes are difficult to predict. This is particularly so in light of the structural deterioration in Indian aviation since 2008 and the increased regulatory risk in the market. In such an environment it is not surprising that the first serious investment interest comes from a Gulf carrier. Aviation is viewed in the UAE as a critically important tool of economic development and the South Asian market in particular presents an enormous opportunity. Given the upside, Etihad and other carriers from the region are likely to have a higher risk appetite than airlines for whom the Indian market is not seen as core.

However, one thing is assured, as a market with huge long-term potential, but encumbered at present by weakness across policy, regulation, taxation, skills and infrastructure, access to capital and expertise is critical.

Foreign airline investment will also deliver greater integration with the global aviation industry and exposure to best practice. As a result, there will be much needed additional pressure to address structural challenges, paving the way for a more efficient, professional and viable industry. An investment by Etihad in Jet Airways, although only a first step, would be a defining moment in bringing India's aviation sector into the mainstream.

About CAPA India: CAPA India is the leading aviation advisory, research and knowledge practice in South Asia with a strong and established track record in accurately identifying key trends and developments in the Indian market. We have completed more than 55 advisory engagements and over 30 in-depth studies, delivering unrivalled analysis and data across the aviation value chain.

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