

LITE AT THE END OF  
THE TUNNEL? –  
JET AIRWAYS ACQUIRES  
AIR SAHARA



PREPARED BY

CENTRE FOR ASIA PACIFIC AVIATION

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## PERSPECTIVE

# LITE AT THE END OF THE TUNNEL ? JET AIRWAYS ACQUIRES AIR SAHARA

***On 20-Apr-07, Jet Airways acquired 100% of the shares in Air Sahara, 15 months after the original purchase agreement was signed. That agreement ended in dispute in Jun-06, and had been in arbitration since.***

***However, in what came as a surprise to many, a deal was hammered out earlier in Apr-07 in which Jet Airways acquired Air Sahara for INR14.5 billion (approximately USD350 million) – 35% less than the original price. In this Perspective, we review whether the Air Sahara take-over is a good deal for Jet Airways.***

### **Inevitable consolidation**

Jet Airways has announced plans to rebrand Air Sahara as JetLite and operate it as a value-based carrier, offering reduced frills, but positioned above the other low cost carriers. The combined entity will have a domestic market share of approximately 32%, making it the largest airline group in the country.

This however compares with what would have been a domestic market share of greater than 45% in Jan-06, reflecting the significant increase in competition and fragmentation since that time. The Centre for Asia Pacific Aviation last year predicted that consolidation of the Indian airline industry is necessary and inevitable – as a second (but not final) phase of domestic Indian airline evolution.

The financial realities of the sector are becoming more visible, as it struggles in the absence of pricing power. In the financial year ended 31-Mar-07, Indian carriers are estimated to have posted combined losses of USD400-500 million, with a similar result projected for 2007/08. Air Deccan alone posted a loss of USD53 million for the quarter ended 31-Mar-07, on revenue of USD108 million – a net margin of -49%.

### **Jet's challenge**

The acquisition of Sahara provides Jet with an increased domestic presence at a time when it is also focusing on expanding its international operations. The take-over will pose significant challenges, and the carrier's downside risks may have increased in the short term. Jet will need to focus on turning around Air Sahara as quickly as possible, with little margin for error.

Some of the key issues requiring attention include:

**Fleet:** Although Jet Airways and Air Sahara both use B737s for their core domestic operations, achieving fleet efficiencies will not be straightforward. Air Sahara has a mixture of B737 classics and next generation aircraft, seven of which are ten or more years old, as well as six Bombardier CRJ-200s. The Sahara fleet also operates with a number of different engine types.

An immediate priority for the new management will be to ensure that the fleet is fully operational to maximise utilisation. Currently, due to engineering, maintenance and equipment issues, only 20 of the 26 Air Sahara aircraft are actually flying. This process will require a review of contracts with aircraft and engine lessors.

The Bombardier CRJs are on lease at very high rentals. One option that Jet may consider is to return them, to be replaced with ATRs, providing commonality with Jet Airways' regional aircraft fleet. Ideally, JetLite needs to operate with a streamlined, two aircraft-type fleet, consisting of possibly B737-800s and ATRs to reduce maintenance, training and conversion costs and to achieve cost efficiencies through a common maintenance operation with Jet Airways.

**Fleets: Apr-07**

	Jet Airways	Air Sahara	Combined
B737-300		2	2
B737-400	6	3	9
B737-700	13	7	20
B737-800	28	7	35
B737-900	2		2
CRJ-200		7	7
ATR-72	8		8
A330-200	2		2
A340-300	3		3
<b>Total</b>	<b>62</b>	<b>26</b>	<b>88</b>

Source: Centre for Asia Pacific Aviation

Air Sahara also has orders for ten B737NGs scheduled for delivery between 2009 and 2011. This delivery schedule will most probably be maintained, as the production slots, after two years of strong global aircraft orders, have become increasingly valuable.

**Staff:** Air Sahara's employees have been seconded to JetLite for a 90-day period. During this time, Jet management will need to establish a new corporate structure, rationalise the workforce and map out an integration plan between the two carriers. Any staff that are not required in JetLite will be accepted by the Sahara Group to be deployed in other areas of the company, reflecting the commitment made by both parties that no employees would involuntarily lose their positions as a result of the acquisition.

Nevertheless, given the shortage of skilled staff in the Indian market, there is a risk that competitors may take the opportunity to poach pilots and engineers during the interim phase, a time when employees may feel less certain about their roles. JetLite therefore needs to quickly define its people strategy, and establish controls to ensure a stable transition.

**Culture:** Jet Airways management is confronted by the need to create a new organisation in JetLite, with a different philosophy from its parent. This requires investment in systems and training, as well as clear leadership regarding the core principles of the value-based carrier. The Jet Airways management has no low cost airline experience, so that a priority will be to avoid repeating the cost structures and strategic thinking of the parent.

**Capital:** JetLite will need to raise capital through equity or debt – or both – to recapitalise the company as soon as possible. The Centre projects that Jetlite would need approximately USD150-200 million plus funding to turn around Jetlite over the next 18-24 months and to absorb projected losses.

**Network:** A new network strategy will need to be developed to optimise the operations of Jet Airways and JetLite. Almost 78 of the 88 aircraft in the combined fleet are currently deployed on domestic routes with significant duplication at present. The combined networks will be structured to ensure that they support rather than cannibalise each other.

Aircraft will also need to be redeployed selectively to achieve higher productivity and revenue potential. South India for example is experiencing above average growth rates and does not currently have an airline which has focused its operations in the region. Air Sahara was developing a hub in Hyderabad, which is a strategy that JetLite may continue.

However, in order to reduce capacity in the domestic market, The Centre expects that JetLite may also be deployed on routes to the Middle East from next year. The South India-Gulf market for example has significant potential, which Air India Express has been achieving some success with. The Government of Kerala has also been keen to see the development of further low cost services between the State and the Gulf to cater to the large expatriate population.

At present, routes to the Gulf are protected for the state-owned carriers. However this restriction is scheduled to expire at the end of this year and those routes can be expected to be prime targets for JetLite. Assuming that this regulation is not extended, this would leave the way open for JetLite to commence operations to the Middle East from Jan-08.

Jet Airways/JetLite will be the only private carriers permitted to operate internationally under the current qualification hurdles, which require five years of domestic flying and a fleet of 20 aircraft. With Air India and Indian also merging, this will mean that India will go from having four international carriers to just two. As a result of this change in the competitive environment, the government could possibly decide that it is appropriate to reduce the qualification period to perhaps three years, a reform which carriers such as Kingfisher Airlines are actively lobbying for. This would allow Kingfisher and SpiceJet onto international routes in May-08 (its launch was in May-05) and immediately for Air Deccan (it launched in 2003).

**Operational Systems:** JetLite will require significant new investment in its IT infrastructure, especially customer facing systems, operations, revenue accounting, sales and cargo systems, to facilitate an efficient, low cost operation. Other areas requiring immediate attention to ensure stability include the administration and finance functions such as treasury management, procurement and accounting.

### **No slowing to capacity growth**

Overall capacity growth in the domestic market is unlikely to slow as a result of this transaction, resulting in further pressure on yields, despite strong underlying demand. (There can be little doubt that this demand has barely been tapped at this stage, but surface infrastructure constraints remain a serious impediment).

The problem of excess capacity could also spill into other markets, including the lucrative Gulf routes, if government approvals are gained as expected for JetLite's expansion to the region in Jan-08.

However, the ultimate outcome may be to usher in more consolidation down the line, which could restore some market discipline as market power shifts to fewer stronger players. This is certainly a strategy which Jet will have considered, even though it would mean more, self-inflicted short-term pain.

The long-term health of the country's aviation and tourism industries requires a viable airline sector, and consolidation and/or market exit is, at this stage, a natural consequence of market forces. As ground infrastructure and popular awareness improves, there will be further surges in new entry and growth. But that will take another two or three years.

However, the government has a critical role to ensure that while this occurs, consumers' interests are protected, by ensuring that the basis for genuine competition exists. At present, there is an absence of a clear regulatory framework with regard to competition policy. This will be critical to future development.

### **Conclusion: Not a Lite and easy integration**

Jet's acquisition of Air Sahara should eventually deliver potential cost and efficiency gains through network optimisation, operational rationalisation and fleet simplification. It also provides the group with an opportunity to segment the market more effectively, as well as access to pilots, engineers and valuable airport slots.

However, integration is a complex process and the cultural and operational differences between the two entities cannot be underestimated. Jet will almost certainly be planning to considerable short-term losses and/or equity dilution to guarantee a successful outcome. The market will be watching carefully to ensure that each of the operational and management areas are effectively staged – so managing the process publicly will also be a key function for Jet's management.

Will it succeed? Time will tell. Jet has the momentum, brand and experience to carry it through. But it has bitten off a large amount, at the same time it is launching a new international presence. The next six months will be critical.