

Indian Aviation 2010: Mid-Year Outlook



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Mid-Year Outlook for Indian Carriers

The operating environment for Indian carriers is looking increasingly positive. Passenger numbers, load factors and yields are all trending upwards, on both domestic and international services. And with the IMF projecting GDP growth of 9.4% in 2010, the demand conditions should continue to remain strong. In this report, we summarise the current status of the Indian scheduled operators.

Foreign Airline Investment

We maintain the position stated in our January 2010 industry outlook, that we believe foreign airline investment of up to 25-26% in Indian carriers will be permitted by the end of the year. This should generate interesting opportunities for Kingfisher and GoAir in particular. It could also facilitate the establishment of cross-border JVs in the near future, particularly in the LCC space, similar to the model pursued by AirAsia, Jetstar and Air Arabia in other parts of the world.

Consolidation

CAPA continues to believe that market consolidation and ownership changes are likely in the short term, particularly amongst the LCCs. Sun TV's acquisition of SpiceJet corresponds with our January 2010 projection that SpiceJet will be a central player in this process. We expect that Sun TV will look for further opportunities in the sector and there could another one or two transactions during the current financial year.

Airline Profitability

We had previously forecast that private Indian airlines would report profits of US\$250-300 million in the current FY2010/11. Our latest assessment is that the result could be higher than this earlier estimate. Air India, however, is expected to post losses of US\$650-700 million.

Aircraft Orders

CAPA expects that Indian carriers will soon be making headlines again for new aircraft orders. IndiGo is looking to acquire up to 150 aircraft, SpiceJet 47 aircraft, and Air India is planning to lease 10 A330s, as well as several A320s and ATRs. Some of these orders may even be announced at Farnborough later this month. Either way, we expect the Indian delegation at the air show to be larger and far more active than in the last couple of years.

Full Service Carriers

Despite the improved environment, for the large three airline groups – Air India, Jet Airways/JetLite and Kingfisher – a complete recovery from the turbulence of the last couple of years will still take time, largely due to the stress experienced on their balance sheets.

The total debt across these three carriers is approximately USD13.5 billion, with an annual interest burden well in excess of USD1 billion. This consists of approximately US\$7.5 billion in aircraft-related debt, and US\$6 billion of working capital and other loans. Outstanding amounts payable to vendors such as oil companies and airports is in addition to this. Debt financing on this scale for aircraft financing is of itself not unusual. The concern relates to the low equity base, which makes raising additional capital a challenge, at a time when the three carriers will need a further USD10-12 billion over the next 2-3 years to finance scheduled aircraft deliveries.

Indian financial institutions have a high exposure to the aviation sector, and a number of banks have approached the government to seek a one-off restructuring of airline debt in order to avoid an increase in non-performing assets.

Air India

Board: Air India has appointed four non-executive directors to the Board. It is encouraging that the Board is taking an active role, however the skill sets of the directors are still not exactly aligned with the requirements of the turnaround plan. There is a need to induct 2-3 independent directors experienced in airline restructuring and in navigating complex industrial relations issues.

Management: The induction of Gustav Baldauf as COO is a major achievement given the controversy that surrounded his appointment, firstly as the first expat senior executive at Air India, and secondly in relation to his remuneration package. A more important question though is whether Mr Baldauf is the right man for the job. He is certainly a highly experienced and accomplished airline operations executive, however he does not have a strong background in turning around an airline from the difficult situation in which Air India finds itself. This will certainly be a challenging role and one which will have to shoulder a significant share of the burden of day-to-day operations.

Industrial Relations: CAPA sees a very positive development in the firm response by the Government and management to industrial action organised by unions over the last couple of months. This more decisive approach will be critical in establishing the tone for management-union relations during upcoming negotiations. The timing may be appropriate to initiate discussions on critical wage agreements.

Network: Air India's route structure has historically included multi-stop itineraries and inefficient domestic extensions of long haul services. However, with the opening of an integrated domestic-international terminal at New Delhi in July 2010, the plan is to establish the airport as a hub for domestic, regional international and an increasing number of non-stop long haul services.

Air India has announced that it intends to launch new non-stop services from Delhi to the US. Although there is logic in the proposed network restructuring, the process needs to be sensitive to Air India's commercial capability, particularly its ability to generate premium traffic. For example, the B777 aircraft proposed for the Delhi-US routes would encounter payload restrictions, which would require a significant improvement in yields in order to make the services viable. Currently, Air India's yields are 20-30% below Jet Airways. To support the new longhaul capacity, the airline will need to actively develop feed from domestic, South Asia and even Southeast Asian operations. This will be challenging and Air India will need to exercise caution with its rate of longhaul expansion.

Star Alliance: One of the ongoing challenges for Air India has been to meet membership requirements for its accession to the Star Alliance, a process which has been delayed well beyond the original schedule. A major stumbling block has been the inability to integrate the IT platforms of Air India with Indian Airlines, and in turn with the other alliance members. A contract has been awarded to SITA to address this issue, and the target is to achieve operations under a single code, ready to integrate with the Star Alliance, by March 2011.

Financial Losses: There are as noted a number of positive developments underway, however financial losses are expected to continue for the next few years because of deep-seated structural issues. However, the strength of market growth in terms of both domestic and international traffic will see the level of losses decline. CAPA expects total losses over the next five years to reach just under USD4 billion, down from earlier estimates of USD4-5 billion.

Turnaround Plan: Despite the various individual initiatives being pursued, a final and comprehensive turnaround plan is yet to be completed. There is a critical need for a realistic business plan with the buy-in of all key stakeholders. Key issues that need to be addressed include:

- Significantly reducing staff costs whilst maintaining strong employee engagement;
- Reducing the debt and interest burden;
- Increasing revenue through higher yields and load factors;
- Organisational restructuring to induct greater capabilities at the Executive Director level in finance, commercial, operations, maintenance, HR and strategy;
- Leadership taking ownership of the turnaround plan and receiving genuine support from all key stakeholders, whilst reducing the number of parties interfering in the restructuring process;
- Quickly establishing special business units in maintenance, cargo and ground handling to unlock value;
- Establishing certainty regarding Air India's longhaul ambitions, which will in turn drive the fleet requirements. If Air India plans to take delivery of the B787s on order within 10 months, it is not adequately prepared in terms of ensuring availability of pilot and engineering resources.

IPO: CAPA expects that Air India will launch an IPO by Q3 of FY2011/12, by which time the establishment of special business units for cargo, maintenance and ground handling should be complete, resulting in an improved balance sheet. We also anticipate that the government will provide assistance with the process of refinancing and restructuring its debt of approximately US\$8.5 billion (of which US\$5 billion is aircraft-related and the balance is for working capital).

Overall: Air India's situation has improved in the last 12 months as a result of greater focus on both cost and revenue. However, the internal and external environment is highly dynamic and restructuring efforts will need to remain aggressive, otherwise the carrier risks becoming marginalised within the next 1-2 years.

Kingfisher

Kingfisher Airlines has managed to restore stability to domestic operations in recent months, having reduced capacity by approximately 20% over the last two years and by maintaining discipline with respect to new services. The airline has no scheduled aircraft deliveries until 2012 and plans to focus on enhancing load factors and revenue. At the same time, the carrier is reducing costs by increasing aircraft utilisation, and further productivity improvement targets are in the process of being defined.

However, the debt burden of US\$1.5 billion – interest charges account for around 20% of costs – remains the greatest obstacle to Kingfisher's turnaround and requires immediate attention. The carrier requires funding of INR20 billion (USD430 million) to cover short term requirements. Management plans to raise USD400 million through Global Depository Receipts and a rights issue, however this process continues to be delayed. CAPA believes that the promoter will need to infuse capital to address the situation.

Nevertheless, the overall improvement in market conditions should ensure modest domestic profitability in the current FY2010/11. International operations could achieve break-even in FY2011/12. However, it is important that the airline continues to focus on further reductions in costs of distribution, staff and maintenance in particular. In addition, there is a need to strengthen its commercial initiatives in the marketplace.

In order to ensure that the airline pursues a disciplined turnaround, a new organisation structure needs to be established with the induction of a CEO and COO.

Jet Airways

Jet Airways has achieved a rapid recovery since Q3 FY2009/10. High load factors in both domestic and international operations (international has exceeded 80% in recent months), combined with strengthening yields and the impact of cost reduction programmes, resulted in a higher than expected profit in Q4 FY2009/10. Key achievements on the cost front included a 15% reduction in staff costs in Q4, and a similar decline in distribution costs.

However, servicing the debt of approximately US\$3.5 billion (of which approximately US\$2.5 billion is aircraft related, and the balance is working capital for both Jet Airways and JetLite) is a major impost on the business.

Jet Airways has transferred 65% of domestic capacity to the low cost Jet Konnect operation. The plan to introduce a business class on some JetKonnect services is reflective of the improved demand environment. Jet is also taking advantage of conditions to enhance yield on both domestic and international routes.

The operation of three brands does however cause confusion in the market. CAPA anticipates that the JetLite and Jet Konnect brands will be combined under Jet Konnect, once the legal dispute with Air Sahara is resolved. It is also expected that JetKonnect will commence services on regional international routes in the short term.

JetLite is planning to restructure its regional operations by inducting six ATR-72s on lease, to replace CRJ-700s which are being returned to lessors. This should help the carrier reduce costs on shorter, thinner regional routes. This will also simplify the number of aircraft types operated on domestic routes from three to two families (B737s and ATR-72s). Meanwhile Jet Airways is planning to induct up to five A330s for international expansion.

CAPA expects that Jet Airways will report full year profitability for the current FY2010/11.

Low Cost Carriers

SpiceJet

The recent acquisition of SpiceJet by Sun TV is likely to have a significant impact on the sector. The new promoters have capital, business acumen, distribution channels and political influence and are investing in a viable business model at an opportune time in the industry cycle, as Indian aviation prepares for a new and sustainable growth phase for the next few years. A re-branding of the airline to align with the Sun Network is possible by the end of the year.

The key to leveraging this opportunity will be to ensure that a high calibre and capable senior management team is inducted and that its middle and lower middle ranks are strengthened. The Board is also likely to be restructured significantly after the conclusion of the open offer for shares. Sun TV's entry and its plans to invest in the long term growth potential of SpiceJet, should deliver stability to an airline which has in the past been distracted by ongoing questions related to ownership issues.

CAPA expects that the Board will shortly approve a new order for approximately 47 firm aircraft and 47 options. The airline plans to expand its operations in the South India market, the new promoter's home territory, and to focus on launching international sectors within a 4-5 hour flying time radius. Key destinations will include Sri Lanka, Singapore and Malaysia (all of which have strong VFR ties to South India) as well as other SAARC and Southeast Asian destinations.

In light of the improved internal and external environment, SpiceJet is expected to achieve a profit of US\$45-55 million in the current FY2010/11.

IndiGo

IndiGo is arguably the leading domestic airline on financial and operational parameters. CAPA estimates that the carrier achieved a profit of US\$75-85 million in FY2009/10. IndiGo will expand its fleet by 8-10 aircraft this year and it plans to continue to grow at this rate over the medium term. As a result, its A320 fleet may overtake Kingfisher within the next 12 months.

CAPA expects that the airline will launch an aggressive international network when it becomes eligible in August 2011. In the meantime, an IPO is under serious consideration and may be announced for Q3 of the current financial year. However, CAPA believes that the promoters have high expectations for the valuation of the airline and this may delay the public offer. This introduces the possibility that a private equity fund may acquire a stake as an intermediate funding exercise prior to an IPO.

A new 150 aircraft order is also being considered, and Embraer (100+ seats) and Bombardier C-Series aircraft types are under evaluation as part of this expansion. We expect that the carrier may take steps to strengthen its management as it prepares for the next phase of expansion and this may include the appointment of a COO.

GoAir:

GoAir has achieved a successful turnaround in the last 12-18 months. The carrier regularly achieves the highest on-time-performance with improved schedule integrity. Management has targeted and delivered improvements in in-flight and ground services. These developments are reflected in the airline's increased load factors.

GoAir currently operates a fleet of eight A320s and is expected to induct two additional aircraft in Q3 of the current financial year. With the market dynamics expected to change in light of Sun TV's acquisition of SpiceJet, and given the cyclical upswing, GoAir may need to accelerate its fleet expansion over the next 12-18 months in order to maintain its market relevance. Based on the current outlook, CAPA expects that GoAir will achieve full year profitability in the current FY2010/11.