Regional Airlines Poised for Growth?

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Perspective

Regional Airlines – Poised for Growth?

India's domestic aviation market has been growing at a blistering pace, registering growth of almost 120% between 2004 and 2007. However, to date, most of the increased activity has been concentrated on services between the major metropolitan airports (Mumbai, Delhi, Kolkata, Chennai, Bangalore and Hyderabad) and the emerging mini-metros, such as Ahmedabad and Pune. The six largest airports account for 72% of traffic handled in India, a figure that is unchanged over the last three years. In this report, we review the prospect for the smaller regional routes in India.

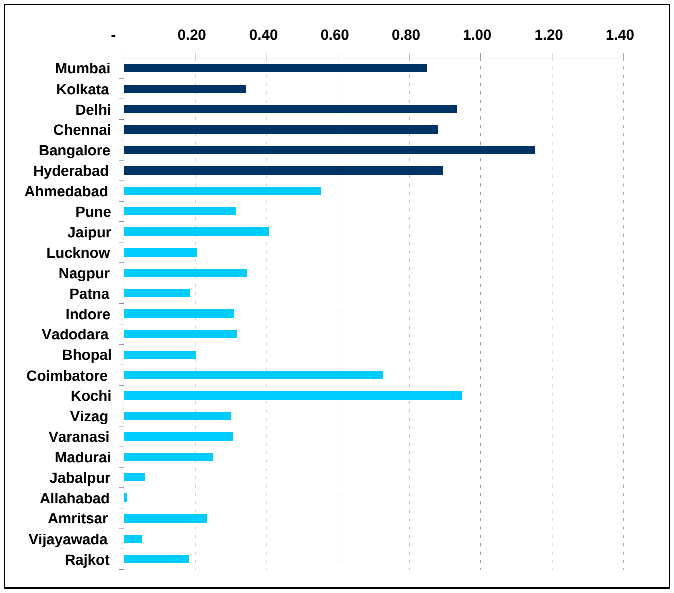
Major Metro Routes a Competitive Battleground

By Sep-06, the route linking India's two busiest airports, Delhi and Mumbai, catapulted up the ranks to become the 7th busiest air route in the world in terms of weekly services. The concentration of capacity on a handful of routes has resulted in a significant overlap of networks and intense competition. The Delhi-Mumbai route for example is contested by eight airlines. There are few, if any, comparable global instances of a domestic route with so many head-to-head competitors. The outcome has been downward pressure on yields and mounting losses.

The following table shows the ratio of airport seat capacity per head of population at cities with more than 1 million people. The six metro cities had an average ratio of 0.84 seats per person, while the 19 non-metro cities had a ratio of just 0.31. This suggests that the smaller cities – with the exception of points such as Kochi and Coimbatore - are currently underserved, and offer potential for increased operations, despite their smaller catchment areas.

Metro v Non-Metro: Ratio of Annual Domestic Seat Capacity

(as at Aug-07) to Population (2001)



Source: Centre for Asia Pacific Aviation, OAG, India Census Bureau

Furthermore, demographic and consumer behaviour research is increasingly showing that non-metro cities are not a market to be ignored. The National Council of Applied Economic Research (NCAER) in its survey of “The Great Indian Middle Class” ranked cities by density of wealthy households.

Leading 20 Cities by Density of Wealthy Households (p/a)

	> INR10 million	INR5-10 million	INR2-10 million
1.	Delhi	Delhi	Delhi
2.	Mumbai	Chandigarh	Chandigarh
3.	Pune	Mumbai	Ludhiana
4.	Chandigarh	Pune	Mumbai
5.	Nagpur	Ludhiana	Pune
6.	Ludhiana	Amritsar	Amritsar
7.	Amritsar	Nagpur	Jalandhar
8.	Jalandhar	Jalandhar	Faridabad

9.	Faridabad	Faridabad	Nagpur
10.	Nasik	Nasik	Coimbatore
11.	Aurangabad	Aurangabad	Goa
12.	Bhiwandi	Coimbatore	Chennai
13.	Ahmedabad	Bhiwandi	Hyderabad
14.	Rajkot	Chennai	Nasik
15.	Coimbatore	Ahmedadabd	Aurangabad
16.	Chennai	Goa	Ahmedabad
17.	Bhavnagar	Rajkot	Rajkot
18.	Jamnagar	Bhavnagar	Bhavnagar
19.	Surat	Jamnagar	Bhiwandi
20.	Goa	Hyderabad	Jamnagar

Source: National Council of Applied Economic Research, India, 2004

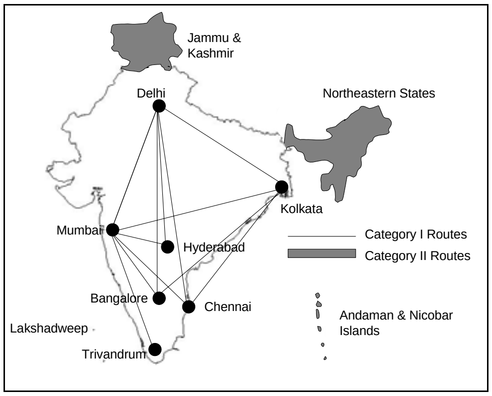
The rankings are notable for the fact that the top spots are not dominated by the six metros. Luxury consumer goods companies appear to support this, with Mercedes Benz for example identifying Ludhiana as the city with the highest per capita ownership of their cars.

Social route obligations

In contrast to the non-metro cities with a population of 1 million or more, there are several remote regions of the country which appear to be experiencing surplus airline capacity. This is as a result of the mandatory social route policy.

In order to ensure distribution of air services across the country - particularly to the more remote parts of the country which are regarded as being uneconomic routes to operate (designated as Category II routes) - the Directorate General of Civil Aviation has issued certain minimum service obligations for scheduled carriers. Domestic air routes are divided into three categories:

Category I trunk routes between major cities



Source: DGCA, Centre for Asia Pacific Aviation

Category II

Routes connecting Jammu & Kashmir, Northeastern states, Lakshadweep and the Andaman & Nicobar Islands to the rest of India.

Category III

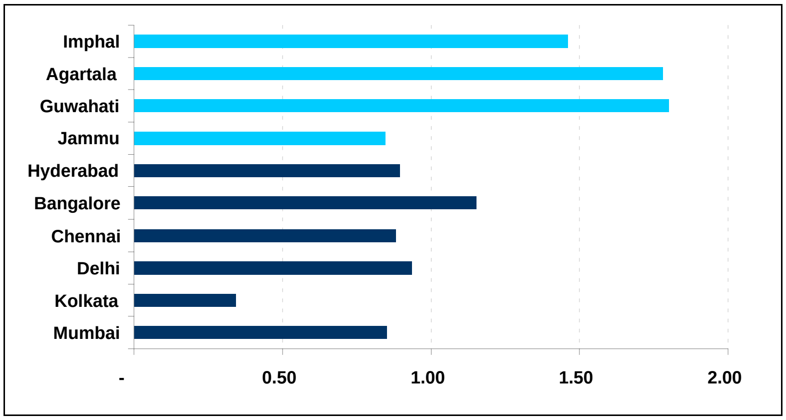
All routes not covered by the above two categories.

The regulations state that an airline operating on Category I routes must provide the equivalent of 10% of that capacity on Category II routes and equivalent to 50% on Category III routes. Furthermore, 1% of trunk route capacity must be deployed on routes within Category II regions eg. Jammu-Srinagar, Guwahati-Imphal.

As a result of Category II obligations, relatively small cities such as Jammu and Srinagar have capacity per population ratios similar to the metro cities, while some airports in the Northeast, such as Guwahati, Agartala and Imphal, actually have significantly higher ratios than even Delhi and Mumbai. To this extent, the policy has been successful in ensuring connectivity to these remote areas, but has resulted in excess capacity and inefficient utilisation.

Metro v Remote Regions: Ratio of Annual Domestic Seat Capacity

(as at Aug-07) to Population (2001)



Source: Centre for Asia Pacific Aviation, OAG, India Census Bureau

Regional Airline Policy released

In an effort to encourage connectivity to these non-metro cities, the Government of India has announced a new policy for carriers designated as "regional airlines". This category of airline will be licensed to operate within one of four defined regions of the country – North, East, West, South – but not between regions. The objective is to develop feeder services into the metro hubs in each of the regions (Delhi in the North; Mumbai in the West; Kolkata in the East; and Bangalore, Chennai and Hyderabad in the South).

Incentives were already in place for operators of smaller aircraft, with airport landing and parking charges waived for aircraft seating less than 80 passengers, and a uniform sales tax of 4% on fuel for aircraft with a maximum take-off weight of less than 40 tonnes (compared with a sales tax for larger aircraft which varies by state and which can be as high as almost 40%).

No new licences have been granted for scheduled national carriers since the launch of IndiGo in Aug-06 and the Government had indicated that it was reluctant to admit new entrants in the current environment of profitless volume growth.

The regional airline category appears to have been developed in recognition of the fact that current operators are not providing adequate service to smaller cities. However, a further point to note, and one which will not be addressed by the regional airline policy, is that of the 35 cities in India with a population of more than 1 million, ten cities either do not currently have regular scheduled services, or simply do not have an airport.

The announcement of the regional airline category is likely to be of particular interest to manufacturers of regional jets and turboprops such as ATR, Bombardier and Embraer. The concessions on airport charges and sales tax on fuel for small aircraft are not new, but the potential for additional licences to be granted specifically in this sector is.

Infrastructure remains a challenge

However, the issue of airport infrastructure remains a key challenge. Although regional carriers will not be operating between metros, they will largely be connecting metros to smaller cities and will therefore require access to slots and parking bays. However, most of India's major airports are currently operating above their design capacities.

Faced with finite infrastructure, Delhi International Airport Limited (DIAL), the operator of India's second largest airport, earlier this month announced a freeze on new services by regional and general aviation aircraft until the opening of a new runway in mid-2008. DIAL is understandably not keen to see a regional aircraft movement (which is exempt from airport charges) displace a larger and commercially more attractive aircraft. This immediately provoked a response by the Ministry of Civil Aviation stating that slot allocation at the airport will be determined by the Ministry rather than the airport operator.

Taking infrastructure issues into account, the South region appears to offer the greatest potential for regional airline operations as it will have two world class, greenfield airports in Hyderabad and Bangalore from March/April 2008, whereas Delhi and Mumbai are likely to face constraints until 2010, although there should be some improvements after 2008.

Conclusion: An untapped regional market

Passengers in the metro cities and in some of the remote locations around the country appear to have benefited from increased capacity and choice in the last couple of years, but the vast bulk of cities in between remain relatively underserved. These cities in fact represent a massive proportion of India's population, and as noted, there is no shortage of disposable income in these locations.

The announcement of the more liberal approach to granting regional airline licences is relatively new, but companies such as Bird Group, Ranbaxy, MDLR, Jagson, Emric Air are already understood to be interested in this category of operation and could be at the vanguard of new airline entry in India.

Airport infrastructure remains the key obstacle to overcome, particularly in Delhi and Mumbai, but the regional centres of India would appear to be an untapped market, suggesting that the recent overall traffic growth rates of 25-30% per annum in India can be sustained for several more years.