

Fostering Innovative Ways to Muster New Avenues of Investment in Indian Aviation Industry



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Assessing Key Areas for Improving Investment Scenario in Aviation Segment

Aviation Industry in India : A Know How

The Aviation Industry in India has been witnessing a turbulent phase over the past decade facing multiple challenges to overcome viz. exorbitant oil prices and inadequate pricing power contribution by industry wide over capacity and periods of subdued growth in demand. Over the near future the challenges in front of the operators in airline industry of India are dominated by high debt burden and liquidity constraints - most prime operators need major equity infusion to effect a consequential improvement in balance sheet statement. Enhanced financial shape would also enable these players to concentrate on steps to perk up long term viability and brand building through distinguished dedicated customer service.

Also, in India for long term the operators need to build on improving cost structure, through rationalization at all levels which includes mix of fleet and routes, solely focused at obtaining cost efficiency. Talking at a macro level i.e. the industry level, long term viability also needs return of pricing power through better channelization of inherent capacity to the underlying demand growth.

While the beginning of 2008-09, marked sharp rise in crude oil prices impacting the sector growth, it was the rising decline in passenger traffic growth which led to severe underperformance during later half of, 2008-09 to first half of 2009-10.

The operating environment for Indian aviation industry showed signs of recovery for a brief period in 2010-11 on grounds of growth in passenger traffic, prevalent industry-wide capacity discipline and relatively stable fuel prices. However, steep rise in fuel prices over the last three quarters coupled with intense competition and unfavorable foreign exchange environment has impacted and again deteriorated the financial performance of airlines. During the same period, while the passenger traffic growth has been relatively firm (averaging 14% in 2011-12), intense competition has at large impacted the yields and forced airlines back into losses in an overblown cost base scenario.

Government of India on its part has lately initiated a string of measures to address the concerns which are impacting the operating viability of Indian carriers like:-

- (a) Allowing FDI in Indian Airlines: - Permitting foreign carriers to make strategic investments (up to 49% stake) in Indian Carriers**
- (b) Importing ATF directly**
- (c) Allowing private airlines for international and**
- (d) Bailout packages and financial assistance to the national carrier.**

However, these steps alone may not be adequate to address the fundamental problems affecting the industry.

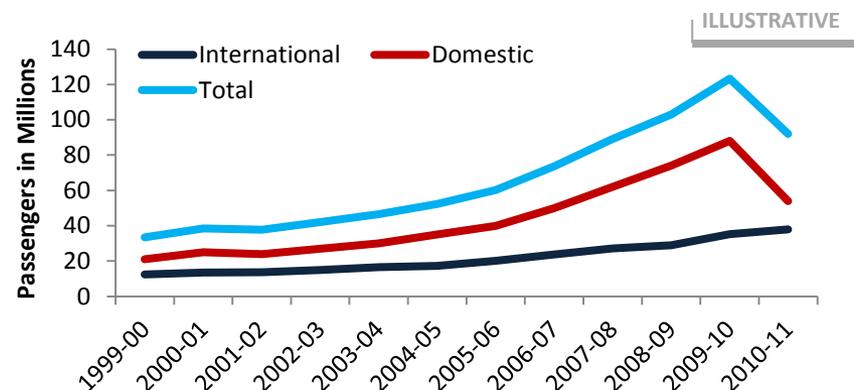
- i. **Unfavorable economics for Indian Aviation Industry:** - Economics for aviation industry is currently adequate and favorable in India resulting in lackluster financial performance of airlines
- ii. **Foreign airlines likely to be cautious for investments in India:** - Globally, too airlines are going through pressure period which could possibly further impact their investment plans in newer markets like India. Besides, foreign carriers already enjoy significant market share of profitable international routes and have wide access to Indian market through code-sharing arrangements with domestic players. Given these considerations, we believe, foreign airlines are likely to be more cautious in their investment decisions and strategies are likely to be long drawn for long-term rather than focused on short-term valuations.
- iii. **Importing, storing and transporting ATF a major road block for domestic carriers** - On the Govt. initiative to allow import of ATF, we feel that the duty differential between sales tax (averaging around 22-26% for domestic fuel uplifts) being currently paid by airlines on domestic routes and import duty (8.5%-10.0%) presents an attractive proposition for airlines. However the inherent challenges in importing, storing and transporting jet fuel will be a considerable roadblock for airlines due to OMCs monopoly on infrastructure at most Indian airports. From the working capital standpoint too, airlines will need to deploy significant amount of resources in sourcing fuel which may not be easy given the stretched balance sheets and tight liquidity profile of most airlines.

Overview of Indian Aviation Sector

Passenger Growth

Generally it has been observed that the air transport grows at twice the rate of GDP growth. The international passenger growth has been growing at a CAGR of over 14 per cent and domestic passenger growth has been an impressive 26 per cent for last 8 years. The passenger growth trend for past 8 years is indicated in Exhibit 01. However, the Indian aviation industry is still in very nascent stage. India's air passenger per capita of its population at 0.09 is abysmally low as compared to 0.30 in China, 5.63 in Australia and 4.69 in USA. With peak annual average of less than 3.90 trips per 100 people, opportunities galore for investors to tap the market in the aviation sector of India exists.

Exhibit 01: Passenger Growth Trends



Source: DGCA , Report of Working Group on Civil Aviation & enincon research

Cargo Growth

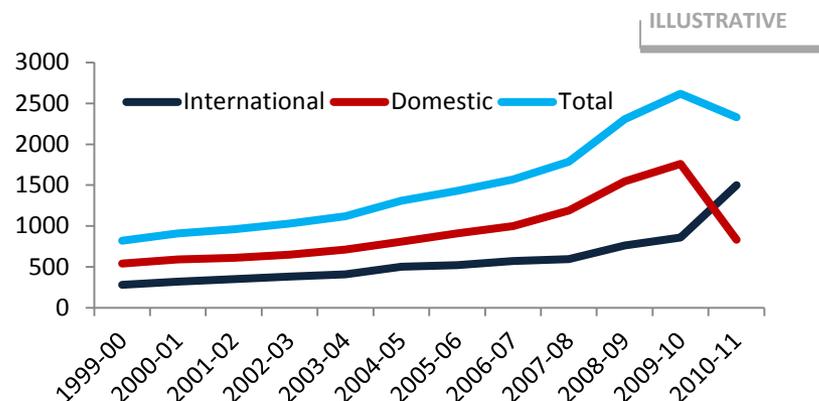
India already has open sky policy for air cargo. An air cargo hub is being developed at Nagpur, Maharashtra by Ministry of Civil Aviation (MoCA). However, the ambitious Multi Modal International Hub Airport (MIHAN) project with an air cargo hub, special economic zone and integrated townships, has been delayed due to the back out of number of companies involved in the SEZ development. On the lines of the MIHAN project, the ministry has planned to build dedicated cargo airport across the country to cater the increasing demand in the air cargo traffic. The domestic cargo grew at a CAGR of 13 per cent during the period of 2007-10 while the international cargo traffic grew at a CAGR of 14 per cent over the same period. At present India’s contribution is little more than 1 per cent of the world air cargo traffic.

Surge in Domestic Airlines

Over the past few years, there is substantial increase in the number of domestic airlines which led to a reduction in passenger which in turn helps the volumes of passenger growth. After the launch of low cost airline model by Air Deccan in 2003, there was series of new airlines coming in the aviation sector taking the total number of airlines to ten. A spate of mergers and acquisitions which started in 2006 has ultimately reduced the number of scheduled airlines to seven.

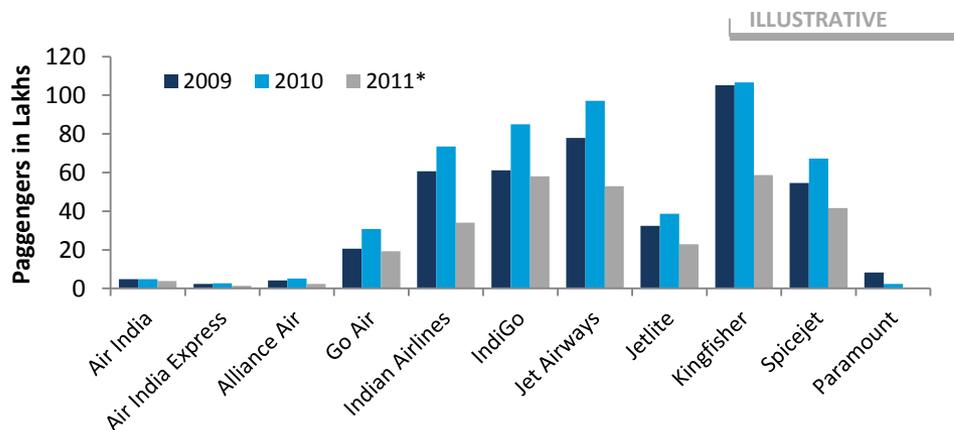
The National Aviation Company of India Limited (NACIL) which includes Air India, Indian Airlines and Air India Express brands; Jet Airways (Jet Airways and Jetlite brands); Kingfisher Airlines (Kingfisher and Air Deccan which are now Kingfisher Red brand); Spicejet, IndiGo Airlines; Go Airways and Alliance Air. NACIL, Jet Airways and Kingfisher-Air Deccan combine have permission to fly international routes. Domestic passengers carried by Indian domestic carriers are shown in Exhibit 03.

Exhibit 02: Air Cargo Growth Trends



Source: DGCA & enincon research

Exhibit 03: Domestic Passengers Carried by Indian Domestic Carriers



Source: DGCA & enincon research

Airport Infrastructure

There are around 454 airports/airstrips in the country which includes operational, non-operational and abandoned airports whose ownership pattern is illustrated in Exhibit 04. In India, Airports Authority of India (AAI) is the authority for the development and management of airport infrastructure and air traffic management. With the rise in the number of airlines, growing passenger segment and route expansion, there is a need for Indian airports to have their infrastructure in place, which unfortunately at present is the weakest link in the chain.

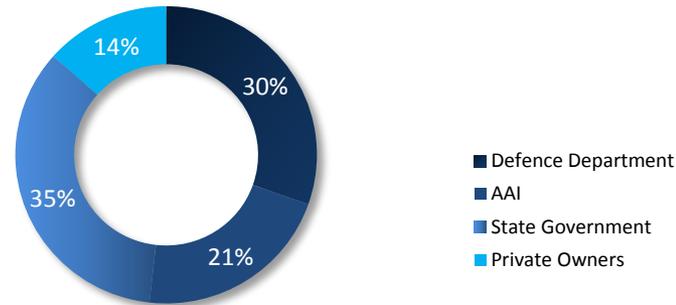
India vs Global Comparison on Key Parameters

Despite of the strong and sustainable growth drivers, India is yet to achieve a level of sophistication in aviation sector commensurate with its economic strength and potential. The relative attractiveness of India on basis of the size of economy and strength of the aviation sector is shown in Exhibit 16. Unsurprisingly, India is unfavorably placed in comparison to some of the key global economies on key parameters of efficiency and cost for the sector.

While air fare in USA and China is high due to large and immensely widespread geographies, it is high in the Indian context due to varying set of factors. These factors are lack of efficient alternatives, poor infrastructure and higher rate of damage of the existing infrastructure. The aviation sector in India thus accounts for almost 3 times and 1.7 times the secondary cost share compared to USA and China respectively. India's slower than desired improvement on several key efficiency indicators

Exhibit 04: Ownership Pattern of Airports/ Airstrips (Operational/ Non Operational) in India

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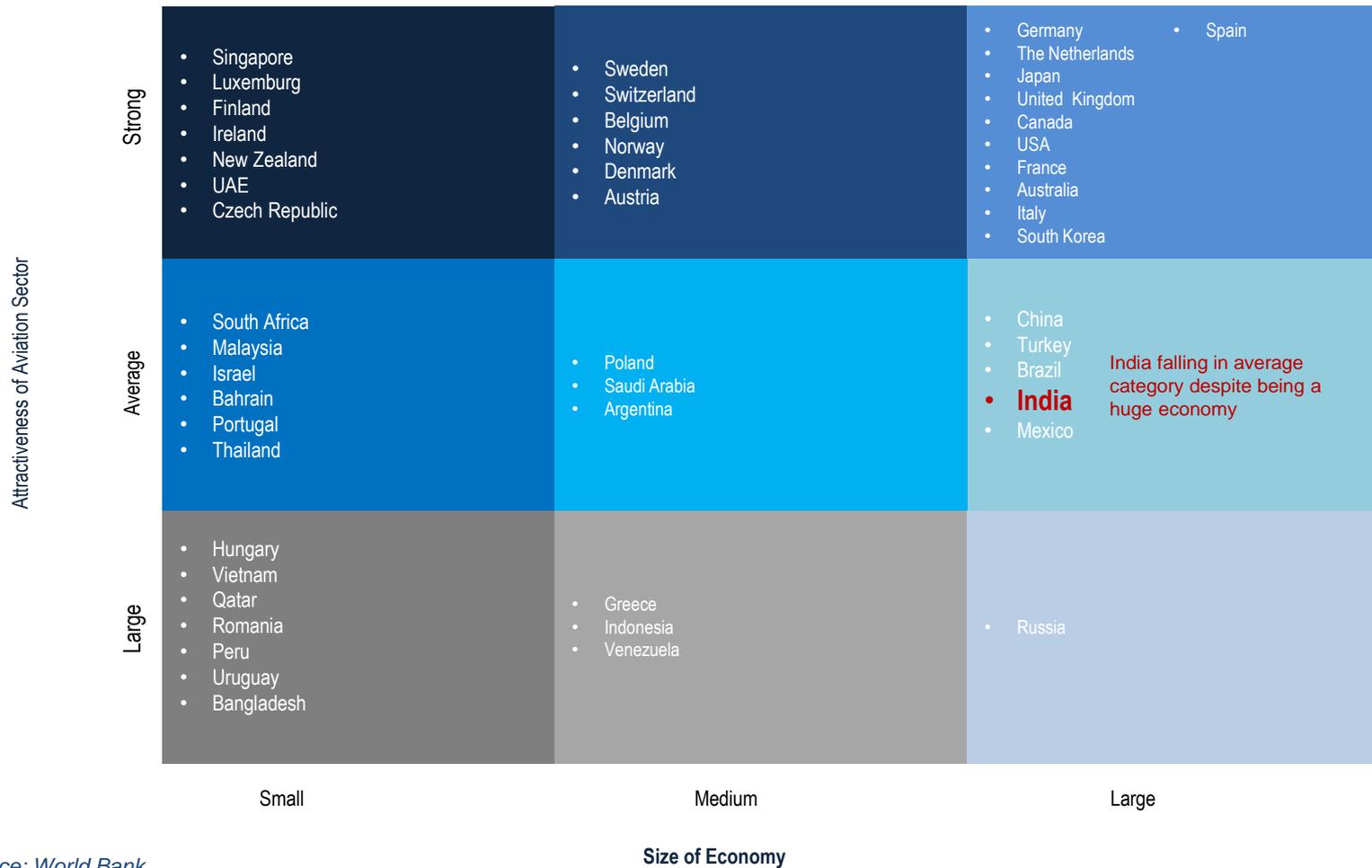


Source: AAI & enincon research

in the aviation sector puts India as a country lacking operational sophistication with poor-interconnection between its inter-components. A parallel of air transportation parameters are shown in Exhibit 05 when India is compared as per Global standards.

Exhibit 05: Relative Attractiveness of Aviation Sector in Comparison to Global Economics

INFOGRAPHIC



Source: World Bank

Exhibit 06: Airport Transportation Efficiency Indicators

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Air Transportation Efficiency Indicators	India	Global
Airport Waiting Time -Exports	50	12
Airport Waiting Time - Imports	182	24
Aviation Turbine Fuel as a % of OC	35-40%	20-25%

Source: World Bank

Major Issues in Aviation Sector

Having appreciated the current scenario in the Indian aviation sector over a very broad canvas, now turn is to shift our attention to the plethora of issues facing the aviation sector and try to examine what options exists before us to deal with these issues. In the Exhibit below for each of these issues you will find:

- Statement of the Issue
- Analysis of the Issue
- Options Analysis

The following are the issues addressed:

- Shrinking profitability of airlines
- The new Ground Handling policy
- High Aviation Turbine Fuel (ATF) prices
- High airport charges

- Shortage of technical manpower
- Safety and security
- Land acquisition
- Closure of old airports

Statement of the issue

Shrinking Profitability of the airlines

It has been observed that the Airlines have reported losses, inspite of the 20-25% y-o-y growth in passenger and cargo volume over the past three years.

Analysis of the Issue

Rising Fuel Prices

Aviation Turbine Fuel (ATF) prices in India are higher than the international market. The airline industry's operational cost component is dominated by the cost of the (ATF). The ATF price accounts for nearly 45% of the operational expenses. A 10% increase in fuel price would push up costs by at least 4%, thus causing a dampener on the financial health of an airline business.

Presently capacity constraints are reported mainly at Delhi and Mumbai airports. Congestion leads to a huge wastage of fuel. It is estimated that if a flight hovers in the sky for an additional half an hour due to delay in allocation of landing slot, it can consume between 25 to 30 per cent extra fuel thereby increasing the operational cost of the airline. Half an hour of hovering costs an airline anywhere over INR 50,000. There are over 40 flights that operate about 80 trips between Mumbai and Delhi every day. If all of them have an average circling time of 30 minutes each, around INR 40 lakhs of fuel is wasted in a day.

Options Analysis

- **Fuel Hedging**

Recently, the Indian Government has also allowed domestic airlines to hedge fuel risk. Hedging would allow the carriers to safeguard themselves against rising fuel prices and increasing operational cost. It would also help airlines generate more cash flows and better predict future cash flows and earnings.

- **Reducing Congestion**

To reduce the air space congestion, the government authorities and airport operator should deploy suitable technology that would result in effective air traffic management. This will ensure that the Air Traffic Controllers are able to leverage on technology to handle increase in traffic. In addition, parking bays and rapid taxiways have to be augmented at the identified airports.

- **The taxation factor**

Service tax and fringe benefit tax (FBT) are emerging as major cost components for the entire industry. FBT has been extended to cover expenses on catering and in-flight entertainment, hotel accommodation provided to passengers due to delays and cancellation, fuel, running and maintenance expenses (including depreciation) of the aircraft etc. which may not exactly constitute fringe benefits. Further, despite the significant reduction in percentages to be applied for valuation of some of the fringe benefits provided by aircraft operators, the FBT continues to remain one of the factors leading to increase in cost.

Statement of the Issue

New Ground Handling(GH) Policy

- According to the new Ground Handling policy, which came into effect from April 2011, only three agencies will be allowed to take up ground handling services at the six major metro airports. The same set of specialized Ground Handling agents would handle passenger baggage and cargo that is carried in the belly-hold of passenger aircraft and express cargo.

- The proposed new GH policy has faced lot of opposition from the airline operators as well as the cargo carriers.

Analysis of the Issue

Rationale for the new Policy

- In the existing scenario for GH services, many ground handling operators are sharing limited space for parking and equipment. Most of the equipment is old and the manpower of these operators is usually outsourced and not properly trained leading to inefficiencies.
- The rationale behind the new policy is that professional ground handlers will provide the latest ground handling equipment and trained professional manpower for ground handling services. The latest equipment will lead to an improvement in the productivity and hence to a better service standard. The aircrafts would also have a faster turnaround time, thereby improving utilization of the same and reducing operational cost for the airlines.

Airlines Perspective

- The airlines feel that they would lose their competitive edge which they possess when they were themselves managing the GH services of their own airlines. Airlines prefer managing their own ground handling services in areas where one needs to interact with the passengers. This helps them to differentiate from other carriers. In addition, airlines view that the specialised foreign ground handling players may need not necessarily have the understanding of the Indian conditions and other operational issues perspective that are unique to India, thereby negating the cost advantage.

Cargo carriers perspective

- Handling of express cargo is different from the passenger segment and special handling is required. Outsourcing it to a third party agency might only increase the cost and reduce operations efficiency. Since express cargo entails time bound deliveries involving a system through which the customer can track the whereabouts of his consignment, the express cargo carriers are of the opinion that it would be prudent for them to do self handling of their cargo
- In US and Canada, where ground handling services are provided by specialised agencies, the cargo carriers are allowed to do their own ground handling. The manpower for handling the cargo carriers are specially trained and in the event these GH services are outsourced to third party agencies, the cargo carriers would be forced to downsize their GH workforce..

Option Analysis

Review of the GH policy

The government may review the Ground Handling policy taking into consideration the interests of all the stakeholders concerned.

Cargo Handling and Warehousing

The ground handling market should be open for free competition and if security is an issue for not doing so, then the number of operators may be restricted for ramp and passenger. However there should be no cap on the number of operators for cargo handling and warehousing. To avoid situations of shortage of space for cargo handling, airports should earmark adequate land for the cargo development as cargo handling is an integral part of airport services.

Statement of the issue High Aviation Turbine Fuel (ATF) Price

The operational cost of an airline significantly depends on the fuel prices. Rising fuel prices affect the airline profitability and have a cascading effect on other supporting services of the aviation industry.

Analysis of the Issue

Multiple Taxation

- In India there is no direct import of ATF. The ATF supplied by the Indian oil companies is from imported crude refined by them.
- The import duty for ATF is 20%. Oil companies thereby follow an import parity principle and levy a 20% add-on to the refinery transfer price.
- Apart from the import parity principle, oil companies also include a 16% to 49% add on towards marketing margin and contingencies on the refinery transfer price (this add on varies between various cities).
- On this, the central government levies an excise duty of 8%.
- On the resultant price, the various state governments levy local sales tax ranging from 4% to 39% which on an average works out to be around 25% countrywide.
- The Government levies, thus work out to an add-on of around 35%.

Due to the discrepancy in the sales tax charges at various states, the airlines tend to fill up more fuel than required at the state where the sales tax is minimal. By doing so, the aircraft weight increases and this leads to burning of more fuel thereby contributing to operational inefficiencies.

Option Analysis

Uniformity of Taxes

One option is to reduce the excise duty to 4% and to undertake necessary measures to remove the disparity in the state levied taxes and enforce a common uniform rate which is the bare minimal. ATF may be put under “Declared Goods” category to bring about uniformity in levy of sales tax.

Direct Import of ATF by Airline

Allowing airlines to import ATF may help in reducing the cost by almost 25% than what the airlines are paying to the oil companies. Even after the 20% import duty is paid, the price of the fuel will be lower than what is charged currently. Airlines however will have to consider the logistics of importing fuel, including warehousing.

Statement of the High Airport Charges issue

The airport (aeronautical) charges levied by the Indian airports are reportedly stated to be the second highest amongst the Asian and Gulf countries, after Hong Kong. The airports/ aeronautical charges include

- Route Navigation Facility Charges (RNFC)
- Landing, Housing and Packing Charges

- User Development Fees (in case of private airports)
- Terminal Navigation Landing Charges
- X-ray Baggage Charges

Though India is the second highest among the Asian airports, airlines do not get value for money at Indian airports. Airlines pay more yet receive service levels that are way below those of Singapore, Kuala Lumpur, Dubai and Bangkok.

For instance, Kuala Lumpur airport charge about \$203 for handling a small Airbus A320 aircraft for a three-hour turnaround while Indian airports charge four times more at \$1,060 for the same. Airlines will have to pay \$2,331 for handling a long haul flight of a Boeing B777 while Kuala Lumpur charges only \$753, which is three times lower. For a Boeing B747 jumbo jet, Indian airports charge \$3,471 for three hour turnaround while Singapore airport charges are 40 per cent lower at \$2,476. While Dubai airport charges \$1,341 to handle a bigger Airbus A340 plane, Indian airports levy \$3,282.

Analysis of the Issue

Low percentage of non-aeronautical revenue

Non-aeronautical revenue stream has not yet been fully tapped by the Indian aviation industry. Globally non aeronautical revenues contribute 50 to 70 percent of the total airport revenues, whereas in India these contribute to a mere 20 percent of total revenues. With the proportion of non-aeronautical revenue being very low, the airport operators are forced to levy higher aeronautical related charges on airlines.

Option Analysis

Tapping the potential of non-aeronautical revenue

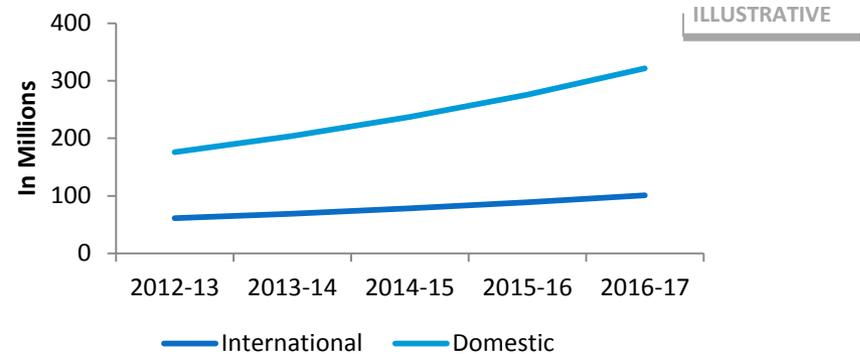
Due to low revenue accrual from terminal infrastructure facilities at India’s airports, the airlines have been subjected to a high operational cost environment. Accordingly, there is a need to seek avenues for non-aeronautical revenues that would provide a means to increase airport profitability without increasing the cost of aeronautical related services.

Way Forward to New Heights

India’s strong economic performance over past couple of years has led to an impressive growth in aviation sector. The recent times have seen India being on radar of global aviation industry players. The growth story for Indian aviation, as experts believe, is going to continue over next decade. However, continuing this growth story would require many structural reforms and removing of bottlenecks from the system. Infrastructure in India still remains a major bottleneck and aviation sector is no different. To create world class infrastructure facilities for aviation industry, India would need gigantic investments to tune of US\$ 51 billion. To make that happen, Indian government needs to formulate relevant policies, conducive regulatory mechanisms and provide a level playing field to all the players.

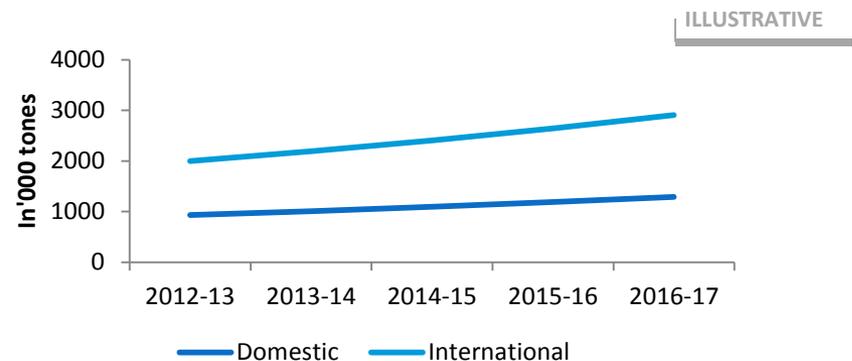
This will create an environment which is conducive to business and to attract large investments from private sector in India as well as abroad. The Indian economy can capitalize on burgeoning opportunities in aviation sector if the current issues facing the industry are resolved appropriately. The growth forecast in the passenger traffic and cargo growth is shown in Exhibit 07 and Exhibit 08 respectively.

Exhibit 07: Domestic & International Passenger Growth Forecast



Source: Airports Authority of India (AAI) & enincon research

Exhibit 08: Domestic & International Cargo Growth Forecast



Source: Airports Authority of India (AAI) & enincon research

Government's Role

The government has taken steps in the direction of structural policy reforms and is coming out with new policies which are liberal and encourage public-private partnerships. The government has embarked on a mission to create infrastructure with ambitious projects. At this point, it is worth noticing that policy formulation is one aspect while smooth implementation of it is another.

India has a history of having rules and regulations in place but not putting emphasis on implementation of the same which has impacted its own interests many a times. Routing development through public-private partnerships presents different challenges in terms of delineation of responsibilities, effective monitoring and evaluation procedure in place and final transfer of rights. The future plan of action would leverage on the past experience with a priority to upgrade the infrastructure to accommodate further expansion.

Given the size and the population of the country, air travel penetration is relatively low, providing an opportunity to sustain the growth rate witnessed in the aviation sector over the past few years.

Role of Private

In India, due to policy changes and reforms, Public Private Partnerships (PPPs) have increasingly become the preferred mode for construction and operation of airport infrastructure. Private sector is actively involved in airlines and airports and their contribution are expected to rise substantially in the coming years.

PPP offers a distinct possibility for increasing total investments by using a limited amount of public resources to leverage a much larger amount of private investment. Such PPPs accordingly could also increase economic efficiency and lower the capital requirement, provided that regulatory mechanisms are adequate.

PPPs can be undertaken through a range of alternatives such as BOT, BOOT etc, with the Model Concession Agreement (MCA) being used to provide a suitable regulatory and policy framework. The MCA regulates the PPP contracts by defining the rights and obligation of all parties concerned. In case a project is not viable due to either long gestation periods or inadequate returns, the government is committed to provide up to 40% funding by way of grants in some cases, called viability gap funding.

The government has a non-interference approach on the commercial matters of the aviation sector. However in the future airports, where the competition is limited, has already come under the purview of AERA. With the number of PPP airports steadily increasing in India, the need of a regulator is felt necessary. The government on its part is continuing to provide a policy framework for the growth of the availability and accessibility of air travel.

Road Map Ahead

Successful and timely execution of the envisaged aviation infrastructure projects will require strong leadership and technical capabilities among the government functionaries.

There will be a need for a specialized steering committee / expert technical advisory group for planning, formulating, executing and overseeing the implementation of such large size projects. India can take lessons from the successful practices adopted by other countries in aviation industry.

Further, the government can seek participation of all the concerned stakeholders in policy formulation by inviting their views and addressing issues faced by them. The need of the hour is to efficiently utilize the existing resources and at the same time commission the planned infrastructure in a timely manner to provide the end user a memorable travel experience.

In addition, a collaborative effort must be initiated involving all the stakeholders concerned to chalk out a framework detailing the measures, the Indian aviation sector needs to pursue in the next five – ten years.

This framework would act as the platform to make India one of the leaders in the global aviation industry and to scale new heights. The framework would require the prioritization of the various issues indicated in the earlier sections on a high, normal or low basis.

This would ensure a focused approach to understand the root cause of the issue and to address the same by taking necessary remedial actions. The framework would also provide a guiding light on the time line for the leveraging on the opportunities abound in the sector.