Absolute Aviation Advantage

An end to boom and bust for Indian Aviation?


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An end to boom and bust for Indian Aviation?

A year ago the new government in India, led by Prime Minister Narendra Modi of the BJP Party, announced that it would embark on a range of significant reforms, not least in the air transport sector. A year down the road, the Indian media are speculating that Modi has so far failed to deliver India from its 'morass of red tape' which brings the question, what evidence is there that real change is taking place in aviation?

With its population getting close to that of China, healthy economic growth and a rising middle class, it's not the first time that India has been perceived as being on the brink of a breakthrough in air travel. Last time, however, the boom times led to bust as excitement over market potential meant the sector lost focus on the business basics. With more capacity than demand and fares lower than costs, the industry stagnated and major players fell by the wayside.

The question is, are we there again? Is there anything different this time around? Will Modi's government be able to change the operating environment so that the most competitive airlines thrive, or will policy be determined by protecting special interests? Could we finally be glimpsing what a sustainable Indian air sector looks like, one which can deliver affordable air travel for the masses?

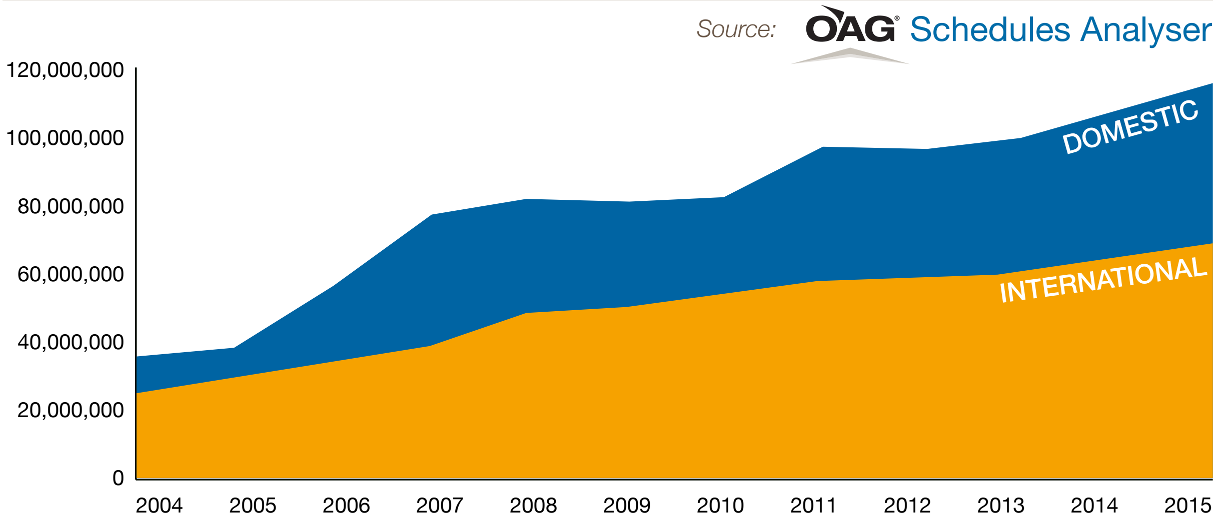
A rollercoaster decade

It's not been a smooth ride for Indian aviation in recent years. Strong growth on the back of domestic deregulation led to a situation of over-capacity by 2007. The low fares introduced by the new low-cost carriers Air Deccan, Go Air, IndiGo and SpiceJet became unsustainable in the face of soaring oil prices and the steep taxation applied to fuel by the Indian government. What followed was a period of stagnation in the market but just as growth returned in 2011, the collapse of Kingfisher heralded a further period of limited growth.

Plenty of potential

Despite these setbacks, India's domestic market has seen an average annual growth of 12% each year for the last 10 years and 10% average annual growth in the international market.

INDIA – SEAT CAPACITY



India has a vision of becoming the third largest civil aviation market by 2020[1] and is expected to become the largest by 2030, according to a recent report by the India Brand Equity Foundation[2]. Is this realistic or just a pipedream? In IATA's latest 20-year forecast, India is expected to grow by an additional 266 million passengers to reach a total of 367 million by 2034[3], making it the third largest market by 2031 - after the United States and China.

Indeed, in 2014, India was the fifth largest global market in terms of seats but is still a long way behind the USA and China which are ranked first and second, respectively.

A major factor in airline passenger growth is how the economy performs. GDP growth leads to passenger growth and the Indian economy is growing well. According to the World Bank[4], GDP growth for India in 2015 is expected to reach 7.2% and follows growth of 6.9% in 2014. The forecast for 2017 and 2018 is currently even stronger, at 8% per annum, which is more than China.

[1] http://makeinindia.com/sector/aviation/

[2] http://www.ibef.org/industry/indian-aviation.aspx

[3] http://www.iata.org/pressroom/pr/pages/2014-10-16-01.aspx

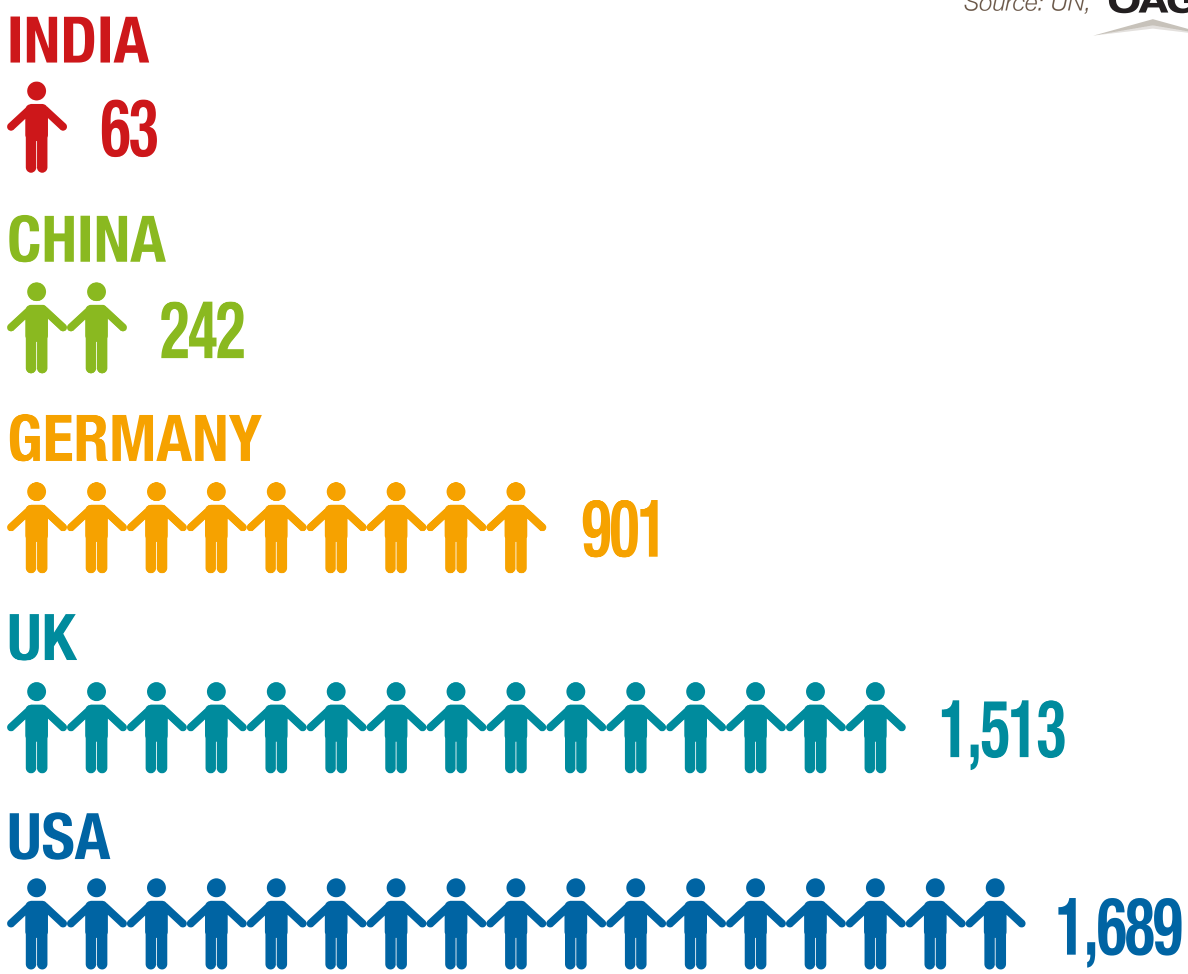
[4] http://www.worldbank.org/en/news/feature/2015/04/28/india-economy-turned-corner-wider-reforms-needed-boost-economic-growth

Economic growth is contributing to the well-documented rise of an Indian middle class, estimated to number 267 million by 2016[5]. Middle-class purchasing habits are gaining traction. Prime Minister Modi's campaign for financial inclusion has led, according to The World Bank, to an estimated 125 million bank accounts being opened in the past year and while many of these will be in poorer households, undoubtedly this combined with the rapid penetration of mobile phones - 47% of the population currently[6] - will have brought the ability to book air travel easily to many more Indian citizens.

Having said all this, the propensity to fly in India is still very low. In 2014 there were 63 air passengers to, from and within India for every 1,000 of the population. This compares to 242 in China, or 1,689 in the US. While the Chinese propensity to fly is four times that of India, in many ways this shows why there is such an expectation on the Indian air transport sector and recognition of their potential.

PROPENSITY TO FLY – PER 1,000 POPULATION

Source: UN, OAG



[5] http://www.makeinindia.com/sector/aviation/

[6] http://www.emarketer.com/Article/Majority-Use-Mobile-Phones-India-Next-Year/1011780

Getting policy right – where the rubber hits the road

In their manifesto, the BJP party promised a programme of modernisation of existing airports and development of low-cost airports to promote air connectivity. A draft civil aviation policy was released in November 2014 for consultation which prioritised the development of six airports as the country's major international hubs. The policy has been received with strong criticism from many of India's states which believe they will be excluded from direct international air services as a result. Although the policy was expected to be finalised earlier this year, there is as of yet no sign of it.

There was also an expectation that India's 5/20 rule – where domestic airlines must have been operating for five years and have a fleet of at least 20 aircraft before they could launch international services – would have been abolished. While this still appears to be the plan, there's been no movement yet[7]. For India's home-grown carriers such as IndiGo, Spicejet and Jet Airways, such a move would remove part of their competitive advantage having waited themselves to gain international air service rights. Might they be lobbying hard for a delay to a change in the 5/20 rule?

Taxation on aviation has been another thorny issue for air transport policy in India. The level of jet fuel tax applied varies from state to state as each is permitted to set its own level of jet fuel tax. Presumably it provides a handy income stream. For airlines though, the high level of fuel tax impinges directly on route profitably. Fuel taxes make up a significant share of the total amount paid by passengers to fly. Non-Indian airlines, or domestic carriers with international operations, have the option to refuel beyond India's borders and reduce costs. Clearly, domestic carriers which have waited years to get rights to fly internationally don't want that cost advantage shared with new entrants. So it is possible that change to the state fuel policy is being resisted by the very States and airlines which could also gain from its removal.

So, the only really substantive change in air transport policy in recent years is the relaxation on foreign ownership of Indian carriers; a rule introduced in 2013 before the current government took office. It's early days but so far this does not appear to have materially changed the landscape in the domestic market although it has prompted the arrival of AirAsia India and Vistara, which currently each have a 1% share of domestic capacity.

Is the domestic bubble set to burst?

While the government may have been slow to act, the past year has been a good one for some of the leading airlines in the market, most notably IndiGo. With domestic seat capacity expected to exceed 100 million for the first time in 2015, India's domestic market is flourishing once again. There are 10% more domestic seats within India this May compared to last year, in line with the trend from the previous year (+11%) and for the rolling 12 months, capacity is up 5%.

Current growth is being driven by LCCs which have added 18% more seats and increased their share of capacity from 59% to 63%.

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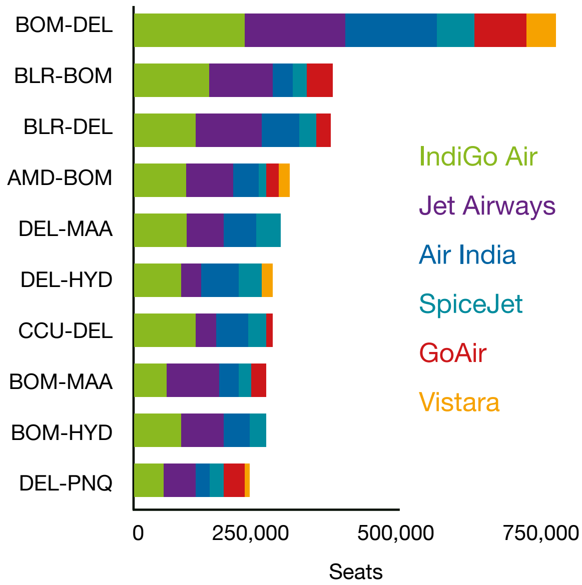
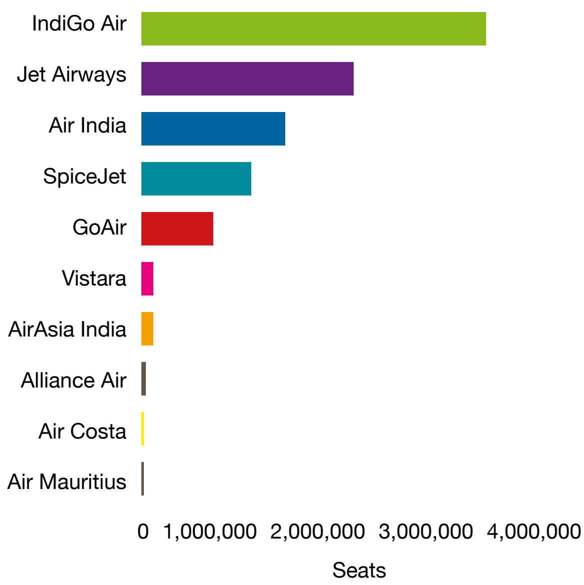
[7] http://www.dnaindia.com/india/report-520-rule-for-indian-carriers-must-go-civil-aviation-minister-2073949

TOP 10 DOMESTIC ROUTES BY CARRIER – MAY 2015



TOP 10 CARRIERS BY DOMESTIC SEATS – MAY 2015



Source: OAG Schedules Analyser

IndiGo is the biggest carrier in the domestic market with 38% of seats and is growing fastest. Ninety percent of the additional 858,000 seats in the domestic market in May 2015, compared to May 2014, are on IndiGo planes. IndiGo's share of capacity has more than doubled in the last five years from its 15% share of seats back in May 2010. They also have the dominant share on all but one (BOM-MAA) of the Top 10 biggest domestic routes in India.

Jet Airways is the second biggest airline in the Indian domestic market with just under a quarter of all seats. At their peak in 2012, they operated 32% of domestic capacity. Their focus is now primarily international, undoubtedly driven by their relationship with Etihad.

Air India, the country's national carrier is third largest with 15% of seats. This has fallen from 19% in 2013 and they now have 4% fewer domestic seats compared to last May, consistent with their pursuit of profitability. Air India finally joined the Star Alliance a year ago and with 7 Boeing 787's due to enter their fleet this year and the next, it suggests a renewed focus on long-haul international growth.

Just 12 months ago Spicejet looked to be in the running to play a significant part in India's domestic market but as the carrier celebrates 10 years of operations so too has it seen flights grounded and routes cancelled over unpaid bills and heavy competition. While Spicejet is adamant the worst is behind them, the arrival of AirAsia India last year and more recently, Vistara can only make the competitive landscape more challenging.

IndiGo rules the roost…for now anyway

A private company owned by the InterGlobe group, IndiGo is now significantly bigger than the next largest carrier in India's domestic market, Jet Airways, and has grown by 24% in the last 12 months.

IndiGo operates a fleet of 94 A320s and in October 2014 placed a record order with Airbus for 250 A320 neos[8], the largest order in India's history and for Airbus, the single largest order ever by number of aircraft. With an average fleet age of just 3.4 years now, it's clear that for IndiGo this order is an indication of their expectations for market growth. They also reportedly have approval from the Indian government to import a total of 400 aircraft and have purchase rights with Airbus for a further 100 aircraft.

Even if we assume 50% of the 180 new aircraft scheduled to join the fleet over the next decade are for growth rather than replacement capacity, IndiGo would need around 1.8 million new passengers each and every year to continue operating at the same load factor. This is calculated as 5% growth in traffic per annum which is not unrealistic given that IndiGo grew by 23% in 2014 and IATA's growth projections for India. In reality, IndiGo's approach to aircraft purchasing is typically sale and leaseback and aircraft stay in the fleet just 6 years, so the proportion of aircraft used to deliver new services may be lower than 50%.

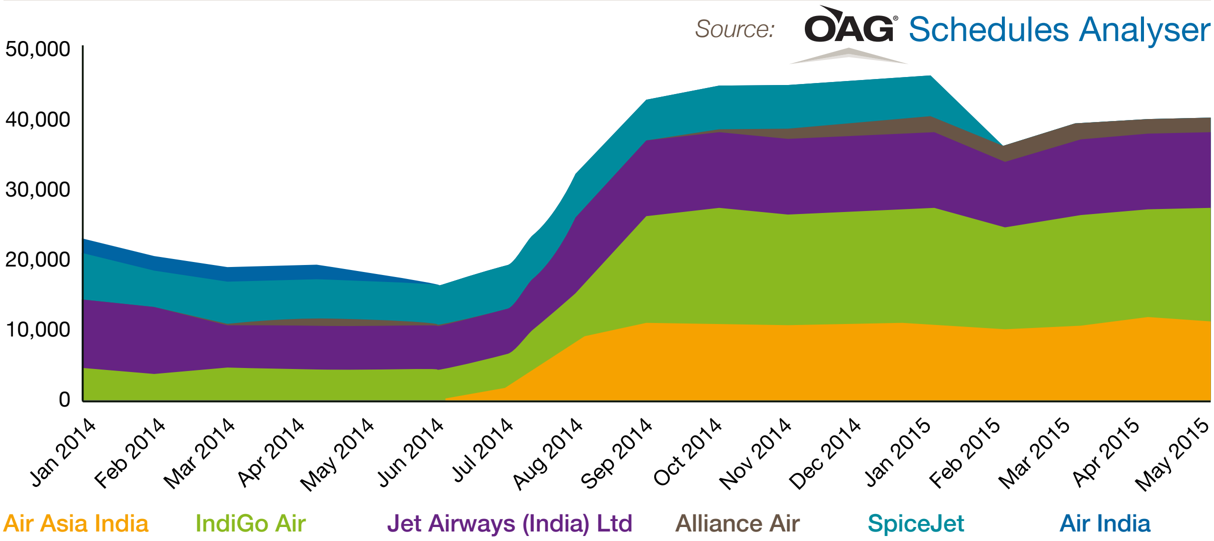
Whether these new aircraft will all serve the domestic market or be used to grow IndiGo's network internationally is a subject that the carrier has, as yet, been quiet on. With an IPO reported to be launched this summer and as yet unrequited interest from Qatar Airways[9], it is clear that IndiGo might just be a rare aviation example of an Indian success story.

The disrupting effect of AirAsia India

There are signs that the arrival of new entrants AirAsia India and Vistara may already be disrupting the domestic market.

AirAsia India is the first foreign carrier to operate Indian domestic routes and has been operating for nearly a year, securing 1% of India's domestic capacity. That percentage may not seem much but it is concentrated on 10 domestic routes operated from a base in Bengaluru. As of May 2015, AirAsia India is operating more than a quarter of capacity on four of those routes: 52% on Bengaluru (BLR) to Chandigarh (IXC); 47% on Bengaluru to Jaipur (JAI); 34% on Bengaluru to Goa (GOI) and 29% on Bengaluru (BLR) to Cochin (COK).

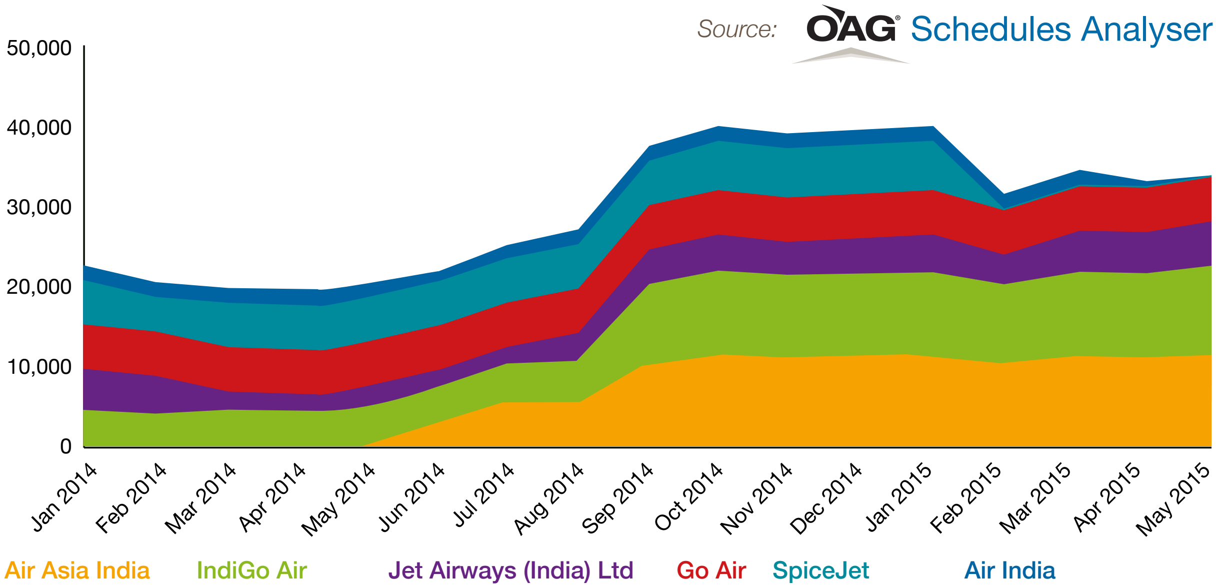
BLR – COK



[8] http://www.businessinsider.com/r-the-40-billion-jet-buying-spree---indigos-big-bet-2014-10?IR=T

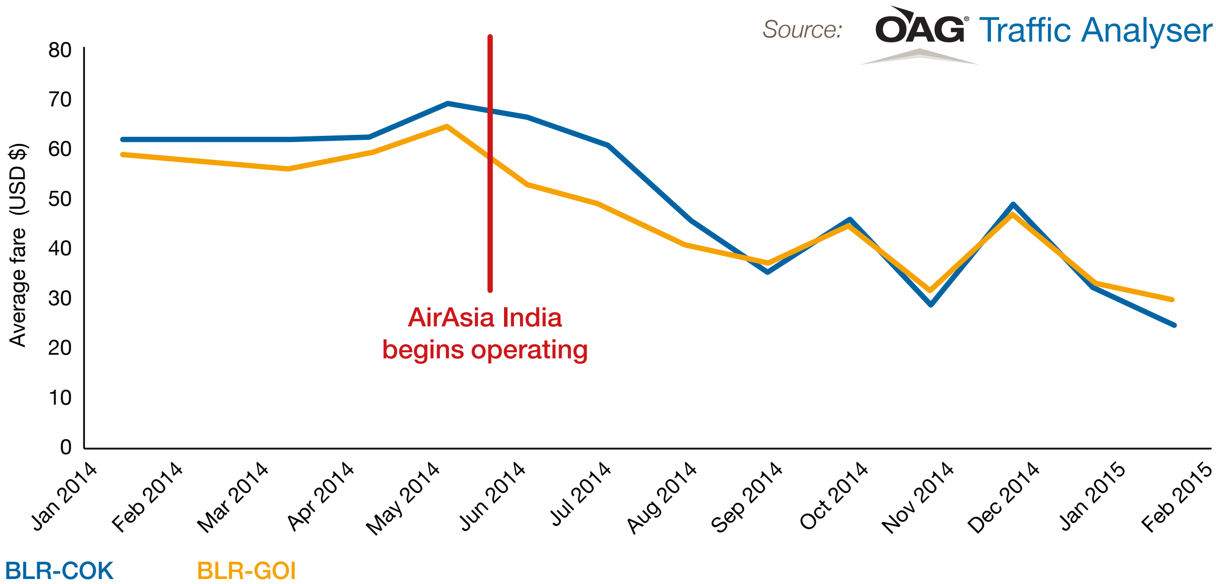
[9] http://www.emirates247.com/business/corporate/qatar-airways-very-interested-in-stake-in-india-s-indigo-2015-05-10-1.590101

BLR – GOI



The arrival of AirAsia India on routes such as Bengaluru to Cochin and Goa spurred competitors to further add capacity and lower fares in a battle for market share. Six months down the road, capacity has flattened, fares are as much as 60% lower and the casualties are mounting with Spicejet and Air India withdrawing from these routes.

IMPACT OF AIRASIA INDIA NEW SERVICES ON AVERAGE FARES



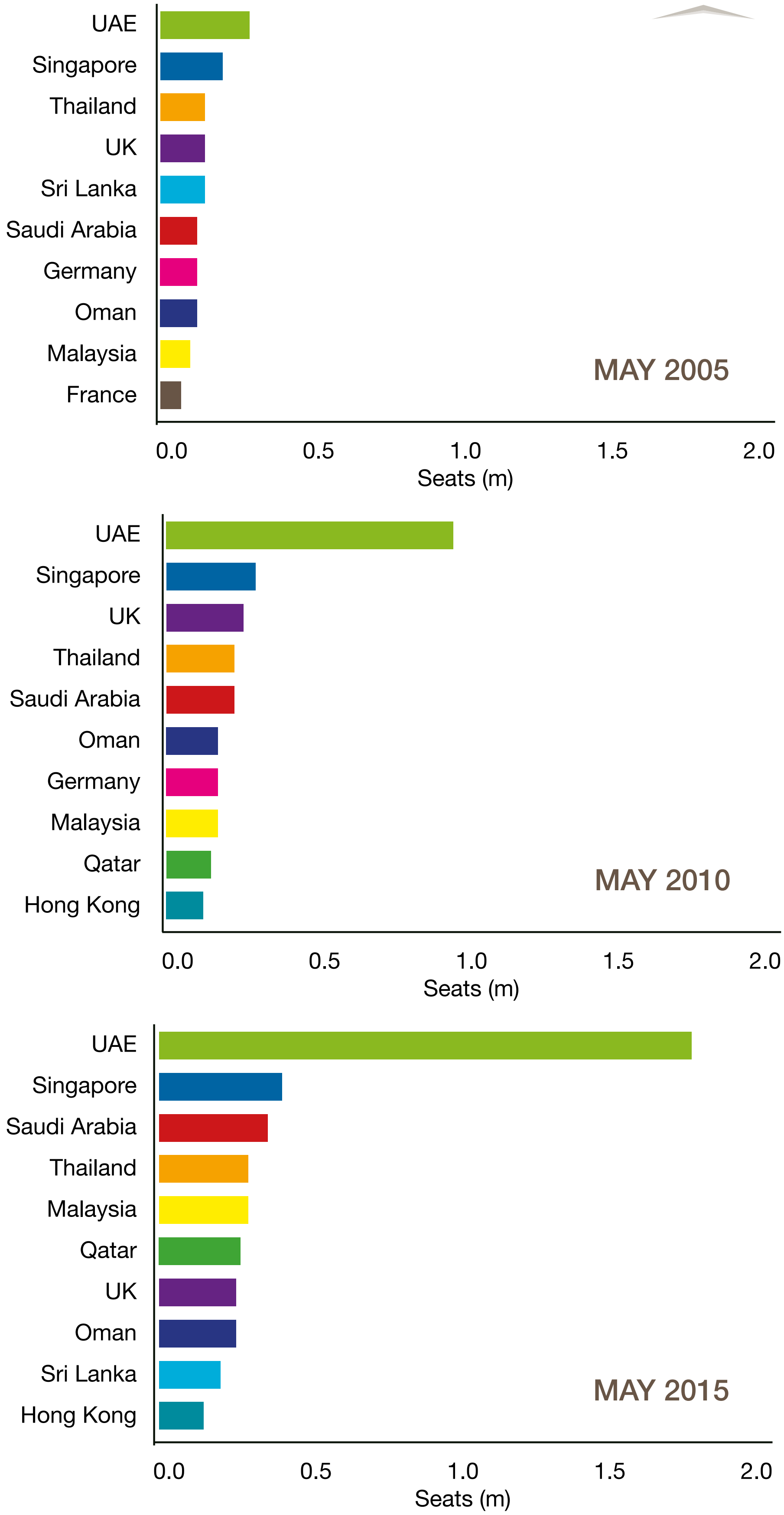
A look at AirAsia's top routes elsewhere in Asia shows that the carrier often ends up with 20% to 35% of total capacity offered on a route. This route-by-route approach to establishing profitable air services and making a name for itself should be a warning of the potential scale of disruption the carrier, or indeed brand, is capable of.

Vistara, the SIA and TATA full-service joint venture, only commenced operations in May 2015 so it is too early to say how disruptive they will be. They have launched services to 10 destinations, four of which are some of India's biggest routes.

How the Gulf is shaping the international market

INDIA: TOP 10 INTERNATIONAL COUNTRY MARKETS

Source: OAG Schedules Analyser



India's international capacity has long been heavily populated with foreign carriers which account for 66% of capacity, a proportion which has remained unchanged for the last 5 years. These carriers can operate into India without the 5/20 restrictions which affect domestic airlines and can also benefit by refuelling outside India.

Currently, Air India (including Air India Express) is the biggest individual carrier with 16% of international seats in May 2015. Jet Airways is ranked second with 14% of seats. With 24% of Jet Airways owned by Etihad, the carrier increasingly operates as a feeder to Etihad. Combining the two airlines makes them the biggest provider of international capacity to and from India (18%).

Although both Etihad and Emirates still have relatively small capacity shares, they are growing fast; they operated 84% and 18% more seats, respectively, this May versus last year.

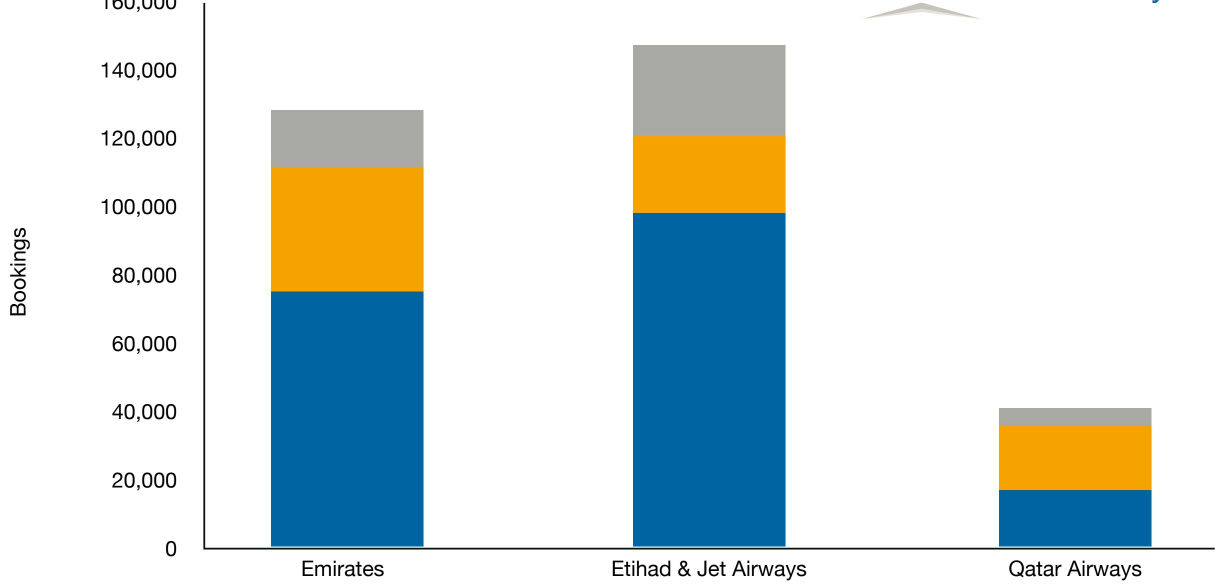
The Gulf carriers are undoubtedly cementing their position in a market where the global alliances have yet to make their mark, although Air India's accession to Star Alliance in 2014 has improved the Star share of Indian capacity to 16%. A look at the evolution of India's Top 10 International markets by seats over the last 10 years shows that whilst there has been little change in which markets are ranked top, there has been a massive shift in the relative importance of the Gulf States.

By May 2015, almost half (47%) of all international seats from India were operated to the Middle East. This has been driven mostly by the migrant worker and business market in the Middle East where the Indian population is estimated to be in the region of 3 million (Saudi, UAE, Oman, Kuwait).

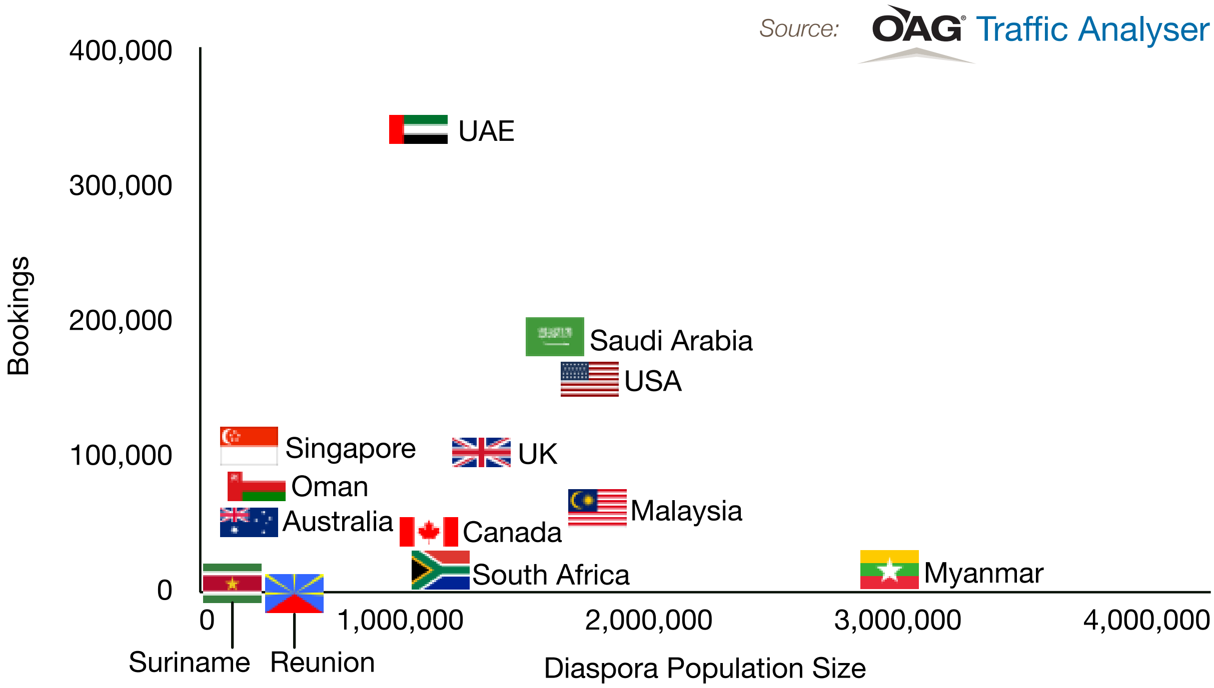
The USA and United Kingdom also have significant India diaspora populations[10], with 1.7 million and 1.2 million respectively, and bookings data from OAG's Traffic Analyser shows that for the Gulf Three (Emirates, Etihad and Qatar), there are significant volumes of passengers whose journeys originate in India, route via one of the Middle East hubs, and end in the USA and United Kingdom.

GULF THREE – INDIA BOOKINGS FEB 2015

Source: OAG Traffic Analyser



INDIAN DIASPORA & PASSENGER BOOKINGS – FEB 2015



The Indian diaspora, whether migrant labour or permanently resident, clearly plays a major role in shaping international air traffic flows. This is especially so for more developed markets (US, UK, Singapore, Australia, Canada) where affordability of air travel is higher.

While Indian propensity to fly is particularly low, it is hardly surprising that the international market is shaped by migrant workers and VFR traffic rather than leisure travel. The continual devaluation of the India rupee over a number of years will not have helped demand for outbound travel. So it is understandable that the Indian carriers have been rather more focussed on the domestic market.

[10] www.indiandiaspora.nic.in

Can India live up to its potential?

Indian aviation appears to be in a similar place to 6-7 years ago with expectations rife on market potential, strong traffic growth and new entrant airlines appearing. Last time around it ended in overcapacity, airline failures and unmet expectations. Can it be different this time around?

Getting it right is dependent on airlines which can manage costs and revenues as well as relying on a policy environment where the airlines which can get their business model right can thrive and the delivery of aviation infrastructure is fit for purpose. The airlines – at least some of them – appear to be in good shape and could deliver. However, the Modi government seems to have slowed reform of the regulatory environment in the face of lobbying. The latest proposal[11] to amend the 5/20 rule might create more bureaucracy, not less, with its complicated suggestion that carriers would be required to operate domestic routes to remote regions in order to gain credits towards rights to serve international routes. Surely a PSO arrangement, as used in Europe, might work better for those non-commercial routes where there is a social case to be made for having air services.

As and when more Indian carriers are able to put up robust competition in international markets, what they will need is great airports to operate to and from. So the government should stick to its original plan – encourage competition among airlines, open international access and focus on infrastructure.

[11] http://m.firstpost.com/business/airasia-india-vistaras-international-plans-may-run-turbulence-new-govt-policy-2181869.html

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