

AIRLINES IN INDIA - A STRATEGIC ANALYSIS

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ABSTRACT

The commercial airlines in India are going through a period of turbulence in terms of the rapid changes in their business environment. Major consolidations have taken place in the industry calling for new or revised strategies. This paper examines the various strategic issues faced by the airlines. The strategies followed by the major players in the industry and their performance are analyzed. The constraints in implementing their strategies are addressed and future prospects are assessed.

Keywords: Strategic Issues; Airlines in India; Airlines Performance and Mergers in India.

INTRODUCTION

The Indian economy has grown at an average rate of around 7% in the last decade. The rise in business and leisure travel (both domestic and international) due to this growth, India emerging as a major origin and destination for international travel have all had a significant impact on commercial aviation in India. According to the airports authority of India (AAI), the passenger traffic is expected to grow at over 20% in the next five years [1]. Since 2003 there has been sharp increase in both domestic and international traffic carried by and in capacity of Indian carriers (Table 1). On the supply side, since 2003, when low fare travel in India was ushered in, a number of low cost carriers (LCC) have entered to serve this fast growing market. However, all of the LCC carriers and—with rare exceptions—even the full service carriers (FSC) charging higher fares have been making losses. By and large, operating a commercial airline in India so far has not been a profitable business. In 2007, the industry witnessed a wave of consolidations primarily to stem the tide of red ink. As the intensity of competition increases and the environment for civil aviation in India changes, the airlines have to rethink their strategies.

CIVIL AVIATION INDUSTRY IN INDIA

Before 1953, all the airlines in India were private ones. In 1953, the government of India under the Air Corporations Act, nationalized and merged the eight private airlines that existed then and

created two state-run airlines out of them. In 1991, the Indian economy began to liberalize. It became more open and market-oriented, and the process of deeper integration with the world economy had begun. These reforms were extended to the civil aviation sector in 1994 when the Air Corporations Act of 1953 was repealed. This enabled the entry of private carriers who could now offer scheduled services. The market did not grow large enough for all these players to compete. There was a shake-out and many of the airlines went bankrupt. Jet Airways and Sahara Airlines (became Air Sahara in 2000) are the only surviving carriers from that era. The year 2003 in many ways was a watershed year for commercial aviation in India because for the first time, a low fare carrier—Air Deccan—began its operation in India. It was also a turning point for demand and capacity which have had an explosive growth since. While the annualized growth rate for the ten year period leading up to 2006 for Available Seat Kilometers (ASK—a measure of capacity) and Revenue Passenger Kilometers (RPK – a measure of demand) for domestic travel were 10.05 and 10.31 respectively (Table 2), the average growth rates in the three years from 2003 jumped to over 15.5% for ASK and over 22.5% for RPK, respectively. This growth in ASK and RPK is largely due to the entry of new private airlines and the strategies they followed. Kingfisher, Spice Jet, Go-Air, Paramount and IndiGo are the major private airlines that began operations after 2003 (Table 7). The new entrants were pursuing a different strategy. Most of them were trying to compete as low cost carriers (LCC) (Table 7).

THE “LCC” PHENOMENON IN INDIA

Southwest Airlines, now a major carrier in the U.S., operating local routes in Texas in the 1970s pioneered the low cost carrier business model. In the early 1990s, the low cost carrier model was introduced in Europe. In India, the model was introduced in 2003 by Air Deccan. However, the same descriptive label masks the significant differences in ways the model has worked in India vs. U.S. and Europe. First, in terms of market share, LCCs accounted for almost 30% of all domestic passengers carried in 2006 (Table 3). As of November 2006, it rose to 35%. This rate of market penetration of LCCs is remarkable given that the market share was zero in August 2003. Low cost carrier operations account for 44% of all flights within India compared to 22% in the U.K. and 19% in the U.S.[2].

The second significant difference has to do with the relationship between low cost and low fare. In U.S. and Europe, the LCCs offering low fares are also truly low cost operations. In India, the airlines that offer low fares are in reality not low cost operations. They are LCCs in name only. Among the LCCs in India, Spice Jet has the lowest unit cost at 6.2 cents per ASK, which is comparable with Southwest, Easy Jet, and Jet Blue. But this is more than twice that of the best performer, Air Asia with unit cost of slightly over 3 cents per ASK. For another Indian carrier Jet Lite, it is 7.2 cents per ASK. Jet Lite is the reincarnation of Air Sahara after it was acquired by Jet Airways in April 2007.

There were operating losses for Air Deccan in 2004-05 and 2005-06. Moreover, while the operating revenue per RPK went up by 9.4 percent, the operating expenses went up by 30.65 percent (Table 4)! This flies in the face of what LCCs outside India like Ryanair have done when they were in a similar stage of their growth. Ryanair ruthlessly focused on lowering costs while finding ways to enhance revenues by selling food and drinks during flight to captive passengers and selling services such as insurance, hotel reservations, and rental cars on its website, [4]. Air

Deccan seems to have followed similar strategy in terms of charging for baggage (by offering limited baggage allowance) and food, and expanding capacity in face of losses, but with a crucial difference—it did not share the obsession of Ryanair and Air Asia to reduce costs.

Typically, LCCs provide point-to-point service avoiding connecting flights and baggage transfers while FSCs base their operation on a hub-and-spoke system. Air Deccan has deviated from the LCC business model in the sense that instead it has a hub-and-spoke type operation to connect metros with smaller towns. It also provides point-to-point service between metros and large cities. Industry analysts have pointed out that this has increased the costs for Air Deccan.

There are serious doubts about whether LCCs (as we know them elsewhere in the world) exist in India. According to Bill Franke, the Managing Director of leading airline investment firm Indigo Partners, “There is not a single airline in India that operates a true low cost structure. Under the current conditions, it’s not possible,”[6]. Similar views were expressed by Narendra Goyal, the founder and chairman of Jet Airways, the largest private airlines and the only airlines in India that has remained profitable over the years. He questions the feasibility of LCCs in India because of lack of infrastructure and skills. He says “India has nothing called low-cost, only low-fare and low-margin. This is irrational pricing which will make the whole industry sick,”[7]. Despite these views, it appears that Jet Airways has not given up on the LCC model. It is interesting to note that Jet Lite (previously Air Sahara), the recent acquisition of Jet Airways, is being run as a short-haul (for domestic routes) and long-haul (for overseas routes) LCC.

Impact of LCCs

The so-called LCCs in India have expanded the market for air travel in India through their low fares but without being profitable. They have made air travel accessible to the middle class. Some travelers who were using trains and buses have switched to traveling by LCCs because of the low fares. Spice Jet for instance, has targeted passengers who are traveling by air-conditioned classes in Indian Railways. They have also made pricing more competitive. They set off a price war with the the incumbent full service carriers (FSCs) Indian, Jet Airways, and Air Sahara. The FSCs started discounting fares by as much as 60%-70% in some routes to match the prices of LCCs. This in turn has hurt their revenues, margins, and market shares. For instance, Jet Airways, which controlled about 50% of the domestic market in 2003, saw its share (including that of its acquisition Jet Lite) drop to about one-third by 2007. Lower fares also meant more frequent travel. Low cost air travel has created both depth and width of demand which has percolated to non-metro towns and Tier-II cities as well.

PERFORMANCE AND CONSOLIDATIONS

There is no question that all the airlines in India are having financial difficulties (Table 5). Even Jet Airways has seen its market share and profits decline and stock price plummet by 40% since 2005. There are couple of factors that account for this. One factor is the inability of the airlines to reduce costs, and the other is the “irrational” pricing that set in after the advent of LCCs.. They have chased market share, i.e., revenue maximization and forced the incumbents to match their low prices. They have been successful in taking the market share from the FSCs. From 2006 until mid-2007, the incumbent FSCs have been losing market share to LCCs at a rate of close to

1.5% per month. While revenue maximization may seem like a good short term strategy to enter the market, sooner or later—and sooner is better—the LCCs have to become profitable. That has not happened so far. These depressing financial conditions can lead only to two types of outcomes for the airlines—either some of them go bust in a market shake-out or they merge/get acquired by other airlines or business groups. Whereas in the 1990s, many private carriers went bust, now the industry is witnessing a wave of consolidations. 2007 became a landmark year in the industry because of the major consolidations that took place during the year.

The following are the major examples of consolidation in the Indian aviation industry. What is striking about these consolidations is that two of them are between carriers which have made heavy losses!

1. Indian Airlines and Air India. These two national carriers enjoyed monopoly power in the industry until the Air Corporations Act was repealed. As mentioned earlier, intense competition from private carriers is the main reason for steep decline in their market share and profits. Indian Airlines, which had a monopoly on domestic services until 1994, had its market share decline from 100% to 17% since. The combined entity NACIL has now a fleet of 112 aircraft, about a third of the national strength.

2. Jet Airways and Air Sahara. Jet Airways acquired Air Sahara in April 2007 for \$346m that has since been rebranded as a low-cost carrier, called Jet Lite. This is an outright purchase making Jet Lite a 100% subsidiary of Jet Airways.

3. Air Deccan and Kingfisher Airlines. India's first low-cost carrier, Air Deccan, which started the low fare boom in India, reported a \$43 million loss for the fourth quarter ending June 2007. To keep afloat, Air Deccan sold 26% of stake in May 2007 at \$136 million to the flamboyant liquor baron Vijay Mallya's then two-year-old Kingfisher Airlines, which itself was losing about \$250,000 a day! This stake was later increased to 46%. The business models of these two airlines seem to be as diametrically opposite as the personalities of Mr. Gopinath (founder of Air Deccan) and Mr. Mallya—all the more likely why these two will not be merged and will continue to be run as separate entities. By this strategic move, both the airlines plan to improve performance and save money by sharing facilities and staff.

After consolidations, one is likely to see the three groups, i.e., NACIL, Jet Airways, and Kingfisher, controlling over 80% of the market. Most likely, there will be 2-3 carriers operating in domestic FSC space, 5-6 carriers in the domestic LCC space and NACIL, Jet Airways, Jet Lite—and soon to be joined in 2009 by Kingfisher—in the international space.

The consumer is likely to be the biggest loser after these consolidations. Ticket prices for LCCs and FSCs went up by an average of 10% in 2007 compared to the fares in 2006 (Table 8). It is possible that LCCs may lose the marginal customers, the top-end train travelers who were lured by the low fares of LCCs.

OUTLOOK FOR THE FUTURE

The long-term outlook for the airlines in India (the ones that survive the current shake-out) appears promising. As long as the Indian economy's growth is strong, they can count on continued growth in demand (for both domestic and international air travel), albeit at a slower rate than the rates for the last three years. Currently, only one percent of India's more than one

billion population travel by air. The airlines' plans to expand capacity and replace ageing fleet aggressively should enable them to meet this growing demand more efficiently. But in the near term, they have to face significant challenges such as: 1) realizing the benefits of the consolidations; 2) realigning their competitive strategies to become profitable; 3) pursuing aggressive cost reduction; 4) the availability of capital; and 5) constraints due to poor infrastructure for aviation in India.

New Strategies

One of the strategic decision variables that has already been adjusted is pricing. Vijay Mallya's views may give a clue as to what pricing strategies the airlines may follow in the near term. "The days of discounting and cut-price ticketing are over. Airfares are going to reflect the actual costs of operation. All of them." Also, he does not believe that hike in prices will dampen the demand. There is some evidence to suggest he may be right. According to a survey conducted by Center for Asia Pacific Aviation (CAPA), 67% of Full Service Carrier (FSC) passengers and 51% of Low Cost Carrier (LCC), passengers would still have traveled by air if the fare had been double and, 57.5% of FSC passengers would fly with an FSC rather than an LCC even if the trip was personal and self-financed.

Another strategic change will be in the business models. Jet Airways is now concentrating on expanding its international operations targeting passengers of Indian origin (there are about 30 million in the Indian Diaspora) who travel to India mainly from U.S., U.K., Canada, European countries, and South Africa. It has established a hub in Brussels, and in August 2007 inaugurated flights from India to U.S. This strategy helps Jet Airways escape the brutal competition in the domestic sector. It hopes to generate more than half of its revenues in 2009 from the more lucrative international flights. Its only Indian competitor for such long haul flights would be Air India, part of NACIL, which it can out-compete due to Jet's superior service advantage. Jet Airways will also enjoy the first mover advantage among the Indian private airlines for at least couple of years, because other private carriers are not allowed to have overseas operations unless they have been in domestic business for at least five years. This policy has frustrated Kingfisher, which has already placed orders for five of the giant double-decker 600 passenger A380 aircraft in preparation for entering the international market in 2009. Kingfisher and Spice Jet have lobbied for the waiting period to be changed to three years, but the government is likely to stand firm on its current policy.

An interesting business model being tried out is long-haul low cost carrier. Air India Express which is part of NACIL and Jet Lite are flying international routes using this model. This model is different from and more complicated than the short-haul LCC model. For instance, passengers are willing to pay for more comforts during long flights. Airlines have to serve food and maintain a larger crew. It is difficult to achieve the same level of cost advantage as short-haul LCCs. Moreover, Jet Lite and Air India Express are likely to face stiff competition from regional carriers such as UAE (United Arab Emirates) based Air Arabia which is also a long-haul LCC. Whether the long-haul LCC model will be profitable remains to be seen, but other LCCs (e.g., Air Asia and Ryanair) are trying to use this model as well.

Cost Challenges

The main cost items in airline business are fuel, labor, charges for landing, en-route navigation, depreciation on aircraft, ground equipment and property (depreciation), outside service expenses (ground handling), financial expenses, and other expenses. Labor is not a significant cost in India, as it is only around 10% of total costs, unlike the United States of America where it is 40%. However, costs for skilled labor like pilots are on the rise in India because of skills shortage. India will need 6,000 more pilots to meet the passenger traffic over the next decade. This, rather than availability of aircraft, could become the bottleneck and limit the growth of capacity. In India, fuel is the main component of cost, accounting for about 37%-38% of the total cost, and this cannot be reduced by the airlines alone without the intervention of government [2]. The operating cost is usually adversely affected by variables like Aviation Turbine Fuel (ATF) prices and congestion at major airports, which lead to higher operating cost and huge losses. In India, the price of ATF is around 70% higher than in most countries, leading to a much higher cost-variable for low-cost carriers. The ministry of civil aviation is working with the various ministries and the state governments reduce taxes on ATF, and with oil companies in India to rationalize the ATF prices. But with crude oil prices going above \$100 a barrel, the government—which wants to reduce its oil import bill—will be hard pressed even to hold ATF prices steady let alone to reduce it. In fact, the government has not reduced the tariffs on ATF in the 2008-09 budget. All this makes operating a LCC in India much more of a challenge. For all the airlines in India, in the near term, cost containment rather than cost reduction appears to be a more realistic and feasible goal.

Expansion Plans and Constraints

The three consolidated airline groups have aggressive fleet expansion plans. According to Centre for Asia Pacific Aviation (CAPA), Indian carriers have approximately 480 aircraft on order (some of it for replacement than expansion) for delivery through to around 2012, against a fleet size of 310 aircraft today. It estimates that India's fleet will reach approximately 500-550 by the end of 2010. The major airlines also need an infusion of capital to finance their growth. NACIL plans to offer 10-20 percent stakes to the public to raise cash. There has been talk since 2006 of Kingfisher (which is part of the UB group) floating an IPO. Air Deccan has found a different route—it sold its options on new aircraft orders to raise US\$100 million [9]. The Indian government is considering raising the foreign direct investment (FDI) ceiling in civil aviation, which is currently at 49%. According to Civil Aviation Minister Praful Patel, India's civil aviation industry will attract investments worth \$150 billion in the next 10 years [8].

The other major factors limiting growth are infrastructure related. The 24 international and customs airports put together account for 94% of traffic, and the balance is spread over 36 smaller airports. Congestion at the airports leads to aircraft circling sometimes for about an hour before they can land. New Delhi airport which is designed to handle about 7 million passengers per year is already handling twice that many. Mumbai and New Delhi airports are being expanded, while Bangalore and Hyderabad will get new airports in 2008. The next 3-5 years will be an exciting and challenging time for airlines in India. It will be quite an achievement if some of them turn a profit in that period.

References are available upon request from the first author.