

## “India is virtually a 100% low fares market” : CAPA India



The structure of India's airline market is expected to change significantly in the coming months as carriers revisit their business models in order to restore industry viability. Nearly two thirds of the seats flying on domestic routes are on LCCs, one of the highest proportions in the world.

In this highly competitive system, the six scheduled airlines have largely converged in terms of pricing and product. But given their significantly different cost structures, this situation is unsustainable for some, while presenting opportunities for others. Over time, the competing airlines will inevitably attempt to carve out more clearly differentiated market propositions, ranging from ultra-low cost to hybrid and premium full service.

While India's low cost carriers (LCCs) have a domestic market share of 63%, passengers flying on full service airlines (Air India and Jet Airways) pay close to LCC fares in economy class. **As a result India is virtually a 100% low fares market.** As the operating environment makes it very difficult to be genuinely low cost, this poses a significant challenge to industry viability.

In 1Q14 the average fares for LCCs IndiGo and GoAir were in the range of INR5000-5200, with SpiceJet close to INR5000. Jet Airways' average fare was INR5632, but this includes the contribution of the premium cabin, suggesting that its average economy class fare was closer to that of the LCCs. GoAir in fact had some of the highest fares in the market in 1Q14, while the regulator also identified a number of routes where FSC fares were below LCCs. The margin between FSC internet-only and LCC fares has narrowed significantly, but in the last 12-18 months even the more flexible GDS fares in higher brackets are only marginally higher. Overall, there is very little difference between LCC and FSC economy class fares.

In the Indian market LCCs and FSCs both operate from the same airports with new aircraft, offering high frequencies on key markets. LCC reliability, on-time performance, consistency, ground product and cabin crew service standards, particularly on IndiGo, are comparable with or even better than FSCs. Baggage allowance on discount fares is the same on all carriers. Thus, from the Indian passenger's perspective there is little to distinguish between an LCC and an FSC in economy class other than the fact that the latter offers a complimentary onboard meal, but this too is being rationalised. And as a larger proportion of seats are being sold in lower fare brackets, even the accumulation of frequent flyer points has diminished on FSCs.

Air India and Jet Airways continue to offer a premium cabin but the business case for such an offering is limited to certain key routes, such as the Delhi-Mumbai-Bangalore corridors and that too primarily during peak hours. In light of the weak economic conditions, which are likely to continue through 2014, a negative impact on business class traffic is inevitable in the short term. Currently business class load factors average around 50%.

As the economy strengthens in due course, there will be absolute growth in demand for full service operations but this is likely to represent a declining share of the total market, especially as LCCs offer a high quality product.

FSCs are capturing some of their traffic because they are pricing below cost, but this is not sustainable. As and when FSCs increase their fares to reflect their cost base and charge a premium above LCCs, which at some point will become necessary, passengers will be then be increasingly shifting to low cost.

LCCs will also continue to grow their share in part because most of the fleet expansion is occurring in this segment. In the second half of FY14 LCCs are expected to induct an additional 20 aircraft on domestic routes, whereas little or no additional fleet deployment is likely by Air India on domestic sectors.

## Scheduled Deliveries to Indian LCCs and FSCs till 2020

New aircraft scheduled for induction by Jet Airways are mostly to be used for replacement, however Jet's current modest expansion strategy could change following the formalisation of the partnership with Etihad.

Furthermore, the convergence of LCC and FSC products in India has resulted in a growing acceptance of low cost carriers, even among corporate travellers. Mumbai, the largest corporate market, was until recently an exception to this as Jet Airways had a very strong and long-established position at this slot-constrained airport.

Jet Airways and Jet Konnect continue to have the largest share of capacity at Mumbai (30.4% compared with their all-India share of 23.9%), but during the last 12 months IndiGo has overtaken Jet Airways as the largest single domestic carrier.

The rise of LCCs at Mumbai was facilitated by Kingfisher's exit which released some slots. Capacity will be further increased with the opening of the new Terminal 2. The congested Bangalore airport has improved with the completion of the extension to Terminal 1, and new, modern terminals opened at Chennai and Kolkata earlier in 2013. LCCs are best-positioned to utilise this expanded airport capacity particularly on intra-metro routes.

## FSCs must restructure !

As long as Air India and Jet Airways continue to operate with a full service cost structure but offer LCC fares, their domestic operations will continue to lose money. Comparing the two listed carriers in 1Q14, SpiceJet's CASK was INR3.62 (the other LCCs are estimated to be in the range of INR3.6-3.7) while Jet's was INR5.44. By September 2013, costs have increased to INR4.30 and INR6.50 respectively, and perhaps higher, as a result of the impact of the depreciation of the Rupee and higher fuel prices.

The market is characterised by a situation in which FSCs, which have a cost structure that is around 50% higher than LCCs, have chosen to compete by matching fares rather than reducing costs. And their load factors remain below those of LCCs. Although the impact of lower loads in business class and on regional aircraft may account for some of this, the differential is significant.

A majority of Air India's active domestic fleet consists of A319s. The single class configured versions have just 144 seats compared with the 180-189 seats on the narrow bodies operated by the LCCs. If Air India was operating larger aircraft it is possible that given its current commercial structure its load factors would be lower still.

## India's full service carriers lack clear strategy

Neither Air India nor Jet Airways have a clear domestic strategy and both of them have been reluctant to decisively move away from their legacy model. Jet confused the market with a half-hearted approach to low cost in which the carrier operated two LCC brands, with an unclear and changing passenger proposition.

Air India has hesitated to introduce a domestic low cost subsidiary for fear of cannibalising itself and owing to concerns about being able to achieve the labour productivity levels required of an LCC. However, many legacy carriers particularly in high growth markets like Asia have increasingly come to the conclusion that it is better to risk self-cannibalisation than allow your competitor to do it to you!

### Air India continues to struggle

Air India has also struggled to achieve a competitive cost base because 60% of its active domestic fleet consists of A319s with a higher unit cost than the larger A320 and 737 aircraft operated by its competitors. Nevertheless Air India continues to be able to survive because it faces less commercial accountability. Being under less pressure to change, status quo is the most likely outcome, which ultimately will hurt the carrier as it fails to keep pace with the changing market realities.

Kingfisher failed in part because it was forced to compete with LCCs while saddled with a high cost structure. With LCCs continuing to expand aggressively and grow their market share, they will increasingly set the pricing levels in the market - they have the scale, network and product to do so. Air India and Jet will be forced to follow their lead, and given their current cost structures will continue to bleed.

## FSCs must hybridise !

Hybridisation in the Indian context will therefore necessitate that Air India and Jet increasingly adopt elements of a low cost airline business model in order to establish a more competitive cost structure, while striving to achieve a yield differential in order to drive profitability.

Higher fares relative to LCCs would be achieved by offering services such as premium cabins, through check-in, interline capability, code sharing and GDS distribution which are important for both the corporate and offshore markets and which have the potential to generate a yield premium. But in order to be profitable they must reduce their cost base to be closer to the LCCs.

The time may now be right for Indian FSCs to introduce more modest and smaller business class cabins, or even premium economy, rather than the relatively luxurious products currently on offer on short domestic sectors. Changes to the product will not be easy and will need to be supported by significant investment in IT, branding

and repositioning, as well as possibly new management that is better attuned to a leaner, more efficient business model.

That is not as easy as it sounds. Changing the business model without a change in culture cannot deliver the results required. And cultural change is a huge challenge, where the new approach must first be embraced by the promoter.

## Jet Airways becoming a premium carrier?

Jet's domestic cost structure is unsustainable given the yield environment in the market. As noted, the most obvious response to this would be to rationalise its cost structure while continuing to offer a product that justifies a fare premium.

This might involve a distribution strategy for example where the carrier may look at a two-tier approach, encouraging direct online sales where possible, but making a certain proportion of higher yielding inventory available on GDS. But Jet is reportedly also evaluating a contrary strategy amongst several options under consideration.

This would involve differentiating itself by moving in the opposite direction - towards a premium full service position, offering a product more closely aligned with its

international operations. Jet Airways has become more focused on overseas expansion opportunities in light of the partnership with Etihad and there may be a subtle shift towards looking at how domestic operations can support international services, rather than focusing on their standalone viability.

There may be a segment of the market that would be willing to pay the fares required to sustain such an operation but the key question is how large is it? Analysis of the market in recent times would suggest that there is unlikely to be sufficient demand for a two class configuration across the entire network. Jet Airways' history is as a full service carrier. The challenge is to avoid reverting to this simply because this is what it knows best and because it is easier than restructuring. The market has changed in the twenty years since Jet Airways first launched and the airline must be certain that a business case exists should it go down this path.

There is also the risk of passengers becoming confused as a result of changes to the product, unless they are well-communicated, as Kingfisher found with the frequent revisions to its business model from hybrid to premium to low cost and back to premium. Jet Airways has already experienced this when it operated two subsidiary brands and pursued a

## Tata-SIA domestic full service strategy for further review

In a surprise announcement in September 2013, one of India's leading business conglomerates the Tata Group, announced that it was establishing a 51:49 JV with Singapore Airlines to operate a full-service airline based in India. The initial plan is to operate domestic routes as is required of a start-up carrier in India for its first five years, but longer term ambitions are to launch international services which could become the primary focus.

This could in fact happen much sooner than expected with the Minister of Civil Aviation recently indicating that the requirement for domestic airlines to have completed five years of operations and have a fleet size of at least 20 aircraft may be lifted in the not too distant future.

Tata-SIA represents a potentially significant challenge to Air India and Jet Airways on domestic routes because as a greenfield operation as it has the ability to establish a business model at the drawing board stage which offers passengers the most valued elements of a full service product but incorporates low cost practices. The objective being to ensure that the cost differential between itself and the LCCs is not more than the yield premium which it attracts.

Given the domestic market dynamics it appears unrealistic that Tata-SIA could pursue a Kingfisher-style premium model. Instead it is more likely to adopt a high quality, two class product which is efficient and appropriate for the relatively short domestic sectors.

As a new entrant, Tata-SIA can engineer a lower cost base than Air India and Jet Airways without the challenges of transformation that a legacy carrier has to face. But in a market which is extremely price

sensitive, and in which LCCs offer a relatively high quality product and experience, Tata-SIA will need to carefully consider its market proposition on domestic routes.

The Tata Group will be a partner in both full service Tata-SIA and low cost AirAsia India. They have stated that the two carriers will service different market segments and will not compete with each other. However, on domestic routes it may be difficult to avoid. Tata-SIA may eventually offer a hybrid rather than a premium full service product to reflect market realities, which would result in less differentiation with AirAsia India. And with AirAsia expected to pursue aggressive growth, the two carriers are likely to come up against each other.

On international routes it will be easier to segment the market as a result of the greater differentiation in their products on longer sectors, as well as in terms of destinations. AirAsia is likely to focus on leisure, VFR and labour routes while Tata-SIA will address larger corporate markets. It could be possible that they segment individual destinations, for example Tata-SIA might operate to London Heathrow while AirAsia operates to London Gatwick.

'swing capacity' strategy, regularly reconfiguring aircraft and transferring routes between full service and low cost in response to market conditions. The strong likelihood is that a premium domestic product would incur regular losses that would need to be funded.

## GoAir may become India's first hybrid carrier

GoAir is expected to make a determined push towards a deeper form of hybridisation which may include participation in an alliance, code sharing and the introduction of a separate premium economy or lite business class cabin. This is a more challenging strategy than unbundling, involving as it does fundamental changes to the business model and a repositioning of the airline's market proposition.

This would be a major step and if undertaken would need to be done on the basis of a clear understanding of the market potential for such a product. Adding such complexity to the business model would probably make most sense if it was in the context of an investment from a foreign airline that was interested in linking the carrier to its international operations.

LCCs are likely to find it easier to hybridise than FSCs because they have fewer legacy issues to deal with in order to change - it's always easier to go up the chain than down. And if they do it will place even greater pressure on FSCs to adapt sooner.

## An ultra-low cost carrier ?

If Jet, IndiGo and GoAir were all to pursue strategies which would see them move up the value chain in different ways, this may create an opportunity for an ultra-low cost carrier, such as AirAsia India, to occupy the space vacated.

The current operating environment is not conducive to an ultra-low cost business model but if and when fuel prices abate such an opportunity could emerge.

## Increased regional international operations

With the domestic market continuing to be very challenging, LCCs are expected to provide a serious thrust to growing their regional international operations. We expect Indian LCCs to offer a traditional low cost or hybrid product and will focus on routes up to four hours for the next 3-4 years. The performance on sectors above five hours has been below expectations as evidenced by IndiGo exiting Delhi/Mumbai-Singapore routes (although SpiceJet continues to operate Delhi-Guangzhou with a block time of 5h45min where it is the sole operator).

The four-hour range enables airlines to leverage their existing domestic fleet by operating overnight, thereby improving aircraft utilisation and maximising economic performance and commercial viability.

## International Routes operated by IndiGo and SpiceJet

The introduction of re-engined A320neo and 737 MAX aircraft from 2016 onwards could change the economics of longer regional international operations as a result of the improved performance over an extended range of over six hours. The A321neo can accommodate up to an additional 56 seats relative to the A320 in an all-economy configuration. The increased real estate on the aircraft could also permit increased legroom for the longer sectors.

A320neo and 737 MAX aircraft could improve the viability of services from Delhi and Mumbai to destinations such as Singapore, Jakarta, Hong Kong, Istanbul and Shanghai using narrow body equipment. And through partnerships with other carriers, 1-stop LCC services would be possible to destinations stretching from Europe to Australia.

AirAsia India is expected to expand aggressively on short haul international routes if the 5 year/20 aircraft rule is lifted, particularly from South Indian points such as Chennai and Cochin. With its huge network, AirAsia could offer one-stop services from India to multiple destinations across Asia via its hubs in Bangkok, Kuala Lumpur and Jakarta.

In fact Chennai, as the capital of Tamil Nadu with its vibrant and diversified economy, large diaspora across Southeast Asia and the Gulf, and favourable geographic location, has the potential to be a strong LCC hub connecting the Middle East, South Asia and ASEAN. In addition to addressing point-to-point markets, an LCC based in Chennai would for example also be able to offer one-stop service on routes such as Manila-Dubai or Jakarta-Riyadh.

## Conditions may support the launch of new long haul LCC based in India

If Jet Airways, which has the highest market share of international traffic to/from India, focuses on using Abu Dhabi as a hub for Westbound routes from India, this means that except for a few high traffic destinations it will serve most points on a one-stop basis. In addition, its product and pricing is likely to be aligned with its partner, Etihad. Tata-SIA will also be focused on delivering a high quality, full service product on long haul routes, with fares set accordingly.

This may create an opportunity for a new long haul LCC to operate competitive non-stop services to Europe, North Asia, Australia and other markets, and establish a long haul LCC hub in India leveraging its advantageous geographical location. AirAsia India could be a prime candidate to pursue this market segment subject to removal of the 5 year/20 aircraft rule.

## India's airlines : hybridisation is inevitable

India's domestic market is almost entirely a low fares market, with full service carriers pricing economy class at a level comparable with LCCs. This is a fundamentally unviable situation given the difference in their cost structures. And the gap in costs is only likely to increase over time as LCCs are scheduled to receive re-engined narrow body aircraft ahead of the FSCs, commencing from 2016. Meanwhile, the recent regulatory approval of unbundling and ancillary pricing will enable LCCs to become even more competitive on base fares. As a result a restructuring of full service business models is inevitable.



Jet Airways Airbus A330



Air India B787-8 Dreamliner



Airliners at Delhi airport on a hazy morning!

Hybridisation is inevitable. If Air India and Jet Airways want to participate in the larger and faster growing segment of the market they must achieve a lower cost base. It is no longer a question of deciding how or whether to establish a lower cost subsidiary. Instead the market has progressed so far that the core operations need to be hybridised to some extent.

Meanwhile, LCCs are also moving to offer more of the features of a full service carrier on a user-pays basis. For India's LCCs unbundling is a way of being able to offer additional but optional services. For the passenger this means greater choice and control of the travel experience, and for the airline it means additional revenue. In contrast the challenge for FSCs in hybridisation is that unbundling generally involves taking something away from passengers and offering it back to them for a fee.

As India's LCCs, and possibly even Jet Airways move up the value chain, and Tata-SIA introduces a full service product, this may recalibrate the market and create an opening for a classic domestic ultra low cost carrier. At present the operating environment is not conducive to support sufficient cost differentiation for such a model, however as when the costs abate the opportunity could arise.

A similar opportunity exists for a long haul low cost airline based in India given that all of India's network carriers will offer a full service product. Subject to the appropriate changes to the regulatory framework AirAsia India could be a prime candidate to occupy both of these spaces. IndiGo could also exploit this segment as it has options to convert some its narrow body orders to A330s.

Recent changes have the ability to transform India's position in global aviation if the market can give rise to globally competitive low cost and full service carriers that are able to leverage the country's advantageous geography.

But for this potential to be unleashed the government must provide a predictable policy and regulatory framework that allows for a level playing field. Only then will India receive the necessary capital inflows from serious operators that can deliver upon this opportunity.

## Airport operators need to factor changing business models

The possible changes in the airline market structure will have significant implications for airport operators and the scale and nature of infrastructure that is required. LCCs account for the majority of the domestic market, yet India has no low cost terminals let alone a low cost airport.

World class infrastructure is being developed at airports across the country, but in some cases it may be of a higher quality (and therefore cost) than the market requires. And the lifting of the 5 year/20 aircraft rule could transform the international market to/from India, leading to a higher than expected growth rate. There could be particularly rapid expansion on regional routes requiring international terminals to factor in the possibility of significant narrow body movements, rather than the long haul operations around which the recent modernisation programmes have been focused.

Airports may also need to consider what role they can play in encouraging and supporting the establishment of "low cost hubs" in India, both on regional and long haul routes, where the airport operator plays a more pro-active role in facilitating connections and transfers between airlines that may not interline in the traditional sense.

The Government of India has recently started the next round of privatisation with tender processes underway for six airports to be offered on a Public Private Partnership basis. A further nine airports will follow shortly, in addition to which the government has announced plans to fast track the development of at least 50 (and possibly up to 100) low cost airports.

Consortia bidding for these airports will need to have a clear understanding of the implications of these changing market dynamics on the capex requirements and the revenue potential of the projects on offer.

**CAPA India is the leading aviation advisory, research and knowledge practice in South Asia with a strong and established track record in accurately identifying key trends and developments in the Indian market.**