

AUGUST 2020

# AVIATION SECTOR:

# POST COVID ANALYSIS

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# WHAT IS IT ALL ABOUT?

*"You can't have a mid-life crisis in the airline industry because every day is a crisis"*

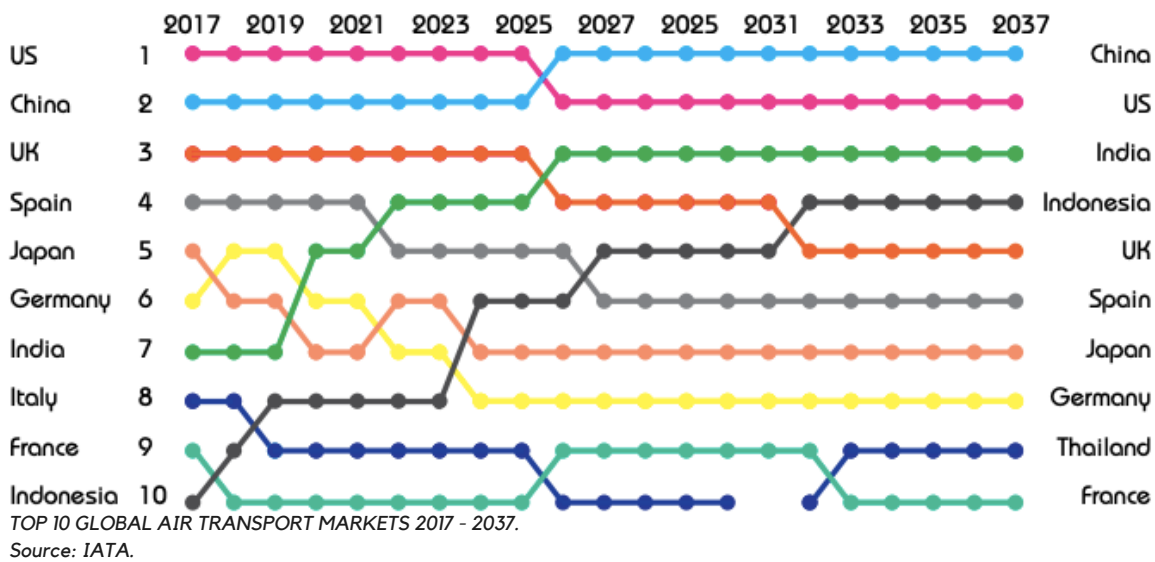
– Herb Kelleher, Former CEO, Southwest Airlines.

The 1950s – "The Era of Mass Air Travel" had begun. Naturally, the aviation industry cannot trace back to the Spanish Flu (1918 - 1920) because mass commercial air travel was a distant reality back then. Since the 1950s, the world has faced many such emergencies and crises but for the aviation industry, it's something that they haven't witnessed before! Hence, an industry that had already been in the doldrums for a long haul stands the risk of being paralyzed for the years to come.

An industry that is marred with high fixed costs and low operating margins, every minute is of high monetary value. Come the pandemic, the aviation industry had been asked to be grounded for months. Its impact is perhaps harsh than even those felt during events of 9/11 and the 2008 global financial crisis combined. The term marked by complete chaos and uncertainty about the future with commercial aircraft being used as freighters and operations team scrambling to repatriate passengers back home. While the industry is trying to get back onto its feet, will it be successful in biting the bullet or will it die a slow poisonous death?

# A BUMP IN THE TAKE-OFF!

"The aviation market in India is expected to grow by 5.3 times by 2033."



## GROWTH DRIVERS:



Increase in disposable income



Growth in passenger volume from the middle income segment

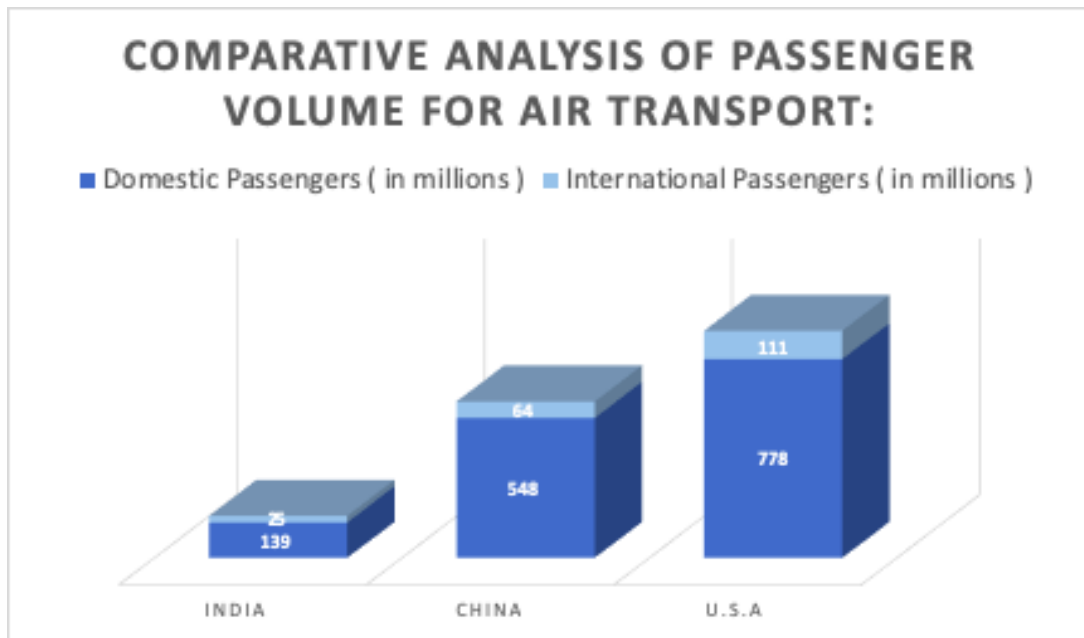


Improving Air infrastructure



Stronger economic growth

# A BUMP IN THE TAKE-OFF!

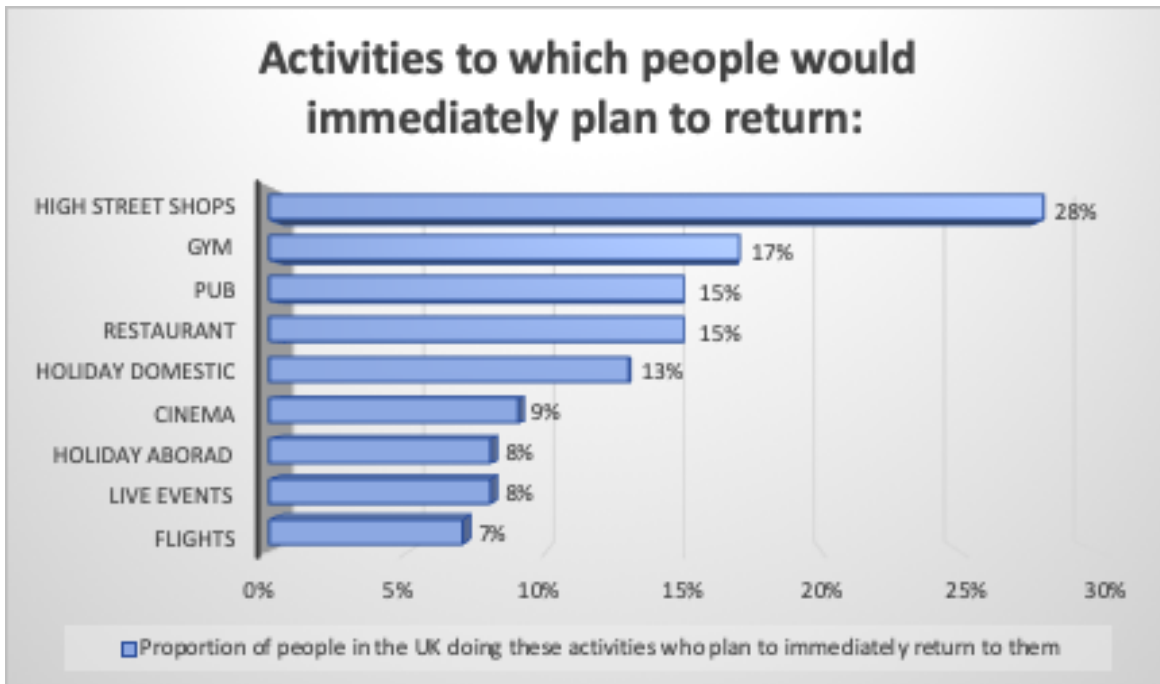


Source: Interglobe Aviation, Annual Report. Compiled by The Financial Pandora.

The growth potential that the Indian aviation industry possesses can be analysed from the graph above. The Indian aviation market is just 26.79% and 18.44% of that of China's and U.S.A's respectively. The pandemic might have spoiled the party to a great extent but the recovery is bound to happen. The important concern is the timeliness of the recovery.

When the aircrafts were completely grounded, the Indian aviation companies were losing around INR 75 - INR 90 Crores on a daily basis. For an industry that faces cut throat competition, this is a humungous strain onto the cash flows and puts a doubt on the going concern of any company simply because the industry in particular does not have the luxury of fat margins on the bottom line.

# OPINION MATTER:



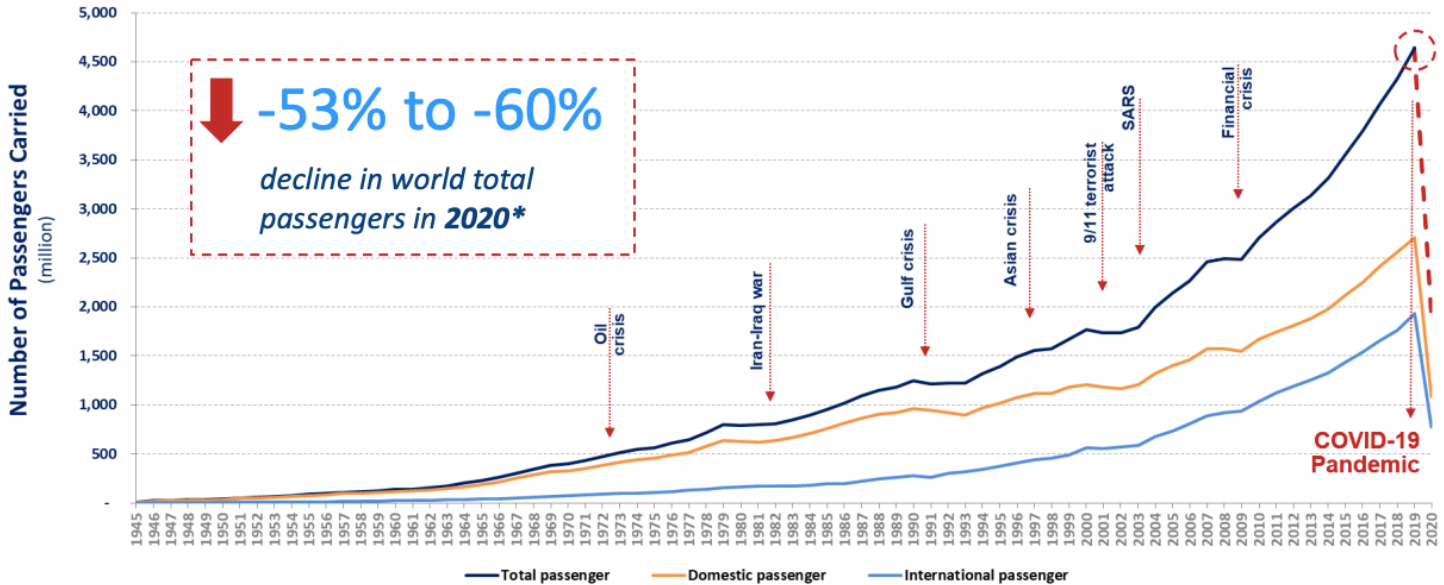
Source: PwC.

The above-mentioned graph clearly outlines the lack of interest that the people have shown in holidays (be it domestic or abroad) and in choosing flying as their preferred option for the same. The fear of contracting the virus is the biggest concern for people and this has prevented them from venturing out of their vicinities. Even for domestic travel, the preferred option for the people would be to use road transport as much as possible to avoid any possibility of bracing the virus.

The current economic scenario also adds to the grievance of the aviation industry. The airlines believe that the pandemic has brought the end of the business travels and they fear that it will never reach back to its pre-Covid levels. With leisure and business travel both looking bleak, it seems an uphill task to retrieve the demand back to the levels before the pandemic.

# THE IMPACT:

## World passenger traffic evolution 1945 – 2020\*



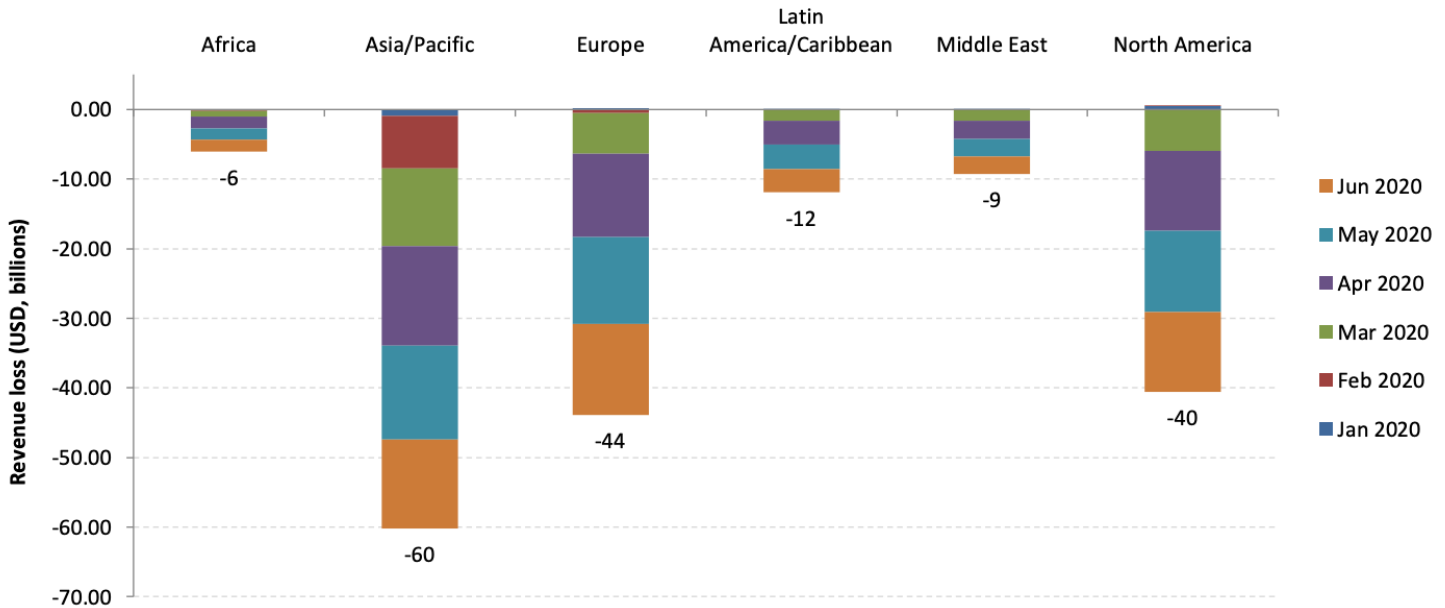
Source: ICAO; Coronavirus Economic Impact Report.

The world has witnessed multiple crisis but none of the magnitudes of the current one and the graph above is a testimonial for the same. A staggering drop of more than 50% could be witnessed in terms of passenger volumes for 2020 according to the estimates of the International Civil Aviation Organization (ICAO).

The only staggering difference between the previous crisis and the current ones is that this is the first time that the operations remained cancelled for a prolonged period of time. Consumer spending has witnessed a drastic dip and disposable incomes have taken a major hit as focus shifted on necessities from luxuries. The current volumes are solely driven by repatriation of passengers and not due to leisure or business travel.

# THE IMPACT:

"Approximately USD 170 billion passenger revenue loss from January 2020 to June 2020." - ICAO



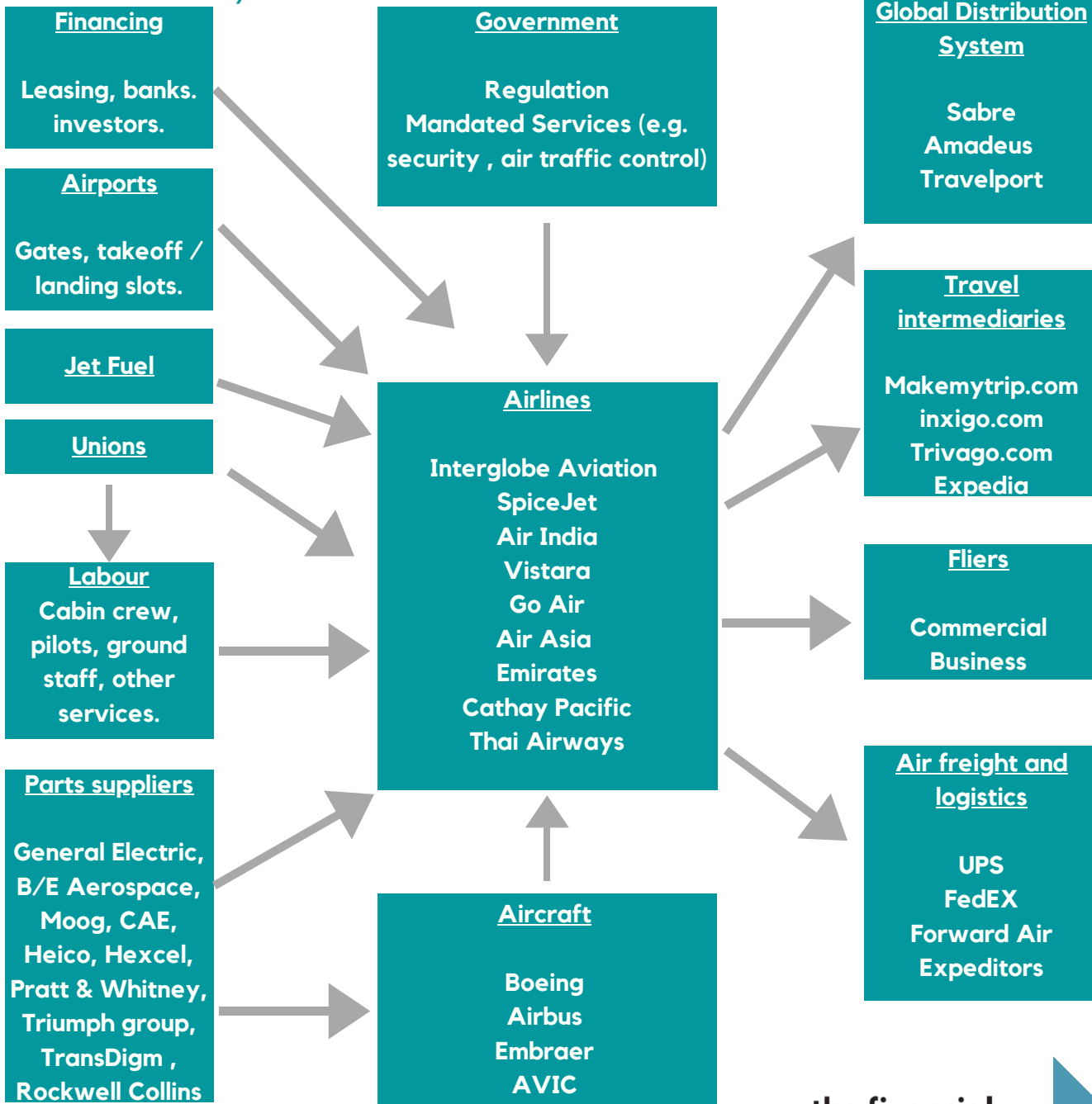
Source: ICAO; Coronavirus Economic Impact Report.

The financial strain on the aviation industry has been witnessed the most in the regions where the pandemic has hit the hardest. Asia - Pacific, European, and the North American region together accounted for 84.70% of the total loss for the first half of 2020.

The major cause of concern is the fattening of the losses as the pandemic has progressed. The quarter of April - June also saw the revival of the domestic aviation segment within the various countries but the unit economics do not support them. Before the pandemic itself, the airlines were functioning with a load factor of around 90% and were still making meagre profits. Now with the occupancy rates having no predictability, the airlines are making losses on a per-flight basis and trying hard to minimize the damage.

# VARIABLES WITHIN AN AIRLINE BUSINESS:

*"An airline company has to manage multiple controllable and non-controllable variables which in itself is a daunting task and hence the industry becomes a difficult nut to crack."*



Source: Credit Suisse; Compiled by The Financial Pandora.



# BREAK-DOWN OF FINANCIAL NUMBERS:

Sr No.	Particulars	Interglobe Aviation		SpiceJet	
		For the year ended 31 March 2019 (in million rupees)	% of Total Revenue	For the year ended 31 March 2019 (in million rupees)	% of Total Revenue
1	Revenue from Operations	₹ 2,84,967.72	95.56%	₹ 91,132.54	99.36%
2	Other Income	₹ 13,249.36	4.44%	₹ 582.90	0.64%
	<b>Total Income</b>	<b>₹ 2,98,217.08</b>	<b>100%</b>	<b>₹ 91,715.44</b>	<b>100.00%</b>
3	<b>Expenses</b>				
a	Aircraft Fuel Expenses	₹ 1,19,427.93	40.05%	₹ 34,452.52	37.56%
b	Aircraft and Engine Rentals	₹ 49,994.49	16.76%	₹ 12,967.16	14.14%
c	Employee benefits expense	₹ 31,377.91	10.52%	₹ 10,570.07	11.52%
d	Finance Costs	₹ 5,089.63	1.71%	₹ 1,312.84	1.43%
e	Depreciation and amortization expense	₹ 7,595.80	2.55%	₹ 2,562.25	2.79%
f	Foreign exchange loss	₹ 4,674.87	1.57%	-	-
4	<b>Other Expenses</b>				
a	Loading fees and en route charges	₹ 30,237.32	10.14%	₹ 7,520.54	8.20%
b	Aircraft repair and maintenance	₹ 21,801.27	7.31%	₹ 6,129.34	6.68%
c	Consumption of stores and spares and loose tools	₹ 3,326.95	1.12%	₹ 1,078.34	1.18%
d	Commission	₹ 4,961.16	1.66%	₹ 1,060.56	1.16%
g	Crew accommodation and transportation	₹ 3,851.05	1.29%	₹ 440.97	0.48%
h	Travelling and conveyance	₹ 1,288.68	0.43%	₹ 1,183.79	1.29%
i	Rent	₹ 1,163.03	0.39%	₹ 567.24	0.62%
j	Sales and Marketing Expenses	₹ 588.02	0.20%	₹ 1,013.85	1.11%
5	<b>Profit / (loss) before tax</b>	<b>₹ (1,490.47)</b>	<b>-0.50%</b>	<b>₹ (3,160.83)</b>	<b>-3.45%</b>
6	<b>Tax (Expense) / Income</b>	<b>₹ 3,051.82</b>	<b>1.02%</b>	<b>₹ (14.45)</b>	<b>-0.02%</b>
7	<b>Net Profit for the year</b>	<b>₹ 1,561.35</b>	<b>0.52%</b>	<b>₹ (3,175.28)</b>	<b>-3.46%</b>

Source: Annual Reports of Interglobe Aviation and SpiceJet, March 2019.

Note: Only the financial entries that are relevant have been extracted and represented in the table above.

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# THE ANALYSIS:

*"The volume within the aviation industry has increased threefold but the competitive nature of the business has kept the margins slim.*

The table in the previous section represents the financial numbers of Interglobe Aviation and SpiceJet for the financial year of 2018-2019.

The biggest problem for any aviation company is that the estimation of two its biggest cost drivers, i.e., fuel costs and lease costs are beyond their control.

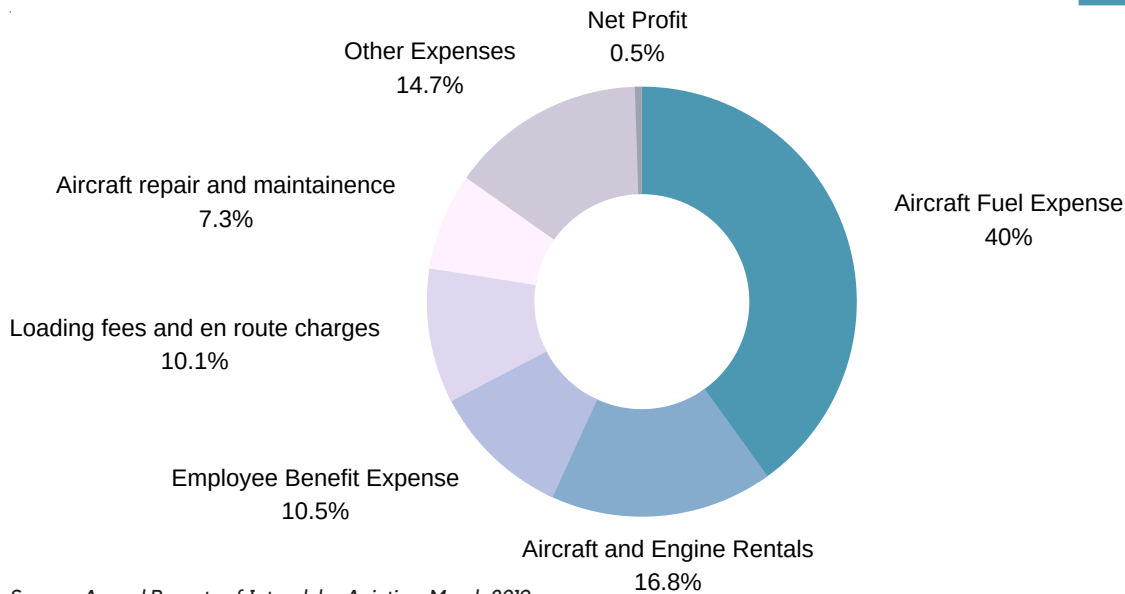
The fuel costs fluctuate in accordance with global oil prices. The airplanes are leased by the companies from the manufactures (e.g. Boeing, Airbus) and are subject to monthly compliance. These payments are subject to currency fluctuations and the companies tend to face foreign exchange risk on an annual basis.

Apart from the above-mentioned

cost drivers, the employee cost is another substantial add-ons to the costs. Pilots, cabin crew, ground staff, logistical staff, and back operational staff all of these need proper co-ordination for a successful take-off.

Lastly, the airplanes are complicated machines that require timely repairs and maintenance, the financial burden of which is nearly 6.5%-7.5% of the total revenues. Now even if a restaurant or a theatre does not function for a quarter, the costs involved in resuming operations will be very minimal. For aircrafts, it is a different story. Even if they were not used in operations, a dedicated team had to ensure timely checks for each aircraft.

# THE ANALYSIS:

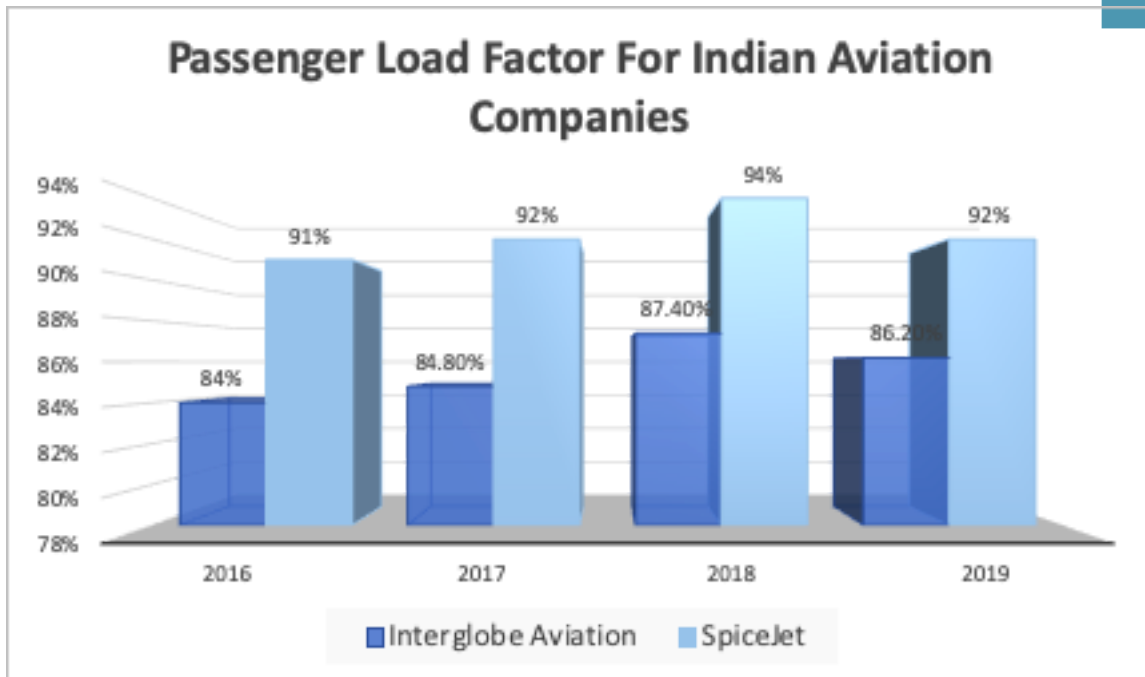


Source: Annual Reports of Interglobe Aviation March 2019.

The biggest constraint of being in a highly capital intensive industry with low moats coupled with slim margins of profits is that there is no room for error. The grounding of the airplanes was an unforced error, the financial burden of which is immense. For every INR 100 that an airline company earns, more than INR 35 is allocated to pay the fixed expense for the company irrespective of the fact that functioning takes place or not. These fixed expenses majorly include the employee benefit expense, aircraft repair and maintenance, and the lease rents.

These expenses are cooking up a big hole in the cash reserves that the companies have built after years of financial discipline. Interglobe Aviation posted a mammoth net loss of INR 2,844.3 Crores for the quarter ended June 30 against a net profit of INR 1,203.1 Crores in the corresponding quarter last year. On its balance sheet, it had freely available cash and cash equivalents of INR 7527.6 crores and INR 10,922.2 crores of restricted cash and cash equivalents, 15% of which was wiped off in a single quarter due to the government restriction and current market scenario.

# THE LOAD FACTOR:



Source: Annual Reports of Interglobe Aviation and SpiceJet.

The passenger load factor majorly indicates the utilization of its available capacity by the passengers of an airline company. Every airline has a fixed cost that is associated with each of its flyings. These costs majorly include employee expense, fuel costs, and operational overheads to name a few. A higher passenger load factor helps the airlines to distribute and bring the unit cost down and increase profitability. If the load factor is low for prolonged durations, the company's sustainability is put to doubt because the airline will be bleeding on a per-flight basis (akin to situation faced currently)

The airlines are in a similar problem currently. Even after maintaining the load factor at 86.2% and 92% for Indigo and SpiceJet respectively, both the companies posted a net loss for the financial year ending 2019. With the revenues dropping by more than 90% for both the airlines for Q1 FY 2020 - 2021, the unit economics of flying will be a difficult nut to crack for both these companies considering that the current scenario shows no sign of revival.

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# THE SUSTAINABILITY CRISIS:

*"SpiceJet's auditor has expressed doubt on the airline's ability to continue as a going concern as two successive annual losses have led to erosion of its net worth."*

*"The company has accumulated losses and its net worth has been fully eroded. The company has incurred a net loss during the current and previous year and, the company's current liabilities exceed its current assets as at the balance sheet date,"* SpiceJet's auditor S R Batliboi & Associates observed.

The aviation industry is actively taking rapid steps like negotiation with lessors, salary restructuring, deferment of payment to partners, and suppliers through mutual negotiations to minimize the damage as much as possible. India's leading aviation company, Interglobe Aviation (also the only cash-positive airline) announced laying off 10% of its workforce

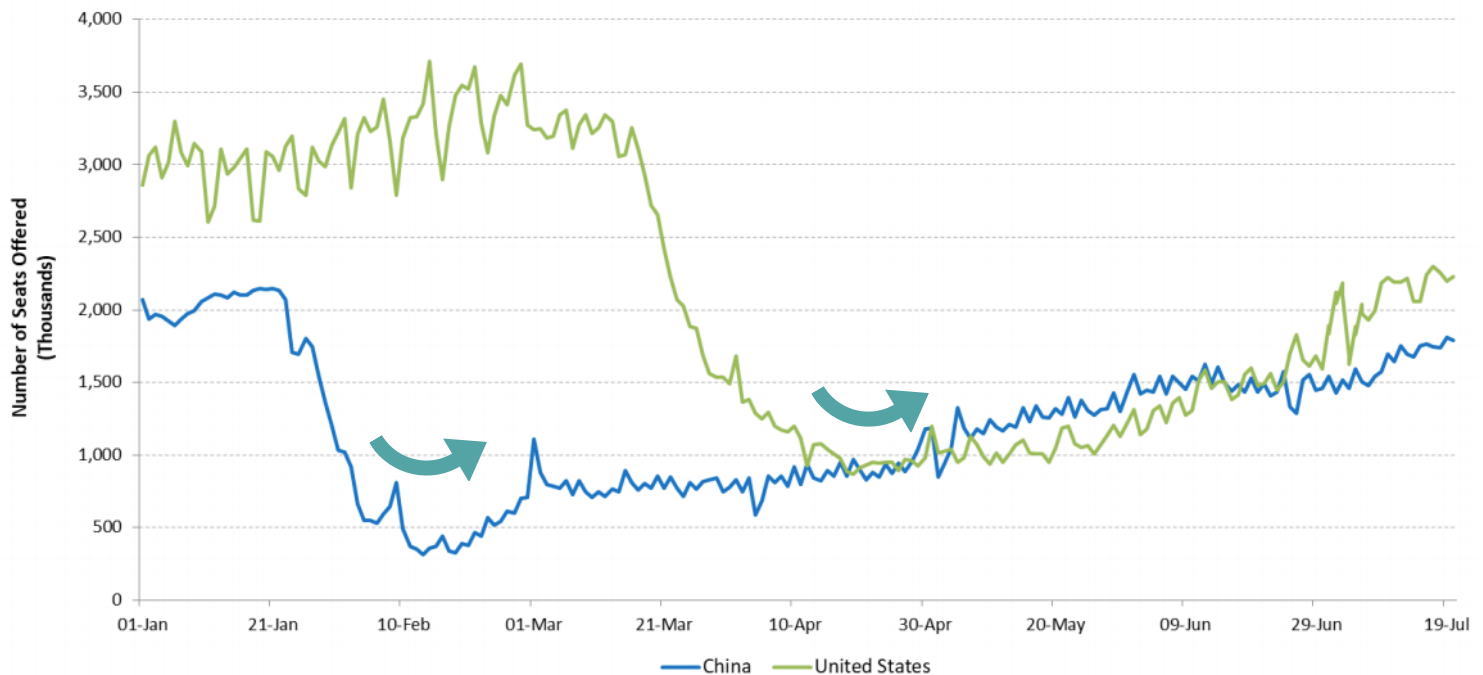
because of the crisis triggered by the current economic scenario (coupled with the pandemic).

Internationally, airline companies have already started filing for bankruptcy (Virgin Australia, Compass Airlines to name a few ). The dent in demand is reflected in lower passenger occupancy for the airlines. This simply raises questions on the sustainability of the industry. The resumption of the domestic market has brought some relief and this sector will be hoping for the chaos to settle soon so that they could unleash their true potential!

# SCOPE OF REVIVAL:

*"Domestic passenger traffic in China already bottomed out in mid - February, and capacity offered in June was recovered to around 76% of last year as per ICAO."*

## Capacity evolution of two largest domestic markets China and United States since January 2020

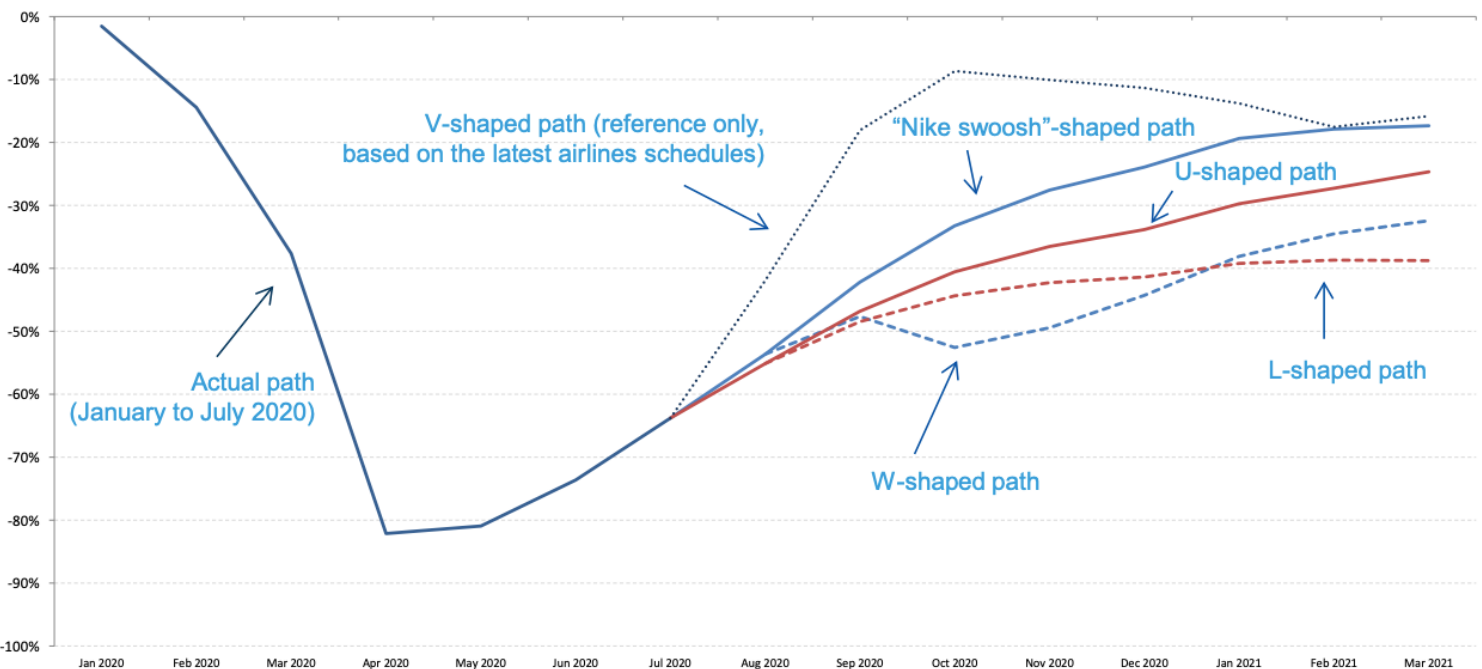


Source: ICAO, Economic Impact Report.

Signs of recovery have been witnessed in various regions of the world. The above graph shows the capacity utilization of the two biggest aviation markets. While China has managed to recover by 76%, the USA has also managed to recover roughly around 70% of the passenger occupancy as compared to last year. Hence, it is understood that once the situation within the countries starts to normalize and the restrictions are eased, the occupancy rates will also start to return but restoring back to the levels before the pandemic will surely take more time than it took in any of the past crisis. Hence the aviation industry might just have to weather the storm for some more time before it could grow exponentially.

# EXPECTATION OF A "SWOOSH SHAPED" RECOVERY:

## Scenarios for passenger seat capacity compared to Baseline (business as usual)



Source: ICAO, Economic Impact Report.

S&P expects a "swoosh shaped" recovery out of all the possible recovery options for the aviation sector. It means a long stay below the trend line of growth with a gradual climb upwards. It believes that air travel will eventually return when current health and safety concerns have been addressed. However, they also believe that the will be a much more protracted recovery than the rebounds observed after the 9/11 terror attack, the SARS pandemic of 2003, and the 2008/ 2009 global financial crisis.

# IoT IN AVIATION:

*"The global 5G in aviation is expected to touch USD 4.2 billion by the end of 2026, surging at a CAGR of 52.46%."*

Provides an end to end, safe and convenient experience for the passengers.

Automates the verification process by adding functionalities at the airport. Reduces multiple checks.

## BIOMETRICS

# THE INTERNET OF THINGS:

With the whole industry being disrupted due the current pandemic, it is imperative that the industry moves to a much more rigorous model backed by technology and contactless solutions until the situations starts to normalize around the globe.

## 5G

Monitoring and controlling real time data that are embedded with sensors  
.....  
Scope includes baggage handling, passenger flow, catering & resource management.

## BLOCKCHAIN TECHNOLOGY

Creation of a paperless and more reliable system.  
.....  
Scope could be expanded beyond e-ticketing and loyalty points.

## CLOUD TECHNOLOGY

Creation of a common platform for integration of data from various sources.

A centralized system will connect and align passengers with real time information across the system.



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# THE GOVERNMENT'S RESCUE PLAN:

*"The Indian carriers need as much as \$2.5 billion to keep flying according to the CAPA Centre for Aviation in Sydney."*

**1**

The Indian manufacture, repair and overhaul (MRO) service providers are exempted from customs and countervailing duties.

**2**

Airport Authority of India (AAI) plans to invest US\$ 3.58 billion in the next five years to expand facilities and infrastructure at airports.

**3**

As of January 2019, GOI has been working on a blueprint to promote domestic manufacturing of aircrafts and aircraft financing within the country.

**2**

Government has opened the airport sector to private participation and now six airports across major cities are being developed under PPP (public private partnership)

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## SUMMING IT UP:

The aviation sector has been one of the most impacted sectors due to the ongoing pandemic. Almost every leisure plan has been cancelled and everyone is restoring to small local holidays to refresh themselves. Business travel has been completely disrupted by technology and the majority of the deals and communications happen online through virtual meeting platforms. The capital intensive nature of the business coupled with weak demand has caused multiple worries for them and the sector is taking all the steps that are possible to minimize the damage.

We have already identified that the Indian aviation sector has immense potential to grow but the current situation has halted all of the projections. The government will be needed to be the initiator and provide the sector with a much-needed stimulus package. Historical crisis are a testimonial to the fact that it would not be easy for the sector to see a sudden spike in the growth of its volumes. The recovery will be slow and gradual. Weathering this storm will be a tough task for them as survival is getting tougher with each passing day.