Analysis of IndiGo's profitability in the draining Indian Civil Aviation Industry

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Abstract:

This study was evaluates the reasons for the continued profits of IndiGo Airlines, the country's largest low-cost carrier, in an otherwise highly volatile Indian Civil Aviation sector. IndiGo Airlines, announced a fivefold increase in net profit to Rs 787 crore for the FY 2012-13. Rivals Jet Airways and Spice Jet together made a loss of over Rs 671 crore in the same financial year. This was IndiGo's fifth straight year of profit, while the industry lost Rs 46,000 crore in the five-year period. IndiGo's profitability is a study in contrast compared to the draining Aviation industry.

The study also analyses the reasons for IndiGo being the first choice of carriers for many fliers. It became the largest airline in India in terms of market share by August 2012 (27%), in the process dethroning the full-service carrier Jet Airways, which had held that position for many years. The airline had reached the pole position in just six years after operations commenced.
This report has been compiled using the secondary data sourced from authentic sources like Centre for Asia Pacific Aviation ***(CAPA)****, an aviation consulting and research firm, The Economic Times, Martin Consulting, Pricewaterhouse Coopers (PWC)& KPMG.*

IndiGo's success can be attributed to deft operational performance and financial engineering in the form of sale-and-leaseback transactions. IndiGo has been the most active user of sale-and-leaseback financing among no frills carriers and makes most of its money through these transactions.

Keywords: *Civil Aviation Sector, Draining, Indigo, Operational, Profitability, Rivals*

1. Introduction

Civil Aviation in India turned 100 on Dec 10, 2010, an important historical milestone in the aviation history of the country. India's civil aviation sector has evolved over time. On February 18, 1911 India's first commercial airplane flew between Allahabad and Naini. In 1912, India's first commercial international flight operated by the erstwhile Imperial Airways took place and connected Delhi to Karachi and beyond. In 1932, J.R.D. Tata flew an air mail service airplane, after which Tata Airlines ventured into scheduled air transport services.

At the time of India's independence in 1947, nine air transport companies, carrying both air cargo and passengers, operated in the country. To further strengthen the national aviation sector, the Government of India and Air India - Tata Airlines was renamed Air India in 1946 – setup a joint sector company, Air India International Ltd. In order to address the deteriorating financial health of India's civil aviation sector, the Government of India passed the Air Corporations Act of 1953, which nationalized all carriers providing services within India's civil aviation industry.

Up until the late 1980s, India's civil aviation sector remained monopolized by India's government owned airlines. However in 1986, the Indian government once again granted permission to private sector companies to provide air taxi service. Additionally, India's Open Sky Policy of 1990 and the Air Corporations (Transfer of Undertakings and Repeal) Act of 1994 further freed up India's civil aviation industry and eradicated the government carrier monopoly. While these policy changes led to a dramatic increase in the number of private airline carriers; due to viability issues, by the end of the 20th century all private air carriers, except Jet Airlines and Air Sahara, exited the market.

In 2003 the introduction of a new type of airline service called low cost carriers - LCCs or no-frills air service - by Air Deccan, reinvigorated India‘s civil aviation sector. By bringing competition into the Jet Airlines-Air Sahara duopoly, Air Deccan brought a new competitive spirit to India‘s civil aviation. Furthermore, introduction of low cost airlines also changed the perception that air travel was reserved only for the elites. A host of LCCs entered the market like SpiceJet, IndiGo, GoAir, Air Costa and just recently Air Asia.

India is one of the fastest growing aviation markets in the world. According to the **Indian Aerospace Industry Analysis** report, in terms of passenger traffic, India is currently the 9th largest aviation market in the world. At present, Indian Aviation market is handling 121 million domestic and 41 million international passengers annually. By the year 2020, India is poised to become the 3rd largest aviation market in the world handling 336 million domestic and 85 million international passengers annually.

Despite the tremendous potential, Aviation has always been a thorny industry in India, one that is said to make millionaires out of billionaires; it is extremely difficult to stay afloat in an industry notoriously brutal owing to high taxes and costly airport charges. IndiGo is the only airline consistently making profits in an industry which is otherwise collectively bleeding.

IndiGo Airlines, the country's largest low-cost carrier, announced a fivefold increase in net profit to Rs 787 crore for FY 2012-13. Rivals Jet Airways and SpiceJet together made a loss of over Rs 671 crore in the same financial year. This was IndiGo's fifth straight year of profit, while the industry lost Rs 46,000 crore in the five-year period. Data compiled by the **Centre for Asia Pacific Aviation** shows IndiGo has made cumulative profit of Rs 2,200 crore in the last five years. In the period, Kingfisher Airlines went belly up. State-owned Air India, despite the infusion of fresh equity from the government and a slight improvement in performance, is still struggling.
What does IndiGo do differently than other carriers? What is the secret of IndiGo's continued profits? Why IndiGo is the preferred choice of carriers among travellers? This is the subject matter of the research analysis in this paper.

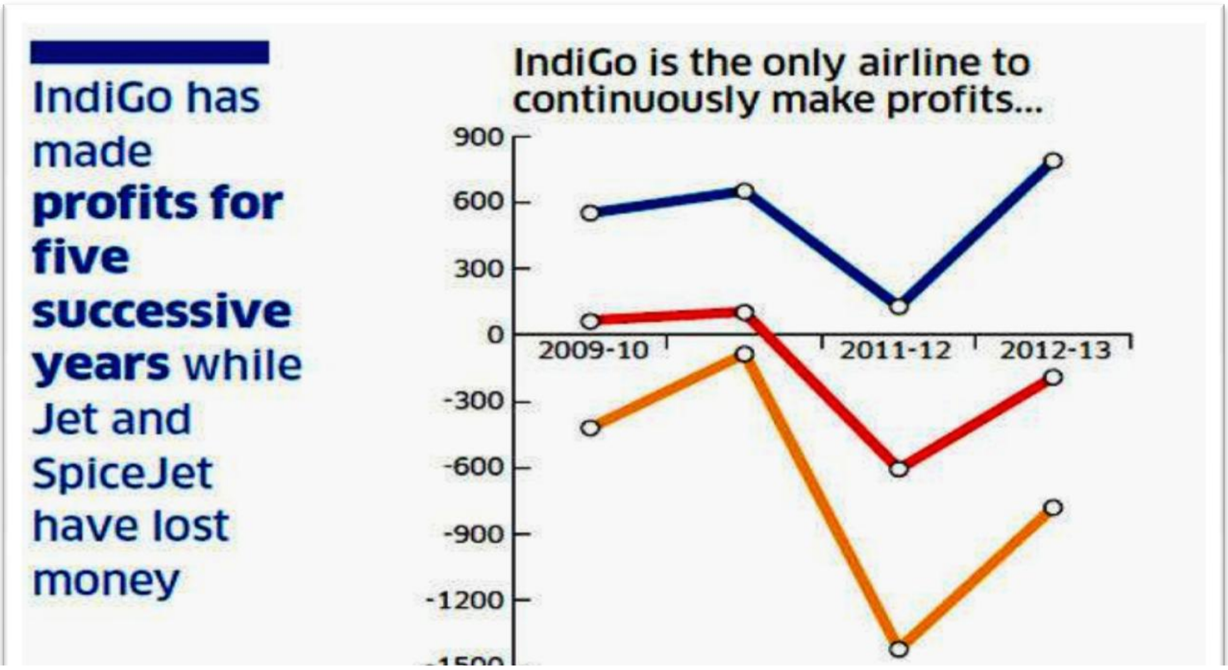
2. Research Design & Methodology

This research has been carried purely on secondary data. The subject matter of this study is to pertain to the profitability of IndiGo over the years. To analyse the reasons for continued profitability, to understand and to conclude with conviction, reference material and secondary data has been sourced from Centre for Asia Pacific Aviation **(CAPA)**, an aviation consulting and research firm, The Economic Times, Martin Consulting, Pricewaterhouse Coopers (PWC)& KPMG.

3. Profitability Analysis

Financial documents that InterGlobe, the parent company of IndiGo, filed with the Ministry of Company Affairs (MCA) shows that the seven-year old airline consistently reported profits from its third year of operations. The year to March 2013 happened to be the worst in recent years due to a steep increase in fuel prices and weakening rupee. During the year, Kingfisher Airlines shut shop and IndiGo's competitors made losses of more than $1 billion.

But IndiGo emerged unaffected from the wreckage. The latest numbers, revealed by IndiGo president Aditya Ghosh, burnished the airline's reputation as the lone Indian carrier to prosper in a troubled industry.



4. Sale & Leaseback Model

IndiGo makes most of its money from sale-and-leaseback transactions. These financial transactions have helped IndiGo record higher profits. In some cases, these transactions have turned losses into profits as it happened in fiscal 2011. Every sale and leaseback brings $4-5 million profit to IndiGo. And this acts as working capital.

Under this transaction, operators sell newly acquired aircraft to leasing companies and in a parallel transaction lease the same aircraft. The price at which the aircraft is sold to a leasing company is usually higher than the price paid to aircraft makers like Boeing or Airbus.

A leasing company agrees to such an arrangement, because it is provided with an asset and an established customer without having to buy a brand new aircraft, but still generates lease income from the airline.

As a financial model, sale and leaseback is popular among no-frills airlines for the flexibility it renders to keep balance sheets light. As aircraft are owned by a lessor, an airline can save on the depreciation provision, which increases profit and saves tax. IndiGo has been the most active user of sale-and-leaseback financing among no frills carriers. IndiGo completed **37 such transactions** in the past two years, followed by Virgin Australia with 35 transactions and Lion Air, India's SpiceJet and Norwegian with 28 each.

The transactions done by IndiGo adhere to Accounting Standards, and these accounting entries can be called as financial engineering to drive more value out of investment. The combination of operational performance and financial engineering has amplified IndiGo's valuation. From an initial investment of around Rs 100 crore as equity capital by promoters, the airline today can be valued at Rs 12,200 crore ($2 billion).

IndiGo makes $4-5 million from sale-and-leaseback of each aircraft. With an average lease term of five-and-a-half years, the airline is also benefitting from the frequent renewal of its fleet by avoiding costly maintenance repairs that creep in after six years.

Returning aircraft to leasing companies after five or six years helps. The maintenance cost will be lower for new aircraft. More important, the D-Check (the most comprehensive check for a plane) approaches around that time. It is very expensive. By returning planes before the D-Check is due, IndiGo makes big savings.

5. Humongous Order

Start-ups start small, right? In 2005, IndiGo tossed this rulebook out of the window a year before launch. The airline shopped for 100 Airbus aircraft, a massive order for any airline, leave alone a fledgling one.

Placing a huge order helps airlines to bring down the cost price sharply. GoAir CEO Giorgio De Roni says a huge order hands the buyer huge bargaining power. "It is true for not just airlines, but also people who buy tomatoes and potatoes," he says.

IndiGo grabbed a discount in excess of 40% of the list price by placing a huge order. The sticker price for an Airbus A320 — the only type of aircraft IndiGo uses — was $55 million in 2007 when the airline signed the agreement. IndiGo had just Rs 100 crore (around $20 million) of promoter money. Yet, it managed to strike a deal for 100 aircraft and by parting with a low down payment at that.

The rules governing aircraft financing stipulate a down payment of only 4% for an entity with credit rating of AAA- BBB-, and 7.5% for the ones with lowest rating (CCC- C), according to the PWC report. (The rest is paid to the aircraft maker from the proceeds of the sale to the leasing company).

This means IndiGo with a 40% discount on list price for Airbus 320 would have had to make a down payment of $151 million for placing an order for 100 aircraft. The company's balance sheet then shows it was well capitalized — Rs 337 crore ($82 million) — to meet the payment schedule.

IndiGo's first 100 aircraft order, proved game-changing both strategically and financially.

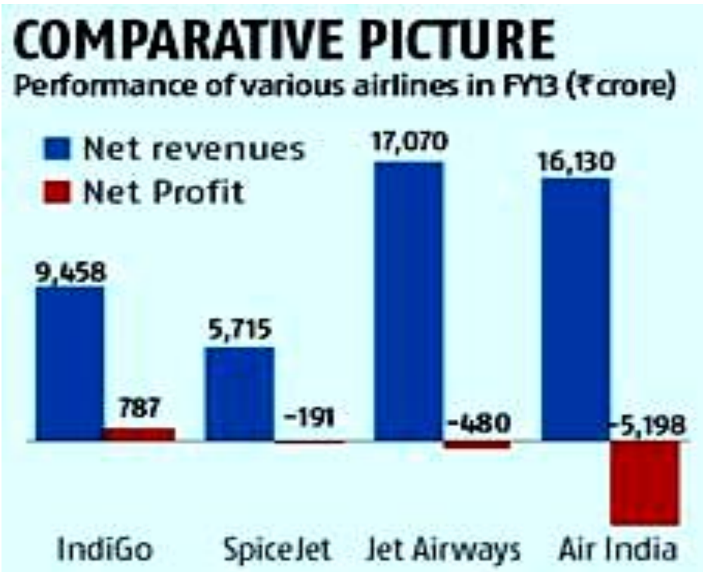
6. Deft Planning

On time Performance & Operational efficiency are the hallmark of IndiGo's operations. They followed a contrarian strategy last year amidst the slowdown and increased capacity and introduced new flights in order to get more passengers. The airline increased its capacity by over 39 per cent, even while the total industry capacity fell by 4 per cent. On top of that, IndiGo did some deft route planning that helped it gain market share and also contain costs. To explain in simple terms, Indigo has a fleet of 74 aircraft, yet it flies to only 29 domestic and four international destinations. In contrast, SpiceJet has 57 planes but it flies to 45 domestic and 10 international destinations.

IndiGo's strategy is to provide more capacity on select routes, rather than spread itself thinly over several. As each destination requires new investments (rentals, staff, ground-handling, equipment et cetera), this helps contain costs. It is better to have six flights from one existing destination than one flight each from six new destinations.

It also helps to capture the local market better. For instance, IndiGo has connecting flights to four destinations from Ranchi: Delhi, Patna, Mumbai and Bangalore. It now wants to add Kolkata and Raipur to the list. The strategy ensures that a traveller from Ranchi will not have to look at a non-IndiGo flight to go to any of these destinations. So he becomes a loyal customer and IndiGo gets a larger share of the Ranchi market and adds new customers. Cost-consciousness is reflected in the fact that it will not go to a new destination until it can fly from there to at least four different cities and amortise costs. IndiGo carried 27 per cent more passengers in the domestic skies last year, while the industry carried 5 per cent less, and added only one new destination in the whole year but flew more flights from existing cities.

The strategy has worked so far. IndiGo was able to increase the passenger load factor by six percentage points, and increase its domestic market share of the domestic skies from 22 per cent in 2012 March to 28 per cent in 2013.



7. Maintenance & Spares

The other key cost is maintenance and spares which constitute about 10 per cent of the operational costs. The strategy is to ensure that the aircraft don't stay grounded for too long because they make money only when they are in air. That is why it has signed up "power by hour" agreements with vendors under which it pays for every hour the aircraft flies; in return, the vendors provide full spares and replacements whenever they are required. The strategy helps in two ways. One, IndiGo doesn't have to maintain a large inventory of spares or engines. Two, its aircraft are not grounded because some spare parts are not available - that is something the vendors have to worry about. That is reflected in the fact that its technical dispatch reliability of 99.4 per cent is amongst the best in the world.

Even its C-checks, which an aircraft has to go through regularly, are planned with cost in mind. IndiGo gets these checks done in Sri Lanka, unlike its competitors who send their aircraft to as far as Dubai, Hong Kong, Singapore and Kuala Lumpur. "The advantage is that you burn less fuel to reach Sir Lanka and, since all your planes go to one place, you get a better price," says an industry insider.

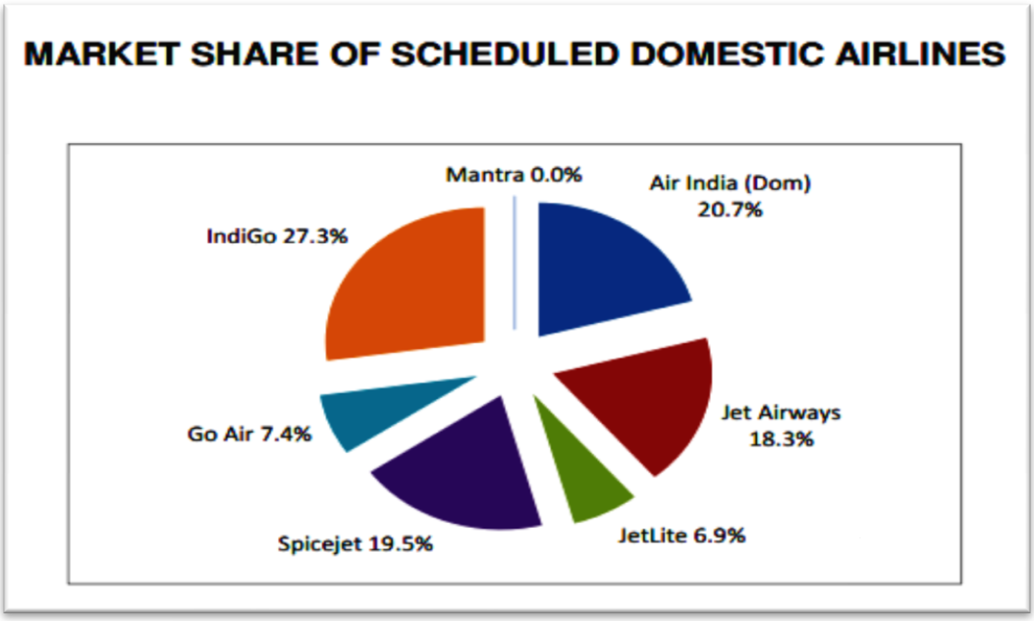
There are other aspects too of the cost-control exercise. For instance, IndiGo's employee-aircraft ratio has improved from around 120 two years ago to 100-102 now. In striking contrast, Jet Airways has a ratio of 130, while Air India's ratio is 221. IndiGo closely monitors turnaround time and fixes tough targets: currently it gets an aircraft ready for its next flight in 31 minutes compared to 35 minutes a few years ago. This has helped the airline achieve its target of keeping the plane airborne for 12 hours a day, despite the fact that it has been getting new aircraft on a regular basis.

That apart, its fleet consists of one kind of aircraft: the Airbus A-320. As a result, it is required to deal with one set of pilots, spares and engines. This simplifies the process of running the airline and also keeps costs on a tight leash. This is in contrast to a rival like SpiceJet which has two sets of aircraft. IndiGo has shied away from any loyalty scheme for passengers or the temptation to join a global alliance which only adds costs.

8. IndiGo – The preferred carrier

IndiGo became the largest airline in India in terms of market share by August 2012 **(27%)**, in the process dethroning the full-service carrier Jet Airways, which had held that position for many years. The airline had reached the pole position in just six years after operations commenced and it has held that position ever since.

The figure below illustrates the market share of all airlines for the year ended 2013. IndiGo is the clear market leader with 27.3% market share. Its market share is even higher than the market shares of GoAir and SpiceJet put together.



9. Conclusion

IndiGo is the clear market leader with 27.3% market share. Its market share is even higher than the market shares of GoAir and SpiceJet put together. Still it keeps on going ahead. One of the distinct features of IndiGo's operations is the "RAMP" (Escalator type step-ladder) which none of the other carriers have. It makes it very convenient for wheel-chair passengers to board the aircraft. It displays a mark of respect and a dignified approach towards the physically challenged passengers. IndiGo has taken a Patent for this unique "RAMP".

Financial Engineering, Start-up strategy & Operational excellence has made IndiGo what it is today, an admirable jewel in the Indian Civil Aviation Industry.

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