Consolidation in the Indian Aviation Industry
Case Study of Jet's Acquisition of Air Sahara

Hitesh Taunk
Prashant Kulkarni

Hitesh Taunk is Research Analyst in a leading Financial Research firm based in Bangalore.
Prashant Kulkarni, is Asst. Professor, Finance and Economics, Indian Business Academy, Bangalore

Abstract

Jet Airways' (Jet) announcement of its acquisition of Air Sahara in April 2007 signaled the end of the saga that had stretched for more than a year ever since Jet made its first offer in January 2006. This move sets the stage for the further consolidation in airline industry in India. Ever since open sky policy came into effect in 1993, the industry has seen a number of entries and exits. Long dominated by government sector monopoly, the industry is now in the phase of consolidation. Jet's acquisition of Air Sahara is one such example of this trend. The case chronicles the acquisition process and the in the process examines the changing structure of the industry, financial implications and how mergers and acquisitions will impact the industry and consumers

Introduction

During the century since Wright brothers invented the aircraft, the airline industry witnessed a sea change from two wheeler bi-planes to the Boeing 747's. Air travel which has become increasingly popular also has seen large number of players in the market. Technology too made a significant contribution to the airline industry. The industry further aided the growth of ancillary services like travel agents, courier services, cargo handling, clearing & forwarding agents etc

The first airlines in India were operated by the Tatas that took off from Karachi to Mumbai in 1931. By the early 1950s the number of operators had increased to nine. The Air Corporations Act 1953 led to the nationalization of the airlines industry. Under this Act, the two air corporations, viz. Indian Airlines Corporation and Air India International, were established and the assets of all the then existing airline companies (nine) were transferred to the two new Corporations. The operation of scheduled air transport services became monopoly of these two Corporations with the Act prohibiting any person other than the Corporations or their associates to operate any scheduled air transport services from, to, or across India.

However, the liberalization and deregulation policies adopted by the government in the early 1990s led to the repeal of this Act in 1994 and opened up the Indian skies to private operators. Air transport in India now became open to any carrier which fulfilled the statutory requirements for operation of scheduled services. In 2006 the government owned Airports Authority of India (AAI) operated 125 airports and civil enclaves out of a total of 449 airports and airstrips found in India. Indian airports handled 46.4 million domestic, 21.5 million international passengers and 1.37 million tons of cargo in 2005.

Besides, the number of players in the aviation industry has continued to show an increase. The entry of low cost players like Air Deccan contributed to a dramatic shift in the aviation sector. However, it was not smooth path for many of the firms in the market. Consolidation seemed inevitable. Therefore when Jet Airways (Jet) announced its decision to back out of its plan to acquire Air Sahara in January 2006, not many were surprised. Ever since Jet announced that it was acquiring Air Sahara, its competitor, there had been considerable speculation about Jet's game plan. Some hailed the acquisition announcement as a sign of consolidation in the airline industry. Some even went to suggest the deal was overpriced. There was interest and skepticism alike among the industry observers over the direction of the deal.

Jet-Airways

Jet Airways, founded by Naresh Goyal was incorporated as a private company in 1992 and commenced its operations as an air taxi operator in 1993 with a fleet of 4 leased Boeing 737 aircrafts. Kuwait Airways and Gulf Air were the early investors with nearly 40% stake. Jet became a public limited company in December 1994 and got the scheduled airline status a month later. In 1997 Naresh Goyal bought out the foreign investors following government policy change which disallowed foreign holdings in domestic airliners. In 2005, it became the first Indian airliner to become a publicly trade company when it raised more than $ 400 million through its Initial Public Offer (IPO).

Since inception it had flown over 53.4 million passengers until the end of May 2005. Operating over 300 flights daily it touched nearly 50 destinations including Colombo and Kathmandu to which it started operating in 2005. Moreover the company with nearly 50 aircrafts (24 owned, 29 leased) and more than third of the share in domestic aviation market was worth more than Rs. 4500 crore by the end of 2005. Though it had services to more than 40 destinations, Mumbai was its hub with almost a quarter of more than 500 flights it operated, originating from Mumbai.

The entry and subsequent expansion of low cost aircraft carriers like Kingfisher and Air Deccan saw an erosion of Jet's share of the market from nearly 50% to around 35% just before the announcement of the *acquisition*. The profits fell by 13% for the year ending December 31, 2005. Jet attributed the fall in the market share to the intense competition and the pilot shortage. The latter had caused Jet to cancel nearly 100 flights in the winter season of 2005.

Air Sahara

Sahara Airlines, a part of the Sahara India Pariwar Group, too took advantage of the open skies policy being pursued by the Government of India and was incorporated as a non-public listed company in 1991. The company which began operation in December 1993 was renamed Air Sahara in October 2000. The parent Sahara India Pariwar established in 1978 was engaged in a host of activities including para banking, media and entertainment, real estate, information technology etc. with a total turnover in excess of Rs. 12 billion by late 2005.

On November 16, 2005, based on code share agreement between Air Sahara and American Airlines, Air Sahara became the first private Indian airline to offer direct flights to the US Air Sahara launched a direct flight between Delhi to Chicago. By early 2006 it connected 24 domestic and 4 international destinations and operated more than 130 flights with nearly 14,000 seats on a daily basis. Employing more than 4,500 people, Air Sahara was the only private domestic operator that had its own aircraft maintenance capability. It had its won wheels maintenance shop, brake assembly shop, battery charging shop, avionics shop, and seat repair shop. Besides Air Sahara had access to nearly 17% of the night parking slots available at the Indian airports. To Sahara this was seen as an advantage owing to shortage of parking space at the airports and the hangars.

The Deal

Speculations of Air Sahara selling itself off or at least entering into a strategic alliance surfaced in September 2005 following the release of Ernst and Young report valuing Air Sahara. The report valued Air Sahara at Rs. 700 million. Kingfisher a small airliner promoted by Vijay Mallya, a liquor baron, and Spice Jet were seen as frontrunners to acquire Air Sahara. Kingfisher had made an offer which was a combination of cash and equity. But later they withdrew from the race on the grounds of high price. Jet made an all cash offer. With Kingfisher opting out of the bid later, Jet emerged as a sole player. On January 18, 2006, jet announced that it was taking over Air Sahara for nearly $500 million. Subject to regulatory approvals from the government, Jet Airways was to acquire 100% stake in Air Sahara for $500 million (Rs. 2300 crore approx.) in an all-cash deal. The deal excluded liabilities of Air Sahara and its right to sponsor the Indian cricket team for the next four years for Rs. 314 cr. However the deal did raise a few questions among experts and competitors alike. The reaction of the competitors was swift and critical, some questioning the price and the availability of parking spaces at different airports.

Operational Synergies

With both the airlines operating similar aircraft, they were expected to reduce maintenance and engineering costs. Jet was like to reap benefits in the form of increased parking slots at Delhi and Mumbai airports with over 60% share in Mumbai and nearly 50% in Delhi. Besides Jet was expected to more than 20 parking bays of Air Sahara at various other airports in the country for night parking which would enable them for early morning take offs.

Exhibit I: Number of Aircrafts owned by Jet Airways and Air Sahara

Number of Air Crafts			
Type of Aircrafts	**Jet Airways**	**Air Sahara**	**Combined**
Airbus A340	3	0	3
Boeing 767	0	1	1
Boeing 737	42	19	61
ATR 72-500	8	0	8
CRJ	0	7	7
Total	53	27	80

Source: Complied from various sources by the authors

By maintaining the same type of aircraft (Boeing 737-800s) the combined jet and Sahara airlines might derive economies of scale by reducing maintenance and engineering costs. The market analysts expect the deal to make Jet Airways the largest domestic airline in terms of fleet, turnover and valuation. The fleet size will grow from the present 53 aircrafts to 80 and it would be slightly more than the Indian airlines alliance air combined aircrafts total.

With the Jet's market share likely to rise to more than 50% might enable it to command more than 80% of the market share on the Mumbai Delhi route. This route accounted for more than half the traffic in the Indian aviation market. Jet was also expected to take advantage of Sahara's international access to gain itself access to international destinations. It was believed that these would facilitate Jet Airways to reap the economies of scale.

Jet Airways, which was suffering from the load factor problem and shortage of trained pilots, was likely to overcome this problem by using Sahara's expertise and manpower. During the third quarter of 2005 Jet Airways' load factor came down to 70.1% from 76.1% in the same quarter of the previous year, losing nearly Rs 21.9 Cr. It also led to cancellation of 1000 airline services on account of shortage of pilots. However concerns were being expressed in certain quarters over possible retrenchment of Air Sahara's employees.

Fear of losing out to competitors

For years rivals had alleged that Sahara was a marginal player in the industry. It charged low prices - and thereby 'spoilt' the market - as it could afford not to make a successful business of flying. Further Air Sahara was a tiny part of the Sahara group's overall interests. While Sahara claimed to be high quality low cost flier, many remained skeptical. The entry of low cost airliners like Air Deccan and Kingfisher seemed to have eroded Sahara's low cost advantage which had helped it corner nearly a fifth of the market share.

Financial Issues

While insiders felt that there were synergies between Jet and Sahara, not many were convinced about this being the stated reason for the merger. They were of the opinion that the financial health of Air Sahara was a cause of concern. It had reserves on more than Rs 500 crore of promoter funding, including equity of Rs 236 crore, preferential shares of Rs 50 crore, and group loans of Rs 250 crore. The data available with the Directorate General of Civil Aviation (DGCA) showed that while Air Sahara made a net profit after tax of Rs 96 lakhs during 2003-04, it recorded a net loss after tax of Rs 37.75 crore during 2002-03 and a net loss after tax of Rs 159.92 crore during 2001-02

Critics also accused Air Sahara, of not being transparent in its financial matters. With Air Sahara not being a listed company, financial statements were not available in the public domain creating difficulties for analysts to estimate financial strengths. But the Sahara group disclosed that its combined group had sales worth of Rs. 2956 Cr and net worth of Rs.1739 Cr in 2003-04. . Besides its debt was estimated to be around Rs.6-7 bn rupees (upto $120mn) (Refer Exhibit II for the overview of its financials).

Exhibit II

Financial Results of Air Sahara

Year	Net profit/ Net Loss after Tax Rs.in Cr.
2004-05	38.37
2003-04	0.96
2002-03	37.75
2001-02	159.92
2000-01	34.9

Source: Compiled by the authors from various sources

Questions were also being raised about the role of top accounting firms and regulations in the airline industry. Air Sahara's balance was not available in the public domain since it was not a listed company. The airline also continued to insist that it was going only for a strategic alliance or a sale of small stake of equity without giving hint of a sell off. Critics alleged that Air Sahara operated in this high-security business without transparency or financial disclosures. Vijay Mallya's backing off from the deal was attributed at least partly to these reasons. They further questioned Sahara's claims of a restructuring exercise being underway in the company. However experts faulted the government more these irregularities. Air Sahara's enterprise value had been initially estimated at one billion dollars. But by March 2006 some estimates seemed to suggest that the figure of $300 million was exaggerated.

While there seemed to be indications of a break even, Sahara was under pressure to dispose off the airline. Discrepancies were pointed out in the valuations undertaken by

E&Y. Issues like compensations to be paid if wet leases are 'transferred,' reduction in value of airport space allocation (since the government has made it clear that it will not automatically transfer these to Jet), a golden parachute for President Rono Dutta (estimated to be run into millions of dollars), as well as unrecorded liabilities and irrecoverable advances, mainly to group companies seemed to complicate the matters. Sahara however defended the valuations arguing that it was based on the future growth potential of the firm.

Jet developing cold feet

The deal was scheduled to be closed around the middle of March. But Jet seemed to develop second thoughts. Government clearances were also not forthcoming. It seemed to many that Jet was looking for lower valuations. It bought itself three months for negotiations. Few experts opined that Jet should have concentrated on setting up a new airliner to operate in the low cost segment than buying Sahara. There was also the possibility of Jet having to deal with pilots and engineers of Air Sahara who were said to be highly paid in the industry.

Moreover there was ambiguity regarding transfer of Sahara's ground permits and hangars to Jet. There was a delay from the government in granting the security clearance. Critics accused the government of not having a clear policy on mergers and acquisitions.

Some argued that Jet had overestimated Sahara's financial position and the late realization of that made Jet to reduce the price. Meanwhile, three small airliners, Kingfisher, GoAir and Indigo were looking at a strategic alliance to fight what they termed as Jet's dominance in the market. They have asked the government to ensure that there is no specific route monopoly. Indian Airlines while pretending to be unconcerned was devising plans to regain its market hare. Air Deccan was busy adding to is fleet of low cost aircraft and extending to destinations that were hitherto unserved. Further, there were comments that irrespective of whether the deal goes through or not, Indian aviation industry has received a jolt to shake off its complacency.

Arbitration and Aftermath

Jet's withdrawal from the deal seemed to suggest a long court battle. To analysts, it seemed that settlement was a better prospect than the arbitration process that was holding them up. Mediation efforts by mutual friends seemed to make no impact. Moreover, Jet's market share had slipped to 25% by early 2007. The Sahara group pumped in Rs. 100 crore into Air Sahara, but the effect was marginal. However pride seemed to prevent them from coming together. Meanwhile the arbitration process seemed to drawing resources from both the side which otherwise could have been utilized for future expansion plans. This was perceived to cost heavily both Jet and Sahara in the highly competitive industry.

Legal experts were increasingly of the opinion that Jet had a weak case by terminating the contract. It was this that led But Naresh Goyal took the initial steps to keep the deal on track. The personal differences were put aside to clear the acquisition.

The Acquisition

Keeping in mind the deadline set by the arbitrators, Jet Airways paid nearly Rs. 4 billion to the Sahara India group on April 20, 2007 concluding the deal. The subsequent payments were to be done in four equal installments totaling Rs. 5.5 billion beginning March 2008. This was in addition to the payment of Rs. 5 billion earlier.

Jet's intentions of operating Sahara as a subsidiary became clear with its press release stating so. Further Jet decided to rename it as Jetlite. It was further expected to become profitable within a year given the perceived synergies between the two. The two companies, however, were to have a consolidated balance sheet. The combined net revenues of the both airlines were expected to touch $2.5 billion by the end of 2007-08. The deal did not cover the acquisition Air Sahara's debts, but would cover acquiring the working capital losses incurred by Air Sahara.

Future Trends

The decision of the government to go ahead with the merger of the state run Indian Airlines and Air India around the same time suggested signs of consolidation in the Indian aviation industry. Jet Airways-Air Sahara and Indian-Air India combine commanded over 50 per cent share of the total market and nearly 70 percent of the total capacity. Route rationalization, common maintenance base and increased fleet size all were expected to contribute to widen the gap emerging between the full service carriers and low-cost airlines. Moreover Jet was expected to take delivery of 10 Boeing 737 aircraft for which orders had been placed by Air Sahara. Kingfisher's acquisition of Air Deccan that followed this event was described by analysts as an attempt to overcome this gap.

Competitors were apprehensive about the success of this acquisition. Opinions were being expressed about Jet having to cannibalize its Economy class to sustain Jetlite. The high employee-aircraft ratio in Air Sahara too seemed to have potential for upsetting Jet's game plan. While competitors seemed confident of countering these changes in the aviation industry, industry watchers were cautious in their assessment on how the future would turn out to be.

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