

## Aviation Industry

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### International Aviation Industry Overview<sup>1</sup>

- As per International Air Transport Association (IATA), passenger traffic is projected to reach 7 billion by 2034 with a 3.8% average annual growth in demand (2014 baseline year). This is almost double the 3.5 billion estimated to have travelled in 2015.
- During 2015, over USD 750b was spent on air transport, approximately 1.0% of global GDP (2014: USD 785b, 1.0%). Decline in spending on air transport is distorted on account of sharp rise in the USD.
- Improved cost efficiencies and reduction in cost of fuel has impacted rates for passengers and cargo freight.
- Consumers are being attracted to air transport due to competitive prices and increased destinations. Total number of passenger departures increased from 3,328m during 2014 to 3,568m for 2015. This translates into revenue-passenger-kilometer<sup>2</sup> (RPK) of USD 6,679b for the year 2015 (2014: USD 6,216). Number of passengers is expected to increase to 3,783m for 2016, generating RPK of USD 7,093.
- In 2016, commercial airlines will take delivery of more than 1,900 new aircrafts representing an investment of over USD 200b. These will be used to partially retire old aircrafts and take advantage of improved fuel efficiencies.
- With aircrafts being flown more intensively, number of scheduled flight departures amounted to 34.8m (2014: 33.0m) for the year 2015. This is equivalent to an average of 70 aircrafts departing each minute during 2015. Flight departures are expected to cross 37m in 2016.
- The biggest factor impacting the airline industry is the reduced fuel bill due to drop in oil prices. Fuel price per barrel decreased from USD 114.8 in 2014 to USD 66.7 in 2015 (averaged across the year).
- The worldwide airline industry fuel bill reduced from USD 226b for the year 2014 to USD 181b for 2015. This drop occurred despite volumetric fuel increase from 278b litres in 2014 to 294b litres in 2015.

### Local Industry Structure

- There are three domestic players in Pakistan: Pakistan International Airlines (PIA), Shaheen Air International Limited (SAI) and Air Blue Limited.
- Indus Air, which commenced flights in 2013, was forced to cease operations in 2015 by the Civil Aviation Authority (CAA) on account of failure to meet legal minimum requirement of fleet size of 3 airworthy aircrafts.

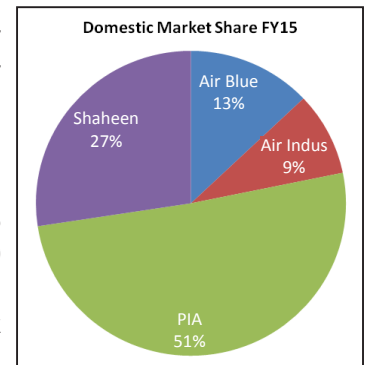
<sup>1</sup> International Air Transport Association

<sup>2</sup> Revenue-passenger-kilometer (RPK) is a measure of traffic for airlines calculated by multiplying the number of revenue paying passengers aboard the vehicle with the total distance travelled

- Total passenger traffic has grown at a CAGR of 5.3% over the last 5 years and has reached 15.1m passengers during FY15.
- Based on economic and demographic growth, IATA has projected intra Pakistan air traffic to grow at 9.9% over the next 20 years, more than twice the 4.1% projected annual world growth rate. This supports the prospects of growing revenues for airlines.

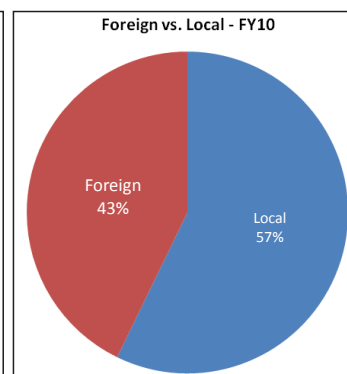
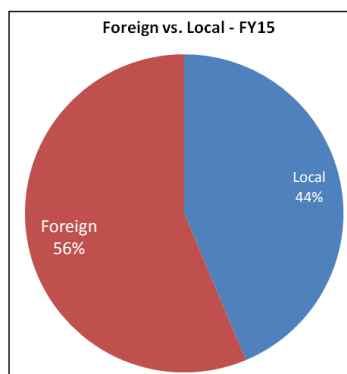
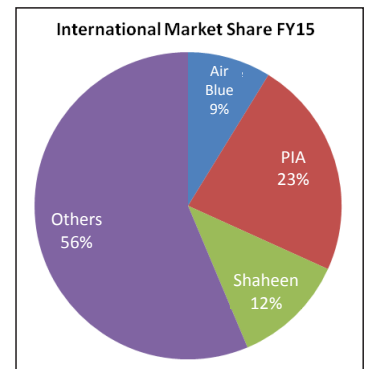
### Market Share (Domestic Passenger Traffic)

- Domestic passenger traffic has remained relatively stagnant over the last five years. During FY15, total number of domestic air passengers amounted to 3.15m vis-a-vis 3.59m during FY14. The reduction was mainly due increase in number of domestic airports / destinations, facilitating direct travel.
- PIA's market share in terms of domestic passenger traffic was 51% for FY15. However, the same has decreased from 72% during FY10 on account of mismanagement and inefficiencies. Market share of PIA is expected to decline further in FY16 due to a two week airline strike, which allowed other players to gain market share.
- Shaheen Air is the second largest player having 27% (FY10: 14%) market share in terms of domestic passenger traffic followed by Air Blue at 13% (FY10: 14%).



### Market Share (International Passenger Traffic)

- Total international air travel for Pakistan has grown at a CAGR 7.1% over the last five years. Total international passenger traffic amounted to 11.9m passengers (FY14: 10.9m, FY10: 8.5m) during FY15.
- Market share of foreign carriers during FY15 has increased to 56% (FY14: 53%) of total international air travel in/out of Pakistan. Based on the above mentioned reasons, along with competitive pricing from Emirates Airlines, PIA's market share decreased from 43% in FY10 to 23% in FY15.



- PIA currently has the highest number of aircrafts with fleet size totaling 43 aircrafts, comprising an average age of 12.8 years. Fleet age of SAI is currently the highest vis-à-vis peers.
- In the backdrop of declining fuel prices and improved profitability & cash flows, all local players are undergoing fleet expansion.

**Fleet Age**

Aircraft type	No. of planes	Average age (years)
<b>PIA</b>		
ATR 42/72	11	7.07
Airbus A310	10	23.74
Airbus A320	11	10.38
Boeing 777	11	10.78
Total	43	12.64
<b>Shaheen Air</b>		
Airbus A320	8	13.26
Airbus A330	7	14.66
Boeing 737	10	23.51
Total	25	17.75
<b>Air Blue</b>		
Airbus A320	3	4.07
Airbus A321	4	2.35
Total	7	3.09

**Business Risk**

- The aviation sector is characterized by high competition arising from soft barriers to entry (given the availability of lease financing and outsourcing support services), cyclicity, and vulnerability to economic shocks.
- Significant costs add to the inherent risk of the airline industry. These include fixed costs such as aircraft lease charges, capital and labor, (with limited ability to adjust the same during downturns and high cash outlay towards pension schemes) and variable costs such as fuel along with regulations focus on safety, maintenance, hours of operation for personnel and restrictions on routes, landing rights and slots.
- While profit margins tend to be low, cash flows tend to be relatively stronger with high levels of depreciation and amortization for airlines that purchase aircrafts. Adjusted leverage (off balance sheet leverage) tends to be high for airlines that use operating lease to finance the acquisition of aircrafts.
- Inability to pass on significant increase in fuel prices to passengers.
- Growing competition from foreign airlines, expected entry of new players' alongwith increased focus of the government to revitalize Pakistan International Airlines may increase the competitive landscape.
- Given these inherent characteristics, the airline industry is generally considered to pose high business risk.

**Financial Risk**

- Financial performance of airline operators has shown improvement in the backdrop of declining oil prices.
- Decline in oil prices allowed PIA to post a gross profit during 2015 for the first time since 2012 despite declining revenues. Moreover, finance cost on account of significant debt carried on balance sheet and sizeable expense base continue to create significant pressure on bottom line.

The company reported negative equity of Rs. 167b at end-September'2015. If mismanagement and inefficiencies are resolved, PIA has the capacity to recuperate its market share given its infrastructure, larger fleet and stronger brand.

- Savings from decline in oil prices has allowed the company to fund increase in its fleet and undertake C-Checks of its aircrafts from internal sources. Overall financial profile has witnessed significant improvement with healthy capitalization and liquidity indicators.

#### **National Aviation Policy (NAP) 2015 (Salient Features)**

- The NAP has introduced a number of financial and operational requirements (fleet age, flight punctuality & regularity) which may pose a challenge for existing operators.
- These include:
  - o Formation of an independent body, Safety Investigation Board reporting to the Minister of Aviation. The body shall investigate accidents and any serious incidents, as deemed fit.
  - o A Pilot Deviating Reporting system has been developed. A web-based portal will allow pilots to anonymously report incidents including regulatory violations.
  - o Maximum chronological age of aircraft operating in Pakistan has been set at 20 years for commercial operations.
  - o Calendar age of all types of commercial aircraft, operated by Pakistani operators shall not be more than 12 years at the time of induction with minimum of 35% remaining operational life. Aircraft older than 20 years, being operated by Pakistani operators, shall not be allowed to continue operations in Pakistan. The existing operators have to fulfill this requirement within 2 years.
  - o Minimum fleet size for domestic and international operations shall be 3 airworthy aircrafts and 5 airworthy aircrafts, respectively.
  - o Paid up capital for Regular Public Transport (RPT) license shall be enhanced to Rs. 500m while current RPT and other operators will enhance their paid-up capital to the revised requirement within a period of two years.
  - o Pakistani designated airlines shall be eligible to commence operations on international routes after one year of continued satisfactory operations on domestic routes.
  - o Import or lease (wet/damp/dry) of any General Aviation aircraft shall be tax and duty free.
  - o Duties shall also be abolished on the import of maintenance kits and associated parts of aircraft.

#### **Analysts Contacts**

**Talha Iqbal**  
Senior Manager  
talha.iqbal@jcrvis.com.pk

**Moiz Badshah**  
Assistant Manager  
moiz.badshah@jcrvis.com.pk