CASE STUDY

Civil Aviation Industry and Company Outlook

Aviation industry has the power to change the economic landscape of a country. Connectivity is important for generation of economic growth, trade, and tourism. Millions depend on this industry for their employment, either directly or indirectly. In the recent past, the entire industry worldwide was cripped by the COVID-19 pandemic. The years 2020 and 2021 proved to be the most trying and difficult period for all companies within this industry.

"When everything seems to be going against you, remember that the airplane takes off against the wind, not with it". Who should know better than Krishna Gupta who is the Managing Director of KG Airlines, one of India's leading airlines? The quote hangs on the wall at the entrance to KG Airlines' headquarters in Gurugram.

It has taken few years to rebound back to normal scale of business operations. With the impact of COVID-19 subsiding and the easing of travel restrictions, there has been a rebound passenger traffic.

Indian economy is being considered as one of the fastest growing economies, with projections for a GDP growth of 7% year on year. Private consumption, growing economic activity in both manufacturing and service sectors has spurred growth since 2022. Post pandemic, with the easing of restrictions on civil aviation that appetite of consumers to travel has increased manifold.

In India, the passenger traffic has increased since 2022. With rise in disposable incomes, rapid urbanisation and increase in working class population, the growth in the demand for air travel is expected to persist. Tier 2 and Tier 3 cities are also expected to play a pivotal role due to greater spread of economic activity and increasing population in these cities. The government is focussed on building and expanding modern infrastructure facilities across the country in order to support the domestic civil aviation industry. Almost 100 more new airports will be operational by 2028 giving scope for development of new regional route that can provide excellent connectivity within India. It is expected that domestic aviation requires at least 4,000 fleets within the next two decades in order to meet the anticipated growth in demand.

KG Airlines

Founded in 1996 by Krishna Gupta of KG Partners and D Gupta, KG Airlines has evolved into a significant player in the aviation industry. KG Partners holds a 59% stake in KG Airlines, while D Gupta's Singapore company, DG Assets, owns 41%. In August 1999, KG Airlines placed a firm order for fifty A320-200 aircraft, with plans to commence operations in mid-2000. The airline received its inaugural aircraft on 10

August 2000, nearly a year after the initial order. The maiden flights connected New Delhi to Mumbai. By the close of 2022, KG Airlines boasted a fleet of 270 aircraft, and an additional 40 were acquired in December 2023, solidifying its presence in the aviation market. Presently, KG Airlines serves approximately 49 cities across 25 states, carrying a total of 90 million passengers. Traded under the symbol "KGA" on NSE, KG's Board of Directors operates from its Gurugram office. A concise overview of the Board of Directors' profiles is provided in **Annexure A**.

Selection of Business Model

The growth trajectory of the industry holds significant potential. Several Board meetings have taken place in the past three months to discuss the optimal strategies for expanding KG Airlines' business. During the meeting, enthusiastically, Managing Director exclaimed, *"The future abounds with enticing opportunities, catering to both full-service airlines, boasting premium offerings and employing a product differentiation strategy, and low-cost airlines, capitalizing on a cost advantage strategy."* Many business propositions for both these models were prepared, analysed, and discussed in depth.

After thorough study and deliberation, it was decided that KG Airlines had better prospects by developing as a low-cost airline. The focus for the next few years will be on the domestic civil aviation sector.

Transitioning to a new business model, KG Airlines has redefined its mission, vision, and purpose as under–

The Mission − "KG Airlines is on a mission to provide connectivity with speed and reliability, making travel hassle free and affordable for our guests."

The Vision − "To be a leader in aviation by offering unmatched connectivity in and with India. Speed in and out of India with ease."

The Purpose − "Be our Guest, we connect you to your world."

The airline aims to build a loyal customer base by (1) providing affordable rates, (2) on-time performance and (3) courteous and hassle-free service. These are reassurances that KG Airlines wishes to provide its customers (guests/ passengers).

Moreover, KG Airlines also envisions growth in size and scale. With 100 more airports coming up within India, KG Airlines aims to increase its fleet size by leasing aircrafts, develop more routes and provide unmatched connectivity to its customers. The expansion project is expected to be substantial, with an initial investment of at least a few hundred crore of Indian Rupees.

Operational Challenges in the Airline Industry

The management at KG Airlines soon realizes that there are multiple roadblocks to this expansion project. Increase in fleet size, development of more routes and providing unmatched connectivity all require one key element – more aircrafts. Unfortunately, in the current global scenario due to disruptions in the supply chain, aircrafts are in short supply. Moreover, the compounding effect of rising operational costs is exerting substantial pressure on margins, and the availability of spare parts poses a significant challenge for KG Airlines.

Aircraft and spare parts availability: One of the key impacts of the pandemic has been the disruption in supply chain in aircraft manufacturing and subsequent shortage of engines worldwide. Manufacturers have been unable to keep pace with growing global demand from airline companies. Market expansion plans by operating new routes have been delayed due to unavailability of additional aircrafts. Therefore, many airlines are extending the existing leases of their current fleet in order to keep up with the operations.

Over and above this, many of the existing aircrafts have had to be grounded due to unavailability of spare parts. Therefore, there has been a shortfall in the deployment of capacity to meet customer demand on many routes.

Due to lop-sided demand-supply of aircrafts, aircraft lessors, who supply the aircrafts on lease, have been increasing the lease rental. This has increased the cost of operations substantially.

Increase in the cost of operations: Jet fuel prices have been very volatile and has been on an upward trend in the recent years. Consequently, KG Airlines regularly monitors the fuel prices and assesses their impact on profitability. But it has not taken use of financial instruments to hedge the exposure.

Another critical cost component for KG Airlines is the cost of leasing and operating aircrafts, which includes lease rental, maintenance and depreciation / amortization. As mentioned earlier, these costs are also on the rise.

In addition to fuel and aircraft-related costs, there is a high demand for pilots, as well as flight and cabin crew members. Consequently, flight crew salaries and expenses have been on the rise.

The cumulative effect of increasing operational costs, including high fuel costs, lease rentals, and personnel costs, has exerted immense pressure on operating margins.

Margins under pressure: The senior management has emphasized the necessity to pass on the increased costs to the customer. However, operating in an intensely competitive market presents a challenge, as there is a limit to how much ticket fares can be raised without losing competitiveness. This is particularly crucial for KG Airlines, which, as a low-cost carrier, has engaged in code-sharing arrangements with partner airlines on specific routes to meet the rising demand and generate profits.

Maintaining profitability in the market-driven passenger ticket fare environment requires KG Airlines to focus on driving cost efficiency. Consequently, the airline has observed a gradual depletion of its cash reserves due to these factors.

Operational Highlights of KG Airlines

Particulars	**FY 2023**	**FY 2022**
Available Seat Kilometers (ASK) (in million)	1,14,000	70,400
Revenue Passenger Kilometers (in million)	94,000	52,000
Passenger Load Factor (%)	82.45%	73.86%
Cost per Available Seat Kilometer (CASK)	4.85	4.65
Revenue per Available Seat Kilometer (RASK)	4.80	3.70
Passenger traffic	90 million	75 million
Average % of scheduled flights cancelled *	1.00%	0.45%
On Time Performance (OTP)** in %	88%	80%
Number of unresolved customer complaints	10	4

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Reasons for increase in fight cancellation were primarily on account of mechanical faults and software glitches that need to be fixed along with unavailability of spare parts. In addition to technical and commercial reasons for cancellations, flights were also cancelled due to non-availability of requisite staff, particularly pilots and cabin crew. The staff attrition rate at KG Airlines has increased from 10% in 2022 to almost 15% this year. HR exit interviews have indicated that low pay scales as compared to market rates, combined with long work hours, are the primary reason for employee attrition.

Whenever a flight is cancelled, the airline has to arrange for an alternate flight or provide a refund to the passenger. In exceptional cases, compensation may have to be paid to the passenger.

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On Time Performance (OTP) is compiled at four metro airports Mumbai, Delhi, Hyderabad, and Bangalore. For delays beyond 2 hours, airlines have to pay compensation ranging from INR 5,000 to INR 20,000 for domestic flight.

Turnaround time is the time between aircraft landing and take-off. The turnaround process is a joint effort of both the ground team and the flight crew. Besides loading and unloading of passengers, aircrafts are cleaned, inspection and maintenance work is carried out. Aircrafts are also refuelled during this time. The average turnaround time is approximately 1 hour for each aircraft. A fast turnaround time ensures that the aircraft is available for the next travel leg quickly, thereby improving asset utilization. Hence, efficiency in these operations will impact revenue generation. Faster the turnaround time of planes on the ground better the prospects for revenue generation.

At the same time, in the pursuit of fast turnaround time, it is critical not to compromise on aircraft safety. Incidents related to safety issues are taken seriously not just by the company but also by the Director General of Civil Aviation (DGCA), the regulatory authority in India. Hence, safety record is also paramount to business operations.

An analysis at KG Airlines of the recent reports for delays in turnaround time and safety incident records has indicated a shortage of technical staff to inspect, detect and report faults in aircraft. The existing staff is overworked. Hence, KG Airlines plans to hire additional 100 engineers across India who can be trained at their internal training department.

As mentioned above, the number of passengers flown by KG Airlines have grown from 75 million in 2022 to 90 million in 2023. Until now there have been only few airlines within the civil aviation industry in India. KG Airlines has managed to capture majority of the traffic in certain routes. However, with the expected potential for growth within the industry, there may be more airlines that may be able to operate in these routes. Therefore, it is very important for KG Airlines to perform efficiently and manage its routes effectively.

Fare Structure in Airline Operations

A ticket worth INR 10,000 is sold at 5% discount per passenger. GST rate @5% is collected on this sale. Aviation security fee is charged at INR 500 per passenger and user development fee is charged at INR 250 per passenger. Airlines collect the aviation security fee from passengers when they book their tickets. This is passed to the government. This fee is used to fund the security arrangements at airports around the country. User development fee or Passenger service fee are levied by the airline when passengers book the ticket. They are then passed onto the airport operator like the government owned Airport Authority of India (AAI) or to other private operators who have the license to operate the airport. In return for this collection service the airline is compensated at the rate of INR 5 per passenger from whom these fees are recovered.

The financial statements of KG Airlines are prepared in accordance with the Indian Accounting Standards (Ind AS). This commitment to compliance is evident in the extracts extracted from 'Management's Responsibility for Financial Statements,' which are provided in **Annexure-B**.

Strategy

To operate as a low cost, high efficiency airline, KG Airlines has the following strategy in place:

Fleet management: The fleet will be of single type of aircraft to reduce maintenance and operational costs. Planes will be leased rather than bought outright. Economy seat will be the only seat class offered.

Building digital capabilities: Digitalize processes to make them efficient, error free and cost effective. KG Airlines already has an online booking and check in system in places. It plans to encourage passengers to utilize these tools to plan their travel. These measures will reduce reliance on human intervention and can help rationalize cost. Human resources freed up from digitalization can be used for other value adding activities. Also, commission paid to travel agents can be saved by introducing online booking services. Digitalizing processes can also aid the company’s capabilities to scale up its operations in future. While the digitalization of processes brings significant benefits, scheduled maintenance activities remain crucial for ensuring the efficiency and safety of airline operations.

Ancillary services: Inflight entertainment, food and beverage will be charged extra and not included in the ticket cost. KG Airlines aims to generate additional revenue through an attractive choice of in-flight entertainment, food and beverage based on popular demand. For this, it can partner with renowned in-flight service providers as well as food and beverage suppliers who can cater to wide range of customer preferences. By charging premium rates for these ancillary services, KG Airlines can improve its revenue yield.

Managing customer loyalty: KG Airlines' management is keen on getting recognition by winning high profile awards for its various services as well as by getting above average ratings from various rating agencies. On time performance, customer satisfaction, value for money are criteria which are considered for awards and ratings.

The management has realized that value for money is partly driven by the redemption choices that customer loyalty programs offer. If passengers are allowed to redeem reward points towards another flight ticket, it takes away the opportunity to earn regular revenue. This is because, a seat in a flight has to be offered at a discounted rate while outside this program it would have earned the regular full ticket revenue. On routes that have a high passenger traffic, this would be a source of loss of regular revenue to the airline.

At the same time attractive loyalty reward programs are the best way to build and retain customer bases. While reward points are being granted, it was found that passengers were not completely satisfied with the range of choices offered for redemption. There has been huge number of unredeemed reward points. To bring a quick churn in redemption of reward points, thereby increasing customer satisfaction, KG Airlines plans to partner with stores in the airport which can accept passenger loyalty points. The passenger can redeem points from the program at these stores and get good value for money. At the same time, KG Airlines does not compromise on avenues to earn entire ticket fare of a seat.

Workforce management: High attrition rate of 15% is impacting operations. HR exit interviews indicate long work hours, low pay scale and lesser opportunities for career growth as primary reasons for high attrition. KG Airlines plans to have tie ups with training colleges and other technical institutes where technical staff and crew members can be trained in the latest developments in aviation. This will allow for personnel growth and improve staff morale. Attractive pay package, reward and recognition programs based on performance track record is being worked out to curb attrition. Improve amenities like staff mess, transportation from work to home, recreation rooms, off-site team building events are being planned out.

Performance Measurement System

The management has recognised that, with an increase in size and scale, the need arises to develop and align resources (people, technology, and processes) to deliver on the three reassurances provided to customers, which are stated above. In the highly competitive airline industry, the top management of KG Airlines desires a comprehensive view of its business regularly. Hence, they have adopted the Balanced Scorecard to access to information in a crisp and concise manner.

Given the challenges of rising costs, decreased profit margins and other business uncertainties, the airline aims to adopt “operational efficiency and performance” as its strategic theme for the coming years. A Balanced Scorecard is being prepared to understand the current performance across the four perspectives: financial, customer, internal business processes, and learning & growth.

Annexure-A: Board of Directors

✈ Jai Kumar, Chairman and Non-Executive Independent Director	A business leader, technocrat and academic, having worked in Australia, Europe, and Asia through a career spanning over 30 years.
✈ Ana Maria, Non-Executive Independent Director	With more than 25 years of extensive experience, Ana holds the position of Managing Partner at a renowned law firm. Her broad and varied representation of public and private corporations, alongside other entities, before various National Courts, Tribunals, and Legal Institutions has earned her acclaim on both national and international fronts.
✈ K. Srinath, Non-Executive Independent Director	Srinath, who founded a technology company during his early twenties, has a track record of developing numerous successful businesses. In 2021, he sold his business interests and was later invited to serve as a non-executive board member for KG in 2022.
✈ Krishna Gupta, Promoter and Managing Director	Krishna is also the Group Managing Director of KG Partners. He holds a degree in electrical engineering from the MIT.
✈ M. Sridharan, Non-Executive Director	Sridharan, currently serving as a Governance Consultant, brings extensive experience collaborating with government, regulatory bodies, investment institutions, and banks.
✈ Harsh Mittal, Non-Executive Director	Harsh, is a fellow member of the Institute of Chartered Accountants of India and is a graduate in Economics from Delhi University.
✈ Markus J., Non-Executive Director	Markus, an aviation industry veteran, with an illustrious career spanning over 36 years.
✈ K.B. Chakraborty, Independent Director*	K.B. had a successful career as a marketing executive, serving as Marketing Director of a major quoted engineering company until he retired in 2015. K.B. is fellow of CSEP. He is also an Independent Director on the Boards of several companies.
✈ Ravi Kishan (Retd.)	Ravi trained as a commercial pilot. He flew long-haul flights with a major airline for much of his career, before being promoted to chief pilot. He retired from flying in 2022. He was then invited to join KG's Board.

*K.B. was appointed as a casual vacancy director on 3rd September 2023. His appointment was subsequently approved by the members in the immediate next general meeting.

Annexure-B: Extracts from Management's Responsibility for Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Act with respect to the preparation of these individual financial statements that give a true and fair view of the financial position, financial performance, ----- in accordance with the Ind AS and other accounting principles generally accepted in India. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the company and for preventing and detecting frauds and other irregularities---- relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.