Pathfinder Economic Flash

Sri Lankan Airlines: Can it Afford to Fly?

Fundamentally Unviable Business Model

From its very inception there have been serious concerns about the financial viability of the national carrier (Air Lanka/Sri Lankan Airlines). These become more intensified each time the need for fleet renewal comes-up. That situation has arisen again. It is important, therefore, to consider very carefully the options available. The way forward should attach priority to ensuring that an undue burden is not cast on the already over-stretched budget and balance of payments of the country. The risks associated with Sri Lanka's budget/balance of payments deficits and debt profile are already elevated.

The then Air Lanka was established with no equity capital. From the outset, it has relied almost entirely on loan capital, particularly as the national carrier has had difficulty in achieving operational profits in most of the years of its existence. Hence, the business model has been fundamentally unviable from the beginning. As far back as the mid-1980s, the World Bank was a constant critic of the operations of the national airline. It was pointed out that in those years the Treasury allocation to finance the airline each year was greater than the total budgetary provision for the Food Stamp Scheme (successor to the rice/kerosene ration and predecessor of Janasaviya/Samurdhi).

This onerous burden on the budget, and therefore, on all Sri Lankans, including the poorest, was reduced when the Emirates Airline was given a strategic investment in the national carrier. While there were a number of disadvantages, particularly regarding operational issues where the interests of the two airlines were not well aligned, on balance the financial health of the national carrier was demonstrably better when this arrangement was in place. The situation has deteriorated since the untimely ending of Emirate's interest in Sri Lankan Airlines. The losses have mounted and the burden on the State Bank balance sheets/government budget has increased.

Losses in 2012 amounted to Rs. 25 billion. It is estimated that it will cost hundreds of millions of dollars and impose an extremely heavy burden on the company's balance sheet to pay off accumulated, ongoing and future losses. There is insufficient fiscal space to finance this amount of money directly out of the budget or by way of loans that ultimately become a contingent liability on the government's balance sheet. In addition, conditions in the global airline industry, combined with the manner in which the company is financially structured, is likely to mean that Sri Lankan Airlines will continue to make operational losses. Even if the uneconomic routes are eliminated and efficiency enhancing internal restructuring is introduced, the airline is unlikely to be financially viable given the lack of a capital base. It will continue to be a burden on the ordinary people of Sri Lanka.

The problems have been compounded by Sri Lankan and Mihin Air being operated together. Both losses and capital requirements have increased. This is clearly an unsustainable situation.

Sir Richard Branson has said: ***"If a Billionaire Wants to Become a Millionaire S/he Acquires an Airline"***

The Way Forward

The following options should be considered now that the war has ended and there is no compulsion for a national airline.

- **Option 1**: Find a strategic investor to fill the large black hole in the Sri Lankan Airline balance sheet which will only grow significantly in the future. Lessons learnt from the Emirates experience can be applied to obtain a better deal on this occasion. Sri Lankan Airlines is unlikely to be sustainable without the infusion of capital from a strategic investor in the current context of fiscal consolidation. Even the scaled down operational model envisaged in Option 2 (below) is unlikely to be viable, without a strategic investor, particularly as the fleet renewal needs to begin very shortly.

  It is likely to be difficult to find a strategic investor for Mihin Air. The most feasible option would be to sell off Mihin Air and compensate for this by providing increased landing rights for regional budget carriers.

- **Option 2**: Scale down the operation of Sri Lankan Airlines only to those routes that are profitable i.e. make it a regional airline servicing South, South East and West Asia, along with a very few non-regional destinations. In addition, close down Mihin Air which is operating in the highly competitive regional budget airline space. Such scaling down could be complemented by some liberalization of access to landing rights for non-national budget carriers.

- **Option 3**: Close down both Sri Lankan and Mihin Air and sell off their landing rights, as well as other assets, to pay off accumulated losses. The catering arm could be continued on a stand-alone basis as it has always been a profit centre. A minority stake could be sold on the Colombo Stock Exchange, while the government retains a controlling interest. This would raise much needed funds for the Government budget. There would also be merit in considering the best commercial option for ground handling which is another profitable part of the business.

  Many countries seem to find it necessary to have an airline for national pride, though such dogma is now becoming less prevalent around the world. More substantive arguments in favour of continuing the operations of Sri Lankan and Mihin Air are related to servicing the tourism sector, the multitude of temporary migrants working abroad, pilgrims and the large Sri Lankan diaspora. However, these objectives can also be fulfilled, without the current adverse impact on the country's budget and external debt servicing, by adopting an "open skies" policy that provides liberalized access to landing at Sri Lankan airports. It could be argued that mounting a national operation during the conflict was necessary as there was a high risk premium attached to landing in Sri Lanka. That compulsion no longer exists. It must be recognized, however, that this option is likely to be the most unpalatable politically. Despite this, it is important that this option is part of the debate on the way forward for the sake of completeness.

The need for urgent initiation of the fleet renewal for Sri Lankan Airlines places a high premium on decisive action to place its operations on a fundamentally more viable basis. One may conclude that Option 3 is considered unrealistic in the Sri Lankan and many other country contexts, though it has been adopted successfully by a few countries. Of the options given above, attracting a strategic investor seems to be the most realistic.

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