CIVIL AVIATION IN INDIA

CARGO & TOURISM

A Knowledge Paper

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FOREWORD

Over the last decade, India's Civil Aviation industry has witnessed massive growth, emerging as one of fastest growing domestic aviation markets globally. In 2016, domestic traffic grew by 21.2% while international traffic grew by 7.7%, making India the 3rd largest in terms of domestic passenger traffic and 4th largest in terms of overall passenger traffic. Freight traffic also exhibited a healthy annual growth rate of nearly 8% over FY13-17.

This unparalleled growth story has largely been fueled by a growing middle class, rising demand, growth in trade and deregulation of the sector, complemented by capacity expansion of Low Cost Carriers (LCCs), investment in airlines and airport infrastructure, among others. Additionally, key policy reforms by the Government such as the landmark National Civil Aviation Policy 2016, significant increase in budgetary allocation, introduction of regional connectivity scheme UDAN, approvals for construction of 18 Greenfield airports and revival of 50 un-served and under-served airstrips and signing of Open Skies Agreement with strategic partners will further boost growth of this important sector.

However, in order to maintain a high growth trajectory, it is important to address key challenges related to upgrading airport infrastructure to handle congestion, impact of GST, lack of skilled workforce, amongst others. Further, to successfully implement the regional connectivity scheme, it is vital to align UDAN with other strategic initiatives such as Smart Cities, HRIDAY and PRASAD to create a multiplier effect on travel & tourism, investment and job creation.

I am pleased to present this **ASSOCHAM – YES BANK Knowledge Paper on *Civil Aviation: Cargo & Tourism*** which highlights the trends and opportunities in the sector as well as provides key recommendations to sustain the growth momentum. I am confident that the contents of this publication will be useful for all stakeholders and will further stimulate growth of the Civil Aviation sector in India.

Thank you.

Sincerely,

Rana Kapoor
Managing Director & CEO YES BANK
Chairman YES Global Institute

President's Message

The Civil Aviation industry has ushered in a new era of expansion, driven by factors such as low-cost carriers (LCCs), modern airports, Foreign Direct Investment (FDI) in domestic airlines, advanced information technology (IT) interventions and growing emphasis on regional connectivity.

The Hon'ble Prime Minister's dream of connecting the unconnected, making airfare in India more affordable under the Government of India's regional aviation scheme named UDAN is a welcome step.

The liberalization of FDI norms in civil aviation is another major boost for the industry. For brownfield airports, 100% FDI has been allowed under automatic route. These measures will help in exponential expansion of aviation and tourism activity in India.

In this backdrop, this Annual Conference will provide a good platform for various stakeholders of the Aviation Industry to come together and deliberate on all the important issues for taking this Industry forward.

I am happy to note that, the ASSOCHAM in association with Yes Bank has prepared a **'Knowledge Report'** for the "10th ASSOCHAM International Conference & Awards on Civil Aviation, Cargo & Tourism" and I am sure that it will provide an insight to all the stake holders & decision maker in civil aviation industry.

Regards,

Sandeep Jajodia
President

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Secretary General's Message

I am happy to announce that the ASSOCHAM, is organizing the 10th ASSOCHAM International Conference on Civil Aviation, Cargo & Tourism on Wednesday, 30th August, 2017 in New Delhi.

With the recent announcement of the UDAN Scheme and Regional Connectivity Scheme (RCS) India is poised to witness phenomenal growth in the Civil Aviation Sector.

This Paper jointly prepared by ASSOCHAM and Yes Bank, looks at the opportunities opening up in the Indian Aviation Sector and I am sure, will be a reference book for the Industry.

I convey my very good wishes to the ASSOCHAM Team for the success of this Annual Conference.

D. S. Rawat
Secretary General

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Chairman's Message

I am happy to note that ASSOCHAM National Council on Civil Aviation, Cargo and Tourism is organizing the 10th ASSOCHAM International Conference & Awards on Civil Aviation, Cargo & Tourism and to the outstanding performance in the Aviation Sector. I consider this event is taking place at a time when fastest Air Traffic growth is taking place in India in the Global Aviation.

The New Aviation Policy will usher higher growth while connecting the smaller cities and towns and also making air travel more affordable in the future.

To cater to the growing demand, we are expected to witness coming up of new airports in smaller towns and we as an Industry see this as a big investment opportunity.

Cargo industry is growing at a good pace and will not only help the Civil Aviation Industry but help the economy grow faster as we expect much support from the Government on this front.

I take this opportunity in thanking Yes Bank and the ASSOCHAM Team, for preparing this Background Paper and convey my best wishes for the success of this Annual Meet.

K. Narayana Rao
Chairman
ASSOCHAM National Council on Civil Aviation &
Director, Delhi International Airport Limited, GMR

Co - Chairman's Message

Air mobility is a proven catalyst for the development of Economy the world over, accounting for 4.5% of the global economic output.

The additional impact triggered by Aviation to the rest of the ecosystem is 3.25 X of economic output and 6.1 X in employment generation in related industries, which is amongst the highest contributors in any single Industry.

However, in India the Aviation sector contributes a mere 0.5% to the Indian GDP; even with the trigger effect on associated ecosystem adding up to 1.5% leaves a huge opportunity to be tapped in the light of India being the 3rd largest aviation market in the world.

Happy to be part and parcel of Indian Government's visionary UDAN endeavour, offering affordable Regional connectivity to Tier II and III towns. Upgrading infrastructure of the existing airports/airstrips besides development of new airports is an extremely progressive step in the direction of creating employment opportunities and enhancing economic output in smaller cities (and satellite towns of metros).

Cargo and Logistics is yet another profitable offshoot of Indian aviation and retail boom, creating a renewed paradigm to every State's economic output.

These are exhilarating times in the Indian Aviation time-zone, as we stand at the cusp of disruptive and innovative expansion, appropriately facilitated by a very progressive Ministry under the visionary leadership of our Hon. Prime Minister.

Best Regards,

Kamal Hingorani
Co-Chairman ASSOCHAM Council on Civil Aviation

Table of Contents

01

Executive Summary

01

Executive Summary

Indian civil aviation industry has witnessed unprecedented growth over the recent years and was the fastest growing aviation market for a period of 23 months, until earlier this year. The recent industry growth can be attributed to several internal and external factors, including increasing middle class, growth in trade, capacity expansion of low-cost carriers (LCCs), development of world class airports, increased Foreign Direct Investment (FDI) in domestic airlines and heightened focus on regional connectivity.

With the implementation of GST framework, airlines in the country have faced certain challenges. Under GST structure, while airlines can claim input tax credit on all inputs (excluding ATF) on the business class; for the economy class they can claim input tax credit only on input services. Considering the fact that majority of revenues come from the economy class to the airlines, partial input tax credit on inputs for economy class would result in an additional cost to the airlines. For airports, sales of goods from Duty free shop would not attract any state taxes, since it was outside the state's jurisdiction to levy duty free shops, under Pre-GST period. However, there is no clarity if the existing exemptions would continue or not under GST structure.

On the policy front, NCAP has introduced slew of measures to promote sustainable and affordable growth in the country. The policy targets to enable 500 Mn domestic ticketing by 2027 and 200 Mn international booking. NCAP has introduced UDAN/RCS Scheme which targets indicative airfare of INR 2500 per passenger approximately, for a distance of 500 kms to 600 kms on RCS routes (equivalent to about one hour of flight). It also provided much respite to the regulatory regime of airport tariff framework. It outlined that future tariffs at all airports will be calculated on a 'hybrid till' basis, unless otherwise specified. Further, it also targets to liberalize the restrictions of land use by future Greenfield airport operators.

The Policy aims to increase cargo volumes by 4 times to 10 million tonnes by 2027 with focus on Express Delivery Services. Further, Air Cargo Logistics Promotion Board (ACLPB) has been constituted to promote growth in air cargo by way of cost reduction, efficiency improvement and better inter-ministerial coordination. ACLPB will develop non-legal and indicative Service Delivery Modules through stakeholder engagement as well as recommend norms for space allocation for air-cargo, including express cargo for all Greenfield airports.

While the Government and policy makers have taken several strategic steps towards strengthening the sector, it is critical to address key challenges of High Aviation Turbine Fuel (ATF) prices and airport charges, growing demand, limited airports, intense competition, among others to leverage the full potential of this important sector.

02
Introduction

02

Introduction

India's growing economy and increasing middle class have helped to make it the fastest-growing air travel market, globally.

The Civil Aviation Industry is an engine of innovation and technological progress in a world of decreasing trade barriers. Backed by a strong and sustainable growth potential, the advance of Indian Civil Aviation is being acknowledged, globally. In 2016, domestic traffic grew by 21.2 percent while international traffic grew by 7.7 percent, making India the 3rd largest in terms of domestic passenger traffic and 4th largest in terms of overall passenger traffic.

History

Indian Aviation market has seen period of peaks and troughs in the last few decades. We can segregate the aviation history in three phases as follows:

1st Phase of Deregulation (1990-1997)

Eight air taxi operators were granted permission to launch. However, majority of new entrants were under-capitalized and lacked management experience. But in many ways the commercial environment was more relaxed than in recent times such as

- There were no route dispersal guidelines
- Liquor could be served in-flight on domestic routes
- Foreign airlines could own up to 40 percent equity

Within a couple of years of the launch of private scheduled airlines, most of the start-ups were facing significant financial stress. Despite some successful IPOs and a key role played by Indian banks, operating losses and the debt burden increased to the heightened level.

2nd Phase of Deregulation (1997 – 2004)

This was a dormant period and the inactivity had a serious negative impact on the sector. No new airlines were granted permission to commence operations and no comprehensive civil aviation policy was framed for the newly deregulated sector. Further, National carriers were neglected and did not receive funding to invest in fleet modernization as well as privatisation of Air India was stalled and plans to commence modernisation of the airport sector continued to be delayed.

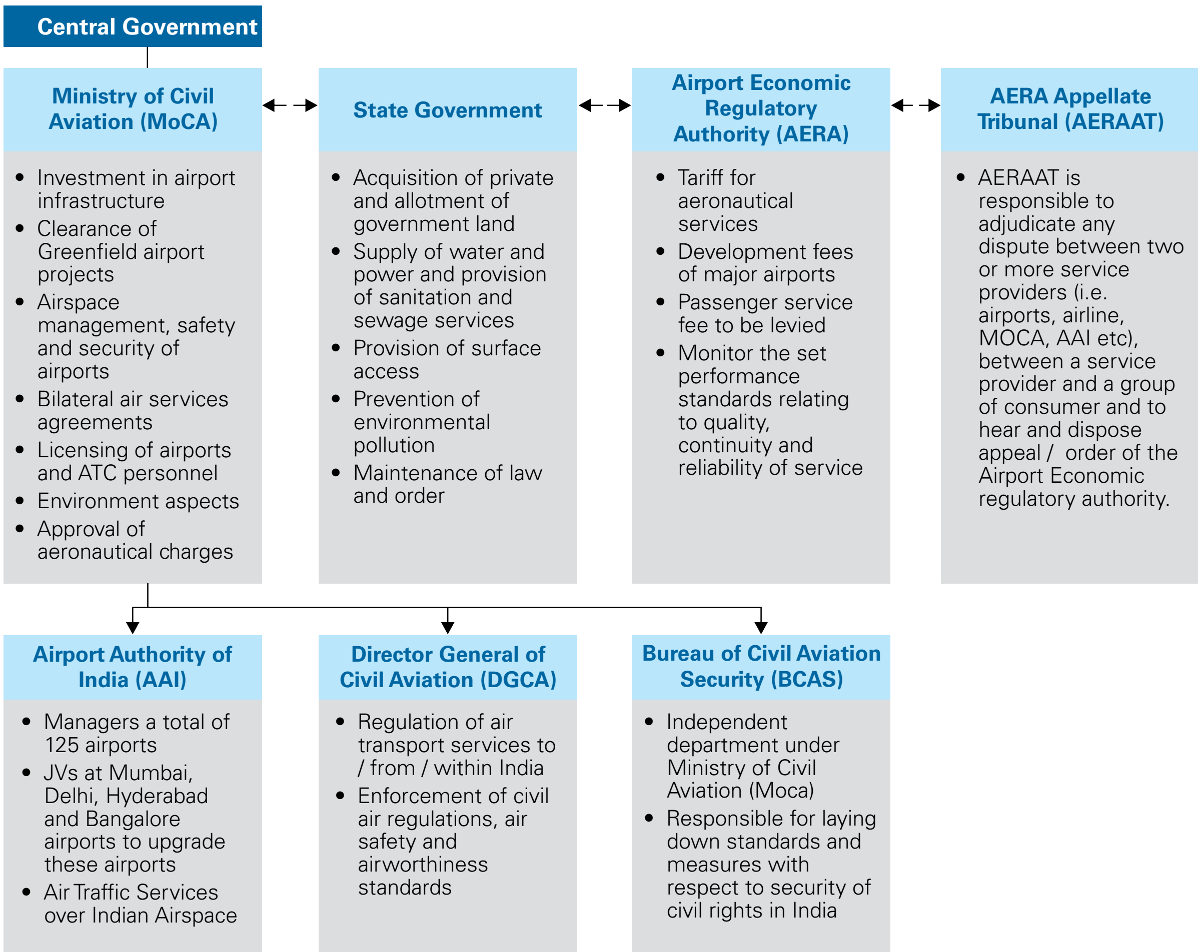
Liberalisation since (2004)

Air travel market expanded due to rapid economic growth, an expanding middle class, higher disposable incomes, emergence of low-cost carriers, modern airports, increased FDI and sophisticated information technology.

After several years of stagnation, domestic traffic in India saw rapid growth and posted a compounded annual growth rate of 11 percent between FY2007 and FY2017. The fleet of Scheduled Indian Carriers which stood at 158 in 2004 increased to 496 at the end of FY2017.

Overview of the Regulatory Framework

In India, the national parliament has exclusive power to legislate aviation sector. The current legal and regulatory framework for the aviation sector is described as below:



- The Ministry of Civil Aviation (MoCA) is responsible for the formulation of national policies and programs for the development and regulation of civil aviation and for devising and implementing schemes for the orderly growth and expansion of civil air transport.
- The Airports Authority of India (AAI) functions under the control and supervision of MoCA and is responsible for building and managing civil aviation infrastructure in India. Air navigation services are under AAI's exclusive control.
- The Airports Economic Regulatory Authority of India (AERA) is a statutory body entrusted with setting tariffs for aeronautical services and establishing the amount of development and passenger service fees, as well as establishing and monitoring performance standards relating to quality, continuity and reliability of aviation services.
- The Directorate General of Civil Aviation (DGCA) is the regulatory body primarily responsible for the regulation of domestic and international air transport services and enforcement of civil aviation regulations, air safety and airworthiness standards. It also coordinates all regulatory functions with the International Civil Aviation Organization (ICAO).

Sector's Contribution to the Economy

Air transport is a key driver of economic development. The economic stimulus provided by Airlines, Airports and other stakeholders in the aviation chain has a direct and indirect impact on the output and employment generation. As per ICAO, every USD 100 of output produced and every 100 jobs generated by air transport trigger additional demand of USD 325 and 610 jobs in other industries throughout the global economy. More than 4.5 percent of world economic output may be attributed to civil aviation. In a report issued by IATA (Economic Benefits from Air Transport in India 2011), the aviation sector contribution to the India GDP was pegged at 0.5 percent to Indian GDP. Out of this,

- INR 147 billion directly contributed through the output of the aviation sector (airlines, airports and ground services, aerospace)
- INR 107 billion indirectly contributed through the aviation sector's supply chain
- INR 77 billion contributed through the spending by the employees of the aviation sector and its supply chain

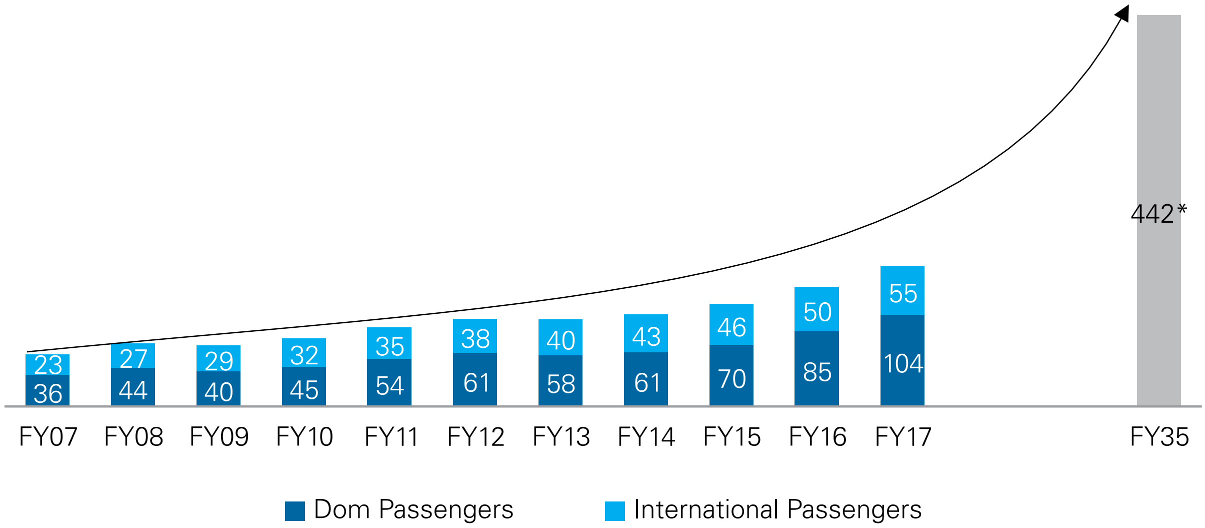
Major Trends in Civil Aviation

Passenger Growth

Indian scheduled airlines carried more than 104 Mn domestic passengers during FY17 against 36 Mn in FY07, recording a CAGR of ~11 percent, while international traffic passenger growth registered a CAGR of ~9.0 percent during the same period. Domestic passenger saw negative growth twice in last decade. First, in FY09 due to the economic slowdown and higher crude prices and second during FY13 majorly due to the shortage of supply as a result of Kingfisher Airline shutdown.

According to IATA, India's air passenger traffic will grow to 442 million by FY35. It projects that India to displace the UK as the third largest aviation market by 2026.

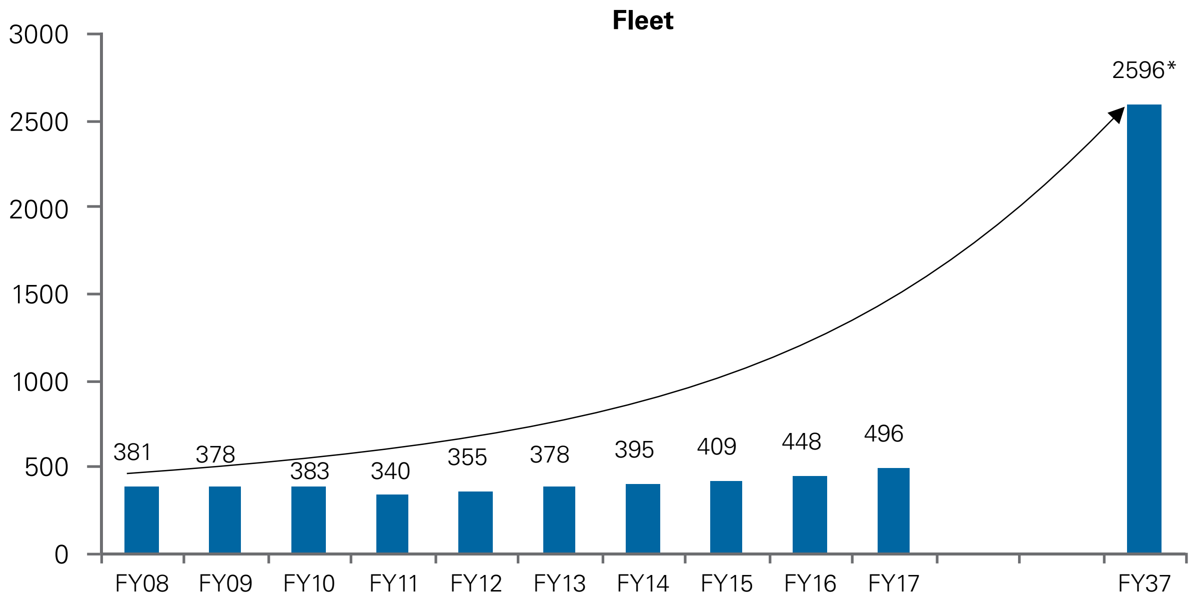
Passenger Traffic



Source: MoCA, IATA

Fleet Strength

Indian carriers operated 496 aircraft in FY17 up from 381 in FY08. In a recent forecast by Boeing, it expects Indian airlines to order as many as 2,100 planes worth US$ 290 billion over the next 20 years. This increase is led by strong passenger demand, low fuel prices, high load factor, strong local currency and economic growth.



Source: MoCA, Boeing

** Projected*

Boeing projects a worldwide demand for 41,030 new airplanes over the next 20 years, with India carriers needing more than 5.1 percent of the total global demand.

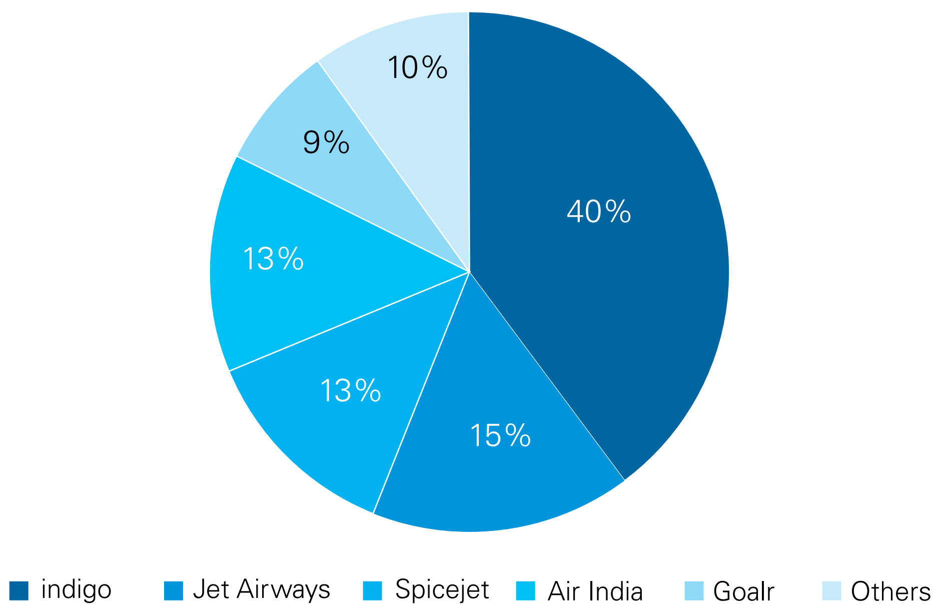
New Airplane Deliveries to India: 2017-2036

Airplane type	Seats	Total new deliveries	Dollar value
Regional jets	90 and below	10	<$1B
Single-aisle	90 - 230	1,780	$195 B
Small widebody	200 - 300	180	$50B
Medium/Large widebody	300 and above	130	$45B
Total		2.100 (5.1 % of world total)	$ 290 (4.8 % of world total)

Source: Boeing

Market Share: In June 2017, Indigo accounted for over 40 percent of India's domestic aviation market with a total 3.83 Mn passengers. It was followed by Jet Airways with 15.2 percent and SpiceJet with 13.3 percent market share. In terms of on-time performance, IndiGo took pole position with 86.1 percent of its flights departing and arriving as per schedule. Air Vistara was a close second in punctuality with 80.8 percent flights on time, followed by SpiceJet with 79.8 percent on-time arrivals.

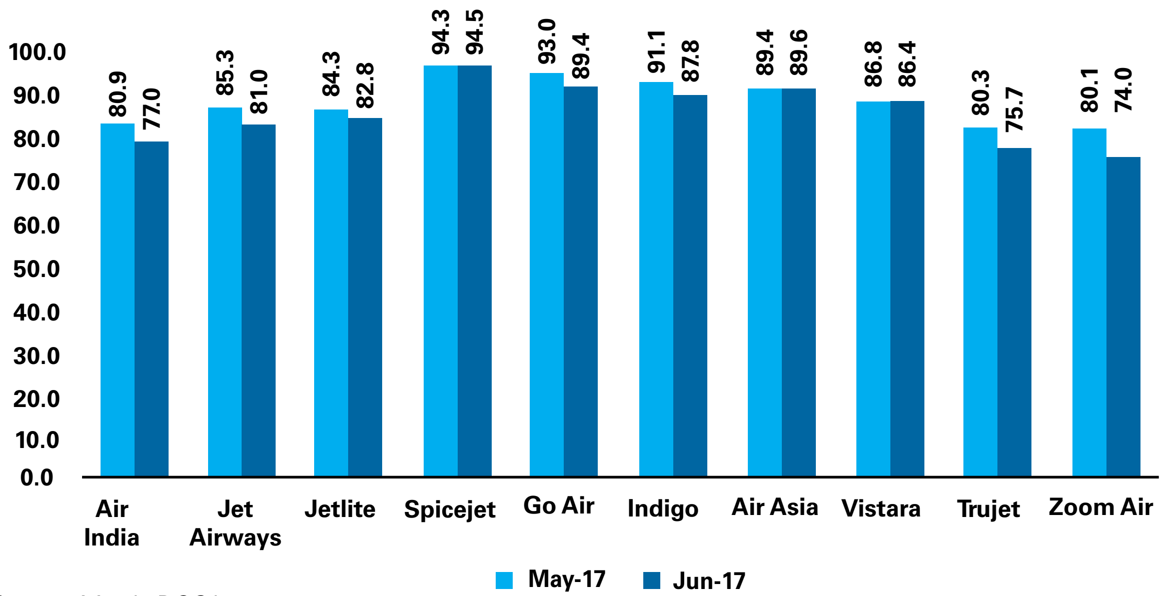
Market Share



Source: DGCA

Passenger Load Factor: In June 2017, SpiceJet led the passenger load factor, with 94.5 percent seat occupancy on its flights. Air Asia saw 89.6 percent seat occupancy, followed by GoAir at 89.4 percent.

Passenger Load Factor



Source: MocA, DGCA

Growth Momentum to continue

Policy Support (NCAP)

- NCAP has laid down the solid foundation for the sustainable future growth. The aviation ecosystem has been targeted to become affordable and convenient flying for everyone, with an ultimate objective of increasing domestic ticketing to 300 Mn by 2022 and 500 Mn by 2027, international ticketing to 200 Mn and cargo volumes to 10 Mn tonne by 2027
- Withdrawal of 5/20 requirement and replaced with a policy which provides level playing field for domestic carriers flying international routes
- Multiple concessions and provisions have been granted for MRO service providers such as rationalizing customs duty, simplification of goods clearance procedure, zero-rated VAT, adequate land in all future airports and no airport royalty for 5 years

Favorable Demographics

About 62 per cent of the population is in the working age group of 15-60 years and this proportion is set to increase in future indicating a larger employee base, greater business travel and greater economic activity. Mckinsey Global Institute's projections state that India's urban population will be 590 million by 2030 i.e. about 40 percent of the total population of India. The number of million plus cities will increase to 68 by 2030 of which 13 cities will have more than 4 million and six cities will have more than 10 million persons

Airport Modernization Plans

Opening up of the airport infrastructure to private sector participation led to unprecedented growth of the air traffic in India. An amount of INR 770 Bn investments made in the airport sector from FY12-17 out of which private investments stood at INR 590 Bn. In the recent future, capacity addition in existing airports, development of Greenfield airports, development of underserved and un-served airports will keep the growth momentum to continue.

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Thrust from Tourism Sector

In line with the trend observed in growth of India's GDP, the tourism sector has displayed satisfactory performance during the last decade. Foreign tourist arrivals in to India which stood at 5.1 Mn in FY07 jumped to 8.0 Mn in FY15. Given the Government's thrust on connecting remote and inaccessible regions of the country, a strong demand will emanate from the tourism sector.

Crude Oil Prices likely to remain under pressure in the short to medium term.

Airline profitability can be easily construed as a function of crude oil prices since Fuel Costs accounts for ~40 percent of total operating costs of the Indian airlines. Below table shows the forecast of crude oil by some of the leading agencies:

Agency	FY17	FY18
World Bank	55	51
U.S. Energy Information Administration	60	52

03

Goods and Service Tax

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03

Goods and Service Tax

Airline

1. **Partial ITC available on Economy Class Travel:** GST is applicable at the rate of 5 percent only on Economy class travel but ITC available on services only. GST on procurement of goods, Import of aircraft, and its spares including engines, tyres, etc, is not available for tax credit setoff on economy class travel. In earlier service tax regime, import of aircraft and its related spares were totally exempt for taxes and duties.

Recommendation: *With ATF kept outside the realm of GST and no exemption given to such imports, and further restrictions on availing tax credit on economy class, there is significant dent to the cash flow of the airlines. Hence, it is requested full input tax credit may be allowed on economy travel*

2. **IGST on re-import of repaired aircraft, aircraft engines and other aircraft parts:** Under section 13(3)(a) of IGST Act, 2017, place of supply in case goods sent for repair outside India shall be the location where services are performed and hence IGST is not applicable in India. However as per notification no. 45/2017 and 46/2017 dated 30th June, 2017, IGST has been made applicable on repair charges (including insurance and freight both ways) on re-import of any goods including aircraft, aircraft engines and aircraft parts etc.

Recommendation: *Since the said notification is in contravention to sec 13(3)(a), it clearly needs to be amended in line with the intention of law with effect from the date of enactment of GST law.*

3. **Reclassification of Engines and Tyres as Aircraft Spares as IGST rate for aircraft spares stands at 5 percent:** All airlines import Engines, APU, Landing gearps, tyres, wings etc. for the maintenance and upkeep of their aircraft. Post GST, IGST rate applicable on imports covered under Tariff 88 under Customs Act, (Aircraft and Spares) are at 5 percent, while those classified under Tariff 84 are 18 percent (Engines) and under Tariff 40 (Tyres) are at 28 percent.

Recommendation: *It is recommended that all aircraft parts i.e. Engines, Tyres, Seats or any other parts which are to be fitted in the aircraft shall be classified as aircraft parts under the Tariff Heading 8803-300 and hence should be levied 5 percent IGST*

4. **GST exemption on inter state stock transfer for captive consumption:** No clarification has been provided to the airlines operating in entire India with respect to movement of stocks from one state to another, in case of movements of goods for captive consumption and not for resale.

Recommendation: *With restrictions imposed on ITC on economy travel, GST payable on such stock transfers would result in incremental costs to the airlines.*

5. **Withdrawal of 'Declared Goods Status' to ATF for aircraft with MTOW of less than 40 tonnes:** Subsequent to the implementation of GST, section 14 (which gives list of declared goods, ATF sold to smaller aircraft of less than 40 MT considered as declared good)and section 15 (which restricts power of states to tax declared goods beyond 4 percent) of Central Sales Tax Act have now been deleted taking effect from 1st July, 2017.

Recommendation: *The above effect will result in the higher cost of operations for regional airlines under Regional Connectivity Scheme since these smaller aircraft are primarily used to build connectivity between un-served and under- served airports. Smaller aircrafts are the enabler for UDAN scheme. Additionally, such increase in cost is also against the basic objective of affordability and sustainability of NCAP.*

6. **IGST exemption on import of Aircraft, Engines, Spares etc:** Under the earlier tax regime, procurement of aircraft, engines and parts were exempt from taxes and duties. Under GST vide Notification no. 65/2017 dated 8th July 2017, exemption is given to import of aircraft, engines and other parts from IGST only when they are taken on operating lease.

Recommendation: *It is recommended that a relief may be given to import of aircraft and spares which are taken on financial lease or purchased upfront.*

Airports

1. **Negative Tax Impact on Duty Free Shops:** Under Old regime Duty Free Shops procured goods from domestic sources without payment of Excise duty by following the procedure given in the Circular No. 970/04/2013-CX read with the Notification no.19/2013-Central Excise read with (both dated 23rd May, 2013) and Customs

notification no.66/16-(NT) dated 14th May 2016) issued under Section 58A (2) of the Customs Act namely for storage of imported goods without payment of Customs duty for duty free shops. No Exemption /Bond procedure has been prescribed for domestic purchases by Duty free shop. Consequently there is additional tax impact on Duty free shop.

Recommendation: *It is recommended that existing bond procedure be allowed for supply of domestic manufactured goods to duty free shop. Alternatively SGST&CGST or IGST so paid be allowed as refund to Duty free shops located at International terminals*

2. **Impact of GST on Airport Construction:** Section 17 (5)(c)& 17(5)(d) of CGST Act and SGST Act imposes input tax credit restriction in respect of of the construction of new airports, renovation, repair and modernization of the existing airport facilities which significantly increases construction cost

Recommendation: *Input tax credit on services used for construction of Airstrips / Runways, ATC, Control rooms, Hangers, cargo warehouses, airport & cargo terminal buildings which are necessary to the direct airport operations be allowed along with other input tax credits*

Cargo

1. **Place of supply under Cargo:** As per the GST Act, the place of supply for transportation of goods where both service provider and service recipient are located in India would be as follows:

   - B2B: Location of service receiver
   - B2C: Where goods handed over for transportation

   As per the GST law, the place of supply for transportation of 'export cargo' (i.e. transportation of cargo from India to a place outside India) would be outside India only if either the service provider or the recipient is located outside India. Where both the service provider and recipient are in India, the place of supply for 'export cargo' would be in India and therefore, subject to GST.

Recommendation: *The new regulation poses practical challenges. There will be insignificant revenue to the Government on this front since exporters would claim of refund of the taxes charged*

2. **Higher GST rates than Asian Neighbors:** Asian neighbors such as Japan and Singapore low tax rates for their hospitality sector (8% and 7% respectively) which has resulted in significant inbound traffic tourism. These high taxes will serve as a roadblock for becoming India as global tourism hotspot.

Recommendation: *A competitive rates in line with other global/Asian tourism hub may be considered for the tourism sector.*

3. **GST rates on Hotels:** GST rates over the hotel and tourism industry has been decided with lots of categorization.

Tariff in Hotels	GST Rates
> INR 1,000	Exempt
INR 1,000 to INR 2,499	12%
INR 2,500 to INR 7,499	18%
INR 7500 and above	28%

Recommendation: *A lower tax rate for hotel sector will ensure that the industry's quality upgrade continues while delivering standardised accommodation to millions of local and foreign travellers*

04
Regional Connectivity

04

Regional Connectivity

Background

UDAN is a path breaking scheme aimed at making flying more affordable and boosting air connectivity to and from un-served and under-served airports. The scheme relies on market-based model to develop regional connectivity. Under the scheme, the airlines get viability gap funding (VGF) besides various concessions from State and Central Governments. The routes are allotted through a reverse bidding mechanism and awarded to the participant quoting the lowest VGF per seat. The following are the key features of the scheme:

- The scheme aims to encourage regional connectivity with flights covering distances up to 800 km.
- The central government provides concessions in tax rates along with liberal code sharing for regional connectivity airports.
- States have a major role to play. They are responsible to make sufficient land available; ensure adequate security; and provide necessary services at discounted rates for the airports or air strips. Further, the States will have to bear 20 percent towards VGF, which is 10 percent for North Eastern States and Union Territories.
- Fares have been capped at INR 2500 per seat per hour.
- Airline gets 3 years exclusivity period to operate on a route, once it is awarded the particular RCS route.
- Airfare for all passenger seats on an RCS Flight will not be subject to any levies or charges imposed by the airport operators (whether under the ownership of the AAI, State Governments, private entities or the Ministry of Defence, Government of India) including charges such as PSF, DF and UDF.

- For fixed wing aircraft, only 50 percent of flight capacity will be considered for VGF

Further, different stakeholders to provide concessions under the scheme detailed as below:

Concession offered by the airport operators shall be as follow:

1. Airport operators shall not levy Landing and Parking Charges on RCS Flights.
2. AAI shall not levy any Terminal Navigation Landing Charges (TNLC) on RCS Flights.
3. Route Navigation and Facilitation Charges (RNFC) will be levied by AAI on a discounted basis @ 42.50 percent of Normal Rates on RCS Flights.
4. Selected Airline operators shall be allowed self-ground handling for operations under the Scheme at all airports.

Concession offered by Central Government shall be as follows:

1. Excise Duty at the rate of 2 percent shall be levied on Aviation Turbine Fuel (ATF) purchased by selected Airlines Operators from RCS Airports for initial period of three (3) years from the date of notification of this scheme.
2. Selected Airline Operators will have the freedom to enter into code sharing arrangements with both domestic as well as international airlines.
3. Concession on Service Tax on ticket will levy on 10 percent of taxable value (abatement of 90 percent) of tickets for RCS Seats on RCS Flight for an initial period of one year from notification of the Scheme

Concession offered by States Governments at RCS Airports within their States shall be as follows:

1. Reduce VAT to 1 percent or less on ATF at RCS Airports located within the states for a period of ten years.
2. Provide minimum land, if required, free of cost and free from encumbrances for development of RCS Airports and provide multi-model hinterland connectivity as required.
3. Provide security and fire services free of cost at RCS Airports.
4. Providing, or cause to be provided, electricity, water and other utility services at substantially concession rates at RCS Airports.
5. Provide a certain share (20 percent for States other than North-Eastern States where the ratio will be 10 percent) of VGF determined.

At present, five airlines — Alliance Air, SpiceJet, Turbo Megha, Air Odisha and Air Deccan — have been awarded 128 routes under the scheme after a bidding process, out of which 33 destinations are expected to be connected by Sep, 2017. Air India's subsidiary Alliance Air became first airline to start operating flights between Delhi and Shimla under the Regional Connectivity Scheme (RCS) in Apr, 2017.

Till Apr 2017, 19 states and 3 Union Territories had signed MoU to participate in the scheme.

Maharashtra	Puducherry	Uttarakhand	Daman & Diu	A&N Islands
Jharkhand	Manipur	Uttar Pradesh	J&K	Karnataka
Guiarat	Assam	Telanqana	Odisha	
Chhattisqarh	West Benqal	Meghalaya	Raiasthan	
Andhra Pradesh	Madhva Pradesh	Himachal Pradesh	Naqaland	

Opportunities

UDAN scheme throws up immense opportunity to the airlines and airports. Mumbai-Porbandar-Mumbai and Mumbai-Kandla-Mumbai started by SpiceJet in June 2017 are registering PLF of more than 90.0 percent.

Citing the opportunity, Indigo has ordered purchase of 50 ATR 72-500 aircraft. This is for the first time Indigo would mix its narrow body fleet with turboprop jets. Indigo will set up a separate division to run turboprop aircraft operations, separate from the company's main divisions. In June 2017, SpiceJet ordered 50 Q400 planes as part of plans to add more flights to smaller towns. The following points lists down the potential offered by UDAN scheme:

1. Regional and remote connectivity has remained highly uneven despite the phenomenal growth in the Civil Aviation in the country. While 70 percent of the Indian population still resides in rural areas, poor reach and inadequate infrastructure have made it difficult for airlines to fully tap into the potential of these markets. The Indian consumption landscape in the small towns is dramatically changing – higher disposable income, demographic dividend of a younger generation, heightened aspirations, increasing urbanization resulting in a growing number of nuclear families are expected to provide strong thrust to the UDAN scheme.

2. Nearly 90 percent of the total seat deployment by scheduled airline operators is over routes between Metro and other towns and cities and only 10 percent is over routes connecting Tier II and Tier III towns and cities. This proportion is highly tilted in favour of Metro cities and will change once the implementation of UDAN scheme.

3. In India, many tourist destinations can double the visitors if they are properly connected by air. Some of these destinations include wildlife parks and sanctuaries which are still far away from the reach of surface connectivity and are time-taking and problematic for tourists to reach.

Challenges

The scheme faces several critical challenges when it comes to the actual implementation as listed below:

1. Support from State governments need to speed up the development of low cost airports, ensure multimodal connectivity to the airport.

2. Routes like Mumbai and Delhi will face implementation challenges. There is almost no availability of slots at Mumbai Airport. It is yet to be seen, how these new slots will be awarded and on what basis they would be taken away from existing operators. Additionally, since majority of RCS routes are VFR routes (Visual Flight) the slots would have to be day-time slots which may coincide with the peak timings at these airports.

3. At the time of 1st phase bidding, out of the 5 awardees only 3 had Air Operator's Certificate (AOC). The AOC approval process is detailed and cumbersome process.

4. Another challenge in developing regional routes is the lack of depth in the market, translating into low load factors. Traffic growth is difficult to predict on these routes.

5. Security is a paramount factor at regional airports. Various challenges exist in maintaining airside security including properly fencing the airport & airside boundary, availability of security personnel in case of emergency, patrol vehicles, etc.

05

Cargo Industry Review

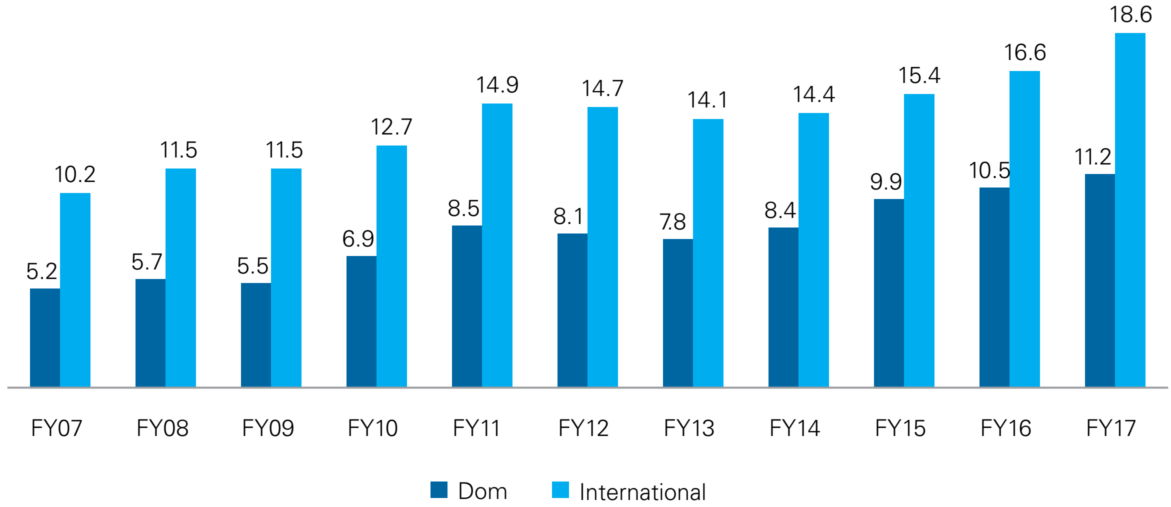
05

Cargo Industry Review

About 35 percent of the value of goods traded internationally is transported by air, directly employing around 2 million people globally. Air cargo represents about 12 percent of the global airline industry's revenues.

In Indian context, Air Trade to GDP ratio has doubled from 4 percent to 8 percent in the last twenty years. Air Cargo contributes about 20 percent of airline revenues. The air cargo pattern in the past is provided below.

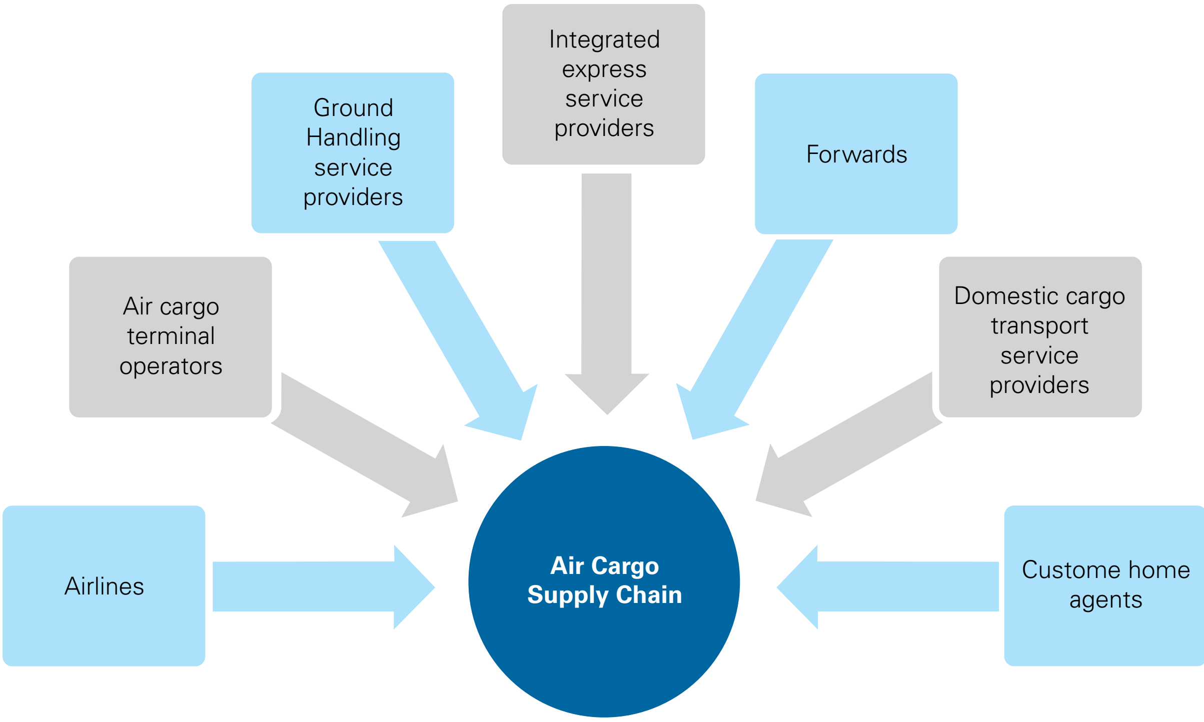
Freight Traffic Carried by Scheduled Carriers in Lakhs MT



Source: MocA, AAI

Domestic cargo has registered a CAGR of 8.0 percent during FY07-17, while international cargo grew at 6.2 percent annually during the same period. In FY09, domestic cargo registered negative growth owing to economic slowdown. Further FY12 and FY13 also saw fall in cargo volumes majorly because of shortage of supply as a result of Kingfisher debacle.

Air Cargo industry involves a wide variety of service providers and employs 70,000 people in the country.



Key Drivers for the Cargo Sector

1. **Increase in Capacity as a result of Growth of passenger fleets:** According to Boeing, Indian airlines to order as many as 2,100 planes worth US$290 billion over the next 20 years.

2. **Express industry to grow multifold:** Indian express cargo industry provides fast, reliable, on demand, integrated and door to door service (including customs clearance and duty and tax payments). The growth of the Express Industry will be driven by the current major customer segments, namely auto components, banking & finance, garments, pharmaceuticals, IT hardware and mobile phones, e-commerce etc.

3. **Rapid economic growth:** As per IMF forecast, GDP growth in India is forecast to grow at an average of 7.5 precent-8.2 percent during FY18-21 and thus Air Cargo could be at the centre of supply.

4. **Government Initiatives:** In order to promote growth in air cargo by way of cost reduction, efficiency improvement and better inter-ministerial coordination, Air Cargo Logistics Promotion Board (ACLPB) and AAI Cargo Logistics & Allied Services (AAICLAS) have been formed. AAICLAS focuses on three verticals (a) air cargo handling and allied services, (b) warehousing and contract logistics and (c) air cargo road feeder and air freight stations. Creating AAICLAS would bring multiple advantages as there is lot of activities on the cargo front.

Key Challenges

The opening of economy, entry of new airlines, new routes, reforms in government policies, advanced technology has helped Indian air cargo to grow. But air cargo sector in India is still fragmented and faces certain challenges:

1. Air traffic in the country is mainly concentrated at only a handful of airports. The challenge lies in connecting cargo volumes of Tier 2 & 3 cities with major cities for air transportation, which lacks appropriate cargo infrastructure.

2. In order to provide scope of capacity addition to the existing cargo players, it is necessary to integrate airport infrastructure with air cargo facilities. Dedicated unused infrastructure at airports may be marked to air cargo operators.

3. The inbound freight demand is not very strong and is not enough to fill up the aircraft. However, that is not the case with exports which see much higher utilization. As a result of intense competition, the export rates have been low. Hence, airlines are finding it tougher to make profit to keep India on their route.

Recommendations

1. Substantial investment is needed to develop dedicated on-airport cargo terminals and air freight stations to handle air cargo across the country. Advances in technology and the implementation of security systems also need to be pursued.

2. Indian airports enjoy a geographical advantage, owing to their strategic location. But the transshipment route has not been fully exploited. In order to develop transshipments, customs and security policies and procedures for transshipment need to be standardized at various airports.

3. Air Cargo should be treated at par with other logistics sector like Roads which is subject to 5% tax rate. It is recommended that air cargo tax rate may be reduced from 18.0% and considered for a lower tax bracket.

4. With the introduction of GST, octroi has been removed, which will propel the demand for cargo movement through roads. Thus, in order to protect Air Cargo from the negative impact emanating from the new developments in the competitor sectors, it is recommended that a connectivity plan should be laid down to connect Rail Cargo with Air Cargo.

06
New Airports Development

06

New Airports Development

Airports in the country are no longer places where planes just take off and land but have evolved into major business establishments with all-around implications on the economy. The wider economic benefits of Air Travel are presented in chart as below:

Greater Access to the Global Air Transport Network

- **Widens the available market**
  - Higher Revenues
  - Higher Potential returns from investment
- **Facilitates efficiency improvements**
  - Access to a wider base of suppliers
  - Access to now production techniques
- **Fosters greater competitiveness**
  - Increases inward and outward investment
  - Ability to explo it economies of scale

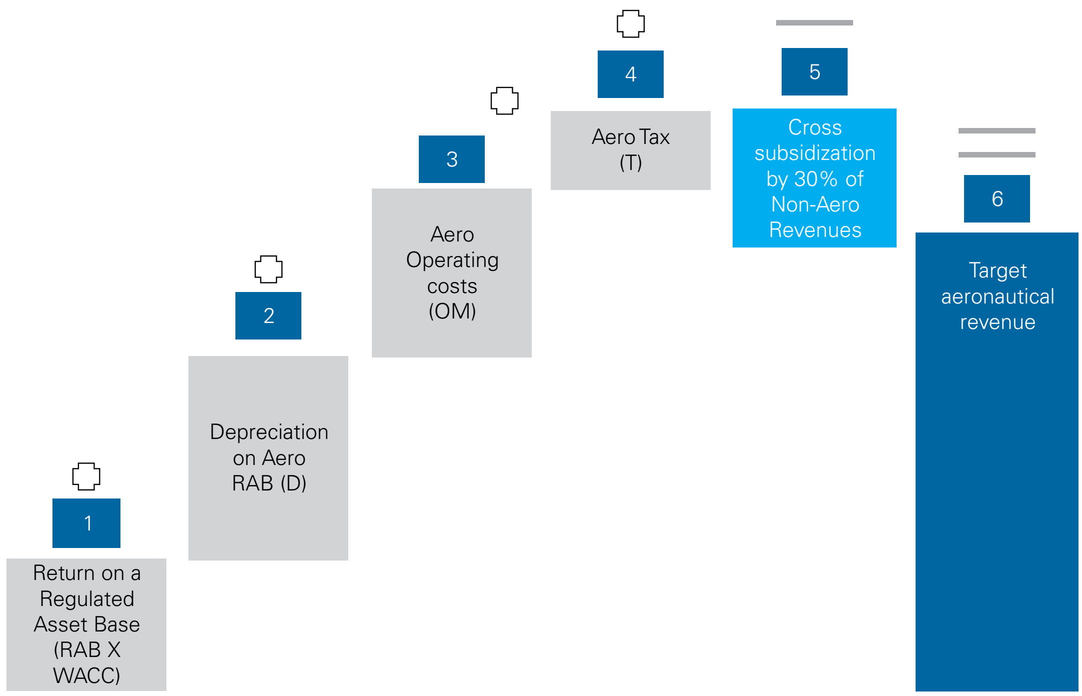
In a recent study conducted by National Council of Applied Economic Research on "Economic Impact of DIAL" it has been deduced that DIAL provides direct, indirect and induced employment to 2.8 Mn workers and contributes 17.9 percent of total Gross State Domestic Product and 0.7 percent of National Value added.

Summary of Economic Effect of IGIA, Delhi by of Impact Assessment Models (2014-15)			
Details	Direct Effect	Type-I Impact Total (Direct + Indirect)	Type-II Impact Total (Direct + Indirect + Induced)
Output (INR Crore)	33139	91054	189831
Value Added (INR Crore)	7979	31366	80724
Employment (lakh)	1.06	6.09	28.39
Value Added (USS billion)@ INR65/USS	1.23	4.83	12.42
Summary of e Economic Effect of IGIA, Delhi as Percentage of National Income (2014-15)			
Details	Direct	Type-I Impact Total (Direct + Indirect)	Type-II Impact Total (Direct + Indirect + Induced)
Value Added as Percentage of National GVA (%)	0.07	0.27	0.70
Value Added as Percentage of Total GSDP of Delhi (%)	1.77	6.95	17.89
Employment /job Creation as Percentage of Total Workers (%)	0.02	0.12	0.56

Source: (basic data): NCAER Research

Indian aviation market has seen double digit growth for last few years. At this pace, soon there will be a situation when demand moves ahead of the capacity/supply. Airports infrastructure are typically planned well ahead. Hence, current airport infrastructure needs immediate attention.

NCAP aims at the development and modernization of airports and upgrading of quality of services. The Policy encourages the development of airports by state governments and the private sector (including via PPPs), with greater regulatory certainty. In order to provide field to airport operators, future tariffs at all airports in India will be calculated on a "hybrid till" basis, unless otherwise specified, which means total of 30 percent of non-aeronautical revenue will be used to cross-subsidize aeronautical charges. The main building blocks under Hybrid Till approach are as follows:



Airports, for the best interest of everyone, should make reasonable returns not just to cover the cost of capital for the investors or lenders. In India, PPP model has been extremely successful in the airport sector and has delivered world class airport infrastructure. DIAL has been ranked second best airport (in the >40 Mn pax) by ACI for 2016. MIAL and GHIAL have consistently featured among the top ten airports in the ACI rankings over the last five years.

Financing Scenario

There is fundamental contradiction in the airport sector between airport operators and the regulator. There is long term debate going on between regulators and investors over the profit sharing mechanism over the capital projects. In order to earn attractive return on equity, airport operators and other stakeholders in the value chain will have to price their products and services accordingly – which seems unacceptable in the Indian Institutional structure.

In order to build world class airports, the government has acknowledged the need for the participation of private players in the development of airport infrastructure. Development of Delhi and Mumbai airports has been done under Public Private Partnership manner. The capital expenditure is funded from private equity, commercial banks borrowings, and internal resources of private partners. The Government of India has approved the construction of 18 Greenfield airports in the country, which would be executed and financed by the respective airport promoters, and are estimated to require an investment of Rs 30,000 crore (US$ 4.66 billion). The Cabinet Committee on Economic Affairs, Government of India, has approved the proposal to revive 50 un-served and under-served airstrips in three financial years starting from 2017-18 at an estimated cost of Rs 4500 crore (US$ 698.7 million).

Let's look at each of possible funding options available to the airport sector.

Internal Cash Flows

Airport earns revenues majorly on account from aeronautical charges like UDF, Landing and Parking Charge etc. (which are fixed by the regulator) and non aeronautical revenues. Airport is a regulated business. There are clear cut guidelines defined by AERA for the determination of tariffs. Despite, the regulator allowing 16.0 percent return on equity, the DIAL and MIAL are struggling to manage their finances who are marred by the high revenue share to AAI (not a pass through in the building block approach under which tariff is determined by AERA), as outlined in the concession agreement. DIAL has to pay 45.99 percent of total revenues to AAI while MIAL pays 38.7 percent as revenue share. However, GHIAL and BIAL have been able to attract investors because of favorable concession terms. Both of them have to pay 4.0 percent revenue share to AAI (pass through in the building blocks)

Loan/Borrowing

Borrowings from domestic commercial banks whether fund in the nature of Term Loan, Working Capital, or non fund based like Bank Guarantee, Letter of Credit etc. is the most widespread manner for medium to long-term financing requirements. Several other sources of external debt financing (External Commercial Borrowings, loans from EXIM banks) are available to the industry. International Commercial banks, Export Credit agencies, Multilateral agencies often lend to well-constructed Capital Projects. Indian private airport operators have used borrowing as a major source of finance.

Private Equity

According to private equity investors, there is a fundamental contradiction in airport sector. Regulators are making ensure that no project should be allowed to make a wind-fall return. Yet, considering the risk premium of dealing with the government and its regulatory machinery, private investors are ready to provide capital at higher return on equity (ROE).

Recommendations

- Indian Airports should be encouraged to follow Hub and Spoke model. There are sizeable economic gains derived from a Hub airport including increased employment opportunities. In order to push hub and spoke mode, a two-way approach between airports and airlines is required to take head on the international competition and addressing the growing air passengers and cargo movements.

- In order to ensure reasonable rate of return to private investor in the airport, concession/project agreements already signed should be adhered to and policy should promote investor return. In an order announced in 2016, the regulator had fixed INR 65,000 per sqm and INR 4,700 per sqm as ceiling cost towards terminal building and runway/taxiway/apron. Typically airports develop terminals in response to market conditions, level-of-service requirements, type of air service provided (e.g., international, domestic, etc.), branding, positioning and nationalistic reason. Additionally, the service standards play a critical role in deciding the infrastructure at airport as mentioned in the OMDA for DIAL and MIAL. The return on capital employed should be in line with the risks involved with operating an airport and ensure that investor confidence is maintained enabling development of the airports in line with the vision of the Indian Government.

07

Tourism and Civil Aviation

07

Tourism and Civil Aviation

Aviation is a major driver for development of tourism. Deregulation in the aviation industry, the emergence of the LCC sector has proven beneficial in promoting domestic tourism and rising disposable income has complemented the increasing demand for leisure travel. Even though domestic tourism has seen uptrend in the last few years, the state of airport infrastructure at tier 2 and tier 3 metros at many tourist destinations still remains a concern.

India's tourism and foreign income earnings are direct function of its Air Service Agreements. India has Bilateral Air Service Agreements, and follows a liberal Air Transport Policy relating to inbound international tourist charter operations. Although the policy on inbound charters is hassle-free, operators face issues with airport infrastructure, slots and delays in obtaining permissions from DGCA and other bodies which has a detrimental impact on the tourism.

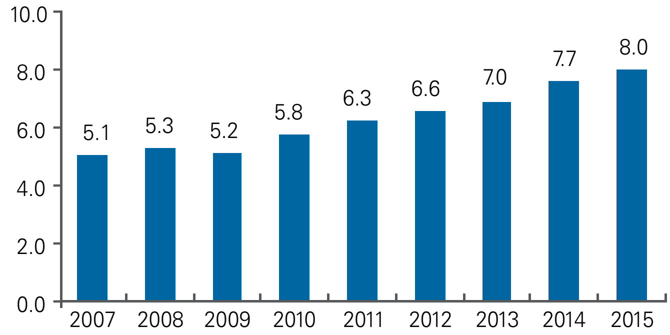
The hub and spoke model is a very important strategy for a country like India with a huge area and varying topography. Considering the fact that even top destinations like Agra do not have regular flight connections, it becomes increasingly important to not only upscale connectivity, but also improve the country's image from a marketing and promotional perspective.

Trends in Tourism Industry

According to Ministry of Tourism, India witnessed 8 Mn foreign tourist arrivals in CY2015, which has grown at a CAGR of ~6.0 percent during the period from CY2007 to CY2015. As per Economist Intelligence Unit (EIU) estimates, the number of foreign tourist arrivals is expected to rise up to 12 million by CY2019, growing at a CAGR of 9.2 percent.

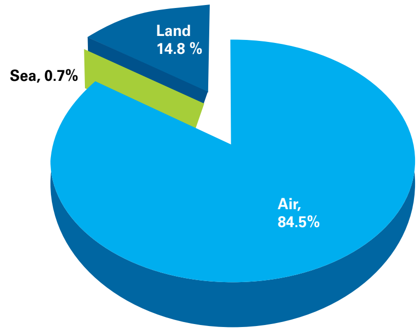
As depicted in the chart below, Air travel accounts for 84.5% of Foreign Tourist Arrivals in the country

Foreign Tourist Arrivals in India (in Mn)



Source: Ministry of Toursim

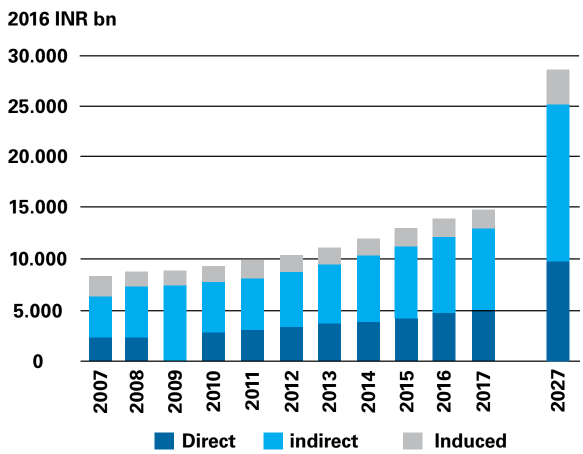
Mode of Travels of Foreign Tourist Arrivals in India, 2015



Source: Ministry of Tourism

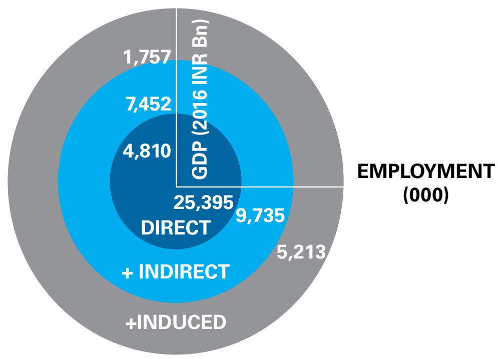
The total contribution of Travel & Tourism to Indian GDP was US$ 208.9 Bn, 9.6 percent of GDP in 2016, and is forecast to rise by 6.7 percent in 2017 and 10.0 percent of GDP in 2027, according to the World Trade and Tourism Council. Further Travel & Tourism investment in 2016 accounted for 5.7 percent of total investment (USD34.0bn). It should rise by 4.5 percent in 2017, and rise by 5.7 percent p.a. over the next ten years to US$ 61.8bn in 2027, 5.7 percent of total.

Total Contribution of Travel & Tourism To GDP



Source: WTTC

Breakdown of Travel & Tourism's Total Contribution to GDP and Employment 2016

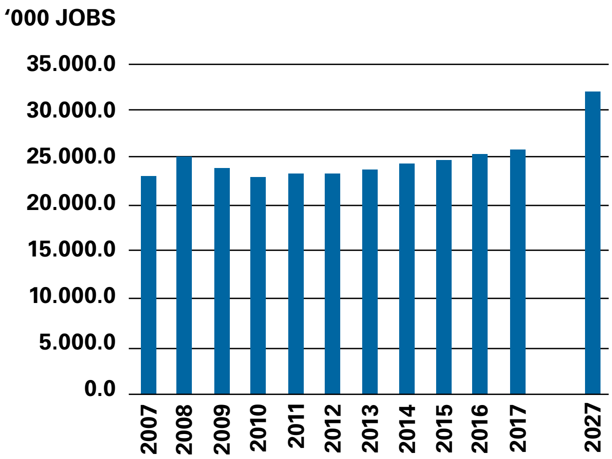


TOTAL CONTRIBUTION OF TRAVEL & TOURISM

Source: WTTC

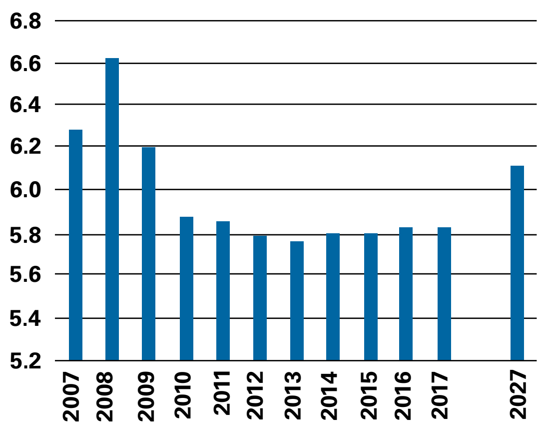
In 2016 Travel & Tourism directly supported 25,394,500 jobs (5.8 percent of total employment). This is expected to rise by 2.1 percent in 2017 and rise by 2.1 percent pa to 31,910,000 jobs (6.1 percent of total employment) in 2027.

Travel & Tourism Contribution to Employment



Source: WTTC

% Of Whole Economy Employment



Source: WTTC

Recommendations:

- **Institutional Structure.** Given the dynamic nature of the Tourism industry and its service orientation, it is imperative to have a strong and efficient institutional structure that supports alignment of the industry to the constant tourism developments. Towards this, while National Tourism Advisory Board (NTAB) and Inter-Ministerial Coordination Committee on Tourism (IMCCT) have been formed, the formation of National Tourism Authority (NTA) also needs to be taken up on priority and position it as an important authority. Similar international tourism bodies like, the Singapore Tourism Board, have had significant impact in tourism development for their respective countries. NTA could be the nodal agency for several activities like investment promotion, marketing, escalation resolutions, capturing and dissemination of more real-time tourism statistics, developmental planning and implementation coordination, extending support to State counterparts etc.

- **Increase Budget Allocation to Tourism Industry.** The recent Union Budget 2017-18 has allocated INR 18.40 Bn which is about 0.09 percent of the total allocations. Given developmental interventions proposed in the sector, including tourism infrastructure development and the emergence of tourism themes, the Government should further increase budget allocations that can also have significant impact on the economic contribution of the tourism sector

- **Taxation in view of GST.** Tourism sector to be accorded lower GST slabs to make the Indian tourism industry more competitive as compared to other affordable global destinations

- **Improving Medical and Wellness Tourism.** India is fast developing into a Medical & wellness tourism hub of Asia because of superior quality healthcare services at a low treatment cost. Treatment of major surgeries in India costs approximately 20 percent of that in developed countries. Creation of Medical hubs through PPP will boost medical tourism. Wellness tourism should be promoted by marketing indigenous methodologies such as Yoga and Ayurveda

Abbreviations

AAI	Airport Authority of India
AERA	Airport Economic Regulatory Authority
BIAL	Bangalore International Airport Limited
CGST	Central Goods and Service Tax
DIAL	Delhi International Airport Limited
DGCA	Directorate General of Civil Aviation
GHIAL	GMR Hyderabad International Airport Limited
GST	Goods and Services Tax
IATA	International Air Transport Association
ICAO	International Civil Aviation Organization
IGST	Integrated Goods and Service Tax
ITC	Input Tax Credit
MIAL	Mumbai International Airport Limited
MoCA	Ministry of Civil Aviation
MTOW	Maximum Take off Weight
NCAP	New Civil Aviation Policy
PLF	Passenger Load Factor
RCS	Regional Connectivity Scheme
SGST	State Goods and Service Tax
UDAN	Ude Desh ka Aam Nagarik

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Together, we can make a significant difference to the burden that our nation carries and bring in a bright, new tomorrow for our nation.

D. S. Rawat
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