# Eroding competitive advantage. The looming profit crisis for full service airlines in South East Asia.

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Streams: A, F

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## Abstract

For over twenty years airlines based in South East Asia have enjoyed a competitive advantage derived from a combination of lower labour costs and a geographic position at the centre of major traffic flows. Tight bilateral links maintained relatively high fares and steep barriers to entry for regional destinations within Asia, while the carriers leveraged their cost advantage and location to tap into large long-haul connecting traffic markets [1]. This advantage was maintained through the opening of Russian airspace and the introduction of long range aircraft in the 1990's, but it is now rapidly eroding as the new generation of extreme long-haul aircraft allows Middle Eastern carriers to replicate the Asian airlines long haul network structure just as low cost carriers are breaking into the formerly profitable regional operations. Full service airlines in the region now have to rapidly reshape their strategies.

## Introduction

The airline business remains one of the least attractive global industries, with heavy capital requirements, high levels of regulatory intervention and chronically poor profit performance. Traffic is growing again after stalling in the wake of the World Trade Centre attacks, SARS, and the Iraq War, but profit recovery is slower, with yields lagging the recovery in passenger numbers. (Shifrin 2004). The growth of low cost carriers in Europe, North America, Australia and Asia is increasing profit pressure on the established airlines. This appears to pose a particular risk to South East Asian airlines that have traditionally seen their regional markets as profit sanctuaries, but are now facing the entry of several value based carriers serving Singapore, Thailand, Malaysia and Indonesia.

## The Airline Industry

Profitability in the airline industry is poor, with operating profit margins consistently below 6%, and aggregate losses in seven of the past sixteen years (ICAO 1995/2003). The industry generated a reasonable return on capital in only a handful of years. While traffic grew 38% from 1992 to 2001, average revenue per Tonne/Kilometre fell by 17% (ICAO 2001). In the period following the September 2001 terrorist attacks in New York, passenger and freight fell in most markets, with industry-wide losses approaching 4% of total revenues, or $US13 billion per annum in 2001/2 and 2002/3 even before the impacts of the Iraq war and the SARS[2] virus hit airlines. The market capitalisation of US airlines has plunged so severely that the industry found itself in mid-2003 with $US100bn in debt and less than $US4bn in equity.

Efficiency alone is not enough for success (Schefczyk 1993), and excessive price discounting or expensive fleet acquisition can destroy airline profitability as easily as inefficient operations. Geographic location (Porter 1990) can play a significant role in conferring advantage, where fringe low density markets are much harder to serve profitably than high value high volume markets, located at the centre of traffic flows. Geographic advantage is also derived when aircraft are able to fly within their maximum range limits.[3].

Since the mid-1990's the airline industry has witnessed two critical developments. Firstly the establishment of value based (low-cost) domestic and regional carriers in North America, Europe and Australia. Secondly, almost 40% of full service airline capacity has consolidated into three global alliance groupings. Contrary to the broad trend in alliance strategies, to improve the firm's value chain, spread development risk, or speed learning (Kanter 1994, Preece 1995, Bleeke and Ernst 1993 ) airlines have formed horizontal alliances with competitors to protect market share (scale) rather than reduce cost or improve efficiency (Flores 1998). For airlines which are neither 'value based' regional operators nor a member of a multi-carrier alliance, competitive pressures are coming from both sides.

## Historical Structure

The Chicago convention of 1944, established commercial aviation around national carriers utilising government negotiated air service agreements [4]. Some airlines in Asia were built from large home market bases (Japan Airlines/All Nippon), while others employed a sustainable location advantage to tap into long-haul traffic flows passing through South East Asia (Malaysian/ Singapore Airlines/Thai International). Market growth accelerated in the 1970's with the introduction of wide-bodied aircraft [5] building traffic flows between Asia, Australia/NZ and Europe. Even points in North East Asia with limited direct air services were available to South East Asian 6$^{th}$ freedom operators seeking volume. Low labour costs, good infrastructure, and in most cases government ownership, provided levels of competitive advantage against airlines from higher cost developed economies, or from less advantageous geographic locations.

The maximum operating range of long-haul aircraft, and closely controlled airspace over China and Russia played an important part in sustaining the extent and durability of geographic advantage. Until the opening of Russian airspace to commercial aviation in the late 1980's flights between Europe or North America and Japan were usually obliged to touch down in Anchorage, Alaska for fuel en-route. The introduction of the Boeing B747-400 long-range aircraft in 1989 brought Thailand, Singapore, Malaysia, Hong Kong, and Japan within non-stop operating range of the major European markets, while the Philippines and Indonesia lay just outside.

Full service carriers in the region continued to grow strongly during the 1990's taking advantage of liberal air capacity regimes in Australia and Europe, and growing tourist travel. Networks and then frequency expanded to Europe, North America, and Australia, while short-haul markets closer to home remained protected within tight bilateral agreements.

The impact of this structure was the development of highly competitive low-yielding, often profitless long haul markets (such as Sydney-London) where cost advantage was a key success factor, and non-competitive high yielding short haul markets where regulated pricing and limited market access ensured superior profits. Regional flying in Asia became the profit sanctuary of the long-haul 6$^{th}$ freedom specialists. When markets dipped after the 1997 Asian crisis, several carriers, including Philippine Airlines, Malaysia Airlines and Garuda Indonesia were forced to restructure their operations, often initially culling unprofitable long-haul flying. In its restructure, Malaysia Airlines also handed financial responsibility for its loss making domestic network back to a national government agency.

## Pricing behaviour

Liberal air-service regimes in countries such as Australia that were focused on building inbound tourism flows allowed capacity to grow rapidly. Growth was generally supported with marginally priced (often loss making) load, which drove down average yields and profitability for the entire market. Airfares between Europe and Australia were often little higher than fares between Europe and Asia as airlines scrambled for market share at the expense of yield. Over time, poor route profitability led European carriers including Lufthansa, Air France, KLM, Alitalia, and finally Olympic to withdraw operations from the Australian market. Only British Airways and Austrian Airlines' low cost subsidiary Lauda Air now operate services from Europe to Australia.

## Industry economics and competitive advantage

Economic orthodoxy suggests that competitive behaviour drives resource allocation towards efficient outcomes, while market power and oligopolistic behaviour can distort outcomes (Jorde and Teece 1989). Firms will be influenced by the actions of their competitors, and even rational firms may engage in 'crazy' predatory pricing behaviour to block a new entrant or force a competitor out of a newly contested market. (Dunning 1995. Fudenberg and Tirole 1986,1987).

The Eclectic (OLI) Paradigm (Dunning 1977) suggests firms can seek advantage from location in more advantageous host countries, but this is denied to airlines by the rigid traffic rights structure. Others (Guisinger 2001, Madhok & Phene 2001, Lundan & Hagedoorn 2001)establish a link between the OLI paradigm and strategic management theory, linking location advantage to Porter's (1990) concept of a nation's unique competitive advantage.

Airlines have varying levels of competence and experience, which impact the firm's internal capabilities to generate strategic advantage. When the competitive landscape changes rapidly, companies may have to compete in their industry 'as they are' (Teece et al 1991).

> 'in the short run firms are to some degree stuck with what they have and may have to live without what they lack.....firms lack the organisational capacity to develop new competences quickly..(and) some assets are simply not readily tradeable.'

This difference in resources and competencies between firms helps to explain why low cost airlines operate profitably in even the most toughly contested markets, while full service carriers struggle.

Airlines have a capacity to compete in even the most tightly regulated structure [6] (Ramaswamy et al 1994). Competitors in a highly regulated environment can adopt differing strategic orientations, with differing results. Following deregulation of the US domestic market there was a proliferation of new entrants, followed by a dramatic shakeout, with many airline failures. The evolution of the US market following this period of turmoil has been a path of steady consolidation amongst traditional carriers, with the industry now more concentrated than it was before deregulation, and the entry of low cost carriers.

## Expansion of Middle East carriers

Middle East based carriers equipped with extremely long range Airbus A340-600 aircraft are now entering the 6th freedom markets that have been the preserve of South East Asian airlines, undermining the historical geographic advantage. The arrival of these aircraft permits carriers like Emirates, Qatar Airways, and Gulf Air to take advantage of this step in technology and mount non-stop services to Australia and North America. As with the Asian carriers before them, 6th freedom market share is being captured with a combination of aggressive pricing and product enhancement.

## Entrance of Low Cost carriers in Asia

By 2005 Singapore should be home base to four low cost carriers as well as full service operator Singapore Airlines. Malaysia based Air Asia is operating regional services from Kuala Lumpur, Johor Bahru, and Singapore to Bali, Bangkok and Phuket as well as to Malaysian and Thai domestic points. Singapore Airlines and Qantas will launch of low-cost subsidiaries to service markets within 5-6 hours flying of Singapore, a range which takes in the developing travel markets in China and India.

The entry of Air Asia to the Bangkok-Kuala Lumpur route, previously served in a bilateral partnership between Malaysia Airlines and Thai Airways International, saw the cheapest fare in the market fall below $US30 for the two hour flight. Thai Airways moved aggressively to compete with pricing levels offered by the low cost carrier, seeing its cheapest publicly available fares on the route fall by around 60%. The pricing was followed by Malaysia Airlines, echoing behaviour of the full service carriers in the US following the entry of low cost carriers Southwest and Jet Blue to US domestic markets.

As Asian low cost carriers, which enjoy the same labour cost advantage as the Asian full service operators [7], expand their networks, the previously protected profits of the regional networks are diminished, exposing the entire network to stiff price competition. Pricing and revenue management approaches will have to change to manage in the new environment (You 1999, Robertson and Ward 1983, Gale and Holmes 1992). Opportunities to cross subsidise routes, or to share risk through revenue pooling with other national full service carriers diminish, while long haul competitors gain a competitive advantage from access to lower cost networks in Asia. Where the emerging low cost carriers are linked, even indirectly, to existing full service operators [8] they enjoy the added benefit of market strength from brand extension (Pilling 2004).

## Eroding advantage

The strategic landscape is now changing rapidly in Asia, undermining the traditional benefits enjoyed by a many full service carriers in the region. While the three global alliances have a presence in the major markets, several of the South East Asian region's national carriers are non-aligned. Their traditional geographic and factor advantages have been eroded on three fronts.

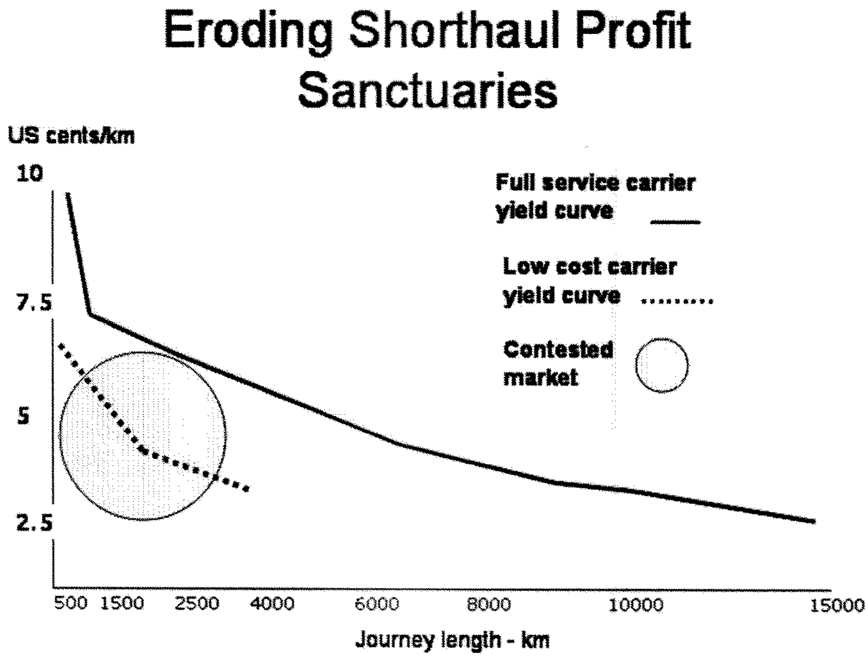
- Low cost carriers are expanding, stripping the high profits from regional markets,
- New ultra long range aircraft are entering the fleets of expanding Middle Eastern carriers, allowing them to tap the same 6th freedom traffic flows that were previously the preserve of the Asian operators,
- Higher cost full service competitors such as Qantas, Singapore Airlines and Cathay Pacific are aggressively stripping significant costs from their businesses.

Full service carriers were forced to revisit their business models, in particular their cost structures, to deal with traffic downturns caused by the Iraq war and SARS outbreak in 2003. These two events have driven industry benchmark carriers like Singapore Airlines to adopt dramatic cost reduction strategies, which have been retained as the markets have begun to recover, and traffic growth has resumed. Similar cost controls were implemented by Cathay Pacific, British Airways, Qantas, all of whom have pushed labour, distribution, and operating costs down significantly. The impact of these cost controls has been to narrow the cost margin enjoyed by Asian 6th freedom operators.

At the same time, alliance carriers have been reducing distribution costs by starting to exchange ticket data electronically. Low cost carriers that depend heavily on Internet bookings to minimise distribution costs have always avoided paper tickets. The eliminated of paper tickets by full service alliance carriers allows them to capture the same cost savings.

These cost reductions further close the gap on the South East Asian carriers, while moving to exclude those which have not invested in e-ticket technology upgrades from global fare participation. Since the capacity to offer interline travel is a core competence of a full service carrier, these contractions seriously weaken the business model of the non-aligned carrier, as well as acting as a barrier to a possible entry to an alliance group.

Weakening competitive advantage in traditional markets is forcing these airlines to search for new market segments in China and India for growth. The relative lack of sophistication of travel from these markets leaves less reliance on interline relationships and alliance benefits, but puts the established carriers into competitive battles with other airlines from a low labour cost base, often styled more like the low cost operators. Moving to compete in unsophisticated markets also starts to fragment the product offer, as quite different product attributes are required to access the emerging group-tour markets from China from those needed to remain competitive in the established 6th freedom long-haul operations to Australia, Europe and North America.




## Caught in the Middle.

From a position of market power with low costs, protected home markets, and access to large 6$^{th}$ freedom traffic flows, non-aligned full service carriers in South East Asia are now finding themselves wedged between, more cost conscious full service alliance competitors, new entrant Middle East based airlines, and at the same time have emerging low cost regional operators eating into their nearby profit sanctuaries. Adequate airport capacity, growing local markets, and diminishing regulatory requirements are minimising the barriers to market entry for low cost airlines. Unprofitable long-haul flying can no longer be cross subsidised, but network reach is part of the competitive offer full service carriers bring to the market.

Faced with these opposite competing pressures, the full service carriers have diminishing options.

- Seek long term partners or a place in an alliance group, with the required investment in technology and infrastructure to capture distribution savings and retain network scale
- position a best cost provider strategy for a differentiated product at a price premium head to head with the low cost entrants, and push for yield improvement on long haul flights through effective revenue management and pricing
- transform into low cost airlines with a smaller more profitable networks.

## The way ahead

So far value-based airlines have not followed the hub-based operations of full service carriers, but have served short haul markets. The concentration on narrow-bodied short haul aircraft locks them into this segment. Since these carriers are not looking to take premium price traffic, the pricing power conferred by hub domination is less important, and access to connecting long haul and international traffic of limited value. These new entrants are often initially more focused on diverting traffic from land transport modes than poaching the customers of existing airlines, though a significant proportion of the short haul market is prepared to try travel on a value based airline. (Gilbert et al 1991).

This leaves the hub and long-haul markets as the domain of full service long-haul carriers, but now requires these long haul networks to operate profitably on a stand alone basis. These routes have in many cases been allowed by 6$^{th}$ freedom operators to run at or below break even level, often under pressure from tourism ministries looking for steady visitor growth. They will now need a new approach to pricing and revenue management, focused on significant yield improvement. For some South East Asian carriers, network rationalisation may be the only choice.

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[2]
Severe Acute Respiratory Syndrome

[3]
The shorter flight time Bangkok-London vs Singapore-London allows 10 tonnes of additional freight to be uplifted on B747-400 operations, conferring a marked competitive advantage on Bangkok as a hub.

[4]
**International Aviation Rights of Passage - Freedoms of the Air**

1st Freedom. The right of an airline of one country to fly over another country without landing.

2nd Freedom. The right of an airline of one country to land in the territory of another country for technical reasons – such flight refuelling or maintenance.

3rd Freedom – The right of an airline of one country to fly traffic to another country

4th Freedom – The right of an airline from one country to fly traffic from another country to its own country

5th Freedom – The right of an airline to carry traffic between two foreign countries on a flight which originated in its own country.

$6^{th}$ Freedom – a combination of $3^{rd}$ and $4^{th}$ freedom traffic rights, where a carrier at a mid-point uses its $4^{th}$ freedom rights to carry a passenger to its home country and $3^{rd}$ freedom traffic rights to carry the passenger on to another destination.

$7^{th}$ Freedom – the right of an airline to carry traffic between two foreign countries on a standalone service.

$8^{th}$ Freedom – the right of an airline to carry traffic between 2 cities in one country. Often referred to as cabotage or domestic traffic.

[5]
Boeing B747, McDonnell Douglas DC-10 and Lockheed L-1011

[6]
The study investigated the US market prior to deregulation, where pricing, route access, and even advertising budgets were government regulated. Despite this, carriers found ways to compete through, service offerings, varying cabin mix between first and economy seating, and company image.

[7]
Air Asia employees are located in Malaysia and Thailand, with monthly salaries below MYR1800/USD500 THB11,000/USD290 per month for most employees (EIU May2003). Air Asia claims a unit cost of US 2cents per Available Seat Km, and at recently released fares earns a comfortable margin at over US3 cents/km for the lowest web-fare on offer between Bangkok and Kuala Lumpur (a yield barely acceptable to the full service carriers for long-haul flying) By comparison – average monthly salaries in Japan (with oncosts) total JPY408,000/USD3720 per month – giving carriers in that market a dramatically different cost structure.

[8]
JetStar Asia to Qantas, Tiger Airways to Singapore Airlines.


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