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Airline industry transformation: A case review in the South East Asian region-Vietnam

D.K.N.P Dassanayake, Bsc(Eng),MBA,
Dr. H.M. R. P. Herath, Senior Lecturer, Department of Marketing Management, University of Kelaniya, Sri Lanka

ABSTRACT: *Airline industry was one that is expensive and also took the transportation industry by storm, where the differentiated benefit of the speed in commuting had driven the industry to a larger scale across borders as well. Along with the basic requirement of speedy transportation been fulfilled for a higher price being levied, later onmore value was added by the traditional legacy airlines with additional services such as meals, entertainment, magazines and papers to read, hospitality and care by air hostesses for free. However after the advent of the year 2000, the legacy airline which was doing good with content customers and also been yearned by the non-targeted segments, lost revenue and underwent financial bankruptcy where no frills airline service, known as low cost carriers known for its lower prices, grew strong and fast in the market amidst lacking off on the facilities and comfort which was provided by legacy airlines; the scenario on the decline of the legacy airlines which also lost then content targeted segment of commuters and the strategy adopted by the low cost carriers making use of the macro environmental changes, and also its strategy to ensure financial profitability is observed in this study through analysis of secondary data from researches and industry research publications. The advent of the global economic crisis in 2008 that shrunk the financial capacity of both consumers and businesses, the prior deregulation of the airline industry giving access to new competition, and the strategy adopted by low cost carriers being carefully selective in cutting off excess facilities towards proving a no frill service for a lower affordable price, amidst other strategies adopted to increase efficiency in operations is looked in along with the risks faced by the low cost carriers, is analyzed in this study for further insights and clarity to the reader, in clarifying the strategic fit of low cost carriers in relation to the South East Asian market.*

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I. INTRODUCTION

The airline industry, which had emerged and rapidly grown in the past decades, had a series of changes in the strategy adopted by airlines amidst the change in the global economy, and competition. The airline industry was initially regulated, where legacy airlines were major players adopting a hub and spoke network structure. Regulations limited the competition faced by these airlines, along with actions related to merger activity, airfare, and route entry/exit decisions, as mentioned by Bailey, Graham, and Kaplan (1985, cited in Henrickson& Wilson, 2016).

A major motivation for deregulating the industry was the inefficiencies in pricing and operations, which included the restrictions on route entry and limiting the level of competition (Leick&Wensveen, 2014). Thus, with the deregulation, the airline industry became more competitive through the entrance of new, low-cost carriers, along with increased route competition between large legacy carriers.With this situation in the economy and the emergence of low cost carriers, the financial strain on the traditional legacy airlines was even more, causing most of them to fall to the brink of bankruptcy, while low cost carriers received more atraction and hence enjoyed substantial growth.

1.1 Purpose of the study

The traditional airline carriers tended to operate hub-and-spoke networks, that offered full service flights including food and beverages, first class seating, and in-flight entertainment (Leick&Wensveen, 2014). With such facilities conforming to comfortableness in commuting along with the speedy travel offered by airlines, the legacy carriers were flourishing in business. However, the target segment of the legacy carriers was disturbed in the late 2000s, which brought about the growth of airlines that offered a scant of facilities and comfort while charging a lower price; a typical no-frills airline service to the market. Liew (2017) stated in his study that in Asian countries like Vietnam, people who could afford the expensive airlines were very much happy about the speed in travel bundled with the comfort and convenience. Liew (2017) also mentioned of the presence of other segments who preferred air travel but could not afford it. The emergence of low-cost carriers long existed before the downfall of the legacy carriers, and this study is aimed on identifying the reasons and circumstances for the enormous transformation of the airline industry and the upsurge of low-cost carriers in the South East Asian market.

1.2 Methodology

The study utilized deductive approach where explanations are mainly supported by evidences and reviewed journal articles and industry publications to review the strategy and environmental phenomena that caused the tremendous growth of low-cost air carriers. Accordingly, literature review was employed as the main research tool. Paper attempted to discuss cases found within the period of the emergence, growth and sustenance of low-cost carriers for better insights for the readers.

II. THEORETICAL REVIEW

One of the major results of the liberalization of air services has been the development of low-cost “no-frills” airlines (Doganis, 2010) that has increasingly gained market shares; this business model is often called a Low-cost Carrier; LCCbeing its abbreviation(Beria, Laurino, &Postorino, 2017).

As per the study by Fernando, Saad and Haron (2012), interviews from several LCC managers in the Indonesian market resulted in the opinion that stated that the low-cost concept is most appropriate to be implemented in the South East market, with special reference to countries like Indonesia and Vietnam.The Indonesian LCC managers’ opinions reflected the opportunity in the Indonesian as well as the South East market, which was also supported by the study of Forsyth et al. (2006). The recent airline growth in the region, for example on the emergence of LCC business model and the Association of South East Asian Nations open skies policy, also suggests that LCC has had a major impact on airlines’ competitiveness in the ASEAN region(Beria, Laurino, & Postorino, 2017).

The open skies policy which was planned in the Asian region would allow all of the carriers of the respective countries of the association to fly without any limitations. The open skies policy would bring considerable benefitsto the region as a whole(Fernando, Saad, & Haron, 2012), depicting the room for further growth in LCCs.The LCC model is appropriate for the South East Asia environment as the market environment in South East Asia remains favorable for the LCC model, as stated by Fernando, Saad and Haron (2012) and Chang et al. (2008).

The LCC business model is promising as it can be seen from the market’s characteristics, such as the geographical regions, incomes, education, user-friendly technologies, lifestyles and low-fare tickets, which have been stimulating customers to consider traveling by air. LCCs attract passengers with low fares (Chang et al., 2008). Over 69 percent of passengers considered the ticket price to be the most important factor that influenced their choice of airline carrier (Fernando, Saad, & Haron, 2012; Zhang and Xie, 2005), where LCC taps on.With the presence of the LCC model, the society was attracted as this model contributed to many benefits compared to the traditional model (Fernando, Saad, &Haron, 2012).The LCC business model can survive and succeed in Asia so long as these companies can ensure an even lower operating cost than their legacy rivals (Lawton and Solomko, 2005; Forsyth et al., 2006).

III. REVIEW ON THE GROWTH OF LOW-COST CARRIERS

Traditionally, legacy carriers have tended to operate hub-and-spoke networks, that offered full service flights including food and beverages, first class seating, and in-flight entertainment (Leick&Wensveen, 2014). Alternatively, low-cost carriers developed point-to-point networks, offering few amenities, and focused on being more efficient and charging low prices. Francis, Dennis, Ison, and Humphreys (2007) and Button and Ison (2008) described many of the practices that have been developed and employed by these low-cost carriers to improve efficiency, including: offering a single class of service, using a single fleet of airplanes, high load factors, use of smaller airports and a generally non-unionized workforce. Thus, LCCs had significant cost advantages over legacy carriers, allowing them to differentiate themselves from the traditional legacy airlines.

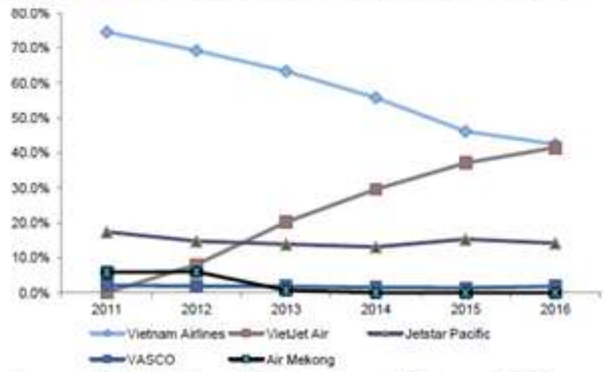
With the industry being majorly deregulated, the occurrence of the economic crisis in 2008 brought about a drastic change in the airline industry, across the globe, including South East Asia, which also brought about financial difficulties to air carriers (airlines). Henrickson and Wilson (2016) stated that if the airline industry was still regulated, an obvious solution that could have occurred was the transfer of the additional cost (resulting from the crisis) to the passengers; but the de-regulation status had already brought in high competition from airlines, especially low cost carriers (LCCs) that offered lower prices to the passengers, which brought about the rapid growth of low cost carriers (LCCs). This resulted in nearly every major legacy carrier being affected, which resulted in bankruptcy, where many resorted to the strategy of merging to address the situation. (Kim &Singal, 1993; Adler &Smilowitz, 2007; Kwoka&Shumilkina, 2010; Morrison, 1996; Richard, 2003).

Thus, where legacy airlines and low-cost carriers were seen earlier as belonging to separate strategic groups (as defined by Porter, 1979). As mentioned by Henrickson and Wilson (2016), legacy airlines was thought of as one "strategic group" as they offered in-flight amenities, charged higher fares and focused on dominating their hub airports. Low-cost carriers were thought of as a different strategic group as they tended to avoid hub airports and focused on providing low cost airfares without in-flight amenities. However, the challenges faced later on (as discussed), along with the impact of the internet in limiting airline pricing power (Brunger, 2010; Brunger&Perelli, 2009), had forced legacy carriers to alter their strategies. Especially, in 2001, the airlines began to debundle many of them in-flight amenities. This trend then continued as the legacy carriers began charging for check baggage, drinks, pillows, and other items that were previously complementary for passengers. As such, one of the primary distinctions defining legacy carrier strategic group has largely disappeared over the past 15 years. Where LCCs had been enjoying the benefit of efficiency and being lower priced, attracting customers; with legacy airlines having stepped down their differentiated efforts; low-cost carriers seized on the financial struggles of legacy carriers by changing their strategies to more directly compete with legacy airlines.

Borenstein (2011) stated that from the demand side, where low-cost carriers offered a lower-quality product, but charged a lower price, they captured the market share of legacy carriers, and those lower costs have allowed them a growth to a 24-percent market share in 2009, which reflects their enormous growth after the economic crisis.

Quang (2017) stated that the total Vietnamese aviation market has more than doubled in size, from 25 million passengers in 2012 to 52 million passengers in 2016, driven to a substantial extent by the low-cost travel. The Civil Aviation Authority of Vietnam reported passenger traffic growth of another 20% in 2017, to 30.3 million, and the growth rate estimates till 2020 is expected to follow the trend displayed. It is to be noted that the Asia Pacific region recorded a 5-year CAGR of 7.9% while Vietnam had an average 5-year CAGR of 13.42%, exceeding the region's growth (Dung, 2017).

Figure 1 - Domestic Market Share (%) by Passenger Volume



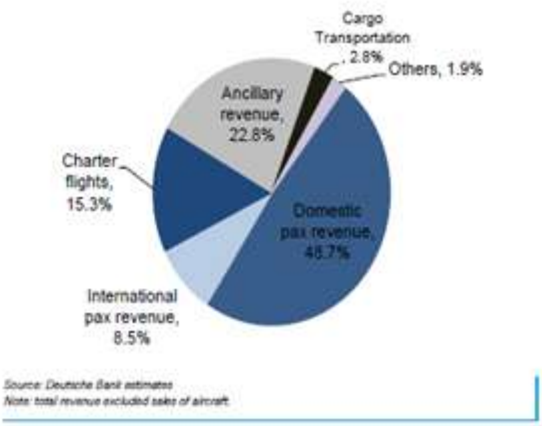
Source: Civil Aviation Administration of Vietnam (2016)

In 2009, Vietnam Airlines was the best in Vietnamese airline industry, which offered long route, high quality service for a high price. Meanwhile, there was a huge demand by people for flights who could not afford the high-priced tickets (Liew, 2017). Also, a lot of Vietnamese small and medium businesses who underwent economic crisis, tried to cut cost as much as possible including flight tickets. Jetstar Pacific was a low-cost airline in Vietnam, which was the first LCC in operation. It had benefitted from its low prices, but had a stagnant growth as it did not perform well to satisfy its customers. Vietjet Air addressed this opportunity by facilitating customers with low priced tickets, flying both short and medium routes, with a consistent service quality (Liew, 2017).

The growth of the two low cost carriers, VietjetAir and Jetstar Pacific, can be seen in Figure 1, where Vietjet Air had displayed tremendous growth in the five-year period, while Jetstar displayed a stagnant performance. The higher priced Vietnam Airlines that was dominant, lost its market share by half.

Charter flights are driven by Jetstar pacific and alsoVietjet targeting the low sale season, which are primarily requested by tour companies. Ancillary services had been an important aspect of revenue for LCCs, where Figure 2 depicts the percentage contribution of them to the revenue of Vietjet Air, amounting to 22.6%. In 2017, VietJet generated ancillary revenue of USD 13.60 per passenger, which was a 20% increase over 2016 where an ancillary revenue of USD 11.30 per passenger was obtained. Approximately 80% of its ancillaries are generated from ancillary fees. Cargo, sale of advertisements on its aircraft, and inflight merchandise (including duty free on international flights) account for the remaining 20%.

Figure 2 - Vietjet Revenue Breakdown (2019E)

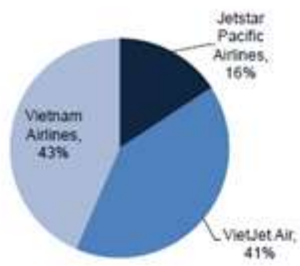


Source:Deutsche Bank estimates

Vietjet believes that it can continue to increase ancillary revenue as it expands its offering to include more non-core or non-flight items. Vietjet is particularly keen to develop new ecommerce platforms that will enable passengers to book flights and other items using social media and partners such as Google and Facebook.The domestic market grew from only 12 million passengers in 2012 to 28 million passengers in 2016, which equates to a staggering average per annum growth rate exceeding 30%, depicting the significant impact Vietjetand also Jetstar had in the industry and the economy. They not only made competitor customers' switch towards low cost carriers, but also attracted first time and infrequent fliers.

Thus, the LCCs cumulatively earned the majority 57% of the market share in Vietnam, with Vietjet having 41% and Jetstar having 16%, as seen in Figure 3.

Figure 3 - Domestic Market Share (Passenger Capacity) 2016



Source:Deutsche Bank estimates

Another dominant low-cost carrier of the region, Air Asia Airlines, currently operates 136 routes to 18 countries in the Asia/Pacific region and Europe and employs almost 7,000. They posted their best–ever set of financial results in 2009. Interestingly, though Air Asia was a Malaysian low-cost carrier, they increased their chances by signing a strategic alliance with Jetstar of Vietnam (aviationstrategy.aero, 2010).

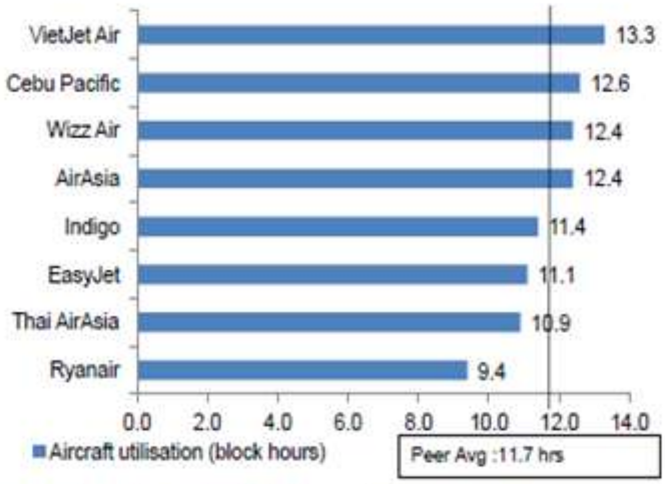
AirAsia's unit costs are among the lowest in the global aviation industry. There is a continuing effort to cut costs (for example, AirAsia aims to eliminate airport check–in by the end of this year, with all passengers then having to check–in online). It is also claimed that AirAsia's expansion options throughout Asia was greater with the new partnership with rival Jetstar, to the extent AirAsia and Jetstar say stated that many hundreds of millions of dollars of cost–saving opportunities are exploited, thought to be in the region of A$200m to A$300m (US$184m–US$276m) annually.

Having seen the growth of these three low cost carriers, where Vietjet had grown on its own, so as Air Asia. Growth with partnership was seen in the case of Jetstar and Air Asia as well. To see how well the strategy of going for a business model of low cost carrier had worked, the three airlines were analyzed, which resulted in the realization of the following.

To offer customers cheaper flight tickets, multiple aspects were looked in, to reduce expenditures.They provided a no-frill product, eliminating expenditure on cutting off entertainment, free meals, magazines, etc on flights. The airlines offered very minimum service on all flights. For customers looking for other services such as souvenirs, meals, etc., they had to pay more money to enjoy those services. In addition, short routes were majorly used which approximately takes less than 10 hours for both ways, allowing aircrew to come back and thus reduced the cost of accommodation expenses for air crew. In addition, the low-cost airlines were able to shorten their parking time at airports reducing parking fee as well. Further, they worked on minimizing costs incurred for travel agents who played a substantial role in revenue; For an instance, Vietjet stopped paying commissions to agents in 2015 while retaining them. It still paid incentive fees to agents, and those fees account for approximately 0.3% of its total costs. Vietjet's total cost of distribution was very low, enabling them to keep its costs down. Also, it was observed that in several areas, decentralization of fuel supply had resulted in a lowered cost due to competition. Fuel accounts around 60% of a generic airlines cost, thus, this action had brought about advantage to all airlines in reducing costs.

The government also regulated prices of the following to support the growth of airlines, in countries like Vietnam, which was a massively growing market whose benefit was obtained by the low-cost carriers.Airport services which the state regulated the price and price frame included the take-off and landing services, aviation security assurance services, passenger service at airports, flight control services, aircraft parking services, check-in counter facilities rental, baggage conveyor belt rental, aerobridge rental services, and package ground handling services.

Figure 4 - Industry leading Aircraft Utilization



Source: Deutsche Bank; SAP Independent Industry Report, Airbus

The number of air travel routes was also increased to share their overhead costs and other fixed costs across to both exploit the gaps in the market and expand their margins. Efficiently utilizing their capacity, most of the low-cost carriers aimed in this arena as well, to utilize their aircrafts as much as possible. As seen in Figure 4, both Vietjet and Air Asia, being LCCs, are in the top amongst those who utilized their airlines well, but there are quite a number of risks faced by low cost carriers in the South East Asian region as well.The effective tax rate which was 4% in 2016 and 7% in 2017, is expected to rise to 10% in 2019, impacting earnings (Liew, 2017). Fuel prices fluctuated during the years, where average jet fuel prices of USD 91/barrel, USD 100/barrel and USD 105/barrel was computed for the years 2017 to 2019 respectively (Liew, 2017). Currency depreciationin many asean countries, where according to Liew (2017), about 69% of the low-cost carrier Vietjet in Vietnam in 2017 costs are in USD and this includes items such as leasing expenses, finance cost, fuel and maintenance expenses. Aircraft acquisitions were also in USD. Thus, a depreciation of the local currency versus the USD would be detrimental. For an instance, a 5% depreciation (year-end) of the VND versus the USD would result in a 24.7% cut in the earnings. The same is applicable to most LCCs, as transactions are dealt majorly in USD, Sterling pounds and Euros, which will be having its impact on currency depreciation.Le (2016) stated that the massive amount of flights ordered by Vietjet, Jetstar and Air Asia (by lease and acquisition) results in massive payments, which could hinder the working capital availability of the company. Maintenance costs will likely increase significantly over time, along with aircraft lease costs and fuel costs. These higher costs, as well as inflationary pressure on wages and the depreciation of the Vietnamese Dong, would put more pressure on these low-cost carriers in the future.

The peculiar elements of the LCC scheme can still be identified according to the aspects of organizational, commercial, and technical (de Wit &Zuidberg, 2012; Dobruszkes, 2006; Doganis, 2010; Hunter, 2006; Lawton, 2002). Beyond the cost minimization and efficiency maximization approach of the low-cost/low-fare model (Doganis, 2010), there are several other factors may explain the dramatic rise of low-cost services.

The distinctive features seen in LCCs which brought about its strategic fit are diverse. LCCs adopted point-to-point connections on short/medium haul routes rather than hub & spoke schemes. To reduce its cost even more, they used secondary non-congested airports with slots available at a relatively low price. Sales were also done using direct online selling, mainly ticketless, and also the use of agencies to ensure the capacity is utilized. As stated by Beria, Laurino and Postorino (2017), LCCs used high commercial ability to bargain with the airports for favorable conditions such asairport charges, handling, etc. They also provided in-flight catering services (i.e., meals, drinks, etc.) to ensure customers are not getrid of facilities required (even though for a fee). It was also observed that a high rate of advertising was also used to promote the brand and increase the number of passengers. Most LCCs used a single or restricted number of models of new aircraft.Further, aircraft cleaning was done by the cabin crew to reduce cost and turnaround times.All of these factors contributed to minimizing the cost of the LCCs.

IV. CONCLUSION AND FURTHER RESEARCH DIRECTIONS

Franke (2004) described how low-cost carriers not only avoidedtroubles that legacy carriers faced, but also actually benefited during the economic crisis by offering similar quality at a significantly lower cost due to their more cost-effective operation models. Further, the low-cost carriers could directly compete with legacy carriers, as the legacy carriers were unbundling their services, both serve to improve efficiency (Henrickson& Wilson, 2016).The strategic fit of the low-cost carriers in the South East Asian region had been primarily set by the demographic tendencies of the people, from their income levels to the need of speedy transportation. This was addressed by the low-cost carriers, who exploited the economic crisis in 2008 to be dominant in the people's lives. Going no frills (as shown by the Bowman's strategic clock) with a low air fare, they were a high appeal to passengers. This strategy was afforded by eliminating costs as well as improving efficiency and sharing costs in their operations. Low airport charges, quick turn arounds, simple terminals, andaffected the overall the level of demand, these findings were similar to the conclusions of studies done by Barrett (2004) and Gillen and Lall (2004). As seen not only by studies, but also by managers of low-cost carriers, the Asian region is preferably the best space which works out with the low-cost carrier business model.

Areas of further research entails the identification of technological aspects and standard of living of the people in relation to the transformation of the airline sector, along with the role of countries adopting open air policies inviting foreign airlines to cater to the target market. Further, insights on the effectiveness of cost management methods utilized by the legacy airlines and low-cost airlines need also to be studied on as financial burden played a role in the airline industry transformation.

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