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When being the lowest cost is not enough: Building a successful low-fare airline business model in Asia

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Abstract

Following the success of budget airlines in Australia, regulatory barriers were eased elsewhere in Asia Pacific to allow the proliferation of low-fare airlines (LFAs). The aim of this paper is to assess whether the profit and growth potential of Asian LFAs are hampered not just by remaining regulatory barriers but also by the embedded revenue and cost advantages of their full fare rivals. The LFAs business model can survive and succeed in Asia so long as these companies can ensure an even lower operating cost than their already cost-efficient full-service rivals. LFAs based in low-income countries with a relative lack of viable land transport infrastructure (e.g. Malaysia) are likely to achieve the greatest market stimulation.

Keywords: Low-fare airlines; Asia; Cost competition

1. Introduction

Following late on the global trend, low-fare airlines (LFAs) rapidly emerged across Asia.[1] After deregulation in 2000, Skymark appeared in Japan, explicitly modeled on Southwest Airlines, and a second carrier, Air Do soon followed. Carriers claiming to be modeled on leading American and European budget airlines also emerged in Thailand (PBAir and Air Andaman) and in Cambodia (Siem Reap Air). In late 2001, AirAsia was re-launched in Malaysia as a no frills operation. In the Philippines, Cebu Pacific Airways, also modeled on Southwest, kept costs down by selling online and operating out of secondary airports. India's first budget airline, Air Deccan, launched in late August 2003 and Valuair and Tiger Airways commenced operations in 2004, both based in Singapore.

As industry shakeouts in the US and Europe illustrated, most of these new entrants were unlikely to survive. In addition to having robust business models and adequate financing—as well as avoiding predatory behavior and regulatory hurdles—the long-term survival of these carriers depended on their ability to compete with Asia's full service legacy airlines. The prevailing sentiment among the Asian majors, expressed by the Asia Pacific Airlines Association in early 2003, was that no-frill fliers are not a threat to Asian airlines. This optimism from full-service Asian carriers is examined to see if it is based on facts or if these companies are 'misjudging' the strengths and adaptability of the LFA business model. Revenue and costs aspects of the potential for LFA growth in Asia are addressed. The revenue side is important as some industry experts argue that the average domestic and intra-Asian fares are already very price competitive as compared to the historical situation in Western Europe or North America prior to the emergence of LFAs. Another focus is an examination of which Asian countries provide the most favorable market environment for low-fare entrants with the least regulatory barriers

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[1]We refer to 'Asia' but are specifically dealing with southeast and east Asia.

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together with a mobile and open-minded consumer population.

On the cost side, the fundamental difference between the Asian and the North American or Western European aviation markets are examined from the perspective that Asian majors already possess lower operating cost structures; their network and fleet structures allowing them to achieve a lower cost per seat than their European or North American full-service counterparts. Most Asian majors operate in high-volume markets with wide-body aircraft that mean lower costs per seat and ensure their market dominance between major population centers. As Ergas and Findlay (2003) found in their work on Virgin Blue's entry into the Australian market, the network structures, range of differentiated services and yield management systems of the full fare carriers constitute important market advantages. Any emerging LFA will find it more challenging to compete with majors that possess such inherent cost advantages, combined with Asia's more flexible hiring practices and labor laws. The common prediction is that any LFA would have a more difficult time surviving in Asia, where a cost gap between a traditional full-service airline and a potential low-cost entrant would be much narrower than in the North American or Western European markets.

The paper draws on primary and secondary documentation from Asian, North American and European airlines and associated organizations. In addition, interviews were conducted with a sample of expert witnesses, comprising a representative group of high-level managers from both full service and budget airlines in Asia.

2. Strategic management in the LFA business

2.1. Developing the low-fare business model

The term 'business model' has a variety of interpretations. In his value chain concept, Porter (1980) describes it as a process for delivering value. By comparison, Magretta (2002) describes is as the corporate story, i.e. how is profit generated? In a more applied sense, Drucker (1980) refers to the business model as the dynamic for delivering what the customer values. We prefer to argue that the business model synchronizes the market perception and the corporate reality. Put another way, the business model is a vehicle for delivering the value proposition to the customer. Each element of the model is a function of part of a value proposition. Therefore, cost is a function of price, innovation is a function of features, execution is a feature of quality, relationships are a function of support, channels are a function of availability and brand is a function of reputation (Finkelstein et al., 2005). In choosing a competitive strategy, a key consideration for company strategists is how to configure the value equation so as to best meet customer demands and offer a viable value proposition. For LFAs, this means striving to achieve the lowest possible prices for their services. Low prices cannot be sustained unless a company maximizes its operational efficiency. This means that the company has to perform similar activities better than rivals (Porter, 1996). One way of doing so is to pursue a rigorous policy of cost cutting. Cost structures constitute a clear distinction between a LFA and a full service airline. One revealing measure of the running costs of an airline is cost per available seat kilometer (ASK). When cost per ASK is compared between airlines, carriers such as Ryanair and easyJet in Europe and Southwest in the US are, on average, operating at almost half the cost of full service carriers (Campbell and Kingsley Jones, 2002). Campbell and Kingsley-Jones further argue that the chief cost differences between low fare and full fare airlines fall into three groups: service savings (e.g. no frills cabin service and extensive use of outsourcing); operational savings (e.g. point-to-point services and uniform fleet); and overhead savings (e.g. internet sales and a streamlined bureaucracy).

How do LFAs ensure considerable cost advantage over traditional airlines? Doganis (2001) argues that the LFAs begin with two initial cost advantages arising from the nature of their operation: higher seating density and higher daily aircraft utilization. By removing business class and reconfiguring their aircraft, LFAs can significantly increase the number of seats on their aircraft. The seat pitch of a LFA is usually 28 in, compared to a conventional economy class pitch of 32 in, thus increasing the maximum capacity of each flight. Overall, Doganis calculates that LFAs should be able to operate at seat costs that are only 40–50% those of a mainline rival. If this is combined with a significant load factor differential and lower distribution costs, a LFA's cost per passenger can drop to about one-third those of a conventional airline's.

2.2. Building a low-fare strategy beyond cost advantage

As Binggeli and Pompeo (2002) have shown in their study of the LFA sector, lower costs and higher seat load factors permit no frills carriers to offer fares 50–70% lower than those of the incumbents. AirAsia's management argues that strict adherence to the budget model pioneered by Southwest Airlines and low labor costs available in Malaysia result in the lowest operating costs in the world: $0.04 per seat mile; half those of Ryanair's.

As more entrants enter the LFA business and as traditional airlines restructure to become more cost efficient, competing on cost/price alone becomes less