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What Determines Airline Profitability: Industry Conditions or Firm Level Capabilities?

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ABSTRACT

Loss making airlines typically blame industry conditions and cite reasons beyond their control for their losses. None of these airlines ever acknowledge that they might have failed to develop or leverage existing firm level capabilities in order to deal with difficult industry conditions. It is an established view in strategy literature that difficult industry conditions can be overcome by developing appropriate firm level capabilities. Therefore, the role of firm level capabilities in determining profitability cannot be ignored. This paper proposes that very difficult industry conditions in the airline industry can be overcome by leveraging one’s resources and capabilities as is the case with other industries (Peng, 2001; Lahiri et. al., 2012). The performance of Malaysia Airlines and Air Asia is analysed and contrasted in support of this argument.

Key Words: Airline Industry, firm level capabilities, industry conditions, Malaysia Airlines, Air Asia, Airline profitability.

INTRODUCTION

Airline CEOs routinely blame industry conditions such as competition from budget airlines, the weather or rise in oil prices while announcing losses or bankruptcy. Using publicly available data such as annual reports and press releases of the top loss-making airlines from Asia (includes Australia) one finds that airline managements have typically blamed higher fuel prices; currency depreciation; low yield in industry or industry conditions for making losses (see appendix 1 for details of top eight loss making airlines in Asia). The logic extended by airline managements that industry conditions are to blame, ignores the well-established theoretical understanding of strategy that a firm’s resources and capabilities (Barney, 1991; Peng, 2001; Lahiri et. al., 2012) can be deployed to overcome difficult industry conditions. Nevertheless, the failure to develop firm level capabilities required to deal with external factors and run the airline at a profit is never mentioned by airline company CEOs when they announce losses and bankruptcy. In other words, managements of loss-making airlines simply shift the blame on industry conditions for losses that most of the time demonstrate lack of management capabilities per se.

It is also observed that shareholders, investors and governments accept financial reports and statements from CEOs of loss making airlines that their losses are on account of industry conditions. In fact governments have bailed out airlines in such situations as with the cases of Air India, Garuda Indonesia and Malaysia Airlines to name a few. Airline managements seem to have succeeded in selling the line that industry conditions, currency depreciation, fuel prices have a profound impact on profitability. One notices an absence of a body of literature relating to the airline industry that can challenge this view and suggest otherwise.

This paper proposes that very difficult industry conditions in the airline industry can be overcome by leveraging one’s resources and capabilities including the building of capabilities as is the case with other industries (Peng, 2001; Lahiri et. al., 2012). Airline industry cannot claim to be very different in terms of applicability of theories of strategy. Therefore, this paper strongly advocates the argument that airline losses are mostly attributable to poor management skills in managing both tangible and intangible resources and their effective utilisation.

The paper starts with a literature review and discussion of relevant literature in the first section followed by a brief history of both Malaysia Airlines (MH) and Air Asia (AA) in the second section. The next three sections contain analysis of MH and AA from industry based, resource based and institution based aspects. The sixth section discusses the impact of all three perspectives on the performance of both airlines concluding that firm level capabilities have played a significant role in AA’s profitability vis-à-vis MH. The last section discusses directions for further research while acknowledging certain limitations.

LITERATURE REVIEW

A literature review using key words such as ‘airline profitability’; airline bankruptcy’; ‘airline losses’; ‘aviation industry losses’; ‘industry conditions and airlines’; ‘resource based view and airlines’ across all major databases reveals only two articles (Gene et.al, 2006; Low & Lee, 2014) dealing with airline profitability and its connection with firm level capabilities. The first study by Gene et. al (2006) deals with US regional airline profitability. In their work, the authors have concluded that external factors such as rise in oil prices or seasons had no significant effect (statistically) on profits. In the
same study, the authors concluded that airline profitability depended more on internal performance enhancing factors rather than industry conditions thereby implying that internal performance enhancing factors depend on efficient deployment of resources at the disposal of an airline. The study by Low & Lee is a comprehensive longitudinal study of 114 airlines over a period of 23 years (1987 to 2010) relating to factors impacting airline profitability. The authors have concluded in their work that ultimately it is intangible resources (such as service skills, reputation, safety record, market entrenchment) that make a difference between a profitable airline and another that is not.

Besides these two studies, one does not come across research or case studies that is specific to Asia that relate to answering the question as to whether it is industry conditions or it is firm level capabilities that determine or at least have a strong influence on airline profitability. One, therefore, notices that literature relevant to the airline industry in Asia is practically non-existent to challenge the popular chant of airline managements (see appendix 1) that industry conditions are to blame for their losses.

As stated in the preceding section, one comes across only two quantitative studies that advance the role and relevance of firm level capabilities in determining airline profitability. Building on these two papers as an emerging body of research in support of the view that resources and capabilities can overcome difficult industry conditions in the airline industry, this paper undertakes the analysis of two airlines from Malaysia, namely Malaysia Airlines (MH) and Air Asia (AA) as case studies to explore and answer the research question posed here. Both airlines are suited for this discussion and analysis as they originate from the same country, operate in similar market conditions and have access to similar resources (although MH being a government sponsored airline has certain additional advantages). In recent years both these airlines from Malaysia are performing in two different directions. MH has been making losses year after year while AA consistently makes profits and expands operations. Both airlines operate in similar institutional contexts and similar markets. However, one airline loses money while the other makes money and grows. Given the fact it is the same industry, same country of origin and therefore subject to similar formal institutions and markets then what is it that contributes to the difference in performance?

From a theoretical perspective, using case studies to build theory is an established way of doing research (Eisenhardt, 1989 p.534) hence analysis of both MH and AA is considered here to initiate a debate as to whether firm level capabilities matter or industry conditions do in the airline industry? Use of even one or two cases studies in building theory is an accepted way of doing research if they are powerful exemplars that address the research question. Both airlines are analysed in the following sections using a three perspective analysis, namely industry based, resource based and institution based views in order to explain some of the variations in firm level capabilities. Therefore, other related aspects such as the importance of a culture of innovation and the role played by formal and informal institutions i.e. the institution based view (Peng et. al, 2009) in an airline’s success is also discussed.

BRIEF HISTORY OF MH AND AA

In October 1937, MH started operations with one aircraft as Malayan Airlines flying between Penang and Singapore.16 It became the national carrier of Malaysia in 1947. Later, in 1963, it changed its name to Malaysian Airlines Ltd. operating 17 aircraft and employing 2400 people.17 Sometime in 1965, when Malaysia and Singapore separated, Malaysia Airlines was renamed Malaysia-Singapore Airlines and introduced flights to Perth, Taipei, Rome and London.17 In 1972, Singapore parted ways with Malaysia and established Singapore Airlines. As a consequence Malaysia-Singapore Airlines was renamed Malaysian Airlines Systems as Malaysia’s national flag carrier. It currently operates as Malaysia Airlines.

Air Asia’s founder, Tony Fernandes, intended to start a domestic airline in Malaysia and met Malaysia’s Prime Minister in 200118 who offered him a debt laden government owned airline for 1 ringgit along with two old aircraft and liabilities amounting to 40 million ringgit.19 Fernandes bought the airline and relaunched AA as Asia’s first low cost carrier with a marketing slogan “Now everyone can fly.”20 “When AA restarted operations in 2002 only 6% of Malaysians had flown on a plane.” The airline’s maiden flights based on low fares within regional Malaysia were an instant success. AA’s marketing campaign “now everyone can fly” targeted 94% of Malaysians who had never flown before. The branding of Air Asia as a low cost airline committed to making air travel affordable for 94% Malaysians was the defining point of its vision, mission, goals, values and ultimately its success.

INDUSTRY BASED ANALYSIS OF MH AND AA

The airline industry is considered extremely risky and subject to a number of external factors, at times, beyond a management’s control and assessment. A basic analysis of the airline industry using Porter’s five forces model (Porter, 1980) reveals typical issues that impact both airlines:

i) Intensity of rivalry is very high: Currently 240 airlines in 115 countries are members of
International Air Transport Association. Both MH and AA face stiff competition in the international sector from rivals such as Singapore Airlines, Thai Airways, Emirates, United Airlines, Lufthansa, British Airways, Virgin Atlantic, Garuda, Cathay, China Eastern and China Southern for passengers and cargo. In the domestic sector, Air Asia enjoys some first mover advantages in regional Malaysia and the ASEAN region. Nevertheless, AA faces competition mainly from Tiger Air and Lion Air in the same segment.

ii) Bargaining power of buyers is strong with a number of airlines offering similar routes and services meaning the industry is highly competitive and is likely to yield low returns. During the period 2004-2014, the annual net profit margin, across the industry, per departing passenger has ranged from -1.5% in 2004 to 2.4% in 2014 with the worst ever margin reported in 2008 at -4.6%. The impact of this force applies equally to both MH and AA and as a consequence both pursue competitive pricing policies.

iii) Bargaining power of suppliers is both strong and weak depending on the supplier one considers. For instance, aircraft purchase or leasing is a cost of major significance. Boeing and Airbus are the only significant suppliers of aircraft to airlines. Both sell aircraft at prices that are highly profitable for them. Both are known for late deliveries of aircraft to the detriment of airlines as they have a combined order book of 10,600 aircraft. The impact of this force applies equally to both airlines and they have no choice except for buying either Boeing or Airbus at manufacturer’s terms.

Airline享受 some bargaining power with suppliers such as inflight caterers. This alone cannot yield significant savings as inflight catering and other services do not form the lion’s share of an airline’s cost structure.

iv) Threat of new entrants is high due to open skies policy in most parts of the world along with access to aircraft leasing options to start an airline. This has ushered in a number of new entrants around the world including the ASEAN region. The force impacts both MH and AA equally without any control over it.

v) Threat of substitute for airline travel in regions of poor connectivity is limited thereby creating opportunities for the industry. However, threat of substitutes for air cargo is evident in the decline of air cargo business with rail and road transport offering a stiff competition in many parts of the world. AA has benefitted from poor connectivity in Malaysia and ASEAN more than MH as explained in the discussion that follows.

Overall, from an industry based view the airline industry remains unattractive in terms of profitability. Building serious long term competitive advantage for many an airline has not been possible as evidenced by the return per passenger kilometre and the decline in cargo business. Both airlines are thus exposed to similar industry forces. Nevertheless, AA has repeatedly made profits for the last 13 years while MH has been losing money during the same period except for one year implying that industry conditions has limited influence on their performance.

RESOURCES BASED ANALYSIS OF MH AND AA

Each airline’s resources are evaluated using the VRIO framework (Barney, 1991 pp.105-106) in terms of value, rarity, inimitability and organisational factors and their contribution towards superior performance and profitability.

MH as Malaysia’s flag carrier uses Kuala Lumpur International airport (KLIA) as their main hub. A relationship of osmosis exists between a nation’s flag carrier and a nation’s transit hub (Roy, 2012) and this applies in case of MH and KLIA. MH enjoys premium airport space allocation, best landing and parking slots along with arrival and departure times that others would find difficult to obtain at KLIA. This is an extremely valuable, rare and inimitable resource.

AA’s brand identification with regional markets in Malaysia and the ASEAN region has proved to be its most valuable, rare and inimitable resource. In its early years, AA’s marketing slogan “now everyone can fly” helped the airline identify with 94% of Malaysia’s population who had never flown before. If one compares AA’s marketing slogan vis-a-vis MH’s vision statement “To be the preferred premier carrier”, one can conclude that MH limited their target market to people who could fly a premier carrier. This ruled out a large segment of Malaysians who had never flown before but had the potential to become customers especially in the domestic context. MH through their limited vision statement profiled 94% of Malaysians as potential customers. They concentrated resources on a small target market i.e. 6% Malaysians plus foreigners flying in and out of Malaysia. The market in regional Malaysia ignored by MH later became the customer base that helped AA grow. Ong & Tan (2010, pp. 211-212) confirm that passengers from regional Malaysia are more likely to choose AA over MH except for business travellers or non-internet users. The authors confirmed that majority of customers from regional Malaysia prefer AA for a number reasons including excellent point to point connectivity without a mandatory stopover at Kuala Lumpur, a feature of MH.

AA pioneered routes within regional Malaysia and other regions in ASEAN countries. AA created a number of regional hubs to operate point to point flights connecting different regions of each
country within 3 to 4 hour flying distances. Some of these flights meet at Kuala Lumpur effectively linking regional Malaysia, Indonesia and Thailand with Kuala Lumpur. The airline runs point to point services from regional hubs such as Kuching, Penang, Kota Kinabalu in Malaysia, Bangkok in Thailand and seven regional hubs in Indonesia connecting most regions of each country. These pioneering routes and their regional hubs add immense value to AA’s operations. AA passengers on these routes can also connect with international flights on Air Asia X at KLIA2. The AA flight network thus is a value adding network that is difficult for anyone to imitate without creating regional networks first to feed into the international connection at KLIA.

According to Toh & Higgins (1985), multiple hubs contribute to higher airline profitability and other operational and marketing advantages. Some key advantages of such a network model noted by Toh & Higgins (1985, p.17) are: i) hubs generate traffic between two different places that otherwise would not have sufficient air traffic between them without the hub; ii) operations can be conducted with minimum number of aircraft of smaller sizes thereby achieving higher aircraft utilisation rates; iii) savings are generated in apron and maintenance services by centralising them at each hub; iv) hubs can help an airline identify with a region thus providing certain unique marketing advantages. Thus, AA’s business model comprising of regional routes within Malaysia and other ASEAN countries connecting effectively with KLIA2 is a winning revenue yielding strategy.

AA also adds value by using a large fleet of Airbus A 380s vis-à-vis Boeings used by MH. Airbuses are smaller, fuel efficient, suitable for point to point services connecting airports under 3 to 4 hours distances, while the Boeing fleet operated by MH is suitable mostly for long haul destinations and more expensive to run. In order to replicate AA’s regional network, it will take MH a complete reconfiguration of its fleet to make it suitable for regional routes and airports. This is yet another valuable, rare and inimitable asset in the possession of AA.

Contrast MH’s strong connection with KLIA and its focus on the premier market segment vis-à-vis AA’s regional appeal, access to KLIA2 and attention to a larger market segment that is likely to have more spending money with a vibrant Malaysian economy. Compare the aircraft configuration owned by each airline, route relevance, utility and cost of maintenance and one can safely conclude that AA has designed firm level capabilities and operations to serve the chosen target market much better than MH.

Except for its connection with KLIA MH does not possess anything that can be termed as rare or inimitable from a resource based perspective. MH thus cannot achieve a competitive position in the domestic market easily. The limited domestic operations by MH are largely a response to Air Asia and Tiger Airways without achieving anything that can be considered rare and inimitable. MH also faces tough competition from a number of other competing airlines using KLIA and nearby transit hubs in Singapore, Hong Kong, China and Indonesia. Stiff competition comes from Singapore Airlines, Emirates, Qatar Airways, Garuda Indonesia and Cathay Pacific with better service reputation, easier connectivity and competitive ticket prices. Here again, MH does not possess anything valuable, rare and inimitable except for their access to KLIA in comparison with AA’s customer offerings of low fares and the routes flown within Malaysia and the ASEAN region. Many of these routes had never been served before meaning potential customers along these routes never had the opportunity to consider flying as an option. These hitherto unserved routes that AA chose to service have lent a great degree of value and rarity to AA from a resource based perspective. AA faces very little competition on many of these regional routes and continues to introduce newer routes, some of which are untried. AA thus enjoys the advantages of rarity in customer offerings, inimitability in achieving customer loyalty and regional identification.

AA’s superior competitive positioning has also been achieved through organisational factors typical to Air Asia that generate employee commitment and better customer service. Fernandes as CEO leads by personal example and has been found working alongside baggage handlers, counter sales and reception staff, and as part of inflight cabin crew attending to customers. He mentors and encourages staff at all levels to excel and seek growth within the company. AA is the only airline in the world where baggage handlers and customer service staff have worked their way through the organisation, acquired pilot training funded by their employer and become pilots. The same cannot be said about MH because MH replicates the bureaucratic style of leadership of its major shareholder, the government of Malaysia. MH is hierarchical with a highly unionised work force and a long history of antagonistic work place relations. Its board of directors are mostly appointed by its major shareholder. Contrast this with AA’s culture of a non-hierarchical CEO who considers his employees as one big family and can be seen working alongside staff at all levels from the cockpit to baggage clearance. AA has achieved strong levels of employee commitment and work ethic motivated by the founder and the aspirational career pathways offered its employees. This organisational factor is a huge strength for AA and extremely difficult to replicate for MH.

AA has achieved high levels of value, rarity, inimitability supported by unique organisational factors that have created superior firm level capabilities. In a ruthlessly competitive industry AA’s superior firm level capabilities denoted by achievements of value, rarity, inimitability and
organisational factors in their operations have translated into superior performance and profitability. AA could achieve these for it started with the desire to serve a virgin market in the ASEAN region and relentlessly concentrated on achieving cost efficiencies, customer conveniences, innovative practices, regional connectivity and a work place culture that offered unlimited opportunities for staff and best services for customers. In other words AA focussed on developing required firm level capabilities.

INSTITUTION BASED ANALYSIS OF MH AND AA

An institution based analysis of both airlines reveals that both got easy access to a licence to operate from the government. MH started as British owned Malayan Airlines in 1937 with permission from the colonial administration and later became a partly government owned company. AA too got easy access to a licence because it purchased a debt laden airline for one ringgit from the Malaysian government. Just obtaining a licence by itself could not have achieved much, had the airline’s management not used it to their advantage. Additionally, MH has been the government most favoured airline in a number of ways which they could not capitalise on.

The informal institutional aspect of Malay culture where people visit their relatives and friends as often as possible has worked in favour of AA. This cultural inclination to travel acted as the backbone against which AA’s internal routes within Malaysia coupled with low fares created opportunities for profitability and sustained growth while MH failed to see the same as an opportunity.

THE DIFFERENCE BETWEEN MH AND AA

The difference in achievements between the two airlines reflects the outcome of their individual firm level capabilities. AA has been voted the world best low cost airline for the fifth consecutive year operating on 182 routes with 79% aircraft utilisation factor.\textsuperscript{xxvii} The airline flies 158 aircraft (average aircraft age is 3.5 years) on 182 routes connecting all 10 ASEAN countries. AA earns an operating profit margin of 20%, regularly announces new routes and has a dedicated employee base of 13000 people who are called ‘All Stars’.\textsuperscript{xxxi} AA has 200 additional aircraft on order with Airbus\textsuperscript{xxi} and will have a larger and younger fleet than MH for years to come. Compare this with MH’s aircraft utilisation of 72%\textsuperscript{xxvi} with a fleet of 147 aircraft (average fleet age of 7.3 years)\textsuperscript{xxvii}, employing 16246 people\textsuperscript{xxviii} and a history of negative work place relations. MH announced a loss of 1,174 billion ringgit for the year ended December 2013.\textsuperscript{xxv} This does not include accumulated losses of past years nor the losses subsequently suffered as a consequence of the downturn in passenger bookings after the two tragic incidents with their flights MH370 and MH 17. At the time of writing this paper, MH is being bailed out by the government through a stock exchange delisting and a restructuring plan that will include downsizing the work force, the number of aircraft and routes flown.

The difference has occurred in their understanding of the market and the nature of capabilities needed to serve that market effectively. MH intended to be a “preferred premier carrier” while AA aimed “to be the largest low cost airline in Asia and serving the 3 billion people who are currently underserved with poor connectivity and high fares.”\textsuperscript{xxv} The two statements actually spell out the chosen markets, AA chose a larger market than MH while MH with a 77 year history stuck to operations as a premier airline in a much narrower market of full service airlines. MH operated largely on international routes where the nature of competition has changed dramatically during the last decade. MH also failed to recognise the potential customer base of a burgeoning middle class in regional Malaysia and the ASEAN region.

AA’s business level strategy to serve 3 billion people who are currently underserved with poor connectivity and high fares helped AA seek firm level capabilities to do that. This strategy is in line with Hamel (1998) and Markides (2000). In a service industry, to be effective, one has to typically start by asking questions proposed in Markides (2000): (i) who are our customers or who should be our customers? (ii) What value can we offer them and (iii) how do we go about doing both these? AA asked precisely those questions and connected with customers effectively while MH chose a narrower market without defining the nature of customer value to be provided except for references to providing Malaysian hospitality, exceeding customer expectations, making travel and doing business hassle free.\textsuperscript{xxv} It is not clear whether these customer value propositions worked for MH or not and whether MH actually created firm level capabilities to deliver them.

Once a company has worked out who the customers are and the value proposition to be achieved (in case of AA, it is lowest cost and highest quality product) then it becomes relatively easy to focus on its supply chain and seek cost efficiencies. This is what AA did by its relentless pursuit of operational cost efficiencies without compromising the quality of customer offerings. In other words, AA developed firm level capabilities required to deliver customer value. The discussion in this paper confirms to an extent (see next section on limitations) the relevance of firm level actions to build firm level capabilities that creates advantages peculiar to a firm and that can, in turn, lead to growth and profitability in an unattractive industry. AA can remain profitable as long as it continues to achieve competitive advantage through innovation, creation of superior resources and capabilities.
DIRECTIONS FOR FUTURE RESEARCH AND LIMITATIONS

This paper initiates a debate specific to the airline industry by analysing two airlines from a single nation serving the ASEAN region. The paper has addressed a fundamental question as to whether firm level capabilities or industry conditions influence airline performance. By nature of the question asked and the use of two case studies from a single nation certain limitations are inherent in the paper namely, two case studies may not be sufficient to justify a sound conclusion but can act as pointers for further research. In addition, the question being mutually exclusive does not consider situations when both aspects can combine to influence performance outcomes. Additionally, the role of institutions (both formal and informal) as applicable to MH and AA has been discussed but their influence in enhancing the utility of resources has not been fully explored in the paper. Further research, both qualitative (using case studies) as well as quantitative studies encompassing a broader group of airlines across continents is needed to explain, understand and conclude as to what really has a profound influence on airline profitability.

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   CEO has blamed higher depreciation, weakening value of ringgit and falling yields as the reason behind their losses.

2. Eva Air, Taiwan losses blamed on increased fuel prices – see

3. Garuda management blamed currency depreciation and increased fuel prices for its losses in 2013 – see Annual report 2013

4. Air India CEO in the airline’s 2013 report attributed the airline’s losses to a ‘hostile cost environment’ and ‘soft yields’; uncontrollable costs such as fuel costs, high airport costs and currency depreciation (Rupee against the USD)

5. China airlines, Taiwan losses blamed on increased fuel prices- see

6. Thai Airways management attributed their 2013 losses to currency depreciation and a write down of asset values, details at http://thai.listedcompany.com/president_message.html

