

THE ASCENDANCE OF AIRASIA: BUILDING A SUCCESSFUL BUDGET AIRLINE IN ASIA

Professors Thomas Lawton and Jonathan Doh wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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Version: (A) 2010-07-21

INTRODUCTION

In September 2001, Tony Fernandes left his job as vice-president and head of Warner Music's Southeast Asian operations, one of the most visible and prominent positions in Asia's music industry. He reportedly cashed in his stock options, took out a mortgage on his house and lined up investors to take control of a struggling Malaysian airline with two jets and US\$37 million in debt. Three days later, terrorists destroyed the World Trade Center.¹

Within two years, AirAsia had demonstrated that the low-fare model epitomized by Southwest and JetBlue in the United States, and by Ryanair and easyJet in Europe, had great potential in the Asian marketplace. AirAsia's success rapidly spawned numerous imitators and competitors. Despite its success to date and continued growth, could AirAsia maintain momentum and continue to expand across Asia and globally? Would the influx of new entrants result in a shakeout such as had occurred in North America and Europe, compromising AirAsia's future in this increasingly competitive market?²

Market Liberalization and the Rise of Low-Fare Airlines in the Asia-Pacific Region

Following late on the global trend, low-fare, budget airlines (LFAs) were rapidly established across Asia. Air Do began operating in Japan in 1998, followed by Skymark in 2000. Carriers 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 relaunched in Malaysia as a no-frills operation. In the Philippines, Cebu Pacific Airways, also expressly modeled on Southwest, focused on cost containment by selling online and operating out of secondary airports. India's first budget airline, Air Deccan (now

¹ Wayne Arnold, "A Continent Divided by Water, Now United by Air," *New York Times*, January 1, 2004, p. W1.

² *Ibid.*

Kingfisher Red), was launched in late August 2003. China entered the game in 2005 with the creation of Spring Airlines, based in Shanghai.

Budget airlines were making inroads into most Asian markets, but the long-term survival of these carriers depended on their ability to compete with Asia's traditional, full-service airlines. The prevailing sentiment among some of 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 view was based in part on the perception that many established Asian airlines were highly cost competitive relative to their global peers. It also illustrates a perception that Asian air passengers valued high service more than low price.

As early as the late 1990s, most observers questioned whether Asia would ever emerge as a viable market for no-frills budget carriers similar to the United States' Southwest and Europe's Ryanair and easyJet. But the environment had since changed dramatically. According to Peter Harbison of the Centre for Asia Pacific Aviation, a consultancy in Sydney, Australia, "the key ingredient is liberalization."³

Air transport liberalization in the Asia-Pacific region began in the 1990s when Australia deregulated its domestic market. Virgin Blue was one of the few carriers that survived this initial battle with incumbents, and it succeeded in establishing its position in the market. New Zealand was one of the first countries to privatize its national flag carrier and embrace airline liberalization. Japan and India subsequently pursued air transport deregulation in order to stimulate competition. Elsewhere in Asia, several countries publicly embraced liberalization in the form of reciprocal access agreements: Singapore, Malaysia, Taiwan, South Korea, Brunei and Pakistan all negotiated open-skies air service agreements with the United States. In Taiwan and South Korea, liberalization measures in the late 1980s and early 1990s spawned the birth of carriers that, by the turn of the century, had all become major players in their countries' air service sectors, both domestic and international. In Thailand, the domestic market underwent deregulation, and new private players were looking to expand. Indonesia witnessed the emergence of a large number of new entrants, following government moves to allow more competition.

In India, Pakistan, Bangladesh, Nepal, the Philippines and Malaysia, domestic markets underwent varying forms of deregulation in the early-to-mid-1990s, and within a decade, despite some glitches, passengers generally experienced much greater choice in domestic travel. The People's Republic of China also began opening up its air transport market and system. Foreign investors were permitted to enter joint ventures with, or buy stock of, domestic Chinese airlines. The first outside investment in China was George Soros's US\$25 million acquisition of a 25 per cent stake in Hainan Airlines in 1995. China Eastern and China Southern Airlines had also issued shares on international capital markets.⁴ In Hong Kong, restrictions barring more than one locally based airline from operating on a particular route had been eased. These moves were long overdue in a region that had been resistant to change in the airline sector.

Association of Southeast Asian Nation (ASEAN) leaders announced plans to fully liberalize air travel by the end of 2008. However, there were doubts as to whether that deadline would mean much in practice, since countries were allowed to opt out and delay liberalization until 2015. Still, according to the Centre for Asia Pacific Aviation, many ASEAN states were prepared to open the skies between their capital cities in 2008⁵ and by 2010, significant liberalization had taken place, although with some countries lagging in their progress.

³ Scott Neuman, "Low-Fare Airlines Take Off in Asia," *Wall Street Journal*, February 25, 2004, p. B6G.

⁴ A. Goldstein and C. Findlay, "Liberalisation and Foreign Direct Investment in Asian Transport Systems: The Case of Aviation," Asian Development Bank and OECD Development Centre, no. 26-27, November 2003, p.11.

⁵ Centre for Asia Pacific Aviation, "Outlook 2007: Full Frontal Attack on Flag Carriers Begins," March 6, 2007, www.centreforaviation.com, accessed July 9, 2007.

Low-Fare Airlines in Japan

Japan was the first Asian country to experience a real boom in both domestic and international travel in the 1960s. Subsequently, Japan retained the status of the largest air travel market among all Asia-Pacific countries as a result of the combination of its population size and a steadily growing disposable income level. Japanese air travel growth rates increased rapidly until the late 1980s, when the market became more mature and reached a plateau. The total Japanese travel market (both international and domestic) grew by only six per cent from 1990 to 2000, which, even allowing for domestic economic slowdown, indicates that it was saturated with the product offered by the traditional, full-service carriers.⁶ Japan undertook comprehensive deregulation and liberalization in a range of sectors throughout the 1990s, partly as a strategy to jump-start its stagnant economy. One sector that was partly liberalized was air transport. Future growth in air transport could come from the introduction of the new business model represented by low-cost, low-fare carriers. Although the total supply of seats provided by the budget airlines in the Japanese domestic market was still very small when compared to Japan Airlines (JAL)⁷ and All Nippon Airways (ANA), the two large traditional carriers, the potential for growth was significant as long as new entrants could successfully compete both with the full-service majors and with intermodal competition from high-speed rail.

Skymark Airlines, one of Japan's first budget carriers, pursued a business model similar to JetBlue and easyJet's differentiated low-fare airline approach rather than the traditional Southwest or Ryanair no-frills, price leadership model. Skymark was established in 1996 and commenced operations in 1998. By 2007, it was flying between five domestic points in Japan — Haneda (Tokyo), Sapporo, Kobe, Fukuoka and Naha on Okinawa — and operating an international charter service to Seoul. It had a fleet of nine aircraft, six Boeing 767s and three Boeing 737s. The service was basic although all aircraft were equipped with a satellite TV entertainment system. Skymark's onboard product was further differentiated through offering a small number of first-class seats on some routes, e.g. 12 seats out of 309 on its Fukuoka route. Such additional features put Skymark closer to a hybrid budget airline model. An advanced entertainment package drew parallels with the JetBlue onboard TV model, while the availability of business-class seats placed Skymark in the same category as AirTran and Spirit in the United States.⁸ Despite challenges, by 2010 Skymark had become Japan's third largest carrier in terms of passenger numbers and consistently outperformed its larger, full-service rivals in terms of cost, load factor and price. Skymark's share value quadrupled in the 2009-2010 period and it was predicted to turn a profit in 2010, despite the adverse economic conditions. JAL's bankruptcy and consequent restructuring (including cutting many domestic routes) provided further growth opportunities for Skymark over the coming years.

Low-Fare Airlines in Malaysia

The emergence of the budget model in Malaysia resulted from market deregulation and the Malaysian government's desire to release Malaysia Airlines (MAS) from its obligation to serve perpetually money-losing domestic routes. Malaysia's geographic position and land structure provided natural conditions that encouraged air travel, but only six per cent of the adult population traveled by air in 2001.⁹ This low figure indicated an underdeveloped aviation market that could be grown significantly through the introduction of low fares on domestic routes.

⁶ Japan Travel Bureau, "Travel Trends and Prospects for 2003," *JTB Newsletter*, January 5, 2003.

⁷ JAL has since become one of Japan's most visible corporate failures, filing for bankruptcy protection in January 2010 and embarking on a major restructuring initiative.

⁸ Centre for Asia Pacific Aviation, "Low Cost Airlines in the Asia Pacific Region: An Exceptional Intra-Regional Traffic Growth Opportunity," September 2002, www.centreforaviation.com.

⁹ *Ibid.*

The policy of highly regulated domestic fares had been long maintained by the Malaysian government.¹⁰ Such a policy created many headaches for the management of MAS, which had “reportedly been losing up to US\$79 million annually” on its domestic routes.¹¹ The initial success of AirAsia may well have validated the Malaysian government’s role in encouraging a budget airline to enter the domestic market. However, the government-controlled MAS did show initial concern about that same success. In fall 2002, MAS introduced discounted fares on limited seats on domestic routes. Meanwhile, after its initial failure, a revamped AirAsia was transformed from a money-losing full-service airline into a low-cost, low-fare airline when a new group of investors, Tune Air Sdn Bhd, bought the shares and half the share of liabilities in the original airline in September 2001.¹²

How did Malaysians react to the introduction of this new business model? The anecdotal evidence points out that they were as eager to embrace it as residents of the United States, United Kingdom, Australia, Canada, Ireland and elsewhere were when they were first given an opportunity to travel for a fraction of historical fares.¹³ Conor McCarthy, AirAsia’s co-founder and a former director of operations for Ryanair, had specifically noted that the management of AirAsia was encouraged by the similarities between the consumer market in Malaysia and in Ireland, the United Kingdom and Germany when Ryanair first entered those markets.¹⁴ One traveler offered the following comment on an online discussion site after traveling on AirAsia in March 2003 from Kuala Lumpur to Penang:

It is good to see the no-frills model finally making headway in the Asia-Pacific region. No food, total scrum for the plane at the boarding announcement, crammed seats . . . but for the equivalent of around US\$15, you can’t complain . . . Let’s hope that the governments around the region put consumer interests ahead of protecting state-owned airlines.¹⁵

But 2006 data¹⁶ comparing the types of aircraft in use in major world regions, showed that on average, Asian airlines had fleets comprising 71 per cent wide-body aircraft (such as the Boeing 747 or the Airbus 340) and only 29 per cent narrow-body (such as the Boeing 737 or the Airbus 320). This compared with North America and Europe, where the average airline fleet was 23 per cent wide-body and 77 per cent narrow-body. This underscored the relative underdevelopment of the Asian market, where narrow-body fleets, typically used for shorter haul intraregional service, were not widely used. Most of the air passenger market remained long haul, often intercontinental and usually full service in nature.

The Rise of AirAsia

The emergence of Malaysian-based AirAsia resembled the story of Ryanair, the Irish low-cost carrier that has dramatically altered the passenger air transport landscape in Europe since the mid-1990s. Both carriers underwent a remarkable transformation from money-losing regional operators into profitable low-cost, low-fare airlines. AirAsia was initially launched in 1996 as a full-service regional airline offering slightly cheaper fares than its main competitor, Malaysia Airlines.¹⁷ This business model failed because AirAsia

¹⁰ Goldman Sachs, “Asia Airlines,” *Asia Research*, October 17, 1997, p. 9.

¹¹ “Malaysian Airline Tests Asia’s Resistance to No-Frills Flights,” *Associated Press*, December 2002.

¹² Centre for Asia Pacific Aviation, “Low Cost Airlines in the Asia Pacific Region: An Exceptional Intra-Regional Traffic Growth Opportunity.”

¹³ “Malaysian Airline Tests Asia’s Resistance to No-Frills Flights,” *Associated Press*.

¹⁴ Interview with Conor McCarthy, April 25, 2003.

¹⁵ Comment of William Ng provided on www.airlinequality.com after traveling on AirAsia in March 2003 from Kuala Lumpur to Penang.

¹⁶ Data sourced from the Association of Asia Pacific Airlines, the Air Transport Association and the Association of European Airlines.

¹⁷ G. Thomas, “In Tune with Low Fares in Malaysia,” *Air Transport World*, May 2003, p.45-46.

could neither sufficiently stimulate the market nor attract enough passengers away from Malaysia Airlines to establish its own market niche.

FERNANDES'S ENTREPRENEURIAL VENTURE

Tony Fernandes had a history of going his own way. Shipped off to boarding school in Britain to become a doctor like his father, Fernandes rebelled, earning an accounting degree and landing a job with the Virgin Group instead. Eventually he left Virgin for Warner Music, which sent him back to Malaysia in 1992. In 1997, he became vice-president for the company's Southeast Asian operations. By 2001, however, he had tired of the politics at what had become AOL Time Warner and decided to start his own airline. This came as no surprise to those who knew him. Unlike many kids, who aspired to become airline pilots, from an early age Fernandes had wanted to own his own airline.¹⁸

On a trip to Europe, he met Conor McCarthy, Ryanair's former director of group operations.¹⁹ Fernandes had envisioned a low-cost airline competing on long-haul routes. McCarthy encouraged him to focus closer to home. In late 2001, AirAsia was up for sale. Founded in 1996 as Malaysia's second airline, AirAsia had been beset by problems from the beginning and failed to turn a profit. Fernandes enlisted leading low-cost airline experts to restructure AirAsia's business model, and he persuaded McCarthy to join the executive team and become one of the investors.²⁰

The investors announced an agreement on September 8, 2001, to buy AirAsia for a symbolic one ringgit (26 cents) and to assume 50 per cent of net liabilities, or around 40 million ringgit.²¹ Paradoxically, the September 11 attacks resulted in lower costs for purchasing and leasing used airplanes. The new AirAsia was relaunched in January 2002 with three Boeing 737 aircraft as a low-fare, low-cost domestic airline. Its value proposition was described as being based on "a Ryanair operational strategy, a Southwest people strategy, and an easyJet branding strategy."²² Fulfilling his boyhood dream, Fernandes was running an airline company in which he had a personal stake of around 35 per cent.

AirAsia co-founder Conor McCarthy noted that one thing which strikes him when telling the story of the AirAsia journey, is how much timing and luck had huge parts to play. AirAsia got its first batch of aircraft when the market was down, then locked in some purchases and long-term leases when the market was still very weak in 2003. In 2004 and 2005, the market was picking up and management concluded only short-term contracts for the necessary aircraft. Management pursued a similar strategy with regard to maintenance contracts and fuel hedging. The one thing the company managed to keep consistent was its no-frills model and always offering value in low fares. In distribution, it kept the largest majority of bookings via the web but in coming to terms with local markets where payment type in particular was an issue, AirAsia did open up some billing and settlement plan (BSP) and computer reservation system (CRS) channels²³ — under its own control — as to stick rigidly to the direct sales-only channel would have been

¹⁸ Nicholas Ionides, "Man of the Moment," *Airline Business*, April 2004, p. 29.

¹⁹ W. Arnold, "A Continent Divided by Water."

²⁰ G. Thomas, "In Tune with Low Fares in Malaysia."

²¹ N. Ionides, "Man of the Moment."

²² Interview with Conor McCarthy, May 8, 2003.

²³ CRS and BSP refer to electronic information and commercial interfaces, typically between airlines and travel agents. A CRS is a system that stores and retrieves air transport data for airlines and enables a transactional interface with travel agents and online consolidators. Similarly, according to the International Air Transport Association (IATA), a BSP is the central point through which data and funds flow between travel agents and airlines. Instead of every agent having an individual relationship with each airline, all of the information is consolidated through the BSP. Agents make one single payment to the BSP (remittance), covering sales on all BSP airlines. The BSP makes one consolidated payment to each airline, covering sales made by all agents in the country/region.

value-destroying. Also, as McCarthy noted, “Competition was complacent when we took over AirAsia in late 2001 and this enabled us to get a foothold, followed by a foothold, followed by a large niche followed by market leadership in our key Malaysian domestic market.”²⁴

The Malaysian government recognized early on that AirAsia could help the economy overall and specifically assisted in infrastructure development (providing huge freedom of movement advantages with none of the associated subsidies/tax expenditure that is required of road and rail) and tourism growth (amplifying the number of visitors per aircraft through the high seat density, short flights and superior utilization). It also could play a role in distributing wealth from the main cities to the outlying areas and in connecting a previously fragmented East (Borneo)-West (Peninsular) Malaysia through a phenomenal increase in flights, seats and destinations at much lower fares. Government support for a more competitive domestic market paid off handsomely and also reduced the need to subsidize Malaysian Airlines (MAS) domestic services. This was a major change and, as McCarthy argued, one for which the policy and decision makers in the Malaysian government deserved genuine credit.

AirAsia's Strategy and Operations

AirAsia focused on ensuring a very low cost structure as a cornerstone of its business strategy. It was able to achieve a cost per available-seat-kilometer (ASK) early in its development of 2.5 cents, half that of Malaysia Airlines and Ryanair and a third that of easyJet.²⁵ UBS research indicated that AirAsia was the lowest cost airline in the world by 2007 (see Exhibit 1). The company continued to retain that position, as it consistently pushed down cost year on year (Exhibit 2). Similar to budget airlines elsewhere in the world, AirAsia's revenue model was driven by the visiting friends and relatives (VFR) market and small business travelers.

Fernandes acknowledged that the timing of the AirAsia start-up in the aftermath of the tragic events of September 11, 2001, helped ensure the lowest possible cost structure, with both leasing and operating aircraft costs sharply declining year over year. By 2007, AirAsia was handling 51,000 passengers a day with a fleet of 54 planes, offering fares as low as 50 Malaysia ringgit (less than US\$15).²⁶ The revenue formula of AirAsia mostly followed the traditional low-fare approach; only three different fare types were offered.²⁷ AirAsia's focus on Internet bookings and ticketless travel allowed it to emphasize simplicity for the customer while securing low distribution costs. With the average fare 40 to 60 per cent lower than the fares of its full-service competitors, AirAsia was able to achieve strong market stimulation in the domestic Malaysian air market.²⁸ For example, when AirAsia started out, the lowest fare it offered for the trip from Kuala Lumpur to Penang started at 39 ringgit. The same trip by bus cost 40 ringgit and increased to about 80 ringgit if traveling by car. The introduction of such super-competitive fares began to produce the same market growth effect that was achieved by the entry of Ryanair (in its low-fare form) into the U.K.-Ireland air travel market — travelers' switching from sea, train and bus to air transportation. In the case of Malaysia, consumers increasingly switched from bus to air travel. Starting with two planes bought from a Malaysian conglomerate in late 2001, the airline had expanded to 54 aircraft by 2007 and more than 70 by 2010, with plans to grow to more than 180 aircraft by 2014. This was impressive growth, but it also raised

²⁴ Noted in discussion with Conor McCarthy, May 12, 2008.

²⁵ McCarthy interview.

²⁶ Centre for Asia Pacific Aviation, “To Malaysia with Love; AirAsia Goes Patriotic,” May 31, 2007, www.centreforaviation.com.

²⁷ Centre for Asia Pacific Aviation, “Low Cost Airlines in the Asia Pacific Region.”

²⁸ G. Thomas, “In Tune with Low Fares in Malaysia.”

concerns because other budget airlines had faced their most serious challenges when they attempted to expand too fast.²⁹

AirAsia expanded quickly. The airline handled 1.5 million passengers in 2003 and this number almost doubled the following year and rose to 6.3 million in 2005. By June 2007, this number had climbed to almost 14 million passengers. In early 2010, despite a fall in global passenger demand, AirAsia had grown its passenger numbers by a further 24 per cent, taking the group total (combining the Malaysian, Thai and Indonesian operations) to 22.7 million. The company quickly repaid its inherited debt and was profitable from the outset. Its profit margins (before interest, depreciation, amortization and aircraft leasing costs) have been as high as 35 per cent, among the highest in the world, according to Michael McGhee, Credit Suisse First Boston's airline analyst. AirAsia announced net profits of RM549 million (US\$162 million) for the full year 2009, despite what was described by many as the worst year in aviation history.

Reaction to AirAsia's Success

The Malaysian government was supportive of AirAsia so long as it was assuming previously money-losing domestic routes and serving as a benchmark for the restructuring of Malaysia Airlines. In August 2006, AirAsia took over 96 of Malaysia Airlines' 118 domestic routes, only four of which had previously been profitable. AirAsia's plans to enter the traditionally profitable intraregional markets of Thailand and other neighboring countries met with less enthusiasm from the Malaysian government. The Malaysian regulatory authorities faced the knotty problem of accommodating the growth plans of a new budget airline at the cost of reducing the market value of government-owned Malaysia Airlines.

Given the initial uncertainty about its ability to fly outside of Malaysia, AirAsia sought creative ways to expand its market coverage by targeting cross-border markets. AirAsia entered into a number of joint ventures, including Thai AirAsia, Indonesia AirAsia and AirAsia X.³⁰ In its cross-border joint ventures with Indonesia and Thailand, AirAsia urged harmonization of national regulations in the areas of pilot hours and maintenance oversight. AirAsia also won greater favor with the Malaysian government, which endorsed AirAsia X (the group's low-cost, long-haul airline) and built the region's first low-cost terminal at Kuala Lumpur International Airport in March 2006.³¹ As with the Thai and Indonesian operations, AirAsia X was a legally separate company in which AirAsia held just a 16 per cent stake. However, a consortium that included Tony Fernandes owned 48 per cent. Virgin Group also had a 16 per cent stake in the long-haul budget carrier.

The Malaysian towns serviced by AirAsia attracted residents of neighboring countries to try AirAsia when they traveled to Kuala Lumpur, as it often meant saving half the airfare by taking a simple car trip across the border. This elicited a response from some of AirAsia's competitors, most notably Singapore Airlines, Asia's largest carrier by market capitalization. Singapore Airlines announced a low-fare subsidiary, and a former Singapore Airlines deputy chairman, Lim Chin Beng, registered "Valuair" in June 2003, intending it to operate as Singapore's third airline. Thai Airways International also launched its own low-fare spin-off, Nok Air, in 2004, which it co-owned as part of a consortium.³² The Sri Lankan government launched a fully state-owned budget carrier, Mihin Lanka, in 2007. In sum, AirAsia was causing competitive ripples that were likely to grow in scale and scope.

²⁹ Goldman Sachs, "Asia Airlines."

³⁰ Centre for Asia Pacific Aviation, "Who's Who in Low Cost Aviation: Air Asia," 2007.

³¹ Ibid.

³² Nicholas Ionides, "Third Japanese New-Start Fair Inc. Launches Services," *Air Transport Intelligence*, August, 2000.

Going International: The Response of Incumbent Carriers

In January 2004, AirAsia started its first international service, from Kuala Lumpur to the Thai holiday island of Phuket. In February, it began flying from Johor Bahru, across the border from Singapore. In 2005, it began flying to Indonesia, a country with 235 million potential passengers. Expansion to India and China was also in the cards, two markets with a combined population of 2.5 billion. By early 2008, AirAsia X was flying to Hangzhou (Shanghai) and by late 2008 AirAsia was connecting Malaysia to Kolkata, Trichy, Kochi and Trivandrum in India. This proved only the tip of the iceberg for both markets, as AirAsia and AirAsia X continued a relentless growth strategy vis-à-vis China and India.

At the same time, incumbents were striking back. Of the 50 or so budget airlines serving East, South, and Southeast Asia, many came from spin-offs of traditional airlines. For example, Thai Airways announced an international carrier, Nok Air, and Singapore Airlines established its own budget airline, Tiger Airways, together with the founders of Ryanair. In 2004, Australia's Qantas announced that it was starting a new Singapore-based low-fare airline, subsequently called Jetstar. Qantas invested about 50 million Singapore dollars (US\$30 million) for a 49 per cent stake in the new airline; Temasek Holdings, the powerful investment arm of the Singapore government, owned 19 per cent, and two local businessmen held the remainder. Although Temasek owned 57 per cent of Singapore Airlines, Temasek officials denied that its ownership in the two carriers represented a conflict of interest. "We think this new player will increase the pie," said Rachel Lin, a spokeswoman for Temasek. "Our interest is strictly for financial returns; we see both of them as potentially attractive investments." Moreover, as the government moved to defend its role as a hub for air travel by building an airport terminal designed to accommodate budget airlines, Singapore's founding prime minister and elder statesman, Lee Kuan Yew, warned Singapore Airlines that the government intended to protect Changi Airport's competitiveness, even at the flag carrier's expense.³³

Some believed many of the incumbents in Asia — like those in the United States — faced inherent disadvantages in their ability to compete on cost and price because they did not have the cost discipline or the entrepreneurial culture of budget start-ups. Thai Airways hired an advertising executive to run Nok, apparently with the intention of mimicking Fernandes, but its choice appeared to lack Fernandes's marketing and operational ability. Eric Kohn, who was number two at Deutsche BA, initially organized as a German-based low-price offshoot of British Airways, argued that established carriers are not set up to succeed in the low-cost space: "People at big airlines don't have accountability or a focus on costs. It is a lot easier to start an airline from scratch than to take a legacy airline and make a profit."³⁴

"We feel pretty vindicated," Fernandes said in a telephone interview from his office at Kuala Lumpur International Airport. "A lot of people laughed at us at first."³⁵ Fernandes disputed analysts' warnings that AirAsia was likely to run into more difficulties as it went more international. "I don't see why it makes any difference," he said. As for Asia's relative lack of bilateral agreements to allow new carriers to ferry passengers from country to country, Fernandes argued that competition for tourist revenue is pushing more countries to open up. Exhibit 3 shows AirAsia's route network (including long-haul AirAsia X) as of 2009, comprising 42 international city pairs and growing fast, despite regulatory and political impediments.

³³ Wayne Arnold, "Qantas Airways Discloses Plan for Low-Cost Singapore Carrier," *New York Times*, April 7, 2004, p. W1.

³⁴ "Having Fun and Flying High," *Economist*, March 11, 2004.

³⁵ W. Arnold, "A Continent Divided by Water."

Moving Forward at AirAsia: Regional and Global Expansion

As more and more countries opened their skies, AirAsia was quick to start cross-border joint ventures, most notably in Thailand and Indonesia. AirAsia prompted increased passenger travel with its 2007-2008 “To Malaysia with Love” campaign. The campaign celebrated 50 years of nationhood for Malaysia, and offered travelers affordable fares “starting from MYR0.50 (about 15 cents), available for all destinations to/from its Malaysian hubs.”³⁶ Cheaper airfares were also made possible by the low-cost carrier terminal at Kuala Lumpur Airport, with a throughput of about 10 million passengers annually.

International route expansion continued unabated. This combined shorter routes (typically up to four hours’ flying time) undertaken by AirAsia (Malaysia), Thai AirAsia or Indonesia AirAsia, with longer routes operated by AirAsia X. By early 2010, AirAsia X was flying long haul from Malaysia to three cities in China and AirAsia was flying shorter routes to a further six cities (including Hong Kong and Macau) from both Malaysia and Thailand. CEO Fernandes declared 2010 his “India year,” with plans to gradually link New Delhi, Chennai, Bangalore, Hyderabad and Mumbai to Kuala Lumpur and Penang, and from there to more than 130 routes.³⁷ In addition, AirAsia X offered daily services to three destinations in Australia, as well as to Taiwan and London. Plans for further long-haul expansion included more Australian routes, Paris and the United States. AirAsia’s sponsorship of sports teams such as Manchester United helped build up brand recognition in many markets. In the United States, the airline signed a sponsorship deal with the Oakland Raiders football team in early 2009, raising the group’s profile in northern California; AirAsia was reportedly exploring Oakland as an alternative airport to San Francisco and investigating additional airports in the Los Angeles and New York City areas. A prerequisite to any of these forays was that the airports must support the needs of budget airlines, including quick turnaround and taxi times.³⁸ An airport such as Oakland was also attractive because of its large base for Southwest Airlines, allowing passengers to connect onwards to hundreds of domestic U.S. routes at a low price. AirAsia X would serve future west coast U.S. routes from Kuala Lumpur via Taipei, Seoul or Honolulu and any east coast routes would route via London Stansted. Another 16 Airbus aircraft were expected during 2010, mostly A320s to serve short-haul routes but including several A330s to support projected growth for long-haul operator AirAsia X.³⁹ The A330 was ideal for long-haul flights between Southeast Asia and Australia or the Middle East. However, to deliver on non-stop service to Europe and a one-stop service to the United States, AirAsia X would need to rely on its small A340 fleet, gradually replacing these and growing a sizeable fleet of the new A350 aircraft. This might take time, as the carrier was currently not scheduled to receive its first A350 until 2016.

In addition to growing its passenger travel, AirAsia also expanded into cargo transportation. In May 2007, the airline made an agreement with the cargo management company Leisure Cargo. One of AirAsia’s regional directors commented on the new partnership, saying, “Cargo plays an integral part of our ancillary income and we foresee cargo to be one of the key drivers with significant contribution towards the company’s bottom line.”⁴⁰ This agreement served 18 destinations, made possible by the airline’s Airbus 320s carrying both passengers and cargo.

Another landmark development for AirAsia was becoming a publicly traded company. After deferring its decision on a public listing early in 2004 to focus on domestic and regional expansion, AirAsia finally

³⁶ Centre for Asia Pacific Aviation, “To Malaysia with Love; AirAsia Goes Patriotic,” May 31, 2007, www.centreforaviation.com.

³⁷ Cuckoo Paul, “AirAsia Aims for a Full Flight in India,” *Business.in.com*, February 8, 2010.

³⁸ Brandon Sobie, “AirAsia X Lands in US for First Times,” *Air Transport Intelligence*, September 18, 2009.

³⁹ Ghim-Lay Yeo, “AirAsia Outlines Priorities for Future Expansion,” *Air Transport Intelligence*, January 26, 2010.

⁴⁰ Centre for Asia Pacific Aviation, “AirAsia & Leisure Cargo Partnership to Generate RM12 million in Revenue per Annum,” June 7, 2007, www.centreforaviation.com.

went public on November 22 of that year. When it did, its initial public offering (IPO) was worth US\$226 million.⁴¹ It was one of the largest public offerings in Malaysia, and brought the company RM717.4 (US\$188.8 million) for its future expansion.⁴² The capital raised enabled AirAsia's management team to diversify its fleet, by placing orders for new Airbus 320s. This did two things: it locked in the company's hardware costs and availability through the very strong surge in orders that followed; and this in turn helped the company's cost competitiveness and capacity/network build out.

AirAsia posted impressive financial results in post-IPO: revenue grew 52 per cent from 2006 to 2007, reaching 1,603 million ringgits in 2007, while pretax profit grew 223 per cent from 86 to 278 million ringgits and net profit grew 147 per cent from 202 to 498 million ringgit. Despite some challenges and a drop in profits between 2007 and 2008, profit continued to grow the following year with core operating profit rising 591 per cent between 2008 and 2009 and net profit increasing 26 per cent in the same period (see Exhibit 4).

The Budget Airline Future in Asia

In 2010, views on whether low-fare airlines would continue to flourish in Asia varied. Three factors — regulation, population demographics, and socioeconomic trends — drove this calculus. Although the target consumer base for AirAsia was enormous — more than 500 million people lived within three hours of AirAsia's hubs in Kuala Lumpur and Bangkok, more than Western Europe's entire population — the failure of Asia's regulatory environment to keep pace and the uncertain demand for low-fare services created uncertainty.

Those who sold airplanes, airports or advice tended to be of the opinion that low-fare carriers would redraw Asia's socioeconomic map, offering affordable international travel to millions and thereby fostering the integration of a region divided by water, politics, and poor infrastructure. Analysts who saw a large and growing market predicted that budget airlines would tap pent-up demand among less affluent Asians, who typically travelled by bus and hardly expected attentive service. Since the global economy peaked in the second half of 2006 and even during the recession of 2008-2009, Asian carriers had seen increased success. "We're seeing that people in Asia travel as soon as they have some extra money in their pocket," said Don Birth, president and chief executive officer of Abacus, a distribution services provider.⁴³ Although average incomes were lower in Asia than in Europe, Timothy Ross, an analyst for UBS, said that the region's lower average incomes should boost rather than constrain demand for cheap fares.

Other analysts argued that there had traditionally been too few bilateral agreements that allowed new low-fare carriers to fly between countries and too few of the satellite airports that the airlines needed to keep costs low. In that vein, budget airlines such as AirAsia were hoping for increased cross-border travel in the wake of the December 2008 ASEAN open skies agreement. The agreement allowed carriers based in the region to make unlimited flights between all 10 ASEAN member states. Although it would be 2015 before the agreement was fully implemented, it was a positive step forward. For instance, in January 2010, the Indonesian Transportation Ministry announced it was gearing up for the country's full participation in the ASEAN air transport liberalization plan and intended to include five of Indonesia's twenty-seven international airports in the implementation.⁴⁴ Although this was only a small proportion, it was a symbolic

⁴¹ "AirAsia IPO Takes Off," *The Standard*, November 23, 2004.

⁴² AirAsia, "Corporate Profile," www.airasia.com, accessed July 2, 2007.

⁴³ Centre for Asia Pacific Aviation, "Outlook for 2007: Prepare for Shakeout," November 10, 2006.

⁴⁴ "Government Readies Airports for ASEAN Open Sky," *The Jakarta Post*, January 16, 2010.

start. "Liberalization tends to be infectious, and the germs of change are in the air," concluded Peter Harbison, the executive chairman of the Centre for Asia Pacific Aviation.⁴⁵

The pattern in other regions suggested that once rules start to relax, growth follows. In the United States, the upsurge of budget carriers saw passenger numbers rise nearly 50 per cent in the five years following deregulation, compared with four per cent for traditional airlines. In 2010, low-fare carriers now had more than a third of the market. In Australia, Virgin Blue took only three years to win a 30 per cent market share.⁴⁶

The growth of low-fare carriers had great potential to spill over into the broader tourist and business travel economy: having more air passengers generates higher demand for hotel rooms. This connection had been seen in Australia, where Virgin Blue took nearly one-third of the domestic market from Qantas Airways (which responded in part by setting up Jetstar). This resulted in a sharp upturn in demand for economy hotels, such as Accor. "In many cases, it's entirely new business that wouldn't have happened if it weren't for cheap air tickets," commented Peter Hook, general manager for communications at Accor Asia Pacific.⁴⁷ In addition, low-fare carriers might offer options for Asian travelers to mix business with pleasure, as many North American and European business travelers did, by extending trips or bringing family members to accompany them. Ultimately, Fernandes pointed out, budget airlines in Asia had an advantage in that Asia had almost no interregional highways and no high-speed international rail. "There's a lot of sea in between," he said. "Air travel is the only way to develop interconnectivity in Asia."

But competition was growing. In addition to the many upstart carriers and joint ventures with majors, some significant players from outside the region were also making rumbles. After his success with Virgin Blue, Richard Branson expressed interest in investing in a low-fare operation specifically in Asia. His stake in AirAsia X ensured he was an ally rather than an adversary of Tony Fernandes. David Bonderman, an airline financier who helped found Ireland's Ryanair, took a stake in Tiger Airways, Singapore Airlines' budget venture. So far, Hong Kong-based Cathay Pacific Airways was one of the few regional heavyweights to say it was not likely to enter the fray.⁴⁸

With all of the new competitors for low-fare air travel in the region, AirAsia needed to stay ahead. In order to do so, it was important to focus on profits, not just cost-cutting, in order to win investors, thereby increasing capital. According to the Centre for Asia Pacific Aviation, "With financial experts predicting that funding aircraft acquisitions with equity and affordable debt will be much more difficult in the near future, only those airlines that have exhibited an ability to wisely increase capacity will be able to grow their operations."⁴⁹

External, industry-wide challenges — particularly the escalating cost of fuel — also posed a threat to AirAsia. As the lowest cost carrier in the world, the company suffered more from high fuel prices, as they were a higher per centage of total costs, than any other airline (assuming similar equipment and seat density). Surcharges and baggage fees covered some of this but the airline was conscious that if it loaded on the full charge, it might find no demand on some flights due to a high base price (e.g. minimum or zero fare plus taxes, fees and surcharges). To offset this eventuality, AirAsia did a lot to improve operations and efficiency and also saw the benefits of the fuel efficient Airbus 320 help to maintain its low-fares brand

⁴⁵ Centre for Asia Pacific Aviation, "Asian Governments to Open Skies in 2007," March 8, 2007.

⁴⁶ "Having Fun and Flying High," *Economist*.

⁴⁷ S. Neuman, "Low-Fare Airlines Take Off in Asia."

⁴⁸ *Ibid.*

⁴⁹ Centre for Asia Pacific Aviation, "Outlook for 2007: Prepare for Shakeout."

position. But what were the business implications for AirAsia if oil prices remained above \$100 a barrel for the foreseeable future?

To retain its cost advantage in the wake of the global recession, AirAsia entered into an alliance in January 2010 with Jetstar, the low-fare subsidiary of Australia's flag carrier, Qantas. This was the first time two leading budget airlines had collaborated in this fashion. The alliance allowed the companies to explore joint aircraft purchasing, passenger and ground handling services cooperation and the transportation of each other's passengers in the event of a disruption.⁵⁰ Assuming the focus of the alliance was on cost sharing for services and aircraft procurement, it might prove effective. However, any alliance — but particularly with another airline — is always difficult to manage for budget airlines. A budget airline's success is predicated on a lean and highly adaptive structure together with an autonomous and often unpredictable strategy. Would the Jetstar alliance put this at risk?

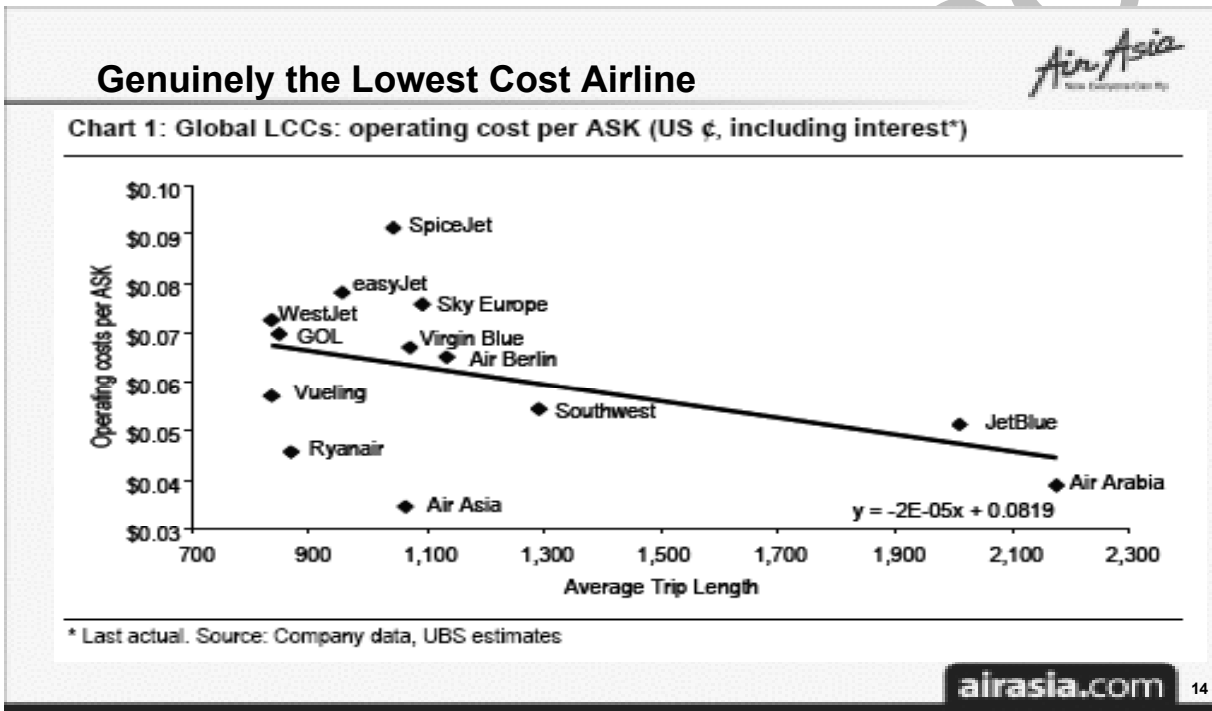
More broadly, did AirAsia's expansion beyond its Southeast Asian focus threaten its long-term viability? Even if expansion to China, South Asia and Oceania was consistent with its core capabilities, how did the AirAsia X initiative fit with this set of competencies?

AirAsia had played the game very well and had ambitious growth plans to keep ahead of the pack. Time would tell if Fernandes and his team could maintain the company's position as Asia's — or perhaps the globe's — most successful budget airline.

⁵⁰ Siva Govindasamy, "AirAsia and Jetstar Ink Wide-Ranging Cooperation Agreement," *Air Transport Intelligence*, January 6, 2010.

Exhibit 1

THE OPERATING COSTS OF GLOBAL LOW-COST CARRIERS



LCC = Low-Cost Carrier (we use the terms "low-fare airline" or "budget airline" throughout this case)

ASK = Average-seat-kilometer

Source: Company files.

Exhibit 2

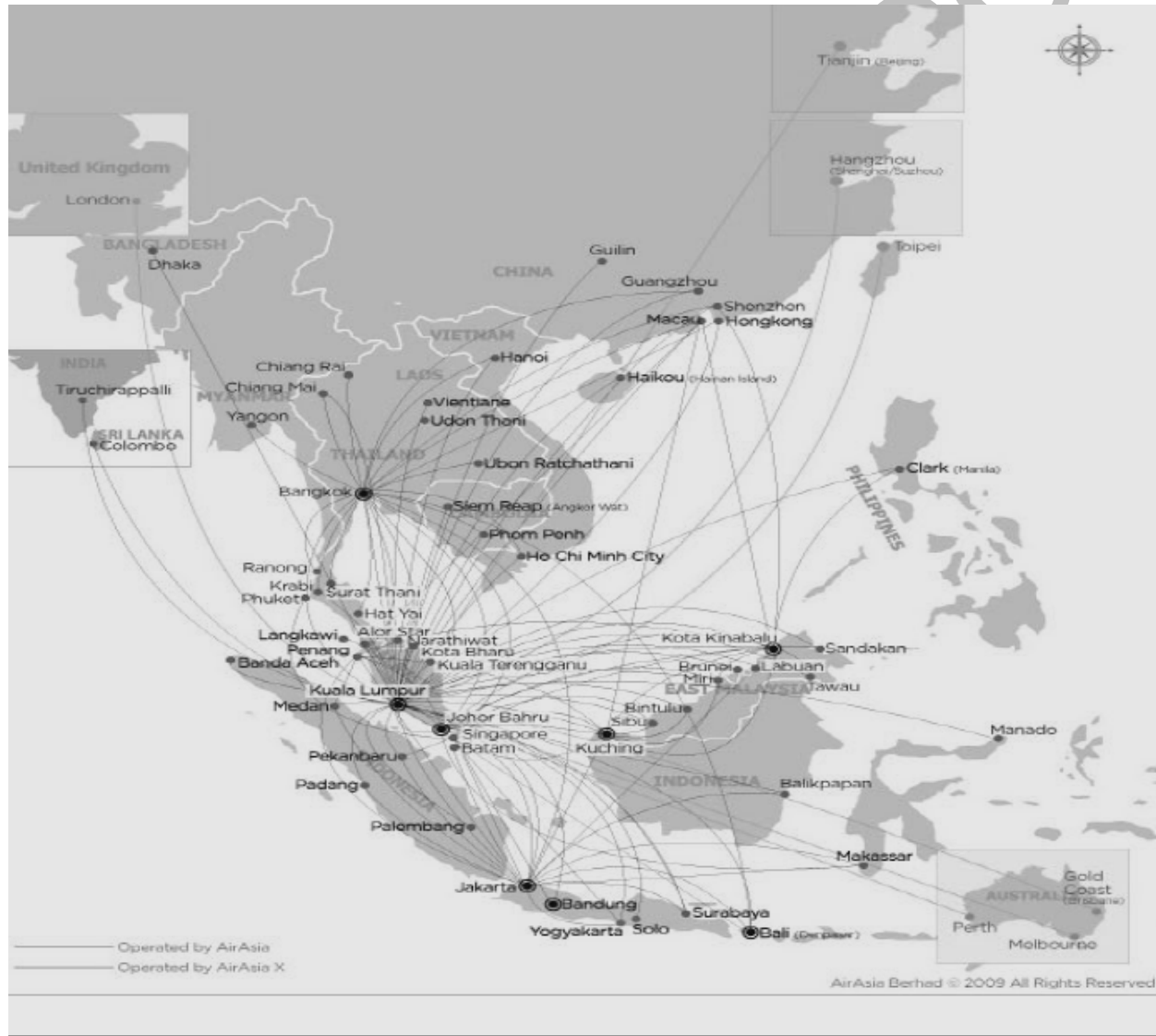
COST/ASK — AIRASIA'S YEAR ON YEAR COMPARISON

Cost Breakdown (US cents / ASK)	Jan-Mar 2009	Jan-Mar 2008	Δ (%)	Reason
Staff	0.34	0.36	-6%	Productivity gains
Fuel and Oil	1.04	1.93	-46%	Lower jet fuel price
User & Station Charges	0.26	0.20	29%	More international routes bias
Maintenance and Overhaul	0.17	0.16	3%	Redelivery of Boeing 737-300 cost
Cost of Aircraft	(0.25)	(0.08)	212%	Sub-lease income from associates
Depreciation & Amortisation	0.52	0.48	9%	More number of owned aircraft
Sales and Marketing	0.11	0.14	-19%	Economies of scale
Others	0.20	0.11	84%	Higher overheads
Cost / ASK	2.38	3.30	-28%	
Cost / ASK - excluding fuel	1.35	1.37	-2%	
Finance Cost	0.51	0.34	49%	More aircraft being financed
Cost / ASK inc. finance cost	2.90	3.64	-20%	

Source: Company files.

Exhibit 3

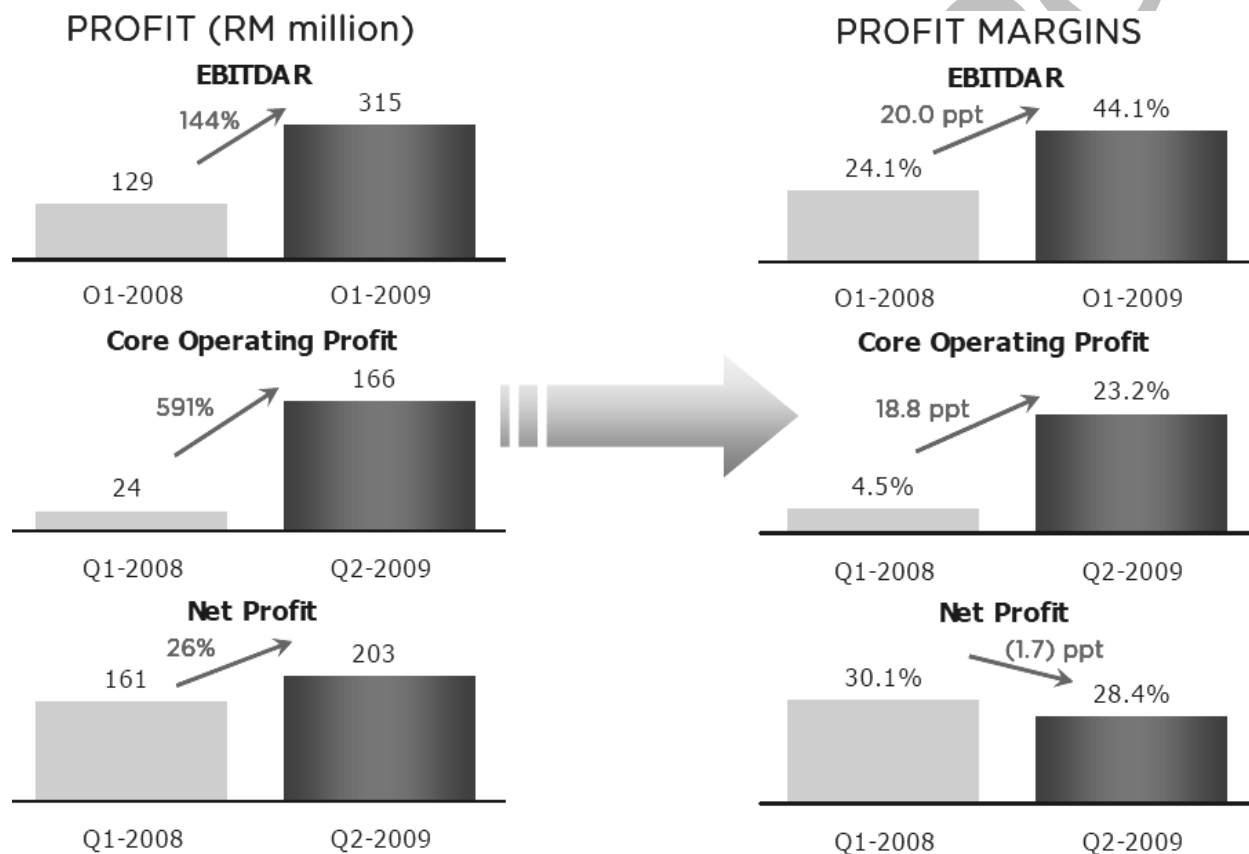
AIRASIA AND AIRASIA X ROUTE NETWORK (2009)



Source: Company files.

Exhibit 4

AIRASIA'S PROFIT AND EXPANDING MARGINS



RM = Ringgit (Malaysia's unit of currency; on June 1, 2008, RM1 was equal to US\$0.30)

EBITDAR = Earnings Before Interest, Taxes, Depreciation, Amortization, and Restructuring or Rent Costs

EBIT = Earnings Before Interest, Taxes

Source: Company files.