Global Conference on Business & Social Science-2014, GCBSS-2014, 15th & 16th December, Kuala Lumpur

The Competitive Pricing Behaviour of Low Cost Airlines in the Perspective of Sun Tzu Art of War

Lim Sengpoh*

Matriculation College Negeri Sembilan, Business Administration unit, Kuala Pilah, Negeri Sembilan, 72900, Malaysia

Abstract

Price wars are the fact of today’s aviation industry. This paper seeks to examine the nature of price setting behaviour of low cost airlines and evaluate their financial performance. The findings reveal that the competitive pressure has led to price predatory. Based on the Sun Tzu Art of War philosophy, this study highlights that the conditions for rationality and success in this business game depends greatly upon the efficiency and intelligence of the line management and believe that the ability to control the price war between these two low cost airlines will provide healthy competition.

Keywords: pricing behaviour; financial performance; low cost airlines; Sun Tzu of art of war; competiveness.

1. Introduction

Sun Tzu Art of War (Chapter 3) highlights that "...Hence to win 100% in every single battle is not supreme excellence; supreme excellence is winning the war without fighting". The battle avoidance theory is one of the important theories that embedded in this philosophy.

The low cost carrier can successfully neutralize the dominance of its competitors by competing on price and its stunning result has triggered the researchers to study the reasons of the success. The deregulation of the aviation industry has had dramatic impacts on the full service carriers especially in Singapore, Indonesia, Malaysia, and Thailand. Open sky policy and deregulation have triggered the full services carriers to react by launching their own

* Corresponding author.
E-mail address: limspoh@gmail.com
low cost carrier versions, for example Singapore Airline owns low cost version i.e Tiger Airways and JetStar Asia; India Airlines Jet launched a no frill subsidiary; Air Deccan has been taken over by Jet Konnect and Kingfisher and Kingfisher Red, a low cost carrier has been created in year of 2008. These low cost carriers offer similar fare prices and reflect a direct competition for larger market share. In the year 2008, AirAsia in Malaysia faced a massive competitive threat an effective assault from the Malaysia Airline. For the first time in the history of aviation industry in Malaysia, the full service airline has launched a “zero fare” campaign to sell surplus seats on domestic and regional flights with the aim to stimulate the consumer market. The incumbent low cost airline, AirAsia, chose to compete directly with the full service airline by launching its own “sub zero fare” campaign (Sidhu, 2008). It is widely held view that by building volume through discounting tends to lead the market into the fluctuation situation, the strategy to fill the vacant seats with zero fare is enough to plunge the stock into tailspin, promotion tactics such as offer heavy discount in the attempt to gain the market shares, it is believed and reflected a short term phenomenon. The predatory pricing strategy has the significant impact on airlines’ financial performance and it has compelled the Malaysia Airlines and AirAsia, eventually entered the Comprehensive Collaboration Framework Agreement in the year 2010, nevertheless, the synergistic collaboration between these fierce competitors and rivals terminated in the year 2012 (CAPA, 2012). The impact from the collaboration has forced MAS to withdrawal from the business game and AirAsia retain the one low cost airline in Malaysia. Hence, this paper attempts to compare the fare patterns, financial performance and explain the factors that drive the party to win the battle without fighting.

Literature review

Stiff competition in the aviation industry has triggered the airlines’ operators looking for the best strategy to sustain. Samui & Amy (1997) argue that the goal of running a business is parallel to the warfare because the objectives are related to a profit increase. They compare the Sun Tzu five factors in the war and the business, they stress that the secrets of success in battlefield and business should base on Sun Tzu’s five factors which are morality, climate, terrain, generalship and doctrine (Table 1). While, in business the moral of the key management in the organization is considered an important factor, the business climate that affects the performance of the organization, the industrial environment could affect the choice of strategies e.g. competitiveness, the intelligence of staffs, the decision making process and finally, government’s policy and regulations. Sun Tzu Art of War highlights the strategy to defend the terrain issue by reminding that “One does not rely on the enemy not attacking, but on the fact that he himself is unassailable”. Hence, an iron powerful brand, high efficiency service reflects the capabilities of the company and retains the confidence of the customers.

Table 1: Sun Tzu’s Five Factors

<table>
<thead>
<tr>
<th>Five Factors</th>
<th>In War</th>
<th>In Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Morality</td>
<td>Moral of the ruler</td>
<td>Moral of the key management</td>
</tr>
<tr>
<td>Climate</td>
<td>Climate nature</td>
<td>Business climate e.g. recession</td>
</tr>
<tr>
<td>Terrain</td>
<td>Terrain of battlefield</td>
<td>Industrial environment e.g competitiveness</td>
</tr>
<tr>
<td>Generalship</td>
<td>Ability of generals</td>
<td>Quality of staff and management</td>
</tr>
<tr>
<td>Doctrine</td>
<td>Discipline of the troops execution of laws and instruction</td>
<td>Government regulations and organization</td>
</tr>
</tbody>
</table>

Source: Samui & Amy (1997)

The art of Sun Tzu warfare highlights that the secrets of success in battlefield need effective strategic planning. In the operational reality, low cost airlines in Malaysia faced with the many challenges such as governmental control and interference, the competitiveness in business, the rising of operating cost and more demanding customers. Therefore, the survivals of the airlines depend greatly upon the sustainable strategies to remain viable (Sengpoh, 2012). Generally, these two rival airlines have operated from the same origin to a number of identical destinations from the year 2008 to 2010, the rivalry is reflected in the fare offering because the service package that they offer to customers is very similar. The trend of the fare pattern demonstrates that a firm responds to the aggressive pricing of the competitors by pricing more aggressively itself. Sun Tzu highlights that the morality issue as the top priority for a leader to join,
develop and reconfigure internal and external competencies in order to address the rapidly changing environment. A firm’s reputation, trustworthiness and solidarity determine the success and failure in business; it is believed that the competitiveness of a business environment is highly correlated with the key managements’ attitude towards ethics. This view is strongly supported by Kadir (2014) who points out that there are perennial issue of indiscipline, low productivity, abuse of power and corruption in MAS. Sun Tzu’s five factors philosophical has emphasized on the “Generalship”. This principle has been supported by Hitt et al. (2001) who states that human capital drives the company performance. Their finding is congruent with Collings and Mellahi (2009), who posit that the skills and abilities of talented employees represent a major source of competitive advantages. Thus, strategic human resource management strategies is essential, Mary and Andreas (2011) proposes the concept of “dynamic capabilities”, they conclude that in order to create a consistently high level of organizational performance, it is not only requires extraordinary technological competence but a high intellectual and emotional strength by the employees. The ability to deliver high performance relies on the talented employees. However, talented employees need effective leadership. Sun Tzu emphasize leadership requires five qualities i.e trustworthiness, intelligence, humaneness, courage and discipline. In the context of airlines, quality key management of the firm must be able to identify the strength and weakness similarly sensitive towards the threats and opportunities in the context of competitive landscape. They have to ensure the internal resources of the firm in terms of human resources, intellectual capital and physical assets owned and capable of generating profits. The stakeholders’ theory holds that maximizing aggregate stakeholder utility results in improving the financial performance. In summary, a successful airline organization requires a team of management that proficient in gathering market intelligence and able to guesstimate and forecast the competitors’ strategic planning. Radhakrishanan (2008) claims that an efficient and dedicated line management must be able to view the company in the context of evolving psychographic buying behaviour, political environment, legal, government policies, economic, social, and technological developments precisely. In the context of aviation industry in Malaysia, the battle between the full service carrier and low cost airline has become intensified after MAS has its own version of low cost airline. The effort to replace each other is obvious, low cost airlines have created a widespread belief that the only way to offer low prices would be to cut back on service level. Nevertheless, the full service carrier has destroyed the myth that “if you have service, it will cost you” by offering zero fare for all the domestic destinations in the year 2008, the reaction of Malaysia Airlines has stimulated the consumer market and the innovative business strategy has effectively creates the confidence and excitement of the customers (Sengpoh, 2012).

2.1 Financial performance before entering the comprehensive collaboration framework agreement

2.1.1 AirAsia

The history of the AirAsia low cost airline is unique because it has transformed itself from a regional operator that incurred heavy loses to a profitable low cost airline. Since 2001, it has been expanding drastically. AirAsia equipped with a fleet of 72 aircrafts, flies to over 61 domestic and international destinations with 108 routes and it operates over 400 flights daily from hubs located in Malaysia, Indonesia and Thailand. AirAsia has flown over 55 million guests across the region and continues to spread its wings to create more extensive route networks through its associate companies, Thai AirAsia and Indonesia AirAsia (Yvonne, 2008). For the first six years, AirAsia has not only developed dramatically in the airline market but also recorded an excellence financial performance. During a five year period, its revenue has increased more than 300% from RM330mil to RM1603 mil. The number of passenger has increased nearly 90% compared to the year 2003 and 2007 and the profit has also increased significantly by 98% from RM3.5mil to RM 278mil compared to year 2003 and 2007. As for the Earning before Interest, Taxes, Depreciation and Amortization (EBITDA) it has indicated a dramatically increased by 80% from 95 mil to 490mil. Overall, AirAsia has managed to achieve an upward trend of financial performance (AirAsia, 2007). However, the growth momentum did not persist forever, as in the year 2009, AirAsia experienced the lowest sales growth. It is believed that this scenario occurred due to the increased competition from other low cost carriers, the uncertainty of crude oil prices and the spillover effects from the global recession. These factors have leaded AirAsia’s net profit for the second quarter which ended June 30 (2008) plunged 95% to RM9.42million from RM185million. Moreover, the weakened ringgit has the significant causal effect on the translation loss (Yvonne, 2008). AirAsia’s product is travel, a service that is highly
competitive by its very nature. Customers have many choices not only in their mode of travelling such as cars and public transportation but also in their own choice of air carriers. Financial performance of the airline has given the signal that reflects the elasticity of the demand, it demonstrates that the low cost airlines faced stiff competition in the duopoly market structure.

2.1.2 Firefly and Mas Wings

The appearance of new low cost airlines, such as Firefly and MAS Wings, which are the subsidiaries of Malaysian Airline System (MAS) Berhad have become a threat to AirAsia in the domestic market. AirAsia’s Fly Asian Xpress (FAX) has ceased operations to rural air sites in Sabah and Sarawak. The service is now operated by MAS Wings Sdn. Bhd. Firefly has established itself as a low cost airline that offers low fares to all its destinations. The liberalization of the Kuala Lumpur to Singapore route in December 2008 and other Association of South East Asian Nations (ASEAN) capital routes offered many opportunities to Firefly. The stiff competition between these two airlines goes beyond domestic routes and across Association of South East Asian Nations (ASEAN), it has been expected that they will compete with each other to have more lucrative markets in Asia. Nevertheless, Firefly has its own threats, being a subsidiary of MAS which is under governmental interference; it has to fly to non lucrative market routes such as Perak State (Sihdu,2008). Some legacy carriers such as the British Airway, KLM, Continental and Delta have already tried and failed to operate low cost airline subsidiaries (Murphy, 2009). Japan Airline, once the pride of Asia and a symbol of Japan’s global economic advances, has filed for legal bankruptcy protection. The bankruptcy of Japan Airline will definitely affect its four subsidiaries low cost airlines, which are Jal Express, Jal Ways, Jal Air and Japan Transocean Air. Thousands of jobs have been cut and more than 30 unprofitable routes have been terminated. For the full financial year of 2009 and 2010 ending at March, the Japanese carrier was reported to incur a loss of RM6.59 billion (USD 2.2 billion) (Andrew, 2010).

The effects of the stiff competition in the duopoly market structure in Malaysia has forced Malaysian Airline, AirAsia and AirAsia X entered into a Comprehensive Collaboration Framework Agreement in the year 2011, a key aspect of the agreement was to explore the co-operation on a broad range of areas. Nevertheless, this cross-ownership agreement between Malaysia Airlines (MAS) and AirAsia has officially been terminated by the year 2012.

2.2 Financial performance after the termination of comprehensive collaboration framework agreement

Lara News (2013) reveals that AirAsia Berhad has declared its financial results for the year ended 31 December 2012 with a profit after tax of RM1.88 billion and for the full financial year ended 31 December 2012, there was 11% increase in revenue at RM5 billion with a net operating profit of RM858.23 million. As reported, there was a 238% increase in profit after tax, yielded profit to RM1.88 billion, relatively compared to RM555 million in 2011. Star (2013) further elaborated that AirAsia has achieved a net profit rose 3.6% to RM157.81mil from152.29 mil. It has posted a record of the revenue of RM1.24bil, up 14.4% from RM1.081bil. The profits per share were 5.70 sen as compared with 5.50 sen. Furthermore, AirAsia has expanded its network to more exotic destination such as China, Lombok, Semarang, SuratThani, Kuming and Nanning. Dalila (2013) noted that in the year 2013, AirAsia flew 9%more passengers and its fleet size has been increased from 57 to 64, route network has been expanded. AirAsia dominated 60% of the domestic travel market and 40% of the international destination market. Apart from this, AirAsia has also entered the partnership with Tata Group and Bhatia family in India to set up operations in the subcontinent. On the contrary, (CAPA,2013) reported that for the year 2012, MAS incurred a net loss after tax of MYR431 million (USD139 million) and an operating loss of MYR361 million (USD116 million), compared to a net loss of MYR2.521 billion (USD813 million) and operating loss MYR2.296 billion (USD741 million) in 2011. MAS embarked on a major restructuring programme, in the late 2011, it cut all the unprofitable routes and costs in a bid to avoid bankruptcy of the firm. In this year 2014, two major tragedies MH370 and MH17 that claimed 537 lives have completely tarnished the airline image and public confidence. It suffered a loss of RM 443 million for the Quarter of 2014, the crisis has forced airline to shed at least 6,000 jobs and hive off large chunks of its operations (Elieen & Kelvin,2014). The revelation of the financial performance of the two parties shocked the nation. Skytrax (2014) reported that AirAsia has won “The Asia’s best low Cost Airline” for sixth consecutive year. The winning award has
bolstered confidence in the quality assurance and enhances the credibility of the airlines in the perception of the stakeholders. It is obvious; the collaboration strategy has given significant beneficial effect to only one party.

**Research methodology**

### 3.1 Ticket price pattern before the comprehensive collaboration framework agreement

Granger Causality Test has been applied to test the relationship between ticket price and airlines. The pair regressions equations were estimated to identify the causality effects. The test assumes that the information relevant to the prediction of the causality (Gujarati, 2007). The relationship between the ticket price of the two airlines in 6 domestic market routes has been examined and further observe the causality pattern that lead to identify the price leader. Data have been collected in two duration periods for 60 days each. The two set of primary data have been collected from the airlines’ websites from (13 November to 11 January 2010) and (23April to 21 Jun 2010).

\[
PAAt = \gamma_0 + \sum_{i=1}^{n} \alpha_i PAA_{t-1} + \sum_{i=1}^{n} \alpha_i PFF_{t-1} + \varepsilon
\]
\[
PFFt = \gamma_0 + \sum_{i=1}^{n} \alpha_i PAA_{t-1} + \sum_{i=1}^{n} \alpha_i PFF_{t-1} + \varepsilon
\]

where PAAt indicates ticket price of Air Asia, PFFt indicates ticket price of Firefly. In Granger causality test ticket price of airlines is assumed to be interlinked and correlated while \(\varepsilon\) represents the “noise” or error term, error \(\varepsilon_{ts}\) incorporated in the equation to cater for other factors that may influence ticket price of AirAsia, \(n\) represents the optimal lag order, and in this study is 19. \(\gamma\) and \(\alpha\) represent the slope and coefficient of regression. The coefficient of regression, \(\alpha\) indicates how a unit change in the independent variable (ticket price of Firefly) affects the dependent variable. Table 2 has demonstrated the summary of the results.

**Table 2: The Results of Granger Causality Test**

<table>
<thead>
<tr>
<th>Null Hypothesis</th>
<th>Destinations</th>
<th>13 Nov – 11 Jan 2010 (Decision)</th>
<th>23 Apr – 21 Jun 2010 (Decision)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AirAsia did not granger cause Firefly</td>
<td>K.Lumpur - Penang</td>
<td>Fail to reject</td>
<td>Reject</td>
</tr>
<tr>
<td>Firefly did not granger cause AirAsia</td>
<td></td>
<td>Fail to reject</td>
<td>Fail to reject</td>
</tr>
<tr>
<td>AirAsia did not granger cause Firefly</td>
<td>K.Lumpur - Langkawi</td>
<td>Fail to reject</td>
<td>Fail to reject</td>
</tr>
<tr>
<td>Firefly did not granger cause AirAsia</td>
<td></td>
<td>Fail to reject</td>
<td>Reject</td>
</tr>
<tr>
<td>AirAsia did not granger cause Firefly</td>
<td>K.Lumpur – Kota Bahru</td>
<td>Fail to reject</td>
<td>Reject</td>
</tr>
<tr>
<td>Firefly did not granger cause AirAsia</td>
<td></td>
<td>Reject</td>
<td>Fail to reject</td>
</tr>
<tr>
<td>AirAsia did not granger cause Firefly</td>
<td>K.Lumpur–K.Terengganu</td>
<td>Fail to reject</td>
<td>Fail to reject</td>
</tr>
<tr>
<td>Firefly did not granger cause AirAsia</td>
<td></td>
<td>Reject</td>
<td>Fail to reject</td>
</tr>
<tr>
<td>AirAsia did not granger cause Firefly</td>
<td>K.Lumpur – AlorSetar</td>
<td>Fail to reject</td>
<td>Fail to reject</td>
</tr>
<tr>
<td>Firefly did not granger cause AirAsia</td>
<td></td>
<td>Reject</td>
<td>Reject</td>
</tr>
<tr>
<td>AirAsia did not granger cause Firefly</td>
<td>K.Lumpur – Johor Bahr</td>
<td>Fail to reject</td>
<td>Fail to reject</td>
</tr>
<tr>
<td>Firefly did not granger cause AirAsia</td>
<td></td>
<td>Reject</td>
<td>Reject</td>
</tr>
</tbody>
</table>

(13 November to 11 January 2010) and (23April to 21 Jun 2010)

### 3.2 Fare pattern after the termination of comprehensive collaboration framework agreement

Granger Causality Test technique has been applied to test the relationship of ticket price (all fares in) of the two airlines in 6 domestic market routes further examined the causality effects of fare pattern after the termination of comprehensive collaboration framework agreement. Data have been traced from the airlines’ website in one duration period for 60 days from 9 October 2014 to 7 December 2014. Table 3 illustrates the summary of the results.
Table 3: The Results of Granger Causality Test

<table>
<thead>
<tr>
<th>Null Hypothesis</th>
<th>Destinations</th>
<th>9 Oct – 7 Dec 2014 (Decision)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AirAsia did not granger cause Firefly</td>
<td>K.Lumpur – Penang</td>
<td>Fail to reject</td>
</tr>
<tr>
<td>Firefly did not granger cause AirAsia</td>
<td>K.Lumpur – Langkawi</td>
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<tr>
<td>Firefly did not granger cause AirAsia</td>
<td>K.Lumpur – Johor Bahru</td>
<td>Fail to reject</td>
</tr>
</tbody>
</table>

(09 October 2014 to 7 December 2014.)

4. Airlines’ future strategic planning

The presence of the Firefly airline has not only neutralized the ticket price of the incumbent low cost airline but has caused a fierce competition for larger and more lucrative market. For example, Firefly has expanded its service to Kuching, Kapit, Sibu and Kota Kinabalu (Sengpoh, 2011). It is a widely held view that when the business environment is extremely competitive and customers have various options to choose, providing superior customer service is critical for the success of an airline. From the customer’s point of view the concept value for money in the airlines industry includes price and quality. The customers requiring reasonable price and reliable service to gain the satisfactory travel experience. The findings of the fare pattern after the termination of Comprehensive Collaboration Framework Agreement has validated there is no causality effects on each other. It demonstrates dynamic pricing strategy of low cost airline. On the contrary, the fare pattern of Firefly implies stability, it has not only changed its business model but also limit the market routes.

Sun Tzu Art of War chapter 3 highlights that:

"So it is said that if you know your enemies and know yourself, you can win a hundred battles without a single loss. If you only know yourself but not your opponent you may win or lose. If you know neither yourself nor your enemy, you will always endanger yourself."

This theory concerns the internal readiness for the future. In an ever-changing competitive environment; the double tragedies have struck Malaysia Airlines in the deeper stage and the government latest effort to resuscitate the ailing flag carrier has triggered the worries of the nation. Kadir (2014) argued that there is eminent danger that airlines could worsen under full government ownership and management as the abuse of power and corruption might lead airline to collapse. Foo (2011) attests that in order to survive in the competitive marketplace, firms need to have a swift paradigm in managing their enterprise and he suggests remodelling of business as the effective strategies. This call has echoed by Sengpoh (2012) that conducted the study by observing the ticket prices of two low cost airlines AirAsia and Firefly in the six domestic routes and she has concluded that the price setting behaviour of these low cost airlines was towards Barometic price setting behaviour, there was a tendency of frequent switches in the price leadership position. Hence,
the healthy competition has promised a significant impact for the beneficial of customers, airlines have to adjust their strategies to deploy alternatives methods when pricing alone is no longer effective. They need to design and create values for the business through strong differentiation and position the business goals precisely.

The Chinese Warrior states that “Those who are not thoroughly aware of the disadvantages in the use of arms cannot be thoroughly aware of the advantages”. In the year 2008 Malaysia Airlines System (MAS) has tried to modernize and expanded the airline’s fleet by purchasing the Airbus A330 and Boeing 777, in the effort to penetrate the low cost business market and this frontal attack strategy in business game it is generally considered risk (Kotler, 2001). If airlines uses low prices as their competitive weapon they must be equally aware of the risks and benefits. Kotler (2001) reveals that implement low prices strategy incurs some risks such as the low quality trap where the consumers judge the price as an index of the quality and the fragile market share. It is believed that the low prices can raise the market share but not the faithfulness of the clients. Porter (1980) in his generic strategy highlights that if a firm engages in the strategy of offering low fares and differentiation but fails to achieve any of them is “stuck in the middle”, competitive advantage requires consistent actions. Porter (1980) again emphasized that a classic example is the Laker Airways which began with a clear cost focus strategy based on no frills operation in the North Atlantic market aimed at a particular segment of the travelling public that was extremely price sensitive. Over time, however this British airline began adding frills to the new service and delivery system. In order to maintain its profitability, Laker Airways had to raise its ticket price and the consequences were disastrous, Laker Airway eventually went bankrupt.

5. Conclusion

For year the rhetoric of marketing has been that of warfare, marketer targets the customers, campaigns and offensives strategies for a more stable market share. It could be concluded that AirAsia which has a powerful brand presence, high efficiency and strong online booking services uses counter-offensive defence skilfully and won the battle without fighting. On the contrary, with the two major tragedies occurred in Malaysia Airline, doubts have been raised about the future of this national flag carrier. This study suggests that in this senility business life cycle stage, Malaysia Airline needs the rejuvenation strategy to survive and prosper, moving towards service recovery and rebranding from the poor public image as the only strategy. Malaysia Airline needs a team of caliber expatriate that able to lead the company towards differentiation by producing new versions and positioning the product with new image. As a matter of fact, the open sky policy has triggered battle among airlines nevertheless, the ability to control the price war between these two low cost airlines will leave a significant impact on airlines’ industry, healthy competition will ensure the customers who purchased the ticket for travelling, normally equipped with price knowledge therefore behave strategically will be benefited from the competition.

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