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Flying High: How Vietnam's aviation industry has become one of the country's fastest growing sectors

While the differences between frontier and developed markets are many, sometimes there are themes or trends that have done well in the latter and are now taking hold in Vietnam. Budget airlines are one such trend, and VietJet Air is leading the way.

Vietnam Airlines, the country's flag carrier, has historically dominated both the international and domestic markets. Foreign ownership of airlines is limited to 30%, meaning that it is difficult for overseas carriers to enter the market. While the flag carrier still dominates international flights, its hold on domestic flights has gradually loosened. In 2007, the company formed a joint venture with Qantas to operate JetStar Pacific, a low-cost carrier (LCC) that primarily flies domestic routes but also to a handful of regional destinations. This carrier has had limited success, while other start-ups, including Mekong Air, have come and gone, some due to flawed business models and a lack of economies of scale, others a victim of timing. The stage was set for a domestic company with scale and ambition to fill the gap between the national flag carrier and other players in the market.

Enter VietJet Air. Founded in 2007 by a young woman educated in the former Soviet Union, VietJet has gone from one jet and two domestic routes in 2011, to 40 jets (and 182 more on order) and a route network spanning 36 routes in Vietnam and 17 international routes to Thailand, Singapore, China, and Myanmar, among others; the company is targeting 45 domestic routes by 2019, and 36 international routes in 2018. Competing head-to-head with Vietnam Airlines and JetStar, VietJet has already taken a 43% share of the domestic air travel market[1].

VietJet's formula for success is simple:

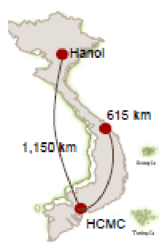
- **Modern fleet**: At an average of 3.3 years old, VietJet's fleet of Airbus aircraft is among the youngest and most efficient in the world.
- **Low costs**: VietJet has among the lowest unit costs in the world, with room to achieve even greater cost savings. High seat density, aircraft utilization, labor productivity and unit maintenance costs enable VietJet to surpass regional peers.

Company	Load factor	Aircraft Utilization (hours/day)	Labor Costs (US cents/ASK*)	CASK ex-fuel (US cents/ASK)
VietJet	88%	13.3	0.41	2.42
Air Asia	81%	12.4	0.51	1.84
Thai Air Asia	83%	10.9	0.54	2.87
Cebu Pacific	84%	12.6	0.37	2.53
Ryanair	92%	11.8	0.45	2.28
EasyJet	93%	11.1	0.90	4.98
Southwest	84%	11.1	n/a	5.35
Peer average	82% Asia/91% global	11.9	0.53	2.87 Asia/3.11 Europe/4.49 Americas

Source: VietJet; *Available Seat Kilometer (ASK)

- **Low fares**: Domestic air travel in Vietnam is comparatively inexpensive. For example, the price of a ticket from Hanoi to HCMC could be the same as that travelling by

Travel mode[2]	HCMC-Hanoi		HCMC-Danang	
	Time (hrs)	Fare (USD)	Time (hrs)	Fare (USD)
Air	2:05	44	1:20	28
Bus	35:00	38	15:30	19
Rail	34:00	49	17:00	28



[1] All figures from VietJet, as of June 30, 2016
[2] Table/map source: VietJet

rail, but takes about 10% of the time to make the journey – two hours while the traditional options take up to 48 hours. Buses are the cheapest form of transport, but take more time and their safety is often questionable. For the average Vietnamese, affordable air travel means that they can get to places cheaper, quicker, and safer than before, while also encouraging more travel, meaning a higher growth rate for the industry as a whole.

- **Attention-getting marketing**: Known the world-over, VietJet is the "bikini airline," thanks to promotional campaigns featuring scantily-clad flight attendants (note: actual flight attendants working flights are not wearing bikinis, no doubt disappointing some passengers).

Vietnam's historical passenger growth (2011-2016) was 17.2%[3], among the highest in the region. The International Air Transport Association notes that Vietnam was the third-fastest growing country in the world, and is expected to be the fifth fastest growing by 2035 with 150 million passengers compared to 52 million[4] now.

While some of this growth can be attributed to higher disposable incomes of Vietnamese people, companies like VietJet have also played an important role in making air travel more accessible to more people. Airlines are not the only companies benefitting from the surge of travel – companies involved in ground services and catering are also seeing growth. But perhaps the biggest beneficiary is Airports Corporation of Vietnam (ACV), which operates all 22 airports in the country. It makes money from charging a range of fees (e.g., airport security, passenger, landing and take-off) as well as leasing retail space within airports. After equitizing in late 2015, and listing on UPCoM in November 2016, ACV's market cap is approximately USD4.8 billion, which would rank it among the top five companies in the VN Index (the company plans to move to the Ho Chi Minh Stock Exchange later this year, at which time it will become part of the VN Index); in contrast, VietJet's market cap is approximately USD1.8 billion.

While VietJet makes most of its money from domestic routes, ACV earns more from international flights, where airlines and passengers pay far higher fees. ACV is in the process of raising domestic fees to narrow the gap and to be more in line with standard practice in other countries. ACV's success has not gone unnoticed – its equitization was among the more successful such endeavors in recent years, and Airports de Paris has been negotiating to take a strategic stake in the company.

Competition to rise as tourism continues to grow

In 2016, international tourist arrivals to Vietnam surpassed 10 million – a 26% increase from the previous year. Moreover, there were more than 60 million domestic air travelers. By 2020, the government is forecasting 17-20 million international arrivals and 82 million domestic travelers[5].The government has made expanding and enhancing the country's tourism infrastructure with a goal of the industry contributing 10% of GDP by 2020, up from 6.6% in 2016. While this may seem ambitious, the

International Tourist Arrivals (thousands)

Country	2014	2015	2016
Vietnam	7,874	7,944	10,013
Thailand	24,809	29,881	32,558
Cambodia	4,503	4,775	5,012
Malaysia	27,437	25,271	26,757
Singapore	15,095	15,231	16,400
Indonesia	9,435	10,231	12,023
Philippines	4,833	5,361	5,900

Sources: respective tourist boards/ministries/agencies

[3] Civil Aviation Administration of Vietnam
[4] Civil Aviation Administration of Vietnam
[5] "Vietnam to strengthen tourism quality," *TTR Weekly*, April 25, 2017

achievements of regional peers suggest that there is ample room for growth.

Competition among LCCs will undoubtedly become fiercer as new players enter the market to participate in this growth. Air Asia recently announced that it is forming a joint venture with a Vietnamese company to form an LCC, to mirror what it has done in markets like Thailand and Indonesia. While it is a late entrant, Air Asia's substantial resources and experience cannot be discounted. Meanwhile, the military is looking to get in the game with Vietstar Air, although the company was recently informed that its license has been put on hold pending expansion of Tan Son Nhat airport.

A recent proposal to set floor prices on domestic routes – which is supported by JetStar and Vietnam Airlines, who have claimed they are losing money on most of the domestic routes even when running at almost full capacity – is under consideration by the CAAV, although recent comments from the Minister of Transport (who would ultimately have to approve such a measure) suggested that such a proposal was not necessary. VietJet opposed the measure.

Looking forward, the government may in principle raise the foreign ownership limit to more than 30%; VietJet recently received shareholder approval for a proposal to lift its limit to 49% should the government allow such a move.

ACV's future is slightly more clear, although it remains to be seen whether the Government will rely solely on the company to invest in expanding existing airports, or building new ones entirely, as has been proposed for HCMC. The Long Thanh International Airport, to be located 40kms from the city's central business district, is estimated to cost approximately USD15 billion, an investment ACV is unlikely able to finance itself, or will be required to take on additional debt or equity funding. If outsiders are involved, will ACV remain the operator of these new terminals? Or will it receive a percentage of revenues with the balance going to external investors? These and other questions bear monitoring.

Long Thanh International Airport design concept

<u>Conclusions</u>

Air travel is still a young industry in Vietnam, and we expect solid growth for the foreseeable future; industry analysts believe market saturation remains a way off. While increasing competition in the airline space is a given, we believe VietJet's competitive advantages – early market entry, brand equity, and a talented management team with an ambitious-yet-realistic business plan – will enable it to continue to grow. Vietnam Airlines, which also recently listed its shares, is always likely to be the key international player, and it too has stepped up its products and services, in part to compete with VietJet. As is typically the case, consumers benefit from increased competition. Vietnam Airlines has some legacy issues that come with being a state-owned enterprise. While we believe ANA's strategic partnership with the flag carrier will be beneficial, we think VietJet has more flexibility that comes from being a relatively new private company with a modern fleet.

Perhaps the biggest challenge for VietJet, Vietnam Airlines, and ACV alike is system capacity. The country's main airports are congested and require expansion, while the air traffic control system also needs modernizing. Flights to Hanoi and HCMC are routinely delayed, and the latter has limited ramp area for parking and servicing aircraft. Both airports have recently undergone expansions, with more in the works.

International investors are betting on VietJet (16.5x PE ratio) and ACV (34.5x PE ratio, based on 2016 earnings). Both companies have seen large share price gains: VietJet has gained 51.5% since its IPO in December 2016, and ACV gained 98% since being listed in November 2016. Both companies now face the challenge of generating profit growth and meeting investor expectations. From our standpoint, we believe that while there may be some occasional turbulence, both companies should be able to navigate around it and course correct as necessary.

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