COULD AIR FRANCE SHRINK LIKE ALITALIA?

News / Airlines

In 2008, air passenger demand was dipping, Gulf countries were building up their national fleets, and easyJet set up shop in Paris. Other European airlines cut routes and jobs in response. **Air France** did not. It has not made a profit since.

The timing of its attempt to catch up seven years later plays into the hands of aggressive competitors, former airline executives, analysts and union officials say, and its decision to slash long-haul routes by 10 percent leaves unsolved the problem of a bloated cost base.

"Many of us in senior management saw this coming," said a former Air France boss now working for one of its fast-growing competitors.

"If you want to be competitive with low cost, and stop them getting too big too quickly, you have to put your own house in order. We didn't do that. We procrastinated."

This week's scenes at the airline's Paris headquarters, when angry workers tore the shirt off a company executive and a security man was knocked unconscious after mass job cuts were announced, are one reminder of the task Air France bosses face.

A pilots' strike this year that cost 500 million euros ($562 million) is another.

The company has also struggled to get its own low-cost business off the ground in the face of union opposition.

France is a notoriously tough place to reduce pay and erode workers' privileges the way corporations have elsewhere. Air France says its pilots work 15 to 20 percent less than their European peers for the same pay.

The airline industry, though, is in the front line of globalization, that brutal killer of the highest-cost player.

Hence the belated biting of the bullet.

Air France, part of the Franco-Dutch Air France-KLM group (AIRF.PA) since 2004, plans 2,900 job cuts, a figure unions say could rise to 8,000 of the carrier's 64,000-strong work force.

Some 900 cabin crew and 300 pilots are among the promised casualties.

It will take 14 of its 107 long-haul fleet of aircraft out of service by retiring planes early and cancelling orders, shutting down five of the least profitable of its more than 80 long-haul routes.

Air France Chief Executive Frederic Gagey said this week the plan would work.

"When I took on the job running this company it was not to see it relegated to the second division ... Operating margins will be positive for the group for 2015; that hasn't been the case since 2008. A part of the recovery has already happened."

But that forecast margin he is so proud of is wafer thin - just 130 million euros ($147 million) on a cost base approaching 25 billion, and analysts are not so confident in the future.

"Even if they can impose the changes they've announced ... it still doesn't put the cost base in a more competitive position, it only reduces routes," said Liberum's Gerald Khoo.

"Maybe management think the 10 percent cut will get the unions into the mindset that they will keep on cutting."

There are several trade unions involved among ground staff and air crew with varying positions about the dispute. It is not yet clear whether any will call further strikes but their view of the future is similar to Khoo's, and with a bad ending.

"We fear attrition will bring on more attrition - a death spiral for our company," said Flore Arrighi, president of the Unac cabin crew union. Air France says it introduced the more draconian cuts after failing to reach a deal with air crew unions on a 'Plan A' that avoided compulsory lay-offs. Arrighi says she believes the deeper cuts were always the management's aim.

Her death spiral fears stem from the timing. The 2008 cuts done by British Airways, now part of IAG (ICAG.L) coincided with a downturn.

Seven years on, the industry is at a more vigorous point in the cycle with some players in expansion mode.

"If cutting routes risks giving up slots at a slot-constrained airport like Paris Charles de Gaulle, this would be a big step to take, because ?once surrendered they may not get them back," said John Strickland, an aviation consultant at JLS Consulting.

"Leading low-cost carriers easyJet EZI.L and Ryanair (RYA.I) would be eager to seize such an opportunity."

EasyJet opened a base at Charles de Gaulle airport, north of Paris, in 2008. Ryanair in the past eschewed major hubs for cost reasons, but last month said it had applied for Paris airport slots.

Should Air France enter that spiral of cutbacks and shrinkage, potentially dragging its Dutch partner with it, it would be following a route already traveled by Italy's flag carrier.

"Over the coming decade the worst-case scenario for Air France would be to end up like Alitalia [CAITLA.UL], where successive restructuring plans were not effective enough, ending with a need for repeated recapitalizations that pushed it eventually into the arms of a foreign investor (United Arab Emirates airline Etihad)," said a French analyst who did not want to be named. "It became a second-division player."

Air France-KLM is not there yet. Some industry sources says there are plenty of Paris airport slots, and that the main likely outcome is more long-haul flights routed through KLM's Schipol and fewer through Paris.

And although this year's pilots strike and this week's row look apocalyptic for the company, Australia's Qantas (QAN.AX) emerged in better shape after winning a similar showdown in 2011.

After failing to agree terms with unions, Chief Executive Alan Joyce simply grounded the company's aircraft until they capitulated.

“They were going to destroy the airline,” Joyce told the CAPA World Aviation Summit on Wednesday. “That (the grounding) changed the whole tone. One engineer told me ‘It showed me that management had a backbone and you were going to stand up to us and it was the first time anyone did’.”

Analysts also say that Air France has no immediate cash crisis, even though membership of the blue-chip French CAC 40 index .FCHI is a distant memory, and its market value has shrunk to just 1.8 billion euros, one-fifth that of easyJet.

Yet self-help is set to be the only way it can avoid slipping down the ranks of the world's airlines.

France's government has a stake of about 18 percent in Air France-KLM, but for all its horror at the image created by this week's violent scenes, and for all its record of intervening to keep other national champions afloat, it is taking a back seat as management and unions seek a way to reopen talks.

"At Air France, it's not about strategy any more, it's about managing its problems," said a government source. "Either there will be an agreement or there won't, and we'll have to live with the consequences."

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