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Low-cost? Low chance for Air France and Lufthansa

(Reuters) - Venerable old airlines Lufthansa (LHAG.DE) and Air France (AIRF.PA) know the smart money is in the low-cost market –Ryanair (RYA.I) raised its forecasts again on Thursday - but powerful labour unions are keeping them from the bounty.

The full-cost airlines were slow to respond to the explosive growth of the likes of Ryanair and easyJet (EZJ.L) from the late 1990s for fear of cannibalising their main revenue and because the upstarts were not directly competing on the same routes, and the efforts of Lufthansa and Air France were modest at best.

But now, with half of Europe's air travel market seized by the budget airlines, it is no longer a lack of will or foresight that is holding back the two carriers.

Air France's big plans to expand its Transavia low-cost unit are in trouble due to a costly strike by French pilots who fear the project would mean lower pay and jobs moving elsewhere.

Talks reached an impasse on Saturday, with both the airline's management and the French government rejecting a request from the union for a mediator. The airline said it would be able to operate only 45 percent of flights on Sunday.

Lufthansa, for its part, plans to expand its little-known regional carrier Eurowings, and is considering setting up a new low-cost long-haul arm, but is running into similar headwinds.

Lufthansa said on Thursday that pilots had been unwilling to engage in talks in trying to reduce costs on certain routes to Asia, where it has already agreed cost reductions with cabin crew, catering and maintenance staff. The pilots have also taken strike action this year over retirement benefits.

Industry experts say the pilots haven't grasped the threat to the legacy carriers from low-cost rivals and fast-growing Middle Eastern airlines. Such threats have already prompted both Lufthansa and Air France to cut their earnings expectations this year, while Ryanair basked in its second uptick in two months last week.

"There is a need to generate a better understanding of the tough market realities which they face, namely tough competition and low margins," independent aviation analyst John Strickland told Reuters.

While Ryanair has reported an operating margin of between 13 and 15 percent since 2010, Lufthansa's has fluctuated between 3 and 5 percent, and Air France's has been negative.

The pressure on margins is only likely to get worse if planemaker Boeing's (BA.N) forecasts are right. It expects low-fare airlines will operate 35 percent of the world's single-aisle planes by 2033, compared with 27 percent today. While costs have risen, it says air fares have come down by about 16 percent since 1995.

GETTING TOUGH

Lufthansa gets around half of its revenues from higher priced premium tickets, but Chief Executive Carsten Spohr, who took over in May, says Lufthansa needs to do more to capture the price-sensitive leisure market, which accounts for around 80 percent of short-haul European flights.

Since its existing domestic budget carrier Germanwings has turned out too costly to compete, he is aiming to use Eurowings for a new run at low-cost expansion in Europe, as its costs are 20 percent lower. The company placed an order for 10 jets for Eurowings last week.

Fuel is typically the biggest expense for airlines, making up around 30 percent of the cost base, but pay comes a close second, at 20-30 percent. Stripping out fuel, Ryanair (RYA.I) has the lowest unit cost in Europe, followed by Spain's Vueling - part of the IAG Group (ICAG.L) - easyJet (EZJ.L) and Norwegian Air Shuttle (NWC.OL).

To stand any chance of competing, that means legacy carriers need to cut staff costs.

Industry watchers point to the example of British Airways' parent IAG, which has struck some tough labour agreements, such as with BA cabin crew in 2011 after a protracted period of strikes that cost it around 150 million pounds, and more recently with Iberia pilots and ground staff.

Analysts estimate BA's labour costs are around 15 percent lower than the average for legacy airlines.

"These changes are allowing IAG to invest in new fleet and routes which will help ensure a brighter future for Iberia and its work force. Lessons need to be learned at Air France and Lufthansa," Strickland said.

Union Investment, one of the biggest 15 shareholders in Lufthansa, said Spohr has to take a firm line with the unions.

"The Anglo-Saxon companies are much tougher, as we saw with British Airways," portfolio manager Michael Gierse told Reuters.

Joerg Handwerg, board member for German pilots' union Vereinigung Cockpit, told Reuters it objected not to cost cuts but to "Lufthansa trying to dissolve collectively agreed pay structures".

UNEVEN FIGHT

Norwegian Air Shuttle gets around high domestic staff costs by using crew based in Asia to staff its flights between the United States and Europe, but the unions are unlikely to accept that at Air France and Lufthansa, analysts say, especially for the nations' flag-carriers.

In such an uneven fight, Gierse doubts the wisdom of Lufthansa even trying to expand its low-cost offering.

"Lufthansa should focus everything on their core product, namely flying business travellers around the world," he said.

If Air France can't reach a deal with its unions, it too might have to retreat to its more profitable segments.

"The backstop position may be to shrink the short-haul altogether," said James Halstead, airlines consultant at Aviation Strategy.

Even if the pair can make headway on cost cuts, the budget market is not standing still.

It is becoming more crowded as carriers such as Vueling and Norwegian challenge Ryanair and easyJet. A report by aviation consultancy Prologis shows that Vueling, acquired by IAG in 2013, now serves 129 destinations, a more than fivefold increase since 2009, catching up with easyJet's 130 destinations and the 179 offered by Ryanair.

Also, low-cost carriers are evolving to offer more services and fly to bigger airports to attack the legacy carriers' hold on corporate and higher paying travellers.

"It's an interesting time in the low-cost industry in Europe," AT Kearney consultant Rene Steinhaus told Reuters.

"Where once the low-cost carriers shied away from direct competition, they are no longer doing so."

That is troubling news for legacy carriers struggling with high costs and weak margins.

"The problem for legacy carriers is the more they are dealing with legacy issues, such as unions, who don't see the way forward, the harder it will be to set up a subsidiary and call it a low-cost airline," Ryanair boss Michael O'Leary said at a conference in Germany this week.

The CEO of Qatar Airways, Akbar Al Baker, put it more bluntly when talking about the challenges faced by Spohr.

"I'm sure he envies me very much because we don't have to take the crap of the unions," he told Bloomberg Television last week.

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