Watching Air France compete with British Airways and Lufthansa could be likened to watching the race between the Tortoise and the Hare. The industry had been complacent about the French flag carrier. But recent restructuring by its management has activated it to take full advantage of its huge potential and become Europe's most dominant airline.

Boum! – Watch out for Air France

Air France has lagged behind its major European counterparts British Airways and Lufthansa for so long (in terms of exerting strategy and financial performance) that it has become almost forgotten in the context of major airlines.

For years Air France failed to take advantage of a large international route network, the ninth largest volume of revenue passenger miles (RPMs) and the fact that it was based at the only major European airport with large expansion potential. However, a new management perspective restructured the airline in the past three years and it is now reaping the rewards.

Many were convinced Air France had been left standing by BA and Lufthansa. While BA and Lufthansa forged ahead, Air France was viewed as an out-of-date bureaucratic dinosaur, which only survived because of huge EU funds and subsidies that were pumped into it. Whatever Air France tried to do to catch up it was too late.

Leapfrog

It is already clear that Air France has the potential of a powerhouse, which could seriously threaten the status of its two main European counterparts.

While the latest activity of airline corporate strategy has been to forge ahead with airline alliances, Air France has held back. It recently announced it would be forming an alliance with Delta.

The delay in joining an alliance has been viewed negatively by some. The choice of Delta, however, will create a powerful alliance. Delta's base, Atlanta, is the world's largest airport and has plenty of expansion capacity. Similarly, Air France's Charles de Gaulle (CDG) base has the best growth potential in Europe. Other carriers have still to strengthen the alliance, which will rank among oneWorld and the Star alliance.

Although Air France may have been complacent over the past decade, its strategic advantages are so many and so significant that whenever it decides to play catch up with other majors it will leapfrog them.

Status

Air France is in an advantageous position. It is the ninth largest airline out of the world's top 10 in terms of total traffic with 67.9 billion revenue passenger kilometres (RPKs). In international terms it is the fifth largest airline with 60.8 billion RPKs.

BA and Lufthansa currently lead Air France, but are the only European carriers to do so. The other airlines in the top 10 are either US or Asian.

A total of 80% of the Air France Group's activities derive from aviation. Other revenues come from, for example, rail activities, catering and maintenance.

As part of its restructuring programme Air France sold its rail catering and Jet Tours charter operations and closed its poorly performing Air Charter subsidiary.

Air France has several key advantages. Because of France's past colonial links the airline has a wide international route network. It operates inter-continental routes from both CDG and Orly Parisian airports.

Following its merger with Air Inter in 1997, the airline has the largest domestic market in Europe, with 24 million passengers carried that year. This is explained by France's large size and its widely spread population. Air France has a 78% share of this market, and derives 20% of its revenues from domestic operations. France is also the largest tourist market in Europe.

The second of Air France's bonanzas is its operation at CDG airport. Unlike all other major airports in Europe, CDG is the only one developed on a site with a large amount of spare land for expansion, while also being situated away from major urban areas to avoid noise complaints.

CDG has two main terminals: Terminal 2, primarily for Air France operations and terminal 1 for most other airlines.

CDG has had two runways since its opening. Unlike Frankfurt or London Heathrow, CDG has kept ample space

Air France has the potential to be the airline powerhouse of Europe. It has closed the gap with Lufthansa in terms of RPKs, it has yet to form an alliance with a major US carrier and is currently based at the only European airport with large expansion potential.

within its boundary to build two more. A third runway, pairing with the existing one for terminal 2, opened earlier this year. A fourth, in proximity to terminal 1, will open in 2001.

CDG also has room for terminal expansion. The airport extended the four sub-terminals at terminal 2 by opening a TGV high-speed train terminal and one of two new sub-terminals, terminal 2F, in 1999. The second sub-terminal, 2E, will open in 2003. Overall, this will increase slots and terminal capacity by 50%.

In summary, while other major European airlines have to face the difficulty of terminal and slot congestion at their hub airports, Air France has no problems with expanding its services and route network. This is a strong competitive advantage against a background of deregulation and market fragmentation.

CDG has motorway and high-speed and local rail links, which make it more accessible than most other large European hubs.

Air France also experiences relatively little local competition. French airlines AOM and Air Liberté offer some competition on international networks, and carriers such as Brit Air and TAT compete on domestic and intra-European markets. Air France does not, however, have to cope with the same level of competition that BA does with British Midland, Virgin, easyJet and Ryanair.

Financial performance

Air France had poor financial and operating performance in the early 1990s. Despite the recession at that time, Air France did not make the best use of the advantages described earlier.

Although Air France has an extensive route network, unlike BA, it operated most of its long-haul routes with multiple stops at low frequency, it did not coordinate them with the rest of the schedule and operated a multiple-type fleet. This threw away the opportunity of coordinating flights with a mass of other potential connections which would have stimulated traffic and yields.

Air France and Air Inter also did little to improve their domestic operations in the face of competition from the high-speed rail TGV service. This caused Air France to lose traffic and market share. The losses had a damaging affect on the airline's overall performance.

Prior to its restructuring programme, Air France made a pre-interest operating profit of FFr201 million ($32.16 million) in 1997, but a pre-tax loss of FFr807 million ($129.12 million) after interest charges and currency losses.

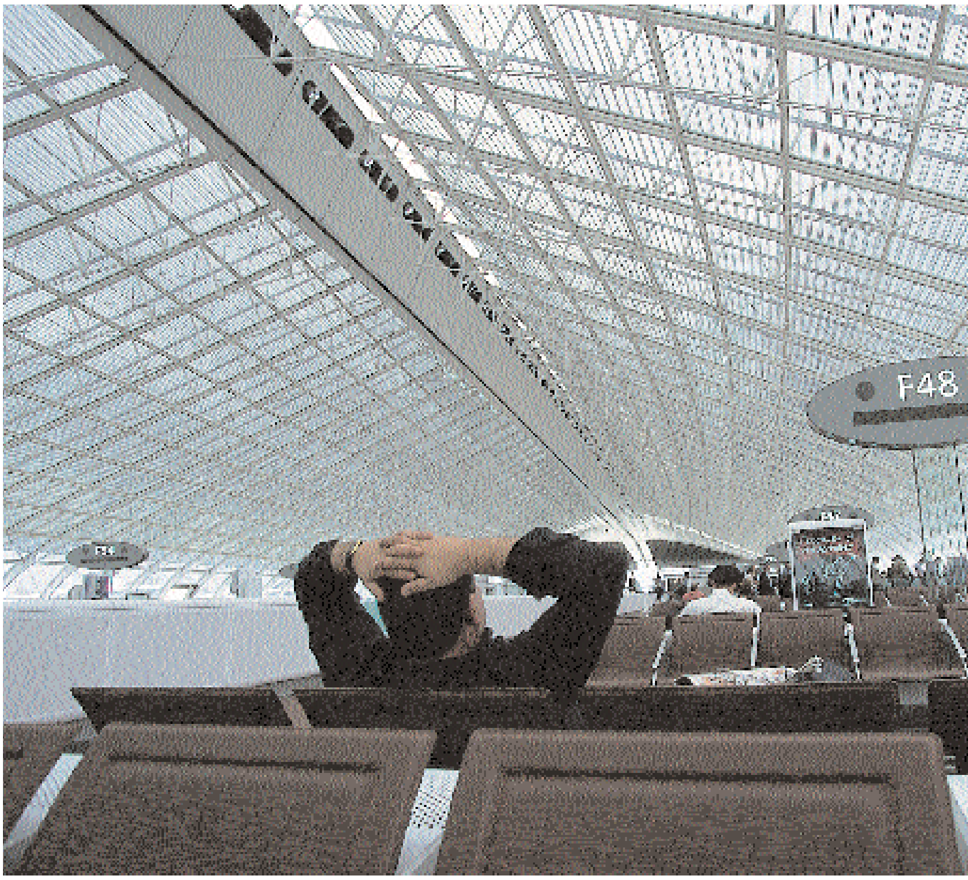
Restructure plan

Air France's restructuring process began with its privatisation. "The state currently holds 63%, the employees 12% and the market 24%. Seven percent of the 12% held by employees is held by the pilots," explains Pierre-Henri Gourgeon, president and chief executive officer of Air France. "By the end of 1999 this structure will have changed to 56% ownership by the state, 12% by employees and 32% on the market; the French government releasing some of its shareholding onto the market during the course of 1999."

Air France's restructuring plan has centred on it making use of its inherent advantages. Two steps the airline has taken have been to reorganise its route structure and schedule and relaunch its domestic operation.

"One weakness we have had to contend with is our bilateral agreement with the US," says Gourgeon. "The same one was in existence from 1946 up until 1992. France left the agreement in 1992 and from May 1993 there was no bilateral agreement. Because of deregulation in the US it became more and more obvious that the existing agreement was effectively open to the US, which now has eight different airlines serving Paris, while Air France is the only French carrier to operate to the US.

"The French government could not stop these US airlines coming in to Paris, *Charles de Gaulle has recently opened a new passenger terminal and runway. Another terminal and runway will open in the next two years. Overall this will increase its passenger and runway capacity by 50%, a feature not possible at any base of any other major European airline.*



and this has put us in a weak position. This led to arguments between France and the US between 1987 and 1992, which led to France arguing that there had to be capacity control. The effects of this were that Air France's market share rose from its 1993 low of 28% to 42% in 1997.

"Having no bilateral agreement is uncomfortable, and so France decided it must have one. It was re-negotiated in May 1998 and came into effect in June the same year.

"During the absence of a bilateral agreement Air France had to bargain for rights, and if it wanted more it had to concede more to the US," says Gourgeon. "The UK was clever in re-negotiating its bilateral with the US in 1978, since it only allows two US airlines into Heathrow.

"The new France-US bilateral includes a transition period of five years. At the end of the period any airline that wants to fly between the two countries can, provided it can get slots at airports. During the transition period an airline can increase frequencies, but at a limited amount each year. Air France and US carriers now have 176 flights per week. This will increase by 14 in 2000, seven in 2001, another 14 in 2002. Subsequently, each carrier will be free to operate the frequencies it wants from 2003. This gives us time to build capacity on routes."

Route network and schedule

Air France's route network and schedule has been transformed from a point to point operation to an efficient and well-coordinated hub and spoke operation.

Prior to its restructuring programme the use of stopping flights on many of its long-haul routes meant Air France was losing traffic to competitors flying into France with sixth freedom rights.

The schedule has been reorganised so that CDG operates as a hub and spoke network, with six arrival and departure waves per day.

This has meant long-haul flights that were operating four or five times per week at different times of the day have been changed to daily flights at the same time every day. Frequencies have also been increased on the European network. The airline accomplished this in just one year. It was essential that this was achieved without delay, since the industry is moving very quickly in the direction of connecting traffic to control and direct passengers as much as possible.

The more efficient use of CDG as a hub increased the number of long-haul to short-haul connections between summer 1995 and summer 1997 from about 1,900 to 5,200. The short-haul to short-haul connections also increased by a factor of 2.5 over the same period.

Part of this ability to coordinate a large number of flights comes from the large number of slots at the airport. By coordinating schedules the number of connecting city-pairs will grow exponentially. This has been the main force in stimulating Air France's traffic growth and its increase in revenues.

As a result of its actions Air France's capacity grew by 8.6%, traffic by 14% and load factor rose by 4.3 percentage points.

"An airline should have daily patterns in its schedule. The old system was efficient for the fleet but inefficient commercially," says Gourgeon.

Air France has code-share agreements with about 30 airlines, including Delta and Continental. The introduction of code-shares with these two airlines improved the number of connections by a further 37%, illustrating Air France's potential for passenger numbers and traffic. The third runway at CDG is expected to improve the number of connections by a further 31%.

The overall effect of the restructuring was to boost the number of weekly connections at CDG that take less than two hours from 2,000 to 10,300. This is far better than its European counterparts. For example, BA has about 4,000 at Heathrow, 5,800 for KLM at Amsterdam and 6,500 for Lufthansa at Frankfurt.

Air France has seen the proportion of connecting traffic on its network rise from 30% to nearly 49%, which has helped load factors rise during the same period.

Air France has also stopped flying unprofitable routes. Up to 23% of its city-pairs have been dropped, one third of which were long-haul routes. This reduction has been compensated for by increases in frequencies and now 76% of long-haul flights are non-stop services.

Domestic

Air France's share of the domestic market fell after European liberalisation. Air France reversed the situation by increasing frequency and using smaller aircraft types. A300s and A330s were swapped for A320s and A321s. Flights now leave as often as every 30 minutes on premium routes. Overall capacity fell, while load factor jumped six percentage points and yields also rose.

Other routes from Orly were also improved and some competitors have withdrawn from the market as a result.

Air France and Delta have recently formed an alliance. Although Air France has made this move late compared to BA and Lufthansa, this will not make the new alliance weaker than it otherwise would have been. The new alliance will be a further boost to Air France's growing power.

"Compared to flying, the TGV takes four and a half hours to reach Marseille, but for business day trips the journey time has to be less than three hours," explains Gourgeon. "If the TGV takes more than three hours it does not pose much of a serious threat to us. If it takes between two and three hours then we lose about 25% market share, but if it takes less than two hours we lose about 50% market share."

Code-share

In line with restructuring its route network and increasing the number of flight connections, Air France has also increased the use of code-sharing. "We now code-share with up to 30 airlines," says Gourgeon. "This includes airlines such as Delta and Continental, as well as Royal Air Maroc, Tunisair, Austrian and Japan Airlines.

"We currently fly to 11 US airports, including Newark, JFK, Houston, Atlanta and Cincinnati, where we get code-share connections with Continental and Delta. As an example of the benefits of code-sharing, at Cincinnati we get connections to a further 79 cities with Delta," says Gourgeon.

Although Air France is making full use of code-sharing, it has just formed a major alliance with Delta. It has entered into this much later than other major European and US carriers. Bearing in mind that the four major airline alliances account for nearly 60% of the world's airline traffic, and that alliances have basically been formed to increase the power to channel traffic, Air France has been late in deciding which alliance to join. However, the selection of Delta as a partner will form a partnership at least as powerful as BA–American or Lufthansa–United.

"If we join either Delta or Continental we will upset a European airline somewhere," said Gourgeon prior to Air France's partner selection announcement. "The north Atlantic market is essential to us and so our decision on which US airline to become aligned with depends on what will be the best for us in terms of the US market". The partnership with Delta is now expected to break the alliance between Delta and European carriers Swissair, Sabena and Austrian.

"The main features we are looking for are economic benefits, how our route networks will complement each other, how we might get synergies and growth and how we could increase our market share," continued Gourgeon. "The scheme will have to be simple enough to work. If we decide to join Continental, and then Northwest we would also get access to connections at Boston, Detroit and Minneapolis."

Besides Delta's Atlanta hub, the airline is the most profitable in the US, it has the best US east coast presence and the best north Atlantic network. Delta also recently entered the latin American market and serves it from the least crowded US gateway. Delta has also signed a code-share agreement with China Southern airlines.

Fleet

The fleet's efficiency has also been streamlined. Only one aircraft type is used on each long-haul sector, whereas before the 747, A340 and 767 were all used on each route.

In 1992, Air France was using eight different types in its long-haul fleet and six different types on the short-haul network. In 1999 there are still as many different long-haul types, but only four basic short-haul types. The 737-200/-300 and -500 families will be phased out, leaving just the A320 family in the narrowbody fleet.

"It has become standard practice in airlines to maximise commonality. Our pilots are divided between being Airbus and Boeing fans, but it would be simpler to have one fleet," explains Gourgeon. "However, we will not need to have mixed fleet flying between short- and long-haul fleets because our A320 fleet is so large.

"The long-haul fleet will be rationalised by reducing the 747 fleet just to the -400 series. The A340 and 777 will remain, but either the A310 or

767-300 will have to go, leaving just four main types.

"Our long-haul fleet is not so simplified. We have the 777, A340, 767, A310 and 747. We have been able to simplify the A340 fleet to just the -300 series. There are still questions relating to the A310 and 767 and we will have to get rid of one type at some point. The 767 was originally ordered by UTA.

"The 777s were acquired as a consequence of a former purchase contract with Boeing to buy 747s which were not required," says Gourgeon. "However, we will not sell the 777 fleet for simplification to have just an A340 fleet."

The improvement in the airline's schedule has resulted in an improvement in aircraft utilisation in the long-haul fleet from about 12.5 to 14.5 hours per day; a total of 19% between 1995 and 1998. "In fact our 747 fleet has reached about 15 hours per day, which is probably the limit," says Gourgeon. "Short-haul fleet efficiency has also improved. The domestic routes are very short distances, but utilisation has still improved because we have been able to reduce turnaround time between flights to 30 minutes. The Paris–Marseille and Paris–Toulouse routes have 26 return flights a day and so are very much shuttle operations."

Flight crew

In parallel with fleet efficiency improvements, flight crews have also re-negotiated their working conditions. Crews now only have the legal minimum rest periods at outstations and this has resulted in an increase in their productivity by 15%.

Air France has also successfully negotiated a voluntary pay reduction deal with its pilots in return for government shares. Air France has always had the highest pay scales of all EU airlines, but the management needed to bring the carrier in line with its competitors.

"The pay deal naturally has led to increased profits, which of course lead to increased share values," Gourgeon points out. "The pilots also benefit because the salary portion they gave up would have been subject to high rates of tax and social costs anyway. The average reduction is equal to about 8% per month, or FFr250 million ($40 million) per year for the airline against a gross pilot employment cost of about FFr3.5 billion ($560 million).

"The scheme will take place over seven years, that is, the pilots will take their shares over this period and there will also be no pay rises during this time.

AIR FRANCE OPERATING & FINANCIAL RESULTS 1997–99

	1997	1998	1999E
RPKs (billions)	68,083	71,553	75,919
ASKs (billions)	92,073	95,168	101,085
Load factor	73.94%	75.19%	75.10%
Unit passenger yields	0.56	0.58	0.57
Unit passenger revenues	0.41	0.44	0.43
Total revenues FFr million	55,602	60,716	59,943
Total costs FFr million	55,653	58,793	58,903
Pre-interest profit FFr million	201	2,430	1,423

Source: Credit Agricole Indosuez Cheuvreux

"We have to be careful that our pilots do not become the worst paid in the EU, because this will lead to industrial and hiring problems. Our strategy therefore is to hold salaries until other EU airlines have caught up with us," says Gourgeon. "New pilot recruits will not get any shares and salaries may have to go up again after the pilots have paid for their shares. We will then have to think of another scheme to keep our pilot costs competitive. One possibility would be a profit share scheme."

Summary

The proof of the success of Air France's restructuring programme lies in its annual results of the past few years.

Since 1997 its pre-interest profit has climbed from FFr201 million ($32 million) to FFr2,430 million ($389 million) in 1998 and is expected to be FFr1,423 million ($228 million) in 1999 *(see table, this page)*.

RPKs in 1997 were up 11% on 1996, and a further 5% in 1998 *(see table, this page)*. Air France took advantage of its CDG hub creation and code-share activities and increased ASK capacity by 7% in 1997 and a further 3% in 1998.

Load factor increased from 73.94% in 1997 to 75.10% in 1998. RPKs in 1999 are expected to reach 75.92 billion, (another 6% rise) while load factors should remain steady at 75%.

Unit revenues have improved marginally over the period, but many other major carriers have suffered falls.

Although the restructuring plan has been impressive, the main effects appear to have been realised. Total revenue for 1999 is expected to be the same as in 1998, despite many airlines experiencing record load factors and profits.

"Although we are smaller than BA or Lufthansa, we think we can be as profitable as either. We can certainly grow faster because of the capacity and expansion available to us at CDG," claims Gourgeon. "In 1998 BA said it was holding expansion, whereas we will expand by 3% in 1999."

This result is impressive when considered against the fact that Air France has not yet fully realised savings in pilot employment costs, the opening of the third runway and the new terminal at CDG, further short-haul and long-haul fleet rationalisation and the revenue-enhancing effects of forming an alliance with a major US airline.

With extra capacity at CDG Air France has the luxury of choosing the optimum number of frequencies, which routes to operate and then coordinate them almost perfectly with code-share partners. Further streams of revenue will now be realised following the formation of an alliance with Delta.

Air France will also gain from the benefits of cost reductions and capacity rationalisation in the alliance process. The deal is expected to add about FFr1 billion ($160 million) in profits over three years. The majority will come from sales, but about 30% will come from cost cuts.

Further fleet rationalisation is bound to deliver cost reductions. The A310 is tipped to go in favour of the 767, leaving Air France with four long-haul types. The A320 family eventually will be Air France's sole narrowbody aircraft.

While Air France's improvements may have peaked temporarily, the airline is yet to enjoy another increase in its fortunes while also having the enviable position of extensive home base expansion to enjoy for years to come. AC