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American Struggles With Costs, Unions as Mergers Boost Rivals

By Mary Schlangenstien - Sep 21, 2010

[American Airlines](#), which stood by as its biggest U.S. rivals completed two mergers, is struggling to return to profit as it confronts the highest costs among its peers, worst margins and the threat of a strike.

American parent [AMR Corp.](#) seeks to end two years of losses by expanding alliances, buying more fuel-efficient planes and refocusing operations on U.S. hub airports. "There are a number of opportunities that we are on the verge of tapping," Treasurer [Beverly Goulet](#) said in an interview.

So far, American has been unable to stem a slide toward third place in the U.S. by [traffic](#) from No. 1 in the world as competitors combine, or to win over unions balking at the new labor contracts the airline says are pivotal in curbing expenses. The stock's 14 percent drop [this year](#) is the only decline among the six biggest U.S. carriers.

"They have performed so poorly, people have written them off," said [Don Hodges](#), chairman of Dallas-based Hodges Capital Management. "They just don't consider American a factor when they think about investing in airlines."

Hodges, whose company held 25,650 AMR shares as of June, includes AMR in his [Pure Contrarian Fund](#) of "good companies going through a temporary problem area." While he recommends the stock to well-off clients who can afford to take [risks](#), he has cut his stake from 2 million shares in 2008.

Talks Today

American's scheduled contract talks today with its pilots' union come four years and a day since bargaining began. Flight attendants, airport ground workers and mechanics began talks as much as three years ago. Among almost 50,000 workers represented by unions at Fort Worth, Texas-based American, only a group of 90 technical specialists has approved a new contract.

“I can’t get comfortable recommending the purchase of American stock as long as that labor situation is an issue,” said [James M. Higgins](#), an analyst at New York-based Soleil Securities Corp. who advises [holding](#) AMR.

American won \$1.6 billion in annual union concessions in 2003 to avert bankruptcy, instead of shedding costs in Chapter 11 as UAL Corp.’s United Airlines, [Delta Air Lines Inc.](#), [US Airways Group Inc.](#) and Northwest Airlines Corp. did last decade. Chief Executive Officer [Gerard Arpey](#) took the job as those agreements were reached.

Airline Consolidation

As recently as 2008, American was the world’s largest carrier. Delta bought Northwest that year, and [Continental Airlines Inc.](#) and [United](#) agreed in May to a tie-up they expect to close by Oct. 1. The combination will leapfrog Delta as the global leader by traffic.

To counter a possible loss of corporate accounts to rivals with broader networks, Arpey, 52, is working to deepen pricing alliances with carriers outside the U.S. and add flights at hubs in five domestic markets used by business travelers. By early 2011, 98 percent of American’s capacity will touch those hubs, up from 88 percent “several years ago,” the carrier said.

In February, American persuaded [Japan Airlines Corp.](#) to stay in the Oneworld alliance, preserving the Asian portion of its global network by fending off Delta’s efforts to lure JAL into the SkyTeam group of carriers.

“Where do premium customers and the rest of the customers want to fly?” said [Kenji Hashimoto](#), American vice president for strategic alliances. “Where American and our partners fly, it lines up really nicely to that list.”

Revenue, Savings

By the end of 2012, American expects about \$500 million in annual revenue and savings from its recently approved joint venture with [British Airways Plc](#) and Spain’s [Iberia Lineas Aereas de Espana SA](#), a pending Japan Airlines venture and the “cornerstone strategy” for U.S. hubs. New York, Los Angeles, Chicago and Dallas-Fort Worth are the four largest [metro areas](#), and Miami is a gateway to the Caribbean and Latin America.

[Cash](#) and short-term investments at the end of June totaled \$5.5 billion, and AMR has about \$5 billion in [debt](#) due in 2011 and 2012, according to Goulet, the treasurer.

“We have a very good plan going forward,” Goulet said. “We can do long-term planning and make changes in our network and let it bear fruit over time, without having to worry about feeding ourselves day to day.”

Investors haven't been as optimistic. Since May 31, 2007, when the last of AMR's competitors left court protection, the shares have tumbled 77 percent, the most among the 12 carriers in the [Bloomberg U.S. Airlines Index](#). AMR rose 7 cents yesterday to \$6.64 in New York Stock Exchange composite [trading](#).

The company also may be the only one of its peers with a 2010 loss, with 14 [analysts](#) projecting an average of 97 cents a share. Analysts estimate the five other major U.S. airlines will post profits, according to Bloomberg surveys.

Operating Costs

Counting fuel, labor and other expenses, American's cost to fly each seat a mile in 2010's first half was 12.76 cents, the most among the 6 biggest U.S. carriers and topping Delta's 12.31 cents, based on data compiled by Bloomberg. Its pretax margin was -4.3 percent, the only negative among its peers.

“They're playing the hand they were dealt by avoiding bankruptcy,” said [Hunter Keay](#), a Stifel Nicolaus & Co. analyst in Baltimore. “It's unfortunately costing them dearly.”

Keay recommends buying AMR because “the downside is pretty limited.”

Part of the financial drag on American comes from its Boeing Co. MD-80s, which make up the largest part of the airline's 619-plane fleet.

Jet Fleet

While they're being replaced by [Boeing](#) 737s that are about 35 percent more fuel-efficient for each seat flown a mile, the MD-80s still account for about 40 percent of American's mainline jets, and won't all be retired until about 2016 at an average replacement rate of 3 to 4 planes a month. American's main jet fleet averages about 15 years of age, tied with Delta for the oldest among the six biggest U.S. airlines.

On labor costs alone, American says its disadvantage against rivals is \$600 million, a figure disputed by unions.

“It's significant,” said [Jeff Brundage](#), American's senior vice president for human resources. “It's a big brick in our backpack to being competitive in this industry.”

American has said boosting productivity would allow it to increase wages while keeping its current cost structure. Studies show the airline at or near the bottom of the industry in productivity, said [Jerry Glass](#), president of F&H Solutions Group in Washington and a former US Airways labor executive.

“It’s critically important that the labor groups understand that work rules are what is preventing American from reporting profits in 2010, to a large degree,” Stifel Nicolaus’s Keay said.

Union Demands

American’s unions insist that at least some of the 2003 concessions be restored. The [Transport Workers Union](#) withdrew a tentative contract for 10,600 baggage handlers and ramp workers in June, saying it couldn’t recommend ratification. Mechanics and stock clerks rejected a proposed three-year contract last month and gave TWU leaders approval to call a walkout among their 12,700 members.

Pilots are working at 1993 hourly rates, leaving them with “massive anger and frustration” over a lack of progress in talks that began in 2006, said [David Bates](#), president of the [Allied Pilots Association](#), which represents 9,600 active pilots at American.

“What we are looking for is not something that’s going to hurt the company,” said Laura Glading, president of the [Association of Professional Flight Attendants](#), which has 16,550 active-duty members at American. “You can’t come to labor and keep taking and taking and taking.”

Glading was prepared to press a U.S. mediator in meetings this week to declare a stalemate in bargaining and recommend that the [National Mediation Board](#) trigger a countdown toward the first strike at a major carrier since 2005. The mediator yesterday canceled the sessions with the attendants.

The union tensions cast a shadow over American’s recovery strategy, Soleil Securities’ Higgins said.

“The changes they are making in their flying are going to help,” he said. “They are doing a lot of sensible things. For me, they’re all completely dwarfed by labor and the question about what’s going to happen there.”

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