

INDUSTRIAL PRODUCTS & SERVICES

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SECTOR SUMMARY

COMPANY	TICKER	CUR PRICE	RETURN	RATING TARGET
WestJet Airlines				OUTPERFORM 2 =
	WJA-TSX	C \$10.11	19%	\$12.00 =
Air Canada				MARKET PERFORM 3 =
	AC.B-TSX	C \$1.62	Under Review	=

All figures in C\$, unless otherwise noted.
Sources: Raymond James Ltd., ThomsonOne, CapIQ

Airline Sector

WJA-TSX | AC.B-TSX

Financing and New Jazz Tune Buy Time for Air Canada

Yesterday, Air Canada announced that it has secured arrangements to raise a total of \$1.0 bln in additional liquidity through a series of financings and other transactions with certain lenders and key stakeholders. The key highlight of this agreement is that a consortium of lenders (including GE, the EDC, Aeroplan, and ACE) will provide a credit facility of up to \$700 mln (at premium rates) for the purpose of refinancing certain debt and to provide funding for working capital and other general corporate purposes. Various other forms of financial relief have been provided through an amended credit card process agreement, a Boeing 777 sale-leaseback, and deferred delivery dates for the B787s, among other items.

This financing agreement follows Tuesday’s announcement that Air Canada and Jazz have concluded their renegotiations of the capacity purchase agreement (CPA) between the two carriers and settled on new terms. The key highlight of this deal is that Air Canada will now pay Jazz a 12.5% mark-up rate on ‘controllable costs’ for the first 375,000 block hours flown and then 5.0% on any additional block hours above that threshold (the previous deal was for a 16.7% mark up on all block hours). Air Canada also reduced its minimum fleet commitment to Jazz from 133 to 125 and committed to defining a new strategy for Jazz’s turboprop fleet over the term of the contract, which has been extended to 2020 (from 2015). According to our analysis, the new CPA terms disproportionately (and negatively) impact Jazz and its revenue outlook. From Air Canada’s perspective, we estimate annual cost savings of \$35-\$40 mln, which are minimal relative to the airline’s total annual cost base of ~\$11 bln. Still, this was clearly one small but important step towards securing the financial support that the airline subsequently announced. Other positive developments over the past few months that have contributed to this favourable outcome for Air Canada include negotiated labour peace, deferred pension financing, and an overall thawing of credit markets.

Although we expect Air Canada’s stock to rally on this news, our rating remains MARKET PERFORM. Our reason is simply that this improved liquidity fails to address many of the fundamental problems plaguing the airline (namely, its inflated cost structure, eroding market share, high debt levels, big pension deficit, and depressed industry demand—particularly for business travel). We also continue to view the enormous financial leverage in the company as problematic for any meaningful valuation of the shares.

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Meanwhile, we are maintaining our OUTPERFORM rating on WestJet and still view its shares as the preferred (and far less risky) way to invest in Canada's airline industry. Indeed, in our Mar-27-09 industry INsight (titled *Analyzing Air Canada's Fate: Déjà Vu?*), we suggested that another Air Canada bankruptcy was not necessarily in the best interest of WestJet. We continue to hold this view, and thus believe that the steps Air Canada has taken to secure its near-term liquidity will potentially benefit the remaining carriers in the market. In particular, we expect a reduced sense of urgency at Air Canada to lead to better industry RASM through continued capacity rationalization (as evidenced in its 787 deferrals and reduced block hours from Jazz) and more disciplined pricing (now that Air Canada has backed away from the financial brink it can get back to running—and optimizing—its business). We expect additional RASM stability to come in 2H09 and 2010 from likely aircraft deferrals by WestJet and an eventual recovery in demand. That said, we are refraining from making any related changes to our financial forecasts for either airline until after we refresh our bearings from the release of 2Q09 results in the coming weeks.

Companies referenced in this INsight:

Company	Symbol
ACE Limited	ACE-TSX
Aeroplan	AER-TSX
General Electric Company	GE-NYSE
Jazz	JAZ.UN-TSX

Risks

Conventional airline profits are sensitive to the general level of economic activity, taxes, interest rates, demographic changes, price levels, telecommunications usage, special circumstances or events occurring in the locations served, and to external factors such as foreign exchange rates and international political events. Reduced market growth rates can create heightened competitive pressures, impacting the ability to increase fares and increasing competition for market share. The airline industry is subject to extensive laws relating to airline safety and security, and competition, environmental, and labour concerns. New or different laws or regulations could have an adverse impact on the airline industry in general. Some of the specific risk factors that pertain to the projected 6-12 month stock price target for WestJet are as follows: Our growth forecasts are predicated on the assumption that WestJet will continue to be able to identify appropriate markets in which to expand. A rebound in system-wide yields is also a key assumption in our projections. WestJet should remain competitive given its very low unit costs. WestJet results could be materially impacted by high aviation fuel prices, because the company no longer has fuel hedges in place. WestJet operates with lower personnel costs than the major established airlines, principally due to lower base salaries, greater productivity, and flexibility in the utilization of personnel, but as growth continues, considerable cultural challenges may be encountered. Operations can be affected by a number of external factors beyond the airline's control such as weather conditions, terrorist attacks, regulatory changes, and work stoppages or strikes by airport workers, baggage handlers, air traffic controllers, and other workers not employed by WestJet. Additionally, any major safety incident could materially and adversely affect WestJet's service, reputation, and profitability. There is the risk that WestJet may not be able to add new aircraft to its fleet as planned, which requires access to adequate capital, including the debt and equity markets. Furthermore, WestJet's U.S. dollar payment obligations for the purchase of its new 737-700 aircraft, as well as the purchase of fuel, spare parts, and maintenance and repair expenses, all result in exposure to fluctuations in the Canada/U.S.

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STRONG BUY 1: the stock is expected to appreciate and produce a total return of at least 15% and outperform the S&P/TSX Composite Index over the next six months. OUTPERFORM 2: the stock is expected to appreciate and outperform the S&P/TSX Composite Index over the next twelve months. MARKET PERFORM 3: the stock is expected to perform generally in line with the S&P/TSX Composite Index over the next twelve months and is potentially a source of funds for more highly rated securities. UNDERPERFORM 4: the stock is expected to underperform the S&P/TSX Composite Index or its sector over the next six to twelve months and should be sold.

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COMPANY	SYMBOL	EXCHANGE	DISCLOSURES
AirCanada	AC.B	TSX	7
WestJet Airlines	WJA	TSX	7

