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AirTrav Research Flash – Air Canada First Quarter 2014

Positive trending in key unit operating financials
Other key announcements and observations

TORONTO (March 15, 2014) – AirTrav Inc. has examined First Quarter 2014 financial and operating statistics released today by Air Canada (TSX: AC.A, AC.B) and compared operational financial metrics with prior quarters back to 1Q-2012.

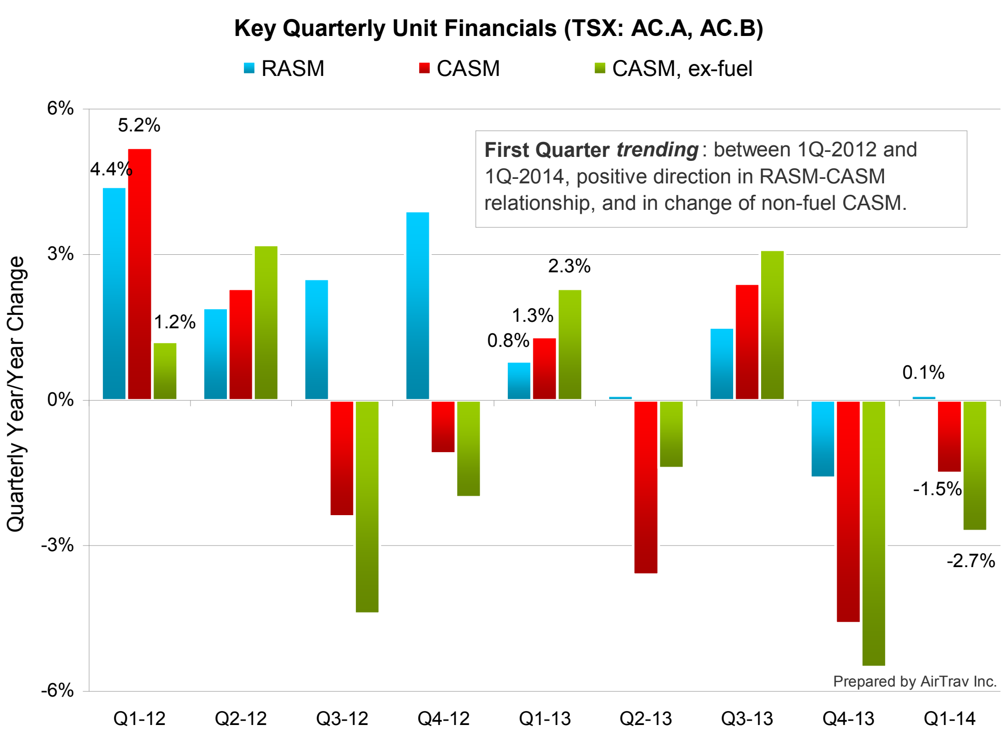
The figure below shows the relationship between select First Quarter unit financials in terms of year-over-year percent change.

While First Quarter revenue per available seat mile ("RASM") has been falling since 1Q-2012, so too have cost per available seat mile ("CASM") and CASM excluding fuel expense. The First Quarter has traditionally been a money loser for many northern hemisphere airlines such as Air Canada, so a key objective is to mitigate losses and potentially to generate profits.

What is more important to note is the relationship between RASM and CASM. Regardless of individual growth rates, when year-over-year percentage RASM change is positive relative to CASM change, then the year-over-year change in quarterly operating income will be positive.

This has been the case since 1Q-2012, when the spread between year/year RASM and CASM growth was -0.8 percent. By 1Q-2013 this spread had narrowed to -0.5 percent and in this most recent 1Q-2014, the spread entered positive territory at +1.6 percent.

CASM ex-fuel is another important metric as the size of fuel expense (i.e., 30 percent of Air Canada's operating expenses in full year 2013) diminishes visibility on other cost items. In 1Q-2012, RASM quarterly growth outpaced CASM ex-fuel by a positive 3.2 percent spread. While the year/year spread became negative in 1Q-2013 at -1.5 percent, that was more due to a slowdown in quarterly year/year RASM growth than year/year CASM ex-fuel growth. But while year/year RASM growth was nearly flat at -0.5 percent this past 1Q-2014, year/year CASM ex-fuel declined by -2.7 percent, resulting in a favourable RASM-CASM ex-fuel spread of +2.8 percent.



Other observations from Air Canada's 1Q-2014 earnings conference call

- **No announcement of a first checked bag fee on domestic routes**
    - Air Canada has not announced a plan to match Porter Airline's new first checked bag fee on domestic Canada (Porter is also implementing the fee on transborder routes, but Air Canada already charges on those sectors).
    - While Porter is not immune to the impact of a weaker Canadian Dollar and stubborningly high fuel costs, its bag fee announcement a few weeks ago surprised us. Porter is a much smaller player than Air Canada and WestJet, and its value-add, brand proposition model includes many services such as lounge access that require top tier frequent flyer status or a higher fare level on the the other carriers.
    - It is possible then that Air Canada (and WestJet, which has also not matched Porter's fee) may prefer to hang Porter out to dry and perhaps gain incremental business, especially at Toronto's city centre airport. That said, Air Canada continues to feel pressure from a weaker CAD notwithstanding the foreign currency surcharge instituted by Air Canada Vacations ("ACV") this January. For example, the non-operating foreign currency loss in Q1 was $161 million, a strong deterioration from the $40 million loss in the year earlier Quarter. Also, individual operating expense line items such as Fuel and Aircraft Rent reflected the deterioration in CAD value.
    - As such, we believe there is a better than 50 percent chance that Air Canada will implement a charge for the first checked bag on domestic routes at some point later this year, with significant new ancillary revenue to be made. As with its first bag fee on transborder routes, top tier frequent flyers and higher fare categories would likely be exempt from such a domestic first bag charge. On international routes, the competitive environment is more complex and we do not expect a first checked bag for the foreseeable future.
    - Either Air Canada or WestJet could be first to match Porter domestically. However, since WestJet did not match ACV, Sunwing or Transat on a FX surcharge and is feeling cost pressure, as soon as its reservation system and internet booking engine are able to handle a first bag fee, WestJet will likely match Porter first followed by AC.
- **Bombardier Inc. (TSX: BBD.A, BBD.B) – no joy for a CSeries order with Air Canada**
    - For the time being, BBD's Aerospace division has nothing to celebrate with the announcement that Air Canada will not embark on a further narrowbody fleet replacement program beyond that which has already been announced.
    - Air Canada will be left with 25 Embraer 190 ("E190") regional jets after Boeing purchases 20 of the present fleet of 45 E190 aircraft. That was part of an earlier announced order that will see Airbus A319/A320/A321 narrowbody aircraft replaced by at least 61 Boeing 737 MAX 9 and MAX 9 aircraft.
    - Air Canada had talked about the possibility of a further narrowbody order to replace its remaining 25 E190 aircraft. As such, it was expected that Bombardier would at least be in the running with its CSeries jet, which will likely enter commercial service in the second half of 2015.
    - In today's conference call, Air Canada announced that it would keep the remaining 20 E190 aircraft in service in order to allocate capital expenditure funding to higher priority projects.
- **Further densification of the widebody fleet**
    - Last year Air Canada began to roll out five new Boeing 777-300ER widebody aircraft that were configured in a new three-cabin and higher density lay-out. The airline installed a Premium Economy cabin that in addition to more ample seat pitch, provided wider seats by reducing the traditional nine-abreast seat configuration in Economy class to only eight-abreast. At the same time, Economy cabin pitch was reduced marginally from 32 to 31 inches, and width was tightened by adding a tenth seat across.
    - These changes, along with a layout change in the Business cabin, increased seating from 349 seats in existing B777-300ER aircraft to 458 in the five new aircraft. This has enabled Air Canada to be more competitive on several long-haul routes, with incremental revenue generating capacity added at signicantly lower incremental cost.
    - Today Air Canada announced it will "densify" its original 12 B777-300ER and 6 B777-200LR aircraft. We agree that this will provide customers a more consistent in-flight product. The new layout will bring the Premium Economy cabin to these aircraft, though Economy seating will not be as densely configured as the five new B777-300ER jets. Most importantly, operating financials will continue to improve and support enhanced stakeholder value.
    - The impending in-service date of Air Canada's new Boeing 787-8 *Dreamliner* will also play a pivitol role in Air Canada's evolution to being a consistently profitable carrier. Going into service initially on the new Toronto to Tokyo-Haneda route, the *Dreamliner* will provide mission economics that will make this aircraft a game changer for the airline. With 40 to 60 more seats than the two versions of the mainline B767-300ER fleet it will replace, much improved fuel burn and longer cruising range, the *Dreamliner* will enhance marginal routes, turn money-losers into money-makers, and enable Air Canada to operate new routes currently deemed uneconomical.

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