Air Canada AC.B [TSE] | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
1.08 CAD	2.00 CAD	1.00 CAD	3.50 CAD	Very High	None	C	—	Airlines

Like other airlines, Air Canada is suffering from high fuel costs.

by Neal Dihora, CFA
Equity Analyst
Analysts covering this company do not own its stock.

Pricing data through January 06, 2012.
Rating updated as of
January 06, 2012.

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.

Thesis Nov. 07, 2011

Air Canada is attempting to steer out of the tailspin caused by the recent global recession. It has articulated a three-point strategy to improve operating results on a sustainable basis. By promoting more international and premium paying traffic, it could generate higher operating margins. Cost reduction programs have helped improve profitability, with 2011 delivering savings of CAD 530 million. Finally, Air Canada wants to build a different culture within its employee base to continually improve the company.

Revenue that declined 12% in 2009 rebounded by 11% in 2010, and we estimate growth of 6% in 2011. Overall, international traffic improved to 60% of revenue in 2010 from 58% in 2009, while premium traffic increased to 21% of revenue from 19%. The company finalized a transatlantic joint venture, known as A++, with Lufthansa and UnitedContinental in December 2010. The joint venture is similar to others commenced recently in the airline industry in order to better manage overall capacity and improve profitability on a sustainable basis.

Air Canada began a Cost Transformation Project, or CTP, in 2009 that aimed at reducing the cost structure by CAD 500 million by year-end 2011, including CAD 115 million from revenue enhancements. The company actually has overachieved on the CTP and announced savings of CAD 530 million for 2011. This value represents a highly meaningful 5% of 2010 operating costs, partly the reason we forecast operating margin to expand to 5% in 2011 from 2.2% in 2010. Longer term, however, we think some of the savings will not be sustainable and we forecast margins to decline.

The company operates a fleet of 205 aircraft along with purchase agreements from Jazz, which operates 121 aircraft. The average age stands at 11.4 years and related maintenance expense has been around 6% of revenue, following the spike to nearly 8% in 2009 as a result of lower revenue. The Jazz aircraft are much older at more than 16 years old and likely will require capital expenditures in the future. Because Jazz provides necessary services for Air Canada's customers, we feel that the relationship is more akin to ownership. As such, part of our margin degradation assumption includes higher costs for Jazz in the future resulting from expiration of cuts during the recession between the two parties.

Liquidity and financial strength were an issue for the company in 2009 when its cash level declined to less than 9% of prior 12-month revenue. The company decided to rebuild that balance through share sale and additional borrowings. Unfortunately, shareholders experienced immense dilution as the company issued 160.5 million shares on an existing base of 100 million. Furthermore, the sale included 80.25 million warrants for additional shares with an exercise price of CAD 2.20 and expiry date of October 2012. Its credit facilities included two grants of 5 million warrants each with exercise prices of CAD 1.51 and CAD 1.44, set to expire in July and October 2013. We believe this was a costly decision just to have cash for the sake of cash; the firm was not anticipating the purchase of new aircraft and it already had renegotiated with other parties, such as employees and Jazz, to reduce costs.

The management at Air Canada has a vision to create a work force that's more entrepreneurial and empowered. This is certainly a move in the right direction and we applaud the recent CAD 500 share grant to each of its employees that will help to align interests with other stakeholders in the company. Air Canada's strategies for improving results are reasonable but we worry about their sustainability. Competing airlines also are attempting to grow international and premium traffic while cutting costs with employees and suppliers, and we don't believe Air Canada has carved sustainable competitive advantages in the difficult airline industry. Thus, our longer-term outlook is subdued in terms of growth and profitability.

Valuation, Growth and Profitability

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Our fair value estimate is CAD 2. We include all issued warrants in our diluted share count, which is higher than what is used in some earnings-per-share calculations by the company. In our base-case scenario, we expect Air Canada to grow capacity by around 2% (versus our prior 3% estimate) during the next five years, with heavy additions in the earlier years. The dramatic reduction in pricing following the fallout from the recession is likely to rebound in the near term, assisting Air Canada's margin performance, but we anticipate operating margins of 4% (versus our prior 6% estimate) in 2011 and vary with our assumptions for capacity growth, load factor, and fuel price increases. We also forecast the company will not pay any taxes for four years and a low 5% rate thereafter due to prior years' losses. We estimate that every 5% increase in the tax rate reduces our fair value by 10%.

Risk

Volatile crude-oil prices and intense pricing pressure from competitors represent the two biggest uncertainties facing airlines in general and they appropriately apply to Air Canada as well. Fuel represents around 25%-30% of revenue, and is dependent on Air Canada's hedging policy and the exchange rate of the Canadian dollar versus the U.S. dollar--oil's typical denomination. Thus, a drastic rise in energy prices would suppress performance results significantly. Operating margins are also highly sensitive to load factor and yield. Other uncertainties include aircraft safety, heightened security, and inclement weather.

Bulls Say

- Worldwide GDP is improving and, historically, air travel demand experiences 1.5 to 2 times this change. Strong demand will help load factor and, more importantly, yields allowing for strong operating margin improvement.
- Air Canada's revenue from Asia should increase from 11.5% of total sales as it increases capacity. This should drive profitability as international travel is more profitable than domestic.

Bears Say

- The airline industry is notorious for adding too much capacity in good times, leading to aggressive pricing in order to maintain load factors. Competitive dynamics lead to an industry where profitability has been elusive over the long term.
- Labor agreements with the unions are up for renewal in 2011 and could result in higher costs as employees look to claw back on the cuts from the recession.
- Air Canada is planning on expanding its fleet in 2011. Recent results have showcased improved utilization of the existing fleet. However, new aircraft could lead to a higher cost base and potentially reduced profitability.

Financial Overview

Financial Health: We think the company is in poor financial health with long-term debt of CAD 4.5 billion and cash of CAD 2.2 billion. Pension liabilities add more than CAD 2 billion to debt outstanding. By our estimates, upcoming annual debt maturities represent around 25% of EBITDA before a large repayment due in 2015. Our base case assumes an improving demand environment. However, a more pessimistic scenario could pressure eventual costs required to repay upcoming maturities. On the positive side, Air Canada embarked on its cost transformation plan in order to lower the cost structure of the company. Still, we expect this to help near-term financials but are unsure whether this is a new level of cost for the company or a temporary measure.

Company Overview

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Profile: Air Canada is Canada's largest domestic and international airline that serves more than 32 million customers annually together with regional partner Jazz. Air Canada is a founding member of the Star Alliance, which currently includes 26 member airlines that offer 1,077 destinations in 175 countries. The company provides passenger (87% of 2010 revenue), cargo (4%), and other services (9%) including ground handling and leasing of aircraft.

Management: Calin Rovinescu was named president and CEO on April 1, 2009, and previously had worked in corporate development and strategy at Air Canada from 2000 to 2004. With ownership of 100,000 shares and 50,000 warrants, we don't feel his interests are well aligned with shareholders' considering he received cash compensation of CAD 1.05 million in 2009. The strategy outlined by the CEO is sound, but it will take time to assess its sustainability. That said, the results to date are encouraging. Nonetheless, we would rather see incentive rewards tied to returns on capital instead of EBTIDAR targets.

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Analyst Notes

Nov. 04, 2011

Air Canada Plans Capacity Growth for 2011 and 2012

We are maintaining our fair value estimate following robust results from Air Canada for its third-quarter operations. Revenue improved 7% as traffic grew 3% and yields increased 4%. The company reported a record load factor of 85.8%, which allowed fuel surcharges to stick. Total fuel costs increased 29% year over year and were CAD 210 million higher from last year; raw fuel prices increased 47% but Air Canada used active hedges along with the natural hedge they have with the Canadian dollar to reduce the overall change. Cost reduction reached the annualized CAD 530 million target one quarter in advance and helped to drive costs excluding fuel down 0.4% per available seat mile (CASM ex-fuel). A large negative foreign currency impact led to negative earnings per share results. Our estimates call for revenue to improve by 6% for 2011, which should lead to an improvement in operating margin north of 5%, including the fuel headwind.

Air Canada sees capacity increasing no more than 1.5% for 2012, following a 4%-plus increase for 2011. We are not as optimistic as the company regarding demand strength 2012 as we are seeing signs of deceleration around the world, especially in the Eurozone and the United States. With competitors reducing capacity because of higher fuel prices and slowing demand, we think Air Canada may need to do the same. Still, results to date have been encouraging, especially those excluding fuel increases.

Regarding the balance sheet, cash was CAD 2.2 billion, or 19% of last 12 months' sales. Long-term debt stands at CAD 4.5 billion. However, pension liabilities increased by CAD 500 million to CAD 3.8 billion, resulting from lower discount rates.

Labor strains continue and the company is working to resolve them in due course. Discussions continue with multiple unions in order to arrive at a final agreement, but the company sounds hopeful that employees will not strike during the negotiations.

Aug. 04, 2011

Air Canada Reports Robust 2Q Results

We are maintaining our fair value estimate following robust results from Air Canada for its second-quarter operations. Revenue improved 11% as traffic grew 6% and yields increased 5%. A stronger pricing environment allowed fuel surcharges to stick. Total fuel costs increased 34% year over year and were CAD 222 million higher from last year; the company estimates them to increase CAD 800 million for 2011. Cost reduction amounted to CAD 119 million and could reach CAD 530 million for the year. The net impact of fuel and cost reduction would be a drag of CAD 270 million. Our estimates for revenue to improve by CAD 538 million, or 5%, for 2011 should lead to an improvement in operating profits of CAD 270 million, including the fuel headwind. We are not as optimistic as the company regarding demand strength in the back half of 2011, as we are seeing signs of deceleration around the world, especially in the eurozone and the United States. With competitors reducing capacity because of higher fuel prices and slowing demand, we think Air Canada may need to do the same. Still, July results show continued strength in operations for the company. Capacity management in Canada has helped maintain strong pricing trends that began in the middle of 2010, but we see these trends softening in the coming months.

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Analyst Notes (continued)

The company announced labor agreement principles with its pilots and customer service personnel, but these are not finalized. Air Canada is set to meet with machinists and dispatchers in the coming weeks. Pension reform remains an outstanding issue for all union members, as the company wants to move to a defined contribution plan from a defined benefit plan. These discussions are in mediation. Wages are set to increase 9% over the next four years under the agreement with the customer service members, which would represent a drag on the coming years.

Air Canada is withdrawing its proposed joint venture with United Continental following a negative opinion from Canada's competitive bureau. We see no major impact, as the two companies have already been working together without an official joint venture.

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Air Canada AC.B

Sales CAD Mil	Mkt Cap CAD Mil	Industry	Sector
11,529	305	Airlines	Industrials

Air Canada is Canada's largest domestic and international airline that serves more than 32 million customers annually together with regional partner Jazz. Air Canada is a founding member of the Star Alliance, which currently includes 26 member airlines that offer 1,077 destinations in 175 countries. The company provides passenger (87% of 2010 revenue), cargo (4%), and other services (9%) including ground handling and leasing of aircraft.

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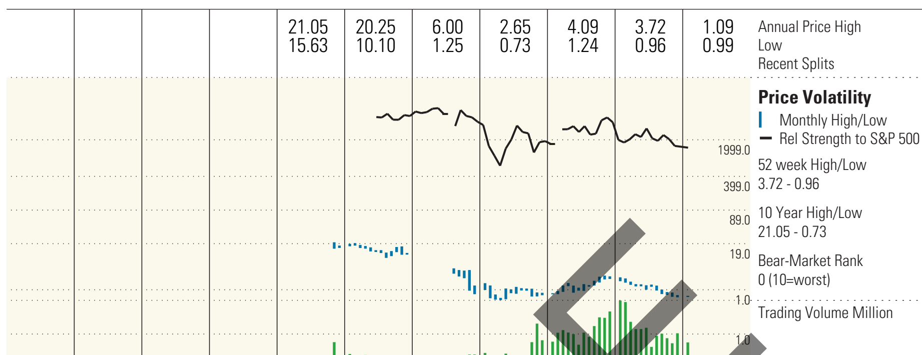
Morningstar Rating	Last Price	Fair Value	Uncertainty	Economic Moat™	Stewardship Grade
★★★★	1.08	2.00	Very High	None	C

per share prices in CAD

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD	
				21.05	20.25	6.00	2.65	4.09	3.72	1.09	Annual Price High
				15.63	10.10	1.25	0.73	1.24	0.96	0.99	Low
											Recent Splits



Price Volatility
Monthly High/Low
Rel Strength to S&P 500

52 week High/Low
3.72 - 0.96

10 Year High/Low
21.05 - 0.73

Bear-Market Rank
0 (10=worst)

Trading Volume Million

Stock Performance

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD	Stock Performance
—	—	—	—	—	-31.6	-85.3	-25.4	161.4	-71.3	9.1	Total Return %
—	—	—	—	—	-35.1	-46.8	-48.8	148.6	-71.3	7.5	+/- Market
—	—	—	—	—	-20.3	-41.7	-50.7	132.7	-46.0	8.8	+/- Industry
—	—	—	—	—	—	—	—	—	—	0.0	Dividend Yield %
—	—	—	—	1762	1205	177	367	962	280	305	Market Cap CAD Mil

Financials

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Financials
9611	9826	8368	—	9458	10167	10599	11082	9739	10786	11529	Revenue CAD Mil
—	—	—	—	30.3	32.1	31.2	51.7	53.7	57.0	55.0	Gross Margin %
-731	-218	-684	—	—	—	—	-164	-316	407	467	Oper Income CAD Mil
-7.6	-2.2	-8.2	—	—	—	—	-1.5	-3.2	3.8	4.1	Operating Margin %
-1315	-828	-1867	—	-20	-74	429	-1025	-24	107	34	Net Income CAD Mil
—	-6.89	-15.53	—	-0.36	-0.83	4.27	-10.25	-0.18	0.37	0.37	Earnings Per Share CAD
—	—	—	—	—	—	—	—	—	—	—	Dividends CAD
—	120	120	—	56	89	101	100	132	292	292	Shares Mil
—	—	—	—	—	24.43	7.62	5.20	6.24	-7.95	-7.95	Book Value Per Share CAD
-1072	-95	139	—	388	393	429	-102	-167	864	688	Oper Cash Flow CAD Mil
—	—	—	—	-868	-888	-2606	-883	-232	-118	-131	Cap Spending CAD Mil
—	—	—	—	-480	-495	-2177	-985	-399	746	557	Free Cash Flow CAD Mil

Profitability

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Profitability
—	-10.3	-26.1	—	-0.2	-0.7	3.6	-8.8	-0.2	1.0	0.3	Return on Assets %
—	—	—	—	-1.9	-5.1	20.0	-64.0	-2.2	6.7	—	Return on Equity %
-13.7	-8.4	-22.3	—	-0.2	-0.7	4.0	-9.2	-0.2	1.0	0.3	Net Margin %
—	1.22	1.17	—	0.92	0.92	0.90	0.96	0.89	1.03	1.12	Asset Turnover
—	—	—	—	9.6	6.3	4.8	14.9	7.2	6.1	6.1	Financial Leverage

Financial Health

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	09-11	Financial Health
-634	-821	-691	—	-275	349	-478	-1453	-351	383	298	Working Capital CAD Mil
—	—	—	—	3336	3196	4006	—	—	—	4050	Long-Term Debt CAD Mil
-1460	-2288	-4155	—	1068	1852	2443	762	1446	1740	-2248	Total Equity CAD Mil
—	—	—	—	—	—	—	6.16	2.80	2.27	2.66	Debt/Equity

Valuation

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Valuation
—	—	—	—	—	2.8	—	—	9.3	2.7	2.9	Price/Earnings
—	—	—	—	—	—	—	—	2.3	0.3	0.3	P/E vs. Market
—	—	—	—	0.1	0.1	0.0	0.0	0.1	0.0	0.0	Price/Sales
—	—	—	—	—	0.5	0.2	0.3	0.6	—	—	Price/Book
—	—	—	—	2.5	2.8	—	—	1.2	0.4	0.4	Price/Cash Flow

Growth Rates Compound Annual

Grade: D	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	10.8	0.6	2.7	—
Operating Income %	—	—	—	—
Earnings/Share %	—	-55.8	—	—
Dividends %	—	—	—	—
Book Value/Share %	20.0	-36.6	—	—
Stock Total Return %	-69.5	-16.4	-43.2	—
+/- Industry	-42.7	-20.7	-32.8	—
+/- Market	-69.8	-27.4	-41.2	—

Profitability Analysis

Grade: F	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	—	-8.9	—	40.7
Return on Assets %	0.3	-1.0	—	16.2
Fixed Asset Turns	2.1	1.6	—	10.3
Inventory Turns	34.5	47.5	—	—
Revenue/Employee CAD K	497.4	445.3*	—	—
Gross Margin %	55.0	45.1	—	57.7
Operating Margin %	4.1	—	—	10.8
Net Margin %	0.3	-1.0	—	6.3
Free Cash Flow/Rev %	4.8	—	—	4.7
R&D/Rev %	—	—	—	3.1

Financial Position

Grade: D	12-10 CAD Mil	09-11 CAD Mil
Cash	1090	974
Inventories	67	184
Receivables	641	760
Current Assets	3445	3417
Fixed Assets	5747	5230
Intangibles	840	619
Total Assets	10544	9862
Payables	2557	2690
Short-Term Debt	—	429
Current Liabilities	3062	3119
Long-Term Debt	—	4050
Total Liabilities	8804	12110
Total Equity	1740	-2248

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	2.9	—	—	8.9
Forward P/E	3.1	—	—	4.8
Price/Cash Flow	0.4	—	—	6.9
Price/Free Cash Flow	0.6	—	—	11.8
Dividend Yield %	—	—	—	—
Price/Book	—	—	—	2.8
Price/Sales	0.0	0.1	—	0.6
PEG Ratio	1.0	—	—	—

Quarterly Results

Revenue CAD Mil	Dec 10	Mar 11	Jun 11	Sep 11
Most Recent Period	2616.0	2748.0	2918.0	3242.0
Prior Year Period	2348.0	2519.0	2625.0	3026.0

Rev Growth %	Dec 10	Mar 11	Jun 11	Sep 11
Most Recent Period	11.4	9.1	11.2	7.1
Prior Year Period	-6.0	5.4	12.7	13.3

Earnings Per Share CAD	Dec 10	Mar 11	Jun 11	Sep 11
Most Recent Period	—	-0.07	-0.17	-0.45
Prior Year Period	-0.50	-0.31	-0.72	0.91

Industry Peers by Market Cap

	Mkt Cap CAD Mil	Rev CAD Mil	P/E	ROE%
Air Canada	305	11529	2.9	—

Major Fund Holders

	% of shares
	—
	—
	—
	—

*3Yr Avg data is displayed in place of 5Yr Avg

TTM data based on rolling quarterly data if available; otherwise most recent annual data shown.

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Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat™ Rating
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Uncertainty
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

Economic Moat™ Rating

The Economic Moat™ Rating is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such

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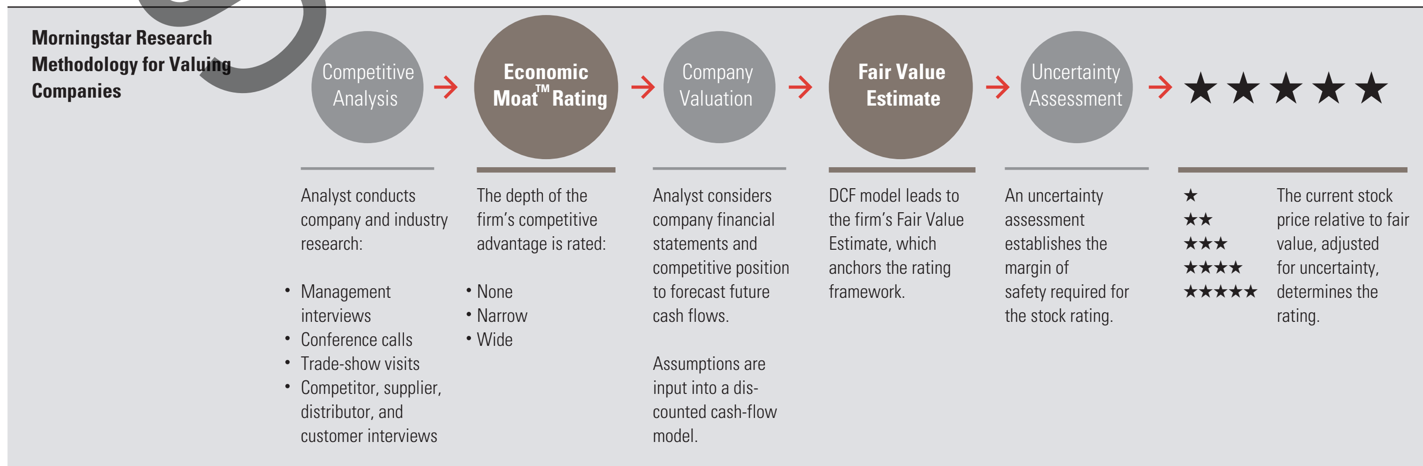

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economic profits, but companies that can earn them for an extended time by creating a competitive advantage possess an Economic Moat. We see these companies as superior investments.

Discounted Cash Flow
This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate
We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

Fair Value
This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

Uncertainty
To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High, Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

Margin of Safety
This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth.The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

Consider Buying/Consider Selling
The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

Stewardship Grades
We evaluate the commitment to shareholders demonstrated by each firm's board and management team by assessing transparency, shareholder friendliness, incentives, and ownership. We aim to identify firms that provide investors with insufficient or potentially misleading financial information, seek to limit the power of minority shareholders, allow management to abuse its position, or which have management incentives that are not aligned with the interests of long-term shareholders. The grades are assigned on an absolute scale--not relative to peers--and can be interpreted as follows: A means "Excellent," B means "Good," C means "Fair," D means "Poor," and F means "Very Poor."

SAMPLE

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