

Industrial

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Industry Brief

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Transportation | Airlines

All I want for Christmas is a Cheap Flight Home!

Christmas is right around the corner and with it—as anyone hoping to get home for the Holidays knows—always comes a seasonal jump in the price of airline tickets. Indeed, every year for as long as we have been doing our monthly surveys (nine years and counting), the value of our domestic airfare index has spiked markedly for both Air Canada and WestJet in November. This year was no different, with domestic fares generally surging for travel during the week of Dec-12 (we always look 4-6 weeks forward to limit booking curve distortions).

If there is any good news to report to travelers from these observations it is that prices did not go as sky-high as they did last year. In fact, the value of our indices actually fell y/y for both Air Canada and WestJet by 16% and 20% respectively, with price discounting in the East being most prominent (see Exhibits 1 and 2). But this, of course, is not what the airlines themselves want to see—at least not in the current fuel price environment. Because costs are on the rise, there has been tremendous pressure to get airfares up. The industry has been successfully doing this for most of the past 24 months, as seen in our index values. However, it appears that this trend may be losing some steam.

Recognizing the limits to our research methodology (see page 3), we believe the more aggressive discounting occurring in the domestic market recently is indicative of the industry's waning pricing power. It should arguably come as no surprise that the consumer has finally balked at a series of endless fare hikes, especially in the wake of heightened economic uncertainty and stock market volatility. Demand for air travel is, after all, famously price sensitive.

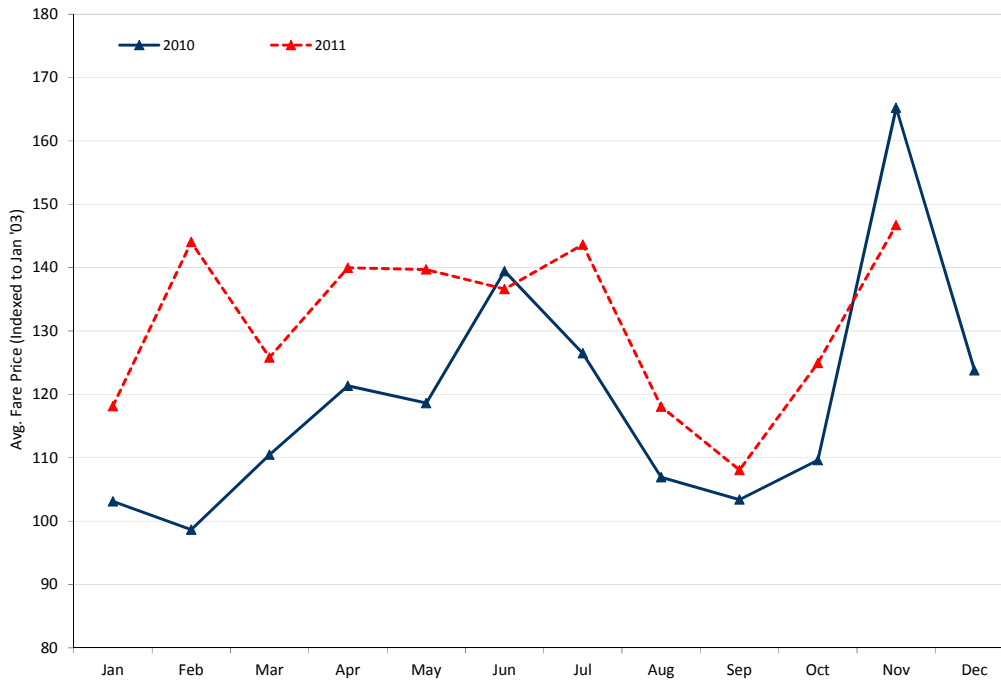
Both Air Canada and WestJet appear to be attune to this apparent inflection point in the pricing environment as they have indicated that domestic RASM growth is decelerating. Accordingly, only marginal (~1%) ASM growth is planned for Canada next year. This degree of capacity discipline is encouraging to see. Still, the fact remains that, with fuel prices stubbornly high and pricing power fully exhausted, the industry is poised to face an increasing headwind in 2012. This dilemma—combined with a host of other prevailing risks and uncertainties—is why we continue to rate Air Canada Market Perform.

As for WestJet, while these macro factors make it more difficult for us to remain convincingly bullish on the stock, we are reticent to downgrade our rating at its currently discounted valuation (see Exhibit 3). Besides, we feel that our core investment thesis on this company—namely that management's renewed focus on ROIC (see our Mar-24-11 *Shift Happens* Comment, price \$14.16, for details)—still holds true, although we concede that it may take longer than we initially expected to come to full fruition.

Company	Ticker Primary	Ticker Secondary	Current Price	Rating
Airlines				
Air Canada	AC.B-TSX		C\$1.21	Market Perform 3
WestJet Airlines	WJA-TSX		C\$12.05	Outperform 2

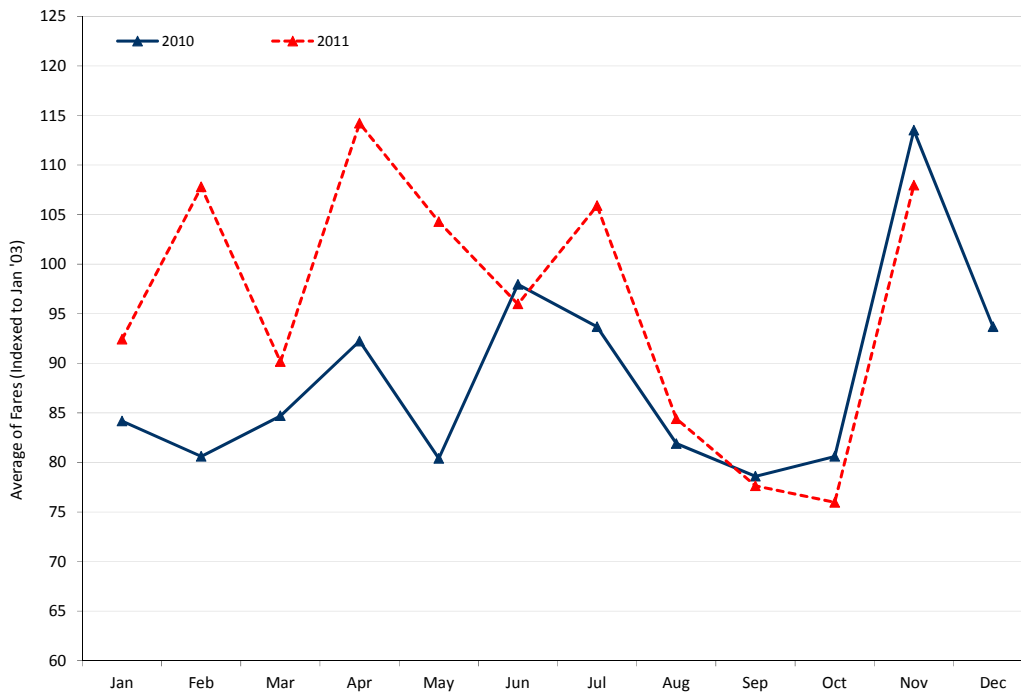
Raymond James Ltd.

Exhibit 1: Raymond James' Domestic Airfare Index for WestJet



Source: westjet.com, Raymond James Ltd.

Exhibit 2: Raymond James' Domestic Airfare Index for Air Canada



Source: aircanada.com, Raymond James Ltd.

Exhibit 3: WestJet's Peer Group Comparables

Company Name	Ticker	Fiscal Year End	FX	Recent Price	Shares O/S (mln)	Market Cap. (mln)	EPS			P/E		
							2010A/E	2011E	2012E	2010A/E	2011E	2012E
Alaska Air Group	ALK.US	12/31	USD	\$64.81	37	\$2,373	\$8.10	\$9.13	\$9.46	8.0	7.1	6.8
Southwest	LUV:NYSE	12/31	USD	\$7.83	792	\$6,201	\$0.74	\$0.39	\$0.60	10.6	20.1	13.0
RyanAir	RYAAY:NASDAQ	3/31	USD	\$29.10	1,480	\$43,074	\$1.71	\$2.11	\$2.50	17.0	13.8	11.6
easyJet	EZJ.GB	9/30	GBP	£3.61	431	£1,554	£0.37	£0.45	£0.50	9.9	8.1	7.3
JetBlue	JBLU.NASDAQ	12/31	USD	\$3.70	346	\$1,279	\$0.31	\$0.21	\$0.30	11.9	17.6	12.3
Allegiant Travel	ALGT:NASDAQ	12/31	USD	\$50.24	19	\$961	\$3.32	\$2.70	\$3.45	15.1	18.6	14.6
Copa	CPA:NYSE	12/31	USD	\$63.00	44	\$2,792	\$5.64	\$7.15	\$7.40	11.2	8.8	8.5
Gol Linhas	GOL:NYSE	12/31	USD	\$7.51	270	\$2,030	\$0.53	(\$0.62)	\$0.33	14.2	n.m.	22.8
Virgin Blue	VBA.AU	9/30	AUD	\$0.38	2,216	\$831	\$0.03	\$0.05	\$0.06	14.7	7.8	5.8
Group Avg.										13.9	12.6	11.2
WestJet	WJA:TSX	12/31	CAD	\$12.12	139	\$1,689	\$0.67	\$1.00	\$1.20	18.1	12.1	10.1

Notes:

- 1.) All estimates are Raymond James Research, except easyJet and Virgin Blue (IBES)
- 2.) Estimates for WJA are IFRS adjusted;
- 3.) RyanAir, Virgin Blue and easyJet estimates are fiscal year, all others are calendar year.

Source: Capital IQ, Raymond James Ltd.

A Word on Our Domestic Fare Survey Methodology

Our airfare index for both WestJet and Air Canada is calculated based on a monthly observation of the *lowest available* afternoon fares that we can find booking six weeks forward on a fixed set of 14 different city-pairs for both peak and off-peak travel days with each airline. The cumulative value of these 28 monthly observations for each airline is indexed to 100, which is equal to the value we observed when we started collecting the data in Jan-2003. Since then, we have been doing this survey in the middle of every month and looking at fares at the end of the next month (~6 weeks forward) to avoid the distortion of the booking curve. We do not suggest that our process is scientific or statistically significant, and we recognize its inherent imperfections. For example, the real time pricing dynamics of today's hypercompetitive markets are not captured by our once a month observations, nor are pricing trends at higher 'buckets'. Nevertheless, this survey has proven to be a good leading indicator of the directional change in the yields that airlines tend to report. Accordingly, we continue to rely on it for impressionistic observations.

Company Citations

Company Name	Ticker	Exchange	Currency	Closing Price	RJ Rating	RJ Entity
Alaska Air Group	ALK	NYSE	US\$	64.83	NC	
Allegiant Travel Co.	ALGT	NASDAQ	US\$	49.66	2	RJ & Associates
Copa Holdings, S.A.	CPA	NYSE	US\$	62.37	2	RJ & Associates
easyJet plc	EZJ.LSE	LSE			NC	
Gol Linhas Aereas Inteligentes S.A.	GOL	NYSE	US\$	7.55	2	RJ & Associates
JetBlue Airways	JBLU	NASDAQ	US\$	3.70	3	RJ & Associates
Ryanair Holdings plc	RYAAY	NASDAQ	US\$	29.28	2	RJ & Associates
Southwest Airlines Co.	LUV	NYSE	US\$	7.78	3	RJ & Associates

Notes: Prices are as of the most recent close on the indicated exchange and may not be in US\$. See Disclosure section for rating definitions. Stocks that do not trade on a U.S. national exchange may not be approved for sale in all U.S. states. NC=not covered.

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Market Perform (Hold)	25%	36%	52%	29%	5%	3%
Underperform (Sell)	1%	6%	8%	0%	6%	0%

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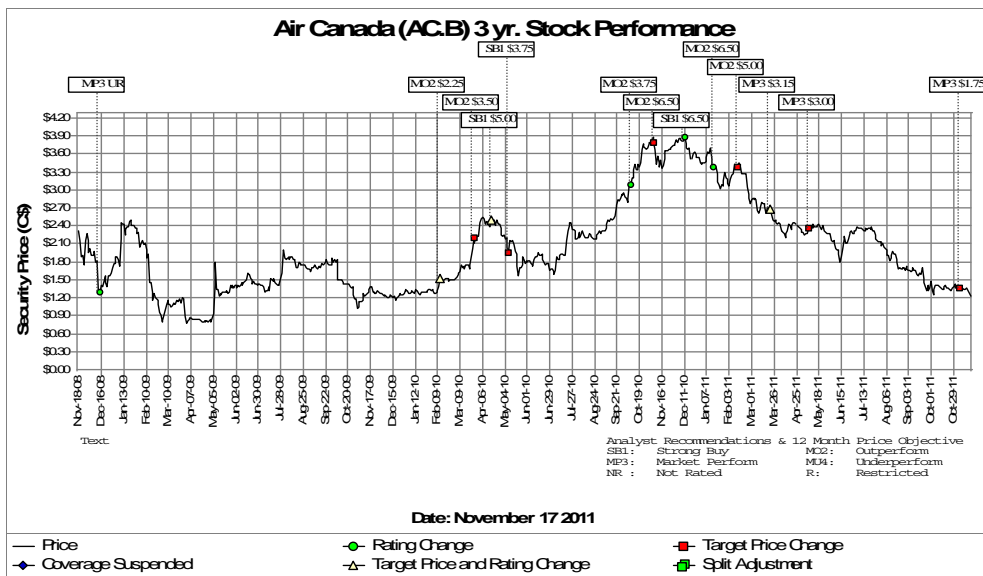
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WestJet Airlines	<p>Raymond James Ltd. has provided non-investment banking securities-related services within the last 12 months with respect to WestJet Airlines.</p> <p>Raymond James Ltd. has received compensation for investment banking services within the last 12 months with respect to WestJet Airlines.</p> <p>Raymond James Ltd. has received compensation for services other than investment banking within the last 12 months with respect to WestJet Airlines.</p>

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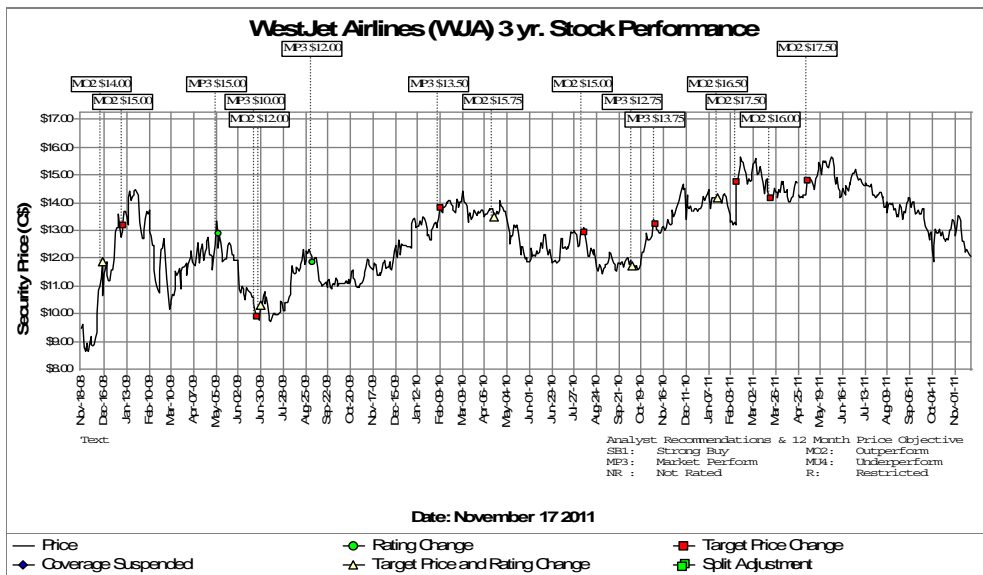
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Target Prices: The information below indicates target price and rating changes for the subject companies included in this research.



Update Date	Closing Price	Target Price	Rating
Nov-04-11	1.36	1.75	3
May-05-11	2.35	3.00	3
Mar-22-11	2.68	3.15	3
Feb-11-11	3.39	5.00	2
Jan-14-11	3.39	6.50	2
Dec-11-10	3.88	6.50	1
Nov-05-10	3.79	6.50	2
Oct-07-10	3.08	3.75	2
May-07-10	1.95	3.75	1
Apr-16-10	2.50	5.00	1
Mar-25-10	2.21	3.50	2
Feb-11-10	1.53	2.25	2
Dec-12-08	1.30	UR	3

Valuation Methodology: We value Air Canada on a comparative basis to peer group EV/EBITDA multiples.



Update Date	Closing Price	Target Price	Rating
May-03-11	14.80	17.50	2
Mar-22-11	14.17	16.00	2
Feb-09-11	14.76	17.50	2
Jan-18-11	14.20	16.50	2
Nov-04-10	13.26	13.75	3
Oct-07-10	11.72	12.75	3
Aug-06-10	12.97	15.00	2
Apr-16-10	13.50	15.75	2
Feb-09-10	13.85	13.50	3
Sep-02-09	11.89	12.00	3
Jun-30-09	10.30	12.00	2
Jun-24-09	9.93	10.00	3
May-06-09	12.88	15.00	3
Jan-08-09	13.19	15.00	2
Dec-12-08	11.85	14.00	2

Valuation Methodology: We value WestJet on a comparative basis to peer group P/E multiples.

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Risks - Air Canada

Some of the specific risk factors that pertain to the projected 6-12 month stock price target for Air Canada are as follows: 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.

Risks - WestJet Airlines

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. 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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