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INDEPENDENT RESEARCH OPINION

WestJet Airlines and 3rd Quarter 2006 Results

WestJet Airlines Ltd. (TSX: WJA)

Beating a Fractured Street

Over the past year there has been a divergence in opinion amongst research analysts covering WestJet on behalf of their respective brokerages, with a fair number of them heading into neutral or negative territory with respect to stock price guidance.

The recent growth in less favourable opinions regarding WestJet's prospects are perhaps best summarized in a report released earlier this week by UBS. In that report, an analyst justified his neutral rating on WestJet stock by pointing to a slowing economy, an increasingly complex business model and rising labour cost pressure. He also expects that WestJet shares will trade in the lower end of its historical trading range.

The EPS call by UBS was only one cent higher than the Street consensus as polled by Reuters Financial and Thomson Financial of 30 cents. While most of the analysts covering WestJet expected the airline to turn in a solid third quarter, few if any expected the much higher earnings posted by WestJet yesterday. EPS (basic) of 41 cents not only trumped last year's quarterly earnings of 24 cents, it crushed this quarter's Street consensus by an astounding 11 cents, or 37%.

This quarter's operating margin of 17.9% versus 13.7% in the same period last year, and EBITDAR (earnings before interest, tax, depreciation, amortization and aircraft rent) margin of 28.2% versus 26.4% last year, should again place WestJet at or near the top of North American airlines.

So much for accurate projections and doom and gloom scenarios. Going forward, at a minimum this should be a maintain situation and more realistically, an outperform story.

Strong Revenue Growth + Brand Focus

At the top end, strong revenue results in the third quarter dominated the headlines. Passenger demand rose faster than capacity, with Revenue Passenger Miles (RPMs) rising 20.1% versus 17.3% for Available Seat Miles (ASMs), and the number of Passenger boarded growing by 17.2%.

While the retrenchment by CanJet Airlines from scheduled to charter carrier midway through September helped, more important was WestJet's ongoing focus on building brand awareness and brand equity – efforts that continue to payoff on the revenue line. Brand building and maintenance are critical as the airline evolves from a small low cost carrier to a much larger "lower" cost, higher value carrier, and also in the context of slowing North American economy.

In addition to a favourable revenue environment, brand building efforts and continued inroads into the higher yielding business sector contributed to improved "quality" of revenue this quarter, noted as follows:

- Passenger Revenue Yield: + 2.5%
- Operating Revenue Yield: +3.1%
- Operating Revenue per ASM (RASM): + 5.5%
- Average Ticket Price per one-way flight segment: + 5.0%, to $153.37

Efficiency Gains – labour and fuel

On the cost side of the equation, efficiencies also helped improve the bottom line.

Is WestJet's corporate culture unique and has the marketing slogan about WestJet employees caring more because they are owners, actually delivered to the bottom line? Marketers can use a variety of metrics to help determine the monetary influence of that campaign on revenues, and internally on attempts to motivate cost controls. We can, however, look at fiscal productivity per WestJet employee.

During the third quarter, despite 16.5% growth in full-time equivalent staff and associated 7.1% rise in headcount per aircraft, growth in operating revenue per employee of 6.2% more than offset growth in operating expense per employee of 1.1%. Excluding aircraft fuel, expense per employee actually decreased by 0.9%. So what does this mean in terms of operating income per employee? A whopping 38.1% increase.

In terms of the high impact aircraft fuel account and notwithstanding the beneficial effect of falling in oil prices during the last month of Q3, the transition to an all-new generation fleet of Boeing 737 aircraft along with pro-active flight management measures resulted in fuel efficiency improvements.

For example, fuel consumption improved by:

- - 3.4% per ASM
- - 5.6% per RPM
- - 2.0% per block hour (AirTrav estimate)
- - 3.3% per employee

Improved Cost of Sales

Sales & Marketing expense has garnered significant attention since the second quarter of 2005, when WestJet ramped up efforts to penetrate the central Canadian marketplace and to build brand equity amongst both travelers and travel agents. Other guests related expenses, visible and behind the scenes, have also been rising.

AirTrav has noted in previous research reports that WestJet has thus far been able to justify these commercial cost increases through increased yields and passenger traffic. After all, there are only so many families the carrier can pull from cars and buses before the well runs dry. WestJet has been forced to evolve and grow beyond its historic roots, demonstrated at one end of the guest spectrum by its pursuit of higher yielding business traffic and at the other end through the recent launch of WestJet Vacations, an effort that should replicate some of the success of other vertically integrated travel enterprises.

The good news is that growth in Sales & Marketing expense, along with other expenses linked to customer contact and the creation of customer value, appear to be leveling off. The spike in costs associated with inaugural marketing campaigns has given way to more normalized growth.

For example, in the third quarter 2006 over 2005, versus the third quarter 2005 over 2004:

- Sales & Marketing: increased 18.8%, versus 68.0% last year
- Sales & Marketing, General & Admin, Inflight and Guest Services combined: increased 18%, versus 27.4% last year
- Inflight: increased 32.4% this quarter, versus 16.8% last year

By virtue of its larger budget impact, the slowdown in Sales & Marketing growth had a favourable impact on total expense growth. Breaking out Inflight from the above grouping, there is some concern as costs this quarter increased by 32.4% in comparision with 12.8% growth in the same period last year.

On a per ASM basis, controllable costs appear for the most part to be quite reasonable when compared with the healthy increase in revenue per ASM. While Sales & Marketing increased by 1.3% per ASM to 1.24 cents, to put this in context, the previous year's same quarter increase per ASM was 43.8%. WestJet has clearly instituted successful measures to control this line item.

The above expenses recorded the following quarterly per ASM unit cost results:

- Sales & Marketing: 1.24 cents, an increase of 1.3%
- Sales & Marketing, General & Admin, Inflight and Guest Services combined:
  - At 2.57 cents, a relatively flat increase of 0.6%;
  - Last year the quarter-over-quarter increase was 8.9%

Excluding Fuel – total unit costs drop

For the quarter, total Operating Cost per ASM (CASM) rose marginally by 0.4% to 12.47 cents.

Excluding the volatile aircraft fuel expense, CASM in the third quarter actually fell by 0.14 cents to 8.87 cents, or - 1.6%. This was facilitated by per ASM reductions in Depreciation & Amortization, General & Admin, Aircraft Leasing, Maintenance and Guest Services expenses, which more than offset increases to all other expenses excluding fuel.

Keep the Spread in Positive Territory

It's simple: keep revenue growth ahead of expense growth as you grow your airline. This is what WestJet accomplished this third quarter.

Last year, the third quarter spread between operating revenue growth of 30.9% and operating expense growth of 30.8% was a paltry 0.1%. This was largely due to significant increases in Aircraft Fuel, Depreciation and Amortization, Aircraft Leasing and Sales & Marketing.

This year, thanks to strong traffic and revenue performance, coupled with overall cost decreases excluding fuel, the spread between operating revenue growth of 23.8% and operating expense growth of 17.8% was 5.9%.

Airlines or widgets, that's how you make money.

Strong Cash Position

Airlines burn through cash quickly. With travel being one of the first discretionary expenditures that consumers tighten during an economic downturn, in effect a leading edge indicator of tougher times to come, it is critical for any airline to maintain a strong cash position. Given the fact that the airline business is a high fixed cost business only makes this imperative that much more essential.

This quarter, WestJet increased its cash position by $119.3-million, or + 45.9%, to $378.9-million. This was thanks to strong traffic, yields and advance bookings that affected operating flows, along with positive movement on both financing and investing flows.

In addition to a position of strong liquidity, WestJet has also previously stated that it will seek to maintain an appropriate and favourable debt to equity ratio. This quarter saw an improvement in the ratio, with a decrease to 2.4 to 1 from the 2.5 to 1 recorded at the end of 2005.

Good Times Ahead…but remain vigilant

AirTrav agrees that in general, cooling domestic and American economies will slow growth trends from the past few years. However, we believe that WestJet's brand building and awareness efforts, plus new product and service roll-outs, should continue to exert positive influence on prospects for continued traffic and revenue growth, albeit at a slightly slower rate.

Going forward against the backdrop of a slowing economy and notwithstanding cost containment measures already in place, WestJet must continue and increase its vigilance over controllable expenses in general, in particular regarding Sales & Marketing and Inflight and to a lesser degree over Guest Services.

In addition, pro-active management of the controllable components of Aircraft Fuel expense should also continue or be accelerated. Growth in all of these controllable charges should be kept in check. Strong negative deviations in these costs, coupled with a potential resurgence in fuel prices, have the potential to significantly and detrimentally impact future quarterly earnings.

Aircraft Fuel – the wild card

Energy prices will continue to demonstrate high volatility and high prices in the global marketplace for the foreseeable future. The price declines seen since late summer have been linked largely to supply and demand factors and to the market exit of some that a speculative elements. That being said, AirTrav believes that crude oil will not trade below the mid-$50 USD/barrel level through 2007, and at the top end no higher than $68/barrel. This is in line with estimates from the Energy Information Administration of the Unite

High prices, though certainly not at the high $70 level being traded on futures markets in mid-summer, are here for the long term based on four key factors:

1. Ever-increasing, high global demand.
2. Lack of recent investment in new refinery capacity.
3. Supply and OPEC quota impacts.
4. Geopolitical concerns, including Nigeria, Venezuela and the Middle East.

Recent rapid price reductions in crude oil may tempt some carriers to risk a greater percentage of their aviation fuel purchases at spot prices in Q4-2006 and into 2007. For those carriers with hedging instruments in place in the $60 plus range, a greater case can be made to rely exclusively on spot pricing for their remaining coverage. Carriers with limited or no hedge transactions in place should consider, based upon the four key cost driving factors noted above, some protection through 2007. Given high-energy volatility, WestJet should carefully consider all options before relying solely on spot.

Should oil remain at current prices or within the trading range noted above, AirTrav predicts that WestJet should post solid results through 2007 even as a softening economy slows traffic growth.

Per AIRTRAV INC.

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