



RESEARCH OPINION

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Reference: Opinion of AirTrav Inc. regarding 4th Quarter and full year 2005 results of WestJet Airlines and ACE Aviation

WestJet Airlines (TSX: WJA)

As recently reported in a national media outlet, the average expected 4th Quarter EPS from a group of 15 analysts was 8 cents, much higher than the actual result of 1 cent. AirTrav believes these analysts missed the trends of the two key expenses at play, Sales & Marketing and Aircraft Leasing. AirTrav's model and earlier forecast shows that these **two items together were underestimated by analysts in the 4th Quarter by \$12-million**. After tax, that amount **makes up the difference between 1 cent and 8 cents per share**. Also, one of the analysts quoted got the increase in unit costs wrong.

Incorrect Analyst Statement – Unit Costs

Per the same media report, an analyst at Merrill Lynch & Co. Inc., said, "WestJet's [sic] unit costs have climbed 16 per cent over the past year." That is totally incorrect on an annual basis, and still off if he was referring only to the 4th Quarter. Total unit costs for the full year rose 4.9% but declined 1.9% for the Quarter. Unit costs excluding (non-cash) Depreciation & Amortization rose 9.5% for the full year and 13.9% for the Quarter. And that's the unit costs. If he really meant actual cost percentage changes, it would differ again (see below).

These are the facts on a year-over-year basis:

<u>Actual Operating Data</u>	Year 2005	4 th Qtr 2005	Comment
Total operating revenues	+31.9%	+34.4%	See same comment below for Unit Costs.
Total operating expenses	+24.9%	+ 6.0%	Q4-04 depreciation bubble made Q4-05 look better, and stabilization of Aircraft Fuel, with lower Q4/Q4 cost rise of +30.3% versus first 9-months' YOY growth of +54.1%.
Operating expenses, excluding Depreciation & Amortization	+30.4%	+23.0%	<u>Already</u> rising Aircraft Lease and Sales & Marketing unit costs partially mitigated by stabilizing Aircraft Fuel cost.
Total operating revenues ("RASM")	+10.7%	+24.4%	Q4-04 res/yield system troubles made Q4-05 look better, plus increased focus on higher yielding business travelers.
Total operating expenses ("CASM")	+ 4.9%	-1.9%	Q4-04 depreciation bubble made Q4-05 look better, and stabilization of Aircraft Fuel, with lower Q4/Q4 <u>unit</u> cost rise of +20.6% versus first 9-months' YOY growth of +25.0%.
Operating expenses, excluding Depreciation & Amortization	+ 9.5%	+13.9%	<u>Already</u> rising Aircraft Lease and Sales & Marketing unit costs exacerbated by lower seasonal ASM production.

Missed Trend – Sales & Marketing

This was the one expense analysts have been quoted as saying came in higher than expectations and which has grown too fast. If one were to look at cost per Available Seat Mile (“ASM”) for Sales & Marketing, the analysts noted above missed the trend in our opinion. They were surprised that the unit cost of 1.16 cents for full year 2005 came in 24.2% higher than 0.94 cents in 2004. Their surprise likely came from the fact that the unit cost for nine months ending September 30th was 1.09 cents in 2005, only 13.3% higher than 0.96 cents for the comparative period in 2004.

The cost in 2005 for each of Quarters’ 1 to 3 was 0.76 cents, 1.29 cents and 1.22 cents respectively. If the analysts’ took Q4-2004 Sales & Marketing and mistakenly inflated it by the 9M-2005 YTD variance of 13.3%, their 4th Quarter forecasts would have come up **short by about \$7-million**. Analysts may have missed the fact that the battle to fill capacity with a greater proportion of business traffic and central Canada originating traffic had already begun in earnest in the 2nd Quarter – higher numbers were already reflected in 2nd Quarter and 3rd Quarter figures. The only reason unit cost dipped to 1.22 cents in the 3rd quarter was because of increased flying in the summer months. AirTrav’s model predicted the 4th Quarter Sales & Marketing expense by assuming the 2nd Quarter unit cost of 1.29 cents multiplied by our forecast of ASM capacity. That ended up making our forecast of \$39.6-million slightly higher than the actual 4th quarter cost of \$37.1-million – but a lot closer than the \$30-million we believe was resident in most analysts’ books.

All that being said, knowing the 4th Quarter is traditionally weaker than the 3rd Quarter, WestJet should at least have held the line on Sales & Marketing expenses at 3rd Quarter (\$34.5-million) or 2nd Quarter (\$32.7-million) levels, versus the increase to \$37.1-million in the 4th quarter. By the way, that 4th Quarter rise in expenditure was 71.5%, not the 68% quoted by analyst David Newman of National Bank Financial Inc.

Missed Trend – Aircraft Leasing

It is also possible that analysts did not accurately forecast Aircraft Lease expense. The cost per ASM for the nine months ending September 30th was 0.58 cents, 19.4% higher than the comparative period in 2004. If the analysts kept to that trend, the expense would have finished the full year at between 0.55 and 0.58 cents. The full year came in at 0.62 cents, 33.7% higher than 2004. We believe what was missed was that the cost in Q3 2005 was already 0.69 cents per ASM, and with a few more aircraft deliveries yet to round out 2005, the unit cost would only rise. And indeed it did, with the 4th Quarter coming in at 0.72 cents.

If the analysts’ mistakenly used the trending from the first nine months of 2005 over 2004, their 4th Quarter forecasts would have come up **short by about \$5-million**.

All Other Line Item Forecasts – OK

AirTrav believes that all of the other 4th Quarter expenses plus Operating Revenues were trended and forecasted correctly by industry financial analysts, including the fall in Aircraft Fuel from the 3rd to 4th Quarter 2005, and the 4th Quarter over Quarter drop in Depreciation/Amortization as a result of the large write-downs WestJet took in late 2004 due to the earlier retirement of its old B737-200 fleet.

Continuing Concern – Aircraft Fuel

Fuel prices will continue to be a major problem for all air carriers in the foreseeable future, with prices remaining high or rising. WestJet has not been able to engage in a fuel hedging program as comprehensive as that of ACE. Although WestJet re-introduced a fuel risk management program last September, it did not have as dramatic an effect on the bottom line as the multi-faceted hedging program employed by ACE.

To illustrate this point, the full year 2005 spread in EBITDAR (earnings before interest, taxes, depreciation and amortization, and aircraft leasing) between WestJet and ACE was 6.9% in favour of the former carrier, with WestJet at 20.7% and ACE at 13.7%. Due to fuel volatility and to measure the impacts of fuel-hedging programs, **AirTrav Inc. also employs the use of “EBITDARF”**, an adjusted measure of EBITDAR that excludes Aircraft Fuel. For the same period, the gap in WestJet’s EBITDARF versus ACE grew to 10.0%, with WestJet at 46.1% and ACE at 36.1%. Clearly then, WestJet did not garner the same degree of hedging benefit from its fuel risk management program as compared to ACE.

The Under Appreciated Story – Revenues & Margins

WestJet CEO Clive Beddoe has stated that much of the increase in Sales & Marketing expense came from the marketing campaign to lure business travelers in Ontario. We believe the analysts did not give enough merit to this factor. Forget about “yield” for a moment (passenger revenue divided by Revenue Passenger Miles, or the “quality” of revenue). Let’s talk apples to apples by using Revenue per ASM (“RASM”) to measure unit revenue and the profitability of capacity deployed, similar to unit costs using ASM’s.

If one were to talk about “trends”, RASM for the first 9 months of 2005 was tracking at 12.9 cents, 6.2% ahead of the comparative period in 2004. However, full year RASM ended up at 13.1 cents, 10.7% ahead of the 11.8 cents posted for 2004. That increase of 1.3 cents in RASM more than funded the year-over-year increase for Sales & Marketing of 0.23 cents and 0.15 cents for Aircraft Leasing. No increase in RASM could have offset the massive spike in Aircraft Fuel of 0.62 cents per ASM.

Much of the full year improvement in RASM can be attributed to a particularly strong 4th quarter, with a RASM of 13.7 cents outpacing by 24.4% the 11.0 cents of the Q4-2004. Adjusting for WestJet’s quoted reservation and yield management systems problems that negatively impacted revenues at the end of 2004 by between \$15 and \$20-million, RASM would have increased to 11.7 cents in Q4-2004. Based on that adjusted 2004 amount, Q4-2005 RASM still grew by 17.0%. Notwithstanding the absence of Jetsgo for the April to December period 2005, this RASM growth is still significant and points to positive traction by WestJet in the Ontario & corporate markets.

Similarly, while WestJet’s improvement in Passenger Yield for the full year grew modestly by 2.0% to 15.2 cents, the story for the 4th Quarter was much better. The last quarter saw a Passenger Yield of 16.3 cents, an increase of 14.0% over the same period in 2004. However, adjusting for the reservation and yield system problems noted above, the same quarter increase would have been reduced to 6.3%.

Ultimately, given current cost pressures WestJet must sustain an improved revenue performance that really did not gain traction until the 4th Quarter, when efforts ramped up to better penetrate the Ontario and corporate markets.

The Bottom Line – Tread Carefully vs. a Revitalized ACE

It is worthy to note that despite the panicky exit of some investors after Q4 financials were released, WestJet posted the best Operating Margin and EBITDAR of all major reporting airlines in Canada and the United States (mainline and low cost carriers, excluding carriers in US-Chapter 11 reorganization).

But WestJet must re-affirm its commitment to cost discipline by finding ways to fund the penetration of the Ontario and corporate markets other than just a reliance on its expanding revenue line. Although the airline has been doing many things right, it must get back to fundamentals. Today's favourable Operating Margin and EBITDAR positions could be tomorrow's bad news story.

Full year RASM between 2003 and 2005 grew by 4.0% while CASM rose by 14.7%. More telling, "Adjusted CASM" (excluding Aircraft Fuel due to the massive price volatility, and excluding Depreciation & Amortization due to the distortional affect in Q4-2004) still rose by 6.1% from 2003 to 2005. In comparison, during the same period RASM at ACE rose by 8.1% while Adjusted CASM (which in the case of ACE also excludes special restructuring items) fell by -17.1%. Even on just the most recent year ended, Adjusted CASM at WestJet rose by 4.8% to 8.2 cents while the same unit cost measure at ACE fell by -5.0% to 11.4 cents. Clearly, the combination of cost reductions at ACE and unit cost increases at WestJet has tightened the cost gap between the two rivals.

This negative implied spread between RASM and Adjusted CASM could worsen should WestJet falter in its drive for higher yielding business and as other cost pressures kick-in. In addition to rising Sales & Marketing expense plus increased labour pressure as WestJet matures, airport fees will continue to rise as the carrier continues to expand its presence at Toronto's ultra high-cost Pearson International Airport. Most importantly, high and possibly increasing fuel prices remain on the foreseeable horizon. As such, Mr. Beddoe and his team must increase their vigilance going forward in order to drive out non-essential costs from WestJet.

AirTrav Inc. understands that the business model of WestJet has been necessarily evolving as the carrier outgrows its early days as a pure play low cost carrier. However, it is the opinion of AirTrav that in order for WestJet to reap the rewards from growing, higher yield business traffic, to support continuing expansion and to mitigate some of the pain associated with rising fuel costs, management must reaffirm their commitment to cost control.

ACE Aviation (TSX: ACE.BT)

The good news about ACE's 4th Quarter 2005 was that both its Operating Margin and EBITDAR (earnings before interest, taxes, depreciation and amortization, and aircraft rent) were ahead of not just all US mainline carriers, but also ahead of two notable US low cost carriers, JetBlue and Southwest. Only Atlanta based low cost carrier AirTran, and WestJet, were ahead of Air Canada. That being said, and even though we are talking about the traditionally weaker 4th Quarter, it is still a sad testament to the state of the industry when ACE makes the statement that its negative -1.5% Operating Margin was "close to North American industry best".

Operating Costs Improving – But Not Enough to Offset Fuel

For the full year, ACE was able to reduce Adjusted CASM (excluding volatile Aircraft Fuel and non-cash Depreciation and Amortization, and before restructuring costs) by -5.0% and since year-end 2003, by -17.1%. The combination of rising costs at WestJet and reductions at ACE since 2003 has reduced the unit cost gap between the two competitors.

As a further example, in 2003 the gap in Adjusted CASM at ACE was 6.0 cents, or +78%, in comparison with WestJet. By 2005, that gap had narrowed to 3.2 cents, or +39.1%.

But like all other carriers, high fuel prices will continue to represent a major drag or outright impediment to profits. So while the reduction in Adjusted CASM gap noted above is significant, it is not enough. In the context of its full year profit in 2005, ACE will be challenged going forward to sustain or improve on those bottom line results if fuel continues a gradual rise or even a spike into the \$70/bbl USD range or beyond. Clearly, ACE must continue to closely scrutinize its non-fuel costs.

On top of that, there will be wage negotiations in 2006 with all but one of the unions represented at ACE. While they cannot strike until at least 2009, most of the key unions including the Canadian Auto Workers and the Canadian Union of Public Employees have stated they are hoping to recover at least what they gave up during the company's recent restructuring.

Fuel Costs and Pending Wage Hikes Behind Reduction in Non-Union Jobs

With the reorganization of ACE and partial spin-offs of its Aeroplan and Jazz divisions, ACE has uncovered and implemented many increased efficiencies. Similarly, in 2005 ACE labour productivity improved despite an increase of 1100 full-time equivalent (FTE) headcounts in Quarter 4, with the number of FTE's per aircraft decreasing by -6.8% while the number of ASM's attributable to each employee increasing by 4.2%. Although other efficiency improvements have yet to be realized, it is the opinion of AirTrav Inc. that they are not the primary driver behind the decision announced by ACE last week to shed 600 non-unionized workers. Instead, stubbornly high and possibly increasing fuel prices, coupled with guaranteed wage hikes in 2006 for most unionized workers, are the primary culprits behind the job cuts.

Other Costs – Airport & Other

Other costs to which ACE must pay close attention include Airport & Navigation Fees, and Other operating expenses. In the former group, which rose 9.1% over full year 2004, the high concentration of Air Canada and Jazz flight operations based at Toronto's Pearson International Airport will continue to be problematic insofar as that airport's ignoble distinction as the world's most expensive airport. ACE (and IATA) Chairman Robert Milton has warned that Pearson's high fees may scare away future business. ACE should "walk the talk" by launching, wherever feasible, new central Canada originating services from other airports such as Hamilton–Munro, Ottawa–Macdonald-Cartier and Montreal–Trudeau, all of which offer either new or renovated terminal facilities.

The macro grouping of Other operating expense must also be scrutinized in more detail for potential cost savings. Other expenses rose 8.3% for the full year 2005, outstripping growth in Revenue Passenger Miles (RPM's) and ASM's, which grew 7.7% and 4.0% respectively. At \$1.6-billion, this line item accounted for a massive 16.8% share of total Operating Expenses in 2005, and represented a higher share, or 20.3%, of the year-over-year increase in total expenses.

Strong Yields Offset Some of High Fuel Costs

The good news for Air Canada in the 4th Quarter was that passenger yields were up across the board and particularly strong in the domestic and transborder markets. New programs for higher yielding business passengers and the expansion of its new pricing model, combined with the demise of Jetsgo and deployment of the right mix of seat capacity across Air Canada and Jazz networks, helped ACE produce its strong domestic results. At the same time, the transborder market has finally posted

substantive results in terms of increased passenger traffic and yields after the years of decline and stagnation post 9-11. Latin America yields and RASM also performed well.

Yields versus WestJet

ACE has many more competitors on a global basis than does WestJet. However, both are still close competitors and as such it is worthy to note that despite WestJet's attempts through 2005 to increase its high-yielding traffic, the Passenger Yield gap on a system-wide basis between ACE and WestJet grew between 2003 and 2005. For example, in 2003 the Passenger Yield gap between ACE and WestJet was 0.96 cents, or 5.9%. Following increases in 2004 and 2005, that gap has grown to 2.51 cents, or 16.6%. Even the domestic-only Passenger Yield of ACE grew by 5.0% in 2005, compared to 2.0% (system) for WestJet.

The reason? As mentioned above, there have been new revenue pricing models and business campaigns. But by streamlining its system-wide network, ACE re-balanced the deployment of its aircraft and seats, right-sizing many routes by matching the right capacity with the right market. A significant amount of domestic and transborder flying was downsized to its own regional jets and to those of its short-haul Jazz subsidiary, freeing larger jets to perform "upstream" flying on longer-haul routes. In other words, the upstream ripple effect improved Air Canada's ability to launch new long-haul services to Latin America, Europe and Asia-Pacific.

The combined effect of these moves did more than re-align fleet and routes – it provided the basis for a sharper focus on yields and profitable, sustainable increases in passenger traffic.

Overall, it is the opinion of AirTrav Inc. that the continued solid focus by ACE management on key fundamentals including cost control and yield management, coupled with benefits that continue to flow from its restructuring and the partial spin-offs of several key divisions, will be insufficient in the near-term to totally negate the effects of continued high fuel prices. That being said, the company's overall cost and revenue focus as discussed should enable ACE to continue to outperform the majority of its North American rivals.

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