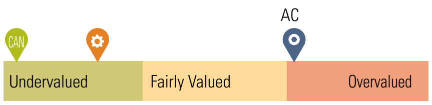
Air Canada AC (XTSE)

Morningstar Rating	Last Price	Fair Value Estimate	Price/Fair Value	Dividend Yield %	Market Cap (Bil)	Industry	Stewardship
★★★	10.99 CAD	9.00 CAD	1.22	—	3.15	Airlines	Standard
28 Sep 2015	28 Sep 2015			28 Sep 2015	28 Sep 2015		

Morningstar Pillars	Analyst	Quantitative
Economic Moat	None	None
Valuation	★★★	Overvalued
Uncertainty	Very High	High
Financial Health	—	Moderate

Source: Morningstar Equity Research

Quantitative Valuation



	Current	5-Yr Avg	Sector	Country
Price/Quant Fair Value	1.07	1.11	0.88	0.78
Price/Earnings	16.7	31.6	17.2	15.1
Forward P/E	3.3	—	14.0	10.2
Price/Cash Flow	2.2	1.4	9.9	6.4
Price/Free Cash Flow	27.6	15.3	16.7	12.3
Dividend Yield %	—	—	2.30	4.12

Source: Morningstar

Bulls Say

- Air Canada's introduction of the Boeing 787 could help attract premium passengers who drive higher profits.
- The company will continue to cut operating costs, helping to improve profitability and operating flexibility.
- Worldwide GDP is improving, and air travel demand historically increases by an additional 1.5%-2%. Strong demand will help load factors, and more important, yields, allowing for strong operating margin improvement.

Bears Say

- Low-fare flying on select routes could lead customers to demand further low-fare destinations, causing issues for Air Canada's multiclass offering.
- Air Canada is exposed to foreign exchange, as the majority (around 80%) of its inflows are in CAD while large outflows, including fuel, debt obligations, and capital expenditures, are in USD.
- 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 make for an industry where profitability has been elusive over the long term.

Air Canada Reports Record Second-Quarter Results

Keith Schoonmaker, CFA, Analyst, 14 May 2015

Investment Thesis

Air Canada has articulated a four-point strategy to improve operating results on a sustainable basis. Record profits in 2013 and 2014 have given management confidence to further capacity and grow the airline in the notoriously volatile no-moat industry. By promoting more international (including U.S. transborder) and premium-paying traffic, the company aims to generate higher operating margins. International traffic improved to 63% of revenue in 2014 from 58% in 2009, while premium traffic has remained around 20% of revenue for the past three years. A++, the company's trans-Atlantic joint venture with Lufthansa and United Airlines, was implemented in January 2010.

Reallocating fleet to cost-appropriate operating structures will aid profitability. The company operates a fleet of [illegible] aircraft and has purchase agreements for regional flying that include 164 aircraft. Air Canada launched a low-cost carrier, Rouge, in July 2013 and has been shifting aircraft to this entity, which has a lower cost structure (lower wages and higher seat density), a necessity in an industry that lacks sustainable competitive advantages. Further, the company is introducing high-density 777 aircraft within its mainline segment to profitably access low-fare, long-haul markets such as Hong Kong.

In 2009, Air Canada began a cost-transformation program aimed at reducing its cost structure by CAD 500 million by year-end 2011. It overachieved by delivering savings of CAD 530 million, helping operating margins increase to 4.3% in 2013. Air Canada's new goal is to reduce total cost per available seat mile by 15% by year-end 2017 from a 2012 base year. It also started charging bag fees in November 2014, which will aid revenue growth.

Finally, management has a vision to create a workforce that's more entrepreneurial and empowered. The company worked through strained employee relationships and concluded a new collective agreement with major unions in 2012 with lower pension expenses. We believe that the upturn in profitability has improved employee relations. Still, the capacity additions across the industry are worrisome and could pressure fares should demand wane.

Kwame Webb, CFA, Analyst, 12 August 2015

Analyst Note

Air Canada reported strong second-quarter results based on 3% sales growth and 32% growth in operating profits to a second quarter record of $323 million. Traffic improved 9% on similar capacity growth. Yields were 2% lower as Air Canada increased low-fare flying on the mainline and Rouge brands, along with collecting lower fuel surcharges. Cost per available seat mile excluding fuel ticked up 1% from the prior-year period, while on a fuel inclusive basis it fell 7%, leading to the period's substantial operating profit growth. We plan to maintain our CAD 9 fair value estimate and our no-moat rating following the latest earnings report.

Air Canada remains focused on maintaining an appropriate cost structure that allows it to improve profitability. Still, the firm is aggressively expanding capacity. Combined with competitive additions, this is translating into weaker domestic yields. For 2015, Air Canada sees capacity increasing 9%-10% and adjusted CASM declining 1.0%-2.0% (versus its prior outlook for 1.5%-2.5%). Air Canada will take delivery of 30 Boeing 787s through 2019 and will start upgrading its single-aisle fleet to 737-MAX aircraft. We see a 5% average annual capacity expansion for the next five years. The company is sitting on CAD $4.9 billion of debt offset by CAD $3.0 billion of cash, and it expects capital expenditures of nearly CAD $8 billion during the next five years.

Air Canada Rouge, launched July 1, 2013, currently operates 34 aircraft (14 Boeing 767-300s and 20 Airbus A319s) and could increase to 50 aircraft (25 Boeing 767-300s and 25 Airbus single-aisle) in the back half of the decade. The low fares and low-cost structure of Rouge allow Air Canada to more effectively compete for leisure passengers than its mainline operations, and it has been the sole source of Air Canada's capacity growth in recent periods.

Economic Moat

Keith Schoonmaker, CFA, Analyst, 14 May 2015

We do not believe Air Canada is protected by an economic moat because of minimal barriers to entry and lack of

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Close Competitors	Currency (Mil)	Market Cap	TTM Sales	Operating Margin	TTM/PE
Delta Air Lines Inc DAL	USD	36,620	40,920	9.48	20.33
Southwest Airlines Co LUV	USD	25,115	18,952	16.35	16.47
United Continental Holdings Inc UAL	USD	20,936	38,398	10.42	8.05
Westjet Airlines Ltd WJA	CAD	3,448	4,030	13.97	8.93

switching costs for its customers, who have ample choices to fulfill their travel needs. Local market competition includes low-cost carrier WestJet, while international competition is intense, with numerous North American and European players vying for share. Returns on invested capital were negative in 2008 and 2009 before turning positive for the past four years. We estimate ROICs can rebound to the low double digits in the later years of our forecast, but these are overstated because of a lack of tax payments resulting from historical losses. Higher capacity increases across the Canadian airline industry point to a lack of barriers to entry in the marketplace.

Valuation

Keith Schoonmaker, CFA, Analyst, 14 May 2015

Our fair value estimate is CAD 9 per share. The company has done a good job of achieving and maintaining cost reductions since the transformation plan was initiated in 2009. In our base-case scenario, we expect Air Canada to increase capacity at an average annual rate of around 4% during the next five years, as it takes delivery of new 787 Dreamliners, and result in revenue growing 6% with some pricing benefit in later years. Greater than 80% load factors experienced by Air Canada, combined with lower fuel costs, should help margin performance, and we anticipate operating margins to average nearly 8% in our forecast period. We do not believe the company will pay taxes for the next four years because of prior years' losses and assume a low 5% rate thereafter. We have included planned capital expenditures for the upcoming five years that total around CAD 7.2 billion compared with CAD 3.3 billion over the past five years.

Risk

Keith Schoonmaker, CFA, Analyst, 14 May 2015

Volatile crude oil prices and intense pricing pressure from competitors are the two biggest uncertainties facing airlines in general, and they apply to Air Canada as well. Fuel represents around 25%-30% of revenue and depends 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 foreign exchange, employee relations, aircraft safety, heightened security, and inclement weather.

Management

Keith Schoonmaker, CFA, Analyst, 14 May 2015

Calin Rovinescu was named president and CEO in April 2009. He worked in corporate development and strategy at Air Canada from 2000 to 2004. The strategy outlined by the CEO is sound, and the fruits of his actions were clear during 2013 and 2014 as operating profitability improved while costs remained under control. In 2012, the company reported positive net income for the first time since 2007. He has brought the company out of the tailspin and returned it to record profits, and deserves a lot of credit.

Importantly, recognizing that a competitive cost structure is a necessity, ongoing cost reduction targets are a key part of his ongoing strategy. The current program calls for reducing CASM by 15% in 2017 from a 2012 base. Nonetheless, legacy airline operators as a group have not done well for most stakeholders over the decades.

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Analyst Notes Archive

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Air Canada remains focused on maintaining an appropriate cost structure that allows it to improve profitability. Still, the firm is aggressively expanding capacity. Combined with competitive additions, this is translating into weaker domestic yields. For 2015, Air Canada sees capacity increasing 9%-10% and adjusted CASM declining 1.0%-2.0% (versus its prior outlook for 0.5%-2.0%). Air Canada will take delivery of 30 Boeing 787s through 2019 and will start upgrading its single-aisle fleet to 737-MAX aircraft. We see a 5% average annual capacity expansion for the next five years. The company is sitting on CAD $4.9 billion of debt offset by CAD $3.0 billion of cash, and it expects capital expenditures of nearly CAD $8 billion during the next five years.

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Air Canada Reports Record 1Q Results

Keith Schoonmaker, CFA, Analyst, 12 May 2015

No-moat Air Canada reported strong first-quarter results, including sales growth of 6% to CAD 3.2 billion and operating profits of CAD 200 million. Traffic improved 10.9% as capacity rose 9.3% and load factor improved 120 basis points to 81.5%. Yields were 4.2% softer as Air Canada increased low-fare flying on the mainline and Rouge brands, both parts of the firm's strategy to push high density and leisure flying. Cost per available seat mile excluding fuel was well controlled and declined 1.8% from the year-ago period. We will update our models after the earnings call but expect to maintain our CAD 9 fair value estimate.

Air Canada remains focused on maintaining an appropriate cost structure that allows it to improve profitability. Still, the firm is aggressively expanding capacity, which could lead to higher total costs and pressure fares in the future. For 2015, Air Canada sees capacity increasing 9%-10% and adjusted CASM declining 1.5%-2.5% (versus its prior outlook for 0.75%-1.75%). Air Canada will take delivery of 30 Boeing 787s through 2019 and will start upgrading its single-aisle fleet to 737-MAX aircraft. We see 5% average annual capacity expansion for the next five years. The company is sitting on CAD 5.8 billion of debt offset by CAD 2.8 billion of cash and expects capital expenditures of nearly CAD 8 billion over the next five years.

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Air Canada Class B AC

Last Close	Quantitative Fair Value Estimate	Market Cap (Mil)	Sector	Industry	Country of Domicile
10.99	10.92	3,340.5	Industrials	Airlines	CAN Canada

Air Canada provides scheduled passenger services in the Canadian market, the Canada-US transborder market as well as the international markets to and from Canada for leisure travelling.

Quantitative Scores

		Scores All	Rel Sector	Rel Country
Quantitative Moat	None	7	5	4
Valuation	Overvalued	6	6	5
Quantitative Uncertainty	High	86	87	94
Financial Health	Moderate	43	36	40

CAN AC

Undervalued | Fairly Valued | Overvalued

Valuation

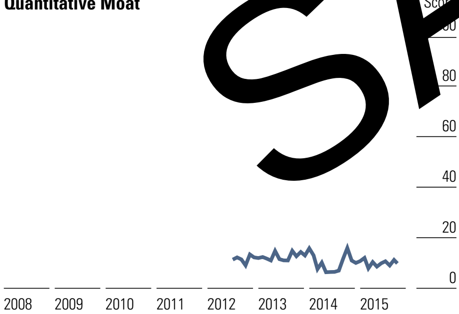
	Current	5-Yr Avg	Sector Median	Country Median
Price/Quant Fair Value	1.07	1.11	0.88	0.78
Price/Earnings	16.7	31.6	17.2	15.1
Forward P/E	3.3	—	14.0	10.2
Price/Cash Flow	2.2	1.4	9.9	6.4
Price/Free Cash Flow	27.6	15.3	16.7	12.3
Dividend Yield %	—	—	2.30	4.12
Price/Book	—	0.5	1.6	0.9
Price/Sales	0.3	0.1	0.8	1.5

Profitability

	Current	5-Yr Avg	Sector Median	Country Median
Return on Equity %	—	—	11.1	11.2
Return on Assets %	1.8	-0.7	4.6	4.0
Revenue/Employee (K)	555.4	503.8	439.3	[illegible]

Quantitative Moat

Score



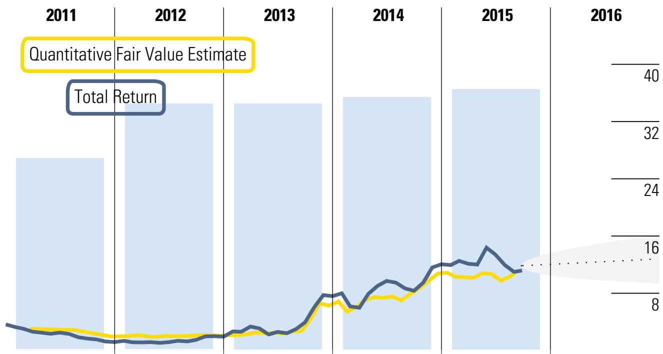
Financial Health

	Current	5-Yr Avg	Sector Median	Country Median
Distance to Default	0.5	0.3	0.6	0.6
Solvency Score	—	—	492.5	584.2
Assets/Equity	-8.9	-2.9	1.8	1.2
Long-Term Debt/Equity	-3.9	-2.6	0.2	0.2

Growth Per Share

	1-Year	3-Year	5-Year	10-Year
Revenue %	7.2	4.6	6.4	4.3
Operating Income %	31.7	65.7	—	—
Earnings %	1,515.5	-62.1	-31.4	—
Dividends %	—	—	—	—
Book Value %	—	—	—	—
Stock Total Return %	29.9	105.3	30.4	—

Price Versus Quantitative Fair Value

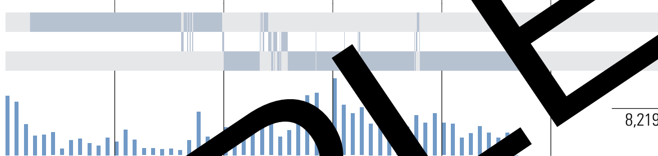


Momentum: —
Standard Deviation: 66.79

6.52 52-Wk 15.09

0.78 5-Yr 15.09

2011	2012	2013	2014	2015	2016	
-71.3	76.8	323.4	60.2	-7.4		Total Return %
-62.6	69.6	310.4	49.6	-0.8		+/– Market (S&P/TSX Composite)
—	—	—	—	—		Dividend Yield %
10.3	2.7	9.6	17.8	[illegible]		Price/Earnings
0.0	0.0	0.2	0.3	0.3		Price/Revenue



Monthly Volume (Thousand Shares)
Liquidity: High

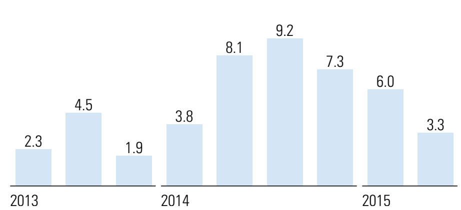
2010	2011	2012	2013	2014	TTM	Financials (Fiscal Year in Mil)
10,786	[illegible]	[illegible]	12,382	13,272	13,565	Revenue
10.8	[illegible]	4.4	2.2	7.2	2.2	% Change
361	[illegible]	[illegible]	619	815	1,155	Operating Income
[illegible]	-50.4	144.1	41.6	31.7	41.7	% Change
107	[illegible]	127	6	100	205	Net Income
[illegible]	[illegible]	649	731	941	1,528	Operating Cash Flow
[illegible]	-220	-462	-962	-1,501	-1,404	Capital Spending
746	366	187	-231	-560	124	Free Cash Flow
6.9	3.2	1.5	-1.9	-4.2	0.9	% Sales
0.37	-0.92	0.45	0.02	0.34	0.70	EPS
—	-348.6	—	-95.6	1,600.0	105.4	% Change
2.55	1.64	0.67	0.04	-1.61	0.42	Free Cash Flow/Share
—	—	—	—	—	—	Dividends/Share
6.24	-8.10	-12.41	-10.96	-5.12	-1.57	Book Value/Share
277,371	274,444	284,532	286,489	—	286,489	Shares Outstanding (K)

2010	2011	2012	2013	2014	TTM	Profitability
6.7	—	—	—	—	—	Return on Equity %
1.0	-2.5	1.4	0.1	1.0	1.8	Return on Assets %
1.0	-2.2	1.1	0.1	0.8	1.5	Net Margin %
1.03	1.15	1.30	1.34	1.32	1.18	Asset Turnover
6.1	—	—	—	—	—	Financial Leverage
60.2	56.4	56.9	58.4	58.5	61.8	Gross Margin %
3.4	1.5	3.6	5.0	6.1	8.5	Operating Margin %
—	—	3,449	3,959	4,732	—	Long-Term Debt
1,740	-4,085	-3,406	-1,460	-1,201	-449	Total Equity
1.8	2.1	2.4	2.5	2.4	2.3	Fixed Asset Turns

Quarterly Revenue & EPS

Revenue (Mil)	Mar	Jun	Sep	Dec	Total
2015	3,249.0	3,414.0	—	—	—
2014	3,065.0	3,305.0	3,798.0	3,104.0	13,272.0
2013	2,952.0	3,057.0	3,479.0	2,894.0	12,382.0
2012	2,962.0	2,989.0	3,328.0	2,841.0	12,120.0
Earnings Per Share					
2015	-1.08	1.00	—	—	—
2014	-1.20	0.75	1.10	-0.35	0.34
2013	-0.95	-0.09	1.05	-0.03	0.02
2012	-0.76	-0.35	1.54	0.02	0.45

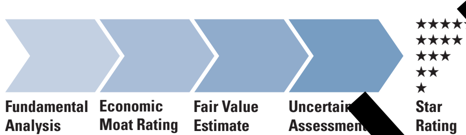
Revenue Growth Year On Year %



Morningstar Equity Research Methodology

Fundamental Analysis

At Morningstar, we believe buying shares of superior businesses at a discount and allowing them to compound over time is the surest way to create wealth in the stock market. The long-term fundamentals of businesses, such as cash flow, competition, economic cycles, and stewardship, are our primary focus. Occasionally, this approach causes our recommendations to appear out of step with the market, but willingness to be contrarian is an important source of outperformance and a benefit of Morningstar's independence. Our analysts conduct primary research to inform our views on each firm's moat, fair value and uncertainty.



Economic Moat

The economic moat concept is a cornerstone of Morningstar's investment philosophy and is used to distinguish high-quality companies with sustainable competitive advantages. An economic moat is a structural feature that allows a firm to sustain excess returns over a long period of time. Without a moat, a company's profits are more susceptible to competition. Companies with narrow moats are likely to achieve normalized excess returns beyond 10 years while wide-moat companies are likely to sustain excess returns beyond 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe lower-quality no-moat companies will see their returns gravitate toward the firm's cost of capital more quickly than companies with moats will. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

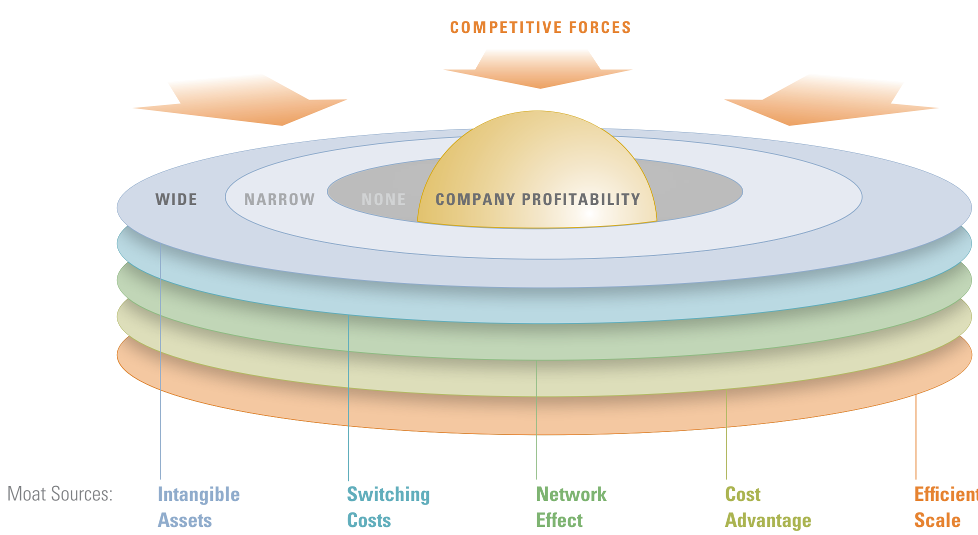
Fair Value Estimate

Our analyst-driven fair value estimate is based primarily on Morningstar's proprietary three-stage discounted cash flow model. We also use a variety of supplementary fundamental methods to triangulate a company's worth, such as sum-of-the-parts, multiples, and yields, among others. We're looking well beyond next quarter to determine the cash-generating ability of a company's assets because we believe the market price of a security will migrate toward the firm's intrinsic value over time. Economic moats are not only an important sorting mechanism for quality in our framework, but the designation also directly contributes to our estimate of a company's intrinsic value through sustained excess returns on invested capital.

Uncertainty Rating

The Morningstar Uncertainty Rating demonstrates our assessment of a firm's cash flow predictability, or valuation risk. From this rating, we determine appropriate margins of safety: The higher the uncertainty, the wider the margin of safety around our fair value estimate before our recommendations are triggered. Our uncertainty ratings are low, medium, high, very high, and extreme. With each uncertainty rating is a corresponding set of price/fair value ratios that drive our recommendations: Lower price/fair value ratios (<1.0) lead to positive recommendations, while higher price/fair value

Economic Moat



Morningstar Equity Research Methodology

ratios (>1.0) lead to negative recommendations. In very rare cases, the fair value estimate for a firm is so unpredictable that a margin of safety cannot be properly estimated. For these firms, we use a rating of extreme. Very high and extreme uncertainty companies tend to have higher risk and volatility.

Quantitatively Driven Valuations

To complement our analysts' work, we produce Quantitative Ratings for a much larger universe of companies. These ratings are generated by statistical models that are meant to divine the relationships between Morningstar's analyst-driven ratings and key financial data points. Consequently, our quantitative ratings are directly analogous to our analyst-driven ratings.

Quantitative Fair Value Estimate (QFVE): The QFVE is analogous to Morningstar's fair value estimate for stocks. It represents the per-share value of the equity of a company. The QFVE is displayed in the same currency as the company's last close price.

Valuation: The valuation is based on the ratio of a company's quantitative fair value estimate to its last close price.

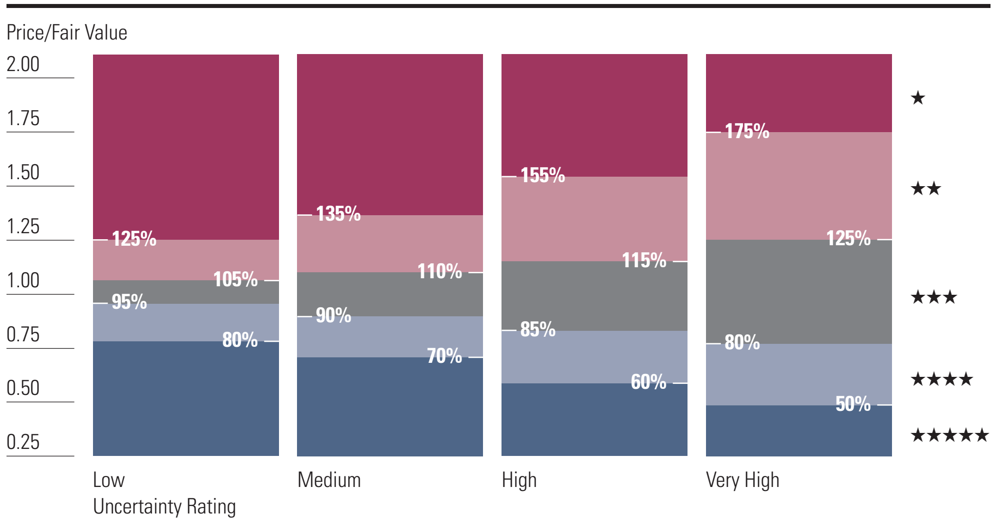
Quantitative Uncertainty: This rating describes our level of uncertainty about the accuracy of our quantitative fair value estimate. In this way it is analogous to Morningstar's fair value uncertainty ratings.

Quantitative Economic Moat: The quantitative moat rating is analogous to Morningstar's analyst-driven economic moat rating in that both are meant to describe the strength of a firm's competitive position.

Understanding Differences Between Analyst and Quantitative Valuations

If our analyst-driven ratings did not sometimes differ from our quantitative ratings, there would be little value in producing both. Differences occur because our quantitative ratings are essentially a highly sophisticated analysis of the analyst-driven ratings of comparable companies. If a company is unique and has few comparable companies, the quantitative model will have more trouble assigning correct ratings, while an analyst will have an easier time recognizing the true characteristics of the company. On the other hand, the quantitative models incorporate new data efficiently and consistently. Empirically, we find quantitative ratings and analyst-driven ratings to be equally powerful predictors of future performance. When the analyst-driven rating and the quantitative rating agree, we find the ratings to be much more predictive than when they differ. In this way, they provide an excellent second opinion for each other. When the ratings differ, it may be wise to follow the analyst's rating for a truly unique company with its own special situation, and follow the quantitative rating when a company has several reasonable comparable companies and relevant information is flowing at a rapid pace.

Uncertainty Rating



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Price/Fair Value Morningstar data as of Sep 28, 2015

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