

# Mind the gap

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Question: when does one plus one not equal two? Answer: in mergers and acquisitions. But in Canada, the disappearance of two major carriers is provoking frenzied start-up activity, increasing the number of airlines in the domestic market. At least, that is, in the short term.

A number of business groups now believe the time is right to launch new airlines. The economic argument is this: with the new Air Canada rationalizing domestic services, there is room for new entrants, right? Wrong, according to Dan Kennedy, chief financial officer (CFO) of Canada 3000. Kennedy has recently steered Canada 3000 through a successful C\$30 million (\$20 million) initial public offering (IPO) on the Toronto Stock Exchange. The cash improves its own position for growth. But the proposed start-up airlines will face a tough task, says Kennedy.

“There is some room in the market with Air Canada rescuing capacity,” he concedes. “But you just can’t replace the capacity that has been withdrawn otherwise you just recreate the problem. There wasn’t a need for two major, old business-orientated carriers in Canada and we fully supported Air Canada’s view that that segment of the market is well served by having just one carrier.”

Kennedy justifiably believes that the established carriers in the domestic market will be well-placed to tap whatever revenue passenger miles (RPMs) Air Canada spills.

The much-publicized criticisms of the consolidated carrier’s service and flight costs – which have been voiced in the Canadian federal parliament – have resulted in a substantial amount of growth opportunity. (Lou Sekora, MP for the ruling Liberal Party that approved the merger said to Air Canada’s CEO, Robert Milton: “All you do is hurt, hurt, hurt, destroy, destroy, destroy.”) Milton has since gone on the record admitting the national carrier’s service failings, and the threatened pilots’ strike, is heaping salt on to the wounds that WestJet, Canada 3000 and Air Transat want to keep from healing.

WestJet is proof of the potential. The low-cost carrier released its second-quarter results in early August, revealing rapid success. Earnings were up 154% to C\$7.4 million from C\$2.9 million. For six months ending June 20, profit leapt 129.6% to C\$11.6 million, from C\$5.1 million in 1999, on the back of a 38% increase in capacity. Load factor increased 3.8 percentage points to 77.4%. The best is apparently yet to come. Commenting on the results, Steve Smith, WestJet’s president and CFO, said: “We are ideally positioned as we move into the next six months, which is traditionally our busiest and strongest period.”

Canada 3000 is also enjoying a buoyant market. The airline is increasing its fleet to service its expanding scheduled service, and reported annual profits of C\$9.5 million, compared with a loss of C\$9.5 million last year. Revenue for the 1999/2000 financial year rose to C\$756.4 million from C\$520 million the previous year. Passenger traffic was up 11.5%, signalling the Canadians’ willingness to vote with their feet and choose carriers other than Air Canada.

The interest in the smaller airlines also enabled Canada 3000 to complete a successful IPO this summer. The lead underwriter was CIBC, but the airline also included internet underwriter Baystreetdirect.com, to open the IPO to a wider investor base. “Baystreet has no institutional clients – they are 100% retail. That appealed to us because we feel that the people that own us will fly us,” says Kennedy.

The IPO has been split 50-50 between retail and institutional. The deal was oversubscribed, but Kennedy says the management wasn’t tempted to increase the offering.

He says: “We didn’t want the overall dilution of the company. In fact, we didn’t really need all of the C\$30 million, although it’s nice to have. It was the timing of the market conditions – with the consolidation of Air Canada – that led us to think, if we were ever going to do anything in the Canadian market, now is the time to do it.”

The stock was issued at C\$10 a share, and has settled at about C\$13.50 during the first couple of months of trading.

Of the proceeds, C\$10 million will be invested in the fleet expansion, mostly in buying spare parts for its A319 deliveries. Five A319s will be

delivered on operating leases between the third quarter of 2001 and the second quarter of 2002. Two will be delivered by CIT, two from Boullioun and one from GATX.

The rest of the cash will be invested in improving the airline's distribution channels, especially the e-commerce channels, paying off the outstanding C\$1.5 million of debt and improving its liquidity position.

However, Kennedy warns against overestimating the potential for growth. "There isn't as much under-capacity as people perceive. Air Canada has largely just taken away the empty capacity in the marketplace. I think the airlines that will benefit will be the airlines that are now operating," he says. "It will be Canada 3000, WestJet and, to a certain extent, Air Transat, because the cost of entry for new airlines will be too high. WestJet isn't going to allow anyone to take market share away, and neither will we."

However, such talk hasn't been taken seriously by some. Russell Payson, CEO of Montreal-based Skyservice is seeking C\$34 million-worth of venture capital to start a business-orientated airline serving the cities of Vancouver, Toronto, Ottawa, Halifax and Los Angeles. CanJet, a Halifax-based regional operator will begin flying in September and Roots, a Toronto-based low-fare carrier, is slated to begin operations in early 2001. Other proposed start-ups include Capital City Air of Edmonton and buyers are being sought for Canadian Regional Airlines.

One Canadian aviation analyst agrees that Kennedy's assessment of the difficulties facing start-up airlines is correct. In the past 12 years, 14 airlines have stopped operations, and the lifespan for new entrants is likely to be short.

"I think there will be room for players to grow a bit, but the winners will be the airlines already operating and which have grown schedules and customer awareness in recent years," says the analyst. "Air Canada will not lose business-class revenue, and with its business-class load factors high, it will gradually expand the size of its business class. It will obviously not want to lose high-yield traffic, so the business it does lose will be some economy passengers. It will push passengers out of the back of its aircraft."

With the increased domestic competition, coupled with a rationalization of its scheduled service, Air Canada saw its domestic traffic fall 0.6% in the second quarter. It will not be too disheartened, however, because higher-yield international traffic grew 4.5% in the same period, and by 5% for the year to date. It also reported record second-quarter results of C\$118 million, up from C\$64 million in 1999.

Milton has highlighted the carrier's five million-strong frequent-flier programme as a key driver of future growth. Its Aeroplan scheme accounts for 50% of all traffic and 60% of revenues. Milton has spun Aeroplan off into a distinct business group, headed by Rupert Duchesne, formerly the airline's chief integration officer.

The financial cloud on the horizon is yet another pilots' strike. Mediation is in progress, but the increasingly bitter war of words between the management and the pilots' union is making an amicable solution less likely. The last pilots' strike at Air Canada cost the airline C\$155 million during a 13-day stoppage in 1998. Milton claims the airline is losing C\$1 million a day because some pilots are refusing overtime. But the chances of a full-scale walkout are slim. With Air Canada accounting for 90% of all Canadian flights, in dollar terms, the government is set to step in and prevent a walkout.

The government has already demonstrated its determination to intervene. It insisted that the combined Air Canada sell off Canadian Regional. Donaldson Lufkin & Jenrette is handling that sale and has confirmed three formal expressions of interest so far. The sale period, which lasts for 60 days, started on June 1. There were, according to sources close to Air Canada, some terse negotiations between the airline and the government about the level of the reserve price, with Air Canada reluctant to sell the airline, which has 30 regional jets and 24 turboprops.

The winning bidder will face several difficulties. The equipment is ageing and load factors on the regional flights are low. Possibly the greatest test will be its labour relations. The pilots' union for Canadian Regional is opposed to its sale and is threatening an uncooperative stance to new owners. The Oneworld alliance is one group rumoured to be interested, using the airline's existing infrastructure as a springboard to get back into the market it lost when Canadian merged into Air Canada, although the government's rules banning more than 25% foreign ownership of a Canadian airline would necessitate a Canadian business group fronting the bid.

Whatever the result, there will certainly be an influx of new competition in the Canadian aviation industry over the coming 12 months. Whether any of the newcomers will be able to create more than a transitory impact is far less certain.

Who will be the winners and losers? That is a very difficult question to answer.

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