WestJet Airlines LTD (TSX: WJA)

Rating: BUY
Current price: $27.60
Target: $36.00
Total Return:30.4%
(as of Nov. 30, 2013)

WestJet Airline Ltd (WestJet) is a Canadian low-cost carrier that provides scheduled and chartered air service to destinations in Canada, United States and Mexico. Founded in 1996, it is publically traded on the Toronto Stock Exchange under symbol "WJA".

WestJet continues to grow at a rapid pace, becoming a key player in the Canadian and North American air service industry by building on its low-cost service with a business model that focuses on efficiency. In its 17 year of operation, WestJet has grown organically in the shadow of dominant industry mainstay, Air Canada.

Since beginning its share buyback and dividend program in November 2010, share prices have doubled and this trend is expected to continue based on management guidelines. Improvements to operational efficiency will ensure it will be able to maintain costs as it grows under the constant threat of price war that has ravaged the industry in the past. We believe if recent trends continue, WestJet will become a dominant airliner within the continent.

With the Canadian and global economy beginning to stabilise, we can predict stability in growth forecasts from WestJet and the industry. The increase in oil production in US will help provide stability in fuel prices, the largest expense within the fuel industry.

Our price target for WestJet is focused on a mixture of future TEV/EBIT, Price/Earnings and future free cash flow projections. We are predicting a target return of 30.4%.

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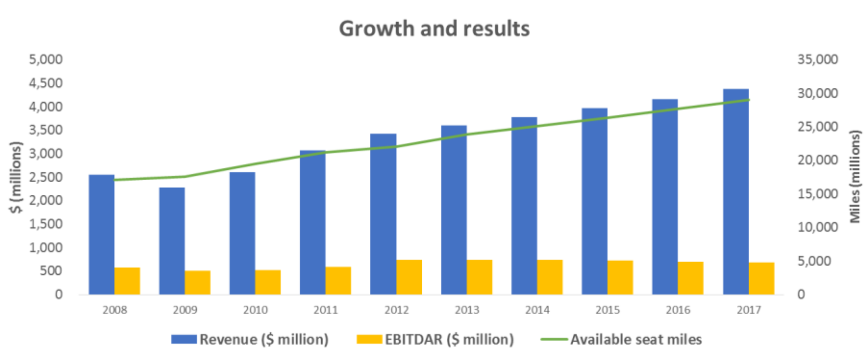

Report date:
November 30, 2013

WestJet Overview

Business model: WestJet currently operates in two models namely – WestJet and Encore. WestJet has traditionally focused as a low cost carrier, over the years successfully improving customer service as reflected in its increasing load factor. WestJet is placing greater emphasis on business and frequent travellers, attracting them with its reputed customer service and the recently implemented WestJet Dollars frequent flyer program. Encore focused on offering value based service to rural locations that are currently serviced by local charter airlines. One of the key motivators for expanded coverage and increased capacity is provided end-to-end flight connectivity to onboard passengers. This improves customer retention and revenue.

WestJet's working fleet currently consists of 103 Boeing 737 and 4 Bombardier Q400 aircrafts with an average of 6.9 years. Having a fleet based on limited model, the company has been able to maintain its aircraft maintenance and training costs. WestJet is not unionized, having focused on an employee culture that rewards them for the company's success through various profit sharing benefits. This gives higher flexibility of managements and has brought recognition to the company as one of Canada' most attractive employers[1]. WestJet had introduced various program such as Plus and partnerships with other airline carriers, that elevate customer flying experience.

Financial strength: On November 2010, WestJet began share buyback and dividend payout initiates resulting in over $400M returned to shareholders. Since the start of these initiatives, the share price of WestJet have more than doubled by 104%[2]. This is further reflected in the return on equity which has doubled in the past three years to 17.1% in 2012.

WestJet has maintained its strong liquidity position through the initiative, maintaining a current ratio of approximately 1.13 while also paying down nearly $875M in debt since 2008. The adjusted debt-to-equity sits at 1.35, which includes over $1B in off-balance sheet aircraft lease commitments. As of Sept. 30, 2013, WestJet has over $6.2B in contractual obligations and commitments, of which approximately $4B is due after 3 years.

Strategy: The current strategy targets increasing capacity and servicing wider geographic locations, while maintaining focus on customer service. WestJet plans to achieve this by expanding its fleet capacity, the Encore business to service 12 cities and increasing bi-lateral code sharing airline partnerships to 33[3].

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[1] http://www.newswire.ca/en/story/1158415/westjet-once-again-canada-s-most-attractive-employer. Access 1 December 2013

[2] https://www.google.ca/finance?q=TSE%3AWJA&ei=GS2cUuDQLuneiALmgAE. Accessed 30 November 2013

[3] WestJet earnings Call transcript, Q3 2013. Accessed 30 November 2013.

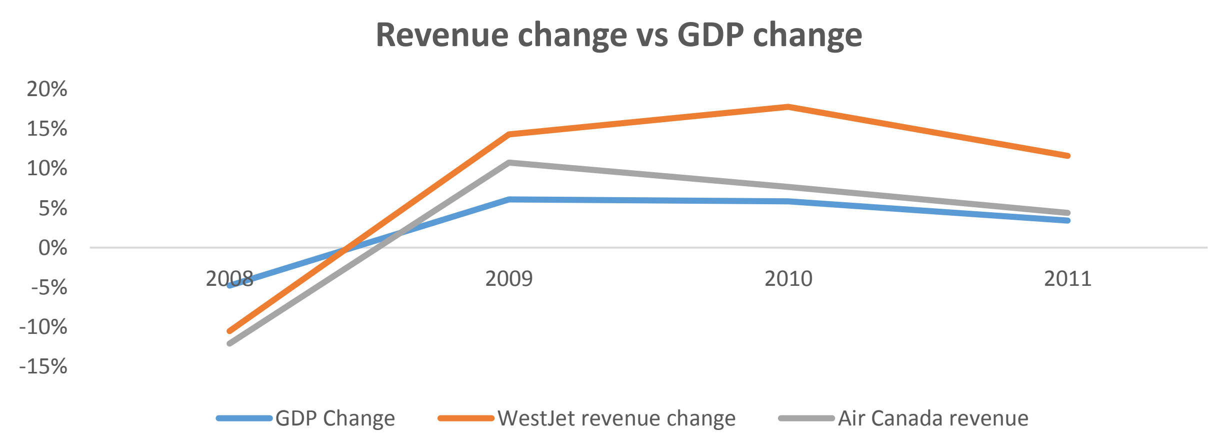
WestJet has committed to 65 Boeing 737 Max and 16 Bombardier Q400 aircrafts, the former has improved fuel efficiency technology to maintain costs while the latter will help expand the Encore business. Addition of new locations have boosted the revenue as the company can leverage on shorter flight time and reduced flight lead times. Last year revenue from partnerships accounted to 50% increase and WestJet is projecting the same for the upcoming years due to addition of more partners.

One of the factors to be considering is the projected increase in the operational costs factored in due to expansions. Increasing fleet capacity will not result in immediate revenue gains as noted by the decrease in Revenue per Available Seated Mile (RASM) and decreased load factor for Q3 2013. There will be greater wear and tear from frequent short distance flights serviced by Encore, this will result in increased maintenance costs of the new Bombarder Q400 aircrafts.

In January 2013, WestJet launched a "business transformation" initiative to reduce annual costs by $100M by the end of 2015; the company predicts to be one year ahead of schedule as of Q3 2013. WestJet plans to control costs by focussing on 3 main areas: aircraft utilization and distribution, overhead efficiency, and productivity.

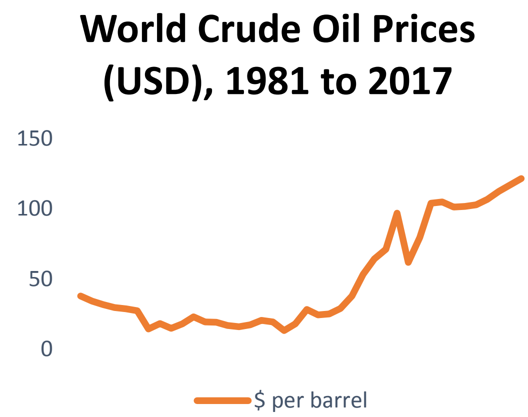
Industry Overview

Canadian Market, Economy, & GDP: Domestic airlines revenues are highly correlated with the general economy, and so are dependent on sustained economic growth to feed into leisure and business travelers. The Bank of Canada in October 2013 lowered economic growth forecasts for the second half of 2013, and further possible revision for 2014 growth projections[4]. Real GDP is expected to grow by 1.6% in 2013, then 2.2% and 2.5% in 2014 and 2015[5][6].



[4] (http://www.huffingtonpost.ca/2013/10/01/bank-of-canada-economy_n_4023848.html) Accessed 30 November 2013.
[5] (Scotiabank Economics, December 2013) Accessed 30 November 2013.
[6] Statistics Canada, CANSIM, table 380-0064. Accessed 30 November 2013.

Global oil price: The airline industry is notoriously susceptible to fluctuations in world crude oil prices. Oil prices have experienced high volatility and growth over the last five years, and is projected to see compounded growth of 2.9% in the next five years[7]. Continued political unrest within the Middle-East and North Africa, or a sharp increase in global demand, could potentially see higher than anticipated Global Oil prices. Although the risks of volatility remain, stagnant demand from Europe and China, and increasing production from the US, will continue to allow a stable growth in prices[8].



Air Travel in Canada has potential for growth: Canada currently represents the 7th largest market for air travel in the world, propelled largely by diffused population centers and a high standard of living. Year on year growth shows that that Canadian market has maintained the 3rd highest year-on-year growth, at 11.3% globally.

Air Canada is the largest Canadian airline and direct competitor for WestJet. Air Canada has begun to streamline its operations in an attempt to meet challenges posed to it by WestJet, including controlling its fleet size and labour union. Air Canada has seen increased revenues and controlled costs through recent initiatives, in response to growing competition domestically and internationally. Air Canada has begun shifting its operations to combat the loss of market share to WestJet. In 2013, Air Canada launched subsidiary Rouge Airlines, servicing holiday destinations at low cost[9]. Air Canada has begun to lower rates on select routes to combat WestJet Encore operations.

Air Canada has maintained its fuel hedging program to protect against volatility in the market, but also adds additional costs as these hedges are neither perfect nor timely in their predictions. Air Canada's unionized labour contracts are a differentiating burden, as compared to non-union WestJet. Maintaining several pension plans, both defined-benefit and defined-contribution, as well as other retirement benefit programs will continue to account for a growing obligation on the part of Air Canada. This risk though, has become manageable by financial support from the Canadian government, and in leveraging new labour agreements with unions for strictly defined-contribution plans for future employees.

JetBlue is a leading value-based carrier that is still recovering from substantial losses in the mid-2000's. Once an industry leader, non-unionized JetBlue has begun a re-expansion of its services and locations through international partnerships. Recently, JetBlue has expanded to target holiday travelers from its

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[7] IBIS World Business Environment Profiles. "World Price of Crude Oil" September 2013. Accessed 29 November 2013. Forecasted value for 2018: $117.03 USD per barrel

[8] Surmising low risk on major conflicts, international incidents or attacks that would trigger increased prices.

[9] (http://www.canadianbusiness.com/companies-and-industries/air-wars) Accessed 29 November 2013.

traditional eastern-US market. JetBlue has petitioning the FAA to allocate landing shares away from the recent mergers in the US airline industry[10]. JetBlue does not service Canada currently.

Sunwing & Air Transat are both private Canadian based airlines competing directly with WestJet's vacation package business. Sunwing follows a similar model to WestJet, in operating solely Boeing 737 aircraft, and has the second youngest fleet in Canada. Both airlines are moving to offer services in Alberta and British Columbia, and working on cost cutting initiatives such as such as fewer flight attendants.

Outlook

Based on the current growth strategy of WestJet, the company is in a strong position to take advantage of the positive market landscape, including a positive growth in the Canadian and global air travel industry. With commitments to increase and modernize its fleet with new fuel efficient aircrafts that offer increasing amenities, WestJet is in a position to improve its operational efficiencies began with the initiatives in January 2013.

Unlike its domestic and international competitors, WestJet's business model is not restricted by its legacy of success and failures. Having created a positive employee culture as one of the best employers in Canada will ensure top talent will come and stay with the company. The non-unionized workforce will give flexibility in the competitive landscape while stabilising fuel prices will ensure cost control.

Valuation (Appendix): We believe WestJet shares are currently undervalued and there is opportunity for growth in the share price to $36. In evenly comparing to the discounted cash flows model and comparative to other industry players, there is upside in the share price.

Risks

Exchange rate: WestJet generate the majority of their revenues in Canadian dollars. World oil prices are pegged to the U.S. Dollar as are orders for aircrafts, translating into risks from USD-CAD exchange rate fluctuations[11]. The continued devaluation of the USD over the last five years is projected to continue, and will have a stabilizing effect on USD-CAD exchange rates through 2016.

Interest rate: Due to the significant capital expenditures expected within the industry, WestJet often takes loans to purchase aircraft, this can leave the company vulnerable with its variable rate loans. WestJet has entered into interest swap agreements to mitigate this risk.

Unionization: WestJet's ability to control labour costs by mitigating unionization has been a tremendous cost control. Although there is still a risk that WestJet employees may attempt to organize a union, management believes tying employee compensation to financial results will encourage employees to become personally vested in the future of the company[12].

[10] (http://www.star-telegram.com/2013/11/07/5316146/southwest-and-jetblue-interested.html?rh=1) Accessed 29 November 2013.
[11] Pg. 14, WestJet Management's Discussion & Analysis of Financial Results Third Quarter 2013..
[12] Pg. 9, WestJet Management's Discussion and Analysis of Financial Results 2012.

Appendix: Discounted Cash Flow analysis

								Forecast		
Income statement	**2008**	**2009**	**2010**	**2011**	**2012**	***2013***	***2014***	***2015***	***2016***	***2017***
Guest	2,549.51	2,067.86	2,390.89	2,790.30	3,133.49	*3,290.17*	*3,454.67*	*3,627.41*	*3,808.78*	*3,999.22*
Other	-	213.26	216.41	281.24	293.92	*308.61*	*324.04*	*340.25*	*357.26*	*375.12*
Revenue	**2,549.51**	**2,281.12**	**2,607.29**	**3,071.54**	**3,427.41**	***3,598.78***	***3,778.72***	***3,967.65***	***4,166.04***	***4,374.34***
Aircraft fuel	803.293	570.57	674.61	915.88	992.79	*1,079.63*	*1,133.62*	*1,190.30*	*1,249.81*	*1,312.30*
Airport operations	342.922	352.33	388.11	421.56	454.11	*467.84*	*491.23*	*515.80*	*541.58*	*568.66*
Flight operations and navigational ch	280.92	298.76	325.58	344.44	366.87	*323.89*	*340.08*	*357.09*	*374.94*	*393.69*
Aircraft leasing	105.849	112.05	143.38	165.57	173.41	*179.94*	*188.94*	*198.38*	*208.30*	*218.72*
Inflight	86.05	103.95	117.06	139.48	156.41	*143.95*	*151.15*	*158.71*	*166.64*	*174.97*
Maintenance	85.093	96.27	124.30	146.26	154.41	*143.95*	*151.15*	*158.71*	*166.64*	*174.97*
Employee profit share	33.435	14.68	22.22	23.80	46.59	*48.48*	*58.17*	*69.81*	*83.77*	*100.52*
Selling General & Admin Exp.	382.67	380.64	446.08	483.24	521.70	*563.44*	*608.51*	*657.19*	*709.77*	*766.55*
Depreciation & Amort.	136.49	141.30	170.46	174.75	185.40	*226.50*	*261.30*	*297.84*	*336.21*	*376.49*
Other Operating Expense/(Income)	-	-	-	6.05	4.81					
Operating Expenses	**2,256.72**	**2,070.56**	**2,411.80**	**2,821.04**	**3,056.50**	***3,177.63***	***3,384.16***	***3,603.82***	***3,837.67***	***4,086.89***
Earnings from Operations	**292.79**	**210.56**	**195.49**	**250.50**	**370.91**	***421.15***	***394.56***	***363.83***	***328.36***	***287.45***
Net Interest Exp.	**-50.62**	**-62.10**	**-56.29**	**-39.81**	**-28.51**	***-25.24***	***-22.05***	***-18.92***	***-15.85***	***-12.82***
EBT Excl. Unusual Items	**272.76**	**137.97**	**136.98**	**208.07**	**341.46**	***395.91***	***372.51***	***344.91***	***312.52***	***274.63***
EBT Incl. Unusual Items	**254.76**	**136.77**	**133.45**	**207.97**	**340.23**	***395.91***	***372.51***	***344.91***	***312.52***	***274.63***
Income Tax Expense	76.24	38.62	43.27	59.30	97.84	*118.77*	*111.75*	*103.47*	*93.76*	*82.39*
Earnings from Cont. Ops.	**178.52**	**98.16**	**90.18**	**148.67**	**242.39**	***277.14***	***260.76***	***241.44***	***218.76***	***192.24***
Net Income	**178.52**	**98.16**	**90.18**	**148.67**	**242.39**	***277.14***	***260.76***	***241.44***	***218.76***	***192.24***

Discount rate (WACC) Worksheet	
Share Price	**27.60**
Shares Outstanding	**129.57**
Market Capitalization	**3,576.02**
Debt	788.86
Cash	1,232.96
Net Debt	2,021.82
Enterprise Value	**5,597.85**
Debt/Equity Weighting	
E/(D+E) @ Market Value	64%
D/(D+E) @ Market Value	36%
Total	**100%**
Interest Expense % of Average Debt	**5.95%**
Marginal Tax Rate	**30.00%**
Post tax cost of debt	**4.17%**
Risk Free rate: Rf	**3.00%**
Beta	**0.320**
Risk premium (Rm-Rf)	**8.00%**
Cost of Equity= rf+beta(Rm-Rf)	**5.56%**
WACC=E/(D+E)* Re+ D/(D+E)*Rd(1-T)	**5.06%**

Terminal Value Perpetuity Method	
WACC	5.06%
Long term growth rate	0.00%
Last forecast FCF	36.87
Maintenance CAPEX adjustment	-133.39
Adjusted last forecast FCF	-96.53
Grown TV FCF	-96.53
Present Value of Terminal Value	4,500.00
Terminal Value as % of Total Value	87%
Present Value of Forecast FCF	675.50
Forecast Period as % of Total Value	13%
Enterprise Value	**5,175.50**
Fair Value Perpetuity Method	
EV (Equity Value + Net Debt)	5,175.50
- Debt	-788.86
+ Cash	1,232.96
Net Debt	444.10
Minority interest	
Equity Value (Market Capitalization)	5,619.60
Shares Outstanding	129.57
Fair value per share	**$ 43.37**

		Growth			
	$ 43.37	0.0%	2.5%	5.0%	7.5%
WACC	3%	32.38	37.81	43.64	49.88
	4%	32.63	37.88	43.51	49.53
	5%	32.86	37.94	43.38	49.20
	6%	33.09	38.00	43.26	48.89
	7%	33.30	38.06	43.14	48.58
	8%	33.50	38.11	43.03	48.30

Appendix: Multiples analysis

Company Name	TEV/Total Revenues LTM - Latest	TEV/EBITDA LTM - Latest	TEV/EBIT LTM - Latest	Price / Earnings (Basic)	P/Diluted EPS Before Extra LTM - Latest	LTM Total Debt/EBITDA
Air Canada (TSX:AC.B)	0.3x	3.6x	6.8x	9.5x	9.7x	3.7x
Alaska Air Group, Inc. (NYSE:ALK)	1.0x	5.6x	8.0x	11.5x	11.7x	1.1x
CAE Inc. (TSX:CAE)	1.8x	8.9x	13.9x	18.7x	18.6x	2.5x
Chorus Aviation Inc. (TSX:CHR.B)	0.5x	4.5x	6.8x	7.0x	6.9x	2.7x
JetBlue Airways Corporation (NasdaqGS:JBLU)	0.8x	6.8x	12.6x	20.7x	23.1x	4.4x
Republic Airways Holdings Inc. (NasdaqGS:RJET)	0.9x	5.2x	9.0x	23.5x	9.9x	4.4x
SkyWest Inc. (NasdaqGS:SKYW)	0.5x	4.1x	10.2x	13.6x	13.7x	3.7x
Southwest Airlines Co. (NYSE:LUV)	0.7x	6.5x	11.8x	21.6x	21.7x	1.5x
Transat AT, Inc. (TSX:TRZ.B)	0.0x	2.0x	3.2x	27.8x	28.4x	-
TransForce Inc. (TSX:TFI)	1.0x	8.9x	14.5x	18.6x	19.3x	2.3x
Median	**0.8x**	**5.4x**	**9.6x**	**18.6x**	**16.2x**	**2.7x**

Using median statistics WestJet, as of Dec. 31, 2012	Revenues ($ million)	EBITDA ($ million)	EBIT ($ million)	EPS	Diluted EPS Excl. Extra Items	Total Debt
	3,427.41	568.21	388.35	1.79	1.78	788.86
Total Enterprise Value	2,570.56	3,068.32	3,728.13			2,129.92
- Debt	(788.86)	(788.86)	(788.86)			(788.86)
+ Cash	1,232.96	1,232.96	1,232.96			1,232.96
Net Debt	444.10	444.10	444.10			444.10
Equity Value (Market Capitalization)	3,014.66	3,512.43	4,172.23			2,574.03
Shares Outstanding	129.57	129.57	129.57			129.57
Fair value per share	**$ 23.27**	**$ 27.11**	**$ 32.20**	**$ 33.43**	**$ 28.75**	**$ 19.87**