STRATEGIC ANALYSIS CORPORATION
INVESTOR-BASED FINANCE

"The Economics of Restructuring Air Canada"
"Mobilizing Bondholders for a Regime Change"
Commentary Update 1

Special ⊕ps Commentary

It Doesn't Compute – What Are We Missing?

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May 27, 2003.

Disclaimer and Potential Conflict

The Economics of Restructuring Air Canada
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Introduction

As we recommended in our first commentary, Air Canada has recognized the formation of an Ad Hoc Committee of Unsecured Creditors, agreed to fund KPMG as financial advisors to the Committee, and to fund legal advisors to the Committee. The formation of this Committee is an important first step in ensuring that the eventual and inevitable debt restructuring occurs with the bondholders and other unsecured Creditors having the opportunity to properly present their case as it relates to the proposed restructuring terms, and at least equally importantly, their case as it relates to the structure of the New Air Canada which will emerge from CCAA, and the critical need to focus its business plan on consistent, sustainable profitability.

National Bank Financial ("NBF") has also emerged as an advisor to the Bondholders, who have formed a separate Ad Hoc Committee. They are on the court service list, and have held conference calls with close to $ 1 billion of bondholders, with no other objective than to maximize the eventual recovery potential for the bondholders. NBF has not been recognized by Air Canada, who apparently want to avoid negotiating with the bondholders as a separate class.

With this in mind, we must reiterate that the interests of the Bondholders are not necessarily the same as the interests of the other unsecured creditors. Aircraft lessors, employees and suppliers may well prefer a "bloated" revenue maximization model for the New Air Canada, rather than a profit maximization model, which maximizes the value of the securities into which the unsecured debt is converted. NBF and KPMG must both recognize the lack of commonality among certain classes of creditors, although only one seems prepared to publicly acknowledge it at the moment. The bondholders may only be able to speak softly, but they do carry a big stick! They may have to threaten to use it, to ensure their interests are not inappropriately compromised in the final Restructuring Plan.

Emerging Themes

There seem to be three major themes emerging which will impact the returns bondholders and other unsecured creditors can expect to receive:

1) Fairness

One of our key restructuring principles and, indeed, one of our key recommendations was that Air Canada recognize and pay the reasonable costs of an independent creditors' committee. This, they have done. Is it being done in a fair manner? It may not be. The Committee is to be chaired by the Chairman of Airbus Industries. The Committee is to be advised by KPMG. The Committee is to be initially comprised of $2.7 billion of unsecured creditors, but they are with doubt a group very much concerned about their ongoing commercial business relationships with Air Canada, post restructuring. The Committee represents 12 major unsecured creditors, representing $2.7 billion, but virtually no bondholders are included. Why? The court should consider forcing transparency on the process right from the start in order to minimize the opportunity of the playing field being unfairly tipped against the interests of the bondholders. The CCAA legislation is more about economics than law and this allows, at least until challenged, Air Canada to pursue a strategy which gives the company greater control over how the class ultimately casts its votes on the restructuring plan.

A simple "headcount" majority and a two-thirds majority in value of those present and voting, within a class must approve the plan. If a class approves the Plan, it can be crammed down on the minority of that class. CCAA does not explicitly allow cramming down of acceptance by one class on another class, as Chapter 11 does in the U.S. Otherwise, if not approved, the Plan either fails (liquidation,) or is sent back for amendment. Air Canada, therefore, seems intent on supporting a "super-sized" unsecured creditor class, tilting the deck against the bondholders in the process. Hence the recognition of KPMG, and Air Canada's agreement to fund them. Hence, the appointment of the Chairman of Airbus Industries as the Chairman of the Ad Hoc Committee. Air Canada has already made it clear that it will downsize its Boeing jet fleets by some 40 aircraft, and as a result leases will be compromised or rejected. Its future plane acquisitions are suggested to be largely Airbus aircraft, and Airbus will clearly have an interest in maximizing the new fleet size. Is there a more blatant potential conflict than negotiating a restructuring of debt with someone who will be, once the restructuring is finalized, the recipient of orders for new aircraft? Can such a party honestly pretend to objectively represent the interests of retail investors in Air Canada bonds? We suggest that the bondholders deserve, and should actively pursue, status as a separate creditor class. It seems to us that National Bank Financial is the uncompromised champion of the bondholders' interests, and that bondholders would be well advised to aggressively pursue recognition by Air Canada and the courts of this currently informal Committee.

Unfortunately, jurisprudence provides no clear assistance in predicting how the court will address this issue. The power initially resides with Air Canada to determine the creditor classes, and they have now shown their cards. Creditors may challenge, via motions to the court, the proposed class compositions. In this case, the court may consider that possible liquidation is such a negative outcome that it will allow Air Canada to keep the "super-sized" creditor class it wants. The lack of commonality between creditors, in that one camp may want to maximize revenue while the other camp, the bondholders, with no conflicting business relationship, want to maximize future profits, may not be enough to cause the court to put the bondholders in a separate class. However, if the court is concerned that the legitimate interests of the bondholders may be submerged in a supersized class, the court might approve the class, but suggest the replacement of the Chairman by an appropriate representative of the bondholders. Alternatively, the court could allow one supersized class, but require the Chairman to garner majority support from the Bondholders separately from the other unsecured creditors in the approval of the eventual plan.

2) Financial Losses and Reporting Transparency

Air Canada's credibility continues to be questioned, based on apparently rapidly-deteriorating revenue numbers.

Prior to filing for CCAA protection, Air Canada refused to acknowledge the possibility of impending insolvency. Statements made early on in the process suggested the company was losing $2 million per day. In court, in mid-April, counsel for Air Canada said it was losing $2 or $ 3 million per day. The court seemed to accept the 50% range of $2 or $3 million per day, made in mid-April. The Monitor's report, the fifth one now on file, states that Air Canada has been losing $4 million per day in the First Quarter of 2003. The following day, in the media, Air Canada reported that it had lost $5 million per day in April, or $152 million for the month.

Air Canada's 2002 fiscal year operating losses, before they were increased by the write-of a tax asset, were $218 million ($444 million, including interest expense). Its first quarter losses amounted to $354 million, coupled with April's losses of $152 million, means in four months they have lost more than they did, on operations, for the entire 2002 year. The losses are clearly escalating. While the Monitor's initial cash flow projections looked like Air Canada might not even need the $1 billion of DIP financing provided by GE, that now seems far from the case. In open court, Air Canada's counsel stated that Air Canada was surviving by "borrowing from other creditors" waiting for the CIBC and GE DIP financings.

Where's the beef? It looks to us that if this restructuring takes until the fall, and the burn rate remains as it is, then by our calculations Air Canada may have used substantially all of the DIP financing. (If revenue picks up during the traditionally strong summer season, the current burn rate could decline materially, perhaps as much as 50%, in which case much of the DIP financing would remain unused. However, we are not comfortable speculating on what the magnitude of such an improvement might be until advised by Air Canada.) Air Canada must be seen to be open, honest and transparent with all parties, starting with its losses, projections and likely revenue scenarios coming out of this restructuring. The longer the restructuring takes, the more DIP financing will be consumed and the worse the eventual returns will be to bondholders and other creditors. Greater transparency would facilitate a speedy resolution. When the counterparties, being asked to make compromises and concessions, are seeking truth, disclosure and transparency, Air Canada must be held to account for any apparent obfuscation and delay!

3) Air Canada's Evolving Restructuring Model

It would appear from press reports (Globe & Mail, May 7, 2003, Keith McArthur reporting) that Air Canada (or some other party to the restructuring) is deliberately leaking key aspects of a restructuring plan:

- that it "is completing plans to reinvent itself radically – by abandoning money-losing routes, charging more often for meals and snacks, and introducing a simpler, more transparent fare structure – to compete with discount rivals"
- "The airline that emerges from bankruptcy protection will be smaller, with much less debt and substantially lower labour costs. It will operate smaller planes, Tango, one of its two discount brands, will likely disappear."
- "Air Canada will maintain its hub-and-spoke structure"
- "Air Canada will be more ruthless about cutting routes that don't post consistent profits….This includes fights into small, regional markets and routes that have been rendered unprofitable because of competition from low-cost rivals such as WestJet Airlines Ltd."
- "Air Canada is looking to halve its debt and to end up with something close to an investment-grade balance sheet."

Air Canada has already filed with the court, a regulated versus non-regulated reorganized business model, not dissimilar to what BCE created in the 1980's. Why is Air Canada taking this approach when it really has no regulated business? Its only business it calls regulated is the deregulated airline industry. Safety, maintenance and other regulations affect the airline industry, not unlike most industries, however, other than cabotage rights, there is less regulation than ever before governing the airline industry.

The regulated vs. non-regulated business model appears to be a smokescreen to permit the same old Air Canada, in new clothes, to continue engaging in destructive competition and bullying its competitors, but doing it with lower costs. A "broken model", with lower costs, is still a broken model. With a lower cost structure already in place in Tango and Zip, Air Canada could still not resist lowering fares more than costs were lowered. If costs are cut 20%, but fares cut 25%, where does the profit come from? Where is the evidence that New Air Canada will abandon its focus on destructive competition once they have cut their overall cost structure?

Air Canada's stated targets, as outlined in monitor and court filings, are to obtain $2.4 billion of concessions with $770 million coming from labor; $400 million from compromised and rejected leases with a big "other category" of $ 1.2 billion to come from reduced interest charges, recovering food and beverage costs from the flying public, less maintenance and operational costs from having a more common fleet, etc..

Let's look at Air Canada's fiscal year 2002 costs versus its stated restructuring targets:

	Actual F/Y 2002 Expenses	Concession Targets
	Millions	Millions
Interest	$221	Zero ($221 mill. saving)
NAV & misc	$772	$826 (Nav 6.9% increase)
Salaries/Wages	$2,492	$1,722 ($770 mill. saving)
Aircraft Rent	$1,109	$709 ($400 mill. saving)
Benefits	$607	$425 (30% less)
Fuel	$1,288	$1,000 (our guesstimate)
Maintenance	$508	$600 (our guesstimate)
Depreciation,etc.	$372	$200 (our guesstimate)
Commissions	$369	$300 (our guesstimate)
Food, beverages	$395	$300 (our guesstimate)
Other	$2,106	$1,700 (our guesstimate)
Total	$10.2 billion	$7.8 billion

The May 23, 2003 Globe & Mail contains further "leaks" of the evolving Plan (Keith McArthur reporting again), including:

- "Air Canada is planning to convert up to $ 9 billion of debt and other unsecured claims into stock"
- "Air Canada says to emerge from bankruptcy protection, unsecured banks and bondholders must agree to convert $ 4.3-billion of debt into new equity."
- "Air Canada must secure financing for $ 3-billion on new aircraft deliveries."
- "An equity plan sponsor must invest about $ 450-million."
- "Exit debt financing of approximately $ 900-million must be arranged by the carrier."

So now it seems clear that Air Canada is setting up the bondholders for a full conversion into equity, though this may not in fact be required. New Air Canada should have "close to an investment grade rating." By dismissing opportunities to raise equity capital in the past, the Regime has decimated the current economic value of the bonds, and is now trying to permanently bury them in common shares. If the Regime has its way, the current bondholders will take it on the chin to allow an investment grade company to emerge temporarily until they start piling on new debt. The current bondholders will be at the bottom of the heap, again. Deja vu, all over again for the bondholders, but starting from a further notch down.

How long will New Air Canada go without adding mountains of new debt, forgetting in the process their focus on "investment grade". Apparently, not long if they are already talking about taking on a new $ 3 billion of leases and $ 900 million of long term debt.

Is there a better way? We called for the emergence of a business model which creates a Resolution Airlines and a profitable carrier based on sustainable profits and competitiveness. British Airways and Qantas are but two major international airlines that have either modified their business model or reorganized the company with a different approach than Air Canada, and appear to be achieving the objective of profitability.

In summary, what does all this suggest for the Bondholders?

1) **Resolution Airlines is going to be Big**

   In our first Commentary, we recommended creation of a new legal entity, we called Resolution Airline Corp, to house the assets and employees related to unprofitable routes. The Plan seems to contemplate discontinuing the 747 fleet and, over time, all of the 737 fleet, and the acquisition of a new fleet of regional jets to be built either by Bombardier or Embraer. If the current debt level is to "cut in half", Resolution Airlines is going to be, on paper (or on the ground, if you prefer) one of the world's larger airlines.

2) **If the existing debt is going to be cut in half, all the Bonds are going to have to be converted into equity!**

   On the surface, such a scale of debt conversion is not surprising, or necessarily worrisome. What is key to the Bondholders fortunes is that New Air Canada is solvent and profitable, and that they have a sufficient equity stake to recoup value in the future above the value available today by selling their bonds in the market. Otherwise, they have no clear economic incentive to support the restructuring plan. Air Canada's total debt, excluding the DIP financing, but including the unfunded pension liability is about $ 14.2 Billion. If $ 7 billion is converted into equity, even using the current common stock price of $ 1.72 per share (which continuing high valuation we cannot comprehend), the unsecured creditors would get 4.07 billion shares, representing about 97% of the equity (making no allowance for shares given to employees in exchange for wage concessions – the U.S. experience of airline restructuring suggests the allocation of a significant equity stake in exchange for union wage concessions). Again, in such a restructuring this outcome is not terribly surprising, or unusual. The current common shareholders are reduced to about 3% of the equity in New Air Canada, just enough to ensure they have an incentive to vote in favour of the Plan (but not enough, in our mind, to begin to justify the current trading price of the stock).

3) **But there must be more!**

   The debt conversion described above, improves the balance sheet to the extent that it exceeds asset write-downs, but Air Canada is starting with a deficit in Shareholder's Equity (of $ 2.3 Billion as at December 31, 2002 – which deficit will be significantly greater now by virtue of losses so far in 2003) which must also be corrected if the Company is to be "close to investment grade." Furthermore, and much more significantly from an operating point of view, the debt conversion outlined above, doesn't put a penny of cash on the Balance Sheet, to repay the DIP financing, let alone to fund the New Air Canada going forward.

4) **Hence the need for Asset Sales and a new Equity Financing.**

Assuming that Air Canada has largely exhausted the DIP funding by the time it emerges from CCAA, it must raise $ 1 billion to repay GE, and, we would hypothesize, at least a further $ 500 million in cash for working capital, even if it is projecting being cashflow positive from ongoing operations.

If its latest "leaks" are to be believed, they will seek to raise $ 900 million in new debt (essentially to repay the DIP financing), and $ 450 million of new equity. We do not see such a financing structure being consistent with a "near investment grade rating." In our view, either the objective of an "investment grade rating" is fictitious, or the required $ 1.5 billion of new cash must be raised through a combination of asset sales and new equity, not more debt.

In our first Commentary, we hypothesized an enterprise value for Air Canada Technical Services ("ACTS") of $ 100 million, and for Aeroplan (100%) of $561 million. It is hard to ascribe any positive value to Jazz. In round figures, and assuming Air Canada is able to sell 100% of ACTS and 100% of Aeroplan on such terms, this still leaves the need to raise $ 1 Billion in cash to repay the rest of the DIP facility and fund working capital.

We hypothesize that any new group of investors providing $ 1 Billion cash for common shares of a down-sized, restructured New Air Canada, is going to receive more than 50% of the common shares. We therefore assume the issuance of a further 4 billion+ common shares to the new equity investors in exchange for their $ 1 Billion cash infusion. (Parenthetically, this suggests a valuation of about $ 0.25 per common share, which is much closer to what we would have expected the current common shares to trade for today.)

5) **What are the Valuation Consequences of such a Scenario?**

New Air Canada would still have $ 7+ billion in continuing "old" debt (now apparently investment grade) plus $ 3 billion in new leases for regional jets for total debt of $ 10 billion. A new investor putting up $ 1 billion of cash for 51% of the company is going to expect his investment to quickly have a market value of $ 2 billion+, implying a total market cap of $ 4 billion. Is this realistic?

6) But Wait a Minute – Are we just assuming that operating losses averaging more than $ 100 million per month are converted into substantial operating profits?

Well, yes, as a matter of fact, one has to do that. Otherwise, who is going to invest $ 1 billion of cash into New Air Canada, for 51% of the equity?

7) But Wait a Minute (2) – Are we assuming the current Air Canada Board Regime knows how to operate an airline profitably? What is the evidence for such an assumption?

Well, no, actually, we are not! The court recently commented: "Under the watch of these fellows (the directors), we have a $ 2-billion deficit". But we are assuming that the new Board of New Air Canada knows how to operate an airline profitably. Because, one has to do that! As above, who is going to invest $ 1 billion of cold hard cash for 51% of the equity of New Air Canada if this is not the case.

8) But Wait a Minute (3) – THIS DOESN'T COMPUTE – If Air Canada currently has $ 10 billion of operating expenses, and succeeds in cutting them by $ 2.4 billion, they will be at $ 7.8 billion going forward. But then they will add another $ 3 billion of new leases, which must cost $ 250 million a year to service, and if they raise $ 900 million of new debt, that has to cost another $ 50 million+ per year, just in interest payments. So they will have in excess of $ 8 billion in operating expenses. But according to Keith McArthur's May 22 report in the Globe & Mail, "Air Canada is looking to post an annual pre-tax profit of about $ 600-million on revenue of between $7.5-billion and $8-billion, after it emerges from bankruptcy protection. Annual revenue will fall from its current level of about $10-billion as Air Canada shrinks its operations and lowers ticket prices."

Something has to give here:

- First, we suggest that the objective of an investment grade rating is a fantasy.
- Second, we suggest that if revenue is projected at $ 7.5-8 billion, either costs have to be reduced significantly more than has currently been discussed, or New Air Canada will fail to earn its target $ 600 million pre-tax. Alternatively, Air Canada management is low-balling the revenue projection, because it isn't really intending to drop any significant routes, but it wants to use a low revenue projection as part of its negotiation strategy with the unions.
- Thirdly, the talk of raising $ 900 million of new debt, on top of the new leases, suggests that Air Canada management has learned nothing about the appropriate mix of debt and equity in running an airline, or indeed any viable company.

SO, NO IT DOESN'T COMPUTE. Air Canada should stop the press leaks, and issue a proper press release outlining which routes it will drop, how it will price its services on its continuing routes, what its employment levels will be, what its projected revenue will be, what its projected expenses will be, and what its projected balance sheet will be, post-restructuring. Then all the interested parties will be able to evaluate the viability of the Plan, and the fairness of the price they are being asked to pay compared to the price being asked of the other stakeholders.

The Unavoidable Conclusion

We keep coming back to one point. Profitability is the key for any successful company. As we wrote in our first Commentary, the Air Canada bondholders, who are about to become the new Air Canada shareholders, must insist that New Air Canada fly planes on routes where it can project passenger revenue exceeding fully-allocated costs. This is a different concept that simply saying that Air Canada must reduce its operating expenses by an amount greater than its current losses. It requires Air Canada to (a) understand its true operating costs, and (b) to price its services above fully-allocated operating costs. Otherwise, the current CCAA process will be repeated in a couple of years, or whenever the next exogenous shock hits the airline industry. Under such circumstances, the current bondholders, who will be converted into common shares, will have done to them what is about to be done to the current Air Canada common shareholders. They will be diluted into near oblivion.

STAY TUNED.