CORMARK SECURITIES INC.

David Newman, CMA, CFA (416) 943-6469, dnewman@cormark.com
Hilda Maraachlian, Ph.D. – Asc. (416) 943-6722, hmaraachlian@cormark.com

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TRANSPORTATION

Airlines Q4 Preview

Heading For Sunnier Climes, Despite Near-Term Currency Turbulence

Air Canada Inc. (AC.B-T; AC.A-T)
Rec.: Top Pick; Target: $13.00

YE Dec. 31	2012A	2013E	2014E
Revenue (MM)	$12,116	$12,443	$13,069
EBITDAR (MM)	$1,321	$1,470	$1,640
EPS (1)	$0.19	$1.32	$1.66

WestJet Airlines Ltd. (WJA-T)
Rec.: Buy (Was Market Perform); Target: $30.00

YE Dec. 31	2012A	2013E	2014E
Revenue (MM)	$3,427	$3,668	$3,860
EBITDAR (MM)	$735	$776	$857
EPS (1)	$1.78	$2.02	$2.34

(1) Earnings per share adjusted for one-time items
* EBITDAR adjusted for FX gains/losses

Disclosure statements are located on pages 20 - 21 of this report

Unless otherwise denoted, all figures shown in C$

We believe passenger demand remains strong, and is poised to accelerate should the global economy witness growth across most regions, as hoped. Airline industry commentary, strong load factors, positive pricing and healthy booking curves all point toward continued strength, which is being leveraged through prudent capacity and cost management, as well as relatively well-behaved jet fuel prices.

Our fare tracking highlights that yields have risen modestly, especially post the WestJet seat sales, with supply and demand remaining in balance. While RASM could soften in 2014, on the back of capacity additions, the Canadian airlines are holding costs equally in check. For example, AC has implemented or planned various initiatives to reduce CASM by 15%, including fleet renewal, shifting capacity to low cost providers, seeking out supply chain savings by leveraging its position with key providers, and other initiatives. Further, AC's narrowbody fleet renewal program is expected to result in ~10% CASM reduction as compared with its existing narrowbody fleet. Similarly, WJA is well on its way to meeting or exceeding its $100 MM business transformation program by the end of 2014. We believe lower costs may offset any pressure from declining yields and currency.

Q4 Themes: Healthy environment, strong demand, improved pricing, growing ancillary revenues and declining fuel prices, offset by the weaker Canadian dollar. Q4 was marked by strong traffic growth and load factors (second highest), coupled with a rational competitive environment and cost-cutting initiatives, which should drive solid earnings performance. Strong execution of the airlines' various initiatives is key to our positive view.

Expect Solid Q4, Driven By Strong Demand And Cost Control

WJA – February 4 – Q4 EPS of $0.51 (Street $0.53), vs. $0.46 last year.

AC – February 12 – Q4 EBITDAR of $314 MM (Street $320 MM) vs. $284 MM last year).

Airlines Q4 Preview And Outlook

Canadian Airline Industry – Blue Skies Ahead; No Change In Heading Despite Near Term Currency Turbulence

We believe the Canadian airlines are poised to report strong Q4 results aided by healthy demand, generally improved pricing, growing ancillary revenues and declining jet fuel prices, offset by a weaker Canadian dollar. Strong traffic growth and load factors (second highest on record), coupled with a relatively rational competitive environment and cost-cutting initiatives, potentially point toward solid earnings performance in Q4.

We believe demand remains very solid, albeit with pockets of competitive pressure offset by continued relatively-rational behaviour by most industry players in terms of capacity and cost management, supported by consolidation and other cooperative efforts (JVs, etc.). The industry's newfound discipline should put it on the path to sustainable profitability, with 2014 expected to be the most profitable year on record, according to the International Air Transport Association (IATA). Further, we believe booking curves remain relatively solid, implying no fundamental deterioration in demand, although waning concerns over the economy remain, albeit progressively easing. The airlines have produced impressive results in the face of weaker conditions, which could accelerate with the potential for synchronous global growth.

We believe demand and supply remain roughly in balance on the domestic front, which should sustain the current, relatively stable-to-positive environment, barring any unforeseen economic or other exogenous events. We would note that our fare tracking shows that yields were also stable-to-positive in Q4, with some pockets of weakness offset by areas of relative strength, which has been confirmed by our conversations with various industry participants. However, competition is heating up in Q1, with seat sales, and in the regional markets as WestJet (WJA) rolls out Encore, its regional airline, into the smaller cities and towns across Canada, starting in the west and migrating east in 2014. Further, with the launch of low-cost leisure carrier *rouge*, the expected delivery of five new (10 abreast) 458-seat 777s and the introduction of new 787s (a total of 6 to be delivered in 2014 and 6 in 2015, with 5-6 per year thereafter to 2019 for a total of 15 787-8s and 22 787-9s), the international skies could become more crowded as well. However, we believe the longer range of the 787s versus the 767s (up to 15,200 km for 787-8 and 15,750 km for the 787-9 vs. just below 11,000 km for the 767s) could expand the addressable market for Air Canada to add new destinations further afar. Regardless, we believe yields and RASM could come under greater pressure in 2014, but AC's and WJA's cost-reduction programs should more than offset any pressure, in our estimation. We have factored the RASM pressure and cost reductions, to a lesser degree, into our forward estimates. We also believe currency represents a risk in 2014, which we discuss in detail in the Valuation And Sensitivity segment of this note.

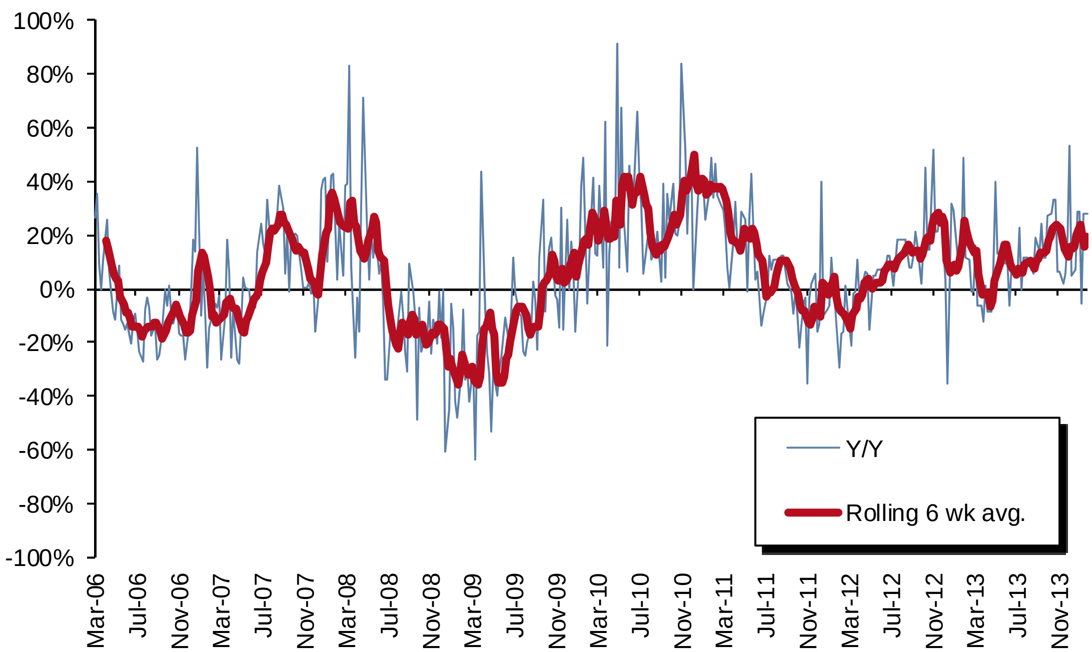
- AC is essentially a derisking story with various catalysts on the horizon, in 2014 and potentially beyond, including its fleet reorganization, international expansion, international premium economy, new routes and capacity strategy, new low-cost leisure carrier (*rouge*), new revenue management system, ancillary revenue opportunities, new lower-rate maintenance contracts, lower cost regional lift through Jazz, Sky Regional and Air Georgian, better contract terms with key suppliers and other various cost-saving projects. In our view, AC is on the cusp of realizing the fruits of its efforts in reducing its unit costs through various CASM-reduction initiatives, which could accrue over the next several years. We believe the airline's revenue opportunities, cost-reduction initiatives, and improved balance sheet and pension picture could continue to lead to a rerating of the stock as it is proven out. Further, the improved pension funding obligation should translate into lower financial risk, improved cash flows as it opts out of the pension moratorium (in time), and support the valuation expansion. The surplus could grow faster than anticipated as the pension assets invested in US equities benefit from weakness in the Canadian dollar.

- WJA is focused on driving growth through further expansion into international and transborder markets (primarily North America, the Caribbean and Mexico, and the transatlantic (new seasonal Dublin service in June 2014)), supported by fleet renewal, its airline partnerships, the launch of premium economy and its new branded fare buckets, with a greater focus on winning corporate accounts and business travelers, the rollout of Encore, its new regional airline, a $100 MM business transformation program (that it should be able to exceed, in our view) to be completed by the end of 2014, and many other initiatives, including its share buyback program.

While RASM could be under pressure in 2014, both AC and WJA are keeping costs equally in check or reducing them dramatically. For example, AC has put several initiatives in place and is planning to reduce its CASM by 15%, which equates to ~$1.75 BB in cost savings, based on current numbers (refer to our note titled *"Investor Day Highlights Strong Flight Plan"*, dated June 11, 2013, for further details). Further, AC's narrowbody fleet renewal program is expected to result in a ~10% CASM reduction as compared with its existing narrowbody fleet. In addition, WJA expects CASM ex-fuel and profit share, to be down 0.5% in 2013 (flat to up 1% in 2014) and should effectively complete its $100 MM business transformation program by the end of 2014.

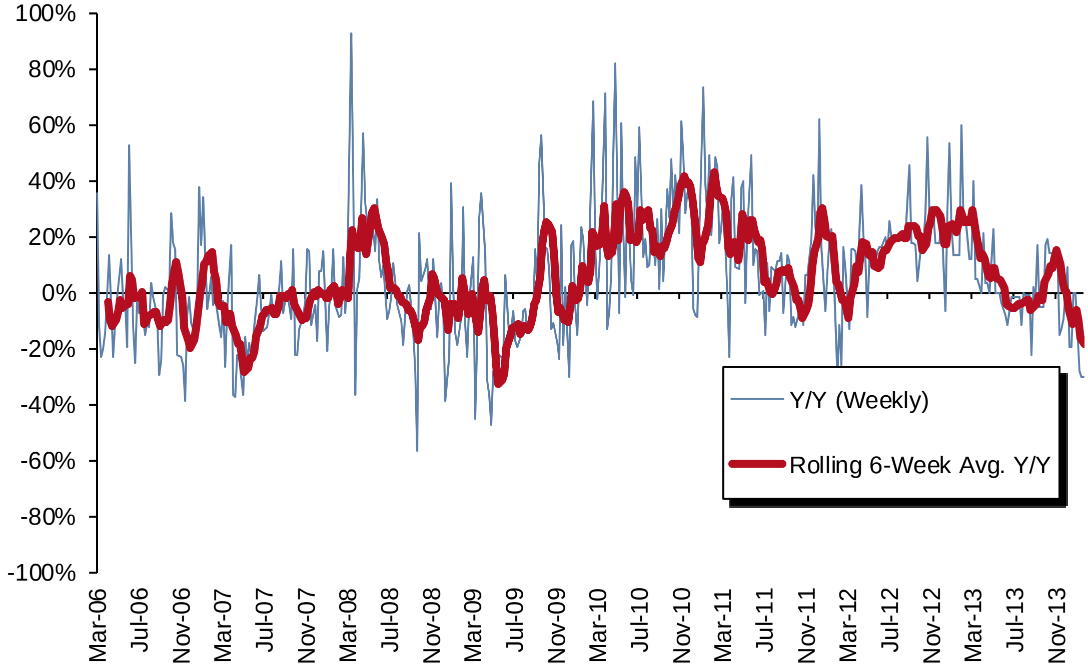
Bottom Line: Although yields could come under pressure in 2014, with some of the early WestJet fare tracking data pointing in that direction on the back of seat sales, the overriding concern relates to expected industry capacity and competitiveness. That said, demand remains solid and lower costs should more than offset any topline pricing pressure, with the RASM-CASM spread poised to widen, in our view. Currency remains a strong headwind, and could serve to hold the spread in check, to a degree. Strong execution on the airlines' various strategic initiatives is key to our positive view on the Canadian airline stocks.

Figure 1 **Air Canada Index: Y/Y Change (Domestic Only)**



Source: Cormark Securities Inc.

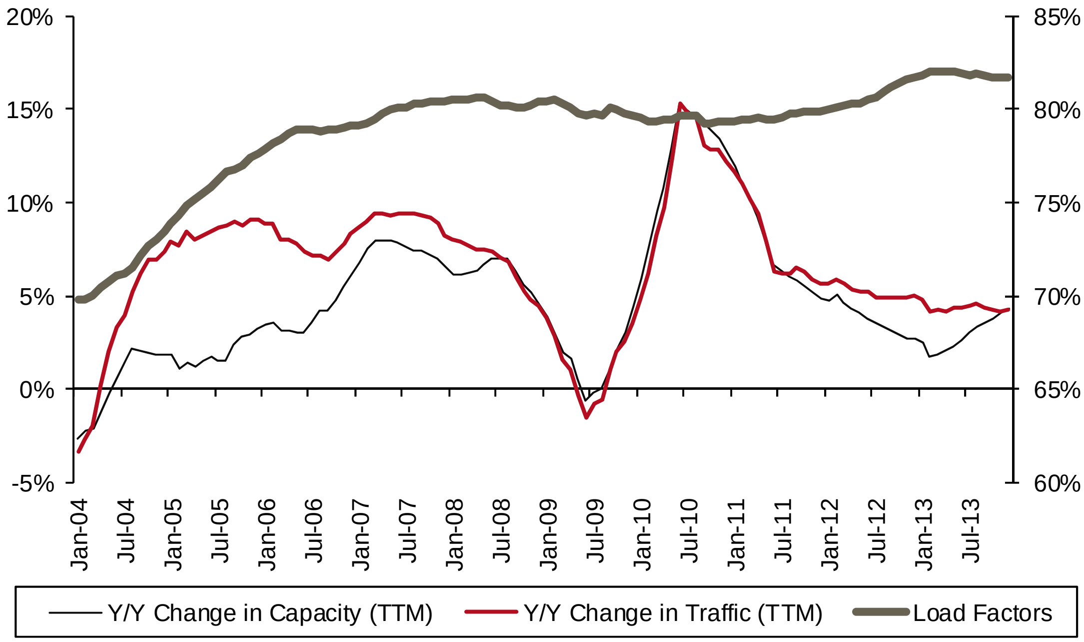
Figure 2 **WestJet Index: Y/Y Change (Domestic Only)**



Source: Cormark Securities Inc.

Our data on traffic, capacity and load factors point toward a continued relatively strong environment with load factors holding at the 81-82% mark, in the "sweet spot" in terms of yield management. We acknowledge that various end markets may witness high-capacity growth next year as Encore, *rouge* and the respective airlines' fleet expansion plans are executed. To the degree that it is absorbed, RASM could perform better than expectations. Figure 3 highlights the airlines' growing discipline in managing capacity and loads.

Figure 3 **TTM Load Factor, Capacity & Traffic Growth In The Domestic & Transborder Market**



Note: Includes WJA and AC domestic and trans-border data
Source: Cormark Securities Inc.

IATA is forecasting another profitable year for the airline industry in 2014, calling for industry net profit of $19.7 BB, a ~ $7 BB improvement over the $12.9 BB profit anticipated for 2013. The latest forecast, posted in December 2013, represents a $3.3 BB increase in IATA's 2014 forecast issued in September 2013. The upward revision was due to lower jet fuel prices over the forecast period as well as improvements to the industry's structure and efficiency that were visible in the recent quarterly results. The structural changes undergone by the airline industry have improved its ability to generate cash despite the high cost of fuel, with recent easing on that front as well. We believe the structural changes undertaken by the industry should place the airlines in a good position when the global economy begins to heat up. Most importantly, IATA expects 2014 to be particularly strong for North American carriers as the economy improves, due to careful capacity discipline and ancillary revenues, which should help offset high oil prices. Despite elevated fuel prices, the airline industry continues to generate healthier profits and returns given airline mergers, much more rational behavior by all players in terms of prudent capacity and cost discipline, yield management and increased ancillary revenues. It is thereby better able to absorb higher costs and buffer its margins, to a certain degree.

Key drivers for IATA's forecast include the economic cycle, with global GDP expected to expand by 2.7% in 2014 (we believe it could be closer to 3%), robust passenger demand, ancillary revenues, and improved industry structure (efficiency gains driven by consolidation, etc.). The general trend of improvement in developed economies, particularly for the US, is expected to continue into 2014. Further, IATA expects that North American carriers will outperform the aggregate industry to deliver both the highest absolute profits and stronger EBIT margins (4.8% in 2013 and 6.4% in 2014).

According to IATA's latest quarterly business confidence survey of airline CFOs, the airlines expect to generate continued strong profits in 2014. The CFOs expressed confidence that air transport volumes will continue to grow over the next 12 months, with stable yields and input costs. According to the survey, about 72% of survey respondents expect passenger travel to expand over the year ahead, but at a slightly slower pace than in the October survey. Further, survey respondents revealed that input costs have declined during Q4, mostly as a result of cost-cutting measures. Most expect costs to remain broadly stable over the next 12 months. In addition, passenger yields are expected to remain stable over the year ahead, as well.

Valuation And Sensitivities

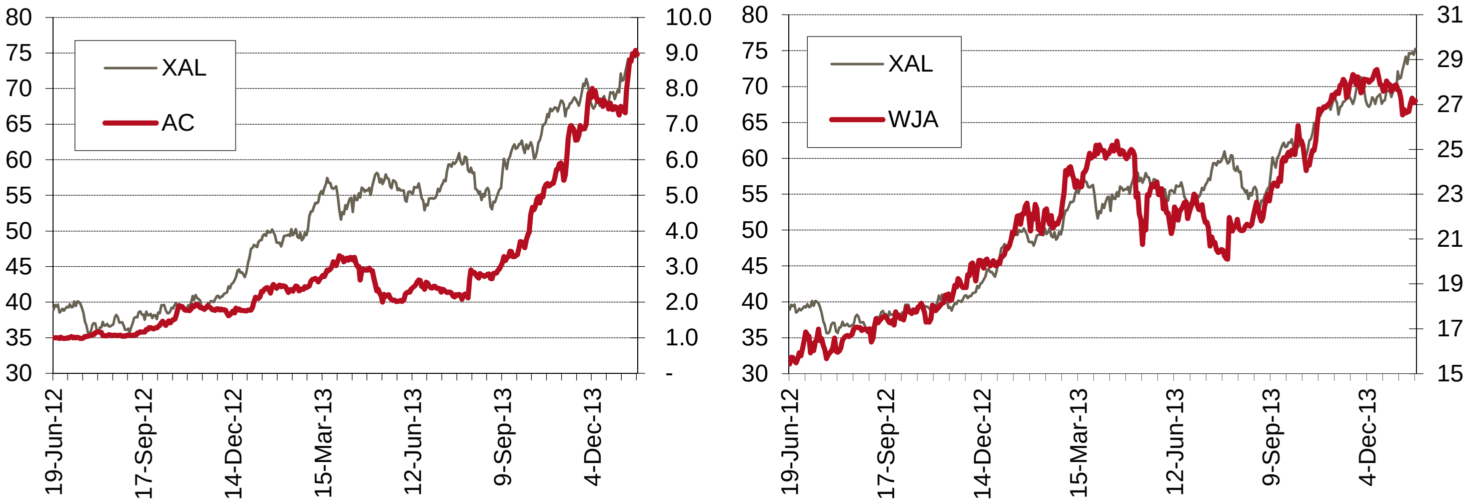
Air Canada Should Continue To Climb, While WestJet Maintains Cruising Altitude, Despite Currency Headwinds

Airline stocks are extremely cyclical, a testament to their significant operating and financial leverage, on average, which can cause substantial earnings volatility. In addition, airlines' operating and financial performance is also impacted by their sensitivity to economic growth, the currency and energy markets, industry regulation, highly elastic demand, demanding and militant unions, airport fees and taxation, the weather, ongoing security issues and their susceptibility to exogenous events.

- **AC** is trading at 4.1x our 2014E EBITDAR versus its peers at ~4.8x (on 2014 consensus EBITDAR). We are maintaining our target price of **$13.00** on AC, which is based on ~4.75x our 2014E EBITDAR, which could directionally be much higher if AC executes well on its various strategic initiatives, including dramatically reducing its cost structure. Our **Top Pick** rating is based on AC's derisking story and various catalysts on the horizon in 2014 and beyond, including its fleet reorganization, international expansion, new routes and capacity strategy, international premium economy, new low-cost leisure carrier (*rouge*), new revenue management system, ancillary revenue opportunities, new lower-rate maintenance contracts, lower cost regional lift through Jazz, Sky Regional, Air Georgian and other providers, better contract terms with key suppliers and other various cost-saving projects. Further, AC now projects that its Canadian registered pension plans are likely to be in a small surplus position as at January 1, 2014, which could lower pension expense and also allow it to eventually (three year trailing has to be in a surplus position before it opts out of the moratorium) recoup the $200 MM it pays into the plan as a result of its previous deficit.

- **WJA** is trading at 10.8x on our 2014E, below its LCC peers at ~12.8x (on 2014 consensus EPS), and the historical LCC valuation range of 14-22x. We are maintaining our target of **$30.00** on WJA, which is based on ~13x our 2014E EPS. Given the stock's recent sell-off on the back of currency concerns, which we believe were overblown (discussed in next section), we are upgrading WJA to a **Buy** rating from a Market Perform previously. Beyond its current discount to peers on valuation, we acknowledge WJA's recent rollout of the Plus product and higher ancillary revenues, WestJet Encore, new airline partnerships, and expected strong traffic results given a healthy demand picture. At the same time, costs continue to be well contained, aided by its $100 MM cost transformation program. Finally, WestJet continues to build shareholder value through its dividend program (yield of 1.65%) and share buyback program (third NCIB), as well as its improving margin and return profile, solid balance sheet and significant growth initiatives.

Figure 4 **XAL Index Performance Versus AC And WJA**



Source: Cormark Securities Inc., Bloomberg

Risks To Our Estimates: Currency The Biggest Area Of Current Concern

Airlines face several typical macro-related risks, such as the state of the global and domestic economy, fuel prices, currency fluctuations, etc., that we believe could affect their outlook. A weakening of the Canadian dollar could negatively impact results for both AC and WJA. **We note that a 1 cent increase in the exchange rate (i.e. $1.00 to $1.01 per US dollar) results in an approximately $33 MM (unhedged) impact to EBIT in the case of AC and $14 MM in the case WJA, in our estimation. Further, a US$1 increase in WTI impacts AC's EBIT by $25 MM and WJA's EBIT by $7 MM, in our estimation. However, we would note investors should focus on jet fuel prices, versus WTI, given jet fuel is the more relevant metric.**

Approximately 65% of AC's total costs are US dollar denominated (with the balance incurred in Canadian dollars) and the biggest foreign exchange (FX) exposed cost factors are: fuel (with 60% exposed to US dollar), debt and aircraft leases (predominantly US dollar). We would note that both AC and WJA periodically use financial derivative instruments, including US dollar FX forward contracts to manage their exposure to foreign exchange risk. In the case of WJA, it hedges its US dollar-denominated lease payments for an average of $13.5 MM per month for the period of October 2013 to September 2014 for a total of US$162.2 MM at a weighted average contract price of 1.0212 Canadian dollar to one US dollar.

According to Air Canada, it has around $2 BB in spot exposure to the US dollar, while it has hedged about $2 BB of its US dollar-denominated exposures (about 50% of its total exposure). AC has a complex and dynamic hedging program in place to manage its exposure to foreign exchange risk, especially on the debt and aircraft leasing side, where the airline's exposure is predetermined (fixed and relatively determinable payments) versus fuel and other cost line items, which are more volatile (more variable in nature). AC hedges 50% of its net US dollar exposure to interest and principal payments.

On the operating side, especially for those relatively fixed and determinable payments, AC hedges either by holding US dollar cash and/or by using relatively exotic FX derivatives (options) to hedge at least 50% of its US dollar exposure for the next 12-15 months, e.g. hedged 100% for the next three months, 75% for following three months, etc. For those more volatile US-dollar-denominated costs, it hedges more holistically and opportunistically. The net gains and losses from its hedges fall below the EBIT line to offset the FX impact realized through its operations. Finally, we believe the Company has a natural hedge through the basket of about $1 BB in foreign currency revenues generated in destination markets (point of sale outside Canada).

We would note that if AC has a view that the currency may swing materially in one direction or the other, it can alter the program by holding more/less cash and/or increasing/decreasing the amount, timing and duration of its foreign exchange program. At times, it deploys other strategies, such as paying vendors in Canadian as opposed to US dollars or pre-paying expenses, or a range of alternatives. As an example, the decline in the Canadian dollar prompted several travel tour operators, including AC, Transat and Sunwing, to implement a $35/ticket 'currency surcharge' for packaged vacations this winter. AC Vacations implemented this charge on its destinations to the Caribbean, Mexico and the US starting on January 27, 2014. AC holds a market share of ~14% to sun destinations with ~525,000 travellers, in our estimation. This currency surcharge will lead to ~$18.4 MM in additional revenues and will partially offset currency headwinds, in our view. WJA on the other hand will not be adding the 'currency surcharge'.

While there is a strong correlation between currency and outbound travel, we would note that ~5 MM Canadian travelers cross the border looking for cheaper flights every year, flying out of Seattle, Bellingham, Buffalo, Niagara Falls, Plattsburgh, and Bangor, Maine. To frame it, there are around 28 MM origin/destination passengers flying between Canada and the US each year, so the impact is material in our view. If the US dollar were to strengthen, Canada may be able to repatriate some or many of those travelers.

While WJA does not hedge its fuel costs, AC has a fuel hedge program in place. As of September 30, 2013, ~40% of AC's anticipated purchases of jet fuel for the remainder of 2013 were hedged (comprising call options and call spreads) at an average WTI capped price of US$98/B. At that time, AC had also hedged ~9% of its 2014 anticipated jet fuel purchases at an average WTI capped price of US$102/B.

Historically, there has been a strong correlation of ~70% between WTI prices and the Canadian dollar, aptly named the "petro-loonie" (i.e. if WTI prices increase, the Canadian dollar strengthens, thus lessening the impact of higher WTI prices). However, at times that correlation has weakened or broken, such as in 2013. Our view is the historic correlation should revert to the mean at some point. Regardless, in Q4, jet fuel prices fell Y/Y, which is the more relevant metric for airlines than WTI (aircraft fill their engines on jet fuel, not crude). In Q1 to date, while the Canadian dollar has deteriorated ~9%, jet fuel prices have also declined ~4%.

In addition to these macro risks, we believe there are a number of other key Company-specific risks that could affect the outlook. For AC, these include execution risks related to the launch of low-cost leisure airline *rouge*, fleet expansion, including the Boeing 777s and 787s, which have been plagued by many teething issues, and increased competition. In the case of WJA, those risks include increased competition and execution risk related to the launch of Encore and the introduction of its new premium economy seats and fare bundles, which initially faced some issues. More generally, we believe WJA may continue to face challenges as it strives to become more of a full-service carrier, broadening its appeal to the full spectrum of travelers, including business and leisure. The airline's growing pains may be most acutely felt by its employees, especially with the opening of multiple crew and maintenance bases (in Vancouver and Toronto in early-2014).

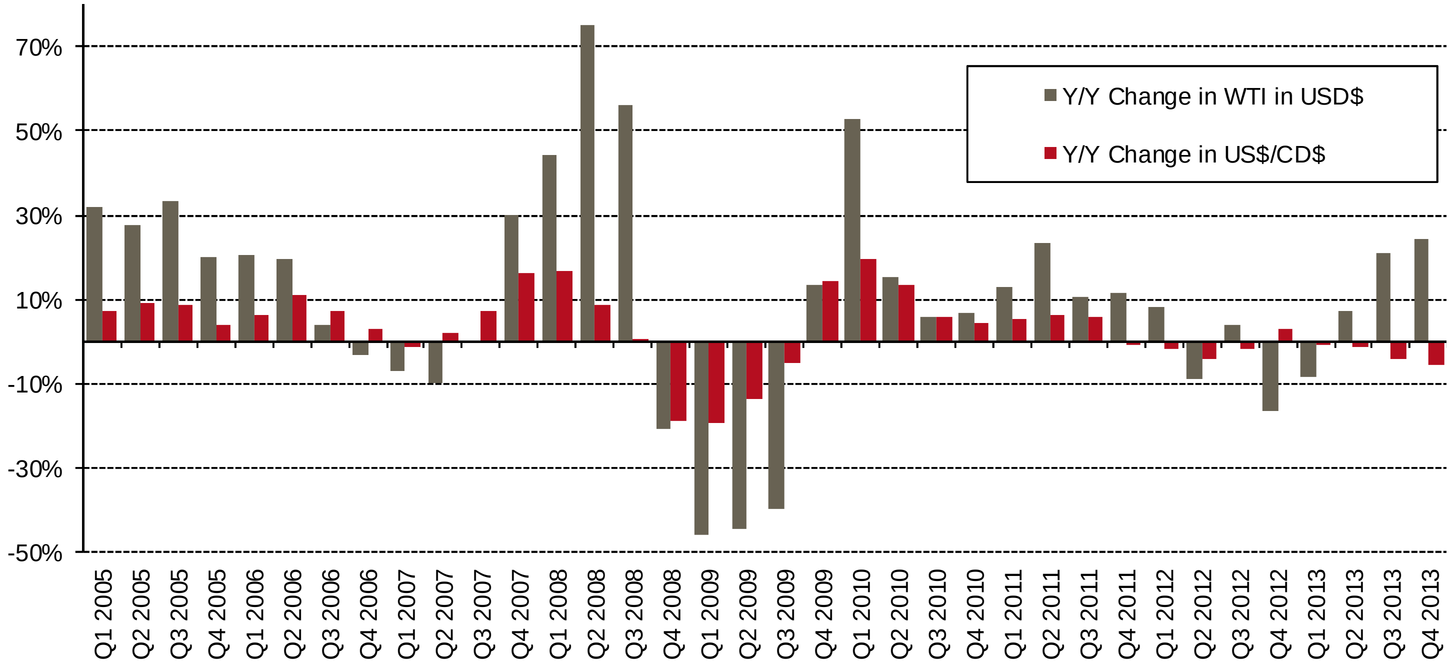
For AC, the solvency deficit used to be a potential area of risk but that has subsided recently, especially in light of AC's recent press release indicating that there is a small surplus in the pension plan, as of January 1, 2014. The surplus could accelerate if the Canadian dollar slackens given a significant investment of its pension assets in US equities, as noted. We provide more details regarding the pension deficit update in the Company Update segment below.

Figure 5 **AC and WJA EBIT Sensitivity To Fuel And FX**

Factor	AC	WJA
US $1/B increase in WTI	$25 MM	$7 MM
1 cent increase in US$/C$	$33 MM	$14 MM

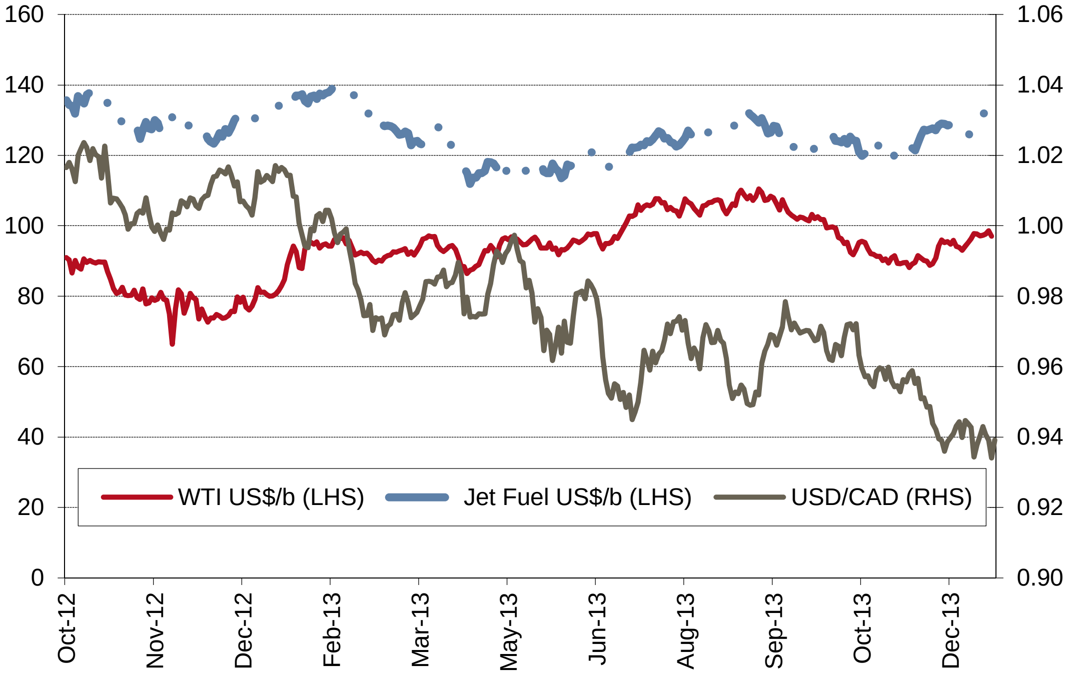
Source: Cormark Securities Inc., Company Reports

Figure 6 **Y/Y Change in WTI and US$/C$; Quarterly Average**



Source: Cormark Securities Inc., Bloomberg

Figure 7 **Currency Represents The Key Risk, Especially As Jet Fuel Prices Moderate**



Source: Cormark Securities Inc., Bloomberg

Sensitivity To Fuel And FX

As we have mentioned, jet fuel price as opposed to WTI is the more relevant pricing metric. In Q4, we estimate jet fuel prices, in US dollars, fell around 4% Y/Y (slightly up 1.6% in Canadian dollars). In the tables below, we look at the sensitivity of AC's 2014E EBITDAR and WJA's 2014E EPS to various WTI and FX scenarios, holding all other assumptions in our model constant. We currently forecast $1,640 MM in EBITDAR for AC in 2014, assuming US$130 for jet fuel (currently ~US$130) and a US$/C$ exchange rate of 0.95 (currently around ~0.89-0.90). Our analysis shows that AC's EBITDAR could decline to $1,310 MM if the Canadian dollar weakens to a $0.85 US dollar for each Canadian dollar. A similar analysis applies to WJA.

Figure 8 **Sensitivity Table To Jet Fuel and Currency**

AC - On 2014 EBITDAR estimates (in Millions of $)

US$/C$ \ Jet Fuel (US$/bbl)	122.5	125.0	127.5	130.0	132.5	135.0	137.5	140.0
1.05	2,225	2,140	2,055	1,970	1,885	1,800	1,715	1,630
1.03	2,159	2,074	1,989	1,904	1,819	1,734	1,649	1,564
1.01	2,093	2,008	1,923	1,838	1,753	1,668	1,583	1,498
0.99	2,027	1,942	1,857	1,772	1,687	1,602	1,517	1,432
0.97	1,961	1,876	1,791	1,706	1,621	1,536	1,451	1,366
0.95	1,895	1,810	1,725	**1,640**	1,555	1,470	1,385	1,300
0.93	1,829	1,744	1,659	1,574	1,489	1,404	1,319	1,234
0.91	1,763	1,678	1,593	1,508	1,423	1,338	1,253	1,168
0.89	1,697	1,612	1,527	1,442	1,357	1,272	1,187	1,102
0.87	1,631	1,546	1,461	1,376	1,291	1,206	1,121	1,036
0.85	1,565	1,480	1,395	1,310	1,225	1,140	1,055	970

WJA - On 2014 EPS estimates

US$/C$ \ Jet Fuel (US$/bbl)	122.5	125.0	127.5	130.0	132.5	135.0	137.5	140.0
1.05	3.45	3.32	3.18	3.04	2.90	2.77	2.63	2.49
1.03	3.31	3.18	3.04	2.90	2.76	2.63	2.49	2.35
1.01	3.17	3.04	2.90	2.76	2.62	2.49	2.35	2.21
0.99	3.03	2.90	2.76	2.62	2.48	2.35	2.21	2.07
0.97	2.89	2.76	2.62	2.48	2.34	2.21	2.07	1.93
0.95	2.75	2.62	2.48	**2.34**	2.20	2.07	1.93	1.79
0.93	2.61	2.48	2.34	2.20	2.06	1.93	1.79	1.65
0.91	2.47	2.34	2.20	2.06	1.92	1.79	1.65	1.51
0.89	2.33	2.20	2.06	1.92	1.78	1.65	1.51	1.37
0.87	2.19	2.06	1.92	1.78	1.64	1.51	1.37	1.23
0.85	2.05	1.92	1.78	1.64	1.50	1.37	1.23	1.09

Source: Cormark Securities Inc.

Airlines Q4 Preview

Air Canada: On The Right Heading; To Stay The Course In 2014 Despite Near-Term FX Headwinds

AC will release its Q4 results before market open (6:00 am ET) on February 12 followed by a conference call at 9 am ET (dial in: 416-340-2219 or 1-866-226-1798). We are expecting revenue of $2.96 BB (up 4.0% Y/Y) and EBITDAR of $314 MM, up 10.6% Y/Y (Street at ~$2.93 BB and $320 MM, respectively), based on our assumption of a 0.8% increase in RASM (1.9% yield) and 1.1% decrease in CASM (a 1.9% decrease in CASM ex-fuel). AC reported a second best Q4 load factor of 80.3%, a 90 bps decline from last year's record 81.2%. The Q4 load factor of 80.3% was on the back of a 2.5% increase in traffic and a 3.5% increase in capacity, at the midpoint of its guidance range for an increase of 3.0-4.0%. In terms of EPS, we expect $0.14 per share versus consensus of $0.12.

Company Updates

1) In January, AC announced that it projects its Canadian registered pension plans at January 1, 2014, to be in a small surplus position. This is a remarkable turnaround considering the solvency deficit as at January 1, 2013, was $3.7 BB ($4.2 BB in 2012). The final valuation as of January 1, 2014, will be completed in H1/14, according to the Company. The elimination of the deficit was due to four factors namely: 1) a 13.8% return on plan assets (ROI) during 2013 (consistently in the top quartile of performance); 2) pension plan amendments, which reduced the deficit by $970 MM; 3) a $225 MM contribution made by AC in 2013; and 4) a higher discount rate of 3.9% for the calculation of future pension obligations, versus the 3% discount used at January 1, 2013 (every 10 bps change in the discount rate would result in ~$150 MM change to the solvency liabilities). Recall that AC has a pension moratorium, which caps its pension solvency payments to at least $150 MM annually, with an average of $200 MM/year to contribute an aggregate minimum of $1.4 BB over seven years in solvency deficit payments. AC would consider opting out of the new pension regulations when the annual solvency deficit payments under normal funding rules, which are determined using deficit levels over three years, would be less than $200 MM. AC does not plan to opt out of the pension regulations in 2014. Eventually, when it does elect to opt out, the funds could be utilized to enhance shareholder value. At present, 70% of AC's pension liabilities are matched with fixed income products to mitigate a significant portion of the interest rate risk. It is AC's objective over the mid-term, to match 100% of the pension liabilities with fixed income products. As mentioned, the silver lining of a weaker Canadian dollar could be a stronger and faster than expected recovery in the surplus, which could grow from its current small surplus position, given a high proportion of US equities in its pension plan assets.

2) During the quarter, Chorus Aviation announced that the benchmarking provisions in the capacity purchase agreement (CPA) with Air Canada (AC) will not result in any changes to the controllable cost mark-up at Jazz Aviation (Jazz), which will remain at 12.5%. While a slight negative to AC, given no reduction in ongoing costs or any retroactive payments, we are encouraged by Jazz Management's commentary that it recognizes the need to reduce the cost of its regional services, and has set up a framework of strategic options to address its cost structure in consultation with AC. AC also will engage Jazz in another round of rate resetting in 2015 and it is important to note the CPA with Jazz terminates in 2020 (will be automatically renewed for two 5-year periods unless notice is provided by either party), implying Jazz has a vested interest to work with AC to provide strong service levels and reduce its costs.

3) Following its Request for Proposal (RFP) process to select a new regional airline to operate certain existing US regional transborder routes, starting in mid-2014, AC announced that it has signed an MOU to expand its relationship and amend its CPA with Air Georgian, and that it has selected Air Georgian to operate a number of additional regional routes.

4) AC and Cargojet announced they have signed a Letter of Intent (LOI) to explore strategic opportunities in both cargo and airline operations within Canada and in international markets. The carriers intend to pursue strategic opportunities and increase cooperation in various areas such as global sales and marketing, expanded interline opportunities and enhanced connectivity that would increase revenues and reduce operating costs. Both airlines would work toward providing optimized services to the shipping community on their respective networks. The deal is subject to making any necessary filings, obtaining regulatory approvals and finalizing documentation.

5) AC's widebody evolution, with its new 777s and 787s, should allow the airline to widen its addressable market, especially on long, thin routes that possess a high volume of leisure passengers, further supported by its Executive First and premium economy seating. The five new high density 777s are targeted at markets with a higher volume of economy travelers, which started with Paris last summer, and expanded to Hong Kong in early-2014. Also, Munich and Vancouver-London could be added.

6) After operating its new 787s on domestic services during the "breaking-in" period, Air Canada intends to tackle international routes starting with Toronto to Tel Aviv and Tokyo Haneda in July 2014. It continues to examine other new routes such as Moscow, Rio de Janeiro and Lagos.

7) In the summer of 2014, *rouge* is bolstering its service to markets such as Athens, Edinburgh and Venice with its older 767 aircraft. In 2014, AC is also launching year-round Dublin service, and adding Barcelona, Lisbon, Manchester, Rome and Nice to *rouge*'s list of destinations. This is in addition to its southern portfolio of vacation destinations.

8) AC announced an agreement to purchase up to 109 Boeing 737 MAX aircraft. At list prices, the order is valued at $6.5 BB and could increase to $11.6 BB if all options and purchase rights are exercised. Deliveries are expected to start in 2017 with two aircraft and ramp in the following four years. We view the narrowbody replacement as the next step in its cost transformation strategy, as AC moves ahead to replace its narrowbody fleet with more fuel-efficient aircraft (10% lower CASM than existing narrowbody fleet). The competition remains open to replace AC's Embraer E190 jets. With AC looking for a larger narrowbody in the 100-150 seat range, and reviewing its options over six months, we believe AC may be leaning toward the CSeries and providing Bombardier enough time to supply aircraft performance data. Of course, Boeing and Embraer are unlikely to yield in pursuit of this order.

9) Again, we would remind investors that Air Canada has a robust hedging program in place to hedge 50% of its US dollar exposure (about 65% of costs), has about $1 BB in foreign currency inflows from point of sale in other countries, recently added a $35 currency surcharge on vacations destinations, could repatriate passengers heading to US border cities for cheap fares and has a significant 15% cost-reduction program, all backstopped by a strong demand environment. The decline in the Canadian dollar prompted several travel tour operators, including AC, Transat and Sunwing, to implement a $35/ticket 'currency surcharge' for packaged vacations this winter. AC Vacations implemented this charge on its destinations to the Caribbean, Mexico and the US commencing January 27, 2014. AC has ~14% market share to sun destinations with ~525 MM travelers. This currency surcharge will lead to ~$18.4 MM in

additional revenues and will partially offset the currency headwind, in our view. WJA on the other hand will not be adding the 'currency surcharge'.

Figure 9 **Air Canada Estimates Summary**

	New Estimates			Old Estimates		
	Q4/13	2013E	2014E	Q4/13	2013E	2014E
Revenue ($MM)	2,955	12,443	13,069	2,937	12,425	13,052
EBITDAR ($MM)	314	1,470	1,640	319	1,475	1,640
WTI (US$/bbl)	94.44	97.20	95.01	105.64	100.00	95.01
FX US$/C$	0.95	0.97	0.95	0.94	0.97	0.95

Source: Cormark Securities Inc.

Outlook & Guidance

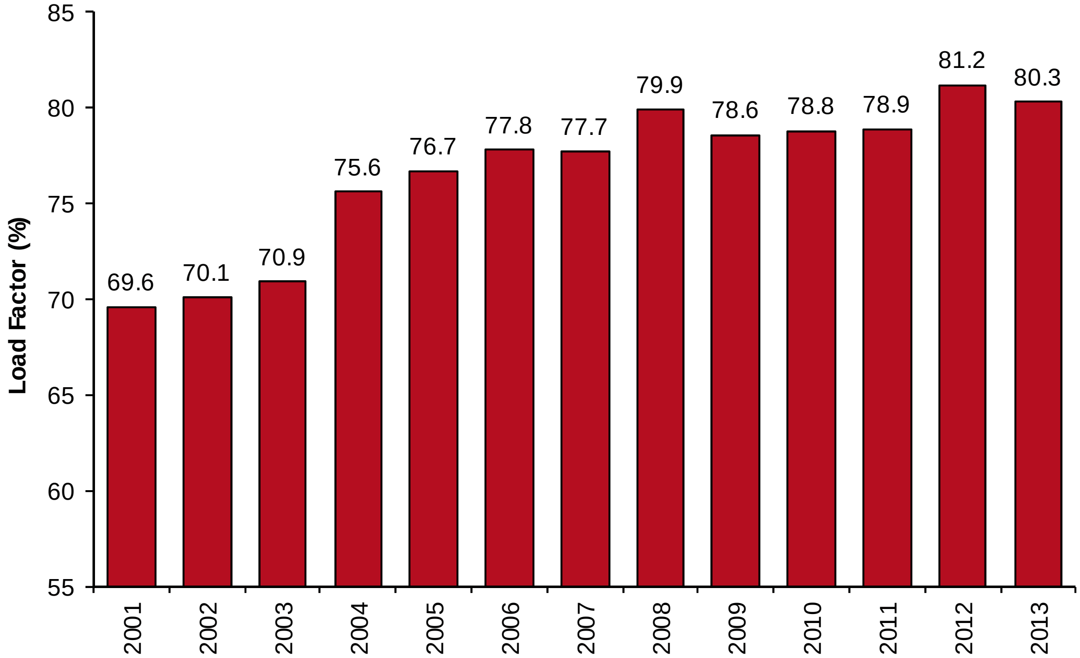
AC is guiding for up to a 15% reduction in CASM as a result of existing plans and initiatives. The initiatives relate to the launch and growth of *rouge*, the scheduled arrival of its Boeing 787 aircraft to replace its less-efficient Boeing 767s (being transferred to rouge), the introduction of higher density Boeing 777s, the transfer of its Embraer 175 aircraft to Sky Regional (low-cost regional carrier), new maintenance agreements, and other ongoing and planned revenue and cost-saving initiatives. In our estimation, a 15% reduction in CASM would imply ~$1.75 BB in cost savings. Refer to our note titled *"Investor Day Highlights Strong Flight Plan"*, dated June 11, 2013, for further details. Further, AC's narrowbody fleet renewal program is expected to result in a ~10% CASM reduction as compared with its existing narrowbody fleet. For 2013, AC is guiding for a 1.5-2.0% decrease in CASM ex-fuel and Air Canada Vacation costs. Details of AC's guidance for 2013 are shown in the table below. We anticipate the airline will provide 2014 guidance on its Q4 call, although would note the airline has forecast capacity to increase by 9-11% during 2014 (much of which is higher margin international flying).

Figure 10 **Air Canada Guidance for Q4 and 2013**

	Q4/13	2013
System Capacity	increase 3.0-4.0%	increase 2.0-2.5%
Domestic Capacity	N/A	increase 2.0-2.5%
CASM, Ex. Fuel and ACV Costs	decrease 2.0-3.0%	decrease 1.5-2.0%
Maintenance Expense	N/A	decrease $40 MM
D&A Expense	N/A	decrease $115 MM
Employee Benefits Expense	N/A	increase $70 MM
Fuel Costs per Litre, Net of Hedging	$0.89	$0.89
FX (C$/US$)	1.03	1.03

Source: Cormark Securities Inc., Company Reports

Figure 11 **Air Canada Q4 Load Factors**



Source: Cormark Securities Inc., Company Reports

Figure 12 **Air Canada Traffic Results By Geographic Segment**

	December			Fourth Quarter		
	2013	2012	Y/Y	2013	2012	Y/Y
ASMs						
Domestic	1,615	1,520	6.3%	4,736	4,591	3.2%
US X-Border	1,043	1,020	2.3%	2,741	2,696	1.7%
Atlantic	1,191	1,109	7.4%	3,794	3,583	5.9%
Pacific	1,128	1,102	2.4%	3,332	3,192	4.4%
Other	588	598	-1.7%	1,431	1,423	0.6%
Total	**5,565**	**5,349**	**4.0%**	**16,034**	**15,485**	**3.5%**
N. America	2,658	2,540	4.6%	7,477	7,287	2.6%
Int'l	2,907	2,809	3.5%	8,557	8,198	4.4%
RPMs						
Domestic	1,331	1,272	4.6%	3,933	3,831	2.7%
US X-Border	820	771	6.4%	2,147	2,063	4.1%
Atlantic	979	933	4.9%	2,886	2,837	1.7%
Pacific	974	943	3.3%	2,756	2,736	0.7%
Other	500	475	5.3%	1,161	1,107	4.9%
Total	**4,604**	**4,394**	**4.8%**	**12,883**	**12,574**	**2.5%**
N. America	2,151	2,043	5.3%	6,080	5,894	3.2%
Int'l	2,453	2,351	4.3%	6,803	6,680	1.8%
Load Factor						
Domestic	82.4%	83.7%	-1.3 pt	83.0%	83.4%	-0.4 pt
US X-Border	78.6%	75.6%	3.0 pt	78.3%	76.5%	1.8 pt
Atlantic	82.2%	84.1%	-1.9 pt	76.1%	79.2%	-3.1 pt
Pacific	86.3%	85.6%	0.7 pt	82.7%	85.7%	-3.0 pt
Other	85.0%	79.4%	5.6 pt	81.1%	77.8%	3.3 pt
Total	**82.7%**	**82.1%**	**0.6 pt**	**80.3%**	**81.2%**	**-0.9 pt**
N. America	80.9%	80.4%	0.5 pt	81.3%	80.9%	0.4 pt
Int'l	84.4%	83.7%	0.7 pt	79.5%	81.5%	-2.0 pt

Source: Cormark Securities Inc., Company Reports

WestJet: On Flight Path To Growth In 2014

WJA will release its Q4 results before market open on February 4, followed by a conference call the same day. We expect WJA to report Q4 EPS of $0.51, up from $0.46 last year (Street at $0.53). We project revenue of ~$933 MM and EBIT of $99 MM, each up 8.4% Y/Y (Street at $929 MM and $103 MM, respectively). We are calling for a roughly flat RASM, largely in line with guidance, a 0.8% increase in CASM ex-fuel and a 0.9% increase in CASM ex-fuel and profit share, versus guidance of down 0.5% Y/Y. We believe challenging weather in December may have slightly lowered revenues and increased costs, explaining our higher CASM versus guidance. Recall WJA reported its Q4 load factor of 80.3%, down 160 bps Y/Y (last year was a record year) on the back of a 6.1% increase in traffic and an 8.3% increase in capacity, largely in line with guidance.

Company Updates

1) WJA is looking to expand Encore, its regional carrier, beyond its western Canadian base to offer service across Canada and potentially into the US in 2015. At a recent conference, WJA Management indicated the airline will expand into Ontario in 2013, as well as be nation-wide by 2015 and possibly even into the US markets by the end of 2015. Again, regional and short-haul transborder represents about a $2.1 BB market opportunity for WestJet.

2) Route Announcements:

   - WJA announced that it will make its first trans-Atlantic flight this upcoming summer (June 2014), offering seasonal daily non-stop flights to Dublin, Ireland, from St. John's, Newfoundland with its Boeing 737-700 aircraft until October. This is likely a small first step of its longer-term plan to extend service over the Atlantic. WJA indicated it is considering four or five other European cities as potential destinations that would be within the range of its fleet of Boeing 737s. WJA noted that advanced bookings are very strong and it is ahead of plan. While interesting, we believe a full-scale foray into international will entail the addition of a widebody aircraft to its fleet, like the Boeing 787 or perhaps the A350. We believe this expansion is several years off and would likely follow the full rollout of Encore to ensure solid regional feed, and perhaps the development of a greater transborder presence. The move will still likely prove to be a fruitful exercise for WestJet as it puts Air Canada on notice that WestJet is not far behind in AC's contrails in terms of developing a full suite of markets and could move up the learning curve on its long-term international aspirations.
   - WestJet launched new daily service between Regina, Saskatchewan and Winnipeg, Manitoba, starting January 15, 2014.
   - WJA announced it will resume its non-stop seasonal service between Toronto and Myrtle Beach, South Carolina, on March 6, 2014, nearly two months earlier than in 2013.

3) WJA could make a decision on exercising its option to buy 25 Q400 turboprops in 2014. WJA is also in talks with two in-flight entertainment vendors and could sign a definitive agreement early this year.

4) WJA could be the first Canadian airline in Canada to offer in-flight wifi in 2014. WJA's CEO has hinted that an announcement could be made soon. The airline's service provider is unannounced, but we believe it may be US-based Gogo, which supplies wifi service to a number of US airlines via skyward towers. In our view, Canadian uptake of in-flight wifi has lagged behind its adoption by US airlines perhaps due to regulation. If an announcement is made, it could take up to six months for wifi service to become available on WJA flights.

5) WJA announced at the end of November that its pilots have voted against a tentative agreement by a margin of 58.7%. Turnout was very strong, with 96% of the pilots voting. The current agreement remains in effect until a new agreement is reached. There are no details on what was at the centre of the conflict but those familiar with the situation have told media sources that it revolved around a few issues, including the expansion to a multi-base model in 2014 (Vancouver and Toronto to be added to its existing base in Calgary), Management's claims that the pilots are among the highest paid in North America and the rapid pace of change underway at WJA. We believe there is little chance that the dispute could evolve into a lock-out or strike given its workforce is currently non-unionized. Management is acutely aware of the benefits that a non-unionized workforce brings in terms of productivity and flexibility, so will work hard to convince the employees, in our view. Historically, WestJet has enjoyed a very good relationship with its pilots and crews, gained from its environment of mutual respect and understanding, employee input into strategic initiatives, strong communication, competitive wages, options and profit sharing, and share purchase plan.

6) While the threat of unionization at WestJet may not be overly significant, clearly there are growing pockets of discontent amongst the pilots and attendants. Last year,

the Canadian Union of Public Employees was attempting to organize WJA's flight attendants.

7) The decline in the Canadian dollar has prompted several travel tour operators, including AC, Transat and Sunwing, to implement a $35/ticket 'currency surcharge' for packaged vacations this winter. WJA, which has ~17% market share to sun destinations, will not be adding the 'currency surcharge'.

Figure 13 **WestJet Estimates Summary**

	New Estimates			Old Estimates		
	Q4/13E	2013E	2014E	Q4/13E	2013E	2014E
Revenue ($MM)	933	3,668	3,860	918	3,654	3,819
EBITDAR ($MM)	196	776	857	191	770	840
EBIT ($MM)	99	397	449	93	390	435
EBIT Margin	10.6%	10.8%	11.6%	10.1%	10.7%	11.4%
EPS, f.d.	$0.51	$2.02	$2.34	$0.47	$1.98	$2.26
WTI (US$/bbl)	$94.44	$96.50	$94.75	$105.65	$99.30	$95.01
FX US$/C$	$0.95	$0.97	$0.95	$0.95	$0.97	$0.95

Source: Cormark Securities Inc.

Outlook & Guidance

In 2013, WJA noted that it expects a moderate decline in RASM and margin improvement driven by its growing Vacations, corporate and airline partnership business, premium economy and its new branded fare buckets, which appeal to its base of leisure travelers and higher yielding corporate customers. WJA is guiding for CASM ex-fuel and profit share to decrease ~0.5%. For 2014, WJA expects capacity to grow by 4-6%, with half of that related to Encore (unchanged from before). Most of the additional capacity is due to the deployment of the 737-800s, which have 25% more capacity compared to the 737-700s they will replace. The capacity growth guidance is relatively reasonable, in our view, and below the ~8.5% increase for 2013. For details on the guidance, refer to the table below.

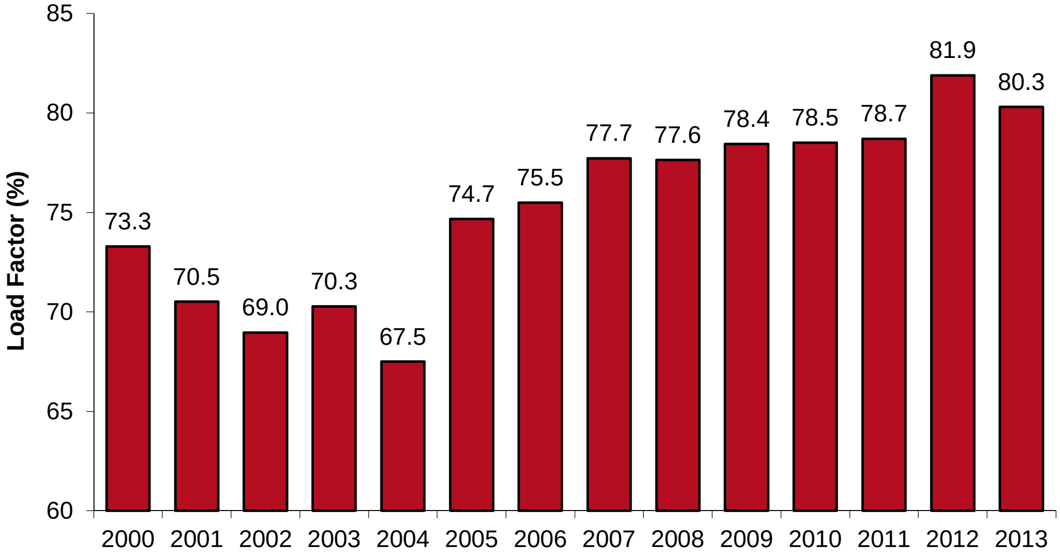
Figure 14 **WestJet Guidance**

	Q4/13	2013	2014
System Capacity	~8%	~8.5%	increase 4.0-6.0%
Domestic Capacity	increase 4.0-4.5%	increase 4.0-5.0%	N/A
RASM Growth	roughly flat Y/Y	N/A	N/A
CASM, Ex Fuel & Profit Share	N/A	down 0.5%	flat to up 1%
Fuel Cost per Litre	$0.90-0.92	N/A	N/A
Jet Fuel	US$122/B	N/A	N/A
FX (C$/US$)	1.04	N/A	N/A
Capex	N/A	~$720 MM	$580-600 MM

Source: Cormark Securities Inc., Company Reports

CORMARK SECURITIES INC.

Figure 15 **WestJet Q4 Load Factor**



Source: Cormark Securities Inc., Company Reports

Recommendation Terminology	Cormark's recommendation terminology is as follows: **Top Pick** our best investment ideas, the greatest potential value appreciation **Buy** expected to outperform its peer group **Market Perform** expected to perform with its peer group **Reduce** expected to underperform its peer group Our ratings may be followed by "(S)" which denotes that the investment is *speculative* and has a higher degree of risk associated with it. Additionally, our target prices are based on a 12-month investment horizon.
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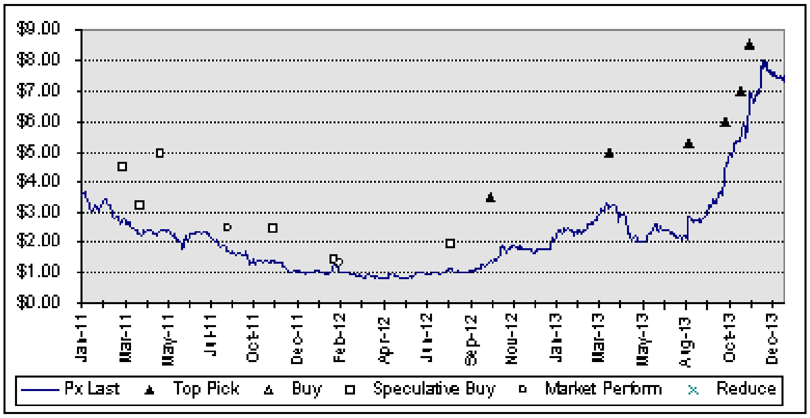
Figure 16 **Air Canada Inc. – Disclosure Chart**

Air Canada Inc.

Updated January 31, 2014

Price Chart and Disclosure Statement

*Information updated monthly on or about the 5th of each month.



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Reduce	14%

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29-Oct-13	7.00 (TP)
04-Oct-13	6.00 (TP)
08-Aug-13	5.25 (TP)
08-Apr-13	5.00 (TP)
04-Oct-12	3.50 (TP)
01-Aug-12	2.00 (B-S)
10-Feb-12	1.35 (MP)
02-Feb-12	1.50 (B-S)
31-Oct-11	2.50 (B-S)
22-Aug-11	2.50 (MP)
06-May-11	5.00 (B-S)
07-Apr-11	3.25 (B-S)
09-Mar-11	4.50 (B-S)

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Source: Cormark Securities Inc.

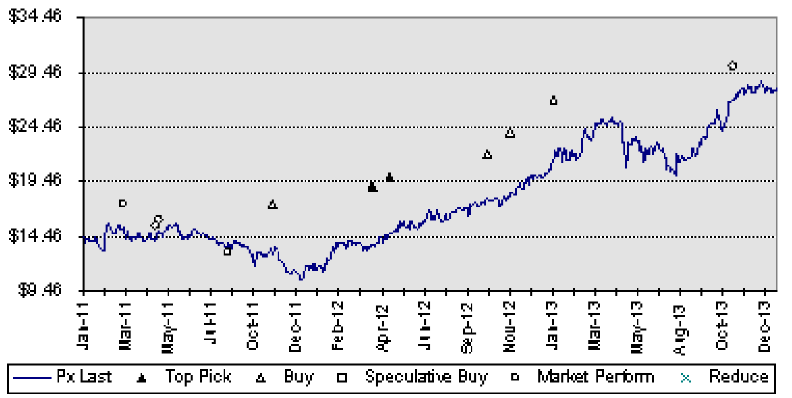
Figure 17 **WestJet Airlines Ltd. – Disclosure Chart**

WestJet Airlines Ltd.

Updated January 31, 2014

Price Chart and Disclosure Statement

*Information updated monthly on or about the 5th of each month.



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Buy or Top Pick	42%
Market Perform	20%
Reduce	14%

Recommendation / Target Chg Date	C$
29-Oct-13	30.00 (MP)
17-Jan-13	27.00 (B)
08-Nov-12	24.00 (B)
04-Oct-12	22.00 (B)
02-May-12	20.00 (TP)
05-Apr-12	19.00 (TP)
31-Oct-11	17.50 (B)
22-Aug-11	13.00 (MP)
04-May-11	16.00 (MP)
02-May-11	15.50 (MP)
09-Mar-11	17.50 (MP)

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TORONTO

Royal Bank Plaza South Tower
200 Bay Street, Suite 2800, PO Box 63
Toronto ON
M5J 2J2
Tel: (416) 362-7485
Fax: (416) 943-6499
Toll Free: (800) 461-2275

CALGARY

Stock Exchange Tower
300 - 5th Avenue SW, Suite 1800
Calgary AB
T2P 3C4
Tel: (403) 266-4240
Fax: (403) 266-4250
Toll Free: (800) 461-9491

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