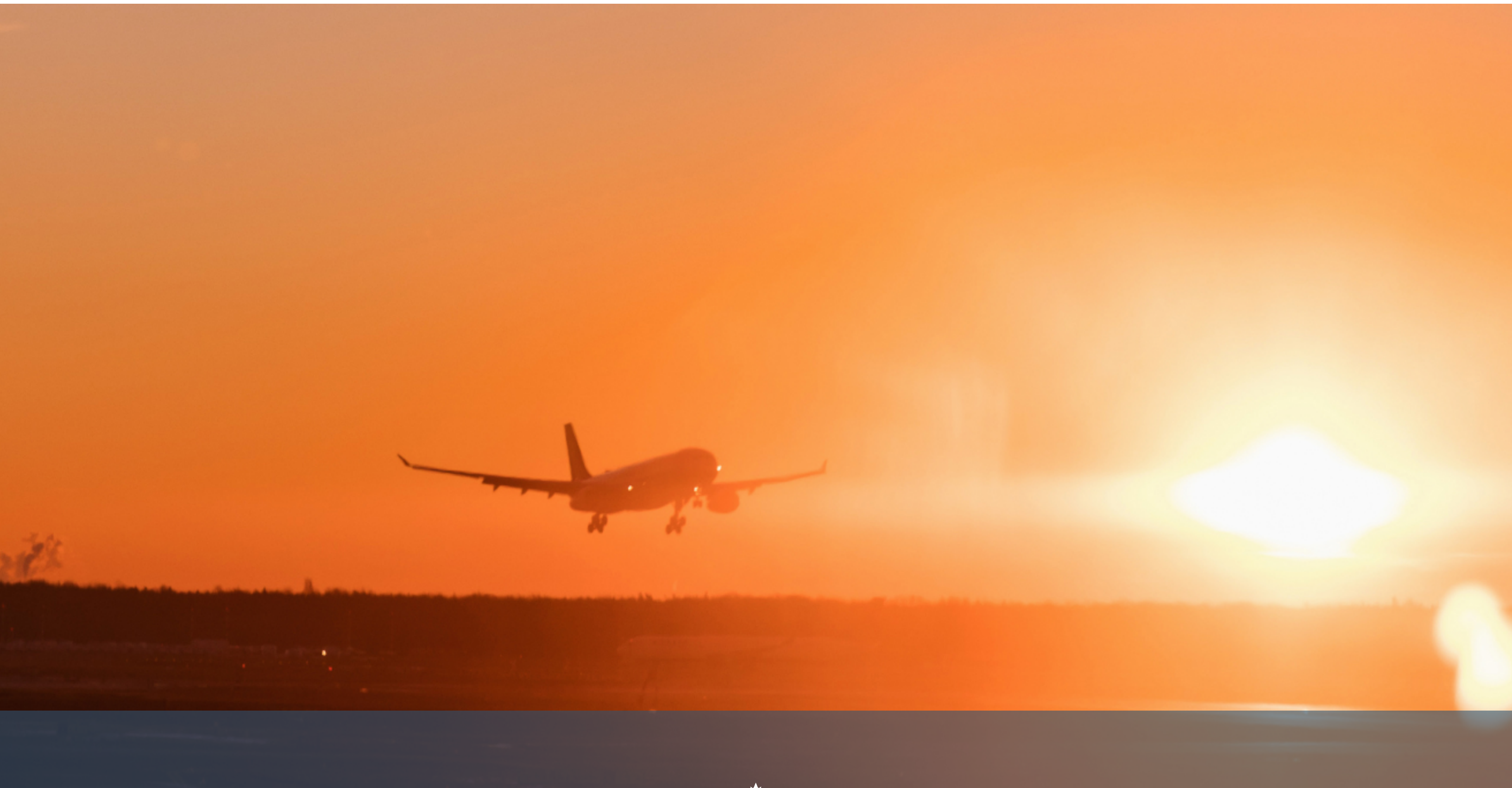
August 12, 2021

FINANCIAL SUPPORT FOR AIR CANADA



OFFICE OF THE PARLIAMENTARY BUDGET OFFICER
BUREAU DU DIRECTEUR PARLEMENTAIRE DU BUDGET

The Parliamentary Budget Officer (PBO) supports Parliament by providing economic and financial analysis for the purposes of raising the quality of parliamentary debate and promoting greater budget transparency and accountability.

This report is intended to help parliamentarians understand the financial support agreement that the Government of Canada entered into with Air Canada on April 12, 2021.

Please note that the information and views expressed in this report do not represent financial or other professional advice.

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Executive Summary

Parliamentarians have expressed interest in the financial support agreement that the Government of Canada entered into with Air Canada on April 12, 2021. In response, the PBO has undertaken an analysis of this support and its cost to the Government.

The support has the following components:

- $500 million in an equity investment;
- $1,500 million in a secured credit facility;
- $2,475 million in a set of unsecured credit facilities; and,
- $1,404 million in an unsecured credit facility intended to refund travelers impacted by COVID-19.

As consideration for making the financial support available, Air Canada issued 14,576,564 warrants to the Government to purchase an equal number of shares with an exercise price of $27.2698 per share. Half of these warrants vested immediately while the other half vest in proportion to Air Canada's usage of the secured and unsecured credit facilities.[1,2]

Air Canada was also obligated to follow a suite of restrictions and make several commitments while benefiting from this support. The severity of these restrictions was partially dependent on Air Canada accessing the secured or unsecured credit facilities. [3]

PBO anticipates that Air Canada will not access the $1,500 million secured credit facility or $2,475 million unsecured credit facilities. It is expected that Air Canada will use $1,197 million of the $1,404 million unsecured credit facility intended to facilitate refunds.

PBO forecasts that the Government of Canada will earn an income of $177 million from providing the financial support to Air Canada over a 10-year period. Differences in Air Canada's share price relative to PBO forecasts will affect the net fiscal impact. If share prices are higher than anticipated at the time of sale then the net cost of the financial support will be lower, and vice versa if share prices are below expectations.

Summary Table S-1: Net Fiscal Cost to the Government

Cost ($ millions)	2021-2022	2022-2023	2023-2024	2024-2025	2025-2026	2026-2027	2027-2028	2028-2029	2029-2030	2030-2031	2031-2032	Total
Interest Expenses Arising from Borrowing	18	19	22	24	27	30	32	3	-	-	-	175
Interest Revenues from Air Canada	-13	-14	-14	-14	-14	-14	-14	-1	-	-	-	-101
Warrants	-105	-2	-2	-2	-2	-2	-2	-2	-2	-2	-	-121
Equity Investment	-45	-9	-9	-9	-9	-9	-10	-10	-10	-10	-1	-130
Net Fiscal Cost	-144	-6	-4	-1	2	4	6	-10	-12	-12	-1	-177

Source: PBO calculations

Notes: Totals may not add due to rounding. Figures represented are in nominal (then-year) dollars.
Positive numbers subtract from the Government’s budgetary balance, negative numbers contribute to the budget balance.
“-” = PBO does not expect a financial cost.

1. Introduction

This report was produced in response to parliamentarian interest in the financial support agreement that the Government of Canada entered into with Air Canada on April 12, 2021. The Government, acting through its subsidiary, the Canada Enterprise Emergency Funding Corporation (CEEFC), provided Air Canada with:[4]

- $500 million in an equity investment;
- $1,500 million in a secured credit facility;
- $2,475 million in a set of unsecured credit facilities; and,
- $1,404 million in an unsecured credit facility to refund travelers impacted by COVID-19.

The agreement also required Air Canada to fulfill several obligations and follow a set of restrictions on their corporate behavior while benefiting from the financial support. The PBO did not estimate the cost of these obligations, hence they are outside of the scope of analysis.

PBO requested information from the Department of Finance regarding the financial support provided to Air Canada through CEEFC and the Large Employer Emergency Financing Facility (LEEFF). The Department of Finance provided all the information that was requested to the PBO, but the information was classified as commercially confidential. The data's confidentiality did not inhibit PBO's work to model the data, determine the costs associated with the financial support, or publish the analytical results of this report.

This report presents the PBO's cost estimate of providing financial support to Air Canada. The cost estimate covers all components of the financial support. Costs are presented separately for each of these components. The combined cost of the financial support is calculated by adding these components.

2. Parameters and Assumptions

PBO's financial modeling is primarily based on the program parameters of the financial support package, public releases made by Air Canada since the support went into effect, and public information on Air Canada's historical share prices. Several assumptions are also necessary to determine the final cost of the support package.

2.1. Program Parameters

The Government of Canada provided financial assistance to Air Canada in the following ways:

- An equity investment of $500 million in Air Canada by the Government of Canada. The Government acquired 21,570,942 class B shares at $23.17933 per share, a 15% discount to the trading price of Air Canada shares on the day that the financial support was finalized.
- A $1,500 million secured revolving credit facility maturing in April 2026, bearing an interest rate of 1.5% plus the Canadian Dollar Offered Rate (CDOR).[5]
- $2,475 million in the form of three unsecured non-revolving credit facilities of $825 million each.
    - The first tranche matures in April 2026 and has an interest rate of 1.75% plus CDOR per annum.
    - The second tranche matures in April 2027 and has an interest rate of 6.5% per annum, increasing to 7.5% per annum after 5 years.
    - The third tranche matures April 2028 and has an interest rate of 8.5% per annum, increasing to 9.5% after 5 years.
- A $1,404 million unsecured credit facility that is to be used to support customer refunds of non-refundable tickets. The facility matures April 2028 and has an interest rate of 1.211% per annum.

As consideration for the secured and unsecured credit facilities being offered to them, Air Canada issued 14,576,564 warrants to the Government to purchase an equal number of shares at an exercise price of $27.2698. Half of these warrants vested immediately. The remaining half will vest in proportion to the amount of the secured and unsecured credit facilities that Air Canada utilizes. These warrants may be not be exercised before April 2022, but after this date may be exercised at any point up until April 2031.[6,7]

In addition to the warrants Air Canada was also required to fulfill the following commitments in return for the financial support:

- To use the proceeds of the financial package, excluding the $1,404 million refund facility, only for the payment of operating expenses and ordinary course business obligations.
- To offer eligible customers who purchased non-refundable fares, but did not travel due to COVID-19 since February 2020 up to April 12, 2021, the option to refund the original form of payment.
- The resumption of service or access to Air Canada's network for most regional communities where service was suspended due to COVID-19's impact on travel.
- To restrict expenditures and senior executive compensation in respect of any financial year during which the secured and unsecured facilities have amounts outstanding, excluding the unsecured credit facility intended to facilitate refunds.
- To restrict dividends, payments of distributions on Air Canada's equity interests, or any purchases, redemptions or other acquisitions or retirements for value of any equity interests or convertible indebtedness of Air Canada while any indebtedness is outstanding under any of the secured and unsecured credit facilities, excluding the unsecured credit facility intended to facilitate refunds, and for a period of 12 months following the termination of such facilities.
- To maintain employment at levels which are no lower than those of April 1, 2021.
- The completion of the Airline's acquisition of 33 Airbus A220 aircraft, manufactured at Airbus' Mirabel Quebec facility, and follow through with its existing order of 40 Boeing 737 MAX aircraft.

2.2. Assumptions

The program parameters provided the basis for the analysis. However, several assumptions were needed to estimate a final value for the cost of providing financial support to Air Canada.

The first assumption is that Air Canada will not make use of the secured or unsecured credit facilities, excluding the unsecured refund facility. Since the financial support went into effect, Air Canada has stated its intention to complete refinancing transactions seeking a gross total of approximately $5.35 billion US.[8] To that end, Air Canada's CEO, Mr. Michael Rousseau, recently made the following statement in their Second Quarter 2021 Conference Call: "[that Air Canada had] nearly $9.8 billion in unrestricted liquidity at the quarter's end, including the funds available under the credit facilities with the Government of Canada. We have said we have viewed the general-purpose government facilities as an insurance policy, and this remains the case."[9] This indicates that Air Canada seeks to avoid using the secured and unsecured credit facilities going forward.[10]

The second assumption is that Air Canada will use the unsecured refund facility up to the level that they have indicated in their financial releases and will not pay back any of the principle until the facility matures. In their second quarterly release for 2021 Air Canada indicated that they had used $997 million of the refund facility by June 30, 2021.[11] Air Canada also anticipates that it will receive an additional $200 million in refund requests by the end of its third quarter. PBO's assumption regarding the absence of any early repayments is based on the favourable interest rate of the unsecured refund facility. PBO notes that at the time of writing, the yield for B-rated corporate debt with a 7-year maturity is 6.16%, whereas the rate of the refund facility is 1.211%.[12] We thus assume that Air Canada will seek to benefit from this low rate as long as it is able.

The third assumption is that the Government of Canada will hold the warrants and shares for a 10-year period. This length of time was selected as a simplifying assumption due to a lack of information on how long the Government desires to hold these assets.[13]

3. Financial analysis

The cost to the Government of providing the financial support to Air Canada arises from four separate components. These components are the costs associated with creating and maintaining the credit facilities, the revenue from Air Canada's usage of the unsecured refund facility, the revenue from the Government holding the warrants to term, and the appreciation of the shares that the Government acquired through its equity investment. By combining these components, the PBO determines the final cost of providing financial support to Air Canada.

3.1. Cost of borrowing

The Government of Canada needs to borrow in order to create the credit facilities involved in the financial support provided to Air Canada. In this case, the Government will only borrow as the credit facilities are accessed. Hence, the cost of borrowing is based on the amount Air Canada is expected to use, rather than the amount that the Government of Canada has made available.

To calculate the Government's borrowing costs, PBO relied upon its Public Debt Charges Calculator.[14] To determine the cost of borrowing between the point in time in which the credit facilities were created, and when they mature and are subsequently liquidated. As only the refund facility is expected to be used, it is the only one that has a borrowing cost associated with it.

3.2. Revenue from the refund loan

As noted earlier, PBO assumes that only the unsecured refund facility will be used. The revenue that comes from this facility is determined by the amount that Air Canada has already used by the end of 2021Q2, and is forecasted to use in 2021Q3, multiplied by the interest rate that is to be charged for withdrawing funds from the facility until it matures. It is not expected that Air Canada will repay any of the principal borrowed until the credit facility fully matures.

3.3. Warrant value

As consideration for making the secured and unsecured credit facilities available, the Government of Canada was provided with 7,288,282 vested warrants having a strike price of $27.2698. As noted earlier, given that Air Canada is not expected to use any of the funds in the secured and unsecured credit facilities, the remaining 7,288,282 warrants are not anticipated to vest.

PBO estimated the value of the warrants over the 10-year time horizon using an option pricing model. It was assumed that consistent with its current policy, Air Canada will not pay dividends. Furthermore, PBO assumed that the Government would hold these assets for the full 10-year period.[15]

3.4. Equity investment

As part of the equity investment of the financial support, the Government of Canada acquired 21,570,942 class B voting shares in Air Canada at $23.17933 per share.

PBO estimated the appreciation of these shares as part of it’s modelling of the warrant valuation described in the previous section. The income gained is the difference between the price at acquisition and the forecasted price at the time the PBO assumes the Government will liquidate its stake in Air Canada.[16]

4. Results

PBO estimates that the financial support provided to Air Canada will produce a net gain for the Government of $177 million over the 10-year agreement.[17]

Table 4-1 presents the change in the Government's cash that the financial support is expected to produce. The large decreases observed in 2021-2022 comes as a result of the Government borrowing to create and finance the unsecured refund facility to the level that it is expected to be accessed, as well as the cost of financing the equity investment. The large increases in the Government's cash flows in 2028-2029 and 2031-2032 are due to these components being wound down. In the case of the credit facility, the amount borrowed has been repaid, and in the case of the equity investment the Government has liquidated its stake.

Table 4-2 presents the net fiscal impact to the Government. The large increase in 2021-2022 from the warrants and the equity investment comes from the difference between their acquisition price and their fair market value. The value in 2021-2022 is the PBO's fair market valuation of the warrants at the end of that fiscal year. The values in following years are the expected changes in this asset's fair market valuation. The value of the equity is the appreciation that the Government realizes while they hold the shares that they had acquired. The increase in 2021-2022 is primarily driven by the discount at which the Government acquired the shares. The values in subsequent years represents the PBO's anticipated appreciation for that fiscal year.[18]

However, it is important to note that differences in the movements of Air Canada's share price relative to PBO forecasts will also impact the net fiscal result. If share prices are higher than anticipated at the time of sale then the net cost of the financial support will be lower, and vice versa if share prices are below expectations.

Table 4-1 Financial Support Components (New Annual Cash Flows)

Cash Flows ($ millions)	2021-2022	2022-2023	2023-2024	2024-2025	2025-2026	2026-2027	2027-2028	2028-2029	2029-2030	2030-2031	2031-2032	Total
Changes in Cash Arising from Borrowing	1,215	19	22	24	27	30	31	-1,194	-	-	-	175
Interest Revenues from Air Canada	-13	-14	-14	-14	-14	-14	-14	-1	-	-	-	-101
Warrants	-	-	-	-	-	-	-	-	-	-	-121	-121
Equity Investment	500	-	-	-	-	-	-	-	-	-	-630	-130
Net Change in Cash	1,702	5	7	10	13	16	17	-1,195	-	-	-751	-177

Source: PBO calculations

Notes: Totals may not add due to rounding. Figures represented are in nominal (then-year) dollars.
Positive numbers subtract from the Government's cash balance, negative numbers contribute to the cash balance.
"-" = PBO does not expect a financial cost.

Table 4-2 Net Fiscal Impact to the Government

Cost ($ millions)	2021-2022	2022-2023	2023-2024	2024-2025	2025-2026	2026-2027	2027-2028	2028-2029	2029-2030	2030-2031	2031-2032	Total
Interest Expenses Arising from Borrowing	18	19	22	24	27	30	32	3	-	-	-	175
Interest Revenues from Air Canada	-13	-14	-14	-14	-14	-14	-14	-1	-	-	-	-101
Warrants	-105	-2	-2	-2	-2	-2	-2	-2	-2	-2	-	-121
Equity Investment	-45	-9	-9	-9	-9	-9	-10	-10	-10	-10	-1	-130
Net Fiscal Cost (Gain)	-144	-6	-4	-1	2	4	6	-10	-12	-12	-1	-177

Source: PBO calculations

Notes: Totals may not add due to rounding. Figures represented are in nominal (then-year) dollars.
Positive numbers subtract from the Government's budgetary balance, negative numbers contribute to the budget balance.
"-" = PBO does not expect a financial cost

Notes

1. The warrants do not consider the unsecured credit facility intended to facilitate refunds when determining how many of the remaining half are vested with the Government of Canada.
2. These warrants are subject to a one-time call right in favour of Air Canada. Air Canada may, upon repayment of all indebtedness to the Government of Canada under the secured and unsecured credit facilities, repurchase the warrants at their fair market value, as determined by third party valuators. This grants Air Canada the chance to repurchase these warrants from the government before they are offered to a broader set of potential buyers.
3. The additional restrictions on Air Canada's corporate behavior do not go into effect if they access the unsecured credit facility intended to facilitate refunds. They are only imposed if they make use of the secured and other unsecured credit facilities.
4. "CEEFC announces financial assistance to Air Canada." Canada Enterprise Emergency Funding Corporation. Published April 12, 2021, https://www.ceefc-cfuec.ca/apr-12-2021-announcement/
5. The Canadian Dollar Offer Rate is a financial benchmark in Canada for banker's acceptances with a maturity period of one year or less. It represents the interest rates at which banks will extend credit to firms that use banker's acceptances and captures the market rate at which firms with secure lines of credit may borrow.
6. These warrants are subject to a one-time call right in favour of Air Canada. In the event that Air Canada is not in debt to the Government of Canada they may repurchase these warrants at their fair market value before they are offered to the broader market.
7. Second Quarter 2021 – Management's Discussion and Analysis of Results of Operations and Financial Condition." Air Canada. Published July 23, 2021. https://www.aircanada.com/content/dam/aircanada/portal/documents/PDF/en/quarterly-result/2021/2021_MDA_q2.pdf. Page 10.
8. "Second Quarter 2021 – Management's Discussion and Analysis of Results of Operations and Financial Condition," Page 9.
9. Mr. Michael Rousseau, CEO of Air Canada. 2021. "Air Canada Second Quarter 2021 Conference Call." https://edge.media-server.com/mmc/p/64dd695w. Timestamp: 4:56.
10. Please note that the information and views expressed in this report do not represent financial or other professional advice.
11. Second Quarter 2021 – Management's Discussion and Analysis of Results of Operations and Financial Condition," Page 8.
12. Information taken from Capital IQ on August 2, 2021.

13. As a corollary, we further assume that Air Canada will not exercise its one-time call right to acquire the warrants at their fair market value at an earlier date.

14. "PBO Public Debt Charges Calculator." Office of the Parliamentary Budget Officer. Published June 19, 2021. https://www.pbo-dpb.gc.ca/en/blog/news/public_debt_calculator

15. Any factors that impact the timing of the options being exercised or sold would influence the results. The value of the options is dependent on the share price at the time they are exercised or sold. There is significant uncertainty in forecasting the value of financial assets over a long time horizon, which can also influence results.

16. Any differences in timing between PBO forecasts and the actual date that the Government liquidates their stake would influence results. The uncertainty associated with forecasting financial assets for this long of a time period can also influence results.

17. This result can be impacted if the cost of supporting Government debt differs from current PBO expectations. Changes in timing for the exercise of the warrants or the sale of the equity stake can also affect this value. Differences in the movements of Air Canada's share price relative to PBO forecasts will also impact the cost. If share prices are higher than anticipated at the time of sale then the net cost of the financial support will be lower, and vice versa if share prices are lower.

18. Please note that the information and views expressed in this report do not represent financial or other professional advice.