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Canadian Low-Cost Carrier Departs From No-Frills Model

One-time upstart plans to rival Air Canada, international airlines by adding long-haul routes to lineup

WestJet, a low-cost airline, controls about one-third of the Canadian airline market, with Air Canada making up about half.

PHOTO: ROBERTO MACHADO

By: **DAVID GEORGE-COSH**

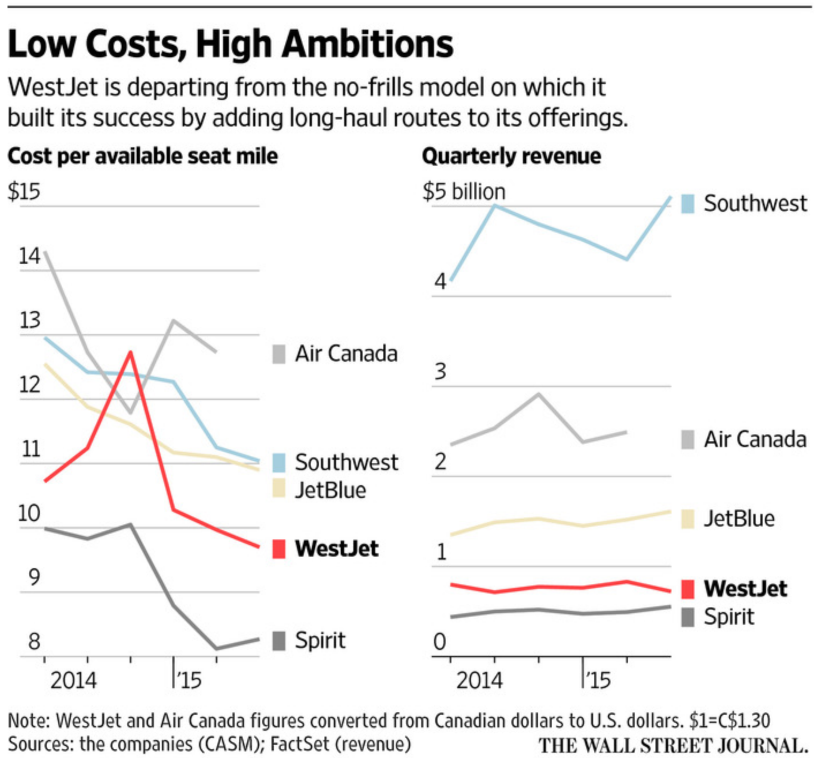
When Canada's WestJet Airlines Ltd. began flying with three planes on five routes in western Canada nearly two decades ago, it took a page from the low-cost business model pioneered by Southwest Airlines Co., billing itself as a folksy, one-size-fits-all alternative to dominant player Air Canada.

Now, after expanding with routes across the country, WestJet is departing from the no-frills model on which it built its success.

The one-time upstart, which now reaches more than 150 destinations in North America and Europe in part through code-sharing agreements, wants to take on international carriers like Deutsche Lufthansa AG and British Airways. The Calgary-based carrier said last month that it would begin flying to London's Gatwick Airport next summer, its first trans-Atlantic destination for the four widebody Boeing 767s it has on order.

The overseas ambitions of Chief Executive Gregg Saretsky will test how far the carrier can stray from its low-cost roots while still retaining the no-frills allure that has attracted customers and allowed the airline to be profitable. It is a move that some analysts and even one of the airline's co-founders are questioning ahead of next year's launch.

“We aspire to be a credible alternative to the existing international flight carrier from Canada,” Mr. Saretsky, a former Alaska Airlines Inc. executive, said in an interview. “That means that all those geographies ultimately are within reason. Why not China? Why not India? Why not South America? Why not Europe? They’re large markets…that could be better served.”



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Part of the reason for the expansion is that after seeking to increase market share during the last five years by courting more lucrative business travelers with perks such as premium seating, and adding a regional subsidiary that flies to smaller Canadian communities, WestJet has run out of room to grow in its domestic market.

WestJet’s growth has made it a powerful challenger to its biggest domestic rival. It controls about one-third of the Canadian airline market, with Air Canada making up about half.

Like most low-cost airlines, WestJet initially operated with a single-class jet, the fuel-efficient Boeing 737, a narrow-body plane giving the carrier the ability to fly short-haul flights throughout the U.S. and Canada. It generates revenue by enticing passengers with low fares within North America while charging for extras like food, priority boarding, seat allocation and checked baggage.

WestJet won’t be able to use the same game plan for its long-haul flights, where meals and first checked bags are complimentary. WestJet flies Boeing 737s on its two existing European routes, to Dublin and Glasgow, and charges for pre-allocated seats.

Expanding too fast and straying too far from the original model may put pressure on WestJet’s passenger yields and earnings. “The farther you fly, the lower the carrier’s unit revenues will be,” saidRobert Kokonis, president of AirTrav Inc., an aviation consultancy.

Tim Morgan, one of the four executives who founded the airline nearly two decades ago, said keeping operations as simple as possible has been key to profitability. Planning international routes so early in the airline’s history was too risky for the fledging carrier, he noted in an interview.

“Going international isn’t something I would have done,” said Mr. Morgan, now chief executive of Enerjet, a Calgary-based charter airline. “If [flying to London] is the best way that WestJet think they can get better yields and the best bang for their buck, all the power to them,” he said.

Mr. Saretsky, who cites a streak of 41 profitable quarters, says WestJet will expand, but with caution. More details on WestJet’s London route, as well as other potential international destinations, will be revealed this September, he added.

“We look at everything we do at returning a minimum 12% return on investment capital,” said Mr. Saretsky. “We think this opportunity passes that threshold.”

Investors will be watching carefully. WestJet shares fell 3.7% Tuesday after the company reported a 19% increase in second-quarter profit and slightly stronger revenue, helped in part by lower fuel costs. The carrier said earnings were a record for the period ended June 30, even though the second quarter is typically a challenging one as capacity moves to domestic markets from southern ones.

WestJet’s net profit rose to 61.6 million Canadian dollars ($47.6 million), or 49 Canadian cents a share in its latest quarter. Revenue edged up 1.3% to C$942 million.

WestJet’s break-even load factor, or the share of passengers needed on a plane before the flight is profitable, is about 68%. That is below the industry average of 72% and far less than Air Canada’s 79% margin, according to a recent report by Raymond James.

Jerome Hass, portfolio manager at Lightwater Partners in Toronto, recently shorted WestJet stock—or bet that its price would decrease—in the firm’s flagship fund. He cited the airline’s rising costs flying its new widebody planes and competition from Air Canada’s low-cost Rouge airline as key concerns.

“We’re seeing less of the old WestJet nowadays,” Mr. Hass said. “They’re getting further and further away from the Southwest model.”

On top of its international expansion, WestJet faces challenges from two emerging flanks: Its pilots are looking to unionize, and analysts expect an ultra-low-cost carrier molded in the same vein as Spirit Airlines Inc. or Frontier Airlines to be launched in Canada before the end of this year.

WestJet’s role model, Southwest, has also faced challenges. The company has struggled in the past with poor arrival performance, high rates of mishandled baggage and labor strife. While Southwest continues stay true to its low-cost origins, it also posted record second-quarter earnings last week after expanding to new destinations in the Caribbean and Mexico.

Only Malaysia’s AirAsia Bhd. has found success as a low-cost airline flying long-haul flights with its AirAsia X subsidiary.

“WestJet is becoming a more complex company,” said Walter Spracklin, an aviation analyst with RBC Capital Markets. “It’s moving toward a more grown-up airline and an increasingly complex route structure. Costs and challenges are likely to keep increasing.”

Capitalizing on what Mr. Saretsky describes as very successful routes to Dublin and Glasgow, WestJet’s route to London’s Gatwick airport will be the airline’s first arrival in a major European hub and allow its passengers to leverage its code-share agreement with British Airways. However, Air Canada said its low-cost Rouge carrier will fly to Gatwick next summer, days after WestJet made its new route announcement.

Mr. Saretsky says he is confident WestJet will remain a formidable competitor against its domestic—and soon, international—competitors.

“We haven’t ever shied away from competition,” he said. “We’ll take the competition when it comes.”

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