



●
**RENEGOTIATED
LABOUR CONTRACTS**

●
**\$2.9-BILLION
EMPLOYEE PENSION
SHORTFALL**

●
**\$400 MILLION IN RED
INK LAST QUARTER**

●
**BANKRUPTCY
PROTECTION—AGAIN?**

●
**\$39 MILLION IN
COMPENSATION**

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**BILLIONS OF
DOLLARS IN DEBT
FOR NEW
AIRCRAFT**

He's helping another friend with a budget airline that's based in Malaysia. At 48, an age when most corporate executives are cranking up their careers, Milton has settled into a slower, less stressful existence. From his new home in London, he is, quite literally, thousands of kilometres away from the battlefield, physically and (somewhat) emotionally removed from the fight to keep Air Canada breathing. "I ceased to be an executive of Air Canada five years ago, approximately, and gave up the chairmanship almost a year and a half ago," he points out. "I always will care about this company. But...I've been gone for so long that decisions made by the company are decisions made by the company." In other words, not by Milton.

And yet, and yet...he is not quite gone, and it is not that simple, because few things are that simple where Robert Milton and Air Canada are concerned. Canada's flag carrier is in a state of upheaval, knocked sideways by recession, its employees fearful and resentful, its multibillion-dollar pension plans so far under water you'd need sonar to find them. Bay Street analysts talk openly of the prospect that the company could file for protection under the Companies' Creditors Arrangement Act (CCAA), the Canadian equivalent of Chapter 11, for the second time in six years. In March, Air Canada pushed out chief executive officer Montie Brewer and brought in Calin Rovinescu, a hard-ass lawyer and Milton's right-hand man for most of the airline's sojourn into bankruptcy protection in 2003-'04. Brewer was terrific in many ways, but in a time of crisis, he "lost the plot," says Milton. That Milton approved of the change goes without saying, because of that other thing he is, besides dad, doorman and airline venture capitalist. He's still the chairman and CEO of ACE Aviation Holdings Inc., the controlling shareholder of Air Canada—arguably, still the most powerful individual in Canadian aviation and, inarguably, the most divisive.

After Air Canada came out of CCAA, Milton achieved what very few in the airline business ever have: He made billions of dollars for investors in the space of just four years. But the record is anything but one-sided. Some people—particularly the union leaders who represent the airline's 26,000 employees—argue that he did so purely by taking out cash and the most valuable ancillary parts of the operation, namely the Aeroplan loyalty program and Jazz Air, the regional airline that feeds passengers from the hinterland to hubs like Toronto. In this recession, unlike the last one, Air Canada must lean on one business—the notoriously unstable one of selling national and international travel. In the critics' version of events, the airline would not be anywhere near CCAA if Milton hadn't left it so naked. "He was not following a strategy that would guarantee the long-term success of the company," says Leslie Dias, head of a Canadian Auto Workers local that represents some 7,000 customer service agents, mechanics and others at Air Canada and Jazz. "He was looking for quick gains to fill his own pockets and the investors' pockets."


Ah yes, the Milton money. It has been a sore point for Dias and others for a long time. In 2006 and 2007, Milton made \$39 million (excluding gains from cashed-in options), mostly in the form of special cash bonuses for orchestrating the very asset sales that Dias and others object to. Even some red-meat capitalists in finance

think there's at least a grain of truth to the asset-stripping charge. Cerberus Capital Management LP, the New York private-equity firm that was until recently one of ACE's biggest equity-holders, made a fortune from the strategy of breaking up the old Air Canada. "It was raped by Cerberus," says Ben Cherniavsky, a leading airline analyst who works for the brokerage Raymond James Ltd. "The good cash-flow businesses were taken out of it."

Cherniavsky believes Air Canada's odds of escaping another date with insolvency are 50-50, at best. A number of things have to go right, and even if it manages to avoid a cash crisis, the company seems a long way from being the healthy airline Milton said it was after the big restructuring. Air Canada's financial straits have also prevented Milton from taking the final steps that would sever his 17-year relationship with the company—finding a buyer for ACE's remaining 75% stake, handing the cash back to investors and killing ACE.

So Milton's still hanging around, still dropping in on Montreal regularly, still a lightning rod in the country he no longer calls home. When CAW leaders presented their own five-point plan for Air Canada in early May, point number two read: "Stop further payments to Robert Milton." He may have given up his executive roles at Air Canada, but even now, his legacy is not yet written. Depending on your point of view, he's a visionary in a brutal industry, a symbol of grotesque executive greed or a man who tried his best but just couldn't keep Air Canada from running into trouble yet again. Maybe all three.

WHEN CAW LEADERS PRESENTED THEIR OWN FIVE-POINT PLAN FOR AIR CANADA IN EARLY MAY, POINT NUMBER TWO READ: "STOP FURTHER PAYMENTS TO ROBERT MILTON"



When Air Canada filed for protection under CCAA on April 1, 2003, Robert Milton described it as the most depressing morning in his entire career—and he'd already faced his fair share of crises at the airline. Two weeks after Milton's August, 1999, appointment as CEO, Schwartz's Onex Corp. made its audacious play to refashion the airline business by bidding for Air Canada and Canadian Airlines with a plan to merge the two companies. Milton eventually won the gunfight, but at a big price. The consequent merger with a nearly

bankrupt Canadian left Air Canada with unmanageable debts. Then came the bursting of the tech bubble, the 9/11 attacks, a sluggish economy, the SARS crisis. There was no way out, but Milton hated to concede defeat. “Right to the end, I did not want to file” for CCAA, he wrote in his 2004 autobiography, *Straight from the Top*.

It didn’t take long, though, for Milton’s concerns to disappear. Soon, his view on creditor protection had shifted 180 degrees. It became apparent that by allowing for the rewriting of plane leases and the loosening of collective agreements, the process was “the most liberating thing that had ever happened to the company,” he wrote in his book. Milton eventually came to believe it was the only way any legacy airline in North America could be “fixed.” Most of the major U.S. airlines have used Chapter 11 for that reason—some twice. Air Canada emerged from creditor protection, 18 months after it went in, as ACE Aviation (comprising Air Canada, Jazz, Aeroplan and other business units), and it did seem that the wringer of bankruptcy court had done it a lot of good. The pilots, the highest-paid group of employees, agreed to hack their pay by 15%. Byzantine work rules were simplified and the wage bill was reduced by \$1.1 billion. Air Canada was able to renegotiate its aircraft leases on the cheap.

Better still, the customers were finally coming back. After the Sept. 11 attacks, Air Canada had struggled to fill 70% of its available seats. But in its first three months out of creditor protection, it filled nearly 76%—a seemingly slight increase that can spell the difference between catastrophe and viability. (The most profitable airlines, like WestJet Airlines Ltd., are usually able to fill about 80% of their seats.) With about \$8 billion less in debt, lower costs and the tail wind of a growing economy, Milton publicly predicted “significant profitability” in 2005.

There were other, even more significant changes in Milton’s business life in the months after CCAA. He handed the day-to-day operations of Air Canada to Montie Brewer, a marketing and scheduling whiz who’d been coaxed away from United Airlines. Then he moved his executive suite from Montreal’s Pierre Elliott Trudeau International Airport to an office on the edge of lower Westmount, far from the runways and the action. Now Milton could spend his energy thinking about the bigger picture of ACE. And he had already made up his mind to take a crowbar to it.

Even from his first days as a rookie CEO in 1999, Milton says, he believed that parts of the business were much better than the core airline. “I loved airplanes and airlines and I wanted to make them work. But you start to become cynical when you look at the historic results.” Since 2000, the global commercial airline industry has lost an estimated \$33.5 billion (U.S.), according to the International Air Transport Association. It has only had one profitable year since 9/11 (2007). It’s not for nothing that Warren Buffett—who nearly lost a huge sum on an ill-considered investment in US Airways in the late 1980s—once quipped that a clear-thinking capitalist ought to have shot down the Wright brothers, saving future investors a lot of trouble.

So the fact that Milton would break up the old Air Canada did not come as a shock to industry observers. What surprised them were the lengths he went to and

the money involved. What’s still hotly debated, outside the airline but even more so within it, is what role the financial machinations had in weakening Air Canada.

One of the most frequently cited examples is the spinoff of Aeroplan, the loyalty program that issues Canada’s second-favourite currency—airline points. Aeroplan’s business model is essentially to act like a broker, buying seats from Air Canada and reselling them, in the form of miles. It also makes money when points expire, unused. Bay Street likes the business because it’s growing, easy to understand and, as long as everyone doesn’t try to redeem their points at once, it’s a prolific generator of cash flow.

The Aeroplan spinoff alone allowed Cerberus to recoup much of its \$250-million investment. (The private-equity fund and other preferred shareholders received stock that was worth \$180 million, based on market values at the time.) Freed of Air Canada, the management of Aeroplan has made acquisitions and signed new customers like Sobeys, Direct Energy, and Shanghai Airlines. It’s also Air Canada’s biggest customer, buying \$490 million worth of seats for frequent fliers in 2008. To Milton, this is proof that the spinoff is a winning proposition: “Aeroplan provides Air Canada more cash than it ever did when it was part of the airline,” Milton says. Andy Wilson, president of the Air Canada Pilots Association, says that misses the point: “Does it put in profit? That’s the point.”

But the concept is compelling enough that it has drawn attention from other airlines. The reason? Simple investment math. As of May 6, Groupe Aeroplan Inc. had a stock market capitalization of \$1.7 billion—12 times that of Air Canada. Spinning off a subsidiary hardly qualifies as a new idea, but for the aviation industry, the notion of an independent loyalty company was ahead of its time. It’s one reason why Milton was hailed by a few as a turnaround king, not least by this magazine, which named him Canada’s CEO of the Year in 2005.

But it was Milton’s next piece of financial shuffling, just two months after receiving that honour, that still amazes. ACE got rid of Jazz Air. Like Aeroplan, Jazz became an income trust, capitalizing on the hot market for the high-yielding equities that prevailed before the federal government imposed new taxes in 2006 that effectively killed most of the trust sector.

Even with the nearly insatiable thirst for trusts, selling Jazz was no sure thing. Trusts attracted an older set of investors who relied on the rich monthly distributions for income, and who valued a stable business. Airlines, of course, were anything but. If Milton could overcome this perception of high risk, though, ACE could get a premium price for Jazz. But how?

The solution was a complex arrangement that saw Jazz become a semi-independent affiliate of Air Canada. The bigger airline would essentially subcontract its short-haul flights to Jazz and guarantee it a minimum number of flying hours. But the really big wrinkle related to its expenses. Jazz covers its most predictable costs, like salaries and aircraft rent. But it can pass on to Air Canada most of the volatile ones, such as fuel. So when oil rocketed past \$140 (U.S.) a barrel last July, and Jazz’s fuel bills jumped by \$107 million, it was Air Canada that paid. “They spun [Jazz] out with the

notion it was 'de-risked.' But the risk didn't go away," says Cherniavsky of Raymond James. "It was just a shell game."

But it was a lucrative one. In the initial public offering in January, 2006, ACE sold a 20% stake in Jazz for \$250 million—implying a \$1.25-billion valuation for the little airline. Right away, a few people on Bay Street cried foul. "This isn't a business," groused Peter Holden at Veritas Investment Research Corp. "It's an integral part of Air Canada carved off to take advantage of the current enthusiasm for income trusts."

The analyst was wrong to be negative on Jazz's prospects, however. Air Canada's financial results continue to careen wildly, losing money in four out of eight quarters in 2007 and 2008, including \$727 million in red ink in the fourth quarter of the latter. But Jazz is consistently profitable, and has never failed to make at least \$27 million in a quarter since going public.

This is why Jazz, which flew about 4.1 billion passenger miles last year, has a market capitalization more than twice that of Air Canada, which flew nearly 11 billion. The financial stability has attracted some of the smartest money on Bay Street. "Jazz has a better cost structure, which is all that matters in the airline industry," says Greg Boland, the chief executive of West Face Capital Inc., which owns stakes in Jazz and ACE. Jazz also enjoys a near-monopoly in some markets. Need to get to Timmins, Ontario, or Bagotville, Quebec? Don't bother calling WestJet or Porter. At 23 small airports, Jazz is the only airline that lands planes of any size.

Jazz's initial success created an obvious opportunity for another bit of manoeuvring by Milton. In the spring of 2006, ACE, which still owned 100% of Air Canada, was trading at less than the value of its cash and its retained stakes in Aeroplan and Jazz. The stock market was essentially saying that Air Canada, without the loyalty program and the regional airline, was worthless. But Milton, who was already mulling his post-ACE life, had already seen the power of a little financial engineering. He quickly announced that Air Canada might go public too.

The deal, which was done in late 2006, was well timed. Canada was enjoying its fifth straight year of solid economic growth. The S&P/TSX composite index was steaming toward 13,000. The memory of terrorism in the skies was receding—in October of that year, Air Canada had filled 79% of its seats. Initially, Milton and his advisers thought they'd raise \$400 million in the IPO. But investor demand was so great that a one-quarter stake in the airline went for \$525 million, with ACE getting \$325 million of the money.

"Equity markets were producing big returns and everything was flying high and screaming hot," says Milton. "Those were different times." His grand restructuring was nearly complete: Eventually, ACE would sell or spin off the rest of what it owned, including 75% of Air Canada, and he would move on. He wanted out, wanted freedom from the grind of running a major public company so he could spend more time with his children. He and his wife, Lizanne, wanted to leave Montreal before their daughter began high school so that she would not have to change schools twice. He asked Lizanne where she wanted to live, where he could be near a major airport, and she chose London.

The Milton family moved to the British capital about 18 months ago. Though he's still in charge of ACE as it tries to wind itself down, and is helping Calin Rovinescu as he gets back up to speed with Air Canada, there's no longer any need for Robert Milton to show up for work every day at an office in Montreal. For that matter, for the first time in his life, there's no need for him to work at all.

The money he made—for himself and for ACE shareholders—was, in a sense, a measure of the cleverness of Milton's post-CCAA design. By setting up ACE as a holding company, he subtly shifted the balance of power. Before, the unions, management and a diffuse set of Air Canada shareholders all had clout. After, the unions were weakened, and Air Canada answered to one shareholder—ACE—which in turn had a powerful owner in Cerberus. And by removing himself from Air Canada and taking the top job at ACE, Milton ensured that his own pay would be linked to things other than how the airline performed.

The size of Cerberus's equity stake—9.2%—belied the firm's influence. It had three of the 11 seats on ACE's board. Michael Green, a Cerberus managing director, was the second-most powerful person in the boardroom next to Milton; he held the lead director's role and headed the governance committee, which, importantly, set executives' pay.

This was a sensitive subject in Milton's case, both for him and for the unions who were watching to see if their sacrifices would be shared. Milton had taken a 20% salary cut during creditor protection and was being paid less than \$1 million a year, excluding stock options. He hadn't been paid a cash bonus since 2000.

But in Cerberus, ACE had an influential investor that had no aversion to paying executives handsomely (their own principals pull in tens of millions of dollars in a good year). Led by Green, the governance committee negotiated a new three-year contract for Milton in early 2005. The deal looked pretty standard—salary, bonus, stock options, a few perks—but for this vague sentence: "In the event of the completion of certain value-enhancing transactions for ACE Aviation and its shareholders, Mr. Milton will be entitled to incentive rewards under his employment arrangements." That line, 29 words in length, was worth \$29.9 million in 2006 and 2007. Milton is supposed to get another \$10 million when he completes the windup of ACE.

“I’VE DESCRIBED BEING AN AIRLINE CEO AS SORT OF ANALOGOUS TO BILL MURRAY’S GROUNDHOG DAY... YOU KEEP WAKING UP AND IT’S THE SAME NIGHTMARE”



The unions call it “the Milton money,” and it grates. More than that, it may be colouring some employees’ view of their company as the two sides gear up for a tough set of labour negotiations this spring and summer. It’s not the employees, though, who have the most to be upset about; it’s the saps who bought into Air Canada’s IPO, which proved to be an unmitigated disaster. After going public in November, 2006, at \$21, the stock began falling in its first hour of trading and just kept going down. In early May, the shares were worth \$1.40.

Perhaps the failure of the IPO shouldn’t have been a surprise. In the fall of 2006, during the marketing of the deal, the airline’s executives and investment bankers had claimed that Air Canada was making nearly \$1 billion in “adjusted EBIT-DAR” (earnings before interest, taxes, depreciation, amortization, and aircraft rent), and used that figure to justify the valuation. But a closer examination of the numbers showed that, by the time the airline finished paying for aircraft and other expenses, it wasn’t making money.

Still, nobody expected such a meltdown, so quickly. There were a series of broadsides: the levitating price of oil, the credit crisis, the onset of a global recession, and a Christmas season filled with snow, freezing rain and wind. There were also self-inflicted wounds. As oil prices moved into the stratosphere, nearly hitting \$150 (U.S.) a barrel last year, Air Canada locked in some of its fuel contracts at high prices, out of fear oil would get even more expensive. That cost the airline about \$400 million when oil dove as low as \$34 (U.S.). But it’s the stock market crash, and the plunge in interest rates, that brought about the crisis du jour. Going

into last year, Air Canada’s employee pension funds had nearly 60% of their assets in equities. If the airline were to go out of business tomorrow, its pension funds would technically be about \$2.9-billion shy of what they need to pay out. Once again, though, the story is not necessarily as simple as all that. Air Canada’s cash-flow problems have been compounded by big spending commitments. Milton—who fell in love with airplanes at the age of 10 when he first spotted a Boeing 747—considers it a major part of his legacy that Air Canada has spent copious sums on new and upgraded planes, financed with money raised while it was in bankruptcy protection or shortly thereafter.

“This was a multibillion-dollar investment that no airline in North America could afford to do, and Air Canada did it,” Milton says. He speaks about the new and renovated aircraft almost the way a proud father does about his children. It’s early May, and Milton has just flown into Montreal on an Air Canada Airbus A330-300 that, like the bulk of the Air Canada and Jazz fleet, boasts a new interior. Listen to the man gush: “The picture of this airplane with the new paint job, the new interior, the video systems, the lay-flat beds [in executive first-class suites]...the way the crews performed. ...That’s what an airline is about—the people and the airplanes. And I felt very good.”

Also feeling good are the people at Boeing, Embraer and the companies that lease planes, all of which have profited greatly from Air Canada’s spending spree. Since 2004, the carrier has added 17 new Boeing 777s and 60 smaller Embraer jets. Still to come in a few years: the new Boeing 787 Dreamliner, a fancy new aircraft that can accommodate up to 250 people on long international flights. Boeing’s list

price: upward of \$150 million (U.S.) each, and Air Canada has ordered 37 of them. If Air Canada does survive its current tight spot, it still faces a \$1.5-billion bill for the first delivery of new planes in 2012-'13.

There is a financial rationale for all this: New aircraft are more fuel-efficient than the ones they are replacing, and if you believe in a future of triple-digit oil, it may make sense to trade higher lease payments for lower fuel costs. But they have come at a price. Air Canada's ownership costs—that's aircraft rent, plus the depreciation on planes it owns—were \$973 million last year, a 17% rise since 2006. That's manageable as long as the customers keep coming. But if oil shoots higher, air travel could once again become a luxury, leaving Air Canada holding a bunch of useless aircraft.

Even those who don't buy the predictions of oil-induced apocalypse question the aggressiveness of the fleet project, which has left the airline with \$7.8 billion of debt (including capitalized plane leases), according to Cherniavsky, the analyst. "I think it's one of the obvious downfalls of the whole strategy. They bought too many planes." If anything—and this point has been argued about Air Canada forever—perhaps the airline should have aimed to get smaller, leaner, more focused on profitable routes, especially international ones where it doesn't face competition from WestJet. But even though Air Canada has lost domestic market share since its merger with Canadian, it still offered about five billion more seat miles last year than it did in 2001. The Milton philosophy has always leaned toward growing out of problems, not shrinking.

Another engagement with CCAA might change that. Milton would rather not see events unfold this way, but at the same

time, he isn't overly concerned about the prospect of it. This is the airline business, right? Continental Airlines went through Chapter 11 twice. US Airways did it twice. "I really care about [Air Canada] and I want it to do well. But I've described being an airline CEO as sort of analogous to Bill Murray's *Groundhog Day*, where you keep waking up and the alarm clock goes off and it's the same nightmare," Milton says. "There are airlines all over the world talking about CCAA or the equivalent. ...Air Canada's not alone."

But those other distressed airlines, for the most part, don't have six dozen shiny new planes, and didn't distribute billions of dollars to their shareholders (mostly in the form of Aeroplan and Jazz shares). Milton hates it when people lose sight of that. "It's not like, by not having done the things ACE did, these other airlines are in great shape," he says. The man who has never wanted to do anything else but run an airline has come to accept that he chose one of the world's lousiest industries—"so if there are good businesses...within an airline, give them freedom, let them prosper." Acting on this belief at ACE, Milton says, justifies his rich bonuses. (Milton also points out that he made another good call, buying 7% of US Airways in 2005, on which ACE made a \$162-million profit.) "I was the head of this company, and billions of dollars were made, and billions of dollars were invested...in the form of aircraft. A lot of things happened because of what we did at ACE, and they stand in stark contrast with what's happened at, really, all other airlines in North America."

Whether those things came at the expense of Air Canada's financial health is something only the future will tell. That they were terrific for Robert Milton's is beyond dispute. 