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Traffic flat, earnings down for BC Ferries ~ Patrick Brown

BC Ferries Services' Financial Statements for the year ending March 31, 2008 show no significant increase in passenger or vehicle traffic over the past five years. The corporation was privatized under provincial ownership in 2003 and at that time, a 25% increase in traffic was projected to occur over the next fifteen years of operation. So far, this trend has clearly not actualized, but BCFS has not commented on this failed prediction.

Net Earnings Down

Meanwhile, net earnings, which had been climbing to approximately $50 million in 2005/06 and 2006/07, have dropped markedly to $37 million in the latest fiscal year.

BC Ferries has attributed this drop to 'the significant cost of new assets that came into service during the year.' According to CEO David Hahn, 'This past year, we made significant capital investments in our fleet, including almost $320 million of a $542 million project for our three new Super C-class ships.'

The first of these ships, the *Coastal Renaissance*, began service on March 8 serving the Departure Bay–Horseshoe Bay route. The second, the *Coastal Inspiration*, starting on the Duke Point–Tsawwassen route this June. The third, the *Coastal Celebration*, has just arrived in BC from its German builders.

Capital expenditures for the 2007-08 fiscal year totalled $452.5 million, including $54.5 million for terminal upgrades. Long term debt increased by $279 million to $1,029 million. (The corporation was essentially debt-free when it was incorporated in 2003.)

Revenue Increase Reflects Fare Hikes Not Increased Traffic

In 2007/08, revenues increased 7.4% over the previous year, with no significant increase in the number of vehicles and passengers carried. In fact, there has been little increase in traffic since the final year of BC Ferries as a crown corporation (before privatization), but there has been a 31% increase in revenues and a 23% increase in costs (not counting deferred fuel costs).

The lack of growth in traffic is in contrast to growth in population of the areas served by BC Ferries. Population growth on Vancouver Island, the Gulf Islands, the Sunshine Coast, and the North Coast has been about 6.7% from 2002-2007.

However, stiff fare increases and fuel surcharges may well have had an effect on the number of ferry travellers. Information from the FACC (Ferry Advisory Committee Chairs) suggests that there has been a decline in full-fare travellers, but not in discounted fare travellers (for whom ferry travel may not be discretionary).

Looking forward, the billion-dollar debt figure will continue to increase (there is another $220 million remaining to finance on the Super–Cs alone), and the interest costs will have a substantial effect on future costs. Will this lead to further fare increases?

Investor Views

From its inception, BC Ferry Services Inc was designed to be financed by market debt, and projections done as part of the original 'core study' anticipated debt of three-to-four times equity. It was important, however, that the company's financial performance appear sound, so as to inspire confidence in bondholders.

The fact that the company: has a near-monopoly on ferry travel on the coast, has a 60-year contract with the provincial government, and is regulated by a Commissioner whose terms of reference were to ensure its financial health, are positive signs as far as the bond rating agencies were concerned, as they commented in January about BC Ferries' $200 million bond issue.

However, Standard & Poor's commented on BCFS's 'highly leveraged capital structure' and 'passenger traffic growth risks'. And, according to the Dominion Bond Rating Service: 'Managing fuel costs is expected to remain the key challenge going forward. The Company continues to hedge a portion of its fuel requirements and the new fuel surcharge mechanism proposed by the Commissioner for the next performance term will add certainty with respect to the extent of fuel cost recovery permitted through user fees. Nonetheless, while ferry services are essential to the residents of the province and demand has so far shown little price sensitivity, increases in user charges through fuel surcharges and statutory fare increases would eventually dampen traffic if sustained at the pace seen in recent years.'

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Future Financing

According to information published for investors in 2007, BCFS expects to make capital expenditures totalling a further $1.2 billion in the five-year period up to March 2012. The company projects that half of this will be financed by further borrowing, and the rest from cash-flow generated by operations. Up to March 2007, bonds outstanding totalled $750 million at an average interest rate of 5.67%, an annual interest cost of some $42.5 million.

With further borrowing of half the anticipated capital expenditures, say $600 million, bond indebtedness would total $1,350 million by 2012 and annual interest (assuming the same favourable rates can be obtained) of $76.5 million.

The remainder of the company's capital needs, some $600 million, are expected to be satisfied from operational cash flow. But current EBITDA (earnings before interest, taxes, depreciation, and amortization) may not be enough to satisfy this need.

Ten Year Plan Needs A Rethink

Possibly increases in fuel costs (over and above recoveries through fuel surcharges), coupled with some increased capital costs, and the absence of anticipated increases in ridership, have had the effect of endangering the original ten-year financial plan. So clearly, the provincial government, the beneficial owners of BCFS, which has a keen interest in ensuring that this ambitious capital program is completed, may have to step in. ✐

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