Air Canada Has 100% Upside After Pension News

Description

In late May **Air Canada** (TSX:AC)(TSX:AC.B) announced it would opt-out of its government pension deal. The previous deal, agreed to in 2013, gave the company significant flexibility in managing its $4 billion pension deficit. The Canadian government allowed the airline to pay a fixed $200 million payment annually for the next seven years. This deal kept Air Canada solvent in a time when its finances were in dire straits.

With record profits, however, Air Canada now has roughly $1 billion in a pension surplus. By opting out of its government plan, the company is now free to distribute dividends and implement a share buyback program. It will also save loads of cash, roughly $110 million this year and $200 million next year.

This could send shares soaring.

The best share buyback program in the industry

Following its opt-out announcement, Air Canada disclosed that it would buy back up to 10 million of its shares, representing 3.5% of the current share count. While this is a meaningful first step, expect Air Canada to ramp up share buybacks in the future.

While other airlines such as **Delta Air Lines, Inc.**, **United Continental Holdings Inc.,** and **American Airlines Group Inc.** have also implemented similar buyback programs, they are authorized over a period of years. With Air Canada's program lasting only until May 2016, the company has an opportunity to buy back over 10% of the float over the next three years alone.

Get ready for some dividends

By opting out of the pension contract, Air Canada is now free to start a dividend policy. While the company hasn't announced one yet, even a small payout would allow dividend-only funds and investors to buy shares. This could provide yet another upside scenario for shares.

Debt reduction still on pace

Even after a share buyback and potential dividend, Air Canada still plans “to apply the majority of its free cash flow to reduce net debt levels.” This focus should reduce debt levels by about $600 million per year over the next several years.

Lower debt levels would help reduce interest expenses, provide stability for the next industry downturn, and help the valuation given its better balance sheet.

Valuation is still rock bottom

If Air Canada meets its expected earnings for 2015, today’s price would be only 3.6 times the next 12-months’ earnings versus 8.2 times for the average airline. With multiple levers for creating shareholder value, expect that discount to disappear over time. If shares traded at the industry average valuation, the stock would have over 100% upside.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:AC (Air Canada)

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