Air Canada Investors: Don’t Worry About Oil Prices

Description

In 2014, jet fuel costs accounted for roughly 27% of the airline industry’s revenue. When oil prices collapsed, airline investors rejoiced, expecting a big drop in operating expenses. For **Air Canada** (TSX:AC)(TSX:AC.B), that hope turned into a reality; last quarter it experienced a 26% drop in fuel costs, boosting profits by $183 million.

Now that oil prices are on the rise, should Air Canada shareholders be worried about rising costs?

Currency shifts will offset most fuel fluctuations

Because a huge portion of the economy is linked to energy, low commodity costs have pushed down the valuation of Canada’s currency. Historically, the loonie has almost always weakened when oil prices fell. When prices rebound, it starts to strengthen. This crisis is no different; with oil prices below US$40, it now takes CAD$1.33 to buy US$1, roughly near decade highs.

“We don’t like the low Canadian dollar … but coming with the low Canadian dollar we have a low fuel price,” said Air Canada’s CEO.

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Air Canada has been hurt by the falling loonie in a few ways. First, it buys fuel, airplanes, and airplane parts in U.S. dollars, even though much of its revenues is denominated in Canadian dollars. So purchasing goods and services to run the business is costing more and more Canadian dollars, even though its revenue base isn’t increasing at the same rate.

The company also prices most of its financing in U.S. dollars. With a weak loonie, Air Canada needs to convert increasing amounts of Canadian dollars to pay the same amount in U.S. interest payments. It’s no wonder that last quarter it reported $105 million in additional operating expenses resulting from a weak Canadian dollar.

If oil experiences a meaningful rebound, nearly every currency trader expects the loonie to reverse course. As Air Canada starts to get hit by higher fuel prices, it should benefit greatly from a strengthening currency. Effectively, it can buy parts, planes, and fuel at cheaper prices, all while paying less towards existing debt obligations. Rising oil prices aren't as scary for Air Canada as they are for other airlines.

What if oil doesn't rebound?

If energy prices don't increase, Air Canada would obviously benefit from lower operating expenses. It also sees opportunities to expand abroad. Just as a weak currency makes it more expensive for Air Canada to buy U.S. goods and services, U.S. consumers find it cost effective to purchase Canadian items.

Air Canada's CEO said that while fewer Canadians are traveling to the U.S., more Americans are flying into Canada to take advantage of their strong currency. Building additional international routes could end up being fairly lucrative with management anticipating "hundreds of millions" in additional revenue sources.

While most airline investors should stay acutely aware of fluctuating oil prices, Air Canada shareholders can rest easy. Up or down, the company should have ways to benefit from wherever prices go.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:AC (Air Canada)

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