2 Reasons Investors Are Missing Out on the Huge Opportunity in Air Canada

Description

A quick comparison between **Air Canada** (TSX:AC)(TSX:AC.B) and its major U.S. peers—**Delta**, **United**, and **American Airlines**—reveals that investors are currently taking an overly cautious and perhaps even pessimistic outlook on the stock.

Air Canada currently has a 2016 forward price-to-earnings ratio of about 2.4, compared to between 5.4 and 6.4 for its American peers, and an average of 5.3 for its global peer group. Looking at 2016 EV/EBITDAR (another measure to value the stock), Air Canada is currently trading at about 3.4 times EBITDAR compared to its U.S. peers, which are between 3.7 and 4.9.

Not only is Air Canada trading at less than its competitors, but it also trading at a lower valuation than it has throughout its history. Air Canada has averaged a forward price-to-earnings ratio of about 4.7.

Why are investors so pessimistic on Air Canada? There are two main reasons.

1. Worries about capacity expansion and demand

Air Canada is currently in the middle of a major business transformation that is aimed at major capacity expansion (which basically means flying more seats longer distances), cost reduction (Air Canada is aiming to reduce its cost per airline seat flown one mile [CASM] by 21% during the 2013-2018 period), and improvement in margins and return on invested capital.

So far, investors have been concerned about parts of this plan, especially the capacity expansion. In 2016 alone, Air Canada is set to grow its capacity by 8-10%, which is a fairly large number, and the big concern with adding capacity is that demand won't match the capacity. This in turn reduces the "load factor," or the amount of capacity that is actually being used, which can put pressure on margins and RASM (revenue per airline seat flown one mile).

Fortunately, this is much less of an issue than investors think. This is because 90% of the capacity that Air Canada is adding is international capacity, and much of this capacity is on existing segments. International capacity has much lower demand risk than domestic capacity growth, and international routes are much more profitable than domestic routes.

It is important to note that this new capacity is also very low-cost capacity. Firstly, much of this capacity is coming through new **Boeing** 787 aircraft, which are replacing older 767 aircraft and offer a 31% reduction in CASM. The older 767 are being transitioned to Air Canada's leisure airline, Rouge, which typically flies longer trans-Atlantic routes to leisure destinations and has more seats due to its economy class nature. The result is that these same planes run at a 30% lower CASM than the same plane flown outside Rouge.

This means Air Canada's capacity growth is both low risk and low cost.

2. Investors are worried about declining yields and RASM

Airline yield basically refers to the revenue per mile flown by a paying passenger. Air Canada has been seeing its yields decline as its executes its strategy because part of its strategy is increasing flight length (which typically reduces yield) and expanding its Rouge airline, which typically has lower fares due to more economy class seats.

Air Canada has stated this is not a concern, because its focus is on increasing margins, reducing costs, and improving returns, which it has been doing. As a result, Air Canada's CEO has constantly reminded investors to focus on long-term metrics such as margins, return on invested capital, and leverage as they more accurately reflect the underlying success of the business.

As the market focuses more on those long-term targets, the stock price should see more improvement.

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