It’s Time to Trade This Airline Stock for Another

Description

U.S. investment bank Cowen and Company downgraded a number of airline stocks January 4. **Air Canada** (TSX:AC)(TSX:AC.B) was among the group hit. Interestingly, Cowen also raised its rating on **WestJet Airlines Ltd.** (TSX:WJA) from “Underperform” to “Market Perform,” while upping its 12-month target price $3 to $22.

Is it time for investors to make a switch? Perhaps, but before we make a decision, it makes sense to understand why the investment bank made the changes to both companies’ ratings.

Why the downgrade to Air Canada?

It’s been a good run for the S&P 500 Airlines Index over the past six months; it’s risen almost 50%. That’s the good news. The bad news is that Cowen senior airlines analyst Helane Becker believes investors haven’t taken into account the fact margins are shrinking — two years ago they were 12%, and Cowen is projecting 7.5% in 2017, which is a 38% decline — and that’s going to have a big impact on future earnings.

A big issue, Cowen believes, is the fuel costs in the first quarter of 2017, which are expected to be up 25% year over year. If investors recall, fuel costs sank airline stocks in 2011, and it looks as though we’re in for a repeat performance in 2017, although this time around, it might not be as a big a deal given that industry consolidation has resulted in higher fares.

With Air Canada’s stock up 33.9% in 2016, Cowen obviously feels its five-year string of positive annual returns could be coming to an end. However, it does have a 12-month price target of $15 — 9% higher than its current price **—** so it’s possible Air Canada shareholders will still make out okay in 2017.

Why the rating bump for WestJet?

As part of Cowen's upgrade of WestJet, it raised its 12-month price target to $22 — $3 higher than its previous target, but still below where it's currently trading. While it's hardly a ringing endorsement ofthe airline, it does suggest that WestJet should be able to hold its own in its battle for domestic airline supremacy.

WestJet is not sitting still.

Its move last spring to run long-haul flights to the U.K., having bought four 767s to service the route, is going relatively well, despite some mechanical issues that have cropped up, disappointing customers.

In late December, the airline's pilots helped this initiative along by voting in favour of a deal that sees them earn more for flying wide-bodied jets like the 767. With that successful vote in hand, WestJet has ordered more planes to service its overseas business.

It's a win/win situation.

And it couldn't have come at a better time, because a number of Europe-based discount airlines, including Norwegian Air, are looking to fly to North America, potentially putting a dent in both its relatively new service to the U.K. as well as Air Canada's existing routes.

"The greater threat [to WestJet] is from Norwegian Air, which has a huge order for 787s and a very low cost structure," said Fred Lazar, who follows airlines at the Schulich School of Business at York University in Toronto. "Norwegian Air will probably try to enter the Canadian market, so [WestJet needs to] get a foothold before they are established."

Bottom line

Air Canada's stock has outperformed WestJet for five consecutive years. I don't see a sixth year in the making, especially given WestJet's reputation for controlling costs much better than its domestic rival.

Clearly, Air Canada is the cheaper stock. However, with WestJet yielding 2.4% and some ominous clouds in the distance related to fuel costs, I think it makes sense for Air Canada shareholders to switch teams.

The party's over for Air Canada stock.

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