Air Canada: Growing Free Cash Flow Is Transforming the Airline Business

Description

Air Canada (TSX:AC)(TSX:AC.B) shares have a 59% year-to-date return in a year that has seen the airliner post financial results that have taken the market by surprise. And with the shares trading at attractive valuation levels, investors can expect the stock to continue to outperform.

The company has been performing well above expectations for at least the last five quarters, which has led to increasing estimates and the outperformance of its shares.

Recall that on July 6, Air Canada significantly increased its guidance for the second quarter, saying that its earnings before interest, taxes, depreciation, amortization, impairment, and aircraft rent, or EBITDAR, would be significantly better than analyst expectations of $475 million at that time. Estimates were then raised to approximately $550 million.

With EBITDAR actually coming in at $670 million for the quarter, we can see that the company is far surpassing expectations and that the shares are in the process of being re-rated by the market.

The 11% increase in EBITDAR compared to the same period last year is just the beginning.

Another key to the story is the company's cash flow and its free cash flow generation. Free cash flow has not been easy to come by. After years of struggling, the company expects to generate free cash flow of $600-900 million for the year. This is the company's revised guidance for free cash flow, which was increased from prior expectations of $200-500 million.

This increase reflects a robust demand environment, with second quarter traffic up 13.6%, and fare growth up 1.4%, as well as a decrease in capital expenditures. These trends are expected to continue into the second half of the year.

And with the airliner sitting on almost $6 billion of debt for a debt-to-capitalization ratio of a whopping 85%, increased cash flow will result in reduced leverage and, ultimately, a lower-risk profile for the company.

The company's returns on invested capital are also increasing nicely, and management is now forecasting its annual ROIC to be between 11% and 14% in 2017 and 2018. This compares to previous expectations of 9-12%.

Going forward, Air Canada expects to continue to reap the rewards of the revamping of its operations. From its $1.25 billion refinancing plan, which reduced the company's average cost of debt by 150 basis points, to actions such as fleet reconfiguration and the higher density Rouge airplanes, management at Air Canada is still in the midst of transforming the airliner.

The company will be hosting its Investor Day on September 19, at which time we will get an update on management's three-year plan and outlook. As analyst estimates continue to get revised upwards, the shares will better reflect the new and improved results and outlook.

The key risks remain the economy, a weakening of the consumer, and rising fuel prices.

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