Why Air Canada Is the Short of Year!

Description

At a price of $23 per share, investors taking too fast a look at shares of **Air Canada** (TSX:AC)(TSX:AC.B) may think they are getting an incredible deal, as shares (on the surface) trade at a trailing price-to-earnings ratio (P/E) of only 3.4 times. Unfortunately for those who do even a reasonable amount of due diligence, the multiples are not that attractive, as the company has benefited from a one-time item.

Over the past three quarters, the company has recovered a total of $790 million in taxes from the government, which has flowed straight to the bottom line. Taxes, of course, are paid out of profits. While this is a good sign for shareholders of the company, the reality is that the future doesn't look nearly as attractive. Given the income tax recovery, the company's total earnings have been increased by more than 60%, which skews the P/E metric that is reported to investors.

To make a better assessment of just is happening with the company's operations, investors should take a few steps back and consider the company's operating income, which declined over the first three quarters of the year from $1,327 million in 2016 to $1,231 for the current three quarters of the year. The increase in bottom-line profits (excluding the tax recovery) was only a result of lower interest expenses and an increase in other comprehensive income (OCI).

OCI is a term used when a company makes a profit/loss from something that falls outside the daily operations of the business. In the case of Air Canada, it can be profit from the sale of a plane.

Looking behind the curtain to the statement of cash flows, the company is currently trading at a very high multiple to cash flows from operations (CFO). Over the past two fiscal years, shares of Canada's airline have traded between 0.75 and 2.1 times CFO. Assuming that the CFO of $2,349 million over the first three quarters of the year annualizes to $3,132 million, then the company's current share price is actually trading at a multiple of two times CFO. Essentially, shares are trading at the highest possible multiple. Barring an increase in CFO, it is highly unlikely that investors will see any substantial profits in this name.

Will CFO increase?

Although CFO has increased steadily over the past few years, investors shouldn't be holding their breath for another increase. As the company has spent close to $3 billion on capital expenditures in the previous fiscal year and close to $2 billion throughout the first three quarters of this year, investors should expect to see a significant amount of depreciation expenses on the statement of cash flows, which will further reduce the amount of CFO. Given this headwind in addition to the current softness in the airline sector, investors may want to open a short position in this security. For long investors, selling out of this name may be the way to go.

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