If You Like Air Canada, Consider This Small-Cap Alternative

Description

My brother recently asked me about **Air Canada** (TSX:AC)(TSX:AC.B) stock. He'd seen an analyst's comments about the company and wondered what I thought.

Here's what I said in my email, word for word:

"It is definitely the cheapest of the North American airlines. It currently has a free cash flow yield of 12%. Anything over 8% is in value territory. I'm not a fan of airlines, but it's done well since its restructuring out of bankruptcy," I wrote. "They're adding more Rouge planes to compete against WestJet and the other two low-cost carriers coming out."

I don't travel a whole lot, but my wife does, and she always flies Air Canada. She's been satisfied with its performance and service.

Fool.ca colleague Chris MacDonald is a fan of Air Canada. He believes it will do just fine against the competition, domestic or otherwise. I'm a little less confident. I see **WestJet Airlines Ltd.** having some success with Swoop, its ultra-low-cost carrier which begins flying in June.

Throw in Air Canada's pension obligations, which ought to be viewed by investors in the same way debt is, and you've got a shorter runway at Air Canada than most analysts are willing to admit.

What's the small-cap alternative?

It's a little $1 billion market cap based in Halifax that, among other things, flies to smaller communities in Canada under the Air Canada Express banner.

Chorus Aviation Inc. (TSX:CHR) operates under a Capacity Purchase Agreement, or CPA, with the airline; it is paid a fixed fee per plane. It's somewhat of a similar arrangement to your neighbourhood snowplow driver, who is contracted for the entire winter at a single rate. If it never snows, he still gets paid. Only in the case of the CPA, higher fuel prices are passed on to Air Canada; the snowplow driver eats them.

The CPA is valid for the next eight years, providing stable cash flow for its other endeavours, which includes a growing regional aircraft leasing business, Chorus Aviation Capital; it leases regional jet and turboprop aircraft seating between 75 and 135 people to regional airlines around the world.

Launched in January 2017, **Fairfax Financial Holdings Ltd.** (TSX:FFH) bought $200 million in convertible units that pay 6% interest and provide 24.2 million warrants that can be converted to common shares at an exercise price of $8.25 any time after December 31, 2019, and before maturity on December 31, 2024.

I'm a big believer in Prem Watsa. His purchase of $200 million in convertible units is a significant endorsement of what Chorus is trying to do. Expect this segment of the business to grow.

In a further move to provide its leasing business with expansion capital, Chorus just announced a $100 million bought deal at $8.60, which puts a bit of a floor on the share price as it expands from the current 21 aircraft available for lease.

My original recommendation

I'd originally recommended Chorus in November 2016 when it was trading around $6.03. It's up 43% since then, an annualized rate of return of 31%. While that's not too shabby, I see even greater returns over the next 12-24 months as it expands the leasing business.

Out of the eight analysts covering Chorus's stock, seven have a buy rating. The average 12-month target price is $10.69, offering 24% upside along with a 5.6% dividend.

Air Canada has had a big run. Maybe it's time to saddle up to one of its partners instead.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:AC (Air Canada)
2. TSX:CHR (Chorus Aviation Inc.)
3. TSX:FFH (Fairfax Financial Holdings Limited)

PARTNER-FEEDS

1. Msn
2. Newscred
3. Sharewise
4. Yahoo CA

Category

1. Investing

Date
2025/08/24

Date Created
2018/02/23
Author
washworth