RRSP Investors: This Stock Doubled in Value Last Year

Description

Air Canada (TSX:AC)(TSX:AC.B), initially chartered by the federal government, is Canada's largest airline. Remarkably, Air Canada began servicing transcontinental routes as early as 1938. The company has been getting a lot of attention from investors in the Toronto Stock exchange lately due to growing revenue and assets.

Air Canada will present the second-quarter 2019 results on Tuesday, July 30, 2019, before the market opens. Last quarter, investors were pleasantly surprised when reported earnings surpassed analyst expectations. Shareholders may be in store for similar results on the upcoming earnings call.

Air Canada has been busy lately introducing new service lines and adding greater flexibility to manage flight reward bookings.

Due to strong earnings and diligent deleveraging efforts, Air Canada's stock price has surged 100% in the past year from $22.18 to over $40 as of July 19, 2019. Nevertheless, Air Canada investors should be wary of the low earnings relative to the share price, which currently stand at 5.8%. The stock may be reaching a valuation peak, at a high price-to-earnings ratio of 73.38.

Airlines are a capital-intensive business. Airplanes are similar to automobiles in that they require significant maintenance and depreciate quickly. That being said, without a dividend to hedge a possible downward correction, Air Canada may end up disappointing bullish investors.

Air Canada reduces debt

Air Canada has reduced its debt burden by 24% since June 2018, according to the quarterly report released at the end of March. Typically, as companies pay down debt, the stock price tends to increase, and Air Canada is no exception. The price decrease happens for several different reasons, including risk perception and the relative cost of debt versus equity.

Shareholders may see the move to reduce debt as fiscally responsible; investors tend to shy away from highly leveraged stocks as they appear to be less profitable. However, debt is not necessarily a sign of weakness. Frequently, growing companies may strategize a period of losses as it acquires market share.

Additionally, corporations weigh the cost of debt versus equity, influencing market valuation changes. Sustained low interest rates in Canada incentivize companies to issue more debt rather than raise capital, putting downward pressure on the stock's price.

Ironically, investors prefer to purchase more equity than debt in low interest rate environments, which explains why the stock market rises on news of central bank decisions to cut interest rates.

Foolish takeaway

Air Canada may see more value in issuing equity versus debt at its current debt-to-equity ratio of 1.7. Moody's and Standard & Poor's credit ratings on Air Canada's long-term debt stand at Ba1 and BBB-, respectively. To stem a downgrade of its long-term debt, Air Canada may be deleveraging to appease credit analysts.

The deleveraging is good news for shareholders, because it means that the stock price will increase as the company deleverages.

To be on the safe side, however, it might be better to hold off on increasing positions in Air Canada. The stock poses too much risk at its current market valuation, and it could correct to the downside at any time. Despite this, it will be interesting to see how the earnings call unfolds at the end of the month for this high-performing stock.

If the stock misses its target causing a steep drop in value, a buy opportunity may be on the horizon.

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Author
debraray