Attention: Do NOT Buy This Stock for Your RRSP

Description

Air Canada (TSX:AC)(TSX:AC.B) has been flying high in recent years with revenues growing from $10.2 billion in FY 2014 to $13.7 billion in FY 2018. This resulted in the company achieving record-setting net income of $2 billion in FY 2017 for an accumulated net income of $3.5 billion from FY 2014 to FY 2018, despite operating in a highly cyclical industry.

Those of you along for the ride will have enjoyed generous returns in 2019 with the stock soaring 70.73% YTD, which outpaced the S&P/TSX Composite increase of 15.41%

Given that Air Canada is one of only two major airlines in Canada — the other being **WestJet**, which has a fraction of the destinations Air Canada has — Air Canada essentially operates a monopoly over international air travel to and from Canada.

With upward-trending revenues, a positive return on investments, and a monopoly over the Canadian air travel industry, Air Canada seems like the perfect candidate for an RRSP. But it isn't and here's why.

High operating leverage

As of December 31, 2018, Air Canada has total funded debt of $6.7 billion and operating EBITDA of $1.8 billion, which gives it an operating leverage (total funded debt: operating EBITDA) of approximately 3.72 times.

Operating leverage is an important measure for a company, as high operating leverage exposes companies to forecasting risk, which means a small error in predicting revenues can lead to larger errors in cash flow projections.

Given that the company had net operating income of $1.2 billion in FY 2018 and total funded debt of $6.7 billion, the company does not generate enough income to service its debt, which amplifies the risk of high operating leverage, leading to the potential for a cash flow problem.

As the old adage goes, "money talks," which means Air Canada's ability to satisfy its creditors ultimately determines the fate of the company. And currently, it's not a pretty picture.

Fluctuating net income

Despite a first-class performance for revenues trending upwards since FY 2014, net income is left stranded in economy with no clear trend.

Air Canada's net income grew exponentially from $100 million in FY 2014 to $2 billion in FY 2017. It then decreased precipitously to $167 million in FY 2018.

Adjusting for one-time charges, such as foreign exchange, disposal of assets, and income taxes recovered, net income in FY 2017 was $1.2 billion and $550 million in FY 2018, which still indicates a significant drop.

With the grounding of the **Boeing** 737 Max aircraft, this will cause further unpredictability to Air Canada's bottom line.

The bottom line

We should not neglect the fact that Air Canada declared bankruptcy in 2003. Despite this being over 16 years ago, it goes to show that the company operates in an industry where the slightest shift in consumer spending patterns can translate to billions of dollars of losses for the company.

Given Air Canada's high operating leverage and its fluctuating net income, I would recommend against investing in this stock for your RRSP, even though it has achieved record-setting results in the past several years

Don't be fooled by Air Canada's strong performance to date, because what goes up must eventually come down.

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