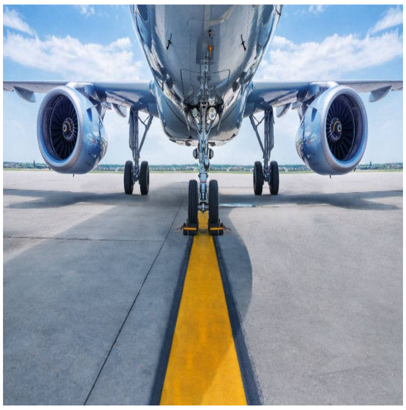

Why Air Canada's (TSX:AC) Stock Price Will Continue its Descent

Description

In a recent article, I'd warned investors that **Air Canada's** (TSX:AC)(TSX:AC.B) stock price was flying too high, and long-term investors should be careful at the $50-per-share level. My rationale was based on fundamentals alone. The company's stock price had begun to run up faster than earnings. This key fact pushed me to step back for a minute and reconsider my bullish position on Air Canada that I have had for years.

As I've pointed out in the past, at a certain price, any company (no matter how solid) can become a sell if the fundamentals do not make sense anymore. This, for me, has been the driver behind my near-term pessimism on Air Canada stock of late. At the time of writing, Air Canada's share price is down 30% from its peak. In my opinion, this reflects the reality that financial markets have been priced to perfection for quite some time. Most investors have been looking for an excuse to sell off positions and take profits at the top.

Coronavirus

For Air Canada, I view this selloff as only the beginning of a broader, longer-term selloff across the airline sector which has yet to fully set in. There are a few reasons for this. Perhaps the most obvious reason I'm bearish on Air Canada in the short term is the understated fact that no-one knows just how pervasive coronavirus is right now. The virus is unique and many factors are unknown. We could still be talking about this outbreak in sic to 12 months from now; it's uncertain how long it will last.

Most folks out there in financial markets want to pretend like they have a PhD in epidemiology right now. Some claim, "this is the same as SARs." Some of these claims may drown out real-world expert data from the WHO and other organizations, which suggests we really don't know how bad things are quite yet.

Cost structure

The second reason I'm bearish in the short term on Air Canada is due to the very sticky nature of this airline's (and most airlines, for that matter) cost structure. Airlines have extremely high fixed costs. They are unable to easily offset these costs, making a pronounced short-term decline in air travel potentially disastrous from a balance sheet perspective. The severity and length of air travel demand decline remains to be seen. But for a heavily unionized company like Air Canada, labour contracts, long-term pension obligations, and airplane leases will not go away, regardless of sector-wide demand.

Bottom line

Air Canada is one of those companies that can perform absurdly well in bull markets. We've seen this over the past 10 years. The company still has some drivers supporting its business such as low oil prices, relatively high load factors (all things considered), and a much better balance sheet than it did 10 years ago. That said, like all airlines, short-term shocks like the coronavirus have the potential to derail earnings for a long period of time. This makes Air Canada too risky at this point in time, even for investors with a long time horizon. I'd recommend waiting at least six months before jumping into Air Canada.

Stay Foolish, my friends.

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