Will the Government Step in to Save Air Canada (TSX:AC) Stock?

Description

Over the past month, **Air Canada** (TSX:AC)(TSX.AC.B) stock has been hit hard by the COVID-19 crisis. Faced with travel bans and customer cancellations, it was forced to shut down almost all international passenger flights. Yesterday, the *Victoria News* reported that Air Canada had laid off 15,000 staff and cancelled 90% of its flights.

The company is trying to make up lost revenue with cargo-only flights, but is still operating far below scheduled capacity.

This raises the question of whether Air Canada will make be able to make it through the crisis on its own. As of its most recent quarter, AC had $8 billion in debt and $4.4 billion in shareholder's equity, giving it a debt-to-equity ratio of 1.8–higher than is normally considered ideal.

A high level of debt to equity suggests that a company may struggle during a business downturn. With Air Canada's earnings likely to be negative for Q1, the company may need government assistance to make it through the crisis if it lasts too long.

Earnings impact of the crisis

It goes without saying that Air Canada's earnings for Q1 will be lower than previously thought. However, it's hard to say in advance how bad they will actually be.

It's beyond dispute that the company's revenue will decline, as 90% of its flights have been cancelled. On the other hand, there could be some pleasant surprises on the expense front.

The price of jet fuel has declined precipitously thanks to the oil price crash, which means lower expenses on the routes Air Canada still operates.

The mass layoff, although a disaster for the country, will help Air Canada keep its expenses in check. Finally, the company has managed to avoid giving refunds to passengers on cancelled flights, after switching to a voucher-based "refund" policy. This move disappointed many passengers–including yours truly — but will stop some of Air Canada's cash bleed.

For these reasons, AC's Q1 earnings will be down from Q4 but may not be *quite* the disaster some are predicting.

Air Canada's financial position

When we look at Air Canada's *long-term* financial position, the issues become more apparent. As of its most recent quarter, Air Canada had $8 billion in long-term debt and $4.4 billion in equity, giving it a fairly high debt-to-equity ratio of 1.8.

Air Canada's $9 billion pile of debt creates massive interest expenses that will be hard to service with lower earnings. In 2019, the company had a $515 million interest expense and $1.65 billion in operating income.

If its 2019 operating profit were cut by about a third, it wouldn't have been able to pay its interest with money left over after operating expenses.

It's therefore not hard to picture a scenario in which Air Canada's operating income falls to a level where it can't service interest. If that happens, we might see AC needing government help to keep operating.

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