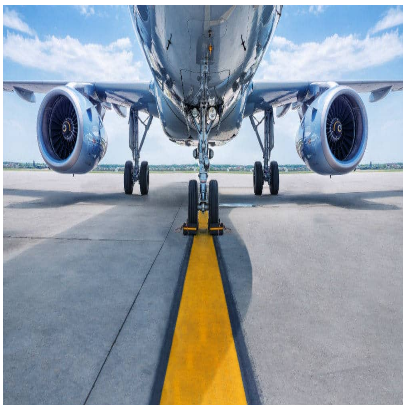

Air Canada (TSX:AC) Stock Is Soaring: Buy the Bounce?

Description

The past three weeks have seen **Air Canada** (TSX:AC)(TSX.AC.B) stock soar, rising 65% from its low on March 19. While the stock is still down 61% year to date, it's been a massive winner for those who initiated new positions on the dip. On its march upward, AC has given investors a volatile ride, but there's no question that its momentum has been positive.

The momentum in question is a little tricky to explain. Air Canada's international passenger flights are basically grounded, and domestic travel is down considerably. All in all, 90% of the company's routes are cancelled with little prospect of restarting in the next two months.

While the company is starting to make up the losses with more cargo flights, that likely won't compensate for the loss of passenger flights.

Which begs the question: why the sudden rally? We've got a company that can't even operate normally without enough cash on hand to cover a year's expenses. If the pandemic goes on long enough, AC could be at risk of bankruptcy. Yet investors are pushing the stock higher.

It seems paradoxical — and it is. To gauge whether the stock is worth buying, we need to understand whether its price movement is rational. Let's explore the reason for the bounce.

Why Air Canada stock is up

The most basic explanation for Air Canada's rally is that investors thought the stock had gotten undervalued and bought in. Going purely off last year's earnings, that makes sense. AC trades at just 3.7 times trailing earnings. Its stock costs less than book value per share, so it's undeniably cheap.

Additionally, there has been some moderately good news out of the Air Canada recently. A few weeks ago, it announced that it was increasing cargo flights to make up for lost passenger flights. Later, the company announced that it would be rehiring the company's 16,000 laid off workers.

That latter development was thanks to a federal wage subsidy, so we're starting to see Trudeau's massive stimulus package pay off for Air Canada.

Why it might not be the best buy

Despite all of the above factors, however, Air Canada may still not be a good buy.

For one thing, after rising 65% from its bottom, AC is no longer quite the bargain it once was. A 3.7 P/E ratio is still low, but remember that's based on *trailing* earnings.

Nobody knows what Air Canada will earn this year, but it will be a lot less than last year. So the stock may actually be expensive compared to forward earnings.

Second, there's the risk of insolvency. Air Canada has gone bankrupt before and could go bankrupt again. The company has a mountain of debt, with about $500 million a year in annual interest expenses. If you decreased last year's operating income by one third, it would have barely been enough to cover interest.

As well, the company is now facing a class action lawsuit from customers who were refused refunds. None of these are good signs for Air Canada's financial picture.

Finally, there's the matter of getting back to business as usual. Nobody really knows how long the COVID-19 travel restrictions will last.

What we do know is that the longer they last, the worse Air Canada's financial position will get. If the situation really drags out, the company might need a government bailout. Overall, it looks like a risky horse on which to bet.

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