WARNING: An Air Canada (TSX:AC) Bailout Won't Save Investors!

Description

Recently, there has been a lot of speculation that **Air Canada** (TSX:AC) could get a bailout from the federal government. As an airline, it's unable to operate normally during the COVID-19 pandemic. It has reportedly cancelled 90% of its flights, which will lead to a huge revenue decline.

Further, there are indications that the company is running out of cash. Recently, *Vice* reported that passengers were denied refunds because Air Canada didn't have the money to fulfill them. These signs point to a cash-strapped company that can't stay afloat through a business shutdown for long.

Being an indispensable business for the country, Air Canada would likely receive a government bailout if it were in serious trouble. On the surface, that looks like a good thing. For employees and passengers, it is. A government bailout could keep Canadians flying and keep over 15,000 workers employed. However, it wouldn't necessarily be great news for shareholders. Here's why.

A bailout could dilute equity

The big problem with bailouts is that they have the potential to dilute equity. If a company is bailed out with low-interest loans, that's usually not a problem. But if the entity bailing out the company demands an equity stake, that dilutes shareholder value.

Let's imagine, for example, that Justin Trudeau stepped in and offered Air Canada $1 billion in cash in exchange for $1 billion worth of shares. That would mean that new shares would have to be issued, and existing shares would represent a smaller claim on the company. The result? If all other things are the same, lower earnings per share.

Of course, if the money is spent wisely, then it could make the dilution worth it. But that's not a guarantee.

Why that could be bad news for investors

An Air Canada bailout would be bad news for investors if it failed to turn things around for the company.

As previously mentioned, equity dilution can be fine if the proceeds generated are used productively. If you double the number of shares in an equity funding round, and quadruple the company's earnings with the funds raised, you double shareholder value.

That all hinges on funds being spent productively, however. If equity-raised funds are wasted, then dilution just means less earnings and book value per share.

In Air Canada's case, it's not certain that bailout funds could used as growth fuel. If Air Canada really is running out of money, then it's possible that a bailout would do little more than keep it from bankruptcy.

The company would need $515 million to pay its 2019 interest expenses alone. If it gets a bailout around that size and does nothing with the money beyond avoiding financial collapse, then investors will suffer. Most likely, they won't suffer as severely as they would in an all-out bankruptcy, but they'll suffer enough to make AC not worth owning at today's prices.

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