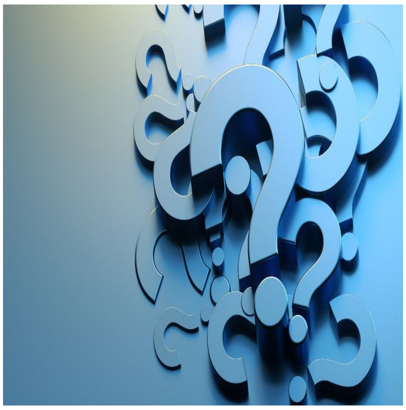

Is Air Canada (TSX:AC) Going to Get Swept Up in the Oil Price Recovery?

Description

With jet fuel being the single largest operating expense for **Air Canada** (TSX:AC), the direction of jet fuel prices has the ability to significantly impact the bottom line of Canada's largest airline. Jet fuel prices are up almost 15% in North America in the past month but are still down over 60% from one year ago. Further rising jet fuel prices could add another challenge to the laundry list of problems that Air Canada faces in the rest of 2020.

The impact of the price of jet fuel on Air Canada's bottom line

Air Canada saved $161 million in fuel costs in Q1 2020 compared to Q1 2019. While most of these cost savings were a result of consuming less fuel, $75 million of these savings were attributable to reduced jet fuel prices. While this may seem like a small amount of money for a company that pulled in almost $4 billion in revenue, it is important to consider this expense in context.

First, Air Canada had an operating loss of $433 million in Q1 2020. The Q1 loss would have been over 15% higher had there been no savings attributable to the drop in fuel prices (excluding the drop in consumption).

Second, airlines have notoriously small profit margins, and Air Canada's net income margin in Q1 2019 was just under 8%. If Air Canada lost the benefit of the $75 million in cost savings due to the drop in fuel prices, it would need almost $1 billion in additional revenue, at Q1 2019's net income margin, to offset the loss of savings on jet fuel.

While $75 million in savings attributable to the drop in jet fuel prices may seem insignificant, if jet fuel prices rise significantly faster than demand for air travel, this could be problematic for airlines like Air Canada.

A possible hedge

Concerned investors in Air Canada who do not want to sell but are worried about further downside, could potentially look to somewhat hedge Air Canada exposure by adding shares in **Suncor Energy** (TSX:SU)(NYSE:SU). Suncor stands to benefit from any rise in crude oil and jet fuel prices and has many other catalysts, including the construction of the Keystone XL pipeline, which should provide support for the stock.

Suncor has been significantly impacted by the recent oil price collapse. This is clear considering that Suncor recently slashed its quarterly dividend by 55% to $0.21. However, Suncor should benefit if oil prices continue to rise, especially given that Western Canadian Select (WCS) is trading at approximately a 15% discount to West Texas Intermediate (WTI). This is a far smaller discount than we have seen as recently as late 2018, when WCS traded at over $40 less than WTI, or over an 80% discount.

Furthermore, Suncor's ownership of the Petro-Canada retail network should provide an added boost, as more and more people begin to venture out into the world and drive as lockdown orders are gradually lifted. Refined products like gasoline will help insulate Suncor from wild oil price gyrations better than more upstream dependent peers and make it a somewhat safer stock to hold as a hedge for rising oil and jet fuel prices in the medium to long term.

Takeaway

It is impossible to tell when demand for air travel will return. There are still many unknowns surrounding the timeline for the lifting of lockdowns, the development of vaccines, or the pace of recovery in the labour market. However, the drop in jet fuel prices has been a silver lining to Air Canada, and the loss of this windfall would be a significant challenge for Air Canada, especially if jet fuel prices rise significantly faster than air travel demand.

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