Air Canada’s (TSX:AC) Latest Move Proves Warren Buffett Right

Description

In May, Warren Buffett held an online shareholders’ meeting, where he revealed that he had sold his entire position in airline stocks. It was a rare move for Buffett. Known for holding the course and buying the dip, he did the exact opposite this time — selling right along with everyone else. The move prompted a lot of speculation, with the general tone being that Buffett had lost his touch.

Now, however, it’s beginning to look like Buffett was right. After selling his airline stocks, Buffett hinted that air travel would could be down for two or three years to come. Shortly afterward, Air Canada released a Q1 earnings report saying almost the same thing: that revenue could take three full years to climb back to 2019 levels. Citing the possibility of prolonged lower passenger levels, the airline cautioned investors to brace for some bad years.

Now, we’re beginning to see the financial effects.

Just recently, Air Canada made a move that was in keeping with Buffett’s thesis for selling airline stocks — a move whose effects won’t disappear even when revenue levels do recover. This action by the company could keep its shares down even in a year of record profitability. And it won’t be easy to reverse.

Air Canada is issuing new shares

In May, Air Canada announced it was raising $575.6 million by selling 35.4 million shares at $16.25 a piece. Later, the value of the issuance increased when the airline added $1 billion worth of convertible bonds. Convertible bonds can be easily converted to stock, making this effectively equivalent to an equity issue.

What all this means is that Air Canada now has millions more shares outstanding than it did before. As a result, each share has a smaller claim on earnings, and that claim could get smaller still if bondholders exercise their conversion rights.

Why this is bad news

A mature company selling equity to raise money for operating expenses is generally not a good sign. While the funds may be necessary, the fact that the company has to resort to it means it's in rough shape. As previously mentioned, the more shares are issued, the smaller each share's claim on earnings. That means that the company has to generate a higher amount of profit to get the same earnings per share it would have earned before the issue.

This is a big part of the reason Warren Buffett sold his airline stocks. In his shareholder meeting, he said that prolonged lower revenue would lead to equity financing to cover expenses. Airlines are capital-intensive businesses, and they can't operate without money coming in for long. As we've seen with Air Canada, that reality has translated into dilutive equity issues and increased debt. So, despite all the criticism Buffett took after selling airlines, his thesis was correct.

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