CAUTION: The Recovery in Air Canada (TSX:AC) Comes With a Lot of ifs and buts

Description

Air Canada (TSX:AC) stock has had a significant run-up since hitting its March lows amid the coronavirus pandemic. I pinched myself to believe that the stock has bounced back over 90% in less than three months, as I maintain a bearish view on the stock.

The optimism over the resumption of flights and gradual reopening of the economy drove Air Canada stock higher. However, investors should keep in mind that there are still a lot of ifs and buts when it comes to investing in Canada's biggest airline company; the rally in the Air Canada stock could be short-lived.

Resumption of flights is not the only solution

Air Canada is set to resume domestic flights in July, but it will be limited to once a day initially. Also, investors should note that flying is not the only solution for the airline companies, as the planes not flying efficiently and in full capacity will continue to put hurdles. Running a half-empty plane would only increase costs and add to the losses.

Investors should note that the airline companies spend a significant portion of their revenues on operating expenses, implying that the planes should be flying with at least 70-80% capacity to break even. As for Air Canada, it spends about 90% of its revenues to meet its operating expenses. A sudden pause in its domestic and international operations in March hit its revenues severely and led to a net loss of over $1 billion in the first quarter. Notably, this was the first time in the last 27 consecutive quarters when Air Canada did not record a year-over-year increase in its operating revenues. Besides, it was forced to lay off almost half its workforce to cut back costs and stay afloat.

I do not expect the demand for international flights to return anytime soon, as people could continue to refrain from travelling abroad due to the health risk posed by the COVID-19 outbreak. Meanwhile, with just domestic flights in operation, Air Canada's revenues will be significantly impacted along with higher cash burn.

Bleak future

The COVID-19 crisis will continue to be a major overhang on Air Canada's operations for the foreseeable future. Air Canada itself does not expect to generate revenues and capacity of 2019 levels for at least three years. In light of the COVID-19 outbreak, Air Canada has reduced its capacity by 85% to 90% for the second quarter. Moreover, it plans to reduce its capacity by 75% in the third quarter.

Recently, the company raised funds to infuse liquidity and cover its working capital needs. These measures are likely to help the ailing airline company to stay afloat. However, I do not expect the traffic to return to normal in the near term. Besides, the international business and leisure trips could continue to remain low and take a toll on its revenues and margins. Rising debt level is also a concern for Air Canada. Undoubtedly, it will be a challenge for Air Canada to return to the pre-pandemic levels soon.

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