Fitch Downgrades Air Canada (TSX:AC): Are Dark Clouds Ahead?

Description

Air Canada (TSX:AC) stock has fallen about 21% in the last five trading days, as troubles continue to mount for the beleaguered airline company. On June 15, Fitch downgraded Air Canada's rating, citing slower recovery.

Fitch lowered Air Canada's long-term issuer default rating to BB- from BB, with a negative rating outlook. Besides, the rating agency also dropped Air Canada's existing unsecured notes to B+/RR5 from BB/RR4. Fitch stated that the airline company has ample liquidity that will help it to sail through the crisis. However, the significant impact of COVID-19 on its business in 2020 and slow recovery in 2021 remain a drag.

In my previous article on Air Canada, I'd stressed that I do not expect international traffic to return anytime soon, and people could continue to avoid traveling abroad. Besides, operating with just domestic flights will only add to its losses.

Fitch's basis for the downgrade follows the same logic. The rating agency expects Air Canada's over-dependence on international traffic to hurt its recovery process. The health risk associated with international travel is likely to take a toll on traffic, in turn, its prospects.

Now what?

Before the recent fall in its price, Air Canada stock witnessed a sharp recovery, as investors bought the airline company's stock due to optimism over the reopening of the economy and the resumption of domestic flights. However, even if the company resumes operations, lower capacity is likely to hurt its profitability.

The threat of the virus is far from gone, and the second wave of the pandemic in China further plays spoilsport and could lead to protracted recovery.

I believe the pandemic-led demand destruction is likely to be a major hurdle for the stock in the foreseeable future. The airline company is planning to operate with a drastically low capacity to contain the spread of the virus. The company expects to fly with a capacity of 10-15% in the second quarter. Meanwhile, it plans to operate at 25% capacity in the third quarter. Such lower traffic could only lead to losses, even if the company strips out a lot of costs to stay afloat.

I have doubts about Air Canada's recovery pace and don't expect the company to see pre-pandemic level traffic till 2022. The company itself expects to take about three years to reach the pre-pandemic level capacity and revenues.

Bottom line

Air Canada stock is down about 62% so far this year. The massive decline in its value might have caught your attention. However, investors should note that the decrease in Air Canada stock is due to the good reasons, with the recovery still not near.

Air Canada is likely to report a significant amount of loss in 2020. Meanwhile, its bottom line could return to the growth path in 2021. However, given the persisting challenges and uncertainty, earnings could remain very low. What's alarming is the company's rising level of debt. Air Canada's net debt increased from $2.84 billion as at December 31 to $4.17 billion as of March 31. Lower revenues, decline in profits, and rising debt indicates that this might not be a good time to invest in Air Canada stock.

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