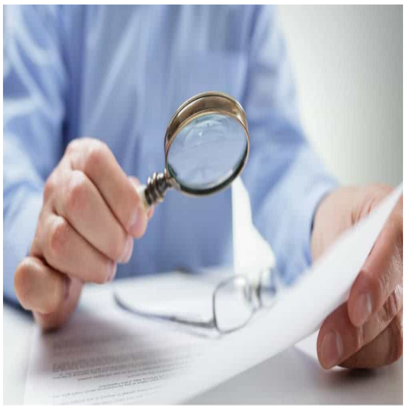

The Next 3 Years Are Crucial for Air Canada (TSX:AC)

Description

Air Canada (TSX:AC) stock is down 60% and is trading between $14 and $19 over the last three months. The big question is whether or not to buy this stock at the dip. Many of our analysts are humming the same answer; the shares are surrounded by uncertainty, and Air Canada's recovery is years away. They are right, because the next three years are the most crucial for AC, as this period will determine its survival.

Air Canada's priority is to increase liquidity and reduce cash burn

In times of emergency, the priority is to mitigate the losses. Airlines worldwide are burning cash, as their planes stay locked in hangars instead of flying in the sky. They have to bear the fixed operating cost while earning less than 20% of their revenue. The need of the hour is to keep the planes operational so that when travel bans lift and demand resumes, their aircraft are ready to take off. For this, airlines need cash.

During the second quarter, AC has added $3 billion in liquidity through equity and short-term debt to meet its working capital and financial commitments. It is also looking to secure an additional debt by putting its unencumbered assets as collateral. The airline is burning $20 million in cash every day. Hence, it is cutting jobs, retiring older aircraft, renegotiating contracts, and flying more cargo jets to reduce the cash burn.

International travel will take three years to recover completely

In the last 20 years, airlines have undergone many crises, including the terrorist attack in 2001, the SARS epidemic in 2003, and the financial crisis in 2008. But none of these crises banned flights. The COVID-19 crisis has seen the Canadian government ban all non-essential international flights from March 21 to July 21. Four months of no flying has buried AC in billions of dollars of losses.

In the pre-pandemic period of 2019, AC took an entire year to earn $2 billion in free cash flow, and it is now burning that much cash in just one quarter. It will continue to lose money until international travel resumes significantly, and it can fill more than 80% of its seats per flight with passengers. AC CEO Calin Rovinescu does not expect international travel to return to the pre-pandemic level before 2023. This means it will take the airline at least three years to stop cash burn.

In these three years, the airline will accumulate billions of dollars in losses and long-term debt. If there is a second wave of coronavirus, and the Canadian government extends international travel bans, AC might file for bankruptcy even before three years. But if international travel resumes faster than expected, AC might survive the pandemic.

Profit is years away for Air Canada

Even after the pandemic is over, AC will take many years to return to profit. Back in November 2002, AC faced the SARS pandemic. It took the airlines seven long years and one bankruptcy (from April 2003 to September 2004) to return to profits. Unlike the COVID-19 pandemic, the company was still flying its planes during the SARS epidemic.

Even though AC is in a much better financial position than it was in 2003, the COVID-19 pandemic is worst than SARS. The first major hurdle for the airline is to withstand weak demand and avoid bankruptcy. If it succeeds, it will take another five years to return to profits. It will have to report profits for two to three years in a row before investors feel confident about the stock.

Bottom line

Even at $19, AC stock is costly, as it is trading at 106 times its last 12-month earnings per share. By year-end, the stock could fall below $10 if there is a second wave of the pandemic. It could also rise to as much as $30 if international travel improves faster than expected.

However, the stock is unlikely to return to a growth trajectory before three to five years. In this period, the most significant risk is a possible bankruptcy, which would leave its equity stocks worthless.

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