



## Why Air Canada's (TSX:AC) Credit-Rating Downgrade Is Bad for Shareholders

### Description

Recently, the credit rating agency **Fitch** downgraded **Air Canada's** ([TSX:AC](#)) issuer default rating to BB-. That's a medium-low score on the rating scale, indicating an "elevated default risk." While this isn't the first time Air Canada has received a BB-, it's the company's first downgrade since the COVID-19 crisis began. The downgrade comes after Air Canada's massive \$1.6 billion financing package, consisting of both equity and debt.

It's not always big news when a company sees its credit downgraded. Air Canada's downgrade, however, comes during a period of close public scrutiny. The company is facing pressure from all sides, with government wanting more safety, shareholders wanting more flights, and passengers voicing various concerns depending on their perspective. As a result, AC's downgrade has received a lot of attention and wide publicity.

### What the downgrade means

When a rating agency downgrades a company's debt, that can mean a number of different things. It depends heavily on what range the company's credit rating was previously in and how much it was downgraded by. For example, a downgrade from AAA to AA just means a lower rating within a range of excellent ratings, while a downgrade from AAA to D means a dramatic fall off in a company's credit worthiness to nearly guaranteed default.

Most credit downgrades are incremental, but occasionally you'll see a company dramatically downgraded in one cut. For example, **Occidental Petroleum** was downgraded by three levels in March due to the oil price collapse at the time.

In Air Canada's case, the downgrade was fairly incremental. The company had been sitting at BB before the update and was [reduced to BB-](#) afterward. That's a decline of just one level. However, BB is already low ("non-investment grade") on Fitch's rating scale. A decline of just one more level would take Air Canada to B, which is very speculative and could make borrowing difficult.

## Higher financing costs

At first glance, it might look like a bond rating cut isn't a big deal for shareholders. Shareholders don't hold a company's bonds, so why worry about it?

The truth is that credit ratings are [very much a concern for shareholders](#). A low credit rating is an indicator that a company's finances are unstable, which is bad for shareholders and bondholders alike. More importantly, a credit downgrade can increase financing costs. When a company's financial situation declines, bond investors demand higher yields, all else equal. Companies can't easily get around this.

If Air Canada were to issue bonds at a low coupon rate, bond buyers would bid the offering down until the yield reached a level they considered appropriate. So, the company would ultimately incur the costs that the market demanded. This would make Air Canada's financing costs higher than they would otherwise be, leaving less residual value for shareholders.

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