The $4.5 Billion Time Bomb That Could Sink Air Canada (TSX:AC)

Description

Air Canada (TSX:AC) is facing a lot of problems in 2020. Between travel bans, forced lockdowns and an 89% decline in revenue, the company is in real trouble. While the broader **TSX Index** has been rising in recent months, AC remains in the gutter, thanks to the long-term problems it's facing. That should come as no surprise.

Air Canada's own management forecasts that it will take three full years just to get back to 2019 revenue levels, indicating a company that will not walk off COVID-19 any time soon.

Indeed, all the problems just mentioned are severe. But there's one problem that, when taken in context, could be the real death knell of Canada. It's a $4.5 billion "time bomb" with the potential to bankrupt the company. While all the other problems Air Canada is facing are temporary in nature, this one isn't going anywhere. And when *combined* with those other problems, it could get much worse.

So what is this $4.5 billion "time bomb," and how could it explode in investors' faces?

A mountain of debt

As of its Q2 quarterly report, Air Canada had $4.5 billion in net debt. That is, in short and long-term debt minus cash and equivalents. This means that Air Canada has $4.5 billion more debt than it has liquid assets. Two things are worth noting about this:

- Air Canada's net debt is nearly as much as its market cap ($4.7 billion as of this writing)
- Net debt increased by $1.25 billion in the second quarter, so the company's indebtedness is on the rise

The two facts above are alarming. They indicate a company whose net debt its rapidly exceeding its market value and is becoming more indebted by the day.

Why it could crash the company outright

The reason Air Canada's net debt is such a problem is because it comes with large interest expenses.

In Q2, Air Canada had $149 million in interest expenses, compared to $130 million in the same quarter a year before. That might not seem like a big difference, but remember that the company's revenue in the prior year quarter was about $4 billion higher. In Q2, Air Canada did just $527 million in total revenue.

Interest expense was nearly a third of that. If Air Canada can't get its routes back up and running again in the near term, then its debt will keep increasing, and its interest expenses will take a larger and larger bite out of revenue. In the end, earnings will fall lower.

Foolish takeaway

For value-oriented investors, it's always tempting to buy stocks "on the dip." Beaten down stocks have more room to grow, and everyone says to "buy when there's blood in the streets."

That makes sense sometimes, but in Air Canada's case, it doesn't. With its ever mounting pile of debt and still-frozen operations, the company is going to see low earnings for at least a few more quarters. Its stock therefore still probably has further to fall.

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