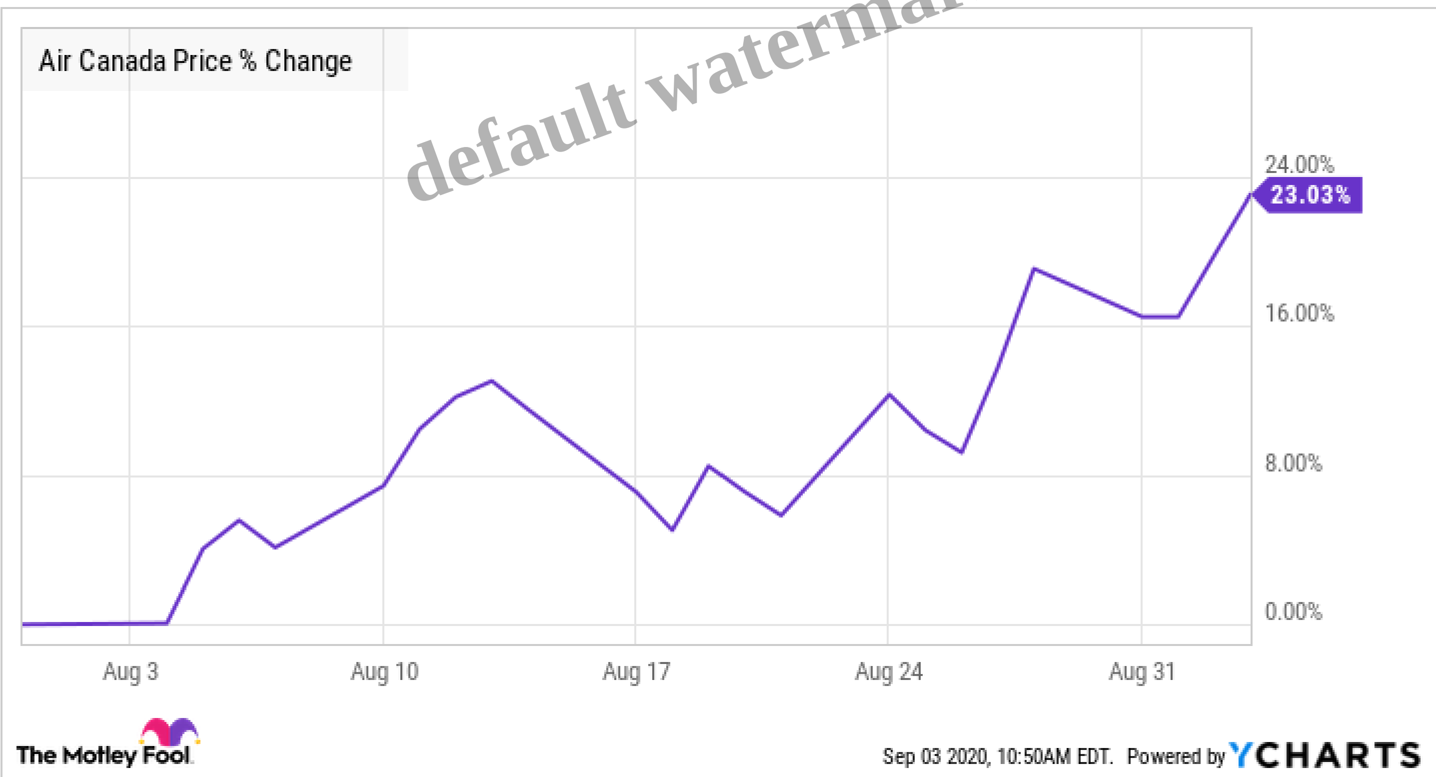
Can Air Canada (TSX:AC) Stock Continue its Rally?

Description

Air Canada (TSX:AC) stock just appreciated close to 23% in the last month. However, this is only the beginning of a long (but volatile) climb up.



AC data by YCharts.

The economic-sensitive stock is trading at a cyclical low. Since the March market crash, Air Canada stock has been consolidating in the range of roughly $12.50 and $22.50.

At about $18 per share at writing, the airline stock has a long way to recovery.

Why Air Canada stock is depressed in the first place

Before we get too excited about the past month's rally, let's review why the stock is down so much in the first place.

The COVID-19 pandemic alongside government-imposed restrictions on air travel to minimize the spread of the virus pretty much wiped out the demand for air travel with Air Canada.

This resulted in a whopping drop of 89% in Air Canada's revenue in the second quarter versus Q2 2019, which was piggybacked with an operating loss of more than $1.5 billion for the quarter.

The company's results in the first half of the year (H1) show a bigger picture of the pandemic impacts. Revenue dropped 54% to $4.2 billion against H1 2019. Losses were softened by a substantial reduction in operating expenses by about 28%.

Accordingly, the stock is trading about 59% lower than a year ago.

AC data by YCharts.

Surviving and on the path to recovery

Air Canada has the financial strength to stay afloat for more than a year. Its current and quick ratios are 1.2 times and 1.1 times, respectively, which have improved from 0.9 times and 0.8 times a year ago.

The company was able to increase its liquidity to $9.1 billion as of the end of Q2. Along with its cost-cutting measures, including permanently retiring 30% of its fleet, the company can survive more than 1.5 years based on its projected Q3 cash burn levels of about $1.5 billion.

As restrictions ease and air travel demand increases, the cash burn will diminish, and the deadline will extend.

The Foolish takeaway

Airline stocks like Air Canada outperform in a growing economy. If you believe the economy will grow over the next five years and you have that long an investment horizon, you can go for a position in Air Canada stock.

It's more likely that the stock will rally higher before the economy and air travel outlook is much brighter. For example, it can pop when it announces a lower cash burn level.

From 2014 to 2019, Air Canada stock delivered annualized returns of close to 37%. That's more than a six bagger! During that period, the U.S. stock market generated annualized total returns of close to 11%.

In the next 12 months, analysts have a price target of $21.80 per share on the stock, which represents 19% near-term upside potential.

My long-term price target on the stock is about $40 per share. So, I believe Air Canada stock can more than double investors' money over the next three to five years.

However, it needs to break above multiple resistances before it can do that. The first resistance is at $22.50 per share. So, watch for that closely. When it solidly breaks above that level, it may be a good time for new money to jump in.

Airline stocks are high risk and potentially high-reward investments right now. So, it may not be suitable for everyone. If you do take a position, take note of your allocation size. For example, you might not want it to exceed 2% of your portfolio.

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