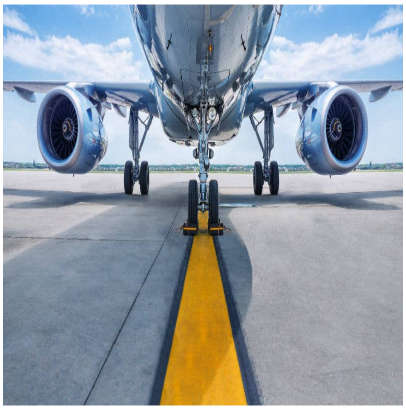

Air Canada Receives a Government Bailout: What's in it for Stock Investors?

Description

After a long wait, **Air Canada** (TSX:AC) stock investors received the news that the ailing airliner finally received a government bailout on Monday. In a deal that I would say minimizes potential dilution and maximizes liquidity, the government of Canada is availing up to $5.88 billion in fresh funding to Air Canada. The funding should allow AC to make good on customer refunds, reopen regional routes, and even increase its fleet, but is this the deal that Air Canada stock investors would have preferred right now?

Minimal dilution for maximum liquidity

On top of over $650 million in gross subsidies given to the struggling airliner in 2020, the federal government is availing $1.4 billion, seven-year term unsecured loan at 1.2% interest. This will facilitate airline customer ticket refunds for canceled flights during the COVID-19 pandemic.

Another $1.5 billion secured revolving credit facility is available at a 1.5% interest premium to the Canadian Dollar Offered Rate (CDOR). The three-month CDOR stood at 0.435% on Monday. Canada is also availing up to $2.48 billion in three unsecured credit line tranches to the airline. The unsecured loan tranches will attract interest at rates ranging between 1.75% and 9.5% per annum if extended beyond five years.

On top of the loans extended, the federal government has also bought a $500 million equity stake in the airline.

Although the airliner issued new equity at a 14.2% discount to Monday's closing price, the new shares increased outstanding share count by 6.4%. Considering the 14,576,564 warrants issued to the financier, the company could issue up to 10.8% more shares in total. However, the warrants will bring new liquidity when exercised at $27.27 a share over the next 10 years.

Considering how bad the airliner's financial situation is right now, I doubt if there was any new investor who would extend multiple billions to the business, demand so little equity interest, and yet offer concessionary-priced, long-term loans. In that regard, the airline has received massive liquidity and exposed its equity investors to as minimum dilution as possible.

A welcome bailout?

There are several angles from which we could evaluate Air Canada's latest bailout.

On the positive side, we can see that the federal government is accepting a limited influence in a profit-oriented business. The extended loans are more than fairly priced. Further, the deal limits government voting power to only 19.99%.

The limit to government influence is only necessary. Profit-focused investors may not be inclined to the idea of having a non-profit-oriented investor wielding significant influence in the airliner's day-to-day operations and strategic decisions.

It's, therefore, encouraging that the bailout has been structured in favour of more debt and low equity. Debt is always cheaper than equity. Once paid off, the company becomes free from any obligations to the lender past the final payment. On the contrary, equity investors will demand performance and benefits forever.

That said, Air Canada is now saddled with much more debt on its balance sheet. Interest costs will be a recurring burden for years. The company is better able to ride out an elongated pandemic, but the interest burden could be very significant to a lean operation. I am not so confident if re-opening non-viable routes, (as part of the deal's provisions) will help contain the airliner's cash bleed. However, the company is now better positioned to survive 2021.

The airliner will release if first-quarter earnings report in the morning on Friday, May 7.

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brianparadza