Air Canada (TSX:AC): Understanding the $5.9 Billion Bailout

Description

The airline-specific bailout is finally here, and **Air Canada** (TSX:AC) is the first and the biggest beneficiary of the taxpayers' money. Then why is the stock falling? Why are analysts lowering their price target? The only reason is the equity dilution. In the $5.9 billion bailout, there is a $500 million equity component.

The Canadian government has equity warrants that give it a right to own around a 5% stake in Air Canada with immediate effect. The government has more equity warrants that it can access over the next 10 years as and when AC accesses bailout money in the form of unsecured loans. This has gotten investors worried; is the bailout a good option?

Air Canada's financial condition before the bailout

When the government announced the sizeable $5.9 billion bailout, the amount attracted investors. This is the amount AC needs to stay afloat for another year, as its financing avenues start drying up. Last year, the airline raised $6.78 billion through a series of equity and debt funding. The cost of raising this money was high, as the unsecured loans came at interest as high as 9%.

AC was gradually pledging most of its assets to get lower rate secured loans. As of December 2020, it had $8 billion in liquidity and $1.7 billion in an unencumbered asset pool left to raise more secured loans.

The airline is burning $1.44 billion in cash every quarter. At this rate, AC could deplete more than 70% of its liquidity by the end of 2021, making it difficult to meet its working capital requirements by 2022. With the third wave of the pandemic diminishing hopes of the return of international air travel this year, the bailout comes as a breather.

AC CEO Michael Rousseau noted that the bailout provided insurance to the airline. He said, “Most importantly, this program provides additional liquidity, if required, to rebuild our business to the benefit of all stakeholders and to remain a significant contributor to the Canadian economy through itsrecovery and for the long term.”

How will the bailout help AC rebuild its business and benefit shareholders?

Understanding Air Canada’s bailout

In the bailout, the government gave AC $1.4 billion in seven-year unsecured loans at 1.211% to pay ticket refunds. This means the government cannot seize AC’s assets if it doesn’t repay the loan. This money will help the airline win back customer loyalty and encourage travelers who were hesitant to book a flight over the fear of losing ticket money. Note that this refund is for passenger who bought the non-refundable tickets, but their flight got cancelled. The airline claims to have already returned $1.2 billion on refundable tickets.

The government gave three more unsecured loans worth $2.475 billion with five-, six-, and seven-year maturity. These loans have interest ranging from 1.75% to 8.5%. The next five years are critical for AC’s survival. It needs cheap finance to withstand the grounding of planes and return to flying at competitive prices.

The airline will use the unsecured loans to prepare for reopening. It will buy 33 Airbus A220 aircraft and 40 Boeing 737 Max aircraft over the next few years. The new fuel-efficient aircraft will help AC reduce operating costs.

The government doesn’t want AC to misuse taxpayers’ money. Hence, the airline will pay decent interest on the unsecured loan. The more from the loan amount that AC withdraws, the more equity stake the government gets. AC cannot give dividends, do stock repurchases, or give more than $1 million in employee compensation during the loan term. This will protect investors from the risk of management misusing the bailout money.

Final thoughts

The bailout terms will protect investors interest and help AC get back to its feet when the skies reopen for flying. For the long-term benefits the bailout brings, a 10% equity stake is a reasonable price to pay. But this doesn’t change the fact that AC is a risky stock with no sustainable upside potential. Instead of parking your funds in risky stocks, there are better growth stocks to consider.

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pujatayal