Will the $5.9 Billion Bailout Save Air Canada (TSX:AC) From COVID-19?

Description

Air Canada (TSX:AC) investors had a bearish reaction to the Canadian government's $5.9 billion bailout package. The stock price jumped upon the hopes of a bailout. But the bailout terms have put the stock under pressure. AC stock price is hovering around $25 at the time of writing.

It is probable that the terms of the bailout, especially the part where the Canadian government could pick up a 9.7% stake in AC, spooked some investors. But there is also a bright side to the bailout. Here I will explain how the bailout package will save Air Canada from COVID-19's wrath, despite the equity dilution risk.

Air Canada's deal with the Canadian government

The bailout package for Canada's biggest airline comes with an array of terms and conditions. Some of them are positive for the airline. For instance, the $1.4 billion loan to process ticket refunds will help AC restore trust among travelers.

Some bailout terms could be onerous. For instance, AC has also agreed to restore service on suspended regional routes. The demand might not rebound quickly enough on these routes because of the third COVID-19 wave that has hit Canada. So, it will be hard for AC to make flights profitable in the short term. For a company burning $15-$17 million per day, loss-making flights could be devastating.

Apart from this, AC has agreed to cap executive compensation at $1 million, restrict share buybacks, stop dividend payments and retain its workforce at the April 1 level. They will complete the deals for 33 Airbus A220 and 40 Boeing 737 Max aircraft as well. They will also continue to access the Canada Emergency Wage Subsidy (CEWS) in 2021.

The bailout will act as a ventilator for AC until air travel demand returns

COVID-affected Air Canada was severely in need of help when the pandemic hit last year. The whole world came to a standstill as COVID-19 paralyzed the airline industry. AC took on a lot of debt to stay operational which more than tripled its debt-to-equity ratio. Since then, waves of COVID infections have stopped the airline from staging a proper recovery.

Canadian government's bailout for Air Canada came before it was too late. Mass inoculation campaigns have stepped up around the globe. There is hope that the vaccines will control the pandemic. And hopefully, demand for air travel will begin to return soon.

Until then, the $2.475 billion in unsecured loans will prove to be the most significant part of the bailout package. It will serve as a life line for the airline because it will provide AC access to credit without putting up anything as collateral. Currently, the airline does not have enough assets to put up as collateral to secure a loan that huge.

Access to easy credit is the need of the hour for AC. This is because the airline will have to endure significant cash burn until demand for leisure travel returns. While the company utilizes a portion of this loan in the first five years, the interest rate will be less than 2%. This is far below the 9% interest the company is paying for the unsecured loans they raised last year. This low interest bailout loan is a big positive for AC.

Foolish takeaway

The recent panic selling was a knee-jerk reaction. While Air Canada's equity dilution over the next 10 years poses a risk, the bailout will support the airline to not succumb to COVID-19. You can expect volatility in the stock until the airline begins to generate enough revenue to break even. That could take many years, provided the mass inoculation campaign proves to be effective in controlling the pandemic.

If you are looking for an investment in the medium term, there are better stocks with growth prospects.

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Date
2025/09/12
Date Created
2021/04/20
Author
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