Air Canada Earnings Preview: What Investors Need to Know

Description

Air Canada (TSX:AC) is set to release its first-quarter earnings on April 26. This range-bound stock continues to face the aftermath of the pandemic with net debt of $7.12 billion. Although the airline is seeing a recovery in travel demand, high oil prices are eating up its chances of profits. An average fuel cost of $83.9 per litre turned the airline's positive third-quarter net cash flow into negative cash flow in the fourth quarter. The upcoming earnings will highlight the financial and operational impact of the Russia-Ukraine war on Air Canada.

Watch out for the war impact on Air Canada's earnings

Air Canada was recovering from the pandemic, and now a new challenge has come. In February, travel between Canada and other countries increased by over 250% but was still lower than the pre-pandemic level. And then came the war on February 24, which significantly impacted airlines on various fronts. Airlines are re-routing their flights to Asia, as Russia banned western airlines from using Russian airspace. Longer routes have increased the cost per flight when fuel prices are above US$100/barrel. There are also some aircraft stuck in Russia.

Air Canada avoided using the $4 billion bailout money, as the pandemic recovery led to pent-up demand. But now, it is facing a challenge to meet the travel demand with high inflation and tense international airways.

In the upcoming earnings, look for four things:

- Fuel cost per litre: I expect it to be US$100 per litre.
- Revenue and net loss: Air Canada could see a significant double-digit revenue jump as Canada opened international borders without restrictions. However, a surge in fuel costs could increase its operating expense and lead to a loss, despite significant revenue growth.
- Free cash flow: AC is unlikely to post positive free cash flow, but look at the rate of cash burn.
- Net debt: Watch out for this space to see if there are new loans.

AC stock's sensitivity to earnings

This set of new challenges has capped Air Canada's stock price to $25. Generally, the stock makes significant strides ahead or after earnings. In the third-quarter 2021 earnings, AC reported its first positive cash flow since the pandemic. That time, the stock surged 18% ahead of earnings and fell 21% for the rest of the month. After the fourth-quarter earnings, the stock fell almost 4% in a week.

Air Canada stock has surged over 6% this week and could surge further. But I am expecting disappointing earnings. So, there could be a significant dip next week post-earnings.

Should you buy Air Canada stock at $25 or below?

Before the war, I expected Air Canada's stock price to surge to $40 in 2022, but now, even $25 looks like an expensive valuation.

The airline raised equity capital and took significant debt to stay afloat during the pandemic. It has a total long-term debt of $16.5 billion and a market capitalization of $8.4 billion on a $24.66 stock price. Its total enterprise value after adjusting for liquidity comes to $16.1 billion.

If any potential bidders were to buy Air Canada, they would have to pay $16.1 billion. In return, they will get the $7.12 billion net debt and years of losses. In 2021, its net loss contracted to $3.6 billion from $4.65 billion in 2020. But rising oil prices and longer air routes will further delay the airline's return profit. The airline is funding its losses from the $10.36 billion liquidity. As the liquidity dries up, the debt portion will increase.

When you look at AC stock from the enterprise value perspective, $25 per share looks expensive. Buying the stock is like funding the debt and losses of AC. Do not buy the dip in AC after earnings, as there could be a value correction to reflect its financial situation. Instead, you could invest in tech stocks that have dipped in the selloff but still have long-term secular demand.

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Date
2025/09/09
Date Created
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