Why Did Air Canada and Cineplex Stocks Fall Near Their Pandemic Lows?

Description

Stocks of **Air Canada** (TSX:AC) and **Cineplex** (TSX:CGX) have fallen 31% and 17%, respectively, since the market started correcting. But yesterday these stocks broke their resistance and fell to their March 2020 level, as the TSX saw a selloff. The selloff came as the U.S. Fed hiked interest rate by 75 basis points — the most aggressive hike since 1994. Air Canada and Cineplex are sensitive to interest rate hikes at the fundamental level. Let's see how.

Why haven't Air Canada and Cineplex recovered from the pandemic shock?

The pandemic put a lock on operations of Air Canada and Cineplex for over 12 months. That's a long time for capital-intensive businesses that bear fixed costs. They were burning cash every quarter. But they managed to survive on the back of fiscal stimulus packages and record low-interest rates. They took on more debt to keep the business alive, so they could restart with full swing and make up for the loss with pent-up demand.

Things were going as planned, and inflation increased as expected. But then came another black swan event, and Russia invaded Ukraine. The two countries are strategically important for the global supply chain, as they are major exporters of oil, gas, metal, food, and fertilizer. The supply shock pushed energy prices to unsurmountable levels. Inflation went out of control. These external factors forced Fed to accelerate its plans to pull back stimulus money. Instead of a 50-basis-point hike, rates were raised 75 basis points.

Inflation has increased the operating expenses for Air Canada and Cineplex. Therefore, these stocks were unable to recover from pandemic levels, despite demand growth.

The correlation between balance sheet leverage and interest rate hikes

As the Fed hikes the interest rate, the U.S. dollar becomes strong. While this is good for Canada's exports, it is not good for imports. Canada hikes the interest rate to match the dollar value. A higher interest rate makes debt costly for those with good credit ratings. So, you can imagine what this rate would do for Air Canada and Cineplex, which have weak credit ratings.

When the interest rate was near zero, Air Canada borrowed at 9% interest. It has long-term debt of over $16 billion sitting on its balance sheet. While it has $10 billion in liquidity, holding that cash comes at a high price. It doubled its minimum liquidity requirements from $2.4 billion in December 2021 to $5 billion in March 2022 to provide for financial covenants and advanced ticket sales. If its liquidity requirements increase further, it would have difficulty keeping up with them. And with the pace at which the rates are rising, restructuring debt is out the window.

Cineplex has a debt of $787 million, and even the pent-up demand couldn't make up for the higher operating expenses due to rising prices. Things will only get tougher, as the Fed plans to increase interest rates throughout the year till inflation comes under control. As per the latest estimates, the Fed could hike its benchmark rate to 3.4% by the end of the year from 1.75% after the latest 75-bps hike. This means another 0.75% hike is likely.

The current environment is not conducive for companies with heavy leverage and insufficient cash flow to pay interest. There is also a risk of default if another COVID wave hits Canada and affects demand for Air Canada's and Cineplex's services.

Should you buy Air Canada and Cineplex at the dip?

Even though the current dip may look tempting, Air Canada and Cineplex are stocks you want to stay away from if you are risk averse. After the pandemic, I'd recommended these stocks for the short term, as they were range-bound. Anyone applying the Greater Fool Theory could have gained 15-25% by buying in the low range and selling in the higher range, irrespective of the stock's intrinsic value.

But now, they are a risky bet, even for this theory, as the nearing stagflation and looming recession could slow demand for leisure travel and movie tickets. Consider buying value stocks with significant upside potential, like **SmartCentres REIT** and **Descartes Systems**.

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