Is it Time to Sell Air Canada (TSX:AC) Stock?

Description

Air Canada (TSX:AC) is a stock that is burning cash. Investors who bought this stock after the pandemic dip are in deep red, as it has burned all the recovery gains and returned to the March 2020 level. They are getting impatient and wondering when to sell this stock.

Air Canada is a classic case of a value trap.

If you look at its price ratios, a 0.75 price-to-sales (P/S) ratio for a company with triple-digit revenue growth (250% in the first quarter) might look tempting. But it is a trap. Never look at a price ratio in isolation. This revenue growth is not sustainable, as it is a recovery from the pandemic. Moreover, the P/S ratio is not the right way to value a capital-intensive stock.

How to value airline stocks in the current environment

A capital-intensive company has significant debt on its balance sheet. Air Canada got the worst of the pandemic, as it had to take up debt to keep the business alive. It has a $7 billion net debt on its balance sheet, and this debt is not cheap because of its weak credit rating. Its annual interest expense is around $600 million, and its principal repayment is around $1 billion. The airline is operating at a loss of $550 million.

These losses will continue for some time, as restarting after COVID is not easy. Airlines don't have an easily scalable capacity. They need planes, staff, and enough passengers to make the flight recover the costs of flying. And with oil prices above US$100 and Russian air space out of the radar, re-routing has increased the cost of flying long-haul flights.

Can Air Canada adjust its operations to uncertainty and manage to save enough to service its debt? It is currently servicing its debt with the $10 billion in liquidity, but this arrangement won't sustain long. Hence, the right way to value Air Canada is by looking at the interest coverage and EV/EBITDA ratio.

The interest coverage ratio tells the company's ability to pay interest from its operations. It is negative for Air Canada. Enterprise value is the amount a buyer would pay for the company's equity plus the net debt it would bear. The enterprise value-to-EBITDA ratio tells you the profitability factor of buying a company, and this ratio is -13.35 for Air Canada. This means that if someone buys Air Canada, the person would be bailing it out.

After reading this, when you see Air Canada’s valuation, it doesn’t look like a value stock even at $17.

Can Air Canada survive a recession?

But Air Canada’s troubles are not over. The United States is closer to a recession, which means discretionary spending is slowing. The one positive factor for Air Canada stock has been its revenue growth from leisure travel recovery. In a recessionary environment, leisure spending will slow, as consumers struggle to make ends meet.

During the 2008-2009 recession, Air Canada stock fell 85% between May 2008 and May 2009. It witnessed small periods of growth, but those who missed selling the stock were stuck with another 30% dip for three years.

The upcoming recession could be worse than the 2008 recession for Air Canada. During the last recession, the airline had a five-year gap between the 2003 SARS epidemic and the 2008 recession. But this time, the gap is just over two years.

The central bank is increasing interest rates at an accelerated pace. This means financing won’t be available easily, as it was during the pandemic. Air Canada’s massive debt puts it at a high risk of default if air travel demand slows. The one way out is for the airline to take the government bailout, but that won’t bode well with shareholders, as the bailout demands a 10% equity stake. A recession could put Air Canada on a ventilator, with a weak survival rate.

When should you sell Air Canada stock?

Don’t hold Air Canada stock in hopes of selling it at a breakeven level of $26. The stock has breached its $20 resistance. This means the new high could be below $24. Sell the stock now or if it reaches $20.

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