Avoid These Canadian Zombie Companies: Buy These Instead

Description

Halloween might be over, but the zombies are still lurking. I'm talking about "zombie companies" in Canada that investors need to avoid. These are companies with so much debt on their books that earnings do not cover the interest payments.

With the country facing a recession, these companies could see a dip in earnings. Meanwhile, inflation is raising costs and squeezing profit margins while rising interest rates are making debt burdens heavier.

Essentially, zombie companies in Canada are heading for a cliff. Here's what investors need to know.

Canadian zombie companies

Recent analysis by the Federal Reserve of NY and the Bank of Canada revealed that roughly 25% of listed companies in North America could be classified as "zombies." However, this analysis was completed in 2020. Since then, debt levels and interest rates have both climbed significantly. Simply put, a surprising number of public companies could be zombies right now.

Telecom provider **Quebecor** (TSX:QBR.B) and airline giant **Air Canada** (TSX:AC) are prime examples.

Quebecor's debt-to-equity ratio is 4.8. That means it has $4.8 in debt for every dollar in shareholder equity. The company's debt is also 3.2 times larger than annual earnings before interest, taxes, depreciation, and amortization (EBITDA).

Roughly $1.1 billion of its debt is maturing in 2023. If Quebecor raises more capital now, the interest rate would be much higher.

Meanwhile, Air Canada has $16 billion in long-term debt on its books. That's more than double the size of its market value ($7.2 billion). The annual net loss was roughly $1 billion but could be more next year if oil prices stay high while air travel demand declines along with the economy. Put simply, investors should steer clear of this nosediving business.

Buy these stocks instead

Instead of investing in companies with growing debt and declining earnings, target companies heading in the opposite direction. Energy companies are seeing a surplus of profits that is being used to pay down debt.

Tourmaline Oil (TSX:TOU) is a great example. The natural gas producer has seen its market value surge 84% year to date. Meanwhile, quarterly earnings are up 96% to $822.94 million compared to the same period last year. Free cash flow over the past 12 months has surged 156% to $2.2 billion.

Much of this excess earning is being used to reduce debt. In 2022, the management team wanted to reduce long-term debt to $1.2 to $1 billion. According to its latest quarterly report, net long-term debt is actually far below that target at $430 million.

With much of its debt paid off and expansion investments completed, Tourmaline can direct more rewards to shareholders. The company has already delivered some special dividends and could be on track to do more of these in 2023. Investors looking for a passive-income play should add this stock to their watch list.

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