Bullish Skies Ahead: Why Air Canada Is About to Take Off

Description

Air Canada (TSX:AC)(TSX:AC.B) stock has been soaring high ever since the company announced a refinancing deal that will wipe $355 million of debt off the books and result in interest savings of $60 million per year. News of the deal was met with approval from Bay Street; several firms upgraded shares of Canada's largest air carrier in the wake of the announcement.

For investors closely following the stock, the refinancing is sign of the much-needed change in the company's risk profile and a clear buy signal for the stock.

Refinancing deal is bullish

Air Canada stock has rallied 31% since the deal was announced on September 26. For those not familiar with the stock's history, Air Canada had been trading a deep discount to U.S. peers and to rival **WestJet Airlines Ltd.** (TSX:WJA).

How deep? Well, prior to the rally, Air Canada was trading at less than four times its estimated 2017 EBITDAR and four times 2017 earnings versus 4.5 times EBITDAR and almost 10 times earnings for WestJet and 10.5 times average earnings for similar U.S. carriers (consensus figures).

What are the reasons behind the cheap valuation? The cheap valuation is due to concerns over Air Canada's capacity, free cash flow generation, and its debt-heavy balance sheet.

Bear case no longer holds up

While Air Canada's valuation had long been pressured due to the aforementioned capacity, cash flow, and leverage concerns, the bear case has been largely played out, and the discount gap is sure to close. Although Air Canada's available seat miles ("ASM," a measure of an airline's capacity) had decoupled from Canadian GDP in the past, a pending rebound in the Canadian economy will soon decrease the ASM/GDP spread.

Moreover, economic growth and the conclusion of Air Canada's expansion cycle in 2017, as well as continued cost-cutting measures will carry the company back to free cash flow positive territory.

Therefore, leverage seems to be the last remaining piece of the puzzle before the bear case is debunked.

And debunked it has been.

The latest refinancing deal means Air Canada can eliminate $355 million from its balance sheet, while generating annual interest expense savings of approximately $60 million. More importantly, the deal will also decrease Air Canada's sector-leading net debt of 2.7 times EBITDAR towards its target of net debt of 2.2 times normalized EBITDAR by 2018.

Bay Street approves

It would appear that the Street has also taken notice of Air Canada's new direction; in the days since the refinancing, **Royal Bank of Canada** upgraded shares of to "Top Pick" while increasing the price target to $18 from $14, and **Bank of Montreal** raised its price target by $2 to $15, while maintaining its outperform rating. Overall, the vast majority of analysts covering the stock has given it a solid buy rating.

In conclusion, the bear case has been dismantled, the Street has turned bullish, and Air Canada's stock is about to take off, so why not hop on for the ride?

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zawtun