Air Canada [TSX: AC]

Flying High: Air Canada is well Positioned for Future Success

Stock Rating	Industry View	Price Target
Buy	In-Line	$35.34

Company Overview. As Canada's premier airline, Air Canada stands as the leading provider of scheduled passenger services within its home country, across the U.S. border, and internationally. Ranking among the world's top 10 airlines by revenue in 2023, it maintained an impressive schedule of over a thousand daily flights reaching a vast array of destinations globally. This network has experienced growth from the previous year, indicating a steadfast expansion in service coverage.

Sector Analysis. The Canadian airline industry revenue took a sharp drop in 2020 by more than 65%. This was attributed to the pandemic. While some segments dropped more than the others, passenger revenue experienced a greater fall. For instance, Air Canada's passenger revenue fell by 74.6% in 2020. However, the industry is estimated to recover, to match or even surpass the pre-pandemic levels over the 5-year outlook. In fact, the 2023 budget highlights the Government of Canada's commitment to bolstering the air transport sector, improving passenger protections, optimizing airport operations, and enhancing data sharing to improve the overall air passenger experience.

Theses. We are confident that Air Canada is well-positioned for significant growth amid the resurgence of the Canadian travel industry. Projections indicate a notable surge in passenger counts on scheduled and chartered services, providing Air Canada with a prime opportunity to capitalize on this momentum. This surge, which exceeds pre-pandemic levels, is underscored by the fact that 79% of Canadian travellers intend to either maintain or increase their frequency of trips abroad in 2024, highlighting the sustained interest in international travel. Moreover, with travellers allocating higher budgets for travel plans in 2024 compared to the previous year, Air Canada stands to benefit from increased consumer spending on travel. Additionally, amidst anticipated interest rate cuts and reduced inflation, consumers are expected to have more disposable income for non-essential spending, potentially driving up expenditures on travel. Given these conditions, we firmly believe that Air Canada represents a compelling investment opportunity, poised to capitalize on the growing demand for travel and achieve substantial growth.

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Market Data *(in mm unless specified)*	
Market Capitalization (bn)	7.04
Net Debt	5,833.0
Enterprise Value	19,472.0
Basic Shares O/S	358.5
Fully Diluted Shares O/S	380.6
Avg. Daily Volume (K)	2,900.0
52 Week Range	$16.04 - $26.04

Financial & Valuation Data

FYE Dec-31	2023A	2024E	2025E
Revenue	21833.0	24016.3	25793.5
EBITDA	3914.0	3450.8	3835.1
EPS	*$4.56*	*$3.64*	*$4.05*
EV/EBITDA	3.21x	3.21x	2.96x
P/E	5.25x	5.25x	4.61x

Financial Analysis. Air Canada is valuing debt repayment above all else. With a large increase in debt over the course of the pandemic, and interest rates rising since then, the company is looking to pay down debt as quickly as possible. Air Canada also has several short-term loans coming to maturity in the next few years, but with a strong balance sheet, we expect them to be able to take care of them without much issue.

Risks & Catalysts. Risks: (1) Tensions in the Middle East affecting the price of oil. (2) New competition from smaller discount airlines. (3) The strength of the Canadian dollar affects travel demand and revenue. (4) Ongoing pilot shortages in Canada could disrupt operations significantly. (5) External events including tragic incidents, terror attacks, and pandemics can affect the company's performance. Catalysts: (1) Gradual signs of recovery from the COVID-19 pandemic, as it is forecasted that pre-pandemic operational levels will be reached in 2025. (2) Lower interest rates would lead to an increase in disposable income for Canadians making air travel more affordable and attractive. (3) Allocating significant resources towards the investment in innovative technologies to augment the overall customer experience and bolster competitiveness within the airline industry.

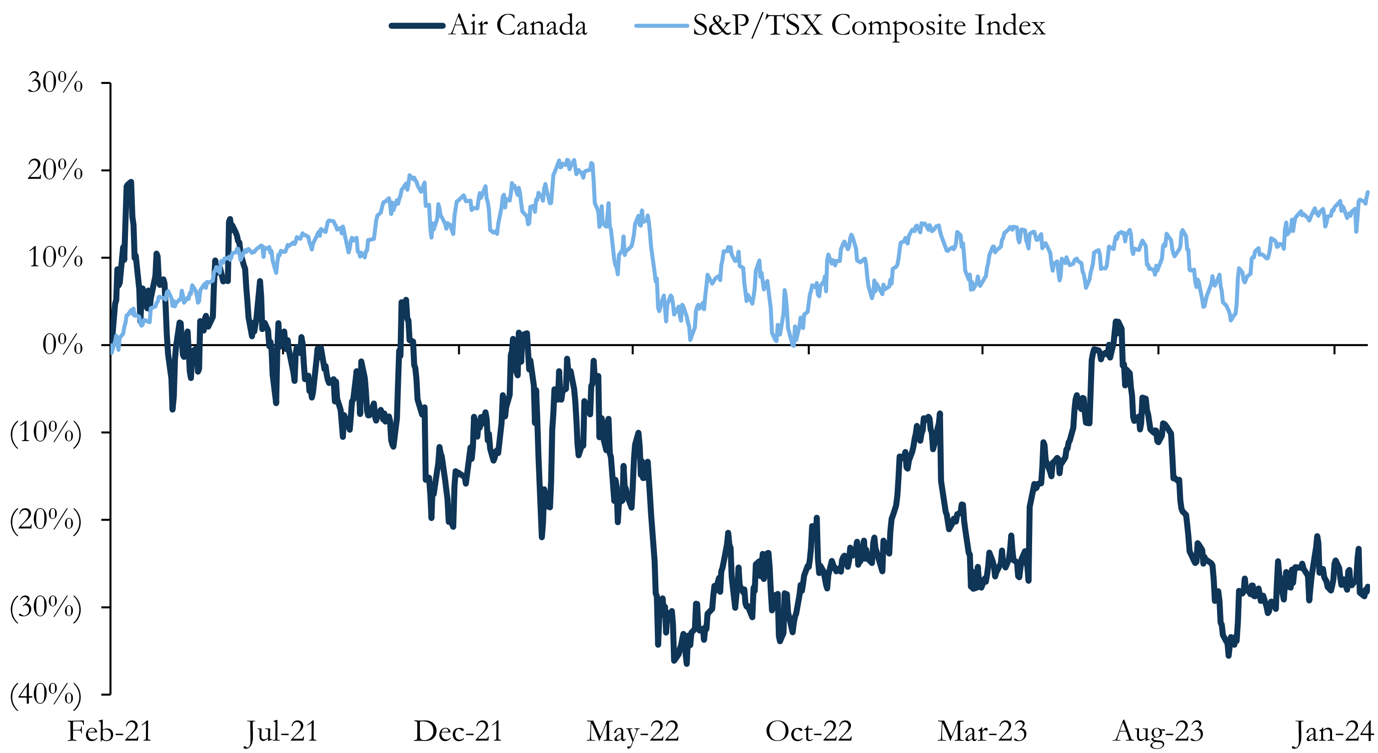
Valuation. Air Canada is poised for future growth with its current share price, at the time of creating our valuation, being ~$18.00 and with an implied price of $35.34, this presents an implied upside of 98.3%.

Company Overview

Air Canada is Canada's largest airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-U.S. transborder market, and in the international market to and from Canada. Its mission is to connect Canada and the world. Air Canada is a founding member of the Star Alliance® network. Through the 26-member airline network, Air Canada offers its customers access to a wide global network, as well as reciprocal participation in frequent flyer programs, a seamless travel experience, and improved customer service, including the use of airport lounges and other common airport facilities. In 2023, it was among the top 10 largest airlines in the world in terms of revenue. During the same year, Air Canada operated, on average, 1,025 daily scheduled flights to 188 direct destinations on six continents. In comparison, in 2022, Air Canada, together with its regional partners, operated, on average, 945 daily scheduled flights to 185 direct destinations on six continents.

The main destinations for passengers flying with Air Canada are Canada (31%), the US (31%), and the Atlantic (21%). In 2023, Air Canada generated revenue of approximately 21.8 billion, with 91% coming from passenger transportation and 5% from cargo. Ina what do you think about the figure text in blue being size 10 instead of 9?

Figure 1: 3-year historical performance vs. S&P/TSX composite



Source: Bloomberg

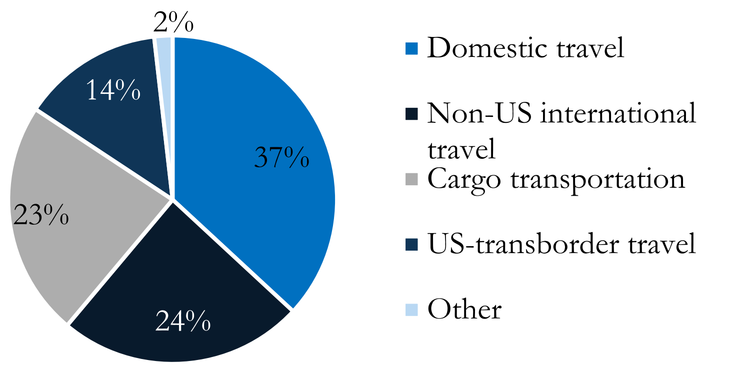
Sector Analysis

Aviation accounts for 3.2% of Canada's GDP, contributing a gross value GDP of US $49 billion. It supports around 633,000 jobs. While its industry revenue experienced a downfall during COVID-19, the sector is estimated to recover by 1.9% from 2023 to 2028. Presently, there are 545 active Canadian air carriers within the industry.

Air Canada's Leading Position in the Market

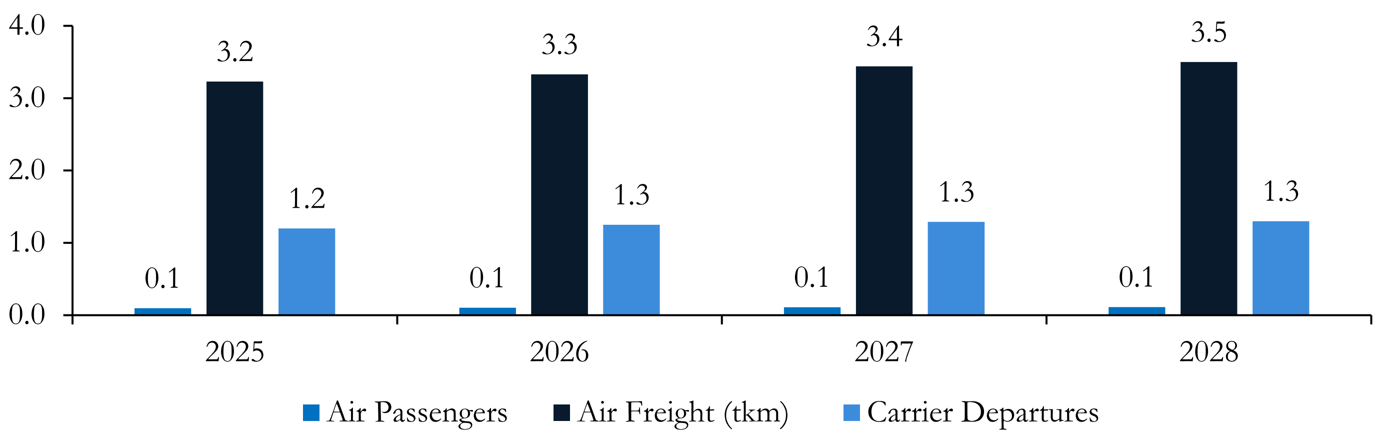
Air Canada is the flag carrier and represents nearly three-quarters of revenue. Most of the other airlines are small and serve a niche audience. Only Air Canada and WestJet command a significant market share. Air Canada has fortified its leading market position with a new U.S. joint venture with United Airlines in 2023, following their previous joint venture in 2022.

Figure 2: Products and services as a percentage of 2023 industry revenue



Source: IBIS World

Figure 3: Forecasted figures (in billions)



Source: Statista

Consolidation – The Name of The Game

WestJet took over Sunwing and Sunwing Vacation as a $5-billion deal in 2019. WestJet now aims to wind down Sunwing Airlines and integrate the low-cost carrier into its mainline business by October 2024. WestJet and Sunwing together make up 37% of seat capacity on direct flights to sun destinations, and 72% from Western Canada. Meanwhile, Air Canada has fortified its leading market position with a new U.S. joint venture with United Airlines in 2023, following their previous joint venture in 2022.

Investment Theses

I. Post-Pandemic Surge in Airfare Demand.

The Canadian travel industry is witnessing a remarkable resurgence following the challenges posed by the COVID-19 pandemic. Major Canadian airlines are reporting a substantial uptick in passenger counts on both scheduled and chartered services, marking a notable shift in travel behaviour. In January 2022, these airlines carried a staggering 2.6 million passengers, showcasing a remarkable 227.0% increase compared to the same period in 2021. Furthermore, on January 1, 2023, passenger counts surged by an impressive 82% compared to pre-pandemic levels, highlighting a significant rebound in travel demand. Industry reports further affirm this trend, revealing that a remarkable 79% of Canadian travellers plan to either maintain or increase their frequency of trips abroad in 2024. This sustained interest in international travel is complemented by travellers' willingness to invest more in their travel experiences, with 35% of them budgeting higher amounts for their travel plans in 2024. These developments underscore a promising outlook for the Canadian travel industry, indicating a strong recovery trajectory and potential for continued growth in the foreseeable future.

II. Increase in Consumer Disposable Income

The anticipated increase in consumer disposable income is expected to have significant implications for the Canadian economy. Forecasts suggest that as many as five interest rate cuts are projected for the upcoming year, starting as early as Q2 2024. These cuts could potentially bring year-end interest rates to 3.75%, translating to substantial savings for Canadian homeowners. On average, a 1% decrease in interest rates equates to over $3,600 in annual savings for homeowners. Additionally, the Bank of Canada's surveys indicate that higher interest rates have effectively curbed inflation expectations and slowed the pace of price increases by companies. The latest reports suggest that the tightening cycle may have peaked, paving the way for potential rate cuts in the first half of the year. Despite concerns about persistently elevated wage growth, businesses expect wage gains to normalize by 2025, further bolstering consumer spending. This anticipated growth in disposable income is expected to drive increased expenditures on non-essential items such as travel and leisure. During periods of low inflation and interest rates, consumer spending on durable goods, including travel-related expenses, has historically seen substantial increases. Lower interest rates and reduced inflation imply that consumers will allocate less spending toward essentials like mortgage payments and grocery prices, potentially freeing up funds for increased expenditures on travel. Overall, these trends indicate a favourable outlook for the travel industry, with consumers poised to allocate more resources towards leisure activities.

Risks & Catalysts

Risks

Tensions in the Middle East affecting oil prices. Tensions in the Middle East can drive up oil prices, significantly impacting Air Canada's fuel expenses and potentially leading to reduced profitability and higher ticket prices for consumers. Exploring alternative and sustainable fuel sources to mitigate the impact of oil price fluctuations.

Ongoing pilot shortages in Canada. This can strain Air Canada's crew availability, leading to potential flight cancellations, delays, and increased operating costs due to the need for hiring and training additional pilots. Offering competitive compensation and prioritizing employee work-life balance is a way to build a stronger relationship with the pilots union and mitigate this risk

Strength of the Canadian dollar affecting travel demand and revenue. The strength of the Canadian dollar impacts Air Canada as the majority of its revenue is in Canadian dollars while many costs, such as aircraft leases and fuel purchases, are in other currencies, potentially affecting profit margins. Mitigation for this risk could include currency hedging and diversifying revenue streams to limit the effect the strength of the dollar has on the company.
Other company-specific and industry-specific risks include (1) New competition from smaller discount airlines. (2) External events including tragic incidents, terror attacks, and pandemics can affect the company's performance.

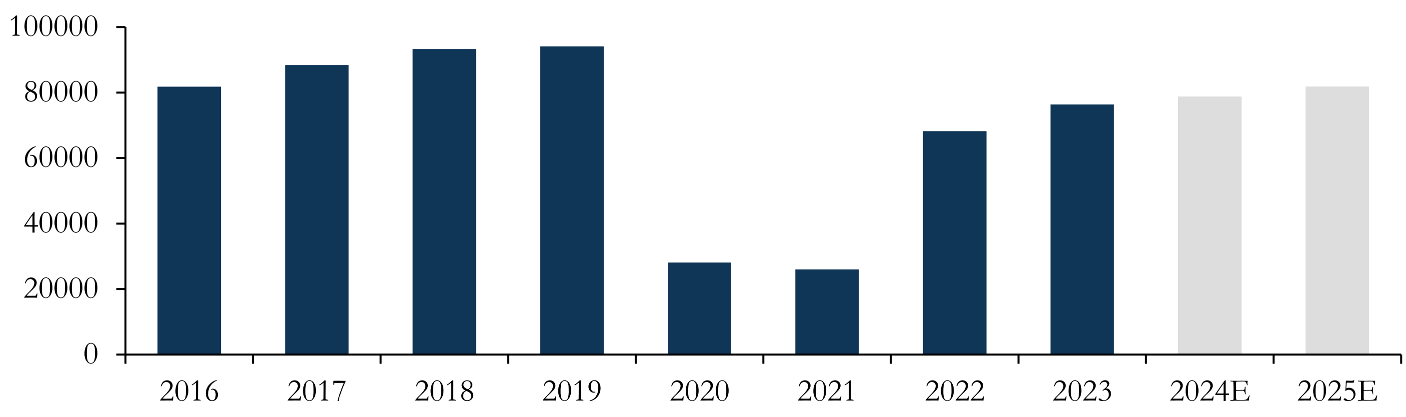
Catalysts

Expected Interest Rate Drop. Lower interest rates can contribute to a rise in disposable income among Canadians, potentially enhancing the affordability and attractiveness of air travel as improved financial circumstances allow for increased discretionary spending on leisure activities.

Adoption of Further Digital Transformation. Allocating significant resources toward investment in innovative technologies aims to enhance the overall customer experience and strengthen Air Canada's competitiveness in the airline industry, ensuring the company remains at the forefront of technological advancements to meet evolving consumer demands and market trends.

Return to Pre-Pandemic Travel Volume. The aviation industry is gradually demonstrating signs of recovery from the COVID-19 pandemic, as it is forecasted that pre-pandemic operational levels will be reached in 2025. The return to pre-pandemic travel volume is shown in the graph below.

Figure 4: Number of passengers carried by Canadian airlines (in thousands)



Source: Statista

Financial Analysis

Air Canada over the course of the pandemic took on a lot of debt from various private and government agencies to stay afloat. With this increase, the company has now made it a priority to pay down its debts as fast as possible. Just recently repaying 589 million dollars in debt that was previously used to buy aircraft. Thanks to a recent uptick in passenger travel and large increases in revenue since the pandemic, Air Canada is in a good position to be able to pay off their upcoming debts. Their first, has a maturity date in 2024 for a total value of 359 million CAD and another 1.1 billion CAD coming to maturity in 2025.

Valuation

Our DCF valuation has deemed the target price for Air Canada to be $35.34. The model uses a WACC of 9.9%, which is on par with the industry average. Figure 5 shows the WACC buildup and exactly what values went into the 9.9% calculation. We are expecting a strong bullish Canadian air travel market into the next several years, with an expected 79% of Canadian air travellers expected to either increase or sustain their travel budgets heading into 2024. Additionally, with an expected slew of rate cuts before the end of 2024, this would lead to an increase in discretionary spending, once again benefitting Air Canada. In preparation for this continued increase in demand, Air Canada will be greatly increasing their capital expenditures, between 2023-2026, to bolster and freshen up their pre-existing fleet. Some of the peers we used to arrive at our 6.3x exit EBITDA multiple was United Airline Holdings, Southwest Airlines CO., and Alaska Air Group INC. For our comparison analysis, we chose to use the median TEV/EBITDA LTM. We also chose to weight the DCF 70% to the perpetuity method and 30% to the EBITDA method. This is due to the fact that we wanted to put a stronger focus on the intrinsic value of the company rather than base it on comparable companies. Furthermore, with the economy currently being in a turbulent state, the perpetuity method allows us to more accurately gauge the effects of inflation and the long term growth prospects of the company. The result of the valuation was a strong upside of 98.8%, displaying Air Canada's strong growth potential.

Figure 5: WACC build-up

Cost of capital assumptions		
Cost of debt	5.0%	
Tax rate	27%	
Cost of debt (after tax)	3.7%	
Risk free rate	5.3%	
Beta	1.1	Weights
Beta #1	1.1	100.0%
Beta #2		0.0%
Market risk premium	4.6%	
Cost of equity	10.3%	

Capital Structure	Current	% of total
Equity	13,862.0	95%
Debt	796.0	5.4%
Total Value	14,658	100%

Cost of Capital

Cost of equity	10.27%
Cost of debt (after tax)	3.68%
Cost of capital (WACC), unadjusted	9.91%
Risk Adjustment	0.00%
Cost of capital (WACC), adjusted	**9.91%**

Figure 6: Implied share price by perpetual growth and EBITDA exit method

Valuation

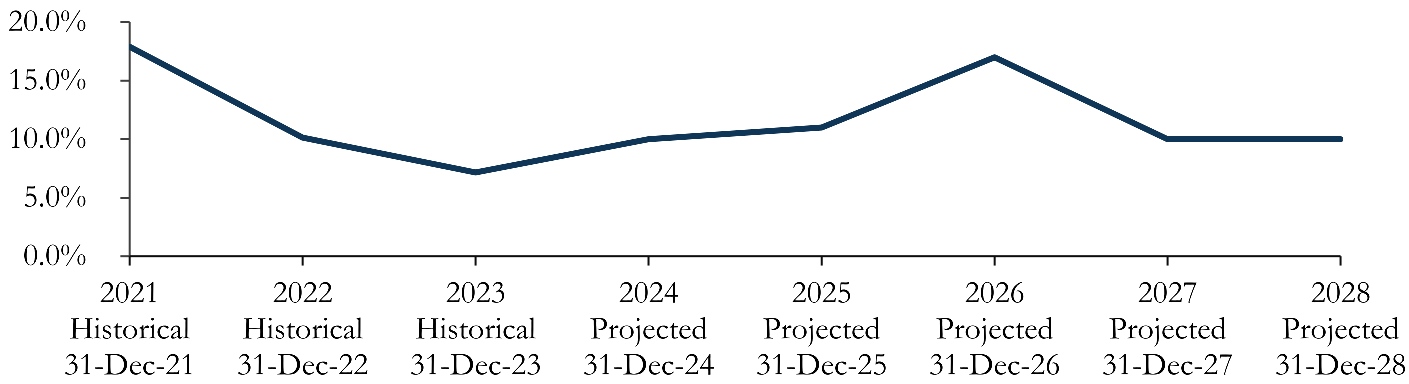
	Perpetuity	EBITDA
Enterprise value	22161.22	13228.62
Net debt	5883.00	5883.00
Equity value	16278.22	7345.62
Shares outstanding	380.58	380.58
Equity value per share	**42.77**	**19.30**
Implied upside/downside	138.3%	7.6%
Weight towards implied share price	70%	30%

Figure 7: WACC sensitivity

		Terminal Growth Rate				
		1.6%	2.1%	2.6%	3.1%	3.6%
WACC	11.9%	$ 27.20	$ 28.82	$ 30.61	$ 32.61	$ 34.84
	10.9%	$ 31.83	$ 33.91	$ 36.23	$ 38.85	$ 41.83
	9.9%	$ 37.69	$ 40.41	$ 43.51	$ 47.06	$ 51.18
	8.9%	$ 45.26	$ 48.95	$ 53.23	$ 58.25	$ 64.21
	7.9%	$ 55.39	$ 60.61	$ 66.81	$ 74.30	$ 83.54

		Exit EBITDA Multiple				
		4.3x	5.3x	6.3x	7.3x	8.3x
WACC	11.9%	$ 7.49	$ 10.83	$ 14.17	$ 17.51	$ 20.85
	10.9%	$ 9.16	$ 12.89	$ 16.62	$ 20.34	$ 24.07
	9.9%	$ 11.04	$ 15.21	$ 19.37	$ 23.54	$ 27.70
	8.9%	$ 13.16	$ 17.82	$ 22.48	$ 27.14	$ 31.80
	7.9%	$ 15.56	$ 20.78	$ 25.99	$ 31.21	$ 36.42

Figure 8: Forecasted increases in capital spending as a percentage of revenue (2021A-2028E)



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