Flash

Company	Ticker	Rating	Intrinsic Value	Current Price
Air Canada	AC	Buy	TSX: $30.00 CAD	TSX: $24.36 CAD

AC: On the Right Heading

Dan Fong
dfong@veritascorp.com

Air Canada unveiled its outlook and longer-term strategy at its its first Investor Day since the pandemic started. In our view, management is taking the appropriate steps to put the company on a path to recovery. We are confident that Air Canada will be on solid operational footing once its strategic initiatives are complete.

The company's key initiatives include capacity restoration, network expansion, fleet renewal, and growing its cargo operations. We expect the re-introduction of capacity to drive signficant traffic and revenue gains, while JVs and partnerships will expand Air Canada's international network and increase connectivity at low incremental cost. In addition, fleet renewal will enable superior operational capability and flexibility, as well as revenue and cost benefits. Finally, expanding its cargo contributions will further increase revenue diversification, reduce seasonality, and improve overall business resilience.

Air Canada expects to recover to pre-pandemic profitability by 2024. If the company can achieve its longer-term margin, cash flow, and leverage targets, we think its shares stand to offer meaningful upside, even if valuation multiples remain unchanged from pre-Covid periods. We caution, however, that headlines related to Covid variants, inflation, and/or jet fuel prices could weigh, and the company's recovery is likely to be volatile. Nonetheless, we think the company's longer-term prospects remain attractive. We are maintaining our BUY rating and $30.00 per share intrinsic value estimate.

Our takeaways from Investor Day:

- **Potential passenger revenue recovery on the horizon:** The company plans to operate at ~80% of its pre-pandemic capacity this year and at ~95% by 2024. If U.S. airline industry capacity and revenue trends are any indication, Air Canada's passenger revenues could recover close to pre-pandemic levels. U.S. carriers have re-introduced about 80-90% of their pre-pandemic capacities and are generating between 70% and 80% of their pre-Covid revenues. In addition, by 2024 management expects corporate travel demand to recover, Asia-Pacific routes to normalize, and premium traffic to account for a larger proportion of leisure bookings than before the pandemic. If management's expectations materialize, we see potential for the company's 2024 passenger revenues to exceed pre-pandemic levels.

- **Cargo operations provide another lever for cash generation:** In 2021, Air Canada generated ~$1.5 billion of cargo revenues, more than double that of 2019. The company currently has one dedicated freighter aircraft and has plans to add seven more by the end of 2023. In addition, Air Canada has been investing in ground handling capabilities both at home and abroad. Although the company will remain a passenger airline first and foremost, we think its cargo operations are on track to becoming a more meaningful part of its revenue mix. In our view, dedicated cargo will help increase revenue diversification, reduce revenue seasonality, and improve business resilience.

- **Fleet renewal yields both operational and cost benefits:** Over the course of the pandemic, Air Canada permanently retired ~80 older aircraft while concurrently introducing new, more efficient jets. By 2024, the company will have largely completed its fleet renewal program with new Boeing 737 MAX, Airbus A220, and Airbus A321XLR jets. In addition to being able to cover a wide range of geographies with favourable unit cost profiles, these new aircraft can be nimbly redeployed as necessary to align capacities and frequencies with demand and, in some cases, can allow Air Canada to resume international growth without the economic burden of a larger, wide-body aircraft. Once all deliveries are complete, management estimates that the revenue and cost benefits will result in a 15% lift to 2019 EBITDA, all else equal.

- **Equity-friendly capital allocation strategy:** Outside of strategic investments mostly related to fleet renewal, management's capital allocation priorities are largely geared to debt reduction. This is an important point: As the company directs free cash to paying down debt, a greater proportion of enterprise value will accrue to shareholders. One of the biggest arguments against owning Air Canada shares today is that its current enterprise value is substantially the same as it was prior to the pandemic($16.8B vs. $16.4B), yet the outlook for the global airline industry is more volatile now than it was in 2019. While this argument may hold in a vacuum, in a recovering environment where free cash is used to retire debt and improve the capital structure, enterprise value and valuation multiples do not have to change in order for equity value to grow. Management anticipates cumulative free cash generation of ~$3.5 billion between 2022 and 2024, and is targeting a ~1.0x leverage ratio by then.

- **Implied valuation based on 2024 financial targets:** If Air Canada achieves its longer-term capacity, cash flow, and leverage targets, we estimate that its shares could be valued at between $26 and $37 by 2024. This is based on pre-pandemic valuation multiple range of 4.0x to 5.0x forward EBITDA. We note that Air Canada has historically traded at an unjustified discount to its U.S. peers, which suggests potential for upside if the company attains its goals and re-rates higher. Our illustrative valuation and other assumptions are detailed in Figure 1.

Figure 1

Implied Forward Valuation

In millions of Canadian dollars, except per share amounts

	2024 Targets / Assumptions			
Seat capacity	95% of 2019 levels			From guidance.
Passenger revenues	100% of 2019 levels			By 2024, management expects: 1) corporate demand to recover to pre-pandemic levels, and 2) leisure travel to be comprised of a larger proportion of premium traffic than 2019. We assume that passenger revenues recover to 2019 levels, despite capacity being 5% lower.
Cargo revenue	230% of 2019 levels			2021 cargo revenues were already >2x 2019 levels. We assume 3% CAGR to 2024.
Other revenues	100% of 2019 levels			Largely related to Air Canada Vacations. We assume recovery to 2019 levels.
	Implied Valuation			
EBITDA margin	19%			From guidance.
Implied 2024 EBITDA	3,800			
Forward EV/EBITDA multiple	4.0x	4.5x	5.0x	Based on normalized, pre-pandemic range.
Implied enterprise value (end of 2023)	15,200	17,100	19,000	
Less: Net debt	-5,700	-5,700	-5,700	Guidance is for leverage to approach 1.0x Net Debt/EBITDA by the end of 2024. We provisionally assume 1.5x by the end of 2023.
Implied equity value (end of 2023)	9,500	11,400	13,300	
Shares outstanding	358			
Implied equity value per share (end of 2023)	**$26.54**	**$31.84**	**$37.15**	
PV10	**$25.13**	**$30.16**	**$35.18**	

Sources: Company disclosures, Veritas.

Dan Fong | 416-866-8783

- **Key risks to consider:** Over the near-term, the emergence of new Covid-19 variants, overall inflation, and elevated fuel prices represent key risks to Air Canada's shares. In our view, Covid-related risks are becoming more manageable given that successive variants appear to be having shorter and lesser impacts on airline operations than their predecessors. Second, although inflation may have a negative impact on discretionary spending and result in higher airfares, in the near-term, we believe air travelers are largely price inelastic given the pent-up demand to travel. Finally, should fuel prices remain elevated throughout the company's forecast period, its margin, cash flow, and leverage targets could be at risk of falling short. For 2022, Air Canada has assumed $1.10 per litre of jet fuel (vs. $0.76 in 2019). For 2023-2024, we believe management has assumed a lower jet fuel price, albeit not necessarily at 2019 levels. Longer-term, we note that the company's collective bargaining agreement with its pilots expires in 2024. Any prospect of labour disruption ahead of that could also weigh on the shares, just as the company expects to recover to pre-pandemic profitability.

Explanation of the Veritas Investment Research Equity Rating System

Our analysts rate stocks based on their view of how the stock will perform over the next 12 months relative to their sector of coverage.

Rating	Description
Buy	Expected to generate a meaningful positive return or outperform analyst's sector coverage over the next 12 months
Reduce	Expected to underperform analyst's sector coverage over the next 12 months
Sell	Expected to generate a negative return over the next 12 months

The Veritas Investment Research Team

Utilities & Infrastructure

Darryl McCoubrey, CPA, CA
VP, Head of Research and Utilities & Infrastructure Analyst
dmccoubrey@veritascorp.com

Benjamin Butler, BA
Research Associate
bbutler@veritascorp.com

Accounting & Special Situations Group

Dimitry Khmelnitsky, CPA, CA
VP, Head of Accounting and Investment Analyst
dkhmelnitsky@veritascorp.com

Jacob Liu, MBA, MA, BBA
Research Associate
jliu@veritascorp.com

Communication Services, Information Technology

Desmond Lau, CPA, CA, CFA
Investment Analyst
dlau@veritascorp.com

Stephanie Shiu
Research Associate
sshiu@veritascorp.com

Consumer Staples & Discretionary

Kathleen Wong, CPA, CA, CFA
Senior Investment Analyst
kwong@veritascorp.com

Maggie Wang
Research Associate
mwang@veritascorp.com

Industrials

Dan Fong, BA, HBA, CFA
Investment Analyst
dfong@veritascorp.com

Financial Services

Nigel D'Souza, B.Sc., CFA
Investment Analyst
ndsouza@veritascorp.com

Financial Services & REITs

Shalabh Garg, CFA, MBA, B.Eng.
Investment Analyst
sgarg@veritascorp.com

Marketing and Business Development

Scott Adams
VP Communications & Strategy
sadams@veritascorp.com

Alain Huneault, BBA
Associate
ahuneault@veritascorp.com

Doreen Sengsavang, BBA
Business Development
dsengsavang@veritascorp.com