Bombardier may yet reward the brave

While high risk, airplane maker's preferred shares could offer high reward

Sacha's Note: The last of my Bombardier preferred share position (BBD.PR.C) was sold in 2018 for roughly $20.50/share

LARRY MacDONALD

Bombardier Inc. is teetering on the edge of a financial precipice. The cash drain of developing the delayed C Series aircraft has turned the manufacturer of trains and airplanes into a high-risk bet. But with high risk comes high reward, say the investors with nerves of steel.

One such brave soul is Sacha Peter, the founder and managing director of Chilliwack, B.C.-based Divestor Investments Inc. Mr. Peter is a chartered professional accountant, and his value-based investing approach has returned 14.4 per cent annually since 2006, according to divestor.com.

He has bought two series of the preferred shares with hefty dividends. Currently, Series 2 (BBD.PR.B) yields 11.5 per cent and Series 3 (BBD.PR.C) yields 17 per cent. They are both cumulative (if the dividends are suspended, they are paid out when payments are restored).

Mr. Peter doesn't think the dividends will be suspended because Bombardier "would likely compromise its ability to access the bond market, and the controlling family ... would lose the privilege of ... declaring common share dividends." The cash drain of $23-million a year for the two series does not seem huge either, considering the scale of company operations.

Bombardier's debt is also trading at levels that "suggest they are not going to be shut out of debt financing," Mr. Peter said. The yields have recently been hovering near 8 per cent for maturities under five years, and just above 10 per cent for longer maturities. These are not prohibitive lending rates, so along with cash balances on hand, "they have a couple years to figure things out," he added.

In addition, the Quebec government, which recently put up $1-billion of financing for completing the development of the C Series aircraft, appears ready to help Bombardier get through its liquidity crisis. Like the auto manufacturers that got billions of dollars from Canadian governments in 2009, Bombardier is "too big to fail," argue observers such as Michael Moffatt, a professor at the University of Western Ontario's Ivey Business School.

Bombardier employs about 17,000 people in Quebec, according to figures from Karl Moore, a professor at the Desautels Faculty of Management at McGill University. Add in people employed at companies that supply Bombardier, and about 40,000 jobs depend upon Bombardier in Canada. If these jobs are lost, the cost of employment insurance benefits and other social assistance programs may end up being greater than the investments being made by governments.

By most accounts, the C Series is a good airplane. It's quieter and more fuel efficient than other offerings in its market niche. If customers can be assured of Bombardier's survival, more orders should flow in as the C Series heads toward certification. So goes the thinking of Mr. Peter and others taking the leap to invest in Bombardier.

Preferred shares usually come with some wrinkles. The Series 2 is tied to the chartered banks' prime lending rate (the yield is 11.5 per cent owing to the collapse in the price of the preferred stock during 2015). So if interest rates start to go back up, they will increase the Series 2 dividend.

Also, Series 2 is convertible into Series 4 (BBD.PR.D) preferred shares every five years at a rate set by management on the basis of the five-year Government of Canada bond yield. The next period for conversion comes in August, 2017.

The quarterly dividend on Series 3 is $1.5625 per share, and yields 17 per cent at current prices for the preferreds. This higher yield reflects a higher level of risk: The company has the option of converting the series into common shares at 95 per cent of the closing price for a given period of time, or at $2 a share, whichever is more.

It may be that Bombardier's common and preferred shares have become additionally depressed at this time owing to investors selling for the purpose of claiming tax losses. For the thinly traded preferreds, the selling pressures may have dragged prices down a fair amount.

Bombardier shares, however, remain highly speculative – especially considering current negative cash flow and the large amount of debt on the balance sheet. There is the possibility all of one's principal at risk could be lost. Nerves of steel are good to have, but so is an investment position of a prudent size within a diversified portfolio.

Larry MacDonald is an economist, author and financial writer who blogs at larrymacdonald.serveblog.net/home. He owns BBD.PR.B.

Bombardier (BBD.B)
Close: $1.15, down 4¢