Dividend Investors: Collect a Massive 8.7% Yield From Bombardier, Inc.

Description

When it comes to **Bombardier, Inc.** (TSX:BBD.B), I think there's no way either Quebec or the Federal Government will ever allow it to go to zero.

This attitude is particularly frustrating for folks in Alberta. Hundreds of oil and gas producers and service companies have gone bankrupt during this downturn, taking thousands of jobs with them, and not one received federal assistance. Bombardier received assistance from its own provincial government as well as Ottawa with the latter giving Bombardier $372.5 million in interest-free loans.

The logic behind giving Bombardier assistance is simple: Quebec is much more politically valuable than Alberta. Prime Minister Justin Trudeau knows he has very little chance to make major inroads in Alberta, especially among energy workers. A Bombardier bailout carries much more clout.

Instead of fighting this, I recommend investors make this knowledge their friend. If we assume Bombardier will be bailed out whenever it experiences difficulties, it makes the company's preferred shares a very attractive dividend option.

Why the preferreds?

Bombardier's preferred shares are essentially perpetual debt issues, but with some major advantages.

The first is, they simply can't be diluted like common shares. At the end of 2013, Bombardier had 1.7 billion common shares outstanding. It has raised capital twice since, raising the total share count by about 500 million. Naturally, each share is worth less than before.

And remember, Bombardier's common shares don't pay a dividend. It costs the company nothing in ongoing costs to raise capital this way.

Preferred shares are different. Although they are technically equities — which means the company can stop paying the dividend at any point — preferred shares are much more like debt. They fluctuate depending on the company's credit worthiness and interest rates. As long as a company can pay the dividend, preferred shareholders are much more forgiving of temporary weakness than common shareholders.

Because preferred shares are essentially debt instruments, a company sends a huge message to the market when it stops paying preferred shareholders. Management will only eliminate preferred share payments as a last resort.

Bombardier has a couple of interesting preferred shares. The Series 3 preferred shares (which trade under the ticker symbol BBD.PR.D) trade at $9.33 each and pay an annual dividend of just over 78 cents per share, which is good enough for an 8.4% yield. One thing to note is these are rate-reset preferreds, which means the payout will reset every five years. The next reset is scheduled to happen later in 2017.

The better choice for investors is likely the Series 4 preferred shares (ticker symbol BBD.PR.C), which maintain the same yield as long as they're publicly traded. They currently trade hands at $17.96 and have an annual dividend of $1.56 each, which is good enough for a yield of 8.7%.

Bombardier can call the Series 4 preferred shares, meaning it can buy them all up and eliminate the obligation. This is unlikely to happen for a couple of reasons. First, Bombardier can't afford it. And second, investors would get the full $25 per share par value. Based on the par price, these preferred shares are actually a low-cost financing option.

Investors don't have to worry about Bombardier being able to afford the dividends. It pays out just US$17 million annually in preferred share dividends — a pittance for a company with a $5.5 billion market cap.

And finally, these preferred shares offer a huge advantage at tax time for folks who hold them in non-registered accounts. The payout is taxed as a dividend, which is much more attractive than getting an equivalent payout as interest.

The bottom line

It's hard to find succulent yield in today's market. While Bombardier's preferred shares don't offer nearly the upside potential as the common shares, I doubt many income investors collecting an 8.7% yield will mind.

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Date
2025/07/07
Date Created
2017/03/06
Author
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