Income Investors: Collect an 8.1% Yield From Bombardier, Inc. (TSX:BBD.B)

Description

I've been pretty bearish on **Bombardier** (TSX:BBD.B) in the past, even going as far as saying I'm avoiding the stock forever in my portfolio. I just don't see how the company can turn around its bloated balance sheet, inefficient operations, and constant cash burn.

But perhaps I'm wrong. Worse situations than Bombardier have turned around before, and I'm the first to admit there's some serious upside potential for investors who get this situation right. Shares are languishing at $2.57 each as I write this. Less than a year ago, they surpassed $5. That's 100% upside potential right there.

There's just one problem: I like to get paid to wait in a situation like that, and I know thousands of other investors also insist on dividends while a turnaround works itself out. Dividends help cut down risk — since you're getting a portion of your investment back every quarter — as well as keeping management focused on generating cash flow.

Bombardier common shares no longer pay a dividend after the board of directors made the decision back in 2015 to eliminate the payout to help conserve cash. But investors don't need to worry. With a little ingenuity, they can have access to Bombardier's upside while still being paid to wait. Here's how.

Preferred shares

Preferred shares are a hybrid security that are a little bit equity and a little bit bond. This means they're impacted by two things — the underlying company's health and interest rate expectations.

Most preferred shares are perpetual, which means a company can keep them outstanding forever. They can also be redeemed, usually at par (which is traditionally $25 per share), on a certain date. They often come with a clause saying the interest rate must be reset every five years based on government bond yields, which protects investors in case of big interest rate spikes.

It’s easy to see why preferred shares have been a popular financing choice. They’re very flexible for issuers while offering buyers some interesting benefits.

Bombardier has three series of preferred shares outstanding. We’re going to focus on the simplest of the three, the Series 4 preferred share. These trade under the ticker symbol BBD.PR.C and offer a consistent dividend of $0.391 per share on a quarterly basis — a payout that doesn’t reset every five years. That’s good enough for a 7.6% yield.

Since preferred shares are technically equity, there’s the risk the payout could be eliminated at any time. But I don’t think that’s very likely with any of Bombardier’s preferred shares. First of all, such a move sends a huge message to the market about the company’s solvency — something management would like to avoid. And the total payout for all three preferred shares is just $20 million annually. That’s a drop in the bucket to Bombardier, which has an enterprise value of more than $12 billion.

And remember, preferred shares aren’t suffering the same dilution as common shares. Bombardier just raised an additional US$500 million equity round, further driving down the value of the common shares. Since preferred shares come with a significant annual cost — at least when compared to the common stock, which pays no dividend — the company will always choose to issue common stock versus issuing new preferred shares. This keeps the preferred dividends on solid ground.

The bottom line

Investors looking for a less-risky way to play a potential Bombardier recovery should really check out the preferred shares. Not only do the preferreds offer a nice payout, but they could easily rise 10% or 20% as the company’s overall credit profile improves. That translates into a nice total return all while taking considerably less risk than an investment in the common shares.

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