

Even Bomber can fly when investors keep buying the turkey

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They really do work on their image, that **Bombardier** clan. Viewers who watched Global's broadcast of the Super Bowl were subjected to repeated airing of the company's TV ads -- the ones starring Canadian tourists in far-off places who spot Bombardier products and lovingly coo, "That's my plane" or "That's my train" to befuddled, non-Canadian tourists.

Don't look now, but the image is improving -- if not with the public or corporate welfare critics, then with investors. Bombardier is a star again. Its 55.6-per-cent gain in the past year is better than all but five other stocks in the large-cap TSX 60. Money managers who'd written it off years ago -- you know who you are -- now regret that decision.

The Bomber's sudden resurrection is partly the result of an improving business and partly good fortune. The corporate governance pests are in retreat, companies have bulging bank accounts, and CEOs and directors feel it's okay to fly around in style again. Bombardier Aerospace had a backlog of \$11.6-billion orders through October, up nearly \$1-billion from January, due mostly to demand for business jets. (The rest of the business is not as healthy, but at least we're past the era when airlines were filing for Chapter 11 every month.)

The good fortune part has to do with the mindset of investors. In a strong economy and a raging bull market, it's the low-quality stuff that moves the fastest, since any improvement in profit margins will have a bigger impact on their bottom line. Not that you'll find very much on the Bomber's bottom line: just \$135-million in profit in the first nine months of fiscal '07, or 8 cents a share. Nor, at the moment, will you find any free cash flow.

But who cares? The stock's going up, and besides, the market is about looking forward, not backward. Investors anticipate improvement in profit margins. And they're likely to get it, too, with a bit of help from the accountants.

Any mention of "Bombardier" and "accounting" in the same sentence is usually enough to cause angina in shareholders. Everyone remembers the big disaster of 2003, when the company admitted that previous profit levels were a mirage and took \$2.2-billion in writedowns (before tax).

Since then, the books have been cleaner but they're still the subject of all kinds of debate. Some of the scrutiny is simply a function of accounting in the aerospace business. If you spend \$1-billion developing a new jet, how quickly do you recognize that expense? That depends: Are you going to build 500 of them or 700? How the hell do you know? The bookkeeping requires constant estimates on costs and volumes. Not until the last one has rolled out of the factory does the company know how much it has really earned on a given aircraft.

Since so many estimates are involved, and since estimates are often wrong, the result is frequent "adjustments" -- writeoffs and the like. It keeps the investor on his toes. In the second quarter, for example, Bombardier lowered its estimate for how many 70- and 90-seat regional jets it will

produce, and the company took a \$74-million "catch up" charge, says Anthony Scilipoti of Veritas Investment Research.

Here's the rub: The company would have had to recognize that \$74-million in costs anyway; it represents cash that has already been spent. But now it has taken that hit all at once, instead of spreading it out over future quarters. And the Bomber has made other adjustments, too, of late -- changing its estimate of the cost to build some business jets, for example.

What does it all mean? With some costs (conveniently) written off and others on the decline, the company's aerospace margins are almost certain to improve, says Mr. Scilipoti, barring an unforeseen collapse in prices and orders. If he's right, that's potentially significant. Right now, Bombardier Aerospace earns just 3 cents in operating profit for every dollar in revenue. Every 1-cent increase adds about \$80-million in operating profit.

To be clear: There's no scandal here. It's just a good illustration of how accounting choices might give a business the *appearance* of big momentum. That's something to watch for when Bombardier releases its year-end results in the coming weeks. Of course, it's still a crummy business. But in some markets, that's what sells. Kenneth Fisher, the American money manager and Forbes columnist, predicted in December that this will be the year of the low-quality stock: "Turkeys will fly," he wrote. Bombardier is one such flying turkey. That's my plane, indeed.

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