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Stormy skies: Bombardier flies a risky flight path

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Bombardier is spending heavily to bring some key new aircraft to market and reassert itself in an increasingly cutthroat industry. But first Canada's planes and trains giant must push hard to pull out of a worrisome descent.

Bombardier Inc. employees have a phrase for the kind of personal feel-it-in-your-gut commitment to the company that goes well beyond normal work duty. They call it "*avoir le sang jaune*."

Literally, it means to have yellow blood, a reference to the colour of the first snowmobiles cranked out by company founder Joseph Armand Bombardier in Quebec's Eastern Townships. There's a book by that name, which chronicles the effort of Mr. Bombardier's son-in-law, Laurent Beaudoin, to put the manufacturer on a fast-growth trajectory from bit regional player to iconic Canadian multinational.

Today, it's Mr. Beaudoin's son Pierre steering Bombardier as chief executive. And the 52 year-old's own yellow, cold-blooded resolve is being tested as never before.

The Montreal-based transportation giant is facing one of the biggest challenges in its 73-year history. Under attack by global competitors and slowed by its own missteps, Bombardier is being forced to re-engineer its business and fend off a brewing cash crunch.

The company has already discontinued a key business jet under development as it focuses resources and cash on priority programs such as the C Series airliner. But with increased focus comes increased risk, and investors see plenty. Bombardier's shares have plunged to levels seen two decades ago, and confidence in the company's prospects for a quick turnaround is slipping.

"There's just too many question marks in my mind to feel comfortable" adding to our position, said Manash Goswami, a fund manager for First Asset in Toronto, which holds Bombardier shares.

"There's just so much uncertainty."

Pierre Beaudoin insists the company will overcome its current struggles.

"We built the company, whether it's my grandfather, my father or myself ... by setting bold targets and going after big projects," he told The Globe and Mail from Davos recently. "In doing this you get some ups and downs. And I feel that, this time, we're coming very close to the delivery of very important projects for Bombardier."

But while Mr. Beaudoin was in Switzerland, back in Toronto Bombardier's share price was finding a bottom near $2.50 after a stunning 40-per-cent drop over three days. The company had warned that already-thin profit margins for both its aerospace and train units in 2014 would be less than previously expected, and said cash flow from operations for aerospace would be $800-million, some $400-million less than the lower end of previous guidance. Investors saw that the company could come dangerously close to running out of money without fresh funds.

Bombardier also announced it would suspend the development of its new Learjet 85 business aircraft and lay off 1,000 workers. Observers took that as a sign Bombardier needed to conserve cash for its other two major jet development projects: The commercial passenger jet C Series and the new Global 7000/8000 business aircraft.

At the heart of the plane and train maker's shocking financial revision was a big mismatch between orders for new aircraft and actual deliveries. Winning fewer orders could erode Bombardier's cash position further and affect its borrowing agreements, just as it pushes to finish tests on the C Series and get it into service by the end of 2015.

The sharply lower financial projections stunned followers. "Management has lost all credibility," said ***Veritas Investment Research analyst Anthony Scilipoti***. "The lowered 2014 guidance suggests that management does not have a clear handle on its existing business," he said, adding that he believes the company's dividend is at risk.

The C Series program was problematic from the start. After restarting development in 2007 following a dearth of orders, Bombardier subsequently pushed back the entry into service again two more times, citing supplier issues. That, in turn, resulted in at least one cancelled order.

When an engine on one of four C Series test aircraft caught fire during a ground test, the program suffered an embarrassing and high-profile setback. Although a minor fault in the lubrication system was the cause, Bombardier didn't have the plane available to show off at the prominent Farnborough air show in England.

Profit misses and program delays didn't sit well in the chief executive suite. Mr. Beaudoin decided he needed a better window into the plane business, one inside source said.

The result was a massive reorganization that saw the dismantling of the aerospace umbrella group this past fall. Some 2,000 white-collar workers lost their jobs and the three senior executives leading the business aircraft, commercial aircraft and aerostructures units now report directly to Mr. Beaudoin.

"He wanted to be able to see the bad news as well as the good news and to have that visibility," said the source, adding that the new structure has also raised the accountability of the business unit leaders. Bombardier used to have senior-level meetings with dozens of people present. Now, attendance is restricted to a select group of the most pertinent.

Corporate jet orders stall

The key challenge now facing Bombardier executives is a slow pace of aircraft sales.

Altacorp Capital analyst Chris Murray estimates Bombardier received new orders for barely 14 Challenger and Global corporate aircraft in the fourth quarter of 2014 while shipping out about 60 of the same models for a book-to-bill ratio of roughly 0.25. Because Bombardier typically books cash advances when planes are ordered, fewer orders means fewer advances.

"Basically they need more order intake, with higher levels of advances up front," Mr. Murray said. "Because that builds up their cash balance."

The analyst predicts Bombardier's business jet unit will end 2014 with a book-to-bill of barely 0.6 per cent, meaning it will tally orders for barely six new jets for every 10 it ships. That's the weakest order intake in at least three years.

Do the slow sales signal tough times for corporate jet sales? Not exactly. General Dynamics, the U.S. military contractor that owns Bombardier rival Gulfstream, said its aerospace business chalked up more jet orders during its last quarter than any quarter in more than three years. Cessna maker Textron also has a positive outlook for business.

As for Bombardier, it held an industry-leading position as recently as 2013, and had a recent business jet backlog that stretched as long as 33 months for the mid-sized Challenger jets. But until it gets its next-generation large-cabin Globals to market, it risks losing ground to rivals.

The problem, notes aerospace consultancy Teal Group, is that Gulfstream largely stole the show in recent years with its new G650 jet. From 2005, when it first unveiled plans to build the jet publicly, to 2014, Gulfstream increased its corporate aircraft market share to 39 per cent from 25 per cent.

Bombardier was late to respond with its own new high-end model, the Global 7000/8000, Teal noted. That plane is scheduled to enter into service next year but still hasn't flown. Bombardier "gave five years, and probably more, to Gulfstream," said Teal's vice-president of analysis Richard Aboulafia.

Interviews with people arranging the corporate jet buying and selling, however, paint a more nuanced picture.

It's not necessarily that the $70-million Gulfstream G650 is such a superior plane to anything Bombardier has. Plane broker Edward Dahlberg with Emerald Aviation in Manassas, Va., said that on early G650 units, the plane's oven would automatically turn on when the aircraft was powered up. "Everything about the inside" of Bombardier's top-priced Global 6000 is better than the Gulfstream, he said.

But Gulfstreams have the advantage on range. Both the G550 and G650 can fly further than current in-service Bombardier planes. Savannah, Ga.-based Gulfstream is also perceived to offer superior post-sale support than Bombardier, Mr. Dahlberg said.

Credit stress

With two critical airplane development programs under way at once and a third on ice, investors are now zeroing in on Bombardier's cash position.

Management insists that with access to $3.8-billion in liquidity (including $2.4-billion in cash and $1.4-billion via separate credit agreements), the company has enough liquidity to fund operations and current aircraft development programs.

Others aren't so sure, and expect the company will have to raise money at some point during the year. Among the various financial covenants under its credit agreements, the company must maintain minimum liquidity of $827-million at its train unit and a minimum $500-million at its aerospace unit at the end of each quarter.

Bombardier has had success raising bond debt in the past. But whether it can do so now on the same terms is unclear. Creditors seem shaken by the recent turn of events at the company, bidding up yields on one tranche of bonds maturing in 2018 to 7 per cent from 4 per cent. Bombardier had some $7.6-billion in long-term debt at the end of September, 2014. Standard & Poor's and Moody's Investors Service rate the company's debt as junk.

Turan Quettawala of Bank of Nova Scotia sums up the worst-case scenario. "The numbers are big and scary" as it relates to Bombardier's liquidity, Mr. Quettawala said in a recent note. He estimates the company will need about $1-billion in financing over the next 12 to 15 months to plug the hole from negative free cash flow in 2014 and 2015. The company also has $750-million in debt maturing in January, 2016.

"The key here is that Bombardier will need to access the capital markets over the next year or so," the analyst said. "While debt will obviously be the first choice, the opportunity is getting slimmer with a worsening balance sheet, another credit downgrade, and continued execution problems."

In the past, Bombardier could frequently count on its train business to provide a floor value on the company's shares when its plane0making side ran into trouble. But now, Mr. Quettawala says even that historic stability has cracked as the train unit's profit margin falls.

The C Series as saviour

Still, Bombardier is far from finished.

Bombardier remains the leading manufacturer of rail transportation equipment in the world. It has historically had a solid position in business jets, especially on the larger-sized aircraft.

The aerospace reorganization should boost income. And Bombardier enjoys remarkable international brand recognition.

A weakening Canadian dollar should also help. And analysts note that the company has bounced back from liquidity issues before.

Mr. Aboulafia argues that when Bombardier put the Learjet 85 development program on ice, it was a de facto admission that it needed to save money everywhere it could so as to finish the jet programs that were a priority. The company this month also sold its military aviation training business to CAE Inc..

Bombardier called its Learjet 85 move a "pause," insisting it would be revived when market conditions improve.

"[That's like saying] 'Kids, the vet had to pause the family dog,' " Mr. Aboulafia says. "You don't fire 1,000 people and write off $1.4-billion for a pause. The 85 is clearly dead."

As for the C Series, tests are going well now after previous delays.

Bombardier has completed one-third of the 2,400 flight test hours needed on the aircraft. With 150 hours of testing per month, the company should be able to achieve its target of putting the jet into service by the end of 2015.

The plane had its so-called cold soak testing in Montreal in January, where it is left outside overnight and restarted in the morning. So far, the jet is performing the way the company predicted it would. But whether the slick-looking and silent aircraft will achieve the kind of sales momentum and payoff the company hopes remains to be seen.

Bombardier has invested a lot of effort and capital on the C Series. The plane maker has secured support totalling $650-million (U.S.) from both the Canadian and U.K. governments and convinced Pratt & Whitney to develop a new fuel-saving engine for the plane.

But total development costs on the program have already blown out to more than $4.5-billion, a sum roughly equivalent to the current market value of Bombardier's widely-traded B shares. As of the end of 2014, the plane maker had booked firm orders for 243 C Series units. It wants 300 by the time the first plane gets delivered.

Bombardier's bet: That passengers, sick of having to fly through major airport hubs to get to where they are going, would appreciate a direct link on a single-aisle jet smaller than existing Boeing 737 and Airbus A320 aircraft. And that by manufacturing a plane with 15-per-cent lower operating costs, it could make it financially viable for airlines.

The company plans to make two models – the smaller CS100 with up to 125 seats and the larger CS300 with up to 160. In a forecast released last year, it predicted that demand for jets seating 100 to 149 people would be as many as 7,100 units over the next 20 years. It said it believed it could win half of those sales.

Intense competition

What Bombardier likely didn't count on was such a forceful and immediate response from the world's two big plane giants.

While Bombardier struggled with delays and convincing prospective clients it could deliver the C Series on time, Airbus and Boeing moved quickly to offer improved but not fully-redesigned versions of their smallest single-aisle planes.

Airbus was first, launching its A320neo line in 2010 – three planes ranging from 124 to 240 seats and promising better fuel economy. Featuring the same Pratt & Whitney engine as the C Series, the jets are being pledged to customers for a delivery date this November. It could beat the C Series to market.

Boeing followed with its revamped 737 Max line, offering roughly the same seat options and also promising savings on fuel burn. Then Brazilian regional jet rival Embraer jumped into the fray with a decision to outfit its commuter planes with new wings and longer fuselages. Its planes will also use the new Pratt engine.

Bombardier had expected Boeing and Airbus to respond to the C Series. But it didn't figure it would happen so fast. The rivals' strategy in sum: Put a new engine on existing planes, keep your current customers.

"The last thing Bombardier ever wanted to do was to have to compete with Boeing and Airbus, I can guarantee you that," said Rolland Vincent, a U.S.-based aerospace consultant who worked for Bombardier Aerospace in the 1990s doing international market analysis.

Among the advantages the incumbents have over challenger Bombardier is their massive, multiyear backlogs. Boeing alone has enough single-aisle jet orders on its books for eight years of work.

That offers the company tremendous pricing power to offer discounts to customers. And it also gives them an edge on arguing for systemic continuity. Airline employee rosters around the world are full of pilots that know how to fly Airbus and Boeing planes. And a vast airport and maintenance infrastructure built for the more than 10,000 Airbus and Boeing single-aisle jets flying today makes planes from competing manufacturers a less obvious choice.

When it comes to market, the C Series will be more than two years late and likely over budget. The real test for the plane will be whether it sells in sufficient quantities to justify its development cost.

Kevin Michaels, vice-president of global aerospace consultancy ICF International, believes Bombardier will sell only 50 C Series units a year when the aircraft goes into service, well shy of the program's likely break-even point. He notes that the company will also need $1-billion to bring the next-generation Global 7000/8000 business jets to market.

"As I look at the world as it is today, I'm not sure I see a real strong path for [Bombardier's] air transport division," Mr. Michaels said. "It's a strategic problem. It's not just a financial problem."

Mr. Michaels raises the possibility that Bombardier will eventually decide to sell its entire commercial aircraft business to focus on higher-margin business aircraft manufacturing. He believes China-based plane maker Comac is a logical buyer, dubbing this the "Combardier" scenario. Bombardier executives have been multiplying their trips to China in recent years in an effort to better understand the market, he notes, adding that the Chinese would benefit most from Bombardier's global product support system.

Faith in the future

Gary Scott, the former Boeing executive Mr. Beaudoin tapped to lead the C Series program before he retired, is among those who have faith in Bombardier's future. He cautions that the vast majority of the single-aisle jet market – 80 per cent in fact – is above 150 seats. Bombardier is just competing for its share of the remaining 20 per cent. And he says that looks perfectly doable.

"I used to always say 'It's a lousy half-a-trillion-dollar market,'' Mr. Scott said. "That's a small number for Boeing and Airbus based on their $5-trillion-plus market. But it's huge for Bombardier and Embraer."

McGill University professor Karl Moore, who has brought Mr. Beaudoin to speak to his students, said the executive appears relaxed.

Bombardier has dropped the ball on execution compared to the company's past record, Mr. Moore notes. But Pierre Beaudoin's eyes are now squarely on the future.

"I don't think he has to worry about Bay Street that much," Mr. Moore said. Mr. Beadoin is thinking "I'm doing the right thing. I'm just going to push forward and I'm not going to quit," Mr. Moore said.

"There are times when it doesn't look good but it works out. And this is one of those times."

With files from reporter Bertrand Marotte in Montreal.