

Pro Forma Numbers Masked Nortel's Woes: Warning Signs Buried: While Reporting Billions In Profits, Nortel Bled Red Ink

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When Nortel Networks Corp.'s stock crested above the \$120 level the market was blasted with hype about the company's enormous potential. When its "can't miss" business model fell short of the target, investors were left wondering how it all went so wrong.

What is now clear is that numbers buried within the company's quarterly financial statements held a warning of what was to come. For an investor willing to do the digging and tune out the noise from the surging stock market, Nortel's cash flows were sending off a barely-audible ticking noise.

Worrying signs emerged months before the company's slide began in spring, 2000, but they were obscured by a "pro forma" accounting system that emphasized the company's growth and profit by excluding acquisition-related costs and items the company considered "unusual." Also buried in those financial reports was the extent to which Nortel was lending money to struggling customers, and inflating its own sales in the process.

Shareholders who wanted to sidestep the stock's devastating fall would have needed to fight through the rosy haze of aggressive accounting to ask some difficult questions about its operations. In doing so, it becomes clear that Nortel never made the mountains of cash from its core operations that many believed, even when it was flying high.

Perhaps the first red flag in Nortel's earnings was the widening chasm between the pro forma results Nortel was emphasizing and the Generally Accepted Accounting Principles (GAAP) numbers revealed in its regulatory filings.

In 1998, the company reported a pro forma "net income from operations" of US\$1.07-billion, while U.S. GAAP showed a bottom-line loss of US\$1.28-billion.

Further complicating matters, Nortel reports its numbers three ways: pro forma (excluding several acquisition-related and unusual charges), and according to the different set of GAAP accounting rules in Canada and the U.S.

For investors trying to compare performance to quarters and years past, that presents the challenge of juggling multiple sets of numbers. Under Canada's different GAAP accounting rules Nortel's 1998 loss was \$569-million. Because Nortel reports in U.S. dollars and does most of its business abroad, we have chosen to focus on the U.S. GAAP results.

In 1999, Nortel's pro forma "net income from operations" swelled to \$1.43-billion as sales increased 26%. The GAAP net income figure remained mired in negative territory, with a loss of US\$351-million.

And in 2000, just as Nortel's pro forma results hit a record high of US\$2.3-billion, standard GAAP accounting showed a staggering US\$1.3-billion loss.

Nortel explained away the differences as distortion caused by non-cash charges from a slew of acquisitions. But buried in the company's cash flow statement, an even more worrying trend was developing and it had everything to do with real money.

Analysts now suggest that Nortel's core operations began bleeding cash at an alarming rate early in 1999, just as its stock was taking flight boosted by optimism about the future of the Internet and demand for telecom services.

To calculate Nortel's real cash from operations, **Anthony Scilipoti**, an analyst at **Veritas Investment Research** in Toronto, started with the company's reported cash generated from operations, found on its cash flow statement in regulatory filings, and subtracted what Nortel spent on capital projects, such as building factories and buying equipment. He then subtracted the net increase in the company's long-term receivables, contracts for which Nortel shipped product without being paid as a form of loan to the customer, known in the industry as "vendor financing." Finally, **Mr. Scilipoti** subtracts dividends paid to preferred shareholders.

This gives a clearer view of the profitability of Nortel's core business, or how much the company made from designing, building and selling equipment to move voice and data traffic over communications networks, he said.

By that measure, Nortel went from a US\$299-million cash income in 1998 to a net cash drain of US\$873-million in 1999.

It was in March, 2000, that Nortel shares hit their super-heated peak of \$123. That was also the year that Nortel's pro-forma results diverged most sharply from its core operating cash flow. As Nortel increased sales 42%, it told investors and analysts its pro-forma profit hit US\$2.3-billion, even as its core business burned through more than US\$2.7-billion. Inventory levels grew by 53% in a year and spending on new facilities more than doubled.

By 2001, the shine had come off the telecommunications sector as the world's major buyers abruptly stopped expanding their networks. As it became clear that the world had a massive glut in capacity, Nortel's sales collapsed 42% to US\$17.51-billion, its first annual sales decline in more than a decade.

Even by Nortel's own pro-forma measures the company was hemorrhaging, with losses of US\$4.5-billion. And that did not include most acquisition-related costs and the price Nortel paid in severance to slash thousands of jobs. GAAP net loss figures hit a staggering US\$27.3-billion as the company wrote off the value of acquisitions and unsold inventory sitting idle and depreciating in warehouses.

In total, between 1997 and 2000, Nortel claimed a pro-forma profit of US\$5.61-billion. But heading into 2001, the company had burned through more than US\$3-billion in cash from its core business. That, combined with an even deeper slowdown in 2001, was at the heart of the company's debt crunch late last year, which forced it to renegotiate some of its debt terms.

Drawing a direct link from Nortel's cash woes to its subsequent meltdown wasn't a slam dunk, says Robert Reid, a veteran stock analyst and head of Independent Equity Research. Mr. Reid says **Mr. Scilipoti's** calculation of cash flow from operations reveals a high cash burn rate that Nortel could have justified if it truly believed it was investing in a business that would continue to grow at an exponential rate.

"I don't think anyone can claim to have predicted the severity of the slowdown," he said. "They were running negative cash, which is important to know whether they'll be able to fund their business, but I don't think it's a measure of profitability."

Nonetheless, Nortel's cash flow statement shows its operating cash flows, excluding capital spending investment losses and financing costs, began to deteriorate in 1999. That year, they fell 29% to US\$1.05-billion and in 2000 those cash flows plummeted to just US\$40-million.

Still, Mr. Reid and others are more concerned with Nortel's use of extensive vendor financing to aggressively pursue market share. He points to the steady increase in Nortel's long-term receivables, and the even quicker rise in provisions for doubtful accounts.

Back in 1997, vendor financing represented just 2.5% of Nortel's overall sales and only 7% of those vendor financing deals were written off as doubtful accounts.

Two years later, in 1999, vendor financing had risen to 7.7% of Nortel's revenue and 17.3% of those sales were written down because the customers were unlikely ever to pay. Through the first three quarters of 2001, as small telecom carriers struggled to stay in business, vendor financing represented 10.8% of Nortel's revenue, with an astonishing 63.8%, US\$968-million, written off as uncollectible debt.

"Nortel and everybody else in the business were actively lending money to customers," Mr. Reid said. "Sure, it's there in 'long-term receivables,' but did they adequately alert people that they were taking money in one pocket and pushing it out the other?"

And this process shows few signs of letting up. Last week, Nortel announced a US\$250-million agreement with Telefonica SA to provide network gear, up to US\$230-million of which will be subject to vendor financing.

With so many worrying signs found in the company's results, how did virtually the entire investment community miss this developing storm? Many investment professionals now call it a disastrous case of peer pressure.

During the run-up, many investors remained highly skeptical of Nortel's meteoric share performance. But money managers are generally judged and paid according to their performance versus the TSE 300. When Nortel's weighting in the index shot above 30%, it became virtually impossible to match the index, let alone beat it, unless you had a significant number of Nortel shares.

Even value-oriented investors, highly concerned about its unconventional accounting and lofty price, felt compelled to jump on the bandwagon. When the music finally stopped, almost every investor in the Canadian market was hit either directly or indirectly.

Nortel may not be deliberately deceiving investors, but it sure doesn't make it easy for small investors to sniff out trouble early on. Until last year, the company didn't provide a complete balance sheet with its quarterly earnings releases. Investors had to wait for weeks until the company filed official documents with securities regulators before getting a look at its debt and asset levels.

And Nortel still doesn't include a cash-flow statement with its earnings reports. Many analysts say it was the cash-flow statement that provided the most important indications that Nortel's business may have been deteriorating in 1999.

"Not releasing a cash-flow statement makes it almost impossible for the investor to make an informed investment decision," **Mr. Scilipoti** said.

But Mr. Reid is quick to point out that many outraged investors simply failed to do their homework, or ignored the signs of what was to come. While Enron Corp. conspired to keep many of its results hidden and out of its financial statements, all of Nortel's results were available for those who went looking. But when stocks are surging, few ask the tough questions, he said.

"People are responsible for looking at these numbers themselves," Mr. Reid said.

"You can't just trust the managements or the auditors or the analysts to do it for you."

DIFFERENT LINES TELL DIFFERENT STORIES:

Nortel's Financials
(Amounts in U.S. dollars)

	1998	1999	2000	2001
Sales	16.86B	21.29B	30.18B	17.51B
Pro-forma earnings -	1.07B	1.43B	2.31B	4.51B
Cash flow from core operations*	299M	873M	2.76B	1.29B

* First 3 quarters of 2001