THE GLOBE AND MAIL

December 2, 2016

Amays's true earnings should be a further warning sign for investors

DAVID MILSTEAD

To use my gift for understatement, there are many reasons why one might consider taking a pass on the stock of Amaya Inc., the online gambling company.

Choose from: the insider-trading charges against its former chief executive officer David Baazov, or a host of other legal squabbles. Or, an offer from Mr. Baazov to take the company private, which when introduced, appears to have included purported financial backers with little to no knowledge of their role in the transaction. Or perhaps simply the pressures on the company's core online-poker business, which may suffer if casual players step away from the game.

All of these red flags are relatively easy to understand. More complex, but no less compelling, is the company's problematic financial reporting. Amaya – which was unable to respond to my questions, submitted late last week – emphasizes an adjusted profit measure that leaves out all sorts of expenses that impact the company's cash flow. Indeed, while the company reported a 2015 profit gain, Amaya's earnings instead declined, if these costs are included.

These matters also suggest that investors who feel Mr. Baazov's $24-per-share offer isn't lucrative enough should consider whether the company truly has the earnings power they think it does.

To examine the nitty-gritty of Amaya's financial reporting, we turn to the analysts at ***Veritas*** Investment Research, the firm that published a major analysis earlier this year on the use of non-GAAP earnings by Canadian companies. These earnings depart from generally accepted accounting principles because companies typically exclude all sorts of expenses to arrive at their preferred, typically higher, number for profits. Often, the justification is that the expenses are unusual and don't represent the ongoing cost of doing business.

Veritas finds that Amaya's "adjusted EBITDA" and "adjusted net earnings" include more adjustments than most of its peers in the online gambling industry. Some exclusions, such as leaving out the cost of stock-based compensation for employees, have become relatively common across a wide spectrum of industries.

Other Amaya adjustments, however, are more unusual. Amaya excludes lobbying expenses, which, as the ***Veritas*** analysts note, should be considered a normal cost of doing business, considering the company's desire enter new markets and maintain its foothold in existing ones. The company also leaves out costs related to the termination of employment agreements, which have appeared in the financial statements in each of the past three full years as well as in the first half of its current year, which suggests the costs are recurring, rather than special.

In these cases, Amaya's management is picking items normally included in EBITDA – earnings before interest, taxes, depreciation and amortization – and removing them to create its preferred, adjusted measure. In other instances, the company's leaders have made accounting choices under International Financial Reporting Standards that boost EBITDA, compared to net income.

In order to get some of its legacy businesses sold, Amaya offered revenue guarantees; if the businesses fall short of expected sales, Amaya makes quarterly cash payments to the two companies that bought them. But the cash payments don't appear as costs each quarter because Amaya estimated their value at the time of the sales. "We view these cash payments as an ongoing financial overhang that should not be ignored," the ***Veritas*** analysts say.

Amaya also capitalizes some of its costs, including employee salaries, for developing new products. Companies that capitalize development costs create an asset that's gradually written down through the process of amortization – yes, the "A" in "EBITDA." (Amaya capitalized $12.1-million in development costs, primarily related to its OnGame subsidiary in 2012 and 2013 – and then had to write off $6.5-million of the costs when it sold the business for one U.S. dollar, and gave the buyer $13.2-million in loans and revenue guarantees.) ***Veritas*** looks at "the short window" between the capitalization of these development costs and their impairment – the company bought OnGame in in November, 2012, and sold it in November, 2014 – and says it "raises questions about the quality of Amaya's deferred development assets and reported earnings.")

By contrast, ***Veritas*** notes, Canadian tech company Constellation Software chooses to place its development costs on the income statement as expenses, when they occur, rather than capitalizing them. Amaya, "in a fiercely competitive market," ***Veritas*** argues, needs to innovate to be competitive, making its development costs ongoing maintenance-type expenses, suggesting a more appropriate accounting treatment for them is expensing, which is what Constellation does.

Let's move past all these accounting and reporting decisions and get to the bottom-line impact: In 2015, Amaya reported "adjusted EBITDA" of $586.9-million, up from a "pro forma" figure of $530.7-million in 2014, a gain of 11 per cent. But ***Veritas***, in adding back all the expenses it deems relevant to Amaya's ongoing business, arrived at 2015 adjusted EBITDA of $457.3-million, suggesting the company boosted its profit figure by 28 per cent. When ***Veritas*** made the same fixes for 2014, it arrived at adjusted EBITDA of $470.8-million, suggesting a 3 per cent decline in profits from 2014 to 2015.

Veritas also spent plenty of time in its report, assessing the company's business prospects, arriving at the conclusion the shares are worth $19. The firm subsequently cut its estimate to $16.70, less than Friday's close of $19.12 and well below Mr. Baazov's offer. Investors getting in now and betting on the former CEO's success in bidding for his own firm may prosper; a look at Amaya's true earnings, however, shows the extent of this gamble.