THE GLOBE AND MAIL

September 3, 2018

Why a short seller is winning the battle so far with Maxar

DAVID MILSTEAD

Satellite company Maxar Technologies Ltd. continues to fight back against a short-seller that says the company's aggressive accounting masks deep problems in the business — but so far, the shorts are winning, with the company's shares hitting new lows last week.

The falling stock price suggests that while Maxar and short-seller Spruce Point Capital Management wrestle over finer points of accounting, investors may now be taking a closer look at Maxar and becoming more aware that with the current business climate and its capital needs, the company is generating very little cash — which may put the company's dividend at risk.

Maxar, known as MacDonald Dettwiler & Associates Ltd. until a merger last year, issued a lengthy statement of defence on Aug. 24, describing a report from Spruce Point as containing "inaccurate statements and misleading conclusions." At the same time, however, it also said it may need to take an impairment charge in the current third quarter, writing down the value of its GEO Satellite business owing in part to potential "lower revenue expectations."

From the Aug. 23 close — the last trade before the Maxar statement of defence — to last Tuesday's 52-week low of $39.74, the company's TSX-listed shares lost nearly 11 per cent. They recovered slightly to close the week at $40.45, but have still lost nearly 30 per cent of their value since Spruce Point released its report Aug. 7. (The company pays a quarterly dividend of 28.4 US cents for a current yield of 3.7 per cent.)

British Columbia-based MacDonald Dettwiler acquired U.S. satellite maker DigitalGlobe in 2017 and said it would adopt a new name, Maxar, and a new headquarters in Colorado in an effort to become a U.S. company, with all the potential government-contract business that entails. The combined company uses its own satellites to sell images to public- and private-sector customers. It also manufactures satellites, a heavily capital-intensive business.

Spruce Point's critique, released Aug. 7, suggested the company's preferred metric of EBITDA, or earnings before interest, taxes, depreciation and amortization, is inflated by accounting choices made as part of the DigitalGlobe merger and after the deal closed. The Maxar accounting incorporates company decisions on how it capitalizes development costs, as well as its merger-accounting choices to create intangible assets when it valued DigitalGlobe. By shifting operating expenses into depreciation or removing them entirely, the company can boost EBITDA or net income.

Maxar says that once Spruce Point published its critique, the audit committee of its board reviewed the company's financial statements and disclosures with the assistance of KPMG, its outside auditor, and other "independent third-party subject matter experts," and "found no material errors."

It's Spruce Point's contention, however, that Maxar's accounting is not so much incorrect under International Financial Reporting Standards, but aggressive. And it is not the first time that this charge has been levied against MacDonald Dettwiler.

In reports in 2011, 2012 and 2014, Toronto-based ***Veritas*** Investment Research issued reports critiquing MacDonald Dettwiler's accounting and disclosure. In 2011, ***Veritas*** noted the company was excluding stock-based compensation costs from its preferred earnings metric, moved interest costs into a different portion of its cash flow statement (as permitted by International Financial Reporting Standards), and had reduced the number of operating segments it reported.

In 2012, ***Veritas*** said the company's earnings seemed to be deteriorating, despite the company's preferred measures, and a weakening in the business seemed to be a motivator to buy Loral Space Systems. And in 2014, the firm said MacDonald Dettwiler was improving its preferred earnings metric by choices it made in merger-related purchase-price accounting and capitalization of development costs, an eerily similar critique to the Spruce Point allegations.

Today, ***Veritas*** analyst ***Dimitry Khmelnitsky***, the author or co-author of those reports, is in the interesting position of keeping Maxar on the firm's "accounting watch list," but placing a "buy" recommendation on the shares. Mr. ***Khmelnitsky*** agrees with some of Spruce Point's accounting observations, while rejecting others.

Mr. Khmelnitsky estimates Maxar's accounting choices boost its earnings per share by 27 per cent, versus Spruce Point's suggestion of a 78-per-cent increase. However, he says ultimately he's valuing Maxar on its potential free cash flow, which is unaffected by the accounting choices at issue.

And while he does not expect the company to generate any meaningful free cash flow through 2020, "given the capital intensity of Maxar's businesses," he sees the company's capital expenditures as necessary to deliver future growth.

That shifts the argument to Maxar's prospects, which Spruce Point says are dim and Maxar says are not, with ***Mr. Khmelnitsky*** leaning toward Maxar's view. He notes that after his skeptical 2012 report on the Loral acquisition, MacDonald Dettwiler landed a $700-million contract to build satellites, which doubled the company's backlog of orders (excluding the Loral business).

Spruce Point argues that the high resolution of Maxar's satellite imagery is unnecessary for most customers and a major U.S. government contract is due for a price cut, not a price increase, on renewal. ***Mr. Khmelnitsky*** models an 8-per-cent decline in the contract price and still arrives at a US$53.50 target price for the company's U.S.-listed shares, which represents upside of 72 per cent.

Maxar's response says the company "continues to articulate a clear strategy for future growth and value creation," including a strategic review of its money-losing telecommunications-satellite business and the possible sale of a property in Palo Alto, Calif., that could yield US$150-million to US$250-million.

These plans prompt ***Mr. Khmelnitsky*** to suggest "concerns related to a potential dividend cut seem overblown." But Spruce Point, in tweets directed at the Maxar response, say the company has a poor track record of forecasting its capital expenditures and its language Friday "does not provide strong support for the dividend." Maxar referred to its liquidity as being a means "to support its operations," and said it would improve its cash flow "with a priority to pay down debt."

Said Spruce Point: "In our view, this is the strongest tacit admission that Maxar is likely to cut the dividend in favour of debt reduction."