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Manitoba Telecom Services will need its strong cash flows if things don't work out quite as well as it expects with its pension plans.
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Manitoba Telecom may gush cash, but watch that pension deficit

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Manitoba Telecom Services Inc. is, in many ways, a cash-flow story.

The company's 2012 revenue was down from the prior year, and 2013 promises no large rebound. Earnings are likely to decline, per the company's guidance. But free cash flow – money generated by operations, minus capital expenditures – is poised to show a healthy increase this year.

That means investors should turn their eyes to the company's underfunded pension plans, and the means by which MTS Allstream, as it likes to be called, satisfies its obligations to them.

The issue came to my attention last fall, when Veritas Investment Research produced a report on pension deficits among companies in the TSX 60 Index. MTS Allstream isn't in that index, but ***Veritas's Dimitry Khmelnitsky*** and ***Diana Akmal*** included the company anyway because of what they called a "material" pension deficit. (The company has produced its 2012 results, and its deficit has increased to $419.3-million, versus the company's market capitalization of about $2.1-billion.)

How is MTS Allstream fixing the situation? While firms like BCE Inc. pump hundreds of millions of dollars of cash into their pensions, MTS Allstream is satisfying much of its obligation by making perfectly legal promises instead.

Changes to the Pension Benefits Standards Act made in 2011 allow companies to use letters of credit – notes from a bank that say a company's good for the money – to meet regulatory funding obligations. All the companies have to do is use these letters of credit for no more than 15 per cent of the plan's assets.

MTS Allstream is taking full advantage of the new regulations. At Dec. 31, it had taken out $235.9-million in letters of credit for its three employee pension plans. It plans to obtain roughly $35-million more in letters of credit in 2013. That will take it close to the limit, the company's chief financial officer, Wayne S. Demkey, said in an interview.

To be clear, MTS Allstream is not borrowing money, putting it into the plan, and investing in the markets. Instead, the letters of credit sit there, un-investable, a kind of IOU. Meanwhile, with the benefit of hindsight, we know that companies that have been pumping cash into their plans in the past three-plus years have benefited from rising equity markets. As have their employees and retirees, to whom these pension payments are owed.

Meanwhile, MTS Allstream's use of letters of credit, rather than cash funding, has propped up its free cash flow numbers. In 2012, it came in at the low end of its cash flow guidance at $117.6-million; it cited "lower pension funding" as a positive, suggesting the $80-million in new letters of credit made the difference in making its numbers.

The company plans to cut back its capital expenditures in 2013, so it's guiding to somewhere between $160-million and $200-million in free cash flow. That's after a $70-million pension cash payment it made earlier this year because it has already maxed out its use of letters of credit for the pension plan at its subsidiary MTS.

Much of the problem with pension plan funding here, and across the world, is rock-bottom interest rates. When companies measure the value of all the future benefits owed to pensioners, it discounts them to one present-day figure. Lower interest rates make that value higher; as rates increase, the value of the benefits looks smaller.

"Their position is not getting better, and they really, really need rates to go up," ***Veritas's Mr. Khmelnitsky*** says. "More so than the other telecoms."

Mr. Demkey, of MTS Allstream, unsurprisingly takes another view, arguing that the deficit, as reported under international accounting standards, paints too harsh a picture.

"If you look at this over the long term, I'm not sure I see the urgency ... I think our pension situation is getting better at this point. Interest rates are moderating, and asset returns have been very strong – we were in excess of 10 per cent last year – and we're funding over a reasonable period of time, using letters of credit in a modest way. Over the long term, we expect our pension situation to get significantly better."

And, he adds, "we have strong cash flows."

Which the firm will need if things don't work out quite as well as it expects with its pension plans.