

Nortel Prompts Some Concern Over a Decline In Cash Supply

By Mark Heinzl, The Wall Street Journal

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While telecommunications investors industry wide are fretting over burgeoning inventory levels, some Nortel Networks investors are focusing elsewhere: shrinking cash coffers.

With orders drying up, some customers struggling to stay afloat and gear backed up in its warehouses, the Brampton, Ontario, telecom-equipment maker last month hit investors with a \$2.58 billion first-quarter net loss. What some investors are finding more worrisome, however, is Nortel's consumption of cash.

To cover greatly ramped-up production and staffing levels that kicked in just as sales began falling far short of expectations, the company's operations and capital expenditures consumed an unusually large \$1.7 billion during the quarter, according to analysts. That left Nortel with \$1.8 billion of cash as of March 31, largely thanks to the \$1.5 billion the powerhouse raised in a debt issue earlier this year, nearly doubling its debt from the previous quarter.

The "serious" issue is Nortel's cash position, says **Anthony Scilipoti**, an analyst with independent

Toronto research firm **Veritas Investment Research**, who has been meeting with fund managers in recent months to point out Nortel's cash-burn rate. "When times are tough, cash is what people worry about."

Nortel is furiously cutting jobs -- one fifth of its work force, or 20,000 positions -- to save cash and stem losses, and nobody suggests the company is about to find itself in a cash crunch like some of its customers that have been battered of late by the continuing telecom storm. But there is "no question" Nortel will have to bring in more cash to fund its operations, either through debt or stock offerings, asset sales or "selling inventory at a discount," **Mr. Scilipoti** says.

WorldCom Inc.'s record \$11.9 billion bond sale yesterday shows that established telecom companies can go to market for additional funding despite the mounting woes in the sector. Still, **Mr. Scilipoti** says investors may find such options unpalatable, given that Nortel already has sharply raised its debt level and diluted its earnings base with stock acquisitions of start-ups with scant earnings. Indeed, should Nortel revisit the debt market, the company would have to "pay a premium," says UBS Warburg telecom fixed-income analyst Philip Olesen. Investors now are "reticent about holding technology bonds" due to the recent "huge swings" in earnings of tech companies and the fact that "these businesses will eat cash very, very quickly in a downturn," he says, adding that Nortel is no exception.

On the other hand, **Mr. Scilipoti** says, "if the company can't generate cash flow from its operations, it can't expand," and Nortel "might lose step" with its competitors once the telecom sector rebounds. Ken Leon, an analyst with ABN Amro in New York, adds that Nortel eventually "might have to revisit other capital-market alternatives," such as more debt or stock, because of the "capital intensive" nature of the telecom-equipment business and continued pricing pressure for certain product lines. "That's a problem they have," he says.

For its part, the company says it has matters well in hand. It notes that it recently boosted an arranged line of credit from a consortium of banks to \$2.5 billion from \$2.1 billion that was available at the end of last year. However, a spokesman says there aren't current plans to tap it. Other than the credit line, "we see no requirement to go forward with any other kind of capitalraising for the rest of the year," said Frank Dunn, the company's chief financial officer, in a

recent conference call with analysts -- even though Nortel has to pay back a \$250 million debt issue this June.

Mr. Dunn told the analysts that the job cuts will save the company about \$2 billion annually once completed later this year. And due to some sharply curtailed or mothballed expansion projects, the company's capital expenditures this year will be "dramatically lower" than last year's \$1.9 billion, he also said. Company officials decline to provide estimates for earnings or cash flow for this year.

But those subjects will be on the table tomorrow when Nortel is scheduled to meet with analysts from Toronto-based Dominion Bond Rating Service to review the company's finances. In February, the ratings agency put Nortel's single-A-(high) debt rating, a strong one in the telecom sector, "under review with negative implications." Rising inventory levels, customer turmoil and "the high cash burn rate" were among the factors behind the move, says DBRS analyst Paul Holman, who will be among those at the meeting to assess whether to proceed with a downgrading.

So far, other ratings agencies haven't budged, partly because Nortel is quickly cutting costs. But even in good times Nortel has struggled to produce much cash flow. Last year, the company's best ever by various measures, Nortel's cash flow from operations was \$40 million, a tiny fraction of its total revenue of \$30.3 billion. By comparison, rival Cisco Systems Inc. reported cash flow from operations of \$2.8 billion for the six months ended Jan. 27. Nortel's cash flow in recent years has been "lacking," says UBS Warburg analyst Nikos Theodosopoulos. Investors largely overlooked Nortel's weak cash flow during the telecom heyday, but they "won't be as lenient" from now on, he says.

Besides plummeting earnings estimates and the deep industry slump, the "ongoing fair concern" about Nortel's cash flow is another reason Bob McWhirter is steering clear of Nortel shares. The Toronto-based Triax Investment Management fund manager briefly held some Nortel shares earlier this year, and currently sees no reason to dive back in. Mr. McWhirter says he "wouldn't put a ton of confidence" in current 2002 earnings estimates for Nortel, which stand at 45 cents a share, according to the analysts' consensus estimate provided by Thomson Financial/FirstCall. As for this year, investors have abandoned any hope for a Nortel earnings rebound. Analysts are expecting a loss of three cents a share for the year, according to Thomson Financial. Nortel's share price, at \$15.80, off 74 cents, at 4 p.m. yesterday on the New York Stock Exchange, is a few points above its 52-week low of \$12.50 set in early April, and a fraction of its all-time high of \$89 set last summer.

To be sure, some investors are looking past the sector's current woes, and are plunging in because they find the stock a lot cheaper than it used to be. Andrew Sweeney, a fund manager with Toronto-based Beutel Goodman, earlier this year started buying Nortel shares, betting that the company's cost-cutting will lead to positive cash flow later this year. He says Nortel is a good long-term bet, even though the share price could still weaken in the short term. Such investors may help to explain a recent bounce in the shares of Nortel and other telecom stocks. But "there's a decent chance the rally will sputter" because investors are "underestimating how long it will take" for the sector to rebound, says Paul Sagawa, an analyst with Sanford C. Bernstein in New York. Spending on telecom equipment could continue declining next year, he says.

Analysts say stiff competition for the gear that Nortel and its peers make is pressuring prices and Nortel's profit margin. The company's gross profit margin dropped to about 30% in the first quarter, from 43% last year. And another trend that could hurt Nortel's cash flow is the financing that Nortel extends to customers for equipment purchases. Some telecom carriers already have defaulted on loans from Nortel.

Some competitors are being "opportunistic" but not "drastic" with prices, Nortel Chief Executive

Officer John Roth said recently. As for Nortel's financing of its customers, 90% of the \$4.7 billion in financing commitments is with "large customers," and the financing is at "a manageable level," Mr. Dunn, the chief financial officer, told analysts in the conference call.

Should Nortel seek some additional financing for itself in the capital markets, the company may have to first smooth ruffled feathers. Nortel issued its \$1.5 billion of five-year bonds in early February, just two weeks before it disclosed the sharp downturn in its business, UBS's Mr. Olesen notes. Nortel has stressed that its downturn was unusually abrupt and unforeseen. When issued, the Nortel debt carried a yield of 1.47 percentage points over a comparable Treasury bond, and the spread has since widened to about 2.20 percentage points.