Valuation Analysis of SaskTel

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Introduction

This analysis arrives at approximations of the value of SaskTel, a provincial Crown corporation owned by the government, and thus the citizens and taxpayers, of the province of Saskatchewan. The valuation ranges could be useful in determining the future ownership or use of this asset. Every organization needs to review what it could or should do to serve its clients and whether its present array of assets is appropriate for its strategy and its future operations.
Valuation

Market-based valuation of SaskTel

The best probable estimate of the total market capitalization, that is, the total value of the company traded on a public stock exchange, is $2.055-billion to $2.147-billion. The calculation used to arrive at this range of figures was performed using comparison companies, the closest peers being three Canadian regional telecommunications companies; however, large Canadian telecommunications services providers and several smaller, profitable regional U.S. companies were also used. In the end, the U.S. examples were retained for comparative purposes, but they were not used in the final calculations.

Intrinsic, Discounted Free Cash Flow (DCFC) valuation of SaskTel

Using several estimates and assumptions, the probable range of value for SaskTel is estimated to be $0.622-billion to $0.883-billion.

The lower figure is based on applying metrics derived from projected Adjusted Free Cash Flows that in turn are projected into the future at a growth rate of 2 per cent, discounted to Present Value at 10 per cent. The upper figure uses the same projected Adjusted Free Cash Flow average, also projected into the future at a growth rate of 4 per cent, discounted to Present Value at 8 per cent. Alternative methods and estimates, shown in Appendix A, arrived at figures that are far below the numbers given above.

Adjustments to cash flow were required, as there were a number of unusual trends or circumstances evident in the financial performance of the company in both recent and earlier years.

Final Caution: Neither of the valuation ranges above, neither the market value nor the intrinsic value, constitutes a Private Market Value that a corporate acquisitor may pay, such acquisitor having the benefit of being able to attempt to optimize the value of the taken-over company, with synergies, cost-cutting, asset disposal, optimization and perhaps the use of previous years’ tax-shielding losses.

Note: For details, please read the entire study that follows this section.
Preface

Privatization and similar options for SaskTel

There are many reasons for the direct involvement of a regional, provincial, state, territorial, national, federal or even municipal government in an industry or endeavour.

This involvement is always present in regulation, which no industry escapes; sometimes it is in direct investment in a commercial or quasi-commercial service or enterprise.

Over time, the Canadian federal government and other provincial governments have extricated themselves from direct ownership of various commercial enterprises. Few such enterprises remain in the hands of these governments.

One that does remain is SaskTel. When it was established in 1908, the Internet, cellular telephony and cable television had yet to be invented.

Communication in those days was not universal and did not always extend to every farm or hamlet. It could be very expensive and often impossible to get a telephone line, as well as quite expensive to keep one.

Now, telephone service is ubiquitous and relatively inexpensive, as is Internet service. There is also a wide array of options for television service: broadcast, cable, satellite or over the Internet.

Whether a government takes a direct stake in a commercial enterprise is a matter for taxpayers, voters and policy-makers to discuss, debate and decide.

The result of those deliberations will in some large measure be influenced by what some people think is a matter of political ideology. That is, some people believe in strong government involvement in the economy in some, many or all industries, sectors and markets. Others believe the opposite: Economic progress, growth and prosperity depend on the best use of natural, technical, commercial, financial and intellectual resources that must be bid for in a competitive fashion by as many economic actors as possible.

In this way, they contend, these resources will attain the highest possible value and the maximum return, from which society will benefit, directly or indirectly, through increased profits, tax revenue and employment or efficient, cost-contained goods and services.
Rationale for divestiture or privatization

While it is up to the people of Saskatchewan through their elected representatives to decide if SaskTel should be sold or otherwise privatized and the proceeds used for the benefit of all its citizens and taxpayers, there are some established general reasons for embarking on such a path, some or all of which are cited for divestiture of such enterprises, but may not be applicable in any single particular case, such as that of SaskTel.

1. The government has no mandate to own or run a commercial enterprise. The provision of citizens’ safety, security and justice is the government’s primary role, and its involvement in the economy should generally not extend beyond this. However, the government of Saskatchewan in its legislation asserts this role for itself, for several entities, including SaskTel.

2. Regulation can usually accomplish any public policy reason for direct involvement in an industry. If regulation is not easily feasible, then a direct contract or subsidy to affected individuals or other entity or entities may be more efficient or effective and less economically disruptive or costly. This could apply to SaskTel, and any customers or others that may be disadvantaged by a future divestiture.

3. A government-owned or -sponsored enterprise may compete directly against private sector firms, which are owned by or employ citizens, or against individual citizens, all of whom the government is supposed to serve, not disadvantage. According to Saskatchewan government policy, SaskTel is supposed to operate as a normal commercial telecommunications company.

4. The government-owned or -sponsored enterprise may compete unfairly against its private sector rivals in that it had or has access to lower-cost, government-sourced and -guaranteed capital (debt). It may have a much larger debt component in its capital versus that which would be tolerated in the private sector. It may not have to meet high standards for profit and cost control, and it may not need to pay provincial or federal income taxes. All these advantages may thereby allow the government to subsidize or lower the prices at which it can sell its product or services. While SaskTel still has this advantage, at current interest rates it may not give it much advantage, although its shareholder capital may not have any market-based or- influenced rate of return requirement, giving it some implicit advantage over a similar publicly-listed or private sector competitor. The tax advantage still pertains.
5. Government-owned or -sponsored enterprises may not have any kind of profit orientation or target, may be used as public policy vehicles and may be given preference in their activities or even their transgressions, such as labour or environmental abuses. SaskTel is, according to its policies, not supposed to behave in any kind of abusive fashion.

6. Government-owned or -sponsored enterprises, by virtue of being public sector vehicles overseen by bureaucrats and politicians, may be places where favoured individuals find employment, particularly at management levels. SaskTel is, according to provincial government policy, supposed to operate like a competitive commercial enterprise in this and other regards.

7. Since profit is a secondary goal of a government-owned or -sponsored enterprise, it is difficult to evaluate the effectiveness, efficiency or productivity of the enterprise or its employees. Consequently, these employees and assets may not be very productive or effective. Again, SaskTel is supposed to behave and operate like a commercial company.

8. Government-owned or -sponsored enterprises are often creations of certain time-fixed circumstances and outlive whatever use or public policy role their creators may have conceived. Often, advances in technology, the modernization of transport, telecommunication or information technology, the evolution of the economy and available products and services and the increasing standard of living make these enterprises potentially obsolete. In the private sector, firms and individuals must adapt and evolve, or decline. This could very well apply to SaskTel, as per the discussion preceding this section; i.e., that telecommunications services are now inexpensive, readily accessible and available to all urban and rural customers.

9. Government-owned or -sponsored enterprises perpetuate their possibly obsolete existences by virtue of the constituencies that build up around them: their employees, their managers and directors, the bureaucrats, their customers, suppliers and associated advocates or consultants. They can lobby to keep the enterprise going, despite dysfunction or losses. They are far more motivated to do so than are taxpayers, whose average cost is much less per person and may be indirect, hidden or difficult to calculate. The constituency for the continued government ownership of SaskTel may not be readily visible or obvious, but every established fiefdom has persons or groups who may lose out should there be a change in ownership or status.

10. By virtue of not being profit-oriented, government-owned or -sponsored enterprises are usually less efficient, and thus they...
lower the overall efficiency of the entire economy. This can make a whole nation less competitive than its global rivals are, whether nations or individual companies. The effects are worse the greater the government involvement in the economy. When taken to its most extreme, as happened in 20th-century communist nations, the countries were unable to compete against capitalist companies, despite their immense direct and indirect subsidies, government support and lack of profit requirement. SaskTel has not been a very profitable venture, nor a good investment for the province or its taxpayers, and has erratic cash flow performance.

11. Funds tied up in the capital of government-owned or -sponsored enterprises could be used to reduce government debt or lower taxes on individuals or corporations, which they could then spend or invest as they freely choose, and thus they could inject money back into the economy in more lucrative ways.

While it is possible that the citizens, taxpayers and government of Saskatchewan would be better off and better served if SaskTel were to become part of the private sector marketplace, this study is just confined to estimating the value that Saskatchewan could accrue by doing so.

Pathway options for divestiture or privatization

SaskTel could be privatized in several different ways.

1. Sold as is, in its entirety, in the public equity market, or stock market, as an Initial Public Offering, or IPO. To do this, it would have to be decided if SaskTel would have any ownership restrictions, as it would, regulated as its peers are by the Canada Radio-television and Communications Commission. Regulation could slightly lower its potential value. These restrictions include limiting foreign ownership to less than 50 per cent.

2. Partial sale, with some government control or influence for a few years or permanently, which would help ensure that the initial sale was not conducted at too low a price. Any follow-on or secondary offerings could then add to the total proceeds garnered and could capture more of the total potential value.

3. Sale to a large strategic buyer, such as another telecommunications service provider. This could result in greater total proceeds to the government, as the rationalization and synergies the buyer could realize cannot be done by simply making an IPO. Telus’s purchase of Edmonton Telephones, a municipally owned utility, is a precedent.

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4. Transfer of ownership to the pension and other asset management portfolio of the Saskatchewan government. This would mean that the asset manager would have to decide when and how to do one of the actions above.

5. Distribute SaskTel shares to each household, citizen, voter or taxpayer in Saskatchewan to retain or sell as they wish. This is cumbersome and expensive, but it has been done elsewhere, particularly in the United Kingdom.

6. Optimize the company as a fully commercial, profit-seeking, profitable corporation, and allow it to dispose of underperforming assets and extinguish liabilities, perhaps with the help of the government, in order to fetch the best possible price for the company in the public marketplace, either from a single strategic buyer or in the stock market, as in the first three points.

These are only suggestions. Proceeds from any SaskTel sale could lower taxes, reduce the government’s current or future debt, be used for needed spending priorities, be used to rationalize government and reduce costs or be added to the assets the government entrusts to its pension asset manager. There could be more ways that others could suggest for removing the involvement of the Saskatchewan government from SaskTel, thus allowing the former to realize the financial benefits and the latter to realize its own destiny and freedom.

However, SaskTel is not considered for imminent or even potential sale, as it is one of the walled-off companies under the mandate of the Crown Investment Corporation, ‘CIC’, of the Saskatchewan government. Until the legislation enforcing this mandate is changed, which the current Saskatchewan Party administration has said it would not introduce for the foreseeable future, divestiture of SaskTel and a number of other CIC-controlled entities will not occur.
Summary

The financial analysis of a privately controlled entity, whether owned by a government body or agency or controlled by individuals, a family, or other private group, is more challenging than a financial analysis conducted on a publicly traded commercial enterprise.

Metrics used in valuing a publicly traded company may not be applicable, or there may be some data that are not available, making such measures absent in the analysis.

This analysis makes no effort to assess or adjust the financial data for any public policy or other aspect of the strategy or operation of this entity, as it is difficult to separate the effects of any non-commercial actions from those that a similar commercial entity would do.

However, this non-taxable entity had estimates for taxation applied against its results to ensure a proper comparison versus its peers and as a fully commercial entity, as it would be if it were divested.

The analysis incorporates certain assumptions and projections. All are elucidated, although a few may have been inadvertently omitted. Comments are inserted in the Excel file, which show details of the calculations and how and why they were done the way they were. How and why adjustments to accounting and other items were made are included in these notes.

The estimates and the final estimated valuation of the enterprise that is the subject of this analysis are just that: estimates only and should not be taken to be definitive, authoritative or unassailable. They are targets of legitimate, alternative valuation by other analysts using other techniques or assumptions or both.

Since the valuation analysis is not definitive, the possible values of the firm, whether using market comparators or intrinsic valuation methods, are given as ranges only and not as single numbers.

It is useful to remember that the market valuation of a company that is listed on a public stock exchange can vary widely, even wildly, from day to day, week to week, month to month, year to year or even within one trading day. Since even a public market-determined share price is not an eternal verity, the possible value of the company in this study should not be given in one single number.

Caution: This study, in neither of the analyses to follow, makes no attempt to estimate or include any sort of pension, other value impairment, derivative or other liabilities or contingent liabilities that have not already been fully discounted and included in the main income, financial position, or cash flow statements; nor any other
Since the valuation analysis is not definitive, the possible values of the firm ... are given as ranges only and not as single numbers.

estimate of liabilities or assets that could augment or detract from the valuations that were calculated.

Summary

Market-based Valuation of SaskTel:
A range of $2.055-billion to $2,147-billion

The lower figure is based on peers’ Price to Book Value, or P/B, or P/BV, ratio, and the upper figure is based on Price to Sales, or P/S, ratio. The Price/Earnings ratio using adjusted Net Income for SaskTel was not useable, as the company’s net income is too variable, as is that of its peers.

Intrinsic (Discounted Free Cash Flow) Valuation:
$0.662-billion to $0.883-billion

The lower figure is based on the average of two projected Adjusted Free Cash Flows derived from peer firms in turn projected into the future at a growth rate of 2 per cent, discounted to Present Value at 10 per cent. The upper figure uses the same projected Adjusted Free Cash Flow average in turn projected into the future at a growth rate of 4 per cent, discounted to Present Value at 8 per cent. Alternative methods and estimates resulted in figures that were far below the numbers given above. Efforts were made to try to find the most favourable valuation that could be realized, without violating logical and conservative parameters. For instance, although the company had negative free cash flow at the time of the analysis, a more optimal estimation of possible, attainable free cash flow was made using peer companies’ operational results.
Market Valuation Analysis

SaskTel is not a publicly listed company. The market metrics analysis uses standard valuation metrics for public companies in order to establish a probable range for a company’s equity, or common shares, were it to be publicly listed, in whole or in part.

For the market valuation, appropriate comparison companies needed to be chosen. As SaskTel is a regional full-service telecommunications company, it was compared against regional Canadian companies offering the same services.

However, there are only three other public, regional Canadian telecommunications companies. Therefore, the comparison sample was expanded to include the large Canadian national telecommunications service providers and solvent regional firms in the United States that did not exceed $5-billion (US) in market capitalization.

Since U.S. telecoms have different regulations and taxation regimes and sometimes wildly different product and service offerings, some caution needs to be exercised when making direct comparisons with Canadian companies. In addition, the recently ended recession depressed net income for many of the U.S. companies and may have, at least temporarily, distorted some of their financial and valuation metrics.

While superficially SaskTel’s net income looks reasonable in relation to revenue and size of the company, its free cash flow is very low and highly variable from year to year. As well, its fixed assets have been growing rapidly, but its net assets have not. Hence, comparing its operational efficiency with that of its peers, whose own operational metrics are erratic, is difficult and was not performed.

Looking at the final financial metrics used for SaskTel, Price to [Trailing] Earnings [Net Income], Price to Sales [or Revenue] and Price to Book [Value], it is evident that there is a wide range of possible values.

Exercising the above-noted caution or conservatism owing to the likelihood of SaskTel in its current state being valued in public capital markets at the lower end of possible ranges, the Price to Earnings ratio set of values for SaskTel is removed.

Table 1 detailing the results is below.
As can be seen in Table 1, the large Canadian telcos could have inflated values on a book value basis and the Canadian regional ones on a trailing P/S basis. For that reason, the highest and lowest averages in each sample were removed.

The large Canadian telcos were also accorded a higher valuation than Canadian or U.S. regional telcos were, owing to their geographic and business line diversification and their size and stability.

**To summarize:** This is the best *probable* estimate of the likely total market capitalization, that is, the total value of the company traded on a public stock exchange: $2.055-billion to $2.147-billion. Interestingly, MTS, the Manitoba telecommunications services provider formerly owned by the Manitoba provincial government and divested several years ago, with a similar customer market size, had a stock market value, or capitalization, of $2.17-billion at year-end 2012.
Intrinsic or Fair Value

Balance sheet items were *not* adjusted.

Generally, when calculating an intrinsic value for an enterprise, one needs to estimate an appropriate discount rate to apply to the free cash flows that the entity generates as well as a reasonable, sustainable, constant growth rate for those cash flows into the indefinite future.

Operating Cash Flow is Net Income adjusting for changes in Working Capital and adding back non-cash charges such as Depreciation and Amortization. Free Cash Flow, or FCF, is simply Operating Cash Flow minus purchases of Fixed Assets.

The discount rate is usually defined as the required rate of return, that is, the rate of return that the investor requires that would make purchasing all or part of the enterprise attractive. This varies from individual to individual, institution to institution and company to company. So, a range of such discount rates must be employed in the analysis.

Commonly, the future cash flows are estimated by projecting all major cash inflows and outflows for the next several years and discounting them to the present in one aggregate total amount. However, the recent as well as the longer-term trends in those cash inflows and outflows can be variable and inconsistent.

When it comes to growth rates, SaskTel is a difficult case. Various revenue items and cost items are growing at different rates and fluctuate in different directions in different years. As well, Net Income is growing at a much different rate from Free Cash Flow. In fact, Free Cash Flow has been volatile and highly variable. Operating Cash Flow is a little more stable.

To overcome these complications, an attempt was made to establish a relationship whereby Free Cash Flow could be reliably estimated. These projections were based on Operating Cash Flow less Capital Expenditure (or Capex) as a proportion of Depreciation expense. These seemed to be more theoretically sound and more practicable than using the actual, most recent one.

Adjusted Free Cash Flow also seemed to be depressed in the most recent fiscal year, although up from a negative value in the preceding year. However, these calculated or pro-forma forecasted figures were also somewhat depressed. In the end, an average of the ratio of free cash flow to revenue for two of its peers, Telus Corp. and Manitoba Telecom Services, was used to estimate the potential free cash flow the company could generate.
This hypothetical FCF projection turned out to be substantially higher than the actual Adjusted Free Cash Flow, even in comparison to Free Cash Flow minus depreciation, the definition of a viable, steady state for a company.

While free cash flow has been low and negative, and in comparator companies, while positive, actually declining, if at a gradual pace, free cash flow for most companies generally tracks net income in variability, and in growth sometimes coming close to the final, actual net income number with a lag of some quarters.

The probable ranges for growth in FCF in this analysis go from a low of -10 per cent to a high of +4 per cent, with -4 per cent to -2 per cent chosen as the most likely range when one takes cues from growth rate in fully taxed income. Again, this is the case despite the recent and longer history of a declining trend in FCF with some perhaps optimistic judgment that FCF can and will track net income in the future.

When it comes to discount rates and required rates of return, with the poor returns in the equity markets over the past decade, it could be argued that a reasonable prediction for long-term nominal (i.e., including inflation) returns, including any dividends, is now roughly an average of 8 per cent for a Canadian investor or perhaps lower.

However, an investor may demand or expect a higher rate, particularly since the telecom sector has, excluding the 2008-2009 period, performed better than the overall Canadian stock market. So, a range of 5 per cent to 10 per cent was used, with a narrower range of 7 per cent to 8 per cent as the more likely true preference zone.

As riskless Canada long bonds were at the time this analysis was conducted trading to yield about 3 per cent, the minimum risk premium an investor would likely expect would bring a required rate of return of at least 7 per cent for a smaller regional telco with somewhat below average financial performance, such as SaskTel.

The average Adjusted Free Cash Flow projection estimates and the growth and discount rates discussed above result in the following table, which illustrates the probable DFCF valuations for SaskTel.
TABLE 2  
Intrinsic or DFCF Valuation of SaskTel Using Estimated Future Free Cash Flow

Valuation Matrix: All Future Intrinsic Values below are at the *end year* of restructuring and *hence must be discounted back to the present year*.

The coloured zones, lighter to darker, indicate increasing plausibility.

<table>
<thead>
<tr>
<th>Cost of Equity or Required Rate of Return===&gt;</th>
<th>5%</th>
<th>6%</th>
<th>7%</th>
<th>8%</th>
<th>9%</th>
<th>10%</th>
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<tr>
<td>Growth Rate=v</td>
<td></td>
<td></td>
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<tr>
<td>-10% $529,623.21</td>
<td>$496,521.76</td>
<td>$467,314.60</td>
<td>$441,352.68</td>
<td>$418,123.59</td>
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<td>-9%  $567,453.44</td>
<td>$529,623.21</td>
<td>$496,521.76</td>
<td>$467,314.60</td>
<td>$441,352.68</td>
<td>$418,123.59</td>
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<tr>
<td>-8%  $611,103.71</td>
<td>$567,453.44</td>
<td>$529,623.21</td>
<td>$496,521.76</td>
<td>$467,314.60</td>
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<tr>
<td>-7%  $662,029.02</td>
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<td>$529,623.21</td>
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<td>$467,314.60</td>
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<tr>
<td>-6%  $722,213.47</td>
<td>$662,029.02</td>
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<td>$567,453.44</td>
<td>$496,521.76</td>
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<tr>
<td>-5%  $794,434.82</td>
<td>$722,213.47</td>
<td>$662,029.02</td>
<td>$611,103.71</td>
<td>$567,453.44</td>
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<td>-3%  $993,043.52</td>
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<tr>
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<tr>
<td>-1%  $1,324,058.03</td>
<td>$1,134,906.88</td>
<td>$993,043.52</td>
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<td>$794,434.82</td>
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<tr>
<td>0%   $1,588,869.64</td>
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<tr>
<td>1%   $2,648,116.06</td>
<td>$1,986,087.05</td>
<td>$1,588,869.64</td>
<td>$1,324,058.03</td>
<td>$1,134,906.88</td>
<td>$993,043.52</td>
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<tr>
<td>2%   $3,972,174.09</td>
<td>$2,648,116.06</td>
<td>$1,986,087.05</td>
<td>$1,588,869.64</td>
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<td>3%   $7,944,348.18</td>
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<td>$2,648,116.06</td>
<td>$1,986,087.05</td>
<td>$1,588,869.64</td>
<td>$1,324,058.03</td>
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</table>

Thus, the *probable* range of SaskTel’s intrinsic value, as is, is **$0.662-billion** to **$0.883-billion**. As discussed below, the “as is” stipulation is an important one.

*The lower figure* is based on the average Adjusted Free Cash Flow projected into the future at a growth rate of -4 per cent, discounted to Present Value at 8 per cent. *The upper figure* uses the same projected Adjusted Free Cash flow that in turn is projected into the future at a growth rate of -2 per cent, discounted to Present Value at 7 per cent.
**Its peer company, Manitoba Tel, similar in size, took several years to achieve a higher valuation.**

**IMPORTANT:** This intrinsic value is actually a future value after successful restructuring brings SaskTel to the same cash flow generation capability, for its size, of its peers Telus Corp. and MTS. This future value then needs to be discounted back to the present at an appropriate cost of capital and over however many years it takes to accomplish the restructuring.

An alternative method of estimating Adjusted Free Cash Flow, in a separate tab of the Excel spreadsheet model of SaskTel, arrived at figures that were far below the numbers given above, owing to the rather low current free cash flow generation capacity of the company, which may not be its potential capacity.

**Observations on the apparent discrepancy between the low intrinsic value and the much higher market value accorded to SaskTel**

SaskTel has been investing and reinvesting heavily in its business. Its purchase of fixed assets, plant and equipment, drastically lowers its available free cash flow. While this may be necessary for the company to maintain and enhance its service capacity and incorporate new, advanced technology, it means that its true economic profit is much less than its apparent net income, as defined in accounting terms.

SaskTel has been recognizing a large, non-cash expense for actuarial losses on its defined benefit pension plan. While this does not affect operating or free cash flow, it has drastically lowered net income, particularly in recent quarters, and masked the promising average return on equity and return on invested capital it exhibited in 2010. This may be an indication that the estimated potential market value could be realistic, and realizable.

SaskTel’s ultimate realizable value could be close to the estimate of its market value calculated in this analysis, as it is restructured and reconfigured to become more profitable, along the lines of its peers and rivals. Its peer company, Manitoba Tel, similar in size, took several years to achieve a higher valuation. As SaskTel is at this time, its estimated intrinsic value does likely indicate what its current cash-generation capability is, and is limited to. What its potential may be could be indicated by the market valuation estimates that are placed upon it.
Notes and calculations of financial data used in this paper are available on demand. Please address request to newideas@fcpp.org.

Caution: The figures above are only estimates, and other analyses and analysts may find or calculate different values using other valid methods. Also, all SaskTel and other financial statements used were from the 2011 fiscal year, and stock market-based figures were from year-end 2012.

Final Caution: The range above is not a Private Market Value that a corporate acquisitor may pay and thus have the benefit of synergies, cost-cutting, asset disposal and optimization and perhaps the use of previous years’ tax losses.
About the author

**Ian Madsen** is an investment and financial analyst based in Surrey, BC. He earned a BA in Economics from the University of Alberta and an MBA in Finance from the University of Toronto. He has managed institutional investment portfolios, lectured at colleges, managed investment research operations, and developed financial valuation models. For several years Ian was vice president at a U.S. investment research firm with extensive operations in India, where he worked and managed staff. He also ran his own investment counseling firm and advisory newsletter. He holds the Chartered Financial Analyst (CFA) designation and is a former president of the Saskatchewan and Edmonton CFA Societies.