

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

SKYTERRA COMMUNICATIONS INC

Form 10-Q

November 12, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the period ended September 30, 2004, or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number 0-13865

SKYTERRA COMMUNICATIONS, INC.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction
of incorporation or organization)

23-2368845
(I.R.S. Employer
Identification Number)

19 West 44th Street, Suite 507
New York, New York
(Address of principal executive offices)

10036
(Zip Code)

Registrant's telephone number, including area code: (212) 730-7540

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of November 9, 2004, 6,089,809 shares of the registrant's voting common stock and 8,990,212 shares of the registrant's non-voting common stock were outstanding.

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

INDEX

	Page
Part I. FINANCIAL INFORMATION	
Item 1. Consolidated Financial Statements	
Consolidated Balance Sheets as of September 30, 2004 (Unaudited) and December 31, 2003	2
Unaudited Consolidated Statements of Operations - Three months and nine months ended September 30, 2004 and 2003	3
Unaudited Consolidated Statements of Cash Flows - Nine months ended September 30, 2004 and 2003	4
Notes to Unaudited Consolidated Financial Statements	5
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3. Quantitative and Qualitative Disclosures About Market Risk	21
Item 4. Controls and Procedures	21
Part II. OTHER INFORMATION	
Item 1. Legal Proceedings	22
Item 2. Changes in Securities	22
Item 3. Defaults Upon Senior Securities	23
Item 4. Submission of Matters to a Vote of Security Holders	23
Item 5. Other Information	23
Item 6. Exhibits and Reports on Form 8-K	23
SIGNATURES	24

SKYTERRA COMMUNICATIONS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands except share data)

September
2004

(Unaudite

Assets

Current assets:

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

Cash and cash equivalents	\$ 34,20	
Short-term investments	14,71	

Total cash, cash equivalents and short-term investments	48,91	
Accounts receivable, net	14	
Note receivable and accrued interest from Motient Corporation, net	-	
Note receivable from Verestar, Inc.	-	
Prepaid expenses and other current assets	63	

Total current assets	49,70	
Property and equipment, net	63	
Notes receivable and accrued interest from Mobile Satellite Venture, L.P.	67,41	
Investments in affiliates	3,21	
Other assets	69	

Total assets	\$ 121,66	=====
Liabilities and Stockholders' Equity (Deficit)		
Current liabilities:		
Accounts payable	\$ 1,75	
Accrued liabilities	3,24	
Deferred revenue	12	

Total current liabilities	5,11	-----
Series A Convertible Preferred Stock, \$.01 par value, net of unamortized discount of \$33,687 and \$36,979, respectively	87,60	-----
Minority interest	13,52	-----
Stockholders' equity (deficit):		
Preferred stock, \$.01 par value. Authorized 10,000,000 shares; issued 1,199,007 shares as Series A Convertible Preferred Stock at September 30, 2004 and 1,171,612 shares at December 31, 2003	-	
Common stock, \$.01 par value. Authorized 200,000,000 shares; issued and outstanding 6,077,309 shares at September 30, 2004 and 6,075,727 shares at December 31, 2003	6	
Non-voting common stock, \$.01 par value. Authorized 100,000,000 shares; issued and outstanding 8,990,212 shares at each of September 30, 2004 and December 31, 2003	9	
Additional paid-in capital	547,22	
Accumulated other comprehensive income	-	
Accumulated deficit	(531,96)	
Treasury stock, at cost, nil shares at September 30, 2004 and 6,622 shares at December 31, 2003	-	

Total stockholders' equity (deficit)	15,42	-----

Total liabilities and stockholders' equity (deficit)	\$ 121,66	=====

See accompanying notes to unaudited consolidated financial statements.

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

SKYTERRA COMMUNICATIONS, INC.
 UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS
 (In thousands except share data)

	Three Months Ended September 30,		Nine
	2004	2003	
Revenues	\$ 418	\$ 196	\$
Cost of revenues	398	219	
Gross profit (loss)	20	(23)	
Expenses:			
Selling, general and administrative	2,224	1,464	
Depreciation and amortization	45	13	
Total expenses	2,269	1,477	
Loss from operations	(2,249)	(1,500)	
Interest income, net	1,900	1,592	
Loss on investments in affiliates	(449)	(67)	
Other (expense) income, net	(63)	3	
Minority interest	(172)	(288)	
(Loss) income from continuing operations	(1,033)	(260)	
Gain from wind-down of discontinued operations	--	319	
Net (loss) income	(1,033)	59	
Cumulative dividends and accretion of convertible preferred stock to liquidation value	(2,492)	(2,429)	
Net (loss) income attributable to common stockholders	\$ (3,525)	\$ (2,370)	\$
Basic (loss) earnings per common share:			
Continuing operations	\$ (0.23)	\$ (0.18)	\$
Discontinued operations	--	0.02	
Net (loss) earnings per common share	\$ (0.23)	\$ (0.16)	\$
Diluted (loss) earnings per common share:			
Continuing operations	\$ (0.23)	\$ (0.18)	\$
Discontinued operations	--	0.02	
Net (loss) earnings per common share	\$ (0.23)	\$ (0.16)	\$
Weighted average common shares outstanding:			
Basic	15,064,616	15,047,262	
Diluted	15,064,616	15,047,262	

See accompanying notes to unaudited consolidated financial statements.

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

SKYTERRA COMMUNICATIONS, INC.
 UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (In thousands)

	Nine Months

	2004

Cash flows from operating activities:	
Net income (loss)	\$ 22,304
Adjustments to reconcile net income (loss) to net cash used in operating activities:	
Gain from adjustment to reserve for note receivable and accrued interest from Motient Corporation	(22,516)
Gain from discontinued operations	--
Depreciation and amortization	95
Loss on investments in affiliates	972
Minority interest	631
Non-cash compensation expense	935
Non-cash charge for issuance of warrants by consolidated subsidiaries	392
Changes in assets and liabilities (excluding effects of acquisitions):	
Accounts receivable, net	88
Prepaid expenses, interest receivable and other assets	(836)
Accounts payable and accrued liabilities	(1,183)
Deferred revenue	(37)

Net cash provided by (used in) continuing operations	845
Net cash used in discontinued operations	(9)

Net cash provided by (used in) operating activities	836

Cash flows from investing activities:	
Sales and maturities of short-term investments	18,949
Purchases of short-term investments	(14,868)
Repayments (purchase) of notes receivable	21,500
Cash paid for investments in affiliates, net of cash received from an investment	(1,422)
Purchases of property and equipment	(603)
Cash paid for acquisitions, net of cash acquired and acquisition costs	(105)

Net cash provided by (used in) investing activities	23,451

Cash flows from financing activities:	
Proceeds from issuance of common stock in connection with the exercise of options	17
Cash paid in connection with tender offer	--
Proceeds from contributions to a consolidated subsidiary	--

Net cash provided by (used in) financing activities	17

Effect of exchange rate changes on cash and cash equivalents	4

Net increase (decrease) in cash and cash equivalents	24,308
Cash and cash equivalents, beginning of period	9,897

Cash and cash equivalents, end of period

\$ 34,205
=====

See accompanying notes to unaudited consolidated financial statements.

SKYTERRA COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(1) Description of the Business

SkyTerra Communications, Inc. (the "Company") operates its business through a group of complementary companies in the telecommunications industry, including the Mobile Satellite Venture, L.P. joint venture ("MSV Joint Venture"), currently a provider of mobile digital voice and data communications services via satellite in North America; Electronic System Products, Inc. ("ESP"), a product development and engineering services firm that creates products for and provides consulting and related services to customers in the telecommunications, broadband, satellite communications, and wireless industries; AfriHUB, LLC ("AfriHUB"), an early stage company that intends to provide the Nigerian market with instructor led and distance based technical training and satellite based broadband Internet access and domestic and international calling services; Navigauge, Inc. (formerly known as IQStat, Inc., "Navigauge"), a media and marketing research firm that collects data on in-car radio usage and driving habits of consumers and markets the aggregate data to radio broadcasters, advertisers and advertising agencies in the United States; and Miraxis, LLC ("Miraxis"), a telecommunications company that has access to a Ka-band license with which it is striving to provide satellite based multi-channel, broadband data and video services in North America.

On February 10, 2003, the Federal Communications Commission (the "FCC") released an order relating to an application submitted by the MSV Joint Venture and certain of its competitors that could greatly expand the scope of the MSV Joint Venture's business by permitting the incorporation of ancillary terrestrial base stations (which we refer to as an "ancillary terrestrial component" or "ATC") into its mobile satellite network (the "ATC Order"). A similar application to the ATC Order was approved by Industry Canada, the FCC's counterpart in Canada, on May 22, 2004. With these ATC orders, the MSV Joint Venture entered a new stage of development which requires significant future funding requirements and/or a need for one or more strategic partners.

In July 2003, the MSV Joint Venture filed a request for reconsideration of the ATC Order which asked the FCC for clarification on some of the requirements and definitions contained in the ATC Order and also to consider relaxing certain of the technical requirements stipulated in the order. Also in July 2003, certain terrestrial wireless providers petitioned the U.S. Court of Appeals for the District of Columbia to review the FCC's decision to grant ATC. The petition has been held in abeyance until the FCC rules on the request for reconsideration filed by the MSV Joint Venture.

In the ATC Order, the FCC established certain requirements with which a mobile satellite service provider must comply in order to operate an ATC. In November 2003, the MSV Joint Venture filed an application demonstrating its compliance with the requirements. On November 8, 2004, the FCC approved the MSV Joint Venture's application, granting the MSV Joint Venture authority to

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

operate an ATC, subject to certain conditions. Further, the FCC approved certain of the technical requirement waiver requests requested by the MSV Joint Venture and deferred ruling on certain other waiver requests until acting on other pending clarifications submitted in the request for reconsideration filed in July 2003.

The Company is headquartered in New York, New York.

(2) Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared by the Company in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments, consisting only of those of a normal recurring nature, necessary for a fair presentation of the Company's financial position, results of operations and cash flows at the dates and for the periods indicated. While the Company believes that disclosures presented are adequate to make the information not misleading, these unaudited consolidated financial statements should be read in conjunction with the audited financial statements and related notes for the year ended December 31, 2003 which are contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission. The results of the three and nine months ended September 30, 2004 are not necessarily indicative of the results to be expected for the full year. Certain prior year amounts in the consolidated financial statements have been reclassified to conform to the current year's presentation. The results of AfriHUB have been included in the consolidated financial statements beginning on April 19, 2004, the date of acquisition.

(3) Interest in the MSV Joint Venture

On November 26, 2001, through its 80% owned MSV Investors, LLC subsidiary ("MSV Investors Subsidiary"), the Company purchased an interest in the MSV Joint Venture in the form of a convertible note with a principal amount of \$50.0 million. Immediately prior to the purchase of the convertible note, the Company contributed \$40.0 million to the MSV Investors Subsidiary and a group of unaffiliated third parties collectively contributed \$10.0 million. The note bears interest at a rate of 10% per year, has a maturity date of November 26, 2006, and is convertible at any time at the option of the MSV Investors Subsidiary into equity interests in the MSV Joint Venture.

On August 13, 2002, the MSV Joint Venture completed a rights offering allowing its investors to purchase their pro rata share of an aggregate \$3.0 million of newly issued convertible notes with terms similar to the convertible note already held by the MSV Investors Subsidiary. The MSV Investors Subsidiary exercised its basic and over subscription rights and purchased approximately \$1.1 million of the convertible notes. The group of unaffiliated third parties collectively contributed \$0.2 million to the MSV Investors Subsidiary in connection with the MSV Joint Venture rights offering.

Pursuant to the joint venture agreement among the partners of the MSV Joint Venture (the "MSV Joint Venture Agreement"), in the event that the MSV Joint Venture had received final regulatory approval from the FCC, as that phrase is defined in the MSV Joint Venture Agreement, by March 31, 2003 for its ATC applications, the certain other investors in the MSV Joint Venture (the "Other MSV Investors") would have been obligated to invest an additional \$50.0 million in the MSV Joint Venture. As the final regulatory approval from the FCC, as defined in the MSV Joint Venture Agreement, was not received by March 31, 2003, the additional investment was not required. However, the Other

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

MSV Investors retained the option to invest the \$50.0 million on the same terms and conditions until June 30, 2003. Prior to its expiration, the option was extended until August 2003. On August 8, 2003, the MSV Joint Venture Agreement was amended and certain of the Other MSV Investors agreed to invest \$3.7 million in the MSV Joint Venture and retain the option to invest an additional \$17.6 million under certain terms and conditions. On April 2, 2004, those certain Other MSV Investors exercised the option in full.

Under the amended MSV Joint Venture Agreement, the convertible notes held by the MSV Investors Subsidiary will automatically convert into equity interests in the MSV Joint Venture upon the repayment of (i) the outstanding principal and accrued interest on certain outstanding debt of the MSV Joint Venture and (ii) the accrued interest on all outstanding convertible notes of the MSV Joint Venture, including the convertible notes held by the MSV Investors Subsidiary. Such principal and accrued interest totaled approximately \$44.0 million as of September 30, 2004 and will need to increase thereafter by an amount equal to the additional interest accrued on the certain outstanding debt and convertible notes. Any additional equity investments used to repay these obligations must be made at a valuation of the MSV Joint Venture equal to or greater than the valuation at the time the MSV Investors Subsidiary purchased the notes. Currently, the MSV Investors Subsidiary would own, upon conversion, approximately 27.4% of the equity interests in the MSV Joint Venture.

On May 7, 2004, in connection with services being provided which support the regulatory effort of the MSV Joint Venture, an unaffiliated consultant was issued an option to purchase a less than one percent ownership interest in the MSV Investors Subsidiary. The option is immediately exercisable and will expire on the earlier of the dissolution of the MSV Investors Subsidiary or December 31, 2010. During the three months ended June 30, 2004, the Company recognized expense of approximately \$0.3 million related to the issuance of the option, which is the approximate fair value of the option using the Black-Scholes option valuation model. To provide additional incentive to the consultant, the MSV Investors Subsidiary agreed to pay the consultant a one-time fee of \$0.4 million upon a liquidity event, as defined in the agreement. The Company would recognize an expense related to this fee when a liquidity event becomes probable.

The \$10.2 million received from unaffiliated persons as an investment into the MSV Investors Subsidiary, as well as their share of the equity in earnings of the MSV Investors Subsidiary, is reflected in the accompanying consolidated financial statements as minority interest.

(4) Business Transactions

(a) Verestar Transactions

On August 29, 2003, the Company signed a securities purchase agreement to acquire, through a newly formed subsidiary, approximately 66.7% (on a fully-diluted basis) of Verestar, Inc. ("Verestar"). Concurrent with the signing of the securities purchase agreement, the Company purchased a 10% senior secured note with a principal balance of \$2.5 million and a due date of August 2007. The Company terminated the securities purchase agreement on December 22, 2003. Subsequently, Verestar filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code.

On March 8, 2004, the Company executed an asset purchase agreement to acquire, through a newly formed subsidiary, substantially all of the assets and business of Verestar pursuant to Section 363 of the Bankruptcy Code. The transaction was subject to a number of contingencies, including an auction on March 30, 2004 at which Verestar considered higher and better offers. At the auction, a bid was accepted from a strategic buyer at a price higher than the

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

Company was willing to offer.

In connection with the Verestar bankruptcy, the Company entered into a stipulation with Verestar pursuant to which the parties agreed to, among other things, the validity and enforcement of the obligation under the senior secured note and the Company's security interest in Verestar's assets. On April 30, 2004, Verestar paid the Company approximately \$2.9 million representing the \$2.5 million outstanding principal amount of the senior secured note and approximately \$0.4 million as a break-up fee in connection with the termination of the March 2004 asset purchase agreement.

On July 9, 2004, the Company settled its dispute with Verestar's parent company regarding the break-up fee in connection with the termination of the August 2003 securities purchase agreement. As consideration for the settlement, Verestar's parent company paid the Company \$1.5 million. This amount was reflected in the consolidated statement of operations as other income in the three months ended June 30, 2004.

On July 29, 2004, the Company entered into a stipulated settlement with Verestar and its Creditor Committee pursuant to which Verestar agreed to pay the Company approximately \$0.4 million representing certain amounts owed, including unpaid accrued interest, in connection with the senior secured note. On August 13, 2004, the Bankruptcy Court approved the stipulated settlement. This settlement amount was reflected in the consolidated statement of operations as interest income in the three months ended June 30, 2004.

(b) Interest in AfriHUB

On April 19, 2004, the Company signed an agreement to acquire 80% of the outstanding membership interests of AfriHUB for an aggregate purchase price of \$1.5 million. Through exclusive partnerships with certain Nigerian based universities, AfriHUB intends to provide instructor led and distance based technical training and satellite based broadband Internet access and domestic and international calling services. From August 2004 through November 2004, the Company purchased promissory notes from AfriHUB with an aggregate principal amount of approximately \$0.2 million. On October 8, 2004, AfriHUB sold membership interests to an unaffiliated third party for \$0.3 million. In addition, if AfriHUB meets certain operating and financial milestones, certain employees will be issued warrants to purchase ownership interests of AfriHUB. Following the October 2004 sale of the membership interests and including the effect of the warrants, the Company owns approximately 60.5% of AfriHUB's membership interests.

In connection with the allocation of the purchase price to the fair value of the identifiable net assets acquired, the Company ascribed approximately \$0.6 million to a significant contract. This intangible asset is included in other assets on the accompanying consolidated balance sheets and is being amortized over the approximate five-year minimum life of the contract.

(c) Interest in Miraxis

On May 28, 2002, the Company acquired Series B Preferred Shares and a warrant from Miraxis for approximately \$0.4 million, representing an ownership of approximately 30%. Miraxis is a development stage, privately held telecommunications company that has access to a Ka-band license with which it is striving to provide satellite based multi-channel, broadband data and video services in North America. The Company has the right to appoint two of the five directors of the manager of Miraxis. Additionally, the Company entered into a management support agreement with Miraxis under which the Company's current Chief Executive Officer and President provided certain services to Miraxis through February 2003 in exchange for additional Series B Preferred Shares and warrants being issued to the Company. In addition, on December 20,

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

2002, the Company acquired Series C Preferred Shares and warrants from Miraxis for approximately \$0.1 million.

In February 2003, the Company entered into a consulting agreement with Miraxis pursuant to which Miraxis personnel provided services to the Company through May 2003. In addition, Miraxis extended the management support agreement whereby the Company's current Chief Executive Officer and President continued to provide certain services to Miraxis through May 2003. In connection with these agreements, the Company paid Miraxis approximately \$40,000 but also received additional Series C Preferred Shares and warrants.

In April 2003, the Company acquired additional Series C Preferred Shares and warrants for approximately \$40,000. Between June 2003 and September 2003, the Company purchased promissory notes from Miraxis with an aggregate principal amount of approximately \$0.1 million. In November 2003, the promissory notes were converted to Series D Preferred Shares. From January 2004 through September 2004, the Company purchased additional promissory notes with an aggregate principal balance of approximately \$0.1 million. Currently, the Company holds approximately 40% of the ownership interests of Miraxis. The Company's President and Chief Executive Officer currently holds an approximate 1% interest in Miraxis.

Miraxis License Holdings, LLC ("MLH"), an entity unaffiliated with Miraxis, other than as described herein, holds the rights to certain orbital slots for which Miraxis has acquired access to one slot in order to implement its business plan. Miraxis issued 10% of its outstanding common equity on a fully diluted basis to MLH as partial consideration for access to that slot. In addition, Miraxis expects to pay certain royalties to MLH for use of the slot should it ever launch satellites. Prior to becoming affiliated with the Company, its Chief Executive Officer and President acquired a 2% interest in MLH. In addition, prior to the Company acquiring an interest in Miraxis, an affiliate of the Company's preferred stockholders acquired an approximate 70% interest in MLH.

In accordance with Financial Accounting Standards Board ("FASB") Interpretation No. 46R, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" ("FIN No. 46R"), beginning January 1, 2004, the operating results and financial position of Miraxis have been included in the consolidated financial statements. Prior to January 1, 2004, this investment was included in "Investments in Affiliates" on the accompanying consolidated balance sheets and was accounted for under the equity method with the Company's share of Miraxis' loss being recorded in "Loss on Investments in Affiliates" on the accompanying consolidated statements of operations. The consolidation of Miraxis did not have a material impact on the Company's operating results or financial position.

(d) Interest in Navigauge

On April 21, 2003, the Company acquired Series B Preferred Shares from Navigauge, formerly known as IQStat, for approximately \$0.3 million, representing an ownership interest of approximately 5%. Navigauge is a privately held media and marketing research firm that collects data on in-car radio usage and driving habits of consumers and markets the aggregate data to radio broadcasters, advertisers and advertising agencies in the United States.

In connection with the acquisition of ESP in August 2003, the Company obtained indirect ownership of Series A Preferred Shares representing an additional 16% ownership interest in Navigauge. In December 2003, the Company acquired additional Series B Preferred Shares and warrants for approximately \$0.1 million. From January 2004 through April 2004, the Company acquired additional Series B Preferred Shares and warrants from Navigauge for approximately \$0.5 million. Furthermore, from April 2004 through June 2004,

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

the Company purchased short-term promissory notes from Navigauge with an aggregate principal amount of approximately \$0.4 million.

On June 14, 2004, Navigauge completed a recapitalization in which all outstanding Series A Preferred Shares and Series B Preferred Shares were converted to new Series A Preferred Shares with substantially similar rights as the old Series B Preferred Shares. Following the exchange, the Company converted the short-term promissory notes into new Series A Preferred Shares and purchased additional Series A Preferred Shares for approximately \$0.4 million. The Company also obtained direct ownership of the old Series A Preferred shares held by ESP in exchange for the forgiveness of an aggregate of approximately \$0.8 million of senior secured promissory notes.

On August 16, 2004, the Company purchased additional Series A Preferred Shares for approximately \$0.2 million. Furthermore, on October 13, 2004, the Company purchased a short-term promissory note from Navigauge with a principal amount of approximately \$0.3 million. Currently, the Company owns approximately 39.3% of the outstanding equity of Navigauge on an undiluted basis.

This investment is included in "Investments in Affiliates" on the accompanying consolidated balance sheets and is being accounted for under the equity method with the Company's share of Navigauge's loss being recorded in "Loss on Investments in Affiliates" on the accompanying consolidated statements of operations.

(5) Note Receivable from Motient Corporation

On May 1, 2002, to mitigate the risk, uncertainties and expenses associated with Motient Corporation's ("Motient") plan of reorganization, the Company cancelled the outstanding amounts due under the original promissory notes issued by Motient and accepted a new note in the principal amount of \$19.0 million (the "New Motient Note") that was issued by a new, wholly-owned subsidiary of Motient that owns 100% of Motient's interests in the MSV Joint Venture ("MSV Holdings Inc."). The New Motient Note was due on May 1, 2005 and bore interest at a rate of 9% per annum. As a result of the uncertainty with respect to the ultimate collection on the remaining amounts due on the New Motient Note, a reserve was maintained for the entire principal amount of the note and unpaid interest accrued thereon.

On April 7, 2004, as a result of a payment received by Motient pursuant to a promissory note from the MSV Joint Venture, Motient paid the Company approximately \$0.5 million of interest accrued on the New Motient Note. This amount was reflected in the consolidated statement of operations as interest income in the three months ended March 31, 2004. Following several successful financings by Motient, on July 15, 2004, Motient paid approximately \$22.6 million representing all outstanding principal and accrued interest due on the New Motient Note as of that date. Accordingly, the reserve was adjusted in the three months ended June 30, 2004 resulting in the recognition of \$19.0 million in other income and \$3.5 million in interest income. The remaining \$0.1 million represents interest earned during July 2004 and was recognized in the accompanying consolidated statement of operations in the three months ended September 30, 2004.

(6) Earnings (Loss) Per Common Share

Basic earnings (loss) per common share is computed by dividing net income (loss) attributable to the common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings (loss) per common share reflects the potential dilution from the exercise or conversion of securities into common stock. The potential dilutive effect of outstanding stock options and warrants is calculated using the "treasury stock" method,

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

and the potential dilutive effect of the convertible preferred stock is calculated using the "if-converted" method.

The following table provides a reconciliation of the shares used in calculating earnings (loss) per common share:

	Three Months Ended September 30,		Nine M
	2004	2003	200
Weighted average common shares outstanding - basic	15,064,616	15,047,262	15,0
Common shares issuable upon exercise of stock options	--	--	6
Weighted average common shares outstanding - diluted	15,064,616	15,047,262	15,7

During all periods presented, the Company had certain stock options and warrants outstanding, which could potentially dilute basic earnings (loss) per common share in the future, but were excluded in the computation of diluted earnings (loss) per common share in such periods, as their effect would have been antidilutive. For the three and nine months ended September 30, 2004, stock options and warrants exercisable for 2,662,950 and 1,727,903 shares of common stock, respectively, were excluded from the computation of diluted earnings per common share, as they were antidilutive. For each of the three and nine months ended September 30, 2003, stock options and warrants exercisable for 2,320,663 shares of common stock were excluded from the computation of diluted loss per common share, as they were antidilutive.

During each of the three and nine months ended September 30, 2004, 1,750,374 shares of common stock issuable upon the conversion of the preferred stock were excluded from the computation of diluted earnings per common share, as they were antidilutive. During each of the three and nine months ended September 30, 2003, 1,690,729 shares of common stock issuable upon the conversion of the preferred stock were excluded from the computation of diluted loss per common share, as they were antidilutive.

(7) Stock Option Plans

The Company accounts for its stock option plan in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"), which allows entities to continue to apply the provisions of APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB Opinion No. 25"), as clarified by FASB Interpretation No. 44, "Accounting For Certain Transactions Involving Stock Compensation," and provides pro forma net income and pro forma earnings per share disclosures for employee stock option grants made in 1995 and future years as if the fair-value-based method, as defined in SFAS No. 123, had been applied. The Company has elected to apply the provisions of APB Opinion No. 25 and provide the pro forma disclosure required by SFAS No. 123.

APB Opinion No. 25 does not require the recognition of compensation expense for stock options granted to employees at fair market value. However, any modification to previously granted awards generally results in

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

compensation expense or contra-expense recognition using the cumulative expense method, calculated based on quoted prices of the Company's common stock and vesting schedules of underlying awards. As a result of the re-pricing of certain stock options in 2001 and 2002, the Company recognized compensation contra-expense of approximately \$0.1 million for the three months ended September 30, 2004 and compensation expense of approximately \$0.9 million for the nine months ended September 30, 2004. As a result of the re-pricing of those certain stock options, for the three and nine months ended September 30, 2003, the Company recognized compensation expense of approximately \$0.3 million and \$0.4 million, respectively.

The following table provides a reconciliation of net loss to pro forma net loss as if the fair value method had been applied to all awards (in thousands):

	Three Months Ended September 30,		Nine Mo
	2004	2003	200
Net (loss) income, as reported	\$(1,033)	\$59	\$
(Deduct) Add: Stock-based compensation (contra-expense) expense, as reported	(61)	297	
Deduct: Total stock-based compensation expense determined under fair value based method for all awards	(121)	(68)	
Pro forma net income (loss)	\$(1,215)	\$288	\$
Basic earnings (loss) per common share:			
As reported	\$(0.23)	\$(0.16)	
Pro forma	\$(0.25)	\$(0.14)	
Diluted earnings (loss) per common share:			
As reported	\$(0.23)	\$(0.16)	
Pro forma	\$(0.25)	\$(0.14)	

For the three months ended September 30, 2004, the Company issued options to purchase 40,000 shares of common stock at a weighted average fair value of \$5.29 using the Black-Scholes option pricing model. For the nine months ended September 30, 2004, the Company issued options to purchase 220,000 shares of common stock at a weighted average fair value of \$2.70 using the Black-Scholes option pricing model. For the three months ended September 30, 2003, the Company issued options to purchase 40,000 shares of common stock at a weighted average fair value of \$1.26 using the Black-Scholes option pricing model. For the nine months ended September 30, 2003, the Company issued options to purchase 235,000 shares of common stock at a weighted average fair value of \$0.83 using the Black-Scholes option pricing model.

(8) Segment Information

The Company's consolidated operations have been classified into three reportable segments: ESP, AfriHUB and Parent and other. ESP is a product

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

development and engineering services firm that creates products for and provides consulting and engineering services to the telecommunications, broadband, satellite communications, and wireless industries. Through exclusive partnerships with certain Nigerian based universities, AfriHUB intends to provide instructor led and distance based technical training and satellite based broadband Internet access and domestic and international calling services. Parent and other includes the Company, other consolidated entities other than ESP and AfriHUB, and eliminations.

The segment information is reported along the same lines that our chief operating decision maker reviews the operating results in assessing performance and allocating resources. For each period presented, all reported revenues were attributable to ESP. For the nine months ended September 30, 2004, two customers individually accounted for more than 10% of the revenues and, combined, accounted for approximately \$0.7 million of revenues and approximately \$0.1 million of accounts receivable as of September 30, 2004.

The following tables present certain other financial information on the Company's reportable segments (in thousands):

	Three Months Ended September 30,		Nine Month
	2004	2003	2004
Loss from operations:			
ESP	\$(197)	\$(185)	\$(77)
AfriHUB	(630)	--	(1,09)
Parent and other	(1,422)	(1,315)	(4,56)
	(2,249)	(1,500)	(6,42)
Interest income, net	1,900	1,592	9,49
Loss on investments in affiliates	(449)	(67)	(97)
Other (expense) income, net	(63)	3	20,84
Minority interest	(172)	(288)	(63)
	(1,033)	(260)	22,30
Gain from wind-down of discontinued operations	--	319	-
	\$ (1,033)	\$59	\$22,30
	\$ (1,033)	\$59	\$22,30
		September 30,	Dece
		2004	
Total assets:			
ESP		\$193	
AfriHUB		1,134	
Parent and other		120,339	
		\$121,666	
		\$121,666	

(9) Discontinued Operations

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

From 1998 through the third quarter of 2001, the Company's principal business was conducted through Rare Medium, Inc., which developed Internet e-commerce strategies, business processes, marketing communications, branding strategies and interactive content using Internet-based technologies and solutions. As a result of the weakening of general economic conditions that caused many companies to reduce spending on Internet-focused business solutions and in light of their performance and prospects, a decision to discontinue Rare Medium, Inc.'s operations, along with those of its LiveMarket, Inc. subsidiary ("LiveMarket"), was made at the end of the third quarter of 2001. As of September 30, 2004, cash of approximately \$40,000 (excluding the \$0.3 million of cash collateralizing a letter of credit) was the remaining asset of Rare Medium, Inc. and LiveMarket. The liabilities of these subsidiaries totaled approximately \$2.3 million, consisting of accounts payable and accrued expenses. Included in the total liabilities of these subsidiaries is \$1.0 million related to a lease obligation which is guaranteed by the Company. The total maximum potential liability of this guarantee is \$3.4 million, subject to certain defenses by the Company. Rare Medium, Inc. holds \$0.3 million of cash in a certificate of deposit which is maintained as collateral for a letter of credit supporting the lease obligation. For the three and nine months ended September 30, 2003, the Company recognized a gain of approximately \$0.3 million and \$0.9 million, respectively, as a result of the settlement of Rare Medium, Inc. liabilities at amounts less than their recorded amounts.

(10) Related Party Transactions

During the three and nine months ended September 30, 2004, ESP recognized revenues totaling approximately \$0.1 million and \$0.5 million, respectively, for certain services provided to Navigauge and the MSV Joint Venture.

(11) Contingencies

Litigation

On November 19, 2001, five of the Company's shareholders filed a complaint against the Company, certain of its subsidiaries and certain of the current and former officers and directors in the United States District Court for the Southern District of New York, *Dovitz v. Rare Medium Group, Inc. et al.*, No. 01 Civ. 10196. Plaintiffs became owners of restricted Company stock when they sold the company that they owned to the Company. Plaintiffs assert the following four claims against defendants: (1) common-law fraud; (2) violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder; (3) violation of the Michigan Securities Act; and (4) breach of fiduciary duty. These claims arise out of alleged representations by defendants to induce plaintiffs to enter into the transaction. The complaint seeks compensatory damages of approximately \$5.6 million, exemplary and/or punitive damages in the same amount, as well as attorney fees. On January 25, 2002, the Company filed a motion to dismiss the complaint in its entirety. On June 3, 2002, the Court dismissed the matter without prejudice. On or about July 17, 2002, the plaintiffs filed an amended complaint asserting similar causes of action to those asserted in the original complaint. On September 12, 2002, the Company filed a motion to dismiss on behalf of itself and its current and former officers and directors. On March 7, 2003, the Court denied the motion to dismiss, and discovery commenced. The Company filed a motion for summary judgment on July 30, 2004. The motion has been fully briefed and submitted to the Court. The Company intends to continue to dispute this matter vigorously.

The Company and certain of its subsidiaries (along with the Engelhard Corporation) are parties to an arbitration relating to certain agreements that existed between or among the claimant and ICC Technologies, Inc., the

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

Company's former name, and the Engelhard/ICC ("E/ICC") joint venture arising from the desiccant air conditioning business that the Company and its subsidiaries sold in 1998. The claimant has sought \$8.5 million for (1) its alleged out of pocket losses in investing in certain of E/ICC's technology; (2) unjust enrichment resulting from the reorganization of E/ICC in 1998; and (3) lost profits arising from the fact that it was allegedly forced to leave the air conditioning business when the E/ICC joint venture was dissolved. The Company intends to vigorously dispute this action.

On July 26, 2002, plaintiffs James D. Loeffelbein, Terrie L. Pham and certain related parties filed suit against the Company, certain of its current and former officers, its former investor relations firm and a former employee of plaintiff Loeffelbein in the District Court of Johnson County, Kansas, Loeffelbein v. Milberg Weiss Bershad Hynes & Lerach, LLP, et al., 02 CV 04867. The plaintiffs asserted claims for fraud, negligence and breach of fiduciary duty against all of the Company and certain of its current and former officers in connection with allegedly false statements purportedly made to the plaintiffs. As a result of a court ordered mediation conducted as part of the appeals process, on September 28, 2004, the Company and the plaintiffs settled the matter. The settlement amount was paid in full by the Company's insurer.

In August 2003, a former employee of the Company's discontinued services subsidiary, filed a putative class action against Rare Medium, Inc. and the Company, and certain other former subsidiaries that were merged into Rare Medium, Inc., in Los Angeles County Superior Court captioned Joe Robuck, individually and on behalf of all similarly situated individuals v. Rare Medium Group, Inc., Rare Medium L.A., Inc., Rare Medium, Inc., and Rare Medium Dallas, Inc., Los Angeles County Superior Court Case No. BC300310. The plaintiff filed the action as a putative class action and putative representative action asserting that: (i) certain payments were purportedly due and went unpaid for overtime for employees with five job titles; (ii) certain related violations of California's overtime statute were committed when these employees were not paid such allegedly due and unpaid overtime at the time of their termination; and (iii) certain related alleged violations of California's unfair competition statute were committed. Plaintiff seeks to recover for himself and all of the putative class, alleged unpaid overtime, waiting time penalties (which can be up to 30 days' pay for each person not paid all wages due at the time of termination), interest, attorneys' fees, costs and disgorgement of profits garnered as a result of the alleged failure to pay overtime. Discovery has commenced. On October 1, 2004, the Company filed a motion for summary judgment. Both the Company and Rare Medium, Inc. expect to vigorously dispute class certification and all other aspects of the action.

Though it intends to continue to vigorously contest each of the aforementioned cases, the Company is unable to predict their respective outcomes, or reasonably estimate a range of possible losses, if any, given the current status of these cases. Additionally, from time to time, the Company is subject to litigation in the normal course of business. The Company is of the opinion that, based on information presently available, the resolution of any such additional legal matters will not have a material adverse effect on the Company's financial position or results of its operations.

(12) Subsequent Events

The terms of the Company's Series A convertible preferred stock provide for dividends of 4.65% of the then current face value to be paid quarterly in arrears commencing with the three months ended September 30, 2004. The first such payment of approximately \$1.4 million was declared by the Company's board of directors and paid on October 14, 2004. The net loss attributable to common stockholders for the three months ended September 30, 2004 reflects the accrual of this dividend.

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

On October 8, 2004, AfriHUB sold membership interests to an unaffiliated third party for \$0.3 million. Following this sale of membership interests and including the effect of the warrants issuable to certain employees if AfriHUB meets certain operating and financial milestones, the Company owns approximately 60.5% of AfriHUB's membership interests.

On November 8, 2004, the FCC approved the MSV Joint Venture's application, granting the MSV Joint Venture authority to operate an ATC, subject to certain conditions. Further, the FCC approved certain of the technical requirement waiver requests requested by the MSV Joint Venture and deferred ruling on certain other waiver requests until acting on other pending clarifications submitted in the request for reconsideration filed in July 2003.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that involve risks and uncertainties, including statements regarding our capital needs, business strategy, expectations and intentions. We urge you to consider that statements that use the terms "believe," "do not believe," "anticipate," "expect," "plan," "estimate," "strive," "intend" and similar expressions are intended to identify forward-looking statements. These statements reflect our current views with respect to future events and because our business is subject to numerous risks, uncertainties and risk factors, our actual results could differ materially from those anticipated in the forward-looking statements, including those set forth below under this "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this report. Actual results will most likely differ from those reflected in these statements, and the differences could be substantial. We disclaim any obligation to publicly update these statements, or disclose any difference between our actual results and those reflected in these statements. The information constitutes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

Overview

We operate our business through a group of complementary companies in the telecommunications industry, including the MSV Joint Venture, ESP, AfriHUB, Navigauge (formerly known as IQStat) and Miraxis.

On April 19, 2004, we signed an agreement to acquire 80% of the outstanding membership interests of AfriHUB for an aggregate purchase price of up to \$1.5 million. Our ownership interest is subject to dilution if AfriHUB meets certain operating and financial metrics. Through exclusive partnerships with certain Nigerian based universities, AfriHUB intends to provide instructor led and distance based technical training and satellite based broadband Internet access and domestic and international calling services. The first two campus facilities are expected to be operational during the fourth quarter of 2004.

We continue to evaluate a number of other business opportunities and are currently engaged in a number of separate and unrelated preliminary discussions concerning possible joint ventures and other transactions. We are in the early stages of such discussions and have not entered into any definitive agreements with respect to any material transaction, other than what has been described in this Form 10-Q. Prior to consummating any transaction, we will have to, among other things, initiate and satisfactorily complete a due diligence investigation, negotiate the financial and other

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

terms (including price) and conditions of such transaction, obtain appropriate board of directors', regulatory and other necessary consents and approvals and secure financing, to the extent deemed necessary.

As a result of the decision made at the end of the third quarter of 2001 to discontinue the operations of Rare Medium, Inc. and its LiveMarket subsidiary, the results of operations of these businesses have been accounted for as discontinued operations. Accordingly, our discussion in the section entitled "Results of Operations" focuses on our continuing operations and includes our results and those of our MSV Investors Subsidiary, ESP, AfriHUB (from the date of acquisition) and Miraxis.

Results of Operations for the Three Months Ended September 30, 2004 Compared to the Three Months Ended September 30, 2003

Revenues

Revenues are derived from fees generated for product development, consulting and engineering services performed by ESP, including reimbursable travel and other out-of-pocket expenses, and the sales of its electronic database of parts commonly used in printed circuit design. ESP provides services to its clients pursuant to both time-and-materials and fixed price contracts. Revenues from time-and-materials service contracts are recognized as the services are provided. For fixed price contracts, revenue is recognized under the percentage-of-completion basis, and accordingly revenues recognized in excess of billings would be recorded as work in progress on the accompanying balance sheet. Billings in excess of revenues recognized are recorded as deferred revenue. Losses on contracts are recognized during the period in which the loss first becomes probable and reasonably estimable. Contract losses are determined to be the amount by which the estimated costs of the contract exceed the estimated total revenues that will be generated by the contract.

Revenues for the three months ended September 30, 2004 increased to \$0.4 million from \$0.2 million for the three months ended September 30, 2003. This increase was due to the acquisition of ESP on August 25, 2003, and accordingly, our inclusion of ESP's operating results from that date. In future periods, we also expect to report revenues of AfriHUB as it expects to begin offering its services on two university campuses in Nigeria during the fourth quarter of 2004.

Cost of Revenues

Cost of revenues includes the salaries and related employee benefits for ESP employees that provide billable product development, consulting and engineering services, as well as the cost of reimbursable expenses. Cost of revenues for the three months ended September 30, 2004 increased to \$0.4 million from \$0.2 million for the three months ended September 30, 2003. This increase was due to the acquisition of ESP on August 25, 2003, and accordingly, our inclusion of ESP's operating results from that date. In future periods, we expect to report an increase in cost of revenues as AfriHUB expects to begin offering its services on two university campuses in Nigeria during the fourth quarter of 2004.

Selling, General and Administrative Expense

Selling, general and administrative expense includes facilities costs, finance, legal and other corporate costs, as well as the salaries and related employee benefits for those employees that support such functions. Selling, general and administrative expense for the three months ended September 30, 2004 increased to \$2.2 million from \$1.5 million for the three months ended September 30, 2003, an increase of \$0.7 million. This increase relates

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

primarily to approximately \$0.6 million of expenses incurred by AfriHUB in the three months ended September 30, 2004 and a \$0.3 million insurance claim payment received in the three months ended September 30, 2003, partially offset by a \$0.4 million decrease in non-cash compensation expense relating to the repricing of certain options in 2002 and 2001. As our selling, general and administrative expense relates to our current operations, including ESP and AfriHUB, we expect these costs, excluding any non-cash compensation expense arising from fluctuations in the price of our common stock in association with the repricing of those certain stock options in 2001 and 2002, to increase in future periods as AfriHUB continues to hire employees and build its business.

Interest Income, Net

Interest income, net is comprised of the interest earned on the notes receivable from the MSV Joint Venture and Motient and on our cash, cash equivalents, and short-term investments. Interest income, net for the three months ended September 30, 2004 increased to \$1.9 million from \$1.6 million for the three months ended September 30, 2003, an increase of \$0.3 million. This increase relates primarily to the \$0.1 million of interest earned on the New Motient Note during the three months ended September 30, 2004 and a \$0.1 million increase in interest earned on the note receivable from the MSV Joint Venture.

Loss on Investment in Affiliates

For the three months ended September 30, 2004, we recorded a loss on investments in affiliates of approximately \$0.4 million relating to our proportionate share of Navigauge's operating loss. For the three months ended September 30, 2003, we recorded a loss on investments in affiliates of approximately \$0.1 million for our proportionate share of each of Miraxis' and Navigauge's respective operating loss. We will continue to monitor the carrying value of our remaining investments in affiliates.

Minority Interest

For the three months ended September 30, 2004, we recorded minority interest of approximately \$0.2 million relating to the \$0.3 million of equity in earnings, primarily the interest income earned on the convertible notes from the MSV Joint Venture, which is attributable to the group of unaffiliated third parties who own approximately 20% of our MSV Investors Subsidiary, partially offset by the \$0.1 million of equity in loss attributable to the other shareholders in AfriHUB. For the three months ended September 30, 2003, we recorded minority interest of approximately \$0.3 million relating to the equity in earnings attributable to the group of unaffiliated third parties who invested in our MSV Investors Subsidiary.

Gain from Discontinued Operations

At the end of the third quarter of 2001, a decision to discontinue the operations of Rare Medium, Inc. and its LiveMarket subsidiary was made in light of their performance and prospects. For the three months ended September 30, 2004 and 2003, we recognized a gain of nil and \$0.3 million, respectively, as a result of the settlement of Rare Medium, Inc. liabilities at amounts less than their recorded amounts.

Net Loss Attributable to Common Stockholders

For the three months ended September 30, 2004 and 2003, we recorded a net loss attributable to common stockholders of approximately \$3.5 million and \$2.4 million, respectively. Included in the net loss attributable to common stockholders for the three months ended September 30, 2004 and 2003 was \$2.5 million and \$2.4 million, respectively, of dividends and accretion related to

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

our Series A convertible preferred stock. Dividends were accrued related to amounts payable quarterly on the Series A convertible preferred stock and to the accretion of the carrying amount of the Series A convertible preferred stock up to its \$100 per share face redemption amount over 13 years.

Results of Operations for the Nine Months Ended September 30, 2004 Compared to the Nine Months Ended September 30, 2003

Revenues

Revenues are derived from fees generated for product development, consulting and engineering services performed by ESP, including reimbursable travel and other out-of-pocket expenses, and the sales of its electronic database of parts commonly used in printed circuit design. ESP provides services to its clients pursuant to both time-and-materials and fixed price contracts. Revenues from time-and-materials service contracts are recognized as the services are provided. For fixed price contracts, revenue is recognized under the percentage-of-completion basis, and accordingly revenues recognized in excess of billings would be recorded as work in progress on the accompanying balance sheet. Billings in excess of revenues recognized are recorded as deferred revenue. Losses on contracts are recognized during the period in which the loss first becomes probable and reasonably estimable. Contract losses are determined to be the amount by which the estimated costs of the contract exceed the estimated total revenues that will be generated by the contract.

Revenues for the nine months ended September 30, 2004 increased to \$1.8 million from \$0.2 million for the nine months ended September 30, 2003. This increase was due to the acquisition of ESP on August 25, 2003, and accordingly, our inclusion of ESP's operating results from that date. In future periods, we expect to also report revenues of AfriHUB as it expects to begin offering its services on two university campuses in Nigeria during the fourth quarter of 2004.

Cost of Revenues

Cost of revenues includes the salaries and related employee benefits for ESP employees that provide billable product development, consulting and engineering services, as well as the cost of reimbursable expenses. Cost of revenues for the nine months ended September 30, 2004 increased to \$1.7 million from \$0.2 million for the nine months ended September 30, 2003. This increase was due to the acquisition of ESP on August 25, 2003, and accordingly, our inclusion of ESP's operating results from that date. In future periods, we expect to report an increase in cost of revenues as AfriHUB expects to begin offering its services on two university campuses in Nigeria during the fourth quarter of 2004.

Selling, General and Administrative Expense

Selling, general and administrative expense includes facilities costs, finance, legal and other corporate costs, as well as the salaries and related employee benefits for those employees that support such functions. Selling, general and administrative expense for the nine months ended September 30, 2004 increased to \$6.4 million from \$4.8 million for the nine months ended September 30, 2003, an increase of \$1.6 million. This increase relates primarily to the recognition of non-cash expense of approximately \$1.2 million in the nine months ended September 30, 2004 relating to the repricing of certain options in 2002 and 2001 and the issuance of an option to purchase a less than one percent ownership interest in our MSV Investors Subsidiary to an unaffiliated consultant. For the nine months ended September 30, 2003, we recognized \$0.3 million of non-cash expense relating to the option repricing. Also included in the increase are approximately \$0.5 million and \$1.0 million

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

of additional expenses incurred by ESP and AfriHUB, respectively, in the nine months ended September 30, 2004, partially offset by the approximately \$0.7 million charge recognized in the nine months ended September 30, 2003 relating to bonuses for certain executive officers for services provided during the year ended December 31, 2002 and the severance and benefits for our former Controller and former Treasurer. As our selling, general and administrative expense relates to our current operations, including ESP and AfriHUB, we expect these costs, excluding any non-cash compensation expense arising from fluctuations in the price of our common stock in association with the repricing of certain stock options in 2001 and 2002, to increase in future periods as AfriHUB continues to hire employees and build its business.

Interest Income, Net

Interest income, net is comprised of the interest earned on the notes receivable from the MSV Joint Venture, Verestar and Motient and on our cash, cash equivalents, and short-term investments. Interest income, net for the nine months ended September 30, 2004 increased to \$9.5 million from \$4.7 million for the nine months ended September 30, 2003, an increase of \$4.8 million. This increase relates primarily to the adjustment of the reserve for the unpaid interest on the New Motient Note in the nine months ended September 30, 2004. The reserve was adjusted because Motient paid approximately \$0.5 million of outstanding interest in April 2004 and approximately \$22.6 million representing the entire outstanding principal and remaining interest due under the New Motient Note in July 2004. As there was no longer any uncertainty with respect to the ultimate collection on the principal or interest due under the New Motient Note, we recognized approximately \$4.1 million in interest income in the nine months ended September 30, 2004, representing all interest earned from the May 2002 issuance of the note through the July 2004 repayment. Also contributing to the increase in interest income, net is the recognition of \$0.3 million of interest in the nine months ended September 30, 2004 related to the senior secured note from Verestar.

Loss on Investment in Affiliates

For the nine months ended September 30, 2004, we recorded a loss on investments in affiliates of approximately \$1.0 million relating to our proportionate share of Navigauge's operating loss. For the nine months ended September 30, 2003, we recorded a loss on investments in affiliates of approximately \$0.3 million for our proportionate share of each of Miraxis' and Navigauge's respective operating loss. We will continue to monitor the carrying value of our remaining investments in affiliates.

Other Income, Net

For the nine months ended September 30, 2004, we recorded other income, net of approximately \$20.8 million relating primarily to one-time items, including the \$19.0 million adjustment to the reserve for the New Motient Note, the \$1.5 million settlement with Verestar's parent company in connection with the termination of the August 2003 securities purchase agreement, and the approximately \$0.4 million representing a break-up fee in connection with the termination of the March 2004 Verestar asset purchase agreement.

Minority Interest

For the nine months ended September 30, 2004, we recorded minority interest of approximately \$0.6 million relating to the \$0.8 million of equity in earnings, primarily the interest income earned on the convertible notes from the MSV Joint Venture, which is attributable to the group of unaffiliated third parties who own approximately 20% of our MSV Investors Subsidiary, partially offset by the \$0.2 million of equity in loss attributable to the other shareholders in AfriHUB. For the nine months ended September 30, 2003,

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

we recorded minority interest of approximately \$0.8 million relating to the equity in earnings attributable to the group of unaffiliated third parties who invested in our MSV Investors Subsidiary.

Gain from Discontinued Operations

At the end of the third quarter of 2001, a decision to discontinue the operations of Rare Medium, Inc. and its LiveMarket subsidiary was made in light of their performance and prospects. For the nine months ended September 30, 2004 and 2003, we recognized a gain of nil and \$0.9 million, respectively, as a result of the settlement of Rare Medium, Inc. liabilities at amounts less than their recorded amounts.

Net Income (Loss) Attributable to Common Stockholders

For the nine months ended September 30, 2004, we recorded net income attributable to common stockholders of approximately \$14.9 million. For the nine months ended September 30, 2003, we recorded a net loss attributable to common stockholders of approximately \$7.6 million. Included in net income (loss) attributable to common stockholders for the nine months ended September 30, 2004 and 2003 was \$7.4 million and \$7.2 million, respectively, of dividends and accretion related to our Series A convertible preferred stock. Dividends were accrued related to amounts payable quarterly on the Series A convertible preferred stock and to the accretion of the carrying amount of the Series A convertible preferred stock up to its \$100 per share face redemption amount over 13 years.

Liquidity and Capital Resources

We had approximately \$48.9 million in cash, cash equivalents and short-term investments as of September 30, 2004. Cash provided by operating activities from continuing operations was approximately \$0.8 million for the nine months ended September 30, 2004 and resulted primarily from the collection of approximately \$3.9 million of accrued interest earned on the notes receivable from Motient and Verestar and the approximately \$1.9 million received in connection with the Verestar transactions, partially offset by cash used for general corporate overhead including payroll and professional fees. Cash used by discontinued operations was approximately \$9,000 for the nine months ended September 30, 2004 and resulted from cash used for settlement of vendor liabilities and legal and advisory fees.

For the nine months ended September 30, 2004, cash provided by investing activities, excluding purchases and sales of short-term investments, was \$19.4 million and resulted primarily from the \$21.5 million repayment of the notes receivable from Motient and Verestar, partially offset by approximately \$1.4 million used to purchase investments in Navigauge. We do not have any future funding commitments with respect to any of our investments. However, we expect that the MSV Joint Venture, AfriHUB, Miraxis, and Navigauge will require additional funding from time to time, and we may choose to provide additional funding, subject to our liquidity and capital resources at the time.

Motient Promissory Note

On May 1, 2002, to mitigate the risk, uncertainties and expenses associated with Motient's plan of reorganization, we cancelled the outstanding amounts due under the original promissory notes issued by Motient and accepted a new note in the principal amount of \$19.0 million that was issued by MSV Holding, Inc., a new, wholly-owned subsidiary of Motient that owns 100% of Motient's interests in the MSV Joint Venture. The New Motient Note is due on May 1, 2005 and bears interest at a rate of 9% per annum. Although the New Motient Note is unsecured, there are material restrictions placed on the use of MSV Holdings Inc.'s assets, and MSV Holdings Inc. is prohibited from

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

incurring or guarantying any debt in excess of \$21.0 million (including the New Motient Note). Additionally, there are events of default (e.g., a bankruptcy filing by Motient) that would accelerate the due date of the New Motient Note. As a result of the uncertainty with respect to the ultimate collection on the remaining amounts due on the New Motient Note, a reserve was maintained for the entire principal amount of the note and unpaid interest accrued thereon.

On April 7, 2004, as a result of a payment received by Motient pursuant to a promissory note from the MSV Joint Venture, Motient paid us approximately \$0.5 million of interest accrued on the New Motient Note. This amount was reflected in the consolidated statement of operations as interest income in the three months ended March 31, 2004. Following several successful financings by Motient, on July 15, 2004, Motient paid approximately \$22.6 million representing all outstanding principal and accrued interest due on the New Motient Note as of that date. Accordingly, the reserve was adjusted in the three months ended June 30, 2004 resulting in the recognition of \$19.0 million in other income and \$3.5 million in interest income. The remaining \$0.1 million represents interest earned during July 2004 and was recognized in the accompanying consolidated statement of operations in the three months ended September 30, 2004.

MSV Joint Venture Convertible Notes Receivable

Through our 80% owned MSV Investors Subsidiary, we are an active participant in the MSV Joint Venture, a joint venture that also includes TMI Communications, Inc., Motient and the Other MSV Investors. The MSV Joint Venture is currently a provider of mobile digital voice and data communications services via satellite in North America. On November 26, 2001, through our MSV Investors Subsidiary, we purchased a \$50.0 million interest in the MSV Joint Venture in the form of a convertible note. Immediately prior to the purchase of the convertible note, we contributed \$40.0 million to the MSV Investors Subsidiary and a group of unaffiliated third parties collectively contributed \$10.0 million. The note bears interest at a rate of 10% per year, has a maturity date of November 26, 2006, and is convertible at any time at the option of our MSV Investors Subsidiary into equity interests in the MSV Joint Venture.

On August 13, 2002, the MSV Joint Venture completed a rights offering allowing its investors to purchase their pro rata share of an aggregate \$3.0 million of newly issued convertible notes with terms similar to the convertible note already held by our MSV Investors Subsidiary. The MSV Investors Subsidiary exercised its basic and over subscription rights and purchased approximately \$1.1 million of the convertible notes. The group of unaffiliated third parties collectively contributed \$0.2 million to the MSV Investors Subsidiary in connection with the MSV Joint Venture rights offering.

Pursuant to the MSV Joint Venture Agreement, in the event that the MSV Joint Venture had received final regulatory approval from the FCC, as that phrase is defined in the MSV Joint Venture Agreement, by March 31, 2003 for its ATC applications, the Other MSV Investors would have been obligated to invest an additional \$50.0 million in the MSV Joint Venture. As the final regulatory approval from the FCC, as defined in the MSV Joint Venture Agreement, was not received by March 31, 2003, the additional investment was not required. However, the Other MSV Investors retained the option to invest the \$50.0 million on the same terms and conditions until June 30, 2003. Prior to its expiration, the option was extended until August 2003. On August 8, 2003, the MSV Joint Venture Agreement was amended and certain of the Other MSV Investors agreed to invest \$3.7 million in the MSV Joint Venture and retained the option to invest an additional \$17.6 million under certain terms and conditions. On April 2, 2004, those certain Other MSV Investors exercised the option in full.

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

Under the amended MSV Joint Venture Agreement, the convertible notes held by our MSV Investors Subsidiary will automatically convert into equity interests in the MSV Joint Venture upon the repayment of (i) the outstanding principal and accrued interest on certain outstanding debt of the MSV Joint Venture and (ii) the accrued interest on all outstanding convertible notes of the MSV Joint Venture, including the convertible notes held by the MSV Investors Subsidiary. Such principal and accrued interest totaled approximately \$44.0 million as of September 30, 2004 and will need to increase thereafter by an amount equal to the additional interest accrued on the certain outstanding debt and convertible notes. Any additional equity investments used to repay these obligations must be made at a valuation of the MSV Joint Venture equal to or greater than the valuation at the time the MSV Investors Subsidiary purchased the notes. Currently, the MSV Investors Subsidiary would own, upon conversion, approximately 27.4% of the equity interests in the MSV Joint Venture.

On May 7, 2004, in connection with services being provided which support the regulatory effort of the MSV Joint Venture, an unaffiliated consultant was issued an option to purchase a less than one percent ownership interest in the MSV Investors Subsidiary. The option is immediately exercisable and will expire on the earlier of the dissolution of the MSV Investors Subsidiary or December 31, 2010. During the three months ended June 30, 2004, we recognized expense of approximately \$0.3 million related to the issuance of the option, which is the approximate fair value of the option using the Black-Scholes option valuation model. To provide additional incentive to the consultant, the MSV Investors Subsidiary agreed to pay the consultant a one-time fee of \$0.4 million upon a liquidity event, as defined in the agreement. We would recognize an expense related to this fee when a liquidity event becomes probable.

The fair value of the convertible notes approximates book value based on the equity value of the MSV Joint Venture's April 2004 funding transaction assuming conversion of such note.

Verestar Transactions

On August 29, 2003, we signed a securities purchase agreement to acquire, through a newly formed subsidiary, approximately 66.7% (on a fully-diluted basis) of Verestar. Concurrent with the signing of the securities purchase agreement, we purchased a 10% senior secured note with a principal balance of \$2.5 million and a due date of August 2007. We terminated the securities purchase agreement on December 22, 2003. Subsequently, Verestar filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code.

On March 8, 2004, we executed an agreement to acquire, through a newly formed subsidiary, substantially all of the assets and business of Verestar pursuant to Section 363 of the Bankruptcy Code. The transaction was subject to a number of contingencies, including an auction on March 30, 2004 at which Verestar considered higher and better offers. At the auction, a bid was accepted from a strategic buyer at a price higher than we were willing to offer.

In connection with the Verestar bankruptcy, we entered into a stipulation with Verestar pursuant to which the parties agreed to, among other things, the validity and enforcement of the obligation under the senior secured note and our security interest in Verestar's assets. On April 30, 2004, Verestar repaid the \$2.5 million principal amount of the senior secured note, along with an additional approximately \$0.4 million representing a break-up fee in connection with the termination of the March 2004 asset purchase agreement.

On July 9, 2004, we settled our dispute with Verestar's parent company

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

regarding the break-up fee in connection with the termination of the August 2003 securities purchase agreement. As consideration for the settlement, Verestar's parent company paid us \$1.5 million. This amount has been reflected in the accompanying consolidated statement of operations as other income in the nine months ended September 30, 2004.

On July 29, 2004, we entered into a stipulated settlement with Verestar and its Creditor Committee pursuant to which Verestar agreed to pay us approximately \$0.4 million representing certain amounts owed, including unpaid accrued interest, in connection with the senior secured note. On August 13, 2004, the Bankruptcy Court approved the stipulated settlement. This settlement amount has been reflected in the accompanying consolidated statement of operations as interest income in the nine months ended September 30, 2004.

ESP Senior Secured Promissory Notes

On August 25, 2003, for nominal consideration, we acquired all of the outstanding common stock of ESP, a product development and engineering services firm that creates products for and provides consulting and engineering services to the telecommunications, broadband, satellite communications, and wireless industries. Subsequent to the stock purchase, we purchased an aggregate of approximately \$1.4 million of senior secured promissory notes from ESP. On June 9, 2004, we forgave approximately \$0.8 million of outstanding principal and accrued interest of the promissory notes in exchange for the Series A Preferred Shares of Navigauge held by ESP. On September 28, 2004, we purchased an additional senior secured promissory note with a principal balance of approximately \$0.1 million. As of September 30, 2004, principal and accrued interest of these senior secured notes totaled approximately \$0.7 million.

AfriHUB Commitment

On April 19, 2004, we signed an agreement to acquire 80% of the outstanding membership interests of AfriHUB for an aggregate purchase price of up to \$1.5 million. Through exclusive partnerships with certain Nigerian based universities, AfriHUB intends to provide instructor led and distance based technical training and satellite based broadband Internet access and domestic and international calling services. From August 2004 through November 2004, we purchased promissory notes from AfriHUB with an aggregate principal amount of approximately \$0.2 million. On October 8, 2004, AfriHUB sold membership interests to an unaffiliated third party for \$0.3 million. In addition, if AfriHUB meets certain operating and financial milestones, certain employees will be issued warrants to purchase ownership interests of AfriHUB. Following the October 2004 sale of the membership interests and including the effect of the warrants, we own approximately 60.5% of AfriHUB's membership interests.

Series A Convertible Preferred Stock Dividend

In accordance with the terms of our preferred stock, the holders are entitled to receive quarterly cash dividends commencing on July 1, 2004. The first such quarterly payment of approximately \$1.4 million, for the three months ended September 30, 2004, was declared and paid on October 14, 2004. The aggregate annual dividend payment will be approximately \$5.6 million through the mandatory redemption on June 30, 2012 or such earlier time as the terms of the preferred stock are renegotiated.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As of September 30, 2004, we had approximately \$48.9 million of cash, cash equivalents and short-term cash investments. These cash, cash equivalents and short-term cash investments are subject to market risk due to changes in

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

interest rates. In accordance with our investment policy, we diversify our investments among United States Treasury securities and other high credit quality debt instruments that we believe to be low risk. We are averse to principal loss and seek to preserve our invested funds by limiting default risk and market risk.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and principal accounting officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, our chief executive officer and principal accounting officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act.

Internal Control Over Financial Reporting

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II

Item 1. Legal Proceedings

On November 19, 2001, five of the Company's shareholders filed a complaint against the Company, certain of its subsidiaries and certain of the current and former officers and directors in the United States District Court for the Southern District of New York, *Dovitz v. Rare Medium Group, Inc. et al.*, No. 01 Civ. 10196. Plaintiffs became owners of restricted Company stock when they sold the company that they owned to the Company. Plaintiffs assert the following four claims against defendants: (1) common-law fraud; (2) violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder; (3) violation of the Michigan Securities Act; and (4) breach of fiduciary duty. These claims arise out of alleged representations by defendants to induce plaintiffs to enter into the transaction. The complaint seeks compensatory damages of approximately \$5.6 million, exemplary and/or punitive damages in the same amount, as well as attorney fees. On January 25, 2002, the Company filed a motion to dismiss the complaint in its entirety. On June 3, 2002, the Court dismissed the matter without prejudice. On or about July 17, 2002, the plaintiffs filed an amended complaint asserting similar causes of action to those asserted in the original complaint. On September 12, 2002, the Company filed a motion to dismiss on behalf of itself and its current and former officers and directors. On March 7, 2003, the Court denied the motion to dismiss, and discovery commenced. The Company filed a motion for summary judgment on July 30, 2004. The motion has been fully briefed and submitted to the Court. The Company intends to continue to dispute this matter vigorously.

The Company and certain of its subsidiaries (along with the Engelhard

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

Corporation) are parties to an arbitration relating to certain agreements that existed between or among the claimant and ICC Technologies, Inc., the Company's former name, and the Engelhard/ICC joint venture arising from the desiccant air conditioning business that the Company and its subsidiaries sold in 1998. The claimant has sought \$8.5 million for (1) its alleged out of pocket losses in investing in certain of E/ICC's technology; (2) unjust enrichment resulting from the reorganization of E/ICC in 1998; and (3) lost profits arising from the fact that it was allegedly forced to leave the air conditioning business when the E/ICC joint venture was dissolved. The Company intends to vigorously dispute this action.

On July 26, 2002, plaintiffs James D. Loeffelbein, Terrie L. Pham and certain related parties filed suit against the Company, certain of its current and former officers, its former investor relations firm and a former employee of plaintiff Loeffelbein in the District Court of Johnson County, Kansas, Loeffelbein v. Milberg Weiss Bershad Hynes & Lerach, LLP, et al., 02 CV 04867. The plaintiffs asserted claims for fraud, negligence and breach of fiduciary duty against all of the Company and certain of its current and former officers in connection with allegedly false statements purportedly made to the plaintiffs. As a result of a court ordered mediation conducted as part of the appeals process, on September 28, 2004, the Company and the plaintiffs settled the matter. The settlement amount was paid in full by the Company's insurer.

In August 2003, a former employee of the Company's discontinued services subsidiary, filed a putative class action against Rare Medium, Inc. and the Company, and certain other former subsidiaries that were merged into Rare Medium, Inc., in Los Angeles County Superior Court captioned Joe Robuck, individually and on behalf of all similarly situated individuals v. Rare Medium Group, Inc., Rare Medium L.A., Inc., Rare Medium, Inc., and Rare Medium Dallas, Inc., Los Angeles County Superior Court Case No. BC300310. The plaintiff filed the action as a putative class action and putative representative action asserting that: (i) certain payments were purportedly due and went unpaid for overtime for employees with five job titles; (ii) certain related violations of California's overtime statute were committed when these employees were not paid such allegedly due and unpaid overtime at the time of their termination; and (iii) certain related alleged violations of California's unfair competition statute were committed. Plaintiff seeks to recover for himself and all of the putative class, alleged unpaid overtime, waiting time penalties (which can be up to 30 days' pay for each person not paid all wages due at the time of termination), interest, attorneys' fees, costs and disgorgement of profits garnered as a result of the alleged failure to pay overtime. Discovery has commenced. On October 1, 2004, the Company filed a motion for summary judgment. Both the Company and Rare Medium, Inc. expect to vigorously dispute class certification and all other aspects of this action.

Item 2. Changes in Securities

- (a) Not applicable
- (b) Not applicable
- (c) Not applicable
- (d) Not applicable

Item 3. Defaults Upon Senior Securities

Not applicable

Item 4. Submissions of Matters to a Vote of Security Holders

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

None

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

- (a) The following sets forth those exhibits filed pursuant to Item 601 of Regulation S-K:

Exhibit Number		Description
-----		-----
31.1	-	Certification of Jeffrey A. Leddy, Chief Executive Officer and President of SkyTerra Communications, Inc., required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	-	Certification of Craig J. Kaufmann, Controller and Treasurer of SkyTerra Communications, Inc., required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	-	Certification of Jeffrey A. Leddy, Chief Executive Officer and President of SkyTerra Communications, Inc., Pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	-	Certification of Craig J. Kaufmann, Controller and Treasurer of SkyTerra Communications, Inc., Pursuant to 18 U.S.C Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- (b) The following sets forth the Company's reports on Form 8-K that have been filed during the quarter for which this report is filed:

On July 16, 2004, the Company filed a report on Form 8-K announcing its receipt of payment of all principal and interest outstanding on the note issued by a subsidiary of the Motient Corporation.

On August 17, 2004, the Company filed a report on Form 8-K announcing its earnings results for the quarter ended June 30, 2004.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, this Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: November 10, 2004

By: /s/ JEFFREY A. LEDDY

Jeffrey A. Leddy
Chief Executive Officer and

Edgar Filing: SKYTERRA COMMUNICATIONS INC - Form 10-Q

President Principal Executive
Officer and Principal Financial
Officer)

Date: November 10, 2004

By: /s/ CRAIG J. KAUFMANN

Craig J. Kaufmann
Controller and Treasurer
(Principal Accounting Officer)