INVESTING IN UTILITY STOCKS: IT'S A BRAVE NEW WORLD

By Donald Cassidy

We are in a brave new competitive and price-sensitive world for utilities, and competition in electric, gas, and telephone service means that a company providing an essential service is not guaranteed to do so profitably enough to pay assured dividends.

Common stock utility investing currently presents the greatest uncertainty since the Great Depression in the 1930s. At the same time, acquisition opportunities are on the rise. Utility companies (with the exception of water services) are involved in major competitive, regulatory, and pricing upheavals that have forcibly transformed once-sleepy monopolies into fast-paced and battling enterprises.

The first action-implying observation for investors is: "This is not your parents' utility company." For older and conservative investors, this may be difficult to accept, but it is extremely important to understand and should be the basis upon which any decisions are acted upon.

ASSUMPTIONS: BE WARY

People easily draw conclusions on the basis of unconscious and faulty or loose syllogisms. This problem is common among utility investors. An illustration:

- *Assumption 1*: The provision of electric, gas, telephone, and water service is essential in an advanced civil society. We cannot live without it.
- *Assumption 2*: Utility X has a monopoly franchise to provide one of these services in its defined territory.
- *Assumption 3*: Utility X has always operated profitably and paid consistent common share dividends.
- *Assumption 4*: Therefore, Utility X is a safe investment.

While the first assumption is accurate, connections become more slippery and ultimately break down en route to Assumption 4.

Regulatory change and consumer pressures for choice have made yesteryear's monopolies either extinct or weak shadows of their former selves. With monopoly undone, the key basis for assuming continued dependable profitability is wiped away.

We are indeed in a brave new competitive and price-sensitive world for utilities. In past years, a request that state regulatory authorities grant a rate increase would cover cost problems, thus restoring margins and return on assets. Today, competition in electric, gas, and telephone service means that raising prices is not a solution, but actually worsens the problem. Thus, we now see, that old line of logic breaks down: a company providing an essential service is not thereby guaranteed to do so profitably, or profitably enough to pay assured dividends. The fundamentals, literally, have fundamentally changed.

As owners in still-consistently profitable companies, utility investors can easily become overly complacent and thereby dismiss significant change that does suddenly appear. Our inertia as investors can harm our wealth.

A CHANGED HOLDING

Many investors accepted and held the seven regional "Baby Bells" distributed under the enforced 1984 break-up of AT&T. Without debating merits of that

*Donald Cassidy is a senior research analyst with Lipper Inc., and the author of four books on investing. His newest (July 1999) is "*When The Dow Breaks*." He can be reached at dcassidy@lasc.com or 303-603-8332.*

investment decision, in millions of cases it was "done" by mere default, by inaction. This illustrates our tendency to be passive rather than active under conditions of uncertainty. And of course investing *always* involves uncertainty over the future. Even if you hold utility companies that haven't been broken up and perhaps may not have acquired other firms, in many instances you now own a "different" company than what you bought. It may have diversified into new regions; today it faces price competition not dreamed of some years ago; it may own assets now underused and about to be written off; it may have abandoned some parts of its operations and focused on other functions. Or, after paying a constant dividend while earnings have sagged or capital expenditures have ballooned, it may now have a debt-heavier capital structure.

Change can be good. By no means will all affected companies be losers—in fact, some will rise to the challenge, moving to the head of the pack as new leaders.

Quality of management is central here, although judging that subtle, critical factor was difficult in the prior, highly regulated atmosphere. One way to sniff out possible differences in management capability is to read the wording of annual reports carefully. Do you sense whining about how tough the world has become (a bad sign—it indicates management is playing from behind) or instead get a strong sense of challenges being quickly perceived, welcomed, proactively met, and used to advantage (clearly a good sign)?

Here are the major changes you can expect by utility type:

- *Telephone*: Price competition; huge capital expenditures to upgrade to replace copper, raise speed, and increase capacity.
- *Electric*: Price competition, implying possible write-offs of stranded capacity; need to rationalize operational functions and perhaps abandon some.
- *Gas*: In mid-1980s, regulatory shift forced open the common carrier model, changing the economic model, and pressuring margins as monopoly benefits waned. Some bankruptcies, now recovered and healthier.
- *Water*: In future, as regulation raises legal potability standards, capital and operating costs will jump, implying much higher user rates. Sticker-shock backlash likely, pinching margins and dividend stability.

Clearly, these major shifts all point to the need for cost reductions, in turn strongly arguing for consolidation. Expect a large number of mergers, well beyond those seen already.

For conservative investors requiring capital preservation, the four utility types present declining risks in this order:

- *Telephone*: Extremely high prices relative to earnings and dividends; uncertain identity of ultimate winners.
- *Electric*: Stranded-plant cost and threats to dividends and, in a few cases, solvency in new competitive environment.
- *Water*: Possible future earnings and dividend challenges described above.
- *Gas*: Structural issues resolved; weather vagaries remain.

As investors see a rising tide of mergers, you must consciously resist allowing events to change your personal investment objectives by default. For example, suppose you bought an electric stock for current income and gradual dividend growth to help offset inflation. The company now faces rougher times due to rising competition and has stopped dividend growth or, worse yet, cut its quarterly rate. You're tempted to shift objectives and hope to be bailed out of your discomfort by a possible future acquisition. In this scenario, by holding on you've shifted from a conservative investor owning a once-quality company to a speculator holding a lower-quality property and yearning for a happy outcome.

Make no mistake: Today there is room for both investing and speculating in utility stocks—owning for dividend income that is secure and rising, or owning in the hope of acquisitions. Both are legitimate strategies if the companies owned have been researched and chosen from one standpoint or the other. The great danger is in passively migrating from an investor's to a speculator's position. Thus a second critical implication: Don't allow a stealth shift in your investment objective as events transform the nature of what you hold.

EXPECT MERGERS

Mergers, acquisitions, partnering, and strategic combinations are on the rise and can be expected to continue for several years, barring a sharp rise in capital costs and until the national utility map has been significantly redrawn through consolidation. The following are predictable major drivers of utility mergers:

- Diversifying mix of business (multiple types of service versus one) such as telephone and electric under one corporate roof.
- Diversifying regulatory risk, both by adding new physical jurisdiction over territories and by mixing types of business (gas plus electric.)
- Cobbling together two or more small companies to gain size efficiencies (New England has numerous, small gas distributors and, likewise, many small-territory electric companies).
- Vertical combinations, especially in gas, where long-distance pipelines capture final customers by buying local distribution companies—or more rarely where a fairly large distribution company moves to secure its energy source by buying a pipeline.
- Classic "PacMan" defensive mergers, where a medium-sized company combines with a like-sized or smaller entity to render

itself less vulnerable to being swallowed by a bigger fish.
- Among electrics, acquisitions of lower-cost providers by higher-cost neighbors. This reduces vulnerability under new competition rules and may allow more opportunity for off-system sales of excess power, whose average cost becomes lowered.
- Horizontal mergers such as electric companies combining with gas distributors. These diversify business and secure energy supply.
- Technology-driven combinations, possibly involving rights of way for long-distance cable (phone and electric) where pipelines or railroads run. Can also include running phone, cable, and electric wires on a single path for economy and possible common use.
- International. Current attraction of diversification and growth potential may mask future risks of currency fluctuation affecting earnings stability.

Defensive mergers might be described as marriages of shaky convenience. Most commonly, utilities' defensive mergers involve two medium-quality or relatively weak companies, often with contiguous service territories, combining to create savings in corporate overhead. Former power purchases and sales between them become internal transfers, saving some accounting costs. Such mergers leave untouched crucial problems such as high generation costs, which will eventually make the company vulnerable to customers' switching in a competitive market.

Expect such mergers among pairs of (especially smaller) companies operating in single states, and sometimes across state lines. Unless there's a critical asset (for example, strategically located long-distance transmission lines that have importance in the power grid), do not expect juicy premiums to be paid in such deals. The reason: Companies cannot depend on regulatory commissions to provide guaranteed returns on overpriced acquired assets, since consumers and price competition rather than tariffs now set rates, and therefore margins and dividend-paying ability.

Strategic combinations tend to be larger and often cut across product types. Strategic mergers can involve physical location of assets, truly major synergies that dramatically lower costs or business risks, and the ability to outflank potential rivals.

One example of a strategic combination was the acquisition of Portland General Electric (Oregon), whose transmission lines form a middle link in the chain from the Pacific northwest (including Canada) to power-hungry California. An earlier example of a strategic combination was then-Duke Power's (Duke Energy) purchase of major gas pipeline PanEnergy. In a single stroke, this greatly widened Duke's geographic diversity, transformed it into an electric-*and*-gas company (reducing risk), and gave it a captive alternative source of lower-cost boiler fuel. Similar reasons justified the proposed acquisition of KN Energy (gas in Colorado, Nebraska, and Kansas) by San Diego's Sempra Energy, a local electric and gas company, before financial setbacks undid the deal.

International mergers should be expected. To date, most have involved U.S. managements' decisions to escape wholly domestic regulation and local competitive risk by buying into companies overseas. Europe, Australia, and Latin America have been common targets. Strength of the U.S. dollar lately has aided this trend. If the dollar weakens considerably, more overseas companies can become buyers, not sellers. Despite current dollar strength, Scottish Power ADS' pending purchase of PacifiCorp may be an early example. Scottish Power perhaps also reasoned that making itself more complex would be an effective "PacMan" defense of its own independence.

Here are some actual examples of done, proposed, or pending deals illustrating various acquisition/diversification drivers:
- *Duke/PanEnergy*: Multiple strategic benefits, noted above.
- *New England Electric System/The National Grid Group plc, and Scottish Power ADS/PacifiCorp (international).*
- *Columbia Energy Group (major pipeline system)*: Hostile bid for Consolidated Natural Gas (rejected); followed by NiSource's hostile bid for Columbia Energy Group (also rejected). "PacMan" defense by Columbia?
- *Sempra Energy/KN Energy*: Geographic-type diversification; securing energy source.
- *Con Ed/Orange & Rockland Utilities*: Territory-bound city utility acquires upstate company with faster growth potential; economies.
- *Montana Power*: Sale of electric generation plants to PP&L Resources, plowing capital proceeds into development of northern-tier, long-distance communications and power backbone.
- *BSE (former Boston Edison)*: Providing cable, electric, phone, and Internet access over fiber-optic system.
- *UtiliCorp United*: Early pioneer of strategic diversification across service types and multiple states, now internationally; 1999 agreements to take over both Empire District Electric and St. Joseph Light & Power—all three headquartered in Missouri.
- *Philadelphia Suburban's acquisition of Consumers Water*: Foreshadows probable future tide of national water business consolidation.

MERGER SELECTION CRITERIA

When looking at utilities to buy in anticipation of their becoming acquisition candidates, remember that such deals usually take about a year or longer to be consummated; regulatory approval is cumbersome. It

TABLE 1. SMALLER COMPANIES WITH ATTRACTIVE RATIOS

Company Name	Type	Symbol	Recent Market Cap ($mil)	Price to Cash Flow (X)	Div Payout (%)	Total Debt as % of Total Cap (%)
Avista Corp.	EL	AVA	680	3.5	45	44
Central Vermont Public Serv	EL	CV	148	4.4	188	41
Green Mountain Power Corp.	EL	GMP	59	2.2	154	44
Kansas City Power & Light	EL	KLT	1,610	5.4	90	49
Madison Gas & Electric Co.	EL	MDSN	352	5.5	92	46
Otter Tail Power Co.	EL	OTTR	471	6.4	66	42
Public Service Co. of New Mexico	EL	PNM	831	4.2	36	53
Rochester Gas & Electric	EL	RGS	985	4.4	77	47
WPS Resources Corp.	EL	WPS	809	6.3	102	39
Chesapeake Utilities Corp.	GD	CPK	97	8.0	85	41
Energysouth Inc.	GD	ENSI	99	5.4	55	48
Northwest Natural Gas Co.	GD	NWNG	620	6.4	118	48
Providence Energy Corp.	GD	PVY	175	5.1	103	52
RGC Resources Inc.	GD	RGCO	39	5.2	78	46
Southern Union Co.	GD	SUG	623	8.6	0	51
Lakehead Pipe Line Ptns, LP	PL	LHP	748	9.9	109	47
Northern Border Ptns, LP	PL	NBP	114	6.7	21	63
American States Water Co.	WS	AWR	247	9.5	47	41
Connecticut Water Serv Inc.	WS	CTWS	272	8.0	73	51
Middlesex Water Co.	WS	MSEX	55	8.6	89	51
SJW Corp.	WS	SJW	75	7.1	39	50
Size-Independent Averages by Type	**EL**		**3,509**	**7.2**	**72.1**	**54.2**
(excluding extreme outliers)	**GD**		**829**	**8.5**	**88.8**	**51.6**
	PL		**4,429**	**14.4**	**62.0**	**56.2**
	WS		**517**	**10.1**	**66.7**	**51.2**

Type key: EL= electric; GD= gas distribution; PL=pipeline; TE=telecom;munications WS=water service.

often pays to accept the initial partial price gain and move on to another possible situation rather than await the final workout. This is especially true where proposals are for stock rather than cash, since actual future value is uncertain in stock swaps. The following are major points of attraction to seek in possible candidates:

- Physical location in strategic position, or providing a natural bridge to another company or territory, or adjacent to a very large company.
- Low debt-equity ratio by industry standards (makes acquisition easier to finance more flexibly). *Note*: Gas, electric, phone, and water companies have differing typical ratios, so they should be ranked and averaged separately.
- Low ratio of price to cash flow, or to free cash flow: The faster the cash flows from an acquired property, the easier it is to justify purchase and the higher a price that can be paid.
- Small size of company, geographically or especially in terms of total equity capitalization. Smaller companies are natural targets in industry consolidations, and in this sector are not as naturally vulnerable to business failure as in other industries.
- Companies paying zero or nominal cash dividends. These are attractive in two ways: First, they build free cash flow faster than high-payout firms; second, it is easier to design a securities package that will buy the company without needing to give current shareholders at least their present dividend stream to secure favorable votes.
- If law or regulation changes, former Bell System regionals are logical targets for acquisition by worldwide or domestic long-distance carriers. Reason: instant access to a large subscriber base. Trend appears to favor combinations of local and long-distance service via a single provider for customer convenience. Example: Qwest/ U.S. West.
- Same-state electric companies; same-state gas distributors; combinations of same-site gas and electric providers. New England south through mid-Atlantic states appear especially ripe for such deals, as multiple companies exist there.

Low-effort access to multiple corporate annual reports (which always contain maps of the service territory) is available from several sources. Many utility firms belong to The Club, a document clearinghouse service that provides annual reports free by calling 1-800-654-CLUB or using www.icbinc.com. Club-shaped symbols in The Wall Street Journal's stock-quote pages identify participants.

Many companies' Web sites also allow ordering of annual reports or give names and phones of investor-relations contacts. Having obtained the documents, photocopy a national map from any source and sketch company territories.

POSSIBLE STUDY CANDIDATES

Apparently size no longer matters in utility acquisitions. Hostile deals in the multiple billions are being proposed. While interest rates are relatively low, both stock and cash are cheap currencies in acquisitions. Strategic considerations will dictate most combinations between huge companies. Otherwise, small size is an indicator of above-average acquisition likelihood. Strategic and

financial ratio considerations are both relevant predictive factors.

Table 1 presents results of one possible screen seeking candidates for further analysis as possible merger targets. In each of the major utility areas (electric, gas distribution, pipelines, water, and telephone), all companies above median market capitalization for that company type were eliminated. Then, companies were sorted on the basis of price-to-cash-flow ratio, dividend payout ratio, and total debt as percent of total capitalization—with lowest numbers considered most attractive. Firms that appeared in the better half of the rankings on two of those three scales were retained; those with debt burdens over 67% were dropped. These are important financial criteria for identifying acquirable utility companies, although some investors prefer others including price/book, price/revenue, and price/free cash flow; no mathematical screen can ever perfectly define future events.

Companies are listed alphabetically by type. Numerous additional companies already "in play" passed the screens but are omitted from the table since their acquisition premiums have been largely realized already. Examples include: Eastern Enterprises, TNP Enterprises, Indiana Energy, SEMCO Energy, Northeast Utilities, CTG Resources, Dominguez Services, Frontier, Orange & Rockland Utilities, and California Water Service Group.

Table 2 lists companies below median size per sector, failing the two-of-three rule above but sited in geographic areas of already brisk merger and acquisition activity. Since these are worth studying more for their strategic-location benefits, the data are omitted in favor of suggested study of possible partnering benefits. Note the significant clusters of companies along the eastern seaboard, where many companies with small territories presently operate.

UTILITIES FOR INCOME

If you are investing in electric stocks for current income and gradual dividend growth, use the general guidelines for any equity-income investment [see "Equity-Income Investing: Beware of Yield Overreaching," in the May 1999 issue of the *AAII Journal*]. These include:

- Look for steady growth in dividends (regular annual increases in the dividend rate).
- Don't automatically reach for the highest-yielders, since this often presages a dividend cut; gravitate to lower-yielding choices that are less risky and that often have a higher rate of annual dividend growth.
- Favor companies with a high percentage of common shareholder's equity relative to total capital. High ratios of equity imply low ratios of debt relative to capital, a good measure of corporate staying power and thus some comfort that dividends can continue to be paid. Make sure you track a company's common equity ratio for five or more years, and compare its level and trend with other companies in the same industry.
- Avoid companies with heavy ratios of short-term debt relative to total debt or total capital. This is also a good measure of comfort that dividend payments are not under near-term pressure. Long-term assets should be financed with long-term debt or equity, rather than short-term debt.

TABLE 2. STRATEGICALLY INTERESTING SMALL COMPANIES

Company Name	Type	Symbol
Bangor Hydro-Elec Co.	EL	BGR
Baycorp Holdings Corp.	EL	MWH
Berkshire Energy Resources	GD	BERK
Buckeye Partners, LP	PL	BPL
Cascade Natural Gas Corp.	GD	CGC
Central Hudson Gas & Elec	EL	CNH
Centurytel Inc.	TE	CTL
Cincinnati Bell	TE	CSN
Colonial Gas Co.	GD	CLG
Connecticut Energy Corp.	GD	CNE
El Paso Electric Co.	EL	EE
Energynorth Inc.	GD	EI
Fall River Gas Co.	GD	FAL
Florida Public Utilities Co.	EL	FPU
Ipalco Enterprises Inc.	EL	IPL
Maine Public Service	EL	MAP
North Carolina Natural Gas	GD	NCG
Northeast Utilities	EL	NU
OGE Energy Corp.	EL	OGE
Piedmont Natural Gas Co.	GD	PNY
Plains All Amer Pipeline, LP	PL	PAA
Public Service Co. of NC	GD	PGS
Southwest Water Co.	WS	SWWC
Unisource Energy Corp.	EL	UNS
United Illuminating Co.	EL	UIL
Unitil Corp.	EL	UTL
Valley Resources Inc.	GD	VR
Virginia Gas Co.	GD	VGCO
Yankee Energy Sys Inc.	GD	YES

Type key: EL= electric; GD= gas distribution; PL=pipeline; TE=telecom;munications WS=water service.

SUMMARY

Utility investing is hardly the simple, vanilla process of past decades. Risks are up, but so are potential rewards. Each investor should decide whether he or she is income-oriented or is willing to speculate on acquisitions.

If you own utilities for income, make regular annual dividend increases your litmus test. If you choose to speculate on acquisitions, this industry will provide fertile hunting grounds. But doing your homework by digging out the numbers will be very important in separating real opportunities from also-rans.

The ideal theoretical targets will provide a strategic fit, be a small bite for a larger partner, and offer attractive financial ratios and total or free cash flow. ✦