94/09-Wall Street v. Five-Line Family

America is phone obsessed, yet the markets hate phone companies. It's time to ask: Do the Bells still toll for individual investors?

By Peter Lynch

This year marks the tenth anniversary of the breakup of AT&T;, alias Ma Bell, in the settlement of the biggest antitrust case ever. The Justice Department required AT&T; to split itself into eight parts, with Ma going her way and the seven new Baby Bells going theirs. The Baby Bells got control of the local phone service in each region. Ma Bell kept the long distance.

Like the former Soviet Union, the old AT&T; was a vast enterprise, often accused of being sluggish and outdated. In its heyday, it employed 1 out of every 100 American workers. It controlled virtually all the phones and all the phone lines. To make a call without Ma Bell, you had to use tin cans and a string.

AT&T; was also the nation's most popular and widely held stock, with 3 million shareholders. Institutional investors avoided it, but small investors have always loved it. The breakup didn't dampen their ardor. For every ten shares of Ma Bell, they got one share in each of the Baby Bells. Ten years later, the four most widely held stocks in the U.S. are Bells, and the remaining Bells are in the top 15.

Meanwhile, AT&T; continues to rank near the bottom of institutional ownership -- which for a large growth company is quite unusual -- and the pros have ostracized the other Bells as well. This has been a bad choice on their part, because the Bells as a group have made investors five times their money since the breakup, while the S&P; 500 has merely tripled. Since a large majority of fund managers have underperformed the S&P; during this period, only one conclusion is possible: The unsophisticates who stuck to their Bells have once again outfoxed the experts.

Until 1990, the offspring flourished while Ma Bell lagged, but lately it's been the other way around. Ma Bell has held its own against some stiff competition, and investors have responded by bidding up the shares, whereas the rest of the Bells have barely advanced. Because they are regulated like electric utilities and pay big dividends like electric utilities, they've been lumped together with electric utilities in the recent massive sell-off.

The big question, of course, is where the Bells go from here. In the end, their prosperity, or lack of it, will depend on who controls the phone lines and who is allowed to offer service to whom. So do not ask for whom the Bells toll, ask from whom they'll be collecting tolls, and whether they'll be collecting enough to make for a good investment.

Let's start with the bullish argument. The bulls say it's unfair to throw out the phone companies with the power companies. Electric utilities are bedeviled by rising costs and almost no growth, whereas phones have become a way of life. A five-line family is no longer out of the question, with one line for the teenagers to breathe into and one dedicated to the fax, plus a home phone and a home-office phone and the cellular unit, which has supplanted the cigarette as the most likely object to be carried into a party. There's shopping by phone, conferencing by phone, and pretty soon they'll have to put nonphone sections in restaurants.

On the cost side, roomfuls of operators have been replaced by machines and digital voices that don't require health insurance. Switching equipment is more compact and easier to manage than it once was. We've seen a 30 percent increase in phone hookups nationwide in the past 10 years, but phone-company payrolls have been cut in half. In 1984, a typical Baby Bell employed around 70 people per 10,000 phone lines. In 1994, they've got it down to about 35 people per 10,000 lines.

This is the heart of the bullish case for the Baby Bells. Demand is up and costs are down. These companies have staying power. At current prices, their stocks are yielding slightly more than 5 percent. It's the highest percentage the Bells have ever paid in dividends, relative to the S&P; 500, which currently pays 2.8 percent. On top of that, the Bells have picked up some valuable assets on the side, most notably the cellular franchises.

Cellular started out as a fad, a curiosity, a CB radio for yuppies. In each region, two franchises were awarded, one to the local Baby Bell and the other to a lottery winner -- Hillary Clinton was in a partnership that won a stake in a franchise in Arkansas. Who could have imagined that by 1994 we'd have over 16 million cellular subscribers nationwide, and no end in sight to the line of recruits? With 6 percent of the population already cellularized, that makes 94 percent who are still potential customers.

Recently, we found out what one of these cellular franchises is really worth. The California Baby Bell, Pacific Telesis, decided to spin off its cellular as a separate business and make it a gift to shareholders. For every share of PacTel, you got a free share of AirTouch Communications. These AirTouch shares now trade on the New York Stock Exchange for about $25 apiece. PacTel without the Airtouch is selling for about $30 a share, so the cellular part turns out to be almost as valuable as the rest of the phone company.

Thanks to the Los Angeles commuters who use their car phones for companionship while they're trapped for hours on freeways and the Hollywood types who make deals while they're jogging, PacTel was number one among the Bells in cellular, with the most customers and most revenue. But the other Bells have built up sizable cellular operations in their regions, and they've bought additional franchises from lottery winners outside their regions. Along the way, they've acquired paging services, cable TV assets, real estate, and bits and pieces of phone companies in Mexico, Russia, and elsewhere.

I got the rundown on Southwestern Bell from Bill Deatherage, a telecommunications analyst for S.G. Warburg. Southwestern has a cellular business that's worth an estimated $13.75 a share, a large stake in the Mexican telephone system ($5 a share), and other assorted properties ($3 a share). That's almost $22 in extras beyond the basic phone service. Deatherage figures the total package, minus the company's debt, is valued at $55, and the stock is selling for $43.

At the moment, Deatherage's favorite Bell is U S West . That stock sells for $42. Every share gives you $5 worth of cellular, $6 worth of Time Warner, $3 in international cable and cellular, $4 in real estate, and $4 in assorted odds and ends. When the company's debts are subtracted, you're left with $58.75 worth of assets.

But before we get too carried away with the bullish case, let me give you the bearish case. The crux of it is that the Baby Bells are losing control of local phone service. Where once they enjoyed a monopoly, now they have to fight off a growing number of competitors, especially for long-distance hookups, known in the trade as "handshakes."

Even though the Baby Bells are not long-distance carriers per se, they get paid for every toll call that begins or ends in their area. On an average call, one costing 17 to 18 cents per minute, the Bells at each end get 3 to 4 cents for transporting the call to and from the local lines to the long-distance lines. Where I live, near Boston, a long- distance call is any call that travels beyond the next town, so a piece of this action is very important to my regional Bell, NYNEX.

Imagine how much cheaper long distance would be if there weren't a Bell at each end. It's already happening in the business districts of major cities, where the so-called competitive access providers, or CAPs, have arrived with their fiber cables. A CAP can connect a local business to a long-distance carrier and cut the local Bell right out of the equation. The Bell is forced to cooperate with its enemies by letting the CAPs install switching equipment on its own premises. Recent court decisions may change this.

The CAPs won't be coming to my house or yours anytime soon, but they have connected enough cables to enough businesses to take a sizable bite out of the Bells' revenues. The Bells are putting up an active resistance. One -- Bell Atlantic -- recently won a court case that frees it from obligation to let the CAPs set up shop in its central office. All seven Bells are seeking permission to compete in the long-distance market, just as other companies have been allowed to compete in their local markets.

Sibling loyalty counts for nothing here. Southwestern Bell recently sought court approval to offer local phone service to a town in Maryland, in the middle of Bell Atlantic's territory. If this holds up, it will be every Bell for itself.

An advocate of the bearish viewpoint regarding the Baby Bells is Jack Grubman, telecommunications analyst for Salomon Brothers. While Grubman acknowledges the value of cellular, etc., he thinks the benefits of cost-cutting are overrated, because whenever a Bell can save a dollar by laying off a worker, it will lose a dollar to the lower rates that result from the fierce competition. He regards the big dividends as something of a hindrance, because they leave the Bells perpetually short of cash. Since it may ultimately cost them billions to rewire their systems to keep up with new technology, they're going to need all the cash they can get.

Grubman rates the Bells as holds. He sees them as 5 percent to 7 percent growers. He prefers long-distance carriers: AT&T;, MCI , and Sprint, in that order -- each of which he thinks can keep up double-digit growth rates. He says the long-distance carriers are growing as fast as many drug companies, but their stocks are much cheaper on earnings.

The future of the Bells and the CAPs, and everybody else in the phone business for that matter, depends to a large degree on the whims of the regulators, the politicians, the courts, and the deal makers on Wall Street. Will the telephone company bring movies into the house, or will the cable company offer telephone service? Will the CAPs be put out of business, or will they capture more revenues from the Bells? Will the Bells be allowed to compete with the long-distance carriers, especially on the calls that begin and end in their regions? Will their various alliances with cable companies and overseas telephone companies prove profitable? Will they be allowed to make massive raids on each other's territory?

There are more questions than answers, and a lot of work for the fortune tellers. But all things considered, I wouldn't bet against the Bells. In fact, I own two of them myself, Southwestern Bell and NYNEX. In the bull market of 1991-93, these stocks went nowhere, and in the decline of 1994 they're falling along with the rest. With their dividends paying almost twice the yield of the S&P; 500, they already reflect a gloomy prognosis.

Wall Street is betting that the Bells will be the losers in the legislation coming out of Congress, but they have a lot of moxie and a lot of clout in Washington. Clout doesn't show up anywhere on a balance sheet, but in a regulated industry, it's the most valuable asset of all. --------------- Peter Lynch writes the Investor's Edge column with John Rothchild for each issue of Worth. From 1977 to 1990 Lynch managed the Magellan Fund, the top-performing mutual fund in the industry. He is vice-chairman of Fidelity Management and Research and the author, with Rothchild, of two books on investing. Beating the Street, the latest, is published by Simon & Schuster.

KEYWORDS: Telecommunications Industry, Stock Investing