

95/04-The Current Thinking

It's been distinctly unrewarding to own electric utilities lately. But that will change__any decade now.

By Peter Lynch

In the past couple of years, I've fielded a lot of anxious questions about electric utilities from investors. They thought they were being conservative when they bought these low-risk stocks, so it was a shock to see them drop faster and further than a lot of the high-risk stocks. Today, the Dow Jones Utility Average hovers around 200, 10 percent below its high of 220 in 1986. Over ten years, this group has gone backward. People want to know if there's something fatally wrong with these companies.

I was mulling this issue when I sat down in January at the annual session of prognostication known as the Barron's Roundtable.

Jim Rogers was sitting directly to my right. This is the man who rode a motorcycle 65,000 miles around the world and lived to write a fascinating book about it, *Investment Biker*. You'd expect Jim to get excited about Iranian stocks, Ghanaian stocks, and real estate on the Turkish border, but there he was, touting the stodgy domestic utilities. He hasn't been shy about buying these. He owns about half of the hundred that are publicly traded

Rogers's enthusiasm is based on simple supply and demand. As individuals, we're not using as much electricity as we used to, thanks to more efficient refrigerators and air conditioners and people turning off the lights. But overall demand is still rising, at least 1 to 1.5 percent a year in the U.S. On the supply side, nobody has built a major electric plant anywhere in the country in two decades. What company wants to face the protesters, the lawyers, the cost overruns, the haggles with regulators?

So the plants we've already got aren't getting any younger, and many of the nuclear reactors are wheezing their way closer to retirement.

The point Rogers makes is that it won't be long before the older plants are unplugged and we'll have a power shortage in this country. In his experience, whenever there's a shortage of anything, the producers raise prices and make bigger profits, and bigger profits push the stock prices up. "I'm usually early about these things," he says. But he can sit back and collect the hefty dividends on his utility shares while he waits.

I speak to utility analysts and read their reports from time to time, but lately I haven't seen many reports that you could call enthusiastic. The prevailing view is that Jim's power shortage won't occur in this millennium. Many utilities generate more electricity than they need, and they've actually upped their production without building huge new plants. Joan Bok, the chairwoman of the board of New England Electric, tells me her company is planning to refurbish an existing plant, which will add 6 percent to its total output. What the company doesn't make itself, it can buy from Canada with its abundance of hydro generators. And as for nuclear plants being decommissioned, Bok says it won't begin to happen until 2002, and for some facilities not until 2033.

One way or another, there's more than enough voltage to go around, which brings us to the utilities' biggest headache: customer defections. A law the utilities would rather do without, passed in 1992, gives industrial users the right to shop around for the best price. Ford Motor doesn't have to get its juice from Detroit Edison. It's free to negotiate with other utilities that might offer lower rates. And if Ford can make a better deal in Wisconsin, Detroit Edison still has to deliver the power over its own lines.

This is called "wheeling," a form of deregulation that's great for industrial customers but puts the utilities in a bind. They can lower their rates to match the competition, which will cut into profits, or they can keep rates high and lose business to the competition, which will cut into profits.

And if they try to raise rates on the residential customers to make up for what they've lost from the industrial defectors, they'll have a consumer revolt on their hands. The regulators will never approve it.

It's the same predicament the regional phone companies are facing, except the Bells have an advantage. The money they lose in their rate wars, they can make back by cutting costs. Also, people are adding more phones and using them more often, which boosts the revenues of the phone companies. The electric utilities have a harder time finding costs to cut. They can't replace thousands of operators with machines, because they don't have thousands of operators. They've made a giant investment in expensive equipment that needs constant repair. As appliances get more efficient, their customers will use less electricity.

Last year's 20-percent-off sale in the utility sector is not a once-in-a-lifetime event. There's a sale of some kind whenever interest rates go up, because high rates make these dividend-paying shares less attractive. In 1971-74, the Dow Jones Utility Average dropped 57 percent, but it came back, eventually, in spite of the dire predictions about nuclear meltdowns and imminent bankruptcies. In the meantime, if you bought near the bottom, you were buying good companies on the cheap. A similar situation exists today, and there's no reason to doubt we'll see a comeback sooner or later.

The biggest difference between 1971 and 1995 is that utilities in 1995 are losing their monopolistic advantage, which means you have to be careful about which ones you buy. The important factors are as follows:

Payout Ratio. You can't invest blindly in the power company that pays the highest dividend, because in today's competitive environment, it may have to cut the dividend to survive. In 1994, six major utilities did just that, and more cuts are likely to come. The danger sign is a high payout ratio. That's the percentage of earnings that goes to paying the dividend.

A company that's paying 100 percent of its earnings in dividends could be in a tight spot. If earnings decline, the dividend can't be maintained. On the other hand, a company that pays out 80 percent of its earnings in dividends has a comfortable cushion.

The investor-relations person at any utility, or any brokerage-house utilities analyst, can give you the payout ratio of a utility. Or you can calculate it yourself by dividing the annual dividend by the annual earnings. A company that pays \$1 in dividends and earns \$2 per share has a ratio of 50 percent. Eighty-five percent or below is considered safe. Above 90 percent and you may be in the danger zone.

Cost of power. Utilities that borrowed billions of dollars in the 1970s and '80s to build expensive nuclear plants, some of which never got their operating license, obviously have more bills to pay than utilities that stuck with gas or coal. Where low-cost producers can generate a kilowatt of electricity for three or four cents, the high-cost producer might be spending as much as 15 cents.

There's no simple calculation you can make to determine whether a company is low cost or high cost, but if your brokerage firm has a utilities analyst, you can find out from him or her. Two low-cost producers on several analysts' buy lists are PacifiCorp(NYSE: PPW) and American Electric Power Company (NYSE: AEP).

The industrial-residential customer ratio. Since it's the industrial customers who are shopping for lower rates, the safest utilities to invest in are those with a high percentage of residential and nonindustrial customers. A good benchmark is 75 percent.

Location. Electricity can't be shipped more than a few hundred miles, because beyond a certain point, too much gets lost in transmission. So gluts and shortages are more regional than national. In the Southeast, where supplies are relatively tight, utilities will have an easier time holding their rates up than in the Southwest, which now generates more power than it needs. Hawaii has a natural protection from competitors: 2,500 miles of ocean makes it wheel-proof.

Cash and miscellaneous assets. Twenty years ago, utilities plowed their excess cash into construction projects. They borrowed heavily and issued more shares to raise the billions they needed to build new plants. They were plant-rich and cash-poor. Since they've stopped building plants, they've been building up cash, and some have more than they know what to do with. They've gone out and bought everything from savings and loans to insurance companies. In January, Minnesota Power & Light bought a company that holds auctions for used cars

A Texas utility, Houston Industries, bought a cable-TV business, which it recently agreed to sell to Time Warner for \$2.25 billion. It's planning to use the proceeds to pay off debt and buy back millions of its own shares.

This could be terrific news for shareholders. Soon there will be fewer shares outstanding, which automatically increases the earnings per share and improves the payout ratio, since there will be fewer dividends to pay out.

It's always been a good strategy to invest in companies that buy back shares. Several other utilities are using their excess cash in this fashion. The list includes Pacific Gas & Electric, Dayton Power & Light, and Florida Power and Light. Southern California Edison recently announced a buyback, too.

The table on page 34 lists ten utilities that have raised dividends ten years in a row and have relatively safe payout ratios. Those shown in italics are considered low-cost producers. Among the top utilities analysts I contacted for this article, Barry Abramson at Prudential recommends Duke Power, LG&E, TECO, and SCANA. Michael Temple at Duff & Phelps likes TECO, Consolidated Edison of New York, and Central & Southwest. Ernest Liu at Goldman Sachs rates Duke Power and LG&E as "outperformers," one notch below Goldman's highest rating, "Buy."

Even if Jim Rogers has to wait until the next millennium to see his prediction come true (and that's only five years away), some utilities are likely to do well. In the meantime, it gets my attention that nearly 70 percent of the shares in this industry are owned by individual investors, and 30 percent by the pros and the institutions, whereas with most stocks, the percentage is reversed. The fact that utilities have been underweighted in the pension funds and the mutual funds is promising in itself. The pros wouldn't be shunning this industry if they didn't expect the worst. So if anything good happens and they get more encouraged, there's always the chance they'll start a buying stampede.

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