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News

Solid Utility Stocks Still Available
By John Henry
Arkansas Business - 11/25/02

Utilities used to be regulated monopolies that returned any excess cash to investors as dividends.

Investors bought utility stocks primarily for those regular, and generous, dividends. They were rock-solid, conservative investments that generated a slow, steady revenue stream. They were reliable but boring, not much different than putting money into a bank CD, and were suitable only for retirees, widows and orphans. Investors looking for larger returns weren't interested in utilities.

What about today?

The deregulation that started in 1996, the mergers and divestitures — and the more recent accounting scandals and huge financial woes — have changed the thinking about investing in utilities. It's now a more risky and volatile proposition.

Utilities are now viewed as more of a growth investment, and instead of paying increasing dividends, many utility companies have been investing more of their earnings in nonregulated businesses and overseas, hoping those investments will pay off in higher earnings — and higher stock prices. Some have done OK; others have failed miserably, and the companies are in jeopardy.

Fully 99 percent of stock-buying mutual funds were down in the third quarter, by an average of 17.5 percent. Mutual funds that

invest in utilities are down about 29 percent for the year, and the the Dow Jones Utility Average is down about 36 percent from its high earlier this year — a far cry from the safe haven that it used to be.

But investors can still find good deals in utilities, according to Lowell Miller, president and chief investment officer of investment firm Miller/Howard Investments Inc. of Woodstock, N.Y.

Solid Deals Out There

It's the unregulated power generation companies that have dragged the utility index down and caused utilities to lose favor, according to Miller, one of the nation's most often-quoted watchers of the utility sector.

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There are, he said, some good dividend-paying electric utilities.

“The plain vanilla local utilities that are local monopolies with no competition and no financial stretches are the same as always,” said Miller. “It’s not a bad year for them.”

Atmos Energy Corp., the Dallas-based natural gas company, and Philadelphia Suburban Corp., the local water company, are two that Miller likes in this category.

Next are those companies that still have some regulated utility business but also may have some deregulated subsidiaries. Most of these, Miller said, are conservative companies dealing in oil and gas exploration, gas storage and pipelines. They have high cash flow; they’re diversified; they have high growth rates, good yields and rising dividends.

Among the companies Miller likes in this category are Consolidated Edison Inc., Questar Corp., KeySpan Corp. and Nisource Inc.

A third category of utilities that Miller favors are those large integrated utilities such as FPL Group Inc., DTE Energy Co., Duke Energy Corp., Dominion Resources, IdaCorp Inc. and American Electric Power Co. (AEP of Columbus, Ohio, is the parent company of Southwestern Electric Power Co. of Fayetteville, No. 2 on the list of electric utilities.)

All have large customer bases, some of their businesses are regulated and all are diversified to grow, Miller said. Large electric-power generators have added gas production, while electric-power transmission operators have added gas pipeline operations. The big integrated companies are all starting to look alike.

Other utility watchers add Kinder Morgan Energy Partners to the list of good-growth companies. That company and Duke Energy now have merchant plants in Arkansas.

Finally, there are the villains of the utility world: the unregulated power generation suppliers and merchant energy companies.

Although there are some opportunities for speculators, Miller said they are not really utilities and are not reliable in producing the income and dividends of a utility. They serve no specific territory but instead sell their power to other utilities.

“When times are fat, they’re OK,” Miller said, “but when times are lean, they blow up.”

These companies borrowed billions to build new generating plants on speculation, then lost almost all of their market value as power shortages vanished with the recession.

Among those that Miller advises to avoid are Mirant Corp., Calpine Corp., Reliant Resources Inc. (the CenterPoint Energy Inc. spinoff), Williams Cos. and El Paso Corp.

Others in the news lately for recent troubles of various sorts are AES Corp., Dynegy Inc., Allegheny Energy Inc. and TXU Corp. Several are trading at all-time lows and just trying to survive until the economy turns around. Some have tried to raise cash by selling off power plant and pipeline assets. Some appear flirting with bankruptcy.

Just last week El Paso came under fire in a The New York Times article that questioned an August transaction with trading partner Morgan Stanley that allowed the company to escape a \$100 million restatement of earnings for the first quarter. Its stock is down 80 percent from its 52-week high, and the Securities and Exchange Commission continues to investigate its trading practices.

Even some traditional utilities, seeking to diversify into this niche when it looked promising, financed these ventures by cutting or eliminating dividends. The result? The electric utility industry's average five-year dividend growth is -10 percent.

The prospects of those utilities that remained true to paying regular dividends to shareholders are good. A good yield plus a high ratio of earnings paid in dividends can still produce an excellent return.

A lot of factors continue to hold the utility sector back — deregulation, energy trading and the overcapacity that has caused several proposed plants in Arkansas and elsewhere to be put on hold until the economy and the demand warrant their building.

So what type of utility does the investor need to pursue?

The safest bets are still utilities that are regulated monopolies. Otherwise, investors need to look and see if the company has a solid balance sheet or has a strong competitive situation. Duke Energy, Southern Co. and American Electric Power all fit the bill.

Fund Impact

While some mutual funds are moving away from investing strictly in utilities, others have done fairly well. Still, total assets in utilities funds have dropped more than \$7 billion this year.

As with individual stocks, the funds to support are those that have continued to focus on state-regulated companies with good dividends.

The Franklin Utilities fund has led the pack this year by focusing on companies with strong balance sheets, low growth earnings projections and a large percentage of earnings in regulated businesses. It had the smallest loss in the sector this year, declining only 15 percent.

Bob Becker, portfolio manager of the \$1.2 billion Franklin fund, remains positive on the sector. Some of the companies are posting dividend yields of 5 percent or more.

The top three companies in Franklin Utilities, making up about 15 percent of the portfolio, are FPL Group, Entergy Corp. and Southern Co.

Becker is high on FPL. "It's 90 percent regulated, has visible earnings, an A-rated balance sheet. It's very attractive."

Entergy appears to be well managed now and has "very reasonable expectations," Becker said.

The Vanguard Group, however, is asking shareholders on Tuesday to approve replacement of its Vanguard Utilities Income fund with the Vanguard Dividend Growth fund, which would focus on dividend-paying companies from different industries. Other funds are following a similar course. Strong Funds last year replaced its no-load American Utilities fund with the Strong Dividend Income fund.

Miller's company offers a Better Than Bonds/Utilities portfolio that is based on research that shows utilities are, over time, a better total return vehicle than bonds. His research has shown a 100 percent probability that utilities will outperform bonds over any 10-year rolling period. Over one-, three- or five-year periods, utilities outperformed bonds 85 percent of the time.

Utilities have historically bounced back from down periods exceptionally well, according to Miller.

Miller doesn't fool with utilities involved with nuclear power such as Entergy Corp., which is now the nation's largest nuclear energy provider. He is concerned about potential liability costs and unsure that nuclear power plants can continue to be the lowest-cost providers in a time of increasing electricity deregulation and stricter environmental and public safety concerns.

However, Entergy posted record third-quarter income of \$366.8 million on revenue of \$2.5 billion. Earnings per share were \$1.50, which beat the Thomson/First Call consensus estimate of \$1.45 a share.

Entergy Corp. recently was highlighted by TheStreet.com because of its huge cash pile, its stock buybacks and its potential for a dividend increase. Entergy was recognized last week as the Global Power Company of the Year at the Platts/Business Week Global Energy Awards.

On the flip side, Arkansas' other major utility, natural gas supplier CenterPoint Energy Inc., which recently changed its name from Reliant Energy, is having a rough time.

CenterPoint has hunkered around its core regulated operations and has spun off most of its nonregulated operations (Reliant Resources Inc.). Still, its stock has remained flat and the company was forced to borrow \$1.31 billion earlier this month from Warren Buffet's Berkshire Hathaway Inc. and Credit Suisse First Boston at an interest rate of 12.75 percent.

Before that loan, Moody's Investors Service's had reduced CenterPoint's credit ratings and the ratings of its gas distribution subsidiary from Baa2 to Ba1 — essentially junk status.

With stock prices at or nearing their lows, some investors see a great deal of upside potential to make money.

Once the economy really starts growing again, utility stocks should pick up, analysts say. But next year isn't expected to be a good one — except in comparison with this year, which has been an exceptionally bad one.

"No one is turning off their lights or gas. People are still making phone calls," Miller said. In time, he said, "some companies will profit from it."

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