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### Dividend boosts could help Baby Bells' beaten-down share prices

By **ANDREW BARY**

**W**ould higher dividend yields help cure what's ailing the depressed Baby Bells? That's the prescription offered by Morgan Stanley analyst Simon Flannery, who recently urged the three main Bells, [SBC Communications](#), [BellSouth](#) and [Verizon Communications](#), to increase their dividend yields to an average of 4.8% from the current 3.4% in a bid to boost their share prices and regain investor confidence after years of heavy capital spending and poor acquisitions.

"The Bells have the cash to do it," he says. "It would be a powerful signal to the market about their ability to sustain long-term cash generation."



*Show Bell shareholders the money, says Flannery.*

Flannery burnished his reputation last year with critical reports on [Qwest Communications](#) and its accounting that raised the ire of former Qwest CEO Joe Nacchio. But the reports proved prescient. The U.S. attorney in Denver last week said Qwest was the subject of a criminal investigation. The company's debt rating was cut to junk after the news.

The idea that the regional Bell telephone companies should lift their dividends significantly would have been ridiculed two years ago. Then the Bells viewed themselves as growth companies, spending heavily on high-speed Internet services, data capabilities and cellular phone operations. Meanwhile, they held their dividends steady or upped them modestly as they spent heavily on what they thought would be high-growth investments.

But a lot has changed since then. The Bells, once considered capable of generating low double-digit annual earnings gains, now face the prospect of yearly increases of 5% to 6% at best as growth slows in wireless and data services. Meanwhile, core local telephone revenues are being hit by competition from cable companies for high-speed Internet access, and the substitution of cell phones for old-fashioned, higher-profit wire lines.

This year, the Bells are expected to show slight profit increases, with BellSouth and Verizon projecting revenue gains of only around 1%. Indeed, the Bells are starting to resemble slower-growing electric utilities such as [Southern Co.](#) and Texas Utilities.

During the bubble era of 1999 and 2000, dividends were dismissed as an old-fashioned, tax-inefficient way to reward shareholders. But dividends now are back in vogue as investors seek safety and income. Indeed, Flannery's proposal of higher dividends for the Bells could be extended to many companies, especially in mature, stable sectors such as food, consumer products and perhaps even drugs.

**Table:** [What If?](#)

As the nearby table shows, the Bells, trading at their lowest levels in over four years, now have valuations comparable to those of electric utilities. Verizon's shares, down 20% this year to 37, fetch 12 times projected 2002 profits of \$3.10 a share. SBC, also off 20% to 30.50, now trades for 13 times estimated earnings of \$2.39. BellSouth, off 17% to 31, commands 13 times projected 2002 profits of \$2.35.

The Bells used to trade at higher price/earnings ratios than electric utilities, but P/Es of the two groups have converged, with the typical integrated electric recently trading for about 11 times estimated 2002 profits. The electric's profits are seen growing 5% to 8% annually over the next few years, comparable to the current best-case scenario for the Bells. A more bearish Flannery sees just 2% to 3% yearly earnings increases for the Bells.



Verizon now has the highest dividend rate among the three Bells, at 4.1%, while SBC yields 3.5% and BellSouth, 2.6%. The average utility yield is 4.6%. Excluded from this exercise is debt-burdened [Qwest](#), the owner of the old US West, whose shares trade under 2 and yield almost 2%.

By Flannery's math, SBC should have \$2 billion of free cash flow (what's available to distribute to shareholders) this year, after paying current dividends. BellSouth and Verizon should have more than \$3 billion each. As such, he reasons, the Bells have the financial wherewithal to boost their dividends to an average of 4.8% by paying out about 60% of their earnings.

Under this scenario, the increase would be most pronounced at BellSouth, where the dividend would go to 4.5% from 2.6%. Verizon would have the smallest increase, because it already has a lofty payout.

David King, co-manager of the Putnam Growth and Income fund, isn't averse to Flannery's idea. "It's a backdoor way to instill capital discipline," King says. "If the Bells had to pay out more of their income as dividends, it would force them to be more disciplined with capital spending and acquisitions." King calls SBC, Verizon and BellSouth "a relatively safe way to play a beaten-down sector."

Thanks to their still-sizable local phone operations, which have been largely sheltered from competition, the Bells have held up better than long-distance providers such as [AT&T](#) and [WorldCom](#), as well as data vendors such as [Level 3 Communications](#) and the bankrupt Global Crossing.

What do the Bells say about boosting their payouts? BellSouth, which has the greatest ability to raise its dividend, did increase its payout recently by 5%, to an annual rate of 80 cents a share. The company's view, a spokesman says, is to have a dividend-payout ratio more in line with the Standard & Poor's 500 than the other Bells. That said, BellSouth is committed to returning cash to shareholders through dividends and share repurchase, the spokesman adds. The company recently announced a \$2 billion share-buyback plan.

Verizon, meanwhile, hasn't hiked its dividend since 1997. A spokesman says the company is committed to the current payout, but downplayed the prospect of an increase, noting Verizon's stated priority of debt reduction. Verizon has the most net debt among the Bells, some \$61 billion. BellSouth has the best balance sheet, with \$20 billion of net debt, and SBC's net debt stands at \$26 billion.

SBC, a spokesman points out, is the only Bell that has lifted its payout every year since the AT&T divestiture in 1984, including a 5.4% increase this year. He adds that the company's dividend-payout ratio has averaged in the mid-40% range, and that dividends plus share repurchases have consumed 70% of profits.

King complains about the Bells' heavy capital spending and acquisitions. "The Bells are in a slow-growth business. The issue is whether you try to buy your way out or manage to that slower growth," he says.

The key, says King, is for the Bells to boost cash flow and return that money in some form to shareholders, either as dividends or stock buybacks, which are considered more tax-efficient. The advantage of high dividends, however, is that they're tougher for CEOs to cut. Shareholders often raise hell when dividends are reduced but barely notice when buyback programs are curbed or ended.



Rob Gensler, manager of the T. Rowe Price Telecom and Media fund, would rather see the Bells buy back stock than increase dividends because of the tax advantage. Among the three Bells, he prefers Verizon because it has the strongest cellular franchise. Verizon Wireless, a joint venture between Britain's Vodafone, which owns 45%, and Verizon, is the No. 1 U.S. wireless carrier with about 30 million subscribers.

Gensler says the Bells look good relative to the S&P 500 because of their appreciably lower valuation and comparable growth outlook. The S&P now trades for around 18 times projected 2002 profits, a 50% premium to the Bells.



The bear case for the Bells is that their highest-margin business, local phone service, is eroding, with access lines down 3% in the latest quarter. At the same time, growth is slowing in their data and wireless businesses, which are less profitable than regulated local service.

Gensler takes a more optimistic view, arguing that with competition all but dead, the Bells may be able to grind out 5% to 6% gains in annual earnings, which won't

look bad relative to the S&P. "Assuming you have a modest economic recovery, you want companies that generate solid free cash flow," he says. Gensler isn't concerned about Verizon's \$61 billion of debt because the company has almost \$30 billion of pretax cash flow, giving it ample ability to service the debt.

The Bells plan cutbacks this year in capital spending, but it remains high. Verizon is projected to spend \$14 billion, down from \$17.4 billion last year. SBC may spend around \$8.5 billion, compared with \$11 billion last year, and BellSouth, \$4 billion, down from last year's \$6 billion. The SBC and BellSouth figures exclude Cingular, their wireless joint venture, which is expected to spend around \$4 billion this year.

The poor investment record of the Bells is apparent in big writeoffs in the past year, especially at Verizon, which has had an amazing \$9.5 billion of writeoffs and restructuring charges since the start of 2001, according to Flannery's calculation. Verizon's losers include investments in Metromedia Fiber Network, Britain's NTL and CANTV in Venezuela. BellSouth has been hurt by its stake in Qwest.

The Bells seem to be getting religion on the acquisition issue. In a possible reversal of SBC's acquisitive ways under CEO Ed Whitacre, the company recently decided to sell back to BCE its 20% stake in Bell Canada, the main operating division of BCE, for around \$4 billion.

BellSouth also could sell its sizable Latin American telecom assets, which contribute over 10% of revenues. A company spokesman says it remains "committed" to the region but is taking a pause on further acquisitions, given

economic and currency turmoil that clipped BellSouth's first-quarter financial results. Those Latin American assets might be worth only \$2 billion, or \$1 per BellSouth share, after subtracting an estimated \$2 billion of debt.

Dividend hikes or not, the Bells look to be one of the safer places to invest in an increasingly dicey stock market.

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