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BUSINESS

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INVESTMENT COUNSEL — SINCE NINETEEN-FORTY

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### THE TELEPHONE INDUSTRY

Financial and operating costs have been accelerating under the impact of inflation putting pressure on earnings. New financing totals have soared at a time of record high interest rates. Labor accounts for more than a third of operating costs and settlements have been expensive. Sharply increased prices for materials has led to much higher expenditures on capital programs.

In the past, telephone companies could offset higher cost levels through gains in productivity via technological improvements but those days are long gone. Applications for higher rates have become commonplace and the time lags before rate relief are now much shorter. Bell Canada, aggressive in seeking upward rate adjustments since the late 1960s, was the only telephone company on our supervised list to produce an earnings gain in 1974. Further rate adjustments and the removal of the 10% corporate surcharge in April allowed earnings advances in fiscal 1975.

#### Basically Income Investments

The common stocks of telephone companies have become basically income investments responding in part to general interest rate trends. Attractive features include the steady increase in revenues, their defensive quality since they tend to be immune from economic and monetary trends and, under normal circumstances, growth in dividends. However, the anti-inflation program has frozen dividend rates and although provision is provided for exemptions where an increase is necessary to issue new capital, the board seems to be taking a tough stand recently turning down a request by Bell Canada.

#### Ongoing Need for Financing

Rates of return on investment and equity have generally been inadequate bearing in mind the continual need for new external financing to maintain capital spending. Funds generated internally have only been sufficient to cover about 50% of total requirements. The debt load has been growing as companies are reluctant to issue new equity at less than book value and thus dilute earnings.

#### YEARLY AVERAGE SHARE PRICES

	1975	1974	1973	1972	1971
Bell Canada	\$44.6	\$42.2	\$41.9	\$44.7	\$42.6
Maritime Tel.	16.4	16.9	20.3	22.8	20.7
N.B. Tel.	13.0	12.7	14.3	14.6	14.3
Quebec Tel.	15.2	15.5	16.5	16.2	13.7

The Canadian telephone industry continues to display sound fundamental growth. Total telephones in service increased 6.4% a year during the 1970-1974 period as number of phones per 100 population rose to 55.0 from 45.2. The trend to individual lines is still in progress showing annual average growth of 6.6%. The number of calls has been rising steadily at 6.8% per year while the more lucrative long distance sector has been gaining even faster at 13.6% per year. Revenues have moved ahead at an annual rate of 11.6%. However, the squeeze on operations is apparent as the 1974 figures indicate total expenses rose by 17.8% while revenues climbed by 14.5%.

#### OUTLOOK

Anti-inflation guidelines have introduced uncertainties about future rate approvals and generally restricted dividend increases. Should the program be effective in reducing inflation, then the telephone companies would benefit. Currently they are unable to cope without further rate increases. Fortunately the regulatory bodies appear to recognize the basic

#### 1971-1975 COMPOUND GROWTH RATE

	Revenues	Earnings/Share	Dividends/Share
Bell Canada	14.6%	12.5%	6.5%
Maritime Tel.	17.4	0.8	2.0
N.B. Tel.	14.4	4.3	10.0
Quebec Tel.	16.2	10.0	14.6

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fact that companies require higher rates to retain their financial health and enable ongoing financing. The higher level of business and economic activity this year will help but the continuing upward trend in interest rates is a further negative.

Accordingly, we recommend that purchases in the telephone industry be deferred at this time.

**BELL** (\$44 3/4) Revenues have shown consistent gains aided by a continuous rise in telephones in use, favourable trends in long distance calling towards more and longer calls and higher rates granted by the Canadian Transport Commission. A rapid growth in expense levels including high debt costs for expanding capital programs has produced a lower than permitted rate of return on total capital. The 1976 program calls for increased spending totalling \$940 million and the addition of 400,000 telephones.

In December the company was awarded full approval for increased rates which will improve revenues by \$110.3 million this year. Operations are currently running full-out on a tight budget and any rate set-back in the future such as occurred last summer would probably impair performance. Further rate adjustments will be necessary if Bell is to continue to provide quality service while meeting the demands of expansion. The proportion of debt in the capital structure has risen from 41.1% in 1965 to about 50% in 1975 resulting in a downward trend in interest coverage.

The 62% interest held in Northern Telecom (formerly Northern Electric) gives the stock added strength since Northern's earnings, not regulated, have been in a strong uptrend. Earnings per share last year rose to \$2.55 from \$2.05 and we are estimating a further increase to about \$3.00 in fiscal 1976.

In fiscal 1975, revenues amounted to \$2.9 billion, a rise of 12% while earnings at \$242 million or \$6.20 per share were up 7% from \$5.57 per share. Bell has generally been accorded favourable treatment by regulatory authorities and we rate the stock as a hold.

**MARITIME TEL.** (\$18 1/4) For the decade ending 1974, average annual growth of revenues amounted to

13%, earnings, 11.4% and telephone plant, 12.0%. Planned construction expenditures for the 1976 to 1980 period will remain at high levels averaging \$72 million per year. Since 1970 growth in telephone installation and usage has been above the industry average. Rates have been raised infrequently with the most recent revision taking effect in November, 1975 and we expect higher rates of return this year. As a result of receiving Anti-inflation Board approval to increase the annual dividend to \$1.60 per share from \$1.30, the company plans to raise between \$16 million and \$19 million in a common share offering this year. In 1975, net profit advanced by 30% to \$10.5 million on a 24% rise in revenue. **Holdings should be retained.**

**NEW BRUNSWICK TELEPHONE** (\$13 1/4) During the past six years operating expenses have more than doubled climbing at a faster rate than revenues. The first rate advance since 1969 enabled a revenue rise of 20.3% last year compared with an increase in expenses of 17.5%. A further submission to raise 1976 revenues by \$6.4 million was only partially approved permitting an additional \$2.8 million. The allowable rate of return on common equity has been moved to 15% from 13%. The swift expansion of assets will continue with capital spending forecast at \$270 million over the next four years of which \$62 million will be spent in 1976. Net profit showed a gain of 31% in 1975 and the shares are classified as a hold.

**QUEBEC TELEPHONE** (\$15 3/8) The pace of telephone installations has accelerated growing at an average rate of 7.2% per year since 1970 compared with 6.9% over the past decade. In 1975 the increase was 9.7% bringing the total number of phones in service to 217,118. Operating costs are also on an uptrend rising 24.7% in 1975 to now represent 41.3% of revenues versus 36.7% in 1970. New rates effective July, 1975 provided revenue increases averaging 8.2%. This year spending will decline by 27% to \$33 million bringing total investment in telephone plant to \$270 million. The company has called for redemption on March 31, 1976 its convertible series A preferred shares. **Hold.**

#### COMPARATIVE STATISTICS

	Recent Price	Earnings Per Share				P/E Ratio '76 Est.	Indicated Dividend	Indicated Yield	Price Range 1976
		1973	1974	1975	1976 (Est.)				
Bell Can.	\$44 3/4	\$5.18	\$5.57	\$6.20	\$6.50	6.9	\$3.44	7.7	\$47 1/4 - 42 7/8
Maritime T.	18 1/4	1.94	1.72	1.89	1.95	9.3	1.30	7.1	18 1/4 - 15 1/4
N.B. Tel.	13 1/4	1.60	1.44	1.68	1.80	7.4	1.20	9.0	15 - 13 1/4
Quebec Tel.	15 3/8	2.08	1.80	2.18	2.30	6.7	1.40	9.1	15 3/4 - 15 1/4