Telecom Services

High-Yielding Telecom Stocks Revert to Normal Spreads over Bonds

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Our View

Sentiment has pressured Telecom equity valuations, but we think the more sanguine credit markets are correct. There is a disconnect between the way the credit market and the equity market view risks associated with high yielding telecom names. We believe that the credit markets can be a leading indicator for the equity markets and individual stocks.

Market View

Many investors are wary of the sector's dividend and FCF sustainability, arguing that the dividends are at risk given top-line pressures due to line loss, slowing broadband growth, and wireless price wars. Savings (both capex and opex) are seen as unsustainable. Concerns also exist that financial stress in the sector could prompt regulators to demand dividend cuts prior to approving new deals.

Within a view of a gradual recovery, the Telecom sector offers a more appealing risk-reward profile than stocks leveraged to a rapid economic turnaround, in our view. Sentiment toward the sector is poor, as worries about wireless saturation, price wars, secular and cyclical pressure, and new regulation have all contributed. We, however, are constructive on the sector, believe that much of the concern is already discounted in the stocks, and see valuations at very attractive levels. Appetite for high-beta stocks can be blamed in part for Telecom's underperformance in 2009.

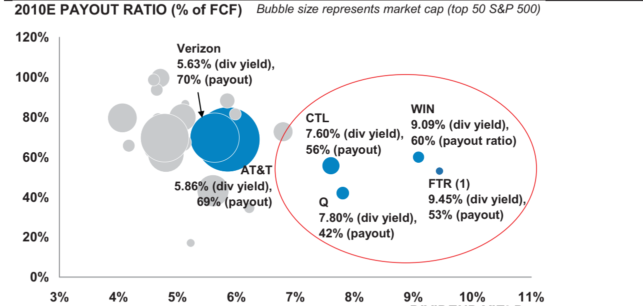
We believe one camp remains wary of the sector's dividend and FCF sustainability. We do not. Profitability is sustainable in the medium term, in our view, although future productivity initiatives will likely have less emphasis on headcount; the levels of layoffs in 2009 are unlikely to be replicated. Weak housing markets and business demand should continue to ease capex needs, at least until 2H10. Cost synergies should partly offset top-line pressure at most rural carriers given ongoing consolidation (which we think could continue). Consumer line loss is troughing, but business line loss still depends on abating unemployment. In wireless, we believe the Bells have key tailwinds (for Verizon, Alltel synergies; for AT&T, strong iPhone activations in 2009 and lower subsidies in 2010) that should boost profitability. We think the risk of price wars in the high end of the market is low.

Balance sheets strengthened further this year through debt buybacks, debt paydown, or M&A. Two of our three Overweight-rated high-dividend-yielding names, AT&T and CenturyLink, have investment-grade balance sheets, while the third, Windstream, is levered at 3.1 times EBITDA but has no major debt maturities until 2013.

We think the credit markets can serve as a leading indicator. Our colleagues in Credit Strategy highlighted in September that "trusting high dividend yields was a risky game to play" earlier in the year but that the "desire to de-lever is slowly fading, in favor of slightly more favorable shareholder activity."[1] The dividend-bond spread has since narrowed somewhat for some blue chip stocks we cover (e.g., AT&T), but we see further room to go.

Telecom bonds have reverted to pre-credit crisis levels; telecom dividend yields, for the most part, haven't. Given this dynamic, the dividend-bond spread for the largest high-yielding Telecom names has widened to 111 bps. Prior to September 15, 2008, the sector's average dividend yield was 100 bps below the average bond yield, a startling 210 bps difference from current levels. Telecom is one of only two sectors in the S&P 500 with a dividend yield above 3% (Utilities is the other). The sector has a 350 bps spread over the market's 1.95% dividend yield, compared to 107 bps prior to September 15, 2008. AT&T's dividend yield is 117 bps over its comparable bond, reverting to the pre-credit crisis 98 bps discount implies 58% equity upside to $44. Assuming a 3% dividend hike the upside would be 63%. Looking at a basket of the largest high-yielding stocks in our coverage (next page), we estimate that tightening of dividend-bond yield spreads through decreasing dividend yields would imply a 56% return on the equities.

Exhibit 1
Top 4 Dividend Yields in the S&P 500 Are Telcos

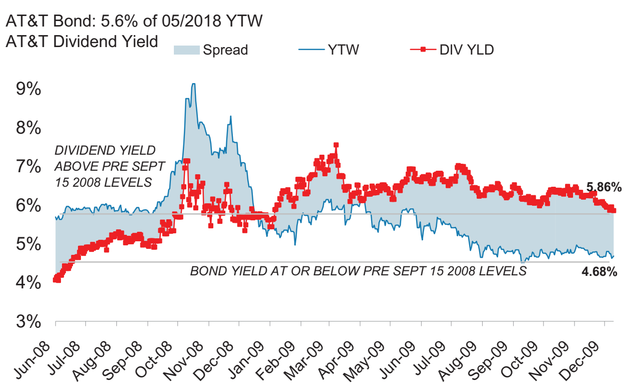


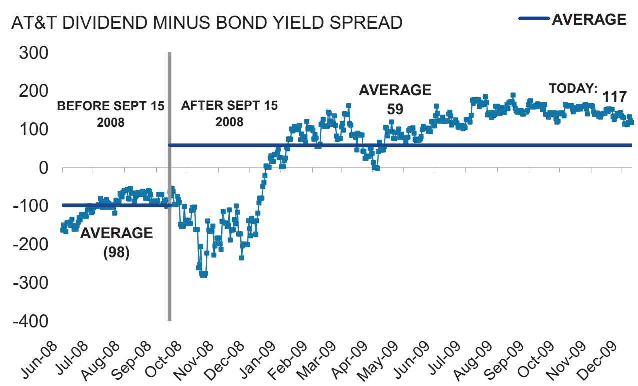
Source: Company data, Morgan Stanley Research (1) Using pro-forma Frontier dividend yield (reducing dividend by 25% post acquisition of Verizon lines). Payout of FCF based on management's proforma estimates pre synergies using 2008 data

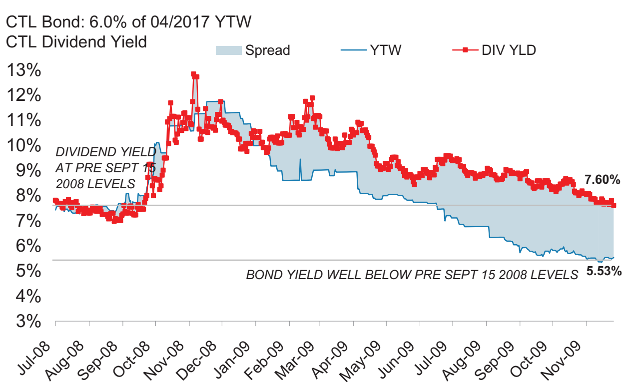
[1] See "*Yield to Dividends*" by Gregory Peters et al., 09/25/2009

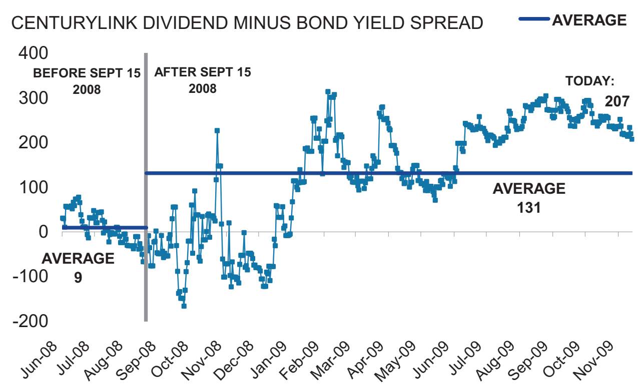
Dividend Yield Minus Bond Yield Should Revert to Normal as Telecom Stocks Climb

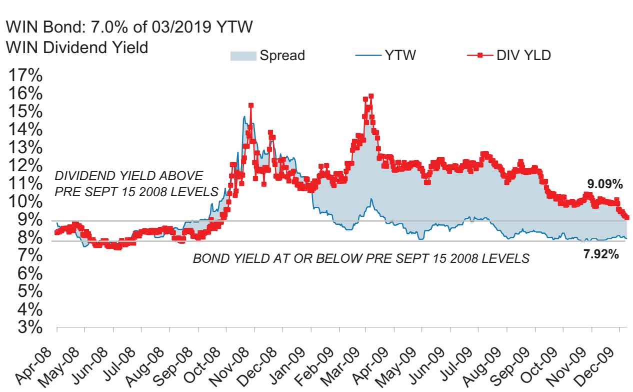
COMPANY	Dividend Yield Today	Bond Yield to Worst (YTW) Today	Dividend Yield less Bond YTW			Reverting to Before Sept 15 2008 Average			Leverage 2010	Dividned Payout of FCF
			Today	Before Sept 15	After Sept 15	Price	Return	Total Return		
T	5.86%	4.68%	117 bps	-98 bps	59 bps	44.28	58.1%	64.0%	1.4x	69%
VZ	5.63%	4.73%	90 bps	-120 bps	13 bps	53.76	59.4%	65.0%	1.8x	70%
Q	7.80%	7.09%	72 bps	-59 bps	-8 bps	4.93	20.2%	28.0%	2.9x	42%
FTR pf (1)	9.45%	8.14%	131 bps	-205 bps	-31 bps	12.33	55.3%	64.7%	2.6x	53% *
WIN	9.09%	7.92%	117 bps	-10 bps	208 bps	12.78	16.2%	25.3%	3.1x	60%
CTL	7.60%	5.53%	207 bps	9 bps	131 bps	49.78	35.2%	42.8%	1.9x	56%
Bells Weighted Avg.	5.83%	4.76%	106 bps	-105 bps	41 bps		57.6%	63.4%	1.6x	68%
RLEC Weighted Avg. (1)	8.25%	6.52%	173 bps	-25 bps	129 bps		32.9%	41.2%	2.3x	56%
Overall Weighted Avg. (1)	5.98%	4.88%	111 bps	-100 bps	46 bps		56.0%	62.0%	1.7x	68%

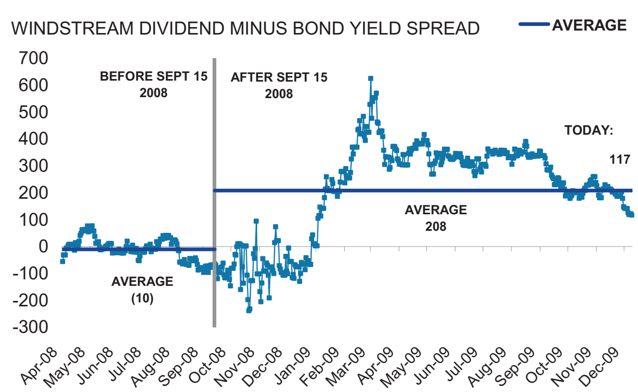












Source: Company data, FactSet, Morgan Stanley Research, (1) Using pro-forma Frontier dividend yield (reducing dividend by 25% post acquisition of Verizon lines).
* Based on management's pro forma estimates pre synergies using 2008 data

Prices of stocks mentioned (12/11/09): AT&T ($28.01), CenturyLink ($36.82), Frontier ($7.94), Qwest ($4.10), Verizon ($33.73), and Windstream ($11.00).