Rural Carrier Dividend Perspectives

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February 2010

In recent years, policymakers have sought to understand the implications of dividend payments by rural telecommunications carriers. Dividend questions arise because the publicly-traded carriers have dividend yields that are higher than those they paid ten years ago, and because, in the context of regulatory reforms, some competitors are suggesting that excessive dividends are being paid out of support funds derived from USF and access charges.

The following paper probes the most common dividend-related questions and misunderstandings.[1] The summary insight, however, is that telecommunications carriers require sufficient access to reasonably-priced equity and debt to ensure that they can fund investment in expensive networks and operations. Without appropriate dividends, equity holders in a slow-growth business, such as telecom, would see the value of their investment collapse, as there would be no fundamental support for the share price based on expected growth. Such a decline in equity value would then impair the company's ability to raise debt. The result will be that customers of local exchange carriers (ILECs) in rural areas will suffer potentially material harm, as the carriers are unable to invest appropriately.

Approaching the questions surrounding dividend payments from a different vantage point, we note that all telecommunications carriers are in a fiercely competitive business environment in their denser service regions. As such, the carriers are vigorously attempting to lower costs in every way possible, including actively managing the costs of capital. It is therefore unreasonable to assert that any telecommunications carrier would willingly pay any more than necessary for capital, in the form of dividends or interest, just as it would not want to pay above-market rates for network equipment, labor, or transport, among others. The carriers have no rational motivation to *overpay* shareholder-dividends or any other cost-center, but are obliged to pay market-determined rates for these operating and capital inputs.[2] The next pages will provide quantification to support this insight.

The key points are the following:

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[1] This paper was prepared by the principals of Balhoff & Williams, LLC (Balhoff & Williams)—Michael J. Balhoff, CFA, and Bradley P. Williams, Esq. The document was not commissioned by any carrier or any group of carriers. Balhoff & Williams has worked for all of the carriers—large and small—cited in this paper, and, before that, the authors provided financial advice to investors regarding investments in the equities of the majority of these carriers. Mr. Balhoff previously headed the telecom equity research group at Legg Mason Wood Walker, Inc. (Legg Mason), and was regarded as a national financial expert in the coverage of the equities of rural telephone companies. Mr. Williams was an investment banker and then a Legg Mason equity research analyst focused on rural telephony. Balhoff & Williams is a specialized professional services organization focused on providing financial and regulatory advice regarding the communications and energy industries. The principals of the firm have more than thirty years of combined experience in advising investors, companies and policymakers on complex investment, transactional and policy issues.

[2] There is an obligation for companies to attempt to maximize shareholder value, and the equity holders derive value based on residual value of the business after other costs are resolved.

- **Rural carriers that have publicly-traded stock pay dividends because the capital markets require a reasonable return on investment.** Investors in equities or in debt do not provide capital unless there is some probability of a competitive return on their investment. For debt-holders, the returns are contractual, based on pre-determined interest rates and a defined schedule for repayment of principal. In the case of equities, stock market investors assess the likelihood that a given company's shares will generate an attractive risk-adjusted return, often composed of a combination of more predictable dividends and the potential for the stock price to rise based on fundamental strength in the business (often evidenced by expanding revenues, earnings, or cash flows).

- **Stock market investors set the level of the rural carriers' dividend yields.** Companies do not control the level of their equity prices, which directly determine the dividend yield for dividend-paying companies (or publicly-traded debt prices in the case of interest yields). Investors in the stock market set the share prices in light of their analysis of the outlook for growth, perceived level of risks (competitive, operating, technology, regulatory, etc.), and the relative value compared with other stocks in various sectors of the market. Dividend yields (the fixed dividend payment divided by the share price), therefore, rise or fall based on movements in the equity value. If a Board of Directors were to choose to adjust the amount of the dividend, the financial markets would simply reset the level of the stock price to assure that a market-determined total return, including the appropriate dividend yield, is generated.

- **A rural carrier's revenues (including support mechanisms) combine to pay for all of a company's "costs" and to generate an appropriate return.** The simple rejoinder to the criticism that "universal service funding is not designed to pay for dividends" is that a carrier cannot function if it fails to meet all of its operating and capital costs. A carrier's revenues combine to support the provision of services by what is, ideally, an effective and stable going-concern. The monies are used to pay for services, employees, capital equipment, taxes, network investment *and* the costs associated with debt and equity funding. In fact, the U.S. Supreme Court was clear in *Hope*[3] and *Bluefield*[4] regarding the fundamental importance of setting a utility's cost of capital (as reflected in rates and revenues) to generate returns that are sufficient to (1) maintain financial integrity, (2) attract necessary capital, and (3) fairly compensate investors for the risks they have assumed. In short, if a carrier cannot meet all of its operating *and capital costs*, it will fail or, at the very least, under-perform in service of customers and other stakeholders.

MISCONCEPTION #1: DIVIDENDS ARE A FORM OF GRATUITOUS RETURN TO SHAREHOLDERS

Rural carriers—like all companies—attempt to generate revenues sufficient, at a minimum, to offset the costs of providing services to wholesale and retail customers. Those costs include network investment and operating costs, but they also include the costs of capital employed to support/fund the business. Critics of rural carriers sometimes mischaracterize the nature and importance of meeting capital costs, or they imply that dividends are "gratuitous" payments to equity investors. The reality, however, is that, for certain types of companies, dividends traditionally are an essential form of payment for the use of capital. Rural ILECs are classic examples of a typical dividend-

[3] *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).
[4] *Bluefield Waterworks & Improvement Co. v, Pub, Serv. Comm 'n*, 262 U.S. 679 (1923).

paying company—low growth business/industry that is still able to generate meaningful cash flows. In fact, if the cash flows weaken or are potentially insufficient, the stock price is likely to contract sharply.

The theory is relatively simple. Investors—whether debt or equity—provide risk capital to companies to generate what the investors believe will be appropriate risk-adjusted returns on that capital. Debt returns—payments of interest and principal—are based on a contractual obligation between borrowers and lenders. Equity is riskier than debt because there is no contractual obligation to repay capital invested or generate a specific return (i.e., the interest rate). As a result, equity capital, under normal circumstances, requires the potential for a greater expected return than that of debt. Accordingly, the total returns to equity holders generally are assumed to be several hundred basis points higher than the rates assigned to debt.

How are returns generated? Equity holders invest capital with the expectation that they can generate positive returns in one or a combination of ways: (1) through the increase in the value of their shares (i.e., capital appreciation), typically due to expected growth in the underlying business, (2) through dividends that provide a more predictable return to shareholders of companies with low growth prospects (and therefore limited prospects for returns generated by share price increases), and (3) through the repurchase of outstanding shares, which involves a "return of capital" to equity holders as the value of the remaining outstanding shares is presumably increased (the enterprise value is divisible among fewer shareholders).

A company generally seeks the most cost-effective ways to fund its business (lowest-cost debt and the lowest-cost equity), while maintaining a balance among funding sources.[5] Typically, a company will monitor the financial markets to determine the availability of less costly capital of one kind or another (e.g., debt or equity or convertible securities), and the company will assess its own needs for capital and how to best allocate the capital at its disposal. If there are growth opportunities, the company will determine how much capital is needed, what are the possible funding sources (internal and external), and whether the growth will be attractive to equity holders, As part of the exercise, the company will also attempt to assess when early repayment of debt is opportune, when there might be repurchases of shares, or, if there are few or no attractive growth prospects, whether it is advisable to pay a relatively larger percentage (or all) of the equity holders' required "return" (the cost of the equity for the company) in the form of dividends. The insight here is that the executives of a well-run company consistently and actively will respond to market conditions and the prospects for the business with a view to minimizing its costs of funding, within the context of the fiduciary duty of the Board of Directors and the management team to attempt to maintain an appropriate residual value for the equity holders.

In the case of rural local exchange carriers (RLECs), it is obvious to all observers that the core telephony business is undergoing a transformation to a data-centric set of services, and, at least for a time, is generating slow or negative organic growth. The operating environment and industry trends, therefore, rationally dictate that dividends for these companies will be required to offset the no-growth, near-term outlook so that equity

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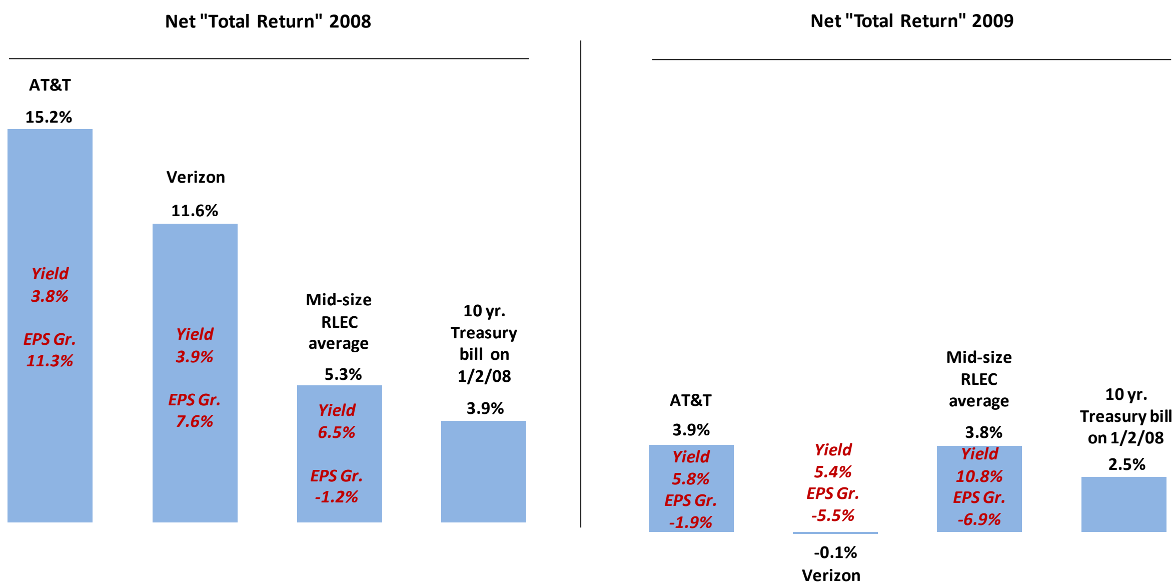
[5] Certain types of investors prefer certain types of equity returns (i.e., income investors prefer stocks paying dividends whereas growth investors prefer to target share price appreciation) and certain forms of return are valued higher based on overall market and economic conditions (i.e., dividends often are preferred as a more secure form of investment return in a declining market/poor economic environment, whereas share price growth is often sought in a rising market/good economic environment). However, as a general rule, no one form of equity return is fundamentally "better" than the other.

investors receive a return on their investment. Figure 1 provides a perspective on the combination of expected growth and dividend yields that generate a proxy "total return" for telecom equity investors. Both graphics—2008 and 2009— illustrate net "total return" which is computed as the total of growth in earnings per share (EPS) and the dividend yield.[6] The EPS growth was the actual growth achieved as reported by the companies,[7] and the yield was the expected dividend yield at the start of 2008 and 2009, respectively. In each of the bars, the red italicized text provides the underlying data about company-specific EPS growth and the dividend yields that were used to calculate the expected "total return" (i.e., for AT&T in 2008, EPS growth was 11.3% and the dividend yield was 3.8%, totaling a 15.2% equity return proxy). In addition, for perspective in the analysis, the graphics include the 10-year Treasury Bill rate (a "guaranteed" or "risk-free" rate of return in the market) at the beginning of each of the years, as an additional point of reference for expected return (and cost for the issuing entity) of a "low-risk" investment. While this summary approach is not perfect, it does provide a helpful perspective on relative expected returns and their composition based on expected total growth combined with expected dividend yields.

FIGURE 1: COMPARATIVE VIEW OF EXPECTED GROWTH PLUS DIVIDEND YIELDS IN 2008 AND 2009



Source: Balhoff & Williams, LLC; Company SEC filings 10-K; Yahoo Finance.

The mid-sized RLEC group—CenturyTel (now CenturyLink), Embarq, Frontier, Windstream, Consolidated Communications, and Iowa Telecom—reported in both 2008 and 2009 EPS contractions that were offset by dividend yields to generate positive (but still relatively low) returns for equity investors. The dynamic here is, as we described above, that when growth is not expected for a company, its equity returns will need to be generated primarily, or entirely, by dividend payments. The RLEC, AT&T and Verizon data provide a clear demonstration of the principle. AT&T and Verizon posted solid EPS

[6] Total return typically is calculated as the dividend yield plus the change in stock price; in this case, we are employing EPS growth as a proxy for expected share price change and adding it to the dividend yield at the start of the year.
[7] Where possible, 2009 EPS growth was based on yearend 2009 reported data; otherwise, the 2009 growth rates reflect year-over-year growth based on the most recent quarterly results reported by the individual companies.

growth in 2008, which combined with their respective dividend yields to generate double-digit "returns" for the year. The growth prospects of AT&T and Verizon, however, allow those carriers to pay relatively lower levels of dividends. The RLECs had negative growth and therefore were required by the markets to pay relatively higher levels of dividends, even as they generated relatively lower total returns compared with the larger telephone companies.

We note that in 2009, as the economy weakened and industry growth prospects dimmed, dividend yields predictably rose for all of the carriers—AT&T (3.8% to 5.8%), Verizon (3.9% to 5.4%), and the RLECs (6.5% to 10.8%). Investors focused on the relative safety of higher dividend yields in 2009, as overall financial market conditions deteriorated and share prices declined (pushing the yields up). The critics of RLEC dividend levels will point to the 10.8% group average yield in 2009 as evidence that the companies' dividends are too generous. Those critics, however, are not telling the entire story. As the graphs and data clearly indicate, despite the 10.8% dividend yield, the RLEC average "total return" proxy *declined* in 2009 versus 2008, due to sharper earnings contraction. So, stock market investors were acting as one would expect—with the potential for growth declining, they reduced the share prices of the stocks with the result that the dividend yields increased. For the RLEC group, the data reveal a "net return" expectation that remained a conservative 130 basis points above the 10-year Treasury yield (consistent with the 140 basis point "spread" seen in 2008). As such, the 2009 RLEC dividend yield did not reflect some sort of outsized "windfall" for equity investors (nor did AT&T's almost 6% yield), but were the result of rational actions by investors (reducing the share price) to attempt to secure an appropriate and consistent (when viewed relative to the Treasury security yield) risk-adjusted return. Dividends were not a form of excess return to the RLEC shareholders, but in fact were the *only* source of RLEC equity "return" for the last two years. Dividends were essential components in paying for the costs of equity capital.

MISCONCEPTION #2: RLEC DIVIDENDS ARE IN EXCESS OF THE RETURNS REQUIRED BY CAPITAL PROVIDERS

Other critics of the rural carriers suggest that dividend payments may be necessary, but they are possibly excessively high, partly due to the fact that the yields are at levels higher than they were a decade earlier.

The reason for the higher dividends is, as noted, that the new yields are determined in financial markets that are assessing the changing risks and more challenging operating outlook. Investors today believe that the RLEC outlook is not as stable today as in the past, and the previously-predictable cash flow and earnings growth is not likely in the foreseeable future. Investors are not focused on margins, but on the slowed growth and contraction. Accordingly, today's telecom shareholder requires risk-adjusted returns that are at least in line with, or possibly somewhat higher than, the levels they previously received when growth and stability were characteristic of the industry. This means that dividend yields are set higher where risk is greater and where growth is largely absent.

The data also provide a clear and forceful response to the question about whether the dividend levels are excessive. First, as illustrated above in Figure 1, the RLEC "total return" proxy is not excessive as it includes only a modest premium above the historical risk-free Treasury bill (140 basis points in 2008 and 130 basis points in 2009). In addition, the RLEC "total return" for the two years combined is well below the approximated AT&T total return generated by earnings (as a proxy for capital appreciation) plus dividend yield. It is noteworthy, that in both years the RLEC dividend

yields were required to generate more than 100% of the "total return," as EPS contraction, not growth, occurred.

A further check on the appropriate level of the RLEC dividends is possible by using a standardized national valuation service such as Ibbotson, owned by Morningstar, Inc.[8] The highly-regarded service publishes an annual Valuation Yearbook, which in January 2010 noted that, as of December 31, 2008, the riskless market rate (the 20-year U.S. Treasury Bond) was 4.6% and the long-horizon expected equity risk premium was 6.7% (above the riskless rate), suggesting that stock market investors were seeking an equity return that is 11.3%. Further, Ibbotson also computes a size premium which should then be added to smaller-capitalization companies. For mid-cap to low-cap companies, which are between $432 million in market capitalization and $5.9 billion, the premia are 1.08% to 1.85%. CenturyLink is the largest of the dedicated rural carriers with a market capitalization, after the merger with Embarq, of approximately $10 billion (which is in the second decile of the size premia table); accordingly, Ibbotson sets a size premium for that grouping at 0.74%. Thus, the total expectation for a return on the major RLEC equities for 2009 would have been 12.04% to 13.15%. Clearly, the RLEC dividend yields have been consistently lower than these return expectations even before adjusting for the earnings contraction annually. By this metric and virtually every metric, the RLEC dividends have not been providing an "excess" return and arguably have not even been sufficient to meet investors' expected equity return.[9] The data affirm the market-based practices of the RLECs regarding dividend policy.

All companies that wish to access the capital markets for external funding (i.e., companies that cannot rely solely on internally-generated cash flows to meet all of their capital needs) must pay what those markets dictate in terms of pricing. In general, the financial markets are efficient and constantly re-price securities relative to company-specific factors (including risk) and relative to other securities. Thus, the markets set interest rates, drive dividend yields, and determine other terms for capital with a view to finding a fair and risk-adjusted price for specific securities. It is clear that the companies do not set the interest rates for debt nor do they create the return expectations of equity investors in some cynical way to drain off profits or other funding. The "cost of capital" is the result of an ongoing assessment by financially-sophisticated investors, and companies that wish to access the capital markets must pay that cost.

If, in spite of the evidence, policymakers believe that market-based dividend yields are too high and the RLECs should be forced to lower their dividend payments, they should understand that the net result of lower dividend payouts will be reduced share prices (and the dividend yields will rise as a result). Falling share prices will have the effect of generating a higher cost of capital and limiting access to various kinds of external funding. Once the share prices have fallen sufficiently that the yields are equivalent to (or even in excess of) the yield levels prior to the policy-induced dividend payment reductions, investors may (or may not) again purchase the securities as the market-based expected return is once again achievable. Perversely, an increase in the cost of equity and a reduction in its availability will also mean that access to sources of debt will be more costly or possibly more constrained, as debt costs are premised significantly on equity availability and prices. The "real world" result for customers will be that investment in advanced networks and the provision of voice, broadband and other services will be curtailed because there is lesser access to reasonably priced external funding.

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[8] We note that the most recent version of Ibbotson has just been published but the figures are skewed by the sharp downturn in the markets in 2008 and 2009; still the message is consistent with the data included for 2009.

[9] Ibbotson SBBI 2009 Valuation Yearbook (Morningstar, Inc.: Chicago, Illinois), Appendix C.

Table 1 summarizes equity pricing data, including longer-term data, and provides performance insights regarding the securities of each of the three surviving RBOCs and the major publicly-traded RLECs. In the recent two-year period, the RLECs have posted results that reflect share price declines, but that are slightly better than the RBOCs as the RLECs were less exposed to the extraordinary downturn in the enterprise business marketplace. Regardless of how selective one might be, the RLEC stocks have not outperformed in a way that might suggest "excess" returns.

TABLE 1: STOCK PRICE PERFORMANCE OF RBOCS AND PRICE-CAP RLECS

	Closing price 12/31/09	2 years	3 years	5 years
S&P 500	1,115.10	-24.1%	-21.4%	-8.0%
RBOCs				
AT&T	$ 28.03	-32.6%	-21.6%	8.8%
Verizon	$ 33.13	-24.2%	-11.0%	-18.2%
Qwest	$ 4.21	-39.9%	-49.7%	-5.2%
Price-cap RLECs				
Consolidated	$ 17.48	-12.2%	-16.4%	
CenturyTel	$ 36.21	-12.7%	-17.1%	2.1%
Frontier	$ 7.81	-38.6%	-45.7%	-43.4%
Iowa Telecom	$ 16.76	3.1%	-15.0%	-22.3%
Windstream	$ 10.99	-15.6%	-22.7%	
RLEC Average		***-15.2%***	***-23.4%***	***-21.2%***

Source: Balhoff & Williams, LLC; Yahoo Finance.

MISCONCEPTION #3: SUPPORT FUNDING CAN BE DIRECTED TO CONSUMERS AND CAN BE EXCLUDED FROM DIVIDEND PAYMENTS

Some critics argue that universal service and other forms of support funding should be segregated from the payments ILECs make to shareholders. The criticism is overly simplified and is in reality profoundly dangerous for policy and for consumers.

The fact is that USF funds, access revenues, and end-user payments are commingled elements of the ILEC revenue model in providing regulated services, often based on policy directives. The revenues combine to cover the costs of regulated operations while generating sufficient additional cash flows to fund maintenance of the network and to pay for the cost of capital (debt and equity). We note that this is not simply financial theory, but is consistent with the standards upheld by the U.S. Supreme Court in the often-cited *Hope* and *Bluefield* cases used by state regulatory commissions in arriving at appropriate levels of costs of capital.[10] Cost of capital clearly includes a return on equity, just as it

[10] Notably, the U.S. Supreme Court has set clear standards for cost of capital in *Bluefield Waterworks & Improvement Co. v, Pub, Serv. Comm 'n*, 262 U.S. 679 (1923) and *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). Those cases set three standards of fairness for a return allowance: financial integrity, capital attraction, and comparable earnings. Two subsequent U.S. Supreme Court cases affirmed the criteria: *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), in which the Court emphasized that the rate of return should "reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed" (at 792); and *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), in which the Court held that "(r)eturn to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. . . A public utility is entitled to such

includes the cost of debt. As discussed above, dividends are an integral part of the payment for the use of equity capital for RLECs—a form of return to equity holders—assigned importantly after operating costs and maintenance capital are funded. So, the appropriate questions would seem to be, not whether support funding is being directed to consumers or to lenders or to equity investors, but whether and how much support funding is needed for policy-directed provision of service by RLECs in high-cost regions where a rational carrier would not otherwise provide service. The focus of any reform should be on the sufficiency of the cash flows for regulated and policy-based services, including a focus on whether the carrier in those high-cost regions can pay its cost of capital, including a market-based return on equity. USF and other forms of support funding cannot and should not be segregated from the overall RLEC financial model that must provide payment for external funding sources, including equity capital. If reform does not incorporate such a theoretically sound financial view, the harm to consumers will be serious.

CONCLUSION

We suggest that reform processes that overlook financial realities will prove destructive to policy goals. In this case, it is dangerous to overlook the importance of all costs—investment, operating and capital—in ensuring quality service in high-cost regions. It is also risky to attempt to divorce universal service and other forms of support funding from the RLEC financial model that must accommodate market-based payments for network investment, operating expenses, and the cost of capital. The cost of capital for RLECs includes a return on equity and, given the limited growth prospects for these companies, dividends are an essential component in providing the market-required equity return. Any reform effort that attempts to diminish the importance of RLEC dividend payments, or to characterize them as unnecessary windfalls to shareholders, misunderstands financial relationships, undercuts the external sources of funding for appropriate capital investment, and potentially destroys the current policy goal to serve consumers pursuant to section 254 of the Telecom Act.

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rates as will permit it to earn a return . . . equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties" (at 314-315).