How Much Upside Potential Is There for the Canadian Telcos?

Description

North American telecommunications companies ("telcos"), including **BCE Inc** (TSX:BCE)(NYSE:BCE) and **Telus Corporation** (TSX:T)(NYSE:TU) trade at valuation multiples that are considerably lower than companies from other economic sectors with similar risk and growth characteristics.

Investors clearly award premium valuations to companies that deliver stable and growing profits and dividends. Some examples are **Canadian National Railway**, **TransCanada Corporation**, and **Fortis Inc**. These companies typically operate in monopolistic or oligopolistic industries with substantial barriers to entry as a result of either government regulation or substantial capital requirements or a combination of these factors. These businesses have also built franchises that are hard if not impossible to replicate, leaving them in a position where profit and dividend growth is reasonably stable combined with attractive returns on capital.

The industry characteristics of the Canadian telcos are not dissimilar to the railroads, utilities, and pipeline companies. An oligopolistic structure, partial government regulation, and huge capital demands are certainly identifiable characteristics in the telecommunications industry.

From a financial perspective, the telcos also stack up well on factors such as profit and dividend growth and return on equity. In fact the profit and dividend growth and return on equity of the telcos were better than that of TransCanada and Fortis although lower than Canadian National over the past five years.

Based on the valuation measures indicated below, the telcos trade at valuation discounts of between 15%-35% to the railways, pipelines and utility companies. Are these discounts justifiable given the industry and financial performance similarities between these companies?

Company	EV/EBITDA 2015	Price/Earnings 2015	Dividend Yield 2014
Canadian National Railway	11.9x	19.0	1.3%
TransCanada	12.5x	21.0	3.6%
Fortis	10.3x	20.3	3.4%

BCE	8.0x	17.2x	4.3%
Telus	8.0x	16.5x	3.7%

Source: Thomson Reuters

Markets are forward-looking and it is therefore important to consider possible business and operating risks as well as the expected profit and dividend growth.

All these companies face considerable operational and business risks. In the case of the telcos, the government clearly would like to see more competition in the domestic market and rule changes and spectrum auctions will favour increased competition. However, the oligopoly has weathered many threats over the years and has built franchises that will be expensive and difficult to replicate. Other companies are certainly not without challenges – consider the six-year ongoing battle of TransCanada to get the Keystone XL pipeline approved.

The industries mentioned above are mature and are not considered high growth areas of the economy. Market expectations for profit and dividend growth for the next few years are indicated below.

Company	Annual EBITDA Growth, 2013-2017	Annual Earnings per Share Growth, 2013-2017	Annual Dividend G 2013-2017
Canadian National Railway	10%	14%	15%
TransCanada	8%	11%	7%
Fortis	12%	8%	4%
BCE	4%	7%	6%
Telus	6%	11%	10%

Source: Thomson Reuters

Apart from Canadian National, which is expected to grow profits and dividends faster than the other companies, the differences are not meaningful and certainly do not justify the ascribed valuation differentials.

How much upside for the telecoms stocks?

As evidenced by the information above, investors place a considerable premium on companies that offer stable profit and dividend growth. However, the historical and expected financial performance of the Canadian telcos justify similar valuations to the other comparable companies mentioned . In my view, the telcos offer better value and higher expected returns given the cheaper valuations.

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