Why Is Telus Corporation Struggling?

Description

Telus Corporation (TSX:T)(NYSE:TU) is actually one of my favourite stocks on the market, because it has a strong economic moat, its customers love it, and it continues to invest intelligently in growing its network, so it can add even more customers.

And yet the company is struggling. Over the past three months, it's down nearly 2%, and it continues to trend down, albeit slowly. That's despite generating strong operating revenues for the quarter, up 3.9% to $3.27 billion. Telus is executing and growing the business; its adjusted EBITDA is growing, up 3.6% to $1.23 billion.

If revenue is up and EBITDA is up, what's the problem? It all has to do with how EBITDA is calculated. Earnings before interest, tax, depreciation, and amortization is, in my eyes, earnings before all the bad stuff. But here's how Warren Buffett describes it: "People who use EBITDA are either trying to con you or they're conning themselves. Telecoms, for example, spend every dime that's coming in. Interest and taxes are real costs." Buffett and his partner Charlie Munger also call EBITDA "horror squared."

If we look at it that way, it's understandable when I say that Telus actually saw its adjusted net income *drop* by 2.7% to $404 million. That's because of the *I* in EBITDA: interest. For Telus, it's paying more in financing charges. Like Buffett said, telecoms spend every dime that's coming in.

And Telus has a lot of debt. According to its Q2 filing, it is sitting on US$18.8 billion in long-term debt with nearly US$1.5 billion due every year between 2019 and 2021. Debt has grown by 19% per year during the last five years. Although the money has been used to invest in capital expenditures, it's still becoming a burden.

Consider that the gross interest expense for the quarter was up 4.3% from a year prior at $144 million. It's not a massive increase, but if revenue only increased by 3.9%, then you've got a 0.4% difference, and growth isn't covering the debt. It's small, but it's there.

So, should investors be running for the doors?

Of course not. The company generates significant amounts of cash flow that more than cover the debt payments it has to make each month/year. And even though it has continued to increase the dividend, the 4.44% yield, which is good for $0.49 a share, appears to be relatively secure.

However, if Telus continues to depend on debt to pay for the expansion while also boosting the dividend, the debt could become a problem. Interest rates in Canada and the United States are beginning to creep up. New notes that are issued will likely come with higher rates, and that’ll increase the gross interest expense for the company.

I believe Telus is a great company and, like I said, it has a strong economic moat and provides a product that customers are never going to give up. However, there’s only so much growth Telus can experience, and if other competitors start to lower prices for customers, reduced cash flow could hurt the business.

Am I a buyer today? Perhaps. Weakness makes the yield look appealing. But it’s important to keep an eye on the company and make sure that the debt doesn’t burn the ship down.

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Date
2025/06/28
Date Created
2017/09/27
Author
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