Don’t get too hung up on BCE’s rosy results

David Milstead, Globe and Mail
Monday, August 13, 2012

BCE Inc. shares have surged to 52-week highs. At long last, they’re trading above the price the company accepted in its failed 2007 buyout deal.

Credit the advance to a couple of factors: The telco has a growth story to tell, as it has been aggressively buying content companies that it says will allow it to boost its subscriber count, revenue per customer – and earnings. BCE is also a dividend story, with an earlier-than-expected boost to its payout and a yield topping 5 per cent.

The downside to all this good news? The shares seem to fully reflect the good news, giving BCE not much room to run higher. And BCE’s all-things-to-all-people approach may offer more downside than upside.

But before we get to the caveats, let’s say some nice things. BCE’s wireless-phone business beat expectations in the recent quarter, driving overall results. Phillip Huang of UBS Investment Research believes it has “significant headroom for growth” as BCE trails Telus and Rogers in wireless penetration, revenue per customer, and margins.

“Since all three incumbents now operate similar networks, offer similar handsets, and have access to similar distribution, we believe Bell will show the strongest overall improvement in wireless over the next couple of years,” says Mr. Huang, who has a “buy” rating and $48 target price on the stock.

Meanwhile, Simon Flannery of Morgan Stanley, who has an “overweight” rating and $47 price target on BCE, calls the Canadian telecom sector “one of the most attractive markets in North America.” He points out that BCE trades at a 16-per-cent discount to AT&T and Verizon Inc. despite having a higher dividend.

Note, however, that the bulls’ targets imply that BCE’s share price will grow just 4 to 6 per cent, as the stock now trades around $45. Plenty of other analysts are unable to place price targets on the stock that imply any upside. According to Bloomberg, nine of the 14 analysts who published price targets last week are between $42 and $44 . Yes, the dividend yield adds a nice sweetener, but most investors would like to see a bit more in the way of share price potential.

The big question is whether BCE’s content-driven strategic shift will pay off. Between the purchases of CTV, Astral Media, and a piece of Maple Leaf Sports and Entertainment, BCE is spending $7-billion on content rather than beefing up its own wireless and video infrastructure.

Dvai Ghose of Canaccord Genuity, who has a “hold” rating and a $44 price target, observes that “compared to Bell, Telus is enjoying tremendous wireless and wireline success without content.” He asks: “Where is the proof that content ownership helps connectivity?”

Mr. Ghose believes that BCE is preoccupied with the successes of Quebecor Media’s Vidéotron in Quebec and has come to see francophone content as the answer. “The problem for us is that, in our view, content ownership, has at best, been a marginal reason for Vidéotron’s success against Bell. Quebeckers we speak with consistently tell us that they prefer Videotron over Bell due to better Internet bandwidth and customer service.”

In the near term, BCE’s media-boosted results will look a lot better than if the company had to rely on numbers from its core business, says ***Neeraj Monga*** of ***Veritas Investment Research***. In a June report called “Running Out of Steam,” ***Mr. Monga*** said that, while BCE management’s free cash flow guidance for 2012 suggests growth of 7.3 per cent, stripping out CTV’s contribution produces a 3.9-per-cent decline from 2011 levels.

He expects a 2.2-per-cent decline in 2013 as the company’s cash taxes rise after the benefits of a tax-saving special pension contribution end.

Mr. Monga, who has a “sell” rating and $42 estimate of BCE’s intrinsic value, says that, while the media acquisitions give “the appearance of a less vulnerable company,” 46 per cent of revenue and 50 per cent of EBITDA will still be dependent upon the company’s wireline – or traditional phone – segment. “We believe that accelerating landline losses and stagnant Internet additions will demand an increasing level of attention and investment at the wireline division and therefore, at current valuation levels, investors need to exercise caution.”

That is a caution that the market seems not to currently show.