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HEARD ON THE STREET

Investors Hope Energy Stocks Will Feel 'Post-Scandal' Pop

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Aside from the technology and telecommunications sectors, few sectors have been bludgeoned like energy. The latest hits came during the past few weeks when both **TXU Corp.** and **Duke Energy Corp.** warned investors that their respective earnings would be significantly off for the year. The share price of both has fallen sharply.

The warnings were reminders to investors that jolts of bad news may be the norm in this sector for some time. In fact, Thursday **American Electric Power Co.**, Columbus, Ohio, is expected to warn investors that its earnings also will be down from previous estimates. Still, despite the barrage of bad news, a few brave investors are turning on to power stocks, betting that some will rebound aggressively once the taint of scandal passes and wholesale electricity prices begin to climb anew.

"We feel like you have to look at these [stocks]. They are so beaten down," says Mark Donovan, who manages Boston Partners Large Cap Value Fund, which ranks among the top 5% in its category of funds, according to fund-tracker Morningstar Inc.

Indeed, the Dow Jones Utility Average Wednesday plunged 9.6% -- the fifth-biggest decline in its history -- and stands at its lowest level in more than 14 years. The average, a sister of the Dow Jones Industrial Average, is made up of 15 stocks including TXU and Duke.

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COMPANIES

Dow Jones, Reuters

TXU Corp. (TXU)

PRICE	14.65
CHANGE	-2.53
U.S. dollars	10/9

Duke Energy Corp. (DUK)

PRICE	16.56
CHANGE	-1.55
U.S. dollars	10/9

American Electric Power Co. Inc. (AEP)

PRICE	17.69
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Investors bold enough to make the move are mostly looking at unregulated power companies, which buy and sell electricity in the wholesale market, and what are referred to as "hybrid energy" companies, which have a constant stream of income from regulated utilities and a chance for growth through unregulated wholesale-power sales and trading businesses.

CHANGE -5.22
U.S. dollars 10/9

* At Market Close

These companies were the product of market deregulation during the late 1990s and the growth of wholesale-energy marketing and trading opportunities that grew out of it.

The shares of hybrids such as Duke and **Xcel Energy** Inc. soared along with those of the most famous of the group, Enron Corp. Then Enron collapsed in December amid an accounting scandal, and the prices of the group started spiraling downward, aided by a softening of power prices in line with the weaker economy.

Once trading in the 40s and 50s, many have watched their shares fall into the single digits. Lots of investors have steered clear, unsure which of the group will survive.

Mr. Donovan is avoiding companies that rely heavily on energy trading because of the risk associated with those operations. Investors have a difficult time figuring out how much money companies truly make from trading because they are allowed to use an easily manipulated accounting technique known as "mark to market" (sometimes derided as "mark to maybe"); it gives companies great flexibility in valuing their energy contracts.

In recent months, some companies have had to restate their earnings from trading operations, and others are facing federal probes into trading practices.

"We have much more of a bias to those companies that have made money off of physical assets," Mr. Donovan says, adding that these companies' highly leveraged balance sheets have to be closely scrutinized. He says the \$53 million fund has bought stock in one of the most highly indebted of them all, **Calpine** Corp., which develops and operates power plants that sell electricity into the wholesale market. Mr. Donovan believes the company has plenty of liquidity to keep it going, and that it will pay down enough debt next year to improve its debt-to-equity ratio.

"The business model is simple and straightforward. They build and operate power plants," he says. "They've got very good assets. They have a lot of assets under construction that will prove to be very valuable." In 4 p.m. New York Stock Exchange composite trading Wednesday, Calpine fell 16%, or 32 cents, to \$1.66, down more than 90% from a year ago.

Mark Stuckelman, a portfolio manager with Nicholas-Applegate Capital Management of San Diego, has a two-pronged strategy for the sector. He has loaded up on deeply discounted stock in **Aquila** Corp., among the hardest hit of the hybrids due to a collapse in its trading business and dwindling access to credit. But he is also buying pricier stock in **FPL Group**, which makes most of its money from regulated utility operations in Florida.

"Our strategy is to buy both ends" of the safety spectrum, says Mr. Stuckelman, who manages the firm's \$47 million Large Cap Value funds for institutional investors, as well as a small-company fund and other portfolios.

FPL, which owns Florida Power and Light, is trading at more than 10.3 times earnings compared with about 12.99 for the industry, according to Multex. Aquila, which lost money in the second quarter and expects to lose money in the third, doesn't have a price-to-earnings trading multiple. Some investors believe that will

turn around soon as the company moves forward with its strategy to return to its regulated roots and get out of the unregulated wholesale business. Aquila also is selling assets world-wide to raise money to deal with its liquidity problems.

"We're holding on. It is still a risky name," Mr. Stuckelman says.

One money manager who specializes in distressed stocks, Martin Whitman of \$2.3 billion Third Avenue Value Fund, also has high hopes for the power sector. "I think Enronitis is much, much overdone. There's going to be long-term growth in power," he says.

Mr. Whitman, whose fund has ranked in the top 20% during the past decade, also has acquired shares of Aquila, as well as Houston's **Quanta Services** Inc., which provides contracting services to power companies and is 27% owned by Aquila. Mr. Whitman has bought the shares because he believes both may be in play. Adding to his speculation is the recent announcement that Aquila's chief executive, Robert Green, would step down. Mr. Whitman adds, "I've been known to be wrong."

Independent New York analyst Paul Patterson says it is best to focus on those companies that already have been hit by the worst headlines, otherwise "you run the risk of catching a falling knife." The hard part, he says, is figuring out whether the companies that operate in the wholesale market and are caught up in federal trading investigations have faced the worst of it.

That said, he likes Xcel, a utility-holding company based in Minneapolis, whose stock price has been crushed in connection with its unregulated NRG Energy unit, which failed to make certain bond payments Sept. 16. Despite the woes at NRG as well as Xcel's recent decision to cut its dividend in half, Mr. Patterson says, Xcel "could provide shareholders substantial long-term value based on its utility properties alone," as long as the parent is insulated from NRG. Xcel has estimated its utilities will earn \$1.45 to \$1.53 a share this year.

Richard C. Kelly, Xcel's chief financial officer and president of its NRG unit, says NRG is continuing to negotiate with more than 100 banks to receive waivers until November on its collateral call of \$1.1 billion to \$1.3 billion. He says the company also is in talks with its bondholders, and that the bondholders don't want to force the company to seek bankruptcy protection. If NRG were forced to file for protection, he maintains the parent company would be insulated from the unit's financial obligations.

Many thought **El Paso** Corp., which operates regulated gas pipelines and unregulated energy marketing and trading businesses, had moved beyond the sector's woes. But it recently was slapped by a federal regulatory ruling, driving its shares below recent lows.

Scott Schermerhorn, who runs the \$2 billion Liberty Growth and Income Fund, feels he has learned the lesson of power-sector stock picking the hard way. There is "no place to hide whatsoever," he says, noting that Duke and some others, including El Paso, which his fund owns, are getting cheaper. He isn't buying anymore right now because he doesn't know where the bad news will end. "In a perfect world, we would be buying them and buying them in size this year," he says. "They just keep getting cheaper."

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