IFB323: Understanding the World of Utilities - Analyzing Southern Company from a Beginner's Perspective

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Dave [00:00:00]:

All right, folks, welcome to Investing for Beginners podcast. Today we have episode 323. Today we're going to answer some fantastic listener questions we got. So speaking of questions, if you have a question, if you have a burning question you're just dying to ask, we would love to answer it on the air. You can go to newsletter@envestingforbeganners.com and submit a question. You can go to Spotify and you can ask questions in the chat there. So those are two great ways for you to reach out to us if you have any questions. So without any further ado, let's go ahead and get into the stuff.

Dave [00:00:35]:

So here we go. So we got this great question from Mercedes about a month ago on Spotify, and she asks, is Robinhood a good starter investment? So, Andrew, what are your thoughts? Is Robinhood a good starter investment?

Andrew [00:00:48]:

Let's take a look at Robin Hood. I actually haven't looked at the company in a while. Felt like they were really popular for a very short amount of time, and then it's kind of fizzled off with a lot of other kind of 2020, 2021 trends. So I haven't looked at them in a while. Have you?

Dave [00:01:06]:

I have not, no. It's been since that period, really, that I kind of like, eh, no, I lumped them in with the pelotons and the zooms of that period.

Andrew [00:01:16]:

So it's down like 75% over its life. So it looks like an IPO at around $35 a share. It's now trading at like $8 a share. So you'd have to, on the air math quadruple, get a five x to make the money back from here. If you're in that, which unfortunately, is more common than I think beginners realize. When you buy into an IPO, a lot of times it doesn't work out well and you lose a lot of money and it becomes hard to make money.

Dave [00:01:50]:

Yeah, very, very hard. And that's not to derail the Robin Hood question, but that is apropos to talk about because I'm going to butcher the name. I've never really been sure exactly how to pronounce it, whether it's sheen, Shane Shine, the clothing, the discount clothing company from China, they filed to do an ipo. And you know that there's going to be a lot of frenzy around that.

Andrew [00:02:12]:

Mean you can't argue with what Robinhood has done. They've completely transformed the whole stock market game. I mean, now we can buy stocks with zero commission. That was not a thing before Robinhood came. If I don't really see them going away. And that's kind of what makes it interesting, brokerage businesses, because I've done some work in the Schwabs, one of those old stodgy brokerage businesses, they have pretty sticky customers for the most part. They had a little scare recently. We won't get into that.

Andrew [00:02:46]:

But it's not rocket science for them to keep customers. And so from a narrative, kind of common sense perspective, it sounds like Robinhood should be around for a while. But does that make that a good investment is a completely other question.

Dave [00:03:06]:

Yeah, it does. And they certainly have been influential in the markets, and not only for the zero commissions, but bringing the whole front running of investments to the forefront that really became much more well known once the GameStop saga kind of played out, because that was a big hullaboo about all that. So I guess the bigger question is, if you were going to start now, so, not whether you bought the company with an ipo, but if you're going to start now, would Robinhood be a good starter investment? And I guess there's a couple of ways you could go about thinking about this. Number one, if this is your step off the ledge, get your feet wet, start investing, then. Yeah. If this is something that you're interested in and you want to learn more about, or you like the company and what they're doing, you have to understand that when you're first starting out, the chances that you'll make a mistake are good. I mean, the chances, even if you know what you're doing are good. But I think as a starter investment, compare that to investing in Netflix or Starbucks.

Dave [00:04:10]:

I don't see any reason why Robinhood wouldn't be a good starter investment. Just because if it gets you in the game and get you started down the path and it's something you're curious to learn more about, then I think, yeah, it's absolutely a great choice for a good starter investment.

Andrew [00:04:27]:

What do you mean by starter investment?

Dave [00:04:29]:

For me, I mean, when I think of starter investment, I'm interpreting it as this is the first time I'm going to buy a, like, you know, the first investment I ever, you know, the first investment I made was Microsoft. A lot of people do Starbucks, a lot of people do Netflix or Amazon or something like that. I think if it gets you in the game, I think I'm okay with it. Is it good? I. That I don't know.

Andrew [00:04:53]:

I mean, we're talking about investing our life savings here.

Dave [00:04:56]:

No, not investing our life savings here. I wouldn't recommend anybody invest their life savings in their first investment ever. I would encourage you to dip your toes in slowly and start to learn how the game is played before you go whole hog and throw everything you've ever earned in your entire life into any one company. Whether it's a Robinhood, whether it's bitcoin, whether it's visa, Microsoft, Apple, you name insert company here. I would never encourage anybody to do that. But as something that you're going to put $50 towards because you want to just get into the game, then I think it's probably fine.

Andrew [00:05:32]:

Yeah, completely agree. So what if it's somebody who, this isn't their very first investment, but they're still looking at this as a potential stock pick and maybe they've been investing for two months, six months, a couple years. What do you have to say about a stock like Robinhood, where it's at right now?

Dave [00:05:51]:

Well, I think then it starts to become more about using this as a tool to learn the fundamentals of trying to figure out what could be potentially a good investment. And that includes some not sexy things like reading the ten k, reading earnings reports, looking through the financial statements to determine whether this company is a viable investment that's going to earn. It's going to grow and earn more money over the years, which will in turn likely cause you to earn more money, because the market will, in theory, recognize that this company is performing well and is a good investment. So that means learning things like ratios, so the PE ratio, the return on equity ratio, really understanding the business model and what it is that Robinhood does to make money, as well as attract and retain customers, and also determining how strong is the balance sheet? Is it a company that can withstand any sort of financial upturn or downturn that may happen in the markets? And how fiscally responsible is the CEO and is he in the business for you or for himself? And those are all things that you have to determine to decide whether it's something you want to add to your portfolio as you've started to grow the portfolio. I don't have direct answers to those. This is not a company that I follow. So I guess turn it back to you. Do you have any thoughts on whether this would be, let's say, your fourth investment? What would be your thoughts?

Andrew [00:07:27]:

I think everything you said is just right on the money. There's just no way of getting around the fact that you're going to have to roll up your sleeves, do the work, and maybe learn something that might be tough to swallow, but you might have to learn some things, if you do want to become a stock picker, that's going to be part of the game. And if you don't want to do that, go buy an index fund. The only thing I will say in regards to Robinhood in particular is these type of stocks tend to have high risk, high reward characteristics. And so it's a very early company, early in its growth stage. It's growing like a weed, but it's also not profitable. And so the ods of those kinds of investments becoming investments that generate good returns for you are a lot lower than buying something like Microsoft or Apple. So your ods are a little bit worse, but your potential rewards are a lot higher.

Andrew [00:08:28]:

And I think that goes for a wide swath of these type of high growth stocks. So that's what I would say. Do I think they'll probably be around in one form or the other 1015, 2030 years from now? Yeah, I think so. I mean, who knows who's going to own what. So things can get confusing. And just because a business is around doesn't mean you'll necessarily make money as a shareholder. But there is the chance that they do. And so if you feel like you have a circle of competence and can learn about the industry and make a good, responsible bet, then do it.

Andrew [00:09:05]:

But if you're going into this thinking it's the same as buying a dividend aristocrat that's been around for 50 years, it's not. It's a completely different ballgame.

Dave [00:09:15]:

Yeah, completely different ballgame. And I think one thing to keep in mind, especially as you're starting out and you're starting to learn about this and exploring the process, a couple of things to always keep in mind, you don't have to swing at every pitch just because you think you like Robinhood initially. And once you start digging into it, there could be something that becomes a red flag for you. You can pass. You do not have to buy it just because, and any work that you do on a company, you can transfer to other companies, because either it might be in the same industry, or it could be just the process of working through learning, using a checklist, or learning about a ten k and how to read it. That's something you can transfer to the next company, so it's not a waste of time. And then the last thing to always kind of keep in mind, not every good company is a good investment, and not every good investment sometimes is a good company. So I know that could be confusing.

Dave [00:10:07]:

But sometimes what makes a good investment is maybe not always a good company. And likewise because there's different cycles and different parts of the life. If you bought Robinhood at its IPO and then you sold at the height, then yeah, you had a great investment. But that doesn't mean, I'm not encouraging people to do that, by the way, because timing the market is impossible. Impossible. I can't say that. So yeah, you could have had a great investment, but that mean it was a great company or a great investment. If you held it for five years, you could say probably not, I guess.

Dave [00:10:39]:

Question I would ask is, are you looking at Robin Hood because it's trading at $8 a share, or are you looking at it because it's something you really want to buy? And the reason why I say that is because some people will look at air quote, cheaper stocks per share and think, hey, I can get into the stock market by buying this, but you can buy now almost anything in the United States, particularly with $5. So you can buy Google if you want for $5. And you don't have to buy a Robin Hood just because it's $8 a share and it's something you think you can afford. If you have $100, you can literally go out and buy 20 stocks with $5 each. And so just wanted to kind of throw that out there because I think sometimes people will confuse a low dollar amount per share as, hey, this is a potential I could get into. And it could be. I'm not saying it's not, but just kind of consider that I can go buy visa or I can go buy Costco for $8 a share and not have to worry about the difference in the price and whatnot. So just something to consider and keep in mind.

Andrew [00:11:46]:

Yeah. Perfect advice for a beginner. Perfect.

Dave [00:11:48]:

Thank you. All right, so let's move on to the next question. So this came from the newsletter. So this is, somebody sent us in a question and they just subscribed to our Nuggets email and they said they're really thankful for this opportunity that's landed on me. One of the challenges I'm facing now is not knowing what to invest in my late 20s because I'm still in college. So this is, I think, a really interesting question. And it goes to when you start and what your choices are, regardless of when you start. What are your thoughts?

Andrew [00:12:18]:

My read on this question is, I feel like this person is saying, because I'm still in college, maybe I don't have as much money and so maybe I don't have as many investment choices. And also because I'm in my late 20s. Maybe this person feels like they got a later start than would have been ideal. And I would just say that neither of those things are true. The world is your oyster, and starting in your late 20s is a crazy good head start. Crazy good head start. We all wish we started earlier. Yes, but that doesn't mean you don't have super long compounding potential just because you're getting started in your late 20s instead of when you're 16 or something.

Dave [00:13:01]:

Yeah, totally. I mean, I think there's two ways you can probably kind of try to maybe invert this question a little bit. Number one is, yeah, you may not have a lot of money to start with, but as we said in the question before, in the United States, you have the opportunity to buy just about anything you want on a very small budget. And so even if you're starting out, there's two ways I would look at it. Number one is if I only have $10 a month to invest, I'm still going to put the $10 a month in the market, and I'm going to buy something. In other words, you can get started with a very little about money. The other way you can look at this as well is that one thing, you may not have a lot of money, but you do have a lot of time. And so you can use that time to help yourself learn about the stock market, learn about the investments, learn about how to pick individual investments if that's something you want to do.

Dave [00:13:55]:

If you want to invest in etfs or index funds, it also gives you the time to learn how those work as well so you don't have the pressure of, hey, I got a whole bunch of money. I want to put it in the market. Now, you can use this time as the opportunity to learn. And then once you graduate and you get, air quote, real job and you're making air quote, real money, then you can start putting all that knowledge that you've used and learned. You can start putting all that to work with a bigger pot of money. And so it can be a way of, I guess, looking at it as this is my tester or this is my starter fund, if you will, and you can use it to make mistakes. And once you get into the real world, so to speak, then you can learn from those mistakes and start really applying what you've learned.

Andrew [00:14:43]:

Nothing like getting kicked around in the market to make you learn a thing or two, right?

Dave [00:14:47]:

Right. It'll humble you fast. And that's one of the best teachers you can possibly have. All right, so let's move on to the last question so we have hello. First off, thank you for taking the time to reach teach beginners like me. I have all but fallen in love with your podcast the past few months and can't wait to get some compounding rolling. Recently, a friend of mine brought up that he had been investing in southern company ticker so monthly because his granddad always liked them. I told him that I would use what I had learned from the podcast to analyze the company for him and me just to see if it was still a good investment.

Dave [00:15:20]:

Well, I got started and quickly realized that the electrical utilities industry is quite different from others. I know it's a great company and I like what I've heard from management, but I can't get over the fact that it seems like they produce almost zero free cash flow and they have a much higher debt to equity ratio than I'd like. My question is, are there other metrics qualities I can use to analyze utilities, or should I just go off which company within the sector has the least amount of cons for me? Thanks again, Jake. So this is a great question, and I don't think we've touched much on utilities in the past and maybe some ideas of how you could start trying to analyze those. So I'll give you a first stab at this.

Andrew [00:16:01]:

All right, hand it over. I'm going to quote something you told me the other day when we were talking about stocks. Different stocks have different objectives, and it makes sense when you say it, but sometimes we don't always think that way. For example, some stocks are better to hold in retirement and other stocks are better to hold when you're in the accumulation phase and you're trying to grow your wealth. A stock in retirement, maybe one where you want a higher income, is good for when you're in retirement because it might have lower risk. So you can depend on that income a lot better than you can a fast grower. But the fast grower might have higher returns. Of course, I'm always looking for the have your cake and eat it too.

Andrew [00:16:47]:

And there is some of that out there, but it's very hard to find. So in general, if you have that spectrum between kind of steady Eddie, really low growth, really stable, maybe a higher income, versus really high growth, maybe no income, no dividend, I would say on that spectrum, southern company probably falls, I must say probably because I haven't done a ton of work on them, probably falls close to that steady Eddie, low growth potential, a lot more income potential, and I think that just goes for utilities with broad brush. It is interesting now to see as things shift to renewable energy we might be seeing a complete paradigm shift in the way utility businesses are run and have return profiles and all that. But historically over the last 1020, 30, 5000 years, utilities maybe not 100. I do think this industry was once a growth industry. So don't 10, 20, 30 years, it's been a very stable, very low growth industry. And it really makes sense when you think about the typical business model of the utility, the regulation that goes with that and all of those details are what make these investments low growth and.

Dave [00:18:05]:

Very, that's a, that's a fantastic way to think about them. And utilities can be as kind of reinforced what Andrew was saying. They can be a great investment depending on where you are in your investment lifecycle. And I think if you have the same expectation for Southern Company, for example, that you're going to have with Apple, you're probably going to be disappointed. And so I think when you go into investing in different companies, you kind of have to understand what it is you're really biting off before you really start biting it off. And if you want to, maybe we could talk a little bit about maybe how you could analyze utilities maybe from a kind of a broader level. I think to kind of start, if you're thinking about utilities, you have to understand their business model and how they kind of operate. And so the first thing you have to understand is they are unlike pretty much any other kinds of businesses because they're regulated.

Dave [00:19:10]:

And because they're regulated, that means that they cannot raise prices like Microsoft can or like Nike can. They have to go to the regulatory board that governs them and request to have rates raised. Because you think about all of us that pay for our utilities in our apartment, our home or whatnot, those prices are regulated. And so southern Company or Duke Energy here where I live in North Carolina, prices are restricted. They can't grow like the prices for a Nike Jordan Air jordans are. And so because of that then they have limited upside based on what they can charge. It's kind of an interesting beast because they have to go to the regulatory boards to request the right to raise rates. But it doesn't happen every year.

Dave [00:20:00]:

And sometimes it can take two or three, four years before they get approval to do that. And so it doesn't operate on the same kind of capitalist structure that we're used to, the free ability to raise rates and whatnot. And so that leads directly to the way that these businesses fund themselves. And so because they have much more limited upside on the rates that they can charge customers. They also have an upside on what kind of margins they can generate. So gross margins, free cash flow margins, like Jake mentions in the question you're going to find across the board that utility free cash flows are not as great as they would be for visa, for example. And in large part, that's because of the investments that they have to make. When you think about a utility, they have to build the towers, they have to build the wire, they have to build the transformers, all that electricity, the generation of it, if they generate it themselves, and if they don't, they got to buy it from somebody else.

Dave [00:21:07]:

And all of those things are kind of expensive. And so generally, those investments outpace the money they can make from the rates that they charge. And so when you think about that, that means that the investments are going to outpace the profits that the company generates, which means they're going to have, a lot of times, especially in southern's case, they have negative free cash flow and they have had it since 2014. And so it's not unusual for them to see that. So that relates to the debt to equity that he was talking about. It also relates to the free cash flow. So because the company doesn't generate enough internal profits to invest in itself, it either has to raise debt, so it has to take on debt, or it has to issue equity to generate more money to be able to cover the costs and expenses of running the utility. And so that's why investing utilities, by listening to this, you can already tell it's a different kind of beast.

Andrew [00:22:15]:

Yeah, that's such a good explanation of how that all works and the realities of those type of businesses. And like you said, the free cash flow. And what's interesting to me is obviously stock investors have seen returns. So kind of going back to earlier in the discussion, from today, you can have negative free cash flow for a long time. It's just, what's your time horizon? Are you trying to jump in and out in one or two years? Are you trying to jump in and stay in for 2030 years? It's a completely different question again. And so it's kind of what makes this stuff endlessly fascinating. And I think it was a great breakdown of why these companies are different. And so my question to you would be that all sounds like terrible things because of regulation.

Andrew [00:23:03]:

You have the cap on pricing and everything that is a result of that. But are there any benefits to the utilities or having the regulation? And why are people even letting the company borrow money if it sounds like they're just going to have negative free cash flow all the time.

Dave [00:23:22]:

Well, I think there's a couple of things you could probably think about. Number one, they are absolute monopolies in the areas that they operate in. And all you have to do is move and realize when you want to connect utilities to wherever it is you live, you have a grand total of one choice. And there are no, like here in North Carolina, it's Duke energy or you don't have mean. You got two, I suppose. But so they have absolute monopolies in the areas that they operate in. So that gives them a very sticky customer base. And so if you think about a place like Florida, for example, which is growing its citizens, so more people are moving there than just about any other state in the country.

Dave [00:24:08]:

That gives the utilities there a monopoly on those customers. And so that allows them to be very steady and very sticky as far as revenue generation. And so there's that part of it. And then the other part of it is that the majority of utilities pay very healthy dividends. And so that's what really attracts most investors to the utility field is because they pay very consistent, very steady, very safe, generous dividends. And that's attractive to dividend investors. So, for example, Southern is paying around 3.97% in a dividend. And so when you think about the overall returns that you get from an investment, dividends are, in the case of utility, can be a third to half of your return.

Dave [00:25:00]:

And so that's a big deal. And so if the company is growing at 3% a year in revenues, then you add on another 4% for a dividend yield, you're looking at an 8% return. That's not horrible. And especially if you're closer to retirement or already in retirement, that's like music to your ears, because it's very safe, it's very secure. It's not like somebody's going to come in and disrupt Southern Company in the utility that they, because you got to think about the billions of dollars you'd have to invest to try to disrupt them. So that's not going to happen. And then you think about how safe and stable and secure that, because they're not going to let that go bankrupt. They can't.

Dave [00:25:40]:

And so it is what it is. It's a utility. It's something that is going to be there for a very long time and goes back to your expectations. So those are some of the reasons why people would invest in a utility. And what can be some of the upsides to the utility, and then you throw in the whole renewable thing. Like Andrew was saying at the beginning of this whole conversation, we don't know where that's going to go, and we don't know how that's going to impact investments like this. Berkshire Hathaway has Berkshire energy underneath its umbrella, and they are one of the largest, if not the largest, solar or wind producers in the country. And we don't know how that's going to impact Berkshire 20 years from now as it becomes more stable and regulated and even continues to improve.

Dave [00:26:26]:

That could be a huge, maybe not a great pun, tailwind for that company, but that's why people invest in the utilities.

Andrew [00:26:33]:

Yeah, I think that closes the book on that one. Hopefully, Jake, that helps.

Dave [00:26:40]:

Yeah. All right, folks, well, with that, we will go ahead and wrap up our show for today. I wanted to thank everybody for taking the time to send us those fantastic questions again. If you do have a question, please reach out newsletter@eninvestingforbeganners.com I will put that in the show notes so you can reach out and ask us any question you want. And with that, we will go ahead and sign us off. You guys go out there and invest with a margin of safety. Emphasis on the safety. Have a great week, and we'll talk to you all next week.

Dave [00:27:06]:

Bye.

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