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Hawaiian Electric Company, Inc. ~ HE (NYSE)

Investment Position: Dividend and (potential) covered call investment

Investment Overview

Hawaiian Electric (HE) is a holding company that supplies power to over 420,000 customers or approximately 93% of the Hawaii market through its regulated electric utilities, Hawaiian Electric Company, Hawaii Electric Light Company and Maui Electric Company. Through a 1988 acquisition the company also controls the American Savings Bank (ABS), which is the third largest financial institution in Hawaii based on assets. The split between utility revenues and banking revenues over the last 5-years has averaged 76% for utilities versus 23% for banking (only 16% of revenues were from banking in 3Q05).

Hawaiian Electric has paid a dividend annually since 1901. And although we do not anticipate an increase in the dividend payout until late 2006 at the very earliest, we are nonetheless confident, as is management, that the current payout will be maintained. As a pure dividend/income investment HE currently yields an attractive 4.73%.

Our confidence in the company's ability to keep paying the current annual rate of \$1.24 per share is why our investment horizon is long term. Nevertheless, insofar as we believe dividend increases will come very slowly, if at all, the 'long term' should not be confused with forever. Quite frankly, if more attractive equity investments were to materialize – perhaps after say the onset of a US/global economic recession – we would not be adverse to taking profits in HE around the \$28 per share area (or 6.7% higher than yesterday's closing price). Conversely, if the US economy, as we suspect, slows down in a grinding fashion as the US interest rate cycle reaches its peak, we have no qualms about owning HE simply for its dividend.

HE is also a potential candidate for writing covered calls. In our opinion the logic behind a covered call strategy is to generate extra income in a security that you do not mind holding on share price weakness, but also do not mind selling (or having your shares covered) on share price strength. Ideally, we would like to write \$30 long-term calls when HE's share price is rising (or when option premiums are more attractive).

Needless to say, for the purposes of the Wish List we will be covering HE solely as a dividend investment.

Business and Operations Overview

By operating in Hawaii the company is insulated, to a degree, from the US mainland economy. The reason for Hawaii's 'insulating' properties is that Hawaii's four pillars of economic growth - Federal government and military spending, Tourism, Construction, and Real Estate – are, generally speaking, not as tied to the spending habits of the average American consumer and capricious/cyclical spending/hiring trends of the average American company. More specifically, Federal government and military spending now represent the largest component of gross state product in Hawaii, and tourism, which is exceptionally strong (thanks in part to Japanese tourists), comes in second. Hawaii, as of November, had an unemployment rate of 2.8% and falling. One major flaw in the insulating argument may turn out to be 'real estate' factor, although mainland price softness has not shown up in Hawaii yet.

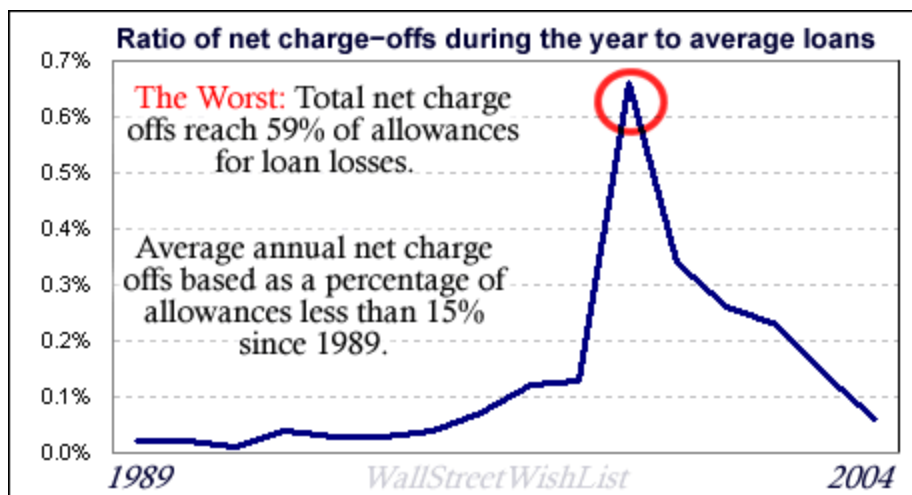
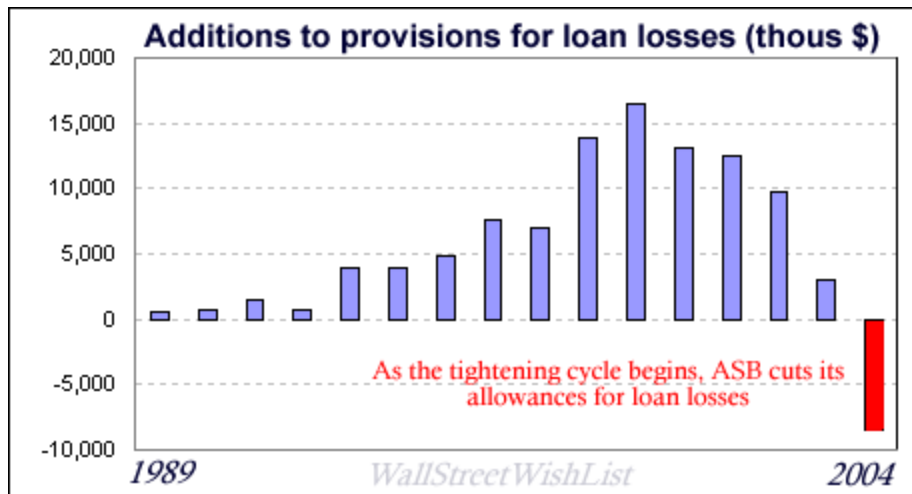
On the utilities side of the equation the insulating theory (not to mention that HE is the only electric public utility servicing the islands of Oahu, Maui, Lanai, Molokai and Hawaii) has shown itself in the form of consistent and steady growth. Unfortunately, with HE's equipment getting older and peak load times increasing to try and keep up with demand, operating and maintenance utility costs are on the rise. The company has plans to try to keep up with demand. Nevertheless, the argument could be made that flat or even slightly declining demand could be beneficial to the company and investors over the near term. The rationalization behind this sentiment is that breakdowns and equipment replacements arise not only because of aging equipment, but also because of the lack of capacity the company has available to deal with demand. Thus, a period of stagnant or falling demand could allow the company to better utilize capital without having to use expensive band aid solutions simply to keep up with demand.

In order to increase capacity for tomorrow the company has adopted many programs, including a planned \$130 million new generation plant, and an estimated \$900 million in capital expenditures through 2009. These actions, along with the recently approved interim rate increase from the Public Utilities Commission of the State of Hawaii (PUC), should prove positive developments in the long-term. In short, the demand/cost picture has not yet reached the point where dividends and returns are in danger, but it could certainly do so in the future should these plans not prove effective at increasing supply and/or should conservation campaigns not help dampen demand.

As for the banking side of the equation, the company sees significantly less competition from large national and global banks when acquiring, or attempting to acquire deposits (and service these deposits with say chequing accounts). Again, this is an 'insulating' feature of the Hawaiian economy; a feature that has, to date, permitted the company to reap the benefits of a declining loan loss reserve and favorable interest rate spreads. For example, despite the fact that the Fed continues to tighten interest rates, ASB's interest rate spread increased to 3.26% in 3Q05, compared with 3.09% in 3Q04. On a negative note, during a recent analyst conference, American Savings Bank CEO, Ms. Constance H. Lau, noted that deposit growth had already (in August) shown signs of slowing

elsewhere in the country, and that many ASB customers were seeing their average balance outstanding decline in the face of rising energy prices.

Obviously any 'insulating properties' when talking about a bank need to be put into perspective. To be sure, with the US yield curve inverting and the US economy potentially about to suffer a consumer led slow down as the ATM like housing market peaks, study of the interest rate cycle would suggest that now is not the best time to be bullish on banking stocks. Suffice to say, the risks associated with HE's American Savings Bank are entirely different from those that can be associated solely with an electric utility. This is an important distinction to remember.



Financially Speaking

Despite excessively long 300+ page 10Ks, HE has a clean set of historical financials that leave little room for serious complaints. Yes, the company was unsure of its obligations with regards to FIN 46R, pension assumptions have historically been high, and the stock options boogey man was/is running a little wild. Nevertheless, the financial statements offer a clear and comparable historical picture of operations since 2001. Prior to 2001 (or before the company started consolidating its utility and banking holdings), the data is a little cumbersome but nonetheless thorough.

Perhaps the only glaring issue we do not like is the fact that the company has not raised the dividend *per share* rate since 1998 and yet in the statement of cash flows dividend payments have been steadily rising. This issue is easily resolved by comparing total dividend payments to the outstanding share base. In short, dilution has been a little excessive, and helps partially explain why the company has seen its operating performance slip since 2004.

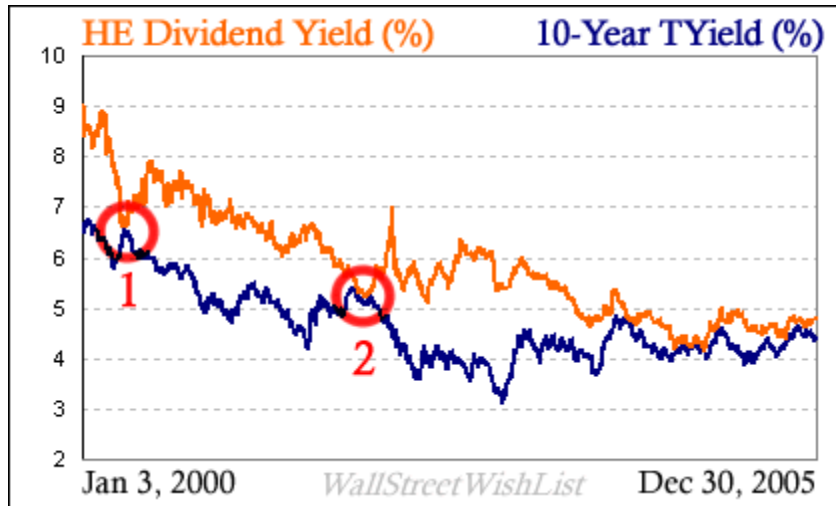
Beyond dilutionary concerns, we believe that most of the numbers speak for themselves. And these numbers speak positively about the stable growth and earnings dynamic of the business: even with a larger share count HE's tangible net equity position is still growing.

Per Diluted Share	Quarters Ended			Years Ended			
	3Q05	2Q05	1Q05	2004	2003	2002	2001
Revenues	7.32	6.43	5.83	24.14	23.76	22.67	25.44
EPS	0.46	0.34	0.30	1.38	1.52	1.62	1.23
Cash from Operations	1.06	0.28	0.59	3.06	3.22	3.55	3.82
Capital Expenditures	0.74	0.58	0.48	2.69	2.17	1.76	1.86
Free Cash Flow	0.32	-0.30	0.10	0.37	1.05	1.79	1.96
Common Dividends Paid*	0.31	0.31	0.31	1.18	1.00	1.01	0.99
FCF after Dividends	0.01	-0.61	-0.20	-0.81	0.04	0.79	0.97
Equity per share	14.91	14.97	14.58	15.19	14.53	14.34	13.69
Tangible Equity per share	13.81	13.86	13.47	14.05	13.27	13.00	12.19

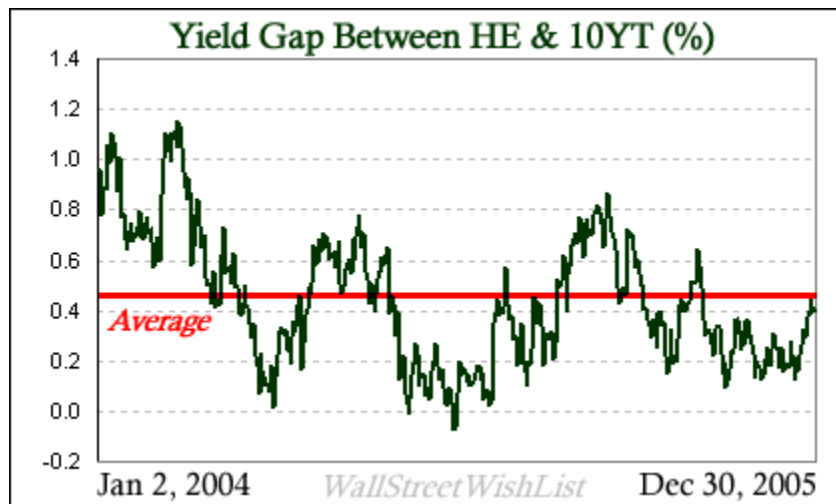
* We used the most dilutive share tally possible. These statistics will not match most company exhibits.

The Yield Field

When compared solely to the yield on the benchmark 10-year Treasury, the 4.7% yield on HE is not exceptionally attractive. Rather, the gap between the 10-year yield and the HE dividend yield has narrowed significantly since the start of 2000, or when HE was yielding more than 9% versus 6.6% on the 10-year.



As the above chart shows (numbers 1 & 2), there can be added volatility in HE's share price when the company's 'risky' trailing dividend yield approaches the 'safe' yield on the 10YT. With the yield on HE only 40 basis points above that of the 10-year, this historical pattern is a concern.



What helps alleviate our gap concern is the fact that there has been no major period of stock price/yield volatility over the last two years, or when US interest rates were rising.

With this in mind, a comparison to some other utilities helps the investor understand HE's investment potential. Note that HE is one of the more consistent dividend payers in this group. Note also that the company has less interest charges than many of the company's highlighted below, and that HE's payout ratio (*based against net income*) is the most consistent. As for growth opportunities, or lack thereof... barring some unexpected bank spin off, or an unbelievable rate increases down the road, that is not what we see and focus on with HE. Wall Street sees HE growing stronger than most utilities in 2006, but this is due to what should be easy year-over-year comparisons.

	Quarters Ended			Years Ended	
	3Q05	2Q05	1Q05	2004	2003
Interest Coverage					
HE	1.974	1.442	1.279	1.421	1.648
MAM	-2.676	-2.550	4.187	1.248	9.291
GXP	5.053	1.169	1.131	2.158	1.490
DUK	0.170	1.034	2.962	1.098	-0.970
POM	3.886	0.670	1.601	0.692	0.308
CV	1.164	0.959	-1.449	2.372	1.585
Return on Equity					
HE	3.09%	2.27%	2.04%	9.06%	10.48%
MAM	-1.95%	-1.66%	2.55%	2.74%	5.97%
GXP	4.18%	1.08%	1.80%	16.38%	14.77%
DUK	0.24%	1.87%	5.27%	8.94%	-9.64%
POM	7.57%	1.63%	4.01%	7.68%	3.70%
CV	1.18%	0.89%	-2.07%	9.76%	8.48%
Payout Ratio					
HE	66.90%	90.89%	104.03%	85.60%	65.79%
MAM	-44.17%	-51.25%	32.03%	139.15%	104.45%
GXP	102.47%	141.45%	158.26%	67.43%	81.33%
DUK	219.28%	147.47%	157.34%	188.44%	257.90%
POM	58.90%	85.95%	35.23%	69.11%	154.45%
CV	115.67%	158.01%	-61.47%	52.05%	62.57%
Current Stats	Div (%)	EPS in 06	EPS next 5-years	P/B	
HE	4.7%	13.7%	4.0%	1.73	
MAM	6.5%	na	na	0.54	
GXP	5.9%	-9.8%	3.0%	1.69	
DUK	4.5%	7.3%	5.0%	1.60	
POM	4.4%	5.3%	4.0%	1.17	
CV	5.1%	na	na	1.03	

Investment Opinion and Conclusions

A 4.7% dividend yield, \$28 price target, and the potential to write covered calls on share price strength. These are the three points that we have settled upon on the basis of our research into HE.

One point we cannot settle on, and everyone else is having fits trying to forecast today, is the US dollar/interest rate picture. Our long-term stance for a weakening US dollar remains intact, and this is one reason not to be heavily involved in a company like HE, or most other American companies for that matter. Having said that, exactly what currency the investor should favor instead of USD (beyond a position in precious metals) it is difficult to say. For example, the Loonie (CND \$) has risen to a point wherein many exporters are seriously feeling the pinch, and Canada is very dependant on exports to the US. The case could be made that a softer US economy and US dollar is not all that bullish for the Loonie...

As for US interest rates, with the yield curve inverting to end 2005 the odds are increasing that the current tightening cycle is near its end. Generally speaking this could bode well for stable dividend paying companies like HE, although there can be no guarantee that investors will not flee all stocks if a recession or bear market arrives.

In short, forecasting dividend/interest rate gaps is not an exact science; spreads/gaps depend solely upon what individual investors are willing to pay for risky stocks versus safe bonds.

Not exactly without risk, HE is our dividend selection for 2006.

Sincerely,

Brady Willett

Todd Alway