Our Outlook for Utilities Stocks

Utilities look increasingly attractive going into critical summer months.

By Travis Miller, Senior Stock Analyst

- Valuations for power producers still ignore any rebound in power demand beyond 2012.

- Big fish likely will continue trolling the mergers and acquisitions market for small fish that need cash or an exit strategy.

- First-half demand showed some meager improvements from a dreadful 2009. The third quarter will determine whether demand breaks its two-year slide.

The first half of 2010 featured the most deal making in the utility industry since 2007 when the economy turned. With three major merger announcements, several other smaller acquisitions, legislative bargaining, tense rate negotiations in many states, more commodity price volatility, tritium leaks, nuclear loan guarantees, and a lot of weather watching, we think the fun has only started.

Where does that leave utility investors? Well positioned, we think. Utilities outperformed the market in the fourth quarter of 2009, underperformed in the first quarter of 2010, and beat the market by 6% in the second quarter. Average utility dividend yields are still close to 5%. Although we think this leaves the sector mostly fairly valued, we do see areas of opportunity. Loosening capital markets and a recovering economy should give utilities more accessible avenues to earnings growth. Headwinds such as rising interest rates and higher dividend tax rates increasingly are priced into valuations.

For the power producers, margins widened significantly in the second quarter as natural gas prices climbed 30% from their low in late March while coal prices climbed just 11% as of June 18. For regulated utilities, we have seen postponed projects put back on the table and state regulators loosening the purse strings, albeit slightly.

Industry-Level Insights

The biggest areas of investor opportunity we see right now in the utility sector are independent power producers and large diversifieds with merchant-generation exposure. Several bullish indicators during the second quarter support our long-term view. Long-anticipated consolidation hit the sector with FirstEnergy's FE $4.7 billion bid for Allegheny Energy AYE in February, Mirant MIR and RRI Energy's RRI $3.0 billion marriage proposal in April, and Calpine's $1.65 billion purchase of Pepco Holdings' POM merchant-generation unit in April. Capacity prices in the mid-Atlantic region for 2013-14 surpassed expectations. And heat rates expanded in some critical regions. We think investors can find value among the low-cost, well-positioned merchant-generation owners such as Exelon EXC, NRG Energy NRG, Mirant, RRI Energy, and FirstEnergy.

Not to be outdone, the mostly regulated utilities had their share of excitement in the second quarter. After hunkering down to survive the capital market shutdown and an unprecedented 5% decline in demand since 2007, the first-half of 2010 marked an operational comeback. Investors should start to see the earnings flow in the second half from the groundwork that was laid. We saw Dominion D, Public Service Enterprise Group PEG, and PPL PPL make key strategic shifts to dilute their merchant-generation exposure in favor of high-return infrastructure growth opportunities in their regulated segments. We expect these earnings-accretive moves could stabilize profits and support dividend growth through 2012.

For more traditional regulated utilities, we saw more constructive regulatory activity that we think prepares several utilities for a breakout second-half of earnings growth. We await several more critical rate filings and negotiations this year from Southern Company SO, Exelon, Constellation Energy CEG, ConEd ED, CMS Energy CMS, and Portland General Electric POR. Normal (warmer) weather in the Midwest, mid-Atlantic, and Northeast and regulatory rate hikes should help earnings for Westar Energy WR, Northeast Utilities NU, and American Electric Power AEP among others. Southeast giants Southern Company and Entergy ETR continue to benefit from recovering industrial demand, up 4% year over year in the first three months of 2010.

We think most regulated utilities in our coverage universe are fairly valued right now. Still-attractive dividend yields and improving growth outlooks offset our view that interest rates will be higher by the end of our three- to five-year investment period. The only fully regulated utilities in our coverage universe that we think are more than 10% undervalued as of June 21 are Westar Energy, National Grid NGG, and Portland General. All these firms feature dividend yields above 5% and strong earnings-growth potential from projects such as environmental controls, new generation, and transmission lines with favorable cash-flow profiles.

Our Top Utilities Picks

Although we have only two 5-star utilities in our coverage universe as of June 21 (Exelon and FirstEnergy), we think several more high-quality utilities are worth watching closely. On a market-capitalization-weighted basis, the average sector price/fair value ratio is 0.90; however several large diversified utilities skew this average lower.

The median price/fair value ratio for the sector is 1.02 at the end of the second quarter, down 3% from the sector median at the end of the first quarter. This reflects our view that the smaller, fully regulated utilities could underperform the large diversified utilities and IPPs in the next few years.

The utilities and IPPs we highlight below feature high-quality assets, strong management teams, and good earnings growth prospects. For the 3- and 4-star picks, we think investors should demand wider margins of safety given their substantial leverage to uncertain future power market conditions and demand recovery. Here are our top utility picks:

Top Utilities Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Dividend Yield (%)
Exelon	★★★★★	73.00	Wide	Medium	5.10
NRG Energy	★★★★	37.00	None	High	NA
National Grid	★★★★	46.00	Narrow	Medium	7.20
Westar Energy	★★★★	27.00	Narrow	Medium	5.40
Southern Company	★★★	36.00	Narrow	Low	5.30

Data as of 6-21-10.

Exelon EXC

Operating leverage at its large nuclear fleet is the name of the game at this wide-moat utility, the only one in our coverage universe. Despite today's weak power prices, we believe Exelon's long-term fundamentals remain intact. With an enterprise value that is just 6.4 times our trough 2011 earnings before interest, taxes, depreciation, and amortization estimate, we think the market is ignoring this upside. We are most focused on the company's ability to hedge in favorable economics for 2012-13. A rebound in Midwest industrial power demand, higher gas prices, and normal summer weather would help. A 10% move in 2012 power prices from today's levels can translate into $800 million of incremental EBITDA. Carbon caps could add another $900 million of incremental EBITDA and account for $6 per share in our fair value estimate. Management's long-standing commitment to creating shareholder value through stock repurchases and dividend hikes along with $2.5 billion of cash as of March 31 give us additional comfort.

NRG Energy NRG

We think NRG is an excellent pick for investors looking for a high-quality management team and good asset profile to benefit from an improving U.S. economy and rising power demand. Margin contraction from less favorable commodity markets could slow earnings growth in 2011 and 2012, but NRG is preserving its optionlike upside for what we think will be a more favorable commodity cycle in 2013 and beyond. Its power plants in Texas, California, and the Northeast are located in supply-constrained markets that should benefit the most from an economic rebound. Even though it has a large fleet of coal-fired power plants, we think it should be able to sustain strong margins even with the threat of carbon-emissions restrictions looming. Its $1.8 billion of cash as of March 31 and timely Reliant marketing acquisition in 2009 should provide an equity cushion.

National Grid NGG

This U.K.-based regulated utility specializes in owning, operating, and building transmission on both sides of the Atlantic. With that expertise and its large service territory footprint, National Grid should benefit more than most other utilities as regulators and politicians force utilities to shift away from fossil fuels and toward renewables in the U.K. and U.S. Northeast. Building high-return transmission grids in both countries should drive strong earnings growth while favorable regulated rate structures protect those earnings from inflation through automatic adjustments. With a dividend yield near 6% and management's 8% dividend-growth target through 2012, we think National Grid is one of the most attractive regulated utility investments still available. We expect the annual fiscal 2010 dividend to climb to GBX 38 per share ($2.95 per ADR share) with the June 2010 final payment.

Westar Energy WR

After suffering its coolest summer in 40 years in 2009, we think this fully regulated Kansas utility has some impressive earnings growth stored up for 2010 and 2011. We expect earnings to rebound some 35% in 2010 if summer weather returns to normal and industrial demand starts to pick up again. Beyond 2010, earnings growth from regulated investments in clean coal and renewables-related transmission should flow directly to shareholders through the company's favorable regulated-rate structures. Of its three-year $1.5 billion investment plan through 2012, $1.1 billion will be spent on projects that have preapproved annual-cost-recovery rate structures or are flexible enough to postpone if market conditions remain unfavorable. A current 5.5% dividend yield is well above the industry average.

Southern Company SO

Southern's total-return proposition is among the more appealing in our coverage universe, especially for patient investors. The current 5% dividend yield still tops parent-company debt yields, a bullish indicator for equity returns. Although economic growth in its service territories remains uncertain, the primary driver of our 5% earnings growth forecast through 2012 is an enviable investment program revolving around environmental upgrades, a new nuclear plant, and transmission and distribution investments, much of which closes to rates annually based on constructive regulatory mechanisms. This minimizes lag, protects equity returns, and justifies our premium 14 times 2011 earnings multiples at our fair value estimate. Southern's Georgia rate request in 2010 will be a key.

Travis Miller does not own shares in any of the securities mentioned above.