Our Outlook for Utilities Stocks

Falling demand, rising interest rates, and inflation could crimp utilities.

By Travis Miller, Senior Equity Analyst

If bad things come in threes, then utilities could be about to experience what they fear most: rising interest rates, falling power demand, and imminent inflation. So far, we've seen all but inflation, and it's enough to make us increasingly bearish on the industry going into the critical summer season.

The current macroeconomic environment is particularly worrisome for fully regulated utilities with relatively fixed customer rates based on historic cost structures. Rising interest rates lift borrowing costs in an industry that is the second-largest corporate borrower behind the financial sector. Rising rates also make equity investments less attractive, raising costs for companies that must issue equity to fund new projects.

Falling power demand typically means falling gross margins for regulated utilities and lower power prices for merchant power producers. The latest industry figures show electricity usage is down 4% year over year through mid-June. Industrial usage is down about 10%, with near-20% declines in some manufacturing-heavy regions. Lower demand on top of collapsed commodity prices have sent power prices to multiyear lows, down more than 50% from peaks in mid-2008. Given utilities' relatively fixed cost structure, falling gross margins can have a leveraged effect on the bottom line.

Inflation—or even the perception of future inflation—raises the cost of replacing, maintaining, and expanding utility infrastructure. If inflation rises more rapidly than regulated rates can adjust, utility investors suffer diminished returns. Many utilities struggled with this in 2007 and early 2008 as commodity prices spiked and rates lagged. We fear a repeat of this scenario could be coming based on accommodative monetary measures worldwide and the steep contango in most commodity markets.

Put these three effects together and near-term returns could plummet for those utilities in slow-moving regulatory environments, or whose earnings are demand-sensitive. Even in jurisdictions with more progressive ratemaking, most regulated utilities will not be able to escape all three effects. Unhedged and high-cost merchant generators could suffer a rough 2009.

As if the macroeconomic conditions were not enough for utility investors to worry about, environmental legislation continues to move closer to President Obama's desk. Both the House and Senate have fast-tracked bills that would significantly alter the industry by implementing carbon emissions restrictions, federal renewable portfolio standards, and new transmission regulations. Some of this legislation would impose significant incremental costs on utilities, although for some it could spell opportunity. We continue to analyze the effects this legislation could have on utilities investors.

Valuations by Industry

The median price/fair value estimate for the utilities sector now stands at 0.93, up 21% from March. We consider utilities one of the most expensive sectors (on a price/fair value basis) in our coverage universe. Challenging macroeconomic head winds, balanced against what we think are attractive yield spreads over U.S. Treasuries for many utilities right now, lead us to consider the industry fairly valued on the whole.

Utilities Industry Valuations

Segment	Average Star Rating	Price/Fair Value*	P/FV Three Months Prior	Change (%)
Electric Utilities	3.27	0.94	0.76	23.7
Gas Utilities	3.31	0.91	0.81	16.1
Water Utilities	3	1.06	0.8	32.5
Diversified Utilities	3.57	0.85	NA	NA

Data as of 06-15-09.
*Market-Weighted Harmonic Mean
**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

Given our bullish outlook for electricity prices in 2010 and beyond, we think diversified utilities, which include companies with large merchant exposure, offer more-attractive valuations than more heavily regulated natural gas and water utilities. On a market-weighted basis, we see relatively high certainty around our fair value estimates and give the utility sector a 20.5 fair value uncertainty rating out of 100, with 100 being the most uncertain.

We see a wide range in earnings prospects among electric utilities and diversified utilities. For the more heavily regulated players, macroeconomic head winds lead us to a more bearish view. Only those utilities with progressive regulatory oversight and less demand-sensitive growth opportunities present good investment potential, in our opinion. These include Westar WR, Consolidated Edison ED, and Northeast Utilities NU. Electric transmission investments at these and other utilities remain an attractive source of earnings growth. Like their regulated electricity peers, natural gas and water utilities could suffer from current macroeconomic conditions.

We think earnings will vary widely between independent power producers and other electric utilities with substantial merchant generation portfolios. Results will depend on commodity price movements, the pace and extent of an eventual recovery in demand, and the form and timing of environmental legislation. We remain especially bullish on electric utilities such as Exelon EXC, NRG Energy NRG, Mirant MIR, and Entergy ETR whose margins could widen substantially if natural gas prices rise during the next three years (as we expect they will). As low-carbon emitters, these firms could also benefit from restrictions on greenhouse gas emissions. Other utilities with higher-cost generation assets in less-favorable regions could suffer significant earnings hits this year. We think Edison International EIX, Dynegy DYN, and RRI Energy RRI are among the utilities in this category.

Our Top Utilities Picks

Independent power producers and integrated utilities with low-cost operations and advantageous near-term hedges continue to be in a strong position, in our opinion. That group includes 5-star pick Exelon and 4-star picks NRG Energy and Mirant. Among regulated utilities, we think historically high dividend yields and cash flow growth potential at Westar, Consolidated Edison, Southern Company SO, Northeast Utilities, and NSTAR can provide strong investor returns through this downturn.

Although we believe the long-term fundamentals for the utilities industry are solid, we have assigned a 5-star rating to only three of the firms we cover. As the economy recovers, however, we could see more-attractive opportunities emerge among some of our top merchant and regulated utilities. As such, we recommend keeping these stocks on your radar screen.

Top Utilities Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Dividend Yield (%)
Exelon	★★★★★	76	Wide	Medium	4.3
Westar	★★★★★	27	Narrow	Medium	6.6
Mirant	★★★★	23	None	High	NA
Consolidated Edison	★★★★	44	Narrow	Medium	6.5
Southern Company	★★★	34	Narrow	Medium	5.8

Data as of 06-17-09.

Exelon EXC

Because of its low-cost nuclear power plants, Exelon is the only utility we cover that has earned a wide-moat rating. Despite a fall in power prices, we believe Exelon's long-term fundamentals remain intact. Management has demonstrated a long-standing commitment to creating shareholder value through stock repurchases and dividend hikes. Exelon hedged substantially all of its power production and fuel costs for 2009 and 2010 prior to the recent collapse in margins, which should lend stability to Exelon's earnings in today's turbulent market.

Westar WR

A stable, constructive regulatory environment in Kansas underpins a 10-year, $3 billion capital investment plan Westar began in 2006. Two thirds of that build-out is either complete or fully approved, and the company is only now beginning to collect the higher returns on those projects. As rates adjust higher in 2009 and 2010, we expect Westar will post industry-leading earnings growth and returns.

Mirant MIR

As an independent power producer in the most volatile markets, Mirant should benefit from rising electricity prices in 2010 and beyond. It remains one of the few power plant owners we cover with a substantial unhedged power sales position in 2010 and 2011 when we think the supply-demand balance in the natural gas markets and an economic recovery will boost power prices.

Consolidated Edison ED

As a regulated "wires and pipes" utility, Con Ed generates dependable earnings and dividends. Aging assets and demand growth in New York City are driving a massive capital investment program at the firm. Over the next three years, Con Ed plans to invest some $7 billion—well above historical levels. Given Con Ed's supportive regulatory environment, we are confident the company will earn an attractive risk-adjusted return well into the future.

Southern Company SO

Southern has garnered envious regulatory relationships by providing comparatively cheap, reliable power to its customers. As a result, the firm enjoys industry-leading allowed returns on equity. Southern's strong earnings growth prospects, rock-solid financial condition, and appealing dividend yield justify its place as a core holding in most income investors' portfolios.

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