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FEATURE

Time to Give Utility Stocks Another Look

After a 10% pullback, utility stocks are looking attractive again, with total return potential of 8% to 9% a year.

By ANDREW BARY
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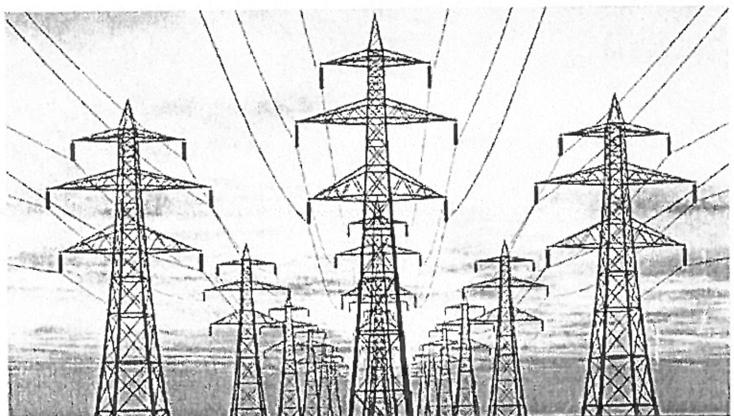
Electric-utility stocks look more appealing after a 10%-plus decline since late January. The selloff comes after a strong 2014 when the group returned 29% and reflects the recent rise in Treasury yields.

Some utility stocks like Duke Energy (ticker: DUK), Southern Co. (SO), and Consolidated Edison (ED) yield more than 4%. Others, like Edison International (EIX), PG&E (PCG), and American Electric Power (AEP) yield less but could produce mid- to high-single-digit growth in earnings per share in coming years.



Power Equation

The eight utilities below feature average dividend yields of 4%. That plus mid-single-digit earnings growth could translate in to average annual returns of 8% or more.

Company / Ticker	Recent Price	12-Mo. Chg	Earnings Per Share 2015E	Earnings Per Share 2016E	P/E 2015E	P/E 2016E	Dividend Yield
Southern Co. / SO	$44.23	-1.4%	$2.84	$2.93	15.6	15.1	4.9%
Consolidated Edison / ED	61.24	6.0	3.91	4.00	15.7	15.3	4.3
Duke Energy / DUK	76.81	4.1	4.68	4.95	16.4	15.5	4.2
American Electric Power / AEP	55.26	3.3	3.53	3.70	15.6	14.9	3.9
Dominion Resources / D	70.93	-1.8	3.69	3.89	19.2	18.3	3.7
PG&E / PCG	51.77	15.8	3.61	3.72	14.3	13.9	3.5
NextEra Energy / NEE	100.60	1.4	5.65	6.08	17.8	16.6	3.1
Edison International / EIX	60.14	5.3	3.58	3.90	16.8	15.4	2.8

Photo: TebNad/iStock

"The relative attraction of utilities has increased in an environment of slower economic growth, when earnings growth is being suppressed by a stronger dollar and energy prices," says Hugh Wynne, a Bernstein utilities analyst. Regulated utilities usually have little overseas exposure and are often insulated from power-price changes. Wynne favors two California utilities, PG&E and Edison International, because of above-average growth and a favorable regulatory environment.

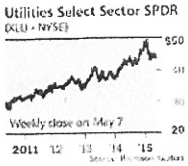
The largest exchange-traded fund in the sector, Utilities Select Sector SPDR (XLU), trades at $44 and yields 3.5%. It's off 12% from its January high of nearly $50. Its top holdings are Duke, NextEra Energy (NEE), and Dominion Resources (D).

UTILITIES AREN'T CHEAP, trading for an average 16.4 times estimated 2015 earnings. However, the sector is at a 5% discount to the Standard & Poor's 500 price/earnings ratio based on projected 2015 earnings, compared with an average premium in the past decade of 4%. And while utility stocks got socked Tuesday, falling 2%, the sector has only about half the market's volatility. The stocks also look good relative to Treasuries and utility debt. The 10-year Treasury yields 2.1%.

"Utilities and the overall market may provide the same total return, but one offers a lower-risk package," says Dan Eggers, a Credit Suisse utility analyst. He sees utilities generating an 8% to 9% annual total return in the next few years, which is in line with the historical return of the S&P 500, with less volatility. He's partial to American Electric Power, NextEra, and PG&E.

One utility fan is Berkshire Hathaway (BRK.A) CEO Warren Buffett. Berkshire owns utilities in the Midwest and West Coast and wants more. Buffett likes the ability to earn a decent, predictable return of about 10% on new capital committed to infrastructure.

ETF/Ticker	Recent Price	12-Mo. Chg	Dividend Yield
Utilities Select Sector SPDR / XLU	$43.72	[illegible]	3.5%



Many view utilities as a no-growth business given little change in U.S. electricity consumption in recent years. However, earnings growth has averaged 4% annually in the past decade and profits could grow at a similar rate in coming years as utilities upgrade or replace aging transmission lines and power plants. Much of the U.S. utility infrastructure is more than 40 years old.

Edison International, for instance, is replacing 35,000 utility poles every year for $300 million, but even at that rate, it may take it 40 years to replace them all. Utilities have sought to mitigate rate increases with cost-control efforts. And with electric utility bills averaging about $100 a month, or less than 2% of household disposable income, there hasn't been a lot of consumer backlash against rate increases given that many American families spend more on cellphones or cable TV.

Eggers sees PG&E ramping up its dividend over the next few years now that it appears to have dealt with financial penalties from a fatal natural-gas explosion at San Bruno in 2010. PG&E's dividend payout rate is 50% based on estimated 2015 earnings, below the group average of 65%. PG&E, at $52, also trades at a discount to the group at 14 times estimated 2015 profit. Edison International, at $60, has one of the lowest dividend yields among top utilities, at 2.8%. But its payout could rise at a double-digit rate in coming years, powered by annual earnings gains of 7% or higher. Historically, high-growth, lower-yielding utilities have generated better total returns than low-growth, higher-yielding ones.

American Electric Power, the big Midwestern utility, has refocused on its regulated business. At $55, it offers a nearly 4% dividend yield and could hike the payout by 5% annually in coming years. NextEra, the former Florida Power & Light, has a business mix that's 60% regulated and 40% wholesale generation, with much of that contracted renewable power. It yields 3.1% and is expected to produce earnings growth of 5% to 8% annually. Southern Co. has one of the highest yields in the group at 4.9%. That reflects a weak earnings outlook, huge cost overruns at a coal-gasification plant in Mississippi, and risk involving two nuclear plants under construction in Georgia.

Consolidated Edison, at $61, has lagged behind the group, and offers a 4.3% yield. It's spending as much as New York regulators will permit to upgrade its transmission infrastructure.

There is concern that the growing use of home solar panels will cut into power demand and hurt industry economics. Yet home-generated solar is still under 1% of total power generation nationwide, and the cost of moving off the grid for a single-family home runs tens of thousands of dollars. Utilities are also resisting regulation that benefits homeowners with solar at the expense of other customers.

Electric utilities are underappreciated, with above-average yields and better growth prospects than most investors believe.

E-mail: editors@barrons.com