JANUARY 9 • 2016 ONLINE EDITION

Forbes

INVESTING

Will Utilities Stocks Recharge After A Dim 2015?

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The benefits of freefalling oil and gas prices have failed to ignite one of their biggest consumers — the utilities sector. Utilities stocks posted dim returns in 2015. They lost nearly 5%, underperforming the stock market's 1.3% uptick last year.

Jay Rhame illuminates what investors need to know about investing in utilities in the new year. Rhame is a vice president of Jersey City, N.J.-based Reaves Asset Management with $2.6 billion in assets under management. He also serves as co-portfolio manager of Reaves Utilities exchange-traded fund (UTES).

Ho: The Utilities Select Sector SPDR ETF (XLU) fell 4.9% last year while the SPDR S&P 500 ETF (SPY) gained 1.3%. What's your explanation for the utilities sector's underperformance?

Rhame: I believe the utilities sector underperformed in 2015 because of concerns that the Federal Reserve would start to increase interest rates. Utilities are one of the highest-yielding sectors on the stock market and underperformance is typical leading into interest rate increases. In the six rate-hike cycles since 1980, utilities have underperformed the S&P 500 Index by an average of 10.3% in the six months before a Fed tightening.

Also, utilities stocks outperformed the S&P 500 Index by a wide margin in 2014 and especially in the fourth quarter of 2014. Utilities, on average, entered 2015 at a high valuation so some of the underperformance in the last year was working off that premium valuation.

Historic Performance of Five Largest Utilities ETFs

Name	Ticker	% Total Return12 Month	% Total Return 5 Year	% Total Return 10 Year	% Total Return 15 Year
First Trust Utilities AlphaDEX® ETF	FXU	-8.28	8.89		
iShares Global Utilities	JXI	-7.85	3.42		
iShares US Utilities	IDU	-6.44	10.47	6.78	5.64
Vanguard Utilities ETF	VPU	-6.37	10.61	7.17	
Utilities Select Sector SPDR® ETF	XLU	-6.2	10.58	6.88	5.88
Source: Morningstar					

2016 Outlook

Ho: What's your outlook for the utilities sector in 2016? What are your earnings and sales growth projections? What will catalyze sales and earnings growth?

Rhame: In the 12 months following the start of a Fed rate-hike cycle, utilities have historically outperformed the S&P 500 index by 6.7% on average. However, rising interest rates do not matter to utilities as much as one would expect. Pension expense declines when interest rates go up because of more favorable actuarial assumptions. This decline in pension expense offsets much of the higher interest rates. As investors realize the impact of higher rates is less than expected, stock prices historically have recovered most of the previous underperformance.

The typically regulated utility should be able to grow earnings 4% to 6% in 2016, which, when combined with a 4% dividend yield, makes for a compelling 8% to 10% total return expectation. A utility earns a return on its investment base, so earnings grow as the investment base grows.

For example, if a utility makes a $100 million investment, a regulator would require it to be financed with approximately 50% debt and 50% equity and then it would give the company a return on equity invested. If the allowed return on equity is about 10%, then the utility would have made around a $50 million equity investment and produced $5 million in net income. On this basis, essentially every $100 million investment grows net income by $5 million.

Opportunities to grow investment base are not unlimited, though. First and foremost, a utility must weigh how increased rates hurt customers. The most important job a utility has, besides safety, is to cut costs and deliver the savings to customers to offset the increased rates from a higher investment base. Currently, the best opportunities to do this comes from replacing coal power plants with natural gas, wind and solar.

To comply with the proposed carbon reduction rules under the Clean Power Plan, electric utilities will have to shut down a significant amount of coal generation and replace it with natural gas, wind and solar. Building new electric generation is always a great way to grow investment base, but importantly, natural gas, wind and solar power plants have significantly lower expenses than a coal plant.

A natural gas plant needs only 10% of the workforce to operate compared to a coal plant while wind and solar plants require even less. The result is that despite the investment base growing dramatically, costs to customers only rise a little. The most successful utilities limit customer bill increases to 3% or less per year and reduces expenses by switching from coal to natural gas. Renewable energy is one of the biggest ways companies will achieve this.

Ho: What are utility firms doing to drive shareholder value? To what extent are they buying back shares? Increasing dividends? Taking on mergers and acquisitions? What other measures are they taking to increase earnings?

Rhame: Shareholder value in utilities is predominantly driven by paying a dividend and growing that dividend consistently over time. Annual increases create steps of value, which reward shareholders. Paying a dividend is important. Utilities outspend cash flow annually, so they constantly need to borrow money. Rewarding shareholders with annual dividend increases encourages confidence in management and the future of the company. Buybacks, on the other hand, are rare in the industry because most companies outspend cash flow.

Mergers and acquisitions will continue to be a major driver. ITC (ITC) recently announced it was undergoing a strategic review with one of the options being a sale. Duke (DUK), Southern (SO) and Exelon (EXC), three of the biggest companies in the industry, will finalize acquisitions and could be back in the market. Smaller gas utilities have a lot of potential growth with pipeline replacement programs and are attractive acquisition candidates.

Low Valuations

Ho: How are the utilities sector's current valuations relative to the S&P 500 and their historical averages?

Rhame: The utilities sector price-to-earnings ratio, relative to the S&P 500 Index, is slightly below the average of the last 10 years though this is somewhat misleading. Utilities today are in much better financial shape than 10 years ago and deserve a higher valuation than average. Most states now offer programs that provide immediate returns on investment.

Typically, a utility has to go through a fully litigated process to begin earning a return on a new investment. This process can take a year or more. Allowing for immediate returns reduces lag and makes the companies much stronger. This was the biggest reason Moody's Investor Service upgraded the whole sector in January 2014. Furthermore, compliance with the Clean Power Plan will ensure utilities have a decade or more of investment opportunities. The backlog of investment opportunities in the utility world is typically much shorter.

Valuations and Fundamentals of Five Largest Utilities ETFs

Name	Ticker	$mil Fund Size Total Assets	% Expense Ratio	Price/ BookTTM	Price/ Earnings Forward	Price/ Sales	% Proj EPS Growth5 Year	% Dividend Yield TTM
First Trust Utilities AlphaDEX® ETF	FXU	137.98	0.66	1.32	15.86	1.02	6.2	3.9
iShares Global Utilities	JXI	156.72	0.47	1.47	14.81	0.93	5.33	3.76
iShares US Utilities	IDU	585.26	0.43	1.58	16.16	1.48	5.05	4.22
Vanguard Utilities ETF	VPU	1,662.13	0.1	1.55	16.78	1.44	5.22	3.63
Utilities Select Sector SPDR® ETF	XLU	5,796.43	0.14	1.53	15.82	1.47	4.63	3.67
Source: Morningstar								

Best Utilities Stocks

Ho: What are your favorite utilities companies right now and why? What catalysts will potentially make them outperform?

Rhame: Two utility companies I like right now are NextEra Energy Resources (NEE) and American Water Works (AWK). NextEra (NEE) is the operator of Florida Power and Light in Southern Florida and is the country's biggest generator of wind power. In Florida, the utility has higher population growth than most of its peers and enjoys constructive regulation.

The Florida Public Service Commission recently approved the construction of a $1.3 billion, 1633-megawatt natural gas power plant to serve its growing population. I believe that the approval of this plant is both a source of growth for NextEra and a sign that it enjoys a good relationship with its regulator.

On the wind generation side, the extension of the Production Tax Credit in the recent federal budget negotiations is a tremendous positive for renewal energy development. The tax credit helps to ease financing and make wind power more economic. Wind generation is already competitive with conventional forms of electricity in the windiest parts of the United States.

This tax credit extension plus continued cost declines should result in even higher demand for wind energy, which could lead to a significant amount of wind generation opportunities for NextEra.

American Water Works (AWK) is a water and wastewater utility that operates in 12 states. It grows by replacing old water pipelines. The good news (or bad news depending on your perspective) is that the water pipeline system in the United States is in such poor shape that trillions of dollars of investment are needed in order to comply with safety, health, and environmental standards.

Trillions of gallons of treated water flowing through the pipeline system ends up leaking into the ground before it reaches the end user. This is an unacceptable situation, especially with the record droughts we have had over the past few years. Most water systems are municipally owned, and they have ignored needed investment for years.

American Water has been doing an impressive job with its system, though, complying with all health standards and reducing leaks by about 25% compared to the average. But it still has a decade's worth of replacement work to do. The opportunity exists for American Water not only to grow its investment base by replacing old pipe but also by purchasing municipal water systems and performing repair work much more efficiently. The result is that American Water could be the fastest growing regulated utility in the industry over the next several years, potentially growing its earnings and dividends up to 10% per year.

Investment Risks

Ho: What risks must investors consider with the utilities sector?

Rhame: First, an investor must consider regulatory risk. Each state has its own regulatory authority, each region has power purchase rules, and each utility is also regulated by the federal government. As an example, a utility in New Jersey is much different than one in California because the local politics shape what kinds of investments and service that utility will provide.

Returns are very different across the country. Secondly, investors should be aware of the types of utilities they own. Several utilities produce and sell electricity at a market price that adds commodity risk to an otherwise commodity-free exposure.

Ky Trang Ho is the founder of Key Financial Media LLC, which produces content and thought leadership for financial advisors and investment strategists.

Contributor Bio: I cover investing strategies and trends in ETFs and mutual funds. I strive to give readers actionable information to make smart investment decisions with exchange traded funds and mutual funds with consideration to the risks involved. I am the founder of Key Financial Media LLC, which produces content and thought leadership for financial advisors and investment strategists. My work has been published in Institutional Investor, FA Mag, Think Advisor, Plan Sponsor, The Street and other leading financial news sites. Before starting my own firm, I covered stocks, ETFs, mutual funds, economics and personal finance at Investor's Business Daily for more than eight years.