



**Under the Hood: What’s in *Your* Index?**

(An Ongoing Series – May 2016)

**Part 1: Why Utility Stocks Should Concern Income-Oriented Investors**

Utilities stocks have become increasingly popular among many asset allocators, particularly those that make use of ETFs. It is not difficult to understand why these model portfolio builders have such an affection for utility ETFs, given the zero interest rate policy of the Federal Reserve since 2009. Many utilities, most of which are permitted monopolies, currently yield 3%-4%, which is far in excess of the 1.78% yield on 10-year U.S. government paper. Seems like a reasonable trade, right?

Yet, most owners of these securities (and ETFs) seem entirely unaware – or simply ignore – the valuation and earnings risks. Take the example of Southern Company (NYSE:SO - \$45 billion market cap), one of the largest utilities in the U.S. It currently trades at 17.9x the 2016 consensus profit estimate. This is not an enormous premium to the S&P 500 Index nor to the company’s historic average of 16.3x. So where is the risk?

Southern Co. Historical P/E Ratio					
Year	P/E		Year	P/E	
2015	18.1x		2008	16.4x	
2014	22.5x		2007	17.0x	
2013	22.0x		2006	17.6x	
2012	16.0x		2005	16.2x	
2011	18.2x		2004	16.3x	
2010	16.2x		2003	15.0x	
2009	16.2x		2002	15.3x	
			2001	15.7x	
			<i>Avg.</i>	<i>16.3x</i>	

Southern Co. may actually be very expensive because it is not growing. **In the last five years, it reported cumulative earnings per share growth of only 1.6% (\$2.59 vs. \$2.55).** Investors have been persuaded to pay a market premium for little to no earnings expansion.

Importantly, the territorial monopolies these companies were once afforded are at risk due to the increasing adoption of solar power. If, over some period of years, the number of consumers using traditional electric power declines, the utilities will have fewer rate-paying customers to finance the enormous ongoing costs of their infrastructure (and assuming state regulatory agencies do not allow the utilities to dramatically increase electricity rates as a compensation mechanism; on the other hand, that may accelerate the exodus from ‘the grid’).

A comparison, although not perfect, could be drawn to the telecom companies. Competition has permanently



damaged the profitability of this industry, once a monopoly. The established providers, such as AT&T Inc. and Verizon Communications Inc., must continuously finance the upgrade of their distribution systems, while subscriber growth is persistently under pressure. These companies trade at 13.7x and 13.1x, respectively, forward earnings estimates – 30% below the average utility P/E. Investors should carefully consider such factors when searching for income/yield alternatives in the equity market. There are alternatives.

## **Part 2: Utility Stocks – Threats from solar? Concerns over future earnings and dividends?**

Solar power generation is rapidly becoming a disruptive technology. Wall St. recognizes this through the ever-topical lens of solar companies such as SolarCity Corporation, which is of course founded by Elon Musk. This is only one-half of the equation. Wall St. has largely ignored the potential casualties of this disruption: utilities.

According to the U.S. Energy Information Administration, solar now accounts for a still modest 0.6% of total power generation (despite the barrage of negative media and political attention, and the increasing number of bankruptcy filings by coal producers, coal is still the largest source of electricity at 33%). While seemingly insignificant, solar was effectively 0% in 2012 – so the growth rate has been tremendous in just three years. In fact, solar accounted for 15% of all new electricity generation capacity added in 2015, and 20% in 2014. The historical success of the utility industry was based on an annual demand growth of only a few percent; it doesn't take much in the way of demand deficit to reach a negative tipping point. If one cares to look beyond Wall St., insiders of the utility industry are rightly alarmed, and seem to be thinking forward well past the 6-month time horizon of brokerage analysts – and 6 months is probably generous.

In a report issued to the Edison Electric Institute<sup>1</sup>, energy groups have outlined in great detail the risks facing the industry. Chief among those is the potential loss of customers and revenues due to self-power generating solar panels being installed at residences and at commercial sites. Even Wal-Mart has begun using solar panels on its vast store roofs. This begs the question: are the earnings and dividends of utilities at future risk? Moreover, what if interest rates were to rise? (Does anyone believe that U.S. interest rates can remain at effectively zero, permanently?) Higher interest rates would increase the borrowing costs of the utilities, which in turn would cause the utilities to lobby their regulators for customer rate increases to offset the expense. This is not a pleasant scenario. Existing customers would be forced to pay higher electricity rates and subsidize the loss of revenues to solar – making the cost of solar installation even more attractive. It actually could be a viscous cycle.

Therefore, the billions of dollars of assets allocated to utility ETFs for the “safe” 3%-4% dividend could be at great risk. If the historical monopoly is in fact in danger of being dismantled, much in the way airlines and telecommunications suffered decades ago, why would the investor assume such risk? The investor could lose over 25% if the sector were revalued to a 13x (i.e., AT&T and Verizon), and the loss would probably be even worse because the utility earnings would be lower. Collecting a 3% dividend while losing capital at a far higher rate seems nothing other than irrational.

## **Part 3: Utility Stocks – Declining ROE, and Rising Interest Expense Risk**

Most investors appreciate that in a rising interest rate environment the yield demanded by investors from utility stocks rises proportionately. It is less understood, however, that movement away from the current zero interest policy actually could damage the earnings (and dividends) of the utilities. Ordinarily, higher interest rates would not pose a threat to the underlying operations of these companies. The increased interest expense associated

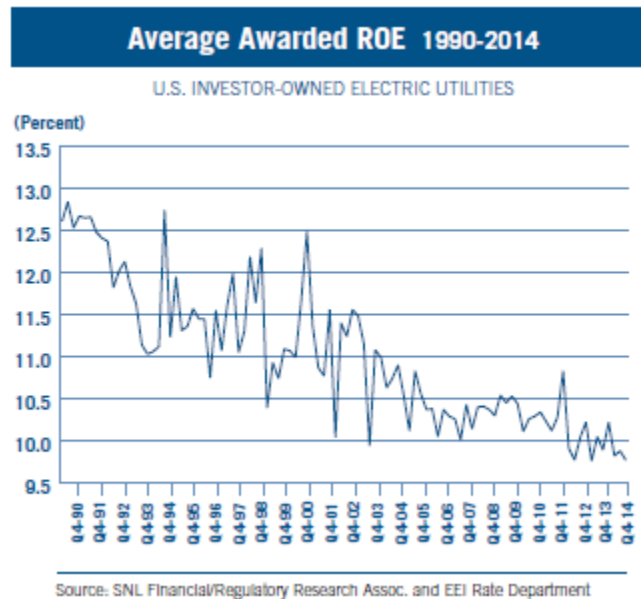
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<sup>1</sup> <http://www.eei.org/ourissues/finance/Documents/disruptivechallenges.pdf>



with the debt that must be issued to finance annual infrastructure improvements would be recovered through the state regulatory process – effectively through a higher permitted ROE.

Conversely, utilities are not really allowed to benefit much from low interest rates, as the savings are passed on to customers. According to the Edison Electric Institute, the allowed industry ROE has declined to approximately 10%, from a prior high of 12.5% in 1990.



The trend shown in this chart is actually very problematic. Conventional wisdom would lead one to believe that the inevitable increase in interest rates and borrowing costs would all but compel state agencies to allow utilities to raise their ROE through higher electricity rates.

However, this historical model does not account for competition, namely solar panel installation (or consumers going off the grid). There likely is a tipping point at which consumers (and politicians) would not allow massive rate increases to subsidize a declining user base.

Here is an interesting – and very mild – example. In 2015, Southern Company (NYSE:SO - \$45 billion market cap) had \$840 million of interest expense, against \$29 billion of total debt, meaning that its average borrowing cost was 2.9%. Assume that this cost was to rise by 100 basis points – to 3.9%, which is certainly not egregious by any standard. The company’s interest expense would expand by \$281 million, leading to a reduction of \$183 million in after-tax profit. This would cause a 7.7% decline in per share earnings (\$2.39 vs. \$2.59). This is only half of the problem. If investors could no longer count on the steadily increasing dividend payments of the utilities, would Southern Co. still trade at the current 17.7x P/E? Most likely not. If the company earned only \$2.39 per share, and were valued at a still generous 15x multiple, the share price would be \$35.85 – a 28% discount to the current price. There is great risk in the current dividend yields/valuation of this industry.



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