

US Electric Utilities & IPPs

Is it Safe to Buy Utilities Yet?

Equities

Americas
Electric Utilities

The short answer: probably not although there are positive signs

With utilities underperforming the broad market -7.8% year-to-date and showing a particularly steep -14.4% since the end of January, it may be reasonable to ask whether we've seen the bottom of relative performance this year. Utilities continue to trade at an elevated 2-year forward P/E of 16.7x vs an average of 14.3x since 2005. However, things don't look as bad on a relative P/E (to the S&P 500) basis, with utilities now trading exactly in-line with the S&P after the recent drop, which also happens to be in-line with the 101% average since 2005. Nevertheless, we would not get aggressive quite yet considering the more historical 25-year average of 82% of the S&P 500 P/E, which was last reached in 2009 during the turmoil of the financial crisis. Prudence would suggest waiting for at least another 5%-10% underperformance before calling a "bottom".

Equities look inexpensive vs the bond market, but caution on rates

Regulated electric utility dividend yields now trade at a mere 79 bps spread to higher yields from Moody's Utility BAA corporates vs pre-recession averages of ~210 bps. On the face of it, a narrowing of the spread suggests that dividend yielding utility stocks could rise as much as 52% to return to pre-recession "normal". However, that's based on today's low interest rates with investors holding back from purchases in anticipation of increases to come. With UBS projecting the 10-year Treasury bond to rise +76 bps through 2016 to 2.95%, the "upside" for utility stocks shrinks to 17%. However, investors appear to anticipate even higher bond yield increases, and we tend to think of this yield spread "upside" as something that merely prevents further significant downside for the moment as investors wait for bond yields to begin rising.

More reason for caution: Authorized ROEs are a lagging factor, heading down

While state regulators use a variety of methods to determine ROEs within customer rates, there has always been a strong correlation to bond (particularly the 10-Yr) and utility dividend yields. However, with about two years of average regulatory lag between higher bond yields and higher authorized ROEs, we anticipate a period of equity underperformance while customer rates catch up to cost of capital. We see this risk as particularly acute for utilities with active cases in '15, including ED, FE, WR, and AEE among several others pending resolution this year. FERC revisions on authorized transmission rates also bear watching to this end as well, albeit are much tracked and anticipated on their detrimental impacts to the likes of ITC.

So who's well positioned among the utility landscape?

If one is to get involved in utilities today, how to do it? We maintain our more constructive view on the smid-cap space, with utility M&A ever evident in the sector. With bond yields particularly cheap relative to equities, we long-term rates anywhere in their current range as particularly accretive to pursuing quasi-leveraged buyouts of faster-growing peers (see our initial smid-bid note from December). We think the smid-cap sector in entirety will continue to outperform with such activity prevalent. While not necessarily takeouts themselves, our top smids of late are TE and DTE. Among large-caps, we maintain our preference for both D and NEE, both cash rich, and well positioned amid the backdrop later this year of a heightened focus on carbon-drive capex opportunities in renewables and gas midstream.

Julien Dumoulin-Smith

Analyst

julien.dumoulin-smith@ubs.com

+1-212-713 9848

Michael Weinstein

Associate Analyst

michael.weinstein@ubs.com

+1-212-713 3182

Paul Zimbardo

Associate Analyst

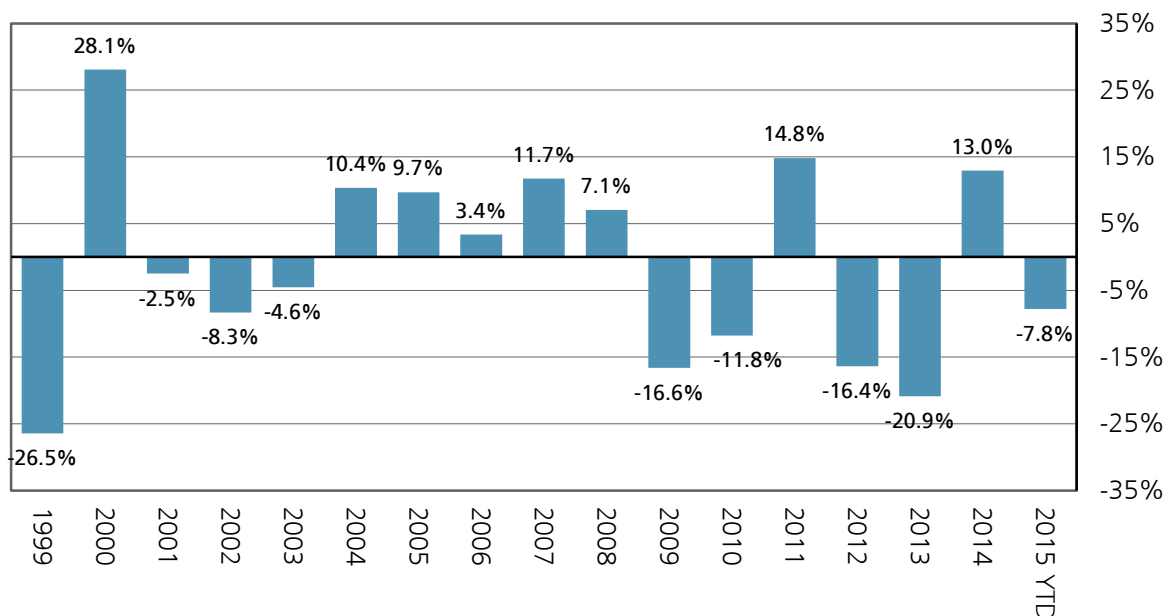
paul.zimbardo@ubs.com

+1-212-713 1033

A bit of perspective; it has been worse

As we illustrate in Figure 1 below, the underperformance we've seen year to date comes on the heels of a fairly strong 2014. Also illustrated below there are significantly higher levels of annual underperformance in most years since the economic recovery began in 2009. Much of the reversal this year can probably be traced to at least three major factors: (1) the Polar Vortex last year significantly boosted sales early in 2014, which was followed by relatively mild summer and expectations for another sales boost this winter. However, while we have indeed seen some cold temperatures this year, sales and revenues have not seen the same magnitude increases that were caused by the Vortex as the Jet Stream brought down a massive lingering deep arctic cold front. (2) the weakness in natural gas pricing has hurt the integrated names too; brought on by higher levels of gas storage inventory as a result of milder temperatures. The global collapse of oil pricing has also had a (lesser) effect on fuel input pricing for the integrated utilities possessing merchant exposure to this theme. (3) The expectation of rising interest rates this year has no doubt played a significant role in underperformance of late.

Figure 1: Annual Relative Performance of Utilities vs S&P 500, 1999-2015 YTD



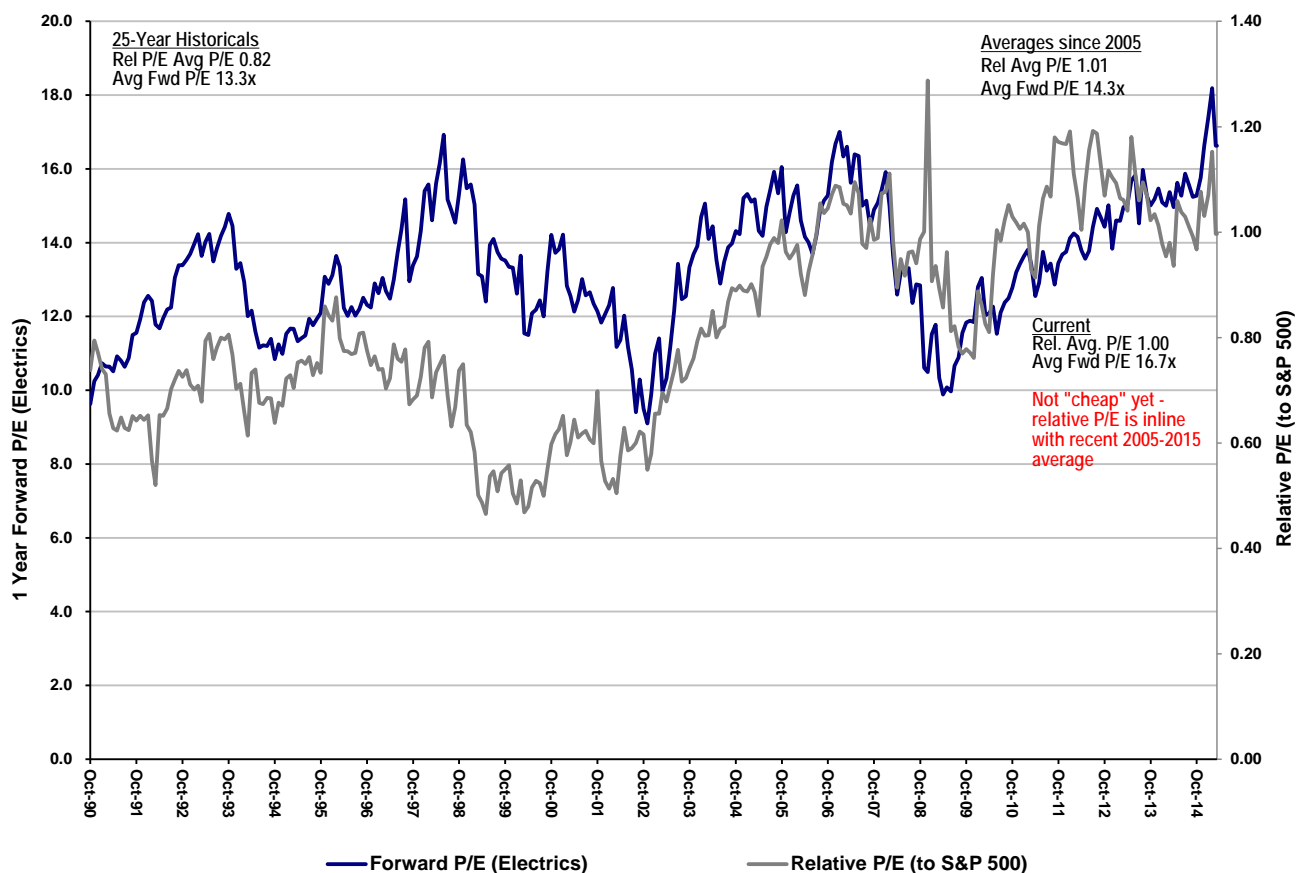
Source: Factset

Utility P/Es are only in-line with the S&P 500 suggesting more downside is possible

Over the past 25 years, utility P/E ratios have averaged about 82% of the S&P 500. This began to change to ~101% in the mid-2000s, when utilities rallied first in response to the Fed's reduction in short term rates from 2000-03 and continued to rally despite rising rates from 2004-07. The relative P/E recently rose as high as 120% in late-January 2015, but has collapsed rather quickly since then to in-line at 100%. As can be seen in Figure 2 below, there is a reasonable basis for continued underperformance of probably 5%-10% more before one could say that utilities are definitively "cheap" vs the broad index (but we're not calling for an imminent

return to historic levels of 82% either). Nevertheless, we see merit to asking the question when 'enough is enough' through the latest downturn.

Figure 2: Utility Forward 2-Yr P/E Ratios Relative to the S&P 500 P/E

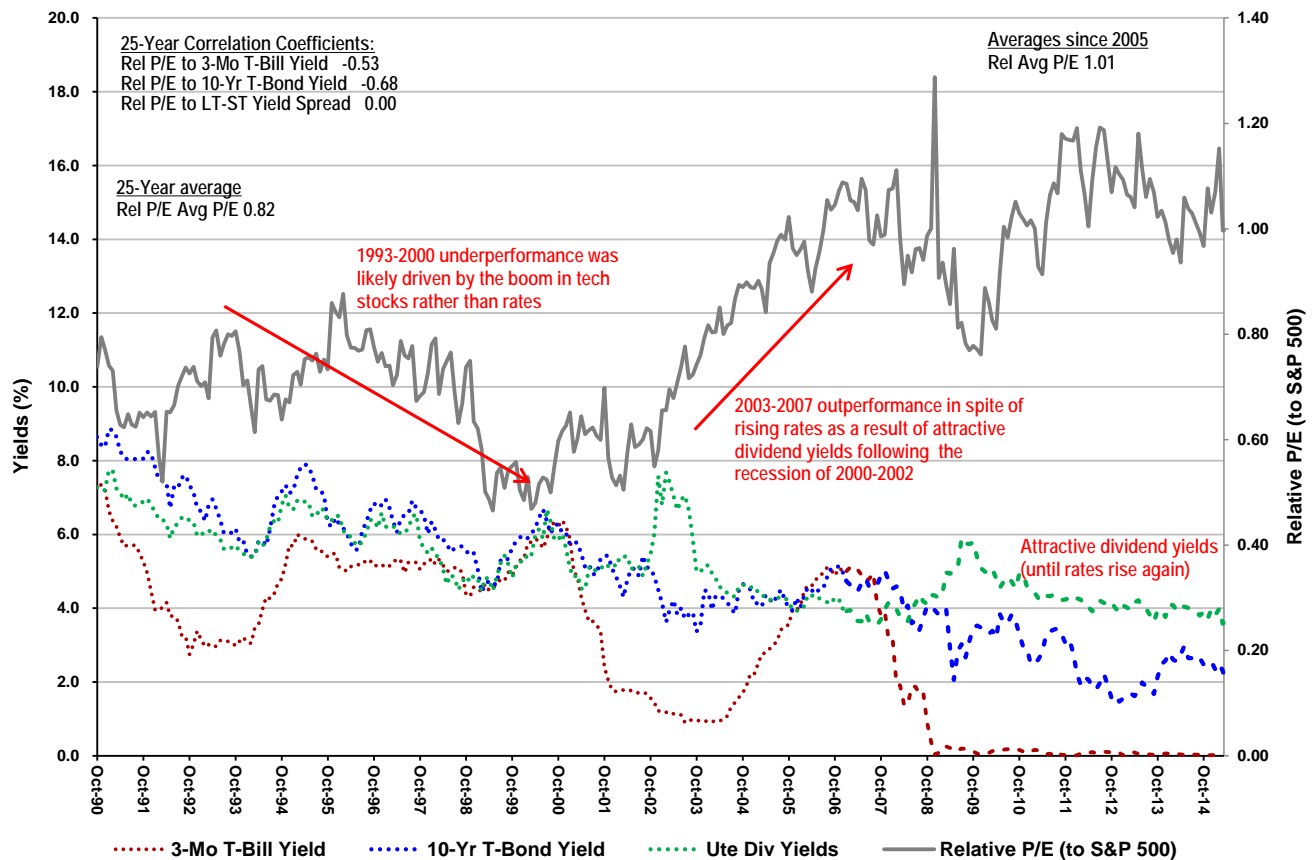


Source: Factset, UBS Estimates

Relative performance is correlated to the 10-Yr but that's not the whole story

In Figure 3 below, we also compare historic 3-Mo T-Bill, 10-Yr Treasury, and utility dividend yields to the relative performance of utilities vs the S&P 500. The strongest statistical correlation (negative) lies with the 10-Yr at -0.68. While one would expect periods of rising rates to result in the underperformance of utilities, this was not the case from 2003-07, probably the result of attractive dividend yields after the 2000-02 stock market correction. With rates near zero since 2008, there haven't been any solid examples of this negative correlative effect in the past 15 years. As we illustrate, perhaps the best example of a "working" negative correlation was back in the mid-1990s. However, even this period is clouded by the strong influence of the boom in technology and growth stocks, which probably had a greater influence on utility underperformance than action by the Fed to raise rates.

Figure 3: Comparison of Relative P/E to Bond and Dividend Yields, 1990-2015



Source: Factset, UBS Estimates

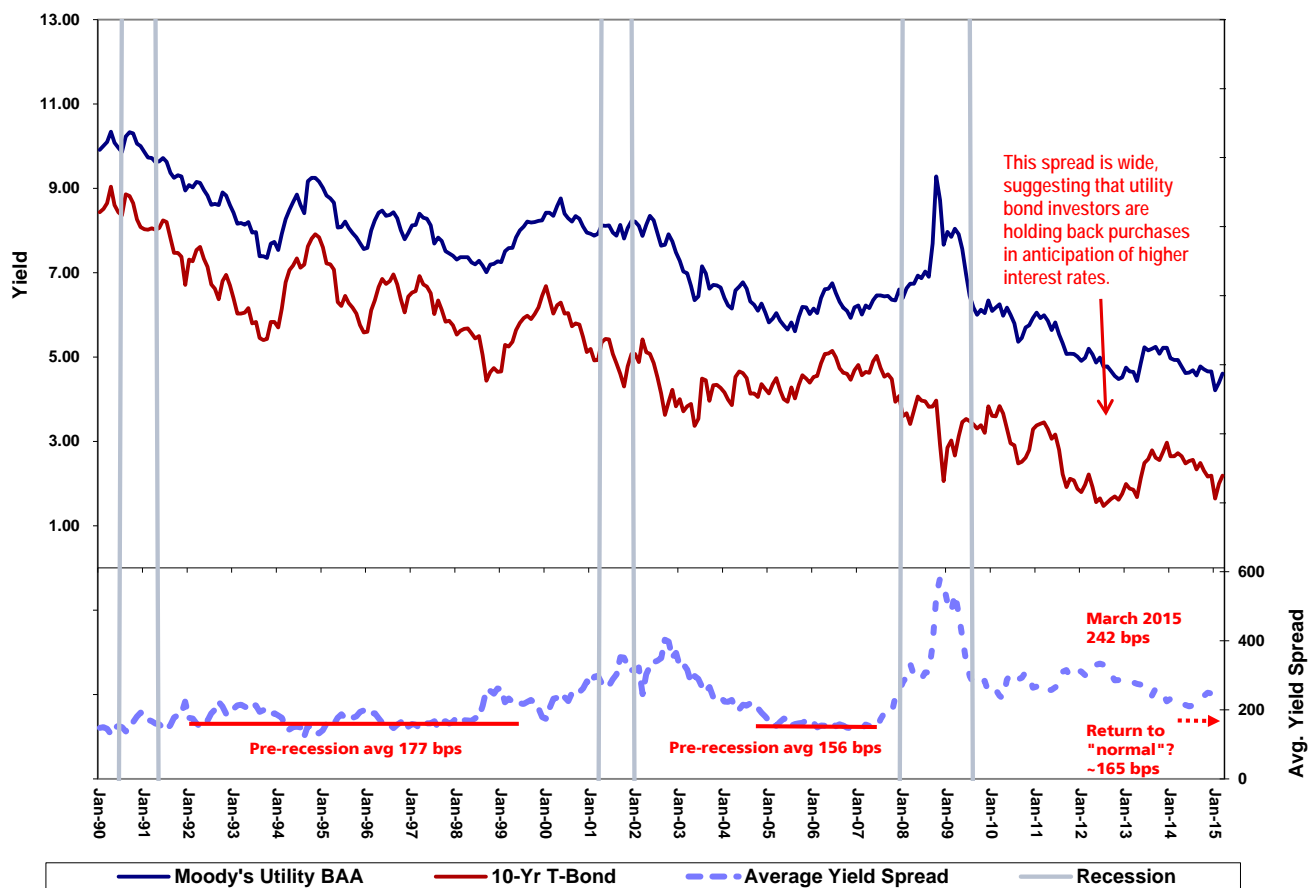
Our take on the apparent attractiveness of utility dividend yields vs the 10-Yr in recent years is that stock investors are anticipating a rise in interest rates (especially considering near zero short-term rates) and are unwilling to "follow" the 10-Yr down any further, widening the spread. Nevertheless, the relative performance of utility stocks vs the S&P 500 is likely being buoyed in these recent years by these widening spreads between dividends and bond yields, with further underperformance of utilities being held in check by relatively high dividend yields. However, as we illustrate below, this check would be lifted by a rise in bond yields.

Further underperformance of utilities stocks is probably being held in check by relatively high dividend yields.

Utility corporate bond spreads are widening vs the 10-Yr...

By our measure, the spread between Moody's Utilities BAA yields and the 10-Yr Treasury has widened by 77 bps to 242 bps vs pre-recession "normal" levels of ~165 bps. This suggests to us that utility bond investors have been increasingly conservative in the face of declining government yields, likely holding back purchases as they assign higher risk premia in anticipation of higher rates to come. It also suggests to us that when the 10-Yr rate begins to rise again, there's about 77 bps of "slack" that need to be taken out of the spread before utility bond yields begin to rise too.

Figure 4: Moody's Utility BAA Yield vs 10-Yr Treasury Yield (Upper) and Spreads (Lower)



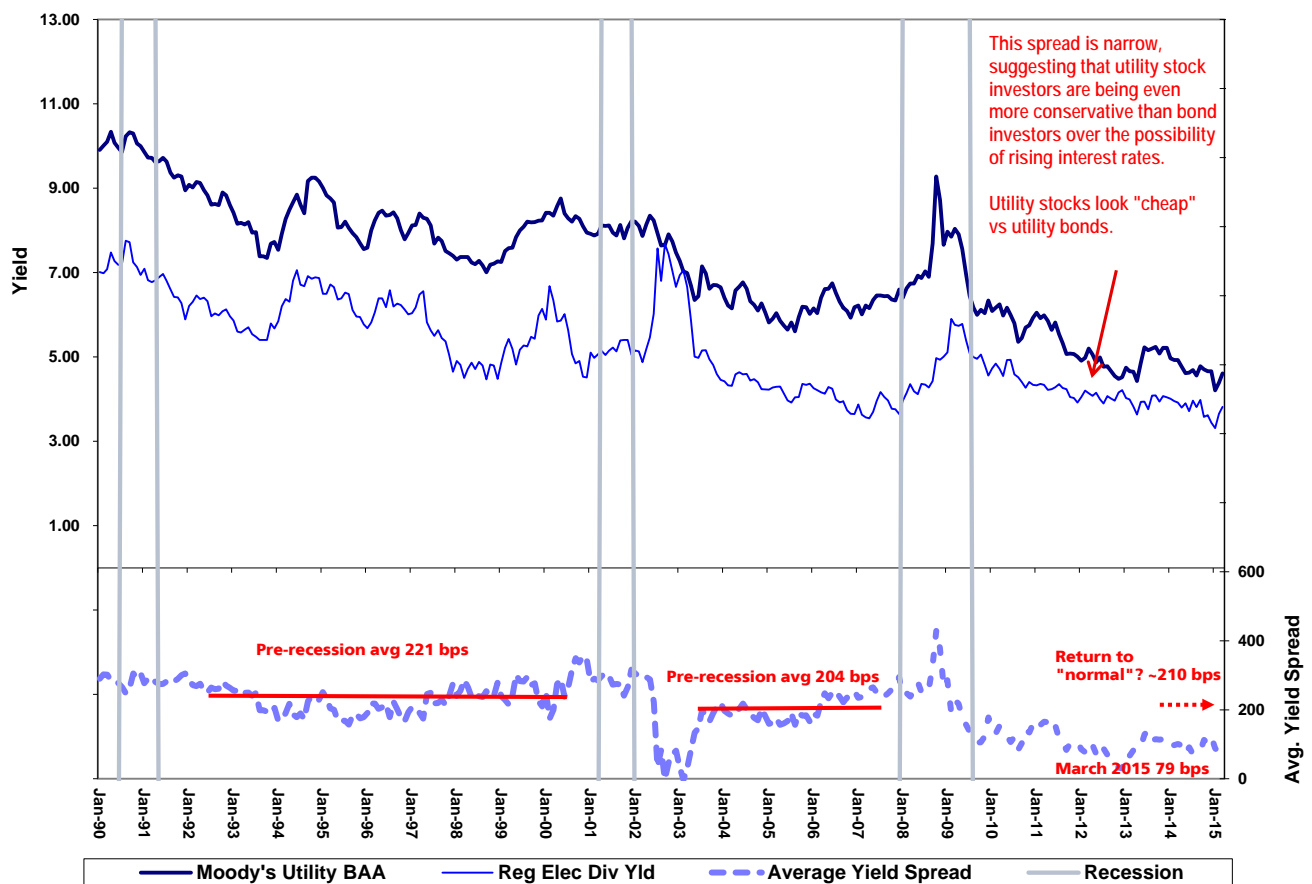
Source: Factset, UBS Estimates

The presence of slack (wideness) in this spread is a positive sign for both utility bonds (and equities) as there may be a built-in "grace period" of 77 bps when the Fed raises rates.

...While div yield spreads are narrowing vs utility bonds

Meanwhile, utility equity investors have been allowing the spread between dividend yields and utility bond yields to narrow, suggesting an even more conservative stance than their fixed income brethren over the possibility of rising rates. This has the effect of making utility stocks look "cheap" when comparing dividend yields to comparable bond yields. By our measure, the spread between Moody's Utilities BAA yields and utility dividend yields has narrowed by -131 bps to a scant 79 bps vs pre-recession "normal" levels of ~210 bps. A return to the 210 bps spread would imply that utility stocks could rise as much as 52% to bring down dividend yields and widen the spread.

Figure 5: Moody's Utility BAA Yield vs Utility Dividend Yields (Upper) and Spreads (Lower)



Source: Factset, UBS Estimates

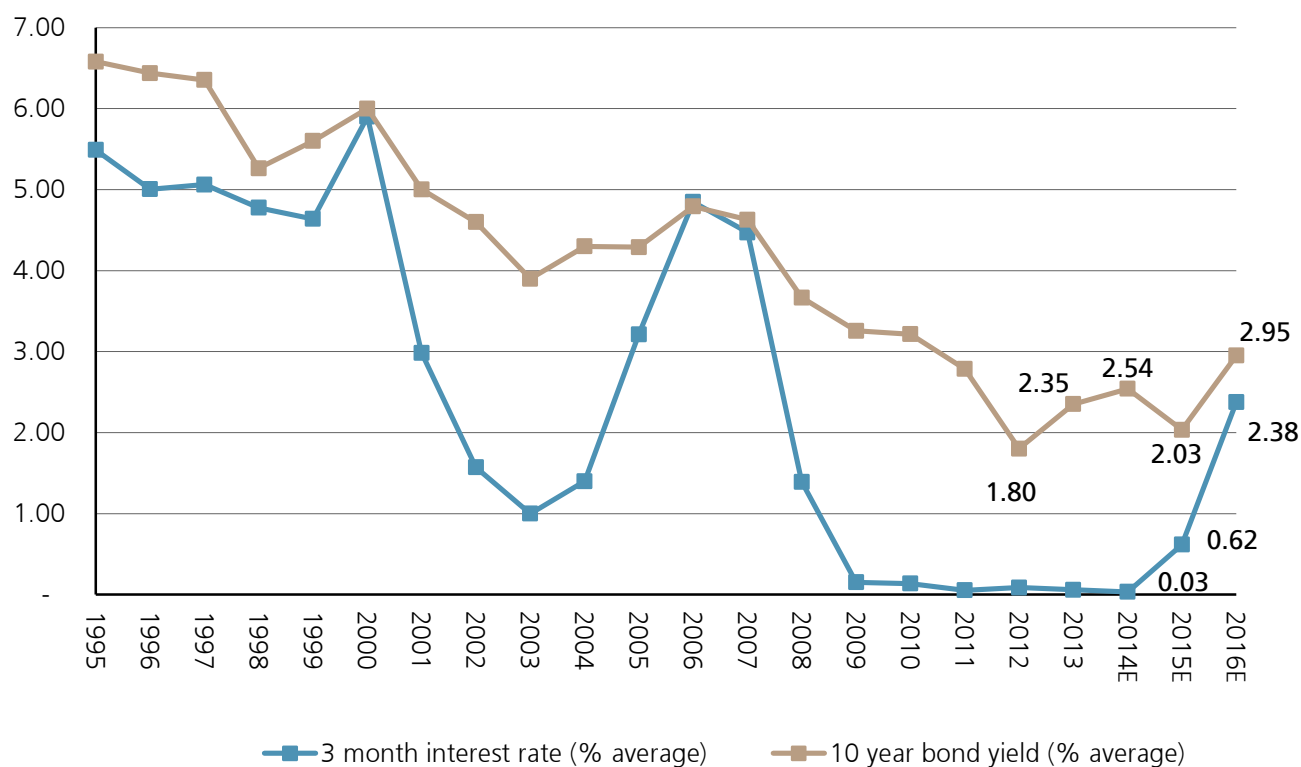
However, slack aside, our UBS economics team is forecasting a 76 bps rise in the 10-Yr by 2016. Applying a 76 bps rise to utility bond rates would widen the spread and reduce the implied upside for equities to about 17%. Investors are almost certainly anticipating even stronger bond yield rises in 2017+, reducing this "upside" even further. We tend to view the room in dividend yield spreads as something that prevents further significant downside at this time while investors wait for higher bond yields to materialize.

Applying a 76 bps rise to utility bond rates would widen the spread and reduce the implied upside for equities to about 17%.

Amidst greater pressure on short term rates – how much will the 10-year and 30-year move?

While the focus in the near-term remains on an anticipated positive revision to the short-term rates either this June or September, the question remains what it's corresponding impact will be on both the 10- and 30-year treasury bonds, utility corporate bond indices, and ultimately utility equities. Despite the threat of a material rise, we emphasize that rising near-term rates will not translate to a linear increase in the rest of the curve – rather a flattening of the yield curve appears more likely. The question to us remains whether fed tightening can occur amidst an environment of global loosening, particularly with impacts on USD competitiveness.

Figure 6: UBS Economics Team Interest Rate and Yield Forecast, 10-Yr Bond vs 3-Mo Interest Rate, 1995-2016E



Source: UBS Estimates

Statement of Risk

Risks for Utilities and Independent Power Producers (IPPs) primarily relate to volatile commodity prices for power, natural gas, and coal. Risks to IPPs also stem from load variability, and operational risk in running these facilities. Rising coal and, to a certain extent, uranium prices could pressure margins as the fuel hedges roll off Competitive Integrations. Further, IPPs face declining revenues as in the money power and gas hedges roll off. Other non-regulated risks include weather and for some, foreign currency risk, which again must be diligently accounted in the company's risk management operations. Major external factors, which affect our valuation, are environmental risks. Environmental capex could escalate if stricter emission standards are implemented. We believe a nuclear accident or a change in the Nuclear Regulatory Commission/Environment Protection Agency regulations could have a negative impact on our estimates. Risks for regulated utilities include the uncertainty around the composition of state regulatory Commissions, adverse regulatory changes, unfavorable weather conditions, variance from normal population growth, and changes in customer mix. Changes in macroeconomic factors will affect customer additions/subtractions and usage patterns.

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Source: UBS. Rating allocations are as of 31 December 2014.

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Consolidated Edison ¹⁶	ED.N	Sell	N/A	US\$61.40	12 Mar 2015
Dominion Resources ^{2, 4, 6a, 6b, 6c, 7, 16}	D.N	Buy	N/A	US\$69.82	12 Mar 2015
DTE Energy Co. ^{2, 4, 6a, 16}	DTE.N	Buy	N/A	US\$78.45	12 Mar 2015
NextEra Energy ^{2, 4, 5, 6a, 16}	NEE.N	Buy	N/A	US\$100.52	12 Mar 2015
TECO Energy Inc. ^{5, 16}	TE.N	Buy	N/A	US\$19.09	12 Mar 2015
Westar Energy, Inc. ^{6a, 16}	WR.N	Neutral	N/A	US\$37.70	12 Mar 2015

Source: UBS. All prices as of local market close.

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