# US Electric Utilities & IPPs

## Is it Safe to Buy Utilities Yet?

Equities

Americas
Electric Utilities

**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

**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 a 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.

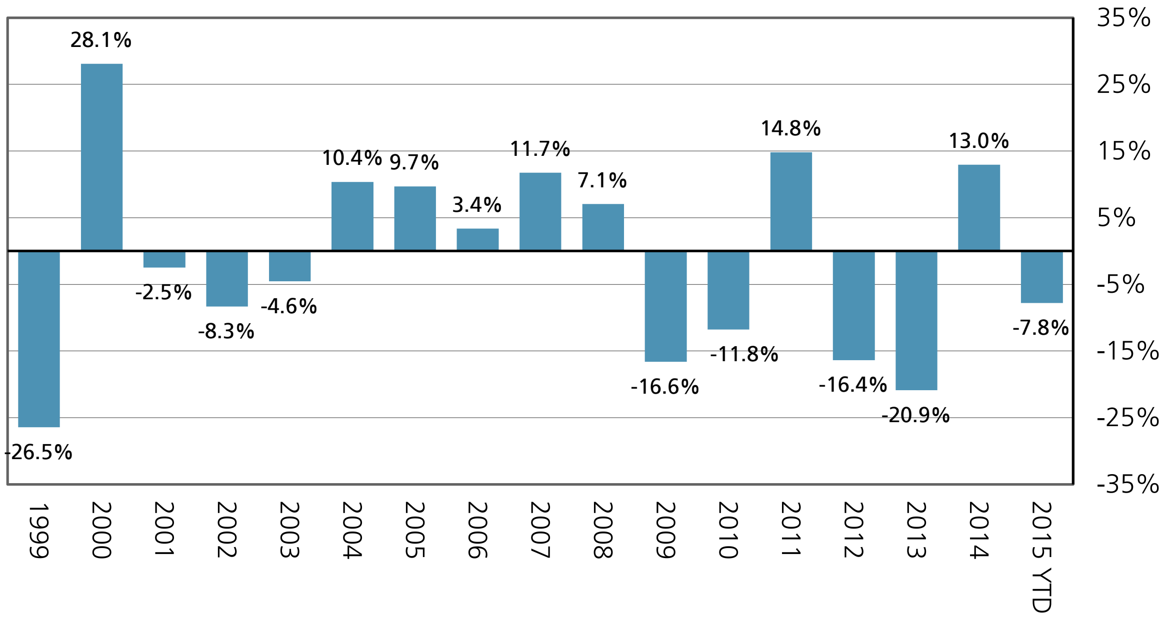
**So who's well positioned among the utility landscape?**

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.

## 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**



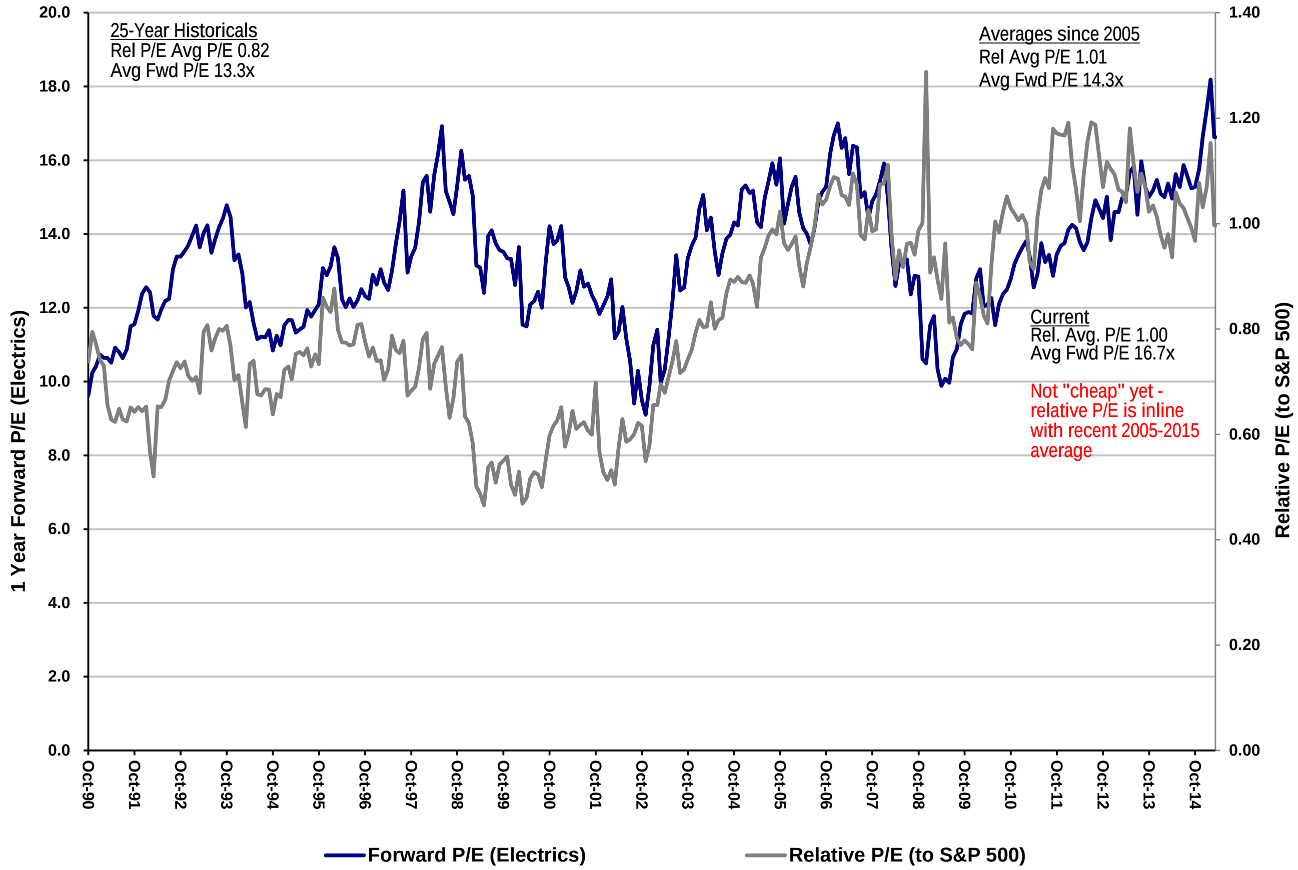

Source: Factset

## 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**

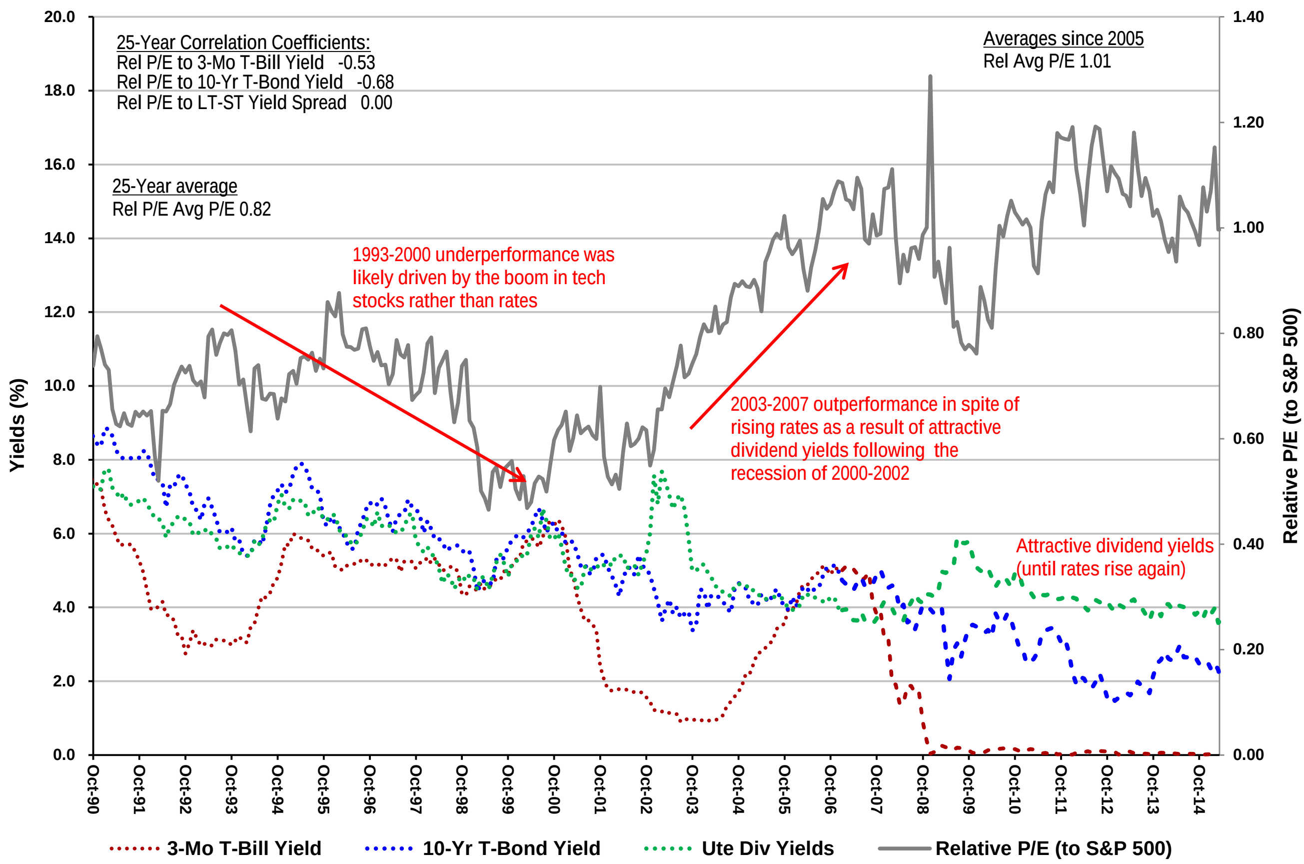



Source: Factset, UBS Estimates

## 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

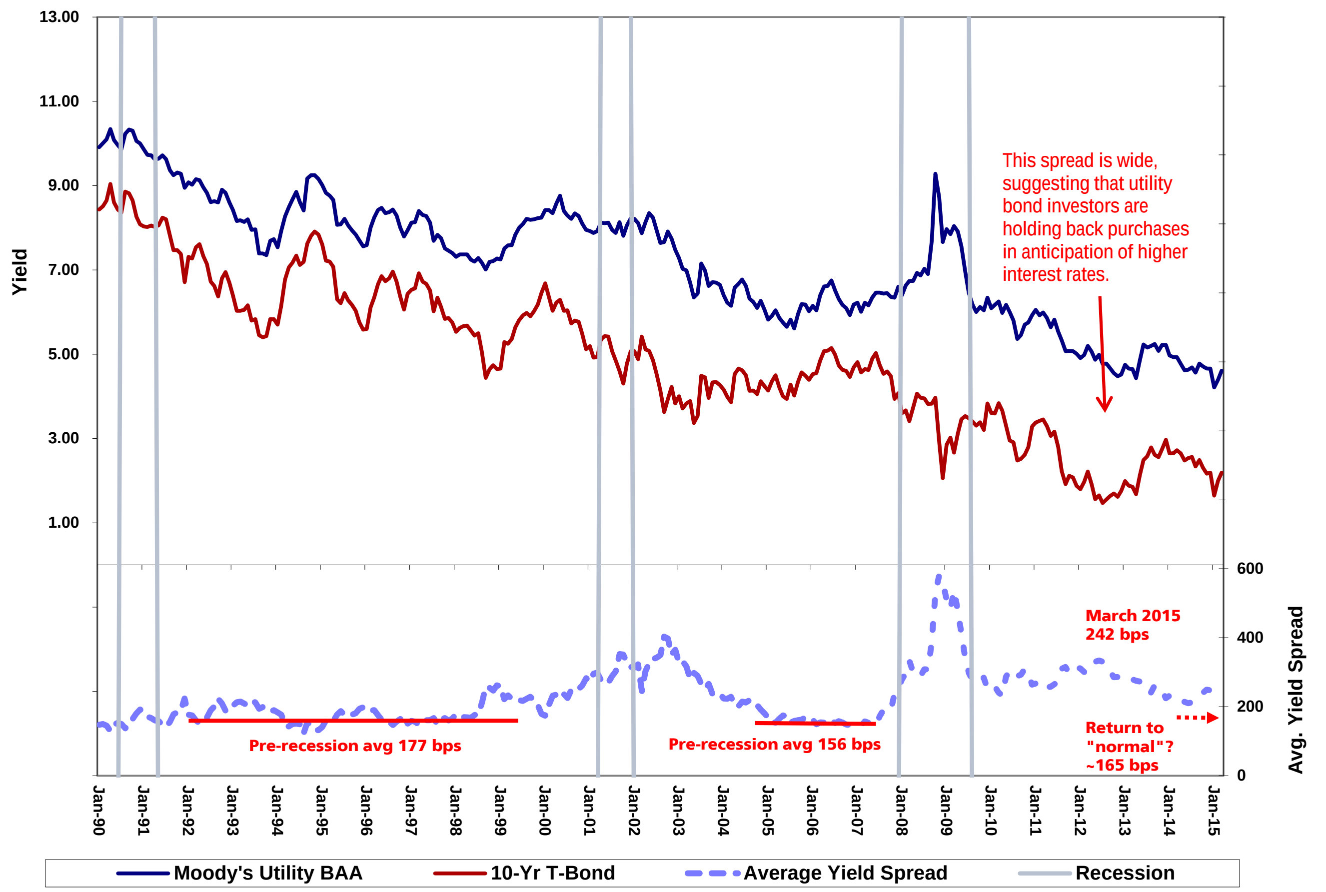
**Further underperformance of utilities stocks is probably being held in check by relatively high dividend yields.**

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.

## 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)**



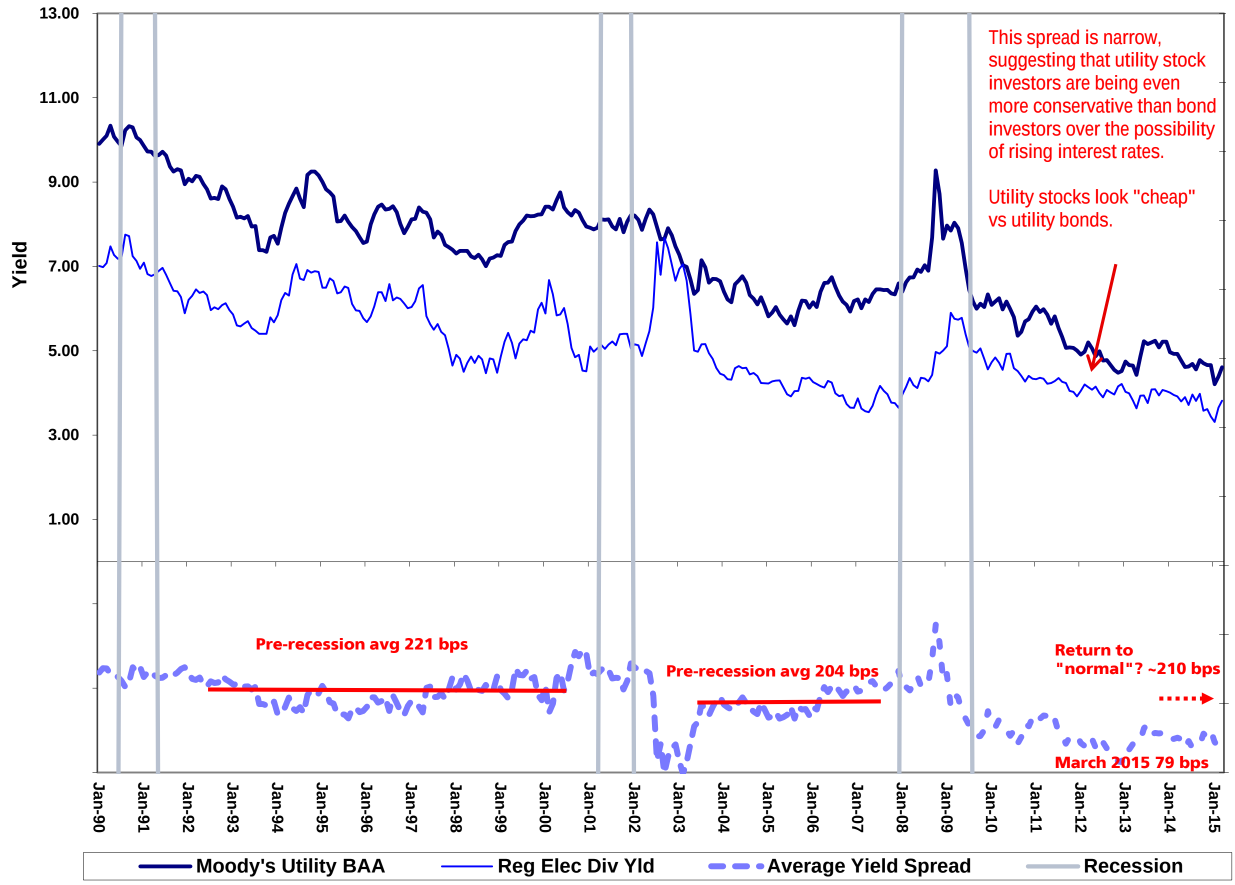

Source: Factset, UBS Estimates

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

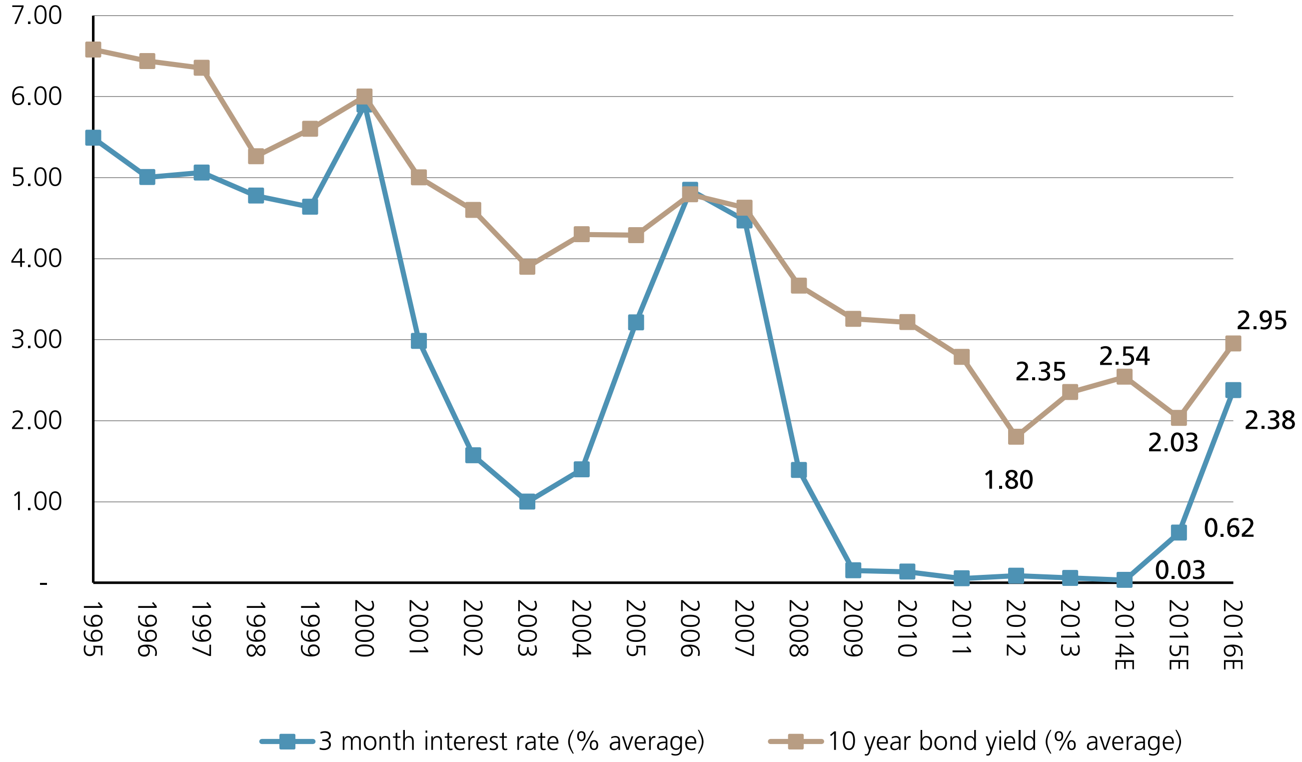
However, slack aside, our UBS economics team is forecasting a 76 bps rise in the 10-Yr by 2016. Applying a 76 bps rise to utility bond rates would widen the spread and reduce the implied upside for equities to about 17%. Investors are almost certainly anticipating even stronger bond yield rises in 2017+, reducing this "upside" even further. <u>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.</u>

**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 Integrateds. 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.

## Required Disclosures

This report has been prepared by UBS Securities LLC, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research recommendations, please visit www.ubs.com/disclosures. The figures contained in performance charts refer to the past; past performance is not a reliable indicator of future results. Additional information will be made available upon request. UBS Securities Co. Limited is licensed to conduct securities investment consultancy businesses by the China Securities Regulatory Commission.

**Analyst Certification:** Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers and were prepared in an independent manner, including with respect to UBS, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

**UBS Investment Research: Global Equity Rating Definitions**

| 12-Month Rating | Definition | Coverage[1] | IB Services[2] |
|---|---|---|---|
| **Buy** | FSR is > 6% above the MRA. | 47% | 37% |
| **Neutral** | FSR is between -6% and 6% of the MRA. | 42% | 32% |
| **Sell** | FSR is > 6% below the MRA. | 11% | 21% |
| **Short-Term Rating** | **Definition** | **Coverage[3]** | **IB Services[4]** |
| **Buy** | Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event. | less than 1% | less than 1% |
| **Sell** | Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event. | less than 1% | less than 1% |

Source: UBS. Rating allocations are as of 31 December 2014.
1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category. 4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

**KEY DEFINITIONS: Forecast Stock Return (FSR)** is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months. **Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium). **Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation. **Short-Term Ratings** reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case. **Equity Price Targets** have an investment horizon of 12 months.

**EXCEPTIONS AND SPECIAL CASES: UK and European Investment Fund ratings and definitions are: Buy:** Positive on factors such as structure, management, performance record, discount; **Neutral:** Neutral on factors such as structure, management, performance record, discount; **Sell:** Negative on factors such as structure, management, performance record, discount. **Core Banding Exceptions (CBE):** Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Company Disclosures table in the relevant research piece.

Research analysts contributing to this report who are employed by any non-US affiliate of UBS Securities LLC are not registered/qualified as research analysts with the NASD and NYSE and therefore are not subject to the restrictions contained in the NASD and NYSE rules on communications with a subject company, public appearances, and trading securities held by a research analyst account. The name of each affiliate and analyst employed by that affiliate contributing to this report, if any, follows.

**UBS Securities LLC:** Julien Dumoulin-Smith; Michael Weinstein; Paul Zimbardo.

**Company Disclosures**

| Company Name | Reuters | 12-month rating | Short-term rating | Price | Price date |
|---|---|---|---|---|---|
| **Ameren Corp.**[6a, 16] | AEE.N | Neutral | N/A | US$41.77 | 12 Mar 2015 |
| **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.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

2. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company/entity or one of its affiliates within the past 12 months.
4. Within the past 12 months, UBS AG, its affiliates or subsidiaries has received compensation for investment banking services from this company/entity.
5. UBS AG, its affiliates or subsidiaries expect to receive or intend to seek compensation for investment banking services from this company/entity within the next three months.
6a. This company/entity is, or within the past 12 months has been, a client of UBS Securities LLC, and investment banking services are being, or have been, provided.
6b. This company/entity is, or within the past 12 months has been, a client of UBS Securities LLC, and non-investment banking securities-related services are being, or have been, provided.
6c. This company/entity is, or within the past 12 months has been, a client of UBS Securities LLC, and non-securities services are being, or have been, provided.
7. Within the past 12 months, UBS Securities LLC has received compensation for products and services other than investment banking services from this company/entity.
16. UBS Securities LLC makes a market in the securities and/or ADRs of this company.

For a complete set of disclosure statements associated with the companies discussed in this report, including information on valuation and risk, please contact UBS Securities LLC, 1285 Avenue of Americas, New York, NY 10019, USA, Attention: Publishing Administration.

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

## Global Disclaimer

This document has been prepared by UBS Securities LLC, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

This document is for distribution only as may be permitted by law. It is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject UBS to any registration or licensing requirement within such jurisdiction. It is published solely for information purposes; it is not an advertisement nor is it a solicitation or an offer to buy or sell any financial instruments or to participate in any particular trading strategy. No representation or warranty, either expressed or implied, is provided in relation to the accuracy, completeness or reliability of the information contained in this document ('the Information'), except with respect to Information concerning UBS. The Information is not intended to be a complete statement or summary of the securities, markets or developments referred to in the document. UBS does not undertake to update or keep current the Information. Any opinions expressed in this document may change without notice and may differ or be contrary to opinions expressed by other business areas or groups of UBS. Any statements contained in this report attributed to a third party represent UBS's interpretation of the data, information and/or opinions provided by that third party either publicly or through a subscription service, and such use and interpretation have not been reviewed by the third party.

Nothing in this document constitutes a representation that any investment strategy or recommendation is suitable or appropriate to an investor's individual circumstances or otherwise constitutes a personal recommendation. Investments involve risks, and investors should exercise prudence and their own judgement in making their investment decisions. The financial instruments described in the document may not be eligible for sale in all jurisdictions or to certain categories of investors. Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Mortgage and asset-backed securities may involve a high degree of risk and may be highly volatile in response to fluctuations in interest rates or other market conditions. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument referred to in the document. For investment advice, trade execution or other enquiries, clients should contact their local sales representative.

The value of any investment or income may go down as well as up, and investors may not get back the full (or any) amount invested. Past performance is not necessarily a guide to future performance. Neither UBS nor any of its directors, employees or agents accepts any liability for any loss (including investment loss) or damage arising out of the use of all or any of the Information.

Any prices stated in this document are for information purposes only and do not represent valuations for individual securities or other financial instruments. There is no representation that any transaction can or could have been effected at those prices, and any prices do not necessarily reflect UBS's internal books and records or theoretical model-based valuations and may be based on certain assumptions. Different assumptions by UBS or any other source may yield substantially different results.

This document and the Information are produced by UBS as part of its research function and are provided to you solely for general background information. UBS has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. In no circumstances may this document or any of the Information be used for any of the following purposes:

(i) valuation or accounting purposes;

(ii) to determine the amounts due or payable, the price or the value of any financial instrument or financial contract; or

(iii) to measure the performance of any financial instrument.

By receiving this document and the Information you will be deemed to represent and warrant to UBS that you will not use this document or any of the Information for any of the above purposes or otherwise rely upon this document or any of the Information.

Research will initiate, update and cease coverage solely at the discretion of UBS Investment Bank Research Management. The analysis contained in this document is based on numerous assumptions. Different assumptions could result in materially different results. The analyst(s) responsible for the preparation of this document may interact with trading desk personnel, sales personnel and other parties for the purpose of gathering, applying and interpreting market information. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS into other areas, units, groups or affiliates of UBS. The compensation of the analyst who prepared this document is determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues; however, compensation may relate to the revenues of UBS Investment Bank as a whole, of which investment banking, sales and trading are a part.

For financial instruments admitted to trading on an EU regulated market: UBS AG, its affiliates or subsidiaries (excluding UBS Securities LLC) acts as a market maker or liquidity provider (in accordance with the interpretation of these terms in the UK) in the financial instruments of the issuer save that where the activity of liquidity provider is carried out in accordance with the definition given to it by the laws and regulations of any other EU jurisdictions, such information is separately disclosed in this document. For financial instruments admitted to trading on a non-EU regulated market: UBS may act as a market maker save that where this activity is carried out in the US in accordance with the definition given to it by the relevant laws and regulations, such activity will be specifically disclosed in this document. UBS may have issued a warrant the value of which is based on one or more of the financial instruments referred to in the document. UBS and its affiliates and employees may have long or short positions, trade as principal and buy and sell in instruments or derivatives identified herein; such transactions or positions may be inconsistent with the opinions expressed in this document.