All major electric utilities located in the eastern region of the United States are reviewed in this Issue; western-based electrics, in Issue 11; and the remaining industry participants, in Issue 5. Since our last review of the Electric Utility (East) group three months ago, utility stocks covered in *The Value Line Investment Survey* increased 3.1% in value on average versus a 3.7% gain in the S&P 500. Meanwhile, the industry's Timeliness rank has moved up to 66 (of 93) from 80.

During the past year, utilities under our coverage have declined 12.1% versus a 13.6% increase in *The Value Line Arithmetic Index*. The rise in interest rates through much of 2023 weighed heavily on utility stocks. The equities have only begun to recover some in more recent months as the uptrend in rates has paused. Because U.S. debt securities provide a competitive investment vehicle to the stocks in this industry, it's important to be cognizant of the spread between the benchmark 10-year Treasury rate (4.63%) and the dividend yields on electric utilities (4.0% on average).

Though the aforementioned spread is important, expectations of where interest rates will go next is the key factor that will drive this rate-sensitive group's performance. The other major factor is how investors feel about the prospects for the economy in general. Overall, this is a defensive industry with low-Beta stocks that tend to outperform when investors rotate out of economically-sensitive, higher-Beta stocks.

Portfolio Considerations

With the uptick in share prices over the past three months, 3- to 5-year total annual return potential for electrics has fallen a bit, to 10.2% on average from 10.9%. The new level is still towards the high end of what we've witnessed over the past two to three years, and there are some decent intermediate values to be found among this group. Additionally, if interest rates begin to drop again, it's highly likely that well-positioned electrics will rebound further.

However, while many stocks within the Electric Utility (East) Industry remain depressed relative to their highs of a couple of years ago, we're not overly bullish on this group. Over the past several months, we've lowered our 3- to 5-year targeted earnings multiples and raised our dividend yield expectations, as the higher-for-longer scenario of the world's central banks seems to be the new normal. In other words, interest rates were in a secular downtrend for decades, with cyclical interruptions along the way. If that course has reversed, it's a big negative for rate-sensitive utilities.

Investors in this group can help their cause by being disciplined buyers. New commitments should only be made when the midpoint of our annual total return projection is at or above 12%. Emphasizing utilities with above-average dividend growth prospects is a good practice. The median is about 4.5% at present. Staying away from utilities in below-average regulatory climates and keeping a well-diversified group of dividend payers are also good practices to follow.

At present, we like *Eversource Energy* as it possesses all of the aforementioned qualities. We also think *FirstEnergy* is close to being a good long-term buy at the recent price and is a name to keep on the watch list. Another stock that's particularly notable in this Issue is *Avangrid*, as its majority shareholder, Iberdrola of Spain, has proposed an all-cash buyout of the public float at $34.25 per share.

INDUSTRY TIMELINESS: 66 (of 93)

Topical Subjects

Key challenges this industry is facing include the rise in interest rates and overall inflation. Due to how regulatory mechanisms work, some higher costs can rapidly be passed along to consumers. This is true of fluctuations in natural gas prices, for instance. Conventions differ among states, but most utilities suffer from some degree of regulatory lag and have to go through a rate-filing process with regulators in order to gain "rate relief." That's industry parlance for regulatory approval to charge customers, through higher delivery rates on the electric bill, for certain expenses previously or about to be incurred. Notably, some companies are better situated and benefit from near real-time pricing adjustments with little regulatory lag on grid improvements.

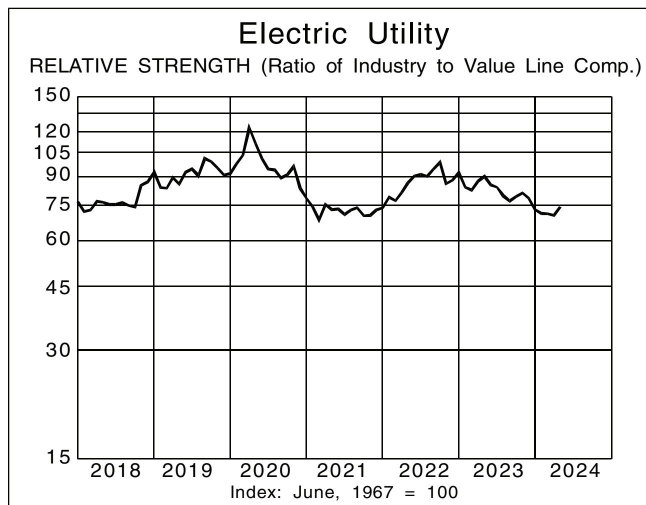
These challenges have been particularly troublesome for companies attempting to build and fund expensive and complicated renewables projects. This has been especially true of offshore wind generation, where the lead times are lengthy. The planning of those ventures took place under a different macroeconomic environment when borrowing, materials, and labor costs were far lower. As a result, many of those projects are only economic at higher electric rates than originally planned for.

Another major problem for this industry is the level of authorized return on equity (ROE) that's being set by some regulators. They're deriving ROEs based on a historically low and now out-of-date cost of capital. Note that the ROE applied to cumulative investments made in grid infrastructure (known as the rate base) is what drives revenue and profit levels for utilities.

Conclusion

Individual companies within this industry vary widely. The regulatory climate and the overall health of the underlying regional and local economies within a utility's service area are impactful. This includes demographics and migratory trends over time. States committing to progressive clean energy goals are generating a lot of invested capital opportunities for utilities, which should translate to improved earnings and dividend growth prospects. Selectivity is key for investors.

Anthony J. Glennon



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