

All of the major electric utilities located in the central region of the United States are reviewed in this Issue; eastern electrics, in Issue 1; and the remaining utilities, in Issue 11.

There has been a lot of merger and acquisition activity in the electric utility industry in recent years, but this has slowed lately.

Due to unfavorable market conditions for owners of merchant (i.e., noncontracted) generating assets, some companies are trying to reduce or eliminate their exposure to this business.

Most electric utility equities have performed well so far this year. We continue to believe that valuations are high.

Mergers And Acquisitions

In recent years, there have been several mergers and acquisitions in the Electric Utility Industry. Eversource Energy (formerly Northeast Utilities) purchased NStar in 2012. Exelon bought Constellation Energy in 2012 and Pepco Holdings in 2016. *WEC Energy Group* (formerly Wisconsin Energy) acquired Integrys Energy in 2015. *Fortis* purchased ITC Holdings last year. Three electric companies (Duke Energy, Southern Company, and Dominion Resources) bought gas utilities in 2016.

Historically, obtaining regulatory approval for electric utility mergers has been a challenge. Numerous proposed combinations did not get completed, either because at least one regulatory commission denied permission or because the conditions the surviving company would have had to agree to were deemed onerous by that company. This has not changed. In 2016, NextEra Energy's attempted buyout of Hawaiian Electric Industries was rejected by the regulators in the Aloha State. This year, NextEra saw its proposed acquisition of Oncor, a Texas distribution utility, turned down by the state commission. NextEra has not yet given up, but if the company attempt is ultimately unsuccessful this would be the fourth fruitless attempt by NextEra or its predecessor company, FPL Group. The proposed merger of *Great Plains Energy* and *Westar Energy* was rejected by the Kansas commission. *Great Plains* is deciding whether to restructure the agreement with *Westar* and make another attempt, or drop the idea. There is a precedent for a utility deal going through after the companies submitted a revised proposal to the regulators. This is what happened in the aforementioned Exelon purchase of Pepco, which was initially rejected by the commission in Washington, DC.

Exiting Nonregulated Businesses

For the past several years, conditions for owners of nonregulated "merchant" (i.e., noncontracted) generating assets have faced unfavorable market conditions. Low natural gas prices and subsidized renewable energy have reduced the prices that these assets can command on the open market. In some cases, the bids of plants' expected output failed to clear the market. And weakening demand for electricity, due to energy efficiency measures and the aftereffects of the 2007-2009 recession haven't helped. Efforts to obtain subsidies for threat-

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ened plants, or return to reregulation, have been unsuccessful or are just beginning.

American Electric Power, *Entergy*, and *FirstEnergy* (covered in Issue 1) intend to exit their nonregulated activities (or at least the vast majority of these) and return to their roots as regulated electric utilities. However, the route to this goal isn't smooth, and these companies have already had to take substantial writedowns of their nonutility generating assets. Some asset sales have already closed—the buyers, in most instances, are private equity companies—but there is still a lot of work to be done before these companies can reach their target. In the case of *Entergy*, its last major nonregulated asset won't be shut until 2021.

Conclusion

Most electric utility stocks have fared well in the first half of 2017. The prices of most issues have risen at a high single-digit or low double-digit percentage. (The exceptions can be attributed to company-specific reasons.) Investors are still reaching for yield, and are not fearful of the expectation that the Federal Reserve will raise interest rates.

The high valuation of stocks in the Electric Utility Industry is evident by a few ways of measuring this. The group's average dividend yield, at 3.3%, is comfortably above the median of all stocks under our coverage. However, this yield is low, by historical standards. In addition, for many years electric utility equities had a price-earnings ratio well below that of the market. Thus, the relative price-earnings ratio shown on our pages was below 1.00. Last year, this figure was right around 1.00 for many electric utility stocks. Today, many issues have a price-earnings ratio above 20. We also note that the majority of electric utility equities are trading within their 3- to 5-year Target Price Range. A few, such as *ALLETE* and *CMS Energy*, have recent prices above their 2020-2022 Target Price Range. As a result, the long-term total return potential of this group is just 3%, despite the likelihood of annual dividend growth from most of these companies. Income-oriented investors should keep this in mind.

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