Analysts see stable utility sector stocks poised to ride out potential recession

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Market Intelligence

Fears of a recession are rising as the S&P 500 index extends its losses, but industry experts anticipate the utilities sector will remain an important flight to safety.
Source: Spencer Platt/Getty Images News via Getty Images

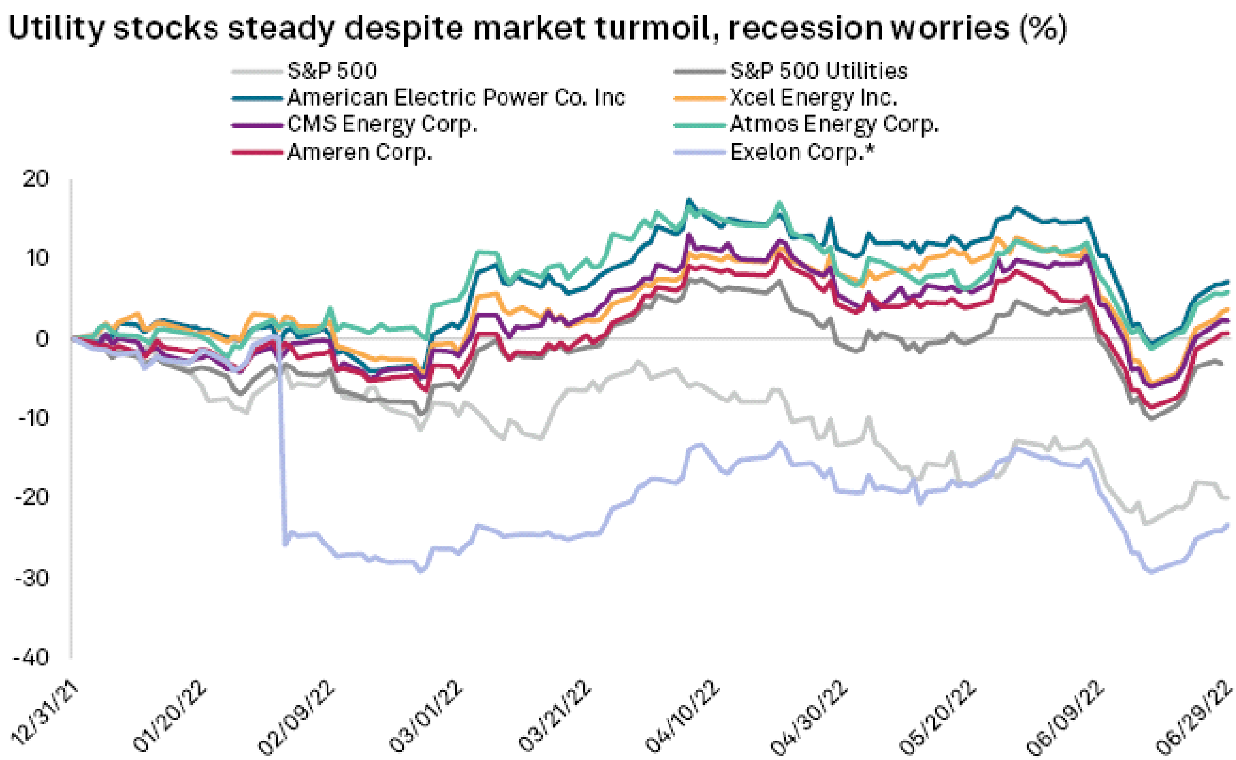
Performance by U.S. utility stocks during previous economic downturns, a decreasing sensitivity to interest rates and stable earnings and dividend growth suggest the sector could see substantial price upside despite signs of a looming recession, industry experts said.

Utility share prices' recent deconsolidation from inflation has transformed the industry from a steady-growth, defensive play to a higher-growth sector that can increase earnings and return material capital to investors during economic dips. So far in 2022, the S&P 500 Utilities index has lost just 3% of its value as of the June 28 market close, compared to the broader S&P 500 index's nearly 20% drop.

Historically, according to analysts at Morgan Stanley, the utility sector's highest stock market outperformance has occurred 12 months before a recession and three months into a recession, suggesting that "the space trades higher on a relative basis well in advance of an actual recession, holds its value on a relative basis until the recession hits, then sees another period of outperformance shortly after a recession begins."

Morgan Stanley said it does not expect utility stocks to rise "on an absolute basis," but thinks "relative performance will be favorable in a downturn." Utilities' price-to-earnings ratios, Morgan Stanley added in a June 29 note to clients, also offer "a neutral risk/reward proposition from a valuation standpoint when compared to other defensive cohorts."

UBS analysts wrote June 30 that investors should still orient their North American utility and power stock picks toward "valuation and yield in stocks with lower risk fundamentals to the accelerating growth from the clean energy transition." This strategy, in UBS' view, sets investors up over the long term to own the stocks most likely "to emerge as the new top-quartile names at the next (price-to-earnings ratio) valuation spread peak."



As of June 29, 2022.
* Exelon Corp.'s share price was affected by the Feb. 23, 2022 spin-off of Constellation Energy.
Source: S&P Gloal Market Intelligence

Morgan Stanley sees investors increasingly attracted to "low-risk, discounted" utility companies like American Electric Power Co. Inc., Exelon Corp. and Atmos Energy Corp., and that CMS Energy Corp., Ameren Corp. and Xcel Energy Inc. still have untapped stock price upside as well.

John Bartlett, president of utilities-focused investment portfolio manager Reaves Asset Management, said in an interview he expects the industry to grow earnings per share by 5% to 6% and pay dividend yields of 3% to 3.5% per year on average even during a recession.

"The backdrop for them providing that consistent earnings growth and an above-market dividend rate is very sustainable," Bartlett explained. "You can count on the sort of slow stair steps of value added to shareholder returns over time … you probably have better visibility into how you're going to get rewarded for your patience" compared to other sectors that investors might turn to as the possibility of a recession rises

Analysts at Scotiabank agreed that utility stocks should be less volatile than the overall market during a downturn, though Morgan Stanley does anticipate earnings growth will slow into 2023 even without a recession.

During a June 14 investor conference, NextEra Energy Inc. President and CEO John Ketchum said the company will have the same cash flow and capital access advantages despite inflation and a potential downturn.

"Don't ever forget we are a cash flow machine. ... If you were ever concerned about the growth maybe slipping a bit, which we are not, then remember the [capital expenditure] opportunities would go down at the same time," Ketchum said. "We'd be enormously free-cash-flow positive, and we'd be able to buy back shares and achieve our EPS expectations."

A high interest-rate environment also gives NextEra "even more headroom when we go to compete against the unrated wind developers, the unrated solar developers, the unrated storage developers" for debt and equity, he continued.

At the Edison Electric Institute's recent annual conference, top utility executives reiterated plans to spend tens of billions on transitioning to cleaner energy sources, with the vast majority of that spending allocated toward regulated assets, even in the face of economic headwinds.

Still, utilities grappling with issues ranging from regulatory support to climate, and slower load and earnings growth could face a higher stock price risk during a recession, according to Morgan Stanley, which named PG&E Corp., Edison International, Entergy Corp., Consolidated Edison Inc., Pinnacle West Capital Corp. and PPL Corp. as utility holdings companies unlikely to perform as well.

UBS agreed that "taking a valuation-driven, low-risk approach and moving to a stock-picking focus versus a defensive sector approach is key to navigating the less bullish backdrop moving forward."

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