

FINANCIAL FOCUS

Amid historic broad-market sell-off in H1, utilities maintain premium valuation

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Market Intelligence

Despite an approximately 5% decline in June and a move into negative territory for the year, the S&P 500 Utilities group again outperformed broad indexes, which continued their decidedly downward trend en route to the worst first half-year for U.S. stock markets in more than a half century.

The Take

The S&P 500 Utilities index extended its valuation premium to approximately 24% over the S&P 500 in June on relative outperformance to other S&P 500 subsectors amid soaring inflation and growing concerns of the likelihood of another recession.

The S&P 500 Utilities index is down 2% year-to-date through June, second only to the S&P 500 Energy subsector, which remains up 29% year-to-date despite heavy selling during the month in tandem with the fall in oil prices. Selling pressure remains concentrated within the consumer discretionary, communications services and information technology subsectors, which are down 33%, 30% and 27% year-to-date, respectively.

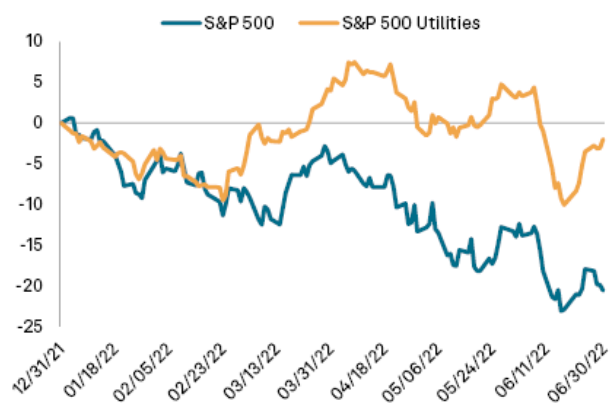
Amid the dimming U.S. economic outlook, the pace of state-level utility rate case activity remains fairly robust. As of June 9, there were 109 electric and gas rate proceedings pending in 38 states.

To recover higher costs associated with inflation and potentially rising interest rates, RRA expects elevated rate case activity in 2022. Rising energy prices, which are placing additional pressure on customer bills, coupled with regulators' focus on rate affordability have the potential to challenge rate case outcomes in the near term. For additional detail, see the June 16 RRA Regulatory Focus report Electric, gas rate case activity remains robust amid dimming US economic outlook.

The S&P 500 Utilities was down 2% year-to-date through June. The S&P 500 was down 20.6% through the first six months of the year following June's 8.4% decline — its worst start since 1970, when the large-cap index dropped 21% in the first half of the year.

The Dow Jones Industrial Average and the tech-heavy Nasdaq composite index declined 15.3% and 29.5%, respectively, in the first half of 2022.

S&P 500 Utilities, S&P 500 YTD performance (%)



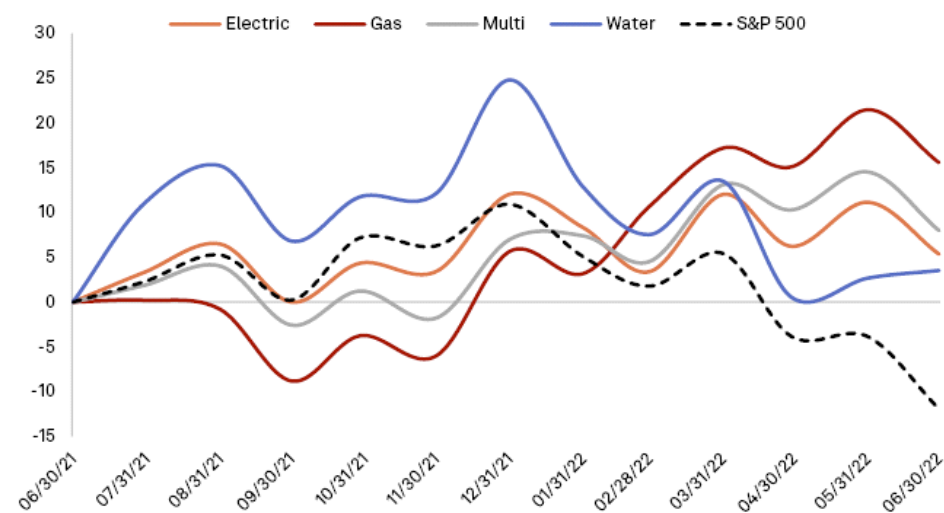
As of June 30, 2022, close.
Source: S&P Global Market Intelligence

Water utilities outperformed energy utility stocks in June, with investors likely taking advantage of recent share price weakness that has dampened sector valuations thus far in 2022. California Water Service Group, Middlesex Water Co. and American States Water Co. rose 3.5%, 3.1% and 2.9%, respectively, in June, yet remain the sector's worst performers year-to-date. Artesian Resources Corp. is the lone water utility stock in positive territory in 2022, up approximately 6%.

Simmering M&A activity may also be at play in investors' move into water utility equities in June; numerous transactions are pending in states spanning nationwide. There has also been increased diversity in the acquirers of water and wastewater systems to include not only smaller investor-owned and private-equity-funded water utilities but also larger investor-owned entities, including some outside the traditional water sector. For additional detail, see the June 23 Financial Focus report Pa. wastewater transactions dominate sector's acquisition market.

American Water Works Co. Inc. currently carries the highest forward share price-to-estimated EPS, or P/E, multiple, at 30.8x, above the group's 27.3x average. By comparison, average multi-utility, electric and gas utility forward P/Es stand at 19.1x, 18x and 17.8x, respectively.

Utility monthly average share price change (%)



Prices are through June 30, 2022.
Source: S&P Global Market Intelligence

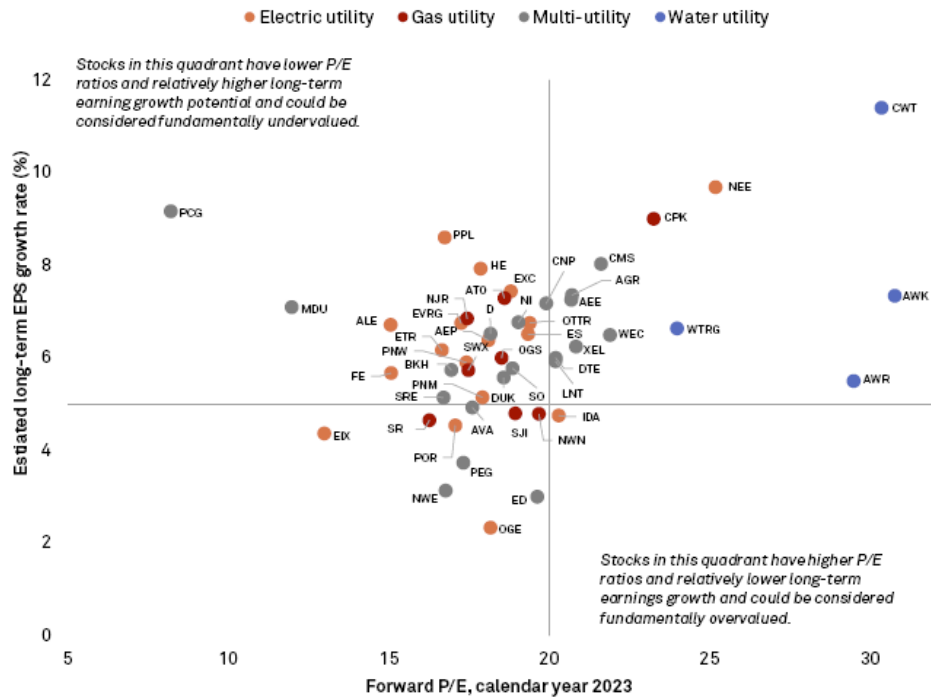
Only four energy utilities registered month-over-month share price gains in June, led by Otter Tail Corp., up 2.7% to pare its year-to-date loss to 6%. Shares had slumped through mid-June before recovering on heightened trading volume. Otter Tail shares currently trade at 19.4x the 2023 S&P Capital IQ consensus EPS estimate, above the electric utility group's 17.8x average. Recent share price appreciation may be attributed to the company's strong EPS outlook, with management recently increasing 2022 guidance to a range of \$5.15 to \$5.45 on record first-quarter results and expected performance from its plastics segment.

NextEra Energy Inc.'s forward P/E multiple increased 1.1% in June to 25.2x — the highest among electric utilities — after shares increased 2.3% following the company's investor and analyst day. On June 14, NextEra unveiled an ambitious decarbonization program and reassured investors that it can continue to hit growth and climate targets despite inflation and a potential recession. For additional detail, see the June 14 S&P Global Market Intelligence news article.

Within the electric utility sector, forward P/Es declined approximately 5% in June to 17.8x. Multi-utilities covered by RRA, a group within S&P Global Commodity Insights, saw forward P/Es decline 5.7% on average to just above 18x, and the average gas utility P/E stood at 18.8x, down 3.6% from May.

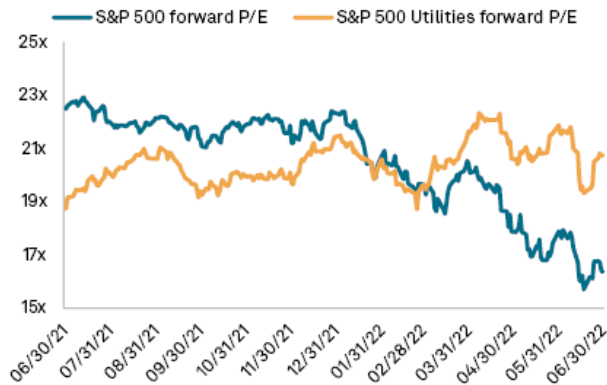
The quadrant chart below shows how Regulatory Research Associates' utility universe appears when comparing the P/E ratio and the estimated long-term earnings growth rate. A sizeable portion of electric utility P/E multiples has remained in the upper-left quadrant in 2022, suggesting the companies could be relatively undervalued considering their lower P/E values and long-term earnings growth potential.

Valuation quadrant: EPS growth forecast vs. forward P/E



As of June 30, 2022, close.
 For the 12 months ending Dec. 31, 2023.
 P/E = stock price-to-earnings ratio
 Source: S&P Global Market Intelligence

S&P Utilities, S&P 500 next-12-months P/E estimates



As of June 30, 2022, close.
 P/E = stock price-to-estimated EPS multiple
 Source: S&P Global Market Intelligence

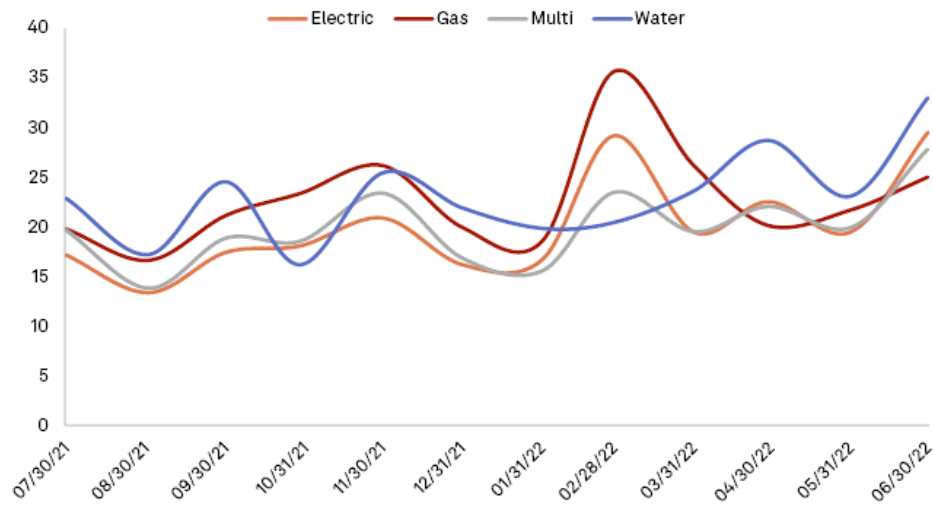
Share price volatility

Smaller-cap companies generally have lower trading liquidity, and, therefore, all other things being equal, tend to have more significant share-price swings than larger-cap equities. An analysis of the standard deviation of log-normalized daily price returns for utility stocks over the past year supports this thesis, with the smaller-cap water utility sector displaying the highest average price volatility.

Electric utility stocks saw the largest increase in average share price volatility — to 29.5% from 19.5% in May — led by OGE Energy Corp. The OGE shares declined 6.6% in June, essentially reversing May's gains.

The company's Oklahoma Gas and Electric Co. subsidiary is presently seeking a \$163.5 million rate increase in Oklahoma, driven by the need for a higher return on equity, revised depreciation rates and an expansion of the grid enhancement mechanism to include certain weather hardening upgrades. Oklahoma Corporation Commission staff recently recommended a base rate hike that is about half of what the company requested earlier in 2022, premised upon an 8.75% ROE, which is well below the prevailing industrywide averages for electric utilities. Staff further recommended that OG&E's request to operate under a performance-based ratemaking framework be rejected. A final OCC decision is expected to be issued by September (Cause No. PUD202100164).

Utility monthly share price volatility (%)



Prices are through June 30, 2022.
 Volatility is calculated as the annualized standard deviation of daily log-normal price returns over each month.
 Source: S&P Global Market Intelligence

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