INDUSTRY TIMELINESS: 73 (of 93)

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, electric utility stocks covered in *The Value Line Investment Survey* dropped 3.9% in value on average, compared to a 10.1% gain in the S&P 500.

On a 12-month basis, the *Value Line Utility Index* has fallen 12.1% versus an 11.5% gain in the *Value Line Arithmetic Index*. This underperformance is in sharp contrast to the first half of 2022 when the defensive nature of utilities was sought after. The rise in interest rates over the last 12 months, however, as evidenced by the one-year Treasury rate's increase from 3.0% to 5.4%, has really pressured these stocks, as Treasuries provide a competitive investment vehicle for income-oriented investors and compare favorably to the 3.8% median dividend yield for electric utilities. A rebound in this group ought to be in play when recession fears resurface and the Federal Reserve eventually starts reducing interest rates.

Total annual return prospects through 2026-2028 for electrics is near the high end of the range witnessed over the past year. The median level for the industry is presently 9.6%. Although there is a generally reduced risk level in owning utilities, given that they are regulated monopolies, we look for at least 10%-11% long-term total annual return potential before recommending an individual equity to utility investors. That level is in line with the broader market's historical returns.

Utility Portfolio Considerations

In regards to the aforementioned relationship between interest rates and the relative performance of electric utility stocks, investors need to be cognizant of the risks if inflation and interest rates are in secular uptrends as opposed to just cyclical upswings. Consider that *Consolidated Edison*, a long-run bellwether for this industry and the oldest consistently listed NYSE member company, traded at a price-to-earnings (P/E) ratio that was about 55% of the market level, while carrying a 9%-10% dividend yield during the last secular peak in interest rates and inflation. This was during the early 1980s when the one-year Treasury rate peaked at just over 17%.

In recent years, *Consolidated Edison* has traded near a market-level P/E ratio with a dividend yield in the 3.5%-4.0% range. Currently the stock carries an earnings multiple of 19.2 (10% above the market level) and a dividend yield of 3.5%. The takeaway here is that over time, this group's relative performance is negatively correlated to movements in interest rates. What that means is, when rates are trending down, utility stocks tend to appreciate in value and vice versa. This is certainly not the only factor that determines valuations, but it is a significant driving force.

Utility investors can help their cause by being disciplined buyers. It's rare to see a utility stock continually rise in value with no opportunities to enter on corrections along the way. The midpoint of the annual total return projections, which are based on the 3- to 5-year Target Price Range and dividend estimates, should ideally be 11% or higher upon entry. Emphasizing utilities with superior dividend growth relative to the industry's projected average of 4%-5% is also highly recommended.

Sticking to utility candidates that possess regulatory environments rated average or better would be ideal. Those with near real-time pricing adjustments that minimize regulatory lag should be sought. A solid or improving balance sheet ought to be a consideration, as well. Solid local economic strength and population growth in a utility's service area is a big plus. A progressive state leadership, in terms of being supportive of "green energy" is also a factor to consider, as that variable should increasingly make a difference in growth prospects for electric utilities.

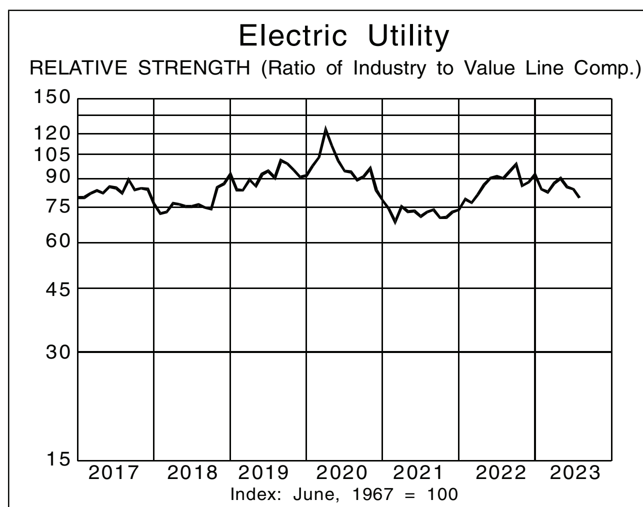
Topical And Concluding Remarks

The recent macroeconomic backdrop is a significant challenge for most electrics. The main difficulties are wage inflation, rising interest rates, and stubbornly high commodity energy and raw material prices relative to where they were a few years ago. Add to that list higher pension costs, at least for this year, due to 2022's stock and bond market declines that triggered higher retirement contributions this year.

Due to how regulatory mechanisms work in this industry, some of these higher expenses can rapidly be passed on to customers, but it varies widely by state. Many costs must instead go through a filed rate case to be reviewed by a regulatory panel, which can be an onerous and lengthy process. This "regulatory lag" can accumulate over time, causing some utilities to perennially under earn their authorized return on equity. This is a prescription for below-average (relative to the industry median) earnings and dividend growth.

While this industry appears homogeneous, individual electrics vary widely. Regulatory climate and the overall health of the underlying regional and local economies within a utility's service area are big difference makers. States committing to aggressive clean energy transitions will generate a lot of invested capital opportunities for utilities in those territories. This should also be a large difference maker. As always, utility investors need to be highly selective.

Anthony J. Glennon



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