Utilities Offer a Defensive Dividend Haven??

OLLI Investment Forum

Brenda Bloch-Young, May 6 2020

Utilities have been deemed defensive

Bond proxies since the financial crises

- Regulated utilities for electricity
- Interest rate sensitive due to debt used to pay for infrastructure investment
- “Risk on” days drive the price down/ “Risk off” days drive the price up
- Low volatility is normal - recent exception was the March sell off
- Power sources range from nuclear power, natural gas and coal to wind and solar
- Electricity usage was expected to decline in the coming decade - that premise is being challenged now
- Some well positioned for ESG initiatives toward clean energy
- Rates approved by state regulatory agencies - some more favorable than others

Trends to consider

Both positives and negatives

- Northeast pursues both solar & wind, West Coast pursues solar and Mid-Atlantic favors offshore wind
- ESG considerations were far more important at the end of 2019
- Gulf states are primarily fired by natural gas
- Coal remains strong in the Southeast and Midwest but waning
- Permitting of natural gas pipelines
- Shutdowns of coal plants continue - natural gas expected to be cheaper by 2024
- Nuclear power is becoming cost prohibitive
- Growth in GDP, population, computing, electric vehicles may increase need for electricity
- Negative demand drivers are energy efficiency, LED lighting, smart homes, industrial weakness
- Potential carbon tax on the horizon

COVID-19 Impact

Mixed information thus far with more guidance coming

- Electricity demand has fallen 4% in April
- Results are mixed based on whether the state was “open” or “shutdown”
- Revenue mix varies based on the ratio of C&I (commercial and industrial) versus residential
- Many industrial customers have fixed contracts rather than usage
- Construction delays as a result of virus infected employees
- Reserves for unpaid electric bills
- Unlikely approval of rate increases for residential customers

Morningstar Dividend Investor

Holdings plus Watch List

MDI holds:

- CNP / CenterPoint Energy - Texas/ impacted by MLPs, open rate case pending, cut dividend 49% at the end of March, Public Utility Commission approved a surcharge to cover unpaid bills
- D / Dominion Energy - rate of dividend increases expected to slow, risk Atlantic Coast Pipeline may not be completed, rate increase approvals likely to be delayed
- DUK / Duke Energy - risk of unfavorable rate case outcomes in NC, risk Atlantic Coast Pipeline will not be completed
- FE / FirstEnergy - 16 coal plants in IN, WV and OH with no plans to retire, wind should be cheaper than coal by 2024 (note the only one of the 4 rated “overweight” by the majority of analysts covering the utility sector)

MDI income bellwethers included in recent editions: AEP, DTE, ETR, EXE, PNW

Regulated utilities most favored by Analysts

+60% of utility analysts rate as OW

- NEE / NextEra Energy - renewables growth + regulated /the old FPL, already trades at a 36% premium to peers, significant debt load
- FE/ FirstEnergy - C&I revenue versus Residential ratio (COVID impact was -13% to C&I and +6% for residential, far better than expected)
- AEE / Ameren - deemed under valued as viewed as having growth potential, positioned well to retire coal plants with a growing support for renewables in Missouri, favorable regulatory environment with rate base linked to interest rates, a rarity in the utility industry
- AEP/ American Electric Power - operates east and west of the Mississippi, many of the industrial customers are fixed contracts rather than usage, well positioned to retire coal plants

Utilities rated UW

Overwhelming ratings of utility stocks are in the range of EW to OW, an UW of more than 5% is highly unusual

- SO/ Southern Company - 28% of analysts rate UW. The Vogtle nuclear plant continues to be delayed and now several employees have tested positive for the virus putting completion deadlines in 2021 at risk. Cost overruns: Base case $2.6B, Bear case $3.9B. Risk that nuclear regulations will change and nuclear is becoming more expensive than other power sources.

- PNW/ Pinnacle West - 21% of analysts rate UW. Primarily coal which is expected to be more expensive than solar in AZ and NM by 2024. Regulatory has become increasingly unpredictable. Projected to need large capex expenditures in the next 3 years and analysts question whether they will be able to raise the funds needed.

XLU

Utility Select Sector SPDR ETF - 3.4% yield

Name	% of Total Portfolio
NextEra Energy Inc.	15.34%
Dominion Energy Inc.	7.75%
Duke Energy Corp.	7.69%
Southern Co.	7.41%
American Electric Power Co. Inc.	5.15%
Exelon Corp.	4.67%
Sempra Energy	4.15%
Xcel Energy Inc.	4.13%
WEC Energy Group	3.63%
Consolidated Edison	3.38%

Market Price & Dividend Yield

As of May 1, 2020

CUSIP	Price as of May 1, 2020	52 week trading range	Price target in the year (Yahoo Finance)	Dividend Yield
AEE	$71.45	$58-87	$96.00	2.67%
AEP	$81.39	$65-105	$84.00	3.40%
D	$75.61	$58-91	$86.00	4.91%
DUK	$82.64	$62-104	$95.00	4.57%
FE	$40.84	$32-53	$49.00	3.61%
NEE	$227.05	$175-283	$255.00	2.47%
SO	$54.41	$42-71	$61.00	4.61%

Sources of information & data used

January -May 2020

- Barron’s
- WSJ
- Bloomberg
- Yahoo Finance
- Morningstar
- Morgan Stanley