Utilities: A Potential New Growth Sector

The rise of renewable energy is transforming the industry.

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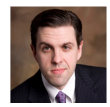

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KEY INSIGHTS

- Utilities offer investors potentially appealing growth opportunities with dividend yields that are still attractive.
- A steady decline in renewable energy costs is transforming the utility sector, lowering operating expenses and fueling faster earnings growth.
- We believe utilities now have the potential to provide returns comparable with the broad U.S. equity market with less volatility, which could raise valuations.

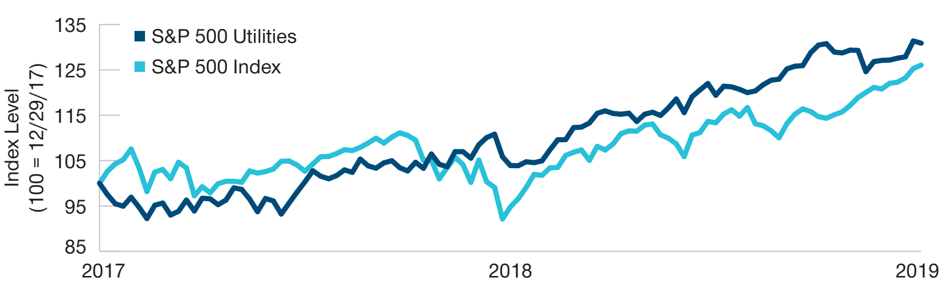
Utilities long have been perceived as a defensive sector, offering investors relatively attractive dividend yields but little or no earnings growth. Those industry dynamics are changing, however, and the conventional view is outdated. In fact, we believe utilities now may provide some of the most favorable long-term, risk-adjusted return opportunities of any U.S. equity sector.

Historically, utility returns were driven almost entirely by the dividend yield, which was highly correlated with yields on Treasuries and corporate bonds. From 1986 to 1998, for example, earnings for the S&P utilities sector were

(Fig. 1) Utilities' Improved Relative Performance

Better earnings, renewable energy drove returns

Total return December 29, 2017, to December 27, 2019, indexed to 100



Past performance is not a reliable indicator of future performance.
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70%

Potential percentage of U.S. energy generation from renewable sources in 20 years.

basically flat, while earnings per share for the companies in the S&P 500 Index rose 159%, or an 8.5% compound annual growth rate (CAGR).

More recently, however, utility earnings growth has accelerated, while earnings growth for the broad market has slowed—narrowing the earnings gap. Over the decade ended 2017, for example, earnings per share for the S&P 500 Utilities Index grew at a 4.1% CAGR compared with 6.1% for the S&P 500.[1] We believe aggregate earnings growth for the S&P Utilities Index could even exceed that of the S&P 500 over the next few years.

This new era is being driven by several developments:

- lower natural gas prices spurred by fracking technology,
- conversion from coal plants to cheaper gas generation,
- more earnings-friendly regulatory policies in many states, and
- the recent emergence of low-cost renewable energy sources, such as wind and solar power, that increasingly are replacing coal and natural gas.

These trends, especially the shift toward renewables, have put downward pressure on fuel, operating, and maintenance costs. That has generally enabled utilities to grow their rate base (the net value of the utility's plant, property, and equipment that it can earn a return on) at a higher rate without driving up customer bills, which marks a powerful change in the utility business model.

Low-Cost Renewables Are Transforming the Industry

Renewables accounted for about 18% of all the electricity generated in the United States in 2017.[2] With renewables becoming more cost-effective, we believe that percentage could rise to 60% to 70% over the next 20 years. The trend should accelerate with improvements in battery storage technology.

In the past, the economics of building wind farms or solar plants were not favorable. Now renewables already are cost-competitive in certain parts of the country, particularly the Midwest, West, and Southeast. And this trend still is in the early stages.

Utilities operating in the Midwest now can take an existing coal plant offline and replace it with a wind farm, even if the coal plant is not closed entirely, because the fuel savings and lower operating costs make it economically worthwhile. In parts of the country that are very sunny or windy, it also may start to make economic sense to replace natural gas plants with renewables within the next five years.

Regulation Has Improved

Improved regulatory structures also are contributing to a more earnings-friendly environment for U.S. utilities. Through the 1980s and into the 1990s, many utilities were focused on coal and nuclear projects that often resulted in huge cost overruns and production delays.

A company might build a large coal or nuclear plant and be granted a 9% return by regulators, only to end up four years later with a plant that might actually cost twice as much as expected. The company was not allowed to earn any returns until the plant went into service.

[1] We calculated earnings only through December 31, 2017, to avoid distortions caused by the 2017 U.S. tax reform law, which included major cuts in corporate income tax rates. These changes greatly increased per share earnings for both the S&P Utilities index and the S&P 500 Index. However, because utilities as a sector generate large amounts of taxable income, they benefited disproportionately from the law. Thus, including 2018 earnings would have created an unfair comparison with the broader S&P 500 Index.

[2] Source: The 2018 sustainable Energy in America Factbook produced by the Business Council for Sustainable Energy and Bloomberg New Energy Finance.

(Fig. 2) Earnings Growth Has Improved for U.S. Utilities

Earnings gap with S&P 500 is narrowing

Earning per share growth rates: 1986–2017

	S&P 500 Utilities	S&P 500	Difference
1986–1998	0.1%	8.5%	8.4%
1998–2007	4.3	7.4	3.1
2007–2017	4.1	6.1	2.0

Source: S&P via FactSet (see Additional Disclosures). T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved. Please refer to footnote 1 for additional disclosure.

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Since returns were actually negative while the plant was under construction, the all-in return might be only 6%–7%. Now, in most U.S. states, utilities are allowed to earn a return while a plant is under construction.

Indeed, the entire regulatory relationship has become less combative, as falling renewable costs are making it possible for utilities to give regulators the environmental footprint they want without a big impact on customer bills. Customers are happy because they are getting energy at a reasonable cost, while regulators and politicians are happy to see faster development of renewable sources.

A New Era for Earnings

We believe low-cost renewables could enable a sustainable, multi-decade period in which utilities can drive above-trend earnings growth. In our view, high-quality utilities could potentially grow their rate base 6% to 8% per year and grow earnings per share at a 5%-to-7% rate on a sustainable basis.

In addition to the possibility of stronger earnings growth, we believe utilities may offer investors other potential advantages.

Among the defensive sectors of the market—those that historically have been relatively less exposed to the economic cycle—the utilities sector is the only one, in our view, that is not threatened by significant secular risks—such as the emergence of a new competitive force or a technological innovation that would damage topline growth and profit margins. While telecoms, consumer staples, and parts of health care all face secular challenges of one form or another, utilities are actually benefiting from secular change.

It is also noteworthy that compared with the broader U.S. market, utilities face relatively few economic or political risks and, as a largely domestic industry, are less vulnerable to exchange rate fluctuations that might reduce the dollar value of foreign earnings. Finally, utilities historically have tended to be much less volatile than the market overall.

We currently favor utilities over consumer staples stocks, which also are often viewed as a defensive, less cyclical sector. In our view, staples are likely to have slower earnings growth than utilities going forward, face greater secular risk to their business models, and historically have been more volatile. Yet, relative to utilities, consumer staples stocks historically have been awarded higher valuation multiples.

We believe that over time, utility valuations should trend higher, while valuations for consumer staples stocks should trend lower, making it possible for utilities to significantly outperform staples over a five- to 10-year time horizon potentially.

What Could Go Wrong?

We believe utilities represent a compelling long-term investment opportunity. However, there are some potential challenges that investors should keep in mind:

- Regulatory limits on fracking or an outright ban on fracking on public lands could put upward pressure on natural gas prices and customer bills.
- Regulation is still a challenge in some states, including California, Arizona, and, more recently, Texas. Before investing in specific utility companies, investors need to know whether the regulatory environment in states where they primarily do business is favorable or unfavorable.
- A significant increase in U.S. inflation and/or interest rates could put pressure on operating costs and customer bills.
- The utility sector is no longer as out of favor as it was several years ago, and valuations are slightly elevated.

On balance, we believe the utility sector's improving dynamics offer an attractive opportunity for long-term investors seeking growth potential with moderate risk.

WHAT WE'RE WATCHING NEXT

Most of the federal tax credits to utilities to spur solar and wind development are set to expire over the next few years. Even without the tax credits, renewable costs have fallen so dramatically that they are increasingly cheaper than coal and on a par with natural gas. If the tax credits are extended, however, it could be an additional growth accelerator for the sector.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material:

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