EQUITY

In the Know: The Current State of the Utilities Sector

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The utilities sector was a rare ray of light for the US market in the fourth quarter of 2018, during which time the S&P 500 Index ended with a steep loss. We recently caught up with Franklin Equity Group's John Kohli to get his take on investment opportunities in the sector. He also discusses why technological innovation may help California utilities rebound from recent wildfires.

The utilities sector performed well toward the end of 2018, while other sectors struggled. What were some of the reasons for the recent outperformance?

The utilities sector was a bright spot in the fourth quarter of 2018, beating the S&P 500 Index[1] by nearly 15 percentage points. In our view, the increasing fear of an economic slowdown was the predominant reason for this outperformance. During the period, some forward-looking economic indicators started to soften from prior strong readings.

That year-end strength helped utilities stocks produce a positive return for 2018 overall.[2] Utilities and health care were the only two S&P 500 sectors with positive performance in 2018.[3]

But, looking back at 2018, utilities stocks overall had a slow start for the year. The market widely regarded the tax reform act the US Congress passed at the end of 2017 as negative for the utilities sector compared to other sectors. As I mentioned in a previous article, lower tax rates tend to lead to lower prices that benefit customers, not the bottom line of utilities companies.

Despite the lack of an immediate earnings uptick after the passage of The Tax Cuts and Jobs Act, the longer-term fundamentals of utilities stocks remained in place. By the end of 2018, many investors seemed to realize the long-term earnings and dividend growth potential for utilities remained on track, given supportive regulatory policies across most US states.

Do you expect the utilities sector to continue to perform well in 2019?

In our view, macroeconomic factors will likely continue to drive the performance of utilities stocks. Demand for utilities services such as electricity and natural gas appears to be relatively insensitive to changes in price or income. In addition, the global trade issues dominating the news on a weekly basis over the past year have not negatively affected US utilities for the most part.

For these reasons, we think the earnings predictability for utilities companies remains relatively sound. According to our analysis, the valuations of utilities companies are neither cheap nor overly expensive from a historical perspective. So, we do not anticipate any share-price movement occurring based on valuations alone.

However, if global economic activity begins to pick up more than anticipated, we would expect to see utilities stocks underperform the market. Conversely, we think utilities stocks are likely to continue to do well if economic indicators continue to underwhelm.

In an article from December 2017, you said forecasted earnings and dividend growth trends for the utilities sector appeared promising, regardless of what happens with US interest rates. Has your outlook changed, given the Fed's recent projection of two rate hikes in 2019?

Our outlook has not changed. We think earnings and dividend growth for utilities seem to be safely locked in a band of around 4-6% annually over the next five or six years.[4]

In our view, while the corporate tax rate reductions that went into place during 2018 failed to provide an immediate boost to earnings for the sector, the pass-through savings garnered from this legislative act provides headroom for the industry to spend on needed infrastructure upgrades. Investment potential for utilities remains healthy, which we think should benefit the longer-term stability of earnings and dividends.

At this time, many companies in the utilities sector offer dividend yields that are attractive relative to Treasury yields. Do you think utilities are likely to continue to raise dividends and stay competitive with Treasury yields?

Overall, we think the industry maintains the ability to continue to grow dividends in line with earnings and is likely to provide a competitive yield opportunity compared to US Treasuries. According to our analysis, balance sheets appear solid, and the dividend payout ratio[5] for utilities remains comfortably within the 60-70% range that most companies target.

Looking around at the S&P 500 Index's other 10 equity sectors, we see many companies that offer competitive dividend yields relative to utilities. However, given the defensive characteristics of utilities stocks, there seems to be a greater level of safety and predictability built into the dividend expectations of utilities compared to those other sectors.

With the recent California wildfires, there's been a lot of talk about damaged power lines and class action lawsuits. Do you see concerns about new US regulations and/or fines leading to bouts of sector volatility?

California is the only US state that imposes the concept of "inverse condemnation" on public utility companies. Under this law, the state's utilities can be held wholly liable for costs associated with damages from natural events such as wildfires, as long as their equipment is involved, and regardless of any finding of fault. We find this law to be troubling. It creates a lot of uncertainty around the state's three main publicly traded utilities.

California has been experiencing a prolonged drought in much of the state, which has led to higher fire risk. It's obviously a difficult situation for the state legislature to tackle, given the size and scope of the drought-related damages and loss of life sustained over the past two years. However, we feel that it is an important issue that needs to be addressed for some investors to feel comfortable investing in California's utilities.

We have greatly reduced our exposure to California over the past year within the Franklin Utilities Fund. In particular, we've reduced the fund's exposure to Northern California-focused utility PG&E, which is facing scrutiny by regulators and policymakers in California.[6]

We remain concerned with PG&E's ongoing economic viability given the amount of uncertainty that exists at this time. We continue to follow legislative actions in the state that we hope can provide some relief to investors going forward.

It seems most utilities are shifting toward renewable energy or piloting

new programs for renewables. Do you see any obstacles, such as higher interest rates, slowing plans to invest in infrastructure?

The shift to renewables for electric utilities definitely can be beneficial for the environment. However, what makes it especially appealing from an investment standpoint is that in most cases, it's beneficial from an economic perspective, too. Because the industry can invest in greater amounts of solar and wind energy while at the same time keeping customer bills flat to lower, according to our analysis, we believe the shift in investment in renewable energy is here to stay.

While some of the economic incentive for a shift to renewables over the past decade has been driven by state and federal subsidies, greater efficiencies and declining cost of production of renewable resources are outpacing the drop-off in these subsidies, which we think should make renewable resources self-sufficient over the next couple years. Overall, we don't anticipate any slowdown of infrastructure plans related to renewable investment.

Do you see any other potential opportunities or obstacles for utilities in the near future?

From an opportunity perspective, we think technological changes will continue to drive new investment in the utilities space. In California, for example, wildfire risks related to power lines coming into contact with vegetation during dry season high-wind events (such as the extremely dry Santa Ana downslope winds that affect coastal Southern California) can be alleviated through investment in different technologies such as insulated power lines. Moving vulnerable parts of the power grid from overhead lines to underground is another potential solution.

There is an added cost to making these investment decisions, but in many cases environmental changes and/or population shifts toward rural, higher-fire-risk communities demands that these technological choices be made. Similar to safety-related regulations for natural gas pipelines implemented in the United States following several high-profile accidents, changes in regulatory standards for utility infrastructure can continue to drive relatively high levels of investment opportunity.

From an obstacle perspective, interest rates and commodity costs continue to be areas we watch extremely carefully. Regulatory relationships between utilities companies and their states over the past decade have remained highly constructive, primarily because we have not witnessed meaningful cost pressures related to higher financing rates or energy prices (about 63% of electricity generated by US utilities comes from fossil fuels such as coal, natural gas, petroleum and other gases).[7] That said, a rise in either natural gas prices or long-term interest rates could disrupt this benign environment we see going forward.

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What Are the Risks?

Franklin Utilities Fund

All investments involve risks, including possible loss of principal. Investing in a fund concentrating in the utilities sector involves special risks, including increased susceptibility to adverse economic and regulatory developments affecting the sector. Stocks historically have outperformed other asset classes over the long term, but tend to fluctuate more dramatically over the short term. Securities issued by utility companies have been historically sensitive to interest rate changes. When interest rates fall, utility security prices, and thus a utilities fund's share price, tend to rise; when interest rates rise, their prices generally fall. These and other risks specific to the public utilities industry are described more fully in the fund's prospectus.

Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. Download a prospectus, which contains this and other information. Please carefully read a prospectus before you invest or send money.

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1. Source: S&P Dow Jones Indices. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. Past performance is not an indicator of future performance.
See www.franklintempletondatasources.com for additional data provider terms and conditions.

2. Ibid.

3. Ibid.

4. Source: Bloomberg. Industry projections are based on the long-term earnings projections of 53 electric, gas and water utilities in the United States and Canada as of January 8, 2019. There is no assurance that any estimate, forecast or projection will be realized.

5. The dividend payout ratio is defined as dividends paid divided by net income.

6. As of November 30, 2017, PG&E common stock represented 2.40% of total net assets of Franklin Utilities Fund. As of November 30, 2018, PG&E common stock represented 0.74% of total net assets of Franklin Utilities Fund. Holdings are subject to change.

7. Source: U.S. Energy Information Administration, as of April 20, 2018.