EQUITY

Shedding Light on the Utilities Sector

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US tax reform legislation dampened investor enthusiasm for utilities stocks in the last four months of 2017. Here, Franklin Equity Group's John Kohli says that view may be creating opportunities for long-term investors. He digs deeper into industry fundamentals that he thinks make for an attractive longer-term investment case for the sector.

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In September 2017, US President Donald Trump unveiled his tax reform plan, and then signed it into law in December. During that time, the US utilities sector lagged the broader US equity market.

In our view, there are likely two reasons for this underperformance, both related to the tax proposals. First, utilities likely won't enjoy the immediate earnings boost from the tax reforms that other sectors expect. Second, some investors think tax reform could lead to higher long-term interest rates and negatively affect utilities companies.

As a result, many investors have felt they should sell utilities stocks. However, this view may be creating an opportunity for long-term investors. We believe the industry remains in a good place from a fundamental perspective, and long-term earnings and dividend growth prospects have good visibility.

How Lower Corporate Taxes May Boost Clean Energy

The new tax law reduces the US corporate tax rate to 21% from 35%. While the lower tax rate is likely to boost earnings in many sectors, we don't see benefits to the utilities sector in the short term. For utilities, corporate tax expense is a pass-through cost in customer rates. So, a lower tax rate would likely lead to lower prices that benefit customers, not the bottom line of utilities companies.

That said, lower pass-through costs will likely free up capital for utilities to continue to invest in infrastructure without raising prices. We see utilities continuing to replace coal-fired power plants with investments in alternative sources such as natural gas, wind and solar.

In our view, utilities will likely further upgrade their distribution networks to handle a higher number of electric vehicles on their grids. We also see increased spending on updating transmission networks to be more responsive to higher renewable energy usage. We think these investments are likely to lead to higher earnings power for utilities over the long run.

On the regulatory front, the Clean Energy Plan (CPP) and previous federal proposals have faced numerous legal challenges over the past 20 years. However, we don't see that as a main concern, because utilities are mostly regulated at the state level.

States, for the most part, have remained steadfast in their desire to reduce environmental emissions from energy generation. It is in each state's best interest to provide cleaner, clearer air to its residents. That desire is only increased by the cost advantages that renewable energy provides over conventional forms of generation.

Why Investors Shouldn't Fret Over Long-Term Interest Rates

Some market observers expect US tax reform to stimulate the US economy, although perhaps only to a minor degree. Expectations for increased economic growth and prospects for higher inflation could lead to higher long-term interest rates. That, in turn, could negatively affect interest-rate sensitive sectors such as utilities.

As we look to the new year, the US Federal Reserve's (Fed) own forecast calls for three interest-rate increases in 2018. Despite improvements in US gross domestic product over the past few quarters, inflation remains subdued, and we've seen a flattening of the Treasury yield curve as the Fed has raised rates.[1]

Against this backdrop, we remain focused on how the Fed's actions impact long-term inflation trends to try to gauge the direction of utilities stocks.

The Outlook for Utilities Stocks

We see many reasons to be optimistic about utilities today as we look out over the next 10, 20 or 30 years. In our view, most companies have established constructive regulatory relationships and should be able to adjust to the higher cost of capital assumptions that would develop due to rising interest rates.

Forecasted earnings and dividend growth trends for the industry over the next several years also appear promising to us. The industry earnings growth rate sits in a range of around 4%-6%, with some companies achieving earnings growth above that range to high single-digit levels.[2]

The projections for dividend growth in the sector are tracking that earnings trajectory, as most companies appear comfortable with their current level of balance sheet financing. Given investment opportunities remain robust, we expect dividend growth to remain near the level of earnings growth over the next few years.

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. The Yield Curve depicts the yields of bonds of varying maturities, from short-term to long-term. The line or "curve" shows the relationship between short- and long-term interest rates.

2. 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 December 27, 2017. Please see www.franklintempletondatasources.com for additional data provider information. There is no assurance that any estimate, forecast or projection will be realized.