US Utilities & Clean Tech

The Incredible, Shrinking Utilities Sector. Relative weakness drawing more attention

Industry Overview

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Equity
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EEI: Edison Electric Institute

Utility mix of S&P declines rapidly in recent months

US utilities represent the smallest percentage of the S&P 500 market cap in the last ten years after the relentless rally in technology stocks, particularly the mega tech stocks. US utilities are now just 2.1% of the S&P 500, down from 2.5% in October 2023 and 3.0% in July 2023. Utilities have hovered around 3% 2014-2023 and a peak of 4% in 2009 great financial crisis, highlighting the velocity of the recent move. For reference, per the Edison Electric Institute (EEI), the US electric utilities represent ~5% of annual US GDP with over 7Mn jobs and $150Mn annual capital investment. Energy peers have had a far more dramatic decline, now 4% of the S&P 500 versus 10% ten years ago. For a brief period during peak-covid in 2020, energy was a smaller sector than utilities.

Relative valuation still diverging. Are utilities cheap?

US utilities trade at 13.5x Consensus FY2, a -22% discount versus the Information Technology sector. This is not only the widest discount in ~20 years, the prior largest discounts were only 7-8%. Given the deterioration in outlooks for many utilities in the high interest rate environment, significant increase in potential for technology oriented firms, and growing regulatory/political/natural disaster challenges, it is difficult to simply label utilities as "cheap" using the historical relationships. When regressed against long term interest rates, utilities look far closer to fair value than the relative P/E comparison would dictate.

Wildfire risk has significantly eroded interest in the sector

Just as investor sentiment was beginning to recover after the 2017/2018 California wildfires, the wildfires for Xcel Energy (XEL), Hawaiian Electric (HE), and PacifCorp (BRK – Not Covered) have sapped enthusiasm for the sector. The Berkshire Hathaway annual letter (details here) stated that some Western utilities will face significant challenges attracting capital just days before the latest 1Mn+ acre Smokehouse Creek fire. It could be argued that many utilities in 2024 have above-average risk profiles yet offer below-average return outlooks. Yet many utilities we speak to do not appear to view wildfires as the same existential threat that an increasing number of investors we speak to do. Hawaii is the only state we are aware of seriously pursuing wildfire legislative changes.

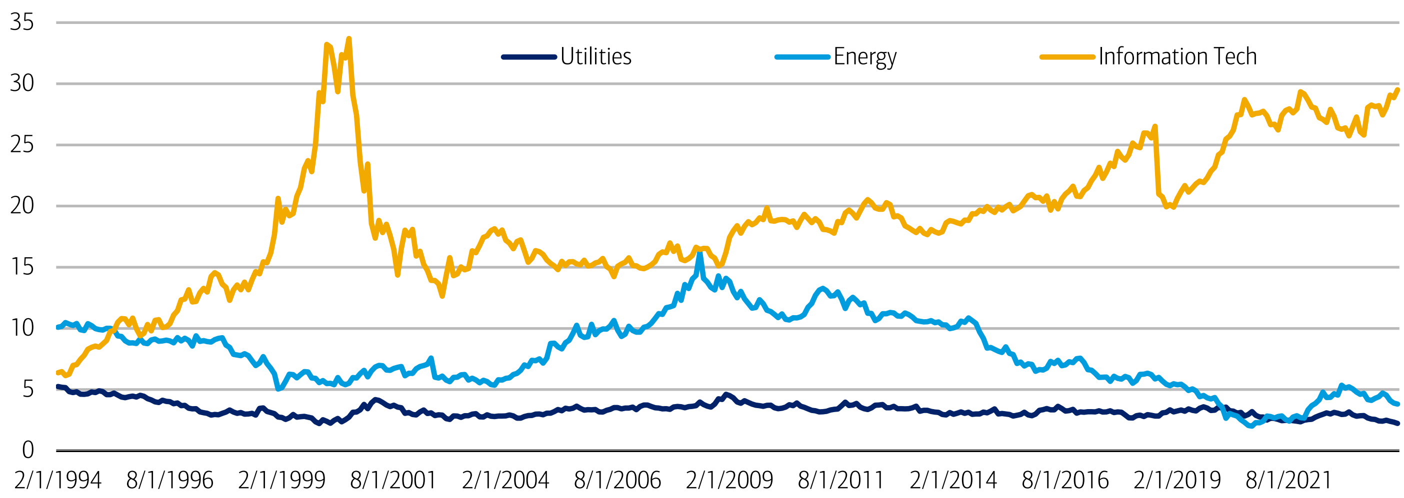
Proof is in the pudding: Almost all utilities increased capex

With this backdrop of compressed utility returns (higher cost of capital and minimally changed allowed returns), substantially every utility we cover has ***increased*** their capital investment plans over the last 12 months. Many of these increases are being financed by new equity issuances at lower P/E valuations. This notably included some of the lowest P/E companies such as Portland General Electric (POR) at 12x 2026E. Despite this, from our regulatory conversations, we do not expect authorized utility ROEs to increase dramatically from current levels now that US Treasury rates have moderated. There could be some continued upward pressure but regulators we have engaged with recently do not seem compelled to increase authorized ROEs in general. NARUC 2024: Reliability, affordability & re-regulating PJM generation. 28 February 2024

Technology firms flying by utilities

Utilities have always represented a small fraction of the S&P 500 equity market cap (much larger enterprise value given the leverage) but the steady compression has accelerated. Notably, the Information Technology (IT) sector is approaching its 2000 era high of the S&P 500 market share. Just in the past twelve months, IT has gained ~3pp of market share, larger than utilities are in total.

Exhibit 1: S&P Subsector Long-Term Comparison: Tech approaching its 1999-2000 high mix of S&P while Utilities hit record low
Utility shrinking has accelerated as tech has been a 'winner take all' sector



Source: Bloomberg

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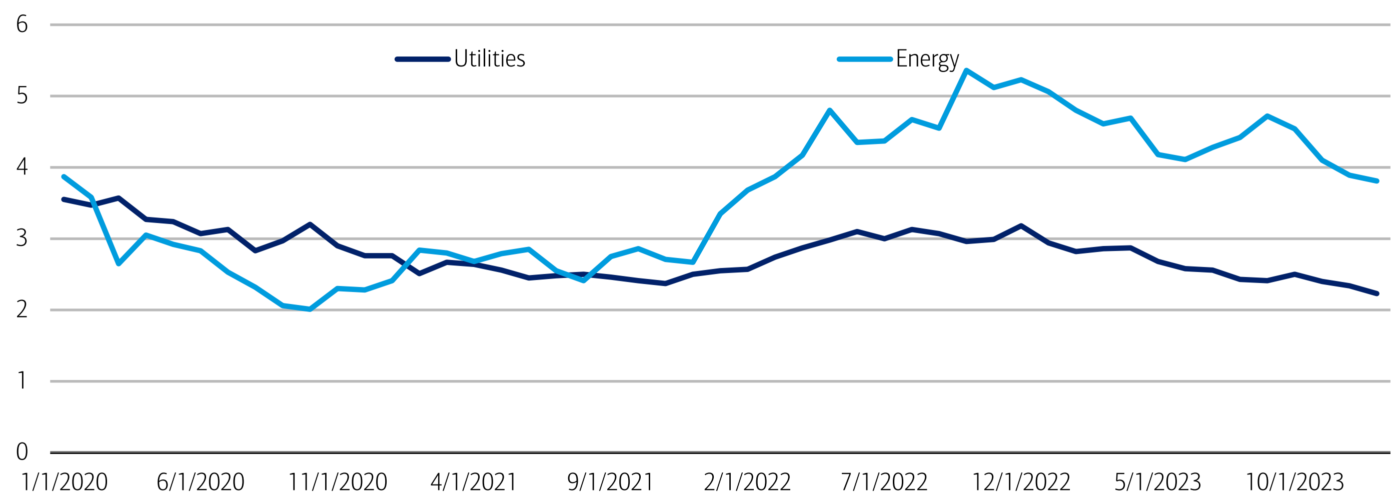
The exhibit below zooms on just utilities and energy since 2000 showing the decline in utilities and rise of energy.

Exhibit 2: S&P Subsector Long-Term Comparison: Utilities and Energy
Energy companies gained market share in 2021/2022 vs utilities and have not looked back



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US utilities now trade at -22% discount vs the S&P 500, the deepest in decades. Some investors have viewed utilities as attractive using that simple methodology, but we believe there is far more than meets the eye.

Exhibit 3: Utilities Relative FY2 P/E Premium vs S&P 500
Utilities now trade at over a 20% discount vs the S&P 500 – largely due to the rise in interest rates but other factors are at play

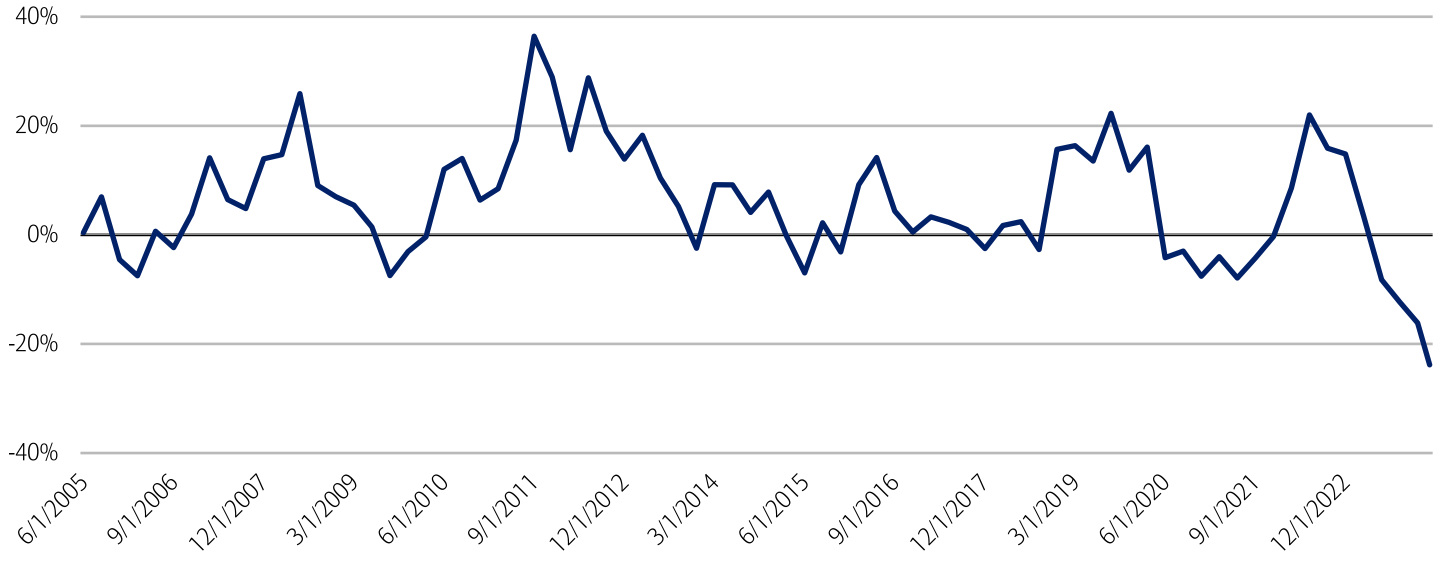

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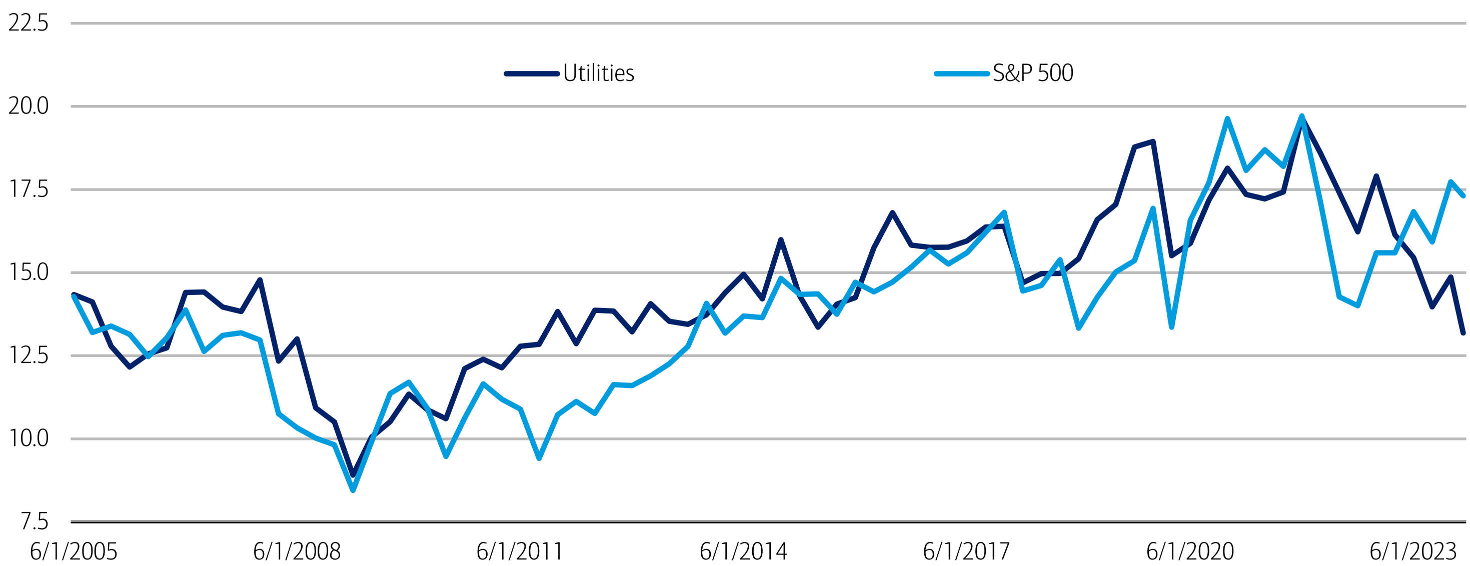
Exhibit 4: Utilities and S&P 500 FY2 P/Es
On an absolute basis, utilities trade at a similar level to the forward multiple back in 2012



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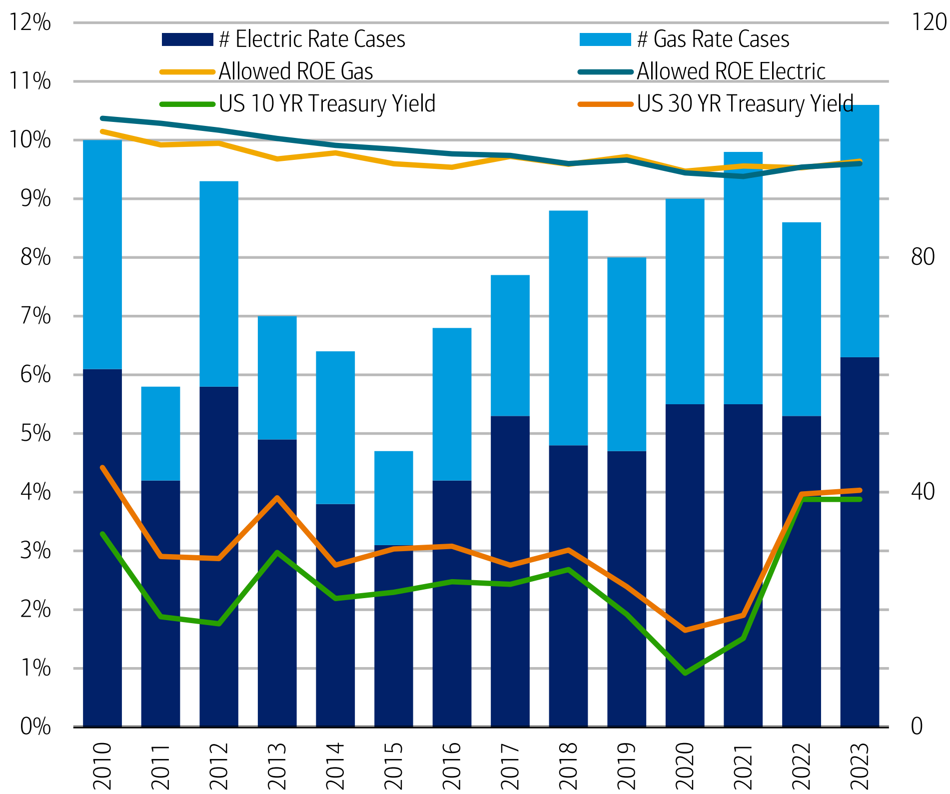
2023 avg Electric and Gas ROEs inched up higher

The average authorized electric ROE inched up higher in 4Q23 to 9.66% vs 9.53% in 3Q23 while the average authorized gas ROE lowered slightly to 9.63% in 4Q23 vs 9.66% in 3Q23. TTM data indicated both average authorized Electric and Gas ROEs moved up higher to 9.60% and 9.64% vs. 9.54% and 9.53% average observed in 2022, respectively, based on 63 and 43 electric and gas rate cases decided in 2023, much higher than 53 and 33 electric and gas rate cases decided in 2022.

We note excluding rider cases the average authorized Electric and Gas ROEs for 2023 were **9.66%** (higher than overall average, given expiration of incentives allowed in Virginia rider cases) and **9.60%** (excluding six gas rider cases vs no rider cases in 2022), respectively.

Exhibit 5: ROE trends vs. US treasury yield

Both Electric and Gas ROEs tracking closely; total number of rate cases decided were at highest since 2010



Source: BofA Global Research, S&P Capital IQ, Factset

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The average spread of authorized ROEs vs 10Yr Treasuries was minimally changed at 5.7% in 2023, similar to 2022. This is much lower than the 7-8% average 2009-2020 and the 8-9% in 2021.

Exhibit 6: Allowed Gas ROE and US 10 YR treasury yield spread

Spread remains widened vs historical; +10bps change vs 2022

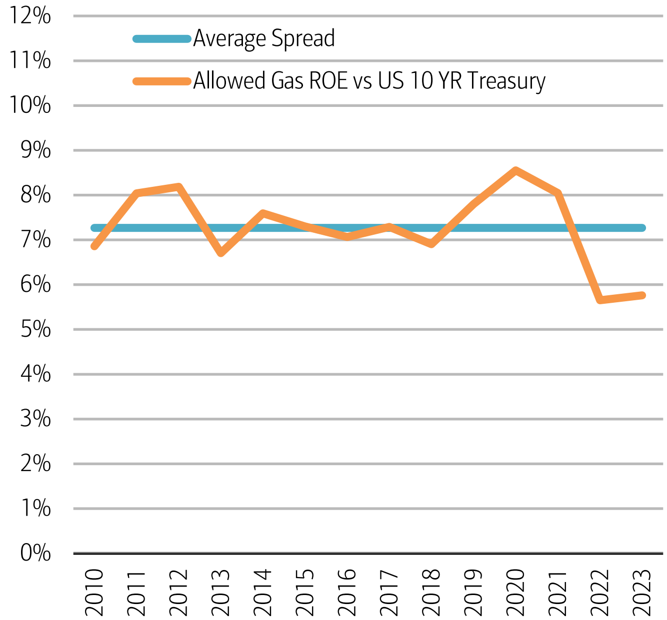

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Exhibit 7: Allowed Electric ROE and US 10 YR treasury yield spread

No discernible change vs 2022

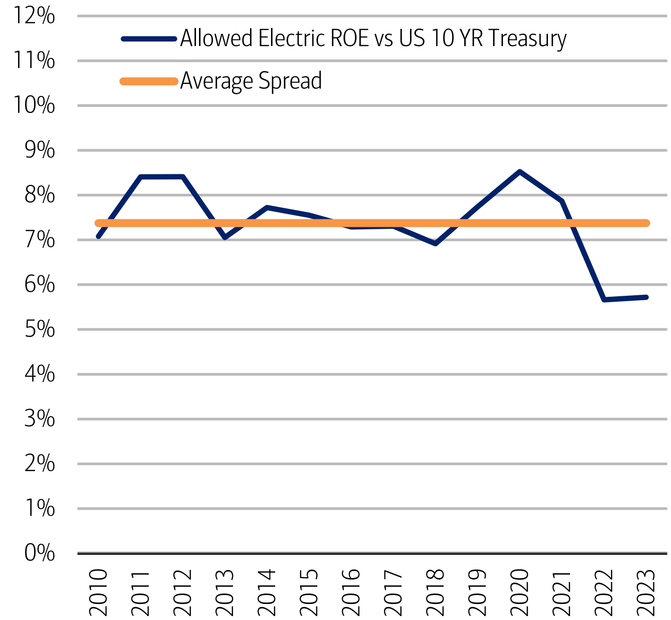

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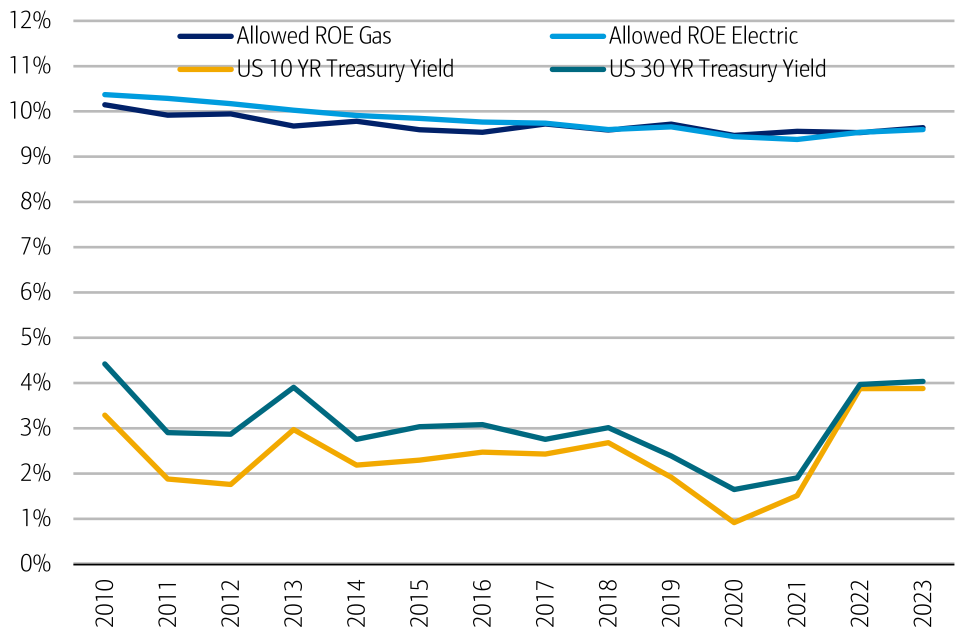
Exhibit 8: Trending of Electric and Gas ROEs vis-à-vis Treasury rates

Spread between ROEs and Treasury narrowed further



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