Why Telecom and Utilities Stocks Are Underperforming

Description

On July 11, the Bank of Canada raised its overnight interest rate by 25 basis points to 1.5%. This was the fourth raise in the last 12 months, and more hikes will come. Interest rate hikes are a sign of a strengthening economy and are generally positive for stocks, with the exception of a few sectors that actually suffer from rising interest rates.

Telecommunications and utilities stocks are particularly impacted by rising interest rates. Those companies are capital intensive, as they need to borrow capital frequently to grow and update infrastructure. Since a higher interest rate increases the cost of borrowing, borrowing costs increase and consequently, the companies' debt levels increase too.

Telecom and utilities usually have a high dividend yield, so they are attractive for investors seeking dividend income. However, when yields rise, investors with low risk tolerance may be tempted to switch to bonds, causing the prices of telecom and utilities stocks to fall.

Therefore, it is not surprising that telecom and utilities stocks have underperformed the market recently.

In the utilities sector, **Fortis** (TSX:FTS)(NYSE:FTS) has taken a big hit. Its shares have dropped 6% since the beginning of the year.

In the second quarter, Fortis reported adjusted net earnings attributable to common equity shareholders of $240 million, or $0.57 per share, compared to $253 million, or $0.61 per share for the same period in 2017.

Fortis' earnings come from regulated gas and electric assets and ITC Holdings Corp., which benefits from regulatory protection. These relatively low-risk operations result in stable earnings and help fund dividend growth.

Fortis' earnings and dividends are projected to grow 5% and 6%, respectively, over the next five years. The current dividend paid amounts to $1.70 per share annually, for a yield near 4%.

Despite the fall in price, Fortis' stock is still overvalued, with a five-year PEG of 6.1. The stock is too much expensive relative to its low expected growth.

In the telecom sector, **BCE** (TSX:BCE)(NYSE:BCE) shares have dropped almost 9% year-to-date.

BCE's net income attributable to common shareholders was $705 million, or $0.79 per share, in the second quarter. That was down from $765 million, or $0.85 per share, in last year's second quarter and below analysts' estimates of $0.88 per share.

While BCE is struggling in the short-term, it appears to be the most favourably positioned among the four largest Canadian providers of wireline and wireless services. BCE is expanding its optic fibre network, which will eventually reduce its operating costs, allow it to offer higher speeds than competitors and charge higher prices.

In the meantime, the stock is too much expensive relative to its growth, showing a very high five-year PEG of 8.7. Earnings are expected to grow by only 2.3% per year on average over the next five years. The current dividend paid amounts to $3.02 per share annually, for a yield of 5.5%.

In short, if you are looking for strong growth and capital appreciation, you won't find that in utilities and telecom stocks over the coming years. These stocks may be good choices for investors seeking high dividends, but I don't see other reasons to hold these stocks now. Even then, you can find stocks that pay higher dividends and show better growth perspectives, like bank stocks.

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1. Dividend Stocks
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2. NYSE:FTS (Fortis Inc.)
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