Are Utilities Still a Rock-Solid Investment?

Description

For some time, utilities have been considered reliable relatively low-risk income-generating investments. Because of these characteristics, their popularity soared in the wake of the global financial crisis almost 10 years ago when near-zero interest rates and growing liquidity caused the yields of traditional, lower-risk income-producing investments to decline significantly.

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Nonetheless, the popularity of utility stocks as income-producing powerhouses appears limited, which has caused them to decline in value over the last year, as markets become increasingly concerned about their ability to deliver further value. Canadian electric utility **Fortis** (TSX:FTS)(NYSE:FTS) has dropped 8%, while **Canadian Utilities** (TSX:CU) plunged by 18%. This has led to some pundits claiming that there is an opportunity to acquire high-quality utilities at an appealing valuation.

Now what?

Central banks across the world are in the process of unwinding the unconventional monetary policy which created cheap credit and boosted liquidity during a time of severe financial crisis. A key part of that process is the normalization of interest rates. The U.S. Fed has hiked the headline rate twice this year to target a modest range of 1.75-2% and flagged that there are potentially two more increases before the end of the year. The Bank of Canada (BOC) has also bolstered rates, lifting them twice since the start of 2018 to set the policy rate at 1.5%.

Higher rates apply pressure to utilities because of the significant debt that many possess and the need to invest large amounts of capital to sustain their operations because the maintenance of infrastructure is costly. This also applies when it comes to building new infrastructure such as power plants, transmission lines and pipelines to meet regulatory requirements, replace obsolete assets, and meet growing demand.

Many utilities borrowed heavily when debt finance was cheap to expand their asset base and grow their operations through acquisitions. This now sees many, such as Fortis and Canadian Utilities, holding tremendous amounts of debt.

Fortis, which is Canada’s second-largest electric utility, borrowed heavy to finance the CH Energy

Group and UNS Energy deals; it ended the second quarter 2018 with a massive $21 billion of long-term debt. This comes to just over six times EBITDA, which is concerning because it indicates that the level of debt could be unmanageable in an operating environment where finance costs are rising.

Canadian Utilities ended the second quarter with long-term debt of just over $8 billion**,** which is just under six times EBITDA. This — along with weaker earnings triggered by regulatory rate re-basing and climbing finance costs — indicates that it could be difficult to manage.

That leaves both vulnerable to higher interest rates, not only because of increased financing costs, but because their operations are heavily regulated.

You see, the contracted nature of their operations where prices are fixed and rigidly governed means that in many cases, they are unable to pass on those additional financing costs to their consumers. This means they must be borne by equity and debt investors making heavily indebted utilities less appealing to investors.

Higher rates also make it difficult for utilities to grow their operations because it becomes more expensive and difficult to raise capital to fund acquisitions. This can cause their earnings to stagnate**,** preventing their market value from appreciating, while restricting their ability to increase their dividend further, reducing their appeal to investors.

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So what?

While higher rates create a poor outlook for utilities, it should be noted that they are still well below their historical averages, even after the modest increases witnessed to date. The U.S. headline rate is less than half of what it was in 2007 when the global financial crisis hit, whereas for Canada it is roughly around a third. This means utilities are not facing the same risks posed by higher interest rates as they were prior to the global financial crisis.

It should also be recognized that rising rates indicate that the economy is growing, leading to greater demand for the services provided by utilities. When coupled with inflation, this will lead to higher contracted prices, which will boost their earnings, offsetting increased finance costs and providing them with ample opportunity to reduce debt before rates reach perilous levels. For those reasons, the latest pullback by Fortis and Canadian Utilities has created an opportunity for long-term investors.

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