If Herds of Investors Crowd Into Utility Stocks for Safety, Should You?

Description

October's volatility is an important reminder that there's no place to hide in equity markets. One trading day last week was the worst-performing TSX day in three years.

Analysts are advocating utilities stocks to preserve investment capital, reduce risk, and calm investors down! Let's consider the advice. First, utilities tend to do well late in economic cycles, and it is fair to say the Bull Run has been long. Second, utility companies have huge infrastructure costs so there's an enormous barrier to entry for competitors.

My third point is that utilities companies often have fairly long-standing revenue streams, as they strive to set up shop in dependable markets.

Savvy investors already knows this stuff! But if everyone and their neighbour crowd into utility stocks then this could create stagnation. How so? No new buyers. Many utilities are undervalued by historical standards, but this could be the new norm as rising interest rates drag on this high borrowing sector.

Cue Bob Dylan's "*the times they are a changin.*" Identifying utility companies that are able to walk the tightrope by keeping creditors, investors and customers happy is the challenge.

Canadian Utilities Ltd. (TSX:CU) is a good case study. This $8.4 billion market cap company operates primarily in Alberta, but also Mexico and Australia, and has a family feeling to it ever since its inception. This may not be your go-to utility stock (frankly, the generic company name is not helping).

Canadian Utilities is majority owned by **Atco Ltd** (TSX:ACO.X), which is the more recognizable name and may be on your watch list alongside names like Fortis Inc. (electricity), Enbridge Inc. (gas), and Rogers Communications Inc. (telecom). Retail investors should view Atco and Canadian Utilities as one in the same simply because the stock price movements are virtually identical.

Stock price return for Canadian Utilities Ltd since 2008 is shown in the table, with an average annual return of 3.7% (underperforming based on competitors in my opinion).

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD

Return (%)	-12.7	8.0	24.3	13.1	16.9	-0.8	14.7	-21.9	13.3	3.4	-17.1

Source: Yahoo Finance

Investors should be looking through the windshield, not just the rearview mirror. After five consecutive missed earnings, starting back in Q2 2017, the most recent Canadian Utilities quarter reported on October 25 had earnings-per-share beating estimates by 23% ($0.49 rather $0.40), largely attributed to strong performance for the Electricity Global Business Unit.

This is good news for investors, along with earnings guidance ticking up into 2019, are signs of a turnaround.

The stock is down almost 18% year-to-date, near a multi-year low. The dividend is consequently over 5% with a payout ratio around 93%. In the first nine months of 2018, capital investment was $1.6 billion, almost four times higher than the same period in 2017.

Part of the capital expense, roughly $110 million, was the acquisition of a hydroelectric company called Electricidad del Golfo in Veracruz, Mexico, reflecting Atco's vision to grow business globally.

Takeaway message

As an offshoot of Atco, shares in Canadian Utilities offer exposure to the utility sector, primarily electricity generation and distribution. Despite the stock price drop, the primary impetus to invest in Canadian Utilities is for the dividend income as the stock seems to be fairly price as the pressure mounts for this sector to hold up during market volatility.

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2. TSX:CU (Canadian Utilities Limited)

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