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UTILITIES | COVER

12 Stocks and Funds to Play the Coming Green Boom for Utilities

By Andrew Bary Updated February 28, 2021 / Original February 26, 2021

Photograph by Sarah Anne Ward; Animation by Sean Lattrell

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A squat power plant with smokestacks may not be what environmentally conscious investors have in mind when they go looking for stocks. Yet electric utilities are at the center of a seismic shift away from coal and toward wind and solar power over the next 15 years. That is expected to be a huge boon to both the environment and investors—and utility company stocks and funds are a cheap way to plug into this critically important transition.

By the next decade, clean power sources such as wind and solar are projected to provide 39% of the U.S. utility industry's generating capacity, versus 13% today, while coal is forecast to account for just 3%, versus 19% now, according to Morgan Stanley analyst Stephen Byrd. He sees natural gas, now the dominant source of electricity generation, falling to 28% by 2030 from 40%. As a result, the industry's carbon emissions could decline by 60% from 2020 to 2030.

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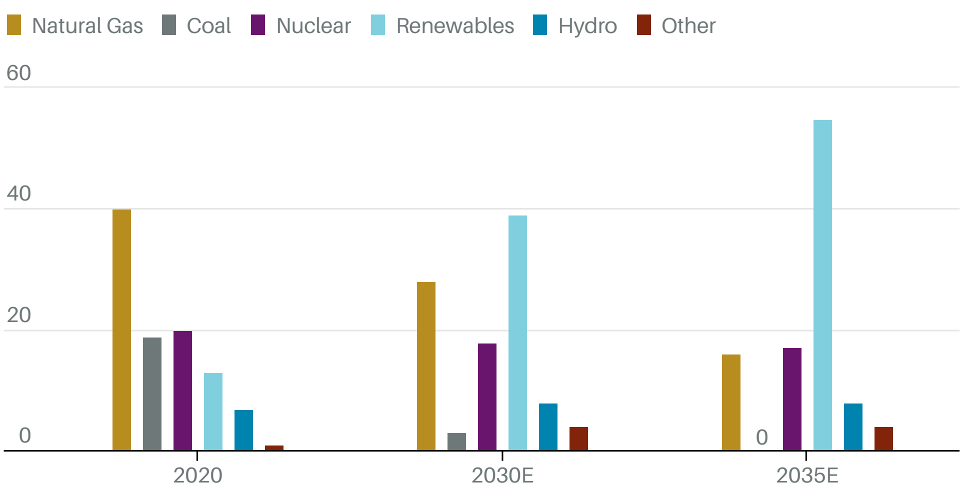
"Everybody wins," Byrd says. "The air is cleaner, utility bills are lower, and shareholders benefit in a big way."

Many investors are overlooking this bright green opportunity. The $500 billion utility sector has badly trailed the overall stock market of late. The largest exchange-traded fund of utility stocks, the Utilities Select Sector SPDR (ticker: XLU), returned negative 10% in the past year compared with a 24% return for the S&P 500 index. Defensive sectors like utilities have been out of favor, as investors gravitate to industries like energy and financials that will more directly benefit from an improving economy.

In the coming years, utilities—now yielding an average of 3.5%—are likely to have annual earnings growth of 5% to 8%. Those results will be driven by heavy investment in renewable-energy sources, batteries and other power-storage devices, new transmission lines, and investments to harden the electrical grid to help avoid blackouts and breakdowns—a need strikingly evident in the recent freeze that nearly collapsed the grid in Texas.

Fuel Sources



E=estimate
Sources: Morgan Stanley; Edison Electric Institute

All of this could translate into 10% annual total returns, which would be competitive with the S&P 500 and much better than those in the bond market, where Treasuries and municipals yield just 1% to 2%.

"Utilities are a stealth green-energy play, with much lower valuations than most alternative-energy providers and less risk," says Hugh Wynne, co-head of utilities and renewable energy research at SSR, an independent research consulting firm.

Investors can play the sector through companies such as American Electric Power (AEP), Dominion Energy (D), Entergy (ETR), Exelon (EXC), and industry leader NextEra Energy (NEE), which has built a large and lucrative renewable-energy business.

In addition to the Utilities Select SPDR fund, another ETF focused on power companies is Vanguard Utilities (VPU). The two ETFs have similar holdings, returns, and current

"Utilities are a stealth green-energy play, with much lower valuations than most alternative-

yields of 3.3%. The top three stocks in both funds are NextEra, Duke Energy (DUK), and Southern Co. (SO).

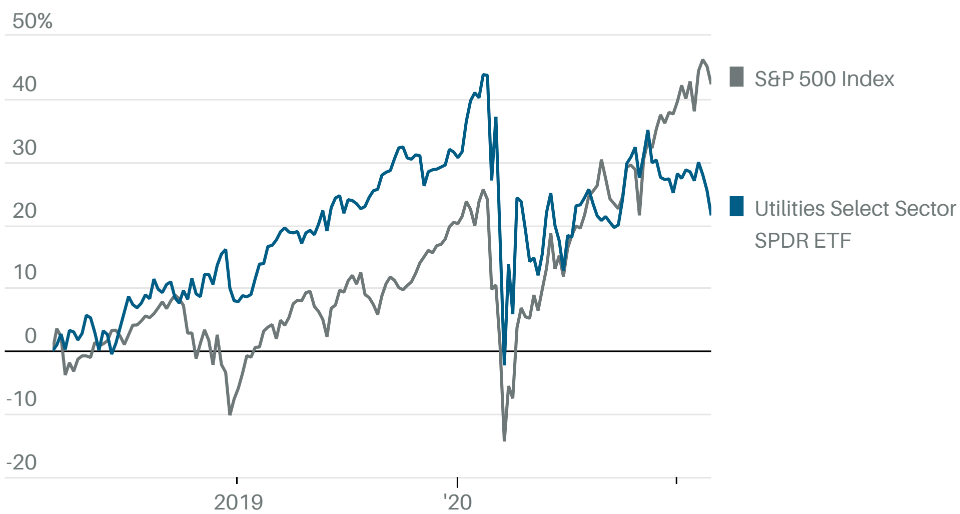
Reaves Utility Income (UTG), a $1.8 billion closed-end fund, is trading at a small premium to its net asset value. It has about half of its assets in electric utilities, with the rest in cable TV, telecom, and other sectors.

Utilities will play a pivotal role in the economy's electrification over the next two decades, as more Americans adopt electric cars and light trucks and use electricity for heating and cooking, replacing oil and natural gas.

energy providers.
"

— Hugh Wynne of SSR, an independent research consulting firm

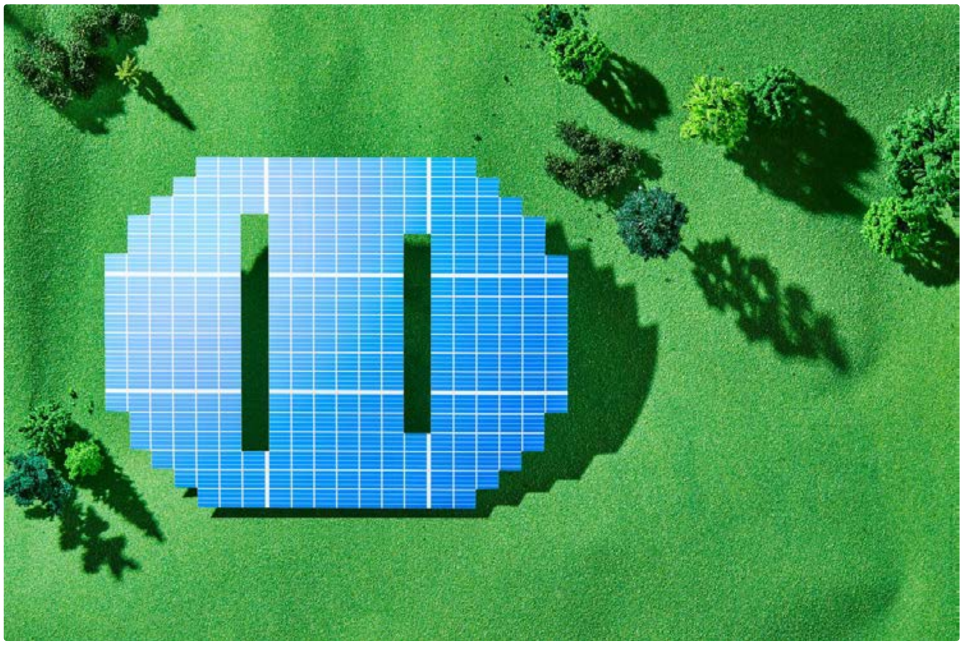
Unloved Utilities



Source: FactSet

"The conventional view is that you need to buy go-go technology companies or renewables developers to participate in the energy transition," says George Bilicic, the vice chairman of investment banking at Lazard and head of the firm's power, energy, and infrastructure group. "But the most efficient and optimal risk-adjusted manner to participate in the energy transition is through well-run electric utilities."

The Biden administration's green initiatives should reinforce the trend toward renewable energy that is being driven by the states, utilities' main regulators. Many, notably California, have aggressive green-energy targets.



Photograph by Sarah Anne Ward; Prop Styling by Paola Andrea

All of this could capture the attention of the growing legion of socially responsible investors, as the utility industry undergoes a huge reduction in its carbon footprint.

"This is as good an opportunity for utilities as I've seen in my career," says John Bartlett, president of Reaves Asset Management, which runs the Reaves Utility Income fund. "The industry hasn't been able to grow like this since the 1950s and 1960s."

Utilities were a growth industry in the postwar period as a result of brisk economic expansion, migration to the suburbs, and the widespread adoption of air conditioning. Now, their time is back, but their stocks are still relatively inexpensive.

Electric utilities trade for an average of 18 times projected 2021 earnings. That is a discount to the S&P 500's about 23 times, although not a bargain. Investors, however, should view them as relatively low-risk stocks with less volatility than the overall market and as appealing substitutes for bonds.

"Utilities look exceptionally attractive relative to fixed-income investments," says Morgan Stanley's Byrd.

Utilities' current yield of about 3.5% is slightly higher than that on Baa-rated corporate bonds. In contrast, over the past decade, utility shares, on average, yielded about 1.5 percentage points less than bonds.

Bilicic calls the industry's current valuations "nonsensical," given its growth outlook, and says that it would take a sharp rise in interest rates to dent the stocks' appeal.

Some environmentally conscious investors might recoil at investing in the likes of American Electric Power, Duke Energy, or CMS Energy (CMS)—which still produce a meaningful portion of their electricity from coal. But investors should look at where the industry is going, rather than where it is.

Current utility carbon emissions total about 1,450 million metric tons annually, or about a quarter of the total in the U.S. Industry emissions could drop to 580 million tons by 2030, according to Morgan Stanley's Byrd. That would help the U.S. meet or exceed international carbon-reduction targets—a Biden administration goal.

Indeed, given its large size, the utility sector "may be the best expression of decarbonization for investors," argues J.P. Morgan analyst Jeremy Tonet.

Coal, for one, is on its way out. "There is not a regulated coal plant in this country that is economic today," said NextEra CEO Jim Robo in January.

Dominion Energy's Jones Act-compliant offshore wind installation vessel, the first in the U.S. The vessel, which is likely to enter service in 2023, is expected to be based in the Hampton Roads region of Virginia.
Courtesy of Dominion Energy

Today, California utilities have the cleanest generating capacity. A nearby table from J.P. Morgan shows 13 utilities ranked by their current green status and the expected rate of change in the coming years.

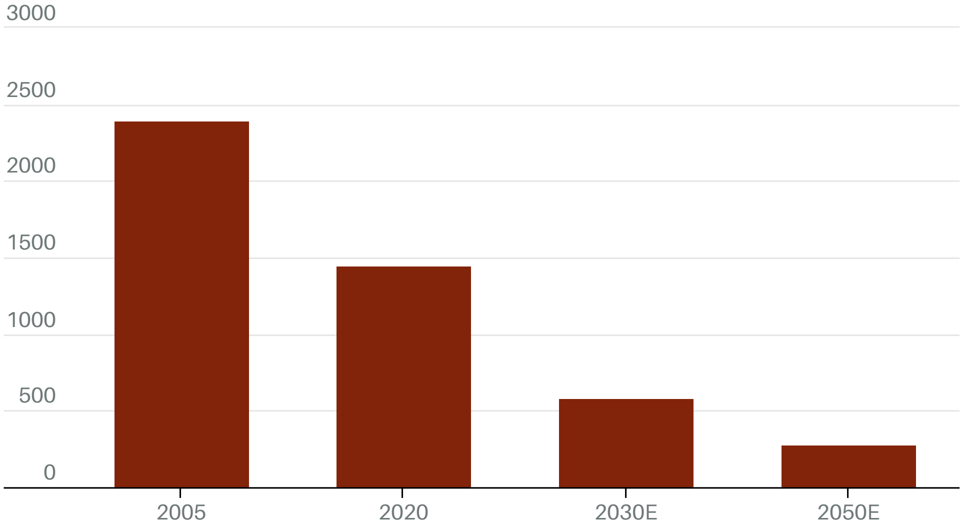
"A lot of folks are interested in impact investing—in making their investments make a difference," says Reaves Asset Management's Bartlett. "One of the wonderful things about utilities is that you're helping them raise money to clean up the environment."

Utilities rely on bond and equity financing to fund heavy capital spending programs. They don't retain a lot of earnings, given their dividend payout ratios, which average about 65%.

Yet as capital spending ramps up, so do utility profits. Regulators allow utilities to earn a 9% to 10% return on their equity, and that equity grows with new investment.

The industry is expected to spend about $130 billion annually on renewable sources of energy, storage and transmission facilities, and electricity distribution networks in 2021, 2022, and potentially longer, up 50% from the level a decade ago.

Industry Annual Carbon Emissions*



E=estimate; *million metric tons
Source: Morgan Stanley

These outlays should drive industry earnings growth at a healthy annual clip of 5% to 8% for the coming years and possibly for the entire decade. Dividends are expected to rise in line with profits.

Residential electricity rates, which rose at just a 1% annual pace in the past decade, could increase at about 2.5% yearly in the 2020s—paralleling expected inflation—as utilities earn a return on their heavy investments.

"We see structural decarbonization, robust growth opportunities, a defensive business model, and solid yield underpinning an attractive outlook for the group," J.P. Morgan's Tonet wrote in late 2020, adding that the combination created a "compelling risk/reward."

One fan of the sector is Berkshire Hathaway CEO Warren Buffett. Berkshire Hathaway Energy, a subsidiary of Berkshire (BRK.B), owns a group of U.S. utilities and is one of the largest wind-power producers in the country.

There are risks, to be sure. Utilities are sensitive to interest rates, and bond yields have lately been climbing, although the prospect of higher rates seems to be already priced into the stocks.

In the wake of the Texas debacle, some politicians have questioned whether the electrical grid can maintain reliability as it becomes more dependent on wind and solar power. There is also skepticism over whether the transition to renewable energy can continue without government tax credits and subsidies.

AMPING UP

Utility companies could have annual returns of
10%
with dividend yields averaging 3.5% and projected earnings growth of 5% to 8% annually in the coming years.

Power Plays

How U.S. utility companies and funds compare in terms of their valuations.

Company / Ticker	Recent Price	12-Mo. Total Return	2021E EPS	2021E P/E	Dividend Yield	Market Value (bil)	Pr A Ea G
Alliant Energy / LNT	$47.37	-15.9%	$2.57	18.5	3.4%	$11.8	5%
American Electric Power / AEP	76.30	-19.6	4.65	16.4	3.9	37.9	5
CMS Energy / CMS	55.06	-15.3	2.85	19.3	3.2	15.9	6
Dominion Energy /D	70.63	-16.1	3.88	18.2	3.6	56.9	6.
Entergy / ETR	88.04	-27.6	5.89	14.9	4.3	17.6	5
Exelon / EXC	38.92	-15.8	2.82	13.8	3.9	37.9	6
NextEra Energy / NEE	74.06	12.4	2.50	29.6	2.1	145.1	6
Pinnacle West Capital / PNW	73.4	-22.7	4.97	14.7	4.6	8.2	N
Xcel Energy / XEL	59.84	-10.7	2.98	20.1	3.1	32.2	5

E=estimate

Source: Bloomberg

Fund / Ticker	Recent Price	12-Mo.Total Return	Expense Ratio	Premium to NAV	Dividend Yield	Market Value (bil)
ETFs						
Utilities Select Sector SPDR / XLU	$59.46	-10.5%	0.12%	--	3.3%	$10.9
Vanguard Utilities / VPU	131.01	-10.5	0.10	--	3.3	4.2
Closed-End Fund						
Reaves Utility Income / UTG	$31.45	-11.2%	1.10%	1.2%	6.9%	$1.8

Source: Bloomberg

Then there is the danger of adverse moves by state regulatory commissions and the difficulties in getting approval for new wind and solar sites. There are also the challenges of developing better battery and other storage technology that will be important to the growth of renewable-energy sources.

Even in Blue states, where many residents are focused on climate change, there has been opposition to offshore wind developments. This has already delayed wind farms off the coast of Cape Cod in Massachusetts and the Hamptons on New York's Long Island.

Opponents have included environmentalists, fishing interests, and the wealthy (some of whom object to the view of wind turbines on the horizon). In the tony Hamptons enclave of Wainscott, residents have objected to power lines running underneath a popular beach.

Costs for wind-generated electricity are declining, however, as prices of wind turbines are sinking, making wind an irresistibly cheaper option than coal or natural gas in many parts of the country. Increasingly, solar power also offers competitive prices.

Impact on the Environment

Company	Green Rank Now	Green Rate of Change
PG&E	21.5	3.0
NextEra Energy	19.0	19.0
Edison Int'l	19.0	3.0
Exelon	18.0	3.0
Entergy	16.5	11.7
Sempra Energy	16.0	1.0
Xcel Energy	16.0	10.6
Consolidated Edison	13.5	8.2
Dominion Energy	11.5	17.8
Duke Energy	9.0	14.1
CMS Energy	8.0	16.1
Southern	6.5	10.2
American Electric Power	3.0	14.8

Source: J.P. Morgan

Indeed, wind has become the cheapest source of power, especially in the nation's mid-continental wind belt, which runs south from North Dakota through Nebraska and into Texas.

"North America has one of the great onshore wind resources in the world," Bartlett says. North America is one of the few continents with land stretching from a pole to the tropics. This creates wide temperature and barometric pressure swings that produce wind. There is also plenty of wind off the East Coast, and many utilities, including Dominion, are seeking to tap that from projects anchored in the Atlantic Ocean.

Morgan Stanley's Byrd says that some investors are skeptical that renewable energy makes economic sense without subsidies. They also question whether it can provide the necessary reliability when the wind isn't blowing and the sun isn't shining.

THE WINDS OF CHANGE

But it's easy to argue for the economics of renewable energy, he says. The all-in cost of electricity from a wind farm in the middle of the U.S. is about one to two cents a kilowatt-hour, much lower than the cash operating cost of four to five cents for coal plants.

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Solar, he notes, is increasingly attractive in the sunnier parts of the country. Solar's all-in costs of 2.5 to 4.5 cents a kilowatt-hour are comparable to or lower than those of natural gas.

"Even if tax credits for renewables were to expire in the mid-2020s and not be further extended by Congress (and the outlook is just the opposite, in our view), the annual cost declines we forecast would result in wind and solar power continuing to be the cheapest forms of power generation in the U.S.," Byrd wrote in February.

Investors benefit from the shift to wind and solar because these energy sources, while capital-intensive, have scant operating costs. Plus, utilities earn a return on invested assets. In contrast, old coal plants are largely depreciated, thus earning low returns, and are costly to operate.

Critics argue, however, that heavy use of wind and solar power could impair the reliability of the electrical grid.

Byrd acknowledges that serious storage facilities will be needed, but says their costs will decline. However, most current storage systems are better suited to intraday use than for sustained demand over a number of days. Utilities might need to maintain natural-gas-powered backup systems to prevent outages.

SSR's Wynne believes that conventional power sources, along with storage, can make "high levels of renewable energy" viable for about 75% of the nation's total electricity needs, although getting to 100% would be "prohibitively expensive." His view is that gas-fired plants will continue to play a crucial backstop role.

Investors will notice a divide in the utility sector: The stocks of companies with the greatest exposure to renewable energy generally carry the highest valuations. With that in mind, here are some stocks that Wall Street likes:

NextEra Energy is the industry leader, with top-tier management, the largest renewable-energy portfolio in the country, and the best-run utility, Florida Power & Light.

The stock, trading recently at $74, or 30 times projected 2021 profits, has the highest valuation among its peers by a wide margin and a market value of $145 billion, more than twice that of No. 2 Duke Energy.

A confident NextEra management projects annual earnings growth of 6% to 8% over the next few years, noting in a recent presentation that it would be "disappointed" if it were "not able to deliver financial results at or near the top end" of its expected earnings-per-share ranges through 2023.

Byrd favors American Electric Power, which he calls a "coal-heavy company that is moving away from that in a big way," aided by favorable wind conditions in its territories. The utility, operating in the Midwest and Texas, generates 43% of its power from coal, but plans to cut that to 24% by 2030 while expanding its use of renewable-energy sources to 39% from 18%.

The stock, recently around $76, is down 20% in the past year, trades for 16 times projected 2021 earnings, and yields 3.9%. The company sees EPS growth of 5% to 7% in the coming years. Byrd says that American Electric Power's valuation could rise as its transformation continues.

AEP is following the lead of another Midwestern utility, Xcel Energy (XEL), which is further along in its transition to renewable energy and fetches a higher valuation. Xcel, at about $60, trades for 20 times projected 2021 earnings and yields 3.1%. The company, favored by SSR's Wynne, is considered to be one of the better-run utilities in the U.S.

Chicago-based Exelon is one of the country's largest utilities, with regulated operations in Illinois (home to probably its best-known unit, Commonwealth Edison), Pennsylvania, New Jersey, and other states. Exelon sees earnings growth of 6% to 8% annually at its regulated utility business through 2024.

This past week, the company announced that it would spin off its deregulated power business, which has the largest fleet of nuclear reactors in the U.S. The stock, at about $39, trades for 14 times projected 2021 earnings and yields 3.9%.

CMS Energy is favored by Reaves Asset Management's Bartlett, who says it is "cleaning up its emissions, while holding increases in electric bills to around the rate of inflation."

The company, which gets about 20% of its electricity from coal, plans to stop using that fuel by 2040, as it expands its renewable-energy portfolio, mostly wind. The stock, at about $55, trades for 19 times projected 2021 earnings and yields 3.2%. The company sees earnings growth of 6% to 8% annually in the coming years, helped by favorable regulation in its home state of Michigan.

Alliant Energy (LNT) is another Midwestern utility moving to renewable energy from coal. With operations in Iowa and Wisconsin, the company sees annual growth of 5% to 7% in earnings per share through 2024. Its stock, trading around $47, changes hands for about 18.5 times projected 2021 earnings and yields 3.4%.

Dominion, with operations in Virginia and the Carolinas, is focused on its regulated electricity business after selling its natural-gas pipeline business to Berkshire Hathaway's utility division in 2020 and cutting its dividend by 33%. The stock, recently around $71, trades for about 18 times estimated 2021 earnings and yields 3.6%. It sees 6.5% annual growth in earnings in the coming years.

Dominion generates the vast majority of its power from gas and nuclear, but it is moving heavily into renewable energy, with plans for the largest offshore wind farm in North America, 27 miles off Virginia's coast. J.P. Morgan's Tonet calls the company a "best-in-class, pure-play regulated utility with attractive green growth plans." He has a $87 price target on the shares.

Tonet also likes Entergy, which owns a group of utilities along the Gulf Coast. The stock, at about $88, trades for 15 times estimated 2021 earnings, a discount to the sector, and yields 4.3%. The company expects annual earnings growth of 5% to 7% in the next few years. Tonet sees Entergy shares garnering a higher valuation as it winds down an independent power business. The Indian Point 3 nuclear plant north of New York City, owned by Entergy, is due to shut down this spring. Entergy also has one of the best hydrogen logistics networks on the Gulf Coast, and that could become valuable as hydrogen usage grows.

“We believe that the market underappreciates the company’s fully regulated business model and green growth potential, given the long generation investment runway,” Tonet wrote. He has a price target of $121 on the stock, up 37% from recent levels.

Pinnacle West Capital (PNW), which operates Arizona Public Service, the state’s largest utility, is a turnaround story. It has pledged to generate more consistent financial results and improve its relationship with state regulators. SSR’s Wynne likes the stock, which has been trading around $73, or an inexpensive 15 times projected 2021 earnings. The yield is 4.6%

In sum, the greening of America has become a major investment theme, and utilities offer an overlooked yet attractive and defensive play on it.

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