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Contrarian views highlight overlooked investment opportunities in utilities

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Key Insights

- Long viewed as bond proxies, significant changes to the sector have left utilities poorly understood by some market participants.
- Transformative investments in renewable energy are a potential catalyst for earnings growth.
- Regulatory risks that are the exception rather than the rule have cast an unwarranted shadow over the sector.

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Utilities—A sector in transition

The utilities sector is in the midst of a seismic change as energy shifts away from coal and natural gas and toward renewable energy sources like wind, solar, and hydrogen. Forward-looking utility companies are investing significantly in the infrastructure for the new forms of energy generation, storage, and transmission that will be vital now and into the future.

More than just a dividend

We think one of the reasons the sector has been miscast as merely a defensive, low-growth sector is the persistent notion that investing in utilities is a play on interest rates because they are often seen as an alternative to bonds due to their historically competitive dividend yield.[1]

Today's utilities aren't your grandfather's utilities, though. In fact, we think the sector may provide better long-term, risk-adjusted returns than many other U.S. equity sectors, even those that are perceived to be more growth oriented.

Many companies in higher-growth sectors such as information technology pay low or no dividends, instead reinvesting capital in ways intended to spur future growth and capital appreciation, such as research and development focused on new products or services. Conversely, companies with stable revenue streams and demand may not pursue long-term growth and capital appreciation. Instead, they tend to distribute profits in the form of dividends, which can be attractive for many investors, particularly those focused on current income.

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[1] **Dividends are not guaranteed and are subject to change.**

Utilities companies have long been placed in this latter basket. However, the urgent transition to renewable energy will be a significant driver of utilities companies reinvesting capital in a way that should change how we value them. Moreover, while the transition to renewables is still underway, many of the impacts of climate change are already here. Utilities companies are in a position where they need to spend significant capital to harden their grids to protect from natural disasters like storms and wildfires and the impact from ever-increasing extreme weather events like the winter storms that crippled Texas' power grid in 2021.

These forces are driving a powerful capital expenditures cycle that can be a catalyst for earnings growth as companies that are investing ahead of change begin to realize the benefits of new infrastructure and capabilities. We think the commonly accepted narrative on utilities underappreciates the transition in the sector, where a number of companies have been:

- growing their earnings at a healthy rate.
- still delivering strong dividends.
- less volatile than the broader market.

Regulatory risks: Exception or rule?

Just as utilities have been mispriced as bond proxies because of long-standing assumptions, the sector has also historically been pressured by uncertainty around rate cases. In short, utility rate cases are a form of government regulation that determines the rates that a regulated utility can charge for electricity, natural gas, water, and other services. These cases have a significant impact on growth and return on equity.

On occasion, such as in a 2023 rate case ruling in Illinois, adverse outcomes do result in less favorable operating environments. This surprising ruling took place in a time when almost every other commission has pushed utilities to make investments to harden the grid, to make investments to enable more renewable resources, and to replace aging infrastructure to reduce storm damage and increase reliability. In that light, we think adverse outcomes are the exception to a pattern of generally constructive outcomes between utilities and regulatory commissions across the country. Setting aside the outcome in Illinois, the vast majority of rate cases across dozens of states have resolved positively with solid rate base[2] growth and, overall, slightly improved returns on equity.

We think concerns over unlikely and adverse rate case rulings, which are typically driven by idiosyncratic factors, contribute to an entire sector being structurally undervalued when we account for potential dividend yields and long-term growth.

Confidently contrarian

As investors, we're willing to go against consensus, question commonly held assumptions, and follow through on our research and process. The utilities sector offers one such opportunity to cut against the grain and pursue attractive risk-adjusted returns in an area we think the market underappreciates and misunderstands. Whether through fundamental research, taking a longer view, or asking the right questions, we are committed to uncovering opportunities that can add value for our shareholders.

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[2] Rate base is the net value of a utility's plant, property, and equipment on which it can earn a return.
Utilities risks: The utilities industries can be significantly affected by government regulation, financing difficulties, supply and demand of services or fuel, and natural resource conservation. They are subject to interest rate risk (higher interest rates have typically pressured utilities because they reduce the present value of future dividends and bond yields also typically become more competitive with the dividend yields offered by the stocks).

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