Lazard
Perspectives

US Regulated Utilities: Still Not Cheap Enough

- Share prices of US regulated utilities—a long-standing underweight in the **Lazard Global Listed Infrastructure** strategy due to our concerns about "overearning" and valuations—have come under considerable pressure in 2023.
- Despite the sector's significant sell-off over the year to date, we believe valuations remain inflated and are predicated on unrealistic growth assumptions.
- While we retain limited exposure to this large chunk of our preferred infrastructure universe and are alert to nascent opportunities as valuations fall, we find superior opportunities elsewhere and remain significantly underweight the sector.

LAZARD
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"While many US utilities are high-quality natural monopoly assets, we are unable to find value in the sector today."

Lazard Global Listed Infrastructure, Letter from the Manager (February 2021).

For a long time, we have cautioned investors about valuations across the US regulated utilities sector. Rock-bottom interest rates and relatively stable allowed-regulatory returns made American utilities stocks a favorite with investors, underpinning strong share price performance. Those halcyon days for the sector are likely behind us. As interest rates have ratcheted up and the gap between bond yields and allowed regulatory returns has narrowed (Exhibit 1), the sector has struggled: the S&P 500 Utilities Index has fallen 17% over the year to date (to 31 October 2023), wiping out 2022's relative outperformance (Exhibit 2).

Today, US regulated utilities account for more than 50% of our Preferred Investable Universe (PIU), or approximately US$1.1 trillion in market capitalization. Yet we only hold 10% of the Lazard Global Listed Infrastructure (GLI) portfolio in US regulated utilities names.

In this brief paper we outline why—with some exceptions—we still believe the sector remains overvalued, why these excessive valuations remain the key risk for the asset class, and why further share price falls will be needed before we find the sector attractive.

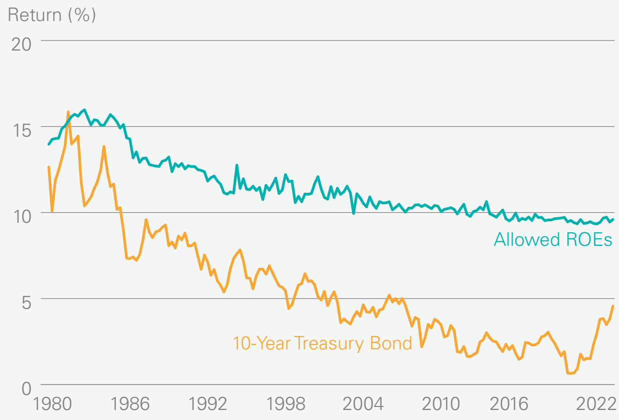
As our clients know, we have long been concerned that the US regulated utilities sector was "over-earning" relative to prevailing interest rates. In contrast to other regions, where regulators had reduced allowed returns on equity (ROE) to reflect lower interest rates, allowed ROEs in the US have been relatively stable. This increased the gap between the allowed ROE and 10-year US Treasury yields to a peak of nearly 900 basis points (bps), a level unprecedented in the past 30 years. The recent jump in bond yields has effectively corrected this gap to a more normalized ~500 bps level, which triggered the recent fall in share prices.

Lower Price-to-Earnings Multiples Do Not Necessarily Mean Value

We have noted commentary from the sell-side as well as some fund managers that US utilities now look attractive, given their price-to-earnings (P/E) ratios have fallen by roughly 25% over the past year and now sit at levels not seen in almost a decade (Exhibit 3).

We disagree with this assessment. First, the past decade is likely to be a poor guide to future market valuations, given interest rates were at record lows for most of this period. We believe market valuations for many assets, including "bond proxies" such US regulated utilities, were inflated over this period. As our clients are aware, we prefer to use normalized interest rate assumptions in our valuation work, not spot rates.

Exhibit 1
A Narrower Gap—Returns on Equity for US Regulated Utilities vs. US 10-Year Treasury Yield

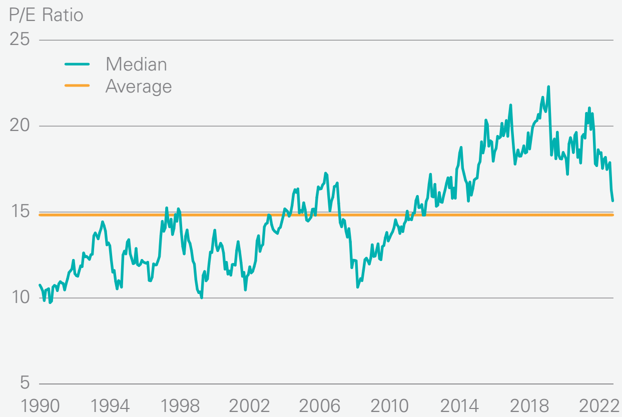


As at 30 September 2023
Source: Lazard, SNL Energy

Exhibit 2
US Regulated Utilities under Pressure in 2023

As at 31 October 2023
Sector returns based on the Utilities Select Sector SPDR® Fund, which seeks to provide an effective representation of the utilities sector of the S&P 500 Index.
Source: FactSet

Exhibit 3
Sinking US Regulated Utilities P/E Ratios



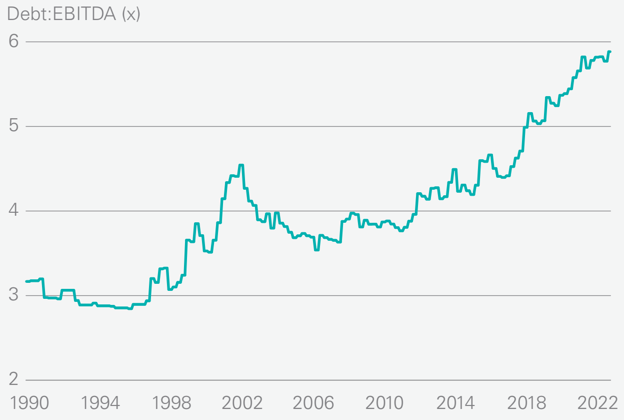
As at 31 October 2023
Source: Lazard, FactSet

Second, P/E ratios can be a poor methodology for valuing assets, including US regulated utilities, because they do not take account of differing levels of leverage among companies. The post-Global Financial Crisis collapse in interest rates contributed to many US utilities accumulating more debt. Leverage is not necessarily a problem for regulated utilities as interest costs are passed through to rate-payers. However, a considerable number of US utilities borrowed beyond their allowed capital structures, adding debt at the parent company level to fund expensive acquisitions (Exhibit 4).

These utilities may be facing a double blow as enterprise values fall—any fall in the EV/EBITDA multiple will be exacerbated by the excess debt on their balance sheet. It also implies that the sustainable P/E ratios of such companies will be lower than in the past.

A better guide to value in the sector is an unleveraged metric such as EV/EBITDA, which adds back debt and therefore shows the market's valuation of a company's assets before leverage. On this basis, US regulated utilities valuations have further to fall, since EV/EBITDA multiples are still 35% above their historical averages (Exhibit 5).

Exhibit 4
US Regulated Utilities—Rising Debt Levels

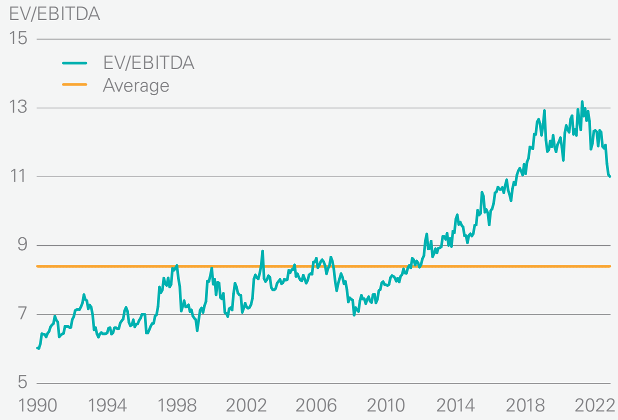


As at 31 October 2023
Source: Lazard, FactSet

But What about the Growth?

One rebuttal to our view is that long-run historical multiples are irrelevant for US utilities, given the substantial growth prospects ahead of them. The Inflation Reduction Act and other state initiatives to decarbonize the US economy are creating growth opportunities, at least for electric utilities. Most regulated utilities have increased their rate base growth forecasts to a range of 5%–10% for the next five or more years, well above levels of underlying electricity demand and historical average growth rates. Notwithstanding our concerns about whether such growth rates are sustainable in view of the risk to customer affordability, we broadly accept such forecasts, at least in the near term.

Exhibit 5
EV/EBITDA Multiples for US Regulated Utilities Remain Well Above Long-Run Averages

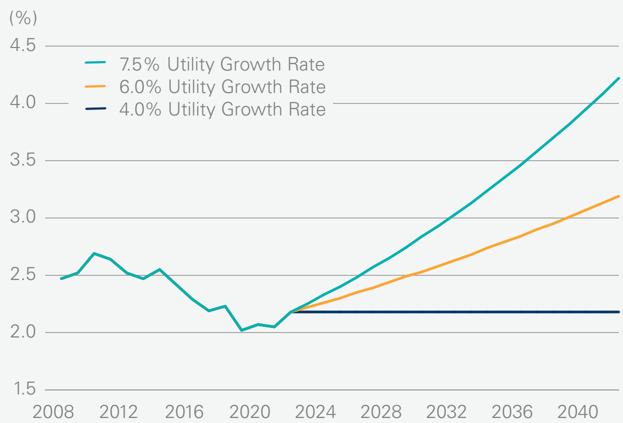


As at 31 October 2023
Source: Lazard, FactSet

However, the amount and duration of excess growth required to justify current market values is implausibly high, in our opinion. For example, we estimate that the current average market valuation of US regulated utilities (~11x EBITDA) requires ~7.5% compound growth in rate base over the next 20 years, assuming a normalized interest rate of 5%. That may not sound heroic, but it would imply US consumers ultimately spending roughly double the current proportion of their incomes on electricity over that period. It is also well above underlying electricity demand growth of ~1% per annum and would represent a period of growth unprecedented in the modern history of the US utilities sector.

Exhibit 6 shows what would happen to consumer electricity expenditures as a proportion of median household incomes in the US over the next 20 years under three base growth rate scenarios: 7.5% (i.e., the base growth rate implied by current market valuations), 6%, and 4%.

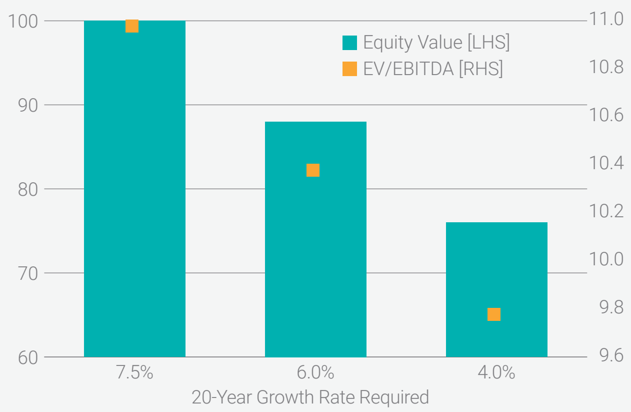
Exhibit 6
Projected Electricity Spend as Share of Median US Household Income Based on Different Base Growth Rates



As at 30 September 2023
Source: Lazard, EIA, FRED. Assumes consumer income growth of 4% p.a.

Finally, Exhibit 7 shows the sensitivity of current valuations to the same growth assumptions, showing approximately 12%–24% downside to current market valuations based on 20-year growth rates of less than 7.5% per annum.

Exhibit 7
Sensitivity of US Regulated Utilities' Valuations to 20-year Growth Rates



As at 30 September 2023

Source: Lazard analysis, FactSet. Assumes 5% risk-free rate; allowed return on equity 10.5%; allowed equity 50%; total debt: capital of 60% (average ratios for US regulated utilities in our preferred infrastructure universe).

Some Exposure—But Opportunities Elsewhere

Notwithstanding our concern about valuations, we still consider US regulated utilities as solid preferred infrastructure assets. They are monopolies providing essential services. As a result, they have highly predictable cash flows and are buttressed by a stable and consistent regulatory system. Furthermore, not all of them are expensive: we currently hold five US regulated utilities stocks in the portfolio, while the recent price falls have created some nascent opportunities, with dividend yields approaching high single digits in some cases.

It is also important to note that there are many other sectors and regions within the global listed infrastructure sector, particularly in the UK and Europe, that are highly attractive, trading on discounted valuations with strong expected returns.

In summary, we believe our decision to remain very underweight the US regulated utilities sector continues to be justified, given our long-run objective of achieving returns at or above Consumer Price Index +5% for our clients.

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