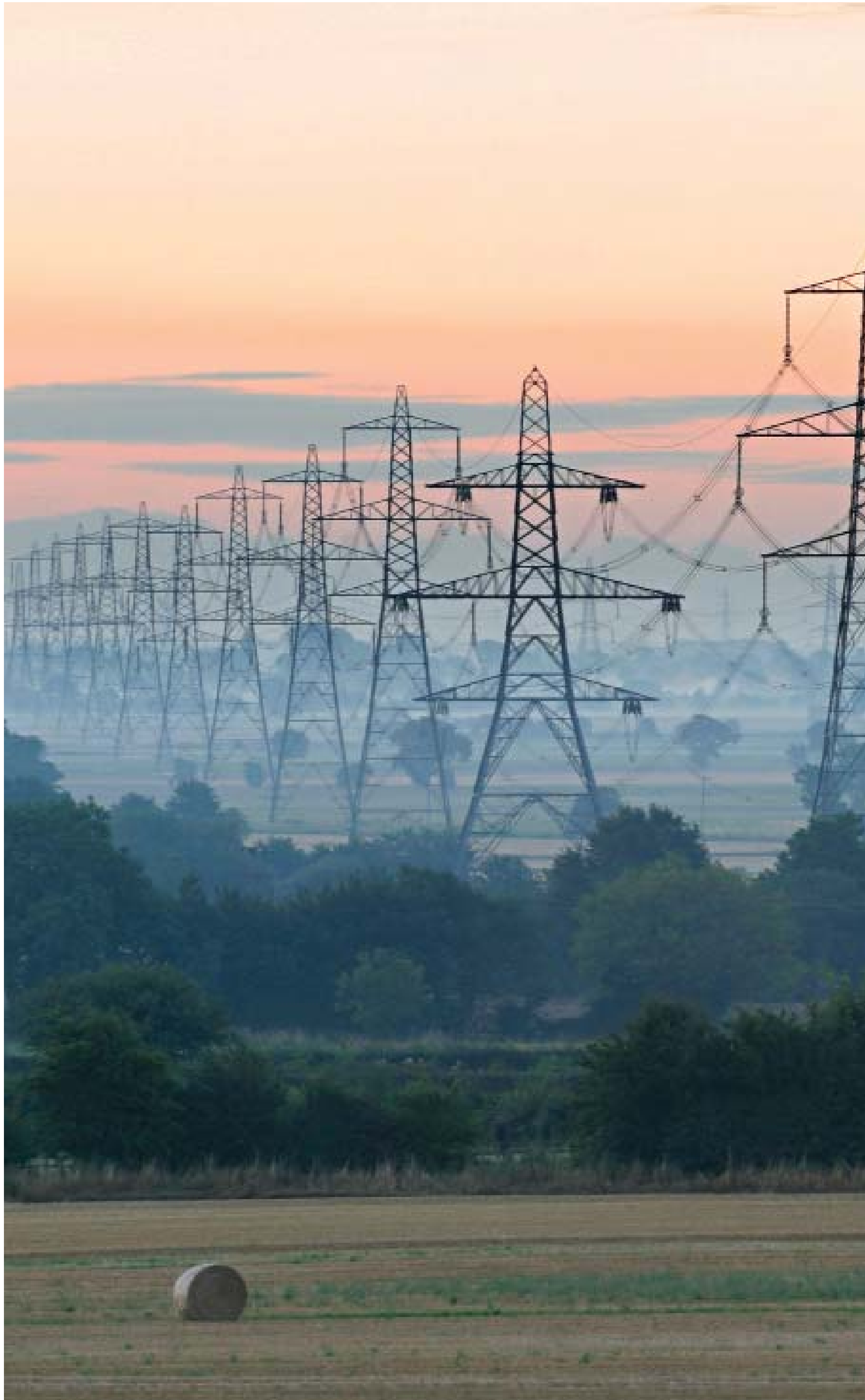
Utilities – Buy, sell or hold?

Traditionally, utilities are seen as a solid, defensive investment. There's ongoing demand for water, electricity and gas and generally utility companies have offered sustainable dividends. So why are they currently out of favour? Graham Spooner, Investment Adviser offers his view on this sector.



The impact of debt

All utilities require significant infrastructure investment which is funded by debt. As the markets turned sour, investors became concerned about companies that run large debts. Banks are not lending as freely as businesses would like and despite the low Bank of England base rate the cost of borrowing by businesses has increased since the start of the credit crisis. As utilities are debt heavy, their running costs could increase when they renegotiate their debts under potentially more onerous financial terms. Consequently, some utility companies may need to rein back on their dividend policies, meaning less income for shareholders.

Reliable dividends are one of the key drivers for investing in utilities. If their payout is in doubt, investors will look elsewhere. When the market started to recover in March of this year, many investors sought out recovery opportunities and growth shares rather than defensive income shares. Investors have been attracted to companies in the property, banking and mining sectors that were hit badly last year while utilities have been left behind in the hunt for greater potential returns.

There has been speculation that rating agencies may downgrade some utility companies from an A grade to a B grade as a reflection that their debts would be more expensive to service. This of course is a self-fulfilling prophecy as such a downgrade would actually increase the cost at which they could borrow money. There has also been speculation that the sector may be forced to replenish its coffers through multiple rights issues but to date there has been little sign of such activity.

Pricing pressures

Debt is of course just one side of the financing equation as the bottom line is also impacted by incoming revenue.

Every five years, the Water Services Regulation Authority (Ofwat) sets limits on the prices the water companies can charge their customers. The 2009 price review is due to be concluded in November 2009 and so some investors are naturally waiting until after November before making any investment. In the last price review in 2004, Ofwat was generous to the water companies so that they could finance programmes of replacing antiquated piping and reduce leakage. This summer, analyst reports predicted that Ofwat would be less kind in future causing share prices to fall across the subsector. Since then, the water companies have been putting their individual cases to Ofwat; the success of their lobbying will be known soon. The review will not just impact the water companies but the whole of the utilities sector as the Office of the Gas and Electricity Markets (OFGEM) is expected to take a lead from this review.

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The gas and electricity providers were also hit hard by rising energy prices throughout 2008 and increased their tariffs accordingly. As prices have dropped off since the third quarter of 2008, so the pressure is now on for these companies to reduce their tariffs. Fierce competition for customer accounts has led to additional pressures on pricing with the companies always looking to attract new customers and defend their market position. In addition, the higher tariffs during a time of recession have led to a fall in demand as both businesses and households have cut back on their utility spending. Bad debts have also increased as consumers have either delayed or defaulted on payment, often due to business failure. When you consider both the price pressure and the debt servicing pressure that such companies are facing it's easy to see why investors who have had their regular income streams impacted by the credit crunch are looking for investments with better growth potential.

However the outlook for electricity in the medium term may be better than for the water companies, if only because of the projected squeeze in electricity supply. Older power stations being decommissioned are unlikely to be matched by new power generators over the next 5 –10 years, and there have even been warnings of potential cuts in supply if demand remains at current levels. This suggests that prices will not reduce far, and could even rise in the medium term.

On the plus side

So it's not all bad news. Energy network operator National Grid runs the electricity wires across Great Britain and Northern Ireland and is one of our favourite plays in this sector. It ruled out a rights issue in May of this year when it published its full-year results and said that it had made good progress on refinancing its current obligations. The company also expected the cost of borrowing to fall this year as debt tied to interest rates and inflation continues to fall. It recently paid out a dividend of 23p bringing the full-year dividend to 35.64p per ordinary share and has stated its intention to grow the dividend by 8% through to 2012, to give investors confidence about medium-term income growth.

Other defensive plays

So if you want some defensive shares in your portfolio but aren't attracted by utilities, what could you consider? Well there are various other sectors that are taking on the defensive 'mantle'. The supermarkets Tesco, Sainsbury's and Morrisons have all remained steady over the last year. Household goods have also held up remarkably well as shown by the performance of Reckitt Benckiser and Unilever. Some of the telecommunications companies are also considered defensive now that the mobile phone is seen by many as a necessity. Vodafone is our company of choice in this sector with its attractive dividend potential.

At a glance

Utilities require significant infrastructure which is funded by debt.

They are under pressure to reduce prices.

Other defensive plays are available.

National Grid intends to grow its dividend by 8% through to 2012.

What next?

Although utilities are out of favour now, there is nothing certain in the markets. If the current market high slides back down the defensive qualities of utilities may cause a rise in their popularity again as investors seek out safe havens. They do, after all, provide essential services and have regular cash flow income streams. It should also be noted that not all utilities are funded in the same way and should therefore not be lumped together when considering an investment in this sector. And remember, share prices can fall as well as rise!

We've upped the risk on utilities over the course of the year in consideration of the aforementioned factors. On the majority of the utility companies we've increased the risk rating from lower risk to medium risk but income seekers should still consider buying or drip-feeding money into the best-placed companies. For most investors, our general recommendation is to invest small amounts regularly into National Grid to take advantage of its current share price. This could be managed through our Regular Investment Service, details of which can be found at share.com/monthly.

Need more help?

If you want investment advice to match your own personal investment profile you can contact our Advice team on 01296 41 43 45.