WATER UTILITY INDUSTRY

The Water Utility Industry consists of eight investor-owned utilities. These companies are very much like electric or gas utilities, but operate in a much smaller universe because the overwhelming amount of water services in the United States are provided by municipally run entities.

These companies have much less exposure to the economic turmoil related to the coronavirus than other industries we follow. Water is essential and its usage doesn't change substantially during an economic expansion or a contraction.

Following years of underinvestment, almost every member of this group is involved in a major construction program aimed at replacing large quantities of old pipelines.

Finances in this group are just average as modernizing the nation's aging water infrastructure is not cheap. Utilities often have taken on decent amounts of debt to fund the construction programs.

One of the biggest influences on how any utility performs is the treatment it receives from regulators. For the most part, the relationship between water companies and state authorities has been constructive.

Coronavirus And Water Utilities

Certain industries are cyclical and very dependent on the state of the general economy. The demand for water is relatively inelastic and people's usage of it is fairly constant. During difficult periods households will cut back on all expenses, including water. However, due to it being such a necessity, demand does not change significantly. So, even though COVID-19 has caused economic uncertainty on a global basis, this sector ought to remain fine. Only should the pandemic become much worse would it have an impact. Ratepayers are citizens that vote, and should a sharp recession or depression take place, regulators would be reluctant to pass along increased operating costs incurred by a utility in the form of higher water bills, no matter how justified the expenses.

Large Construction Programs

Until the past decade, or so, both municipal and investor-owned utilities didn't sufficiently invest in keeping pipelines and other assets in proper condition. As a result, the average age of pipelines in the U.S. is estimated to be between 50 and 75 years. Utilities and regulators have realized that more funds would have to be allocated to replacing and modernizing large portions of the nation's water infrastructure. That's why this group's construction budget is large, though manageable. Authorities also realize that water bills were kept artificially low for years, especially in relation to other vital utility services, and have to be gradually raised.

Average Finances

Although domestic water utilities are very stable, their balance sheets reflect the industry's hefty capital budget. Still, these companies are not overleveraged, with the average Financial Strength rating for the group being a B+. As an increased amount of money is used to replace pipes, we think the overall financial health of the industry ought to remain unchanged.

INDUSTRY TIMELINESS: 5 (of 95)

Regulation

Probably the prime reason for water utilities stocks performing so well over the past five years has been due to constructive regulation. Unlike, electric utilities, for example, both sides are basically in agreement that upgrades are required and ratepayers bills will have to raised. Investors should be aware of what can happen when authorities and utilities do not work as partners (i.e. the Electric Utility Industry). As of now, we see no signs of rifts between the water group and regulators.

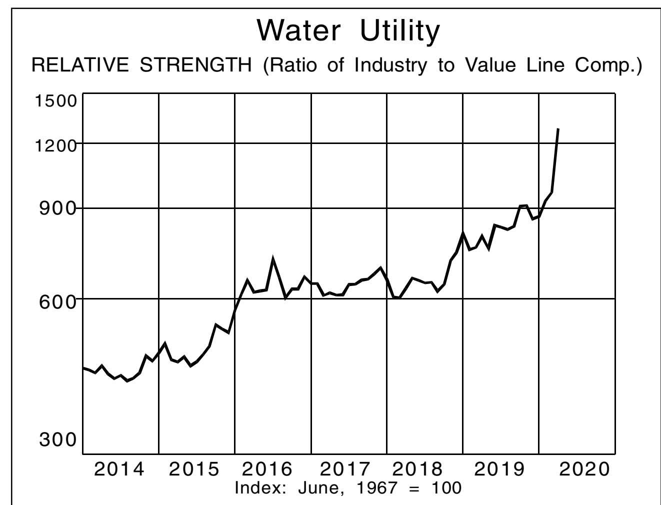
Untraditional Behavior

As we mentioned earlier, these equities were historically purchased by conservative investors looking for income. Over the past several years, the profile of the stocks has changed. Indeed, no longer are the yields on these shares high. In fact, the average water equity has a much lower dividend yield than the typical stock in the *Value Line* universe. Moreover, utility stocks typically underperformed during bull markets and outperformed in bear markets. Over the past five years, however, many in this group posted higher total returns than the S&P 500 Index. We attribute this to two factors: the scarcity of stocks in this sector, and the low interest rate environment. For example, only two of these equities have a market capitalization of over $5 billion. Professional money managers looking to diversify there holdings in the utility segment (electric, gas, and water) have very few options here. Therefore, a premium has to be paid to own these stocks. Furthermore, since these equities are often seen as alternative to bonds by income-investors, near-zero interest rates make them look more attractive to fixed-income accounts.

Conclusion

Despite the industry's high rank, we advise subscribers to exercise caution when investing here. While there is very little operational risk, these equities often have well below average long-term total return potential.

James A. Flood



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