Edward Jones
MAKING SENSE OF INVESTING

The Edward Jones Utility Framework

UTILITIES SECTOR REPORT

October 14, 2020

ANALYST(S)

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Companies mentioned in this report followed by Edward Jones:

- **Emera** - Buy; (EMA.TO - $55.82)
- **Fortis** - Buy; (FTS.TO - $54.60)

Prices and opinion ratings are as of market close on 10/13/20 and are subject to change.

Investment Overview

- We prefer utilities that receive the majority of their income from regulated businesses given the stable and predictable nature of these operations.
- To have a "Buy" rating, we typically must believe the current dividend is not only safe, but we also have the expectation that the company will grow the dividend on a consistent basis over time.
- Other key attributes include a solid investment-grade credit rating, low share price volatility, a good balance between risk and growth, a solid management team, and an attractive valuation.

Favourable Industry Outlook

We have a favourable outlook for the Canadian utility industry given our outlook for solid earnings growth and rising dividends in general. We believe earnings growth will be driven by the need for investment in new cleaner power generation, electric and gas transmission and distribution, and the ongoing refurbishment of existing equipment (poles, wires, pipes, etc.).

Stable and Predictable Earnings

Given our emphasis on dividend safety and consistent growth, our preference is for regulated utilities. The operations of a regulated utility fall under the jurisdiction of a regulatory commission. Each Canadian province has its own commission that is charged with the responsibility of making sure the investment a utility undertakes is prudent and the resulting rate it charges for its service is just and reasonable for the ratepayer.

The reason we prefer utility companies that operate a regulated business is because it helps enable the company to earn a reasonable and stable return on its investment for shareholders. In order to achieve this, the utility must operate in a favourable regulatory environment, because not all regulatory commissions are created equal. Part of assessing the regulatory environment for a specific company is to view past regulatory rulings in light of the environment of that time to determine the balance of the decision between shareholders and ratepayers.

Our research has found that those companies that pursue nonregulated businesses typically have more volatile earnings and provide lower returns for shareholders over time. We are much more comfortable with a nonutility business that is utility-like in nature, such as ownership of natural gas pipelines, which are actually semi-regulated. We prefer this to a nonregulated business that has nothing to do with utility operations.

Please see important disclosures and analyst certification on pages 3 - 5 of the report.

It is these types of operations that have often in the past jeopardized the safety of the dividend and have decreased shareholder value.

We assess each company on a case by case basis; however, Edward Jones will typically only rate a utility a "Buy" if the majority of the company's earnings come from a regulated utility business.

Rising Income

Typically, individual investors primarily invest in utilities to receive a dividend. Companies that increase the dividend on a consistent basis over time typically perform better than those that do not. A dividend that is increased consistently every year can help offset the impact of inflation over time. Without increases, dividend income can lose its purchasing power rather quickly, which could negatively impact a person's standard of living over time.

We also believe that a rising dividend generally portends a good long-term outlook for the company. When management is confident about its ability to sustain reasonable earnings growth, it is typically more comfortable recommending to its board of directors to raise its dividend. However, dividends can be increased, decreased or totally eliminated at any point without notice.

Edward Jones will typically only rate a utility a "Buy" if we believe the dividend is safe and is expected to grow throughout the future.

Other Favourable Utility Attributes

The status of regulated versus nonregulated and whether we have an outlook for rising income are not the only qualities we look for when making utility recommendations. Other key qualities we look for when assessing utilities include:

- Investment-grade credit quality
- Low share price volatility relative to the overall market
- Proper balance between risk and growth
- Strong track record
- Good management team
- Attractive valuation

As a whole, we believe these are the attributes that most individual investors would want in their utility stocks, because we see investors generally averse to taking undue risk as well as wanting a competitive total return over the long term with less chance of a negative surprise. Therefore, our analysis of these and other factors are important criteria to our utility recommendations.

A Perspective of the Canadian Utility Industry

Emera is a traditional electric and natural gas utility serving Nova Scotia and parts of Florida, New Mexico and the Caribbean. **Fortis** is the largest regulated Canadian utility with operations spanning five Canadian provinces, three Caribbean countries, and numerous states in the United States. Fortis entered the U.S. with acquisitions in Arizona and New York, and then completed its acquisition of ITC Holdings (ITC), a U.S. company entirely focused on transmission. Prior to the acquisition of ITC, Fortis was roughly equally split between electric and natural gas. Now Fortis has a majority footprint in electric transmission.

Favourable Outlook for the Industry

We have a favourable outlook for the Canadian utility industry given our outlook for solid earnings growth and rising dividends in general. We believe earnings growth will be driven by the desire for cleaner power generation, new electric and gas transmission and distribution, and ongoing investment in basic utility equipment (poles, wires, pipes, etc.).

For the industry as a whole, we expect average customer growth of around 1%. We expect the average regulated utility to have average earnings growth of around 5% when including potential cost savings and necessary investments to maintain and improve utility infrastructure. We expect similar growth in dividends.

The regulated rate a utility is allowed to earn, as set forth by regulators, is partly a function of what the yield is on the 10-year Government of Canada bond. Thus, we believe allowed returns have probably reached close to a bottom given the historically low rates on the current 10-year bond. If interest rates were to move higher over time, we believe there is a good chance that most regulated utilities would be allowed to earn at higher rates. However, we would also expect that this potential benefit would be partly offset by the historical relationship between long-term interest rates and utility stock prices, which we discuss next.

Utility Stocks and Long-term Interest Rates

Yields on income-oriented securities, such as utilities, often move with long-term interest rates. Hence, when long-term interest rates move up, utility stock prices have typically gone down. This is because for the dividend yield to go up, the share price must go down unless the dividend itself has been increased significantly.

While not predicting the direction of long-term interest rates, the potential exists for rates to increase in the future. Edward Jones recommends not focusing on things an investor cannot control; thus, we believe an investor should not invest based on interest rate expectations. We believe that utility stock investors have the potential to receive an attractive total return over longer time periods even if interest rates rise initially. We believe it is important to periodically review portfolios to ensure that they remain properly diversified, especially given the current changing interest rate environment and its potential impact on utility stocks.

Over the last few years, there have been fits and starts in longer-term interest rates. Moves up have generally spurred declines in utility stocks, while retreats in interest rates have typically driven utilities higher. We reiterate that trying to time entry and exit points for stocks based on interest rate predictions is a risky endeavour. Coming out of the Great Recession, most professional investors seemingly thought interest rates had nowhere to go but up. The main point to remember is that even professionals find it very difficult to predict the direction and magnitude of interest rate changes, so we would not recommend making major changes to portfolios based on predictions. We continue to believe utility stocks have attractive characteristics, and we believe they should be part of a diversified portfolio, regardless of short-term movements in interest rates.

Some Investors May Own More Than the 4% Weighting

Edward Jones generally recommends that utility stocks comprise 4% of a well-diversified portfolio. This is roughly consistent with the TSX Composite* weighting for utilities.

For younger investors who have less need for income in their portfolio, utilities may represent 4% or less of a portfolio. Utilities that have more of a growth orientation with a relatively lower dividend yield may make the most sense for such investors.

Having more than 4% may make sense for some investors if they need additional income. This may be especially true for retired investors who may use dividend income to help pay for their daily living expenses and who likely desire less risk of the share price going down dramatically.

Owning Multiple Utilities May Make the Most Sense

Edward Jones encourages proper diversification in an investor's portfolio. We recommend that no particular security represent more than 5% of an overall portfolio. Given that an individual may have more than 4% of their portfolio in utility stocks, it makes sense for those individuals to own multiple companies to be properly diversified.

We suggest diversifying across the stocks we recommend with a Buy opinion. One way to do this would include diversifying geographically (where the utility is located) to reduce regulatory risks. An investor could also diversify across different types of utilities (electric and natural gas).

Valuation

Methods used to evaluate the attractiveness of utility stocks include traditional measurements such as price-to-earnings (P/E), price-to-book value (P/B), and P/E relative to the summation of our earnings growth outlook and the dividend yield (PEGY), both on an absolute basis and relative to competitors.

Risks common to all utilities include

- Rising long-term interest rates can negatively impact the share price as alternative investments become more attractive.
- Adverse regulatory or legal decisions, as well as significant changes in commodity prices such as for electricity and natural gas, can negatively impact earnings, cash flow and the share price.
- A weak economy can reduce demand and thus negatively impact earnings, cash flow and the share price.

*The TSX Composite Index is based on the average performance of around 240 widely held common stocks. This is an unmanaged index and cannot be invested in directly. Past performance is no guarantee of future results.

Required Research Disclosures

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.
Andy Pusateri, CFA and Mike Doyle, CFA

Analysts receive compensation that is derived from revenues of the firm as a whole which include, but are not limited to, investment banking revenue.

Buy (B) - We believe the valuation is attractive and total return potential is above average over the next 3-5 years compared with industry peers. Hold (H) - We believe the stock is fairly valued and total return potential is about average over the next 3-5 years compared with industry peers or a special situation exists, such as a merger, that warrants no action. Sell (S) - We believe the stock is overvalued and total return potential is below average over the next 3-5 years compared with industry peers. In some cases we expect fundamentals to deteriorate considerably and/ or a recovery is highly uncertain. FYI - For informational purposes only; factual, no opinion.

The table below lists the percent of stocks we follow globally in each of our rating categories. Investment banking services indicate the percentage of those companies that have been investment banking clients within the past 12 months. As of: October 14, 2020

	BUY	HOLD	SELL
Stocks	**52%**	**46%**	**2%**
Investment Banking Services	**4%**	**2%**	**0%**

Other Disclosures

This report does not take into account your particular investment profile and is not intended as an express recommendation to purchase, hold or sell particular securities, financial instruments or strategies. You should contact your Edward Jones Financial Advisor before acting upon any Edward Jones Research Rating referenced.

All investment decisions need to take into consideration individuals' unique circumstances such as risk tolerance, taxes, asset allocation and diversification.

It is the policy of Edward Jones that analysts or their associates are not permitted to have an ownership position in the companies they follow directly or through derivatives.

This opinion is based on information believed reliable but not guaranteed. The foregoing is for INFORMATION ONLY. Additional information is available on request. Past performance is no guarantee of future results.

In general, Edward Jones analysts do not view the material operations of the issuer.

Diversification does not guarantee a profit or protect against loss in declining markets.

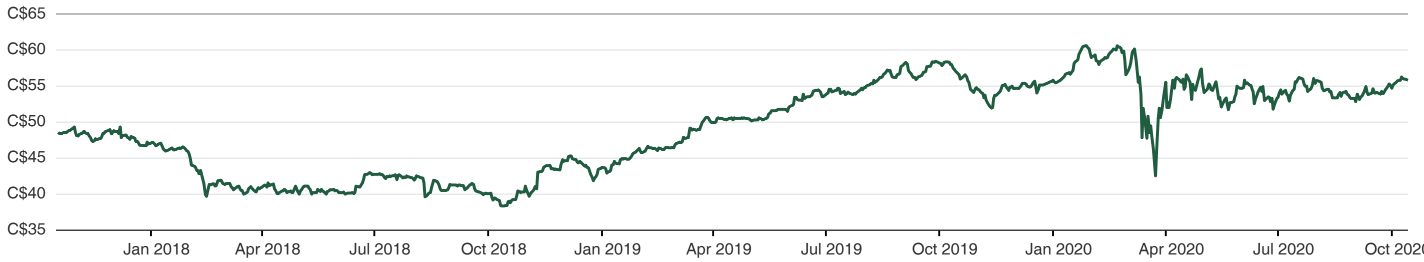
Special risks are inherent to international investing including those related to currency fluctuations, foreign political and economic events.

Dividends can be increased, decreased or eliminated at any time without notice.

An index is not managed and is unavailable for direct investment.

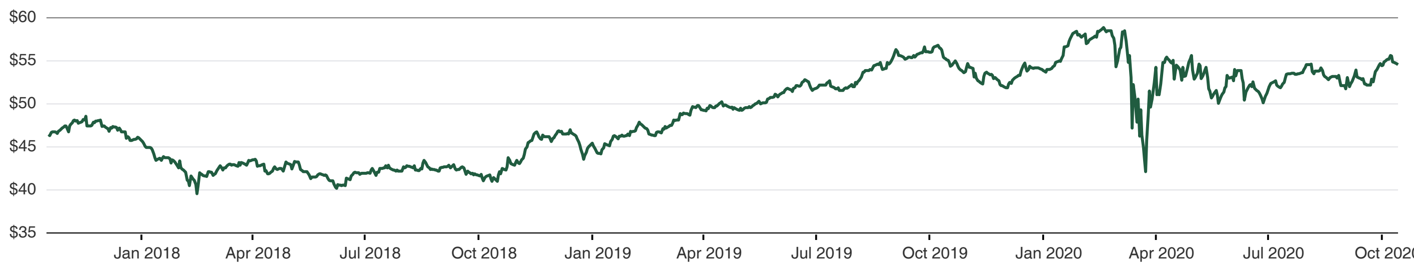
Member - Canadian Investor Protection Fund

3-Year Rating and Price History for: Emera (EMA.TO) as of 10/13/2020



Source: Reuters

3-Year Rating and Price History for: Fortis Inc. (FTS.TO) as of 10/13/2020



Source: Reuters