Ecofin Podcast

ecofin

Oct. 10, 2019

Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, Tortoise provides a timely update on trending topics in the market.

Hello! This is Jean-Hugues de Lamaze, Senior Portfolio Manager at the Ecofin Platform of Tortoise in the UK, in London.

Today we would like to talk about utilities worldwide. A key day to speak about utilities actually as we just heard this morning additional negative news about California's PG&E, one of the largest utility groups in the U.S. The judge has decided to terminate PG&E's exclusivity, meaning this will most likely increase dramatically the compensation amounts related to wildfires of the past couple of years, thereby accelerating the company's fall. So a dramatic situation. PG&E actually contrasts with some other groups like Southern or American Water Works which have been strong performers year-to-date up close to 40%, and it contracts with the sector as a whole which has been an outperformer compared to both the S&P market in the U.S. and the MSCI World index overall.

So we are going to analyse today the dramatic transformation and de-risking of the utilities business models worldwide on the back of the so-called energy transition. I mean by that primarily the effects of the fast development of greener forms of electricity generation. We will see how utilities actually still look undervalued relative to not only the bond market but also to their own fundamentals.

The utilities sector has been outperforming global equity markets roughly over the past couple of years after years of performance lag. The move is particularly salient in the U.S., where utilities are now trading at their peak relative price/earnings multiples of the past decade.

So, are utilities over valued? We do NOT think so. We even think that the market yet has to acknowledge the significant de-risking of the utilities business models, which in our view would justify a further re-rating.

Historically, utilities have been very much perceived as either bond proxies with limited growth prospects, or commodity-driven and heavily indebted merchant businesses. It is interesting to note that actually global utilities have overall de-rated over the past decade. In Europe, the largest listed utilities groups have even lost 50% of their market caps over the period.

We see at least three reasons for the sector to re-rate from its current valuation levels:

1) De-risking of the business models
2) Strong growth prospects
3) Fundamental under-valuation

Starting with de-risking of the business models, while 10 years ago close to 50% of European utilities' operating profits were stemming from conventional power generation businesses, largely dependent on commodity price fluctuations, this proportion has reduced significantly to represent less than 20% today. Commodity-driven power generation was replaced by a combination of regulated networks and fully contracted renewable energy projects. These two combined, according to Goldman Sachs, now account for close to 80% of European utilities' EBITDA.

In the U.S., utilities have been largely regulated for longer than in Europe, but we are also noticing some structural evolution. As an example, Virginia-based utility Dominion increased the weight of its regulated businesses from 40% in 2006 to 95% today.

In our view, such a trend is transforming the sector and de-risking it dramatically. Cash flows are more predictable than ever, and returns are protected by the heavy capex requirements that regulators and governments want to incentivize.
This is bound to lead to a re-rating of the investment space in our view.

A good illustration of this re-rating phenomenon is what happened with the German utility group RWE. When RWE announced in March 2018 that it would transform itself, via an asset swap with its main competitor E.ON, from a primarily

coal & lignite-fired power generation company to a group that will stem two thirds of its operating profits from renewable energy contracts, the stock's price earnings ratio has re-rated from 8-10x to 17-18x today, 18 months later.

A second reason for a re-rating of the space is the strong growth prospects. The increasing exposure to those two strategic legs, namely power grids and renewable energy, is a consequence of the rising focus on decarbonized and decentralized sources of power. Investment in grids seems necessary in view of the recent blackouts in New York and London, to ensure the reliability of power supplies from much more diversified sources than in the past.

We expect the transformation of the energy spectrum to represent significant growth driver for utilities going forward. While the current run rate of renewable capacity additions is around 200GW per annum globally, the growing political ambition – confirmed by some U.S. states, by the EU and a growing number of countries worldwide - to reach zero net emissions of carbon by 2050 would require three times as much renewable capacity additions every year.

We also expect the growth to be return enhancing. The fast reduction in wind and solar production costs – which have already been cut by 80% over the past decade – is here to ensure attractive returns. We would highlight on top of that power prices are low in the U.S. but have bounced by 50 to 100% across Europe since 2016, supported by pro-active carbon policies. This is a further boost to profitability of the clean generators.

Finally, the third reason for a re-rating is we see a fundamental under-valuation of the utilities universe. We believe that the global utilities sector overall remains significantly undervalued and I'll detail it via two illustrations.

First of all, at a time when private transactions are facilitated by the low interest rate environment, we see a massive disconnection between the valuations that private equity operators are ready to pay versus how those same assets are valued within listed equity vehicles. Recent offshore wind transactions were based on close to two times invested capital in an area where utilities groups are often at the origin of the project. More traditional utilities businesses like regulated water networks are also being taken out at 30-50% premiums to their regulated asset value while listed water names trade on 5-10% premiums only on the UK equity markets.

Last but not least, it is worth highlighting that utilities appear like a safe haven, with sustainable returns and self-fueled growth prospects at a time of expected slowdown in the global economy. The sector overall offers an attractive 4.5% dividend yield average, one of its highest historic spreads with long-bond yields. U.S. utilities notably, which, as mentioned before, may appear to be trading on high relative PE multiples, have never been as attractive relative to the bond market valuations since the mid-1980s.

In conclusion, we expect the current supportive momentum in utilities shares worldwide to continue on the basis of solid fundamentals and growth prospects, secured by the irreversible energy transition trend worldwide.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.