

Spotlight Utilities and Growth: Contradictory? We don't think so.



A conversation with Michael Jin, CFA,
Managing Director, Senior Research Analyst

QUESTION. *Some investors consider utilities a low-growth industry. Do you agree with that?*

ANSWER. That perception is based on the fact that electricity demand has been mostly flat since the global financial crisis (GFC), even as the economy grew. This was due, mainly, to energy conservation efforts, such as the adoption of LED and CFL light bulbs and efficiency improvements in home appliances. As such, it appears logical to conclude that utility companies' earnings and/or cash flow growth must have been nonexistent or very low at best. On the contrary, many utility companies have delivered attractive and consistent earnings and cash flow growth, often in the range of middle to high single digits. These growth rates, particularly in the years post-GFC, have often been higher than the nominal GDP growth rates achieved by the countries in which the companies operate.

QUESTION. *How did these companies generate that growth without selling more kilowatt-hours of electricity?*

ANSWER. The utilities industry is partly regulated and partly unregulated. Due to the monopolistic nature of certain utility assets, such as electric transmission grids and natural gas pipelines, these assets are highly regulated for price control. The unregulated side of the industry has been highly competitive and, thus, growth has been challenging for the companies in those markets. We have been focusing our investments on the regulated side of the industry, where several secular factors have been driving the growth of utility rate bases, earnings and cash flow. These factors are aging infrastructure, the emergence of renewables, the shale revolution and digitization.

QUESTION. *How can aging infrastructure be a positive driver?*

ANSWER. Aging energy infrastructures are less reliable and often cause severe social, economic or environmental impact when they fail. A blackout in New York City, for example, could cause billions of dollars of economic damage. As a result, regulators, who are responsible for reliability, have required the utility companies to upgrade their aging infrastructures. As these upgrades are capital intensive, regulators are obliged to grant the companies favorable terms, such as allowed rates of return and other incentives that will allow them to attract investments, while at the

same time mitigating the impact on the consumer's utility bills. This balancing act has led to lasting capital programs that contribute to the growth of rate bases, which the utility companies use to drive earnings and cash flow growth.

QUESTION. *How are renewables beneficial for utilities?*

ANSWER. Non-hydro renewable sources of energy, such as wind and solar, grew significantly in the last 10 years and have become an integral part of the energy resource mix. Their growth was driven by country or state environmental targets, government incentives and a drastic fall in component costs in recent years. To support the development of renewables, utility companies are tasked with building new transmission lines to connect the new energy sources to the power grids. Capital spending on the new transmission lines, together with the required system upgrades to accommodate and optimize flows on the grid, are added to the rate bases, driving additional earnings and cash flow growth.

QUESTION. *What about the shale revolution?*

ANSWER. The advancement of oil and gas production technology, notably horizontal drilling and hydraulic fracturing, has led to a great abundance of natural gas in North America. As a result, natural gas prices have been in a steady decline over the last 10 years. Cheap natural gas has stimulated demand. Residential customers have been switching from oil to natural gas for home heating during the winter. More and more power generation has switched from coal to natural gas. Utility companies, during this energy transition, benefited in multiple ways, such as building long-haul pipelines to gas producing shale, constructing new gas distribution lines to homes, and adding new gas power plants to their generation mix. Capital spending associated with these activities is added to their rate bases and again contributes to growth.

QUESTION. *Epoch has spoken often about tech being the new macro, but how does that affect utilities?*

ANSWER. Digitization has had a large impact on the industry. Digitization of energy consumption starts with smart meters, for both electricity and gas transmission and distribution networks. Smart meters not only automate the meter reading, significantly reducing the costs of dispatching human readers, but also improve the speed of emergency responses by quickly identifying the location and scale of outages. Smart meters can also detect and measure the two-way flow of electricity, making the distributed generation by rooftop solar feasible. Time-of-use rates that allow consumers to pay less at off-peak hours will only be possible with smart meters. Utility companies are rolling out smart meters and getting incremental growth from the investments.

QUESTION. *Is the growth expected to continue?*

ANSWER. We believe that the growth will continue, as the aforementioned drivers will still be valid for many years to come. Tens of thousands of miles of transmission and distribution lines still need to be replaced or upgraded. Renewables are still in the early innings of development. Natural gas abundance continues to benefit consumers and industries. Finally, while smart meters will eventually saturate, digitization is still ongoing.

In addition, new growth drivers are emerging. Utility companies are just starting to get approvals to put wind and solar power facilities into their rate bases. As technology advances and costs come down, renewables are becoming more competitive even without government incentives. As this trend continues, it will drive further rate-based renewables growth by the utility companies. Also, as battery costs keep coming down, we view the mass adoption of electric vehicles as a question of when, not if. Electric vehicles will switch transportation fuel from carbon-emitting hydrocarbons to electrons. This inevitably leads to a significant growth in power consumption. New power generation facilities will need to be built and added to the rate bases, hopefully with an even higher mix of renewables. This will also require the expansion of transmission and distribution capacities to handle higher charging throughput. Time-of-use rates may become mainstream.

QUESTION. *What are the implications for investors?*

ANSWER. The characteristics of the utilities' growth are unique. They are independent of electricity consumption, have multi year visibility from the rate-making process, and offer low correlation with, yet often higher rates than, GDP growth. The utilities sector also has low beta, providing a risk-reduction benefit to portfolios. For our shareholder yield strategies in particular, we favor those utility companies that operate in constructive regulatory environments, where regulators understand the need for investment and offer attractive allowed returns to properly compensate capital providers. We also look for management teams that have the operational track record of consistently delivering the projects and the associated growth.

Michael's primary focus is on Epoch's Equity Shareholder Yield strategies. Prior to joining Epoch in 2010, Michael was a research analyst at AllianceBernstein. Prior to Bernstein, Michael worked as a corporate finance consultant at McKinsey and a process engineer at Praxair. He received his MBA from the University of Chicago, an MS from SUNY Buffalo and Notre Dame, and completed his undergraduate study at the University of Science and Technology of China.

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