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Utilities – the transition to a growth sector

A raft of utilities sector heavyweights have staged a transformation in their operations to decarbonize their business portfolios over recent years. New energy sources – such as wind and solar power – have become much more competitive and are spurring on the transition to clean energy to tackle today's climate change challenges.

Stéphanie Faibis, Head of Insurance Equity Portfolio Management, and **Sylvie Sauvage**, Head of Investment Grade Corporate Credit Research, in charge of utilities, analyze the utilities sector's transition and consider the opportunities it harbors for insurance equity portfolio management.

Key takeaways

- Pledges to reduce greenhouse gas emissions should drive estimated annual growth of 6-8% for renewable energy out to 2050, offering opportunities for insurance portfolio management.

- The utilities sector sits at the very center of energy transition challenges and is now an attractive growth sector for long-term investors.

- Looking to utilities companies that have successfully reoriented their businesses to concentrate on the transition to clean energy, we focus on integrated companies – covering both energy generation and distribution – with a solid grip across the entire value chain, and boasting stronger business diversification as well as renowned expertise.

- We also focus on companies with strong operational credibility, as well as worldwide companies that can draw on market opportunities across different regions of the globe, and leverage economies of scale.

- Investment in utilities sector stocks while being selective should be among the themes championed by insurers i.e. growth stocks with a defensive slant, as well as increasing and more importantly sustainable returns, while supporting the energy transition.

Cutting back greenhouse gas emissions – ambitious commitments to tackle an environmental emergency

A real revolution in the energy mix kicked off after the Paris Agreement on the climate was signed in 2015, geared to bolstering the proportion of renewable energy in the overall mix to 80% out to 2050.
Meeting this challenge would keep the increase in the earth's temperature at no more than 2°C as compared to the pre-industrial era out to the end of the century.
The recent European Green Deal is more ambitious in terms of greenhouse gas emission reductions than the European Commission's previous program, and is also more extensive from a financial standpoint with hefty amounts mobilized for this package.
The Green Deal was waved in by the European Commission in 2019 as soon as the new president Ursula von der Leyen was appointed, and makes ecology one of the key priorities for the current term. The program allocates funding of €1,000 billion over ten years with a view to reducing greenhouse gas emissions by at least 55% from 1990 levels by 2030, upgrading the target by 15 points compared to the earlier 2030 goal set out in the previous roadmap in 2014.

"We expect renewable energy to grow at an annual pace of 6-8% out to 2050"

Three catalysts for renewable energy growth

Decarbonization of the electricity produced. Worldwide, 2/3 of electricity is generated from carbon sources (mainly coal and gas). Replacing them represents a major growth opportunity for renewables.

Greater electrification of energy (such as the electrification of transportation) could increase the portion of electricity in the energy mix from 20-25% to 50% by 2050.

Development of renewable hydrogen: more than 95% of hydrogen production is currently derived from fossil fuel. Practically speaking, this means that producing one ton of hydrogen emits 10 tons of CO_2 into the atmosphere. Meanwhile, producing one ton of steel generates two tons of CO_2 emissions. So hydrogen production only makes sense from an environmental perspective if it is generated from a carbon-free energy source. This is a particularly useful energy source for power sectors that are not suitable for electrification, such as heavy goods transportation, and the steel and cement industries: these sectors together account for around 20% of CO_2 emissions.

Opportunities for long term investors like insurance companies

The European Green Deal takes the long view and in this respect it dovetails with our investment timeframe, which focuses on companies with sustainable and visible business models.

Additionally, the renewable energy theme fits with our goal of investing in structural mega-trends.

Lastly, this approach chimes with our pledge to enhance the impact of our clients' commitments by translating their climate goals via investments in listed companies.

Is the utilities sector a buoyant industry to invest in the energy transition?

The utilities sector sits at the very center of energy transition challenges and spans four business segments i.e. the generation, transmission, distribution and supply of electricity and gas. The industry boasts a broad geographical footprint and offers opportunities across various technologies, such as solar power, on-shore and off-shore wind power, etc. The sector has not been the most stellar source of value creation for shareholders over the past ten years, but the opportunities harbored by the ecological transition and the industry's renewed focus on less volatile operations currently make the utilities sector more attractive for long-term investors.

Are dividend yields the only appeal for the utilities sector?

The answer to this question is a resolute no, as the sector is now also a growth industry with sector incumbents staging a transformation in

their operations and focusing on their core businesses, while reinvesting their cashflow in the energy sources of the future.

This growth obviously comes at a cost. Profitability on the development of renewable infrastructure projects has a very long-term profile, with return on investment – or payback – spread out over around 20 years. So the utilities sector involves investing capital with a view to long-term returns.

However, with electricity use trending at a pedestrian pace in Europe – sliding 1.3% between 2008 and 2018 for the EU27 vs. an 18% jump between 1998 and 2008 – investment in renewable infrastructure should ultimately ensure stronger return on invested capital and clearer revenue and project visibility on the back of advantageous regulation and a buoyant contractual environment, with government auctions, prices set in long-term contracts with a counterparty, and priority access to the grid as compared with fossil resources, etc. Financial returns should therefore be regular and sustainable as a result of these factors.

But are returns now weaker than before?

No – or at least not for integrated utilities companies that have admittedly redirected their capex towards renewable energies, but also continue to pay out steady or even rising dividends.

Average dividend yield for utilities currently remains above market figures at close to 4% (6% for regulated companies). Payout rates come to 70% for integrated companies (85% for regulated players). By way of comparison, the sector's hyper-growth stocks we just mentioned pay out 1% of their market capitalization, such as Orsted with 1.3% (dividend payout ratio comes to 50-60% of profits) and EDPR at 0.5% (payout 18%), but this figure comes to zero for most companies as cashflow is entirely reinvested in growth. This is one of the reasons why we do not view these stocks as attractive for the moment.

A sector doomed to rely on subsidies?

We can legitimately expect productivity gains of around 1-2% per year on the back of technical progress. The sector has admittedly been driven by subsidies in the past to support companies' development as they grew. However, new projects now require much smaller subsidies as a result of technological research, which has sliced production costs. In the solar power sector, the cost of energy generation has plunged by 90% since 2000. With some technologies such as the development of solar panels' chemical composition, lab-tested efficiency could more than double. Taking this example of solar power specifically, today's new technologies offer yield of around 25% in lab testing (energy input/output ratio) and some experts believe that yield could feasibly increase to around 40%. By way of comparison, average yield for solar panel cells came to just 4% fifteen years ago.

Marking a sign of the times, the latest power auction in Spain saw prices of €25 per MWh for solar and on-shore wind power as compared with the average European electricity price of €40-45, attesting to sector companies' productivity gains. Internal rates of return for solar power comes out at 5% at this price, with a cost of capital at 4-6% depending on the company and country risk. Payback for a renewable project is on average 20 years, equating to contracts of 10-20 years for grid supply.

Is the market not overly competitive now with the arrival of oil majors and financials?

The new feature of the segment is that there is now room enough for all companies, with niche companies and incumbent integrated companies, including oil and gas majors, some of which are reinventing their business while preserving robust cashflow generation capabilities. Our feeling is that oil majors cannot indiscriminately let yield slip on their projects in comparison with attractive profits on oil and gas operations. Meanwhile, purely financial companies have a lower cost of capital and are less willing to take on construction risk, so they often prefer to opt for projects that have already been built. We note that the world invested more in green energy ($500bn) than fossil fuels ($400bn) in 2020 for the first time.

How much leeway do sector companies have in the event of an interest rate hike?

The utilities sector is one of the largest corporate bond issuers. Around 20 sector companies have already issued bond debt since the start of the year worth some €15bn.

"We expect debt to surge to fund the massive investment needed for the energy transition."

Any potential interest rate hike legitimately begs the question of these companies' leeway. We are confident in their ability to maintain the strongest credit quality. In this respect, Standard & Poor's recently eased its requirements, with less demanding financial metrics to maintain a same credit rating, with a view to supporting utilities as they finance the transition to clean energy. For example, to maintain its BBB+ rating, Iberdrola must display a funds from operations to net debt ratio of above 17% vs. 18% previously. Similarly, ratings agencies also include hybrid debt issues when calculating their metrics, thereby helping utilities companies to stabilize their ratings. Hence these companies retain reasonable leeway in the event of an interest rate hike, and this should keep them in the Investment Grade category with an average rating of around BBB/BBB+, preserving credit access at attractive conditions.

Looking to the equity markets, the sector is buoyed by the current low interest rate environment, as companies need to make hefty investments, which require funding from the market. The sector's debt remains high with economic debt standing at 4x EBITDA for integrated utilities – companies that combine energy generation and distribution – with an impact also on companies that are most aggressive in their growth. With a cautious approach in mind, we believe that investment in these integrated utilities companies is opportune: part of their revenues are regulated and hence secure, with 50% of revenues for Iberdrola and Enel regulated via the power grid for example, while portfolios are also well balanced.

So it will be key to remain watchful on any interest rate hikes, and in this case, we would expect an adjustment right along the value chain. However, our scenario is still for continued low interest rates.

What are the best investment vehicles for insurance equity management?

We invest exclusively in companies that have successfully reoriented their businesses. Meanwhile, our coal sector policy involves excluding any corporations that do not press forward with their energy transition at pace.

Utilities previously with commodities in their portfolios – oil and gas field operation divisions at Engie and RWE – have started selling off their most volatile assets and operations that do not harbor synergies with their other businesses. Management teams have taken steps to adapt and reorganized business portfolios. Utilities companies have thus realigned their businesses to focus on three main activities i.e. clean electricity generation, electricity and gas transportation, and energy supply.

In a now more defensive sector, we have a preference for integrated utilities with stronger business diversification and renowned expertise.

The sector has proven to be defensive in terms of earnings growth since 2017. Over 2018/19, profits broadly outstripped the market and gained 9% (Euro Stoxx Utilities) vs. a 6% decline for the market as a whole (Euro Stoxx). Meanwhile in 2020, earnings per share for the utilities sector again outperformed the market significantly, shedding 8% vs. a market plunge of 34%, with the sector and the entire market dented by the collapse in international trade. Looking to stock-market showings, the utilities sector was the third best performer in 2020 (net total return), hot on the heels of Technology and Everyday Consumer Services & Products.

We also note that contractual arrangements for sales have become the new normal, and act to stabilize revenues and profits. This is particularly true for renewable energy contracts. Companies in Europe were previously much less likely to hedge against electricity price fluctuations – or even speculated on the market via trading operations – when electricity use was increasing on the continent in volume terms. However, revenue profiles have become much more steady, with the regulated network portion of business rising from a bit over 30% of profits in 2008 to 50% currently for listed European companies.

More broadly speaking, we focus on integrated profiles that operate across several segments – energy supply to the end customer, high-value regulated assets (networks), renewable energy generation – and that can combine cashflow generation, growth and a solid grip across the

entire value chain. Companies that focus solely on new energy are not compatible with the volume of assets under management in our insurance portfolio management business, and are currently trading on valuation multiples on a par with high-tech stocks, which is off-putting for majors in terms of price. Meanwhile, their share price volatility means they are not always the right choice for insurance investors.

"We focus on companies with strong operational credibility and high-quality, experienced management".

We pay very close attention to the quality of management teams, which we also assess from a governance standpoint, as well as worldwide companies that can draw on market opportunities in different regions across the globe: it is worth bearing in mind that these companies are often former national monopolies. Additionally, economies of scale are extensive on these segments, with 75% of renewable infrastructure project costs related to equipment. These projects also benefit from aggressive leverage effects – like other infrastructure projects, they carry little risk – making the cost of debt a critical aspect. Enjoying credibility along with size helps keep funding costs low. These companies are also in the best position to benefit from consolidation in this ongoing immature sector: by way of illustration, world leader Enel's market share stands at around 2%. Size also affords more opportunities to expand in countries with a stable regulatory and legal framework.

What are the advantages of green bonds for investors?

Utilities companies are among the largest green corporate bond issuers. Proceeds from this type of issue are used to finance the transition to clean energy, for example construction of a wind farm. Seven of the sector's 20 bond issues since the start of the year were devoted to financing the energy transition, amounting to 41% of issue volumes. These issues were heavily oversubscribed, reflecting investor interest in sustainable finance, as they enjoy a twofold advantage: supporting the energy transition and investing in some of the best rated companies in terms of ESG criteria.

Conclusion

Investing in utilities sector stocks while complying with stringent criteria fits with our aim of singling out high-quality assets for our insurance company clients. These investments feature in our three equity insurance strategies – Sector Leaders, Sustainable Growth, High Quality Dividend – and meet with themes championed by insurers, i.e. growth stocks with a defensive slant, as well as increasing and more importantly sustainable returns. They also chime with their Corporate Social Responsibility (CSR) policies, supporting their efforts to combat climate change. A company analysis in terms of themes, and on financial and non-financial criteria, is geared to offering them instruments to limit their ESG risks, particularly as regards the climate.

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Additional notes

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