Comment

June 2025

Utilities

Power up

LATITUDE
INVESTMENT MANAGEMENT

POWER UP

2025 | Utilities

EXECUTIVE SUMMARY

Utilities, in our view, are a significantly overlooked sector. We believe that utilities can offer investors highly attractive risk-adjusted returns with **long-term earnings growth ahead of the market, with less than half the beta of the market**.

We illustrate how Latitude's research process approaches large and diverse sectors, identifying the drivers of risk and return within the sector and how we isolate the most promising sources of durable returns.

Specifically, we identify that the most successful utilities share five common characteristics: (1) **low physical risks**, (2) **low distributed energy risks**, (3) **high ratepayer affordability**, (4) **a constructive regulatory bargain** and (5) a **long runway of investment opportunities**.

The qualitative nature of these risks and opportunities provides the opportunity for alpha when the whole sector is dominated by one factor, as was the case in 2023/24.

Finally, we argue that utilities can offer valuable incremental optionality within a portfolio. **The benefit of generating earnings growth ahead of the market, with half the volatility of the market, accrues through the trading opportunity presented by embracing volatility.** Volatility at various times can be cheap or expensive, and holding a low volatility stock can offer investors the opportunity to buy another stock when it's volatility is mispriced.

We would wager that utilities is a sector that few investors give much consideration to, and much less so to the individual utilities contained within. Utilities tend to grab the headlines on two occasions, the first when stock markets are melting and the flight to perceived safety makes the sector a relative outperformer, and the second when powerlines are literally melting, for example, in the context of the recent Californian wildfires.

Most of the time utilities are seen as a homogenous 'bond-proxy' sector driven by interest rates, but with little discernible interest for the fundamental investor.

While we acknowledge the role of interest rates in driving multiples over the last decade, this is true of all sectors, and we would argue that this view overlooks the significant dispersion within the sector.

THE VIRTUES OF UTILITIES

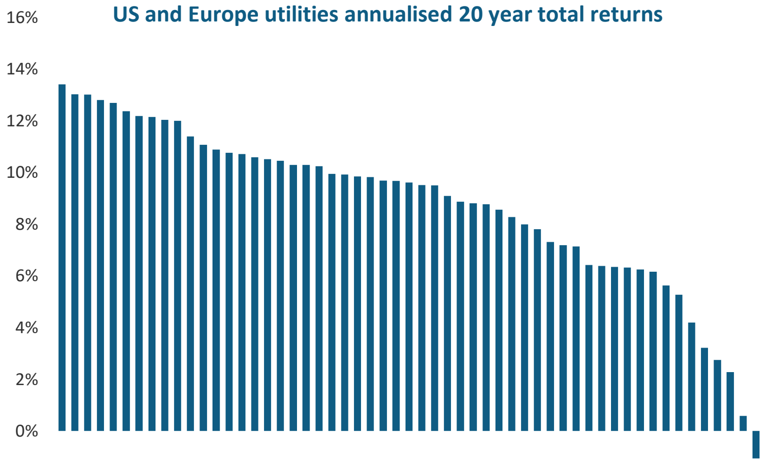
Utilities are **regulated monopolies**, earning modest but attractive, *acyclical* allowed returns (9-11% return on equity); with potentially long and highly visible reinvestment runways, often spanning decades, they can provide both durable and knowable returns.

50-TO-1

Utilities is not a small sub-sector, which is a challenge that as analysts we are confronted with all the time. They're asset heavy, located in different geographies, with different regulatory regimes, and offer different growth prospects. How do we filter through large sub-sectors to find the one or two great opportunities worthy of a place on our shelf of possible investments?

It's not enough to find the best *historic* performers, we need to understand why, forming a view on whether this is temporal or can potentially persist.

Looking at our broad investable universe, we observe a wide spectrum of returns, noting that the top decile of utilities has compounded at a very impressive 13% for 20 years (cf. FTSE All World 7.7%) with half the beta of the market. What's not to like?



Source: Bloomberg

Whenever we observe superior returns, we ask ourselves, what are the drivers and conditions that permitted such returns, and are they durable? Equally, how do we identify and avoid the pitfalls that have driven the worst investment outcomes?

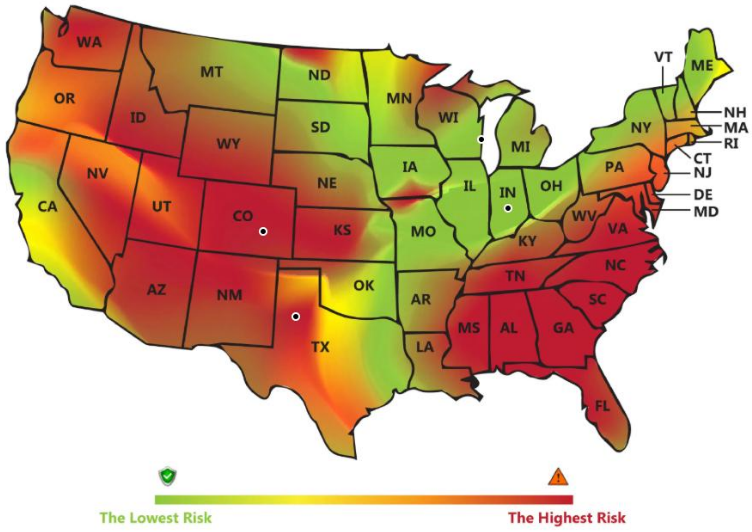
In our research, we identified five significant factors driving returns within the sector:

1. Low physical risks
2. Affordability – low pressure on ratepayers
3. Low distributed energy risk
4. A constructive regulatory bargain
5. A long runway of capital investments on which to earn a ROE

We apply this framework for utilities *globally* but in this note will limit ourselves to illustrating how this works specifically in the US.

Low physical risks: With all the noise post President Trump's inauguration, it could easily be forgotten that the year started with a different story from the US, with the Californian wildfires causing widespread destruction in Los Angeles. PG&E and Edison International stocks are down 16% and 30% respectively. Avoiding wildfires, earthquakes and hurricanes is critical for companies that operate large amounts of physical infrastructure spread across large areas.

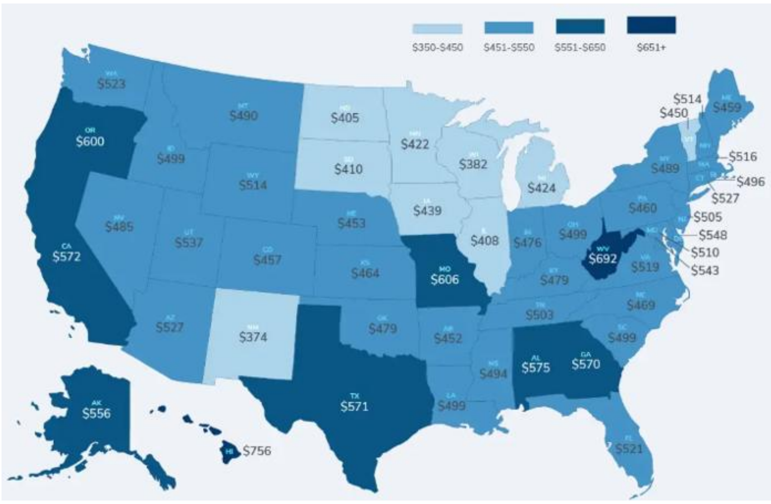
Natural disasters – *the East Coast faces the highest risk of hurricanes while the West Coast faces wildfires and earthquakes. The Midwest carries the lowest physical risks.*



Source: Envista

High ratepayer affordability: Utilities are regulated monopolies which makes bill affordability a political issue. All capex must be pre-approved by the regulator, affordable bills give the regulator scope to approve the investments on which utilities can earn their allowed returns. Utilities operating in states with the highest bills relative to median household income typically exhibit slower capex and thus lower earnings growth.

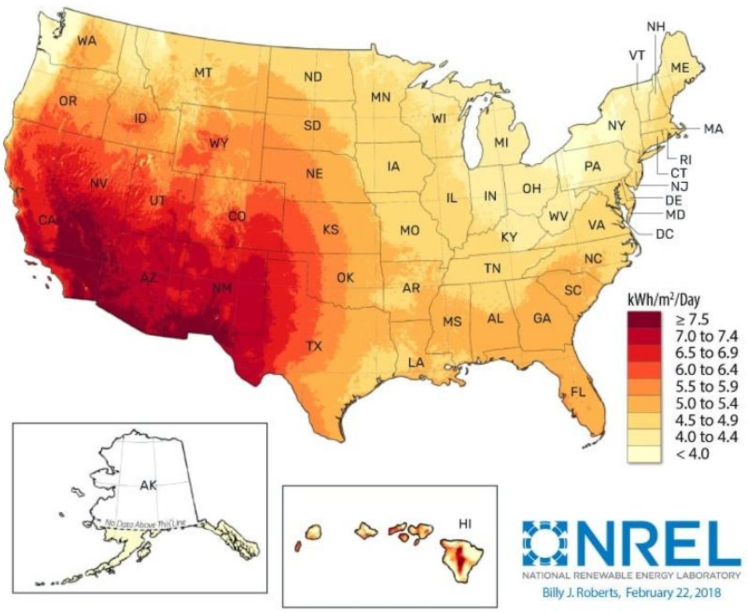
***Affordability –** the cheapest utility bills are also found in the Midwest.*



Source: Move.org

Low distributed energy risk: Many local, state and national governments offer incentives for the installation of solar power and batteries. High ratepayer bills and high subsidies in geographies with a lot of sunshine risk falling demand for the grid as more consumers install their own distributed generation. This becomes a vicious downward spiral as grid costs are saddled by fewer consumers, elevating ratepayer bills further and incentivising ever greater individual investment in distributed energy. In the US, this is most evident in sunshine states like California and least in the Midwest.

***Solar Intensity –** is most acute in the Southwest and least acute in the Northeast.*



A constructive regulatory bargain: Regulators set the allowed returns utilities can earn on their capital investments. Regulators want efficient, affordable and reliable power that supports regional economic growth. Poor operational performance and expensive bills risk regulatory intervention, typically squeezing allowed returns and making approval of growth capex difficult.

A long runway for reinvestment: Utilities need to grow their regulatory asset base through incremental capex to grow their earnings. Utilities with long, visible and low-risk capital programmes are preferable to those with short and novel ones.

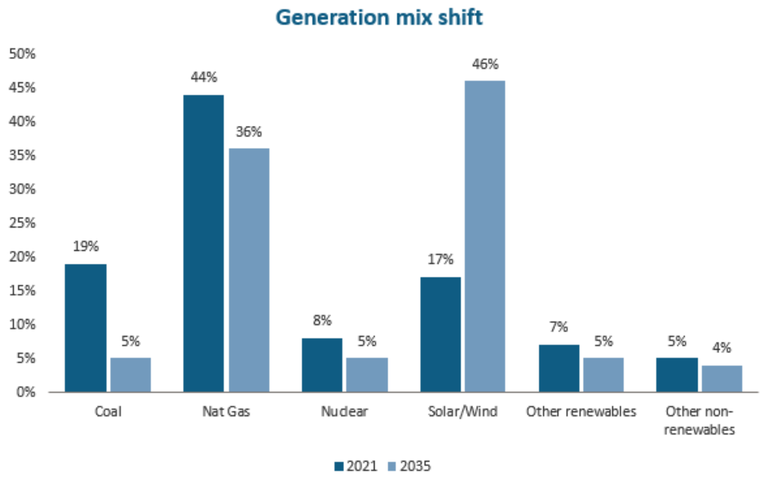
The reader will note that in an adverse scenario, these risks overlap and reinforce one another. High physical risks can result in damaged infrastructure and poor ratepayer affordability, making for a difficult regulatory bargain and a challenging process to obtain approval for growth capex.

Combining these factors, we observed that the top decile performers over the last two decades were concentrated in the Midwest – these include Alliant (Iowa, Wisconsin), CMS Energy (Michigan) and WEC Energy (Wisconsin). Conversely, the worst performers were found in states where these risks are most prevalent (notably California).

GROWTH OUTLOOK

With a framework for understanding long-term sector returns, we need a deeper understanding of what is driving the long-term capex visibility in the Midwest states.

Electrification and the energy transition have been significant investment themes in markets over the last few years. Part of this stems from the fact that coal is still a high teens percentage of the US generation mix.



Source: EIA

A significant growth driver has been the shift towards cleaner and cheaper sources of generation. With thanks to the US onshore energy renaissance, the growth of shale fracking has brought about abundant US natural gas – offering both cleaner and cheaper generation. Newer generation fleet carry lower operational, maintenance and fuel costs – presenting savings to ratepayers.

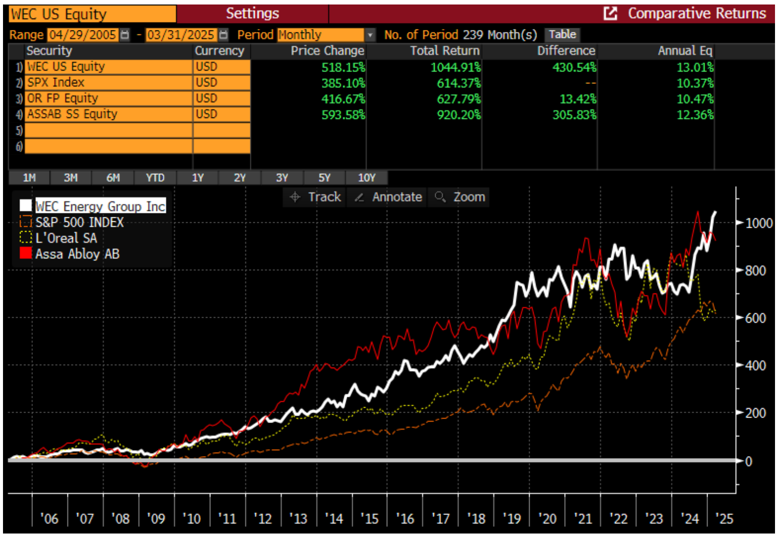
After years of stagnant growth, the IEA forecasts electricity demand will accelerate to 4% p.a. until 2030[1], driven by rising demand for air conditioning and data centres, alongside the accelerating electrification of the transport sector. Regular readers will know that we are somewhat sceptical of the optimism embedded in long-term data centre forecasts, but we would observe utilities have achieved robust capex growth even in modest demand growth environments.

This is because rising demand has already pressured the grid's reliability. The US has ageing infrastructure, with much of the grid built in the 1960s-70s and now 50-60 years old. Outages in 2015-2020 were double of those in 2009-2014.

WEC ENERGY GROUP

We have owned **WEC Energy Group (WEC)** in our portfolio since 2023. WEC is a Midwestern US utility with assets predominantly concentrated in the state of Wisconsin. WEC has compounded at 13% for 25 years, substantially outperforming broad market indices and a broad spectrum of high-quality compounders as illustrated below.

[1] Growth in global electricity demand is set to accelerate in the coming years as power-hungry sectors expand - News - IEA

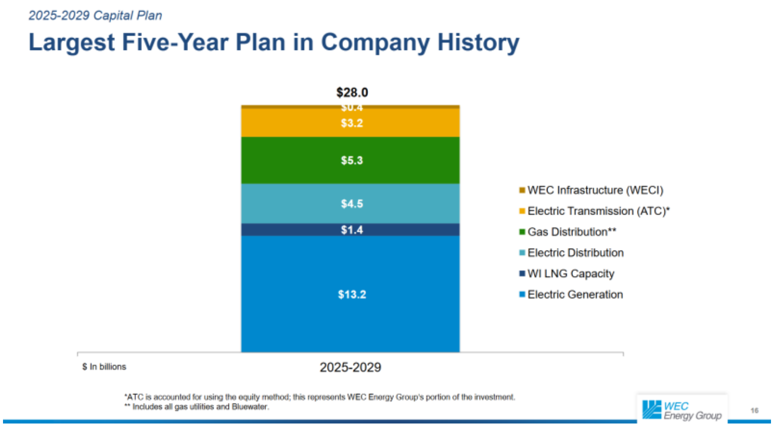


Source: Bloomberg

WEC has grown earnings and dividends per share at 7% over the long term, which combined with a dividend yield of 4%, has offered a double-digit total return. We've previously reviewed the specifics of the investment case in our annual report.

WEC operates in a state experiencing strong economic growth and a below average unemployment rate of 3%. WEC recently presented its largest capital plan in its history, spread broadly across electricity generation, transmission and distribution.

WEC has an excellent track record of operational execution, and the strength of its regulatory relationship was reinforced by recent rate reviews in Wisconsin which were concluded in December. We believe WEC can continue its record of attractive growth for years to come.



Source: WEC Energy Group

BALLAST AND TORQUE

Having identified a subset of advantaged utilities with attractive growth prospects, growing earnings ahead of the market with half the beta of the market, we want to comment briefly on their role within a portfolio context.

It's important to state that we are careful not to conflate volatility with risk. In fact, volatility is opportunity, as it proved to be when we acquired WEC on its lowest valuation in a decade in 2023.

In periods of market stress, utilities often outperform, owing to their acyclical earnings and narrower range of outcomes. To achieve maximum torque in our portfolio from the limited trading we do, we need to be able to sell something which has held up well. Everything in our portfolio is a relative decision and we believe this optionality is valuable.

CONCLUSION

We find many of our opportunities within often overlooked sectors like utilities. Superficially similar, yet on closer inspection surprisingly different, we've presented a simple framework for identifying the drivers of risk and opportunity within the sector. Far from being homogenous bond proxies, a subset has managed to compound at 12-13% over decades, outperforming many of the markets more popular quality compounders.

Furthermore, the addition of a high-quality utility in the portfolio provides optionality without necessarily sacrificing returns.

At Latitude, our research process is designed to approach such overlooked parts of the market with clear and reasoned frameworks for value creation, in order to identify attractive opportunities away from the overvalued market darlings.

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