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Ecofin's 2024 Outlook

November 2023

Electrification Trends Remain Robust: Fundamentally, demand is strong as we see more evidence that electrification is happening, be it due to the large amount of electricity needed for datacentres, AI, or electric cars, to name a few. Demand for electricity worldwide is expected to more than triple by 2050 as electricity is more widely adopted for use.

Further, electricity can increasingly be generated using renewables. Renewables' attributes intersect government policy and economic preference with strong customer demand. Renewables have the potential to offer security of supply and energy independence, decarbonisation benefits, and relative affordability, as renewable electricity cost differentials provide attractive levels compared to traditional fossil fuel alternatives. In terms of costs, declining solar panel and other technologies point to improving cost formation within renewables. Further, contracted power prices for new projects, have by-and-large adjusted upward to reflect the higher cost of capital and overall equipment costs to maintain project returns.

Policy Catalysts: From a macro perspective, we see robust policy support for our sector looking into 2024. We believe we will see full benefits stemming from the U.S. Inflation Reduction Act (IRA) starting to be reflected within companies' financial statements. We also expect clarity on broader European and German pro-renewables policies and Canada's response to the U.S. IRA.

Attractive Valuations: Valuations for the stocks in our investment universe have come down relative to history and relative to the broader market. The sharp increase in long-term interest rates has created a larger headwind to valuations and capital formation of new projects, overshadowing other drivers as the market questions the value of actual cash flows and the value of growth for companies in the sector. We believe these doubts surrounding growth are likely overly pessimistic.

Delving deeper into valuations, as an illustration of their attractive levels; the PE of the U.S. S&P Utilities Index is trading about one standard deviation below its 2010-2023 average and below where it was trading before the IRA was announced, despite an expected acceleration in EPS growth in the next few years relative to the past 5 years. The sector is therefore declining or derating while the broad market multiple has expanded relative to history, creating an attractive set-up for our space. This is perhaps not entirely unexpected given the rate sensitivity of our investments, but we believe the mean-reverting aspects of utilities and infrastructure have been historically compelling. Over-time, in our sector, share prices will tend to correlate with earnings. We anticipate these dynamics in 2024.

In 2024, we will likely see interest rates stabilise, and we believe that would be very supportive for the sector. In the U.S., history shows that the sector does very well 12 months after the last Fed rate increase. Stability in interest rates should help reduce volatility by offering more consistent net present values of operating cash flows and growth. This is unfortunately an exogenous factor, but equally is not fundamental to operating earnings before interest and taxes (EBIT).

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It has been a challenging environment to be a larger user of capital for growth. In the coming months, as the cost of equity might constrain the attractiveness of some companies' renewables projects, and share prices are not reacting to strong dividend yields, we expect some companies may cut their dividend to retain more cash and maintain some ability to grow. Any dividend cut would simply be a re-direction of cash flows internally to fund growth or to de-risk balance sheets for a period of potential upcoming 'defence.' We see almost no fundamental (EBIT deterioration) rationale for dividend cuts in the sector.

Through 2023 many companies have reset priorities among growth, credit rating, and dividend. The sector should therefore enter 2024 offering a clearer picture with potentially less volatility and a focus on execution.

On balance, moving into 2024, and considering valuations, strength in demand, and where we are in the inflation and interest rate cycles, we believe that we are approaching an inflection point and are in an attractive spot within our universe looking ahead. Our sector is expected to capture structural growth in a slowing global economic environment. Portfolio companies should deliver more stable, and more predictable non-cyclical earnings, and we believe the portfolio is positioned to protect better in falling markets while also participating in rebounds.

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