MARTEN & CO

Update | Investment companies

9 November 2017

# Ecofin Global Utilities and Infrastructure Trust

## Delivering the goods

The manager of Ecofin Global Utilities and Infrastructure Trust (EGL), which invests in utilities and other economic infrastructure equities, says that the company's portfolio has benefitted from a tactically overweight position in continental European stocks, good stock selection and an upswing in power prices which have moved higher on the back of rising commodity prices.

Earlier this year the manager trimmed exposure to UK utilities, which have suffered as interest rate expectations and regulatory pressures have increased. The manager believes that we are in a new phase of consolidation activity within the utilities sector, which could contribute to future NAV and share price growth for the company. EGL looks set to deliver a total return of 6-12% per annum to shareholders over time.

### Developed markets utilities and other economic infrastructure exposure

EGL seeks to provide a high, secure dividend yield and to realise long-term growth, while taking care to preserve shareholders' capital. It invests principally in the equity of utility and infrastructure companies which are listed on recognised stock exchanges in Europe, North America and other developed, OECD countries. It targets a dividend yield of at least 4% per annum on its net assets, paid quarterly, and can use gearing and distributable reserves to achieve this. The portfolio is invested entirely in securities that pay a yield.

| Year ended | Share price total return (%) | NAV total return (%) | MSCI World Utilities TR. (%) | MSCI World total return (%) | MSCI UK total return (%) |
|---|---|---|---|---|---|
| 31/10/17 | 9.7 | 9.1 | 5.7 | 13.5 | 11.9 |

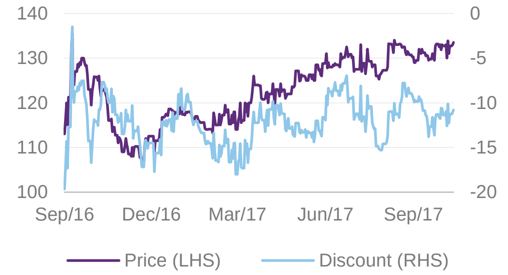
Source: Morningstar, Marten & Co

| | |
|---|---|
| **Sector** | Sector specialist: utilities |
| **Ticker** | EGL LN |
| **Base currency** | GBP |
| **Price** | 133.5p |
| **NAV** | 149.61p |
| **Premium/(discount)** | (10.8%) |
| **Yield*** | 4.8% |

* Note: yield assumes that EGL is able to at least maintain the quarterly dividend rate at 1.6p.

### Share price and discount

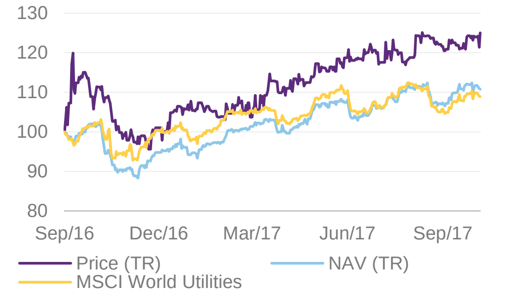
Time period 26/09/2016 to 07/11/2017




Source: Morningstar, Marten & Co

### Performance since launch

Time period 26/09/2016 to 31/10/2017




Source: Morningstar, Marten & Co

| | |
|---|---|
| **Domicile** | United Kingdom |
| **Inception date** | 26 September 2016 |
| **Manager** | Jean-Hugues de Lamaze |
| **Market cap** | 122.6m |
| **Shares outstanding** | 91.9m |
| **Daily vol. (1-yr. avg.)** | 269,632 shares |
| **Net cash** | 1.5% |

Click here for our initiation note

# Manager's view

Manager happy with EGL's progress. UK utilities overshadowed by possibility of regulatory pressure

Jean-Hugues de Lamaze (the manager or Jean-Hugues) says that he is happy with Ecofin Global Utilities and Infrastructure's (EGL's) progress and the shape of its portfolio. Generally, markets have been strong and EGL has been outperforming its universe. Strengthening power prices have had a positive impact and we have also seen more consolidation in the sector. Currency swings have been impacting on the NAV but, in general, sterling weakness is helpful. Mindful that interest rates look set to rise and regulatory pressure is mounting, Jean-Hugues has adopted a more cautious view on UK utilities.

## Rising power prices

For some time, we have been in an era of low power prices. This has been a global phenomenon, in part due to demand which has been reflecting weak economic growth but also due to efficiency measures designed to reduce power consumption. The development of the renewable energy sector has also been much faster than was widely anticipated only a handful of years ago, adding to capacity. However, in recent months, power prices have been on a rising trend.

German power prices up by more than 75%

In Europe, one of the factors that has driven the increase in power prices has been a rising coal price. European coal prices are up 35% this year, partly on the back of a revival in demand from China. The effect has been dramatic; in Germany prices have risen from €21 MWh (at the lows reached in H1 2016) to €37 MWh and the manager says that there have been similar moves in France.

In the US, economic growth has led to increased demand and this is feeding through to higher power prices there.

Utilities seeing higher profitability and cash flow. Improved balance sheets and dividends may follow

Utilities adjusted to a world of lower power prices and now, as prices rise, the benefits are often flowing straight through to the bottom line. This, in turn, means that many companies in the sector are revealing positive earnings surprises, and higher cash flow suggests improving balance sheets and increased dividends. This is good news for a trust which places great emphasis on generating income. The manager points out that the identification of stocks that are capable of producing dividend growth is a critical factor in stock picking decisions.

## Modest inflation

Accelerating inflation is also having an effect on the sector. Inflation has been picking up in the UK and also in Europe, where the ECB is encouraging it, and in the US where the economy has been fairly strong. Higher inflation could clearly drive interest rates higher too but the manager believes that those increases are likely to be modest and gradual. The manager says that a moderate amount of inflation is positive for EGL's investment universe, and only becomes an issue if it is very high and difficult to pass through to consumers; 4% or so would be positive for the universe's earnings base.

Lately, interest rate rises – and the fear of interest rate rises – have impacted on regulated utilities as momentum moves to other, more cyclical, areas of the market. Jean-Hugues had trimmed exposure to UK regulated names earlier in the year but the portfolio overall remains well exposed to this sub-sector, not least because large positions in regulated utilities elsewhere, such as Innogy, American Electric Power, Algonquin Power and Italgas have performed very well and fundamentals remain strong.

### M&A picking up

The manager believes that we are in a new phase of consolidation activity within the utilities sector. M&A potential is not a driver of stock selection decisions but the manager thinks that it may be a factor in future NAV and share price growth for the trust.

To give some examples, there has been some bid speculation among US yieldcos, and in Portugal EDP launched a buyback offer for renewables subsidiary EDPR, although the market considered the offer insufficient and the offer was only partially subscribed. Fortum, a Finnish utility, is bidding for Uniper, a company that was spun out of E.ON (E.ON retained a significant stake) and is focused mainly on hydro-electric and thermal generation. In the Philippines, Energy Development Corp (EDC, a geothermal power producer) was targeted by a consortium led by Macquarie and GIC. EGL was an investor in EDC and in September tendered its shares; it received cash for 85% of its holding and the manager says that the exit price was a substantial premium to EGL's entry price.

Utility companies are reshaping their businesses to reflect the need to curb $CO_2$ emissions

The push towards a lower carbon world is driving utility companies to reshape their portfolios of generating assets. It was one of the reasons why E.ON created Uniper (E.ON's rump generation business).

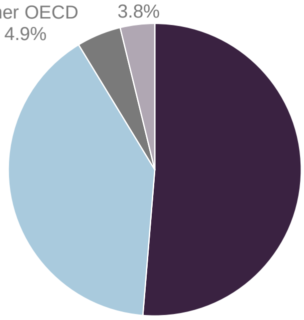
## Asset allocation

Jean-Hugues emphasises that turnover in the portfolio should not usually be very high; reflecting his deep-dive analytical process, he takes his time to add new stocks to the portfolio. He does optimise positions continually however, taking profits and adding to positions on weakness. Since we published our initiation note, the UK is now a lower proportion of the portfolio as the manager has reduced exposure to stocks such as SSE and Severn Trent. The continental European portion of the portfolio has grown with new investments and capital appreciation.

Exposure to non-OECD countries (including emerging markets) peaked in the summer and has since been reduced by profit taking and the partial bid for EDC. Early in July, EGL invested in B. Grimm, a gas-fired power generating business in Thailand, at IPO (EGL can invest up to 10% of its portfolio in non-OECD countries – see page 12 of our May 2017 initiation note). Jean-Hugues believed that the stock, which is the largest supplier to Thailand's state-owned power distributor, was underpriced relative to listed peers. He has been proved right as the stock is up by more than 70% since IPO.

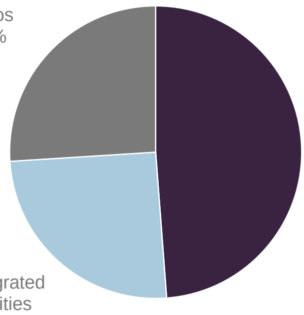
The manager says that gearing is being kept low at the moment so that EGL can take advantage of opportunities, should they arise.

**Figure 1: Geographic allocation as at 31 October 2017**




Source: Ecofin Global Utilities and Infrastructure Trust

**Figure 2: Sub-sector allocation as at 31 October 2017**




Source: Ecofin Global Utilities and Infrastructure Trust

**Figure 3: Top 10 holdings as at 31 October 2017**

| Holding | Sector | Geography | Allocation 31/10/17 (%) | Allocation 31/03/17 (%) | Change (%) |
|---|---|---|---|---|---|
| **Innogy** | Renewable energy | Germany | 5.8 | 4.7 | +1.1 |
| **Covanta** | Waste to energy | US | 4.3 | 3.4 | +0.9 |
| **NextEra Energy Partners** | Renewable energy | US | 4.2 | 2.7 | +1.5 |
| **Engie** | Energy | France | 4.1 | 1.8 | +2.3 |
| **E.ON** | Renewables and networks | Germany | 3.9 | 1.4 | +2.5 |
| **American Electric Power** | Electricity | US | 3.8 | 2.8 | +1.0 |
| **Williams Companies** | Energy infrastructure | US | 3.7 | 3.7 | 0.0 |
| **EDF** | Electricity | France | 3.7 | - | +3.7 |
| **Algonquin Power and Utilities** | Renewable energy | Canada | 3.3 | 3.0 | +0.3 |
| **Italgas** | Gas distribution | Italy | 3.1 | 2.7 | +0.4 |
| **Total** | | | 39.9 | | |

Source: Ecofin Global Utilities and Infrastructure Trust

## EDF

The manager took the opportunity to take a significant position in EDF. He had previously been cautious on the stock but concluded that the bad news (unfavourable pricing context in France, issues at Areva, risk of nuclear closures and uncertainties on EPR developments including Hinkley Point) had been discounted in the share price and the market was being overly bearish on the stock. The manager thinks that, of all of the major utilities, EDF has the highest sensitivity to power prices and carbon prices (it benefits as these rise). The carbon price has risen from €5 per tonne of carbon dioxide to €7 but France is now proposing a floor in Europe of €30 per tonne. The manager says that its implementation largely depends on whether Germany agrees but he believes that, if the policy proceeds, EDF will be directly and positively affected. In contrast, RWE and Polish utilities would likely suffer if the policy is implemented but EGL does not hold these. Not surprisingly, Poland is opposed to the idea.

We asked about Hinkley Point as it is probably the first thing that comes to many UK investors' minds when considering EDF. Jean-Hugues points out that it is a huge project with its costs and benefits spread over many years and that, ultimately, he is comfortable with the projected returns to EDF. The UK is clearly in need of the extra generation capacity and while there has been some political posturing, the UK has signed a contract with EDF and EDF would be heavily compensated should it decide to reverse its decision. He also observes that EDF has been working through problems with its trial reactors at Flamanville, France (also over budget and behind schedule); Olkiluoto-3, Finland (expected to open a decade late and three times over budget - €8.5bn versus €3.2bn); and China. He thinks that Hinkley Point is a very good development for EDF, which can be financed and that EDF has an excellent portfolio of assets, which could be used to support the project.

### E.ON

The manager added to EGL's position in E.ON in July, which has proved to be a good decision with M&A activity providing a boost. E.ON's share price had suffered in the wake of the nuclear scrappage scheme in Germany (in 2011 Angela Merkel announced that Germany would be nuclear-free by 2021). This not only curtailed the lives of the affected facilities but also imposed huge decommissioning costs on operators, E.ON included. However, Germany's courts ultimately awarded in E.ON's favour and the German government has paid several billion euros in compensation, thereby lifting a burden on the company and other operators. Jean-Hugues says that, excluding its German nuclear assets that are in run-off, the company is now focused on renewable energy, infrastructure and customer services. He says that the infrastructure business provides solid cash flows, the renewables business provides growth and the customer facing division provides it with pricing power.

## Performance

**Figure 4: Cumulative total return performance to 31 October 2017**

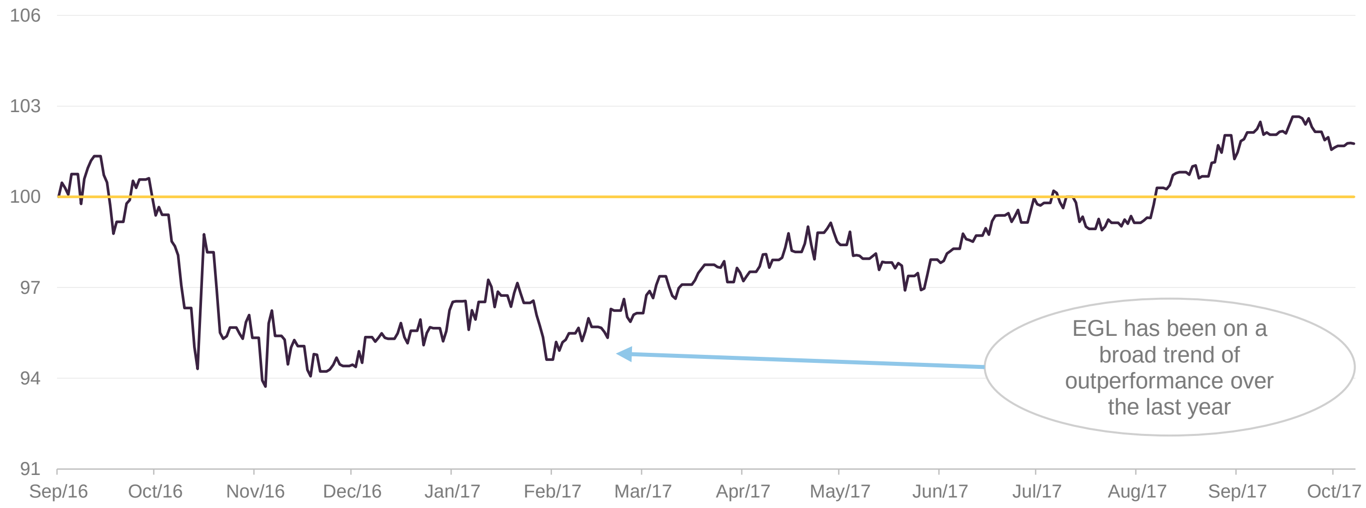
| | 1 month (%) | 3 months (%) | 6 months (%) | 1 year (%) | Since launch* (%) | Volatility (%)** |
|---|---|---|---|---|---|---|
| EGL NAV | 3.5 | 4.3 | 11.3 | 9.1 | 10.9 | 0.68 |
| EGL share price | 0.4 | 3.2 | 9.3 | 9.7 | 21.4 | 1.39 |
| MSCI World Utilities | 3.9 | 2.7 | 6.7 | 5.7 | 9.0 | 0.76 |
| MSCI World | 3.0 | 3.7 | 7.0 | 13.5 | 19.2 | 0.66 |
| MSCI UK | 1.6 | 2.4 | 5.8 | 11.9 | 14.3 | 0.55 |

Source: Morningstar, Marten & Co. *Note: EGL was launched on 26 September 2016. **Note: Volatility is the standard deviation of daily returns over the year to 30 September 2017.

You can see up-to-date information on the QuotedData website.

As mentioned on page 3, asset allocation – in particular a fairly heavy weighting in continental Europe – and stock selection – especially in Europe, non-OECD and emerging markets – have been helpful to EGL's absolute and relative performance. EGL's relatively new position in EDF has benefitted from rising power and carbon prices (primarily because its portfolio of generation assets is biased towards nuclear) and Uniper has also performed well. Energy Development Corp, B Grimm and Mercury NZ (all in the 'rest of the world' portfolio) have contributed positively to the NAV progress this year. Conversely, the manager reports some disappointment with the trust's exposure to US mid-stream infrastructure companies, in particular Plains Group Holdings which missed its guidance and turned out to be more sensitive to commodity prices (as opposed to volumes) than had been expected.

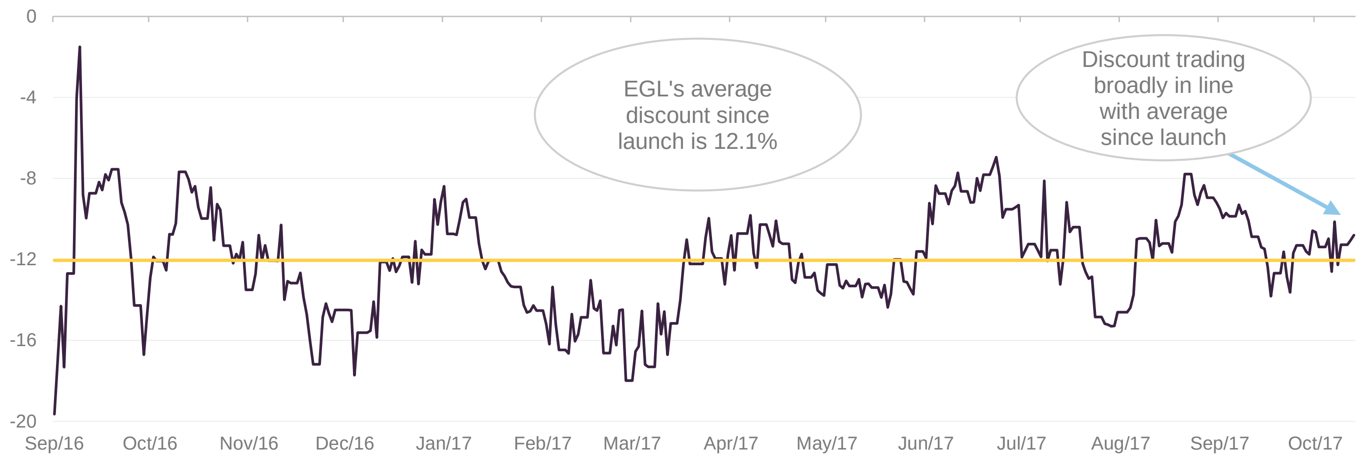
**Figure 5: EGL NAV/MSCI World Utilities Index – rebased to 100 since launch**




Source: Morningstar, Marten & Co.

## Discount / premium

**Figure 6: Premium/(discount) since launch**




Source: Morningstar, Marten & Co.

Year-to-date, EGL has traded at discounts in a range of between 7% and 18%, while its average discount has been 12.1% (it has averaged 12.3% since launch). The discount as at 7 November 2017 was 10.8%, which is wider than the board would like or expect it to be. The board says that it will consider using share repurchases to assist in limiting any sustained discount and discount volatility but there is no formal discount control mechanism, or discount target, and, to date, the trust has not repurchased any of its shares. We said in our initiation note that we think that this is reasonable. We believe that, given EGL's present size, share repurchases would likely have a limited impact on the discount as they would also serve to reduce liquidity and put upward pressure on EGL's ongoing charges ratio. We therefore consider that EGL would be better served by increasing its size and are encouraged that the managers have been allocating more resources to increasing awareness of the trust among investors. As discussed below, EGL's strategy has room to grow.

# Fund profile

## Developed markets utilities and infrastructure exposure with an income and capital preservation focus

Further information regarding EGL can be found on Ecofin Limited's website: www.ecofin.co.uk

Ecofin Global Utilities and Infrastructure Trust Plc is a UK investment trust, listed on the main market of the London Stock Exchange (LSE). The trust invests globally in the equity and equity-related securities of companies operating in the utility and other economic infrastructure sectors. EGL is designed for investors who are looking for a high level of income, would like to see that income grow, wish to preserve their capital and have the prospect of some capital growth as well.

EGL has a strong focus on capital preservation.

Reflecting its capital preservation objective, EGL does not invest in start-ups, small businesses or illiquid securities, as these may involve significant technological or business risk. Instead, it invests primarily in businesses in developed markets, which have 'defensive growth' characteristics: a beta less than the market average; dividend yield greater than the market average; forward looking EPS growth; and strong cash flow generation.

It also operates with a strict definition of utilities and infrastructure as follows:

- Electric and gas utilities and renewable operators and developers – companies engaged in the generation, transmission and distribution of electricity, gas, liquid fuels and renewable energy
- Transportation – companies that own and/or operate roads, railways, ports and airports
- Water and environment – companies operating in the water supply, wastewater, water treatment and environmental services industries.

EGL does not invest in telecommunications companies or companies that own or operate social infrastructure assets funded by the public sector (for example schools, hospitals or prisons).

## No formal benchmark

EGL does not have a formal benchmark and is not constructed with reference to any index.

EGL does not have a formal benchmark and its portfolio is not constructed with reference to an index. However, for the purposes of comparison, EGL compares itself to the MSCI World Utilities Index, the MSCI World Index and the All-Share Index in its own literature. We are using a similar approach here, but are using the MSCI UK Index to represent the UK market. Of the three indices, we consider the MSCI World Utilities to be the most relevant although it should be noted that this index has a strong bias towards US companies.

## Strategy has room to grow

Expanding EGL's size should lower its ongoing charges ratio and improve liquidity in its shares.

EGL had a market capitalisation of £122.6m as at 7 November 2017). The manager believes, and we agree, that its strategy could easily be applied to a much larger fund and its defensive growth characteristics should prove attractive to investors. Expanding the size of the trust should have the dual benefits of lowering the ongoing charges ratio and improving liquidity in EGL's shares.

# Previous research publications

We published an initiation note on EGL – *Structural growth, low volatility and high income* – on 23 May 2017. This explains, in some detail the workings of the trust, the background of the manager, the investment philosophy and approach that drives stock selection, fees, capital structure and the board. It contents pages are included below.

## Structural growth, low volatility and high income – 23 May 2017

## Contents (continued)

MARTEN & CO

Authorised and regulated by the Financial Conduct Authority
123a Kings Road, London SW3 4PL
0203 691 9430

www.martenandco.com

Registered in England & Wales number 07981621,
2nd Floor Heathmans House
19 Heathmans Road, London SW6 4TJ

**Investment company sales:**

Edward Marten
(em@martenandco.com)

**Investment company research:**

James Carthew
(jc@martenandco.com)

Matthew Read
(mr@martenandco.com)

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