ENERGY AND UTILITIES - INVESTMENT OUTLOOK

MULTIPLY GROUP

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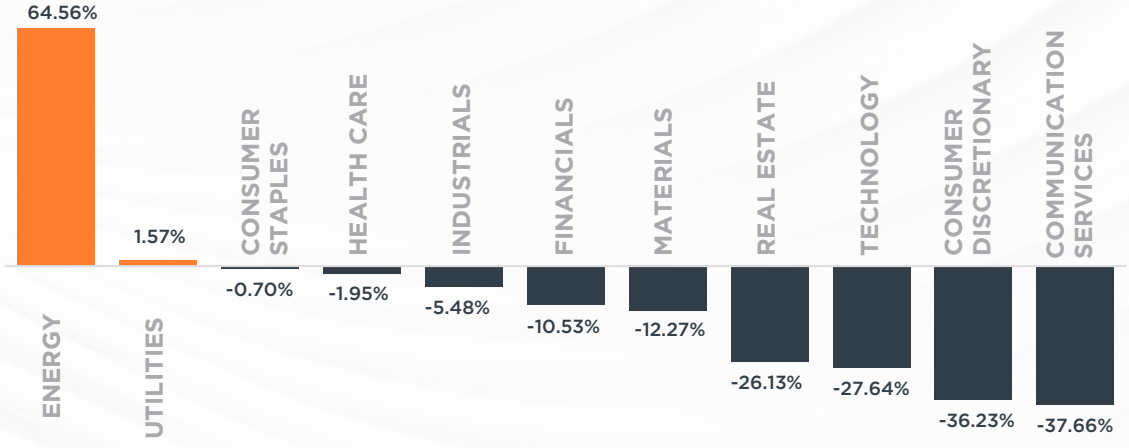
2022 PERFORMANCE

Utilities and energy sectors saw strong relative performance in 2022, having come into the year fairly undervalued, particularly in comparison to technology and other growth segments that performed well during the markets post pandemic surge.

Macroeconomic worries started to amass at the start of the year, driven by surging inflation, interest rate hikes and geopolitical conflict. **Investors began to favour market segments offering more defensive qualities.** By mid-year, these sectors had gone from being among the weakest-performing sectors in the S&P 500 to ranking among the strongest.

S&P 500 Performance by Sector 2022

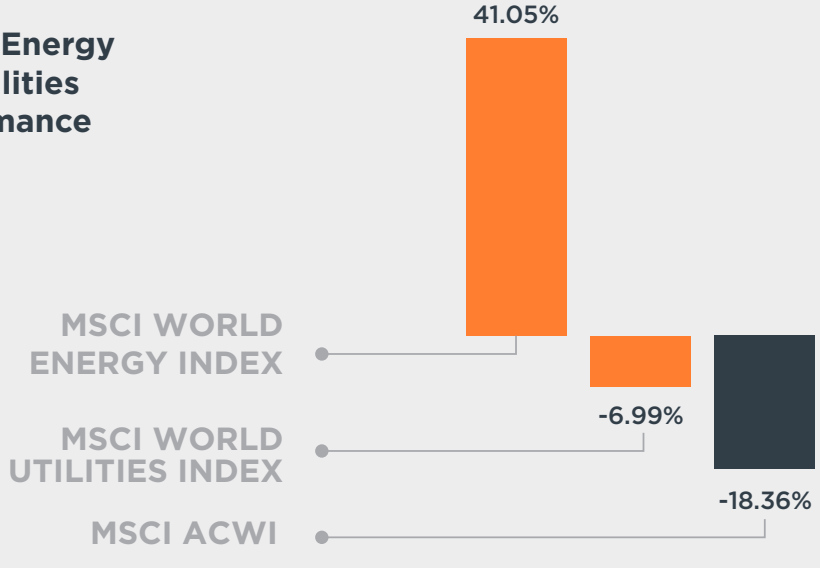


Source: S&P Global

Utilities, although beating the broader market, still struggled at the global level in 2022.

A major driver was higher energy prices and input costs combined with government limitations on price increases, which put pressure on margins.

2022 Global Energy and Utilities Performance



Source: Yahoo Finance

2023 OUTLOOK

As we look to 2023, the economy and markets continue to face the same headwinds as last year – including rising interest rates, elevated inflation, geopolitical unrest, and slowing global growth. Amid this environment, utilities and energy could again remain in favour for their defensive characteristics, which include durable cash flows and dividends.

However, there are **short term concerns over the higher valuations these stocks are now trading at and risk lower performance in the event conditions improve and the market rotates holdings into higher growth sectors.**

Another concern is the high cost of capital in an industry that is capex heavy. New investments may be curtailed as a consequence.

The long-term story could be more compelling as these sectors are at the centre of the global transition to renewable energy sources.

Renewable energy production is now more economical than generating power from fossil fuels, thanks to technology improvements and increased economies of scale. Meanwhile, consumers, businesses, and governments are actively seeking to reduce their carbon footprints. These factors are propelling accelerated earnings growth for utilities and energy.

The combination of a potentially challenging economic environment and long-term tailwinds from a substantial industrial shift, provides an optimistic backdrop for long term performance in the sector.

INDUSTRY TRENDS

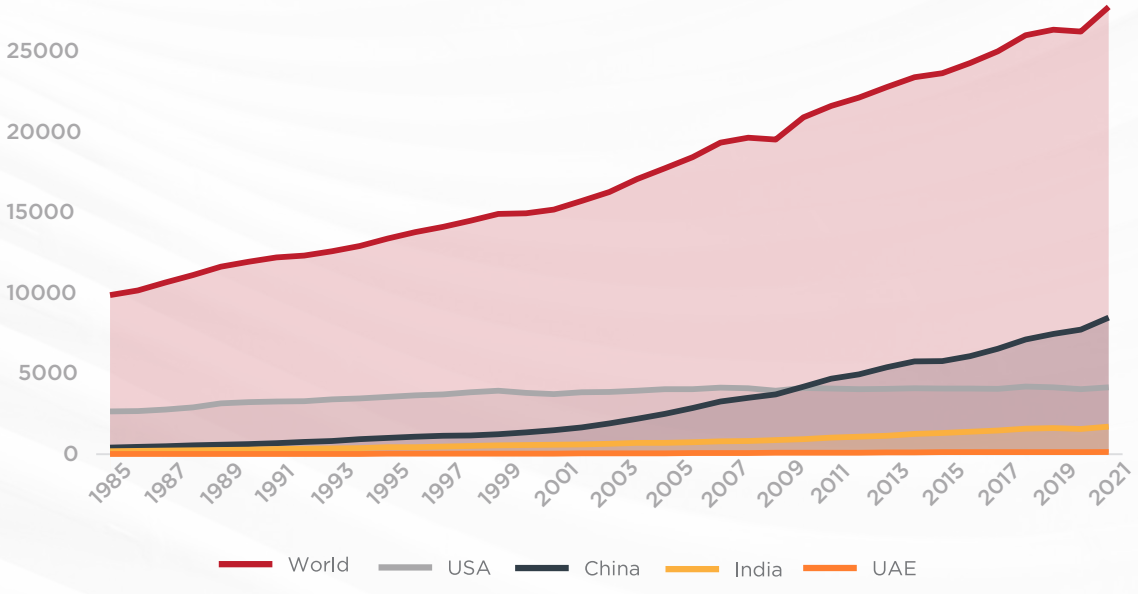
Energy demand should continue to grow in 2023 as economies continue to rebound from the pandemic, with a full Chinese reopening on the horizon. And supply is likely to remain constrained due to disruptions related to the Russian war in Ukraine and years of low investment in production.

Whilst not expected to maintain prices as high as last year, an overall tight energy market should continue to bolster profits for the industry.

The clean energy transition will require a vast increase in materials such as lithium and copper that are needed for batteries, solar panels, and other components. Currently, the vast majority of these minerals are refined and processed in China, and many are mined by Chinese firms around the world.

The world is already seeing the risks of tight supply chains, which have pushed up clean energy technology prices in recent years, making countries' clean energy transitions more difficult and costly. This also plays a role in clean energy markets facing thin margins.

Global Electricity Generation (TWh)



Source: BP Statistical Review of World Energy

GROWTH PROSPECTS

Utilities and energy companies rarely rival tech companies or biotech companies in terms of growth. However, these sectors, which has long been characterised by low and stable growth (less so with energy) paired with competitive dividends, may be entering a new growth environment.

The macroeconomic themes of **electrification and the clean energy transition will require massive amounts of infrastructure investment and bolster a sizable increase in electricity demand, which could provide a long runway for utilities growth.**

The International Energy Agency believes the 2022 energy crisis has been a turning point, causing a meaningful acceleration in government investment in new renewable supply.

They now estimate investment to increase from $1.1 trillion last year, to over $2 trillion a year by 2030.

Having beat the market in 2022, the earnings growth trajectory is as compelling as the industry has seen in decades. Whilst yields may settle as growth improves, pay-out ratios are expected to continue to look attractive for income investors.

GEOGRAPHIC OUTLOOK

US

The Inflation Reduction Act and the Bipartisan Infrastructure Act together are set to provide nearly USD 560 billion in public support for clean energy, with the Inflation Reduction Act alone contributing roughly USD 370 billion, mobilising much more in private investment.

This generates investment opportunities for private investors as the US clean energy industry picks up considerable momentum.

EU

Climate policies, high fossil fuel prices and efforts to reduce import dependency on Russia combine to reduce fossil fuel demand, despite a temporary resurgence of coal in the current crisis.

Covid-19 recovery plans and energy crisis packages contribute around USD 389 billion to clean energy by 2030, helping spur this reduction.

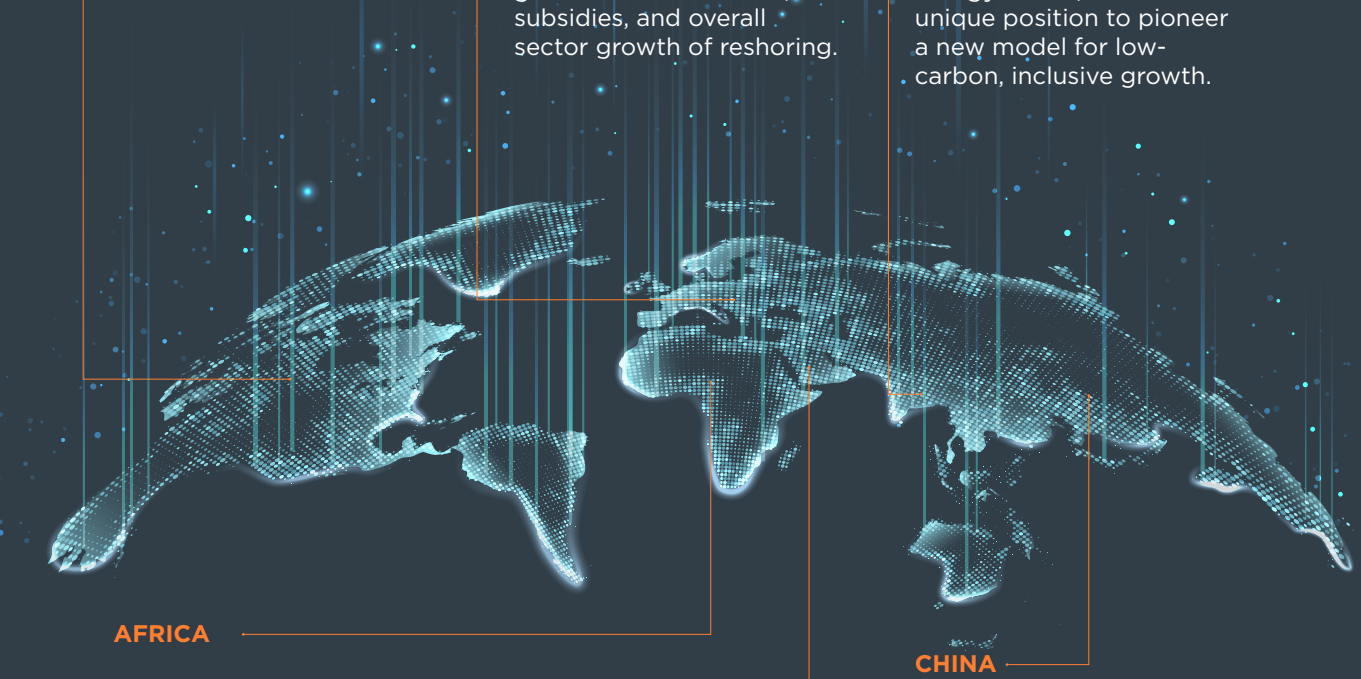
Government spending will spur private investors to enter who can benefit from government incentives, subsidies, and overall sector growth of reshoring.

INDIA

An expanding economy, population, urbanisation, and industrialisation mean that India will see the largest increase in energy demand of any country moving towards 2030.

The pace of change in the electricity sector puts a huge premium on robust grids and other sources of flexibility, with India becoming a global leader in battery storage.

As the government seeks ways to accelerate the pace of transformation in the energy sector, India is in a unique position to pioneer a new model for low-carbon, inclusive growth.



AFRICA

IEA see a modest improvement in the number of people without access to electricity by 2030 and per capita energy use remains low which hinders economic growth.

Increases in low-cost renewable power resources will need to increase substantially and will account for more than 35% of Africa's power supply by 2030.

The region falls behind others in terms of adoption, however, this presents tremendous opportunity for future growth prospects when demand for power picks up as the continent develops quickly.

THE MIDDLE EAST

There is increasing demand for natural gas, which makes up over 60% of the overall forecasted demand growth in the region leading up to 2030.

Renewables emerge as a notable contributor in the power sector, thanks to some of the lowest cost solar in the world and to increasing interest in economic diversification.

CHINA

The world's largest energy consumer, China, will see its economy and consequently energy demand growth rate begin to slow this decade.

China remains heavily dependent on coal, although the IEA estimates this is increasingly being squeezed by renewables (of which China has been the dominant producer of technologies), which will account for 45% of power production by 2030.

The sheer size and technological leadership of China presents a multitude of opportunities across the value chain for modern clean power production.

IEA Electricity Demand Forecast (TWh)

	2010	2021	2030	2050
North America	4623	4852	5266	6830
United States	3880	4004	4281	5482
Central and South America	932	1097	1308	2168
Brazil	451	541	622	985
Europe	3567	3645	4182	5060
European Union	2574	2608	2922	3327
Africa	570	707	994	2041
South Africa	214	194	229	365
Middle East	709	1064	1372	2430
Eurasia	985	1181	1291	1669
Asia Pacific	7154	12164	16208	23475
China	3659	7556	9969	12868
India	717	1273	2117	4293
Japan	1071	934	893	922
Southeast Asia	607	1037	1537	2848
Global electricity demand	18548	24700	30621	43672

Source: IEA

VALUATIONS

On a price-to-earnings basis, utilities and energy companies are trading somewhat above their historical average and when compared relative to the broader market, have also become more expensive.

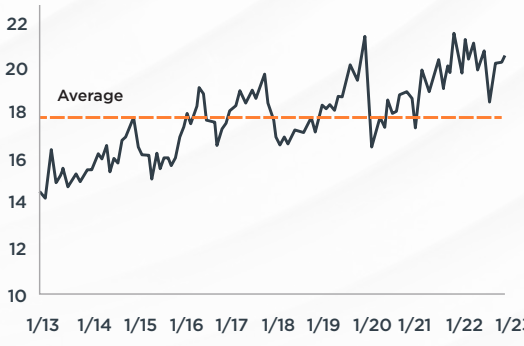
Despite this, these sectors can play an important role in a diversified portfolio, with opportunities still out there to buy quality companies at reasonable prices as industry **fundamentals remain healthy and the outlook is supportive of earnings and dividend growth.**

Global Power Producer P/E Ratios

	1Q FY 2022	2Q FY 2022	3Q FY 2022	4Q FY 2022
TAQA	22.3x	19.6x	54.6x	46.2x
NextEra Energy	103x	61.7x	40.7x	36.5x
Equinor	7.1x	6.2x	4.6x	5.1x
LG Energy Solutions	137.3x	77.8x	82.2x	75.2x
Duke Energy	21.7x	20.0x	18.1x	17.2x

Source: Investing

S&P 500 Utilitities P/E Ratio



Source: Bloomberg

M&A DEAL MAKING

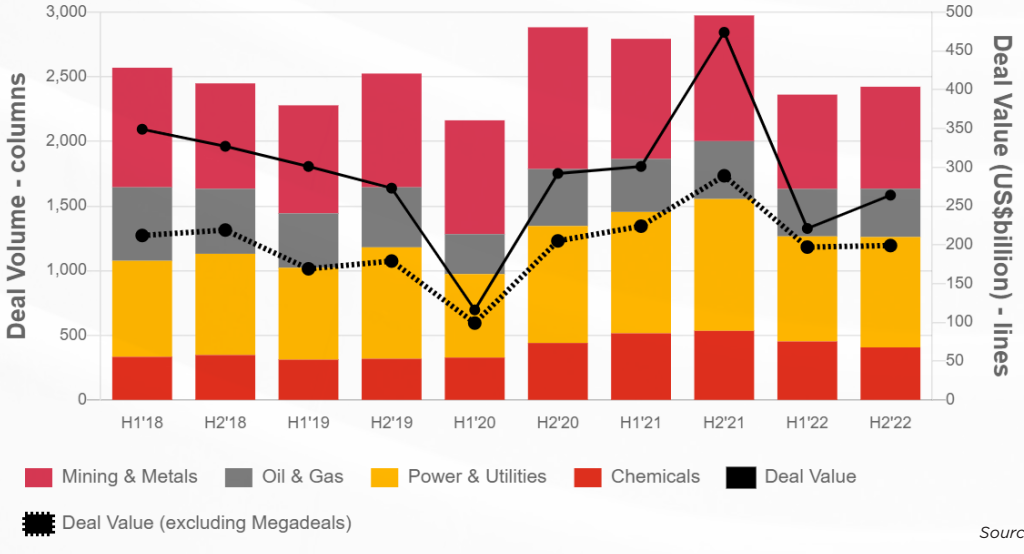
M&A volumes and values from power producers decreased globally in 2022, activity in the EU fell between 2021 and 2022 by 17% and 37%, respectively. **The decline was consistent with the broader M&A market, which came off a record year of dealmaking in 2021 and growing macro concerns.**

Although traditional sources of debt capital today are more expensive and harder to obtain, high commodity prices have strengthened the balance sheets of many businesses. We have also seen the emergence of alternative debt providers, such as credit funds. These two factors have reduced dependence on traditional bank debt as a means of financing M&A, meaning management can, and will, continue to pursue acquisitions.

Large utilities are shifting toward portfolio optimisation strategies, mainly evidenced through a move to shed non-core assets to improve balance sheets and reposition capital to energy security, decarbonisation, and energy transition-aligned themes.

Electrification of the energy system will likely continue to drive value creation opportunities for utilities.

Global Energy, utilities and resources deal volumes and values, 2018-2022



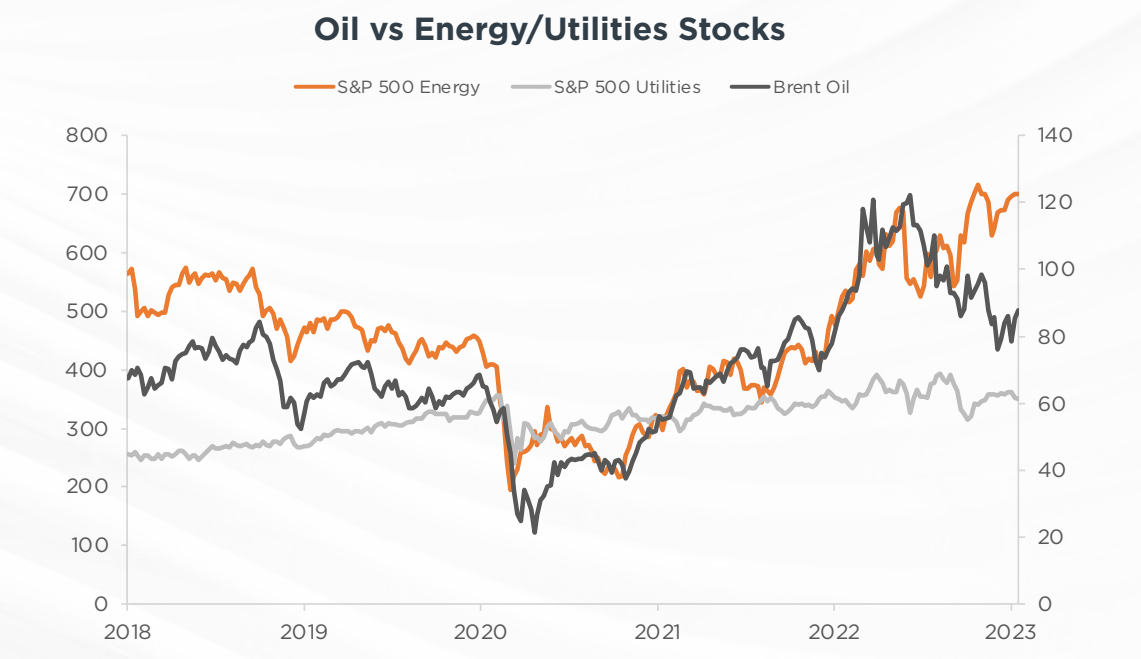
Source: Pwc

SHORT-TERM PRICE RISKS

Growth stocks were overbought and most suspectable to losses as markets slowed down early last year, this saw a rotation to defensive and dividend yielding sectors such as utilities benefit. **As we approach a peak rate, and markets anticipate equity markets reversing, we may see investors again rotate back towards growth stocks.**

Utilities generally see their growth tied to GDP growth, an eventual return to normal market conditions will ultimately see the sectors relative prospects on the lower end of the markets performance. This, however, should see a re-emergence of competitive dividend yields to compensate to some degree.

Energy stocks, similarly, are not expected to have the support of peak prices seen last year, although still elevated from recent years. Oil prices, having peaked a month after Russia's invasion of Ukraine, has been on a downward trajectory. **Despite forecasts around $90 to $100, this comparative weakening should result in lower earnings from traditional energy companies.**



Source: S&P Global, Bloomberg

RELATIONSHIP WITH INTEREST RATES

Interest rates impact utility and energy companies by increasing their borrowing costs. Of course, interest-rate hikes affect all businesses this way, but it's an especially important factor for companies in sectors with typically high debt levels.

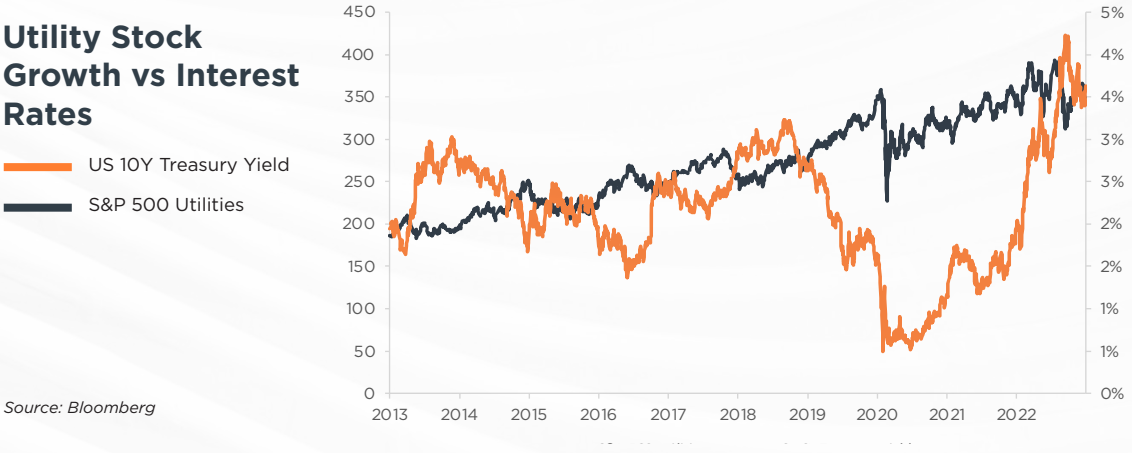
Utility and energy firms have major capital expenditures and high debt-to-market cap levels. The construction of power plants and the maintenance of the vast infrastructure required to deliver gas, water, or electricity makes it a very expensive business that requires major debt financing.

For that reason, **stocks typically perform well when interest rates fall** (or there is an indication that they will not rise further) and fall when rates rise, **but that relationship has been less consistent recently.**

The full effects of recent tightening may have been offset so far by stronger earnings as energy prices have been high, as well as strong investor demand.

Utilities and energy have benefited from cheap financing rates in recent years, but realization of the significant rise in interest rates would change that. Some utility companies can offset their increased borrowing costs by passing them on to customers, but being able to raise their rates enough to cover the extra cost of financing is not a given.

Utility Stock Growth vs Interest Rates



Source: Bloomberg

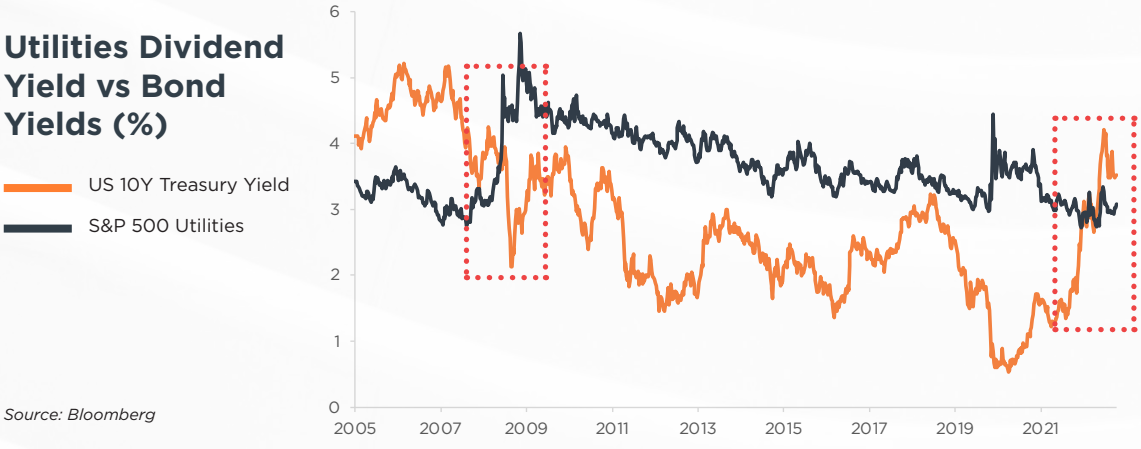
COMPETITION WITH BONDS

The historically low interest rate environment and a corresponding lack of options available to investors to generate current income, have helped boost utilities in the years since the financial crisis. Many investors have used utilities and other defensive sectors as substitutes for bonds, as dividend yields often exceeded bond yields.

A higher interest rate environment makes bonds look more attractive to those same conservative investors, who have flocked to the safety of the utilities and energy sectors as a bond proxy, as **for the first time since the financial crisis bond yields offer a greater yield than utilities dividends.**

With interest rates and corresponding bond yields available again, utilities will likely lose some of those investors.

Utilities Dividend Yield vs Bond Yields (%)



Source: Bloomberg

INVESTMENT CONSIDERATIONS

Utilities investments will continue to play an important role in any diversified portfolio, both from a growth and income perspective.

Valuations are higher than they have been historically, but **long-term growth and earnings prospects look at their strongest in decades** and have a long runway as demand grows and the clean energy transition picks up speed.

At a time where treasury yields are set to outperform utilities dividends, from an income perspective, investors must be more selective.

MULTIPLY SPECIFIC

With a significant concentration in the energy and utilities sectors (TAQA, DEWA, IEH ect.), we must consider these risks:

Share price could moderate as the market looks at riskier growth segments as dividends fail to catch up with the rising risk free rate.

Energy and utilities businesses will limit leverage driven expansion plans due to high cost of capital. While this will hinder their growth in general, they will seek more equity to fund growth - this is where we come in.

Payback period and exits could be stretched as energy businesses adapt to the new normal and IPO environment remains bearish.

Balancing cash flow requirements to service debt and a healthy growth above the risk free rate will be challenging.