U.S. Utilities: An Attractive Opportunity Within Infrastructure Equities

KEY TAKEAWAY

- We believe U.S. utilities have improved fundamentals and will play a key role in ensuring a successful energy transition, fueling a stronger growth outlook for the sector. Yet the broader market appears to underappreciate these companies, still viewing them as slow-growing bond proxies. In our view, this misperception represents a compelling opportunity within an actively managed, diversified infrastructure equities portfolio.

Our diversified, actively managed approach to listed infrastructure centers on investing in high-quality, attractively priced infrastructure companies across geographies and sectors. We utilize a value-based investment process emphasizing fundamental, bottom-up research to identify the most exciting opportunities at any point in time.

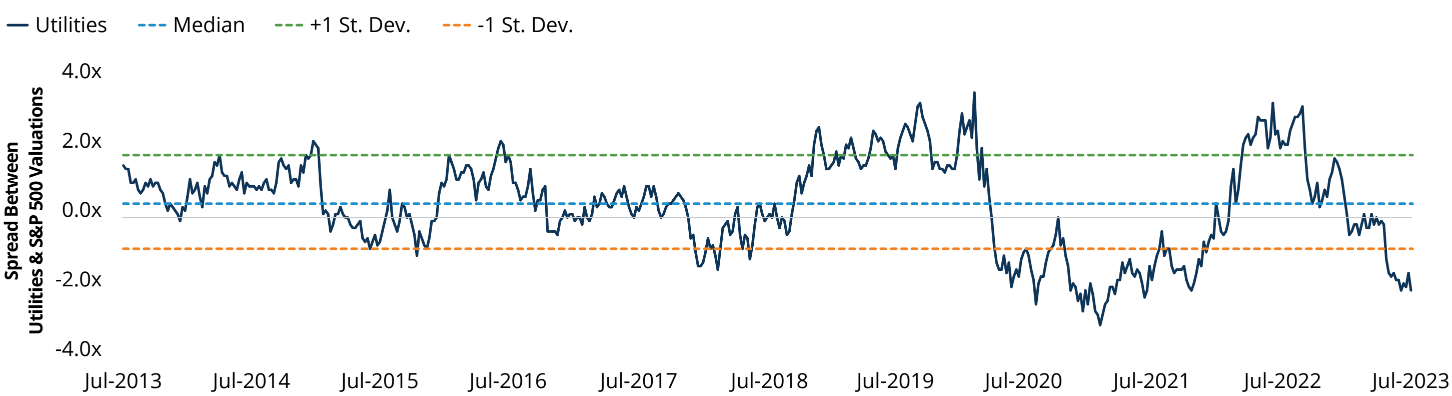
One such exciting opportunity we see today: the U.S. utilities sector. We have an overweight position in the sector within our diversified infrastructure portfolio because we believe current valuations underappreciate the sector's long-term value proposition.

A CHALLENGING YEAR FOR UTILITIES

U.S. utilities companies, which make up the largest part of the listed infrastructure universe, have had a challenging 2023 despite a favorable setup amid a volatile economic backdrop. The S&P U.S. Utilities Sector Index lost 7.8% through the beginning of August, underperforming the broader S&P 500 by over 25%. Recent relative valuations of U.S. utilities vs. the broader S&P 500 are at levels well below normal historical ranges.

LISTED U.S. UTILITIES APPEAR INEXPENSIVE RELATIVE TO THE BROADER EQUITY MARKET

U.S. Utilities Sector Valuations Relative to S&P 500 Valuations



As of July 28, 2023. Source: Brookfield Public Securities Group LLC, Bloomberg. Data represented by the S&P 500 Utilities Sector GICS Level 1 Index and S&P 500 Index. Valuations reflect two-year forward price-to-earnings (P/E) multiples. Spread refers to the difference in the two-year forward P/E multiples of the S&P 500 Utilities Sector GICS Level 1 Index and the S&P 500 Index. "St. Dev." refers to standard deviation, with the +1/-1 lines marking the area where 68% of the data are relative to the mean. See disclosures for full index representations and definitions. **Past performance does not indicate future results.**

Rising nominal interest rates are the most likely reason for the sector's underperformance, given the long-held perception that the sector is a bond-proxy income play and consists of inefficient, poorly-run companies with a matured, low-growth profile. Amid higher rates, income-seeking investors have turned instead to higher-yielding bonds and other long-duration equity sectors like technology.

However, we find U.S. utilities' legacy growth profile is no longer the standard, as we believe current inexpensive valuations represent a misperception of the sector's growth potential and long-term fundamentals, creating a compelling buying opportunity within a diversified infrastructure equities portfolio.

UNDERAPPRECIATED GROWTH PROFILE

The sector has improved its operating efficiency and growth profile significantly, offering attractive returns in a relatively safe market. Utilities companies are remunerated on regulated earnings annually and have a growing capital expenditure profile, as they lead the charge on the energy transition through investments to support the growing demand made possible by the electrification of the economy. We believe this additional avenue for investment activity will allow utilities to further increase their regulated earnings, given that higher electricity demands will require a more flexible grid.

Improved Operating Efficiency

Various mergers and acquisitions have consolidated the U.S. utilities market over the years, and the prevailing public companies have attracted high-quality management teams and best-in-class operators. Companies have focused on operational efficiency to eliminate excess costs from their systems, while optimizing capital spending to generate additional growth avenues. In addition, many companies in the sector have sold their non-core assets, leaving them more focused on regulated assets that allow for lower-risk/higher return-on-equity investments.

A Stronger Growth Outlook

We believe the utilities focused on electricity transmission & distribution assets will play a key role in ensuring a successful energy transition toward a world that runs increasingly on renewables, fueling a strong growth outlook for the sector. Moving away from centralized fossil fuel power stations to wind and solar farms, which tend to be located in much larger areas with reliable wind speeds or adequate levels of sunshine, is altering the makeup of electricity transmission & distribution networks. These constraints mean renewable energy supply sources are generally located farther away from power consumers than fossil fuel energy sources.

As the energy transition progresses, we expect substantial investment will be needed to build and upgrade transmission & distribution infrastructure so it can transport green electrons from sources of renewable supply to key areas of both existing and new power demand. We believe that utilities which invest in new transmission, distribution and generation assets will have a better-regulated asset base growth profile, and the value of their overall assets will improve relative to those of companies that have potential stranded-asset risk from fossil-fuel generation. Accompanied by an already attractive dividend yield profile, the risk-adjusted earnings growth profile for utilities presents an opportunity for better returns for investors, especially when compared with other investment alternatives.

UTILITIES ARE PROJECTED TO POTENTIALLY EARN HIGHER RETURNS THAN THE BROADER MARKET OVER THE NEXT FOUR YEARS

	INCOME YIELD	EARNINGS CAGR	TOTAL RETURN
S&P 500	1.5%	9.1%	10.6%
S&P Utilities	3.2%	8.8%	12.0%
U.S. 10-Year Risk-Free Rate	4.0%	–	4.0%

As of August 8, 2023. Source: Bloomberg, Brookfield Public Securities Group. Data represented by the S&P 500 Index, the S&P 500 Utilities Sector GICS Level 1 Index and the 10-Year Treasury, and reflect analyst forecasts. Earnings compound annual growth rate (CAGR) is defined as the annualized growth rate in the value of earnings. There is no assurance that such events or projections will occur, and actual outcomes may be significantly different than those shown here.

Legislative efforts in the U.S. are also helping to make this growth outlook a reality. The 2021 bipartisan infrastructure legislation includes funding designed to help upgrade U.S. transmission assets, and we expect to see permitting reform legislation eventually on the docket for the U.S. Congress, making it easier for new electricity transmission projects to be built across state lines.

CAPTURING THE OPPORTUNITY

We believe active management and broad infrastructure expertise are key for capturing this valuation opportunity. Regulations, policies and politics vary by state—and even more by locality—introducing additional complexities to the infrastructure universe. Each state has unique demographics, customer growth profiles and average $/kwh rates, among other complex varying factors, so how utilities manage their relationships with local regulators and involved parties is important to understand.

In our view, a deep roster of sector specialists can help analyze critical elements such as these—as well as company-level risk/reward and cash flow potential across sectors—to determine which high-quality infrastructure companies are truly undervalued and deserve an allocation. In addition, while we see an opportunity in U.S. utilities today, there could be better opportunities elsewhere within infrastructure tomorrow. An actively managed, diversified approach to infrastructure can be adjusted accordingly.

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The S&P 500 Index is an equity index of 500 widely held, large-capitalization U.S. companies.

The S&P 500 Utilities Index (or the S&P 500 Utilities Sector GICS Level 1 Index) comprises those companies included in the S&P 500 that are classified as members of the Global Industry Classification Standard (GICS) utilities sector.

The 10-year Treasury is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance.

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