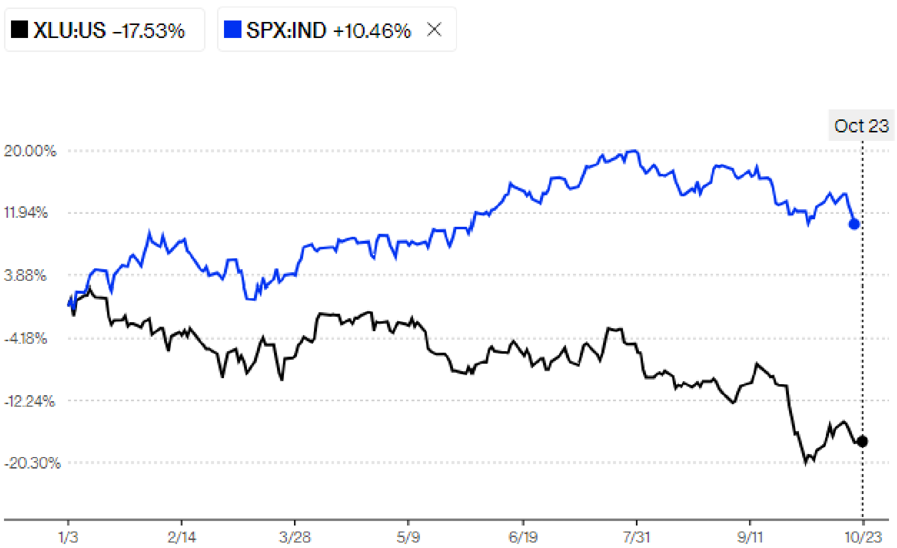
UTILITY HEADWINDS CALL FOR **SMART COST MANAGEMENT**

Our "Triple 2s" white paper discussed emerging challenges facing the utility industry as higher interest rates, cost inflation, and rising commodity prices close out a decade of low-cost "tailwinds." Lately, our concerns appear warranted as the industry's ability to sustain earnings growth and strong credit ratings against a "higher for longer" interest and inflationary backdrop is being questioned. That may be contributing to the stark underperformance of utility stocks, which are seeing their worst year since 1999 and the third worst in four decades.

Chart 1:
YTD Performance of Utilities Sector Exchange-Traded Funds vs. S&P 500



Source: Bloomberg

For most of the past decade, utilities have enjoyed ready access to historically (and abnormally) cheap debt and equity capital, underwriting mid-to-high single-digit earnings growth and keeping dividend yields (the cost of equity capital) at historically low levels. Borrowing also remained cheap in a near-zero interest rate environment. Utility "paper" was readily accepted in the capital markets, underpinned by continued investment in the rate base that in turn supported earnings, dividend growth, and strong investment-grade credit ratings. A virtuous circle, so to speak.

All that began to change this year, and the pace of change is accelerating. A move back toward historically average interest rates has driven debt costs significantly higher. As shown in Chart 1, utility stocks underperformed the S&P 500 by nearly 30% through October 2023. This has driven average utility yields toward 5%, a nearly 40% jump relative to the start of the year. Equity markets have effectively closed for some utilities as rising yields, concerns about future growth, and a perception of rising regulatory and operational risks (e.g., wildfires) have soured investor appetites.

Taking Stock

Earnings season is underway, and U.S. utilities report third quarter 2023 results during the last week of October. Over the past weeks and months, there has been an increased market focus on how higher financing costs are affecting the capital-intensive utility sector, particularly with renewable energy projects challenged by higher manufacturing and labor costs. Renewable energy is an important growth driver for many U.S. electric utilities, and investors are likely watching for any hints of slowing forward capital and earnings growth.

Bond yields and Federal Reserve commentary seem to indicate that interest rates will remain high, while ongoing labor disputes and geopolitical unrest could drive further cost inflation. Through all of this, utilities need to enhance reliable and resilient energy delivery, lower carbon emissions, improve energy efficiency, and embrace emergent technologies such as distributed energy and electric vehicles.

The ability to raise rates to offset higher costs is limited. Utility customers in all market segments are facing the same challenges as utilities themselves: higher financing costs, compounded by rising prices for everything from fuel to food to labor. Utility bill inflation adds to these pressures, creating an environment that is ripe for regulatory pushback and calls for moderation, even as the need to invest capital in infrastructure continues to grow. The only other options are to sell assets or cut costs. Indeed, many utilities are converting hard assets into cash, but what about cost management?

It's Time to Focus on Cost Management

Absent a return of 2% interest and 2% inflation, we believe a utility's ability to manage operating and capital costs will become an increasingly important differentiating factor for both investors and regulators. Most enterprises tend to manage costs by scaling back operating and capital budgets across the board when belt-tightening is called for. Utilities are no exception, although as noted in our regulatory strategy discussion, cost management is a delicate process that must be balanced with regulatory and rate case strategy—you can't simply save your way to better returns.

To meet these challenges, utilities need to employ a strategic approach to plan and manage capital and operating expenditures. The strategic approach prioritizes desired outcomes by challenging the current expenditure-focused approach and seeking long-term, sustainable process improvement. We will explore these ideas in greater detail in an upcoming white paper.

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For further information, please contact:

Sam Brothwell
VP, Strategic and Financial Advisory
203-331-7391 • sbrothwell@mcr-group.com