TRIVARIATE RESEARCH

HAVE YOU BEEN LOOKING FOR SHORT IDEAS?

05/09/2022

ADAM S. PARKER, Ph.D., FOUNDER
adam@trivariateresearch.com
646-734-7070

COLIN COONEY, HEAD OF SALES
colin@trivariateresearch.com
617-910-7934

JONATHAN GILL, SR. ANALYST
jonathan@trivariateresearch.com
203-461-5110

SUMMARY AND CONCLUSIONS

Utilities are flattish YTD and are the 2nd best performing sector in the market - despite a rising 10-year yield, which historically had a statistically significant and negative, not positive, relationship with utility returns. Many long-only portfolio managers do not view utilities as particularly important, given the bench-weight is around 2.6%, and most hedge funds do not cover the space. However, as the market has been declining, and it feels late to short hyper growth stocks (many of which are down more than 50% YTD), **our view is that CIOs should be looking to the utilities sector to find short ideas.**

Utilities are a relatively small universe of 69 stocks, with few diverging business models, so an expert can wrap their arms around the space relatively quickly.

The preponderance of stocks in the utilities sector are small and mid cap. value, a good area to search for both over-and-underweight ideas for many managers who have over-indexed resources to growth ideas in the last decade. **Utilities have almost zero correlation to the hyper growth universe today.**

The company-specific risk of the average utility stock is above that of the market and rising, while the average stock in the market is getting more macro. **These stocks are also very low beta.**

Utility stocks are not just a rate call right now. The utilities sector was historically negatively correlated to the slope and level of the US government bond yields. However, that relationship broke down four years ago and in Q1 of this year, utilities performed well even as bond yields rose, a relationship that has been positive and statistically significant. Moreover, there has been near zero correlation between utility performance and Fed Fund Futures, so the group should not necessarily be strongly impacted by incrementally dovish or hawkish commentary like other parts of the market.

SUMMARY AND CONCLUSIONS

Over three-quarters of all utility companies have negative free cash flow today - up from only one-third a decade ago. There is now a meaningful disconnect between earnings and cash flow, and **this dynamic typically points toward more efficacious shorts.**

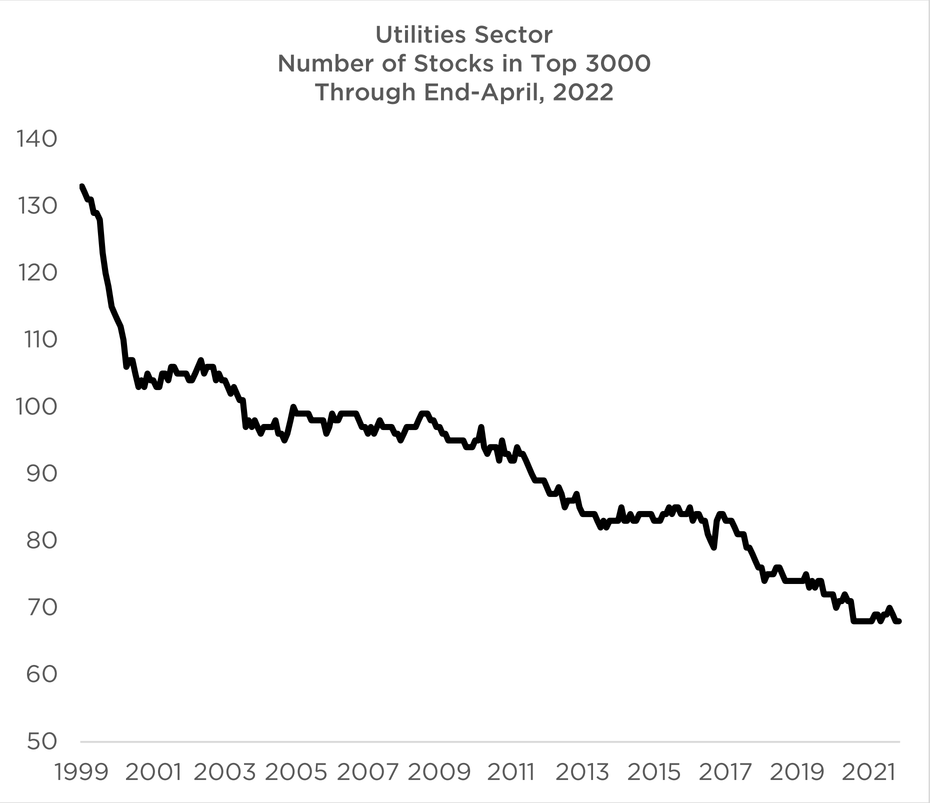
Not only are there a huge number of utilities with negative free cash flow, but 20% of all utility stocks have dividends that are greater than their net income, which ultimately increases the probability of a dividend cut or cancellation. Utilities with payout ratios greater than 100% that also have negative free cash flow have historically meaningfully lagged. Despite the consistent underperformance of high payout ratio / negative FCF utilities, and the huge increases in the percentage of utilities with negative FCF, high debt levels, and dividend yields that are no longer attractive relative to US Treasuries - **the percentage of stocks that have high short interest is low relative to history, which we feel is evidence this space is under-examined by investors**. 58 of the 68 utilities we track currently have less than 4% short interest, and only 2 have above 10% short interest. **Slide 13 shows current short ideas,** all of which have high payout ratios, bad credit ratings, and relatively low short interest.

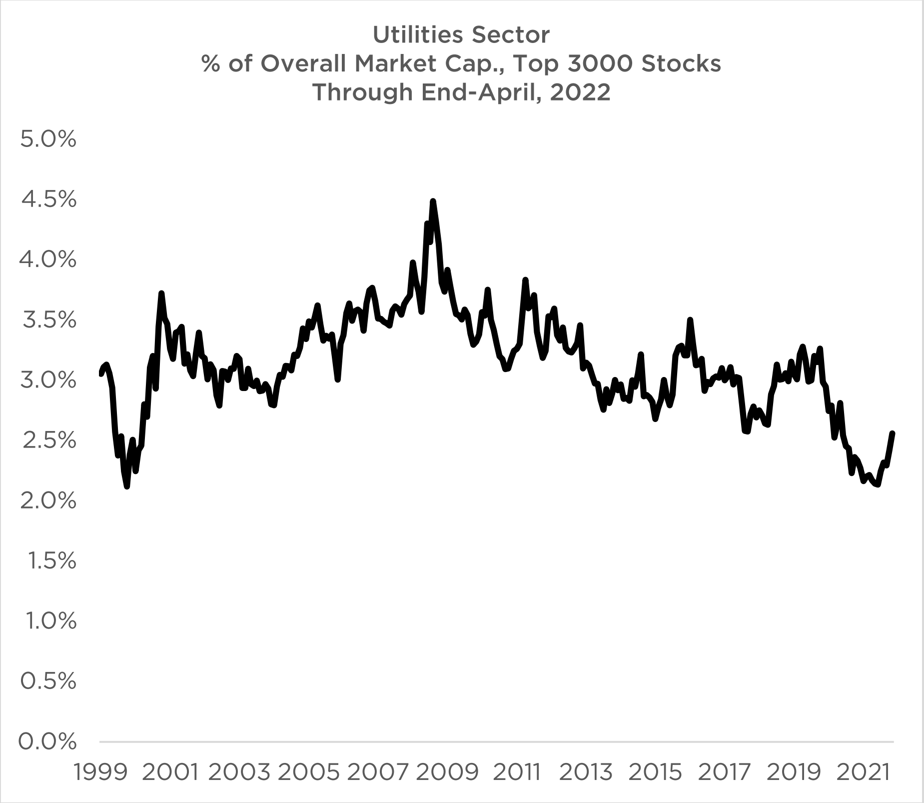
Dividend expanders with ample ability to pay their dividend are more expensive in the utilities sector than in other parts of the market, with record high relative price-to-forward earnings multiples – however, there are some exceptions that may be good long ideas.

Criteria for our buy recommendations are stocks that are disfavored by the sell-side, have positive net income, reasonably low pay out ratios, bonds that are not poorly or downwardly rated, and are not crowded by a proprietary universe of hedge funds we track.

THERE ARE HALF AS MANY UTILITY STOCKS AS THERE USED TO BE

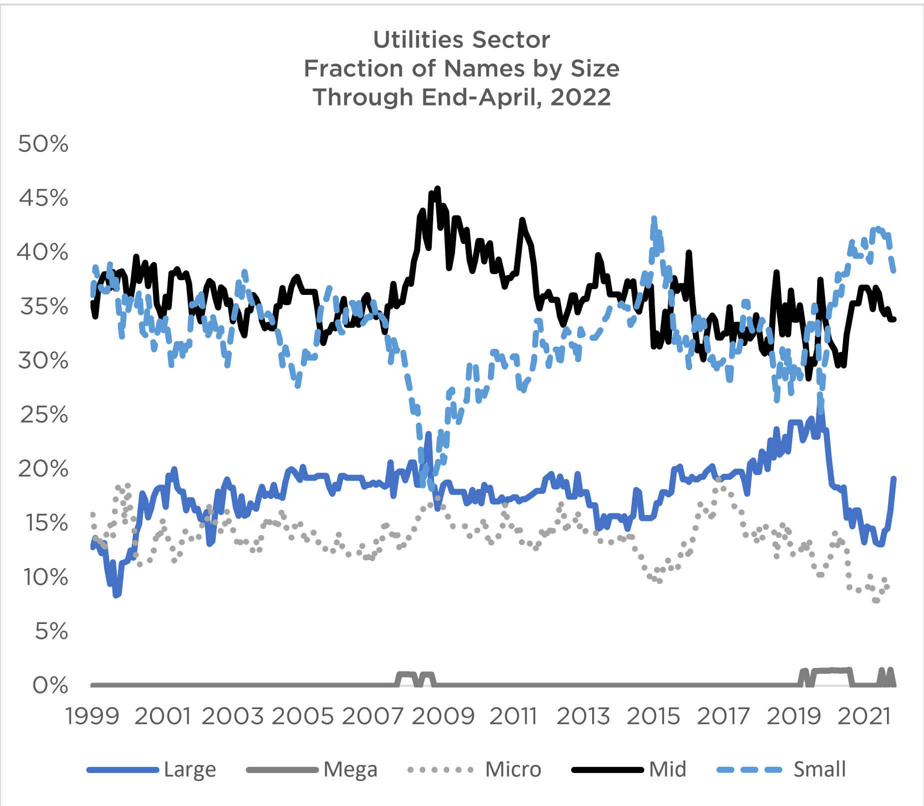
In the middle of 1999, there were 133 utility stocks in the top 3000 US equities by market capitalization (left chart) and that number steadily declined over the past two decades to 68 stocks today. Despite the decline in the number of relevant stocks, the market total market capitalization of the utilities sector among the top 3000 US equities has tripled since 1999, from under $400 billion then to over $1.2 trillion today. That has kept the market cap at about 2.4% of the universe today, vs. the longer-term average of 3.1% of the universe (right chart). Our view is that a firm can hire a utilities analyst or focus resources here and get up to speed quickly - **this makes resource allocation to utilities a viable option for the many who do not spend researching the sector today.**

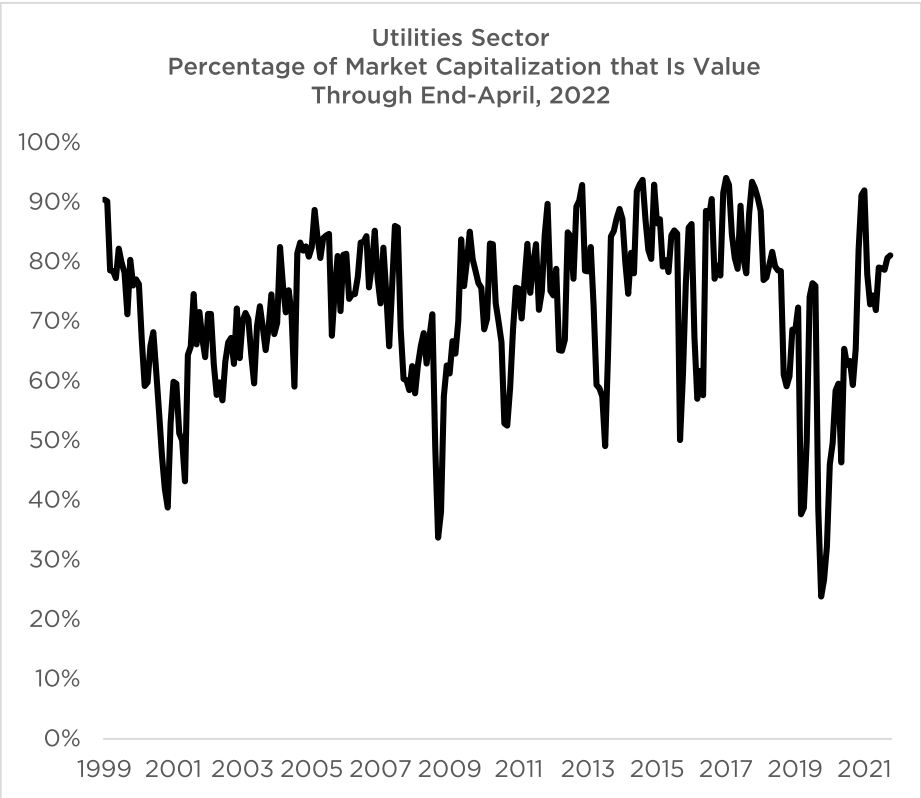




UTILITIES ARE LARGELY SMID-CAP, VALUE STOCKS

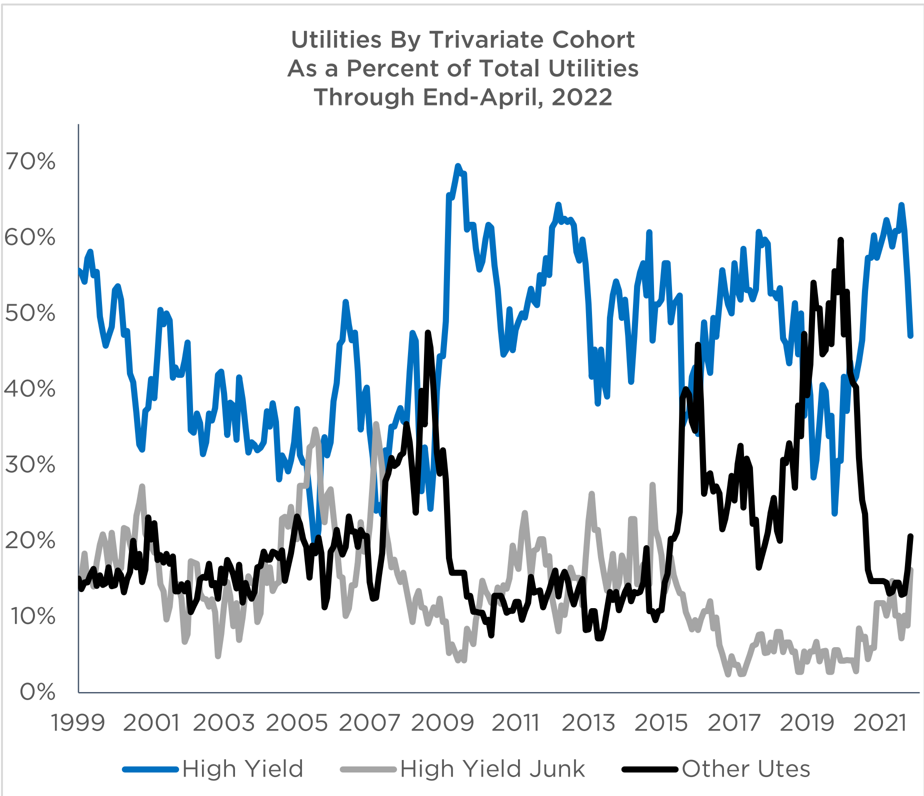
The utilities sector has nearly always been comprised of small and mid-cap stocks (left chart), with 50 of the current 68 stocks and 41% of the market cap in those two buckets. There is currently one mega cap (NEE) and 11 large caps, which account for 59% of the market cap. of the entire sector. There are six microcap utilities, which combined are less than $4B market cap. Most of the sector (over 82%) is value or deep value today (right chart), with zero stocks in the growth universe and only 2.7B market cap in "hyper growth". **Given many investors have ample exposure to large cap growth stocks, it is likely prudent portfolio strategy and risk management to do work on SMID cap value stocks such as utilities at this point in the cycle.**

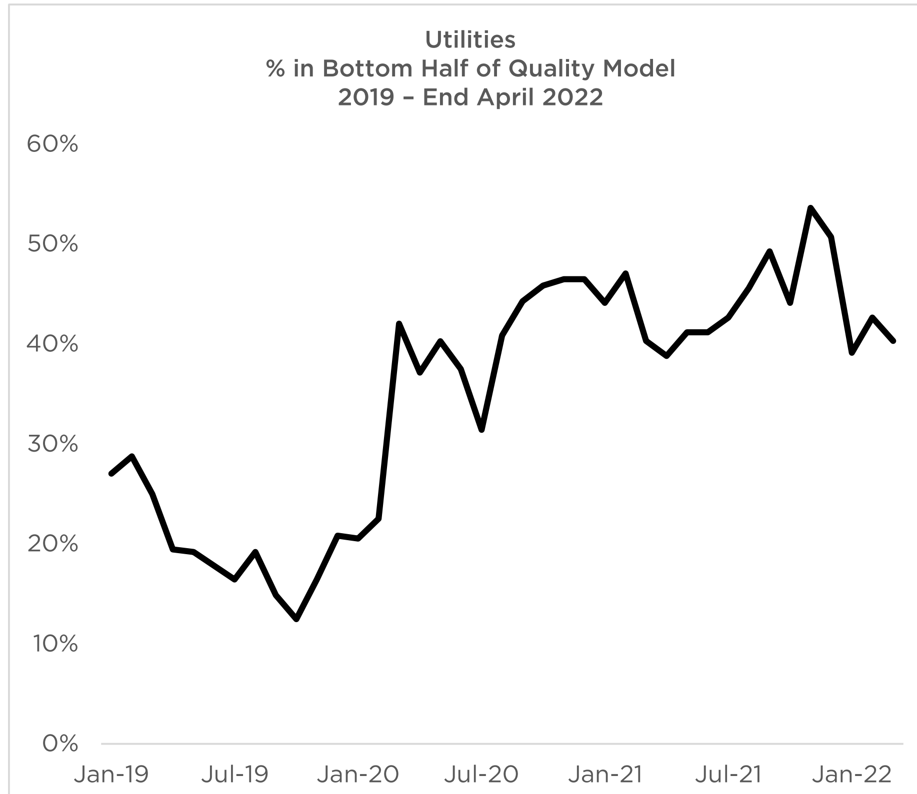




THERE ARE A MIXTURE OF BUSINESSES, ~½ HAVE A HIGH DIVIDEND

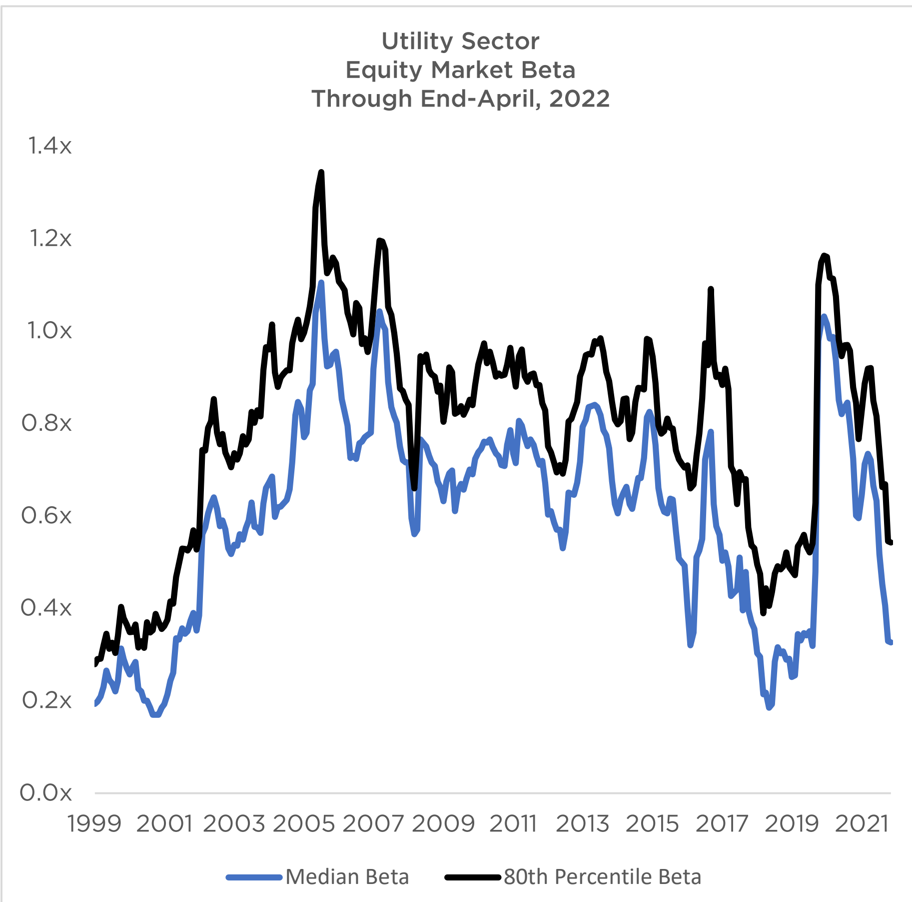
When we break the traditional utility GIC into Trivariate's quantitative modeling cohorts, we observe that the utilities sector is just over 50% comprised of high dividend yielding stocks (defined as currently greater than 2.7% yield) with reasonable balance sheets - but there is more business model dispersion than some may suspect. 23% of utilities are without high dividend yields, with the remaining 25% being junk stocks (either with a high dividend yield or not) (left). This is a different mix than we saw two years ago, when non-high yielding, non-junk, or "other utilities" were over 60% of the universe. One recent post-COVID trend that has emerged for utilities is that more of the names are lower quality or junk than prior to the crisis (right).

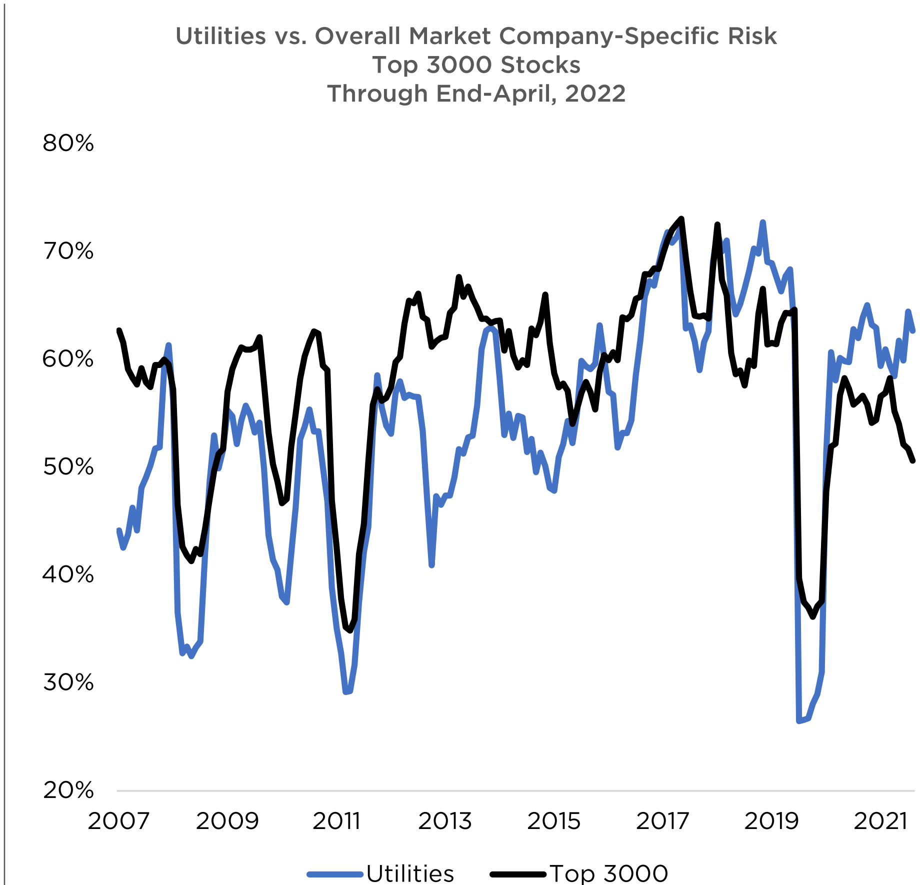




VERY LOW BETA AND ABOVE AVERAGE COMPANY-SPECIFIC RISK

The utilities sector has become substantially lower beta over time, with 80% of the sector now having equity market betas below 0.6x (left chart). This is a function of more volatile markets relative to the more stable underlying businesses this sector offers. The median utility stock now has higher company-specific risk than the median stock in the broader market (right chart), **so while many think utilities are just a macro rate call, they have as much idiosyncratic risk as the broader market,** indicating there is alpha potential, and it should be an area for bottom-up stock pickers to focus on potentially more than they previously thought.





LOW CORRELATION TO GROWTH STOCKS AND NOT CROWDED

From the portfolio construction and risk standpoint, the utilities sector generally has extremely low return correlation to the hyper growth universe, except during the depths of COVID when everything sold off (left). This means it like is a good place to hunt for differentiated return streams. We follow the high conviction (3% or more of long AuM) positions of 60 well-known fundamental equity hedge funds, and the only utility stock where more than one of these managers has high conviction is PCG. EVRG, FE, EXC, and AES are the only other four stocks where any of these funds have big positions. **If you are looking for differentiated alpha, 67 of the 68 utilities (ex PCG) are not owned with conviction by the most active fundamental hedge funds.**

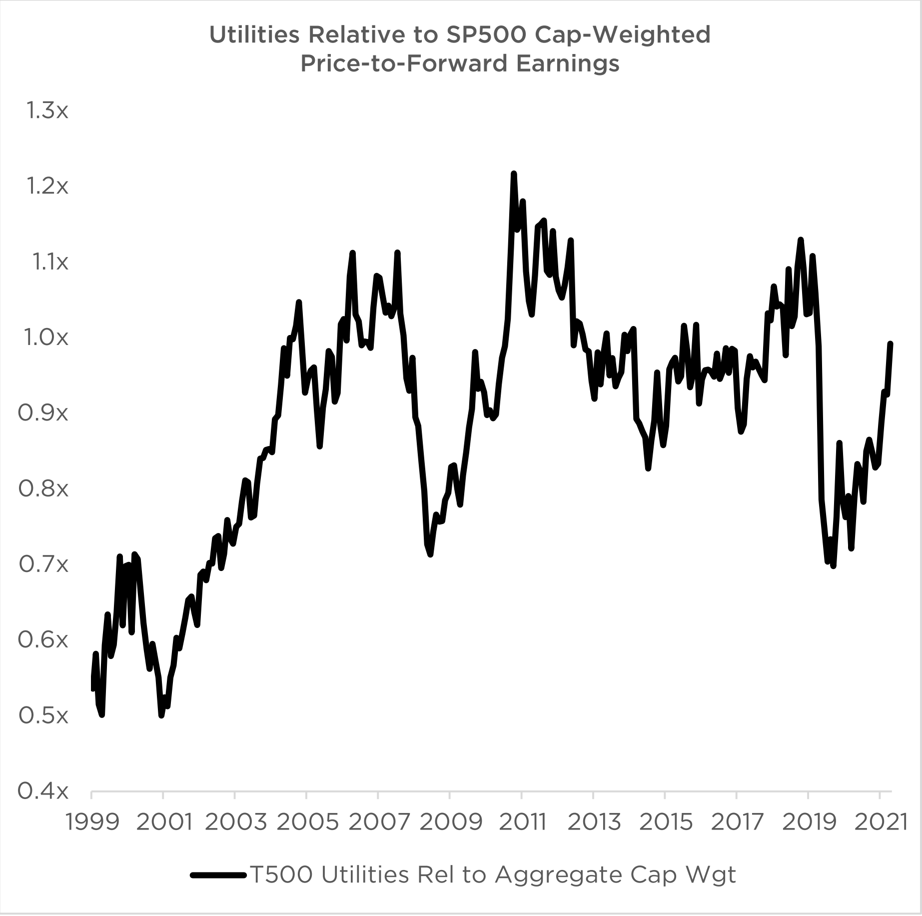
Utilities Sector vs. Hyper Growth Universe
Return Correlation
Through End-April, 2022

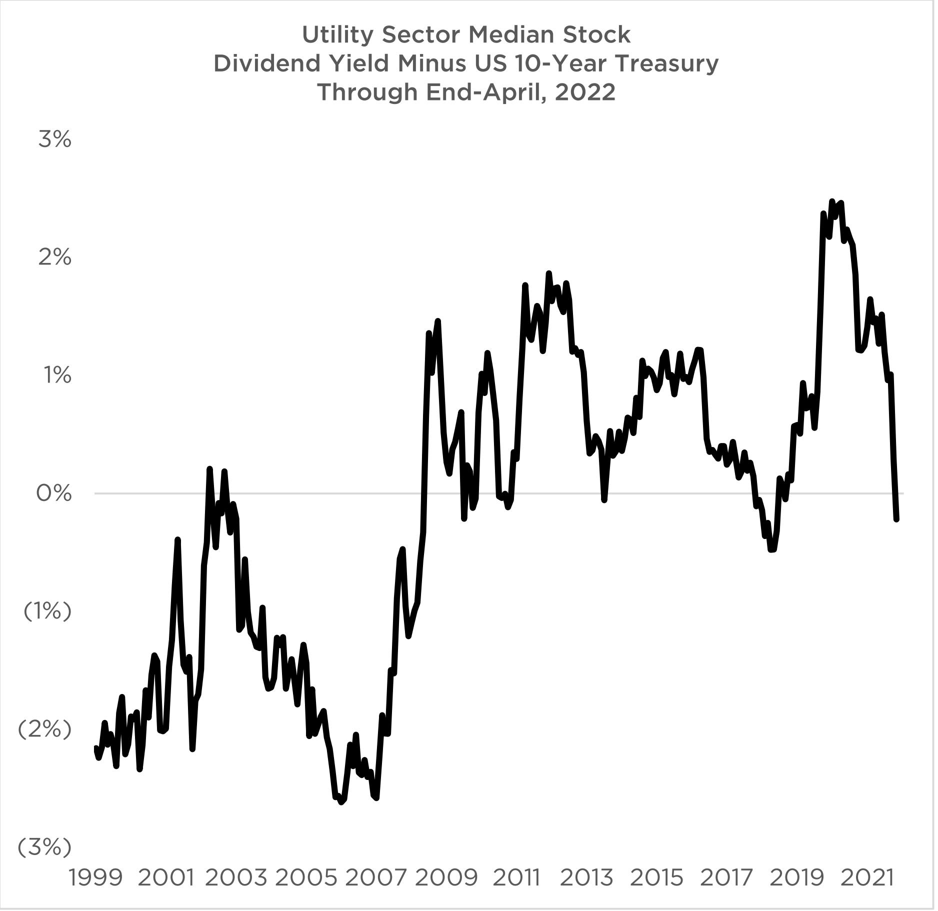
High Conviction (>3% of Long AuM) Utilities Holdings
Trivariate Universe of Fund Managers
End-April, 2022

Ticker	Company	Market Cap. (US$ Bil.)
EXC	Exelon Corporation	45.85
PCG	PG&E Corporation	25.14
FE	FirstEnergy Corp.	24.73
EVRG	Evergy, Inc.	15.56
AES	The AES Corporation	13.63

RELATIVE VALUATIONS NO LONGER COMPELLING

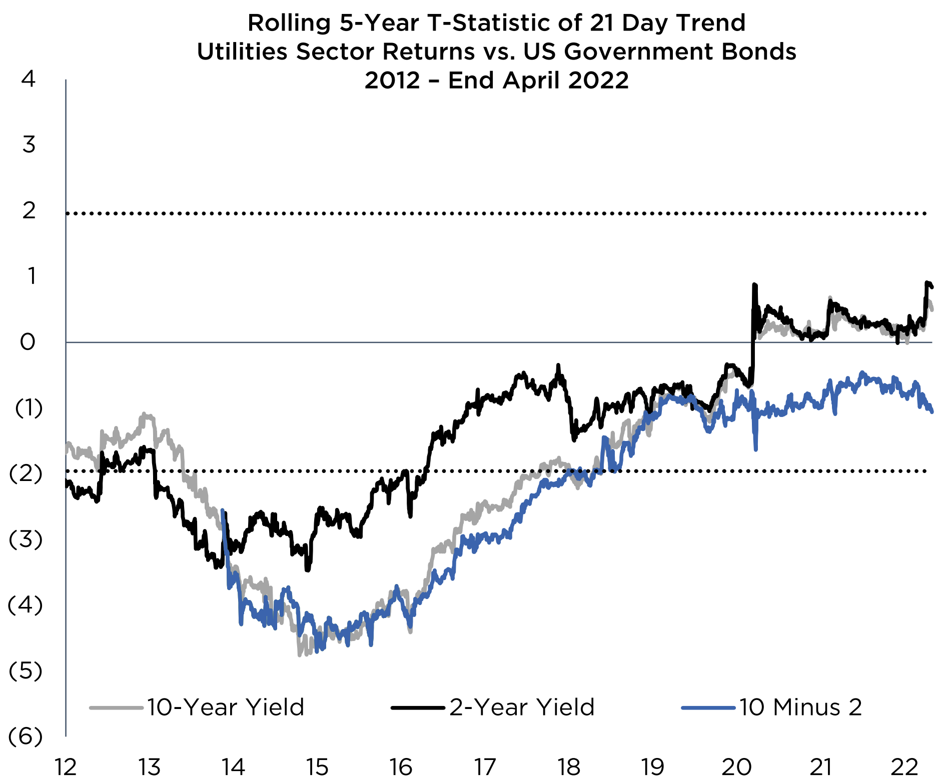
Given the flattish returns for the utilities sector this year in a tape with heavy negative returns, we noticed the relative price-to-forward earnings has now expanded to about just about parity to the broader market (left). In aggregate, this doesn't seem unreasonable to us given that estimate achievability is a chief concern in risk-off regimes, and utilities' relative estimate achievability should be above average. However, we now know there is no "relative yield" argument, as the median utility stock has the same dividend yield as the 10-year yield, and many think of utilities as bond-like stocks.

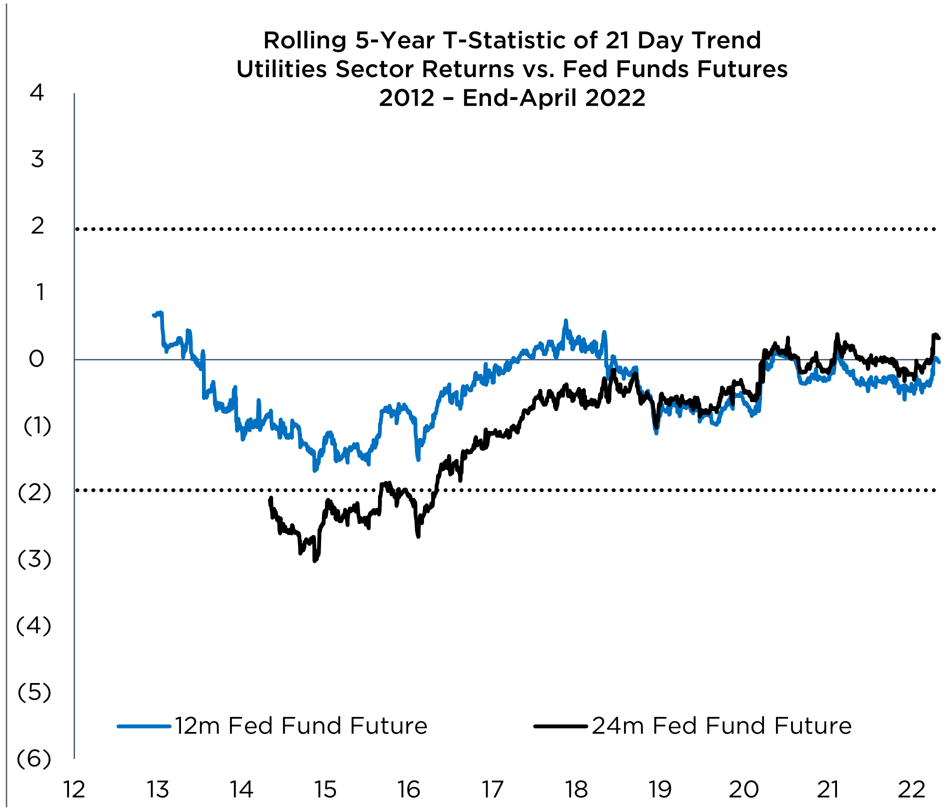




LESS RATE SENSITIVE NOW THAN THEY USED TO BE?

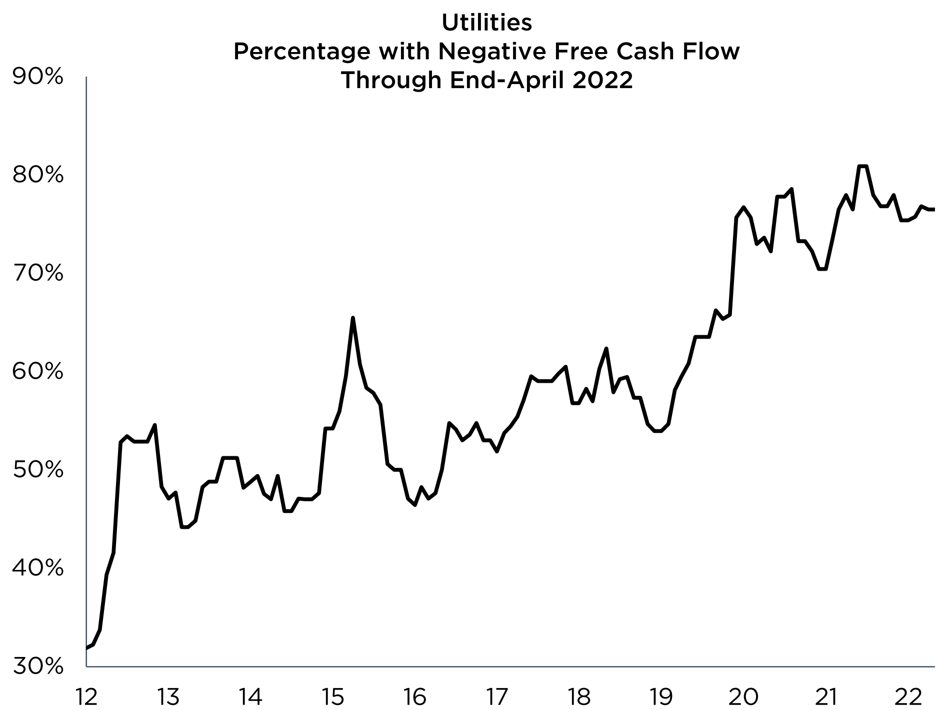
In addition to the parity of level of utilities to bond yields, **the relationship of utilities to bond yields has changed.** The utilities sector was historically negatively correlated to the slope and level of the US government bond yields - the relationship was strongly negatively statistically significant from 2010-2017 (left chart). But that relationship broke down four years ago and in Q1 of this year, utilities performed well even as bond yields rose – a counter-trend relationship. Over the past six months, we have been focused on the impact of perception of changes to interest rates – or the Fed Fund Futures – and there has been near zero correlation between utility sector performance and changes to perceptions about interest rates over the past several years (right), so the group should not be strongly affected by directionally dovish or hawkish commentary.

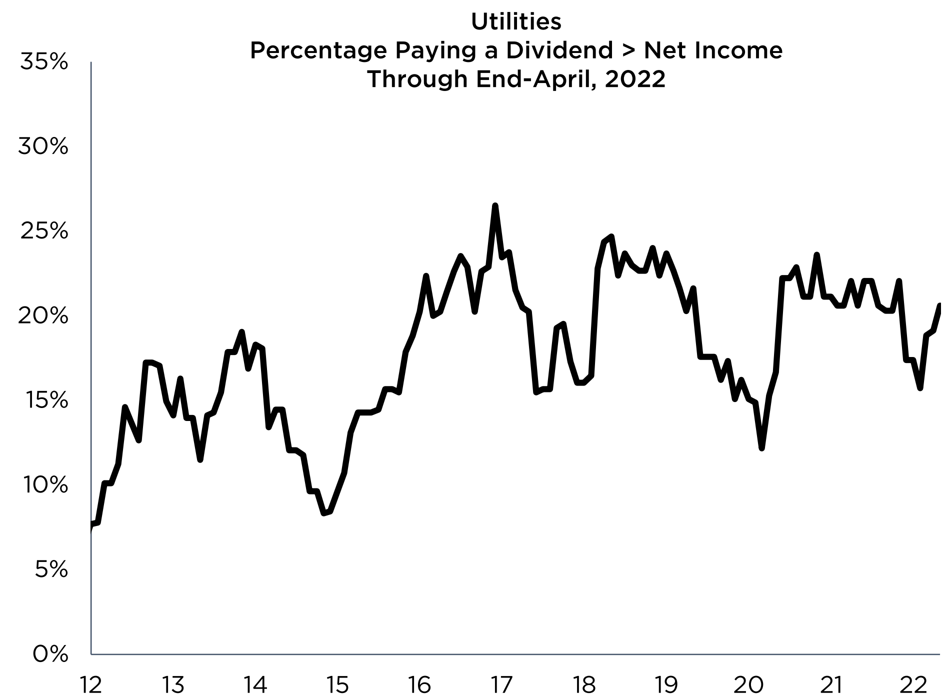




MOST UTILITIES HAVE NEGATIVE FREE CASH FLOW

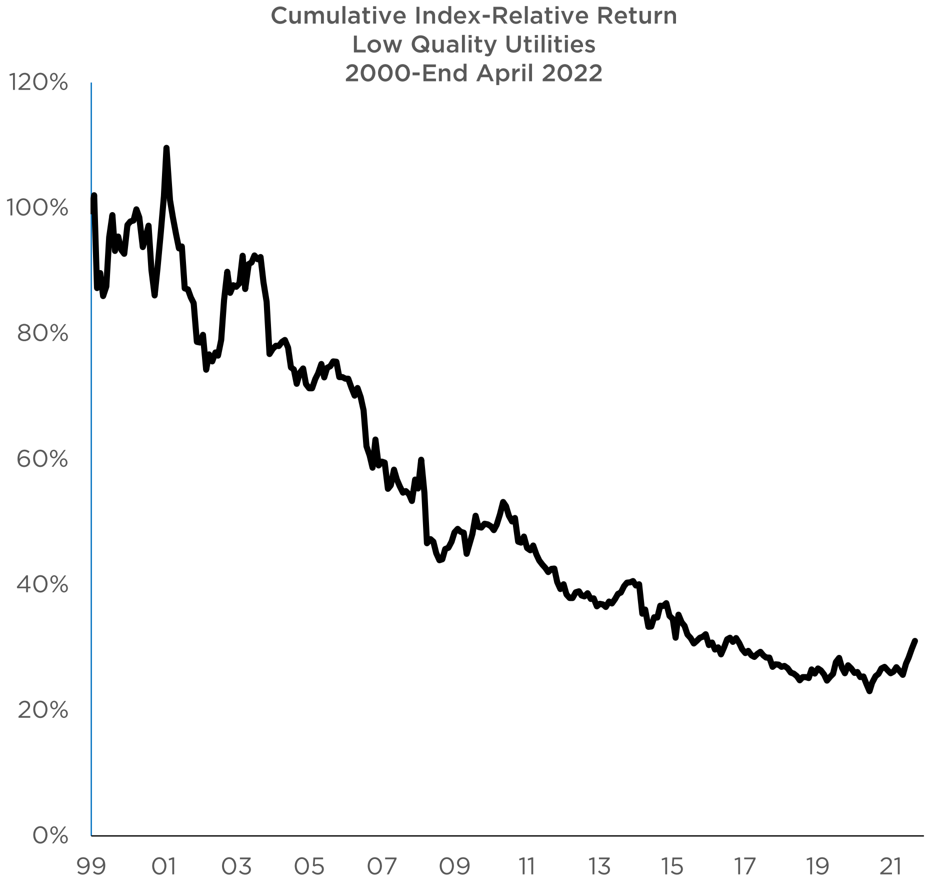
Even if the relationship with interest rates remains perverse, underlying fundamentals appear to have evolved. Utilities now have meaningful disconnects between earnings and cash flow. **In fact, over three-quarters of all the utilities companies have negative free cash flow today (left), up from only one-third a decade ago. This makes us excited there are some short ideas in the sector!** Not only are there a huge number of utilities with negative free cash flow, but also 20% of them have dividends that are greater than their net income (right), which ultimately increases the probability of a dividend cut or cancellation. Our prior work shows these stocks strongly underperform in a rising rate environment.

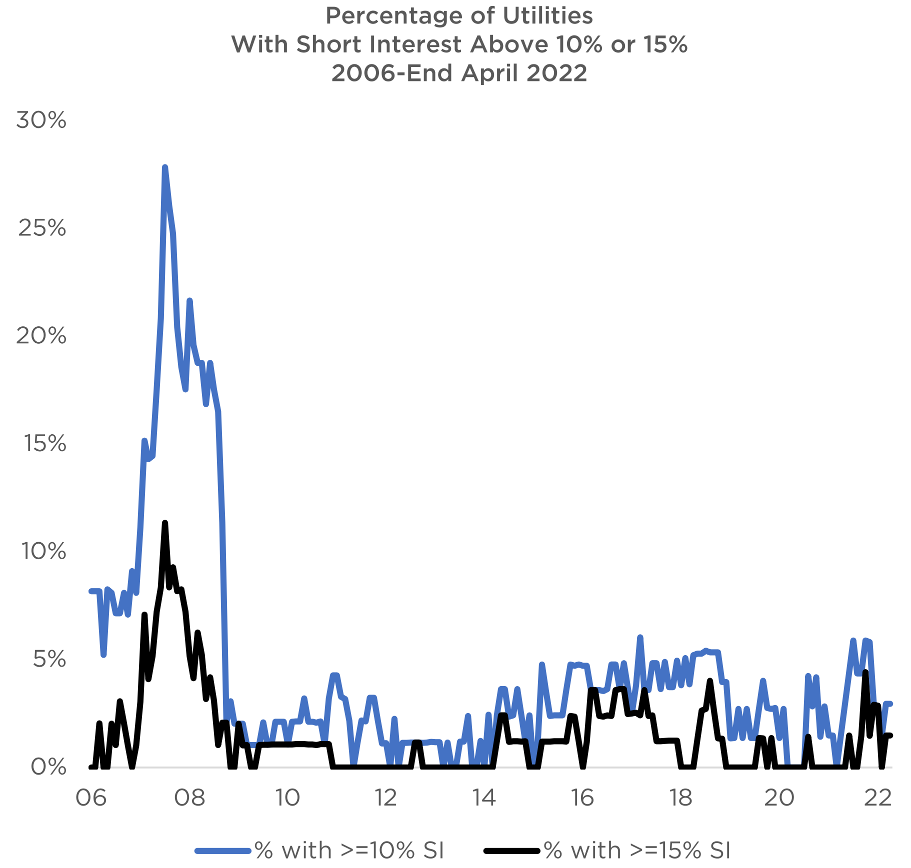




WE CAN FIND UNDERPERFORMERS WITH LOW SHORT INTEREST

We have identified a group of utilities that have performed quite poorly over the last two decades – those with payout ratios greater than 100% that also have negative free cash flow (left). Despite the consistency of this underperformance, and the huge increases in the percentage of stocks with negative free cash flow, high debt levels, and dividend yields that are no longer attractive relative to US Treasuries, the percentage of stocks that have high short interest is low (right). 58 of the 68 utilities we track currently have less than 4% short interest, and only 2 stocks have above 10% short interest (NOVA, and MIC, a microcap holding company with a recent large transaction).





POTENTIAL SHORT IDEAS IN UTILITIES

Utility stocks that have dividends above their net income, have below investment grade credit, have negative or very low free cash flow, and still have low short interest are shown below.

Select Quantitatively Derived Utilities Shorts
Through End-April 2022

Ticker	Company Name	S&P LT Local Issuer Bond Rating	Short Interest to Floatcap	Price-to-Forward-Earnings	Market Cap ($ US. Bil)
SO	The Southern Company	BBB+	1.60%	20.67x	77.98
SRE	Sempra	BBB+	1.50%	18.96x	50.95
PEG	Public Service Enterprise Grp. Inc.	BBB+	1.30%	20.07x	34.97
EIX	Edison International	BBB	1.10%	15.12x	26.19
DTE	DTE Energy Company	BBB+	1.50%	22.06x	25.39
AES	The AES Corporation	BBB-	1.20%	12.64x	13.63
VST	Vistra Corp.	BB	3.40%	10.93x	11.03
SJI	South Jersey Industries, Inc.	BBB*-	3.80%	20.53x	4.18

BUY IDEAS IN UTILITIES – EXPANDING DIVIDENDS AND ABILITY TO PAY

Several data points lead us to conclude there are ample short ideas in the utilities sector. To offset that, we searched for long ideas in case a defense tape persists. Our prior work shows companies that can consistently expand their dividends do well in rising rate environments, so we compared the valuation of the dividend expanders with positive net income and reasonably low payout ratios (less than 66%) to those same stocks not in the utilities sector. Utilities with these attributes are at all time highs (left). Buy ideas (right) are utilities that the sell-side is biased against, have positive net income, reasonably low payout ratios, and bonds that are not poorly or downwardly rated (right).

Price-to-Forward-Earnings
Utilities vs. Non-Utilities Dividend Expanders
Through End-April, 2022

Select Quantitatively Derived Utilities Longs
Through End-April 2022

Ticker	Company Name	S&P LT Local Issuer Bond Rating	Short Interest/ Floatcap	Price-to-Forward-Earnings	Market Cap ($ US. Bil)
NRG	NRG Energy, Inc.	BB+	4.6%	12.60x	8.70
AWK	American Water Works Company, Inc.	A	1.2%	34.62x	28.00
OTTR	Otter Tail Corporation	BBB	0.9%	14.69x	2.41
CMS	CMS Energy Corporation	BBB+	1.8%	23.88x	19.93
CWT	California Water Service Group	A+	1.7%	28.04x	2.79
MSEX	Middlesex Water Company	A	5.9%	32.94x	1.56
SR	Spire Inc.	A-	5.4%	18.34x	3.77
PNM	PNM Resources, Inc.	BBB	5.7%	18.32x	4.00

DISCLOSURES

Disclaimer

This presentation is confidential and may not be reproduced or distributed without the express prior written permission of Trivariate Research LP and its affiliates (collectively, "**Trivariate**").

The information contained herein reflects the opinions and projections of Trivariate as the date of publication, which are subject to change without notice at any time subsequent to the date of issue. Trivariate does not represent that any opinion or projection expressed herein will be realized. All information provided is for informational and research purposes only and should not be deemed as investment advice or a recommendation to purchase or sell any specific portfolio investment, security or other asset. While the information presented herein is believed to be reliable, no representation or warranty is made concerning the accuracy of any data or other information presented. Information obtained by Trivariate from third party sources in connection with the preparation of this presentation has not been independently verified by Trivariate. Additional information regarding Trivariate is available on request.

Any projections, forecasts, targets or other estimates presented herein constitute "forward-looking statements" that can be identified by the use of forward-looking terminology such as "may," "will," "should," "could," "would," "predicts," "potential," "forecasted," "continue," "expects," "anticipates," "future," "intends," "plans," "believes," "estimates," or the negatives thereof or other variations thereon or comparable terminology. Furthermore, any projections, targets, forecasts or other estimates in this presentation are "forward-looking statements" and are based upon certain assumptions that may change. Due to various risks and uncertainties, actual events or results or the actual performance of the funds may differ materially from those reflected or contemplated in such forward-looking statements. Moreover, actual events are difficult to predict and often depend upon factors that are beyond the control of the Trivariate. Nothing herein shall under any circumstances create an implication that the information contained herein is correct as of any time after the earlier of the relevant date specified herein or the date of this presentation. In addition, unless the context otherwise requires, the words "include," "includes," "including" and other words of similar import are meant to be illustrative rather than restrictive. Forward-looking statements and discussions of the business environment included herein (e.g., With respect to financial markets, business opportunities, demand, investment pipeline and other conditions) are subject to the ongoing novel coronavirus outbreak ("**COVID**" or "**COVID-19**"). The full impact of COVID-19 is particularly uncertain and difficult to predict, therefore such forward-looking statements do not reflect its ultimate potential.

This shall not constitute an offer to sell or the solicitation of an offer to buy any interests in any fund, product or account that is or may in the future be advised or managed by, Trivariate or any of its affiliates.

All data sourced from S&P Global, Bloomberg, or our Trivariate estimates. All forward-looking-statements reflect the opinion of Trivariate.