Trip Insights

Europe
July 2019

September 2019

A cornerstone of our investment process is company management meetings and site visits. These meetings serve several purposes, including providing an insight into management – how they think and run their business – and whether management priorities align with ours as investors. Our Company Quality Grading process involves explicitly ranking company management, so first-hand contact is vital.

The 4D investable stock universe is dispersed broadly around the globe. This necessitates our team travelling widely to call on companies, meet management and conduct site visits. This invariably provides a great insight into not only the specifics of the company being visited, but also a real perspective on what is happening more broadly in the relevant sector, economy and society. We prepare detailed notes after those meetings which capture and relay the key issues and themes of the day.

This is the eighth in our series of *Trip Insights* where we share those experiences. It follows two trips in 2019 when Sarah Shaw, Global Portfolio Manager and Investment Analyst, Tasneef Rahman completed extensive company engagement and calling programs in Europe, meeting with management teams from Regulated Utilities, Renewables, Communications and Transport.

Contents

Amager Bakke, Copenhagen – waste to energy plant that doubles as a ski slope. Source: 4D Infrastructure

Trip Agenda

Investor meetings included the following companies / regulators:

Company	Sector/Topic	Location
Orsted	Renewables	Copenhagen
Innogy	Utilities	Essen
RWE	Utilities	Essen
Hamburger Hafen	Ports	Hamburg
Fraport	Airports	London
Zurich Airport	Airports	London
Bloomberg	Telecommunications	London
Getlink	Transport	London
National Grid	Utilities	London
Severn Trent	Utilities	London
United Utilities	Utilities	London
JP Morgan	European Utilities	London
RBC	European Utilities	London
Ofwat	Regulator	London
Ferrovial	Airports	Madrid
Santander	European Utilities	Madrid
Santander	Macro economics	Madrid
Cellnex	Telecommunications	Madrid
AENA	Utilities	Madrid
Endesa	Utilities	Madrid
Iberdrola	Utilities	Madrid
Red Electrica	Utilities	Madrid
Italgas	Utilities	Milan
Snam	Utilities	Milan
Aeroports de Paris	Airports	Paris
Eiffage	Airports	Paris
Neoen	Renewables	Paris
Eutelsat Communications	Telecommunications	Paris
Eiffage	Transport	Paris
Vinci	Transport	Paris
Engie	Utilities	Paris
Suez	Utilities	Paris
Veolia	Utilities	Paris
Inwit	Telecommunications	Rome
Atlantia	Transport	Rome
Terna	Utilities	Rome

Politics

- **UK**

The two key issues in the UK from an infrastructure perspective are Labour Leader Jeremy Corbyn's proposed nationalisation agenda and Brexit. Neither bode well for infrastructure operators.

A number of parties believe that nationalisation of the domestic rail network, as proposed by Jeremy Corbyn, makes sense. Ideally, they just need to leave everything else alone as the UK utility model is working effectively. Even if Corbyn wins the next election he is not expected to gain a majority so he could ultimately be largely powerless – however, the overhang remains while ever he pushes the agenda.

New UK Prime Minister, Boris Johnson, is promising a Brexit resolution by 31 October, but it remains very difficult to see how he will achieve this. Ultimately, we expect the UK could ask for a delay from 31 October to try to develop a Brexit solution as Europe will not negotiate further. However, it is looking increasingly likely that Boris will support a Hard Brexit over a further extension.

Many believe there could be a second referendum or quasi referendum – a new UK election would all be about Brexit and effectively a second referendum. There are likely two (extreme) Brexit outcomes at the moment – either a Very Soft Exit or a Hard Brexit/No Deal with the latter gaining traction recently.

- **France**

The Yellow Vest protest movement was losing steam, with the more recent strikes not being driven by the economic situation – the French will strike for anything! Policies to improve household incomes are playing out which is reducing unrest.

- **Germany**

Politically relatively stable at the moment.

- **Italy**

Still a mess. Matteo Salvini clearly won the EU elections and it was believed that, if he wanted a new domestic election, he had to act either immediately or post the Budget Law. Immediately would have been better, but he failed to get it organised; and in the meantime it looks as if he lost political support, with a new coalition between 5Star and PD having been formed which is not good news. Italy needs a government that will support labour market reform in order to get Italy back on track.

Hamburg Central Station. Source: 4D Infrastructure

- **Spain**

The most recent Spanish election saw a better outcome than the previous election, but recent events suggest Spain could again be heading to the polls:

- ***Podemos*** pretty much dead – losing a lot of power and expect will be merged into the previous communist party.
- ***Vox*** – a new far right party in Spain. Makes the Conservatives look more centre, yet the Conservatives lost out to Vox indicating how people are thinking. However, the splintering of the Right vote resulted in a weaker overall position for them. Importantly, in Madrid the Centre Right won with a majority.

Housing starts are likely to improve under the new government – local authorities had been stopping building permits in an effort to increase local house prices. This was disruptive and misleading, and the new government will see permitting start again which is positive.

The Spanish Catalan trial is ongoing, and the result is expected in the next few months. If found guilty then former leader Josep Rull will be jailed. It is unclear what the socialist government will do. It could see PM

Sanchez pardon him – he needs support to be Prime Minister and this could be a negotiating factor. Watch closely.

Hamburger Hafen Head Office, Hamburg. Source: 4D Infrastructure

Economics

While Europe's macro outlook remains mixed the general consensus was that, ignoring event driven shocks, the growth environment is still solid, with Spain looking the strongest and Italy the weakest (ex UK which is event dependent). The biggest risks to the macro outlook are geo-political events, namely trade wars (will hit Germany hard as heavily dependent on manufacturing and exports) and the Brexit outcome (could cause logistics issues).

Real wages are going up, supporting ongoing household consumption, but we need to watch productivity closely – at the moment it is not improving which will cause corporate margin squeeze, and while balance sheets remain solid enough to support this for a while, this is an early indicator of a turn in the cycle. Germany is closest to this turn while Spain is a good few years behind.

Europe needs a resolution of the trade wars to provide a boost, and if resolved we expect strong momentum across Europe.

There wasn't much expectation of interest rates rising across Europe any time soon – they are expected to remain low for the foreseeable future supporting investment plans, but the threat of trade wars is seeing investment lag and inventories remain low.

European Country Ranking

In order of attractiveness from a macro perspective

1. ***Spain***: stronger growth than anywhere else and politics relatively stable, although a little more unstable recently with the collapse of the coalition. Consumption and production both remain very strong. Need to watch the households, though, as we believe they have been supporting consumption with savings which is not sustainable. However, real wages are now improving, so the gap between consumption and income is rapidly shrinking, which is positive for the Spanish consumer. The corporate side in Spain isn't looking as strong with investment down and productivity weaker – there is a need for productivity improvement.

2. ***France*****:** more stable than Germany but lower growth – manufacturing and exports low so not as impacted by trade wars. Internal demand is strong, with private consumption up in both real and nominal terms, investment ok and France less exposed to trade tensions (low relative exports).

3. ***Germany***: stronger growth but volatility around the global trade outcome – Germany will fly if a trade deal is done but will be hit hard if not – all about where we are in the manufacturing space. The German economy is actually quite solid with the services sector strong. Recent headline weakness has been event driven (trade wars and logistic issues), pressuring manufacturing. Germany is closer to the end of the cycle than some of its peers with real wage growth (positive for consumption) not being supported by improved productivity, which will ultimately see corporate margins squeezed. Productivity and unit labour costs are an early indicator of the shift in a cycle, so watch these closely as Germany is close to the turn.

4. ***Italy***: the weakest. It is still a political mess, which is pressuring growth. The country needs a stronger government that will support labour reform if Italy wants to start growing again – very much on hold economically until politics improve. Put simply, productivity is a disaster in Italy, and it is killing growth.

Infrastructure

DSB Train prior to entry onto Train Ferry between Rødby (Denmark) and Puttgarden (Germany). Source: 4D Infrastructure

- **Airport regulation**

A number of the airport operators are in the midst of regulatory conversations with mixed outlooks. Generally, the regulatory outcomes are becoming tougher and negotiations with the airlines are proving equally difficult. The proposed expansion of Heathrow airport is becoming increasingly political.

- **Growth and investment profiles of the infrastructure companies**

With strong balance sheets and large underlying FCFs, the infrastructure players continue to look for a home for capital with a both a domestic and international mandate. They are aggressively pursuing assets in both developed and emerging markets. Expansion of existing assets is also a focus.

- **Asset sales**

Low growth and de-risked assets are available for sale, with operators using an asset rotation strategy to fund further growth. Non-core assets are also on the block.

- **Balance sheets**

A concern for the sector generally is that balance sheets are nearing, or at, sub-optimal levels (too lowly geared) with the operators searching for growth.

- **Dividends**

Remain solid but we don't see any significant up-tick at the moment, particularly while the operators focus on growth.

Communications

The Communications sector is all about consolidation as the European mobile operators prepare for 5G rollout and are looking to shore-up their balance sheets. Towers become one of their clearest sources of capital. The 5G rollout is a huge opportunity for tower operators as they renegotiate MSAs to accommodate it. Operators believe the extent of 5G usage is not yet known, but will have an industrial driver.

- **Dividends**

Are not a focus for the operators at present as they seek growth.

- **Ownership**

Ownership shifts are on the cards with an improving free float. ***Inwit*** – as a result of the Vodafone deal, TI and VOD will each own 35% of Inwit at its close. However, as both have a target of 25% ultimately, should see ~20% stake come to the market over time. ***Cellnex*** – Benneton's ownership plan is unclear and we are not convinced they are long-term holders. While they participated in the last capital raise, the company is not necessarily expecting they will continue to do so in any future raises.

Utilities

- **Regulation**

There is an increasing focus on regulation and approval of Investment Plans as companies look to support individual country Energy Transitions Plans (ETPs). In Spain, CNMC was appointed as an independent regulator with the operators hopeful that sustainable, visible regulatory outcomes will result. See further discussion below.

- **Growth plans**

All but a few companies are looking for a home for balance sheet capacity. International expansion remains an opportunity, but a few have returned their focus to domestic capex deployment to support ETPs. LatAm remains a clear focus for international deployment with Mexico, Brazil, Chile and Peru all mentioned in company meetings.

The Renewables theme continues to gain traction as the future of generation, and many are looking to take part in this development either directly (***Iberdrola/ Endesa***), or indirectly by way of connecting the new generation to the Grid (***Terna/REE via connections***) (see further discussion below).

Non-core assets are for sale as a means of raising capital for expansion.

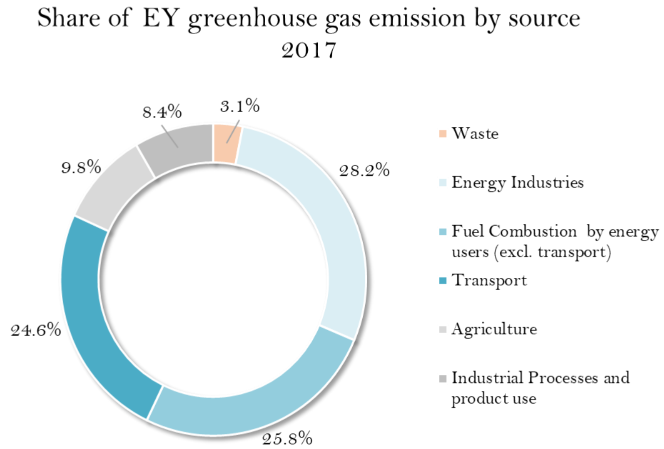
- **Leverage and capital management**

In contrast with the Airport operators, leverage among the Utilities remains comfortable across the board with many capitalising on the low cost of debt to fund their investment pipelines. Recent debt costs range in the 1-2% pa range – clearly very low by historic standards.

Capital management and dividend policies look adequate at present, but there is some risk of policy disappointments as the companies fund growth.

Europe is a leader in facilitating the Global Energy Transition – a trip led case study

As concerns about climate change mount globally, governments are increasingly looking at ways to counter the challenges presented by carbon emissions. In the developed world, nowhere is this more evident than in Europe. The European Union as a collective is arguably one of the global leaders in the fight against greenhouse gas emissions and climate change. Not surprisingly, this EU mandate has extensive public support, with 93% of Europeans believing climate change is induced by human activity and 85% believing countering the problem is positive for the EU economy[1].



As this chart shows, currently a third of greenhouse gas emissions are generated through the process of electricity production.[2] Including the use of energy in transportation and industry, this figure rises to almost 80%. As such, fully decarbonising Europe's energy supply has been one of the key strategic priorities for the EU as it aims to move towards a climate neutral economy by 2050. The Commission has developed a roadmap towards this goal, targeting 20% of aggregate energy supply from renewable sources by 2020 and at least 32% by 2030, with countries each having their own individual goals. Aside from the obvious proliferation of renewable generation capacity, this development has given rise to a number of trends which were increasingly evident in our recent meetings with European Utility companies.

- **Increased investment in transmission**

To connect new generation capacity into the grid, a significant increase in transmission investment is required. Offshore generation sources such as offshore wind require power transmission through subsea

[1] Special Eurobarometer 479, ec.europa.eu/clima/sites/clima/files/docs/pages/vision_1_emissions_en.pdf
[2] ec.europa.eu/eurostat/cache/infographs/energy/bloc-4a.html

cables into the terrestrial national transmission network. Similarly, given the intermittent characteristics of RES such as wind and solar, increased interconnections between countries are necessary to ensure security of supply, while transmission upgrades are increasingly required domestically to transport electricity from often isolated generation locations to metropolitan demand centres.

The European Network development plan estimates an additional €114bn of grid related investments out to 2030 will be required, with close to ~€50bn being allocated towards subsea cables[3]. Higher capital expenditures are supportive of earnings for regulated utilities as approved investments are included in the Regulated Asset Base (RAB) and are remunerated at the cost of capital. These trends of increased investment are evident in the capital allocation and investment budgets of a number of listed transmission service operators we met with or have spoken to recently. Some examples include:

Orsted's Svanemølle District Heating Power Station, Copenhagen. Source: 4D Infrastructure

- In the UK, ***National Grid*** in their meeting with us highlighted their increased investment in interconnections, to supplement two existing connections with the Netherlands and France. There are now another three under construction (Great Britain to Belgium (JV with Elia), France and Norway), set to deliver an additional 3.4GW of capacity by 2021 / 2022.
- ***Terna***, the Italian TSO, reiterated that they have paused their international investments to focus on the massive investment needs in Italy. Over ~€13bn of investment is expected over their 10-year investment plan, for grid reinforcement, expansion and new connections in the Italian grid. Management believes that this investment phase could extend well beyond this 10-year period.
- ***50 Hertz*** (one of the 4 German TSOs and part of Elia Group), which integrates over 54% of energy via renewables, currently has a five-year €3.4bn investment plan that is expected to almost double from ~€490m in 2018 to over €800m+ by 2023, with roughly 40% of capex allocated towards the offshore transmission network, supported by growing Offshore Wind capacity in the Baltic Sea.

- **Decentralised power generation and storage**

Local or decentralised power generation is another emerging theme within the European Utility landscape. Traditionally, a country's energy system relied on a few big power plants feeding into the transmission network, which would transport electricity into local distribution networks which would then supply local customers. With the proliferation of smaller scale renewable sites in high wind or sun regions, there are now a larger number of generation facilities, albeit with smaller capacity than conventional power plants. As a result, a significant amount of renewable generation no longer needs to be transported via transmission cables, and instead can connect straight into the distribution network. Decentralised power is supported by storage technology, which allows the network to better manage demand and supply and smooth out grid volatility.

Unsurprisingly, decentralisation was a recurrent theme amongst the utilities and renewable generation companies we saw. TSOs (such as ***National Grid*** and ***Terna),*** Integrated Utilities (***Engie, Innogy, E.On, Iberdrola***) and pureplay Renewable operators (***Orsted, Neoen***) are all investing in, or conducting (or intending to conduct) research into, distributed energy and storage solutions. For example, in our meeting with ***Orsted*** they highlighted that at the start of the year they had invested in their first battery storage park, a 20MW project in Liverpool, UK. These storage solutions provide flexibility to Orsted's intermittent renewables portfolio and make them more competitive against other conventional dispatchable plants.[4] Like Orsted, French Integrated Utility ***Engie*** also acknowledged this development and has highlighted its focus on

[3] renewables-grid.eu/topics/offshore-grids.html, European 10 Year National Development Plan
[4] greentechmedia.com/articles/read/orsted-diversifies-from-offshore-wind-with-20mw-uk-battery#gs.ykd022

'implementing power storage and load smoothing solutions to cope with the intermittent nature of decentralized generation'.[5] Similarly, German DSOs such as ***E.On*** and ***Innogy*** were also increasingly bullish on their distribution networks as over 90% of new renewable energy in Germany is generated onshore and connected straight to the distribution grid, whilst the remainder, largely all offshore generation, is connected into the transmission network.

- **Thermal closures, divestments and self-generation**

Onshore wind farms with offshore turbines in the background, Copenhagen. Source: 4D Infrastructure

The European move towards carbon neutrality has resulted in major changes to the strategic direction of a number of energy and utility companies. In early 2019, Germany, one of the world's biggest coal users, announced its commitment to phase out coal fired generation in an effort to meet its renewable energy targets. Such policy shifts, coupled with the growing importance of ESG investing, have seen companies become increasingly conscious about their asset portfolios. A number of institutional investors no longer invest in companies with fossil fuel operations, whilst asset allocators similarly scrutinise investment managers who do not adequately assess ESG factors. This in turn places significant scrutiny on companies to be ESG friendly. In our company meetings, several management and IR teams stated that they are now inundated with ESG reporting and questionnaires, the output of which is often used as a screening tool by investors. As such the combination of renewable energy targets and the growing importance of ESG investing has seen utilities divesting, reducing their exposure to, or entirely discontinuing thermal generation.

Recent examples amongst companies we met with include:

- Integrated utility ***Iberdrola*** hastily selling the fossil fuel plants owned by its subsidiary Scottish Power to Drax for £700m in 2018;
- ***RWE*** positioning itself as a leader in renewables through the asset swap with E.On and Innogy. The German coal exit was announced subsequent to this and will ultimately reduce RWE's fossil fuel exposure even further;
- ***Engie*** divesting their oil and gas exploration unit (E&P) and LNG assets over the past couple of years, now focusing on lower polluting generation (gas, nuclear) and growing renewables; and
- ***Orsted,*** which was previously called DONG (Danish Oil and Gas Energy), rebranding and divesting its upstream oil and gas business to INEOS, and positioning itself as a global renewables leader in Offshore Wind.

Similarly, companies are now more conscious of their energy sourcing and carbon emissions. Globally more and more companies are entering into power purchase agreements (PPAs) directly with renewable energy generators.

In Europe, a number of utilities have taken this one step further and have branched into renewables for self-generating capacity. ***Severn Trent***, one of the three listed water companies in the UK with whom we met with in London is a prime example of this. ***Severn*** is on track to exceed their target of 50% self-generation by 2020, as a step towards their commitment for 100% of energy from renewable sources by 2030.[6]

[5] engie.com/en/innovation-energy-transition/decentralized-energy-generation/
[6] Severn Trent 2018 Annual Report