Do Utilities Suck?

We recently reviewed a client's portfolio performance. She is a 62-year-old retired professional with no pension, relying on her life's savings to generate income. In good health with a family history of longevity, inflation is a worry. 'Happily,' she is in the upper income tax bracket. Her goals are to maintain her income purchasing power after tax and inflation. She would like to see the principle remain intact for the next decade, but with no children or dependants, it's all about her lifestyle. She is risk-tolerant, with a history of putting up with the occasional drama inherit in owning equities. She has directed us to manage the investment decision making process under our discretionary management platform.

With her cash income mandate in mind, we began building her portfolio for the income generation well before her targeted retirement date in the summer of 2022. She now holds a cash reserve to fund monthly income. The reserve varies between 6 and 12 months of payments. The remainder is invested in large-cap, dividend paying common stocks. She holds roughly 58% in Canadian dollar stocks and 42% in US and Intl stocks, all paying dividends. The Canadian content provides income eligible for the Canadian Dividend Tax Credit, reducing her tax burden.

Under her dividend income/growth mandate, she holds Canadian and US Utility stocks. She reviews her holdings a few times a month via her online statements. She noted the various utility stocks seemed to show modest returns versus other stocks she'd read about or holds now. She asked "*My nephew says utility stocks suck. He owns Tech and Bitcoin and has had amazing returns. Why do I own them? Are we making a mistake?*"

Oh boy.

We believe investors should clarify where their income is coming from. Placing a large portion of one's holdings into a sector that has (recently) generated large gains (by investors, driving up the price) MIGHT continue to deliver large gains in total value to the portfolio.

This notion implies selling portions of a concentrated holding at a continued skyrocketing price to generate income. As sales are capital gains, the tax treatment is favorable. More money, less tax. Easy Peezy…. maybe.

What happens if (when?) the skyrocketing price reverts to the mean by falling enough to reduce that amazing short-term return into a 'normal' longer-term one? Continue to sell on the way down? It can get ugly, fast (see Trump Media below).

Experience says growing earnings beget rising dividends. While a corporation with growing earnings <u>will</u> be more <u>valuable</u> in the future, investors rarely increase the price they're willing to pay in lockstep with those rising fundamentals. Experience tells us the market price <u>will</u> reflect the earnings growth…. eventually. The gap between fundamentals and price is where all the fun is. Some patience may be required.

We look for companies with rising fundamentals that are out of favor, whose prices have fallen. There's always a reason why to scare investors off. Fear is contagious. Overaction is common. If analysis say business fundamentals look solid, and earnings growth likely, the dividend should rise. If the price has fallen, the steady dividend will reflect a higher 'yield' on current price. If the current dividend is covered, growing and appealing we're happy to buy, getting paid to wait for the enthusiasm to return to the sector and the stock. With a nod to Jermey Siegel's *'Stocks for the Long Run'*, our focusing on the Tried and True vs. the Bold and New, is often counter to the *'latest/greatest'* narrative in financial media. Our buying/holding out-of-favor names may look crazy. Again, there will be scary headlines.

Utility stocks have been an example.

Dow Jones US Utilities Index: From Aug/2019 to March/2024 the DJ utilities generated a disappointing 4.4% total gain <u>from prices</u> = 0.95% annual return. Anticipating US Fed rate cuts, the DJ Utilities Index jumped 15.3% from March to August. Even that surge takes the 5-year total <u>price return</u> to 22.05% or only 3.8% annualized. No surprise wonder-nephew thinks *'Utilities suck!'*. Not so fast.

Aug 31/2019 to last Friday's Sept 20/2024 close, <u>reinvested dividends</u> pushed the 5-year cumulative total return (dividends reinvested) to +49.5% or roughly 8.4% annualized. Hardly a disaster. Dividends matter. Compounding those dividends and maybe adding a bit during troughs accelerates the dividend income growth and total returns. Boring and effective.

We've advised short and long-term lending rates are likely to decline. We thought lower rates would favor Utilities. We thought utilities had fallen enough to be held/bought over the past three of years. As often happens, we were proved early, and they went down some more! Patience is a virtue. It can be really hard to stick with it.

Rates have finally declined, and Utility stocks have finally gained in price. We think this decline will continue…for now. We don't see US Fed 30-year T-bond yields rates falling back to the 2020 levels under 1.5%. We believe sustained sub-2% inflation is gone. We think bond yield will trend 3-4% in the near term. The slope is flat to up over the next few years. Farther out into the future we worry about geopolitical risks may drive up inflation and interest rates. War is inflationary. Peace is not. More on that one below.

Staying with Utilities…

If electric is the future… about that build-out?

Consensus political and public opinion says…

- The future of transportation, heating/cooling residences and business, data management via AI, will be electric.
- The future of power generation will be 'zero emissions.
- The expansion of power generation capacity to meet demand is huge.
- Many Western Government have set firm (kind of) net-zero dates of 2035, banning new internal combustion engine sales.

If we have 10 years to meet the above demands, how has that buildout thing been going?

US total power generation by source: 2010-2024

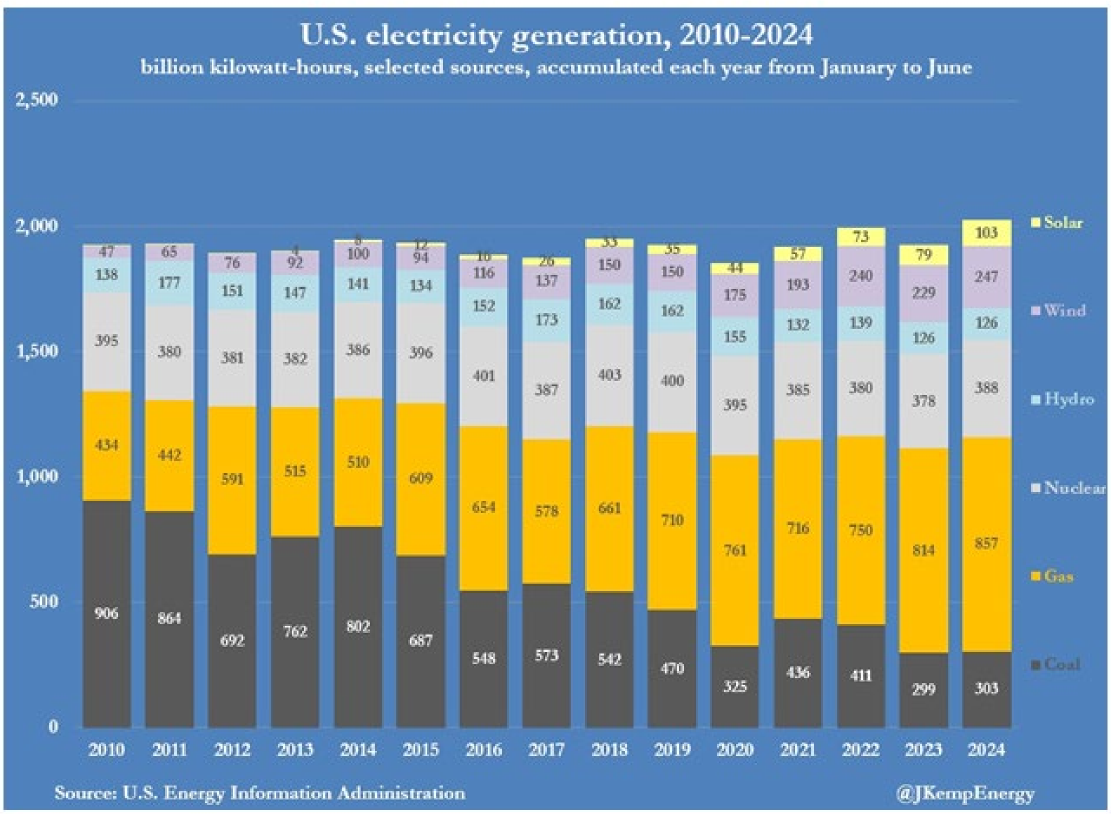


Chart Source: J Kemp Energy

For more detail see

https://www.statista.com/statistics/220174/total-us-electricity-net-generation-by-fuel/

US Total Power production Terawatt Hours (TWh):

- 2004: 4,049 TWh
- 2010: 4,117 TWh
- 2023: 4,174 TWh

The composition of the power grid has changed. Since 2004 thermal coal and bunker fuel-fired power generation declined from 53% to 17% of total generation. Renewables double in %'s from a low base. The majority of the shift was to natural gas. Emissions have fallen.

The problem is not enough net gains. Shuttering large portions of the existing grid takes time and money. Politicians promise what bureaucracy can't deliver. As evidence, power production has increased a total of 2.99% from 2004 and 1.4% since 2010.

How has the US economy been able to grow with such modest power production gains? One positive factor getting a lot of credit is falling energy intensity per unit GDP. It's complicated. An economy moving from heavy to 'knowledge' industries will use less energy per unit of GDP. It will also generate less emissions. As we still want the products from heavy industry, this implies moving the heavy, dirty manufacturing somewhere else and buying the finished product with our knowledge bucks. Brilliant! We got cleaner skies and a clear conscience. Less developed countries gladly took the heavy industry jobs and growth. North America now produces less than 6% of total steel tonnage. China produces 55% (*source: World Steel.Org*).

That's offshoring/globalization for you. Suddenly the global trade is freezing up. We're at odds with some of the world's largest heavy/dirty economies. Some say we're already in a Cold War II. Re-shoring those industries is likely to increase overall energy intensity of the economy and increase demand for electrical power.

Another factor covering low US power grid expansion has been the US purchasing power from Canada and Mexico. California famously pays a premium for BC Hydro power due to its 'green' bona fides. Will that continue be able to continue to sell?

CONCLUSIONS: Utilities don't suck. They might even be sexy again.

TC Energy (TRP-TSX-$64.40) is restructuring this week

We hold TC Energy in our Canadian Dividend Growth mandate. While not technically a Utility, pipeline companies have historically traded on similar valuations. The company, once named Trans Canada Pipeline, is spinning off its interest in South Bow. National Bank Financial provided the following summary in the Wed Sept 25, 2024 'Before The Bell' daily comment (if you'd like to be added to the email list let us know)

TC Energy will commence trading on the TSX under the ticker TRP.W between Sept 25th and Oct 1st on an "if, as and when issued" basis, which will allow the purchase and sale of common

shares on an ex-distribution basis (i.e., without the entitlement to receive 0.2 South Bow common shares for each TRP share held). *It is expected that "if, as and when issued" trades will settle on the second business day following close of the spin.*

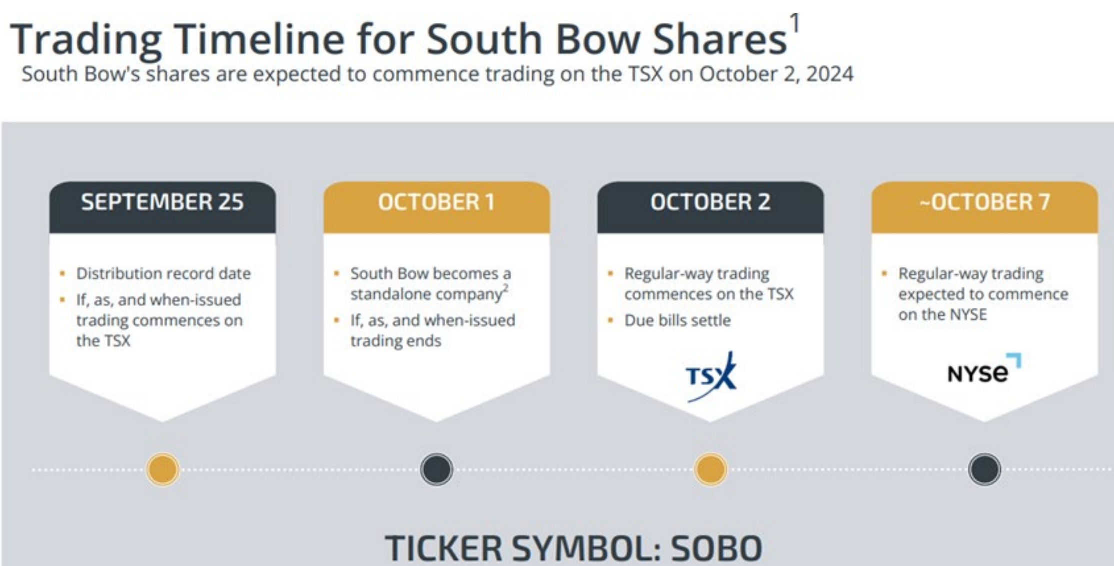
- *There will also be an "if, as and when issued" market on the TSX for South Bow under the ticker* ***SOBO*** *between September 25th and October 1st, which will reflect a price for SOBO standalone.*

- *Of note, TRP will cease regular way trading between September 25th and October 1st. Any trades of TRP during such period will be on a due bill basis, which will include the entitlement to receive 0.2 South Bow common shares for each TRP share held (i.e., TRP share price shouldn't change all else equal);*

- *Recall from our sum-of-the-parts analysis highlighted below, assuming a Gibson (GEI) multiple of ~9.5x EBITDA (we're open for debate here) translates into ~$6/sh for SOBO baked into TRP's closing price yesterday of ~$63, suggesting TRP.W would trade in the ~$57 range all else equal. Post share consolidation, the ~$6/sh market comparable valuation for South Bow would translate into a ~$30 share price for SOBO;*

- *Meanwhile, with $0.55/sh of TRP's current $3.84/sh dividend being transferred to SOBO, maintaining a similar ~6% yield on the $3.29/sh dividend would translate into ~$55 price for TRP.W, whereas a slightly compressed 5.5% yield for TRP.W would result in a price closer to $60;*

- *Of note, analyst Pat Kenny believe TRP.W (TRP Remainco) deserves a further positive valuation re-rate, mainly reflecting the improved pure play natural gas infrastructure business mix (with an equity stake in Bruce Power of course). Combined with the company's balance sheet repaired (tracking ~4.75x D/EBITDA for 2024e, and <4.75x pro forma Southeast Gateway in service mid-2025), Pat thinks TRP Remainco should regain its premium valuation to other large cap peers, currently trading in line with TRP at ~11.5x.*



Source: SOBO

$mlns, except per share amounts	Status Quo	RemainCo	South Bow
Adj. EBITDA			
Cdn Natgas Pipes	3,623	3,623	
US Natgas Pipes	4,543	4,543	
Mexico Natgas Pipes	(5) 1,736	(5) 1,736	
Liquids	1,546		1,546
Power & Energy Solutions	1,079	1,079	
Corporate	-16	-16	
	12,511	**10,966**	**1,546**
FFO			
Financial Charges	-3,632	-3,118	(3) -514
Cash Taxes	-649	(4) -391	(2) -258
	8,231	**7,457**	**774**
AFFO			
Maintenance Capex	-1,900	-1,823	(1) -77
NCI Distributions	-159	-159	0
	6,172	**5,476**	**696**
Net Debt	59,423	51,544	7,879
D/EBITDA	4.7	4.5	5.1
Shares O/S	1,037	1,037	1,037
Dividends/sh	$3.96	$3.39	$0.56
FFO/sh	$7.94	$7.19	$0.75
payout	50%	47%	75%
AFFO/sh	$5.95	$5.28	$0.67
payout	66%	64%	84%
EPS	$4.31		
payout	92%		
Valuation			
13.0x Cdn Natgas Pipes	47,105	47,105	
11.5x US Natgas Pipes	52,250	52,250	
9.5x Mexico Natgas Pipes	16,492	16,492	
9.5x Liquids	14,682		14,682
15.5x Power & Energy Solutions	16,718	16,718	
11.0x Corporate	-176	-176	
	147,072	**132,389**	**14,682**
Total Debt	62,077 (7)	54,198	
NCI	13,918 (6)	13,918	
Equity Value	71,077	64,274	6,803
Value Per Share	**$68.50**	**$62.00**	**$6.50**

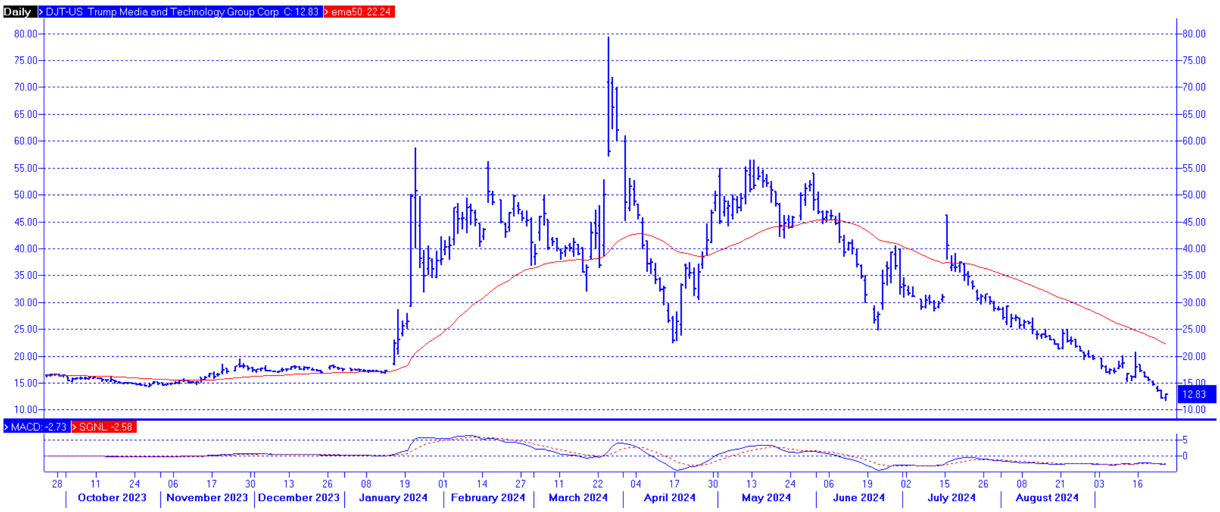
Source: NBF

Clients holding TC Energy will see adjustments between the ‘old’ and ‘new’ TC Energy plus the addition of South Bow (SOBO). We expect the changes to be reflected on the October statements. The TC Energy per-share adjusted cost for capital gains calculation purposes will be reduced by the spin-off, that value will be trading separately in South Bow common shares. The cost base for South Bow will be the attributed per-share cost out of the ‘old’ TC Energy. We will make this adjustment for clients on their statements.

DISCLOSURE: Anna and I hold TC Energy personally, for family members and for client accounts over which we have trading authority. We have traded in the security within the last 60 days. Please see additional important disclaimers at the end of this document.

Geopolitical risk. What do investors think of Donald Trump's election hopes.

Déjà Vu all over again? Trump Media (DJT-NYSE-$12.80) daily pre-SPAC IPO Mar 26/2024 to date



Source: Refinitiv, NBF, Hilberry

Trump Media (DJT) went public via a merger with digital World Acquisition Corp (DWAC). On Dec 15, 2023, Trump's valuation pre-IPO on his 114,750,00 shares (for which he paid…?) was $1.478 billion equating to a share price equivalent of $12.88. The original structure was created in Sept 2021. The Special Purpose Acquisition Vehicle (SPAC) Digital World Acquisition Corp (DWAC-NASDAQ) at $10 per share Sept 3, 20121 was 'interesting'

https://en.wikipedia.org/wiki/Digital_World_Acquisition_Corp

March 26, 2024. First trade was $70. That first trading session saw the price spike to a high of $79.38 closing at $57.99. +16% from the previous day's close.

There were questions about relative valuations early on. The initial day of the SPAC merger trading saw Trump Media valued as high as $1,096 per signed up user, versus their nearest competitors Reddit: $148 per user, 'X' formerly known as Twitter: $80 per user, and Snapchat: $46 per user. That peak proved ethereal.

https://www.reuters.com/markets/us/trumps-media-company-shares-jump-ahead-backdoor-nasdaq-debut-2024-03-26/

https://www.cnn.com/2024/03/26/markets/trump-media-stock-truth-social/index.html

US Congresswoman Marjorie Talor Greene bought into Digital World Acquisition prior to the merger with Trump Media on Oct 22, 2021. That day DWAC opened at $118.80 and closed at $67.

https://www.nbcnews.com/politics/congress/marjorie-taylor-greene-held-trump-stock-now-s-tanking-wont-say-happene-rcna147504

Tuesday this week saw DJT trade at a new low of $11.75. Investors appear to be pricing out a Presidential victory for Mr. Trump. Or maybe it's just another 'meme stock' thing. Current valuation is still a tidy $1 billion for Mr. Trump. As my grandfather used to say "Nice work…if you can get it. Madame Greene, if she still holds DFT shares, may not be as amused.

Geopolitical risk 2. Stay up to date on Ukraine via podcasts.

'Battleground' Pod Cast with Saul David and Patrick Bishop (free):

Podcast 199: Inside the economic war to bring down Russia Sept 24, 2024

In this episode of Battleground Saul and Patrick speak to award-winning Bloomberg journalist Stephanie Baker about her in-depth investigation into the unprecedented economic war the US and its allies are waging against Russia as detailed in her compelling new book *Punishing Putin: Inside the Economic War to Bring Down Russia*.

Spotify: https://open.spotify.com/episode/7GnqpUPYVkJnLPTy0Jf0LV

Podcast Addict (free): https://podcastaddict.com/podcast/battleground/4098940

Ukraine: The Latest – The Telegraph daily editions (free)

Spotify: https://open.spotify.com/show/6cnkk1J0I1UqtxTYVUL4Fe

Podcast Addict (free): https://podcastaddict.com/podcast/ukraine-the-latest/4805122

YouTube: https://www.youtube.com/playlist?list=PLJnf_DDTfIVCYlsANGtNkzMeM9Fdmqzxr

Ukraine's future may be dependant up this November's US Presidential Election. GOP nominee Donald Trump has shown little interest in supporting Ukraine. Some worry he may favor Russia's stance. Kamala Harris is seen to be continuing the Biden Adminstration's support for Ukraine. Who will win? Does it matter?

'The Rest is Politics – US' – Katy Kay & Anthony Scaramucci -

Esteemed US political journalist Katy Kay has teamed with previous Trump administration advisor 'The Mooch' Anthony Scaramucci to create *'The Rest Is Politics – US ',* provided by UK based 'Goalhanger Productions'. Born in the UK, Madame Kay has covered Washington politics for various media outlets sine the 1990's. Mr. Scaramucci is a past Wall Street hedge fund manager (he still is active) and a longtime Republican fund raiser, appearing regularly on US news media including CNN and Fox, 'The Mooch' was pilloried for his brief sojourn under Mr. Trump's banner, a decision he has publicly regretted. Mr. Scaramucci is now a firm 'never Trumper' (along with 40 of his past Trump administration peers). Posted each Friday, *'The 'Rest Is Politic-US'* provides insights into US politics. I am a subscriber through Podcast Addict.

Spotify: https://open.spotify.com/show/1OY3nyGYqjIO4aWMW2feLy

Podcast Addict: https://podcastaddict.com/podcast/the-rest-is-politics-us/5095076

YouTube: https://www.youtube.com/@RestPoliticsUS

It’s all great listening while mucking out horse-stalls in the barn each evening, and somehow appropriate.

Have a Great Weekend

Steve & Anna Hilberry

FOR THE RECORD September 26, 2024

DOW INDUSTRIALS:	42,175
S&P 500:	5,745
S&P/TSX COMP:	24033
WTI:	$67.48
LOONIE IN $USD:	$0.7412 $US

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CIRO Canadian Investment Regulatory Organization

CIPF Canadian Investor Protection Fund MEMBER

NATIONAL BANK FINANCIAL WEALTH MANAGEMENT