

Multi Asset: navigating waters

June 2024

Join Steven Milne and Nicoleta Dumitru as they dissect the investment opportunities in Severn Trent and United Utilities, highlighting the resilience and growth prospects amid regulatory and environmental challenges.

Your capital is at risk. Past performance is not a guide to future returns.

Steven Milne (SM): Hi there, and welcome to this short video for our multi-asset strategy. I'm Steven Milne. I'm an investment specialist in the multi-asset team within the clients department at Baillie Gifford. I'm delighted to say that I'm joined by Nicoleta Dumitru, who is a decision-maker on the multi-asset strategy and also the head of our real assets group.

Today, we're going to be discussing our water utility purchases for the multi-asset strategy, and really looking to cover the investment case for these companies, thoughts on the regulatory backdrop, and also our outlook as well. So, welcome, Nicoleta.

Nicoleta Dumitru (ND): Hi, everyone.

SM: Perhaps we can dive straight in, so really some comments from you regarding the negative news coverage that we've seen in the press recently, regarding water utilities. So why is now the right time for UK water investments, and which companies have you selected?

ND: Okay. I think it's fair to say that there has been no shortage of negative headlines in the UK water sector. So much so that companies across the sector have been lumped together, unfairly. And that has actually created an interesting opportunity for us to buy a couple of regulated utilities in the sector that we believe are ahead of the game.

We have made an investment into Severn Trent and United Utilities, and we think that they stand out for a number of reasons. They have strong management teams and a solid operational performance, as well as very attractive valuations. And we think none of the attractive entry points would have been available without the negative background.

SM: You mentioned valuations there, they're obviously going to be quite important aspects in terms of looking at Severn Trent and also United Utilities, but could you maybe just set out what our overall investment case is for both companies?

ND: Okay. The investment case here is a combination of improving fundamentals and attractive

valuations. On the fundamentals side, we believe that the UK water sector is at an inflection point. There will be significantly more investments being made by all players across the board, and the two names that we have selected are very well-positioned to finance that growth.

They have strong balance sheets, and their leverage is in line with the regulatory guidelines, which is not something we can say about every player in this space. On top of that, they have a strong operational performance, they have strong management teams, and we believe that they're well-placed to take advantage of outperformance incentives that will improve the returns that they earn on that growing regulated asset base.

When it comes to valuations, we think those are very interesting. Right now, it is very difficult to find a regulated utility that is trading at a discount to the regulated asset base, and certainly that is the case with the UK water names which we have been able to buy at an attractive valuation.

SM: That's great. So alongside the growth that we can see for both of these companies, and them being the best in the sector, the valuations have still been affected recently. So is there a reason that they're currently cheap?

ND: That's a really good question. I suppose with any investment there are always risks, and here the primary risks are around political intervention and regulator risks around the upcoming regulatory review, as well as any surprise environmental investigations that could translate into a financial penalty that could affect the earnings and the cash flows for these businesses.

We are positive on valuations, because we think that the upcoming regulatory review is going to signal an improving regulatory environment for these companies, and we have selected names that have a strong financial position and also have a strong operational performance.

SM: Perhaps sticking with the topic of regulation just now, actually, there could be action from the regulator either issuing fines or penalties for pollution, so how do you gain comfort around the ESG implications of your investments and the outcomes for the investigations?

ND: Taking a step back, it is very clear that we need to keep a very close eye on the risk and potential risk of environmental fines. There are a few very reassuring factors around the investment case that help with this. Number one is the fact that these companies are proactively managing the risk of pollution. They have very clear targets that they set for themselves. For example, Severn Trent has a target of having no serious pollution events.

They have internal teams who have and oversee the data, so that any sort of unexpected event is caught very early and dealt with as soon as possible. And on top of that, both of these holdings, they are making very significant investments into minimising that risk into the future.

And so it's those factors that help reassure us that both companies have the right compliance culture as well as they're doing all the right things to minimise the risk of an unexpected pollution incident.

SM: Okay. So we've touched on the regulation side, we've perhaps not really explored the topic of politics. Can you provide some thoughts on what a change in government might mean for UK water companies more generally?

ND: The short answer is not much for the time being. Any changes that could be made, and potentially there will be some changes, those will come through into the next regulatory period, and we're talking a few years down the line. So for the time being, it seems like there is coalescing agreement into agreeing on a more transparent regulatory environment, which is something that we welcome.

SM: Okay. The regulatory backdrop we're seeing is positive, and the political backdrop remains quite positive as well, so perhaps we can finish off with what is the outlook for United Utilities and Severn Trent from here, and really if there's anything you're looking out for as a catalyst that will back up your investment view?

ND: Okay. When it comes to catalysts, there are a few things we're looking out for. One is the upcoming regulatory review that I alluded to a few times earlier today. We want to see an improvement in the regulator environment, higher allowed investments as well as a higher return.

On top of that, we're keeping a very close eye on any environmental incidents. We want to see both companies delivering strong operational performance as well as being on top of any surprise pollution event. And, quite frankly, any sort of resolution around Thames Water would be very helpful in the sector. I would help to attract capital back in.

Taking a step back, this is a challenging sector, there's no doubt about that, but it's also important to recognise that the companies are rising above that, and they are fighting towards breaking the cycle of previous underinvestment.

We have selected two holdings that we believe can honourably deliver on higher investment, on a better quality of service for customers, and ultimately who we believe have a good compliance culture.

At the end of the day, some of the more uncomfortable investments will end up being some of the best investments we'll have made. And there is a degree of discomfort here but, as long-term investors, we have to look through that and see the long-term opportunities.

SM: That's brilliant. Thank you very much for your time. I think that's a great place to wrap up today. I think that's been really helpful for everybody, I think that gives a really clear picture on the sector backdrop and why we've also selected Severn Trent and United Utilities to be added to the multi-asset portfolios that we have, based on the really attractive valuations and also to hold over the long term.

ND: Great.

SM: Alongside our water company investments, we have a number of other interesting articles on our website. You can get in touch with us as well regarding today's content, or any other multi-asset queries, using the contact us details at the bottom of this page. But until then, from both Nicoleta and I, we thank you very much for watching this short video, and we look forward to speaking to you again soon.

ND: Thanks, everyone.

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