UK interest rates and "risk-free" gilts at their peak? Infrastructure stocks struggle

By Nigel Hawkins

Executive summary

Infrastructure/Renewable Energy Funds

- The share price performances of the nine Infrastructure Investment Companies (IICs) and of the 22 Renewable Energy Infrastructure Funds (REIFs) have been dire over the past year. Undoubtedly, the sharp rise in interest rates has presented the sector with serious challenges, especially since the yield on “risk-free” 10-year gilts has risen appreciably. Furthermore, the ongoing war in Ukraine and high inflation rates, from which many IICs and REIFs are partially – if not wholly – protected, continue to unsettle the sector.

- Not only are rising interest rates seriously eroding investor sentiment, as the appeal of “risk-free” gilt-edged stocks is significantly raised, but they also directly affect NAVs. In recent months, several NAV reductions have taken place. Moreover, the average IIC is currently trading at a 22% discount (on an unweighted basis) to its NAV; the comparable discount (also on an unweighted basis) for the REIFs is 21%. Not surprisingly, there are now several share buyback schemes under way.

- In recent months, spot energy prices have fallen markedly, after the massive surge, in early 2022, when the war in Ukraine began. However, this scenario has had less effect on long-term energy price projections, which are key to REIF valuations. Along with higher interest rates and the consequential impact on discount rates, the growth of many REIFs’ NAVs has stalled.

- All constituents of the 31-strong IIC/REIF sector have seen their share prices fall over the past year – some very substantially. Three subsectors have been particularly badly affected: many smaller energy stocks; the two US-based renewable energy stocks (US Solar has now aborted its efforts to sell its business, due to the non-conducive market backdrop); and the telecoms stocks, most notably Digital 9 Infrastructure.

- Prior to COVID-19, when both inflation and interest rates were low, real dividend growth was commonplace, while cuts in nominal growth were very rare. In recent years, though, few IICs/REIFs have been able to replicate this trend; although Greencoat UK Wind remains committed to its dividend growth, matching changes in RPI.

- On the downside, leading IIC, HICL, has flagged a six-year flat dividend – until 2024/25 – of 8.25p per share. Within the REIF sector, Ecofin US Renewables has announced a probable halving – for 2Q’23 only – of its quarterly dividend, which was previously $1.40 per share, following the impact of a tornado in Texas on nearby electricity transmission infrastructure. As for ThomasLloyd Energy Impact, its shares have remained suspended since 24 April 2023, following material accounting issues.

- The average prospective dividend yield (on an unweighted basis) for the IICs is currently 6.7%; the comparable figure (also on an unweighted basis) for REIFs is 6.9%. These much higher yields reflect the sharp decline in recent months of the share prices of many sector constituents.

- Discounting the suspended ThomasLloyd Energy Impact, only 3i Infrastructure, Bluefield Solar, Greencoat UK Wind and Sequoia Economic Infrastructure have been able to keep their percentage share price falls over the past year within single figures. By contrast, over the same period, Digital 9 Infrastructure’s shares are down by 45%, while both Ecofin and HydrogenOne Capital Growth have seen falls of ca.40%.

Background

The worm has turned – and rather abruptly – from the pre-COVID-19 optimism

Within the 31-strong infrastructure and renewable energy sectors, most of the constituents have floated within the past decade, with various IPOs undertaken in the lead-up to COVID-19. Subsequently, it has been quite quiet on the IPO front, and, importantly, sector fundraisings since the sharp rise in interest rates – to counter rising inflation – have been few.

Share buybacks become popular

Undoubtedly, this reversal has seen much of the optimism drained from the sector, with the pronounced premiums over NAVs, at which most stocks then traded, being reined in very substantially. Hardly surprisingly, share buybacks have become popular of late.

The larger IICs, such as 3i Infrastructure and BBGI, continue to prosper, albeit at rather lower valuations. Similar comments apply to the two largest REIFs, Greencoat UK Wind and TRIG. Other less mature stocks, however, continue to struggle.

Clearly, the substantial discounts to NAV at which some stocks are trading – in the cases of Digital 9 Infrastructure, Ecofin US Renewables and HydrogenOne Capital Growth at 40%+ discounts – sum up the poor market sentiment. Rising interest rates, and their impact in driving up discount rates, have undoubtedly cut valuations, a scenario to which markets have reacted accordingly.

Harbingers of doom

The current situation is well-illustrated by US Solar, which has been the subject of major internal reviews regarding its ongoing strategy. In effect, it put itself up for sale, but the bids submitted were below expectations. Indeed, in its RNS statement, dated 10 July 2023, US Solar confirmed as follows: "*The Board has concluded, given the extensive discussions with numerous parties over the last six months, that the current market backdrop is not conducive to a sale of the company or its assets*".

Shares in ThomasLloyd Energy Impact suspended

In the case of ThomasLloyd Energy Impact, its shares have been suspended since 24 April 2023, pending resolution of various accounting issues relating to its operations in India.

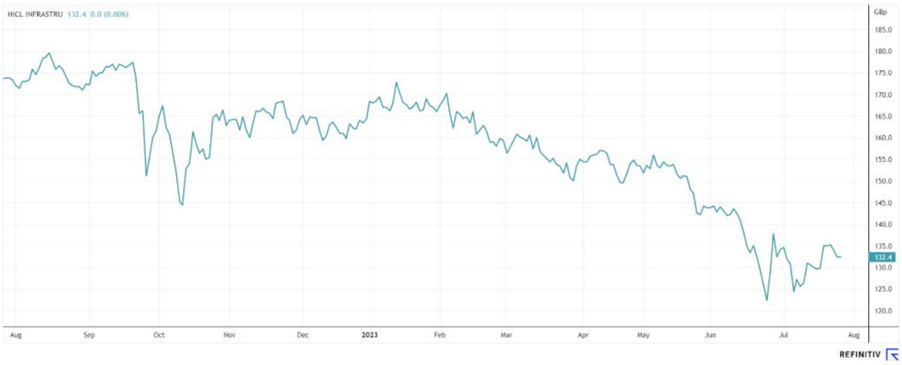
Recent share price performance

While well-established IICs, excepting the telecoms component, have fared better than many REIFs over the past year, their share price performance has been poor.

Lacklustre HICL

To be sure, 3i Infrastructure has seen a comparatively modest 6.2% decline in its share price over the past year, but sector leader, HICL, with its six-year flat dividend profile, has seen a 22.8% decline, as the graph below highlights.

HICL: one-year share price performance

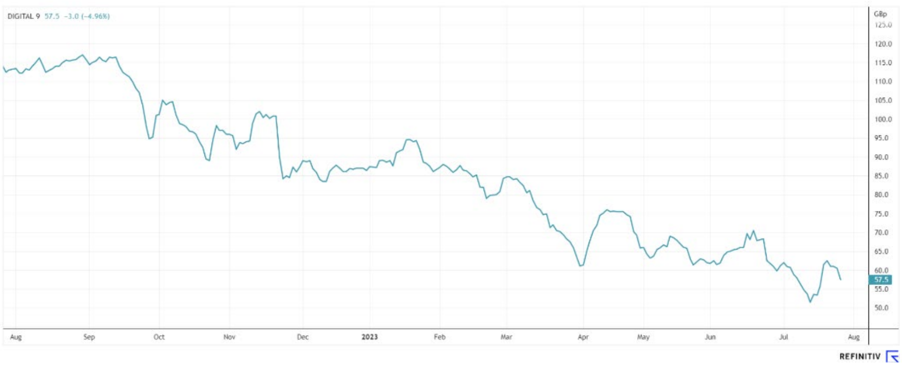


Source: Refinitiv

Digital 9 Infrastructure struggles

GCP Infrastructure has also disappointed – its shares are down by 31.2% over the past year – as concerns abide about both the quality of its assets and its capacity to deliver dividend growth, even in nominal terms. However, the most pronounced fall has been in the share price of Digital 9 Infrastructure, which has suffered particularly from the impact of higher interest rates on the valuation of its projected long-term earnings. The graph below highlights its poor share price performance of late.

Digital 9 Infrastructure: one-year share price performance



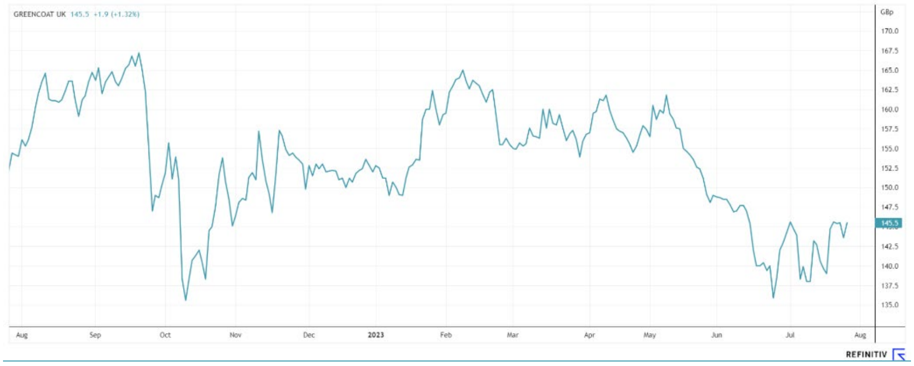
Source: Refinitiv

Greencoat UK Wind and TRIG have been comparatively solid

Many REIF stocks have faced real pressure, especially those that are relative newcomers to the sector. Clearly, higher interest rates and lower long-term energy prices are not a good combination for sector investors, especially in terms of valuation. As such, many REIFs have seen sharp falls in their share prices, although the two leading REIFs, Greencoat UK Wind and TRIG, with valuations of £3.3bn and £2.9bn, respectively, have outperformed a weak subsector; the former's RPI-linked dividend policy has been a key factor.

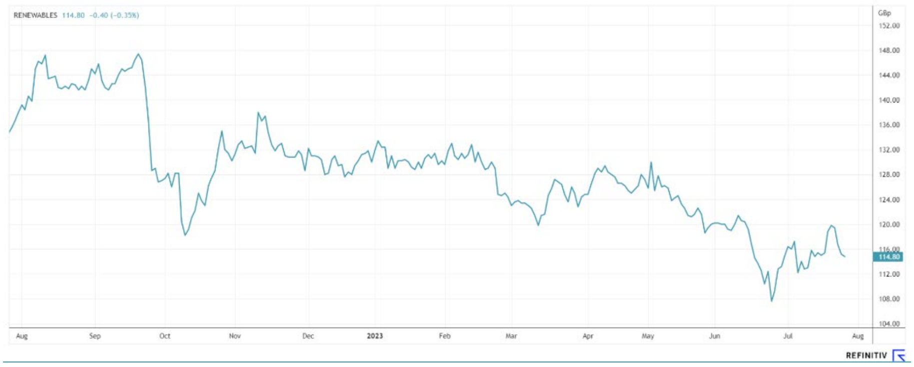
The share price graphs of both funds are reproduced below.

Greencoat UK Wind: one-year share price performance



Source: Refinitiv

TRIG: one-year share price performance



Source: Refinitiv

Ecofin and HydrogenOne Capital Growth lead the laggards

Far less satisfactory have been the share price ratings of some of the smaller REIFs. Ignoring the currently suspended ThomasLloyd Energy Impact, several of the 21-group REIF subsector have faced share price falls of over a third during the past year. The worst REIF performers have been Ecofin US Renewables and HydrogenOne Capital Growth, shares of which have plunged by 41.5% and 39.6%, respectively; in the case of the latter, the hydrogen boom has lost much of its glamour for investors.

NAVs

Useful premia in the past are now, in many cases, very hefty discounts

Undoubtedly, the advent of higher interest rates – and their impact on long-term valuations – has adversely affected NAVs. While, previously, many IICs and REIFs had traded at a premium to their NAV (for much of 2021, for example, BBGI's premium exceeded 20%), all, except the suspended ThomasLloyd Energy Impact, are now trading at substantial discounts.

Current market ratings of UK IICs

IIC	Share price (p)	Shares in issue (m)	Market cap (£m)	Year-end	NAV per share (p)	Premium vs. discount	Prosp. dividend (p)	Prosp. yield
3i Infrastructure	314	922	2,895	Mar	336.2	-6.6%	11.90	3.8%
BBGi	138	715	987	Dec	149.9	-7.9%	7.93	5.7%
Cordiant Digital Infrastructure	82	773	634	Mar	113.4	-35.6%	5.00	6.1%
Digital 9 Infrastructure	61	865	528	Dec	109.8	-53.6%	6.00	9.8%
GCP Infrastructure	77	878	676	Sep	110.0	-30.0%	7.00	9.1%
HICL	133	2,035	2,707	Mar	164.9	-19.3%	8.25	6.2%
INPP	131	1,910	2,502	Dec	159.1	-17.7%	7.93	6.1%
Pantheon Infrastructure	81	478	387	Dec	99.2	-18.1%	4.00	4.9%
Sequoia Economic Infrastructure	80	1,695	1,356	Mar	93.7	-14.6%	6.88	8.6%
			12,671					

Source: Hardman & Co Research

48% trading discount over NAV for HydrogenOne Capital Growth

As the table below shows, HydrogenOne Capital Growth is currently trading at a discount of 48% over its NAV, with several other sector constituents now trading at a discount of more than 30%.

Current market ratings of UK REIFs

REIF	Share price (p)	Shares in issue (m)	Market cap (£m)	Year-end	NAV per share (p)	Premium vs. discount	Prosp. dividend (p)	Prosp. yield
Aquila Energy Efficiency	59	100	59	Dec	95.2	-38.0%	5.00	8.5%
Aquila European Renewables	75	386	290	Dec	94.0	-20.2%	4.68	6.2%
Atrato Onsite Energy	83	150	125	Sep	93.8	-11.5%	5.00	6.0%
Bluefield Solar	118	611	721	Jun	139.1	-15.2%	8.40	7.1%
Downing Renewables and Infrastructure	92	184	169	Dec	115.8	-20.6%	5.38	5.8%
Ecofin US Renewables	47	138	65	Dec	73.6	-36.1%	3.82	8.1%
Foresight Solar	99	604	598	Dec	124.2	-20.3%	7.55	7.6%
Gore Street Energy Storage	101	481	486	Mar	115.6	-12.6%	8.00	7.9%
Greencoat Renewables (ex €)	87	1,141	991	Dec	97.4	-10.8%	5.52	6.4%
Greencoat UK Wind	143	2,320	3,318	Dec	165.8	-13.8%	8.76	6.1%
Gresham House Energy Storage	129	573	739	Dec	155.6	-17.1%	7.35	5.7%
Harmony Energy Income	96	227	218	Oct	117.1	-18.0%	8.00	8.3%
HydrogenOne Capital Growth	52	129	67	Dec	100.0	-48.0%	0.00	0.0%
JLEN	106	662	701	Mar	123.1	-13.9%	7.57	7.1%
NextEnergy Solar	95	590	561	Mar	114.3	-16.9%	8.35	8.8%
Octopus Renewables	91	565	514	Dec	107.7	-15.5%	5.79	6.4%
SEEIT	79	1,092	863	Mar	101.5	-22.2%	6.24	7.9%
ThomasLloyd Energy Impact*	84	176	148	Dec	78.6	6.9%	1.40	1.7%
TRIG	115	2,484	2,857	Dec	134.8	-14.7%	7.18	6.2%
Triple Point Energy Transition	69	100	69	Mar	99.4	-30.6%	5.50	8.0%
US Solar	48	332	159	Dec	74.7	-35.7%	4.41	9.2%
Victory Hill GSEO	89	423	376	Dec	112.3	-20.7%	5.52	6.2%
			14,093					

** Shares currently suspended*
Source: Hardman & Co Research

The impact of more conservative discount rates

In recent months, there have been various financial adjustments, many reflecting the adoption of more conservative discount rates. However, the decline in long-term term energy price projections has also been a factor for some REIFs. In general terms, over the past year, many NAVs have been quite flat, whereas dividends for many IICs/REIFs are projected to grow, at least in nominal terms.

Removing the battery storage discount rate anomaly

More specifically, in the case of Gore Street Energy Storage, its recent results confirmed that its discount rate had risen very appreciably, from 8.3% in 2021/22 to 10.1% in 2022/23. This pronounced increase brings its discount rate much closer into line – previously, it had been somewhat anomalous – with its nearest comparator, Gresham House Energy Storage; the latter's latest published figure is 10.9%.

Dividends

Solid nominal dividends

Despite the relative lack of growth in NAVs, dividend payments – at least in nominal terms – remain robust. Increasing focus, however, will fall on dividend cover levels.

Greencoat UK Wind's RPI-related dividend uplift

Most impressively, Greencoat UK Wind has retained its RPI-related dividend policy, despite the recent surge in UK inflation: its 2022 dividend, at 7.72p per share, was up by 7.5% compared with its 2021 dividend of 7.18p per share. For 2023, based on an inflation figure of over 13%, it is projecting a figure of 8.76p per share.

Dividend cuts in the sector are rare

Several funds, most notably HICL, have maintained their dividends in nominal terms in recent years. Dividend cuts, however, have been very few; although Ecofin US Renewables has confirmed a probable halving of its quarterly payment per share for 2Q'23, following tornado-related damage to a nearby electricity substation in Texas, which its key 60MW Whirlwind windfarm uses to transmit its generated output.

Prospective yields – 6.7% for IICs and 6.9% for REIFs

In terms of current dividend yields, the prospective yield – on an unweighted basis – for the IIC subsector averages 6.7%; the comparable figure – also on an unweighted basis – for the REIFs is 6.9%.

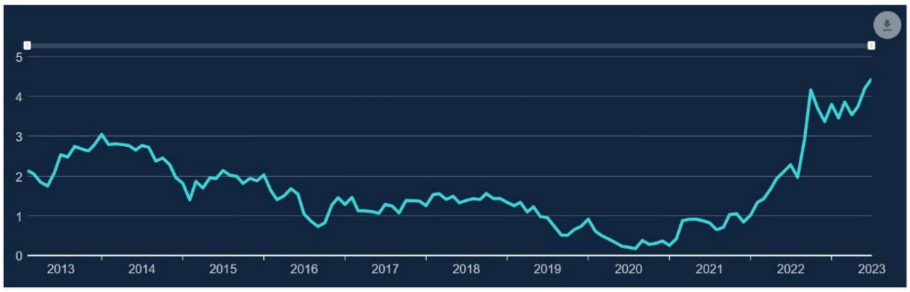
10-year gilts

Gilt yields on the move

When assessing IIC/REIF sector yields, they need to be compared with those currently available on 10-year "risk-free" gilts, which have risen sharply of late, on the back of higher interest rates.

The graph below, published by the Bank of England, sets out how the pivotal 10-year gilt yield has increased in recent years, after a lengthy period of very low yields, when interest rates were far lower.

10-year gilt yield



Source: Bank of England

Energy prices

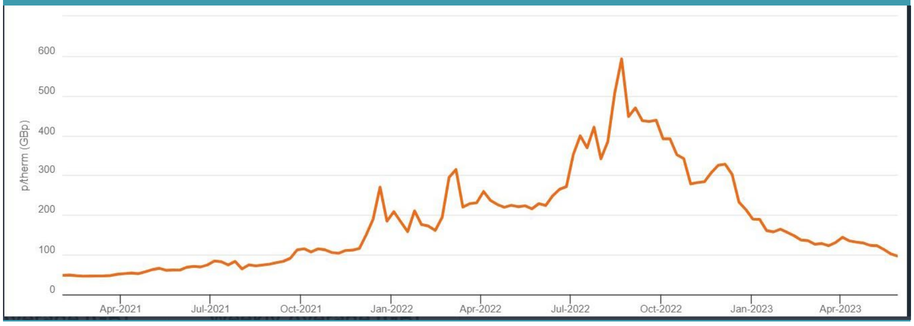
Gas prices way off 2022 spring peak

Wholesale gas prices, both within the EU and in the UK, soared in the latter part of 2021 – and increased even further following the invasion of Ukraine by Russia. In recent months, they have fallen sharply, as the demand for gas has faltered and various alternative gas supplies have been found.

Volatility is quite remarkable

Ofgem's latest graph for forward delivery of gas in GB is reproduced below – its pricing volatility since the early months of 2021 is quite remarkable

Gas prices – forward delivery contracts (GB weekly average)

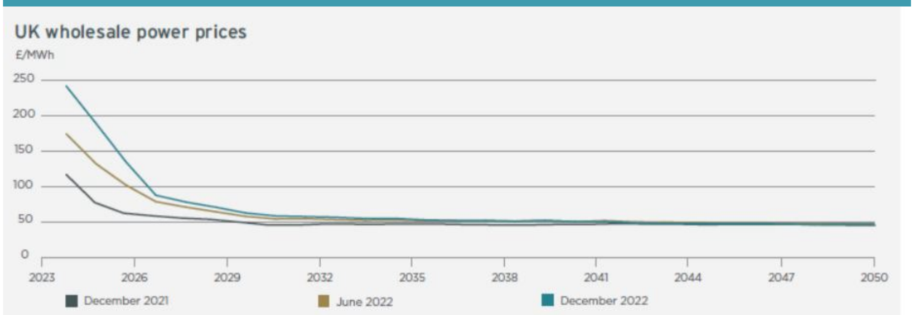


Source: Ofgem

Foresight's foresight on energy prices – up to 2050

Looking forward, there is considerable disagreement about long-term energy prices. However, Foresight Solar has published its long-term energy price projections until 2050, based on the figures calculated by the three consultants that it retains. The graph is shown below.

UK wholesale power prices (£/MWh)



Source: Foresight Solar

Other renewable energy issues

A major offshore project loses key backer

The state-owned Vattenfall, Sweden's leading power company, has confirmed its withdrawal from the 1,400MW Boreas offshore wind project, off the coast of Norfolk. In 2022, Vattenfall was successful in its record-low bid for an off-take contract of a minimum £37.35 per MWh (at 2012 prices) for this project. Subsequently, increases in supply costs, notably of wind turbines, more challenging transport issues and higher interest rates have combined to make the project uneconomic – in Vattenfall's view – at the agreed 2022 price.

It seems very likely that similar withdrawals from planned offshore wind projects will be confirmed, especially those where gas offtake prices of below £45 (at 2012 prices) per MWh were agreed.

Low winds in Scotland

FTSE 100 stock, SSE, has confirmed that, in its April to June 1Q'23/24, its renewables division's generated output was 29% below budget – windless weather was cited as the prime cause of this pronounced shortfall.

Major acquisition planned

In addition to its half-year results for 2023, which highlighted some shortfalls in output from its Scottish windfarms – as experienced by SSE – Greencoat UK Wind has confirmed that it plans to acquire a net 13.7% stake in the 630MW offshore London Array windfarm from the Danish-based Orsted.

Conclusion

Challenges afoot

There is no doubt that the pronounced – and sudden – increase in interest rates, and not only in the UK, has presented the sector with real challenges. To be sure, gearing levels are still quite modest – and certainly compared with private equity undertakings.

Long-term contract protection

For many IICs, with a portfolio of solid contracts, the impact has been less – although it has dented their valuations.

For the REIFs, the challenges are arguably greater for wind and solar generators operating in a market where prices fluctuate quite markedly, even if long-term energy price projections are less volatile.

The gilt market has its attractions

For investors, real reassurance has been provided by the reliability – at least to date – of dividend payments, even if any increases are nominal, rather than being real. However, in the quest for their funds, many investors will be more attracted – at current yields – to "risk-free" 10-year gilts than to IICs and REIFs.

Challenges

Undoubtedly, challenges on several fronts – operational, financial and even political – abound.

About the author

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Nigel specialises in the energy sector, with a particular focus on the expanding renewable generation market, both in the UK and overseas, about which he has written several reports assessing the sector's finances. He has been involved in analysing the utilities sector since the 1980s. He covered the privatisation of the water and electricity companies for Hoare Govett between 1989 and 1995. Subsequently, he researched the UK and EU telecoms sector for Williams de Broe.

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