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The inside story: tale of two energy utilities

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In this note, I'll discuss a couple of our top ideas in the portfolio today – both energy names but very different in nature. One is a Latin American power generator with plans to clean up its environmental footprint, and the other is a middle eastern electricity utility with defensive qualities.

AES ANDES SCALING NEW HEIGHTS IN RENEWABLE ENERGY

AES Andes, the second largest electricity generation company in Chile, is a large thermal coal player. For an ESG-aware investor, this doesn't sound like an obvious fit. But in emerging markets, where energy generation is generally "dirtier" than in developed countries, the direction of travel is important. Value can be added by identifying improving business models early, and we are interested in the way AES is tackling its environmental challenges.

On paper, based on reported quantitative ESG metrics, AES doesn't screen particularly well. In fact, it scores "orange" in our own Responsible Investing Indicator Model (RIIM) based on environmental factors. But quantitative metrics are just a starting point. In 2018, management announced its Greentegra strategy, which focuses on environmental impact and includes the addition of 2.3 gigawatts of renewable energy between 2019 and 2024. Steps include disposal of coal-fired assets, addition of wind and solar projects, and the large Alto Maipo hydroelectric project, which is currently nearing completion.

The company expects to grow energy generation from renewables from 33% of EBITDA in 2017 to 66% in 2024. The issuer's parent company has committed to shrinking coal from 50% of generation in 2018 to less than 10% by 2025 and to have net zero carbon emissions from electricity sales. It is targeting 100% renewable energy systems by 2040 in line with the Paris Agreement.

We have held the company's bonds for several years, and its decarbonisation strategy is starting to gain credibility in the broader market. Rating agency Fitch said recently that it "believes the company has proven it can successfully decarbonize and expand into renewables, even with a heavy coal concentration."

OMAN ELECTRICITY TRANSMISSION COMPANY OFFERS RESILIENCE AT A DISCOUNT

The Oman Electricity Transmission Company is a monopoly state-owned electricity utility. As a transmitter rather than a generator of energy it doesn't face the same environmental challenges as AES, and scores "green" on our ESG model. Rather, the story here is a combination of resilience, and some uncertainty in the market about how to price the risks.

In December 2019, China State Grid bought 49% stake in The Oman Electricity Transmission Company. When the Omani government owned 100% of the company, the bonds had traded largely in line with those

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of the sovereign. Since the deal, the bonds have been trading cheaper, adding an implied company-specific risk premium onto the sovereign risk. The question is: how much risk should we be pricing in?

From the point of view of sovereign risk, we're encouraged by fiscal reform momentum we've seen, and the rise in oil prices is positive for the macroeconimc backdrop. Lingering uncertainty was also resolved last year as a successor was named to Sultan Qaboos bin Said Al Said, who died heirless in 2020 after a 50-year reign.

Looking at idiosyncratic risk, the fact that the company is no longer 100% state owned (and implicitly guaranteed) is, on paper, a negative factor. But we think China State Grid brings some new elements to the mix that could be beneficial for credit quality.

For example, the new partner has a strong credit profile and, given its access to the much deeper Chinese financial sector, it potentially opens up previously unavailable sources of funding. Another positive is that, compared with a more passive state owner, China State Grid is likely to be a more strategic partner, better placed to help find ways to optimise operations or improve efficiencies.

More broadly, though, the electricity transition business is one of the most resilient models available to investors. The Oman Electricity Transmission Company is not exposed to input cost inflation or commodity risk as the regulatory environment allows these costs to be passed on to the underlying customer. Moreover, while the issuer no longer carries 100% state backing, keeping the lights on is such a high priority on any government's agenda that the state is highly incentivised to help ensure the company stays afloat.

Risks - The following risks are materially relevant to the portfolio:

- **China Interbank Bond Market risk** - market volatility and potential lack of liquidity due to low trading volume of certain debt securities in the China Interbank Bond Market may result in prices of certain debt securities traded on such market fluctuating significantly.
- **Contingent convertible bond** risk - contingent convertible bonds have similar characteristics to convertible bonds with the main exception that their conversion is subject to predetermined conditions referred to as trigger events usually set to capital ratio and which vary from one issue to the other.
- **Country risk (China)** - all investments in China are subject to risks similar to those for other emerging markets investments. In addition, investments that are purchased or held in connection with a QFII licence or the Stock Connect program may be subject to additional risks.
- **Credit risk** - a bond or money market security could lose value if the issuer's financial health deteriorates.
- **Default risk** - the issuers of certain bonds could become unable to make payments on their bonds.
- **Derivatives risk** - derivatives may result in losses that are significantly greater than the cost of the derivative.
- **Emerging markets risk** - emerging markets are less established than developed markets and therefore involve higher risks.
- **Frontier markets risk** - small market nations that are at an earlier stage of economic and political development relative to more mature emerging markets typically have limited investability and liquidity.
- **High yield bond risk** - a bond or debt security rated below BBB- by Standard & Poor's or an equivalent rating, also termed 'below investment grade', is generally subject to higher yields but to greater risks too.
- **Interest rate risk** - when interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.
- **Liquidity risk** - any security could become hard to value or to sell at a desired time and price.
- **Sector concentration risk** - the performance of a portfolio that invests a large portion of its assets in a particular economic sector (or, for bond portfolios, a particular market segment), will be more strongly affected by events affecting that sector or segment of the fixed income market.

General Portfolio Risks

- **Capital risk** - the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.
- **Counterparty risk** - an entity with which the portfolio transacts may not meet its obligations to the portfolio.
- **ESG and sustainability risk** - ESG and sustainability risk may result in a material negative impact on the value of an investment and the performance of the portfolio.
- **Geographic concentration risk** - to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.
- **Hedging risk** - a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.
- **Investment portfolio risk** - investing in portfolios involves certain risks an investor would not face if investing in markets directly.
- **Management risk** - the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).
- **Operational risk** - operational failures could lead to disruptions of portfolio operations or financial losses.

Important Information

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for the portfolio, and no assumptions should be made that the securities identified and discussed were or will be profitable.

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