Stock story: National Grid

Delivering for customers and investors rain, hail or shine.

In April 2020, thunderstorms capable of triggering tornedoes swept through the east coast of the US. Fierce gusts pounded New York City and the surrounding region and many areas suffered blackouts after falling branches snapped powerlines. Amid covid-19 restrictions, out hurried the local employees from a UK-based company. In no time, its 200,000 customers across New York, Rhode Island and Massachusetts had their power restored.

The company that once again showed its mettle at operations was National Grid, one of the world's largest publicly listed utilities focused on transmission and distribution of electricity and gas. National Grid's core business is that it owns and operates regulated electricity and gas infrastructure in the UK and the northeast US. More specifically, National Grid combines a UK electricity transmission business (34% of fiscal 2020 operating profit), a UK gas transmission arm (12%), a US regulated utility business (47%) and National Grid Ventures (7%), where sit an assortment of other assets.

The electricity and gas networks of National Grid, which earned revenue of 16 billion pounds in fiscal 2020, extend a long way. In the UK, the company has 7,212 kilometres (4,481 miles) of overhead electricity lines, 2,239 kilometres of underground electricity cables and 7,630 kilometres of high-pressure gas pipes. In the US, National Grid boasts 14,659 kilometres of overhead electricity transmission lines, 169 kilometres of underground electricity transmission cables and 57,425 kilometres of gas pipelines.

The company, which was formed in 1990 as part of the privatisation of the electricity industry in England and Wales (and listed in 1995), focuses too on renewables. In the US, National Grid, for instance, has connected more than 200 Megawatts of rooftop solar for 27,000 customers and aims to boost the output of wind and solar energy projects to more than 2.4 Gigawatts in coming years.

National Grid's appeal to investors is that the utility aims to be a low-risk business that generates shareholder value through dividends and a higher share price – just what the fund is looking for. To understand how National Grid operates, it's best to understand what utilities are and how that drives the way they are regulated.

The distinctive feature of utilities is that they are monopolies in their local areas because most of their customers generally have no alternative source of the essential service the utility provides. Because privately owned utilities do not face competition, they are subject to economic regulation that seeks to replicate competition in terms of prices for consumers. Regulators typically set relatively fair prices for consumers based on their estimates of a utility's operating costs and capital expenditure. Regulators thus settle on a fair return on the capital spending a utility has undertaken to fulfil its role. The way, therefore, for a utility to increase gross earnings is to spend more on approved capital works.

As expected from a well-managed utility, National Grid has delivered robust and predictable returns for investors in recent years – a weighted average return on equity of 12.4% in fiscal 2020 no less. And it's likely to achieve its target to deliver asset growth of between 5% and 7% in coming years (after achieving 9% growth in fiscal 2020) as approved capital works expand, especially in the US where regulators are allowing for higher utility returns on investment.

The main reason electricity utilities in the UK and the US are expected to find significant opportunities for capital investment is that these countries are shifting towards 'net zero' emissions. A key plank of the transition to this climate-change-mitigation target is the increased electrification of the economy – think electric vehicles – which will require substantial investment in the electricity grid.

To gain more exposure to this theme, National Grid recently spent 14 billion pounds to acquire Western Power Distribution, which is the UK's largest electricity distribution network and a supplier that plugs into National Grid's transmission network. As well, National Grid's UK gas transmission business is well placed to play a central role in the move towards increased penetration of hydrogen in the economy, another key plank in the transition to a net-zero economy. National Grid is a leader in the testing and development of the use of a hydrogen as an alternative source of clean energy.

National Grid Ventures is another promising asset. The arm includes the ownership and operation of electricity interconnectors (key infrastructure for the UK economy), a

US renewable-energy-development business, a UK electricity-metering business and a business redeveloping excess company-owned property for residential housing. While National Grid Ventures accounts for less than 10% of company earnings today, its contribution is expected to swell over the next five years as its assets deliver. All up, National Grid is primed to deliver what we want from stocks in our portfolio – steady income and some capital growth.

To be sure, National Grid, as do all utilities, faces risks, especially regulatory and political ones. Political risks were especially apparent when the UK Labour Party under Jeremy Corbyn had a policy to nationalise utilities at below-market prices – and nearly all of National Grid's UK assets were targeted. Every time Labour rose in the opinion polls in recent years, utility shares sank. But that risk vanished when Labour lost badly in the 2019 elections and Corbyn went as leader. The regulatory risk is that officials can make adverse decisions at any time though none such appear to be looming for National Grid. The company paid a 60% premium for Western Power (over its regulated asset base) so it needs to better manage these assets to ensure a worthwhile return. The takeover has boosted National Grid's debt beyond industry norms (to a debt-to-capital ratio of 70% and above the common ceiling of 60%), even allowing for the imminent sales of its Rhode Island power operations in the US and the future sales of a stake in its UK gas transmission business. Cyber threats are an emerging menace for utilities these days, but any damage is usually only temporary. Renewables are a threat as well as an opportunity for the company. If enough households, for instance, were to install solar panels and the ability of batteries to store power were to improve, demand for grid electricity might slide.

But not that many people are likely to disconnect from the grid. National Grid appears to be entering a phase where it can command a steady growth in earnings as electricity demand rises, even allowing for the odd storm, real and metaphorical.

Sources: Company website, Bloomberg, Dunn & Bradstreet.

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