Developed Markets Income Strategy

MONTHLY COMMENTARY | DECEMBER 2022

Our global listed infrastructure strategies underperformed infrastructure benchmarks and global equities for the month.

The outlook for interest rates and inflation continues to cause volatility in markets as investors digest expectations of a global slowdown in growth in conjunction with central bank tightening, with elevated volatility in the U.K. and Europe as a result of sustained high energy prices.

Inflation continues to sustain itself at a higher level for longer, making it difficult for central banks to refrain from loosening policy even as the economic outlook deteriorates. Although maintaining a tightening position is common across most economies, varying economic circumstances may lead monetary policies to diverge in the extent of tightening. As a recession continues to be part of consensus expectations, the duration and depth of the recession remains the largest risk to investors.

Portfolio Performance

On a stock specific basis, Portuguese renewables utility Energias de Portugal was the top contributor to monthly performance (+0.14%), along with U.S. electric utility Public Services Enterprise Group (+0.10%) and Spanish electric utility Iberdrola (+0.07%).

Energias de Portugal (EDP) is an integrated utility based in Iberia, operating electricity distribution, generation, and energy supply businesses. It has a growing exposure to global renewables, through its 83%-owned subsidiary EDPR (mostly onshore wind farms), and operates electricity distribution and generation businesses in Brazil through its 50%-owned EDP Brasil.

Iberdrola is a multinational integrated electric utility company headquartered in Spain. Iberdrola is engaged in energy networks, renewables and wholesale and retail operations. The company has expanded internationally with operations in the U.K. (via Scottish Power), the U.S. (via Avangrid), Brazil (via Neoenergia) and Mexico.

EDP and Iberdrola's share prices were driven by the general equity market strength in Europe during December. Additionally, the EU's gas price cap was agreed, along with a high gas storage level and a milder-than-expected winter which lessened concerns on potential blackouts and the gas price crisis. Additionally, EDP also benefited from some recovery in rainfall and, in turn, hydropower conditions across Europe, particularly in Portugal.

Public Services Enterprise Group (PEG) operates the largest utility business (~90% of earnings) in New Jersey, along with a generation business (~10% of earnings) comprising nuclear and gas turbine facilities. Shares were higher as broader utilities outperformed on lower rates.

U.S. renewables utility NextEra Energy Partners (-0.42%) was the largest detractor from monthly performance.

NextEra Energy Partners (NEP) is a growth-oriented contracted renewables company formed by its sponsor and general partner NextEra Energy (NEE) to own, operate and acquire contracted renewable energy generation assets located in North America. The share price of NextEra Energy Partners fell as the higher rates narrative impacted longer duration stocks, along with general market weakness.

All returns are in local currency.

Positioning and Outlook

On a regional level, the strategy's largest exposure is in the U.S. and Canada (43%) and consists of exposure to regulated and contracted utilities (31%) and economically sensitive user pays infrastructure (12%).

For the **ClearBridge Developed Markets Infrastructure Income Strategy**, the primary quantitative tool in portfolio construction is excess return, on which our stock-ranking system is based. The ClearBridge Developed Markets Infrastructure Income Strategy also uses yield quality as a secondary measure. As such, driven by valuation, the Investment Committee initiated a position in U.S. electric utility Southern Company.

Monthly Stock Highlight

This month we review U.S. electric utility Southern Company.

Southern Company serves 4.4 million electricity customers in south-east U.S. Southern has over 42,000MW of generating capacity in Georgia, Alabama, Mississippi and Florida and has some of the best regulatory relationships in the nation. Southern businesses include electric utilities in four states and a growing competitive generation company, as well as fibre optics and wireless communications.

Southern has three regulated electric utility subsidiaries, Alabama Power, Georgia Power and Mississippi Power. The company also has a network of regulated gas local distribution companies across seven states as well as midstream operations and an unregulated business (Southern Power) that owns one of the larger portfolios of wind and solar in the U.S.

Completing construction of the Vogtle nuclear plant is seen as a substantial overhang and has resulted in Southern trading at a significant discount to peers. We believe that the discount is unjustified for two reasons. First, while the company estimates that it will take around $USD2 billion to complete the project, its 5-year capex plan is $USD40 billion - only a small amount of the overall picture. Second, construction of Unit 3 is 95% complete and functional testing could commence as early as next month. The remainder of the business is considered high quality, with above average permitted returns of ~11% and equity layer of 55%. There are also significant opportunities for investment going forward e.g. plans to replace coal generation which makes up 22% of current generation. The dividend yield is 3.9% which remains above peers and a rebasing appears unlikely as the company considers the dividend sacrosanct. There is also ample liquidity available as a cushion until Vogtle's completion, at which point the plant will generate additional cash flow of ~$USD800 million p.a. for the company.

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