Investors' Chronicle | Alpha

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Alpha shares analysis

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Leopards changing spots

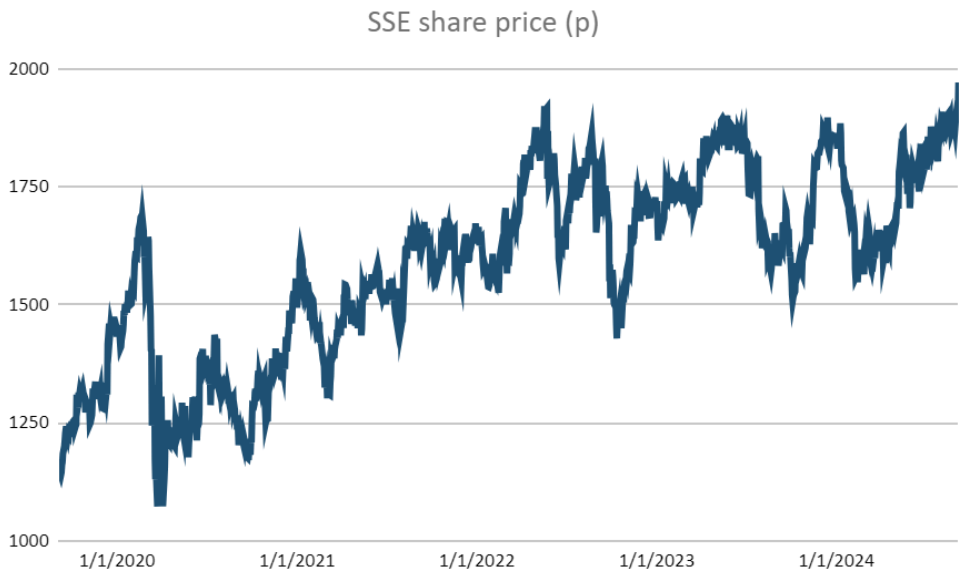
The energy transition is big business, yet there are relatively few ways to invest directly. Perhaps the easiest way to gain exposure is by buying into companies that still make money from old sources of energy, too. This week we recommend taking a look at a former bond-proxy utility business that is transforming into a clean energy growth stock and a 'big oil' business looking to replace a substantial amount of its 'dirty' energy earnings with something greener.

- SSE (SSE) – For over 25 years, SSE was known as a 'dividend hero', acting as a reliable bond proxy investment by providing investors with steadily increasing income. However, since 2019, the board has reduced the dividend twice and shifted focus towards green investments, transforming this previously stable income stock into a more dynamic growth stock. SSE is already the UK's leading green energy generator, surpassing competitors like Drax, and its capacity is expanding quickly. Additionally, significant investment is being channelled into the often overlooked areas of connectivity and distribution. With solid earnings per share (EPS) growth, a market-average yield, and potential for a future re-rating, investors could expect double-digit total shareholder returns (TSR) over the next three years, with the possibility of outperforming the market up to 2030 and even beyond to 2050.

- BP (BP) – Oil stocks face a significant image problem. Despite generating high profits and operating in a market where oil demand is expected to decline only minimally, even with large-scale energy transition, they remain viewed as undesirable investments. However, BP is currently directing around a quarter of its capital expenditure towards green energy and related sectors, with the potential to generate 33-50 per cent of its earnings before interest, taxes, depreciation, and amortisation (Ebitda) from non-oil activities by 2030. Similar to SSE, this transition is expected to lead to a re-rating, potentially allowing the stock to achieve double-digit total shareholder return (TSR) over an extended period. It may seem counterintuitive, but we have previously suggested that investing in green energy conversion might be more effective through traditional oil companies. These firms have the most to lose from the energy transition, the greatest need to improve their investment ratings, and the financial resources necessary to develop greener technologies that will help offset the decline in profits as oil demand gradually decreases.

Analyst: **Robin Hardy**

SSE – cutting or pruning?



Source: LSEG

SSE (SSE) is a UK diverse energy and electricity business with seven discrete business units across the energy space. It no longer has a UK domestic supply business making a well-timed exit at the beginning of 2020, selling seven million customer accounts to OVO.

Renewables – a green electricity generator operating onshore & offshore wind, pumped hydro, solar and battery storage.

Thermal – gas fired power generation plus carbon capture and storage (CCS), hydrogen thermal, energy-from-waste and energy storage (grid scale batteries).

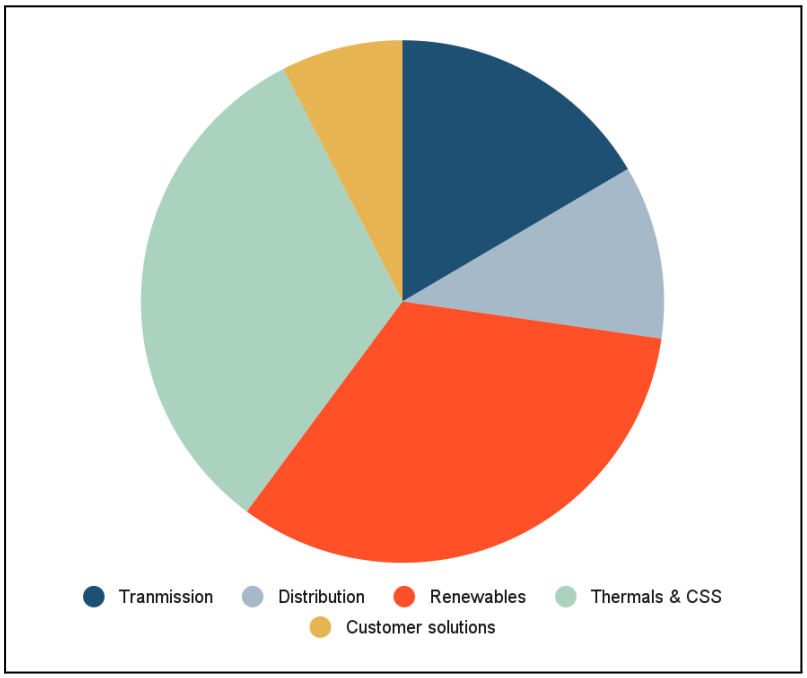
Transmission – operating the electricity transmission network in the north of Scotland for 132kV, 220kV, 275kV and 400kV systems; and investment in a wider network.

Energy solutions – direct and joint venture (with TotalEnergies) investment in and consultancy for decarbonising systems local heat, transport and energy systems in the UK and Ireland.

Airtricity – retail green electricity supply in Northern Ireland and Ireland.

Energy markets – managing wholesale energy trading to buy-in and sell-out electricity for its own contracts and for third parties.

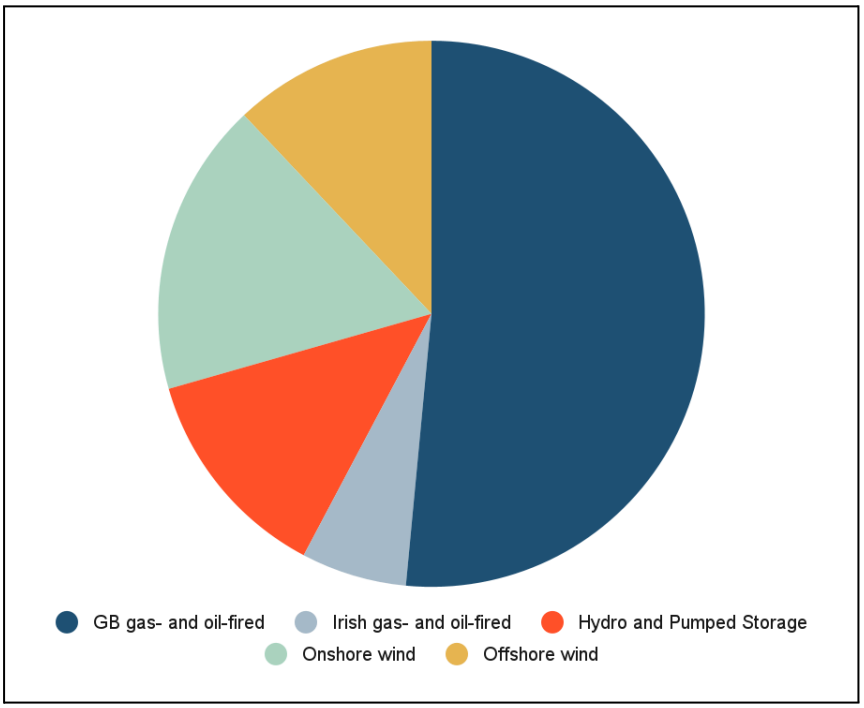
Business split – 2023 EBIT



Source: SSE

SSE has a market cap of £21bn, delivering around £11bn of revenues and £2.5bn of EBIT. Performance has been positive with a 112 per cent TSR over five years (16 per cent per annum) - roughly two fifths of that coming from income.

SSE electricity generation – 26GWh capacity



Source: SSE

This is a story of conversion: on the one hand, a business playing a key role in decarbonising the UK economy and on the other, its own shift from a plodding utility viewed by most investors as a dull but dependable bond proxy stock. Growth (actually more likely growth and income) is the preferred path for most investors, especially where that growth is going to be supported by positive macro trends and by accelerated policy. The transition to cleaner energy generation along with an improved grid and up-rated local distribution is a very large and enduring operating framework that should allow SSE to sustain an above market average rate of growth until at least 2035 and with continuing solid prospects until 2050, the objective for the "Government Net Zero Target".

Energy transition

SSE is a major contributor to the UK's energy transition, being the largest renewable energy generator in the UK and Ireland. The company has ambitious plans, involving over £20 billion in capital expenditure, to boost its clean energy generation and improve distribution, which is a crucial yet often overlooked component of the green grid and local generation schemes. The five-year plan, known as the Net Zero Acceleration Programme (NZAP), spans from 2022 to 2027 and aims to increase green generation capacity from 4 gigawatts (GW) to 9 GW, primarily through offshore wind. It also includes an £8 billion investment in expanding and extending the transmission (the national grid) and distribution (local networks) systems, alongside efforts to reduce emissions from thermal and gas-powered stations that will continue to be a significant part of the UK's energy mix for years to come. As the first two charts (above) illustrate, natural gas remains a major component of UK energy generation, though its usage is rapidly declining.

Gas, or 'thermal' power, is still necessary due to the intermittent nature of both wind and solar energy, ensuring a flexible baseline of generation is always available. In the future, battery and hydrogen storage will increasingly fulfil this role, alongside nuclear power at both the grid level and locally through Small Modular Reactors (SMRs). As with the demand for crude oil, the demand for gas-fired power is unlikely to disappear entirely for a considerable time. Therefore, similar to the oil sector, the advancement of green and clean energy over the next 25 years is a matter of 'and, not or'.

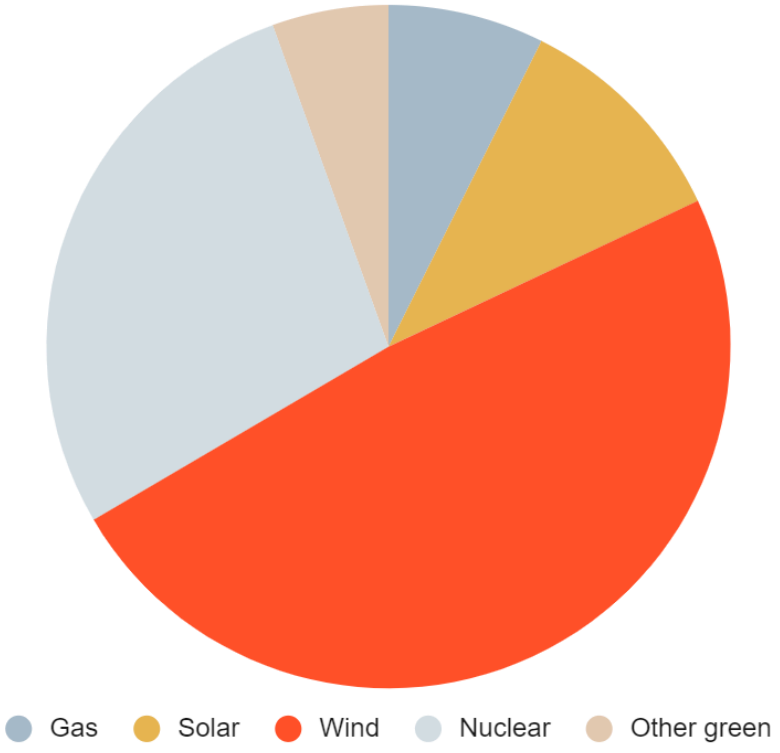
An often overlooked but crucial area of growth in decarbonisation is transmission and distribution. While large generating assets are more visible, these must all be connected to the national grid, new local distribution networks, or high-demand hubs such as centralised electric vehicle (EV) charging stations. Nearly half of the capital expenditure (capex) in SSE's NZAP is allocated to transmission and distribution rather than generation. This creates a highly stable business, as the primary customers are effectively public bodies, resulting in higher quality revenues.

Additionally, these revenues are linked to CPIH (Consumer Prices Index including owner occupiers' housing costs) inflation, which is typically one of the higher measures of price increases (currently 2.87 per cent compared to the basic CPI at 2.2 per cent). By 2027, over 60 per cent of

SSE's earnings will come from this stable, regulated base. This is a higher quality business compared to solar or wind generation because, as experience shows, green generation can be unreliable due to weather conditions—offshore wind being an exception. In contrast, the transmission of power is inherently more stable in terms of demand.

In 2024, the majority of SSE's capital expenditure (55 per cent) was allocated to networks, with 45 per cent directed towards wind generation, and only 4 per cent invested in thermal generation. The remaining 6 per cent was devoted to emerging technologies, including carbon capture and storage (CCS), energy cybersecurity, hydrogen for generation and storage, geothermal, and bioenergy. These investments allow SSE to maintain a presence in technologies that are currently small-scale but have the potential to become significant in the future.

UK's target electricity mix for 2050



Source: SSE, Statista

Strong capital allocation profile

SSE's capital allocation policy has materially shifted. From higher dividends and share buy-backs, it has swung to lowered shareholder rewards, higher capex and higher debt. Businesses might normally be expected to lower debt as a good use of their free cash flow. However, while SSE looks to have relatively high debt (2.8x Ebitda or £9bn) for utilities, debt forms a larger part of the equity base than for other sectors, and the management's ceiling on its debt is c.4.5x EBIT (earnings before interest and tax). As Ebitda is rising and should reach around £4.5bn by 2027,

the debt ceiling will be around £21bn. Overall, this is better than National Grid's expensive and dilutive, deep discount rights issue.

Free cash flow is forecast to be strong and in the next three years should total £11bn. With non-core disposals of c.£1bn the £20.5bn investment programme from 22-27 will be funded by taking on around £7bn of additional debt. Dividends are factored into the plan at a cost of £4bn in total, so everything that SSE is looking to deliver in its growth plan is fundable. Overall, this major change in the capital allocation is for the good as it raises the quality of earnings.

Quality of earnings

SSE's quality of earnings are rising through: the growing exposure to a high growth market; the decision to move away from low growth/low quality domestic supply; the bold decision to convert the business from an income to a growth oriented stock. In the five years before selling off the domestic book, EBIT barely grew (from £1.6bn in 2013 to £1.8bn in 2018) but, since the change of focus, EBIT has grown from the re-based £1.2bn (the consumer business was dull but profitable at c.£750m of EBIT) to £2.4bn in 2024. However, this is a somewhat inflated figure because of much higher wholesale energy pricing. What is notable is that while other energy-oriented stocks are likely to see profits fall back as prices stabilise, the consensus is for SSE's profits initially to hold at the 2024 peak level and then press on to be close to 30 per cent higher by FY2028; by this stage EBIT is forecast to be more than 2½ times higher than in 2019 post the sale of the consumer supply business. Transparently, SSE's changes have created a large amount of shareholder value.

SSE's earnings quality is improving due to several factors: increased exposure to a high-growth market, the strategic shift away from low-growth (and low-quality) domestic supply, and the bold decision to transition focus just from paying dividends to growth. In the five years prior to selling off its domestic business, earnings before interest and tax (EBIT) saw minimal growth, rising only from £1.6bn in 2013 to £1.8bn in 2018. However, following the change in strategy, EBIT increased from a re-based £1.2bn (with the consumer business, though steady, contributing approximately £750mn of EBIT) to £2.4bn in 2024. This figure is somewhat inflated by significantly higher wholesale energy prices.

What stands out is that, while other energy companies are expected to see profits decline as prices stabilise, the consensus is that SSE's profits will initially hold at the 2024 peak level and then grow to be nearly 30 per cent higher by FY2028. By that time, EBIT is expected to be more than two and a half times greater than it was in 2019, following the sale of the consumer supply business. Clearly, SSE's strategic changes have generated substantial shareholder value.

The dividend

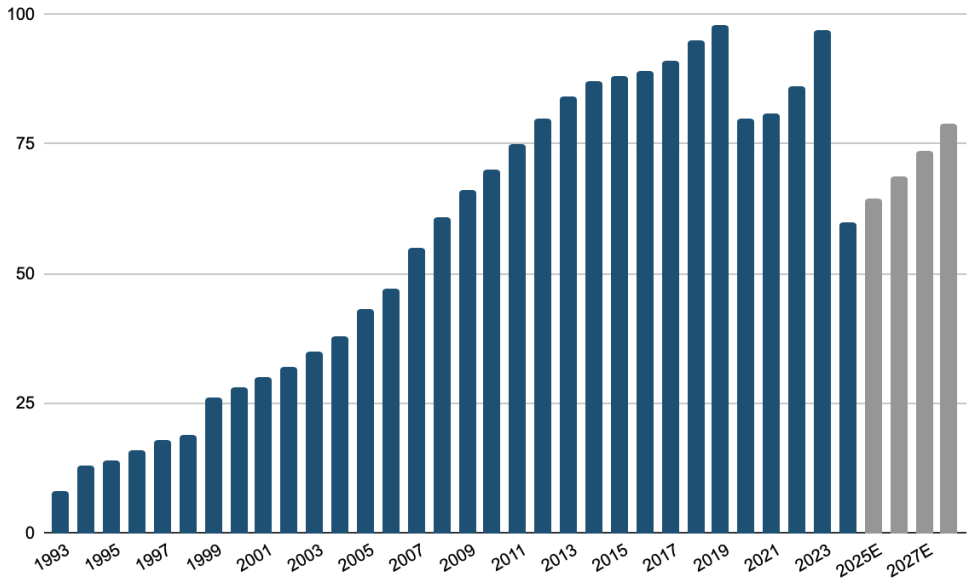
For 20 years SSE was seen as a 'dividend hero', a stock offering a good level of income with an unbroken growth record. As the chart below shows SSE increased its cash dividend from the time of its IPO in 1993 for the next 26 years. However, since then the board has decided to lower the payment twice, first in 2020 (97.5p to 80p) and again in the year just ended (from 96.7p to 60p).

While we have referred to this as 'cutting' the dividend, a term typically used when a company lowers payments due to affordability issues, a more accurate description might be 're-basing' or, even better, using the gardening analogy, 'pruning'. Pruning is done to maintain a plant's health and encourage growth, which is effectively what has happened here. The reduction in dividend payments has saved £620mn (compared to what continued payments post-2019 might have cost), and these savings, along with carefully managed debt expansion (avoiding the debt issues seen in the water sector), grants, and co-investment with other businesses, are now being reinvested in growth.

The lower dividend, like SSE's earnings, is of higher quality. Firstly, the dividend cover has improved (from 1.4 times pre-pruning to 2.4 times currently). Secondly, the dividend is growing faster (2.5 per cent before the first reduction, with a 7 per cent increase forecasted since the latest reduction). Thirdly, the dividend was reduced to enable faster growth and broader investment. Fourthly, the yield remains attractive at a more typical 3 per cent historically, with projections to rise to 4 per cent.

Today, the dividend appears very solid, and with strong earnings per share (EPS) growth, prudent capital allocation, and a more sustainable yield, it is unlikely that the payment will be reduced again

SSE dividend history and forecasts

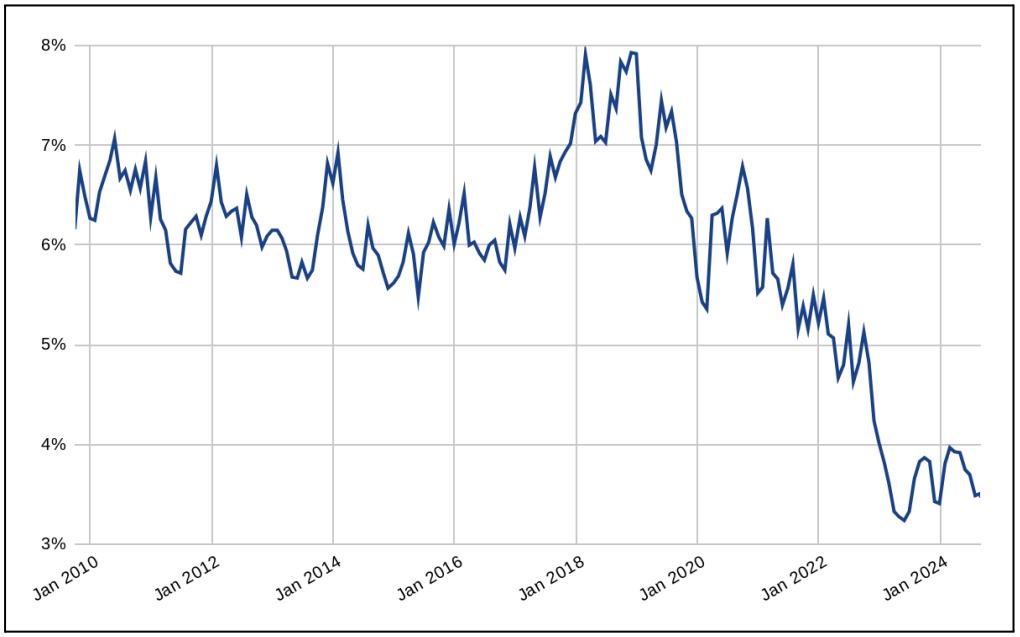


Source: FactSet

Conclusions and valuation

There are several positive aspects to the SSE investment story. These include its exposure to the energy transition, drivers with long-term visibility, a revamped capital allocation strategy, a higher quality yield, improved earnings quality, and bold management. All of this is reflected in a price-to-earnings (PE) ratio of just 11.5x, which is expected to decrease to below 10x by the third year. This rating might seem reasonable if earnings were still inflated by the energy crisis and set to decline, but further growth is anticipated, even with an expected drop in thermal generation profits due to pricing. This indicates a business model focused on investment and expansion in the right areas. The recent successful auction for offshore wind contracts, following a previous round with no bids, suggests that the transition away from fossil fuels is accelerating. In light of all this, the current PE ratio appears low.

SSE forward dividend yield since the GFC



Source: FactSet

The dividend looks secure, and although the yield is not as high as it once was, today's SSE is very different from the company it was before 2019. Back then, the dividend was the primary driver of total shareholder return (TSR) and compensated for a lacklustre share price. However, the drivers of TSR have since reversed, and the yield is now a 'nice to have' rather than a 'must have'

The stock does appear to be under-valued, though it is unlikely that full credit will be given for the Net Zero Acceleration Programme (NZAP) investments until the assets are closer to delivery and there is evidence that the target returns will be achieved. This suggests that, in addition to earnings per share (EPS) growth gradually pushing the share price upward, there is also potential for a moderate re-rating. Assuming the current PE ratio of 11.5x holds steady and applying it to the consensus forecast EPS of 191 pence for 2027, the share price could increase from approximately 1,900 pence today to around 2,200 pence in three years—equating to a 16 per cent total return or a 5 per cent compound annual growth rate (CAGR).

Further, if the market begins to re-rate the stock to reflect the improved earnings quality, even a modest shift toward a 13x PE (still at a discount to the FTSE 100 average) could see the share price rise to over 2,400 pence—resulting in a 27 per cent total return or an 8.5 per cent CAGR.

Adding in the average dividend yield of 3.5 per cent, this could translate to a 12 per cent annual total shareholder return (TSR) over three years. While this is less than the returns seen over the past five years, during which the market started to price in the anticipated transformation, growth investors may have begun to show interest in the stock. Pure income investors might not find the same appeal as before, but with a low double-digit TSR potential and room for continued growth well beyond the current forecast horizon, long-term growth investors should be taking a look.

BP – not going anywhere

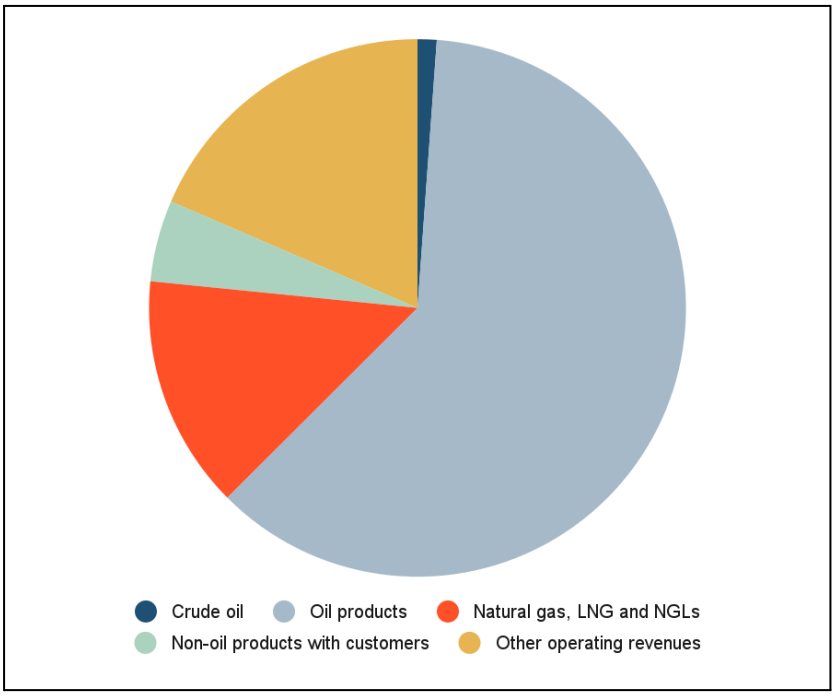
Source: FactSet

BP (BP.) is a global integrated oil and gas company operating in upstream (production and third party sales) and downstream (refining and wholesale & consumer product sales) with a revenue split as shown below in 2023. Oil production has dropped by around one-third since the board succumbed to pressure to exit its stake in Russia's Rosneft – crude production today is around

one million barrels per day. Revenues run out at around $150bn per annum, down from recent highs due to more stable oil and gas prices since the start of Covid and the Ukraine war. EBIT is around $18bn, but both this and revenues are drifting slowly downwards on levelling out of demand and lower price expectations. Estimates have been falling for the last year and today are around one quarter lower than the 2023 peaks. The current oil price weakness may drive this for longer.

There is a decent yield (5¼ per cent on 2024 consensus) with payments forecast to rise by 18 per cent by 2027. Total shareholder return (TSR) has been poor at just 12 per cent total over the last five years with a capital loss of around 15 per cent, and a similar capital loss in the last 12 months. BP is dual-listed in London and in Frankfurt on Xetra and has a market cap of around £70bn.

BP revenue split 2023



Source: BP | LNG = liquefied natural gas; NGL = natural gas liquid by products

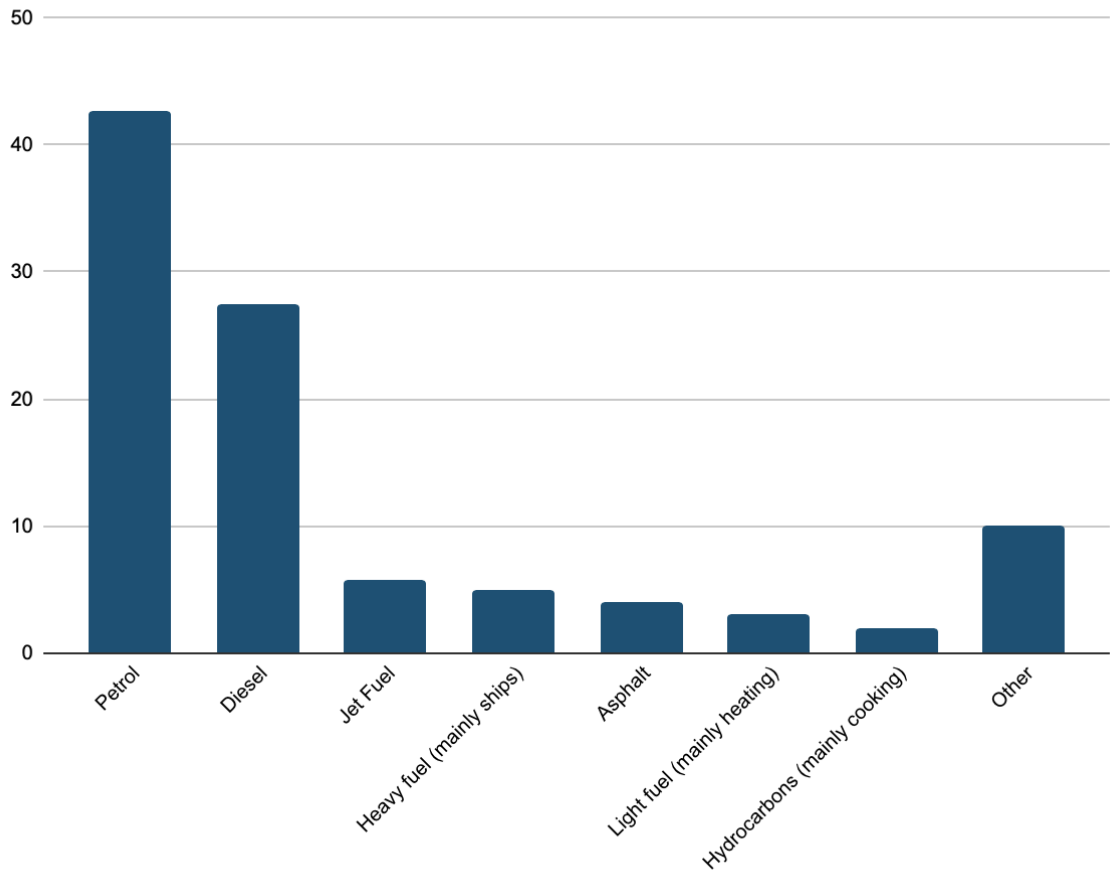
Large oil and gas has long been a pariah sector, transparently a major contributor to both global warming and increasingly poor air quality in many parts of the world. This, plus supernormal (often viewed as usury) profits when the oil price spikes, leads this sector to be something of an Aunt Sally and is a frequent target for additional, often punitive taxation. This can have a somewhat levelling effect on the profitability and cash flow for shareholders. As the green energy transition gathers pace, is oil rapidly going to become yesterday's energy source? Not so fast.

Oil demand

It might appear that oil demand is heading into terminal decline as oil fired power is pushed out by renewables and electric vehicles are planned to fully dominate new cars within the next couple of

decades, in some markets at least. However, oil demand is forecast to remain at a high level for many years even if the historic long term growth rate (historically higher than global GDP although only 1 per cent annually since 2005) isn't maintained. Goldman Sachs reckons that oil demand is still 10 years from peaking (110 million barrels/day by 2034 versus 102 million barrels in 2023). The investment bank then forecasts a slow decline with demand dropping around 1.5-2 per cent only by 2040 and remaining close (but below) to 100 million even by 2050. Petrol and diesel demand in the GS model has, notably, already peaked and petrol will halve by 2050.

Uses of crude oil



Source: Visualcapitalist.com, Canadian Assoc of Petroleum Producers | Other = plastics, agrochemicals, paint, tyres, candles, cosmetics

Oil prices are and will remain erratic and unpredictable, but are unlikely to show any significant underlying fall in real terms. This, of course, depends on reserve depletion, new finds and the rate of voluntary well closures. In cash terms, the EIA (US Energy Information Agency) suggests the following trend per barrel for the Brent Crude standard: $61 in 2025, $73 in 2030, $80 in 2035, $87 in 2040, $91 in 2045 and $95 in 2050 indicating perhaps that supply will drop faster than demand in the coming years. The EIA also suggests (disturbingly) that the world can only achieve full net zero carbon if oil demand drops to 24 million barrels: that underscores how steep the climb to global net zero will be.

Energy transition

Facing a long-tail decline, the better run oil & gas businesses are investing in energy transition, although given the near glacial pace of and limited decline in crude oil demand, their efforts are often relatively slow. In its own literature on low carbon energy BP stresses that clean energy will be an "and, not or" situation. That said, BP has sharply stepped up its investments in low carbon energy from just 3 per cent of total capex in 2019 to 23 per cent, $3.8bn, in 2023. This investment was primarily in biogas, carbon capture, offshore wind, solar and electric vehicle (EV) charging. Total investment was fractionally lower than in 2022.

However, only a little more than half of this capex is spent on actual low carbon energy directly with a substantial amount being spent on EV charging, and here someone else invests in clean generation. BP is only playing a passive role plus protecting its significant retail operations from fast declining fossil fuel demand.

That same hint of a defensive mindset is also present in the investment in hydrogen production. Almost all hydrogen today is produced using the 'grey' process of cracking methane (CH_4, natural gas – one of the largest end uses for natural gas) using steam which releases a lot of CO_2 into the atmosphere. BP is investing in 'blue' hydrogen (grey but with carbon capture) and 'green' (cracking water using fuel cells) but the production of 'clean' hydrogen remains tiny with blue at 0.7 per cent and green at 0.04 per cent of global output in 2022. BP is a major natural gas producer and would want to protect the process that can promote hydrogen in the clean energy mix (direct burning, methane enrichment and energy storage). As we have discussed before, fully converting to 'green' production would require trillions of dollars in investment and is, for any meaningful impact, well beyond the scope of individual businesses.

BP's presence in offshore wind generation is a more direct play in energy transition with operations in the UK, Germany, USA, Japan and South Korea. By 2030 there are plans to generate around 10GW of electricity, six in the UK (the government target by 2030 is for 50GW of capacity, so BP could be a material player).

CCS or carbon capture & storage is another area of investment for BP working as part of the East Coast Cluster consortium (with Equinor and TotalEnergies). This a project to scrub emissions from industry and power plants on the Humber and the Tees. This is a netting exercise rather than full energy transition.

The final green footprint is in solar via a 50 per cent holding in a JV Lightsource BP, which is the largest solar generator in Europe and one the world's largest outside China, with operations in 19 centres globally. Installed power, however, is just 9.5GW (115GWh assuming 12 hours of sunlight daily) which compares with global electricity demand of 27,000 terawatt hours. That means BP could generate power to meet a tiny fraction of global electricity demand.

Conclusions

While BP is involved in the energy transition process and has massive resources available to invest, one could be concerned that its investment has a sizable tangential twist to it. There is potentially as much investment to underpin falling 'dirty' energy as there is in making a true contribution to lowering carbon. That's good for its business but is less green. .

Clean(er) energy involvement and business other than fossil fuels is, however, going to grow fast within BP. In 2023, green/clean/other energy delivered an Ebitda of $1bn within the group total of $44bn, so still in the margins. However, growth ambitions are substantial with a target for 2025 of $3bn-$4bn and an 'aim' for 2030 of $10bn-$12bn. Note also that the general trend for Ebitda towards the end of the decade is one of shallow decline and potentially a group total of only around $37bn-$42bn. That could mean that green/clean energy may move from 2½ per cent of the group total to 30-35 per cent in just seven years. It would be hard to invest in that expansion rate.

That scale of profits and that change in the importance of green energies demonstrates how BP may be more of a play on clean energy than one of the smaller, niche companies such as Ceres or ITM Power. For instance, if ITM Power was to achieve profitability by the end of the decade, it might be making £30mn against BP's $10-12bn. Notably, the PE at ITM even by 2030 is likely to be 2x or 3x that of BP today.

We do need to be careful that a lot of the profit from BP's transition drive will not be directly lowering greenhouse gas emissions. As mentioned, EV charging is relying on someone else to do the heavy lifting of generation and transmission. But, that said, widespread EV charging does make the switch to electric more viable. Also 'convenience' is a large part of BP's drive for the growth of other revenue streams – this is food & beverage provision at the roadside and is aiming to deliver more than $4bn of the $10bn-$12bn in 'clean' profits. This is not green at all but is still a move away from fossil fuel profits.

We have argued before that the best growth in new and alternative energies is likely to come from the more enlightened big oil businesses (i.e. less likely to include US businesses and those from OPEC nations but strong from European operators) as they: 1) have the resources to make the investment; 2) have the global spread; 3) have the incentive to plug the growing fossil fuel gap in their profits; 4) need to do better for their shareholders by raising the quality of earnings and shedding at least some of that pariah discount; 5) by delivering on point 4, the shareholder base could widen (less ESG issues), also having a positive impact on the rating.

Investing in BP is transparently not a pure green investment, but it could be the cheapest, fastest growing, most impactful way to see cleaner energy spreading, although there is no escaping that this is a company still chest deep in dirty and polluting industries. That is all bound up in the rating with a 2024 PE of 8x, but this falls to just 5.7x by 2027. This low PE should not, however, be viewed either through the lens of classic reasons for single digit valuations, namely an expected EPS collapse or a cyclical, false highpoint PE – its is all about the quality of earnings and the still

large numbers of people who will not or cannot - because of environment, social and governance (ESG) policies - buy the shares.

There is also the ever present risk of catastrophe. BP is still paying out over $1bn in the last year for the Deep Horizon spill 14 years ago with a total settlement of $65bn – that is 70 per cent of the market cap to settle a single (albeit catastrophic) incident. This is and will remain a drag on the valuation of oil-related earnings.

Establishing a fair value for an oil giant is problematic – catastrophe risk, oil prices (remember the oil price went technically negative during the early days of Covid) and punitive taxes are a permanent overhang. Add to this the ending of market growth and then rolling into decline then a low rating for oil-related elements is inevitable. However, within 10 years 33-50 per cent of the earnings could be coming from green and/or growth non-oil markets. These are more palatable to investors so the earnings profile should improve. The oil business might justify an even lower rating than current 5½x PE, but the market is clearly willing to pay 2-3x that for greener, cleaner energy businesses and divisions.

Potential valuation for BP

2030 EPS	Weighting	PE ratio	
Dirty	50%	5.0x	2.5
Clean, green and other	50%	12.0x	6
Overall group	100%	8.5x	

Source: Investors' Chronicle

If earnings per share (EPS) by the end of the decade (admittedly, a dangerously long way off to be forecasting for investment calculations) could be more than 75p, then could a fair value for the shares be as high as 600p (using the 8.5x PE from the table above) against today's 430p? That is very speculative but logically does point to a materially higher share price than today. If 600p was achievable then the capital element of TSR would be 40 per cent in six years or 5½ per cent per annum. From income, dividends per share (DPS) might easily average 28p through to 2030 to give 196p, so total return could be 85 per cent or a 9 per cent CAGR.

BP is still a risky and quirky, tangential way to play energy transition. Furthermore, pure-plays already on the market (and doubtless those to come) could easily make returns that are multiples of this but they are likely to be volatile and possibly very illiquid (the shares less easy to buy and sell at a decent spread). BP should at least be considered as part of a portfolio if one is looking for profit from the long energy transition.

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