Renewables and grids: The dynamic duo powering growth for European utilities

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Energy transition-related goals and timelines are being recalibrated, but for investors who can take the long view there remains a rich opportunity set.

The tailwind from fiscal stimulus has already helped propel changes. However, politics, regulation, trade policy and legal rulings add uncertainty to the outlook.

The implications of a Trump Administration on utilities companies may be front of mind for many. Risks include opposition to renewables, potentially higher inflation and bond yields, and lower gas prices.

European utilities have posted solid returns over the past six months, so the short-term market reaction to the US election result is not surprising. In the longer term, however, the trend for 'more of everything' when it comes to power generation, electricity demand and grid investment sets a more positive tone for utilities.

Renewables remain key to the energy mix

Fossil fuels will, by necessity, likely still play a key role in the global energy mix in the next decade or two. Views on the outlook for the composition of primary energy usage and how that might change over time vary.

In power generation, capital expenditures on fossil fuel power decreased 10% in 2023, to US$90 billion. Conversely, solar and wind power drove a record- breaking US$735 billion investment in renewables in 2023, according to the IEA. Shrugging off concerns about the profitability of certain firms and higher interest rates, renewables have deployed rapidly in the US, EU and Asia.

In the EU, renewables' share of public electricity generation exceeded 50% for the first time, in the first half of 2024. Over the same period, 65% of electricity on the German grid came from renewables.

Earnings growth among utilities in the EU could improve significantly, according to Capital Group analysis. (See table)

Renewables and grids to power more growth for European utilities?

Illustrative examples: Estimated potential earnings growth attributable to renewables and grids

	Renewables EBITDA (CAGR)		Grid EBITDA (CAGR)	
Company	Last five years	Estimate for next five years	Last five years	Estimate for next five years
Utility A	7%	12%	–1%	9%
Utility B	4%	20%	6%	14%
Utility C	10%	13%	4%	11%
Utility D	5%	5%	1%	4%

Four companies selected from the 25 largest European utilities by market capitalisation. Estimates for potential compound annual growth rate (CAGR) of earnings before interest, taxes, depreciation and amortization (EBITDA).

Source: Capital Group. Analysis as of April 2024.

Our research indicates we may be at a tipping point, with faster growth from both regulated grid businesses and renewables potentially sustaining for the coming decade and beyond. Recent valuations among European utilities haven't reflected the future prospects that our investment analyst anticipates. For long-term investors, this could shape up to be a golden age for grids.

Capital expenditure (capex) on the grid, which could underpin more rapid growth potential, is in effect, unavoidable. "Keeping the lights on" in Europe amid growing power demand will require the grid to adapt:

- **Old infrastructure.** In November 2023, the European Commission noted that about 40% of the European power distribution grid was more than 40 years old (typical asset life is 45-50 years, according to Capital Group estimates).
- **New locations.** The decline of coal-fueled power plants (often in proximity to coal fields), increased urbanisation, and new population centres mean that the locations of supply and demand have changed.
- **New supply.** Removing grid constraints and speeding up connection queues will get the most out of renewables and other new sources of power.
- **New demand.** Electrification — of transport, heating and certain parts of heavy industry — and data centre expansion are creating sources of demand that simply did not exist a few decades ago. Third-party analysis suggested that, as measured by electricity consumption, European data centre capacity will increase fivefold by 2035.

Of course, firms will need to be sufficiently financially strong to support higher capex. That means in the next decade or so, balance sheets will matter even more than usual. In many European markets, regulators limit returns relative to equity (or asset base, capital or cost of capital) for fixed periods of up to five years. Across the continent, these "allowed rates of return" are resetting higher — which should help bolster corporate coffers.

Renewables will likely be both a significant contributor to growth and a major investment area for years to come. The headwinds of higher inflation and higher funding costs may be easing.

Dependent on the specific technology and location, analysis suggests European utilities firms could earn double-digit internal rates of return from renewables projects. Supply chains are a risk in the growth outlook that Capital Group investment professionals are keeping an eye on. Transformers and cables are among the costlier items. Supply is tight, and the lag between order and delivery has lengthened — 18 months or longer is typical for transformers.

We are already seeing considerable progress in grid modernisation and expansion. For example, nearly 90% of the generation capacity connected to German-based E.ON's power grid in 2023 was due to renewables.

The energy transition is in a period of non-linear progress. However, changes are already underway and the direction of travel seems set. The sector continues to offer fertile ground for selective investors.

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