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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Finding Good, Consistent Growth in Utilities

JAY RHAME is CEO and a Portfolio Manager at Reaves Asset Management. He was named to the post on January 1, 2019. He is a member of the portfolio management team, serves on the risk management committee and is Co-Portfolio Manager of the Reaves Utilities ETF. Mr. Rhame joined Reaves Asset Management as a full-time employee in 2005. Previously, he was an energy and utility analyst and one of the firm's traders. Mr. Rhame received a B.A. degree from St. Mary's College of Maryland and is a CFA charterholder.

SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the firm?

Mr. Rhame: We were founded in 1961 and started managing money in 1978. We invest in utility, energy and communications companies. We do deep fundamental research. We like to hold our holdings for a long time. And we've been very successful sticking to what we know. I guess our whole investment philosophy is that we'd rather be experts in areas where we could do well, rather than trying to invest in all areas and be all things to everybody.

TWST: What is your investment philosophy on something like utilities?

Mr. Rhame: I think that most people approach the utility sector as defensive positioning, either for macro reasons or something else. People sometimes miss the fundamental stories that are going on beneath the surface. It's not just dividend yield that is the main driver of returns; we're starting to see real solid mid- to high-single-digit earnings growth that's pretty consistent year in, year out. Yet, we still see people, like we did in the fourth quarter, buying utilities because the market is selling off and you're worried about the rest of your portfolio. Certainly, some of our investments benefit from that, but generally, it's a sector where most people focus on it for macro reasons. We believe there are good reasons to dive into the companies and really look at them, find the differences and take advantage of it that way.

TWST: Do you also have some investors that are looking at it from the dividend point of view? Because fixed income hasn't been paying as much as maybe it has in the past, and this is one way, if you're in retirement years or nearing retirement, that might be interesting to invest in to get the dividend.

Mr. Rhame: Certainly. I think the most important thing is these dividends actually grow if you compare them to fixed income. In our portfolio, the average utility has been growing their dividends 5%, 6%, 7% a year, sometimes a little bit higher than that. And that growth is really the key.

What we tell investors is: Obviously, the stock market goes up and down, and sometimes you have very little control of the volatility. But we know that when we invest in companies that are paying a dividend and growing that dividend, they're creating value. And over time, that value creation should be reflected in the higher stock price. Hopefully, it doesn't take forever for that to happen. But that's the general idea, that at least you have a steady stream of income that's growing year in and year out, and that's really providing a base.

TWST: Did you want to highlight a company that you find interesting now?

Mr. Rhame: Yes. Since the last time we talked, we had a utility in California, **Pacific Gas and Electric** (NYSE:PCG), that went bankrupt. And I'm not actually highlighting that company but some of the companies that have been affected by it. The problem in California was that there were a couple big fires. The way the state has dealt with natural disasters like that is basically the utilities have strict liability. If a utility pole or wire has caused a fire, anywhere, well, they're liable for the entire damage. The last two years, the fires have been incredibly disastrous, and damages are likely in the tens of billions of dollars, so **Pacific Gas and Electric** was forced into bankruptcy.

And that's really affected every company that deals in California. One in particular, **Sempra** (NYSE:SRE), is a utility, which includes **San Diego Gas and Electric**, but they're a pretty diversified company. They just bought a utility in Texas — in Dallas, actually. They have an LNG export terminal that should be operational in the next several months. They have a pipeline business in Mexico and some South American assets that they're actually looking to sell right now.

But you add it all up, and in California, at least the electric utility portion of California is only about 25% of their total assets, whereas the company has had a long track record of very successful growth. They've been able to grow their dividend in the high single digits for a long time. Right now, it may be an opportunity to buy a company that's been successful for a long time but has come down in valuation because of its exposure to California.

TWST: And so one of the things that investors might want to do if they're looking at utilities is maybe find one company that is more diversified, or one that focuses mainly on one state or one region?

Mr. Rhame: Sometimes. It's not really easy to say that. We've had success, a lot of success, over the years by investing in single-state utilities. At least in utilities, we really pay attention to regulation. We go out and meet management teams of all these companies, but we also spend a lot of time talking with regulators both at the state and federal level. And I think people underappreciate how different regulatory policies are from state to state.

So California is really one of about two or three states that have that strict liability standard. If the same fire had happened in New Jersey, for example, the utilities wouldn't have been pushing to bankruptcies, unless they were completely negligent, unless they actually really did start the fire out of pure negligence. So there's a lot of difference state to state. I think that where we've been successful is studying states that are improving and investing in utilities in that improving regulatory district.

So that's the way you can do it, but I think it requires a really close look. We think it requires a lot of experience to really know what's going on in the state to really be comfortable doing that. For the, say, nonspecialist, a diversified utility is certainly a less risky way to go. I think sometimes you can give up some growth potential, but it's certainly less risky from a regulatory point of view.

TWST: And I would think too that sometimes with regulators it might be one governor who appoints them and then that person could be replaced by another governor who is maybe a little less strict on the regulation. So you have to have a broad picture on what's really going on in the state, know some of the specifics.

Mr. Rhame: Yes, absolutely. And some states do some stuff to combat that. A lot of regulators have staggered terms. So a new governor can come in with a completely new energy policy, but it'll take several years until he or she is able to replace all the regulators. But not every state has that for sure. I think one thing that's interesting about the sector in general: I believe that regulatory policies are becoming less and less exposed to the whims of politicians, if you will.

Highlights

Jay Rhame discusses Reaves Asset Management. Mr. Rhame invests in utility, energy and communications companies. He says most investors use utilities for defensive positioning and sometimes miss the fundamental stories under the surface. He does deep fundamental research to find investments he can hold for a long time. Mr. Rhame notes that he is seeing both dividend yield and earnings growth in the sector.

Companies discussed: PG&E Corporation (NYSE:PCG); Sempra Energy (NYSE:SRE); NextEra Energy Partners LP (NYSE:NEP); NextEra Energy (NYSE:NEE); NRG Energy (NYSE:NRG) and Vistra Energy Corp. (NYSE:VST).

Mr. Rhame: Yes. Speaking of renewables, another company that was hurt by the California bankruptcy, **NextEra Partners** (NYSE:NEP). This is the renewable partnership of **NextEra Energy** (NYSE:NEE), which is the biggest utility in the industry. **NEP** purchases renewable energy assets from their parent, **NextEra Energy**. These assets typically have 20-year contracts with fixed prices that go up a little bit every year. So you know how much they're going to make, you kind of know how much growth there is, and really their ability to survive depends on the price that they pay for the assets from their parent.

This is a yield co. What's different about this one than some of the other yield cos — that have really not performed well — is that the parent is very supportive of **NEP**. The price of renewable assets they've sold to **NEP** has always been completely reasonable.

Then, about two years ago, they were one of the first of the whole MLP industry, they were one of the first companies to come in and restructure the IDRs, but they did it for free. They didn't say **NEP** had to pay them to restructure the IDRs. They did it because they wanted **NEP** to have a lower cost of capital, and they wanted **NEP** to survive. And surprisingly, that attitude is pretty unique in the limited partnership area.

They certainly have a lot of contracts, 15% or 20% of their cash flow comes from Northern California, and so there is some exposure to the bankruptcy. We think that the contracts survive because California wants more renewable energy. And certainly, canceling contracts with some of the biggest providers doesn't help you reach that goal any quicker.

But secondly, they have an analyst day scheduled in June. And we think that they're going to talk about some of the recent contracts they've signed, some of which are really exciting. It's something we call the triple play, where they have a deal to sell wind power, solar power and battery power all combined in one contract. The company has been talking about it as if it's almost as good as a baseload generation plant; that's a natural gas or a coal plant. So if the company is really able to do that with a battery connected to solar and wind, that's a huge step forward for the industry and certainly creates a huge backlog of opportunities for the company to then sell down. So that's a pretty interesting company right now.

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Right now, we're seeing renewable energy prices come down so much; there's a lot of technology that's able to be installed that's reducing costs. And now, we're at a time where I think regulators want utilities to spend a lot of money either to improve safety, to increase the amount of renewable energy being generated, to just make the customer interaction a little bit better. And so there's a lot of real positive investments. I think lower bills transcend party lines, right? So if utilities can make investments that are lowering costs, I think that removes a lot of the political risk.

TWST: Did you want to mention another company?

TWST: Could you define both IDR and yield co?

Mr. Rhame: Yield cos are the companies that have highly contracted assets. So most of them are renewable energy, and most of them will have 15- to 20-year contract lives. Then, the company itself would go and pay out all of its cash flow, 98% of its cash flow, in order to have a big dividend yield, hence the term yield co. So really, the companies have survived on their ability to continue to finance.

Every time they wanted to buy a new asset, they would have to either issue equity or raise debt. When the prices of the renewable assets that you're buying are too expensive, the market can balk at raising equity or issuing debt then. And so it's really a cost of capital arbitrage structure that happens to pay out a really good dividend.

So that's where the parent really helps. If the parent is supportive and helps lower the cost of capital for the yield co, the yield co can survive and prosper. But when the parent wants to sell an asset at as high a price as possible and book as big a gain as possible, it can really hurt the yield co.

1-Year Daily Chart of Sempra Energy

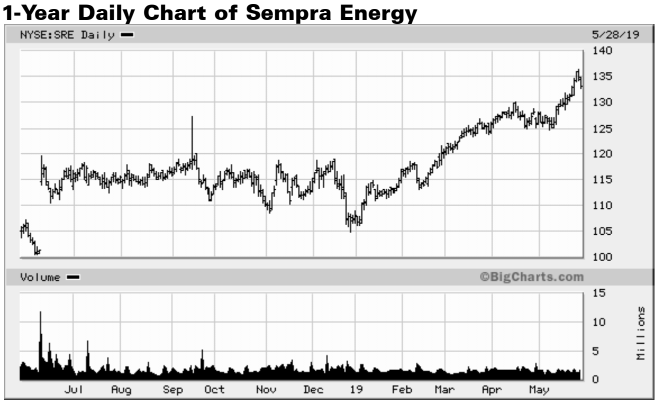

Chart provided by www.BigCharts.com

NRG Energy (NYSE:NRG) and **Vistra Energy** (NYSE:VST). They're both independent power producers. That's really a sector we've avoided for a while because we're concerned about falling power prices, weak demand and new renewables coming on with a marginal cost of power of zero. Their preceding companies had way too much debt five and 10 years ago; there's been a lot of bankruptcies in the industry.

Fast forward to today, both **NRG** and **Vistra** have cleaned up their balance sheets, and they're generating about midteens free cash flow yield, so most of that free cash flow is going to buying back stock. It's a powerful buyback story. Just in the last few weeks, both the stocks have really rallied on an outlook for a warm summer in Texas. The rates — about 20% or 25% of their cash flow comes from Texas.

Heading into the summer, reserve margins, which is the amount of power they have on reserve for a peak day, an estimate, coming in the summer, they were the lowest they've ever been because demand in Texas continues to grow, supply hasn't come on quite as fast. In the last two weeks, the forecast for a hot summer has come down a little bit, mostly because it's been a cool spring. Then, there was a report out that talked about a little over 5 gigawatts of solar and wind power were going to be installed in Texas sometime in 2021 and beyond — a huge number and one that certainly affects the long-term outlook for these companies.

But I think what they're missing is that there's so much free cash flow, the companies are so much better than where they were, and they're a lot better hedged. They have big retail books, which effectively hedged a lot of that out-year power price exposure. I think both stories are pretty good and interesting at these prices.

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1-Year Daily Chart of NextEra Energy Partners LP

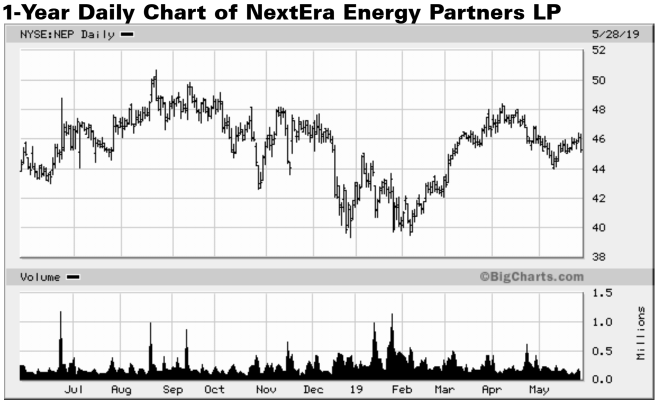

Chart provided by www.BigCharts.com

IDR is incentive distribution rights. That is where if the limited partner grows their dividend, as they do, the general partner receives a higher and higher share of the dividend. This has been a pretty standard structure across the energy MLP world, and **NEP** and **NEE** used it for this one. Essentially, when the parent reaches a deal with **NEP**, they were able to lower those incentive distribution rights, which has effectively brought down the amount of cash that **NEP** had to pay out each quarter, which then increased the amount of cash available for the limited partner holders.

TWST: Did you want to mention one other company?

Mr. Rhame: Yes. This is kind of a two-in-one because they have both been affected by the same thing, both interesting right now:

TWST: Changing direction a little bit, as we look at the sector this year and into next year, are there new technologies that are coming onboard that are going to change the way that utilities are run, at least marginally, things like artificial intelligence or maybe smart technology or internet of things, or are there others out there?

Mr. Rhame: Yes. There are a lot of technologies. It's hard to say that any of them are really going to change the industry so much. Certainly, battery technology is a game changer, but there's nothing that's new or proprietary to any of the utilities that's doing that. They're mostly piggybacking off the automakers and their research and development of better batteries.

I think all the stuff you mentioned, internet of things, smart grid, etc., will all certainly help. I think it'll help make the utility distribution systems much more efficient. It'll help with figuring out outages quicker. Artificial intelligence, I think, will help a lot with predicting where outages might occur, and so improving your maintenance expense rather than waiting for an outage, because naturally, most outages are going to happen on Christmas Eve or New Year's Eve or the worst possible time.

Anything they can do to improve the maintenance of the system and not have outages would be a huge win for these guys. All that stuff that makes the utility distribution system more efficient really just results in lower costs, lower cost inflation to the customers, and really every utility is focusing on that. They all want maintenance expense to be growing at inflation or less, and a lot of them have been successful doing that. So it's certainly been pretty exciting.

I know a lot of them are building apps on your phone, which will help with hookups and disconnects, moving in, moving out — should speed that along and certainly help reduce truck rolls and stuff like that. So it's nothing that will really change the way utilities operate. I think a lot of it will just help make the assistance more efficient and more affordable for customers.

TWST: Do you foresee more merger and acquisition activity in the next couple years, or is that not really a major factor?

Mr. Rhame: It's hard to say. We went through a big run of M&A over the last five years. So a lot of the big companies are still digesting those acquisitions, but I think there certainly could be. The story we hear from management teams over and over again is that the organic growth opportunities are so good, and that's really driven by installing smart grid or renewable energy.

Those organic growth opportunities are so good and will last for so many years that there's really no need to go out and do M&A. You obviously never say never, and if the right deal comes along at the right time, of course, a utility will look at it. But I don't think there's any need for any companies in particular to have to go out and buy something out of a growth strategy need.

TWST: Is there anything we haven't talked about you care to mention, either about the sector or about your own firm?

Mr. Rhame: One other thing that's been interesting is, utilities were flat in the fourth quarter, and there was obviously a lot of defensive rotation coming in. And it wasn't really surprising that they did so well versus the market when it sold off. What's been surprising is that utilities were up about 10% this year despite the market rebounding so strongly. And I think what that is saying is that some people are starting to not just look at the sector just as a pure defensive replacement, but they're realizing that growth is pretty good, growth is consistent.

Most of the companies in the sector operate exclusively in the U.S., so there's no foreign currency worry. There's no exposure or very limited exposure to any trade war with China or anything like that. In the meantime, you're going to get a nice dividend that grows pretty consistently year in, year out. The strength has definitely been surprising, but I think somewhat warranted.

TWST: Thank you. (ES)

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Virtus Reaves Utilities ETF Top Holdings as of May 31, 2019

Security Description	% of Portfolio
NEXTERA ENERGY INC	16.25%
DTE ENERGY COMPANY	8.43%
SEMPRA ENERGY	6.17%
PUBLIC SERVICE ENTERPRISE GROUP INC	6.05%
NISOURCE INC	5.05%
SOUTHWEST GAS CORP	4.93%
CMS ENERGY CORP	4.78%
NEXTERA ENERGY PARTNERS LP	4.28%
CONSOLIDATED EDISON INC	3.67%
XCEL ENERGY INC	3.45%

Holdings subject to change

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