TD Wealth

# The Growing Demand for Utilities

## Part 1

Market Insights

October 2024

Wealth Investment Office

# Part 1
# The Growing Demand for Utilities

Neelarjo Rakshit, Senior Equity Analyst | TD Wealth

Given where we are in the economic cycle, the utilities sector presents an attractive combination of yield and growth, supported by a capex cycle that should drive above-average historical earnings growth in 2024 and beyond. Having some utilities exposure in your portfolio is a good way to increase diversification and protect against rough patches, particularly with increased recessionary risks on the horizon.

There are a multitude of macroeconomic trends reshaping energy's future and benefitting utilities in the process. We see three key themes that we believe will be drivers of long-term utility-sector demand:

- explosive growth of and demand for data centres
- electric vehicles and their accompanying infrastructure
- load growth acceleration supported by regulation

This article is the first of a three-part series where we discuss how each of the drivers above could influence the long-term demand for utilities across North America. In this installment, we'll delve into data centres — how they have exploded in growth, how the rise in artificial intelligence (AI) is influencing energy demand, and how utilities are positioning themselves to take advantage of the growth in data centres. First, though, let's review some of the more general risks and opportunities that entail an investment in North American utilities.

## We see an opportunity

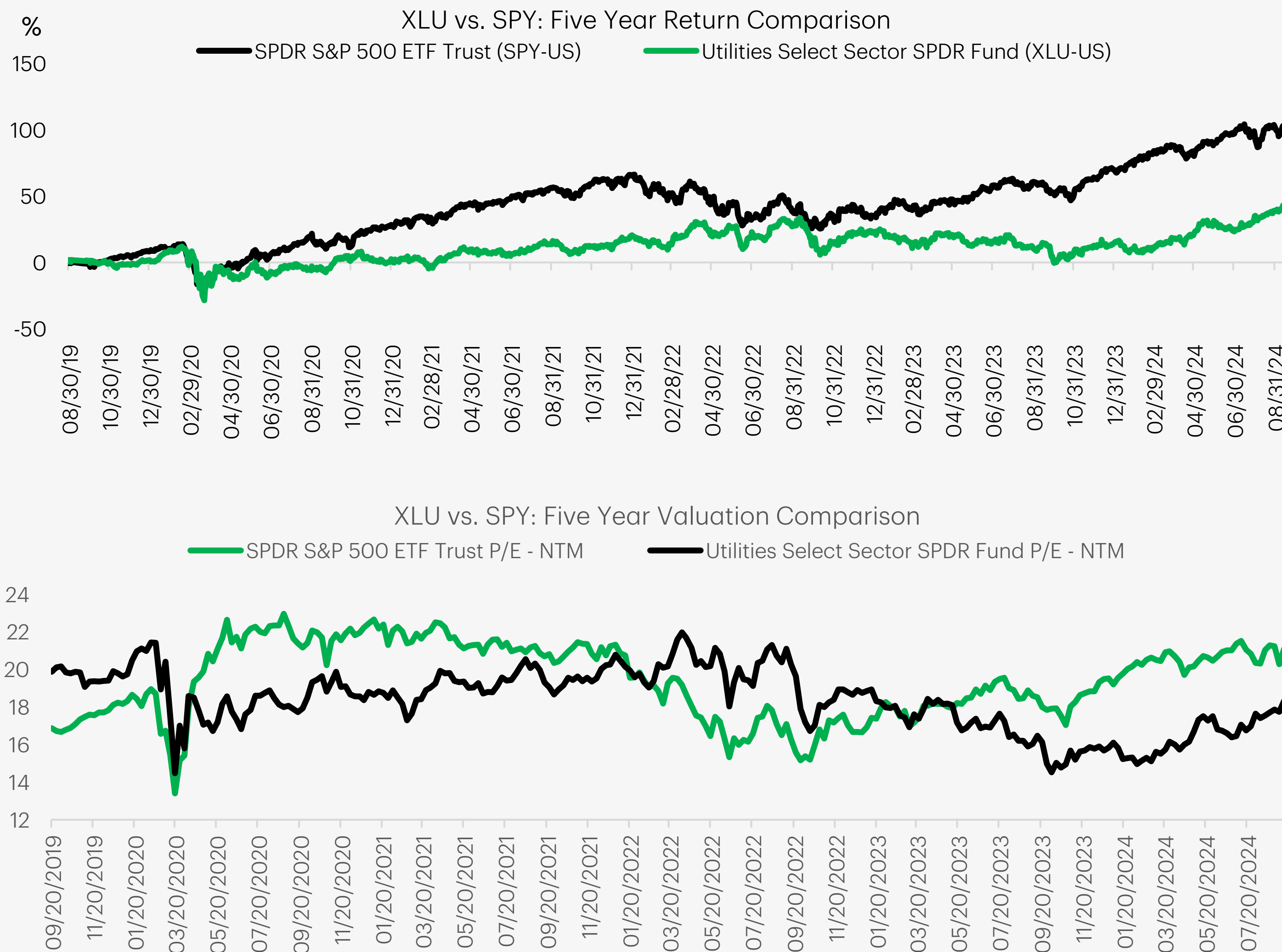
While we, at the Wealth Investment Office, acknowledge the near-term challenges that utilities face — with inflation, rising labour costs and high interest rates — we think the outlook for the sector is positive both over the near term and long. We believe the opportunity for capital expenditures over at least the next five years is significant as utilities continue to support the energy transition.

We believe that renewable energy sources, including wind, solar and battery storage, will become increasingly popular in the coming years as utilities transition their generation fleets to clean energy assets, and that investment into the supporting transmission infrastructure will be robust.

Finally, the utility sector's valuation should also improve through 2025 given downward pressure on interest rates, both in the U.S. and Canada. Stronger growth prospects should drive utilities to trade at a higher relative multiple going forward versus historical levels.

The Utilities Select Sector SPDR ETF (XLU) underperformed the S&P 500 in 2023 by 31% due to a combination of higher-for-longer interest rates, rising labour costs and broader inflationary pressures. As a result, the relative valuation today presents an attractive entry point at a lower beta. As of writing, on September 15, XLU's forward (next 12 months) price/earnings multiple stands at 18.3x, versus 21.1x for the S&P 500 (Figure 1)

**Figure 1: Utilities have underperformed**




Source: FactSet, Wealth Investment Office as of September 15, 2024

It should also be noted that utilities provide investors with a reliable income stream, given that they tend to pay investors a steadily growing dividend. XLU, for example, is yielding 2.82% versus the S&P 500 at 1.23%.

## Still a defensive sector

The utilities sector remains a defensive sector and typically features a steady dividend with single-digit earnings-per-share (EPS) growth through the cycle. The sector continues to hold a significant weighting in North America, comprising 2.4% of the S&P 500 and 3.8% of the S&P/TSX Composite Index with a total public-market capitalization of approximately US$1.3 trillion across North America.

Even though the utilities sector pays a higher dividend yield relative to the S&P 500 today, we note that the sector has compounded dividends at a slower rate than the S&P 500 over the past decade — a 3.6% compounded annual growth rate versus the S&P 500's 6.4% over the same period. Looking forward, however, the utilities sector is expected to grow earnings annually through 2026 at the same rate as the rest of the S&P 500. The sector is projected to grow EPS by 8.5% annually from 2024 to 2026, in line with the S&P 500 (8.6%).

## Explosive data-centre growth influences utility growth

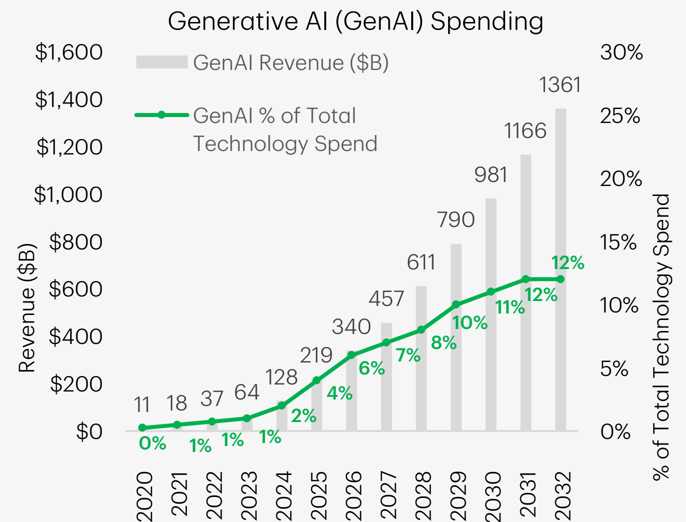
Data centres have emerged as a meaningful driver of power demand in recent years. Secular tailwinds — generative AI, internet adoption, mobile data usage, 5G deployments, cloud storage, as well as migration away from on-premise data centres — should all support data-centre growth through 2030.

Through 2023 and 2024, we have seen tech companies like Nvidia, Google, Meta and Amazon increase their investment in data centres as a way of supporting their AI growth initiatives. Bloomberg estimates that the market for generative AI could grow to US$1.3 trillion by 2032, with the big tech companies benefitting the most (Figure 2).

The development of AI technology requires a significant amount of computing power and storage, and a data centre can provide both. The same Bloomberg report finds that the respective markets for AI infrastructure, computer servers and digital advertising could grow to US$247 billion, US$134 billion and US$192 billion by 2032. As AI continues to advance, demand for these data centres is expected to ramp up to support the technology.

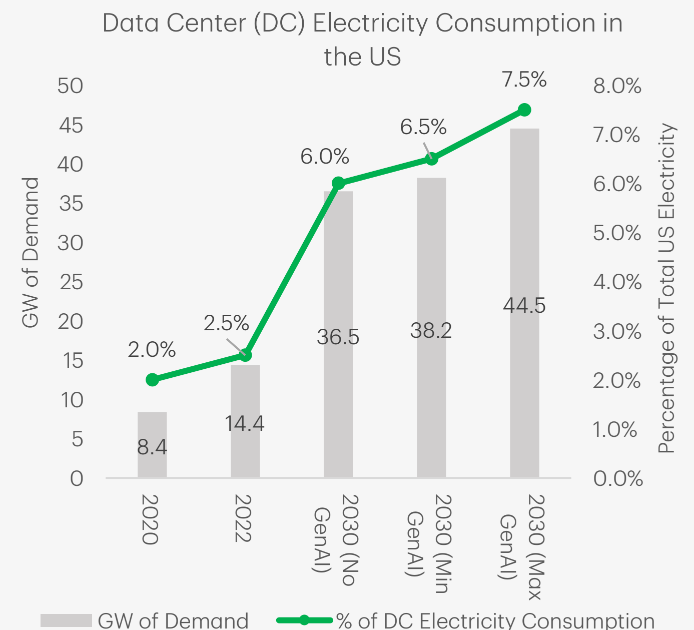
What's important to note, as it relates to the utilities sector, is that these data centres are extremely energy intensive — with the U.S. Department of Energy estimating energy demand at 10 to 50 times that of a typical commercial building. Indeed, data-centre growth is expected to support utility rate base growth through 2030, with most utility companies citing the trend as one of the reasons for upward revisions of load growth forecasts in recent years (Figure 3). Data centres under construction over the next several years should also remain resilient even in a challenging macro environment given their mission-critical nature.

**Figure 2: AI market expected to grow exponentially**




Source: FactSet, Wealth Investment Office as of September, 2024

**Figure 3: Data centres to factor in energy demandof PTPP earnings growth**




Source: TD Securities Cowen as of September, 2024

## Bottom line: AI will require lots of energy

While we acknowledge the near-term challenges that utilities face, we view the outlook for utilities as positive. We believe the opportunity for capital expenditures over the next five years may be significant as utilities continue to support the energy transition. Finally, with rate cuts in the United States and Canada, we believe that the sector's valuation should improve, with stronger growth prospects driving utilities to trade at a higher multiple relative to historical levels.

In part two of our three-part series, we will highlight how electric vehicles (EVs) are impacting long-term demand for utilities infrastructure, and how utilities are preparing themselves for the increased load due to higher EV adoption rates in the 2030s.

# Wealth Investment Office, TD Wealth

**Head of Wealth Investment Office**

Brad Simpson | Chief Wealth Strategist

**North American Equities:**
Christopher Blake | Senior Portfolio Manager
Chadi Richa | Senior Equity Analyst
David Beasley | Senior Quantitative Portfolio Manager, Equities
Andrej Krneta | Senior Equity Analyst
Neelarjo Rakshit | Senior Equity Analyst

**Managed Investments:**
Christopher Lo | Senior Portfolio Manager, Head of Investment Team
Fred Wang | Senior Portfolio Manager
Aurav Ghai | Senior Fixed Income Analyst
Mansi Desai | Senior Equity Analyst
Kevin Yulianto | Portfolio Manager, Equities
Shezhan Shariff | Senior Alternative Investments Analyst

**Investment Consulting:**
Brian Galley | Head of Investment Consulting
Shanu Kapoor | Senior Portfolio Consultant
Richard Nguyen | Senior Portfolio Consultant
Shaun Arnold | Senior Portfolio Consultant
Greg McQueen | Senior Portfolio Consultant
Remek Debski | Senior Portfolio Consultant
Jesse Kaufman | Senior Portfolio Consultant
Ivy Leung | Senior Portfolio Consultant
Anita Linyu Li | Senior Portfolio Consultant
Shaiara Hossain | Senior Portfolio Consultant
Joseph Abinaked | Senior Portfolio Consultant
Dan Iosipchuk | Portfolio Consultant
Kerron Blandin | Senior Portfolio Consultant
Jack Zhang | Investment Management Analyst
Leroy Li | Investment Management Analyst
Daria Yip | Investment Management Analyst

---

The information contained herein has been provided by TD Wealth and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance.

Certain statements in this document may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "believes", "estimates" and similar forward- looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, the general business environment, assuming no changes to tax or other laws or government tregulation or catastrophic events. Expectations and projections about future events are inherently subject to risks and uncertainties, which may be unforeseeable. Such expectations and projections may be incorrect in the future. FLS are not guarantees of future performance. Actual events could differ materially from those expressed or implied in any FLS. A number of important factors including those factors set out above can contribute to these digressions. You should avoid placing any reliance on FLS.

TD Wealth represents the products and services offered by TD Waterhouse Canada Inc., TD Waterhouse Private Investment Counsel Inc., TD Wealth Private Banking (offered by The Toronto-Dominion Bank) and TD Wealth Private Trust (offered by The Canada Trust Company).

Source: London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group"). © LSE Group 2024. FTSE Russell is a trading name of certain of the LSE Group companies. "FTSE®", "Russell®", and "FTSE Russell®" are trademarks of the relevant LSE Group companies and are used by any other LSE Group company under license. "TMX®" is a trade mark of TSX, Inc. and used by the LSE Group under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.

Bloomberg and Bloomberg.com are trademarks and service marks of Bloomberg Finance L.P., a Delaware limited partnership, or its subsidiaries. All rights reserved.

All trademarks are the property of their respective owners.

® The TD logo and other trade-marks are the property of The Toronto-Dominion Bank