Selling: SSE PLC (SSE)

__Managing a portfolio:__ Managing a portfolio is much like managing a garden. There are regular recurring tasks such as trimming back fast-growing plants and replacing unattractive plants with more attractive alternatives. In a portfolio this means regularly trimming back oversize positions and replacing unattractive holdings with more attractive alternatives.

Purchase price	Current price	Holding period
1,333p on 01/11/2011	1,115p on 01/09/2019	7 Years 10 months
Capital gain	**Dividend income**	**Annualised return**
- 14.5%	47.9%	4.7% per year

"SSE is engaged in the provision of energy and related services in the United Kingdom and Ireland, and the developing, operating and owning of energy and related infrastructure" (sse.com)

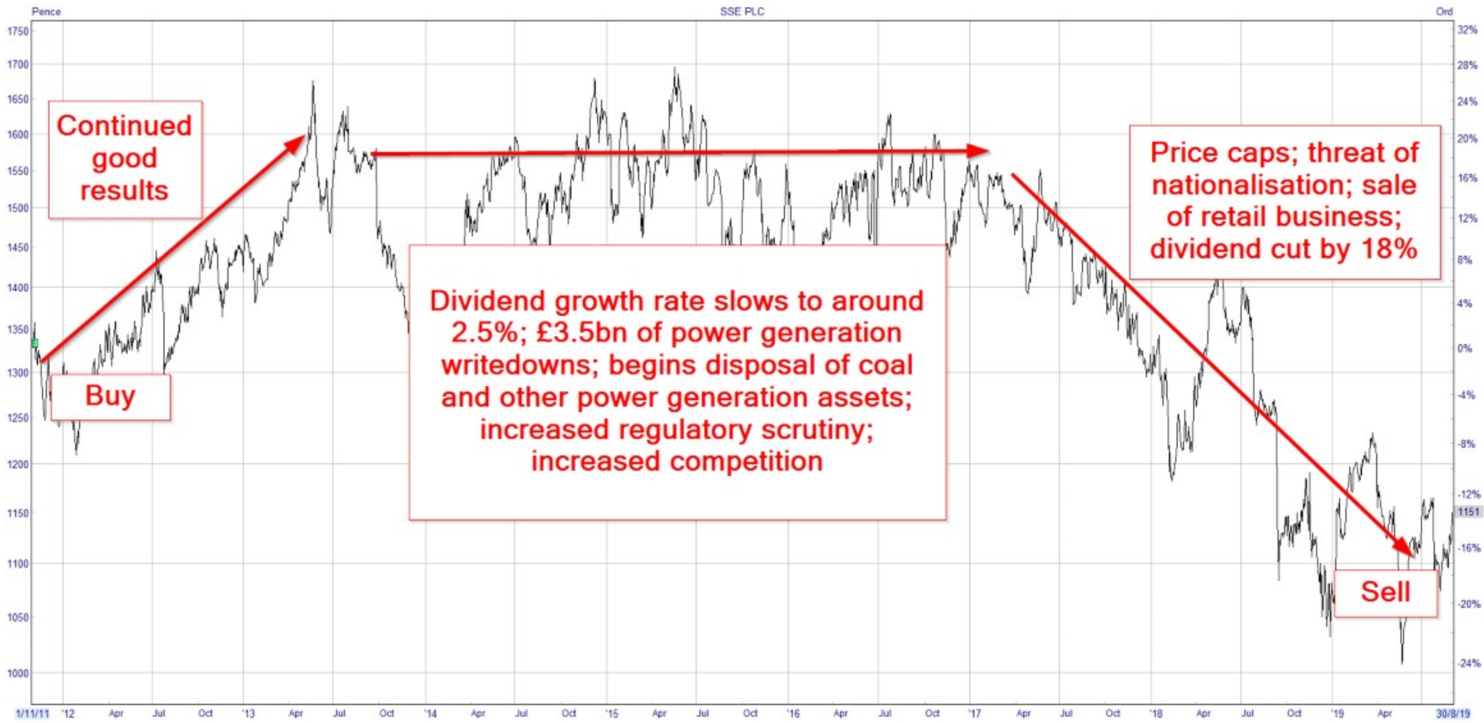
Overview

SSE joined the model portfolio in late 2011 and was the very first company I reviewed in this newsletter. I bought it because it had a ten-year track record of steady growth, very dividend-oriented management and was exactly the sort of large-cap defensive stock I was looking for at the time.

However, things have moved on and both the company's track record and what I look for in an investment have changed. The end result is that SSE is leaving the portfolio as part of what I think of as a process of 'spring cleaning'; removing old investments which don't meet my evolving and more restrictive investment criteria.

The other two companies which have been spring cleaned-away in 2019 are Centrica and Vodafone. Together, SSE, Centrica and Vodafone are great examples of household-name utility companies which at first glance appear to be sensible defensive investments. But if you dig under the covers a bit more, what you'll find is a lot of complexity, a lack of focus, low returns and high debts.

Like Vodafone, SSE suffered a capital loss which was more than offset by its large and growing dividend. Once again, this highlights the useful always-positive nature of dividends. But that dividend is soon to be cut, and with the dividend goes any remaining reason to hang onto this problematic company.



Problem 1: A lack of focus

Warren Buffett has often said he likes to invest in simple and understandable businesses. This makes a lot of sense because if you can't understand a business then how can you have a meaningful opinion on its true value or whether there's a likely gap between market price and true value? This seems obvious enough, but it's something I haven't always paid enough attention to.

And as well as making sense, there's a lot of evidence which suggests that simpler businesses (ones that have had the same highly focused core business for decades) tend to outperform their less focused, less experienced peers.

In this case, SSE does not have a highly focused core business. Instead it has historically had three main businesses: Wholesale (around 30% of overall profits from producing gas and electricity); Networks (around 50% of overall profits from distributing gas and electricity around the UK); Retail (around 20% of overall profits from selling gas and electricity to businesses and households).

I see no obvious reason why these three businesses should be under one roof as there are many examples of more focused businesses in each area: E.g. BP produces gas but it doesn't operate gas distribution assets; National Grid owns and operates gas and electricity distribution assets but it doesn't sell either to households; Telecom Plus sells gas and electricity to households but it doesn't produce or distribute either.

On a more positive note, it does appear as if SSE has finally started to improve its focus. The retail business is in the process of being spun off (if a suitable exit route can be found) and the wholesale business is transforming itself into SSE Renewables, a separate subsidiary business focused solely on renewables without the distracting relics of coal and gas (both of which have an uncertain future if the UK is to meet its 2050 target of producing net zero carbon emissions).

This restructuring is good news and will leave SSE with two focused core businesses, although I still think one focused core would be better than two.

Problem 2: Weak returns on capital boosted by high debts

SSE's renewable energy and networks businesses require lots of expensive capital assets such as wind farms and kilometre after kilometre of electricity cables. This all adds up, and in 2019 SSE was employing more than £15 billion of shareholder and debtholder capital. This creates quite a few problems, so I'll just highlight two of the main ones:

Low returns: SSE's networks business owns and operates regulated network assets. These are gas pipes and electricity cables which are heavily regulated because they are natural monopolies. In other words, if SSE lays electricity transmission cables from one region to another then there is little point in another company doing the same. This is much like the rail network where it makes sense to have a small number of companies operate as regional monopolies and then for the government to heavily regulate them to avoid companies taking advantage of their local monopoly position.

Since energy network revenues are very stable (energy consumption doesn't change much during economic booms or busts), the return on regulated assets allowed by Ofgem, the energy regulator, are quite low (around 6% in 2019). In order to produce reasonable returns on shareholder equity, SSE has to supercharge these returns by taking on lots of debt, and that's the second problem.

High debts: In 2019, shareholders had a combined claim on SSE's assets of £5.8 billion (also known as shareholder equity). Also in 2019, debtholders had a combined claim on SSE's assets of £9.3 billion. So SSE is funded far more by debtholders than it is by shareholders, and that should give you a good idea of who really has power over this company.

High debts are a risk because the more debt a company has, the less wiggle room it has when profits go south. In SSE's case, its £9.3 billion debt pile is slightly more than 11-times its ten-year average profits of £0.85

billion. That's more than double my preferred debt-to-profit ratio of 5.0, and if SSE's future includes a few unexpected bumps in the road then a large dividend cut and even a rights issue could be unavoidable.

The counter argument would be that renewable and network revenues should be very stable, so it isn't really very risky to take on lots of debts. I would say perhaps, but in theory borrowing money to invest does not boost risk-adjusted returns and in practice, regulatory risk means that revenues from renewables and (especially) transmission and distribution networks may not be as dependable as they first appear.

Problem 3: Regulatory risk

SSE's businesses are all exposed to significant regulatory risk. For example:

- **Wholesale:**
    - **Coal and gas:** The UK has set a goal to phase out the use of unabated coal (coal with no significant use of carbon capture and storage technology) by 2025 and to produce net zero carbon emissions in 2050 and beyond. These regulatory changes are why SSE has been forced to close down virtually all of its coal-fired power stations, offload gas production assets and re-focus its wholesale business around SSE Renewables.
    - **Onshore wind:** Recent regulatory changes have led to a near-total block on new onshore wind farms in the UK. This is unlikely to happen with offshore wind farms, but it does illustrate the degree of control that the government has over the UK's renewable energy sector.
- **Networks:**
    - **Network price controls:** Ofgem is set to introduce tougher price controls which are expected to lower profits for network operators. This tougher stance is, it seems, in response to endlessly negative press about energy companies and the price of energy in the UK.
    - **Nationalisation:** Labour wants to take back control to a much greater extent and currently plans to nationalise much of the UK's energy network if it gets elected into power. Some details have been leaked suggesting that SSE shareholders may receive less than the market price for their shares.
- **Retail (which is in the process of being spun off):**
    - **Price caps:** A new default tariff cap has recently been introduced and is expected to last until at least 2023. Like the upcoming tougher network price controls, this seems to be in response to endlessly negative press about energy companies and energy prices.
    - **Increased switching:** Ofgem is in the process of developing and rolling out its Switching Programme which will mandate simple, reliable one-day energy supplier switching in the UK. Once this is up and running the regulator hopes that more people will actively look for their best energy deal. If that happens, the market should become more competitive and retail energy supplier profits will, in most cases, probably suffer.

Problem 4: Significant customer concentration risk

In SSE's networks business there is one customer: The UK government. This gives the government enormous power and puts SSE almost completely at the mercy of a single entity. This is not what I'd call operating from a position of strength.

Problem 5: Commodity price risk

SSE uses gas to generate electricity in gas power plants. Although a small part of SSE's overall business, the profit from gas power plants are significantly affected by gas prices for obvious reasons. In addition to price risk, profits from gas power plants are becoming more volatile as renewable energy becomes a growing and preferred source of electricity. That's because gas power plants are used to fill in the power gaps left when wind and solar generation is low (when it isn't windy or sunny). This means gas power plants will have to be powered down more frequently and for longer and that trend seems set to continue.

Problem 6: No competitive advantages

As far as I can see, SSE has no meaningful competitive advantages.

You could argue that its energy networks business owns unique assets and is a natural monopoly, but this is negated by the near-total control of profits by the UK government.

You could argue that the retail business has high switching costs (i.e. the time and effort required to switch supplier), which was true in the past. But switching is becoming more popular thanks to comparison websites and Ofgem's Switching Programme is expected to be up and running very soon, significantly reducing switching for most people.

What about SSE's brand (often still known as Scottish & Southern Energy)? It's a household name, but I don't think that gives it any pricing power. People who want a major supplier have a handful to select from and price comparison websites make price comparisons quick and easy. So I think very few people would happily pay more for their gas or electricity just because it's from SSE.

Live, Learn, (don't) Repeat

SSE hasn't been a great investment, but it hasn't been a disaster either. The dividend yield at purchase was 5.6% and that dividend has grown in every one of the investment's seven years. The accumulated return from dividends is a healthy 48%, and that has more than offset the 15% decline in share price.

The annualised return over almost eight years was 4.7% and although that's below the market's return, SSE's dividends have been a useful source of cash to help grow the overall value of the portfolio.

However, the time has come to say goodbye to SSE. As my investment reviews have become more detailed over the years, looking for additional factors such as a focused core business, high returns on capital and durable competitive strengths, companies such as Centrica, Vodafone and now SSE have failed to clear more and more of these hurdles.

I can't really blame SSE because it is what it is: A highly regulated company with low returns on assets (as demanded by the regulator) which needs to use lots of debt to boost returns on equity. If someone want to invest in that sort of company then great; it's an entirely reasonable thing to do if those companies are within your circle of competence and can be purchased at the right price. But I want to invest in focused businesses with high returns on capital, low debts, low external risks and some durable competitive strengths.

SSE doesn't fit that description, so I'll be removing it from the model portfolio and my personal portfolio a few days after this issue is published.

Lower ranked stocks that were not sold	Reason for not selling
Mitie Group PLC	Mitie is nearing the end of a multi-year turnaround and I want to see how the company performs as I think Mitie's low rank may not reflect its potential.