

Exit Centrica: I misjudged political pressure

Company:	Centrica	Market Cap:	£4.55bn
Industry:	Utility	Net Cash:	£316mio (+ ~£1.9bn liabilities)
Country:	UK	Revenue:	£20.6bn
Date:	30 th August 2022	Net Income:	£722mio (3.5%)
Dividend:	4.6%	Free Cash Flow:	£1.3bn (6.3%)
Entry:	£4.83bn	Exit:	£4.5bn

Political risks remain high

The market has valued Centrica lower after beating results and uplifting price targets by analysts due to increasing political pressures to tax energy producers with nuclear potentially next in line. I have underestimated this risk and have ultimately pulled the plug when gas prices began declining on Tuesday. While the likely next PM has ruled out any additional tax hikes, Truss' policies of tax cuts appear difficult to follow through and she might back paddle once the nomination is secured on Monday (this is a bit of a wild card to me). A "tax" on electricity producers is therefore still in the cards¹, which could affect Centrica's nuclear power profits negatively. In addition, the higher Ofgem energy tariff will put more pressure on British Gas to use some of their profits to help lower income households – this has led Centrica to announce 10% of British Gas profits to go to lower income households. Although this figure is ultimately small, it shows that profits are somewhat capped.

Hedged vs. realized gas prices

Despite the political risks, another large risk I view (and which the market might not currently price for) is that in a scenario of falling gas prices, warmer weather and demand destruction, British Gas would need to sell back excess energy, which they hedged, at potentially lower prices. This risk can go both ways and also be positive when gas prices are higher realized than hedged – which happened in March this year.

¹ <https://www.bnnbloomberg.ca/uk-plans-to-cap-renewables-profits-with-households-hit-by-costs-1.1812960>

For example, the average UK household uses 33 kWh of gas per day² (during winter more). If the winter is warmer than anticipated and British Gas's 9mio households suddenly consumes 30 kWh of gas less than usual for one day (as a very crude and simple example), the difference of hedging vs. realized might be over 9mio therms. If the price hedged vs. realized differs by £1 a therm (gas price has traded between 300-800p/th over the last two month for Dec/Jan delivery), this could lead to a gain/loss of £9mio a day. This adds quite some uncertainty to the earnings estimates.

Fair valuation assessment

I was unwilling to sell Centrica at a valuation of less than £5bn and ended up selling at £4.5bn. This has clearly been a mistake. I have made similar mistakes in the past when I was too hesitant after somewhat disappointing earnings releases. The difficulty lies in assessing the investment horizon. Given that I invested in Centrica in March, I have already held shares for over five months. With my investment horizon being six months, the 40% targeted returns were simply not achievable any longer. The picture has changed and even though I find a £7.5bn valuation still fair for Centrica, the risks for additional windfall taxes or financial turmoil in the utility sector have clearly increased, making the investment riskier than five months ago, especially when gas prices are now declining as well.



² <https://usave.co.uk/energy/how-much-energy-does-the-average-uk-household-consume/#:~:text=According%20to%20Ofgem%2C%20the%20average,kWh%20of%20gas%20each%20year.>

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