NORTH STAR
Investment Management

March 2022

Inflation Mitigation

Small-Cap Utilities Outshine Energy

By: Eric Kuby, Chief Investment Officer & James (Jim) Lane, Senior Analyst

Small-Cap Utility Sector

Historically, investor interest in publicly traded Utility companies has been yield-oriented and therefore has been impacted significantly by prevailing interest rates. While this dynamic will likely persist, the emerging themes of E.S.G. investing, as discussed in our last white paper, may increasingly impact market participant interest in the Utilities sector. In addition, while Utilities sector growth is driven mostly by rate increases tied to infrastructure improvements, efforts to mitigate climate change will likely energize new investment in alternatives to traditional power generation sources, as well as investment in new transmission and storage capabilities resulting in increased demand for certain materials critical to clean energy efficiency.

Within the small-cap universe, the most differentiated sector may be the Utilities sector. Whereas the Utilities sector has the smallest number of constituents in the Russell 2000 Index with only 37 members, it also has the largest median market cap of just over $3.0B and an attractive median dividend yield of 3.21% as of December 31, 2021. Utilities are almost famously known for deploying the most leverage and being the most heavily regulated. With high dividend yields and consistent returns, the Utilities sector's earnings are far more predictable than other sectors.

More Company Differentiation Likely

Utility stocks have been strong performers for the latest period of lower-than-average interest rates with a 48.10% return which places it in the middle of the pack for the Russell 2000. It is worth noting that over the last five years these returns were earned while only experiencing 69% of the volatility of the Russell 2000. Investors have been rewarded over this period with both modest growth characteristics and attractive yields relative to the so-called 'risk-free' yield of the U.S. Ten-Year Treasury. However, given the increasing likelihood of more market-driven interest rates as the U.S. Federal Reserve System removes accommodative and expansionary monetary policy tools, successful investments in Utility sector stocks will likely require more in-depth research. North Star's goal is to identify companies with idiosyncratic catalysts to higher earnings that will enable higher dividends to keep pace with, or even exceed, rising risk-free yields.

In our view, there will be a few key differentiation points between attractive Utility stocks and possibly much less successful investments in the sector. First, we believe that unit growth from positive net customer additions is critical. Second, a realistic approach to progressively generating clean energy will discern winners from losers. Third, companies in markets with more favorable rate regulators will be critical to passing on inflationary trends in inputs.

Accelerating M&A Environment

Out of 102 company takeovers in the Utility sector since 2000, 100 of those acquired utilities were small-cap companies. As Utility regulations have changed, allowing for cross-state transportation and distribution of utility power, economies of scale have resulted. Thus, small-cap utilities have represented attractive consolidation candidates.

North Star's Small-Cap Utility Picks

When the North Star screening process generates new Utility stock ideas, the research team applies fundamental analysis to promising prospects. For Utility stocks, North Star looks for companies operating in regions with attractive macroeconomic fundamentals, such as characteristics that would suggest strong population growth and solid local economies. **Unitil Corp (UTL)**[i] mainly operates on the New Hampshire (NH) and Maine (ME) seacoast where out-of-state buyers have fueled an unprecedented demand for real estate. In addition to a hot housing market, NH and ME have the highest percentage of homes heated with fuel oil in the United States; with an on-the-main gas penetration rate of 60%, the company can leverage its dominant market share to convert customers to natural gas over time.[ii]

We also look for utilities in business-friendly markets that are attracting new businesses or where companies are expanding into. In the case of **Global Water Resources Inc (GWRS)**[i], the Phoenix metropolitan region offers affordable housing and lower tax structures. Businesses such as Intel Corp (two semiconductor factories at $20B)[iii], Nikola (production facility)[iv], and Lucid Motors (production facility) are all making investments to expand production capacity there. According to the Arizona Commerce Authority, the state is projected to add 720,000 jobs by 2030.[v] Furthermore, approximately 31,000 single-family home building permits were issued in 2021 while forecasts suggest annual building permits to increase to 35,000 in 2022 and 36,000 in 2023.[vi] In addition to achieving organic connection growth, GWRS is a best-in-class consolidator within a highly fragmented water utility industry. Global Water capitalizes on the Arizona Corporation Commission incentives including rate base premiums for targeting business combinations with ample small operators in the region.

Another important consideration is evolving mitigation trends. With over 100 years of operating history, one legacy utility business that has been increasing its portfolio diversification efforts in a climate friendly manner is **NorthWestern Energy (NWE)**[i]**.** In 2021, 56% of the company's long-term contracted supply came from carbon-free sources such as solar, hydro, and wind – far surpassing the national average of 40%.[vii] Going even further, the company announced on March 3, 2022, its intention to reach Net Zero carbon emissions by 2050.

Lastly, all three of these small-cap utilities have good working relationships with constituents and regulators that tend to be less adversarial than those of large-cap peers. We believe these increasing factors in Utility investing will merge with similar considerations of investing in the publicly traded Energy sector companies.

Small-Cap Energy Sector

Given North Star's focus on predictable and growing earnings, we have historically underweighted the energy sector due to the volatile nature of its cash flows. Additionally, in the interest of climate change concerns, the pressure has mounted on energy consumers to move away from carbon-based power sources and toward cleaner technologies, underlining our negative outlook on the sector. As of December 31, 2021, 90 members of the Russell 2000 were classified as energy stocks, with most related to the exploration and production of oil and gas. The sector boomed last year as EBITDA margins improved from a negative 1.75% at December 31, 2020 to 12.31% at December 31, 2021, and the median market cap of $743.0M grew to $1.3B.

Small Cap Energy Sector Performance

The stellar results of 2021 were the exception rather than the rule for energy companies. Indeed, the sector has produced the lowest returns out of the Russell 2000 sector indices over the last 20 years. Whereas the Russell 2000 has returned nearly 500% in the last 20 years, the energy sector has only returned 14%. Even more dramatic, the energy sector produced a -60% return over the last ten years, flagging it as the only sector to produce a negative return during that period.

Russell 2000 Energy Index (RGUSES) vs Russell 2000 (RTY) Performance		
As of December 31, 2021	**10Y Total Return**	**20Y Total Return**
Russell 2000 Energy Index (RGUSES)	-60.15%	14.13%
Russell 2000 (RTY)	240.91%	496.41%

Bankruptcies have certainly contributed to those poor returns; while leverage can look reasonable during periods of high energy prices and peak earnings, when the pendulum swings to depressed energy prices and losses, solvency risk soars. Case in point, four out of the last six years showed the sector as a whole operated unprofitably.

Russell 2000 Energy Index (RGUSES) Profitability						
As of December 31, 2021	**FY2016**	**FY2017**	**FY2018**	**FY2019**	**FY2020**	**FY2021**
Operating Margin (%)	-21.85	-3.12	1.01	-3.57	-23.34	8.01
Return on Common Equity (%)	-28.01	-4.69	-2.51	-13.69	-38.39	10.03

More recently, geopolitical concerns have exacerbated supply shortages resulting in surging crude oil prices, and the small-cap energy sector has regained popularity and outperformed the broader index. The higher prevailing crude oil prices will likely lead to increased production that should eventually solve the supply-demand imbalance. This volatility does not undermine but reinforces our concern about the energy sector. Energy company profit booms are typically followed by energy company profit busts.

While North Star's strategies have historically navigated away from unpredictable cash flows, we still capitalize on our expertise in identifying undervalued and overlooked opportunities even in the energy sector. One small-cap energy company we have been favorably inclined towards is **Evolution Petroleum Corp (EPM)[i].** EPM's unique business model consists of 1) acquiring proved oil and gas assets inexpensively; 2) efficiently harvesting long-lived reserves; and 3) diversifying into a more socially popular portfolio mix by seeking out natural gas assets. Trading at less than 10 times earnings at year-end 2021, the Company presents a low risk, high margin investment opportunity with capital discipline, no leverage, and an attractive dividend yield of 4.55% as of December 31, 2021.

Utilities, Energy, Inflation, and Interest Rates

We are currently in the fourth period of rising interest rates over the past few decades due primarily to improved economic conditions from peak Covid economic conditions and related supply-demand imbalances. As shown in the below table, the three prior periods of rising rates were near the turn of the millennium, late 2012 until late 2013, and late 2016 through late 2018.

Period	Beginning Date	Beginning Rate	End Date	End Rate
First Period	12/31/1998	4.65%	03/31/2000	6.26%
Second Period	06/29/2012	1.62%	12/31/2013	2.90%
Third Period	09/30/2016	1.63%	09/28/2018	3.00%
Current Period	08/04/2020	0.52%	01/31/2022	1.79%

While large-cap utility equities seem to perform poorly during periods of rising rates, small-cap utilities have performed well during these periods. The tables below show that during rising interest rate periods, small-cap utility equities have exhibited solidly positive returns, significantly outperforming large-cap utilities equities. Small-cap energy equities have also outperformed large-cap energy equities during three of the four periods.

12/31/1998-03/31/2000	Price Change	Total Return	Annual Equivalent Rate
Russell 2000 Utilities Index (RGUSUS)	43.67%	43.67%	33.65%
Russell 2000 Energy Index (RGUSES)	**76.12%**	**76.12%**	**57.31%**
Russell 2000 Index (RTY)	27.72%	29.85%	23.25%
S&P 500 Index (SPX)	21.91%	23.81%	18.64%
Energy Select Sector SPDR Fund (XLE)	25.57%	28.05%	21.89%
Utilities Select Sector SPDR Fund (XLU)	**-11.58%**	**-7.94%**	**-6.40%**
06/29/2012-12/31/2013	**Price Change**	**Total Return**	**Annual Equivalent Rate**
Russell 2000 Utilities Index (RGUSUS)	21.62%	27.65%	17.59%
Russell 2000 Energy Index (RGUSES)	44.63%	45.43%	28.21%
Russell 2000 Index (RTY)	**45.73%**	**48.86%**	**30.22%**
S&P 500 Index (SPX)	35.69%	40.25%	25.17%
Energy Select Sector SPDR Fund (XLE)	33.36%	37.16%	23.33%
Utilities Select Sector SPDR Fund (XLU)	**2.65%**	**9.07%**	**5.93%**
09/30/2016-09/28/2018	**Price Change**	**Total Return**	**Annual Equivalent Rate**
Russell 2000 Utilities Index (RGUSUS)	23.08%	29.66%	13.91%
Russell 2000 Energy Index (RGUSES)	**1.58%**	**2.81%**	**1.40%**
Russell 2000 Index (RTY)	35.55%	39.10%	17.99%
S&P 500 Index (SPX)	**34.39%**	**39.83%**	**18.30%**
Energy Select Sector SPDR Fund (XLE)	7.27%	13.72%	6.66%
Utilities Select Sector SPDR Fund (XLU)	7.47%	14.96%	7.24%
08/04/2020- 01/31/2022 (present)	**Price Change**	**Total Return**	**Annual Equivalent Rate**
Russell 2000 Utilities Index (RGUSUS)	**13.06%**	**17.30%**	**11.28%**
Russell 2000 Energy Index (RGUSES)	**115.91%**	**118.10%**	**68.58%**
Russell 2000 Index (RTY)	33.70%	35.75%	22.71%
S&P 500 Index (SPX)	36.57%	39.58%	25.03%
Energy Select Sector SPDR Fund (XLE)	77.97%	92.08%	54.83%
Utilities Select Sector SPDR Fund (XLU)	13.84%	19.39%	12.60%

Convergence of Utilities and Energy Sectors

The downward pressure in energy costs over the last 15 years has allowed for Utilities to get rate relief without shocking consumers. Historically, Utility stocks have been able to raise rates for capital improvements without generating too much consumer pushback. Those capital improvement projects have largely been related to clean energy initiatives.

There has been a wave of specific state-by-state guidelines concerning the transition to clean energy. Currently there are 38 states and the District of Columbia which have enacted individual Renewable Portfolio Standard (RPS) legislation, or agendas geared toward reaching decarbonization goals. The RPS requires 100% clean electricity by 2050 or earlier for 12 of those states and the District of Columbia.[viii] As more legislation is written, Utility companies must adapt to provide for customers. This pivot by Utilities toward clean energy is influencing the Energy sector by shifting away from carbon fuels to other sources.

The recent surge in energy costs could be viewed as a headwind for Utility stocks' earnings, but it will become a tailwind in future periods as they recover those costs. Clean energy initiatives and the related capital expenditures have emerged as a major part of the Utilities sector's investment thesis, as there is potential for elevated return on capital investment and return on input costs (such as energy costs). This will negatively impact consumers as they get hit with higher rates; however, the utilities nevertheless benefit from regulated returns and recaptured energy costs.

Conclusion

There is a strong case for long-term investors to overcome their concerns regarding Utility stock returns in a rising interest rate environment by considering the underfollowed small-cap utility universe. Traders that are enjoying the recent performance of small-cap energy companies, on the other hand, should be mindful of the boom-and-bust nature of that sector.

March 2022

Contact Information

Please contact us at info@nsinvest.com if you would like to discuss the North Star funds, strategies, and investment research.

North Star Funds do not utilize Environmental, Social and Governance (ESG) practices in their fund activities nor do they consider this their area of expertise.

ESG Investing: Environmental, Social and Governance (ESG) investing may take into consideration factors beyond traditional financial information to select securities, which could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. Further, ESG strategies may rely on certain values-based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviating. There is no assurance that employing ESG strategies will result in more favorable investment performance.

Investors should carefully consider the investment objectives, risks, charges, and expenses of the North Star Funds. This and other important information about each of the Funds are contained in the prospectus, which can be obtained at www.nsinvestfunds.com or by calling (855) 580-0900. The prospectus should be read carefully before investing. The North Star Funds are distributed by Northern Lights Distributors, LLC member FINRA/SIPC. Northern Lights Distributors, LLC and North Star Investment Management are not affiliated. 1318-NLD-03182022

Important Risk Information

Mutual funds have investment risks including loss of principal. There is no guarantee either fund will meet its objective. No-load mutual funds are sold without sales charge; however, they have ongoing expenses, such as management fees.

About North Star Investment Management

North Star is an employee-owned boutique asset management firm. The North Star Funds, managed by North Star Investment Management Corporation, are part of the North Star Family of Financial Services. North Star is a Chicago-based investment management firm serving individual investors since 2003.

The North Star Funds actively invest in undervalued and often overlooked small and micro capitalization companies where our macroeconomic and primary research and analysis indicate a catalyst for growth. We believe in the businesses we own—we have “high conviction” in the securities we select, and typically only hold 40 to 50 names in each portfolio.

Portfolio Selection – High Conviction, Low Turnover, Risk Management

- Each fund has a concentrated portfolio of 40 to 50 high conviction names with low turnover averaging 11%
- For risk management, each position is limited to approximately 3.0% of a portfolio
- We overweight the best stocks, but no more than 5% in any one position
- For both SMAs and funds we will nibble and bunt our way into positions by buying a little at a time
- We talk to company management in addition to doing our own primary research
- We have a bullpen of potential stocks to add to our portfolios
- Sell discipline results from a dramatic change in firm strategy, or failure to perform according to business goals.

Appendix

Russell 2000 Index: The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

S&P 500 Index: The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

Utilities Select Sector SPDR Fund: The Utilities Select Sector SPDR Fund is an exchange-traded fund incorporated in the USA. The Fund's objective is to provide investment results that correspond to the performance of the Utilities Select Sector Index. The Index includes communication services, electrical power providers, and natural gas distributors.

Energy Select Sector SPDR Fund: The Energy Select Sector SPDR Fund is an exchange-traded fund incorporated in the USA. The ETF tracks the performance of the Energy Select Sector Index. The ETF holds large-cap U.S. energy stocks. It invests in companies that develop and produce crude oil & natural gas, provide drilling and other energy related services. The holdings are weighted by market capitalization.

Dividend Yield: The dividend yield is a financial ratio that shows how much a company pays out in dividends each year relative to its share price and is calculated as dividing Annual Dividends Per Share by Price Per Share.

EBITDA Margin: EBITDA margin is an assessment of a firm's operating profitability as a percentage of its total revenue. It is equal to earnings before interest, tax, depreciation, and amortization (EBITDA) divided by total revenue.

Operating (Cash Flow) Margin: Operating margin is a cash flow ratio which measures cash from operating activities as a percentage of sales revenue in a period.

Return on Common Equity (ROE): Return on Equity is the amount of net income returned as a percentage of shareholder's equity.

Price-to-Earnings (P/E) Ratio: The price-to-earnings ratio is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

Free Cash Flow Yield: Free cash flow yield is a financial solvency ratio that compares the free cash flow per share a company is expected to earn against its market value per share. The ratio is calculated by taking the free cash flow per share divided by the current share price.

Definitions provided by Bloomberg LP.

---

[i] The stocks mentioned may be holdings in our mutual funds. For more information, please visit www.nsinvestfunds.com.
[ii] Unitil Corp Fourth Quarter 2021 Earnings Call. February 2022.
[iii] CNBC Intel is spending $20 billion to build two new chip plants in Arizona. March 2021.
[iv] Nikola Corp Global Water Resources to Provide Water Services to Nikola's New Zero-Emission Semi-Truck Manufacturing Plant. January 2021.
[v] Arizona Commerce Authority Industry Projections 2020-2030. November 2021.
[vi] Global Water Resources Fourth Quarter 2021 Press Release. March 2022.
[vii] NorthWestern Energy Press Release. March 2022.
[viii] Renewable Energy Explained published by the U.S. Energy Information Administration. June 2021.