US Electric Utilities & IPPs
Searching for Clues in Utility M&A

Equities

Americas
Electric Utilities

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Starting 2016 with a bang: Three deals in ten days
Following the latest spree of regulated utility M&A announced this month, we revisit the theme to see where premiums have trended. Despite investors and management teams pointing at rising premiums, we see that *premiums have remained in a relatively tight range* at 20-22x 2017E P/E with DUK-PNY the primary outlier (27x P/E). The average equity deal size in the eleven deals announced over the last ~2 years is $5.0Bn with an equal number of small- ($3-5Bn) and mid- ($5.5-$8Bn) sized transactions.

Looking for common threads in transactions: We see two core strategic reasons
Out of recent deals we classify the strategic rationale into one of two groups: (1) a US utility acquiring a peer to increase or support its EPS growth trajectory; and (2) a foreign energy company purchasing a US utility to add exposure to the US market. *These are not mutually exclusive traits* as the management teams in the recent Canadian transactions also expect near-term EPS accretion. A key factor in the Exelon-Pepco merger was to make Exelon more regulated (EXC expects earnings to be ~60% regulated in 2018E if the transaction closes vs ~45% in 2015A); we expect more of these deals to occur going forward. Underlying all of the deals has been a heavy reliance on low interest rates with transactions becoming increasingly levered. For example we estimate that the majority of the DUK-PNY (65%) and SO-AGL (62%) transactions will be financed with debt.

Are we at the top of the cycle in utility M&A – Or is this the new normal?
The 2016 batch of M&A (AQN-EDE, FTS-ITC, and D-STR) had P/E ratios that were approximately in-line with recent deals (~20x 2017E) but we see a distinct lack of growth from the targets (ex. STR's Consensus 5Yr EPS CAGR is 1.9%). In contrast, more 'challenging' acquisition targets were acquired at 16-17x 2017E P/E in 2014. For the purpose of this analysis we call NEE-HE, EXC-POM, and WEC-TEG 'challenging' as the first two deals have not closed after 1+ year and the latter was perennially under-earning its ROE (a situation which WEC has seemingly been able to resolve promptly).

Premiums still in place for smaller utilities – but is that necessarily logical?
We look at the current relationship between P/E valuation and small-and-mid-cap (SMid) US regulated utilities (defined as sub-$10Bn market capitalizations) on Page 7 and as expected we see a greater portion of the small utilities trading at material premiums. For example, UTL, CPL, MGE, and LG are all trading at 10%+ premiums over their peers. Collectively sub-$3Bn market cap utilities are trading at 17.5x 2017E P/E versus 16.8x for the broader group, likely implying that the market estimates a higher probability for M&A activity at this level of market cap. While it is logical to assume that smaller transactions have a higher probability for success, only one of the eleven recent utility transactions has been under $3Bn (EDE). Smaller targets likely have fewer organic growth and synergy opportunities, thus generally making them less attractive to acquirers focused on growth. With respect to diversification/accretion, the benefits of acquiring a ~$1Bn regulated utility if you are already a $10Bn+ company could simply be too small to drive a material change in parent valuation, particularly when weighing the prospects of a lengthy approval process.

What are other factors to consider?
In our earlier note, 'The SMid Bid' we see five key metrics as important to assessing likelihood of an acquisition: (1) ratebase & earnings growth; (2) secondary equity needs; (3) parent leverage; (4) jurisdiction breadth; and (5) a willing seller [CEO tenure/age].

Comparing the Transactions

Figure 1: Recent Utility M&A Transactions

Deal	Deal Announcement	Stated Deal Equity Value ($mn)	Implied 2016 P/E	Implied 2017 P/E	Target Regions
DUK-PNY	10/26/2015	4,795	30.0x	26.9x	**North Carolina**, Tenessee, South Carolina
EMA - TE	9/4/2015	6,506	23.7x	21.7x	Florida
SO - AGL	8/24/2015	7,943	22.0x	21.4x	Illinois, **Georgia**, Virginia, New Jersey, Florida, Tennessee, Maryland
AQN-EDE	2/9/2016	1,492	22.6x	21.0x	**Missouri,** Kansas, Oklahoma, Arkansas
IBE - UIL	2/26/2015	2,983	21.6x	20.4x	**Connecticut** / Western Massachusetts
FTS-ITC	2/9/2016	6,961	22.0x	20.1x	Iowa, Illinois, Kansas, Missouri, Oklahoma, Wisconsin
Macq - CNL	10/20/2014	3,342	22.1x	20.1x	Louisiana
D-STR	2/1/2016	4,404	18.7x	18.3x	**Utah,** Idaho, Wyoming
NEE-HE	12/3/2014	3,643	19.2x	17.3x	Hawaii
EXC-POM	4/30/2014	6,840	19.1x	16.9x	Washington DC, **Maryland**, New Jersey
WEC-TEG	6/23/2014	5,852	17.8x	16.2x	City of **Chicago**, Michigan's U.P, Lower Michigan, Minnesota
Average Implied Deal P/E Multiple		**4,978**	**21.7x**	**20.0x**	
Average Implied Deal P/E Multiple (Ex DUK-PNY)			**20.9x**	**19.3x**	
US Utilities Average P/E			**17.8x**	**16.8x**	

Source: Company Filings, FactSet, SNL Energy, and UBS Estimates; Note: forward multiples as of deal announcement dates

We note for deals inked in 2014 compare best to 2016E P/E multiples, whereas deals penned in 2015 (and first month of 2016) compare best to 2017E. We note the time series does lend itself towards a bias for earlier deals to have cheaper implied values on near years.

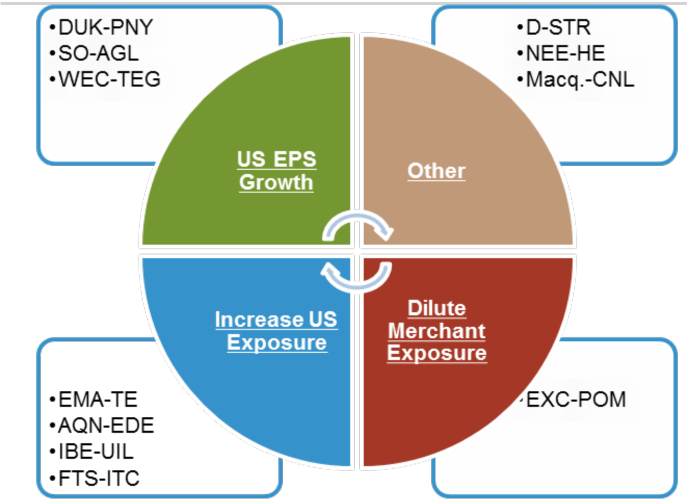
Discussing the rationale

Substantially all companies have pointed to adjusted EPS accretion from their pending/approved transactions but we attempt to classify the transactions to see if there was another strategic motivation. We have been surprised by the lack of transactions aimed to diversify the earnings mix but expect more of this type of deal if merchant economics do not materially recover.

To date most US-only deals have been focused primarily on EPS growth profiles rather than secondary strategic rationales.

In EXC-POM, Exelon expects EPS accretion but a key factor is the reduction in risk profile as management estimates that its earnings would become majority regulated.

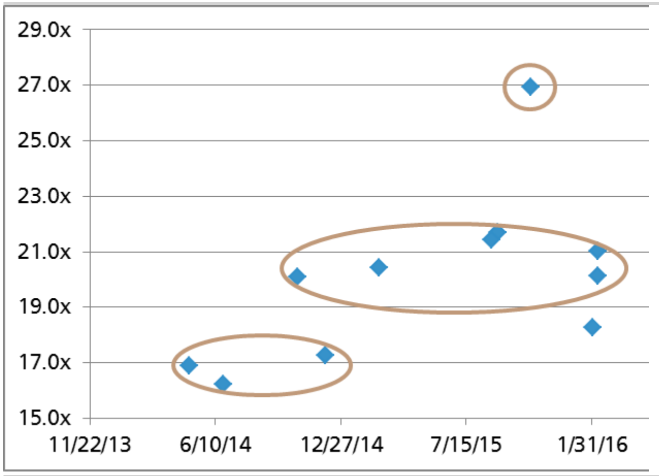
Figure 2: Recent Regulated Transactions Strategic Rationale



Source: UBS Estimates

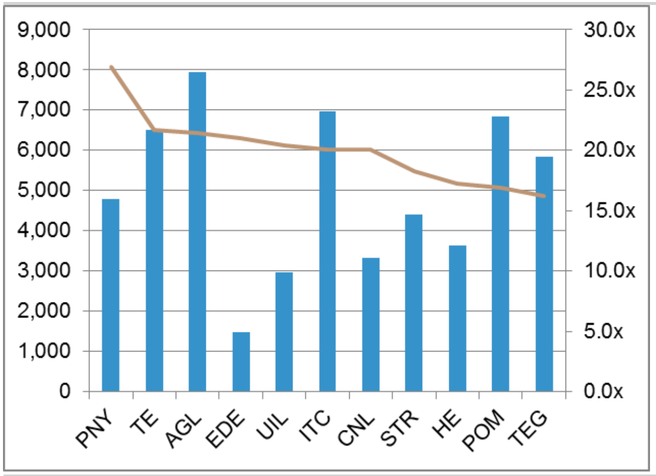
As shown in the Figure below, the majority of the utility M&A announced in recent years has been in a relatively tight 20-22x 2017 P/E multiple band. There is no real evidence market cap size has correlated with the premium with both small and large caps being acquired at largely similar premiums.

Figure 3: Historical Utility M&A 2017E P/E – We see a clear difference in 2014 deals vs 2015/2016 transactions



Source: Company Filings, FactSet, SNL Energy, and UBS Estimates

Figure 4: Historical Utility M&A by Market Cap – No real correlation between size and premium

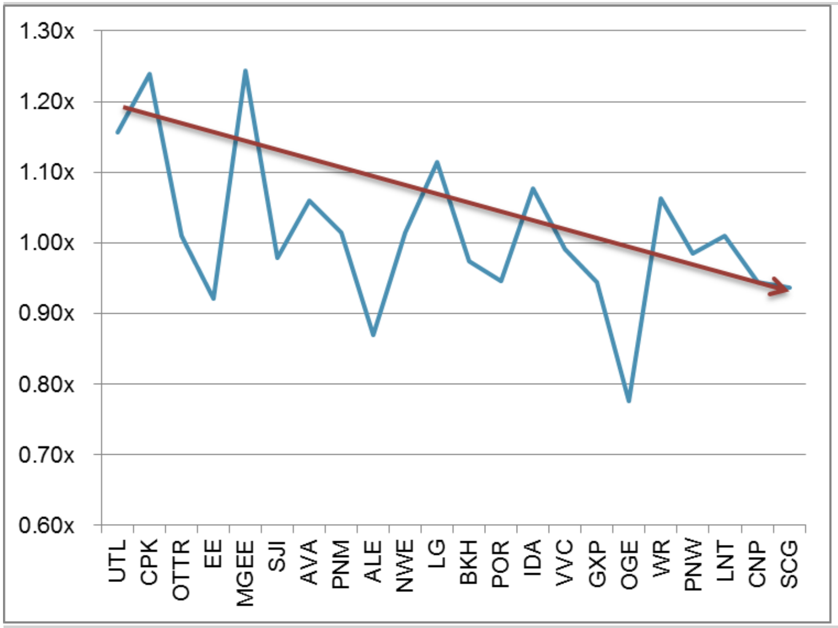


Source: Company Filings, FactSet, SNL Energy, and UBS Estimates

While not a one-for-one relationship, there is an inverse correlation for SMids between market cap and 2017E relative P/E premiums. On the subsequent page we show the detailed comp sheet with relative premiums and discounts.

In general the lower the market cap the greater the valuation with investors likely embedding an M&A premium in names.

Figure 5: Small- and Mid-Cap Utilities by 2017E Relative P/E



Source: FactSet; Note: X-axis goes from lower to higher market cap.

Earning Authorized Returns

Another clear bucket of considerations has been previously expounded by NEE at length: its acquisition of HE appears predicated on the synergies brought from a focus on consolidating costs across the organization. To this end, we recently hosted a conference call with consultants at PwC's Strategy& to discuss cost and synergy trends in the sector. See the full transcript and summary here. NEE continues to state that further M&A would be guided by the ability to find those companies with an ability to continue to extract cost – even in cases where already earning ROE – in order to provide headroom for additional capital projects/ratebase growth.

What about EXC-POM and EXC-CEG: Improving Earned ROEs

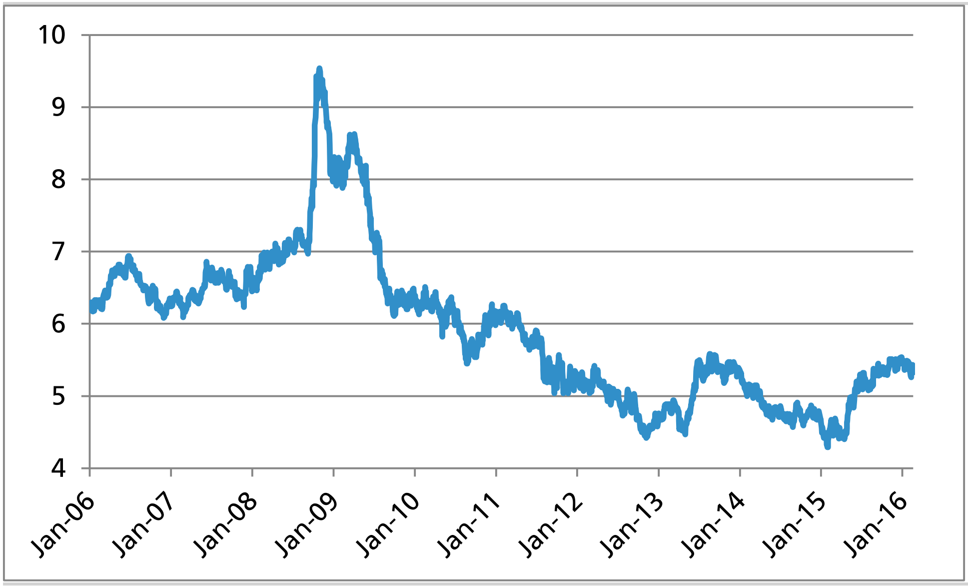
Buying utilities unable to earn their ROEs is a critical avenue to recouping premiums paid

We see both transactions as focused on improving the underlying profitability of the core utility. Rather than buying utilities fully earning their ROE, subsidiaries for both POM and CEG (both principally in Maryland) didn't earn their authorized levels, with promises from EXC to do the same in the case of POM as it already executed with the BGE subsidiary of CEG. The prospects of improving net income by ~10-20% (1-2% of utility under-earning of ROE) allow for utilities to be bought at a material premium to their trading prices.

End of the Credit Cycle: Not So Fast

Lastly, we had perceived an acceleration earlier on the back of 'fears' the credit cycle was poised to turn with higher interest rates. Given the higher HoldCo back-leverage enabled many transactions, we see a 'lower for longer' thesis on interest rates enabling a continued runway of dealmaking. We include below a chart of the Moodys BAA-index below, illustrating that credit spreads remain modest despite the wider pullback in energy.

Figure 6: Moodys BAA Utility Index – Cost of Debt Remains (Relatively) Low



Source: Bloomberg

Can the capital markets handle the issuance: a tale of two markets.

Contrasting the low cost of debt and low interest rate environment backdrop, we perceive a wider concern in the marketplace to excessive capital market access, particularly given the lessons learned in recent memory in the MLP sector. Access to capital remains critical, and outsized as its pursuit remains a clear risk.

But are Utilities digesting for now?

We flag many of the larger cap utilities have engaged in transactions, potentially limiting the desirability to engage in further transactions prior to 'digesting' the latest round. As a consequence, we see many as having achieved in either filling earning deficiencies or bolstering their growth outlooks already. Moreover, aggregate sector re-leveraging is well under way. Should low interest rates persist, the question remains how willing will companies be towards continued leveraging of balance sheets towards mid-teen FFO/debt metrics – the low end of acceptable investment grade metrics – exposing companies to risk around IG ratings should interest rates or other aspects of the stories erode.

We still expect Power M&A to make a reappearance.

Despite our focus in the latest note, we emphasize that power M&A should make a reemergence after a several year hiatus. Further, with limited market cap relative to overall EV value, contemplated synergies would have a disproportionate impact on improving the thin equity market caps remaining for many IPPs, encouraging deals all the more. Lastly, impacts of divestments to address market power would likely have limited EBITDA impacts.

Diversified Utilities Becoming *Less* Diversified:

We continue to perceive a wide desire by diversified utilities to offer investors a single fully-regulated value proposition. We see this across the entire space as the back to basics effort sees yet another year of divestments from a litany of companies. Specifically, DUK and AEP have specifically indicated their interests in divesting remaining merchant generation interests. Further, FE is pursuing

effectively re-regulation of its asset base rather than pursuing a sale to return to a fully regulated profile. Ultimately, we suspect few diversified utilities will remain truly 'diversified' in the conventional sense – rather we suspect the future of such utilities to stray increasingly towards 'infrastructure' oriented towards taking on only 'contracted' exposures into gas midstream, competitively-bid transmission, and renewables outside of ratebase.

<u>What's the trigger point for a spin? It's about valuation multiples.</u> We see the math as all about what 'metric' companies are valued. With utilities clearly valued as a function both visible future dividend growth (yield) and P/E off earnings, we see a clear bias to divest assets generating limited earnings (but still real cash flow). Ultimately, there is a clear arbitrage point between EV/EBITDA and P/E metrics; PSEG for instance has indicated it intends to eventually spin its Power business from the utility – we suspect this is when the backwardated earnings profile of the segment would lend itself towards a better valuation with EV/EBITDA and FCF metrics.

Below we present the full comp tables for both the SMids and the broader utilities universe.

Figure 7: Small- and Mid-Cap Utilities Comp Sheet (In Ascending Order of Market Cap)

Company	Tkr	UBS Rating	Market Cap ($ mill)	Price 2/22/2016	Dividend Yield	P/E 2015E	2016E	2017E	2018E	2017E Rel. P/E
Unitil Corp	UTL	Not Rated	$553	$39.51	3.59%	21.0x	20.4x	19.3x	18.5x	1.16x
Chesapeake Utilities Corp	CPK	Not Rated	$978	$64.06	1.80%	22.5x	21.1x	20.7x	NA	1.24x
Otter Tail Corp	OTTR	Not Rated	$1,020	$27.02	4.63%	17.3x	17.4x	16.9x	15.9x	1.01x
El Paso Electric	EE	Not Rated	$1,649	$40.78	2.89%	20.3x	16.1x	15.4x	14.8x	0.92x
MGE Energy	MGEE	Not Rated	$1,766	$50.94	2.32%	22.9x	21.9x	20.8x	19.8x	1.24x
South Jersey Industries	SJI	Not Rated	$1,860	$26.84	3.93%	18.1x	16.6x	16.4x	NA	0.98x
Avista Corp	AVA	Neutral	$2,346	$37.65	3.64%	19.4x	18.4x	17.7x	NA	1.06x
PNM Resources Inc.	PNM	Not Rated	$2,598	$32.61	2.70%	20.5x	20.0x	17.0x	15.6x	1.02x
Allete	ALE	Not Rated	$2,588	$52.94	3.93%	15.2x	15.9x	14.5x	14.3x	0.87x
NorthWestern Corp	NWE	Not Rated	$2,846	$59.07	3.39%	18.8x	17.8x	17.0x	15.7x	1.02x
The LaClede Group	LG	Not Rated	$2,836	$65.30	3.00%	20.5x	19.4x	18.6x	18.2x	1.11x
Black Hills Corp	BKH	Not Rated	$2,916	$56.97	2.95%	19.1x	18.6x	16.3x	15.3x	0.97x
Portland General Electric	POR	Buy	$3,395	$38.23	3.14%	18.7x	16.8x	15.8x	15.5x	0.95x
Idacorp, Inc.	IDA	Not Rated	$3,639	$72.34	2.82%	18.7x	18.6x	18.0x	17.0x	1.08x
Vectren Corporation	VVC	Not Rated	$3,760	$45.46	3.52%	19.7x	18.0x	16.6x	15.4x	0.99x
Great Plains Energy	GXP	Not Rated	$4,488	$29.07	3.61%	20.8x	16.5x	15.8x	14.9x	0.94x
OGE Energy Corp	OGE	Not Rated	$5,334	$26.72	4.12%	14.9x	13.9x	13.0x	12.3x	0.78x
Westar Energy, Inc.	WR	Neutral	$6,479	$45.87	3.14%	20.9x	18.8x	17.8x	17.1x	1.06x
Pinnacle West Capital Corp	PNW	Neutral	$7,678	$69.17	3.61%	17.6x	17.3x	16.5x	15.7x	0.98x
Alliant Energy Corp.	LNT	Not Rated	$7,680	$67.75	3.47%	18.9x	17.9x	16.9x	15.8x	1.01x
CenterPoint Energy Inc.	CNP	Not Rated	$7,990	$18.57	5.55%	17.4x	16.5x	15.8x	14.9x	0.94x
SCANA Corp.	SCG	Neutral	$9,358	$65.48	3.51%	17.2x	16.5x	15.7x	14.6x	0.94x
Full SMid Average					**3.52%**	**19.1x**	**17.9x**	**16.9x**	**15.9x**	
Full SMid Median					**3.47%**	**19.0x**	**17.8x**	**16.7x**	**15.6x**	
<$3Bn SMid Average					**3.23%**	**19.6x**	**18.6x**	**17.5x**	**16.5x**	
Full Utilities Average					**3.42%**	**18.7x**	**17.8x**	**16.8x**	**16.0x**	

Source: FactSet and UBS; Note: All forecasts data based on consensus from FactSet

Figure 8: UBS Utilities Comp Sheet

	Ticker	Rating	Market Cap. ($ in millions)	Price 2/21/2016	Price Target	Dividend Yield	P/E Multiple 2016E	2017E	2018E	2019E
COMPETITIVE INTEGRATED										
American Electric Power, Inc.	AEP	Buy	30,666	62.48	65.00	3.59%	16.6	16.0	15.2	14.7
Dominion Resources	D	Neutral	41,917	70.41	71.00	3.98%	18.5	18.1	15.8	15.0
Entergy Corp.	ETR	Sell	13,174	73.85	66.00	4.60%	14.4	14.9	14.9	14.4
Exelon Corp.	EXC	Neutral	29,120	31.66	30.00	3.92%	12.4	12.2	11.1	10.6
FirstEnergy Corp.	FE	Neutral	14,061	33.19	32.00	4.34%	11.6	11.7	11.6	10.7
NextEra Energy	NEE	Buy	53,027	115.16	115.00	3.02%	18.6	17.7	16.6	16.5
Public Service Enterprise Group	PEG	Neutral	22,146	43.77	44.00	3.75%	15.1	15.2	16.1	15.2
Sempra Energy	SRE	Buy	24,446	98.49	116.00	2.84%	18.7	17.8	15.0	13.1
Average						3.75%	15.7	15.4	14.5	13.8
REGULATED INTEGRATED UTILITIES										
Large Cap										
Ameren Corp.	AEE	Neutral	11,093	45.72	43.00	3.72%	17.1	15.8	14.8	13.9
Alliant Energy Corp.	LNT	Not Rated	7,680	67.75	NA	3.47%	17.9	16.9	15.8	14.9
CenterPoint Energy Inc.	CNP	Not Rated	7,990	18.57	NA	5.55%	16.6	15.9	14.9	14.3
CMS Energy Corporation	CMS	Neutral	10,960	39.43	41.00	3.14%	19.5	18.3	17.1	16.0
DTE Energy Co.	DTE	Buy	15,282	85.15	100.00	3.43%	17.3	15.9	14.6	13.4
Duke Energy	DUK	Buy	51,480	74.79	82.00	4.41%	16.3	15.3	14.6	14.4
Edison International	EIX	Buy	20,787	63.80	65.00	3.01%	17.1	16.0	15.4	14.8
PG&E Corporation	PCG	Neutral	27,702	56.21	60.00	3.24%	15.0	15.4	14.8	14.1
Pinnacle West Capital Co.	PNW	Neutral	7,678	69.17	73.00	3.61%	17.1	16.5	15.2	14.9
PPL Corporation	PPL	Buy	24,286	36.04	38.00	4.22%	15.4	14.8	14.3	13.8
SCANA Corp.	SCG	Neutral	9,358	65.48	66.00	3.51%	16.3	15.6	15.0	14.8
Southern Company	SO	Sell	44,670	48.98	44.00	4.43%	17.3	17.2	16.5	15.9
WEC Energy Group Inc.	WEC	Sell	17,939	56.83	53.00	2.99%	19.4	18.4	17.2	16.5
Xcel Energy Inc.	XEL	Sell	20,056	39.52	36.00	3.44%	18.0	17.2	16.4	15.5
Average						3.73%	17.2	16.4	15.5	14.8
Small and Mid-Caps										
Avangrid, Inc.	AGR	Not Rated	2,193	38.72	NA	4.46%	17.3	15.5	14.9	na
Avista Corp	AVA	Neutral	2,346	37.65	33.00	3.64%	18.6	17.7	16.9	16.3
Black Hills Corp.	BKH	Not Rated	2,916	56.97	NA	2.95%	16.0	14.5	na	na
Empire District Electric Company	EDE	Neutral (CBE)	1,459	33.33	34.00	3.12%	23.0	21.9	21.0	21.6
Great Plains Energy	GXP	Not Rated	4,488	29.07	NA	3.61%	16.6	15.8	15.0	na
Hawaiian Electric Industries	HE	Not Rated	3,231	30.07	NA	4.12%	16.8	15.8	15.0	na
Idacorp, Inc.	IDA	Not Rated	3,639	72.34	NA	2.82%	18.0	17.6	na	na
NorthWestern Corp	NWE	Not Rated	2,846	59.07	NA	3.39%	17.0	15.7	na	na
Portland General Electric Company	POR	Buy	3,395	38.23	43.00	3.14%	16.8	15.7	15.3	14.0
PNM Resources Inc.	PNM	Not Rated	2,598	32.61	NA	2.70%	20.0	17.0	15.6	15.2
TECO Energy Inc.	TE	Neutral	6,464	27.48	27.55	3.35%	23.4	21.1	19.8	18.5
Westar Energy, Inc.	WR	Neutral	6,479	45.87	41.00	3.14%	19.3	18.2	17.5	16.1
Average						3.27%	18.7	17.4	17.0	16.9
Regulated Average						3.53%	17.8	16.8	16.0	15.4

Source: Rated Companies = Company Filings, FactSet, and UBS Estimates. Not Rated companies = FactSet.

Valuation Method and Risk Statement

Risks for Utilities and Independent Power Producers (IPPs) primarily relate to volatile commodity prices for power, natural gas, and coal. Risks to IPPs also stem from load variability, and operational risk in running these facilities. Rising coal and, to a certain extent, uranium prices could pressure margins as the fuel hedges roll off Competitive Integrateds. Further, IPPs face declining revenues as in the money power and gas hedges roll off. Other non-regulated risks include weather and for some, foreign currency risk, which again must be diligently accounted in the company's risk management operations. Major external factors, which affect our valuation, are environmental risks. Environmental capex could escalate if stricter emission standards are implemented. We believe a nuclear accident or a change in the Nuclear Regulatory Commission/Environment Protection Agency regulations could have a negative impact on our estimates. Risks for regulated utilities include the uncertainty around the composition of state regulatory Commissions, adverse regulatory changes, unfavorable weather conditions, variance from normal population growth, and changes in customer mix. Changes in macroeconomic factors will affect customer additions/subtractions and usage patterns. Valuation for IPPs and competitive integrated utilities is based on a sum-of-the-parts analysis.

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12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	48%	36%
Neutral	FSR is between -6% and 6% of the MRA.	39%	28%
Sell	FSR is > 6% below the MRA.	12%	22%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 31 December 2015.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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