UBS

Global Research

5 May 2016

NRG Energy Inc.

Sprucing Up the Portfolio

Partnering with SunRun and Spruce on Home Solar; substantially exiting EVgo

NRG announced the completion of its latest corporate realignment and as expected opted for a joint venture with Sunrun (RUN) and Spruce Financial to originate residential solar opportunities in NJ, MA, and NY. Although the business is expected to be FCF negative through at least 2017, we still see the opportunity for long-term upside via marketing to its Texas retail customers. While many investors wanted to see NRG exit this market entirely, we think this is ultimately the right move. NRG is also selling a majority stake in its EVgo business for $20Mn cash and is retaining the California litigation settlement liabilities (~$84Mn as of September 2015 – reaffirmed on the call at ~$20Mn annually for four years). The EV business lost -$17Mn of EBITDA in 2014 and we believe that simply ending the cash investment into the FCF-negative venture will be received positively.

NRG expects to be one of the 'last men standing' in ERCOT coal market

NRG disclosed potential capital costs for its ERCOT fleet's compliance with regional haze which the company believes will be ~$100/kW for scrubber upgrades at Limestone 1-2 (1,850MW). In contrast NRG estimates that scrubber installations could cost $400-$500/kW for impacted Energy Future Holdings (EFH) and Dynegy (DYN) assets. We continue to expect compliance with regional haze to be delayed into the ~2019-2021 timeframe: further details on ERCOT compliance are available in our March report. This follows continued bullish comments from Calpine last week on TX.

2016 Guidance maintained and PJM capacity revenue cash pulled forward

FY16 adjusted EBITDA was maintained and the company believes it can achieve its $400Mn run-rate cost reduction target by 2017E. Target recourse debt paydown was maintained at ~$775Mn and NRG repurchased $55Mn of debt since the last update. NRG executed a forward capacity sale at its Midwest Gen assets, pulling forward $253Mn of proceeds for PJM capacity auctions through 2018/19 with proceeds dedicated to post-2016 debt paydown or redemption of preferred stock.

Valuation: Maintain $16 Price Target

Valuation is based on 2018E SOTP. NRG expects to negotiate with its non-recourse GenOn subsidiary creditors and is still targeting $362Mn of further asset sales for 2016.

Equities

Americas
Electric Utilities

12-month rating	**Buy**
12m price target	**US$16.00**
Price	**US$14.86**

RIC: NRG.N **BBG:** NRG US

Trading data and key metrics	
52-wk range	US$26.43-8.98
Market cap.	US$4.99bn
Shares o/s	336m (COM)
Free float	100%
Avg. daily volume ('000)	1,606
Avg. daily value (m)	US$20.5
Common s/h equity (12/16E)	US$5.73bn
P/BV (12/16E)	0.8x
Net debt / EBITDA (12/16E)	5.6x

EPS (UBS, diluted) (US$)	12/16E	
	UBS	Cons.
Q1E	0.24	0.06
Q2E	0.60	0.41
Q3E	0.73	0.56
Q4E	(0.38)	(0.25)
12/16E	1.18	0.74
12/17E	0.99	(0.22)
12/18E	2.06	0.68

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Highlights (US$m)	12/13	12/14	12/15	12/16E	12/17E	12/18E	12/19E	12/20E
Revenues	11,295	15,868	14,674	15,258	15,153	15,377	15,521	15,513
EBIT (UBS)	1,380	1,605	1,831	2,183	2,085	2,270	2,398	2,370
Net earnings (UBS)	274	262	(1,487)	373	304	616	829	839
EPS (UBS, diluted) (US$)	0.85	0.78	(4.43)	1.18	0.99	2.06	2.84	2.95
DPS (US$)	0.48	0.54	0.54	0.24	0.12	0.12	0.12	0.12
Net (debt) / cash	(14,812)	(18,568)	(18,277)	(17,592)	(16,608)	(14,761)	(12,839)	(10,872)

Profitability/valuation	12/13	12/14	12/15	12/16E	12/17E	12/18E	12/19E	12/20E
EBIT margin %	12.2	10.1	12.5	14.3	13.8	14.8	15.4	15.3
ROIC (EBIT) %	7.4	7.9	9.5	12.6	12.5	14.5	16.7	18.1
EV/EBITDA (core) x	6.3	6.2	5.5	5.1	5.1	4.2	3.5	2.9
P/E (UBS, diluted) x	31.3	39.6	(4.7)	12.6	15.0	7.2	5.2	5.0
Equity FCF (UBS) yield %	(9.1)	5.9	0.4	(0.8)	6.4	23.7	25.2	26.1
Net dividend yield %	1.8	1.7	2.6	1.6	0.8	0.8	0.8	0.8

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of US$14.86 on 05 May 2016 16:41 EDT

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What do we think about NRG Energy?

We continue to view NRG primarily as a capital allocation story in the current commodity market. The outlook for its baseload assets continues to face long-term structural headwinds but its retail business generates strong cash flows today which are available to reduce debt and preserve optionality. For this reason the decision to substantially end the capital investment into residential solar and EVgo is a positive development, regardless of any future potential upside from the businesses. The most significant uncertainty continues to revolve around the outlook for the non-recourse GenOn subsidiary – as we saw with Dynegy yesterday, addressing the issue head-on can unlock further value.

We think the solar arrangement is ideal.

A complete sell-down of the business would have removed the ability to leverage the retail platform the company has in place with ~3Mn customers. Rather, the front end monetization makes sense for complete sales to a Spruce or SunRun. We emphasize this is likely to lead to ~$0.30/W cash margins on sales. Assuming a modest 20MW/yr initial pace which could ramp up to 50MW/yr, this would add ~$15Mn per annum in FCF (mgmnt expects to be EBITDA breakeven in the business by 2017). Margins could be wider for fully developed projects.

The solar partnership will be a small incremental contributor off the wider retail franchise but a positive rather than a historical negative.

We highlight other takeaways from the NRG Energy/NRG Yield earnings calls:

Coal capacity factors highlight the long-term challenges for NRG's fleet

The baseload coal assets reported net capacity factors between 21-34%, sharply lower YoY due to the decline in gas prices and milder winter weather. The gas fleet acted as a partial offset but this datapoint is consistent with strong coal-to-gas switching trends which pressure NRG's energy margins (currently 33% of consolidated margins). 1Q16 adjusted EBITDA of $812Mn was slightly ahead of $804Mn UBSe and significantly higher than Consensus ($661Mn). The smaller-than expected YoY decline was driven primarily by the expected ~$40Mn increase in NRG Yield, +$47Mn sale of California emission credits, lower outage expense, and only a $15Mn decrease in retail EBITDA also due to cost cutting.

A reduction in expense and the sale of emission credits were key components in NYLD's strong quarter.

Hedge disclosures also slid as management locked-in lower prices

NYLD project debt amortization details indicates bullet payments

NRG Yield provided enhanced disclosures regarding project-by-project debt amortization which reveals that some assets have bullet payments. For example the South Trent wind asset averages $4Mn of annual debt amortization from 2016-2020 but there is a $45Mn payment required in 2020. A similar profile is apparent for Alpine Solar ($8Mn average annual debt amortization from 2016-2020 but $112Mn obligation to be satisfied in 2021/2022) and El Segundo ($47Mn average annual debt amortization from 2016-2020 but $250Mn obligation to be satisfied in 2021-2023).

NRG expects to offer CVSR for $150-$200Mn to NYLD

Based on previous NRG/NYLD disclosures the remaining stake of CVSR has $55MnEBITDA/$25Mn CAFD and NRG expects to raise $150-$200Mn. As of 3/31/16 there was $780Mn of project-level debt at consolidated NRG Energy implying ~$400Mn of debt associated with the drop-down. With a target transaction enterprise value in the range of $550-$600Mn we estimate transaction economics similar to the last EME wind drop-down (~11x EV / EBITDA and ~10% CAFD Yield). Specifically based on its guidance management is targeting 10-11x EV / EBITDA and a 13-17% gross CAFD Yield. In Figure 1 to the right we show 9-12% net CAFD which we explain below.

Management has indicated that it is open to adding secured debt to reduce the liquidity requirements from the transaction and based upon its current liquidity we believe that is the prudent choice. Prior to the CVSR financing we forecast that NYLD will have ~$220Mn of liquidity capacity assuming it fully utilizes its revolver, leaving less than $50Mn of liquidity at the midpoint of the CVSR transaction price. Adding secured debt to the project will help the liquidity situation but also reduce the cash flow profile. For example, on the right we assume that NRG Yield will finance half of the $175Mn equity component of the transaction with additional project debt which would reduce CAFD on the project -$8Mn to $17Mn. **Factoring in this adjustment is how we arrive at the 9-12% net CAFD, emphasizing that the 10% midpoint is in-line with the last ROFO transaction**. Although NRG Yield has indicated it has project debt latitude for both the initial and ROFO portions of CVSR the asset is already significantly levered (7x+ debt / EBITDA) and it is unclear how much capacity there is with respect to its financing agreements at the project. For the purposes of the exercise we assume that there is sufficient capacity for the debt we estimate. An update on the transaction is expected on the 2Q16 call.

Figure 1: CVSR Drop Analysis

CVSR Drop (UBSe)	EBITDA	CAFD
Implied CVSR Guidance	55	25
Incremental Financing		(8)
Debt Assumed ($Mn)	398	398
Equity to NRG ($Mn)	150	200
Total EV	548	598
EV / EBITDA	**10.0x**	**10.9x**
Gross CAFD Yield (%)	**17%**	**13%**
Net CAFD Yield (%)	**12%**	**9%**

2Q16E Liquidity Walk ($Mn)	
Unrestricted Cash 1Q16	76
Revolver Availability 1Q16	119
Plus: 2Q16E CAFD	66
Less: 2Q16E Dividend	(42)
Pre-CVSR Liquidity	219
Less: CVSR Midpoint	(175)
Plus: Estimated Project Debt	88
2Q16E Ending Liquidity	**132**

Source: Company Filings and UBS Estimates

Forecast returns

Forecast price appreciation	+7.7%
Forecast dividend yield	0.8%
Forecast stock return	+8.5%
Market return assumption	5.7%
Forecast excess return	+2.8%

Valuation Method and Risk Statement

Risks for NRG Energy (NRG) include but are not limited to: (1) potential increases in environmental capital expenditures; (2) unfavorable commodity movements [natural gas, power, etc.]; (3) adverse political/legal/regulatory actions; (4) unfavorable weather; (5) operational and construction risk; (6) inability to access the capital markets on attractive terms; (7) declines in customer demand and population; (8) failure to close pending or prospective M&A transactions; (9) natural disasters or nuclear accidents; (10) losses at the retail marketing segment; (11) change in macroeconomics; (12) operational challenges at the nuclear and other assets; (13) inability to achieve synergy and other financial metrics; and (14) inability to meet debt obligations as due; and (15) other unforeseen changes.
Valuation is based on a sum-of-the-parts analysis.

Risks for NRG Yield include but are not limited to: (1) Inability to complete drop-downs in an accretive manner; (2) lack of access to capital markets for debt and/or equity; (3) changes to the dividend per share growth rate; (4) counterparty defaults on contracted assets; (5) cash flows from assets differing from historical expectations from changes in resources; (6) loss of value from natural disaster; (7) corporate conduct as many board members are also on NRG Energy's board; (8) unfavorable legislative or regulatory policies impacting renewable assets; (9) uncertainty around terminal value for contracted assets; (10) reductions in economic activity and end-user demand and (11) unforseen changes. Our price target is based on an equal weighting of DCF and Yield approach.

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Buy	FSR is > 6% above the MRA.	49%	32%
Neutral	FSR is between -6% and 6% of the MRA.	38%	26%
Sell	FSR is > 6% below the MRA.	14%	19%
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 March 2016.
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.
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Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
NRG Energy Inc.[7, 16]	NRG.N	Buy	N/A	US$14.62	04 May 2016
NRG Yield[16]	NYLDa.N	Buy	N/A	US$15.08	04 May 2016

Source: UBS. All prices as of local market close.
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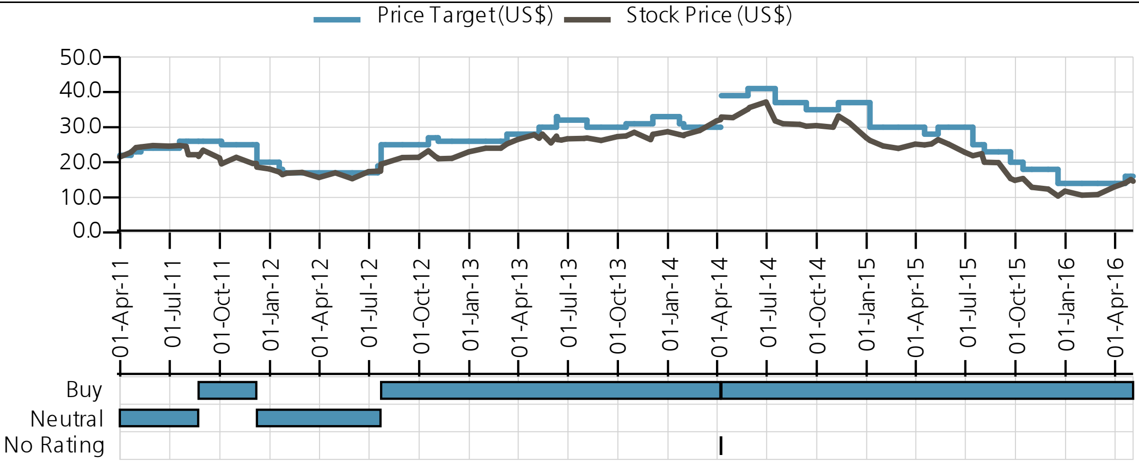
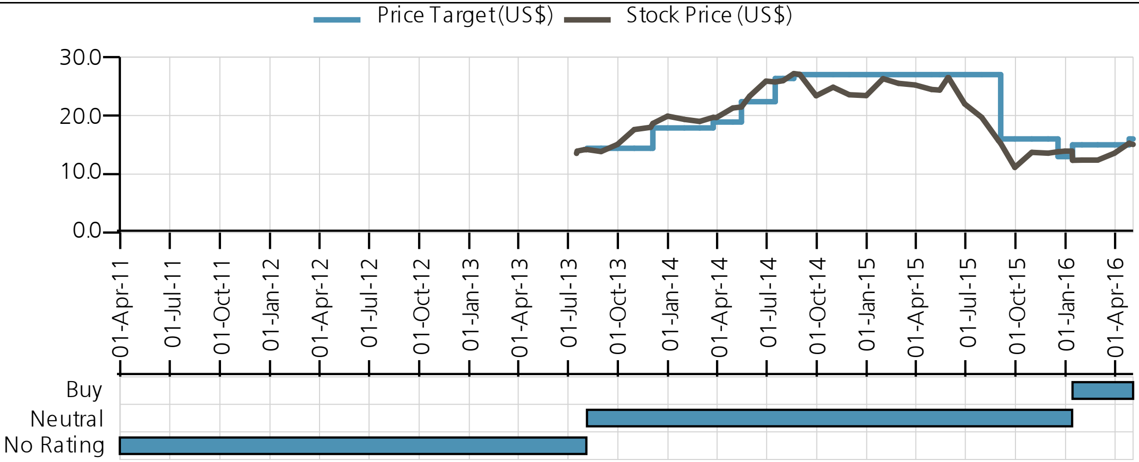
NRG Energy Inc. (US$)



Source: UBS; as of 04 May 2016

NRG Yield (US$)



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