

AES Corporation

Rolling Back Down the Earnings Hill

Toning down expectations – not just on 2014, but more structurally

While not just bringing down '14 EPS on ~\$0.20 of headwinds this year (somewhat predictable), we see pressure on shares as really emanating from mgmt's more significant scaling back of EPS in '15 and '16, with mgmt promising '15 EPS of \$1.30-1.40 (vs. Consensus of \$1.41) – and flat to 'modest' growth in turn for '16. While this year always had the Tiete cliff which is 'only' -\$0.08, the flat EPS off mgmt's initial '14 range effectively delays growth by 1-2 years vs. plan. Primary drivers of the pullback include not just hydrology, but more structural concerns around F/X and interest expense. Moreover, with Brazilian hydrology appearing worse of late, we're not confident around assumption of normalization of hydrological conditions in '15 either.

Few clues on value of the California build-out; we estimate at least ~\$0.10+

Mgmt provided scant details around the most significant contract win in years, adding at least \$0.10+ in EPS in '20/'21 between the (2) new CCGTS at Alamitos and Huntington Beach and 100MW battery. We emphasize '19 will see a -\$0.06 offset as existing above-market contracts on the legacy plants roll-off (contracts are to repower units). We also flag the storage contract appears south of \$2,000/kW and appears competitive vs. conventional peakers as best we understand the procurement terms. Mgmt looks to bring in a partner, which is likely to be a YieldCo to fund the equity.

Tax back in focus, as look to Congress to pass 'CFC look-through' extension

Also baked into '15+ EPS guidance is a \$0.06 benefit associated with the further extension of the CFC look-through (formerly TIPRA); while non-cash, we think this is likely part of a tax extenders bill. We see this as further uncertainty in December.

Valuation: Shares likely impaired while EPS credibility reinstated; keep \$15 PT

Valuation is via SOTP. Given the company's tricky history with achieving stated EPS growth targets, we see the latest pull back in guidance as particularly disconcerting. Ahead of a formal update of our target and estimates, we look for mgmt to articulate a growth story at EEI, articulating how it intends to grow its EPS at an accelerated 8-10% rate in '17/'18 off re-baselined year as many of its ongoing projects are slated to reach in-service.

Equities

Americas
Electric Utilities

12-month rating **Neutral**

12m price target **US\$15.00**

Price **US\$13.95**

RIC: AES.N BBG: AES US

Trading data and key metrics

| | |
|----------------------------|-----------------|
| 52-wk range | US\$15.57-12.84 |
| Market cap. | US\$10.1bn |
| Shares o/s | 723m (COM) |
| Free float | 100% |
| Avg. daily volume ('000) | 1,159 |
| Avg. daily value (m) | US\$16.5 |
| Common s/h equity (12/14E) | US\$4.86bn |
| P/BV (12/14E) | 2.1x |
| Net debt / EBITDA (12/14E) | 3.8x |

EPS (UBS, diluted) (US\$)

| | 12/14E | |
|--------|--------|-------|
| | UBS | Cons. |
| Q1 | 0.24 | 0.24 |
| Q2 | 0.28 | 0.28 |
| Q3E | 0.34 | 0.34 |
| Q4E | 0.43 | 0.50 |
| 12/14E | 1.30 | 1.31 |
| 12/15E | 1.33 | 1.41 |
| 12/16E | 1.46 | 1.47 |

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| Highlights (US\$m) | 12/11 | 12/12 | 12/13 | 12/14E | 12/15E | 12/16E | 12/17E | 12/18E |
|---------------------------|----------|----------|----------|----------|----------|----------|----------|----------|
| Revenues | 17,274 | 19,232 | 15,891 | 19,254 | 19,310 | 19,271 | 19,282 | 19,345 |
| EBIT (UBS) | 3,390 | 1,537 | 2,484 | 3,462 | 3,514 | 3,473 | 3,584 | 3,694 |
| Net earnings (UBS) | 818 | 946 | 958 | 942 | 937 | 1,004 | 1,062 | 1,174 |
| EPS (UBS, diluted) (US\$) | 1.04 | 1.24 | 1.29 | 1.30 | 1.33 | 1.46 | 1.58 | 1.79 |
| DPS (US\$) | 0.00 | 0.16 | 0.16 | 0.16 | 0.16 | 0.16 | 0.16 | 0.16 |
| Net (debt) / cash | (20,941) | (19,481) | (19,485) | (18,195) | (17,733) | (17,074) | (16,207) | (15,089) |
| Profitability/valuation | 12/11 | 12/12 | 12/13 | 12/14E | 12/15E | 12/16E | 12/17E | 12/18E |
| EBIT margin % | 19.6 | 8.0 | 15.6 | 18.0 | 18.2 | 18.0 | 18.6 | 19.1 |
| ROIC (EBIT) % | 11.7 | 5.2 | 8.9 | 12.8 | 13.1 | 13.0 | 13.4 | 14.0 |
| EV/EBITDA (core) x | 6.3 | 11.0 | 7.8 | 6.3 | 6.0 | 6.0 | 6.1 | 6.0 |
| P/E (UBS, diluted) x | 11.5 | 9.6 | 10.0 | 10.7 | 10.5 | 9.6 | 8.8 | 7.8 |
| Equity FCF (UBS) yield % | (2.4) | 20.8 | 12.5 | 19.4 | 13.1 | 14.5 | 16.8 | 19.7 |
| Net dividend yield % | 0.0 | 1.3 | 1.2 | 1.1 | 1.1 | 1.1 | 1.1 | 1.1 |

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\$13.95 on 05 Nov 2014 19:39 EST

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The Power Line on AES: *Picking the Pieces Back Up*

We see the story as migrating away from the capital re-allocation story for the medium term as investors re-assure themselves of the fundamental drivers – and exposures in the AES story. Notably, focus on Brazil only continues to grow amidst the latest elections, ongoing rationing concerns, as well as broader international growth and FIX concerns. We also continue to see macro risks around higher interest rates as disproportionately impacting AES vs. peers given their substantial OpCo and parent leverage behind fixed-price offtake agreements

We emphasize the update today did little to address other remaining potential overhangs, including potential contract re-negotiation in Bulgaria for Maritza with the latest new government. Other nuanced risk around CFC look-through (TIPRA) extension remains a further near-term overhang into December.

As for capital allocation – the subject we had largely anticipated would capture much of the original call attention – management upped its repurchase program leaving it with \$150 Mn in latitude as of November 5th. With ~\$300 Mn yet to be spoken for in capital allocation in its budget, we wouldn't be surprised to see this added authority largely utilized to lift EPS expectations as much as possible.

Ultimately, we see expectations and the implied value in AES shares as providing potentially 'deep value' for those willing to embrace further headline risk heading into 2015. The key question remains how much investors discount the '17/'18 uplift in EPS following the latest scaling back of expectations. We emphasize delineation of further growth projects in 2015 (alongside partner sell-downs) could yet work to boost confidence yet again with brownfield coal expansions at Masinloc (Unit 2) and Mong Duong (Unit 3).

Forecast returns

| | |
|-----------------------------|-------|
| Forecast price appreciation | +7.5% |
| Forecast dividend yield | 1.1% |
| Forecast stock return | +8.6% |
| Market return assumption | 5.5% |
| Forecast excess return | +3.1% |

Statement of Risk

AES's stock could be negatively affected by weather; weak wholesale power prices; economic downturn in its regulated service territories; interest rate risks; negative regulatory decisions for both its regulated and merchant subsidiaries; and disruption of trading activity in power markets. The company is also exposed to risks from its international operations including adverse changes in foreign exchange rates; international regulations; and economic, social and political instability. Its United States Generation business is exposed to unfavorable regulatory developments from the FERC and state utility commissions. Further, AES is subject to stringent environmental laws and regulations by federal, regional, state and local authorities, international treaties and foreign government authorities. Its business remains exposed to commodity, power and capacity price volatility.

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|-------------------|---|-----------------------|--------------------------|
| Buy | FSR is > 6% above the MRA. | 47% | 34% |
| Neutral | FSR is between -6% and 6% of the MRA. | 42% | 28% |
| Sell | FSR is > 6% below the MRA. | 11% | 21% |
| 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. | less than 1% | less than 1% |
| Sell | Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event. | less than 1% | less than 1% |

Source: UBS. Rating allocations are as of 30 September 2014.

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UBS Securities LLC: Julien Dumoulin-Smith; Michael Weinstein; Paul Zimbardo.

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|---|---------|-----------------|-------------------|-----------|-------------|
| AES Corporation ^{2, 4, 6, 16} | AES.N | Neutral | N/A | US\$13.06 | 06 Nov 2014 |

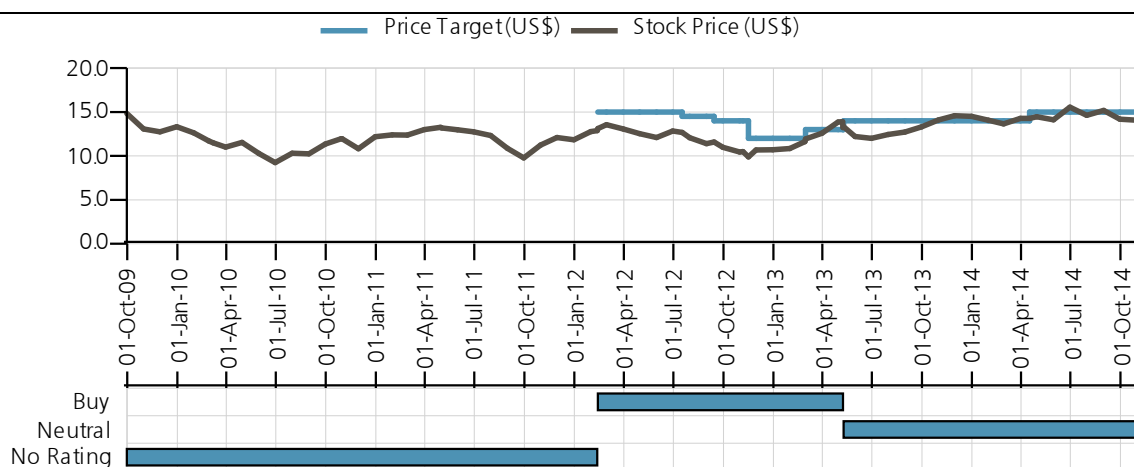
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AES Corporation (US\$)



Source: UBS; as of 06 Nov 2014

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