

FirstEnergy Corp.

Contracting: What is the Street Expecting?

We polled the Street on expectations around FE's refilled PPA case

We held our latest investor poll yesterday asking investors for their expectations on both whether the current Ohio PPAs would be approved and how much corresponding equity FirstEnergy might need, particularly if rejected. The Street overwhelmingly believes the latest PPA effort will be rejected (59%) while a further 12% are unsure; just 29% expect the latest effort to be approved. We emphasize the poll results are consistent with our perception on shares of late, having failed to regain much of the ground lost the day the PPA was initially rejected by FERC under its prior structure. In contrast to the Street, we hold out greater confidence both that the PUCO will approve the contract, and that the FERC will prove unable to claim jurisdiction.

We see FE as in need to act decisively to avoid credit action; equity raise risk

We see action from FE to at least begin to shore up its balance sheet as a near term datapoint if it is not successful in its pending petition for a PPA. While incremental equity would likely still be required to keep its capital structure intact even with the PPAs, the question is whether a PPA or an equity raise would be necessary to fix its balance sheet 'problem' to stay Investment Grade. We emphasize expectations span the gamut, between limited quantities (assuming a PPA is approved) to north of \$3 Bn. The majority appear to assume well north of \$1 Bn in equity.

How would an equity raise be achieved? A mix of sources including pension

Practically speaking, we see a large equity raise would be funded by ~\$500 Mn via a direct FE share infusion into the pension (10% of fund assets is max permissible), ongoing equity DRIP of ~\$80 Mn/yr, and a substantial secondary market raise for the balance (albeit potentially multiple tranches as postulated by some in the survey). We understand the agencies are requiring FE to achieve a minimum 14% FFO/Debt by the end of 2017, albeit with a requirement for action prior to ensure it is on its way towards achieving such a metric, off a 12/31/2015 position of 12.3% per the agencies.

Valuation: We're actually a bit more constructive on shares

Given the pervasive negativity on shares, we are a bit more constructive, seeing clear near-term potential for continued volatility in May as an accelerated timeline for resolution from the PUCO is sought by end of May. Subsequent FERC petition would also likely have an expedited timeline. Our SOP is derived via P/E on 2018 for the utes and EV/EBITDA for FES.

Equities

Americas
Electric Utilities

12-month rating **Neutral**

12m price target **US\$32.00**

Price **US\$33.51**

RIC: FE.N BBG: FE US

Trading data and key metrics

52-wk range	US\$36.34-29.12
Market cap.	US\$14.2bn
Shares o/s	424m (COM)
Free float	100%
Avg. daily volume ('000)	1,179
Avg. daily value (m)	US\$40.6
Common s/h equity (12/16E)	US\$13.5bn
P/BV (12/16E)	1.1x
Net debt / EBITDA (12/16E)	5.1x

EPS (UBS, diluted) (US\$)

	12/16E	
	UBS	Cons.
Q1	0.79	0.80
Q2E	0.44	0.55
Q3E	0.74	0.87
Q4E	0.51	0.45
12/16E	2.49	2.68
12/17E	2.36	2.51
12/18E	2.41	2.55

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Highlights (US\$m)	12/13	12/14	12/15	12/16E	12/17E	12/18E	12/19E	12/20E
Revenues	14,917	15,053	15,026	17,879	17,936	18,027	18,164	18,344
EBIT (UBS)	2,800	2,335	2,498	2,721	2,769	2,796	2,815	3,414
Net earnings (UBS)	1,270	1,067	1,146	1,057	1,005	1,032	1,065	1,470
EPS (UBS, diluted) (US\$)	3.04	2.53	2.71	2.49	2.36	2.41	2.48	3.40
DPS (US\$)	2.20	1.44	1.44	1.44	1.44	1.44	1.44	1.44
Net (debt) / cash	(20,432)	(21,694)	(21,935)	(22,195)	(22,724)	(23,125)	(23,253)	(23,494)
Profitability/valuation	12/13	12/14	12/15	12/16E	12/17E	12/18E	12/19E	12/20E
EBIT margin %	18.8	15.5	16.6	15.2	15.4	15.5	15.5	18.6
ROIC (EBIT) %	6.1	5.0	5.2	5.5	5.5	5.5	5.5	6.5
EV/EBITDA (core) x	9.2	10.7	9.3	9.3	9.3	9.4	9.3	9.1
P/E (UBS, diluted) x	12.8	13.3	12.6	13.4	14.2	13.9	13.5	9.9
Equity FCF (UBS) yield %	1.9	(2.4)	7.5	6.3	0.0	0.9	2.9	2.1
Net dividend yield %	5.7	4.3	4.2	4.3	4.3	4.3	4.3	4.3

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\$33.51 on 05 May 2016 19:42 EDT

UBS Research THESIS MAP a guide to our thinking and what's where in this report**PIVOTAL QUESTIONS****Q: What is Wall Street expecting with regards to the PPA?**

Wall Street overwhelmingly expects the Ohio PPA as revised to be rejected by the PUC or to be accepted and eventually rejected due to legal challenges further down the road. In contrast, we're actually quite comfortable the PUCO could yet again vote to approve the deal. Without FERC oversight, this...

[more →](#)**UBS VIEW**

FE is one of the more binary stories we cover as the company will have drastically different outlooks depending on whether it is successful with its Ohio PPAs. We estimate ~5% utility plus parent EPS growth 2015A-2018E but the potential for additional equity could dilute the outlook.

EVIDENCE

Based upon FirstEnergy's Pennsylvania guidance it's ~70% of its revenue request would translate to pre-tax earnings versus 55-60% in the latest request. Actual EPS from the rate case have been ~\$0.25/sh for the adjusted full year compared with the original guidance of \$0.30 as higher O&M dinged results. An analysis of historical rate requests in the state shows that FE's request is in-line with the average but actual authorized increases have averaged 8%.

WHAT'S PRICED IN?

Following FE's Ohio ESP filing with the PPA, investors have increasingly been valuing FirstEnergy as utilities plus parent with an uplift for the PPA earnings (either multiple of earnings or discounted cash flow for the life of the contract). Following the April 27th FERC ruling FE retreated \$3-4/sh as investors seemingly removed the full contract value but are not yet embedding dilution from a potential block equity issuance. This remains a key risk.

UPSIDE / DOWNSIDE SPECTRUM

Value drivers	Regulated P/E	Ohio PPA Value	Block Equity
\$39 upside	17.1x	~\$3/sh	\$0
\$32 base	15.5x	~\$0/sh	\$0
\$28 downside	14.5x	~\$0/sh	~\$1,000Mn

Source: UBS

[more →](#)**COMPANY DESCRIPTION**

FirstEnergy Corp. (FE) is a diversified energy company involved in the generation, transmission, and distribution of electricity and other energy-related services. The regulated...

[more →](#)

PIVOTAL QUESTIONS

[return](#) ↑**Q: What is Wall Street expecting with regards to the PPA?**

UBS VIEW

Wall Street overwhelmingly expects the Ohio PPA as revised to be **rejected** by the PUC or to be accepted and eventually rejected due to legal challenges further down the road. In contrast, we're actually quite comfortable the PUCO could yet again vote to approve the deal. Without FERC oversight, this could prove quite compelling.

Our principle concern is that the PUCO will have difficulties in accepting the terms of the revised deal such that there is no explicit linkage *requiring* FE to maintain the coal plants even with the PPA revenues; this would be implicit, but not necessarily an explicit requirement. The risk remains that the PUCO would once more attempt to *link* these two concepts as part of any approval, therefore introducing potential FERC oversight again.

We expect IPP interests to attempt another effort to file a complaint before FERC that would once more attempt to claim jurisdiction in the case. While this is likely to be filed only after the latest petition is approved by the PUCO, we would expect the filing to take effect immediately.

Why is the Street so doubtful?

We sense this is due to two factors: 1) Because AEP has not followed suit, yet; and 2) The companies would have filed for such treatment earlier if they had thought such a path of less resistance were possible. We're less convinced. While this approach surely is less ideal for the PUCO, we're biased to believe this could yet happen.

What about the timing?

What about the PUCO dynamics? With the sitting chair, Andre Porter, set to rolloff by the end of the month, we see a clear potential that only (4) of (5) commissioners vote. That said given the unanimous vote last time we're not sure that the departure of the current chair for MISO matters.

For more: See our latest note, [Successfully Going Back to the Drawing Board](#).

EVIDENCE

Our survey confirms Street expectations are low.

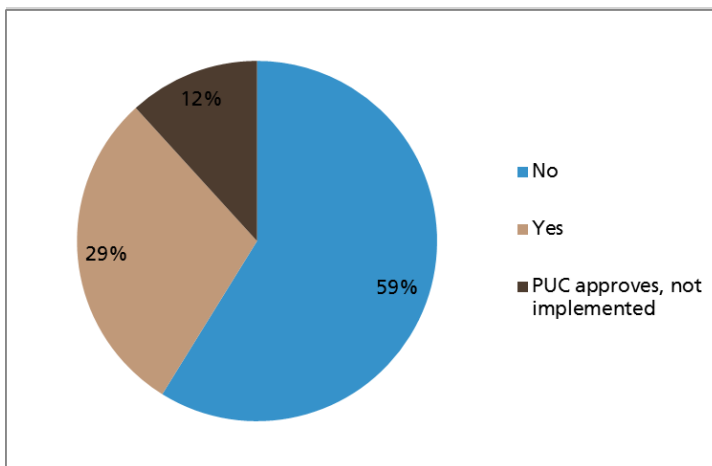
WHAT'S PRICED IN?

With the stock having a limit positive reaction since the release of the PPA, despite a -10% move down the day prior when the PPA was initially rejected, the stock appears to embed little by way of confidence for any approval..

Question #1: Will the PPA Happen?

We reached out to investors and asked them what they were expecting following the recent updates to the Ohio PPA issue. The sentiment among those surveyed was fairly consistent: a convincing majority believes the Ohio PPA ruling will not be approved by the PUC and implemented. As we illustrate below, nearly 60% of investors are expecting a rejection from the state's regulators. Additionally, 12% expect irrespective of a PUC decision the PPA will not be implemented as legal challenges arise down the line. Here is the breakdown of the responses to our question, **"Will the Ohio PPA as revised be approved by the PUC and be ultimately implemented?"**

Figure 1: Responses from those surveyed (%)

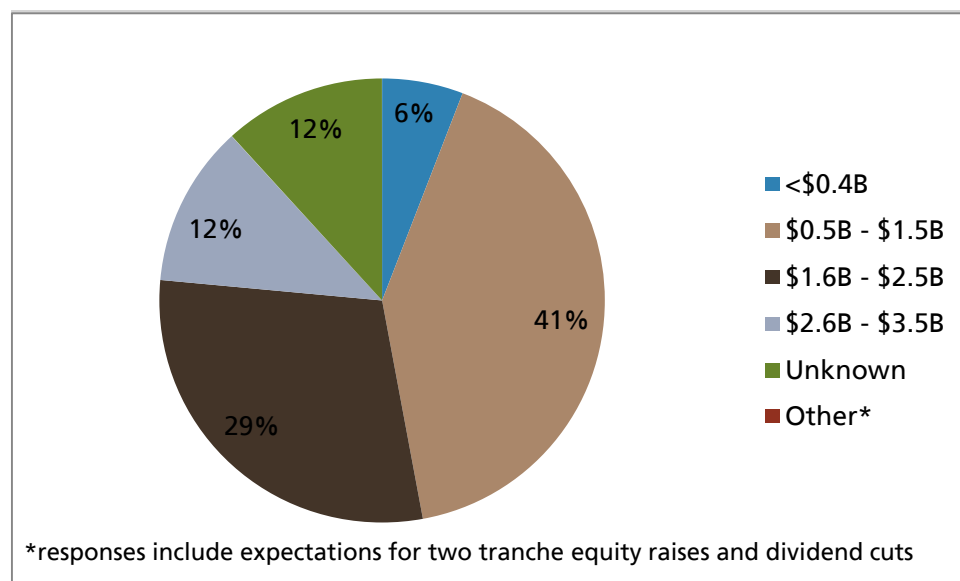


Source: UBSe; responses = 17

Question #2: How Much Equity will FE Need?

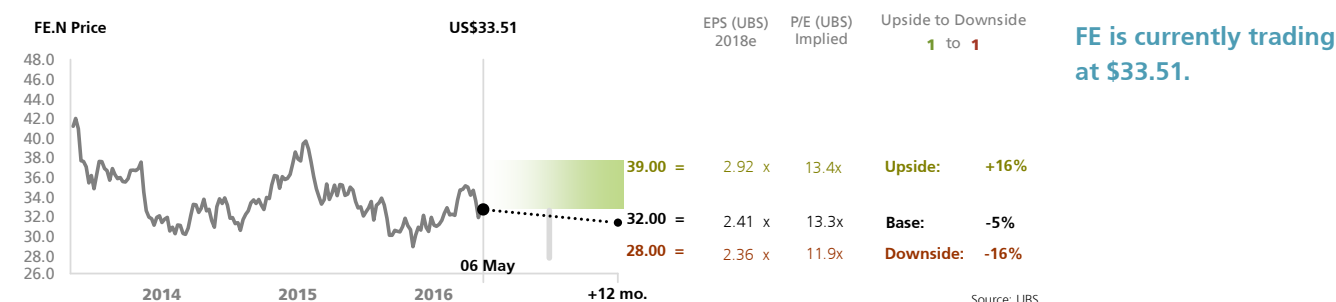
We were also curious to find out where expectations were regarding an equity raise to address the balance sheet structure and growth through 2018. A large number of investors expect anywhere from \$500 million to \$2.5 billion of equity capital to be raised. Of those surveyed, no response denied the possibility of an equity raise, with the smallest amount estimated at \$200 million and the highest estimate at \$3.5 billion. Some respondents mentioned an expectation of the equity raise to be split up into separate tranches or the equity raise to be accompanied by a dividend cut. See below the range of responses:

Figure 2: Range of responses relating to equity capital raise



Source: UBSe; responses = 17

UPSIDE / DOWNSIDE SPECTRUM

[return](#) ↑

Value drivers	Regulated P/E	Ohio PPA Value	Block Equity
\$39 upside	17.1x	~\$3/sh	\$0
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Source: UBS

Upside (US\$39): Our upside case for FirstEnergy is based improved in the regulated earnings growth profile and a more favorable valuation methodology for the PPA.

Base (US\$32): Our base case is based on 2018E sum-of-the-parts methodology with P/E multiples for the regulated utilities and non-interest parent drag. We continue to net out the parent debt given the magnitude, utilization of revolver which understates interest expense and overall risk profile for the generation (assuming FES is non-recourse). We exclude the PPA from the base case (~\$3/sh).

Downside (US\$28): Our downside case is premised on continued weakness in power prices and further economic softness in FE's markets. This scenario also assumes that FE's Ohio PPA does not withstand legal challenges and that FE has to issue equity to improve its credit metrics.

COMPANY DESCRIPTION

[return](#) ↑

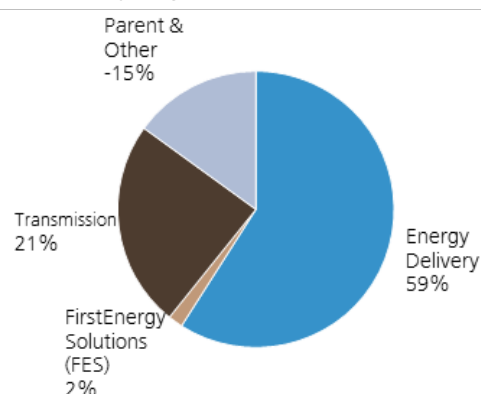
Market Cap	US\$15.3bn
Shares Outstanding	424m (COM)
Industry	Electric Utilities, Diversified
Region	Americas
Website	www.firstenergycorp.com/

FirstEnergy Corp. (FE) is a diversified energy company involved in the generation, transmission, and distribution of electricity and other energy-related services. The regulated distribution business serves ~6m customers across five primary states (OH, PA, NJ, WV, and MD). FE has 24,000 miles of regulated transmission lines in PJM, the largest system in the region.

Industry outlook

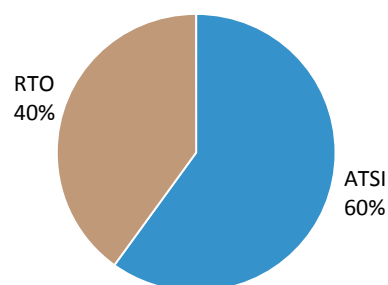
The electric utility industry is projected to experience flat electric demand growth in coming years as a tepid economy and energy efficiency dampen demand. In the unregulated merchant power space, we see limited potential for a meaningful recovery from currently low power prices due to limited projected demand growth, growth of subsidized renewables and potential for only modest further retirements. At regulated utilities, we believe rising interest rates and robust valuations are a challenge to the sector, particularly as earnings growth stalls once EPA-mandated growth capex slow mid-decade. We expect cost-cutting and strategic planning to be a key theme across both regulated and competitive companies, with M&A at modest premiums designed to extract cost synergies. Efforts to limit impacts on jobs and maintain fuel diversity could keep coal and nuclear plants open, benefitting the likes of FE, as the industry continues to take steps back towards re-regulation.

Adjusted EPS by Segment (2017E%)



Source: Company data, UBS estimates

PJM Capacity by Region (2018/2019)



Source: Company data, UBS

For additional context, please refer links to relevant recent reports below:

[2/17/16 Pension Woes](#)

[12/2/15 At the Goalline in Columbus](#)

[11/2/15 In a Holding Pattern Above Columbus](#)

[10/13/15 Will Ohio Come Through?](#)

[8/3/15 Keeping Up With The Jones](#)

[5/4/15 Carving Out Another Chunk of Change](#)

[3/19/15 More March Madness in Columbus](#)

[2/20/15 Hitting The Reset Button Again](#)

For further details on the Ohio proceedings, please refer to reports below:

[Losing the Battle at Buckeye](#)

[Ohio: Scoring a Contract](#)

[Ohio: Is Re-Regulation on the Table?](#)

[PJM's Ohio Conundrum](#)

[FE: At the Goal Line in Columbus](#)

[AEP: Buying into Ohio](#)

Forecast returns

Forecast price appreciation	-4.5%
Forecast dividend yield	4.3%
Forecast stock return	-0.2%
Market return assumption	5.7%
Forecast excess return	-5.9%

Valuation Method and Risk Statement

Risks to FirstEnergy (FE) investment thesis include but are not limited to: 1) adverse regulatory/legislative/legal outcomes; 2) declines in customer usage and growth; 3) unfavorable weather; 4) weak wholesale power prices; 5) economic downturn in its regulated service territories; 6) inability to access the capital markets on attractive terms; 7) nuclear risks and other natural disasters; 8) disruption of trading activity in power markets; 9) unfavorable changes in commodity costs; 10) inability to achieve regulated capital expenditure targets and/or higher than expected unregulated capital expenditure needs; and 11) other unforeseen risks.

Valuation is based on 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.	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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UBS Securities LLC: Julien Dumoulin-Smith; Michael Weinstein; Paul Zimbardo.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
FirstEnergy Corp. ^{7, 16}	FE.N	Neutral	N/A	US\$33.51	05 May 2016

Source: UBS. All prices as of local market close.

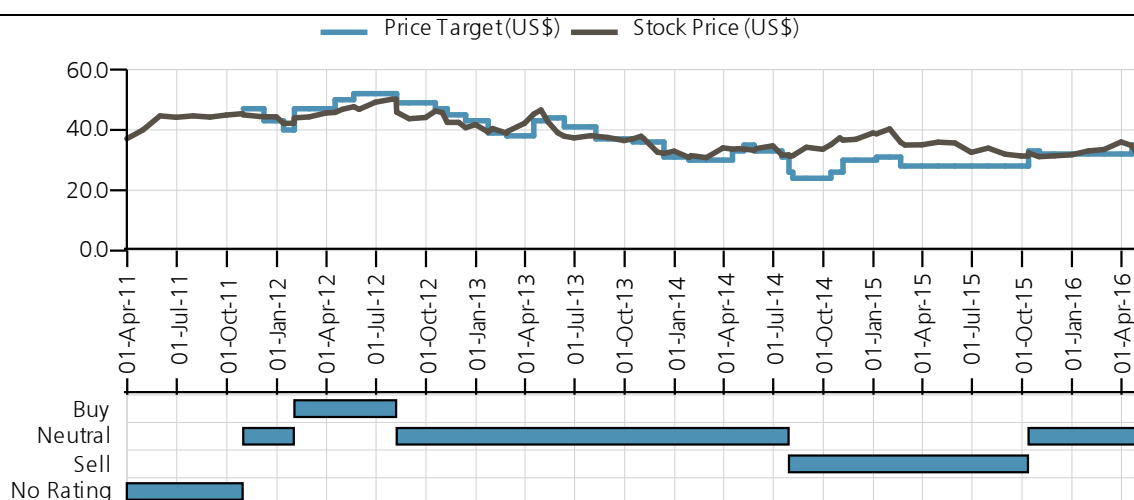
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FirstEnergy Corp. (US\$)



Source: UBS; as of 05 May 2016

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