

Dynegy, Inc.

Marrying up the Power Business

Dynegy announces two major transactions, transforming the company

DYN announced this morning the acquisition of both Duke's Midwest Gen for \$2.8Bn and ECP's Equipower IPP at \$3.45Bn. In tandem with the deal, mgmt launched '15 EBITDA guidance of \$1.2-1.4 Bn, allocating effectively ~\$400 Mn to DYN (in-line with our ~\$380 MtM est.), ~\$400Mn for Duke, and ~\$500Mn for Equipower (\$100 Mn of this is from Brayton Point, slated to retire in '17). Our combo DYN+DUK EBITDA with initial synergies was \$807Mn, in-line with disclosures. We caution that both DUK and Equipower see some forward est compression, although we see the bulk of the Brayton rolloff as offset by the uplift in capacity prices in '17 for the balance of the portfolio. Meanwhile, Duke's assets appear to have a run-rate closer to the mid-\$200 Mn level.

Synergies seem quite conservative; expect more to come here

While initial synergies are delineated at \$40 Mn/yr in EBITDA (and ~\$30 Mn/yr reflected in 2015 guidance), with management acknowledging they are admittedly light, and ramping up into 2016+ as the company executes its PRIDE cost savings initiative. We caution that the Equipower portfolio was probably light on synergies given more limited SG&A (likely ~\$10-20Mn), with bulk of the potential still associated with the Duke transaction. Using the historical transaction average of ~\$15/kW, synergies could well be ~\$100 Mn/yr on a fully-loaded basis when all is reviewed.

What about the valuation? We think shares remain elevated

Using the low-end of the new '15 EBITDA range (to reflect a conservative view Duke's run-rate as well as roll-off of Brayton) as an initial starting point on valuation- and applying a 9x multiple- we derive a quick back-of-the-envelope valuation of ~\$33/share. Given more attractive '15 FCF yield (~\$500 Mn or ~11%) - and potential use of FCF, coupled with prospects for more synergies, we see some upside still.

Valuation: Maintain Buy on back of deal; equity overhang will clear

The transaction is precisely the upside we had contemplated within our investment thesis, with presumption of Duke deal alone driving upside to the mid-30s on a MtM basis. Our existing target had assumed a 50% deal likelihood. Our price target is based on 2017E EV/EBITDA weighted 50/50 M&A scenario vs standalone.

Highlights (US\$m)	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
Revenues	1,585	1,293	1,466	2,904	2,320	1,969	1,978	2,051
EBIT (UBS)	(44)	(97)	(309)	172	145	184	168	227
Net earnings (UBS)	(1,645)	(224)	(359)	60	13	28	(40)	(3)
EPS (UBS, diluted) (US\$)	(13.48)	(2.24)	(3.59)	0.59	0.13	0.27	(0.38)	(0.03)
DPS (US\$)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Net (debt) / cash	(1,442)	(1,067)	(1,149)	(1,032)	(961)	(885)	(858)	(1,026)
Profitability/valuation	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
EBIT margin %	-2.8	-7.5	-21.1	5.9	6.3	9.4	8.5	11.1
ROIC (EBIT) %	(0.9)	(2.8)	(8.9)	4.9	4.2	5.5	5.1	6.7
EV/EBITDA (core) x	15.9	27.7	14.9	10.3	11.0	10.1	10.6	9.3
P/E (UBS, diluted) x	(0.4)	(2.3)	(5.9)	50.6	NM	NM	(78.2)	NM
Equity FCF (UBS) yield %	(57.1)	(62.8)	6.9	3.9	2.4	2.6	0.9	(5.7)
Net dividend yield %	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Company accounts, Thomson Reuters, UBS estimates. UBS adjusted EPS is stated before goodwill-related charges and other adjustments for abnormal and economic items at the analysts' judgement. Valuations: based on an average share price that year, (E): based on a share price of US\$29.72 on 21 Aug 2014 19:39 EDT

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Equities

Americas
Electric Utilities

12-month rating **Buy**

12m price target **US\$33.00**

Price **US\$29.72**

RIC: DYN.N BBG: DYN US

Trading data and key metrics

52-wk range	US\$36.14-18.50
Market cap.	US\$2.97bn
Shares o/s	100m (COM)
Free float	100%
Avg. daily volume ('000)	230
Avg. daily value (m)	US\$7.2
Common s/h equity (12/14E)	US\$2.27bn
P/BV (12/14E)	1.3x
Net debt / EBITDA (12/14E)	2.5x

EPS (UBS, diluted) (US\$)

	12/14E	
	UBS	Cons.
Q1	(0.41)	(0.41)
Q2E	0.17	(1.23)
Q3E	0.44	0.26
Q4E	0.39	0.33
12/14E	0.59	(0.18)
12/15E	0.13	0.16
12/16E	0.27	0.42

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The Power Line on DYN Deal:

We view the deal as quite constructive, illustrating the opportunities still inherent in the Power sector from cost-oriented M&A. With much of the investment thesis oriented towards the successful execution of this transaction, we see follow through on additional synergies as the imperative next step. While management has admittedly stated it is not looking at further consolidation for the time being (at least next year), we continue to see this side of the equation as the key to unlocking further value, particularly for the jointly owned assets in the transaction. The transaction propels Dynegy to among the largest IPPs in the industry, likely no longer a take-out target, and largely utilizing its latent balance sheet latitude. Given no exposure in ERCOT (despite its headquarters in the state), we suspect future transactions will look to expand in this market, although with the clear exception of combining with AES' DPL portfolio inevitably (or its subsequent creditors in any eventual restructuring). We believe full realization of Duke portfolio synergies are dependent upon a merger with the DPL assets (whose coal-asset are largely co-owned); we suspect any transaction would likely prove an attractive price to Dynegy given its majority ownership in many of the co-owned assets (net-net, the delay in AES' sale of this portfolio could prove value accretive to Dynegy, although timing of any sale is likely a ~2017 event following October 2016 maturity). Further longer-dated M&A possibilities include a tie-up with AEP's merchant generation business once on the market (likely a 2H15 event), although market overlap could prove a bit more problematic with Duke coal overlap.

Strategically, the deal adds substantial diversification to a portfolio both overly levered to the MISO market, as well as some further diversification from coal. 2015 capacity gross margin for legacy Dynegy was ~10% and is expected to rise to 25% after the acquisition closes. With the bulk of the Equipower portfolio oriented towards the New England market, we see a vibrant outlook for the year ahead, as new pipes for gas supply are likely to be delayed/protracted, coupled with additional capacity upside (on little anticipated new build). We maintain our more near-term constructive view on MISO capacity prices, with bilateral transactions continuing to appear materially above recent auction levels – and ahead of potential tightening of MISO's Zone 4 in Illinois. While balanced between gas-coal capacity, we suspect the Duke portfolio could yet face pressures around continued development of Utica shale and more gas-fired capacity (hence its cheaper implied valuation).

As for execution of the transaction, we do not anticipate any significant hurdles with only very limited market overlap across any of the contemplated portfolios or regions. We see the jump in shares as appropriate and maintain our Buy rating. We suspect peer IPPs, CPN and NRG could prove a tad weak on the back of the news, with both having been named as contenders in the process in recent media articles. Although the valuation on a kW basis could have a positive readthrough for peers after recognizing that Dynegy could afford to unlock more value than other bidders given its NOL position.

We attribute today's relative intraday weakness to the forthcoming equity offering of ~40% of its equity market (with ~33% issued via a forthcoming public offering). Given the ~13% FCF yield off 2015, we see more limited downside, with FCF deployment offsetting uncertainty over its '16+ trajectory.

Dynegy deal delivers the goods as the company leapfrogs to form a 'Big 4' of competitive generation operators by capacity.

Our first cut at valuing the New Dynegy

Below we provide our first view of the new consolidated entity given initial disclosures. Our \$1,200Mn of 2015E adjusted EBITDA is slightly above the midpoint of the adjusted guidance range. While Dynegy presents a valuation matrix using EV / EBITDA multiples ranges of 9-11x on an EV / EBITDA basis on 2015 which cites a multiple for peer IPPs of Calpine at 10.1x, we believe the latest mark-to-market there is close to the 9.0-9.5x range.

\$1.2Bn 2015E adjusted EBITDA for the new entity at first look.

Figure 1: Dynegy Pro-Forma Value Breakout

DYN Accretion Calcs. (\$Mn)	Duke Merchant	EquiPower	Dynegy	Combined	Guidance
2015 Adjusted EBITDA	\$431	\$500	\$376	\$1,307	\$1,200-\$1,400Mn
Plus: Run-Rate Synergy Uplift	\$5	\$5	\$0	\$10	\$10Mn
Less: Brayton Point	\$0	-\$107	\$0	-\$107	~\$100Mn
Total 2015 EBITDA	\$436	\$398	\$376	\$1,210	\$1,100-\$1,300Mn
EV / EBITDA	8x	9x	10x		9-11x
EV	\$9,681	\$10,891	\$12,101		\$11.7-\$14.3Bn
Less: Pro-Forma Debt	(6,200)	(6,200)	(6,200)		-\$6,200Mn
Equity Value	\$3,481	\$4,691	\$5,901		\$5,500-\$8,100Mn
Equity Issuance	\$1,250	\$1,250	\$1,250		\$1,200-\$1,300Mn
Shares Outstanding (\$31/sh issuance)	140	140	140		145Mn S/O
Valuation	\$24.80	\$33.43	\$42.05		
Guidance Implied Value per Share		\$31.55	\$39.66		

Source: Company Filings and UBS Estimates

The 1,500MW Brayton Point plant in Massachusetts is slated for retirement around May 2017 indicating that at best Dynegy will generate earnings (and importantly free cash flow) from the plant for ~2.5 years.

Figure 2: Brayton Point 2015 UBSe

Brayton Point - 2015 Financial Snapshot	
1,493	Capacity (MW)
30%	Capacity Factor, UBSe
76	2015 Mass-Hub On-Peak (\$/MWh)
(41)	Variable Cost (Coal & Dispatch) (\$/MWh)
35	Energy Margin (\$/MWh)
3.9	Generation (TWh)
138	Energy Margin (\$Mn)
3.1	PJM MAAC Capacity Payment (\$/kw-month)
50	Capacity Revenue (\$Mn)
55.0	O&M (\$/kW-yr), UBSe
82.1	O&M (\$ Mn)
106.8	EBITDA

Source: Company Filings, SNL, Platts, and UBS Estimates

Figure 3: Brayton Point 2016 UBSe

Brayton Point - 2016 Financial Snapshot	
1,493	Capacity (MW)
30%	Capacity Factor, UBSe
67	2016 Mass-Hub On-Peak (\$/MWh)
(41)	Variable Cost (Coal & Dispatch) (\$/MWh)
26	Energy Margin (\$/MWh)
3.9	Generation (TWh)
104	Energy Margin (\$Mn)
2.9	PJM MAAC Capacity Payment (\$/kw-month)
46	Capacity Revenue (\$Mn)
55.0	O&M (\$/kW-yr), UBSe
82.1	O&M (\$ Mn)
68.3	EBITDA

Source: Company Filings, SNL, Platts, and UBS Estimates

What's on the table here?

We include a list of the assets below for each of the two portfolios. The portfolio value remains diverse, spread across a range of the mid-merit gas assets acquired.

Figure 4: Dynegy Portfolio Acquisition – Plant Details

Portfolio	Plant	MW	Fuel/Type	Market
EquiPower	Brayton Point ¹	1,493	Coal ST	ISO-NE
EquiPower	Kincaid Generation	1,108	Coal ST	PJM
EquiPower	Milford	579	Gas CCGT	ISO-NE
EquiPower	Lake Road	856	Gas CCGT	ISO-NE
EquiPower	Dighton Power	187	Gas CCGT	ISO-NE
EquiPower	Masspower	280	Gas CCGT	ISO-NE
EquiPower	Liberty ²	600	Gas CCGT	PJM - EMAAC
EquiPower	Elwood	780	Gas CT	PJM - RTO
EquiPower	Richland-Stryker	466	Gas CT	PJM - RTO
Duke	Killen ²	198	Coal ST	PJM - RTO
Duke	Stuart ²	900	Coal ST	PJM - RTO
Duke	Zimmer ²	622	Coal ST	PJM - RTO
Duke	Fayette	640	Gas CCGT	PJM - RTO
Duke	Miami Fort Station 7 & 8 ²	653	Coal ST	PJM - RTO
Duke	Washington	637	Gas CCGT	PJM - RTO
Duke	Hanging Rock	1,274	Gas CCGT	PJM - RTO
Duke	Lee Energy Facility	640	Gas CT	PJM - RTO
Duke	Dicks Creek	136	Gas CT	PJM - RTO
Duke	Conesville 4 ²	312	Coal ST	PJM - RTO
	Gas Subtotal	7,075		
	Coal Subtotal	5,286		
	Total	12,361		

1 Scheduled to retire in May 2017
2 Co-owned assets

Source: Company reports, SNL, and UBS estimates

Implied Valuation Robust for Sector

We see the implied valuation on an asset level basis as suggestive of near new entrant economics for the CCGT assets for both New England, and particularly PJM. We emphasize the Duke transaction appears to provide substantially greater value than ECP.

Figure 5: Implied Valuations for Each Portfolio, by Fuel Type

<i>\$/kW valuation implied in the deal</i>			
	ECP	Duke	Total
Overall Portfolio Cost	3,450	2,800	6,250
ECP:	MWs	\$/kW	\$ Mn
New England CCGT	1,902	850	1,617
PJM CCGT	600	950	570
Kincaid	1,108	450	499
Brayton Point	1,493	100	149
Elwood	780	500	390
Richland/Stryker	466	500	233
<i>Total</i>			3,458
<i>Actual</i>			3,450
Duke	MWs	\$/kW	\$ Mn
PJM Coal	2,685	350	940
PJM CCGT	2,551	600	1,531
PJM Peaker	1,556	200	311
<i>Total</i>			2,782
<i>Actual</i>			2,800

Source: Company reports, UBS estimates

What about Duke? Accretive to 2016.

Duke's statement on its sale (\$500 Mn better than previously impaired value) states it would be accretive to 2016 assuming an undisclosed use of proceeds (seemingly ~\$0.10/sh dilutive on 2015 given the peak nature of PJM capacity payments in this year). We see the announcement as constructive for Duke shares as well, helping to re-define the company towards its regulated utility roots.

Midwest sale appears dilutive on 2015, slightly accretive on 2016, and modestly accretive on 2017+ on a pure debt paydown assumption.

Figure 6: Duke Merchant Sale Analysis – Debt Pay-down Scenario

Duke Merchant Sale: Debt Paydown	2015	2016	2017	2018
Asset Sale Proceeds \$Mn (~\$2.6Bn BV)	2,800			
Less: Tax on Sale and Trans Costs	105			
After-Tax Sales Proceeds	2,695			
Interest Expense Avoided (@ 4.5%)	121	121	121	121
After-Tax	42	42	42	42
Net Income Accretion	79	79	79	79
Shares Outstanding	706	706	706	706
EPS Uplift from Interest Paydown	\$0.11	\$0.11	\$0.11	\$0.11
Duke Energy Ohio EPS Contribution	\$0.21	\$0.11	\$0.05	\$0.07
Accretion/(Dilution)	-\$0.10	\$0.01	\$0.06	\$0.05

Source: Company Filings and UBS Estimates

The portfolio had a 12/31/13 book value of approximately \$3.5Bn and has taken a \$1.4Bn write down to \$2.1Bn; however, in the third quarter the company plans to book a \$500Mn reversal which will return the portfolio to ~\$2.6Bn. Above we present a scenario where Duke utilizes the after-tax interest savings from a \$2.7Bn debt paydown.

Duke also noted that the Beckjord Units 5 and 6 (390MW) were not included in the deal and have the possibility of joining Units 1-4 in retirement.

Duke reaffirmed its \$4.50-\$4.65 adjusted EPS guidance for 2014 and will include the Midwest fleet in core earnings until the deal closes despite including in discounted operations for GAAP purposes.

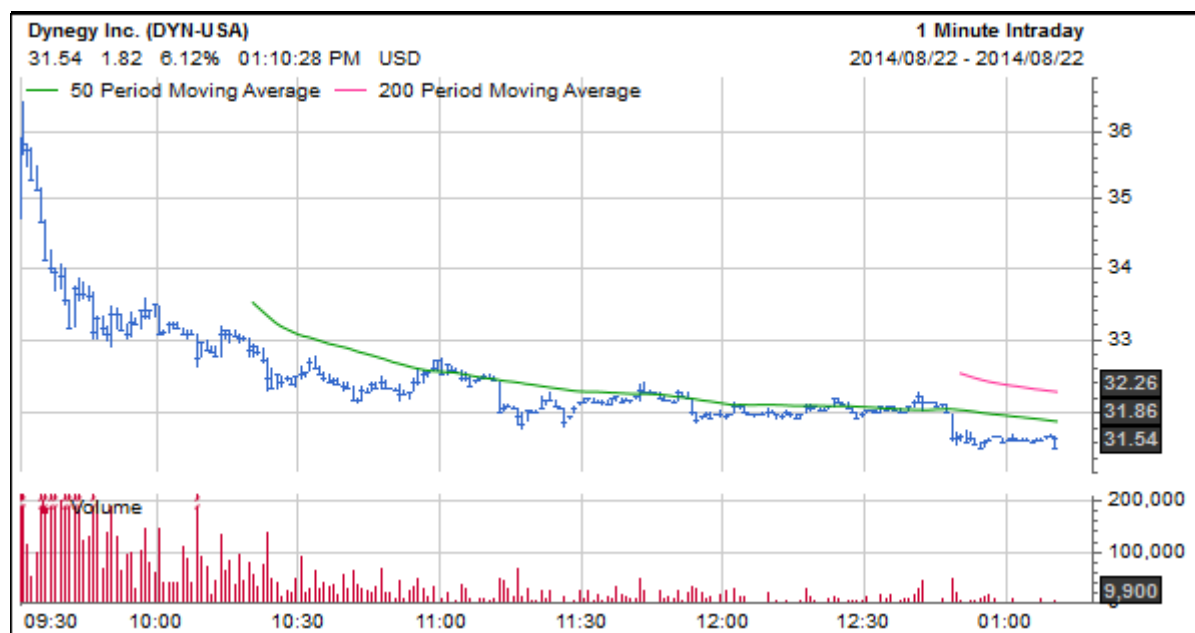
Below we present our full Duke Energy Midwest generation estimates which reflect the current mark-to-market.

Figure 7: Duke Energy – Merchant Portfolio - Open Generation Projections (\$Mn)

Duke Energy OH & NA	2012A	2013E	2014E	2015E	2016E	2017E	2018E
Duke Energy Ohio - Commercial Power Generation (GWh)							
Coal	16,164	18,548	14,485	14,952	15,186	14,485	14,485
Gas	17,122	13,784	12,635	11,946	11,257	10,568	9,878
Total	33,286	32,332	27,120	26,898	26,443	25,053	24,363
Guidance		35,000					
Energy Margin	351	381	276	343	315	320	328
Hedge Value		6					
Guidance		350					
Capacity Revenues	140	51	173	294	204	133	133
Guidance		50					
Gross Margin							
O&M	299	295	245	243	243	239	238
Property and Other Taxes	26	24	23	21	20	20	20
Duke Energy Retail (Not in historicals)		24	24	24	24	24	24
Total EBITDA	92	143	205	398	281	217	227
Gas CCGT EBITDA			82	204	146	118	119
Gas Peaker EBITDA			36	46	30	18	18
Total Gas			118	250	176	135	137
Coal EBITDA			63	124	81	58	65
Other Income	4	2	2	2	2	2	2
D&A	159	154	149	144	139	134	129
Interest Expense	28	28	28	28	28	28	28
EBT	(91)	(37)	30	228	116	57	72
Income Tax	(24)	13	(11)	(80)	(41)	(20)	(25)
Net Income	(115)	(24)	20	148	75	37	47
Shares Outstanding	574	706	706	706	706	706	706
Duke Energy Ohio EPS Contribution	(0.20)	(0.03)	0.03	0.21	0.11	0.05	0.07

Source: Company Filings and UBS Estimates

Figure 8: Dynegy One-Minute Chart 8/22/14



Source: FactSet

Shares of Dynegy reached a high of ~\$36 but have given up ~\$4 and have settled around \$31/32, implying slightly below a 9x 2015E EV / EBITDA on our pro-forma valuation above.

Forecast returns

Forecast price appreciation	+11.0%
Forecast dividend yield	0.0%
Forecast stock return	+11.0%
Market return assumption	5.5%
Forecast excess return	+5.5%

Statement of Risk

Risks to our investment thesis include: 1) actual commodity prices differing significantly from our assumptions; 2) political and regulatory intervention to change the structure of competitive markets in response to high power prices and insufficient new build; 3) the current state of credit markets that has limited the companies' flexibility to return excess cash to shareholders; and 4) unknown impact from a potential carbon legislation. Other investment risks include abrupt changes in weather pattern, sharp slowdown in economic demand, interest rate risks, and disruption of trading activity in power markets.

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Buy	FSR is > 6% above the MRA.	48%	33%
Neutral	FSR is between -6% and 6% of the MRA.	41%	30%
Sell	FSR is > 6% below the MRA.	11%	23%
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 June 2014.

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Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Duke Energy ^{2, 4, 6, 16}	DUK.N	Buy	N/A	US\$73.04	21 Aug 2014
Dynegy, Inc. ^{5, 16}	DYN.N	Buy	N/A	US\$29.72	21 Aug 2014

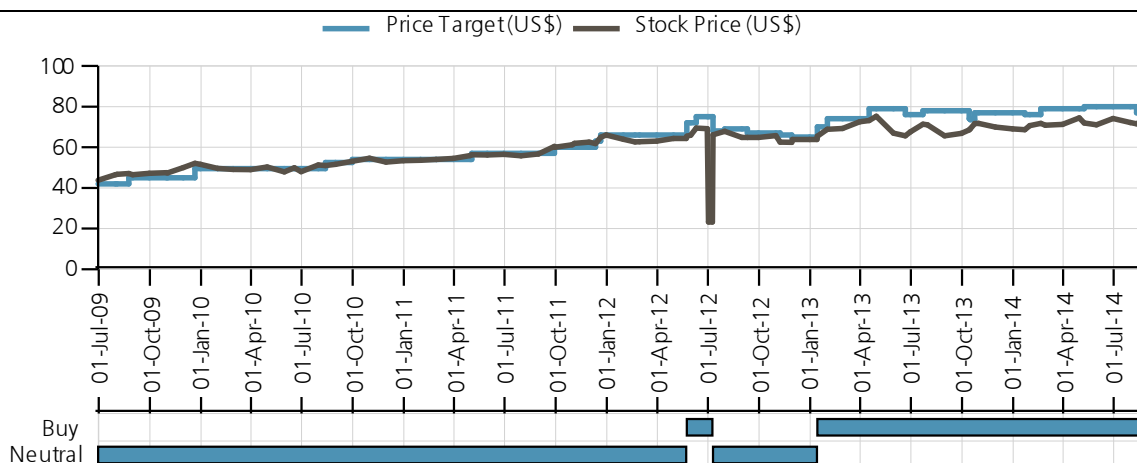
Source: UBS. All prices as of local market close.

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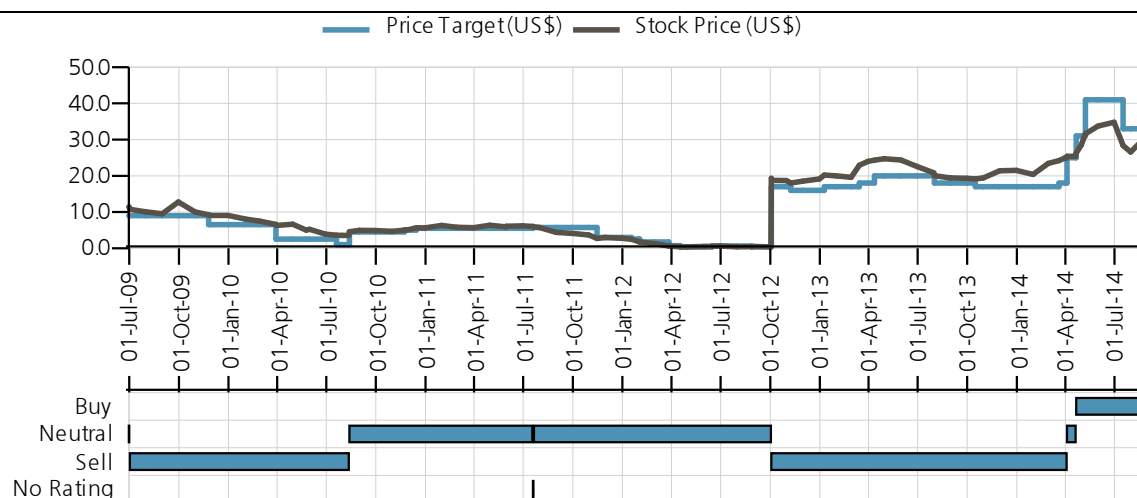
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Duke Energy (US\$)



Source: UBS; as of 21 Aug 2014

Dynegy, Inc. (US\$)



Source: UBS; as of 21 Aug 2014

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