US Electric Utilities & IPPs
In Search of Parent Leverage

Equities

Americas
Electric Utilities

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With investors focused on rising rates, we're focused on levered equities
With concerns about rising rates pervasive across utility investor sentiment, we thought we would compile an apples-to-apples comparison of parent/HoldCo leverage in the table below, with an average of 14% capitalization coming from parent leverage across our measured subset of some of the more levered utilities. We continue to see names with the greatest interest rate exposure as those employing greater levels of leverage, as well as those tapping the markets to achieve stated ROE targets. While we are broadly supportive of companies pursuing further parent leverage across the sector, we suspect those equities today with the highest parent borrowings could yet underwhelm. We see diversified utilities, FE and ETR as the most exposed to this thesis given their meaningful short-term debt balances as a proportion of their overall capitalization. Meanwhile, a key company that appears 'under' levered- and willing to deploy the capital is Sempra; we anticipate the company will not need to tap equity markets even for incremental growth opportunities as it continues to enjoy meaningful latitude from the agencies in its current rating bracket (~18.4% in 2016 vs. necessary range of 17%-19% at Moody's).

Major financings this fall to alleviate some concerns; reiterate Buy on SRE/D
Meanwhile, we see higher-growth utilities as potentially at risk from rising rates as they tap new debt capital to fund growth projects. We anticipate both Sempra and Dominion will largely 'lock up' their financing needs this Fall, with both teams keen to promptly pursue final financing on their large-scale LNG export terminals (Cameron/Cove Point, respectively) with both DOE non-FTA and FERC EIS approvals in hand this Fall. Moreover, both names appear poised to have limited external equity needs through the forecast period given their ability to tap into a combination of asset sales (particularly SRE) as well as organic MLP drop-downs (moreso D, but also look for SRE to finalize its own organic strategy later this year.)

What are our UBS economists thinking? Still a risk in the back half of the year.

Our UBS Economics team's latest comments on the upcoming June 18th FOMC decision is focused on the increasingly hawkish makeup of the committee as well as both low and falling unemployment at 6.3% and low but rising core PCE inflation of 1.4%, well below the target 2.0%. With both measures moving in the "right direction…the evidence suggests that the Fed is gaining ground on their mandates for 'maximum employment' and 'stable prices'". The presence of more hawkish Governor Fischer and new Cleveland Fed President Mester may push the so-called Fed "neutral" rate above the Chairman Yellen's 4.0%, with the Fed continuing to taper in support of moderate long-term interest rates. However, holding off this upward push on rates is the weak 1Q GDP growth, which may allow the Fed to keep their unemployment and inflation forecasts unchanged, with the "cover to taper but to also argue that any rate hike is in the distant future." See our latest UBS economics note (6/9) "FOMC: The Dot Matrix".

What about utility debt? Not so much of a concern, but yes elsewhere.
We're not overly concerned around debt to be found at utilities themselves, as we anticipate regulators will largely enable its recovery (with some regulatory lag). With many utilities poised to continue to file rate cases in the next years to recoup costs from continued capital investment. We also emphasize greater interest rate risk in PPAs and other bilateral contracts (primarily highly-levered renewables but also midstream), where an implicit assumption on rates is embedded into infrastructure pricing upfront, creating timing risk on when projects are financed and completed. This would appear to impact renewable projects moreso, with an emphasis on NEE's risk in 2015 given expectations for meaningful PPAs on new build to be finalized later this year for construction by year-end 2015.

Will regulators 'allow' for parent leverage?

Among the chief questions for many utilities- and likely the driver of the wide discrepancy across the US utility sector – is the willingness for utility regulators to 'ignore' parent capitalization in deriving utility authorized equity ratios. Given the clear discrepancy in risk profile between HoldCo leverage and utility-segment debt, we see no reason for regulators to impute any of this interest down to subsidiaries. Furthermore, while clearly single jurisdictions can impute their portion, we see this as substantially more challenging and unlikely in multi-state utilities than under a single-state construct.

Key question has always been how regulators will react to employing parent debt

We tend to see clear latitude in metrics to doing so if regulators permit

Does M&A actually enable HoldCo debt? We think so.

We believe as US utilities continue to grow, we see merit to arguing that regulators are increasingly challenged to specifically 'ascribe' parent leverage back to a utility subsidiary. We emphasize this reality as a further motivating factor broadly in pursuing sector M&A. We see broad support for further parent leverage, while maintain investment grade credit ratings across the sector, particularly across jurisdictions with advantageous/constructive frameworks, such as FERC. In fact, we believe many utilities that have recently spun out TransCo's will focus on creating new intermediate holding company structures to add leverage. Moreover, we see the latest trend towards 'de-integration' among diversified utilities could yet drive a consolidation trend on the regulated side as well, as the availability of more pure-play utilities (primarily across the PJM footprint) enables deal-making. Please see our recent June 9th note on utility M&A.

Bigger utilities should limit ability for regulators to impute debt back to utilities

How to value utilities? Investors still clearly option for P/E on interest.

We flag a meaningful divergence in the sector on how to value leverage, particularly that found at the parent. While many investors have historically opted to do so using a P/E methodology on interest expense, the more academically correct approach would reflect a netting of the liability against underlying utility equity value. In our opinion, the P/E approach only makes sense when parent leverage is relatively small vs the whole capital structure (rather than the absence of any non-regulated subsidiaries, as some investors have suggested to us). Large debt balances which add substantially to liquidity risk and interest rate risk deserve to be counted against equity at cash value, in our view. We think A P/E treatment understates this risk.

Rising rates could drive greater scrutiny around use of P/E multiple against interest expense vs. netting of debt

Growth vs yield – growth is the winner when interest rates rise

We believe fears of rising rates will only contribute to our perception of haves- and have-nots in the sector. We see the value proposition around rising payouts and dividends associated with slowing utility growth rates as particularly challenged (with SO epitomizing this trend in our view). In the most extreme example, utilities such as EDE without any growth to speak of in the back half of the decade appear particularly vulnerable to falling out of favor.

Meanwhile, we sense rising rates will lend favor to both the power trade (seeing this as a hedge to rising rates in the sector), as well as to utilities able to continue to show best-in-class earnings growth through the cycle. In particular, we see 'faster' growers such as ITC and SRE as particularly well positioned to avoid this thesis. Moreover, with both able to avoid tapping equity markets, execution risk is likely further impeded.

With concerns over rising rates, we believe companies able to grow EPS meaningfully ahead of peers as outperforming despite employing parent leverage

Yieldco (and MLP) rate exposure among the highest in the sector

With so-called "Yieldcos" having been created from the dropdown of long-term contracted assets in the 10-20 year range, these new yield-focused investment vehicles are particularly exposed to a rising rate environment, similar to corporate debt in the same maturity profile. Furthermore, with Yieldcos paying 80%-90% of their cash available for distribution out to investors, they depend almost entirely on the capital markets for non-organic growth via dropdowns and third-party acquisitions. As we saw in 2008, the MLP sector (similarly exposed) was hit especially hard by inaccessibility to capital.

Comparing Parent Leverage

In the chart below, we include an apples-to-apples table of US utilities, with aggregate estimates of parent leverage. We note a wide variety of exposures, with diversified utilities appearing the most exposed. Specifically, we cite AES', FE's, and ETR's risk to rising rate concerns given their meaningful unallocated parent debt balances. With regard to AES, this is one of the few names in which the equity appears to fully reflect a netting of parent debt obligations (meaningful to overall capitalization). While we see netting of parent leverage as appropriate given the clear non-recourse nature of cash distributions from subsidiaries, shares at $14/sh appear to largely reflect this risk. While D's parent debt also appears high currently, the company plans to refinance much of it at Dominion Gas and utility VEPCO over time (where rates are essentially hedged through regulation), including $2B in 2014 alone. Asset sales through its MLP should also give the company room to reduce leverage, although we suspect most proceeds will be plowed back into higher-return pipeline projects as a first priority.

Figure 1: Utility Sector - Parent Leverage

Co.	LT Debt	ST Debt	Total Debt	Parent Unsec Debt	Total Equity	% Debt	% Parent Debt	% EPS Sensitivity to 1% move in Int Rates	Commentary
CMS	$ 7,536	$ 666	$ 8,202	$ 2,777	$ 3,655	69%	23%	5%	Parent debt excludes that $668M at Enerbank, which is self-funded without any anticipated Parent support (looking to monetize). Management is satisfied with current IG ratings and will only pay down parent debt slowly over time using $100M annual cash flow step-up over next few years. Otherwise, management says they would rather invest FCF in the utilities where it will earn 10%-11% returns.
AES	$ 18,869	$ 2,180	$ 21,049	$ 5,431	$ 7,651	73%	19%	5%	Have said that strong BB is a goal but it is not something we will rush to get to. Still some improvement would be needed in order to get there. Expected (FCF+Interest)/Debt range for 2014 is 16.7%-17.5% vs 19% needed for a "strong BB" rating.
FE	$ 28,526	$ 4,819	$ 33,345	$ 6,071	$ 12,695	72%	13%	5%	FE Corp ST Revolver - $1.871Bn; FE Corp LT - $4.2Bn = $6,071Mn Total as of May 2014
D	$ 20,458	$ 2,888	$ 23,346	$ 11,367	$ 11,699	67%	32%	5%	DRI (parent) debt is being slowly refinanced with Dom Gas Holdings (50% debt ratio target) and Vepco debt (48%-50% debt ratio target). Have already issued $1B this year and will do another $1B. Expect most refinancing to occur at Dom Gas, where all the growth is. Will continue as maturities occur. Essentially, only Cove Point Export and merchant facility debt will remain at DRI, with 63% debt/equity there. Somewhat vague about DRI parent debt levels but want to keep maximum flexibility and ratings intact.
TE	$ 2,838	$ 112	$ 2,950	$ 1,041	$ 2,334	56%	20%	4%	Selling coal could be used to paydown the debt but no specific comments beyond that.
SRE	$ 11,253	$ 1,692	$ 12,945	$ 4,926	$ 11,008	54%	21%	4%	
DUK	$ 39,000	$ 2,622	$ 41,622	$ 10,947	$ 40,789	51%	13%	3%	Includes $700M of notes payable at the parent. Parent debt is currently 28% of total consolidated debt (excluding $3B of purchase accounting adjustments), implying another $800M of capacity before exceeding goal of keeping below 30%. However, company is satisfied with current level of parent debt - they would like to keep ratings of parent vs the utilities within one notch or so. No parent debt is allocated to the international business and DUK finances locally; $1Bn of intl debt is present.
ETR	$ 12,199	$ 1,628	$ 13,826	$ 2,768	$ 10,042	58%	12%	3%	As disclosed at its recent Analyst Day, the parent debt is $2.7Bn comprised primarily of permanent debt as well as commercial paper. The absolute dollar amount of parent debt is expected to remain close to $2.7Bn ('should come down a little bit but not dramatically from there'), indicating that the 'improvement' in parent leverage will come from additional debt issuances at the utilities. Entergy's parent debt is current ~22% of total consolidated debt and mgmt stated that they see it ticking slightly lower by 2016E (18-20%), but was quick to provide a caveat. Based upon disclosures it has latitude in its Debt/EBITDA and FFO/Debt metrics to provide financial flexibility, especially given the improvement in fundamentals following the latest movements in power.
XEL	$ 10,911	$ 1,041	$ 11,952	$ 2,175	$ 9,566	56%	10%	2%	
NU	$ 7,777	$ 1,626	$ 9,403	$ 1,867	$ 9,612	49%	10%	2%	
EXC	$ 19,195	$ 1,353	$ 20,548	$ 2,773	$ 22,778	47%	6%	1%	
PPL	$ 20,514	$ 1,883	$ 22,397	$ 1,700	$ 12,717	64%	5%	1%	Total debt at PPL Capital is $3.6Bn which is allocated to all of the major business segments except the PA utilities. Specifically $1.15Bn is related to the KY acquisition and another $750Mn relates to the UK acquisition. The balance of $1.7Bn relates to PPL Supply ($880Mn split between $400Mn and $480Mn issuances) and $800Mn allocated to the parent (two separate $400M tranches). The $880Mn of parent debt allocated to PPL Supply will remain with PPL Corp (as well as the $50Mn interest drag disclosed with the Talen announcement); therefore, the unallocated parent debt balance is ~$1.7Bn.
AEE	$ 5,226	$ 1,348	$ 6,574	$ 592	$ 6,655	50%	4%	1%	Subtracting Ameren MO and Ameren IL debt from the Ameren Corp. consolidated debt produces $592M as of March 31, 2014. Subtract cash to arrive at a net debt number of $567M. This Parent debt includes debt allocated to Ameren Transmission Company of Illinois (ATXI) subsidiary, which is $91M (average 2014) in a FERC Attachment O filing.
AEP	$ 18,087	$ 1,332	$ 19,419	$ 911	$ 16,416	54%	3%	1%	Have $911M of parent debt. Preserving credit ratings is important. Could possibly do up to nominally more, but only to grow the transmission ratebase. Most of the growth in the company going forward is going to be from transmission.

Source: Company reports and UBS estimates

Statement of Risk

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

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Source: UBS. Rating allocations are as of 31 March 2014.
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Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
AES Corporation[2, 4, 6a, 16]	AES.N	Neutral	N/A	US$14.20	13 Jun 2014
Ameren Corp.[6a, 16]	AEE.N	Neutral	N/A	US$38.40	13 Jun 2014
American Electric Power, Inc.[4, 6a, 6b, 6c, 7, 16]	AEP.N	Neutral	N/A	US$52.78	13 Jun 2014
CMS Energy[4, 5, 6a, 16]	CMS.N	Not Rated	N/A	US$29.56	13 Jun 2014
Dominion Resources[2, 4, 6a, 6b, 6c, 7, 16]	D.N	Buy	N/A	US$68.44	13 Jun 2014
Duke Energy[2, 4, 5, 6a, 16, 22]	DUK.N	Buy	N/A	US$70.83	13 Jun 2014
Entergy Corp.[16]	ETR.N	Neutral	N/A	US$78.20	13 Jun 2014
Exelon Corp.[2, 4, 5, 6a, 6c, 7, 16, 22]	EXC.N	Neutral	N/A	US$35.72	13 Jun 2014
FirstEnergy Corp.[6a, 16, 22]	FE.N	Neutral	N/A	US$34.18	13 Jun 2014
Northeast Utilities[6a, 13, 16]	NU.N	Buy	N/A	US$45.36	13 Jun 2014
NRG Energy Inc.[16]	NRG.N	Buy	N/A	US$36.71	13 Jun 2014
PPL Corporation[2, 3, 4, 5, 6a, 6c, 7, 16]	PPL.N	Neutral	N/A	US$34.03	13 Jun 2014
Sempra Energy[2, 4, 5, 6a, 6c, 7, 16]	SRE.N	Buy	N/A	US$101.12	13 Jun 2014
TECO Energy Inc.[16]	TE.N	Neutral	N/A	US$17.39	13 Jun 2014
Xcel Energy Inc.[4, 6a, 16]	XEL.N	Neutral	N/A	US$30.69	13 Jun 2014

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