

Duke Energy

The Duke of North Carolina

Duke the latest utility to pay-up (27x P/E 2017E) for gas growth

Duke announced the acquisition of Piedmont Natural Gas (PNY) for \$4.9Bn equity value (\$60/sh vs \$42/sh Friday close) as another electric utility executes on natural gas M&A. Piedmont is concentrated in North Carolina (70% of rate base) and also has ownership in the Atlantic Coast and Constitution pipelines. Piedmont has been growing EBITDA and ratebase at ~9% along with 1.6-2.0% customer growth, notable premiums to Duke's ~4% earnings growth target (<2% 2010A-2015E EPS CAGR) and ~1% customer growth.

Supports existing growth rate while offering EPS accretion in 2017

Duke guides to EPS accretion in 2017 which "enhances" Duke's long-term 4-6% EPS target. In 2Q15 Duke described its guidance as a "target" rather than a deliverable and we see the deal as helping to push growth back towards the midpoint. We estimate \$0.10/sh EPS accretion (~2%) in 2017E which would increase our 2013A-2017E EPS CAGR to 4.5% from 4.0% currently. The \$6.7Bn enterprise value is expected to be financed with (1) assumption of \$1.8Bn; (2) a \$500-\$750Mn equity forward; (3) holding company debt; and (4) cash. Potential sources of cash include a dividend from Florida to Duke Corp from the Crystal River 3 securitization (\$600Mn) and Latin American repatriation (\$300Mn).

Continuation of growing interest in natural gas and emphasis on sales growth

Following Southern/AGL Resources in August 2015, TECO/New Mexico Gas Company in May 2013, and numerous pipeline stakes we see electric utilities increasingly interested in gas infrastructure. As electric demand stagnates (Duke previously characterized as "anemic") we expect to see more interest in gas utilities and utilities that see real growth.

Valuation: Maintain \$74 Price Target; deal posts limited accretion amidst debt

Valuation is based on 2017E P/E. Deal helps to fill the earnings gap from international but high transaction multiple leaves limited accretion and raises questions about lack of investment opportunities for Duke's cash flows.

Equities

Americas
Electric Utilities

12-month rating **Neutral**

12m price target **US\$74.00**

Price **US\$72.30**

RIC: DUK.N BBG: DUK US

Trading data and key metrics

52-wk range	US\$89.36-67.74
Market cap.	US\$50.0bn
Shares o/s	692m (COM)
Free float	97%
Avg. daily volume ('000)	1,192
Avg. daily value (m)	US\$86.0
Common s/h equity (12/15E)	US\$40.3bn
P/BV (12/15E)	1.2x
Net debt / EBITDA (12/15E)	4.3x

EPS (UBS, diluted) (US\$)

	12/15E	
	UBS	Cons.
Q1	1.24	1.24
Q2	0.95	0.95
Q3E	1.50	1.51
Q4E	0.88	0.92
12/15E	4.59	4.64
12/16E	4.90	4.87
12/17E	5.06	5.11

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Highlights (US\$m)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	19,624	24,598	23,925	25,096	25,970	26,576	27,371	28,406
EBIT (UBS)	5,026	5,885	6,511	6,427	6,948	7,230	7,515	7,917
Net earnings (UBS)	2,480	3,067	3,214	3,178	3,384	3,498	3,635	3,908
EPS (UBS, diluted) (US\$)	4.32	4.35	4.55	4.59	4.90	5.06	5.26	5.66
DPS (US\$)	3.03	3.09	3.16	3.28	3.39	3.54	3.69	3.94
Net (debt) / cash	(38,875)	(39,594)	(40,498)	(41,141)	(45,364)	(47,630)	(50,039)	(47,622)
Profitability/valuation	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
EBIT margin %	25.6	23.9	27.2	25.6	26.8	27.2	27.5	27.9
ROIC (EBIT) %	10.8	9.5	10.7	11.0	11.3	11.0	10.9	11.3
EV/EBITDA (core) x	9.0	10.1	9.6	9.5	9.1	7.0	6.7	6.4
P/E (UBS, diluted) x	14.9	16.0	16.2	15.8	14.8	14.3	13.7	12.8
Equity FCF (UBS) yield %	(3.2)	0.4	0.0	0.6	(3.7)	0.4	0.3	10.3
Net dividend yield %	4.7	4.5	4.3	4.5	4.7	4.9	5.1	5.4

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\$72.30 on 26 Oct 2015 16:12 EDT

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Modest accretion as high purchase price a drag

We estimate that the deal is accretive by \$0.10-\$0.13/sh in 2017/2018 (2.0-3.0%) with synergies and \$0.08-\$0.11/sh excluding synergies. From the Duke-Progress transaction in 2011 Duke management commented that it believed the synergies on that deal would be in the range of 5-7% total non-fuel O&M, consistent with other transactions. For the Piedmont transaction management commented that synergies were not a consideration in the accretion and we view them as immaterial as well. Given the magnitude of debt financing (details on the subsequent page) a 50bp increase in the interest rate would reduce accretion by ~\$0.01-\$0.02/sh.

We estimate ~2% EPS accretion for the \$4.9Bn transaction.

Figure 1: DUK-PNY Accretion Calculation

PNY Resources Transaction - Initial Accretion Analysis (Pro-Forma)						
Duke Energy - Legacy	2013A	2014A	2015E	2016E	2017E	2018E
Pre-Transaction Net Income (\$Mn) - UBSe	3,067	3,214	3,178	3,384	3,498	3,635
Pre-Transaction Shares (Mn) - UBSe	706	707	693	691	691	691
Pre-Transaction EPS	\$ 4.35	\$ 4.55	\$ 4.59	\$ 4.90	\$ 5.06	\$ 5.26
PNY Adj. Net Income (\$Mn)	134	144	148	161	180	201
PNY O&M	253	271				
Synergies assumption 5%-7% - UBSe			16	16	16	16
PNY Shares Outstanding (Mn)	79.2					
Deal Terms						
Total Consideration per Share	\$60.00	All cash				
Financing (\$Mn):		\$4,752				
Debt		\$3,127	Expected issuance			
Cash		\$1,000	~\$300M/yr from International +			
			~\$600M from CR3 securitization			
Equity		\$625	Expected forward sale of \$500M-\$750M			
Total		4,752				
DUK Share Price (as of 42303)		\$72.01				
Increase in Shares Outstanding (Mn)		8.7	8.7	-	-	
		Total				
Combined Net Income (\$Mn)		3,358	3,326	3,545	3,678	3,836
Incremental After-Tax Interest Expense (\$Mn) at ~4%			81	81	81	81
After-tax Synergies [6% of PNY O&M]			11	11	11	11
Pro-Forma Revised Combined Net Income (\$Mn)			3,255	3,475	3,607	3,765
New Shares Outstanding			701.7	699.6	699.6	699.6
Pro-Forma Revised Combined EPS			\$ 4.64	\$ 4.97	\$ 5.16	\$ 5.38
Change in EPS (Accretion/Dilution)*			\$ 0.05	\$ 0.07	\$ 0.09	\$ 0.12
% Change in EPS			1.2%	1.4%	1.8%	2.3%
*Note: The companies anticipate closing the deal in 2H16. 2015/2016 accretion is illustrative.						
P/E Multiples	2013	2014	2015	2016	2017	2018
DUK	16.6x	15.8x	15.7x	14.7x	14.2x	13.7x
PNY	25.0x	23.2x	22.6x	20.8x	18.6x	16.6x
Pro-Forma DUK + PNY (DUK at \$72.01)			15.5x	14.5x	14.0x	13.4x
Regulated Average		17.9x	17.8x	16.7x	15.8x	15.1x
PNY Takeout Implied P/E		33.0x	32.1x	29.5x	26.4x	23.6x

Source: Company Filings, FactSet, and UBS Estimates

Accretion premised on heavy debt financing

Duke is financing the \$6.7Bn enterprise value by assuming \$1,800Mn of Piedmont debt, issuing \$500-\$750Mn equity via a forward sale, and pointed at ~\$1Bn of cash indicating that the remaining ~\$3.3Bn will be financed with Duke holding company debt. The incremental after-tax interest expense on the deal will erase nearly half of Piedmont's consensus 2017E earnings. The ~75% debt-to-total capitalization implied for the deal is on the high-end of the spectrum as utilities continue to take advantage of historically low interest rates to execute on M&A.

Deal sets new high watermark for the industry

Duke's proposed acquisition of Piedmont continues the upward trend in 2015 of implied takeout P/E multiples and is well above both Southern Company/AGL Resources in August (21.6x 2017E) and Emera-TECO in September (21.2x 2017E). The DUK-PNY transaction represents a 42% premium to Friday's close of \$42.22 and a 65% premium to where shares traded as recently as last month. We see the early underperformance in shares (~2% underperformance in early Monday trading) related primarily to the significant premium paid for shares.

Figure 2: Piedmont Financing

Piedmont Transaction Financing (UBSe \$Mn)	
Enterprise Value	6,700
Assumption of PNY Debt	1,800
DUK Equity (\$500-\$750Mn)	625
DUK Cash (~\$1Bn)	1,000
DUK Holding Co Debt	3,275
Debt-to-Capitalization	76%
After-Tax Interest (at 4%)	85
PNY Consensus 2017 NI	180

Source: Company Filings, FactSet, and UBSe

Figure 3: Recent Utility Transactions: Average 20-21x implied 2017E P/E multiple, 2016E-17E

	Deal Announcement	Deal Equity Value (\$mn)	2016 Earnings (\$mn)	2017 Earnings (\$mn)	Implied 2016 P/E	Implied 2017 P/E	Target States
DUK-PNY	10/26/2015	4,900	161	180	30.4x	27.2x	North Carolina, Tennessee, South Carolina, Illinois, Georgia, Virginia, New Jersey, Florida, Tennessee, Maryland
SO - AGL	8/24/2015	8,000	361	371	22.2x	21.6x	Florida, Tennessee, Maryland
EMA - TE	9/4/2015	6,474	276	306	23.5x	21.2x	Florida
NEE-HE	12/3/2014	3,500	160	170	21.9x	20.6x	Hawaii
IBE - UIL	2/26/2015	3,000	138	146	21.7x	20.5x	Connecticut / Western Massachusetts
Macq - CNL	10/20/2014	3,400	151.2	166	22.5x	20.4x	Louisiana
EXC-POM	4/30/2014	6,800	358	405	19.0x	16.8x	Washington DC, Maryland, New Jersey
WEC-TEG	6/23/2014	5,715	328	361	17.4x	15.8x	City of Chicago, Michigan's U.P, Lower Michigan, Minnesota
Average Implied Deal P/E Multiple -->					22.3x	20.5x	

Source: FactSet and Company Filings

Transaction expected to close in 4Q16

The deal requires approval from the North Carolina commission as well as the US Department of Justice and FTC. Approval is not required in South Carolina and Tennessee but management commented that it has been communicating with the relevant regulators to keep them informed. The transaction is also subject to majority shareholder approval of Piedmont but not Duke.

Moody's downgrade possible with high leverage employed

While S&P's corporate credit rating is currently A-/Stable, Moody's currently sits at a consolidated senior unsecured rating of A3 on negative outlook. Considering the expected deployment of over \$3B debt for the acquisition (on a \$50B+ base), we think it's somewhat likely that Moody's may take this opportunity to bring their rating down a notch. We take note that Moody's negative outlook for Duke Energy (consolidated) is strongly reflective of the negative outlook for Duke Energy Progress, currently rated two notches higher at A1 but under stress from an expected decline in credit metrics due to increased O&M expense and higher debt levels from coal ash basin remediation.

Use of cash from a possible extension of bonus depreciation could mitigate credit deterioration.

However, while the high degree of leverage and 27x P/E takeout multiple are negative for credit, we also note that the acquisition of a contiguous regulated utility is positive for business risk. Use of cash from a possible extension of bonus depreciation could mitigate credit deterioration, especially considering that any reduction in ratebase as a result of deferred taxes would be replaced with Piedmont ratebase that is expected to grow at 9% going forward.

As illustrated in the table below, we project the expected deterioration in DUK's credit metrics as calculated by UBSe in-line with S&P and Moody's methodology.

Figure 4: DUK Credit Metrics (pre-acquisition) vs S&P and Moody's

S&P Corp Credit Rating A-/Stable	2014	2015E	2016E	2017E	2018E
S&P calc FFO/Debt	18.3%	18%-20%	17%-19%		
UBSe (adjusted, see below)	18.3%	19.6%	18.7%	18.4%	18.1%
UBSe (adjusted) - post PNY acquisition			17.8%	17.5%	17.3%
S&P calc Debt/EBITDA	4.9x	4.6x-4.8x	4.6x-4.8x		
UBSe (adjusted, see below)	4.9x	4.6x	4.7x	4.7x	4.8x
UBSe (adjusted) - post PNY acquisition			5.0x	5.0x	5.0x
S&P: "There are no meaningful insulation measures in place that protect any subsidiary from its parent and, therefore, all issuer credit ratings are in line with Duke's group credit profile of 'a-'."					
UBSe metrics with S&P Adjustments (pre-acquisition)					
GAAP Debt	42,534	42,434	46,556	47,678	50,278
Operating leases	1,233	1,233	1,233	1,233	1,233
Pension	413	413	413	413	413
Cash	(2,036)	(1,293)	(1,192)	(48)	(239)
PPAs	1,089	1,089	1,089	1,089	1,089
AROs	1,898	1,898	1,898	1,898	1,898
Accrued interest	418	418	418	418	418
Other	129	129	129	129	129
UBSe Adjusted Debt	45,678	46,321	50,545	52,811	55,219
GAAP EBITDA	8,389	9,155	9,736	10,122	10,494
Operating leases	160	160	160	160	160
Pension	(58)	(58)	(58)	(58)	(58)
Stock comp	61	61	61	61	61
PPAs	151	151	151	151	151
AROs	246	246	246	246	246
Other	441	441	441	441	441
UBSe Adjusted EBITDA	9,390	10,155	10,737	11,122	11,495
GAAP EBITDA	8,389	9,155	9,736	10,122	10,494
Interest expense	(1,622)	(1,678)	(1,913)	(2,026)	(2,106)
Tax adjustments	(200)	(200)	(200)	(200)	(200)
Operating leases	96.8	97	97	97	97
Pension	-64.4	(64)	(64)	(64)	(64)
Cap interest	-75	(75)	(75)	(75)	(75)
Stock comp	61	61	61	61	61
PPAs	74.4	74	74	74	74
AROs	1287.3	1,287	1,287	1,287	1,287
Other	434.8	435	435	435	435
UBSe Adjusted FFO	8,382	9,092	9,438	9,711	10,003
Moody's Senior Unsecured Duke Energy Corp A3, negative outlook (pre-acquisition)					
Moody's calc CFO (pre-working Cap)/Debt	17%-18%				
UBSe CFO (pre-working Cap)	7,299	7,605	8,021	8,302	8,598
UBSe Debt	42,534	42,434	46,556	47,678	50,278
UBSe CFO (pre-working Cap)/Debt	17.2%	17.9%	17.2%	17.4%	17.1%
UBSe CFO (pre-working Cap)/Debt - post PNY acquisition			16.3%	16.5%	16.3%
Moody's: "The negative outlook on Duke's rating reflects consolidated financial metrics that are weak for its currentA3 rating and likely to decline slightly over the next few years, persistently high levels of debt at the holding company level, future financing needs for pipeline and other parent company investments, and challenges at some of its international businesses, which the company has Moody's notes that Duke Energy initiated a \$1.5 billion accelerated stock repurchase plan in April of this year [and has a] nearly \$2 billion [commitment] in the Atlantic Coast Pipeline and a smaller \$250 million investment in the Sabal Trail Pipeline."					

Source: S&P, Moody's, UBS estimates

Natural gas utility comps shows magnitude of premium

Below we show comparable natural gas utilities highlighting the magnitude of Piedmont's premium P/E following the deal.

Figure 5: Natural Gas Utilities Comps

Company	Price 10/26/2015	Mkt Cap (\$MM)	Enterprise Value	Current Dividend	Current Yield	DPS CAGR		2014 ROE	P/E		EV/EBITDA	
						3-Yr Hist	2-Yr Fwd		2015	2016	2015	2016
Gas Utilities												
AGL Resources, Inc.	\$62.29	\$7,460	\$11,482	\$2.04	3.3%	2.9%	4.0%	15.3%	20.9x	20.4x	10.0x	9.6x
Atmos Energy Corp.	\$61.80	\$6,075	\$8,777	\$1.56	2.6%	2.7%	5.5%	10.5%	20.1x	19.0x	9.7x	9.0x
CenterPoint Energy, Inc.	\$18.76	\$8,011	\$15,399	\$0.99	5.3%	6.3%	4.3%	13.8%	17.9x	16.8x	8.1x	7.9x
MDU Resources Group, Inc.	\$18.75	\$3,679	\$6,092	\$0.73	3.9%	2.7%	1.7%	9.9%	19.8x	15.2x	11.2x	9.5x
National Fuel Gas Co.	\$52.04	\$4,470	\$6,295	\$1.58	3.0%	2.8%	2.6%	12.4%	17.8x	18.0x	7.4x	7.5x
New Jersey Resources Corp.	\$30.98	\$2,639	\$3,423	\$0.90	3.1%	5.9%	6.1%	25.9%	17.8x	18.3x	12.0x	13.2x
NiSource, Inc.	\$19.57	\$6,233	\$16,140	\$1.04	3.2%	3.8%	2.3%	8.8%	15.6x	18.6x	12.0x	11.2x
Northwest Natural Gas Co.	\$48.37	\$1,304	\$2,113	\$1.86	3.9%	1.8%	3.1%	7.7%	23.4x	21.3x	10.2x	9.1x
ONE Gas, Inc.	\$49.17	\$2,520	\$3,648	\$1.20	2.5%	NA	6.7%	7.2%	22.6x	21.0x	9.9x	9.3x
Questar Corp.	\$20.86	\$3,580	\$5,110	\$0.84	4.1%	7.5%	6.9%	18.5%	16.3x	15.8x	8.2x	8.1x
Piedmont Natural Gas Co., Inc.	\$57.73	\$3,344	\$5,121	\$1.32	3.1%	3.2%	3.5%	10.7%	30.9x	29.2x	12.4x	11.4x
UGI Corp.	\$36.21	\$6,203	\$10,639	\$0.91	2.5%	5.7%	8.2%	9.5%	18.6x	16.8x	8.5x	7.6x
Vectren Corp.	\$46.62	\$3,802	\$5,456	\$1.52	3.3%	1.3%	5.3%	10.6%	19.0x	17.9x	7.8x	7.1x
WGL Holdings, Inc.	\$62.19	\$3,066	\$4,180	\$1.85	3.0%	4.2%	5.0%	12.0%	20.6x	20.4x	11.4x	9.8x
Southwest Gas Corp.	\$61.74	\$2,881	\$4,405	\$1.62	2.6%	11.5%	4.8%	9.7%	19.9x	18.4x	8.2x	7.8x
Gas Utilities Average					3.3%	4.5%	4.7%	12.2%	20.1x	19.1x	9.8x	9.2x

Source: FactSet

Forecast returns

Forecast price appreciation	+2.4%
Forecast dividend yield	4.6%
Forecast stock return	+7.0%
Market return assumption	5.6%
Forecast excess return	+1.4%

Statement of Risk

Risks to our estimates and price targets include: unfavorable terms of regulatory approval, including clawback to customers of synergies; mild weather; unfavorable environmental legislation; unexpected plant outages; commodity price risk; foreign country and currency risk; and unattained merger synergies.

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12-Month Rating	Definition	Coverage ¹	IB Services ²
Buy	FSR is > 6% above the MRA.	49%	33%
Neutral	FSR is between -6% and 6% of the MRA.	40%	26%
Sell	FSR is > 6% below the MRA.	12%	18%
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 2015.

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Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Duke Energy ^{2, 4, 5, 6a, 6b, 7, 16}	DUK.N	Neutral	N/A	US\$73.74	23 Oct 2015
Piedmont Natural Gas Inc ¹⁶	PNY.N	Not Rated	N/A	US\$42.22	23 Oct 2015

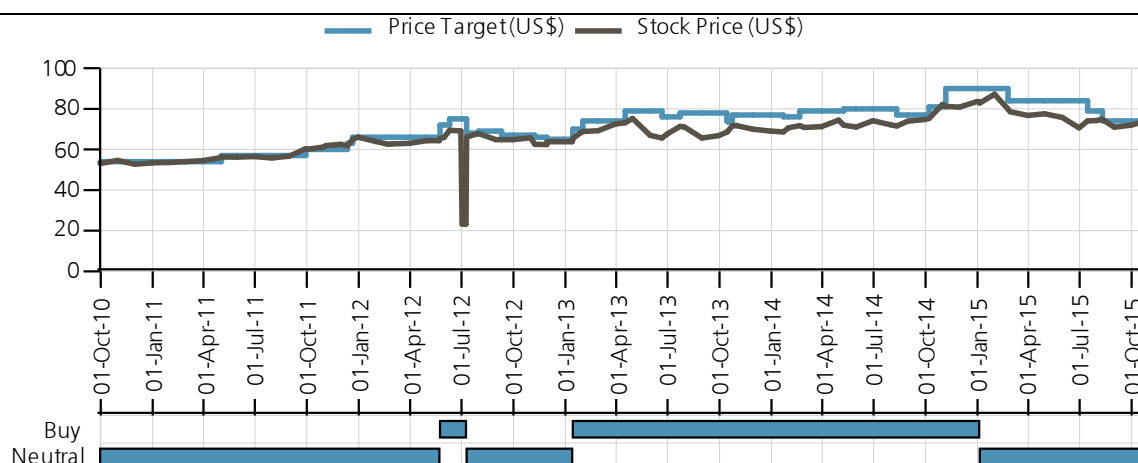
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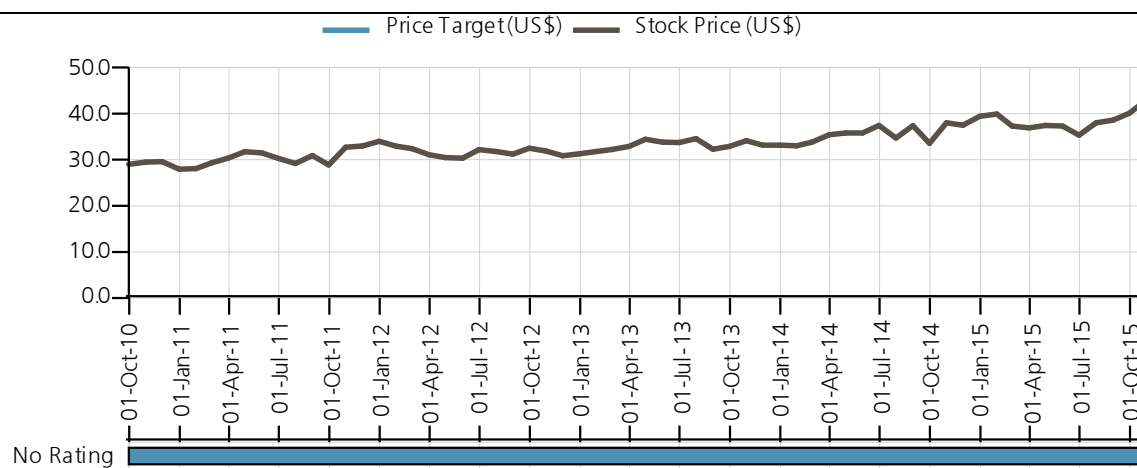
Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Duke Energy (US\$)



Source: UBS; as of 23 Oct 2015

Piedmont Natural Gas Inc (US\$)



Source: UBS; as of 23 Oct 2015

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