

## First Read

# FirstEnergy Corp. Successfully Going Back to the Drawing Board

### FE proposes modified Rider RRS as part of PUCO rehearing request

Monday night FE filed with the Public Utilities Commission of Ohio (PUCO) for rehearing in its Electric Security Plan (ESP) which includes modifications to the Rider RRS to respond to the FERC's rescinding of [FE's affiliate waiver on April 27<sup>th</sup>](#). The modifications are designed to create a mechanism that is "solely within the Commission's [PUCO] jurisdiction" by removing the contractual tie to FirstEnergy Solutions (FES) but still offering a hedge to ratepayers. Specifically FE is proposing to use *projections* of the cost and revenues rather than *actual* costs and revenues associated with the Rider RRs plants (Davis-Besse, Sammis, and OVEC share). Under this new modification customer bills would not be impacted by future actual economics of the plants; instead the ESP would use assumptions for volume, capacity revenue, etc. By simulating the effect of a rider (i.e. financial hedge) rather than establishing one, management argues that the FERC's concerns about non-competitive bilateral affiliate transactions will be preempted and the ESP would not be subject to FERC review. The rider is subject to PUCO review if FE owns less than 3.2GW of local assets (900MW nuclear). Please click here for FE's [application](#) and [testimony](#) (Docket14-1297-EL-SSO).

### Revenue would now accrue to utilities rather than FES: Valuation positive

Under the modified order the revenues under the ESP would accrue to the regulated utilities rather than the non-recourse FES subsidiary. This is a key new development that would enhance the value uplift in our view. We estimate +\$1-2/sh additional value should investors apply a P/E multiple to the earnings uplift (\$4-5/sh) to the utilities rather than valuing the discounted cash flows (\$3/sh) to FES over the 8-year deal. We're still biased to think a DCF is appropriate, but flowing rev's through utilities could bias investors to simplify their analysis towards this higher figure.

### Race against the clock: Timeline is supportive of June 1<sup>st</sup> implementation

FE has requested an expedited procedural schedule as the last case was fully litigated: intervenor testimony May 9<sup>th</sup>, hearings May 11<sup>th</sup>, oral arguments May 16<sup>th</sup>, opinion/order by PUCO May 25<sup>th</sup>, and rider filed May 26<sup>th</sup>. It is unclear whether current Chairman Porter will vote on the matter as he is [resigning effective May 20<sup>th</sup>](#). Or stay till month end. Mgmt states that it has support from "many" of the parties to the previous settlement and while it does not have full agreement today, it hopes to do so shortly.

### Valuation: Maintain \$32 Price Target and Neutral Rating

We see Monday evening's filing as potentially positive for shares. While it is to be determined whether the latest modification will be confirmed, FE appears to have navigated the pitfalls in the previous order and increases the probability of success. We expect shares to recover much of the ~\$3.40 they lost on 4/29. Valuation is based on a 2018E sum-of-the-parts analysis without the contribution from the original PPA or modified.

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	9.2	9.3	9.3	9.3	9.0
P/E (UBS, diluted) x	12.8	13.3	12.6	13.3	14.0	13.7	13.3	9.7
Equity FCF (UBS) yield %	1.9	(2.4)	7.5	6.4	0.0	1.0	2.9	2.2
Net dividend yield %	5.7	4.3	4.2	4.4	4.4	4.4	4.4	4.4

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\$33.05 on 02 May 2016 18:41 EDT

## Equities

Americas  
Electric Utilities

12-month rating **Neutral**

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

Price **US\$33.05**

RIC: FE.N BBG: FE US

### Trading data and key metrics

52-wk range	US\$36.65-29.12
Market cap.	US\$14.0bn
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)	1.0x
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	2.69
12/17E	2.36	2.52
12/18E	2.41	2.56

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### Forecast returns

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Forecast price appreciation	-3.2%
Forecast dividend yield	4.4%
Forecast stock return	+1.2%
Market return assumption	5.8%
Forecast excess return	-4.6%

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### 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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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 <sup>3</sup>	IB Services <sup>4</sup>
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.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
<b>FirstEnergy Corp.</b> <sup>7, 16</sup>	FE.N	Neutral	N/A	US\$33.05	02 May 2016

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

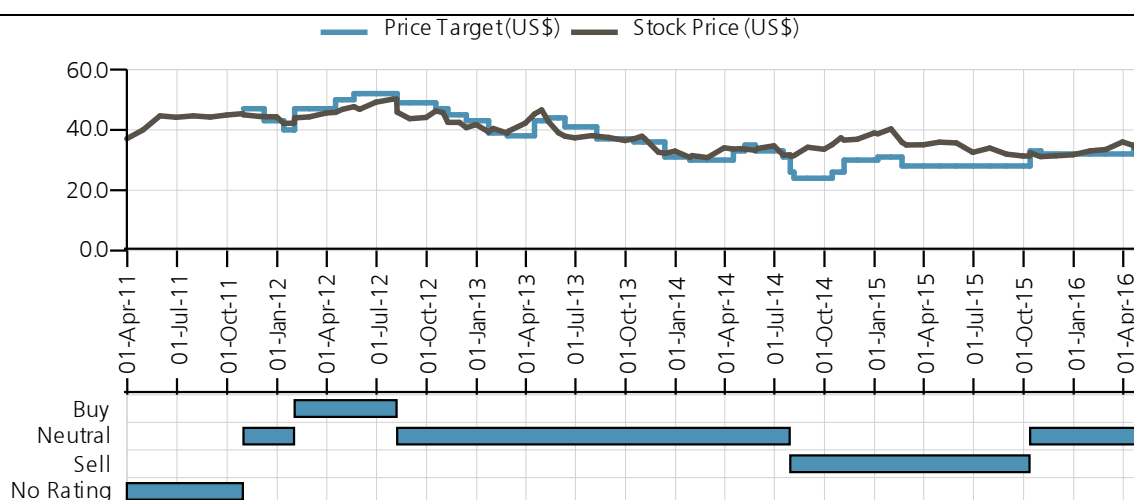
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## FirstEnergy Corp. (US\$)



Source: UBS; as of 02 May 2016

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