

Exelon Corp.

Capital Allocation In Transition

Reducing debt a good step but really need POM and nuclear direction

The initial details on ExGen debt pay-down and a three-year dividend increase plan are steps in the right direction but we see management as limited in providing a long-term outlook without clarity on POM or the nukes. With most investors taking a pessimistic view on the merchant power outlook, debt reduction is always a safe move but we question whether that capital could be dedicated to higher NPV investments such as the utility (*mgmt stated this is a priority*). For this reason we would not be surprised to see management adjust this plan in the future with the \$3.6Bn plan essentially a placeholder to give investors confidence that mgmt will pay-down debt in a 'worst case' and also largely eschew further investment in merchant assets. The next key question will be follow-through on nuclear retirements and/or regulatory relief.

Escaping the bonus trap: No material change to utility EPS growth outlook

The most important part of the 4Q update was ironically how little the company's outlook was changed. The utilities growth rate was maintained with minimal erosion, a sharp contrast to large cap peers who more materially cut LT growth forecasts on the back of bonus depreciation. Power and commodities have stabilized in recent months and ExGen was able to post a slight *increase* in gross margin guidance, addressing lingering concerns on the outlook; this bodes well for IPP 4Q results at month end.

Getting going on dividend growth is a good sign in gradual turnaround

We forecast an 89% utilities payout ratio in 2018E (excluding ExGen, Pepco, and Parent) based on the +2.5% DPS growth announced. If able to close on POM and achieve the accretion targets, we estimate the payout ratio would fall to 75% in 2019E, indicating latitude to grow the dividend by +5% if comfortable with an 80-90% utility payout ratio. Ultimately we expect mgmt to be extremely cautious in growing the dividend following its Feb 2013 dividend cut (to the current \$1.24 from \$2.10)

Valuation: Maintain \$30 Price Target; POM clarity remains near-term key

Valuation is based on 2018E sum-of-the-parts analysis. We reiterate that closing Pepco is the key to shares (we exclude from our PT). While management can unwind the financing drag from the deal if the transaction fails to close, the pressure on nuclear reform efforts will intensify.

Equities

Americas
Electric Utilities

12-month rating **Neutral**

12m price target **US\$30.00**

Price **US\$32.25**

RIC: EXC.N BBG: EXC US

Trading data and key metrics

52-wk range	US\$36.60-25.46
Market cap.	US\$28.0bn
Shares o/s	867m (COM)
Free float	100%
Avg. daily volume ('000)	2,277
Avg. daily value (m)	US\$63.7
Common s/h equity (12/15E)	US\$25.2bn
P/BV (12/15E)	1.1x
Net debt / EBITDA (12/15E)	3.7x

EPS (UBS, diluted) (US\$)

	12/15E			
	From	To	% ch	Cons.
Q1	0.71	0.71	0	0.71
Q2	0.59	0.59	0	0.59
Q3	0.83	0.83	0	0.83
Q4E	0.34	0.38	12	0.38
12/15E	2.47	2.49	1	2.49
12/16E	2.55	2.56	0	2.51
12/17E	2.59	2.61	0	2.64

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Highlights (US\$m)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	24,674.00	25,442.00	27,889.00	29,237.00	21,007.37	21,065.26	21,765.94	22,258.07
EBIT (UBS)	4,539.00	4,179.47	4,198.00	4,510.00	4,603.86	4,827.62	5,215.38	5,448.81
Net earnings (UBS)	2,326.00	2,149.47	2,068.00	2,227.00	2,280.05	2,334.74	2,557.05	2,689.94
EPS (UBS, diluted) (US\$)	2.84	2.50	2.39	2.49	2.56	2.61	2.84	2.98
DPS (US\$)	2.10	1.46	1.24	1.24	1.26	1.29	1.32	1.35
Net (debt) / cash	(18,134.00)	(18,495.00)	(20,273.00)	(22,213.79)	(24,360.38)	(25,046.17)	(25,476.03)	(25,591.86)
Profitability/valuation	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
EBIT margin %	18.4	16.4	15.1	15.4	21.9	22.9	24.0	24.5
ROIC (EBIT) %	11.8	9.1	8.7	8.8	8.5	8.4	8.8	8.9
EV/EBITDA (core) x	7.4	8.4	8.8	8.4	8.5	8.3	7.8	7.5
P/E (UBS, diluted) x	12.9	12.4	14.0	12.9	12.6	12.4	11.3	10.8
Equity FCF (UBS) yield %	1.3	3.6	(5.6)	(2.7)	(4.5)	0.7	2.0	3.3
Net dividend yield %	5.7	4.7	3.7	3.8	3.9	4.0	4.1	4.2

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\$32.25 on 04 Feb 2016 18:41 EST

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

[2/3/16 Returning to Dividend Growth](#)

[1/13/16 We Just Can't Get There](#)

[11/2/15 Taking a Bite Out of Pepco Accretion](#)

[10/20/15 Exploring EDF's Nuclear Put on Exelon](#)

[9/28/15 A Concentrated Nuclear Play](#)

[9/10/15 Keeping the Nuclear Option Alive](#)

What are the pivotal questions for Exelon?

How fast can ExGen reduce leverage?

- **Our FCF estimates are ~5% lower than guidance but still supportive of significant debt latitude:** We show our updated free cash flow estimate below which are slightly below management's cumulative 2016-2018E guidance but still supportive of significant debt reduction. Exelon stressed that the decision to reduce leverage was not driven by concerns around asset life or deterioration of the business but was more responding to investor feedback.
- **What to do with the cash?** Reinvest in the utility. We believe the story could yet continue to evolve to resemble PSEG as Exelon continues to emphasize regulated growth. With ~\$2 Bn of contemplated debt paydown in the period, we see roughly ~\$1 Bn of truly available FCF to push back to the parent.

Even without debt reduction EXC believes that 3x debt / EBITDA is reasonable with its asset profile.

Figure 1: ExGen FCF Profile – Robust Cash Inflows

ExGen Free Cash Projections	2016	2017	2018
Segment EPS	1.31	1.31	1.42
Net Income	1,161	1,174	1,274
D&A	1,002	999	998
Nuclear Fuel (both EXC/CENG)	1,252	1,274	1,274
Dfd Inc. Taxes/Bonus Depreciation	26	28	-
Changes in Working Capital	941	49	(37)
Net Pension/OPEB Contribution	(110)	(98)	(47)
Adjusted Cash from Operations	4,273	3,425	3,462
Less: Maintenance Capital & Fuel			
Base Capex	750	750	750
Nuclear Fuel	1,050	1,050	1,050
CENG Maintenance	100	100	100
CENG Nuclear Fuel	126	129	129
Total Baseline Capex	2,026	2,029	2,029
FCF Pre-Div/Growth Capex	2,247	1,396	1,433
Total Free Cash Flow pre Growth Capex/Dividend: 2016-18			5,076
Guidance: Total FCF pre Growth Capex/Dividend 2016-18			5,350
Less: Growth Capex			
Merchant Projects	400	400	-
"Contracted" (Inc. New England)	625	625	100
Total Growth Capex	1,025	1,025	100
Available FCF	1,222	371	1,333

Source: Company Filings and UBS Estimates

- **What leverage is being targeted?:** Management stated that it is targeting \$3.6Bn of debt reduction including ~\$1.2Bn of low cost commercial paper. This implies \$2.4Bn of long-term debt reduction over the five year period. We highlight the near-term maturities below which also sums to the same \$2.4Bn.

Exelon is targeting \$2.4Bn of debt reduction – we highlight maturities with an average 5.2% interest rate.

Figure 2: ExGen Long-Term Debt Obligations

Exelon Generation (ExGen) Long-Term Debt		Issue Date	Intrest Rate	Maturity (\$Mn)	Maturity Date
Company	Funding Type				
Debt as of 12/31/2014					
(A) Exelon Corporation	CEG Senior Notes	6/13/2003	4.55%	550	6/15/2015
Exelon Generation Company, LLC	2007 Senior Unsecured Notes	9/28/2007	6.20%	700	10/1/2017
Exelon Generation Company, LLC	2009 Senior Unsecured Notes	9/23/2009	5.20%	600	10/1/2019
Exelon Generation Company, LLC	2010 Senior Unsecured Notes	9/30/2010	4.00%	550	10/1/2020
Exelon Corporation	CEG Senior Notes	12/14/2010	5.15%	550	12/1/2020
Exelon Generation Company, LLC	2012 Senior Unsecured Notes	6/18/2012	4.25%	523	6/15/2022
Exelon Corporation	CEG Senior Notes	3/26/2002	7.60%	258	4/1/2032
Exelon Generation Company, LLC	2009 Senior Unsecured Notes	9/23/2009	6.25%	900	10/1/2039
Exelon Generation Company, LLC	2010 Senior Unsecured Notes	9/30/2010	5.75%	350	10/1/2041
Exelon Generation Company, LLC	2012 Senior Unsecured Notes	6/18/2012	5.60%	788	6/15/2042
New Issuances 1Q15-3Q15					
Exelon Generation Company, LLC	2015 Senior Unsecured Notes	1/15/2015	2.95%	750	1/15/2020
Exelon Generation Company, LLC	Tax Exempt Pollution Control Revenue Bonds	6/1/2015	2.5%-2.7%	435	2019/2020
New Retirement/Redemptions 1Q15-3Q15					
(A) Exelon Corporation	CEG Senior Notes	6/13/2003	4.55%	(550)	6/15/2015
Total			5.01%	6,404	

Source: Company Filings, SNL Energy, and UBS Estimates

Will New York and Illinois reform the market to support nuclear?

- **EXC looks to be the main beneficiary at first glance at NY white paper:** If successful, Exelon could keep Ginna online following the expiration of the asset's current RSSA (Mar-2017). Although the economics of the ZEC payments are unclear currently, EXC management is optimistic that they will be based on both a return and recovery of underlying costs (this is less clear to us). If the ZEC economics are as expected, mgmt notes that they would refuel Ginna following the RSSA expiration, and the ZEC payments would continue through the balance of the unit's licensed operational life (not a finite ~5-year life). Notably even if ZECs are not successful (target is June), RMR authority remains NYISO's backstop to keep it if deemed necessary. Should ETR move forward with the Fitz retirement, we believe this could strengthen EXC's position further. Ultimately, with Ginna losing more than \$50 Mn/yr without any subsidy (it benefits from an RSSA arrangement today through March 2017) and Nine-Mile (no RSSA) in NY also likely losing a modest amount, we see accretive benefits to the company (capitalizing at 6x EV/EBITDA would drive ~\$0.30/sh in value).

In a reversal from 2016, New York improvement appears to have a higher probability while Illinois looks more challenged.

[Please click here for further details on the New York Zero Emission Credits proposal.](#)

- **Still waiting on a deal in Illinois with the Budget?:** Following a substantial delay from last year in hashing out a final operating budget, the state of Illinois continues to wrangle between the Governor and the heads of the state assembly. While we continue to see a deal as likely, the continued budget talks

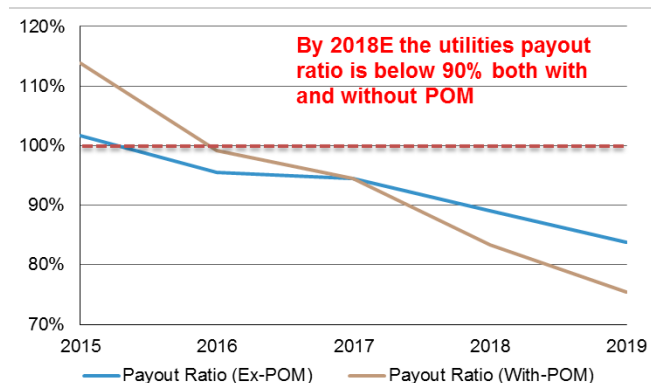
could once more crowd out all other activity. We note the budget debate in the state continues to limit any debate on any other policy issues including any further discussion of a nuclear/coal 'clean energy' solution.

How much dividend growth can be supported?

- **The 2.5% dividend growth can more than be sustained – even without POM:** The Board revised the dividend policy calling for +2.5% annual growth for three years (a ~\$0.10/sh increase to ~\$1.34 annualized in 2019) but we see the utilities payout ratio (excluding ExGen and parent) as staying below 100%. Management did give a prescriptive payout ratio but has stated they are comfortable with the utilities payout ratio today. With utilities growing net income at 7-9% from 2015-2018E we see latitude for management to grow the dividend at 5% but the payout ratio would stay close to 100% in that scenario assuming that POM does not close. With POM there is latitude to grow the payout even further but we expect management to be extremely cautious to avoid putting the dividend at risk with the 2013 dividend cut a painful memory. Please refer to the next page for more details on the payout ratios with our updated EPS estimates.

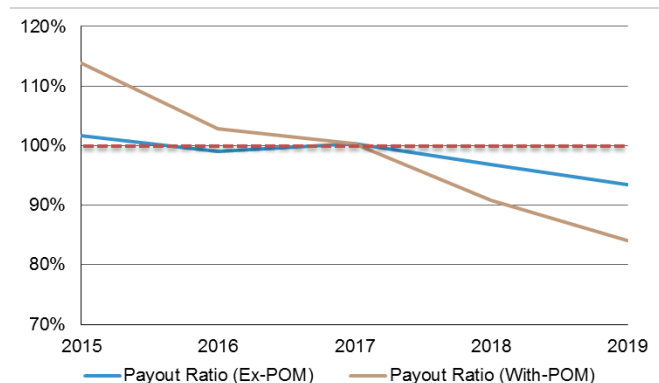
The utility EPS is growing faster than the DPS which is creating a payout buffer.

Figure 3: Exelon Utilities Payout Ratios (+2.5% Growth)



Source: Company Filings and UBS Estimates

Figure 4: Exelon Utilities Payout Ratios (+5% Growth Scenario)



Source: Company Filings and UBS Estimates

- **Core utility growth intact despite bonus depreciation but we do see a degree of risk:** Management expected -70bp of weather normalized load contraction as recently as November 2015 at ComEd but FY15 was actually down -140bp. All demographics underperformed expectations but large C&I load contracted -200bp versus expectations for +70bp. Exelon projects an improvement in load growth/less contraction for 2016E but we remain concerned about weakness particularly from large C&I customers. Although this class typically has the lowest margin this is an area to watch in 2016. Staying at ComEd we see some risk that the interest rates will not rise as much as previously expected in 2016, thus keeping the authorized ROE suppressed. We had embedded +\$0.04 of growth for an expected 100bp increase in US Treasuries (50bp = \$0.02/sh FY).

What is the latest outlook for Pepco?

- **Bonus depreciation expected to have a relatively small impact on accretion:** Utilizing Pepco's last presentation which is admittedly dated (May 2014) there is ~\$1.1Bn of annual capex forecasted for 2015-2018 we estimate a \$5-\$10Mn impact from bonus depreciation (~\$0.01/sh) depending on the assumed ROE (8-10%). For context, the capex plan is modestly larger than PECO (\$675Mn) or BGE (\$800Mn) respective average annual plans. This could become a larger issue if Exelon looks to materially increase spending after the transaction but the impact would still be delayed with rate cases not planned for the immediate future.
- **Management is still confident in Resolution by March 4th:** In setting expectations EXC stated that Washington D.C. Commission could call a special meeting to review the transaction with 48-hours' notice. While investors appear to be returning to the 'default' assumption that this deal will go through, we are not so sure given continued uncertainty over settlement. Exelon did secure a victory in Maryland when the appeal to vacate the PSC approval was denied on January 8th but the political nature of the Washington D.C. settlement leaves questions about whether Exelon will ultimately prevail.

Mgmt did not update the impact of the bonus depreciation extension on potential accretion from the pending PEPCO deal but we see only an immaterial impact (<\$10Mn or ~\$0.01/sh)

Pepco deal is not 100% certain despite being priced as if it is

This remains the primary uncertainty in shares

Updated EPS Estimates: Minimal changes in 2016-2018

Management embeds ~\$0.07/sh drag for Pepco which assumes that it will take five months to repurchase the equity issued (-\$0.06) and three months to retire the associated debt (-\$0.01). EXC plans to reverse the same nominal 57.5Mn shares issued for the deal but did indicate that it could increase the repurchase dollar amount given the decline in share value since the deal was announced. We see an upsized repurchase as unlikely with management likely wanting to focus more on the dividend profile.

We reflect the latest forward curves, edging up our longer-dated estimates higher. We continue to see modest upside to estimates on deal close – or unwinding of the deal to drive share repurchases. While mgmt avoided updating synergy expectations for POM, we look for a full Analyst Day later this year to provide a comprehensive view of pro-forma regulated earnings and cash flow uses.

Figure 5: Updated Exelon EPS Estimates – Excluding Pepco in 'Total EPS'

Exelon Consolidated EPS	2015	2016	2017	2018	2019
PECO	0.43	0.45	0.47	0.50	0.54
ComEd	0.48	0.55	0.56	0.62	0.69
BGE	0.31	0.31	0.34	0.36	0.39
Exelon Generation	1.40	1.31	1.31	1.42	1.42
Other	(0.13)	(0.06)	(0.07)	(0.06)	(0.06)
Total EPS	2.49	2.56	2.61	2.84	2.97
Guidance	\$2.40-\$2.60	\$2.40-\$2.70			
Consensus	2.51	2.53	2.68	2.85	3.02
Prior UBS estimates	2.47	2.55	2.59	2.85	2.87
Accretion from POM Deal	(0.13)	(0.05)	-	0.07-0.12	0.18
Regulated EPS (UBSe)	\$1.22	\$1.32	\$1.36	\$1.48	\$1.61
Regulated Guidance Midpoint	\$1.24	\$1.34	\$1.42	\$1.50	N/A
Dividend Per Share	\$1.24	\$1.26	\$1.29	\$1.32	\$1.35
Utility Payout Ratio (Ex-POM)	102%	95%	95%	89%	84%
Utility Payout Ratio (W./-POM)	114%	99%	95%	83%	75%

Source: Company Filings, FactSet, and UBS Estimates

What do we need to see to see a turnaround?

We see close of the POM deal (slated to close literally in the next 30-days if approved) as critical to sentiment. Should it close, we see clear upside (+~\$1.5/sh) to our valuation from simple accretion as well as ROE upside should management prove capable in turning around operations. Moreover, we see the deal as increasingly perceived by investors as a critical juncture in repositioning the company as a regulated profile. With a clear bias from investors assuming POM deal close already, it does not skew extremely positively in our view. While there is accretion to be had from repurchasing more shares than originally planned, we think a failure to close would draw more scrutiny to the challenges for ExGen.

If unsuccessful on the latest deal, acquisitions remain the strategy: We believe management will remain focused on regulated deal acquisitions in the event the POM deal is rejected. Even if it is approved, we wouldn't doubt continued interest from EXC to continue to 'dilute' down its meaningful generation exposure still. Following the news that PSEG was aiming to eventually spin off its Power business (something EXC cannot do given the need for an IG credit rating to support its meaningful trading and retail operations), we wouldn't doubt efforts to de-emphasize the volatility of the underlying earnings stream. More regulated deals like POM would achieve this goal. Additionally, presenting a story clearly linked to continued reinvestment in regulated asset base will appeal to investors here too – we note the modest multiple premium embedded in PSEG on account of both its higher quality Genco and utilities, but also the more intact regulated growth and corresponding DPS growth. Establishing a more consistent DPS growth trajectory as the company 'normalizes' is a key ambition.

Valuation: Maintain \$30 Price Target

Valuation is based on utilities sum-of-the-parts. After outperforming the XLU by 9% over the past ten days we see far less of an upside skew to our price target and estimates. From this point we do not see material upside without a recovery for the broader power markets and/or pro-nuclear legislation. Resolution on POM is a catalyst but to a lesser degree but as we mentioned we think investors still largely assume the transaction will be completed.

The next month will prove critical

- **What about the Genco?** With many on the Street focusing on the low consolidated P/E multiple on shares, we encourage investors comp shares on a SOP basis relative to its respective utility and genco peers. We continue to see IPP peers trading around ~5-7x EV/EBITDA suggesting the overall valuation applied remains appropriate vs. peers (albeit we continue to see the entire power sector as exceptionally distressed vs. historic valuations).
- **Genco cash flow quality also makes it a discount.** We emphasize the bulk of its cash flows generated at the Genco remain derived from seemingly non-generation sources, driving a discounted valuation (albeit supported by its core generation function). Further, with EBITDA failing to translate to FCF due to meaningful nuclear related capex, we believe shares here too will continue to trade at a discount as well vs. other more FCF profitable peers (DYN and CPN are able to translate more directly from EBITDA given their more modest FCF capital needs for their respective gas portfolios).

Figure 6: Exelon Sum-of-the-Parts Valuation

All figures in US \$ million except per share data				EV/EBITDA & P/E Multiple				Enterprise Value		
	2018 EBITDA		Low	Base	High	Low	Base	High		
Generation	1,950.44		4.0x	6.0x	7.0x	7,802	11,703	13,653		
DOE Nuclear Fuel Disposal Fee Uplift	150		3.0x	4.0x	5.0x	450	600	750		
Hedge Value	(285)		5.0x	6.0x	7.0x	(1,427)	(1,712)	(1,997)		
Other/Equity Investments	214		4.0x	6.0x	7.0x	856	1,284	1,498		
Retail & Wholesale Margin (Power+Non-Powe	798		4.0x	5.0x	6.0x	3,192	3,989	4,787		
Total / Implied	2,827		3.8x	5.6x	6.6x	10,873	15,864	18,691		
Total EBITDA w/Hedges	3,112									
less ExGen Net Debt							(7,522)			
less HoldCo debt							(1,300)			
add Hedge Value							285			
Equity Value						2,336	7,327	10,154		
Mn. Shares Outstanding (2017E)						900	900	900		
Merchant Generation Value Per Share						\$ 2.60	\$ 8.14	\$ 11.28		
Regulated Utilities				P/E Multiple				Equity Value		
	2018 Net Income	EPS	Low	Peer	Prem/Discount	Base	High	Low	Base	High
BGE Net Income	324	\$0.36	13.0x	15.0x	-1.0x	14.0x	15.0x	4,209	4,532	4,856
PECO Net Income	450	\$0.50	15.0x	15.0x	1.0x	16.0x	17.0x	6,752	7,202	7,652
ComEd Net Income	559	\$0.62	13.5x	15.0x	-0.5x	14.5x	15.5x	7,553	8,112	8,672
Total / Implied	1,333	\$1.48	13.9x			14.9x	15.9x	18,513	19,846	21,180
Implied EPS										
Mn. Shares Outstanding (2017E)								900	900	900
Regulated Utility Value per Share						\$ 20.57	\$ 22.06	\$ 23.54		
Total Equity Value per Share						\$ 23.00	\$ 30.00	\$ 35.00		
Potential Accretion on POM Deal	EPS		Low	Peer	Prem/Discount	Base	High	Low	Base	High
EPS Accretion (2018 UBSe)	\$0.10		13.0x	15.0x	-1.0x	14.0x	15.0x	\$ 1.24	\$ 1.33	\$ 1.43

Source: Company Filings, FactSet, and UBS Estimates

Forecast returns

Forecast price appreciation	-7.0%
Forecast dividend yield	3.9%
Forecast stock return	-3.1%
Market return assumption	5.7%
Forecast excess return	-8.8%

Valuation Method and Risk Statement

Valuation is based on a sum-of-the-parts approach.

Risks for Exelon Corp (EXC) include but are not limited to: (1) potential inability to deliver on its capital expenditure program; (2) unfavorable commodity movements [natural gas, power, etc.]; (3) adverse political/legal/regulatory actions; (4) decline in the demand for new conventional and renewables projects; (5) unfavorable weather and natural resources yield [sun radiance and wind generation]; (6) operational and construction risk; (7) inability to access the capital markets on attractive terms; (9) inability to re-contract assets after contract expiration; (10) declines in customer demand and population; (11) failure to close pending or prospective M&A transactions; (12) natural disasters or nuclear accidents; (13) losses at the retail marketing segment; (15) change in macroeconomics; and (16) more stringent environmental standards; and (17) other unforeseen changes..

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UBS Investment Research: Global Equity Rating Definitions

12-Month Rating	Definition	Coverage ¹	IB Services ²
Buy	FSR is > 6% above the MRA.	48%	36%
Neutral	FSR is between -6% and 6% of the MRA.	39%	28%
Sell	FSR is > 6% below the MRA.	12%	22%
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 December 2015.

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.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Exelon Corp. ^{4, 6, 7, 16}	EXC.N	Neutral	N/A	US\$32.25	04 Feb 2016

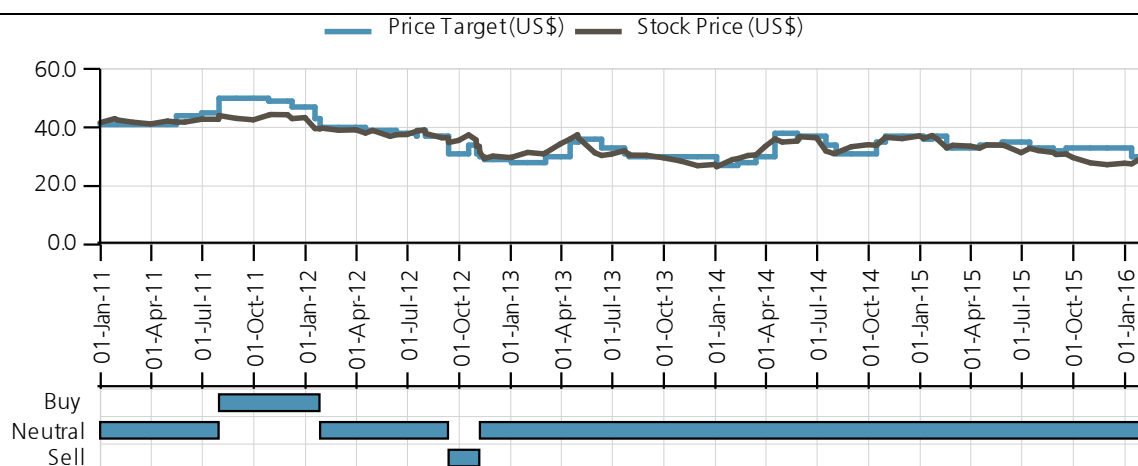
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Exelon Corp. (US\$)



Source: UBS; as of 04 Feb 2016

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