

# US Electric Utilities & IPPs

## NextEra's Bold Attempt to Rope A Texas Utility

### Equities

Americas  
Electric Utilities

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### What does NextEra see in EFH/TXU's Oncor utility? Seemingly good value.

With many investors remaining curious around NextEra Energy's last-minute bid through a DIP financing package for a ~28% stake in EFH's Oncor (T&D) utility business in Dallas, we thought we would shed some initial light on the subject. We see this as a bold, positive data point, with valuations for the assets seemingly much more reasonable given the restructuring of 1<sup>st</sup>-lien debt, with an implied valuation at ~15x P/E or ~9x EV/EBITDA, as well as 6-7% yield.

### What does this mean for NEE? Modestly accretive transaction

We suspect NEE would leverage any successful bid in the bankruptcy into an outright bid for the entire underlying business. We estimate a deal could add ~\$0.10/sh to adjusted EPS (+2% to EPS) prior to assumption of any utility synergies from a full integration under a 100% ownership scenario with cost savings potentially being worth up to an additional ~\$0.20/sh (+4% to EPS) given the scale of the two businesses.

### But how realistic is the proposal now? We think still a bit of a challenge.

The key question to be resolved will be whether the bankruptcy judge is convinced on the merits of NEE's last minute effort to interject itself into the bankruptcy process with a competing offer vs. the establish 2<sup>nd</sup> lien DIP package put forward. While initial reactions appear to be less than enthusiastic, we still see some merit. Looking beyond the competing DIP proposals, we see a clear path towards an eventual transaction with NEE or another party post-bankruptcy still as well.

### Bigger strategic question remains how this would mesh with a REIT?

We continue to suspect Oncor would qualify for a REIT structure, particularly with the Hunt Family group's Sharyland Utility (itself, already a REIT) stating their interest alongside Texas Teachers Retirement System. The question remains whether and if NextEra could possibly spin out the structure itself if it did indeed qualify for a REIT later (adding to the potential 'upside' of NEE's proposal). As a reminder, NEE already owns a 330-mile portion of CREZ transmission lines in Texas (\$760Mn in rate base) as part of its Lone Star project, which could be collapsed into Oncor.

### Understanding the NEE's need to deploy the Balance Sheet

We emphasize yet again the move as a illustrative of NEE's need to deploy its balance sheet as its cash flow profile improves significantly through 2017. Our model projections indicate FFO/Debt steadily improving to ~23% in 2017E off high teen lows in recent years, and ~20% min target from agencies. While management has historically run the company substantially closer to the bottom ends of its metrics, we believe investors fail to fully appreciate its 'dry powder' available to deploy through any such transaction. We see the latest petition to involve itself in the bankruptcy process of a peer as further illustrative of management's creative solutions to finding large potential capital opportunities.

### When will we find out if NEE's bid is successful? Later this week likely.

We move towards hearings this Thursday and Friday, where the Bankruptcy Judge will decide whether to approve the EFH proposed DIP financing plan- specifically, whether there is more evidence needed to satisfy the court that there was sufficient diligence pursued in evaluating competing offers, such as NEE's last minute bid. The existing \$1.9 Bn proposal backed by the Hunt Family (owned of the existing InfraREIT) and Texas Teachers remains the working proposal.

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## Looking into the Structure of the Transaction

We include estimates of the pro-forma Oncor capital structure if NEE's DIP proposal were accepted, with the \$3.6 Bn in equity value implying a 15x 2016E P/E on the overall entity. Underneath the capital base would be the newly created 1<sup>st</sup> Lien DIP at the Holding Company Level (\$5.4 Bn) as well Oncor utility-specific debt.

We incorporate EFH's projections from its 8k earlier this year of its five-year outlook for the Oncor subsidiary as a baseline for our EBITDA and Net Income.

Meanwhile, consistent with recent peer utility transactions (EXC-POM), we assume 50% Parent leverage from NEE to fund any financing of the DIP (and eventual equity ownership of Oncor).

### Price looks good, but be careful on underlying assumptions

While the nominal implied P/E for the transaction at ~15x appears quite palatable vs. recent transactions, we caution the utility has seemingly been earning above its authorized level and also has some exposure to rising rates as the 1<sup>st</sup> Lien DIP financing would be refinanced into longer-tenor maturities on exit of bankruptcy (likely at a higher rate).

Despite these concerns, we would describe the transaction as still attractive given meaningful further development opportunities as attractive including:

- (1) Expansion of CREZ
- (2) Continued robust sales growth

### And what if NEE were to take down the whole thing?

We also include a scenario in which NEE would pay a further 15% premium to remaining equity holders in the structure in order to effectuate the 100% acquisition of Oncor. We flag while Oncor would struggle to have such a pre-packaged deal approved as part of its bankruptcy offering (given tax implications), we suspect a bid would likely be in the offing shortly. We suspect this would be ~\$0.10/sh accretive prior to embedding any synergies of integrating the two platforms.

Figure 1: Oncor Projections from Mgmt and NEE Accretion from Contemplated DIP Financing

<b>EFIH</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
<b>EBITDA Projections (excluding)</b>	1,744	1,838	1,870	1,904	1,929	1,952
Securitization	146	111	11	-	-	-
<b>EBITDA Projections (including)</b>	1,890	1,949	1,881	1,904	1,929	1,952
<b>TXU Portion of EBITDA @ 80%</b>	1,512	1,559	1,505	1,523	1,543	1,562
Oncor Debt (as of 3/31)	6,464					
TXU Portion @ 80% Ownership	5,171					
1st Lien DIP @ 4% (From Loop / Williams Capital)	5,400					
DIP Financing Proposal from NEE (Cash pays down 2nd Lien bonds)	2,400					
Implied Total EFH Equity @ DIP for 68% Implied Equity of 98% Interest	3,601					
<b>Total Enterprise Value for 80% Stake in Oncor</b>	<b>14,173</b>					
<b>Total Implied Enterprise for 100% of Oncor</b>	<b>17,716</b>					
<b>Implied EV/EBITDA</b>	9.4x	9.1x	9.4x	9.3x	9.2x	9.1x
<b>Leverage (Debt/EBITDA)</b>	7.0x	6.8x	7.0x	6.9x	6.9x	6.8x
<b>Net Income Projections (from EFH 8k)</b>	<b>395</b>	<b>437</b>	<b>459</b>	<b>469</b>	<b>476</b>	<b>478</b>
Net Income @ 80% Ownership for TXU	316	350	367	375	381	382
Interest Expense on 1st Liens @ 4% (Tax-effected)	(140)	(140)	(140)	(140)	(140)	(140)
Net Income to Equity	176	209	227	235	240	242
<b>Implied P/E Multiple on Equity</b>	<b>20.5x</b>	<b>17.2x</b>	<b>15.9x</b>	<b>15.3x</b>	<b>15.0x</b>	<b>14.9x</b>
Distributions to Owners (80%)	(310)	(282)	(344)	(340)	(404)	(344)
Distributions to Owners @ 80% Ownership	(248)	(226)	(275)	(272)	(323)	(275)
<b>Implied Yield on \$3.6 Valuation</b>	<b>6.9%</b>	<b>6.3%</b>	<b>7.6%</b>	<b>7.6%</b>	<b>9.0%</b>	<b>7.6%</b>
<b>NEE's Stake \$1 Bn is in DIP</b>						
NEE's Ownership of Net Income	48.8	58.1	63.0	65.2	66.8	67.2
50% Parent Leverage @ 5% (\$500 Mn Issuance)	(16.3)	(16.3)	(16.3)	(16.3)	(16.3)	(16.3)
Net Income Accretion to NEE	32.5	41.8	46.7	48.9	50.5	50.9
50% Equity NEE @ \$100/sh						
<b>New Shares Issued (Mn)</b>	<b>5</b>					
Stand-Alone NEE Net Income	2,121.5	2,370.0	2,703.0	2,982.7	3,234.1	3,356.7
Stand-Alone NEE Shares Outstanding	427.0	440.8	454.9	467.4	465.8	450.2
Stand-Alone NEE EPS	\$4.97	\$5.38	\$5.94	\$6.38	\$6.94	\$7.46
<b>EPS Accretion to NEE Calculation (2013 Illustrative) for Partial Stake</b>						
Combo NEE Net Income	2,154.0	2,411.9	2,749.7	3,031.7	3,284.6	3,407.6
Combo NEE Shares Outstanding	432.0	445.8	459.9	472.4	470.8	455.2
Combo NEE EPS	\$4.99	\$5.41	\$5.98	\$6.42	\$6.98	\$7.49
<b>EPS Accretion to NEE (Pre-Synergies) on Partial Stake</b>	<b>\$0.02</b>	<b>\$0.03</b>	<b>\$0.04</b>	<b>\$0.04</b>	<b>\$0.03</b>	<b>\$0.03</b>
<b>EPS Accretion to NEE Calculation (2013 Illustrative) for Full Acquisition (15% Premium to Other Equity Holders)</b>						
New Shares (Mn): 50% Equity NEE @ \$100/sh on ~50% of \$3.5 Bn	20					
Parent Leverage: 50% @ 5% (\$500 Mn Issuance)	(64)					
Combo NEE Net Income	2,233.6	2,515.7	2,866.3	3,154.0	3,411.0	3,535.2
Combo NEE Shares Outstanding	446.5	460.3	474.5	487.0	485.3	469.7
Combo NEE EPS	\$5.00	\$5.47	\$6.04	\$6.48	\$7.03	\$7.53
<b>EPS Accretion to NEE (Pre-Synergies) on Full Stake</b>	<b>\$0.03</b>	<b>\$0.09</b>	<b>\$0.10</b>	<b>\$0.10</b>	<b>\$0.08</b>	<b>\$0.07</b>

Source: Company reports and UBS estimates

## And so now, what about the synergy potential?

Applying the reference statistic for Utility M&A of 5-7% of total cost structure, we estimate total potential O&M savings of \$75-\$110Mn, worth an additional ~\$0.20/sh in EPS accretion. We caution attempts to mitigate the effect on the local community – particularly with competing DIP financing proposal emphasizing their ability to maintain jobs locally – are likely to drive lower synergies than conventional utility M&A with contiguous service territories. We look towards an update on synergies from recent non-contiguous deals such as TE-NM Gas to provide a better 'datapoint' on potential synergies.

Figure 2: Estimates of Utility Synergy Benefits

<u>Potential O&amp;M Savings</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>
<u>Scenario 1: 6% O&amp;M Savings at Oncor Alone - Full Acquisition</u>						
Oncor O&M (Assume 2% Growth)	658	669	681	695	709	723
6% O&M Savings, After-Tax	26	26	27	27	28	28
EPS Accretion	\$0.06	\$0.06	\$0.06	\$0.06	\$0.06	\$0.06
<u>Scenario 2: 6% O&amp;M Savings at FP&amp;L Alone - Full Acquisition</u>						
FP&L O&M	1,699	1,773	1,699	1,648	1,632	1,632
6% O&M Savings, After-Tax	66	69	66	64	64	64
EPS Accretion	\$0.15	\$0.15	\$0.14	\$0.13	\$0.13	\$0.14
<u>Scenario 3: 6% O&amp;M Savings at Oncor and FP&amp;L - Full Acquisition</u>						
Combined O&M	2,357	2,442	2,380	2,343	2,340	2,354
6% O&M Savings, After-Tax	92	95	93	91	91	92
EPS Accretion	\$0.21	\$0.21	\$0.20	\$0.19	\$0.19	\$0.20

Source: Company Filings and UBS Estimates

## Rate base Potential: Slower, but Good Cash Flow

We include our latest projections of ratebase and potential earnings power based on management's projections of capex. We compare this versus disclosed earned ROE and capitalization metrics filed with the PUCT. We flag the underlying ratebase growth of Oncor is just ~3% due to a disproportionately high D&A figure versus peers, resulting in a high implied yield on the \$3.6Bn valuation implied by NextEra on its proposal.

Figure 3: Oncor – A bit of an over-earning issue potentially?

<u>Oncor Projections</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>
<u>Ratebase Projections</u>						
Rate Base - BOY per Start		9,543	9,825	10,069	10,311	10,590
Rate base - EOY	9,543	9,825	10,069	10,311	10,590	10,869
% Growth Rate		3.0%	2.5%	2.4%	2.7%	2.6%
Capex	1,054	1,008	1,002	1,022	1,059	1,059
D&A (without securitization)	690	726	758	780	780	780
% Equity	40.00%	40.00%	40.00%	40.00%	40.00%	40.00%
ROE	10.25%	10.25%	10.25%	10.25%	10.25%	10.25%
Earned Return	10.53%					
Authorized Net Income on Avg Ratebase	391	397	408	418	428	440
Projections from EFH	395	437	459	469	476	478

Source: Company projections, PUCT, and UBS estimates: Projections from 8k/Earnings Monitoring Report

## Updating Competitive Projections from Management

Along with the update on Oncor, we thought we would also include an updated 'mark-to-market' of management's previously disclosed projections for its IPP business, Luminant.

Figure 4: Updated Adjusted EBITDA and FCF using Mgmt Projections on Current ERCOT Forwards

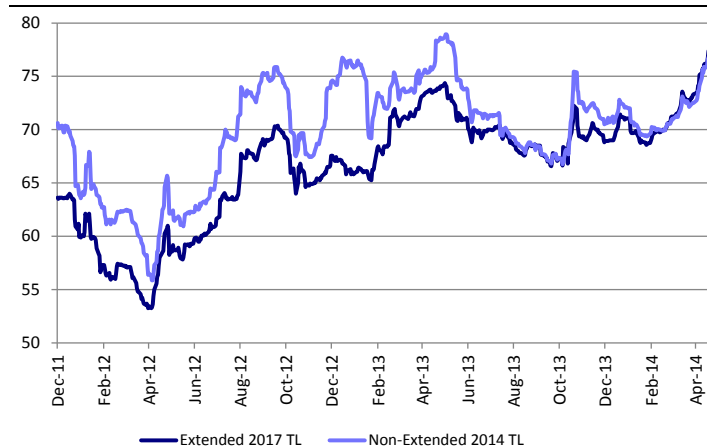
EFH Corp Mini-Model Projections using Mgmt Projections and Updating using MtM Commodities						
	2013	2014	2015	2016	2017	2018
<b>TCEH Consolidated Adjusted EBITDA (from 4-29-14 8k), using 8/30 Co</b>	<b>2,721</b>	<b>2,109</b>	<b>1,656</b>	<b>1,587</b>	<b>1,850</b>	<b>1,942</b>
Subtract: TXU Energy (using 2012 Guidance midpt & projected Yo)	719	619	589	559	544	529
<b>Implied Generation (Luminant) EBITDA</b>	<b>2,002</b>	<b>1,490</b>	<b>1,067</b>	<b>1,028</b>	<b>1,306</b>	<b>1,413</b>
Hedge Value (Disclosed) - 10/15/13 8K	1,018	(587)	0	0	0	0
<b>Implied Open EBITDA Generation (Luminant) , using 8k</b>	<b>984</b>	<b>2,077</b>	<b>1,067</b>	<b>1,028</b>	<b>1,306</b>	<b>1,413</b>
O&M (UBSe)	875	875	875	875	875	875
<b>Implied Open Generation GM</b>	<b>1,859</b>	<b>2,952</b>	<b>1,942</b>	<b>1,903</b>	<b>2,181</b>	<b>2,288</b>
Implied Open Revenue	2,879	3,963	2,992	3,071	3,360	3,479
<b>Expected Generation TWh (Mgmt Projection from from 4-29-14 8k)</b>	<b>70</b>	<b>68</b>	<b>68</b>	<b>72</b>	<b>72</b>	<b>72</b>
Nuclear TWh (UBSe)	19	18	19	18	18	18
Coal TWh (Implied)	51	50	49	54	54	54
Total Coal Capacity (MW), Monticello 1&2 for Summer-Only (33%)	7,303					
Implied Capacity Factor on Coal (%)	80%					
Open Revenues (Est. Using Premium to ERCOT Prices)	2,520	2,564	2,693	2,964	3,286	3,288
ERCOT-North (ATC), as of Aug 30th, 2013	34.28	36.26	38.45	40.36	45.19	45.67
Houston Shipping Channel Gas, as of Aug 30th 2013	3.45	3.88	4.08	4.20	4.31	4.44
Implied Heat Rate	9.94	9.35	9.42	9.61	10.48	10.29
ERCOT-North Premium (% over ATC)	5%	4%	3%	2%	1%	0%
Realized Power Price (\$/MWh)	35.99	37.71	39.60	41.17	45.64	45.67
Nuclear Dispatch Costs (\$/MWh)	7	7	7	7	7	7
Coal Dispatch Costs (\$/MWh)	20	20.21	21.42	21.63	21.84	22.05
Implied Delivered PRB Price (\$/t), UBSe	38	39	40	41	42	43
Implied Delivery Price (\$/t), UBSe	27	28	29	30	31	32
Fuel Cost (Only Coal/Nuclear Fuel Excl from Adj. EBITDA)	1,020	1,011	1,050	1,168	1,179	1,191
<b>Baseload-Only Gross Margin (UBSe), as of Feb 1st</b>	<b>1,500</b>	<b>1,554</b>	<b>1,643</b>	<b>1,796</b>	<b>2,107</b>	<b>2,098</b>
<b>Asset Management, using this as Plug to Mgmt</b>	<b>359</b>	<b>1,398</b>	<b>299</b>	<b>107</b>	<b>74</b>	<b>190</b>
<b>Open Luminant EBITDA (UBSe), as of Feb 1st</b>	<b>625</b>	<b>679</b>	<b>768</b>	<b>921</b>	<b>1,232</b>	<b>1,223</b>
Add : Hedges (As disclosed by Mgmt) - 4/29/14 8K	1,018	(587)	-	-	-	-
<b>Hedged Luminant (Generation) EBITDA (UBSe), as of Feb 1st</b>	<b>2,002</b>	<b>1,490</b>	<b>1,067</b>	<b>1,028</b>	<b>1,232</b>	<b>1,223</b>
Add : TXU Energy, Retail Business EBITDA (from above)	719	619	589	559	544	529
<b>Hedged TCEH EBITDA (UBSe), as of Feb 1st</b>	<b>2,721</b>	<b>2,109</b>	<b>1,656</b>	<b>1,587</b>	<b>1,776</b>	<b>1,752</b>
Implied All-in Fuel, O&M, SG&A Costs (\$/MWh)	27	28	28	28	29	29
Guidance	30-32					
<b>Reflecting the Latest Commodity Shifts</b>						
ERCOT-North (ATC) - MtM Improvement/(Declines), \$/MWh		3.54	1.11	(0.67)	(3.77)	(1.41)
Volumes		68	68	72	72	72
Change in Hedge Value since Feb 1st		241	76	(48)	(271)	(101)
<b>Hedged TCEH EBITDA (Mgmt Projections), using latest MtM</b>	<b>2,350</b>	<b>1,732</b>	<b>1,539</b>	<b>1,539</b>	<b>1,579</b>	<b>1,841</b>
Nuclear Fuel (Not Included in Mgmt's EBITDA), UBSe		(126)	(133)	(126)	(126)	(126)
Maintenance/Enviro Capex (Plug from Nuclear Fuel vs. Mgmt Total)		(228)	(472)	(369)	(329)	(602)
<b>TCEH FCF (Pre-Other CF Items)</b>	<b>1,996</b>	<b>1,127</b>	<b>1,044</b>	<b>1,044</b>	<b>1,124</b>	<b>1,113</b>
Working Capital		41	(29)	1	-	-
Margin Deposits		(322)	-	-	-	-
Other CF Items		(104)	(27)	(51)	(51)	-
State Tax Payments		(30)	(29)	(26)	(26)	(26)
<b>TCEH FCF (Pre-Interest), using Mgmt Projections / UBSe for Capex &amp; Fuel</b>	<b>1,581</b>	<b>1,042</b>	<b>968</b>	<b>968</b>	<b>1,047</b>	<b>1,087</b>

Source: Mgmt Projections, Platts, and UBS estimates

### TCEH (IPP) debt continues to climb despite pull back in forwards

Secured (1<sup>st</sup> Lien) Debt against the Luminant Business, effectively the equity of the business, has continued to climb despite the recent pullback in power forwards in ERCOT. We also flag other asset classes (2<sup>nd</sup> lien) have also similarly seen improvement in total value.

**Figure 5: Texas Competitive Energy Holdings (TCEH) Term Loans (vs. par)**

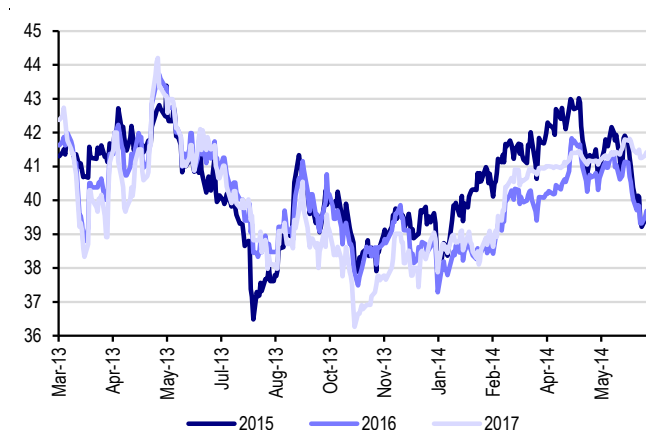


Source: Bloomberg

### Power forwards in ERCOT North have continued to decline...

While 2015 and 2016 forwards have declined, 2017 forwards have remained more resilient of late. We flag a disappointing summer YTD and growing expectations for greater wind penetration appear to be the dual culprits. Additionally, we flag more talk of new brownfield expansions as also weighing on expectations (EXC is contemplating adding to brownfield CCGT sites rather than acquiring incremental capacity in the state).

**Figure 6: ERCOT-North ATC Power Forwards (\$/MWh)**



Source: Platts and UBS estimates

We suspect the impact of another wave of wind development in Texas will have a disproportionate impact on Luminant's primarily coal-based portfolio. We suspect any future mothballing/retirement/conversion to gas of assets could help focus attention once again on demand growth.

## 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 Integrators. 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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UBS 12-Month Rating	Definition	Coverage <sup>1</sup>	IB Services <sup>2</sup>
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%
UBS 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.	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.

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>NextEra Energy</b> <sup>16</sup>	NEE.N	Buy	N/A	US\$98.48	07 Jul 2014

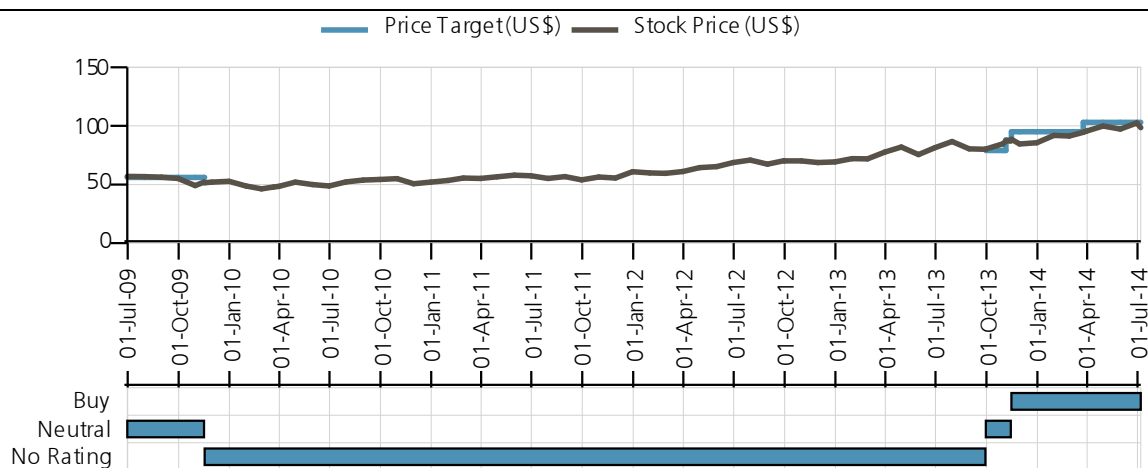
Source: UBS. All prices as of local market close.

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## NextEra Energy (US\$)



Source: UBS; as of 07 Jul 2014

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