

NRG Energy Inc.

Addressing the Slide

Management not sitting idle as stock declines

We visited with management yesterday to assess their latest thoughts amidst the recent pressure on both power and YieldCos. The key takeaway is that neither the NRG Energy nor NRG Yield have plans to issue equity with NRG poised to potentially announce *incremental* repurchases as soon as 3Q results. This increased NRG capital allocation would be above and beyond the \$437Mn already communicated for '15 and tap into the \$400Mn unallocated FCF showing receptiveness to investor feedback on capital allocation. With NRG Energy trading at ~\$20/sh, mgmt stated that all uncommitted capital is up for review against the now higher repurchase threshold.

Spin of solar biz still a possibility despite execution bumps

Following the disappointing Home Solar results with 2Q (more cash burn and less household penetration) and increased focus on capital allocation, we believe management could have an increased sense of urgency on finding a solution to financing the segment. A criterion for the segment was line of sight into capital replenishment/no dependence on NRG Energy; the original plan was to sell to NRG Yield but at the current discounted share price there is less visibility into the plan. We now see a spin in early 2016 as a higher probability event, particularly if NRG's stock does not recovery. The key will be whether the CA ad push can help propel to 40K cumulative customers.

How to stop the bleeding at NRG Yield? Delaying equity issuances

Management elaborated on its recent 2Q earnings call on ways to increase confidence in the story after what it views as an overly extensive market reaction to YieldCos in recent weeks. First NRG Yield stated that it has ~\$45Mn of CAFD payout latitude assuming a hypothetical 90% payout ratio versus 75%. Another lever available to management is that it could refinance some of its fully amortizing debt as holding company non-amortizing debt which would further unlock CAFD latitude. There is also a capital buffer at NRG Yield that could be utilized as another source of distribution liquidity. Lastly, there is the possibility that NRG Energy could execute a drop-down and receive a portion or all of the proceeds in NRG Yield shares, eliminating concerns about secondary public equity issuances while showing confidence in the future of NYLD.

Valuation: Maintain PT; willingness to deploy FCF into buyback a positive

PT based on 2017E sum-of-the-parts valuation. Mgmt said all the right things and we see the laser-focus on cash as telling a compelling relative FCF yield story [\[details here\]](#).

Equities

Americas
Electric Utilities

12-month rating **Buy**

12m price target **US\$23.00**

Price **US\$20.53**

RIC: NRG.N BBG: NRG US

Trading data and key metrics

52-wk range	US\$33.72-19.23
Market cap.	US\$6.90bn
Shares o/s	336m (COM)
Free float	100%
Avg. daily volume ('000)	907
Avg. daily value (m)	US\$20.8
Common s/h equity (12/15E)	US\$11.8bn
P/BV (12/15E)	0.5x
Net debt / EBITDA (12/15E)	5.3x

EPS (UBS, diluted) (US\$)

	12/15E	
	UBS	Cons.
Q1	(0.40)	(0.37)
Q2E	(0.15)	(0.06)
Q3E	1.25	0.50
Q4E	1.53	0.14
12/15E	2.31	0.83
12/16E	1.56	0.34
12/17E	1.39	(0.29)

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Highlights (US\$m)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	8,422	11,295	15,868	16,279	15,977	15,767	15,838	15,998
EBIT (UBS)	969	1,380	1,605	2,157	1,820	1,630	1,676	1,832
Net earnings (UBS)	579	274	262	726	490	436	492	722
EPS (UBS, diluted) (US\$)	2.47	0.85	0.78	2.31	1.56	1.39	1.57	2.30
DPS (US\$)	0.18	0.48	0.54	0.58	0.58	0.58	0.58	0.58
Net (debt) / cash	(14,042)	(14,812)	(18,568)	(17,448)	(16,295)	(14,916)	(13,336)	(11,273)
Profitability/valuation	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
EBIT margin %	11.5	12.2	10.1	13.3	11.4	10.3	10.6	11.5
ROIC (EBIT) %	6.5	7.4	7.9	10.3	9.0	8.5	9.3	11.0
EV/EBITDA (core) x	6.2	6.3	6.2	4.7	4.8	4.7	4.1	3.2
P/E (UBS, diluted) x	7.5	31.3	39.6	8.9	13.2	14.8	13.1	8.9
Equity FCF (UBS) yield %	(50.4)	(9.1)	5.9	7.4	8.6	11.9	14.8	21.8
Net dividend yield %	0.9	1.8	1.7	2.8	2.8	2.8	2.8	2.8

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\$20.53 on 12 Aug 2015 18:41 EDT

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

[8/5/15 Buy-Into the Free Cash Flow Yield Story](#)

[8/4/15 Lack of Wind Hits Results](#)

[5/15/15 Let the Summer of Repurchases Commence](#)

[2/27/15 Splitting The YieldCo](#)

[1/20/15 Picking Apart The Solar Opportunity](#)

[1/16/15 Daring to Dream](#)

- **No longer the 'no-spin' zone:** Our reaction to the 2Q call was that the possibility of spinning the Home Solar business in the near-term was relatively low given the immediate negative free cash flow profile and lack of scale but we see a much higher possibility after our latest meeting. Management stated that based upon comparable companies it sees a credible spin/public offering needing approximately 40,000 cumulative customers and sees visibility to 35,000+ for Home Solar by YE15. This is far from a guarantee as NRG backed away from expectations for 35,000-40,000 Home Solar customers by year-end and completed 1H15 with 19,400 customers, up from 16,200 at 3/30. Management indicated that the inability to hit the target announced in May was due to unfavorable early 2015 weather in the Northeast given a reliance on door-to-door sales. The latest increase in cash burn for a California advertising boost to improve the Net Promoter Score (NPS) could be the catalyst to help achieve this goal. Whatever the path that management intends to travel for the business, they are cognizant of the synergies of cross-selling to the retail customers so mechanisms will be in place to keep this relationship while compensating NRG

An answer to Home Solar is expected to be in-place early in 2016.

How do we see NRG Home Solar implied valuation from the recent VSLR deal?

We include our implied segment valuation where we previously reduced the DevCo target from the 250MW guided for 2015 due to the latest slip with 2Q.

Figure 1: Total of ~\$4/sg for DevCo and PowerCo

NRG Valuation (based on mgmt guidance)	
2015 Annual Development MW	
Capacity (Annualized Pace MW)	200
Guidance	<250
Margin (\$/W)	\$0.40
DevCo Monetization (\$m)	\$80.0
Implied multiple	5.0x
Implied Value of DevCo (\$M)	\$400.0
2015 Cumulative (PowerCo) MW	
2015 CAFD (\$/W)	\$0.155
Installed Capacity (MW)	400
CAFD (\$m)	62.0
Unlevered yield	8%
Value of PowerCo (\$M) - 2015	\$774.4
NRG Home Implied Valuation (\$M)	\$1,174
Per Basic Share	\$3.70

Source: Company reports and UBS estimates

- **How would a solar biz combo with NRG work?** We think NRG Energy would retain a marketing relationship with any spun off entity, effectively entitling it to a fee for sales referenced back to NRG Solar from its incumbent retail business. While the bulk of the business is in Texas (and hence not eligible for solar given low incumbent rates), the northeast business remains the clear focus. We see this as more of an income stream rather than the capital allocation drag it has thus far been. Such payments could be as little as \$0.20/W or as high as \$0.50/W (entirely UBS based off other such arrangements), suggesting an ongoing income stream of \$40-100 Mn back to NRG Energy in referral fees.
- **Are returns lower in solar or late?** Mgmt considers the \$175 Mn 'step-up' in capital commitments to the solar biz (from \$100 Mn in initial guidance) as largely a 'one-time' marketing name recognition fee. We see this as part of a necessary ongoing cost, reflecting our wider concerns for higher marketing and sales cost as the industry becomes increasingly competitive.
- **Doubling-down on capital deployment:** With shares down 22% in the past three months management stated that all capital projects where cash has not yet been deployed are subject to additional review against the opportunity to repurchase shares. As an example management discussed the optimization plan at the acquired Midwest Generation assets where management disclosed an implied EV / EBITDAR of ~5.5x in 2Q14: even this committed capital will face scrutiny to assess whether it surpasses the elevated opportunity cost of repurchasing shares. Perhaps most obviously we would expect NRG to address the \$400Mn unallocated excess capital generated in 2015 on its next earnings call.
 - As part of the 70%/90%/10% capital allocation plan 10% are dedicated to Carbon360, NRG EVgo, and other venture investments including GoalZero. In 2015 this is \$170Mn of spending and management reiterated that it has no further commitments to Carbon360 beyond the PetraNova/Parish project given the weak commodity market. With respect to EVgo NRG agreed to invest \$100Mn in California to settle legacy liabilities and substantially all of the capital will be focused on the market in the next three years (although we do note the Company has expressed interest in potential growth in New York).
- **Embedding more conservatism into NYLD guidance:** The recently provided run-rate adjusted EBITDA (\$760Mn) and CAFD (\$245Mn) guidance for NRG Yield assumes no additional drop-downs (the package currently being negotiated is excluded) and was presented to show the improvement in 2016 for items such as the Alta X & XI refinancing and full-year contribution from Desert Sunlight. Furthermore, NYLD has haircut the run-rate guidance to incorporate some conservatism below 'normal' p50 conditions although it does anticipate a recovery the objective was to exercise more caution. Following two guidance reductions in 2015 management is reviewing its practices for providing investors with more detailed disclosures. We do not anticipate a shift to a current year EBITDA/CAFD guidance range for NRG Yield (similar to how NRG Energy provides guidance) but we would expect sensitivity about the impact of an X% change in wind speed and solar irradiance. The natural analogy would be providing disclosures similar to how NRG Energy provides sensitivities around natural gas and heat rate movements.

At its Analyst Day mgmt indicated incremental adjusted EBITDA potential of \$250Mn for Carbon360 and EVgo, respectively.

- **YieldCo M&A could become a theme as sector weakness drives consolidation:** Without specifically discussing NRG Yield, when describing the recent declines for all of the YieldCos management anticipated that there could be an increase in YieldCo consolidation across the sector. We have flagged this previously as a potential theme following the currency declines and we see two characteristics as likely necessary: (1) share-for-share deal; and (2) a willing seller. An equity transaction would prevent floating public equity in a generally unreceptive capital market today. A YieldCo without a public sponsor or one with a sponsor facing fundamental issues could be more likely candidates as well. NRG also stated that it sees YieldCos with development platforms that could offer synergy savings albeit more limited with YieldCos generally running relatively 'lean'. An important consideration in any deal would be a desire to acquire a development pipeline such that the remaining YieldCo could at least maintain its distribution per share guidance rate.
- **TX summer misses the mark:** NRG commented that although there has been some pricing spikes in real-time trading, the recent power prices in ERCOT have been generally disappointing, even with the recent heat this past week. Material relief is not expected to come in Ernst until ~2019 when environmental regulations could drive retirements. Leading up to that point, if units are free cash flow negative management still sees a possibility for economic rationalization from players with more challenged fleets. Despite wider price weakness in ERCOT, mgmt remains adamant that its fleet is *not* subject to any retirement risk.

Forecast returns

Forecast price appreciation	+12.0%
Forecast dividend yield	2.8%
Forecast stock return	+14.8%
Market return assumption	5.7%
Forecast excess return	+9.1%

Statement of Risk

Risks to our investment thesis include but are not limited: 1) actual commodity prices differing significantly from our assumptions; 2) political and regulatory intervention to change the structure of competitive markets in response to high power prices and insufficient new build; 3) the current state of credit markets that has limited the companies' flexibility to return excess cash to shareholders; and 4) unknown impact from a potential carbon legislation (likely a modest negative). Other investment risks include abrupt changes in weather patterns, sharp slowdown in economic demand, interest rate risks, large renewable/transmission build-out across TX, declining valuation for NRG Yield investment, and disruption of trading activity in power markets.

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Buy	FSR is > 6% above the MRA.	45%	36%
Neutral	FSR is between -6% and 6% of the MRA.	42%	32%
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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 June 2015.

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Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
NRG Energy Inc. ¹⁶	NRG.N	Buy	N/A	US\$20.53	12 Aug 2015
NRG Yield ¹⁶	NYLDa.N	Neutral	N/A	US\$15.97	12 Aug 2015

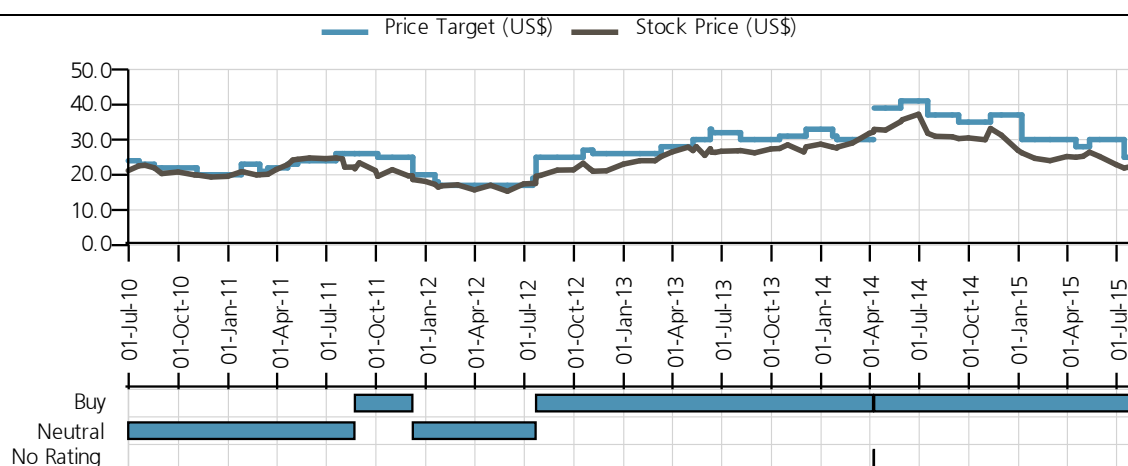
Source: UBS. All prices as of local market close.

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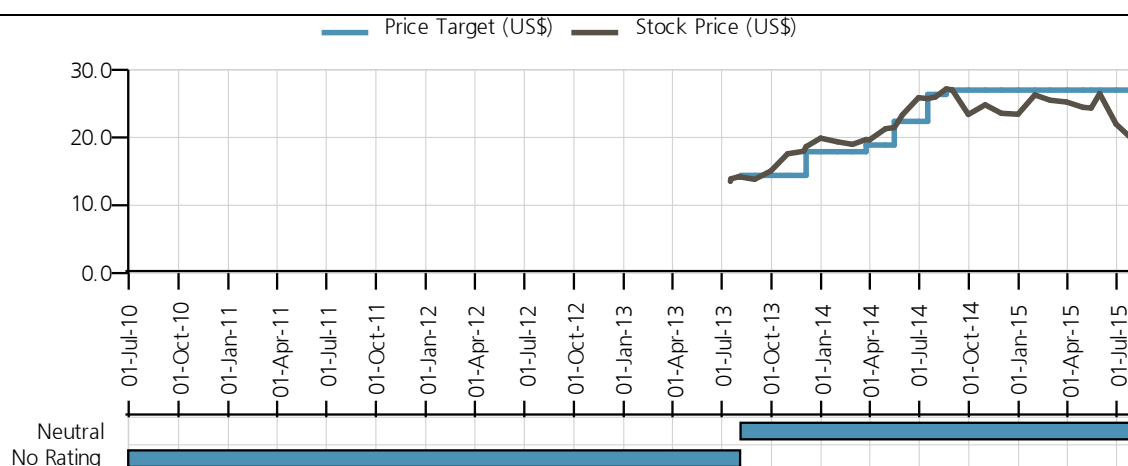
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NRG Energy Inc. (US\$)



Source: UBS; as of 12 Aug 2015

NRG Yield (US\$)



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