

# Sweet 16 - Investment Themes for 2016

## Summary

We present our *16 Key Investment Themes for 2016*. The year ahead could prove to be challenging on many fronts and we expect investors to tread carefully and remain nimble throughout the year.

## Key Points

2016 could well be another year of major twists and turns. Here are the 16 major themes as we see them plus one other one we dare not to handicap, at least not at this stage:

1. The best offense is probably a good defense.
2. 2016 is likely to be the "Critical Year of the YieldCo".
3. For power-sensitive names, it's still about underlying commodity prices. Nothing more, nothing less.
4. Certain equity stories became credit ones.
5. Beware of asset impairments.
6. Parent leverage is good, until it's not.
7. Pension plans and nuclear decommissioning trusts face greater scrutiny.
8. Another tough year appears in store for natural gas, which faces challenges on several fronts.
9. \$2 natural gas prices, or less, do not lend itself well to renewables growth (or new nuclear) without continued public policy and regulatory support.
10. Solar enters the teenage years.
11. Welcome back...is re-regulation is upon us?
12. The pace of M&A activity begins to slow, despite the low cost of capital environment for strategic and financial sponsors alike.
13. The gas infrastructure play for utilities is far from over.
14. A rising rate environment is not necessarily a recipe for underperformance.
15. The capital spending cycle is not over.
16. Expect another year of significant price discrepancy in the group; and, importantly,
17. The presidential election bears careful monitoring (as it relates to energy policy).

*Each of these themes are flushed out in the body of this report. Key stock ideas are included as well.*

Company	Symbol	Price (12/11)	Rating			PT
			Prior	Curr	PT	
8point3 Energy Partners LP	CAFD	\$12.98	-	Buy	\$21.00	
American Electric Power Company, Inc.	AEP	\$54.56	-	Buy	\$65.00	
Consolidated Edison, Inc.	ED	\$60.81	-	Neutral	\$66.00	
Duke Energy	DUK	\$67.84	-	Neutral	\$75.00	
Edison International	EIX	\$59.23	-	Neutral	\$60.00	
Entergy Corp	ETR	\$65.66	-	Neutral	\$67.50	
Eversource Energy	ES	\$48.91	-	Neutral	\$52.00	
NextEra Energy, Inc.	NEE	\$97.41	-	Buy	\$125.00	
NextEra Energy Partners LP	NEP	\$25.60	-	Buy	\$47.00	
PG&E Corporation	PCG	\$51.71	-	Buy	\$56.00	
Pinnacle West Capital Corporation	PNW	\$61.53	-	Neutral	\$60.00	
SCANA Corporation	SCG	\$57.45	-	Neutral	\$56.00	
TECO Energy, Inc.	TE	\$26.66	-	Neutral	\$27.50	
The Southern Company	SO	\$44.40	-	Neutral	\$45.00	
WEC Energy Group	WEC	\$48.56	-	Buy	\$54.00	

Source: Bloomberg and Mizuho Securities USA

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## 2016 Investment Themes – Power & Utilities, Alternative Energy

As we leave a challenging 2015 and turn the focus to 2016, we are a bit more sanguine on the fundamental issues confronting the Power & Utilities/Alternative Energy sector than in years past but nevertheless we think the group's stock performance will fare relatively well, especially the regulated names given the broader macro issues. Importantly, our track record for identifying the themes over the last few years has been pretty darn good. Perhaps we've been both a bit lucky and a bit smart.

Heading into 2015, while employed elsewhere, we expected a year of significant twists and turns and stated that companies with a "flat to slightly down price performance" would have a good year. For 2014, we were the lone Bull and appropriately entitled our year ahead preview note "Perhaps the Consensus is Wrong" and our thesis played out as expected.

As we head into 2016, we see these 17 major themes playing out:

- 1) **The best offense is probably a good defense.** The Utility sector generally outperforms the S&P 500 on a relative basis heading into major periods of uncertainty and our view is investors should seek a defensive bias. The macro data suggests challenges ahead: S&P 500 estimates are beginning to roll over; operating margins are declining; U.S. and Global GDP expectations are falling; and, industrial production hurting. If the Fed does hike, credit spreads are likely to widen, the dollar will strengthen, oil will continue to fall, and the yield curve will flatten, in our view, all of which bodes ill for the economy but augurs well for the utility sector.
- 2) **2016 is likely to be the "Critical Year of the YieldCo."** If 2015 was the year where YieldCo's experienced the Virtuous to Vicious capital cycle seemingly overnight, we believe 2016 is the make or break year for YieldCo's. In our judgment, these factors will dictate the YieldCo investment appeal longevity:
  - a. **The capital market appetite for YieldCo's is likely to be a function of how MLP follow-on offerings perform in the aftermarket.** With MLPs traditionally raising equity following quarterly reporting periods, aftermarket "price stickiness" and/or subscription levels for the individual MLP offerings would be a pretty clear indication if the markets are re-opening and receptive to secondary issuances. Additionally, re-establishing the confidence of the investment community is critical, and may be a tall order, in our view, given the group's underperformance and its attendant impact on investment portfolios.

- b. **Despite long-dated PPA contracts, the sector is still beholden to commodity prices**, which ultimately affects power prices. Low natural gas prices leads to low power prices in turn leading to lower PPA prices. All of this leads to reduced DCF valuations prospectively because the underlying economics have declined. Similarly, continued weakness in oil prices is expected to influence MLP investments and performance, follow-on equity needs, and the like, which obviously affects YieldCo's.
  - c. **The YieldCo industry is not really an industry *per se***, it's a niche sub-sector play. There are eight U.S. YieldCo's with a market cap totaling \$9.4 billion, three of whom have serious issues with their sponsor entity. By contrast the REIT sector has a market cap of \$806 billion, the Power & Utilities (ex IPPs) has a market cap of \$543 billion, and the MLP sector's market cap is \$252 billion (measured using the Alerian MLP ETF market cap). The YieldCo sector needs scale and scope in order to survive, in our view.
  - d. **Consolidation is not a panacea to growing YieldCo investor appeal**. Through consolidation, the total market cap is likely to remain relatively unchanged. If the eight YieldCo's all merge with one another, it will be tough to garner investor interest when there are just four companies. And if YieldCo privatization is the path taken, it's just that, the elimination of the sector.
  - e. **Implied volatility must come down in order for the premise of the YieldCo cost of capital advantage to materialize**. A quick analysis of YieldCo betas produces a range of 2.5-4.0, implying the YieldCo cost of capital is likely well underwater relative to its sponsor. A wise investor – who has been around for many business cycles – recently said he looks at the YieldCo space as nothing more than a closed-end investment fund and “those funds trade at 0.80x book.” If he is right, if this valuation methodology is the one that ought to be utilized, and with the average YieldCo Price/Book multiple currently at 0.86x, the implication is the YieldCo space is appropriately valued at current levels.
- 3) **For the power-sensitive names, it's still about the underlying commodity price**. At the start of 2015, the conventional wisdom was that coal asset retirements, capacity auctions, the absence of fully built-out gas pipeline infrastructure systems, and weather would boost outperformance for the IPPs. Instead, investors

experienced collapsing commodity prices, and result was stock prices were cut in half, on average, despite coal plant retirements and favorable capacity auction results.

- 4) **Certain equity stories become credit stories.** None of the IPPs have investment grade credit ratings and we are relatively confident that with many IPPs stock prices hitting single-digits, or headed that way, the credit folks are probably starting to take a hard look. Will 2016 become a repeat of the 2001-2003 era? Will the rising concern about the E&P sector and its ability to meet debt service obligations on nearly \$200 billion in high-yield debt bleed into and affect the IPP sector?
- 5) **Beware of asset impairments.** Merchant coal and oil generation assets, perhaps even nuclear and gas assets are not meeting, or barely meeting, breakeven cash costs. Will the plants be retired or will management's take an impairment? Further, as some companies move into midstream businesses, the value of reserves has to be falling and logic would dictate there needs to be an impairment along the way given the collapsing price of natural gas.
- 6) **Parent leverage is good, until it's not.** One needs to look no further than the TECO saga to learn important lessons: the cash flows from the underlying utility and non-core, non-utility businesses need to cover *both* the dividend and parent interest obligations or something will have to give, *i.e.*, borrow more, issue equity, cut the dividend, divest assets, or some other combination. DUK and ETR face this now and we believe this is Issue #1 for both these companies in 2016. DUK's non-regulated cash flow is declining given that its merchant business has been divested and its International business languishes. What can and does DUK do strategically? Similarly, the economics underscoring ETR's wholesale business, where the merchant nuclear fleet is housed, have deteriorated. If TE is a roadmap, how did TE solve its issue? First, it bought NM Gas to stabilize its cash flow, and then it ultimately sold itself.
- 7) **Funding levels for pension funds and nuclear decommissioning trusts come under greater scrutiny.** While the investor focus is largely on the EPS impact from pension accounting, there is, and always has been less focus on underlying performance expectations and funding needs. The pension debate, in our view, is 'how big are the US GAAP funding deficiencies growing as the long end of the yield curve is pushed down, especially given the anemic market returns and lower discount rates?' And, with return assumptions and discount rates being key drivers about future funding needs, there appears to be a disconnect between return projections and discount

rate assumptions especially given the market's recent performance and the Fed's highly accommodative monetary policy. Importantly, through all this, something's gotta give: either plan returns are too high or utility stocks are inexpensive. Finally, remember, the ratings agencies view unfunded pension obligations as debt – despite regulatory recovery for many – leading to credit pressure as funding deficiencies increase liabilities. Switching to the nuclear decommissioning trust funds, better known as the cousin to pensions, the same mathematics and same types of questions hold true here too. Will the NRC adjust its methodology or kick the can down the road? But more importantly, has EXC, the parent, guaranteed the funding levels for its large nuclear fleet? If there's no operating nuclear fleet, how does the fund get topped off and who pays? ETR has small guarantees and some credit facilities its Vermont Yankee decommissioning, but nothing else. At NEE, there are no parent guarantees on the NEER decommissioning trust funds to meet the NRC requirements.

- 8) **Another tough year appears in store for natural gas, which faces challenges on several fronts.** The 2018 calendar strip continues to hover in the \$3.00 per mmbtu range, while the Street consensus remains about \$3.50 per mmbtu. (Current spot is \$1.77 per mmbtu). What does the investment community see that the markets do not? Meantime, several phenomenon are occurring simultaneously, notably that gas flows from the lower-priced Marcellus and Utica gas and is competing with higher-priced Henry Hub gas. Most of this gas is headed in a southerly direction and will ultimately compete with Henry Hub. (We leave the topic of contracts that indexed to Henry Hub pricing aside for this report). In supply-based pricing, so long as the rate of breakeven prices fall, which we're told continues to be the case, there is still enough incentive to support continued drilling activity and production growth, which, by the way, doesn't augur well for a rebound in natural gas pricing anytime soon. Ironically, the oil and gas economics are doing more to the power sector than the EPA could have envisioned. Said differently: Mr. Market: 1; EPA: 0, especially in deregulated markets. That said, there are two unanswered questions: how long will the oil companies continue to produce, thereby pressuring the gas producers (remember not to forget about the wet/dry gas issue); and, is there anything in the crude/gas producing regions that could occur that ultimately pushes up gas pricing? On the former, unclear. As for the latter, it's the typical supply/demand issue, namely how will the supply cuts (lower capex spend by oil and gas producers) affect pricing when new demand from gas-fired generation ramps up? Yes, but when? At that point, the power trade most likely returns, in earnest, in our judgment.

- 9) **\$2 gas, or less, does not lend itself well to renewables growth (as well as new nuclear) without continued public policy and regulatory support.** For wind companies, the PTC is positive relative to cash grants across almost all capital cost, capacity prices and PPA price scenarios (\$40 per MWh assumed). Said differently the NPV/Capital produces positive returns at hurdle rates just above 7%. Solar continues to do well for a variety of reasons – wind is an off-peak coincident resource; solar PV has lived up to its original business case and in many cases is exceeding them; more solar insolation than wind resource throughout the US – as costs have come down. But like wind, solar too needs its tax credits in order to remain competitive and NPV/Capital positive. By our math, a reduction in the ITC to 10% lowers the hurdle rate to less than 5% where the investment is NPV/Capital positive. While some players have indicated that “they’ll raise the PPA price” to keep the economics consistent, I’m not so sure regulators are happy to pay full retail. No one pays retail anymore!
- 10) **Solar enters the teenage years.** A confluence of events appear to be lining up for 2016. The solar business model, at least mathematically, will be tested if the ITC stepdown from 30% to 10% occurs. If so, we expect to see excess solar panel inventory flood the market driving down end-user prices (a buyer’s market) as manufacturers move to raise cash. This could be the biggest single issue affecting the solar stock performance in 2016. On the regulatory front, Arizona remains the bellwether for solar where new rate structures are being evaluated. Two critical issues at play. First, will the regulators reset time of use rates to more reasonable and market-based levels? The last TOU rates were established when gas was \$10 per mmbtu and the peak/off-peak spread was 4:1. Natural gas is around \$2 per mmbtu and the spread is 2:1. At these levels, market fundamentals indicate that solar can’t reasonably compete. The second issue is the net metering debate. This is where the solar users want to be able to sell excess power into the grid, keep the grid as a free option for coming and going as one chooses and as necessity dictates, all without having to pay a monthly fee or any other fee. The problem is the math. There is a cost for this optionality and those not on solar are expected to absorb the higher costs. As more of the fixed costs are spread out over fewer users, the price for maintaining the facilities rises disproportionately on those not opting to switch, especially lower income brackets. All of this needs vetting concurrently with the cross-subsidization issues where higher rate structures (typically residential) are subsidizing the lower ones (again, a fixed cost issue). There are no easy answers here. And finally, the utilities are now fighting back, using the same aggressive tactics as the solar players, much to the consternation of

the solar group, and making the fight a simultaneous one in both the land of public opinion and the regulatory arena.

- 11) **Welcome back...is re-regulation upon us?** The state of Ohio is the gift that keeps on giving. Questions about the motivations of the Ohio regulators and possibly allowing long-dated PPAs on merchant generation assets still owned by the incumbent utilities are certainly being asked. While the devil is in the details, and has no decision has been made, it appears as though the Ohio regulators are undertaking some form of quasi-reregulation. Will a PPA agreement encumber the existing owner to maintain ownership over the life of the PPA or can the asset be sold? Are the Ohio regulators wary of losing jurisdictional control of generation assets to an out of state entity? What is the commitment to the state by that outside company? And, what is the financial viability of that company?
  
- 12) **The pace of M&A activity begins to slow, despite the low cost of capital environment for strategic and financial sponsors, alike.** The number of announced corporate merger transactions in 2015, 2014, 2013, and 2012 were four, four, two, and one for total consideration of \$33.8 billion in 2015 vs \$46.3 billion in 2014. Why the slow down? Simply put, the number of attractive targets with market caps under \$10 billion is declining. Those attractive remaining companies, in our view, include PNW, Southwest Gas (SWX), Atmos Energy, Columbia and NiSource. Valuations continue to rise – for both those transactions deemed “material” and those “non-material.” However, price paid per book value has not changed much despite the M&A boom and rising P/E multiples; the average P/Book is 1.8x (we note that DUK is paying 3.5x for PNY and SO is paying about 2.0x for GAS). Today’s utilities are presently trading at a range of trading at 1.7x price/book. In an era of high premium takeover offers, it will take some time for low-premium deals to be accepted by Companies, in our view.
  
- 13) **The gas infrastructure play is far from over.** DUK and SO’s acquisitions of gas companies is as much an infrastructure play as it is about securing supply for its gas-fired generation assets. We see the industrial logic in the deals given the reduction/elimination of coal assets from the country’s generation fleet and a potential imbalance of pipeline supply but still struggle with pricing. We see the trend continuing. Perhaps the fact that both deals fell under the “non-material” threshold and thus aren’t subjected to shareholder votes of the acquirer will give each company more time to allow the investment community time to ease into the merits of each deal; the passage of time may help. Meanwhile, NEEs investment in gas reserves was a first mover and we expect more deals behind them. Despites the challenges of effectuating a deal with a midstream

player and a host of operational and accounting considerations, electric utilities will want to keep the fuel component of the bill minimized while it maximizes the flexibility on the base component of the bill to allow EPS growth to continue.

- 14) **We still believe a rising interest rate environment is not necessarily a recipe for underperformance just as the previous 20 years of declining interest rates did not lead to outsized returns for utility investors.** The empirical evidence continues to demonstrate that whatever the macro rate environment, investors are paid to trade the sector.
- 15) **The capital spending cycle is not over.** The industry trade group, EEI, says capital spending has remained consistent at \$90B-plus per year since late 2012 and is expected to remain at these peak levels over the medium-term. We believe companies will continue to invest at these levels so long as the fuel prices remain low or go lower and regulators allow higher base rates to recover investment. This is especially important for keeping earnings growth profiles at current levels as lower fuel prices creates headroom in the end-user bill structure allowing capital (earnings via rate base) to be substituted for fuel (pass throughs).
- 16) **We expect another year of significant price discrepancy in the group.** It's easy to envision a 2016 year where flat is good, really good, especially when down, down, down is the prevailing view. However, the same was said in 2015, 2014, and 2013. As we went to print, in 2015 the best performing, non-merger related stock (CMS) rose 0.32% while the worst performer (EXC) was down 30.0%, for nearly a 3,030 basis point spread. This followed 2014's best/worst of 41.4%/(1.0%) which were EIX/BKH, respectively. We anticipate no change to the tried and true formula from an investment perspective in 2016 where growth, earnings and dividends matter most, and in that order. Although there are only two utilities that have outpaced the S&P 500 thus far this year, numerous utilities can, and have outpaced the broader market, and the utility indices, notably in 2014 and 2013.
- 17) **The presidential election bears careful monitoring** as a shift to a conservative Administration might mean an alteration to the Clean Power Plan or other environmental initiatives, despite the historic Paris climate agreement reached over the weekend. As we have learned, one shouldn't underestimate the power of executive order.



## Stock Ideas

Favorite large cap ideas (alphabetical):

- 1) **American Electric Power (AEP, Buy, Target: \$65).** AEP's new management team is moving forward with simplifying the business, i.e. selling non-core assets, and in so doing, gaining a valuation uplift akin to other simplified stories. The next key catalyst could come late this week, early next week when a settlement between AEP and key advocacy groups might be announced. That settlement will give insight whether AEP goes down the path of full or partial divestiture for its merchant generation fleet. Key Risk: retain all generation and hence, commodity exposure.
- 2) **NextEra Energy (NEE, Buy, Target: \$125)** 14 year track record under current leadership speaks for itself, having delivered growth each year, including the period of the Great Recession. Investment thesis consists of 6-8% annual EPS growth and 12-14% DPS annual growth through 2018. *Key Risk:* Crowded Long; M&A interest, especially Oncor, the T&D subsidiary of the bankrupt Energy Future Holdings Company.
- 3) **PG&E Corp. (PCG, Buy, Target: \$56).** One major regulatory proceeding remains outstanding in the very near term, but the PCG investment thesis is about dividend growth resumption and capital investment. A simple story, but the valuation is unlikely to rebase appreciably until PCG articulates its dividend growth outlook. Another key investment consideration is succession planning, and as we've stated previously, the easiest way to solve a succession issue is via M&A. *Key Risk:* regulatory uncertainty and disconnected regulatory decisions from the filings that were made.
- 4) **WEC Energy (WEC, Buy, Target: \$54)** While the conventional wisdom around the WEC premium is the "Klappa call," namely CEO Klappa continues to deliver on his promises and then some, the real thesis has been the cash flows, and earnings from the Power the Future program which has allowed the company to reinvest in Wisconsin without having to tap the equity markets. Meantime, investors are rewarded with stated DPS growth of 5-7%. Growing short position in a defensive tape may require some unwinding. Key Risk: executing the gas main replacement program, on time and on budget, which remains the best defense of Illinois' seemingly continuous political interference and Monday morning quarterbacking.

Other 'favorite' names we like but not enough upside to warrant a Buy recommendation:

- 1) **Consolidated Edison** (ED, Neutral, Target: \$66). “Steady EDdie,” and nothing fancy here as ED is largely a call on the broader bond market. ED consistently delivers, but that EPS and DPS growth is below the broader group median. Historically, ED has demonstrated an ability to outperform the S&P. Shareholder friendly CEO is better at articulating its investment thesis to the investment community than his predecessor.
  
- 2) **Edison International** (EIX, Neutral, Target: \$60). An investor favorite given its above average longer-term EPS growth profile and above-average dividend growth potential. Regulatory interference seems to have slowed down and the California regulatory body is marshalling forward with the green goals supported by the state legislature and Governor Brown. And, with the SONGs and general rate case now behind them, there are probably few near-term catalysts to get the shares moving appreciably higher for now, and the EIX Board raised its dividend 15%, in line with our view, but above Street expectations for growth of 11%. The shares are trading at a group average P/E multiple and one could rightfully argue there is a longer-term argument for a higher P/E but that would likely occur over time, in our view.
  
- 3) **Eversource Energy** (ES, Neutral, Target: \$52). 6.1% price upside from current levels. In the tale of the tape, ES and WEC are similar across all metrics – exceptionally strong balance sheets, no equity needs, above average EPS and DPS growth expectations, proven management teams – with the exception of one. That exception is the execution and construction risk with its two large infrastructure projects: Northern Pass transmission and Access Northeast natural gas pipelines. The pending generation plant shutdowns in the Boston area make ES’ projects all the more critical. Yet, with the construction risk, the timing and certainty of the cash flows are not known. It should be noted that every project ES has undertaken has made it over the finish line.

The following mega-caps have their “puts” and “takes” fundamentally although they may be attractive investments from a ‘defensive’ perspective.

- 1) **Duke Energy (DUK, Neutral, Target: \$75)**. Largest company by market cap, but plagued by challenges at its International business. Its minority investment in National Methanol is tied to oil prices which remain weak are below the levels set by DUK in their formal guidance. The weak hydrology story in Latin America is well known, but the reality is it will rain. What’s unclear is the tenuous political and economic situation in Brazil and the duration of the same, primarily the economy. Weak economic conditions don’t lend itself to improved power production. Meantime, DUK owns 523MW in Argentina, and with the political party turnover, there is

compelling reason to believe the Argentine peso will be devalued. If Argentina and Brazil stutter, will the rest of LatAm be far behind? And although LatAm is less than 10% of DUKs earnings power, it tends to become the tail that wags the dog.

- 2) **Southern Company (SO, Neutral, Target: \$45).** Just when you thought it was perhaps safe to begin investing, and not trading, in SO again – given its pending deal with AGL Resources that raises and solidifies the underlying growth expectations – Mississippi and the ills of the IGCC Plant Ratcliffe at Kemper County continue to pop up. The latest is a consultant’s report that places 70% odds that the plant will be fully operational by December 2016. At \$30 million per month in owner’s costs, that equates to \$0.13-0.15 per share in shareholder funded expenses potentially. There’s been enough uncertainty, *i.e.*, budget overruns, and timing delays regarding this facility that perhaps investors won’t be convinced until the switch is flipped on and the regulators have opined (and no more state Supreme Court interference).

## Price Target Calculation and Key Risks

### *8point3 Energy Partners LP*

#### For CAFD:

**Our 12 month price target is \$21 per unit, reflecting a 5.25% targeted yield, or a 90 basis point discount to its three key peers**, on our 2017 DPU of \$1.11. The discount is assigned because CAFD doesn't expect to reach the high end of its distribution splits until 2019 whereas its competitors are intent on doing so much earlier. As CAFD executes over time, which we believe it will, the units should trade similarly to its peers and at today's 4.0% average yield; this implies \$28 per unit

**Key risks to the CAFD story include:** corporate governance and management rotation; limited operational experience; the tax status for renewables could change under Congressional directive; virtually all of the ROFO portfolio is not yet in commercial operation; 75% of the expected 2016 cash available for distribution (cafd) comes from three projects: Quinto (42%), Solar Gen (21%) and NorthStar (12%)

#### For NextEra Energy Partners:

Our price target takes the current market yield of 2.0% on the current payout and extrapolates that yield to the expected annualized distribution at year-end 2015. **Key risks to the NEP story include:** significant investor concentration and limited daily trading volumes; the tax status for renewables could change under Congressional directive; and currently, NEPs Genesis project produces 40-45% of the EBITDA from the initial portfolio

### *American Electric Power Company, Inc.*

We value AEP using several methodologies, including P/E, DDM and price to book value. We avoid using Sum of the Parts given the high likelihood (>70%) that the company sells its merchant generation fleet. DCF valuations are difficult given the capital intensive nature of the Power & Utility sector, especially regulated companies, and the lack of free cash flow generation, net of dividends. For triangulation purposes, we look at dividend discount models to see where the imputed price lies based on underlying dividend growth assumptions. We look principally towards a relative P/E approach. Our \$65 per share 12-month target assumes a 15.5x P/E multiple rolled forward on our 2018 EPS estimate of \$4.20 per share.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new construction, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

### *Consolidated Edison, Inc.*

Our 12-month \$64 per share price target for ED utilizes relative P/E multiples and we utilize a 7.5% premium to the underlying large cap P/E multiple on our 2017E. Our DDM methodology includes single stage and two stage approaches with the single stage under a baseline DPS growth rate. The two-stage uses various three year DPS growth expectations followed by a static long-term growth DPS growth rate. DCF methodologies are difficult given the limited free cash flow generation characteristics

found in regulated companies. All underlying figures use constant betas, equity risk premiums, and risk-free rates.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new plant builds, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

### ***Duke Energy***

We value DUK based on the arithmetic averages of P/E, P/Book, Single Stage DDM, and Yield support methodologies to arrive at our \$75 target. The relative P/E basis method is consistent with the valuation methodologies of its large-cap (>\$10.0 billion) peers. Premium valuations are ascribed for regulatory and better transparency when predicting earnings, while discounted valuations include heightened regulatory, construction, and operational/execution risks. Typically, businesses outside the core, in this case DUK's International unit, will tend to weigh more on the shares when trouble arises. This is known as the "dog wagging the tail" issue and DUK's International businesses consume a disproportionate amount of investor interest. We look at Yield support and Price to Book as indicators of future stock potential. DDM methodologies are highly dependent on underlying risk premiums, and DPS growth projections, which can swing valuations considerably.

The key risks for DUK include regulatory risk in six states, from rate regulation to operation of coal and nuclear units. Environmental regulation remains omnipresent and DUK's February 2014 coal ash spill at the Dan River facility has heightened regulatory risk around the company. DUK is active in building a renewables business and has done a good job doing so – nearly 2,000MW of owned and/or equity interest in both wind and solar. building regulatory General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new plant builds, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

### ***Edison International***

Our 12-month \$60 per share price target for EIX is primarily based on a relative P/E basis and we adjust our multiples accordingly based on the inherent growth and risk profile. We look at single-stage and two-stage dividend discount models for valuation triangulation purposes. A two-stage model may be a tough argument given the call by TURN. A sum of the parts analysis is problematic given the integrated model and lack of desire to spin out the FERC-regulated transmission business.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new plant builds, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

### ***Entergy Corp***

We value ETR using four valuation methodologies but rely primarily on P/E, and dividend discount models. We use sum of the parts, but the complicated tax structures and allocation among units makes its difficult to use with any sense of comfort. For triangulation purposes, we also look at price to book value. Our target is the arithmetic average of these methodologies.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new plant builds, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

### *Eversource Energy*

We value Eversource on a P/E multiple based on a t+2 forward year analysis, consistent with valuation methodologies for regulated names. For triangulation purposes, we turn to dividend discount models (single- and two-stage) as well as price/book methodologies. Our \$52 per share, 12 month price target represents a 10% premium to the regulated group average P/E of 14.5x on our 2017E. ES is, in our view, one of the three premier companies in the space. Given the simplistic nature of its story, its proven track record, financial strength and integrity, coupled with its growth and dividend aspirations, ES has earned the right to trade at a premium. But, there isn't enough upside from current levels to warrant the Buy recommendation, hence our Neutral rating on the shares.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new transmission and pipeline builds, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

### *NextEra Energy, Inc.*

We value NEE utilizing five valuation methodologies but rely primarily on Sum of the Parts given its various businesses, all of which have scale. Our \$125 target price is the arithmetic average of the P/E, Sum of the Parts, and DDM valuation methodologies. We utilize group average multiples as the baseline and adjust up or down based on the specific business unit. This is key in SOP analysis. For example, the regulated business operates in one of the better jurisdictions, thus it receives a premium valuation, the highly contracted cash flows also receive a modest premium. We also assign small valuations on a \$/KW basis for the development pipeline. The Sum of the Parts methodology also captures pipeline development and the benefits of the company's considerable tax attributes. All valuation metrics are on 2017.

**The key risks for NEE** include potential changes at the state and/or Federal level related to environmental policy; potential changes in state regulation or assigning more punitive allowed returns than previously authorized; tax policy, especially at the Federal level as it relates to renewables; operational risk; M&A; and, weather, especially since weather influences renewable generation. Broader macro concerns regarding economic outlook, changes in underlying Treasury securities or expectations of the same are other key concerns and can influence the investment appeal of utilities in general, and NEE, in particular.

**Our NEP price target is \$47 per unit and reflects a 3% targeted yield, which is the 2015 current yield applied to our year-end 2016 DPU level.**

**Key risks to the NEP story include:** significant investor concentration and limited daily trading volumes; the tax status for renewables could change under Congressional directive; capital markets need to remain friendly in order to fund transactions at a low cost of capital. NEPs Genesis project produces 40-45% of the EBITDA from the initial portfolio.

### *NextEra Energy Partners LP*

Our price target is \$47 per unit reflects a 3% targeted yield, which is the 2015 current yield applied to our year-end 2016 DPU level. **Key risks to the NEP story include:** significant investor concentration and limited daily trading volumes; the tax status for renewables could change under Congressional directive; capital markets need to remain friendly in order to fund transactions at a low cost of capital. NEPs Genesis project produces 40-45% of the EBITDA from the initial portfolio.

### *PG&E Corporation*

We examine PCG on a relative P/E basis and adjust our multiples accordingly based on the inherent growth and risk profile. A sum of the parts analysis is tough given the integrated operational profile of its core utility and gas transmission. We look at single-stage and two-stage dividend discount models for triangulation purposes only, and see where value could go in the event the Board moves to reinstate dividend growth We've looked at P/Book over the prior five years and derived a reasonable range of multiples. A DCF is problematic given the negative free cash flow throughout the forecast period. Combined, our 12-month per share price target for PCG is \$56, equating to a 14.8x multiple on our 2017E, representing a modest, 7% premium to the large cap regulated peer universe.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with new plant builds, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.

### *Pinnacle West Capital Corporation*

Our 12-month \$60 per share price target is based on four valuation methodologies – P/E, DDM, DCF and Price to Book – but rely primarily on P/E given that its EPS stream is derived entirely from regulated activities. Our Neutral recommendation is premised on two factors: outstanding considerations with rate design and underlying customer growth, while still up, is not materializing in the manner PNW anticipates. The P/E methodology utilizes group average multiples as a Base Case and adjusts the multiples +/- 7% from the base. The DDM utilizes current 10 Year Treasury as the risk free rate and a 7% equity risk premium and utilizes either near-term dividend growth objectives (5%, in the single-stage approach) or a combination of N/T growth and long-term industry average DPS outlook for the two-stage approach. The DCF valuations are highly sensitive to underlying cost of capital expectations and presumed growth rates. The Price to Book methodology uses historical P/Book as a reasonable range of expectations.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with ongoing business operations, construction risk (both transmission build and generation plant upgrades), nuclear plant operations, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance outlook.

### *SCANA Corporation*

Our 12-month \$56 per share price target is based on the arithmetic average of P/E and DDM valuation. We utilize a 14.5x P/E multiple on our 2017E and use current 10 year Treasury notes when calculating DDM. Key risks include execution risk with the

nuclear project; the cost of building the two new nuclear units is roughly equivalent to SCGs market cap today and once complete, will represent nearly one-half the earnings power and two-thirds of the cash flow. General risks include economic conditions, a changing regulatory environment, and changes in interest rates.

### ***TECO Energy, Inc.***

Our price target and investment recommendation reflects TECO acknowledging that it is "in play" and average of precedent transaction multiples to arrive at our \$24 PT. Key risks include regulatory changes at both the Federal and State level, execution risk associated with new plant build, general economic conditions. Additionally, utilities tend to have a high correlation with interest rate moves and any material upward move in underlying Treasuries could impact valuations for TE and the broader utility group. In addition, TECO may not be able to find an acceptable buyer at an acceptable price.

### ***The Southern Company***

Our \$45 price target is calculated as the arithmetic average of P/E and sum of the parts on our 2017 financial estimates. We utilize group multiples for the various components. Execution risk with the development of two large generating facilities is a key risk, as are potential changes in environmental compliance and regulation both the Federal and state levels. The moves in underlying Treasury securities is statistically significant with movement in utility share prices.

### ***WEC Energy Group***

Our \$50 per share 12 month price target utilizes relative P/E and DDM as the basis for our valuation methodology although we look at DCF and yield support for triangulation purposes. WEC shares are currently trading at 15.5x our 2017 EPS estimates and are priced to yield 3.6% (full year 2015 dividend expectations) compared with group averages of 13.7x and 4.1%, respectively.

General economic conditions, changes in state and/or Federal regulation, environmental compliance, execution risk with merger integration, weather, ongoing business operational risk, broader macroeconomic conditions, and interest rate movements are among the key risks to our rating and expected stock performance.



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(As of 12/11 )	% of coverage	IB service past 12 mo
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Hold (Neutral)	50.73%	25.96%
Sell (Underperform)	1.46%	0.00%

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