Utilities

Downgrading CPK, WTR and XEL with Price Strength Despite Upward Price Target Revisions

Company	Ticker	Closing Price 1/5/11	Mkt Cap (mil)	New Rating	Prior Rating	New Price Target	Prior Price Target
Alliant Energy	LNT	37.25	4,131.03	No Chg	O / L	42	39
American Water Works Co.	AWK	25.53	4,465.20	No Chg	O / L	28	26
Aqua America, Inc.	WTR	22.71	3,111.27	N / L	O / L	24	22
Chesapeake	CPK	40.42	383.99	N / A	O / A	42	40
Progress Energy	PGN	43.39	11,281.40	No Chg	N / L	46	45
SJW Corp.	SJW	26.15	489.01	No Chg	N / L	27	26
TECO	TE	18.00	3,825.00	No Chg	N / A	18	16
Wisc. Energy	WEC	57.74	6,836.42	No Chg	N / L	64	62
Xcel Energy	XEL	23.52	10,866.24	N / L	O / L	25	24

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Please refer to Appendix - Important Disclosures and Analyst Certification.

Action

Solid sector stock price support has moved most utility stocks to expected full value despite valuation benefit from lower dividend tax rate. Lowering ratings on CPK, WTR and XEL to Neutral following stock price support. We maintain our near-term Neutral sector outlook but upside is possible if clarity emerges around US energy policy, potentially in 1H11. We recommend an overweighting in water utilities where EPS growth benefits from accelerated infrastructure investment.

Summary

- **Increasing multiple price targets by 5-7%.** The extension of a lower tax rate on stock dividends is expected to make dividend paying stocks slightly more attractive to investors.
  - While EPS growth, dividend growth/yield, and investment risk play important roles in company-specific valuation, we believe electric, natural gas, and water utilities are fully valued at P/E multiples of 13-14x, 16-17x, and 20-24x 2012E EPS, respectively.
  - Average NTM P/E multiples since the adoption of a lower dividend tax rate are: electric - 13.9x, natural gas - 14.4x and water - 21.6x. While current average P/E multiples on 2012E EPS are: electric - 12.8x, natural gas - 15.8x and water - 17.7x.
- **Lowering ratings on CPK, WTR and XEL to Neutral from Outperform.**
  - Despite upward revision to our target prices, solid stock price support has moved CPK, WTR and XEL to what we believe are appropriate valuations.
  - We believe these companies should remain core long-term holdings.
- **Sector Overview:**
  - **Our near-term sector outlook is Neutral** reflecting solid stock price support and continued, slowed EPS growth due to significant federal policy uncertainty, which has reduced infrastructure investment from robust levels. Water utilities are an exception, as they continue to invest at heightened levels.
  - **Our medium-term (2012-2013) sector outlook is Positive,** as we expect environmental standards could facilitate the reacceleration of infrastructure investment, most likely the next investable theme for utilities.
  - **Our long-term sector outlook remains Positive,** as we expect infrastructure investment of over $1 trillion should return EPS growth to 5-7% annually, helping boost sector valuations and fuel attractive total returns.
- **Top ideas**: **HE, UIL, CWT and AWR**.
  - See Details section for brief investment thesis.

Details

Top ideas: **HE, UIL, CWT and AWR**.

- **HE**: With regulatory modifications now in place, improved YOY EPS performance is expected to fuel stock price upside.
- **UIL**: Following the acquisition of three natural gas LDCs, EPS growth expectations could increase as UIL lays out its strategy.
- **CWT** and **AWR**: Both expected to benefit with much improved YOY EPS performance in the 4Q10 and 2011, following recent California rate relief.

Valuation and Risk

- **LNT Valuation.** Our $42 target price reflects a 13.5x P/E multiple of our 2012 EPS estimate, or in line with its regulated utility peers when fully valued. Some additional upside to our target price exists as LNT demonstrates that its pipeline of infrastructure investments position the company well to provide above-average EPS growth.
  - LNT risks include state/federal regulation, weather, natural gas wholesale pricing, and acquisition integration risk.
- **AWK Valuation.** Our $28 price target is 16.5x our 2012 EPS estimate, we believe a discount to its peers when fully valued due to lower earned ROEs is deserved. Upside to our target price exists as margins improve via rate relief and longer-term infrastructure investment opportunities.
  - AWK risks include state/federal regulation, decreased water consumption, acquisition integration risk, water supply (notably in CA), balance sheet risk related to potential goodwill write-downs, and the water industry valuation premium.
- **WTR Valuation.** Our $24 target price reflects a 23x P/E multiple of our 2012 EPS estimate, or a slight premium to its regulated water utility peers when fully valued. reflecting our expectations for above-average EPS growth of 8-10% per year and generally more constructive regulatory mechanisms that facilitate earnings consistency.
  - WTR risks include state/federal regulation, decreased water consumption, acquisition integration risk, and the water industry valuation premium.
- **CPK Valuation.** Our 12-month price target of $42 is 16x our 2012 EPS estimate, or a slight premium to its peers given above-average EPS growth expectations.
  - CPK risks include state/federal regulation, weather, natural gas/propane wholesale pricing, competitive pressures in its propane segment, and acquisition integration risk (especially regarding the recent FPU acquisition).
- **PGN Valuation.** Our 12-month price target of $46 is 13.5x our 2012 EPS estimate, when adjusting for an estimated $1-2/share incremental value associated with PGN's synfuel-related tax credit carry forwards. We believe a P/E multiple in line with its regulated peers is appropriate reflecting improving regulatory environment in Florida, accelerating infrastructure investment opportunities in the Carolinas, and an above-average dividend yield.
  - PGN risks include state/federal regulation, weather, natural gas/coal/oil wholesale pricing, electricity wholesale pricing, and acquisition integration risk.
- **SJW Valuation**. Our price target of $27 is 22.5x our 2012 EPS estimate. We believe a premium to its peers when fully valued, reflects above-average earned ROEs and attractive EPS growth prospects.
  - SJW risks include state/federal regulation, decreased water consumption, acquisition integration risk, water supply (notably in CA), balance sheet risk related to potential goodwill write-downs, the water industry valuation premium, and real estate valuation risk.
- **TE Valuation.** Our 12-month price target of $18 is 12.8x our 2012 EPS estimate is a discount to its peers, reflecting the volatility of coal earnings.
  - TE risks include unseasonably warm/cold weather, commodity price fluctuations (particularly coal), state/federal regulation, and macroeconomic swings impacting regulated and unregulated operations.

- **WEC Valuation**. Our 12-month price target of $64 is 14.5x our 2012 EPS estimate. We believe a modest premium to its electric/gas utility peers, when fully valued, is appropriate. This reflects above-average EPS growth driven by pre-approved rate base additions recovered through enhanced recovery mechanisms.
  - WEC risks include commodity price volatility, state/federal regulation, and unfavorable weather risk.
- **XEL Valuation.** Our 12-month price target of $25 is 13.5x our 2012 EPS estimate a multiple in line with its peers in Baird's Electric/Gas Utility group when fully valued. This reflects our expectations for consistent 5-7% EPS growth over the next decade, due to enhanced regulatory recovery mechanisms for its accelerated utility infrastructure investment programs.
  - XEL risks include fluctuations in wholesale energy prices and associated purchased power costs, state/federal regulation, acquisition risk, and risks associated with unfavorable weather.

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