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FINANCIAL ANALYSIS

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SURREBUTTAL TESTIMONY

OF

DAVID MURRAY

KCP&L Greater Missouri Operations Company
Great Plains Energy, Incorporated

CASE NO. ER-2016-0156

Jefferson City, Missouri
September 2016

** Denotes Highly Confidential Information **

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1 **SURREBUTTAL TESTIMONY**

2 **OF**

3 **DAVID MURRAY**

4 **KCP&L Greater Missouri Operations Company**
5 **Great Plains Energy, Incorporated**

6 **CASE NO. ER-2016-0156**

7 Q. Please state your name.

8 A. My name is David Murray.

9 Q. Are you the same David Murray who prepared the Rate-of-Return Section of
10 Staff's Revenue Requirement Cost of Service Report ("Staff Report") and rebuttal testimony
11 for this case?

12 A. Yes, I am. I filed rate-of-return (ROR) testimony on July 15, 2016, and
13 rebuttal testimony on August 15, 2016.

14 Q. What is the purpose of your surrebuttal testimony?

15 A. The purpose of my surrebuttal testimony is to respond to Robert B. Hevert's
16 and Kevin E. Bryant's Rebuttal testimonies. Mr. Hevert's Rebuttal Testimony addresses my
17 recommended allowed return on common equity and cost of equity analyses. Mr. Bryant's
18 Rebuttal Testimony addressed my proposed use of Greater Plain's Energy, Inc., ("GPE")
19 consolidated capital structure and cost of debt to set KCP&L Greater Missouri Operations
20 Company's ("GMO" or "Company") allowed ROR. Both witnesses sponsor testimony on
21 behalf of GMO.

22 I will also provide Staff's true-up ROR recommendation because the Company
23 provided true-up capital structure and embedded cost of debt information before the due date
24 for surrebuttal testimony. Staff does not believe the updating of this data should create much

1 controversy since there has not been any significant changes in the way in which the
2 companies are financially managed or any significant changes in the issuance of securities at
3 GMO, Kansas City Power & Light Company ("KCPL") and/or Greater Plaines Energy, Inc.,
4 ("GPE"). However, GPE did redeem the preferred stock it had in its capital structure as
5 of August 10, 2016. Consequently, Staff removed this capital from its recommended
6 capital structure.

7 **EXECUTIVE SUMMARY**

8 Q. What should the Commission be aware of after reading your surrebuttal
9 testimony?

10 A. The Commission has not had to make a determination on whether to use
11 GMO's or GPE's capital structure for ratemaking because the Company and Staff had always
12 proposed the use of GPE's capital structure for ratemaking. GMO is proposing to change
13 this approach. GMO's proposed ratemaking capital structure is based on balances it provided
14 to Staff through discovery and through workpapers, but these balances do not match balances
15 shown on GMO's highly confidential audited financial statements. The fact that GMO's
16 stand-alone audited financial statements do not match the capital structure sponsored by
17 GMO is of significant concern to Staff. Although there may be legitimate explanations for
18 these differences, Staff believes these discrepancies are another reason the Commission
19 should rely on GPE's publicly reported capital structure, which is also the basis for S&P's
20 BBB+ rating assigned to GMO.

21 In determining a fair allowed return on common equity ("ROE") for GMO, the
22 Commission simply needs to determine if Staff's or the Company's logic is supported by the
23 capital market evidence and corroborated directly by investors. Staff will provide evidence

1 and explanations that help the Commission understand why valuation ratios of utility stocks
2 continue to climb. This information will also help explain the significant premiums being
3 offered in certain merger and acquisition activity. Low interest rates translate into lower
4 discount rates, which means that consistent cash flows produced by utilities based on static
5 allowed ROEs will be more valuable. Considering that earnings are falling in the competitive
6 markets, utilities' consistent earnings levels and dividends are highly attractive to investors.
7 It is only fair and reasonable to lower utilities' allowed ROEs to reflect the realities of the
8 macroeconomic environment.

9 **STAFF'S TRUE-UP CAPITAL STRUCTURE AND RATE OF RETURN**
10 **RECOMMENDATION**

11 Q. What is Staff's recommended capital structure and ROR as of the true-up
12 date, July 31, 2016?

13 A. Staff still recommends the Commission use GPE's consolidated capital
14 structure to set GMO's allowed ROR. After Staff removed preferred stock from the capital
15 structure, this capital structure contains ** ______ ** common equity and ** ______ **
16 long-term debt (*see* Highly Confidential Schedule DM-s1).

17 After Staff applied its recommended ROE range of 8.65% to 9.35% and its embedded
18 cost of debt recommendation of 5.42%, this resulted in an overall recommended ROR range
19 of ** _____ ** to ** _____ ** (*see* Highly Confidential Schedule DM-s2).

20 Q. Why did Staff exclude preferred stock from its recommended ROR?

21 A. GPE redeemed all of its preferred stock ($39 million) on August 10, 2016.
22 This preferred stock was originally issued by KCPL in the 1950s and was perpetual in nature.
23 Because the amount of preferred stock redeemed is relatively small compared to GPE's total

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1 capitalization, it is likely that some combination of short-term debt and/or internally
2 generated cash flow was used to redeem the preferred stock. Consequently, Staff is simply
3 eliminating the preferred stock amount from the capital structure (rather than substituting
4 some other specific form of capital in the same amount) and allowing both the equity and
5 debt ratios to increase slightly.

6 **STAFF'S RESPONSE TO KEVIN E. BRYANT'S REBUTTAL TESTIMONY ON**
7 **CAPITAL STRUCTURE AND COST OF DEBT**

8 Q. What are Mr. Bryant's main concerns about the Commission's continued use
9 of GPE's consolidated capital structure for purposes of setting GMO's allowed ROR?

10 A. Mr. Bryant claims that it is important to use a subsidiary-specific capital
11 structure in order to ensure that the revenue requirement is determined based on the costs
12 specific to that utility, which should include the subsidiary's capital structure.

13 Q. Is this consistent with KCPL and GMO's past practice?

14 A. No. Mr. Bryant claims that this is now possible because GMO was able to
15 issue its own debt in a private placement in 2013. However, KCPL has always been able to
16 issue its own debt directly, but in the past KCPL recommended the use of GPE's
17 consolidated capital structure to set KCPL's rates both before and after it acquired GMO.
18 Consequently, Mr. Bryant's logic is not consistent with KCPL's past practice.

19 Q. How long has KCPL been recommending the use of GPE's consolidated
20 capital structure to set its rates?

21 A. I believe since GPE was formed. I reviewed KCPL's rate cases since GPE
22 was formed and it appears their first rate case subsequent to formation was in 2006, Case No.
23 ER-2006-0314.

1 Q. Do you think it is fair for Mr. Bryant to claim that your rationale for
2 recommending GPE's consolidated capital structure was simply because it was used in the
3 last GMO rate case?

4 A. No. Mr. Bryant sponsored testimony in GMO's 2012 rate case, Case No.
5 ER-2012-0175, and is aware of the significant disputes Staff and the companies had
6 regarding GPE's financial management of KCPL and GMO. While the companies and Staff
7 have for the most part been in agreement about the use of GPE's consolidated capital
8 structure to set the allowed ROR for both subsidiaries, we have had significant disagreements
9 about a fair and reasonable debt cost to allow each subsidiary. Because GPE, and therefore
10 KCPL, have had to support GMO's financing needs since it was acquired, Staff has heavily
11 scrutinized each financing transaction performed by GPE on behalf of GMO. In past
12 testimonies, Staff explained that the debt costs charged to GMO's ratepayers were lower than
13 the debt costs charged to KCPL's ratepayers because GPE was issuing short-term tenor debt
14 for GMO because it was done for GPE's best interest, not each subsidiary's best interest.

15 Q. Why has Staff consistently recommended the use of GPE's consolidated
16 capital structure for purposes of setting KCPL's and GMO's allowed ROR?

17 A. Because this is the true market-tested capital structure analyzed by investors
18 for purposes of determining the required return to invest in GPE and its subsidiaries.
19 As Staff discussed in the COS Report, GPE's business and financial risks impact S&P's
20 ratings of KCPL and GMO and Moody's has expressed concern about the amount of debt
21 GPE plans to issue to complete its acquisition of Westar. If KCPL and GMO were
22 financially managed as independent entities with accompanying safeguards to ensure GPE
23 cannot unilaterally decide to upstream KCPL's and GMO's cash flows to service debt at GPE

1 or any of its other subsidiaries, then Staff would have more confidence that KCPL's and
2 GMO's healthier stand-alone financial metrics would receive full credit from debt investors
3 and allow for lower costs of debt. However, S&P has consistently stated the following in its
4 ratings of GPE, KCPL and GMO:

> 5 There are no meaningful insulation measures in place that
> 6 protect KCP&L and GMO from their parent and therefore,
> 7 KCP&L's and GMO's issuer credit ratings are in line with
> 8 GPE's group credit profile of 'BBB+'.

9 Considering the above, if GPE has more financial risk (i.e. it has more debt in its capital
10 structure) than its subsidiaries, the subsidiaries' less leveraged capital structures will not
11 allow for a debt cost as low as they deserve because of the pressure on the subsidiaries to
12 provide cash flow to service the holding company debt. Absent acknowledgment by rating
13 agencies that KCPL and GMO have meaningful measures in place to allow for stand-alone
14 ratings, and therefore debt costs, the higher debt costs incurred by the subsidiaries due to
15 their affiliation with GPE will be inappropriately matched to the lower risk subsidiary capital
16 structures.

17 Q. Are debt costs the only concern regarding matching of capital costs with the
18 capital structure causing the capital costs?

19 A. No. If a subsidiary's capital structure contains more equity than its parent
20 company's consolidated capital structure, then one needs to question whether the subsidiary's
21 capital structure is being managed to achieve the lowest capital cost for the ratepayer.
22 This includes the weighted cost of equity included in the capital structure. Being that GPE
23 has a fiduciary duty to its shareholders to attempt to maximize shareholder value, it is
24 logical that it will manage its consolidated capital structure to the lowest capital cost, i.e. an
25 optimal capital structure, so the present value of the cash flows to its shareholder are

1 maximized. If a holding company, such as GPE, knows commissions will set rates based on
2 a higher cost, subsidiary-capital structure and not consider its holding company financing
3 activities, then it achieves the best of both worlds: higher cash flows from its subsidiaries,
4 discounted at a lower rate to the consolidated holding company, resulting in a higher value to
5 the shareholder.

6 Q. Why should this matter if the financial risk is borne by the holding company?

7 A. If the financial risk of the holding company were truly stand-alone and
8 separate from the subsidiaries, then GPE shareholders would have to consider the risk that
9 GPE's utility subsidiaries may not distribute dividends to GPE if GPE's financial risk causes
10 deterioration to its subsidiaries' credit quality. Unfortunately, as recognized by S&P, there
11 are no meaningful measures in place to prevent this from happening. Consequently, as long
12 as GPE's consolidated capital structure affects the subsidiary utilities' capital costs and this is
13 the least cost capital structure as compared to the subsidiary's equity-rich capital structure,
14 this is the most fair and balanced capital structure to use to set the utility's ROR.

15 Q. Did GMO provide financial statements that support its proposed capital
16 structure in this case?

17 A. No. The only information Staff found in GMO's workpapers were the
18 common equity values shown on GMO witness Hevert's Schedule RBH-10. Staff could not
19 find the GMO balance sheet that supported the common equity balance.

20 Q. Does GMO disclose its audited financial statements to the public?

21 A. No. In fact, when Staff requested GMO's financial statements since 2010,
22 GMO provided FERC Form-1 Filings, not audited financial statements.

23 Q. Has Staff requested GMO's audited financial statements?

1 A. Yes. In response to Staff Data Request No. 0418, GMO provided its highly
2 confidential private placement memorandum. This private placement memorandum included
3 GMO audited financial statements for 2011 and 2012. As a follow-up, Staff issued Staff
4 Data Request No. 0418.1 to request all of GMO's audited financial statements.

5 Q. Is this another reason to dismiss Mr. Bryant's claim that the Commission
6 should adopt GMO's stand-alone capital structure?

7 A. Yes.

8 Q. Did you discover any relevant discrepancies in the GMO stand-alone financial
9 statements as they compare to GPE's consolidated financial statements?

10 A. Yes. Mr. Bryant claimed that the $169 million of goodwill shown on
11 GPE's financial statements should be removed from GMO's common equity balance.
12 I discovered that GMO's stand-alone financial statements reported a goodwill asset amount
13 of **_____ ** million.

14 Q. Why is there a discrepancy?

15 A. Staff could not determine the reason for this discrepancy.

16 Q. Did you notice any other discrepancies?

17 A. Yes. GMO's audited balance sheet as of December 31, 2015 indicated GMO
18 had an equity balance of **_____ ** billion rather than the $1.327 billion as of the same
19 date provide in GMO's response to Staff Data Request No. 0220.

20 Q. Do you think these discrepancies are related?

21 A. They appear to be. However, even if these discrepancies could be explained,
22 Staff would still recommend the use of GPE's consolidated capital structure to set
23 GMO's rates.

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1 Q. In your effort to attempt to understand why a larger amount of goodwill would
2 be recorded on GMO's audited balance sheet, did you discover any other information that
3 supports Staff's position to use GPE's consolidated capital structure?

4 A. Yes. GPE is required to perform a goodwill impairment test specific to GMO
5 for purposes of its FERC Reporting. GPE specifically indicated the following about testing
6 goodwill for impairment based solely on the value of GMO:

7 ** ______________________________
8 ______________________________
9 ______________________________
10 ______________________________
11 ______________________________
12 ______________________________ **[1]

13 Q. Even though you disagree with the use of GMO's per books capital structure
14 to set GMO's allowed ROR, does its use have a large impact on the revenue requirement as
15 of the true-up date in this case?

16 A. No. The pre-tax ROR (which is the figure that drives the total revenue
17 requirement assigned to all factors related to ROR) is 9.98% based on Staff's recommended
18 allowed ROE of 9.0%. Although GPE's consolidated capital structure has less equity than
19 GMO's capital structure, GPE's cost of debt is higher than GMO's, which offsets the higher
20 pre-tax ROE (*see* Highly Confidential Schedule DM-s3). Consequently, other than GMO
21 possibly wanting to establish precedent for future cases, Staff is not sure why GMO changed
22 its approach for purposes of this case.

[1] "2011 Annual Goodwill Impairment Test, GMO Subsidiary for FERC Reporting, September 1, 2011," KCPL's Response to Staff Data Request No. 0209 in Case No. ER-2012-0174.

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1 Q. Does this have the potential to have a much larger revenue requirement impact
2 if there was more equity in GMO's capital structure?
3 A. Yes. For example, if GMO had continued to propose the use of its original
4 recommended capital structure that contained 54.83% common equity, GMO's pre-tax ROR
5 would have been 10.31% (*see* Highly Confidential Schedule DM-s4). Using Staff's total rate
6 base in its direct testimony, this would have caused GMO to claim it needed an approximate
7 $6 million additional annual increase in rates to fund the shareholders' return.
8 Q. Mr. Bryant indicates that the use of GMO's capital structure is consistent
9 with the rate-making construct of other electric utilities throughout the state. Is this an
10 accurate statement?
11 A. No. The only situation in which Staff has recommended the use of an electric
12 utility's subsidiary-specific capital structure is for purposes of Union Electric's ("UE") rate
13 cases. Staff has always clearly explained that the reason it considered UE's capital structure
14 appropriate for ratemaking is because its parent company, Ameren Corporation ("Ameren"),
15 was not issuing much, if any debt, for purposes of investments in either UE or any of
16 Ameren's other operations. Additionally, Ameren's and UE's consolidated capital structures
17 consistently had similar equity ratios. This alleviated Staff's concern about any potential
18 manipulation of UE's capital structure for ratemaking purposes.
19 Staff has always recommended the use of The Empire District Electric Company's
20 ("Empire") consolidated capital structure for purposes of setting Empire's allowed ROR.
21 It is important to understand that Empire's electric utility assets are directly owned by
22 Empire rather than by a subsidiary. It is also relevant for the Commission to be aware that
23 Staff has recommended that Empire's consolidated capital structure and capital costs be used

1 for setting Empire's gas utility assets even though they are held in a separate subsidiary, as
2 well as Empire's water utility assets, which are also directly owned by Empire.

3 Q. What has Staff's approach been as it relates to Missouri natural gas
4 distribution utilities?

5 A. Staff has always recommended the use of either the gas utility's ultimate
6 parent company capital structure or the intermediate holding company. For purposes of
7 Laclede Gas Company, Staff and Laclede Gas have recommended the use of The Laclede
8 Group's capital structure. For purposes of the Liberty Utility Midstates ("Midstates") natural
9 gas utility rate case, Case No. GR-2014-0152, Staff recommended the use of Midstates'
10 intermediate holding company's, Liberty Utilities, capital structure because this was the
11 entity that issued all of the debt on behalf of its regulated utility subsidiaries. The
12 Commission adopted Liberty Utilities' capital structure in its Report and Order in that case.

13 Q. What has Staff's approach been as it relates to Missouri-American Water
14 Company ("MAWC")?

15 A. Staff has recommended the use of American Water Works Company, Inc.'s
16 ("American Water") consolidated capital structure and capital costs for purposes of setting
17 MAWC's allowed ROR for over 10 years. Staff started recommending the use of American
18 Water's capital structure for MAWC when American Water decided to consolidate the
19 financing functions of its subsidiaries at the holding company level and make affiliate loan
20 transactions to the parent and its subsidiaries.

21 Q. In what situation would Staff recommend the use of a subsidiary-specific
22 capital structure?

1 A. If the subsidiary's capital structure is fair and reasonable and is directly
2 consequential to raising debt capital at reasonable costs. The company would have to prove
3 that the subsidiary's capital costs are not being detrimentally impacted by the parent
4 company's and/or its affiliates' other business and financial risks. The company would also
5 have to prove why the subsidiary's capital structure is more economical than the consolidated
6 capital structure. If it is not more economical, the company would have to prove why it's in
7 the company's best interest to maintain a less economical capital structure for the utility.

8 **STAFF RESPONE TO ROBERT B. HEVERT'S REBUTTAL TESTIMONY**

9 Q. What are Mr. Hevert's primary criticisms of your testimony?
10 A. Mr. Hevert claims that I rely too heavily on the DCF methodology when
11 quantifying the decline of the cost of equity as compared to the last time the Commission
12 determined that allowed ROEs of approximately 9.5% were fair and reasonable. Mr. Hevert
13 doesn't refute that utility stock valuation levels are fairly high, causing a decline in utility
14 dividend yields. However, he and I have a fundamental disagreement in how this capital
15 market data should be interpreted when setting allowed ROEs. While I interpret this capital
16 market information as a clear indication that investors are discounting expected utility cash
17 flows/dividends at a lower rate, i.e. lower cost of equity, Mr. Hevert indicates that "recent
18 high utility stock valuations are related to a 'reach for yield,' as opposed to a reduction in
19 perceived equity risk."[2]
20 Obviously, there is always risk to investing in the stock market, just as there is risk to
21 investing in the bond market, but this doesn't change the cost to the issuer. For example,
22 even though Mr. Hevert consistently uses projected higher interest rates in his cost of equity

[2] Hevert Rebuttal, p. 6, ll. 9-10.

1 methodologies, this doesn't change the fact that when the U.S. government issues a 10-year
2 Treasury bond it will only cost approximately 1.5% to do so. Utilities have been able to
3 issue 30-year debt at a rate of around 3.5% and 10-year debt in the 2% range. These are very
4 low costs and justify lowering allowed ROEs below the averages of the last couple of years.
5 Consequently, even though Mr. Hevert believes investors may be foolish accepting such low
6 rates on their investment because of potential loss of principal (only if they sell before
7 maturity), this does not change the fact that capital costs are low. Apparently, Mr. Hevert
8 believes his testimony about current market conditions not being sustainable will eventually
9 become accurate, just as economists' projections of higher interest rates may eventually be
10 proven accurate. However, the current capital market evidence overwhelmingly supports a
11 reduction to allowed ROEs. The average awarded ROEs will only be reduced if
12 commissions start to collectively recognize the evidence that supports reducing them.

13 Q. Do the utility stock valuation levels still support the Commission lowering the
14 allowed ROE to 9% as Staff recommended?

15 A. Yes, but utility dividend yields have increased slightly since Staff sponsored
16 its direct testimony. Consequently, being that GMO is expected to file another rate case in
17 2018,[3] the Commission may want to consider reducing the allowed ROE to 9.25% in this
18 case and then, if utility securities' continue to support the full 50 basis point reduction
19 (or more) to the allowed ROE, the Commission can consider that in 2018.

20 Q. Have utility bond yields declined since Staff recommended the Commission
21 lower the allowed ROE to 9.0%?

[3] Great Plains Energy Investor Presentation, June 7, 2016, p. 15.

1 A. Yes. As evidenced by the Moody's Utility Bond Yield averages for
2 July 2016, utility bond yields are now lower than they were in early 2015, which was
3 described by Mr. Hevert as being an unsustainable situation at the time of UE's and KCPL's
4 2014 rate cases. It appears that the utility bond markets have now caught up to the decline in
5 the cost of equity as the Staff explained in the Staff Report. For some reason, there was a lag
6 in the decline in utility bond costs as compared to utility equity costs.
7 Q. Did Mr. Hevert update his cost of equity studies in his rebuttal testimony?
8 A. Yes.
9 Q. What is the most recent market data Mr. Hevert used for purposes of his
10 updated analyses?
11 A. Mr. Hevert used data through June 30, 2016.
12 Q. What did Mr. Hevert's updated DCF analyses imply about the change in the
13 cost of equity?
14 A. It has declined.
15 Q. Can you provide some updated charts from your rebuttal testimony showing
16 the performance of Mr. Hevert's proxy group through June 30, 2016?
17 A. Yes. The below chart shows the total return of his proxy group from
18 January 15, 2016 through June 30, 2016:
19
20
21
22
23 *continued on next page*

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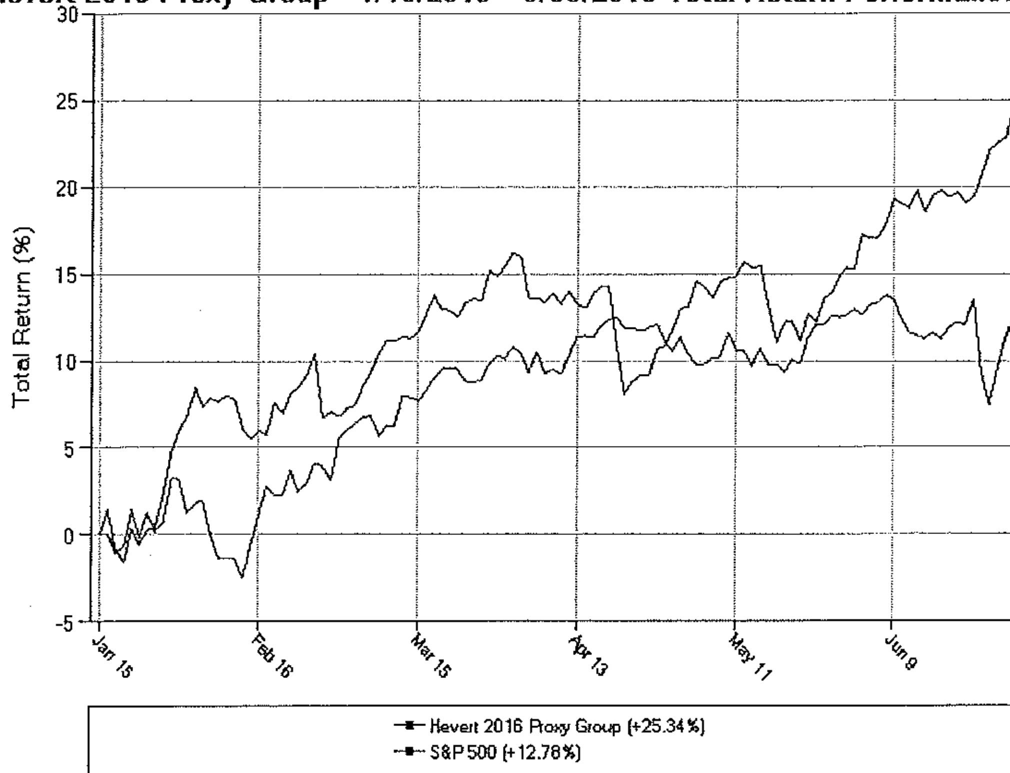

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3 As Staff indicated in rebuttal testimony, it is not advisable to annualize returns for evaluating
4 performance or to project future returns, but in order to appreciate the magnitude of how well
5 Mr. Hevert's proxy group's stock prices performed between the time he performed his direct
6 analyses in this case to the time he updated his analyses for his rebuttal testimony, the
7 annualized total return of his proxy group was 63.69%. It would seem that such a significant
8 increase in utility stock values would cause one to lower his cost of common equity
9 estimates.

10 Q. Instead of revisiting his cost of common equity estimates, what did Mr. Hevert
11 do in his rebuttal testimony to continue to support his original estimate?

1 A. He modified the assumptions in his DCF methodologies. Instead of accepting
2 the clear evidence that his proxy group's cost of equity had declined since he initially
3 performed his analyses for direct testimony in this case, Mr. Hevert altered his terminal value
4 assumption in his multi-stage DCF analyses. Rather than performing a constant-growth DCF
5 analysis to determine the terminal value for his multi-stage DCF, he now uses a terminal
6 p/e ratio of 20.39x to determine the terminal value. Because Mr. Hevert has now
7 increased the terminal value estimate by altering his original analysis, this requires a higher
8 discount rate, i.e. cost of common equity, to cause the present value of his future projected
9 cash flows to equate to the current stock prices.

10 Q. If Mr. Hevert had not altered the assumptions he used in his multi-stage DCF
11 analysis, how would this have impacted his implied cost of equity estimates as compared to
12 when he originally performed his analysis through January 15, 2016?

13 A. Because Mr. Hevert eliminated Dominion Resources, Inc., and Westar
14 Energy, Inc., in his updated analysis in his rebuttal testimony, I also eliminated these
15 companies from his original analysis in his direct testimony. Comparing the same proxy
16 groups and using the same assumptions Mr. Hevert used in his direct testimony, the results
17 imply a significant decline in the cost of common equity.

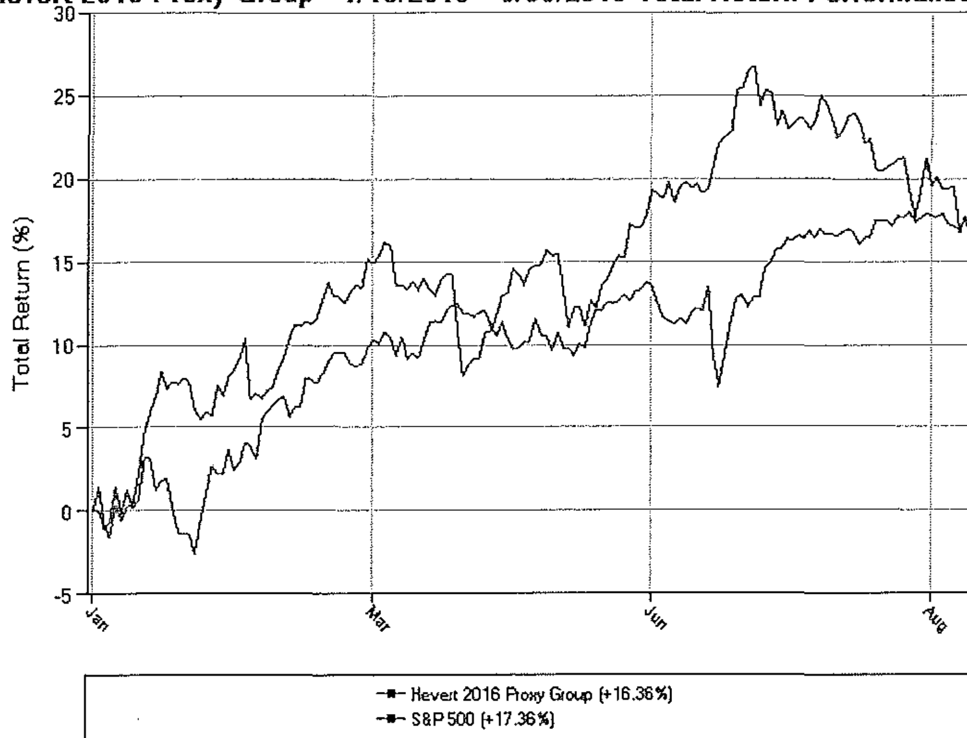
18 Specifically, his 30-day multi-stage DCF now implies a cost of equity of 9.12%,
19 whereas in his direct testimony, this cost of equity estimate was 9.77%, a decline of 65 basis
20 points. Mr. Hevert's 90-day multi-stage DCF now implies a cos of equity of 9.24%, whereas
21 in his direct testimony, the same methodology implied a cost of equity of 9.81%, a decline of
22 57 basis points. Mr. Hevert's 180-day multi-stage DCF now implies a cost of common

1 equity of 9.46%, whereas in his direct testimony, the same methodology implied a cost of
2 equity of 9.89%, a decline of 43 basis points.

3 Consequently, if Mr. Hevert had not changed the assumptions he used in his
4 multi-stage DCF analyses, his conclusions would have been the same as Staff's, which is that
5 the cost of equity for utility companies has declined considerably since the first of the year.
6 While there has been some pull back in utility stocks since June 30, 2016, it hasn't been
7 enough to warrant not lowering allowed ROEs for Missouri's electric utilities.

8 The below charts show the total returns for Mr. Hevert's proxy group from
9 January 15, 2016, through the most recent period and for the past 12 months:

10



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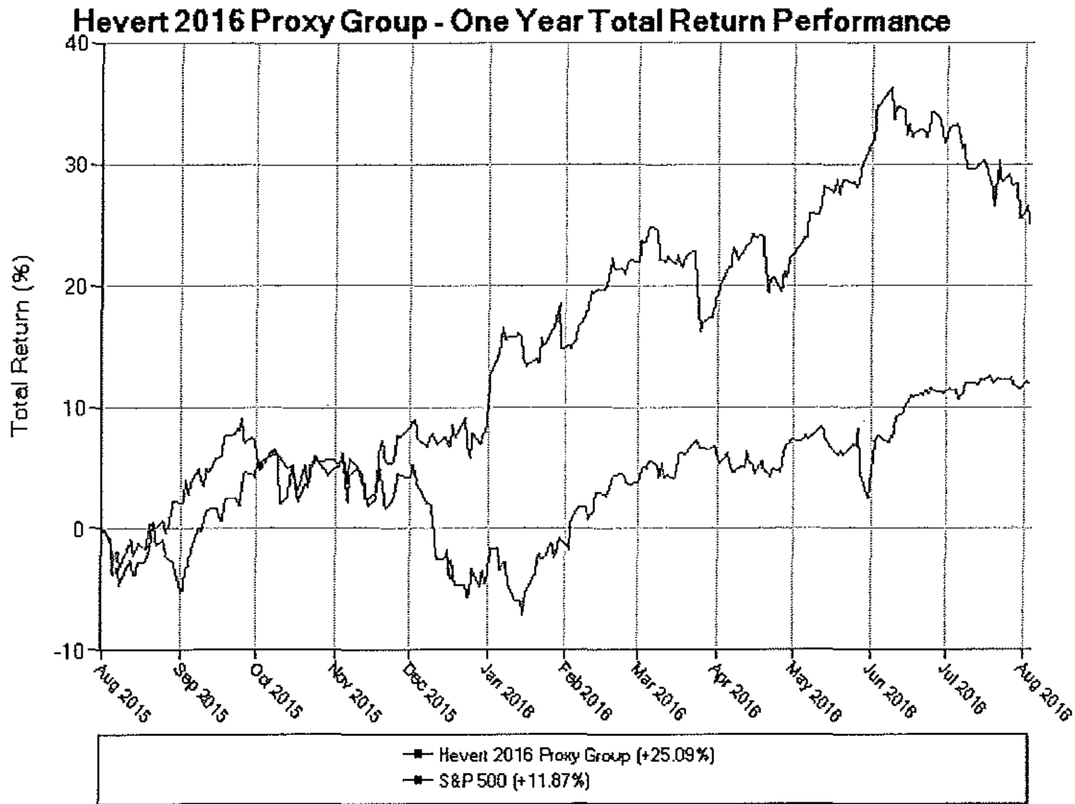

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3 As is demonstrated in both graphs, the absolute return of Mr. Hevert's proxy group of
4 electric utilities has been quite good for both the last 12 months and since January 15, 2016.
5 The performance of his proxy group as it relates to the S&P 500 has been much better over
6 the 12-month period because, toward the end of 2015 and into early 2016, the S&P 500
7 traded much lower as a result of concerns about global market conditions, including
8 significant concerns about commodity prices.

9 Q. Have low-risk stocks, such as utilities, been trading at significant premiums to
10 the market over the last several years and even more so lately?

11 A. Yes. According to an August 22, 2016, article in the *Wall Street Journal,*
12 forward price/earnings ratios for 20% of the S&P 500 with lowest betas are trading at an

1 average p/e ratio of 1.12x that of the overall market, whereas the p/e ratio of the highest beta
2 stocks are trading at 0.77x the overall market. Mr. Hevert has questioned whether the
3 fundamentals of the markets have changed so much as to justify the very low cost of equity
4 estimates that are implied from using the DCF methodology. This evidence clearly
5 demonstrates that investors have and are placing a high prémium on low-risk stocks such as
6 utilities. Although the article also states that "[i]n their zeal for safe stocks, investors may
7 have made them anything but,"[4] this does not translate into risk that requires a higher return,
8 this translates into investors requiring a fairly low return with the possibility that the
9 valuation levels of these low-risk stocks may decline. If investors are willing to provide
10 capital at a very low cost to the issuer, then this low cost should be passed on to ratepayers in
11 the form of a lower allowed ROEs.

12 Q. Have the dividend yields in Mr. Hevert's 2016 proxy group remained fairly
13 low up to the time you drafted this testimony?

14 A. Yes. The below graph shows the dividend yields of Mr. Hevert's proxy
15 group. As can be seen, the change in dividend yields approximates the amount of change in
16 Mr. Hevert's DCF results since the primary change to any of the variables used in the DCF
17 has been the increase in utility stock prices.

18

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21

22 *continued on next page*

[4] Justin Lahart, "Two Strategies, One Busy Trade," August 22, 2016, *Wall Street Journal,* p. C6.

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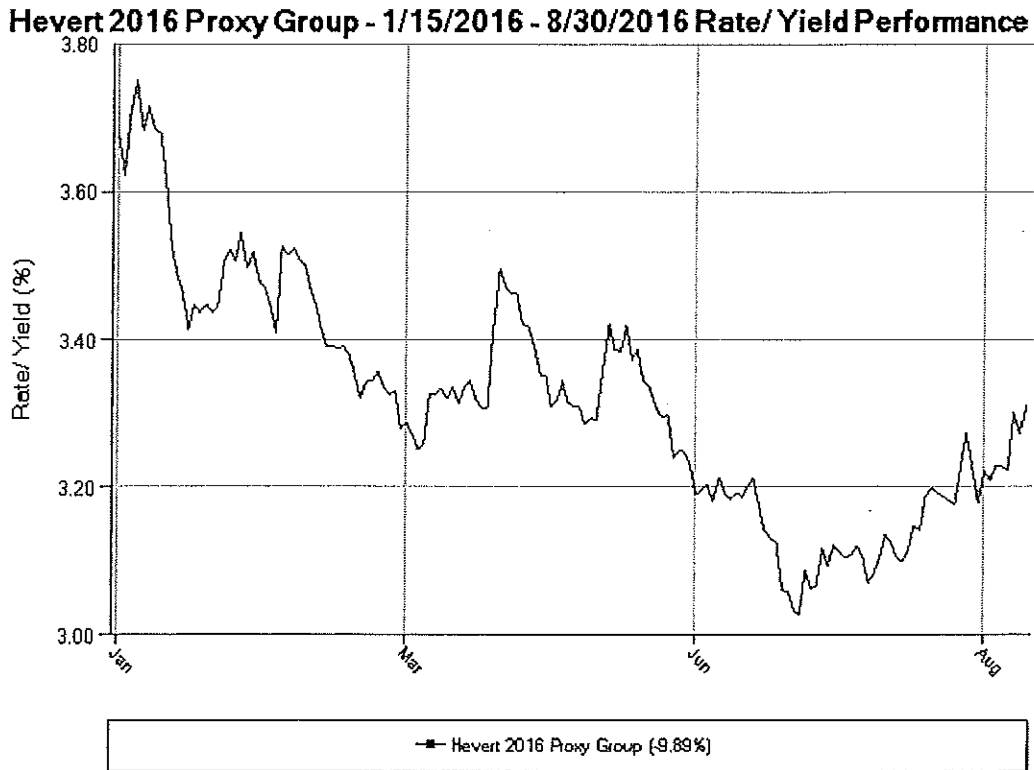
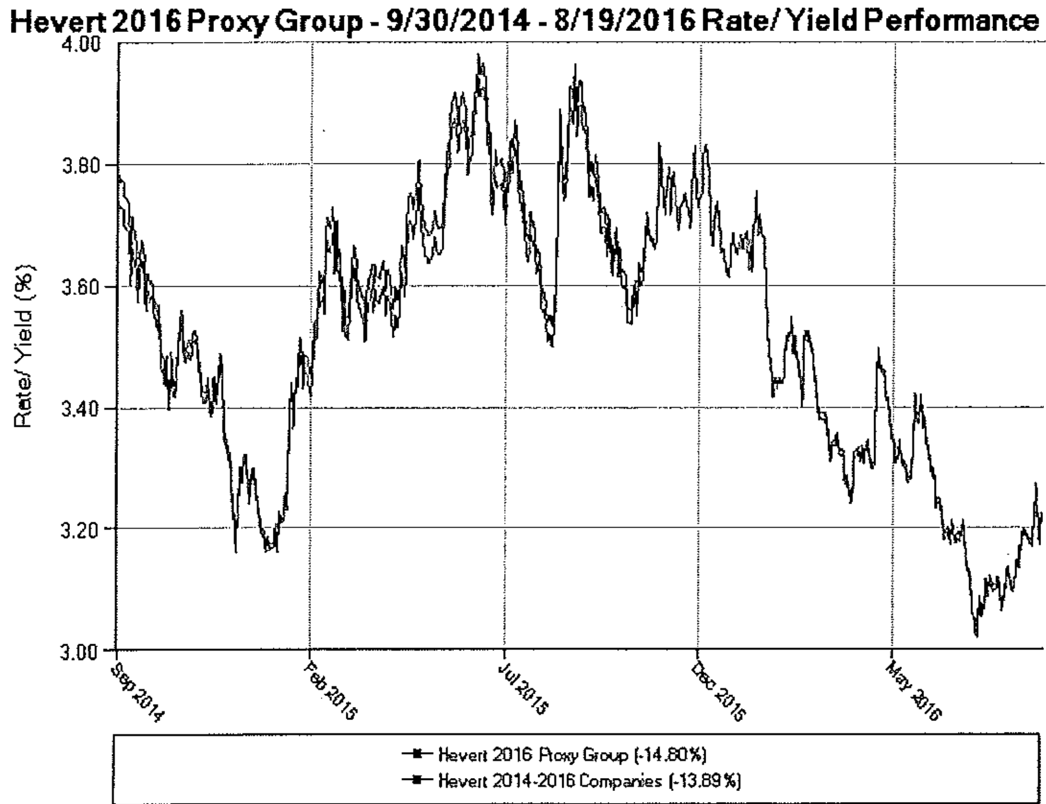


2

3 As can be seen, the decline in the dividend yield since Mr. Hevert sponsored his testimony
4 has been approximately 40 to 50 basis points. If the Commission accepts Staff's opinion that
5 the cost of equity up until the end of last year was not that much different than when the
6 Commission last authorized ROEs for KCPL and UE, then the evidence through much of this
7 year supports a further reduction to the Commission's awarded ROEs in the 2014 UE and
8 KCPL cases.

9 Q. How do the current level of dividend yields compare to what they were during
10 the UE and KCPL rate cases in 2014?

1 A. For purposes of showing the changes in the dividend yields since the fall of
2 2014, Staff is showing charts for Mr. Hevert's 2016 proxy group as well as companies he
3 used in both the 2014 and 2016 rate cases. The chart is as follows:
4



5

6 In the 2014 rate cases, Staff used market data from August, September, and October 2014 to
7 quantify its recommended allowed ROE reduction of 25 to 75 basis points. As can be seen
8 above, the dividend yields for Mr. Hevert's 2016 proxy group as well as the overlapping
9 companies from his 2014 and 2016 analyses, show a 50-basis point decline in the dividend
10 yields for these proxy groups. This supports Staff's position to lower the allowed ROE to
11 9% for Missouri's electric utilities.

1 Q. How can the above chart be used by the Commission in determining a
2 reasonable ROE to authorize in this case?
3 A. While it is true that utility stocks are trading at historically high levels, the
4 valuation levels have been consistently climbing over the last several years. This is directly
5 related to the level of long-term interest rates because utility stocks are a close alternative to
6 bond investments. While there have been predictions that long-term bond yields will
7 increase for the last several years, the U.S. and other developed markets have remained in a
8 low-growth, low-rate environment since 2010. Utility companies in Missouri typically file
9 rate cases every 2-3 years. If there is a reversal in the downward-trend in long-term interest
10 rates, it is highly unlikely this will be reversed so rapidly that this can't be captured in
11 allowed rates of return in future rate cases. The Commission should also consider the
12 investor information Staff discussed in the Staff Report, which indicates that if interest rates
13 stay "lower for longer," investors would expect the average allowed ROEs to decline by
14 25 basis point increments annually until the spread between allowed ROEs and the cost of
15 equity reverts to 225 basis points. Staff is attaching this report (*see* Schedule DM-s5) so
16 the Commission can review this information first hand and ask Staff any questions about it at
17 the hearing.[5]
18 Q. Did Mr. Hevert discuss the relationship of price-to-earnings ratios and how
19 they are important in estimating the cost of common equity?

[5] Greg Gordon, Kevin Prior, Dmitri Pchelintsev, Phil Covello, "Utilities Have Hit The 'Air Pocket' We Feared Was Coming," April 25, 2016, p. 12, Evercore ISI.

1 A. Yes. Mr. Hevert explains that the reason the constant-growth DCF cost of
2 equity estimates are highly questionable is because p/e ratios are currently quite high and are
3 likely to fall.[6]

4 Q. Have Mr. Hevert's terminal p/e multiples been increasing in his multi-stage
5 DCF analyses over the last several years he has sponsored ROR testimony in Missouri?

6 A. Yes. In UE's Case No. ER-2011-0028, Mr. Hevert's terminal p/e multiple
7 was approximately 13.7x. In UE's Case No. ER-2012-0166, his terminal p/e multiple was
8 15.98x. In UE's Case No. ER-2014-0258, his terminal p/e ratio was in the range of 16.31x to
9 17.13x. In this rate case, his terminal p/e ratio was in the range of 17.11x to 18.64x.
10 Additionally, as Staff explained earlier in this testimony, Mr. Hevert even makes an explicit
11 assumption of terminal p/e of 20.39x in his updated multi-stage DCF analyses.

12 Consequently, Mr. Hevert's own DCF analyses are not reflecting a decline in
13 p/e ratios. If Mr. Hevert's DCF analyses did assume a decline in the p/e ratios, his cost of
14 equity estimates would be much lower.

15 The clear signal from these ever increasing p/e ratios in the utility industry is that the
16 cost of equity has been declining over the last several years. This clearly is a factor in the
17 recent high multiples that are being offered in utility mergers and acquisitions.

18 Q. Do you have any other concerns regarding Mr. Hevert's rebuttal testimony?

19 A. Yes. Mr. Hevert claims that cost of equity (Mr. Hevert uses cost of equity and
20 return on equity interchangeably) estimates "as low the 5.61 percent have no practical

[6] Hevert Rebuttal, p. 11, l. 11 – p. 12, l. 9.

1 meaning, and highlight the inherent risk of not questioning the applicability of models and
2 assumptions in the current market environment."[7]

3 Staff is very concerned about Mr. Hevert's opinion that this cost of equity estimate
4 has no practical meaning considering the fact that ** ____________________________
5 ____
6 ____
7 ____
8 ____
9 ____
10 ____
11 ____ **

12 **SUMMARY AND CONCLUSIONS**

13 Q. What are the key takeaways from your surrebuttal?

14 A. Staff's position on the cost of equity as compared to allowed ROEs is
15 supported by evidence from the investment community. Mr. Hevert's positions are not and
16 they do not comport to GPE's own analysis on a fair price to pay for utility assets in the
17 current market environment.

18 Mr. Bryant's argument that GMO has a legitimate stand-alone capital structure cannot
19 be tested with publicly-available audited financial statements. Instead, the Commission will
20 have to rely on highly confidential financial statements to assure ratepayers that the capital
21 structure used to set rates for GMO is appropriate. Regardless, the Commission simply needs

[7] Hevert Rebuttal, p. 13, ll. 13-14.

NP

1 to determine whether it believes GMO is viewed by the investment community as stand-
2 alone entity.
3 Q. Does this conclude your surrebuttal testimony?
4 A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of KCP&L Greater Missouri Operations Company's Request for Authority to Implement A General Rate Increase for Electric Service	))))	Case No. ER-2016-0156

AFFIDAVIT OF DAVID MURRAY

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

COMES NOW DAVID MURRAY and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing Surrebuttal Testimony and that the same is true and correct according to his best knowledge and belief.

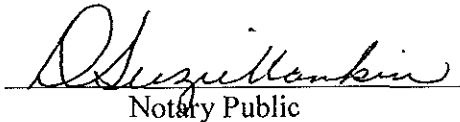
Further the Affiant sayeth not.

DAVID MURRAY

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 2nd day of September, 2016.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070



Notary Public

SCHEDULE DM-s1

through

SCHEDULE DM-s4

HAVE BEEN DEEMED

HIGHLY CONFIDENTIAL

IN ITS ENTIRETY

EVERCORE ISI

Energy | Power & Utilities

April 25, 2016

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Utilities Have Hit The "Air Pocket" We Feared Was Coming

But the Pull Back Is Healthy, Valuation vs. Bonds Rationalizing

In our last note on 4/11 and on a 4/12 Webinar with our Head of Global Portfolio Strategy Dennis DeBusschere we opined that we thought utilities were susceptible to a "rate hike" air pocket. Dennis said that market based odds of a Fed rate hike in June were way too low at 17% and that as we approached the Fed's next commentary on April 27th improving economic data from China, higher commodity prices and EM credit tightening that those odds were likely to go up if the data continued to trend positive. We said with the bond market having rallied and utilities at higher valuations we thought it made them more susceptible to a pullback on a Fed rate hike in June despite looking better in the bond regression model. While this seems counterintuitive, our view was supported by the idea that utilities, treasuries and corporates trade more correlated to each other when the spread between treasuries and corporates tightens. While we sounded cautious, we should have been more negative in our ratings construct (as we were last January), but we second guessed ourselves on how quickly the market would re-rate the group's valuation. On 4/1/16, utilities were trading at 18.94 on NTM P/E, 1.12 on NTM relative P/E and 11.3% expensive in our bond regression model. The group looks much better vs. the bond market, but still rich on P/E.

Relative performance in '16 for regulated utilities peaked on 2/8/16 at 16.9%! Utes were up 7.6% vs. (9.3%) for the SP500. At that point regulated utilities were up on average 6.5% vs the SP500 (9.3%). The top five performers in the regulated group (ED, WEC, CMS, DUK, NEE) were up >11%. The group was trading at 17.7X '16 EPS, and a relative P/E to the SP500 of 1.18X. The 10-year Treasury yield was 1.75%, with the Moody's Baa corporate bond yield average at 5.28%, a 353 basis point spread. Utilities looked 12.5%/8% expensive on current and 1-year forward dividends.

Since 4/1 regulated utilities are down 6.2% vs. the S&P500 up 1% (mostly in the last week), compressing relative outperformance YTD to 8.4% (+8.8% for utilities vs. +0.4% for the S&P500). Today the market based odds of a Fed rate hike in June have risen to 33%. The global economy continues to expand at a low level. Eurozone inflation expectations and yield curve increased following Draghi's press conference yesterday which is a sign the outlook for Europe is stabilizing. Inflation expectations in the U.S. continue to increase and stronger high frequency fundamental data would confirm that trend. We are now trading at 17.74 NTM P/E, 1.05 NTM relative P/E on Factset consensus, and 2.4% expensive in our bond regression model. The 10-year Treasury yield is 1.86%, up from its 2/11/16 low of 1.66% with the Moody's Baa corporate bond yield average at 4.75%, a 289 basis point spread. A massive move tighter from the 363bp spread at the peak on 2/18/16. Absolute P/E multiples are still a bit stretched but relative P/E looks better with the market up / utilities down and they are less expensive vs. the corporate bonds because yields have come down from 5.28% to 4.75% and utilities have corrected. This is a healthy correction. If Utilities continue to fall whilst the spread between Treasuries and corporates tightens we could hit a "sweet spot" where absolute / relative P/E and our bond regression model signal opportunity.

Utilities are now only 2.4% expensive on current yield and 2.3% cheap in our bond regression model. They are discounting a 2.65% 10-year Treasury yield and 4.85% Moody's Baa bond yield average 12-months out assuming that corporates trade back to their historic 220 basis point spread to treasuries (1970-present). At the current spread of 289 basis points they are discounting a Treasury yield of 1.95%. They are looking more reasonable on P/E since the recent pullback but still expensive relative to our dividend discount model, trading on average at 17.4X FY '17 EPS estimates.

According to our Technical Analyst Rich Ross, Utilities broke below the 50 day moving average and have 3-4% downside in until we hit the next level of resistance.

Please see the analyst certification and important disclosures on page 23 of this report. Evercore ISI and affiliates do and seek to do business with companies covered in its research reports. Investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

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Regulated Utilities: April 22, 2016

Utilities Have Hit The "Air Pocket" We Feared Was Coming, Down >6% Since 4/1/16, But We Think This Pullback Is Healthy

At A +/-17X Average P/E on '17 EPS They Are Still A "A Turn" Expensive In Our Dividend Discount Model

However the Rally In Corporate Bonds / Tightening Spreads Between Corporates & Treasuries Has Pushed Our Bond Regression Model Back Towards Equilibrium

Assuming A Return Towards More "Normal" Bond Market Conditions We Are Discounting A 2.65% 10 Year T-Bond Yield 12-Months Out

Our Technical Analyst Rich Ross Sees Support 3-4% Lower

Our Regulated Buy Rated Stocks Are D, NEE, SRE, PCG, EIX, and AEP.

**See the last page for important disclosures regarding these stocks and this report.*

Our Coverage Universe Has Dropped A Turn on P/E Since 4/1/16

- **Right now we are at 18.5x '16, 17.4x '17 and 16.4x '18. Excluding TE, WR & ITC (which are at deal premiums) the valuation is about a half a turn lower.**
- **This is down from the recent peak on 4/1/16 at 19.4x '16, 18.4x '17 and 17.3x '18.**
- **In late-January '15 when the group was last at its defensive apex valuation peaked at around 19.5X '15, 18.5X '16 and 17.5x '17 EPS**
- **We have Buy ratings on D, NEE, SRE, EIX, PCG, and AEP. We are recommending a mix of traditional utilities at valuation discounts and differentiated longer term EPS and dividend growth stories.**

Valuation & Earnings Snapshot (Trading Comps)

		4/21/16	ISI	Shares	Market	2016	2016	ISI EPS Estimate			P/E Multiple			'15-'18	Price to	Prem. to
Ticker	Company Name	Price	Rating	Out	Cap	Div Yld	Payout	2016	2017	2018	2016	2017	2018	EPS Growth	Book	Group
TE	Teco Energy Inc	$27.69	HOLD	234	6,468	3.4%	80%	1.16	1.29	1.36	23.8x	21.5x	20.3x	7.5%	2.5x	23%
WR	Westar Energy Inc	$49.88	HOLD	139	6,950	3.0%	61%	2.45	2.55	2.60	20.4x	19.6x	19.2x	7.2%	1.9x	17%
ITC	ITC Holdings Corp.	$42.71	HOLD	155	6,613	1.8%	42%	1.87	2.12	2.26	22.8x	20.2x	18.9x	2.8%	3.6x	15%
WEC	WEC Energy Group	$55.90	HOLD	250	14,000	3.5%	68%	2.93	3.07	3.21	19.1x	18.2x	17.4x	5.6%	1.9x	6%
CMS	CMS Energy Corp	$39.38	HOLD	277	10,907	3.1%	61%	2.02	2.18	2.35	19.5x	18.1x	16.8x	7.5%	2.7x	2%
NEE	NextEra Energy, Inc.	$112.91	BUY	454	51,261	3.1%	58%	6.05	6.30	6.75	18.7x	17.9x	16.7x	6.1%	2.2x	2%
HE	Hawaiian Electric Industries, Inc.	$31.71	HOLD	107	3,383	3.9%	73%	1.70	1.80	1.90	18.7x	17.6x	16.7x	4.7%	1.7x	2%
SRE	Sempra Energy	$100.47	BUY	251	25,249	2.9%	62%	4.75	5.20	6.05	21.2x	19.3x	16.6x	5.1%	2.1x	1%
ED	Consolidated Edison Inc	$71.10	HOLD	294	20,914	3.8%	67%	4.00	4.10	4.30	17.8x	17.3x	16.5x	2.4%	1.6x	1%
ES	Eversource Energy	$55.02	HOLD	318	17,522	3.3%	61%	2.95	3.15	3.40	18.6x	17.5x	16.2x	6.6%	1.6x	-2%
D	Dominion Resources Inc	$69.51	BUY	594	41,265	4.0%	75%	3.75	3.95	4.30	18.5x	17.6x	16.2x	7.8%	2.8x	-2%
PNW	Pinnacle West Capital Corp	$71.07	HOLD	112	7,928	3.6%	63%	4.00	4.20	4.40	17.8x	16.9x	16.2x	3.9%	1.7x	-2%
SO	Southern Company Inc	$48.94	HOLD	913	44,670	4.5%	78%	2.85	2.95	3.05	17.2x	16.6x	16.0x	1.7%	2.1x	-2%
XEL	Xcel Energy Inc	$38.61	HOLD	508	19,622	3.5%	61%	2.20	2.35	2.45	17.6x	16.4x	15.8x	5.4%	1.8x	-4%
DUK	Duke Energy Corp	$76.34	HOLD	694	52,980	4.4%	72%	4.60	4.60	4.85	16.6x	16.6x	15.7x	2.2%	1.3x	-4%
EIX	Edison International	$68.00	BUY	328	22,321	2.8%	49%	3.90	4.20	4.35	17.4x	16.2x	15.6x	2.0%	1.8x	-5%
AEE	Ameren Corp	$46.47	HOLD	243	11,300	3.7%	68%	2.50	2.80	3.05	18.6x	16.6x	15.2x	6.1%	1.6x	-7%
DTE	DTE Energy Co	$85.07	HOLD	179	15,267	3.6%	62%	5.00	5.30	5.60	17.0x	16.1x	15.2x	5.3%	1.7x	-8%
AEP	American Electric Power Co Inc	$62.26	BUY	491	30,545	3.6%	61%	3.70	4.00	4.20	16.8x	15.6x	14.8x	4.3%	1.7x	-10%
PCG	PG&E Corp	$56.62	BUY	486	27,520	3.3%	50%	3.70	3.65	3.85	15.3x	15.5x	14.7x	4.7%	1.5x	-11%
PPL	PPL Corp	$36.27	HOLD	672	24,384	4.2%	65%	2.35	2.40	2.50	15.4x	15.1x	14.5x	4.4%	2.2x	-12%
Regulated Group Average						**3.5%**	**64%**				**18.5x**	**17.4x**	**16.4x**	**4.9%**	**2.0x**	
Regulated Group Max						4.5%	80%				23.8x	21.5x	20.3x	7.8%	3.6x	
Regulated Group Min						1.8%	42%				15.3x	15.1x	14.5x	1.7%	1.3x	

***Updated as of 4/21/16 close.**

Source: FactSet, Evercore ISI Research

Utes Are Down >6% Since The Valuation Peak But There Have Been Alpha Generating Opportunities

- The top 5 best performing stocks are up on average 11.7% YTD
- The bottom 5 worst performing stocks YTD (excluding deal stocks), are up 6.3%.
- So within the group there has been relative valuation opportunities YTD.

	Big Selloff 1/30/15 to 6/30/15	Big Rally 6/30/15 to 10/22/15	10/22/15 to 12/31/15	2015	Recent Peak 12/31/15 to 4/1/16	4/1/16 to 4/21/16	YTD
Regulated	(14.8%)	14.8%	(3.0%)	(1.6%)	16.5%	(6.2%)	8.8%
S&P 500	3.4%	(0.5%)	(0.4%)	0.6%	1.4%	0.9%	0.4%

#	1/30/15 to 6/30/15		6/30/15 to 10/22/15		10/22/15 to 12/31/15		2015		12/31/15 to 4/1/16		4/1/16 to 4/21/16		YTD	
1	UIL	1.5%	TE	54.7%	ITC	16.9%	TE	34.5%	EIX	22.3%	TE	0.5%	WR	18.5%
2	POM	0.1%	WR	21.7%	WR	3.6%	CMS	7.2%	ED	20.8%	POM	0.0%	EIX	15.7%
3	NEE	(8.9%)	WEC	20.0%	SO	1.8%	WR	6.3%	WR	19.6%	WR	(0.9%)	ED	11.7%
4	SRE	(10.3%)	EIX	19.7%	AEP	(0.6%)	XEL	3.5%	CMS	19.2%	ITC	(1.5%)	PNW	11.2%
5	D	(11.3%)	AEE	19.2%	POM	(0.8%)	PCG	3.3%	PNW	18.0%	HE	(3.4%)	HE	10.6%
6	HE	(11.5%)	ED	18.2%	TE	(0.8%)	ED	1.3%	AEE	17.9%	NEE	(4.9%)	CMS	10.0%
7	XEL	(12.5%)	PNW	18.2%	HE	(0.9%)	NEE	0.6%	WEC	17.8%	SRE	(5.1%)	WEC	9.9%
8	AEP	(14.0%)	CMS	17.7%	NEE	(1.0%)	POM	0.6%	XEL	17.7%	SO	(5.3%)	NEE	9.5%
9	CMS	(14.1%)	ES	17.0%	PCG	(1.6%)	WEC	0.6%	ES	16.0%	PCG	(5.4%)	ITC	9.3%
10	ED	(14.6%)	XEL	16.4%	AEE	(1.9%)	SO	(0.3%)	AEP	16.0%	EIX	(5.5%)	ES	8.6%
11	PCG	(15.0%)	DTE	14.7%	CMS	(2.2%)	AEP	(0.5%)	NEE	15.1%	PNW	(5.9%)	AEE	8.5%
12	AEE	(15.0%)	AEP	12.7%	ES	(2.3%)	ITC	(1.2%)	DUK	14.8%	DUK	(5.9%)	XEL	8.5%
13	TE	(15.1%)	D	12.4%	PNW	(2.3%)	ES	(1.5%)	HE	14.5%	ES	(6.4%)	DUK	8.1%
14	DTE	(15.2%)	SO	12.3%	XEL	(2.5%)	PNW	(2.1%)	DTE	14.5%	DTE	(6.6%)	AEP	7.8%
15	SO	(15.3%)	PCG	11.9%	WEC	(3.7%)	AEE	(2.7%)	SRE	13.5%	WEC	(6.8%)	SRE	7.7%
16	ES	(16.8%)	NEE	8.6%	DUK	(3.8%)	DTE	(3.9%)	PCG	13.3%	AEP	(7.1%)	PCG	7.3%
17	DUK	(17.1%)	DUK	7.5%	ED	(4.2%)	EIX	(6.9%)	D	12.5%	ED	(7.7%)	DTE	7.0%
18	EIX	(17.2%)	ITC	5.5%	DTE	(4.7%)	D	(8.7%)	SO	11.7%	CMS	(7.8%)	SO	5.8%
19	WEC	(17.5%)	SRE	4.3%	SRE	(7.6%)	HE	(9.8%)	ITC	10.9%	D	(7.8%)	TE	4.8%
20	PNW	(18.1%)	HE	0.3%	D	(8.3%)	DUK	(10.7%)	TE	4.3%	XEL	(7.9%)	D	3.8%
21	WR	(18.2%)	POM	(0.7%)	EIX	(9.7%)	SRE	(13.1%)	POM	3.5%	AEE	(8.1%)	POM	3.5%

***Updated as of 4/21/16 close. Regulated average represents our coverage universe excluding ITC / TE / POM / HE / WR.**

Source: FactSet, Evercore ISI Research

Utilities Have Underperformed Since Early February & Have Hit A >6% "Air Pocket" Since 4/1/16.

- **Relative performance in '16 peaked on 2/8/16 at 16.9%! Utes were up 7.6% vs. (9.3%) for the SP500.**
  - At that point regulated utilities were up on average 6.5% vs the SP500 (9.3%). The top five performers in the regulated group (ED, WEC, CMS, DUK, NEE) were up >11%. The group was trading at 17.7X '16 EPS, and a relative P/E to the SP500 of 1.18X. The 10-year Treasury yield was 1.75%, with the Moody's Baa corporate bond yield average at 5.28%, a 353 basis point spread. Utilities looked 12.5%/8% expensive on current and 1-year forward dividends.

- **From 2/8/16 through 4/1/16 utilities were up another 7.5% on average, but lagged the market which rallied 11.8% so relative performance dissipated to 13.1%. On 4/1/16 utilities hit the peak on valuation we saw in January '15 on absolute and relative P/E and looked expensive vs. bonds.**
  - They were trading at 18.94 on NTM P/E, 1.12 on NTM relative P/E and 11.3% expensive in our bond regression model.

- **In our 4/11 note and 4/12 Webinar with our Head of Global Portfolio Strategy Dennis DeBusschere we opined that we thought utilities were susceptible to a "rate hike" air pocket.**
  - Dennis said that market based odds of a Fed rate hike in June were way too low at 17% and that as we approached the Fed's next commentary on April 27th improving economic data from China, higher commodity prices and EM credit tightening that those odds were likely to go up if the data continued to trend positive.
  - We said with the bond market having rallied and utilities at higher valuations we thought it made them more susceptible to a pullback on a Fed rate hike in June despite looking better in the bond regression model. While this seems counterintuitive, our view was supported by the idea that utilities, treasuries and corporates trade more correlated to each other when the spread between treasuries and corporates tightens.
  - While we sounded caution, we should have been more negative in our ratings construct (as we were last January), but we second guessed ourselves on how quickly the market would re-rate the group's valuation.

- **Since 4/1 regulated utilities are down 6.2% vs. the S&P500 up 1% (mostly in the last week), compressing relative outperformance YTD to 8.4% (+8.8% for utilities vs. +0.4% for the S&P500).**
  - Today the market based odds of a Fed rate hike in June have risen to 33%. The global economy continues to expand at a low level. Eurozone inflation expectations and yield curve increased following Draghi's press conference yesterday which is a sign the outlook for Europe is stabilizing. Inflation expectations in the U.S. continue to increase and stronger high frequency fundamental data would confirm that trend.
  - We are now trading at 17.74x NTM P/E, 1.05x NTM relative P/E, and 2.3% expensive in our bond regression model
  - The 10-year Treasury yield is 1.86%, up from its 2/11/16 low of 1.66%, with the Moody's Baa corporate bond yield average at 4.75%, a 289 basis point spread. A massive move form the 363bp spread at the peak on 2/18/16. Absolute P/E multiples are still a bit stretched but relative P/E looks better with the market is up/utilities down and they are less expensive vs. corporate bonds because yields have come down from 5.28% to 4.76% and utilities have corrected.

Source: FactSet, Evercore ISI Research

This Is A Healthy Correction. Look For An Overshoot For Opportunities

- **This is a healthy correction. If Utilities continue to fall whilst the spread between Treasuries and corporates tightens we could hit a "sweet spot" where absolute / relative P/E and our bond regression model signal opportunity**

- **Utilities are now only 2.4% expensive on current yield and 2.3% cheap 12-months out in our bond regression model**
  - They are discounting a 2.65% 10-year Treasury yield and 4.85% Moody's Baa bond yield average 12-months out assuming that corporates trade back to their historic 220 basis point spread to treasuries (1970-present). At the current spread of 289 basis points they are discounting a Treasury yield of 1.95%.
  - From October of last year through early April this year utilities were trading on the expensive side of the model, which they can do during periods of significant macro-economic uncertainty. The wide spread between Treasuries and Corporates was the key factor that impacted this valuation reading in our bond model. At the beginning of 2015 the 10-Year was +/-2.2% and corporates were 4.7%, a spread of 250bp. That spread peaked on 363bp on 2/18, with the 10-year yield at 1.74% and corporate bond yield average at 5.37%. It has now moderated to 289bp.

- **They are looking more reasonable on P/E since the recent pullback but still expensive relative to our dividend discount model, trading on average at 17.4X FY '17 EPS estimates (17X excluding names trading at deal premiums)**
  - Our model indicates that 16X one year forward earnings a is a more realistic valuation assuming modest increases in interest rates over the next few years, a modest further decline in authorized ROE's and a stable near term rate base growth outlook. Since a turn on the P/E is about 8% on price, the "bottom up" view we come to with our DDM approach is consistent—more or less—with the regression model output when looking at valuation.
  - So valuation is getting a bit less discomforting. We are focused on the best relative value investment ideas in the group and continue to like some differentiated growth stories (see pages 21-22).

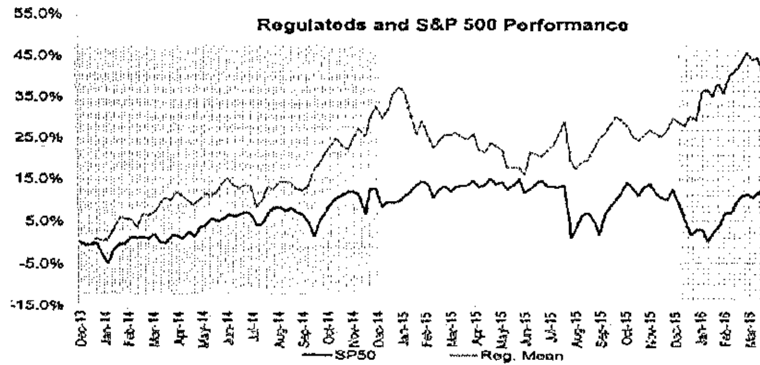
- **If utilities were to trade down another multiple point to a 16X P/E on our average '17 EPS expectations, and we held all things equal, they would be trading at a relative P/E of 0.99x to the SP 500 and be 3.%/8% cheap in our bond model.**
  - At that average valuation we think there would be good entry points on the lower end of the valuation spectrum.
  - If we drop below 16x on an average multiple, all things equal, then the higher quality names start to look more attractive

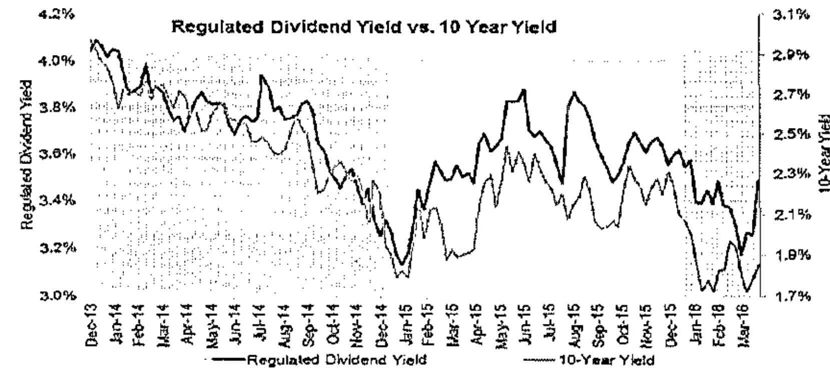
- **Our Technical Analyst Rich Ross sees 3-4% downside in regulated utilities until we hit the next level of resistance (see page 17).**

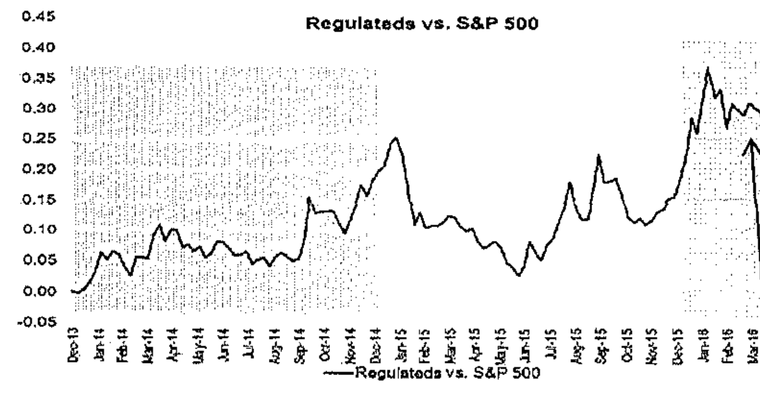
Source: FactSet, Evercore ISI Research

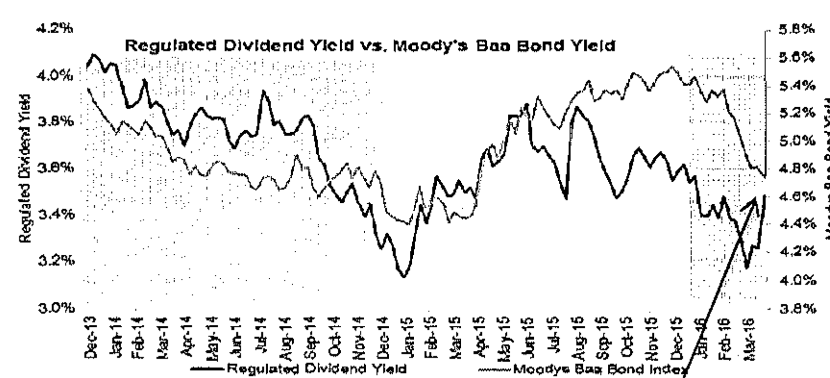
Utilities Have Giving Up A Lot Of Ground Vs. The Market But They Look Less Stretched Vs. Corporates

- Below we show absolute and relative performance for the group from the beginning of 2014 to present on the left side of the page.
    - The highlighted area to the right third of those charts shows YTD performance. The stocks had continued to perform well through March, but have underperformed dramatically on both an absolute and relative basis since 4/1/16.
- With utilities having fallen and corporate yields lower they look a lot less expensive compared to corporate bond yields.
- It is also why they are now trading more contemporaneously with Treasuries.
    - Looking at the chart on the top right of the page you can see that utilities stopped following the 10-year yield lower from mid-January through mid-February 2016.
    - This is because of the tension created by the wide spread at the time between Treasury yields and corporates, as shown in the chart on the bottom right. The recent decline in corporate bond yields created room for utility yields to start acting more correlated to Treasuries









The group ripped versus the market to start the year. While the market gained some ground in February the group continued appreciate until it peaked on April 1.

The spread between corporate and utility yields has tightened, Utilities no longer look stretched. It has also caused them to trade lower on the recent move in Treasury yields.
An overshoot vs. corporates would be an opportunity

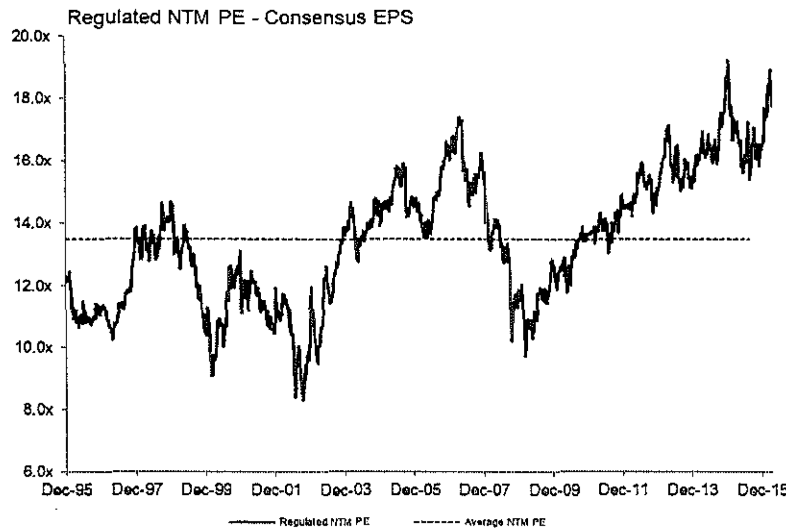
*Updated as of 4/21/16 close.

Source: FactSet, Evercore ISI Research

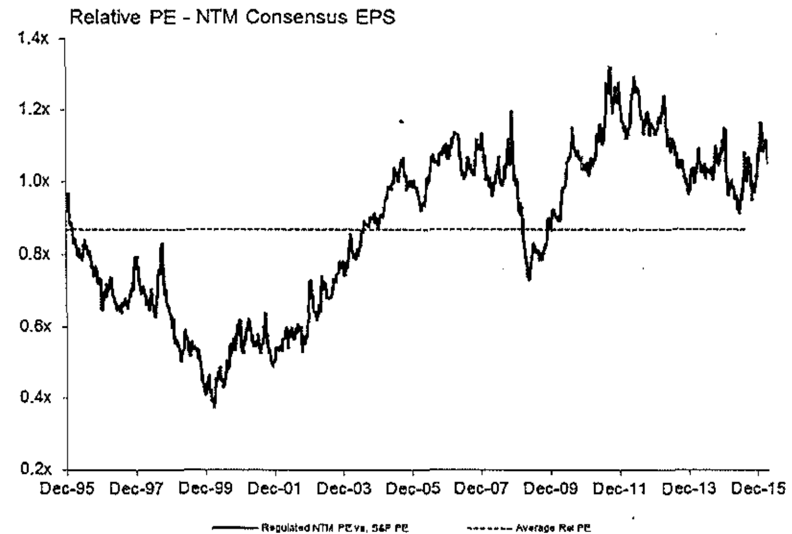
Absolute P/E Has Ripped Higher, Relative P/E Has Moderated

- Current NTM relative P/E is 1.05x. That is off from the FY '16 peak of 1.18x on 2/8/16.
  - On 4/1/16 when utilities peaked on absolute valuation it was 1.12x
- Current NTM absolute P/E is 17.74, off a YTD peak of 18.86x on 4/1/16. The last recent historical high of ~19.2 was in late January '15.
- Since 1995, the average NTM P/E has been 13.4x with a relative NTM P/E averaging 0.87

Absolute PEs of Regulated Names Are Back to Historic Highs



Relative PE on Next-Twelve Months Forward Consensus EPS Is Also a Bit Off Recent Peaks



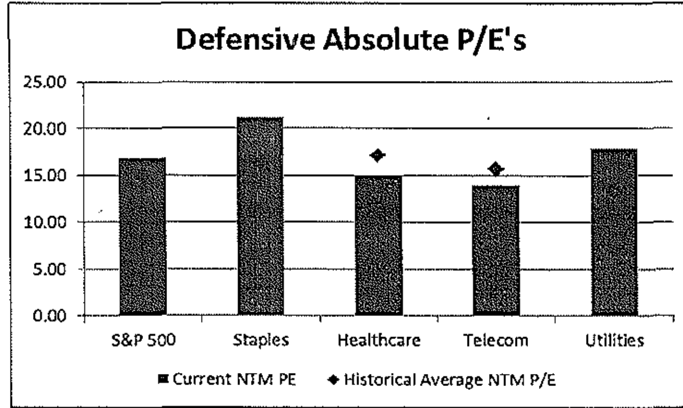
***Updated as of 4/21/16 close.**

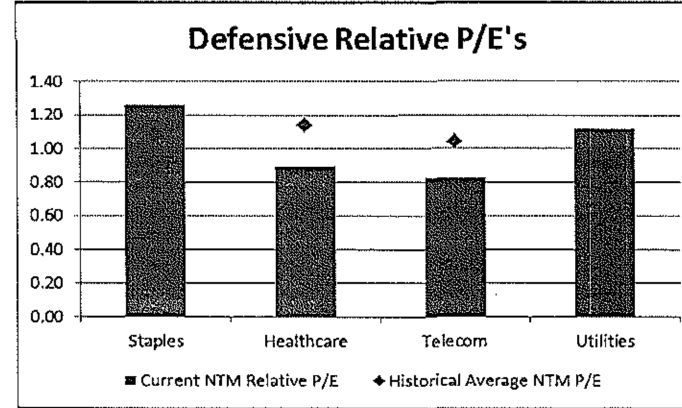
Source: FactSet, Evercore ISI Research

Defensive Sector Valuations: Utilities Are Behind Staples, Ahead Of Healthcare & Telecom

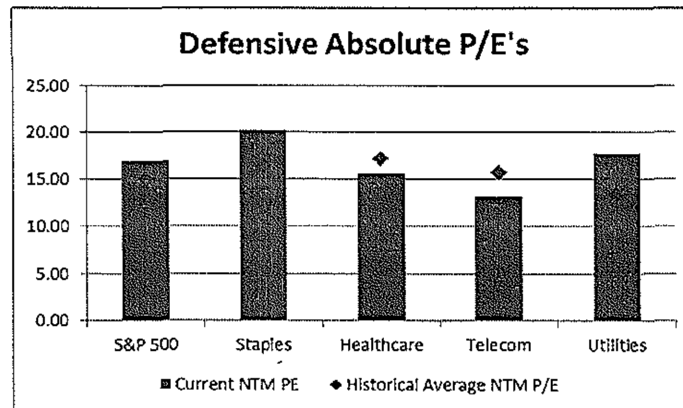
- Below we look at how defensive sectors are behaving relative to historical performance in terms of Absolute and Relative P/E.
  - Since 4/1/16 Staples, Healthcare, and Utilities have underperformed on both an absolute and relative basis to the S&P, while Healthcare has outperformed.
- According to Dennis DeBusschere increasing inflation expectations and 10yr yields will continue to support financials at the expense of utilities and staples

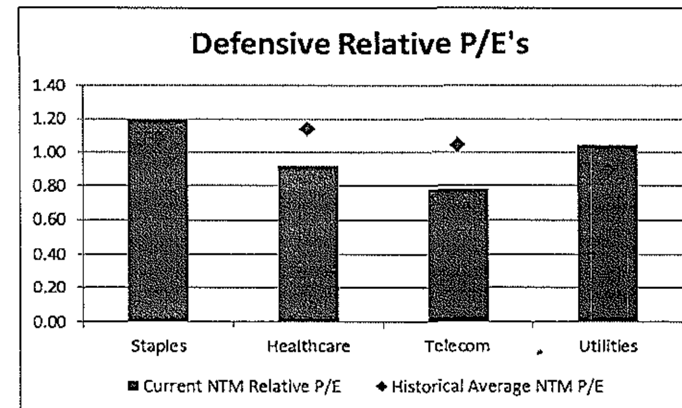
4/1/16





4/21/16





Source: FactSet, Evercore ISI Research

P/E Multiple Is Down A Turn A Valuation vs. Corporate Bonds Is Normalizing...

- The group is currently trading at a much more reasonable valuation to corporate bond yields due the recent pullback and the spread between Treasuries and the Moody's Baa Corporate Bond Yield Average, which has narrowed materially from its peak of 363 basis points on 2/18/16 (see page 11), coupled with the air pocket in utility valuation since 4/1/16.
- The group is +/-2.4% expensive today on current corporate bond yields. If we held current yields constant for 12 months, taking into account a year's worth of dividend growth, the group looks +/-2.3% undervalued.
- The "breakeven" corporate bond yield, at which the group is fairly priced 12 months out is ~4.85%, implying a 2.65% 10-year bond yield at the historic average spread of 220bp. If the spread stayed at its current levels we are discounting closer to a 1.95% yield.

	Peak 1/30/2015	Trough 6/30/2015	Peak 10/22/2015	YE 15	Recent Peak 4/1/2016	4/21/2016 Current
Regulated P/E '15	19.4x	16.0x	18.3x			
Regulated P/E '16	18.4x	15.2x	17.4x	16.8x	19.4x	18.5x
Relative NTM Reg P/E to S&P500	1.14x	0.93x	1.06x	1.02x	1.12x	1.05x
Regulated Dividend Yield	3.3%	4.0%	3.4%	3.6%	3.3%	3.5%
10 Year Yield	1.65%	2.36%	2.03%	2.28%	1.77%	1.86%
Moody's Baa Bond Yield	4.29%	5.18%	5.37%	5.54%	4.89%	4.75%
Valuation vs. Corporate Bonds*	-2.2%	-0.3%	-14.6%	-10.2%	-11.3%	-2.4%

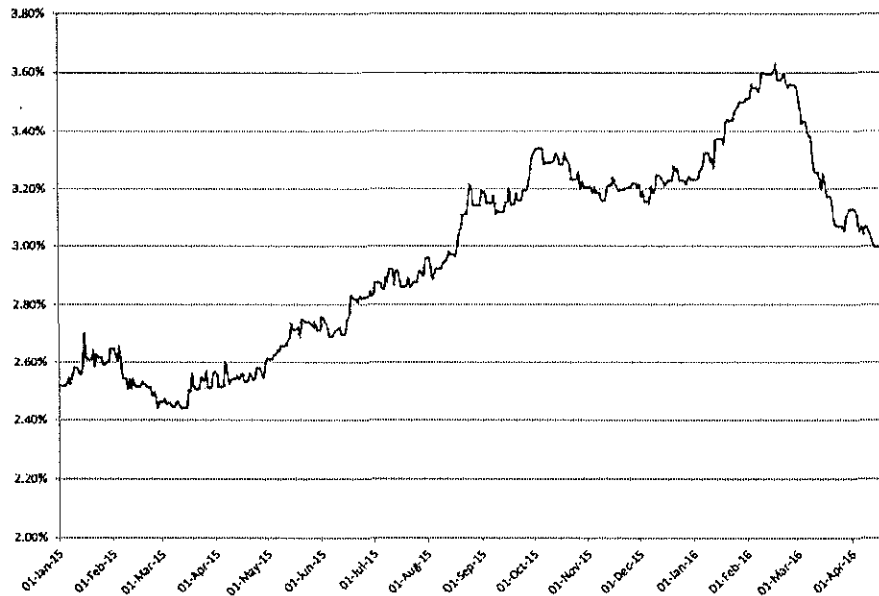
*Represents upside to predicted valuation using Evercore ISI's proprietary dividend yield/bond yield regression.

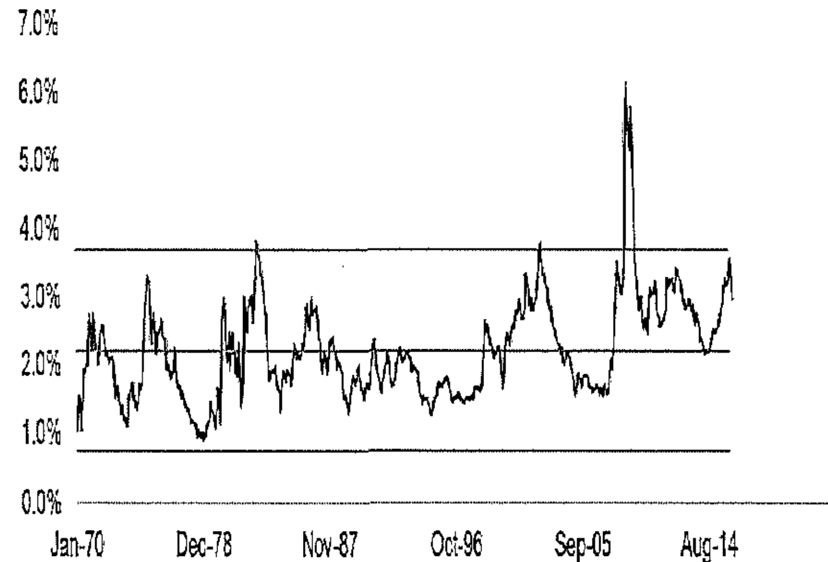
Source: FactSet, Evercore ISI Research

...In Part Because The Spread Between Treasuries & Corporates Has Rallied Hard

- The wide spread between Treasuries and Corporates was the key factor that made utilities look fully priced in our bond model from 10/2015 through early April 2016
- At the beginning of the 2015 the 10-Year was +/-2.2% and corporates were 4.7%, a spread of 230bp.
- That spread peaked on 363bp on 2/18, with the 10-year yield at 1.74% and corporate bond yield average at 5.37%.
- Today that spread has moderated to 289bp, with Treasuries at 1.86% and Corporates at 4.75%
- The spread has averaged 220 basis points since 1970.

Spread Between BAA Corporate Bond Yields and 10 YR Treasury Yield has Continued to Increase Until Recently





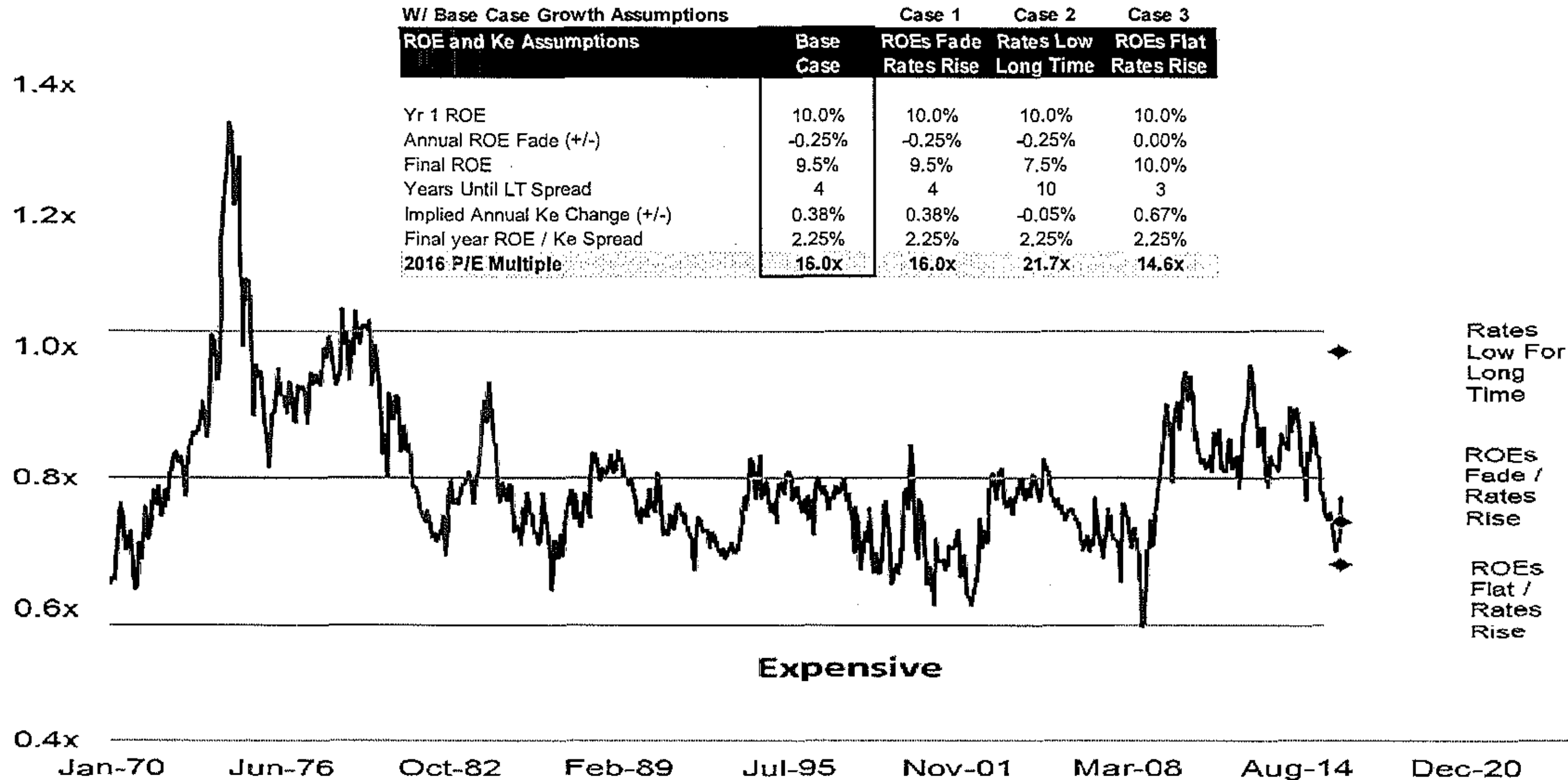
*Updated as of 4/21/16 close.

Source: FactSet, Evercore ISI Research

…That Is Causing The Bond Model To Look Much Better, With An Improving DDM Reading

- Traditional utility stocks are currently trading at ~17x '17 (excluding deal premium stocks), 1 turn higher than our base case (case 1) scenario as articulated in our DDM analysis on page 11.
- In January of 2015 they were trading at 19.5x / 18.5X '15 / '16 EPS, discounting a move towards case 2.
- They looked a bit less stretched in the corporate bond model than they do now in early '15 despite their higher P/E multiple because at the time the 10-Year T-Bond Yield was 1.65% and corporates were at 4.29%
- Now the 10-Year T-Bond Yield is 1.86% and corporates are at 4.75%, creating a bit more tension, but not much and it looks much better recently.

Dividend Yield to BAA Bond Yield (Monthly; Jan '70- Present)



W/ Base Case Growth Assumptions		Case 1	Case 2	Case 3
ROE and Ke Assumptions	Base Case	ROEs Fade Rates Rise	Rates Low Long Time	ROEs Flat Rates Rise
Yr 1 ROE	10.0%	10.0%	10.0%	10.0%
Annual ROE Fade (+/-)	-0.25%	-0.25%	-0.25%	0.00%
Final ROE	9.5%	9.5%	7.5%	10.0%
Years Until LT Spread	4	4	10	3
Implied Annual Ke Change (+/-)	0.38%	0.38%	-0.05%	0.67%
Final year ROE / Ke Spread	2.25%	2.25%	2.25%	2.25%
2016 P/E Multiple	**16.0x**	**16.0x**	**21.7x**	**14.6x**

Source: FactSet, Evercore ISI Research

Bond Model Approaching Equilibrium, Owing To The Tighter Treasury vs. Baa Spread & Utility Stock Correction

Regulated utilities looked 11.3% expensive on 4/1/16 on then current yields.

Utility Valuation 4/1/16			10 YR / BBB	1.77% / 4.89%
Confidence Intervals	BBB Yield %	Expected Defensive Index Yld	Implied 2017 P/E	Upside / (Downside) for Index
- 95.0% Confidence Interval	1.81%	1.78%	34.9x	96.6%
	2.03%	1.94%	32.1x	80.9%
	2.47%	2.25%	27.7x	56.0%
	3.13%	2.71%	22.9x	29.2%
- 68.0% Confidence Interval	3.35%	2.87%	21.7x	22.3%
	3.57%	3.02%	20.6x	16.0%
	4.45%	3.64%	17.1x	-3.7%
	4.67%	3.80%	16.4x	-7.7%
Predicted Valuation	4.89%	3.95%	15.7x	-11.3%
	5.11%	4.11%	15.1x	-14.6%
	5.77%	4.57%	13.6x	-23.3%
	5.99%	4.73%	13.2x	-25.8%
+ 68.0% Confidence Interval	6.21%	4.88%	12.7x	-28.2%
	6.43%	5.04%	12.3x	-30.4%
	6.87%	5.35%	11.6x	-34.4%
	7.53%	5.81%	10.7x	-39.7%
+ 95.0% Confidence Interval	7.75%	5.97%	10.4x	-41.2%

On 4/1/16 If rates stayed unchanged for 12 months utilities looked 7% expensive.

Utility Valuation 4/1/16			10 YR / BBB	1.77% / 4.89%
Confidence Intervals	BBB Yield %	Expected Defensive Index Yld	Implied 2017 P/E	Upside / (Downside) for Index
- 95.0% Confidence Interval	1.81%	1.78%	34.5x	106.1%
	2.03%	1.94%	31.7x	89.7%
	2.47%	2.25%	27.4x	63.5%
	3.13%	2.71%	22.7x	35.5%
- 68.0% Confidence Interval	3.35%	2.87%	21.5x	28.2%
	3.57%	3.02%	20.4x	21.6%
	4.45%	3.64%	16.9x	0.9%
	4.67%	3.80%	16.2x	-3.2%
Predicted Valuation	4.89%	3.95%	15.6x	-7.0%
	5.11%	4.11%	15.0x	-10.5%
	5.77%	4.57%	13.5x	-19.6%
	5.99%	4.73%	13.0x	-22.2%
+ 68.0% Confidence Interval	6.21%	4.88%	12.6x	-24.7%
	6.43%	5.04%	12.2x	-27.0%
	6.87%	5.35%	11.5x	-31.2%
	7.53%	5.81%	10.6x	-36.7%
+ 95.0% Confidence Interval	7.75%	5.97%	10.3x	-38.4%

Utility Valuation 4/21/16			10 YR / BBB	1.86% / 4.75%
Confidence Intervals	BBB Yield %	Expected Defensive Index Yld	Implied 2017 P/E	Upside / (Downside) for Index
- 95.0% Confidence Interval	1.67%	1.68%	37.0x	123.5%
	1.89%	1.84%	33.9x	104.7%
	2.33%	2.15%	29.0x	75.1%
	2.99%	2.61%	23.9x	43.9%
- 68.0% Confidence Interval	3.21%	2.77%	22.5x	35.9%
	3.43%	2.92%	21.3x	28.7%
	4.09%	3.39%	18.4x	11.0%
	4.31%	3.54%	17.6x	6.1%
Predicted Valuation	4.75%	3.85%	16.2x	-2.4%
	4.97%	4.00%	15.5x	-6.2%
	5.41%	4.31%	14.4x	-12.9%
	5.85%	4.62%	13.5x	-18.7%
+ 68.0% Confidence Interval	6.07%	4.78%	13.0x	-21.4%
	6.29%	4.93%	12.6x	-23.8%
	6.51%	5.09%	12.2x	-26.2%
	7.39%	5.71%	10.9x	-34.2%
+ 95.0% Confidence Interval	7.61%	5.86%	10.6x	-35.9%

Now regulated utilities look 2.4% expensive on current yields

Utility Valuation 4/21/16			10 YR / BBB	1.86% / 4.75%
Confidence Intervals	BBB Yield %	Expected Defensive Index Yld	Implied 2017 P/E	Upside / (Downside) for Index
- 95.0% Confidence Interval	1.67%	1.68%	36.7x	134.2%
	1.89%	1.84%	33.6x	114.5%
	2.33%	2.15%	28.7x	83.5%
	2.99%	2.61%	23.6x	50.8%
- 68.0% Confidence Interval	3.21%	2.77%	22.3x	42.4%
	3.43%	2.92%	21.1x	34.8%
	4.09%	3.39%	18.2x	16.3%
	4.31%	3.54%	17.4x	11.2%
Predicted AND Current Valuation	4.75%	3.85%	16.0x	2.3%
	4.97%	4.00%	15.4x	-1.7%
	5.41%	4.31%	14.3x	-8.7%
	5.85%	4.62%	13.3x	-14.9%
+ 68.0% Confidence Interval	6.07%	4.78%	12.9x	-17.6%
	6.29%	4.93%	12.5x	-20.2%
	6.51%	5.09%	12.1x	-22.6%
	7.39%	5.71%	10.8x	-31.0%
+ 95.0% Confidence Interval	7.61%	5.86%	10.5x	-32.9%

If rates stay unchanged for the next 12 months, regulated utilities look 2.3% inexpensive .

- **The group is trading a turn lower than April 1st on absolute valuation, and corporate yields have fallen from 4.89% to 4.75% over that period.**
- **Regulated utilities are discounting corporate bond yields at 4.85% 12 months out, implying a 2.65%10 Year T- Bond Yield up from 1.86% if corporates and treasuries traded to their historic 220 basis point spread. At the current spread they discount +/- 1.95% 10-year one year hence**

*Updated as of 4/21/16 close.

Source: FactSet, Evercore ISI Research

Our Proprietary DDM Valuation Yields an Anchor Utility Multiple of 16x

- **The Forward P/E multiple that a utility investor are willing to pay (based on our DDM) is highly influenced by how quickly investors believe the yield curve will steepen**
  - Our base case for awhile has assumed an orderly transition to higher interest rates, with authorized ROEs falling to 9.5% from 10%, and that 10-year Treasury yields rising to 3.5% over a multi year period, resulting at the end in a 2.25% spread between the return on equity and the cost of equity.
- **They also reflect more or less "status quo" assumptions about rate base growth**
- **The stocks are now moving toward our base case valuation inching away from "case 2"**
  - In all cases a change to our status quo assumptions regarding rate base growth would negatively impact valuation, as shown in the tables below.

W/ Base Case Growth Assumptions

ROE and Ke Assumptions	Base Case	Case 1 ROEs Fade Rates Rise	Case 2 Rates Low Long Time	Case 3 ROEs Flat Rates Rise
Yr 1 ROE	10.0%	10.0%	10.0%	10.0%
Annual ROE Fade (+/-)	-0.25%	-0.25%	-0.25%	0.00%
Final ROE	9.5%	9.5%	7.5%	10.0%
Years Until LT Spread	4	4	10	3
Implied Annual Ke Change (+/-)	0.38%	0.38%	-0.05%	0.67%
Final year ROE / Ke Spread	2.25%	2.25%	2.25%	2.25%
2016 P/E Multiple	16.0x	16.0x	21.7x	14.6x

W/ Case 2 ROE / Ke Assumptions: Rates Low For Long Time

Growth Assumptions	Base Case	Med Growth	Low Growth	Lowest Growth
Year 1 to 5 Rate Base Growth	5.25%	5.25%	4.00%	3.00%
Year 5+ Rate Base Growth	3.50%	2.50%	2.00%	1.00%
Terminal Growth	2.50%	2.00%	0.00%	NA
Terminal Value (beyond 35 years)	Yes	Yes	Yes	No
35 Year Average Payout Ratio - Implied	65%	67%	73%	84%
2016 P/E Multiple	21.7x	19.3x	17.5x	13.1x

W/ Case 1 (Base Case) ROE / Ke Assumptions: ROEs Fade / Rates Rise

Growth Assumptions	Base Case	Med Growth	Low Growth	Lowest Growth
Year 1 to 5 Rate Base Growth	5.25%	5.25%	4.00%	3.00%
Year 5+ Rate Base Growth	3.50%	2.50%	2.00%	1.00%
Terminal Growth	2.50%	2.00%	0.00%	NA
Terminal Value (beyond 35 years)	Yes	Yes	Yes	No
35 Year Average Payout Ratio - Implied	65%	73%	77%	87%
2016 P/E Multiple	16.0x	15.0x	14.5x	12.4x

W/ Case 3 ROE / Ke Assumptions: ROEs Flat / Rates Rise

Growth Assumptions	Base Case	Med Growth	Low Growth	Lowest Growth
Year 1 to 5 Rate Base Growth	5.25%	5.25%	4.00%	3.00%
Year 5+ Rate Base Growth	3.50%	2.50%	2.00%	1.00%
Terminal Growth	2.50%	2.00%	0.00%	NA
Terminal Value (beyond 35 years)	Yes	Yes	Yes	No
35 Year Average Payout Ratio - Implied	66%	74%	78%	87%
2016 P/E Multiple	14.6x	13.8x	13.4x	11.7x

Source: FactSet, Evercore ISI Research

Our Policy Team Believes That A June Fed Rate Hike Is More Likely Than Not

- According to Evercore ISI Analyst Krishna Guha, the March decision by the Fed not to raise rates and set a median path for only two hikes this year, down from four in December, reduces the risk of a hawkish Fed policy error and raises the likelihood of stronger nominal growth.

- Krishna is struck by the widening disconnect between market rate expectations in the US that discount less than one hike by year end and comments by relatively dovish Fed officials, which suggests to us that market participants may have gone too far in pricing out Fed hikes following Yellen's March FOMC speech and the "goldilocks" employment report in March. We believe Yellen is proceeding in a cautious and risk-averse manner, with an eye on helping to entrench the recent stabilization in global markets while accumulating substantial further evidence that the US remains resilient to external pressures, but we also think that she likely anticipates that it will be appropriate to move rates a quarter point higher in the Summer.

- According to our Head of Global Portfolio Strategy Dennis DeBusschere the Fed being constrained from raising rates (as U.S. monetary policy is linked to financial conditions and EM growth prospects) was the prevailing view at the EISI investor conference. Also as we said earlier in this note in early April the market odds of a Fed rate hike in June had dropped to 17%. That looked too low. The odds of a rate hike by the December FOMC meeting have increased to 58% from 46% yesterday and the odds of a rate hike in July are up to 33% from 22%. Keep an eye on the EISI company surveys over the coming weeks. If they start to improve, rate hike expectations should continue to move higher, putting more downward pressure on Utilities and Staples relative to Financials and Energy.

Source: FactSet, Evercore ISI Research

Utilities Have Outpaced The Market Dramatically Since The First Fed Rate Hike

- The last six times we approached a Fed tightening cycle, as measured by an increase in the Fed Funds Rate, utilities underperformed in the 12, 6 and 3 months prior to the first tightening
- This time around that underperformance was modest.
- The data never supported the notion that utilities are prone to continue underperforming once the Fed starts raising rates.
- Utilities have outperformed the market 8.4% YTD on the back of a 8% move vs. a 0.4% by the market.
- But they have pulled back recently as they probably started to discount too low a probability of two more Fed rate hikes this year.

Performance Before and After Initial Rate Tightening				10-Yr Treas. Yield Change	
Period	**ISI Utility**	**S&P 500**	**ISI Utility vs. S&P**	**Yield Change**	**% Change**
Prior to Rate Tightening (Last 6 Cycles)					
12 Months	2.7%	19.8%	(17.1%)	86 bps	16.5%
6 Months	1.6%	5.3%	(3.7%)	88 bps	14.7%
3 Months	(2.7%)	2.5%	(5.2%)	56 bps	9.8%
After Rate Tightening (Last 6 Cycles)					
3 Months	(1.9%)	(3.6%)	1.8%	(6 bps)	(1.2%)
6 Months	(2.3%)	(3.2%)	0.9%	20 bps	3.3%
12 Months	7.1%	4.6%	2.5%	(4 bps)	(1.1%)
Prior to Rate December Hike					
12 Months	(1.3%)	6.3%	(7.6%)	17 bps	8.0%
6 Months	5.7%	(0.9%)	6.7%	(8 bps)	(3.4%)
3 Months	2.3%	4.8%	(2.4%)	4 bps	1.8%
After December Hike					
3 Months	13.1%	1.1%	12.1%	(45 bps)	(20.2%)
6 Months	6.7%	2.8%	3.9%	(39 bps)	(17.2%)

Source: FactSet, Evercore ISI Research

Technical Readings From Evercore ISI Analyst Rich Ross Are Less Bullish

- Regulated utilities broke sharply below the 50 day moving average for the first time since January as 10 year yields moved out to their "highest" levels in over 2 weeks rising from 1.68 to 1.88 over that period. The trend remains higher for utilities and lower for yields and there is initial support near current levels around 207, but we must consider that given the magnitude of the recent run up and the ongoing strength in Crude and the reflation trade, that there is still room for yields to move higher and for Utilities to pull back to that rising trend line and 150 day ma around the big round number at 200.

Source: SNL Financial, Evercore ISI Research

Utility Sector Allocation Survey: LO Slightly Bearish, HF Near Historical Avg

- In our March Evercore ISI surveys (Oscar Sloterbeck's Team) long investors slightly more bearish than historical averages.
- Hedge fund sector allocation "net" position is 0%, the same reading as last month vs. "flat" historic average since 7/2004.

Institutional Equity Sector Allocation Survey

Sector	Net Position	Historic Avg.	Difference	+/- Stdev
Technology	+ 61%	+ 40%	+ 21%	20%
Cons Staples	- 9%	- 21%	+ 12%	15%
Financials	- 19%	- 27%	+ 8%	16%
Telecom	- 35%	- 42%	+ 7%	8%
Industrials	+ 13%	+ 11%	+ 2%	17%
Materials	- 18%	- 19%	+ 1%	13%
Cons Discretionary	+ 8%	+ 9%	- 1%	15%
Utilities	**- 72%**	**- 68%**	**- 4%**	**8%**
Healthcare	+ 4%	+ 11%	- 7%	10%
Energy	- 21%	+ 3%	- 24%	14%

Historic avg. since December 2003

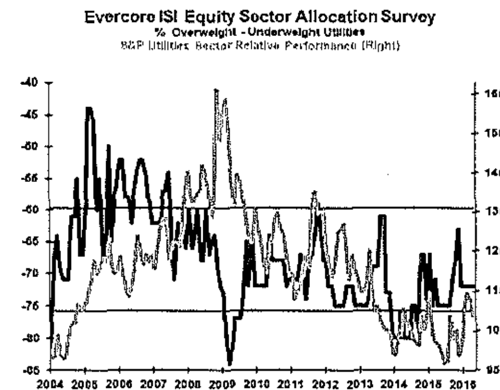
Hedge Fund Sector Allocation Survey

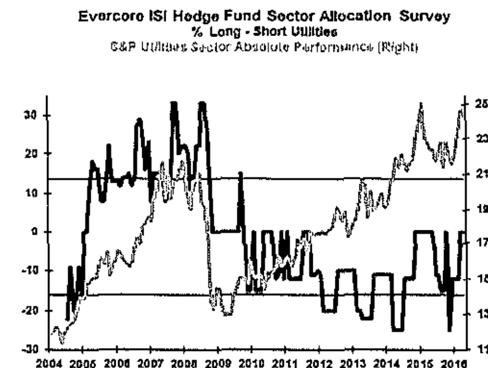
Sector	Net Position	Historic Avg.	Difference	+/- Stdev
Cons Discretionary	- 9%	- 33%	+ 24%	27%
Technology	+ 40%	+ 22%	+ 18%	21%
Telecom	+ 30%	+ 15%	+ 15%	17%
Materials	+ 10%	+ 7%	+ 3%	18%
Utilities	**0%**	**-1%**	**+1%**	**15%**
Energy	+ 30%	+ 31%	- 1%	24%
Healthcare	+ 22%	+ 36%	- 14%	19%
Cons Staples	+ 10%	+ 32%	- 22%	21%
Financials	- 37%	- 7%	- 30%	24%
Industrials	- 18%	+ 13%	- 31%	21%

Historic avg. since July 2004

*Data Through April 21, 2016

Utility Allocation is In Line With Historical Trends





Source: Oscar Sloterbeck's Survey Team at Evercore SI

Utilities Are Trading At A Less Discomforting Valuation.

- The group trades at 17.6x '16, 17.0x '17, and 15.9x '18 EPS and a 3.6% yield (on avg. excluding names with deal premiums). Our bottom up dividend discount model puts fair value for the average utility in our coverage universe today at around 16x on year forward earnings, so at 17.0X '17 EPS the stocks still look fully priced but are more reasonably valued.

- **In our 4/11 note and 4/12 Webinar with our Head of Global Portfolio Strategy Dennis DeBusschere we opined that we thought utilities were susceptible to a "rate hike" air pocket.** Dennis said that market based odds of a Fed rate hike in June were way too low at 17% and that as we approached the Fed's next commentary on April 27th improving economic data from China, higher commodity prices and EM credit tightening that those odds were likely to go up if the data continued to trend positive. We said with the bond market having rallied and utilities at higher valuations we thought it made them more susceptible to a pullback on a Fed rate hike in June despite looking better in the bond regression model. While this seems counterintuitive, our view was supported by the idea that utilities, treasuries and corporates trade more correlated to each other when the spread between treasuries and corporates tightens. While we sounded caution, we should have been more negative in our ratings construct (as we were last January), but we second guessed ourselves on how quickly the market would re-rate the group's valuation.

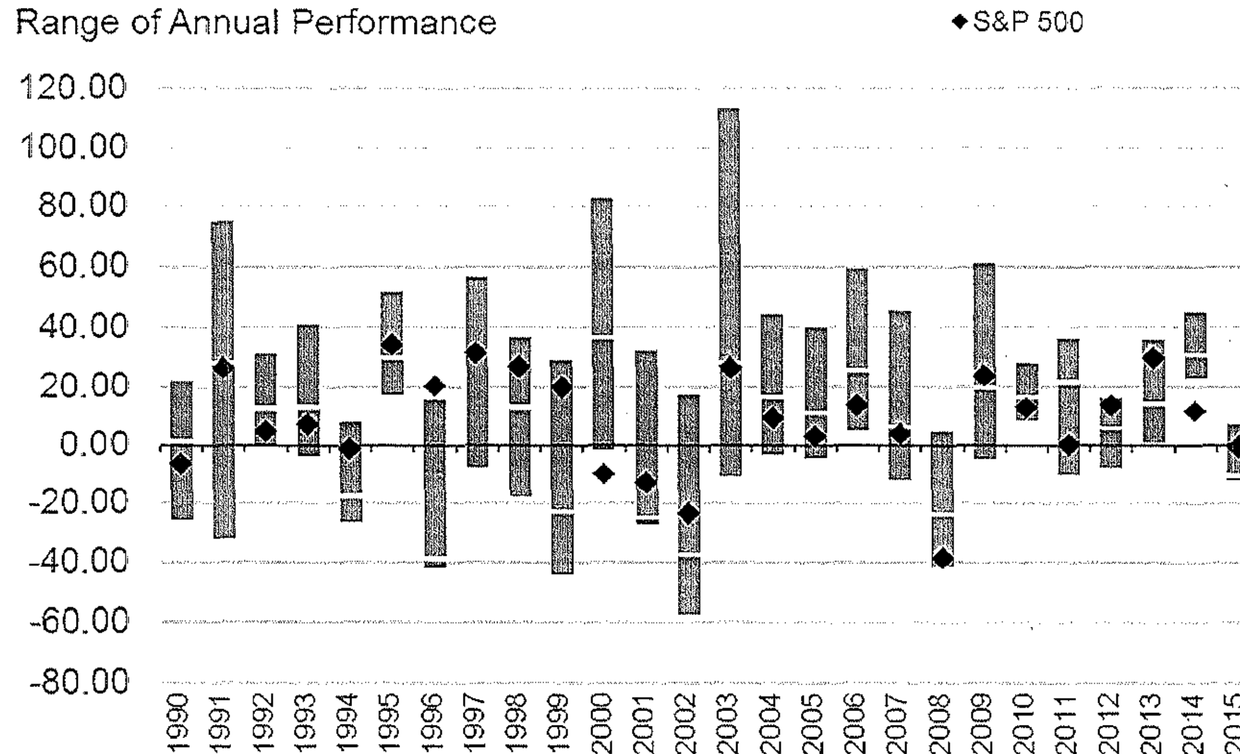
- If utilities were to trade down another multiple point to a 16X P/E on our average '17 EPS expectations, and we held all things equal, they would be trading at a relative P/E of 0.99x to the SP 500 and be 3% / 8% cheap in our bond model. At that average valuation we think there would be good entry points on the lower end of the valuation spectrum. If we drop below 16x on an average multiple, all things equal, then the higher quality names start to look more attractive. The relative stability of the utility total return profile is somewhat intriguing if we get back to lower valuations if one assumes a continued tough overall market backdrop

- From a stock selection perspective we have a barbell strategy in place. First, we are recommending differentiated growth stories that didn't perform particularly well in '15 because they didn't represent the "plain vanilla" defensive exposure investors seemed to crave. We have buy ratings on NEE, D, and SRE. All three underperformed in '15 but should get their lets back in 2016. Our other Buy ratings are more or less "plain vanilla" utilities that look like good relative values. Those names include AEP, EIX, and PCG. All of them trade at a discount on '18 EPS expectations but we believe can potentially convince investors over the next twelve months that they offer at least an industry average total return and risk profile.

Source: FactSet, Evercore ISI Research

Regulated Utilities are a "Stock Pickers" Group

- Standard deviation of returns has averaged ~13.5% in our regulated universe since 1990.



- In 2015 even excluding TE and UIL (up 34.5% and 16.3% respectively due to takeovers), the top five names in our coverage universe returned 5.2% whilst the bottom five returned (8.6%).
- As we showed on the prior page YTD the top five names have 11.7% average total return vs. 6.3% for the bottom five.

Source: FactSet, Evercore ISI Research

Buy Rate Stocks – SRE, D, EIX, NEE, PCG, and AEP

- **SRE – BUY, TP: $110.00, ETR: 12%:** We remain confident in SRE's ability to achieve at least its 11% EPS growth target from '15-'19 with 8% dividend growth over that period. This is contingent on achieving their base capital investment plan, with upside if more of SRE's infrastructure investment opportunities come to fruition (closing the acquisition of PEMEX's portion of their Mexican pipeline JV, other pipeline projects in the U.S. and Mexico, further renewable energy investments, and other activities). We still believe the lower end of SRE's $7.00-$7.50 EPS target for FY '19 is achievable despite the sale of REX (we assume sales proceeds will be used for debt reduction). Our forecast includes the negative impact from recent macro headwinds (Latin American currency/commodity prices), and assumes that by 2018 LNG development expenses for Port Arthur are no longer an EPS drag, the earnings contribution from the new renewables projects announced in early '15 now impact '17 EPS, and the PEMEX JV acquisition contributes earnings of $0.02/share in '16 vs. $0.05 previously (in line with SRE's revised guidance) but still grows to $0.10 in '19. The risk/reward is not as compelling today as it was in December/January when the stock was under more pressure due to the Aliso Canyon gas leak, but with utility valuations nearing January '15 highs, SRE looks like a better value than most of the stocks in our regulated utility coverage universe. The company believes that its insurance policies provide >$1bn in coverage in the Aliso Canyon gas leak and will pay for the majority of the costs they incur associated with the incident. SRE's EPS growth opportunity post '19 could decelerate with the absence of the potential addition of one more LNG export train at Cameron, one at Costa Azul, and perhaps two trains at the greenfield facility at Port Arthur. However, the current business platform supports our target price before factoring in the value of any incremental LNG growth opportunities.

- **D – BUY, TP: $74.00, ETR: 11%:** Dominion is one of the diversified growth stories that we continue to find attractive. There is some debate that D might be a bit "cuspy" for a Buy rating in the very short run given its valuation and some concern about the near term earnings mix – namely the large contribution of renewable ITC as a percentage of total EPS in 2016. However, VEPCO is still one of the best positioned utilities in the group, with rate base growth visibility and no rate risk through at least 2022. Cove Point (COD in late '17) and ACP (COD in late '18) should improve the earnings quality and support earnings growth with full year contributions in '18 and '19, respectively. While MLP's are obviously under pressure, Dominion Midstream has maintained a premium valuation due to its premium asset profile (D has guided to ~$2Bn of potential drop down eligible assets excluding the Atlantic Coast Pipeline, CGT and Iroquois), placing DM at the top of peers in terms of expected distribution growth. Despite facing potential EPS headwinds in '17, if they don't secure more renewable investment projects post '16, we still see D as having a credible path to achieving their EPS growth target of 5-6% through '17, accelerating to 7-9% through '20.

- **EIX – BUY, TP: $70.00, ETR: 6%:** On the 4Q15 call, EIX announced they would be recovering incremental capital spending through 2017 on their pole replacement program, allowing the company to offset any impact of bonus depreciation over our forecast period. EIX's expects rate base growth of 7% annually through 2017. We expect capital spending will exceed $4bn annually in 2018 and beyond. We forecast EIX maintaining a strong parent balance sheet and not needing equity to fund its capital spending plan and dividend increases over the next two years. We forecast the current dividend of $1.92 / share rising to $2.28 / share in FY'18, a 52% payout ratio and '16-18 CAGR of 9%. Lastly, we expect the SONGS nuclear plant settlement to be upheld which will finally completely de-risk the EIX investment thesis on this issue.

 Source: Evercore ISI Research

Buy Rated Stocks

- **NEE – BUY, TP: $114.00, ETR: 4%:** NEE's core utility business (FPL) offers a better than industry average rate base and earnings growth profile in a historically stable regulatory environment. We believe the 2016 rate case proceeding will result in a constructive outcome for the core utility. The company also continues to be the largest renewable energy developer in North America with a robust growth backlog of development opportunities, which bolsters EPS growth visibility. The recently extended wind and solar tax credits stand to benefit NEE's development arm and remove some uncertainty about their ability to expand their project backlog. Our forecast corroborates NEE's total return aspirations. Given their capital investment initiatives, they expect to grow EPS at a 6-8% average annual rate through at least '18, with operating cash flow growing 9% annually over that same period and dividend growth of 12%-14%. NEP, NEE's YieldCo vehicle, has a highly visible medium-term distribution growth profile and the ability to limit its dependence on public equity markets due to its strong relationship with NEE and the sponsor's willingness to support the YieldCo through the current market volatility, which makes NEP one of the best positioned yield vehicles to weather current market conditions.

- **PCG – BUY, TP: $57.00, ETR: 4%:** PCG is poised to finally get its San Bruno issues behind it in 2016. The criminal case regarding San Bruno begins in April and should be resolved in mid-'16, but we believe financial exposure related to a potentially negative outcome is already priced into the stock. The company boasts $5.3-6.5bn in capex annually through 2017 driving rate base growth of 5-7%. With significant further balance sheet setbacks unlikely we think they can get on a steady path to EPS growth and start growing the dividend. The company is still reviewing its dividend policy, but we think they are likely to raise the dividend in '16 for the first time in five years and articulate a dividend growth policy that could make the total return profile look more like industry peers. If we are wrong, the stock is already pretty cheap, so we like the risk/reward.

- **AEP – BUY, TP: $62, ETR: 3%:** Looking at AEP's business profile after the proposed sale of its merchant power assets (expected by YE '16), we think the balance sheet, earnings, and dividend growth outlook are similar to other "low risk" regulated utilities, with XEL energy being the closest comparable. XEL trades at a discount to "premium" names like WEC and CMS, more in line with SO, and at a premium to DUK. If we divide AEP's current share price by XEL's P/E multiple, the stock is discounting '18 earnings that look conservative under most scenarios given our view on potential dilution from merchant generation asset sale. The PUCO has approved the settlement which allows a portion of AEP's merchant fleet to be contracted (similar to the deal granted to FE). Looking at the range of potential EPS outcomes assuming a full sale (in the event FERC intervenes and negates the PPAs) or partial divestiture with retention of the assets that are contracted, we like the risk/reward. If the PPA ultimately stands, we see the potential for minimal dilution of our current "status quo" estimate of $4.20/share EPS estimate in '18. Assuming a 50/50 cap structure and a 10.38% ROE on the $1.6Bn PPA asset value, the contract would contribute an incremental +/-$0.11/share to AEP's consolidated EPS (on top of what the assets would get in the wholesale market; on current share count). Further, essentially all of the debt on the generation assets would remain with the PPA assets by virtue of the approved capitalization, leaving AEP to dispose of +/-5,245 MWs of relatively unencumbered power plants with EBITDA of ~$260m. Assuming a 5.0x EBITDA multiple, and before tax leakage, we project proceeds of ~$1.4Bn, which, if used entirely for share buybacks, would result in minimal dilution of our '18 estimate, when considering the EPS contribution of the PPA.

 Source: Evercore ISI Research

ANALYST CERTIFICATION

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Buy – the total forecasted return is expected to be greater than 10%
Hold – the total forecasted return is expected to be greater than or equal to 0% and less than or equal to 10%
Sell – the total forecasted return is expected to be less than 0%
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Buy - Return 10% to 20%
Neutral - Return 0% to 10%
Cautious - Return -10% to 0%
Sell - Return < -10%

For disclosure purposes, ISI Group and ISI UK ratings were viewed as follows: Strong Buy and Buy equate to Buy, Neutral equates to Hold, and Cautious and Sell equate to Sell.

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Ratings	Count	Pct.
Buy	337	51%
Hold	287	43%
Sell	24	4%
Coverage Suspended	7	1%
Rating Suspended	7	1%

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Rating	Count	Pct.
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Sell	2	8%
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Rating Suspended	0	0%

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