Northwest Natural Gas (NWN)

Updated April 16th, 2018 by Josh Arnold

Key Metrics

Current Price:	$60	**5 Year CAGR Estimate:**	0.8%	**Quality Percentile:**	N/A
Fair Value Price:	$46	**5 Year Growth Estimate:**	2.9%	**Momentum Percentile:**	N/A
% Fair Value:	131%	**5 Year Valuation Multiple Estimate:**	-5.2%	**Total Return Percentile:**	N/A
Dividend Yield:	3.1%	**5 Year Price Target**	$53	**Valuation Percentile:**	N/A

Overview & Current Events

NW Natural was founded in 1859 and has grown from just a handful of customers to serving 740,000 today. The utility's mission is to deliver natural gas to its customers in the Pacific Northwest and it has done it well, affording it the ability to raise its dividend for 60 consecutive years and sport a market cap of $1.7B.

The company's 2017 results fell on impairment charges but volume growth has been strong thanks to steady customer growth. In addition, NWN is due for a sizable pricing increase in some of its markets later this year, so after years of very slow growth, things are looking up. It also purchased two private water utilities outside of its core markets, looking to expand and diversify simultaneously. Growth will be slow going forward but the company isn't resting on its laurels.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$2.57	$2.83	$2.73	$2.39	$2.22	$2.24	$2.16	$1.96	$2.12	$1.94	***$2.30***	***$2.65***
DPS	$1.52	$1.60	$1.68	$1.75	$1.79	$1.83	$1.85	$1.86	$1.87	$1.88	***$1.89***	***$2.10***

EPS has declined rather steadily in the past decade or so as NWN has been unable to push through any pricing increases. It is obviously highly regulated and as such, is not in control over its pricing and margins. Revenue has fallen as well, providing another headwind to earnings growth. We are forecasting an average growth rate of 2.9% for the next five years as NWN pushes through approved pricing increases and continues to acquire customers at low single digit rates. NWN also has its water utilities that will provide a small amount of growth, but higher EPS will primarily come from customer and pricing growth.

The company's dividend has been raised for more than 60 years and the stock yields a respectable 3.1%, so the payout is of great importance to shareholders. The dividend has grown very slowly in recent years as a lack of earnings growth has capped the amount of cash NWN can return to shareholders. We are therefore forecasting 2% dividend growth going forward in a continuation of that trend. NWN's payout ratio has grown too much to allow for higher rates of growth.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	18.1	15.2	17.0	19.0	21.1	19.4	20.7	23.7	26.9	31.9	***26.1***	***20.0***
Avg. Yld.	3.3%	3.7%	3.6%	3.9%	3.8%	4.2%	4.1%	4.0%	3.3%	3.0%	***3.1%***	***4.0%***

NWN's PE has risen substantially during the past decade as dividend stocks have become more valuable with low rates persisting around the globe. This has seen NWN's PE rise from 15.2 in 2009 to 31.9 in 2017, although it has settled at 26.1 today. Still, with rates rising and dividend stocks losing their luster when it comes to high valuations, we are forecasting a 5.2% headwind to total returns from a PE multiple that should fall back towards 20 from today's levels.

The yield will rise from today's 3.1% to a more normalized 4.0% in the next five years as the dividend grows but the stock's valuation falls. NWN's massive rise in its PE multiple has created an uncharacteristically low yield in recent years, a situation we do not believe will persist.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	34.3%	37.2%	45.3%	43.5%	51.4%	50.8%	51.5%	54.8%	61.4%	57.4%	***60.0%***	***60.0%***
Debt/A	52%	72%	74%	74%	74%	75%	75%	75%	72%	76%	***76%***	***75%***
Int. Cov.	3.9	4.0	3.9	3.4	3.3	3.2	3.2	2.9	3.6	3.6	***3.6***	***3.7***
Payout	59%	56%	61%	73%	80%	81%	85%	92%	87%	97%	***82%***	***79%***
Std. Dev.	37.8%	22.0%	20.1%	21.8%	14.4%	14.3%	15.8%	18.9%	21.3%	15.7%	***18.0%***	***20.0%***

NWN's quality metrics have been very steady in the past decade as its financial position hasn't changed much. Since it is highly regulated, it has limited flexibility when it comes to financing and indeed, it has limited need for additional financing since its business is largely fixed. Seventy-six percent of its total assets are financed by debt, which is completely acceptable for a utility. Its interest coverage is therefore fairly strong at 3.6, a number which we expect will creep higher over the coming years as earnings improve slightly and debt remains stable.

The dividend is consuming almost all of NWN's earnings currently but that situation should improve as EPS picks up this year and growth returns in the coming years. Steadily declining EPS has caused the payout ratio to move significantly higher but given NWN's improved outlook for at least some EPS growth, that situation should improve going forward.

NWN's obvious competitive advantage is in its monopoly in its service areas. It competes against other types of fuel but it is the only gas supplier in its distribution areas. That allowed it to perform extremely well during the Great Recession as discretionary use of natural gas is very low, and thus during hard economic times, NWN fares well, as you'd expect.

Final Thoughts & Recommendation

Overall, NWN looks to be well in excess of fair value. The combination of the 3.1% yield, 5.2% headwind from the valuation decline and 2.9% EPS growth should keep total returns at just 0.8% annually. This makes NWN unfavorable from a growth and value perspective as the valuation should return to more normal levels in the coming years, and growth is limited by the fact that it is a utility. The current yield is nice but should offer better opportunities later on as the payout grows but the stock price languishes. NWN is only for investors seeking a safe, 3%+ current yield.

Total Return Breakdown by Year