Otter Tail Corporation (OTTR)

Updated June 1st, 2018 by Josh Arnold

Key Metrics

Current Price:	$46	**5 Year CAGR Estimate:**	5.4%	**Quality Percentile:**	N/A
Fair Value Price:	$41	**5 Year Growth Estimate:**	5.0%	**Momentum Percentile:**	N/A
% Fair Value:	113%	**5 Year Valuation Multiple Estimate:**	-2.5%	**Total Return Percentile:**	N/A
Dividend Yield:	2.9%	**5 Year Price Target**	$52	**Valuation Percentile:**	N/A

Overview & Current Events

Otter Tail Corporation goes back to 1907 with its electric utility, which was founded in Fergus Falls, MN. The company eventually expanded into metal fabrication and plastics manufacturing and today, it has about $900M in annual revenue split between utility (51%), manufacturing (27%) and plastics (22%) operations, and has a $1.8B market cap.

The company's recently reported Q1 was excellent as OTTR produced a large increase in revenue and earnings per share, and even increased guidance for the full year as a result of a strong outlook. Total revenue was up 13%, driven by higher rates for its North Dakota utility, as well as higher volumes for its manufacturing and plastics businesses. Margins increased as well as OTTR was able to boost EPS by an exceptional 35% YoY. In other news, OTTR filed for rate increases in North Dakota and South Dakota and while the former allowed an interim increase while the case was being reviewed, progress there looks unfavorable at this point for the full 4.8% increase. The South Dakota rate case is still under consideration but an interim rate increase was denied. OTTR's utility outlook is still bright but these are short term setbacks in terms of recovering its costs and generating return on equity.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$1.09	$0.71	$0.38	$0.45	$1.05	$1.37	$1.55	$1.56	$1.60	$1.86	***$2.00***	***$2.55***
DPS	$1.19	$1.19	$1.19	$1.19	$1.19	$1.19	$1.21	$1.23	$1.25	$1.28	***$1.34***	***$1.50***

OTTR's EPS history has been fairly strong in the last decade as earnings bottomed in 2010 and have grown every year since. Guidance for this year is for ~$2 in EPS and we see average growth of 5% going forward. OTTR will achieve this growth via revenue increases from its utility business – assuming its rate cases in the states in which it operates come through with some sort of approval – as well as continued strong performances in its other two, non-utility lines of business. It continues to increase margins as well and the diversification OTTR offers over other utilities is certainly a strength that is showing its value. The company's manufacturing and plastics businesses have benefited from higher order rates as well as a lower income tax rate, while seeing gross margins tick higher over time. We see all of these factors as continuing until further notice and as a result, OTTR's EPS should grow steadily in the coming years.

The dividend was stagnant from 2008 to 2013 as OTTR wasn't able to cover the payout with earnings. However, that situation has rectified itself as the company has managed to produce some robust earnings growth and as a result, the dividend is being raised again. This is an important factor for the stock and we see modest payout growth ahead.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	30.1	31.2	55.1	47.5	21.7	21.1	18.8	18.2	20.2	22.1	***23.1***	***20.4***
Avg. Yld.	3.6%	5.4%	5.7%	5.6%	5.2%	4.1%	4.1%	4.3%	3.9%	3.1%	***2.9%***	***2.9%***

OTTR's P/E multiple has moved significantly lower in recent years after being artificially inflated due to low EPS from 2008 to 2011. However, today's multiple of 23.1 is in excess of its recent historical norm of 20.4 and as such, we see the stock as overvalued here. We think shares will drift back towards a multiple of 20.4 over time, causing a modest 2.5% headwind to total returns. The yield should remain where it is today at 2.9% as dividend increases keep pace with the stock and OTTR remains a decent income stock choice among utilities.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	20.0%	22.7%	11.8%	13.1%	19.0%	18.3%	21.3%	23.5%	24.7%	25.2%	***25.0%***	***25.5%***
Debt/A	59%	61%	63%	66%	67%	66%	67%	67%	65%	65%	***65%***	***65%***
Int. Cov.	2.9	1.8	1.8	2.1	2.7	3.3	3.5	3.6	3.6	4.3	***4.5***	***4.7***
Payout	108%	--	--	--	113%	87%	78%	79%	78%	69%	***68%***	***59%***
Std. Dev.	54.6%	40.5%	25.1%	16.5%	10.1%	24.3%	19.3%	18.7%	15.9%	15.9%	***18.0%***	***21.0%***

OTTR's quality metrics have improved over the past decade, although most gains have been slight. The largest improvement is in gross margins, which has driven profitability and earnings growth along with its impressive rates of revenue growth more recently. We see a continued long term tailwind for gross margins although further gains are likely to be slight. The company's balance sheet is very clean for a utility and its interest coverage is more than sufficient, so no financing concerns exist. The payout ratio should fall from today's 68% to ~59% as earnings improve and growth outpaces increases in the dividend.

OTTR's competitive advantage of having a diversified business model is also its disadvantage during recessions. The non-utility businesses are providing strong growth today but during the last recession, earnings fell much more than you'd expect for a pure utility. That will happen again next time there is a downturn so investors should keep this in mind.

Final Thoughts & Recommendation

We see OTTR as a stock that has a strong growth outlook compared to its peers but also one that is trading in excess of fair value. Growth levers with all three of its businesses are apparent but the stock's strong returns in the past two years have left it overvalued. We see total returns of 5.4% annually moving forward, consisting of the current 2.9% yield, 5% EPS growth and a 2.5% headwind from the lower valuation. OTTR's dividend is safe so it would be appropriate for income investors as well as those seeking moderate levels of growth. It is not a value stock at this stage so investors that are interested in OTTR would do well to wait for a better price.

Total Return Breakdown by Year