



Middlesex Water (MSEX)

Updated August 5th, 2018 by Josh Arnold

Key Metrics

Current Price: \$43	5 Year CAGR Estimate: -1.7%	Volatility Percentile: 79.3%
Fair Value Price: \$32	5 Year Growth Estimate: 1.9%	Momentum Percentile: 55.3%
% Fair Value: 134%	5 Year Valuation Multiple Estimate: -5.7%	Valuation Percentile: 12.9%
Dividend Yield: 2.1%	5 Year Price Target \$36	Total Return Percentile: 2.5%

Overview & Current Events

Middlesex Water Company was formed in 1897. The company is a water and wastewater utility in New Jersey and Delaware. Its market capitalization is \$700 million, and it produces about \$130 million in revenue annually. Middlesex has paid consecutive dividends since 1912 and has reached its 44th consecutive year of dividend increases.

Middlesex reported Q2 earnings on 8/2/18 and results were very strong. Earnings-per-share rose 58% against the comparable quarter last year, driven mostly by a lower tax rate. However, revenue did rise thanks to a rate base increase approved in New Jersey that took effect in April. Operating and maintenance expenses also fell slightly, improving margins. The company's interest expense rose significantly, increasing from \$1.4 million in last year's Q2 to \$2.0 million in this one, so that is something shareholders will want to keep an eye on. In addition, Q2's spectacular earnings growth was due almost entirely to lower taxes, so it is not repeatable. We maintain our 2018 estimates.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	\$0.89	\$0.72	\$0.96	\$0.84	\$0.90	\$1.03	\$1.13	\$1.22	\$1.38	\$1.38	\$1.50	\$1.70
DPS	\$0.70	\$0.71	\$0.72	\$0.73	\$0.74	\$0.75	\$0.76	\$0.78	\$0.81	\$0.86	\$0.90	\$1.10

Earnings-per-share has been rising fairly steadily over the past decade, although gains have been far from linear. The Great Recession saw earnings fall markedly in 2009 but recovery was fairly quick and since 2009, earnings have essentially doubled. We see total earnings-per-share growth for the next five years of just 1.9%, which is slightly below historical rate of growth. However, the only meaningful sources of growth will be the rate increase in New Jersey and lower taxes. The rate hike will boost revenue by ~3% this year and a lower tax rate will help as well, but starting in 2019, those things will be part of the comparable base. Therefore, growth will look much better in 2018 than in later years, a fact reflected by our estimates. Following this year, earnings growth will have to come primarily from cutting operating expenses and customer growth, both of which have historically contributed small amounts of growth.

We are forecasting the dividend to continue its streak of small increases, rising from this year's payout of 90 cents to \$1.10 in five years' time. Middlesex has an impressive streak of dividend increases that will continue to grow but on a percentage basis, the payout will rise rather slowly. The company's payout ratio was far too high during the Great Recession and management pulled way back on dividend increases to avoid a similar fate down the road.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	19.8	21.0	17.8	21.7	20.8	19.7	18.5	19.1	25.6	28.4	28.4	21.2
Avg. Yld.	4.0%	4.7%	4.2%	4.0%	4.0%	3.7%	3.7%	3.3%	2.3%	2.2%	2.1%	3.1%

The company's price-to-earnings multiple has risen sharply in recent years and as a result, the stock looks substantially overvalued today. After spending much of the past decade under 20, the current multiple is 28.4, becoming even more expensive since our last update. We are forecasting a decline back towards 21 in five years, indicating a meaningful 5.7% annual headwind to total returns. Given the stock's growth profile, it simply cannot sustain a price-to-earnings multiple near its current level.

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

Given this and weak dividend growth, we are forecasting the yield to rise back to more normalized levels in excess of 3% from the current 2.1%. The yield is another way to demonstrate just how overvalued Middlesex is today, but we see that situation being rectified by a lower stock price and higher payout going forward.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	50.8%	42.6%	46.0%	44.5%	45.2%	46.8%	49.5%	48.3%	50.7%	50.6%	50.5%	50.5%
Debt/A	68%	69%	64%	66%	67%	64%	65%	64%	64%	65%	65%	65%
Int. Cov.	3.6	3.2	4.0	4.1	4.2	5.3	6.1	6.5	7.5	7.2	7.4	7.6
Payout	78%	98%	75%	87%	83%	73%	67%	63%	58%	62%	60%	65%
Std. Dev.	43.2%	38.7%	28.2%	28.5%	16.7%	21.6%	19.3%	20.6%	30.7%	26.0%	27.0%	27.3%

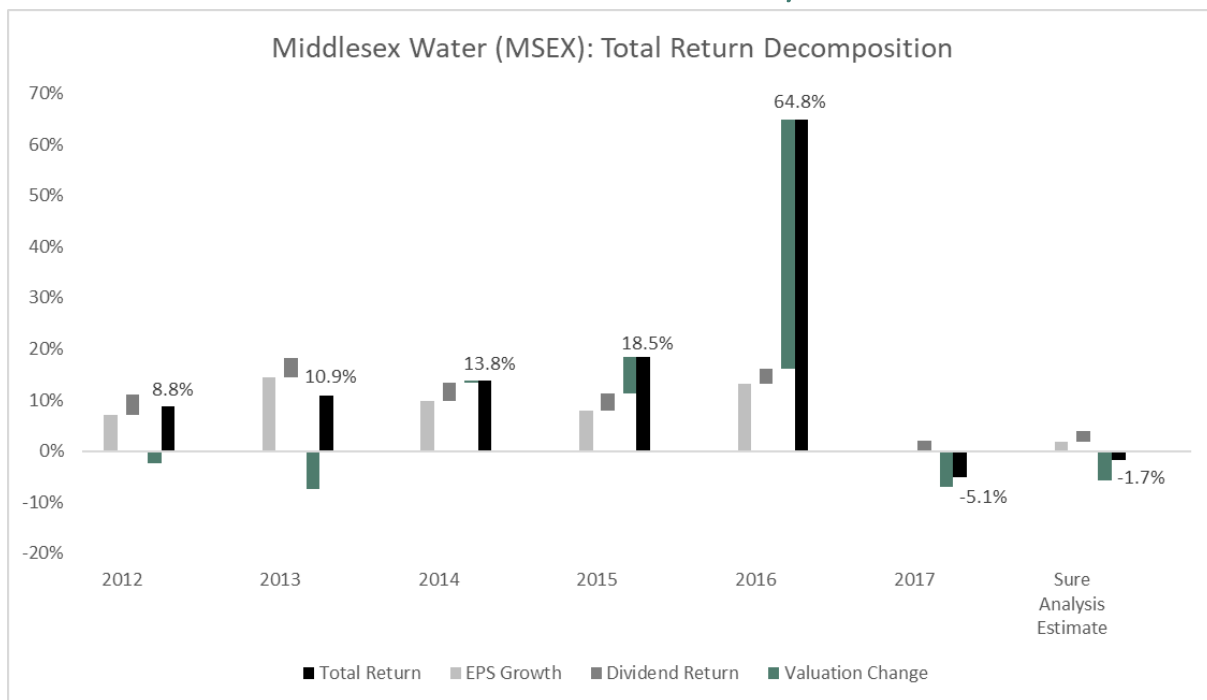
Like many other utilities, Middlesex’ quality metrics have remained steady in the past decade. Its margins are right where they were 10 years ago and have remained very stable in the past few years in particular. Its assets are 65% debt-financed, allowing for an excellent interest coverage ratio for a utility. Middlesex has the balance sheet to weather any economic storm so there is no question of safety, but obviously growth remains an issue. The payout ratio neared 100% in 2009 but slow growth in dividends and better rates of earnings-per-share growth have led it back down to 60% today. We see that rising slightly over time but overall, the dividend is very safe.

Middlesex’ recession performance is decent given that it sells the most basic staple of all and indeed, its revenue was basically flat in 2009 at the height of the recession. Its earnings didn’t fare quite as well, but it certainly stood up to the Great Recession. Its obvious competitive advantage is in the monopoly it enjoys in its service area.

Final Thoughts & Recommendation

Middlesex looks to be overvalued here as the stock has had an impressive run in the past several years. We see total annual returns of -1.7% going forward, consisting of the current 2.1% yield, 1.9% earnings-per-share growth and a 5.7% headwind from the valuation reset. Its impressive dividend history is certainly worth noting but the current yield is too low to attract income investors. Middlesex would also be unattractive for those seeking growth or value, given the low potential for the former and very high current valuation. We recommend selling MSEX at current prices and investing the proceeds elsewhere due its -1.7% expected total returns over the next 5 years.

Total Return Breakdown by Year



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