Otter Tail Corporation (OTTR)

Updated August 15th, 2018 by Josh Arnold

Key Metrics

Current Price:	$49	**5 Year CAGR Estimate:**	4.7%	**Volatility Percentile:**	23.5%
Fair Value Price:	$42	**5 Year Growth Estimate:**	5.0%	**Momentum Percentile:**	63.8%
% Fair Value:	117%	**5 Year Valuation Multiple Estimate:**	-3.0%	**Valuation Percentile:**	35.8%
Dividend Yield:	2.7%	**5 Year Price Target**	$53	**Total Return Percentile:**	26.6%

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 $900 million in annual revenue split between utility, manufacturing and plastics operations. Otter Tail has a $1.9 billion market capitalization.

Otter Tail reported Q2 earnings on 8/7/2018 and results were strong. Revenue rose almost 7% and earnings-per-share increased from 42 cents to 47 cents. All of the company's operating segments saw higher profits as the utility business benefited from favorable weather, the plastics business produced higher margins and the manufacturing segment saw volume growth. Overall, Otter Tail's Q2 was quite good and we've raised our estimate of earnings-per-share per management's new guidance of $1.95 to $2.10.

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	***$2.05***	***$2.60***
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***

Otter Tail's earnings-per-share 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 about $2 and we see average growth of 5% going forward. Otter Tail 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. Indeed, the North Dakota Public Services Commission reached a settlement agreement in July with Otter Tail on its pending rate case in the state, so things are looking up for the utility business there. It continues to increase margins as well and the diversification it 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, earnings should grow steadily in the coming years.

The dividend was stagnant from 2008 to 2013 as Otter Tail was not 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	***23.8***	***20.4***
Avg. Yld.	3.6%	5.4%	5.7%	5.6%	5.2%	4.1%	4.1%	4.3%	3.9%	3.1%	***2.7%***	***2.9%***

The stock's price-to-earnings multiple has moved significantly lower in recent years after being artificially inflated due to low earnings-per-share from 2008 to 2011. However, today's multiple of 23.8 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 3.0% headwind to total returns. The yield should remain near where it is today at 2.7% as dividend increases keep pace with the stock and Otter Tail 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%	***65%***	***58%***
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%***

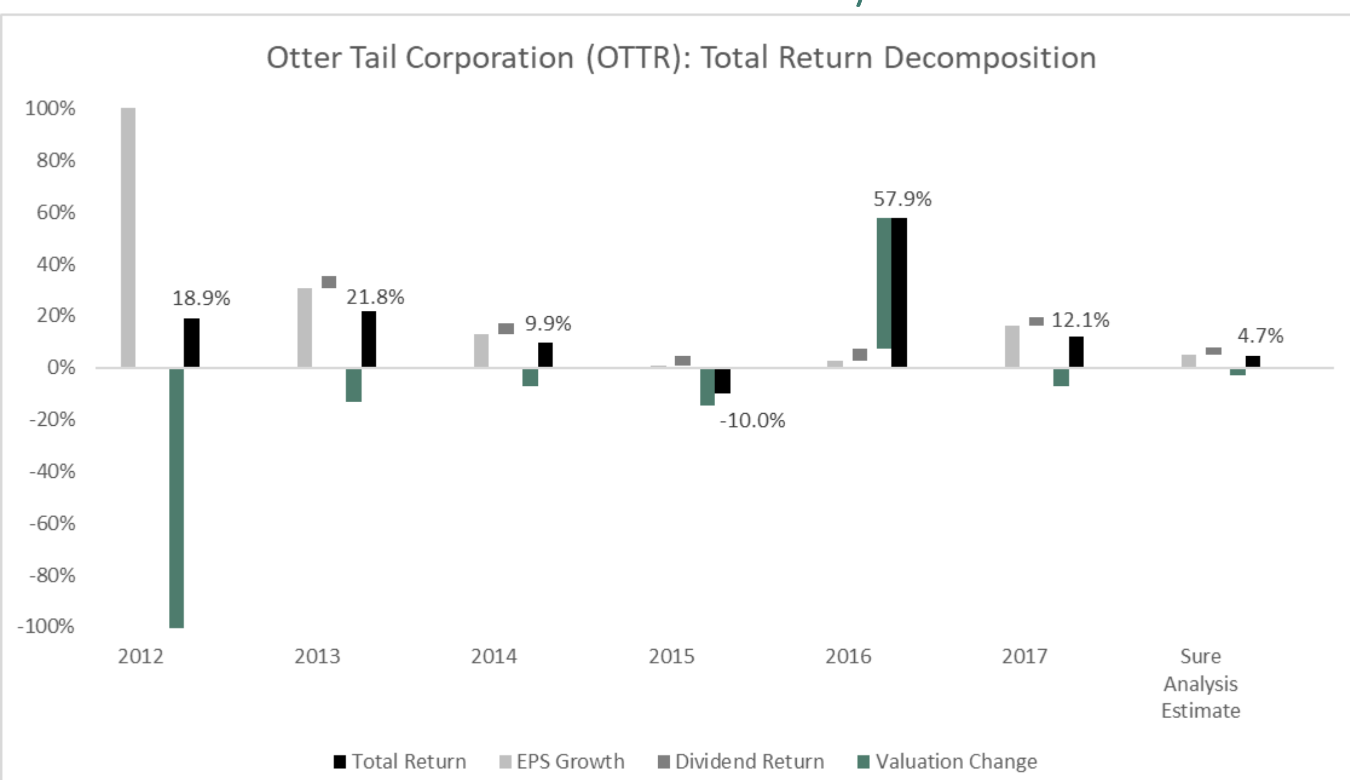
Otter Tail's quality metrics have improved over the past decade, although most gains have been slight. The largest improvement is in gross margins, which has driven profitability and earnings growth along with its impressive rates of revenue growth. We see a continued long-term tailwind for gross margins, 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 65% to 58% as earnings improve and growth outpaces increases in the dividend.

Otter Tail'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 next time there is a downturn, so investors should keep this in mind.

Final Thoughts & Recommendation

We see Otter Tail 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 4.7% annually moving forward, consisting of the current 2.7% yield, 5% earnings-per-share growth and a 3.0% headwind from the lower valuation. The 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 Otter Tail would do well to wait for a better price. Given all of this, we rate Otter Tail a sell due to the high valuation and low projected total returns.

Total Return Breakdown by Year



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.