Northwest Natural Gas (NWN)

Updated August 14th, 2018 by Josh Arnold

Key Metrics

Current Price:	$64	**5 Year CAGR Estimate:**	-0.5%	**Volatility Percentile:**	N/A
Fair Value Price:	$46	**5 Year Growth Estimate:**	2.9%	**Momentum Percentile:**	N/A
% Fair Value:	139%	**5 Year Valuation Multiple Estimate:**	-6.4%	**Valuation Percentile:**	N/A
Dividend Yield:	3.0%	**5 Year Price Target**	$53	**Total Return 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 that well, affording it the ability to raise its dividend for 60 consecutive years. NW Natural trades with a market capitalization of $1.8 billion.

NW Natural reported Q2 earnings on 8/7/18 and results were somewhat mixed. NW Natural made progress on several fronts operationally, including selling its Gill Ranch storage interest, creating plans to buy two private water utilities in Washington, reaching an agreement with Oregon's utility regulator on rates, and producing 1.6% customer growth year-over-year. However, the timing of certain tax items sent earnings-per-share to a loss of 3 cents against a profit of 10 cents in the comparable quarter last year. We continue to see NW Natural as producing mid-single digit growth over the long-term and given the progress made in Q2, we've reiterated our estimate for this year of $2.30.

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***

Earnings-per-share has declined rather steadily in the past decade or so as NW Natural 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 NW Natural pushes through approved pricing increases and continues to acquire customers at low single digit rates, as it did in Q2. NW Natural also has its water utilities business that will provide a small amount of growth, but higher earnings 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 3.0%, 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 NW Natural can return to shareholders; we are forecasting 2% dividend growth going forward in a continuation of that trend. The 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	***27.8***	***20.0***
Avg. Yld.	3.3%	3.7%	3.6%	3.9%	3.8%	4.2%	4.1%	4.0%	3.3%	3.0%	***3.0%***	***4.0%***

NW Natural's price-to-earnings multiple has risen substantially during the past decade. This has seen the stock's multiple rise from 15.2 in 2009 to 31.9 in 2017, although it has settled at 27.8 today. Still, with rates rising and dividend stocks losing their luster when it comes to high valuations, we are forecasting a 6.4% headwind to total returns from a price-to-earnings multiple that should fall back towards 20 from today's levels.

We believe the yield will rise from today's 3.0% to a more normalized 4.0% in the next five years as the dividend grows but the stock's valuation falls. NW Natural's massive rise in its price-to-earnings 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%***

NW Natural's quality metrics have been very steady in the past decade as its financial position has not 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 encumbered 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.

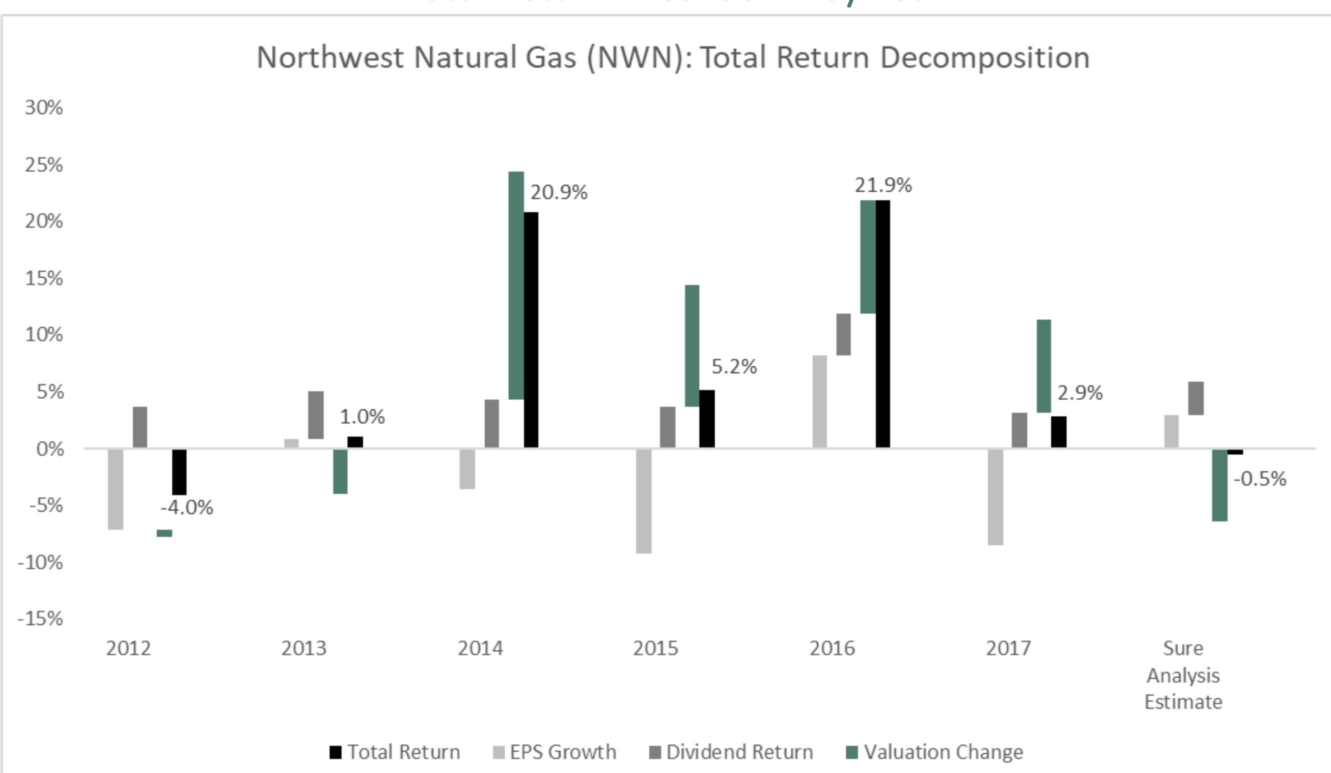
The dividend is consuming almost all of NW Natural's earnings currently, but that situation should improve as earnings growth picks up this year and beyond. Steadily declining earnings has caused the payout ratio to move significantly higher but given the improved outlook for at least some growth, that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

Its 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, the company fares well.

Final Thoughts & Recommendation

Overall, NW Natural looks to be well in excess of fair value. The combination of the 3.0% yield, 6.4% headwind from the valuation decline and 2.9% earnings growth should keep total returns at -0.5% annually. This makes the stock 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. Given this, we rate the stock a sell despite the strong yield.

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.