MGE Energy (MGEE)

Updated November 7th, 2018 by Josh Arnold

Key Metrics

Current Price:	$62	**5 Year CAGR Estimate:**	-2.2%	**Volatility Percentile:**	17.2%
Fair Value Price:	$42	**5 Year Growth Estimate:**	2.8%	**Momentum Percentile:**	34.3%
% Fair Value:	146%	**5 Year Valuation Multiple Estimate:**	-7.2%	**Growth Percentile:**	10.1%
Dividend Yield:	2.2%	**5 Year Price Target**	$49	**Valuation Percentile:**	6.2%
Dividend Risk Score:	A	**Retirement Suitability Score:**	B	**Total Return Percentile:**	1.7%

Overview & Current Events

MGE Energy has grown out of a small power station in Wisconsin built in 1902 to a $2.1 billion market capitalization, integrated energy company today. The company has paid consecutive dividends for more than 100 years and has raised its payout for the past 42 years. MGE principally operates gas and electric utilities in addition to transmission and construction businesses, which collectively produce nearly $600 million in annual revenue.

MGE reported Q3 results on 11/6/18 and the quarter was largely in line with expectations. Revenue fell just over 1% but lower margins caused operating income to fall more than 5%. MGE suffered during Q3 from warmer-than-normal temperatures in its service area, particularly during August. Indeed, the company's service area saw average temperatures that were five degrees higher than last year's Q3, which negatively impacts demand. On the plus side, a lower tax rate saw earnings-per-share increase 10% over the year-ago quarter to 85 cents. We've slightly boosted our estimate of earnings-per-share for this year to $2.35 from our prior estimate of $2.32 after Q3 results.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$1.59	$1.47	$1.67	$1.76	$1.86	$2.16	$2.32	$2.06	$2.18	$2.20	***$2.35***	***$2.70***
DPS	$0.96	$0.97	$0.99	$1.01	$1.04	$1.07	$1.11	$1.16	$1.21	$1.26	***$1.35***	***$1.60***
Shares	34	35	35	35	35	35	35	35	35	35	***35***	***35***

Earnings-per-share gradually increased from 2009 to 2014 but since that time, they has failed to move higher. Recent results have been strong, but we believe MGE will struggle to grow in the coming years. Its only sustainable growth catalyst is customer acquisition and that is being done at a low single digit rate. We are therefore forecasting 2.8% earnings-per-share growth going forward, which is slightly below its historical rate of growth. With flat margins and a lack of catalysts for meaningful top line improvement, MGE looks poised to continue to struggle to move the needle when it comes to earnings. Investors would do well to consider that weather can contribute positively – as it did in Q2 – but can easily swing the other direction, as it did in Q3. Thus, building a bull case predicated upon this is not reasonable.

We see continued low single digit growth for the dividend as well as MGE is comfortable with where the payout ratio is today. Dividend growth will likely slightly outpace earnings growth in the coming years but expect the payout ratio to remain roughly where it is today. MGE is on par with other utilities in terms of dividend growth in the low single digits.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	14.2	15.1	15.0	15.8	17.2	17.0	17.2	20.3	24.9	22.9	***26.2***	***18.0***
Avg. Yld.	4.2%	4.4%	4.0%	3.6%	3.2%	2.9%	2.8%	2.8%	2.2%	2.0%	***2.2%***	***3.3%***

MGE's price-to-earnings multiple has moved significantly higher in the past few years after spending much of the last decade in the mid-teens. It sits at 26.2 today, and as a result, we believe MGE is quite overvalued. The lack of earnings growth it has exhibited and a lack of catalysts for it to pick up in the coming years mean that the current multiple seems unsustainable. Thus, we are forecasting a strong 7.2% headwind to total returns in the coming years from the valuation.

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.

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The dividend yield is also telling us the stock is overvalued as it is still near its lowest point in the past decade. We think the combination of continued payout growth and a stock price that should come down over time will produce a much higher, more normalized 3.3% yield against the current 2.2%. The enormous increase in the valuation for MGE has not only made the stock very expensive, but it has made the dividend far less attractive as well.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	49.5%	54.1%	59.3%	60.8%	63.3%	60.4%	58.1%	62.6%	66.3%	66.5%	***66.5%***	***66.5%***
Debt/A	62%	61%	60%	62%	63%	61%	61%	60%	60%	58%	***58%***	***58%***
Int. Cov.	6.8	6.8	6.7	5.4	5.8	6.8	7.0	6.2	6.5	6.7	***6.8***	***7.0***
Payout	60%	66%	60%	57%	56%	50%	48%	56%	55%	57%	***57%***	***59%***
Std. Dev.	36.0%	22.1%	17.9%	23.8%	15.9%	17.8%	18.0%	22.0%	21.2%	20.5%	***21.0%***	***21.5%***

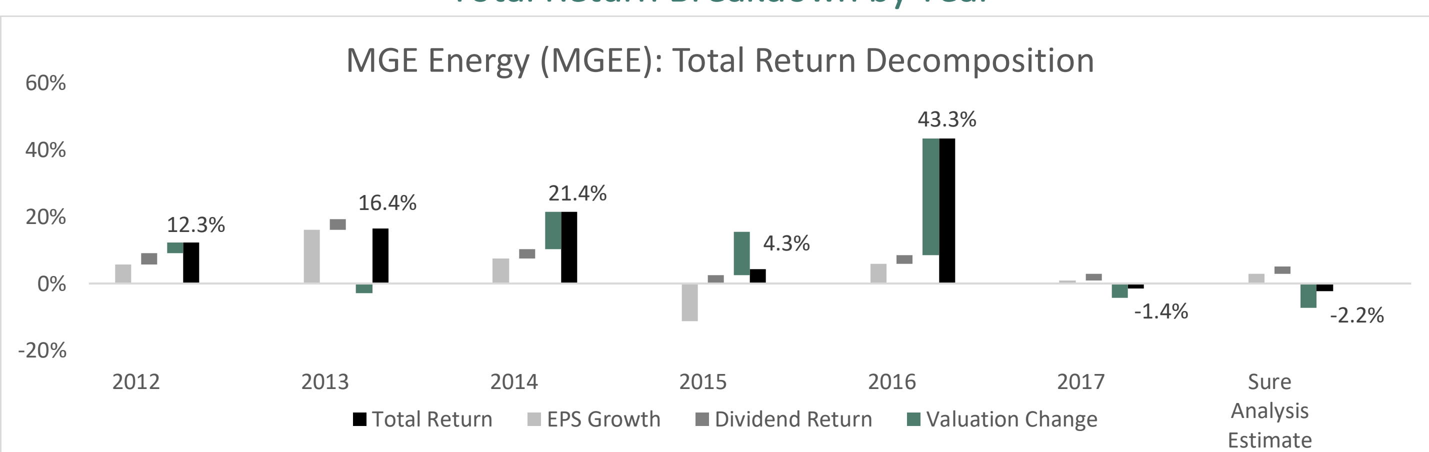
MGE's quality metrics have been roughly flat over the past decade, as it does not go after growth via acquisition and its business has not really changed. Gross margins have drifted up over time but appear to have plateaued, while its debt-to-asset ratio remains flat as well around 60%. MGE's interest coverage is outstanding for a utility at 6.8 and we forecast this will improve slightly over time as earnings grow and MGE keeps its debt at manageable levels. The payout ratio should remain under 60% as dividend growth may slightly outpace earnings growth, but the two should be very close. Overall, MGE is conservatively financed and run basically the same way year after year, meaning changes in the quality metrics will likely be few and far between. That's great from a predictability standpoint, but it is not helping growth.

MGE's main competitive advantage is in its virtual monopoly in its service area. Like many other utilities, MGE has a small but profitable service area where it is continuing to grow its customer base. That helped it hold up well in the Great Recession as earnings-per-share dipped slightly but recovered quickly.

Final Thoughts & Recommendation

Overall, MGE looks very overvalued here. We are forecasting total annual returns for the next five years to be -2.2%. This disappointing performance will consist of the current 2.2% yield, 2.8% earnings growth and a sizable 7.2% headwind from the valuation reset. MGE has not shown the ability to grow its earnings faster than a low single digit rate, but the valuation is pricing in much more growth than that. MGE therefore looks unattractive for just about any type of investor as it is overvalued, its current yield is relatively low, and its dividend growth is unattractive as well. We recommend investors sell MGE and invest the proceeds into a stock with more attractive total return characteristics.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	596	534	533	546	541	591	620	564	545	563
Gross Profit	295	289	152	166	170	185	198	188	193	201
Gross Margin	49.5%	54.1%	28.5%	30.4%	31.4%	31.4%	32.0%	33.4%	35.4%	35.7%
D&A Exp.	N/A	41	38	41	39	39	41	44	45	53
Operating Profit	88	85	97	108	113	128	138	124	128	129
Operating Margin	14.7%	15.9%	18.1%	19.7%	20.8%	21.7%	22.3%	22.0%	23.5%	22.9%
Net Profit	53	51	58	61	64	75	80	71	76	98
Net Margin	8.9%	9.6%	10.8%	11.2%	11.9%	12.7%	13.0%	12.6%	13.9%	17.3%
Free Cash Flow	-31	40	64	66	48	21	36	69	64	25
Income Tax	29	28	34	36	39	45	48	41	43	22

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	1268	1282	1318	1459	1587	1579	1694	1726	1801	1855
Cash & Equivalents	4	5	7	41	46	69	66	81	96	108
Accounts Receivable	53	38	44	37	41	45	42	37	40	42
Inventories	61	51	47	40	38	36	46	48	41	44
Total Liabilities	790	780	793	908	1007	962	1035	1036	1077	1077
Accounts Payable	47	36	33	35	44	44	42	41	48	48
Long-Term Debt	397	387	359	364	362	404	406	391	387	427
Shareholder’s Equity	478	502	525	551	579	618	659	690	724	778
D/E Ratio	0.83	0.77	0.68	0.66	0.62	0.65	0.62	0.57	0.53	0.55

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	4.4%	4.0%	4.4%	4.4%	4.2%	4.7%	4.9%	4.2%	4.3%	5.3%
Return on Equity	11.6%	10.4%	11.2%	11.3%	11.4%	12.5%	12.6%	10.6%	10.7%	13.0%
ROIC	6.3%	5.8%	6.5%	6.8%	6.9%	7.6%	7.7%	6.6%	6.9%	8.4%
Shares Out.	34	35	35	35	35	35	35	35	35	35
Revenue/Share	17.90	15.43	15.36	15.76	15.61	17.04	17.88	16.27	15.71	16.24
FCF/Share	-0.93	1.16	1.84	1.89	1.37	0.61	1.04	1.99	1.84	0.72

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.