



Middlesex Water (MSEX)

Updated November 3rd, 2018 by Josh Arnold

Key Metrics

Current Price:	\$44	5 Year CAGR Estimate:	1.7%	Volatility Percentile:	76.6%
Fair Value Price:	\$38	5 Year Growth Estimate:	2.2%	Momentum Percentile:	52.4%
% Fair Value:	115%	5 Year Valuation Multiple Estimate:	-2.7%	Growth Percentile:	8.0%
Dividend Yield:	2.2%	5 Year Price Target	\$42	Valuation Percentile:	29.3%
Dividend Risk Score:	A	Retirement Suitability Score:	B	Total Return Percentile:	6.8%

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 another strong quarter for Q3 on 11/1/18. Total revenue increased 7% as the majority of the gain came from higher rates, but customer growth contributed as well. Operating and maintenance expenses increased at a lower rate than that of revenue, leading to profitability gains, as expected. This, along with a lower tax rate, helped earnings-per-share jump 60% to \$0.74 from the year-ago quarter. The company also boosted its dividend by 7%, bringing the new annual payout to \$0.96. Overall, Middlesex continues to perform very well and we've boosted our earnings-per-share estimate for this year to \$1.80.

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	\$1.80	\$2.00
DPS	\$0.70	\$0.71	\$0.72	\$0.73	\$0.74	\$0.75	\$0.76	\$0.78	\$0.81	\$0.86	\$0.96	\$1.20
Shares	13	14	16	16	16	16	16	16	16	16	17	17

Earnings-per-share has been rising 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 more than doubled. We see total earnings-per-share growth for the next five years of just 2.2%, which is slightly below its 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. Indeed, Q3 results were driven almost exclusively by these two items. 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. Q3 results have us reiterating that view at this time.

We are forecasting the dividend to continue its streak of small increases, rising from this year's payout of 96 cents to \$1.20 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	24.3	21.2
Avg. Yld.	4.0%	4.7%	4.2%	4.0%	4.0%	3.7%	3.7%	3.3%	2.3%	2.2%	2.2%	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 24.3, although it is cheaper

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than it was at the time of our last report. We are forecasting a decline back towards 21 in five years, indicating a meaningful 2.7% annual headwind to total returns. Given the stock's growth profile, it simply cannot sustain a price-to-earnings multiple near its current level.

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 2.2%. 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%	53%	60%
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%

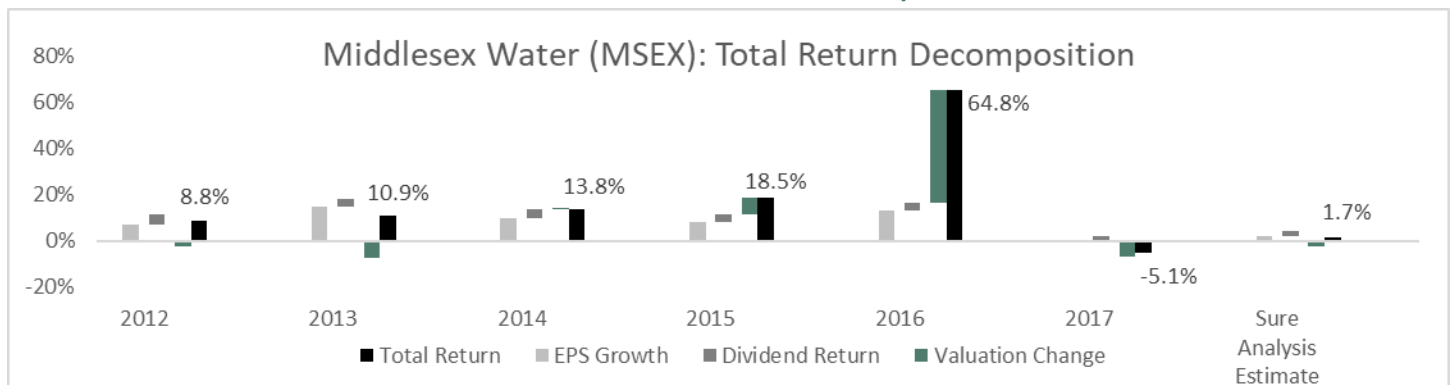
Like many other utilities, Middlesex' quality metrics have remained steady in the past decade. Its margins are right where they were 10 years ago and have remained very stable in the past few years in particular. Its assets are 65% debt-financed, allowing for an excellent interest coverage ratio for 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 53% 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 did not fare quite as well, but it certainly stood up to the downturn. Its obvious competitive advantage is in the monopoly it enjoys in its service area.

Final Thoughts & Recommendation

Middlesex still 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 2.2% yield, 2.2% earnings-per-share growth and a 2.7% headwind from the valuation reset. Its impressive dividend history is certainly worth noting but the current yield is likely 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 high current valuation. We recommend selling Middlesex 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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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	91	91	103	102	110	115	117	126	133	131
D&A Exp.	9	9	10	10	11	12	12	13	14	15
Operating Profit	24	20	27	24	28	31	34	36	41	39
Operating Margin	26.4%	22.1%	25.9%	23.7%	25.0%	27.0%	29.4%	28.4%	30.6%	29.5%
Net Profit	12	10	14	13	14	17	18	20	23	23
Net Margin	13.4%	10.9%	13.9%	13.2%	13.0%	14.5%	15.7%	15.9%	17.1%	17.4%
Free Cash Flow	-11	-2	-4	-1	8	14	10	25	0	-7
Income Tax	6	5	7	7	7	9	10	11	12	11

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	440	458	489	538	562	530	576	581	620	661
Cash & Equivalents	3	4	2	3	3	5	3	3	4	5
Accounts Receivable	10	11	12	11	12	12	10	10	10	11
Inventories	1	2	2	2	1	2	2	3	4	4
Total Liabilities	299	315	313	357	377	342	376	375	399	430
Accounts Payable	6	4	6	6	4	6	6	7	12	14
Long-Term Debt	162	171	155	161	171	164	161	142	153	174
Shareholder's Equity	138	140	173	177	182	186	197	204	218	229
D/E Ratio	1.15	1.20	0.88	0.89	0.92	0.87	0.81	0.69	0.69	0.75

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	2.9%	2.2%	3.0%	2.6%	2.6%	3.0%	3.3%	3.5%	3.8%	3.6%
Return on Equity	9.0%	7.2%	9.2%	7.7%	8.0%	9.1%	9.6%	10.0%	10.8%	10.2%
ROIC	4.2%	3.2%	4.4%	4.0%	4.1%	4.7%	5.2%	5.6%	6.3%	5.9%
Shares Out.	13	14	16	16	16	16	16	16	16	16
Revenue/Share	6.69	6.65	6.89	6.43	6.90	7.13	7.22	7.72	8.09	7.93
FCF/Share	-0.80	-0.12	-0.27	-0.05	0.50	0.85	0.61	1.56	-0.02	-0.45

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

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