# Otter Tail Corporation (OTTR)

*Updated November 7th, 2018 by Josh Arnold*

## Key Metrics

| | | | | | |
|---|---|---|---|---|---|
| **Current Price:** | $47 | **5 Year CAGR Estimate:** | 5.3% | **Volatility Percentile:** | 21.0% |
| **Fair Value Price:** | $42 | **5 Year Growth Estimate:** | 5.0% | **Momentum Percentile:** | 56.9% |
| **% Fair Value:** | 113% | **5 Year Valuation Multiple Estimate:** | -2.5% | **Growth Percentile:** | 30.3% |
| **Dividend Yield:** | 2.8% | **5 Year Price Target** | $53 | **Valuation Percentile:** | 32.5% |
| **Dividend Risk Score:** | B | **Retirement Suitability Score:** | B | **Total Return Percentile:** | 25.0% |

## 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 Q3 earnings on 11/6/18 and results were largely in line with expectations. Revenue was up 5% as the company saw interim rate increases in North Dakota, in addition to favorable weather. Its manufacturing business saw increased earnings from higher sales and margins, in addition to a lower tax rate. North Dakota also approved a permanent rate increase of 3.1% for Otter Tail, so that will drive revenue higher moving forward for the power business. Otter Tail projects 9% average rate base growth through 2022, so its outlook is bright for the utility business. The company slightly raised the bottom end of its guidance for 2018 but our estimate of $2.05 per share remains unchanged.

## 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*** |
| **Shares** | 35 | 36 | 36 | 36 | 36 | 36 | 37 | 38 | 39 | 40 | ***41*** | ***45*** |

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 just over $2 and we see average growth of 5% going forward. Otter Tail will achieve this growth via revenue increases from its utility business – which is looking stronger now that North Dakota has approved rate increases – as well as continued strong performances in its other two, non-utility lines of business. 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. Otter Tail's rate case in South Dakota is still pending, but the company has a favorable relationship with its regulators, so we are optimistic that Otter Tail will continue to receive the rate increases it needs to grow revenue.

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 | ***23.2*** | ***20.4*** |
| **Avg. Yld.** | 3.6% | 5.4% | 5.7% | 5.6% | 5.2% | 4.1% | 4.1% | 4.3% | 3.9% | 3.1% | ***2.8%*** | ***2.8%*** |

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 23.2 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 2.5% headwind to total returns. The yield should remain near where it is today at 2.8% 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%*** |

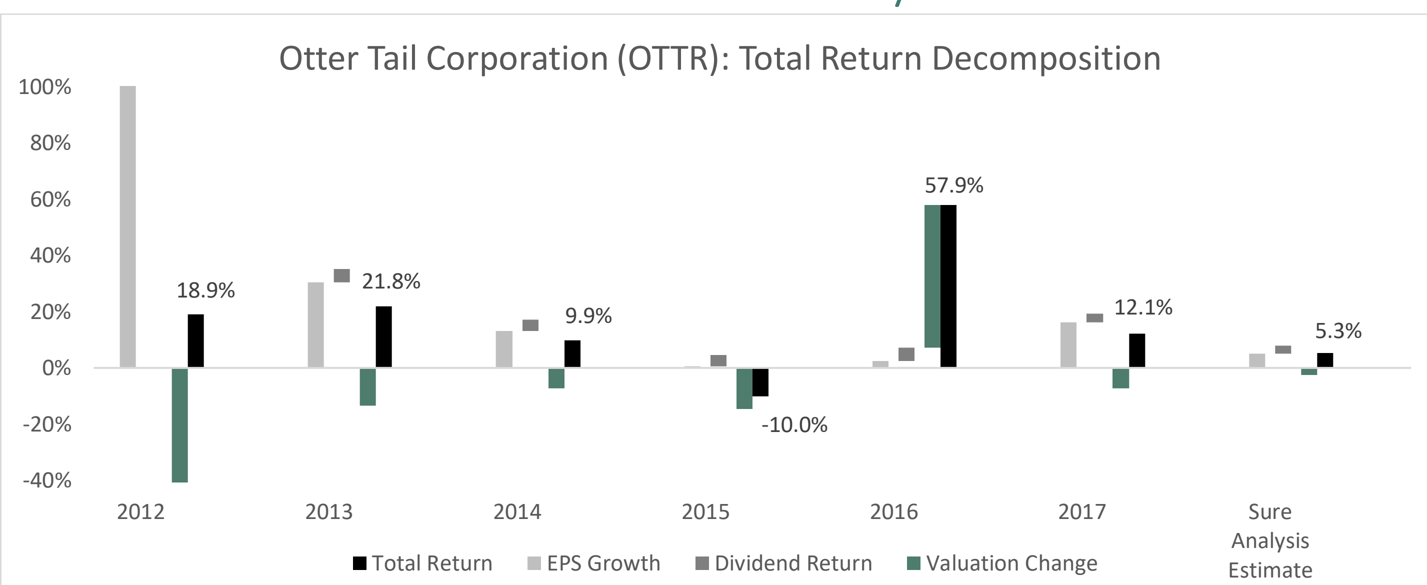
Otter Tail's quality metrics have improved over the past decade, although most gains have been slight. The largest improvement is in gross margins, which has driven profitability and earnings growth along with its impressive rates of revenue growth. We see a long-term tailwind for gross margins, although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

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 5.3% annually moving forward, consisting of the current 2.8% yield, 5% earnings-per-share growth and a 2.5% headwind from the lower valuation. Given these low projected returns, Otter Tail Corporation earns a sell recommendation from Sure Dividend at current prices.

## Total Return Breakdown by Year

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*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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## Income Statement Metrics

| Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|---|---|
| Revenue | 1311 | 1040 | 718 | 840 | 710 | 743 | 799 | 780 | 804 | 849 |
| Gross Profit | 262 | 236 | 132 | 141 | 163 | 163 | 170 | 183 | 199 | 214 |
| Gross Margin | 20.0% | 22.7% | 18.3% | 16.8% | 23.0% | 22.0% | 21.3% | 23.5% | 24.7% | 25.2% |
| D&A Exp. | 65 | 74 | 58 | 58 | 58 | 58 | 58 | 60 | 73 | 73 |
| Operating Profit | 73 | 45 | 65 | 72 | 95 | 94 | 100 | 109 | 111 | 126 |
| Operating Margin | 5.6% | 4.4% | 9.0% | 8.6% | 13.3% | 12.7% | 12.5% | 14.0% | 13.8% | 14.9% |
| Net Profit | 35 | 26 | -1 | -13 | -5 | 51 | 58 | 59 | 62 | 72 |
| Net Margin | 2.7% | 2.5% | -0.2% | -1.6% | -0.7% | 6.8% | 7.2% | 7.6% | 7.8% | 8.5% |
| Free Cash Flow | -155 | -14 | 47 | 37 | 119 | -12 | -51 | -43 | 2 | 41 |
| Income Tax | 15 | -5 | 3 | 4 | 7 | 13 | 17 | 22 | 20 | 27 |

## Balance Sheet Metrics

| Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|---|---|
| Total Assets | 1693 | 1755 | 1771 | 1701 | 1602 | 1596 | 1741 | 1819 | 1912 | 2004 |
| Cash & Equivalents | 8 | 4 | 0 | 16 | 52 | 2 | 0 | 0 | 0 | 16 |
| Accounts Receivable | 150 | 107 | 95 | 93 | 91 | 58 | 60 | 63 | 68 | 68 |
| Inventories | 102 | 87 | 72 | 69 | 69 | 73 | 85 | 85 | 84 | 88 |
| Goodwill & Int. Ass. | 142 | 141 | 56 | 54 | 53 | 44 | 43 | 55 | 53 | 51 |
| Total Liabilities | 1001 | 1068 | 1123 | 1129 | 1080 | 1061 | 1168 | 1214 | 1242 | 1307 |
| Accounts Payable | 113 | 84 | 103 | 80 | 88 | 96 | 107 | 89 | 89 | 84 |
| Long-Term Debt | 478 | 503 | 513 | 472 | 422 | 441 | 510 | 577 | 581 | 603 |
| Shareholder's Equity | 676 | 671 | 632 | 571 | 522 | 535 | 573 | 605 | 670 | 697 |
| D/E Ratio | 0.69 | 0.73 | 0.79 | 0.83 | 0.81 | 0.82 | 0.89 | 0.95 | 0.87 | 0.87 |

## Profitability & Per Share Metrics

| Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|---|---|---|---|
| Return on Assets | 2.2% | 1.5% | -0.1% | -0.8% | -0.3% | 3.2% | 3.5% | 3.3% | 3.3% | 3.7% |
| Return on Equity | 5.9% | 3.9% | -0.2% | -2.2% | -1.0% | 9.6% | 10.4% | 10.1% | 9.8% | 10.6% |
| ROIC | 3.3% | 2.2% | -0.1% | -1.2% | -0.5% | 5.3% | 5.6% | 5.2% | 5.1% | 5.7% |
| Shares Out. | 35 | 36 | 36 | 36 | 36 | 36 | 37 | 38 | 39 | 40 |
| Revenue/Share | 41.40 | 29.10 | 19.93 | 23.29 | 19.60 | 20.45 | 21.75 | 20.70 | 20.75 | 21.37 |
| FCF/Share | -4.88 | -0.40 | 1.30 | 1.03 | 3.29 | -0.33 | -1.39 | -1.13 | 0.05 | 1.02 |

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