MGE Energy (MGEE)

Updated March 1st, 2019 by Samuel Smith

Key Metrics

Current Price:	$64	**5 Year CAGR Estimate:**	-3.2%	**Volatility Percentile:**	20.0%
Fair Value Price:	$44	**5 Year Growth Estimate:**	2.8%	**Momentum Percentile:**	80.5%
% Fair Value:	145%	**5 Year Valuation Multiple Estimate:**	-8.1%	**Growth Percentile:**	10.5%
Dividend Yield:	2.1%	**5 Year Price Target**	$52	**Valuation Percentile:**	5.1%
Dividend Risk Score:	A	**Retirement Suitability Score:**	B	**Total Return Percentile:**	2.1%

Overview & Current Events

MGE Energy has grown from a small power station in Wisconsin built in 1902 to a $2.2 billion market cap 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 Q4 results on 2/22/19 and the quarter was largely in line with expectations. Revenue was essentially flat year-over-year but persistently lower margins once again caused operating income to fall nearly 5% (though the decline was not as large as that seen in Q3). Despite the troubling headline numbers, the underlying business maintained steady growth, thanks to continued increases in customer count. The reason that year-over-year numbers were down was due to the one-time boost to earnings in Q4 2017 due to a one-time, non-cash tax benefit from the passage of the Tax Act. Discounting this boost to earnings, Q4 2018 earnings per share were higher than Q4 2017 earnings per share. Additionally, EPS for the year came in at $2.43, beating our previous estimate of $2.35 handily.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$1.47	$1.67	$1.76	$1.86	$2.16	$2.32	$2.06	$2.18	$2.20	$2.43	***$2.50***	***$2.87***
DPS	$0.97	$0.99	$1.01	$1.04	$1.07	$1.11	$1.16	$1.21	$1.26	$1.35	***$1.39***	***$1.60***
Shares	35	35	35	35	35	35	35	35	35	35	***35***	***35***

Earnings-per-share gradually increased from 2009 to 2014 but since that time have floundered a bit. 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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	15.1	15.0	15.8	17.2	17.0	17.2	20.3	24.9	22.9	26.7	***26.6***	***18.0***
Avg. Yld.	4.4%	4.0%	3.6%	3.2%	2.9%	2.8%	2.8%	2.2%	2.0%	2.1%	***2.1%***	***3.1%***

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 26.6 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 8.1% headwind to annual total returns in the coming years from the valuation.

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 3.2% 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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	66%	60%	57%	56%	50%	48%	56%	55%	57%	56%	***56%***	***56%***

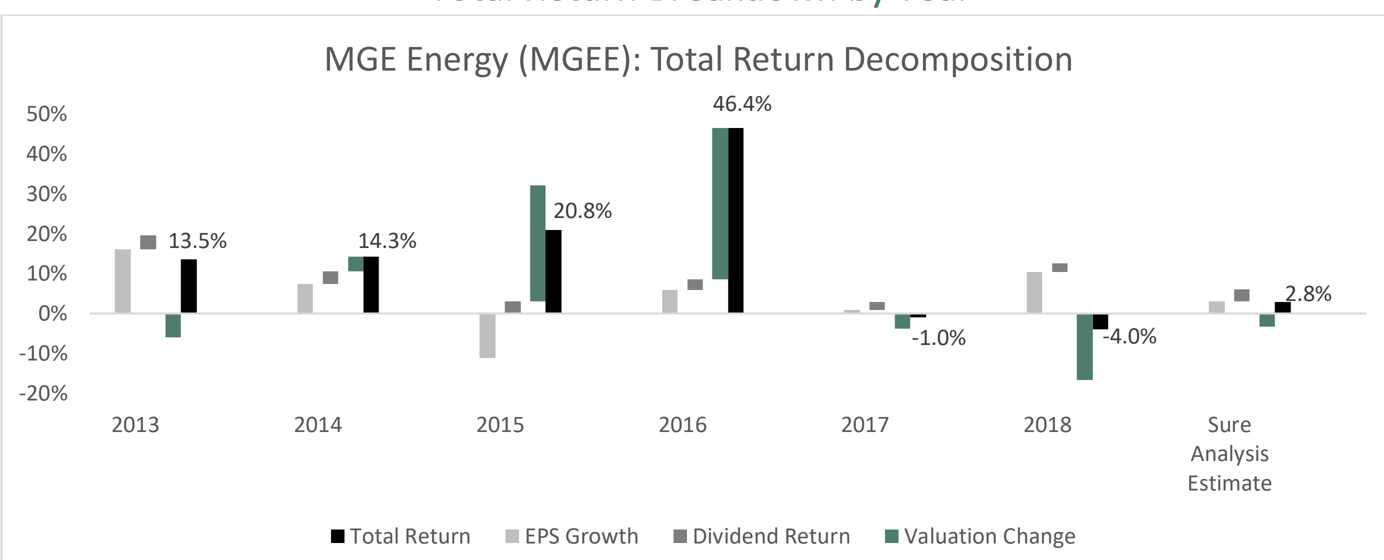
MGE's quality metrics have been roughly flat over the past decade, as it does not go after growth via acquisition and its business has not really changed. Gross margins have drifted up over time but appear to have plateaued, while its debt-to-asset ratio remains flat as well around 60%. MGE's interest 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.

MGE's main competitive advantage is 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 appears very overvalued right now. We are forecasting total annual returns for the next five years to be -3.2%. This disappointing performance will consist of the current 2.1% yield, 2.8% earnings growth and a sizable 8.1% headwind from the valuation reset. MGE has failed 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, making it a sell.

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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	534	533	546	541	591	620	564	545	563	560
Gross Profit	289	152	166	170	185	198	188	189	197	190
Gross Margin	54.1%	28.5%	30.4%	31.4%	31.4%	32.0%	33.4%	34.6%	35.0%	33.9%
Operating Profit	41	38	41	39	39	41	44	45	53	56
Operating Margin	85	97	108	113	128	138	124	124	125	114
Net Profit	15.9%	18.1%	19.7%	20.8%	21.7%	22.3%	22.0%	22.7%	22.1%	20.4%
Net Margin	51	58	61	64	75	80	71	76	98	84
Free Cash Flow	9.6%	10.8%	11.2%	11.9%	12.7%	13.0%	12.6%	13.9%	17.3%	15.0%
Income Tax	40	64	63	48	21	36	69	64	23	-59

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	1282	1318	1459	1587	1579	1694	1726	1801	1855	1989
Cash & Equivalents	5	7	41	46	69	66	81	96	108	83
Accounts Receivable	38	44	37	41	45	42	37	40	42	44
Inventories	51	47	40	38	36	46	48	41	44	42
Total Liabilities	780	793	908	1007	962	1035	1036	1077	1077	1172
Accounts Payable	36	33	35	44	44	42	41	48	48	46
Long-Term Debt	387	359	364	362	404	406	391	387	427	511
Shareholder's Equity	502	525	551	579	618	659	690	724	778	817
D/E Ratio	0.77	0.68	0.66	0.62	0.65	0.62	0.57	0.53	0.55	0.63

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	4.0%	4.4%	4.4%	4.2%	4.7%	4.9%	4.2%	4.3%	5.3%	4.4%
Return on Equity	10.4%	11.2%	11.3%	11.4%	12.5%	12.6%	10.6%	10.7%	13.0%	10.6%
ROIC	5.8%	6.5%	6.8%	6.9%	7.6%	7.7%	6.6%	6.9%	8.4%	6.7%
Shares Out.	35	35	35	35	35	35	35	35	35	35
Revenue/Share	15.43	15.36	15.76	15.61	17.04	17.88	16.27	15.71	16.24	16.15
FCF/Share	1.16	1.84	1.83	1.37	0.61	1.04	1.99	1.85	0.67	-1.71

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