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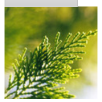

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OGE Energy Is A Unique Opportunity For Energy Bulls

Must Read | Oct. 16, 2015 8:26 AM ET | About: OGE Energy Corp. (OGE) by: Tristan R. Brown

Summary

Oklahoma utility holding company OGE Energy's shares have underperformed its peers by a wide margin YTD, as investor sentiment has turned negative due to its exposure to oilfields.

The company's unique status, as both a regulated utility and a stakeholder in an MLP, has allowed it to finance rapid dividend growth via distributions.

The company will struggle to meet its future dividend targets, if sustained low energy prices cause the MLP distribution growth to cease and Oklahoma's economy to stagnate.

The company's share valuations have fallen sharply, however, and do not reflect the benefits provided by its unique position.

While a sufficient margin of safety is not available for conservative investors, aggressive investors, who expect energy prices to remain above their earlier lows, should consider it as an investment.

Investors in Oklahoma utility holding company **OGE Energy** (NYSE:OGE) have seen their holdings underperform the broader Dow Jones Utility Average by a significant margin in 2015 YTD, as the company's shares have declined by 25%. Worse, unlike many of its peers, it has been beset by slow growth over the last five years, having achieved an EBITDA increase of a mere 1% over the entire period. More recently, the market has expressed skepticism over the company's ability to achieve its ambitious dividend goals, given its direct and indirect exposure to the financial health of domestic oilfields. This article evaluates OGE Energy as a potential long-term investment in light of these conditions.

OGE Energy at a glance

Headquartered in Oklahoma City, OGE Energy is comprised of two segments. The primary segment is Oklahoma Gas & Electric (OG&E), which is a regulated electric utility generating, transmitting, and distributing electricity to 819,000 customers, primarily residential and commercial, in central Oklahoma and a small part of western Arkansas (Arkansas only contributes to 7% of the company's rate base, with Oklahoma contributing the rest). OG&E owns and operates 6,800 MW of electric generating capacity and enough transmission and distribution lines to supply a service area, including Oklahoma City and the surrounding area, covering 30,000 square miles. OG&E's generating capacity consists of 54% coal, 35% natural gas, and 11% wind power. While it recently began operating a pilot 2.5 MW solar PV installation, by 2020 it expects its fuel mix to be 50% coal, 37% natural gas, and 13% wind.

OG&E operates within a moderately favorable regulatory scheme that includes a 11.1% allowed return on equity and a 56% equity ratio. This combination has supported rapid and accelerating dividend growth by its parent OGE Energy since FY 2011, most recently in the form of a 11% YoY increase, and the company is targeting a 10% annual growth rate through FY 2019. The high allowed return on equity has also led to above-average debt ratings for OG&E of 'A1' from Moody's and 'A-' from Fitch.

In addition to OG&E, OGE Energy also owns a 26.3% limited partner stake and 50% general partner stake in MLP, **Enable Midstream Partners LP** (NYSE:ENBL). With $11 billion in assets, Enable gathers and processes natural gas from a number of South Central gas fields, including within Oklahoma, that it then pipes to destinations both within the region and outside of it. Distributions from Enable in recent quarters have equaled only 16% of OGE Energy's total cash flows, or 20% of OG&E's cash flows, although the parent company's management expects them to increase by 6% to 8% annually.

Q2 earnings report

OGE Energy reported Q2 revenue of $549.9 million (see table), down 10.1% YoY and missing the analyst consensus estimate by $68 million. The decline and miss were the result of the utility's electric sales volume falling by 5.3% YoY, partially offset by a 1.1% increase to customer numbers over the same period. The reduced demand was in turn due to the prevalence of cool temperatures in May and June that allowed the company's customers to avoid using their air conditioners, with the average number of cooling degree-days over the quarter coming in 10.7% below the previous year's average and 2.4% below the long-term average.

OGE Energy financials (non-adjusted)

	Q2 2015	Q1 2015	Q4 2014	Q3 2014	Q2 2014

Revenue ($MM)	549.9	480.1	526.2	754.7	611.8
Gross income ($MM)	339.0	268.5	289.2	449.4	340.9
Net income ($MM)	87.5	43.2	58.4	187.3	100.8
Diluted EPS ($)	0.44	0.22	0.29	0.94	0.50
EBITDA ($MM)	237.5	170.2	202.4	367.6	251.7

Source: Morningstar (2015).

OGE Energy's gross margin declined slightly YoY from $340.9 million to $339 million, as its cost of revenue declined by 22% over the same period due to falling energy prices, almost offsetting the negative impact of reduced electricity demand on earnings. OG&E's utility operating income fell to $127.2 million from $141.8 million over the same period, however, while income from distributions fell to $28.2 million from $39.3 million. The former was the result of the utility segment's O&M and depreciation costs increasing compared to the same quarter of the previous year, driving a 6.4% increase to OGE Energy's operating expenses. While management didn't attribute this increase to regulatory lag in its Q2 earnings call, it did state that it was the result of the previous year's capex, suggesting that rates have not kept pace.

The company's net income declined to $87.5 million from $100.8 million YoY, resulting in a diluted EPS result of $0.44 versus $0.50 in the previous year. The EPS result was in line with the consensus analyst estimate, despite the substantial revenue miss. The utility segment contributed $0.34 to the EPS result, down from $0.38 YoY, while the company also reported distributions from its stakes in Enable of $0.12, down from $0.10. EBITDA also fell from $251.7 million from $237.5 million over the same period. The company's board opted to increase its dividend by 11% despite the overall decline to net income, exceeding its target and providing investors with a pleasant surprise in the process.

Outlook

Management reiterated in its Q2 earnings call that its previous forecast for OG&E to generate diluted EPS of $1.41-$1.49 and Enable to provide distributions to OGE Energy equal to an additional $0.35-$0.40 in FY 2015. An important assumption behind this forecast is that the company's service area experiences normal weather in Q3 and Q4. Q3 temperatures were close to the average, with warmer numbers in early August and September being offset by cooler numbers in the latter parts of both months.

Q4 is currently on track to be close to normal in terms of temperatures. Oklahoma is one of the few U.S. states that is not expected to experience large temperature variations resulting from the strong El Nino that has been developing over the last several months. Historical data indicates that OGE Energy's service area experienced only slightly warmer-than-normal temperatures between October and February and slightly cooler-than-normal temperatures between April and June during previous El Nino events. This could result in higher electricity demand in Q4 (electricity demand tends to increase along with the number of heating degree-days, although not by nearly as much as natural gas demand does) and lower demand in Q2 2016, although any impacts are likely to be too small to have much of an impact on earnings.

Of much greater concern is OGE Energy's exposure to Oklahoma's economy. The state has benefited strongly from the expansion of domestic crude and natural gas production that has developed in the region over the last five years, so much so that Forbes recently placed Oklahoma at #7 on its Best Places For Business list while CNNMoney named it #9 on its Fastest Growing Cities list. Between 2010 and 2015 Oklahoma's unemployment rate was substantially lower than that of the U.S. while its GDP growth rate was higher. While the state's economy has remained strong to date, its unemployment rate has begun to climb as sustained low energy prices have caused the finances of many oilfield firms to deteriorate.

OGE Energy is exposed to sustained low energy prices in two ways. First, Enable's share price has fallen by 34% YTD, as the value of many of its assets have declined, pushing its forward yield to nearly 10%. A further share price decline could cause the MLP to reduce its yield, in which case its distributions to OGE Energy will decline in absolute terms. While OGE Energy's management has stated that it does not expect this to occur, a sentiment supported by its recent dividend increase, the company does intend to use its Enable distributions to finance both its planned dividend growth rate of 10% over the next five years as well as much of its capex, with the former resulting in an attractive dividend payout ratio of 55% by 2019. Capex in turn is expected to peak in FY 2016 at $720 million, mostly due to modernization and environmental investments, before declining to $445 million in FY 2019. Reduced distributions from Enable would not prevent this capex from occurring but it would increase the likelihood that OGE Energy would raise the capital in the form of additional debt, exposing itself to the Federal Reserve's upcoming interest rate increase.

OGE Energy is also exposed to sustained low energy prices via OG&E. 12% of the utility's sales volume came from oilfield customers, a number that remained steady in the first half of 2015 despite declining demand overall. Crude and natural gas prices fell again in Q3, however, causing domestic production to also decline, and this weakness could show up on OGE Energy's earnings statements later this year in the form of reduced electricity consumption by oilfield customers. Potential investors will want to keep a close eye on the company's Q3 earnings report release next month for any such signs. Furthermore, slowing domestic fuel production will eventually cause Oklahoma's population growth to decline if oilfield jobs growth slows or even stops. Such population growth in the first half of 2015 helped to mitigate the negative impact of mild weather in the service area on OGE Energy's earnings, but such a buffer is by no means assured of existing in the future if energy prices remain low.

While the precarious state of U.S. oilfield suggests that potential investors in OGE Energy should exhibit some caution, it is worth noting that the company is also competitively placed compared to many of its peers in other areas. In the short-term is its above-average credit rating strength. Even in the event that the company is forced to turn to debt to finance its planned capex just as interest rates are increasing, the fact that OG&E's credit ratings are superior to those of its peers will enable it to take advantage of the widening spread that has already opened up in the corporate bond market. The impact of higher rates on its interest costs will be mitigated so long as it maintains its strong credit ratings.

In the long-term OGE Energy is also better-positioned than many of its peers to weather upcoming federal rules on power plant carbon intensity (lbs of CO_2 per MWh generated). The U.S. Environmental Protection Agency's Clean Power

Plan requires each state to develop its own mechanisms for reducing their average carbon intensity by a predetermined amount. Oklahoma, for example, is required to achieve a 21% reduction by 2024 and a 32% reduction by 2030. OGE Energy has already begun to reduce OG&E's carbon intensity in order to meet other environmental regulations and changing market conditions, however, and expects to achieve a 30% reduction by 2020 regardless of the Clean Power Plan's implementation. Cheap natural gas will only provide the company's existing plans to convert coal-fired units to gas with additional impetus.

Valuation

The consensus analyst estimates for OGE Energy's diluted EPS results in FY 2015 and FY 2016 have declined slightly over the last 90 days, as weak energy prices have increased the likelihood that Enable's distribution growth slows in the future. The FY 2015 estimate has declined from $1.87 to $1.86, while the FY 2016 has fallen from $2.02 to $2.00. Based on a share price at the time of writing of $28.52, the company's shares are trading at a trailing P/E ratio of 15.2x and forward ratios of 15.3x and 14.3x for FY 2015 and FY 2016, respectively. All three ratios are much lower than they were at the beginning of the year and are roughly in the middle of their respective historical ranges.

Conclusion

OGE Energy shares have performed poorly in FY 2015 YTD as the market has responded negatively to its exposure, both direct and indirect, to inland domestic oilfield production. Sustained low energy prices threaten to reduce both electricity demand from its oilfield customers and the distributions that the company earns via its positions in Enable. An especially lengthy period of low energy prices could hamper both economic and population growth in Oklahoma, depriving OGE Energy's utility operations of expected demand growth in its service area as well.

While the current investor sentiment around the company is bearish, it also presents a unique opportunity for those potential investors with a higher risk threshold. OGE Energy's management has committed the company to a high dividend growth rate that it expects to be supported by distributions from Enable. Furthermore, management also anticipates using the distributions to help finance its planned capex over the next several years, mitigating the potential negative impacts of higher interest rates on its earnings. A rebound in energy prices from their current levels would provide investors in OGE Energy with both market-beating dividend growth and appreciating share values, the latter in particular being a rarity in the current utilities sector following several years of outsized returns. While the company's shares currently appear to be fairly valued on the basis of their historical valuations, the prospect of future earnings growth and limited downside from higher interest rates makes OGE Energy a compelling investment for those investors who don't expect energy prices to return to their previous lows for a sustained period.

