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Industry Note | Initiating Coverage

Utilities

ATLANTIC EQUITIES

Utilities: Initiate NEE, WEC at Overweight

2020 has not been a vintage year for the regulated utility sector (-8% YTD) but the core attraction of dependable, low volatility growth remains intact. Selected names have access to a range of opportunities which should generate EPS growth across a multi-year period. We initiate coverage of WEC with an Overweight rating, $112 price target and NEE at Overweight, $330 price target.

- **We see a range of investment opportunities for regulated utilities** that will drive robust earnings growth at selected names**.** Earnings growth will be investment led, focused upon 1/ replacing obsolete assets 2/ expanding renewables 3/ upgrading transmission/distribution 4/ improving grid resilience 5/ upgrading technology and 6/ modernising gas lines. Utilities lost out to the 'stay-at-home' names as a defensive choice when the pandemic spread, but the insulation of regulated earnings from tax increases and the potential for a US infrastructure renewal plan would help the sector regain its lustre.
- **Initiate WEC Energy at Overweight, $112 price target**. WEC's strong reputation for earnings delivery (8.5% CAGR in 2009-2019) is being further enhanced during the pandemic, as the company guides EPS toward the top end of guidance ($3.75) despite pre-tax COVID-19 headwinds of $0.22-$0.25. We estimate an earnings CAGR of 6.5% (7% if consistent with company guidance) between 2019-2024, driven by $15bn investment in rate base investment. Five investment themes dominate, led by gas distribution (38%), electricity distribution (18%), power generation (15%) and IT (8%). These themes sit firmly within WEC's core competencies and >90% within its geographic footprint. The regulatory backdrop is constructive and WEC's weighted 10.3% authorised ROE is high by sector standards. Management incentives are aligned with EPS growth, the balance sheet is strong (Opcos rated A/A-) and the CEO succession plan smoothly enacted. Our YE21 $112 price target equals ~26x FY22 PER, similar to the current 12m forward consensus rating, and is in-line with WEC's 52-week high.
- **Initiate NEE at Overweight, $330 price target**. NEE has built the most successful non-regulated renewables business in the utilities space, which provides a long-lived growth opportunity at scale, and a high ESG ranking. NEE's highly efficient Florida utility FPL benefits from growth opportunities (7.8% CAGR in regulatory capital employed in 2019-2024) and high ROEs (up to 11.6%). COVID-19 disruption is offset in FPL earnings by reserve amortisation. The balance sheet is strong (A-) with good capital funding conduits. We estimate an 8% EPS CAGR in 2019-2024. Our YE21 $330 price target equals 31x FY22 PER, equal to the prevailing 12m forward consensus multiple and our rating is Overweight..

Companies Mentioned

NextEra Energy (NEE)		**Overweight**	
Price		$280.59	
Price Target		$330.00	
Pricing Date / Time		3 Sept 2020 / 16:00 ET	
Market Capitalisation		$137,390m	
Y/E Dec	**2019A**	**2020E**	**2021E**
Adjusted EPS ($)			
Q1	2.20	2.38A	—
Q2	2.35	2.66A	—
Q3	2.39	2.53	—
Q4	1.44	1.59	—
Annual	**8.38**	**9.17**	**10.03**
GAAP DPS			
Q1	1.25	1.40A	—
Q2	1.25	1.40A	—
Q3	1.25	1.40	—
Q4	1.25	1.40	—
Annual	**5.00**	**5.60**	**6.16**

Wisconsin Energy (WEC)		**Overweight**	
Price		$96.36	
Price Target		$112.00	
Pricing Date / Time		3 Sept 2020 / 16:00 ET	
Market Capitalisation		$30,395m	
Y/E Dec	**2019A**	**2020E**	**2021E**
Diluted EPS ($)			
Q1	0.00	1.42A	—
Q2	0.00	0.76A	—
Q3	0.00	0.75	—
Q4	0.00	0.81	—
Annual	**3.58**	**3.75**	**4.02**
GAAP DPS			
Q1	0.59	0.63A	—
Q2	0.59	0.63A	—
Q3	0.59	0.63	—
Q4	0.59	0.63	—
Annual	**2.36**	**2.53**	**2.68**

IMPORTANT DISCLOSURES ARE INCLUDED AT THE END OF THIS REPORT

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2. Company snapshots of WEC and NEE

Figure 1: WEC summary: Overweight, $112 price target

Company Description

WEC Energy (ticker: **WEC**) is the ninth largest utility in the S&P 500 by market value (~$30bn). With a regulated rate base of $22bn, WEC supplies 4.5m electricity and gas customers in Wisconsin, Illinois, Michigan and Minnesota. WEC operates 7.1GW of rated generation capacity, approximately 70,000 miles of distribution lines and 500 substations. Generation and purchased power totalled ~47,000 GWh in 2019. WEC is the ninth-largest US gas distributor, based on customer accounts (2.9m) and operates 50,000 miles of distribution pipes. Total volumes transported in 2019 were 3Bcf/d. WEC has a 60% ownership in ATC, a FERC-regulated electricity transmission business. Within its infrastructure segment WEC is investing in non-utility wind generation in various US states.

Investment Thesis

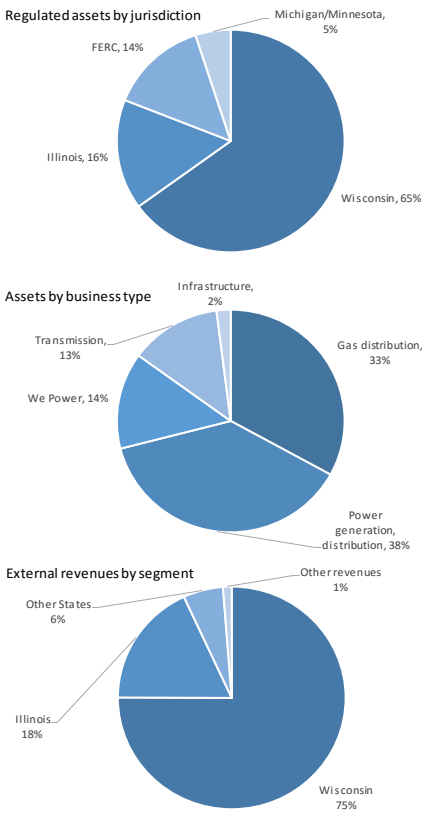
We estimate an EPS CAGR of 6.5% in 2019-2024, at the top of WEC's guidance. As WEC has exceeded guidance for each of the last 16 years, this could prove conservative. The EPS growth flows from a well-founded, $15bn capex plan that focuses on WEC's core strengths, but with a growing slant toward renewables, which are an underdeveloped opportunity in Wisconsin. Management bonuses are closely tied to EPS growth.

COVID-19 challenges well managed. Pre-tax earnings will fall $70-$80m due to lost sales in the pandemic but will be entirely offset by cost savings and WEC guides to the top of FY20 EPS guidance.

Regulatory environment is constructive. The regulatory 'bargain' of delivering low/no price increases for customers, and safe, reliable supplies balanced with a healthy ROE continues to function well in Wisconsin.

Strong balance sheet a strategic asset. WEC Opcos are rated A/A-, M&A could feature but would be disciplined and the pension was fully funded as at YE19.

2019 key metrics



YE21 Price Target $112

- Our YE21 price target of $112 assumes a PER of 26x FY22 EPS, in-line with the current twelve-month forward consensus PER multiple (and the 52-week high).
- At our target price the shares would trade at an EV/rate base multiple of 2.2x

Balance Sheet and Cash Flow

Enterprise Value	-	$43bn
Debt/ Cash	-	$13m in cash, $12.8bn net debt
Free Cash Flow	-	$85m in FY19
Dividend Yield	-	2.60%

Source: Company, Atlantic Equities

Figure 2: NEE summary: Overweight, $330 price target

Company Description

NextEra Energy (ticker: **NEE**) is the largest utility in the S&P 500 by market value (~$137bn). NEE owns two rate-regulated electricity utilities in Florida, Florida Power & Light (FPL) serving 5m+ customers and Gulf Power (acquired in 2019), serving ~470,000 customers. FPL/Gulf have a combined regulatory capital employed of ~$44bn. 90% of FPL revenues derive from retail sales, the majority of which are residential users. NEER is the world's largest wind/solar generator, operating ~22GW of total capacity in competitive markets across the US, with 90% of output sold under long-term contracts (weighted 16 year life). NEER also owns ~4.3Bcf/d in gas transmission capacity, ~520 miles of regulated power transmission and a commodity trading arm. NEER holds ~60% in NEP, a separately listed entity.

Investment Thesis

Well run, efficient Florida business. As the largest US utility by customer accounts, FPL benefits from economies of scale and efficiency levels are high. Authorised ROEs are relatively high (up to 11.6%) and the regulatory environment is constructive.

Global leader in wind/solar generation. NEER operates ~24GW capacity of which 77% is wind/solar. Order backlog is 12GW. NEER's market knowledge, construction skills, buying power and financing options are competitive advantages. NEE is highly ranked on ESG metrics.

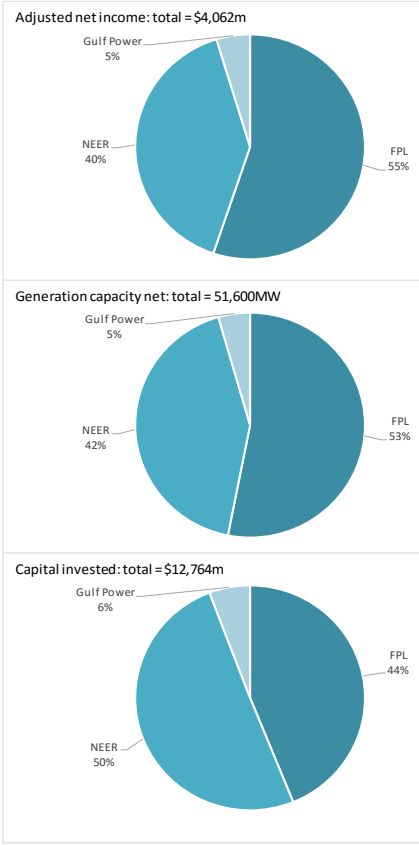
8% CAGR in earnings to 2024. We estimate an 8% CAGR in earnings between 2019-2024, one of the highest growth rates amongst peers. Adverse COVID-19 effects have been limited. FPL guides to 9% p.a. rate base growth in 2019-2022.

Strong balance sheet a strategic asset. NEE entities are rated A/A-, high by utility standards. NEE utilises asset drop downs to affiliate NEP and sells renewable tax credits to boost sources of capital. NEE is looking for M&A but has pledged a disciplined approach (e.g. earnings accretion in first full year).

YE21 Price Target $330

- Our price target of $330 assumes a PER of 31x FY22 EPS, equal to the current twelve month forward consensus multiple. An outlook of low interest rates supports our multiple assumption.
- Our target price sits toward to upper end of the share's 16-66% market-relative PER premium over the past twelve months.

2019 key metrics



Balance Sheet and Cash Flow

Market Cap	-	$137bn
Enterprise Value	-	$188bn
Debt/ Cash	-	$1bn in cash, $45.5bn net debt
Free Cash Flow	-	$(4.5)bn in FY19
Dividend Yield	-	2.0%

Source: Company, Atlantic Equities

3. An investment case for utilities

YTD performance (-8%) from the utility sector has been disappointing compared to the market's 7% gain. Following a strong January (>600bps outperformance) as bond yields declined, utilities failed to provide a strong defensive buffer during the COVID-19 sell-off. Stay-at-home names, including many businesses not typically seen as defensive (e.g. gaming), were preferred to offset COVID-19 threats. Amongst traditional defensive sectors, Utilities lost out to Staples as pantry-stocking, raised hygiene product demand and latterly a weaker dollar boosted the attractions of Staples. So, while one would expect utilities to lag a risk-on market recovery, the performance compared to other defensive havens has been lacklustre.

Despite the poor YTD performance, we don't see a structural problem in the Utility investment proposition. In the following sections we argue that generating low volatility earnings growth is the key to boosting utility share price performance. Earnings growth will be led by investment in regulated electricity and natural gas assets and we see a range of opportunities to put capital at work, despite flat US power demand. WEC Energy (Overweight, $112 price target) and NEE (Overweight, $330 price target) are our preferred choices to gain exposure to this theme, where we see robust growth credentials and a strong track record of delivering rising earnings over time.

Utility performance strong longer-term performance

Notwithstanding the underwhelming YTD performance from utilities, over a longer time period the utility sector performance has been more positive. On a five-year total return basis (annualised, Figure 3) the utility sector ranks mid-range, and ahead of other defensive sectors. The sector's track record shows its investment proposition, namely reliable earnings growth, is competitive versus the broader market.

Figure 3: Utilities a laggard in 2020, but competitive longer-term

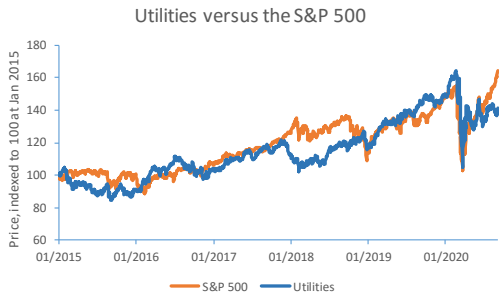
	1M	3M	6M	YTD	1YR	3YR ann	5YR ann	10YR ann
SPX Index	5.08	11.14	16.19	8.35	21.21	13.90	14.38	15.14
S5UTIL Index	-0.77	-2.18	-6.56	-6.02	-2.98	6.50	11.36	10.87
S5FINL Index	4.27	2.05	-5.19	-17.21	-3.26	2.62	8.28	10.69
S5INDU Index	7.92	9.34	6.63	-3.49	6.39	5.99	10.60	12.84
S5MATR Index	7.49	11.50	19.75	6.45	17.79	7.51	10.92	10.09
S5ENRS Index	-3.28	-15.55	-21.47	-40.47	-34.53	-14.24	-8.00	-0.76
S5COND Index	8.75	19.94	34.41	26.41	33.69	21.53	17.53	19.85
S5CONS Index	5.18	10.71	10.27	5.87	10.89	9.15	9.88	12.56
S5RLST Index	1.95	0.73	-4.15	-4.45	-5.30	7.06	8.28	9.02
S5INFT Index	5.81	20.54	34.31	31.66	54.85	29.28	27.71	22.54
S5HLTH Index	-0.10	4.47	13.76	5.52	21.24	11.63	10.97	16.64
S5TELS Index	8.87	13.93	22.42	15.88	28.15	12.93	11.26	11.02
Utility rank:	*10*	*10*	*10*	*9*	*8*	*8*	*3*	*7*

Source: Bloomberg

The performance of the S&P500 in recent years has been propelled by a small number of large tech-related names. In Figure 5 below we portray utility performance against what we refer to as the 'S&P 494' or the S&P 500 excluding FB, AAPL, AMZN, GOOGL, MSFT and NFLX. Over five years the Utility sector has risen 65% versus 44% for the S&P 494 index.

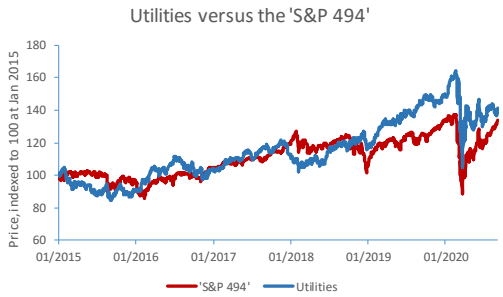
The utility sector has matched the S&P 494 performance over a three year span (both +21%) despite utility performance being penalised by a pronounced, one-off period of underperformance at the end of 2017, stemming from the cut in US income taxes from 35% to 21%. The S&P 500 Utility sector fell 16% from mid-November 2017 to early February 2018, compared to a flat performance from the S&P 500 over the same period (Figure 4).

Figure 4: Utilities versus the S&P 500



Source: Bloomberg

Figure 5: Utilities versus the 'S&P 494'



Source: AE calculations from Bloomberg data

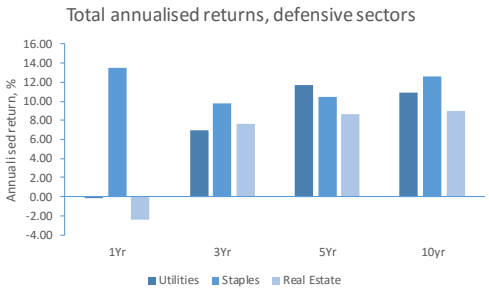
An unintended consequence of the tax cuts was to create a problematic position whereby utilities could no longer benefit from all deferred income taxes accrued on their balance sheets. Unlike other industries, regulated utilities are required to refund excess deferred taxes to customers (albeit not as a single repayment), forcing utility companies to divert cash from other uses, or raise debt, in order to fund the reimbursements.

Utility price performance stacks up well against other bond proxy sectors

Utilities have broadly matched other bond proxy sectors in total returns across three, five and ten year horizons. Utilities have outperformed Consumer Staples on a five year span, and Real Estate on five and ten year spans.

As economies emerge from the pandemic-induced recession, we expect Utilities to be preferred over Real Estate, as demand for office space will be negatively impacted by unemployment and work-from-home trends, plus retail store closures in malls.

Figure 6: Utilities hold up well against other defensive sectors



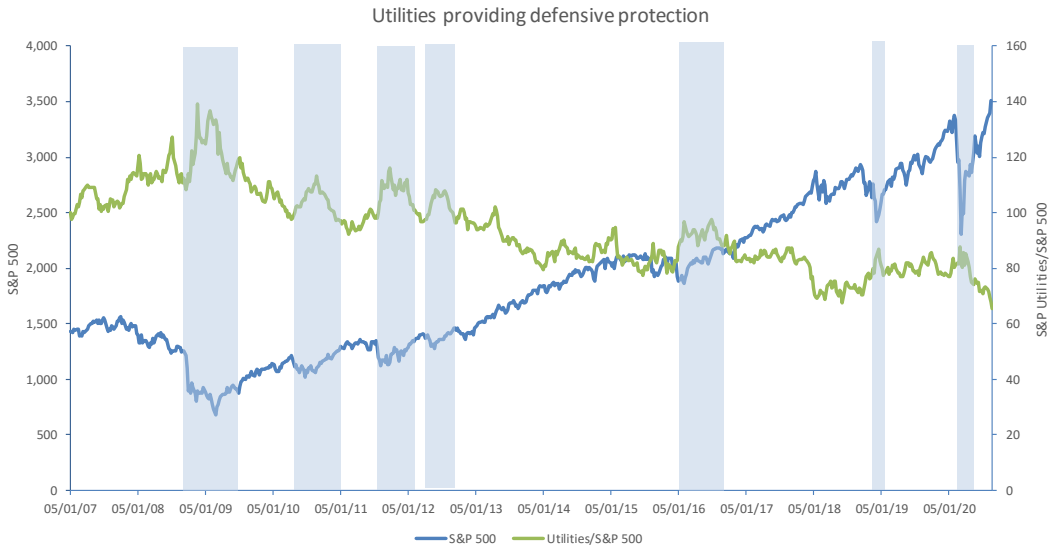
Source: Bloomberg

Consumer staples were supported by pantry stocking during lockdown and demand for cleaning products which we would expect to wane as the lockdowns abate. That outcome would provide a catch-up opportunity for utilities. Importantly larger staples companies have significant exposure to global developed and emerging markets and consequently earnings will reflect the trajectory of non-US recovery in addition to currency impacts, both of which are largely absent from regulated utilities. Staples have benefited in recent months from the weakening dollar.

Defensive credentials tested in COVID-19 sell-off

In the GFC and subsequent periods, many periods of utility outperformance have occurred when the broader market was in decline, burnishing the Utility sector's credentials as a defensive sector.

Figure 7: Utility defensive merits not strongly evident in 2020



Source: Bloomberg, Atlantic Equites calculations

We would have expected utilities to deliver stronger outperformance during the COVID-19 sell-off. Over the course of 1Q20 Utilities outperformed the S&P 500 by 580 basis points. However, performance measured from end-January to end-March was identical, as both Utilities and the SPX dropped by 20%. In other words, Utilities outperformed strongly in January as bond yields fell, but not when the market became disorderly.

We see five factors which stymied stronger outperformance from Utilities in the heat of the crisis:

1/ **The period was marked by a rapid liquidation event sell-off in which other defensive instruments declined**. These included government bonds (10-year yields briefly spiked from 0.5% to 1.2%) and gold (fell 12% peak to trough). At the time these moves were variously described as de-leveraging trades, or sales to cover losses, boost cash reserves and fund redemptions as investors exited en-masse.

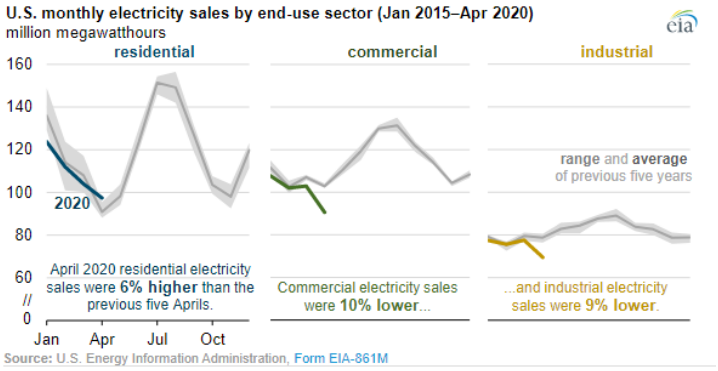
2/ **Utilities lost out to Consumer Staples (-13% in 1Q20) as the preferred defensive sector** as the latter benefited from consumer stockpiling during the early spread of the pandemic. Utilities did not offer a similar buffer to the effects of the virus.

3/ **The emergence of the stay-at-home trade,** which saw investors sidestep traditional havens including utilities and instead flock to Amazon, gaming companies etc.

4/ **US power demand dropped abruptly as stay-at-home orders took effect**, with a 4% YoY fall in April. Versus the five year average, Commercial and industrial demand fell by 10% and 9% respectively, which was not fully offset by a 6% rise in residential demand.

5/ **Bad debt charges at Utilities will rise** as disconnections and late payment fees were suspended in most states. These issues are relatively minor, as losses can typically be reclaimed, but there is a lag in many cases, crimping utility cash flows.

Figure 8: Total US power demand fell 4% YoY in April as the pandemic spread



Source: EIA

State regulators have not been sympathetic toward prompt rate increases to recover costs: A multi-utility request to the Indiana regulator to raise charges on a temporary basis in order to recover costs was rejected in a Jun 29 verdict. A similar proposal in Wisconsin also failed.

Utility returns not homogenous

Despite the bond proxy label and profitability capped by regulatory limits, share price performance within the utility space has not been uniform. The spread in share price performance amongst sector constituents has been quite diverse over a number of time periods (Figure 9).

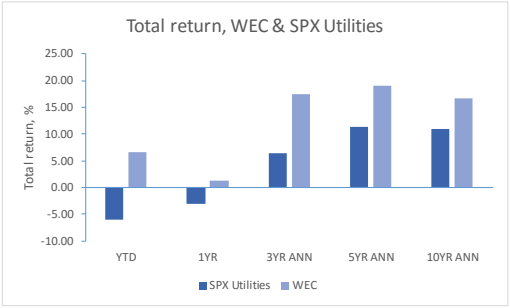
Figure 9: A diverse range of returns, selectivity pays

	1M	3M	6M	YTD	1YR	3YR ANN	5YR ANN	10YR ANN
Max	17.00	31.01	9.34	17.73	27.07	26.12	27.40	22.99
Min	-15.52	-31.52	-34.51	-37.65	-34.37	-9.45	1.70	2.09
Spread	32.51	62.53	43.85	55.38	61.44	35.58	25.70	20.89

Source: Bloomberg

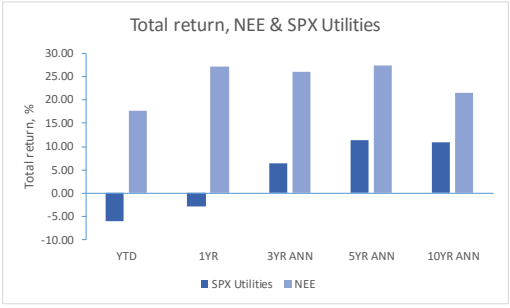
The range in price performance indicates good potential for stockpicking within the sector. The wide range in fuel mix, geographic spread, regulatory approaches, gas/power splits, customer categories, financial strength and corporate strategies is likely to lead to a continued divergence in price performance in future periods.

Figure 10: WEC outperformance



Source: Bloomberg

Figure 11: NEE outperformance



Source: Bloomberg

Both WEC and NEE have strong track records of sector-relative outperformance (Figure 10, Figure 11).

Filtering for quality names

For this initiation report we whittled down the S&P 500 Utility members to select our initiation targets based on a number of criteria.

Figure 12: S&P Utilities stock screener

9/4/2020		Mkt Cap	EV	Price	S&P rating	1yr ROE	3yr ROE	5yr ROE	EPS, $				DIVIDEND			
		$bn	$bn	$		%	%	%	2017	2018	2019	r CAGR	2017	2018	2019	3YR
NEXTERA ENERGY	**NEE**	137.4	168.0	**280.59**	**A-**	**11.8**	**17.4**	**11.4**	6.70	7.37	7.55	**6%**	**3.93**	**4.44**	**5.00**	**13%**
DOMINION ENERGY	**D**	**66.4**	**112.5**	**78.99**	**BBB+**	**16.3**	**12.5**	**16.2**	3.60	4.07	5.63	**25%**	**3.04**	**3.34**	**3.67**	**10%**
DUKE ENERGY CORP	DUK	59.7	59.7	81.14	A-	8.6	7.3	7.7	4.57	4.71	5.06	5%	3.49	3.64	3.75	4%
SOUTHERN CO	SO	55.6	107.2	52.6	A-	12.1	10.2	12.8	3.02	3.12	2.98	-1%	2.30	2.38	2.46	3%
AMERICAN ELECTRI	**AEP**	**39.5**	**71.9**	**79.56**	**A-**	**9.8**	**10.3**	**10.4**	3.68	3.94	4.01	**4%**	**2.39**	**2.53**	**2.71**	**6%**
SEMPRA ENERGY	SRE	35.5	60.3	122.72	BBB+	0.8	7.1	9.6	5.42	4.87	5.61	2%	3.29	3.58	4.18	13%
EXELON CORP	EXC	36.3	75.2	37.29	BBB+	9.0	9.8	9.4	2.62	3.19	3.10	9%	1.31	1.38	1.45	5%
XCEL ENERGY INC	**XEL**	**37.1**	**54.4**	**70.65**	**A-**	**10.9**	**10.5**	**10.5**	2.30	2.47	2.64	**7%**	**1.44**	**1.52**	**1.62**	**6%**
WEC ENERGY GROUP	**WEC**	**30.4**	**40.6**	**96.36**	**A-**	**11.5**	**11.8**	**10.9**	3.14	3.34	3.58	**7%**	**2.08**	**2.21**	**2.36**	**7%**
EVERSOURCE ENERG	ES	29.5	43.5	86.08	A-	9.0	8.6	9.0	3.11	3.28	3.44	5%	1.90	2.02	2.14	6%
CONS EDISON INC	ED	24.2	46.7	72.40	A-	8.1	8.9	8.7	4.12	4.31	4.37	3%	2.76	2.86	2.96	4%
PUB SERV ENTERP	PEG	26.3	41.4	52.03	BBB+	11.5	11.1	10.8	2.93	2.73	3.26	6%	1.72	1.80	1.88	5%
FIRSTENERGY CORP	FE	15.9	43.0	29.39	BBB *-	13.5	-0.8	14.9	2.17	1.93	2.56	9%	1.44	1.46	1.53	3%
AMERICAN WATER W	AWK	25.8	33.4	142.48	A	11.5	9.5	10.2	3.03	3.24	3.77	12%	1.62	1.78	1.96	10%
EDISON INTL	EIX	20.0	43.6	52.96	BBB	11.6	3.9	12.5	4.50	4.14	5.13	7%	2.23	2.43	2.48	5%
DTE ENERGY CO	DTE	22.9	39.3	119.12	BBB+	11.2	11.4	10.9	5.59	6.37	6.29	6%	3.36	3.60	3.85	7%
ENTERGY CORP	ETR	19.6	39.5	98.00	BBB+	20.5	9.4	17.1	7.20	7.31	11.42	26%	3.50	3.58	3.66	2%
PPL CORP	PPL	21.7	42.6	28.28	A-	14.4	13.8	14.9	2.25	2.41	2.45	4%	1.58	1.64	1.65	2%
AMEREN CORP	AEE	19.5	28.2	79.10	BBB+	10.6	9.6	9.9	2.83	3.32	3.35	9%	1.78	1.85	1.92	4%
CMS ENERGY CORP	**CMS**	**17.7**	**30.4**	**61.91**	**BBB+**	**15.6**	**12.9**	**14.1**	**2.17**	**2.33**	**2.49**	**7%**	**1.33**	**1.43**	**1.53**	**7%**
ATMOS ENERGY	ATO	12.1	16.8	98.09	A	9.5	11.5	10.2	3.73	4.00	4.35	8%	1.80	1.94	2.10	8%
ALLIANT ENERGY	LNT	13.5	18.7	53.97	A-	12.6	11.5	11.3	1.93	2.17	2.31	9%	1.26	1.34	1.42	6%
NISOURCE INC	NI	8.6	19.4	22.42	BBB+	12.0	2.7	9.0	1.21	1.39	1.49	11%	0.70	0.78	0.80	7%
PINNACLE WEST	PNW	8.2	15.1	72.97	A-	10.5	10.0	9.7	4.35	4.43	4.49	2%	2.70	2.87	3.04	6%
AES CORP	AES	11.8	32.2	17.69	BB+	32.5	2.7	20.9	1.08	0.89	1.48	17%	0.49	0.53	0.55	6%
CENTERPOINT ENER	CNP	11.0	25.4	20.15	BBB+	17.1	20.2	13.4	1.37	1.55	1.70	12%	1.07	1.11	0.86	-10%

Source: Bloomberg

Our criteria include:

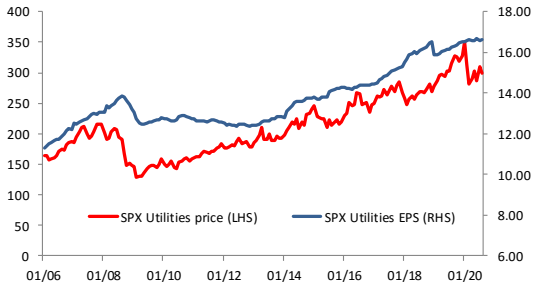
- Strong balance sheets with S&P credit ratings of BBB+ or higher
- Double digit earned ROEs, using adjusted earnings if warranted
- Dividend growth mid-single-digit or higher CAGR in past three years
- EPS growth mid-single-digit or higher CAGR in past three years
- A track record of sector-relative outperformance
- A demonstrated commitment to good performance on ESG criteria

Companies that met or exceeded our criteria are WEC, NEE, XEL, CMS, AEP and D.

We see scope for continued growth in regulated earnings

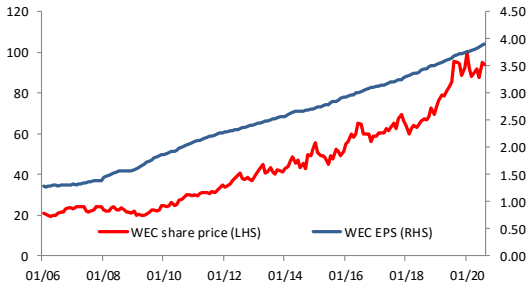
Predictable earnings growth is an important share price driver within the Utility sector, as shown by historic performance (Figure 13, Figure 14).

Figure 13: Utilities: price vs earnings



Source: Bloomberg. Consensus 12m forward EPS

Figure 14: WEC: price vs earnings

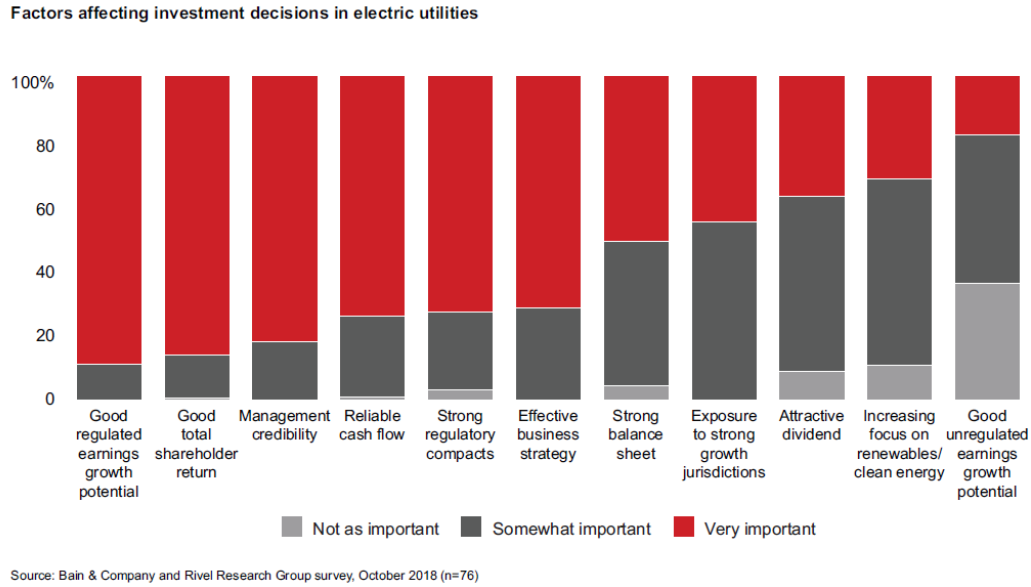


Source: Bloomberg. Consensus 12m forward EPS

Utility earnings have been significantly more predictable than the broader market. We calculate a 10% standard deviation in monthly consensus EPS forecasts for Utilities versus 25% for the S&P 500 since 2006.

Growth potential in regulated earnings ranked highest in importance for investors in a survey carried out by Bain & Company, a consultancy (Figure 15).

Figure 15: Investors want predictable earnings growth from Utilities



Source: Bain & Company, Rivel Research Group

Indeed, it would be challenging to argue for the defensive merits of Utility investing in the absence of a reliable earnings stream. Note that dividends were considered significantly less important than earnings growth by respondents, undermining the stereotype of utilities being a dividend play. Nonetheless the results are internally consistent, as a preference for earnings growth requires ongoing investment in regulated assets, which precludes a very generous dividend policy that constrains management from investing capital in growth opportunities.

A summary of medium-term earnings growth targets is shown below.

Figure 16: Medium-term target growth rates at utilities

EPS CAGR target	Companies			
6-8%	Ameren	Exelon*	NextEra	
5-7%	American	Dominion**	DTE	Eversource
	FirstEnergy	WEC	Xcel	
4-6%	Duke	Southern		

Source: Company presentations. *regulated utilities only, **5%+

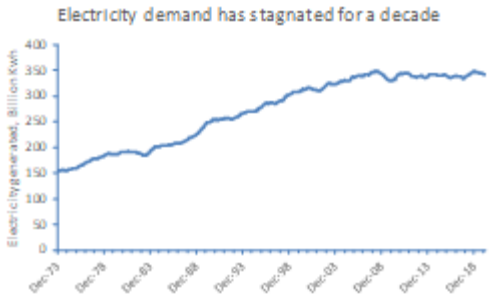
Regulated utilities delivered a 5.9% CAGR in adjusted earnings between 2009 and 2019, according to Edison Electric Institute (EEI), which represents all US investor-owned utilities.

Utilities have successfully overcome flat power demand to grow earnings.

Earnings growth within utilities has been delivered against a backdrop of stagnant power demand over the past decade. Between 2010-2019, US electricity demand grew at a CAGR of just 0.03%, as raised energy efficiency has offset increased numbers of customer accounts and higher economic activity. Gas has fared better than power, with a 2010-2019 CAGR of

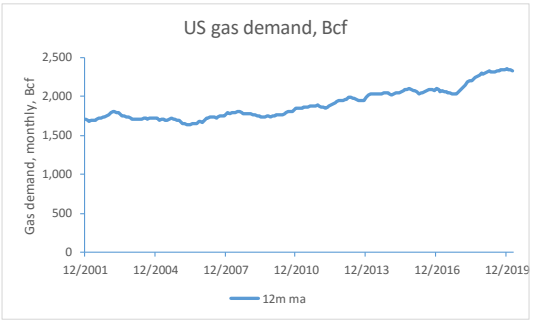
2.6% in consumption, but gas transmission/distribution is minor, at 15% of utility revenues in 2019 (EEI membership).

Figure 17: Stagnant US power demand



Source: EIA

Figure 18: Gas demand growth modest



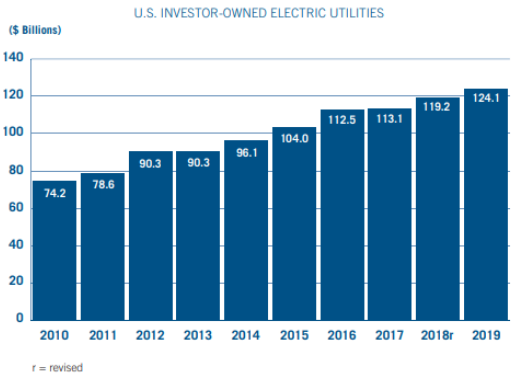
Source: EIA

We assume these trends do not meaningfully change in our forecast period and that Utilities will continue to increase earnings despite the absence of secular growth in power demand.

Growing rate base investment will continue to drive earnings growth

For regulated utilities we expect that the principal driver of earnings growth will remain authorised returns on rising investment. Overall, investments will continue to be targeted at improving service reliability and quality rather than in incremental generation capacity.

Figure 19: Capex to continue to rise



Source: EEI

Utility capex has been on a rising trend for several years (Figure 19) and is estimated to reach ~$140bn in 2020.

We think investment needs should deter significant adverse changes in regulatory stances around the US. Regulators rely on utilities to invest in climate resilience, replace aging infrastructure, roll out EV charging networks, deter cyberattacks, facilitate smart meters and reconfigure grids for renewables/distributed energy.

The track record of increased capex over many years suggests regulators are broadly comfortable with the investment strategies deployed by the utilities. From the corporate perspective the rising spending needs to be balanced against balance sheet health (dividend security) and that customer bill increases are kept to a minimum. For the latter, utilities have been favoured by lower gas, coal and oil fuel bills.

In the following sections we discuss the important drivers for investment growth at regulated utilities. These are:

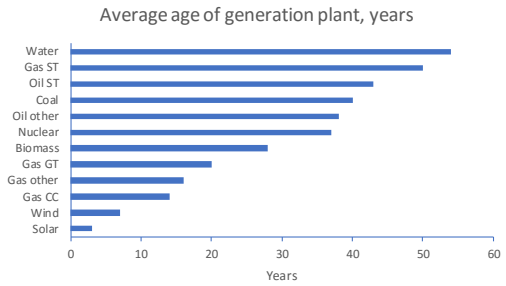
- Replacing aging and obsolete generation
- Responding to customer, shareholder and regulatory demand for low-carbon power
- New transmission and distribution to facilitate a reshaped generation system
- Investment in network resilience to offset climate change, wildfires, cyber-attacks, natural disasters, etc
- New technologies such as smart grids and utility-scale battery storage
- Natural gas distribution pipe upgrades and replacement

We also look at longer-term potential drivers for growth in power demand, namely electrification of transport (modest medium term potential) and green hydrogen production (high long-term potential).

Capex driver I - renewing obsolete and aging power generation

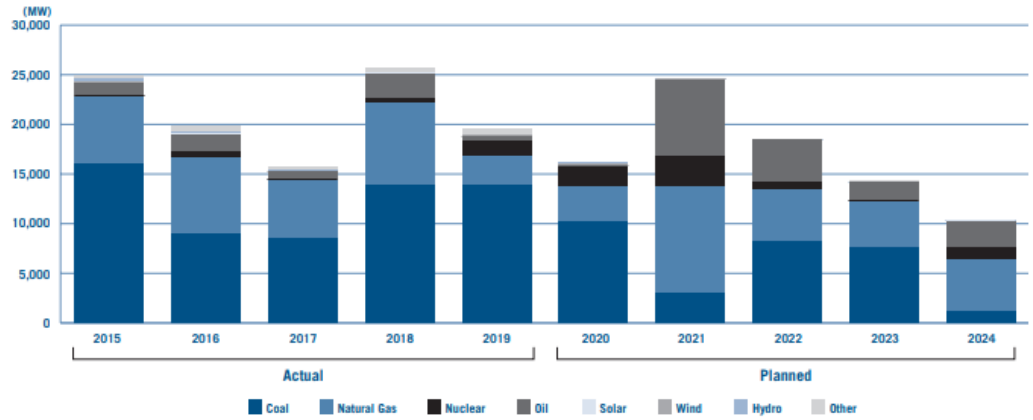
A significant amount of the US generation fleet is approaching the end of its useful life or is using obsolete technology which is inefficient by modern standards. New capacity will have higher energy efficiency and lower operating costs. One example is NEE's modernisation of its Dania Beach generation facility. Here two new, large gas-fired generation units are ~20% more efficient than the national average. Absolute savings in saved fuel are significant at $2/mmBtu and life-of-project savings estimated at ~$340m to the benefit of customers. In addition, environmental performance is superior.

Figure 20: Much aging kit to be replaced



Source: EIA. ST = steam turbine, GT = gas turbine, CC = combined cycle

Figure 21: Generation capacity retirements to remain elevated, MW



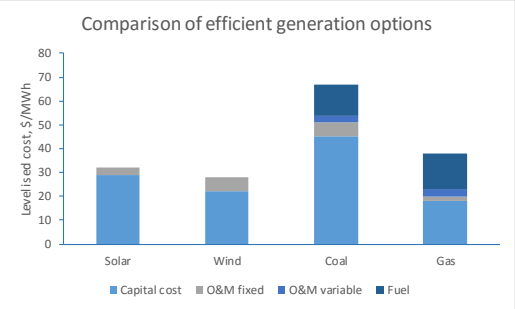
Source: EEI

Investor-owned utilities plan to retire an average of ~20,000MW of capacity in 2020-2022 (Figure 21). The total capacity with firm closure plans tails off in further out years but we expect numbers to rise as portfolios remain under regular review.

Capex driver II - New renewables

Until recently, most regulated utilities preferred to purchase power from merchant renewable generators, rather than owning the generation facilities outright. For example, 80% of new wind capacity in 2018 was owned by independent power producers. The reluctance to own assets was partly due to the higher cost of renewables and the inability of regulated utilities to effectively utilise tax credits and capital allowances. In addition, falling fuel prices have supported the competitiveness of coal and gas generation. With continued falls in

Figure 22: Displacing fuel costs is feasible



Source: Lazard's levelized cost of energy analysis, v13

capital costs, some renewables are now cost competitive with many traditional power sources, without subsidies (Figure 22), which has boosted utility interest in owning and operating these assets.

As an example of the improved pricing dynamics, a utility could install twice the effective generating capacity (adjusted for load factor) of solar as for coal (Figure 22). This would displace $13/MWh in fuel costs by rateable investments that add to earnings, rather than a pass-through of fuel costs, without increasing customer bills.

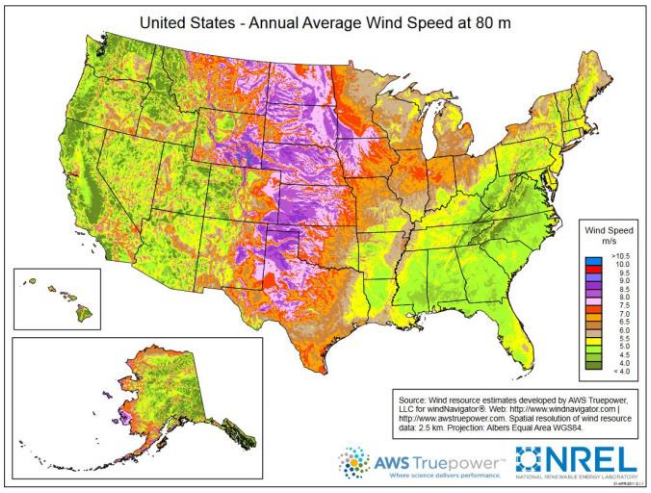
Apart from the economic parity arguments, investors are increasingly focused on ESG criteria which for utilities means a strong focus on carbon emissions. US insurers and credit rating agencies are increasingly looking at risks of stranded assets, impacts of carbon taxes, climate resilience and other issues that support growing adoption of renewables. Renewables versus fossil fuel/nuclear is a politicised debate in the US but environmental awareness has generally risen in the past several years amongst voters. A recent research study from Italy (Evidence-Based Considerations Exploring Relations between SARS-CoV-2 Pandemic and Air Pollution) linked higher COVID-19 deaths to higher air pollution, putting more pressure on emitters.

Some new renewables capacity is mandated by state Renewable Portfolio Standards programmes and therefore will have regulatory support.

Capex driver III - Rewiring the transmission network for new era generation

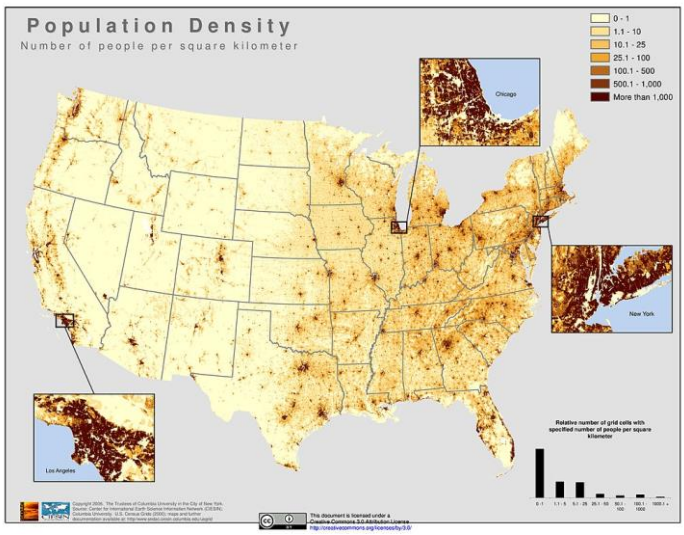
Continued large scale adoption of renewables will require additional transmission capacity to bring power from the best generation sites to customers. Wind is a good example: where the wind strength is highest, in the central US states, relatively few people live (Figure 23, Figure 24). Added capacity will require new transmission to key markets.

Figure 23: Where the wind blows…



Source: NREL

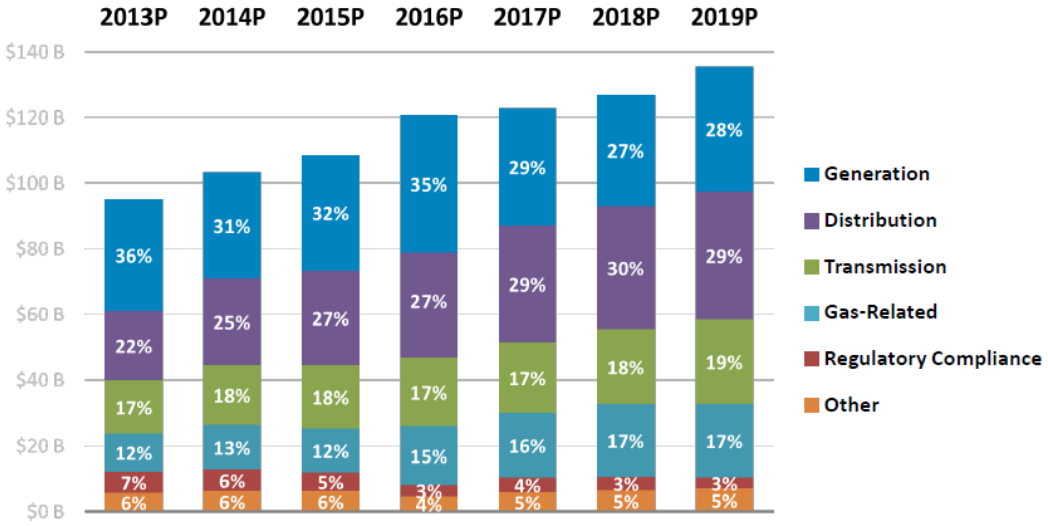
Figure 24: …nobody goes



Source: Columbia University

As the US generation network becomes more reliant on intermittent sources of renewable power, increased redundancy in transmission capacity is likely to be required, in order to facilitate back-up, alternative sources of power. One of the reasons California imposed demand rationing during its heatwave a few weeks ago was the lack of surplus transmission capacity to bring power from other, non-affected states into California.

Figure 25: Transmission spending an important element in total utility capex



Source: EEI

A second adaptation required for transmission is to accommodate the changing nature of demand peaks, with higher peaks due to rising populations, larger houses, more air conditioning and more gadgets.

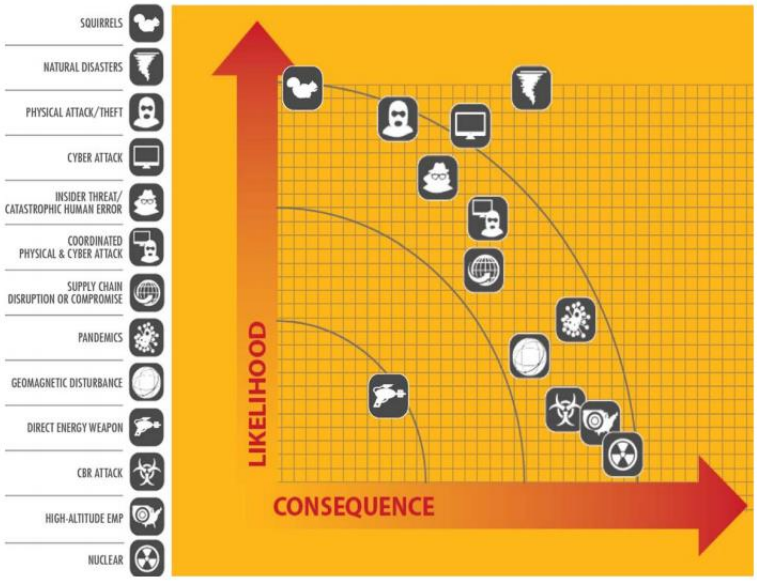
Expenditure on transmission has risen in absolute terms and on a relative basis (albeit modestly) over time (Figure 25). Recent FERC decisions on authorised ROEs make transmission very competitive for investment versus other competing projects.

More broadly the US would benefit from closer integration of its three large regional grid networks via greater transmission links to facilitate trading of power more easily to where it is needed. However, in practice large transmission projects could be strongly opposed by local communities, resulting in delays or higher costs.

Capex driver IV – investing in network resilience

Utilities are critical to society but are taken for granted – until something goes wrong. From a utility planner's perspective, there are a worryingly diverse range of potential disruptions which could impact a utility's ability to perform its supply obligations (Figure 26).

Figure 26: Electricity grid threat landscape



Source: EEI. Note CBR is Chemical, Biological, Radiation, EMP is electromagnetic pulse

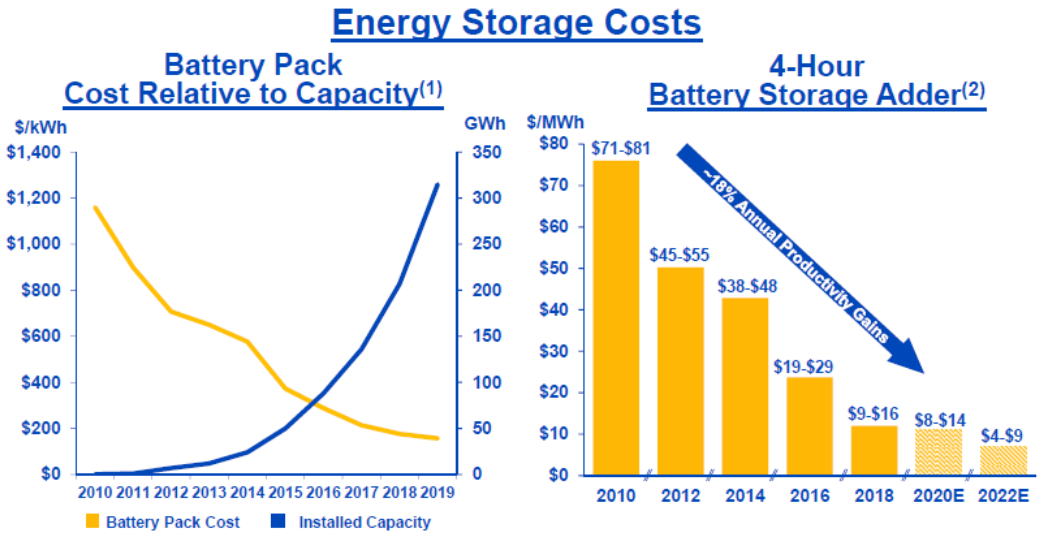
Already this year there's been significant power disruption along the mid-Atlantic/New England coast due to Tropical Strom Isaias, which knocked out power to over three million properties, in some instances for several days. Prior notable events include the 2003 Northeast blackout (50m properties affected), the New England ice storm of 1998 (5m properties affected), Hurricane Katrina in 2005 (3m affected, some for weeks) and Storm Sandy (2012, causing widespread, long duration outages in New York and New Jersey, 8m affected).

In response to reliability threats, a number of states promote grid improvement plans, although there is a wide variety of regulatory mechanisms in pace. Southern, more hurricane prone states are more likely to approve the addition of specific storm hardening cost "riders" to customer bills, or the creation of reserve accounts as a form of self-insurance, or the ability to securitise costs. Some states, including California, Florida and Connecticut require utilities to submit emergency preparedness plans, which opens dialogue on approving resilience expenditures. PG&E's problems with wildfires in 2017 and 2018, which resulted in its bankruptcy and guilty pleas to 84 felony counts of involuntary manslaughter, should boost willingness in other states and within utilities to construct networks that are robust to a variety of threats.

Capex driver V – new technology

In some parts of the US a power provider only discovers a fault when a customer phones in to notify it of lost service. More technologically advanced providers are deploying equipment which can detect and even prevent outages. The smart grid relies on two main approaches to improve supply: automated meters which enable two-way communication between the utility and its customers, and sensor equipment along the transmission/distribution lines to conduct ongoing efficiency checks. IT/digitalisation programmes can be substantial capital projects, as shown at WEC, which has allocated a total of $1.2bn to technology spending in 2020-2024.

Figure 27: Falling cost of battery storage and solar pairing has spurred adoption



Source: NEE

Utility-scale battery storage is gaining traction within regulated utilities. Rising adoption reflects a good pairing of storage with solar and a rapidly falling cost profile (Figure 27). NEE is building the world's largest battery storage facility at its Manatee plant, comprising ~410MW of capacity. The storage facility comes on-line in 2021 and will expedite the retirement of two, 1970s-era gas generating units. NEE estimates customer savings of $100m over the life of the project.

Storage can be seen as a challenge or opportunity for regulated utilities. By offering cost effective storage using renewables, utilities remove an incentive for customers to install their own storage behind the meter. Utilities have a benefit from economies of scale to make storage a success within the regulated sector.

Capex driver VI – replacing/upgrading gas distribution lines.

The risks of aged and poorly managed gas lines were shown in Massachusetts where, in September 2018, up to 100 properties were burnt or badly damaged when an improperly abandoned iron pipe failed and the network was over-pressured. There are ~1.9 million miles of iron or steel gas mains or service lines in use across the US. The vast majority of the total are bare steel supply lines readily replaced by more reliable plastic lines. A further benefit of replacement is that the renewed, plastic lines have lower leakage of methane, which is a greenhouse gas.

The investment opportunity for regulated utilities is substantial. At WEC, gas distribution is the largest component of capital spending at 38% of total capex in 2020-2024, comprising a total of $5.7bn during that period. The projects include replacing iron pipes in Chicago.

$1 saved in O&M supports ~$8 of investment that boosts utility earnings

Many utilities have become adept at reducing operating costs, creating headroom for rateable assets to grow, thereby generating earnings growth. The industry's rule of thumb is that one dollar saved in opex supports $8 in rateable investment without raising customer bills, as shown in the illustrative example in the following table.

Figure 28: Opex savings support rateable investment without higher customer bills

Item	Value, $		Comment
Operations and maintenance saving, pre-tax	-100	a	
Tax adjustment	21	b	Assumes 21% rate
Post-tax impact on customer bill	-79	c=a+b	
Depreciation of $800 rate base investment	20	d	40-year asset life, straight line
Incremental interest charge	16	e	Assuming 50% debt finance @ 4%
Assumed 10% ROE = net benefit to utility net income	**40**	**f**	**10% ROE applied to 50% equity layer**
Net impact on customer bills	**-3**	**=c+d+e+f**	**Net change in customer bills**

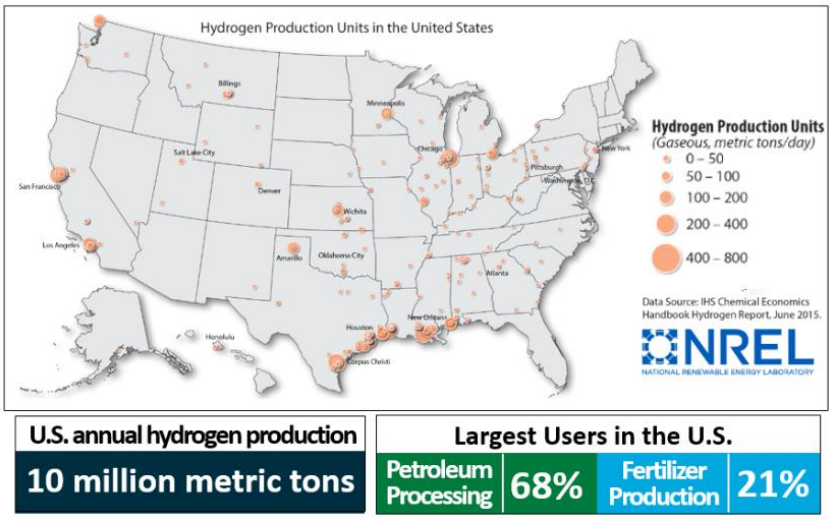
Source: Atlantic Equities

As the example above shows, the earnings benefit from displacing opex with regulated capex is meaningful, with every $100 saved in O&M translating into $40 in incremental net income for the utility. Operations and maintenance costs totalled $92bn for EEI member companies in 2019 so every one percent saving would translate into $7.4bn in regulated investment potential. Using the parameters in our example we calculate a resulting benefit to annual industry earnings of $370m.

Green hydrogen's high energy needs a potential long-term growth driver

Just replacing global current output of hydrogen (~65mT, produced from coal/methane) with green hydrogen (from electrolysis of water using renewables) would require power inputs equivalent to Europe's entire power generation. The potential requirements for clean energy to produce green hydrogen are clearly enormous.

Figure 29: Hydrogen – small today, bigger in future?



Source: NREL. DOE

In the US hydrogen consumption is tied to industry, particularly oil refining (Figure 29) with current usage around 10 million tonnes per year. Assuming electrolysis efficiency of 50MWh/T of hydrogen implies annual power demand of 500m MWh to generate all the hydrogen as green fuel. That is ~12.5% of total power demand in the US and would require a doubling in renewables supply (as of 2019). Additional energy requirements for compression, transport and liquefaction of hydrogen are excluded from this analysis. If green hydrogen grows to displace natural gas and other fuels, the requirements for additional renewable energy capacity will be very significant.

In July NEE announced a $65m hydrogen test pilot facility at FPL, subject to regulatory approval. The plant will utilise solar energy to produce hydrogen in a ~20MW facility. The pilot is expected to be operational in 2023. If successful hydrogen can displace natural gas in fuel generation and provide a pathway to eventual zero carbon (versus net zero) generation, while providing a significant growth opportunity for renewable power generation. In terms of earnings

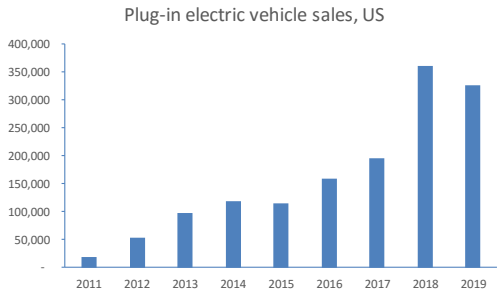
contribution, NEE does not expect hydrogen to be a material earnings driver until next decade, assuming technology adoption follows a similar trajectory to battery storage, but nonetheless sees hydrogen as a significant strategic initiative which has strong long-term growth potential. Of course, the time scale could be compressed if government policy was more supportive, for example under a Biden presidency. We believe a Trump presidency would continue to promote fossil fuel consumption in preference to green hydrogen.

Plug-in EV power demand to remain modest, infrastructure rollout could be supported by state regulators.

Plug-in electrical vehicles (PEVs) could provide a modest boost to US power demand in 2020-2030. Hydrogen offers more long-term potential for electrical demand growth, in our view.

With cumulative sales of 1.6m vehicles, PEV power demand is at *de minimus* levels today and transport demand accounted for 0.2% of total power demand in January-April 2020.

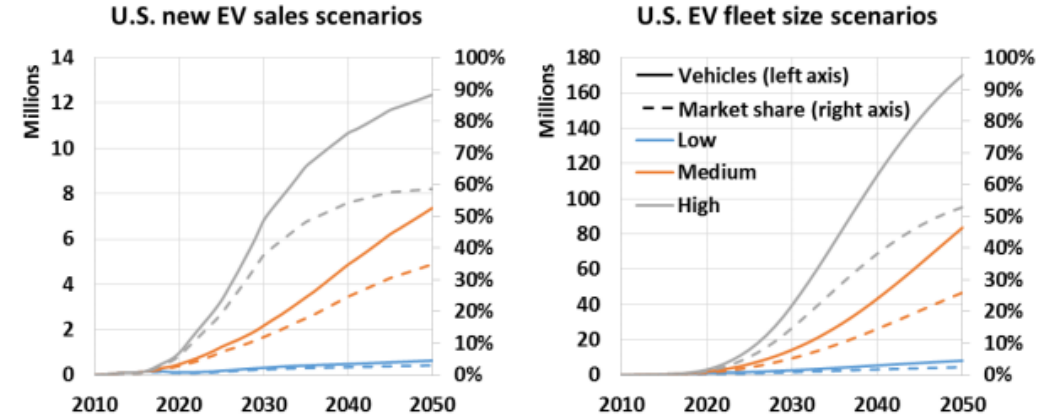
Figure 30: PEV numbers small today



Source: Argonne National Laboratory

Even in a strong growth scenario, we do not see material EV-led demand in our forecast period. Assuming power consumption of 4MWh/car/year it would take 10 million vehicles to raise annual average power consumption by 1%.

Figure 31: EV sales scenarios



Source: US Dept. of Energy

In a scenario analysis, the US Energy department looked at electricity demand under different PEV uptakes (Figure 30). Under the high scenario, the PEV fleet size increases to 40 million vehicles by 2030, equal to 15% market share. Incremental generation required would be 16TWh (~4% of 2019 total US power demand). The analysis excludes non plug-in vehicles.

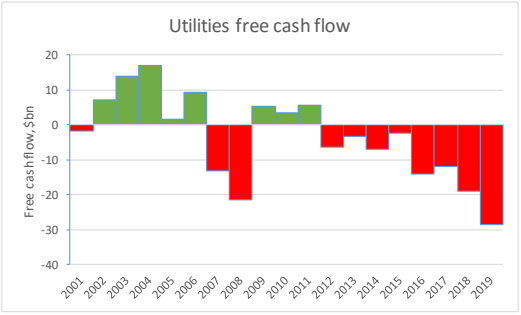
Approaches to infrastructure provision vary by state, depending on the regulatory environment. As PEV penetration increases utilities could employ more time-based pricing to encourage off-peak charging which would avoid expensive investment in boosting peak load provision, while adding sales without network expansion, resulting in lower unit costs for all consumers.

There is an opportunity for utilities to build and manage charging depots for larger vehicle fleets such as municipal buses. There's a further opportunity in expanding distribution capacity particularly in overcoming legacy infrastructure constraints in densely populated urban areas.

Why there's no free cash flow from Utilities….

Given the above focus on capital investment to generate earnings growth, investor-owned utilities are motivated to reinvest as heavily as possible. One consequence of the capex-heavy strategy is the absence of free cash flow from the companies. Utilities have not generated material amounts of free cash flow in over a decade (Figure 32), without ostensibly damaging share price performance, which indicates shareholders accept the precedence of earnings growth over cash flow. However, at first glance this seems atypical for a cash generative sector but, as we note above (e.g. Figure 13, Figure 14) investors have rewarded utilities for earnings growth rather than free cash flow generation so this is not problematic.

Figure 32: Capex not free cash flow



Source: EEI. Equals cash from operations less capex.

….and why lacking free cash flow does not weigh on valuations

The utility sector's capital spending is significantly in excess of maintenance levels, as approximated by depreciation charges. If investor preferences change to prioritise free cash flows above earnings growth, utilities can dial down investments to maintenance levels, resulting in significant free cash flow generation. Surplus funds could be directed to share buybacks in order to generate per-share earnings growth. For example, for the EEI universe of companies (i.e. all investor owned utilities) capital investment totalled $124bn in 2019, more than double depreciation charges of $54bn. For WEC, FY20 guidance for consolidated capex of $2.4bn compares with depreciation costs of ~$920m. Free cash flow yield would be ~4.5% if capex fell to maintenance levels. For NEE, consolidated capex of $12-14bn p.a. to 2022 compares with depreciation of ~$4-5bn p.a. If capex fell to maintenance levels, we estimate free cash flow yield would be ~4%. The S&P 500 has a ~3.1% free cash flow yield in FY20, rising to ~4.0% in FY21, based on Bloomberg consensus data. We see utilities offering a more predictable cash flow stream than the broader market.

Regulated utilities insulated from higher income tax rates, competitive renewables exposed

US income taxes could rise under a Biden presidency, to narrow the large budget deficits in recent years and/or to fund economic recovery from COVID for example via an infrastructure programme (which would presumably include utility spending). Regulated utilities are insulated from tax increases as they are passed through to customers i.e. customer bills rise while utility earnings are unchanged.

Figure 33: Higher taxes will not impact net income at regulated utilities- illustrative example

Item	Unit	Calculation	21% tax	28% tax	Change
Rate base	$m	a	10,000	10,000	0
Equity layer	%	b	50%	50%	0
Authorized ROE	%	c	10%	10%	0
Net income	**$m**	**d=a*b*c**	**500**	**500**	**No change**
Tax rate	%	e	21%	28%	0
Tax gross up	$m	f= d*(e/(1-e))	133	194	62
Pre-tax income	$m	g=e+f	633	694	62
Interest @5% rate	$m	h= a*b*.05	250	250	0
EBIT	$m	i=g+h	883	944	62
Depreciation @40yr life	$m	j=a/40	250	250	0
EBITDA	$m	k=i+j	1,133	1,194	62
EBITDA/Interest expense	x		4.5	4.8	0.2
Debt/EBITDA	x		4.4	4.2	-0.2

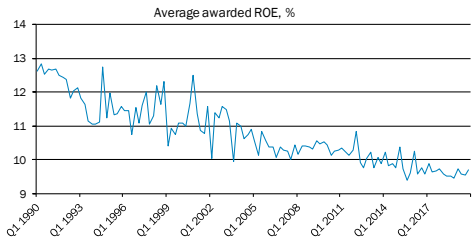
Source: Atlantic Equities calculations

A beneficial effect of higher pass-through costs comes via the mechanical uplift in EBIT and EBITDA resulting from the requirement to recover costs. The net effect is improved debt coverage ratios, such as Net debt/EBITDA as shown in the preceding illustrative example. This is not simply an optical change: when tax rates were cut in late 2017, credit rating agencies adjusted for the adverse shift in coverage metrics in their rating assessments. For example, Moody's placed more than twenty utility entities on negative rating watch partly due to the reduced metrics. Utilities significantly underperformed the broader market when the Trump tax cuts were enacted so we see scope for relative outperformance if taxes rise. The 2017 tax reform was particularly damaging to utilities as it diminished excess deferred tax assets on utility balance sheets which had to be repaid to customers in a manner consistent with the useful life of the underlying asset.

Regulated ROEs are in a declining trend but spreads to treasuries have widened

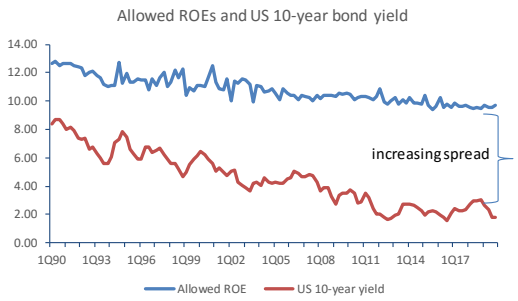
The recent sharp fall in government bond yields raises the potential for regulatory bodies to look afresh at allowed returns for utilities. Allowed ROEs have been on a downward trajectory for more than twenty years due to lower inflation/bond yields (Figure 34) but we do not see an acceleration in the trend within our forecast period, even assuming government bond yields remain depressed.

Figure 34: Secular trend of declining ROEs



Source: EEI

Figure 35: ROE spread over 10-yr widening over time.



Source: EEI

From the regulatory perspective, assessing a reasonable return for utilities must be balanced against the other important criteria of safety and reliability. On the returns point specifically, average US residential power bills have risen by a total of just 4% from 2013 to 2019, so there has been little inflationary pressure to discomfort regulators or to justify excessive pricing. Bills

have been helped by lower costs for fuel, lower taxes and lower debt costs over that period in addition to efficiencies generated by many of the utilities.

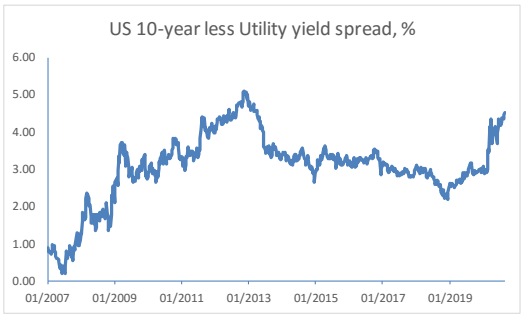
Sharply reduced ROEs would impair the utilities ability to fund their planned improvements or cause delays in the pace of investment that might have a negative impact on service provision. As a result, we believe many regulators will be slow to meaningfully cut authorised ROEs.

Allowed ROEs have declined at a much slower pace than bond yields (Figure 35) so that the spread between the effective risk-free rate represented by government bonds and allowed ROEs has progressively widened. In effect WACC has declined more than ROEs, all else equal. We note the decline in ROEs has slowed in recent years, and a fall in yields below 2% in 2016 did not trigger a kneejerk sharp fall in authorised ROEs.

With US 10-year yields near zero is a tailwind to Utility share gains exhausted?

In a word, no. While the US 10-year yield is near all-time lows, the spread between government bonds to Utility dividend yields is near all-time highs. Therefore bond proxy equities including utilities remain relatively attractive. There is significant scope for a rise in bond yields to be offset by a reduced yield spread, even if the kneejerk initial response to rising bond yields would be negative for utility shares. If interest rates remain low for an extended period, so may bond yields, which would make utilities more attractive to income-seeking investors.

Figure 36: Dividend yield to bond yield spread is unusually wide

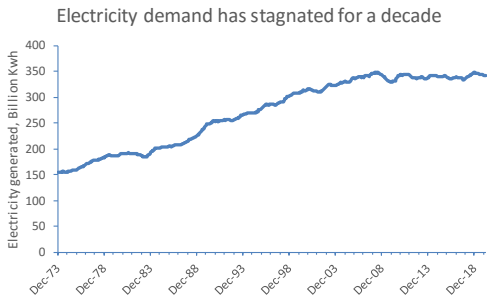


Source: AE calculations from Bloomberg data

Demand trends in electricity and natural gas

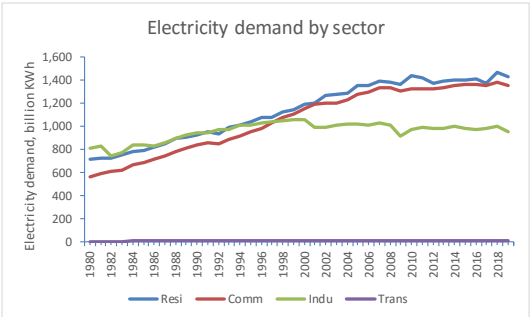
US power demand has been essentially stagnant since 2007 (Figure 37) following a long period of rising consumption, during which demand grew by a CAGR of 2.3% from 1977 to 2007. We expect end-user demand to remain moribund during our forecast period.

Figure 37: Secular stagnation in power



Source: EIA

Figure 38: Slowdown in all major segments



Source: EIA

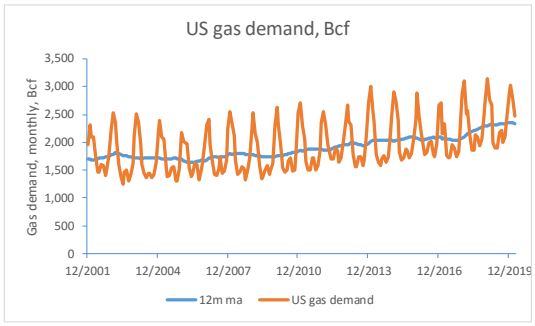
Growth rates in every main end-use category have slowed over the past decade (Figure 38). Industrial consumption has shown the weakest growth and demand is lower today than twenty years ago. The slowdown in demand growth largely reflects gains in energy efficiency, for example in improved insulation in building design. It also reflects a fall in energy-intensive heavy manufacturing over the period.

The absence of structural demand growth helps to explain why investment in generation is a minority of total expenditures, at ~30% of total spending at investor-owned utilities (Figure 25). More power capex is directed to transmission and distribution (~50% combined) as utilities look

to improve service quality and reliability and reverse prior decades of underinvestment in transmission. From a returns perspective, regulators do not distinguish between generation and non-generation spending so ROEs are identical. Transmission assets generate competitive ROEs under FERC rulings.

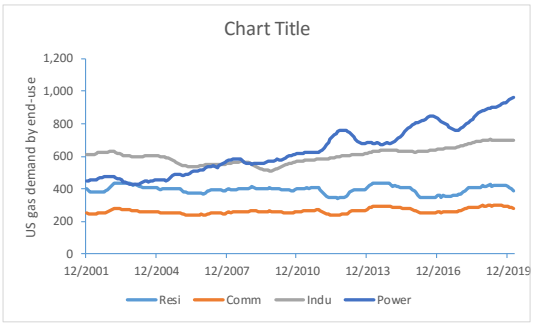
US gas demand has increased by a CAGR of 2.6% over the past ten years (Figure 39) but the EIA forecasts flat demand out to 2030 as gas loses some market share in power generation to renewables and energy efficiency continues to improve in the commercial and residential sectors. Over the past decade gas had benefited from rising industrial demand due to low prices and by displacing coal in power generation. Industrial demand could surprise to the upside in a low price scenario.

Figure 39: Gas demand levelling off



Source: EIA

Figure 40: Gas growth to slow as renewables take share in power



Source: EIA

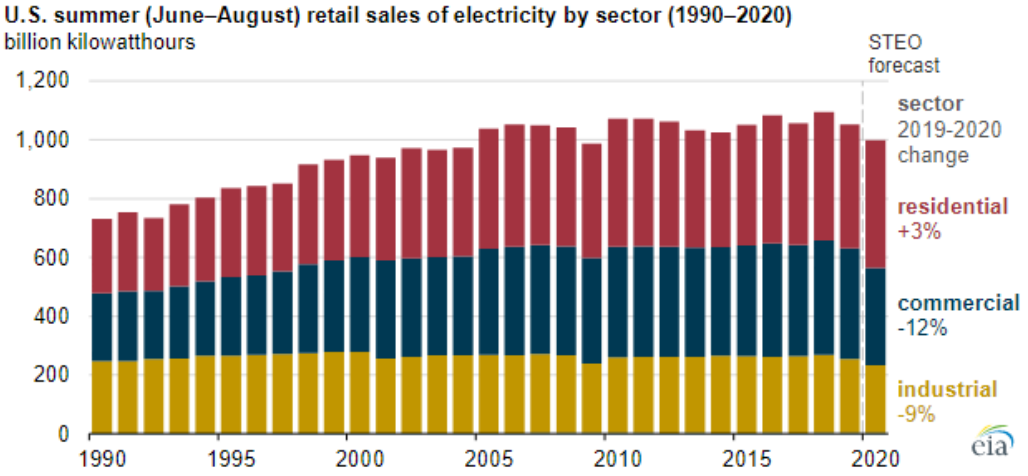
As Figure 39 shows, gas usage is highly seasonal with January peaks typically ~40% above the twelve month average. The variations create volatility in quarterly earnings.

Natural gas fuel costs are normally a pass-through cost item for utilities with ROEs based on supply infrastructure rather than volumes supplied.

COVID-19 – recovering lockdown disruption

US summer power demand is seen down 5%, according to EIA estimates (Figure 41) due to COVID-19 effects. Residential demand is boosted by stay-at-home trends including social distancing, rising 3% YoY in the EIA's projection. However, this is more than offset by falls in commercial (-12%) and industrial (-9%) demand. For utilities with revenue decoupling, where revenues are not linked to sales, this is not problematic. For others, such as WEC, swift action to cut costs can fully offset the negative effect of lower sales on earnings.

Figure 41: Summer power demand seen down 5% YoY



Source: EIA

A moratorium on disconnections was almost ubiquitous during the lockdown phase, and various regulatory treatments are in place for recovery of bad debts, deferred late payment fines and other COVID-19 related costs and expenses. These will normally be recovered with a lag and we do not see the resulting loss of cash flow as a material item.

As Figure 41 shows, power demand quickly recovered from a 2009 slump during the global financial crisis, and from the shallower economic slowdown in 2001. These precedents suggest power demand will be quick to recover when the pandemic comes under control, for example when a vaccine becomes widely available.

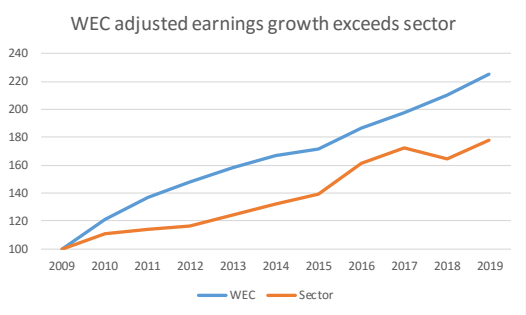
Economic weakness has been partly offset by warmer-than-normal US weather in July and August, which has boosted demand for air conditioning. In July, US weather was 4.8% warmer YoY and 23% warmer than the long-run average for the month. Preliminary data for August shows US weather was 5.3% warmer YoY and 20% warmer than the long-run average August temperatures. This data is derived from the American Gas Association, and is weighted by electric home air conditioning customers, so is more likely to be reflective of power demand shifts.

4. WEC: Initiate at Overweight, $112 price target

Summary WEC investment case

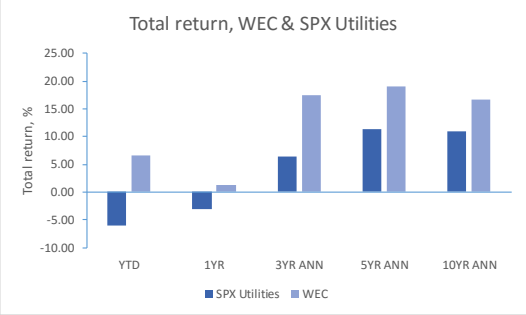
Outstanding track record for earnings delivery. WEC's adjusted EPS CAGR of 8.5% between 2009-2019 (Figure 42), is above the utility sector's 5.9% performance over the same period (using the EEI universe and methodology). WEC earnings have exceeded guidance each of the past sixteen years and quarterly earnings have beaten consensus for each of the past 22 quarters. The continued delivery has been rewarded by sector-relative outperformance (Figure 43).

Figure 42: Sector-beating EPS growth



Source: Company, EEI. Extraordinary and non-recurring items are excluded from our calculation

Figure 43: Drives sector-beating share price performance



Source: Bloomberg

WEC dividends per share have grown at a higher rate than earnings growth, with a CAGR of 13.3% between 2009-2019 versus 5% for the sector. The payout ratio has progressively risen, from 42% in 2009 to 66% in 2019, compared to 63% for the sector.

WEC benefits from relatively high authorised ROEs relative to peers, with a weighted average authorized ROE of 10.3%, above the 9.6% level seen in recent rate base determinations among regulated peers. A recent FERC award allows a 10.52% ROE at WEC's ATC affiliate (10% of total rate base) and We Power (14% of total rate base) benefits from a locked-in 12.7% ROE that extends at least until 2030.

Regulatory environment in Wisconsin (67% of rate base) has delivered win-win solutions. Wisconsin's regulator requires utilities to deliver safe, reliable power and gas at a reasonable price. WEC's success on each of these criteria is a positive backdrop for future rate base negotiations. Average bills for residential customers of WEC's Wisconsin power subsidiaries have fallen by 1% since 2013, versus a 4% gain across the nation, supporting WEC's cost management credentials. Wisconsin is the only state using an extended, two-year basis for forward looking rate years which minimises regulatory lag in recouping WEC's investment outlays, helping earned ROE to closely track authorised ROE. Wisconsin's use of earnings sharing provides a performance incentive for WEC.

We see WEC EPS growth towards the top of its 5-7% target band to 2024. We estimate an earnings CAGR of 6.5% between 2019-2024, or 7.0% if calculated consistently with WEC guidance, which uses a mid-point of FY19 guidance. Growth is driven by $15bn investment in the rate base. Five investment themes dominate, led by gas distribution (38%), electricity distribution (18%), power generation (15%), transmission (9%) and IT (8%). WEC plans to grow its dividend in-line with earnings growth and to sustain the current payout range of 65-70%.

WEC adeptly navigating adverse impacts of COVID-19. WEC has not cut earnings guidance because of the pandemic; rather it guides to the upper end of its 2020 EPS guidance of $3.71-$3.75. The positive outlook is in spite of an estimated $0.22-$0.25 per-share hit from COVID effects. Downside risk to FY20 EPS is reduced by seasonality whereby earnings are first-half weighted: YTD EPS of $2.19 is 58% of the top end of the company's guidance range. Cost reductions, both temporary and structural, have been enacted to offset falls in commercial and

industrial demand, with most savings in operations and maintenance costs. If the economic recovery reverses and activity falls back to the 2Q nadir, WEC sees an incremental negative $0.03-$0.05 per-share hit to pre-tax earnings, which it believes it can offset by stepping up its existing cost reduction initiatives.

No higher-risk, big bets in new areas. In WEC's $15bn investment plan, there is a welcome absence of big ticket items such as new nuclear, offshore wind or gas transmission pipelines where problems have been seen elsewhere, or where the risk of cost overruns or delays are relatively high. Almost all capex fits within WEC's geographic footprint and is focused on WEC's core competencies.

Management incentives aligned with shareholders. Annual cash bonuses are closely linked to achieving EPS growth. Approximately two-thirds of the CEO's LTIP is in performance units, whose pay-out is based on total shareholder returns over three years relative to a peer group of 18 utilities. Total shareholder return was in the 94th percentile of the peer group for the three year period ended 2019. The value of performance units can be varied by +/-10% depending on how closely actual ROE at WEC utility companies tracks the authorised ROE.

Strong balance sheet and no need to issue equity. WEC parent debt is rated BBB+ by S&P and the Opco subsidiary level debt is rated A (Wisconsin Gas) or A-. Holding company debt is 28% of total debt, below WEC's self-imposed 30% ceiling. WEC reported a ratio of funds from operations/debt of 18.5% for FY19 and sees a range of 16-18% in 2020-2024, sufficiently high to sustain current ratings in our view. WEC believes it can achieve its investment goals in 2020-2024 and grow its dividend in line with earnings without issuing equity.

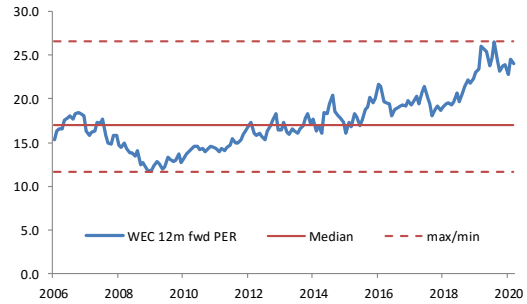
Risk of an expensive acquisition diminished by WEC playbook. Any public market M&A must be accretive to earnings in the first full year following closing, not stress the balance sheet and offer an earnings growth rate at least as strong as WEC's standalone 5-7%. WEC's success in cost management within its business should help it improve any less efficient businesses that it acquires. The last large acquisition ($9bn purchase of Integrys, including debt) was successfully integrated so the track record on deals has been positive.

Management succession enacted. An extended rotation of senior management is underway including a CEO change, which has been a smooth process. The well-regarded Gale Klappa moved from a second stint as CEO to executive chairman in early 2019, succeeded by Kevin Fletcher, an industry veteran who joined WEC in 2016. Mr Fletcher came from Southern Company, the Georgia-based utility, where Xia Liu, appointed CFO in June 2020, had also worked for 21 years. Mr Klappa will remain at WEC until 2022.

WEC Valuation

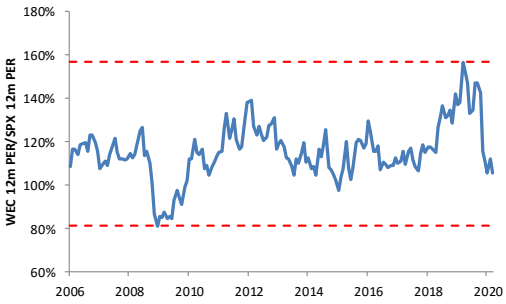
WEC trades at a multiple of 25.8x consensus EPS over the next four quarters. While the PER multiple is higher than the historical average (Figure 44), the market-relative PER is below the middle of its trading range over the past decade, and close to its lows of the past twelve months (Figure 45).

Figure 44: WEC absolute PER has risen



Source: Bloomberg consensus. 12m forward.

Figure 45: WEC relative PER in-line with historical level

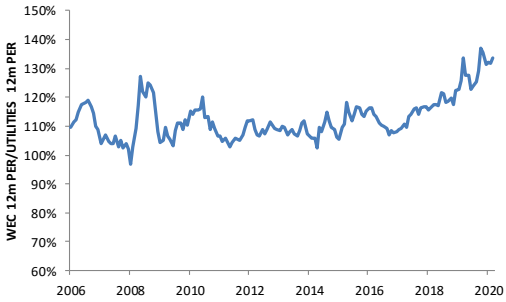


Source: Bloomberg consensus

WEC's market-relative multiple premium has averaged 16% since 2006 and 21% in the past five years.

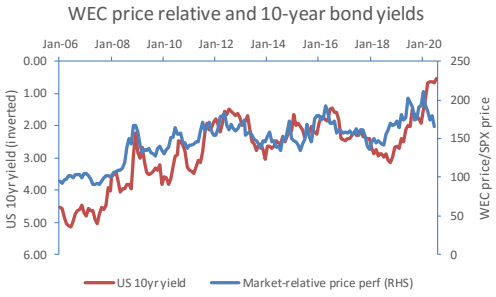
Note the market PER reflects strong optimism about future earnings. For the S&P 500, consensus currently expects EPS of $165.76 in FY21, 18% above 2019 earnings. For FY22, earnings are expected to grow 16% YoY to $192.41. The FY19-FY22 CAGR would be 11.2%, above trend growth of 6.7% (2003-2019) and WEC's 5-7% guidance for EPS growth. If the market achieves the higher expected growth rate, WEC's relative multiple will be elevated versus history. Conversely, investors who are sceptical of the rate of growth in market earnings would perceive more value in WEC.

Figure 46: PER re-rating versus peers



Source: Bloomberg

Figure 47: Relative price performance and 10-year bond yields

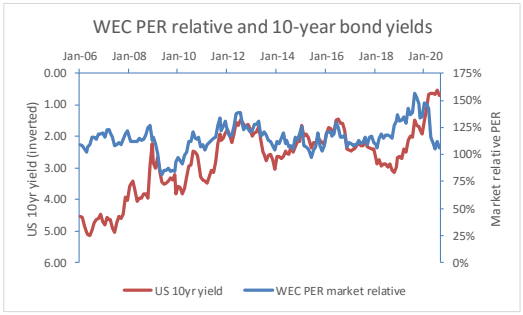


Source: Bloomberg

WEC shares have benefited from a re-rating versus peers (Figure 46), coincident with a move lower in US government bond yields which began in 2018 (Figure 47). Strong execution, a settled well-articulated strategy, constructive regulatory engagements, a clean CEO succession and a strong balance sheet combine to make WEC more attractive than peers for investors looking for exposure to lower bond yields.

Our YE21 $112 price target equals 26x FY22 EPS, which assumes the current twelve-month forward PER is sustainable. We believe PERs will be supported by a low interest rate outlook for an extended period, as articulated by the Federal Reserve and other central banks. Our price target equals a 45% premium to the market, using the SPX consensus estimates discussed above. The market premium compares to the 0%-60% range seen in the last twelve months and a 12-month high of $109.53. In recent weeks WEC's market relative performance has weakened to a greater degree than bond yields, as shown in Figure 47. A similar divergence is seen in market-relative PER, where the WEC market-relative multiple has contracted in recent months (Figure 48). If instead the relative multiple had continued to expand, tracking the drop in bond yields, the WEC share price would be $143.

Figure 48: WEC's market relative PER has fallen vs bond yields



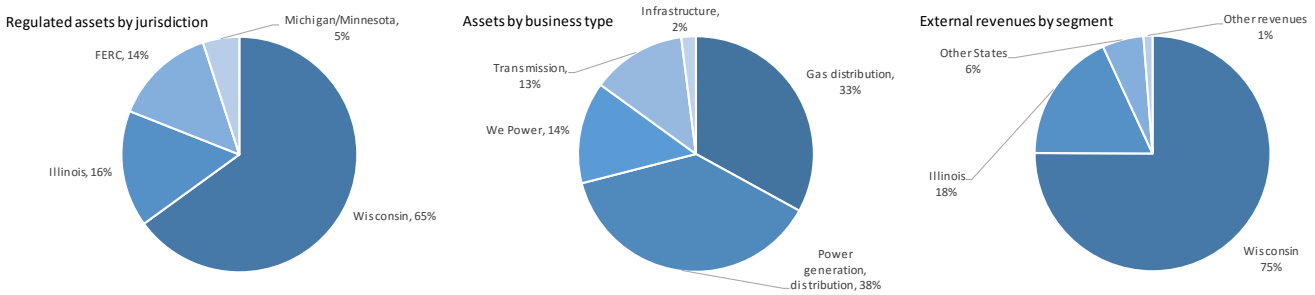
Source: Bloomberg, AE calculations

Downside risks to our Overweight rating include markedly higher bond yields which would cause investors to exit the sector. Unseasonal weather, specifically mild winters/cool summers, would reduce demand and Wisconsin's absence of revenue decoupling means WEC would need cost reductions to offset the lost demand, as it has achieved in 2020. Cuts in authorised ROEs are a recurring risk for all regulated utilities. Utilities have a capital intensive business model so continued access to funding is important, as is an investment grade credit rating. A large expansion of distributed energy e.g. residential rooftop solar would reduce growth potential. An aggressive policy switch to renewables by the federal government could result in fossil fuel plants becoming stranded assets. Higher fuel costs (e.g. natural gas) would push up customer bills, making it more challenging to achieve rate base increases. For additional items please refer to WEC's discussion of risk factors in its 10-K filing.

WEC asset overview: Wisconsin weighted, with gas diversification

WEC has a total regulated rate base of ~$22bn (Figure 49) and serves 4.5 million customer accounts, mainly in Wisconsin but also with an important presence in Illinois and smaller footholds in Michigan and Minnesota (Figure 50). Gas delivery accounts for one-third of the asset base and 64% of the customer base. WEC is the ninth largest gas distribution utility in the US, based on customers, and operates ~50,000 miles of gas distribution pipelines. Gas is delivered across all four states whereas electricity is almost exclusively delivered within Wisconsin.

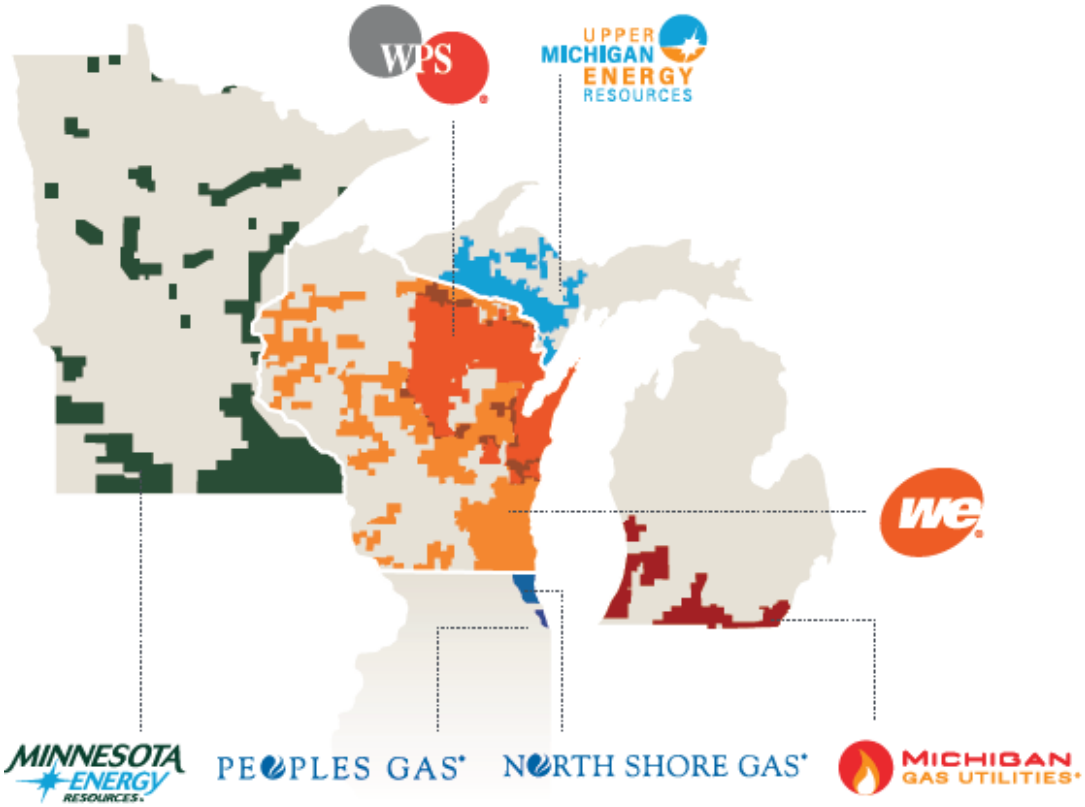
Figure 49: WEC's business by regulatory area, asset mix and revenue



Source: Company. Data for FY19

WEC has a FERC-regulated transmission arm, American Transmission Company (ATC), in which it holds a 60% ownership position (ATC is classed as an affiliate as WEC lacks board control).

Figure 50: WEC service areas in Wisconsin, Illinois, Michigan and Minnesota



Source: Company

Within its electricity business WEC operates 7.1GW of rated power generation capacity, ~70,000 miles of distribution cables and 500 substations. Within its Infrastructure segment WEC has a growing non-utility wind business comprising ~1GW of installed capacity in Illinois, Nebraska and South Dakota, with most output sold to commercial/industrial buyers.

WEC is net short generation capacity, with purchases accounting for 31% of the total 46,828 GWh power supplied in FY19. Purchases are made either under long-term Power Purchase Agreements (PPAs) or in the spot market operated by MISO, the regional independent market for wholesale power transactions.

Figure 51: WEC power sources

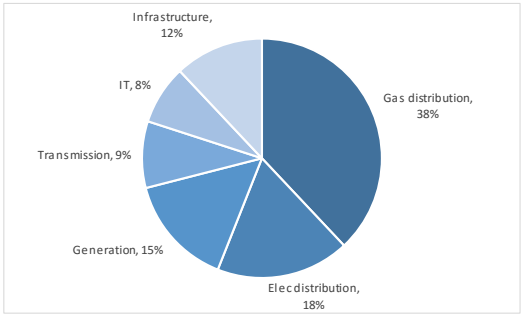
Rated generation capacity (MW)	
Coal	3,158
Natural gas	3,753
Renewables	207
Total	7,118
Generation & purchased power (GWh)	
Coal generation	16,498
Natural gas generation	13,562
Renewable generation	2,022
Purchased power, renewables	892
Purchased power, nuclear PPA	8,979
Purchased power, MISO/other	4,875
Total	**46,828**

Source: Company. Data is for 2019

Whilst declining in importance, coal remains the largest source of power at WEC, followed by natural gas, with internal renewables in third place (albeit growing). WEC does not own nuclear generation capacity but purchases significant quantities of nuclear power from Point Beach, under a long-term purchase agreements. Point Beach was formerly owned by WEC and was divested to NEE in 2008. The purchase agreements expire in 2030 and 2033.

Figure 52: $15bn 2020-24 capex split

As a regulated utility, earnings growth at WEC comes from increasing the rate base. WEC's cumulative, $15bn capex programme in 2020-24 will increase the rate base over 40% by YE24, we estimate, which will drive earnings growth. In order to offset customer bills rising more rapidly than inflation, which would likely incentivise switching and opposition from regulators, WEC targets lower O&M charges over time. WEC sees potential for O&M costs to fall by 2-3% per annum driven by technological adoption, improved efficiency and reshaped generation.



Source: Company

WEC earnings growth outlook – top end of guided range

Our EPS estimates are shown in the following table.

Figure 53: WEC earnings expectations and guidance comparison

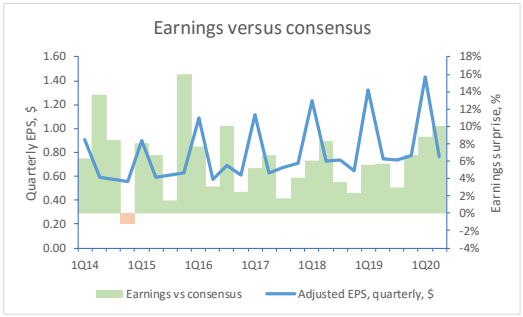
	2020	2021	2022	2023	2024
AE estimates	3.75	4.02	4.32	4.62	4.91
YoY change, %	*4.7%*	*7.2%*	*7.5%*	*6.9%*	*6.3%*
Consensus	3.75	4.00	4.24	4.55	4.85
5% EPS CAGR	3.68	3.86	4.05	4.25	4.47
7% EPS CAGR	3.75	4.01	4.29	4.59	4.91

Source: Atlantic Equities estimates and Bloomberg for consensus

WEC guides to long-term growth in EPS of 5-7%, measured from the mid-point of 2019 guidance ($3.50), implying $4.47-$4.91 in FY24 i.e. at least ~$1 in incremental EPS by 2024. Our forecasts match the top end of guidance in FY24.

WEC's track record in growing earnings is good, with an 8.5% CAGR between 2009-19. WEC has also consistently exceeded consensus earnings estimates (Figure 54). One of the reasons for the repeated earnings beats is that guidance is set on a conservative basis (partly reflecting weather/fuel cost variability) such that the company has delivered earnings which have exceeded guidance each year for the past sixteen years. We believe this helps to explain why consensus estimates sit in the upper end of the guided range.

Figure 54: Earnings beats



Source: Bloomberg

As capex drives earnings it is important to note the company's $15bn investment guidance to 2024 is a rolling five-year guide and we believe it is highly likely the scope of investment will increase as guidance is updated, with a positive effect on earnings. Capex is normally updated each November at the Edison Electrical Institute (EEI) conference. Spending in the rolling plan has reliably increased in each of the past several years. For example, in the most recent iteration, announced last November, spending in the five-year plan rose 6% ($900m) to $15bn.

We review the main earnings growth drivers in more detail in the following sections.

Earnings growth driver I – Wisconsin, Michigan electricity distribution

WEC's largest component of capex in the five-year plan is directed to electricity distribution in (mostly) Wisconsin and Michigan, which has been allocated $3.1bn capex in 2020-2024. The majority of the spending is directed to replacing and upgrading distribution equipment, with the aim of enhancing network reliability. From regulatory filings in recent years it is evident that the bulk of spending is in individual small projects which are either local upgrades or improvements rather than a small number of big ticket items. A 2019 filing by Wisconsin Electric Power Company lists hundreds of individual expenditure projects, which cumulatively add up to several hundred million dollars in annual expenditure.

Figure 55: Power distribution growth

2020-24 Wisconsin, Michigan power distribution	$m
Cumulative capital investment, $m	3,100
Incremental depreciation @3% p.a., $m	437
Change in WI/MI rate base, $m	2,663
Equity component, %	53%
Authorised return on equity, %	10.20%
Incremental FY24 income, $m	143
WEC shares, m	315
Incremental FY24 EPS, $	0.45
% FY19 EPS	13%

Source: Company, Atlantic Equities estimates

Spending includes Advanced Metering Infrastructure (AMI) upgrades, including the integration of smart meters, communication networks and data processing systems that enable two-way communication between WEC and customers, for example in managing connections/disconnections or fault reporting. WEC operates ~70,000 miles of distribution lines in Wisconsin and Michigan, of which approximately half are overhead cables, and half underground. Spending incorporates WEC's ongoing SMRC project (System Modernisation and Reliability Project) at WPS which involves undergrounding of distribution lines in areas where reliability is low, typically rural, forested areas. WEC also operates 500 sub stations. Some upgrades are also required, for example to facilitate new industrial developments in Wisconsin, including the Foxconn manufacturing campus which is currently under construction.

Earnings growth driver II – Wisconsin generation

Spending on electricity generation is a modest part of the overall $15bn five-year investment plan, with spending of $2.4bn or 16% of the total outlays. The relatively low expenditure as a proportion of the total pot reflects continued weak demand growth prospects for electricity, as seen across the US.

Figure 56: Generating earnings growth

2020-24 Wisconsin, Michigan power generation	$m
Cumulative capital investment, $m	2,100
Incremental depreciation @3% p.a., $m	189
Change in WI/MI rate base, $m	1,911
Equity component, %	52.5%
Authorised return on equity, %	10.00%
Incremental FY24 income, $m	100
WEC shares, m	317
Incremental FY24 EPS, $	0.32
% FY19 EPS	9%

Source: AE calculations from Company data

Falling costs of solar generation (discussed in a subsequent section) has raised WEC's interest in adding solar to its generation portfolio. In addition, WEC sees solar as complimentary to summer load planning. WEC has received regulatory approval to develop three sites with total nameplate capacity of 300 MW. WEC is working with smaller peer Madison Gas and Electric to develop two sites. Work started at the Two Creek Solar Project and Badger Hollow Solar Park I in 2H19. Two Creek is expected in-service in December 2020 and Badger Hollow in April 2021 (modestly delayed), in-time for MISO's annual capacity resource planning auction. Capex for each project is $130m ($1,300/kw). A third project, Badger Hollow II was approved in February 2020, with the same capacity and cost as the first two solar projects. WEC expects the project to enter service in December 2022 (modestly later than planned but WEC sees cost benefits from the slower pace).

Earnings growth driver III - Illinois gas distribution upgrades & extensions.

The largest share of capex in the 2020-2024 plan is dedicated to gas distribution upgrades which account for $5.7bn or 38% of the total (more than double the 15% allocation to power generation).

$3.2bn of the total is allocated to Illinois. This includes a $1.4-$1.5bn outlay in 2020-2024 for modernising Chicago's gas distribution network, under which WEC's costs are recovered through a specific surcharge on customer bills. The remaining investment is recovered by additions to the rate base, with the incremental cost offset for customers by higher reliability (including lower leakage), smart meters etc. Gas costs are treated as a pass-through item so consumer bills will have seen a benefit from lower gas prices in recent years. Assuming the entire $3.2bn outlay is treated as additions to the rate base, then the incremental EPS benefit in 2024 is estimated at ~$0.45/share

Figure 57: Illinois gas important for EPS

2020-2024 Illinois gas investment	$m
Cumulative capital investment, $m	3,200
Incremental depreciation @2.5% p.a., $m	80
Incremental move in Illinois rate base, $m	3,120
Equity component, %	50%
Authorised return on equity, %	9.05%
Incremental income, $m	141
WEC shares, m	315
Incremental EPS, $	0.45
% FY19 EPS	13%

Source: Atlantic Equities from company guidance

Illinois applies a lower authorised ROE on gas distribution than Wisconsin, but this is partly offset by revenue decoupling, bad debt riders and an invested capital tax rider. Illinois also uses forward-looking test years which facilitate a normalised analysis of activity and costs.

Because gas costs are a pass through, profitability in Illinois is insensitive to customers switching to a third party gas supplier.

Earnings growth driver IV - Wisconsin, Michigan gas distribution.

$2.8bn capex in 2020-2024 is earmarked for Wisconsin and Michigan to improve and extend gas distribution networks. Most of the investment is targeted for Wisconsin, specifically to the southeast of the state, in and around Milwaukee. Most expenditure is to replace old pipe and extend the reach of the network, in many cases replacing or supplementing propane fuel. We estimate the investment programme will add $0.43 in EPS compared to FY19. We assume a forty-year asset life equal to a 2.5% annual depreciation rate. Our estimated EPS benefit is equal to that from the Illinois gas programme (described in the prior paragraph) although the planned investment is 14% lower, due to the higher authorised ROE in Wisconsin.

Figure 58: Gas-fired earnings growth

2020-2024 Wisconsin & Michigan gas investment	$m
Cumulative capital investment, $m	2,760
Incremental depreciation @2.5% p.a., $m	207
Change in Wisconsin rate base, $m	2,553
Equity component, %	53%
Authorised return on equity, %	10.20%
Incremental FY24 income, $m	137
WEC shares, m	315
Incremental FY24 EPS, $	0.43
% FY19 EPS	12%

Source: Atlantic Equities from company guidance

Gas distribution includes the proposed construction of two LNG storage facilities, for a total of $370m. During arctic winter conditions in 2019, WEC recognised a potential shortage of gas to meet peak demand on the coldest days of winter. Rather than rely on very expensive spot purchases of gas in those circumstances (or risk a shortfall in deliveries), WEC is seeking regulatory approval for two LNG storage facilities in Wisconsin, each with a 1 Bcf capacity. A proposal was submitted in November 2019 and if approved, the facilities will enter service in 2023.

Transmission investments provides incremental earnings benefit

WEC receives an important earnings contribution from its 60% holding of American Transmission Company (ATC), which as the name suggests, owns and operates electric transmission networks. ATC's activities extend across Wisconsin, Illinois, Michigan and

Minnesota and is regulated by FERC rather than state utility commissions. ATC assets are operated by MISO, a large regional transmission operator on a non-profit, non-preferential basis to all customers. Accordingly and despite holding a majority 60% ownership, ATC is classed by WEC as an affiliate.

ATC contributed 11% ($128m) of WEC EPS in FY19 and paid $87m in dividends to the WEC Holdco.

ATC's earnings have been affected in a number of periods by FERC rulings, stemming from a complaint first heard back in 2013, when the base ROE for WEC was 12.2%. A preliminary award in 2016 set the base ROE at 10.32%, with an incentive adder of 0.5% on top. The ROE was then set at 9.88% in November 2019, and WEC booked a charge in 4Q19 to cover the backdated ruling. Subsequently in a May hearing the saga took a final twist with an increase in base ROE to 10.02%, for a revised 10.52% ROE including the incentive adder. The revision boosted 2Q20 EPS by $0.03 which covers the backdated adjustment and will not recur.

ATC's attributable earnings also declined in 2018, by $18m to $137m due to a one-off $34m charge relating to changes in tax legislation, partly offset by a $17m improvement for a reversal of one-off expenses in 2017 (relating to a FERC audit) and from new investments.

Following the resolution of the base ROE hearings, we see modest earnings expansion ahead for ATC as capital investments appear set to remain modest. We forecast a CAGR of 4% in attributable earnings at ATC in 2021-2024.

Figure 59: ATC regulated income profile ($m except where stated)

ATC	2020E	2021E	2022E	2023E	2024E
Rate base, start of period	2,300	2,397	2,563	2,740	2,858
Capex	212	286	305	255	199
D,D&A	-115	-120	-128	-137	-143
Rate base, end of period	2,397	2,397	2,397	2,397	2,397
% equity	50%	50%	50%	50%	50%
ROE (including 0.5% incentive)	10.52%	10.52%	10.52%	10.52%	10.52%
Regulated income, $m	160	135	144	150	153
Per WEC share, $/share	0.50	0.43	0.46	0.48	0.49

Source: Atlantic Equities estimates.

WEC guidance is for its share of ATC capex to average $200-$300m in 2020-2024. Most of the spending will go towards replacement of assets at the end of their useful lives and to improve system reliability. Net depreciation is guided to an average of $127m in 2020-2024. At the ATC level the increase in ATC earnings is equivalent to an incremental EPS benefit of ~1% pa. in 2021-2024.

COVID-19 negative impact on earnings offset by cost savings

COVID-19's major impact on WEC is via the fall in commercial and industrial demand, which is not fully offset by higher residential demand as citizens stay at home. WEC estimates a 5% drop in retail electric deliveries in April-December 2020 due to CVOID-19, resulting in lost pre-tax earnings of $70-$80m. Wisconsin's regulatory regime does not include decoupling of volumes from revenues so WEC is exposed to the shortfall. WEC expects to fully offset the fall via lower O&M costs.

Temporary measures put in place to assist Wisconsin consumers have been lifted. Initial orders were implemented on 24 March, the day after Wisconsin governor Tony Evers ordered residents to stay at home, and so had minimal impact on 1Q20 earnings. The measures froze disconnections due to non-payment and barred late payment charges. Following a legal challenge from opponents of lockdown, the stay at home order was struck down by the Wisconsin supreme court on 13 May, forcing the regulator to halt many special measures, except for the ban on disconnections, which ended on 25 July, four months after their

introduction. Non-payment and late charges in excess of budgeted amounts can be deferred for recovery in future periods for Wisconsin customers (both residential and non-residential). We see little risk that WEC will not be fully compensated for these extra costs, although the pace of recovery may be slow to reflect regulator's wishes to smooth customer bills.

Figure 60: Regulatory mechanisms for COVID-19 effects

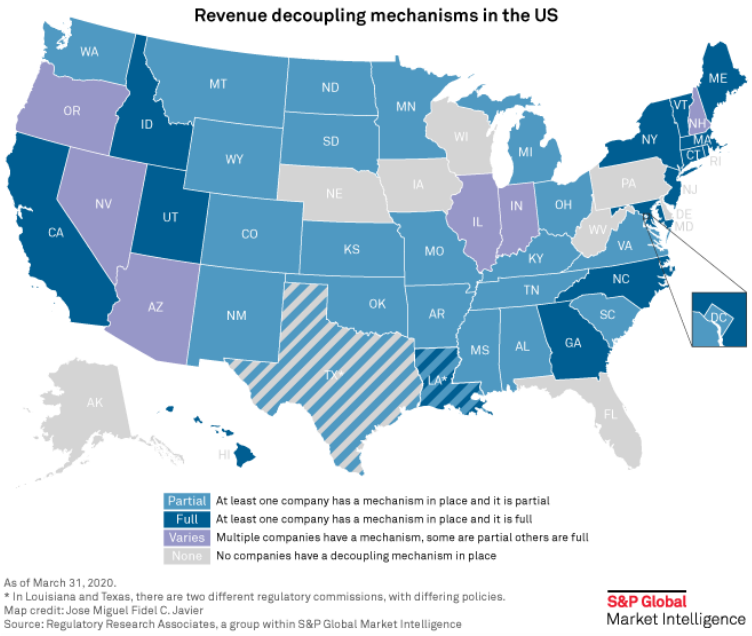
Type	Wisconsin	Illinois[1]	Michigan[1]	Minnesota
Incremental Bad Debt / Uncollectibles	Res. – Escrow C&I – Defer	Existing Rider	Defer	Defer
Incremental O&M	Defer	Pending	Pending	Defer
Foregone Late Payment Fees	Defer	Pending	Pending	Defer
Carry Cost on Deferrals	Short-Term Debt Rate	No	Pending	No
Dockets	5-AF-105 5-UI-120	20-0309	U-20757	20-427

Source: Company

No revenue decoupling in Wisconsin

Wisconsin has moved away from revenue decoupling, a mechanism that removes the link between revenues and volumes so a utility can earn its authorised ROE even if sales are materially different to planned levels. Under decoupling, utilities can adjust rates between rate cases for peaks and troughs caused by weather, economic activity, demographic shifts and other factors. In states where it is applied decoupling is helping utilities mange the impact of COVID demand losses.

Figure 61: Wisconsin one of a minority of states with no revenue decoupling



Source: S&P Global Market Intelligence

In the absence of decoupling, WEC has quickly reduced costs, particularly Operating & Maintenance expenses, which it expects to reduce by $70-$80m in FY20, i.e. enough to fully

offset the expect lost margin from lower sales. The O&M cuts are in addition to the 2-3% p.a. run-rate of O&M savings targeted by WEC on an ongoing basis. The targeted cuts are a substantial 6-7% of day-to-day O&M expense in FY19.

Relatively high regulated returns

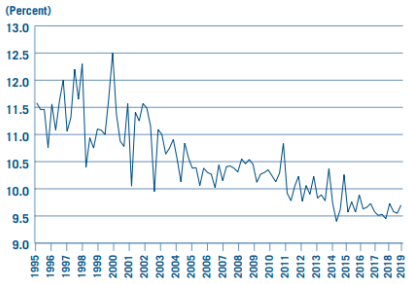
We calculate a weighted average authorised ROE for WEC of 10.3% (Figure 62), above the average awards for investor-owned utilities in recent years (Figure 63).

Figure 62: Authorised ROE relatively high

Unit	Asset base	% Total	ROE
	$bn (2019)	%	%
Wisconsin Electric	6.30	30.3%	10.00
Wisconsin Public Service	3.40	16.3%	10.00
Wisconsin Gas	1.50	7.2%	10.20
Peoples Gas (Illinois)	3.00	14.4%	9.05
North Shore Gas (Illinois)	0.30	1.4%	9.05
Minnesota Energy Resources	0.30	1.4%	9.70
Michigan Gas Utilities	0.70	3.4%	9.90
We Power	3.00	14.4%	12.70
American Transmission Company (affiliate)	2.30	11.1%	10.52
Authorised ROE (%) weighted by assets			**10.30**

Source: Company data, Atlantic Equities calculations

Figure 63: WEC ROE above average awards



Source: EEI 2019 Financial Review

In addition to the authorised ROE, all three Wisconsin utilities (54% of FY19 regulated assets) have an earnings sharing mechanism as a performance incentive, which will continue at least until the end of 2021. Under the mechanism WEC retains all the earnings for the first 25bps above the authorised ROE and 50% of the next 50bps, with all the excess above that level refunded to customers. For example, an 11% ROE at Wisconsin Electric would become a net 10.5% ROE post-sharing.

WEC benefits from forward-looking rate base assessments in each of its key states. Forward looking rate base assessments minimise lags in matching expenditures to recovery of outlays within the regulated asset base. The forward look incorporates expected market growth and normalised weather patterns and so is likely to be a fair representation of reasonable expectations. Wisconsin is the sole US state to utilise a two-year forward looking assessment, others being limited to a single year.

14% of regulated asset base has high, guaranteed returns

WEC earns a premium 12.7% ROE from its We Power business.

We estimate We Power contributed $0.65 or 18% of WEC EPS in FY19 (assuming a rate base of $3bn, 12.7% ROE and 54% equity layer). We Power paid $193m in dividends to the WEC parent in 2019 or 26% of total WEC dividend payments in that year. We Power is the second largest contributor of payouts to the Holdco, after WE ($360m in 2019). We Power raises WEC's weighted ROE by 40bps, according to our estimates.

Figure 64: We Power assets

Power the Future investments	Natural gas	Coal
Capacity, MW	1,090	1,030
Investment, $m	664	2,000
Authorised ROE, %	12.7%	12.7%
Equity layer, %	53.0%	55.0%
Year commissioned unit 1	2005	2010
Year commissioned unit 2	2008	2011
Lease length	25	30
Lease expiry unit 1	2030	2040
Lease expiry unit 2	2033	2041

Source: Company

The premium We Power returns fall under Wisconsin-specific legislation and so are not generically available across the sector or in other states. Under the Leased Generation law, a non-utility affiliate can construct generation facilities in Wisconsin and lease those to a public utility. In turn the public utility is entitled to charge the lease cost, and other appropriate costs, to retail users. The relative generosity of the terms reflects the high upfront capex required for the facilities, of $3bn, for approximately 2,500 MW of new capacity. We Power owns 100% of the gas generation assets and 83% of the coal assets; only its share of the coal business is shown in Figure 64.

To further encourage investment the law prevents the regulator from altering or terminating the lease with We Power, except under certain pre-defined circumstances. This measure offers regulatory clarity to WEC. FERC, the federal regulator has clarified that the We Power units are outside its reach.

The premium ROE arrangements extend for 25-30 years and will expire in four stages between 2030 and 2041, reflecting the staggered timing of commissioning the four generation units.

Ongoing investments in the We Power facilities are relatively small (~$50m run-rate pa) and these are also covered by the Leased Generation Law. No significant further investments under the Leased Generation Law are expected at this time. As such we consider We Power a core contributor to earnings but not a driver of earnings growth.

No specific downward pressure on WEC ROEs

Authorized ROEs across the US regulated utility sector have been on a declining trend for over twenty years, as we discuss in a previous section of this report. However, spreads to government bond yields have widened, supporting above-WACC returns. Specifically for WEC, we do not see a high risk of material cuts to authorised ROEs. In last year's rate case settlement for gas service, the Wisconsin regulator described the 10.2% ROE as "a reasonable balance between the needs of investors and the needs of consumers".

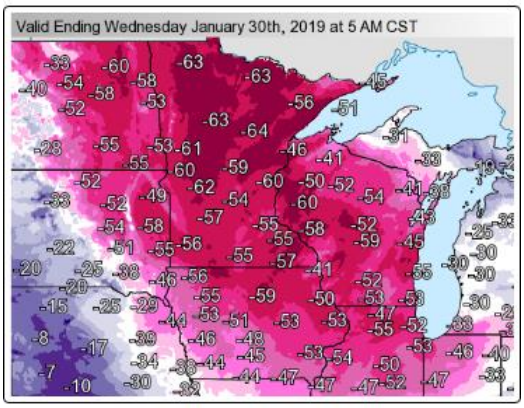
Figure 65: WEC's authorised ROEs have moved lower at a slow rate

Entity	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Wisconsin Electric	10.4	10.4	10.4	10.4	10.4	10.2	10.2	10.2	10.2	10.2	10.0
Wisconsin Gas	10.5	10.5	10.5	10.5	10.5	10.3	10.3	10.3	10.3	10.3	10.2

Source: Company

The regulator's mandate is not simply cost-based but aims for safe, reliable, affordable and environmentally responsible energy services. Network resilience is as important as cost efficiency in order to cope with winter temperatures as low as those seen in January 2019 (Figure 66), when air temperatures fell to -40 deg. F (-40 deg. C) and wind chill to -64 deg. F (-48 deg. C). During that time, wind turbine blades became too brittle to safely function. A well-funded utility is required to achieve each of the regulator's objectives (most WEC capex is reliability-based). Electric residential bills are below the national average and have been flat or modestly increased over the past five years, suggesting little consumer or political pressure for change. Electric service reliability is high.

Figure 66: Resilient power supply needed when temperatures plummet



Wind chills from 5 am Wed, Jan 30th

Source: NOAA

Competitive landscape is benign with little risk of retail electricity competition

We see no imminent earnings risk from deregulation in WEC's markets. The competitive landscape is summarised in Figure 67. US competition in the supply of electricity and gas is set at state level resulting in a hodge podge of regimes across the country. In general, a shift to retail choice has stalled in the US in recent years and we see little momentum for a shift. End-user choice to switch power supplier has not been enacted in Wisconsin and the regulator has determined a change would be driven by the state legislature, where there is no discernible momentum to change the status quo. In Michigan retail choice is capped at 10% of a utility's retail load within the state. For the natural gas business, the gas fuel cost is simply passed on to the customer so there is no impact from a customer switching to a third party. WEC earnings are based on the delivery of gas, not the gas itself.

Figure 67: Benign competitive landscape

State	Business	Competitive situation
Wisconsin	Electricity	No retail choice
Wisconsin	Gas	Full customer choice. As gas costs are a pass-through item, profit is not impacted by customer switching
Illinois	Gas	Customer choice (via regulatory tariff, not state law). Gas costs are a pass-through item
Michigan	Gas	Customer choice available, not mandated. Gas costs a pass though item
Michigan	Electricity	Retail choice capped at 10% of company's utility load in state. WEC retains distribution if client switches
Minnesota	Gas	Industrial and commercial choice, not mandated. Gas costs a pass through item

Source: Company

Wind farms – tax efficient investments

WEC has majority ownership of five wind farms as summarised in Figure 68. Wind assets are included in WEC's Energy Infrastructure segment, in which We Power is the largest constituent.

Figure 68: Summary of WEC wind assets

Wind farm	Location	Capacity, MW	In service	Investment, $m	ownership, %	Offtake	Customer/s
Upstream	Nebraska	200	Acquired 1Q19	307	90	10 years	Allianz
Bishop Hill III	Illinois	132	Acquired 3Q18	166	90	22 years	WPPI Energy
Coyote Ridge	South Dakota	97	YE19	145	80	12 years	Google
Thunderhead	Nebraska	300	YE20	381	90	12 years	AT&T
Blooming grove	Illinois	250	YE20	389	90	12 years	Verizon, Saint Gobain

Source: Company. Note excludes proposed acquisition of 85% of Tatanka Ridge (155MW gross) which is subject to regulatory approvals.

Three wind farms are operational and two more will enter service within the next twelve months which, when complete, will give a total installed capacity of 979MW (~870MW net to WEC). Sales are covered by bilateral, multi-year contracts rather than regulated tariffs. The facilities fall under FERC's supervision within the Federal Power Act which covers sales of wholesale energy. Acquisition of a sixth project, Tatanka Ridge, is awaiting regulatory approval.

Wind power comes with attractive tax features. One is 100% bonus depreciation. Another is the Production Tax Credit (PTC)

Figure 69: Wind Production Tax Credit schedule

Year construction commenced	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Tax credit accrued	100%	80%	60%	40%	60%	0%	0%	0%	0%	0%
Tax credit, $/MWh	25	20	15	10	15	0	0	0	0	0

Source: US Dept. of Energy

The PTC is a significant benefit, which extends for ten years from the first year of production, at the rate applied to the year in which construction began. The PTC varies significantly by year, due to a changing legislative history. At present the PTC is scheduled to be phased out by year-end 2020 for new investments but has been extended on twelve prior occasions, including a number of retrospective reinstatements following lapses.

WEC's wind facilities that were operational in 2019 generated modest operating losses, which partly reflects higher depreciation charges under the 100% bonus depreciation regime. However, the PTC generated a $34m benefit to tax line in 2019, equal to a $0.11/share uplift. Our estimates for PTC in our forecast period are shown below (Figure 70).

Figure 70: Wind Production Tax Credit calculation

	2019	2020	2021	2022	2023	2024	2025
Installed capacity, MW	332	429	979	979	979	979	979
Capacity factor, %	35%	35%	35%	35%	35%	35%	35%
Output, MWh	1,017,912	1,315,314	3,001,614	3,001,614	3,001,614	3,001,614	3,001,614
PTC, $m	25	31	65	65	65	65	65

Source: Atlantic Equities

We estimate PTC benefits of $65m pa in 2021-2025 ($0.21/share). WEC expects its wind assets to deliver a higher rate of return than its regulated investments, with an unlevered IRR of ~8.5%. With 50% leverage, we calculate returns on equity of low teens are feasible.

WEC's intent is to keep exposure to non-utility wind to below 10%.

M&A: WEC seen as a consolidator

M&A frequently arises as a question on WEC earnings calls with the company seen as more predator than prey. Given the flat outlook for US power demand, we consider further M&A likely as companies seek scale/efficiency offsets to the lack of end-user growth. We are not concerned that WEC might do a risky deal. WEC has a long-standing set of criteria governing deals.

WES requires that any acquisition is:

- Accretive to earnings in the first full year after closing
- Does not stress the balance sheet
- Offers a growth rate as least as high as WEC's 5-7% target

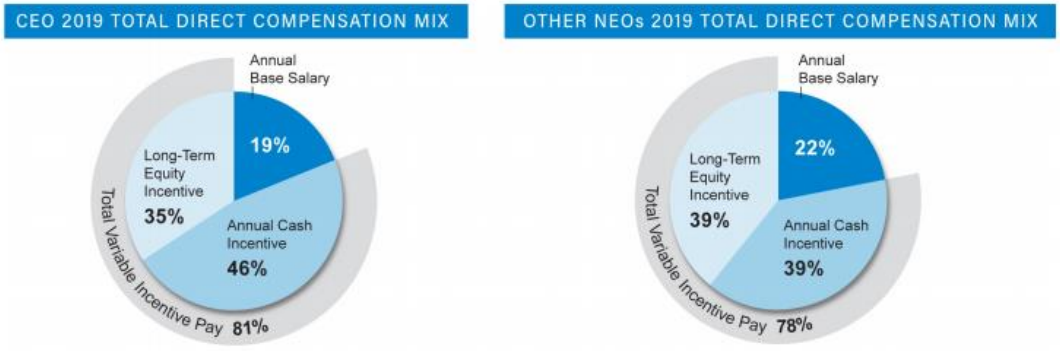
On the 2Q20 earnings call Chairman Klappa noted the third point was the most constraining of the three at present, adding the company had little interest in auctions or other competitive bidding situations.

WEC's last significant acquisition was successful. In 2014 WEC agreed to acquire Integrys in a $9,1bn deal (including $3.3bn in Integrys debt), with ~75% equity. The two companies had a good geographic fit and the deal combined their separate minority stakes in ATC, the transmission company, into a majority ownership position (60% interest). The deal provided diversification on a regulatory basis away from Wisconsin, and on a business basis by raising pro-forma rate base in gas from 14% to 27% of total regulated assets, thus offering exposure to gas' higher growth potential. When announced the Integrys deal fit the WEC criteria for a transaction, as itemised above. Customer bills have been virtually flat since the deal, so the acquisition was also successful from that perspective.

Management incentive compensation and alignment with investors

A majority of senior leadership compensation is linked to performance-related metrics which aligns incentives with shareholders.

Figure 71: Majority of senior leadership compensation is variable



Source: Company 2020 proxy statement

The annual cash incentive component depends on achieving absolute EPS (75% weighted) and cash flow (25% weighted) targets and payouts range from 0-210% of target. The target levels are tied to the company's 5-7% long-term EPS growth target. Annual incentive awards are also subject to a +/-10% shift based on ESG criteria. Customer satisfaction has the highest weighting (half) in the adjustment criteria.

The long-term incentive plan comprises performance units, restricted shares and stock options. Approximately two-thirds of the CEO's LTIP is in performance units, whose pay-out is based on total shareholder returns over three years relative to a peer group of 18 utilities. Total shareholder return was in the 94th percentile of the peer group for the three year period ended 2019. WEC's compensation committee also has discretion to tweak the performance criteria in the units. In 2017, following shareholder consultations, the committee added ROE to its award criteria. The value of the performance units can be varied by +/-10% depending on how closely actual ROE at WEC utility companies tracks the authorised ROE.

As is common across the regulated utility space, insider ownership is not high at WEC. By their nature these are long-standing organisations, not start-ups with high founder shares. Total insider ownership at WEC is $60m.

Management succession plan enacted, Klappa remains until 2022

Executive Chairman Gale Klappa (age 69) has been synonymous with WEC for many years, having led Wisconsin Energy as chairman/CEO from 2004-2016. He returned to the role in October 2017 to provide continuity when his successor suffered a health emergency. Klappa's accolades include being named by Business Worldwide magazine as CEO of the year – Electric and Natural Gas industry in 2016 and again in 2018, in addition to CEO – growth strategy of the year, USA.

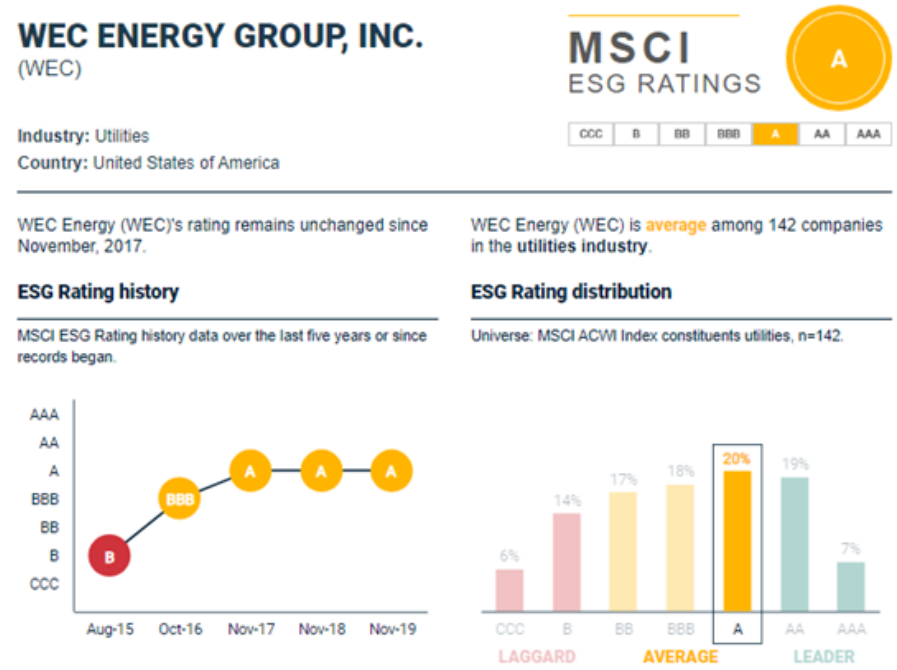
A succession process has been enacted which seems designed to promote stability across a lengthy transition period, and which see Mr. Klappa remaining with WEC until early 2022. The process has been clearly communicated to investors. In February 2019 Kevin Fletcher was promoted from President to CEO/President, reporting to Mr Klappa as executive chairman. Klappa has agreed to remain at WEC until 2022 which should ensure a smooth leadership transfer. Mr Fletcher is an electrical engineer with extensive industry experience including 34 years at peer Southern Company. He joined WEC in 2016.

Coincident with Mr. Fletcher's promotion, an office of the Chair was established, comprising Messrs Klappa and Fletcher in addition to Scott Lauber (newly appointed COO, twenty-year WEC veteran) and Xia Liu, who succeeds Mr. Lauber as CFO and joined from CenterPoint Energy in June (where she held the same role). The retiring Rick Kuester is also a member.

ESG – plans for more environmentally friendly power

WEC has an A rating from MSCI's ESG rating system, which places it in the middle of the pack when evaluated versus utility peers (Figure 72). For a coal burning utility, the 'E' in ESG is the focus. Here WEC has made good progress in recent years. 40% of coal-fuelled generation has been retired since 2014, although coal continues to have the highest fuel share in supply. Nonetheless system GHG intensity has declined from 0.66 tonnes/MWh in 2017 to 0.54 tonnes/MWh in 2019, as coal declined while lower-intensity gas rose. Following the fall in solar costs in recent years, WEC has become more active in this area. With 300MW of solar capacity under construction in Wisconsin. In the natural gas businesses, WEC has been very active replacing aging pipes and infrastructure such that methane emissions fell by 20% in 2019 (to ~0.4m tonnes CO2 equivalent) from a 2011 base. WEC targets a cumulative 30% fall in emissions by 2030.

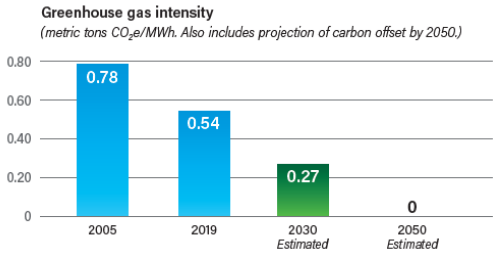
Figure 72: WEC ESG rating



Source: MSCI

In July WEC announced it would achieve net-zero carbon emissions from its generation fleet by 2050, with a 70% reduction by 2030, from a 2005 base. The cumulative reduction by 2019 was approximately 45%. In effect this means less coal-fired generation. WEC sees coal's weighting in its generation fuel mix falling from 40% in 2019 to 21% in 2030 in order to meet the 70% reduction. WEC has successfully negotiated early retirements of other coal-fired plant so that the utility has not suffered stranded costs from partly depreciated assets. WEC's good track record, the regulator's balanced approach and the Wisconsin governor's support for clean energy indicates further retirements can be successfully negotiated.

Figure 73: Falling GHG intensity



Source: Company

Renewables a little-tapped opportunity in Wisconsin – opportunity for WEC?

Wisconsin has not been a leader in renewables, with just 2.5% of power needs met by within-state wind generation. Utility-scale solar generation is negligible, although increasing, as

shown by WEC's recent investment in this area. The slow expansion in wind reflects Wisconsin's rancorous siting and permitting climate, according to Renew Wisconsin, a non-profit advocate for renewables.

In autumn 2019 Democrat Governor Evers signed an executive order aiming to make Wisconsin energy consumption 100% carbon-free by 2050. While an executive order lacks legal powers of enactment and will require legislative change for enactment, it shows an ambition to move forward on climate change preparedness, which we expect to be welcomed by many voters. We see growing support for within-state renewables as an opportunity for WEC. If driven by political consensus, we consider it unlikely WEC would have to bear the cost of stranded fossil fuel assets. Wisconsin's track record in working with WEC to avoid stranded assets has been a positive one.

Figure 74: WEC summary income statement, $m except where stated

	2019	1Q20	2Q20	3Q20	4Q20	2020	2021E	2022E	2023E	2024E
EBITDA	2,457	865	581	590	630	2,666	2,858	3,018	3,194	3,388
D,D&A	926	239	242	243	247	971	989	1,023	1,072	1,139
EBIT	**1,531**	**626**	**339**	**347**	**383**	**1,695**	**1,869**	**1,994**	**2,122**	**2,249**
Interest income/(expense)	-502	-129.4	-124.4	-125	-125	-504	-550	-570	-590	-610
Other income/(expense)	102	5.6	28.6	20	20	74	75	75	75	75
Income from affiliates	128	38.9	52.9	39	29	160	135	144	150	153
Pre-tax income	1,260	541	296	281	307	1,425	1,529	1,644	1,757	1,867
Tax expense	125	90	54	45	49	238	255	274	293	312
Tax rate %	*9.9%*	*16.6%*	*18.2%*	*16.0%*	*16.0%*	*16.7%*	*16.7%*	*16.7%*	*16.7%*	*16.7%*
Net income	1,135	451	242	236	258	1,187	1,274	1,369	1,464	1,556
Pref stock dividends of subsidiary	1.2	0.3	0.3	0.3	0.3	1.2	1	1	1	1
Minorities	0.5	0.2	0.2	0.2	0.2	0.8	1	1	1	1
Attributable net income	1,134	451	242	236	258	1,187	1,274	1,369	1,464	1,556
Diluted shares outstanding (W average)	317	316.7	316.7	316.7	316.7	316.7	317	317	317	317
Recurring attributable EPS (diluted)	3.58	1.42	0.76	0.75	0.81	3.75	4.02	4.32	4.62	4.91

Source: Company, Atlantic Equities estimates

Figure 75: WEC statement of cash flows, $m

	2019	1Q20	2Q20	3Q20E	4Q20E	2020	2021E	2022E	2023E	2024E
Net income	1,135	453	242	236	258	1,189	1,274	1,369	1,464	1,556
Depreciation and amortization	926	239	243	243	247	972	989	1,023	1,072	1,139
Deferred taxes and investment tax credits, net	163	92	51	45	49	238	255	274	293	312
Payments related to pension and OPEB	-66	-4	-3	-5	-5	-17	-20	-20	-20	-20
Equity income in transmission affiliates, net of distributions	-3	0	-20	0	0	-20	0	0	0	0
Other	0	0	0	0	0	0	0	0	0	0
Change in -										
Accounts receivable and unbilled revenues	98	-4	219	0	0	215	0	0	0	0
Materials, supplies, and inventories	-2	159	-77	0	0	82	0	0	0	0
Other current assets	-7	65	-3	0	0	63	0	0	0	0
Accounts payable	2	-250	62	0	0	-188	0	0	0	0
Other current liabilities	79	-28	-40	0	0	-67	0	0	0	0
Other, net	21	-32	14	0	0	-18	0	0	0	0
Net cash provided by operating activities	**2,346**	**691**	**689**	**519**	**549**	**2,448**	**2,498**	**2,647**	**2,809**	**2,986**
Capital expenditures	-2,261	-496	-541	-642	-636	-2,315	-2,926	-2,633	-2,870	-3,120
Acquisitions	-268	0	0	0	0	0	0	0	0	0
Capital contributions to transmission affiliates	-53	-3	-6	0	0	-9	0	0	0	0
Proceeds from the sale of assets	38	1	1	0	0	2	0	0	0	0
Proceeds from rabbi trust investment sales	0	17	0	0	0	17	0	0	0	0
Proceeds from cash surrender value of life insurance	0	8	0	0	0	8	0	0	0	0
Other, net	49	10	3	0	0	13	0	0	0	0
Net cash used in investing activities	**-2,495**	**-463**	**-543**	**-642**	**-636**	**-2,284**	**-2,926**	**-2,633**	**-2,870**	**-3,120**
Exercise of stock options	67	16	4	16	16	52	60	60	60	60
Purchase of common stock	-140	-40	-10	-20	-20	-90	-100	-100	-100	-100
Dividends paid on common stock	-745	-200	-200	-200	-200	-800	-850	-901	-955	-1,013
Net movement in debt	926	-18	90	327	291	691	1,318	927	1,056	1,187
Other, net	-22	-3	-34	0	0	-37	0	0	0	0
Net cash used in financing activities	**86**	**-244**	**-149**	**123**	**87**	**-184**	**428**	**-14**	**61**	**134**
Net change in cash	-64	-17	-3	0	0	-20	0	0	0	0
Cash, beginning of period	146	82	66	62	62	66	46	46	46	46
Cash, end of period	82	66	62	62	62	46	46	46	46	46

Source: Company, Atlantic Equities estimates

Figure 76: WEC balance sheet

	2019	1Q20	2Q20	3Q20E	4Q20E	2020	2021E	2022E	2023E	2024E
Cash and cash equivalents	38	15	13	13	13	13	13	13	13	13
Accounts receivable	1,177	1,177	957	957	957	957	957	957	957	957
Inventories	550	391	468	468	468	468	468	468	468	468
Prepayments	262	200	210	210	210	210	210	210	210	210
Other	68	62	64	64	64	64	64	64	64	64
Current assets	**2,094**	**1,845**	**1,713**	**1,713**	**1,713**	**1,713**	**1,713**	**1,713**	**1,713**	**1,713**
Property, plant, and equipment, net	23,620	23,797	24,172	24,571	24,960	24,960	26,896	28,505	30,304	32,285
Regulatory assets	3,507	3,566	3,510	3,510	3,510	3,510	3,510	3,510	3,510	3,510
Equity investment in transmission affiliates	1,721	1,718	1,745	1,745	1,745	1,745	1,745	1,745	1,745	1,745
Goodwill	3,053	3,053	3,053	3,053	3,053	3,053	3,053	3,053	3,053	3,053
Other	958	853	849	849	849	849	849	849	849	849
Long-term assets	**32,858**	**32,987**	**33,329**	**33,728**	**34,117**	**34,117**	**36,053**	**37,662**	**39,460**	**41,442**
Total assets	**34,952**	**34,832**	**35,041**	**35,440**	**35,829**	**35,829**	**37,766**	**39,375**	**41,173**	**43,155**
Short-term debt	831	827	1,212	1,212	1,212	1,212	1,212	1,212	1,212	1,212
Current portion of long-term debt	693	694	895	895	895	895	895	895	895	895
Accounts payable	908	598	697	697	697	697	697	697	697	697
Accrued payroll and benefits	200	129	162	162	162	162	162	162	162	162
Amounts refundable to customers	88	156	100	100	100	100	100	100	100	100
Other	463	444	420	420	420	420	420	420	420	420
Current liabilities	**3,183**	**2,848**	**3,485**	**3,485**	**3,485**	**3,485**	**3,485**	**3,485**	**3,485**	**3,485**
Long-term debt	11,211	11,195	10,722	11,049	11,340	11,340	12,658	13,585	14,641	15,828
Deferred income taxes	3,769	3,870	3,946	3,991	4,040	4,040	4,295	4,570	4,863	5,175
Deferred revenue, net	497	429	424	424	424	424	424	424	424	424
Regulatory liabilities	3,993	3,987	3,969	3,969	3,969	3,969	3,969	3,969	3,969	3,969
Environmental remediation liabilities	589	589	589	589	589	589	589	589	589	589
Pension and OPEB obligations	326	324	322	317	312	312	292	272	252	232
Other	1,129	1,106	1,093	1,093	1,093	1,093	1,093	1,093	1,093	1,093
Long-term liabilities	**21,515**	**21,500**	**21,065**	**21,432**	**21,767**	**21,767**	**23,320**	**24,502**	**25,831**	**27,309**
Common shareholders' equity	10,113	10,344	10,384	10,416	10,470	10,470	10,853	11,281	11,750	12,253
Preferred stock of subsidiary	30	30	30	30	30	30	30	30	30	30
Noncontrolling interests	111	110	77	77	77	77	77	77	77	77
Total liabilities and equity	**34,952**	**34,832**	**35,041**	**35,440**	**35,829**	**35,829**	**37,765**	**39,375**	**41,173**	**43,154**

Source: Company, Atlantic Equities estimates

5. NEE: Initiate at Overweight, YE21 $330 price target

NEE summary investment case

We initiate coverage of NextEra Energy with an Overweight rating and YE21 price target of $330, implying 18% upside potential.

Highly efficient, well run FPL utility is a bedrock for earnings. FPL (55% of adjusted FY19 EPS) is the largest US utility measured by retail MWh sales, with one of the highest levels of efficiency (low opex) nationwide. In a sector where regulators can wield considerable influence over company operations, FPL's residential bills are ~30%/~20% below the national/Florida average, supporting high customer satisfaction levels and constructive regulatory relations.

Global leader in renewable generation. NEE's NEER segment (40% of adjusted EPS in 2019) is the world's largest wind/solar generator, with ample scope for further growth. NEER operates 24GW capacity and has 12GW in its order backlog. NEER's technical know-how, buying power, access to financing and strong credit rating make it a formidable operator in US renewables. Savvy use of tax structures further boosts returns. Meanwhile, the absence of regulatory support for returns is offset by credit-worthy counterparties, long-term deals, take-or-pay obligations for counterparties, and hedging.

Constructive regulatory environment in Florida. Authorised ROEs at FPL are at the high end of the national range, with a midpoint of 10.55% and a cap at 11.6%. Equity layers are relatively high, regulatory time lags on recouping investment costs are limited and surcharges (e.g. for storm repairs) work well. FPL's authorised ROE was set in 2016, little changed from the 10.50% ROE granted under the 2012 rate base review. We believe FPL's positive track record in regulatory/customer performance will support ROEs in the forthcoming 2021 rate base review.

We estimate an adjusted EPS CAGR of 8% in 2019-2024, which compares to the top end of NEE's 6-8% guide for 2019-2022, and would put the company in the top tier of sector growth rates (Figure 16). For the post 2022 period, we see ample investment opportunities in the regulated and non-regulated businesses to maintain earnings growth at a sustained 8% rate, assuming no swingeing cuts in authorised ROEs from the Florida regulator, which history suggests is unlikely. FPL contributes 53% of FY24 EPS in our forecasts leaving the overall balance of earnings between regulated/non-regulated businesses similar to that in 2020, which is supportive for a sustained premium earnings multiple.

Strong growth in FPL rate base. NEE expects a 9% CAGR in FPL's rate base in 2018-2022, which will drive earnings growth at the utility. Investment is focused on transmission/distribution, solar generation and improving service quality (including storm hardening). Under a law passed following Hurricane Michael in 2018, Florida utilities must develop 10-year plans to improve resilience, and associated capex can be recovered via a cost recovery rider to customer bills. The provision is in addition to existing hardening work, ongoing since the damaging 2004-05 hurricane seasons (recoverable under the normal base rate mechanism). FPL plans to invest ~$1bn annually in undergrounding cables, flood protection, replacing wooden poles and other measures.

Adept handling of solar opportunity in Florida. FPL targets a $10bn expansion of solar capacity in Florida by 2030, adding ~10GW of capacity. Customers can subscribe and avail of lower costs than for residential rooftop solar in a win-win arrangement, with FPL's net capex covered by the rate base. This side-steps a challenge for utilities from rooftop solar, which has a negative impact on demand as customers use less grid-supplied power.

Adverse COVID-19 impacts on earnings are limited. FPL benefits from an earnings smoothing mechanism, reserve amortisation, to offset the negative earnings impact of COVID-19 disruptions. At end-June the amortisation reserve balance stood at $736m, with $156m utilised in 1H20 to allow FPL achieve the top of its ROE band. NEE believes the remaining balance should be sufficient to see it through to the end of 2021. A low exposure to industrial

customers at FPL means NEE has had little exposure to the fall in industrial power demand stemming from lockdowns. Residential customers generated over 55% of FY19 revenues and FPL has benefitted from higher, stay-at-home demand. Hot summer weather has boosted air-con demand, helping to offset pandemic-related demand losses.

Culture of continuous improvement. NEE runs an annual bottom-up survey that challenges and rewards employees for their ideas on improving business performance and profitability. NEE estimates the initiatives, named Project Momentum and Project Accelerate, will generate ~$1.4bn ($2.90 per share) in cumulative, annual pre-tax improvements versus a 2012 base, when the programmes first began. The programmes are credited with much of the O&M improvement achieved at FPL in recent years. We expect these programmes to be an evergreen feature of NEE planning. These initiatives are encouraging as cost complacency can be an issue in regulated utilities because of pass-through cost arrangements, and each dollar of lowered opex facilitates multiple dollars of rate base capex.

An acquiror with a disciplined approach to M&A. As the largest US utility by market value, NEE is an acquiror in the consolidating utility space. The company's acquisition criteria limit the risk of an expensive transaction and are based on the following requirements 1/ immediate earnings accretion, 2/ constructive regulatory environment, 3/ maintains balance sheet strength and 4/ allows growth in rate base to displace opex without hurting consumers. The swift improvements seen at Gulf Power, following its acquisition by NEE in January 2019, shows good post-deal execution.

Limited big project risks. Despite receiving federal approval to expand its 3,500MW of existing nuclear capacity in Florida, FPL has paused capex for new nuclear, partly due to construction/cost problems elsewhere in non-associated nuclear plants and partly due to cost effective alternatives with lower up-front costs, including solar. Risks of cost overruns are accordingly reduced. Nor is NEE involved in the nascent US offshore wind expansion, which also requires high upfront costs (and offers inferior returns). However, NEE is involved in an Appalachian gas pipeline (MVP) which has been plagued by costly permitting delays due to environmental objections. NEE's net share of MVP capex is $1.8bn, of which most is sunk cost.

High credit rating and strong capital funding structures. NEE's A- rating from S&P is the highest rating for a US HoldCo electric utility. Subsidiaries FPL and Gulf Power are each rated one notch higher at A. Funds from operations/debt of 22.8% and net debt/EBITDA of 3.6x in FY19 were comfortably removed from downgrade thresholds. Affiliate NEP is rated below investment grade, at BB, reflecting its leverage (6.1x total debt/EBITDA in FY19) and absence of regulated cash flows. NEP is a funding source for NEE via asset drop downs that have averaged $1.0-$1.3bn p.a. in recent years. Tax equity investors are a further source of funding for renewables projects, contributing an average $1.6bn in cash proceeds to NEE (2017-19) in return for tax credits generated from renewables. NEE's pension fund is in a significant surplus.

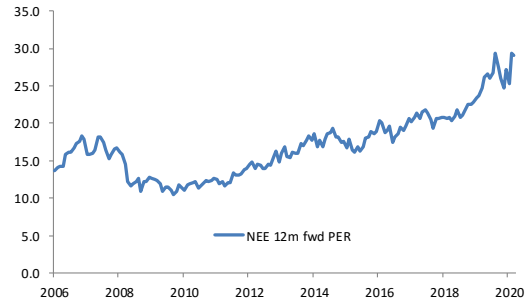
Management bonuses tied to earnings growth and relative TSR, creating alignment with shareholders. Annual and long-term incentive pay awards are linked to peer-relative EPS growth and ROE. CEO James Robo holds ~$165m in NEE stock and total insider ownership stands at ~$300m.

Strong ESG credentials. NEE has a top AAA ranking under MSCI's scoring criteria, placing it in the top 7% of global utilities (over 140 constituents), where it is seen as a leader in pursuing renewable opportunities. Coal accounts for a low single digit percentage of generation capacity at NEE, far below coal's 23% share of US power generation. CO_2 emissions per MWh are 47% lower than the US electric sector average and fell by 18% between 2014 and 2018.

Valuation and share price drivers

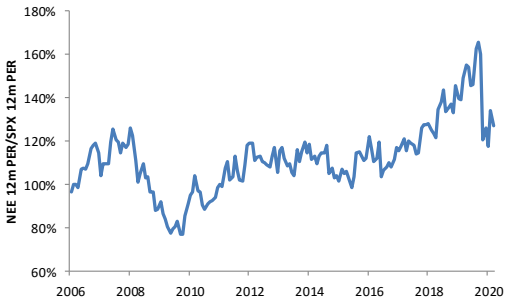
NEE currently trades at a PER of 30.7x consensus estimates for the next four quarters, which is an elevated level versus its historical range (Figure 77) but the market relative premium of ~30% is well down from peaks >60% in the past twelve months and more in-line with its historical average (Figure 78).

Figure 77: NEE 12m forward PER



Source: Bloomberg

Figure 78: NEE PER relative

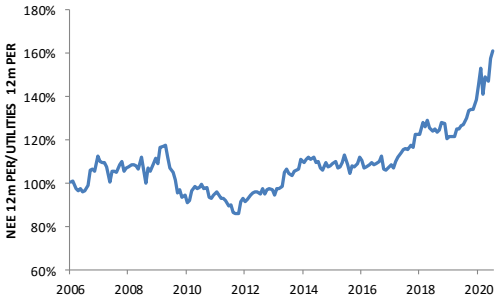


Source: Bloomberg and Atlantic Equities calculations

With respect to market relative earnings comparisons, we note that consensus estimates for S&P 500 earnings are for strong growth in EPS, with FY21 estimates of $166, 19% above 2019 levels, followed by 16% YoY growth in 2022. Consensus implies a CAGR in S&P 500 earnings of 11.2%, above trend growth of ~7%. A strong earnings rebound would compress the market multiple and make NEE appear more expensive. Conversely weaker earnings growth would increase NEE's relative attraction to investors.

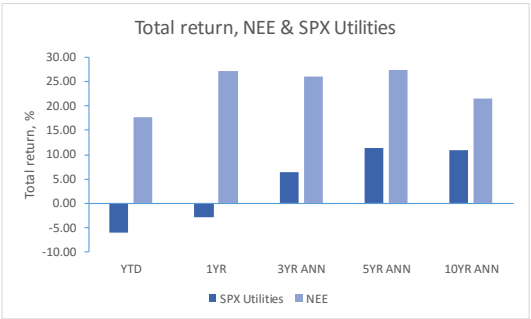
NEE shares have re-rated versus utility peers (Figure 79) helped by relatively strong earnings growth but also by continuing a long record of share price outperformance (Figure 80). NEE's multiple is a 60% premium to peers, reflecting above-average earnings growth.

Figure 79: NEE PER versus sector multiple



Source: Bloomberg

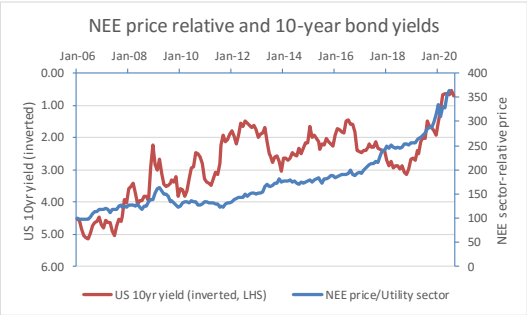
Figure 80: NEE track record of peer-relative outperformance



Source: Bloomberg

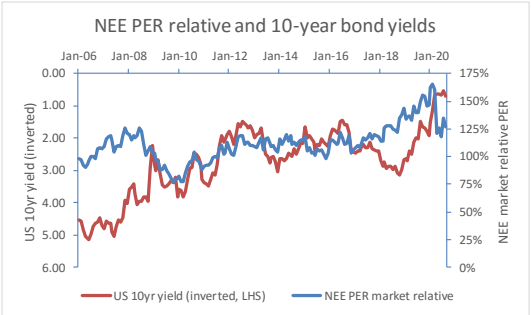
The re-rating also reflects the decline in bond yields since 2018 (Figure 81, Figure 82). NEE has enjoyed a stronger benefit from the move lower in bond yields whereas many of its peers have not (Figure 81).

Figure 81: Sector-relative performance and 10yr bond yields



Source: Bloomberg

Figure 82: Market relative PER and 10yr bond yields.



Source: Bloomberg

Reasons for NEE's multiple premium include its earnings growth which exceeds the peer average, Florida's constructive regulatory regime, strong ESG scores and a long-term growth

opportunity in renewables. As the largest listed US utility, and 2x the market cap of its nearest rival, NEE benefits from an index weighting and liquidity advantage over its sector peers.

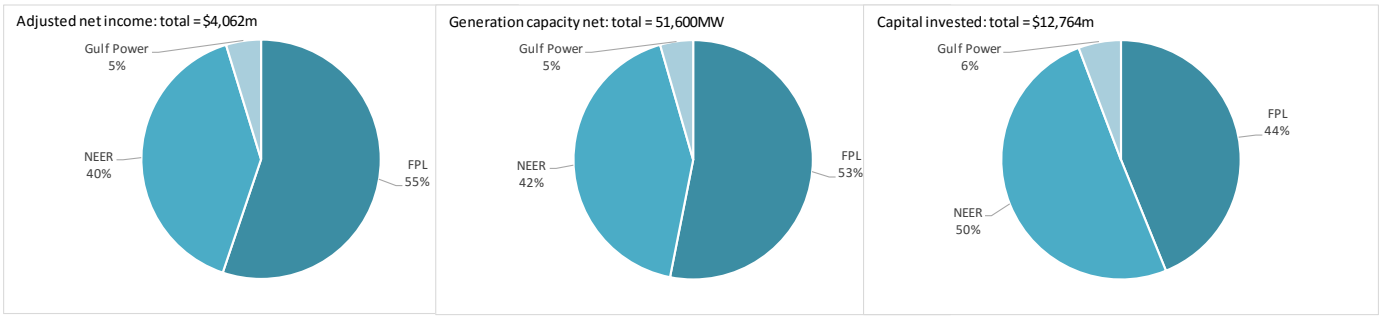
Our YE21 $330 price target is derived by applying a 65% market premium, in-line with levels reached in the past twelve months, to our FY22E EPS. This implies the current forward 12-month multiple is sustained which, in a world of lower-for-longer rates and yield curve control, we see as a reasonable assumption. The premium rewards NEE for its strong earnings growth relative both to the sector and other defensive peers. We are comfortable with this considering the predictability and long duration of the regulated utilities growth with a strong, multi-year outlook in demand for renewables from customers.

Downside risks to our estimates and rating include reduced renewables support from the federal government, for example in a Trump presidency. Higher fuel costs, taxes and interest on debt affecting end-user bills and would challenge NEE's ability to grow rate base without raising customer bills. Access to capital is crucial for continued investment funds so changes here can be impactful. We worry cheap capital could flood the renewables space and drive down returns. NEE's wish to execute M&A brings normal transaction risks. Cuts to authorised ROEs are a generic risk across the regulated utility sector. For additional risk please refer to NEE's 10-K filing.

NEE business and asset overview

NEE is primarily engaged in two business segments, one being the regulated supply of electricity in Florida and the other the competitive supply of mostly renewable power across much of the US. In 2019, NEE had revenues of $19bn, adjusted net income of $4,062m and, as at year end, had total assets of $118bn. Total generating capacity was ~51,500MW in 2019 and the company operated ~87,000 miles of transmission and distribution lines.

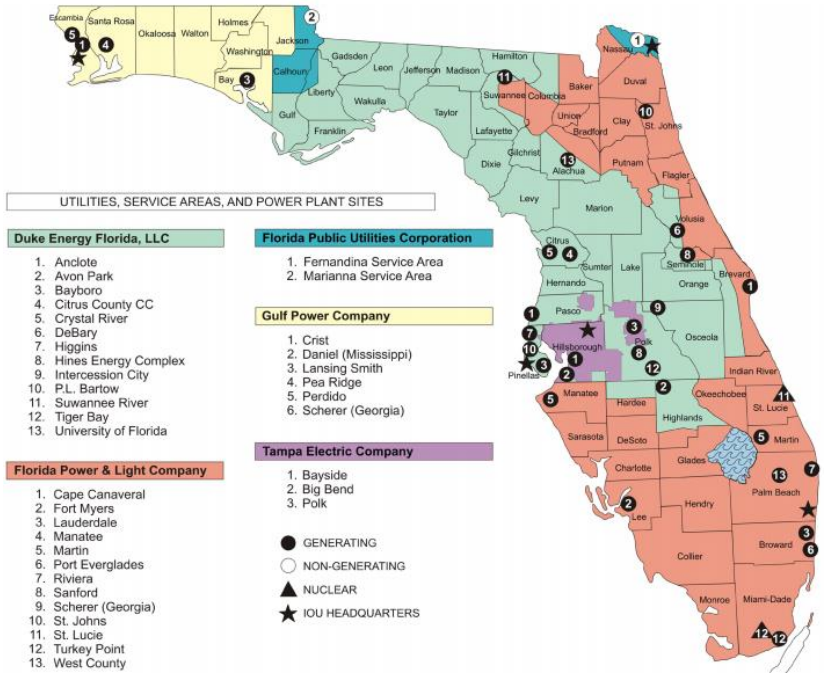
Figure 83: NEE summary data



Source: Company

Within the regulated Florida businesses (FPL and Gulf), NEE operates ~30GW of nameplate capacity, and supplied ~5.5m end users with 122 million MWh of electricity in 2019. FPL is Florida's largest utility and one of the largest in the US, serving five million customers. At year-end 2019 FPL operated ~75,000 miles of transmission and distribution lines and ~660 substations. Unlike many other utilities, FPL has minimal exposure to gas distribution. FPL generated 55% of NEE's adjusted net income in 2019, with Gulf Power providing 5%.

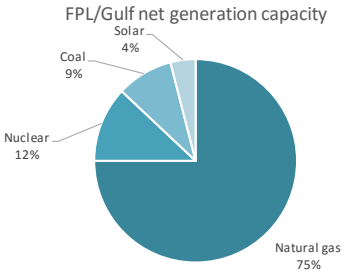
Figure 84: FPL and Gulf Power location of power plants and service areas



Source: FPSC http://www.psc.state.fl.us/Files/PDF/Publications/Reports/General/Factsandfigures/April%202020.pdf

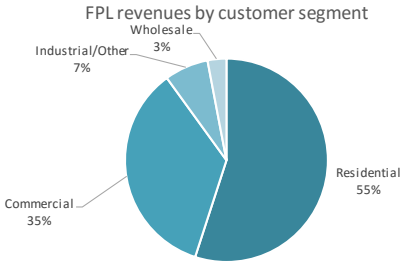
Net generation capacity by fuel at FPL/Gulf is shown in Figure 85. Coal's share of capacity, at 9%, is much lower than coal's 23% share in US generation in 2019. More efficient and lower carbon natural gas has a 75% weighting which compares to 38% for the share of gas in US generation.

Figure 85: Gas dominates generation



Source: Company

Figure 86: Small industrial base

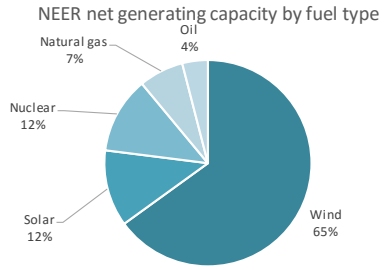


Source: Company

Industrial customers make up ~5% of the FPL revenue base, so the company has been some insulation from the negative effects of industries being curtailed during the pandemic, although the large commercial customer base has been negatively affected.

NEER encompasses NEE's competitive supply business, comprising ~22GW of net capacity, of which more than three quarters is wind and solar. NEER operations are spread across 37 US states and four Canadian provinces. NEER has interests in ~520 miles of regulated electricity transmission links and ~4.3Bcf/d in regulated gas transmission capacity, underpinned by long-term contracts. It also contains a commodity trading business. NEER is also expanding in battery storage. NEER contributed 40% of NEE adjusted net income in 2019.

Figure 87: NEER's renewable-centric asset portfolio



Source: Company

NEE earnings growth outlook

Our EPS forecasts for NEE are shown in the following table. We forecast an 8% CAGR in adjusted EPS between 2019-2024.

Figure 88: NEE earnings outlook

	2020	2021	2022	2023	2024
AE estimates	9.17	10.03	10.76	11.45	12.27
YoY change, %	*9.6%*	*9.3%*	*7.3%*	*6.4%*	*7.2%*
Consensus	9.12	9.87	10.65	11.25	11.75
YoY change, %	*9.0%*	*8.2%*	*7.9%*	*5.6%*	*4.4%*
6% EPS CAGR + Gulf Power synergies	8.70	9.40	10.00	10.60	11.24
8% EPS CAGR + Gulf Power synergies	9.20	9.95	10.75	11.61	12.54

Source: Atlantic Equities, Bloomberg for consensus. Note NEE does not guide beyond 2022.

NEE's earnings track record is strong, at a CAGR 8.5% p.a. between 2009-2019 so the forecast growth continues the momentum, despite NEE's scale as the largest US utility. Both regulated and non-regulated arms of the business grow in our forecasts, and FPL continues to contribute a little more (53%) to adjusted EPS than NEER in FY24. As such the risk profile of earnings does not materially shift. Note that NEE will file a joint rate case for FPL/Gulf in early 2021, to take effect in 2022. Our forecasts assume no change in authorised ROE at this time.

FPL rate base growth seen at 8% CAGR to 2024

We forecast an 8% CAGR in FPL regulatory capital employed (rate base less excess deferred tax) between 2018-2024, based on NEE guidance (to 2022), which marks a continued strong rate of growth at the utility, and one above the sector average. NEE itself guides to ~flat residential (1,000kWh) bills in 2021 compared to a 2018 base. FPL is highly efficient, with fewer low-hanging opex reductions to facilitate adding rateable costs without raising customer bills, yet there are ways to grow rate base while maintaining bills flat:

1/ Improved fuel efficiency in gas plants. Two new, large gas-fired generation units are highly efficient, requiring ~6,100 btu of gas to produce 1kWh of electricity. This is 10% more efficient than the average across the FPL generation portfolio in 2018 and ~20% more efficient than the national average. Absolute savings for customers are pegged at at $2/mmBtu.

2/ using less higher cost coal, more zero-fuel cost generation via solar. We estimate each GW of solar capacity saves ~$60m pa in fuel costs compared to a coal-fired plant, assuming recent coal prices ($40/T) and typical heat values.

4/ reduced maintenance from upgraded infrastructure. A significant proportion of capital spending is directed towards storm hardening including undergrounding distribution lines. Infrastructure improvements designed to improve storm resilience also help to make day-to-day operations more efficient. For example, moving distribution lines underground removes the

need for ongoing vegetation management or outages caused by wild animals, or vehicle collisions with roadside poles.

5/ introducing new technology to improve maintenance performance, including predictive maintenance, has resulted in avoiding a cumulative 7.7 million outage incidents, according to NEE.

6/ continued focus on improvement Employee-sourced ideas for improved efficiency and productivity (Project Accelerate and Project Momentum) have $400m cumulative run-rate savings targeted for 2020 and 2021 combined. Thanks in no small measure to these initiatives, FPL's service reliability was 62% above the national average in 2019 and the firm was recognised as the nation's most reliable electric utility.

7/ growth in customer base. Spreading costs over a growing customer base helps to offset a rising base rate. FPL's customer base grew by a CAGR of 1.3% in the 2014-2018 period, and the company assumes 1.1% annual growth in 2018-2022E. in absolute terms the cumulative increase is 0.3m customer accounts to a total 5.3m.

All major projects at FPL remain on time and on budget. NEE's track record is good for project delivery with an average project conclusion twenty days ahead of schedule and 7% below budget.

Figure 89: Continued strong investment in FPL to grow rate base

FPL Capital plans, $m	2020	2021	2022	2023	2024	Total	%
Generation - new	1,345	730	555	500	0	3,130	10%
Generation - existing	855	970	930	925	840	4,520	15%
Transmission and distribution	3,150	3,905	4,030	4,120	4,885	20,090	65%
Nuclear fuel	205	220	165	120	145	855	3%
General and other	730	480	440	380	470	2,500	8%
Total	6,285	6,305	6,120	6,045	6,340	31,095	100%

Source: Company

Transmission and distribution investment accounts for the bulk of investment, at an estimated 65% of the total. This investment includes storm hardening work (pegged at ~$1bn pa by NEE through to 2030), continuing multi-year upgrades to improve grid resilience. Under Florida legislation passed in 2019, utilities can recover storm hardening through a cost recovery clause and earn a ROE at the midpoint of FPL's allowed ROE range, currently 10.55%. Undergrounding of distribution laterals are also covered. FPL sees an investment opportunity of $25-$35bn under the storm hardening category in the next two to three decades. Another T&D renewal project covers the replacement of foundations for 500kV transmission lines across the service territory. Other T&D capex includes connections and expansions to link up new customers. FPL is also building a transmission line to link to the recently acquired Gulf Power's territory in northwest Florida (Figure 84).

Figure 90: FPL capex breakdown

Project	Status	Capex	Recovery method
Dania Beach Clean Energy Center	Underway, 2022 finish	~$900m	Base rates
Solar under Base Rate Adjustment	Completed 2Q20	~$390m	Solar base rate adjustment
Solar Together	20 sites by YE21	~$1.8bn	Base rates with customer offset
Other solar	In early development	~$1.0-$1.5bn	Base rates
Battery storage	Manatee underway	~$420m	Base rates
500 kV transmission project	Underway	~$1.0-$1.5bn	Base rates
Storm hardening (2019-2022 only)	Underway	~$3.0-$4.0bn	Base rates, storm recovery clause
Other transmission, distribution (2019-2022 only)	Underway	~$7.0-$8.0bn	Base rates
Asset maintenance, fuel, other to 2022	Ongoing	~$5.5-$6.5bn	Base rates

Source: Company

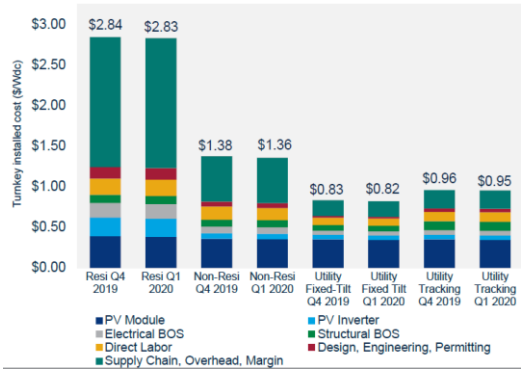
New generation capex includes a large-scale modernisation project at Dania Beach in Lauderdale, where two existing generating units will be retired and replaced by a combined cycle, gas-fired unit totalling 1,200MW capacity. Capex is pegged at $900m and completion is

expected in 2022. The new unit is expected to be 22% more efficient than the retiring plants (heat rate of 6,119/kWh) and can be ramped up or down ten times more rapidly than the older kit. The fuel saving will be passed through to customers.

Solar is the growth area for new generation capacity, where FPL sees a cumulative $10bn investment opportunity out to 2030, of which we estimate ~$3.5bn could be delivered by 2024, through a variety of projects. These comprise the '30 by 30' projects which target installation of thirty million solar panels by 2030, representing ~10GW of incremental solar capacity, versus the present installed base across the state of ~2GW. The total also includes the final 300MW of annual capacity additions envisaged in the 2016 rate settlement, which came on-line in 2Q20 ($390m capex).

FPL has adjusted rather adeptly to the increasing interest in solar in the state. Following a successful pilot project which began in 2014, FPL launched a large-scale community solar project ("SolarTogether") in 2019. Rather than constructing inefficient rooftop solar, customers subscribe to utility-scale solar plants within Florida. Customers pay a fixed subscription fee which is offset by credits from enrolling in the programme, with a net effect of lowering bills over time, while receiving renewable energy and avoiding upfront rooftop installation costs. FPL estimates a simple payback for a typical residential customer of 5-7 years versus 12-14 years for rooftop solar. Subscriptions are transferrable within FPL's service territory, unlike fixed rooftop panels.

Figure 91: FPL is leveraging the cost benefit of utility-scale solar

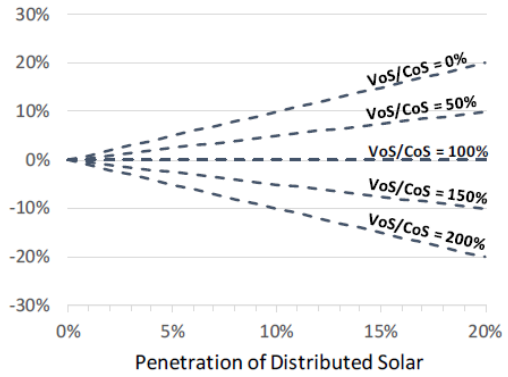


Source: Wood Mackenzie

Unsurprisingly, given the commercial incentives and environmental benefits, SolarTogether has had a very successful launch with the first six solar plants fully subscribed in just three days. A further 14 plants are targeted for construction in 2020-2021. Approximately 100 plants would be required to achieve the 10GW installed capacity target in 2030 (enough power for ~two million homes). From FPL's perspective SolarTogether costs can be recovered through the normal rate base mechanism (adjusted for subscriptions).

SolarTogether sidesteps a potential challenge facing incumbent regulated utilities from rooftop solar. The more widespread rooftop solar becomes, the less demand for power delivery through the grid but the number of customer connections remains unchanged, resulting in higher prices for all to sustain utility revenues to recover costs. For example, as Figure 92 shows, customer bills would rise 5% if rooftop solar penetration hits 10% (assuming avoided cost of supply is 50% of overall cost of supply). Nor are non-subscribers to SolarTogether disadvantaged by not participating; FPL estimates those customers choosing not to join will see 20% of the cost benefits over the life of a project.

Figure 92: Rooftop solar a challenge to legacy utility models



Source: Berkeley Lab Energy Policy and Markets Group.

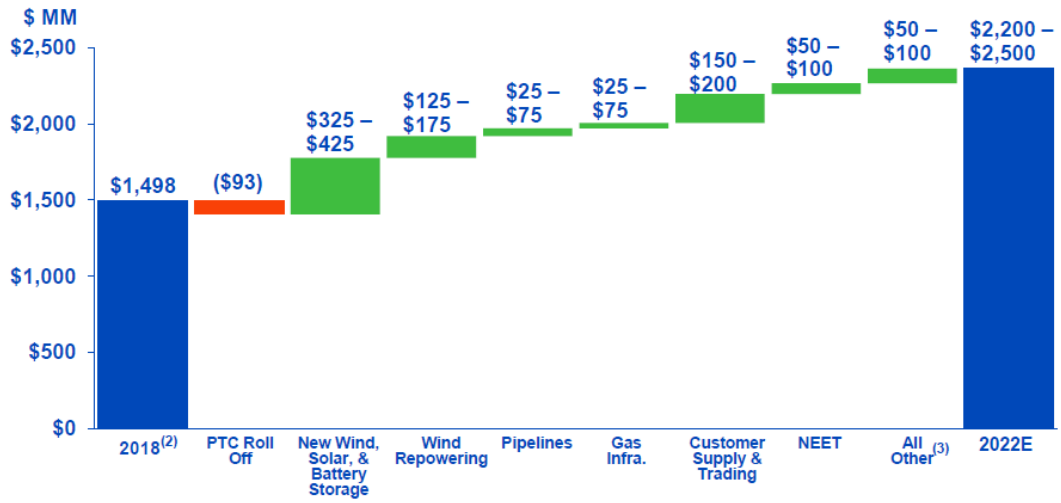
New nuclear investment is de-emphasised, reducing risks of cost overruns

Investors are likely to look positively upon FPL's hiatus on plans to invest in new nuclear capacity during this decade, because of the industry's poor cost record in constructing new facilities. despite receiving approvals which would have moved those projects forward. FPL operates four nuclear units in Florida with a total ~3,500MW capacity and has approval from the US Nuclear Regulatory Commission to add two further plants (Turkey Point 6 and 7, located on Florida's southern tip). With two of the existing facilities having received approval for an extended lifespan, the need for new capacity has diminished. With delays and cost overruns plaguing nuclear new builds in Europe, China and the US (the Vogtle plant in Georgia, which is >$13bn above budget).

NEER the global wind/solar leader

NEER (NextEra Energy Resources) provides an important source of earnings outside the regulated utility ringfence and contributed 40% of adjusted NEE earnings in 2019. NEER has successfully built a world-leading business in an area where utilities have struggled to expand beyond their traditional franchises. NEE guides to a 12% CAGR in NEER earnings between 2019-2022 driven from an expanding asset base as renewables penetration increases.

Figure 93: NEER adjusted earnings CAGR of 12% (midpoint) between 2018-2022



Source: Company

NEER earnings are not secured under a regulatory compact and so carry a higher risk than earnings within FPL and other regulated utilities. In order to offset earnings risk NEER has adopted a number of measures including

1/ long-term contracts with customers with a weighted life of 16 years

2/ contracts impose take-or-pay responsibilities on customers

3/ hedging is deployed to secure cash flows

4/ customer base is dominated by credit worthy counterparties, particularly utilities

Many utilities and other developers have struggled to generate returns from renewables that are competitive with regulated assets. In contrast, NEE noted at its investor day last year that it achieves leveraged returns of over 20% in its wind business and in the teens for its solar business. NEER's competitive advantages include purchasing power as the largest global player in the business. The company has twenty years' experience in site selection, procurement, construction, connection to transmission networks and operating capability, whereas many competitors have had intermittent focus on the space. A deep technical understanding of location-specific issues is a particular benefit in siting wind projects, and NEER is using advanced analytics/big data to support its evaluation of target sites. A strong,

investment grade balance sheet, long-lived commercial relationships with counterparties and the ability to take on the largest projects are further important advantages.

NEER's capacity to raise funds benefits from NEP, a listed subsidiary (61% owned, not under AE coverage). NEP purchases projects from NEER at an average run-rate of $1.0-$1.3bn p.a. Tax equity investors are a further source of funding for renewables projects, contributing an average $1.6bn in cash proceeds to NEE (2017-19) in return for tax credits generated from renewables. Utilising tax credits has been more challenging within regulated utilities as these are typically passed through to customers.

Figure 94: Tax incentive expiry schedule

	Year construction of project begins[a]							
	2015	2016	2017	2018	2019	2020	2021	2022
PTC[b]	100%	100%	80%	60%	40%	60%	-	-
Wind ITC[c]	30%	30%	24%	18%	12%	18%	-	-
Solar ITC[d]	30%	30%	30%	30%	30%	26%	22%	10%

(a) Project must be placed in service no more than four years after the year in which construction of the project began to qualify for the PTC or ITC.
(b) Percentage of the full PTC available for wind projects that begin construction during the applicable year.
(c) Percentage of eligible project costs that can be claimed as ITC by wind projects that begin construction during the applicable year.
(d) Percentage of eligible project costs that can be claimed as ITC by solar projects that begin construction during the applicable year. ITC is limited to 10% for solar projects not placed in service before January 1, 2024.

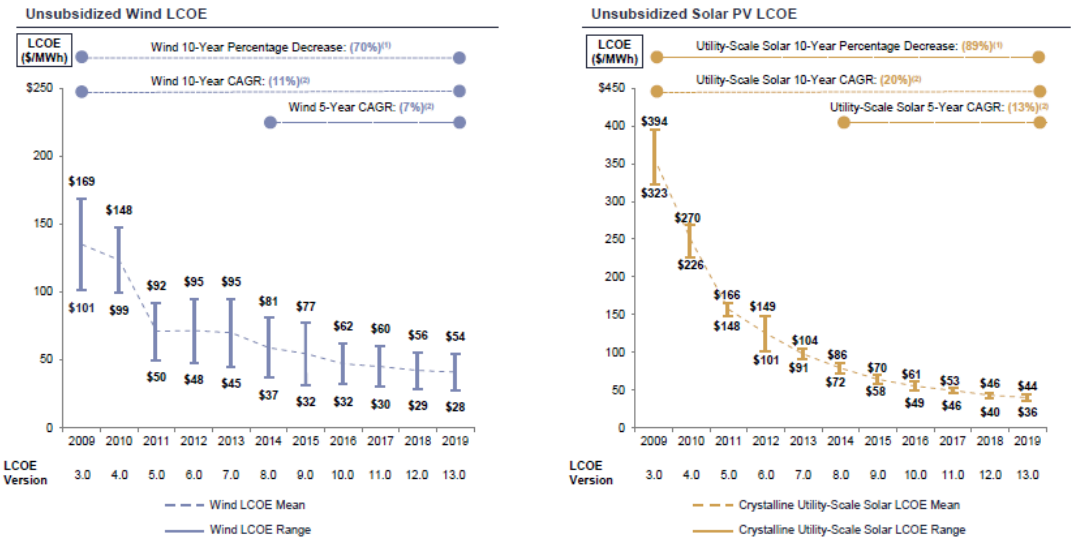
Source: Company

As currently envisaged, federal tax credits for new wind projects will expire at the end of 2020, which will have a knock-on effect on new tax equity investors. However, this event will not be a cliff-edge drop off in tax credits. Current projects with tax credits are unaffected. Projects begun in 2020 have four years to complete and will have access to tax credits for ten years following start up. Note that the wind tax credit has been extended several times, including retrospective reinstatements, so this situation may change. A change in president could lead to a shift in tax credits for renewables. By 2023-2024 NEE expects the cost of new wind and new solar will be competitive against new fossil fuel thanks to the falling cost of new renewables kit. We assume power prices under NEER's long-term agreements continue to fall in-line with lower installation costs, such that EBITDA margins are stable.

Renewables growth prospects underpinned by falling costs, regulation, customer choice

Growth in renewables looks assured due to rapidly falling costs (Figure 95). As a new build option, efficient solar and wind now compete with gas and trump coal and nuclear. Note that when tax subsidies are excluded, new build solar and wind is not yet sufficiently competitive to displace much existing coal and nuclear capacity (i.e. new build solar costs are above marginal costs for much of the US coal/nuclear fleet).

Figure 95: Solar costs have caught up with wind, both now competitive with fossil fuel

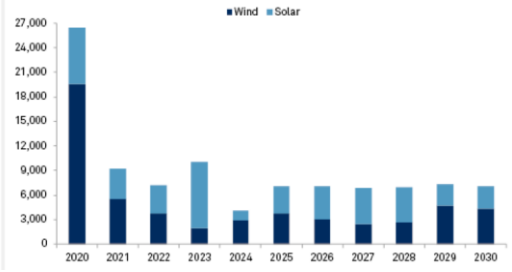


Source: Lazard's levelized cost of energy analysis, v13

Given the near-stagnant growth trends in US power demand, accommodating the growth in renewables capacity means replacing retiring coal (mostly) and some nuclear capacity.

Most looming retirements are expected before 2025 with the EIA forecasting a cumulative ~120GW in plant retirements by YE25, creating a significant growth opportunity for solar and wind to fill the gap. Renewables versus gas competition will be tougher (levelized cost of $35-$48/MWh @$2/mmBTU gas price) but here renewables will benefit from state-level mandates for increased renewables content in electricity sources, known as the Renewable Portfolio Standard, (RPS, Figure 96).

Figure 96: RPS a tailwind for renewables over competitive new gas (MW)



Source: S&P Global Market Intelligence

One driver for renewables growth comes from customer preferences for renewable power, e.g. by large listed corporates who have ESG targets to hit, requiring them to utilise green energy in preference to fossil fuel-derived power. The focus on green energy also applies to the listed utilities producing power to the grid. Residential customers are increasingly looking for green power options.

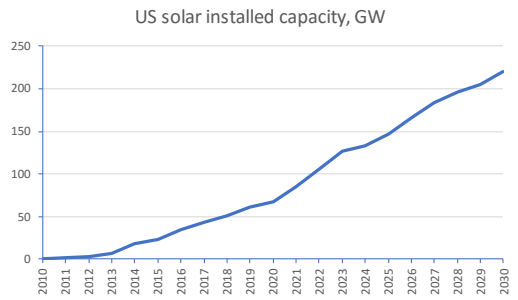
NEER's growth outlook in solar supported by a large order backlog

As at end 1Q20, NEER had 2.9GW net solar capacity, about 13% of NEER's total net capacity (including the NEP affiliate), so a smaller share than wind (~66%) but nonetheless a segment that is undergoing rapid growth. We expect capacity to continue to expand very rapidly, as evidenced by NEER's large and growing order backlog. NEE guides for new capacity agreements totalling 3,800-7,300 MW capacity in 2019-2022. The estimate already seems conservative, as signed contracts are already above the low end of the range at 5.1GW and a further 2GW is already signed for post-2022. As such, NEER can tolerate some project cancellations (e.g. due to COVID-19 related demand softness) without putting its guidance under threat.

Solar: Strong growth ahead, NEER well positioned

Large scale solar barely existed as a generation source in the US ten years ago, but from 2013 capacity grew rapidly, reaching ~70 GW in 2019. The strong growth is set to continue. Based on the EIA's reference outlook, installed solar capacity is expected to reach 220GW in 2030, a ten year CAGR of 13%. Growth continues in the 2030s, albeit at a slower rate of 3.3% p.a., according to the EIA. Most of the 2020-2030 growth is driven by the utility sector, which adds 110GW during this decade, outpacing less-competitive rooftop, community and other solar plants.

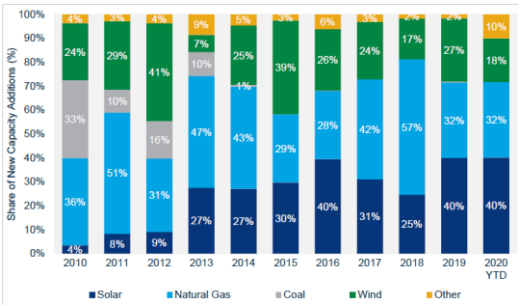
Figure 97: Go-Go solar



Source: EIA, annual energy outlook, reference case

Solar accounted for 40% of all US capacity additions in 1Q20, continuing its share of new capacity in 2019, more than other source, including wind. Note that solar and wind initially beat out coal and nuclear as new capacity choices (pre-2015) but latterly solar has competed more directly with wind (and natural gas), with solar winning the market share battle versus wind in recent years. Solar has an edge over wind as investment tax credits for new solar extend to 2022, compared to an end-2020 expiry for new wind credits.

Figure 98: Solar leads new capacity growth



Source: Wood Mackenzie

Battery storage to enable more renewable adoption, NEE a leader

Falling costs have raised the profile of battery storage in renewables and NEE (and others) sees continued declines in costs leading to higher adoption rates. In a sense the renewables industry is piggybacking on the R&D work done in the automotive sector, where technological progress is being transferred to utility-scale generation.

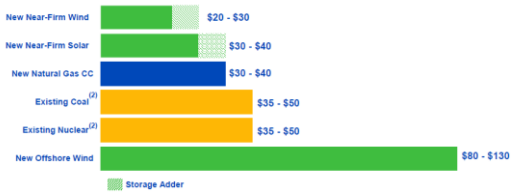
NEE estimates the cost of battery storage could halve by 2024 versus 2020, to $5-$9/MWh. With continued falls in solar and wind costs, that would make storage/renewables competitive with gas-fired power. The company has 2GW of battery storage capacity in backlog, including FPL's Manatee project, and FY21 battery-related capex will exceed $1bn.

We see it as important that NEER and other power providers monetise the benefits of storage as customers may deploy storage behind the meter, which could be disruptive for reserve margin, load balancing, etc. reducing the utilities investment requirement, and therefore earnings potential.

NEER avoiding potential pitfalls in offshore wind.

NEER is not involved in offshore wind despite the increased attention this source is receiving in the US. The US has lagged Europe in developing offshore wind and has minimal offshore infrastructure today. However, many new projects are planned, with most off the East coast to supply the high cost North East market. NEER's view of the economics of offshore wind is unfavourable (Figure 99).

Figure 99: Offshore wind not economic



Source: Company

NEER's headwind: MVP gas transmission pipeline

Gas transmission is a smaller business within NEER's portfolio, with aspirations to deliver adjusted EBITDA of ~$600m in 2022. The segment has a 31% interest in the Mountain Valley Pipeline (MVP), a 42" diameter line under development with a 2.0Bcf/d capacity that runs 300 miles in the Appalachians from West Virginia to Virginia. Capacity is fully booked on a firm basis for twenty years.

Like a number of other East coast gas pipeline projects, MVP has hit permitting problems due to environmental objections. As a consequence, completion is delayed and the project is over budget. Total projected costs (100%) for MVP are ~$5.7bn versus an initial guide of $3.3bn. The operator expects the pipe to enter service in early 2021 (subject to permit approvals) versus an initial 4Q18 date.

On the plus side the line is 92% complete, most costs are sunk, and the line could be finished within months of restarting operations. MVP is regulated by FERC and additional costs are borne by NEE, not customers. A 75-mile extension ('Southgate') of the MVP to North Carolina was approved by FERC in June 2020.

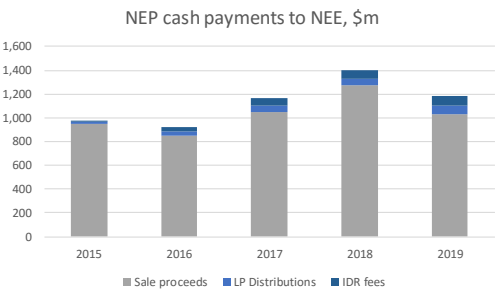
Other pipelines have had significant problems. Williams's Constitution and Dominion's Atlantic Coast pipeline in the Appalachian region have both been abandoned. As a result, MVP may be in greater demand, assuming it is completed, as there are few competing options. The line could be readily expanded via added compression to accommodate new customers.

NEP a source of funding to parent

NEER's listed affiliate NEP (60.8% owned) provides three main benefits to the parent: 1/**a source of funding** 2/ **tax optimisation** and 3/ **demonstration of value** in assets via transaction prices.

NEER periodically sells (drop down) assets to NEP, at a run-rate of ~$1-$1.4bn each year, with the purchases funded by external capital (the 39% minority investors and external equity/debt capital). For example, in 2019 NEP purchased a 611MW portfolio of wind and solar assets from NEER for $1.02bn, equal to an unlevered EBITDA multiple of 8.9-10.2x. NEP's asset portfolio comprises 5.3GW of wind and solar capacity compared to 19.1GW at NEER so there is a substantial inventory of potential further sales. (NEP's other main assets are gas pipelines in Texas with 3Bcf/d contracted capacity).

Figure 100: NEP supplies funds to NEER



Source: Company

Although NEP is a limited partnership under state law and the business model closely follows MLP strategies, it is a corporation for US tax purposes. Consequently, NEP benefits from an increased tax depreciation allowance for purchased assets, reflecting their acquisition value, not replacement cost. As a result, NEP generates sufficient net operating losses to fully offset its tax bill and it expects to not pay cash taxes for fifteen years. NEER benefits from the tax shield as all surplus cash is paid out by NEP. In addition, the tax benefit boosts asset values and allows NEP to pay higher prices for assets purchased from NEER.

NEP was established and listed in 2014, with a ~1GW renewables portfolio. Initially fully consolidated, NEP was deconsolidated in January 2018 when outside unitholders were handed a majority say in approving board personnel. NEP sells almost all its output under multi-year flat-price contracts known as PPAs or power purchase agreements. NEP has no employees and all assets are managed by NEE, for which NEE management receives a fee.

For modelling purposes, we assume no further drop downs i.e. the growth generated within NEER remains within NEER. Note that PG&E, the Californian utility, is a significant customer of NEP and its bankruptcy resulted in some cash distributions being frozen ($51m) but distributions have resumed following PG&E's emergence from bankruptcy and we expect cash disbursements from affected projects to continue.

Gulf Power improvements to help earnings, albeit modestly

Gulf Power is a recent addition to the NEE portfolio, having been acquired from Southern Company in January 2019 in a $4.44bn cash deal, plus the addition of $1.3bn in Gulf Power debt. Gulf Power serves half a million customers in northwest Florida and in 2019 operated approximately 2,300 MW of gas/coal generation capacity, plus ~9,500 miles of transmission and distribution lines.

In 2019, unit non-fuel operations and maintenance expense at Gulf fell 20%, service reliability improved by 20% and safety performance improved by 40%. These metrics show NEE is moving quickly to improve Gulf's efficiency. One coal-fired power station (Crist) is being modernised and converted to more efficient natural gas, which will cut non-fuel opex. The introduction of smart grid technology and infrastructure upgrades have improved performance.

Gulf brought its first solar project on-line in early 2020, the ~75MW Blue Indigo project.

NEE targets a fall in Gulf power costs via lowered operating & maintenance costs, more efficient generation and – over time – the expiry of high cost power purchase agreements with third parties. This will benefit customers: for a typical 1,000 kWh residential bill, NEE targets a fall from $137/month to ~$125/month by mid-decade.

Gulf Power's authorised ROE midpoint of 10.25% is less than FPL's 10.55% ROE. In addition, and unlike FPL, Gulf's regulatory settlement does not include reserve amortisation which acts as an earnings smoothing mechanism. NEE plans to file a joint Gulf/FPL rate base submission in 2021 and has already filed a joint ten-year plan with the regulatory authorities. NEE hopes to fully merge FPL and Gulf in 2022.

Figure 101: Gulf Power financial forecasts

	2018	2019	2020E	2021E	2022E	2023E	2024E
Regulatory capital employed	3,000	3,300	3,995	4,569	4,995	5,401	5,812
Gulf Power net income	160	200	212	270	295	319	343
Contribution to NEE EPS, $/share	n/a	0.41	0.44	0.55	0.59	0.63	0.67

Source: Company, Atlantic Equities forecasts

Since the acquisition, NEE has indicated capex at Gulf Power will approximately double from pre-acquisition levels, suggesting Gulf's high cost base partly reflects capital rationing under the previous owner. The increased spending drives strong growth in rate base, with a 14% CAGR guided between 2018-2022. NEE guides net income at Gulf to grow at a 16% CAGR between 2018-2021. However, 2Q20 earnings bucked the growth trend with a $0.01/share YoY

decline to $0.11, despite a 23% expansion in regulatory capital employed. COVID-19 effects and weather were each a $0.01 headwind to 2Q earnings. On a brighter note, customer numbers grew 1% YoY. Our take is that the softness in 2Q earnings does not negate the longer-term earnings growth potential at Gulf due to the ongoing potential for reducing opex allowing for growth in the rate base whilst lowering customer bills.

Constructive regulatory environment in Florida

Florida's regulatory regime is not onerous by US standards. Authorised ROEs are at the high end of the national range, equity layers are high, regulatory lags are limited and surcharges (e.g. for storms) work well. Regulatory amortisation is allowed to smooth earnings and keep customer bills from changing too much.

FPL's authorised ROE is a midpoint of 10.55% within a range of 9.6% to 11.6%, with NEE performing at the top end of the allowed range in recent years. This settlement allows FPL to generate a higher ROE than the typical level seen in the industry. The authorised ROE was set in 2016 and is little changed from the 10.50% ROE under the 2012 rate base review. FPL's equity layer is relatively high at 59.6% versus ~52.5% at WEC so a higher proportion of earnings are allocated to investors.

The rate settlement allows for additions of identified new assets to be incorporated into the rate base when completed. For example, the 2016 rate base agreement allows for 300 megawatts of new solar generation capacity to be added annually and to be rolled into the rate base when operational. The additions are subject to a cost cap ($1,750/kW) so customers are not on the hook for a high cost project.

The upcoming rate base review

Florida's Public Service Commission regulates the power sector. Five commissioners are appointed by the Governor (Republican, Ron DeSantis), based on recommendations from a 12-member nomination committee (which includes six state politicians), and are confirmed by the State Senate. Terms are for four years and can be renewed up to a total of three terms.

FPL and Gulf Power expect to file a combined rate case in 1Q21 to take effect from January 2022 and which is intended to cover the 2022-2025 period. Cases should be settled within eight months of filing. While there is a risk that the FPSC will reduce authorised ROEs, the FPSC's mission is threefold: ensuring safe, reliable/efficient and cost effective power supplies (ranked in that order), and the balance between customer benefit and investor return appears to be well recognised, based on prior outcomes and commissioner commentary. According to the FPSC's Long Range Program Plan, updated last October, the commission targets a ROE for power utilities of +/-1% from the national average. Clearly this allows a wide range of outcomes. However, the average rate base decisions since 2016 have remained above 9.5% with little downward movement. If that remains the case into the rate review period, FPL may emerge with a little-changed ROE. One other factor the FPSC weighs is to limit increases in residential bills to 1% above CPI (equal to 2.44% in FY18/19). As discussed above, minimising bill inflation is a key focus at FPL and Gulf Power, so we expect ongoing efforts to achieve the commission's target.

For its part NEE has been a good corporate citizen, with lower than average residential bills, which should put it in good standing with the regulator (Figure 102). FPL bills are ~30% below the national average. NEE plans to reduce Gulf Power's typical residential bill to ~$125 by mid-decade.

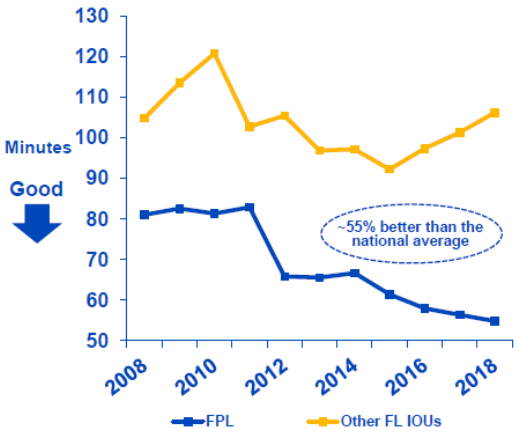
Figure 102: FPL's below average cost to residential customers

Comparison of residential power costs, Florida investor-owned utilities					
	FPL	Duke Energy	Tampa Electric	Gulf Power	Florida PUC
Base Rate Charges	$69.94	$72.30	$67.76	$68.06	$56.04
Fuel and Purchased Power Cost Recovery Clause	$18.84	$30.67	$22.85	$32.62	$74.59
Fuel Credit	N/A	N/A	-$18.40	N/A	N/A
Energy Conservation Cost Recovery Clause	$1.39	$3.39	$2.32	$0.60	$1.32
Environmental Cost Recovery Clause	$1.55	$0.79	$2.44	$18.86	N/A
Capacity Cost Recovery Clause	$2.30	$12.00	-$0.12	$8.78	N/A
Storm Damage Cost Surcharge	N/A	$5.34	N/A	$8.00	$1.54
Asset Securitization Charge	N/A	$2.35	N/A	N/A	N/A
Gross Receipts Tax	$2.41	$3.25	$1.97	$3.51	$3.42
Total	**$96.43**	**$130.09**	**$78.82**	**$140.43**	**$136.91**

Source: FPSC http://www.psc.state.fl.us/ElectricNaturalGas Note: For July-December 2020, for 1,000kWh

FPL has a track record of improving reliability which it attributes to appropriate investments over a number of years. As such FPL can show it has delivered noticeable customer improvements because of previously approved investments, which strengthens its case for the next four-year cycle of investment. In a similar fashion, FPL can show that storm hardening investments have paid off in reducing recovery times following storms. FPL calculated that customer outages were three days shorter on average following Hurricane Irma, which hit Florida in 2017, when compared to Hurricane Wilma in 2005. The performance improvements support FPL's request for further regulatory support in building resilience into its network.

Figure 103: Interruption duration index



Source: Company

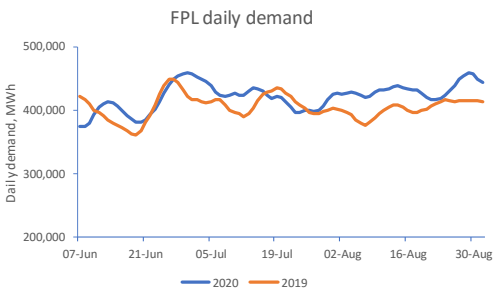
COVID-19 impacts limited

NEE is insulated from the negative impacts of COVID-19 on earnings.

A low exposure to industrial customers at FPL means NEE has had little exposure to the fall in industrial power demand stemming from lockdowns. Residential customers generated over 55% of FY19 revenues and have benefitted from stay at home demand upticks.

Power demand will be hit by fewer tourist arrivals in Florida due to the pandemic, but our assumption is that air-conditioning demand will continue in order to maintain building integrity (e.g. preventing damp, mould) even in the absence of occupants. So far demand is holding up well, helped by hotter July/August weather (Figure 104). Longer term impacts on tourism depend on two offsetting factors; fewer foreign tourists flying in but more US/Canadian citizens opting to vacation in Florida rather than fly overseas. US/Canadian travellers accounted for 92% of total Florida visitors in 2019, suggesting a resilience of tourism in the absence of overseas arrivals.

Figure 104: Hot summer helps demand



Source: EIA

FPL is using reserve amortisation to offset the earnings impact of COVID-19 disruptions. Reserve amortisation is effectively an earnings smoothing mechanism endorsed by the

regulator. In strongly profitable years, FPL may raise the amortization charge to keep returns below the regulatory cap and in weaker periods, as when COVID-19 hit Florida, the reserves can be reversed, to boost earnings via a lower amortisation charge. The measure has been used annually by FPL since 2016 and is not problematic.

The sums involved in reserve amortisation movements can be significant, with amortisation charges increased by $541m and $357m in 2018 and 2019, respectively. Amortisation was reduced by $1.25bn in 2017 as FPL reversed reserves to offset storm repair costs (Hurricane Irma) – rather than push the costs onto customers. NEE utilised $149m of amortisation reserves to meet the target ROE in 1Q20 and had $744m balance remaining (Gulf Power does not have an equivalent mechanism). NEE believes that amount should be sufficient to see it through to the end of 2021 (note amortization is typically higher in the first half so the 1Q amortization reversal should not be used as a quarterly run-rate). NEE likes the mechanism and considers it a win-win for the company and for consumers, as it avoids volatility for both.

Strong, highly rated balance sheet

NEE is rated A- by S&P, the equal-highest rating for a US HoldCo electric utility. FPL and Gulf Power are each rated one notch higher at A and NEP is rated below investment grade, at BB, reflecting its leverage and absence of regulated cash flows.

Figure 105: Credit metrics for large utilities

	S&P LT local credit rating	Bloomberg implied CDS spread (5yr) bps	Current mkt cap $m	Current Net debt $m	Net debt/mkt cap %	Weighted average debt maturity yrs	Net debt/12m fwd EBITDA x	FCF yield 12m fwd %
NEE	A-	44	137,390	42,537	31%	13.7	4.0	-2.8%
D	BBB+	52	66,362	38,232	58%	13.1	5.5	4.7%
DUK	A-	54	59,673	62,709	105%	13.9	5.8	-4.0%
SO	A-	55	55,599	6,779	12%	14.5	0.8	-1.2%
AEP	A-	50	39,474	47,614	121%	15.5	8.0	-3.2%
SRE	BBB+	55	35,498	26,171	74%	14.2	5.5	-1.5%
EXC	BBB+	58	36,318	38,386	106%	15.5	4.4	2.1%
XEL	A-	49	37,115	20,280	55%	18.0	4.9	-2.9%
WEC	A-	48	30,395	12,739	42%	15.3	4.6	-3.7%

Source: Bloomberg

Net debt/EBITDA sits within the peer range and FFO/debt is ahead of peers. There are no material debt maturities (total $1.3bn to mid-2021) and a weighted debt maturity of 13.7 years, so no near-term funding pressure.

NEE's well-funded pension unlikely to need company contributions

As at year-end 2019, NEE's defined benefit pension plan had an accounting surplus of $1.5bn (fair value of $4.8bn versus obligations of $3.4bn). We see lowered risk that NEE will be required to top up the fund during our forecast period.

As a result of the pension surplus, NEE has a conservative split of investments within the funds, including just 33% allocated to equities although it plans to raise the equity to 45% over time. The relatively low equity exposure is likely to have insulated the fund from market gyrations related to the COVID-19 shutdown.

M&A is on the agenda at NEE

NEE sees itself as a consolidator in the utility sector which raises the risk of a high-priced M&A deal. However, NEE's CEO repeatedly argues there is not a single US utility which NEE could not run more effectively for shareholders and customers (as supported by the high opex efficiency at FPL – see Figure 103). In 2019, NEE's first year of owning Gulf Power, operating

and maintenance costs per retail MWh at the subsidiary fell by 20%, reliability improved by 20% and safety by 40%.

NEE has laid out a clear set of M&A criteria which limit the risk of a poor deal. These are:

- A constructive regulatory environment
- Immediately accretive to earnings
- Does not threaten balance sheet strength
- Allows capital investment for cost to be extracted
- Improves the customer value proposition

NEE has declared an interest in the Midwest and Southeast, i.e. eschewing the more difficult regulatory markets of California and the North East. NEE is also interested in FERC-regulated assets – i.e gas and electricity transmission that crosses state lines.

In 2016 an agreed $18bn deal (inclusive of debt) to take control of Texas utility Oncor was rejected by PUCT, the Texas regulator. The regulator also rejected a separate transaction to purchase a 20% stake in Oncor later in 2017. Another proposed transaction, of Hawaiian Electric Industries, was also rejected by regulators in 2016.

NEE has participated in the stop/start sale of Santee Cooper, South Carolina's state-owned electric and water utility. Santee Cooper is burdened with ~$4bn debt from the abandoned construction of two new nuclear reactors. The company's sale requires approval from the state legislature, and a consensus on how to progress has yet to emerge. NEE remains interested in acquiring Santee Cooper but we wonder if a competitive bid process will leave sufficient scope for attractive shareholder returns.

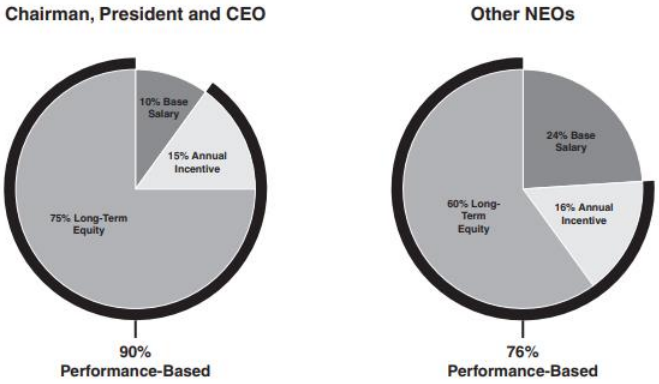
NEE was one of nine bidders for JEA, the Jacksonville electric/water utility in northeast Florida in 2019. The sale process of the community-owned utility was halted by city authorities who became concerned by high potential payouts to incumbent staff under a bonus scheme established by prior JEA management, and elements of the sale process. Initial bids were between $6.8-$7.3bn, according to local press reports.

M&A in the regulated utility space is challenging as most operating synergies are passed through to customers. Nonetheless there are advantages to scale in terms of spreading capital investment across more customers, reducing the impact on individual bills. There is potential to grow earnings by acquiring less efficient utilities and raising the rate base (thus growing regulated earnings) while removing operating costs or less efficient generation equipment. There may be a regulatory diversification benefit, as cited by credit rating agencies when NEE bid for Oncor such that not all regulated assets would be under a single state's regulatory purview.

Management incentives and alignment to shareholders

Utilities is a sector in which management teams are typically not large shareholders in their businesses, as there are no founder-owned businesses. However, in absolute terms NextEra management hold sufficient shares to ensure alignment with shareholders. Senior NextEra insiders hold 1.078m or ~$300m in NEE shares, of which CEO Robo holds ~$165m.

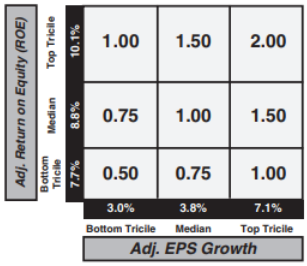
Figure 106: Target pay mix is majority performance based



Source: Company

In 2019 the annual incentive plan was weighted 50/50 between operational goals and financial targets. Financial targets are measured relative to S&P peers on a trailing ten-year basis. Operational goals are based on tangible budgeted items in most instances. The net impact is to create a relative matrix whereby the best financial outcome derives from outperforming peers on adjusted earnings and ROE. We believe this is likely to find favour with investors as per our discussion of investor preferences in the Utility sector above. Long term incentive plans (LTIP) include 60-65% performance shares whereby 80% of the base award is determined by relative performance in adjusted EPS growth and ROE over a three-year period (i.e. 2019 awards will pay out in 2022). A further 3-20% of the LTIP in restricted shares requires adjusted group earnings to exceed $1.2bn in each year of the 2019-2021 period.

Figure 107: Mgmt incentivised to exceed industry EPS growth, ROE

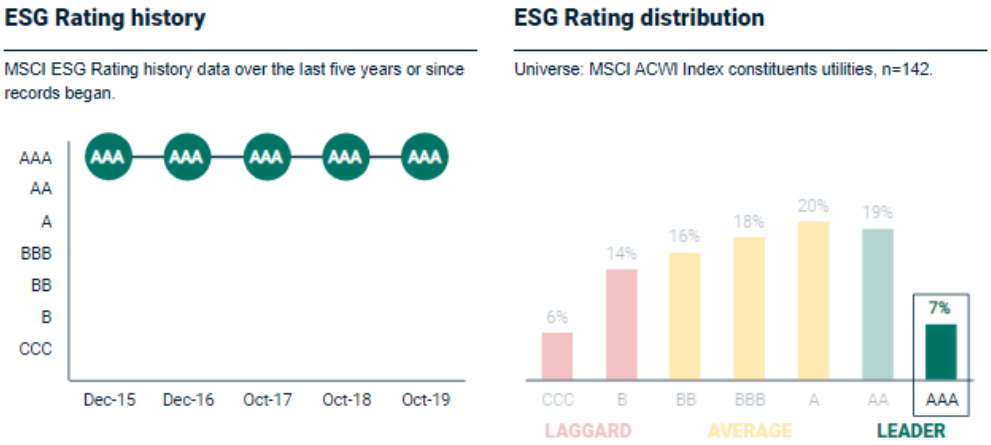


Source: Company

NEE highly rated on environmental criteria versus peers

NEE performs well relative to sector peers on environmental criteria. NEE has a top AAA ranking under MSCI's scoring criteria, placing it in the top 7% of global utilities (over 140 constituents), where it is seen as a leader in pursuing renewable opportunities and in minimising water waste (~99% of water used is recycled). NEE did not fall into the laggard category for any of the criteria evaluated by MSCI.

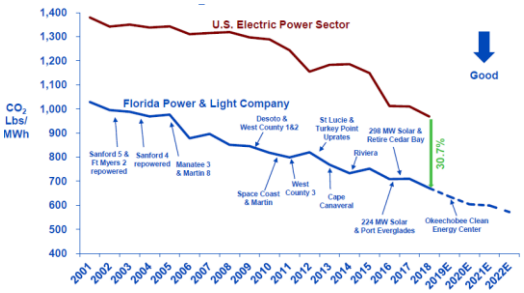
Figure 108: MSCI rates NEE an ESG leader



Source: MSCI.

NEE benefits from lower GHG emissions versus peers due to the high weighting of gas, wind, nuclear and solar in its generation portfolio. Coal accounts for a low single digit percentage of generation capacity at NEE versus 23% for the US. Nuclear waste management is potentially problematic for some ESG-focused investors but standards at NEE are in-line with US best practice.

Figure 109: FPL CO2 emissions profile versus US peers



Source: Company

Trends over time have been generally encouraging, with CO2 emissions per MWh falling by 18% between 2014 and 2018 (most recent data) as shown in the following table. The Gulf Power acquisition brings more coal-fired generation into the mix, but it is a significantly smaller business than FPL and NEE intends to reduce coal use at Gulf Power over time. In June 2020, FPL announced it would retire the last remaining coal-fired plant on its system, racking up 2,700MW (gross) in cumulative coal closures since 2015.

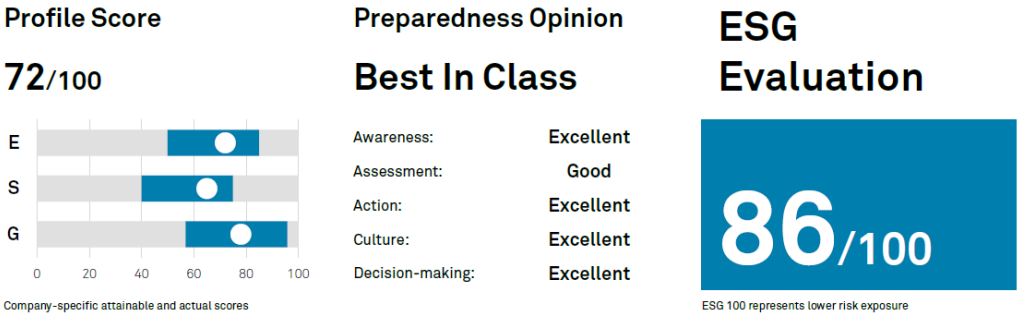
Figure 110: NEE emissions and intensity over time

	2014	2015	2016	2017	2018	2019*	5-yr change
NOx emissions (tons)	16,454	17,212	13,010	12,379	9,825	12,039	-4,415
SO2 emissions (tons)	6,454	4,678	3,120	2,400	1,907	2,482	-3,972
CO2 emissions (tons)	49,644,040	54,495,287	46,159,388	43,004,601	42,097,424	49,953,427	309,387
NOx emissions rates (lbs/MWh)	0.18	0.17	0.13	0.13	0.10	0.12	-0.06
SO2 emissions rates (lbs/MWh)	0.07	0.05	0.03	0.03	0.02	0.02	-0.05
CO2 emissions rates (lbs/MWh)	533	548	477	455	436	482	-51

Source: Company. *Includes Gulf Power, acquired in January 2019

In their review of NEE's ESG rating last year S&P gave high marks to the engagement and action on ESG themes at the company (Figure 111), which it described as best in class. In particular, the culture at the company was seen by S&P as one that co-opted ESG metrics into performance assessments at all levels of the company.

Figure 111: S&P rates NEE's preparedness on ESG topics as best in class.



Source: S&P Global Ratings

NEE is planning for the early retirement of four coal-fired plants which will further reduce carbon-intensity. A 330MW power purchase agreement concludes in 4Q20 which will see the associated plant's retirement. The Scherer Unit 4 plant in Georgia (FPL 76% ownership, ~630MW) is set to shutter by January 2022. Two coal fired steam units which are 50% owned by Gulf Power (~510MW) in the Mississippi Power service territory will close by January 2024. In addition, within the Gulf Power service area two units (Crist 6 and 7, ~924MW) are being converted from coal to gas with an expected conclusion date by end-2020.

Figure 112: NEE summary income statement

	2019	1Q20	2Q20	3Q20	4Q20	2020	2021	2022	2023	2024
Operating income:										
Florida Power & Light	3,302	915	1,065	1,085	662	3,727	4,082	4,344	4,559	4,768
NextEra Energy Resources	2,004	1,067	102	529	398	2,096	2,438	2,729	3,055	3,476
Gulf Power	271	58	74	79	81	292	371	405	437	468
Corporate	-224	-59	-55	-55	-55	-224	-220	-220	-220	-220
Total operating income	**5,353**	**1,981**	**1,186**	**1,638**	**1,086**	**5,891**	**6,671**	**7,258**	**7,830**	**8,493**
Net interest expense	-2,195	-1,298	-309	-381	-381	-2,369	-1,670	-1,780	-1,868	-1,949
Affiliate income	66	-390	154	120	120	4	500	540	560	570
Allowance, funds used in construction	67	22	20	20	20	82	80	80	80	80
Gains on disposal	55	24	2	0	0	26	0	0	0	0
Mark to market securities	238	-328	218	0	0	-110	0	0	0	0
Other net periodic benefit income	185	52	47	50	50	199	200	200	200	200
Other	67	10	-4	0	0	6	0	0	0	0
Total other income/(deductions)	-1,517	-1,908	128	-191	-191	-2,162	-890	-960	-1,028	-1,099
Pre-tax income	3,836	73	1,314	1,447	895	3,729	5,781	6,299	6,802	7,394
Income tax	448	-235	185	223	126	299	844	922	996	1,077
Tax rate (%)	*12%*	*-322%*	*14%*	*15%*	*14%*	*8%*	*15%*	*15%*	*15%*	*15%*
Post-tax income	3,388	308	1,129	1,224	769	3,430	4,937	5,377	5,807	6,316
Net loss attributable to non-controlling interests	381	113	146	0	0	259	0	0	0	0
Attributable net income	3,769	421	1,275	1,224	769	3,689	4,937	5,377	5,807	6,316
Per-share	7.76	0.86	2.64	2.53	1.59	7.60	10.03	10.76	11.45	12.27
Weighted average shares outstanding	486	492	483	483	483	485	492	500	507	515
Adjustments										
Non-qualifying hedges	546	974	166	0	0	1140	0	0	0	0
Mark to market equities	-249	321	-219	0	0	102	0	0	0	0
Other	-4	-546	64	0	0	-482	0	0	0	0
Total adjustments	293	749	11	0	0	760	0	0	0	0
Adjusted attributable net income	**4,062**	**1,170**	**1,286**	**1,224**	**769**	**4,449**	**4,937**	**5,377**	**5,807**	**6,316**
Per-share	8.37	2.38	2.66	2.53	1.59	9.17	10.03	10.76	11.45	12.27

Source: Company, Atlantic Equities estimates

Figure 113: NEE cash flow statements

	2019	1Q20	2Q20	3Q20E	4Q20E	2020	2021	2022	2023	2024
Cash Flows From Operating Activities										
Net income (loss)	3,388	308	1,128	1,224	769	3,429	4,937	5,377	5,807	6,316
Adjustments										
Depreciation and amortisation	4,216	848	981	998	1,018	4,050	4,562	5,099	5,598	6,111
Nuclear fuel and other amortisation	262	74	51	50	50	225	225	225	225	225
Unrealized losses (gains) on marked to market derivative contracts – net	-108	563	167	0	0	730	0	0	0	0
Foreign currency transaction losses (gains)	17	-39	17	0	0	-22	0	0	0	0
Deferred income taxes	258	-180	47	111	63	41	422	461	498	539
Cost recovery clauses and franchise fees	155	-10	-161	0	0	-171	0	0	0	0
Equity in losses (earnings) of equity method investees	-66	390	-154	-120	-120	-4	-500	-540	-560	-570
Distributions of earnings from equity method investees	438	100	109	109	109	427	480	540	560	570
Losses (gains) on disposal of businesses, assets and investments – net	-461	-297	-19	0	0	-316	0	0	0	0
Other - net	-321	311	-104	0	0	207	0	0	0	0
Changes in operating assets and liabilities:										
Current assets	123	142	-348	0	0	-206	0	0	0	0
Noncurrent assets	-93	-56	-97	0	0	-153	0	0	0	0
Current liabilities	116	-245	271	0	0	26	0	0	0	0
Noncurrent liabilities	231	-15	10	0	0	-5	0	0	0	0
Net cash provided by (used in) operating activities	**8,155**	**1,894**	**1,898**	**2,373**	**1,889**	**8,258**	**10,126**	**11,162**	**12,128**	**13,191**
Capital expenditures - FPL	-5,560	-1,394	-1,704	-1,575	-1,570	-6,243	-6,305	-6,120	-6,045	-6,340
Capital expenditures - Gulf Power (incl acquisition in FY19)	-5,165	-340	-168	-200	-200	-908	-770	-645	-650	-680
Capital expenditures - NEER	-6,385	-1,492	-1,040	-1,800	-1,800	-6,132	-6,000	-7,000	-6,000	-6,000
Nuclear fuel purchases	-315	-57	-74	-50	-50	-231	-225	-225	-225	-225
Other capital expenditures and other investments	-37	-1	-8	0	0	-9	0	0	0	0
Acquisitions	0	0	0	0	0	0	0	0	0	0
Sale of independent power and other investments of NEER	1,163	0	151	0	0	151	0	0	0	0
Net movement in special use funds	-152	-3	-105	0	0	-108	0	0	0	0
Other - net	274	152	-102	0	0	50	0	0	0	0
Net cash used in investing activities	**-16,177**	**-3,135**	**-3,050**	**-3,625**	**-3,620**	**-13,430**	**-13,300**	**-13,990**	**-12,920**	**-13,245**
Movements in debt, net	5,178	4,727	-696	1,929	2,407	8,367	6,207	6,215	4,488	4,067
Issuances of common stock/equity units - net	1,494	-57	6	0	0	-51	0	0	0	0
Dividends on common stock	-2,408	-685	-686	-676	-676	-2,723	-3,034	-3,387	-3,696	-4,014
Other - net	-391	-24	138	0	0	114	0	0	0	0
Financing cash flows	**3,873**	**3,961**	**-1,238**	**1,252**	**1,731**	**5,706**	**3,174**	**2,828**	**792**	**54**
FX Effects	4	6								
Net increase (decrease) in cash, cash equivalents and restricted cash	-4,145	2,726	-2,398	0	0	328	0	0	0	0
Cash, cash equivalents and restricted cash at beginning of year	5,253	1,108	3,834	1,436	1,436	1,108	1,108	1,108	1,108	1,108
Cash, cash equivalents and restricted cash at end of period	1,108	3,834	1,436	1,436	1,436	1,108	1,108	1,108	1,108	1,108

Source: Company, Atlantic Equities estimates

Figure 114: NEE summary balance sheet

	2019	1Q20	2Q20	3Q20E	4Q20E	2020	2021	2022	2023	2024
Electric plant in service and other property	96,093	97,717	99,955	103,530	107,100	107,100	120,175	133,940	146,635	159,655
Nuclear fuel	1,755	1,839	1,690	1,690	1,690	1,690	1,690	1,690	1,690	1,690
Construction work in progress	9,330	10,201	10,553	10,553	10,553	10,553	10,553	10,553	10,553	10,553
Accumulated depreciation and amortization	-25,168	-25,884	-25,872	-26,870	-27,888	-27,888	-32,450	-37,549	-43,147	-49,258
Total property, plant and equipment - net	**82,010**	**83,873**	**86,326**	**88,903**	**91,455**	**91,455**	**99,968**	**108,634**	**115,731**	**122,640**
Total current assets	7,408	9,725	7,581	7,581	7,581	7,581	7,581	7,581	7,581	7,581
Total other assets	28,273	27,039	28,054	28,065	28,076	28,076	28,096	28,096	28,096	28,096
Total Assets	**117,691**	**120,637**	**121,961**	**124,549**	**127,112**	**127,112**	**135,645**	**144,311**	**151,408**	**158,317**
Total common shareholders' equity	37,005	36,403	37,073	37,621	37,714	37,714	39,618	41,608	43,719	46,022
Noncontrolling interests	4,355	4,472	4,501	4,501	4,501	4,501	4,501	4,501	4,501	4,501
Total equity	41,360	40,875	41,574	42,122	42,215	42,215	44,119	46,109	48,220	50,523
Redeemable noncontrolling interests	487	238	291	291	291	291	291	291	291	291
Long-term debt	37,543	41,116	42,667	44,596	47,003	47,003	53,210	59,425	63,913	67,980
Total capitalisation	79,390	82,229	84,532	87,008	89,508	89,508	97,620	105,825	112,424	118,794
Total current liabilities	13,853	13,722	12,365	12,365	12,365	12,365	12,365	12,365	12,365	12,365
Total other liabilities and deferred credits	24,448	24,686	25,064	25,175	25,238	25,238	25,660	26,121	26,619	27,158
Total Capitalisation and Liabilities	**117,601**	**120,637**	**121,961**	**124,549**	**127,112**	**127,112**	**135,645**	**144,311**	**151,408**	**158,317**

Source: Company, Atlantic Equities estimates

IMPORTANT DISCLOSURES

Recommendation History

None

Stocks under the analyst's coverage

NextEra Energy [NEE], WEC Energy [WEC], Apache [APA], Baker Hughes [BKR], ConocoPhillips [COP], EOG Resources [EOG], Halliburton [HAL], Hess [HES], Marathon Oil [MRO], Noble Energy [NBL], Occidental [OXY], Schlumberger [SLB]

Risks

A more punitive regulatory environment would be negative for earnings. Access to financial markets for funding is important - If this was not available, many utilities spending targets would be reduced. Ease of capital access could increase competition in non-regulated areas including renewables. Utilities are considered alternatives to bonds and have benefited from rising bonds/lower yields. Continued falls in bond yields would be positive; higher yields would be negative. Increases in customer bills due to higher fuel costs, higher interest costs or higher taxes (including carbon taxes) could make growing rate base more challenging. Sweeping climate change laws could create significant stranded assets.

Consensus Estimates

Where used, consensus numbers have been sourced from Bloomberg.

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Barry MacCarthy, hereby certifies that the views expressed in this research report accurately reflects his/her personal views about the subject Security and Issuer as of the date of this report. He/She further certifies that no part of his/her compensation was, is, or will be directly, or indirectly, related to the specific recommendations or views contained in this research report.

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