Gas Utility Customer Growth Study – July 23, 2014

Overview

This report represents ***the first in a three-part series*** where we dig deeper into each of three regulated earnings drivers (customer growth, rate relief and infrastructure replacement) to better gauge their general level of importance to utilities, assess which companies have the greatest leverage to each driver, and identify emerging trends where investors may find value in the stocks.

We begin our analysis with customer growth, as it was the driver most directly impacted by the 2008 economic recession. Customer growth trends remain depressed from pre-recession levels (<1% annually), though faster gas conversions tied to low natural gas prices and modest economic growth in recent years has begun to ramp customer growth rates.

We believe gas utility stocks may have upside potential in future years tied to customer growth, with an expected acceleration in gas conversion activity and a return to more normal new construction trends as the economic recovery continues.

Key Takeaways

- **The recession of 2008 cratered growth rates…** Historically, gas utility customer growth ~1% annually and driven primarily by new housing starts. The 2008 recession smacked customer growth hard, dropping it from ~1% in 2007 to almost nil by 2009. Few gas utilities were spared the effects of the downturn.
- **…but the shale revolution is driving rebound via faster gas conversions.** Pre-2009, gas utilities derived only a modest amount of customer growth via customer conversions. In recent years, the ability to extract natural gas from shale via alternative drilling techniques has ushered in a new cheap era of natural gas, driving sizable gas conversion activity.
- **Optics for continued growth ramp look promising.** Of the ~120mm households in the U.S., only ~49% use natural gas for their heating fuel despite it being the lowest cost option. Natural gas has historically enjoyed a price advantage relative to heating oil and propane, but the spread has become much more pronounced since 2009. If NYMEX forward gas prices for the next five years hold true, it should continue to be a great environment for more gas conversion activity.
- **Northeast leads several key growth regions.** The Northeast and Mid-Atlantic regions have been the most active for growth in recent years and contain the majority of the potential ~7mm conversions from heating oil. The bulk of these conversions should occur over the next decade. The Midwest and South regions contain the majority of the potential ~6mm conversions from propane. Shortages of propane this past winter, as well as record prices, should help conversions going forward.
- **A slowly improving economy is also fueling the comeback.** Along with faster gas conversions, modest economic gains have fueled improvement in housing starts since 2010. With both trends at play, last year the gas customer growth rate reached within spitting distance of rebounding to the pre-recession level of ~1%.
- **USCA forecasts average growth ramp to 1%+ in coming years...** Assuming continued economic improvement and favorable gas conversion dynamics, we see gas customer growth of ~1.0+% from 2014-2016, up from 0.5% from 2008-2013, and fully back to pre-recession levels. Faster growth names in recent years, more heavily levered to more gas conversions, should continue to lead the pack.

For more information or a copy of the full report, please contact Daniel Fidell (dfidell@uscallc.com) or Barry Guinn (bguinn@uscallc.com).

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Analyst Certification:

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Opinion Key:

USCA uses a Buy, Overweight, Hold, Underweight and Sell rating system.

BUY - The stock has among the best combination of risk/reward and positive company specific catalysts within the sector. Stock is expected to trade higher on an absolute basis and be a top performer relative to peer stocks over the next 12 months.

OVERWEIGHT - The stock has above average risk/reward and is expected to outperform peer stocks over the next 12 months.

HOLD - The stock has average risk/reward and is expected to perform in line with peer stocks over the next 12 months.

UNDERWEIGHT - The stock has below average risk/reward and is expected to underperform peer stocks over the next 12 months.

SELL - The stock's risk/reward is skewed to the downside with possible negative company specific catalysts or excessive valuation. The stock is expected to trade lower on an absolute basis and be among the worst performers relative to peer stocks over the next 12 months.

** Important Disclosures on pages 2-3 of this report **

Price Target Methodology:

Price targets for downstream utility stocks are developed through a combination of techniques, including relative and absolute measures. We believe it is important to look at both types of valuation methods in order to get a full understanding of a stock's trading dynamics. Our fair value estimate is based on an average of the two techniques. Downstream gas and electric utilities tend to trade on both projected earnings and cash flow. We believe investors should take both these considerations into account equally. Given their status as income-producing investments, we believe it is also important to value gas distributors based on the value of the future dividend streams. Unlike comparative valuation techniques, this method ignores the current or historic trading multiple implied by the market. An increase in interest rates, a poor regulatory decision, a decrease in commodity price volatility, bypass threat from large industrial customers, a decline in the broad market or a decline in profits from non-regulated operations are among the many potential risks to achieving our price targets.

Distribution of Ratings (as of July 23, 2014):

Recommendation	Count	Percent	Investment Banking Relationship	Count	Percent
Overweight/Buy	31	50%	Overweight/Buy	7	23%
Hold	31	50%	Hold	1	3%
Underweight/Sell	0	0%	Underweight/Sell	0	0%

Historical Ratings and Price Targets may be found by clicking the link below:
USCA Rating and Price Target History

For hard a hard copy of our price target/ratings history, please call 888-601-USCA (8722), or write to U.S. Capital Advisors, 1330 Post Oak Blvd., Suite 900, Houston, TX, 77056.

A list of common terms and abbreviations may be found by clicking the link below:
Glossary

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