

Duke Energy Corp.

Ticker: DUK

Business Description

Duke Energy is a high yield energy utility company that operates in North Carolina, South Carolina, Kentucky, Ohio, and Indiana. They operate in three main segments including, regulated utilities, international energy, and commercial power (Morningstar). Duke Energy is a defensive stock with an annual yield of 4.2%.

Thesis

Utility stocks are very similar being that they are all regulated monopolies and are allowed to charge any price necessary as long as they can give sufficient reasoning to the government. The natural monopoly structure encourages investment which can cause utility companies to take on excess risk. However Duke Energy has slowly been decreasing its risk by selling off international assets leaving them with only 10% international exposure. They also pay out a 4% dividend which is supported by cheap debt, free cash flow, and a sizable cash position. In times of market uncertainty investors chase high yield defensive stocks like Duke Energy, making it a good play right now. It is overvalued but I believe that it is warranted in the current market environment. The risk/reward of defensive stocks has changed since 10-year treasuries dropped below 2%. Investors decided that the extra risk associated with defensive stocks was warranted due to the sectors predictable and stable business model along with its above average annual yields. In addition, we need to allocate a portion of our portfolio to utilities per our Investment Policy.

Valuations

- P/E – 21.8 – much higher than the industry average of 16.1 (overvalued/expensive)
- P/S – 2.6 – higher than the industry average of 2.1 (overvalued/expensive)

- P/B – 1.5 – lower than the industry average of 1.8
- PEG –4.4 – expensive compared to its expected growth
- P/Cash Flow – 8.5 – less than the benchmark S&P 500 of 12.5

Source: Morningstar

Income Statement

- Revenue – plateaued over the last 3 years
- Net Income – volatile in 2014 but increasing YOY

Balance Sheet

- Cash – \$857 million – Lowest level since 2011
- Long-Term Debt – has increased significantly since 2011
- Goodwill/Intangibles – \$16.3 billion – stayed constant over last 3 years (no accounting manipulation)

Source: Morningstar

Cash Flow Summary

CFO grew modestly until 2013 and has been fairly flat ever since. CFI along with CFF have decreased significantly since 2013. It looks like they are issuing debt in order to pay dividends and issuing equity in to finance their acquisitions. The net change in cash has decreased YOY since 2011 and reached its lowest point in 2015 at -\$2 billion. With their cash balance at \$857 million I am not exactly sure how they will continue paying dividends.

Ratios

- Operating Margin – 22.88 and increasing YOY
- Dividend Payout Ratio – 93.3% – at historic highs and free cash flow per share is less than the dividend per share so they must be using either debt or cash reserves to fund their dividends
- Return on Assets – 2.33 – at historical average
- Return on Equity – 7% - DUK can create shareholder value by issuing debt. They can issue debt for sub 3% making it advantageous for the shareholder to do so.

Source: Morningstar

Recent Events

- Acquisition of Piedmont Natural Gas for \$4.9 billion in cash
- Sale of \$766 million worth of equity equivalent to 10.6 million shares
- Plans to sell Latin America business
- Plans to build 3 gas-fired plants in Florida and North Carolina
- Will modernize its electric grid in Indiana

Source: Value Line

Risks

- Acquisition of Piedmont may not perform as expected
- Suppressed commodity prices
- Growth expectations in customer usage
- If 10-year treasury increases above 2%, investors may take risk off the table
 - Must monitor the 10-year treasury yield. We will see a rotation of money out of utilities, consumer staples, and telecoms if the 10-year yield increases above 2%

Source: Duke Energy 2015 10-K

Models & Analyst Price Targets

- Value Line - \$75 - \$100
- Yahoo Finance Analyst Price Target - \$85.12

Closing Summary

I believe that we should DCA into Duke Energy when the chart looks good. We can see that it is a fundamentally strong company and that our portfolio is lacking a utility. Now it is simply a timing issue.

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