VERITAS INVESTMENT RESEARCH

Emera Inc.

Sell – $38.00

Ticker	Current Price
TSX-EMA	$41.53

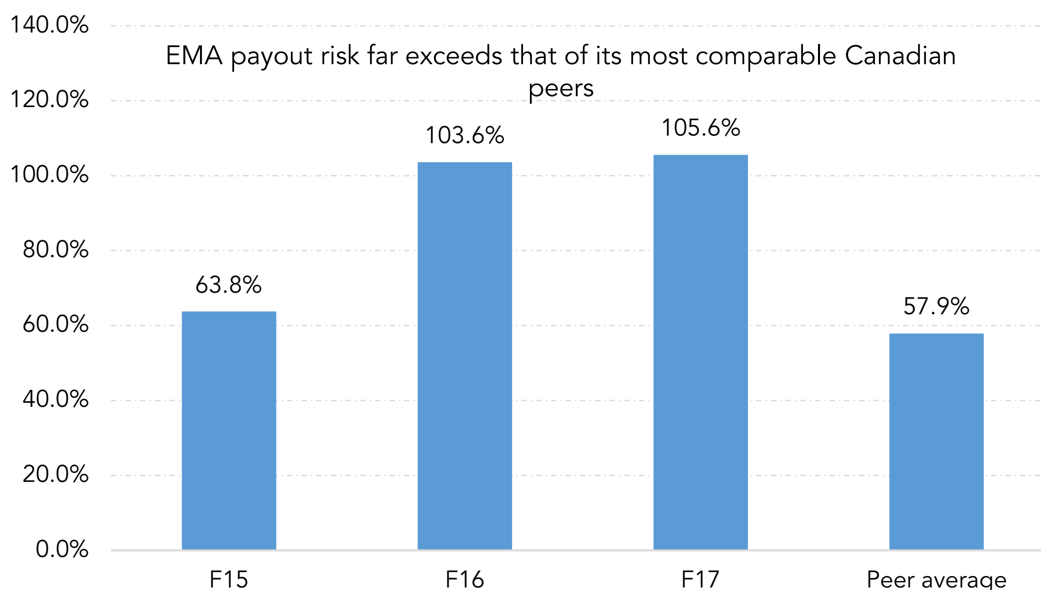
NEED-TO-KNOW Q4-F17

Darryl McCoubrey
dmccoubrey@veritascorp.com

EMA Dividend Growth in Jeopardy

Emera Inc.'s ("EMA") target of 8% average annual dividend growth through F20 could be in jeopardy, as U.S. tax reform, only temporary improvement in New England generation profits, and cost recovery risk in Nova Scotia and Newfoundland weigh on its prospective cash flow. Accentuating prospective cash flow headwinds is EMA's sector-high cash-based payout ratio of 106%, which is up drastically from the 64% ratio observed in F15, and well above the sub-60% peer average (Figure 1).

Figure 1
EMA cash-based dividend payout ratio, F15 to F17
Dividend amounts expressed as a percentage of adjusted funds from operations



* *Our estimate of adjusted funds from operations is calculated as cash flow from operations before non-cash working capital less preferred share dividends, distributions to non-controlling interests and sustaining capital expenditures. Our peer group consists of Canadian Utilities Ltd., Fortis Inc., and Hydro One Ltd., with financial figures based on trailing twelve-month performance.*

Source: Company reports and Veritas estimates.

(Amounts are stated in Canadian dollars, unless otherwise noted.)

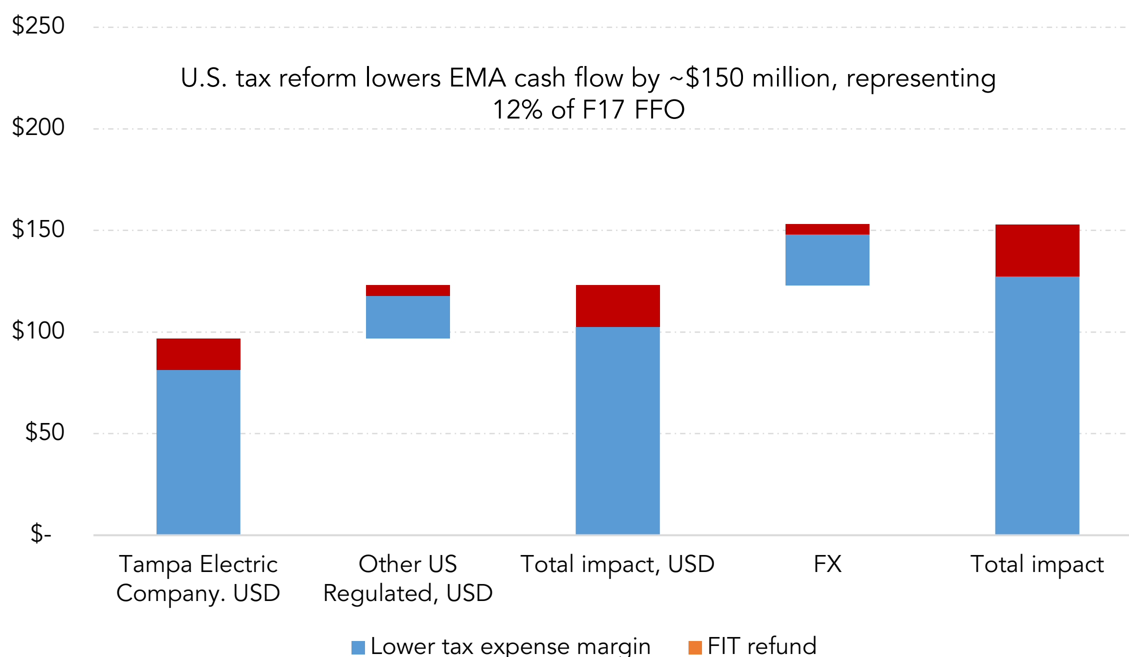
As a final factor weighing on EMA's ability to deliver targeted dividend growth, we believe EMA's U.S. operations are already near the debt ceiling for interest deductibility, with considerably larger equity funding required in future years to meet the more stringent interest deductibility limitation imposed after F21. On account of a combination of lower cash flow, financial risk and associated payout risk, we are reducing our EMA value estimate to $38.00 per share, from $45.00 previously. We maintain a SELL recommendation.

U.S. Tax Reform, New England Power & Maritime Cost Recovery Deferrals

In this update, we highlight the three main factors undermining our view of EMA's investment proposition:

- **U.S. Tax Reform:** EMA cites lower income tax expense flow-through and the amortization of deferred tax regulatory liabilities as elements which will reduce annual cash flow from operations ("CFO") by US$50 to US$200 million per year. Our estimate of annual CFO loss is US$124 million, which is essentially the mid-point of EMA's guidance, with US$103 million of the decline attributable to lower income tax expense flow-through and US$21 million on account of deferred tax liability refunds (Figure 2).

Figure 2
Estimated impact of U.S. tax reform on EMA cash flow
Amounts are in millions of U.S. dollars, unless otherwise noted.

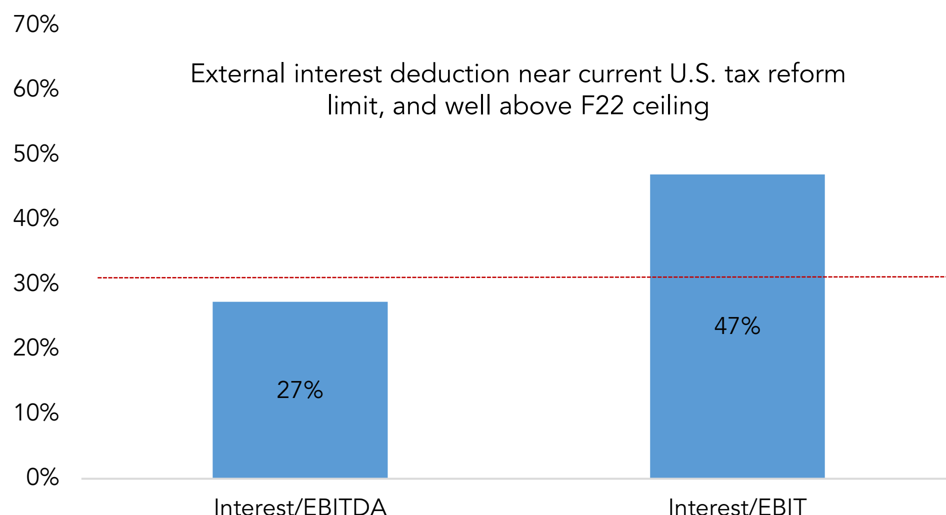


** Other US regulated is the aggregate impact from Peoples Gas, New Mexico Gas Company and Maine Utilities.*
***US dollars translated at 1-month trailing average Bank of Canada noon rate.*
Source: Company reports, US regulatory filings, Bank of Canada and Veritas estimates.

To put the materiality of U.S. tax reform into perspective, our cash flow loss estimate of US$124 million represents 12% of EMA's F17 CFO before changes in working capital (i.e. funds from operations).

As for limitations on interest deductibility, our estimates suggest that EMA's interest expense on external debt accounts for 27% of its US EBITDA, suggesting a slim margin of safety relative to the 30% limit imposed under U.S. tax reform (Figure 3).

Figure 3
EMA's U.S. external interest expense as a % of EBITDA and EBIT
Amounts are presented as a % of EBITDA and EBIT, respectively



Source: Company reports, US regulatory filings, Bank of Canada and Veritas estimates.

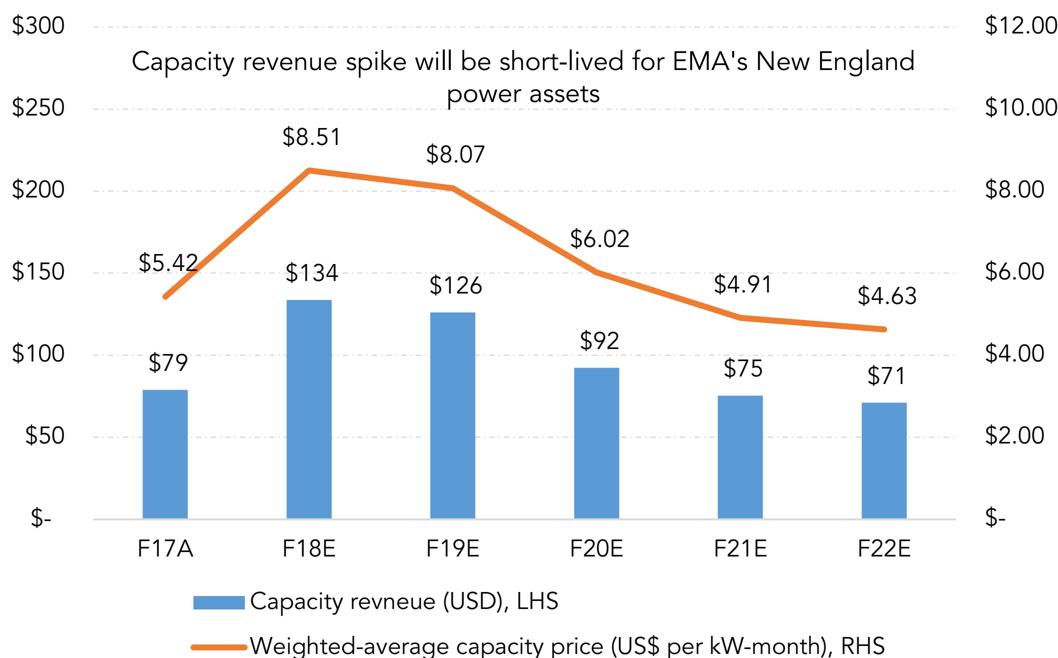
While we believe EMA will be able to deduct its holding company debt, since the total U.S. external interest expense represents slightly less than the 30% of EBITDA, prospective funding will mandate higher equity contributions. In explanation, under U.S. tax reform, after F21 the 30% ceiling is driven by EBIT, as opposed to EBITDA and, based on EMA's current financing structure, we believe its external interest payments are well above the deduction limit. Accordingly, EMA must de-lever its U.S. operations over the next four years.

Based on our analysis, if EBIT were utilized to establish interest deductibility limitations in F18, as opposed to EBITDA, 36% of interest expense on EMA's external U.S. debt would be denied.

- **New England Power:** EMA's assets in New England generate revenue under a capacity market structure, with the bulk of profits earned through monthly capacity payments for asset availability. As has been proposed for Alberta, New England's capacity price is set through an auction process each year which establishes the payment to be made in 3 years for selected generating capacity.

  In its most recent auction, the New England capacity price cleared at US$4.63 per kW-month for the 12-month period of June F21 to May F22, which is 13% lower than the price established during last year's auction. More importantly, adjusted to EMA's fiscal year, the recently established US$4.63 per kW-month capacity price is 46% below that in effect for F18, suggesting a loss of US$63 million in capacity revenue by F22 (Figure 4)

Figure 4
New England capacity revenue and pricing, F17A to F22E
Amounts are in millions of U.S. dollars, unless otherwise noted.



Source: Company reports, US regulatory filings, Bank of Canada and Veritas estimates.

Since capacity payments are awarded for plant availability, as opposed to production, and EMA pays little to no tax in the U.S., the post-F18 downward trajectory illustrated in Figure 3 will weigh heavily on EBITDA and cash flow. At current exchange rates, the annualized EBITDA/cash flow loss at US$4.63 per kW-month capacity pricing is roughly $70 million versus peak New England Generation performance anticipated in F18.

- **Muskrat Falls Transmission:** On account of a lengthy delay at the Muskrat Falls hydroelectric facility in Labrador, Nova Scotia Power Inc. ("NSPI") has deferred recovery of $106 million of revenue from ratepayers over the next two years on account of its investment in the Maritime Link transmission project. In addition, NSPI will withhold payment of $10 million to EMA's wholly-owned, unregulated subsidiary, Nova Scotia Power Maritime Link ("NSPML") in F18 and F19, with ultimate recoverability of these amounts contingent upon proof that the Maritime Link has provided this level of financial benefit to ratepayers – proof that will be undermined by the fact that no energy deliveries will be made from Muskrat Falls.

  We continue to caution investors on elevated cost recovery risk on both the Maritime Link and Labrador Island Link transmission assets, given the profound delays and cost overruns at Muskrat Falls. While Maritime Link could begin recovery of full costs of service beginning in late-F19 (when Muskrat Falls enters service), the Newfoundland regulator could impose further cost recovery deferrals to ease rate strain on its ratepayers, which might flow-through to lower cash flow to EMA via its Labrador Island Link investment.

Veritas Investment Research Corporation ("Veritas") its directors, officers, employees and their immediate families are prohibited from trading any position in the securities profiled in a report thirty (30) days before and five (5) days after the publication date where the report involves coverage initiation or a change of opinion (the "Blackout Restriction"). Veritas has not offered any consulting, financial advisory, investment banking or underwriting services to the companies mentioned. Veritas does not accept research fees from the companies profiled herein. The information contained in this report has been obtained from sources believed reliable however the accuracy and/or completeness of the information is not guaranteed by Veritas, nor does Veritas assume any responsibility or liability whatsoever. All opinions expressed are subject to change without notification. This report is for information purposes only and does not constitute and should in no way be construed as a solicitation to buy or sell any of the securities mentioned herein. The contents of this research report do not, in any way, purport to include any manner of legal advice or opinion. The intention of this report is to provide a forthright discussion of business, accounting and financial reporting issues, as well as generally accepted accounting principles and the limits of their usefulness to investors. As such, please do not infer from this report that the accounting policies of any company mentioned herein are not allowed within the broad range of generally accepted accounting principles, or that the policies employed by that company were not approved by its auditor(s). Veritas Asset Management Inc. ("VAM"), an affiliate of Veritas by virtue of being under common control that may also from time to time have certain common directors, officers and/or employees, is registered in Ontario as a Portfolio Manager, Investment Fund Manager and Exempt Market Dealer (with the same or similar registrations in certain other jurisdictions in Canada) and may, from time to time, advise and counsel its investment clients, including one or more investment funds established by VAM, with respect to investments in public companies. VAM is a client of Veritas and receives research reports from Veritas at the same time as Veritas' other clients. Like Veritas' other clients, neither VAM nor its investment clients are subject to the Blackout Restriction. Veritas and VAM have implemented policies and procedures to minimize the potential for and to address conflicts of interest, which are available to clients of Veritas upon request. This report may not be reproduced in whole or in part without the express prior written consent of Veritas. Veritas is a 100% employee owned firm. ©2018 Veritas Investment Research Corporation.