



## COMPANY UPDATE / ESTIMATE CHANGE

### Key Metrics

NWN - NYSE - as of	8/1/17	\$64.15
Price Target		\$50.00
52-Week Range	\$53.50 -	\$65.53
Shares Outstanding (mm)		28.6
Market Cap. (\$mm)		\$1,837.5
1-Mo. Average Daily Volume		114,543
Institutional Ownership		66.7%
LT Debt/Total Capital	Q3'17	45.4%
ROE	TTM	7.6%
Book Value / Share	Q3'17	\$30.14
Price / Book Value		2.1x
Dividend Yield		2.9%
LTM EBITDA Margin		36.6%

### EPS FY 12/31

		Prior	Current		Prior	Current
	2016A	2017E	2017E	A	2018E	2018E
1Q	*\$1.40	--	\$1.40	A	--	--
2Q	\$0.07	--	\$0.10	A	--	--
3Q	(\$0.29)	(\$0.28)	(\$0.28)	--	--	--
4Q	\$1.00	\$1.03	\$1.04	--	--	--
Year	\$2.19	\$2.20	\$2.25	\$2.23	\$2.25	\$2.25
P/E	29.3x		28.5x			28.5x

\*Adjusted for special items

### Net Operating Revenue (\$MM, excludes cost of sales)

		Prior	Current		Prior	Current
	2016A	2017E	2017E	A	2018E	2018E
1Q	\$147	--	\$154	A	--	--
2Q	\$78	--	\$83	A	--	--
3Q	\$59	\$61	\$61	--	--	--
4Q	\$130	\$134	\$135	--	--	--
Year	\$415	\$428	\$434	\$432	\$437	\$437

**Company Description:** NW Natural is a natural gas distribution company headquartered in Portland, Oregon, and has been in business nearly 160 years. It serves 725,000+ residential and business customers in Oregon and southwest Washington. The company also provides natural gas storage and related transportation services. It is the largest independent natural gas utility in the Pacific Northwest.

### Natural Gas Utilities

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## Northwest Natural Gas Co.

NWN – NYSE – Underperform-2

### Q2'17 Results from NWN; Reiterating Underperform Rating and \$50 Price Target.

#### Investment Highlights

- NWN reported Q2'17 EPS of \$0.10 versus \$0.07 in Q2'16, beating the consensus estimate for \$0.06, which was \$0.02 above our target. Core utility growth was partially offset by Storage; the effective tax rate was a slight yr/yr benefit.
- Adjusted net income was higher by 35.2% in the second quarter, offset by 4.2% greater average shares; normal seasonality limits FY impact of the strong Q2.
- Net operating revenue (NOR) grew a robust 6.3% in Q2, although even the cleaner gauge of utility gross margin was higher by 7.7%. We underestimated the impact of favorable weather comps, but see a fair comparison for the year-ahead quarter.
- Utility customers rose 1.8% yr/yr exiting Q2'17; this rate continues to expand and is at the core of the narrative from our vantage point.
- Net income for the Storage segment declined in Q2'17, down about \$700k (\$0.02/share) from the prior year. Our expectations for the segment over the balance of 2017 fall slightly. We note that the North Mist Expansion (~\$120MM on line Q4'18) will be reported within the Utility segment.
- Operations and Maintenance (O&M) expense growth of 7.2% in Q2 again more/less tracked topline growth.
- Mostly reflecting the upside to Q2, our 2017E EPS rises to \$2.25, at the top end of reiterated guidance for \$2.05-\$2.25. Our 2018E EPS rises \$0.02 to \$2.25, with 2019 remaining the more interesting model year for us given the potential for 2018 OR rate case filing.
- We are reiterating our Underperform rating, and 1-yr target of \$50. Based on relative growth prospects and valuation, we still see downside for NWN; our target assumes ~22x our 2018E EPS.

**Note Important Disclosures on Pages 5-6**  
**Note Analyst Certification on Page 5**

**ADDITIONAL DISCUSSION—FINAL THOUGHTS**

The organic growth narrative was emphasized heavily on the conference call this morning, although we still see this item as a more reasonable complementary catalyst. This might not always be the case, but at this point with the range of accelerated investment programs and complementary ‘major’ investment projects across the industry, we see substantially more compelling growth outlooks amongst NWN’s peer group. We acknowledge the N. Mist Expansion as an attractive project, particularly given its rate base eligibility, but we hold low conviction that there is a pipeline of similar projects to sustain elevated growth over a more extended 4 to 7 year outlook horizon.

Despite a resilient share price over the last couple of years, we are compelled to reiterate our Underperform rating on shares of NWN, despite no obvious near-term negative catalyst that might expedite a re-pricing. We balk at current valuation (~30x the consensus 2017 EPS estimate), which we believe feeds into a very narrow path (perhaps M&A) for meaningful outperformance over our investment time horizon.

**SUITABILITY**

We assign NWN a suitability rating of ‘2.’ A complete description of our suitability scale is on page 5. Size versus peers across the Utility sector and a relatively narrow geographic focus keep Northwest Natural well below our ‘1’ suitability rating. Sector-appropriate leverage, a consistent history of capital return and a highly regulated business mix keep NWN a bit above our more aggressive ‘3’ rating.

**CONSIDERATIONS AND RISKS**

Utility operations are weather sensitive. Warmer weather can lead to lower total margin from lower volumes of natural gas sold or transported, while extremely cold weather may lead to conservation by customers in order to reduce consumption.

Gas utilities face competition from alternative fuels. In the industrial market, many customers have the capability of using both natural gas as well as another source of energy. Increases in the price of natural gas can negatively impact a competitive position by decreasing the price benefits of natural gas to the end user. The cost of natural gas from non-domestic sources may play a greater role in establishing the market price of natural gas in the future.

Gas utilities are subject to regulation at the federal and state levels. Regulatory commissions and policies vary from state to state, and have a significant bearing on the profitability of gas utilities.

Our Suitability rating is 2 on a 1-to-4 scale (1 = most conservative, 4 = most aggressive).

*Additional information is available upon request.*

## Northwest Natural Gas (NWN)

Income Statement	FY'14	FY'15	Q1'16	Q2'16	Q3'16	Q4'16	FY'16	Q1'17	Q2'17	Q3'17E	Q4'17E	FY'17E	FY'18E
Operating Revenues:													
Operating Revenue	\$754,037	\$723,791	\$255,529	\$99,183	\$87,727	\$233,528	\$675,967	\$297,323	\$136,238				
Cost of Gas	365,490	327,305	108,411	20,871	28,264	103,042	260,588	143,611	53,005				
Revenue Tax	-	-	-	-	-	-	-	-	-				
Net Operating Revenue	388,547	396,486	147,118	78,312	59,463	130,486	415,379	153,712	83,233	61,340	135,310	433,600	436,800
Operating Expenses:													
O & M	136,982	157,521	38,939	35,962	34,870	40,203	149,974	40,420	38,546	35,570	41,010	155,550	155,030
Enviro Remediation		3,513	5,029	1,893	1,191	5,185	13,298	6,954	2,611	1,190	5,190	15,950	15,940
General Tax	29,407	30,281	8,684	7,438	7,211	7,205	30,538	9,025	7,564	7,440	7,470	31,500	31,740
D & A	79,193	80,923	20,394	20,413	20,628	20,854	82,289	21,085	21,355	21,990	22,180	86,610	90,290
Total Operating Expense	245,582	272,238	73,046	65,706	63,900	73,447	276,099	77,484	70,076	66,190	75,850	289,610	293,000
Operating Income	142,965	124,248	74,072	12,606	(4,437)	57,039	139,280	76,228	13,157	(4,850)	59,460	143,990	143,800
%	36.8%	31.3%	50.3%	16.1%	-7.5%	43.7%	33.5%	49.6%	15.8%	-7.9%	43.9%	33.2%	32.9%
Other Inc / (Exp)	1,933	7,747	(2,309)	513	652	601	(543)	881	958	652	601	3,092	3,092
Interest--Net of Captzd	44,563	42,539	9,736	9,718	9,729	9,945	39,128	9,876	9,717	9,820	9,970	39,383	39,070
Pre-tax Income	100,335	89,456	62,027	3,401	(13,514)	47,695	99,609	67,233	4,398	(14,018)	50,091	107,699	107,822
Income Tax	41,643	35,753	25,386	1,382	(5,474)	19,420	40,714	26,923	1,669	(5,747)	20,337	43,182	43,022
Net Income	58,692	53,703	36,641	2,019	(8,040)	28,275	58,895	40,310	2,729	(8,271)	29,754	64,517	64,800
Average shares outstanding (FD)	27,223	27,417	27,560	27,550	27,554	28,202	27,427	28,723	28,717	28,725	28,733	28,725	28,751
EPS	\$2.16	\$1.96	\$1.33	\$0.07	(\$0.29)	\$1.00	\$2.11	\$1.40	\$0.10	(\$0.29)	\$1.04	\$2.25	\$2.25
Adjusted EPS		\$2.29	\$1.40				\$2.19						
Dividends	\$1.845	\$1.863	\$0.4675	\$0.4675	\$0.4675	\$0.4700	\$1.873	\$0.4700	\$0.4700	\$0.4700	\$0.4725	\$1.883	\$1.893
<b>Rate of Change Analysis:</b>													
Net Operating Revenue	0.9%	2.0%	8.2%	2.9%	3.8%	2.6%	4.8%	4.5%	6.3%	3.2%	3.7%	4.4%	0.7%
O&M Expense	0.3%	15.0%	-28.0%	1.8%	8.9%	11.5%	-4.8%	3.8%	7.2%	2.0%	2.0%	3.7%	-0.3%
Operating income	0.2%	-13.1%	39.8%	-2.4%	136.9%	-5.3%	12.1%	2.9%	4.4%	9.3%	4.2%	3.4%	-0.1%
EPS	-3.7%	6.1%	2.2%	-8.6%	19.4%	-7.3%	-4.5%	0.1%	29.7%	-1.3%	3.3%	2.7%	0.3%
EBITDA	1.6%	-7.6%	29.2%	-0.4%	-12.3%	-3.2%	8.0%	3.0%	4.5%	5.9%	4.8%	4.1%	1.5%
<b>Margin Analysis:</b>													
O&M/Net Op Rev (NOR)	35.3%	39.7%	26.5%	45.9%	58.6%	30.8%	36.1%	26.3%	46.3%	58.0%	30.3%	35.9%	35.5%
General Tax / NOR	7.6%	7.6%	5.9%	9.5%	12.1%	5.5%	7.4%	5.9%	9.1%	12.1%	5.5%	7.3%	7.3%
Op Income / NOR	36.8%	31.3%	50.3%	16.1%	-7.5%	43.7%	33.5%	49.6%	15.8%	-7.9%	43.9%	33.2%	32.9%
Tax Rate	41.5%	40.0%	40.9%	40.6%	40.5%	40.7%	40.9%	40.0%	37.9%	41.0%	40.6%	40.1%	39.9%
Net Income / NOR	15.1%	13.5%	24.9%	2.6%	-13.5%	21.7%	14.2%	26.2%	3.3%	-13.5%	22.0%	14.9%	14.8%
			*\$3.3MM pre-tax charge; \$0.07/sh AT for reg disallowance				Adj EPS guidance \$2.05-\$2.25					EPS guidance \$2.05-\$2.25	Expect Mist storage for PG&E to be on-line 2018 2019 heating season; \$128MM investment

Source: Company reports and Hilliard Lyons estimates

## Northwest Natural Gas (NWN)

Summary Balance Sheet (000s)	FY'14	FY'15	Q1'16	Q2'16	Q3'16	Q4'16	FY'16	Q1'17	Q2'17	Q3'17E	Q4'17E	FY'17E	FY'18E
Cash	\$9,534	\$4,211	\$5,218	\$5,463	\$6,230	\$3,521	\$3,521	\$40,639	\$20,854	\$15,680	\$2,000	\$2,000	\$3,460
A/R	69,818	68,228	69,066	23,353	25,506	66,700	66,700	70,429	31,908	26,020	68,030	68,030	69,390
Inventory	77,832	70,868	60,581	66,171	67,470	54,129	54,129	48,484	57,666	67,470	54,130	54,130	54,130
Other CA	205,376	188,756	137,335	107,073	111,379	163,703	163,703	106,341	81,576	113,610	166,980	166,980	170,320
Total Current Assets	362,560	332,063	272,200	202,060	210,585	288,053	288,053	265,893	192,004	222,780	291,140	291,140	297,300
Net PP&E	2,121,593	2,182,663	2,196,667	2,214,452	2,233,862	2,260,900	2,260,900	2,286,841	2,360,584	2,375,590	2,393,410	2,393,410	2,463,120
Regulatory Assets	368,908	370,711	351,390	344,969	341,188	357,530	357,530	349,057	348,284	351,420	368,260	368,260	379,310
Other	211,884	191,255	181,776	181,663	174,249	173,318	173,318	168,865	164,282	177,730	176,780	176,780	180,320
Total Assets	\$3,064,945	\$3,076,692	\$3,002,033	\$2,943,144	\$2,959,884	\$3,079,801	\$3,079,801	\$3,070,656	\$3,065,154	\$3,127,520	\$3,229,590	\$3,229,590	\$3,320,050
ST Debt	234,700	270,035	164,900	152,800	194,900	53,300	53,300	-	-	100,000	120,000	120,000	160,000
A/P	91,366	73,219	57,407	57,756	55,933	85,664	85,664	73,245	95,761	53,140	81,380	81,380	77,310
CP of LTD	40,000	25,000	24,980	24,987	64,994	39,989	39,989	61,994	61,991	22,000	22,000	22,000	30,000.00
Other CL	103,344	109,460	114,936	78,090	86,877	95,564	95,564	99,780	77,330	88,610	97,480	97,480	99,430
Total Current Liabilities	469,410	477,714	362,223	313,633	402,704	274,517	274,517	235,019	235,082	263,750	320,860	320,860	366,740
LTD	621,700	576,700	569,745	570,045	530,219	679,334	679,334	657,716	658,118	697,710	697,710	697,710	689,710
Regulatory Liabilities	317,205	339,287	346,761	341,259	342,143	349,319	349,319	357,587	359,205	359,210	359,210	359,210	359,210
Def Tax Liabilities	530,965	530,021	550,731	554,400	544,575	557,085	557,085	575,451	577,176	550,020	562,660	562,660	568,290
Other	358,344	371,998	365,618	363,808	361,041	369,049	369,049	370,268	370,144	364,650	372,740	372,740	376,470
Shareholders' Equity	767,321	780,972	806,955	799,999	779,202	850,497	850,497	874,615	865,429	892,180	916,410	916,410	959,630
Total Liab & SE	\$3,064,945	\$3,076,692	\$3,002,033	\$2,943,144	\$2,959,884	\$3,079,801	\$3,079,801	\$3,070,656	\$3,065,154	\$3,127,520	\$3,229,590	\$3,229,590	\$3,320,050
Summary Cash Flow (000s)	FY'14	FY'15	Q1'16	Q2'16	Q3'16	Q4'16	FY'16	Q1'17	Q2'17	Q3'17E	Q4'17E	FY'17E	FY'18E
Net Income	\$58,692	\$53,703	\$36,641	\$2,019	(\$8,040)	\$28,275	\$58,895	\$40,310	\$2,729	(\$8,270)	\$29,750	\$64,520	\$64,800
D&A	79,193	80,923	20,394	20,413	20,628	20,854	82,289	21,085	21,355	21,990	22,180	86,610	90,290
(Inc) / Dec in Wrk Cap.	(21,930)	13,143	50,534	33,888	(794)	(41,759)	41,869	51,075	54,170	(67,291)	(44,930)	(6,980)	(6,820)
Other Operating	99,702	36,919	38,569	(2,898)	(4,955)	8,378	39,094	32,696	(29,189)	(2,000)	12,000	13,507	24,000
Operating CF	215,657	184,688	146,138	53,422	6,839	15,748	222,147	145,166	49,065	(55,571)	19,000	157,657	172,270
Cap Ex	(120,092)	(118,320)	(30,054)	(32,099)	(35,958)	(41,400)	(139,511)	(38,924)	(55,394)	(37,000)	(40,000)	(171,320)	(160,000)
Utility Gas Reserves	(26,798)	(1,549)	-	-	-	-	-	-	-	-	-	-	-
Other Investing	2,567	4,571	24	2,429	415	14	2,882	98	(502)	-	-	(400.00)	-
Investing CF	(144,323)	(115,298)	(30,030)	(29,670)	(35,543)	(41,386)	(136,629)	(38,826)	(55,896)	(37,000)	(40,000)	(171,720)	(160,000)
Change in ST Debt	46,500	35,335	(105,135)	(12,100)	42,100	(141,600)	(216,735)	(53,300)	-	100,000	20,000	66,700	40,000
LTD Proceeds	-	-	-	-	-	150,000	150,000	-	-	40,000	-	40,000	20,000
LTD (Retired)	(80,000)	(60,000)	-	-	-	(25,000)	(25,000)	-	-	(40,000)	-	(40,000)	(20,000)
Stock Issued--Net	8,986	3,875	1,999	2,333	500	55,290	60,122	(1,257)	532	500	500	275	2,000
Dividends	(50,093)	(49,243)	(12,823)	(12,854)	(12,879)	(12,952)	(51,508)	(13,456)	(13,463)	(13,500)	(13,580)	(54,000)	(54,410)
Other Financing	3,336	(4,680)	(39)	11	(250)	(2,809)	(3,087)	(1,209)	(23)	400	400	(432)	1,600
Financing CF	(71,271)	(71,271)	(115,998)	(22,610)	29,471	22,929	(86,208)	(69,222)	(12,954)	87,400	7,320	12,543	(10,810)
Net Cash Flow	63	(1,881)	110	1,142	767	(2,709)	(690)	37,118	(19,785)	(5,171)	(13,680)	(1,520)	1,460
EBITDA	\$222,158	\$205,171	\$94,466	\$33,019	\$16,191	\$77,893	\$221,569	\$97,313	\$34,512	\$17,140	\$81,640	\$230,600	\$234,090
EV / TTM EBITDA	9.1x	9.7x	9.2x	10.5x	10.0x	10.8x	10.8x	10.6x	11.2x	11.2x	11.1x	11.1x	10.9x
Selected Financial Statistics	FY'14	FY'15	Q1'16	Q2'16	Q3'16	Q4'16	FY'16	Q1'17	Q2'17	Q3'17E	Q4'17E	FY'17E	FY'18E
Book Value	\$28.11	\$28.43	\$29.28	\$29.04	\$28.28	\$30.16	\$30.16	\$30.45	\$30.14	\$31.06	\$31.89	\$31.89	\$33.36
Price / Book	1.8x	1.8x	1.8x	2.2x	2.1x	2.0x	2.0x	1.9x	2.1x	2.1x	2.0x	2.0x	1.9x
LT Debt / Total Capital	46.3%	43.5%	42.4%	42.7%	43.3%	45.8%	45.8%	45.1%	45.4%	44.7%	44.0%	44.0%	42.9%
Total Net Debt / Total Capital	53.6%	52.6%	48.3%	48.1%	50.1%	47.5%	47.5%	43.7%	44.7%	47.4%	47.8%	47.8%	47.7%
ROE (TTM)	7.7%	6.9%	7.9%	7.9%	7.7%	7.3%	7.3%	7.6%	7.6%	7.4%	7.3%	7.3%	7.0%

Source: Company reports and Hilliard Lyons estimates

### **Analyst Certification**

I, Spencer E. Joyce, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

### **Important Disclosures**

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

### **Suitability Ratings**

- 1** - A large cap, core holding with a solid history
- 2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks
- 3** - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage
- 4** - Speculative, due to small size, inconsistent profitability, erratic revenues, volatility, low trading volume or a narrow customer or product base

### **Investment Ratings**

**Buy** - We believe the stock has significant total return potential in the coming 12 months.

**Long-term Buy** - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.

**Neutral** - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.

**Underperform** - We believe the stock is vulnerable to a price setback in the next 12 months.



Hilliard Lyons Recommended Issues			Investment Banking Provided in Past 12 Mo.	
Rating	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Buy	36	29%	14%	86%
Hold/Neutral	79	63%	5%	95%
Sell	10	8%	0%	100%

As of 7 July 2017

### Other Disclosures

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