



## COMPANY UPDATE / ESTIMATE CHANGE

### Key Metrics

OGS - NYSE - as of	7/31/17	\$72.78
Price Target		--
52-Week Range	\$55.98 -	\$73.34
Shares Outstanding (mm)		52.4
Market Cap. (\$mm)		\$3,816.2
1-Mo. Average Daily Volume		185,310
Institutional Ownership		7355.2%
LT Debt/Total Capital	Q2'17	38.2%
ROE	TTM	8.0%
Book Value / Share	Q2'17	\$36.50
Price / Book Value		2.0x
Dividend Yield		2.3%
EBITDA Margin	FY'16	28.9%

### EPS FY 12/31

		Prior	Current	Prior	Current
	2016A	2017E	2017E	2018E	2018E
1Q	\$1.22	--	\$1.44	A --	--
2Q	\$0.38	--	\$0.39	A --	--
3Q	\$0.24	\$0.28	\$0.28	--	--
4Q	\$0.80	\$0.88	\$0.89	--	--
Year	\$2.64	\$3.00	\$3.00	\$3.16	\$3.17
P/E	27.6x		24.3x	--	23.0x

### Gross Margin (\$MM)

		Prior	Current	Prior	Current
	2016A	2017E	2017E	2018E	2018E
1Q	\$273	--	\$287	A --	--
2Q	\$189	--	\$197	A --	--
3Q	\$180	\$187	\$187	--	--
4Q	\$243	\$254	\$254	--	--
Year	\$885	\$924	\$925	\$954	\$957

**Company Description:** *ONE Gas, Inc. is a stand-alone, 100% regulated natural gas utility, trading on the NYSE under the symbol 'OGS,' and listed in the S&P MidCap 400 Index. OGS serves more than 2.1MM natural gas distribution customers across Oklahoma, Kansas and Texas.*

### Natural Gas Utilities

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August 1, 2017

## ONE Gas, Inc.

OGS — NYSE — Neutral-2

### Rare Miss in Q2'17 for OGS, but Slight Raise to FY Guidance; Reiterating Neutral Rating.

#### Investment Highlights

- OGS reported Q2'17 EPS of \$0.39 versus \$0.38 in Q2'16; results missed our target for \$0.40 (tied for Street-low), while consensus was at \$0.42. Rate activity in TX and KS was offset by higher Op Ex.
- Total gross margin rose 4.0% in Q2, slightly above our +3.1% estimate. Rate awards effective Q1'17 in TX and KS drove ~\$5MM of margin growth; two separate GRIP filings in Texas went into effect in June and July for \$4.9MM and \$4.3MM (annualized), respectively.
- The regulatory outlook/calendar remains constructive, in our view, but our model is essentially unchanged. The next source of potential surprise we see is an expected Q3 GSRS (surcharge) filing in Kansas.
- Operations and Maintenance expense (O&M) grew 4.3% in Q2, modestly above our +1.2% target and factoring heavily into the narrative on the quarter from our perspective. O&M exceeded core margin growth for the first time since Q1'15.
- OGS ended Q1'17 at a cap structure of 39.7% total debt / capital, up y/y from 38.9% and flat sequentially. We calculate TTM earned-ROE at 8.0%, flat from Q1 and higher by 90bps yr/yr. We expect both metrics continue to rise, on average, over the next few years.
- ONE Gas narrowed its 2017 EPS guidance range, effectively raising the mid-point to \$2.99 from \$2.97. Despite the very slight miss to our Q2, our FY 2017 EPS estimate is unchanged at \$3.00 due to rounding, with our outlook for 2H'17 essentially unchanged.
- We are reiterating our Neutral rating on OGS. We like the exposures offered by the multi-state regulated-only OGS, but see just average near-term risk/reward at current levels with no major near-term catalysts.
- OGS' investor call is scheduled for 11a this morning.

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

**ADDITIONAL DISCUSSION—Q2 COMMENTS AND FORWARD OUTLOOK**

Modest margin growth and steady progress on the regulatory front were more/less in line with our Q2 outlook. Higher O&M costs (mostly driven by employee costs) were an upside surprise for a second straight quarter, although we view the higher expenses as reasonable. Setting the cost structure as a standalone company has been one of the more volatile pieces of the OGS story over the company's first few years, and at this point we view steadier growth as a sign of maturation. In our view, ONE Gas continues to hold a resilient outlook for 2H'17 and into 2018, based on the regulatory calendar and Cap Ex schedule; we believe investors should expect incremental earned-ROE expansion and leveraging over the next several years.

**SUITABILITY**

We assign OGS a suitability rating of '2.' A complete description of our suitability scale is on page 5. ONE Gas represents one of the only 100% regulated publicly traded natural gas distribution companies, operating what we view as strong franchises in three states; ONE Gas was separated from a larger energy conglomerate in early-2014. A relatively narrow geographic footprint and short history as a standalone company, along with smaller scope versus the largest Utility sector companies, push OGS just below our most conservative '1' suitability rating. Resilient cash flow, below-sector leverage, and a strictly regulated business mix keep OGS well above our more aggressive '3' rating.

**CONSIDERATIONS AND RISKS**

ONE Gas has only been a standalone company since early 2014, and thus holds a short track record of independently managing certain corporate level functions. OGS' strategic focus and growth strategy consists only of regulated operations, which is unique in the gas utility industry. A deviation from the articulated strategy would likely come as a surprise to investors, and longer-term could alter the risk profile of the company.

Natural gas competes with other fuel sources for customers, primarily on the grounds of cost and service reliability. Lower electricity prices and/or a substantial change in hydraulic fracturing laws that reduces the supply of domestically produced natural gas could negatively impact growth in the future. We expect company management has few levers over which to exercise control over these potential trends.

Regulatory approval is necessary for OGS' subsidiaries to grow earnings/cash flow and generate an attractive return on investor/invested capital. A deterioration of relationships at the germane OK, KS or TX regulatory commissions could have a pronounced negative effect on the company.

Gas distribution is a capital intensive business, and we believe continued access to debt and equity financing may be important for the company to be able to pursue all prudent Cap Ex investments. Broader capital market disruptions could affect the company's ability to grow and execute its growth strategy.

Natural gas is a combustible fuel and volatile chemical compound; several highly publicized disasters have impacted the industry in recent years. Should OGS experience a disaster, we believe the company could be responsible for direct costs and/or compensation, while issues on this front could also compel deterioration of regulatory relationships.

As a mid-cap company, ONE Gas may present an element of liquidity risk for larger investors.

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

*Additional information is available upon request.*

ONE Gas, Inc.			mar	jun	sept	dec		mar	jun	sept	dec		
Income Statements (000's), FYE Dec	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	\$1,818,906	\$1,547,692	\$508,364	\$245,923	\$232,191	\$440,753	\$1,427,232	\$550,408	\$279,689				
Cost of gas	991,949	705,959	235,729	56,457	52,253	197,358	541,797	263,154	82,572				
Gross Margin (GM)	826,957	841,733	272,635	189,466	179,938	243,395	885,435	287,254	197,117	187,110	253,880	925,360	957,390
Operating Expenses													
O & M	420,686	414,476	106,131	97,119	99,402	114,490	417,142	109,357	101,241	99,900	114,490	424,990	429,230
D & A	125,722	133,023	34,684	35,565	36,241	37,339	143,829	37,019	37,851	38,480	39,430	152,780	160,850
General Tax	55,255	55,105	15,747	13,161	13,403	13,033	55,344	15,746	13,973	13,940	13,590	57,250	59,210
Total Operating Expenses	601,663	602,604	156,562	145,845	149,046	164,862	616,315	162,122	153,065	152,320	167,510	635,020	649,290
Operating Income	225,294	239,129	116,073	43,621	30,892	78,533	269,120	125,132	44,052	34,790	86,370	290,340	308,100
Other Income	1,625	263	18	416	911	102	1,447	1,246	875	910	100	3,130	3,140
Other Expense	(2,949)	(2,813)	(455)	(314)	(357)	(364)	(1,490)	(340)	(462)	(360)	(360)	(1,520)	(1,520)
Interest Expense	(45,842)	(44,570)	(10,847)	(10,848)	(10,809)	(11,235)	(43,739)	(11,481)	(11,305)	(11,490)	(11,720)	(46,000)	(47,770)
Income Before Tax	178,128	192,009	104,789	32,875	20,637	67,036	225,338	114,557	33,160	23,850	74,390	245,950	261,950
Income Tax	(68,338)	(72,979)	(40,046)	(12,575)	(7,900)	(24,722)	(85,243)	(38,101)	(12,537)	(9,060)	(27,450)	(87,150)	(93,840)
Net Income	\$109,790	\$119,030	\$64,743	\$20,300	\$12,737	\$42,314	\$140,095	\$76,456	\$20,623	\$14,790	\$46,940	\$158,800	\$168,110
Average shares outstanding (FD)	52,946	53,254	53,107	52,836	52,942	52,967	53,254	53,056	52,969	52,976	52,983	52,996	53,000
EPS (GAAP)	\$2.08	\$2.23	\$1.22	\$0.38	\$0.24	\$0.80	\$2.64	\$1.44	\$0.39	\$0.28	\$0.89	\$3.00	\$3.17
Non-recurring items													
EPS (adjusted if necessary)	\$2.08	\$2.23	\$1.22	\$0.38	\$0.24	\$0.80	\$2.64	\$1.44	\$0.39	\$0.28	\$0.89	\$3.00	\$3.17
Dividends	\$0.840	\$1.200	\$0.350	\$0.350	\$0.350	\$0.350	\$1.400	\$0.420	\$0.420	\$0.420	\$0.420	\$1.680	\$1.800
<b>Rate of Change Analysis:</b>													
Gross Margin	1.7%	1.8%	3.7%	7.1%	5.5%	5.2%	5.2%	5.4%	4.0%	4.0%	4.3%	4.5%	3.5%
Op Income	2.2%	6.1%	6.5%	39.5%	23.8%	6.3%	12.5%	7.8%	1.0%	12.6%	10.0%	7.9%	6.1%
EPS--Adj if Necessary	9.8%	7.3%	7.9%	70.0%	73.2%	8.2%	18.3%	18.2%	1.3%	16.0%	10.9%	13.3%	5.9%
EBITDA	-3.9%	6.0%	7.2%	23.2%	14.0%	7.0%	11.0%	7.6%	3.4%	9.1%	8.6%	7.3%	5.8%
O&M Expense	7.0%	-1.5%	-0.4%	-2.3%	0.7%	4.3%	0.6%	3.0%	4.2%	0.5%	0.0%	1.9%	1.0%
<b>Margin Analysis:</b>													
O&M / GM	50.9%	49.2%	38.9%	51.3%	55.2%	47.0%	47.1%	38.1%	51.4%	53.4%	45.1%	45.9%	44.8%
General Tax / GM	6.7%	6.5%	5.8%	6.9%	7.4%	5.4%	6.3%	5.5%	7.1%	7.4%	5.4%	6.2%	6.2%
Op Income / GM	27.2%	28.4%	42.6%	23.0%	17.2%	32.3%	30.4%	43.6%	22.3%	18.6%	34.0%	31.4%	32.2%
Net Income / GM	13.3%	14.1%	23.7%	10.7%	7.1%	17.4%	15.8%	26.6%	10.5%	7.9%	18.5%	17.2%	17.6%
Tax Rate	38.4%	38.0%	38.2%	38.3%	38.3%	36.9%	37.8%	33.3%	37.8%	38.0%	36.9%	35.4%	35.8%
			*New base rates OK	*Raised guide from net income: \$127MM-\$137MM				*New base rates KS		*Narrowed EPS guide from \$2.87-\$3.07		*Guidance \$155MM-\$161MM net income; \$2.94-\$3.04	

Source: Company reports and Hilliard Lyons estimates

## ONE Gas, Inc.

ONE Gas, Inc.													
Balance Sheet Analysis (000's)	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	\$11,943	\$2,433	\$52,657	\$54,257	\$4,513	\$14,663	\$14,663	\$13,206	\$5,113	\$69,160	\$39,870	\$39,870	\$27,240
Trade A/R	326,749	216,343	195,158	115,265	105,060	290,944	290,944	249,155	152,278	110,310	305,490	305,490	320,760
Gas in storage	185,300	142,153	80,553	103,741	144,230	125,432	125,432	91,231	114,996	147,110	127,940	127,940	130,500
Other CAs	143,509	121,916	89,243	108,193	123,370	137,884	137,884	127,540	139,192	125,840	140,640	140,640	143,450
Total Current Assets	667,501	482,845	417,611	381,456	377,173	568,923	568,923	481,132	411,579	452,420	613,940	613,940	621,950
Net PP&E	3,293,720	3,511,911	3,557,734	3,611,481	3,680,325	3,731,620	3,731,620	3,773,888	3,834,793	3,886,310	3,931,880	3,931,880	4,131,030
Goodwill	157,953	157,953	157,953	157,953	157,953	157,953	157,953	157,953	157,953	157,950	157,950	157,950	157,950
Reg Assets	478,723	435,863	421,559	410,648	431,086	440,522	440,522	430,338	421,094	421,090	421,090	421,090	421,090
Other	51,313	55,838	43,247	49,294	47,142	43,773	43,773	46,563	64,455	66,390	68,380	68,380	76,960
Total Assets	\$4,649,210	\$4,644,410	\$4,598,104	\$4,610,832	\$4,693,679	\$4,942,791	\$4,942,791	\$4,889,874	\$4,889,874	\$4,984,160	\$5,193,240	\$5,193,240	\$5,408,980
CP of LTD	6	7	7	7	7	7	7	0	0	0	0	0	300,000
ST Note to ONEOK	-	-	-	-	-	-	-	-	-	-	-	-	-
Other ST/Comm Paper--Approx	42,000	12,500	-	-	41,000	145,000	145,000	85,400	79,000	154,000	244,000	244,000	249,000
A/P	159,064	107,482	59,887	59,983	70,562	131,988	131,988	76,142	60,458	73,380	134,630	134,630	137,320
Other CLs	191,363	184,232	168,699	157,994	147,263	166,938	166,938	146,401	153,227	154,630	175,280	175,280	184,040
Total Current Liabilities	392,433	304,221	228,593	217,984	258,832	443,933	443,933	307,943	292,685	382,010	553,910	553,910	870,360
LTD	1,201,311	1,201,305	1,191,854	1,192,050	1,192,248	1,192,446	1,192,446	1,192,647	1,192,848	1,192,850	1,192,840	1,192,840	992,840
LT LoC w/ONEOK	-	-	-	-	-	-	-	-	-	-	-	-	-
Def Income Tax	894,585	951,785	967,943	987,906	1,011,691	1,038,568	1,038,568	1,065,096	1,077,992	1,087,990	1,097,990	1,097,990	1,137,990
Other	366,844	345,544	342,527	337,304	368,564	379,564	379,564	379,610	393,053	372,250	383,360	383,360	387,190
Total Equity	1,794,037	1,841,555	1,867,187	1,875,588	1,862,344	1,888,280	1,888,280	1,944,578	1,933,296	1,949,060	1,965,140	1,965,140	2,020,600
Total Liab & SE	\$4,649,210	\$4,644,410	\$4,598,104	\$4,610,832	\$4,693,679	\$4,942,791	\$4,942,791	\$4,889,874	\$4,889,874	\$4,984,160	\$5,193,240	\$5,193,240	\$5,408,980
Cash Flow Analysis (000's)	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	\$109,790	\$119,030	\$64,743	\$20,300	\$12,737	\$42,314	\$140,095	\$76,456	\$20,623	\$14,790	\$46,940	\$158,800	\$168,110
D&A	125,722	133,023	34,684	35,565	36,241	37,339	143,829	37,019	37,851	38,480	39,430	152,780	160,850
Deferred Tax	49,935	63,789	16,113	19,918	23,740	27,017	86,788	37,461	12,847	10,000	10,000	70,310	40,000
(Inc) / Dec in Wrk Cap	(30,229)	116,433	52,330	27,146	(45,613)	(100,499)	(66,636)	9,951	52,600	37,530	(108,910)	(8,830)	(9,190)
Operating CF	255,218	432,275	167,870	102,929	27,105	6,171	304,076	160,887	123,921	100,800	(12,540)	373,060	359,770
Cap Ex	(297,103)	(294,320)	(75,261)	(69,499)	(86,576)	(77,735)	(309,071)	(70,471)	(84,195)	(90,000)	(85,000)	(329,670)	(360,000)
Dividends	(43,696)	(62,826)	(18,380)	(18,258)	(18,285)	(18,286)	(73,209)	(22,034)	(22,008)	(22,250)	(22,250)	(88,540)	(95,400)
Free Cash Flow	(85,581)	75,129	74,229	15,172	(77,756)	(89,850)	(78,204)	68,382	17,718	(11,450)	(119,790)	(45,150)	(95,630)
LTD Proceeds	1,199,994	-	-	-	-	-	-	-	-	-	-	-	100,000
LTD (Repayments)	-	-	-	-	-	-	-	-	-	-	-	-	-
Net Borrow/(Repay) Notes Payable	42,000	(29,500)	(12,500)	-	41,000	104,000	132,500	(59,600)	(6,400)	75,000	90,000	99,000	5,000
Sttlment of ST Notes to ONEOK	-	-	-	-	-	-	-	-	-	-	-	-	-
Cash Pmt/Distrib to ONEOK	(1,130,000)	-	-	-	-	-	-	-	-	-	-	-	-
Borrowings LT LoC w/ONEOK	-	-	-	-	-	-	-	-	-	-	-	-	-
(Repayments) LT LoC w/ONEOK	-	-	-	-	-	-	-	-	-	-	-	-	-
DRIP/ESOP or Eq Raise	2,001	7,051	-	1,983	-	2,034	4,017	-	2,208	500	500	3,208	2,000
Stock Repurchased	-	(24,122)	(24,066)	-	-	-	(24,066)	(2,469)	(15,043)	-	-	(17,512)	(24,000)
Net Cash Flow	28,414	28,558	37,663	17,155	(36,756)	16,184	34,247	6,313	(1,517)	64,050	(29,290)	39,546	(12,630)
EBITDA	\$351,016	\$372,152	\$150,757	\$79,186	\$67,133	\$115,872	\$412,949	\$162,151	\$81,903	\$73,270	\$125,800	\$443,120	\$468,950
EV / TTM EBITDA	9.6x	10.4x	11.5x	11.7x	11.0x	11.1x	11.1x	11.2x	11.8x	11.5x	11.3x	11.3x	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	\$33.70	\$34.70	\$35.16	\$35.50	\$35.18	\$35.65	\$35.65	\$36.65	\$36.50	\$36.79	\$37.09	\$37.09	\$38.12
Tangible BV	\$30.73	\$31.72	\$32.18	\$32.51	\$32.19	\$32.67	\$32.67	\$33.67	\$33.52	\$33.81	\$34.11	\$34.11	\$35.14
Price / Book	1.2x	1.4x	1.7x	1.9x	1.8x	1.8x	1.8x	1.8x	2.0x	2.0x	2.0x	2.0x	1.9x
LT Debt / Total Capital	40.1%	39.5%	39.0%	38.9%	39.0%	38.7%	38.7%	38.0%	38.2%	38.0%	37.8%	37.8%	32.9%
Total Debt / Capital	40.9%	39.7%	39.0%	38.9%	39.8%	41.5%	41.5%	39.7%	39.7%	40.9%	42.2%	42.2%	43.3%
ROE (TTM)	6.6%	6.5%	6.7%	7.1%	7.4%	7.5%	7.5%	8.0%	8.0%	8.0%	8.2%	8.2%	8.2%

Source: Company reports and Hilliard Lyons estimates

### **Analyst Certifications**

I, Spencer E. Joyce, 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

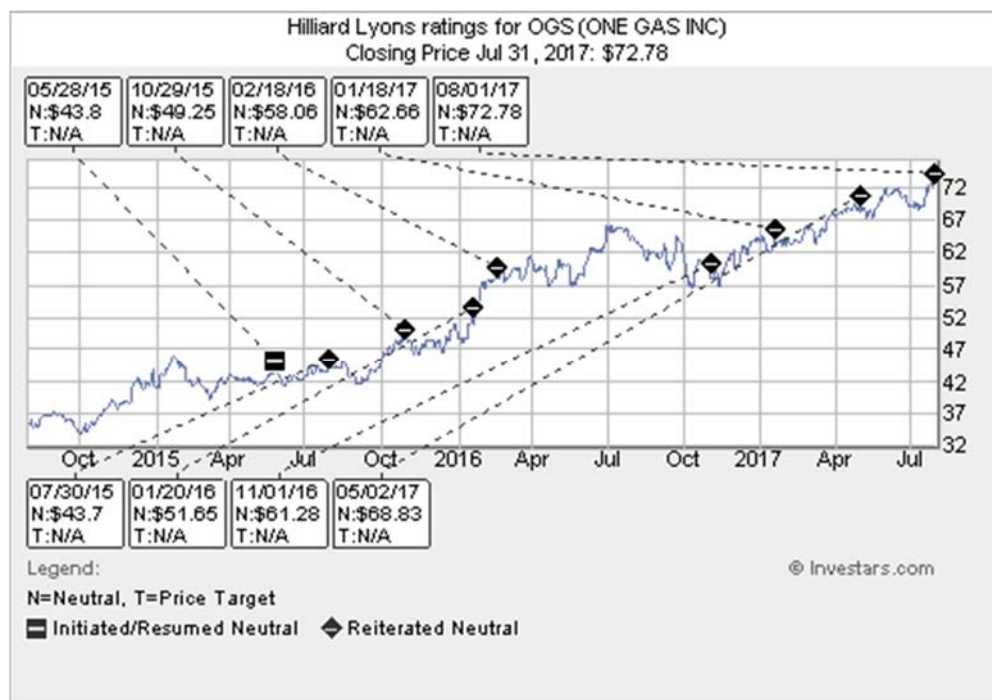
### **Investment Ratings**

**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.



Rating	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
	# 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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