



## COMPANY UPDATE / ESTIMATE CHANGE

### Key Metrics

OGS - NYSE - as of	2/22/17	\$64.39
Price Target		--
52-Week Range	\$55.96 -	\$67.35
Shares Outstanding (mm)		52.2
Market Cap. (\$mm)		\$3,364.1
1-Mo. Average Daily Volume		228,316
Institutional Ownership		73.7%
LT Debt/Total Capital	Q4'16	38.7%
ROE	TTM	7.5%
Book Value / Share	Q4'16	\$35.65
Price / Book Value		1.8x
Dividend Yield		2.6%
EBITDA Margin	FY'16	23.9%

### EPS FY 12/31

	Prior 2016A	Current 2017E	Prior 2018E	Current 2018E
1Q	\$1.22	--	\$1.34	--
2Q	\$0.38	--	\$0.42	--
3Q	\$0.24	--	\$0.31	--
4Q	\$0.80	--	\$0.88	--
Year	\$2.64	\$2.97	\$2.93	\$3.10
P/E	24.4x	22.0x	--	20.8x

### Gross Margin (\$MM)

	Prior 2016A	Current 2017E	Prior 2018E	Current 2018E
1Q	\$273	--	\$286	--
2Q	\$189	--	\$197	--
3Q	\$180	--	\$190	--
4Q	\$243	--	\$252	--
Year	\$885	\$925	\$924	\$955

**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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## ONE Gas, Inc.

OGS — NYSE — Neutral-2

**Good Q4'16 Results; Reiterating Neutral Rating, but Looking Forward to an Entry Point.**

### Investment Highlights

- OGS reported Q4'16 EPS of \$0.80 versus \$0.74 in Q4'15; results met consensus while we were forecasting \$0.85. FY 2016 EPS rose 18.3% to \$2.64. OGS befitted substantially from rate activity in 2016 for the first time in the company's short history.
- Total gross margin rose 5.2% in both Q4 and across the full year. The quarter fell short of our 6.9% estimate, but the full year marked substantial acceleration in margin growth, due primarily to new base rates in OK.
- Operations and Maintenance expense (O&M) rose 4.3% in Q4, while FY 2016 O&M grew just 0.6%. We expect growth in the 1% to 2% range over the next couple of years, as we believe OGS is approaching a sustainable and/or normalized post-spin cost structure.
- OGS settled three separate rate proceedings in Q4'16, with impacts phasing in through Q1'17. We expect margin growth to slow more noticeably in 2018, but new base rates in KS and two separate consolidated TX jurisdictions make this year resilient, in our view.
- OGS exited the year at a cap structure of just 41.5% total debt / capital, up from 39.7% at year-end 2015. We continue to expect leveraging moving forward, and an expansion of earned ROE; we calculate the latter marks 7.5% on a TTM basis.
- ONE Gas reiterated 2017 EPS guidance in the range of \$2.87-\$3.07. Mostly reflecting the downside to our Q4, our 2017/2018 EPS estimates slip to \$2.93/\$3.10.
- We are reiterating our Neutral rating on OGS, based mostly on valuation. We particularly like the rising-ROE component to the ONE Gas story, but wait for a more compelling entry point before potentially making a more aggressive recommendation.

**Note Important Disclosures on Pages 6-7  
Note Analyst Certification on Page 6**

**ADDITIONAL DISCUSSION—Q4 RESULTS AND FORWARD OUTLOOK**

ONE Gas turned in an exemplary year in 2016 from our vantage point, based on effective bottom-up execution and the confluence of a few other factors. The expiration of a rate stay out in Oklahoma dating back to OGS's formation back in 2014 allowed the company to benefit from material margin growth in its largest jurisdiction for the first time last year. Furthermore, rationalization of what we view as a formerly-bloated cost structure continued to play out in 2016, and the company benefitted from a new accounting rule tied to share based compensation. The surprise upside in 2016 from the accounting item was actually noted as the driver for OGS tweaking lower its stretch EPS growth target to 5%-7% (from 5%-8%, due to higher base year).

In meeting FY 2016 guidance and reiterating FY 2017 targets that were updated just ~1 month ago, we have few changes to our forward outlook as we move through early-2017, outside of a relatively mechanical EPS revision. We expect the margin growth conversation to carry momentum through most of this year, with O&M trends and any necessary weather tweaks more likely to push estimates within the outlined guidance range. We believe the material increase in Cap Ex that is projected for 2017 (\$350MM, versus \$310MM in 2016) bodes well for growth into 2018/2019, although we are not yet keying in on any major rate proceedings at this point.

**SUITABILITY**

We assign OGS a suitability rating of '2.' A complete description of our suitability scale is on page 6. 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	Q1'17E	Q2'17E	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							
Cost of gas	991,949	705,959	235,729	56,457	52,253	197,358	541,797							
Gross Margin (GM)	826,957	841,733	272,635	189,466	179,938	243,395	885,435	285,550	196,530	190,210	251,800	924,090	955,310	
Operating Expenses														
O & M	420,686	414,476	106,131	97,119	99,402	114,490	417,142	107,990	98,820	101,140	114,490	422,440	426,660	
D & A	125,722	133,023	34,684	35,565	36,241	37,339	143,829	36,450	37,390	38,060	39,010	150,910	160,500	
General Tax	55,255	55,105	15,747	13,161	13,403	13,033	55,344	16,810	14,130	14,280	13,970	59,190	60,490	
Total Operating Expenses	601,663	602,604	156,562	145,845	149,046	164,862	616,315	161,250	150,340	153,480	167,470	632,540	647,650	
Operating Income	225,294	239,129	116,073	43,621	30,892	78,533	269,120	124,300	46,190	36,730	84,330	291,550	307,660	
Other Income	1,625	263	18	416	911	102	1,447	20	420	910	100	1,450	1,450	
Other Expense	(2,949)	(2,813)	(455)	(314)	(357)	(364)	(1,490)	(460)	(310)	(360)	(360)	(1,490)	(1,490)	
Interest Expense	(45,842)	(44,570)	(10,847)	(10,848)	(10,809)	(11,235)	(43,739)	(11,140)	(11,120)	(11,310)	(11,540)	(45,110)	(47,050)	
Income Before Tax	178,128	192,009	104,789	32,875	20,637	67,036	225,338	112,720	35,180	25,970	72,530	246,400	260,570	
Income Tax	(68,338)	(72,979)	(40,046)	(12,575)	(7,900)	(24,722)	(85,243)	(41,930)	(13,120)	(9,740)	(26,110)	(90,900)	(96,140)	
Net Income	\$109,790	\$119,030	\$64,743	\$20,300	\$12,737	\$42,314	\$140,095	\$70,790	\$22,060	\$16,230	\$46,420	\$155,500	\$164,430	
Average shares outstanding (FD)	52,946	53,254	53,107	52,836	52,942	52,967	53,254	52,975	52,983	52,990	52,998	52,986	53,017	
EPS (GAAP)	\$2.08	\$2.23	\$1.22	\$0.38	\$0.24	\$0.80	\$2.64	\$1.34	\$0.42	\$0.31	\$0.88	\$2.93	\$3.10	
Non-recurring items														
EPS (adjusted if necessary)	\$2.08	\$2.23	\$1.22	\$0.38	\$0.24	\$0.80	\$2.64	\$1.34	\$0.42	\$0.31	\$0.88	\$2.93	\$3.10	
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%	4.7%	3.7%	5.7%	3.5%	4.4%	3.4%	
Op Income	2.2%	6.1%	6.5%	39.5%	23.8%	6.3%	12.5%	7.1%	5.9%	18.9%	7.4%	8.3%	5.5%	
EPS--Adj if Necessary	9.8%	7.3%	7.9%	70.0%	73.2%	8.2%	18.3%	9.6%	8.4%	27.3%	9.6%	11.1%	5.7%	
EBITDA	-3.9%	6.0%	7.2%	23.2%	14.0%	7.0%	11.0%	6.6%	5.5%	11.4%	6.4%	7.1%	5.8%	
O&M Expense	7.0%	-1.5%	-0.4%	-2.3%	0.7%	4.3%	0.6%	1.8%	1.8%	1.7%	0.0%	1.3%	1.0%	
<b>Margin Analysis:</b>														
O&M / GM	50.9%	49.2%	38.9%	51.3%	55.2%	47.0%	47.1%	37.8%	50.3%	53.2%	45.5%	45.7%	44.7%	
General Tax / GM	6.7%	6.5%	5.8%	6.9%	7.4%	5.4%	6.3%	5.9%	7.2%	7.5%	5.5%	6.4%	6.3%	
Op Income / GM	27.2%	28.4%	42.6%	23.0%	17.2%	32.3%	30.4%	43.5%	23.5%	19.3%	33.5%	31.5%	32.2%	
Net Income / GM	13.3%	14.1%	23.7%	10.7%	7.1%	17.4%	15.8%	24.8%	11.2%	8.5%	18.4%	16.8%	17.2%	
Tax Rate	38.4%	38.0%	38.2%	38.3%	38.3%	36.9%	37.8%	37.2%	37.3%	37.5%	36.0%	36.9%	36.9%	
			*New base rates OK	*Raised guide from net income: \$127MM-\$137MM			*Guidance \$135MM-\$140MM net income; \$2.55-\$2.65		*New base rates KS			*Guidance \$152MM-\$162MM net income; \$2.87-\$3.07		

Source: Company reports and Hilliard Lyons estimates

## ONE Gas, Inc.

<b>Balance Sheet Analysis (000's)</b>	<b>FY'14</b>	<b>FY'15</b>	<b>Q1'16</b>	<b>Q2'16</b>	<b>Q3'16</b>	<b>Q4'16</b>	<b>FY'16</b>	<b>Q1'17E</b>	<b>Q2'17E</b>	<b>Q3'17E</b>	<b>Q4'17E</b>	<b>FY'17E</b>	<b>FY'18E</b>
Cash	\$11,943	\$2,433	\$52,657	\$54,257	\$4,513	\$14,663	\$14,663	\$101,780	\$55,240	\$36,460	\$6,220	\$6,220	(\$10,470)
Trade A/R	326,749	216,343	195,158	115,265	105,060	290,944	290,944	204,920	121,030	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	82,160	105,820	147,110	127,940	127,940	130,500
Other CAs	143,509	121,916	89,243	108,193	123,370	137,884	137,884	91,030	110,360	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	479,890	392,450	419,720	580,290	580,290	584,240
Net PP&E	3,293,720	3,511,911	3,557,734	3,611,481	3,680,325	3,731,620	3,731,620	3,780,170	3,832,780	3,884,720	3,930,710	3,930,710	4,130,210
Goodwill	157,953	157,953	157,953	157,953	157,953	157,953	157,953	157,950	157,950	157,950	157,950	157,950	157,950
Reg Assets	478,723	435,863	421,559	410,648	431,086	440,522	440,522	440,520	440,520	440,520	440,520	440,520	440,520
Other	51,313	55,838	43,247	49,294	47,142	43,773	43,773	45,090	46,440	47,830	49,260	49,260	55,440
<b>Total Assets</b>	<b>\$4,649,210</b>	<b>\$4,644,410</b>	<b>\$4,598,104</b>	<b>\$4,610,832</b>	<b>\$4,693,679</b>	<b>\$4,942,791</b>	<b>\$4,942,791</b>	<b>\$4,903,620</b>	<b>\$4,870,140</b>	<b>\$4,950,740</b>	<b>\$5,158,730</b>	<b>\$5,158,730</b>	<b>\$5,368,360</b>
CP of LTD	6	7	7	7	7	7	7	10	10	10	10	10	10
ST Note to ONEOK	-	-	-	-	-	-	-	-	-	-	-	-	-
Other ST/Comm Paper--Approx	42,000	12,500	-	-	41,000	145,000	145,000	105,000	95,000	170,000	260,000	260,000	265,000
A/P	159,064	107,482	59,887	59,983	70,562	131,988	131,988	62,280	62,380	73,380	134,630	134,630	137,320
Other CLs	191,363	184,232	168,699	157,994	147,263	166,938	166,938	177,130	165,890	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	344,420	323,280	398,020	569,920	569,920	586,370
LTD	1,201,311	1,201,305	1,191,854	1,192,050	1,192,248	1,192,446	1,192,446	1,192,450	1,192,440	1,192,440	1,192,440	1,192,440	1,292,430
LT LoC w/ONEOK	-	-	-	-	-	-	-	-	-	-	-	-	-
Def Income Tax	894,585	951,785	967,943	987,906	1,011,691	1,038,568	1,038,568	1,048,570	1,058,570	1,068,570	1,078,570	1,078,570	1,118,570
Other	366,844	345,544	342,527	337,304	368,564	379,564	379,564	345,950	340,680	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	1,972,230	1,955,170	1,919,460	1,934,440	1,934,440	1,983,800
<b>Total Liab &amp; SE</b>	<b>\$4,649,210</b>	<b>\$4,644,410</b>	<b>\$4,598,104</b>	<b>\$4,610,832</b>	<b>\$4,693,679</b>	<b>\$4,942,791</b>	<b>\$4,942,791</b>	<b>\$4,903,620</b>	<b>\$4,870,140</b>	<b>\$4,950,740</b>	<b>\$5,158,730</b>	<b>\$5,158,730</b>	<b>\$5,368,360</b>
<b>Cash Flow Analysis (000's)</b>	<b>FY'14</b>	<b>FY'15</b>	<b>Q1'16</b>	<b>Q2'16</b>	<b>Q3'16</b>	<b>Q4'16</b>	<b>FY'16</b>	<b>Q1'17E</b>	<b>Q2'17E</b>	<b>Q3'17E</b>	<b>Q4'17E</b>	<b>FY'17E</b>	<b>FY'18E</b>
Net Income	\$109,790	\$119,030	\$64,743	\$20,300	\$12,737	\$42,314	\$140,095	\$70,790	\$22,060	\$16,230	\$46,420	\$155,500	\$164,430
D&A	125,722	133,023	34,684	35,565	36,241	37,339	143,829	36,450	37,390	38,060	39,010	150,910	160,500
Deferred Tax	49,935	63,789	16,113	19,918	23,740	27,017	86,788	10,000	10,000	10,000	10,000	40,000	40,000
(Inc) / Dec in Wrk Cap	(30,229)	116,433	52,330	27,146	(45,613)	(100,499)	(66,636)	116,630	29,760	(46,310)	(108,910)	(8,830)	(9,190)
Operating CF	255,218	432,275	167,870	102,929	27,105	6,171	304,076	233,870	99,210	17,980	(13,480)	337,580	355,740
Cap Ex	(297,103)	(294,320)	(75,261)	(69,499)	(86,576)	(77,735)	(309,071)	(85,000)	(90,000)	(90,000)	(85,000)	(350,000)	(360,000)
Dividends	(43,696)	(62,826)	(18,380)	(18,258)	(18,285)	(18,286)	(73,209)	(22,250)	(22,250)	(22,260)	(22,260)	(89,020)	(95,430)
Free Cash Flow	(85,581)	75,129	74,229	15,172	(77,756)	(89,850)	(78,204)	126,620	(13,040)	(94,280)	(120,740)	(101,440)	(99,690)
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	(40,000)	(10,000)	75,000	90,000	115,000	5,000
Cash Pmt/Distrib to ONEOK	(1,130,000)	-	-	-	-	-	-	-	-	-	-	-	-
DRIP/ESOP or Eq Raise	2,001	7,051	-	1,983	-	2,034	4,017	500	500	500	500	2,000	2,000
Stock Repurchased	-	(24,122)	(24,066)	-	-	-	(24,066)	-	(24,000)	-	-	(24,000)	(24,000)
Net Cash Flow	28,414	28,558	37,663	17,155	(36,756)	16,184	34,247	87,120	(46,540)	(18,780)	(30,240)	(8,440)	(16,690)
EBITDA	\$351,016	\$372,152	\$150,757	\$79,186	\$67,133	\$115,872	\$412,949	\$160,750	\$83,580	\$74,790	\$123,340	\$442,460	\$468,160
EV / TTM EBITDA	9.6x	10.4x	11.5x	11.7x	11.0x	11.1x	11.1x	10.6x	10.6x	10.5x	10.4x	10.4x	10.1x
<b>Selected Financial Statistics</b>	<b>FY'14</b>	<b>FY'15</b>	<b>Q1'16</b>	<b>Q2'16</b>	<b>Q3'16</b>	<b>Q4'16</b>	<b>FY'16</b>	<b>Q1'17E</b>	<b>Q2'17E</b>	<b>Q3'17E</b>	<b>Q4'17E</b>	<b>FY'17E</b>	<b>FY'18E</b>
Book Value	\$33.70	\$34.70	\$35.16	\$35.50	\$35.18	\$35.65	\$35.65	\$37.23	\$36.90	\$36.22	\$36.50	\$36.50	\$37.41
Tangible BV	\$30.73	\$31.72	\$32.18	\$32.51	\$32.19	\$32.67	\$32.67	\$34.25	\$33.92	\$33.24	\$33.52	\$33.52	\$34.43
Price / Book	1.2x	1.4x	1.7x	1.9x	1.8x	1.8x	1.8x	1.7x	1.7x	1.8x	1.8x	1.8x	1.7x
LT Debt / Total Capital	40.1%	39.5%	39.0%	38.9%	39.0%	38.7%	38.7%	37.7%	37.9%	38.3%	38.1%	38.1%	39.4%
Total Debt / Capital	40.9%	39.7%	39.0%	38.9%	39.8%	41.5%	41.5%	39.7%	39.7%	41.5%	42.9%	42.9%	44.0%
ROE (TTM)	6.6%	6.5%	6.7%	7.1%	7.4%	7.5%	7.5%	7.7%	7.7%	7.9%	8.0%	8.0%	8.3%

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

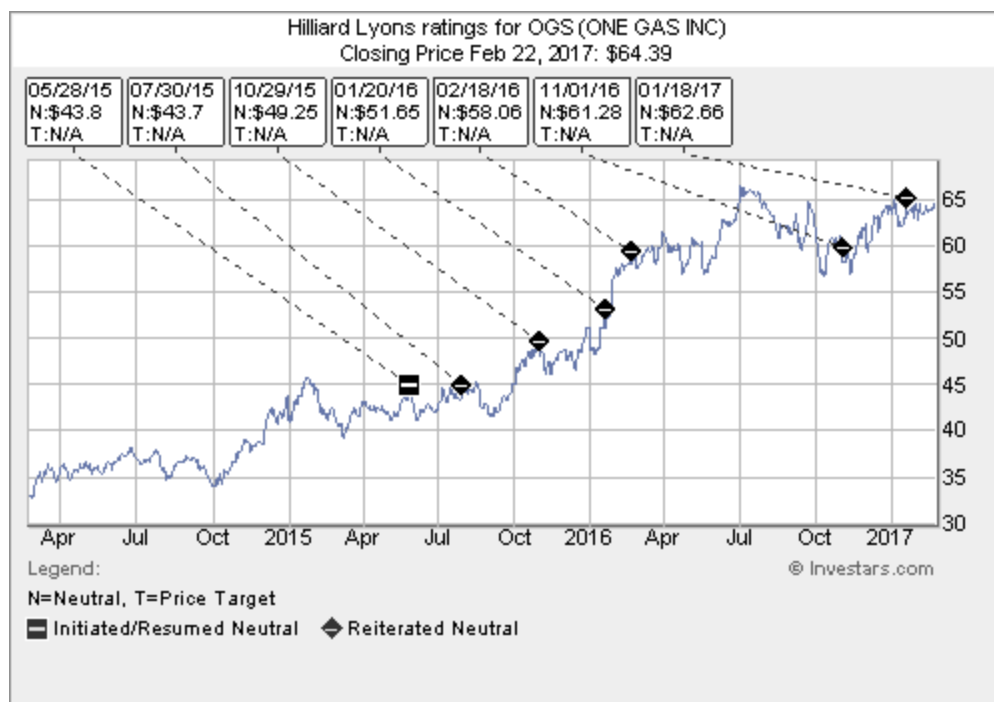
### **Investment Ratings**

**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	30%	17%	83%
Hold/Neutral	76	62%	7%	93%
Sell	10	8%	0%	100%

As of 6 February 2017

### Other Disclosures

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