



## COMPANY UPDATE / ESTIMATE CHANGE

### Key Metrics

OGS - NYSE - as of	5/1/17	\$68.83
Price Target		--
52-Week Range	\$55.98 -	\$70.64
Shares Outstanding (mm)		52.2
Market Cap. (\$mm)		\$3,595.7
1-Mo. Average Daily Volume		201,038
Institutional Ownership		73.2%
LT Debt/Total Capital	Q1'17	38.0%
ROE	TTM	8.0%
Book Value / Share	Q1'17	\$36.65
Price / Book Value		1.9x
Dividend Yield		2.4%
EBITDA Margin	FY'16	28.9%

### EPS FY 12/31

		Prior	Current		Prior	Current
	2016A	2017E	2017E	A	2018E	2018E
1Q	\$1.22	--	\$1.44	A	--	--
2Q	\$0.38	\$0.42	\$0.40		--	--
3Q	\$0.24	\$0.31	\$0.28		--	--
4Q	\$0.80	\$0.88	\$0.88		--	--
Year	\$2.64	\$2.93	\$3.00		\$3.10	\$3.16
P/E	26.1x		22.9x		--	21.8x

### Gross Margin (\$MM)

		Prior	Current		Prior	Current
	2016A	2017E	2017E	A	2018E	2018E
1Q	\$273	--	\$287	A	--	--
2Q	\$189	\$197	\$195		--	--
3Q	\$180	\$190	\$187		--	--
4Q	\$243	\$252	\$254		--	--
Year	\$885	\$924	\$924		\$955	\$954

**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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May 2, 2017

## ONE Gas, Inc.

OGS — NYSE — Neutral-2

**Strong Q1'17 Results from OGS, Boosted a bit by Taxes; Reiterating Neutral Rating.**

### Investment Highlights

- OGS reported Q1'17 EPS of \$1.44 versus \$1.22 in Q1'16; results beat our estimate for \$1.34 by a dime, which was a penny below consensus at \$1.35. Rate activity in TX and KS mostly fell to the bottom line, and a lower effective tax rate boosted EPS.
- Stripping out the +\$0.10 EPS impact that a change in share-based comp accounting had in Q1, EPS met our target; however, this was a known item entering the year. Versus our model, the \$0.10 'beat' was driven by tax: +\$0.07, and core operations: +\$0.03.
- Total gross margin rose 5.4% in Q1, slightly below our +4.7% estimate, but quicker growth than we expect over the balance of 2017. Rate activity in TX and KS went into effect in Q1'17, driving ~\$10MM of margin upside and taking over leadership from OK, where OGS is lapping new base rates from Q1-to-Q4'16.
- Operations and Maintenance expense (O&M) grew 3.0%, modestly above our +1.8% target, but boosted more so by the maintenance piece and still comfortably below core margin growth.
- OGS made two GRIP surcharge filings in March, to be effective in June/July 2017. OGS' Texas Gas is requesting net revenue of \$4.9MM and \$4.5MM for its Central and West Texas jurisdictions, respectively.
- OGS ended Q1'17 at a cap structure of 39.7% total debt / capital, up y/y from 39.0%. Nevertheless, we calculate TTM earned-ROE at 8.0%, up 130bps yr/yr.
- ONE Gas reiterated 2017 EPS guidance in the range of \$2.87-\$3.07; we view the mid-point as conservative. Reflecting Q1 results, our 2017/2018 EPS estimates rise, but growth in '18 over '17 flattens.
- We are reiterating our Neutral rating on OGS, based mostly on valuation.

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

**ADDITIONAL DISCUSSION—Q1 COMMENTS AND FORWARD OUTLOOK**

In our view, another strong quarter from the team at ONE Gas, with the company effectively transitioning past its first big Oklahoma rate case that substantially drove growth in 2016. Q1'17 margin growth was competitive with what OGS posted last year, and while we believe the O&M structure is mostly normalized at this point, we do not see much reason to expect operating expense growth to outstrip margin growth over the next couple of years. In our view, ONE Gas continues to hold a resilient outlook for 2017, and into 2018, based on the regulatory calendar; we believe investors should expect incremental earned-ROE expansion over the next year+, sustaining what we view as a key element of the investment thesis for OGS.

**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	Q2'17E	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	\$550,408						
Cost of gas	991,949	705,959	235,729	56,457	52,253	197,358	541,797	263,154						
Gross Margin (GM)	826,957	841,733	272,635	189,466	179,938	243,395	885,435	287,254	195,360	187,140	253,930	923,680	953,980	
Operating Expenses														
O & M	420,686	414,476	106,131	97,119	99,402	114,490	417,142	109,357	98,330	99,900	114,490	422,080	426,290	
D & A	125,722	133,023	34,684	35,565	36,241	37,339	143,829	37,019	37,730	38,400	39,340	152,490	160,380	
General Tax	55,255	55,105	15,747	13,161	13,403	13,033	55,344	15,746	13,570	13,940	13,600	56,860	58,730	
Total Operating Expenses	601,663	602,604	156,562	145,845	149,046	164,862	616,315	162,122	149,630	152,240	167,430	631,430	645,400	
Operating Income	225,294	239,129	116,073	43,621	30,892	78,533	269,120	125,132	45,730	34,900	86,500	292,250	308,580	
Other Income	1,625	263	18	416	911	102	1,447	1,246	420	910	100	2,680	2,680	
Other Expense	(2,949)	(2,813)	(455)	(314)	(357)	(364)	(1,490)	(340)	(310)	(360)	(360)	(1,370)	(1,370)	
Interest Expense	(45,842)	(44,570)	(10,847)	(10,848)	(10,809)	(11,235)	(43,739)	(11,481)	(11,460)	(11,650)	(11,880)	(46,470)	(48,410)	
Income Before Tax	178,128	192,009	104,789	32,875	20,637	67,036	225,338	114,557	34,380	23,800	74,360	247,090	261,480	
Income Tax	(68,338)	(72,979)	(40,046)	(12,575)	(7,900)	(24,722)	(85,243)	(38,101)	(13,060)	(9,040)	(27,440)	(87,640)	(93,810)	
Net Income	\$109,790	\$119,030	\$64,743	\$20,300	\$12,737	\$42,314	\$140,095	\$76,456	\$21,320	\$14,760	\$46,920	\$159,450	\$167,670	
Average shares outstanding (FD)	52,946	53,254	53,107	52,836	52,942	52,967	53,254	53,056	53,063	53,071	53,078	53,067	53,096	
EPS (GAAP)	\$2.08	\$2.23	\$1.22	\$0.38	\$0.24	\$0.80	\$2.64	\$1.44	\$0.40	\$0.28	\$0.88	\$3.00	\$3.16	
Non-recurring items														
EPS (adjusted if necessary)	\$2.08	\$2.23	\$1.22	\$0.38	\$0.24	\$0.80	\$2.64	\$1.44	\$0.40	\$0.28	\$0.88	\$3.00	\$3.16	
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%	3.1%	4.0%	4.3%	4.3%	3.3%	
Op Income	2.2%	6.1%	6.5%	39.5%	23.8%	6.3%	12.5%	7.8%	4.8%	13.0%	10.1%	8.6%	5.6%	
EPS--Adj if Necessary	9.8%	7.3%	7.9%	70.0%	73.2%	8.2%	18.3%	18.2%	4.6%	15.6%	10.7%	13.7%	5.1%	
EBITDA	-3.9%	6.0%	7.2%	23.2%	14.0%	7.0%	11.0%	7.6%	5.4%	9.2%	8.6%	7.7%	5.4%	
O&M Expense	7.0%	-1.5%	-0.4%	-2.3%	0.7%	4.3%	0.6%	3.0%	1.2%	0.5%	0.0%	1.2%	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%	50.3%	53.4%	45.1%	45.7%	44.7%	
General Tax / GM	6.7%	6.5%	5.8%	6.9%	7.4%	5.4%	6.3%	5.5%	6.9%	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%	23.4%	18.6%	34.1%	31.6%	32.3%	
Net Income / GM	13.3%	14.1%	23.7%	10.7%	7.1%	17.4%	15.8%	26.6%	10.9%	7.9%	18.5%	17.3%	17.6%	
Tax Rate	38.4%	38.0%	38.2%	38.3%	38.3%	36.9%	37.8%	33.3%	38.0%	38.0%	36.9%	35.5%	35.9%	
			*New base rates OK	*Raised guide from net income: \$127MM-\$137MM				*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>Q1'17</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	\$13,206	\$73,390	\$53,780	\$25,310	\$25,310	\$10,500
Trade A/R	326,749	216,343	195,158	115,265	105,060	290,944	290,944	249,155	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	91,231	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	127,540	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	481,132	410,600	437,040	599,380	599,380	605,210
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	3,826,160	3,877,760	3,923,420	3,923,420	4,123,040
Goodwill	157,953	157,953	157,953	157,953	157,953	157,953	157,953	157,953	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	430,338	430,340	430,340	430,340	430,340	430,340
Other	51,313	55,838	43,247	49,294	47,142	43,773	43,773	46,563	47,960	49,400	50,880	50,880	57,270
<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>\$4,889,874</b>	<b>\$4,873,010</b>	<b>\$4,952,490</b>	<b>\$5,161,970</b>	<b>\$5,161,970</b>	<b>\$5,373,810</b>
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	75,400	150,400	240,400	240,400	245,400
A/P	159,064	107,482	59,887	59,983	70,562	131,988	131,988	76,142	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	146,401	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	307,943	303,670	378,410	550,310	550,310	866,760
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	1,192,650	1,192,640	1,192,640	1,192,640	992,630
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	1,075,100	1,085,100	1,095,100	1,095,100	1,135,100
Other	366,844	345,544	342,527	337,304	368,564	379,564	379,564	379,610	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	1,944,578	1,960,910	1,924,090	1,940,560	1,940,560	1,992,130
<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>\$4,889,874</b>	<b>\$4,873,010</b>	<b>\$4,952,490</b>	<b>\$5,161,970</b>	<b>\$5,161,970</b>	<b>\$5,373,810</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>Q1'17</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	\$76,456	\$21,800	\$15,090	\$47,890	\$161,230	\$166,570
D&A	125,722	133,023	34,684	35,565	36,241	37,339	143,829	37,019	37,730	38,400	39,340	152,490	160,380
Deferred Tax	49,935	63,789	16,113	19,918	23,740	27,017	86,788	37,461	10,000	10,000	10,000	67,460	40,000
(Inc) / Dec in Wrk Cap	(30,229)	116,433	52,330	27,146	(45,613)	(100,499)	(66,636)	9,951	136,440	(46,310)	(108,910)	(8,830)	(9,190)
Operating CF	255,218	432,275	167,870	102,929	27,105	6,171	304,076	160,887	205,970	17,180	(11,680)	372,350	357,760
Cap Ex	(297,103)	(294,320)	(75,261)	(69,499)	(86,576)	(77,735)	(309,071)	(70,471)	(90,000)	(90,000)	(85,000)	(335,470)	(360,000)
Dividends	(43,696)	(62,826)	(18,380)	(18,258)	(18,285)	(18,286)	(73,209)	(22,034)	(22,290)	(22,290)	(22,290)	(88,900)	(95,570)
Free Cash Flow	(85,581)	75,129	74,229	15,172	(77,756)	(89,850)	(78,204)	68,382	93,680	(95,110)	(118,970)	(52,020)	(97,810)
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)	(10,000)	75,000	90,000	95,400	5,000
Cash Pmt/Dstrib to ONEOK	(1,130,000)	-	-	-	-	-	-	-	-	-	-	-	-
DRIP/ESOP or Eq Raise	2,001	7,051	-	1,983	-	2,034	4,017	-	500	500	500	1,500	2,000
Stock Repurchased	-	(24,122)	(24,066)	-	-	-	(24,066)	(2,469)	(24,000)	-	-	(26,469)	(24,000)
Net Cash Flow	28,414	28,558	37,663	17,155	(36,756)	16,184	34,247	6,313	60,180	(19,610)	(28,470)	18,411	(14,810)
EBITDA	\$351,016	\$372,152	\$150,757	\$79,186	\$67,133	\$115,872	\$412,949	\$162,151	\$83,460	\$73,300	\$125,840	\$444,740	\$468,960
EV / TTM EBITDA	9.6x	10.4x	11.5x	11.7x	11.0x	11.1x	11.1x	11.2x	11.1x	11.0x	10.8x	10.8x	10.5x
<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>Q1'17</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	\$36.65	\$36.95	\$36.26	\$36.56	\$36.56	\$37.51
Tangible BV	\$30.73	\$31.72	\$32.18	\$32.51	\$32.19	\$32.67	\$32.67	\$33.67	\$33.98	\$33.28	\$33.58	\$33.58	\$34.54
Price / Book	1.2x	1.4x	1.7x	1.9x	1.8x	1.8x	1.8x	1.8x	1.9x	1.9x	1.9x	1.9x	1.8x
LT Debt / Total Capital	40.1%	39.5%	39.0%	38.9%	39.0%	38.7%	38.7%	38.0%	37.8%	38.3%	38.1%	38.1%	33.3%
Total Debt / Capital	40.9%	39.7%	39.0%	38.9%	39.8%	41.5%	41.5%	39.7%	39.3%	41.1%	42.5%	42.5%	43.6%
ROE (TTM)	6.6%	6.5%	6.7%	7.1%	7.4%	7.5%	7.5%	8.0%	8.0%	8.1%	8.3%	8.3%	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

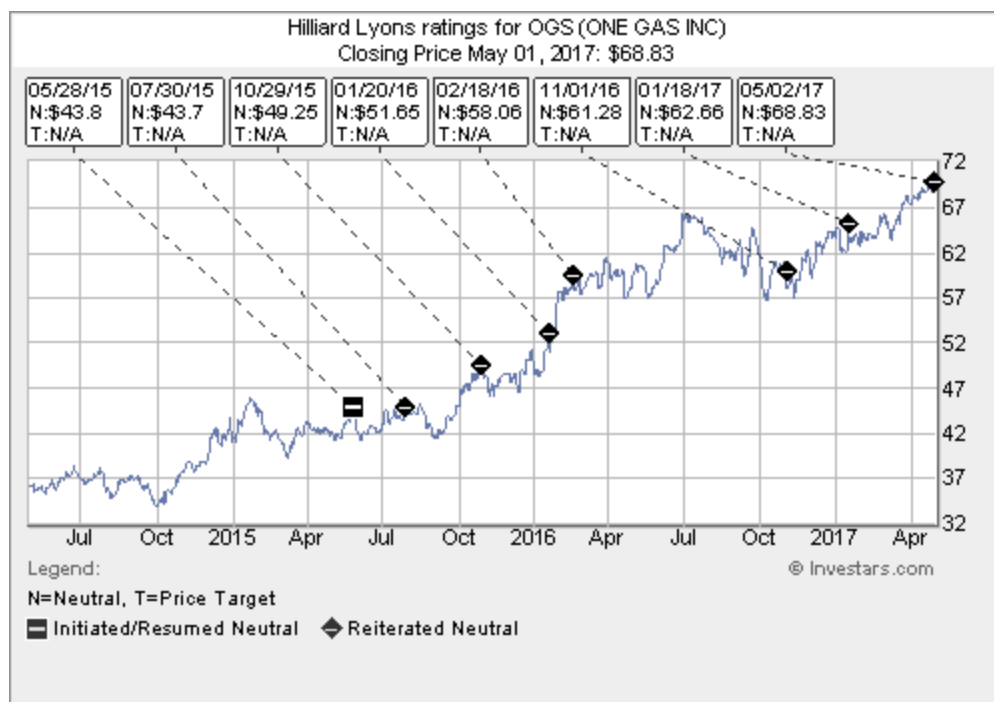
### **Investment Ratings**

**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%	14%	86%
Hold/Neutral	71	58%	6%	94%
Sell	15	12%	7%	93%

As of 5 April 2017

### Other Disclosures

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