The Value of Strategic Direction

Strategy Analyses Across Natural Gas LDCs

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Contents

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Executive Summary of Findings

Purpose and Introduction

Purpose

- This report focuses on natural gas distribution businesses and/or executives contemplating adding natural gas distribution businesses to their current business portfolio
- We analyzed and examined a panel of 10 natural gas distribution companies to understand the relationship between strategic direction and resulting performance, both internal performance metrics and attendant shareholder return
- To assist executives assessing strategic direction, we performed in-depth analyses of strategic focus, resulting return on equity (ROE), and shareholder return across the natural gas distribution companies

Introduction

- In this report, executives will find a summary of varying strategic plans/direction among gas LDCs, a 10-year shareholder value analysis, analyses on ROE, and the breakdown of ROE across its three components—return on sales (ROS), asset turnover, and financial leverage—over the same period of time
- Executives will find that LDCs are indeed pursuing a wide range of strategies that group into three categories
  - Conventional Strategy – Traditional dividend play, focus on the fundamental LDC business
  - Horizontal Integration Strategy – Growth via acquisition of additional LDC businesses, gas trading, and/or field service businesses
  - Vertical Integration Strategy – Growth via midstream (pipelines, storage, etc.) asset acquisition/investment and, in some instances, extension upstream into gathering and drilling
- Importantly, executives will also find that these strategies are producing significantly different results
- Whether you are a stand-alone LDC company executive or a combo-utility executive, you will find this study to be a compelling read

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Summary of Findings

General Findings

- Strategy matters…some natural gas LDC strategies produce consistently higher returns—both ROE and shareholder return—than others
- Clarity and decisiveness of strategy appear to influence the amount of value created as much as the strategy itself
- Strategies should be regularly reassessed for changes in the “environment;” however, a shift in strategic direction appears to be accompanied with a lag in value creation
- Execution matters – those companies shifting away from the Conventional Strategy to one of the growth strategies have considerably higher variability of results
- Across the entire natural gas LDC panel, no companies appeared to be utilizing leverage to boost ROE

Strategy-Specific Findings

- The “right” strategy should be uniquely aligned with company-specific circumstances
- Those natural gas LDCs pursuing the Conventional Strategy consistently produced the lowest, or worst, returns
  - Of the 10 panel companies, seven supplemented their regulatory assets with other strategic assets
  - However, only three of the seven have made a clear, well-understood shift in strategic direction; those three LDCs with a clear shift in strategy have outperformed the rest of the panel
- The most significant difference across the three strategies was the ability to generate operating profit
  - The Vertical Integration Strategy produced the highest operating profit and attendant ROE

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Approach

Project Objectives and Key Activities

Project Objectives

- Create strategic analyses of natural gas LDCs financial performance to determine if different strategies produce different returns
- Identify strategic opportunities and ideas that enable C-suite executives to enhance shareholder value

Key Activities

Determined Panel of Companies

- Selected 10 natural gas LDCs, gas only
- Ensured all companies were publicly traded and had at least $500M in revenue

Correlated TSR and ROE

- Documented and agreed on metric calculations
- Set up database architecture
- Collected data and made source decisions
- Tested third-party source data and researched differences
- Correlated Total Shareholder Return (TSR) and actual ROE over 10–12 years
- Identified outliers
- Researched supporting documentation for explanations
- Organized outputs in graphic form and consolidated various explanation sources

Completed DuPont Decomposition Analysis

- Broke down ROE into three components to identify drivers of financial performance
- Assessed outputs and created hypotheses
- Researched and validated hypotheses
- Prepared results in appropriate formats

Validated Company-Stated Strategies

- Reviewed stated company strategies
- Attended CEO strategy briefings
- Assimilated results

Prepared Findings that Deliver Value to Executives

- Prepare statement of value analyses
- Make findings available to executives
  - Post findings on website
  - Send findings to C-suite executives
  - Prepare and post news releases to make the study known
- Ensure clarity of results for valuable executive review

Note: Data sources include SNL Financial and publicly available sources (e.g., 10-Ks, shareholder reports)

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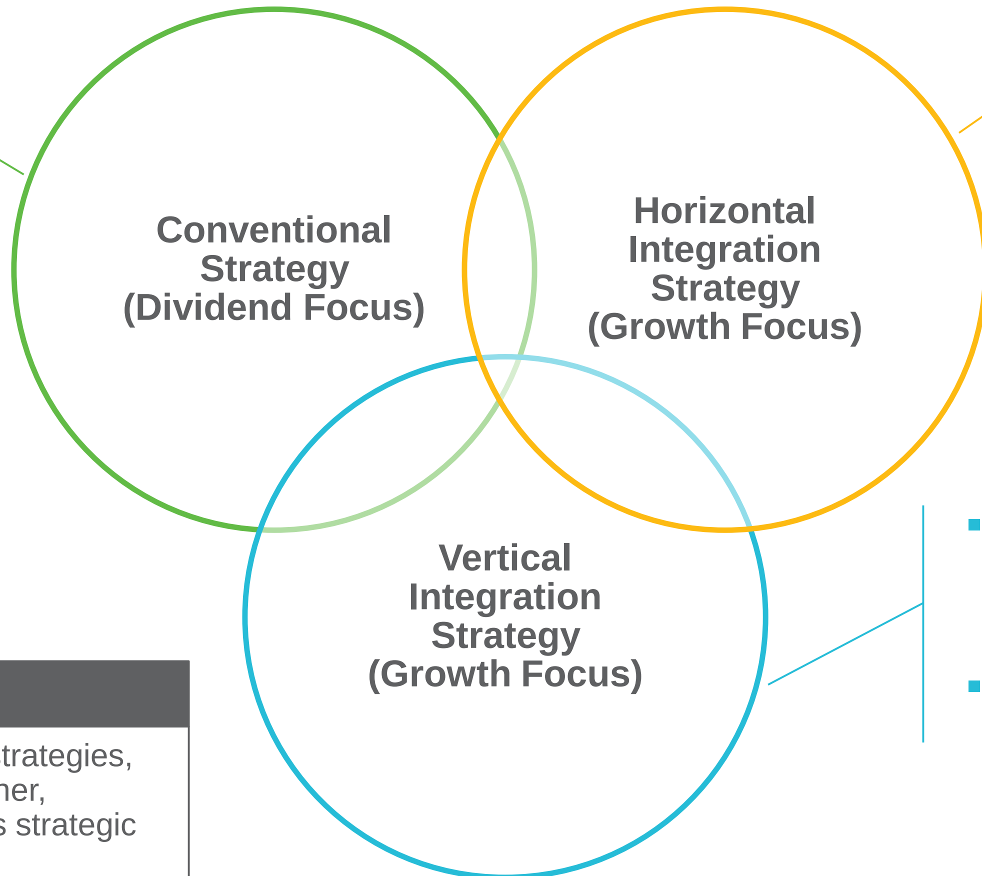
Panel Company Strategy Categories

Panel Company Strategies

- Major focus on regulatory compact
- Maintain dividend payments
- Any acquisitions are minor enough that Wall Street discounts the value



- Acquisitions are mostly focused on additional LDCs and/or field service businesses
- Acquisitions are considered material

- Acquisitions are mostly upstream from the LDC, typically pipelines and/or storage
- Acquisitions are considered material

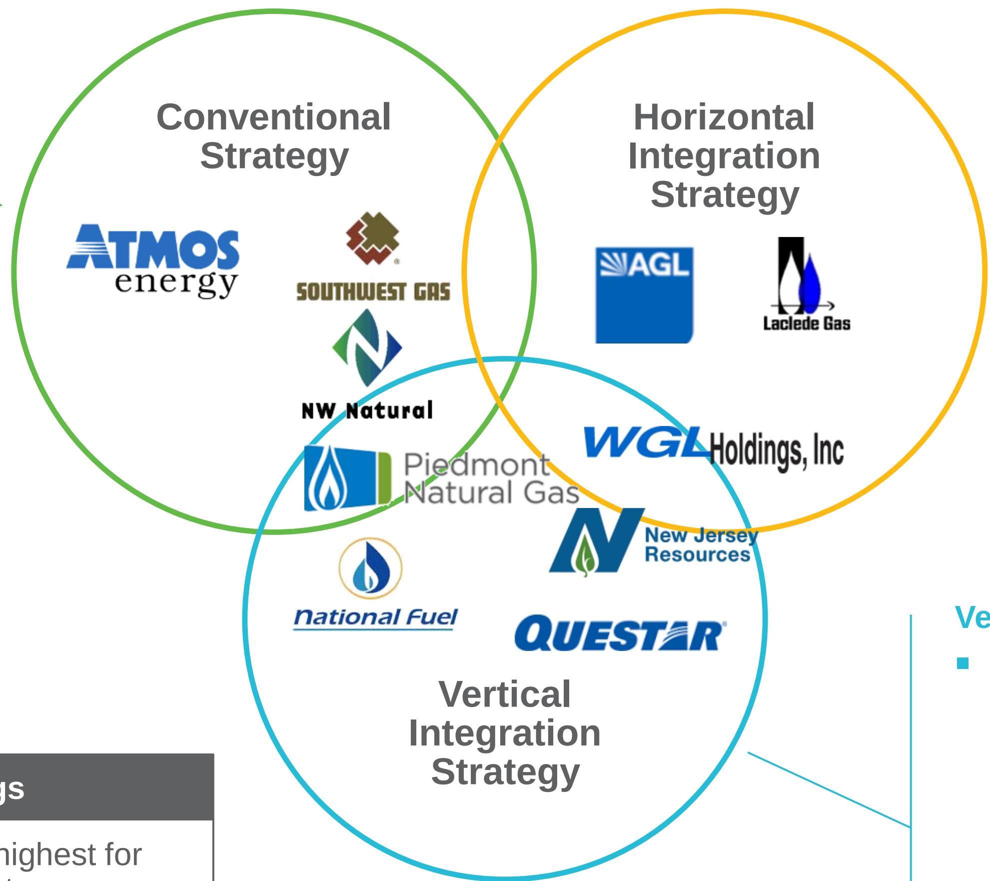
Key Points

- While we see three varying strategies, none are pure or distinct; rather, companies participate across strategic categories
- Therefore, we categorized based on Wall Street's view of each company's strategy which generally coincides with…
  - Materiality of investments
  - Clarity of communication with the Street

Where Companies Are Viewed Today

Conventional Strategy

- ATMOS appears to be the purest of the Conventional Strategy plays
- Piedmont Natural Gas appears to be Conventional, but moving to a Vertical Integration Strategy, although its in the early stages



Horizontal Strategy

- Laclede Group appears to be the purest of the Horizontal Growth plays, shedding its service business and concentrating on LDC acquisitions
- WGL, while once pursuing a Horizontal Strategy, appears to be moving aggressively toward Vertical Integration Strategy

Vertical Strategy

- QUESTAR is the purest of the Vertical Integration plays, followed by National Fuel; QUESTAR has been pursuing this strategy since the early ’80s
- Others appear to be headed toward a Vertical Integration Strategy, but returns still lag

Summary Findings

- Returns were consistently highest for the Vertical Integration Strategy category
- Companies pursuing the Vertical Integration Strategy utilize unregulated assets to raise overall financial performance

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Panel Company Strategies – Another View

	Company	Strategy			Equity Market's View of Strategy
		Conventional	Horizontal	Vertical	
Conventional Strategy	Company A				▪ Rate cases
	Company B				▪ Rate cases and small gas storage
	Company C				▪ Rate cases and small energy construction services business
Horizontal Integration	Company D				▪ Organic growth + growth through acquisitions of local distribution companies and midstream investments
	Company E				▪ Growth through acquisitions (LDCs/utilities)
	Company F				▪ Growth through retail energy marketing, but shifting focus to midstream (pipeline) equity investments
Vertical Integration	Company G				▪ Upstream and midstream acquisitions/ownership
	Company H				▪ Organic growth + investments in natural gas production from cost-of-service reserves
	Company I				▪ Growth through midstream assets, expansion into clean energy (solar and wind) and energy services
	Company J				▪ Organic growth through utility territory; shale gas distribution through pipeline projects; storage and delivery of natural gas to power generation facilities

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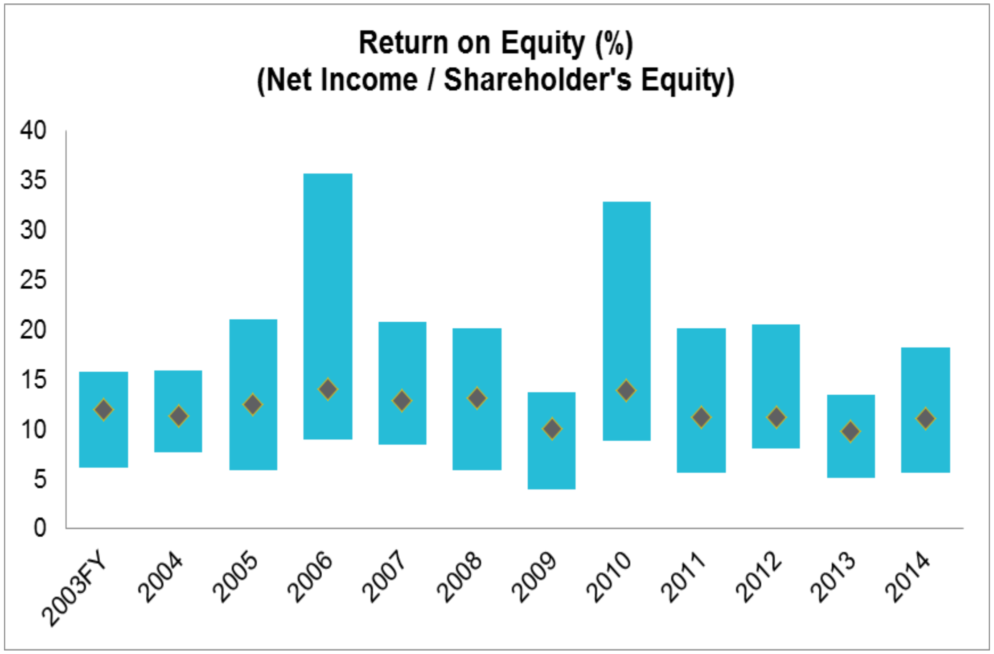
ROE and DuPont Decomposition of Panel Companies

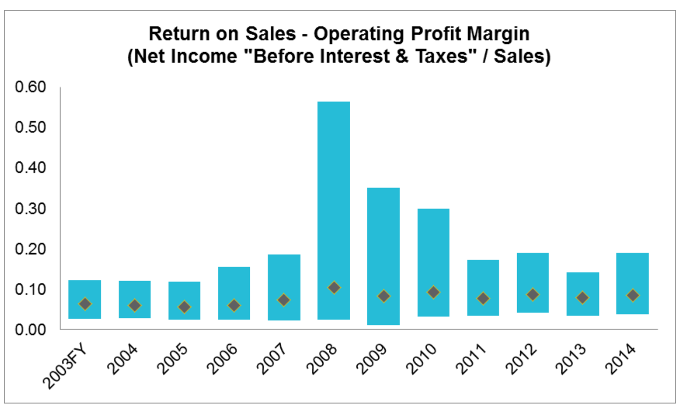
ROE and the DuPont Decomposition Analysis

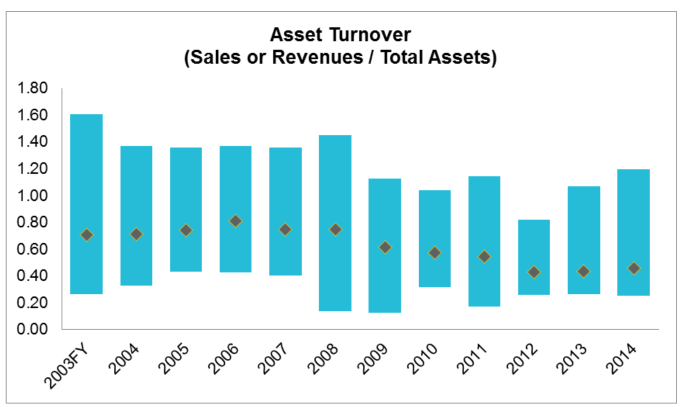
- Using the DuPont Decomposition Analysis, ROE is broken down into the three components that ultimately drive results—ROS, asset turnover, and equity multiplier (or leverage)

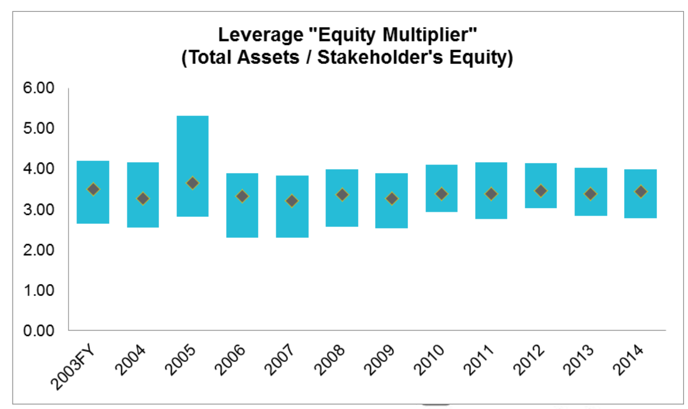


- As an industry, performance is steady…remarkably steady
- However, the variability between the highest ROE and the lowest ROE is surprisingly high, especially during certain years
- Asset turnover seems to be the differentiating factor separating high-performance LDCs from the pack
- Since 2008, asset turnover across the industry has dropped from pre-2008 levels, even among the highest performing LDCs
- ROS is steady as an industry, but some strategies are producing higher ROS than others; 2008 – 2010 ROS was high due to more rate increases across the panel than normal
- Leverage, with the exception of 2005, has remained steady, regardless of varying strategies

Min/Max Range
Average







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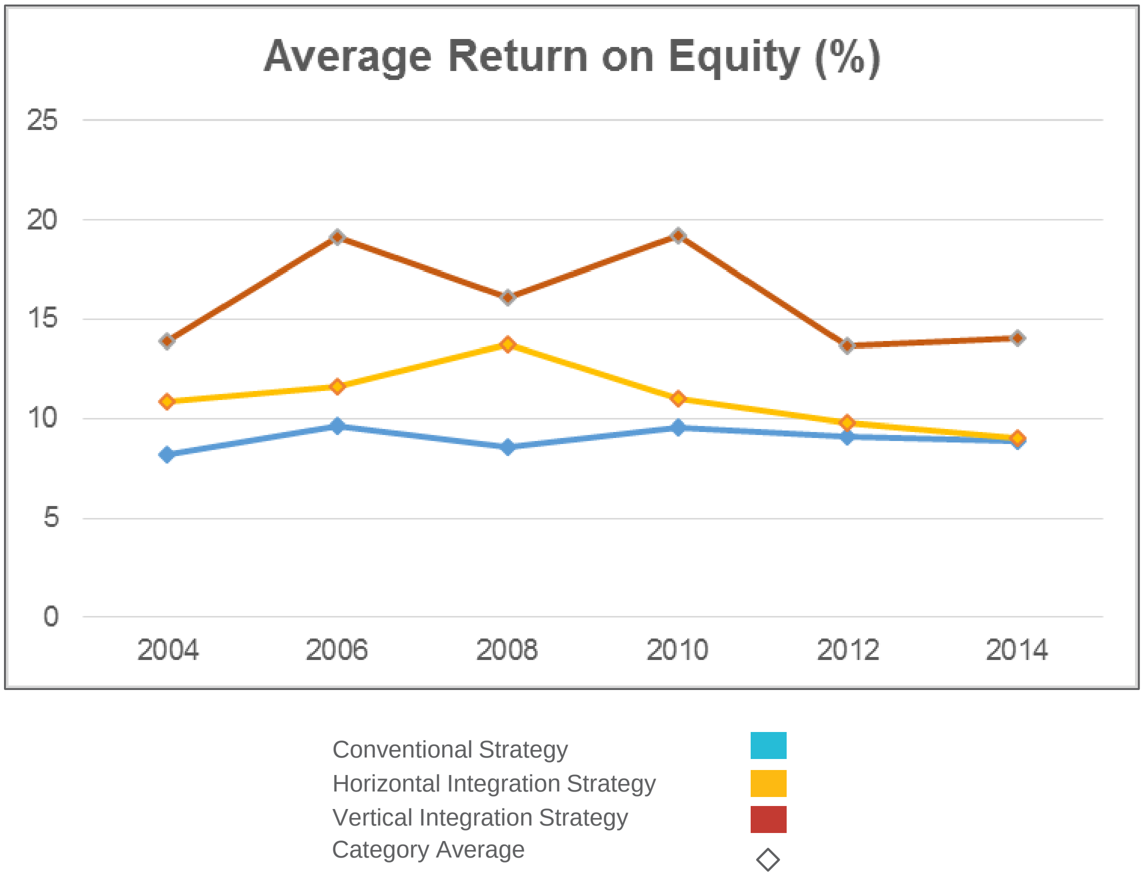
Panel Company Strategy Results

Average ROE Across Strategies

Strategies Produce Substantively Different Results

- As the chart below indicates, the Vertical Integration Strategy has produced substantively higher ROE in each of the last 10 years



Key Takeaways

- The Conventional Strategy—conserve cash for dividends and manage the regulatory compact—produces the most consistent results; however, it also produces the lowest ROE over the 10-year study
- The Horizontal Integration Strategy produced consistently better returns during the 2004 to 2010 timeframe, but returns have since converged with the Conventional Strategy returns
  - This phenomenon can best be explained by the transition of one company's strategy from growth via field service businesses to growth through acquisition of other LDCs, resulting in significantly lower returns
- The Vertical Integration Strategy has consistently produced higher ROE
  - ROE among this group of panel companies has consistently been 50% to 100% higher than the Conventional Strategy group

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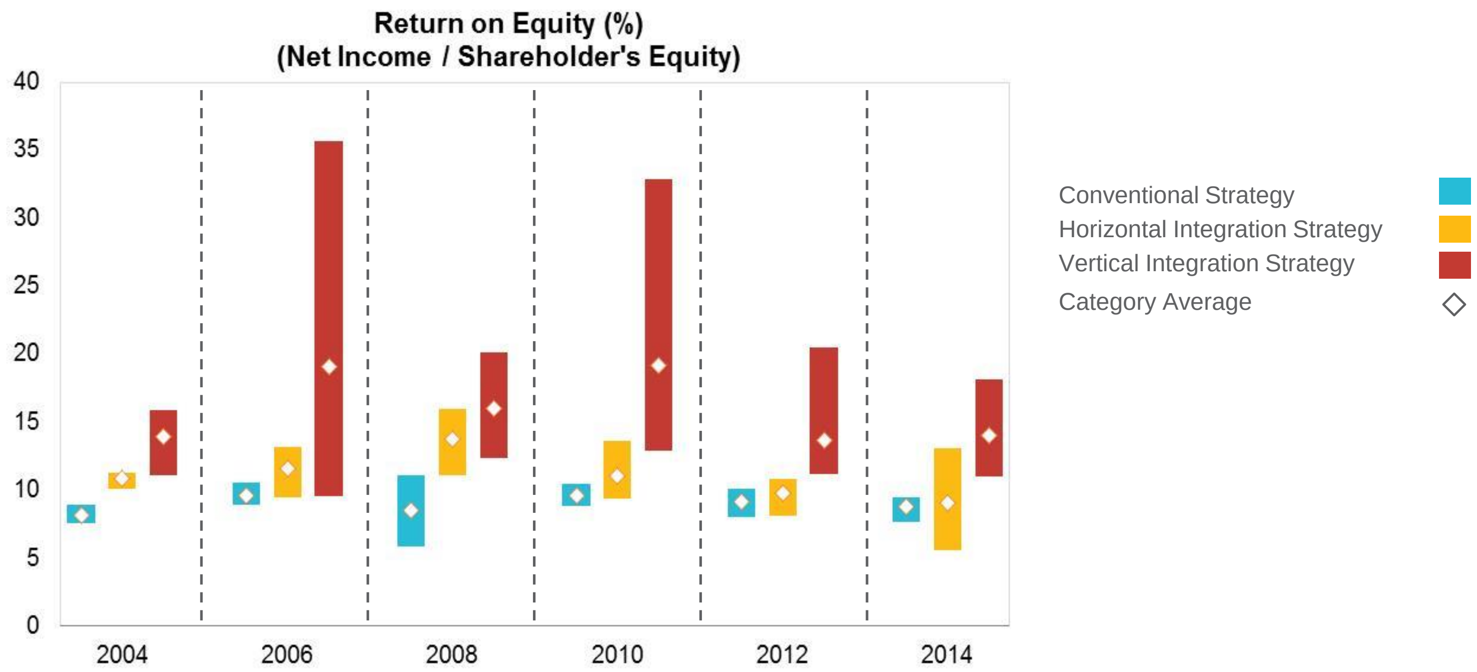
Variability of ROE Across Strategies

Findings

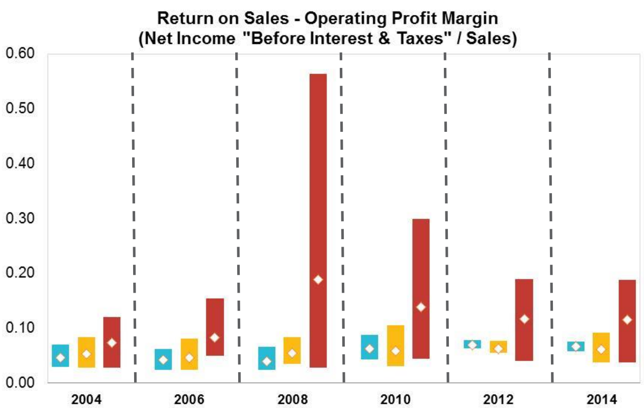
- When we look at variability of returns across the strategies, we find the following:
  - Least performance variability among the Conventional Strategy or dividend play companies
  - Highest performance variability with the Vertical Integration Strategy companies
- While this difference in variability may simply be the risk-return paradigm, there may be a more interesting finding here
  - When we analyzed the operational performance, we found that the best run companies, even in the Vertical Integration Strategy, performed fairly consistently
  - This suggests that for those utilities venturing out of the Conventional Strategy, execution matters greatly

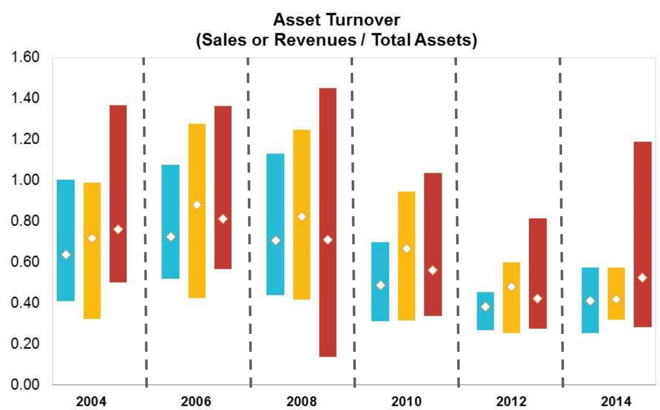


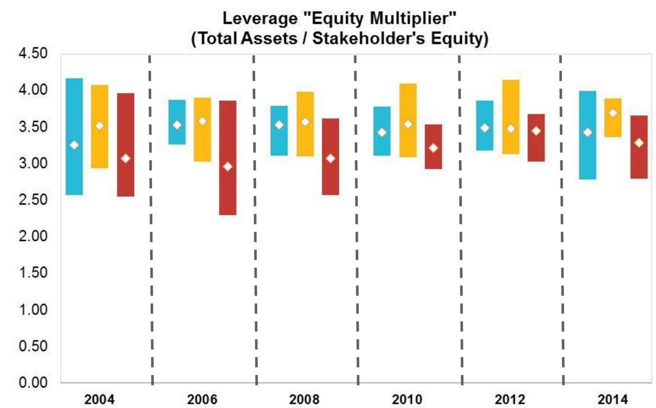
DuPont Decomposition by Panel Company Strategy

Findings

- When ROE is broken down into its components—ROS, asset turnover, equity multiplier—it can be seen that the entire panel, regardless of strategy, depends most on ROS to generate higher ROE
- The Vertical Integration Strategy companies have leveraged asset turnover more than the other strategies
  - This indicates that these companies are buying more productive assets than the regulated assets they own
  - Conversely, the Horizontal Integration Strategy companies are adding less-productive assets
    - Again, one company in this strategic category is driving the lower results as it shifts from unregulated, low asset-intensive businesses to regulated, asset-heavy businesses
- Finally, the use of leverage tended to be the most steady, and least-utilized, tool to manage ROE

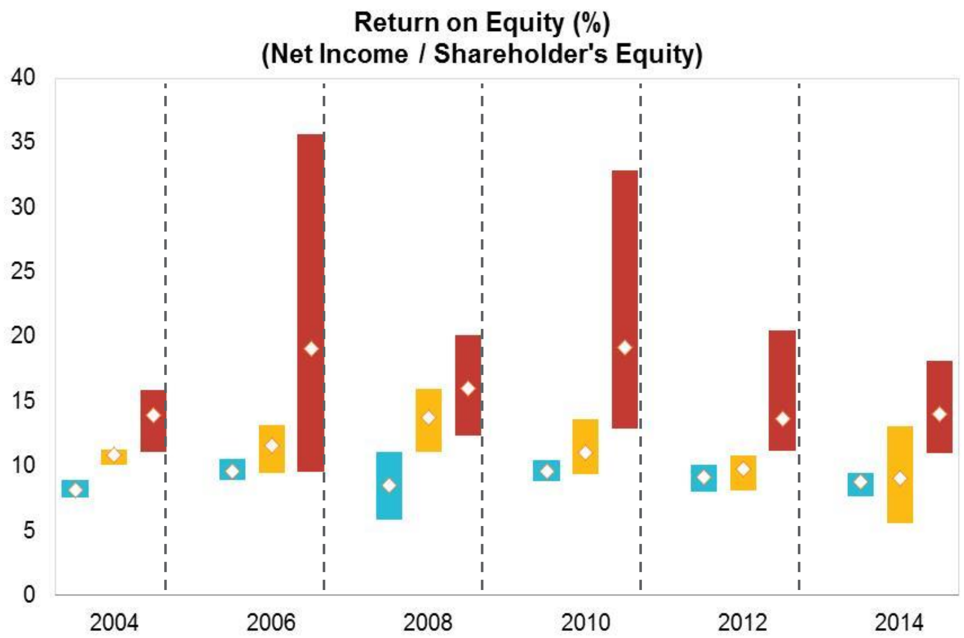






Conventional Strategy
Horizontal Integration Strategy
Vertical Integration Strategy
Category Average

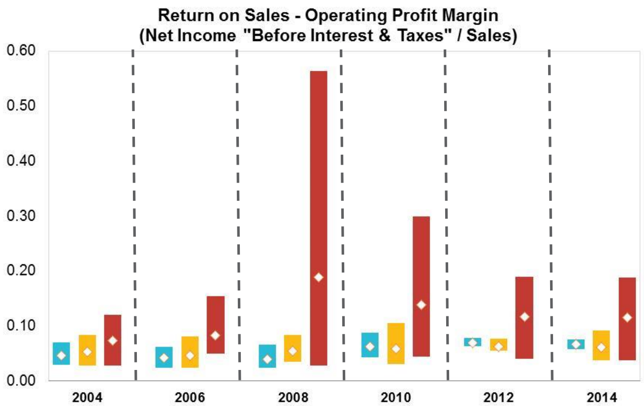
Putting It All Together – Here Is What We Found

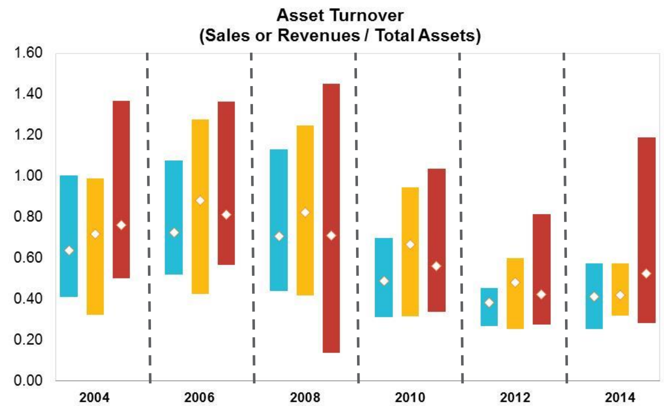


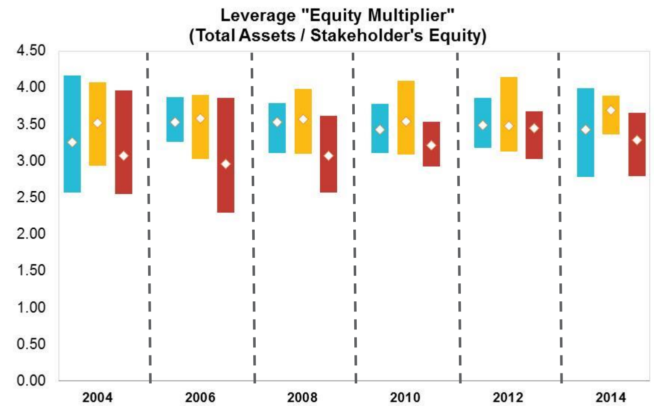
Key Takeaways:

- Some strategies create more value than others
  - The lowest performing Vertical Integration Strategy outperforms the best Conventional Strategy
  - The Conventional Strategy creates the least shareholder value but provides most the consistent results
- However, with risk comes variability, just like the textbook says
- Finally, when LDCs venture away from the Conventional Strategy, how it executes matters…big time
  - LDCs that manage all three components of ROE do better than those that do not

Conventional Strategy
Horizontal Integration Strategy
Vertical Integration Strategy
Category Average







Example Company-Specific Analyses

Example Company-Specific Analyses

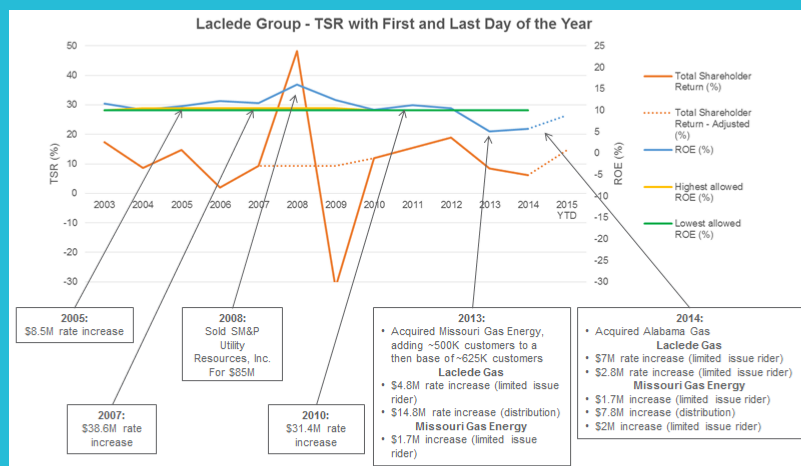
Introduction to Company Analyses

Company-Specific Analyses

- In addition to the general panel company findings, executives can access detailed analysis for individual companies by contacting us
- Executives can access TSR, correlation of that return to ROE, and a breakdown of ROE using DuPont Decomposition Analysis to understand what was driving ROE
- With this data, executives are able to assess ways to improve shareholder value creation with specific strategies

Example Analyses

Stages of Financial Analyses



ScottMadden Perspectives

- Between 2012 and 2014, return on sales was significantly higher than other years
- Asset turnover has declined steadily since 2008 and significantly in 2013 and 2014
  - This trend appears to be driving the overall decrease in ROE since 2012
  - Moreover, this trend coincides with the strategy shift from growing utility services businesses to acquiring other LDCs
- The equity multiplier has been relatively consistent since 2008
- Laclede Group stock has languished, similar to the ROE results over the past three years; however, when we add the first two quarters of the 2015FY, the stock seems to be gaining momentum
  - That said, the 2015FY stock movement may simply be the result of one of the longest and coldest winters on record rather than the payoff of Laclede's strategy
    - This finding is based on 1) weather in degree days, and 2) the low asset turnover level and flat leverage level Laclede continues to see

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