Weekly Trends

PRIVATE CLIENT SOLUTIONS

Larbi Moumni, Equity Specialist

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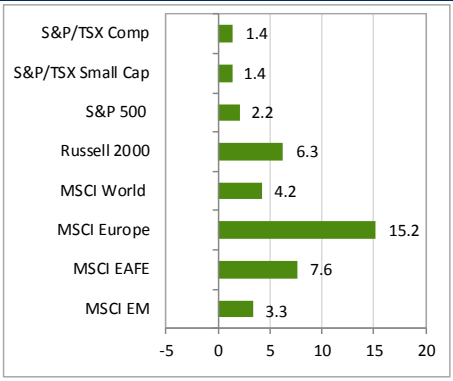
Why We Are Underweight Utilities

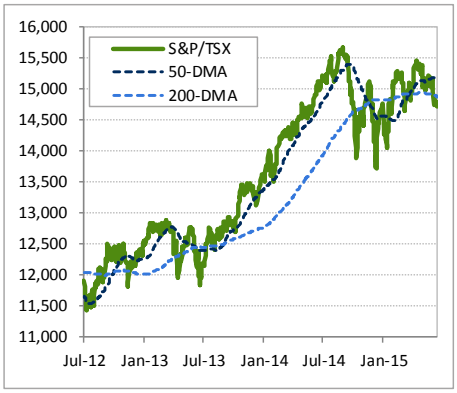
- After energy and industrials, the Canadian utilities sector has been the third worst performer YTD, down 4.6%, while the S&P/TSX Composite Index is up 1.4%.
- The utility sector is very capital intensive, pushing companies to take on debt, meaning higher interest rates may result in higher interest payments and lower earnings per share.
- There is an inverse correlation between utilities performance and interest rate direction; when rates rise utilities underperform.
- Our favorite players within the sector are electric utility companies with exposure to renewable generation as they may experience stronger growth.
- We prefer Northland Power (NPI-T), which we own in the Canadian Growth Guided Portfolio. The stock is up 6.8% YTD, while the S&P/TSX Utilities Index is down 4.6%.

Equity Market YTD Returns (%)



Canadian Sector	TSX Weight	Recommendation
Consumer Discretionary	6.7	Overweight
Consumer Staples	3.8	Market weight
Energy	20.4	Market weight
Financials	35.2	Market weight
Health Care	6.0	Market weight
Industrials	7.7	Overweight
Information Technology	2.5	Overweight
Materials	10.7	Underweight
Telecom	4.8	Market weight
Utilities	2.1	Underweight

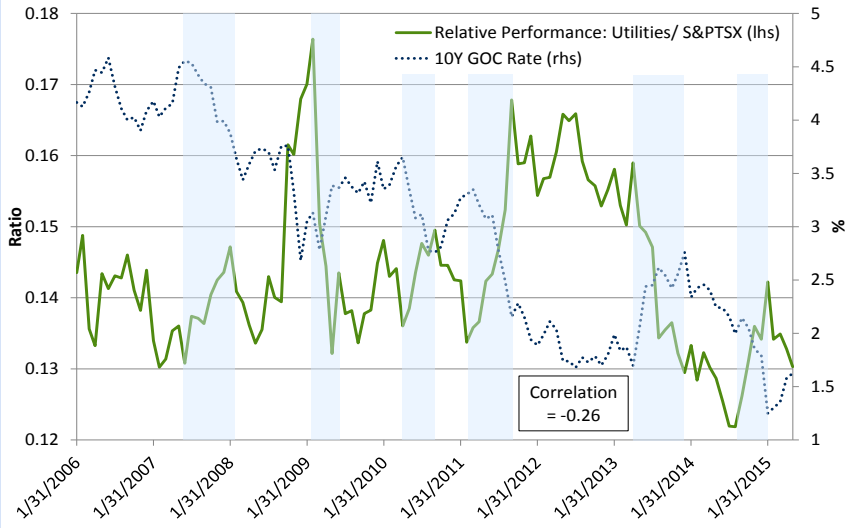
Technical Considerations	Level	Reading
S&P/TSX Composite	14,844.3	
50-DMA	15,079.1	Downtrend
200-DMA	14,854.0	Downtrend
RSI (14-day)	48.8	Neutral



Source: Bloomberg, Raymond James Ltd.

Chart of the Week

Inverse Relation Between Interest Rates & Utilities



Source: Bloomberg, Raymond James Ltd.

Raymond James Ltd. 5300-40 King St W. | Toronto ON Canada M5H 3Y2.
2200-925 West Georgia Street | Vancouver BC Canada V6C 3L2.

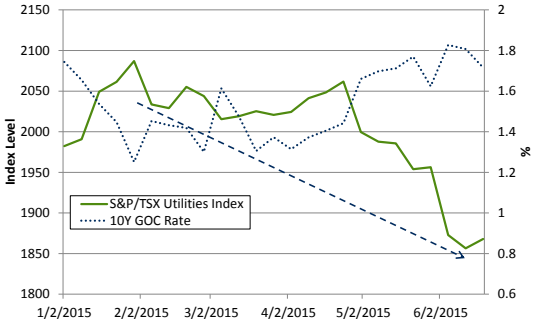
Why We Are Underweight Utilities

After energy and industrials, the Canadian utilities sector has been the third worst performer YTD, down 4.6%, while the S&P/TSX Composite Index is up 1.4%. The utilities sector, which represents only 2.1% of the S&P/TSX Composite Index (S&P/TSX), is heavily affected by interest rates. As shown in the chart to the right, as rates continue to rise, utilities may be driven lower. We remain underweight the sector over concerns of a Federal Reserve (Fed) interest rate hike, which could lead to both US and Canadian yields rising and result in an underperformance of utilities in the long term.

The utility sector is very capital intensive, pushing companies to take on debt, meaning higher interest rates may result in higher interest payments and lower earnings per share. Monetary policy changes, including an anticipated increase in interest rates, can hamper utility returns. Expectations are that the Fed will raise rates later this year and the Bank of Canada will in 2016, which could hurt many utility valuations. In addition, the increased cost of debt when refinanced will lead to lower profitability and growth prospects for the industry.

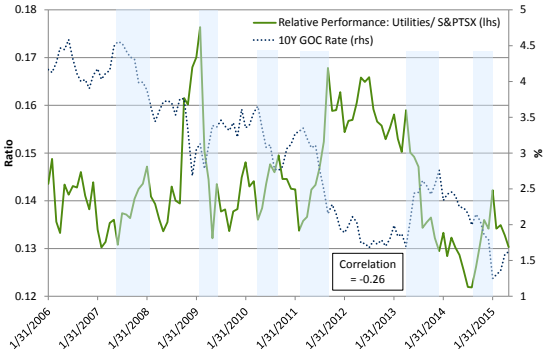
The chart to the right shows the relative performance of the utilities sector against the S&P/TSX compared to the 10Y GOC Yield since 2006. There is an inverse correlation between utilities performance and interest rate direction; when rates rise utilities underperform. Hence, given our belief that rates could rise later this year and/or in 2016, our recommendation is to be underweight the Canadian utilities sector.

Decline in Utilities Index vs. Rising 10Y GOC YTD



Source: Bloomberg, Raymond James Ltd.

Relative Sector Performance vs. the 10Y GOC Rate since '06



Source: Bloomberg, Raymond James Ltd.

Where Does the Growth Lie?

Our favorite players within the sector are electric utility companies with exposure to renewable generation as they may experience stronger growth. Renewable energy projects are being driven by country-specific renewable generation targets, technological innovations, and policy incentives that could make renewable energy more competitive and profitable. Certain countries in North America, Europe, and Asia have specific renewable energy targets. For instance, in the US, individual states are imposing a Renewable Portfolio Standard (RPS) which requires a certain portion of total energy production (20-40%) to come from renewables such as solar, wind, biomass, or geothermal. In addition, technological innovation in the space is leading to more efficient solar and wind farms and lowering their costs. Finally, government incentives such as feed-in tariffs, rebates, and tax credits allow renewable energy to be competitive with cheaper alternatives such as coal and natural gas.

With this in mind, we prefer **Northland Power (NPI-T)**, which we own in the Canadian Growth Guided Portfolio. NPI-T develops, builds, owns and operates thermal, hydro, wind and solar power generation projects, mainly in Ontario, Quebec and Saskatchewan. It also has smaller operations in the US and Germany. Its main expansion projects are focussed in the North Sea. Its facilities generate over 1,300 MW of electricity. FY14 revenue totalled $760 mln. The stock is up 6.8% YTD, while the S&P/TSX Utilities Index is down 4.6%. Our bullish view on NPI-T is predicated on the following factors:

- **Gemini**: Northland Power has a 60% stake in its North Sea Gemini project. Gemini is a 600 MW (360 MW net to Northland, 28% of Northland's current MW generation capacity) wind project in advanced development located 53 miles off the coast of the Netherlands in the North Sea. Once complete, Gemini will be one of the world's largest wind farms and produce enough electricity to power more than 785,000 households. Northland has a 15-

year revenue contract with the Dutch government and significant cash flow should be realized when Gemini reaches full commercial production in 2017.

- **Nordsee**: Northland agreed in September 2014 to take a majority 85% share in three German offshore windfarms. The key project is Nordsee One, a 282 MW project (net to Northland) currently in advanced development (again, a significant 21% of the company's current capacity). The total estimated project cost of Nordsee One is EUR1.2 bln, but once operational in 2017–18 it is expected to generate enough electricity to meet the needs of 400,000 German households. If the deal is finalized (a decision is expected in H1 2015), Northland's total offshore North Sea wind portfolio, including Gemini, would equate to 642 MW, nearly 50% of the company's current capacity.
- **Non-Gemini and non-Nordsee**: Growth Excluding Gemini and Nordsee, management is still forecasting strong EBITDA growth over the next several years from its existing project pipeline as it has nearly 120 MW of other capacity in advanced development stages. Management expects EBITDA to grow from $263 mln last year to between $380-400 mln by 2015.
- **Management Skin In the Game**: Management has a vested interest through a 39% ownership interest and has executed well by growing operating capacity from ~450 MW in 2008 to 1,329 MW currently.
- **Dividend**: Dividend increases are unlikely until Gemini and Nordsee are fully operational but the current 6.6% yield is attractive and likely safe barring any serious downturn in Northland's business. 2013 free cash flow totalled $130 mln and operating cash flow totalled $257 mln vs. a total dividend expense (including DRIP program) of $132 mln. Excluding DRIP, the dividend expense was $99 mln (i.e., 76% free cash flow payout ratio). Northland's credit rating was also upgraded by S&P from BBB- to BBB Stable in November 2013.

Conclusion

We remain underweight the utility sector given our belief that rates could rise later this year and/or in 2016. Despite this concern, we remain constructive on NPI-T due to its strong exposure to renewable energy, strong management, and solid dividend.

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A member of the PCS team responsible for preparation of this newsletter or a member of his/her household has a long position in the securities of Northland Power Inc. (NPI-T).