



Middlesex Water Company Research (12/2/19)

Description: Middlesex Water Company owns and operates regulated water utility and wastewater systems. It operates in two segments, Regulated and Non-Regulated. The Regulated segment engages in collecting, treating, and distributing water on a retail and wholesale basis to residential, commercial, industrial, and fire protection customers in parts of New Jersey, Delaware, and Pennsylvania. This segment also includes regulated wastewater systems in New Jersey and Delaware. The Non-Regulated segment provides non-regulated contract services for the operation and maintenance of municipal and private water and wastewater systems in New Jersey and Delaware. Middlesex Water Company was founded in 1897 and is headquartered in Iselin, New Jersey.

Ticker: MSEX

Price: \$62.81

Market Cap: \$1.1B

Performance YTD: +19.7%

Dividend Yield: 1.64%

MSEX is a water utility company and is not something that is going to experience any kind of significant growth like that of the usual tech companies the mainstream media follows. The company was formed back in 1897 and revenue growth has been pretty sluggish over the last several years. In fact, 2019 is shaping up to be a drop in growth similar to 2017.

Income Statement		Dec 2009	Dec 2010	Dec 2011	Dec 2012	Dec 2013	Dec 2014	Dec 2015	Dec 2016	Dec 2017	Dec 2018	TTM
Revenue												
Revenues		91.2	102.7	102.1	110.4	114.8	117.1	126.0	132.9	130.8	138.1	135.1
Total Revenues		91.2	102.7	102.1	110.4	114.8	117.1	126.0	132.9	130.8	138.1	135.1

Water utility companies have been on a tear over the year as seen by MSEX and its peers like that of American Water Works (AWK), Aqua America (WTR), American States Water Co. (AMR), California Water Services Group (CWT), and SJW Corp (SJW).



Year-to-date, AWK leads the pack up over 35% followed by WTR, SJW, MSEX, and CWT. With these big gains this year, the real question now is whether MSEX is still worth grabbing.

Based on CUBE's research, right now doesn't seem like the best time to really touch many of the water utility companies but even more so the case with MSEX. The reasons are many:

1. Expensive fundamentally (P/E, EV/Sales, Debt/EV, etc)
2. Dividend Yield not attractive enough at 1.7%
3. Heavy debt
4. Free cash flow not strong enough

To kick this off, when examining a company like MSEX the most important areas we are looking at include free cash flow and consistent earnings because MSEX is not a growth company. It is a company you invest in for safety and income generation through dividends. Unfortunately, when examining MSEX's financials we aren't confident enough that that is the case.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Operating Revenues	\$ 37,769	\$ 38,713	\$ 101,859	\$ 104,809
Operating Expenses:				
Operations and Maintenance	17,669	18,114	50,569	52,773
Depreciation	4,246	3,792	12,415	11,137
Other Taxes	3,871	3,889	10,913	10,910
Total Operating Expenses	25,786	25,795	73,897	74,820
Operating Income	11,983	12,918	27,962	29,989
Other Income (Expense):				
Allowance for Funds Used During Construction	871	424	2,030	805
Other Income (Expense), net	(4)	409	(142)	1,277
Total Other Income, net	867	833	1,888	2,082
Interest Charges	1,996	1,723	4,984	4,929
Income before Income Taxes	10,854	12,028	24,866	27,142
Income Taxes	(265)	(262)	(952)	1,683
Net Income	11,119	12,290	25,818	25,459
Preferred Stock Dividend Requirements	30	36	102	108
Earnings Applicable to Common Stock	\$ 11,089	\$ 12,254	\$ 25,716	\$ 25,351
Earnings per share of Common Stock:				
Basic	\$ 0.67	\$ 0.75	\$ 1.56	\$ 1.55
Diluted	\$ 0.66	\$ 0.74	\$ 1.55	\$ 1.54
Average Number of				
Common Shares Outstanding:				
Basic	16,610	16,394	16,520	16,379
Diluted	16,757	16,550	16,673	16,535

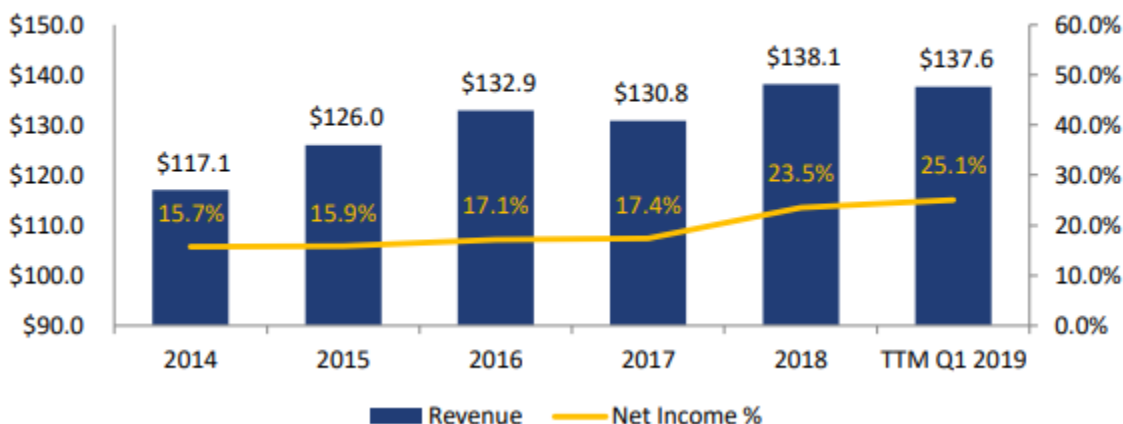
One of the first things we notice when looking at MSEX is that revenues are struggling and are going to come in down Y/Y which is the first negative sign. While we aren't looking for exploding growth, we would like to see a sustained move higher year in and year out. Additionally, and much more importantly, we noticed a few other things:

1. Operating income margins fell from 28.61% to 27.45%
2. Excluding the income tax benefit for the year, income before taxes actually fell from \$27.1M to \$24.9M.
3. EPS year-to-date may be flat but if MSEX has another down quarter it will be down Y/Y as seen by a fall in EPS from \$0.75 in Q3 of 2018 vs. \$0.67 this past quarter

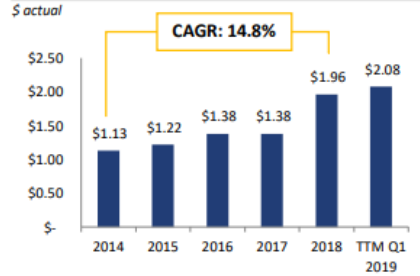
Below is a screenshot from the company's Q1 presentation earlier this year at an investor conference. If we fast forward to Q4 where we are now, the picture isn't as bright. Trailing twelve months (TTM) revenue is now \$135.1M which vs. \$137.6M after Q1 and net income margins are now 24.3% TTM vs. 25.1% earlier this year and only up 0.8% Y/Y. After Q4, there is a solid possibility net income margin may be lower than 2018 on top of much lower revenue in the \$134M range.

Financial History

\$ in millions



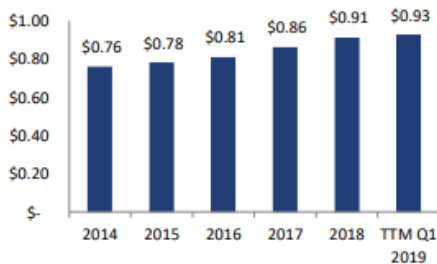
Diluted Earnings Per Share



On the EPS front, the same applies here. Fast forward to where we are now and TTM is \$1.96 – flat with 2018 and after Q4 will most likely be lower than 2018.

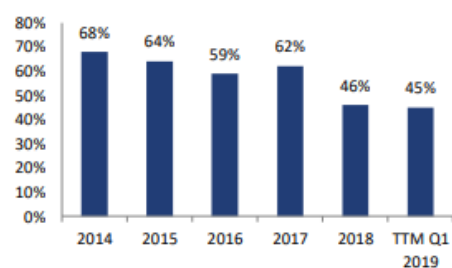
Dividends Paid

\$ actual per share



Dividend Payout Ratio

% of earnings per share

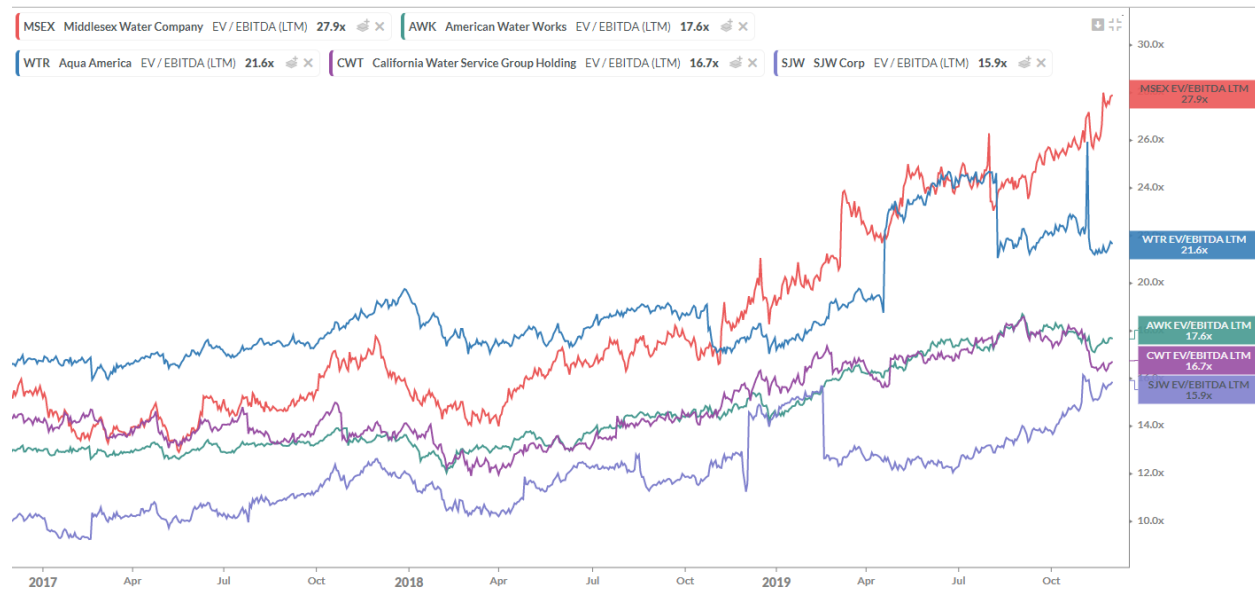


As for dividends, we must give credit where credit is due. MSEX has successfully increased their dividend for 46 straight years. The issue here is that the dividend yield has fallen by quite a large margin from the 4% level to 1.7% today – making it much less appealing.



If we compare MSEX to their notable peers mentioned above, it doesn't make the case any better for MSEX.

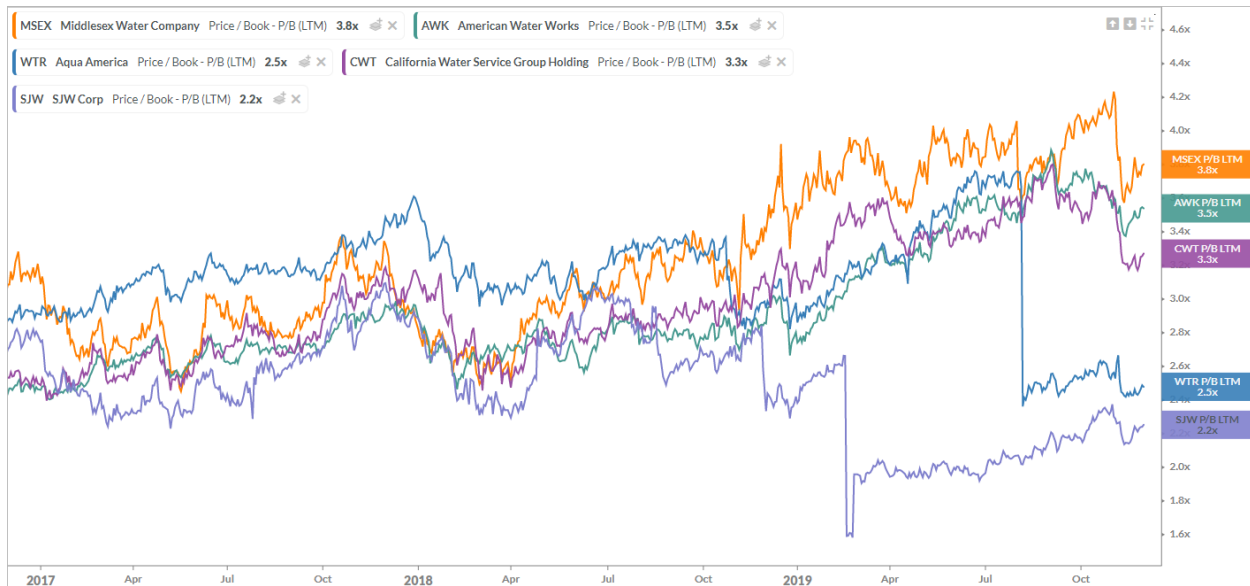
From an Enterprise Value (Market Cap + Debt – Cash) to EBITDA standpoint, MSEX is much more expensive at nearly 28x while the others float around the mid-teens except for WTR which is at 21.6x.



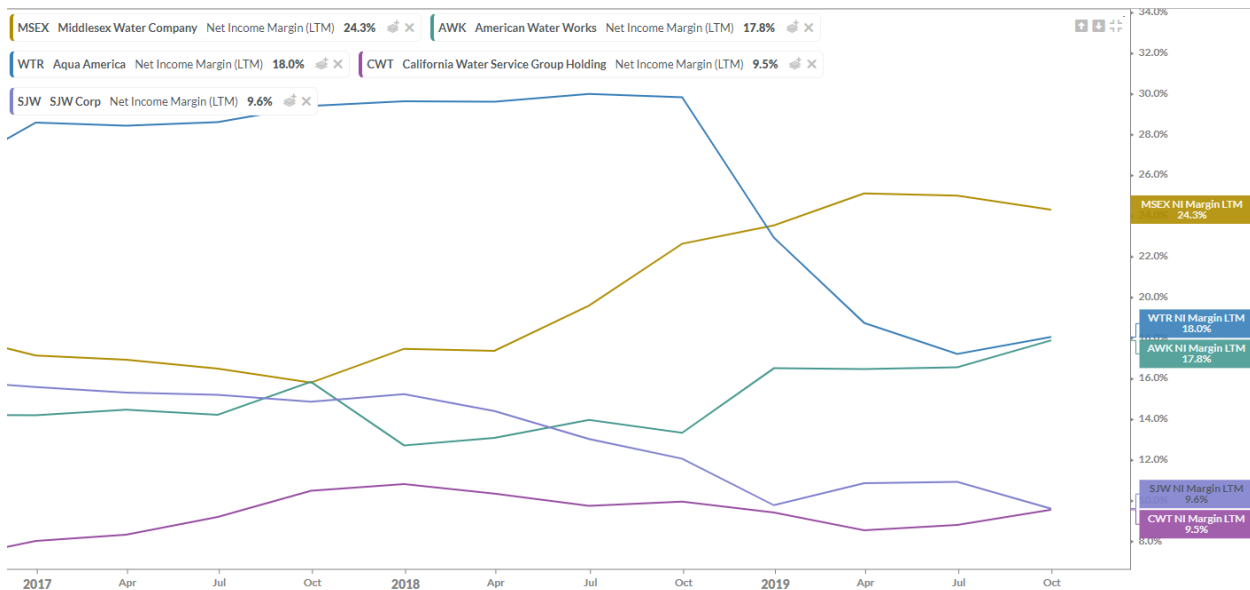
On a P/E basis, MSEX is far better positioned in the low 30s but with their falling margins and revenues, the forward P/E could be higher for the company and as far utilities goes this is fairly expensive across the board for all the names.



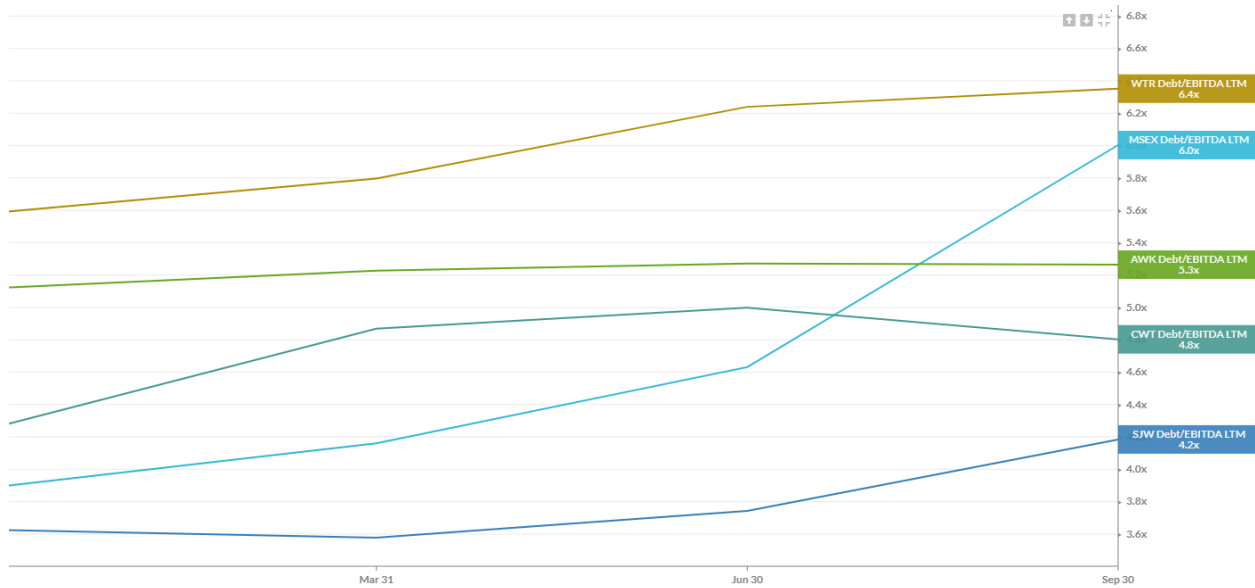
On a Price to Book ratio, MSEX leads the group at almost 4.0x.



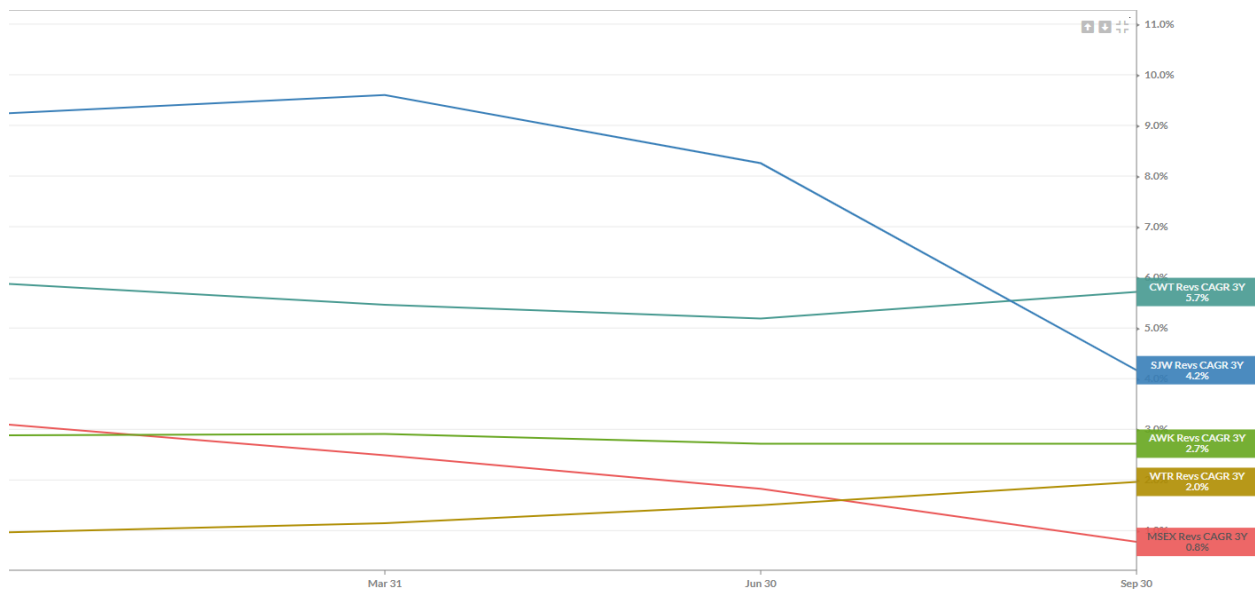
With regards to margins like originally spoken about, MSEX is actually doing the best at 24.3%.



When looking at debt to earnings before interest, taxes, depreciation, and amortization (EBITDA), MSEX is the second highest at a whopping 6.0x. Frankly, all of these companies are loaded with debt and that makes the whole industry pretty concerning.



When looking at revenue growth rates compounded over the last three years, MSEX is growing the slowest at less than 1.0% while the other are in the 2-6% range.



Looking at the company's balance sheet there are some concerns as well. Firstly, cash on hand stands at a mere \$3.1M while debt sits at \$228M. When looking at the cash flows, MSEX has pretty much been relying on recycling debt to keep the dividend paid as levered free cash flow over the last twelve months has been -\$50.2M.

		September 30, 2019	December 31, 2018
ASSETS			
UTILITY PLANT:	Water Production	\$ 157,970	\$ 156,423
	Transmission and Distribution	536,367	512,202
	General	80,635	74,371
	Construction Work in Progress	69,651	32,878
	TOTAL	844,623	775,874
	Less Accumulated Depreciation	166,873	157,387
	UTILITY PLANT - NET	677,750	618,487
CURRENT ASSETS:	Cash and Cash Equivalents	3,151	3,705
	Accounts Receivable, net	13,407	11,762
	Unbilled Revenues	9,417	7,293
	Materials and Supplies (at average cost)	5,159	5,411
	Prepayments	3,577	2,644
	TOTAL CURRENT ASSETS	34,711	30,815
DEFERRED CHARGES AND OTHER ASSETS:	Operating Lease Right of Use Asset	6,133	—
	Preliminary Survey and Investigation Charges	2,252	5,254
	Regulatory Assets	100,320	99,236
	Restricted Cash	53,927	1,956
	Non-utility Assets - Net	10,306	9,989
	Other	1,954	2,093
	TOTAL DEFERRED CHARGES AND OTHER ASSETS	174,892	118,528
	TOTAL ASSETS	\$ 887,353	\$ 767,830
CAPITALIZATION AND LIABILITIES			
CAPITALIZATION:	Common Stock, No Par Value	\$ 170,562	\$ 157,354
	Retained Earnings	105,233	91,433
	TOTAL COMMON EQUITY	275,795	248,787
	Preferred Stock	2,084	2,433
	Long-term Debt	228,272	152,851
	TOTAL CAPITALIZATION	506,151	404,071
CURRENT LIABILITIES:	Current Portion of Long-term Debt	7,161	7,343
	Notes Payable	58,500	48,500
	Accounts Payable	20,178	19,325
	Accrued Taxes	12,132	14,230
	Accrued Interest	799	1,289
	Unearned Revenues and Advanced Service Fees	1,048	1,036
	Other	3,657	2,640
	TOTAL CURRENT LIABILITIES	103,475	94,363
COMMITMENTS AND CONTINGENT LIABILITIES (Note 7)			
DEFERRED CREDITS AND OTHER LIABILITIES:	Customer Advances for Construction	22,682	22,572
	Operating Lease Obligation	5,908	—
	Accumulated Deferred Income Taxes	50,947	47,270
	Employee Benefit Plans	27,826	30,661
	Regulatory Liabilities	72,000	79,112
	Other	2,567	2,730
	TOTAL DEFERRED CREDITS AND OTHER LIABILITIES	181,930	182,345
CONTRIBUTIONS IN AID OF CONSTRUCTION		95,797	87,051
	TOTAL CAPITALIZATION AND LIABILITIES	\$ 887,353	\$ 767,830

In fact, MSEX just recently did something very interesting. Instead of raising more debt, the company did a secondary offering of shares to raise cash. On November 20th, the company priced its underwritten public offering of 661,157 common shares at \$60.50 per share, for gross proceeds of ~\$40M (up from ~\$35M). So the company is currently sitting on around \$43M worth of cash now which puts them in a much better position to continue paying their dividend. Upon further review, it seems this will be used for other purposes, though.

In the most recent 10Q, the company has a multi-year capital construction program, Water for Tomorrow, which encompasses numerous projects designed to upgrade and replace utility infrastructure as well as enhance the integrity and reliability of assets to better serve the current and future generations of water and wastewater customers. The company plans to invest approximately \$105 million in 2019 in connection with this plan for projects that include, but are not limited to;

1. Construction of a 4.6 mile water transmission pipeline to provide critical resiliency and redundancy to the Company's water transmission system in New Jersey
2. Replacement of four miles of water mains including service lines, valves, fire hydrants and meters in Carteret, New Jersey
3. Enhanced treatment process at the Company's largest water plant in Edison Township, New Jersey, to mitigate the formation of disinfection by-products that can develop during treatment
4. Relocation of water meters from inside customers' premises to exterior meter pits to allow quicker access by crews in emergencies, to enhance customer safety and convenience and to reduce unmetered water
5. Additional standby emergency power generation

Upon even further review we also found this:

The capital investment program for 2019 is currently estimated to be approximately \$105 million. Through September 30, 2019, we have expended \$61 million and expect to incur approximately \$44 million for capital projects for the remainder of 2019.

So, while it did at first seem like the company may be using those proceeds to stay more liquid and pay down debt and better secure the dividend, it looks like all of it is going into the above project. This has its pros because it can lead to better growth in the long-term but in the short-term has us more worried about liquidity and free cash flow.

With all this in mind, CUBE believes MSEX isn't the best investment to make at this time, especially in the \$62-63 price range, as we feel the company is quite expensive and has some fundamental issues with cash, cash flow, margins, and growth. It is still uncertain how the company is going to increase cash flow to secure the dividend let alone grow the dividend and, honestly, at a 1.7% yield there are much less risky names with higher yields and far better balance sheets to invest in.

Technical Analysis



When looking at the charts, MSEX did a solid job bouncing off of its 200DMA (not seen here) but CUBE believes the stock will have some trouble getting back above its 50DMA of \$63.38. If it does, the stock should see resistance at \$64.01 followed by even more resistance at \$65.61. To the downside, the 100DMA should serve as support at \$61.05. If that doesn't hold the next support line is the 200DMA of \$59.67. The stock is looking overbought on the W%R and nearing that on the MFI but not quite there on the RSI. Short-term, CUBE expects the stock to try those previously mentioned resistance levels but get denied.