Utilities aren’t exactly known for high drama. But forces beyond their control are pushing them to pursue increasingly dramatic mergers and acquisitions (M&A).

Over the past year, there have been nearly $100 billion worth of deals announced among U.S. electric and gas utilities. And we expect more to come.

As income investors, takeovers can be a bittersweet experience. On the one hand, acquirers generally pay a handsome premium, which can give you a pretty nice payday. On the other hand, you might be losing a dependable dividend payer from your portfolio. And now you’ve got to find another one.

At Utility Forecaster, we don’t generally make bets on M&A. Instead, we try to find high-quality stocks that we’d be happy to hold through thick and thin.

If you’re a longtime utility investor, the trend toward consolidation is nothing new. Indeed, the number of publicly traded electric utilities has roughly halved over the past 20 years.

This time around, however, the factors driving utility sector M&A are a bit more existential than, say, empire-building.

Since the downturn, growth in electricity demand has been weak or on the decline due to rising efficiency, an underwhelming economic recovery, and the regulatory push toward renewable energy. That’s left utilities scrambling to find growing regulated earnings streams.

M&A allows utilities to quickly grab new sources of growth, while also diversifying earnings operationally and geographically.

And now that the Federal Reserve has finally shown that it’s serious about raising rates, the sector could see one last dealmaking push before the cost of money goes up.

Cashing In

One of the biggest trends in utility M&A is the pursuit of pure-play natural gas distributors.

In most of these deals, the acquirer’s strategic rationale is to diversify into another stable regulated earnings stream with a tailwind from rising gas demand in order to help offset weak or declining electricity demand.

There’s also an opportunity for an earnings boost by rate-basing upgrades to aging pipes and expanding infrastructure to meet new demand.

“Gas companies have more growth opportunities,” observed Jay Rhame, a Reaves portfolio manager, in an interview with Bloomberg. “A lot of the gas systems were built out 50 or 60 years ago. They need replacement work and a lot of state commissions have been positive on safety-like spending.”

However, even if such deals prove accretive to earnings, credit raters can’t ignore the elevated risk resulting from acquirers’ higher leverage—nor can our Safety Rating System.

Rating agencies also worry that such premiums could set a precedent for future deals. And there certainly is evidence of this in terms of valuations.

With most gas distributors owned by municipalities, the pool of publicly traded pure-play gas distributors is small (and getting smaller with each new deal). Indeed, there are just a dozen left.

No GasCo Left Behind

Part of the sudden acceleration in dealmaking is likely due to acquirers racing to make transactions while rates remain near historic lows.

Then there’s human nature. Potential suitors don’t want to miss out on an attractive takeover target. As J.P. Morgan’s head of power and utilities recently quipped, “If you’re not telling the
girl next door that you love her, one day you may wake up and see her driving off with another guy to her wedding.”

Of course, he’s an investment banker, so naturally he wants to encourage as much dealmaking as possible.

But the industry, itself, is similarly enthusiastic about the prospect of consolidation.

In addition to gas utilities, small, single-state electric utilities are also exploring their options, in part because they don’t necessarily have the scale or the expertise to accommodate regulatory momentum toward cleaner energy.

Who’s Next

Even if you’re looking to catch a windfall, it’s important to maintain discipline. After all, there’s no guarantee that a firm will become a takeover target.

As such, we have to evaluate each company as if it were to remain a standalone.

And that means finding fundamentally strong, dividend-paying stocks that we’d be happy to buy and hold forever.

There are numerous small utilities that have been tipped as potential takeover targets. But in compiling “The Fine Nine” table that accompanies this article, we narrowed our focus to only the highest-quality names in our coverage universe.

Right now, just about all of these stocks trade at premium prices, well above their buy targets (See “How They Rate,” starting on page 9 in the latest monthly issue of Utility Forecaster). But with the Fed in rate-hiking mode, you could soon have an opportunity to pick up shares of one or more of these companies at much more reasonable prices.

Growth Portfolio Core Holding Atmos Energy Corp. (NYSE: ATO) is one of the largest natural gas distributors in America. As such, the company is well positioned to meet growing demand for cheap natural gas as a result of the Shale Revolution.

Based in Dallas, Texas, Atmos serves more than 3 million customers across eight states. It also owns one of the largest intrastate natural gas pipeline systems in Texas and non-utility operations that market gas throughout the U.S.

Beyond retail, the firm serves other distribution companies, industrial firms, and power generators. This diverse geographic footprint and customer base translates into greater earnings reliability, as well as further growth opportunities.

Atmos plans to invest about $1.1 billion to $1.4 billion annually through 2020 to upgrade and expand its infrastructure. This spending is forecast to drive earnings growth of 6.4% annually over the next three years, which is expected to flow through to the dividend.

The main hurdle is whether regulators agree to rate increases. Fortunately, Atmos generally enjoys constructive relationships with regulators across its service territories. And given rising demand for natural gas, we believe this plan is a winner, from a firm that has a proven track record.

Atmos has grown its dividend 6.5% annually over the past three years, and its quarterly payout currently yields around 2.2%.

Midwesterners are well known for their quiet reserve, and this attribute is best exemplified by Wisconsin-based Alliant Energy Corp. (NYSE: LNT).

After enduring significant challenges during the Great Recession, the mid-cap utility buckled down and looked for ways to substantially reduce financial and operating risk. Consequently, the firm has become one of the least-risky stocks in our portfolios.

By any measure, Alliant is a formidable company. In an industry beset by declining electricity demand, Alliant is expected to grow earnings per share at an above-average pace over the next three years.

These results should flow through to the dividend, which is expected to rise 7.0% annually through 2019. And strong earnings coupled with a reasonable payout ratio leave room for further dividend growth. No doubt these attractive characteristics have caught the attention of at least a few of the utility giants.

Despite its relatively small market capitalization, Chesapeake Utilities Corp. (NYSE: CPK) has managed to diversify both operationally and geographically across the midstream and downstream value chains.

For the most up-to-date guidance and pricing, go to www.UtilityForecaster.com or check your latest Utility Forecaster issue.
While Chesapeake primarily operates in the Delmarva peninsula, which is shared by Delaware, Maryland, and Virginia, it does substantial business in Florida and also has a toehold in Ohio.

In addition to gas distribution, the company’s Regulated Energy segment, which accounts for 82% of operating profits, is also involved in electricity distribution in Florida and gas transmission in both Florida and on the Delmarva peninsula.

The Unregulated Energy segment is involved in demand-facing businesses such as propane distribution, as well as gas gathering and marketing, among other activities.

Chesapeake is forecast to grow earnings per share by nearly 12% annually over the next two years, which should drive further growth in the dividend.

Although Chesapeake only yields 1.7%, it’s grown its quarterly payout by 5.8% annually over the past five years.

### The Fine Nine: High-Quality Takeover Targets

<table>
<thead>
<tr>
<th>Company (Exchange: Symbol)</th>
<th>Price</th>
<th>Yield</th>
<th>3-Year Dividend Growth</th>
<th>Market Cap ($ billions)</th>
<th>Price to Earnings</th>
<th>3-Year EPS Growth</th>
<th>Enterprise Value to EBITDA</th>
<th>Safety Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allete Inc. (NYSE: ALE)</td>
<td>$70.85</td>
<td>3.0%</td>
<td>3.0%</td>
<td>$3.6</td>
<td>20.5</td>
<td>6.7%</td>
<td>11.2</td>
<td>7</td>
</tr>
<tr>
<td>Alliant Energy Corp. (NYSE: LNT)</td>
<td>$40.07</td>
<td>3.0%</td>
<td>7.6%</td>
<td>$11.1</td>
<td>20.0</td>
<td>6.4%</td>
<td>14.1</td>
<td>4</td>
</tr>
<tr>
<td>Ameren Corp. (NYSE: AEE)</td>
<td>$55.43</td>
<td>3.1%</td>
<td>2.6%</td>
<td>$13.4</td>
<td>20.0</td>
<td>6.0%</td>
<td>9.0</td>
<td>6</td>
</tr>
<tr>
<td>Atmos Energy Corp. (NYSE: ATO)</td>
<td>$80.01</td>
<td>2.2%</td>
<td>6.5%</td>
<td>$8.4</td>
<td>22.6</td>
<td>6.4%</td>
<td>11.5</td>
<td>6</td>
</tr>
<tr>
<td>Chesapeake Utilities Corp. (NYSE: CPK)</td>
<td>$73.00</td>
<td>1.7%</td>
<td>5.9%</td>
<td>$1.2</td>
<td>23.2</td>
<td>6.0%</td>
<td>11.7</td>
<td>6</td>
</tr>
<tr>
<td>NiSource Inc. (NYSE: NI)</td>
<td>$24.26</td>
<td>2.7%</td>
<td>N/A</td>
<td>$7.9</td>
<td>20.8</td>
<td>6.4%</td>
<td>10.7</td>
<td>2</td>
</tr>
<tr>
<td>Pinnacle West Capital Corp. (NYSE: PNW)</td>
<td>$86.18</td>
<td>3.0%</td>
<td>4.8%</td>
<td>$9.6</td>
<td>20.3</td>
<td>5.1%</td>
<td>9.2</td>
<td>6</td>
</tr>
<tr>
<td>Portland General Electric Co. (NYSE: POR)</td>
<td>$46.20</td>
<td>2.8%</td>
<td>5.2%</td>
<td>$4.1</td>
<td>20.3</td>
<td>4.9%</td>
<td>9.5</td>
<td>4</td>
</tr>
<tr>
<td>Vectren Corp (NYSE: VVC)</td>
<td>$59.65</td>
<td>2.7%</td>
<td>4.7%</td>
<td>$4.9</td>
<td>22.7</td>
<td>5.5%</td>
<td>9.6</td>
<td>7</td>
</tr>
</tbody>
</table>

**Price, Yield** as of 04/24/17, close. **3-Year Dividend Growth** is growth in the company’s quarterly payout over the trailing three-year period. **Market Cap** is share price times shares outstanding as of 04/24/17, close. **Forward P/E** compares the current share price to the consensus forecast for earnings per share for full-year 2017. **3-Year EPS Growth** shows average basic earnings per share growth over the trailing three-year period. **Enterprise Value to EBITDA** compares the company’s total value based on equity plus debt to earnings before interest, taxation, depreciation, and amortization over the trailing 12-month period, adjusted for one-time items. **Safety Rating** is based on a 0 (riskiest) to 8 (safest) scale. Criteria listed in table key following How They Rate on page 12 in each monthly issue. Sources: Bloomberg, Utility Forecaster
IMPORTANT NOTE:

Guidance concerning the stocks highlighted in this report is believed to be accurate and represent our best advice at the time of writing. However, market conditions change constantly and guidance at the time of this writing may not reflect our latest advice. For our current take on any stock in this report, it is vitally important that you check the Portfolio tables on the website and confirm that the stock still earns a buy rating. Furthermore, confirm that the stock trades below our current buy limit. Do not buy any stocks above our recommended buy limits. If a stock’s price exceeds our buy limit, wait for a pullback or invest in another Portfolio holding that trades below our buy limit. Any advice in the Portfolio tables, a recent issue of the publication, or our email alerts always trumps older advice in this special report. We reserve the right to substitute special reports as market trends dictate.

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