

## Spotlight On . . .

### Consolidated Edison Inc.: Initiated Coverage With Neutral 1 Rating

#### Summary

We initiated coverage of Consolidated Edison (ConEd) with a Neutral 1 rating and a 12-month price target of \$36 per share. ConEd is a safe/low-risk company, deriving 97% of its recurring net income from regulated operations. Other positives include an attractive franchise area, a controlled foray into unregulated operations, a healthy balance sheet, strong credit ratings, and a safe dividend.

There are some near-term concerns, however. ConEd faces declining earnings in 2003-04 because of the impact of weak equity markets on pension income and, to a lesser extent, exposure to weak commodity prices through its energy merchant operations. Furthermore, there is a strong chance of a \$500 million equity issuance in early 2004 to reduce its debt/capital ratio to under 50%. We believe these concerns are not adequately reflected in the current stock price. In our opinion, positive catalysts are likely to emerge in late 2004/early 2005 as the next rate cases become due for ConEd's regulated utilities.

#### Return Potential

Our \$36 12-month price target is derived using a dividend discount model. The stock offers a total return potential of negative 1.4% (7.2% downside, 5.8% yield) and an excess return potential of negative 3%. Hence, we rate ConEd Neutral 1.

#### Valuation

ConEd is currently trading at 12.9 times 2003E EPS and 8.2 times 2003E EBITDA (adjusted for pension); this is close to the upward bound of both its historical PE and EV/EBITDA valuation ranges. On a relative PE basis, ConEd currently trades at a 9% premium to the UBS Regulated T&D Utilities Index. The company has enjoyed a premium to its peer average over the last few months owing to its lower risk profile, above-average dividend yield, and stable dividend policy. However, we believe it will be difficult for ConEd to sustain this premium over the next one to two years in light of a negative earnings momentum in 2003 and 2004 because of significantly lower pension income and impending equity dilution. Our \$36 price target implies a target PE of 12.0 times our estimated 2003 earnings and a 2% premium to peer group average.

We used a dividend discount model to value ConEd, which suits the company's stable dividend policy and high payout ratio. Despite a weak cash flow outlook over the next two years, we believe the dividend is safe. In particular, we have used a two-stage dividend discount model to value ConEd. The first stage assumes a 1% growth rate per year in dividends over a five-year period. The second stage is a stable growth period where dividends are grown at an annual rate of 2.5% to perpetuity. This growth rate corresponds to a payout ratio of 75% and an ROE of 10% in the stable period.

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NATURAL GAS & ELECTRIC  
UTILITIES

February 28, 2003

**Rating: Neutral 1**

**Ticker**  
ED

**02/27/2003 Price**  
\$38.81

**52-Week Range**  
\$46-34

**Equity Mkt. Cap. (MM)**  
\$8,290

**Shares Out. (MM)**  
213.6

**Earnings Per Share**  
2002A: \$3.13  
2003E: \$3.00  
2004E: \$2.95

**PE**  
2003E: 12.9x  
2004E: 13.2x

**Ind. Dividend**  
\$2.24

**Yield**  
5.8%

**Secular Growth**  
4%

**12-Mo. Target Price**  
\$36

**12-Mo. Total  
Return Potential**  
(1.4%)

*Fiscal year ends in  
December.*

Using our dividend discount model, we arrive at our 12-month price target of \$36. This price target—when combined with a \$2.24 current dividend (or 5.8% yield)—implies a negative 1.4% total return potential and negative 3% excess return potential over the next 12 months.

Note, the new UBS rating system mandates that a stock with an *excess* (positive or negative) total annual return potential of less than 15% be rated Neutral. Excess return is after considering the opportunity costs of the U.S. risk-free rate of approximately 2%, thus the total annual return must be greater than or equal to positive 17% or negative 13% to not be rated Neutral.

## Company Overview

ConEd operates through a holding company structure with the following subsidiaries:

- **Consolidated Edison of New York (CENY)** provides electric service to 3.2 million customers in all of New York City (except parts of Queens) and most of Westchester County as well as gas service to 1.1 million customers in Manhattan, The Bronx, and parts of Queens. It also provides steam service to around 1,850 customers in parts of Manhattan.
- **Orange & Rockland Utilities (O&R)** provides electric service to 280,000 customers and gas service to over 120,000 customers in southeastern New York and in adjacent sections of New Jersey and northeastern Pennsylvania.
- **Unregulated subsidiaries** consist of Consolidated Edison Development, which acquires, develops, and operates generating projects; Consolidated Edison Communications, which builds and operates fiber optic networks to provide wholesale telecommunications services; Consolidated Edison Solutions, a retail energy company that sells electricity and gas to delivery customers of utilities; and Consolidated Edison Energy, a wholesale energy supply company that is involved in energy marketing activities including the output of ConEd Development.

Both CENY and O&R sold most of their generation assets following electric industry restructuring in their respective states and focus primarily on the distribution of electricity and gas in their service areas.

## Investment Positives

- **Strong regulated operations in a fundamentally sound market.** ConEd provides energy service in New York City, one of the most vibrant economies in the world. Energy demand in the city grew steadily in the 1990s because of a booming economy, a growing population base, and increased energy usage. Though New York City's economy has been hit by a recession and the September 11 attacks, the underlying fundamentals remain sound. Over the last four years, after adjusting for weather, CENY's electric and gas volume sales have grown by 2.2% and 1.4%, respectively. For the same period, O&R's electric and gas volume sales have grown by 2.5% and 0.3%, respectively. Therefore, we estimate that ConEd's electric and gas volumes can continue to grow at a 1-2% rate in the future.

- **Deregulation in ConEd's service areas is complete, which dissipates regulatory uncertainty.** The deregulation process has been successfully completed in ConEd's service territories. Moreover, ConEd enjoys a constructive relationship with its regulators, as is evidenced by its restructuring agreements that allow its regulated subsidiaries to: 1) earn attractive incentive-based rates of return; 2) pass through all fuel and purchased power costs; 3) partially hedge energy supply through long-term contracts; and 4) fully recover stranded costs.
- **Enlightened regulatory environment mitigates regulatory risk.** ConEd divested most of its generation assets subsequent to its restructuring agreements. As a result, the company has very limited commodity price exposure through its regulated subsidiaries. Thus, ConEd is considered to possess a much lower risk profile than some of its regulated peers, which are either yet to experience electric industry deregulation in their service areas or still possess significant generation capacity in an overbuilt market.
- **ConEd's regulated subsidiaries have an attractive incentive-based ROE structure in place.** There is no cap on the ROE that ConEd can earn; instead, the regulators have specified a threshold ROE level. Earnings beyond the threshold are shared with customers in a defined proportion. CENY's current thresholds for its electric, gas, and steam businesses are 11.75%, 11.5%, and 10.5%, respectively, and O&R's current threshold for its gas businesses is 11.1%. These thresholds can be further increased by a small amount if the utilities meet certain performance objectives. ConEd will earn beyond its threshold for the 12 months ending March 31, 2003, primarily because of continued O&M costs reduction. The next rate case is due in October 2004 for CENY's gas and steam businesses and in April 2005 for its electric business. ConEd is optimistic that it can secure a higher ROE threshold for both its electric and gas businesses.
- **A cautious approach toward unregulated businesses gives ConEd a lower risk profile than some of its regulated peers.** ConEd has followed a very conservative approach toward investing in unregulated businesses. The company has four unregulated subsidiaries that are involved in merchant energy generation, energy services, and telecom services. We estimate that ConEd's investment in unregulated businesses comprised roughly 7% of its total asset base and 3% of its consolidated net income in 2002. Even as its unregulated businesses continue to grow, we forecast that these will comprise only 7% of ConEd's consolidated net income by 2006.
- **Solid balance sheet supports robust credit ratings.** ConEd has one of the strongest balance sheets in the industry. We estimate that as of December 31, 2002, ConEd's total debt to capitalization was 53% (excluding off-balance sheet items and considering preferred stock as equity). Including the operating leases as debt, the total debt to capitalization ratio was around 55%. The company currently enjoys strong credit ratings of A2, A, and A- from Moody's, S&P, and Fitch, respectively. (Moody's has a negative outlook.) ConEd's utility subsidiaries, CENY and O&R, are rated higher at A1, A+, and A+, respectively, by the rating agencies. Management's goal is to reduce leverage below 50% and to preserve the current credit ratings.

■ **Strong dividend track record should continue.** ConEd's current annual dividend of \$2.24 per share (or 5.8% yield) makes it an attractive yield play. The company has maintained a strong dividend policy and has increased dividends consistently for the last 29 years. The payout ratio has held fairly steady over the years in the 70-75% range. Despite potential pressure on operating cash flows through 2005 and a strong likelihood of a \$500 million equity issuance in early 2004, we believe the dividend is safe. Assuming that the company continues to increase its dividend moderately, the payout ratio would peak at 77% in 2004. From 2005 onward, we project the payout ratio to trend lower toward 70% as earnings increase at an annual rate of 3-5%.

■ **Potential elimination/reduction of dividend tax could benefit shareholders.** Any policy changes with respect to dividend taxation relief will likely further benefit ConEd's shareholders. While it is difficult to estimate by how much the current stock price already discounts an elimination/reduction of dividend tax, our calculations indicate that a cut in dividend tax to 20% would raise the intrinsic value of the stock by 6%.

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Dividend Dividend*

■ **Quality management with a proven and focused strategy.** ConEd's focus on regulated operations has taken care of its shareholders through the years. Relative to the S&P 500, ConEd's stock has returned 7%, 49%, and 29% over the last 10-, five-, and one-year periods, respectively. We have confidence that management will continue to focus on the energy distribution business, which it knows and executes well. ConEd has the distinction of being the most reliable electric utility in the country. Besides, the steady cash flows from the regulated distribution businesses should give management the flexibility to consistently reward shareholders with a high dividend, make limited forays into unregulated businesses, and scout around for opportunistic acquisitions of other distribution utilities.

■ **World Trade Center costs to be fully reimbursed.** ConEd estimates the total costs for repairs and upgrades following the World Trade Center attacks to be around \$400 million. The company expects insurers to cover \$65 million of the costs with the balance reimbursed by the federal government. Federal reimbursement has already been approved. In case of any shortfall in reimbursement, ConEd expects NYPSC to allow the recovery of the shortfall from customers. We estimate a reimbursement of \$200 million both in 2003 and 2004, providing the company with much-needed cash infusion.

## Investment Negatives

■ **Potential downside from dilution of earnings.** A heavy capital expenditure program over the 2002-05 period (estimated at over \$5 billion) and continued modest increases in dividend payout will put pressure on ConEd's leverage over the next two to three years. Management's goal to reduce leverage below 50% will likely imply an equity issuance over the next 12 months. Our projections factor in an equity issuance of \$500 million in the first quarter of 2004. Based on our 12-month price target of \$36 per share, this implies 6% dilution.

- **Lower pension credits should put pressure on earnings.** We estimate ConEd's 2002 pension income at \$0.70 per share, or 23% of recurring net earnings. The after-tax pension credits are expected to take a big hit in 2003 because of the poor performance of pension assets over the last three years and a change in the return on plan assets assumption in 2003 to 8.8% from 9.2%. We estimate the net after-tax credits because of pension and other post-retirement benefits to be lower by \$0.25 per share in 2003 and by an additional \$0.14 per share in 2004 (ignoring equity dilution). ConEd will have to absorb the impact of lower pension income at least until its next rate agreement in April 2005.
- **A rising interest rate scenario should negatively impact ConEd's share price.** ConEd's stock has historically exhibited a high negative correlation with interest rates since it is mainly a dividend play. The United States appears to be close to a bottom of an interest rate cycle and we believe it will be tough for ConEd's stock to outperform the market in an environment of rising interest rates. A regression analysis shows that a 25 basis point increase in the 10-year treasury yield would have a 4% negative impact on ConEd's share price.
- **Power situation in NYC is a cause for concern.** The tight power supply-demand situation in New York City could pose a risk to ConEd. Though its current rate agreements allow a complete pass-through of fuel and purchased power costs, there does exist a risk that ConEd may not be able to fully recover purchased power costs if there are large and prolonged price spikes, as was witnessed in California. The current capacity in New York City is just about sufficient to meet projected demand in 2003, leaving utilities limited flexibility to meet any unusual demand spikes or supply constraints. We expect the situation to ease in 2004, as Keyspan will bring online a 250-MW plant.
- **Albeit small, ConEd bears commodity price risk through its unregulated generation.** ConEd has roughly 1,700 MW of merchant generation through its unregulated subsidiary, ConEd Development (CED). Management has contracted only a portion of the total capacity (exact details are not known) and the unhedged portion remains exposed to commodity price risk. Most of the unregulated capacity is located in New England, where a weak outlook for spark spreads over the next 12 months could keep CED's earnings depressed.
- **Northeast Utilities litigation remains a stock overhang.** ConEd and Northeast Utilities had proposed to merge in October 1999. However, the talks fell apart after ConEd filed for action against Northeast Utilities in March 2001 citing material breach of merger agreement. Northeast Utilities filed a counter claim against ConEd. These claims are still pending and an initial decision could be rendered sometime in late 2003. The financial impact of any adverse decision on ConEd is difficult to gauge at this point, but management does not expect it to be materially significant.

## Earnings Outlook 2003-04

- We estimate ConEd's recurring EPS at \$3.00 for 2003, \$2.95 for 2004, and \$3.05 in 2005. This compares with First Call consensus estimate of \$2.95 in 2003 (reflecting a range of \$2.85-3.00) and \$3.02 in 2004 (reflecting a range of \$2.95-3.15). There are no Street estimates for 2005 at present. Management has indicated a range of \$2.90-3.05 for 2003 EPS and has not given any guidance for 2004 as yet. Longer term, management targets 3-5% growth in consolidated earnings, driven by 2-3% growth in regulated businesses and the balance driven by the unregulated subsidiaries.
- We forecast our 2003 earnings to be positively impacted by CENY's electric and gas sales volume growth at 1-2% and O&R's electric and gas sales volumes at 2-3%. O&R's electric sales have shown strong growth despite the recessionary conditions in 2001 and 2002. We estimate O&R to add an incremental \$0.02 per share in 2003 as compared with 2002. The unregulated subsidiaries will be a strong revenue driver in 2003, primarily driven by more than 1,000 MW of additional capacity coming on stream at CED in mid 2002/early 2003. As a result, we estimate the unregulated subsidiaries will add \$0.05 per share to 2003 earnings. We estimate ConEd to continue to reduce O&M costs (excluding pension and other benefit costs); we project a \$0.08 per share of cost savings in 2003.
- The major negative factor impacting 2003 earnings is lower pension income. We expect the net after-tax credits because of pension and other post-retirement benefits to be lower by \$0.25 per share as compared with 2002 levels, because of weak equity markets in 2002 and a change in the expected return on plan assets assumption in 2003 to 8.8% from 9.2%. Further, we estimate interest rate expenses to be \$0.01 per share higher in 2003, despite lower interest rates, because of increased debt at the company.
- We forecast our 2004 earnings to be positively impacted by CENY's electric and gas sales, which we project will grow at 3% driven by an economic rebound in the utility's service areas. For the same reason, we project O&R's electric and gas sales to grow by 4% and 3%, respectively, over 2003 levels. Other positive factors include an incremental \$0.05 per share contribution from the unregulated subsidiaries and continued O&M cost reduction (excluding pension and other benefit costs) of \$0.08 per share.
- The negative factors impacting 2004 earnings include lower pension income and a potential dilutive equity issuance. We project the net after-tax credits because of pension and other post-retirement benefits to be lower by \$0.14 per share as compared with 2003 levels. We are projecting a \$500 million equity issuance in early 2004, which implies a 6% dilution at our 12-month price target of \$36.

### **Statement of Risk**

Investors should be aware of the following risk factors when owning ConEd shares: the risk of an adverse decision in the litigation with Northeast Utilities; the risk of an adverse decision by NYPSC investigating nuclear plant outage in the February 2000 - January 2001 period; the potential impact of mild weather on regulated utility sales; the commodity price risk associated with the unregulated energy assets; the potential impact of a continued sluggish economy; and the risk of any unexpected or unreasonable regulatory decision.