WEC Energy Acknowledges Need To Change

Image Source: WEC Energy Group Inc – IR Presentation

By Callum Turcan

WEC Energy Group Inc. (WEC) is a regulated electric and natural gas utility based in Milwaukee, Wisconsin, that serves 4.5 million customers across the Midwest primarily in the following states; Wisconsin, Illinois, Michigan and Minnesota. That includes power generation, transmission, and natural gas delivery operations that are supported by its natural gas storage assets. Shares of WEC yield 2.6% on a forward-looking basis as of this writing. We aren't interested in WEC Energy given its heavy reliance on coal-fired power plants at a time when natural gas and renewables (aided by government subsidies) are increasingly dominating the power generation landscape. Furthermore, we caution that domestic utilities that are overly reliant on coal-fired power plants will likely face major regulatory and environment hurdles in the medium-term, especially if the Clean Power Plan or some version of it is reinstated and that plan is enforced with the teeth of federal regulators.

Dividend Commentary

In 2018, WEC Energy generated $0.3 billion in free cash flow (defined as net operating cash flow less capital expenditures) while spending $0.7 billion on dividend payments. Debt issuance was used to cover the gap. We like the stability of WEC Energy's free cash flows over the past three full fiscal years, which averaged $0.4 billion during this period, but caution the firm needs to maintain access to capital markets to cover both its dividend commitments and growth trajectory. We would like to note that if WEC Energy didn’t pursue significant growth activities its free cash flows would likely be much stronger (as its capital expenditures would be materially lower).

However, the company is seeking growth opportunities as many are available and capital markets are very willing to keep lending WEC Energy more money. We’ll cover that growth runway in greater detail in a moment. Having investment grade credit ratings and positive free cash flows make this process significantly easier.

WEC Energy prefers to use debt issuance, and not equity issuance, to fund its growth trajectory and please note the company has historically repurchased a marginal amount of its stock each year to offset dilution (from activities like stock-based compensation). At the end of June 30, 2019, WEC Energy had a net debt load of $11.9 billion (inclusive of short-term debt). Lower interest rates in the US will make refinancing activities significantly easier, and should lower WEC Energy’s cost of debt.

Shifting Away from Coal

As you can see in the graphic below, 48% of WEC Energy’s rated electric generation capacity was represented by its coal-fired power plants at the end of last year. Most of the remainder is made up by older less economical peaker plants (fueled by oil and natural gas) which are turned online during times of elevated demand (cold winters, hot summers, unplanned outages at baseload facilities). Only a quarter of WEC Energy’s rated power generation capacity is represented by more modern (and most importantly, very economical) combined cycle natural gas-fired power plants. Please note that natural gas prices in America have been very low for some time and are likely to remain subdued going forward given the abundance of domestic and Canadian gas supplies. Renewables made up just a tiny portion of WEC Energy’s rated power generation capacity at the end of 2018.

WEC Energy is making major investments to change this picture, which we can appreciate. In its 2018 Annual Report, the company notes it planned to retire 1,800 MW of coal-fired power generation capacity by 2020. Last year, the firm retired 1,500 MW of coal-fired power generation capacity as part of that effort. This year, WEC Energy retired the coal-fired Presque Isle power plant. That capacity is being replaced with natural gas-fired generation capacity at WEC Energy’s Upper Michigan Energy Resources (“UMERC”) subsidiary. UMERC turned two new gas-fired power plants online this year with a combined 180 MW of power generating capacity. WEC Energy is also investing in a handful of renewable energy projects as well.

Betting Big on Wind

By the end of 2019, WEC Energy expects that its Coyote Ridge Wind Farm project in South Dakota will be completed. WEC Energy has already signed an offtake agreement with Alphabet Inc.’s (GOOG) (GOOGL) Google Energy to buy 100% of that power generation for 12 years. The utility mentions that over three dozen wind turbines made by General Electric Company (GE) will be used to create the wind farm, which is expected to have almost 100 MW of power generation capacity.

Keep in mind that Google Energy is likely to need power indefinitely, so there are reasons to believe that its 12-year deal with WEC Energy could be extended given that Alphabet wants to source as much of its electricity consumption as possible from renewable energy. Avangrid Renewables, a subsidiary of Avangrid Inc. (AGR), is developing the wind farm and will be the operator once completed. WEC Energy acquired an 80% stake in this development in early-January 2019 for $145 million. That asset is expected to qualify for the federal production tax credit.

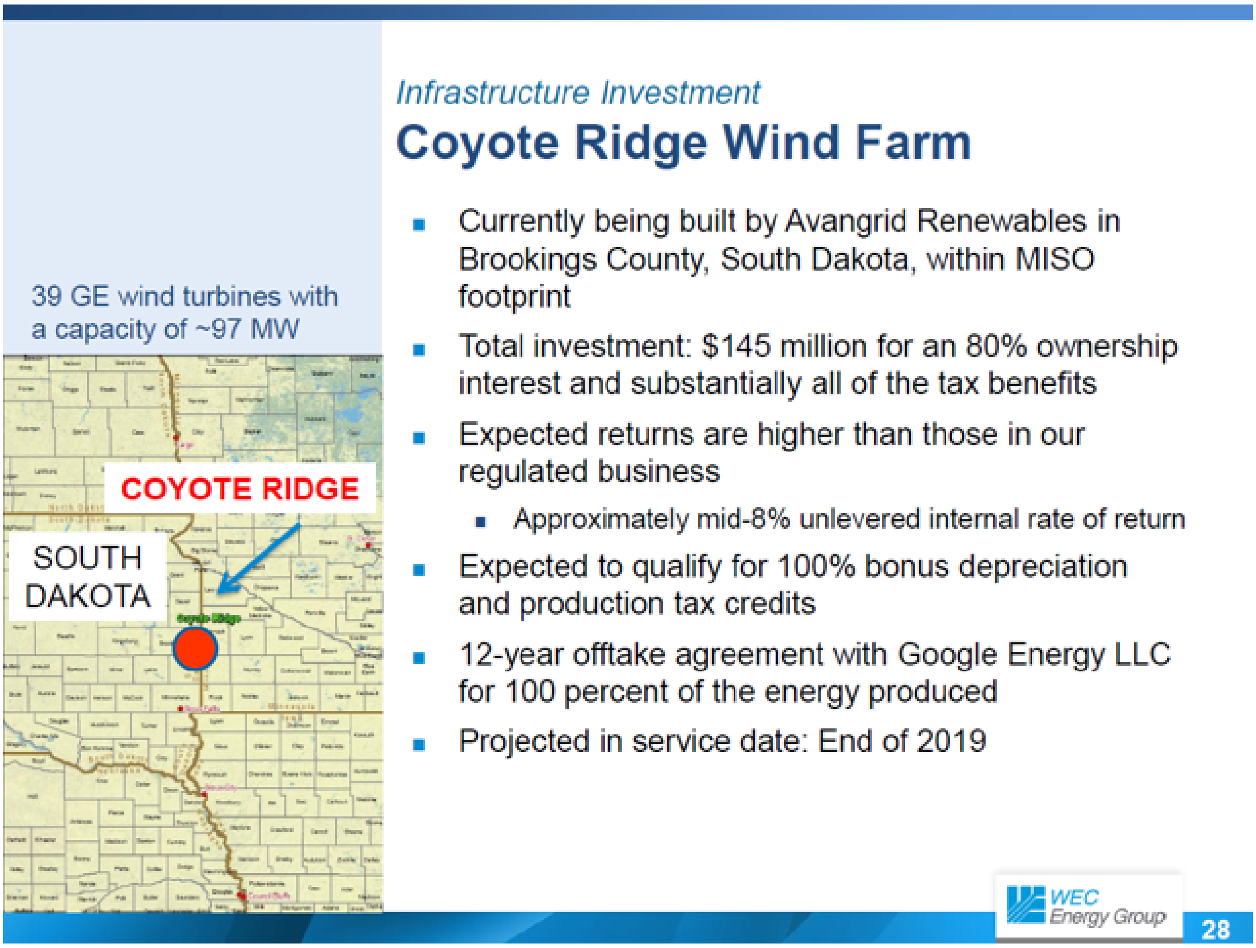

Image Shown: An overview of WEC Energy's Coyote Ridge Wind Farm project. Image Source: WEC Energy – IR Presentation

The Coyote Ridge Wind Farm project is one of many renewable energy endeavors WEC Energy is pursuing. WEC Energy increased its stake in the 132 MW Bishop Hill III wind farm in Illinois to 90% from 80% last year, and at the start of 2019, WEC Energy acquired an 80% stake in the ~203 WM Upstream Wind Energy Center in Nebraska. Both of those power plant facilities are now operational. The revenue streams generated through the power produced and sold from these assets are secured by long-term contracts.

On September 3, 2019, WEC Energy agreed to acquire an 80% stake in the 330 MW Thunderbird Wind Energy Center in Nebraska for $338 million. By the end of 2020, commercial operations are expected to commence. 108 GE wind turbines are expected to be use to develop this wind farm, and the venture is supported by an offtake agreement for 100% of the energy produced.

Management is serious about bulking up WEC Energy’s renewable asset base, with the production tax credit meaningfully enhancing the expected returns on these developments. Please note that as things stand today, the production tax credit is expected to phase out soon, which is why it’s very important that the developers WEC Energy is working with bring these wind farms online on-time.

When it comes to solar, WEC Energy teamed up with a subsidiary of MGE Energy Inc. (MGEE) to bring an additional 150 MW of power generation capacity at the Badger Hollow Solar Farm in Wisconsin online. That’s on top of the 150 MW of power generation capacity already planned at the site. The expansion was announced on August 1, and the joint venture expects to begin commercial operations by the end of 2020 from the development’s first phase. The second phase is forecasted to start commercial operations a year later in 2021. At peak capacity, the Badger Hollow Solar Farm will add 300 MW of gross renewable power generation capacity to WEC Energy’s asset base.

Concluding Thoughts

WEC Energy has accepted it needs to shift its power generation operations away from coal (which faces major medium- and long-term regulatory and environmental hurdles) and towards cleaner options. Natural gas represents America’s bridge fuel as the country slowly shifts towards a world where renewables will no longer play second fiddle to coal, natural gas, nuclear, or hydro-conventional sources of electricity generation. That being said, we still aren’t interested in shares of WEC here as we see better income growth opportunities out there.