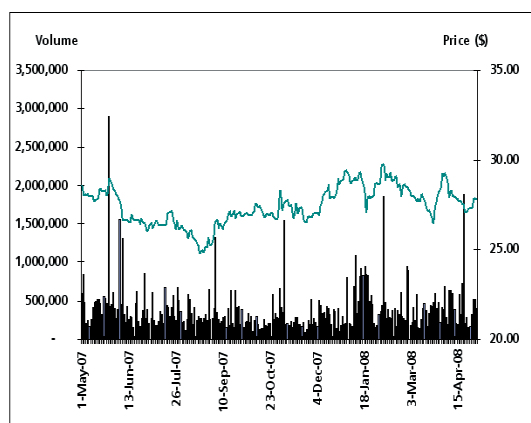


**Fortis Inc.**  
**(FTS - \$27.26)**  
**Earnings Update**
**Outperform**  
**Target Price: \$33.00**


Market Capitalization (\$ million)	4,279
Outstanding Number of Shares (million)	156
Dividend Yield (%)	3.66

(\$ million except per share data)	2007	2008E	2009E
Revenues	2,718	3,733	3,957
EBITDA	814	1,116	1,204
EPS	1.40	1.58	1.89

Citadel Securities Estimates

Fortis Inc. is the largest investor-owned distribution utility in Canada, serving almost 2,000,000 gas and electric customers. Its regulated holdings include a natural gas utility in British Columbia and electric utilities in 5 Canadian provinces and 3 Caribbean countries. It owns non-regulated hydroelectric generation assets across Canada and in Belize and upper New York State. It also owns hotels & commercial real estate in Canada.

**May 2, 2008**
**Good quarter boosted by Terasen**

Fortis announced its Q1 financials for 2008. Revenue growth (y-o-y) was 137% mainly due to the contribution from Terasen (Terasen Gas Companies). The organic revenue growth was approximately 5% thanks to Fortis Alberta and Newfoundland Power.

Operating income of the Company increased 118% overall and 4% excluding the contribution of Terasen. Due to the nature of its business, Terasen's annual earnings is virtually created in the fourth and first quarter of the year. Fortis Alberta and Caribbean Utilities enjoyed growth in their earnings y-o-y. Due to quarterly shift in the distribution of annual purchased power expense, earnings of Newfoundland Power will be lower in the first and fourth quarters and higher in the second and third quarters of 2008 as compared to the same periods in 2007. Annual earnings of Newfoundland Power will not be affected from this shift.

The table below presents the quarterly highlights of the segments:

(\$ million)	Operating Revenues		Operating Income	
	Q1/2008	Q1/2007	Q1/2008	Q1/2007
Terasen	635	na	113	na
Fortis Alberta	73	64	20	17
Fortis BC	66	64	20	20
NF Power	164	154	18	24
Other Canadian	70	70	10	11
Electric Caribbean	75	77	17	9
Fortis Generation	19	21	11	12
Fortis Properties	45	40	10	9
Corporate & Other	7	3	1	-
Intersegment Elimination	(8)	(10)	(4)	(3)
<b>Consolidated</b>	<b>1,146</b>	<b>483</b>	<b>216</b>	<b>99</b>

Announced Q1 EPS of \$0.58 is in line with our annual estimates. Our target price for the Company is \$33.00 (unchanged) and recommendation is "Outperform" (unchanged).

## **Terasen**

As the largest investor-owned distribution utility in Canada, Fortis has been increasing its presence and its revenue by mostly acquisitions. The Company acquired Terasen Gas Companies (Terasen) for \$3.7 million on May 17, 2007. The acquisition has been accretive to the Company as expected. Due to the nature of its business, Terasen's earnings are created in the fourth and first quarters of the year. Therefore Q1/2008 was a supergrowth quarter for the overall financials of Fortis.

## **Recent Developments**

As for the 2008 allowed rates of return on common shareholders' equity for Terasen, Fortis Alberta, Fortis BC and Newfoundland Power, they have been set at 8.62 per cent, 8.75 per cent, 9.02 per cent and 8.95 per cent, respectively. Also in February 2008, Fortis Alberta received regulatory approval of a Negotiated Settlement Agreement for its 2008 and 2009 electricity rates. Caribbean Utilities was granted a new exclusive 20-year transmission and distribution licence and a new non-exclusive 21.5 year generation licence by the Government of Cayman Islands in April 2008.

## **Cash Flow and capex**

The Company's operating cash flow was also more than doubled by the increase in its earnings. Fortis is planning to spend \$4 billion for capital expenditures in five years including 2008. Also, Fortis forecasts a budget of \$890 million for 2008 capital expenditures. The Company spent \$162 million for utility capital expenditures in Q1/2008.

## **Segments**

Fortis Alberta continued to be one of the high performers in this quarter. Energy deliveries increased by 4.9% q-o-q and the company enjoyed both customer growth and increase in distribution rate. Although these are offset by lower tax recoveries (driven by a decline in deductions taken for a tax purposes compared to accounting purposes), higher labour and employee benefit costs and increased amortization costs, Fortis Alberta managed to increase its operating earnings while having slightly less net earnings.

Newfoundland Power also enjoyed the increase in electricity sales as well as the average increase in customer rates. However, due to the quarterly shift in distribution, the company's earnings were lower. Under the regulated rate structure, annual purchased power expense per kilowatt hour is higher in the winter months and lower in the summer months. Although annual earnings will not be impacted by this shift, Newfoundland Power will post lower earnings in the first and fourth quarters and higher in the second and third quarters of 2008 as compared to the same period in 2007.

Other Canadian Electric Utilities, which include Maritime Electric and FortisOntario, had lower revenues mainly due to the lower average consumption as a result of warmer-than-normal weather conditions in Ontario. The comparison also shows the impacts of the loss of a major industrial customer and a temporary shutdown of operations of another industrial customer in Ontario.

Caribbean Utilities had 7.1% increase in electricity sales; however, the revenues were affected by foreign exchange associated with the translation of foreign-currency dominated revenue - by \$12 million. Excluding this unfavorable impact, revenues increased by \$10 million quarter over quarter. Caribbean Utilities also enjoyed higher earnings partially offset by increased finance charges, amortization costs and unfavorable foreign exchange impact.

Fortis Generation experienced a decline in its revenues and earnings mainly due to the lower production, reduced average wholesale energy prices per MWh in Ontario and unfavorable impact of foreign exchange. On the other hand, Fortis Properties had a good quarter with increased revenues and earnings boosted by the acquisition of Delta Regina.

## Valuation

We have initiated coverage on Fortis on Feb 25, 2008. Here are the assumptions we presented in our initial report:

2008 will be another year of high growth for Fortis mainly due to the full-year consideration of Terasen's financials. Considering that one of Terasen's best quarters was not accounted for in the Fortis 2007 financials, most of the new growth will come from Terasen. Keeping other segments relatively conservative, we assumed that FortisAlberta and FortisBC would continue to take advantage of the economic growth and investments made previously. The Caribbean will be another growing segment of the Company. Overall, we assumed that total revenue will grow approximately 37% in 2008. From 2008 on, we assumed that the Company would grow by 6% over the long term. The loss of revenue from Ontario generation in 2009 is the only expected hiccup in the Company's estimated revenue stream, which is not expected to have a significant affect. This loss (of revenue and earnings) is expected to be partially offset by Vaca Hydroelectric generating facility being online in late 2009.

- We assumed that the operating margin of Fortis would gradually increase over the next five years. For 2008, our estimate is 21%.
- Our DCF scenario is based on the current status of the Company with an assumption of "no acquisition." Although this is highly unlikely, with no specific data on prospective acquisitions, this is the most conservative scenario.
- Our capex assumption is based on the Company's plan of \$4 billion in five years. Also, Fortis forecasts a budget of \$890 million for 2008 capital expenditures. We assume that Fortis would finance this budget 60% by debt.
- We calculated the weighted average cost of capital as 7% for the Company using its current borrowing rate and cost of equity derived from the CAPM run for Fortis.

We do not see any reasons to change our assumptions that provided the base for our DCF valuation. We also used a Dividend Discount Model to determine the target value of Fortis. In this method, we used the same cost of equity that we derived for the DCF method. We assumed that the Company would keep its payout ratio unchanged for the next five years and after five years, the stable growth rate would settle at 3%.

The last method that we applied for the Company's valuation is Market Multiples. Selected multiples are P/E, P/S, P/BV and EBITDA Margin. The peer group consists of Canadian Utilities, Atco Ltd, Emera Inc., Epcor Power, Algonquin Power, Northland Power, and Transalta Corporation.

According to weighted average of these methods, we keep our target price of \$33.00 for the Company. We think that Fortis is a well-managed, dynamic utility company with significant upside growth potential as well as attractive income-portfolio staple with its increased dividends.

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Outperform: 15% or more

Market Perform: Between 15% and -15%

Underperform: -15% or less