

BELCO Holdings Limited

July 2008

(BELCO-BH)

BSX Utilities – Electricity & Gas

Share Price (07/22/08):	\$21.40
Stock Rating:	Hold
Risk Profile:	Low
1-Year Target:	\$21.00
1-Year Implied ROR:	2.1%

Annual Dividend:	\$0.85
Current Yield:	3.97%
Payout Ratio:	43%
Ex-Dividend Date:	09/12/08
Frequency:	Quarterly

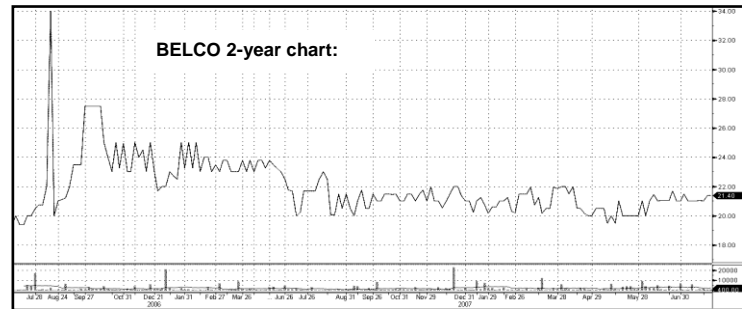
Shares O/S:	10.29m
Market Cap:	\$220.2m
BSX Weight:	8.57%
Book Value:	\$28.71
Price/Book:	0.75x

52-Week High:	\$23.00
52-Week Low:	\$19.50
Avg. Monthly Volume:	16,500

Earnings Snapshot:	2005	2006	2007	2008E
EPS:	\$1.99	\$2.10	\$1.98	\$1.87
YoY Growth:	9.9%	5.5%	(5.7%)	(5.6%)
P/E Ratio:	10.14x	10.95x	10.61x	11.44x
Fiscal YE Price:	\$20.18	\$23.00	\$21.00	

Current P/E Ratio:	10.81x
Shareholder's Equity:	\$295.5m
Total Assets:	\$339.7m
Return on Equity:	6.9%
Return on Assets:	6.0%

Notes: -BELCO raised its annual dividend by \$0.04 in August 2007.
-BELCO fiscal year end is Dec. 31st.



Price chart as of July 22, 2008. Courtesy of Bloomberg LLP.

2007 Earnings Decline by 5.6%

INVESTMENT HIGHLIGHTS

- BELCO Holdings reported 2007 operating earnings of \$20.4 million, or \$1.98 per share, down 5.6% from 2006 earnings of \$21.6 million, or \$2.10 per share, and short of our expectations of \$2.12 per share.
- Operating costs of \$1.8 million associated with inventory write-offs and \$684,000 related to cancellation penalties served to undermine BELCO's 2007 profit figures. Without these one-time items, the company earned \$22.9 million, or \$2.22 per share – slightly above our EPS estimates.
- Overall electricity sales came in less than projected. Although the number of residential customers increased by 2.53% year-on-year, the average customer usage declined by 4kWh per month. This decline in consumption was the result of conservation efforts brought about by higher fuel costs (passed on to consumers through the Fuel Adjustment Rate) as well as milder summer temperatures.
- Bermuda Gas posted net income of \$1.13 million, a 57.4% improvement over 2006 results. This earnings increase was attributed to a rise in propane revenues in addition to higher appliance sales.

Residential Usage Down 7.4% in 2008

CONSUMER CONSERVATION EFFORTS CONTINUE

- BELCO's fuel input prices have climbed substantially during the first half of 2008 – with April diesel fuel prices rising over 43% since the last shipment of November 2007. Bermuda's residential consumers have continued their conservation efforts accordingly, with average monthly usage down a significant 7.43% during the first five months of 2008.

- Bermuda Gas reported an annual revenue increase of 4.3% for first half 2008, with most of these gains due to higher propane prices. Appliance sales were down almost 7% year-on-year.

No “Quick Cure”- Renewable Energy a Ways Off

NEAR-TERM FUTURE TIED TO TYNES BAY PLANT

- At the 2007 AGM, BELCO presented to shareholders its Electric System Discussion Document, highlighting the timeline for installation of new electricity generation facilities. In order to meet projected electricity demand by 2011 – and in the absence of any viable large-scale renewable energy plans – the expansion of the Tyne’s Bay facility will continue apace. BELCO submitted an application to Government in November 2007, with eight phases proposed through 2030, including the installation of several new diesel engines and gas turbines.
- The agreement with Current to Current for the provision of ocean-generated power is still without a delivery date and appears to be “dead in the water” (no pun intended.) BELCO has subsequently turned its attention towards small-scale renewable technologies, with a pilot project currently taking place at its Belmont substation facility.
- In June 2008, BELCO announced the formation of a new subsidiary – PurEnergy Renewables Ltd. – which will focus on hybrid combinations of renewable power technologies, including Solar Photovoltaic (PV), Solar Thermal Water Heating, and small wind turbines. PurEnergy’s focus is twofold. Firstly, from a “macro” perspective, it plans to integrate new renewable-energy installations onto the grid in order to subsidize conventionally-generated power from BELCO’s central plant in Pembroke. Secondly, the subsidiary intends to provide consumers with customized designs which will reduce their dependence on fossil fuels and allow for backup power in the event of prolonged electricity outages following tropical storms and hurricanes.
- BELCO’s discussion of trendy renewable energy options is bound to elicit some “warm fuzzy” feelings. At present, however, this dialogue appears as little more than reactionary corporate rhetoric. While we hold ample confidence in the company’s renewable energy initiatives in the future, BELCO has decided to pursue a near-term plan centered around the expansion of its existing conventional facilities – replete with a continued reliance on fossil fuels and consumer prices subject to the vagaries of current energy markets.

New Projects, High Oil Costs Will Hurt Profits

FORECAST AND RECOMMENDATION

- Because BELCO passes on the majority of its oil price increases through the Fuel Adjustment Surcharge, higher electricity bills have led to a coincident decline in usage by the average consumer. In other words: “As energy costs rise, Bermudians conserve.” That having been said, it will be difficult for BELCO to pass the substantial price tag of its new infrastructure projects onto an already burdened consumer. BELCO has received Government approval on a 2.5% price increase per year for four years beginning in 2008, with a 3.0% rise in the fifth year. Given the \$195 million in electricity sales during 2007, these price increases equate to roughly \$5 million in supplementary annual revenue going forward. The remainder of the approximately \$100 million in funds required for near-term plant expansion – in addition to the costs of renewable energy initiatives – will be provided through a combination of working capital, equity/debt offerings, external lending facilities, and government subsidies.
- In order to meet Bermuda’s growing energy demands, BELCO estimates a required infrastructure investment of approximately \$500 million over the next 10 years. To put this number in perspective, BELCO’s current market capitalization stands at \$216 million, with total assets of \$340 million and shareholder’s equity of \$300 million. Government has recently established a new Ministry of Energy, which should (hopefully) provide a formidable ally for BELCO with respect to the planning, approval, and funding of future energy infrastructure projects.
- With crude oil trading over \$140 per barrel during July 2008, and Bermudians staring at over 50% year-on-year increases in fuel surcharges, we project sustained energy conservation efforts by residential customers in the range of 7-10% for the remainder of 2008. This “demand destruction” effect will be offset marginally by an increase in the number of residential customers and by higher commercial demand, as newly-completed office buildings and tourism projects “plug in” to the electrical grid.
- We apply an 11.0x multiple to our 2008 operating earnings estimate of \$1.87 per share, resulting in a one-year price target of \$21.00 and a recommendation of “hold”. We would note that BELCO shares offer an attractive dividend yield of 4.0% and currently trade at a 25% discount to book value.

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