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BJORKLUND FUND

April 13, 2018

Chesapeake Utilities Corp. : CPK

Matt Lucarelli

Sector: Utilities
Industry: Natural Gas Utilities
Current Price: $74.35
Target Price: $87.54

Company Description:

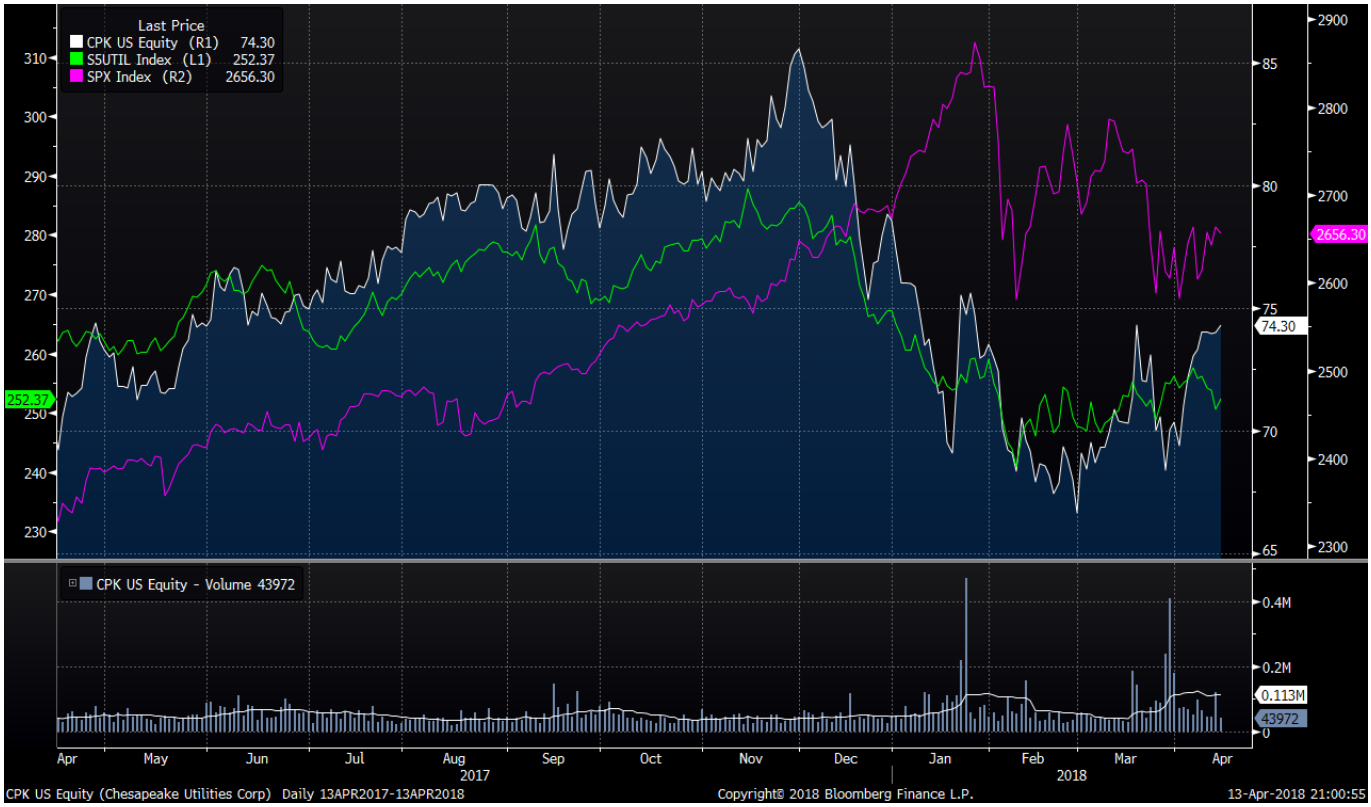
Chesapeake Utilities Corporation is a diversified utility company that specializes in providing natural gas transmission and distribution, propane distribution, and information technology services. They distribute natural gas to residential, commercial, and industrial customers in Delaware, Maryland, and Florida.

BUY

Current Price:	$74.35
Target Price:	$87.54
Market Cap:	$1.216 billion
52 Week Range:	$66.35 - $88.35
Beta:	0.72
WACC:	6.76%
ROIC:	7.37%
EBITDA Margin:	21.12%
Credit Rating	A-

Catalysts:

- **Short Term (within the year):** Earnings announcement May 2nd, 2018. 2017 Eastern Shore Natural Gas Expansion in service through 2018. Recent tax reform.
- **Mid Term (1-2 years):** Northwest Florida Expansion and other Florida Pipeline Expansions. Expansion of propane vehicular platform through AutoGas, where propane is the clean-burning fuel alternative.
- **Long Term (3+):** Organic growth in existing markets and future expansion of pipelines into new states.



Thesis:

Chesapeake exhibits robust revenue growth, net income growth, and a largely solid financial position with reasonable debt levels by most measures. In the short-term the company can expect a strong earnings announcement on May 2nd, 2018 as well as the positive effects from the recently completed project of the Eastern Shore Natural Gas Expansion. For the mid-term catalysts, Chesapeake is motivated to further expand both in northwest Florida and their Florida pipeline service for natural gas. In addition, the company seeks to expand part of their unregulated sector as well, which includes them expanding their propane vehicular platform through AutoGas, where propane is the clean-burning fuel alternative. While these projects can expected to be completed before the end of 2018, the company will not experience growth from these synergies until 1-2 years, which is why this is a mid-term catalyst. In the long-term, Chesapeake is determined to continue expanding through organic growth and by potentially expanding their pipelines into already occupied states or developing distribution and pipelines into new states. Recently, the utilities sector has been underperforming relative to the market, however, despite an underperformance in the sector, the proposed catalysts can assure that Chesapeake will outperform the market and their competitors in the upcoming months.

Segment Analysis:

Chesapeake Utilities operates in two main segments, regulated energy and unregulated energy. Year over year the company has experienced increasing residential, commercial, industrial customers equaling a total of over 240,000 distribution customers. Chesapeake Utilities Corporation owns multiple companies, which helps them strive towards creating a successful diversified energy company.

Chesapeake's regulated segment is their largest segment comprised of three different operations. First, they have their natural gas distribution operations in Delaware, Maryland and Florida. Second, is their electric distribution operations in Florida. Last, is their natural gas transmission operations on the Delmarva Peninsula and in Florida. Their natural gas and electric distribution operations are local distribution utilities and generate revenues based on tariff rates approved by the PSC of each state in which they operate. The regulated segment consists of Chesapeake utilities, Eastern Shore natural gas, Florida Public utilities, Peninsula pipeline, and Sandpiper energy. Over the years, the company's regulated segment contribution to total revenue has been decreasing relative to the unregulated segment. It accounted for a 52.8% of the total revenue in 2017. However, with the recently completed projected for Eastern Shore natural gas, the regulated segment may account for a larger percentage of total revenue. In 2017 operating income for the Regulated Energy segment increased by $3.3 million. The Eastern Shore natural gas expansion project cost $117 million and is estimated to provide a $15.8 million annual margin in the first full year of operations. As for the project itself, there are 23 miles of pipeline looping in PA, DE, and MD with 17 miles of new mainline extension. There were upgrades to the TETCO pipeline and two new pressure control stations were added. With these upgrades, the total capacity will increase to 61,162 dts/d on Eastern Shore's pipeline system, which is a 26% increase in capacity.

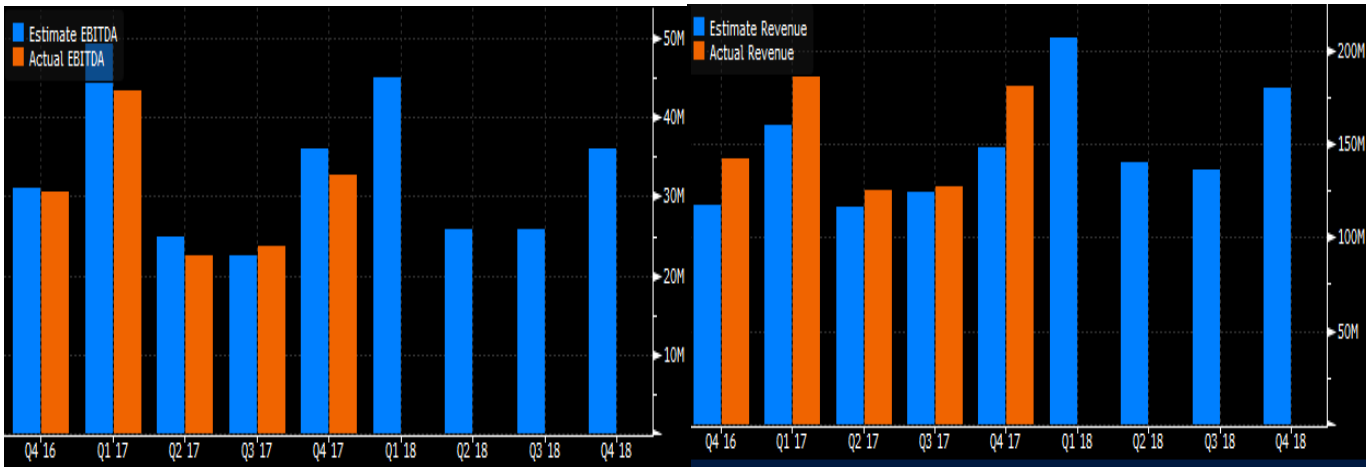
Another project currently underway are the Florida pipeline expansions. The first one is the Northwest pipeline expansion, which is estimated to cost $35.9 million with a $6.0 million annual gross margin. It is looking to be completed by the end of the second quarter of 2018 and will have a 38 mile transmission and 5 mile distribution. Currently, there are customer commitments of 68,500 dts/s and there is a total capacity of 80,000 dts/s. The other two projects are the New Smyrna pipeline expansion and the Belvedere pipeline expansion, which will both be completed in the third quarter of 2018. Together, they are a $12.9 million investment, generating a projected annual return of $2.0 million running a total transmission pipeline if 16 miles.

12 Months Ending	12/31/2014		12/31/2015		12/31/2016		12/31/2017	
Revenue	498.8	100.0%	459.2	100.0%	498.9	100.0%	617.6	100.0%
Regulated Energy	299.3	60.0%	301.9	65.7%	305.7	61.3%	326.3	52.8%
Unregulated Energy	184.6	37.0%	162.1	35.3%	203.8	40.8%	324.6	52.6%

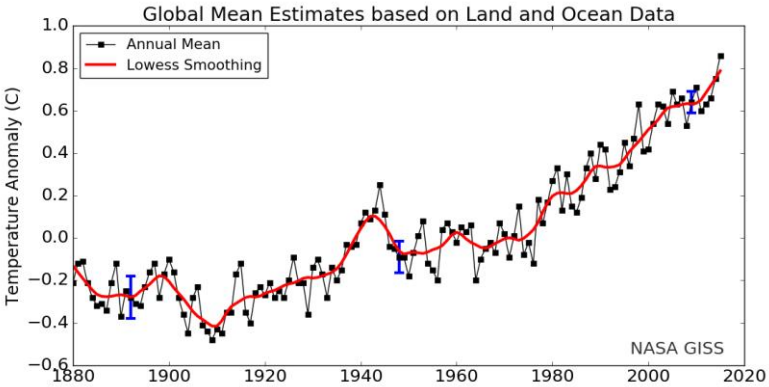
The unregulated segment provides five energy-related service to their customers. They are, propane distribution, natural gas marketing, unregulated natural gas supply, gathering and processing, electricity and steam generation, and other unregulated services. The difference between the regulated and the unregulated segment is that revenues generated from this segment are not subject to any federal, state or local pricing regulations. Their propane distribution operations sell propane to residential, commercial/industrial, and wholesale customers, including AutoGas customers, in Delmarva and southeastern Pennsylvania, through Sharp and Sharpgas, and in Florida through FPU and Flo-gas. A majority of their customers are classified as "bulk delivery" customers. In Florida, they also offer metered propane distribution to residential and commercial customers, in which they are billed monthly. One of their unregulated companies, PESCO competes with regulated utilities and other unregulated third-party marketers to sell natural gas supplies directly to commercial and industrial customers through competitively-priced contracts. Another, is Aspire Energy, which is an unregulated natural gas infrastructure company that owns approximately 2,600 miles of pipeline systems in 40 counties throughout Ohio. The majority of Aspire Energy's margin is derived from long-term supply agreements with Columbia Gas of Ohio and CGC, which together serve more than 20,000 end-use customers. Eight Flags provides electricity and steam generation services through its CHP plant located on Amelia Island, Florida. Eight Flags also sells steam, pursuant to a separate 20-year contract, to the industrial customer that owns the property on which Eight Flags' CHP plant is located. The catalysts for the unregulated segment is seen through the expansion of propane vehicular platform through AutoGas, where propane is the clean-burning fuel alternative. In addition, the company is receiving a 100% expense deductibility for capital investments in their unregulated businesses, which is a significant benefit and will be valuable, giving them the opportunity to grow and expand their unregulated portfolio.

Earnings Performance:

Chesapeake Utilities Corporation has experienced an increasing revenue growth and EBITDA year over year. Their revenue growth came in higher than the industry average of about 15.60%. In the chart below, Chesapeake has consistently outperformed their estimated revenue quarter over quarter and is expected to continue to grow their revenue for the remainder of 2018. A strong earnings announcement in May and the recognition of revenue from the previously completed $117 million expansion project in 2017 accounts for the estimated growth in revenue for Chesapeake. In addition, because the recent tax reform in 2018, Chesapeake has also recognized an increase in their EPS. Also, due to colder weather conditions this winter, in the fourth quarter of 2017, this increased customer consumption and generated $1.9 million in additional gross margin compared to 2016. While revenue did increase and outperform its estimates, the company's EBITDA was lower than its estimates, but is expected to be more accurate with future estimates. The company experienced a $17.2 million increase in operating expenses for both their regulated and unregulated sectors in 2017. The drivers of this include $4.1 million in higher depreciation, asset removal and property tax costs associated with recent capital investments; $2.9 million in higher operating expenses for Eight Flags' CHP plant in support of the higher margin generated; $6.5 million in higher payroll expenses for additional personnel to support growth; $1.0 million in regulatory expenses, due primarily to costs associated with Eastern Shore's rate case filing in 2017, which was partially offset by $529,000 in reduced credit, collection and customer services expenses, exc. While these unexpected operating expenses adversely affected their EBITDA, they are a onetime thing and Chesapeake will be closer to their future estimates for the remainder of 2018.

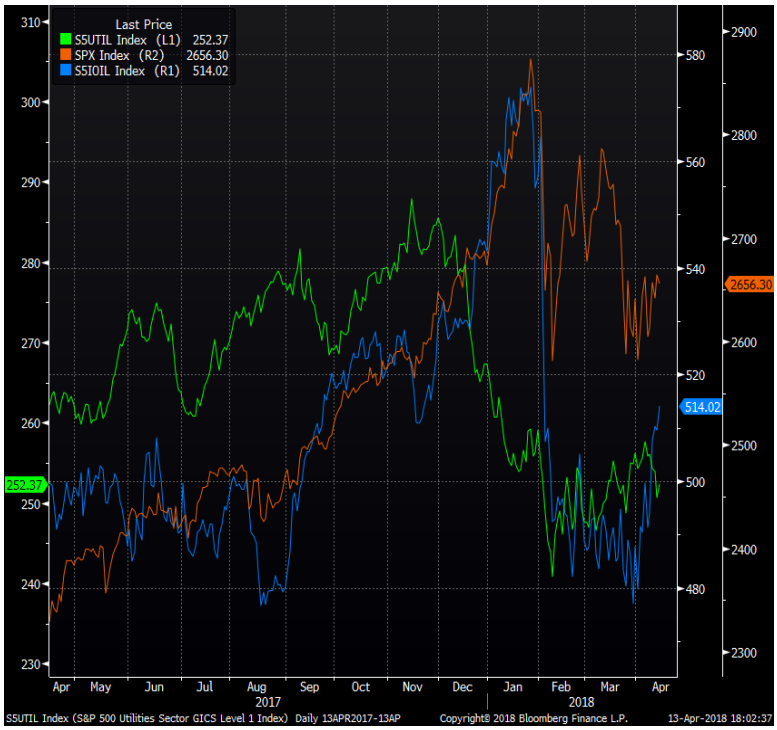


Industry Outlook:



The utility industry and the stock market as a whole have experienced more significant stock price and volume fluctuations that have affected stock prices in ways that may have been unrelated to operating performance. In the utility sector, revenues are directly affected by weather conditions. Generally, in the winter more customers will consume a higher amount of natural gas for heating purposes. In the summer, people typically use a higher amount of electricity for cooling purposes. For this reason, revenues for Chesapeake are usually higher in both the first quarter and the fourth quarter. With more unpredictable climate changes, Chesapeake will be positively and negatively affected. If the climate becomes harsher, meaning hotter summers and colder winters, Chesapeake and other utility companies will experience growing demand for natural gas and electricity. However, with harsher climates, comes more violent storms. Furthermore, more storms, creates the possibility of Chesapeake's pipelines and facilities being damaged. In addition, if their customers' homes are destroyed, they will lose customers and business.

Currently, we are in a rising interest rate environment. Since companies in the utilities sector generally require significant infrastructure, companies usually carry large amounts of debt, meaning they are sensitive to interest rates. As interest rates continue to increase, so does the cost of capital, making future projects and capital expenditures more expensive. However, diversified utilities have actually performed better and have been benefiting from the tax-law changes, seeing a boost in their EPS.

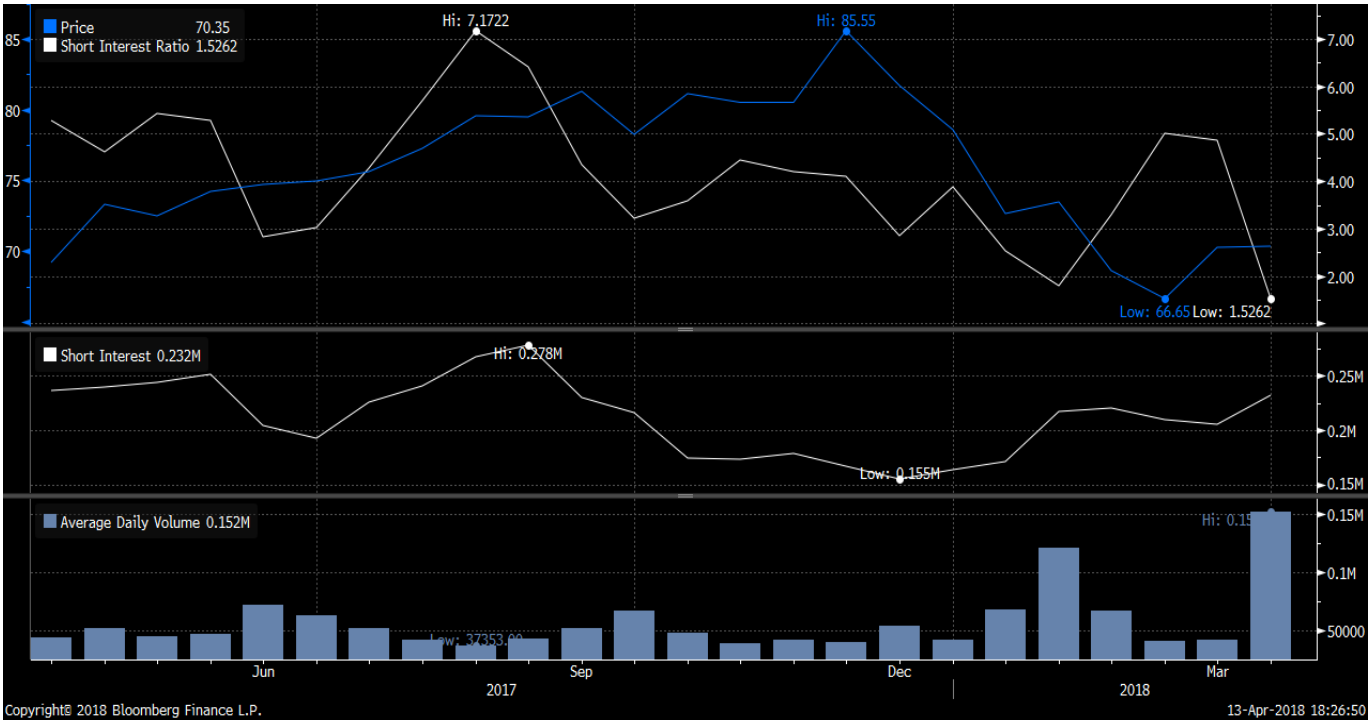


To the left shows the oil & natural gas index (blue), the utilities index (green), and the S&P 500 index (orange). We can see how the utilities index moves inversely and directly with the other two indexes. As the prices of natural gas increases, utility companies are negatively affected. Considering many utilities have contracts setup, they cannot change their prices. In addition, it is also difficult to increase utility prices if natural gas prices increase because customers will switch to a cheaper alternative. However, in the past couple months, the price of natural gas has been decreasing since February. This is good news for utility companies considering interest rates are rising.

Management/Ownership

For the ownership of the company, it is primarily owned by Investment advisors. The top three investment advisors consist of T. Rowe Price Group Inc. with 12.36%, Blackrock holds 6.24%, and Vanguard has 5.53%. In the past year, investment advisors have increased their holding percentage by 5.08% and currently possess 86.42%, while individuals decreased 2.19% and is now at 5.46%, and hedge fund managers decreased 0.57% and is now at 4.40%. The current percentage of float is at 76.79%, a 20.45% increase from the previous year.

54) Ownership Type	04/09/17	Curr	Change
41) Investment Advisor	81.34	86.42	+5.08
42) Individual	7.65	5.46	-2.19
43) Hedge Fund Manager	4.97	4.40	-0.57
44) Pension Fund	3.25	1.49	-1.76
45) Insurance Company	1.58	1.34	-0.24
46) Government	0.48	0.47	-0.01
47) Bank	0.55	0.32	-0.23
48) Brokerage	0.14	0.04	-0.10
49) Other	0.01	0.03	+0.02



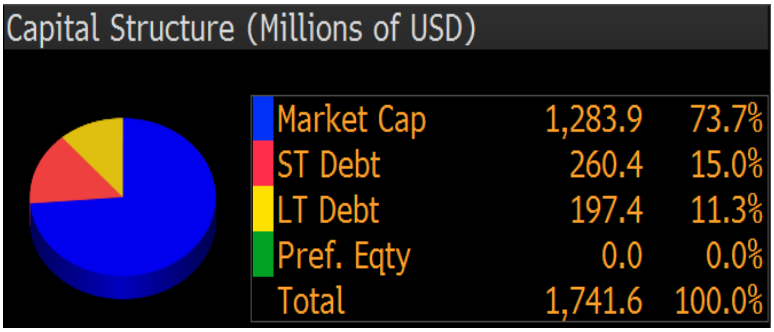
The chart above presents the short interest ratio. In the past year, the short interest was at a high of 7.1722 and recently hit a low of 1.5262. The sudden decrease in the short interest ratio from about 5 to 1.5 would imply that investors exercised their short positions. In addition, there is an inverse relationship between the short interest ratio and the price of the stock, as the short interest decreases, the stock price increases.

The management of Chesapeake starts with the Michael P. McMasters, who is the President and Chief Executive Officer that has been with the company for 37 years. He is responsible for execution of the company's strategic plan and providing leadership and oversight of the company's businesses. His annual compensation for 2017 was $783,320, which has been decreasing since 2015. Stephen C. Thompson is the Senior Vice President of Chesapeake Utilities Corporation since 2004 and has been with the company for 35 years. He is also President and Chief Operating Officer of Eastern Shore Natural Gas Company, the Company's natural gas transmission subsidiary. Mr. Thompson is responsible for the oversight of the Company's Delmarva-based regulated businesses. His annual compensation for 2017 was $485,520, which also has decreased since 2015. Jeffry M. Householder was appointed as President of Florida Public Utilities Company in June of 2010. For the 10 years prior to his appointment, he operated a consulting practice that provided business development and regulatory services to utilities, propane retailers and industrial clients. While he only has been with the company for 7 years, he has 38 years of energy related experience. He made $432,551in 2017, which is also a decrease from 2015. Something important to note is that even with a growing company and an appreciating stock price, the executives decided to take pay cuts for the better of the company.

Name	Title Sort by Rank	FY 2014 (USD)	FY 2015 (USD)	FY 2016 (USD)	FY 2017 (USD)
McMasters, Michael P.	President, CEO & Director	917,767	1,264,599	976,064	783,320
Thompson, Stephen C.	Senior Vice President	530,056	589,505	536,236	485,520
Householder, Jeffry M.	President of Florida Public Utilities Company	428,775	495,159	423,020	432,551

Capital Structure:

In the utility sector, the average debt used by a company is generally around 40.21%, while the average equity is around 59.79%. For Chesapeake, their total debt is at 26.3%, while their equity is at 73.7%. Recognizing that they have lower debt levels than the industry averages, they will be less affected by rising interest rates. In addition, when comparing their credit rating to their competitors, they have an A- rating compared to the industry average credit rating of about BBB+. Considering they have a higher credit rating than a majority of their competitors, the cost of debt will essentially be cheaper for them, giving the ability to borrow more debt. Chesapeake also is a company that is creating value, unlike many of the companies in the utilities sector. The industry average return on invested capital (ROIC) is at 5.15%, with an average weighted cost of capital (WACC) at 6.72%. Thus, giving a ROIC/WACC industry average of 0.78 in the last twelve months. For Chesapeake, they have a ROIC of 7.37%, with a WACC of 6.76%, providing them with a ROIC/WACC of 1.08. Chesapeake is creating more value relative to the industry average in the last twelve months, according to the ROIC/WACC ratio.



Profitability Comparison:

When comparing Chesapeake to their competitors, they appear to have stronger financials in most aspects. Chesapeake is presents a higher P/E than the median average at 21.58 relative to 21.50. With a higher P/E than the industry average, the investors can expect to anticipate higher growth in the future.

	Name (BICS Best Fit)	Est P/E Current Yr	Market Cap	Enterprise Value	Dividend Yield
	Median	21.50	3.50B	5.04B	2.98%
100)	CHESAPEAKE UTILITIES C...	21.58	1.22B	1.67B	1.75%
101)	NORTHWEST NATURAL GA...	26.10	1.68B	2.51B	3.24%
102)	CONNECTICUT WATER SV...	29.20	751.53M	1.03B	1.88%
103)	CALIFORNIA WATER SERV...	26.51	1.81B	2.52B	1.99%
104)	ONE GAS INC	21.50	3.50B	5.04B	2.76%
105)	AMERIGAS PARTNERS-LP	15.53	3.90B	6.76B	9.05%

The picture that illustrates sales growth, Chesapeake is growing at 23.80% for the current fiscal period, which I higher than the median average at 7.88% and any of its competitors. This displays that Chesapeake has significant potential and with the proposed initiatives, we can expect potentially more sales growth by the end of 2018.

	Name (BICS Best Fit)	Sales Growth (%)
	Median	7.88%
100)	CHESAPEAKE UTILITIES C...	23.80%
101)	NORTHWEST NATURAL GA...	12.75%
102)	CONNECTICUT WATER SV...	8.50%
103)	CALIFORNIA WATER SERV...	9.44%
104)	ONE GAS INC	7.88%
105)	AMERIGAS PARTNERS-LP	6.13%

Looking at Chesapeake's ROA, they present a higher percentage than their competitors. They have a 3.56% compared to the median average at 2.79%, implying that Chesapeake is managing their overall resources better than their competitors. Chesapeake also displays a higher ROE at 10.10% compared to the industry median at 9.93%. This means that Chesapeake is turning the cash put into the business into greater gains and growth for the company and its investors than most of its competitors.

	Name (BICS Best Fit)	Return on Assets (%)	Return on Equity
	Median	2.79%	9.93%
100)	CHESAPEAKE UTILITIES C...	3.56%	10.10%
101)	NORTHWEST NATURAL GA...	2.11%	8.09%
102)	ATMOS ENERGY CORP	3.85%	10.19%
103)	CALIFORNIA WATER SERV...	2.61%	9.93%
104)	CONNECTICUT WATER SV...	3.15%	10.00%
105)	ONE GAS INC	3.21%	8.47%
106)	AMERIGAS PARTNERS-LP	5.00%	18.91%

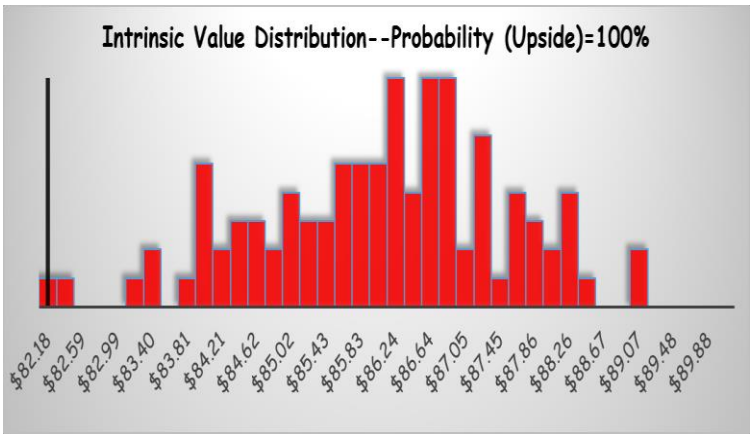
Based off of the five metrics, Chesapeake outperforms the median average in three of them. While they may have the lowest EBITDA margin at 21.12, they have the highest sales growth at 23.80%. As mentioned earlier, the company had unexpected operating expenses which directly impacted their EBITDA. However, with an increasing sales growth and multiple expansion projects underway, the company can expect substantial growth in the next couple of years. The EBITDA margin can expect to increase because of a 100% expense deductibility for capital investments in their unregulated businesses. In addition, Chesapeake is above the industry median for EBITDA growth year over year, which will also help improve their EBITDA margin.

Metric	CPK	Low	Comp Range	High
Est P/E Current Yr	21.58	11.88		29.20
Ind. Dividend Yld (%)	1.75	1.75		9.05
Sales Growth Yoy (%)	23.80	-3.01		23.80
EBITDA Margin (%)	21.12	21.12		47.10
EBITDA Growth Yoy...	5.65	-9.38		21.63

CPK US ◆ Median

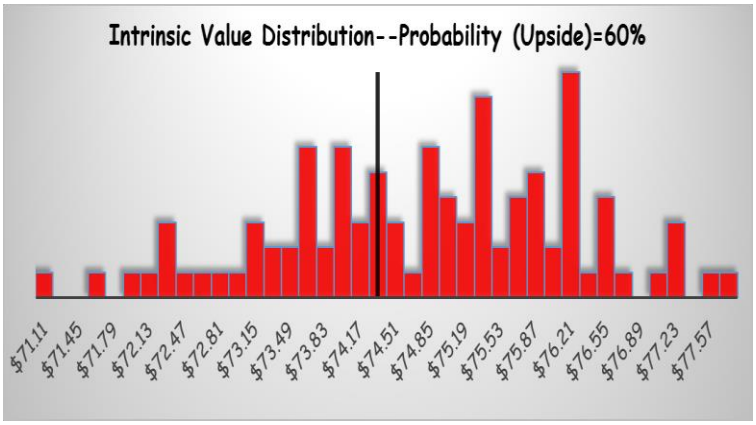
Sensitivity Forecast:

BASE CASE



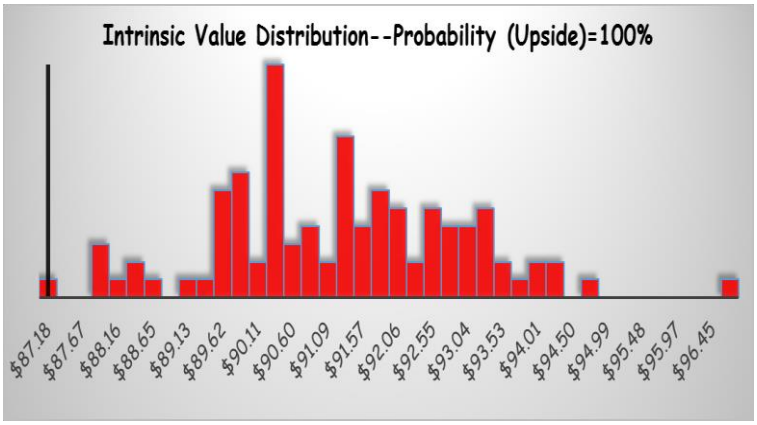
The utility sector has been underperforming relative to the market in the new year of 2018. Some speculations are that utility stocks have depreciated due to increasing interest rates. Utility companies generally use a large amount of leverage for their infrastructure, meaning companies are sensitive to rising interest rates. For Chesapeake, however, they use much less debt than the industry average and diversified utilities have benefited from the recent tax plan. With the recent expansion of the Eastern Shore pipeline, and future expansions of other pipelines in Florida, the company can expect healthy growth and returns. I estimated an 81% operating expense to revenue, which was based off the historical average and other estimates. With many new projects underway, I increased the CAPEX/Rev to be 25% and equaled all other factors to historical averages. Since the company is experiencing significant growth and is expanding, I placed them in the growth stage. I also used a 2.9% cost of debt. I used a Monte Carlo simulation and a conservative prediction of 8.5% revenue growth, I reached a target price of $87.54, providing a 19.50% return with an upside of 100%.

BEAR CASE



For a pessimistic case I predicted expansion projects failing and costing more than expected, interest rates increasing dramatically, and natural gas prices beginning to increase. I increased Op/Rev to 82%, and assumed that revenue growth would be only 6%. The target price comes out to $76.55, with a return of 4.72% and upside probability of 60%.

BULL CASE



In an optimistic scenario where all projects are successful, interest rates still increase slightly, and where natural gas prices remain at low prices, I came up with 81% Op/Rev. I predicted that revenue growth will grow at 13%, which is still less than their current growth at 23.80%. The target price comes out to $94.12, with a return of 28.35%.

Conclusion:

In conclusion, Chesapeake Utilities Corporation is a buy at its current price. This is due to robust sales growth, the expansion of several pipelines, and their ability to create value over their competitors. With the proposed catalysts, Chesapeake is a growing company and has much potential to expand their utility services into new areas or possible new states. Under a base assumption, the company's one year target price came out to $87.54 with an 19.50% return. While Chesapeake Utilities Corporation's stock has been underperforming relative to the market, they are still outperforming other companies in their sector and I am confident that Chesapeake has the ability to outperform the market.

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Chesapeake Utilities Corporation (CPK)

NEUTRAL

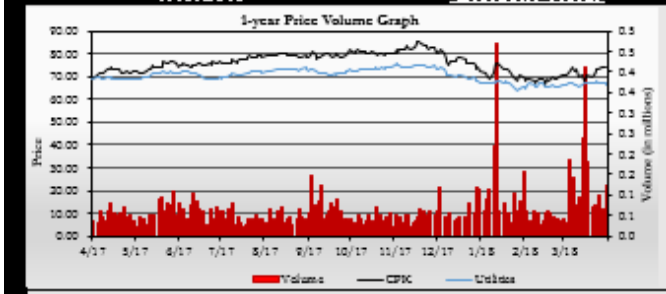
Analysis by Matt Lucarelli

4/13/2018

Current Price:	$74.35	**Intrinsic Value**	$80.49
Divident Yield:	1.8%	**Target Price**	$87.54

Target 1 year Return: 19.5%

Probability of Price Increase: 100



Description

Chesapeake Utilities Corporation, a diversified energy company, engages in regulated and unregulated energy businesses.

General Information

Sector	Utilities
Industry	Gas Utilities
Last Guidance	February 12, 2018
Next earnings date	May 3, 2018

Market Assumptions

Estimated Equity Risk Premium	5.00%
Effective Tax rate	21%

Market Data

Market Capitalization	$1,210.77
Daily volume (mil)	0.02
Shares outstanding (mil)	16.36
Diluted shares outstanding (mil)	16.38
% shares held by institutions	109%
% shares held by investment Managers	51%
% shares held by hedge funds	5%
% shares held by insiders	3.68%
Short interest	1.42%
Days to cover short interest	2.74
52 week high	$86.35
52-week low	$66.35
Volatility	20.91%

Past Earning Surprises

Quarter ending	Revenue	EBITDA
12/31/2016	21.57%	3.10%
3/31/2017	15.94%	-8.79%
6/30/2017	7.37%	-1.47%
9/30/2017	-1.37%	11.42%
12/31/2017	6.03%	-4.92%
Mean	9.91%	-0.13%
Standard error	1.1%	5.2%

Market and Credit Scores

Recommendation (STARS) Value	0
Recommendation (STARS) Description	0
Quality Ranking Value	A
Quality Ranking Description	High
Short Score	0
Market Signal Probability of Default % (Non-Ratings)	0.547%
Credit Model Score (Non-Ratings)	a-

Industry and Segment Information

LTM Revenues by Geographic Segme	LTM Revenues by Business Segments
United States	100%
--	Regulated Energy	53%
--	Unregulated Energy	53%
--	Other Businesses	0%
--	Intersegment Revenues	-6%
--	--

Peers

Northwest Natural Gas Company	RGC Resources, Inc.
South Jersey Industries, Inc.	--
WGL Holdings, Inc.	--
New Jersey Resources Corporation	ONE Gas, Inc.
Spire Inc.	--

Management	Positions	Total Compensations Growth	Stock Price Growth During Tenure
McMasters, Michael	President, CEO & Director	5.87% per annum over 6y	2.64% per annum over 6y
Cooper, Beth	Senior VP, CFO, Assistant Secretary	2.56% per annum over 6y	2.64% per annum over 6y
Thompson, Stephen	Senior Vice President	2.24% per annum over 6y	2.64% per annum over 6y
Bittner, Elaine	Senior Vice President of Strategic Developmen	-3.21% per annum over 6y	2.64% per annum over 6y
Householder, Jeffry	President of Florida Public Utilities Company	5.61% per annum over 4y	9.11% per annum over 4y
Gadgil, Vikrant	Chief Information Officer and Vice President		

Profitability	CPK (LTM)	CPK Historical	Peers' Median (LTM)
Return on Capital (GAAP)	7.4%	8.72%	5.15%
Operating Margin	12%	12.85%	20.26%
Revenue/Capital (GAAP)	0.60	0.68	0.25
ROE (GAAP)	9.6%	10.9%	11.2%
Net margin	6.9%	7.4%	8.7%
Revenue/Book Value (GAAP)	1.38	1.47	1.30

Invested Funds	CPK (LTM)	CPK Historical	Peers' Median (LTM)
Cash/Capital	0.6%	0.6%	0.4%
NWC/Capital	3.6%	-0.5%	5.6%
Operating Assets/Capital	93.5%	98.6%	89.9%
Goodwill/Capital	2.3%	1.2%	4.1%

Capital Structure	CPK (LTM)	CPK Historical	Peers' Median (LTM)
Total Debt/Market Capitalization	0.49	0.43	0.55
Cost of Debt	3.3%	4.3%	4.1%
CGFS Rating (F-score, Z-score, and default Probability	A		
WACC	6.8%	7.7%	6.7%

Porter's 5 forces (Scores are percentiles)

Valuation

Forecast Assumptions	Explicit Period (12 years)	Continuing Period
Revenue Growth CAGR	7%	2%
Average Operating Margin	18%	19%
Average Net Margin	5%	4%
Growth in Capital CAGR	8%	2%
Growth in Claims CAGR	10%	2%
Average Return on Capital	5%	4%
Average Return on Equity	8%	9%
Average Cost of Capital	5%	5%
Average Cost of Equity Ke	8%	8%