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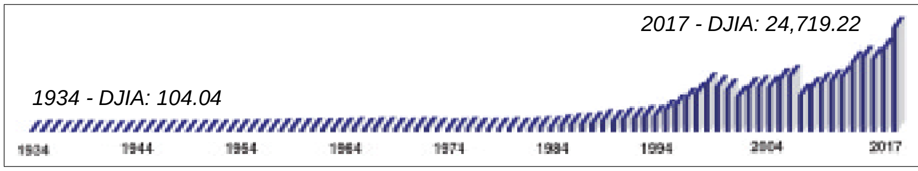
MARKET DIGEST



FRIDAY, MAY 4, 2018
MAY 3, DJIA 23,930.15
UP 5.17

Good Morning. This is the Market Digest for Friday, May 4, 2018, with analysis of the financial markets and comments on **American International Group Inc., Juniper Networks Inc., Norwegian Cruise Line Holdings Ltd., Xerox Corp., AT&T Inc., ConocoPhillips and Public Service Enterprise Group Inc.**

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MARKET REVIEW:

Stocks pared sharp early losses on Thursday as investors weighed mixed 1Q earnings ahead of the April employment report on Friday morning. The current consensus calls for 192,000 new payroll jobs, up from 103,000 in March, and a slightly lower unemployment rate of 4.0%. On Wednesday, payroll processor ADP reported that U.S. companies added 204,000 jobs in April, down from a revised 228,000 in March. The Dow rose 0.02%, the S&P fell 0.23%, and the Nasdaq fell 0.18%. Crude oil traded near $68 per barrel, while gold rose $10 to trade near $1315 per ounce.

AMERICAN INTERNATIONAL GROUP INC. (NYSE: AIG, $51.94) .... BUY

AIG: Lowering target to $63 from $68 following 1Q miss

* On May 2, AIG reported a 1Q18 after-tax operating profit of $963 million or $1.04 per share, down from $1.37 billion or $1.36 per share a year earlier. EPS missed our estimate of $1.36 and the consensus forecast of $1.25. The weaker-than-expected earnings reflected pretax catastrophe losses of $376 million.
* We are lowering our 2018 EPS estimate to $5.12 from $5.55 following the significant earnings miss. However, our revised estimate still represents a 119% increase from 2017, reflecting the company's efforts to improve core operations, add new businesses, and lower its risk profile.
* In January 2018, AIG purchased Validus, a Bermuda insurer and reinsurer, for $5.56 billion. The purchase should help to mitigate the company's exposure to catastrophe losses.
* AIG shares look cheap relative to peers. The price/book ratio is 0.7, below the industry median of 1.5, and the projected 2018 P/E ratio is 9.8, below the peer median of 16.4. Our revised target of $63 implies modest expansion of the price/book multiple to 0.9, still well below the industry median.

ANALYSIS

INVESTMENT THESIS

We are reiterating our BUY rating on American International Group Inc. (NYSE: AIG), but are lowering our target price to $63 from $68 following the company's substantial 1Q earnings miss. We see challenges ahead for AIG following continued higher-than-normal catastrophe losses in 1Q18. However, investor sentiment has become more positive with the appointment of new CEO Brian Duperreault, who replaces Peter Hancock. Mr. Duperreault is an industry veteran who favors growth, including growth through accretive M&A, over further restructuring. In September 2017, the Financial Stability Oversight Council (FSOC) removed AIG's designation as a nonbank SIFI, which should free up reserve capital. We also like the company's leading position in global P&C and U.S. life insurance, geographic diversification, efforts to cut costs and sell noncore assets, and strong liquidity.

The company has spun off its mortgage insurance business. It also plans to boost dividends and pursue acquisitions, as demonstrated by the recent $5.56 billion purchase of Validus, a Bermuda insurer and reinsurer. AIG also appears well positioned to improve returns on its $246 billion bond portfolio as interest rates move higher, and should benefit from both reduced financial regulation and lower taxes.

AIG shares look cheap relative to peers. The price/book ratio is 0.7, below the industry median of 1.5. The projected 2018 P/E ratio is 9.8, below the peer median of 16.4. The ROE of 7.7% is below the five-year average, but in line with peers. As profitability improves, the price/book gap should close between AIG and its peers. Our revised target of $63 implies modest expansion of the price/book multiple to 0.9, still well below the industry median.

RECENT DEVELOPMENTS

AIG shares have underperformed over the past three months, declining 19%, compared to a 5% decrease for the S&P 500. They have also underperformed over the past year, declining 17% compared to a gain of 10% for the S&P 500. The beta on AIG shares is 1.04, compared to 0.89 for peers.

On May 2, AIG reported 1Q18 results that came in well below our estimates and consensus expectations. After-tax operating profit fell to $963 million or $1.04 per share from $1.37 billion or $1.36 per share a year earlier. EPS missed our estimate of $1.36 and the consensus forecast of $1.25. The weaker-than-expected earnings reflected pretax catastrophe losses of $376 million, mostly due to mudslides in California, winter storms, an earthquake in Papua New Guinea, and $135 million of other severe losses. On a GAAP basis, AIG reported net income of $938 million or $1.01 per share, compared to $1.2 billion or $1.18 per share in 1Q17. Net premiums earned rose 3% to $6.7 billion, and net premiums written fell 2% to $6.2 billion. Revenue fell 7% to $11.7 billion, which matched our estimate but missed the consensus forecast of $12.0 billion. Book value at the end of the quarter was $69.95 per share, down from $78.59 at the end of 1Q17. The stock fell as much as 10% the day after the earnings release.

Adjusted 1Q18 ROE came to 7.7%, down from 9.6% a year earlier. The year-over-year decline reflected lower profitability, especially in General Insurance. However, ROE was higher than the 4.2% achieved in 4Q17 and the negative 8.4% seen in 3Q17. CFO Sid Sankaran recently noted that a reduction in the statutory tax rate to 21% (from a prior 35%) would boost ROE by 150 basis points.

In September 2017, the company announced it would change its reporting structure beginning in 1Q18. Its new reporting segments are General Insurance and Life and Retirement. The company also has a stand-alone technology-enabled platform. It no longer has Commercial and Consumer segments.

In 1Q, General Insurance posted a pretax operating profit of $510 million, down from $1.1 billion a year earlier due to weaker North American and international results, higher favorable prior-year loss reserve development of $110 million, and a higher current-accident-year loss ratio in North America. The unit reported $376 million in catastrophe losses. The General Insurance combined ratio worsened to 103.8 from 99.8 a year earlier.

In Life and Retirement, the pretax operating profit declined 1% from the prior year to $892 million. Revenue and fees declined 22% to $1.2 billion.

In January 2018, AIG acquired Validus Holdings, an insurance and reinsurance company based in Bermuda, for $5.56 billion or $68 per share. The purchase price represents a 46% premium to the Validus share price the day before the announcement. CEO Duperreault said that the acquisition would further diversify AIG's business and help to mitigate the impact of catastrophe losses. The transaction will be partly funded with debt and is expected to close mid-2018.

In September, the FSOC removed AIG's designation as a nonbank SIFI, which should free up reserve capital and remove federal oversight for M&A. Likely influenced by the new Republican administration at Treasury, the FSOC now believes that AIG has significantly reduced its risks to the broader economy.

On the 1Q call, CEO Duperreault declared 2018 as the "year of the underwriter," as he expected a yearly profit in underwriting by the end of the year and a combined ratio of less than 100, both of which have been out of reach in recent years. On the 4Q17 call, he stressed the importance of growth over restructuring. He also said that the company would no longer provide financial targets, such as ROE or stock repurchase amounts. AIG has disappointed investors in some of these areas over the years. The company had expected to return $25 billion to investors in 2016-2017, but fell short of that goal by nearly $2 billion. AIG now joins peers Travelers and Chubb in scaling back its disclosures to investors.

In sum, the quarter was disappointing, with higher catastrophe losses, a weaker underlying margin in North American General Insurance Commercial Lines, lower premiums, and a combined ratio above 100. On a positive note, the company has been reducing operating costs, which fell 7% to $2.3 billion in the first quarter. Additionally, claim costs on policies older than one year were lower than expected. The company also benefited from the stabilization of the General Insurance accident-year loss ratio, margin improvement in the International Commercial Lines unit, and favorable reserve development. We think the company will be successful over the remainder of 2018, with healthy reserves, a diminished risk of future large reserve charges, and improved pricing.

EARNINGS & GROWTH ANALYSIS

AIG's recent financial performance has been poor, and we feel that management's new strategic plan could be more aggressive. Despite a higher-than-usual 1Q18 ROE of 7.7%, we think the company is unlikely to consistently reach the level of MetLife and Prudential, which regularly generate ROE of almost 10%.

However, we believe that AIG is changing direction, and that the tone of the new CEO is boosting investor confidence. We like the company's leading positions in global P&C and U.S. life insurance, geographic diversification, ongoing divestitures of noncore assets, and strong liquidity. We also see margins improving due to reduced operating expenses.

We are lowering our 2018 EPS estimate to $5.12 from $5.55 following the significant 1Q earnings miss. However, our revised estimate still represents a 119% increase from 2017, reflecting the company's efforts to improve core operations, add new businesses, and lower its risk profile. We are also lowering our 2019 estimate to $5.93 from $6.17.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on AIG is Medium-Low, the second-lowest point on our five-point scale.

The total debt/capital ratio was 33% at the end of 1Q18, above the peer median of 20%. Operating income covered interest expense by a factor of 4.2, compared to a peer median coverage ratio of 5.6. The adjusted net margin was 4.1%, below the peer median of 8.2%.

The company's senior debt has a Baa1 rating with a stable outlook from Moody's and a BBB+ rating with a negative outlook from S&P.

AIG pays a quarterly dividend of $0.32 per share, or $1.28 annually, for a yield of about 2.6%, above the peer median of 1.9%. Our dividend estimates are $1.28 for both 2018 and 2019.

In the first quarter, the company repurchased 5.4 million shares for $298 million and warrants for $2 million. AIG has $2.0 billion remaining on its existing buyback authorization. Buybacks have often had a greater impact than operating results on EPS growth. On the 1Q call, CEO Duperreault said the company would prioritize the allocation of capital toward growth initiatives, including acquisitions, over stock repurchases.

MANAGEMENT & RISKS

Brian Duperreault has CEO served as CEO since May 2017. Mr. Duperreault previously served as CEO at Marsh & McLennan and ACE, two competing insurance companies. He also previously worked at AIG for 21 years. Peter Zaffino has served as COO since July 2017. Mr. Zaffino previously served as CEO of Marsh, an insurance firm and subsidiary of Marsh & McLennan, where he worked with Mr. Duperreault.

Risks for AIG include larger-than-expected catastrophe losses, reserve losses, pricing pressure, lower investment income, and continued low interest rates.

COMPANY DESCRIPTION

AIG is a leading provider of insurance products. The company is based in New York and has operations in more than 130 countries.

VALUATION

We think that AIG shares are attractively valued at current prices near $51. Over the past year, the share price has ranged between $50 and $67.

AIG shares look cheap relative to peers. The price/book ratio is 0.7, below the industry average of 1.5. The projected 2018 P/E ratio is 9.8, below the peer average of 16.4. We note that the 2017 ROE of 4.1% was below the long-term industry average of 10%. In our view, that’s the opportunity for AIG investors. As the company responds to pressure from activist shareholders, we expect earnings and ROE to improve. And as the profitability gap with peers closes, the price/book gap should close as well. Our revised target of $63 implies modest expansion of the price/book multiple to 0.9, still well below the industry mean.

On May 3, BUY-rated AIG closed at $51.94, down $2.90. (Jacob Kilstein, CFA, 5/3/18)

JUNIPER NETWORKS INC. (NYSE: JNPR, $25.16)... HOLD

JNPR: Sequential progress but deep annual lags; reiterating HOLD

* Juniper posted an 11% decline in 1Q18 revenue, leading to a 40% EPS decline.
* Slowing momentum in cloud has now become a persistent challenge for Juniper. Although this business improved sequentially, cloud margins will remain challenging into early 2019.
* Once it gets underway, recovery in cloud could be uneven; and the company not expect much recovery in telco service providers in 2018.
* Despite having backed down on multiple disappointments, JNPR shares do not yet look attractive.

ANALYSIS

INVESTMENT THESIS

HOLD-rated Juniper Networks Inc. (NYSE: JNPR) posted 1Q18 results that cheered the Street by beating low expectations. While Juniper is working to turn around operations, revenue in 1Q18 lagged year-earlier levels by double-digit percentages. Lacking sufficient volume leverages, margins continued to compress in the first quarter and are well below company targets.

From an end-customer perspective, an ongoing issue for Juniper is that early momentum among cloud titans appears to have waned; this category remained disappointing for a third consecutive quarter. While the company is seeking intermediate-term solutions to reduce gross margin pressures, the longer-term outlook is dependent on recovery in the cloud customer class, which in the fast-shifting world of cloud allegiances is never a certainty.

Cloud business has been insufficient to offset weak trends among Juniper's historical customer base of tier one communications service providers. In its core routing & switching business, Juniper is in competition with companies that are giant (Cisco) and/or nimble (Arista). In cloud, Juniper competes against hardware & software solutions provided by Hewlett-Packard Enterprise, Dell EMC, Cisco, and others. All of Juniper's markets are fiercely competitive, and loss of momentum in any one sends a troubling message. Slowing momentum in cloud has now become a persistent challenge for Juniper.

Despite having backed down on multiple disappointments, JNPR shares do not yet look attractive. Even as its multiples come down from premium territory to more industry-equivalent levels, JNPR does not offer compelling value. Our blended valuation analysis suggests a risk-adjusted fair value for JNPR within 10% of its current price, typically consistent with an intermediate-term HOLD rating. We are reiterating our near-term HOLD rating on JNPR while still keeping an eye out for value-upgrade opportunities.

RECENT DEVELOPMENTS

So far in 2018, JNPR is down 13%, while peers are up 6%. JNPR shares edged up 1% in 2017; the peer group of Argus-covered communications equipment companies rose 7% in 2017. JNPR rose just 2% in 2016, lagging the peer group's 9% gain. JNPR was up 24% in 2015, compared to a 6% average decline for the peer group. JNPR declined 1% in 2014; rose 15% in 2013; declined 4% in 2012; plunged 45% in 2011; and rose 38% in 2010.

For 1Q18, Juniper posted revenue of $1.08 billion, which was down 11% annually and down 13% sequentially from its seasonally strongest quarter. Revenue was at the top of guidance of $1.02-$1.08 billion and above the $1.05 billion consensus forecast. Non-GAAP EPS for 1Q18 totaled $0.28 per diluted share, which was down 40% annually; at the top of non-GAAP EPS guidance of $0.22-$0.28; and well above the $0.23 consensus call.

Although Juniper handily beat consensus expectations, those expectations were set by explicit management guidance, which appeared to be on the low-ball side. Juniper is facing near-term constraints that are both industry-general and company specific. In its service provider end-market, like all equipment providers Juniper is idling as carriers await finalized 5G standards and the first 5G wireless deployments late in 2019 and into 2020. The 5G standard works with an IP (internet protocol) core, which plays to Juniper's strengths.

In terms of company-specific challenges, the falloff in cloud business that occurred somewhat suddenly in 3Q17 was first described as a temporary blip. In 4Q17 reporting, the company acknowledged that challenges in the cloud market could be longer-lasting. Cloud infrastructure providers have come to represent about half of Juniper's top-10 customers in any quarter, compared with none 3-5 years ago.

In the multi-year in which Juniper has supported Cloud service providers, their needs have evolved and the technology has evolved. Since mid-year 2017 at least, major cloud customers have slowed spending as they transitioned their network architectures to create more scalable, cost-effective networks. The spending delays among cloud titans worsened meaningfully in 4Q17 and persisted across 1Q18.

Juniper has multiple ways to assess its revenue progress – by product type, by geography, and by customer vertical (end market). Broadly, slowdown in telco and cloud has hurt routing, while steady demand in enterprise has helped switching. The weakness in tier one telcos continues to impact North American revenue.

On a customer vertical basis for 1Q18, cloud-related revenue of $268 million (25% of total) declined 19% annually but did recover by 4% from the December quarter, after being down 25% sequentially in 4Q17. Elsewhere in the major verticals, telecom & cable (44% of revenue) declined 16% annually and also declined 21% sequentially from 4Q, which is historically the strong, “budget flush” quarter for the major carriers. Among legacy business customers, the strategic enterprise vertical (31% of revenue) was up 4% annually while declining a normally seasonal 10% on a sequential basis.

On a product category basis, routing product revenue (38% of total sales) was down 22% annually, for a second consecutive quarter, and also declined 20% sequentially. Switching revenue (21% of total) was down 5% annually but flat quarter-over-quarter. Routing was primarily hurt by weakness among both cloud and telco service providers, while switching relatively outperformed based on legacy enterprise strength. Total services revenue (34% of total) was down 5% annually; this former growth category is being impacted by weakening product sales, as well as the self-provisioning and self-healing nature of modern network elements.

On a regional basis, sales to the Americas (54% of total) were down 17% year-over-year and also 17% sequentially, in what is normally a sequentially weak quarter. EMEA revenue (28% of total) increased 8%, while A-P revenue declined 17%.

CEO Rami Rahim has had to navigate simultaneous weakness in cloud, as leading cloud providers retool their infrastructure, and in telco, as the major carriers twiddle their thumbs while waiting for 5G. The CEO pointed out that Juniper exceeded its expectations (modest as they were) and that enterprise continues to relatively outperform. He somewhat boldly stated that Juniper should return to growth and improved profitability by the end of the year; we note that comps against 4Q17 will be the easiest Juniper will face in the near term, given last year’s surprising falloff.

The CEO was particularly encouraged that the cloud vertical showed sequential growth. Cloud customers are upgrading from lower capacity MX platform to the high-capacity PTX platform. PTX now accounts for 80% of ports shipped to cloud customers, vs. 40% a year ago.

Although this MX to PTX transition process is creating ASP pressures in cloud routing sales that is likely to persist past mid-year, this transition should be less of a headwind as the year progresses. Importantly, several cloud projects that were previously on hold have started to move forward. Juniper expects these deployments to ramp into year-end and 2019. The company is confident it is “holding its cloud footprint” (not losing share). However, uncertainty remains how much these buildouts will add to demand and the exact timing of cloud demand growth.

In the other critical vertical, Juniper expects telco service provider demand to remain lumpy and sluggish overall in 2018. Despite the slow start to the year, Juniper does expect to see gradually improving carrier demand beyond the March quarter. Juniper is also making progress in its efforts to capture more software revenue. While this business has doubled in three years, thanks to demand for Contrail (software-defined networking), it is still a relatively small piece.

For 2Q18, Juniper guided slightly above the pre-reporting consensus, which as noted has been highly conservative. Juniper forecast revenue of $1.17 billion; +/- $30 million, and non-GAAP net income of $0.41, +/- $0.47; the Street had been modeling $0.43.

We think the recovery in cloud could be uneven, and the company has warned not to expect much recovery in telco service providers in 2018. Despite having backed down on multiple disappointments, JNPR shares do not yet look attractive. Even as its multiples come down from premium territory to more industry-equivalent levels, JNPR does not offer compelling value, given the uncertain timing of demand recovery, and we reiterate our HOLD rating.

EARNINGS & GROWTH ANALYSIS

For 1Q18, Juniper posted revenue of $1.08 billion, which was down 11% annually and down 13% sequentially from its seasonally strongest quarter. Revenue was at the top of guidance of $1.02-$1.08 billion and above the $1.05 billion consensus forecast. Non-GAAP gross margin contracted sequentially to 58.2% in 1Q18 from 61.3% in 4Q17, while narrowing from 62.5% a year earlier.

Despite past cost-containment actions, weak volumes caused non-GAAP operating margin to crash to 12.3% in 1Q18 from 22.7% in 4Q17 and from 20.8% a year earlier.

Non-GAAP EPS for 1Q18 totaled $0.28 per diluted share, which was down 40% annually; at the top of non-GAAP EPS guidance of $0.22-$0.28; and well above the $0.23 consensus call.

For all of 2017, a year that started well and ended badly for Juniper, revenue of $5.03 billion was up 1% from $4.99 billion for 2016. Non-GAAP EPS for 2017 totaled $2.11, which was up 1% from $2.10 for 2016.

For 2Q18, Juniper forecast revenue of $1.17 billion; +/- $30 million; non-GAAP Gross margin of 58%-60%; non-GAAP operating expenses of $485-$495 million; and tax rate of 21%.That results in non-GAAP net income of $0.41, +/- $0.47; the Street had been modeling $0.43.

Principally on a lower forecast tax rate, we are raising our non-GAAP EPS forecast for 2018 to $1.82 per diluted share from $1.81. Our 2018 non-GAAP forecast assumes a good bounce-back in cloud business in 2H18, which is far from a foregone conclusion. We are reducing our non-GAAP EPS forecast for 2019 to $2.00 per diluted share, from an initial $2.13, on expectations that carrier weakness will drag into 2019. Our long-term earnings growth rate forecast is 9%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating for JNPR is Medium-High, the second-highest rank on our five-point scale. Juniper has spent aggressively to reduce its share count and improve EPS comparisons. To pay for buybacks, Juniper has increased its indebtedness, from $999 million at year-end 2013 to $2.13 billion at the end of 2016. Given annual free cash flow of around $400 million after dividends, Juniper will be carrying this debt for some time.

Cash & equivalents were $3.49 billion at 1Q18, reduced primarily by share buybacks. Cash & equivalents were $4.02 billion at the end of 2017; $3.66 billion at the end of 2016; $3.19 billion at the end of 2015; $3.10 billion at the end of 2014; $4.03 billion at the end of 2013; $3.84 billion at the end of 2012, $4.3 billion at the end of 2011, and $2.89 billion at the end of 2010.

Debt was $2.14 billion at 1Q18. Debt was $2.14 billion at the end of 2017, $2.13 billion at the end of 2016, $1.95 billion at the close of 2015, $1.35 billion at the end of 2014, $1.02 billion at the end of 2013 and $1.02 billion at the end of 2012. In March 2011, Juniper issued $1 billion of senior notes. The offering consisted of $300 million of 3.1% senior notes due 2016, $300 million of 4.6% senior notes due 2021, and $400 million of 5.95% senior notes due 2041. Prior to 2011, Juniper had had no debt since 2007.

Net cash was $1.31 billion at 1Q18. Net cash was 1.88 billion at the end of 2017, $1.52 billion at the end of 2016, $1.24 billion at the end of 2015, and $1.76 billion at the end of 2014. Net cash was $3.1 billion at the end of 2013, compared to $2.95 billion at the end of 2012, $3.3 billion at the end of 2011, $2.89 billion at year-end 2010, $2.66 million at the end of 2009, $1.62 billion at the end of 2007, $2.21 billion at the end of 2006, and $1.58 billion at the end of 2005.

Debt/cap was 31.3% at the end of 2017, vs. 30.0% at the end of 2016. Juniper’s debt/cap ratio was 29.9% at the end of 2015, up from 21.1% at the end of 2014. Via goodwill impairment, Juniper reduced shareholders’ equity to $4.92 billion at year-end 2014. Juniper’s debt/cap ratio was 12.0% at the end of 2013 and 12.5% at the end of 2012.

Cash flow from operations was $1.26 billion in 2017, compared with $1.11 billion in 2016, $892 million in 2015, $763 million in 2014, $841 million in 2013, $642 million in 2012, $987 million in 2011, $812 million in 2010, $796 million in 2009, and $875 million in 2008.

Juniper has become a significant repurchaser of its own debt, beginning in 2014. In 1Q18, Juniper entered into an accelerated share repurchase (AASR) program to buy back an aggregate $750 million in shares. Under the ASR, Juniper made an upfront payment of $750 million and received 23.3 million shares for an upfront price of $600 million. The ASR is expected to be completed no later than August 2018.

Juniper began to pay a $0.10 per share quarterly dividend in 2014. We expect Juniper to focus on buybacks in the coming year. Our dividend estimates are $0.40 per common share for both 2018 and 2019.

MANAGEMENT & RISKS

Rami Rahim became CEO and a board member in November 2014, replacing Shaygan Kheradpir who had served in that role only since January 2014. Longtime company executive Ken Miller is now CFO. Former CEO Scott Kriens remains chairman of the board. Robert Muglia joined Juniper in 2011 as EVP of Software Solutions Division.

The newest risk facing Juniper is that cloud, its formerly fastest-growing business and the one keeping it relevant, might be in trouble. Cloud was the source of 3Q17 weakness, after being a source of strength that compensated for carrier and enterprise weakness in prior quarters. It is too soon to say if the current malaise is anything more than inventory adjustment at one or more key customers. If Juniper is on the outs with rumored key customer Amazon, that would represent a much deeper and potentially intractable problem.

After twice going outside the company to find its CEO (Kevin Johnson from Microsoft, and Shaygan Kheradpir from Barclay’s), Juniper selected an insider in Rami Rahim. In his prior roles at Juniper, Rahim has touched every product and solution offered by the company. On the upside, there will be no learning curve for the new CEO.

As part of the Integrated Operating Plan announced on 2/20/14, former CEO Kevin Johnson exited the board. Two new independent directors suggested by Elliott Management joined the board. Kevin DeNuccio is the former CEO of Redback Networks and the current CEO of flash memory company Violin Networks. Gary Daichendt is a former Cisco executive serving on numerous technology company boards.

The Integrated Operating Plan represents more opportunity than risk, in our view. Juniper has underperformed for years, hurt by being too thinly spread, which has resulted in R&D spending that as a percentage of revenue is among the highest in the industry. The tighter operational focus should allow Juniper to operate more effectively and profitably.

COMPANY DESCRIPTION

Juniper provides network infrastructure products and network security solutions. The company's operations are divided into Infrastructure (80% of revenue) and Service Layer Technology (20% of revenue). Key network infrastructure products from Juniper include the E-series edge routing platform; the M- and T-series of metro and core routers; the SDX 300 service deployment system; the MX carrier-grade Ethernet aggregation platform; and the EX enterprise Ethernet platform. The Service Layer Technology unit includes security products that serve niches such as SSL VPN, Firewall/IPsec VPN and intrusion detection and prevention and niche businesses such as applications acceleration.

INDUSTRY

Our rating on the Technology sector is Over-Weight, as we see value in Tech stocks following the recent selloff.

Over the long term, we expect the Tech sector to benefit from pervasive digitization across the economy, greater acceptance of transformative technologies, and the development of the Internet of Things (IoT). Healthy company and sector fundamentals are also positive. For individual companies, these include high cash levels, low debt, and broad international business exposure.

The sector is outperforming the S&P 500 thus far in 2018, with a gain of 3.2%. It also outperformed in 2017, with a gain of 36.9%, and in 2016, with a gain of 12.0%.

Fundamentals for the Technology sector look reasonably balanced. By our calculations, the P/E ratio on projected 2018 earnings is 17.8, above the market multiple of 16.7. Earnings are expected to grow 24.3% after rising 33.2% in 2017. Earnings rose in the low single digits in 2015-2016. The sector's debt ratios are below the market average, as is the average dividend yield of 0.8%.

VALUATION

JNPR trades at 13.6-times our 2018 non-GAAP EPS estimate and at 12.5-times our 2019 forecast, compared to a five-year (2013-2017) average of 13.9. The shares trade at a 16% discount to the market P/E on average 2018-2019 earnings, in line with a typical 16% discount (based on a five-year historical relative P/E of 0.84). JNPR was accorded premium absolute and relative P/E's when earnings were growing rapidly from late 2012 through 2016; we now expect EPS to decline for 2018, with only a slight recovery in 2019. Comparable valuation supports a value in the mid-20s, in a declining though stabilizing trend.

Compared to peers, JNPR trades at discounted multiples; but all peers are growing faster than Juniper. Our more forward-looking discounted free cash flow model renders a value in the mid-$20s, in a declining trend. Our blended valuation model renders a fair value for Juniper of $25, in a declining trend. Declines in our fair value calculation are often precursor to additional share price declines. The stock also trades within 10% of fair value, on a risk-adjusted basis, and that is consistent with a HOLD rating.

Even as its multiples come down from premium territory to more industry-equivalent levels, JNPR does not offer compelling value. From an operations perspective, Juniper faces more difficult top-line and EPS comparisons particularly if cloud demand is slow to recover. We are reiterating our near-term HOLD rating on JNPR.

On May 3, HOLD-rated JNPR closed at $25.16, up $0.24. (Jim Kelleher, CFA, 5/3/18)

NORWEGIAN CRUISE LINE HOLDINGS LTD. (NGS: NCLH, $51.10).................................. BUY

NCLH: Strong quarter; maintaining BUY

* Founded in 1966 and based in Miami, this mid-cap cruise company offers cruises to 510 destinations worldwide.
* Norwegian plans to spend $1 billion annually to construct new ships through 2020. The additional capacity should boost revenue and margins, as new ships generate more revenue per berth.
* The shares appear attractively valued given the company's clean balance sheet, experienced management team, expanding fleet, and prospects for strong earnings growth.
* NCLH shares have outperformed since their IPO, but have recently pulled back in price, offering investors a favorable entry point.

ANALYSIS

INVESTMENT THESIS

We are maintaining our BUY rating on Norwegian Cruise Line Holdings Ltd. (NGS: NCLH) with a $68 target price. NCLH is smaller than the other cruise lines that we follow (Royal Caribbean and Carnival, both BUY-rated) and, in our view, has more room to increase capacity over the next several years. The company recently added the Norwegian Joy in the Chinese market, returning to China after a long absence. NCLH expects the Norwegian Joy to be profitable in its first year. It also plans to spend $1 billion annually to construct new ships through 2020. The additional capacity should boost revenue and margins, as new ships generate more revenue per berth. Norwegian should also continue to benefit from its clean balance sheet and experienced management team, as well as from growing demand for cruise vacations. The company notes that bookings remain strong, and it has been able to boost ticket prices and occupancy over the last year. On valuation, the stock appears attractive at just 10.4-times our revised 2018 EPS estimate, well below the average multiple of 19.0 for hotel and cruise line companies. Our target price of $68 implies a potential return of 33% from current levels.

RECENT DEVELOPMENTS

On May 2, Norwegian reported adjusted first-quarter EPS of $0.60, up from $0.40 in the prior-year period. EPS topped the consensus estimate of $0.54 and management's guidance of $0.52. The positive earnings surprise reflected stronger-than-expected net yields and 2.7% lower net cruise costs.

First-quarter revenue rose 12% to $1.3 billion. The increase reflects the addition in 2017 of the Norwegian Joy, stronger ticket pricing and much higher onboard revenue. Reported net yields rose a solid 1.4% (up 1.0% in constant currency), above our estimate of 1% growth. The consensus estimate had called for a 0.1% increase in net yields in constant currency and management had projected a 0.5% improvement. Adjusted net cruise costs excluding fuel decreased 2.1% year-over-year on a reported basis (and 2.7% in constant currency). The consensus estimate had called for a 2.8% decrease in constant currency and management had projected a 2.75% decrease. Fuel costs of $93 million were in line with our forecast. Adjusted EBITDA rose 28% to $326 million and was $7 million above consensus. Below the line, interest expense increased from $53 million to just under $60 million, while the tax rate fell by 80 basis points to 2.4%. The share count rose slightly from 228 million to just above 229 million.

As discussed in a previous note, in 2017, revenue increased 11% to $5.4 billion and earnings rose from $3.41 per share in 2016 to $3.96. Management's guidance had been for full-year earnings of $3.80 per share.

EARNINGS & GROWTH ANALYSIS

In 2Q18, Norwegian Cruise Lines expects net yields in constant currency to increase 2.0% from the prior year (up 2.75% on a reported basis). The modest increase in net yields reflects the recent addition of Norwegian Joy in China. Management expects net cruise costs in constant currency to rise 7.5%-8.0% and increase 9.0% as reported in 2Q18. The company projects earnings of $1.02 per share. The Street currently expects earnings of $1.02 per share on revenue of $1.48 billion.

For 2018, management now estimates a 2.5% increase in net yields in constant currency (up 50 basis points from its prior forecast). The consensus estimate had called for net yields to increase 1.7%. It still expects net cruise costs excluding fuel to be flat to 1.0% higher in constant currency and up 0.5%-1.5% as reported. Based on these projections, management now estimates 2018 EPS of $4.55-$4.70, up from a prior $4.45-$4.65. We are raising our 2018 estimate from $4.80 to $4.90 per share, above the consensus of $4.64. For 2019, we are raising our estimate from $5.30 to $5.40 per share.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on NCLH is Medium, the middle rank on our five-point scale.

Norwegian's 1Q18 EBITDA margin rose 260 basis points to 25.2%, 50 basis points above consensus, reflecting solid net yields and lower net cruise costs. Operating income covered interest expense by a factor of 2.8, up from 2.3 in the prior-year period, as operating income outpaced higher interest expense. The debt/capital ratio at the end of the first quarter was 49.7%, below the industry average of 58.7% as management works to reduce the company's leverage.

The company does not pay a dividend and, in view of its need to finance additional capacity, we do not expect it to initiate one in the near term.

MANAGEMENT & RISKS

Frank Del Rio became the company's CEO in January 2015 following the resignation of former CEO Kevin Sheehan. Mr. Del Rio had been president and CEO of Prestige Cruise Holdings, which NCLH acquired at the end of 2014.

Norwegian Cruise Lines' business is at risk from terrorism or the threat of terrorism, which could cause travelers to cancel cruise vacations. Hurricanes are also a risk. The company's results could also be hurt by heightened safety concerns following ship malfunctions or by an increase in fuel costs. In addition, the company faces risks from general economic weakness, especially in the U.S., where it generates most of its revenue. A strong U.S. dollar could also temper international revenue growth.

COMPANY DESCRIPTION

Founded in 1966 and based in Miami, Norwegian Cruise Line Holdings offers cruises to approximately 510 destinations worldwide. NCLH sells its cruises through independent travel agents, wholesalers, and tour operators. The company went public on January 17, 2013, closing at $24.89. In 2014, Norwegian Cruise Lines acquired Prestige Cruise Holdings, the parent company of Oceania Cruises and Regent Seven Seas. As of May 10, 2017, it operated a fleet of 25 ships with approximately 50,400 berths under the Norwegian Cruise Line, Oceania Cruises, and Regent Seven Seas brands.

INDUSTRY

Our rating on the Consumer Discretionary sector is Over-Weight. The sector has shown solid market momentum, reflecting investor expectations for strong durable goods demand in the wake of tax cuts. At the same time, Consumer Discretionary stocks have been out of favor for multiple quarters, and appear undervalued relative to peers.

The sector accounts for 12.7% of the S&P 500. We think investors should consider allocating 13%-14% of their diversified portfolios to the group. Over the past five years, the weighting has ranged from 8% to 13%. The sector is outperforming thus far in 2018, with a gain of 2.8%. It outperformed in 2017, with a gain of 21.2%, but underperformed in 2016, with a gain of 4.3%.

Consumer Discretionary earnings are expected to increase 14.0% in 2018 after rising 5.8% in 2017 and 9.4% in 2016. On valuation, the 2018 projected P/E ratio is 19.8, above the market multiple of 16.7. The sector's debt ratios are high, with an average debt-to-cap ratio of 52%. Yields are below average at 0.9%.

VALUATION

Despite strong 1Q18 earnings, the shares fell recently as investors appeared to worry that capacity growth of 5%-7% in 2018 will depress ticket prices. In our view, the current NCLH share price inadequately reflects prospects for solid net yields (management projects 3.0% growth as reported this year), additional cruise capacity, and relatively high margins. We also believe that the recent pullback offers patient investors a buying opportunity. NCLH is trading at 10.4-times our revised 2018 EPS estimate, well below the average multiple of 18.0 for other leisure companies. We expect strong cruise demand, supply discipline and management's cost-cutting efforts to boost earnings in the coming quarters and are keeping our price target at $68. Our target, if achieved, offers investors the prospect of a 33% return.

On May 3, BUY-rated NCLH closed at $51.10, down $0.93. (John Staszak, CFA, 5/3/18)

XEROX CORP. (NYSE: XRX, $28.31)... HOLD

XRX: 1Q18 results in the shadow of board takeover

* Xerox released weak 1Q18 results that were overshadowed by significant events in the Xerox boardroom.
* On 5/2/18, Xerox announced that CEO Jeff Jacobson and most of its board would step down. Directors and a CEO chosen by activists Carl Icahn and Darwin Deason will lead Xerox.
* The fate of the Fuji-Xerox JV is now in question, though not in immediate danger.
* Apollo Global is reportedly mulling an offer for Xerox, but would unlikely offer much of a premium given the secular decline in its business.

ANALYSIS

INVESTMENT THESIS

HOLD-rated Xerox Corp. (NYSE: XRX) released weak 1Q18 results that were overshadowed by significant events in the Xerox boardroom.

The revolution at Xerox occurred about three months after Xerox first announced a definitive agreement to sell itself to its long-standing joint venture partner, Fujifilm. The combined company was expected to have annual revenue exceeding $18 billion and to be a "global leader in innovative print technologies and intelligent work solutions." The fate of that deal is decidedly uncertain.

Activist shareholders Carl Icahn and Darwin Deason, who as No.1 and No.3 outside holders collectively own a 15% stake, won their coup d'état with surprising speed and ease. In mid-February, the two sent a joint letter to Xerox decrying the deal which the two said dramatically undervalued Xerox while disproportionately favoring Fuji. The two stepped up their criticism recently, claiming Jeff Jacobson struck the Fuji deal without full board knowledge in a bid to save his job.

While investors were braced for a long fight, on 5/2/18 Xerox announced that CEO Jacobs and most of the board would step down, allowing board members and a CEO picked by the activists to run the company. The fate of the Fuji-Xerox JV is now in question, though not in immediate danger. Apollo Global is reportedly mulling an offer for Xerox, but would unlikely offer much of a premium given the secular decline in its business.

First-quarter results signal the challenges facing Xerox in the current environment regardless of the ownership structure. Putting aside potential outcomes for this deal and its opponents, XRX shares appear appropriately valued at current levels. While awaiting the next steps in this ongoing story, we are reiterating our HOLD rating on XRX.

RECENT DEVELOPMENTS

XRX is down 3% in 2018, versus a 7% gain for a peer group of Argus-covered computing, storage, and information-processing stocks. Xerox spun off Conduent on 12/30/16. Adjusted for subsequent repricing and reverse split, XRX advanced 6% in 2017, versus a 12% gain for peers. XRX declined 18% in 2016, while the peer group advanced 12%. XRX declined 23% in 2015, compared to a 16% decline for the peer group. XRX rose 14% in 2014, soared 78% in 2013, declined 14% in 2012, and fell 31% in 2011.

For 1Q18, Xerox posted revenue of $2.44 billion, which was down less than 1% year-over-year on a GAAP basis and down 5% in constant currency. Revenue was better than consensus expectations of $2.41 billion. Non-GAAP earnings were $0.68 per diluted share, up from $0.67 a year earlier. The consensus had modeled non-GAAP EPS of $0.72 per diluted share.

On 5/2/18, Xerox announced that CEO Jeff Jacobson and most of its board would step down, in a move engineered by activist shareholders Carl Icahn and Darwin Deason. The No.1 and No.3 outside holders, who collectively own a 15% stake, pushed back against the deal by Xerox to sell itself to Fuji.

Here is a quick recap of the events leading up to the surprise outcome on 5/2/18. On 1/31/18, Xerox and Fujifilm, the company's long-time joint venture partner in Asia, announced a $6.1 deal whereby Xerox would be combined into Fujifilm, a market share leader in imaging technologies in Asia with a $9.7 billion revenue base. XRX shareholders were to get an immediate one-time dividend equivalent to about $9.80 per share, along with a collective 49.9% stake in "new Fuji." The ability to monetize that position had appeared murky.

On 2/12/18, Carl Icahn and Darwin Deason sent a joint letter to Xerox decrying the deal which the two said dramatically undervalued Xerox while disproportionately favoring Fuji. The two activists sued Xerox and won a court order temporarily blocking the deal. Late in April, the judge ruling on the case stated that CEO Jacobson was "hopelessly conflicted," given his knowledge that the board intended to replace him and that this knowledge motivated his actions to structure the Fuji deal.

On 5/2/18, Xerox announced that CEO Jacobson and six other members of the 10-person board would step down. Further, those board slots and the new CEO John Visentin were selected by the dissident activists. Keith Cozza, CEO of Icahn Enterprises, will become the new Xerox chairman.

Xerox stated that it decided to settle with Icahn and Deason given the risks and uncertainty of prolonged litigation. The speed with which Xerox handed the reins to its minority owner suggests that the board knew Icahn's key allegation was true: that Jacobson put together the Fuji deal knowing he was to be fired and without the board's knowledge or approval.

Carl Icahn was not gracious in victory; given the highly unusual circumstances, few investors expected him to be. Mr. Icahn inveighed against "supposed partner" Fujifilm for conduct "more unbelievable than what you see on fictional shows such as House of Cards or Billions." It is too soon to say what will become of Xerox, though ownership by Fujifilm now seems highly unlikely.

More vexing is what will become of Xerox's JV relationship with Fuji. In the current Fuji Xerox JV, Fujifilm has a 75% share and Xerox has a 25% share. The JV is the source of Xerox's document technology R&D and engineering. Were an embittered Fuji to pull out of the JV, Xerox would be left without a technology partner. While Xerox could likely line up another Asian copier company as a partner, the resulting dislocation would potentially leave Xerox with no product to sell for an extended period. It might even put the company's viability at risk. However, we emphasize that this is all worst-case speculation and unlikely to transpire.

According to various sources, Apollo Global is reportedly mulling an offer for Xerox. There is no certainty that a deal will emerge. We believe the company would unlikely offer much of a premium for Xerox given the secular decline in its business.

The rancor surrounding this battle likely weighed on Xerox's 1Q18 results. Revenue declined 5% in constant currency. Equipment revenue (20% of total) declined a like amount, along with post-sales revenue. The company's managed document service revenue was a bright spot, rising 5% annually and declining just 1% sequentially while comprising 35% of total revenue.

Regardless of whether an outside party ends up owning Xerox or the company continues on a standalone basis, the structural and secular challenges facing Xerox will persist. The quick acquiescence by the old board suggests that the worst of Icahn's allegations are true, and that further dampens our enthusiasm toward the stock.

Putting aside potential outcomes for this deal and its opponents, XRX shares appear appropriately valued at current levels. While awaiting the next steps in this ongoing story, we are reiterating our HOLD rating on XRX.

EARNINGS & GROWTH ANALYSIS

For 1Q18, Xerox posted revenue of $2.44 billion, which was down less than 1% year-over-year on a GAAP basis and down 5% in constant currency. Revenue was better than consensus expectations of $2.41 billion. Non-GAAP earnings were $0.68 per diluted share, up from $0.67 a year earlier. The consensus had modeled non-GAAP EPS of $0.72 per diluted share.

For all of 2017, revenue of $10.27 billion declined 5% from a restated $10.77 billion in 2016. Non-GAAP earnings totaled $3.40 per diluted split-adjusted share, down 3% from $3.52 per diluted split-adjusted share in 2016.

The company withdrew its forecast for 2018. In January, the company offered stand-alone guidance for non-GAAP EPS of $3.50-$3.70 per diluted share. That guidance is no longer valid, given disruptions related to change in management, although the company indicated it would have reaffirmed guidance if not for the transition.

We are reducing our 2018 forecast to $3.56 from $3.58, and our 2019 non-GAAP EPS projection to $3.69 from $3.75. Our five-year annualized EPS growth rate forecast for Xerox is 9%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating for Xerox is Medium. We have reassessed our financial strength rating now that Conduent has been divested. The company has paid down debt, which resulted in reduced cash on the balance sheet.

Xerox raised $1 billion in senior note issuance; $500 million was used as incremental pension contribution, with most of the balance used for early redemption of 2018 senior notes. Xerox paid down short-term debt in 4Q17.

Cash was $1.29 billion at the end of 2017, compared to $1.05 billion at the end of 1Q17. Prior to the Conduent spinoff, cash was $2.23 billion at the end of 2016. Cash was $1.37 billion at the end of 2015 and $1.4 billion at the end of 2014.

Debt was $5.5 billion at year-end 2017, reduced from $6.0 billion at the end of 3Q17. Debt was $5.0 billion at midyear 2017. Debt was $6.32 billion at the end of 2016, $7.37 billion at the end of 2015, and $7.7 billion at the end of 2014.

Although debt declined after being transferred to Conduent, shareholders equity also declined as a result of the divestiture. Total debt/cap was 51.0% at 4Q17, up from 49.2% at the end of 2Q17. Debt/cap was 56.6% at the end of 2016, 45.3% at the end of 2015 and 42.0% at the end of 2014.

Cash flow from operations was $34 million for 2017, significantly reduced by pension payments and one-time A/R eliminations. Cash flow from operations was $1.02 billion in 2016, $1.08 billion (restated from an original $1.6 billion) in 2015, and $2.06 billion in 2014.

Xerox discontinued share repurchases in 2016. It spent $1.3 billion on buybacks in 2015, $1.07 billion in 2014, $696 million in 2013, and $1.05 billion in 2012.

As a result of the reverse stock split, the company's quarterly dividend is now $0.25 per share, for a yield of about 3.0%. Our dividend estimates are $1.00 for both 2018 and 2019.

MANAGEMENT & RISKS

On 5/2/18, Xerox announced that CEO Jacobson and six other members of the 10-person board would step down. Further, those board slots and the new CEO John Visentin were selected by the dissident activists. Keith Cozza, CEO of Icahn Enterprises, will become the new Xerox chairman. At least for now, CFO Bill Osborn is in place.

We see a low probability that the combination with Fuji will transpire. The new risk in the stock is that JV with Fujifilm that supplies Xerox its office-machine technology could be at risk. We do not believe this arrangement is at immediate risk, but we will actively monitor this relationship.

The Conduent spinoff now seems like ancient history in light of recent dramatic events. While splitting into two companies entails multiple risks, those are now largely behind Xerox. We think the Document Technology company will have a clear focus and market leadership.

Xerox's business is very sensitive to changes in overall economic conditions, and continued weakness could hurt the company's earnings. Xerox's recurring revenue stream from post-sale products and services has mitigated the impact of reduced hardware intensity in the age of cloud.

COMPANY DESCRIPTION

For the past six years, Xerox operated as a technology services company following the February 2010 acquisition of Dallas-based ACS. Xerox sold its ITO business in 2015. In January 2016, Xerox announced plans to split into two companies: a document technology & outsourcing company, and a BPO services company (Conduent). Xerox completed the spinoff of Conduent at the end of 2016. In January 2018, Xerox announced a planned combination with JV partner Fujifilm; elevation of a board opposed to that deal in May 2018 makes the combination highly unlikely.

INDUSTRY

Our rating on the Technology sector is Over-Weight, as we see value in Tech stocks following the recent selloff.

Over the long term, we expect the Tech sector to benefit from pervasive digitization across the economy, greater acceptance of transformative technologies, and the development of the Internet of Things (IoT). Healthy company and sector fundamentals are also positive. For individual companies, these include high cash levels, low debt, and broad international business exposure.

The sector is outperforming the S&P 500 thus far in 2018, with a gain of 3.2%. It also outperformed in 2017, with a gain of 36.9%, and in 2016, with a gain of 12.0%.

Fundamentals for the Technology sector look reasonably balanced. By our calculations, the P/E ratio on projected 2018 earnings is 17.8, above the market multiple of 16.7. Earnings are expected to grow 24.3% after rising 33.2% in 2017. Earnings rose in the low single digits in 2015-2016. The sector's debt ratios are below the market average, as is the average dividend yield of 0.8%.

VALUATION

XRX trades at 6.8-times our 2018 non-GAAP EPS estimate and at 6.5-times our 2019 estimate. The average two-year forward P/E of 6.7 is below the stock's five-year (2013-2017) historical average of 9.5; however, all P/E discounting reflects share-price decline, not EPS growth. P/E's are distorted because of the business realignment; service businesses, such as the divested BPO business, tended to carry higher P/Es. At this point, Xerox has entered uncertain territory, causing investors to discount the likelihood of it hitting earlier EPS targets.

Historical comparable valuation points to a value of about $25 per share, in a declining trend. Discounted free cash flow suggests a value above current levels, but our DFCF model is now in a declining trend. Our blended fair value estimate for XRX is $26-$27, above the current price but down from a split-adjusted mid-$30s level one year ago. In our experience, declines in estimated fair value are consistent with further share price declines and/or a market-tracking performance.

Putting aside the drama of the Icahn-Xerox battle, the structural and secular challenges facing Xerox will persist. Given the underlying value of name brand and market position, a SELL rating is not appropriate. XRX shares appear appropriately valued at current levels, and we are reiterating our HOLD rating on XRX.

On May 3, HOLD-rated XRX closed at $28.31, down $1.07. (Jim Kelleher, CFA, 5/3/18)

AT&T INC. (NYSE: T, $31.94) .... BUY

T: Reaffirming BUY and $48 target

* A federal court has now heard closing arguments in the DOJ's suit to block AT&T's acquisition of Time Warner; the court will announce its decision on June 12.
* AT&T reported first-quarter results on April 25 after the market close. The company's adjusted EBITDA margin rose 80 basis points to 32.7% despite a 1% decline in comparable revenue.
* Recent acquisitions should help AT&T to maintain its industry position in terms of both spectrum and content as the U.S. wireless market transitions to 5G and converges with the fixed-broadband services offered by the cable companies.
* We are lowering our 2018 EPS estimate to $3.49 from $3.52 and our 2019 forecast to $3.52 from $3.65. AT&T's valuation metrics remain favorable.

ANALYSIS

INVESTMENT THESIS

We are maintaining our BUY rating on AT&T Inc. (NYSE: T) to a target price of $48. AT&T has been busy with strategic acquisitions, completing a major deal with the First Responder Network as it fights in court to save its Time Warner acquisition. These deals should help AT&T to maintain its industry position in terms of both spectrum and content as the U.S. wireless market transitions to 5G and converges with the fixed-broadband services offered by the cable companies.

At the same time, AT&T continues to face intense competition as the U.S. wireless industry has moved back to unlimited data plans after prodding first from T-Mobile and then from Sprint. The saturation of the U.S. market has led to a price war and white-hot competition for both high-value postpaid and lower-value prepaid subscribers, with the predictable impact of narrower margins. Although the competitive environment has become quieter with the beginning of a new iPhone/smartphone refresh cycle, it remains to be seen whether this will continue as the cycle matures.

We think that the competitive wireless environment in the U.S. strengthens management's case for diversification into satellite video and Mexico/South America — now with the possible addition of premium branded content from Time Warner. Though the moves south of the border carry significant risks, including greater exchange rate exposure, AT&T sees opportunities in upgrading its Mexican wireless networks to 4G LTE as it integrates them into a common North American calling area.

AT&T's valuation metrics remain favorable.

RECENT DEVELOPMENTS

AT&T reported first-quarter results on April 25 after the market close. Revenue fell 3.4% year-over-year to $38 billion. However, the company's adoption of new accounting standard ASC 606 negatively impacted 1Q18 revenue. On a comparable basis using the historical standard, pro forma revenue fell 1.1% to $38.9 billion. Declines in legacy wireline services, domestic video, and wireless service revenue were partially offset by growth in wireless equipment and strategic business services. Wireless service revenue declined 7.4% from 1Q17, though just 1.7% on a comparable basis. Management expressed confidence on the 1Q call that service revenue would improve over the course of 2018, and return to growth for the full year on a comparable basis. The adjusted consolidated EBITDA margin rose 80 basis points from the prior year to 32.7%. Adjusted EPS rose 15% to $0.85. Adjusted EPS excluded intangible amortization charges and an actuarial gain, among other smaller items. GAAP EPS rose to $0.75 from $0.56 a year earlier.

AT&T gained a net 49,000 postpaid subscribers, though it lost 22,000 postpaid phone net adds. This marked an improvement from a loss of 194,000 postpaid subscribers and 348,000 postpaid phone subs in 1Q17. The company reported 241,000 lower-value prepaid net adds, including 192,000 prepaid phone net adds in 1Q18. The company also lost 388,000 lower-value reseller subscribers in 1Q18. AT&T, along with Verizon, has been forced by competitors to tweak its wireless plans to add more unlimited data packages. AT&T has created bundles of wireless plans with its DirecTV video offers in order to improve the value of its plans and thereby boost subscriber loyalty. Postpaid churn was 1.06%, down 6 basis points from the prior year and 5 basis points sequentially. Phone-only postpaid ARPU declined 1.9% to $57.01 on a comparable basis due to continued subscriber migration to no-device subsidy and no-overage plans. The subscriber upgrade rate also continued to decline, falling to 3.9% from 4.3% in 1Q18.

A federal court has now heard closing arguments in the DOJ's suit to block AT&T's acquisition of Time Warner; the court will announce its decision on June 12. The DOJ filed suit on November 20, 2017 and AT&T, far from backing down, chose to fight the government in court. The trial did not appear to go well for the DOJ, as most antitrust case law seems to have favored AT&T. The DOJ may also have failed to convince the judge that the merger would lead to a destructive aggregation of market power for AT&T. In its closing statement, the DOJ said that if the deal were not blocked, AT&T should be forced to divest certain assets, a nonstarter idea that the government had brought up in pretrial negotiations.

Time Warner's current share price remains 15.5% below AT&T's $107.50 offer price, which we believe reflects market uncertainty about the deal. However, the TWX share price has closed that gap by eight percentage points since the DOJ filed its suit, reflecting the market's perception of the relative merits of AT&T's case versus the DOJ's at trial.

EARNINGS & GROWTH ANALYSIS

We are lowering our 2018 EPS estimate to $3.49 from $3.52 and our 2019 forecast to $3.52 from $3.65. Our revised 2018 estimate is just below management's adjusted EPS forecast of $3.50, which includes a projected $0.45 boost from a lower effective tax rate. AT&T's financials are also impacted by a number of accounting rule changes in 2018. Our EPS estimates imply growth of about 8% on average over the next two years, above our long-term growth rate forecast of 5%.

AT&T's strategic philosophy, like that of its cable company peers, is now all about "selling the bundle." However, in AT&T's case, the difference is that its bundle includes wireless as well as video, high-speed internet, and VoIP. The company added 400,000 bundle subscribers in 1Q18, bringing the bundle customer base to 12.2 million. Management sees the service bundle as a key future profit driver, as well as a driver of customer loyalty and lower churn.

AT&T's has several strategic initiatives for 2018.

— Closing the Time Warner acquisition. This will, of course, depend on successful litigation against the Department of Justice.

— Strengthening the network. This also is no surprise. Like its wireless industry peers, AT&T is upgrading its network infrastructure to 5-G, a so-called "gigabit network." The company is targeting $1 billion in incremental investment in 2018, mostly for network fiber deployment. This investment will be funded in part by savings from the reduced tax rate.

— Launching DirecTV NOW 2.0, the next iteration of the company's nascent internet video streaming service.

— Creating a new platform for targeted advertising across its services.

— Boosting subscriber numbers and profitability in its Mexican operations.

— Lowering its cost structure. Management has noted that 55% of the company's network operations are already virtualized. It expects to boost this to 75% by 2020 with, we expect, concomitant cost savings.

In the Entertainment Group, 1Q revenue fell 8.1% to 11.6 billion, or 6.4% on a comparable basis, due to declines in traditional TV subscribers and in legacy DSL internet connection services (which are not competitive with broadband internet) and to bundle discounts. DirecTV lost 188,000 subscribers, though the company's over-the-top video service DIRECTV NOW added 321,000. The overall video subscriber base was stable at 25.4 million.

On March 30, 2017, AT&T announced an agreement with the federal First Responder Network Authority (FirstNet) to build and operate a dedicated national wireless broadband network for police, firefighters and emergency medical services. Emergency workers currently use commercial wireless networks that can become clogged during emergencies. FirstNet will provide 20 MHz of national 700 MHz low-band telecommunications spectrum, and success-based payments of $6.5 billion over the next five years to support the buildout of the new network. Under the terms of the agreement, AT&T will spend $40 billion over the 25-year life of the agreement to build, operate and maintain the network, including upgrading to 5G. The FirstNet network will also integrate with AT&T's own network assets. In addition, AT&T will be able to use/resell unused time on the FirstNet network.

We think the FirstNet deal is a positive for AT&T, particularly since it has had 100% buy-in from the individual states. From AT&T's standpoint, greater network coverage is an obvious plus. FirstNet provides opportunities for AT&T to expand its service network footprint into geographic areas with lower population density that may be uneconomical on a commercial basis alone. The addition of the 20MHz of adjacent 700 MHz spectrum to the 40MHz of currently unused spectrum held by the company should also benefit network capacity, putting AT&T in a strong strategic position as wireless data usage continues to explode. AT&T launched the FirstNet network core in March 2018.

While the Time Warner acquisition is in litigation and therefore remains in doubt, we think acquiring a premium content provider like Time Warner would a plus for AT&T. It would also take a particularly valuable piece off the entertainment industry M&A game board, preventing Time Warner's sale to another industry player. Time Warner is one of the largest integrated media companies in the world, with industry-leading assets in film, TV, and videogame production, as well as basic and premium cable channels. We see this acquisition as a strategic move by AT&T to ensure access to premium branded content not only for its DirecTV direct satellite video distribution business, but also for its nascent wireless video business. Management has been clear that it sees mobile video as the future of the wireless business as wireless bandwidth increases and as network technology evolves from LTE to 5G. Verizon has taken a similar, though more conservative approach, in a series of smaller acquisitions, including AOL, the Huffington Post, and Yahoo.

AT&T management has justified the deal by projecting accretion to both adjusted EPS and free cash flow per share in the first year after the closing. However, we expect adjusted results to ignore merger integration costs. AT&T looks for $1 billion in run-rate cost synergies within three years of the closing. Management also expects to rapidly delever after the closing and to return to historically normal debt levels by 2022.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on AT&T is Medium, the midpoint on our five-point scale. The Time Warner transaction will add more than $23 billion in debt to AT&T's balance sheet. Despite the increase in leverage, the company expects to maintain its investment-grade credit rating and to return to its target debt/EBITDA multiple of 1.8 by the end of the fourth year after the closing. AT&T's credit ratings are in the high B's, solidly investment grade. However, the ratings agencies put the company on negative credit watch on October 24, 2016, the day after the Time Warner acquisition was announced.

AT&T's quarterly dividend is $0.50 per share, or $2.00 annually, for a yield of about 6.2%. Our dividend estimates to $2.00 for 2018 and $2.04 for 2019. AT&T has a five-year compound annual dividend growth rate of 2%.

RISKS

The Time Warner acquisition, if it happens, will present significant integration risk as well as regulatory risk for AT&T. Time Warner will be run as a separate subsidiary of AT&T. However, the combined company will still have to integrate two very different corporate cultures: the relatively staid culture of AT&T, a regulated telecom, and the more free-wheeling, entertainment-oriented culture of Time Warner. If the DOJ is successful in blocking the acquisition, the market could interpret this as a negative for AT&T.

AT&T faces a number of traditional and newer competitors, as the telecom industry continues to evolve from a voice-centered to a wireless data and converged fixed broadband data model. In addition, the U.S. wireless industry is essentially at saturation which has led to increased competitive intensity to win subscribers and narrower margins. These trends have been partially offset by the rapid adoption of smartphones, which come with higher-priced data plans, and by other data devices like tablets that generally carry lower-priced plans though smartphones and tablets are also now beginning to close in on saturation. AT&T has diversified its handset portfolio from an over-reliance on Apple's iPhone (notwithstanding its blockbuster status), into Android, Windows Phone and other smartphones. On the wireline side, cable companies are fierce competitors for video and broadband internet services, and have also made large inroads with VoIP and into communications for small and medium-sized business customers.

Following its spinoff from Deutsche Telekom and acquisition of regional wireless telecom MetroPCS, a resurgent T-Mobile has been particularly effective in challenging the larger wireless industry incumbents with discounts and inventive new service plans. Sprint joined the fray in 2015 with cut rate plans of its own, and has gone even further by offering a promotion for a year of free service. AT&T has responded to this heightened competition with new plans and incentives of its own, including unlimited data — though this is pressuring margins. The new no-subsidy equipment installment plans will also shift revenue out of service and into the equipment line in the short term, while increasing risks related to long-term accounts receivable. Management has pledged to value receivables conservatively and may be able to reduce this risk by factoring.

Through its recent moves into Mexico and elsewhere in Latin America, AT&T will be entering foreign markets that may not have the same demand dynamics as its home U.S. market. Mexico has, at least initially, been a capex drain on AT&T as it upgrades wireless networks to the 4G LTE standard of its U.S. network. Issues such as corruption and organized crime are also more prevalent in these markets than in the U.S., and could entangle AT&T. In addition, the company's foreign exchange risk will increase.

Another risk is that the market continues to shift rapidly to new communications formats, such as VoIP, Wi-Max and wireless/IP integration. The danger is that AT&T will be unable to adapt quickly enough to keep pace with the new technology.

AT&T also has a large retiree population and correspondingly large pension and benefit obligations. Retiree benefit plans could become more of a burden in the future. The company is acting to minimize the risk of future OPEB payments through its pension plan trust preferred equity plan.

AT&T is highly regulated on the federal, state and local levels. As a regulated entity, it is vulnerable to changes in regulatory philosophy that could put it at a disadvantage relative to other industry players. We think this risk may have lessened with the change in administration in Washington.

COMPANY DESCRIPTION

AT&T provides telecommunications and entertainment services to consumers in the U.S. and Latin America and to businesses worldwide. SBC acquired the old AT&T in November 2005 and took the AT&T name shortly thereafter. The combined company acquired BellSouth Corp. in December 2006 and spun out its Directories business in May 2012. The company acquired Mexican wireless telecoms Iusacell and Nextel Mexico in January 2015, and direct broadcast satellite video operator DirecTV in July 2015.

VALUATION

AT&T shares have lost 12% in the last year, compared to a total return of 12% for the S&P 500 and a loss of 4% for the S&P 500 Telecommunication Services Index. AT&T is trading near the bottom of its five-year average range for trailing enterprise value/EBITDA (7.0 versus a range of 6.9-7.9). Close rival Verizon has a multiple of 7.3. AT&T's forward enterprise value/ EBITDA multiple of 6.0 is 10% below the peer average, greater than the average discount of 9% over the last two years. We are maintaining our BUY rating on AT&T to a target price of $48.

On May 3, BUY-rated T closed at $31.94, down $0.12. (Joseph Bonner, CFA, 5/3/18)

CONOCOPHILLIPS (NYSE: COP, $65.99).. BUY

COP: Boosting target by $11 to $76

* We believe that Conoco's combination of major long-cycle and unconventional short-cycle projects will enable it to generate shareholder value in a wide range of commodity price environments.
* On April 26, the company reported a 1Q18 adjusted net profit of $1.1 billion or $0.96 per share, compared to an adjusted net loss of $19 million or $0.02 per share in 1Q17. EPS topped our forecast of $0.68 and the consensus estimate of $0.74.
* The swing to an operating profit was mostly driven by higher realized prices for crude oil, natural gas, and natural gas liquids. The company's average realized price was $65.47 per barrel of oil equivalent (boe) in 1Q, up 29% from the prior year.
* We are raising our 2018 EPS estimate to $3.52 from $2.60 based on the strong 1Q results and our expectations for modestly higher commodity prices, ongoing cost reductions, and expanding gross and operating margins this year. The 2018 consensus is $3.46.

ANALYSIS

INVESTMENT THESIS

We are reaffirming our BUY rating on ConocoPhillips (NYSE:COP) and raising our price target to $76 from $65. We believe that Conoco's combination of major long-cycle and unconventional short-cycle projects will enable it to generate shareholder value in a range of commodity price environments.

Conoco is the third-largest U.S. oil company by market capitalization, and we believe that it has successfully differentiated itself from other large-cap peers: it is the largest independent pure-play E&P in the world; it is increasingly levered to high-margin liquids production; and it has most of its proven reserves in low-risk, OECD countries.

Based on our expectations for stable to modestly higher commodity prices and continued cost reductions, we expect Conoco to post stronger earnings in 2018.

RECENT DEVELOPMENTS

COP shares have outperformed since the beginning of 2018, rising 18.0% while the S&P 500 Energy index has climbed 1.9%. The shares have risen 37.6% over the past year, while the Energy index has increased 9.4%.

On April 26, ConocoPhillips reported a 1Q18 adjusted net profit of $1.1 billion or $0.96 per share, compared to an adjusted net loss of $19 million or $0.02 per share in 1Q17. EPS topped our forecast of $0.68 and the consensus estimate of $0.74.

The swing to an operating profit was driven by higher realized prices for crude oil, natural gas, and natural gas liquids. The company's average realized price was $65.47 per barrel of oil equivalent (boe) in 1Q, up 29% from the prior year.

First-quarter production from continuing operations, excluding Libya, totaled 1,224 thousand barrels of oil equivalent per day (mboe/d), up 4% from the prior year, adjusted for closed and planned dispositions. The increase reflected stronger production growth in the Lower 48 segment (Big 3 of Eagle Ford, Bakken and Delaware). Total revenue rose 15% to $8.961 billion.

The company organizes its reportable segments operations by region, which we review below.

In the Lower 48, first-quarter production averaged 352,000 barrels of oil equivalent per day (boe/d), down 20% from the same period last year. The segment had 12 operating rigs at the end of 1Q18, up from 9 a year earlier. The company expects to operate an average of 15 rigs in the Lower 48 in 2018.

In the Asia Pacific and Middle East and Other segment, average production increased 2% year-over-year to 398,000 boe/d. The company remains optimistic about future production following the ramp-up of operations at the Gumusut field in Malaysia and two exploration wells in Chile.

In Canada, average 1Q production decreased to 70,000 boe/d from 333,000 boe/d in the prior-year quarter, due mainly to the sale of Conoco's Canadian assets to Cenovus Energy, a Canadian oil company. Under the terms of the transaction, Conoco received $10.6 billion in cash and 208 million Cenovus shares valued at $2.7 billion as of March 28, 2017.

In Europe, average production rose 8% year-over-year to 258,000 boe/d. Management attributed the increase to increased well efficiency. In Alaska, average production was comparable to the prior year at 191,000 boe/d.

EARNINGS & GROWTH ANALYSIS

For 2018, COP now expects full-year production of 1,200-1,240 mboe/d, up from a prior forecast of 1,195-1,235 mboe/d. The increase reflects the strong first-quarter performance and management's revised assumptions for asset sales. It continues to forecast production and operating costs of $5.7 billion and capital expenditures of $5.5 billion.

We are raising our 2018 EPS estimate to $3.52 from $2.60 based on the strong 1Q results and our expectations for modestly higher commodity prices, ongoing cost reductions, and expanding gross and operating margins this year. The 2018 consensus is $3.46.

We are also raising our 2019 EPS estimate to $4.05 from $2.99. This implies about 15% growth from our 2018 forecast. Our estimate again assumes modestly higher commodity prices and stronger gross and operating margins. The 2019 consensus is $3.34.

FINANCIAL STRENGTH & DIVIDEND

We rate COP's financial strength as Medium-High, the second-highest rating on our five-point scale. The company's debt is rated A-/stable by Standard & Poor's, Baa1/positive by Moody's and A-/positive by Fitch.

At the end of 1Q18, COP's total debt/capitalization ratio was 35.7%, down from 42.6% a year earlier. The total debt/cap ratio was in line with the peer average and has averaged 35.9% over the past five years.

Total debt fell to $17.05 billion at the end of 1Q18 from $26.44 billion at the end of 1Q17. In early 2016, COP raised $4.6 billion through a debt offering, but is now on a path to lower overall debt. The company has a $6.75 billion revolving credit facility that expires in July 2020.

The company had cash and cash equivalents of $4.98 billion at the end of 1Q18, up from $3.11 billion at the end of 1Q17. The increase reflects proceeds from asset dispositions. Cash from operating activities was $2.399 billion in 1Q18, up from $1.790 billion in 1Q17.

In February 2018, the company raised its quarterly dividend by 8% to $0.285, or $1.14 annually, for a yield of about 1.8%. Our dividend estimates are $1.14 for 2018 and $1.22 for 2019.

The COP board recently approved an increase in the existing share repurchase authorization to $6 billion, double the previous $3 billion authorization. In 2017, the company repurchased $3 billion of its common stock. It plans to purchase $2 billion in 2018, up from a previous estimate of $1.5 billion.

MANAGEMENT & RISKS

Ryan Lance became chairman and CEO of Conoco in May 2012 after serving as SVP Exploration and Production-International since May 2009. The CFO is Jeff Sheets, who has been with the company since 2008.

Investors in COP shares are exposed to numerous risks, including trends in the volatile oil and natural gas markets, in interest rates, and in global economic growth.

The nature of its business exposes ConocoPhillips to a myriad of lawsuits. The company operates in some countries with a history of official corruption and in others that are prone to political upheavals. At the same time, its broad geographic presence reduces the impact of risk in any single country. Some 83% of COP's proved reserves are in OECD countries, while a relatively small 17% are in non-OECD markets. In our view, this may make it easier for the company to take on additional risks in developing markets.

COMPANY DESCRIPTION

ConocoPhillips is the world's largest independent E&P company based on production and proved reserves. Based in Houston, Conoco has operations in 21 countries and approximately 15,900 employees.

INDUSTRY

Our rating on the Energy sector is Over-Weight. We note that investors remain skeptical about the sector despite prospects for significant earnings acceleration in 2018-2019. We also expect Energy stocks to benefit as OPEC continues to limit production in order to boost oil prices. The sector accounts for 5.7% of the S&P 500. Over the past five years, the weighting has ranged from 5% to 12%. We think that investors should consider allocating 6%-8% of their diversified portfolios to the Energy group. The sector includes the major integrated firms, as well as exploration & production, refining, and oilfield & drilling services companies. The sector is underperforming in 2018, with a loss of 6.6%. It also underperformed in 2017, with a loss of 3.8%.

By our calculations, the projected P/E ratio on 2018 earnings is 19.4, above the market multiple of 16.7.

We forecast that West Texas Intermediate crude oil (WTI) will average $56 per barrel in 2018, up from $50 in 2017 and $43 in 2016 but well below the average price of $93 in 2014. At the same time, we expect oil prices to remain volatile. We look for a full-year price range of $48-$64 per barrel.

Our 2018 forecast for the average wellhead price of Henry Hub natural gas is $2.90 per MMbtu with a range of $2.75-$3.05, compared to $3.00 per MMbtu in 2017.

VALUATION

COP shares are trading near the high end of their 52-week range of $42.27-$67.30. They are trading at 18.7-times our 2018 EPS estimate and 16.2-times our 2019 estimate, below the multiples of close competitors. They also trade well below the peer average for price/book, price/sales, price/cash flow and price/EBITDA, though we believe that higher multiples are warranted. The company has realigned its portfolio toward higher-growth, higher-margin assets, and has focused on boosting shareholder returns through buybacks and dividends.

On May 3, BUY-rated COP closed at $65.99, up $0.54. (Bill Selesky, 5/3/18)

PUBLIC SERVICE ENTERPRISE GROUP INC. (NYSE: PEG, $51.87) .... BUY

PEG: Raising target price; solid EPS comparisons; reaffirming BUY

* We are raising our target price on Public Service Enterprise by $4 to $60.
* On April 30, Public Service Enterprise posted 1Q18 non-GAAP adjusted earnings of $492 million or $0.97 per share, compared to $466 million or $0.92 per share in 1Q17.
* We view the company's increased spending on electric transmission and gas pipeline projects as a strong plus, as these facilities are more likely to provide higher returns on equity than those earned on distribution and generation assets.
* The company should continue to benefit from strong cost controls, solid cash flow from operations, a strong management team, and what we view as a favorable regulatory environment at both the state and federal levels.

ANALYSIS

INVESTMENT THESIS

We are raising our target price on BUY-rated Public Service Enterprise Group Inc. (NYSE: PEG) by $4 to $60, based on the company's growing network of transmission assets, and its well-managed regulated utility subsidiary, Public Service Electric & Gas Co. (PSE&G).

We view the company's increased spending on electric transmission and gas pipeline projects as a strong plus, as these facilities are more likely to provide higher returns on equity than those earned on distribution and generation assets.

We expect above-average growth in the company's rate base from infrastructure investments, as well as higher profitability in its nonregulated operations. In addition, we continue to expect annual dividend growth of 4.0%-5.0% over the next several years. The shares currently offer a solid dividend yield of 3.5%.

Utilities as a group are heavily debt-financed and aggregate interest charges are likely to rise. In addition, in a rising interest rate environment, equity investors seeking income more often than not move away from utility industry shares and turn to the bond market, as fixed-income rates begin to rise. Even so, we think Public Service, with its strong finances and solid management execution, will outperform other utilities in a rising interest rate environment.

The company should continue to benefit from strong cost controls, solid cash flow from operations, a strong management team, and what we view as a favorable regulatory environment at both the state and federal levels. In addition, our positive assessment reflects the company's efficiently operated nuclear generation units, focus on balance sheet improvement, and expanding economic activity in its service area. We believe that the company's core business strategy complements its well-balanced asset portfolio, and that its regulated electric and gas business is well-positioned for growth beyond 2018.

RECENT DEVELOPMENTS

Over the past three months, PEG shares have fallen 4%, compared to an advance of 3% for the S&P 500. Over the past 52 weeks, the shares have risen 17%, compared to an advance of 11% for the S&P 500. The five-year track record shows an increase of 47% for PEG, versus a gain of 63% for the S&P 500. The beta on PEG shares is currently 0.35.

On April 30, Public Service Enterprise posted 1Q18 non-GAAP adjusted earnings of $492 million or $0.97 per share, compared to $466 million or $0.92 per share in 1Q17. Operating revenue rose to $2.564 billion from $2.463 billion in 1Q17.

Public Service Enterprise Group Inc. is a publicly traded diversified energy company. Its operating subsidiaries are: PSEG Power, Public Service Electric & Gas Co., and PSEG Long Island.

The company's regulated electric and gas utility, PSE&G, posted earnings of $319 million for 1Q18, compared with $299 million in 1Q17. Results at PSE&G in 1Q18 reflect successful execution of its infrastructure investment programs and costs related to winter storm activity. In addition, PSE&G experienced higher costs associated with restoring service to customers following four separate winter storms that occurred over a 30-day period. The increase in storm costs boosted O&M expenses, as well as higher depreciation expense due to the utility's expanded asset base.

Weather-normalized electric sales to residential and commercial customers in 1Q18 rose 0.4% year-over-year. Weather normalized natural gas sales in 1Q18 were higher by 1.6%, due to increased residential and commercial usage.

In response to the New Jersey Board of Public Utilities recent order regarding the Tax Cut and Jobs Act of 2017, PSE&G filed to lower its electric and gas revenue requirement by $114 million annually, effective April 1, to reflect the reduction in the federal corporate tax rate from 35% to 21%.

Non-regulated PSEG Power reported earnings of $234 million in 1Q18, compared to a net loss of $170 million in 1Q17. PSEG Power's earnings comparison for 1Q18, compared to the loss in 1Q17, primarily reflects an increase in capacity prices and lower market demand.

Generation output in 1Q18 at PSEG Power declined modestly compared with 1Q17. Output was affected by severe winter weather at the start of the year. On the positive side, Power's nuclear fleet operated at an average capacity factor of 99.5% in 1Q18.

PSEG Enterprise/Other posted earnings of $5 million for 1Q18, compared to a net loss of $15 million for 1Q17. The loss for 1Q17 reflects the absence of tax benefits and higher interest expense at the parent company.

EARNINGS & GROWTH ANALYSIS

Management's 2018 adjusted earnings guidance is $3.00-$3.20 per share. The company is expected to announce its 2Q18 financial results on July 26.

Our 2018 EPS estimate is $3.11. As for 2019, we are looking at $3.22 per share. We believe both estimates reflect the continued expansion of the company's electric and gas transmission and distribution facilities, as well as the company's favorable natural gas supply position. In addition, the company is beginning to benefit from a turnaround in nonregulated wholesale power prices and lower energy supply costs, as well as declining O&M expenses. At the same time, both estimates assume some pressure from rising depreciation and higher property taxes, both related to the infrastructure buildout program, as well as from customer conservation efforts.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating on Public Service Enterprise is Medium-High, the second-highest rank on our five-point scale. The company's bond ratings are investment grade. Public Service remains focused on balance sheet improvement, growth in cash flow, and strong cost controls. While total debt has increased as a result of its infrastructure buildout program, the overall cost of financing has declined due to refinancing activity and lower interest rates. The company ended 1Q18 with a relatively low long-term debt/capital ratio of 46%, well below the sector average of 55%. EBITDA covered interest expense by a factor of 6.9 in 1Q18, slightly below the industry average of 7.2. The 1Q18 profit margin was 14.9%, compared to 14.1% in 1Q17. Operating cash flow advanced to $1.574 billion in 2017 from $887 million in 2016.

Increasing shareholder value remains a priority for management, and the company has paid dividends without interruption since 1907. The annualized dividend is currently $1.80 per share, for a yield of about 3.5%. Our dividend estimates are $1.82 for 2018, and for 2019, we are looking at $1.88. We expect dividend increases of close to 5% annually over the next 3-4 years.

MANAGEMENT & RISKS

Ralph Izzo was elected chairman and CEO of Public Service Enterprise Group in April 2007. He became the company's president and chief operating officer and a member of the board of directors in October 2006. He previously served as president and chief operating officer of PSE&G.

In September 2015, Daniel J. Cregg, formerly VP of Finance for PSE&G, was named executive vice president and CFO. During his 24-year career with the company, Mr. Cregg has held senior financial positions at both PSE&G and PSEG Power.

Overall, we believe that Public Service Enterprise is committed to electric and gas service expansion strategies in its regulated service territory and that it is keeping O&M expenses in check. In addition, we think the company's platform for growth is solid, and we are confident in management's ability to provide shareholders with increased value over the long term.

The company's regulated utility operations are subject to cooler-than-normal conditions during the summer air-conditioning season, and the gas distribution business faces the possibility of warmer-than-normal temperatures during the winter heating season. Although utility regulation in New Jersey is generally balanced, there is always the possibility that regulators will lower the company's allowed return on common equity. The company's earnings could also come under pressure in the event of a downturn in the U.S. economy.

COMPANY DESCRIPTION

Public Service Enterprise Group is a combination electric and gas utility holding company, with regulated operations serving a large part of New Jersey, and nonregulated operations serving electricity markets primarily in the Mid-Atlantic and Northeast. It has two primary wholly owned subsidiaries: PSE&G (a regulated utility), and nonregulated PSEG Power (nuclear, solar and fossil-fuel-powered electric generating operations). At the end of 2017, the company operated a portfolio of 13,200 megawatts of installed generating capacity.

INDUSTRY

Our rating on the Utility sector is Under-Weight. The sector is underperforming in 2018, with a loss of 4.2% after also underperforming in 2017, with a gain of 8.3%. Utilities outperformed the S&P 500 in 2016, with a gain of 12.2%. The sector accounts for 2.9% of the S&P 500. Over the past five years, the weighting has ranged from 2.5% to 5.0%. We think the sector should account for about 2% of diversified portfolios.

The sector includes the electric, gas and water utility industries. By our calculations (using 2018 EPS), the sector price/earnings multiple is 16.2, below the market average of 16.7. Earnings are expected to rise 8.1% in 2018 after rising 6.3% in 2017 and 21.5% in 2016.

The sector's debt-to-cap ratio is about 55%, above the market average. This represents a risk, given the current state of the credit markets, particularly if corporate bond rates rise. The sector dividend yield of 2.8% is above the market average of 1.8%.

VALUATION

PEG trades at 15.5-times our 2019 EPS estimate of $3.22, below the average multiple for electric and gas utilities with both regulated and nonregulated assets. The stock also trades at a discount to peers based on price/cash flow and price/book.

Other favorable factors are the company's experienced management team, strong operating efficiencies, limited risk profile, solid cost controls, and generally positive relations with regulators. The company also has a strong balance sheet and continues to add new customers in an improving service area economy. Overall, we believe that the company is committed to optimizing the value of its regulated and nonregulated assets.

We believe that Public Service has the potential to generate total annual returns for shareholders of 5%-6% over the next four to five years. Our revised target price of $60, along with the dividend, implies a potential total return of about 18% from current levels.

On May 3, BUY-rated PEG closed at $51.87, up $0.41. (Gary Hovis, 5/3/18)