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## Financial Analysis of Otter Tail Corporation

Shawn Tykwinski  
tykwinsksh@mnstate.edu

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# Financial Analysis and Valuation of Otter Tail Corporation

Shawn Tykwinski  
[tykwinsksh@mnstate.edu](mailto:tykwinsksh@mnstate.edu)

# Otter Tail Corporation

OTTR / NASDAQ

## Initiating Coverage Investment Recommendation: Hold

PRICE: USD 49.82 S&P 500: 2,900.45 DIJA: 26,449.54 Russell 2000: 1,567.60

- \$270 million wind farm project to be online in 2020 – largest capital project in company history.
- \$165 million natural gas-fired plant to be in service in 2021.
- Pursuing \$973 million in capital investments in utility between 2019 and 2023 producing an expected 8 percent growth rate between 2018 and 2023.
- Forecast of generating 23% more megawatt-hours annually by 2022
- Utility expected to make up 75-85% of earnings (66% in 2018).
- Manufacturing and plastic pipe business to grow organically from new products, increased efficiency, and use of increased plant capacity from previous years capital investments.

| Valuation | 2018 A | 2019 E | 2020 E |
|-----------|--------|--------|--------|
| EPS       | 2.08   | 2.13   | 2.09   |
| P/E       | 23.11  | 24.38  | 25.70  |
| CFPS      | 4.13   | 6.88   | 5.92   |
| P/CFPS    | 11.63  | 7.55   | 9.08   |

| Market Capitalization             | Stock Data |                             |               |
|-----------------------------------|------------|-----------------------------|---------------|
| Equity Market Cap (In Millions):  | 1,979      | 52-Week Range:              | 42.55 - 51.88 |
| Enterprise Value:                 | 2,589      | 12-Month Stock Performance: | 16.54%        |
| Shares Outstanding (In Millions): | 39.73      | Dividend Yield:             | 2.65%         |
| Estimated Float (In Millions):    | 39.1       | Price to Book:              | 2.75          |
| 3-mo Avg. Daily Volume:           | 77,045     | Beta:                       | 0.19          |

### Company Quick View:

**Location:** 215 South Cascade Street, Fergus Falls, MN 56538

**Industry:** Electric Services (SIC 4911) / Other Electric Power Generation (NIACS 221118)

**Description:** Otter Tail is a holding company with 5 subsidiaries residing in three different business segments: electric, which includes the production, transmission, distribution and sale of electric energy; manufacturing, which consists of businesses in the manufacturing contract machining, metal parts stamping, fabrication and painting, and production of material and handling trays and horticultural containers; and plastics, which consists of businesses producing polyvinyl chloride pipe. The electric segment provided electricity to more than 130,000 customers in western Minnesota, eastern North Dakota and northeastern South Dakota.

**Website:** <http://www.ottertail.com/>

**Analyst:** Shawn Tykwinski

## Stock Price Performance

The below chart shows Otter Tail's stock price performance from the period 03/31/2014-03/29/2019.

**Figure 1: 5-year Stock Price Performance**



Source: Yahoo Finance

Otter Tail Corporation's stock has performed well over the past 5 years, growing from about \$30 to almost \$50 per share in that time. The short-term return on Otter Tail's stock has been just as impressive as the stock price has returned almost 20% over the last year. This well exceeds the market during that time, outperforming the S&P 500 by about 9% and the Russell 2000 by over 15%. It is tough to compete with their main competitor, Black Hills Corporation. Otter Tail seemed to outperform Black Hills Corporation throughout 2018. However, Black Hills Corporation's stock price has jumped \$13 this year, resulting in an annually return of 42%. This steep climb in stock price could be associated with the purchase of 50 percent interest in Busch Ranch Wind Farm along with the approval for \$57 million wind project that occurred in December of 2018. Otter Tail reported good FY17Q3 and FY17Q4 earnings and just filed a rate case with North Dakota to increase their rates. The drop in share price during this time might be explained as the market correcting itself after a steep climb in stock price during the second half of FY17 to put it back on pace for a linear increase. This also could be explained as a cyclical movement in the company's stock price as a similar drop occurred at the end of 2016 and into 2017, although this movement did not appear to take place to the same degree at the end of 2018. The drop at the end of 2018 could also be explained by the decrease of the whole market.

## Investment Summary

I am giving the recommendation to hold on Otter Tail Corporation stock over the next 12-month period. Through my analysis, I have valued the company at \$48.59 per share as of 03/31/2019. This is \$1.23 per share less than the market value of \$49.82. I am providing the hold recommendation despite the lower valuation as I believe Otter Tail Corporation has a

promising outlook and has a corporate strategy that, if executed, will increase the company's credit rating, provide more predictable earnings, and allow for dividend growth.

### **Continued Capital Investment in Otter Tail Power Company**

Otter Tail plans to continue to grow their electric utility business through several capital investment projects over the next 5 years. The total investment planned is \$973M and is expected to result in an annual growth rate of 8% from 2018-2023. The capital projects are detailed below:

- *Merricourt Project:* This project includes an Asset Purchase Agreement with EDF Renewable Development, Inc of \$34.7M as well as an agreement with EDF to construct a wind farm for \$200.5M. The wind farm project is expected to begin in 2019 and be completed by 2020.
- *Astoria Station:* Otter Tail is developing a simple-cycle natural gas-fired combustion turbine generation facility in preparation for the retirement of the Hoot Lake Plant in 2021. The project was approved by the FERC in January of 2019 and is expected to cost \$158M.
- *Big Stone:* This project includes a 163-mile transmission line between Big Stone City, South Dakota and Ellendale, North Dakota. The Transmission line was energized on February 6, 2019. Otter Tail jointly owns the line with its equal owner Montana-Dakota Utilities Co. Total expenditures for Otter Tail on this project were \$106M.
- *Other Capital Projects:* Other capital projects include \$348M for renewable wind and solar energy generation, including the Merricourt project, the exercise of purchase options for Ashtabula III wind farm in 2022, a large investment in solar generation in 2022, and routine asset replacement and improvements.

### **Focus on efficiency and utilizing existing capacity in manufacturing subsidiaries**

Otter Tail is focused on growing their Manufacturing and Plastics line of businesses (LOBs) organically through efficiency gains and utilization of prior periods capital expenditures. These LOBs will continue to be an integral part of Otter Tail's business plan, however; Otter Tail does not plan to force growth through additional capital expenditures. Otter Tail is planning to allocate capital expenditures of \$77M and \$20M to the Manufacturing and Plastics LOBs, respectively, over the next 5 years. Most of this investment will go toward replacing equipment, plant expansions, and information systems.

## **Company Description**

Otter Tail Corporation was incorporated in 1907 when the company began construction on a Dam near Fergus Falls, MN that would transmit power to the customers of the Northern Light Electric Company in Wahpeton, North Dakota. The company quickly grew by merging with Northern Light Electric Company in 1912. By this time, the company had connected or purchased electric distribution systems in towns across Minnesota. In the 1940's, the company merged with or acquired six smaller power companies. These acquisitions increased their territory to their present size of 50,000 square miles. Otter Tail Corporation is headquartered in

Fergus Falls Minnesota and Fargo, North Dakota. They are a publicly traded company and trade on the NASDAQ under OTTR.

### **Otter Tail Corporation Subsidiaries**

Currently, Otter Tail Corporation is the parent company to five subsidiaries. The main subsidiary is the Otter Tail Power Company, producing about 50% of revenues in 2018. Otter Tail Power Company provides electricity and energy services to 132,200 customers across Minnesota, North Dakota, and South Dakota. Otter Tail Power Company generates most of its electricity through coal-fired plants (45%) and wind power (19%). The rest of the power is generated through hydroelectric plants, combustion turbines, natural gas, and solar power. Otter Tail Power Company employs approximately 800 employees.

BTD manufacturing Inc. is a wholly owned subsidiary of Otter Tail Corporation acquired in 1995. BTD manufacturing provides metal fabrication services for custom machine parts and metal components through metal stamping, tool and die, machining, tube bending, welding, and assemble. This subsidiary is headquartered in Detroit Lakes, MN and employs approximately 1,273 employees throughout their 7 locations.

T.O. Plastics, Inc. is a wholly owned subsidiary of Otter Tail Corporation acquired in 2001. They manufacture extruded and thermoformed plastic products, including custom parts for customers in several industries and its own line of horticulture containers. T.O. Plastics is located in Clearwater, MN and employs approximately 172 employees. The Manufacturing subsidiaries of BTD and T.O. Plastics produced 29% of revenues in 2018.

Northern Pipe Products and Vinlytech Corporation are wholly-owned subsidiaries of Otter Tail Corporation. Norther Pipe Products was acquired in 1995 and has 90 employees. Vinlytech Corporation was acquired in 2000 and has 70 employees. They manufacture and sell PVC pipe used in municipal water, wastewater and water reclamation systems. These subsidiaries made up 22% of revenue in 2018.

### **Business Strategy**

Otter Tail Corporation's focus is on growing Otter Tail Power Company in hopes of lowering risk, creating more predictable earnings, improving credit quality and maintaining dividends. It is expected that over time, Otter Tail Power Company will provide 75-85% of overall earnings. Manufacturing and plastic pipe businesses will continue to be a fundamental part of Otter Tail's strategy. These businesses will provide 15-25% of earnings and will look to provide organic growth through new products and services, market expansion and increased efficiencies. Much of the growth in these businesses will come from existing plant capacity from capital investments made in previous years. When evaluating their portfolio, Otter Tail Corp looks for specific characteristics including: a threshold of net earnings and return on invested capital over their WACC, a strategic differentiation from competitors and sustainable cost advantages, operating within a stable growth industry, being able to quickly adapt to changes, and having a strong management team committed to operational excellence.

### **Top Competitors**

Otter Tail Corporation competitors include Black Hills Inc. and Allete, Inc. Black Hills is a public company founded in Rapid city, SD in 1941. They serve 1.2 million natural gas and

electric utility customers in eight Midwest states. Allete Inc. is a public company founded in Duluth, MN in 1906. They provide energy to 140,000 residents across the Midwest. The manufacturing and plastics subsidiaries of Otter Tail have a vast number of competitors due to the number of producers and the nature of the products.

## Industry Analysis

- Industry SIC Code: Electric Services (SIC 4911)
- Industry NAICS: Electric Bulk Power Transmission and Control (NAICS 221121)

**Bargaining Power of Suppliers:** Most utility companies are not reliant on suppliers as they generate a large portion of the energy that they provide themselves. If retail energy is used, the company is reliant on the supplier providing the necessary energy. The high level of competition among energy generators pushes the cost of energy down, which reduces the bargaining power of the suppliers. Additionally, suppliers have less bargaining power due to the concern of losing high volume customers.

**Bargaining Power of Customer:** Most customers do not have an option on their energy supplier due to government regulations. Therefore, customers do not have bargaining power and must accept whatever utility supplier is available in their location and must accept the rates. However, deregulation has started in some states allowing customers to have options in their energy suppliers. Bargaining power of customers will be a factor in the future if the deregulation continues.

**Intensity of Existing Rivalry:** Competition is naturally reduced in the utilities industry due to regulation. Government policies and regulations determine the level of competition within the utilities industry. Due to the current regulation limiting competition, companies are not competing over the same customer. Additionally, the size of the industry allows for many companies to reach economies of scale and succeed without having to take market shares from competitors.

**Threat of Substitutes:** There is a limited number of substitutes available to the consumer due to the uniqueness and the need of the product. Technological advancements could produce more substitute products in the future. One example of a substitute is solar energy. However, the upfront cost of solar energy will deter many customers from consideration.

**Threat of New Competitors:** The threat of new competitors entering the market is low. New competitors will have high upfront cost due to high capital requirements involved in building and running power plants. Regulation from government reduces the ability to enter the market without approval from the governing agency. Economies of scale with also deter new competitors, as they will have a higher cost of production. Additionally, existing competitors have a competitive advantage when it comes to already owning the best geographical locations.

## Peer Analysis

Listed below are Otter Tail's main competitors. Each of these companies are medium-sized and operate primarily in SIC Code 4911 (Electric Services) and NAICS Code 221118 (Other Electric Power Generation). They are also all located in the mid-west region.

### Black Hills Corporation

Black Hills Corporation is a 130-year-old energy company headquartered in Rapid City, South Dakota. The company provides utility services to 1.2 million customers in eight Midwest states and has over 2,800 employees. Black Hills Corporation operates in four business segments: Electric Utilities, Gas Utilities, Power Generation, and Mining.

### Allete Inc.

Allete Inc. is an energy company headquartered in Duluth, Minnesota. Allete operates in three business segments: Regulated Operations, ALLETE Clean Energy, Inc. and U.S. Water Services Holding Company. Through Minnesota Power, as part of their Regulated Operations, Allete provides 145,000 residents, 16 municipalities and some of the nation's largest industrial customers with electric utility services throughout northern Minnesota.

### NorthWestern Corporation

NorthWestern Corporation is headquartered in Sioux Falls, SD. They provide over 718,300 customers with electricity and natural gas services. They service about 73% of Montana's land area and have the exclusive right for 25 counties in South Dakota. They have approximately 1,600 employees.

Otter Tail Corporation Peer Analysis (As of 3/29/2019)

| Company                 | Ticker Symbol | Market Cap (in Billions) | 2018 Revenues (in thous) | PE ratio | P/BV | EV/EBITDA | Debt/Assets | ROA   | ROE    |
|-------------------------|---------------|--------------------------|--------------------------|----------|------|-----------|-------------|-------|--------|
| Otter Tail Corporation  | OTTR          | 1.96                     | 916,447                  | 24.76    | 2.78 | 13.18     | 30.00%      | 3.82% | 11.55% |
| Black Hills Corporation | BKH           | 4.46                     | 1,754,268                | 15.62    | 2    | 12.88     | 49.95%      | 3.61% | 13.61% |
| Allete Inc.             | ALE           | 4.24                     | 1,498,600                | 24.2     | 1.95 | 14.22     | 29.00%      | 2.56% | 8.24%  |
| NorthWestern            | NWE           | 3.58                     | 1,192,009                | 16.94    | 1.8  | 12.46     | 37.00%      | 3.14% | 11.05% |

Source: Yahoo Finance as of 03/31/2019



## Corporate Governance

### Senior Leadership

Charles S. MacFarlane: President & CEO

- MacFarlane first joined Otter Tail Power Company in 2001 as Director of Financial Analysis and Planning. He was promoted to president in 2003 and CEO in 2007 of the company's electric utility, Otter Tail Power Company. He became President and CEO of Otter Tail Corporation on April 13, 2015.

Kevin G. Moug: CFO & Senior Vice President

- Moug joined Otter Tail Corporation in 1996. His main responsibility is overseeing the financial performance of the corporation. Moug was the CFO of Advance Dental Management and worked at Deloitte & Touche prior to joining Otter Tail Corporation.

Timothy J. Rogelstad: Senior Vice President, Electric Platform; President, Otter Tail Power Company

- Rogelstad first joined Otter Tail in 1989 as an Engineer. He was named as Vice President in 2012 and President in 2014. He is responsible for the overall operations of Otter Tail Power Company.

John S. Abbott: Senior Vice President, Manufacturing Platform; President, Varistar

- Abbott became President of Varistar in 2015. Varistar is responsible for providing Otter Tail Corporation's manufacturing platform with operational and talent support.

Jennifer O. Smestad: Vice President, General Counsel, & Corporate Secretary

- Smestad joined Otter Tail Corporation in 2001. She was promoted to Senior Associate General Counsel in 2012, General Counsel in 2013, and her current position in 2018. She is responsible for ensuring that the company is compliant with current laws and regulations.

### Management Incentives

Adjusted EPS is one of the main incentives that affect Otter Tail's top executives. Adjusted ROE at the corporate level affects the CEO, CFO, and the Secretary. Rather than ROE, Rogelstad and Abbott are incentivized by their related platform performance indicators (NI for both and ROE for Rogelstad). All executives are evaluated by CEO Charles MacFarlane and given a score for individual performance. The Compensation Committee determines MacFarlane's individual performance and is subject to ratification by the independent members of the Board of Directors.

Top executives are also rewarded long term incentives that align the interest of the executives with the shareholders. Total shareholder return is compared to the total shareholder return of companies in the Edison Electric Institute Index. This comparison determines half of the share-based awards. The return is based on the three-year period beginning on the first day of the year. The remaining half of the share-based awards vest based on achieving targets

for three-year adjusted return on equity. The target for return on equity is based on multiple criteria including prior years ROE, weighted average authorized return on equity, and EEI Index.

## Board of Directors

The Board of Directors include nine members, eight of which are non-employees. Charles MacFarlane, the CEO, is the only member of the Board who is not independent. The Board consist of two females and seven males and is summarized in the below table.

| Board of Directors    | Board Committees                    | Experience   |
|-----------------------|-------------------------------------|--|
| Steven L. Fritze      | Audit (Chair); Corporate Governance | Retired CFO of Ecolab, Inc.                          |
| Kathryn O. Johnson    | Compensation; Corporate Governance  | Owner of Johnson Environmental Concepts              |
| Timothy J. O'Keefe    | Compensation; Corporate Governance  | Retired CEO of UND Foundation                        |
| John D. Erickson      | N/A                                 | Former CEO of Otter Tail Corporation                 |
| Nathan I. Partain     | N/A                                 | President of Duff & Phelps Investment Management Co. |
| James B. Stake        | Compensation (Chair); Audit         | VP of Enterprise Services at 3M                      |
| Karen M. Bohn         | Corporate Governance (Chair); Audit | CEO and President of Galeo Group                     |
| Charles S. MacFarlane | N/A                                 | Current CEO and President of Otter Tail Corporation  |
| Thomas J. Webb        | Audit; Compensation                 | VP and CFO of CMS Energy Corporation                 |

\*Source: Otter Tail Corporation website.

The table below compares Otter Tail's return on invested capital to one of their main competitors, Black Hills Corporation, over the last 5 years. The ROIC ratio reflects on management's ability and effectiveness at turning investment in capital to earnings for the company.

| Year | Otter Tail ROIC | Black Hills ROIC |
|------|-----------------|------------------|
| 2018 | 6.17%           | 6.92%            |
| 2017 | 5.88%           | 6.10%            |
| 2016 | 5.72%           | 7.30%            |
| 2015 | 5.99%           | 7.05%            |

\*Source: Ratios calculated from data provided by Otter Tail Corporation website and Black Hills Corporation website

The above table suggests that Otter Tail has done an adequate job at turning invested capital into profit over the last 5 years. They have consistently been around 6%, which is

## Shareholder Analysis

Below is a breakdown of the top 10 shareholders of Otter Tail Corporation stock as of 12/31/2018. Otter Tail has 190 institutional holders making up 43.66% of their total shares outstanding.

| Owner Name                    | Shares Held | Percentage |
|-------------------------------|-------------|------------|
| VANGUARD GROUPD INC           | 4,073,670   | 10.3%      |
| BLACKROCK INC                 | 2,826,591   | 7.1%       |
| DIMINSIONAL FUND ADVISORS LP  | 1,204,554   | 3.0%       |
| GABELLI FUNDS LLC             | 1,019,200   | 2.6%       |
| RENAISSANCE TECHNOLOGIES LLC  | 954,000     | 2.4%       |
| NORTHERN TRUST CORP           | 930,082     | 2.3%       |
| STATE STREET CORP             | 808,378     | 2.0%       |
| FIRST TRUST ADVISORS LP       | 501,216     | 1.3%       |
| GEODE CAPITAL MANAGEMENT, LLC | 471,635     | 1.2%       |
| BANK OF NEW YORK MELLON CORP  | 390,968     | 1.0%       |

\*Source: NASDAQ

The table below shows the net insider transactions since 12/31/2018. President and CEO Charles S. Macfarlane has been the most active insider, acquiring more than 38K shares this year.

| Insider                                   | Net Transaction | Shares |
|---|-----------------|--------|
| Charles S. Macfarlane (President and CEO) | Acquisition     | 38,524 |
| Kevin G. Moug (Senior VP & CFO)           | Acquisition     | 15,228 |
| John Abbot (Senior VP)                    | Acquisition     | 9,320  |
| Timothy J. Rogelstad (Senior VP)          | Acquisition     | 9,296  |
| Jennifer O. Smestad (VP, Secretary)       | Acquisition     | 1,336  |

\*Source: NASDAQ

In 2018, Otter Tail Corp issued 178,601 shares of common stock and retired 71,208 shares of common stock. As of 3/27/2019, Otter Tail Corp has issued an additional net 64,824 shares of stock in 2019.

## Risk Analysis

### General

The utilities industry is subject to federal, state and local environmental laws and regulations. Companies must comply with any regulation related to air quality, water quality, waste management, natural resources, and health safety. Existing laws could be modified, and new laws could be implemented, causing unplanned capital expenditures and operating costs. The failure to meet regulatory standards set by the government could lead to fees, penalties and even civil or criminal liabilities, even if the failure is caused by factors outside of the control of the company.

Access to borrowing is necessary when cash flows from operations do not support capital requirements. Volatile financial markets can impact Otter Tail's ability to borrow at a

competitive rate. The revolving credit agreements currently use LIBOR to determine the appropriate interest rates. LIBOR is expected to be eliminated by January 1, 2022. An alternative method for determining interest rates for agreements set to expire on October 31, 2023 have not yet been established. There is no guarantee that the replacement method will be as favorable as the LIBOR method.

Otter Tail relies on their subsidiaries to provide cash flows and earnings in order to fulfill their debt covenants and to fund the dividends to shareholders. Bad economic conditions can lead to a decrease in the customers' ability to purchase products and services, leading to a decrease in sales and an increase in write offs.

Some products or services have warranty agreements. Based on experience and history, Otter Tail estimates the amount of warranty expense to reserve. The amount claimed could materially exceed the reserve balance, especially if there is a duplicate default in products. This could lead to an unplanned cash expenditure.

Energy markets could adversely affect the financial performance of the company. Shortages in supply could force Otter Tail to obtain supply at a higher cost in order to fulfill contractual obligations.

Income taxes and other tax related items require judgement and estimates. This can cause, along with change in tax laws, a material variance between estimated tax and actual tax.

A large portion of Otter Tail Corp.'s revenue stems from single customers in four of the operating companies. The loss or decrease in revenue from any of these customers will have a material impact on the finances of the company.

## **Electric**

Otter Tail could experience volatility in revenues and expenses related to their electric operations from period to period. This could affect their ability to make dividend payments and meet their debt obligations.

Subject to federal and state regulations, Otter Tail could experience regulation that negatively affects the financials of the company. This includes rate reductions, lower revenues and earnings or delays in recovering capital expenditures. Otter Tail is subject to material penalties if they are not compliant with the standards set by governing authorities.

Operating risks at generating facilities are present due to unplanned plant outages, increased costs and unexpected expenses. Otter Tail uses coal to generate most of its energy. They use a small number of suppliers for coal, which exposes them to increased prices. Otter Tail uses the railroad for shipments of coal, which can result in a delay in shipments due to rail line congestion. Otter Tail is also susceptible to security breaches, cyber-attacks or system failures due to the use of technology and information systems. Additional operation risk includes equipment failure, labor disputes, operator error and other extraordinary events.

## **Manufacturing**

Otter Tail's Manufacturing segments have high competition from manufactures who have more capital and resources. The raw materials used in manufacturing include steel, aluminum

and polystyrene. The cost of these materials can be volatile which can lead to smaller profit margins if the cost cannot be passed onto the customer.

**Plastics**

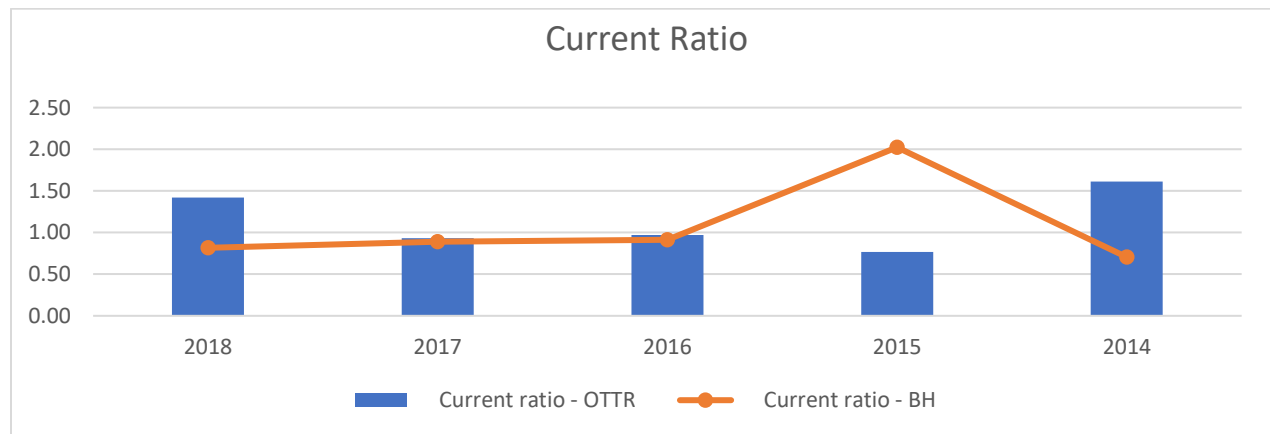
Otter Tail's Plastic operations rely on a small number of suppliers for their raw materials. Two suppliers provide 99% of raw materials. This puts the company at risk for any increased cost or delay in supply.

The plastic operations compete against many manufacturers. The products in this segment have a large amount of substitutes including iron, steel and concrete pipe manufacturers. The high level of competition and not being able to distinguish the products may lead to a smaller profit margin.

**Ratio Analysis**

Otter Tail's sales growth has increased by about 2.5% each year over the past 3 years with this year reaching 7.9%. This can be mostly attributed to the continued increase in revenue from the manufacturing segment as revenues increased USD \$38.7 million from 2017. Electric segment revenues also increased by USD \$15.7 million due to an increase in retail sales (USD \$13.3 million) and wholesale energy sales (USD \$2.6 million).

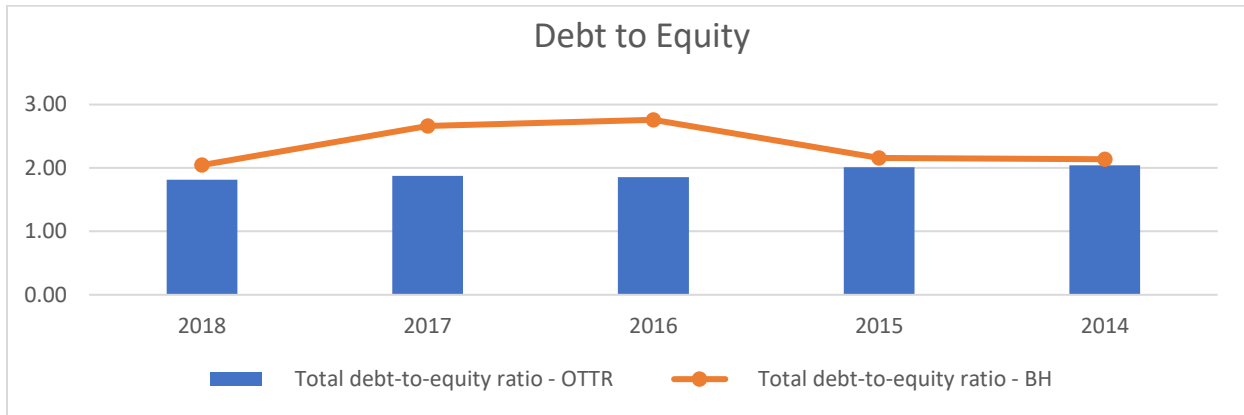
Otter Tail's current ratio compares well with Black Hills Corp. In 2016 and 2017, both companies' current ratio sat between .9 and 1. This seems to be the norm for companies in the utilities industry. Neither company has high current assets relative to fixed assets as they are capital intensive and most of their cash is passed on to the shareholders in the form of dividends. In 2018, Otter Tail's current ratio jumped up to 1.42 where Black Hills Corp. dropped to .82.



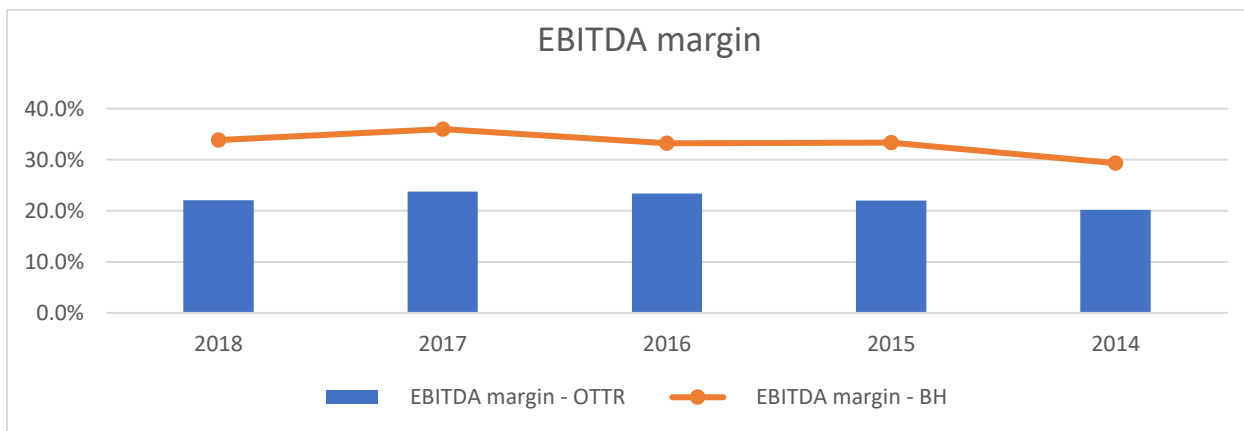
Otter Tail and Black Hills are very similar in other liquidity ratios. Both companies fall between .1 and .2 for the cash ratio, never varying by more than .04 between the two companies over the past 3 years. Historically, Otter Tail has had a quicker cash cycle, however; in 2018, both companies were around 37 days. Their operating cycle's have also been very

close, with Otter Tail averaging 72 days and Black Hills averaging 77 days over the past 5 years.

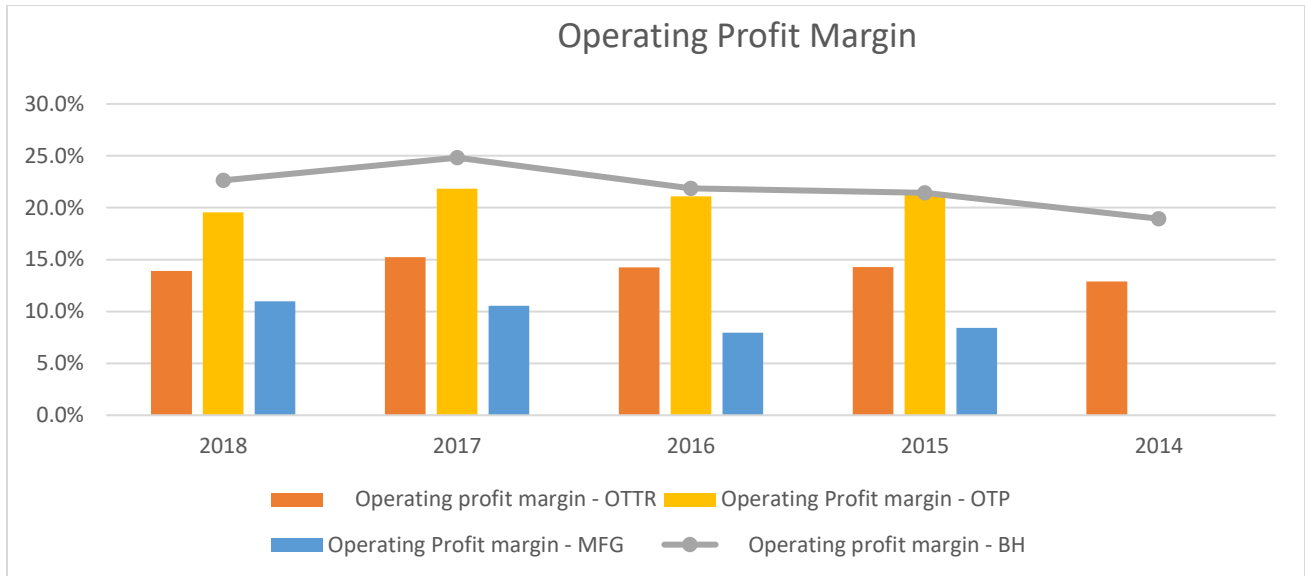
Both Otter Tail and Black Hills are highly financially leveraged companies. Both companies are able to borrow at low rates. This allows them to use debt to finance their operations while keeping their interest coverage ratio at acceptable levels.



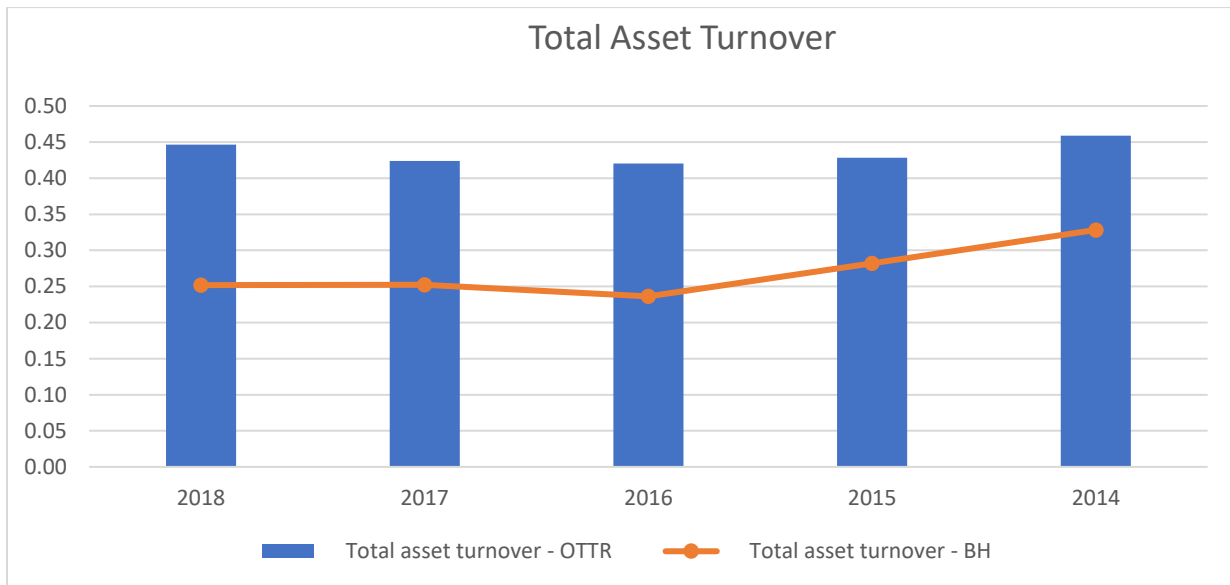
One area where Black Hills separates themselves from Otter Tail is in profitability. Black Hills has significantly better margins than Otter Tail. Operating profit has historically been about 9% higher for Black Hills. EBITDA margin, as seen below, has been about 11% higher for Black Hills.



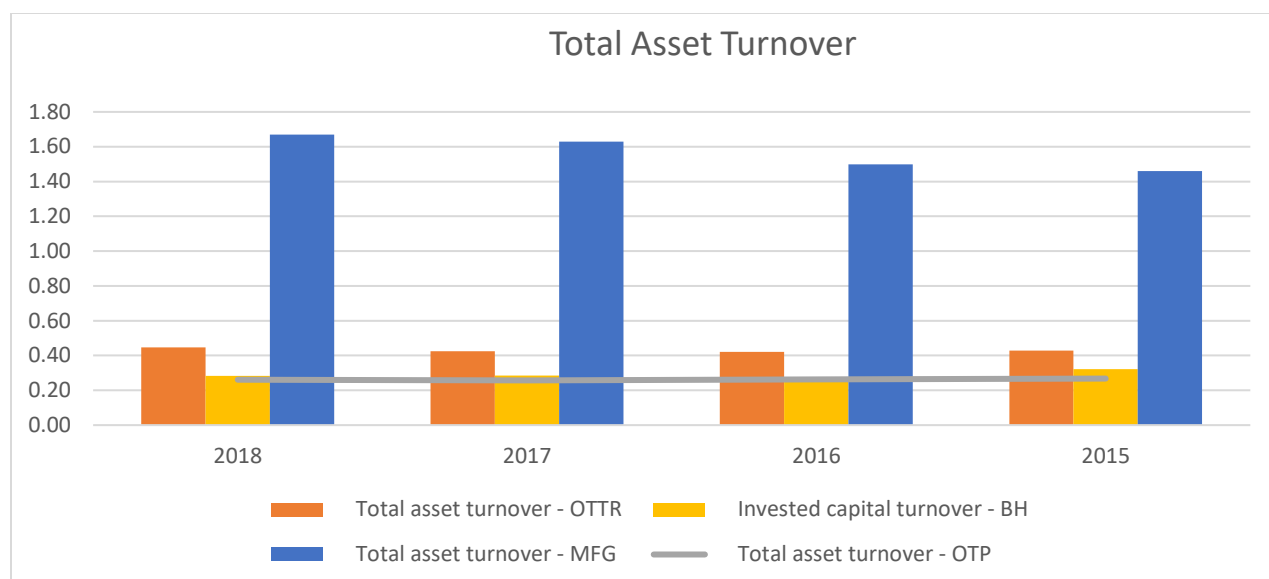
I broke Otter Tail’s operating profit margin out by segment because of the large difference in margins between Otter Tail and Black Hills. This provides a better understanding as to how much of the difference is management effectiveness related and how much is company structure related. The below table demonstrates the Otter Tail’s electric segment competes well with Black Hills in operating profit margin. This suggests that the lower margins have more to do with the manufacturing businesses and less to do with management’s ability to efficiently produce profit.



Return on assets has been consistent for both companies at about 6% over the last 5 years. Otter Tail has shown the ability to more efficiently generate sales from assets. As shown below, Otter Tail has a much higher total asset turnover than Black Hills. The invested capital turnover ratio is similar as Otter Tail had a ratio of .49 where Black Hills had .28 in 2018.



I also broke total asset turnover out by segments to get a more accurate analysis of Otter Tail’s management effectiveness. The below graph suggest that the turnover ratio is higher for Otter Tail because of their manufacturing segments. Otter Tail Power Company and Black Hills have roughly the same total asset turnover ratio over the last 4 years.



## Financial Performance and Projections

I projected pro-forma financial statements for Otter Tail Corporation based on historical data, ratio analysis and other public information. I projected sales to grow about 7% over the next five years. The sales growth projection is in line with management's estimate of 8% annual growth from 2019-2023 from capital investments in the electric utility business. The 8% growth in the electric utility is roughly 4% growth in the consolidated revenue. The remaining estimated sales growth is attributed to expected organic growth in the manufacturing subsidiaries which I have estimated at 6% over the next 5 years. I projected long-term sales growth rate at a 3%.

I project COGS to steadily decrease over the next 5 years starting at 76.46% in 2019 and dropping to 76.29% by 2023. The drop in COGS is expected due to the anticipation in an increase in gross margin. I believe that gross margin will increase for three reasons; first, the company's expected growth in the electric segment which has better margins, second, the company's planned increase in power generation which will eliminate some cost of purchased power, third, the expected efficiency gains in the manufacturing businesses. These activities should all improve the company's overall margins.

The projected growth in net PP&E is consistent with Otter Tail's expected invested capital projects over the next 5 years with a total of \$1.07B. I expect Otter Tail to return to their normal P&E/Sales ratio after these capital projects. I project Otter Tail using a mixture of equity, short-term debt and long-term debt to fund these projects. I project equity to increase 2% per year, which is consistent with historical growth. The remaining funds will come from a mixture of short-term and long-term debt.

## Valuation

I estimated the price Otter Tail's share price to be USD 48.59 on 03/31/2019. To estimate the share price, I used the Corporate Valuation Model, which uses discounted free cash flows at the Weighted Average Cost of Capital (WACC).



I calculated the cost of equity to be 4.52% using the following assumptions; beta of .19, risk-free rate of 3%, market risk premium of 8%. I estimated the cost of long-term debt to be 7.06% before taxes and 5.58% after taxes. I estimated short-term debt to be 4.25% before taxes and 3.36% after taxes. I estimated short-term debt using LIBOR + 1.50% per Otter Tails current revolving credit agreement. I calculated the after-tax cost of debt assuming a 21% tax rate. I estimated WACC to be 4.78% using the above assumptions and calculations.

I also used the EBITDA multiple and dividend payout methods to value Otter Tail. I used a multiple of 9.43 based on the multiple assigned to the electric segment from Equidam.com. Using this multiple I got a price of \$47.92 per share as of 12/31/2018. Using a dividend growth of 2.13% I got a value of \$56.07 per share as of 12/31/2018 for the dividend growth model.

## Conclusion

Otter Tail's corporate strategy is to focus on the growth of Otter Tail Power Company. This will lower overall risk and increase profit margins. However, due to the restrictions of regulation, OTP is limited with how much they can grow outside of an acquisition or merger. For this reason, I do not believe Otter Tail has potential as a growth stock. Otter Tail is a dividend stock and should be invested as such. I would recommend this stock to anyone looking for dividend income, especially those at or near retirement. Investing as a growth stock should be approached with caution.

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| <b>Otter Tail Corp. (NMS: OTTR)</b>                |                     |                     |                     |                     |                     |                     |                     |                     |
|--|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| <i>In thousands of USD</i>                         |                     |                     |                     |                     |                     |                     |                     |                     |
| <b>Income Statement</b>                            | <b>12/31/2016</b>   | <b>12/31/2017</b>   | <b>12/31/2018</b>   | <b>12/31/2019</b>   | <b>12/31/2020</b>   | <b>12/31/2021</b>   | <b>12/31/2022</b>   | <b>12/31/2023</b>   |
| Sales  | 803,539.00          | 849,350.00          | 916,447.00          | 980,437.78          | 1,048,988.32        | 1,122,429.84        | 1,201,118.03        | 1,285,434.90        |
| Costs of goods sold (COGS)                         | 613,463.00          | 644,518.00          | 712,392.00          | 749,657.49          | 801,631.10          | 857,282.66          | 916,877.61          | 980,700.89          |
| Sales, general and administrative expense (SGA)    | 2,205.00            | 2,988.00            | 2,048.00            | 2,191.00            | 2,344.19            | 2,508.31            | 2,684.16            | 2,872.58            |
| Depreciation                                       | 73,445.00           | 72,545.00           | 74,666.00           | 80,562.58           | 95,607.52           | 97,530.65           | 102,099.19          | 102,892.54          |
| <b>Operating profit</b>                            | <b>114,426.00</b>   | <b>129,299.00</b>   | <b>127,341.00</b>   | <b>148,026.71</b>   | <b>149,405.51</b>   | <b>165,108.22</b>   | <b>179,457.08</b>   | <b>198,968.89</b>   |
| Interest expense                                   | 31,886.00           | 29,604.00           | 30,408.00           | 36,277.10           | 35,380.33           | 41,607.66           | 40,192.52           | 41,548.50           |
| Interest income                                    | -                   | -                   | -                   | 700.17              | 1,882.66            | -                   | 183.02              | 1,168.90            |
| Nonoperating income (Expense)                      | -                   | -                   | -                   | -                   | -                   | -                   | -                   | -                   |
| Earnings before taxes (EBT)                        | 82,540.00           | 99,695.00           | 96,933.00           | 112,449.78          | 115,907.85          | 123,500.56          | 139,447.58          | 158,589.29          |
| Tax expense  | 20,219.00           | 27,256.00           | 14,588.00           | 23,614.45           | 24,340.65           | 25,935.12           | 29,283.99           | 33,303.75           |
| Net income before extraordinary items              | 62,321.00           | 72,439.00           | 82,345.00           | 88,835.33           | 91,567.20           | 97,565.44           | 110,163.59          | 125,285.54          |
| After-tax extraordinary income (Expense)           | -                   | -                   | -                   | -                   | -                   | -                   | -                   | -                   |
| <b>Net income (NI)</b>                             | <b>62,321.00</b>    | <b>72,439.00</b>    | <b>82,345.00</b>    | <b>88,835.33</b>    | <b>91,567.20</b>    | <b>97,565.44</b>    | <b>110,163.59</b>   | <b>125,285.54</b>   |
| Dividends-- preferred                              | -                   | -                   | -                   | -                   | -                   | -                   | -                   | -                   |
| Dividends-- common                                 | 48,244.00           | 50,632.00           | 53,198.00           | 57,742.96           | 59,518.68           | 63,417.54           | 71,606.33           | 81,435.60           |
| Additions to RE                                    | 14,077.00           | 21,807.00           | 29,147.00           | 31,092.36           | 32,048.52           | 34,147.90           | 38,557.26           | 43,849.94           |
| <b>Balance Sheet</b>                               | <b>12/31/2016</b>   | <b>12/31/2017</b>   | <b>12/31/2018</b>   | <b>12/31/2019</b>   | <b>12/31/2020</b>   | <b>12/31/2021</b>   | <b>12/31/2022</b>   | <b>12/31/2023</b>   |
| <b>Assets</b>                                      |                     |                     |                     |                     |                     |                     |                     |                     |
| Cash   | -                   | 16,216.00           | 861.00              | 3,927.98            | 4,202.61            | 4,496.85            | 4,812.10            | 5,149.90            |
| Inventory  | 83,740.00           | 88,034.00           | 106,270.00          | 107,848.16          | 115,388.72          | 123,467.28          | 132,122.98          | 141,397.84          |
| Accounts receivable                                | 74,092.00           | 76,227.00           | 84,885.00           | 89,953.82           | 96,243.24           | 102,981.40          | 110,200.93          | 117,936.89          |
| Other short-term operating assets                  | 20,742.00           | 23,608.00           | 26,065.00           | 25,278.86           | 27,046.32           | 28,939.88           | 30,968.71           | 33,142.67           |
| Short-term investments                             | 29,441.00           | 35,042.00           | 23,339.00           | 62,755.30           | -                   | 6,100.79            | 38,963.50           | 128,834.43          |
| Total current assets                               | 208,015.00          | 239,127.00          | 241,420.00          | 289,764.12          | 242,880.88          | 265,986.19          | 317,068.22          | 426,461.73          |
| Net plant, property, & equipment (PPE)             | 1,477,225.00        | 1,539,603.00        | 1,581,098.00        | 1,705,961.74        | 2,024,547.46        | 2,065,270.91        | 2,162,012.45        | 2,178,812.15        |
| Other long-term operating assets                   | 218,728.00          | 216,919.00          | 221,038.00          | 254,351.37          | 272,135.19          | 291,187.85          | 311,601.64          | 333,475.66          |
| Long-term investments                              | 8,417.00            | 8,629.00            | 8,961.00            | -                   | -                   | -                   | -                   | -                   |
| <b>Total assets</b>                                | <b>1,912,385.00</b> | <b>2,004,278.00</b> | <b>2,052,517.00</b> | <b>2,250,077.23</b> | <b>2,539,563.54</b> | <b>2,622,444.96</b> | <b>2,790,682.32</b> | <b>2,938,749.54</b> |
| <b>Liabilities and Equity</b>                      |                     |                     |                     |                     |                     |                     |                     |                     |
| Accounts payable (AP)                              | 89,350.00           | 84,185.00           | 96,291.00           | 110,601.89          | 118,334.99          | 126,619.83          | 135,496.54          | 145,008.21          |
| Accruals   | 48,874.00           | 49,731.00           | 54,293.00           | 56,914.02           | 60,893.35           | 65,156.60           | 69,724.42           | 74,618.98           |
| Other operating current liabilities                | -                   | -                   | -                   | -                   | -                   | -                   | -                   | -                   |
| All short-term debt                                | 76,084.00           | 122,245.00          | 19,509.00           | -                   | 57,797.33           | -                   | -                   | -                   |
| Total current liabilities                          | 214,308.00          | 256,161.00          | 170,093.00          | 167,515.91          | 237,025.66          | 191,776.43          | 205,220.95          | 219,627.19          |
| Long-term debt                                     | 687,245.00          | 692,631.00          | 784,247.00          | 782,750.58          | 866,178.66          | 889,215.02          | 923,299.95          | 937,806.15          |
| Deferred taxes                                     | 249,440.00          | 121,880.00          | 140,950.00          | 227,986.46          | 270,562.58          | 276,004.90          | 288,933.54          | 291,178.67          |
| Preferred stock                                    | -                   | -                   | -                   | -                   | -                   | -                   | -                   | -                   |
| Other long-term liabilities                        | 91,288.00           | 236,714.00          | 228,364.00          | 274,522.58          | 293,716.73          | 314,280.36          | 336,313.05          | 359,921.77          |
| Total liabilities                                  | 1,242,281.00        | 1,307,386.00        | 1,323,654.00        | 1,452,775.53        | 1,667,483.63        | 1,671,276.70        | 1,753,767.50        | 1,808,533.77        |
| Par plus PIC Less treasury (and other adjustments) | 622,396.00          | 627,377.00          | 630,201.00          | 667,547.34          | 710,277.03          | 755,217.47          | 802,406.77          | 851,857.78          |
| Retained earnings (RE)                             | 47,708.00           | 69,515.00           | 98,662.00           | 129,754.36          | 161,802.88          | 195,950.79          | 234,508.04          | 278,357.98          |
| Total common equity                                | 670,104.00          | 696,892.00          | 728,863.00          | 797,301.70          | 872,079.91          | 951,168.25          | 1,036,914.82        | 1,130,215.76        |
| <b>Total liabilities and equity</b>                | <b>1,912,385.00</b> | <b>2,004,278.00</b> | <b>2,052,517.00</b> | <b>2,250,077.23</b> | <b>2,539,563.54</b> | <b>2,622,444.96</b> | <b>2,790,682.32</b> | <b>2,938,749.54</b> |

| <b>Otter Tail Corp. (NMS: OTTR)</b>         |                     |                     |                     |                     |                     |                     |                     |                     |
|---|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| <i>In thousands of USD</i>                  |                     |                     |                     |                     |                     |                     |                     |                     |
| <b>Statement of Cash Flows</b>              | <b>12/31/2016</b>   | <b>12/31/2017</b>   | <b>12/31/2018</b>   | <b>12/31/2019</b>   | <b>12/31/2020</b>   | <b>12/31/2021</b>   | <b>12/31/2022</b>   | <b>12/31/2023</b>   |
| <b>Operating Activities</b>                 |                     |                     |                     |                     |                     |                     |                     |                     |
| Net income                                  | 62,321.00           | 72,439.00           | 82,345.00           | 88,835.33           | 91,567.20           | 97,565.44           | 110,163.59          | 125,285.54          |
| Depreciation                                | 73,445.00           | 72,545.00           | 74,666.00           | 80,562.58           | 95,607.52           | 97,530.65           | 102,099.19          | 102,892.54          |
| Change in deferred tax                      | 17,265.00           | (127,560.00)        | 19,070.00           | 87,036.46           | 42,576.12           | 5,442.32            | 12,928.64           | 2,245.13            |
| Change in inventory                         | 1,676.00            | (4,294.00)          | (18,236.00)         | (1,578.16)          | (7,540.56)          | (8,078.57)          | (8,655.70)          | (9,274.86)          |
| Change in accounts receivable               | (2,045.00)          | (2,135.00)          | (8,658.00)          | (5,068.82)          | (6,289.42)          | (6,738.16)          | (7,219.53)          | (7,735.96)          |
| Change in other short-term operating assets | 1,127.00            | (2,866.00)          | (2,457.00)          | 786.14              | (1,767.46)          | (1,893.56)          | (2,028.84)          | (2,173.96)          |
| Change in accounts payable                  | (149.00)            | (5,165.00)          | 12,106.00           | 14,310.89           | 7,733.10            | 8,284.84            | 8,876.71            | 9,511.67            |
| Change in accruals                          | 2,648.00            | 857.00              | 4,562.00            | 2,621.02            | 3,979.33            | 4,263.25            | 4,567.82            | 4,894.56            |
| Change in other current liabilities         | -                   | -                   | -                   | -                   | -                   | -                   | -                   | -                   |
| <b>Net cash from operating activities</b>   | <b>156,288.00</b>   | <b>3,821.00</b>     | <b>163,398.00</b>   | <b>267,505.44</b>   | <b>225,865.83</b>   | <b>196,376.22</b>   | <b>220,731.87</b>   | <b>225,644.67</b>   |
| <b>Investing Activities</b>                 |                     |                     |                     |                     |                     |                     |                     |                     |
| Investment in PPE                           | (162,856.00)        | (134,923.00)        | (116,161.00)        | (205,426.32)        | (414,193.25)        | (138,254.10)        | (198,840.73)        | (119,692.24)        |
| Investment in other long-term oper. ass.    | (4,508.00)          | 1,809.00            | (4,119.00)          | (33,313.37)         | (17,783.82)         | (19,052.66)         | (20,413.79)         | (21,874.02)         |
| <b>Net cash from investing activities</b>   | <b>(167,364.00)</b> | <b>(133,114.00)</b> | <b>(120,280.00)</b> | <b>(238,739.69)</b> | <b>(431,977.06)</b> | <b>(157,306.76)</b> | <b>(219,254.52)</b> | <b>(141,566.26)</b> |
| <b>Financing Activities</b>                 |                     |                     |                     |                     |                     |                     |                     |                     |
| Change in short-term investments            | (2,084.00)          | (5,601.00)          | 11,703.00           | (39,416.30)         | 62,755.30           | (6,100.79)          | (32,862.71)         | (89,870.93)         |
| Change in long-term investments             | 3,764.00            | (212.00)            | (332.00)            | 8,961.00            | -                   | -                   | -                   | -                   |
| Change in short-term debt                   | (57,132.00)         | 46,161.00           | (102,736.00)        | (19,509.00)         | 57,797.33           | (57,797.33)         | -                   | -                   |
| Change in long-term debt                    | 63,804.00           | 5,386.00            | 91,616.00           | (1,496.42)          | 83,428.07           | 23,036.36           | 34,084.94           | 14,506.19           |
| Preferred dividends                         | -                   | -                   | -                   | -                   | -                   | -                   | -                   | -                   |
| Change in preferred stock                   | -                   | -                   | -                   | -                   | -                   | -                   | -                   | -                   |
| Change in other long-term liabilities       | (36.00)             | 145,426.00          | (8,350.00)          | 46,158.58           | 19,194.15           | 20,563.63           | 22,032.69           | 23,608.72           |
| Change in common stock (Par + PIC)          | 51,004.00           | 4,981.00            | 2,824.00            | 37,346.34           | 42,729.69           | 44,940.44           | 47,189.31           | 49,451.01           |
| Common dividends                            | (48,244.00)         | (50,632.00)         | (53,198.00)         | (57,742.96)         | (59,518.68)         | (63,417.54)         | (71,606.33)         | (81,435.60)         |
| <b>Net cash from financing activities</b>   | <b>11,076.00</b>    | <b>145,509.00</b>   | <b>(58,473.00)</b>  | <b>(25,698.77)</b>  | <b>206,385.87</b>   | <b>(38,775.23)</b>  | <b>(1,162.10)</b>   | <b>(83,740.61)</b>  |
| Net cash flow                               | -                   | 16,216.00           | (15,355.00)         | 3,066.98            | 274.64              | 294.23              | 315.25              | 337.80              |
| Starting cash                               | -                   | -                   | 16,216.00           | 861.00              | 3,927.98            | 4,202.61            | 4,496.85            | 4,812.10            |
| <b>Ending cash</b>                          | <b>-</b>            | <b>16,216.00</b>    | <b>861.00</b>       | <b>3,927.98</b>     | <b>4,202.61</b>     | <b>4,496.85</b>     | <b>4,812.10</b>     | <b>5,149.90</b>     |

| Ratios  | 2018   | 2017     | 2016   | 2015    | 2014    |
|---|--------|----------|--------|---------|---------|
| <b>Productivity Ratios</b>                            |        |          |        |         |         |
| Growth in sales                                       | 7.9%   | 5.7%     | 3.0%   | -2.4%   | -10.5%  |
| Receivables turnover                                  | 10.80  | 11.14    | 10.85  | 10.82   | 10.90   |
| Inventory turnover                                    | 8.62   | 9.65     | 9.60   | 9.13    | 9.38    |
| Operating working capital turnover                    | 13.58  | 12.10    | 19.91  | 17.88   | 28.86   |
| Net fixed asset turnover                              | 0.51   | 0.48     | 0.47   | 0.49    | 0.54    |
| Total asset turnover                                  | 0.45   | 0.42     | 0.42   | 0.43    | 0.46    |
| Invested capital turnover                             | 0.49   | 0.46     | 0.46   | 0.47    | 0.53    |
| <b>Liquidity Ratios</b>                               |        |          |        |         |         |
| Current ratio   | 1.42   | 0.93     | 0.97   | 0.77    | 1.61    |
| Quick ratio   | 0.79   | 0.59     | 0.58   | 0.45    | 1.08    |
| Cash ratio  | 0.14   | 0.20     | 0.14   | 0.10    | 0.51    |
| Short-term investments over invested capital          | 0.01   | 0.02     | 0.02   | 0.02    | 0.05    |
| Operating Cycle                                       | 76.13  | 70.59    | 71.69  | 73.70   | 72.41   |
| Cash Cycle  | 37.78  | 34.41    | 31.11  | 31.81   | 23.54   |
| <b>Financial Risk (Leverage) Ratios</b>               |        |          |        |         |         |
| Total debt-to-equity ratio                            | 1.82   | 1.88     | 1.85   | 2.01    | 2.04    |
| Total debt-to-equity ratio (excluding deferred taxes) | 1.62   | 1.70     | 1.48   | 1.63    | 1.68    |
| Total financial debt-to-equity ratio                  | 1.10   | 1.17     | 1.14   | 1.25    | 1.21    |
| Interest coverage ratio (accounting-based)            | 4.19   | 4.37     | 3.59   | 3.57    | 3.48    |
| Interest coverage ratio (cash-based)                  | 6.64   | 6.82     | 5.89   | 5.51    | 5.44    |
| Total debt-to-assets ratio                            | 0.64   | 0.65     | 0.65   | 0.67    | 0.67    |
| Total financial debt over invested capital            | 0.39   | 0.41     | 0.40   | 0.42    | 0.40    |
| Long-term financial debt over invested capital        | 0.42   | 0.38     | 0.40   | 0.38    | 0.45    |
| <b>Profitability/Valuation Ratios</b>                 |        |          |        |         |         |
| Gross profit margin                                   | 22.3%  | 24.1%    | 23.7%  | 21.7%   | 19.7%   |
| EBITDA margin   | 22.0%  | 23.8%    | 23.4%  | 22.0%   | 20.2%   |
| Operating profit margin                               | 13.9%  | 15.2%    | 14.2%  | 14.3%   | 12.9%   |
| NOPAT margin  | 13.9%  | -4.0%    | 12.9%  | 13.6%   | 12.4%   |
| Earnings before taxes margin                          | 10.6%  | 11.7%    | 10.3%  | 10.3%   | 9.2%    |
| Net margin  | 9.0%   | 8.5%     | 7.8%   | 7.6%    | 7.2%    |
| Return on Assets                                      | 6.20%  | 6.45%    | 5.98%  | 6.12%   | 5.92%   |
| Net investment rate                                   | 33.75% | -268.93% | 87.46% | 137.66% | 130.09% |
| Dividend payout ratio                                 | 64.60% | 69.90%   | 77.41% | 77.89%  | 76.68%  |
| ROIC  | 6.97%  | -1.94%   | 6.30%  | 7.06%   | 7.24%   |

