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**Rating: Hold**

### FPL GROUP

(NYSE-FPL)

Multiples on Tax-Derived Earnings

Fpl Group	10/20						
Price (intra day)	44						
52-week range	74-34						
Book 6/30/08	26.33	167%	P/b	Performance	Price 10/20	Y-t-d %	12 Mos. %
Adjusted Earnings*				Fpl Group	44	(35)	(27)
2005 Actual	2.63	16.8		Phil. Electric Index	387	(32)	(27)
2006 Actual	3.04	14.5		Dow Industrials	9,041	(32)	(33)
2007 Actual	3.48	12.7		Analyst Total	19		
2008 Consensus	3.88	11.4		Buys	12		
2009 Consensus	4.18	10.5		%	63%		
2010 Mid-guidance	4.70	9.4		Shares (mil)	407		
2012 Mgmt Target***	5.40	8.2		Equity Value \$ Bil.	18		
Dividend	1.78	4.0%	Yield				

GAAP per share earnings: \$3.37 – 2007, \$3.23 – 2006, \$2.34 – 2005, \$2.48 – 2004, \$2.53 - 2003

\*\* Source: Bloomberg Financial Service

\*\*\* Management target of increasing earnings per share 10%-plus annually over 2006/12

#### Street Opinion & Shareholder Profile

FPL Group is regarded as a well-run integrated electric utility, with a sound non-utilities business strategy, led by eco friendly wind power, and, to a lesser extent, solar. According to Bloomberg Financial Service, FPL Group has 19 active recommendations in the sell side community - 12 buys, 6 holds, and 1-sell (Matrix USA). Recent buy/outperform ratings with share targets ranging from \$55 (15%) to \$78 a share (52%) include: Jesup & Lamont (\$55), Macquarie (\$67), UBS (\$56), Barclays (\$64), BMO Capital (\$78), and Robert Baird (\$75).

Its 10 largest holders as of June 30, 2008 held 111 million shares, 27% of shares outstanding: Wellington (20.6 million), Barclays (13.8 million), State Street Corp. (12.8 million), Vanguard (12.5 million), Pictet Asset Management (10.3 million), Neuberger Berman (10.0 million), Capital Research (8.3 million), Franklin Resources (8.0 million), Mass. Financial Services (8.0 million) and Fidelity Management (6.5 million).

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## Market Performance - Earnings

The prestigious shareholder profile and favorable sell-side opinions offered little protection in the current market debacle. The stock's trading 30% above its 12-month low and down 41% from the 12-month high of \$74 a share. But in a market where the S&P 500, and the S&P Utilities are down 38% and 36%, respectively, from their highs we're not sure what significance to place on the under performance, other than the economy, energy prices and financing concerns.

Florida's economy, particularly in Florida Power & Light's service territory, is one of the more publicized victims of the sub-prime housing bubble. Florida Energy's potential margins on non-regulated generation may be squeezed, and financing of its huge capital budget could prove difficult. On September 24, 2008, Lewis Hay III, FPL Group's Chief Executive Officer, at a Merrill Lynch conference, indicated that the Utility has lost over a 1,000 customers since last August, non-weather usage is declining among active accounts, and inactive meters continue to rise. But he also reaffirmed the goal of increasing adjusted earnings per share at least 10% annually over the 2007/12 period.

Earnings guidance for 2008 is \$3.83 to \$3.93 a share, 2009 - \$4.15 to \$4.25 a share, and 2010 - \$4.50 to \$4.90 a share. Reported ongoing adjusted earnings of \$3.48 a share (GAAP - \$3.37 a share) in 2007 was 14% higher than the \$3.04 a share (GAAP \$3.23 a share) in 2006. Florida Power & Light earned \$2.08 a share (60% of consolidated), FPL Energy - \$1.56 a share (45%) while Parent and Other (FiberNet - a telecommunications company) lost \$0.16 a share. Tax-generated earnings represented by Production Tax Credits and Investment Tax Credits contributed \$0.57 a share in 2007, up from \$0.42 a share in 2006, \$0.32 a share in 2005 and \$0.29 a share in 2004.

## Our Opinion

FPL Group's earnings goal of 10%-plus annually over the 2007/12 period relies on the continuation of a favorable regulatory climate in Florida and for non-utility businesses to generate earnings via Production Tax Credits and Investment Tax Credits. We believe the goal is achievable.

Florida Power & Light's success is tied to its 2005-2009 stipulation agreement with the Florida Public Service Commission allowing rate increases for approved generation additions (representing investments of \$7.1 billion-to-date). The stipulation may be extended, but slower sales growth and heavy capital demands exacerbate rate relief needs that could be tempered by lowering allowed returns on common (the return is not specifically identified in the current agreement) and reducing the common equity component of rate base.

Florida Energy's growth hinges on profit generation via wind and solar which, in turn, hinge on Florida Power & Light's ability to generate taxable income. Wind power profits almost entirely rely on Production Tax Credits (refer to Tables 3 and 4 on pages 6 and 7). The ability to value wind is difficult since there are few comparables. The company's sum-of-the-parts analysis uses 3-foreign companies. That methodology applied to a single unit would produce a price/earnings ratio in excess of 40 times (Table 2). We would not value tax-generated earnings higher than its source, the utility, and probably lower because of the risk of any political subsidiary - remember synfuel credits.

That being said, at its current price of \$44, FPL Group trades at 11.4 times and 10.5 times 2008 and 2009 consensus estimates of \$3.88 and \$4.19 a share, respectively, about parity to the 11.2 and 10.2 times for the S&P Utilities. In what we consider its peers - Exelon (EXC-Hold), PPL Corp. (PPL-Hold), Dominion Resources (D-Buy), Entergy (ETR-Not Rated), Public Service Enterprises (PEG-Not Rated), and Southern Co. (SO-Hold), the price earnings discount widens to about 10%. Parity would price FPL Group shares in the \$48 to \$50 area. We rate the shares Hold.

## Background

FPL Group's two principle businesses are Florida Power & Light, an integrated electric utility, and FPL Energy, a non-regulated electric generator. In 2007, Florida Power & Light contributed the bulk of earnings - \$2.08 a share (60% of consolidated \$3.48 a share) and earned the higher return (11.7%). FPL Energy's adjusted earnings were \$1.56 a share (45% of consolidated) and its return on common, 9.7%. The higher leveraged consolidated FPL Group earned a 12.7% return on common.

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**Florida Power & Light:** The Florida economy is one of the more publicized victims of the housing sub-prime bubble. Yet the utility, Florida Power & Light, with a 20% reserve margin, has a construction budget that may reach \$17 billion over the 2008/12 period. Capitalization of \$13.7 billion in 2007 could rise 75% over this period. Rate base is forecast at 10% annually while sales may be flat-to-up 1% to 2% annually.

Florida Power & Light's success is tied to its 2005-2009 stipulation agreement with the Florida Public Service Commission, allowing rate increases for approved generation additions (\$7.1billion-to-date). Although it didn't cite a specific return on common, all other regulatory purposes are based on an 11.75% return. In addition to a revenue-sharing arrangement, the agreement allowed the company to reduce depreciation rates, cease nuclear decommissioning payments, and seek rate relief if the regulatory return on common dropped below 10%. Our concern revolves around the Florida economy and the likelihood of increased resistance to higher rates. Extension of the stipulation beyond 2010 could be tied to lower returns and a reduced common equity component in rate base.

Our forecast averages the \$13 to \$17 billion construction estimates through 2012, assumes a 50/50 debt-to-equity capital structure (down from 47/53) and an 11% return on average common. Utility earnings work out to \$2.05 a share (\$833 million) – 2008, \$2.21 a share (\$917 million) – 2009, \$2.29 a share (\$996 million) – 2010, \$2.40 a share (\$1,073 million) – 2011, and \$2.52 a share (\$1,172 million) - 2012.

### FPL Energy

FPL Energy was formed in 1998 to aggregate and grow its non-utilities businesses, primarily generation. Its assets are defined in three categories: 1) wind, 2) non-wind contracted, and 3) merchant. Net plant in service was \$11.4 billion at 2007 year-end. Capitalization of \$10.9 billion consisted of debt of \$4.9 billion, 36% of total and common equity of \$6.9 billion (64%). Earnings of \$1.56 a share (\$626 million) in 2007 represented 45% of FPL Group consolidated \$3.48 a share. Energy's returns on common in 2007 and 2006 were 9.1% and 8.7%, respectively.

Wind generation is Energy's growth vehicle. At 2007 year-end, wind capacity totaled 5,077 megawatts covering 16 states. The company plans to add 8,000 to 10,000 megawatts over the 2007/12 period, including 1,100 in 2008 and 1,500 to 2,000 megawatts annually over the 2009/12 period. At year-end 2007, Energy's capitalization stood at \$10.7 billion and compares to a construction budget that could exceed \$19 billion through 2012: \$2,085 million in 2008, \$3,000 million in 2009, and \$4,000-\$5,000 million annually in years 2010/12.

Non-wind contracted assets represent 3,542 megawatts, including natural gas fired units totaling 1,825 megawatts, nuclear - 1,423 megawatts, and Other - 204 megawatts. Merchant business consists of 6,924 megawatts, including 1,098 megawatts nuclear (Seabrook). Approximately 40% of Generation is located in ERCOT (2,700 megawatts), 40% in NEPOOL (2,752 megawatts), and 20% Other (1,472 megawatts). Outlays for non-wind businesses are estimated at \$2,055 million over the five years ending 2012.

**Forecast:** Management forecasts Energy profit growth of over 20% a year through 2012. Earnings of \$626 million (\$1.56 a share) in 2007 are expected to fall in the \$1,416 million (\$3.05 a share) to \$1,646 million (\$3.54 a share) area in 2012.

Wind generation should account for 60% of Energy's growth (\$500-\$590 million), trading and marketing - 15% (\$115-\$165 million), solar-transmission-fossil - 14% (\$105 to \$155 million) and existing assets - 10% (\$70 to \$110 million). Earnings based on 465 million shares work out to a midpoint of \$3.30 a share. Table 1, Columns 5 and 6 are best guess estimates for the tax components of earnings. Our wind estimates assume Production Tax Credits account for 100% of wind earnings (Table 3) and that Investment Tax Credits would contribute half the profits of Solar Transmission and Fossil. Overall we expect tax credits to account for \$1.82 a share (\$867 million) to \$2.10 a share (\$1,000 million), or 60%-65% of Energy earnings. In 2007, tax-derived earnings were \$0.57 a share (\$230 million).

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Table 1  
FPL Energy  
Cumulative Profit Forecast  
2007-2012

Column	(1)	(2)	(3)	(4)	(5)	(6)
	\$-Mil	\$-Mil	Per	Share	Taxes	Est.*
Earnings	Low	High	Low	High	Low	High
Base 2007	626	626	1.35	1.35	0.57	0.57
Additions						
Existing Assets	70	110	0.15	0.24	0.07	0.11
Wind	500	590	1.08	1.27	1.08	1.27
Solar Transmission Fossil	105	155	0.23	0.33	0.10	0.15
Trading & Marketing	115	165	0.25	0.36		
Total	1,416	1,646	3.05	3.54	1.82	2.10

Source: Management Presentations \* Taxes – Shields' Estimates

We take a cautious approach toward any tax-generated earnings sources.

**Risk # 1** What Uncle Sam giveth can be taken away; remember synfuel credits.

**Risk #2** Price/earnings valuation. Management suggests that wind earnings be valued on earnings before interest, income taxes, depreciation and amortization (EBITDA) multiples. Florida Power & Light's taxable income is the primary source of wind earnings. Why should tax-derived earnings trade at higher multiples than the source of those profits?

**Risk #3** Wind has few publicly traded comparables. Management in its sum-of-the parts analysis uses 3 foreign companies Iberdrola Renovables, EDF Energies Nouvelles, and EDP Renovavies. Management also boosts the pretax equivalent of Production Tax Credits to EBITDA and calculates Enterprise Value of 11 to 12 times. Multiples for nuclear and fossil are 8.5 to 9.5 times. At a Lehman conference in September 2008 the company listed a slide showing market value of FPL Group overall at \$62-\$82 a share, with a \$72 a share midpoint.

**Risk #4** The source in this case, Florida Power & Light, may not generate sufficient taxable income to absorb the tax credits. In 2007, management sold differential partnerships, giving up the benefits of 5-year accelerated depreciation and 10 years of Production Tax Credits. Sales of differential partnerships make sense only if the company lacks the appetite for tax benefits or seeks to set precedent for future transactions. Is there a market for differential partnerships today?

**Risk #5** We admit to a bias against valuations based on EBITDA. EBITDA often has no relationship to earnings, disguises losses of individual components, and overstates values when compared to price/earnings ratios. Take for instance EBITDA multiples cited by Constellation Energy (CEG-\$26-no longer rated) in the non-regulated businesses. Implied market values exceeded \$100 a share while price/earnings values were dramatically lower (Refer to our CEG reports - 8/7/08 and 9/27/07). Moreover, it's not unusual to have rising EBITDA and deteriorating financials, Enron being the classic example, but Independent Producers had rising EBITDA as did CMS Energy (CMS-\$10-Hold) in the days of diversification.

**Risk #6** Price/earning ratios under EBITDA appear high. Table 2 applies management methodology for wind valuations to a hypothetical 100 megawatt unit, and calculates values for years 1, 6 and 11. Implied price/earnings ratios range from 44.6 times in year 1, 39.8 times in year 6, and 55.4 times in year 11.

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### Management's Sum-of-the-Parts Methodology

The life cycle for wind covers three stages: 1) years 1 to 5 – when it benefits from 5-year accelerated amortization and production tax credits; 2) years 6 to 10 – cash flows decline as accelerated depreciation reverses. Production tax credits maintain or grow earnings modestly; 3) years 10 to 25 - the absence of both accelerated amortization and production tax credits reduces earnings, cash flows and returns.

**Year 1-Column 1** revenue of \$15.7 million less production and O&M expenses produces traditional EBITDA of \$12.8 million. EBITDA is next grossed up to the pretax equivalent of \$6.0 million production tax credits to \$17 million based on a 35% tax rate. Adjusted EBITDA of \$30 million multiplied by 11.5 times (mid-point multiple) creates an Enterprise Value of \$344 million. Enterprise Value of \$344 million less average debt of \$92 million leaves an equity value of \$253 million. The price/earnings multiple based on earnings of \$5.7 million (\$6.0 million of which is PTC) is 44.6 times. Return on equity is 6.4%. Cash flow net of interest payments is \$23.9 million, producing a market to cash flow multiple of 10.6 times.

**Year 6-Column 2** adjusted EBITDA rises to \$32.5 million (we assumed Production Tax Credits rise 3% annually). Enterprise value increases to \$374 million, while equity value reaches \$308 million as debt declines to \$67 million. The price/earnings ratio on \$7.7 million in earnings is 39.8 times. Our worksheet in Table 2 returns cash in excess of annual debt payments of \$6.3 million to the parent, reducing common equity from \$89 million to \$36 million. Return on common rises to 21.4% up from 6.4% in year 1. Cash flow declines in year 6 as deferred taxes from 5-year accelerated depreciation reverse from a positive \$10.6 million to a negative \$2.7 million. Cash flow net of interest payments declines to \$12.7 million and the cash flow to market value increases to 24.3 times.

**Year 11-Column 3** Production Tax Credits expire and adjusted EBITDA declines to \$12.8 million, Enterprise Value to \$147 million and Equity Value to \$112 million. Return on average common drops to 4.7%. The price/earnings multiple rises to 55.4 times and the cash flow multiple declines to 16.1 times.

Table 2  
100 megawatt Wind Project  
Sum of Parts Market Valuation

Column	1	2	3
Year	1	6	11
Revenues	15.7	15.7	15.7
Production	2.8	2.8	2.8
EBITDA	12.8	12.8	12.8
PTC Pretax Equivalent	17.1	19.7	0
Adjusted EBITDA	30.0	32.5	12.8
Multiple mid	11.5	11.5	11.5
Enterprise Value	344	374	147
Less Average Debt	92	67	35
Equity Value	253	308	112
Earnings	5.7	7.7	2.0
Price/Earnings Multiple	44.6	39.8	55.4
Return on Average Equity	6.4%	21.4%	4.7%
Average Equity	89	36	43
Cash Net of Interest payment	23.9	12.7	7.0
Cash Flow Multiple	10.6	24.3	16.1

Source: Management Methodology in Sum-of-the-Parts Analysis

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### Wind Power Economics

Table 3 columns 1 and 2 list the economic parameters for a typical wind generator. Column 3 averages columns 1 and 2. The numbers are taken directly from management presentations.

**Table 3**  
**Typical Wind**  
**Economic Assumptions**

Column	(1)	(2)	(3)
<b>Company Input</b>	High	Low	Average
Capital Costs 2008 Kilowatts (Kw)	2,000	1,800	1,900
Typical Wind Size 50-150 Megawatts (Mw)	150	50	100
Investment \$-millions	300	90	190
Tax Depreciation 5-years	60	18	38
Capacity Factor (35-43%)	40%	25%	33%
Production -O&M &Cost per Mwh	10.0	10.0	10.0
Purchase Power Mwh -15 to 25 years	40	70	55
Production Tax Credit (PTC) \$21 Mwh.	21	21	21
Capital Structure beginning			
Debt	50%	50%	50%
Equity & other	50%	50%	50%
Shields Estimated Debt Cost	6.0%	6.0%	6.0%
Debt Repayment Years-Shields Est.	15	15	15
Book Depreciation 25-years	12.0	3.6	7.6

### Income Statement Cash Flow

Table 4 forecasts income statements, cash flows, capitalization and profitability for a hypothetical 100 megawatt wind unit for an 11 year period. Forecasts are derived from Column 3 in Table 3. For capitalization, we begin with a 50/50 debt to equity component and have assumed a 15-year life for debt repayment. Cash generated beyond debt repayment is up-streamed to the parent in the form of dividends thereby reducing the common equity component.

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Table 4  
Income Statement, Cash Flow, Profitability

Column	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Year	1	2	3	4	5	6	7	8	9	10	11	11
<b>Income Statement</b>	No Tax Benefits	AD PTC	AD PTC	AD PTC	AD PTC	AD PTC	PTC	PTC	PTC	PTC	PTC	
Revenues	\$-Mil 15.7	\$-Mil 15.7	\$-Mil 15.7	\$-Mil 15.7	\$-Mil 15.7	\$-Mil 15.7	\$-Mil 15.7	\$-Mil 15.7	\$-Mil 15.7	\$-Mil 15.7	\$-Mil 15.7	\$-Mil 15.7
Total Revenues	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7
Operating Exp.												
Production Costs	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Depreciation	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6
Operating Exp.	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4	10.4
<b>Oper. Inc.</b>	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Interest Exp.	5.7	5.7	5.1	4.9	4.8	4.4	4.0	3.6	3.2	2.9	2.5	2.1
Pretax Inc.	(0.5)	(0.5)	0.1	0.3	0.5	0.8	1.2	1.6	2.0	2.4	2.7	3.1
Taxes @ 35%												
Deferral Tx.		10.6	10.6	10.6	10.6	10.6	(2.7)	(2.7)	(2.7)	(2.7)	(2.7)	(2.7)
Taxes Payable		(10.4)	(10.6)	(10.5)	(10.5)	(10.3)	3.1	3.2	3.4	3.5	3.6	3.8
Net bef.PTC	(0.2)	(0.2)	0.0	0.1	0.2	0.3	0.4	0.6	0.7	0.8	1.0	1.1
<b>PTCs</b>	<b>0.0</b>	<b>(6.0)</b>	<b>(6.2)</b>	<b>(6.3)</b>	<b>(6.5)</b>	<b>(6.7)</b>	<b>(6.9)</b>	<b>(7.1)</b>	<b>(7.4)</b>	<b>(7.6)</b>	<b>(7.8)</b>	<b>0</b>
Total Taxes	(0.2)	(6.1)	(6.1)	(6.2)	(6.4)	(6.4)	(6.5)	(6.6)	(6.7)	(6.7)	(6.8)	1.1
<b>Net Income</b>	<b>(0.3)</b>	<b>5.7</b>	<b>6.2</b>	<b>6.5</b>	<b>6.8</b>	<b>7.3</b>	<b>7.7</b>	<b>8.2</b>	<b>8.6</b>	<b>9.1</b>	<b>9.6</b>	<b>2.0</b>
<b>Cash Gen</b>												
Net Income	(0.3)	5.7	6.2	6.5	6.8	7.3	7.7	8.2	8.6	9.1	9.6	2.0
Tax Def. (payable)	0.0	10.6	10.6	10.6	10.6	10.6	(2.7)	(2.7)	(2.7)	(2.7)	(2.7)	(2.7)
Depreciation	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6
Cash After Interest	7.3	23.9	24.5	24.8	25.1	25.5	12.7	13.1	13.6	14.0	14.5	7.0
Cash Paid to Parent		17.6	18.1	18.4	18.7	19.2	6.3	6.8	7.2	7.7	8.2	0.6
Debt Retirement		6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3
<b>Investment</b>												
Debt	95.0	88.7	82.3	82.3	76.0	69.7	63.3	57.0	50.7	44.3	38.0	31.7
Equity	95.0	83.1	71.2	59.3	47.4	35.5	36.9	38.3	39.6	41.0	42.4	43.8
Total	190.0	171.8	153.5	135.1	123.4	105.1	100.2	95.3	90.3	85.4	80.4	75.5
<b>Profitability</b>												
Return on Avg. Com.	-0.3%	6.8%	8.1%	10.0%	12.8%	17.6%	21.4%	21.8%	22.2%	22.6%	23.0%	4.7%
Return on Investment												
Inc After Inc Tx.	5.4	11.4	11.3	11.5	11.6	11.6	11.7	11.8	11.9	12.0	12.1	4.1
Return	2.8%	6.3%	7.0%	7.9%	9.0%	10.2%	11.4%	12.1%	12.8%	13.6%	14.5%	5.3%
<b>Credit</b>												
Cash Gen. Plus Interest	13.0	29.6	29.6	29.7	29.8	29.9	16.7	16.7	16.8	16.9	17.0	9.1
Interest @ 6%	5.7	5.7	5.1	4.9	4.8	4.4	4.0	3.6	3.2	2.9	2.5	2.1
Coverage	2.28	5.19	5.77	6.01	6.28	6.84	4.17	4.63	5.20	5.93	6.88	4.33
Net Income Per Share	(0.00)	0.01	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.01
PTC Per Share	(0.00)	0.01	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.00
Shares out mil	407											

## Analyst's Certification

I Raymond E. Moore certify that the views expressed in this research report accurately reflect my personal views about the subject companies and their securities. I also certify that I have not been and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendations in this report. Other FPL Group reports issued by me are: 1/9/06 (\$42) – Not Rated; 8/3/07 (\$56) – Not Rated; 8/9/07 (\$63) – Not Rated; 2/26/08 (\$64) – Hold.

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**Buy** Total return is expected to exceed significantly the average total return of the analyst's industry coverage universe over the next 12 months.

**Market Perform & Hold** Total return is expected to equal the average total return of the analyst's industry coverage universe over the next 12 months.

**Sell** Total return is expected to significantly under perform (15% plus) the total return of the industry coverage universe over the next 12 months.

### Analyst's Ratings Distribution

		% Investment Banking
Buy	12%	0%
Hold	88%	0%
Sell	0%	0%

The principal risks to the achievement of our price targets include general market trends, disappointing earnings and lower energy prices and adverse regulatory developments

Our target prices are based on projected earnings for the following calendar year, and an assumed price/earnings ratio in line with the company's historical valuation or those of other companies with similar businesses and prospects.



## Important Disclosures, continued

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