Quickie idea / what am I missing: First Energy $FE

This post is another in a series I plan do on an irregular basis. A “quickie” idea is an investment specific idea that I’ve been mulling over and find interesting, but haven’t dove fully into yet. The hope with this particular idea is to provide the jumping off point for a discussion of an idea I find extremely interesting right now, as I suspect the opportunity could be fleeting but it’s liquid enough that just about anyone could participate at any size. The idea? Buying First Energy (FE).

Let me start with a little background for the idea generally. I wasn't going to write anything on First Energy as I'm just starting to dive in. However, last month I did a quickie idea on PCG, and a bunch of the conversation on the heels of that post were really helpful (both in my DMs and in the comments; I generally discourage reading the comments on anything but if you're interested in PCG you should probably read the comments of that one!). So I figured I'd throw some quick thoughts on FE out there and see if anyone more knowledgeable wanted to add anything. Seriously, I'm just starting on this, so anything in here could be way off. Feel free to let me know if you agree / disagree.

Anyway, FE has a lot of similarities to PCG- same sector, similar discounted multiple, scary headlines. Given how good the discussion on PCG was, I figured I'd post something on FE too.

First Energy is a regulated utility company. They've got two main business: regulated distribution, which generates electricity and serves serves 6m customers in 6 states (ohio, Pennsylvania, West Virginia, Maryland, New Jersey, and New

York), and regulated transmission, which owns electricity transmission (think the wires that run along the road that connect the power plant to your house).

First Energy has emerged as the key player in the Ohio House Speaker / House Bill 6 scandal. The market has responded to FE"s involvement by shooting first and asking questions later: the stock has dropped from ~$41/share to ~$29/share as I write this.

My suspicion is that the market has rightly shot FE.... but it's shot FE way too hard (I tried the very tortured metaphor "the market shot FE with a nuclear weapon when it should have been shot with a handgun" on a call earlier; I think that metaphor is apt though I also think it proves my dreams of writing the next great american fiction novel will never be reality (pun semi-intentional)). The facts around the scandal don't look good for FE (to put it mildly and in a way that won't get me sued), but the market reaction seems way too harsh.

I think the easiest way to frame it is this: before the scandal broke, FE's stock was at ~$41/share, for a ~$22B market cap (and a ~16x multiple on 2020 P/E). Today, FE is at ~$29, for a ~$16B multiple and a <12x P/E. So the market is currently saying the scandal will burn >$6B of value for FE.

That seems much too high to me. I tend to break the cost of the scandal to FE into two buckets: how much they'll pay in fines, and how much they'll lose in ongoing earnings. Even when I put a conservative number out there for both of those buckets, I get to a number way lower than where the market is currently penalizing FE.

In terms of fines, it's pretty rare to see a nine figure fine. Maybe we see one here; I've seen a bunch of people point to the Exelon $200m fine. I haven't dug deep enough to see if this case is similar to or worse than Exelon's. For conservatism, let's go crazy for a second and say FE's case is 5x worse, so they pay a $1B fine.

Then there's the loss of on going earnings. It looks like FE's benefit from HB6 was somewhere between $150-300m/year. Let's take the high end and say FE was getting $300m/year from HB6. Tax that at 21% and HB6 gave FE ~$240m/year in earnings; slap a 16x multiple on it (FE's pre-HB6 multiple) and HB6 was worth ~$3.8B to FE.

Put that $3.8B in lost earnings from HB6 together with the $1B fine and HB6 should have resulted in FE losing ~$4.8B in market cap. Let's add in another $200m for ongoing compliance costs and legal fees to bring it to an even $5B.

The market has currently slashed $6B off FE's market cap. That's $1B more than the cost we just estimated. If we're right, FE should be trading in the low $30s, not the high $20s.

There are obviously a lot of assumptions there. First, we're assuming FE was fairly priced a week ago, pre-HB6. Also, I think we were pretty conservative on the fees / lost earnings, but maybe I haven't penalized them enough there.

But we're also assuming there's 100% chance FE pays the full fees / lost earnings laid out here. I think it's likely that the ultimate penalties are a lot smaller than I've discussed. Heck, there's even the chance the CEO is right and FE did nothing wrong / had no involvement here, and the stock is headed back to >$40 as more information comes out and the market realizes FE will be cleared.

I don't know. It's a complicated situation, and I'm literally just digging in. My initial take is the market has shot this much too hard. But I'm open to other takes. And it's possible I'm discounting the "if you see one cockroach, there's generally a bunch more" principal. Maybe the market has already incorporated that if FE was running bribes here they've been doing sketchy things throughout the rest of their portfolio.

So I'm going to keep doing work on this. But given how helpful the discussion on PCG was, I figured I'd throw the idea out there and see what other people are thinking. If you've done work here and want to swap thoughts, please feel free to comment below or slide into my DMs.