Talen Energy Corp
A Call To Action

Equities

Americas
Electric Utilities

12-month rating	**Neutral**
12m price target	**US$6.00**
Price	**US$7.81**

RIC: TLN.N **BBG:** TLN US

Trading data and key metrics	
52-wk range	US$23.48-5.76
Market cap.	US$1.00bn
Shares o/s	129m (COM)
Free float	100%
Avg. daily volume ('000)	266
Avg. daily value (m)	US$1.7
Common s/h equity (12/15E)	US$4.30bn
P/BV (12/15E)	0.2x
Net debt / EBITDA (12/15E)	4.3x

EPS (UBS, diluted) (US$)

	12/15E			
	From	To	% ch	Cons.
Q1	0.83	0.86	4	-
Q2	0.20	0.20	0	0.26
Q3	1.09	1.09	0	1.42
Q4E	(0.81)	(0.09)	NM	(0.17)
12/15E	1.29	2.04	58	2.69
12/16E	0.65	0.51	-22	0.66
12/17E	(0.15)	(0.95)	NM	0.20

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Debt reduction plan is credible and likely to be well received in our view

In the absence of significantly accretive M&A, we see debt reductions as the best use of TLN's capital. Mgmt has already committed to reducing borrowing by ~$900M in '16 ($54M done in Jan/Feb + $355M debt maturing). We est that there is another ~$545M of capital available for allocation. TLN confirmed interest in a potential tender which could target the '19/'21 maturities as they offer material discounts (15-30%) while also helping to address liquidity concerns with $1.67B of debt maturing in '18-'19. TLN is also exploring adding secured asset-level debt to create further capacity to reduce corp obligations. Since the 2/25 call the TLN bonds have rallied 5-10pts. In a scenario where mgmt retires $500M of '19 bonds at a 20% disc we est ~$0.75/sh of improved value.

Timing is the key question: will a deal come before addressing debt?

With proceeds pending from the asset sale in March (~Spring latest)- and given the meaningful cash on the balance sheet and more IG-like covenant package pro-forma (limited change of controls, except revolver and some of the muni-package), we see the valuation case becoming more attractive given cash on the balance sheet with limited restrictions. Mgmt has been clear in recent quarters of its interest to evaluate further deals despite loss in its bid for Engie assets. Mgmt is keen to explore asset acquisitions rather than just debt paydowns (with a preference to diversify – and not just pursue more PJM coal like AEP's portfolio, etc). Expect meaningful updates in the ~2Q period.

Flexibility to refi w/ secured capacity and asset sale bolster outlook too

The focus on lowering debt (and refinancing w/ secured debt at cheaper rates) should help improve FCF which we forecast to decline to below-$100Mn/yr in '17-'19. Further w/ largely unlimited secured debt capacity, we suspect market could support 2-3x EBITDA (although this would also include a new debt package). Taxable income could prove limited given losses likely recognized under a sale of Colstrip in MT (likely this year).

Valuation: Maintain $6 PT; As debt reduction nears, shares should trade up

We rolled our SOP to '18E. TLN looks to be the most aggressive IPP w.r.t reducing debt, a characteristic that investors are looking for. While capital available for allocation in '16 is robust due to the divestiture proceeds, the qn turns to how TLN will manage its FCF in '17+ to address obligations given lowest FCF yield vs. peers (even ex-taxes).

Highlights (US$m)	-	-	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	-	-	4,274	4,481	3,916	3,748	3,802	3,795
EBIT (UBS)	-	-	441	500	244	79	89	57
Net earnings (UBS)	-	-	139	262	66	(125)	(106)	(140)
EPS (UBS, diluted) (US$)	-	-	1.08	2.04	0.51	(0.95)	(0.80)	(1.05)
DPS (US$)	-	-	0.00	0.00	0.00	0.00	0.00	0.00
Net (debt) / cash	-	-	(3,931)	(4,705)	(4,932)	(5,054)	(5,260)	(5,492)

Profitability/valuation	-	-	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
EBIT margin %	-	-	10.3	11.2	6.2	2.1	2.4	1.5
ROIC (EBIT) %	-	-	-	5.2	2.3	0.7	0.8	0.5
EV/EBITDA (core) x	-	-	-	4.9	7.0	10.1	10.2	11.3
P/E (UBS, diluted) x	-	-	-	3.8	15.4	(8.2)	(9.8)	(7.4)
Equity FCF (UBS) yield %	-	-	-	31.6	128.7	10.2	7.2	5.5
Net dividend yield %	-	-	-	0.0	0.0	0.0	0.0	0.0

Source: Company accounts, Thomson Reuters, UBS estimates. UBS adjusted EPS is stated before goodwill-related charges and other adjustments for abnormal and economic items at the analysts' judgement. Valuations: based on an average share price that year, (E): based on a share price of US$7.81 on 04 Mar 2016 19:41 EST

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ENERGY AND
TELECOMMUNICATIONS INTERIM
COMMITTEE 2015-16
March 11, 2016 Exhibit 2

For additional context, please refer links to relevant recent reports below:

- 2/25/16 How Will Capital Be Allocated?
- 1/7/16 Will 2016 Offer a Turnaround?
- 11/16/15 Riding the Power Curve
- 10/26/15 Unpacking the Latest Portfolio Developments
- 10/9/15 Extracting Top Dollar on Divestments
- 9/18/15 Capacity Auction Misses The Mark
- 8/18/15 Tapping Into Gas Conversions
- 8/7/15 Traveling on Calmer Waters (Upgrade to Neutral)
- 7/21/15 Deploying The War Chest
- 7/20/15 Opening The War Chest?
- 6/4/15 Initiation: Choppy Waters on the Susquehanna
- 5/22/15 The 10 Key Talen Debates

Capital available for allocation: Strong today but the future is the question

Preference is for growth but repurchasing debt is very compelling: The number one topic for Talen continues to be capital allocation and how management decides to utilize the proceeds from its asset divestitures ($1,220Mn) disclosed in 2015 as well as organic free cash flow generated in 2016E ($350Mn midpoint pre-$108Mn growth capex). On the 4Q15 call Talen disclosed that it has already repaid $500Mn of revolver borrowings in February and at a minimum intends to retire $396Mn of maturing debt obligations in 2016. We present our preliminary cash flow analysis on the next page. While Talen's first preference is seemingly to execute on growth opportunities, it sees the return profile of repurchasing its own debt as very compelling as it can effectively 'lock-in' an IRR on the transaction (*rather* than buying assets at an unknown realized IRR through the merchant cycle). With 2019+ debt trading at material discounts (20%+ as of the earnings call and still 16% today) it sees an attractive return profile but management is mindful of the need to balance the return profile with investors' desire for near-term liquidity. Although Talen was not involved in the Engie transaction, management comments that it still sees a robust opportunity set of potential power assets in the market. For example, Talen estimates that ~20GW of capacity trades hands on average annually in the power markets.

If it is able to achieve the same/similar returns from executing on M&A/organic expansions vs paying down debt, we believe Talen will pursue the growth avenue given the qualitative attributes (asset/fuel diversification, etc.)

Secured debt could help facilitate liabilities management program: Talen has been exploring whether it should add more secured asset-level debt to some of its facilities in order to create capacity to reduce corporate level obligations. Management is carefully weighing its options as it sees value in its current flexible capital structure which does not have significant covenants currently.

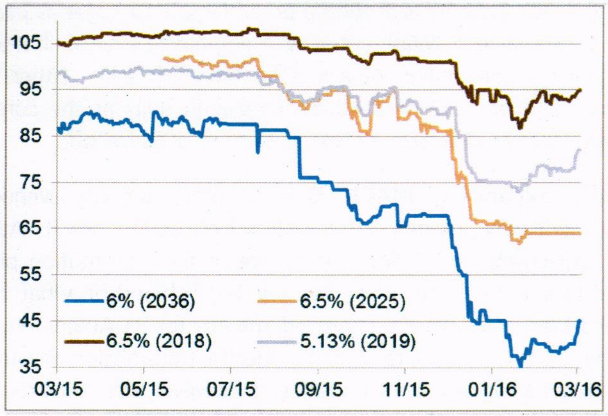
Below we detail estimated capital available for allocation showing that management still has adequate cash at its disposal to make a dent in upcoming maturities but the question will be if investors reward this. Talen indicated that an update on capital allocation is unlikely until it has actually received the divestiture proceeds cash (~end of March) and made a decision on the Montour gas project (1H16).

Figure 1: Talen Cash Flow Analysis

Cash Flow Analysis ($Mn)	2016E
YE15 Unrestricted Cash Balance	141
Release of Restricted Cash	55
Divestiture Proceeds	1,220
2016E FCF	249
Less: TSA Costs	(25)
Less: Feb Revolver Repayment	(500)
Less: Jan Ironwood Redemption	(41)
Capital Available for Allocation	**1,099**
Less: 2016 Debt Maturities	(355)
Less: Minimum Cash Target	(200)
Remaining Available for Allocation	**544**
Commited 2016 Debt Reduction	**(896)**
Total Potential Debt Reduction in 2016	**(1,440)**

Source: Company Filings and UBS Estimates

Figure 2: Talen Bond Trading Values



Source: FactSet

2016 FCF profile improves but 5Yr capex forecast is lifted $53Mn

The 2016E adjusted FCF guidance increased to $250-$450Mn from $260Mn despite a $100Mn reduction in adjusted EBITDA and while lower cash taxes is the primary driver, it appears that mgmt has deferred "sustenance" capex into 2017. 2016E maintenance capex *declined* $56Mn since EEI disclosures but 2017E *increased* $49Mn; collective 2016-2019E capex increased $53Mn. "Reduced outage scope" was mentioned as a driver of $70Mn lower O&M for 2016 versus its prior guidance midpoint; the question is how much of this could return in 2017 along with higher maintenance capex?

Best Harquahala risk/reward likely involves finding a local solution:

Management believes the best risk/reward is in finding a local solution such as selling the plant to a local utility or entering into a PPA rather than attempting to move the unit. While the cost estimate to relocate the asset has been refined to ~$315-$500/kW, if management is able to able to realize $500-$700/kW in value depending on the market for the new plant it would have essentially the same value creation as if it simply sold the asset for ~$200-$250/kW without the risk of transportation.

We're biased to believe the asset is able to get a contract – rather than moving

- As a reminder, Arizona Public Service has an RFP set for March but the timeline could be protracted – details on the RFP are available in our Conference note here (Page 45).
- The plant was built in a modular way, has three independent units, and TLN has been working with firms that specialize in the type of work so management is not concerned by the prospects of moving the asset; however, we would be surprised if management opts to relocate the asset. In the interim Talen is attempting to improve the cost structure of the plant and reduce the EBITDA drag which is estimated to be $5-10Mn.
- Mgmt has indicated it would address the future of this plant in 2016e. It would appear the cost of transporting the plant could approach ~$350/kW.

Eliminating taxes with Colstrip sale: another 2016 positive

We see elimination of any forecasted taxable liabilities as a result of a sale or closure of this plant for TLN. While a discussion of a sale or divestment of Colstrip has been contemplated for some time (dating back to the legacy PPL ownership), we expect this issue to be resolved in the medium-term. We see mgmt as closely focusing on developments around a potential sale to Puget as part of an ongoing review in the state of Washington. We emphasize even a shutdown of the unit would force a recognition of a loss on the asset sale. Either way, we expect pressure to grow to reconcile these remaining units as the company steps into years with projected taxable income as existing NOLs roll off.

Carefully expanding MACH Gen: Another growth avenue discussed by management was potential attractively priced uprates for its Athens/Millennium plants, collectively ~80-85MWs. In-service of the Constitution pipeline has been delayed to late-2016/early-2017 (we say 1H17) based on what management has observed but it still expects improved spreads for its Athens plant in New York. Talen has also observed a reduction in electric transmission constraints around the Athens plant as flows have been reduced; however, this could relate to the below-average weather recently.

Looking at the markets: In its Pennsylvania footprint management believes drilling is slowing and that natural gas pricing should stabilize but does not anticipate a quick commodity recovery. Following a strong operational year at Susquehanna, management is confident that it can further improve the cost structure of the 2.3GW nuclear asset as part of the broader industry-wide push to reduce nuclear costs.

TLN sees its nuclear cost structure as competitive and anticipates improvements.

Across its fleet none of Talen's eastern assets are generating losses although the economics of the ERCOT fleet are more challenged. Management believes that there could be further asset rationalization in the TX market in 2017-2018 as generators get closer to facing environmental liabilities. Additionally potential reforms to the ORDC could help price formation going forward if approved by the Public Utilities Commission of Texas (PUCT). Finding a way to monetize the money-losing Colstrip assets remains a priority but any transaction with a utility seemingly would still require local legislation to be passed.

In 2015 Talen made substantially all of the year's EBITDA in ERCOT in a ~10-day period this summer when there was above-average weather; FY15 adjusted EBITDA from the West was $56Mn but this also includes Colstrip.

Still confident in competitive markets for the long term: Talen continues to believe that the Supreme Court and FERC will make the "right decision" when reviewing the facts of the relevant cases impacting the power markets such as the Maryland/New Jersey case and the Ohio PPA requests. Talen does not perceive a risk that there will be a broader push for re-regulation in its markets.

As we depict in Figure 3 we see free cash flow declining sharply in 2017-2019 but recover to ~$140Mn in 2020-2023E based upon management's expected decline in 'sustenance'/maintenance capex and preliminary adjusted EBITDA estimates. The effective cash tax rate was revised lower once again to near zero for at least the next five years. Our FCF estimates below <u>include</u> growth capex and our comparable basis 2016E FCF estimate is $357Mn, near the midpoint of management's guidance.