MONEY MORNING

Buy, Sell or Hold:

Why NRG Energy Inc. (NYSE: NRG) is the Energy Sector's "Triple-Threat" Profit Play

By Horacio Márquez, Contributing Editor, *Money Morning*

If **NRG Energy Inc. (NYSE: NRG)** were an athletic prospect, scouts would rate it as a "triple threat." That's because the Princeton-based wholesale power generator is involved in all three of the key energy sources of the future: Solar, wind and nuclear.

And that's only part of the reason I like this stock.

Growing profit margins and earnings momentum add to the energy company's appeal – and a rebound in U.S. economic activity hasn't even begun in full.

When NRG announced its second-quarter results a few weeks ago, the company said that its profits tripled from a year ago – eclipsing Wall Street estimates and setting a new record. It also boosted its earnings guidance for all of 2009, and increased its stock buyback target from its previous $330 million worth of its shares to $500 million.

Income from continuing operations was $432 million – a marked improvement over last year's $41 million loss. And its recent acquisition of the Texas retail-energy business of **Reliant Energy Inc.** [now **RRI Energy Inc. (NYSE: RRI)**] is starting to pay off.

In two months the tie-up has already delivered $200 million of the planned $400 million in adjusted earnings before income taxes, depreciation and amortization (essentially a cash-flow metric that professional investors refer to as "EBITDA") gains for the year. With disciplined management this acquisition should outperform its estimated gains.

NRG has interest in 44 power plants with 24,005 megawatts (MW) net ownership, most of which is in the United States. Plants in Texas and the Northeast account for almost 18,000 MW, but NRG also has operations in Australia and Germany.

The company distinguishes itself by having operating margins that are roughly double that of its peers – the product of its efficient fleet composition and prudent active energy price hedging policies. The hedges NRG currently has in place are likely to outperform analysts' estimates, as well. That's because no analyst wants to be caught over-estimating upside, especially in volatile markets like energy futures. So, Wall Street consistently undervalues the expected value of these hedges, which the firm carries on a mark-to-market basis. That was the case in the second quarter.

With respect to the economy, industrial sector inventories are very low, meaning they will need to be replenished in the third quarter. The government's Car Allowance Rebate System (CARS), popularly known as "Cash for Clunkers," gave a nice boost to industrial production, and some signs of stability and even some gains – let's cross our fingers – can be seen in some areas of the housing market.

We're by no means out of the woods, yet, but U.S. gross domestic product did better than expected in the last quarter – shrinking by just 1% – and is likely to beat analysts' expectations in the third quarter as well. That's good news for NRG because the third quarter is traditionally the most profitable quarter of the year for utilities. Prices should firm up, benefiting this company's already stellar return on investment.

And in addition to being well positioned to profit in the short-term, NRG is an outstanding long-term play because it's ready to capitalize on the next stage of "green" energy development: low carbon emissions. After all, green is the color of money.

The company's natural-gas, new and existing commercial nuclear, and new and very large wind-and-solar-power projects are sure to benefit longer term from the move towards environmentally-friendly forms of energy generation.

With total liquidity of $4 billion, NRG is in an impeccable position to develop its planned projects and take advantage of small opportunistic acquisitions, should they appear. The company has a very prudently managed balance sheet and a shrewd growth management discipline, which is an invaluable attribute in adverse economic conditions where cash is king.

And let's say that all of these advantages that we have outlined here have not gone unnoticed by the competition: Two companies in the last three years have attempted to acquire NRG. Most recently, **Exelon Corp. (NYSE: EXC)** attempted to buy NRG outright. And even when the takeover attempt was rebuffed, NRG stock did not suffer. Exelon has since backed off from its acquisition attempt. That stock-price stability reflects strong investor confidence in management's execution.

At Friday, August 28th's closing price of $27.50, NRG's stock was still down about 30% from its 52-week high of $39.09 – just one of several reasons it still has room to rise, even after a scorching 91% run from its 52-week low of $14.39.

The stock is trading at a low 10 times forward earnings, has been consistently above its 200-day moving average since mid-July and is oversold by many proprietary measures. This stock could be ripe for a strong upward move as we approach the end of the year. What's more important is that the intrinsic long-term value of the company is undervalued at these prices.

Recommendation: Buy NRG Energy Inc. (NYSE: NRG) at market (**).

(**) – Special Note of Disclosure: Horacio Márquez holds no interest in **NRG Energy Inc.**

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