

09:01am EDT 19-Jun-00 Merrill Lynch (S.Brothwell/S.Fleishman) AVA
AVISTA:From Sizzle to Fizzle

ML++ML++ML Merrill Lynch Global Securities Research ML++ML++ML
AVISTA CORP. (AVA/NYSE)
From Sizzle to Fizzle
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ACCUMULATE

Long Term
BUY

Reason for Report: Lowering Estimates, Near Term Rating

Price:	\$23 5/16		
Estimates (Dec)	1999A	2000E	2001E
EPS:	\$0.48	\$0.90	\$1.25
P/E:	48.6x	25.9x	18.7x
EPS Change (YoY):		87.5%	38.9%
Consensus EPS:		\$1.05	\$1.22
(First Call: 08-Jun-2000)			
Cash Flow/Share:	\$3.21	\$1.90	\$2.40
Price/Cash Flow:	7.3x	12.3x	9.7x
Dividend Rate:	\$1.05	\$0.48	\$0.48
Dividend Yield:	4.5%	2.1%	2.1%

Opinion & Financial Data

Investment Opinion: D-1-1-7 to D-2-1-7
Mkt. Value / Shares Outstanding (mn): \$1,165.6 / 50
Book Value/Share (Sep-1999): \$13.14
Price/Book Ratio: 1.8x
LT Liability % of Capital: 54.9%

Stock Data

52-Week Range: \$68-\$14 5/8
Symbol / Exchange: AVA / NYSE
Options: None
Institutional Ownership-Spectrum: 26.3%
Brokers Covering (First Call): 8

ML Industry Weightings & Ratings**

Strategy; Weighting Rel. to Mkt.:
Income: Overweight (07-Mar-1995)
Growth: Underweight (07-Mar-1995)
Income & Growth: Overweight (07-Mar-1995)
Capital Appreciation: Overweight (25-Mar-1997)

Market Analysis; Technical Rating: Above Average (24-Apr-2000)

**The views expressed are those of the macro department and do not necessarily coincide with those of the Fundamental analyst.
For full investment opinion definitions, see footnotes.

Investment Highlights:

o Soaring power prices in the Northwest are likely to send AVA's Q2 numbers--around which the co. had set high expectations--crashing back to earth. We expect the company to preview things this week.

o Worse, AVA remains unhedged for much of its needs for the rest of the

year. Taking our \$1.15 EPS estimate to \$0.90--it could drop more.

- o We still like the growth stories--Avista Labs (fuel cells) & Avista Advantage (B2B energy), but missing another quarter--regardless of the cause--will hurt the stock.

- o Many utilities are finding themselves in this situation, as we previewed in our "Sizzle/ Fizzle" piece a couple of weeks ago.

- o Because of Avista Labs' considerable promise, we had placed AVA in our "Sizzle" basket of companies that could benefit from high prices and/or power shortages this summer.

- o An unprecedented and sharp uptick in NW power prices--what used to average \$20/MWh is now fetching \$hundreds--has turned power-short Avista Utilities into a "Fizzle."

- o We're keeping our long term Buy--there is big upside potential in this stock, but believe the utility issues--power prices and a tough rate case--will be a near term overhang.

Too Bad

We've been big supporters of AVA and its growth strategy from day one, but have consistently been bothered by the way that the energy commodity trips this company up. AVA just finished shutting its East Coast and Houston books down, and was looking forward to a promising quarter with unregulated Avista Energy back to its well-known Pacific stomping grounds, making money in a robust power market. Except for one thing...

Gotcha

Avista Utilities, formerly known as Washington Water Power, has operated for decades in one of the most flush (apologies) power markets in the country--the Pacific Northwest, awash in abundant and cheap hydropower. That is, until last month. While Avista Energy was making money trading around a robust California and Southwestern market, Avista Utilities was paying up for power due to weak hydro conditions and other factors that nobody in this crazy power market can completely understand.

A few things, however, are clear:

- o Avista historically has maintained a short position, given its geographic location and abundance of resources in the region;

- o That short position grew this year following the sale of the Centralia plant by PacifiCorp, in which AVA had a stake;

- o AVA doesn't have a fuel or power purchase pass through mechanism in Washington--it's trying to get one, but doesn't have one now.

- o A naked short is not a good thing to have in today's power markets.

Bottom line, while Avista Energy has been profiting in the West, Avista Utilities has been paying \$hundreds for what used to cost \$tens, and has no immediate way of recouping those costs. And there go the utility earnings.

Speaking of Rates...

We had previously noted that AVA's request for a \$30 or so million rate hike in Washington didn't play to rave reviews--the Staff and AG suggested a rate cut. We think that's preposterous, given the fact that the company has just about the lowest rates in the country, hasn't raised them in 14 years--and, interest rates are on the rise. With utility analysis in our blood, we also know that this type of gambit isn't uncommon in a rate proceeding--this isn't a ruling, just a Staff rec. But, it's still not a rosy start.

Upside Still Tremendous

Avista still holds two of the most promising new economy plays in Energy Technology--Avista Labs, its PEM fuel cell developer, and Avista Advantage, a highly advanced commercial energy B2B portal that continues to make huge inroads into the deregulating energy market. We think both of these platforms offer substantial upside potential for AVA holders and would actually use weakness in the stock as a long term value buying opportunity. That said, we do believe that the current troubles in the utility--ironically, it's the commodity getting this company in trouble AGAIN--will put near term pressure on the stock. Especially in light of the better expectations that management had put forth earlier.

We are therefore moving our intermediate term rating to Accumulate from Buy. Our 2000E EPS moves to \$0.90 from \$1.15, and we note that if the fizzle short proves long term--as in if power prices stay high--that number could go lower still.

(AVA) MLPF&S was a manager of the most recent public offering of securities of this company within the last three years.

Opinion Key (X-a-b-c): Investment Risk Rating(X): A - Low, B - Average, C - Above Average, D - High. Appreciation Potential Rating (a: Int. Term - 0-12 mo.; b: Long Term - >1 yr.): 1 - Buy, 2 - Accumulate, 3 - Neutral, 4 - Reduce, 5 - Sell, 6 - No Rating. Income Rating(c): 7 - Same/Higher, 8 - Same/Lower, 9 - No Cash Dividend.

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W/D

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