29th January 2016

Sector View

Integrated Utilities

Provisions are key, but liquidity even more so

	1 M	3 M	6 M	31/12/15
Utilities	-2.2%	-4.5%	-6.4%	-2.3%
DJ Stoxx 600	-7.1%	-8.5%	-11.8%	-7.0%

*Stoxx Sector Indices

Companies covered

E.ON		**BUY**	**EUR10,2**
Last Price	EUR9,637	*Market Cap.*	EUR19,284m
EDF		**NEUTRAL**	**EUR18,5**
Last Price	EUR11,745	*Market Cap.*	*EUR22,552m*
ENGIE		**BUY**	**EUR19**
Last Price	EUR14,6	*Market Cap.*	*EUR35,555m*
RWE		**NEUTRAL**	**EUR9,8**
Last Price	EUR12,88	*Market Cap.*	*EUR7,803m*

Yesterday morning we hosted a breakfast with the S&P Utilities team (Paris), who gave us an update on their credit view for the European sector as whole, while detailing their analysis of nuclear liabilities for utilities groups. General comments were reassuring on the potential conclusion expected from the German government on nuclear liabilities funding, to the profit of RWE and E.ON principally, although the risk of a cut in the haircut rate applied by S&P to their nuclear liabilities in its adjusted net debt calculation remained present, assuming a cash funding in the short term. For these two stocks, we assume that investors are already aware of the majority of unwelcome news, which is well priced in, thereby explaining our positive stance.

ANALYSIS

- **Interesting indicators to retain from the slideshow: 1)** Out of a rated universe in Europe of **120** utilities, S&P has a "Stable" outlook on **68%**, a "Negative" outlook on **20%** and a "Positive" outlook on only **12%** since fundamentals remain negatively oriented, mainly for unregulated power and gas companies. Downgrade risks are lower for regulated firms. **2)** Since 2009, ratings have been increasingly moving into the **BBB category** with **BBB+** being the most representative category (*21% of the rated universe*) at end 2015 vs. **A-** at end 2009 (*20% of the rated universe*). Out of the **34** latest "Rating Actions", **16** were for "Sovereign" reasons and **10** for "Financial" reasons. **3/** Like us, S&P only expects an earnings rebound for major utilities in **2017 and not in 2016**, which combined with lower capex (*lower growth capex*), should prompt an increase in the FFO/debt ratio by 2017 and hence net debt reduction. **4/** As a whole (*out of the rated universe*), nuclear liabilities represent a **EUR100bn package**, which compares to a total of **EUR174bn** in gross financial debt reported by the groups. As a reminder, the main nuclear operators in Europe include **EDF, Engie, E.ON, EnBW, RWE, Vattenfall, Fortum** and **CEZ** with EDF, E.ON & RWE being the most exposed (*respectively EUR45.4bn, EUR19bn and EUR10bn*). In France and Germany, nuclear operators remain in charge of their nuclear liabilities (*the government could require a segregated fund in operators' books to secure financing*) while in Sweden, the UK, Finland and partially the Czech Republic, the government levies charges on nuclear liabilities and is responsible for them, with companies making payments to external funds.
- **What to retain from this intervention?** Overall comments were reassuring on the potential conclusion expected from the German government on nuclear liabilities funding, to the profit of RWE and E.ON principally. Most downside credit risk for both stocks nevertheless still concerns the potential cut in the **30%** haircut applied to nuclear liabilities on restated S&P debt (*discount applied to reflect the more conservative view adopted by German firms compared with other European peers*), assuming that the German government's report (*due to be published in coming weeks*) asks both utilities to fund an external fund directly in cash that will be directly managed by the government. Apart from this potential risk, we see very limited downside risk for the credit rating and share price. As for the other main utilities we cover, the rating view on EDF remains negative, with EDF's liabilities provisions risk concerning more the longer term than the shorter term (*short term risk is more linked to HP C project*), while stable on Engie as the group has sufficient financial flexibility to adjust its growth capex to protect its rating.
- **Conclusion**: **We remain positive on E.ON & RWE** (*Buy for E.ON and Neutral for RWE*) despite the negative short to mid-term risk of having to fund a portion of nuclear liabilities either by creating a segregated fund in operators' books or by payments into an external fund. The German government needs these operators to remain financially healthy at least over the dismantling period *(>30 years for dismantling and 100 years for storage*) and most importantly, needs these operators to assume the energy transition until the grid is well balanced between the new utilities world (*renewables*) and the old utilities world (*fossil fuels & nuclear*). We therefore assume that for all these reasons, the German government will reach a compromise that will not kill off the operators, while reassuring taxpayers that they will not have to pay for both renewables expansion and nuclear dismantling. Fundamentals on both stocks are likely to remain weak this year (*2016e EPS expected to drop 21% at E.ON and 12% at RWE*), although we believe 2017 should be the year of earnings recovery. With 2017e P/E at 12.4x and 11.9x for E.ON & RWE respectively on still under-stressed EPS, both stocks are not so expensive compared with other integrated utilities (13x).

VALUATION

- At the current share price the integrated utilities sector is trading at 7x its 2017 EBITDA and at 13.1x its 2017 earnings.
- We are positive on **E.ON** (FV @ EUR10.2) & **Engie** (FV @ EUR19) but remain Neutral on **EDF** (FV @ EUR18) and **RWE** (FV @ EUR9.8)

NEXT CATALYSTS

- 16th February – EDF // 2015 earnings
- 25th February – Engie // 2015 earnings
- 8th March – RWE // 2015 earnings
- 9th March – E.ON // 2015 earnings

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BUY Positive opinion for a stock where we expect a favourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential upside based on valuation), but also takes into account a number of elements that could include a SWOT analysis, momentum, technical aspects or the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

NEUTRAL Opinion recommending not to trade in a stock short-term, neither as a BUYER or a SELLER, due to a specific set of factors. This view is intended to be temporary. It may reflect different situations, but in particular those where a fair value shows no significant potential or where an upcoming binary event constitutes a high-risk that is difficult to quantify. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

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Distribution of stock ratings

BUY ratings 72% NEUTRAL ratings 0% SELL ratings 28%

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