Sector View

Utilities

Top Picks Q1 2016: We play Suez for M&A

	1 M	3 M	6 M	31/12/14
Utilities	-3.1%	-1.8%	-2.8%	-6.3%
DJ Stoxx 600	-7.0%	-4.0%	-7.0%	1.2%

*Stoxx Sector Indices

Companies covered

ALBIOMA		**BUY**	**EUR20**
Last Price	EUR14,26	*Market Cap.*	EUR425m
E.ON		**BUY**	**EUR10,2**
Last Price	EUR8,204	*Market Cap.*	*EUR16,416m*
EDF		**NEUTRAL**	**EUR18**
Last Price	EUR12,56	*Market Cap.*	*EUR24,117m*
ENGIE		**BUY**	**EUR19**
Last Price	EUR15,44	*Market Cap.*	*EUR37,601m*
PENNON GROUP		**NEUTRAL**	**800p**
Last Price	852p	*Market Cap.*	*GBP3,513m*
RWE		**NEUTRAL**	**EUR9,8**
Last Price	EUR10,86	*Market Cap.*	*EUR6,580m*
SUEZ		**BUY**	**EUR19**
Last Price	EUR16,875	*Market Cap.*	*EUR9,157m*
VEOLIA		**NEUTRAL**	**EUR22,5**
Last Price	EUR21,22	*Market Cap.*	*EUR11,955m*
VOLTALIA		**BUY**	**EUR13**
Last Price	EUR9,92	*Market Cap.*	*EUR260m*

LOOKING BACK ON Q4 2015

The **Utilities sector** performed slightly better than the **Stoxx 600** (**-1.3%** for SX6P vs. **-1.9%** for the Stoxx 600) during Q4-15 after having underperformed in Q3-15 (+**4.4%** for SX6P vs. **+5.2%** for the Stoxx 600). Since our initiation of coverage in July 2014, we recommended to stay out of the sector as a whole and to play it safe through stocks offering strong earnings growth equity stories based on restructuring efforts. We previously played the sector through Veolia & Engie during Q3-15, on positive momentum and catalysts trends. As for Q4-15, we decided to play the sector through **Albioma**, as we assumed investors would come back to the investment case following details unveiled during the Analysts' Event on the growth potential from the French overseas departments' energy transition. Inside the SX6P, in Q4-15, **E.ON** was the top performer (**+16.3%**) followed by its German peer **RWE** (+**15.4%**) and **Engie** (+**13%**), while the worst performers were **CEZ** (**-12.2%**), **EDF** (**-10.6%**) and **Centrica** (**-4.8%**). In our coverage (*Albioma, E.ON, EDF; Engie, Pennon; RWE; Suez, Veolia & Voltalia*), **integrated utilities clearly out-performed environmental services stocks,** while **EDF** (**-14%**), **Albioma** (+**0.4%**) and Voltalia (+**6.6%**) were the worst performers. During the period, European power prices (*forward FY1 power prices for France, Germany, Belgium, the UK and the Netherlands*) dropped by **12%** (**-7%** QoQ in Q3-15) while gas (*TTF*) prices continued to decline as in first nine months, by **-20%**, as well as coal prices with a drop of **-8%** in Q2-15. During Q4-15 investors came back on stocks offering attractive valuations, and positive newsflows.

WHAT WE SEE FOR Q1 2016

Fundamentals are expected to remain weak in Q1-16 given we do not expect power & gas prices to pick-up in the short term, and given power & gas demand in Europe is set to remain poor (*at average climate)*. The margin for gas thermal assets should remain under pressure in Europe, as well as profits coming from E&P activities, yet we anticipate a slight improvement in the CSS (*Clean Spark Spread*) margin following the strong gas price declined observed at the end of 2015. **Only Utilities exposed to renewables assets, regulated markets or environmental services exposed to industrials** (*in both the water and waste markets*) are still expected to **stand out from the crowd** yet following strong performances of these stocks in 2015, the valuation is no longer so undemanding. In our models, we do not expect power prices to pick up in Europe for 2015-18 (*except on ARENH in France*) and expect a gradual European industrial recovery to positively affect margins for environmental services' operators (*Veolia & Suez*). **In our view, the Utilities sector can only be played by investors for its attractive valuation and its attractive yield in the short term, not for its earnings growth potential, at least not today (not until H2-16 in our view).**

CONCLUSIONS AND TOP PICKS

In our last sector reports published in December 2015 (*report on Integrated Utilities: Gone too far? (Upgrade on E.ON & RWE)* and on Suez/Veolia: *It is time to take a rest on Veolia (Downgrade on Veolia to Neutral))*, we had **already updated most of our models with the latest macro data and latest rollover to 2016** implying no changes in either estimates or FVs in our universe today. Please note that BG valuation criteria remain **unchanged** (*risk-free rate 2.0%, equity risk premium 6.4%).* Given we believe investors will only start to focus on 2017 earnings growth potential during H2-16, **we prefer keeping our cautious view on the sector for Q1-16** (*and then for H1-16*) and therefore do not integrate "value" stocks like Engie, RWE & E.ON even if we believe the market went too far on pricing in the commodity prices deterioration on these stocks.

Nevertheless, we choose to put **Suez** (*Buy, FV @ EUR19*) on our BG Top Pick list for first quarter as we see **two potential positive catalysts** that could alter both stock and earnings estimates upwards. The first one is a structuring acquisition (*like Urbaser ACS's waste management unit for instance)* that will allow the group to grow at a faster pace than the market and to raise its exposure to Southern Europe as the group always had ambitions to do so. Given its 2017 guidance to reach **EUR3bn EBITDA** is based partly on M&A, we believe it is fair to assume Suez M&A teams are working quite hard to find the perfect match. **We can therefore expect positive news from this subject during the quarter**.

The second driver that could alter the stock positively is the potential deal with Engie, which, according to some rumours, **seems credible**. As a reminder, back in November 2015, "*La Lettre de l'Expansion*" reported Engie was studying possible moves to retake control of Suez after it lost it under a shareholder pact that expired in 2013. The group which recently entered into an important reorganisation phase is, in our view, **looking at all opportunities to reduce its direct earnings exposure to merchant activities** (*commodities exposure*) and **is reviewing all options**. We believe raising its stake in Suez (*currently 34%)* to get access to regulated assets (*Agbar & United Water*) and to a more stable subsector in the utilities world (*water & waste management*) is the last-ditch option for the group given it would imply all other options to generate earnings growth (*merchant assets disposals to finance large infrastructure acquisitions; launch of a new cost reduction programme, rise in growth capex dedicated to renewables*) **were fruitless**. This deal which could either be made through **a takeover bid** or through the **disposal of its Energy Services business** (*Cofely*) to Suez is clearly more positive for Suez than for Engie (*premium paid by Engie on the latest Suez share price to raise its 34% stake above 50%; higher impact on Suez's EBIT than on Engie's EBIT from synergies between both groups on IT, purchasing…*) explaining our move to select Suez as our Top Pick for Q1-16.

At the current share price, we see 13% upside and the stock is trading at 7.3x its 2016e EBITDA and offers a 4% yield. Buy, FV @ EUR19.

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