Utilities

EDF

Price EUR11.81

There is a captain on board!

Fair Value EUR14,5 (+23%) **BUY vs. NEUTRAL**

Bloomberg	EDF FP
Reuters	EDF.PA
12-month High / Low (EUR)	23.8 / 11.0
Market Cap (EUR)	22,677
Ev (BG Estimates) (EUR)	84,399
Avg. 6m daily volume (000)	2 407
3y EPS CAGR	-23.0%

	1 M	3 M	6 M	31/12/15
Absolute perf.	-13.0%	-27.6%	-43.5%	-13.0%
Utilities	-1.1%	-3.8%	-6.6%	-1.1%
DJ Stoxx 600	-6.6%	-9.0%	-13.8%	-6.6%

YEnd Dec. (EURm)	2014	2015e	2016e	2017e
Sales	72,874	75,765	76,950	78,165
% change		*4.0%*	*1.6%*	*1.6%*
EBITDA	17,279	17,411	16,514	16,141
EBIT	7,984	5,211	7,867	6,932
% change		*-34.7%*	*51.0%*	*-11.9%*
Net income	4,464	4,043	2,725	2,103
% change		*-9.4%*	*-32.6%*	*-22.8%*

	2014	2015e	2016e	2017e
Operating margin	11.0	6.9	10.2	8.9
Net margin	6.1	5.3	3.5	2.7
ROE	11.0	9.6	6.5	5.0
ROCE	3.4	2.4	3.3	2.9
Gearing	139.8	142.7	153.1	160.0

(EUR)	2014	2015e	2016e	2017e
EPS	2.40	2.11	1.42	1.10
% change	-	*-12.2%*	*-32.6%*	*-22.8%*
P/E	4.9x	5.6x	8.3x	10.8x
FCF yield (%)	NM	0.3%	NM	1.3%
Dividends (EUR)	1.25	1.25	1.04	0.84
Div yield (%)	10.6%	10.6%	8.8%	7.1%
EV/Sales	1.1x	1.1x	1.2x	1.2x
EV/EBITDA	4.6x	4.8x	5.4x	5.7x
EV/EBIT	10.0x	16.2x	11.3x	13.2x

EDF is among the European integrated utilities that have suffered the most since 2008, for good reasons (strong decline in French power prices combined with significant political uncertainty concerning Areva). Since the beginning of the year, the downside spiral has continued with the stock dropping 13% while the SX6P index has only lost 1.1%, as French forward prices have fallen further to EUR30/MWh (>EUR65/MWh in 2008). The fact that EDF is in trouble is no news. However, at the current share price we consider the market is over-reacting and has factored in French power prices of EUR22/MWh, well below the current price. We have adjusted our model to include the latest market prices and still find upside. As such we have upgraded our recommendation to Buy (vs. Neutral). Our FV now stands at EUR14.5/share implying >20% upside to the current share price. All has a price, even EDF.

ANALYSIS

- **Risks are high, but are well identified**: We have identified several short terms risks at EDF: **1/** approval by board members to build up and operate **two EPR reactors in the UK** (HPC project) with Chinese operator CGN. Recent delays and higher capex for all other EPR projects (EDF and Areva in France, Finland & China) are not reassuring, especially as EDF will consolidate the entire debt. As a reminder, S&P has warned several times that it might downgrade EDF's debt if it goes ahead with Hinkley Point, given the project's high execution risk and substantial investment needs. EDF's board recently delayed the decision on whether to go ahead with this project last week. **2/Areva NP integration**: We now know the price-tag at which Areva NP will be bought by the group (around EUR1.3bn for a 51% stake) but still have no clue as to the potential P&L and CFS impact for EDF (positive or negative), once the entity is fully consolidated. **3/**A reduction in the group's average French power price (ARPU) due to both market share loss to the profit of alternative suppliers and to lower forward French power prices (currently at EUR30/MWh vs. EUR38/MWh in 2015 and EUR42/MW in 2014), set to alter the group's earnings and cash flow. **4/A cut in the dividend** which we view as inevitable, since the group cannot afford to spend **EUR2.3bn** on dividends, and **EUR4bn** on gross capex while committing itself to an important programme such as the Hinkley Point C project. **We do view at all this cut as a risk if it is part of a strategic plan unveiled by the group during its 2015 full-year publication**.

- **A negative EPS adjustement prompting us to lower our FV from EUR18.5 to EUR14.5…**: We have updated our model to include the latest French forward prices *(EUR30/MWh)* and the latest indications on the cost of Cigeo, while integrating further market share losses in the French power market to the profit of alternative suppliers. In all, we have cut our 2016-17 adjusted EPS by **16%** and our FV from **EUR18.5 to EUR14.5/share**, which still points to **>20%** upside to the current share price. In our model we currently stand **8%** below consensus on 2016-17 earnings, implying further downside potential for the consensus over the short term.

- **…and to upgrade our recommendation from Neutral to Buy:** Despite the average **16%** negative adjustment in our restated 2016-17 EPS, we have decided **to upgrade EDF from Neutral to Buy** for **<u>four main reasons</u>**: **1/** Recent newsflow on EDF has been fairly reassuring, and should provide positive potential catalysts in coming months (ARENH price increase announced by French government, law change to allow the disposal of a RTE stake to non-French state entities). We also see the potential departure of Segolène Royale as positive for the group. **2/** With the arrival of Jean-Bernard Lévy, the group is entering a massive transformation phase (disposals, growth capex optimisation, cost-control optimisation…) that can only create value. **3/**At the current share price, the yield implied is quite attractive, even if we assume a cut. **4/** At the current share price, we assume the market is pricing in a further fall in French power prices from **EUR30/MWh to EUR22/MWh,** which we view as unlikely given the structure of the French power market.

- **1/Recent newsflow is quite positive** Unofficial recent indications (unveiled in most cases by union members), indicate that the group's management, prompted by the recent arrival of Mr Lévy at the head of the group, is currently working on implementing a cost-cutting programme. While we were already aware that the group was working on a way to optimise its operating costs to adapt its structure to the progressive opening of the French power market, we were positively surprised by the group's new 2019 targets (up to 4,000 job cuts in France and 2,000 additional job cuts in the international division, mainly in the UK), these being far more aggressive than we expected. These job cuts (no redundancies, as natural departures will more than offset the group's annual recruitment) are set to increase the group's EBITDA by around **EUR700m or 4%** by 2019 with very limited restructuring costs as all departures (at least in France) are set to be natural. The group also indicated it will reduce its exposure to international merchant activities, with different rumours hinting at potential disposals of **EUR6-7bn**. The group could also benefit from positive newsflow over coming months (ARENH price increase announced by French government, law change to allow the disposal of a RTE stake to non-French state entities), which as in the past, could positively impact the share price. We also consider the the potential departure of **Segolène Royale** from the French Environment & Ecology ministry to Quai d'Orsay (*French Foreign Affairs*) during the next ministerial shuffle as a positive factors, since EDF has suffered in the past from her unexpected intervention in tariff increases. A new minister (even stemming from the French ecologist party) could be seen as positive since it would reduce interference risk for EDF (the new minister should notably be more malleable).

- **2/…with the group entering a transformation phase,** EDF is hard to restructure, like all old French monopolies (Orange or Engie). The most virulent French trade unions (CGT & FO) have strong positions in the group, and clearly try their best to protect both existing and future jobs, as well as employee advantages from the former monopolistic positions, to the detriment of the group's long-term survival. We believe the new CEO's arrival should definitively help EDF to adapt itself to this more competitive environment. Several transformation plans are currently ongoing: reform of standard contracts for some employees, to obtain greater flexibility more cheaply, lowering annual job creations to optimise the cost structure. A transformation is clearly needed, especially given the strong changes in the European energy environment since 2008. Increasing presence in renewables (5% of EBITDA) should definitively help the group to generate growth over coming years, although an adjustment is clearly needed in its merchant activities.

- **3/Yield is attractive, even after a dividend cut:** We still find upside despite slashing our estimates for the French power market, and cutting the **EUR1.25** dividend (the 2015 dividend looks safe) **to EUR1.04** for 2016 and to **EUR0.84** for 2017, assuming the group's guidance on dividend payout remains at **55-65%** without a "political" floor at EUR1.25. At the current share price, the 2015 implied yield is unreal and attractive (10.7%), even based on our 2016 earnings and dividends estimates (respectively 8.6% and 7%). Assuming we are right, the cut would imply a positive share price reaction (as for Engie when it cut its EUR1.5 dividend to EUR1 for a similar reason, the share rose 6%). However, if we are wrong, at the current share price, it would imply a very attractive yield on dividends already under pressure. **In both cases, investors win!**

- **4/** At the current share price, based on our dividend yield calculation model, we identify that the market has overpriced the deterioration in French forward power prices, since the current share price implies **EUR22/MWh** whereas prices are currently closer to **EUR30/MWh** (a 5.5% average yield for the sector on the current share price of EUR11.8/share leads to a EUR0.64 theoretical dividend, which leads to a EUR1.07/share EPS based on a 60% mid-range guidance payout ratio, implying EUR22/MWh in our model vs. a current price at EUR30/MWh).

- **Conclusion:** Following the strong share price deterioration in 2015 (-40%) due to lower French forward power prices, as well as newsflow on Areva and Hinkley Point C, the EDF share is trading close to its lowest level (EUR11.7) since the IPO at EUR32/share (2005). On our adjusted estimates, the stock is trading at **5.4x** its 2016e EBITDA and at **8.5x** its 2016e earnings, versus peers at respectively **7x** and **13x** and most importantly, versus historical multiples of respectively **6.5x** and **11.3x**. While risks to our investment case are high, at the current share price, we consider that downside risk is pretty limited (-10%), compared with potential upside (>30%). **As such, we have upgraded our recommendation from Neutral to Buy, with a new FV at EUR14.5.**

VALUATION

- At the current share price, the stock is trading at 5.4x its 2016e EBITDA and offers a 9% yield.
- Buy, FV @ EUR14.5

NEXT CATALYSTS

- 16th February: 2015 earnings publication

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