

10th February 2016

Utilities

Pennon Group

Price 832.50p

At any price? (full report published today)

Fair Value 825p vs. 800p (-1%)

SELL vs. NEUTRAL

Bloomberg	PNN LN
Reuters	PNN.L
12-month High / Low (p)	896.5 / 713.0
Market Cap (GBpm)	3,433
Ev (BG Estimates) (GBpm)	6,182
Avg. 6m daily volume (000)	817.6
3y EPS CAGR	9.2%

This morning we publish a report in which we review Pennon following the stock's fairly strong relative performance over the past six months and the fact that it is now trading just 9% below its all-time high. We appreciate the group's strategy, especially in the waste business, but see potential uncertainty on UK inflation and power prices as clearly negative for the investment case, especially at current multiples. Despite raising our FV from 800p to 825p, we are downgrading our recommendation from Neutral to Sell.

	1 M	3 M	6 M	31/12/15
Absolute perf.	-2.2%	5.4%	4.3%	-3.3%
Utilities	-5.6%	-10.3%	-15.2%	-9.3%
DJ Stoxx 600	-9.4%	-17.7%	-22.1%	-15.4%

YEnd Mar. (GBpm)	03/15	03/16e	03/17e	03/18e
Sales	1,357	1,449	1,501	1,566
% change		6.7%	3.6%	4.3%
EBITDA	411	443	465	495
EBIT	232.9	258.8	262.7	278.0
% change		11.1%	1.5%	5.8%
Net income	126.3	147.9	152.5	164.4
% change		17.1%	3.1%	7.8%

	03/15	03/16e	03/17e	03/18e
Operating margin	17.2	17.9	17.5	17.8
Net margin	9.3	10.2	10.2	10.5
ROE	9.3	10.7	10.9	11.6
ROCE	5.2	5.4	5.2	5.5
Gearing	162.3	182.8	195.4	196.6

(p)	03/15	03/16e	03/17e	03/18e
EPS	30.70	35.95	37.07	39.96
% change	-	17.1%	3.1%	7.8%
P/E	27.1x	23.2x	22.5x	20.8x
FCF yield (%)	NM	NM	NM	3.0%
Dividends (p)	31.80	33.55	35.56	37.87
Div yield (%)	3.8%	4.0%	4.3%	4.5%
EV/Sales	4.1x	4.3x	4.3x	4.1x
EV/EBITDA	13.6x	13.9x	13.7x	13.0x
EV/EBIT	24.1x	23.9x	24.3x	23.1x

ANALYSIS

- **An impressive performance since 2008...** Pennon, like other regulated European and US water stocks, has massively outperformed all major indices since the 2008 crisis (*Pennon share up 23% vs. SX6P at -50%, and Stoxx 600 at -15%*), as investors were looking for visibility on earnings and above-average real yields. Even within its regulated water universe, the stock has outperformed peers by **>20pp**, reflecting a solid growth perf. over similar period (*EBITDA up 13% vs. +0.8% for peer group*).
- **...bringing the share's valuation close to its peak level:** At the current share price, the stock is not cheap, by any means. While we understand the reasons for this outperformance, we struggle to see how investors can still be attracted to a stock trading at **13.9x** 2016/17e EBITDA and **22.5x** earnings, vs. hist. multiples of respectively **11x** and at **14.3x**, and most importantly, vs. the peer group at **10x** and **19.x**. At **833p** the stock is only **9%** below its highest ever level while the SX6P is trading **50%** below!
- **Uncertainty on inflation offsets M&A potential in our view:** UK inflation is key for Pennon as it impacts its South West Water metrics, and since it affects the dividends paid to shareholders. A look at the consensus on both P&L metrics and dividends shows that the market is quite optimistic on a potential rebound in inflation, although latest indicators are not reassuring. The risk of earnings downgrades cannot be ruled out.
- **Recommendation downgraded from Neutral to Sell:** We have notched up our 2015-19e EPS by an average **4.5%**, on the back of a slightly better operating performance by Viridor and lower financial charges. However, since we have also cut our short/mid-term inflation expectations for the UK, we have reduced dividends. **Recommendation downgraded from Neutral to Sell.**

VALUATION

- At current share price the stock is trading at 13.9x its 2016/17e EBITDA and offers a 4.3% yield
- We downgrade our Rating from Neutral to Sell with a new FV @ 825p

NEXT CATALYSTS

- May 25th 2016: Pennon 2015/16 earnings results

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Analyst :

Xavier Caroen

33(0) 1.56.68.75.18

xcaroen@bryangarnier.com

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London	Paris	New York	Geneva	New Delhi
Beaufort House	26 Avenue des Champs Elysées	750 Lexington Avenue	rue de Grenus 7	The Imperial Hotel
15 St. Botolph Street	75008 Paris	New York, NY 10022	CP 2113	Janpath
London EC3A 7BB	Tel: +33 (0) 1 56 68 75 00	Tel: +1 (0) 212 337 7000	Genève 1, CH 1211	New Delhi 110 001
Tel: +44 (0) 207 332 2500	Fax: +33 (0) 1 56 68 75 01	Fax: +1 (0) 212 337 7002	Tel +4122 731 3263	Tel +91 11 4132 6062
Fax: +44 (0) 207 332 2559	Regulated by the	FINRA and SIPC member	Fax+4122731 3243	+91 98 1111 5119
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