25th April 2016

Sector View

Environmental Services

We bet on a timid year start for French environmental services group

	1 M	3 M	6 M	31/12/15
Utilities	2.3%	1.0%	-6.2%	-3.6%
DJ Stoxx 600	2.4%	3.0%	-5.8%	-4.7%

*Stoxx Sector Indices

Companies covered			
PENNON GROUP		**SELL**	**825p**
Last Price	788.5p	*Market Cap.*	*GBP3,253m*
SUEZ		**BUY**	**EUR18.5**
Last Price	EUR16.05	*Market Cap.*	*EUR8,738m*
VEOLIA		**NEUTRAL**	**EUR21.5**
Last Price	EUR21.06	*Market Cap.*	*EUR11,864m*

In coming weeks, both Suez and Veolia are expected to post poor Q1 2016 metrics on the back of low inflation and no industrial recovery in Europe and a negative FX impact following a strengthening in the euro versus most emerging markets currencies. The majority of earnings growth is only set to stem from a cost cutting programme and new contract signatures, which is not new. From this Q1 earnings presentation, we expect a stronger growth performance from Veolia, but assume the market is already aware of this outperformance, making Suez more attractive than Veolia in valuation terms. We stick to our Buy rating with FV @ EUR18.5.

ANALYSIS

- **What to expect from Suez Q1 publication?** Suez is set to report its main Q1 metrics next week on Thursday 28th April in the morning (*conf. call @ 08.30 am CET: **+44(0)20 3427 1919** – Code: 4791364*) a week ahead of Veolia. We do not expect any change in management's message concerning the global outlook in Europe compared with February 2016. For both the European water and waste segments, underlying growth should remain quite limited due to low inflation and non-existent industrial recovery while growth outside Europe should be affected by a negative FX effect. In all, we expect Suez to post flat Q1 sales compared with last year at **EUR3.54bn**, with the **International division** being the sole segment we expect to post sales growth *(+7% YoY*). The **Water Europe division** will be negatively impacted by poor inflation, loss of the Lille contract and poor tariff indexation (Spain and Chile) while the Waste Europe division is set to suffer from a decline in commodities (scrapped metal down 30% over Q1 vs. Q1) and from flat waste treated volumes. All combined we expect this flat sales performance to have a negative impact on the group's operating performance. EBITDA growth is likely to be negative on a YoY basis by **0.5%** to **EUR579m** yet positive on a LFL basis, to **+1%.** As for EBIT, we expect a slightly better performance due to lower D&A charges (due to CLP depreciation) and to lower concession charges (*loss of Lille contract*). All in all we then anticipate Suez will post Q1-16 EBIT of **EUR258m** down **3.1%** YoY but up **2.6%** LfL close to the low range of its annual guidance for 2016. Net debt should increase compared with end 2015 due to traditional WCR reversal, to **EUR8.4bn**. All in all we then assume as for 2015 that most of 2016 earnings growth for Suez will come from Compass costs reduction program only. Any announcements on M&A deals will be well appreciated given 2017 EBITDA target is based on it.

- **What to expect from Veolia's Q1 publication?** Like Suez, Veolia is unlikely to post incredible Q1 earnings growth on Wednesday 4th May before trading (*conf. call @ 08.30 am CET: **+44 (0)20 3367 9456***). The group is likely to suffer from its presence in the Energy segment in the US and in Central Europe due to an unfavourable weather effect during the quarter compared with last year while benefiting in its Water division from the win of the Lille contract to the detriment of Suez. We do not expect growth in France and in European regions, leading to total group Q1 sales of **EUR6.19bn** down **1.8%** YoY. As for EBITDA YoY growth is set to be higher thanks solid contribution to Convergence program (*EUR50m over the quarter*). We therefore forecast that Veolia will post EBITDA of **EUR843m**, reflecting a **+3.3%** YoY and a **+5.2%** LfL growth over the period while recurring EBIT is likely to stand at EUR410m, up **3.3%** YoY and up **5.8%** LfL. Net recurring income and net debt are respectively expected at around **EUR190m** and **EUR8.6bn** (*integration of Kurion acquisition and reimbursement of Transdev loan*).

- **Conclusion**: The earnings growth generation we expect for both stocks during the quarter will only come from **cost cutting programmes**, although this is not new. We now assume investors are today well aware of both investment cases, making us believe the share price reaction to the earnings publication should be quite limited (*limited potential surprise*). We anticipate higher LfL EBIT growth at Veolia than at Suez (*6% vs. 2.6%)* for Q1 as for entire year yet when looking at current 2016 multiples we see the market is already paying a premium for Veolia. Suez therefore more attractive to us (*notably on the yield*) with higher upside than downside on consensus adjustment given that investors are not giving credit to the group's 2017 EBITDA target of **EUR3bn** (*smart consensus currently at **EUR2.9bn***).

VALUATION

- At the current share price, Suez is trading at **9x** restated 2016e EBITDA, at **19.5x** 2016e EPS, while offering a **4%** 2016e yield.
- At the current share price, Veolia is trading at **8.5x** restated 2016e EBITDA, at **22.5x** 2016e EPS, while offering a **3.44%** 2016e yield.

NEXT CATALYSTS

- 28th April: Suez Q1 publication
- 4th Ma: Veolia Q publication

Table 1: Suez Q1 estimates (EURm)

	Q1-16e	Q1-15	YoY growth	LfL growth	2016e	2015	YoY growth	LfL growth
Sales	**3 566**	**3 536**	**0,9%**	**-**	**15 444**	**15 135**	**2,0%**	**-**
o/w Water Europe	1 111	1 120	-0,8%	-	4 757	4 677	1,7%	-
o/w Waste Europe	1 533	1 539	-0,4%	-	6 431	6 357	1,2%	-
o/w International	896	851	5,3%	-	4 150	3 997	3,8%	-
o/w Others	26	26	2,0%	-	106	104	2,0%	-
EBITDA	**591**	**597**	**-1,0%**	**1,5%**	**2 690**	**2 751**	**-2,2%**	**4,0%**
% of sales	16,6%	16,9%	-	-	17,4%	18,2%	-	-
EBIT	**258**	**266**	**-3,1%**	**2,6%**	**1 315**	**1 381**	**-4,8%**	**6,8%**
% of sales	7,2%	7,5%	-	-	8,5%	9,1%	-	-

Source: Company Data; Bryan Garnier & Co. ests.

Table 2: Veolia Q1-16e estimates (EURm)

	Q1-16e	Q1-15	YoY	LfL	2016e	2015	YoY	LfL
Sales	**6 191**	**6 305**	**-1,8%**	**-**	**25 324**	**24 965**	**1,4%**	**-**
o/w France	1 309	1 320	-0,8%	-	5 445	5 471	-0,5%	-
o/w RoEurope	2 277	2 312	-1,5%	-	8 489	8 575	-1,0%	-
o/w RoWorld	1 457	1 510	-3,5%	-	6 074	5 926	2,5%	-
o/w Other worldwide business	1 095	1 112	-1,5%	-	4 979	4 881	2,0%	-
o/w Others	52	51	2,0%	-	111	112	-0,7%	-
EBITDA (recurring)	**843**	**816**	**3,3%**	**5,2%**	**3 148**	**2 997**	**5,0%**	**-**
EBIT (recurring)	**410**	**397**	**3,3%**	**5,8%**	**1 375**	**1 315**	**4,6%**	**-**
Net income (recurring)	176	212	-16,9%	21,5%	601	580	3,6%	17,2%

Source: Company Data; Bryan Garnier & Co. ests.

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