

Pennon Group

Price 824.50p

2015/16 earnings - first take: in line thanks to Viridor and Bournemouth

Fair Value 825p (0%)

SELL

Bloomberg	PNN LN
Reuters	PNN.L
12-month High / Low (p)	896.5 / 713.0
Market Cap (GBPm)	3,402
Ev (BG Estimates) (GBPm)	6,152
Avg. 6m daily volume (000)	821.3
3y EPS CAGR	9.2%

	1 M	3 M	6 M	31/12/15
Absolute perf.	4.6%	-0.8%	-0.9%	-4.2%
Utilities	-2.0%	2.5%	-7.8%	-5.6%
DJ Stoxx 600	-3.4%	2.7%	-11.5%	-8.0%

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	26.9x	22.9x	22.2x	20.6x
FCF yield (%)	NM	NM	NM	3.0%
Dividends (p)	31.80	33.55	35.56	37.87
Div yield (%)	3.9%	4.1%	4.3%	4.6%
EV/Sales	4.1x	4.2x	4.2x	4.1x
EV/EBITDA	13.6x	13.9x	13.7x	12.9x
EV/EBIT	23.9x	23.8x	24.2x	23.0x

Pennon has posted 2015/16 earnings in line with market expectations for EBITDA and net profit before tax, but higher than our EBITDA forecast. The fairly good performance (+1.1% EBITDA growth) was only driven by the rise in the Viridor asset base and the Bournemouth acquisition. Excluding these factors, we estimate the group's core business operating profit would have fallen 4.6% YoY compared with the decline of just 3.6% posted by Severn Trent yesterday. At the current share price, we continue to assume the premium paid on Water RAB is too high and reduces the risk of a takeover bid. Sell rating confirmed with FV @ 825p.

ANALYSIS

- Main 2015/16 metrics:**
 - 2015/16 sales fell **0.4% YoY** to **GBP1.35bn** with most of the sales decline coming from **Viridor** (sales down 3.6% YoY) while the water entities (**SWW and Bournemouth**) generated a combined **4.7%** in sales growth over the period. In our model we were anticipating a 5% YoY increase at least, closer to GBP1.45bn.
 - The group's EBITDA came out at **GBP448.4m**, **1.1%** ahead of our **GBP443m** estimates but in line with market expectations. This reflects 9% YoY growth compared with last year, thanks primarily to the Viridor assets extension. EBITDA from the water business suffered from lower allowed returns for the K6 regulatory period and generated positive growth only thanks to the integration of Bournemouth.
 - In all, the group's net profit before tax for the fiscal year is GBP211m while profit after tax was up 20% to **GBP152m** thanks to lower tax.
 - The final dividend rose **6%** to **23.12p** bang in line with our **23.09** estimate, and leading to a total 2015/16 dividend of **33.58p** in line with both BG and consensus full-year estimates.
 - Net debt surged by **GBP287m** to **GBP2.48bn** (slightly below our expectations) reflecting capital investment and the net debt taken on in the Bournemouth acquisition. In all, overall results were ok, thanks to Viridor notably (scope effect) and to the Bournemouth acquisition. Excluding these two scope effects, the group's underlying water EBITDA would have fallen **4.6%** vs. **-3.6%** posted by Severn Trent yesterday.
- What about 2016/17?:** The group reiterated its aim to generate annual dividend growth of **4% above RPI inflation to 2020** while indicating that all 11 committed ERFs in the Viridor portfolio will be on-stream by **H1 2018/19** and that **RCV** in the water business is set to grow by **21%** over the same period. All these targets are in line with our estimates and in line with market expectations, implying no further upside relative to the short term consensus (assuming a rise in RPI expectations, which we view as unlikely). The group is well on track to deliver **GBP100m in EBITDA by 2016/17** from Viridor ERFs assets. Further synergies between SWW and Bournemouth could be implemented, potentially ahead of our expectations.
- What to retain from this publication?**
 - 2015/16 sales came out below expectations due to Viridor, yet EBITDA came out in line with consensus expectations and above our own estimate (+1.1%),
 - All 2015/16 targets were achieved, albeit only thanks to Bournemouth and Viridor. When excluding these two scope effects, it appears that SWW's performance is lower compared with Severn Trent during the same period.
- Conclusion:** At this stage we confirm our **Sell rating with an 825p FV** unchanged as we continue to consider that the market currently over-prices the group's waste business, mechanically undervaluing the water business in our model and SOTP. In our view, the implied premium paid by investors to Pennon water RAB is already above 30% limiting upside to the latest share price and limiting the probability of a take-over bid. We will have to adjust our estimates, but do not see significant changes, thereby limiting potential upside to the recent share price. A conference call is scheduled for 10.00am GMT.

VALUATION

- At the current share price Pennon is trading at **13.7x** its 2016/17 EBITDA and offers a **4.3%** yield
 - Sell, 825p**
- ## NEXT CATALYSTS
- September 6th: H1-2016/17 trading statement
 - November 25th: H1-2016/17 earnings



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