BRYAN, GARNIER & CO

INDEPENDENT RESEARCH

16th June 2016

Environmental Services

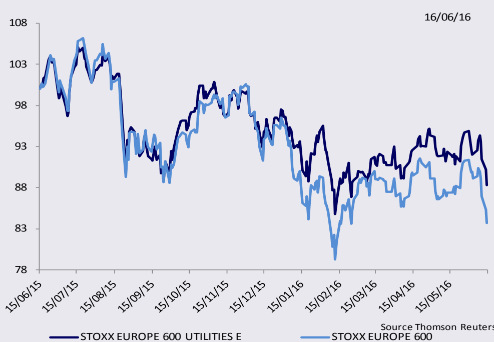
Haste makes waste, it's upside time!

Environmental Services

VEOLIA ENVIRONNEMENT		BUY vs. NEUTRAL	FV EUR23 vs.22
Bloomberg	VIE FP	Reuters	VIE.PA
Price	EUR19.31	High/Low	22.89/17.81
Market cap.	EUR10,879m	Enterprise Val	EUR18,569m
PE (2016e)	19.8x	EV/EBIT (2016e)	13.2x

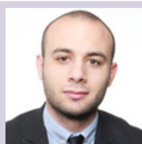
SUEZ		BUY	FV EUR17.5 vs. 18.5
Bloomberg	SEV FP	Reuters	SEVI.PA
Price	EUR14.035	High/Low	18.32/13.885
Market Cap.	EUR7,641m	Enterprise Val	EUR17,071m
PE (2016e)	17.6x	EV/EBIT (2016e)	13.3x

PENNON GROUP		SELL	FV 830p vs. 825p
Bloomberg	PNN LN	Reuters	PNN.L
Price	804.5p	High/Low	896.5/713
Market Cap.	GBP3,320m	Enterprise Val	GBP6,144m
PE (2016e)	21.3x	EV/EBIT (2016e)	23.0x



Ahead of the H1-16 results (and after the FY15/16 results for Pennon), we update our models and review our investment case on environmental services companies. Despite the still challenging macro environment, we remain confident of the resilience of the companies' margins and the cost-reduction measures being implemented. We upgrade our rating on Veolia from Neutral to Buy and maintain our Buy rating on Suez as we believe current and potential additional cost-cutting measures could, at least, partly offset macro headwinds and M&A shortfall for Suez. We also maintain our Sell rating on Pennon.

- We take the opportunity of this note to transfer the coverage of Veolia Environnement and Suez to Pierre-Antoine Chazal.
- **As expected, the beginning of the year has been tough for environmental services companies**. All the three stocks we cover suffered from tepid European industrial production recovery, low inflation in the Eurozone, the drop in energy and raw materials prices as well as commercial pressure in their respective water businesses. This leads us to lower our estimates on their traditional activities. **Mid-term targets could be at risk at different levels** (*FY-18e top line for Veolia, FY-17e EBITDA, which includes M&A, for Suez*).
- **Despite this challenging environment and unsupportive macro outlook, we remain confident of the resilience of the companies' margins.** Both Suez and Veolia will mainly rely on their cost-reduction measures in the years to come (*EUR600m over 2016-2018 for Veolia vs. EUR300m over 2016-2017 for Suez*). **We believe Suez is likely to announce additional cost-cutting measures in its upcoming H1-16 results** as the macro outlook has deteriorated. As for Pennon, we still expect solid EBITDA growth thanks to the Viridor business's ramp-up.
- **We upgrade Veolia to Buy & maintain our ratings on Suez (*Buy*) and Pennon (*Sell*):** As we now consider cost-cutting part of Veolia's DNA and as we appreciate the company's new financial flexibility, we upgrade **Veolia from Neutral to Buy** and increase our FV to EUR23 (*vs. EUR22*). We maintain our **Buy rating on Suez** (*FV down to EUR17.5 vs. EUR18.5*) as we believe additional costs measures which could be implemented could partly offset a too short M&A timing in order to reach the **FY-17e EUR3bn EBITDA ambition.** We remain confident of management's strong commitment to increase EPS growth and we see substantial upside to our valuation through various topics. As for Pennon, after updating our model, we continue to find downside, justifying our Sell rating.



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1. A quick look in the mirror

As expected, **the beginning of the year has been tough for both Suez and Veolia Environnement** amid tepid global growth, a low inflation environment and the continuous drop in commodity prices (*electricity, scrap metal, plastic, …*). **The mid-term objectives (*FY-17e for Suez and FY-18e for Veolia*) could be at risk at different levels (*the top-line for Veolia Environnement, EBITDA – including M&A – for Suez*).** International operations could, however, enable both companies to keep their heads above water, while the situation remains challenging in France (*poor inflation, no strong recovery, contract renewals and regulatory changes*).

The Q1-16 results have highlighted different dynamics between the two French environmental services companies with Veolia showing resilience in its French activities *(notably in the waste segment)* while Suez has mainly relied on its international businesses.

Both confirmed their respective targets for 2016 and beyond. Pennon also confirmed its 2016/17 EBITDA guidance of **GBP100m** for its EfW business while indicating it will continue to distribute a dividend reflecting a **RPI +400bp growt**h after the 2015/16 dividend.

1.1. Different dynamics in traditional activities

In their Q1-16 results, **Suez and Veolia Environnement reported quite different dynamics in their traditional activities (*water and waste segments*),** notably due to different exposures (*to geographies, to raw materials…*). Pennon, which only posted its 2015/16 annual results a few days ago, did not communicate specifically on the Q1-16 trend but indicated it suffered from similar trends to Veolia and Suez, at least in the UK.

- In its **water business**, Suez reported sales of **EUR1,120m**, up **0.3%** organically, thanks to the increase in Chilean (*+6.7%*) and Spanish tariffs (*+1.0%*). Volumes were flat in Spain but decreased in Chile due to unfavourable weather conditions in the summer. **Overall, the good performances in Chile and Spain offset the decline in France** (*revenues down 1.0% organically*) penalised by both the decrease in volumes (*-1.2%*) and flat tariffs (*+0.4% over the period*). **Veolia reported flat sales in France** in its water segment. **The division posted a 2.2% organic decline to EUR2,634m, principally due to the planned decline in revenues of Veolia Water Technologies (VWT)**. Adjusted for this activity, the division would have been up 2.6% organically, of which we estimate 0.6% coming from the gain of the Lille Water contract last year (*c. EUR60m of additional sales per year*).

- **In the waste segment, both Suez and Veolia have suffered from the strong drop in raw material and energy prices since the beginning of the year**. Suez posted a 1.9% organic decline in revenues vs. a 1.2% increase for Veolia (*the geographies are different, Europe for Suez vs. worldwide for Veolia*). Veolia's volumes treated increased by 1.6% while the price effect was modest but positive (*+0.9%*). **In France, Veolia has been much more resilient than Suez with a 1.0% organic decline in revenues vs. a 5.4% decline for Suez** (*despite a slight increase in volumes*). On the contrary, in the UK, Veolia's revenues (*coupled with Ireland*) fell 2.3% organically, mainly due to the decrease in landfill volumes, while Suez's UK revenues (*coupled with Scandinavia*) are up 4.7% thanks to the increase in recovered volumes.

The strong increase in Suez's international activities (*+9.5% organically to EUR920m*) **helped the company to post a 1.5% positive organic change at the group level**, to EUR3,555m.

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At the top-line level, Veolia reported a 1.7% organic decline to EUR6,089m. **Adjusted for VWT and energy prices, revenues would have been up 1.6% organically. Veolia's international activities** (*RoW and Global Businesses geographic segments*) **have, however, posted very poor sales** (*-2.5% and -4.3% organically, respectively*). The United States (*14.7% decline in revenues*) has suffered notably from unfavourable weather conditions, the drop in energy prices, as well as from a poor performance in industrial services.

Despite this context, Veolia Environnement succeeded in organically increasing its EBITDA by 5.0% to EUR840m (*13.8% EBITDA margin vs. 12.9% in Q1-15*), **principally through the cost-reduction measures** already **implemented** (*EUR53m positive impact*). **Suez's EBITDA reached EUR574m** (*16.1% EBITDA margin vs. 16.9% in Q1-15 at EUR597m, below consensus expectations*), **organically flat YoY,** but notably penalised by the depreciation of the Chilean peso leading overall to a 3.9% gross decline YoY.

Fig. 1: Suez Q1-16 key metrics

Suez	Q1-16	Q1-15	Organic growth (%)
Revenues	**3 555**	**3 536**	**1.5%**
o/w Water Europe	1 110	1 120	0.3%
o/w Waste Europe	1 501	1 539	-1.9%
o/w International	920	851	9.5%
EBITDA	**574**	**597**	**-0.1%**
EBITDA margin	16.10%	16.9%	-

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

Fig. 2: Veolia Environnement Q1-16 key metrics

Veolia	Q1-16	Q1-15	Organic growth (%)
Revenues	**6 089**	**6 305**	**-1.7%**
o/w Water	2 634	2 706	-2.2%
o/w Waste	2 012	2 077	1.2%
o/w Energy	1 443	1 522	-4.7%
EBITDA	**840**	**816**	**5.0%**
EBITDA margin	13.80%	12.9%	-

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

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1.2. Targets confirmed…but, updates awaited

Despite the challenging environment, **all three companies confirmed their targets for 2016 (*2016/17 for Pennon*) and beyond**.

Updates are however awaited for both Veolia Environnement and Suez as their mid-term targets for revenues (*for Veolia*) **and EBITDA** (*with M&A, for Suez*) **appear now to be at risk.**

All three companies confirmed their targets for 2016 (2016/17 for Pennon) and beyond.

- **Suez** aims at increasing its revenues organically by at least **2%** while organic EBIT is expected to grow faster than revenues. Free-cash flow is guided at around **EUR1bn** with the net debt/EBITDA ratio expected to be around 3.0x, in line with historical levels. The dividend is guided at **EUR0.65+ per share**. Additionally, Suez reiterated its 'ambition' to reach **EUR3bn** of EBITDA in FY-17 through both organic growth and M&A. **During the results call, Suez's management announced it could implement additional cost-reduction measures but failed to detail what they were. More information may be released during the H1-16 results** on July, 28th. **The group is also likely to update its 2017 ambitions** (*EUR3bn of EBITDA*) as Suez is still looking for an M&A opportunity which, however, implies too short a time to fully integrate a potential target by 2017 and therefore reach the lauded 'ambition'.

- **Veolia Environnement** also reiterated its ambition to generate sales and EBITDA growth in FY-16, to generate at least **EUR650m of FCF** and to post an adjusted net income of at least **EUR600m**. As for the 2016-2018 period, Veolia targets **2-3%** annual growth in revenues *(to EUR27bn+)*, **5%** annual growth in EBITDA spurred on by at least **EUR600m** in cost reductions over the period. This should support other 2018 objectives: **EUR800m** of adjusted net income and **EUR1bn of free-cash flow**.

- **Pennon** reported its growing 2016/17 earnings on May 25th, thanks predominantly to the acquisition of Bournemouth Water and to the expected ramp-up of new EfW facilities. The group, which never indicates any sales or EBITDA targets at the group level, only indicated years ago that it was aiming at generating **GBP100m of EBITDA on its EfW business** within the Viridor waste business. Following the solid performance of this waste business over the last two years, despite the challenging environment, Pennon's management reiterated this target. Management, however, indicated that, in the recycling business *(representing so far 13.5% of Viridor's EBITDA and 4% of the group's total EBITDA*), it has suffered from lower commodity prices and has also had to close two sites in its landfill activities while focusing on the most profitable ones. Further cost cutting or what the group calls "self-help measures" are set to be implemented, but more marginally than at Suez or Veolia. The group also confirmed its aim to distribute a dividend reflecting a **RPI +400bp** growth compared with the 2015/16 dividend.

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2. Suez *(Buy, EUR17.5)*

Suez now appears unlikely to reach its EUR3bn EBITDA 'ambition' by 2017.

Following the Q1-16 results, in our opinion, **Suez appears now unlikely to reach its EUR3bn EBITDA 'ambition' in 2017**, which was to be delivered through both organic growth and M&A. Starting from 2015, adjusting for the EUR131m Chongqing Water stake revaluation and assuming a 50/50 breakdown between organic growth and M&A (*according to management's indications*), Suez would need to increase its EBITDA organically by c. EUR190m while buying in another EUR190m. Although the highly challenging environment (*no significant signs of industrial recovery in Europe, poor inflation, drop in commodity prices*) infringes on Suez's organic goal, **the timing for M&A appears now too short to fully integrate the c. EUR200m+ contribution to EBITDA** (*initial EUR190m plus an additional contribution needed to bridge the gap due to the organic shortfall*) by 2017, implying that the **EUR3bn** EBITDA 'ambition' appears more than at risk.

However, **we remain confident of Suez's ability to find new growth drivers** (*smart water services, industrial water and strong growth in its international division expected at 6-8% per year over 2016-2018*) **and the resilience of the company's mid-term margins** as most of the potential headwinds appear now to be behind (*dilutive impact of the decrease in landfill activity, French big contract renewals*). On top of this, **we believe management could confirm the implementation of additional cost-reduction measures at the upcoming H1-16 results** as the macro outlook remains spluttering and **Suez's management is strongly committed to EPS growth and dividend distribution** (*EUR0.65 per share is still seen as a floor to be exceeded in the years to come*).

We estimate that c. EUR90m of additional cost-reduction measures equally split over the next three years would increase the company's EBITDA by 0.9%, 1.7% and 2.4% in 2016, 2017 and 2018 respectively.

We estimate that c. EUR90m of additional cost-reduction measures equally split over the next three years **would increase the company's EBITDA by 0.9%, 1.7% and 2.4% in 2016, 2017 and 2018 respectively.**

All in all, we lowered our EBITDA forecasts by 1.4%, 4.0% and 5.2% in FY-16e, FY-17e and FY-18e respectively and consequently our EPS forecasts by 1.8%, 11.2% and 11.7% over the same period.

Our valuation, based on cautious assumptions (*lowered macro assumptions on European waste and water segments, international revenue growth at the mid-range of the company's target,* ***no M&A included at all in our model anymore****, no additional cost-reduction measures considered*)**, leads to a EUR17.5 FV (*vs. EUR18.5 previously*), c. 26% above the company's current share price** (*at EUR13.9*)**.**

Buy rating maintained.

2.1. Finding organic growth

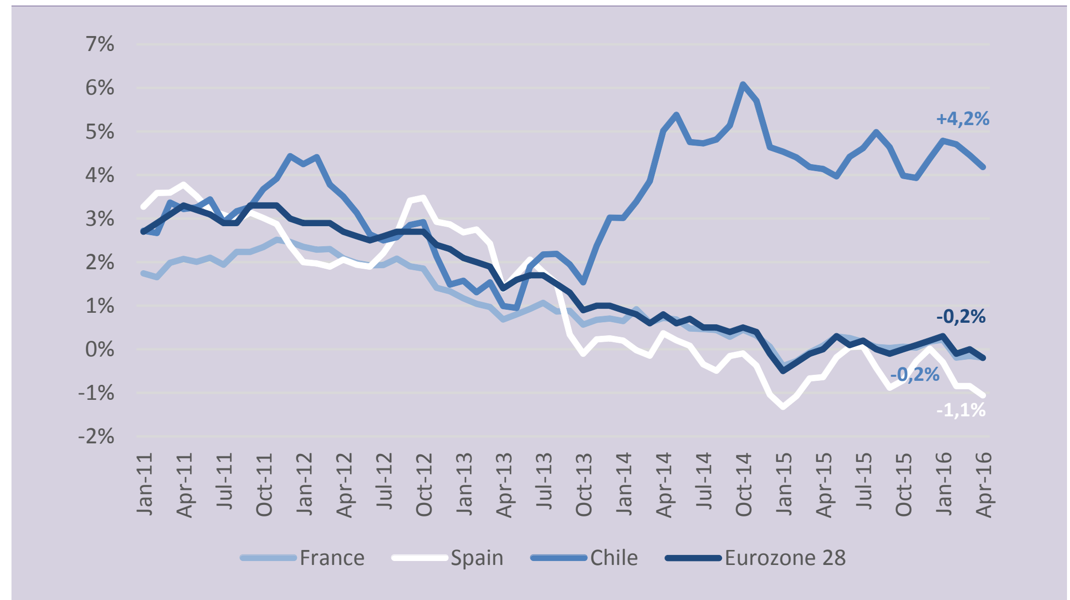
2.1.1. Water Europe

Over 2015-2017, we assume prices to be flat in France and Spain and to increase by 3.0% in Chile.

The water segment (*31% of 2015 the group's sales, 48% of 2015 the group's EBITDA*) is still impacted by both flat volumes (*maturing economies, development of water management services*) and a **poor inflation environment**, which are limiting price increases, at least in Europe. We expect, however, revenues to grow organically by 2.3% and 2.0% in 2016e and 2017e respectively (*vs. 2.9% and 2.5% before*), spurred on by new water services (*+7.5% CAGR over 2015-2017e*) and the growing industrial water business (*+10% CAGR over 2015-2017e*). The tariffs increase obtained last year in Chile (*quinquennial negotiations 2015-2020*) may partly offset the weak pricing environment in France and Spain which are both bearing the brunt of the overall low inflation in the Eurozone. **Over 2015-2017e, we assume prices**

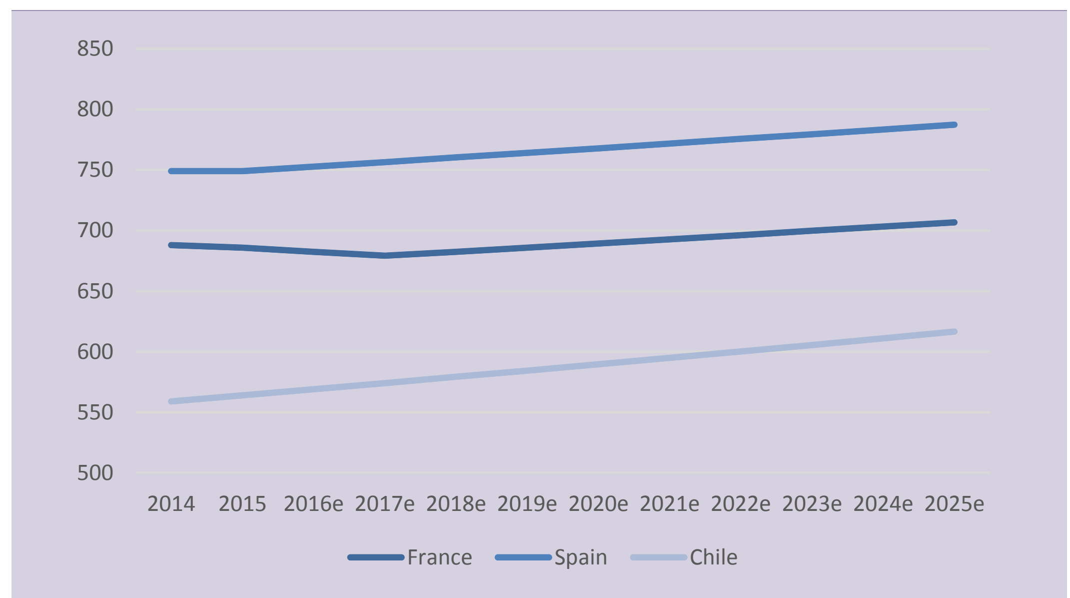
to be flat in France and Spain (*unchanged*), **and to increase by 3.0% in Chile** (*vs. 3.0% in FY-16e and 2.0% in FY-17e before*) in line with inflation in the area. **As for volumes, we assume a 0.9% annual increase in Chile** (*unchanged*)**, a 0.5% increase in Spain** (*unchanged*) **and -0.5% decrease in France** (*vs. 0% before*), over the 2015-2017e period.

Fig. 3: Inflation discrepancies between the Eurozone and Chile



Source: OECD; Bryan, Garnier & Co ests.

Fig. 4: Water Europe: flat volumes (m^3) expected to be sold (2014-2025e)



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

We expect the division's EBITDA margin (*adjusted for the EUR20m exceptional 2015 volume impact due to more than average favourable weather in France in that year*) **to be broadly flat over 2015-2017e** as cost reduction implementation measures (*34% of the overall costs reduction*) should offset flattish volumes and potential headwinds from regulatory changes. **Margins are unlikely to be greatly impacted by the**

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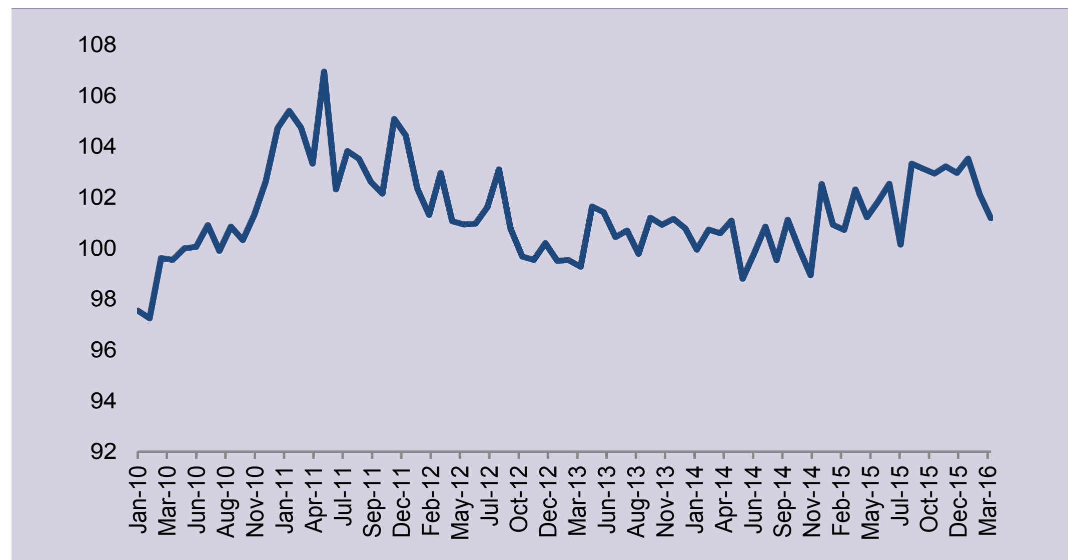
French contract renewals as most of them – at least the significant ones – were already renewed last year. During the Q1-16 results, **Suez unveiled that the pricing of contract renewals in France was up 2.8% over the quarter** which came as a good surprise.

The favourable weather (*more favourable than the historical average*), notably **during the summer could also support the division's margin** as additional volumes would be generated with a 70-75% EBITDA margin, according to our estimates.

2.1.2. Recycling & Recovery Europe

The waste segment (*42% of the group's 2015 sales and 28% of the group's 2015 EBITDA*) may also suffer from a **spluttering industrial recovery in Europe** in general, and in France in particular. We expect the division's revenues to be flat in 2016e (*vs. 1.2% before*) amid **flat volumes** (*+0.7% - inc. +1.1% coming from new capacities - vs. +1.4% before*) due to flat industrial production and the **drop in commodity prices** - among which electricity (*c. EUR30m negative impact on EBITDA in FY-16e*), plastic, metal, and steel.

Fig. 5: French industrial production 2010-2016



Source: INSEE; Bryan, Garnier & Co ests.

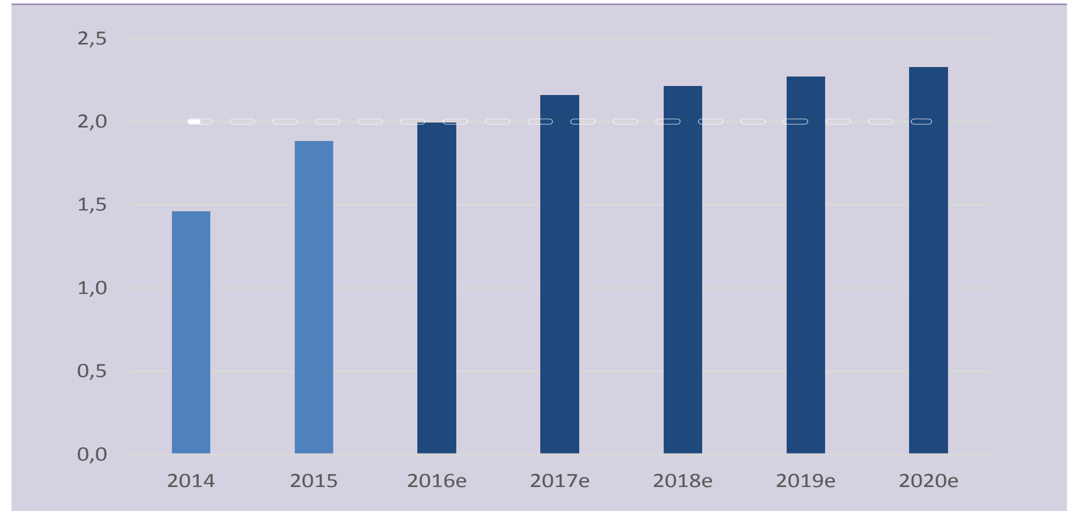
We estimate new waste capacities should bring in an additional EUR195m of revenues and EUR28m of EBITDA in FY17e.

We however expect **a rebound in 2017** (*+3.5% organic growth for the top line vs. 4.3% before*) as **the group will be able to rely on the addition of new capacities** (*Surrey in Q1-17, as well as Poznan, West London and Merseyside since Q3-16*). **Through these new capacities, about 1.2m tons will be added to the division's annual treatment capacity**. We estimate these new capacities should bring c. EUR195m of revenues and EUR28m of EBITDA in FY-17e, which will thus enable the **division's margins to be stable over the 2015-2017e period.**

We assume volumes from existing capacities to be broadly flat over the medium term (*broadly unchanged*). **We consider that most of the dilutive impact on margins coming from the decrease in UK landfill volumes is now behind.** A significant number of the company's landfills have already been closed in the UK following the increase in landfill tax in the country (*from £7/t in 1996-1997 to £84/t today*). This decreasing trend has been well identified by management although it may be much more progressive in France. Moreover, **the decrease in French landfill volumes should gradually**

be offset by higher recycled volumes. The target of 2 tons recovered for 1 ton eliminated should be reached this year (*we have 1.99 for 2016e and 2.16 for 2017e, thanks to new capacities*).

Fig. 6: Recycling & Recovery Europe: tons recovered over tons eliminated (2014-2020e) vs. 2016 target

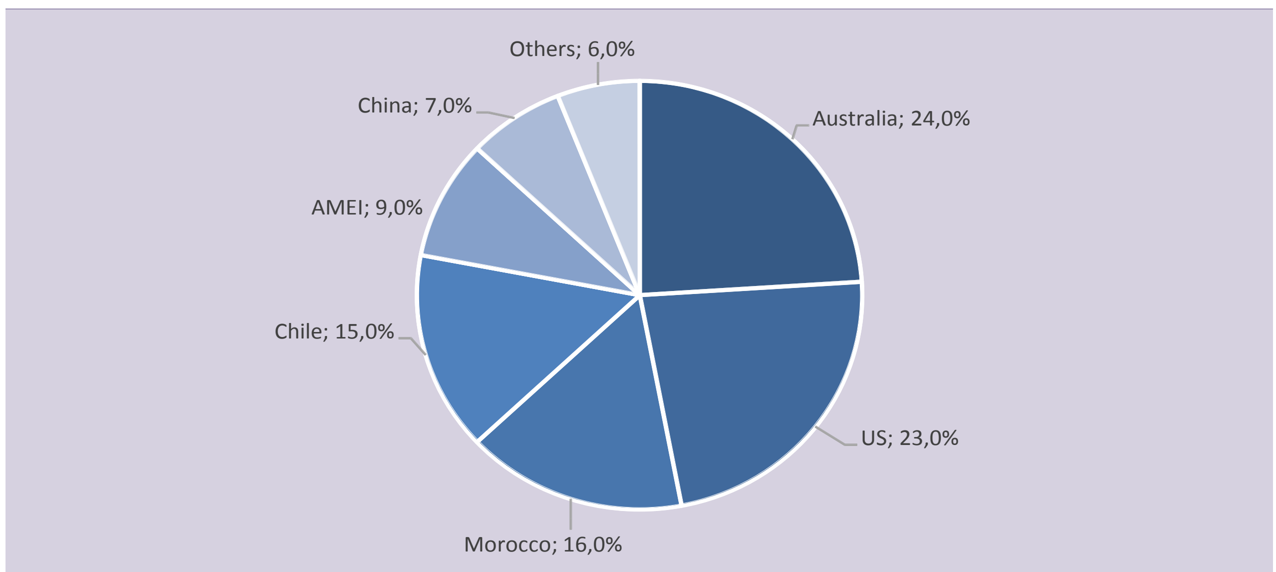


Source: Company Data; Bryan, Garnier & Co ests.

2.1.3. International

The international division (*26% of 2015 the company's sales and 29% of 2015 the company's EBITDA*) **should be the company's key top-line driver in the years to come as Suez aims at increasing its revenues by 6-8% per year until 2018**. Our estimates are broadly in the mid-range of this target with revenues expected to increase by 6.7%, 6.8% and 6.1% in 2016, 2017 and 2018 respectively (*vs. 3.9%, 4.6% and 4.7% before*). **Suez's international development is limited to a few very specific countries: Australia, USA, Chile** (*integrated in the Water Europe division within Agbar's subsidiary*), **China and Morocco.** In January 2016, Suez also strengthened its footprint in India as it bought the industrial water treatment company Driplex.

Fig. 7: Suez's international division: 2015 revenue breakdown (%)



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

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Since the beginning of the year, Suez has already been awarded significant contracts in its international businesses, spurring the Design & Build division's backlog which reached EUR1.2bn in Q1-16, up 16% YoY.

Fig. 8: Selected International contracts awarded by Suez in 2016

Contract	Business	Announcement	Amount (EURm)	Duration	Renewal
Colombo (Sri Lanka)	**Design and construct an additional phase of the drinking water production plant**	**Q2-16**	**EUR168m**	**-**	**N**
Hong Kong	DBO Wastewater treatment plant extension	Q2-16	c. EUR100m	10 years	N
Sydney (Australia)	**Operate & Maintain the Prospect drinking water treatment plant**	**Q2-16**	**c. EUR650m**	**14 years**	**Y**
China	Engineering and equipment procurement services contracts/Industrial services	Q2-16	c. EUR20m	-	N
Putnam (USA)	Manage & Operate municipality's water and wastewater system	Q2-16	c. EUR30m	10 years	N
Barka (Oman)	**Finance, build & operate a new seawater desalination plant**	**Q1-16**	**c. EUR550m**	**20 years**	**N**
Sub-Saharian Africa	9 new contracts in six countries (construction of drinking water treatment plant mainly)	Q1-16	c. EUR55m	-	N

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

We see three main triggers to the potential increase in revenue in the division:

1). The recent increase in tariffs in the United States – where around 60% of the company's water business is regulated – should support both revenue growth and the progressive improvement of the division's margin. As the country's infrastructure network is becoming more and more aged and municipalities are still under pressure (*while only 5-10% of the water market is currently in private hands*), **we continue to see Suez as well positioned in this area to participate in any potential market opening or upgrading**;

2). Suez is well positioned in China where it could win market shares from industrial customers in the years to come amid rising environmental concerns in the country. We estimate revenues to grow by 12% CAGR in Asia between 2015 and 2018 (*vs. c. 8% before*);

3). Water distress situation in areas (*principally in China and in the Middle East*) where the group is already present as shown by the desalination contracts awarded over the past few years (*among them Oman, Abu Dhabi*).

Spurred by both organic growth and the ongoing implementation of cost-reduction measures (*27% of the overall plan*), **we expect the division's EBITDA margin to improve gradually** (*5.9% organic increase in FY-16e, 8.0% in FY-17e and 7.9% in FY-18e – vs. 4.1%, 7.7% and 7.0% before - leading to a c. 17.0% EBITDA margin in FY-18e*).

We estimate organic growth (*including the Compass costs reduction plan*) would lead to a **positive EUR207m net impact** (*EUR68m in FY-16e and EUR139m in FY-17e vs. EUR105m and EUR182m*

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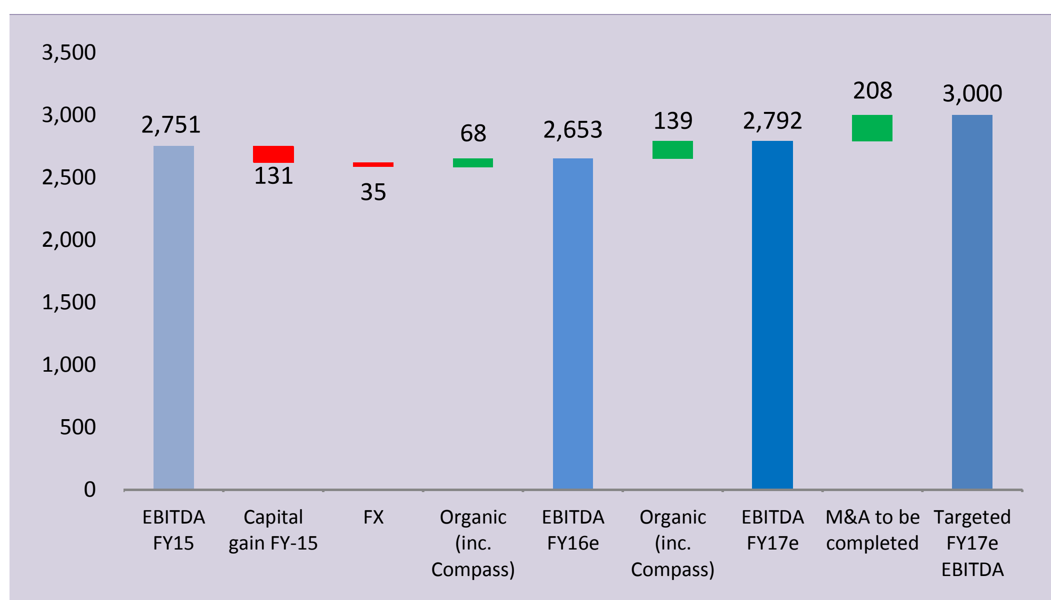
before) on the company's EBITDA between 2015 and 2017 whereas FX has a negative EUR35m impact (*on FY-16e only*).

Following the update of our assumptions, we estimate Suez would finally need EUR208m of EBITDA to reach its FY-17e EUR3bn 'ambition'

Fig. 9: EUR208m needed to bridge the gap



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

2.2. Too late to bridge the gap

The timing appears now too tight for Suez to integrate fully any potential acquisition by 2017 and then reach its EUR3bn EBITDA target while also contributing to the company's EPS growth.

Suez is considering acquisitions in areas where it already has a strong presence. **Over the past few months, Suez has been very active in this and admitted it had bid**, in vain, **for two assets** that could have strengthened the company's existing portfolio in terms of businesses *(waste management and regulated water*) and geographies (*Benelux and Chile*):

- **Antofagasta Water Division**, operating in the regulated water business in Chile, with estimated revenues of c. EUR100m and an estimated EBITDA of c. EUR60m. Estimated enterprise value: c. EUR800m implying a c. 13x EV/EBITDA multiple;

- **Indaver**, operating in the waste treatment and management business *(mainly for industrial customers)* in the Benelux, with estimated revenues of c. EUR500m for an estimated EBITDA of EUR100m. Estimated enterprise value: c. EUR800m implying a c. 8.0x EV/EBITDA multiple;

Its interest in other companies (*Spanish Urbaser and Benelux's Van Gansewinkel, both in the waste segment*) has also been in the news over the past few weeks, highlighting that Suez remains active in M&A screening. Targets exist, especially in the waste business, but the company's management confirmed during the Q1 results call that **sellers remain too demanding** - Antofagasta Water Division (*regulated business hence higher implied multiples*) implied an EV/EBITDA multiple at c. 13x, waste treatment

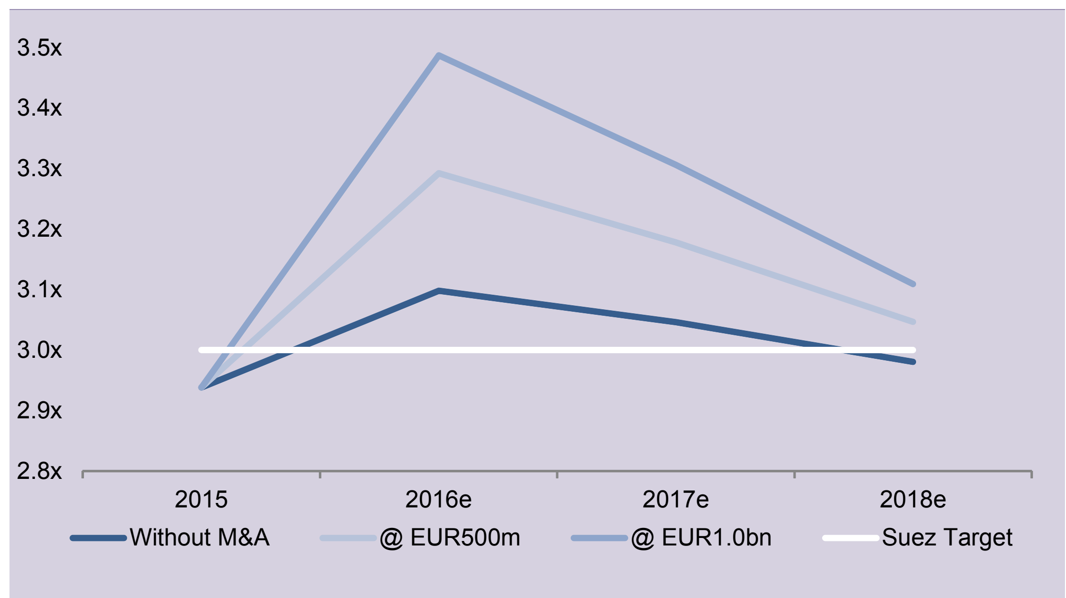
company Ekokum, valuing at c. 12.7x current EV/EBITDA, has recently been bought by Fortum - **while Suez aims at staying close to its 3x net debt/EBITDA ratio objective** (***the group has no covenant*** *but wants to keep its credit rating*).

Suez can, however, temporarily consider exceeding this level – to 3.4-3.5x – **as it did for the Agbar acquisition a few years ago** (*and then return to c. 3x within the following 18 months*).

Adding about EUR200m of EBITDA would imply a c. EUR1.4-1.6bn cash-out for the company, considering a 7.0-7.5x EV/EBITDA multiple.

Assuming a different scenario (*i.e. no M&A, EUR500m cash-out in 2016 and EUR1bn at a 7.0x multiple with an equal contribution to EBITDA between 2017 and 2018*), **Suez would then be able to keep its net debt/EBITDA ratio below 3.5x and to progressively decrease it toward more manageable levels (*between 3.0x and 3.2x in FY-18e*). Non-core asset disposals and/or a capex reduction could eventually be considered if Suez aims at reaching the 3.0x standard level faster.**

Fig. 10: Net debt/EBITDA ratios



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

In our estimates, we do not consider anymore future potential acquisitions as there are too many uncertainties: timing, amount to be paid, target multiple, target businesses and geography. **More information could be disclosed at the time of the H1-16 results.**

Please see the section headed "Important information" on the back page of this report.

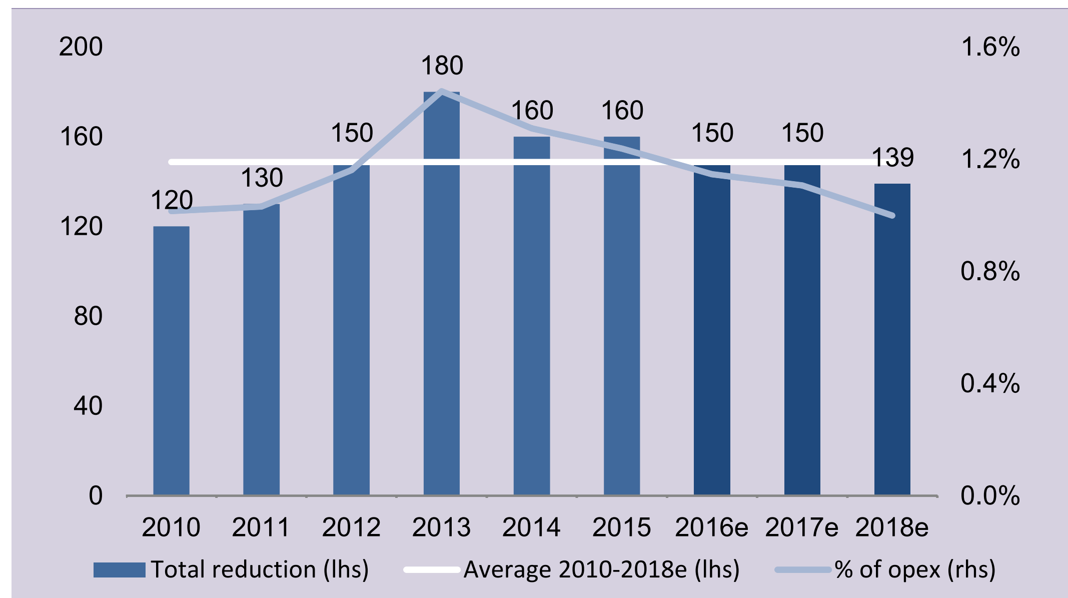
2.3. Upside remains…everywhere?

Despite lowering our estimates in Suez's traditional activities (*Water Europe and Recycling & Recovery Europe*), **we remain confident in the company's ability and ambition to raise EPS.** As we adopt quite cautious assumptions for various topics, **we see substantial upside in four main areas which leads us to maintain our Buy rating.**

1) **Implementation of cost-reduction measures: we believe Suez is likely to announce additional cost-reduction measures at the time of the H1-results**.

   Since 2010, Suez has already completed EUR900m of costs-reduction implying c. EUR150m of costs-reduction per year which represents 1.0% to 1.4% of company's overall yearly addressable costs base.

Fig. 11: EUR900m of costs-reduction completed between 2010 and 2015

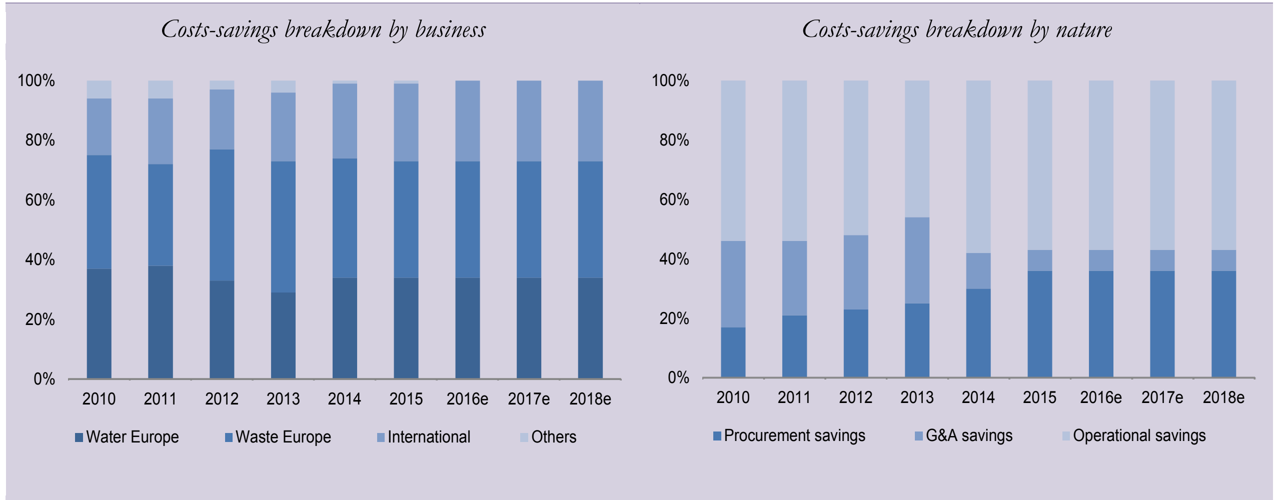


Source: Company Data; Bryan, Garnier & Co ests

Most of the company's costs-savings came from operational savings (*54% of the overall costs savings on average between 2010 and 2015; 57% completed in 2015*) **and procurement savings** (*25% on average over the same period; 36% in 2015*). **We believe G&A savings could have reached a cap** as their shares in Suez's yearly costs savings only represented about 7% in 2015 (*vs. 12% in 2014 and 29% in 2013)*. In terms of businesses, most of the cost-savings have been completed in the Waste Europe division (*c. 39% of the overall costs savings on average between 2010 and 2015; 41% in 2015*) and in the Water Europe division *(c. 34% on average over the same period; 33% in 2015)*.

Please see the section headed "Important information" on the back page of this report.

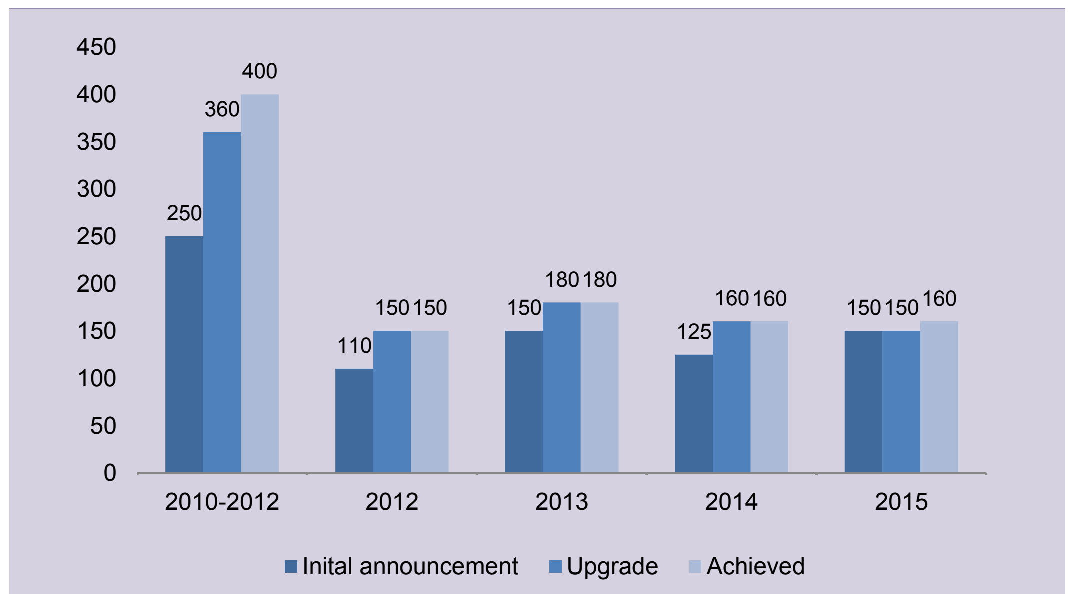
Fig. 12: Costs-savings breakdown (2010-2018e)



Source: Company Data; Bryan, Garnier & Co ests

Since 2010, Suez has a solid track record in delivering costs-savings. **For each of the last five years, Suez has upgraded its initial costs-savings target and/or has exceeded it,** with an average 23.0% beat over the period. **Since 2012, Suez completed EUR650m of costs-savings, EUR115m higher than initial company's announcements.**

Fig. 13: Suez costs-savings track record between 2010 and 2015 (EURm)



Source: Company Data; Bryan, Garnier & Co ests

We believe Suez is likely to upgrade its target this year again *(during H1-16 results)*. **We estimate that additional EUR90m-EUR100m procurement savings could be achieved by 2018**. We assume Suez overall addressable purchasing costs base is around EUR6bn *(40% of Group's sales in FY-15)*. Assuming a 1.5% yearly decline until 2018, towards 35.0% of Group's sales *(for EUR5.8bn)*, Suez would reduce the discrepancy with Veolia whose purchasing addressable costs base is around 32.0% of Group's sales in 2015. **We think this**

Please see the section headed "Important information" on the back page of this report.

procurement optimization could lead to EUR30m-EUR35m of additional savings per year between 2015 and 2018.

Fig. 14: c. EUR100m of potential additional procurement savings by 2018

	2015	2016e	2017e	2018e
Group's revenues (EURm)	15,135	15,456	16,066	16,557
Purchasing addressable costs base (EURm)	6,054	5,966	5,880	5,795
% of sales	40.0%	38.6%	36.6%	35.0%
Implied savings (EURm)	-	(88)	(86)	(85)
Current forecasted savings (EURm)	-	(54)	(54)	(50)
Additional potential savings (EURm)	**-**	**(34)**	**(34)**	**(34)**
Cumulative additional savings (EURm)				**(102)**

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

We estimate an additional cost-reduction of EUR30m per year (*i.e. EUR90m gross savings after having taken into account a 80% retention rate*) **would increase the company's EBITDA by 0.9%, 1.7% and 2.5% in FY-16e, FY-17e and FY-18e respectively**. This implementation would increase the company's EPS by 4.1%, 7.3% and 9.8% over the 2016-2018 period. **This would represent a EUR0.7 upside to our current FV**.

This potential increase in savings' objective as well as the potential official announcement of the M&A delay could lead to a new convergence in Veolia and Suez respective strategies

We strongly believe these "self-help" measures are the main triggers for company's EBITDA and EPS future growth as well as for the company's overall valuation. This **potential increase in savings' objective** as well as the **potential official announcement of the M&A delay** *(at least regarding its inclusion in FY-17e company's EBITDA 'ambition')* could lead to a new **convergence in Veolia and Suez respective strategies** *(while they look opposite for now: organic for Veolia vs. external for Suez).*

2) **M&A and inherent synergies:** for simulation purposes, we consider a EUR1bn acquisition made by Suez in FY-16e (*at a 7.0x EV/EBITDA multiple*) that would impact the company's EBITDA equally in FY-17e and FY-18e (*no impact in FY-16e*). As we consider the acquisition will be accretive on the company's margins, we take into account an 18.0% EBITDA margin for the potential target (*higher margin than the overall group*) which should then generate c. EUR800m of additional sales. As this will mechanically increase the company's cost structure, we estimate additional cost reductions will be increased by c. EUR20m by 2020e (*as per the group's indications, we still consider annual cost reductions to represent 1.0% of the overall cost base*). According to our estimates, such an operation would therefore increase the company's EBITDA by 3.1% and 6.2% in FY-17e and FY-18e respectively and by 2.1% and 10.6% the company's EPS in the respective years. As previously mentioned, this would however significantly increase the company's net debt/EBITDA ratio – but still keep to slightly below 3.5x. **We estimate this would represent a EUR0.3 upside to our current FV.**

3) **Greater-than-expected organic growth in the International division**: we estimate international revenues to grow annually by 6.6% between 2015 and 2018 at the middle of the

range provided by the company (*6%-8% CAGR*). Given Suez's increasing focus on its international activities (*notably in Asia but also in Australia and the US*) and strong performance posted in Q1-16 *(+9.5% organic growth*), the top-end of the range (*i.e. 8% growth per year*) could be achievable. Such an assumption would increase the company's EBITDA by 0.2%, 0.4% and 0.9% in FY-16e, FY-17e and FY-18e respectively. The impact on the EPS would, however, be marginal, except for FY-18e (+*2.1%*).

4) **Progressive recovery in the Waste business:** we estimate the volume effect from existing capacities to be broadly flat between 2016 and 2018. Assuming a slight recovery in European industrial production leading to a 1.0% annual increase – between 2016 and 2018 – in volumes treated from the company's existing capacities, this would increase the group's EBITDA by 1.3%, 2.7% and 2.9% (*in FY-16e, FY-17e and FY-18e*) and the group's EPS by 6.0%, 11.6% and 11.5% over the same period.

Please see the section headed "Important information" on the back page of this report.

2.4. Change in our estimates

Fig. 15: Suez – BG estimates (new estimates vs. old estimates) - EURm

	2015	2016e			2017e			2018e		
	-	new	old	Estimates change (%)	new	old	Estimates change (%)	new	old	Estimates change (%)
Revenues	**15,135**	**15,456**	**15,444**	**0.1%**	**16,066**	**16,031**	**0.2%**	**16,557**	**16,459**	**0.6%**
o/w Water Europe	4,677	4,728	4,757	(0.6%)	4,824	4,876	(1.1%)	4,950	5,013	(1.3%)
o/w Waste Europe	6,357	6,357	6,431	(1.1%)	6,579	6,708	(1.9%)	6,665	6,794	(1.9%)
o/w International	3,997	4,267	4,150	2.8%	4,559	4,339	5.1%	4,837	4,541	6.5%
EBITDA	**2,751**	**2,653**	**2,690**	**(1.4%)**	**2,791**	**2,907**	**(4.0%)**	**2,932**	**3,092**	**(5.2%)**
o/w Water Europe	1,321	1,307	1,320	(1.0%)	1,337	1,372	(2.5%)	1,371	1,425	(3.8%)
o/w Waste Europe	766	772	812	(4.9%)	824	914	(9.9%)	870	983	(11.4%)
o/w International	797	705	689	2.3%	762	754	1.0%	822	818	0.5%
EBITDA margin	**18.2%**	**17.2%**	**17.4%**	**(1.5%)**	**17.4%**	**18.1%**	**(4.2%)**	**17.7%**	**18.8%**	**(5.7%)**
o/w Water Europe	28.2%	27.6%	27.7%	(0.4%)	27.7%	28.1%	(1.5%)	27.7%	28.4%	(2.5%)
o/w Waste Europe	12.0%	12.1%	12.6%	(3.8%)	12.5%	13.6%	(8.1%)	13.1%	14.5%	(9.7%)
o/w International	19.9%	16.5%	16.6%	(0.5%)	16.7%	17.4%	(3.8%)	17.0%	18.0%	(5.7%)
D&A	(1,108)	(1,114)	(1,123)	(0.8%)	(1,181)	(1,174)	0.6%	(1,214)	(1,243)	(2.3%)
Others/Adjustments	(262)	(252)	(253)	(0.4%	(255)	(256)	0.0%	(259)	(259)	0.0%
EBIT reported	**1,381**	**1,287**	**1,315**	**(2.1%)**	**1,355**	**1,477**	**(8.2%)**	**1,459**	**1,590**	**(8.2%)**
% of sales	9.1%	8.3%	8.5%	-	8.4%	9.2%	-	8.8%	9.7%	-
Exceptional	-174	(50)	(47)	(6.4%)	(15)	(15)	0.0%	(15)	(15)	0.0%
EBIT adjusted	1,207	1,237	1,268	(2.4%)	1,340	1,462	(8.3%)	1,444	1,575	(8.3%)
% of sales	8.0%	8.0%	8.2%	-	8.3%	9.1%	-	8.7%	9.6%	-
Financial Result	(422)	(393)	(416)	(5.5%)	(405)	(434)	(6.7%)	(415)	(437)	(5.0%)
Taxes	(173)	(206)	(207)	(0.5%)	(231)	(256)	(9.8%)	(258)	(288)	(10.4%)
Net income reported	**407**	**449**	**457**	**(1.7%)**	**511**	**578**	**(11.2%)**	**575**	**653**	**(11.9%)**
Net income adjusted	560	428	436	(1.7%)	490	557	(12.0%)	554	632	(12.3%)
EPS reported	0.76	0.83	0.85	(1.8%)	0.95	1.07	(11.2%)	1.07	1.21	(11.7%)
EPS BG estimates	**1.04**	**0.80**	**0.81**	**(1.7%)**	**0.91**	**1.04**	**(12.4%)**	**1.03**	**1.17**	**(12.0%)**
Dividend	0.65	0.65	0.65	0.0%	0.65	0.70	(7.1%)	0.69	0.79	(12.1%)
Implied pay-out	85.9%	77.9%	76.6%	1.6%	68.4%	65.0%	5.3%	65.0%	65.0%	0.0%
Net debt	8,083	8,218	8,756	(6.1%)	8,503	9,170	(7.3%)	8,740	9,253	(5.5%)

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

Fig. 16: YoY growth – Key metrics (new estimates vs. old estimates)

YoY growth - Key metrics	2016		2017		2018	
	New	Old	New	Old	New	Old
Revenues	2.1%	2.0%	3.9%	3.8%	3.1%	2.7%
EBITDA	**(3.6%)**	**(2.2%)**	**5.2%**	**8.1%**	**5.1%**	**6.4%**
EBIT reported	(6.8%)	(4.8%)	5.3%	12.3%	7.7%	7.7%
EBIT adjusted	2.5%	5.0%	8.3%	15.3%	7.8%	7.7%
Net income reported	**10.4%**	**12.3%**	**13.8%**	**26.5%**	**12.5%**	**13.0%**
Net income adjusted	(23.5%)	(22.1%)	14.5%	27.8%	13.1%	13.5%
EPS reported	10.4%	12.4%	13.8%	25.9%	12.5%	13.1%
EPS BG estimates	(23.5%)	(22.1%)	14.5%	28.4%	13.1%	12.5%
Dividend	**0.0%**	**0.0%**	**0.0%**	**7.7%**	**6.9%**	**12.9%**

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

Please see the section headed "Important information" on the back page of this report.

2.5. Buy rating maintained, FV down to EUR17.5

SEV SOTP valuation	Value (EURm)	Implied EV/EBITDA 2016e	EBITDA 2016e	Method	% Weigh of EV	Value per share
Water Europe - Non regulated - Excluding contributions from associates & JVs	6,336	6.8x	927	DCF	29%	11.8
Aguas Andinas - Regulated	**3,605**	**9.5x**	**379**	**9.5x EBITDA**	**17%**	**6.7**
Waste Europe - Excluding contributions from associates & JVs	6,093	7.9x	772	DCF	28%	11.3
International - Excluding United Water Regulated - Excluding contributions from associates & JVs	4,959	8.9x	556	DCF	23%	9.2
United Water - Regulated	**1,417**	**9.5x**	**149**	**9.5x EBITDA**	**7%**	**2.6**
Others	(921)	7.0x	(132)	7.0x EBITDA	-4%	(1.7)
Implied EV	**21,489**	**8.1x**	**2,649**	**-**	**-**	**39.9**
Net debt at end 2016e	**(8,218)**					**(15.3)**
Integration of hybrid @ 100%	(1,000)					(1.9)
Provisions (@ Book value 2015)	(2,050)					(3.8)
Minority interest @ Market value (non-regulated assets @ 14x; regulated assets @ 17x) net of Sembsita	(3,083)					(5.7)
Financial assets	2,282					4.3
o/w Financial assets (marked-to-market)	180					0.3
o/w Associates (@ 2015 book value)	1,345					2.5
o/w financial receivables (o/w receivables on concessions @ 2015 book value)	767					1.4
Total implied Equity value	**9,430**					**17.5**
Number of shares (net of owns shares) (m)	538.3					
Equity value per share rounded(EUR)	**17.5**					
Current share price (EUR)	13,9					
Up/Downside	**26.0%**					

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

- **Our valuation, which is based on quite cautious assumptions** *(no M&A at all, no additional cost-reduction measures taken into account, no substantial recovery in European industrial production hence in the company's waste business)* **implies a c.26% upside compared to Suez's current share price;**

- **Considering a more optimistic scenario** *(EUR1bn M&A at 7.0x EV/EBITDA multiple realised in FY-16e and equally integrated in FY-17e and FY-18e, EUR90m of additional cost-reduction measures spread over 2016, 2017 and 2018)*, **our FV could be increased by c. 5% to EUR18.5 which implies a c.33% upside compared to Suez's current share price.**

We value Suez regulated assets at 9.5x EV/EBITDA 2016e. Indeed, as the Group is not a pure regulated water player, **we assume a 15% discount vs. other regulated water companies** *(American*

Water Works, Aqua America, California Water Service Group, American States Water) **whose EV/EBITDA 2016e median reaches 11.0x.**

As for our DCF valuation, we used the following assumptions:

Fig. 17: Suez – DCF assumptions

DCF Assumptions	WACC used	Beta used	LT growth	LT EBIT margin
Water Europe	5.9%	1.05	1.0%	12.5%
Waste Europe	6.1%	1.08	1.2%	5.5%
International	6.1%	1.08	2.0%	8.6%
Suez Group	**6.0%**	**1.07**	**1.1%**	**7.0%**

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

3. Veolia Environnement *(Buy, EUR23)*

Despite the challenging environment affecting Veolia Environnement's traditional activities (*just like Suez*), **we have been positively surprised by the resilience of its margins in its Q1-16 results.** The company's EBITDA organically increased by 5% during the first quarter of the year, principally due to the continuous implementation of cost-reduction measures (*Convergence plan*) as well as thanks to the increase in volumes treated in its waste business *(+1.2% organic growth in the segment*). **We believe cost-reduction implementation is now part of the company's DNA after: 1) Veolia exceeded its initial objective** (*EUR802m of gross savings reached between 2012 and 2015 vs. EUR750m initially forecasted*); and **2) Veolia announced a new ambitious cost-cutting plan** (*EUR600m over 2016-2018, i.e. EUR200m per year of gross savings*).

This new plan strengthened the differences between Veolia Environnement's and Suez's strategies, as Veolia's growth drivers will rely on organic growth and cost-reduction while Suez's drivers will mainly rely on acquisitions. **However, as the timing appears now too short for Suez to fully integrate any potential acquisition** (*in order to reach its EUR3bn FY-17e EBITDA 'ambition'*) **and as new costs-savings measures could be announced in the coming weeks** (*during H1-16 results*) **we think Suez and Veolia respective strategies could converge again.**

As inflation is still quite weak in the Eurozone (*on top of the downsizing of VWT*) and as the company is still bearing the brunt of the drop in raw material and energy prices, **we slightly lowered our revenue estimates for all three business divisions**. **Veolia's ambition to post EUR27bn+ of revenues by 2018 appears now unlikely to be reached** (*we stand at c. EUR26.5bn*) despite the company's increasing presence in developing markets, notably in China where it aims at almost doubling its revenues over the 2016-2018 period. **Yet, due to the efficiency of the implementation of the Convergence plan, margins should not be too under pressure** (*we slightly changed our EBITDA estimates for FY-16e (-0.6%), FY-17e (+0.8%) and FY-18e (+1.3%) but we still see strong improvements year-on-year*). **We expect net income objectives for 2016** (*EUR600m+*) **and 2018** (*EUR800m+*) **to be reached** (*EUR620m for FY-16e and EUR820m for FY-18e*) **as well as the 10% annual growth in yearly dividends by 2018** (*we stand at EUR0.99 per share vs. EUR0.97 per share for the implied group's guidance*).

We finally upgrade our rating for Veolia Environnement from Neutral to Buy and increase our FV to EUR23 (*vs. EUR22*) implying a **19.4%** upside to the current share price. **We see four main reasons for this upgrade:**

1) **The company's recent track record regarding the implementation of cost-reduction measures**: despite the fact that the story is now well known by investors, we believe Veolia could be able to beat its EUR600m savings target or announce additional measures before the end of the current plan;

2) **The resilience of the company's margins** despite the challenging environment (*low inflation in the water business, strong decrease in energy prices, flat industrial production*) due to restructuring (*Veolia Water Technologies for instance*) and a strong positioning in value-added businesses and geographies;

3) **Increased financial flexibility** (*net debt/EBITDA ratio 'only' at c. 2.7x for 2016e, far below past levels*). New proceeds from disposals cannot be excluded in the near future (*Transdev, Sade*),

while the company should adopt a very opportunistic approach towards M&A (*Latin American targets could be considered as their prices have deflated over the past few months*);

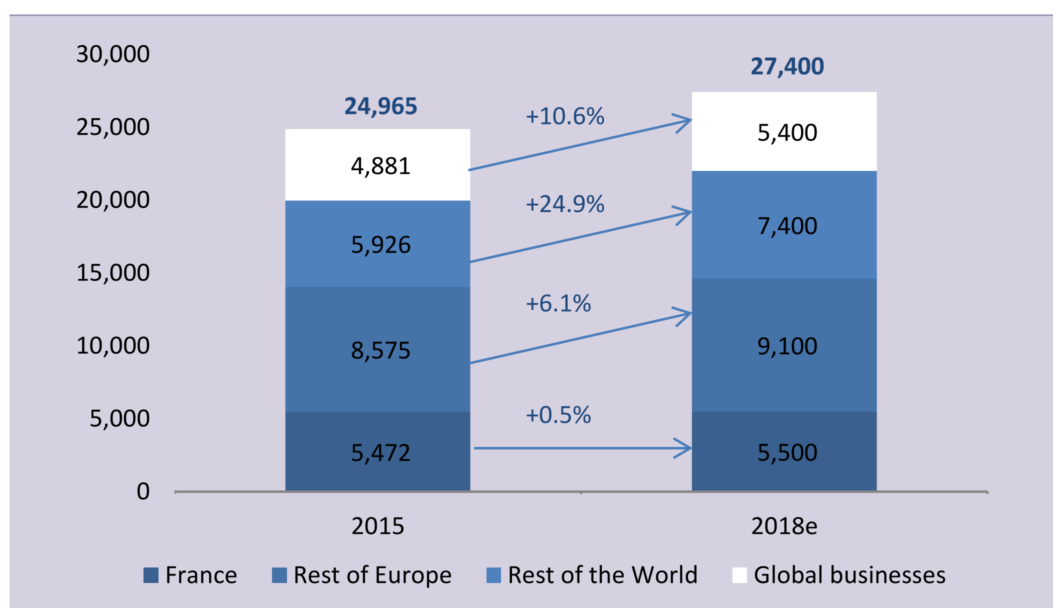
4) **Focus on more value-added businesses** (*hazardous waste and industrial water in particular*), **notably in China with several new plants to be operated in 2017/18** and inherent increase in volumes.

Please see the section headed "Important information" on the back page of this report.

3.1. Lower pace of sales growth

During its December 2015 Investor Day, **Veolia Environnement unveiled its objective to increase its revenues from c. EUR25bn to more than EUR27bn through: 1) a 2% CAGR in its municipal activities** (*notably thanks to new municipal business models and development in emerging countries*); and **2) a 5% CAGR in its industrial revenues with six priority growth areas/industries** (*Oil & Gas/Chemicals, Metals & Mining/Power, Food & Beverage/Pharma, Circular Economy, Difficult pollutions and Dismantling*).

Fig. 18: Veolia Environnement revenue growth objectives (2015-2018) (EURm)



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

We believe this FY-18e EUR27bn+ target would be hard to achieve for Veolia. We forecast 2.0% annual growth over the period for the company's revenues *(vs. at least 2.6% for Veolia's target)* leading to EUR26.5bn sales in FY-18e. **Our growth estimates for FY-17e and FY-18e are in line with Veolia's trajectories** (*YoY revenues' growth at +3.6% and +2.5% respectively*) **but we are more sceptical over FY-16e** for which we expect a 0.2% decrease in YoY sales following the company's ongoing restructuring (*downsizing of VWT*) and the difficult market environment penalising the company's traditional businesses.

Fig. 19: Sales estimates (2016e-2018e)

EURm	2015	2016			2017			2018		
	-	New	Old	Estimates change (%)	New	Old	Estimates change (%)	New	Old	Estimates change (%)
Revenues	**24,965**	**24,927**	**25,324**	**(1.6%)**	**25,821**	**25,870**	**(0.2%)**	**26,471**	**26,474**	**(0.0%)**
o/w Water	11,348	11,298	11,565	(2.3%)	11,658	11,836	(1.5%)	11,953	12,159	(1.7%)
o/w Waste	8,692	8,728	8,735	(0.1%)	9,141	8,910	2.6%	9,369	9,088	3.1%
o/w Energy	4,925	4,900	5,024	(2.5%)	5,023	5,124	(2.0%)	5,148	5,226	(1.5%)

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

Please see the section headed "Important information" on the back page of this report.

We therefore made the following adjustments vs. our previous estimates:

- **Water:** we lowered our revenue forecast by 2.3%, 1.5% and 1.7% for FY-16e, FY-17e and FY-18e respectively as we expect volumes in France to decrease slightly in FY-16e *(-0.5% followed by a slight 1% increase for FY-17e and FY-18e in line with the mid-term trend – vs. 0%, 1.0% and 1.0% in our previous estimates*). We also update our model with the planned progressive downsizing and restructuring of the construction & engineering subsidiary Veolia Water Technologies (VWT) which completed in 2015 its Az Zour North and Sadara main projects. We expect VWT sales to decrease by EUR250m in 2016 (*to c. EUR2bn*). We also add the contribution of the Lille water contract (*EUR60m of yearly sales*).

- **Waste:** we left our estimates broadly unchanged for FY-16e (*-0.1% vs. our previous estimates*) but increased our forecasts for FY-17e and FY-18e (*+2.6% and 3.1% respectively*). Despite the difficulties in some key industrial end-markets for Veolia (*Oil & Gas, Metals & Mining*) which could infringe on the company's growth ambitions (*Veolia is targeting a 10% CAGR in revenues from Oil & Gas between 2015 and 2018 and a 5% CAGR in revenues from Metals & Mining over the same period*), we believe Veolia could benefit from a strong performance in hazardous waste *(+5.7% organic growth in Q1-16*), notably in China, as well as from the addition of some new capacities (*Leeds incinerator in the UK, new Chinese plants in the hazardous waste segment*). Veolia should also benefit from the positive impact of past acquisitions completed in the segment (*Kurion's revenues amount to c. EUR90m while Chemours' sulfur product assets reached EUR230 of revenues in 2015*).

- **Energy:** we lowered our revenue estimates by 2.5% for FY-16e, by 2.0% for FY-17e and by 1.5% for FY-18e. We notably expect a 0.5% decrease in sales in FY-16e (*vs. 2.0% before*), Veolia being impacted by lower than expected energy prices (*notably in Q1-16*) and poor performance in the United States.

All in all, we lowered our revenue estimates at the group level by 1.6% and 0.2% for FY-16e and FY-17e respectively while our revenue forecasts remain unchanged for FY-18e.

Please see the section headed "Important information" on the back page of this report.

3.2. Yet, margins are not at risk

Despite the lower pace of sales growth implied by our estimates, as well as pricing pressure and commercial headwinds - in the water business mainly - **we remain confident of Veolia's ability to improve its margins gradually and reach its short- and medium-term targets**.

As a reminder, Veolia Environnement's targets are the following:

- **For FY-16e: overall increase in EBITDA, and current net income above EUR600m;**
- **For FY-16e/18e: 5% average annual growth for EBITDA, and current net income above EUR800m.**

Our estimates imply the group's EBITDA will grow by 4.6%, 6.4% and 5.4% in FY-16e, FY-17e and FY-18e respectively, slightly above Veolia's target (*at 5% per year over the same period*). **These margin improvements would mainly rely on the company's cost savings** (*EUR200m per year between 2016 and 2018*). Our assumptions are in line with the company's guidance regarding its implementation costs between 2016 and 2018.

Fig. 20: Veolia cost-cutting plan (2016-2018)

EURm	2016	2017	2018	2016-2018
Gross savings	200	200	200	600
Implementation costs	60	30	10	100
Net savings	**140**	**170**	**190**	**500**

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

The areas of improvement will mainly concern operations (*45% of the savings or EUR270m*) **and purchasing** (*35% or EUR210m*) **rather than SG&A** (*only 20% of the savings or EUR120m vs. 50% in the previous 2012-2015 plan*). The group has already identified nine levers, among them include:

- **Reducing purchasing and outsourcing costs:** *centralised purchasing of pumps at the group level, rationalisation of maintenance expenditures in the USA*;
- **Organisational efficiency:** *one Veolia company in Czech Republic and Slovakia, instead of two distinct ones before (EUR1.5m savings);*
- **Reducing information system costs:** *reduction in ERP costs at VWT (EUR3m savings);*
- **Reducing real estate costs:** *new headquarter in Aubervilliers (EUR8m savings).*

The reorganisation of Veolia Water Technologies (*VWT*) will also bring in additional organic margin to the water division as Veolia is implementing various measures including the streamlining of its engineering departments worldwide, the creation of two cost efficient Engineering Platforms in the Middle East and in Asia, the standardisation of its offers for small projects and additional G&A reductions. These measures should enable the subsidiary to increase its EBITDA margin from 2% in FY-15 to 5% over the mid-term. **We estimate these restructuring measures could bring in up to EUR55m of EBITDA by 2018**.

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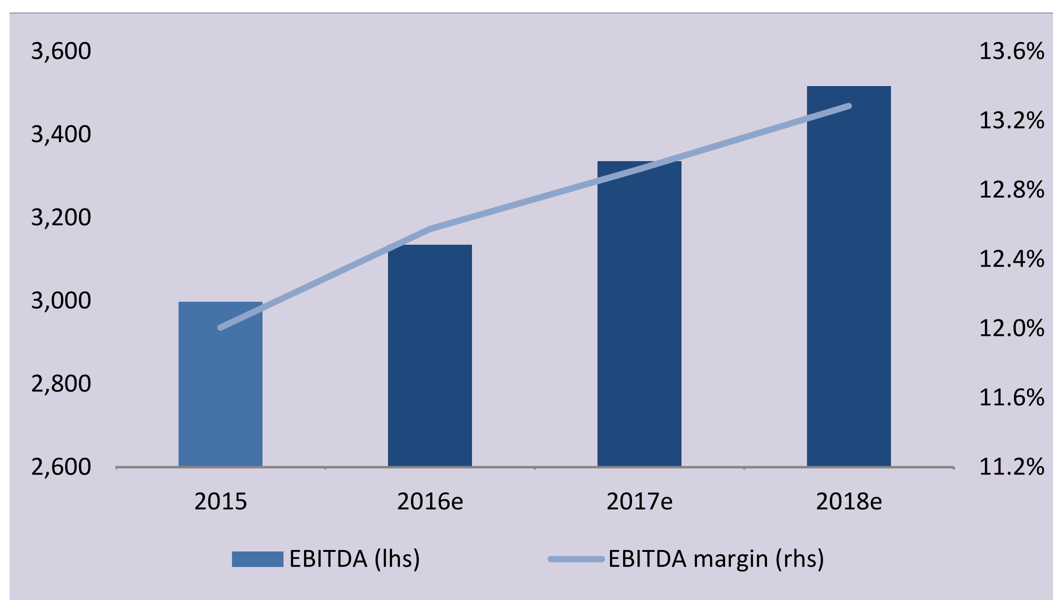
While the details of this restructuring/downsizing have only been unveiled during the Q1-16 results, these measures were already included in the Convergence plan figures. Therefore, we have not revised upward our assumptions following this announcement.

Fig. 21: Strong EBITDA margin improvements (2015-2018e)



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

Following these implementations, we expect:

- **Veolia's FY-16e adjusted net income to reach EUR620m, i.e. slightly above the company's target of EUR600m**. We update our tax rate assumption (*29.0% now vs. 30.0% before but we are still conservative regarding management's statement guiding toward 28.0%*). We also add a EUR12m headwind vs. 2015 due to the decrease in financial income inherent to the reimbursement of the Transdev shareholder loan in Q1-16. However, this would not impact the company's guidance as both Veolia and consensus are using an adjusted metric;

- **Veolia's FY-18e adjusted net income to reach EUR820m, i.e. slightly above the company's target at EUR800m**.

- **Our estimates are in line with Veolia's objective to increase its dividend by 10% per year between 2015 and 2018.** Such an increase would lead to a EUR0.97 dividend per share in FY-18e while we stand at EUR0.99 per implying a 10.7% average increase per year. We progressively lowered our payout ratio to 65% in 2017 and beyond (vs. 76% in 2016 and 108% in 2015).

For 2016e, we expect the water business EBITDA to increase by 2.5% YoY with growth mainly coming from the cost-reduction measures while renewals and unpaid bills may have a negative impact (*EUR20m and EUR5m headwinds respectively*). The renewal impact should be much lower than previous years (*EUR20m vs. EUR70m last year*) as only around 7% of Veolia's contract portfolio will be renewed in 2016 (*vs. 15-16% last year*). The next big contracts will be renewed at the end of the decade (*Toulouse water and wastewater for EUR95m in 2020 and Toulon for EUR20m in 2019*). **Despite the forecasted growth in the waste division, we expect the EBITDA margin to partly suffer from**

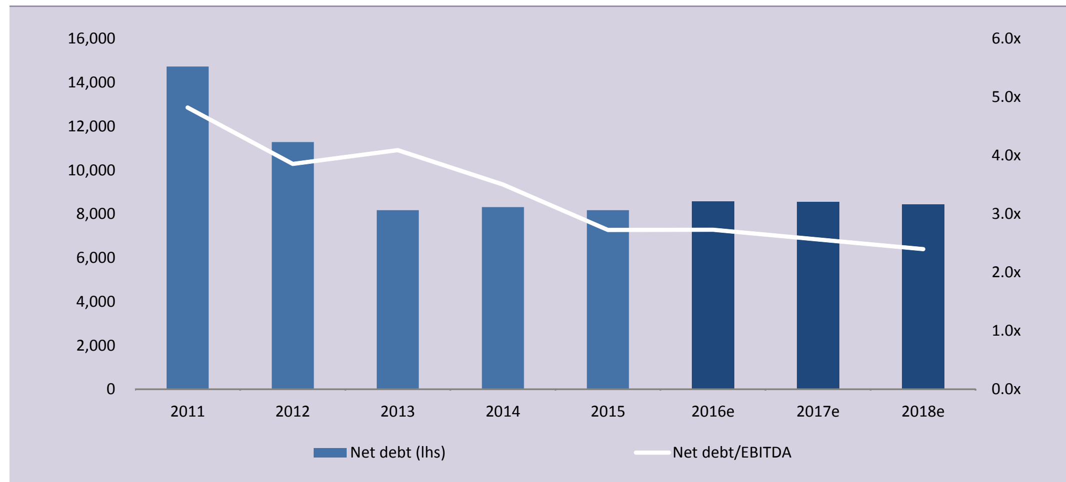
an unfavourable comparison effect due to non-recurring items in 2015 (*settlement of a dispute for EUR20m*) **and poor performance in industrial services in the United States.** We expect however a strong EBITDA improvement in 2017/2018 as Veolia would take benefit from additional capacities in hazardous waste *(in China)*, highly relative on EBITDA margin *(15%-20% EBITDA margin vs. c. 12% currently)*.

Please see the section headed "Important information" on the back page of this report.

3.3. Taking benefit from financial flexibility

We appreciate Veolia's new financial profile as the company has now more flexibility than it ever had in the past five years. In FY-15, the net debt/EBITDA ratio reached 2.7x (*vs. 3.5x one year before*), a ratio which should decline in the coming years thanks to both strong margin improvements and solid cash-flow generation.

Fig. 22: Veolia Environnement's increased financial flexibility



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

We believe Veolia has even more room to increase its financial flexibility by continuing with its disposals policy (*c. EUR7.5bn of disposals since 2012, including the Dalkia operation*). Two potential 'candidates' have already been identified by the company for disposal which could occur in 2016 (*or 2017 at the latest*):

- **Transdev**: Veolia Environnement still aims at completing the disposal of its 50% Transdev stake by the end of the year. Veolia's stake in Transdev has a c. EUR436m book value as of December 2015 (*as a reminder, the EUR345m shareholder loan has been paid back in Q1-16*). We assume the disposal would be made at the current book value (*even if a small capital gain could be made given the recent good performance of Transdev*) implying no change in our FV. Assuming a mere 10% capital gain, our fair value would only be increased by EUR0.1. **More than the financial part of the disposal, we believe the disposal would be well received by investors as: 1) this is a long-lasting story; and 2) proceeds could be used to fund future organic growth and contribute to ensure the company's dividend target;**

- **Sade:** In 2015, Veolia began the process of selling Sade, which is specialised in the design, construction, renovation and maintenance of networks and facilities for the conveyance and distribution of drinking water for public sector customers. The sale process is however on hold for now and the disposal might be unlikely to occur in 2016. About 70% of Sade's revenues are generated in France. In FY-15, it reported revenues of EUR1.3bn for around EUR20m of EBITDA (*we estimate, however, the company's normative EBITDA to be between EUR30m and EUR40m*) implying a poor 2-4% EBITDA margin. We assume the sale of Sade could bring in c. EUR100m to Veolia. Here again proceeds would be used to fund the company's future organic growth and/or bolt-on acquisitions (*small to medium-sized acquisitions*). **Assuming these**

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EUR100m are reinvested to fund future growth (*organically or through M&A*), **we assume this could bring between EUR0.1 and EUR0.2 gross upside to our fair value.**

In spite of the amount of cash that could be generated through these disposals, **we do not believe Veolia will carry out a share buy-back programme as the company appears to be clearly focusing on organic growth for now.**

Veolia could also take the opportunity of this financial flexibility to acquire new companies, aiming at strengthening or broadening its current scope. The company's approach toward M&A is very different from Suez's as **Veolia is targeting bolt-on acquisitions** (*small- to medium-sized acquisitions or local acquisitions*) in value-added businesses/niche markets, such as the recent ones it has completed:

- US **Chemours' sulfur products assets** (*recovery of sulfuric acid and gases of the refining process*) for c. EUR290m (*Revenues of c. EUR230m)* ;
- US **Kurion** (*low and medium-level radioactive waste treatment*) for c. EUR330m (*Revenues of c. EUR90m)*
- German **Nuon Energie und Service** (*industrial services*);
- **Dutch** AKG (*recycled raw materials producer*).

Please see the section headed "Important information" on the back page of this report.

3.4. Change in our estimates

	2015	2016e			2017e			2018e		
EURm	-	New	Old	Estimates change (%)	New	Old	Estimates change (%)	New	Old	Estimates change (%)
Revenues	**24,965**	**24,927**	**25,324**	**(1.6%)**	**25,821**	**25,870**	**(0.2%)**	**26,471**	**26,474**	**(0.0%)**
o/w Water	11,348	11,298	11,565	(2.3%)	11,658	11,836	(1.5%)	11,953	12,159	(1.7%)
o/w Waste	8,692	8,728	8,735	(0.1%)	9,141	8,910	2.6%	9,369	9,088	3.1%
o/w Energy	4,925	4,900	5,024	(2.5%)	5,023	5,124	(2.0%)	5,148	5,226	(1.5%)
EBITDA (CAFOP)	**2,677**	**2,721**	**2,737**	**(0.6%)**	**2,917**	**2894**	**0.8%**	**3,091**	**3,050**	**1.3%**
% of sales	10.7%	10.9%	10.8%	-	11.3%	11.2%	-	11.7%	11.5%	-
o/w Water	1,059	1,086	1,093	(0.6%)	1,145	1187	(3.5%)	1,220	1,282	(4.8%)
o/w Waste	1,076	1,076	1,091	(1.4%)	1,190	1141	4.3%	1,266	1,190	6.4%
o/w Energy	587	603	598	0.9%	627	611	2.6%	650	623	4.3%
EBITDA (CAFOP) margin	**10.7%**	**10.9%**	**10.8%**	**-**	**11.3%**	**11.2%**	**-**	**11.7%**	**11.5%**	**-**
o/w Water	9.3%	9.6%	9.5%	-	9.8%	10.0%	-	10.2%	10.5%	-
o/w Waste	12.4%	12.3%	12.5%	-	13.0%	12.8%	-	13.5%	13.1%	-
o/w Energy	11.9%	12.3%	11.9%	-	12.5%	11.9%	-	12.6%	11.9%	-
New EBITDA definition	**2,997**	**3,135**	**3,148**	**(0.4%)**	**3,336**	**3,310**	**0.8%**	**3,516**	**3,471**	**1.3%**
% of sales	12.0%	12.6%	12.4%	-	12.9%	12.8%	-	13.3%	13.1%	-
Reported EBIT	1,024	1,278	1,232	3.8%	1,436	1,403	2.4%	1,584	1,529	3.6%
% of sales	4.1%	5.1%	4.9%	-	5.6%	5.4%	-	6.0%	5.8%	-
Net financials	(418)	(444)	(430)	3.3%	(419)	(328)	27.7%	(417)	(325)	28.3%
Adjusted EBT	**751**	**965**	**955**	**1.0%**	**1,151**	**1235**	**(6.8%)**	**1,304**	**1386**	**(5.9%)**
Taxes	(200)	(242)	(248)	(2.4%)	(295)	(331)	(10.9%)	(338)	(375)	(9.9%)
Net income reported	450	619	587	5.5%	750	778	(3.7%)	857	869	(1.4%)
Net income adjusted - Veolia def.	**580**	**620**	**601**	**3.1%**	**730**	**762**	**(4.2%)**	**820**	**833**	**(1.5%)**
Net income adjusted - BG def.	**380**	**549**	**517**	**6.2%**	**680**	**708**	**(4.0%)**	**787**	**799**	**(1.5%)**
										-
EPS reported	0.80	1.10	1.04	5.9%	1.33	1.38	(3.4%)	1.52	1.55	(1.7%)
EPS adjusted - Veolia def.	**1.03**	**1.10**	**1.07**	**3.0%**	**1.30**	**1.36**	**(4.5%)**	**1.46**	**1.48**	**(1.4%)**
EPS adjusted - BG def.	**0.68**	**0.98**	**0.92**	**6.1%**	**1.21**	**1.26**	**(4.1%)**	**1.40**	**1.42**	**(1.5%)**
Dividend	**0.73**	**0.84**	**0.72**	**16.2%**	**0.87**	**0.90**	**(3.7%)**	**0.99**	**0.96**	**3.2%**
Implied Pay-out	91%	76%	69%	10.1%	65%	65%	0.0%	65%	65%	0.0%
Net margin	1.5%	2.2%	2.0%	10.1%	2.6%	2.7%	(2.5%)	3.0%	3.0%	(0.9%)
Net debt	8,170	8,564	8,320	2.9%	8,553	8,170	4.7%	8,433	8,009	5.3%

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

Fig. 23: YoY growth – Key metrics (New estimates vs. old estimates)

YoY growth - Key metrics	2016		2017		2018	
	New	Old	New	Old	New	Old
Revenues	**(0.2%)**	**1.4%**	**3.6%**	**2.2%**	**2.5%**	**2.3%**
EBITDA (CAFOP)	1.6%	2.2%	7.2%	5.7%	6.0%	5.4%
New EBITDA definition	**4.6%**	**5.0%**	**6.4%**	**5.1%**	**5.4%**	**4.9%**
Reported EBIT	24.8%	20.3%	12.3%	13.9%	10.3%	9.0%
Net income reported	37.5%	30.4%	21.1%	32.6%	14.3%	11.7%
Net income adjusted - Veolia def.	6.8%	3.6%	17.9%	26.8%	12.3%	9.3%
Net income adjusted - BG def.	**44.4%**	**36.0%**	**23.8%**	**37.0%**	**15.8%**	**12.8%**
EPS reported	37.6%	30.0%	21.1%	32.7%	14.3%	12.3%
EPS adjusted - Veolia def.	7.0%	3.9%	17.9%	27.1%	12.3%	8.8%
EPS adjusted - BG def.	**43.6%**	**35.3%**	**23.8%**	**37.0%**	**15.8%**	**12.7%**
Dividend	14.6%	(1.4%)	3.6%	25.0%	14.3%	6.7%

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

3.5. Upgrade from Neutral to Buy, FV up to EUR23

Veolia SOTP valuation	Value (EURm)	Implied EV/EBITDA 2016E	EBITDA 2016e	Method	% Weigh of EV	Value per share
Water - World	9,485	8.7x	1,086	DCF	44%	17.3
Waste - World	8,363	7.8x	1,076	DCF	39%	15.3
Energy	4,162	6.9x	603	DCF	19%	7.6
Others (Holding costs…)	(314)	7.0x	(45)	7x EV/EBITDA	(1%)	(0.6)
Implied EV	**21,695**	**8.0x**	**2,714**	**-**	**100%**	**39.6**
Net debt at end 2015	(8,170)					(14.9)
Kurion & Chemours Sulfur products assets acquisitions not yet included in our 2015 net debt	(618)					(1.1)
Integration of hybrid @ 100%	(1,500)					(2.7)
Provisions @ book value (end 2015)	(2,618)					(4.8)
Minority interest @ Market value (14x)	(1,415)					(2.6)
Financial assets	5,326					9.1
o/w Other financial assets (@ 2015 Book value) including Transdev loan	626					1.1
o/w Repayment of Transdev loan in 2016 not included in our 2015 net debt	345					0.6
o/w Non-operating financial assets (@ 2015 Book value)	1,926					3.5
o/w Chinese concessions + Transdev equity value + Others associates (@ 2015 Book value)	2,429					4.4
Total implied Equity value	**12,700**					**23.2**
Number of shares (net of own shares) (m)	548.0					
Equity value per share rounded (EUR)	**23.0**					
Current share price (EUR)	19.3					
Up/Downside	19.4%					

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

- **We add the Kurion acquisition** (*for c. EUR330m*), **the acquisition of the Chemours sulfur products assets** (*for c. EUR285m*) as well as **the Transdev shareholder loan repayment** (c. *EUR345m*) to our valuation as these are not included in our net debt in 2015.

- **We lower our corporate tax rate** to 29.0% (*vs. 30.0% before*) while still being conservative (*management guided more toward 28.0%*).

For our DCF valuation, we used the following assumptions:

DCF Assumptions	WACC used	Beta used	LT growth	LT EBIT margin
Water	6.2%	1.07	1.0%	6.0%
Waste	6.1%	1.05	1.5%	6.0%
Energy	6.1%	1.05	2.0%	7.0%
Veolia Group	**6.2%**	**1.06**	**1.4%**	**6.3%**

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

4. Suez vs. Veolia: a word on multiples

Suez and Veolia Environnement are still trading at demanding multiples compared to their historical multiples.

At the current share price, Veolia is trading at a 6.6x FY2 EV/EBITDA (*i.e. for FY-17e*) **consensus multiple, implying an 8.3% discount to Suez which is trading at a 7.2x FY2 EV/EBITDA** (*i.e. for FY-17e*) **consensus multiple**.

While Suez remains above its historical levels (*6.6x EV/EBITDA on average over the past 6 years*), Veolia appears to be slightly cheaper (*6.6x vs. 6.8x on average since 2010*). **As around 20% to 25% of Suez's EBITDA comes from regulated assets** (*United Water and Aguas Andinas*) – contrary to Veolia – **this discrepancy appears however logical and expected**.

Considering the 2017e P/E ratios, Veolia is however more expensive than Suez (*15.7x vs. 14.8x*). Both companies are however trading slight above their historical consensus FY2 P/E multiples (15.7x vs. 16.3x for Veolia Environnement; 14.8x vs. 15.4x for Suez).

When taking into account the few changes we have made to both companies' EBITDA and EBIT (*i.e. concession charges, OFA reimbursement and financial payments, notably*), **we find Veolia Environnement slightly more attractive than Suez** (*c. 5% discount at 7.7x vs. 8.1x for Suez on 2017e EV/EBITDA multiple)* **but still more expensive than Suez of 2017e P/E ratios** *(15.9x for Veolia vs. 15.2x for Suez).*

Our changes to the EBITDA and EBIT are the following:

- On **Veolia, for the EBITDA, we integrate the concession charges and we deduct the OFA reimbursement and the OFA financial payments**, two elements that positively impact the group's EBITDA (*while they are only cash-flows*). For the EBIT, **we deduct the contribution from associates and JVs.**

- On **Suez**, for the EBITDA, **we also integrate the concession charges and we deduct the OFA reimbursement and the OFA financial payments**. We also **deduct from EBITDA the contribution from JVs and associates** as we already value them by using the book value of the assets. **For the EBIT, we only deduct the contribution from associates and JVs.**

Please see the section headed "Important information" on the back page of this report.

Fig. 24: Suez's & Veolia EBITDA adjustments (2015-2018e)

Suez	2016e	2017e	2018e
EBITDA reported	**2,653**	**2,791**	**2,932**
Adjustments (- associates - OFA financial payments - concessions charges)	(405)	(411)	(418)
o/w Associates & Co-enterprises	(135)	(138)	(140)
o/w OFA Financial Payments	(25)	(25)	(25)
o/w Concessions charges/Renewables costs	(245)	(248)	(252)
EBITDA adjusted	**2,248**	**2,380**	**2,515**
% of sales	14.5%	14.8%	15.2%
Market capitalisation	7,474	7,474	7,474
Net debt (+)	8,218	8,503	8,740
Pensions and other provisions (+)	2,050	2,050	2,050
Minorities (+) @ Market value (14x for traditional assets & 17x for regulated assets)	3,083	3,139	3,197
Associates & Other financial assets @ Book value (-)	2,292	2,292	2,292
Implied EV	**18,533**	**18,874**	**19,169**
Implied EV/EBITDA multiple restated	**8.24x**	**7.93x**	**7.62x**
Hybrid	1,000	1,000	1,000
Associates @ book value	1,421	1,421	1,421
Associates @ market value (P/E 14x)	(1,890)	(1,928)	(1,966)
Implied fully restated EV	19,064	19,368	19,624
Implied EV/EBITDA multiple restated with hybrid & with associates at market value	**8.48x**	**8.14x**	**7.80x**

Veolia	2016e	2017e	2018e
EBITDA reported	**3,135**	**3,336**	**3,516**
Adjustments (- OFA reimb. - OFA financial payments - concessions charges)	(584)	(584)	(584)
o/w OFA reimb.	(170)	(170)	(170)
o/w OFA financial payments	(130)	(130)	(130)
o/w Concessions charges/Renewables costs	(284)	(284)	(284)
EBITDA adjusted	**2,551**	**2,752**	**2,932**
% of sales	10.2%	10.7%	11.1%
Market capitalisation	10,832	10,832	10,832
Net debt (+)	8,346	8,343	8,222
Pensions and other provisions (+)	2,618	2,618	2,618
Minorities (+) @ Market value (14x)	1,451	1,487	1,524
Associates, JVs & Financial assets @ Book value (-)	4,921	4,921	4,921
Implied EV	**18,543**	**18,569**	**18,486**
Implied EV/EBITDA multiple restated	**7.27x**	**6.75x**	**6.30x**
Hybrid (+)	1,500	1,500	1,500
Chinese concessions @ book value (+)	2,050	2,050	2,050
Chinese concessions @ market value (P/E 14x)	(840)	(840)	(840)
Implied fully restated EV	22,093	22,119	22,036
Implied EV/EBITDA multiple restated with hybrid & with associates at market value	**8.33x**	**7.73x**	**7.23x**

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

Please see the section headed "Important information" on the back page of this report.

5. Pennon (*Sell, 830p*)

5.1. 2015/16 results in line with expectations, thanks to Viridor and Bournemouth

On May 25th, Pennon posted its 2015/16 earnings. Below are the main metrics of the publication:

- **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%** 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 reflected **9% YoY growth** compared with last year, thanks primarily to the positive perimeter change at Viridor (*commissioning of new assets*). 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.

- 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 23.10p,** bang in line with our **23.09p** estimate, and leading to a total 2015/16 dividend of **33.58p which is** 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 with the Bournemouth acquisition.

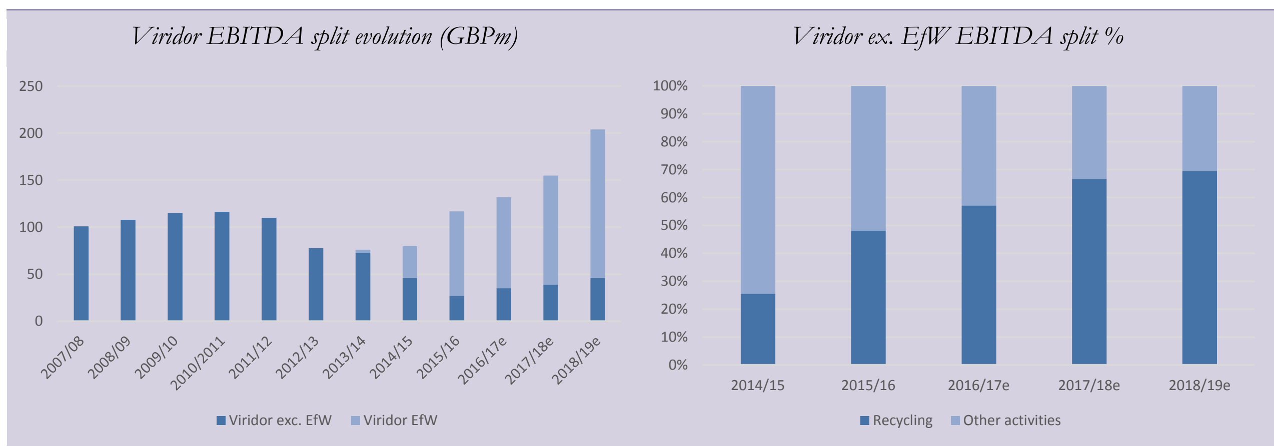
- **Overall, the results were ok, thanks notably to Viridor (*scope effect*) and also the Bournemouth acquisition.**

5.2. Viridor is growing, but only thanks to EfW facilities

Like other waste companies present in Europe, the group, through Viridor, was impacted by the poor commodities environment which negatively affected the recycling business of the group. The shift imposed by the UK government to favour EfW and recycling over more traditional landfill businesses negatively affected the group's sales and EBITDA over the last three years. We estimate that since 2007/08 the group's traditional waste business EBITDA declined by **>70%** from **GBP100m** to less than **GBP30m,** while the EfW new facilities started to generate growth as soon as 2013/14.

We are not surprised by this given this reflects the market shift as well as group's good strategy to adapt its business model to this market change. Yet, given the macro conditions remain quite negative these days, we see potential risks of further disappointments on the main EBITDA contributor of Viridor's traditional activities: **recycling**. In our model, we assume over the coming years this business will progressively represent **70%** of Viridor ex. EfW EBITDA vs. **49%** at end 2015/16 and **25%** at end 2014/15. Any change in market trends, or any impact on volumes and gate fees on this specific business could then dramatically impact the group's EBITDA and so net income over the next four to five years.

Fig. 25: Viridor's EBITDA is more dependent on EfW and recycling



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

To offset the decline in revenues and revenue per tonne within the recycling business, the group had no choice but to implement self-help measures. Most of this sales decline comes from weaker commodity prices, which are affecting the prices of recyclates and therefore the implied margin to treat and recycle the products. In our model, we currently forecast a stabilisation in prices, benefiting the margin but see stronger downside risk than upside risk in this activity. **We slightly lowered the group's EBITDA from recycling over 2016/17 by putting in no growth in gate fees vs. + 1.2% previously.**

5.3. Lower inflation to the detriment of dividend growth

As already mentioned in our previous report on Pennon (*At Any Price? Downgrade on Pennon to Sell – 11/02/2016)*, Pennon's investment case is highly correlated to the UK's inflation trends and, more specifically, to changes in the **RPI** index. Firstly, RPI has an impact on sales and margin growth potential for the **South West Water business & Bournemouth** (*regulated water business*) like all regulated business, and secondly, it has an impact on the dividend pay-out policy as Pennon's management has committed itself to an annual dividend increase of **RPI inflation + 400bp until 2019/20**. However, since the beginning of 2015, the RPI index has remained under pressure, flirting with the **1.5% level**. At the end of April 2016, the RPI index was **1.3%,** vs. **1.6%** in March 2016 and **1.3%** in February 2016. Current forecasts for the RPI index in coming years are more optimistic, but still indicate a slow recovery in the UK economy in the short term. The real acceleration is expected by end-2016 with RPI forecasts standing above the **>2% mark**.

The risk of lower inflation, or at least of a longer than expected low rise in inflation in the UK for 2017 and beyond, could clearly put the stock under pressure

Interestingly, when looking at current consensus dividend growth expectations, it appears that these fully integrate the prospective RPI rise over coming years reflecting an average RPI index growth of **2.2%** for the 2016-19 period and net dividend growth of **2.6%** (*gross increase of 6.4% over the period*). In our model, we remain more cautious as we currently assume average net dividend growth of 2.3% over the same period, more in line with the prevailing low inflation environment in Europe and the UK.

Fig. 26: Pennon – consensus estimates on dividend and on RPI growth

	2015	2016	2017e	2018e	2019e	Average 2016-19
RPI Index forecast	**1.20%**	**2.0%**	**2.9%**	**3.20%**	**3.25%**	**2.5%**
Consensus dividend (p/share)	33.58	35.68	38.06	40.78	43.29	38.28
YoY growth	5.6%	6.3%	6.7%	7.1%	6.2%	6.4%
RPI growth index implied by consensus	**1.60%**	**2.25%**	**2.67%**	**3.15%**	**2.15%**	**2.36%**
BG dividend (p/share)	33.58	35.53	37.84	40.30	42.92	38.03
Difference with consensus	0.0%	-0.4%	-0.6%	-1.2%	-0.9%	-0.6%
Yoy growth	5.6%	5.8%	6.5%	6.5%	6.5%	6.2%
RPI growth index in our model	**1.60%**	**1.80%**	**2.50%**	**2.50%**	**2.50%**	**2.18%**

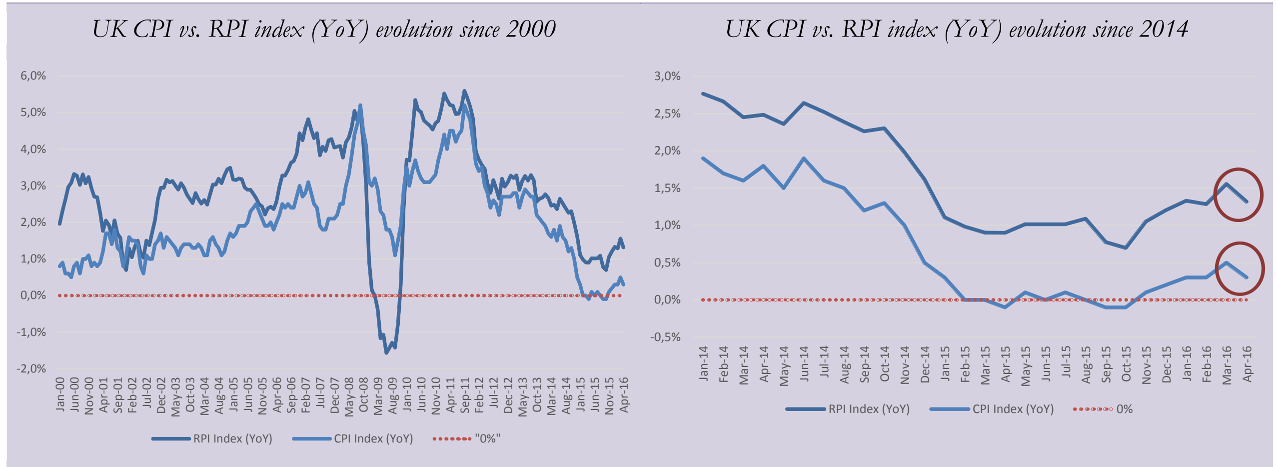
Source: Company Data; Bryan, Garnier & Co ests.

Recent UK inflation statistics unveiled in April 2016 negatively surprised since inflation (*CPI*) in April was up **0.3%,** after being up **+0.5%** in March 2016. Most of this slowdown came from the decline in prices of air fares, vehicles, clothing and social housing rents. A similar negative trend was observed in the RPI index, which was only up **1.3% in April 2016, vs. 1.6% in March 2016**.

This slowdown confirms the uncertainty concerning the emerging markets and the changes in commodity prices are currently too important to have an impact on the Bank of England's decision to change its monetary policy. As a reminder, at the beginning of January, **the Bank of England** left interest rates unchanged at **+0.5%** with expectations growing that there will be no rise in the base rate throughout 2016. This adds weight to our more cautious stance on dividend growth, compared with the consensus. Besides this, we assume, as in USA; that the UK could see its economic growth prospects affected by the crisis in the oil & gas sector, pushing further down the likelihood of inflation and interest rates increases.

Please see the section headed "Important information" on the back page of this report.

Fig. 27: UK CPI vs. RPI index evolution (YoY)



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

The risk of lower inflation, or at least of a longer than expected low rise in inflation in the UK for 2017 and beyond, could clearly put the stock under pressure, especially following its strong share price outperformance since 2008, versus 1/ the SX6P index, 2/ the regulated water index, and 3/ the Footsie index. A risk on future dividends and, as such, on the Pennon share price, clearly exists.

5.4. Changes in our estimates

We updated our model with the 2015/16 figures, with lower commodity prices, and lower CPI & RPI inflation for 2016/17 period. All in all, we slightly raised our 2016/17 EPS estimates by **1.8%** and our 2017/18 estimates by **3.0%.**

We continue to integrate the group's dividend guidance (*RPI + 400bp*), despite being concerned by the way this dividend is being funded at least in the next two years. We understand the need for regulated stocks as **Pennon, Severn Trent or United Utilities** to attract long-term investors with attractive dividends, yet assume funding the dividends by raising debt is clearly negative.

Fig. 28: Pennon – Debt change analysis (GBPm)

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17e	2017/18e	2018/19e
EBITDA reported	**410**	**402**	**416**	**395**	**407**	**411**	**448**	**464**	**496**	**552**
EBITDA margin	38.4%	34.6%	33.7%	32.9%	30.8%	30.3%	33.2%	33.0%	33.9%	35.3%
Operating cash-flow after tax and financials	290	269	221	274	250	274	305	387	385	433
Gross capex (including acquisitions)	(202)	(224)	(287)	(425)	(361)	(298)	(408)	(390)	(278)	(249)
FCF before dividends	**88**	**45**	**(65)**	**(151)**	**(111)**	**(24)**	**(103)**	**(3)**	**107**	**185**
Dividends	(64)	(57)	(69)	(78)	(69)	(69)	(123)	(138)	(146)	(156)
Cash flow post dividends	25	(12)	(135)	(229)	(181)	(93)	(227)	**(142)**	**(39)**	29
Net debt reported	**1 895**	**1 934**	**2 105**	**2 009**	**2 194**	**2 197**	**2 484**	**2 634**	**2 681**	**2 660**
Net debt reported /EBITDA ratio	4.6x	4.8x	5.1x	5.1x	5.4x	5.3x	5.5x	5.7x	5.4x	4.8x

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

Fig. 29: Pennon – changes in our estimates (GBPm)

	2016/17		2017/18		2018/19		2016/17	2017/18	2018/19
	Old	*New*	*Old*	*New*	*Old*	*New*	*Change*	*Change*	*Change*
Revenues	**1 501**	**1 403**	**1 566**	**1 466**	**1 665**	**1 564**	**-6.5%**	**-6.3%**	**-6.0%**
o/w South West Water	516	512	528	524	538	534	-0.8%	-0.8%	-0.8%
o/w Viridor	948	847	998	896	1 085	980	-10.7%	-10.3%	-9.6%
o/w Bournemouth Water	37	44	39	47	42	50	19.7%	19.7%	19.7%
EBITDA	**465**	**464**	**495**	**496**	**547**	**552**	**-0.2%**	**0.4%**	**0.9%**
% of sales	30.9%	33.0%	31.6%	33.9%	32.9%	35.3%	-	-	-
o/w South West Water	320	321	329	329	336	335	0.6%	0.0%	-0.5%
o/w Viridor	130	129	150	153	195	202	-1.2%	1.9%	3.8%
o/w Bournemouth Water	16	17	17	18	18	19	4.7%	5.1%	5.3%
EBITDA margin	30.9%	33.0%	31.6%	33.9%	32.9%	35.3%	-	-	-
D&A	-202	-196	-217	-211	-242	-237	-2.9%	-2.7%	-2.3%
% of sales	13.4%	14.0%	13.8%	14.4%	14.6%	15.1%	-	-	-
Reported EBIT	**263**	**268**	**278**	**286**	**305**	**315**	**1.9%**	**2.7%**	**3.4%**
% of sales	17.5%	19.1%	17.8%	19.5%	18.3%	20.2%	-	-	-
o/w South West Water	205	217	210	221	214	223	6.1%	5.2%	4.3%
o/w Viridor	52	46	61	60	85	88	-11.0%	-2.1%	3.8%
o/w Bournemouth Water	8	8	8	8	8	8	0.0%	0.0%	0.0%
Share of JVs and associates (post tax)	4.4	4.4	4.5	4.5	4.6	4.6	0.0%	0.0%	0.0%
Net financials excluding hybrid coupon	-59	-60	-60	-61	-60	-62	2.5%	2.3%	2.2%
Tax	-40	-40	-42	-44	-47	-49	1.6%	2.8%	3.6%
Hybrid coupon	-16	-16	-16	-16	-16	-16	0.0%	0.0%	0.0%
Result from abandoned activities	0.0	0.0	0.0	0.0	0.0	0.0	-	-	-
Net income reported	152.5	155.3	164.4	169.4	186	193	1.8%	3.0%	3.9%
Net income adjusted - BG Estimates	**152.5**	**155.3**	**164.4**	**169.4**	**185.7**	**193.0**	**1.8%**	**3.0%**	**3.9%**
EPS reported	0.37	0.38	0.40	0.41	0.45	0.47	1.8%	3.0%	3.9%
EPS adjusted - BG Estimates	**0.37**	**0.38**	**0.40**	**0.41**	**0.45**	**0.47**	**1.8%**	**3.0%**	**3.9%**
Dividend (pence)	335	355	355	378	378.7	403	5.9%	6.4%	6.4%
Net debt	2734	2634	2786	2681	2772	2660	-3.7%	-3.8%	-4.0%
Net debt/EBITDA	5.9x	5.7x	5.6x	5.4x	5.1x	4.8x	-	-	-

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

5.5. We remain negative, with a new FV of 830p

Without changing the way we model Pennon (*50% SOTP and 50% DDM*), the changes in our estimates lead us to slightly raise our **FV by less than 1% from 825p to 830p, implying 2.9% downside to the current share price.**

We maintain our Sell rating given: 1/ we have only limited upside compared with the latest share price, and as 2/ we do not expect any positive momentum over the coming months, especially on the macro side in both Europe and the UK (*risk of a further decline in inflation, limited upside on commodities…*).

Fig. 30: Pennon – FV in GBPp

Sum-up FV Pennon	
SOTP	792
DDM	870
FV (average)	**830**
Price	807
Upside/Downside	+2.9%

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

As can be seen in the table above, our **DDM** values Pennon at **870p**, ahead of our FV derived from **our SOTP (*792p*)** and ahead of the latest price. This difference is only due to the very attractive yield the group is willing/committed to distributing (*dividend growth at minimum RPI +400bp*), a yield which does not fully reflect the group's earnings performance, at least in the short term (*implied pay-out based on the group's dividend guidance is set to grow above the 2015/16 level to respectively **94%** in 2016/17 and **92%** in 2017/18*). By taking a more coherent pay-out in line with UK water regulated peers (*Severn Trent and United Utilities*), at around **80%,** we derive a new **fair value of 780p**, which is closer to the fair value from our SOTP.

Fig. 31: Pennon – SOTP (GBPm)

Pennon SOTP valuation	Value (GBPm)	Implied EV/EBITDA 2016/17E	EBITDA 2016/17E	Method	% Weigh of EV	Value per share
Water business						
SWW						
South West Water RCV	3 080	-	-	March 2016/17 RCV	49%	7,5
Outperformance (5%)	154	-	-	5% of RCV	2%	0,4
Premium (21%)	808	-	-	25% premium	13%	2,0
Total SWW	**4 042**	**13x**	**321**	**-**	**64%**	**9,8**
Bournemouth Water						
South West Water RCV	153	-	-	March 2016/17 RCV	2%	0,4
Outperformance	0	-	-	-	0%	0,0
Premium	31	-	-	20% premium	0%	0,1
Total Bournemouth Water	**183**	**11x**	**17**	**-**	**3%**	**0,4**
Total Water business	**4 226**	**12,5x**	**339**	**-**		**10,3**
o/w South West Water	4 042	12,6x	321	RCV + premium	64%	9,8
o/w Bournemouth Water	183	10,7x	17	RCV + premium	3%	0,4
Waste business						
o/w Viridor excluding new EfW projects	290	9,0x	32	9x EV/EBITDA	5%	0,7
o/w Viridor - New EfW projects (excluding Avenmouth & excluding projects through JVs)	1 613	16,7x	97	DCF	26%	3,9
o/w Viridor - Avenmouth (70% probability)	179	-	-	DCF	3%	0,4
Total Waste business	2 082	16,2x	129	-	33%	5,1
Others (Holding costs…)	(26)	8,0x	(3)	8x EBITDA	0%	(0,1)
Implied EV	**6 281**	**14,0x**	**448**	**-**	**100%**	**15,3**
Net debt at end March 2017 (2016/17e)	(2 634)					(6,4)
Integration of hybrid @ 100%	(295)					(0,7)
Fair value of debt/derivatives (end March 2016)	114					0,3
Provisions @ book value (March 2015) - excluding pensions	(221)					(0,5)
Minority interest @ Market value (14x) 2015/16e	0					0,0
Pensions provisions @ end of March 2016	(41)					(0,1)
JVs contribution @ Market value (14x) 2015/16e (Lakeside, Greater Manchester, Runcorn I)	50					0,1
						0,0
Total implied Equity value	**3 255**					**7,92**
Number of shares (net of owns shares)	411,1					
Equity value per share rounded (GBPp)	**792**					
Current share price (GBPp)	807					
Up/Downside	-2.9%					

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

Please see the section headed "Important information" on the back page of this report.

Fig. 32: Pennon – DDM (GBPp)

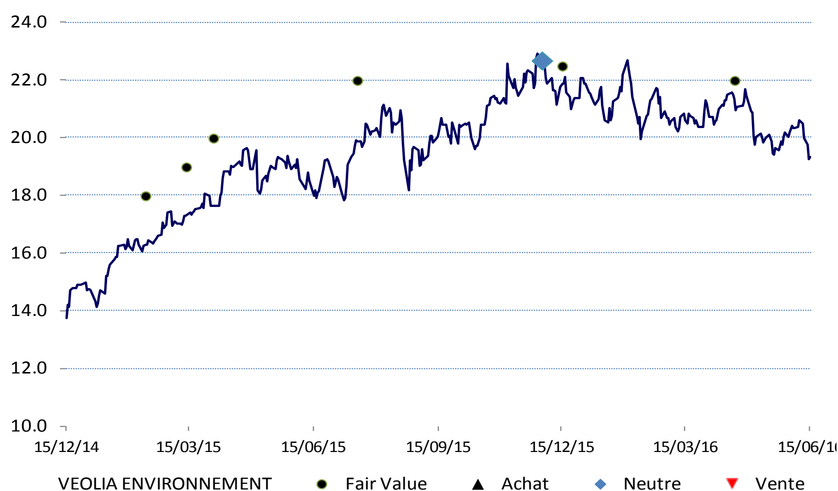
		2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
Dividend per share		**0,231**	**0,355**	**0,378**	**0,403**	**0,429**	**0,453**	**0,478**	**0,504**	**0,532**	**0,561**	**0,592**
RPI growth		1,5%	1,8%	2,5%	2,5%	2,5%	1,5%	1,5%	1,5%	1,5%	1,5%	1,5%
YOY growth			53,67%	6,50%	6,50%	6,50%	5,50%	5,50%	5,50%	5,50%	5,50%	5,50%
Cost of Equity	**6,5%**											
Discount factor	1,00	1,04	1,11	1,18	1,26	1,34	1,43	1,52	1,62	1,72	1,84	1,96
Discounted dividend		0,22	0,32	0,32	0,32	0,32	0,32	0,31	0,31	0,31	0,31	0,30
Cumulative PV of Dividend per share (2014-50)	3,37											
Long term growth	1,2%											
Terminal Value of dividend per share	**11,1**											
Discount factor	2,08											
Present Value of Terminal Value	**5,33**											
Equity value per share (GBPp)	**869,6**											
Current share price (GBPp)	807											
Up/Downside	7.8%											

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

Please see the section headed "Important information" on the back page of this report.

Price Chart and Rating History

Veolia Environnement



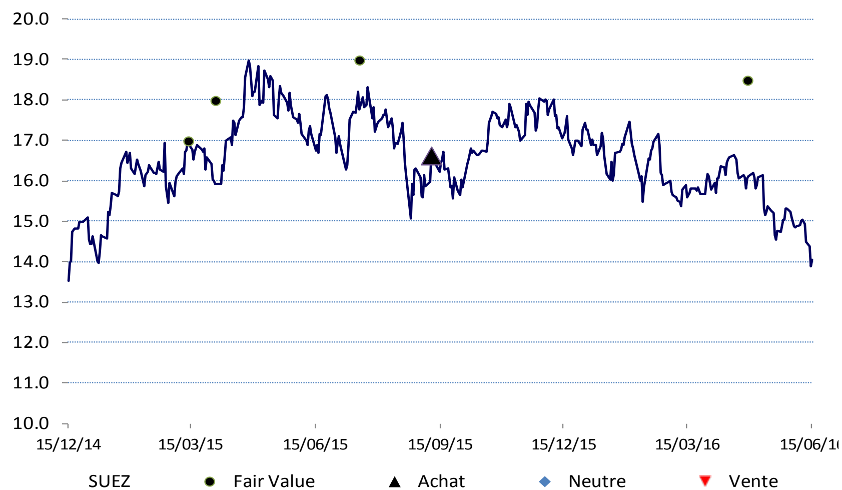
Ratings

Date	Ratings	Price
30/11/15	NEUTRAL	EUR22.765
30/09/14	BUY	EUR13.625

Target Price

Date	Target price
20/04/16	EUR22
15/12/15	EUR22.5
17/07/15	EUR22
02/04/15	EUR20
13/03/15	EUR19
11/02/15	EUR18
30/09/14	EUR17

Suez



Ratings		
Date	**Ratings**	**Price**
08/09/15	BUY	EUR15.96
30/09/14	NEUTRAL	EUR13.155

Target Price	
Date	**Target price**
28/04/16	EUR18.5
28/04/16	EUR18.5
17/07/15	EUR19
02/04/15	EUR18
13/03/15	EUR17
09/12/14	EUR16
30/09/14	EUR14

Pennon Group

Ratings		
Date	**Ratings**	**Price**
11/02/16	SELL	832.5p
07/05/15	NEUTRAL	840p

Target Price	
Date	**Target price**
11/02/16	825p
11/09/15	800p
21/05/15	835p
07/05/15	860p

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Stock rating

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NEUTRAL

Opinion recommending not to trade in a stock short-term, neither as a BUYER or a SELLER, due to a specific set of factors. This view is intended to be temporary. It may reflect different situations, but in particular those where a fair value shows no significant potential or where an upcoming binary event constitutes a high-risk that is difficult to quantify. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

SELL

Negative opinion for a stock where we expect an unfavourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential downside based on valuation), but also takes into account a number of elements that could include a SWOT analysis, momentum, technical aspects or the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

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BUY ratings 55.8% NEUTRAL ratings 34.7% SELL ratings 9.5%

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