1st July 2016

Sector View

Utilities

TOP PICKS Q3 2016: VEOLIA

	1 M	3 M	6 M	31/12/15
Utilities	-0.2%	2.8%	-2.6%	-2.6%
DJ Stoxx 600	-5.1%	-2.3%	-9.8%	-9.8%

*Stoxx Sector Indices

Companies covered

ALBIOMA		**BUY**	**EUR16**
Last Price	EUR13.85	*Market Cap.*	EUR413m
AMOEBA			
Last Price	EUR25.7	*Market Cap.*	*EUR154m*
E.ON		**BUY**	**EUR10.2**
Last Price	EUR9.026	*Market Cap.*	*EUR18,061m*
EDF		**BUY**	**EUR13.8**
Last Price	EUR10.97	*Market Cap.*	*EUR22,085m*
EDP RENOVAVEIS		**NEUTRAL**	**EUR7.5**
Last Price	EUR6.78	*Market Cap.*	*EUR5,914m*
ENGIE		**BUY**	**EUR16.8**
Last Price	EUR14.51	*Market Cap.*	*EUR35,336m*
PENNON GROUP		**SELL**	**830p**
Last Price	945.5p	*Market Cap.*	*GBP3,901m*
RWE		**NEUTRAL**	**EUR9.5**
Last Price	EUR14.19	*Market Cap.*	*EUR8,568m*
SUEZ		**BUY**	**EUR17.5**
Last Price	EUR14.08	*Market Cap.*	*EUR7,665m*
VEOLIA		**BUY**	**EUR23**
Last Price	EUR19.47	*Market Cap.*	*EUR10,969m*
VOLTALIA		**BUY**	**EUR13**
Last Price	EUR9.6	*Market Cap.*	*EUR252m*

LOOKING BACK ON Q2 2016

The **Utilities sector** performed better than the **Stoxx 600** during Q2 2016 *(2.8% for SX6P vs. -2.3% for the Stoxx 600*). Since the beginning of the year, the Stoxx 600 Utilities has dropped 2.6% vs. a 9.8% decline for the Stoxx 600. Since our initiation of coverage in July 2014, we have recommended staying out of the sector as a whole and playing it safe through stocks offering strong earnings growth stories based on restructuring efforts. As a reminder, after having played Suez for Q1 2016, **we decided not to put any utilities stocks on the BG Top Picks List for Q2 2016 as we saw limited positive catalysts**. Inside the BG utilities universe (*Albioma, EDF, EDPR, Engie, E.ON, Pennon, RWE, Suez, Veolia and Voltalia)* the top performers were RWE *(+24.7%)* followed by Pennon *(+16.6%)* and Voltalia *(+13.6%)* while the worst performers were the two French environmental services companies we cover: Suez *(-12.7%)* and Veolia *(-8.0%)*. Overall, integrated utilities outperformed environmental services companies. **Both the increase in power prices and positive newsflow** *(potential agreements on nuclear dismantling in Germany, potential carbon floor prices implementation in France)* **have contributed to this performance**. During the quarter, **European power prices** *(forward FY1 power prices for France, Germany, the UK and the Netherlands)* **surged by 26.7% on average** *(vs. a 20% drop in Q1-16)* **while gas (TTF) and coal prices increased by 23.5%** *(vs. -12% in Q1-16)* **and c.28%** *(vs. -4% in Q1-16)* **respectively over the period**.

WHAT WE SEE FOR Q3 2016

As for Q2 2016, during the summer we expect no short term recovery in commodity prices in Europe. As a reminder our **models are marked-to-market** and therefore integrate no upside from any price recovery as yet. Except the traditional H2 earnings publications for almost all our stocks we do not **expect any precise catalysts.** All major events (*investor day, workshop cession*) occurred during Q2-16 and affected positively Engie and RWE. **We remain cautious on the sector** given the lack of visibility on the macro and commodity prices environment, but have to admit that the sector could be played by investors as a defensive means of protecting against Brexit risks given that utilities remain poorly exposed to UK and the sector is not so cyclical.

At this stage we remain Neutral.

CONCLUSIONS AND TOP PICKS

In our last reports, **we updated our models with our latest macro data assumptions** *(update on integrated utilities: Potential upside from higher Brent for EDF & Engie and report on environmental services companies: Haste makes waste, it's upside time!*) which implies no further changes in our FV and estimates today.

We have chosen to put Veolia *(Buy, FV @ EUR23)* **on our BG Top Pick list for Q3 2016** as **1) the stock's derating** over the past quarter *(-8.0% in Q2-16 vs. 2.8% for the Stoxx 600 Utilities)* now implies a **6.5x 2017e EV/EBITDA multiple** - a 4% discount vs. its 6-year historical average – and a 5% discount vs. Suez on comparable basis. **2) Following Brexit, we believe Veolia's exposure to the UK is rather limited today** *(c. 9% of revenues of Group's revenues i.e. EUR2.3bn out of which 80% coming from the waste business)* as GBP headwinds could be partly offset by USD tailwinds for an overall fairly **limited FX impact**. In addition, **Veolia appears well-protected in case of a potential macro downturn in the UK** as around one third of its UK waste revenues are generated by PFI contracts *(around 50% EBITDA margin)* whereas about 70-75% of **volumes are guaranteed**. **3)** Despite, a potential weak sales performance in H1 2016 *(due to FX headwinds, unsupportive weather as well as the downsizing of Veolia Water Technologies)*, **we think Veolia will post a strong and resilient EBITDA performance in line with its 5% organic growth objective**, notably thanks to its ability to **deliver cost-savings measures** *(EUR600m over 2016/2017/2018 i.e. EUR200m per year)*. **4)** Finally, we believe the **Transdev's disposal** – *Transdev is 50% owned by Veolia* – could be a **positive catalyst** in the upcoming quarter. More than the financial part of the disposal *(EUR0.1 positive impact on our FV according to our estimates, assuming a mere 10% capital gain*), **we believe the disposal should 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 ensuring the company's dividends target.**

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BUY ratings 56.8% NEUTRAL ratings 33.8% SELL ratings 9.5%

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