

Central West European Utilities

Where To Focus – September 2013

- **Market Sentiment** — Consensus forward year EPS reduced again in the last month by an average of 2.9%, for a 13% cumulative ytd reduction. The power market continues to be a big driver for these downgrades. Dividend expectations followed the earnings cuts for the power names with E.on and RWE most affected and the 2012-15 DPS CAGR is now a negative 4%. Overall incoming investor interest was down by 30% vs last month and traded volumes are down ytd, over 12 months and vs July. **We view the Market Sentiment developments as still Negative for utilities stocks, with geopolitical uncertainty and the upcoming German elections as headwinds into September.**
- **Commodity Prices** — Absolute power prices remain under pressure, as do spreads, despite modest improvement in clean dark spreads vs last month. The power curve remains in backwardation and the peak base spread compressed in outer years. On the positive side recycle prices have improved vs last month, and are now up yoy, and the oil price has risen, which could help offset profitability impact from H1 output shortfalls. **Overall we view Commodity Prices developments as Modestly Negative for utilities stocks.**
- **Credit Environment** — CDS levels for the French names have largely tightened in contrast to the Central European names where recent credit rating commentary has impacted sentiment. **Overall we view the Credit Environment as Neutral across the utilities stocks.**
- **Citi view** — Market sentiment is likely to remain unchanged until further guidance is provided in Q4. We view earnings and dividends at risk for outer years for the Central European names but generally well anchored for the French, and we therefore maintain our preference for the latter. We remain cautious on the outlook for the power market and believe European political developments might come into play again after a relatively quiet H1 for the sector. **We still see GDFSuez as the best way to play our outlook, and see upside for Veolia, which remains in our sector's Most Preferred list.**

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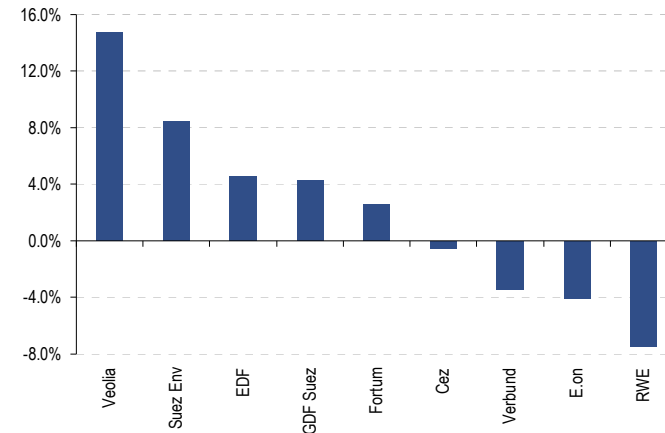
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Market Sentiment

- Over the last month consensus lowered next year's EPS by a further 2.9% on average, bringing the ytd cumulative reduction in estimates to 13% on average
- With the exception of Suez Environnement, EDF and Fortum, all other companies suffered earnings downgrade, Veolia's NY EPS being marked lower by 5.5%, although CEZ, Eon and RWE saw 4-5% downgrades.
- Veolia was the best performing stock during the month, rising 14.7% and is now up 28% ytd, while EON and RWE underperformed around H1 results.

Figure 1. Last month total return (share price performance + dividends)



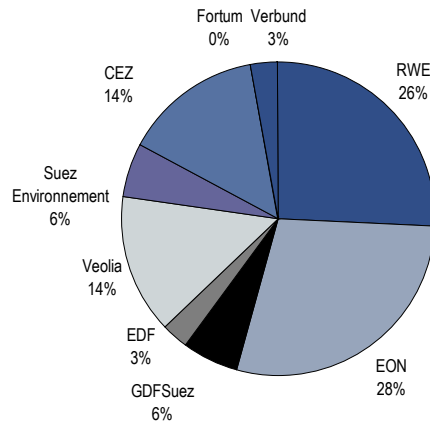
Source: Bloomberg, Citi Research.

Figure 2. Consensus Earnings Forecasts and Revisions in the last month (August 2013)

| | CY EBITDA today | CY EBITDA last month | Current Year EBITDA revision over last month | NY EPS today | NY EPS last month | Next Year EPS revision over last month |
|----------------------|-----------------|----------------------|--|--------------|-------------------|--|
| Fortum | 2,476 | 2,476 | 0.0% | 1.22 | 1.219 | 0.1% |
| Verbund | 1,155 | 1,160 | -0.4% | 0.829 | 0.855 | -3.0% |
| Cez | 81,872 | 82,369 | -0.6% | 59.696 | 62.481 | -4.5% |
| E.on | 9,378 | 9,405 | -0.3% | 1.247 | 1.309 | -4.7% |
| RWE | 8,950 | 8,877 | 0.8% | 3.003 | 3.13 | -4.1% |
| GDF Suez | 13,543 | 13,492 | 0.4% | 1.386 | 1.391 | -0.4% |
| EDF | 16,455 | 16,184 | 1.7% | 2.044 | 2.021 | 1.1% |
| Veolia Environnement | 2,027 | 2,080 | -2.5% | 0.584 | 0.618 | -5.5% |
| Suez Environnement | 2,490 | 2,495 | -0.2% | 0.735 | 0.706 | 4.1% |

Source: Bloomberg, Citi Research.

Figure 3. Client interest by stock



Source: Citi Research

- Overall incoming investor interest in these 9 utilities fell 31% vs last month.
- Investor interest was focused on the two large cap vertically integrated utilities: EON and RWE due to rating newsflow and results
- Veolia also saw reasonable interest as improving economic sentiment focused the market on the prospects for recovery and delivery on the group's restructuring program.

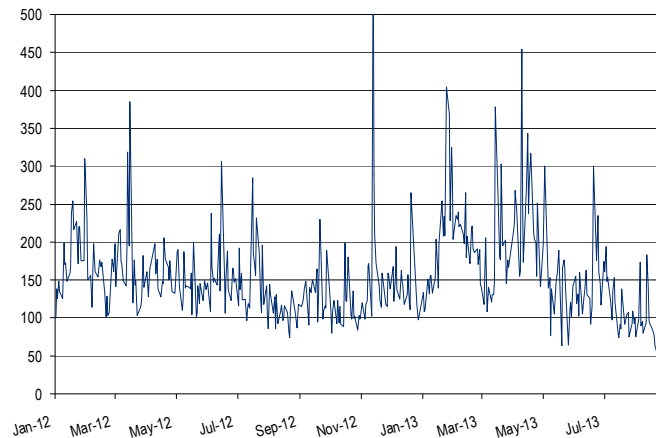
Figure 4. Dividend expectations by analysts and swaps market

| | Divswaps | | | Consensus | | | | |
|----------------------------------|----------|------|------|-----------|-------|-------|-----------------|-----------------|
| | FY12A | FY13 | FY14 | FY13 | FY14 | FY15 | 2012-14 CAGR | 2012-15 CAGR |
| Fortum | 0.98 | N/A | N/A | 1.00 | 0.96 | 0.96 | -0.8% | -0.7% |
| Verbund | 0.56 | N/A | N/A | 0.98 | 0.46 | 0.49 | -6.6% | -4.7% |
| Cez | 40.00 | N/A | N/A | 40.30 | 35.51 | 32.98 | -3.9% | -6.2% |
| E.on | 1.10 | 1.10 | 0.64 | 0.70 | 0.69 | 0.68 | -14.6% | -14.7% |
| RWE | 2.02 | 2.00 | 1.62 | 1.97 | 1.54 | 1.46 | -8.7% | -10.3% |
| GDF Suez | 1.50 | 1.50 | 1.30 | 1.50 | 1.48 | 1.37 | -0.6% | -3.1% |
| EDF | 1.16 | N/A | N/A | 1.19 | 1.23 | 1.31 | 2.0% | 4.3% |
| Veolia Environnement | 0.70 | N/A | N/A | 0.69 | 0.67 | 0.68 | -1.7% | -1.1% |
| Suez Environnement | 0.65 | N/A | N/A | 0.65 | 0.65 | 0.66 | -0.2% | 0.1% |
| Source: Bloomberg, Citi Research | | | | | | | | |

Source: Bloomberg, Citi Research

- Dividend expectations were lowered again with the 2012-14 and 2012-15 CAGR down to -3.9% and -4% respectively. The 2012-15 CAGR was -3.2% last month
- There is only one stock that the sell-side expects to see dividend growth – EDF. Eon, RWE and Verbund all saw significant reductions in dividend growth expectations following results and EPS downgrades highlighted above.
- Consensus DPS expectations are now more inline with the divswaps markets having been appreciably higher than divswaps last month.

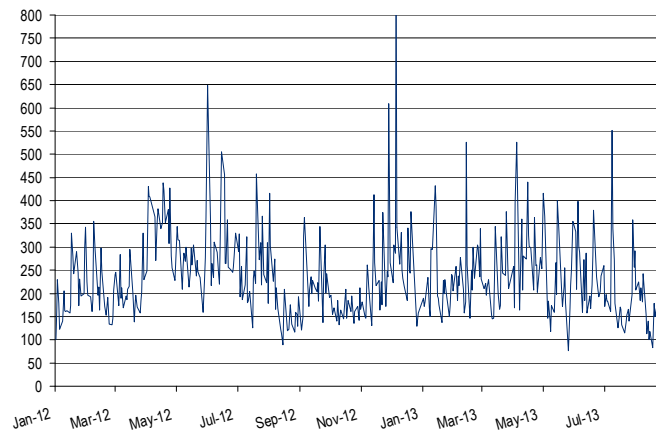
Figure 5. Shares Traded Volume Index for Central and North European Utilities



Source: Citi Research, Bloomberg

- Volumes traded for the overall group were down considerably over the last month although the summer month is likely to be a considerable factor here. Volumes in August were 14% lower than those in July on average.
- However, this is split as a ~21% drop in traded volumes for the Central and North European utilities (EON, RWE, Forum) and a 10% increase for the French Utilities

Figure 6. Shares Traded Volume Index for French Utilities

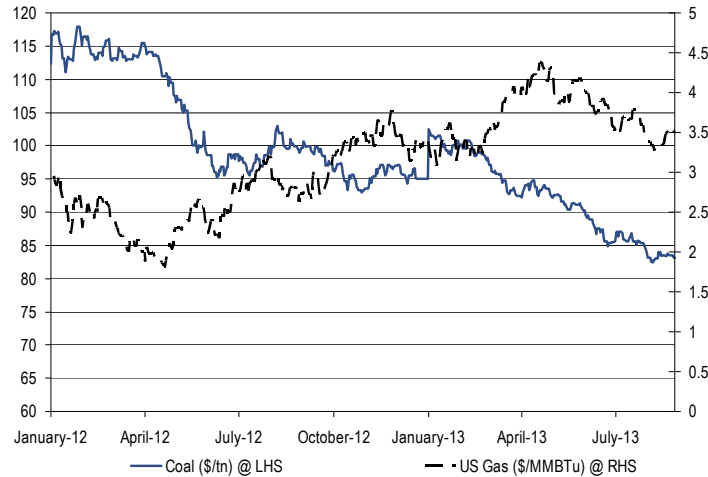


Source: Citi Research, Bloomberg

- Over 12 months, to capture the seasonal effects of summer, traded volumes are down 10% for August vs. 2012, -8% for the French Utilities and -13.5% for the Central and North European stocks.

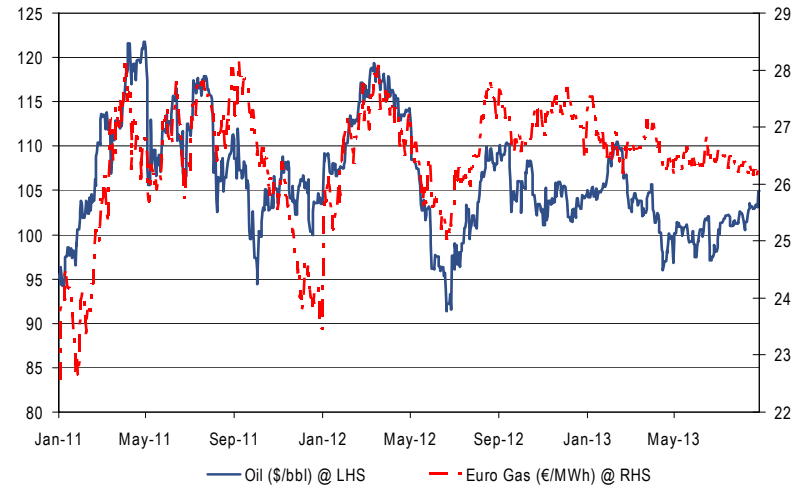
Energy Price Trends

Figure 7. Coal prices vs US gas prices



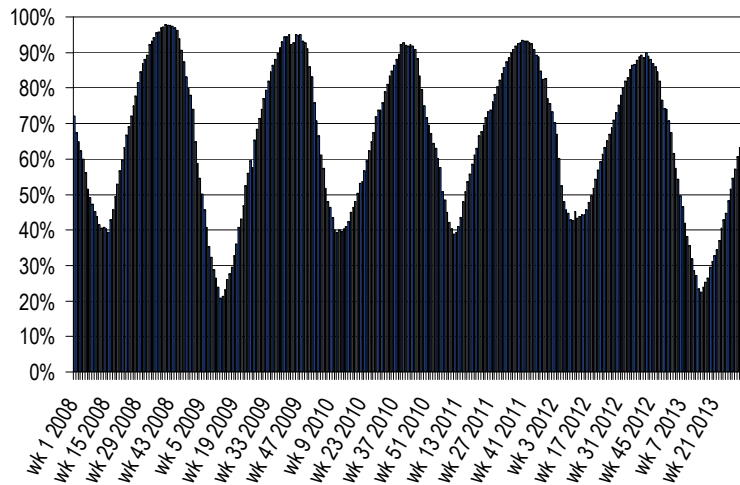
Source: Bloomberg, Datastream, Citi Research

Figure 8. Oil prices vs European Gas prices



Source: Bloomberg, Datastream, Citi Research

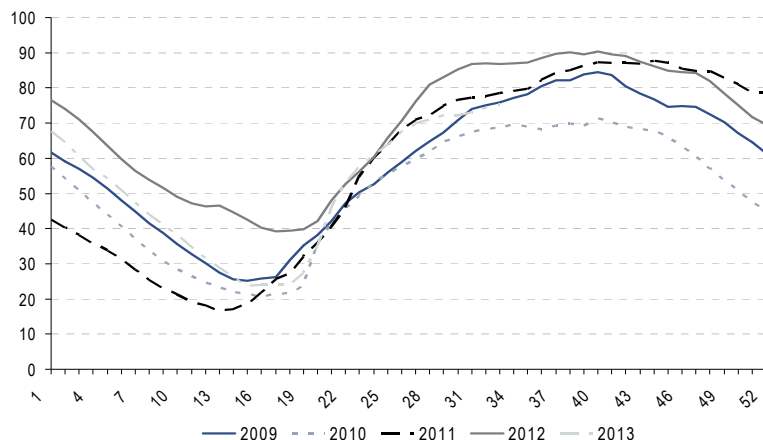
Figure 9. Europe Gas Storage % fill



Source: GSE, Citi Research

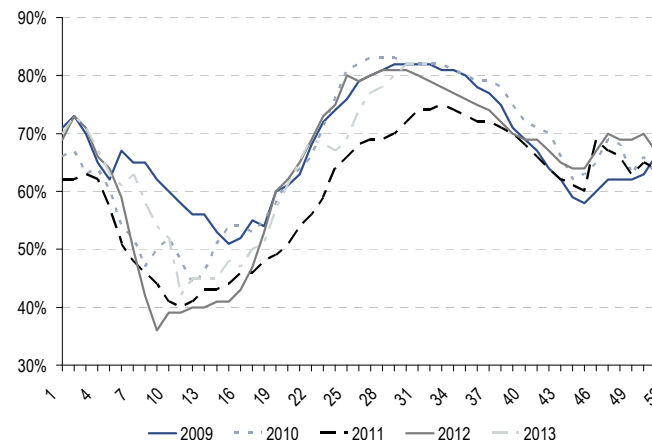
- Gas storage fill levels rose to 68%, some 14ppts lower than the same time last year.
- This slower refilling of gas storage has provided support to European gas prices, which despite the summer months have held flat.
- Coal prices are still under pressure with year forward at \$83/tn while US gas prices continue to be below \$4/MMBtu, maintaining the competitiveness of the US gas fleet versus coal plants with impacts in the overall global supply of coal

Figure 10. Nordic Hydro Reserves (% fill by week of the year)



Source: Nordpool, Citi Research

Figure 11. French Hydro Reserves (% fill by week of the year)



Source: RTE, Citi Research

- Nordic hydro reserves were 75% full by week 33 of the year.
- This was a higher monthly increase compared to the previous year but the reserves are still over 11pts lower than a year ago.
- We view fill levels as continuing to support near-term power prices and this partly explains the backwardation in the forward curve.
- On our estimates, Fortum is 55% hedged for 2014 so firm 1yr fwd power prices are likely to be supportive for the stock with nearly half of output remaining exposed.

- French hydro reserves were 82% full by week 32 of the year, the highest they have been since 2010 at this time of year and slightly ahead of average for this time of year.
- Hydro reserves depleted more than usual in H1 as cold weather and weak nuclear production caused higher hydro production. However, hydro reserves have recovered and could help to insulate EDF's earnings in H2 if nuclear production doesn't improve as we anticipate.

Figure 12. German Baseload Forward Power Prices (€/MWh)



Source: Bloomberg, Citi Research

Figure 13. German Peakload Forward Power Prices (€/MWh)



Source: Bloomberg, Citi Research

Figure 14. German Clean Dark Spreads @ 40% and 48% Plant Efficiency (€/MWh)



Source: Bloomberg, Citi Research

Figure 15. German Clean Spark Spreads @ 50% and 60% Plant Efficiency (€/MWh)



Source: Bloomberg, Citi Research

Figure 16. Nordic Baseload Power 1-3yr Forward Curve (€/MWh)



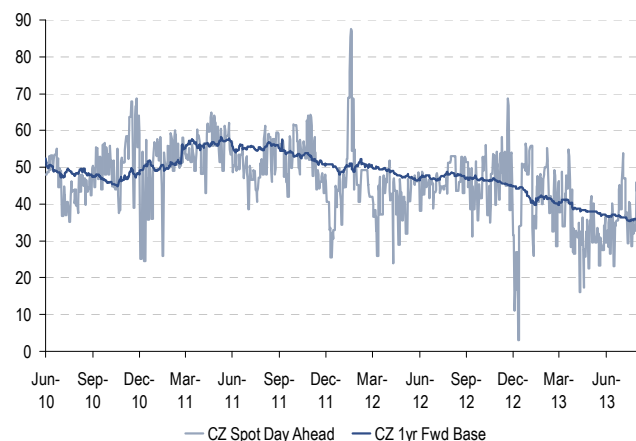
Source: Bloomberg, Citi Research

Figure 17. Nordic System Average Spot Power Price (€/MWh)



Source: Bloomberg, Citi Research

Figure 18. Czech 1yr Forward Baseload and Day Ahead Spot Power Prices (€/MWh)



Source: Bloomberg, Citi Research

- The power curve declined across the board during the last month by 2-3% and now stands sub €37/MWh in Germany on the baseload and sub €47/MWh on the peakload.
- The decline was driven primarily from lower fuel costs, particularly coal prices, as clean dark spreads improved slightly. Spark spreads deteriorated further and stayed negative as gas prices held up in Europe.
- The Nordic curve increased slightly by 1.5-2%, reflecting the lower than average hydro conditions.
- Czech prices, tracked German prices lower and are now below €36/MWh, with a consistent €1/MWh gap vs Germany.
- Uncertainty over longer term policy is likely to increase as we head into the final stretch before the German national elections in September and that could cause reduced liquidity in the forward curve ahead of this which could affect hedging strategies for E.ON, RWE, CEZ and Verbund.

Figure 19. Year 3 To Year 1 Contango in Central European power curve (€/MWh)



Source: Bloomberg, Citi Research

Figure 20. Differential of Peak to Base Power Prices in Central Europe (€/MWh)



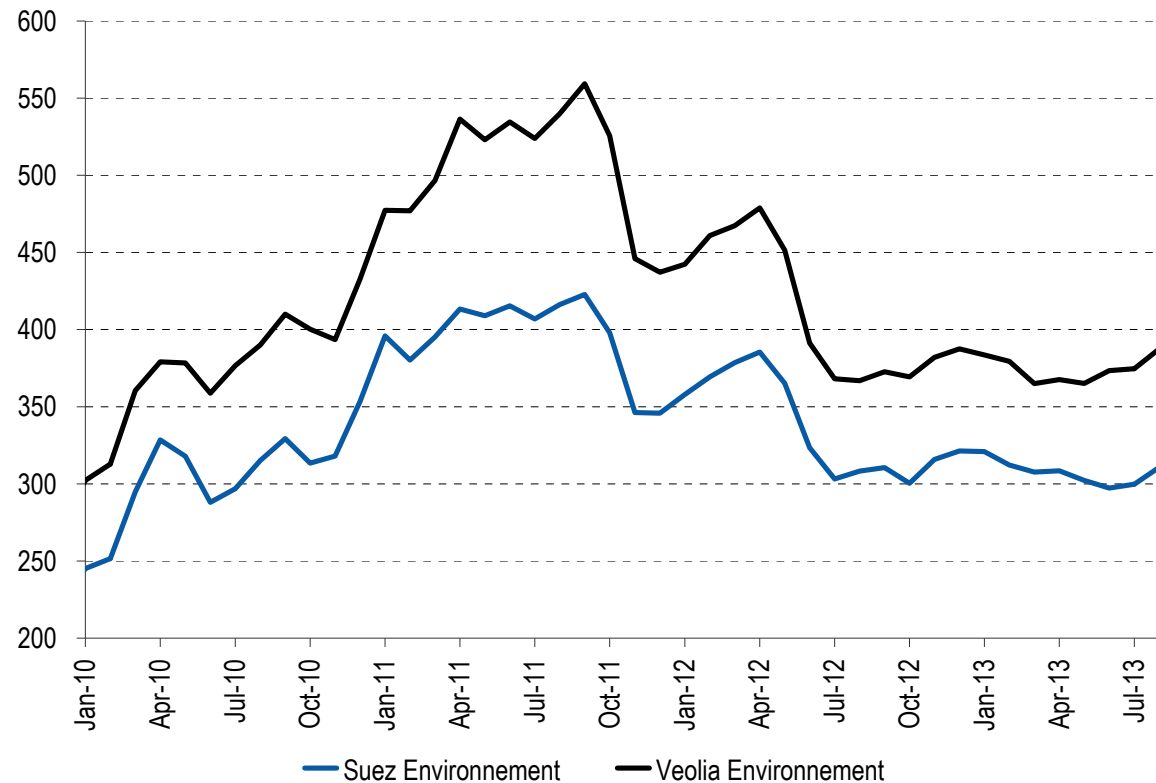
Source: Bloomberg, Citi Research

- We are now in the sixth month running that the German power curve has been in slight backwardation, although the discount of YR3 power prices vs YR1 has reduced to below €1/MWh.
- The backwardation in the market reflects the increasing impact of solar output and is likely to increase as installations moves towards the Government's 52GW target.
- In our note [The Lost Decade: Where Next](#), we detailed our view on how the game changing effects of energy efficiency and renewables should drive changes in the remuneration structures of utilities and the overall regulatory regime.
- The peak to base spread remained flat at ~€10/MWh for the forward year, but declined by 3-4% for the outer years to €9/MWh. This should continue to put pressure on CCGT profitability.
- The ongoing increase in renewable installations is in our opinion going to depress that spread further, ultimately causing peak pricing to be a product of little relevance for the utility industry.

Recyclate Prices

Figure 21. Veolia Environnement and Suez Environnement custom recycle price index

- Our custom recycle price indices for Veolia and Suez Environnement have moved into positive territory YoY and are up 6% and 1% respectively (Aug '13 vs Aug '12)
- The ytd averages are 12% and 12.5% down y-o-y, respectively
- The implied annualized average for 2013, assuming stability from here on, is down 8% for both indices
- Today's level is 3% down for Veolia and flat for Suez Environnement.



Source: www.revipap.com, www.acier.org, www.letsrecycle.com, Citi Research

Credit Trends

Figure 22. Fortum 5yr CDS (bps)



Source: Bloomberg, Citi Research

Figure 23. E.ON 5yr CDS (bps)



Source: Bloomberg, Citi Research

Figure 24. RWE 5yr CDS (bps)



Source: Bloomberg, Citi Research

- E.ON and RWE's 5-year CDS widened following Fitch's downgrade and are now above the rolling 12m average, while Fortum is trading comfortably below it
- The gap is 8.5bps for Fortum, 1bp for E.ON and 10bps for RWE
- The 12 month rolling average is down 4bps for Fortum ytd, down 11bps for E.ON and down 14bps for RWE.
- Fortum outperformed over the last month, as its CDS tightened by 5bps, and is now trading c.25bps tighter than E.ON and 45bps tighter than RWE
- While company specific information continues to weigh considerably in terms of price action, the market is mainly driven by movements in rates and possible Fed tapering

Figure 25.GSZ 5yr CDS (bps)



Source: Bloomberg, Citi Research

Figure 26.EDF 5yr CDS (bps)



Source: Bloomberg, Citi Research

Figure 27.Veolia 5yr CDS (bps)



Source: Bloomberg, Citi Research

- The 5-year CDS of the French continues to trade below their 12 month rolling averages contrary to the experience of the Central European names.
- The gap is 16bps for GDFSuez, 20bps for EDF and 24.5bps for Veolia
- The 12 month rolling average is down month on month and ytd it is down 19bps for GDFSuez, 28bps for EDF and 35bps for Veolia
- Despite the recent push higher, with the exception of Veolia, the French utilities 5 year CDS tightened month-on-month, continuing the trend started at the end of June.

Figure 28. Citi Utilities Recommendations (Local Currency)

| RIC | Stock | Rating | Current Price | Target Price |
|----------|----------------------|---------|---------------|--------------|
| VERB.VI | Verbund | Sell | 14.68 | 13.00 |
| CEZP.PR | CEZ | Neutral | 455.60 | 465.00 |
| FUM1V.HE | Fortum | Neutral | 15.18 | 14.00 |
| EONGn.DE | E.ON | Sell | 12.08 | 11.50 |
| RWEG.DE | RWE | Neutral | 21.16 | 22.50 |
| GSZ.PA | GDF Suez | Buy | 16.52 | 18.00 |
| EDF.PA | EDF | Neutral | 21.26 | 20.00 |
| VIE.PA | Veolia Environnement | Buy | 11.49 | 13.00 |
| SEVI.PA | Suez Environnement | Neutral | 11.19 | 12.00 |

Source: Citi Research

Appendix A-1

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| | 12 Month Rating | | | Relative Rating | | |
|--|-----------------|------|------|-----------------|------|------|
| | Buy | Hold | Sell | Buy | Hold | Sell |
| Data current as of 30 Jun 2013 | | | | | | |
| Citi Research Global Fundamental Coverage | 48% | 40% | 12% | 6% | 88% | 6% |
| % of companies in each rating category that are investment banking clients | 53% | 50% | 45% | 58% | 51% | 49% |

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