19 November 2015

HSBC Global Research

Drax Group PLC (DRX LN)

Reduce: Cut TP to 190p on lower power price outlook

EQUITIES
ELECTRIC UTILITIES

United Kingdom

- Commodities continue to slide
- EU needs to agree on Contract for Difference (CfD) in order to stabilise earnings; Gov't policy puts future of coal in doubt
- TP cut to 190p from 230p on lower power price forecasts; we remove yield from our valuation methodology

MAINTAIN REDUCE

TARGET PRICE (GBPp)	PREVIOUS TARGET (GBPp)
190	**230**

SHARE PRICE (GBPp)	UPSIDE/DOWNSIDE
227	**-16.1%**

(as of 17 Nov 2015)

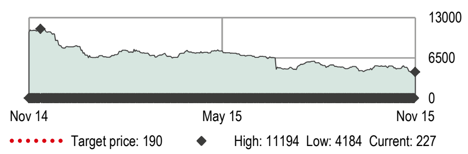
MARKET DATA

Market cap (GBPm)	920	Free float	100%
Market cap (USDm)	1,400	BBG	DRX LN
3m ADTV (USDm)	14	RIC	DRX.L

FINANCIALS AND RATIOS (GBPp)

Year to	12/2014a	12/2015e	12/2016e	12/2017e
HSBC EPS	23.85	13.27	5.94	6.53
HSBC EPS (prev)	-	6.57	6.28	7.77
Change (%)	-	102.0	-5.4	-16.0
Consensus EPS	21.69	11.74	4.55	10.66
PE (x)	9.5	17.1	38.2	34.7
Dividend yield (%)	5.3	2.9	1.3	1.4
EV/EBITDA (x)	4.4	6.4	8.2	7.8
ROE (%)	6.4	3.4	1.5	1.7

52-WEEK PRICE (GBPp)



Source: HSBC estimates, Thomson Reuters IBES

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Power price slide since H1

At the H1, Drax indicated that it had contracts in place for over 50% of its power sold forward for 2016 at an average price of GBP48MWh compared with 1 year forward rates today of GBP39MWh. Even though Drax has three units generating power from renewable biomass the Renewable Obligation Certificates it receives for this are paid on top of a falling power price. We now assume an achieved price (pre subsidy) of GBP38MWh for 2017 (previously GBP45MW/h). With these low power prices we think there is some risk that the coal plant value will be impaired given the market cap of Drax is at a 45% discount to the book value at December 2014.

No visibility on state aid approval for a Contract for Difference, DECC anti coal

A key earnings stabilisation factor would be the recognition that biomass was eligible for state aid through a Contract for Difference at a set price (Drax has asked for GBP105MWh - we assume it achieves GBP95MWh). However uncertainty remains on the timing of the decision by the EU. Drax publishes its 3m trading statement to the end of September on 24 November. We expect some commentary about its forward sales of electricity for 2016 and beyond. On 18 November Amber Rudd, Secretary of State for Energy and Climate Change (DECC) announced that she will be launching a consultation in the spring on when to close all unabated coal-fired power stations. She said "If we take this step, we will be one of the first developed countries to deliver on a commitment to take coal off the system."

Maintain Reduce, TP cut to 190p from 230p on lower power prices

We have reduced our estimates (EPS by 5% for 2016 and 16% for 2017) because of new lower power price assumptions. This reduces our TP to 190p from 230p. Given the low earnings outlook for 2016 and 2017, we are also removing our yield valuation for Drax and now only use a DCF valuation. We do not believe yield is a consideration for investors given the current challenging environment. Our DCF-based valuation assumes a WACC of 7.34%, comprising a 4.0% cost of debt and 8.6% cost of equity. Our new target price of 190p implies downside of c16% from the current share price; we maintain our Reduce rating.

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Financials & valuation

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (GBPm)				
Revenue	2,805	2,734	2,826	2,990
EBITDA	229	166	130	131
Depreciation & amortisation	-81	-99	-81	-81
Operating profit/EBIT	149	67	49	50
Net interest	-29	-30	-19	-18
PBT	166	37	30	32
HSBC PBT	166	37	30	32
Taxation	-37	-7	-6	-6
Net profit	129	30	24	26
HSBC net profit	96	54	24	26
Cash flow summary (GBPm)				
Cash flow from operations	90	161	95	88
Capex	-200	-150	-80	-40
Cash flow from investment	-220	-150	-80	-40
Dividends	-55	-48	-27	-12
Change in net debt	170	37	12	-36
FCF equity	-120	-13	15	48
Balance sheet summary (GBPm)				
Intangible fixed assets	11	11	11	11
Tangible fixed assets	1,697	1,749	1,747	1,706
Current assets	1,156	1,172	1,217	1,279
Cash & others	221	257	276	291
Total assets	2,975	3,042	3,086	3,107
Operating liabilities	833	821	836	863
Gross debt	320	393	425	403
Net debt	99	136	148	112
Shareholders' funds	1,573	1,578	1,575	1,590
Invested capital	1,810	1,853	1,862	1,841

Ratio, growth and per share analysis

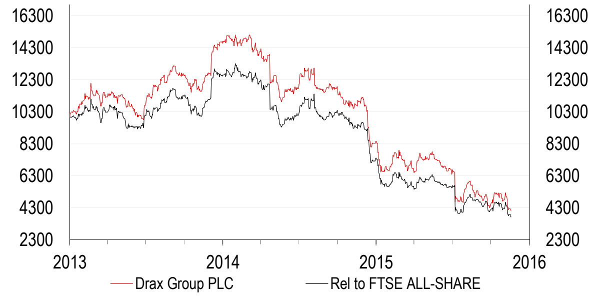
Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	36.0	-2.5	3.3	5.8
EBITDA	-0.3	-27.8	-21.5	1.1
Operating profit	170.4	-54.9	-27.2	3.1
PBT	422.3	-77.7	-20.1	8.6
HSBC EPS	-31.8	-44.4	-55.3	10.0
Ratios (%)				
Revenue/IC (x)	1.7	1.5	1.5	1.6
ROIC	6.9	2.9	2.1	2.2
ROE	6.4	3.4	1.5	1.7
ROA	5.5	1.8	1.3	1.3
EBITDA margin	8.2	6.1	4.6	4.4
Operating profit margin	5.3	2.5	1.7	1.7
EBITDA/net interest (x)	8.0	5.5	6.8	7.3
Net debt/equity	6.3	8.6	9.4	7.0
Net debt/EBITDA (x)	0.4	0.8	1.1	0.9
CF from operations/net debt	91.0	118.1	63.8	79.0
Per share data (GBPp)				
EPS reported (diluted)	32.03	7.33	5.94	6.53
HSBC EPS (diluted)	23.85	13.27	5.94	6.53
DPS	11.93	6.63	2.97	3.26
Book value	390.71	390.27	389.57	393.13

Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	0.4	0.4	0.4	0.3
EV/EBITDA	4.4	6.4	8.2	7.8
EV/IC	0.6	0.6	0.6	0.6
PE*	9.5	17.1	38.2	34.7
PB	0.6	0.6	0.6	0.6
FCF yield (%)	-13.1	-1.5	1.6	5.3
Dividend yield (%)	5.3	2.9	1.3	1.4

* Based on HSBC EPS (diluted)

Price relative



Source: HSBC

Note: Priced at close of 17 Nov 2015

HSBC

Lower power price, lower earnings

- Commodities continue to slide
- EU needs to agree on the Contract for Difference (CfD) in order to stabilise earnings – no visibility as yet; UK government policy puts future of unabated coal in doubt
- TP cut to 190p from 230p on lower power price forecasts; we remove yield from our valuation methodology

Power price slide since H1

Power price decline: One year forward wholesale price GBP39WW/h compared to Drax's achieved price for 2016 of GBP48.5/MWh

At the H1 Drax indicated that it had contracts in place for over 50% of its power sold forward for 2016 at an average price of GBP48.5MWh compared with 1 year forward rates today of GBP39MWh.

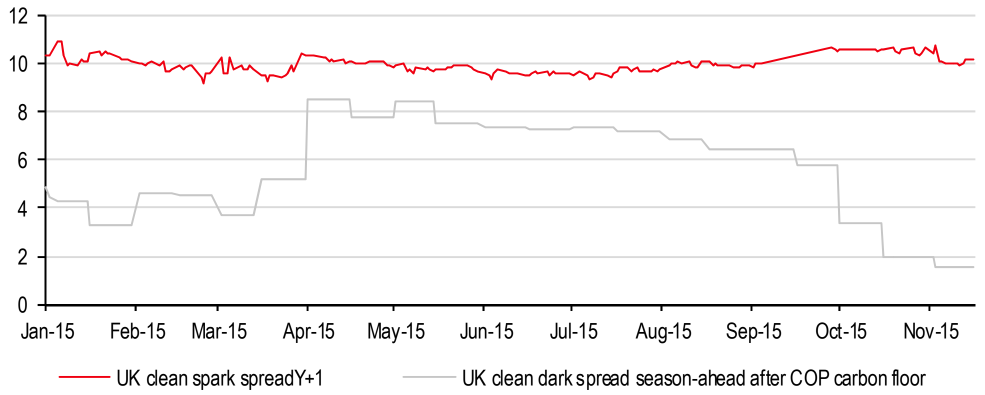
Even though Drax has three units generating power from renewable biomass it is still at the mercy of the wholesale power price as the Renewable Obligation Certificates it receives are paid on top of a falling power price. We assume an achieved price of GBP44MWh for 2016e and GBP38MWh for 2017. Although our 2016 estimates remain broadly unchanged, we now assume a marked decline in 2017.

Estimate changes	2016e	2017e
Achieved power price (GBP/MWh)		
Revised	44.0	38.0
Previous	44.0	45.0
% change	*-0.0%*	*-15.6%*

Source: HSBC estimates

The charts below shows that the UK spark spread has been relatively flat as power prices and gas have fallen. However, season-ahead clean UK dark spreads, after inclusion of the CPS carbon floor, have narrowed from just below GBP5/MWh at the end of 2014 to below GBP2/MWh as of mid-November for a 35%-efficiency plant (Drax has an efficiency of nearly 40%).

UK clean spark spreads Y+1 and season-ahead clean dark spreads (after COP carbon-floor) in GBP/MWh



Source: Thomson Reuters Datastream

With these low power prices we think there is some risk that its coal plant value will be impaired given the market cap of Drax is at a 45% discount to the book value at December 2014. Optically this may improve Drax's earnings for 2016 and 2017. We assume there will be an impairment of Drax's coal assets, which would have the effect of reducing Drax's depreciation charge by GBP20m from 2016. This might explain why our EPS forecast for 2016 is higher than consensus (4.55p) at 5.94p (see page 1).

Power market lack of resilience still not reflected in forward prices

There is considerable uncertainty about the resilience of the power market as coal-fired generation closes in spring 2016 driven by lower prices and the UK Government's Carbon Price Floor, which will be at GBP17.50 from 1 April 2016. The forward electricity market does not seem to be factoring in the falling reserve margin and scarcity of flexible thermal generation. This could change but we continue to mark-to-market our power price assumptions.

We believe a key earnings stabilisation factor would be the recognition that biomass was eligible for state aid through a Contract for Difference at a set price (Drax has asked for GBP105MWh - we assume it achieves GBP95MWh). However uncertainty remains on the timing of the decision by the EU. The Contract was notified by Government to EU in April 2015. When approval is gained Drax will fully convert its third unit.

The future of Drax's 3 remaining unabated coal stations (without carbon capture and storage) seem to be less certain given the comments by the Energy Secretary Amber Rudd in recent months who favours gas-fired thermal generation and nuclear energy. In a speech given on 18 November published on the DECC website, she said:

"Unabated coal is simply not sustainable in the longer term. In an ideal world, the carbon price provided by the ETS would phase out coal for us using market signals. But it's not there yet. So I want to take action now. I am pleased to announce that we will be launching a consultation in the spring on when to close all unabated coal-fired power stations."

> **"Our consultation will set out proposals to close coal by 2025 - and restrict its use from 2023. If we take this step, we will be one of the first developed countries to deliver on a commitment to take coal off the system.**
>
> **Amber Rudd, Secretary of State for Energy and Climate Change**

Trading statement due 24 Nov; we expect guidance on the amount and price achieved for additional power sold forward for 2016 at lower prices

Drax publishes its 3m trading statement to the end of September on 24 November. We expect some commentary about its forward sales of electricity for 2016 and beyond and some update to its 2015 guidance given power price volatility over the last three months.

Rating and Valuation

We have reduced our estimates (EPS by 5% for 2016 and 16% for 2017) because of new lower power price assumptions. However we increase our 2015e DPS from 3.2p to 6p. Drax has a 50% payout policy. The company flagged at the H1 results that it will have a cGBP25m tax credit as a result of the change in UK corporation tax which, although non-recurring, will nevertheless be used to pay the 2015 dividend. Given the low earnings outlook for 2016 and 2017 we are removing our yield valuation for Drax and now use only a DCF valuation. We do not believe yield is a consideration for investors given the current challenging environment.

Our DCF-based valuation assumes a WACC of 7.34%, comprising a 4.0% cost of debt and 8.6% cost of equity (all unchanged). Our new target price of 190p implies downside of c16% from the current share price; we maintain our Reduce rating because the announcement of a consultation on the future of coal by the UK Government adds an extra dimension of uncertainty to the Drax investment proposition.

Valuation summary

GBPp	Revised	Previous
Current price as on 17-Nov-15	**227**	**NA**
DCF	191	262
Yield (no longer used)		205
Target price (rounded)	**190**	**230**
Upside/downside (%)	-16.1	NA
Rating	**Reduce**	**Reduce**

Source: HSBC estimates

DCF and WACC assumptions:

WACC inputs		Equity valuation	GBPm
Pre-tax cost of debt	5.0%	DCF value	1,017
Marginal tax rate	18%	Associates and ST marketable assets	-
Risk-free rate	3.5%	**EV (asset side)**	**1,017**
Equity risk	4.0%	Less: Financial net debt	-136
Additional risk	0.0%	Less: Others	-110
Beta	1.28	**Total non-equity liabilities**	**-246**
Debt - 30%	4.1%	**Value of equity**	**771**
Equity - 70%	8.6%	0	0
Cost of Capital	**7.3%**	**DCF value per share - GBp**	**191**

Source: HSBC estimates

Our stage 2 DCF valuation now assumes an EBIT margin of 1.7% previously 2.2%. Our terminal growth rate remains unchanged at zero.

Risks to our rating

Upside risks: The key risk is higher than anticipated power prices reflecting a tightening market. In addition the December capacity auctions could see higher capacity payments from 2019 onwards. There could be upside if the Secretary of State concludes her review and decides there is a place for unabated coal in the UK's generation mix. If the EU agrees to a CfD of GBP105MW/h this could underpin the stability on one unit of biomass generation in a falling power price environment.

Disclosure appendix

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From 23rd March 2015 HSBC has assigned ratings on the following basis:

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

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For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands were classified as Neutral.

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Rating distribution for long-term investment opportunities

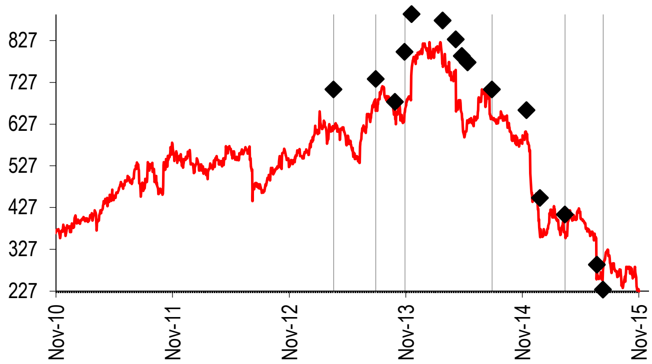
As of 18 November 2015, the distribution of all ratings published is as follows:

Buy	45%	(31% of these provided with Investment Banking Services)
Hold	41%	(29% of these provided with Investment Banking Services)
Sell	14%	(17% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see “Stock ratings and basis for financial analysis” above.

Share price and rating changes for long-term investment opportunities

Drax Group PLC (DRX.L) Share Price performance GBp Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Neutral	Overweight	05 April 2013
Overweight	Neutral	15 August 2013
Neutral	Overweight	14 November 2013
Overweight	Neutral	14 August 2014
Neutral	Hold	31 March 2015
Hold	Reduce	28 July 2015

Target Price	Value	Date
Price 1	710	05 April 2013
Price 2	735	15 August 2013
Price 3	680	14 October 2013
Price 4	800	14 November 2013
Price 5	890	06 December 2013
Price 6	875	13 March 2014
Price 7	830	23 April 2014
Price 8	790	12 May 2014
Price 9	775	30 May 2014
Price 10	710	14 August 2014
Price 11	660	01 December 2014
Price 12	450	12 January 2015
Price 13	410	31 March 2015
Price 14	290	09 July 2015
Price 15	230	28 July 2015

Source: HSBC

HSBC & Analyst disclosures

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Company	Ticker	Recent price	Price Date	Disclosure
DRAX GROUP PLC	DRX.L	2.26	18-Nov-2015	2, 7

Source: HSBC

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