

Energias de Portugal (EDP PL)

Hold

Target price (EUR)	3.50
Share price (EUR)	3.25
Upside/Downside (%)	7.7

Dec	2014 a	2015 e	2016 e
HSBC EPS (EUR)	0.26	0.26	0.27
HSBC PE	12.6	12.5	12.1
Performance	1M	3M	12M
Absolute (%)	-7.0	-3.8	-1.0
Relative ^A (%)	-2.4	2.9	-1.3

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Downgrade to Hold: Rising risk premium in Portugal

- ▶ **Political developments in Portugal have created uncertainty which is negative for sovereign bonds and energy regulation**
- ▶ **Appealing valuation metrics (PE at 12x and DY >5.5% for 2016e) may be overshadowed by these political concerns**
- ▶ **Downgrade to Hold from Buy, cutting target price to EUR3.50 from EUR3.80 reflecting higher equity risk premium**

Downgrade to Hold from Buy. The recent political developments in Portugal (where a leftist coalition has forced the current centre-right government to step down after a confidence vote) are negative for EDP's equity story. The Socialist Party leader claims he should be able to form a government by virtue of an unprecedented deal with the Left Bloc and Communist Party. Under such a scenario many uncertainties could emerge: what would the new government's fiscal policy be? what would the impact on sovereign bond yields be and how would the new government deal with Portugal's energy policy? (in order to remove the tariff deficit, Portugal would need to raise tariffs every year until 2019e, which for EDP implies recovering EUR2.2bn in receivables).

Appealing metrics could be overshadowed by rising sovereign concerns. We still find EDP's equity story attractive: the stock trades at an attractive discount to peers with an equally attractive dividend yield of more than 5.5%; FCF generation is improving and we see medium-term earnings growth from asset growth and cheaper cost of debt. But the stock is likely to be negatively impacted by political and sovereign concerns following the recent political developments and is likely to remain under pressure until there is greater visibility on the new government and the implications (if any) for the electricity industry. EDP has less than 50% of its EBITDA generated in Portugal, but as a proxy for the Portuguese stock market (it has one of the largest weightings in the Portuguese PSI 20 main index), we believe it will be difficult for it to outperform in an environment of rising uncertainty.

We cut our target price to EUR3.50 from EUR3.80. In order to reflect the rising sovereign and political concerns in Portugal, we are including 1% specific equity risk premium in our WACC calculation (from 6.0% to 6.4%) and increasing the target valuation yield to 5.5% from 5.0% before. Our new fair value target price of EUR3.50 is based on the rounded weighted average of DCF (25% weighting), sum-of-parts (25% weighting) and yield (50% weighting) valuations. Although our revised TP implies 8% upside, we downgrade the stock to Hold from Buy because of the uncertainty linked to growing political concerns.

^A Index	PSI 20
Index level	5,256
RIC	EDP.LS
Bloomberg	EDP PL

Source: HSBC

Enterprise value (EURm)	31,351
Free float (%)	75%
Market cap (USDm)	12,626
Market cap (EURm)	11,808

Source: HSBC

Financials & valuation

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (EURm)				
Revenue	14,957	14,715	15,133	15,643
EBITDA	3,642	3,862	3,798	3,951
Depreciation & amortisation	-1,449	-1,437	-1,477	-1,516
Operating profit/EBIT	2,193	2,425	2,321	2,434
Net interest	-878	-779	-722	-680
PBT	1,636	1,761	1,705	1,830
HSBC PBT	1,636	1,761	1,705	1,830
Taxation	-372	-403	-386	-415
Net profit	1,041	1,021	1,056	1,111
HSBC net profit	941	951	986	1,041

Cash flow summary (EURm)

Cash flow from operations	1,901	2,546	2,678	2,816
Capex	-1,872	-1,707	-1,331	-1,346
Cash flow from investment	-1,462	-1,131	-1,331	-1,346
Dividends	-796	-796	-796	-796
Change in net debt	-41	-148	-530	-654
FCF equity	-292	723	1,242	1,395

Balance sheet summary (EURm)

Intangible fixed assets	9,134	9,134	9,134	9,134
Tangible fixed assets	20,523	20,793	20,648	20,477
Current assets	11,354	12,167	12,329	12,502
Cash & others	2,614	2,614	2,614	2,614
Total assets	42,873	43,230	43,247	43,250
Operating liabilities	7,661	7,636	7,692	7,762
Gross debt	19,656	19,508	18,978	18,324
Net debt	17,042	16,894	16,364	15,710
Shareholders' funds	8,681	8,835	9,025	9,269
Invested capital	30,736	31,844	31,804	31,738

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
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Y-o-y % change

Revenue	-0.5	-1.6	2.8	3.4
EBITDA	0.8	6.0	-1.7	4.0
Operating profit	5.5	10.6	-4.3	4.9
PBT	18.9	7.6	-3.2	7.3
HSBC EPS	-6.0	1.1	3.7	5.6

Ratios (%)

Revenue/IC (x)	0.5	0.5	0.5	0.5
ROIC	5.5	6.0	5.6	5.9
ROE	11.0	10.9	11.0	11.4
ROA	4.6	4.6	4.4	4.5
EBITDA margin	24.4	26.2	25.1	25.3
Operating profit margin	14.7	16.5	15.3	15.6
EBITDA/net interest (x)	4.1	5.0	5.3	5.8
Net debt/equity	142.4	135.6	126.7	116.7
Net debt/EBITDA (x)	4.7	4.4	4.3	4.0
CF from operations/net debt	11.2	15.1	16.4	17.9

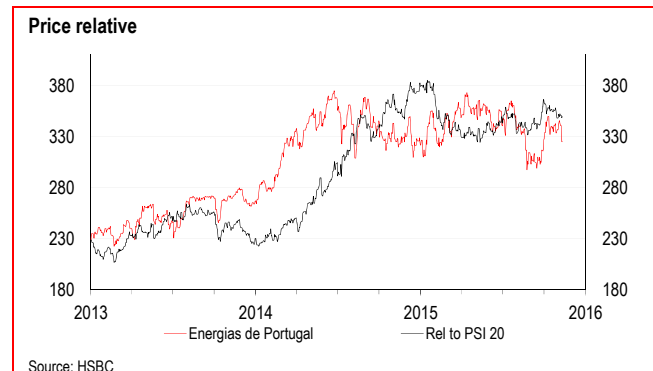
Per share data (EUR)

EPS reported (diluted)	0.28	0.28	0.29	0.30
HSBC EPS (diluted)	0.26	0.26	0.27	0.28
DPS	0.19	0.19	0.19	0.19
Book value	2.37	2.42	2.47	2.54

Valuation data

Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	2.1	2.1	2.1	2.0
EV/EBITDA	8.6	8.1	8.2	7.8
EV/IC	1.0	1.0	1.0	1.0
PE*	12.6	12.5	12.1	11.4
PB	1.4	1.3	1.3	1.3
FCF yield (%)	-2.1	5.0	8.4	9.3
Dividend yield (%)	5.7	5.7	5.7	6.0

* Based on HSBC EPS (diluted)



Note: Priced at close of 10 Nov 2015

Downgrade to Hold

- ▶ Latest political developments in Portugal suggest a period of uncertainty related to sovereign outlook and energy regulation
- ▶ Attractive multiples (DY above 5.5% at the current price) could be overshadowed by regulatory uncertainties (tariff deficit, energy tax, etc.) and sovereign risks
- ▶ Cutting our target price to EUR3.50 from EUR3.80

Investment thesis

Downgrade to Hold from Buy

In this note, we are downgrading EDP's rating to Hold from Buy. We have incorporated in our valuation a higher equity risk premium (in the form of a higher WACC and higher target yield) in order to reflect the rising sovereign and political concerns in Portugal after the recent political developments.

The possibilities of a change in government have spiked following the approval of the recent confidence vote triggered by the leftist coalition parties in Parliament. This, in our view, may open a scenario of strong uncertainty affecting both the sovereign outlook but also potentially the regulatory terms of the energy markets in Portugal, where EDP has a strong presence.

Albeit less than 50% of group's EBITDA is generated in Portugal (the balance from Spain, US and Brazil); the implications of the Portuguese political turmoil could be very relevant.

On the one hand, EDP's deleverage strategy is partially dependant on the recovery of the historical tariff deficit (regulatory receivables that currently stand at EUR2.2bn on EDP's balance sheet) that requires under an agreed framework real tariff increases of 1.5%-2.0% per year to 2019e. Even though the former centre-right government has committed to this framework (increasing annual tariffs by more than 2% in the last 4 years), the formation of a new leftist government might result in a change to current terms, putting under question mark the timing and the pace of the recovery of these regulatory receivables for EDP (and lastly its deleverage ambitions).

On the other hand, EDP has already suffered from adverse regulatory measures deployed by the former government in the last years (several revenue claw-backs, introduction of a specific energy tax for the industry, etc.). However, an effective change in the government could also trigger the development of new studies to analyse further cost savings in the electricity industry that would ultimately raise the risk profile of the domestic earnings.

Therefore, for the time being we believe that EDP's equity story will be overshadowed by the new uncertainties, and we downgrade our rating to Hold from Buy. The company is certainly offering appealing valuation metrics such as a PE of 12x for 2016e (a 15% discount to peers) or a DY above 5.5% for the next years (assuming no change in our current net income estimates from regulatory intervention), but we outline that investors might now argue that a discount is justified given recent political developments.

Political risk increasing in Portugal

Centre-right government falls, leftist coalition to try to form a government

After the elections on 4 October, which saw the centre-right coalition Portugal a Frente (PaF) obtain the largest share of votes (38.6%), President Cavaco Silva gave the mandate to the leader of PaF, Pedro Passos Coelho, to form a government. However, after only 11 days in office, the centre-right government lost a vote of confidence Parliament. According to the press, the President now appears likely to nominate the leader of the Socialist Party, António Costa. Mr Costa claims that he can form a government by virtue of an unprecedented deal with the Left Bloc and Communist Party. These parties jointly command 122 seats in the 230-seat parliament. However, the opposition parties did not present a joint motion against the government. The press mentions a possible alternative which would not be until April at the earliest. Given that the left-wing coalition might not be committed to austerity, political risk has increased because of uncertainty surrounding Portugal's commitment to fiscal adjustment.

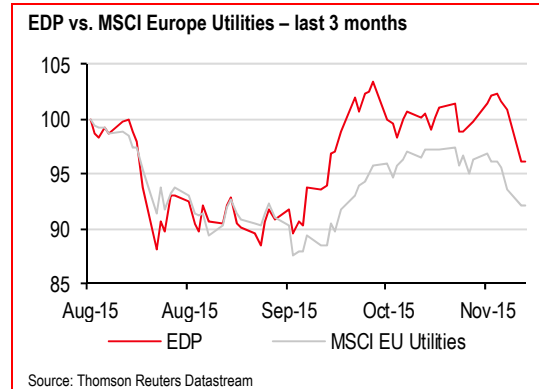
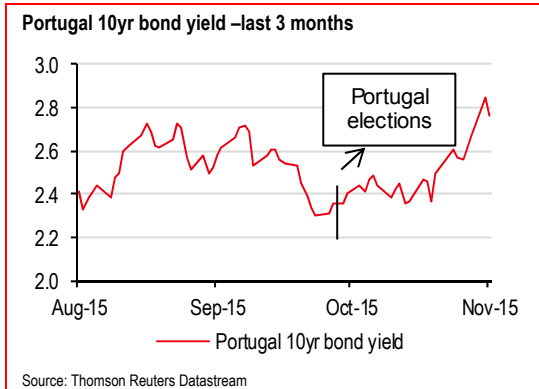
Uncertainty on fiscal consolidation could negatively impact the sovereign rating

In the short term, the most important event for Portugal is probably the rating decision of DBRS (the only rating agency that has Portugal on an investment grade) which is currently scheduled to take place on Friday. According to our economist, if DBRS were to downgrade Portugal's rating, this could mean that Portuguese sovereign bonds would no longer be accepted as collateral by the ECB or included in the QE programme (see [Portugal: government loses confidence vote](#) note for more details).

Increasing political risk warrants additional risk premium

The yield on Portugal's 10-year bond has increased by almost 40 bps to 2.8% since elections on 4 October. Further widening is possible given the uncertainty regarding the political backdrop.

EDP has corrected by around 6%-7% on absolute terms in the last days after the political news-flow in Portugal, but the stock has still outperformed the European utility index (MSCI utilities) in the last 3 months (see Charts on next page). In our view, EDP may struggle to show an outperformance trend versus peers without having more clarity on the implications about the potential government change in Portugal.



Increasing our WACC reflecting a higher risk premium

In order to reflect the new political uncertainties in Portugal, we have incorporated a 1% specific equity risk premium in our calculation of EDP's cost of capital. After that change, we have increased our WACC estimate for the company to 6.4% from 6.0% before, as we detail in the table below.

Changes to our WACC used in DCF calculation

	Revised	Previous
Risk free rate	3.5%	3.5%
Equity risk premium	5.5%	5.5%
Stock specific risk premium	1.0%	0.0%
Beta factor (previous 0.86)	0.85	0.85
Cost of equity	9.2%	8.2%
Gross cost of debt	6.5%	6.5%
Corporate tax rate	28%	28%
Cost of debt (after taxes)	4.7%	4.7%
Weight of debt	62%	61%
Weight of equity	38%	39%
WACC, after taxes	6.4%	6.0%

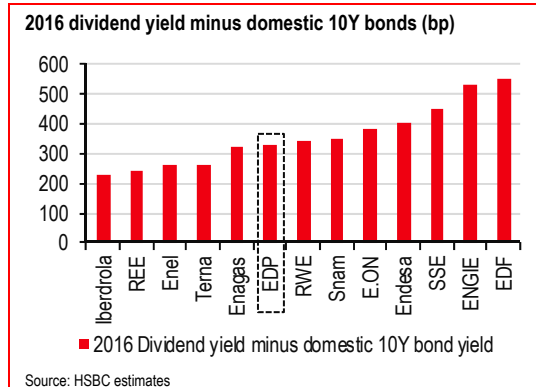
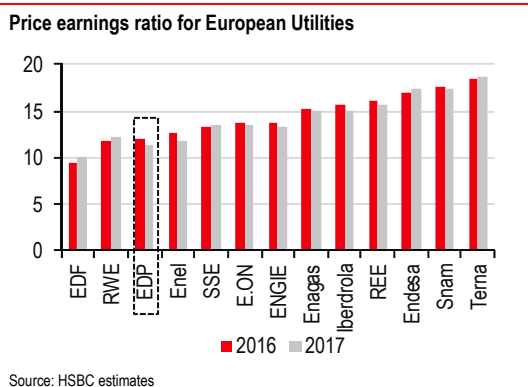
Source: HSBC estimates

Valuation metrics remains appealing

The Charts on page 6 show the implied PE multiple and the spread between the 2016e dividend yield and the domestic 10-year bond for EDP and other sector peers.

We highlight that EDP screens well on these metrics, but the attraction could be overshadowed by the current uncertainty as we have argued above.

EDP trades at a 15% discount to peers on 2016e PE, showing one of the most appealing metrics among Iberian utilities. The dividend yield stands above 5.5% for the next two years, but the recent spike in the Portuguese sovereign risk (measured by the 10Y bond yield) has narrowed the spread between the stock yield and the country sovereign yield. If the Portuguese sovereign yield keeps suffering greater pressure from political uncertainty during the next months, we highlight that the current spread (set at around 300 bps) could be reduced making the stock less attractive versus peers in this particular metric.



Valuation and risks

Downgrading to Hold rating with a new target price of EUR3.50/share

Our valuation is based on the weighted average of DCF (25%), sum-of-parts (25%), and yield (50%). We downgrade EDP's rating from Buy to Hold with a new fair value target price of EUR3.50/share, implying upside of c8%.

Summary of EDP valuation - EUR3.50/share target price (EUR)

Methodology	Weighting	Revised	Previous
DCF value	25%	3.9	4.5
SOP value at 10% discount	25%	3.4	3.4
Yield	50%	3.4	3.7
Target price		3.5	3.8

Source: HSBC estimates

We arrive at a DCF value of EUR3.9 (previously EUR4.5) for EDP. Our DCF is based on WACC of 6.4% (before 6.0%) that includes a specific 1% equity risk premium to account for the growing political concerns in Portugal and terminal growth rate of 1% (unchanged). Our WACC of 6.4% is derived from a cost of equity of 9.2% vs. 8.2% previously (risk free rate of 3.5%, country risk premium of 5.5%, specific equity risk premium of 1% and beta of 0.85) and a post-tax cost of debt of 4.7% (pre-tax of 6.5%).

EDP - DCF valuation

	EURm
DCF value (core operations)	34,595
Associates, ST marketable assets, other assets	3,027
EV asset side	37,622
Financial debt	(16,894)
Quasi-debt (nuclear, pension provisions)	(1,822)
Minorities and other liabilities	(4,776)
Total liabilities	(23,492)
Value of equity	14,130
No. of shares (m)	3,657
DCF value per share (EUR)	3.9

Source: HSBC estimates

In terms of the SOP valuation, we arrive at a value of EUR3.4 (unchanged), after aggregating value of all the assets of EDP and assuming a 10% discount justified by political risk, Brazil exposure and conglomerate status (two quoted subsidiaries).

EDP - SOP valuation

Business	EV (EURm)	EUR/share	Comment
Generation Iberia - Portugal and Spain	10,192	2.8	DCF and capacity multiple
Portugal - Distribution & Supply	5,552	1.5	DCF and EBITDA multiple
Spain HC - Distribution & Supply	2,721	0.7	DCF and EBITDA multiple
EDP Renovaveis (EDPR)	11,027	3.0	Market price of EUR6.75/share plus debt and TEI (2015 reference)
Energias do Brazil (EDB)	3,804	1.0	Market price of BRL13.2/share plus net debt (including Pecem)
Financial assets	977	0.3	
Enterprise value	34,272	9.4	Implied 2015e EV/EBITDA of 8.6x
Net Debt	(16,894)	-4.6	2015 Estimate
TEI liability at EDPR	(1,150)	-0.3	2015 Estimate
L/T Provisions	(1,822)	-0.5	2015 Estimate
Minorities	(2,532)	-0.7	2015e (including EDP Renovaveis and EDB)
Pending Regulated Receivables	2,050	0.6	Pending Regulatory receivables in Portugal and Brazil (end 2015E)
SOTP value (EUR/share)	13,924	3.8	Implied 2016e PE of 14.1x
SOTP Value at 10% discount (EUR/share)		3.4	

Source: HSBC estimates

Lastly, our yield-based valuation is EUR3.4 assuming a 5.5% (previously 5.0%) target yield versus the 2015e DPS.

EDP - Yield valuation

	EUR
DPS 2015e (EUR/share)	0.185
Implied DY (in %)	5.5%
Value per share based on implied yield (EUR/share)	3.4

Source: HSBC estimates

Our financial estimates for EDP are unchanged and therefore the valuation changes are only triggered by a higher WACC estimate and a higher target yield assumed after the sovereign deterioration in Portugal.

Risks

Downside risks

- ▶ Political instability in Portugal that may provide uncertainty about sovereign outlook;
- ▶ Deterioration in the credit spreads; Further regulatory changes in Spain or in Portugal;
- ▶ Deterioration in Brazil (economy, power rationing and currency) where EDP is present;
- ▶ Lack of development in the growth projects of the renewable industry or domestic hydro;
- ▶ Lack of success in balance sheet deleveraging efforts.

Upside risks

- ▶ Additional improvement in sovereign yields pushed by QE in Europe,
- ▶ Improvement in the domestic sovereign outlook,
- ▶ Significant improvement in macro conditions in Brazil,
- ▶ Quicker reduction in the cost of debt for the group

Disclosure appendix

Analyst Certification

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Important disclosures

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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.

*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Rating distribution for long-term investment opportunities

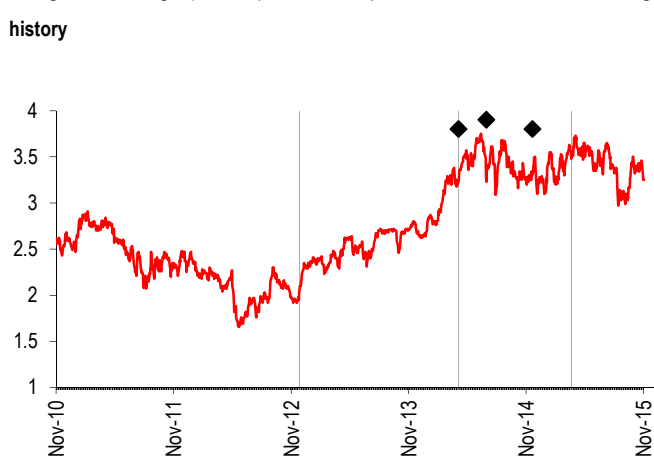
As of 11 November 2015, the distribution of all ratings published is as follows:

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

Energias de Portugal (EDP.LS) Share Price performance EUR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Underweight	N/A	06 December 2012
N/A	Overweight	15 April 2014
Overweight	Buy	31 March 2015
Target Price	Value	Date
Price 1	N/A	06 December 2012
Price 2	3.80	15 April 2014
Price 3	3.90	10 July 2014
Price 4	3.80	01 December 2014

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
ENERGIAS DE PORTUGAL	EDP.LS	3.25	11-Nov-2015	1, 2, 5

Source: HSBC

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- 2 HSBC expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
- 3 At the time of publication of this report, HSBC Securities (USA) Inc. is a Market Maker in securities issued by this company.
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