26 November 2015

HSBC Global Research

European Utilities

Power prices: the nightmare is far from over

EQUITIES
UTILITIES

Northern Europe

- China's coal glut, a sharp rise in LNG supply, and EU power oversupply will keep European electricity prices depressed
- We continue to recommend avoiding the northern European utilities with significant non-regulated power generation
- Reduce on E.ON, RWE, EDF, Fortum, Verbund (downgraded from Hold) and Drax; Hold Centrica, SSE, ENGIE and CEZ

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If you think that power prices have bottomed, then think again

We maintain our negative outlook for northern European power generators. Hopes of a soft landing for post-2015 achieved prices are being dashed: we estimate a 14% decline in average achieved non-regulated prices between 2016 and 2018 (and 24% between 2015 and 2018) for the northern mainland-EU utilities.

Still too soon to return: multiple reasons for continued caution

Issues include: a **depressed commodity environment** is provided by the combination of the deteriorating political and demand outlook for coal together with a likely upcoming flood of cheap shale-based US LNG into Europe; **narrow spreads** through wholesale markets that will remain well supplied due to the combination of sluggish demand and strategic reserve mechanisms, preventing squeezes in the wholesale supply/demand balance; **adverse forex trends** with USD weakness expected by HSBC FX strategists in 2016, depressing the price of USD-denominated commodities when translated into EUR, and **rising interconnection** bringing a deluge of cheaper EU power into the UK towards the end of the decade. In addition, although it has eased in some cases**, political risk** remains a point of vulnerability for the utilities, ie energy policy and Areva financial and industrial restructuring in France; avoidance of the German government being perceived as using public funds to help the nuclear industry, and UK policy on coal. Finally, M&A represents a risk for Fortum and CEZ, in our view.

Changes in ratings and target prices

Company	RIC	Currency	Share price	Old rating	New rating	Old TP	New TP	Up/Downside
Centrica	CNA.L	GBp	212	Hold	**Hold**	250	225	***+6%***
SSE	SSE.L	GBp	1,448	Hold	**Hold**	1,575	1,475	***+2%***
Drax	DRX.L	GBp	233	Reduce	**Reduce**	190	190	***-18%***
E.ON	EONGn.DE	EUR	8.89	Reduce	**Reduce**	8.00	8.00	***-10%***
RWE	RWEG.DE	EUR	10.9	Reduce	**Reduce**	10.5	10.0	***-8%***
EDF	EDF.PA	EUR	14.2	Reduce	**Reduce**	14.0	13.5	***-5%***
ENGIE	ENGIE.PA	EUR	16.4	Hold	**Hold**	16.0	16.0	***-2%***
Fortum	FUM1V.HE	EUR	14.0	Reduce	**Reduce**	13.0	12.5	***-11%***
Verbund	VERB.VI	EUR	13.4	Hold	**Reduce**	14.0	12.5	***-7%***
CEZ	CEZP.PR	CZK	477	Hold	**Hold**	530	490	***+3%***

Source: HSBC estimates. Closing prices as at 23 November 2015

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This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it.

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European utilities valuation sheet

Company	Rating	Share price	Target price	Market cap (EURm)	EV/EBITDA 2014a	EV/EBITDA 2015e	EV/EBITDA 2016e	EV/EBITDA 2017e	HSBC P/E 2014a	HSBC P/E 2015e	HSBC P/E 2016e	HSBC P/E 2017e	Dividend yield 2014a	Dividend yield 2015e	Dividend yield 2016e	Dividend yield 2017e	FCF yield (before dividend) 2014a	FCF yield (before dividend) 2015e	FCF yield (before dividend) 2016e	FCF yield (before dividend) 2017e
Centrica	Hold	212p	225	15,292	5.0x	4.9x	5.2x	4.9x	11.1x	12.3x	12.1x	10.8x	6.4%	5.7%	6.0%	7.2%	18.3%	12.1%	10.3%	10.2%
SSE*	Hold	1,448p	1,475	20,757	8.6x	8.7x	8.5x	8.2x	11.7x	13.0x	12.8x	12.9x	6.1%	6.3%	6.5%	6.6%	2.5%	2.7%	3.3%	5.3%
Drax	Reduce	233p	190	1,350	4.4x	6.1x	8.2x	8.5x	9.8x	18.5x	-	-	5.1%	2.7%	1.2%	0.9%	-11.7%	1.1%	0.1%	5.4%
E.ON	Reduce	EUR8.9	8.0	17,797	5.2x	5.3x	5.9x	5.8x	10.6x	11.2x	13.4x	13.3x	5.6%	5.6%	4.5%	4.5%	7.9%	13.0%	11.1%	8.5%
RWE	Reduce	EUR10.9	10.0	6,273	4.9x	4.9x	5.3x	5.3x	5.2x	6.0x	10.4x	11.6x	9.2%	4.6%	4.6%	4.6%	58.4%	36.4%	25.8%	31.0%
EDF	Reduce	EUR14.2	13.5	27,488	5.2x	5.4x	5.6x	5.9x	6.0x	7.5x	8.9x	9.8x	8.8%	8.8%	6.7%	6.3%	-11.3%	-2.7%	-3.3%	-5.8%
ENGIE	Hold	EUR16.4	16.0	39,951	6.7x	7.1x	6.9x	6.8x	12.8x	14.3x	14.3x	13.9x	6.1%	6.1%	6.1%	6.1%	6.6%	9.8%	10.8%	12.8%
Fortum	Reduce	EUR14.0	12.5	12,464	10.2x	7.2x	8.6x	8.9x	11.6x	17.4x	20.6x	21.3x	9.3%	7.8%	4.3%	4.3%	7.4%	3.7%	2.8%	2.7%
Verbund	Reduce	EUR13.4	12.5	4,657	11.2x	9.9x	11.7x	12.0x	21.6x	16.8x	24.9x	25.7x	2.3%	3.0%	2.0%	1.9%	6.1%	7.4%	6.5%	5.5%
CEZ	Hold	CZK477	490	9,492	5.7x	6.4x	6.4x	6.4x	8.6x	9.4x	12.6x	13.4x	8.4%	8.4%	5.9%	5.5%	14.2%	12.2%	10.9%	10.6%

*SSE 2015/16, 2016/17 and 2017/18. Share prices as of close on 23 November 2015
Source: HSBC estimates

Contents

Too much of everything

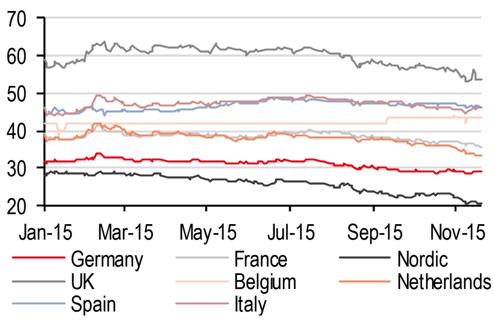
- Negative coal outlook and European LNG supply to keep the lid on northern EU wholesale power prices
- Growing renewables, sluggish demand and ever-present political risk represent further negatives
- Avoid the northern European generators: we have Reduce ratings on RWE, E.ON, Fortum, EDF, Verbund and Drax; Hold on ENGIE, Centrica, SSE, CEZ

Power prices set for further falls

Oversupply in everything: coal, gas, EU power … no prospect of price recovery

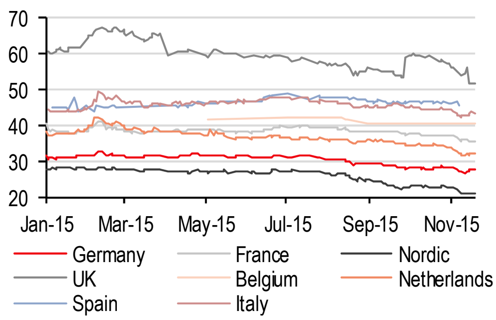
In this report, we argue that four out of the five components of power prices – coal, gas, spreads, and the USD – are likely to remain weak or weaken further and only CO_2 is set to continue its gradual rise. Thus, we anticipate further weakness in European base-load power prices.

European baseload prices Y+1 (EUR/MWh)



Source: Thomson Reuters Datastream

European baseload prices Y+2 (EUR/MWh)

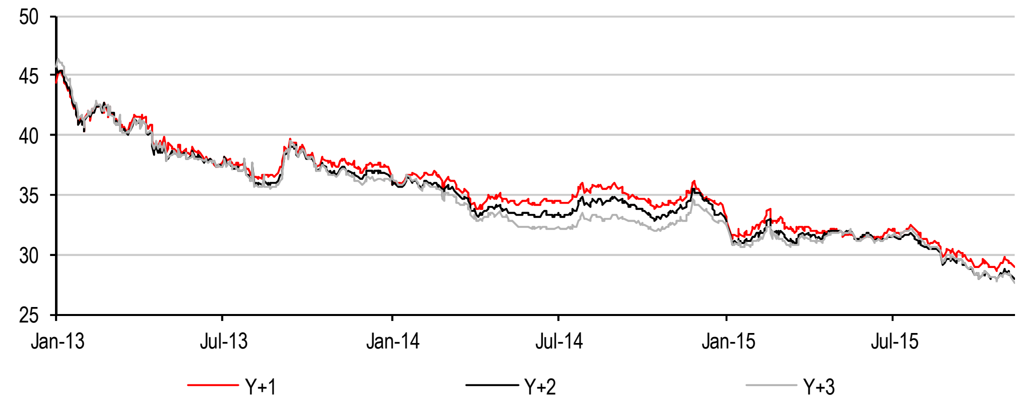


Source: Thomson Reuters Datastream

- Coal demand is suffering in China, Europe's largest market by far, and the pollutive perception of coal depresses its outlook;
- massive new LNG supply in the US and Australia will weigh down gas prices in Europe, which will become the dumping ground for uncontracted US LNG;
- spreads are misleadingly high since they apply to average-efficiency power plants and we see further downside on sluggish demand (around 200bp below GDP), more efficient inter-regional and international grid connection, and new renewables capacity: we note that the recent falls triggered by the upcoming re-opening of two Belgian nuclear reactors caused spreads to fall significantly in Belgium's neighbouring markets;
- HSBC FX strategists see US rate rises leading to a 10% USD fall versus the EUR by end-2016, which will exacerbate weak prices in USD-denominated coal and (to some extent) gas';

- the UK is not affected by forex under our forecasts, with the GBP virtually flat against the USD over the next year, but we reiterate our view that sharply rising interconnection will allow a flood of cheaper mainland-EU electricity to depress UK prices;
- although we see a gradual tightening of CO2 oversupply, we do not see this happening sufficiently rapidly to accelerate the existing gradual upward trend in the CO2 price, which we expect to continue.

German baseload power prices (EUR/MWh)



Source: Thomson Reuters Datastream

We see German power prices potentially falling to EUR25/MWh on a lower marginal cost of production, and we see UK prices at levels at which Drax will struggle to make a profit. We continue to recommend avoiding the northern European power generators with high sensitivity to non-regulated markets, in particular RWE, E.ON, Drax, EDF and Fortum. Out of 15 EU companies we cover that produce electricity, our only Buy rating is ENEL (ENEL IM, EUR4.05)).

EUR25/MWh

Our estimate for German base-load floor

Change in ratings and target prices

Company	RIC	Currency	Share Price	Old rating	New rating	Old TP	New TP	Up/Downside
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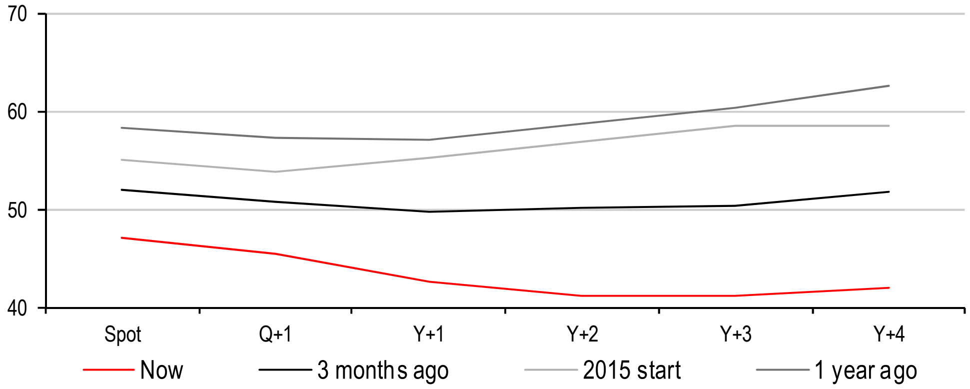
Closing prices as at 23 November 2015
Source: HSBC estimates

1. Coal prices: weak demand, Asian capacity rising

It is hard to see any relief for coal prices, even after their recent accelerated decline. The chart below shows that prices have fallen by more further along the forward curve, with prices four years ahead now virtually the same as one year ahead, having been at a 10% premium this time last year.

RTR API2 coal forward curves (EUR/t)



Source: Thomson Reuters Datastream

Coal's adverse environmental perception to weigh on coal-determined power prices

Politically, it would be a major surprise to see any positive sentiment towards coal resulting from the upcoming COP21 UN Climate Change Conference in Paris (30 November to 11 December 2015). Although coal consumption should be expected to decline on mature markets on renewables expansion and efficiency gains, demand for coal in emerging markets also looks set to disappoint, partially on reductions in economic growth forecasts. Below we compare HSBC economists' GDP forecasts from the Q4 2015 Global Economics quarterly (*The waiting game*, 24 September 2015) with those in the Q1 2015 quarterly (*One false move …*, 18 December 2014).

HSBC GDP forecast changes

	2015e			2016e			2017e
	Dec 2014	Sep 2015	Change bp	Dec 2014	Sep 2015	Change bp	Sep 2015
China	+7.3%	+7.1%	-20	+7.4%	+7.2%	-20	+7.2%
India*	+6.5%	+7.6%	+110	+7.1%	+7.8%	+70	+8.2%
Japan	+0.6%	+0.6%	-	+1.1%	+0.9%	-20	+0.4%
Asia excl Big Three	+3.7%	+2.7%	-100	+3.9%	+3.1%	-80	+3.5%
LatAm	+1.2%	+0.3%	-90	+3.3%	+1.3%	-200	+2.5%
CEEMEA	+1.5%	+0.7%	-80	+2.2%	+1.1%	-110	+2.0%

*India data for fiscal year to March
Source: HSBC Economics team

India and China rank equally as the world's largest thermal coal importers (117m toe net imports in 2014 for both countries) having almost doubled imports since 2012. India is aiming for self-sufficiency by 2020, but we believe that greater reliance on domestic coal will take time and increased imports will be essential to meet economic growth targets. On the other hand, Chinese net imports of coal and lignite were down by 31% in the first eight months of 2015.

As of early November, we estimated that Chinese thermal coal was trading about 14% above production costs, having fallen by 28% y-t-d.

Typically at this time of year we would expect some degree of concerted action by the industry to hold prices up in the run-up to annual contract negotiations with the IPPs. However, there has been no sign of this in 2015 since in our view the overcapacity in the coal market prevents the companies negotiating from a position of strength.

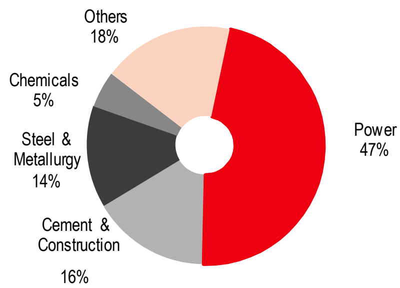
We think China coal's price is bottoming at around RMB360/ton (QHD 5500kcal) but we see various reasons why there may not be a significant recovery in coal prices either:

(1) There are substantial capacities of 700-800m tpa under construction: these will be more efficient and are likely to cause a reduction in the marginal cost of production.

(2) We believe that although many mines are loss-making at the cash level, many are indebted and are likely to continue to produce, in order to generate the cashflows required to meet their debt repayment commitments.

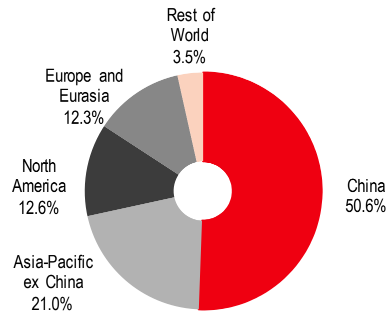
(3) Demand for coal from the power industry is set to contract. China accounted for over half of global coal consumption in 2014. The power sector is the largest consumer of coal, accounting for 47% of domestic demand and 24% of global coal demand in 2014.

China coal consumption breakdown, 2014e



Source: HSBC Metals and Mining team estimates

China accounted for half of global coal demand in 2014 (total 3,881.8mtoe)



Source: BP Statistical Review of World Energy, June 2015

In our previous publication on power prices of 10 August 2015 (*Chinese drag on German power prices*), we forecast weather-adjusted stability-to-slight-rises in demand. In HSBC's 12 November 2015 report on China Utilities and Alternative Energy – *Time to buy wind/solar; setting expectations for the 13th FYP,* our growth assumptions have become more conservative following China's 3 November proposal of the 13th Five-year Plan (FYP), which favours clean energy and non-fossil fuel: we now forecast average demand declines of 1%.

Chinese coal-fired power output peaked in 2013, now on a downward trend

Installed capacity and power generation forecast for China

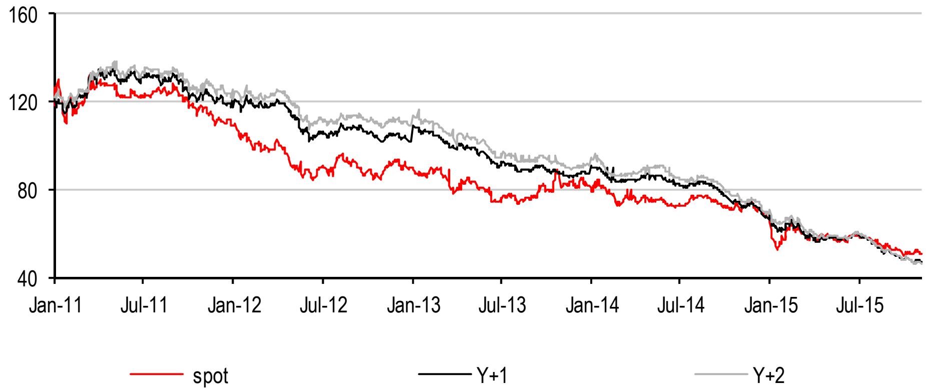
	Installed capacity											
	Total		Thermal		Hydro		Nuclear		Wind		Solar	
	GW	y-o-y	GW	y-o-y	GW	y-o-y	GW	y-o-y	GW	y-o-y	GW	y-o-y
2010	966	10.6%	710	9.0%	216	10.1%	11	18.7%	30	68.2%	-	N.A.
2011	1,065	10.2%	768	8.3%	233	7.8%	13	16.7%	46	56.1%	-	N.A.
2012	1,145	7.5%	820	6.7%	250	7.1%	13	0.0%	61	32.9%	3	N.A.
2013	1,251	9.3%	870	6.1%	280	12.4%	15	16.7%	77	24.6%	16	367.6%
2014	1,360	8.%	917	5.4%	302	7.8%	20	36.7%	97	27.1%	24	51.6%
2015e	1,468	7.9%	961	4.7%	320	5.9%	29	44.3%	116	19.3%	42	73.9%
2016e	1,548	5.5%	998	3.9%	328	2.4%	33	14.9%	135	16.6%	54	29.1%
2017e	1,626	5.0%	1,025	2.7%	335	2.4%	38	14.9%	158	16.6%	70	29.1%
2018e	1,713	5.4%	1,052	2.6%	343	2.4%	44	14.9%	184	16.6%	90	29.1%
2019e	1,806	5.5%	1,074	2.1%	352	2.4%	50	14.9%	214	16.6%	116	29.1%
2020e	1,909	5.7%	1,091	1.6%	360	2.4%	58	14.9%	250	16.6%	150	29.1%

	Power generation											
	Total		Thermal		Hydro		Nuclear		Wind		Solar	
	TWh	y-o-y	TWh	y-o-y	TWh	y-o-y	TWh	y-o-y	TWh	y-o-y	TWh	y-o-y
2010	4,228	14.8%	3,417	14.1%	687	-2.7%	75	6.7%	49	78.9%	-	N.A.
2011	4,731	11.9%	3,899	14.1%	668	-2.7%	87	16.8%	76	53.6%	-	N.A.
2012	4,977	5.2%	3,911	0.3%	864	29.3%	98	12.6%	103	35.5%	4	N.A.
2013	5,350	7.5%	4,203	7.5%	891	3.1%	112	14.0%	140	36.3%	9	141.7%
2014	5,546	3.7%	4,173	-0.7%	1,066	19.7%	126	12.6%	156	11.6%	23	165.5%
2015e	5,585	0.7%	4,081	-2.2%	1,103	3.5%	167	32.4%	193	23.5%	40	74.0%
2016e	5,663	1.4%	4,020	-1.5%	1,142	3.5%	209	25.0%	232	20.0%	60	50.0%
2017e	5,756	1.6%	3,980	-1.0%	1,176	3.0%	240	15.0%	278	20.0%	81	35.0%
2018e	5,891	2.4%	3,960	-0.5%	1,212	3.0%	276	15.0%	334	20.0%	110	35.0%
2019e	6,054	2.8%	3,940	-0.5%	1,248	3.0%	318	15.0%	400	20.0%	148	35.0%
2020e	6,271	3.6%	3,940	0.0%	1,285	3.0%	365	15.0%	480	20.0%	200	35.0%

Source: HSBC estimates

(4) We see a slower implementation of infrastructure projects, because initiatives to address local government debt issues and boost demand (eg bond swaps, PPP projects) remain in relative infancy. We believe there remains a considerable gap between the top level 'initiatives' and the local level 'implementation'. Until some key roadblocks are removed (eg clear evidence of success in municipal bonds issuance) the pace of implementation is likely to be slow. Please see the note published by mining analyst Jeff Yuan on 6 October: *China trip feedback: big plans, slowly implemented*.

RTR API2 coal prices (USD/t)

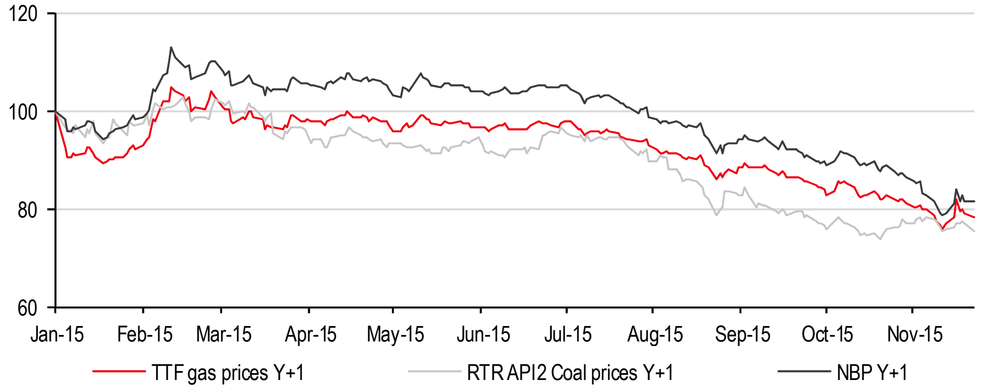


Source: Thomson Reuters Datastream

2. Gas prices to remain weak

Gas prices have declined steadily for virtually the entire year to date.

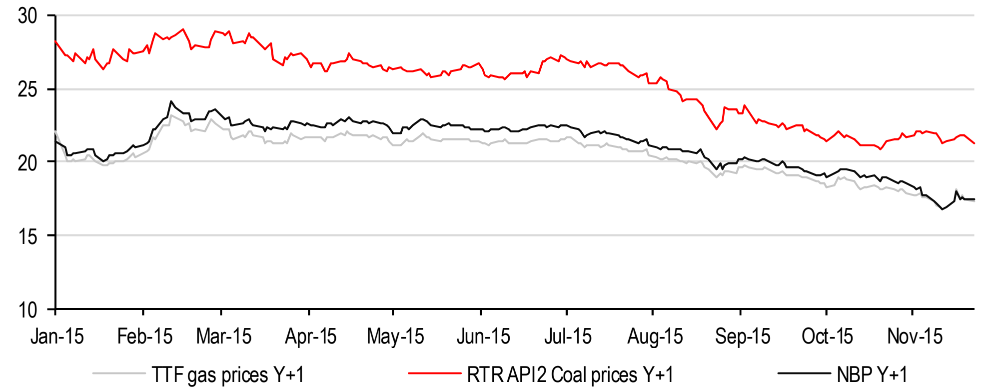
Year-ahead RTR API2 coal prices, TTF gas prices, NBP gas prices (EUR/MWh) rebased to 100



Source: Thomson Reuters Datastream

The spread between TTF gas and coal is EUR4/MWh, having started this year at EUR6/MWh.

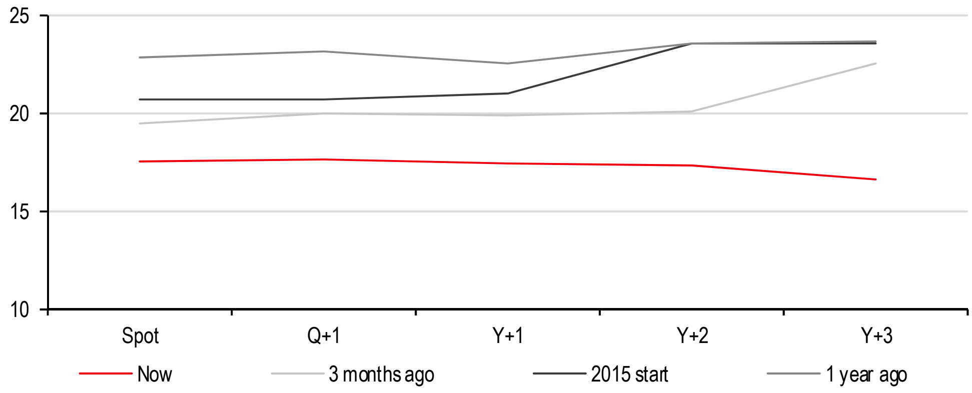
Year-ahead RTR API2 coal prices (EUR/MWh), TTF gas prices (EUR/MWh), NBP gas prices (EUR/MWh)



Source: Thomson Reuters Datastream

We note that the forward curve (for full years, not subject to seasonal fluctuations, ie between one year ahead and three years ahead) is now on a slightly declining trajectory or in backwardation, having previously been on an upward trajectory or in contango.

TTF forward curve (EUR/MWh)



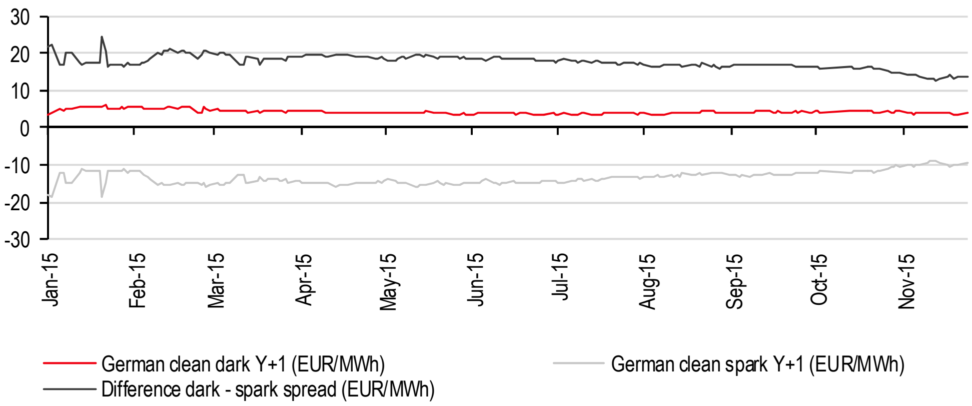
Source: Thomson Reuters Datastream

There has been a narrowing of the differential between the clean dark spread (still narrow in Germany) and the clean spark spread (less substantially negative), helped by higher CO2 prices. However, cash costs of gas-fired generation from a standard-efficiency power plant are still EUR12/MWh higher than those for coal-fired equivalent units. During Q1, the differential was around EUR20/MWh.

35%

Narrowing of the negative differential between gas- and coal-fired power production costs since the start of 2015

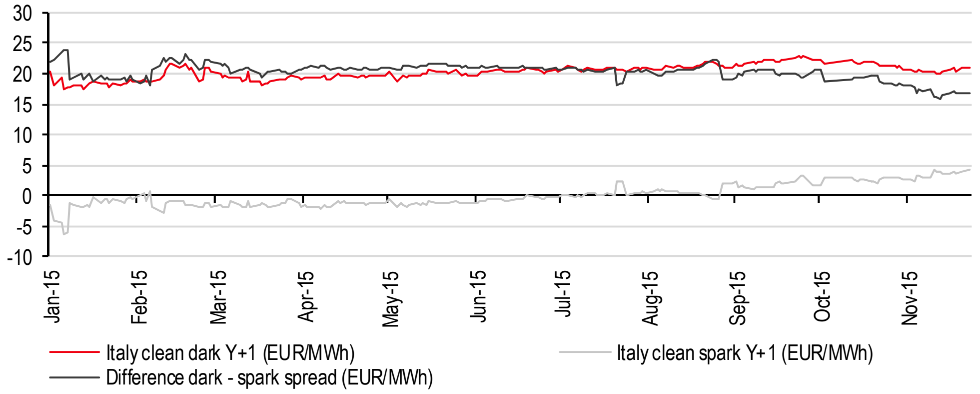
German clean dark vs clean spark spread (EUR/MWh)



Source: Thomson Reuters Datastream

In contrast, in Italy, where gas is the main price-setter, the gap has also narrowed in a similar fashion to Germany but spark spreads have risen into positive territory.

Italy clean dark vs clean spark spread (EUR/MWh)

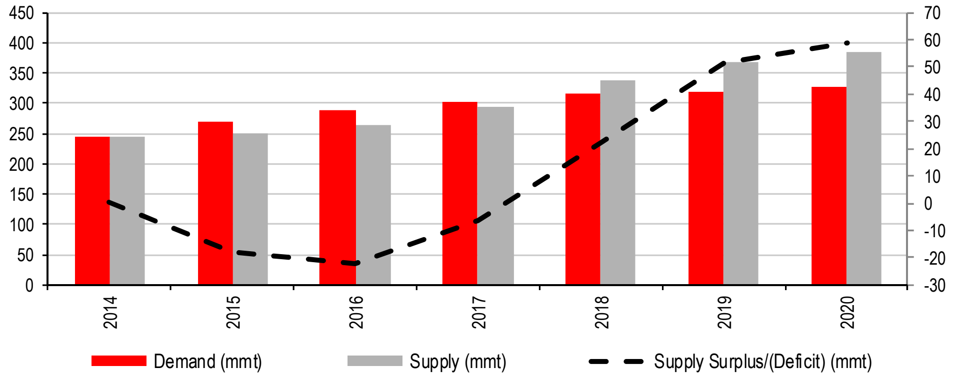


Source: Thomson Reuters Datastream

Upcoming LNG glut to weigh on gas-determined EU power prices

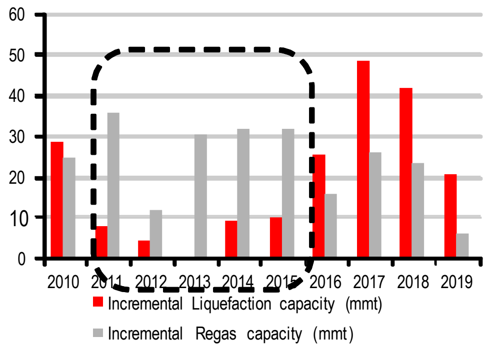
The major reason we see no recovery in gas prices is the unprecedented LNG supply boom. There is 143mpta of LNG under construction, of which 45% (64mtpa) in the US and 37% (53mpta) in Australia. Any upside in gas prices is likely to be capped by US LNG availability.

LNG supply additions to outpace demand addition



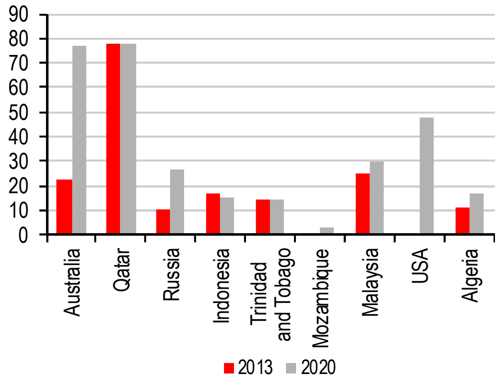
Source: BP Statistical Review 2014, HSBC estimates

Liquefaction capacity additions to be higher than regasification capacity additions for the first time in six years in 2016



Source: BP Statistical Review 2014, HSBC estimates

Change in Global LNG supplier landscape – 2013 and 2020: Australia to rival Qatar, US moves from nowhere to no 3

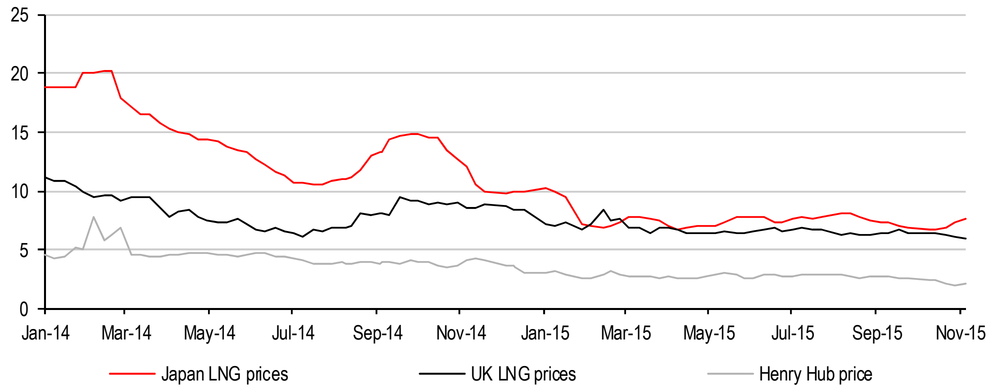


Source: BP Statistical Review 2014, HSBC estimates

There should be two waves of new supply:

- 40mtpa of Australian supply is scheduled to start up in the next two years (80-90% contracted). Asian buyers are currently exercising their DQT (Downward Quantity Tolerance) given low spot prices, freeing up LNG cargoes that are finding a home in "new markets" (Egypt, Jordan, Pakistan, South-East Asia). In 2016, new contracted Australian supply looks likely to start to displace LNG that is currently going to the Pacific Basin. Displaced LNG should then first go to "new markets" (LatAm, Middle East & North Africa, South-East Asia), then when these are full, LNG would go to north-west Europe.
- The wave of US LNG arrives in 2017-20, with the risk of nowhere else to go but Europe (the market of last resort). We believe the cash cost of shipping US LNG to Europe and regasifying it is around USD1.5/mmbtu, with Henry Hub at USD3-4/mmbtu. Some sellers will choose to deliver LNG at cash costs, but the majority of sellers will be expected to endeavour to cover their capital costs as well. It seems highly likely to us that US LNG will be the major price determinant by far for European gas, even if the Brent oil price were to rebound.

Gas prices across different regions (USD/MMBTU)



Source: Thomson Reuters Datastream

Historically, booms in FIDs (final investment decisions) have been followed by leaner years. In 2005-06 for example, Qatar sanctioned 61mpta of capacity, taking out all of the forward demand. Over the last five years, 100mtpa has been sanctioned, leaving little space for future FIDs. This lack of FIDs in 2016-18 could create supply problems for the 2022+ period, implying upside for gas prices but not for the next few years.

3. CO2 to continue to rise gradually

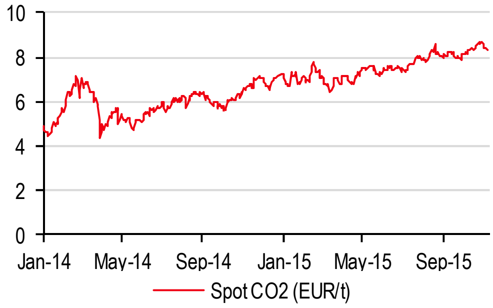
We do not anticipate any new decision made at the COP21 UN climate change summit (30 November to 11 December) regarding cutting the cap on EU greenhouse gas emissions faster than the present post-2020 level of 2.2% per year (from 1.74% annual cuts up to 2020). In our Climate Change team's note of 27 October *Bonn – the long bridge to Paris*, they anticipated that negotiations will be tough and that "global ambition falls short of limiting warming to 2°C".

COP21: CO2 pricing to be perceived increasingly as a 'tool' towards emission cuts

We note, however, that in the most recent talks in Bonn in October, the subject of CO2 pricing, hitherto excluded from any discussions, floated the idea that the CO2 pricing should be acknowledged in the preamble text as a means to reduce emissions with a proposal to improve pricing mechanisms. If the CO2 price is thus mentioned, this would provide a clear signal that high polluters would need to take account of this factor in their future strategies.

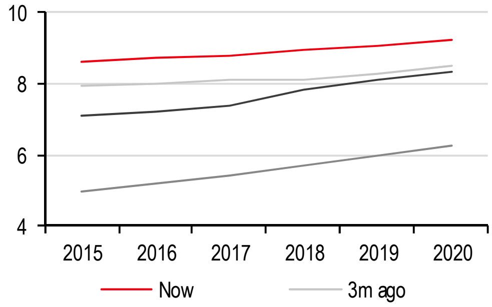
The year-ahead CO2 price has risen steadily since the start of 2015 from EUR7.2/t to EUR8.6/t.

CO2 spot prices (EUR/t)



Source: Thomson Reuters Datastream

CO2 forward curve (EUR/t)



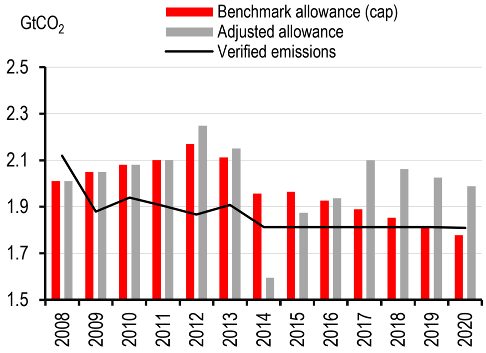
Source: Thomson Reuters Datastream

We estimate cumulative surplus allowances as of end-2014 at c1.85bn t and forecast this to be over 1.25bn t by 2020. Our forecast is based on the assumption that 900mt of back-loaded allowances (2014-16), which are supposed to come back to the market in 2019/20, would remain in the reserve with implementation of the market stability reserve (MSR). Another key assumption in our forecast is on the verified emissions, where we assume annual emissions for the forecast period (2015-20) to remain constant at 2014 levels (in 2014, verified emissions reached 1.8bnt, which equated to the EU Commission's 2020 target cap under the third phase of EU ETS). However, with declining power demand in the EU, more closures of coal-based generating capacity and increasing share of renewables, we expect verified emissions to decline to 2020, as a result of which the cumulative surplus of allowances is likely to be higher than our forecasts. In our view, this will prevent CO2 prices rising any faster than has been the case in 2015.

1.3bn t

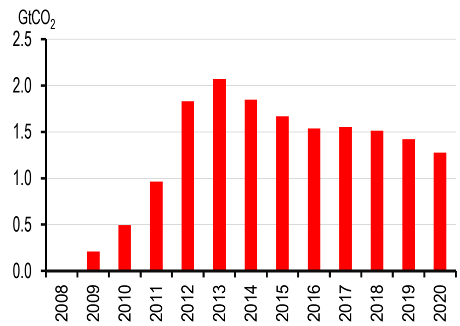
HSBC estimate for cumulative surplus of CO2 allowances at end of Phase III of EU emissions trading system at end-2020

EU ETS: allowances and verified emissions in Phases II and III



Source: European Commission, HSBC estimates

Cumulative surplus of allowances in EU ETS



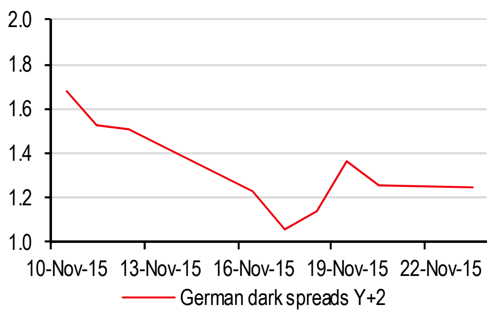
Source: European Commission, HSBC estimates

4. Spreads could narrow on oversupply

We note that the re-opening from mid-December of ENGIE's Tihange 2 and Doel 3 nuclear power plants has led not only to a (predictable) collapse of forward Belgian power prices (from EUR44/MWh to EUR38/MWh for 2017), but also affected power prices in neighbouring markets as spreads have narrowed on the imminent increase in the supply of cheap base-load power.

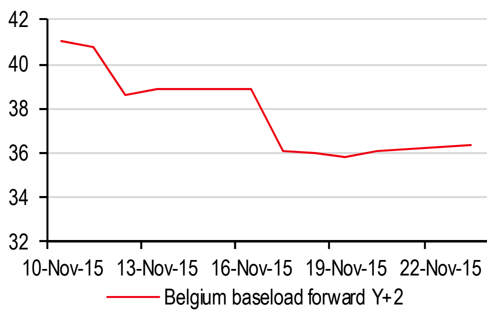
The German two-year-ahead dark spread has lost EUR0.5/MWh (falling to just EUR1.2/MWh) since 10 November, the last day before the Dutch press suggested that the decision had been made to re-open the twin reactors. The two re-openings add around 1.6% of supply to the combination of Belgium and its interconnected neighbours France, the Netherlands and Germany.

German dark spreads, 35% efficiency coal-fired plant, two years ahead (EUR/MWh)



Source: Thomson Reuters Datastream

Belgian baseload forward, two years ahead (EUR/MWh)



Source: Thomson Reuters Datastream

"Official" spreads under-state competitiveness of new plants

Spreads data misrepresents the picture, being taken for middle-aged and not new plants of far better efficiency and lower cost

Coal: clean dark spreads

It is worth stating that the clean dark spread concerns a coal-fired power plant of 36% efficiency (versus 44% or more efficiency of the so-called "super-critical" new openings). This implies there is no major reason why dark spreads should not be close to zero in Germany given the substantial output from the new coal-fired power plants opened over the last three years with per-MWh cash costs roughly EUR3-4/MWh lower than the "middle-aged" 36%-efficiency plants on which dark spreads are based, as provided by Reuters and Bloomberg. Platts data shows that whilst German dark spreads for 35%-efficiency coal-fired plants have fallen 40% from EUR2.14/MWh at the start of November to EUR1.25/MWh on 23 November. A new 45%-efficiency coal-fired unit's spread has fallen by a similar level in absolute terms but remains reasonably significant at EUR5.06/MWh.

Gas: clean spark spreads

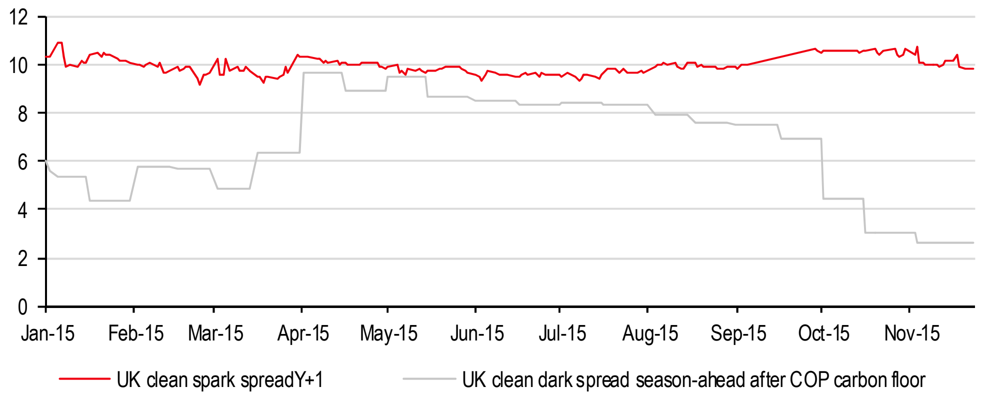
The spark spread, provided by Reuters, applies to a typical CCGT of 50% efficiency, versus 60% or more efficiency for the latest plants offered by Siemens. We estimate that CCGT units of 50% efficiency benefit from cash costs around EUR8/MWh lower than older units of 40% efficiency.

For new units, the cost advantage of coal is now relatively narrow, at around EUR8/MWh, we estimate

We stated earlier that the differential between clean dark spreads and clean spark spreads, as provided by Reuters and thus for standard-efficiency units of 10-15 years, has narrowed in Germany from EUR20/MWh to EUR12/MWh since Q1 2015. Given the lower costs for new plants mentioned in the paragraphs above, we estimate that, for new state-of-the-art units, the differential is about EUR8/MWh in favour of coal-fired units.

For the UK, comparison is skewed in favour of gas by the carbon price support (CPS), which is currently GBP18.08/t on top of the EU's ETS traded CO2 price (currently EUR8.6/t). The charts below show 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.

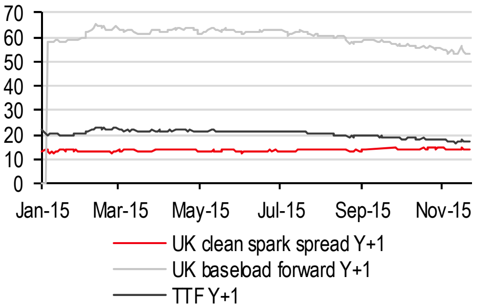
UK clean spark spreads Y+1 and season-ahead clean dark spreads (after COP carbon-floor) in GBP/MWh



Source: Thomson Reuters Datastream

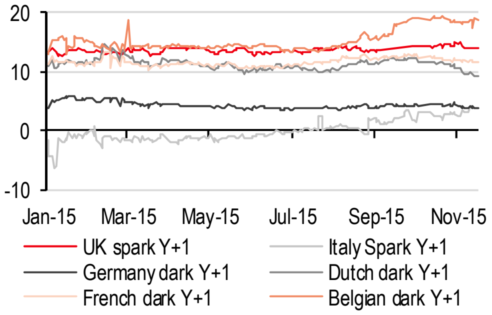
As spark spreads in Europe have tended to hold up or rise as the fall in gas prices has surpassed that of coal recently, dark spreads have tended to narrow (see charts for Italy and Germany on page 10-11).

UK clean spark spread Y+1 vs baseload forward Y+1 vs TTF Y+1 (EUR/MWh)



Source: Thomson Reuters Datastream

European dark and spark spreads (EUR/MWh)



Source: Thomson Reuters Datastream

5. We expect USD to weaken, bringing negative commodity translation effect into EUR

We would add that HSBC's FX strategy team forecasts a decline in the USD against the EUR of 10% by the end of 2016e, exacerbating coal's weakness when translated into EUR. It sees UK interest tightening in 2016 resulting in a slight strengthening of the USD against the GBP between now and the end of 2016.

EUR set to strengthen: negative for EUR-denominated commodities

	Current	End-Q1 2016	End-Q1 2016	End-Q1 2016	End-Q1 2016	Change by end-2016
USD to EUR1	1.078	1.15	1.16	1.18	1.20	-10%
GBP to EUR1	0.706	0.72	0.73	0.70	0.80	-13%
USD to GBP1	1.526	1.60	1.58	1.55	1.50	+2%

Source: HSBC FX strategy team

6. Interconnection boom to flood UK with cheaper EU power

Interconnection boom: UK no longer a "power island"; prices to adapt accordingly

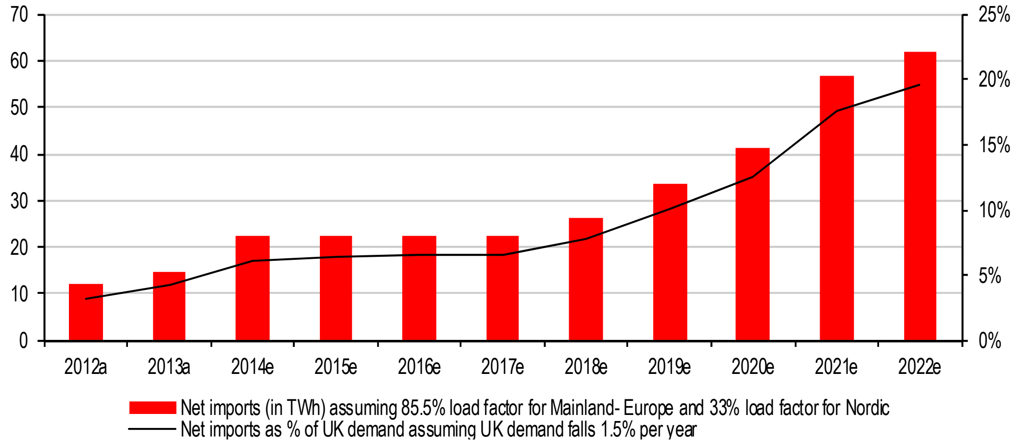
Although the UK will not suffer from these adverse forex movements since HSBC economists do not see the USD weakening versus the GBP, we would re-emphasise our argument, set out in our 28 July 2015 UK Electricity report Britain to join the (electricity) eurozone, that the five new UK-to-Europe interconnectors opening over the next six to seven years will result in more than three-fold growth in interconnection capacity and, we expect, trigger sharp rises in net imports. As a result, mainland European prices could frequently set UK prices, with the result that the average UK premium to mainland Europe narrows via UK price falls rather than mainland European price rises.

UK power production and demand - HSBC forecasts

TWh	2000	2010	2013	2014	2020e	2025e	2030e
Coal	120	108	131	101	13	0	0
Gas	148	176	96	101	100	81	44
Nuclear	85	62	71	64	60	45	18
Wind, solar	1	10	30	36	79	100	120
Hydro	8	7	8	9	8	8	8
Bio-energy	4	12	18	23	35	35	35
Oil	7	5	2	2	0	0	0
Other	4	2	3	3	3	3	3
Total generated (1)	377	382	359	339	298	272	256
Net generated (2)	357	353	329	312	277	251	235
Net imports (3)	14	3	14.5	20.5	41	50	50
Total demand (4=1+3)	390	384	375	359	339	322	306
Losses (5)	30	27	27	28	16.6	15.1	14.1
Final consumption (=2+3-5)	329	329	318	305	301	286	271
CO_2 emitted (e) mt	159	157	147	121	41	30	27

Source: DECC, HSBC estimates

UK to transform into a major net importer



Source: HSBC estimates

December capacity auction – a key indicator of market sentiment for 2019-2020

The upcoming second capacity auction will be a key indicator of the market's view of the power market in 2020. The clearing price of GBP19.40/kW for the first auction in 2014 for winter 2018-2019 was below the expectation of many in the market and with a Carbon Price Floor of GBP18/tonne in effect from 1 April 2015 made the commercial viability of coal-fired generation less certain. DECC is has a procurement target of 44.67GW for the upcoming auction. In addition, interconnectors will be eligible to take part in the auction.

We set out details of the interconnectors expected to be operational and their derated capacity (the amount that Ofgem/DECC consider is appropriate to be bid in at times of system stress). Also the additional comments by Ofgem that give some indication of the price arbitrage between the markets.

2015 capacity auction: Interconnector participation and commentary

	Derated capacity %	Comment
IFA France	50	Peak prices expected to be lower in France
Britned Holland	75	Healthy margins and lower prices than in GB
Moyle Ireland (export)	25	Prices expected to be higher than in GB
Nemo Belgium	50	Uncertainty about Belgian nuclear plant at the time (now re-opened)
Eleclink France	60	Peak prices expected to be lower in France

Source: Ofgem – the Norwegian Interconnector NSN may not be completed in time but is assumed to have 85% capacity – lower prices expected than in GB

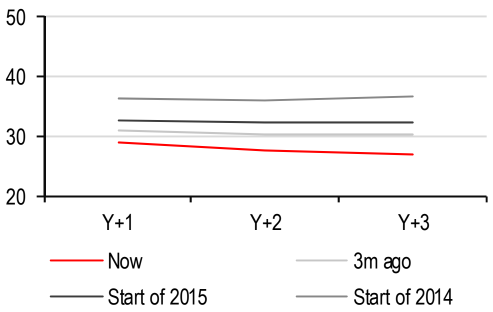
The combination of the short-term Supplementary Balancing Reserve and Demand Side Balancing Reserve, which have allowed National Grid to procure generation in order to bridge any capacity shortfall before 2019-2020, have lessened the likelihood of any significant shortfall in capacity. These mechanisms have, in our view, lessened the likelihood that the forward power market in the UK will rise to new entrant prices. This, combined with the weak commodity prices, make us less optimistic than some in the market that there will be price increases for winter 2016-2017.

7. Forward curve does not anticipate any near-term improvement

Declining forward curves reflect the pessimism of market participants

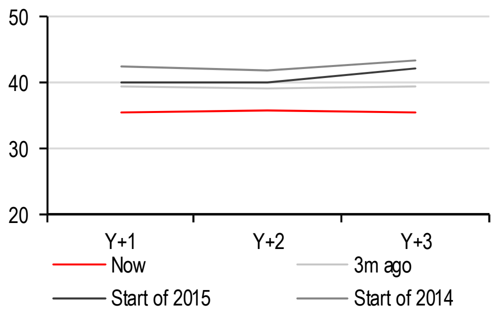
We find it striking that the trajectory of forward curves for base-load power in wholesale markets in the EU has moved from slightly upward (in contango) to flat or even slightly downward (in backwardation) with further-forward power prices having fallen more than nearer term prices in 2015.

German forward curve (EUR/MWh)



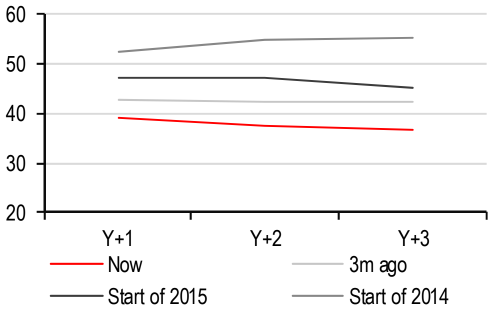
Source: Thomson Reuters Datastream

French forward curve (EUR/MWh)



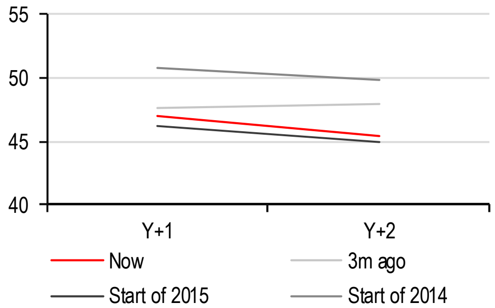
Source: Thomson Reuters Datastream

UK forward curve (GBP/MWh)



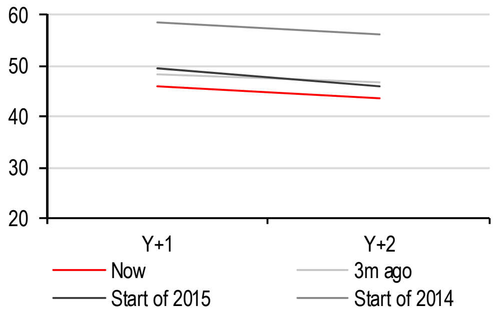
Source: Thomson Reuters Datastream

Spain forward curve (EUR/MWh)



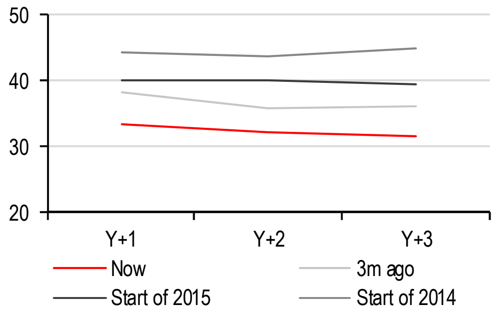
Source: Thomson Reuters Datastream

Italy forward curve (EUR/MWh)



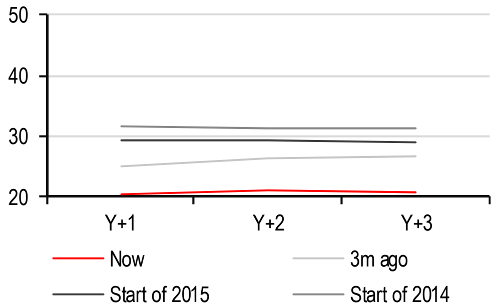
Source: Thomson Reuters Datastream

Netherlands forward curve (EUR/MWh)



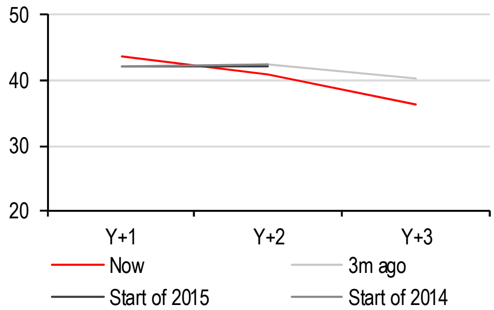
Source: Thomson Reuters Datastream

Nordic forward curve (EUR/MWh)



Source: Thomson Reuters Datastream

Belgian forward curve (EUR/MWh)



Source: Thomson Reuters Datastream

Conclusion: still bearish

Although there has been a degree of focus on the possibility of tight upcoming margins in the UK this winter, we believe that the market has been over-preoccupied with what is no more than a slight and short-lived risk.

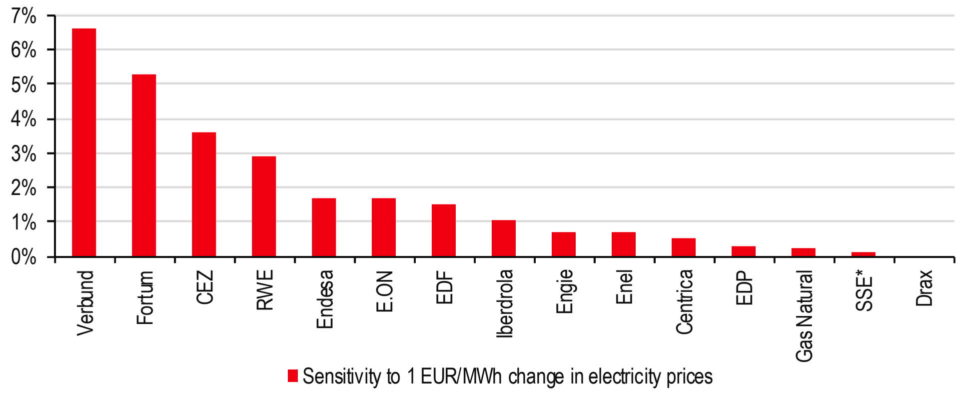
We remain bearish on the EU power generators. We do not believe that the decline in power prices has yet ended, tempting as this may be to assume after the sharper fall of recent weeks.

We have discussed the multiple reasons for coal, as an increasingly friendless fuel, remaining in the doldrums; why European gas prices should be heavily influenced by shale-based exported US LNG with nowhere else to go; and why EU CO2 prices need not rise rapidly with coal-fired plants being taken off-line and the process of new coal-fired plants at a virtual end. The trajectory of EU forward curves, having moved from slight contango to slight backwardation over the course of 2015, shows that market participants are pessimistic. Adverse forex trends risk exacerbating the negative trend when USD-denominated commodities are translated into EUR, whilst the upcoming transformation of interconnection between the UK and mainland Europe is likely to trigger a sharp rise in imports of cheap electricity into the UK, weighing on the wholesale price.

Who is at risk?

We set out below a chart comparing companies' EBIT sensitivity to a EUR1/MWh change in power prices, based on their 2015e EBIT. This chart assumes that this EUR1/MWh change is caused only by commodities (coal/gas) and not by a change in the spark or dark spread. For EDF, our figure is based on 2016 French market conditions, when around one-quarter of currently regulated tariff volumes will be subject to open market prices. The three most commoditised EU power utilities are Verbund, Fortum and CEZ.

2015e EBIT sensitivity of European generators for EUR1/MWh change in power prices triggered by commodity prices



*2015/16
Source: HSBC estimates

The table below lists the spread- and outright power output in 2014 of the stocks we cover in the non-regulated EU markets as well as France, which is partially de-regulating in 2016. The profitability of spread generation is measurable by clean dark and clean spark spreads (the profitability of 70% of Drax's 2014 generation, for instance, was reliant on clean dark spreads, but the percentage will fall to about 50% with the 2015 conversion of Unit III from coal to biomass).

2014 output of European power generators

in TWh	Europe (ex France)		France		Total
	Spread generation (gas, coal, oil)	Outright generation (nuclear, lignite, hydro)	Spread generation (gas, coal, oil)	Outright generation (nuclear, lignite, hydro)	
EDF	38.0	63.8	6.9	453.5	623.5
ENGIE	56.9	28.0	2.5	25.3	327.8
E.ON	64.3	72.6	3.8	0.0	215.2
RWE	81.1	108.9	0.0	0.0	208.3
Enel	78.3	57.9	0.0	0.0	169.7
Iberdrola	20.8	42.9	0.0	0.0	80.0
Fortum	0.9	46.3	0.0	0.0	74.6
Endesa	36.1	33.5	0.0	0.0	69.7
CEZ	2.9	54.0	0.0	0.0	63.1
EDP	7.6	7.5	0.0	0.0	41.5
Verbund	1.9	31.2	0.1	0.0	34.0
Gas Natural	19.8	8.7	0.0	0.0	30.5
SSE*	18.9	3.7	0.0	0.0	27.6
Drax	18.8	0.0	0.0	0.0	26.7
Centrica	10.0	11.2	0.0	0.0	22.1

*2014/15
Source: Company filings

For those companies with high sensitivity to power prices or spreads, power generation is particularly dominant within their earnings.

% of EBITDA from unregulated power generation from EU

	2016	2017
Drax	100%	100%
Verbund	80%e	80%e
Fortum	64%	64%
CEZ	51%	50%
EDF	33% (11% excluding France)	32% (11% excluding France)
Endesa	31%	30%
SSE	26%	23%
E.ON	25%	19%
Iberdrola	16%	16%
RWE	16%	14%
Enel	12%	12%
EDP	12%	11%
ENGIE	12% (9% excluding France)	11% (9% excluding France)
Gas Natural	11%	11%
Centrica	8%	7%

Source: HSBC estimates

Hedging inflates current results: E.ON's selling price to halve in 2014-18e

The table below shows that, under our current estimates, which mark to market for today's power prices for remaining open positions, the major generators' achieved prices will fall sharply even after 2016, in particular for those (such as E.ON) which hedge forward the most and whose 2015 earnings are therefore the most inflated by high achieved selling prices. Hopes for a "soft landing" are in the process of being dashed.

Declining achieved prices for outright generation

	2014a	2015e	2016e	2017e	2018e	*Change 2018 vs 2016 (%)*
E.ON C Europe (EUR/MWh)	56.0	49.0	39.0	33.0	28.5	*-10.5*
y-o-y change			*-20%*	*-15%*	*-14%*	*-27%*
E.ON Nordic (EUR/MWh)	42.0	35.3	31.4	26.5	22.9	*-8.5*
y-o-y change			*-11%*	*-15%*	*-14%*	*-27%*
RWE Germany (EUR/MWh)		39.4	34.6	33.0	28.1	*-6.5*
y-o-y change			*-12%*	*-5%*	*-15%*	*-19%*
ENGIE F+B (EUR/MWh)	47.0	43.0	41.0	39.5	37.0	*-4.0*
y-o-y change		*-9%*	*-5%*	*-4%*	*-6%*	*-10%*
Fortum (EUR/MWh)	41.4	35.5	31.5	28.5	27.5	*-4.0*
y-o-y change		*-14%*	*-11%*	*-9%*	*-4%*	*-13%*
CEZ (EUR/MWh)	44.0	39.5	33.5	30.0	28.7	*-4.8*
y-o-y change		*-10%*	*-15%*	*-10%*	*-4%*	*-14%*
Verbund (EUR/MWh)	33.1	35.0	30.5	28.0	27.0	*-3.5*
y-o-y change		*6%*	*-13%*	*-8%*	*-4%*	*-11%*

Source: Company data, HSBC estimates

Stock ratings

Six Reduce ratings, four Holds, no Buys amongst the 10 northern European generators

We are Reduce on six out of the 10 northern European generators we cover and forecast dividend cuts for all six companies in 2015 and/or 2016:

RWE (TP EUR10.0 from EUR10.5)

E.ON (TP EUR8.0)

EDF (TP EUR13.5 from EUR14.0)

Drax (TP 190p)

Fortum (TP EUR12.5 from EUR13.0),

Verbund (downgraded from Hold, TP EUR12.5 from EUR14.0)

We rate the remaining four at Hold:

Centrica (TP 225p from 250p)

SSE (TP1,475p from 1,575p)

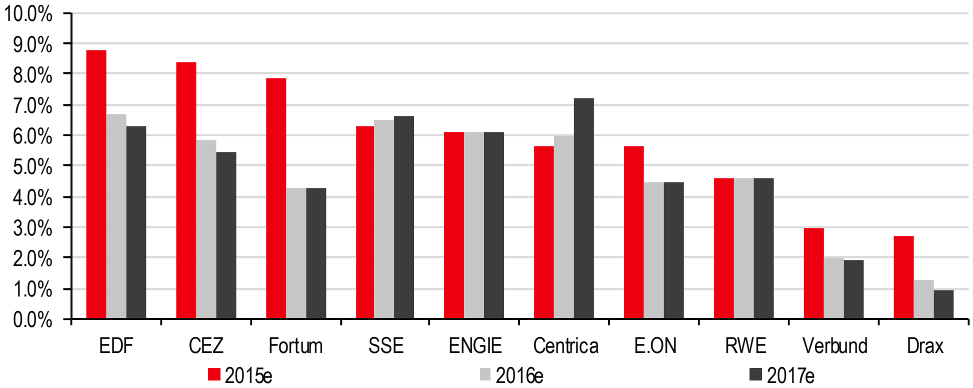
ENGIE (TP EUR16.0)

CEZ (TP CZK490 from CZK530)

Within the sector overall, our Buy ratings are centred on the regulated stocks National Grid (NG/ LN, 940p), Snam (SRG IM, EUR4.73), with ENEL (ENEL IM, EUR4.05) our only Buy amongst the integrated names.

Yield is the major attraction for the utilities, in our view. High yields become far less of a focus if the dividend appears less-than-securely based. Below we set out 2016-18e dividend yields for the ten stocks covered in this report. We estimate cuts in dividends between 2015e and 2017e for six out of the ten; for RWE, we forecast a halving of the dividend in 2015 versus 2014 and see a strong possibility of a capital increase, which could cast doubt on post-2015 dividend levels; for ENGIE, we estimate an average 2015-17e pay-out of 87% assuming a flat dividend at the stated minimum of EUR1.0, which is well above the 65-75% targeted pay-out range.

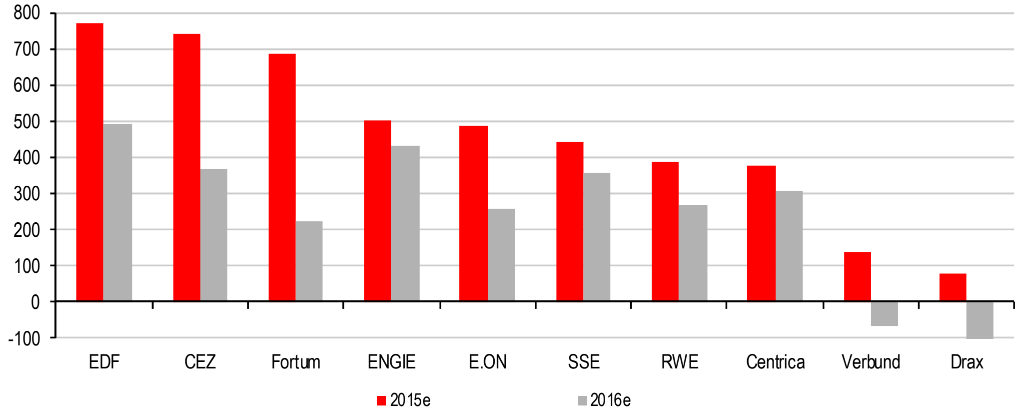
Dividend yield forecasts 2015-17e



*SSE 2015/16, 2016/17 and 2017/18; closing prices as at 23 November 2015
Source: HSBC estimates

Below, we adjust the stocks' dividend yield for domestic 10-year bond yields and inflation.

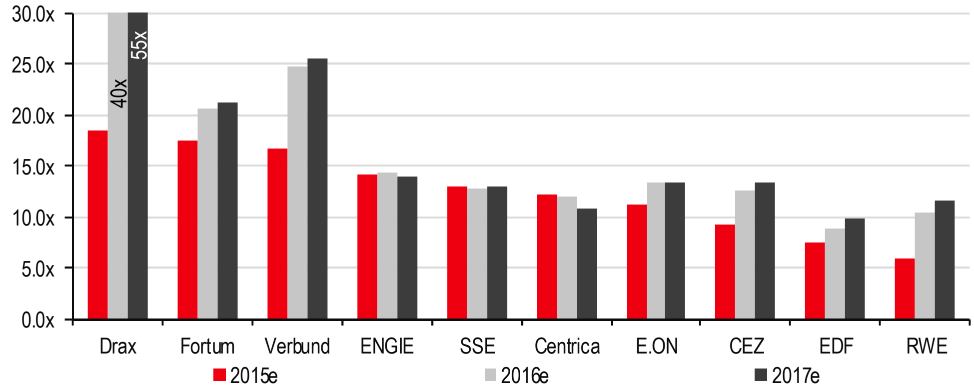
Dividend yield minus domestic yield minus inflation 2015-16e



*SSE 2015/16, 2016/17; closing prices as at 23 November 2015
Source: HSBC estimates

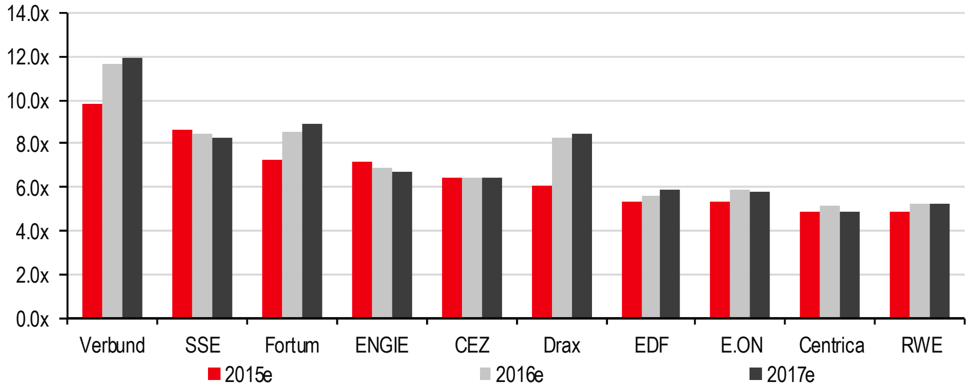
If dividends are in danger of falling, or there is deemed to be major political or financial risk, or if market conditions are changing rapidly, we would contend that traditional multiples such as PER or EV/EBITDA have limited significance. This is particularly the case for RWE and EDF, in our view.

Price to earnings ratio 2015-17e



*SSE 2015/16, 2016/17 and 2017/18; closing prices as at 23 November 2015
Source: HSBC estimates

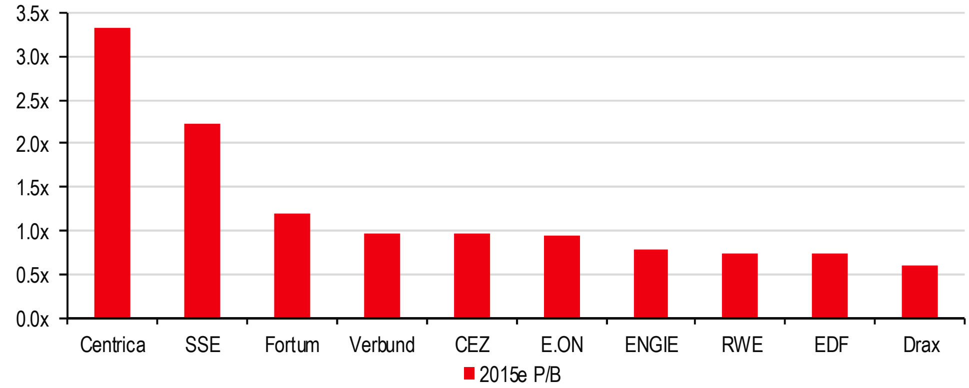
EV/EBITDA 2015-17e



Source: HSBC estimates; *SSE 2015/16, 2016/17 and 2017/18; Price as at 23 November 2015

Much of the sector currently trades at or below book value. This is perfectly justifiable, in our view, if there is a danger of impairments (ENGIE has warned of 2015 impairments, E.ON took EUR8.3bn of Q3 impairments, RWE has not ruled out impairments, and in our view both Drax and EDF may elect to take impairments) and/or capital increases (RWE).

Price to book value 2015e



Source: HSBC estimates: *SSE 2015/16; Price as at 23 November 2015

Company section

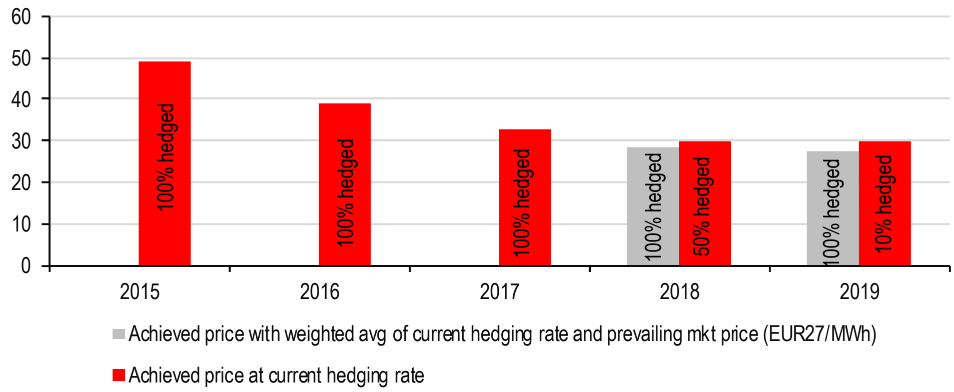
E.ON

- Political risk diminished but do not expect an easy solution for back-end nuclear cost coverage
- Negative pricing environment affects both New E.ON and Uniper
- Reiterate Reduce rating and EUR8.0 target price

2015 results based on highest selling prices amongst peers

We maintain our Reduce rating and EUR8.0 target price. We have cut our forecasts slightly to reflect lower German, Nordic and UK prices. More than any other utility, E.ON faces substantial falls in post-2015 achieved selling prices due to its policy of hedging far forward and to its presence on oversupplied, coal-driven and renewables-heavy markets. This in turn means that its 2015 results are the most inflated by high selling prices that are about to fall sharply. Finally, it implies that E.ON will be the last utility to benefit from any eventual recovery in power prices.

E.ON's Central Europe achieved price and hedging (EUR/MWh)

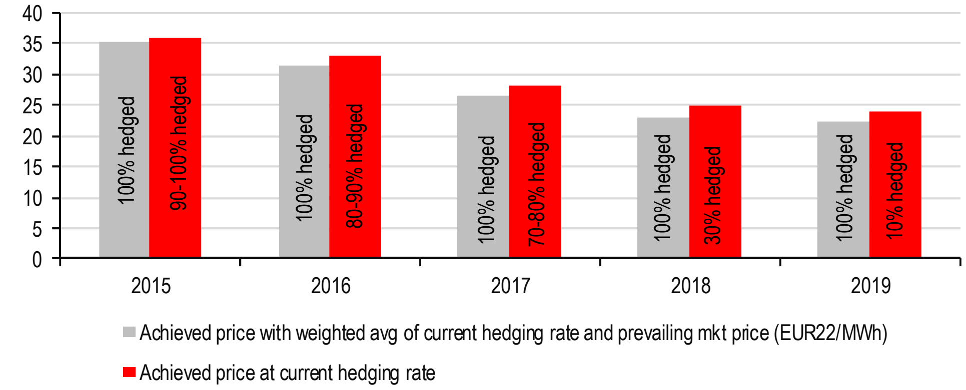


Source: E.ON, HSBC estimates

42%

Decline in achieved selling prices for E.ON Central Europe outright generation between 2015e and 2018e

E.ON's Nordic achieved price and hedging (EUR/MWh)



Source: E.ON, HSBC estimates

We can understand the wish of the German government to prevent the spin-off of domestic nuclear activities that led to E.ON's September decision to retain the German nuclear business rather than transfer it to the to-be-spun-off Uniper (as initially planned). In our view, this U-turn reduced the rationale for the group's de-merger, in that:

- E.ON retains merchant market exposure and loses its defensive appeal,
- the business split between E.ON, which contains German nuclear, and Uniper, which contains Nordic nuclear, lacks logic,
- the impact of the new de-merger terms will diminish the free cashflow of Uniper (where FCF will be the determinant of the dividend) and lead to a 20% cut in the 2016e combined E.ON-Uniper dividend, in our view, assuming a 50-60% pay-out policy for New E.ON, and
- E.ON is likely to be less able to cut its cost of debt (highest in the sector) under the revised de-merger terms.

We estimate a 20% cut in the 2016e combined E.ON-Uniper dividend to EUR0.40, assuming a 50-60% pay-out policy for New E.ON and three-quarters of free cash flow for Uniper.

We agree that E.ON is better able than RWE to fund growth in its attractive businesses, wind power and regulated distribution. This does not, however, make the stock sufficiently attractive to warrant investment, in our view.

Nuclear commission: could further de-risk the nuclear provision factor, but do not expect a free lunch

Following the conclusion of the independent auditors in late September that the German utilities' nuclear provisions are adequate under normal circumstances, the government has set up a commission whose objective is to propose the most suitable way that the provisions can be funded. At present, they are funded internally by the companies. The Commission consists of 19 people and is headed by Juergen Trittin (previously the environment minister, member of the Green party), Ole Van Breust (previously mayor of Hamburg, member of the CDU), and Matthias Platzeck (previously Prime Minister of the Brandenburg region, member of the SPD). Below these three is a mix of politicians covering the political spectrum as well as non-politicians (including the founder of Greenpeace Germany and a prominent cleric). So far, no statement has been made by the Commission, which had its initial session in mid-November. At a future session, the companies will be represented, with a final round expected in early 2016. The final report is expected around late January or in February. It would not surprise us if initial indications were to emerge during January.

The report will propose a concept rather than hard numbers and it will be submitted to a multi-ministry group for preparation for parliamentary debate.

The market, in our view, is hoping for an external fund for waste storage funds, preferably with a cap or some form of guarantee regarding elements such as collateral, with a trust-type CTA fund for dismantling provisions (similar to the trusts covering the companies' pension funds). We would caution that the government will not wish to be seen as assisting what is an industry (nuclear power) that is widely mistrusted by the German public. We would add that the major parties will already be mindful of positioning themselves prior to the next elections, which are not far away in September 2017.

Next election uncomfortably close: time may run out before any decision is passed into law

The main risk for us is that the time schedule for the Commission appears tight, and delays are possible that could prevent any recommendations being passed into law soon enough. There is a significant risk, in our view, that nothing may emerge from the Commission's ongoing deliberations, and the whole issue risks being kicked into the long grass until after the 2017 elections.

Slight reduction in estimates on declining selling prices

We have cut our EBITDA estimates for 2015e-18e slightly on account of lower power prices. Consequently, our EPS estimates are down by an average of 2% for 2015e-18e.

E.ON: Change in forecasts

	2014a	2015e	2016e	2017e	2018e
Adj. EBITDA (EURm)					
Previous		7,439	6,349	6,419	6,397
New	8,337	7,433	6,337	6,389	6,347
% Change		0%	0%	0%	-1%
Adj. net income (EURm)					
Previous		1,546	1,313	1,341	1,319
New	1,612	1,540	1,304	1,319	1,282
% Change		0%	-1%	-2%	-3%
HSBC EPS (fully diluted) (EUR)					
Previous		0.80	0.67	0.68	0.66
New	0.84	0.79	0.67	0.67	0.64
% Change		0%	-1%	-2%	-3%
HSBC DPS (EUR)					
Previous		0.50	0.40	0.40	0.40
New	0.50	0.50	0.40	0.40	0.40
% Change		0%	0%	0%	0%

Source: Company data, HSBC estimates

Valuation and risks

Maintain Reduce rating and EUR8.0 target price

We have cut our earnings estimates for 2015e-18e by an average of 2% for lower electricity prices. However, we maintain our target price at EUR8.00, implying 10% downside, as we cut our additional risk premium by 50bps to 100bps due to the passing of nuclear stress tests. Our maintained Reduce rating is based on the weak power price environment together with the risk of disappointment in the setting up of an external nuclear fund.

We have cut our earnings estimates for 2015e-18e by an average of 2% for lower electricity prices. However, we maintain our target price at EUR8.00 as we cut our additional risk premium by 50bps to 100bps due to the passing of nuclear stress tests.

We have rolled forward our valuation to 2016e. We assign a 50% weight to our yield-based valuation and 25% each to our DCF and SOP valuations. Our target price of EUR8.00 is based on:

- DCF (EUR8.10 per share from EUR7.80, WACC of 6.6%)
- Yield-based valuation (EUR8.00, at 5.0% yield, unchanged)
- SOP (EUR7.80 per share from EUR8.40, at 30% risk discount)

Our target price of EUR8.00 implies downside of 10.0% to the current price.

Summary of E.ON valuations: EUR8.00 target price

Valuation technique	Valuation weight	Revised value (EUR)	Previous value (EUR)
DCF	25%	8.10	7.80
Sum-of-the-parts, 30% discount	25%	7.80	8.40
Yield-based valuation	50%	8.00	8.00
E.ON target price		**8.00**	**8.00**

Source: HSBC estimates

DCF EUR8.10

We have increased our DCF valuation to EUR8.10 from EUR7.80 as the cut in our earnings estimates for 2015-18 is more than offset by the narrowing of the additional risk premium, which we apply due to energy policy and restructuring risk, by 50bps to 1.0% on the recent conclusions of independent auditors that nuclear provisions were adequate under normal circumstances. Our DCF valuation is based on a WACC of 6.6% from 6.7% (beta 1.09, cost of equity 10.5% from 11.0%). We maintain our terminal growth rate at 1.5%.

E.ON: WACC calculation

	Calculation
Risk-free rate	3.5%
Country risk premium	5.5%
Additional risk premium	1.0%
Beta	1.09
Cost of equity	10.5%
Gross cost of debt	4.0%
Corporate tax rate	30.0%
Cost of debt, post tax	2.8%
Weight of debt	50.8%
Weight of equity	49.2%
WACC, post tax	6.6%

Source: HSBC estimates

E.ON DCF equity valuation: EUR8.10: WACC 6.6%, terminal growth rate 1.5%

	EURm
DCF value (core operations)	34,385
Associates, ST marketable assets, others	12,333
EV (asset side)	**46,718**
Less: Financial net debt	(2,900)
Less: Provisions, minorities & others	(27,925)
Total non-equity claims/liabilities	(30,825)
Value of equity	15,893
Shares (m)	1,966
DCF value per share - EUR	**8.10**

Source: HSBC estimates

Yield-based valuation: EUR8.00

We maintain our yield-based valuation at EUR8.00 per share valuing E.ON at a 5% yield.

E.ON yield-based valuation at 5.0% yield: EUR8.00

	EUR
Yield based valuation at 5% yield to 2015e dividend	8.0

Source: HSBC estimates

SOP: EUR7.80

We have cut our SOP valuation to EUR7.80 from EUR8.40 as we cut the value of generation assets on lower power and commodity prices. We maintain our SOP discount at 30%.

E.ON SOP value: EUR7.80 after 30% discount

Activity	Valuation methodology	EV EURm	EUR per share	% gross SOP
New E.ON				
Renewables	DCF/MW	9,702	4.9	18%
Distribution	8.5x 2016e EBITDA	22,100	11.2	42%
Customer solutions	EUR/customer	5,581	2.8	11%
Others (Turkey)	DCF/MW, EUR/KM, EUR/customer	1,000	0.5	2%
Nuclear		1,795	0.9	3%
Uniper				
Generation	DCF/MW	7,284	3.7	14%
Global commodities	At 2.0x EBIT 2016e	300	0.2	1%
Exploration & Production	At 5.0x Post-tax EBIT 2016e	900	0.5	2%
Add: Associates, LT investments, disposal and impairment		3,940	2.0	7%
Total assets		**52,602**	**26.8**	**100%**
Less: Debt, provisions, minorities	End-2016 estimates	(30,825)	-15.7	
SOP value per share - EUR		21,777	11.1	
SOP value per share - EUR	**At 30% discount**		**7.80**	

Source: HSBC estimates

Upside risks

- External fund recommended by the government for nuclear waste storage liabilities is deemed by market to substantially de-risk the company's nuclear business
- German constitutional court finds nuclear tax illegal (Q1 2016e)
- German power prices recover
- Dividend commitment from combination of New E.ON and Uniper implies a more generous future policy than we, and the market, expect.

HSBC

New E.ON income statement

(EURm except per share data)	2016e	2017e	2018e
Net sales	56,223	58,321	60,103
EBITDA	**4,943**	**5,200**	**5,282**
Depreciation and amortisation	-2,210	-2,250	-2,300
Adjusted EBIT	2,779	2,996	3,028
Interest expense	-787	-756	-665
Other financial income & expenses	238	210	175
Income before taxes	1,630	1,790	1,838
Taxes	-408	-448	-461
Associate income from Uniper	155	111	85
Net income	1,378	1,452	1,462
Share of minorities	-225	-235	-245
Adjusted net income	**1,153**	**1,217**	**1,217**
Net ordinary (EPSc)	0.59	0.62	0.62
Dividend per share (60-70% pay-out)	0.30	0.31	0.32
Net debt	-8,625	-9,043	-9,493
Net debt + provisions	-29,238	-30,656	-31,106
Net debt/EBITDA	1.74x	1.74x	1.80x
Net debt + provisions/EBITDA	5.92x	5.90x	5.89x

Source: HSBC estimates

New E.ON cash flow statement

(EURm)	2016e	2017e	2018e
Cash flow before working capital	3,888	4,032	4,112
Working capital changes	-15	-16	-14
Cash from operations	**3,872**	**4,016**	**4,098**
Net investments in tangible and intangible fixed assets	-4,000	-4,100	-4,200
Net cash flows from investing	**-4,000**	**-4,100**	**-4,200**
Changes in debt	0	1,000	1,000
Changes in equity capital	79	126	131
Dividends paid	-526	-461	-478
Cash from financing activities	-447	666	653
Currency translation and other effects	0	0	0
Changes in cash and cash equivalents	**-574**	**582**	**551**
Financial net debt	**-8,625**	**-9,043**	**-9,493**

Source: HSBC estimates

Uniper income statement

(EURm except per share data)	2016e	2017e	2018e
Net sales	69,957	70,451	70,835
EBITDA	**1,394**	**1,189**	**1,065**
Depreciation and amortisation	-519	-474	-454
Adjusted EBIT	875	715	611
Net interest expense on pension & other provisions	-104	-81	-71
Income before taxes	530	409	310
Taxes	-154	-125	-85
Net income	376	284	225
Share of minorities	-70	-70	-70
Adjusted net income	**306**	**214**	**155**
Net ordinary EPS (EUR)	0.16	0.11	0.08
Net debt (+ve for cash)	-2,273	-2,138	-2,087
Net debt + provisions	-6,887	-6,752	-6,701
Net debt + provisions/EBITDA	4.94x	5.68x	6.29x

Source: HSBC estimates

HSBC

Uniper cash flow statement

(EURm)	2016e	2017e	2018e
Cash flow before working capital	947	799	714
Working capital changes	7	-4	-3
Cash from operations	**954**	**795**	**711**
Net investments in tangible and intangible fixed assets	-350	-350	-350
Net cash flows from investing	**1,450**	**-350**	**-350**
Changes in debt	0	0	0
Changes in equity capital	85	85	85
Dividends paid	-393	-395	-396
Cash from financing activities	-309	-310	-311
Currency translation and other effects	0	0	0
Changes in cash and cash equivalents	2,096	135	51
Opening cash and cash equivalents	0	0	0
Closing cash and cash equivalents	**2,096**	**135**	**51**
Financial net debt	**-2,273**	**-2,138**	**-2,087**

Source: HSBC estimates

HSBC

Financials & valuation: E.ON

Reduce

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (EURm)				
Revenue	111,556	117,814	120,317	125,029
EBITDA	8,337	7,433	6,337	6,389
Depreciation & amortisation	-3,673	-3,219	-2,729	-2,724
Operating profit/EBIT	4,664	4,214	3,608	3,665
Net interest	-234	73	79	157
PBT	-2,379	-5,306	2,029	2,112
HSBC PBT	-2,379	-5,306	2,029	2,112
Taxation	-576	-700	-454	-513
Net profit	-2,985	-6,296	1,304	1,319
HSBC net profit	1,612	1,540	1,304	1,319
Cash flow summary (EURm)				
Cash flow from operations	6,031	6,612	5,971	6,018
Capex	-4,633	-4,300	-4,000	-4,500
Cash flow from investment	-3,235	-1,284	-2,284	-4,873
Dividends	-1,039	-759	-765	-617
Change in net debt	-2,683	-3,594	-2,325	135
FCF equity	1,398	2,312	1,971	1,518
Balance sheet summary (EURm)				
Intangible fixed assets	16,694	12,694	12,694	12,694
Tangible fixed assets	41,273	35,254	34,725	36,501
Current assets	36,855	41,323	42,469	41,470
Cash & others	6,067	9,516	10,341	8,706
Total assets	125,690	120,223	120,924	122,073
Operating liabilities	35,443	36,268	36,598	37,219
Gross debt	19,667	18,022	16,522	15,022
Net debt	8,819	5,225	2,900	3,035
Shareholders' funds	24,585	18,155	19,325	20,535
Invested capital	53,312	43,487	42,948	44,739

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	-8.9	5.6	2.1	3.9
EBITDA	-10.5	-10.8	-14.7	0.8
Operating profit	-19.3	-9.6	-14.4	1.6
PBT	-174.2			4.1
HSBC EPS	-28.7	-5.5	-16.0	0.4
Ratios (%)				
Revenue/IC (x)	1.8	2.4	2.8	2.9
ROIC	9.6	9.9	6.5	6.3
ROE	5.6	7.2	7.0	6.6
ROA	-1.2	-4.1	1.8	1.8
EBITDA margin	7.5	6.3	5.3	5.1
Operating profit margin	4.2	3.6	3.0	2.9
EBITDA/net interest (x)	35.6			
Net debt/equity	33.0	25.9	13.7	13.6
Net debt/EBITDA (x)	1.1	0.7	0.5	0.5
CF from operations/net debt	68.4	126.6	205.9	198.3
Per share data (EUR)				
EPS Rep (diluted)	-1.55	-3.24	0.67	0.67
HSBC EPS (diluted)	0.84	0.79	0.67	0.67
DPS	0.50	0.50	0.40	0.40
Book value	12.72	9.31	9.83	10.37

Valuation data

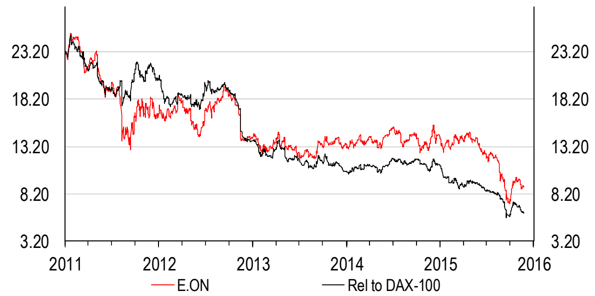
Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	0.4	0.3	0.3	0.3
EV/EBITDA	5.2	5.3	5.9	5.8
EV/IC	0.8	0.9	0.9	0.8
PE*	10.6	11.2	13.4	13.3
PB	0.7	1.0	0.9	0.9
FCF yield (%)	4.0	6.7	5.7	4.4
Dividend yield (%)	5.6	5.6	4.5	4.5

* Based on HSBC EPS (diluted)

Issuer information

Share price (EUR)	8.89	Free float	100%
Target price (EUR)	8.00	Sector	Multi-Utilities
Reuters (Equity)	EONGn.DE	Country	Germany
Bloomberg (Equity)	EOAN GR	Analyst	Adam Dickens
Market cap (USDm)	18,894	Contact	+44 20 7991 6798

Price relative



Source: HSBC
Note: Priced at close of 23 Nov 2015

RWE

- Impairments could shrink equity value to a level that would require capital injection
- Stress test hurdle overcome, but do not expect government to “support” nuclear industry any more than strictly necessary
- Maintain Reduce rating, cut target price to EUR10.0 from EUR10.5

Situation remains delicate; capital increase required

Modest equity, impairment risk, rating agency pressure: capital increase is needed

Asset value of generation is substantial and will be tested for possible impairment in Q4
Management stated at RWE’s nine-month conference call on 12 November that its books contain no goodwill on Central Europe generation but that asset book value is "clearly below EUR10bn". Given warnings of impairments by ENGIE and actual asset impairments of EUR3.0bn by E.ON at the 9M15 stage, we see a major risk that RWE will have to make a charge. Management also stated on 12 November that goodwill in other divisions is tested quarterly against the start-2015 internal business plan. Thus, we assume that a structural deterioration could bring a goodwill write-down when set against the 2016 business plan, which in the UK is likely to reflect the major billing problems at npower that have led to nine-month losses as well as falls in UK power prices; UK goodwill currently amounts to EUR2.2bn in the 2015 accounts.

A modest EUR9.2bn of equity ex-hybrids and minorities; rating agency pressure
RWE, according to management (12 November), is "working with S&P" regarding the rating agency’s decision to treat RWE's hybrid issuance as 100% debt rather than 50% debt/50% equity (adding EUR2bn to debt and removing EUR2bn from equity) and is "pretty confident" of finding a solution. Hybrid interest in the 9M balance sheet has been cut to EUR0.9bn with equity at what we believe is an uncomfortably low level of EUR9.2bn (before minorities and hybrids). We note that Moody’s has not changed its treatment of hybrids and maintains a 50-50 equity-debt split unless the corporate rating of the company falls below investment grade. RWE is rated Baa1 with a negative outlook by Moody’s, suggesting that, both on RCF/net debt and FFO/net debt criteria, it risks a downgrade to Baa2, just one notch above the lowest investment grade.

External nuclear fund? Unlikely to be a panacea
Following the nuclear stress test that found the utilities’ provisions are adequate in a normal environment, the utilities stated at their 9m 2015 results that the Commission appointed by the German government will report around late January 2016 its conclusions as to how such provisions should be structured and covered. It appears likely that an external, or partly external fund, may be set up, to be covered by financial and even operating assets, as discussed on pages 24-25. The hope is that this de-risks the thorny subject of nuclear provisions once and for all.

We would caution that the government will not wish to be seen as assisting what is an industry (nuclear power) that is widely mistrusted by the German public. We would add that the major parties will already be mindful of positioning themselves prior to the next elections, which are not far away in September 2017.

The main risk for us is that the time schedule for the commission appears tight, and delays are possible that could prevent any recommendations being passed into law soon enough. There is a significant risk, in our view, that nothing may emerge from the Commission's ongoing deliberations and the whole issue risks being kicked into the long grass until after the 2017 elections.

Hope from disposals ... of stable assets

The CEO has stated that in an environment of low power prices, he is maintaining the option of a split. However, we find it hard to see any attraction of a Uniper-style upstream division, due to the dependence on lignite and nuclear, whose futures do not appear secure. The CFO stated on 12 November that he is aware certain assets could attract a high value if monetised (ie grid, with Fortum having sold its three Nordic networks at an average of 16x EV/EBITDA), but we see problems here too: the company would raise its operational risk profile if it sells down stable regulated assets (the rating agencies carried out a double-downgrade of Fortum on the exit from distribution, despite the company completely wiping out its net debt), and, unlike Fortum, it does not benefit from an existing 'A'-category rating.

Our view is that if RWE wishes to implement a split, it would need to repair its balance sheet first. CEO Terium was quoted in FAZ on 23 November as saying that the issue of a capital increase could climb up the agenda again.

Slight reduction in estimates on declining selling prices

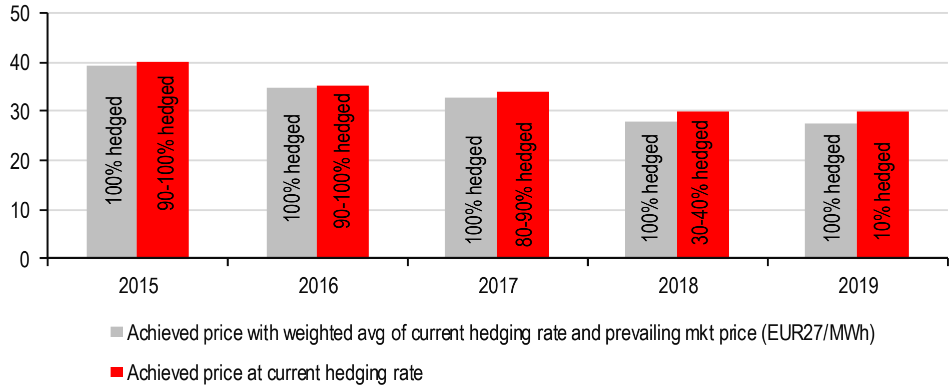
We have reduced our EBITDA estimates for 2015e-18e by an average of 1% on lower electricity prices. Consequently, we reduce our EPS estimates by an average of 6% for 2015e-18e.

RWE: Change in forecasts

	2014a	2015e	2016e	2017e	2018e
EBITDA (EURm)					
Previous		6,164	5,559	5,510	5,485
New	7,131	6,104	5,559	5,440	5,350
% Change		-1%	0%	-1%	-2%
Recurrent net income (EURm)					
Previous		1,156	643	617	617
New	1,282	1,117	643	576	537
% Change		-3%	0%	-7%	-13%
HSBC EPS (fully diluted) (EUR)					
Previous		1.88	1.05	1.00	1.00
New	2.09	1.82	1.05	0.94	0.87
% Change		-3%	0%	-7%	-13%
HSBC DPS (EUR)					
Previous		0.50	0.50	0.50	0.50
New	1.00	0.50	0.50	0.50	0.50
% Change		0%	0%	0%	0%

Source: Company data, HSBC estimates

RWE outright German generation achieved price and hedging (EUR/MWh)



Source: RWE, HSBC estimates

Valuation and risks

Reduce rating, cut target price to EUR10.0 from EUR10.5

We cut our earnings estimates by an average of 6% over 2015-18 on account of lower power price assumptions, and cut our target price to EUR10.0 from EUR10.5, implying 8% downside. Our Reduce rating is based on the risk of a capital increase and the potential negative impact on yield support. We have rolled forward our valuation to 2016e.Our new target price of EUR10.0 is derived 50% from our yield-based valuation, 25% on DCF and 25% on SOP valuations:

- DCF (EUR10.3 from EUR11.5, WACC of 7.0%)
- Sum-of-parts (EUR9.7 from EUR10.3 after 40% discount).
- Yield-based valuation (EUR10.0 at 5% yield, unchanged)

Summary of RWE valuations: EUR10.0 target price

Methodology	Valuation weight	Revised value (EUR)	Previous valuation (EUR)
DCF	25%	10.3	11.5
Sum-of-the-parts (40% discount)	25%	9.7	10.3
Yield based valuation	50%	10.0	10.0
RWE target price (rounded)		**10.0**	**10.5**

Source: HSBC estimates

DCF: EUR10.3

We have cut our DCF valuation to EUR10.3 from EUR11.5 on account of the cut in our earnings estimates for 2015-18 on the unfavourable outlook for power prices. Our DCF valuation is based on a WACC of 7.0% from 6.6% due to the rise in the stock beta to 1.32 from 1.20 since our last publication on 8 October. We maintain our additional risk premium at 5.0% due to our view that RWE runs the major risk of a rights issue. We maintain a zero terminal growth rate.

RWE: WACC calculation

	Calculation
Risk-free rate	3.5%
Country risk premium	5.5%
Additional risk premium	5.0%
Beta	1.32
Cost of equity	15.2%
Gross cost of debt	4.8%
Corporate tax rate	36.0%
Cost of debt, post tax	3.1%
Weight of debt	67.7%
Weight of equity	32.3%
WACC, post tax	**7.0%**

Source: HSBC estimates

RWE: DCF equity valuation: EUR10.3

	EURm
DCF value (core operations)	37,587
Associates, ST marketable assets, others	(4,304)
EV (asset side)	**33,283**
Less: Financial net debt	(2,402)
Less: Provisions, minorities & others	(24,566)
Total non-equity claims/liabilities	(26,967)
Value of equity	6,315
Shares (m)	614.7
DCF value per share - EUR	**10.3**

Source: HSBC estimates

Yield-based valuation: EUR10.0

We maintain our yield-based valuation for RWE at EUR10.0. We value RWE at an unchanged 5.0% yield based on a 2016e dividend of EUR0.50, in line with its German peer E.ON.

RWE: yield-based valuation at 5.0% yield: EUR10.0

	EUR
Yield-based valuation at 5.0% yield to 2016e dividend	10.0

Source: HSBC estimates

SOP: EUR9.7

We have cut our SOP valuation to EUR9.7 from EUR10.3 as we cut the value of generation assets on lower power and commodity prices. We maintain our SOP discount at 40%, a wide level to reflect the multiple financial, political and environmental risks faced by the group.

RWE: sum-of-the-parts value: EUR9.7 post-40% discount

Activity	Valuation methodology	EURm	EUR per share
Electricity	Generation: DCF/MW, T&D: EURm/km lines length, Supply: per account	24,290	39.5
Gas	Reserves: EUR/mmboe, Storage: EUR/cu m, T&D: EURm/km lines length, Supply: per account	5,477	8.9
Others	Lignite mines, trading	2,445	4.0
Core assets		**32,212**	**52.4**
Add: Non-core assets and divestitures	Associates, ST marketable assets, others	4,696	7.6
Total assets		36,908	60.0
Less: Financial debt	Net debt 2016e	(2,402)	(3.9)
Less: Quasi debt	Pension, nuclear, minorities, other liabilities	(24,566)	(40.0)
SOP value per share		9,941	16.2
SOP value per share	**with 40% discount**		**9.7**

Source: HSBC estimates

Upside risks

- External fund recommended by the government for nuclear waste storage liabilities is deemed by market to substantially de-risk the company's nuclear business;
- German Constitutional Court rules against the nuclear tax (Q1 2016e);
- German power prices recover
- RWE implements a split that is deemed favourable by the market, without having to resort to a prior capital injection
- RWE reassures on its dividend.

HSBC

Financials & valuation: RWE

Reduce

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (EURm)				
Revenue	46,149	47,016	46,774	47,268
EBITDA	7,131	6,104	5,559	5,440
Depreciation & amortisation	-2,892	-2,523	-2,573	-2,618
Operating profit/EBIT	4,239	3,582	2,987	2,823
Net interest	-952	-413	-488	-418
PBT	2,246	2,539	1,875	1,785
HSBC PBT	2,246	2,539	1,875	1,785
Taxation	-553	-889	-769	-732
Net profit	1,340	1,117	643	576
HSBC net profit	1,282	1,117	643	576
Cash flow summary (EURm)				
Cash flow from operations	6,368	5,035	3,621	3,947
Capex	-2,703	-2,750	-2,000	-2,000
Cash flow from investment	-4,869	3,192	-2,058	-2,058
Dividends	-1,061	-1,015	-707	-707
Change in net debt	-1,901	-5,262	-855	-1,182
FCF equity	4,783	1,285	2,112	2,296
Balance sheet summary (EURm)				
Intangible fixed assets	12,797	12,797	12,797	12,797
Tangible fixed assets	31,059	25,287	24,714	24,097
Current assets	26,552	32,807	33,086	33,693
Cash & others	7,581	10,591	10,744	11,224
Total assets	86,316	86,856	86,621	86,669
Operating liabilities	22,069	24,547	24,481	24,615
Gross debt	18,566	16,114	15,412	14,710
Net debt	8,519	3,257	2,402	1,220
Shareholders' funds	7,388	9,116	9,123	9,063
Invested capital	40,758	35,753	35,371	34,748

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	-10.2	1.9	-0.5	1.1
EBITDA	-18.6	-14.4	-8.9	-2.1
Operating profit	-27.9	-15.5	-16.6	-5.5
PBT		13.1	-26.2	-4.8
HSBC EPS	-44.6	-12.8	-42.4	-10.4
Ratios (%)				
Revenue/IC (x)	1.0	1.2	1.3	1.3
ROIC	7.2	6.1	5.0	4.7
ROE	17.0	13.5	7.1	6.3
ROA	3.0	2.4	1.7	1.6
EBITDA margin	15.5	13.0	11.9	11.5
Operating profit margin	9.2	7.6	6.4	6.0
EBITDA/net interest (x)	7.5	14.8	11.4	13.0
Net debt/equity	94.0	29.0	20.7	10.2
Net debt/EBITDA (x)	1.2	0.5	0.4	0.2
CF from operations/net debt	74.8	154.6	150.8	323.5
Per share data (EUR)				
EPS Rep (diluted)	2.18	1.82	1.05	0.94
HSBC EPS (diluted)	2.09	1.82	1.05	0.94
DPS	1.00	0.50	0.50	0.50
Book value	12.02	14.83	14.84	14.74

Valuation data

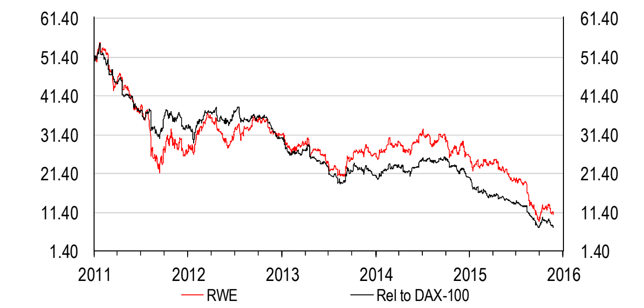
Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	0.8	0.6	0.6	0.6
EV/EBITDA	4.9	4.9	5.3	5.3
EV/IC	0.9	0.8	0.8	0.8
PE*	5.2	6.0	10.4	11.6
PB	0.9	0.7	0.7	0.7
FCF yield (%)	18.3	4.8	7.8	8.4
Dividend yield (%)	9.2	4.6	4.6	4.6

* Based on HSBC EPS (diluted)

Issuer information

Share price (EUR)	10.89	Free float	89%
Target price (EUR)	10.00	Sector	Multi-Utilities
Reuters (Equity)	RWEG.DE	Country	Germany
Bloomberg (Equity)	RWE GR	Analyst	Adam Dickens
Market cap (USDm)	7,018	Contact	+44 20 7991 6798

Price relative



Source: HSBC
Note: Priced at close of 23 Nov 2015

Centrica

- Reducing our EPS estimates for 2016 by 1% and 2017 by 6% on lower commodity prices but dividend remains secure, in our view
- Self-help in progress but no news until February; CMA remedies for lack of competitiveness of UK energy supply market due
- Cut target price to 225p from 250p on lower commodity assumptions, upstream and power valuation, reiterate Hold rating

Commodity review: cut our EPS for 2016 by 1% and 2017 by 6%

Centrica is not likely to fail its credit metrics, so its dividend, in our view, remains secure

We cut our forecasts given the recent further decline in commodity and power prices. Despite this, we believe Centrica is not likely to fail its credit metrics, so its dividend, in our view, remains secure. Given the lack of short-term growth we believe the market will continue to ascribe a premium to Centrica's yield. On our valuation we assume 5%. The stock is currently yielding a premium to this.

The one-year and two-year forward UK electricity prices have declined 20% and 22% respectively since the beginning of the year. One of the key reasons is the reduction in gas prices (gas being the power price setter in the UK market). Given this ongoing decline in prices, we have cut our achieved gas price sales forecasts for Centrica's upstream business. This compares with NBP gas prices at 38p for this winter.

Centrica: Change in achieved gas price assumptions (European assets)

Gas prices (GBp/therm)	2016e	2017e	2018e
Revised	40	38	40
Previous	40	40	45
Change (%)	*0%*	*-5%*	*-11%*

Source: HSBC estimates

Self-help in progress but no update until February

Investors remain sceptical about how Centrica can grow

Three key strategies emerged from management's strategic review announced in July 2015: (i) focus on its customer-facing business – British Gas and Direct Energy; (ii) bottom-line growth in the medium term through significant cost savings (GBP750m savings by 2020); and (iii) E&P business rationalisation. These together underpin management's guidance of 3-5% OCF growth and aligned dividend growth. We think the short-term commodity headwinds will make it more challenging for Centrica to grow earnings until 2017. If Centrica can cut costs to stem a further earnings decline in 2016, we think the stock could rerate but investors remain sceptical about how Centrica can grow. A potential catalyst could be an announcement at the FY results in February 2016 of guidance for 2016 EPS above consensus expectations of 17.6p.

Recent stock underperformance reflects news vacuum and commodity slide

Centrica has underperformed the MSCI Europe Utilities index by 22% in the last 12 months. As a commoditised utility it is out of favour in the sector. In addition to commodity pressures, the Competition and Market Authority (CMA) is due to announce remedies reflecting some lack of competitiveness in UK supply. Although many radical structural remedies have been rejected by the CMA, the remedies proposed may reduce the considerable price differential between it and its peers, leading to some margin erosion. The market is especially concerned regarding the proposals for 'Safeguard tariffs'. This or other remedies could reduce retail margins for both SSE and Centrica. The CMA plans to publish its provisional decision on remedies in January 2016 with a view to reaching its final decision by the end of April 2016. We continue to assume that Centrica can achieve a blended margin for gas and electricity of around 5% in British Gas Residential.

The medium-term growth question remains

The major shift in Centrica's new strategy is to focus on its downstream supply business. It aims to utilise its competitive advantages − strong market shares, good brands and extensive energy services capability − to achieve growth. It has identified five businesses − energy supply, services, distributed energy and power, the connected home and energy marketing and trading − for its long-term growth prospects. Centrica plans to spend cGBP1.2bn additional resources on its connected homes and Distributed generation business. From our discussions with investors we believe there is scepticism in the market that this will be a major growth driver for Centrica. The company has limited exposure to these businesses and there is uncertainty about whether it can achieve growth with sustainable returns. As it remains committed to its upstream business albeit at a smaller level – the stock remains correlated to commodity prices. The company has committed to reduce its production to 40-50mmboe per annum from current levels of c75-80mmboe per annum with a reduced annual capex of cGBP400-600m.

We believe if Centrica can grow earnings in the short term through cost-cutting the market will give it some credence for medium-term growth potential. Until it stops its earnings decline, the market, we believe, will be unwilling to ascribe much value to its medium and long-term growth aspirations.

With current low commodity prices we assume upstream capex reduces from GBP600m to GBP500m from 2016-2018. Centrica is continuing to invest in fields which will come onstream to maintain its reserves such as Cygnus (2016) and Maria (2017). It has also committed to sell wind assets.

In power Centrica announced on 26 November that it will spend GBP63m on an overhaul of the gas turbines at the South Humber gas-fired power station. The part-mothballed plant will return to full service in 2017 in time for its capacity market contract in October 2018. Centrica's gas-fired generation focus benefits from the current Government's power strategy favouring nuclear, and gas-fired generation.

Credit metrics are at lower end of range of metrics for the current rating but upstream capex flexibility could create headroom

We continue to believe that Centrica has sufficient levers within the business, including reduced upstream investment, to underpin its current credit metrics. The metrics below indicate lower headroom than we assumed at the H1 results given the commodity price fall but if Centrica were to reduce upstream capex below our expectation GBP500m this could increase its headroom. This assumes 3% dividend growth for 2016 and 10% for 2017. For current ratings Moody's requires a mid-30s FFO/adjusted net debt and an RCF/adjusted net debt in the mid-20s.

HSBC

Centrica credit metrics

	2015e	2016e	2017e
FFO/net adj debt (incl decomm. liabilities)	30.8%	31.8%	34.3%
RCF/net adj debt	22.0%	20.9%	21.6%

Source: HSBC estimates

Valuation and risks

We have rolled forward our valuation base to December 2016, revised our upstream valuation to reflect lower gas prices, and reviewed both our power assets valuation and our British Gas valuation in the light of this lower commodity environment.

We value Centrica via three methodologies – DCF, dividend yield and SOTP. Under this methodology, we assign a 50% weight to yield and 25% each to DCF and SOTP to arrive at our rounded new fair value target price of 225p (was 250p). Our target price implies upside of 6% and we have a Hold rating on the stock. Our dividend yield assumption for valuation is 5.5%, up from 5.0% previously, given the lack of earnings growth we foresee for the short term from the commodity risk profile.

We have chosen Hold as we expect no update on the transformation plan until February and we await Centrica's trading statement due on 10 December.

Centrica: Revised estimates

	2015e	2016e	2017e
Revenue			
Revised	29,060	28,839	29,277
Previous	29,060	29,200	30,508
Change	*0%*	*-1%*	*-4%*
EBITDA			
Revised	2,814	2,588	2,725
Previous	2,827	2,640	2,859
Change	*0%*	*-2%*	*-5%*
EPS (GBp)			
Revised	17.26	17.79	19.63
Previous	17.30	17.70	20.90
Change	*0%*	*1%*	*-6%*

Source: HSBC estimates

Centrica: Summary of valuation

(p)	New	Previous
Current price as on 23-Nov-15	**214**	**NA**
DCF	235	296
Yield 5%	231	240
Sum-of-the-parts	212	239
Target price (average rounded)	**225**	**250**

Source: HSBC estimates

Centrica: DCF WACC: 235p

WACC inputs		Equity valuation	GBPm
Cost of debt		**+ DCF value**	**16,159**
Pre-tax cost of debt	4.0%	+ ST marketable assets	-
Marginal tax rate	30%	+ Value of associates	-
Cost of equity		+ Other assets	-
Risk-free rate	3.5%	EV (asset side)	16,159
Equity risk	4.0%	- Net debt (+ if Net cash)	-3,485
Additional risk	0.5%	- Quasi debt (pension)	-123
Beta	1.10	- Value of minorities	-342
Debt - 33%	2.8%	Total non-equity claims / liabilities	-3,950
Equity - 67%	7.9%	**Value of equity**	**12,209**
Cost of capital	**6.3%**	**Value per share (GBp)**	**235**

Source: HSBC estimates

Centrica: Sum of the parts: 212p

Division	Metric			Value (GBPm)
Centrica Energy				
UKCS, Norway and NA	DCF assumes USD50 oil price for 2016			1,545
				0
	Total value			**1,545**
Power Generation		**Capacity (MW)**	**GBP/kW**	
CCGT including capacity payments for Langage and Humber		*2,070*	*356*	736
Wind		*200*	*1,000*	200
Nuclear assuming 80% of original purchase price		*1,642*	*725*	1,190
Total including nuclear stake				**2,126**
Centrica Storage	DCF			232
Total upstream		**3,912**	**Noplat**	**3,904**
British Gas Business 10% discount to historic multiple	PE	11.1x	107	1,184
British Gas Residential 10% discount to historic multiple	PE	11.1x	361	4,005
British Gas Services historic multiple	PE	11.1x	272	3,019
Total British Gas				**8,208**
Centrica North America Peer group PE	PE	15.0x	233	3,501
Bord Gais consideration + small premium				120
Group enterprise value				**15,613**
2016e net debt & Minority Interests				- 4,601
Group equity value				**11,012**
Shares outstanding				5,200
Group equity value per share (p)				**212**

Source: HSBC estimates

Downside risks: Centrica fails to achieve the targets it guided to in its new strategic plan; Centrica fails to maintain margins at British Gas; sees no growth in British Gas Business, Services or in North America. Centrica cannot create cost savings to offset the effect of the CMA's final remedies. It cannot reduce costs in its upstream business, long-term gas prices fall below our assumptions.

Upside risks: Centrica is able to raise EPS for 2016 in February above the 2016 consensus level of 17.08p (Thomson Reuters Smart estimate 2016e); it increases its dividend payout ratio using cash from disposals. Its payout ratio remains around 70% on our estimates for the next three years.

HSBC

Financials & valuation: Centrica

Hold

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (GBPm)				
Revenue	29,408	29,060	28,839	29,277
EBITDA	2,928	2,814	2,588	2,725
Depreciation & amortisation	-1,314	-1,242	-990	-934
Operating profit/EBIT	1,614	1,572	1,598	1,791
Net interest	-266	-280	-242	-227
PBT	-1,403	1,224	1,299	1,516
HSBC PBT	1,480	1,292	1,357	1,564
Taxation	398	-343	-364	-485
Net profit	-1,012	872	925	1,021
HSBC net profit	962	872	925	1,021
Cash flow summary (GBPm)				
Cash flow from operations	2,747	2,292	2,077	2,087
Capex	-781	-989	-966	-982
Cash flow from investment	-651	-816	-966	-982
Dividends	-882	-606	-661	-728
Change in net debt	953	-1,021	-846	-329
FCF equity	1,602	1,303	1,111	1,105
Balance sheet summary (GBPm)				
Intangible fixed assets	4,600	4,600	4,600	4,600
Tangible fixed assets	6,377	6,124	6,100	6,149
Current assets	8,118	7,951	7,814	7,824
Cash & others	621	621	621	621
Total assets	22,692	22,099	21,938	21,997
Operating liabilities	8,251	8,184	8,141	8,226
Gross debt	6,986	5,965	5,120	4,791
Net debt	6,002	4,981	4,136	3,807
Shareholders' funds	2,735	3,226	3,951	4,252
Invested capital	15,227	14,874	14,756	14,730

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	10.7	-1.2	-0.8	1.5
EBITDA	-24.4	-3.9	-8.0	5.3
Operating profit	-36.1	-2.6	1.7	12.0
PBT	-185.1		6.1	16.7
HSBC EPS	-27.9	-9.4	3.0	10.3
Ratios (%)				
Revenue/IC (x)	1.9	1.9	1.9	2.0
ROIC	7.3	7.5	7.8	8.3
ROE	24.3	25.0	22.6	22.2
ROA	-3.5	4.8	5.0	5.4
EBITDA margin	9.2	9.4	8.8	9.1
Operating profit margin	5.5	5.4	5.5	6.1
EBITDA/net interest (x)	11.0	10.1	10.7	12.0
Net debt/equity	195.4	139.7	96.3	82.8
Net debt/EBITDA (x)	2.0	1.8	1.6	1.4
CF from operations/net debt	45.8	46.0	50.2	54.8
Per share data (GBPp)				
EPS Rep (diluted)	-20.04	17.26	17.79	19.63
HSBC EPS (diluted)	19.05	17.26	17.79	19.63
DPS	13.50	12.00	12.72	13.99
Book value	55.04	63.90	75.99	81.76

Valuation data

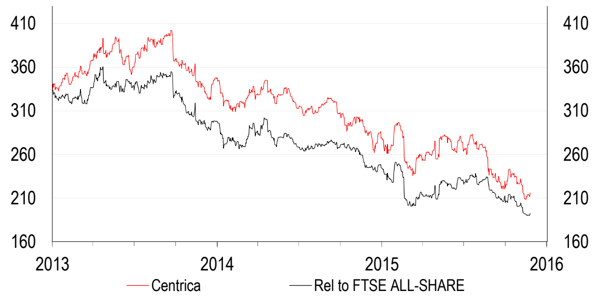
Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	0.5	0.5	0.5	0.5
EV/EBITDA	5.0	4.9	5.2	4.9
EV/IC	1.0	0.9	0.9	0.9
PE*	11.1	12.3	12.1	10.8
PB	3.9	3.3	2.8	2.6
FCF yield (%)	18.5	14.7	12.5	12.3
Dividend yield (%)	6.4	5.7	6.0	7.2

* Based on HSBC EPS (diluted)

Issuer information

Share price (GBPp)	212	Free float	100%
Target price (GBPp)	225	Sector	Multi-Utilities
Reuters (Equity)	CNA.L	Country	United Kingdom
Bloomberg (Equity)	CNA LN	Analyst	Verity Mitchell
Market cap (USDm)	16,237	Contact	44 20 7991 6840

Price relative



Source: HSBC
Note: Priced at close of 23 Nov 2015

SSE

- H1 results – benefit of wind on renewable generation performance, lower costs and higher consumption drive improvement in retail earnings
- Challenging conditions but SSE holds guidance; we raise 2016e EPS after H1 results to 116p in line with company guidance up 3% but cut 2017e by 3% and 2018e by 4% on lower commodity prices
- Maintain Hold rating and cut target price to 1,475p from 1,575p on lower estimates and power plant valuation

H1 results: wind drives renewable generation performance

Improved margin in its supply business from higher consumption and lower costs
SSE reported its H1 results on 11 November 2015. The company reported adjusted EPS of 45.9p implying y-o-y growth of 48%. The major contributors for this growth were the wholesale and retail division. The wholesale division delivered an operating profit of GBP160m compared to GBP27m in the same period last year, primarily driven by the renewables energy segment in which it reported a 1.1TWh (38% y-o-y) increase in output of renewable energy to 3.8TWh (wind energy contributing c0.7TWh increase y-o-y). This reflected higher rainfall and windier conditions over the six months. The retail segment registered an operating profit of GBP102m compared to GBP37m in the same period last year. The increase was largely driven by a better performance in the Industrial & Commercial sector, lower-than-average temperatures leading to an increase in gas consumption, and lower operating costs. Despite this solid performance, the company only reiterated its FY guidance of at least 115p adjusted EPS, implying a tough and uncertain operating environment – including volatility in commodity prices.

SSE: H1 results comparison

GBPm	H1 2016a	H1 2015a	Y-o-y growth (%)	HSBC FY 2016e
EBIT	702	530	32.4%	1,663
PBT	549	370	48.3%	1,471
EPS (p)	45.9	31.1	47.6%	114.5
DPS (p)	26.9	26.6	1.1%	91.37

Source: HSBC estimates

Update on business segments

SSE will review the future of its Fiddler's Ferry coal plant after the December capacity auction

EPM and Generation: The continued low commodity price environment and the lack of any evidence of market tightening in forward prices continue to present a challenge to this division. SSE will review the future of its Fiddler's Ferry coal plant after the December capacity auction. With its Ferrybridge plant closing early in 2016 there will be pressure on the company to utilise coal stocks and run the plant at full capacity to use up the inventory. SSE wants to recycle its capital from sales in wind assets to underpin new wind investment and hence we expect some net growth in this segment for full year.

Challenging conditions

Power prices continue to decline
Forward power prices for UK continue to decline, as shown above. The one-year and two-year forward prices have declined 20% and 22% respectively since the beginning of the year. One of the key reasons for the power price decline is the reduction in gas prices (gas being the power price setter in the UK market). Both TTF gas and NBP gas have declined c21% year-to-date.

Further, there is considerable uncertainty about the resilience of the power market as more coal-fired generation are likely to close in spring 2016, driven by lower prices and the UK Government's Carbon Price Floor, which will be at GBP18.08 from 1 April 2016. However, the forward electricity market does not seem to be factoring in the falling reserve margin and scarcity of flexible thermal generation, with the forward curve being almost flat until 2018. We continue to mark to market our power price assumptions. In the long term, we estimate the UK's interconnection capacity (excluding to Ireland) will rise by two-and-a-half times to 7.4GW in 2020 from the current level of 3GW, with a further jump to 10.2GW by end-2021. As a result, we expect the cheaper-priced mainland European imports to rise sharply. We believe this will result in a decline in UK power prices with a narrowing of the UK's premium to mainland Europe on this sharply increasing 2018-21 imports (see our report *UK Electricity: Britain to join the (electricity) eurozone,* 28 July 2015, for details),

Reducing power price assumptions: We have cut our power price assumptions for 2016-20 in our model as summarised in the table below. This has resulted in a reduction to our target price. In addition, we have revisited the value of the SSE's power assets in the light of recent power prices and the Carbon Price Floor.

Changes to our power price assumptions

Power price (GBP/MWh)	2016e	2017e	2018e	2019e	2020e
Revised	44.0	38.0	36.5	36.5	36.5
Previous	44.0	45.0	46.0	47.0	48.0

Source: HSBC estimates

The CMA plans to publish its provisional decision on remedies in January 2016 with a view to reaching its final decision by the end of April 2016

Retail The CMA plans to publish its provisional decision on remedies in January 2016 with a view to reaching its final decision by the end of April 2016.

In the retail business, the CMA has set out an initial list of possible measures that could increase competition and ensure a better deal for customers. The market is especially concerned regarding the proposals for 'Safeguard tariffs', which could reduce retail margins for SSE and Centrica.

Networks We expect SSE's combined network businesses to deliver flat operating profit y-o-y. Although transmission earnings will grow reflecting accelerated investment, there will be lower earnings in Gas Distribution from the sharing mechanisms with customers. Electricity Distribution earnings will be rebased at the beginning of its eight-year price control period ED- 1 as set out in its regulatory settlement. Further minor erosion of earnings will occur following the CMA investigation in subsequent years.

Credit metrics remain within rating agency parameters for current rating

The maintenance of current EPS guidance for FY 2015-2016 means SSE still has headroom in its credit metrics. Both rating agencies have a negative outlook on their rating A3/BBB+ respectively and SSE remains challenged to maintain the current rating given the commodity environment. However, asset sales and scrip take-up should provide sufficient support, we believe, to allow it to continue to maintain its dividend even if its Moody's rating were to be cut to Baa1. Moody's requires a RCF/adjusted net debt ratio above 13%, S&P FFO/adjusted net debt above 20%.

Financial credit metrics

	2015e	2016e	2017e
FFO/net adj debt	24.1%	23.6%	22.4%
RCF/net adj debt	16.4%	15.3%	14.2%

Source: HSBC estimates

Valuation and risks

We value SSE via three methodologies – DCF, dividend yield and SOTP. Under this approach, we assign a 50% weight to yield assuming a 6% yield given the commodity risk profile (previously 5.5%) and 25% each to DCF and SOTP to arrive at our new target price of 1,475p (previously 1,575p). Our target price implies upside of 2% and we maintain our Hold rating.

We have rolled our estimates forward to March 2017. We have reduced our power price assumptions resulting in a flat price trajectory of prices for the remainder of the decade which has resulted in a reduction to our estimates.

SSE: Revised estimates

	2016e	2017e	2018e
PBT (GBPm)			
Revised	1,518	1,512	1,526
Previous	1,488	1,581	1,636
% change	*2%*	*-4%*	*-7%*
EPS (GBp) - post hybrid issue			
Revised	115.9	113.4	112.8
Previous	112.8	116.8	117.5
% change	*3%*	*-3%*	*-4%*

Source: HSBC estimates

We assume a dividend yield of 6% (previously 5.5%) for 2016 and 2017 in our valuation. We believe the commoditised nature of SSE justifies a premium to our current yield assumption. We have revisited our power plant assumptions, removing Ferrybridge power station from our estimates as it is due to close at the end of the winter. We have reduced our valuation for all other generating assets to reflect lower power prices.

SSE: Valuation summary

Particulars (GBP)	Revised	Previous
Current price as on 23-Nov-15	**14.70**	**NA**
DCF lower margins	14.90	15.07
Sum-of-the-parts – revised power fleet valuation	12.80	14.64
Yield 6% - previously 5.5%	15.61	16.61
Target price (average rounded)	**14.75**	**15.75**

Source: HSBC estimates

SSE: WACC and DCF GBP14.90

WACC inputs		Equity valuation	GBPm
Cost of debt		**+ DCF value**	**22,090**
Pre-tax cost of debt	4.8%	+ ST marketable assets	-
Marginal tax rate	18.0%	+ Value of associates	-261
Cost of equity		+ Other assets	291
Risk-free rate	3.5%	**EV (asset side)**	**22,121**
Equity risk premium	4.0%	- Net debt (+ if Net cash)	-4,850
Additional risk	0.0%	Other liabilities	-1,686
Beta	**0.68**	Provisions	-611
Debt - 31%	3.9%	Total liabilities	-7,146
Equity - 69%	6.2%	**Value of equity**	**14,974**
Cost of capital	**5.5%**	**Value per share (GBP)**	**14.90**

Source: HSBC estimates

SSE: SoP GBP12.80

Division		Valuation method	Valuation
Generation	**MW**	**GBP/kW**	**GBPm**
Gas	5,628	153	860
Coal	1,125	150	169
Hydro	1,165		1,491
		1,280	
Pumped storage	300		336
		1,120	
Wind onshore GB and Eire NI	1,404	560	786
Wind planning/consented	499	280	140
Biomass	38		494
Wind - Offshore	355	800	284
CM NPV benefit from GBP19.30kW from 2019 for 6 years		19	401
Total	**10,514**	**472**	**4,961**
Gas storage and production		Invested capital	1,290
Wholesale			6,250
Retail		SSE historic PE 10% discount	4,426
Electricity and Gas Networks March 2017		RCV+ value creation	9,001
Enterprise division (non electric utility businesses)		National Grid PE	418
EV			**20,095**
Total Liabilities (including 50% hybrid)	GBPm		-7,075
Equity value	GBPm		13,020
No of shares	m		1,017
Equity value	**GBP/share**		**12.80**

Source: HSBC estimates

Upside risks

Improvement in wholesale power market; SSE continues to outperform its regulatory incentives in its networks businesses; SSE's asset disposal programme exceeds expectations. Now there will be a degree of regulatory clarity with the CMA, SSE can respond accordingly when the remedies are announced.

Downside risks

The CMA final remedies are detrimental to SSE's supply business growth and profitability. The Capacity Auction in December does not provide a high enough price to enable SSE to justify keeping its Fiddler's Ferry station open from 2016. This would reduce our SoP further.

HSBC

Financials & valuation: SSE

Hold

Financial statements

Year to	03/2015a	03/2016e	03/2017e	03/2018e
Profit & loss summary (GBPm)				
Revenue	31,654	30,492	29,513	29,960
EBITDA	2,199	2,275	2,337	2,421
Depreciation & amortisation	-660	-688	-730	-782
Operating profit/EBIT	986	1,700	1,730	1,776
Net interest	-207	-148	-185	-217
PBT	735	1,518	1,512	1,526
HSBC PBT	1,565	1,583	1,599	1,774
Taxation	-70	-213	-227	-244
Net profit	543	1,183	1,162	1,159
HSBC net profit	1,219	1,157	1,147	1,154
Cash flow summary (GBPm)				
Cash flow from operations	1,958	1,821	2,067	2,128
Capex	-1,587	-1,386	-1,585	-1,343
Cash flow from investment	-1,455	-1,651	-1,760	-1,498
Dividends	-599	-699	-734	-766
Change in net debt	-672	641	540	248
FCF equity	411	355	391	682
Balance sheet summary (GBPm)				
Intangible fixed assets	768	768	768	768
Tangible fixed assets	11,304	12,001	12,856	13,397
Current assets	8,815	9,139	8,913	8,928
Cash & others	1,512	1,512	1,512	1,512
Total assets	23,296	24,582	25,386	26,117
Operating liabilities	9,210	9,360	9,186	9,266
Gross debt	7,406	8,047	8,587	8,835
Net debt	5,894	6,535	7,075	7,323
Shareholders' funds	6,081	6,547	6,963	7,348
Invested capital	10,165	11,036	11,839	12,316

Ratio, growth and per share analysis

Year to	03/2015a	03/2016e	03/2017e	03/2018e
Y-o-y % change				
Revenue	3.5	-3.7	-3.2	1.5
EBITDA	4.4	3.5	2.7	3.6
Operating profit	16.1	72.5	1.8	2.6
PBT	27.7	106.6	-0.4	0.9
HSBC EPS	1.0	-6.4	-2.1	-0.6
Ratios (%)				
Revenue/IC (x)	3.2	2.9	2.6	2.5
ROIC	10.8	10.5	9.8	9.5
ROE	21.8	18.3	17.0	16.1
ROA	4.2	6.3	6.1	6.0
EBITDA margin	6.9	7.5	7.9	8.1
Operating profit margin	3.1	5.6	5.9	5.9
EBITDA/net interest (x)	10.6	15.4	12.6	11.2
Net debt/equity	96.9	99.4	100.9	98.7
Net debt/EBITDA (x)	2.7	2.9	3.0	3.0
CF from operations/net debt	33.2	27.9	29.2	29.1
Per share data (GBPp)				
EPS Rep (diluted)	55.20	118.41	114.96	113.29
HSBC EPS (diluted)	123.85	115.87	113.44	112.76
DPS	88.74	91.37	93.65	96.00
Book value	612.34	651.50	684.66	713.95

Valuation data

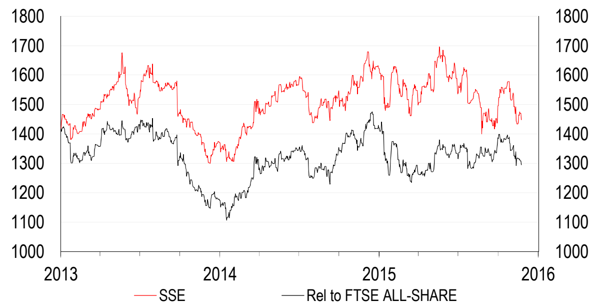
Year to	03/2015a	03/2016e	03/2017e	03/2018e
EV/sales	0.6	0.6	0.7	0.7
EV/EBITDA	8.6	8.5	8.5	8.2
EV/IC	1.9	1.8	1.7	1.6
PE*	11.7	12.5	12.8	12.8
PB	2.4	2.2	2.1	2.0
FCF yield (%)	3.1	2.8	3.1	5.4
Dividend yield (%)	6.1	6.3	6.5	6.6

* Based on HSBC EPS (diluted)

Issuer information

Share price (GBPp)	1,448	Free float	100%
Target price (GBPp)	1,475	Sector	Multi-Utilities
Reuters (Equity)	SSE.L	Country	United Kingdom
Bloomberg (Equity)	SSE LN	Analyst	Verity Mitchell
Market cap (USDm)	22,041	Contact	44 20 7991 6840

Price relative



Source: HSBC
Note: Priced at close of 23 Nov 2015

HSBC

Drax

- Trading statement: 70% of power sold forward for one year vs 60% at 9M 2014, improved hedge against falling power prices
- EU needs to agree on Contract for Difference (CfD) in order to stabilise earnings; government policy puts future of coal in doubt
- Reiterate Reduce rating and 190p target price

Trading update details

Drax published its three-month trading statement (to the end of September) on 24 November. Some 70% of its power is now sold forward for one year vs 60% at the nine-month trading statement in 2014. This is an improved hedge against falling power prices.

Power sales contracted for 2015-2016

	2015	2016
Power sales (TWh) comprising:	26.1	18.0
-Fixed price power sales (TWh)	26.1	15.5
At an average achieved price (per MWh)	GBP49.6	GBP47.2
Structured power sales (and equivalents) (TWh)		2.5

Source: Drax

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.

With the low power prices we discuss above, we think there is some risk that its coal plant value will be impaired given the market cap of Drax was 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 of 5.82p is higher than consensus at 4.55p.

HSBC

Changes to our estimates

GBPm	2015e	2016e	2017e
EBITDA			
Revised	172	130	121
Previous	166	130	131
% change	*3.7%*	*-0.3%*	*-7.7%*
EBIT			
Revised	74	48	40
Previous	67	49	50
% change	*9.8%*	*-1.3%*	*-20.5%*
Adj. EPS (p)			
Revised	12.62	5.82	4.27
Previous	13.30	5.90	6.50
% change	-5.1%	-1.4%	-34.3%

Source: HSBC estimates

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 GBP18.08 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 assume Drax receives a CfD for one of its biomass units but at a strike price of GBP95/MWh

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

UK will launch a consultation in the spring to set out proposals to close coal by 2025 and restrict its use from 2023

"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.

In the long term, we estimate the UK's interconnection capacity (excluding to Ireland) to rise by two-and-a-half times to 7.4GW in 2020 from the current levels of 3GW, with a further jump to 10.2GW by 2021 end. As a result, we expect the cheaper-priced mainland European imports to rise sharply. We believe this will result in a decline in UK power prices with a narrowing of the UK's premium to mainland Europe on this sharply increasing 2018-21 imports (see our report *UK Electricity: Britain to join the (electricity) eurozone* published on 28 July 2015 for details).

Valuation and risks

Our DCF-based valuation assumes a WACC of 7.34%, comprising a 4% cost of debt and 8.6% cost of equity. Our target price of 190p implies downside of c18% 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.

Drax: DCF valuation

WACC inputs		Equity valuation	GBPm
Pre-tax cost of debt	5.0%	DCF value	966
Marginal tax rate	18%	Associates and ST marketable assets	-
Risk-free rate	3.5%	**EV (asset side)**	**964**
Equity risk	4.0%	Less: Financial net debt	-136
Additional risk	0.0%	Less: Others	-40
Beta	1.28	**Total non-equity liabilities**	**-206**
Debt - 28%	4.1%	**Value of equity**	**760**
Equity - 72%	8.6%	0	0
Cost of capital	**7.4%**	**DCF value per share – GBp (rounded)**	**190**

Source: HSBC estimates

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.

HSBC

Financials & valuation: Drax Group PLC

Reduce

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (GBPm)				
Revenue	2,805	2,712	2,916	2,975
EBITDA	229	172	130	121
Depreciation & amortisation	-81	-99	-81	-81
Operating profit/EBIT	149	74	48	40
Net interest	-29	-30	-19	-19
PBT	166	44	29	21
HSBC PBT	166	44	29	21
Taxation	-37	-9	-6	-4
Net profit	129	35	24	17
HSBC net profit	96	51	24	17
Cash flow summary (GBPm)				
Cash flow from operations	90	161	81	92
Capex	-200	-150	-80	-40
Cash flow from investment	-220	-150	-80	-40
Dividends	-55	-48	-26	-12
Change in net debt	170	37	25	-40
FCF equity	-120	-5	1	52
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	1,165	1,230	1,265
Cash & others	221	257	264	282
Total assets	2,975	3,036	3,099	3,093
Operating liabilities	833	817	851	861
Gross debt	320	393	425	403
Net debt	99	136	161	121
Shareholders' funds	1,573	1,576	1,574	1,579
Invested capital	1,810	1,851	1,873	1,839

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	36.0	-3.3	7.5	2.0
EBITDA	-0.3	-24.9	-24.8	-6.7
Operating profit	170.4	-50.5	-34.3	-17.8
PBT	422.3	-73.6	-33.7	-27.5
HSBC EPS	-31.8	-47.1	-53.9	-26.6
Ratios (%)				
Revenue/IC (x)	1.7	1.5	1.6	1.6
ROIC	6.9	3.2	2.1	1.8
ROE	6.4	3.2	1.5	1.1
ROA	5.5	2.0	1.3	1.1
EBITDA margin	8.2	6.3	4.4	4.1
Operating profit margin	5.3	2.7	1.7	1.3
EBITDA/net interest (x)	8.0	5.8	6.7	6.5
Net debt/equity	6.3	8.6	10.2	7.6
Net debt/EBITDA (x)	0.4	0.8	1.2	1.0
CF from operations/net debt	91.0	118.0	50.4	75.9
Per share data (GBPp)				
EPS Rep (diluted)	32.03	8.66	5.82	4.27
HSBC EPS (diluted)	23.85	12.62	5.82	4.27
DPS	11.93	6.31	2.91	2.14
Book value	390.71	389.62	389.13	390.50

Valuation data

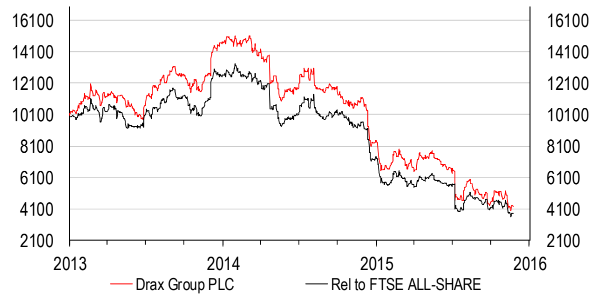
Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	0.4	0.4	0.4	0.3
EV/EBITDA	4.4	6.1	8.2	8.5
EV/IC	0.6	0.6	0.6	0.6
PE*	9.8	18.5	40.1	54.6
PB	0.6	0.6	0.6	0.6
FCF yield (%)	-13.3	-0.6	0.1	5.7
Dividend yield (%)	5.1	2.7	1.2	0.9

* Based on HSBC EPS (diluted)

Issuer information

Share price (GBPp)	233	Free float	100%
Target price (GBPp)	190	Sector	Electric Utilities
Reuters (Equity)	DRX.L	Country	United Kingdom
Bloomberg (Equity)	DRX LN	Analyst	Verity Mitchell
Market cap (USDm)	1,434	Contact	44 20 7991 6840

Price relative



Source: HSBC
Note: Priced at close of 23 Nov 2015

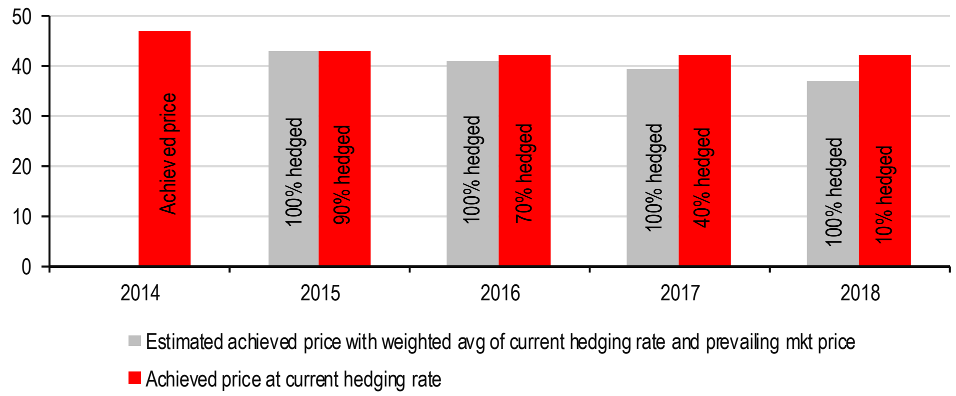
ENGIE

- Strategic changes ahead ... but group's complexity and commodity exposure unlikely to diminish significantly
- Dividend prioritised over growth; but market may doubt the sustainability of 80%+ pay-outs
- Reiterate Hold rating and EUR16.0 target price

Resumption of Doel 3 and Tihange 2 output is positive ...

The re-opening of the Doel 3 and Tihange units will add some EUR400m to 2016e EBIT based on ENGIE's achieved selling price of EUR43/MWh. However, the annual positive impact will diminish by about EUR110m by 2019e as the collapse of forward Belgian prices to EUR36/MWh is reflected in future achieved prices due to lower prices for the remaining open positions for 2017 and beyond.

ENGIE outright generation (Belgium, France) at mid-2015 (EUR/MWh)



Source: ENGIE, HSBC estimates

.. but a mixed 2016-17 outlook

ENGIE's 2016-17e earnings are set to be depressed by low oil prices, virtually non-existent profitability in LNG, adverse forex (USD weakness expected by HSBC FX strategists), and lower selling prices on merchant markets where gas or coal are the price-setters. These factors will offset improvement in Brazil, a reasonable level of new openings, mainly in LatAm, and the re-opening of the two Belgian reactors.

Slightly lower estimates on declining selling prices

We have cut our EBITDA estimates slightly for 2016e-17e on account of lower electricity price assumption. Consequently, we cut our earnings estimates for 2016e-17e by 1%.

ENGIE: Change in forecasts

	2014a	2015e	2016e	2017e	2018e
EBITDA (EURm)					
Previous		11,578	12,125	12,425	
New	12,138	11,578	12,110	12,395	12,668
% Change		0%	0%	0%	
Net income - after minorities (EURm)					
Previous		2,748	2,747	2,843	
New	3,055	2,748	2,737	2,822	2,845
% Change		0%	0%	-1%	
HSBC EPS (fully diluted) (EUR)					
Previous		1.15	1.15	1.19	
New	1.28	1.15	1.14	1.18	1.19
% Change		0%	-1%	-1%	
DPS (EUR)					
Previous		1.00	1.00	1.00	
New	1.00	1.00	1.00	1.00	1.00
% Change		0%	0%	0%	

Source: Company data, HSBC estimates

2015-17e average dividend pay-out of 87%

Our forecasts assume the new Belgian nuclear tax regime is implemented now that Doel 3 and Tihange 2 are to be re-opened, and that the levy is included in underlying net earnings, on which the dividend is based. The company has stated that it will cut growth capex before it cuts the dividend from the present EUR1.00, which it states is a floor, and its cash generation is sufficient to fund EUR1.00 in cash plus dividends to minority shareholders of its subsidiaries. Nonetheless, on our estimates, EUR1.00 implies pay-outs of 87% for 2015e and 88% of 2016e, and growth expenditure has already been cut.

87%

Average dividend pay-out 2015-17e based on our estimate of EUR1.0 cash dividend

Impairments as a way to hold up 2016 earnings? Repetition of 2014

As we have already seen in 2013, ENGIE could well take an impairment charge on its thermal power and E&P assets: with equity in excess of EUR50bn, the balance sheet can support a major write-down. At its nine-month results conference call on 4 November, management was explicit in warning of a potential impairment. And as in 2014, net earnings in 2016 could be boosted by the lower depreciation resulting from the write-downs. We have not assumed 2015 impairments with lower 2016 depreciation in our estimates, but we estimate that EUR5bn of asset impairments would add about EUR0.06 to 2016e EPS and reduce the dividend pay-out from 88% (under our present forecast) to 83%.

Strategic developments likely under incoming CEO

We await updates in 2016 on potential changes in strategy under the incoming CEO Isabelle Kocher. We expect a "greener" strategy, although we are sceptical as to what extent this might cut the group's commodity exposure via its integrated gas business.

ENGIE has stated (4 November) that it will no longer invest in coal-fired assets except in exceptional situations, and we see increased emphasis on renewables: the present target is a doubling of renewables capacity from 8GW in 2015 to 16GW in 2025.

- At the start of July ENGIE acquired France's leading solar power generator Solairedirect, which has 224MW of capacity and aims for 125MW of new capacity per year.

- Bloomberg (17 August) reported that ENGIE is looking to raise USD1bn from Asian coal-fired power plant disposals; Reuters (20 October) reported that ENGIE has hired banks to advise on the potential sale of US gas-fired power plants; the company has made no comment on these reports.

Although selling coal-fired plants (profitable, but selling prices unlikely to be strong in the current environment) and expanding renewables (mainly via projects, takes time for earnings to come through, more competitive environment than previously) is likely to provide net dilution in the near-term, the longer-term implications of this process are positive in that they provide more consistent as well as greener earnings.

Valuation and risks

Maintain Hold rating and EUR16 target price
We have cut our earnings estimates for 2016e-17e by an average of 1%. However, we maintain our target price at EUR16, implying downside of 2%. Our rating is Hold as the diversity of the group and the elevated yield confer a relatively defensive character.

We have rolled forward our valuation to 2016e. We assign a 50% weight to yield and 25% each to DCF and SOTP. Our target price of EUR16 is based on:

- DCF (EUR15.1 from EUR15.5, WACC 5.9%)
- SOTP (EUR16.4, after 15% discount, from EUR17.1)
- Yield-based valuation (EUR16.7, at 6% yield, unchanged)

Summary of ENGIE valuation: EUR16 target price

Methodology	Valuation weight	Revised value (EUR)	Previous value (EUR)
DCF	25%	15.1	15.5
Sum-of-the-parts, 15% discount	25%	16.4	17.1
Yield-based valuation	50%	16.7	16.7
ENGIE target price (EUR)		**16.0**	**16.0**

Source: HSBC estimates

DCF: EUR15.1
We have reduced our DCF valuation to EUR15.1 from EUR15.5 due to a 1% cut in our earnings estimates for 2016e-17e and an increase in WACC. Our DCF valuation of EUR15.1 is based on a WACC of 5.9% (beta of 0.95 and additional risk premium of 0.7% for political risk in France and Belgium) from 5.8% as the rise in stock price since our last publication on 21 September 2015 has increased equity weightage. We maintain our terminal growth rate at 1.0%.

ENGIE: WACC calculation 5.9%

	Calculation
Risk-free rate	3.5%
Country risk premium	5.5%
Stock-specific risk premium	0.7%
Beta	0.95
Cost of equity	9.7%
Gross cost of debt	3.2%
Corporate tax rate	30.0%
Cost of debt, post tax	2.2%
Weight of debt	50%
Weight of equity	50%
WACC, post tax	**5.9%**

Source: HSBC estimates

ENGIE: DCF value: EUR15.1

	EURm
DCF value (core operations)	80,054
Associates, ST marketable assets, others	8,928
EV (asset side)	**88,982**
Less: Financial net debt	(30,828)
Less: Provisions, minorities & others	(21,501)
Total non-equity claims/liabilities	(52,328)
Value of equity	36,654
Shares (m)	2,435
DCF value per share - EUR	**15.1**

Source: HSBC estimates

Yield-based valuation: EUR16.7

We maintain our yield based valuation for ENGIE at EUR16.7. We value ENGIE at a 6.0% yield based on the 2016e dividend.

Yield-based valuation: EUR16.7

Yield-based valuation 6.0%	16.7

Source: HSBC estimates

SOTP: EUR16.4

We reduce our SOTP valuation to EUR16.4 from EUR17.1 as we cut our valuation of generation assets due to poor outlook for electricity prices. We maintain the discount for political and conglomerate risk at 15%.

ENGIE SOTP value: EUR16.4 after 15% discount

Activity	Valuation methodology	EURm	EUR per share	% gross SOP
Energy International	Generation DCF/MW, Supply - EUR/customer	37,166	15.3	37.4%
Energy Europe	Generation DCF/MW, Supply - EUR/customer	13,354	5.5	13.4%
Global Gas & LNG	Upstream value/bbl; Other: EV/EBITDA	4,635	1.9	4.7%
Infrastructure	RAV,	27,175	11.2	27.4%
Energy Services	At 5.0x 2016e EBITDA	8,030	3.3	8.1%
Less: Assets to be sold		0	0.0	0.0%
Core assets		90,359	37.1	91.0%
Add: Other assets	Associates (including 33.7% in SEVI and 40% Jirau), ST marketable assets, others	8,928	3.7	9.0%
Total assets		**99,287**	**40.8**	**100.0%**
Less: Financial debt	Net debt 2016e	(30,828)	(12.7)	
Less: Quasi debt	pension, nuclear, minorities, other liabilities	(21,501)	(8.8)	
SOP value per share - EUR		46,958	19.3	
SOP value per share - EUR	**after 15% discount**		**16.4**	

Source: HSBC estimates

Upside risks

- Recovery in regional LNG price differentials and rebound in arbitrage opportunities measures that will restore the group's growth profile
- More radical restructuring measures by the new management than the market currently anticipates, which could allow a rebalancing of ownership between EU assets and emerging market assets, and/or reduce the perceived complexity of the group that we believe is an element of concern to investors
- French government states that it does not intend to sell down more shares in ENGIE

Downside risks

- Growth move of a size and at a price that the market perceives as unattractive
- Political and economic instability in France
- Aggravated currency difficulties in overseas businesses, particularly LatAm
- Aggravated and longer weakness in oil and gas prices

HSBC

Financials & valuation: ENGIE

Hold

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (EURm)				
Revenue	74,686	77,256	79,952	82,930
EBITDA	12,138	11,578	12,110	12,395
Depreciation & amortisation	-4,977	-5,017	-5,273	-5,503
Operating profit/EBIT	7,161	6,561	6,836	6,891
Net interest	-1,160	-1,095	-1,079	-978
PBT	4,698	5,071	5,317	5,474
HSBC PBT	5,285	5,071	5,317	5,474
Taxation	-1,588	-1,457	-1,660	-1,714
Net profit	2,371	2,748	2,737	2,822
HSBC net profit	3,055	2,748	2,737	2,822
Cash flow summary (EURm)				
Cash flow from operations	8,751	8,706	9,210	10,101
Capex	-6,130	-7,300	-7,400	-7,500
Cash flow from investment	-3,939	-7,000	-7,000	-7,500
Dividends	-3,720	-2,690	-2,692	-2,694
Change in net debt	-1,329	984	482	93
FCF equity	2,039	1,406	1,810	2,601
Balance sheet summary (EURm)				
Intangible fixed assets	28,791	28,791	28,791	28,791
Tangible fixed assets	64,030	66,013	67,740	69,737
Current assets	55,306	52,431	53,371	55,171
Cash & others	9,996	10,012	10,529	11,436
Total assets	165,305	164,414	167,080	170,877
Operating liabilities	43,447	40,238	40,500	41,791
Gross debt	38,321	39,321	40,321	41,321
Net debt	29,361	30,345	30,828	30,921
Shareholders' funds	49,527	50,286	51,010	51,803
Invested capital	94,684	96,986	98,873	100,471

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	-8.1	3.4	3.5	3.7
EBITDA	-9.5	-4.6	4.6	2.4
Operating profit	-1.1	-8.4	4.2	0.8
PBT		7.9	4.9	2.9
HSBC EPS	-11.5	-10.4	-0.5	3.0
Ratios (%)				
Revenue/IC (x)	0.8	0.8	0.8	0.8
ROIC	5.3	4.9	4.8	4.7
ROE	6.3	5.5	5.4	5.5
ROA	2.3	2.6	2.6	2.6
EBITDA margin	16.3	15.0	15.1	14.9
Operating profit margin	9.6	8.5	8.6	8.3
EBITDA/net interest (x)	10.5	10.6	11.2	12.7
Net debt/equity	52.5	53.3	53.3	52.5
Net debt/EBITDA (x)	2.4	2.6	2.5	2.5
CF from operations/net debt	29.8	28.7	29.9	32.7
Per share data (EUR)				
EPS Rep (diluted)	1.00	1.15	1.14	1.18
HSBC EPS (diluted)	1.28	1.15	1.14	1.18
DPS	1.00	1.00	1.00	1.00
Book value	20.72	21.02	21.30	21.62

Valuation data

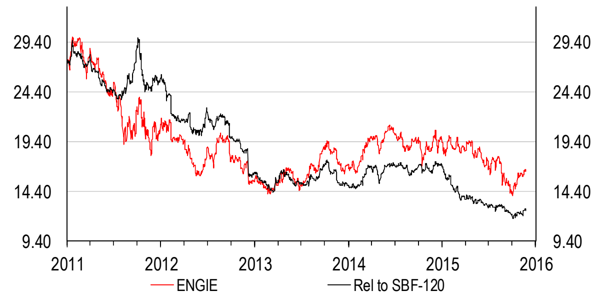
Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	1.1	1.1	1.0	1.0
EV/EBITDA	6.7	7.1	6.9	6.8
EV/IC	0.9	0.9	0.8	0.8
PE*	12.8	14.3	14.3	13.9
PB	0.8	0.8	0.8	0.8
FCF yield (%)	3.9	2.7	3.4	4.9
Dividend yield (%)	6.1	6.1	6.1	6.1

* Based on HSBC EPS (diluted)

Issuer information

Share price (EUR)	16.41	Free float	65%
Target price (EUR)	16.00	Sector	Gas Utilities
Reuters (Equity)	ENGIE.PA	Country	France
Bloomberg (Equity)	ENGI FP	Analyst	Adam Dickens
Market cap (USDm)	42,415	Contact	+44 20 7991 6798

Price relative



Source: HSBC
Note: Priced at close of 23 Nov 2015

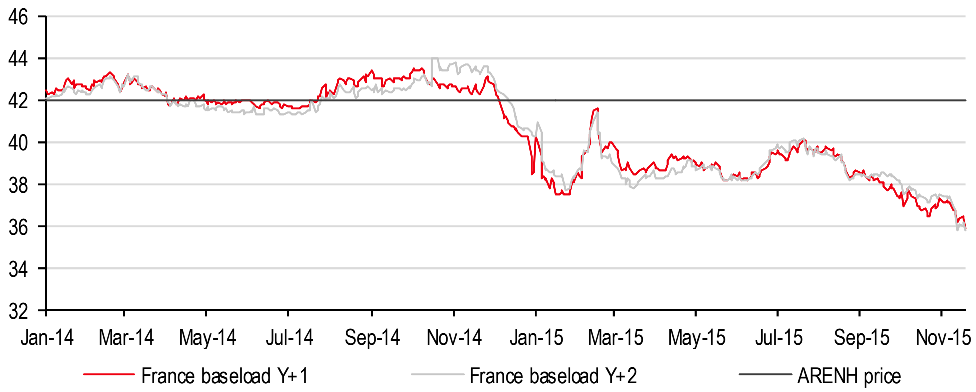
EDF

- Scrip dividend: offsets Areva outlay but adds future pressure when State returns to taking cash dividend
- Pricing pressures in UK and France cloud near-term outlook
- Retain Reduce rating, cut target price to EUR13.5 from EUR14.0

Open market pricing situation deteriorating

France: unfortunate timing of open-market price weakness, just ahead of de-regulation
We are becoming more concerned that falling French wholesale prices, which are showing a widening discount to the so-called ARENH price currently at EUR42/MWh, will encourage commercial and industrial customers (whose tariffs are de-regulating in 2016) to seek cheaper power offerings more aggressively, or will force EDF to defend its position by offering its own discounted offers.

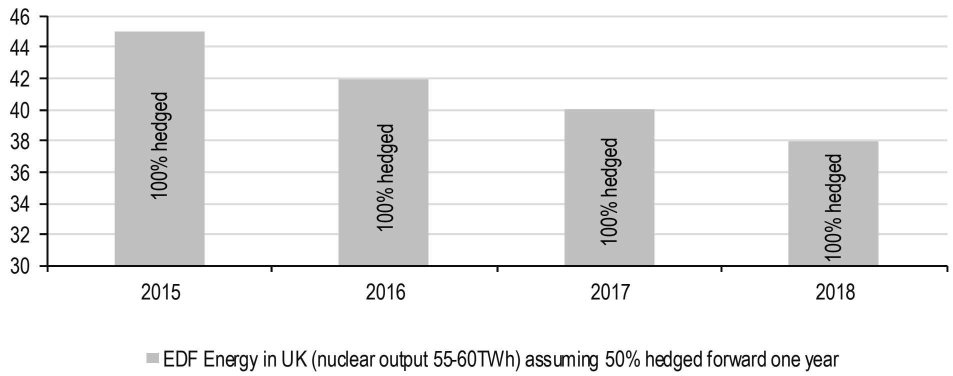
ARENH price vs French year-ahead wholesale price (EUR/MWh)



Source: Thomson Reuters Datastream

Slight cut to estimates on declining selling prices
In the UK, where EDF Energy's annual nuclear generation is typically above 55TWh, we see earnings coming under some pressure as UK wholesale power prices weaken on cheaper gas price. We are not aware of to what extent EDF Energy in the UK hedges forward its nuclear output. The chart below, which assumes that 50% is hedged a year ahead, is set out above all to show that, given current UK prices, EDF Energy faces a significant fall in its average achieved wholesale prices to 2018.

EDF Energy in UK (nuclear output 55-60TWh) assuming 50% hedged forward one year (GBP/MWh)



Source: HSBC estimates

We have cut our EBITDA estimates for 2016e-17e by an average of 1% on account of lower electricity prices for unhedged output in the UK. Consequently, we cut our earnings estimates for 2016e-17e by an average of 4%. We have cut our dividend forecasts from EUR1.00 to EUR0.95 in 2016e and to EUR0.90 in 2017e in order to remain within EDF's pay-out range of 55-65% of adjusted earnings after hybrid interest.

EDF: Change in forecasts

	2014	2015e	2016e	2017e	2018e
EBITDA (EURm)					
Previous		17,034	16,896	16,942	
New	17,279	17,034	16,746	16,742	16,797
% Change		0%	-1%	-1%	
HSBC net profit (EURm)					
Previous		3,625	3,240	3,051	
New	4,464	3,625	3,141	2,918	2,720
% Change		0%	-3%	-4%	
HSBC EPS (EUR)					
Previous		1.93	1.65	1.52	
New	2.39	1.91	1.60	1.46	1.36
% Change		-1%	-3%	-4%	
DPS (EUR)					
Previous		1.25	1.00	1.00	
New	1.25	1.25	0.95	0.90	0.85
% Change		0%	-5%	-10%	

Source: Company data, HSBC estimates

We estimate 7.2% increase in number of shares through 2015 EDF scrip dividend

The French State (owner of 84.5% of EDF and 83.2% of Areva) agreed to accept a scrip interim dividend, thereby saving EDF EUR0.74bn of cash outlay. We forecast a similar outcome for the final dividend (saving EDF EUR1.67bn at the same share price and offsetting the large majority of the debt to be assumed by the Areva nuclear reactor transaction. We calculate that the scrip dividend, if accepted only by the State, will raise the number of shares by 7.2% to 1.993bn.

Valuation and risks

Maintain Reduce rating, cut target price to EUR13.5 from EUR14.0

As a result of our earnings reductions, we cut our target price to EUR13.5 from EUR14.0, implying 5% downside. We remain at Reduce since we believe EDF faces an increasingly challenging situation on its main two markets, and that its balance sheet has been weakened by the Areva situation (by which we mean we doubt that EDF would have needed to consolidate Hinkley C in the UK if Areva had been able to take a stake and if Areva's EPR nuclear model had developed at least some degree of track record). In our view, EDF remains under pressure from rising debt, low market prices in Europe, and increasing competition in its home market. These should more than offset the prospect of lower depreciation on the French nuclear fleet and scope for further financial income from the dedicated asset portfolio. In our view, EDF cannot achieve its 2018 ambition of free cashflow after dividend without a cut in the dividend or a continuation of scrip payments.

We assign a 50% weight to yield and 25% each to DCF and SOTP. Our new target price of EUR13.5 is based on:

- DCF (EUR11.6 from EUR12.2, WACC 5.8%),
- Yield-based valuation (EUR14.6, at 6.5% 2016e yield, down from EUR15.4),
- SOTP (EUR13.1 from EUR14.1, after 30% discount),

Summary of EDF valuations: EUR13.5 target price

Valuation technique	Valuation weighting	Revised valuation (EUR)	Previous valuation (EUR)
DCF	25%	11.6	12.2
Yield based valuation	50%	14.6	15.4
Sum-of-the-parts, 30% discount	25%	13.1	14.1
EDF target price		**13.5**	**14.0**

Source: HSBC estimates

DCF: EUR11.6

We have cut our DCF valuation to EUR11.6 from EUR12.2 primarily due to the cut in our earnings estimates by an average 4% for 2016e-17e. Our DCF is based on our WACC assumption of 5.8% (beta 1.0) from 5.9% as the 11% decrease in the share price since our last publication on EDF on 10 November has reduced the weight of cost of equity. We maintain our additional risk premium of 1.5% for political and investment risk (EPR, UK) and terminal growth rate of 0.5%.

EDF WACC: 5.8%

	Calculation
Risk-free rate	3.5%
Country risk premium	5.5%
Beta	1.00
Additional risk premium	1.5%
Cost of equity	10.5%
Gross cost of debt	4.00%
Corporate tax rate	32.80%
Cost of debt, post tax	2.69%
Weight of debt	60%
Weight of equity	40%
WACC, post tax	**5.8%**

Source: HSBC estimates

EDF DCF valuation: EUR11.6 (WACC of 5.8% and beta of 1.0)

	EURm
DCF value (core operations)	122,495
Value of ST marketable assets, associates	14,989
EV asset side	**137,484**
Net debt, 2016e	-45,675
Quasi-debt (nuclear, pension, other provisions), minorities	-68,513
Total liabilities	-114,189
Value of equity	23,295
No. of shares (m)	2,006
Value per share (EUR)	**11.6**

Source: HSBC estimates

Yield-based valuation: EUR14.6

We have cut our 2016e yield-based valuation for EDF to EUR14.6 from EUR15.4, maintaining a suitable 6.5% yield but based on a 2016e dividend estimate that we have cut by 5% to EUR0.95 from EUR1.00.

EDF yield-based valuation: EUR14.6

	EUR
2016e dividend at yield of 6.5%	14.6

Source: HSBC estimates

SOTP: EUR13.1

We cut our SOTP valuation to EUR13.1 from EUR14.1 on a lower valuation for European power generation. We maintain the discount related to political and conglomerate risk at 30%.

EDF SOTP valuation: EUR13.1 after 30% discount

Activity	Valuation methodology	EURm	EUR per share	% gross SOP
France	Generation: DCF/per-MW, regulated: RAV, supply: per account	101,118	50.4	66.6%
UK	EDF Energy	11,079	5.5	7.3%
Rest of Europe, rest of world, associates	EDF EN, Edison, Alpiq, trading, gas, Dalkia, China, etc	39,533	19.8	26.1%
Total assets		151,730	75.7	100.0%
Net debt	2016e	-45,675	-22.8	
Quasi-debt, minorities	Nuclear, pension, and other provisions	-68,513	-34.2	
Sum-of-parts	2005.5 m shares	37,541	18.7	
Sum-of-parts with 30% discount			**13.1**	

Source: HSBC estimates

Upside risks

- All of EDF's French nuclear fleet sees an extension of its accounting depreciation to 50 years
- EDF surprises the market with reductions in capex guidance
- Market prices rise back to a level over ARENH (EUR42/MWh)
- Resolution of final toxic waste storage cost estimate (Cigeo) which avoids raising provisions on EDF's balance sheet.

HSBC

Financials & valuation: EDF

Reduce

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (EURm)				
Revenue	72,874	74,940	76,670	78,445
EBITDA	17,279	17,034	16,746	16,742
Depreciation & amortisation	-7,894	-7,952	-8,225	-8,479
Operating profit/EBIT	9,385	9,082	8,520	8,263
Net interest	445	142	101	44
PBT	5,612	6,390	5,772	5,423
HSBC PBT	7,013	6,601	5,972	5,623
Taxation	-1,839	-2,138	-2,004	-1,878
Net profit	3,701	4,102	3,618	3,395
HSBC net profit	4,464	3,625	3,141	2,918
Cash flow summary (EURm)				
Cash flow from operations	10,625	13,252	13,082	13,403
Capex	-13,721	-14,000	-14,000	-15,000
Cash flow from investment	-12,393	-15,000	-14,000	-15,000
Dividends	-2,556	-1,918	-1,784	-2,382
Change in net debt	746	3,665	2,702	3,980
FCF equity	1,123	723	547	-119
Balance sheet summary (EURm)				
Intangible fixed assets	18,578	18,578	18,578	18,578
Tangible fixed assets	127,500	132,708	138,646	145,334
Current assets	72,769	73,449	73,519	72,188
Cash & others	25,453	26,536	25,383	22,952
Total assets	267,989	275,877	281,885	287,242
Operating liabilities	87,756	87,037	87,965	89,039
Gross debt	61,458	66,207	67,756	69,304
Net debt	39,308	42,973	45,675	49,655
Shareholders' funds	35,191	37,517	39,483	40,673
Invested capital	105,638	111,161	117,395	124,109

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	-3.6	2.8	2.3	2.3
EBITDA	3.1	-1.4	-1.7	0.0
Operating profit	3.9	-3.2	-6.2	-3.0
PBT	-1.5	13.9	-9.7	-6.0
HSBC EPS	10.5	-20.3	-16.3	-8.8
Ratios (%)				
Revenue/IC (x)	0.7	0.7	0.7	0.6
ROIC	6.1	5.7	5.0	4.6
ROE	12.9	10.0	8.2	7.3
ROA	2.0	2.1	1.9	1.8
EBITDA margin	23.7	22.7	21.8	21.3
Operating profit margin	12.9	12.1	11.1	10.5
EBITDA/net interest (x)				
Net debt/equity	96.8	100.1	101.7	107.7
Net debt/EBITDA (x)	2.3	2.5	2.7	3.0
CF from operations/net debt	27.0	30.8	28.6	27.0
Per share data (EUR)				
EPS Rep (diluted)	1.98	2.16	1.84	1.69
HSBC EPS (diluted)	2.39	1.91	1.60	1.46
DPS	1.25	1.25	0.95	0.90
Book value	18.79	19.42	19.69	20.28

Valuation data

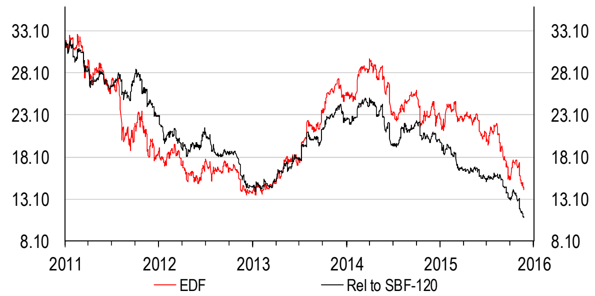
Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	1.2	1.2	1.2	1.3
EV/EBITDA	5.2	5.4	5.6	5.9
EV/IC	0.9	0.8	0.8	0.8
PE*	6.0	7.5	8.9	9.8
PB	0.8	0.7	0.7	0.7
FCF yield (%)	2.2	1.5	1.1	-0.2
Dividend yield (%)	8.8	8.8	6.7	6.3

* Based on HSBC EPS (diluted)

Issuer information

Share price (EUR)	14.24	Free float	13%
Target price (EUR)	13.50	Sector	Electric Utilities
Reuters (Equity)	EDF.PA	Country	France
Bloomberg (Equity)	EDF FP	Analyst	Adam Dickens
Market cap (USDm)	28,120	Contact	+44 20 7991 6798

Price relative



Source: HSBC
Note: Priced at close of 23 Nov 2015

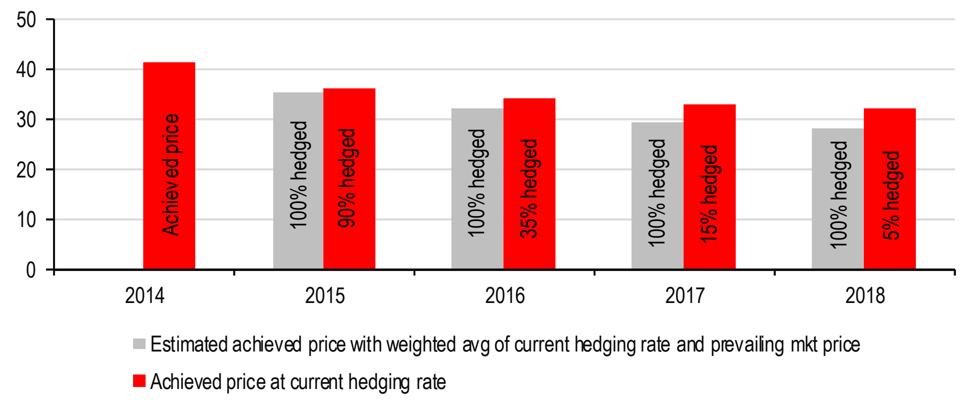
Fortum

- Ill-timed strategic change away from regulated businesses adds sensitivity to Nordic power prices
- Uncertainty on dividend and re-investment of the proceeds of the distribution exit
- Retain Reduce rating: cut our estimates slightly and target price to EUR12.5 from EUR13.0

Cut in estimates reflects Nordic price weakness

We have marked to market for current Nordic prices, adding the premium typically achieved by Fortum due to the split of its regional location. We estimate a 21% decline in Fortum's average Nordic selling price of 21% between 2015e and 2018e.

Fortum hedging at end-September 2015 (EUR/MWh)



Source: Company data, HSBC estimates

We have reduced our EBITDA estimates for Fortum by an average of 9.5% for 2016e-17e and our EPS estimates by an average of 7%.

Fortum: Change in forecasts

	2014a	2015e	2016e	2017e	2018e
Comparable operating profit (EURm)					
Previous		870	781	789	
New	1,085	870	736	709	717
% Change		0%	-6%	-10%	
Net profit (EURm)					
Previous		715	651	665	
New	1,077	715	606	585	626
% Change		0%	-7%	-12%	
HSBC EPS (EUR)					
Previous		0.80	0.73	0.75	
New	1.21	0.80	0.68	0.66	0.70
% Change		0%	-7%	-12%	
HSBC DPS (EUR)					
Previous		1.10	0.60	0.60	
New	1.30	1.10	0.60	0.60	0.60
% Change		0%	0%	0%	

Source: Company data, HSBC estimates

A completely different investment proposition compared to two years ago

Bad timing: distribution exit followed by Russia profit warning and sharp Nordic price fall
At its 9m results, Fortum downgraded its earnings guidance for its Russian power generation business, indicating that the RUB18.2bn EBIT would be achieved two to three years later than expected up to now, on low demand and low market pricing. Although already in our numbers, this represents a further setback for the company, which has become more dependent on Nordic and Russian prices after its strategic decision to exit regulated Nordic distribution.

Fortum's new CEO Pekka Lundmark, who has an M&A background, must now decide how extensively and in what businesses Fortum will re-invest the EUR8bn proceeds of its distribution exit. We see no possibility of such re-investment – even if it is sufficient to bring Fortum's net debt/EBITDA back up to the desired 2.5x – bringing EPS above EUR1, which would still be below the current EUR1.10 ordinary dividend level. We continue to forecast an ordinary dividend of EUR0.60 for 2016e, with a special additional EUR0.50 dividend representing 10% of the capital gain from the Swedish grid disposal (the EUR0.20 special dividend on 2014 earnings having represented 10% of the gain from the Finnish and Norwegian grid disposals). Until the market benefits from visibility on strategy and dividend, as well as from some degree of stabilisation in Nordic prices and Russian economic conditions, it is hard for us to see the shares as anything other than risky and worthy of a discount rating.

Valuation and risks

Maintain Reduce rating, cut target price to EUR12.5 from EUR13.0
We have cut our target price to EUR12.5 from EUR13.0, implying 11% downside, on account of the poor outlook for electricity prices. We maintain our Reduce rating since we estimate that the stock is at an unjustifiably wide PER premium to the sector given the lack of dividend visibility and the high risk profile of its businesses. Our new target price of EUR12.5 is weighted as follows:

- 25% on DCF (EUR13.0 from EUR13.4, WACC of 7.3%, beta of 1.0)
- 25% on SOTP (EUR12.8 from EUR13.4, after 20% discount)
- 50% on yield-based valuation (EUR12.0, at 5.0% yield, unchanged)

Summary of Fortum valuations: EUR12.5 target price

	Valuation weight	Revised valuation (EUR)	Previous valuation (EUR)
DCF value	25%	13.0	13.4
SOTP value, 20% discount	25%	12.8	13.4
Yield	50%	12.0	12.0
Average value per share		**12.5**	**13.0**

Source: HSBC estimates

DCF: EUR13.0

We have cut our DCF valuation to EUR13.0 from EUR13.4 primarily on account of the 8% cut in our EPS estimates for 2016e-17e. Our valuation of EUR13.0 is based on an unchanged WACC of 7.3% (beta 1.0 and additional risk premium to 0.8% for M&A and Russian forex risk). We maintain our terminal growth rate at 0%.

Fortum WACC, post tax: 7.3%

	Calculation
Risk-free rate	3.5%
Country risk premium	5.5%
Additional risk premium	0.8%
Beta	1.04
Cost of equity	10.0%
Gross cost of debt	3.4%
Corporate tax rate	20.0%
Cost of debt, post tax	2.7%
Weight of debt	37.5%
Weight of equity	62.5%
WACC, post tax	**7.3%**

Source: HSBC estimates

Fortum DCF valuation: EUR13.0

	EURm
DCF value (core operations)	8,666
Associates, ST marketable assets, other assets	3,301
EV (asset side)	**11,967**
Financial debt	549
Quasi debt (pension, nuclear), minorities, other liabilities	(933)
Total non-equity claims / liabilities	(383)
Value of equity	11,584
No. of shares (m)	888.4
DCF value per share - EUR	**13.0**

Source: HSBC estimates

Yield: EUR12.0

We believe a 5% yield is a feasible level for a stock such as Fortum, so long as the dividend is securely based. This represents a 10% discount to the current sector average, justifiable in our view because of the volatility of the company's businesses. We maintain our yield-based valuation at EUR12.0.

Yield-based valuation: EUR12.0

	EUR
2015e dividend at yield of 5%	12.0

Source: HSBC estimates

Sum-of-parts: EUR12.8

We have reduced our SOP valuation of Fortum to EUR12.8 from EUR13.4 on a lower valuation of the power generation assets, given the depressed outlook. We retain a 20% discount associated with business and political risk.

Fortum sum-of-the-parts value: EUR12.8

Activity	Valuation methodology	EURm	EUR per share	% gross SOP
Generation	Hydro: 0.50 EURm/MW, Nuclear: 0.35 EURm/MW, Thermal: 0.15 EURm/MW, Other: 0.80 EURm/MW	4,176	4.7	28.6%
Heating	At 0.5x EUR/MW	4,335	4.9	29.7%
Supply/retail	1.2m customer accounts at EUR200/customer	240	0.3	1.6%
Russia	At 5.5x 2015e EV/EBITDA	2,035	2.3	14.0%
Core assets		10,786	12.1	73.9%
ST marketable assets & associates	Includes Hafslund at market cap, remainder at BV	2,527	2.8	17.3%
LT investments and Other assets		1,274	1.4	8.7%
Non-core assets		3,801	4.3	26.1%
Total assets/firm value		**14,587**	**16.4**	**100.0%**
Financial debt	Net debt end-2016e	549	0.6	
Other claims	End-2016e provisions (pension, nuclear), minorities	(933)	-1.0	
Total liabilities		(383)	-0.4	
Sum-of-parts equity value		14,204	16.0	
SOP value per share	**with 20% discount**		**12.8**	

Source: HSBC estimates

Upside risks

- Nordic power prices rise
- RUB strengthens and Russian economy recovers
- Fortum carries out a major, EPS-enhancing acquisition at a price deemed favourable by the market
- Swedish coalition adopts a more benign stance regarding nuclear taxes and closures
- Fortum explicitly states that EUR1.10 ordinary dividend will be retained.

HSBC

Financials & valuation: Fortum OYJ

Reduce

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (EURm)				
Revenue	4,088	3,865	3,915	3,954
EBITDA	1,462	1,236	1,114	1,095
Depreciation & amortisation	-377	-366	-378	-386
Operating profit/EBIT	1,085	870	736	709
Net interest	-211	-25	60	70
PBT	1,231	5,305	796	779
HSBC PBT	1,231	5,305	796	779
Taxation	-143	-180	-180	-182
Net profit	1,081	5,115	606	585
HSBC net profit	1,077	715	606	585
Cash flow summary (EURm)				
Cash flow from operations	1,762	1,156	994	983
Capex	-837	-700	-650	-650
Cash flow from investment	2,816	5,400	-650	-650
Dividends	-977	-1,155	-977	-533
Change in net debt	-3,611	-5,401	634	200
FCF equity	225	456	344	333
Balance sheet summary (EURm)				
Intangible fixed assets	276	276	276	276
Tangible fixed assets	11,195	4,929	5,201	5,465
Current assets	4,301	9,950	9,620	9,720
Cash & others	2,766	8,457	8,113	8,203
Total assets	21,375	21,258	21,199	21,563
Operating liabilities	1,366	1,449	1,462	1,471
Gross debt	6,984	7,274	7,564	7,854
Net debt	4,218	-1,183	-549	-349
Shareholders' funds	10,864	10,403	10,065	10,136
Invested capital	11,640	5,249	5,521	5,786

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	-32.5	-5.5	1.3	1.0
EBITDA	-37.7	-15.5	-9.8	-1.7
Operating profit	-32.5	-19.8	-15.4	-3.6
PBT	-17.9	330.9	-85.0	-2.1
HSBC EPS	-2.0	-33.6	-15.2	-3.4
Ratios (%)				
Revenue/IC (x)	0.3	0.5	0.7	0.7
ROIC	7.1	10.0	10.6	9.6
ROE	10.3	6.7	5.9	5.8
ROA	5.7	24.3	2.9	2.8
EBITDA margin	35.8	32.0	28.5	27.7
Operating profit margin	26.5	22.5	18.8	17.9
EBITDA/net interest (x)	6.9	49.4		
Net debt/equity	38.6	-11.3	-5.4	-3.4
Net debt/EBITDA (x)	2.9	-1.0	-0.5	-0.3
CF from operations/net debt	41.8			
Per share data (EUR)				
EPS Rep (diluted)	1.22	5.76	0.68	0.66
HSBC EPS (diluted)	1.21	0.80	0.68	0.66
DPS	1.30	1.10	0.60	0.60
Book value	12.23	11.71	11.33	11.41

Valuation data

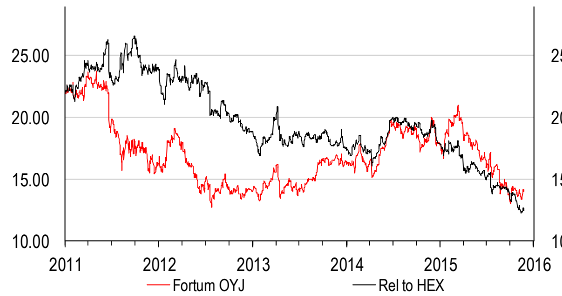
Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	3.6	2.3	2.4	2.5
EV/EBITDA	10.2	7.2	8.6	8.9
EV/IC	1.3	1.7	1.7	1.7
PE*	11.6	17.4	20.6	21.3
PB	1.1	1.2	1.2	1.2
FCF yield (%)	2.1	4.5	3.4	3.3
Dividend yield (%)	9.3	7.8	4.3	4.3

* Based on HSBC EPS (diluted)

Issuer information

Share price (EUR)	14.03	Free float	49%
Target price (EUR)	12.50	Sector	Electric Utilities
Reuters (Equity)	FUM1V.HE	Country	Finland
Bloomberg (Equity)	FUM1V FH	Analyst	Adam Dickens
Market cap (USDm)	13,232	Contact	+44 20 7991 6798

Price relative



Source: HSBC
Note: Priced at close of 23 Nov 2015

Verbund

- Split of the single Germany-Austria power market would boost Austrian prices, but is several years away and likely to be resisted
- We cut our estimates for 2016-17e on lower achieved prices
- Downgrade rating to Reduce from Hold, cut target price to EUR12.5 from EUR14.0

Unattractive as power price outlook deteriorates further

Change in market framework: possible, but likely to be resisted
The Verbund share price has outperformed the sector by 4% over the last three months on the possibility of a split of the single Germany-Austria power zone, which would mean the Austrian power price-setter would switch from German coal-fired to Austrian gas-fired, leading to higher power prices over time. The change is being considered by the German regulator in order to reduce the flow of renewables electricity out of Germany as well as to placate the Czech Republic and Poland, whose grids are adversely affected by surges of wind power generated in north-eastern Germany and *en route* to southern Germany and Austria.

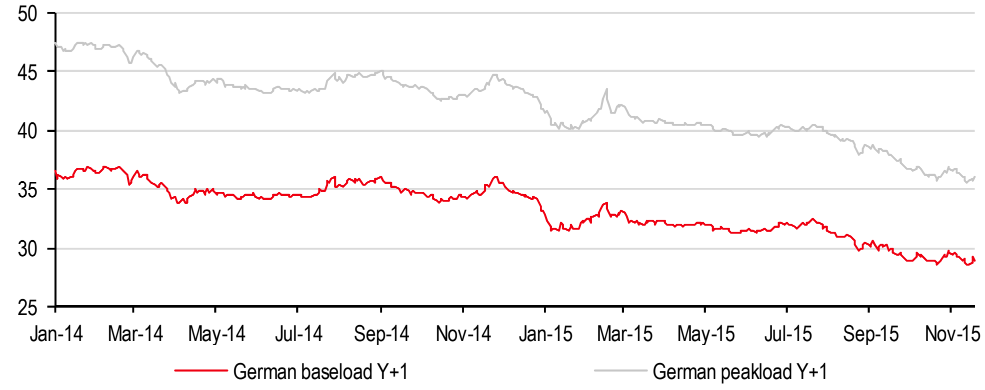
Austrian power market to de-couple from Germany? Politically difficult

The change would not happen before 2018-19 and would hardly fit into the European Commission's aim of an integrated European energy market. In addition, the higher prices would have a negative influence on the Austrian economy (consumer, industry tariffs), would raise Austrian greenhouse gas emissions as gas-fired power plants would be once again required, and sharply reduce Austrian market liquidity. The single major beneficiary would be Verbund (higher prices on stable-cost hydro production) and, as its controlling shareholder with a 51% stake, the Austrian Federal State.

Although we continue to believe this decoupling is a possibility, we could imagine efforts being made to limit this process and thus the impact on Austrian consumers (especially wholesale, which would see a 30%+ rise, based on current market levels). As a result, we believe it is too early to invest in Verbund on the basis of a possible future change in market framework.

Higher 2015e but lower 2016-17e estimates
We have raised our 2015 estimates, in line with the new guidance provided by the company at nine-month results on the positive impact of restructuring. However, we have reduced our 2016 and 2017 estimates on lower achieved power prices, marking to market to reflect the recent decline in forward prices and our negative outlook. We note the narrowing of the premium of peak (a significant volume contributor to Verbund, as a pumped hydro generator) to base-load.

German baseload and peakload electricity prices (EUR/MWh) – Narrowing gap



Source: HSBC estimates

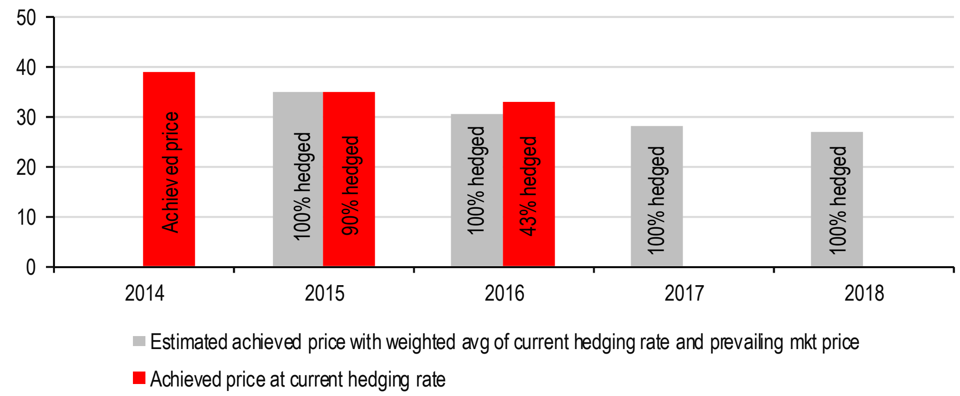
Verbund is the most sensitive of the stocks we cover to power price movements: based on 2015 EBIT, we estimate a 6.6% swing in earnings for Verbund from a EUR1/MWh change in achieved power prices.

Verbund: change in forecasts

EURm	2014a	2015e	2016e	2017e	2018e
EBITDA					
Previous	809	850	799	820	
New		900	754	730	765
% Change		6%	-6%	-11%	
Net income					
Previous	216	238	195	210	
New		277	187	181	202
% Change		16%	-4%	-13%	
HSBC EPS (fully diluted) - EUR					
Previous	0.62	0.68	0.56	0.60	
New		0.80	0.54	0.52	0.58
% Change		16%	-4%	-13%	
HSBC DPS - EUR					
Previous	0.31	0.34	0.28	0.30	
New		0.40	0.27	0.26	0.29
% Change		16%	-4%	-13%	

Source: Company data, HSBC estimates

Verbund: hedging as of 30 September 2015 (EUR/MWh)



Source: Company data, HSBC estimates

Valuation and risks

Downgrade to Reduce from Hold, cut target price to EUR12.5 from EUR14.0
On the basis of our lower forecasts, we have cut our target price from EUR14.0 to EUR12.5. We downgrade our rating to Reduce from Hold as we see the stock as unattractive in the context of falling power prices and lacking any significant yield support.

We have rolled forward our valuation to 2016e. Our new target price of EUR12.5 is based on:

- 50% on DCF (EUR12.8 from EUR14.1, at WACC of 6.2%)
- 50% on SOP (EUR12.1 from EUR13.9)

Our target price of EUR12.5 implies downside of 7%. We assign a Reduce rating since we expect the shares to be depressed by further weakness in power prices, and because yield support is lacking in comparison with peers.

Summary of Verbund valuations: EUR12.5 target price

Methodology	Valuation weight	Revised valuation EUR	Previous valuation EUR
DCF	50%	12.8	14.1
Sum-of-the-parts	50%	12.1	13.9
Verbund target price		**12.5**	**14.0**

Source: HSBC estimates

DCF: EUR12.8
We cut our DCF valuation to EUR12.8 from EUR14.1 due to the cut in our earnings estimates on the poor outlook for electricity prices. Our DCF is based on our unchanged WACC assumption of 6.2% (beta 0.81), which incorporates an equity risk premium of 0.6% for restructuring and political risk. We maintain our terminal growth rate at 0.75%.

Verbund WACC: 6.2%

	Calculation
Risk-free rate	3.5%
Country risk premium	5.5%
Additional risk premium	0.6%
Beta	0.81
Cost of equity	8.6%
Gross cost of debt	3.3%
Corporate tax rate	24.0%
Cost of debt, post tax	2.5%
Weight of debt	40%
Weight of equity	60%
WACC, post tax	**6.2%**

Source: HSBC estimates

Verbund DCF equity valuation: EUR12.8

	EURm
DCF value (core operations)	8,329
Associates, ST marketable assets, others	929
EV (asset side)	**9,258**
Less: Financial net debt	(3,527)
Less: Provisions, minorities & others	(1,196)
Total non-equity claims/liabilities	(4,723)
Value of equity	4,536
Shares (m)	347.4
DCF value per share (EUR)	**12.8**

Source: HSBC estimates

SOP: EUR12.1

We have cut our SOP valuation to EUR12.1 from EUR13.9 as we reduce valuation of generation assets on poor outlook for power prices.

SOP: EUR12.1

Activity	Valuation basis	EURm	EUR per share	% Gross SOP
Generation assets	11.4GW at an average EUR0.59m/MW	6,653	19.2	74.4%
Transmission network	RAB	1,301	3.7	14.5%
Electricity supply/retail	0.4m customers at EUR150 / customer	60	0.2	0.7%
Core electricity assets		8,014	23.1	89.6%
Associates and participating interests		358	1.0	4.0%
LT investments, receivables	book value 2015e	571	1.6	6.4%
Total Other assets	Associates, participating interests, and other assets	929	2.7	10.4%
Total assets		**8,943**	**25.7**	**100.0%**
Less: Financial net debt	End-2016e	(3,527)	-10.2	
Less: Other claims	End-2016e Minorities, provisions	(1,196)	-3.4	
SOP value	**347.4m shares**	**4,221**	**12.1**	

Source: HSBC estimates

Upside risks

- Full split of the single zone bidding system
- Recovery in power prices triggered by coal and CO2
- More substantial closures of German coal-fired plants than the market currently discounts
- EU agreement(s) that would tighten the supply-demand balance of the EU ETS CO2 trading system
- Change in dividend policy to a pay-out level more generous than we estimate

HSBC

Financials & valuation: Verbund

Reduce

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (EURm)				
Revenue	2,835	2,686	2,695	2,720
EBITDA	809	900	754	730
Depreciation & amortisation	-385	-380	-356	-342
Operating profit/EBIT	424	520	399	388
Net interest	-254	-124	-98	-93
PBT	147	414	299	294
HSBC PBT	147	414	299	294
Taxation	33	-99	-72	-71
Net profit	126	277	187	181
HSBC net profit	216	277	187	181
Cash flow summary (EURm)				
Cash flow from operations	718	626	583	566
Capex	-432	-280	-280	-308
Cash flow from investment	18	20	-280	-308
Dividends	-418	-193	-223	-179
Change in net debt	394	-453	-80	-79
FCF equity	441	328	305	259
Balance sheet summary (EURm)				
Intangible fixed assets	796	796	796	796
Tangible fixed assets	9,437	9,337	9,261	9,227
Current assets	1,071	2,517	3,698	4,879
Cash & others	42	1,595	2,775	3,954
Total assets	12,237	13,284	14,389	15,536
Operating liabilities	1,736	1,561	1,562	1,564
Gross debt	3,707	4,807	5,907	7,007
Net debt	4,060	3,606	3,527	3,448
Shareholders' funds	4,689	4,805	4,807	4,840
Invested capital	9,526	9,494	9,419	9,384

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	-13.3	-5.2	0.3	0.9
EBITDA	-37.6	11.2	-16.1	-3.2
Operating profit	-56.1	22.7	-23.2	-2.7
PBT	-83.2	180.8	-27.7	-1.7
HSBC EPS	-43.9	28.0	-32.3	-3.1
Ratios (%)				
Revenue/IC (x)	0.3	0.3	0.3	0.3
ROIC	5.2	4.2	3.2	3.1
ROE	4.5	5.8	3.9	3.8
ROA	3.8	3.2	2.2	2.0
EBITDA margin	28.5	33.5	28.0	26.8
Operating profit margin	14.9	19.3	14.8	14.3
EBITDA/net interest (x)	3.2	7.3	7.7	7.8
Net debt/equity	76.9	66.8	65.2	63.2
Net debt/EBITDA (x)	5.0	4.0	4.7	4.7
CF from operations/net debt	17.7	17.4	16.5	16.4
Per share data (EUR)				
EPS Rep (diluted)	0.36	0.80	0.54	0.52
HSBC EPS (diluted)	0.62	0.80	0.54	0.52
DPS	0.31	0.40	0.27	0.26
Book value	13.50	13.83	13.84	13.93

Valuation data

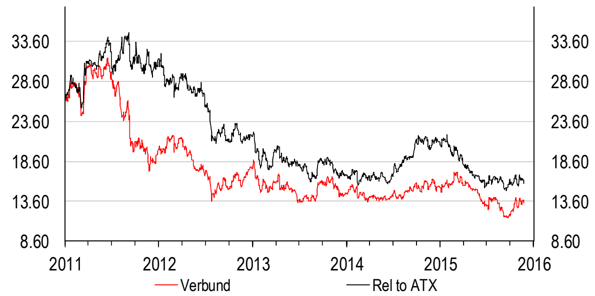
Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	3.2	3.3	3.3	3.2
EV/EBITDA	11.2	9.9	11.7	12.0
EV/IC	0.9	0.9	0.9	0.9
PE*	21.6	16.8	24.9	25.7
PB	1.0	1.0	1.0	1.0
FCF yield (%)	8.9	6.2	5.8	4.9
Dividend yield (%)	2.3	3.0	2.0	1.9

* Based on HSBC EPS (diluted)

Issuer information

Share price (EUR)	13.40	Free float	24%
Target price (EUR)	12.50	Sector	Electric Utilities
Reuters (Equity)	VERB.VI	Country	Austria
Bloomberg (Equity)	VER AV	Analyst	Adam Dickens
Market cap (USDm)	4,660	Contact	+44 20 7991 6798

Price relative



Source: HSBC
Note: Priced at close of 23 Nov 2015

CEZ

- Cutting our estimates again on falling power prices
- Interest in Vattenfall's German lignite and hydro assets: an unfavourable development
- Yield the main attraction: retain Hold rating, cut target price to CZK490 from CZK530

Lower estimates, strategic uncertainty

Cutting estimates on delays, prices

We have cut our 2015 EBITDA estimate, in line with company guidance at the 9m 2015 stage, to reflect lengthy outages at the Dukovany nuclear reactors until end-year (Units 2+3), end-November (Unit 1) with Unit 4 to close for a month in December, according to management. However, reimbursement of the so-called Czech "gift tax" (a tax on income resulting from free CO2 allowance allocation, imposed by the Czech government in 2012 and now successfully challenged by industry) allows our net adjusted income forecast to remain unchanged at CZK26.7bn (versus company guidance of CZK27.0bn).

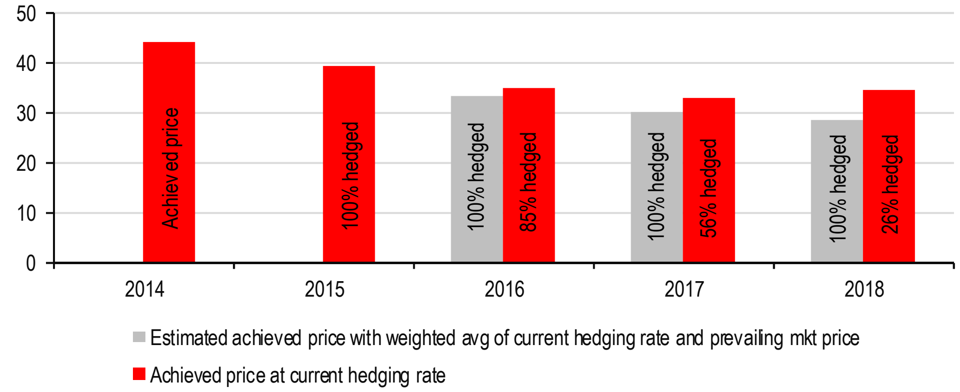
We have reduced our 2016 estimates to account for the delay of the opening of the new Ledvice lignite-fired plant to end-Q1 2016, according to management expectations, and we have cut 2017e to reflect a lower achieved selling price on CEZ's remaining open position (44% of 2017e outright power output still to be sold as of the end of October 2015), which results in an EUR0.5/MWh cut in our estimated average achieved price to EUR30/MWh. We assume that CEZ pays out 75% of its earnings, towards the top end of its current 60-80% pay-out policy.

CEZ: change in forecasts

	2014a	2015e	2016e	2017e	2018e
EBITDA (CZKm)					
Previous		69,653	66,484	65,278	64,543
New	72,498	64,153	63,934	61,778	62,543
% Change		-8%	-4%	-5%	-3%
Net income (CZKm)					
Previous		26,693	20,719	19,518	18,914
New	22,403	24,402	20,280	18,960	18,942
% Change		-9%	-2%	-3%	0%
HSBC EPS (CZK)					
Previous		50.0	38.8	36.5	35.4
New	55.2	50.9	38.0	35.5	35.5
% Change		2%	-2%	-3%	0%
HSBC DPS (CZK)					
Previous		40.0	30.0	30.0	30.0
New	40.0	40.0	28.0	26.0	26.0
% Change		0%	-7%	-13%	-13%

Source: Company data, HSBC estimates

CEZ: hedging data at end-Oct 2015 (EUR/MWh)



Source: CEZ, HSBC estimates

Interest in Vattenfall's German assets is a drag on the share price

German lignite interest: adds risk and shakes market confidence in management

On 13 October 2015 CEZ sent a Statement of Interest to Vattenfall to acquire the lignite mines and power plants (8.16GW of lignite 2.89GW of hydro) in Germany that Vattenfall is looking to sell. CEZ can afford it and we estimate that, in view of the forward-selling policy of the target, such an acquisition would be highly earnings-enhancing initially. However, if we mark-to-market for current German forward prices of EUR27/MWh, we estimate the acquisition would hardly boost earnings at all (from 2018e). In addition, for all CEZ's expertise in lignite mining and power production, we believe CEZ's exposure to an increasingly disliked and highly CO2-intense part of German energy could raise its political risk profile.

Valuation and risks

Hold rating, cut target price to CZK490 from CZK530

We cut our target price to CZK490 from CZK530 due to cut in our earnings estimates on poor outlook for electricity prices. This implies 3% upside. Our rating remains Hold, since we believe that yield support should outweigh depressed prices.

We have rolled forward our valuation to 2016e. Our new target price of CZK490 is based on:

- 25% weight to DCF (CZK469 from CZK496, WACC 7.0%)
- 25% weight to SOTP (CZK474 from CZK534, 10% discount)
- 50% weight to yield-based valuation (CZK509 from CZK545, 5.5% yield)

Summary of CEZ valuations: CZK490 target price

Methodology	Valuation weighting	Revised valuation (CZK)	Previous valuation (CZK)
DCF	25%	469	496
Sum-of-the-parts (with 10% discount)	25%	474	534
Yield	50%	509	545
CEZ target price (rounded)		**490**	**530**

Source: HSBC estimates

DCF value at CZK469

We have reduced our DCF valuation to CZK469 from CZK496 driven by the cut in our earnings estimates by an average of 2% for 2016e-17e. Our DCF is based on a WACC of 7.0% (beta 0.83); we maintain the equity risk premium at 1.0% on M&A risk. We maintain our terminal growth rate at 0.5%.

CEZ WACC: 7.0%

	Calculation
Risk-free rate	3.5%
Country risk premium	5.5%
Beta	0.83
Additional risk premium	1.0%
Cost of equity	9.1%
Gross cost of debt	3.8%
Corporate tax rate	19.0%
Cost of debt, post tax	3.1%
Weight of debt	35%
Weight of equity	65%
WACC, post tax	**7.0%**

Source: HSBC estimates

CEZ DCF valuation: CZK469

	CZKm
DCF value (core operations)	426,975
Associates, ST marketable assets, others	10,328
EV (asset side)	**437,302**
Less: Financial net debt	(130,667)
Less: Provisions, minorities & others	(55,971)
Total non-equity claims / liabilities	(186,638)
Value of equity	250,665
Shares (m)	534
DCF value per share	**469**

Source: HSBC estimates

Yield: CZK509

We value CEZ at CZK509 on yield, down from CZK545. We have cut our dividend forecast for 2016e by 7% on our lower earnings estimates for 2016 and bringing the dividend in line with the company's payout policy. We continue to value CEZ at a 5.5% yield.

Yield-based valuation: CZK509

	CZK
2015e dividend at yield of 5.5%	509

Source: HSBC estimates

SOTP value at CZK474

We have cut our SOTP valuation for CEZ to CZK474 from CZK534 as we reduce our estimate of the value of generation assets due to the poor outlook for electricity prices. We maintain a 10% discount related to uncertainty in CEZ's performance if it manages to acquire Vattenfall's assets.

CEZ sum-of-parts: CZK474

Activity	Valuation basis	CZKm	CZK per share	% gross SOP
Lignite mines	At 5x EV/EBITDA (acquired Mibrag at low multiple of 3.7x)	17,606	33	3.8%
Generation assets	15.2GW at EUR0.80/MW	268,372	502	57.3%
Distribution network	RAB value	106,481	199	22.7%
Electricity supply/retail	8.5m customers at EUR175 / customer	37,188	70	7.9%
Core assets		429,647	804	91.8%
Associates, Marketable assets, others	Includes investment in MOL	38,599	72	8.2%
Total assets		**468,246**	**877**	**100.0%**
Less: Financial net debt 2016e		-130,667	-245	-27.9%
Less: Minorities, nuclear, other claims		-55,971	-105	-12.0%
SOP value	534m shares	281,608	527	60.1%
SOP value	**with 10% discount**		**474**	

Source: HSBC estimates

Upside risks

- Commodity rally
- CEZ fails to acquire Vattenfall's German assets

Downside risks

- CEZ's bids for Vattenfall's German lignite assets and wins, at an acquisition price more generous than the market expectations.
- Commodity prices fall sharply.
- The Czech government announcement on new-nuclear implies that CEZ will have a major financial commitment to this.

HSBC

Financials & valuation: CEZ a.s.

Hold

Financial statements

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Profit & loss summary (CZKm)				
Revenue	200,657	199,953	199,805	202,483
EBITDA	72,498	64,153	63,934	61,778
Depreciation & amortisation	-27,705	-31,400	-30,110	-31,551
Operating profit/EBIT	44,793	32,753	33,824	30,227
Net interest	-3,042	-838	-5,982	-4,257
PBT	28,656	30,081	25,708	23,886
HSBC PBT	28,656	30,081	25,708	23,886
Taxation	-6,224	-5,650	-5,399	-4,897
Net profit	22,403	24,402	20,280	18,960
HSBC net profit	29,503	27,202	20,280	18,960
Cash flow summary (CZKm)				
Cash flow from operations	70,920	69,194	56,436	52,899
Capex	-34,417	-37,936	-28,381	-25,672
Cash flow from investment	-34,680	-37,936	-28,381	-37,822
Dividends	-21,549	-21,367	-21,367	-14,957
Change in net debt	-9,266	-9,891	-6,688	-120
FCF equity	43,344	20,058	24,155	27,257
Balance sheet summary (CZKm)				
Intangible fixed assets	20,611	20,611	20,611	20,611
Tangible fixed assets	426,542	433,078	431,349	425,470
Current assets	130,354	146,221	152,864	153,790
Cash & others	36,885	53,373	60,060	60,181
Total assets	627,870	639,273	640,187	647,364
Operating liabilities	109,974	109,682	109,621	110,731
Gross debt	184,134	190,731	190,731	190,731
Net debt	147,245	137,354	130,667	130,546
Shareholders' funds	261,308	264,343	263,256	267,259
Invested capital	430,648	436,855	435,143	428,959

Ratio, growth and per share analysis

Year to	12/2014a	12/2015e	12/2016e	12/2017e
Y-o-y % change				
Revenue	-7.6	-0.4	-0.1	1.3
EBITDA	-11.6	-11.5	-0.3	-3.4
Operating profit	-17.2	-26.9	3.3	-10.6
PBT	-35.5	5.0	-14.5	-7.1
HSBC EPS	-17.8	-7.8	-25.4	-6.5
Ratios (%)				
Revenue/IC (x)	0.5	0.5	0.5	0.5
ROIC	8.0	6.1	6.1	5.6
ROE	11.4	10.3	7.7	7.1
ROA	4.0	4.4	3.6	3.4
EBITDA margin	36.1	32.1	32.0	30.5
Operating profit margin	22.3	16.4	16.9	14.9
EBITDA/net interest (x)	23.8	76.5	10.7	14.5
Net debt/equity	55.4	51.1	48.8	48.0
Net debt/EBITDA (x)	2.0	2.1	2.0	2.1
CF from operations/net debt	48.2	50.4	43.2	40.5
Per share data (CZK)				
EPS Rep (diluted)	41.94	45.68	37.97	35.49
HSBC EPS (diluted)	55.23	50.92	37.97	35.49
DPS	40.00	40.00	28.00	26.00
Book value	489.18	494.86	492.82	500.32

Valuation data

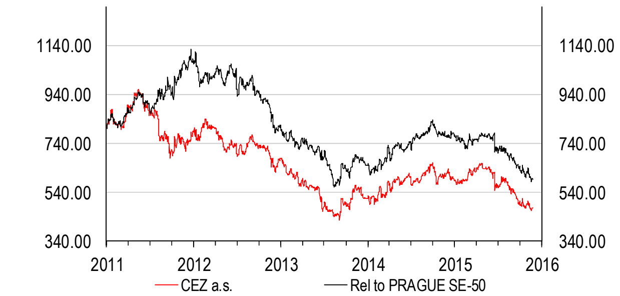
Year to	12/2014a	12/2015e	12/2016e	12/2017e
EV/sales	2.0	2.1	2.0	2.0
EV/EBITDA	5.7	6.4	6.4	6.4
EV/IC	1.0	0.9	0.9	0.9
PE*	8.6	9.4	12.6	13.4
PB	1.0	1.0	1.0	1.0
FCF yield (%)	16.4	7.3	8.7	10.2
Dividend yield (%)	8.4	8.4	5.9	5.5

* Based on HSBC EPS (diluted)

Issuer information

Share price (CZK)	476.80	Free float	29%
Target price (CZK)	490.00	Sector	Electric Utilities
Reuters (Equity)	CEZP.PR	Country	Czech Republic
Bloomberg (Equity)	CEZ CP	Analyst	Adam Dickens
Market cap (USDm)	10,075	Contact	+44 20 7991 6798

Price relative



Source: HSBC
Note: Priced at close of 23 Nov 2015

Disclosure appendix

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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.

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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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Hold	40%	(29% of these provided with Investment Banking Services)
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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.

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CENTRICA	CNA.L	2.12	24-Nov-2015	1, 2, 5, 6, 7
CEZ A.S.	CEZP.PR	470.00	24-Nov-2015	5, 6, 7
DRAX GROUP PLC	DRX.L	2.44	24-Nov-2015	2, 7
E.ON	EONGn.DE	8.80	24-Nov-2015	2, 4, 6
EDF	EDF.PA	13.96	24-Nov-2015	1, 2, 5, 6, 7
ENGIE	ENGIE.PA	16.20	24-Nov-2015	1, 4, 5, 6, 7
RWE	RWEG.DE	10.66	24-Nov-2015	1, 2, 4, 5, 6
VERBUND	VERB.VI	13.24	24-Nov-2015	7

Source: HSBC

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