

RWE and E.ON

German utilities investor tour feedback - ALERT

On July 1st we hosted group meetings with Klaus Schaffer, E.ON's CFO, Stein Dale, E.ON's Head of Strategy, Peter Terium, RWE's CEO, and Martin Hermann, CEO of RWE East. RWE conveyed the vision of a leaner group focused on downstream with a free option in power generation, which in our view continues to contrast favorably with E.ON (see links to previous research in the right panel). That being said, at these levels we see more potential value in the latter (positive gearing to a CO2 recovery and German capacity markets, growth options outside of Europe). Near term, however, we would expect investors to continue reducing underweight positions indiscriminately in both E.ON and RWE given the perceived potential upside from capacity payments, higher power prices, further cost cutting and a burden sharing deal with the government on long-term nuclear liabilities.

- **German political backdrop: benign, not yet supportive.** According to E.ON and RWE, the reformed EEG law will change very little for conventional utilities, with renewable additions simply slowing down versus 2012/13. RWE's lignite mining business will continue to be exempt from the EEG levy for now, but there is no clarity beyond 2016 (maximum downside to EBIT €190m p.a. or 10% of 2017 EPS). Both companies reiterated their wishes for a non-discriminatory capacity market but E.ON management in particular is realistic about the likelihood of the system being geographically and technologically selective. Timing wise, the capacity market design should be finalized by the end of this year and a white paper should be published by the middle of next year. This will be followed by a consultation with the EU and other countries which may lead to legislation before 2016.
- **No discussions on a nuclear "bad utility".** Both companies reiterated that there are currently no discussions with politicians on the subject of a potential burden sharing agreement on long term nuclear liabilities, though clearly they would be open to this. As detailed in our May 15th [note](#), unburdening E.ON and RWE of their long term fuel storage liabilities (the most sensitive topic from the point of view of public health and the environment) could potentially accrete equity values by €6.6bn and €5.5bn, respectively. Any potential negotiation will likely take several years to conclude, in our view.
- **Generation a free option?** Both companies expect their generation businesses will not turn cash negative on a mark to market basis (according to E.ON, €1.2bn of EBITDA in the medium term is a reasonable objective, which would allow the company to cover both maintenance capex of c€0.3-0.4bn and cash outflows related to nuclear liabilities of c€0.8bn). According to RWE, with coal prices having bottomed out (which we do not think is evident, as per JPM coal analysts' latest [report](#)) and plans for capacity payments being drawn up in the UK and Germany, generation now represents a free option. That the business stays cash positive remains a strict requirement and further cost cutting efforts, if necessary, will ensure this is the case.

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European Utilities

Nathalie F Casali ^{AC}

(44-20) 7134-9023

nathalie.x.casali@jpmorgan.com

Bloomberg JPMA CASALI <GO>

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Previous research:

- **Sept. 4th:** [German utilities: RWE: balance sheet and political risks discounted - upgrade to Neutral; prefer to E.ON \(UW\)](#)
- **Sept. 13th:** [Rising bond yields: an overlooked tailwind for EDF, RWE, and E.ON](#)
- **Sept. 19th:** [RWE: Dividend cut a signaling move, rights issue now off the table](#)
- **Oct. 4th:** [German utilities: Reiterate preference for RWE over E.ON into Q3 results following power price rally](#)
- **Oct. 15th:** [RWE: Credit day comforts our non-consensus view on the balance sheet](#)
- **Nov. 19th:** [RWE: Balance sheet story continuing to unfold, maintain preference vs. E.ON](#)
- **Jan 2nd:** [RWE: Capital increase fears resurface temporarily, but are still overdone](#)
- **Jan. 31st:** [E.ON: 2014 expectations rebased, supportive court case news flow set to continue. Upgrade to Neutral](#)
- **May 15th:** [German utilities: Lack of earnings upside is no longer the focus. "Bad utility" concept could gain traction](#)

- **Clear vision of the equity story transformation at RWE.** RWE's CEO thus conveyed a clear message of deep equity story transformation, in our view. Following the sale of DEA (which is very likely to complete, with the government expected to give its view on the deal by the end of the year), RWE's refinancing requirements should be very manageable. However, management continues to consider that a 3.0x economic leverage target is prudent, and it is also an important point of focus for the company's internal focus on efficiency. Our view however remains that the leverage target could be reviewed over the next 18-24 months. The group remains very focused on FCF generation (including working capital management) and a third cost cutting wave will be announced, most likely in March 2015. Given the above, and with cash costs of nuclear decommissioning expected to stay stable at €0.3-0.4bn p.a. for the next decade, we believe a return to growth capex or indeed a payout ratio increase (though obviously politically undesirable near term) are options that will be considered once the company has "earned its right to grow again".
- **More uncertainty about the future shape of the group at E.ON.** Our perception remains that there is less strategic clarity at E.ON than at RWE, partly because of the group's higher geographical and business diversification. Management is pleased with the progress of its Turkish business, whilst it continues to focus on stabilizing Eneva before further growth options are examined. E&P is managed as a standalone business, given the lack of synergies with the rest of the group. Capex over the next few years will focus on renewables, distributed energy and regulated grids. Cost cutting efforts will continue, potentially beyond the need to offset inflation, but the company does not expect to communicate group-wide targets at this stage. Management says it will rotate assets on an opportunistic basis (no comment on press reports of a disposal process in Italy or Spain). In summary, E.ON's diversification seems to be less of an advantage versus peers (particularly RWE) than it could be.

Companies Discussed in This Report (all prices in this report as of market close on 02 July 2014, unless otherwise indicated)

E.ON (EONGn.DE/€15.21[01 July 2014]/Neutral), RWE (RWEg.DE/€32.15/Neutral)

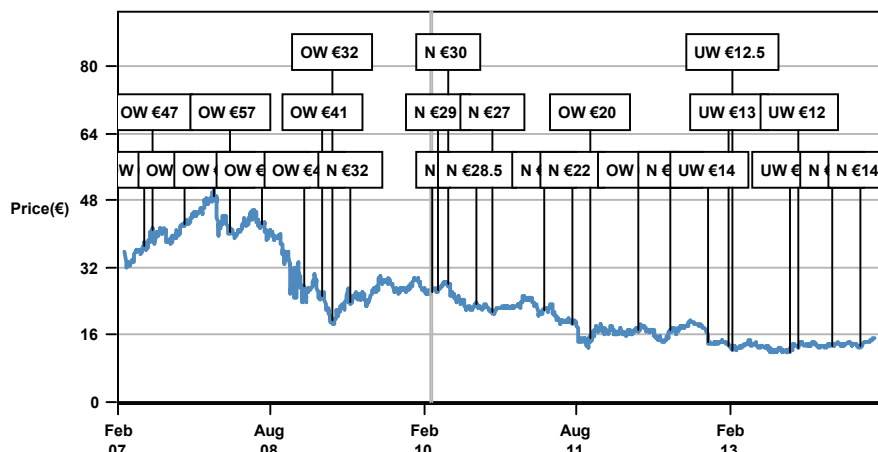
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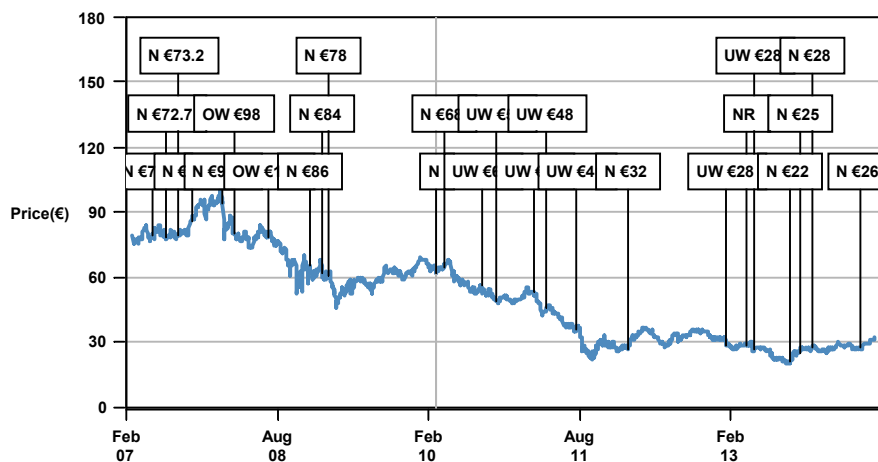
E.ON (EONGn.DE, EOAN GR) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Break in coverage Mar 01, 2010 - Mar 26, 2010.

Date	Rating	Share Price (€)	Price Target (€)
08-May-07	OW	37.26	43.50
31-May-07	OW	40.80	47.00
26-Sep-07	OW	42.55	51.90
14-Jan-08	OW	49.16	58.00
10-Mar-08	OW	40.67	57.00
30-Jun-08	OW	42.26	60.50
28-Nov-08	OW	27.58	44.00
03-Feb-09	OW	25.29	41.00
11-Mar-09	OW	19.34	32.00
15-May-09	N	24.04	32.00
01-Mar-10	N	26.13	--
26-Mar-10	N	26.73	29.00
30-Apr-10	N	28.15	30.00
10-Aug-10	N	23.40	28.50
05-Oct-10	N	21.38	27.00
05-Apr-11	N	22.10	24.00
20-Jul-11	N	18.78	22.00
16-Sep-11	OW	15.22	20.00
09-Mar-12	OW	16.94	19.00
04-Jul-12	N	17.16	19.00
14-Nov-12	UW	14.18	14.00
28-Jan-13	UW	13.34	13.00
06-Feb-13	UW	12.56	12.50
04-Sep-13	UW	12.04	11.00
04-Oct-13	UW	13.12	12.00
31-Jan-14	N	13.33	13.00
15-May-14	N	13.18	14.00

RWE (RWEg.DE, RWE GR) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Break in coverage Mar 01, 2010 - Mar 26, 2010.

Date	Rating	Share Price (€)	Price Target (€)
08-May-07	N	79.25	77.50
25-Jun-07	N	78.41	72.70
09-Aug-07	N	78.97	73.20
25-Sep-07	N	85.66	82.20
14-Jan-08	N	94.16	93.80
29-Feb-08	OW	79.86	98.00
30-Jun-08	OW	78.68	105.00
28-Nov-08	N	65.73	86.00
14-Jan-09	N	61.55	84.00
02-Feb-09	N	61.14	78.00
01-Mar-10	N	62.30	--
26-Mar-10	N	64.50	68.00
10-Aug-10	UW	56.08	62.00
05-Oct-10	UW	49.21	55.00
14-Feb-11	UW	53.58	51.00
05-Apr-11	UW	46.56	48.00
20-Jul-11	UW	36.22	41.00
25-Jan-12	N	26.84	32.00
15-Jan-13	UW	28.88	28.00
28-Mar-13	NR	28.76	--
26-Apr-13	UW	26.94	28.00
04-Sep-13	N	21.23	22.00
04-Oct-13	N	25.06	25.00
19-Nov-13	N	27.43	28.00
15-May-14	N	27.46	26.00

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