

Company

11 November 2009 | 12 pages

E.ON AG (EONGY)

 ADR
 Estimate change

Still Cheap Despite Everything

- 9M results in line** — Adj.EBIT reached \$11.27 billion, 1% below last year's level despite disposals and the adverse trading environment: a solid result all considered. Numbers were broadly in line with our estimates and consensus.
- Mid-term challenges** — Weakness in gas spot prices is EON's major challenge, leading to lower margins and volumes. EON is renegotiating some gas import contracts. but we see continued difficulties as It could take few years before the gas market returns to normality. A glimpse of hope: 3Q09 volumes were up 6TWh, so maybe the very worst is coming to an end.
- How we account for this** — To put ourselves on the conservative side, we assume a collapse in profits in the gas division this year, remaining at depressed levels for the foreseeable future. We acknowledge gas contract renegotiations could bring some relief, but we don't put that in our numbers.
- What we assume in our numbers** — We account for the disposal of assets, such as the transmission grid announced yesterday and include details of asset swaps released during the conference call. All in all, our Adj.Net Income changes are 2.9%, -4.9% and -4.2% in 09E, 10E and 11E, respectively.
- Valuation still attractive** — Despite these changes and our conservative assumptions on the gas business, EON still trades at a 10E P/E of 9.1x, thus being the cheapest vertically integrated utility in Europe while offering a 5.9% yield. We reiterate our Buy/High Risk (1H) rating and target price of \$49.44 per ADR.

Buy/High Risk	1H
Price (11 Nov 09)	US\$40.75
Target price	US\$49.44
Expected share price return	21.3%
Expected dividend yield	5.7%
Expected total return	27.0%
ADRs Outstanding	1,830M
ADR/Ord Ratio	1:1
Local Share Price	€27.25
Market Cap	US\$81,698M

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Year to 31 Dec	2007A	2008A	2009E	2010E	2011E
Sales (\$m)	94,221	127,628	114,138	115,586	122,977
EBITDA (\$m)	17,139	15,999	21,627	20,268	22,452
Net Income (\$m)	7,012	8,236	7,521	8,540	9,473
EPADR (\$)	3.68	4.32	3.95	4.48	4.97
EPADR (Old) (\$)	3.68	4.32	3.84	4.71	5.19
PE (x)	11.07	9.42	10.32	9.09	8.19
EV/EBITDA (x)	5.4	7.5	6.9	7.5	6.8
Dividend/ADR (\$)	5.62	2.21	2.13	2.42	2.69
Dividend Yield (%)	13.8	5.4	5.2	5.9	6.6
FX Used EUR	1.37	1.47	1.40	1.50	1.50

See Appendix A-1 for Analyst Certification and important disclosures.

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Still Cheap Despite Everything

9M results in line

EON announced 9M results today that were broadly in line with our numbers and consensus. At the bottom line, though, Adj.Net Income was 6% ahead of our forecast and 4% better than consensus (see Figure 1).

Figure 1. E.ON — 9M 2009 Results vs Estimates (\$ in Millions)

	9M08A	9M09A	Growth	9M09E	Difference
CE	5,173	5,402	1.0%	5,641	-4.3%
PEG	2,888	2,013	-33.0%	1,958	2.8%
UK	1,050	1,050	-3.0%	860	22.1%
Nordic	922	588	-38.0%	626	-6.0%
US	385	464	16.0%	526	-11.7%
Trading/New markets/Corporate	443	1,634	256.0%	1,445	13.1%
Adj. EBIT	10,861	11,181	-1.0%	11,055	1.1%
Net Interest	(1,911)	(2,202)	11.0%	(2,139)	3.0%
Adj. PBT	8,951	8,979		8,918	1.0%
Adj. Net Income	14,956	6,561	-58.0%	6,169	6.4%
F/X Used (\$/€)	1.41	1.46		1.46	

Note: Percentage figures are calculated on local currency numbers not accounted for F/X rate.

Source: Company Reports and CIRA Estimates

As to the divisions, generation in Central Europe was below our forecasts mainly due to Other Effects and a gross margin in retail power below what we had anticipated.

On a positive note, though, P/E (Pan European Gas), which includes the all important gas subsidiary Ruhrgas, was some 3% better than we had expected. Arguably this is not a big difference, but it is one that helps sentiment on the ADR, in our view.

Since October last year, spot gas prices fell well below gas contract prices (ie prices that gas exporters charge to EON and that EON charges to its customers). This led to some of EON's customers to purchase gas away from EON, which therefore ran the risk of exceeding the minimum take-or-pay limits set in its long-term gas purchase contracts. 3Q09 numbers on volumes, however, show that the situation is gradually improving rather than getting worse, as most market commentators were expecting (including ourselves). In 1Q09, EON lost 18TWh because of the price differential between spot and contracted gas, accelerating to 20TWh in 2Q09. In 3Q09, however, volumes grew by 12TWh vis a vis 3Q08, a mild sign that the hemorrhage may be coming to an end.

The UK division did better than we had anticipated, although how exactly profits are allocated between this division and trading is always difficult to spot on a quarterly basis given the existing transfer price varies, sometimes substantially, on a quarterly basis.

Finally the Nordic regions also performed poorly, with EBIT falling 38% from last year, driven by the poor situation for demand of electricity and outages at two nuclear power stations.

All in all, this was a solid set of results all considered, but with a slight positive spin on the gas business.

Mid-Term Challenges

No doubts EON faces mid-term challenges stemming from weakness in spot gas prices relative to contract prices. Whether spot and contract gas prices will converge in the future is effectively of function of gas demand, but on this, views diverge. Some, like IEA, believe the gas market will be tight again in 2015, while other industry experts believe this could happen as early as 2011; in between these views is EON, which believes 2011-2012 is when spot and contract prices should converge.

Figure 2. E.ON – Non-regulated Gas Business – Adjusted EBIT (\$ million)

	2008	2009E	2010E	2011E	2012E
E&P	516	314	612	977	1,158
Storage	654	554	566	582	621
Supply	1,241	433	378	504	648
Total Non-Regulated	2,409	1,299	1,556	2,063	2,429
F/X Used (\$/€)	1.47	1.40	1.50	1.50	1.50

Source: Company Reports and CIRA Estimates

Who is right is difficult to say given the many uncertainties regarding the extent and speed with which world economies will recover next year. From our perspective, though, it is probably wiser to assume that the margin erosion EON has experienced this year will stretch further out than just a couple of years, so to put our selves on the conservative side. As we will argue later, even under this conservative scenario, EON still looks cheap on multiples relative to its peers.

In Figure 2, we also show how we expect the profits of the Non-Regulated part of EON's Pan European Gas division to develop over the coming years, whereby under the heading Supply we include Ruhrgas.

During the conference call, EON clearly indicated that profits in Supply over the period 2006-08 were exceptionally high given the high oil price environment and that a normal level of profitability going forward therefore should be much lower. In our numbers, we assume a cut in EBIT for Supply of 63.4% or \$748 million (that compares to \$1,242 million FY08). We then assume just a gentle recovery both in volumes and margins, but back-end loaded.

What We Assume in Our Numbers

With this note, we take the opportunity to make some changes to our forecasts; in summary:

- Pan European gas division — as already mentioned, we are taking a more prudent stance on gas margins at Ruhrgas. In the end, our numbers may end up being overly pessimistic, but we want to put ourselves on the conservative side.
- UK and Nordic — we just do a minor change here, postponing Kingsnorth power station by one year and lower load factors at the nuclear stations in the Nordic given the outages for repowering works.

- Assets disposals — we strip out from our model the transmission grid EON sold as announced yesterday, we strip out further generation capacity that EON has to sell in Germany as a consequence of a EU request, and finally we better account for a decline in EBIT caused by asset swaps of generation assets that EON has executed over the course of this year¹. Note that our previously published numbers already incorporated the disposal of assets to Statkraft, Verbund and Thuga.
- Power prices — finally, we account for the most recent data released on power forward sales and recent movement in the power forward price curve.

The effect of these changes is summarised in Figures 3 and 4.

Figure 3. E.ON — New vs Old Forecasts (\$ million)

	2009E	2010E	2011E
Adj EBIT			
Old	13,748	16,271	18,123
New	13,607	15,150	16,857
Change	-1.0%	-6.9%	-7.0%
Adj Net Income			
Old	7,318	8,990	9,897
New	7,529	8,550	9,483
Change	2.9%	-4.9%	-4.2%
EPADR (\$)			
Old	3.84	4.73	5.19
New	3.95	4.49	4.98
Change	2.9%	-4.9%	-4.2%
F/X Used (\$/€)	1.40	1.50	1.50

Note: Percentage figures are calculated on local currency numbers not accounted for F/X rate.

Source: Citi Investment Research and Analysis

Figure 4. E.ON — New Forecasts for Adjusted EBIT and Adjusted Net Income (\$ million)

	2,008	2009E	2010E	2011E	2012E
Central Europe	6,938	6,853	7,524	7,580	7,217
Pan-European Gas	3,868	2,360	2,222	2,742	3,119
UK	1,357	1,011	971	1,440	1,719
Nordic	1,132	721	894	891	924
US Midwest	581	780	1,010	1,049	1,089
Corporate Centre	(434)	(413)	(443)	(443)	(443)
Other Activities/New Businesses	1,079	2,293	2,975	3,599	4,185
Adjusted EBIT	14,521	13,607	15,150	16,857	17,810
<i>Growth %</i>		-1.6%	3.9%	11.3%	5.7%
Adjusted Net Income	8,229	7,529	8,550	9,483	9,893
<i>Growth %</i>		-3.9%	6.0%	10.9%	4.3%
F/X Used (\$/€)	1.47	1.40	1.50	1.50	1.50

Note: Percentage figures are calculated on local currency numbers not accounted for F/X rate.

Source: Company Reports and CIRA Estimates

¹ In essence: the asset swap executed have an impact of c€60m relating to the purchase price allocation related to SNET, that are however are non cash; also difference in timing of withdrawing rights of the nuclear assets EON has swapped have short term a negative impact on EBIT for c€130 although they have no impact on the net present value of the assets exchanged.

Since most of the assets deconsolidated or swapped will have an effect on next year's results, our 2009E forecasts are broadly unchanged, while for 2010E we move our Adj.EBIT from \$16.26 billion before to \$15.13 billion now. To put this into context, current EON's guidance for 2010E stands at \$16.48 billion, but that was predicated on the same perimeter of consolidation. As EON commented at the conference call, assets disposed will generate a loss in Adj.EBIT of \$1,348 million, hence their 'restated' guidance assuming the disposal should be \$15.13 billion.

Valuation Still Attractive

Despite all these adjustments, EON still looks cheap, in our view. We stress that our numbers incorporate conservative assumptions on the gas business, yet EON appears to be trading at a P/E 10E CO2 adjusted of 9.6x vs ENEL at 10.2x, RWE at 11.9x or Fortum at 13.1x.

We prefer E.ON to RWE and believe that E.ON's focus on cost cutting and disposals could drive earnings higher while it also trades on a lower valuation than RWE and the sector. RWE, in contrast, is in the process of integrating Essent, which carries execution risk and remains leveraged to a forward power curve in steep contango where recent economic and demand data suggests risks are to the downside.

Figure 5. E.ON — Profit and Loss Estimates (\$ million)

	2008A	2009E	2010E	2011E	2012E	2013E
External Revenue	127,515	114,264	115,718	123,117	128,649	132,755
Costs	(109,262)	(96,758)	(95,826)	(101,114)	(105,158)	(108,723)
Income from Associates	1,423	1,382	1,188	1,212	1,236	1,262
Adjusted EBITDA	19,676	18,887	21,080	23,216	24,728	25,292
Depreciation and Amortisation	(5,155)	(5,281)	(5,930)	(6,360)	(6,917)	(7,328)
Adjusted EBIT	14,521	13,607	15,150	16,857	17,810	17,964
Net Interest Income	(1,582)	(1,568)	(1,734)	(1,923)	(2,187)	(2,343)
Interest Accretion on Provisions	(1,116)	(1,063)	(1,139)	(1,139)	(1,139)	(1,139)
Adjusted PBT	11,823	10,976	12,278	13,794	14,484	14,483
Tax	(3,097)	(2,965)	(3,095)	(3,509)	(3,767)	(3,765)
Minority Interests	(497)	(480)	(633)	(803)	(825)	(815)
Adjusted Net Income	8,229	7,529	8,550	9,483	9,893	9,903
EPADR - Adjusted	4.32	3.95	4.48	4.97	5.19	5.21
EPADR growth	9.4%	-3.9%	6.0%	10.9%	4.3%	0.1%
DPADR - Ordinary	2.21	2.13	2.42	2.69	2.81	2.81
F/X Used (MXN/\$)	1.47	1.40	1.50	1.50	1.50	1.50

Note: Percentage figures are calculated on local currency numbers not accounted for F/X rate.

Source: Company Reports and CIRA Estimates

Figure 6. E.ON — Cashflow Forecasts (\$ million)

	2008A	2009E	2010E	2011E	2012E	2013E
Net Income - Continuing Operations	2,546	10,944	8,808	9,986	10,718	10,718
Depreciation, Amortisation and Impairment Losses	10,128	5,281	5,930	6,360	6,917	7,328
Changes in Provisions	933	36	39	39	39	41
Changes in Deferred Taxes	(1,552)	(1,152)	(833)	(945)	(1,014)	(1,014)
Change in Working Capital	(419)	(2,913)	497	(768)	(777)	(69)
Other Non-Cash Items	(1,732)	(2,961)	0	0	0	0
Operating Cash Flow	9,905	9,234	14,439	14,673	15,884	17,001
Capital Expenditure	(13,224)	(13,110)	(13,109)	(11,903)	(9,663)	(8,706)
Free Cash Flow	(3,319)	(3,875)	1,331	2,771	6,222	8,297
Acquisitions and Disposals	(13,198)	2,660	6,075	0	0	0
Change in Equity	(4,338)	0	0	0	0	0
Dividends Paid to Shareholders/Minorities	(4,317)	(4,519)	(4,832)	(5,144)	(5,708)	(5,999)
Net Cash Flow	(25,172)	(5,734)	2,574	(2,373)	515	2,297
Other Movements in Financial Net Debt	(7,460)	0	0	0	0	0
	0	0	0	0	0	0
Financial Net Cash/(Debt)	(43,649)	(47,305)	(48,108)	(50,481)	(49,968)	(47,670)
Economic Net Cash/(Debt)	(69,099)	(71,579)	(74,156)	(76,569)	(76,094)	(73,838)
F/X Used (MXN/\$)	1.47	1.40	1.50	1.50	1.50	1.50

Source: Company Reports and CIRA Estimates

Figure 7. E.ON — Sum of Parts Valuation (\$ million)

	\$ million	\$ million	EBITDA 10E	EV/EBITDA	\$ per ADR.
CENTRAL EUROPE	65,519		10,025	6.5x	34.35
Central Europe West - Power		50,220	8,192	6.1x	26.40
Central Europe West - Gas		3,972	488	8.2x	2.10
Central Europe East		7,991	930	8.6x	4.20
Others / Consolidation		3,336	417	8.0x	1.80
PAN EUROPEAN GAS	24,582		3,108	7.9x	12.90
Upstream (E&P + Yuzhno)		6,417	818	7.9x	3.30
Midstream		14,382	1,635	8.8x	7.50
Downstream		3,561	624	5.7x	1.80
Others / Consolidation		221	32	7.0x	0.15
UK	14,235		1,673	8.5x	7.50
Regulated		7,067	824	8.6x	3.75
Non-Regulated		7,545	902	8.4x	3.90
Others / Consolidation		(377)	(54)	7.0x	(0.15)
NORDIC	13,518		1,484	9.1x	7.05
Regulated		3,899	483	8.1x	2.10
Non-Regulated		9,342	962	9.7x	4.95
Others / Consolidation		278	39	7.0x	0.15
US-MIDWEST	9,288		1,265	7.3x	4.95
Regulated		8,129	1,112	7.3x	4.20
Non-regulated, Others		1,160	155	7.5x	0.60
OTHERS	20,699		2,352	8.8x	10.80
FINANCIAL ASSETS	29,933		n.m.	n.m.	15.75
3.5% stake in Gazprom (Russia)		5,865	n.m.	n.m.	3.15
Equity accounted		24,069	n.m.	n.m.	12.60
TOTAL EV	177,773		n.m.	n.m.	93.30
LIABILITIES	(76,916)		n.m.	n.m.	(40.35)
Net financial debt		(50,684)	n.m.	n.m.	(26.55)
CASH FROM Disposals		6,075			3.15
Pension liabilities		(5,378)	n.m.	n.m.	(2.85)
Nuclear liabilities		(11,927)	n.m.	n.m.	(6.30)
Other liabilities		(8,549)	n.m.	n.m.	(4.50)
Minorities		(6,455)	n.m.	n.m.	(3.45)
EQUITY VALUE	100,856		n.m.	n.m.	52.95
F/X Used (MXN/\$)	1.50	1.50	1.50		1.50

Source: Citi Investment Research and Analysis

E.ON AG

Company description

E.ON is one of the four dominant power generators in Germany, and it supplies some 7.5 million customers with electricity. The company's Ruhrgas subsidiary is the largest importer of gas into Germany. E.ON also has operations in the electricity and gas markets in the UK, in the US and in the Nordic regions.

Investment strategy

We rate E.On Buy/High Risk (1H). We believe E.On remains a ADR worth buying for the following reasons: 1) E.On remains at a significant P/E discount to the sector; 2) fundamental of German markets are sound with limited risks of over capacity in the long term; and 3) streamlining of corporate structure could add further upside.

Valuation

We use a sum-of-parts method to derive our target price of \$49.44, applying a variety of valuation techniques to the various divisions. We rely chiefly on a mix of DCF valuations, regulatory asset basis and EV/EBITDA multiples. Financial assets are taken at book value, save for the stake in Gazprom, which is marked to market. Nuclear liabilities are subtracted at a value generated by a separate DCF model. Pension provisions are deducted at book value and a portion of the book value of "other" provisions is also subtracted. Our latest SOTP valuation is \$52.44 per ADR on a standalone basis but we apply a discount to set our target price to account for high equity risk premium and volatility of commodity prices.

Risks

We rate E.On as High Risk based on our assessment of industry- and company-specific risk factors. Risks that may affect the achievement of our target price include the possibility that power prices might fall, as well as regulatory risks in both the gas and the electricity markets. With regard to the investment thesis and achievement of our target price, these could be undermined by renewed competition in German generation or by regulatory change proving more severe than we anticipate. In addition, E.On may still make value-destructive acquisitions.

Appendix A-1

Analyst Certification

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E.ON AG (EONGn.DE)

Ratings and Target Price History Fundamental Research

Analyst: Alberto Ponti
Covered since July 15 2008

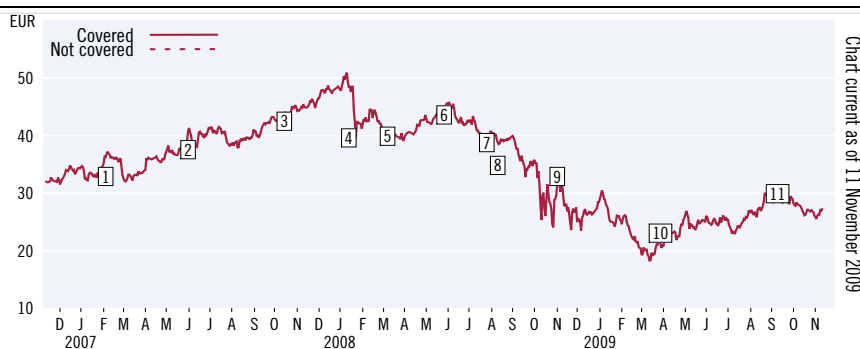


Chart current as of 11 November 2009

	Date	Rating	Target Price	Closing Price
1	5-Feb-07	1M	*43.33	36.32
2	31-May-07	1M	*46.67	40.73
3	15-Oct-07	1M	*49.00	42.96
4	14-Jan-08	1M	*56.33	48.35

	Date	Rating	Target Price	Closing Price
5	7-Mar-08	1M	*55.67	40.67
6	27-May-08	1M	*57.33	44.27
7	25-Jul-08	1M	*56.67	40.06
8	11-Aug-08	1M	*56.67	38.80

	Date	Rating	Target Price	Closing Price
9	3-Nov-08	1M	*38.00	31.77
10	27-Mar-09	*1H	*28.00	21.20
11	9-Sep-09	1H	*33.00	29.06

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 30 Sep 2009

	Buy	Hold	Sell
Citi Investment Research & Analysis Global Fundamental Coverage	44%	38%	18%
% of companies in each rating category that are investment banking clients	47%	45%	36%

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