BRYAN, GARNIER & CO

INDEPENDENT RESEARCH UPDATE

21st March 2013

Utilities

Pennon Group

The benefits of inflation!

Fair Value 800p (price 640.00p) **BUY**

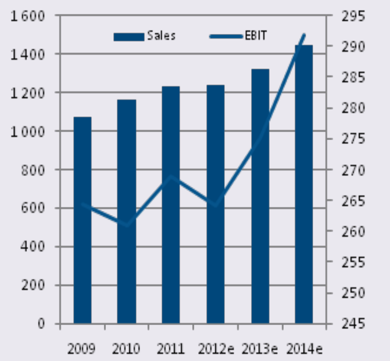
Bloomberg	PNN LN
Reuters	PNN.L
12-month High / Low (p)	796.0 / 598.0
Market capitalisation (GBPm)	2,334
Enterprise Value (BG estimates GBPm)	4,685
Avg. 6m daily volume ('000 shares)	1,388
Free Float	100%
3y EPS CAGR	4.8%
Gearing (03/12)	262%
Dividend yield (03/13e)	4.44%

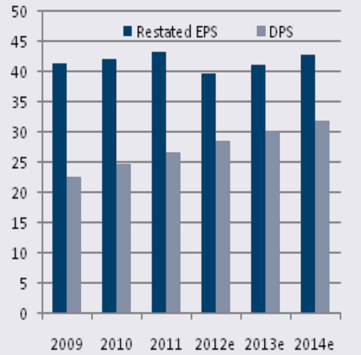
YE March	03/12	03/13e	03/14e	03/15e
Revenue (GBPm)	1,233	1,237	1,290	1,412
EBIT (GBPm)	268.80	260.25	277.30	303.05
Basic EPS (p)	47.92	44.95	45.65	50.93
Diluted EPS (p)	43.24	44.16	44.60	49.75
EV/Sales	3.6x	3.8x	3.8x	3.6x
EV/EBITDA	10.8x	11.3x	11.1x	10.6x
EV/EBIT	16.7x	18.0x	17.7x	16.7x
P/E	14.8x	14.5x	14.4x	12.9x
ROCE	7.1	6.8	6.6	6.7

Inflation forecasts in the UK have risen by 60 basis points since January 2013. Regulated water treatment companies in the UK not only offer excellent protection against inflation (indexation) but are also beneficiaries of it (increase in ROC). In recent months, the main catalyst for the Pennon share has been the cyclical nature of Viridor, the waste management division (25% of EBIT). This has helped mask changes in inflation forecasts. We are reiterating our BUY recommendation on Pennon with a Fair Value of 800p per share in order to also benefit from investor renewed interest in protection against inflation.

- **Hike in inflation forecasts:** Break-even inflation, which represents the difference between the yield on nominal bonds and that on indexed bonds, has increased by 60 basis points since the start of the year. It now stands at 3.3%, which is the highest level since 2008. The implications of this are numerous and positive for Pennon.
- **Inflation pushes up the RAB and pulls down leverage:** The UK water industry is regulated. The watchdog authorises a yield on the regulated asset base (RAB). The RAB is recalculated on an annual basis and indexed to inflation. In addition, just 23% of South West Water's debt is indexed to inflation. As such, the higher inflation is, the faster the net debt/RAB ratio declines, thereby increasing the parent company's flexibility in financing Viridor's project portfolio.
- **The rise in yields prompted by inflation warrants a higher premium:** With most debt not indexed to inflation, ROC depends directly on the level of inflation. We estimate that a 1-point increase in inflation prompts a near 2-point rise in ROC. This warrants a higher premium. In the current backdrop, we estimate that a 15% premium to RAB is justified vs. ~1% implicitly presumed by the market for Pennon and 8-10% for peers.
- **An attractive profile in a negative real-rate backdrop:** The recent downward drive in real interest rates (now clearly negative) reflects increased inflationary fears by investors who are prepared to pay to cover themselves. However, this was not felt in the yield on regulated water company dividends in the UK whereas these offer excellent shelter from inflation. We consider this a market inefficiency that is likely to be corrected.

Analyst:
Julien Desmaretz
33(0) 1 56 68 75 92
jdesmaretz@bryangarnier.com





Company description

Pennon Group is one of is one of the leading companies in the UK environmental services sector. The group operates in water (38% of sales) and waste (61%). The free float is 100%.

Simplified Profit & Loss Account (GBPm)	**2009**	**2010**	**2011**	**2012e**	**2013e**	**2014e**	**2015e**
Revenues	1,069	1,159	1,233	1,237	1,290	1,412	1,653
Change (%)	*12.2%*	*8.4%*	*6.4%*	*0.3%*	*4.3%*	*9.5%*	*17.0%*
Adjusted EBITDA	405	403	416	416	443	477	561
EBIT	264	261	269	260	277	303	381
Change (%)	*4.5%*	*-1.3%*	*3.0%*	*-3.2%*	*6.6%*	*9.3%*	*25.7%*
Financial results	(81.6)	(76.7)	(72.3)	(72.4)	(75.0)	(77.0)	(80.0)
Pre-Tax profits	184	189	201	193	205	229	304
Exceptionals	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tax	44.3	16.9	28.1	30.8	41.1	45.8	60.8
Profits from associates	1.1	4.3	4.0	4.7	3.0	3.0	3.0
Minority interests	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net profit	140	172	172	162	164	183	243
Restated net profit	146	150	156	159	160	179	238
Change (%)	*9.5%*	*3.0%*	*3.8%*	*2.1%*	*1.0%*	*11.6%*	*32.7%*
Cash Flow Statement (GBPm)							
Operating cash flows	275	255	209	252	334	364	435
Change in working capital	(11.8)	(36.4)	35.8	(34.2)	0.41	(0.92)	(3.0)
Capex, net	(195)	(190)	(262)	(363)	(478)	(418)	(315)
Financial investments, net	(217)	(205)	(283)	(357)	(478)	(418)	(315)
Dividends	(63.8)	(56.8)	(69.1)	(71.1)	(81.3)	(87.1)	(93.1)
Other	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Net debt	1,913	1,955	2,153	2,351	2,576	2,717	2,690
Free Cash flow	58.1	49.5	(74.6)	(105)	(144)	(54.2)	120
Balance Sheet (GBPm)							
Tangible fixed assets	2,823	2,928	3,083	3,284	3,597	3,842	3,976
Intangibles assets	254	292	327	331	331	331	331
Cash & equivalents	494	556	425	291	320	332	514
current assets	205	236	258	230	227	234	256
Other assets	106	125	178	213	213	213	213
Total assets	3,882	4,136	4,271	4,349	4,688	4,952	5,290
L & ST Debt	2,407	2,511	2,579	2,642	2,896	3,050	3,204
Others liabilities	814	845	870	878	875	882	908
Shareholders' funds	661	780	822	850	938	1,040	1,200
Total Liabilities	3,882	4,136	4,271	4,370	4,708	4,972	5,311
Capital employed	3,578	3,776	3,926	3,991	4,333	4,590	4,903
Ratios							
Operating margin	24.73	22.51	21.80	21.04	21.50	21.46	23.05
Tax rate	23.46	8.97	14.02	16.00	20.00	20.00	20.00
Net margin	13.61	12.93	12.62	12.85	12.44	12.68	14.38
ROE (after tax)	22.02	19.23	18.92	18.69	17.10	17.21	19.81
ROCE (after tax)	6.01	5.84	7.12	6.81	6.60	6.68	7.43
Gearing	289	251	262	277	275	261	224
Pay out ratio	56.58	50.94	55.09	62.83	66.26	63.49	50.95
Number of shares, diluted	352	357	365	365	365	365	365
Data per Share (p)							
EPS	39.69	48.12	47.92	44.95	45.65	50.93	67.60
Restated EPS	41.39	42.04	43.24	44.16	44.60	49.75	66.04
% change	*9.0%*	*1.6%*	*2.9%*	*2.1%*	*1.0%*	*11.6%*	*32.7%*
EPS bef. GDW	41.39	42.04	43.24	44.16	44.60	49.75	66.04
BVPS	188	219	225	233	257	285	329
Operating cash flows	0.78	0.71	0.57	0.69	0.92	1.00	1.19
FCF	0.17	0.14	(0.20)	(0.29)	(0.39)	(0.15)	0.33
Net dividend	22.55	24.65	26.52	28.43	30.45	32.55	34.67

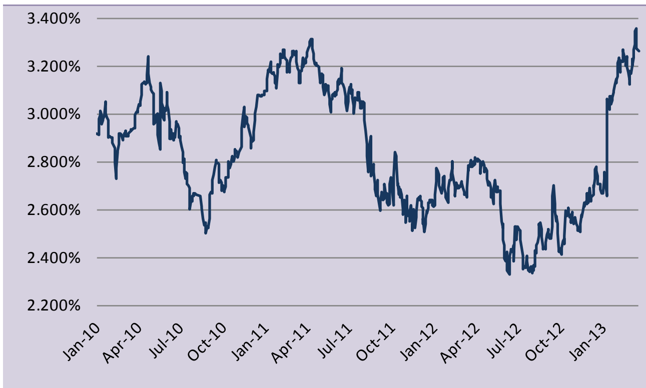
Source: Company Data; Bryan, Garnier & Co ests.

Higher inflation forecasts in the UK

Break-enven inflation of 3.3% ; + 60bps YTD

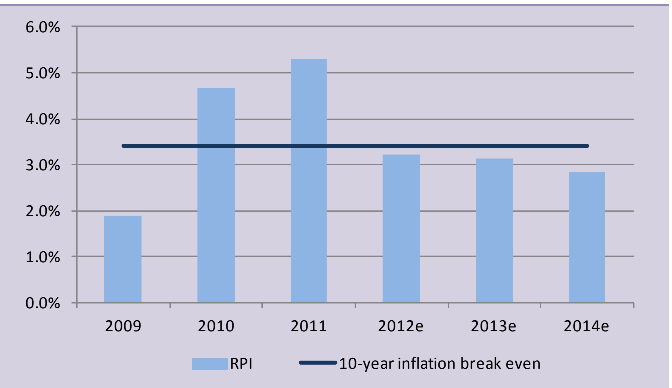
Figure 1 represents break-even inflation in the UK, reflecting the change in investor inflation forecasts. Note that break-even inflation is deduced from the difference in yield between nominal bonds and those indexed to inflation. This has risen by 100 basis points since mid-2012 and 60 basis points since early 2013, thereby bringing medium-term inflation forecasts to 3.3% at present in the UK. This is the highest level since September 2008. In addition, the Bank of England's message has reached a turning point suggesting that the fight against inflation was not a goal in itself. Indeed, the institution recently indicated that it was prepared to accept inflation in order to help restore growth (lien) and recognised that the target inflation rate of 2% would not be reached before 2016.

Fig. 1: 10-year break-even inflation



Source: Datastream

Fig. 2: Consensus vs. break-even inflation



Source: Economic Consensus; Datastream

Increase in demand for protection against inflation

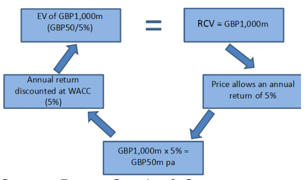
The implications of higher inflation are numerous and positive for Pennon, and in general for regulated water companies in the UK. Appetite for assets sheltering investors from high inflation could increase demand for Pennon and provide a significant catalyst for the share.

High inflation is a positive factor for regulated companies. It enables them to achieve more attractive yields since prices and regulated capital values (RCVs) are indexed to inflation. Our base case scenario is based on the inflation forecasts set out in Figure 2.

Revaluation of equity and decline in leverage

Indexation of regulated asset base …

RAB, a good approximation of EV



Source: Bryan, Garnier & Co.

The UK water industry is regulated by The Water Services Regulation Authority (OFWAT), which fixes prices such that private companies cover their respective cost of capital. The regulated asset base (RAB) or regulated capital value (RCV) is the key concept in economic regulation. Indeed, depending on various criteria, OFWAT allocates to each company a level of profitability authorised relative to the capital invested, i.e. the RAB. As such, the RAB is generally considered as the best approximation of enterprise value (re. chart opposite). It is recalculated on an annual basis in order to take account of investment spending and write-downs, but also inflation. As such, all other factors remaining equal elsewhere, the higher inflation is, the more the RAB increases automatically, like yields since prices are determined depending on a nominal WACC.

23% of SWW debt is linked with inflation

And a low share of inflation-adjusted debt...

23% of South West Water's debt is indexed to changes in inflation. This represents 11% of Pennon's net debt thereby signifying that the stock of indexed debt rises in line with inflation.

+1ppt of inflation leads to a 2% RAB increase

… prompting a revaluation of equity…

As such, since just a small share of debt is indexed to inflation, this means that the RAB (and hence, Pennon's enterprise value) increases more than debt, thereby increasing the value of equity. We estimate that one point of inflation prompts an increase in the value of equity of 2.1%.

+1ppt of inflation reduces ND/RAB by 0.4ppt

… and accelerates the decline in leverage

Leverage at UK water companies is generally expressed according to the RAB. Indeed OFWAT fixes leverage restrictions based on the ratio of net debt/RAB, which should stand at between 55% and 65%. On 30 September 2012, South West Water's financial leverage stood at 58.6%. We estimate that one point of inflation helps (all other factors remaining equal elsewhere) reduce leverage by 40 basis points, or to generate debt capacity in order to finance the development of Viridor.

Dividend policy: "4% + inflation" growth per annum

Increase in inflation-linked dividends

Note finally that Pennon's management has pledged to increase the dividend paid to shareholders by "4% + inflation" every year between now and 2015. If inflation forecasts prove correct, the sequence of dividends expected by the consensus should be revised upwards. Assuming break-even inflation of around 3.5%, we note that dividend estimates should be increased by around 1.5% by 2015. This would result in average annual growth in the dividend of 7.5% vs. the 6.7% forecast at present.

Hike in ROI

Authorised profitability levels are directly linked to inflation. With the majority of debt not indexed to inflation (77%) until 2015, the return on equity is directly dependent on inflation. We estimate that a 1-point increase in inflation leads to a near 2-point increase in the return on equity. This justifies a higher premium.

Fig. 3: Return on investment vs. cost of capital

Inflation (i)	-1.0%	0.0%	1.0%	2.0%	3.0%	3.3%	4.0%	5.0%
Allowed return (ii)	5.1%	5.1%	5.1%	5.1%	5.1%	5.%	5.1%	5.1%
Allowed nominal return (iii)=(i)+(ii)	4.1%	5.1%	6.1%	7.1%	8.1%	8.5%	9.1%	10.1%
Gearing (ND/RCV) (iv)	58.6%	58.6%	58.2%	57.8%	57.4%	57.0%	56.6%	56.2%
Nominal cost of debt (v)	3.4%	3.4%	3.4%	3.4%	3.4%	3.4%	3.4%	3.4%
Index linked cost of debt (vi)	1.7%	1.7%	1.7%	1.7%	1.7%	1.7%	1.7%	1.7%
Proportion of index-linked (vii)	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%
Average nominal pre-tax cost of debt (viii)=(i)*(1-(vii))+(vii)*((i)+(v))	2.9%	3.1%	3.3%	3.5%	3.7%	3.7%	3.9%	4.1%
Average nominal post-tax cost of debt (ix)=(viii)*(1-0.28)	2.1%	2.2%	2.3%	2.5%	2.6%	2.7%	2.8%	2.9%
Post-tax return on equity (x)=(iii)-(ix)*(iv)	7.0%	9.2%	11.3%	13.4%	15.5%	16.2%	17.3%	19.3%
Cost of equity (xi) [risk-free rate of 2%; ERP 5.4% & beta of 0.9]	4.8%	5.8%	6.8%	7.8%	8.8%	9.2%	9.8%	10.8%
Spread (xii)=(x)-(xi)	2.2%	3.4%	4.5%	5.6%	6.7%	7.0%	7.6%	8.5%

Source: Bryan, Garnier & Co ests.

Justified premium over RAB of ~15%

Based on the returns on investment presented in the table above as well as on dividend valuation models, we justify the level of premium (or discount) possible that should be attributed to a regulated asset. In the current backdrop, we calculate that a 15% premium to the RAB is justified, vs. around 1% implicitly presumed by the market for Pennon and 8-10% for peers.

Fig. 4: Return on investment vs. cost of capital

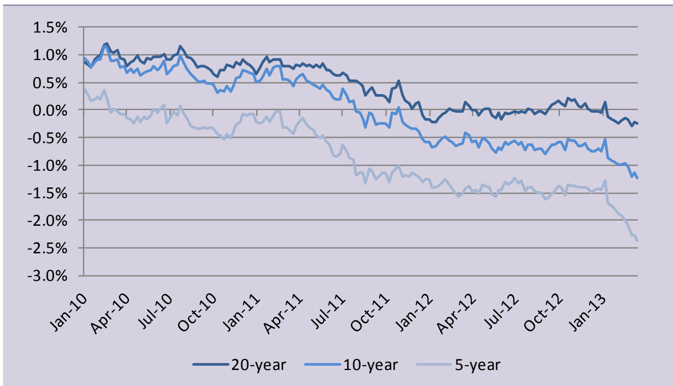
Inflation	-1.0%	0.0%	1.0%	2.0%	3.0%	3.3%	4.0%	5.0%
RCV	100	100	101	102	103	**103.4**	104	105
RoE (i)	7.0%	9.2%	11.3%	13.4%	15.5%	**16.2%**	17.3%	19.3%
Payout (ii)	65%	65%	65%	65%	65%	**65%**	65%	65%
Cost of Equity (iii)	4.8%	5.8%	6.8%	7.8%	8.8%	**9.2%**	9.8%	10.8%
Equity value (vi) = [(iii)-(1-(iv))]/(v)	95.0	103.5	109.7	114.3	117.9	**118.6**	119.9	122.2
Discount/Premium	-5.0%	3.5%	8.6%	12.1%	14.5%	**14.7%**	15.3%	16.4%

Source: Company Data; Bryan, Garnier & Co ests.

An attractive profile in a backdrop of negative real interest rates

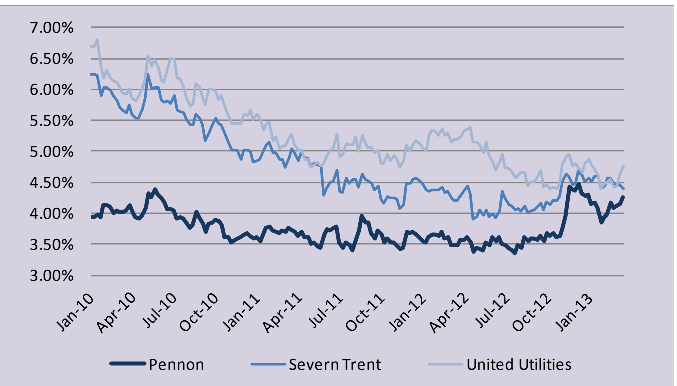
Since January 2013, real interest rates in the UK have slumped significantly, settling into negative territory. As such, the real yield on a government bond in the UK works out to -2.4% over five years and -1.2% over 10 years. This explains inflationary fears by investors and the price they are prepared to pay to cover themselves. However, this was not felt in the dividend yield of regulated water companies in the UK, as shown by chart 6 and has prompted a fairly high increase in the difference between the real yield on a government bond and the Pennon dividend (see Fig. 7) whereas the group offers genuine protection against inflation.

Fig. 5: Real interest rates in the UK



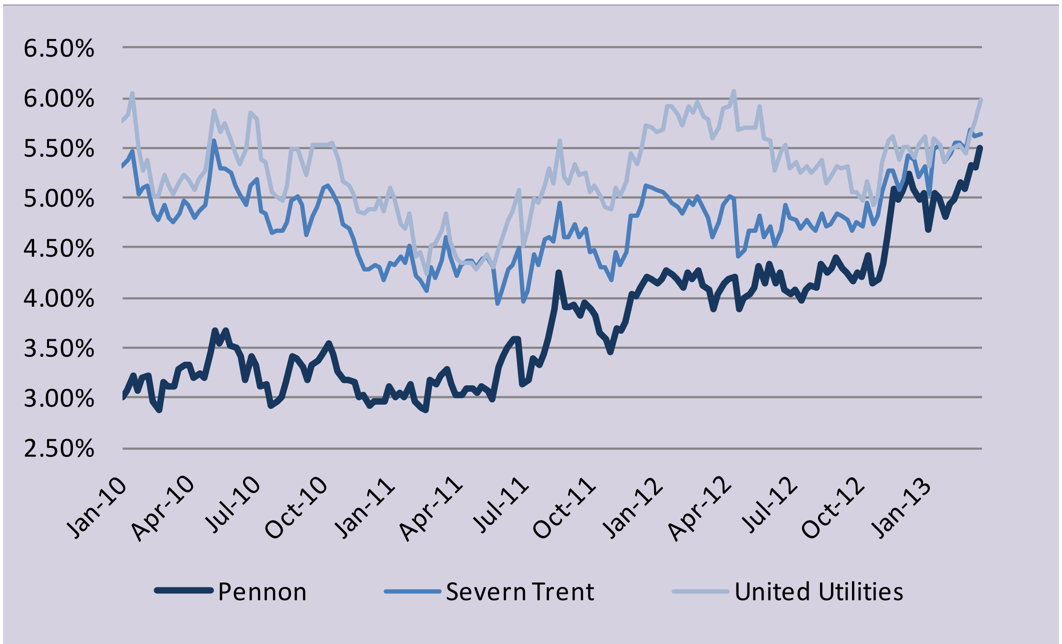
Source: Datastream

Fig. 6: Dividend yields



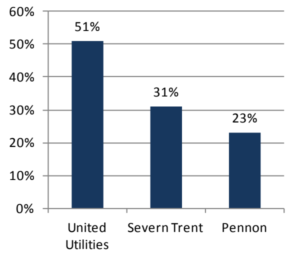
Source: Datastream

Fig. 7: Difference in yield between treasury notes (real rates) and dividends



Source: Bloomberg

Proportion of indexed debt vs. overall net debt



Source: Bryan, Garnier & Co.

We believe that numerous investors are inevitably likely to turn to regulated water companies in the UK in order to shelter themselves more cheaply from inflation, thereby prompting significant demand for shares of these group. Among the three last companies listed in London, Pennon is the one that boasts the lowest level of inflation-linked debt.

Sum-of-the-parts valuation: 800p per share

We have valued Pennon by a sum-of-the-parts calculation which points to a Fair Value of 809p that we have rounded down to 800p.

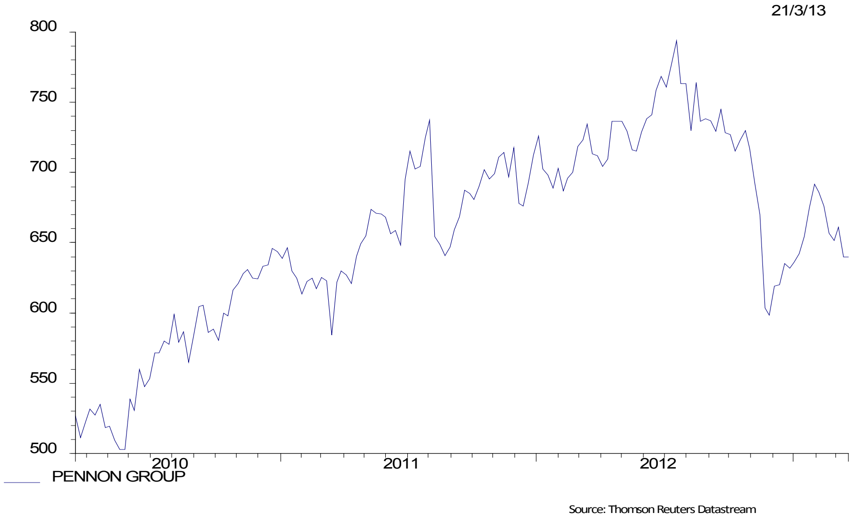
Fig. 8: SOTP valuation

Valuation - base case	GBPm	% EV	Per share	Comment
SOUTH WEST WATER				
South Waste Water RAB	3,047	54.8%	835.5	March-2014
Capex clawback	(43)	-0.8%	(11.8)	Removing prior year under spent on capex: 2011-15 period; discounted, post-tax
COPI Adjustment		0.0%	-	
Financing outperformance	152	2.7%	41.8	5% of RAB
Premium	457	8.2%	125.3	15% premium
South West Water	**3,613**	**65.0%**	**990.8**	
VIRIDOR				
Landfill space	213	3.8%	58.4	GBP3m/cm
LFG	216	3.9%		GBP2m/MW
Recycling, collection & others	322	5.8%		Ex JVs
Energy-from-Waste pipeline	853	15.3%		Bolton, Runcorn II, Exeter, Ardley, Cardiff and Glasgow
Dunbar + Avonsmouth	164	3.0%		DCF; 50% probability; projects not committed yet
Lakeside + Runcorn I equity stakes	174	3.1%		DCF
Viridor	**1,942**	**35.0%**	**532.6**	
= Enterprise Value	**5,555**	**100.0%**	**1,523.4**	
- Net Debt	(2,576)		(706.4)	
- Provisions	(29)		(8.1)	25% of pensions as Ofwat covers the liability
Equity Value (€)	**2,950**		**809.0**	**Rounded down to 800p/sh**

Source: Company Data; Bryan, Garnier & Co ests.

Price Chart and Rating History

Pennon Group



Ratings		
Date	**Ratings**	**Price**
08/03/12	BUY	721.5p

Target Price	
Date	**Target price**
15/02/13	800p
16/11/12	810p
04/09/12	840p
24/07/12	791p
08/03/12	780p

Bryan Garnier stock rating system

For the purposes of this Report, the Bryan Garnier stock rating system is defined as follows:

Stock rating

BUY	Positive opinion for a stock where we expect a favourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential upside based on valuation), but also takes into account a number of elements including a SWOT analysis, positive momentum, technical aspects and the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.
NEUTRAL	Opinion recommending not to trade in a stock short-term, neither as a BUYER or a SELLER, due to a specific set of factors. This view is intended to be temporary. It may reflect different situations, but in particular those where a fair value shows no significant potential or where an upcoming binary event constitutes a high-risk that is difficult to quantify. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.
SELL	Negative opinion for a stock where we expect an unfavourable performance in absolute terms over a period of 6 months from the publication of a recommendation. This opinion is based not only on the FV (the potential downside based on valuation), but also takes into account a number of elements including a SWOT analysis, positive momentum, technical aspects and the sector backdrop. Every subsequent published update on the stock will feature an introduction outlining the key reasons behind the opinion.

Distribution of stock ratings

BUY ratings 51.4% NEUTRAL ratings 27.5% SELL ratings 21.1%

Research Disclosure Legend

1	Bryan Garnier shareholding in Issuer	Bryan Garnier & Co Limited or another company in its group (together, the "Bryan Garnier Group") has a shareholding that, individually or combined, exceeds 5% of the paid up and issued share capital of a company that is the subject of this Report (the "Issuer").	No
2	Issuer shareholding in Bryan Garnier	The Issuer has a shareholding that exceeds 5% of the paid up and issued share capital of one or more members of the Bryan Garnier Group.	No
3	Financial interest	A member of the Bryan Garnier Group holds one or more financial interests in relation to the Issuer which are significant in relation to this report	No
4	Market maker or liquidity provider	A member of the Bryan Garnier Group is a market maker or liquidity provider in the securities of the Issuer or in any related derivatives.	No
5	Lead/co-lead manager	In the past twelve months, a member of the Bryan Garnier Group has been lead manager or co-lead manager of one or more publicly disclosed offers of securities of the Issuer or in any related derivatives.	No
6	Investment banking agreement	A member of the Bryan Garnier Group is or has in the past twelve months been party to an agreement with the Issuer relating to the provision of investment banking services, or has in that period received payment or been promised payment in respect of such services.	No
7	Research agreement	A member of the Bryan Garnier Group is party to an agreement with the Issuer relating to the production of this Report.	No
8	Analyst receipt or purchase of shares in Issuer	The investment analyst or another person involved in the preparation of this Report has received or purchased shares of the Issuer prior to a public offering of those shares.	No
9	Remuneration of analyst	The remuneration of the investment analyst or other persons involved in the preparation of this Report is tied to investment banking transactions performed by the Bryan Garnier Group.	No
10	Corporate finance client	In the past twelve months a member of the Bryan Garnier Group has been remunerated for providing corporate finance services to the issuer or may expect to receive or intend to seek remuneration for corporate finance services from the Issuer in the next six months.	No
11	Analyst has short position	The investment analyst or another person involved in the preparation of this Report has a short position in the securities or derivatives of the Issuer.	No
12	Analyst has long position	The investment analyst or another person involved in the preparation of this Report has a long position in the securities or derivatives of the Issuer.	No
13	Bryan Garnier executive is an officer	A partner, director, officer, employee or agent of the Bryan Garnier Group, or a member of such person's household, is a partner, director, officer or an employee of, or adviser to, the Issuer or one of its parents or subsidiaries. The name of such person or persons is disclosed above.	No
14	Analyst disclosure	The analyst hereby certifies that neither the views expressed in the research, nor the timing of the publication of the research has been influenced by any knowledge of clients positions and that the views expressed in the report accurately reflect his/her personal views about the investment and issuer to which the report relates and that no part of his/her remuneration was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in the report.	Yes
15	Other disclosures	Other specific disclosures: Report sent to Issuer to verify factual accuracy (with the recommendation/rating, price target/spread and summary of conclusions removed).	No

A copy of the Bryan Garnier & Co Limited conflicts policy in relation to the production of research is available at www.bryangarnier.com

BRYAN, GARNIER & CO

London	Paris	New York	Geneva	New Delhi
Dowgate Hill House	26 Avenue des Champs Elysées	750 Lexington Avenue	rue de Grenus 7	The Imperial Hotel
14-16 Dow Gate Hill	75008 Paris	New York, NY 10022	CP 2113	Janpath
London EC4R 2SU	Tel: +33 (0) 1 56 68 75 00	Tel: +1 (0) 212 337 7000	Genève 1, CH 1211	New Delhi 110 001
Tel: +44 (0) 207 332 2500	Fax: +33 (0) 1 56 68 75 01	Fax: +1 (0) 212 337 7002	Tel +4122 731 3263	Tel +91 11 4132 6062
Fax: +44 (0) 207 332 2559	Regulated by the	FINRA and SIPC member	Fax+4122731 3243	+91 98 1111 5119
Authorised and regulated by	Financial Services Authority (FSA) and		Regulated by the	Fax +91 11 2621 9062
the Financial Services	l'Autorité des Marchés Financiers		Swiss Federal Banking	
Authority (FSA)	(AMF)		Commission	