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Stock Rating
Underweight

Industry View
Cautious

E.ON

Downgrade to Underweight: Lower relative growth prospects still not discounted

What's Changed	
Rating	**Equal-weight to Underweight**
Price Target	**€28.00 to €27.00**

Our Underweight thesis focuses on relative valuation and lack of relative growth. Despite E.ON's good asset quality and sound overall strategy, we expect the stock to underperform the sector. Based on 'clean' multiples (8.3x 2010 EV/EBITDA, 11.7x PE), the shares look expensive versus the sector; we see a relative lack of growth; and we expect consensus EPS downgrades. The shares also trade very close to our EUR 27 fair value, offering less upside than the sector.

We forecast -1.7% EPS growth (2008-13), depressed by (1) lower power and gas prices as hedges roll off, (2) low contributions from past acquisitions, and (3) dilution from disposals. We see better growth elsewhere, and believe consensus has some room to fall (5-15% for 2010-13) to properly discount the current environment.

Still cautious on European Power and Gas markets: Power prices have fallen 15% since October 2009. Current forward curves imply that E.ON's core power generation business will see profits decline from 2010 to 2013, with further downside possible. We also remain cautious on the outlook for gas prices and mid-stream gas margins, although 2009-10 should see the trough for E.ON's gas business.

Where could we be wrong? Operational improvements and cost-cutting could foster growth, in line with our Bull case. We expect incoming CEO Dr. Johannes Teyssen to increase the operational focus, and see opportunity here for improvement. We explore options he may have to improve the business. We see scope for further cost cutting, with the caveat that this could take time and may require union agreements.

Key Ratios and Statistics

Reuters: EONGn.DE Bloomberg: EOAN GR
Utilities / Germany

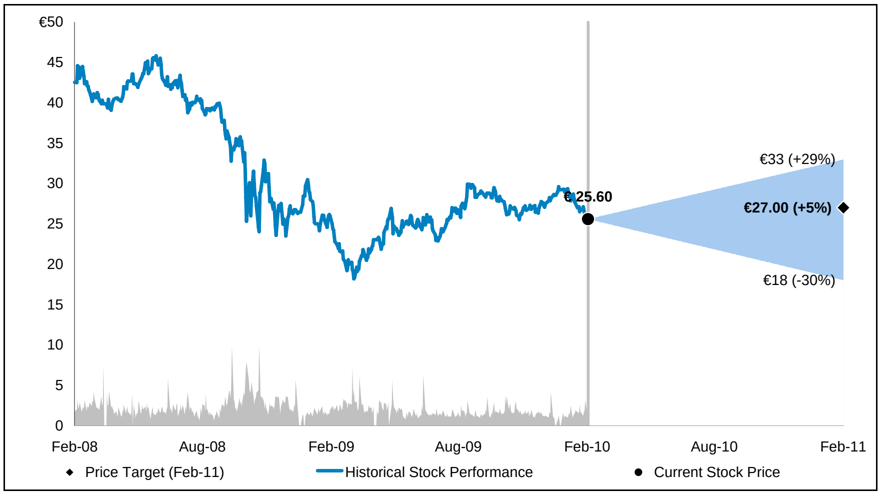
Price target	**€27.00**
Shr price, close (Feb 5, 2010)	€25.60
52-Week Range	€30.47-17.77
Mkt cap, curr (mn)	€48,768

Fiscal Year ending	**12/08**	**12/09e**	**12/10e**	**12/11e**
Revenue (€mn)**	87,031	74,499	74,868	77,130
EBITDA (€mn)**	13,385	13,615	13,875	14,491
EBIT (€mn)**	9,877	9,953	9,865	10,240
EPS (€)**	**3.00**	**2.84**	**2.79**	**2.83**
ModelWare EPS (€)	3.00	2.84	2.79	2.84
Prior ModelWare EPS (€)	-	2.81	2.80	2.93
Consensus EPS (€)§	2.97	2.93	2.92	2.99
P/E**	9.9	10.3	9.2	9.0
Div per shr (€)	1.50	1.56	1.56	1.62
Div yld (%)	5.0	5.3	6.1	6.3
FCF yld ratio (%)**	10.0	11.2	13.5	13.8

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework (please see explanation later in this note).
**** =** Based on consensus methodology
§ = Consensus data is provided by FactSet Estimates.
e = Morgan Stanley Research estimates

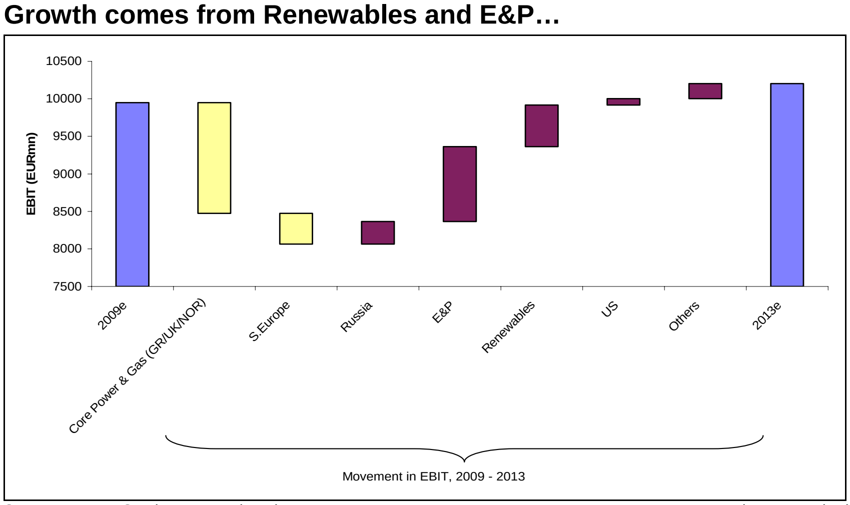
E.ON (EONGn.DE, Underweight, PT €27)

Limited upside to our target price – risks to the downside



Bull Case: €33 ***"Higher power prices, more growth"***	11.8x Base Case 10e EPS 11.6x Base Case 13e EPS	LT German Baseload: €82/MWh LT Coal: $109/tonne LT Carbon: €25/tonne Nuclear Life Extensions: 8 years
Base Case: €27 ***"Power prices recover to new entrant levels, nuclear life extensions"***	10x Base Case 10e EPS 9.9x Base Case 13e EPS	LT German Baseload: €65/MWh LT Coal: $80/tonne LT Carbon: €20/tonne Nuclear Life Extensions: 8 years
Bear Case: €18 ***"Energy prices collapse, no growth, nuclear shut-down"***	6.4x Base Case 10e EPS 6.3x Base Case 13e EPS	LT German Baseload: €41/MWh LT Coal: $48/tonne LT Carbon: €10/tonne Nuclear Life Extensions: 0 years

Growth comes from Renewables and E&P…



Source: Morgan Stanley Research estimates

Note: Assuming current hedging

Why Underweight?

- We believe E.ON offers less growth relative to peers, and the valuation looks unappealing when adjusted for growth rate.
- Our forecasts show EPS growth of -1.7% 2008-13, and are 5-15% below consensus for 2010-13
- We recognize E.ON's solid assets. However, we see cheaper ways to play the sector, with better growth prospects.

What's new?

- Lower power price forecasts drive earnings downgrades approximately 5-7% below consensus for 2010-2012.
- Analysis of underlying valuations excluding carbon allocations and hedges.

Where are we different?

- We believe that the contango in European power and gas prices could further collapse – back to historical averages – putting pressure on E.ON's power generation and mid-stream gas earnings.
- Our forecasts now take account of all announced disposals and current forward power prices, and are 5-15% below consensus for 2010-13.

Where could we be wrong?

- A rally in power and gas prices before earnings estimates are corrected would be positive for the E.ON investment case.
- Operational improvements and cost cutting, especially with a new CEO incoming, could prompt growth.

Potential catalysts

- E.ON reports FY 2009 results on 10 March. We expect limited updated guidance until later in the year, after the new CEO takes charge in May.

Key Debates

Debate	E.ON
1. Is E.ON too cheap to ignore?	*Market view – E.ON is cheap, and the low multiples mean it is too cheap to sell.* **Our view – We disagree.** However, our thesis is more about relative underperformance than absolute value. E.ON may look inexpensive on headline multiples, but these include some unsustainable profits – especially from free carbon allocations and short-term hedges. 'Clean' multiples (8.3x 2010 EV/EBITDA, 11.7x PE) are much less compelling, in our view, and make the shares look expensive versus the sector when E.ON's growth profile is taken into account. We believe high financial leverage means that EV/EBITDA, which takes account of different capital structure, is a better metric than PE. E.ON trades in line with our fair value, which is calculated using consistent assumptions across the sector. We see upside at other stocks and thus conclude the relative value attractions are not compelling. Although 'notional' FCF yield numbers look high, these are based on maintenance capex, which is much lower than depreciation and thus not sustainable. A sustainable FCF yield is 10%. With few catalysts, the shares can grind lower versus the sector.
2. Have power prices bottomed, set for a rebound?	*Market view – Power price risks are already discounted.* **Our view – We disagree.** We see a 2-3 year period of moribund power prices in Germany, as we believe demand will take years to recover and new capacity will dampen pricing power. Power prices have fallen 15% since October. Consensus forecasts bake in power price and dark spread assumptions that are too high, in our view, especially for 2012/13. Marking to market, as we believe the street will likely do post the FY 2009 results on 10 March, would mean further EPS downgrades. We believe E.ON's core power generation business will see profits decline from 2010 to 2013.
3. Is the EU gas market set to recover quickly?	*Market view – Gas prices and margins can't get any worse.* **Our view – We partly agree.** We believe that the ongoing gas contract renegotiations will help ease some of the pressure on E.ON's mid-stream margins, but we expect the market to remain very competitive and believe margins may never recover to old super-normal levels. We think gas prices could stay weak, as we think demand will take years to recover. But 2009-10 should see the trough for E.ON's gas business.
4. Is E.ON on the brink of the new CEO driving big operational benefits?	*Market view – A new CEO will bring a refresh of strategy, and new cost cutting targets.* **Our view – We partly agree.** We believe that the new CEO is likely to announce a greater focus on improving the operational performance of E.ON. As long as this is measurable, it should be good news as we see scope to improve here. But a major cost-cutting and performance improvement effort is already underway, and it may be hard to drive out further cost-cutting without new union agreements.
5. What guidance will E.ON give at its full year results on 10 March	*Market view – E.ON will refresh 2010 guidance but not give new mid term guidance.* **Our view – We agree.** The new CEO will not take charge until after the results and will probably want to 'kick the tyres' before setting out any new guidance. We therefore expect that E.ON will simply update its existing 2010 guidance for the impact of disposals. We expect little new information on the outlook or strategy until the new CEO presents this, probably in late summer or at the H1 results.

Investment Case

Summary & Conclusions

More underperformance to come. E.ON has underperformed the utility sector by 2% in 2010 so far and is trading close to its 6-month relative low to the sector. But, in our opinion, the investment case is pretty finely balanced, and we believe that E.ON could continue to underperform the sector over the next 6-12 months. For this reason, we downgrade our rating to Underweight from Equal-weight.

Positives offset by lack of growth, earnings momentum and valuation. We do see some positives coming at E.ON – notably a greater operational focus and the longer term scope for more cost cutting. In addition, we think that E.ON has some very attractive assets, especially its core German business. However, we think that these arguments can be made for most large integrated utilities in Europe. In our view, these are offset by the relative lack of growth, the risk of consensus EPS downgrades and unappealing relative valuation.

On an absolute basis, E.ON trades in-line with our target price, which is derived from our sum of the parts analysis – this implies much less upside than we see elsewhere, using consistent assumptions. Although headline multiples are not stretched and may appear to offer support, we believe these are flattered, like for many other utilities, by a combination of free carbon allowances and short term commodity hedges. Cleaning up the multiples for these shows a much less compelling picture, especially relative to the other big integrated utilities. In addition, E.ON offers less growth than peers, so growth-adjusted multiples are worth considering, and these look unattractive, in our view.

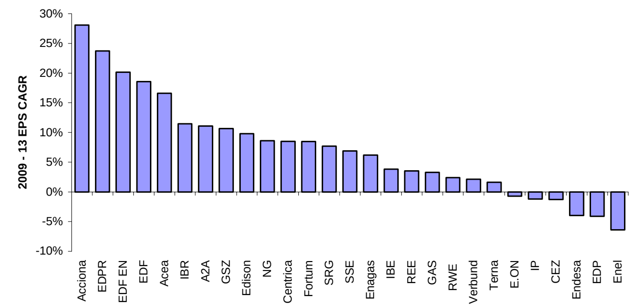
Lack of growth is the key challenge. We see some positives emerging. However, these remain offset by some very tough growth challenges. The main headwinds for growth are (1) a tough power and gas price outlook, and (2) the dilution from disposals. And in the medium term, what growth there is comes mostly from businesses with less visibility than the core German power businesses (Russia, Southern Europe, Renewables, E&P). Although this is not an E.ON-specific issue – many European utilities are only growing due to investment in new markets and businesses – it definitely does mean a deteriorating visibility of earnings for the sector overall.

Our forecasts are 5-15% below consensus. As shown in Exhibit 2, our forecasts are below consensus, especially in the medium term. We therefore do not believe that consensus has yet factored in the true extent of the slowing growth, and expect earnings momentum to disappoint. We also expect limited guidance, other than for 2010, at the FY 2009 results on 10 March. The biggest upside risk to our forecasts is if power prices recover sharply. A further source of downside risk would be if E.ON sells more assets, which we think a plausible scenario in 2010-11.

Our Underweight rating is not a judgement of the company's strategy (we think E.ON is now doing the right things) or the quality of the assets (we think E.ON has a solid portfolio in the main). Our thesis simply focuses on valuation and unappealing relative growth. If the shares were to de-rate enough, or the growth prospects improve, this would cause us to revisit our stance.

Exhibit 1

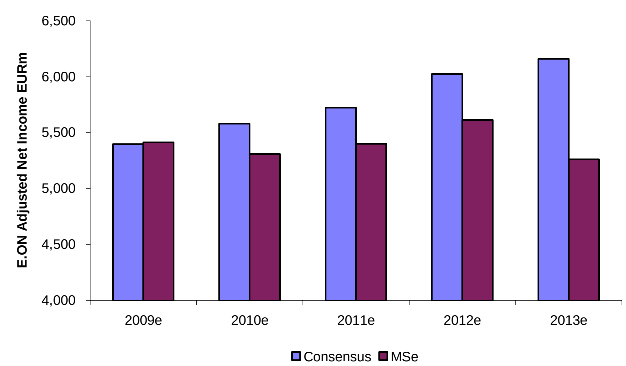
2009-2013 EPS CAGR: We Forecast that E.ON Will Deliver Low Growth Versus Peers



Source: Company data, Morgan Stanley Research estimates

Exhibit 2

Our Adjusted Net Income Forecasts Are Well Below Consensus in the Medium Term



Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

Where could we be wrong? Obviously we could be too bearish on power and gas prices. If these rally before earnings estimates are corrected, then this would be positive for the E.ON investment case. However, even in this case, we see better leverage to power prices elsewhere. So what could really drive E.ON back to sector-leading growth? In our view, this can only really come from operational improvements and cost cutting, which may be the real risk to our Underweight, especially with a new CEO incoming.

Exhibit 3

'Clean' Sector Multiples and Growth Rates Lead Us to Conclude Relative Value Is Unappealing

	Clean P/E				EPS CAGR	Clean EV/EBITDA				EBITDA CAGR
	2010e	2011e	2012e	2013e	10-13	2010e	2011e	2012e	2013e	10-13
EON	11.7	11.0	10.0	9.2	10.7%	8.3	7.8	7.7	7.3	5.2%
RWE	13.1	11.9	10.4	9.3	17.1%	7.8	7.5	6.9	6.3	10.0%
GSZ	16.6	12.1	10.6	9.3	22.3%	7.3	6.3	5.7	5.0	11.0%
IBE	15.0	13.0	11.7	9.9	12.4%	9.1	8.6	8.3	7.7	8.9%
ELE	16.7	13.4	13.9	12.2	11.0%	7.2	7.0	7.1	6.6	3.9%
GAS	15.2	13.0	12.3	9.4	17.2%	9.5	8.8	8.5	7.3	7.3%
ENEL	15.4	12.6	13.1	10.1	14.9%	7.9	7.0	7.1	6.6	5.5%
CNA	11.7	10.7	9.9	9.2	9.1%	6.3	5.7	5.5	5.3	7.7%
SSE	11.4	10.2	8.7	8.1	13.8%	8.9	8.1	7.2	6.7	12.6%
FUM	11.3	13.5	13.3	11.9	-1.5%	8.4	9.4	9.2	8.5	0.2%
VER	22.0	15.4	13.8	12.2	14.3%	11.8	9.5	8.6	7.9	22.4%
CEZ	17.6	14.2	12.7	10.7	21.4%	10.3	9.4	8.8	7.8	15.7%
Average	**14.9**	**12.6**	**11.7**	**10.1**	**14.0%**	**8.5**	**7.9**	**7.5**	**6.9**	**9.2%**

Source: Morgan Stanley Research estimates

New CEO: What We Would Look For

Dr. Johannes Teyssen, the current Deputy CEO and COO of E.ON, takes over as the new CEO in May 2010. He succeeds existing CEO Wulf Bernotat. Dr. Teyssen has a long background at E.ON, and has been a management board member since 2004. He joined PressenElektra AG (a subsidiary of the company that is now E.ON) in 1989 and has worked at a range of E.ON companies since then.

He has wide experience of the E.ON group and sits on the Supervisory or Management Boards of a number of its subsidiaries. He is also a Supervisory Board member of Deutsche Bank AG and Salzgitter AG. He therefore has wide experience not only of E.ON but also of the wider corporate environment. He comes with a solid reputation as a manager and leader, and we believe he is widely expected to make a positive difference when in sole charge.

What could change the outlook for E.ON? We would view the following scenarios as positive signs

We think it plausible management could consider asset sales, in line with its stated EUR 10bn disposals target. Utility disposals over the last year have generally fetched good prices, so it may still be possible to sell more assets at a good price. In addition, the market may view some disposals as helping to refocus the business, which is always a good way for a CEO to start tenure. We note that E.ON has little spare balance sheet capacity currently, which we believe would discourage asset purchases.

We believe assets that are least integral to E.ON's core business include the Russian assets, the US Midwest assets, the Spanish and Italian businesses and a number of small stakes elsewhere owned by Ruhrgas International (E.ON has not commented that these businesses are for sale). We view the "core" E.ON business as the German, UK and Nordic operations.

Although it is a difficult time for the European power industry, we believe that in some respects it is a good time for Dr. Teyssen to take over. Dr. Teyssen was one of the main architects of the Perform-to-Win plans that were announced in 2009 and, as COO, is in charge of driving these to completion. We therefore would expect that he will adopt a more stringent operational focus – this was hinted at when E.ON gave its Capital Markets Day in October 2009. We believe the company could achieve significant further benefits from integrating E.ON's corporate structure, reducing layers of management, cutting back on multiple systems and introducing rigorous process standardisation. To achieve this may require union agreements in some countries, but we think evidence the company is working on this would be a strong positive.

E.ON has started some impressive benchmarking in its generation business, and we believe extending this to other businesses could achieve upside. In addition, providing detailed operating metrics to measure performance by would likely help the market appreciate any improvements. For example, E.ON is targeting improvements in its Nordic nuclear load factors, and we would watch for precise, timely data on this.

Another scenario we explore as a potential benefit would be to re-integrate the E.ON Energy Trading business into the operating units. The profits of EET are unlikely to ever be viewed as "proper" profits while they are reported under EET and, given that this division basically monetizes the physical option value of the power plants and gas assets, it would be possible, in our view, to argue that the profits should be directly linked to the assets. We note that E.ON has not proposed such a move.

And finally, we would look for E.ON to maintain its renewables activities, near term. Although other companies have spun out sub-IPOs of their renewables activities, we believe it is probably a little early for E.ON to consider this. This is because E.ON, like RWE, is very focused on offshore wind and we think it would be much easier to prove the value of the business when a track record, even if a short one, for developing and operating these assets has been developed.

Operational Improvement Potential

We see potential for operational improvement over and above the current Perform-to-Win plans.

Exhibit 4 shows a very crude analysis of productivity based on group employee numbers and reported EBIT. Obviously this approach can have a number of flaws but our analysis indicates that E.ON has some room to improve productivity. For example, to increase productivity to the same level as GDF Suez, probably the most similar company in terms of business mix, we calculate that E.ON would have to cut costs by EUR 1 bn. If E.ON were to announce and deliver a range of new cost cutting programs to deliver a further EUR500m – 1bn of benefits this would increase our 2013 EPS forecasts by 6 – 13%.

Exhibit 4

EBIT per Employee Analysis Indicates Productivity Could Improve

Company	2008
EDF	0.057
Gas Natural	0.262
Centrica	0.214
EDP	0.161
Iberdrola	0.129
Enel	0.116
GDF-Suez	0.117
RWE	0.096
E.ON	0.109
Scottish & Southern	0.072

Source: Company data, Morgan Stanley Research

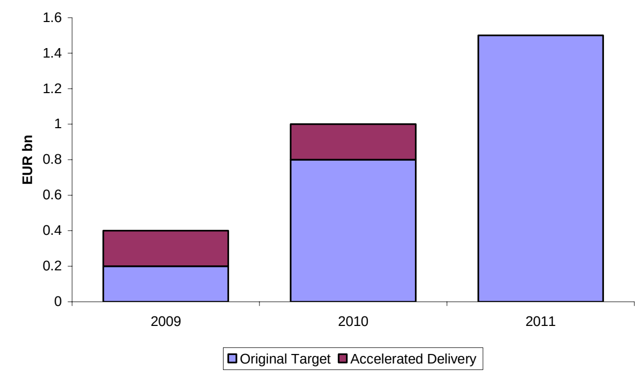
E.ON's management team has turned its focus to operational improvements, following a period of growth through organic capex and acquisitions. We would expect significant opportunities exist, union agreements notwithstanding, to slim the corporate machine. However it's worth noting that (1) the current Perform-to-Win plan already targets EUR 1.5bn of cost cutting and productivity benefits that we include in our forecasts, and (2) it is not currently an easy environment to drive out further union agreements in Germany, so the timing of further restructuring benefits is uncertain.

In addition, we expect the new CEO to outline a more rigorous operational focus and enhanced capital discipline, particularly given the slightly stretched nature of the balance sheet. We do not expect the new CEO to lay out his strategic vision and mid-term financial targets until Q3 2010 so investors may have a while to wait before this clarity emerges.

We include all of the Perform to Win benefits in our base case forecasts. E.ON has been convincing on how it will drive these savings and benefits through. In addition, other initiatives, like global information system standardization (scheduled for completion by 2012), should allow management to run the business more efficiently over time. Exhibits 5 and 6 show the evolution of the PTW targets and how these split by division.

Exhibit 5

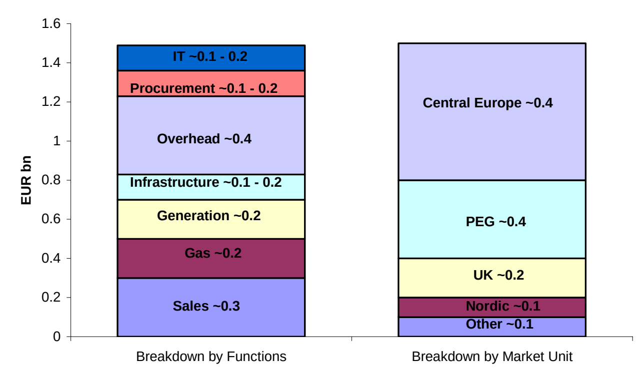
Evolution of the Perform to Win benefits – EUR1.5bn in total by 2011, already included in our forecasts



Source: Company data, Morgan Stanley Research estimates

Exhibit 6

Breakdown of Perform To Win by Activity and Division



Source: Company data, Morgan Stanley Research

E.ON will deliver lower growth than peers, on our numbers

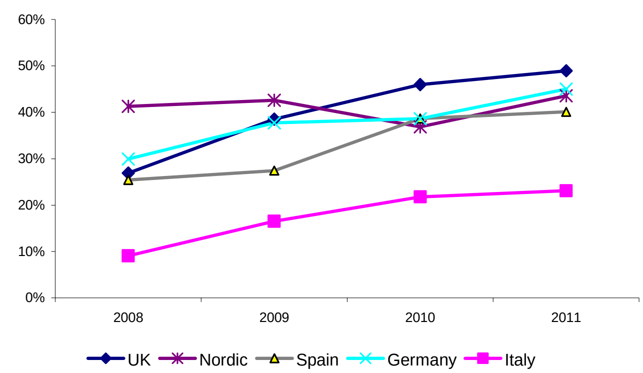
One major concern for us is that our analysis indicates E.ON simply will not deliver much growth at all, and will certainly deliver less than its main peers, partly due to the effect of disposals (8% earnings dilution in 2010). Our forecast EPS CAGR is just -0.7% (2009-2013), and we expect the short-term outlook to be muted also.

Power prices continue to trend down …

Power prices continue to trend down, and, as hedges roll off, this will put medium-term profits under pressure. In our opinion, this is due to (1) oversupply building up in the European generation markets, as shown in Exhibit 7, and (2) lower for longer gas prices.

Exhibit 7

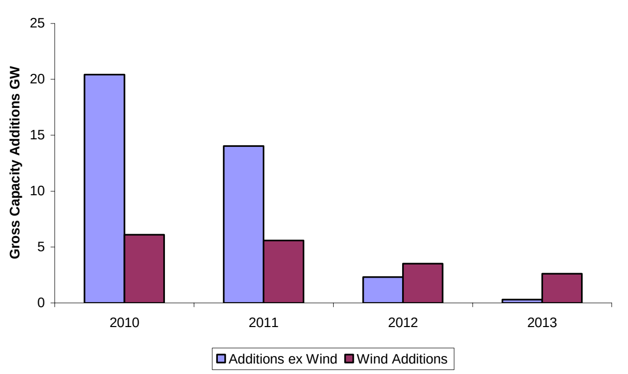
We Forecast Near-Term Increases in Reserve Margins Across Europe



Source: Company data, Morgan Stanley Research estimates

Exhibit 8

The Bulk of European Capacity Additions to 2013 are Thermal, not Renewables

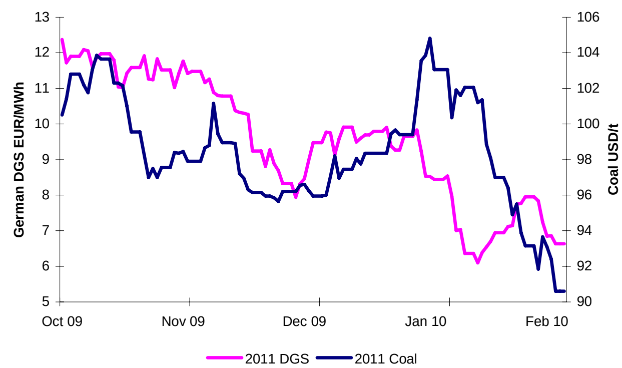


Source: Company data, Morgan Stanley Research

Exhibits 9-10 show the recent trends in power prices, fuel prices and dark green spreads. These are the key value drivers for E.ON's core generation businesses and, as these charts show, have all been trending negative for some time.

Exhibit 9

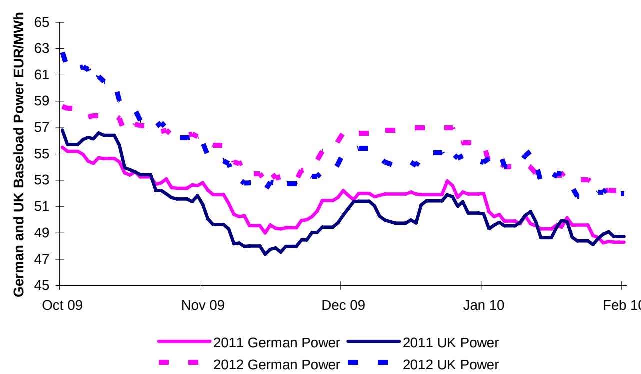
German dark green spreads down substantially



Source: Bloomberg, Morgan Stanley Research

Exhibit 10

UK and German power prices weak too



Source: Bloomberg, Morgan Stanley Research

Of course E.ON is well protected from the effect of falling power prices in the short term. As Exhibit 11 shows, it has some very large hedges for 2010-12. However, the impact does increase as each year passes.

… which will affect profits

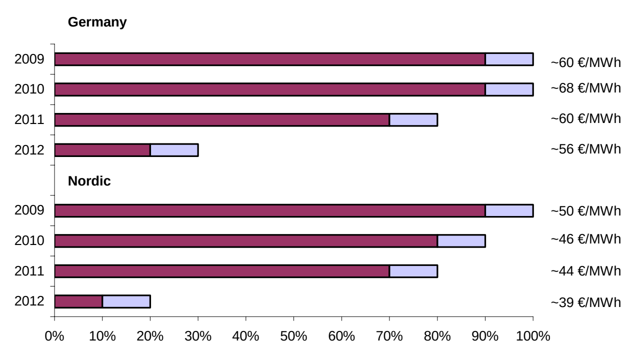
E.ON recently showed in a presentation the effect of lower wholesale power prices on its combined German and Nordic generation businesses. This showed that, taking the net effect of the large hedged positions and the much smaller

Exhibit 11
Power Hedges – E.ON is well hedged in 2010-11

	Power Sold Forward		
Company	2010	2011	2012
Drax (%)	90	60	--
Fortum (%)	70	40	--
Cez (%)	>90	>25	>4
RWE (%)	>90	>65	>30
E.ON (%)	100	80	30
Enel (%)	80	30	--
IBE (%)	50	--	--
Endesa (%)	50	--	--
EDP (%)	70	--	--
GDF SUEZ	>90	>40	--
Verbund (%)	44	--	--

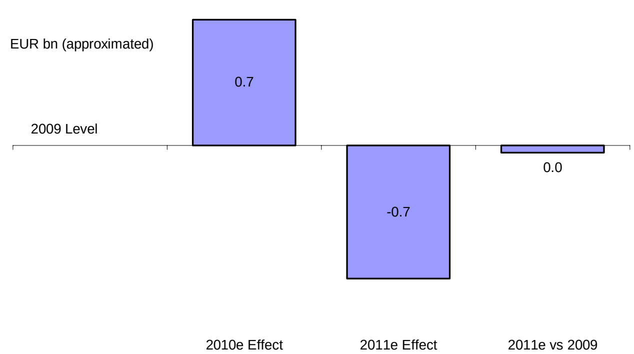
Source: Company data, Morgan Stanley Research

Exhibit 12
Hedging of E.ON's Outright Generation Provides Short-Term Protection



Source: Company data, Morgan Stanley Research

Exhibit 13
E.ON recently clarified the near term impact of power prices on German & Nordic generation profits – 2011 was expected to be flat on 2009



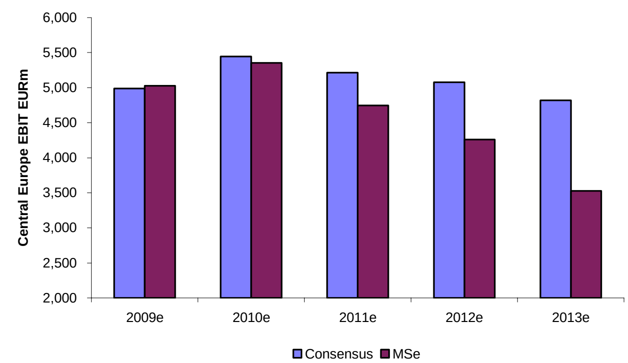
Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

open positions, E.ON expects its combined German and Nordic generation EBIT to increase by EUR 700m in 2010 vs. 2009 and then decline by slightly more than EUR 700m in 2011 vs. 2010.

This analysis is for the "outright power business" (nuclear and hydro volumes only). However, we calculate that the achieved spreads in the coal and gas generation business will be pretty flat over this period. Thus, the profit effect outlined by E.ON for the "outright power" business is likely to be the same for the entire generation unit.

It's important to note that there are some other factors that will also affect profits in the German and Nordic divisions over this timeframe – cost savings will be achieved and there will be

Exhibit 14
Our 2012-13e Central Europe Forecasts Are Below Consensus



Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

negative effects from disposals. But we have considered the net effect of these issues in our forecasts, and we believe that consensus forecasts are too high and have room to decline by approximately 5% for 2010 and 2011.

In 2012 and 2013, where power prices have also declined materially in Germany, we also see downside risk, especially as the open positions are bigger in 2012/13. Our forecasts for the core German power business are considerably below consensus for this period.

More disposals still possible

E.ON has invested heavily in acquisitions and organic investments. Its balance sheet now is slightly more leveraged than the company targets. We believe this could lead E.ON to contemplate further disposals, in line with its target of EUR 10bn of disposals, although management has not announced any such move.

E.ON currently has an "A2" credit rating from Moody's and "A" from S&P, with stable outlooks from both agencies. But the operating environment is getting tougher and E.ON has committed to EUR 10bn of disposals that are not yet complete. Given that leverage metrics remain slightly above the target of 3x, we cannot rule out that the rating agencies will want to see debt reduce a bit more.

On our forecasts, the economic net debt/EBITDA after the EUR 6bn of announced/competed disposals remains at 3.3x in 2010-11, slightly above the target of 3x. E.ON has said recently that in 2009/10 there will be "some pressure on (the) balance sheet and ratios due to (the) challenging environment in gas/power."

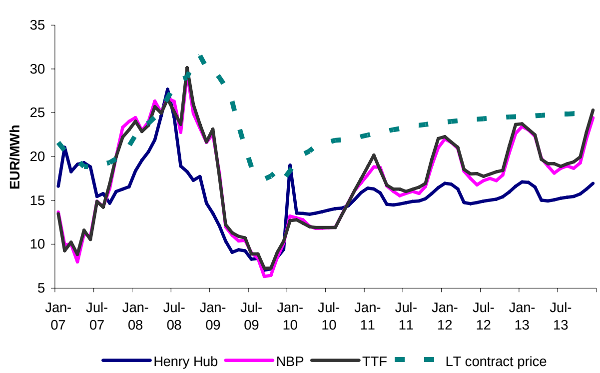
So far E.ON has sold EUR 6bn of assets from its target of EUR 10bn of disposals. It therefore appears that E.ON could push ahead with the remaining EUR 4bn of its EUR 10bn disposal plan. We believe it has a range of assets that could meet this target, but some of these would mean further EPS dilution.

Gas market remains oversupplied also

We have written extensively on the EU gas market and how this affects the midstream gas part of E.ON's Pan European Gas business. For details please see our previous report *(E.ON: Tougher Outlook on Gas and Power Becoming Clear, October 13, 2009)*. Our thesis remains unchanged. We expect the European gas market to remain heavily over-supplied for the next 2-3 years. This will depress margins in the midstream business and keep spot gas prices weak. This will also put downward pressure on power prices.

Exhibit 15

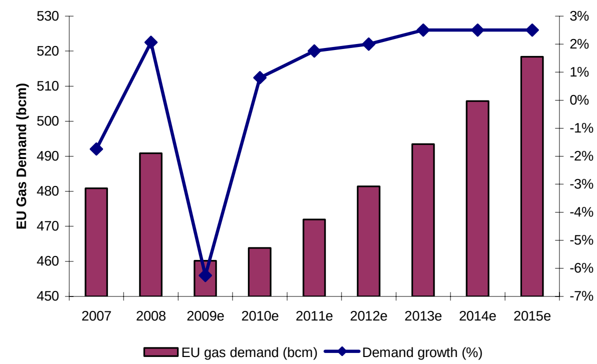
Spot vs Long Term Contract Gas Prices – Spot Prices Expected to Remain at a Discount



Source: Bloomberg, Morgan Stanley Research

Exhibit 16

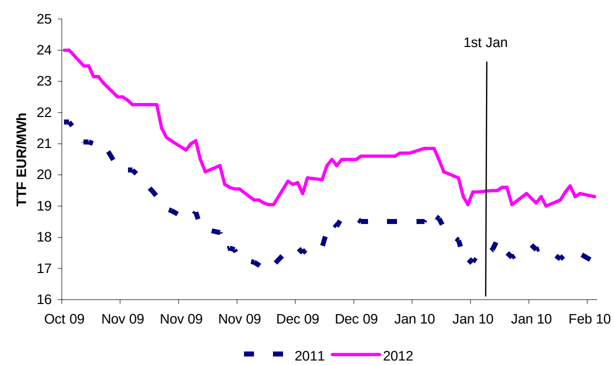
EU Gas Demand Will Recover Slowly, Leading to Continues Oversupply



Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

Exhibit 17

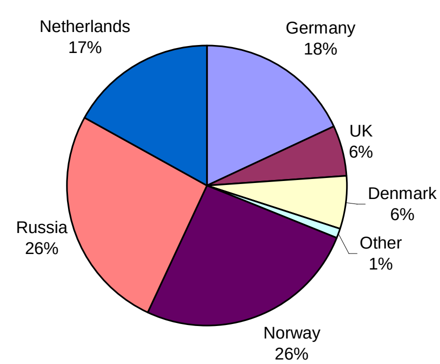
European (TTF) Gas Prices Have Declined Even With Very Cold Weather



Source: Bloomberg, Morgan Stanley Research

Exhibit 18

E.ON's Pan European Gas Procurement Portfolio (2008) – E.ON Has a Diverse Portfolio



Source: Company data, Morgan Stanley Research

Recently Gazprom, one of the biggest gas exporters into Europe, made a number of statements about its expected production and exports for 2010-12 (FactSet, 26 January). It stated that 2009 gas exports to Europe were 12.3% down year on year at 140.2 BCM. But it also said that it expects exports to be 160.8 BCM in 2010 (+15%), 163.5 BCM in 2011 (+2%) and 170.9 BCM in 2012 (+5%). E.ON is Gazprom's biggest customer in Europe.

Our understanding is that these stated volumes are the minimum take levels under the current contracts. In addition, Gazprom has said that it may be prepared to allow 5-10 BCM (3-6%) additional volumes flexibility below these minimum take volumes in 2010-11, if this can be made up in 2012.

Media sources (FSU Energy, 29 January) indicated that Gazprom was prepared to renegotiate some gas contracts materially, offering large temporary (2010-11) increases in flexibility on minimum volumes, and a bigger element of spot pricing in the indexation basket.

This seems to be in line with a statement made by E.ON recently in a presentation in NY when they said that "limited additional flexibility (is being) targeted" and that the "minimum take obligation (is) tight but manageable." E.ON also said that the contract renegotiations on approximately 80% of its contract portfolio were ongoing and "clear progress is being made on constructive, long-term relationships."

After discussion with a number of parties, including E.ON, we draw the following conclusions:

- Discussions on the gas contracts are not yet complete, but have gone well and it seems that the gas producers have been more flexible than some may have expected.
- We see a possibility that the min-take volumes will be reduced, for a short period, by as much as 10%. But in due course, Gazprom expects to materially increase the volume of gas exported to Europe.
- There is also a possibility that the indexation basket will be altered from the current basket, which is typically >95% oil indexed, to something that could be more like 80% oil price/20% spot gas price indexed.

Such a scenario, if correct, could help the gas suppliers like E.ON, and most other utilities. It could mean they would not have to pre-pay for gas that is not needed and could provide some support for spot gas prices, as it would reduce oversupply. It would probably mean that a collapse in spot prices to the same extent we saw in 2009 could be avoided. But we do not believe it would cause spot and LTC gas prices to recouple; it would simply prevent the spread getting any wider.

It's also important to consider the implication of a bigger spot gas market in Europe. We think this scenario would have the following implications:

- A bigger spot market would surely mean more liquidity. This could mean that competition increases, and that mid-stream margins would be structurally lower than in the past.
- Given the abundance of gas globally, we see it as likely that spot gas markets would price at a discount to the oil-implied LTC price.
- Spot gas would start to play a bigger role in electricity generation in Germany, which could mean that peak electricity prices in Germany would reduce, all else being equal. We would view this scenario as a negative for all large European generators, but especially for E.ON, RWE and CEZ.

Given the expected increase in Russian gas exports to Europe, as well as the commissioning of a lot of new LNG import capacity and other gas infrastructure, we expect the EU gas market to stay oversupplied in the medium term. We believe this is likely to have a number of effects for E.ON and other EU Utilities:

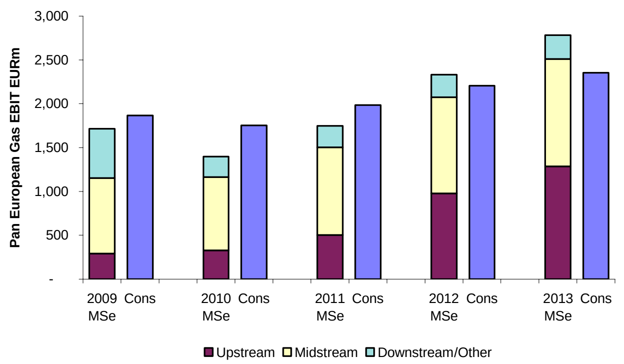
Midstream margins to stay under pressure: First, an oversupplied gas market would keep spot gas prices at a material discount to the long-term oil-linked gas contract prices. This would likely keep mid-stream wholesale gas margins under pressure, as customers would demand discounts reflective of this oil-gas spread. The two biggest mid-stream gas players are E.ON and GDF Suez. E.ON has been very open about the pressures on its gas business. It has said that low margins have effectively been locked in through customer contracts for 2009/10 and that they will not recover before 2011.

Lower gas prices drag power prices lower: In Germany we estimate that gas fired power plants now set the price in about half of the hours. Lower gas prices will therefore mean lower power prices as (1) an increasing number of power stations burn spot gas, and (2) the big oil-gas spread will mean that long-term gas contract prices will likely be negotiated down over the next few years.

We believe the market's recent focus on the possibility of a recovery in gas supply margins due to the cold weather/economic recovery/material contract renegotiations is overly optimistic. We forecast that 2009-10 will remain tough for the Pan European gas business with recovery from 2011 as (1) the gas market tightens, and (2) the E&P business profitability begins to increase materially.

Exhibit 19

MSe PEG Forecasts Less Optimistic than Consensus in Near-Term



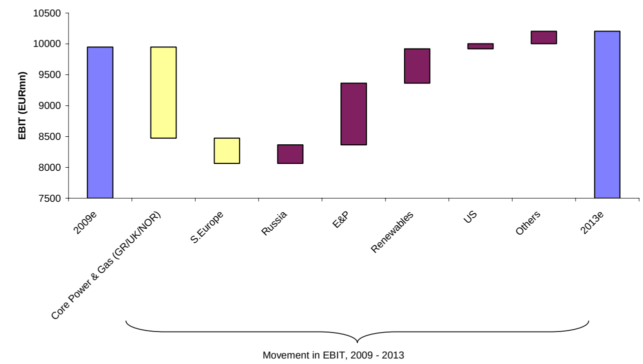
Source: Company data, Morgan Stanley Research

Growth coming from New Businesses/Regions

We found it useful to break down the E.ON P&L to understand where the growth derives from. Our analysis, shown in Exhibits 20 and 21, indicates that the "core" business (which we identify as the German, UK and Nordic power and gas businesses) is not driving any growth – quite the opposite, in fact. This is due to lower power prices and the move to Phase 3 of the EU ETS, which means utilities will have to pay for all the carbon emissions they produce.

Exhibit 20

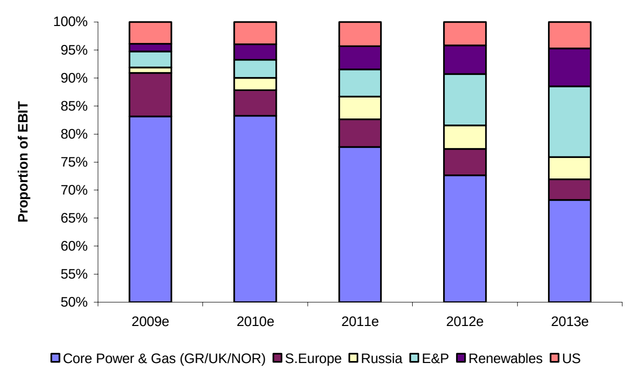
2009 – 2013 EBIT Growth Mainly Comes from E&P, Russia and Renewables



Source: Company data, Morgan Stanley Research

Exhibit 21

Changing Profit Mix – Less Profit From "Core" Generation Units – Could Justify Lower Valuation Multiples Going Forward



Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

Our analysis demonstrates that the main drivers of growth are the E&P business, the renewables business and the Russian business. In our view, these have less visibility than the old "core" business and therefore may justify a lower multiple for valuation terms for this part of the group. This is something that we think should be an important valuation consideration when investors think about what the 'right' multiple is.

Why isn't E.ON delivering better growth?

In our view, the main problem that is keeping E.ON's growth low relative to peers is because of previous investment decisions. This is for two reasons. First, the cash return on invested capital is poor in the near term, as shown in Exhibit 22. The same is true of the earnings power of these businesses.

Second, the same investment decisions meant that E.ON decided to deleverage somewhat in 2009 and sell assets. Selling decent assets has been, and likely will be, earnings dilutive.

Exhibit 22

Southern Europe and Russia ROICs Look Poor in the Near Term

	2009e	2010e	2011e	2012e	2013e
Southern Europe					
NOPAT	444	346	370	368	278
Invested Capital	12,592	13,186	13,482	13,634	13,790
ROIC (%)	3.5	2.6	2.7	2.7	2.0
Russia					
NOPAT	72	160	308	326	292
Invested Capital	4,820	5,171	5,464	5,464	5,464
ROIC (%)	1.5	3.1	5.6	6.0	5.4

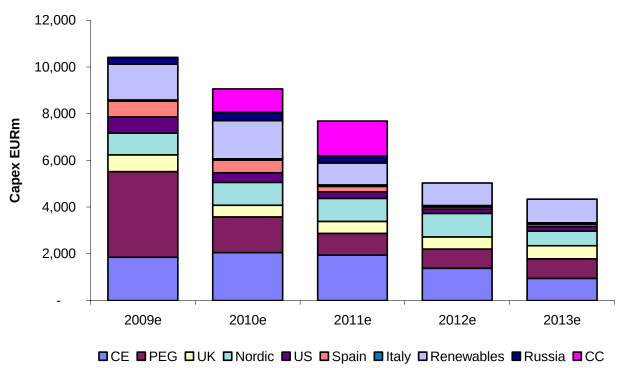
Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

Capex likely to reduce but not until 2012

Exhibit 23 shows our forecast capex for E.ON. For 2009-11, this is in line with E.ON's current plans. We think it unlikely that much, if any, of this capex will be cancelled as most projects are already underway. Post 2011, E.ON has said that it will reduce capex, and we forecast a material reduction to EUR 4.4 bn pa on average. We do not include any capex for new nuclear power plants in the UK, which could be material.

Exhibit 23

E.ON Capex: We Expect No Near-Term Cancellations, But Capex Will Decline Post 2011

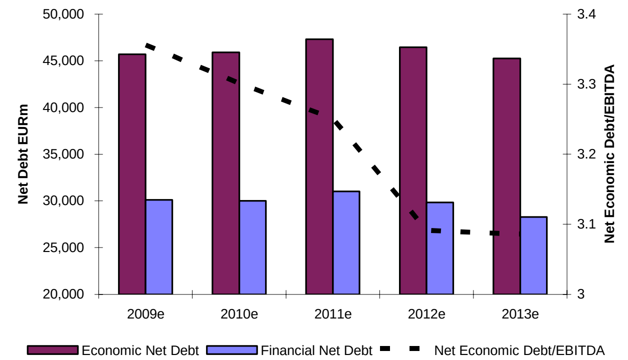


Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

Our forecasts suggest that E.ON will start to generate cash to pay down debt from 2012 onwards. This is positive as we believe that rating agencies will get tougher if power prices remain low. Exhibit 24 shows our forecasts for E.ON's net debt, and its leverage ratio.

Exhibit 24

Net Debt to EBITDA – Leverage Ratio Slightly Above Target in Short Term

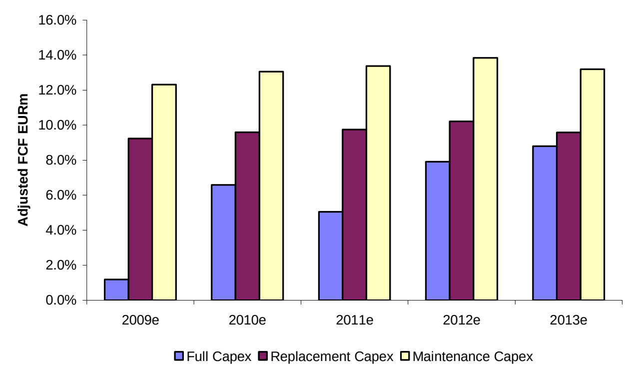


Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

We also show in Exhibit 25 the E.ON FCFe yield based on (1) maintenance capex, (2) total capex, and (3) replacement capex. It's worth stressing here that our maintenance capex assumption is a lot lower than depreciation. It is not a proper replacement capex number, which would be much higher. Rather, it is the amount that E.ON could spend for a period of time in the unlikely event that it suspends all growth/replacement capex. The FCF yield based on replacement capex – probably the best indication of sustainable FCF – is 8-9%.

Exhibit 25

FCF Yield Under Various Capex Scenarios – "Replacement Capex FCF Yield" is 8-9%



Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

Still Need Clarity on the Nuclear Life time extension discussions

The political situation in Germany, with the new coalition still finding its feet and an important state election in North Rhine Westphalia in May, is contributing to nuclear talks taking longer than expected. Although there have been many negotiations, and it seems that there is some progress, it is now very possible that there will be no clarity on this issue until a new energy plan is unveiled in October.

On 19th January German Economy Minister Rainer Bruederle said that he has a "clear idea" about extending nuclear plant lives and that a 50-50 profit share between the utilities and consumers or the government is fair. A 50/50 profit share is, we think, widely expected by the market.

A number of other comments have also been made by prominent politicians and involved parties, some of which are supportive, others less so, but overall the tone of the debate is as expected. Many of these comments may also simply be part of the lobbying/discussion process, and as we note above we think it unlikely that an agreement is finalised until much later in the year.

We believe that RWE and E.ON are similarly affected (defined as NPV of life extensions as proportion of current equity value) by the nuclear life extension debate. For E.ON, our calculations suggest it is worth €2.6 per share and for RWE €6.2 per share.

In terms of EPS, our base case assumption means that life extensions contribute 1% to E.ON EPS in 2011 and 6% from 2012-14, and 9% in 2015. For RWE, whose first station closes earlier, our base case assumption means that life extensions contribute 2% to RWE in 2010, 3% in 2011-12, 5% in 2013 and 7% in 2014-15.

Revising down mid-term forecasts

We have changed our forecasts to reflect two major changes:

We have marked all our assumptions for “open” (i.e. unhedged) commodity (power, coal, gas, carbon) positions to market at current forward prices. This means our forecasts now reflect the blended effect of the historic hedges, which are deeply in the money, and the current power prices for the open position.

We have moved out the point at which we switch to our long term power and fuel price assumptions. We used to assume that these took effect from 2013 but we now use forward curves out to 2013 and assume a smooth glide path to our long term assumptions, which are unchanged, by 2015. Given current forward power prices, our forecasts are reduced for 2013.

Exhibit 26

New vs. Old - Group

	2009e	2010e	2011e	2012e	2013e
EBIT					
New	9,949	9,861	10,236	10,558	10,019
Old	9,941	10,173	10,756	10,894	12,002
Financial Expense					
New	(2,467)	(2,464)	(2,526)	(2,553)	(2,514)
Old	(2,552)	(2,715)	(2,778)	(2,821)	(2,806)
Adjusted Net Income					
New	5,414	5,309	5,400	5,613	5,261
Old	5,344	5,337	5,571	5,644	6,439
Adjusted EPS					
New	2.84	2.79	2.83	2.95	2.76
Old	2.81	2.80	2.92	2.96	3.38
DPS					
New	1.56	1.56	1.62	1.62	1.63
Old	1.54	1.54	1.61	1.63	1.86
Capital Expenditure					
New	10,405	9,054	7,688	5,032	4,343
Old	10,452	9,016	7,664	5,008	4,342
Net Debt/(Cash)					
New	45,690	45,938	47,405	46,728	45,644
Old	45,832	45,921	47,179	46,467	44,244

Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

Exhibit 27

New vs. Old – Divisional EBIT

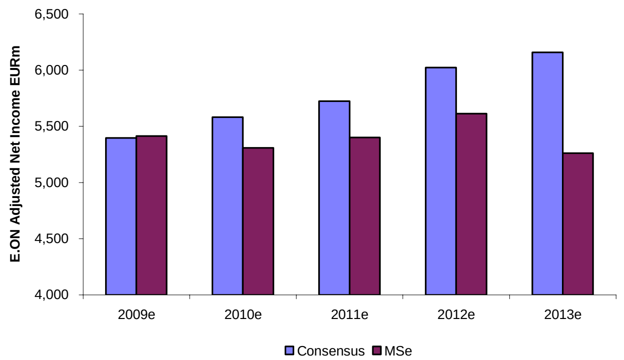
	2009e	2010e	2011e	2012e	2013e
EBIT					
Central Europe					
New	5,029	5,352	4,748	4,258	3,530
Old	5,029	5,569	5,042	4,677	4,707
Pan European Gas					
New	1,716	1,365	1,690	2,225	2,598
Old	1,673	1,532	1,950	2,234	2,883
UK					
New	476	617	620	821	823
Old	471	676	627	820	979
Nordic					
New	631	703	809	687	714
Old	697	502	578	488	914
US Midwest					
New	395	402	448	444	481
Old	387	329	392	405	465
Energy Trading					
New	875	625	625	625	400
Old	875	625	625	625	400
Spain					
New	107	50	74	67	111
Old	123	162	158	113	173
Italy					
New	684	412	434	437	269
Old	650	438	492	494	331
Renewables					
New	137	275	427	546	693
Old	138	274	426	545	703
Russia					
New	99	220	421	447	400
Old	98	187	417	443	396
Others					
New	(200)	(160)	(60)	-	-
Old	(200)	(120)	50	50	50
Total					
New	9,949	9,861	10,236	10,558	10,019
Old	9,941	10,173	10,756	10,894	12,002

Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates~

Our revised forecasts, marked to market for current power, gas, carbon and coal prices, are 15% below consensus for 2013. We expect some negative EPS momentum to continue. In the short term this, coupled with the lack of a bullish message at the FY 2009 results, could lead to some further underperformance. Thus we expect some further downside to consensus forecasts, continuing the trend we have seen through most of 2009, as shown in Exhibit 29.

Exhibit 28

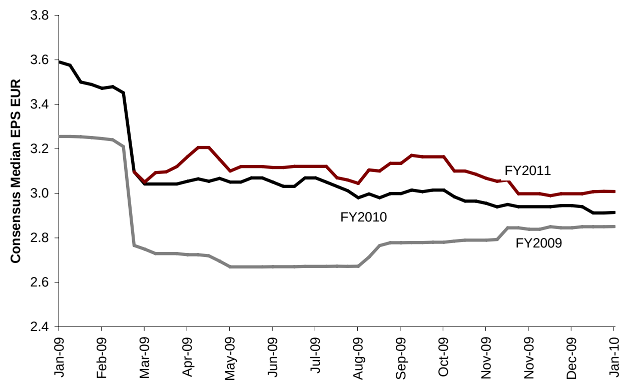
Our Forecasts for Adjusted Net Income are Below Consensus



Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

Exhibit 29

E.ON Consensus Earnings Revisions – More Revisions Expected to the Downside



Source: Company data, Morgan Stanley Research

What to expect from 2009 results?

E.ON will report FY 2009 results on 10 March. Our forecasts are shown in Exhibit 26. We expect E.ON to comfortably meet its 2009 guidance, which it has increased slightly through the year due to lower than expected financial expenses.

More important, as ever, will be the comments that the management makes regarding the outlook for 2010 and beyond. We expect E.ON to recalibrate its 2010 guidance from the existing target of EUR 11bn on a "constant perimeter" basis down to EUR 10.1bn. This solely reflects the effect of the disposals. This EUR 900m disposal effect has been well flagged in late 2009 and should come as no surprise.

More important still will be the divisional guidance, with the market keen to see the extent to which the Pan European Gas business will decline in 2010, and also how the new businesses, like Energy Trading, Spain, Italy, Renewables and Russia, are set to perform. The quality of the mix will be important.

We do not expect E.ON to give medium-term guidance for 2011 or later years until the new CEO takes charge and has conducted a review – this may mean no news on this front until late summer or early autumn. However we suspect they will be drawn into making qualitative comments on the outlook. Given the current company-specific issues and the macro outlook, we would expect management to foresee muted growth in 2011 vs. 2010.

Exhibit 30

What we expect E.ON to comment on at the results

Adjusted EBIT guidance	2010 guidance to be around EUR 10bn, or "flat" on 2009. No medium term guidance expected.
Adjusted Net Income	2010 guidance to be "flat" on 2009. No medium term guidance expected
Dividend	Payout ratio to be maintained at 50% – 60% of adjusted net income
Disposals	Comments on further EUR 4bn of disposals to reduce debt ratio

Source: Company data, Morgan Stanley Research

Valuation – Not enough upside given the low expected growth rate

Our detailed sum of the parts valuation is shown in Exhibit 35, and a summary version in exhibit 31 below. This implies a fair value of EUR 27 (down from EUR 28 mainly brought about through changing our mid-term commodity assumptions) which offers just 5% upside from the current share price. This does not compare very attractively with the average upside for E.ON's key peers (10%) or with that offered for the utility sector overall (12%). This is one reason for our Underweight rating – poor relative total return.

Exhibit 31
Summary SOTP

	EURm	EUR/share
Central Europe	34,940	18.3
Pan European Gas	19,790	10.4
UK	11,190	5.9
Nordic	9,815	5.2
US Midwest	4,082	2.1
Russia	3,635	1.9
Southern Europe	6,237	3.3
ECR (Climate & Renewables)	7,545	4.0
Energy Trading	3,750	2.0
Corporate Centre	(1,008)	(0.5)
Total Enterprise Value	**99,976**	**52.5**
Investments	2,823	1.5
Net Debt	(29,225)	(15.3)
Provisions	(18,705)	(9.8)
Minorities	(3,874)	(2.0)
Equity Value	**50,995**	**26.8**
Shares in issue (m)	1,905	

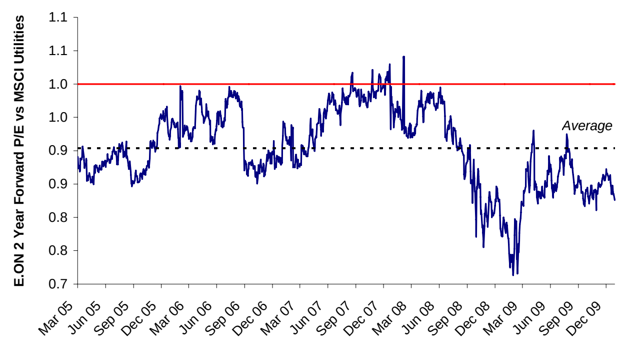
Source: Company data, Morgan Stanley Research

On most conventional valuation metrics, and when viewed in absolute terms, E.ON shares do not look overvalued with a headline 2011 PE of just 9.0x and EV/EBITDA of 7.1x.

Analysis of PE ratios flatters E.ON versus many of its peers as E.ON has greater financial leverage than most of them. This is best demonstrated by Exhibit 24, which shows (1) financial net debt, and (2) economic net debt/EBITDA. Adding leverage always flatters the PE ratio, but it's arguable whether it actually adds much value, if any. Thus, it's more accurate, in our view, to consider the EV/EBITDA ratios and the rate of EBITDA growth that can be expected from any business.

Exhibits 33-34 shows the EV/EBITDA ratios of E.ON and its key peers, and also shows these adjusted where possible for the free carbon allocations and for the short term hedges.

Exhibit 32
2 Year P/E Relative to Sector



Source: Company data, Morgan Stanley Research

Why adjust the ratios? We think it's pretty clear that, barring a huge global reversal of climate policy, there will be no free allocations of EUAs (carbon credits) post 2012 for all major European utilities bar CEZ. Thus, the earnings of these businesses are flattered by this short term, finite earnings stream from these free allocations. To adjust, we strip out the benefit of the phase two allocations from annual profits. Importantly, we also adjust the equity value of the companies being analysed, reducing this by the NPV of the remaining free allocations. This is fair as the freely allocated EUAs could be sold and thus have a clear market value.

In addition, we believe that the value from short term (2-3) year hedges of forward power sales and fuel purchases add value, but only in a short-term way. Hedging can smooth the evolution of prices, but ultimately a power generator will always receive the market price. So if power prices stay where the curves are right now, this is what would determine utilities earnings. Thus, we also adjust for the profit from, and value (NPV) of, these hedges. This is a complex adjustment, but we think it offers a useful cross-check on the true multiples that these businesses are trading on.

Exhibit 32 shows the E.ON PE relative to the European Utility Sector over the last five years. At present, the relative PE is slightly below the five-year average. However, the expected EPS growth is also much lower than it has been over the last few years, and we see downside from here to consensus. Thus, a lower relative PE is justified, in our view.

Exhibit 33

Headline sector valuation multiples – flattered by hedges and free carbon allocations

	P/E				EPS CAGR	EV/EBITDA				EBITDA CAGR	Dividend Yield			
	2010e	2011e	2012e	2013e	09-13	2010e	2011e	2012e	2013e	09-13	2010e	2011e	2012e	2013e
EON	9.2	9.0	8.7	9.3	-0.7%	7.3	7.1	7.1	7.3	1.6%	6.1%	6.3%	6.3%	6.4%
RWE	8.7	7.8	7.8	9.0	2.4%	6.4	6.0	5.9	6.2	3.9%	6.0%	6.4%	6.4%	6.7%
GSZ	13.4	11.3	10.3	9.3	10.6%	6.8	6.1	5.6	5.0	7.3%	5.7%	6.1%	6.6%	7.0%
IBE	12.6	12.4	11.6	9.9	3.8%	8.4	8.4	8.2	7.7	5.1%	4.9%	4.8%	5.2%	6.0%
ELE	11.8	11.9	12.8	12.4	-4.0%	6.4	6.7	6.9	6.7	-1.9%	4.2%	4.2%	3.9%	4.0%
GAS	10.7	11.3	11.2	9.5	3.3%	8.4	8.4	8.2	7.4	1.0%	5.6%	5.3%	5.3%	6.3%
Enel	9.0	10.4	11.6	10.6	-6.4%	6.7	6.9	7.0	6.6	-0.8%	6.6%	5.8%	5.2%	5.7%
CNA	11.3	10.3	9.6	9.2	9.0%	6.2	5.6	5.4	5.3	9.2%	5.1%	5.3%	5.6%	5.9%
SSE	10.2	9.1	8.0	8.1	7.1%	8.2	7.4	6.8	6.7	7.9%	6.5%	6.9%	7.4%	7.9%
FUM	11.7	12.8	12.7	11.4	-0.5%	8.6	9.1	8.9	8.2	1.8%	5.6%	5.6%	5.6%	5.6%
VER	17.3	14.9	13.3	12.2	2.1%	10.3	9.3	8.5	7.9	2.9%	3.6%	3.6%	3.6%	3.8%
CEZ	9.6	10.1	9.6	8.9	-1.7%	7.4	7.7	7.5	7.0	2.6%	5.4%	5.1%	5.3%	5.7%

Source: Morgan Stanley Research estimates

Exhibit 34

Revised sector valuation multiples – Adjusted for free carbon allocations and short term energy hedges

	Clean P/E				EPS CAGR	Clean EV/EBITDA				EBITDA CAGR
	2010e	2011e	2012e	2013e	10-13	2010e	2011e	2012e	2013e	10-13
EON	11.7	11.0	10.0	9.2	10.7%	8.3	7.8	7.7	7.3	5.2%
RWE	13.1	11.9	10.4	9.3	17.1%	7.8	7.5	6.9	6.3	10.0%
GSZ	16.6	12.1	10.6	9.3	22.3%	7.3	6.3	5.7	5.0	11.0%
IBE	15.0	13.0	11.7	9.9	12.4%	9.1	8.6	8.3	7.7	8.9%
ELE	16.7	13.4	13.9	12.2	11.0%	7.2	7.0	7.1	6.6	3.9%
GAS	15.2	13.0	12.3	9.4	17.2%	9.5	8.8	8.5	7.3	7.3%
ENEL	15.4	12.6	13.1	10.1	14.9%	7.9	7.0	7.1	6.6	5.5%
CNA	11.7	10.7	9.9	9.2	9.1%	6.3	5.7	5.5	5.3	7.7%
SSE	11.4	10.2	8.7	8.1	13.8%	8.9	8.1	7.2	6.7	12.6%
FUM	11.3	13.5	13.3	11.9	-1.5%	8.4	9.4	9.2	8.5	0.2%
VER	22.0	15.4	13.8	12.2	14.3%	11.8	9.5	8.6	7.9	22.4%
CEZ	17.6	14.2	12.7	10.7	21.4%	10.3	9.4	8.8	7.8	15.7%
Average	**14.9**	**12.6**	**11.7**	**10.1**	**14.0%**	**8.5**	**7.9**	**7.5**	**6.9**	**9.2%**

Source: Morgan Stanley Research estimates

Exhibit 35

E.ON: Sum of the Parts

	EURm	EUR/share	%EV	EV/EBITDA - 2009e	EV/EBITDA - 2010e
Central Europe	34,940	18.3	34.9%	5.3	5.1
Unregulated	22,927				
Regulated	12,013				
Pan European Gas	19,790	10.4	19.8%	8.7	9.9
Upstream	6,533			10.8	9.6
Mid-stream	11,401			10.2	10.5
Downstream	1,856				
UK	11,190	5.9	11.2%	12.1	10.4
Nordic	9,815	5.2	9.8%	10.1	9.2
US Midwest	4,082	2.1	4.1%	7.3	7.1
Russia	3,635	1.9	3.6%	16.2	8.6
Southern Europe	6,237	3.3	6.2%	5.9	8.2
ECR (Climate & Renewables)	7,545	4.0	7.5%	24.1	14.2
Energy Trading	3,750	2.0	3.8%	4.3	6.0
Corporate Centre (%)	(1,008)	(0.5)	-1.0		
Total Enterprise Value	**99,976**	**52.5**		**7.3**	**7.2**
Share Investments - Gazprom stake	2,823	1.5			
Net debt (09E)	(29,225)	(15.3)			
Pension provisions (@ BV)	(3,559)	(1.9)			
Nuclear provisions (@BV)	(13,396)	(7.0)			
Other asset ret. & env prov (@BV)	(1,750)	(0.9)			
Minorities (@ BV)	(3,874)	(2.0)			
Equity value	**50,995**		**27**		
Shares in issue (m)	1,905		26.1		
Equity value per share	**26.8**		**0.68**		

Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

Risks to our price target:

The biggest downside risks to our target price could be a sharp and persistent collapse in commodity prices due to either very low oil/coal prices, sustained negative economic growth or a break out of a price war in the German power market. If carbon prices were to increase sharply above our estimates, this could also put pressure on dark spreads, and our target price. Lower than expected returns on the capex plan, or a new acquisition that does not cover cost of capital could be other main risks. Lastly, punitive measures by the German government or the Federal Cartel office, either in return for nuclear life extensions or simply as a way to tax the industry, could put our target price at risk.

Key upside risks: 1) A rebound in commodity prices; 2) If disposal proceeds significantly exceed our estimates and therefore EPS dilution is lower; and 3) If cost savings and operational improvements materially exceed current targets.

Exhibit 36

E.ON: 2008–2013e Income Statement

	2008	2009e	2010e	2011e	2012e	2013e
Total Sales	**87,031**	**74,499**	**74,868**	**77,130**	**78,925**	**82,565**
Operating expenses	(73,646)	(60,884)	(60,993)	(62,639)	(64,007)	(68,081)
Total EBITDA	**13,385**	**13,615**	**13,875**	**14,491**	**14,918**	**14,484**
Total Depreciation & Amortisation	(3,507)	(3,662)	(4,011)	(4,251)	(4,357)	(4,461)
Investment income	1,001	915	584	602	620	640
EBIT						
Central Europe	4,720	5,029	5,352	4,748	4,258	3,530
Pan-European Gas	2,630	1,716	1,365	1,690	2,225	2,598
UK	922	476	617	620	821	823
Nordic	770	631	703	809	687	714
US Midwest	395	395	402	448	444	481
Energy Trading	645	875	625	625	625	400
Corporate Center/New Markets	(205)	827	797	1,296	1,497	1,474
Spain	(17)	107	50	74	67	111
Italy	-	684	412	434	437	269
Renewables	66	137	275	427	546	693
Russia	41	99	220	421	447	400
Others	(295)	(200)	(160)	(60)	-	-
Total EBIT	**9,877**	**9,949**	**9,861**	**10,236**	**10,558**	**10,019**
Financial income/(expense)	(1,835)	(2,467)	(2,464)	(2,526)	(2,553)	(2,514)
Internal operating profit	8,042	7,482	7,397	7,711	8,005	7,506
Non-operating items	(5,448)	-	-	-	-	-
Pre-tax income from continuing operations	**2,594**	**7,482**	**7,397**	**7,711**	**8,005**	**7,506**
Taxation	(863)	(1,758)	(1,849)	(2,082)	(2,161)	(2,027)
Tax Rate (%)	42	24	25	27	27	27
After Tax income	**1,731**	**5,724**	**5,547**	**5,629**	**5,844**	**5,479**
Minority interests	(338)	(310)	(239)	(229)	(231)	(218)
Net income from continuing operations	1,393	5,414	5,309	5,400	5,613	5,261
Income (loss) from discontinued operations	(128)	-	-	-	-	-
Net income incl. discontinued operations	1,265	5,414	5,309	5,400	5,613	5,261
Extraordinary Adjustment	4,332	-	-	-	-	-
Adj. Net income	**5,597**	**5,414**	**5,309**	**5,400**	**5,613**	**5,261**
No. of shares	1,865	1,905	1,905	1,905	1,905	1,905
EPS from continuing operations	0.75	2.84	2.79	2.83	2.95	2.76
EPS including discontinued operations	0.68	2.84	2.79	2.83	2.95	2.76
Adjusted EPS	**3.00**	**2.84**	**2.79**	**2.83**	**2.95**	**2.76**
Dividend per share	**1.5**	**1.6**	**1.6**	**1.6**	**1.6**	**1.6**
Payout ratio (%)	50	55	56	57	55	59
DPS growth (%)	10	4	0	4	0	1

Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

Exhibit 37

E.ON: 2008–2013e Cash Flow Statement

	2008	2009e	2010e	2011e	2012e	2013e
Net income before minorities	1,603	5,724	5,547	5,629	5,844	5,479
Depreciation and amortization	6,890	3,662	4,011	4,251	4,357	4,461
Losses (gains) from disposals	(1,407)	(961)	-	-	-	-
Other non-cash items	357	(200)	(200)	(200)	(200)	(200)
Changes in deferred taxes	(1,056)	(145)	(143)	(149)	(155)	(145)
Changes in other provisions	635	(250)	(250)	(250)	(250)	(250)
Changes in working capital	(285)	350	350	350	(350)	(350)
Operating cash flow	**6,737**	**8,507**	**9,650**	**9,974**	**9,598**	**9,356**
Capital expenditure	(8,996)	(10,405)	(9,054)	(7,688)	(5,032)	(4,343)
Central Europe	(2,965)	(1,853)	(2,051)	(1,944)	(1,387)	(947)
Pan-European Gas	(943)	(3,662)	(1,524)	(926)	(816)	(837)
UK	(1,120)	(722)	(510)	(514)	(521)	(569)
Nordic	(923)	(934)	(972)	(992)	(1,008)	(621)
US Midwest	(650)	(687)	(418)	(277)	(180)	(193)
Energy Trading	(7)	-	-	-	-	-
Spain	-	(675)	(534)	(236)	(90)	(93)
Italy	-	(59)	(59)	(61)	(62)	(64)
Renewables	-	(1,525)	(1,635)	(946)	(968)	(1,020)
Russia	-	(288)	(351)	(293)	-	-
Corporate Center/New Markets	(2,388)	-	(1,000)	(1,500)	-	-
Investments/acquisitions	(9,410)	-	-	-	-	-
Sales proceeds	432	2,875	2,885	-	-	-
Changes in LT securities	1,136	-	-	-	-	-
Other	(240)	1,800	-	-	-	-
Investing cash flow	**(17,078)**	**(5,730)**	**(6,169)**	**(7,688)**	**(5,032)**	**(4,343)**
Free cash flow	**(10,341)**	**2,776**	**3,480**	**2,286**	**4,565**	**5,013**
Payments received changes in capital	87	-	-	-	-	-
Share buybacks	(2,951)	-	-	-	-	-
Dividends to						
E.ON shareholders	(2,560)	(2,797)	(2,978)	(2,973)	(3,078)	(3,087)
Minority interests	(377)	(396)	(416)	(436)	(458)	(481)
Net movement on financial debt	17,192	600	700	1,000	(1,300)	(1,350)
Financing cash flow	**11,391**	**(2,593)**	**(2,693)**	**(2,409)**	**(4,836)**	**(4,918)**
Net cash movement	1,050	183	787	(123)	(271)	94
Non cash FX movement in Net Debt	(267)	-	-	-	-	-
Net cash (debt)	**(29,693)**	**(30,110)**	**(30,023)**	**(31,146)**	**(30,117)**	**(28,673)**

Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

Exhibit 38

E.ON: 2008–2013e Balance Sheet

	2008	2009e	2010e	2011e	2012e	2013e
Depreciable fixed assets	56,526	58,594	60,753	64,190	64,865	64,747
Intangible assets	6,749	6,749	6,749	6,749	6,749	6,749
Goodwill	17,166	17,166	17,166	17,166	17,166	17,166
Companies under equity method	8,981	8,981	8,981	8,981	8,981	8,981
Other financial assets	8,823	8,823	8,823	8,823	8,823	8,823
Financial receivables and other financial assets	2,451	2,451	2,451	2,451	2,451	2,451
Long-term securities	7,468	7,468	7,468	7,468	7,468	7,468
Fixed assets	**100,696**	**102,764**	**104,923**	**108,360**	**109,035**	**108,917**
Other long term assets	5,740	5,740	5,740	5,740	5,740	5,740
Inventories	4,774	4,424	4,074	3,724	4,074	4,424
Financial receivables	2,101	2,101	2,101	2,101	2,101	2,101
Operating receivables	32,857	33,002	33,145	33,295	33,450	33,595
Businesses held for sale	4,529	4,529	4,529	4,529	4,529	4,529
Securities	2,125	2,125	2,125	2,125	2,125	2,125
Restricted Cash	552	552	552	552	552	552
Cash	3,671	3,854	4,641	4,518	4,247	4,341
Liquid funds	6,348	6,531	7,318	7,195	6,924	7,018
Current assets	**50,609**	**50,587**	**51,168**	**50,844**	**51,078**	**51,668**
Total assets	**157,045**	**159,092**	**161,831**	**164,944**	**165,853**	**166,324**
Financial liabilities - external	24,993	25,593	26,293	27,293	25,993	24,643
Financial liabilities - intra group	43	43	43	43	43	43
Operating liabilities	6,063	6,063	6,063	6,063	6,063	6,063
Pension provisions and similar obligations	3,559	3,559	3,559	3,559	3,559	3,559
Nuclear Provisions	13,069	13,396	13,731	14,074	14,426	14,786
Other asset retirement	1,193	1,193	1,193	1,193	1,193	1,193
Miscellaneous provisions	4,936	4,686	4,436	4,186	3,936	3,686
Other	9,117	8,917	8,717	8,517	8,317	8,117
Non current liabilities	**62,973**	**63,450**	**64,035**	**64,928**	**63,530**	**62,090**
Financial liabilities - external	14,102	14,102	14,102	14,102	14,102	14,102
Financial liabilities - intra group	1,920	1,920	1,920	1,920	1,920	1,920
Trade Payables and other operating liabilities	32,060	32,060	32,060	32,060	32,060	32,060
Nuclear Provisions	288	288	288	288	288	288
Other asset retirement obligations	290	290	290	290	290	290
Miscellaneous provisions	3,682	3,682	3,682	3,682	3,682	3,682
Other	3,303	3,303	3,303	3,303	3,303	3,303
Current liabilities	**55,645**	**55,645**	**55,645**	**55,645**	**55,645**	**55,645**
Shareholder's equity	34,467	36,123	38,454	40,881	43,416	45,590
Minority interests	3,960	3,874	3,698	3,490	3,262	2,999
Shareholder's equity	**38,427**	**39,997**	**42,151**	**44,371**	**46,678**	**48,589**
Total liabilities and equity	**157,045**	**159,092**	**161,831**	**164,944**	**165,853**	**166,324**

Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

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(as of January 31, 2010)

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Overweight/Buy	**999**	**40%**	**296**	**41%**	**30%**
Equal-weight/Hold	**1088**	**43%**	**333**	**46%**	**31%**
Not-Rated/Hold	**21**	**1%**	**4**	**1%**	**19%**
Underweight/Sell	**396**	**16%**	**90**	**12%**	**23%**
Total	**2,504**		**723**		

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Industry Coverage:Utilities

Company (Ticker)	Rating (as of)	Price* (02/08/2010)
Nicholas J Ashworth, CFA		
Drax (DRX.L)	E (10/13/2009)	408p
Pennon Group (PNN.L)	U (01/22/2010)	514p
United Utilities (UU.L)	E (01/22/2010)	530p
Antonella Bianchessi		
A2A SpA (A2.MI)	O (10/13/2009)	€1.27
ACEA (ACE.MI)	O (01/27/2010)	€7.5
EDP (EDP.LS)	E (11/28/2008)	€2.7
ENEL (ENEI.MI)	U (10/14/2008)	€3.77
Edison (EDN.MI)	E (10/13/2009)	€1.01
Enagas (ENAG.MC)	E (08/13/2009)	€15.1
Endesa (ELE.MC)	E (07/10/2009)	€21.13
Gas Natural (GAS.MC)	U (05/07/2009)	€13.32
IRIDE S.p.A. (IRD.MI)	++	€1.3
Iberdrola (IBE.MC)	E (10/13/2009)	€5.85
PPC (DEHr.AT)	E (03/26/2009)	€10.9
Red Electrica (REE.MC)	E (08/13/2009)	€34.55
Snam Rete Gas (SRG.MI)	O (08/13/2009)	€3.4
Terna (TRN.MI)	NA (04/23/2009)	€2.88
Bobby Chada		
Centrica (CNA.L)	E (10/13/2009)	267p
E.ON (EONGn.DE)	U (02/09/2010)	€25.95
International Power (IPR.L)	E (10/13/2009)	321p
National Grid plc (NG.L)	O (10/13/2009)	629p
Northumbrian Water Group (NWG.L)	U (01/22/2010)	279p
RWE AG (RWEG.DE)	E (10/13/2009)	€63.58
Scottish & Southern (SSE.L)	O (06/05/2008)	1,165p
Severn Trent (SVT.L)	O (01/22/2010)	1,127p
Igor Kuzmin		
CEZ (CEZP.PR)	E (05/28/2009)	CZK867
Federal Grid Co of Unified Energy System (FEES.RTS)	U (12/17/2009)	US$.01
RusHydro (HYDR.RTS)	E (12/15/2008)	US$.04
Sean Lee, CFA		
Fortum (FUM1V.HE)	U (05/28/2009)	€18.07
Verbund (VERB.VI)	U (11/26/2009)	€29.1
Emmanuel Turpin		
EDF (EDF.PA)	O (10/13/2009)	€37.9
GDF SUEZ (GSZ.PA)	O (10/13/2009)	€26.48
Suez Environnement (SEVI.PA)	O (08/28/2009)	€15.81
Veolia Environnement (VIE.PA)	++	€23.23

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* Historical prices are not split adjusted.