RWE

Price Objective Change UNDERPERFORM

Equity | Germany | Electric Utilities
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Has it ever been this bad?

Peter Bisztyga >> +44 20 7995 0535
Research Analyst
MLI (UK)
peter.bisztyga@baml.com

Paul Rogers +44 20 7996 4142
Specialist Sales
MLI (UK)
paul2.rogers@baml.com

1. EPS expectations up to 30% too high

We have cut our EPS forecasts to up to 30% below consensus. This reflects: (1) RWE's admission that the future tax rate will be materially higher than previously expected; (2) our increasingly pessimistic view on prospects for German power price recovery; and (3) our belief that consensus underestimates the negative mark-to-market in generation. We now expect EPS to trough in 2018E, 34% below 2014.

2. Political risks are real

Our recent investor trip to Berlin provided us with significant insight into the current status of political discussions. We came away with the view that the proposed carbon levy will be implemented (though may be watered down). We think this will cause RWE to shut 4GW of capacity and two lignite mines. This could hit EPS by up to ~10% and increase mining provisions by >€1bn. Furthermore, we believe there is genuine appetite to require companies to fund their nuclear waste provisions. This could trigger a €5.5bn funding obligation for RWE.

3. Potential downgrade to 'junk' and a 50% dividend cut

We forecast RWE's FFO/ND will drop to ~15% in 2015-16E, compared to S&P's threshold of >20% for BBB+. In the event that nuclear provisions have to be funded and that lignite mines need to be closed, this could drop to ~12%. We believe this would trigger a sub-investment grade credit rating. We believe the prudent option for RWE is to cut its dividend by 50% to €0.50, and we reflect this in our forecasts.

4. Risks still not discounted in valuation

We estimate RWE's sustainable FCF yield is just 5.5%, while 2018E P/E is 16.1x. Our revised €19.1 PO implies ~15% further downside risk, and we highlight our DDM valuation of just €14.3 (~40% downside). We recognise that there are material binary upside risks (e.g., nuclear tax case), but in our view these are unpredictable, while the weak fundamentals are real and insufficiently discounted in valuation.

Stock Data

Price (Common / ADR)	EUR22.23 / US$25.27
Price Objective	EUR19.10 / US$21.68
Date Established	13-May-2015 / 13-May-2015
Investment Opinion	B-3-8 / B-3-8
Volatility Risk	MEDIUM / MEDIUM
52-Week Range	EUR21.66-EUR32.98
Market Value (mn)	EUR13,666
Shares Outstanding (mn)	614.7 / 614.7
Average Daily Volume	3,906,326
BofAML Ticker / Exchange	RWNFF / GER
BofAML Ticker / Exchange	RWEOY / OTU
Bloomberg / Reuters	RWE GR / RWEG.DE
ROE (2015E)	11.3%
Net Dbt to Eqty (Dec-2014A)	88.1%
Est. 5-Yr EPS / DPS Growth	-8.5% / -12.9%
Free Float	84.5%

Key Changes

(EUR)	Previous	Current
Price Obj.	20.10	19.10
2015E EPS	1.70	1.82
2016E EPS	1.39	1.19
2017E EPS	1.84	1.59
2015E DPS	0.80	0.50

Estimates (Dec)

(EUR)	2013A	2014A	2015E	2016E	2017E
EPS (Adjusted Diluted)	2.14	2.61	1.82	1.19	1.59
EPS Change (YoY)	-46.4%	21.6%	-30.1%	-34.6%	33.6%
Dividend / Share	1.00	1.00	0.50	0.50	0.50
ADR EPS (Adjusted Diluted - US$)	2.85	3.46	2.07	1.35	1.81
ADR Dividend / Share (US$)	1.33	1.33	0.57	0.57	0.57

Valuation (Dec)

	2013A	2014A	2015E	2016E	2017E
P/E	10.4x	8.52x	12.2x	18.6x	13.9x
Dividend Yield	4.50%	4.50%	2.25%	2.25%	2.25%
EV / EBITDA*	5.30x	5.88x	6.74x	7.39x	6.92x
Free Cash Flow Yield*	6.99%	16.9%	-2.66%	14.3%	13.3%

* For full definitions of *iQmethod* SM measures, see page 15.

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Refer to important disclosures on page 16 to 19. Analyst Certification on Page 14. Price Objective Basis/Risk on page 14.

iQprofile SM RWE

Key Income Statement Data (Dec)	2013A	2014A	2015E	2016E	2017E
(EUR Millions)					
Sales	52,425	48,468	47,221	46,383	45,900
EBITDA Adjusted	7,903	7,132	6,220	5,670	6,054
Depreciation & Amortization	(2,534)	(3,115)	(2,512)	(2,503)	(2,509)
EBIT Adjusted	5,369	4,017	3,708	3,167	3,545
Net Interest & Other Income	(1,905)	(1,848)	(1,439)	(1,528)	(1,510)
Tax Expense / Benefit	(2,144)	(577)	(749)	(520)	(654)
Net Income (Adjusted)	1,318	1,603	1,120	733	979
Average Fully Diluted Shares Outstanding	614	614	614	614	614
Key Cash Flow Statement Data					
Net Income (Reported)	1,422	1,711	1,232	845	1,091
Depreciation & Amortization	2,534	3,115	2,512	2,503	2,509
Change in Working Capital	(1,331)	1,860	(1,625)	175	(200)
Deferred Taxation Charge	121	45.0	0	0	0
Other CFO	2,057	(1,175)	450	575	549
Cash Flow from Operations	4,803	5,556	2,569	4,099	3,949
Capital Expenditure	(3,848)	(3,245)	(2,933)	(2,143)	(2,136)
(Acquisition) / Disposal of Investments	NA	NA	NA	NA	NA
Other CFI	2,149	(949)	4,700	1,685	0
Cash Flow from Investing	(1,699)	(4,194)	1,767	(458)	(2,136)
Share Issue / (Repurchase)	163	122	0	0	0
Cost of Dividends Paid	(1,611)	(1,061)	(1,062)	(712)	(730)
Increase (decrease) debt	(1,226)	913	(1,978)	(832)	(100)
Other CFF	817	(2,112)	781	0	0
Cash Flow from Financing	(1,857)	(2,138)	(2,258)	(1,544)	(830)
Total Cash Flow (CFO + CFI + CFF)	1,247	(776)	2,078	2,096	983
FX and other changes to cash	(490)	2,455	0	0	0
Change in Cash	757	1,679	2,078	2,096	983
Change in Net Debt	(1,983)	(766)	(4,055)	(2,928)	(1,083)
Net Debt	11,137	10,371	6,316	3,387	2,305
Key Balance Sheet Data					
Property, Plant & Equipment	34,313	31,142	31,103	29,058	28,685
Goodwill	NA	NA	NA	NA	NA
Other Intangibles	13,409	12,797	12,797	12,797	12,797
Other Non-Current Assets	7,578	7,819	7,852	7,912	7,965
Trade Receivables	7,964	6,512	7,512	7,712	7,912
Cash & Equivalents	8,368	10,047	12,125	14,221	15,204
Other Current Assets	9,749	17,999	13,459	13,459	13,459
Total Assets	81,381	86,316	84,847	85,158	86,022
Long-Term Debt	17,356	17,076	15,098	14,266	14,166
Other Non-Current Liabilities	30,027	29,248	31,768	32,370	32,988
Short-Term Debt	2,149	3,342	3,342	3,342	3,342
Other Current Liabilities	19,712	24,878	22,990	22,831	22,214
Total Liabilities	69,244	74,544	73,199	72,810	72,710
Total Equity	12,137	11,772	11,648	12,348	13,311
Total Equity & Liabilities	81,381	86,316	84,847	85,158	86,022
Business Performance*					
Return On Capital Employed	4.37%	5.05%	4.18%	3.68%	4.03%
Return On Equity	10.4%	15.6%	11.3%	7.43%	9.40%
Operating Margin	10.2%	8.29%	7.85%	6.83%	7.72%
Free Cash Flow (MM)	955	2,311	(364)	1,955	1,813
Quality of Earnings*					
Cash Realization Ratio	3.64x	3.47x	2.29x	5.59x	4.03x
Asset Replacement Ratio	1.52x	1.04x	1.17x	0.86x	0.85x
Tax Rate	61.9%	26.6%	33.0%	31.7%	32.1%
Net Debt/Equity	91.8%	88.1%	54.2%	27.4%	17.3%
Interest Cover	4.87x	3.72x	4.03x	3.59x	4.10x

* For full definitions of *iQmethod* SM measures, see page 15.

Company Description

RWE is an integrated power and gas utility with major presence in Central Europe and the UK. It is also active in renewable power generation.

Investment Thesis

RWE earnings are under significant pressure in the current commodity and power price environment. We think a dividend cut is now inevitable, and we are becoming concerned again about RWE's balance sheet. We see little prospect of earnings recovery before 2018.

Stock Data

Shares / ADR	1.00
Price to Book Value	1.4x

Key Changes (ADR)

(US$)	Previous	Current
Price Obj.	23.29	21.68
2015E EPS	1.93	2.07
2016E EPS	1.58	1.35
2017E EPS	2.08	1.81
2015E DPS	0.91	0.57

Negative EPS momentum gathers pace

We cut EPS to ~30% below consensus

There seems to be no end to the earnings pressures that RWE is facing. Indeed, RWE's 1Q15 conference call contained three incremental negatives: (1) an implicit profit warning on the tax rate (we estimate ~10% negative EPS hit from 2016); (2) 2015 net debt guidance is ~€2bn higher than consensus (due mainly to higher pension provisions); and (3) an admission that early lignite mine closure could cost RWE in excess of €1bn. We once again find ourselves having to significantly downgrade our medium-term EPS forecasts:

- We cut 2016-17E EPS by ~14% on average and 2018E by 34%; and while we have lifted 2015E EPS, our revised 2015E forecast is at the bottom end of RWE's guidance range of ~€1.80-2.10 (despite RWE beating market expectations in 1Q15).

Table 1: EPS Forecasts (€)

	2015E	2016E	2017E	2018E
EPS - BAML New	1.82	1.19	1.59	1.38
EPS - BAML Old	1.70	1.39	1.84	2.08
Change	*7.0%*	*-14.1%*	*-13.2%*	*-33.7%*
EPS - RWE Adjusted Consensus (ave.)	1.91	1.60	1.85	-
EPS - Bloomberg Consensus (ave. post-event)	1.95	1.73	1.88	2.04
BAML EPS vs. Bloomberg Consensus	*-6.5%*	*-30.9%*	*-15.1%*	*-32.4%*

Source: Company data, BofA Merrill Lynch Global Research estimates, Bloomberg. RWE consensus as at 28 April 2015.

- As a result of these changes we are ~30% below consensus for 2016E and 2018E. The main reasons we are below consensus are the revised tax rate assumption and our mark-to-market achieved price assumptions. For example, we assume €33.3/MWh in 2017E vs. consensus (RWE) of €35.7/MWh, a difference worth ~€240m (for reference, the current 2017 German baseload forward price is just €31.9/MWh). Specifically regarding 2016E, we forecast that RWE's lignite earnings could be affected by the sharp decline in lignite spreads caused by the rally in CO_2 prices: we estimate the 2016E lignite spread has dropped by ~€4/MWh since 4Q14 compared to a drop in baseload power of €2/MWh. However, we acknowledge there is upside risk to our forecast if RWE can use its opaque financial CO_2 hedges to offset this.

- Our forecasts imply that RWE's Recurrent EPS will decline by 34% 2014-18E. We now expect 2018E will be the trough in EPS, since the introduction of the UK capacity market provides some relief in 2019 (we forecast 2019E EPS €1.68, +21% y/y) but there is no guarantee that the level of income will be sustainable in subsequent years.

The main driver behind the decline in our 2015-18E EPS forecasts is an expected €670m decline in Operating Result. The drivers for this are summarized in Table 2.

Table 2: Drivers of y/y Operating Result (€m)

	2015E	2016E	2017E	2018E	Total Δ 15-18E
Generation - Outright Power	(677)	(583)	(251)	(352)	(1,862)
Generation - Lignite Spread	29	(95)	(54)	(35)	(156)
Generation - Spark/Dark Spreads	(64)	20	(59)	158	55
Generation - Nuclear Tax			350	0	350
Generation - Depreciation/Impairment	500	53	10	(9)	554
Generation - Disposals		(28)	(28)	0	(57)
Renewables - New Offshore Wind	87	34			121
CEE - Repricing of LTCs	(30)				(30)
Weather	150				150
Cost Savings - Announced	100	100	400		600
One-Off Reversal - Renewables	42				42
One-Off Reversal - Germany	(73)				(73)
One-Off Reversal - Generation	(350)				(350)
Supply - Margin Pressure UK/Neth	(42)	(26)	(56)	(6)	(131)
Distribution - Photo Year Effect	(10)	(40)	50	0	0
Other	30	25	16	45	116
Total	(309)	(540)	378	(200)	(671)

Source: BofA Merrill Lynch Global Research estimates

The two most significant drivers behind our EPS downgrades are as follows:

Surprise increase in long-term tax rate

Tax effects drive a ~10% downgrade to our EPS forecasts

RWE disclosed at 1Q15 results that it now expects a tax rate above 30% from 2015 onwards (previous guidance had been for a tax rate of below 30%). As a result, we have increased our tax rate forecast for 2015E+ to 32-33% compared to 28-29% before. Furthermore, RWE has lost the tax shield on its hybrid coupons. Together, these tax effects drive a ~10% downgrade to our forecasts. The reason behind this sharp increase in tax is as follows: RWE had created a tax group in Germany, which allowed RWE to use losses from one company in the tax group to reduce taxable profits of another; unfortunately the tax group is no longer generating income, so RWE can no longer benefit from the netting of losses against profits. We do not foresee any circumstances that are likely to improve this situation in the foreseeable future. We are also concerned that RWE was unaware of this significant change in its internal tax position when it published its annual report only two months ago.

Lower long-term power price outlook has deteriorated

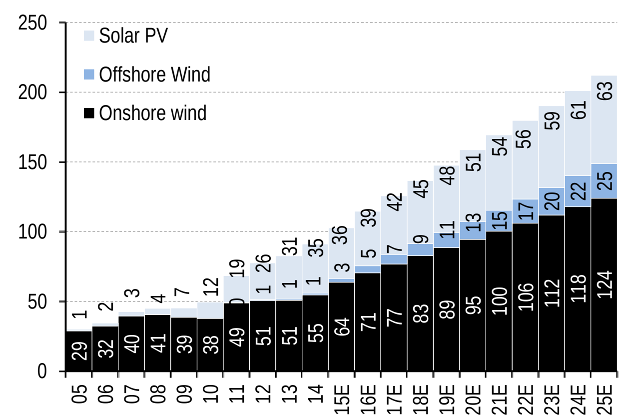
We abandon our expectations of medium-term German power price recovery

The dramatic cut in our 2018E EPS forecast reflects our decision to mark-to-market against the current forward power price of €31.9/MWh. We had previously assumed that German forward prices would recover to ~€36/MWh on the back of our expectation that Germany would see an extra 8-10GW of capacity closures. However, we are now much less confident that this will happen for several reasons:

- As we discuss below, we estimate only ~4GW of (mainly lignite) capacity needs to close to deliver Germany's target of 22mt of incremental CO2 emissions cuts from generation by 2020. We are sceptical of RWE's claims that significant further closures will be triggered by the proposed carbon tax.
- There is no evidence that hard coal plant closures will accelerate. Notably, Steag recently stated that it intends to keep its 7.4GW hard coal fleet in Germany for the time being. Meanwhile, RWE and E.On themselves have hardly any additional coal plant left to close.

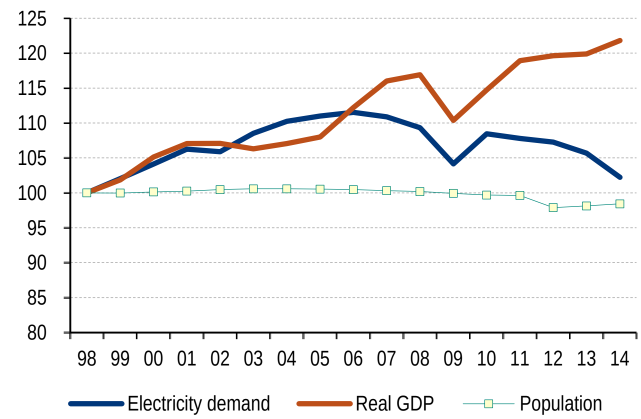
- Although solar PV growth has slowed to <2GW pa, there has been a sharp increase in wind capacity additions. Germany added 5.8GW of onshore and offshore wind in 2014, and we forecast an additional 16GW to be added 2015-18E. Overall, this means output from renewables could displace another ~50TWh of conventional generation output over the next 4-5 years.
- The overall trend in power demand has been weaker than we anticipated, with demand falling despite a recovery in real GDP over the last four years. It seems a shrinking population and energy efficiency are to blame.

Chart 1: German electricity generation from wind and solar (TWh)



Source: BofA Merrill Lynch Global Research approximations using data from BDEW, ENTSOE & BSW

Chart 2: German electricity demand trend



Source: Eurostat, BDEW, BofA Merrill Lynch Economics team, BofA Merrill Lynch Global Research

Political risk is growing

We recently hosted an investor trip to Berlin, where we gained valuable insight into the current status quo of policy discussions around a number of issues facing the German utilities. In our view RWE faces three key areas of incremental political risk:

"Climate Contribution" carbon levy

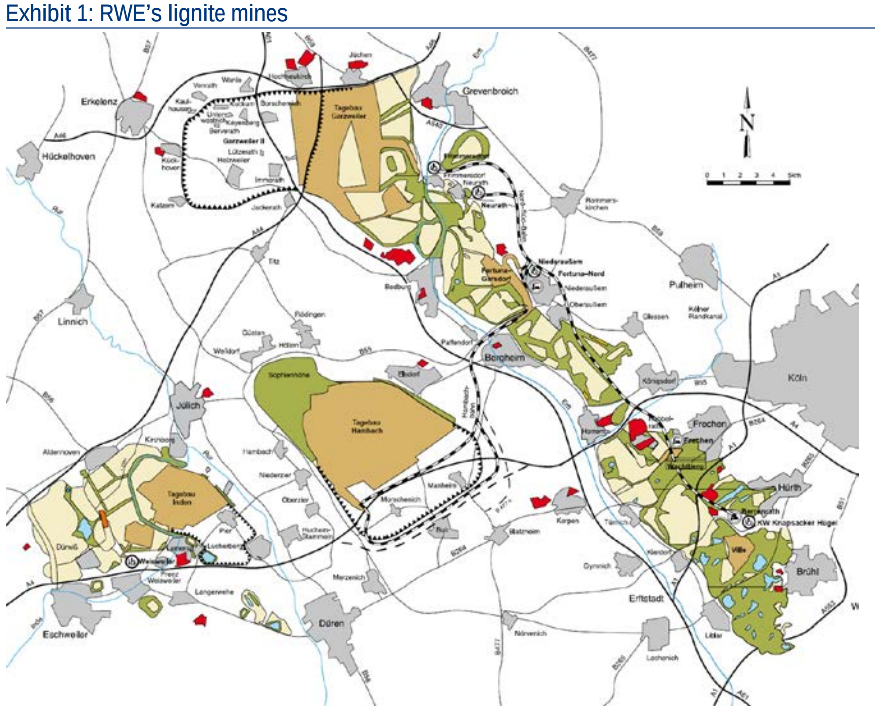
Lignite plant closure could further negatively impact EPS by ~10%

In Berlin, we heard that Angela Merkel wants to go to the UN Climate Change Conference in Paris this December with a clear message that Germany is on track to meet its target of 40% CO_2 reduction by 2020. Power generation is to contribute an extra 22mt cut in emissions and we saw no appetite to reallocate this to other sectors (e.g., housing or transport), since these are already shouldering their share of the burden. However, the Ministry of Economics and Energy (BMWi) has listened to objections to its Climate Contribution proposal (see Goodbye lignite?, 23 March 2015 for more details) and appears willing to adjust it if necessary, but is yet to receive any convincing evidence to support these objections, nor any credible alternative proposal. Indeed, RWE admitted on its 1Q15 conference call that it had not put forward an alternative plan, despite its protestations. So, we are left with the view that the Climate Contribution proposal will be implemented, but it could be watered down to ensure no more than 22mt of carbon emissions are delivered by 2020, for example by linking the carbon levy amount to the level of power prices.

We estimate that, to hit a 22mt reduction, would require ~4GW of closures of old lignite plant. We believe RWE could achieve this by closing its 1.8GW Weisweiler plant and associated Inden mine, and, for example, its 2.1GW Neurath plant and either its Garzweiler mine (lower quality lignite, but located by most of the plants) or its Hambach mine (higher quality lignite, but requires rail transport). The one remaining mine could then serve its remaining 5.7GW of capacity (of which 3GW would not be affected by the carbon levy as it stands, while the remainder could reduce output to peak times).

A simple calculation of the impact of lignite closure on RWE would be as follows: the closure of 4GW of plant producing 29TWh of output at a gross margin of €4.1/MWh would entail ~€120m of lost EBIT or ~10% of 2018E+ EPS. This impact could be further reduced by foregone opex at the closed plants, although there is likely to be some offsetting increase in average cost of lignite extraction. As a result, the exact impact on RWE's EPS is difficult to quantify at this stage. In addition, RWE itself has suggested that bringing forward mine closures could increase its mining reclamation provisions by over €1bn.

Exhibit 1: RWE's lignite mines



Source: DEBRIV.

RWE could be required to fund ~€5.5bn of nuclear waste provisions

Funding of nuclear provisions

We also learned in Berlin that the German government is seriously considering whether to establish either an internal or external nuclear fund. These discussions are at a relatively early stage and the government has not made any concrete decisions. Our view is that there is a reasonable likelihood that the nuclear operators will be required to fund at least the portion of their nuclear provisions that relate to nuclear waste (as opposed to dismantling), albeit this would likely be over a period of a few years. RWE currently has ~€5.5bn of unfunded nuclear waste provisions. There is also a risk that provisions could be revalued as part of this exercise, although we do not think this is necessarily in the politicians' interests at this stage.

Table 3: RWE's nuclear provisions (€m)

	2014	2013
Decommissioning of nuclear facilities	4,830	4,847
Disposal of nuclear fuel assemblies	4,661	4,760
Disposal of radioactive operational waste	876	803
Total	10,367	10,410

Source: Company data.

Electricity market reform

Little hope of capacity payments in Germany

It is clear from recent commentary from the BMWi that Germany does not intend to introduce a capacity market and will instead put through some reforms to the existing power market (to ensure better price signals) and perhaps supplement it with a strategic reserve. Therefore, any lingering hopes that RWE could benefit from capacity payments are likely to be dashed when the government publishes its White Book in June/July. In addition, we think it is unlikely that many of RWE's plants would qualify for the strategic reserve and any associated revenues since its assets are mainly located in the oversupplied north of the country.

We forecast a 50% dividend cut

We believe RWE needs to cut its dividend by 50%

RWE finally abandoned its 3.0x ND/EBITDA target earlier this year, and committed just to *"keeping solid investment grade rating"*. Our financial forecasts and sensitivity analysis suggest to us that RWE is almost certain to lose its BBB+ credit rating[1], and could even risk losing its investment grade credit rating. While RWE's CFO has indicated that he would not defend RWE's credit rating at any cost, it seems to us that RWE needs to make some significant changes if it wants to create the flexibility to invest in longer-term growth and ensure some recovery in credit metrics over the next few years.

The phrasing of RWE's current dividend policy suggests that the dividend could be sacrificed in order to achieve this. It states that the 2015 dividend will be *"orientated towards growth opportunities, indebtedness and earnings situation".* RWE existing €1.00 DPS costs RWE ~€0.6bn per annum. In order to make a meaningful impact on the medium-term trajectory of the balance sheet and cash flow, we believe RWE needs to cut its dividend by 50% to €0.50. We now factor this into our base case forecasts (compared to a 20% cut to €0.80 before).

Balance sheet scenarios

We see credible scenarios where RWE's credit rating is cut to sub-investment grade

S&P placed RWE on negative outlook in April stating that RWE *"might struggle to maintain credit metrics commensurate with our 'BBB+' rating, namely adjusted FFO to debt of about 20%"*. Our own analysis suggests RWE's FFO/ND will drop significantly below 20%, and there are scenarios where it could drop to just 12%:

- **Base case.** Our base case assumes €1.7bn of further planned disposals in 2016 and a 50% dividend cut from 2015. Under this scenario, FFO/ND drops to ~15% in 2015-16E but then recovers to 18% by 2019E. With no DPS cut, FFO/ND would remain below 17%. In our view, the latter would almost certainly trigger a downgrade to BBB flat.
- **Nuclear fund scenario.** S&P and Moody's both currently apply a ~30% 'equity credit' to RWE's nuclear provisions, deeming them to be conservatively accounted and long term in nature. However, our view is that if RWE was required to pre-fund these provisions with cash, the equity credit could be rescinded. The impact of this would be material, reducing FFO/ND to ~13% on average. We believe this would put RWE on the cusp of a sub-investment grade credit rating.

[1] RWE is rated BBB+ with negative outlook by S&P and Baa1 with stable outlook by Moody's.

- **Bear case.** A nuclear fund, a €1bn increase in mining reclamation provisions, a 10% EPS downgrade due to reduced lignite output and failure to execute remaining disposals. In combination, we estimate that these factors would reduce FFO/ND to just 12% on average. This would almost certainly leave RWE sub-investment grade, in our view.

It is clear from our scenarios that a 50% DPS cut alone is not enough to avert credit rating downgrades, but it would at least free up ~€1.5bn of cash for reinvestment over a five-year period.

Table 4: FFO/ND scenarios

	2014	2015E	2016E	2017E	2018E	2019E	15-19E Ave.
Base Case (50% DPS cut)	18.1%	14.6%	15.0%	16.7%	16.6%	17.9%	16.2%
Base Case (with no DPS cut)	18.1%	14.6%	14.8%	16.2%	15.9%	16.8%	15.7%
Nuclear Fund Scenario (50% DPS cut)	15.9%	12.6%	12.7%	14.0%	13.8%	14.8%	13.6%
Nuclear Fund Scenario (with no DPS cut)	15.9%	12.6%	12.6%	13.6%	13.3%	14.0%	13.2%
Bear Case (50% DPS cut)	15.9%	12.6%	11.9%	12.7%	12.4%	13.3%	12.6%
Bear Case (with no DPS cut)	15.9%	12.6%	11.8%	12.4%	12.0%	12.7%	12.3%

Source: BofA Merrill Lynch Global Research estimates

It is important to highlight three potential sources of upside to our balance sheet analysis that could potentially also trigger significant share price upside:

There are also some significant sources of potential upside

- **Capital injection.** RWE has confirmed recent press speculation that it is in talks with an Abu Dhabi-based investor, and that these talks could result in anything from RWE providing a consultancy role to the investor funding a full 10% capital increase at RWE in return for growth investment. Although we estimate that such an increase would be 7-8% EPS dilutive, it would boost FFO/ND by ~1ppt and provide RWE with access to capital fund growth projects (presumably in the UAE). Whilst not transformational, the market would likely view this more favourably than a rescue rights issue.

- **Nuclear tax court case.** RWE will hear the final verdict on its nuclear tax court cases from the ECJ on 4 June and from the German Constitutional Court likely later in 2015 or early 2016. Victory would see RWE reimbursed a total of ~€1.9bn relating to 2011-16E.

- **Nuclear phase out court case.** The German Constitutional Court also has on its agenda for 2015 the nuclear phase out case. A favourable ruling would have to be followed with a separate damages suit that could take several more years to resolve. However, we estimate that the potential upside for RWE could be as much as €5bn.

Free cash flow illusion

We estimate a sustainable FCF yield of just 5.5%

RWE's headline free cash flow (based on OCF less capex) looks highly attractive at ~€1.8bn p.a. on average for 2016-19E. However, we believe this figure is misleading: it does not include ~€0.3bn p.a. of dividends paid to minority interests; it does not reflect the full cash outflows that RWE will face from 2022 once its begins full decommissioning, which we estimate would be an additional €0.4bn p.a.; it is ~€0.5bn below depreciation and contains only ~€0.3bn p.a. of capex over and above day-to-day maintenance. Normalising for these items would suggest a sustainable free cash flow of just €0.8bn on average. This implies a sustainable FCF yield of just 5.5% on average, considerably below the headline figure of 13%. Furthermore, we estimate that sustainable FCF to EV is less than 2%.

Although our estimate of sustainable free cash flow is sufficient to cover RWE's current €0.6bn ordinary dividend, it leaves hardly any headroom for deleverage, and certainly very little for funding additional burdens, e.g., lignite mine reclamation or accelerated funding of final storage provisions. So again, we reach the conclusion that if RWE wishes to secure itself a future and regain some control over its own outlook, the prudent thing to do would be to cut the dividend by 50% and use the surplus proceeds to fund growth.

Table 5: Free cash flow analysis (€m)

	2015E	2016E	2017E	2018E	2019E
OCF	2,569	4,099	3,949	3,732	3,895
- Capex	(2,933)	(2,143)	(2,136)	(2,147)	(2,156)
= FCF	(364)	1,955	1,813	1,585	1,739
- Minority Dividends	(335)	(293)	(311)	(315)	(315)
- Full Decommissioning Costs	(383)	(380)	(377)	(301)	(297)
- Capex Normalised to Depreciation	421	(360)	(373)	(386)	(362)
= Sustainable FCF	(661)	922	752	583	765
FCF/Equity	-2.7%	14.3%	13.2%	11.6%	12.7%
Sustainable FCF/Equity	-4.8%	6.7%	5.5%	4.3%	5.6%
Sustainable FCF/EV	-1.4%	2.1%	1.7%	1.3%	1.8%

Source: BofA Merrill Lynch Global Research estimates.

Valuation

Table 6: SOTP valuation

	€m	€/sh	% EV	Methodology	EV/EBITDA 2014E	EV/EBITDA 2015E	EV/EBITDA 2016E	5yr CAGR (2015+)
Conventional Power Generation	2,393	3.9	5%	-	1.6x	2.7x	2.3x	1.7%
of which: Germany	300	0.5	1%	*DCF: 7.0% WACC; €31.9/MWh baseload '17E+; €14/kW*	-	-	-	-
of which: Netherlands/Belgium	896	1.5	2%	*DCF: 7.0% WACC; €38.0/MWh baseload '17E+; €214/kW*	-	-	-	-
of which: UK	1,039	1.7	2%	*DCF: 7.0% WACC; £46.1/MWh baseload '17E+; £82/kW*	-	-	-	-
of which: Turkey	157	0.3	0%	*Multiple: €200/kW*	-	-	-	-
Supply / Distribution Networks Germany	26,278	42.7	55%	*DCF: 5.1% WACC*	10.5x	10.5x	9.9x	0.9%
Supply Netherlands / Belgium	2,292	3.7	5%	*DCF: 5.8% WACC; €485/cust*	9.0x	9.3x	9.5x	-0.6%
Supply United Kingdom	2,436	4.0	5%	*DCF: 5.8% WACC; €490/cust*	7.8x	7.8x	7.8x	0.0%
Central and Eastern Europe	4,819	7.8	10%	*DCF: 9.5% WACC*	5.6x	5.6x	5.6x	0.0%
Renewables	7,137	11.6	15%	*DCF: 5.8% WACC; €2015/kW*	9.8x	8.8x	8.4x	4.7%
Trading / Gas Midstream	1,062	1.7	2%	*Multiple: 4.0x FY1 EV/EBITDA*	4.1x	4.0x	3.9x	1.3%
Corporate	(1,278)	(2.1)	-3%	*Multiple: 6.0x FY1 EV/EBITDA*	-	-	-	-
Core Enterprise Value	45,138	73.4	-	-	-	-	-	-
Share Investments	2,276	3.7	5%	*Multiple: 1.0x BV as at 31 Dec 15E*	-	-	-	-
Total Enterprise Value	47,414	77.1	-	-	-	-	-	-
Financial Net Debt (exc. Hybrid)	(4,686)	(7.6)	-	*BV as at 31 Dec 15E*	-	-	-	-
Hybrid Bonds	(3,260)	(5.3)	-	*BV as at 31 Dec 15E*	-	-	-	-
Pension Provisions	(8,036)	(13.1)	-	*Multiple: 1.0x BV as at 31 Dec 15E*	-	-	-	-
Nuclear Provisions	(10,601)	(17.2)	-	*Multiple: 1.0x BV as at 31 Dec 15E*	-	-	-	-
Mining Provisions	(2,507)	(4.1)	-	*Multiple: 1.0x BV as at 31 Dec 15E*	-	-	-	-
Minorities	(4,111)	(6.7)	-	*Multiple: 15.0x FY1 P/E*	-	-	-	-
Equity Value	14,214	23.1	-	-	-	-	-	-

Source: BofA Merrill Lynch Global Research estimates

Table 7: Valuation multiples implied by our €19.1 PO

	2015E	2016E	2017E	2018E
P/E - Recurrent	10.5x	16.0x	12.0x	13.8x
P/E - exc. Nuclear Tax	8.6x	12.0x	12.0x	13.8x
EV/EBITDA - exc. Assoc	6.3x	6.4x	5.9x	6.0x
EV/EBITDA - inc. Assoc	7.2x	7.5x	6.9x	7.1x
EV/NOPAT	17.1x	18.5x	16.4x	17.2x
Dividend Yield	2.6%	2.6%	2.6%	2.6%
FCF Yield	-3.1%	16.6%	15.4%	13.5%
P/BV	1.0x	1.0x	0.9x	0.8x
EV/IC	0.8x	0.8x	0.7x	0.7x

Source: BofA Merrill Lynch Global Research estimates

Financial forecasts

Table 8: Divisional Earnings (€m)

	2010	2011	2012	2013	2014	2015E	2016E	2017E	2018E
EBITDA									
Conventional Power Generation	4,510	3,252	4,378	2,455	2,522	1,509	873	1,032	802
of which: Western Europe	-	-	3,928	2,274	2,412	1,404	737	872	588
of which: UK	-	-	456	165	90	85	116	140	194
Supply / Distribution Networks Germany	2,218	2,167	2,266	2,316	2,650	2,513	2,514	2,664	2,674
Supply Netherlands / Belgium	660	462	293	368	203	254	247	240	240
Supply United Kingdom	504	606	371	366	294	314	314	314	314
Central and Eastern Europe	1,440	1,364	1,312	1,281	913	863	863	863	863
Renewables	211	338	364	454	547	727	807	845	886
Upstream Gas & Oil	619	923	1,041	-	-	-	-	-	-
Trading / Gas Midstream	(7)	(784)	(591)	841	286	262	266	269	273
Other / Consolidation	101	132	(120)	(177)	(284)	(223)	(213)	(173)	(173)
EBITDA	10,256	8,460	9,314	7,904	7,131	6,220	5,670	6,054	5,879
Growth (%)	*11.9%*	*-17.5%*	*10.1%*	*-15.1%*	*-9.8%*	*-12.8%*	*-8.8%*	*6.8%*	*-2.9%*
Margin (%)	*19.2%*	*16.4%*	*17.5%*	*15.1%*	*14.7%*	*13.2%*	*12.2%*	*13.2%*	*12.9%*
Operating Result									
Conventional Power Generation	4,000	2,700	3,275	1,384	979	466	(117)	52	(187)
of which: Western Europe	-	-	3,085	1,451	1,362	711	68	215	(75)
of which: UK	-	-	194	(76)	(384)	(246)	(185)	(165)	(113)
Supply / Distribution Networks Germany	1,575	1,505	1,578	1,626	1,871	1,811	1,807	1,952	1,957
Supply Netherlands / Belgium	391	245	190	278	146	199	192	186	186
Supply United Kingdom	272	357	286	290	227	243	239	236	232
Central and Eastern Europe	1,173	1,109	1,052	1,032	690	663	663	663	663
Renewables	72	181	183	203	186	371	415	446	481
Upstream Gas & Oil	305	558	685	-	-	-	-	-	-
Trading / Gas Midstream	(21)	(800)	(598)	831	274	250	254	257	261
Other / Consolidation	(86)	(41)	(235)	(275)	(356)	(296)	(286)	(246)	(246)
Operating Result	7,681	5,814	6,416	5,369	4,017	3,708	3,167	3,545	3,346
Growth (%)	*8.3%*	*-24.3%*	*10.4%*	*-16.3%*	*-25.2%*	*-7.7%*	*-14.6%*	*11.9%*	*-5.6%*
Margin (%)	*14.4%*	*11.2%*	*12.1%*	*10.2%*	*8.3%*	*7.9%*	*6.8%*	*7.7%*	*7.3%*

Source: Company data, BofA Merrill Lynch Global Research estimates

Table 9: Income Statement (€m)

	2010	2011	2012	2013	2014	2015E	2016E	2017E	2018E
External Revenue	53,320	51,686	53,227	52,425	48,468	47,221	46,383	45,900	45,697
Costs	(43,409)	(43,826)	(44,500)	(44,936)	(41,784)	(41,434)	(41,145)	(40,294)	(40,269)
Income from Operating Investments	345	600	587	415	447	433	433	449	450
EBITDA	10,256	8,460	9,314	7,904	7,131	6,220	5,670	6,054	5,879
Depreciation and Amortisation	(2,575)	(2,646)	(2,898)	(2,534)	(3,115)	(2,512)	(2,503)	(2,509)	(2,533)
Operating Result	7,681	5,814	6,416	5,369	4,017	3,708	3,167	3,545	3,346
Net Interest	(810)	(633)	(836)	(787)	(862)	(779)	(701)	(664)	(635)
Interest Accretion on Provisions	(940)	(869)	(1,208)	(953)	(1,114)	(820)	(827)	(846)	(866)
Other Finance Income/(Costs)	(186)	(131)	(48)	(165)	128	160	0	0	0
PBT	5,745	4,181	4,324	3,464	2,169	2,269	1,640	2,036	1,845
Tax	(1,699)	(1,338)	(1,469)	(2,144)	(577)	(749)	(520)	(654)	(589)
Income from Discontinued Operations	0	0	0	312	364	25	0	0	0
Minority Interests	(279)	(305)	(302)	(210)	(245)	(313)	(274)	(291)	(295)
Hybrid Capital	(15)	(59)	(96)	(104)	(108)	(112)	(112)	(112)	(112)
Recurrent Net Income	3,752	2,479	2,457	1,318	1,603	1,120	733	979	849
Growth (%)	*6.2%*	*-33.9%*	*-0.9%*	*-46.4%*	*21.6%*	*-30.1%*	*-34.6%*	*33.6%*	*-13.3%*
Margin (%)	*7.0%*	*4.8%*	*4.6%*	*2.5%*	*3.3%*	*2.4%*	*1.6%*	*2.1%*	*1.9%*
EPS - Basic	6.20	3.35	2.13	(4.49)	2.77	4.26	1.19	1.59	1.38
EPS - Recurrent	7.03	4.60	4.00	3.76	2.09	1.82	1.19	1.59	1.38
EPS - Recurrent (ex-Nuclear Tax)	-	-	-	-	2.49	2.22	1.59	1.59	1.38
Growth (%)	*6.0%*	*-34.6%*	*-13.0%*	*-6.0%*	*-44.4%*	*-12.8%*	*-34.6%*	*33.6%*	*-13.3%*
DPS	3.50	2.00	2.00	1.00	1.00	0.50	0.50	0.50	0.50
Growth - Ordinary DPS (%)	*0.0%*	*-42.9%*	*0.0%*	*-50.0%*	*0.0%*	*-50.0%*	*0.0%*	*0.0%*	*0.0%*
Payout Ratio (%)	*49.8%*	*43.5%*	*50.0%*	*26.6%*	*47.8%*	*27.4%*	*41.9%*	*31.4%*	*36.2%*

Source: Company data, BofA Merrill Lynch Global Research estimates

Table 10: Cash Flow (€m)

	2010	2011	2012	2013	2014	2015E	2016E	2017E	2018E
Income from Operating Activities	6,507	4,129	3,845	(5)	3,914	4,799	2,735	3,097	2,896
+ Depreciation and Amortisation	3,184	3,443	5,356	7,311	3,083	2,512	2,503	2,509	2,533
(-) Net Interest Paid	(797)	(632)	(799)	(777)	(870)	(769)	(692)	(654)	(629)
(-) Net Tax Paid	(1,723)	(920)	(628)	(1,216)	(951)	(1,028)	(770)	(969)	(964)
+ Dividends Received	428	461	490	383	383	400	373	395	400
+/(-) Changes in Provisions	(602)	(782)	(837)	1,177	(2,191)	(222)	(225)	(228)	(304)
+/(-) Changes in Working Capital	(2,349)	(436)	(1,051)	(1,331)	1,860	(1,625)	175	(200)	(200)
+/(-) Income from Disposals	(165)	(364)	(530)	(400)	(472)	0	0	0	0
+/(-) Other Non-Cash Income/Expenses	1,017	611	(1,451)	(339)	800	(1,499)	0	0	0
Operating Cash Flow	5,500	5,510	4,395	4,803	5,556	2,569	4,099	3,949	3,732
Capital Expenditure	(6,379)	(6,353)	(5,081)	(3,848)	(3,245)	(2,933)	(2,143)	(2,136)	(2,147)
Free Cash Flow	(879)	(843)	(686)	955	2,311	(364)	1,955	1,813	1,585
Acquisitions and Disposals	138	467	1,584	1,953	906	6,000	1,685	0	0
Change in Equity	1,765	2,141	948	163	122	0	0	0	0
Dividends Paid	(2,198)	(2,301)	(1,556)	(1,611)	(1,061)	(1,062)	(712)	(730)	(734)
Net Cash Flow	(1,174)	(536)	290	1,460	2,278	4,574	2,928	1,083	851
Other Movements in Financial Net Debt	(1,216)	292	(394)	523	(1,512)	(519)	0	0	0
Financial Net Cash/(Debt)	(12,772)	(13,016)	(13,120)	(11,137)	(10,371)	(6,316)	(3,387)	(2,305)	(1,454)
Economic Net Cash/(Debt)	(28,964)	(29,948)	(33,015)	(30,727)	(31,010)	(27,460)	(25,033)	(24,467)	(24,076)
Financial Net Debt/EBITDA	*1.2x*	*1.5x*	*1.4x*	*1.4x*	*1.5x*	*1.0x*	*0.6x*	*0.4x*	*0.2x*
Economic Net Debt/EBITDA	*2.8x*	*3.5x*	*3.5x*	*3.9x*	*4.3x*	*4.4x*	*4.4x*	*4.0x*	*4.1x*

Source: Company data, BofA Merrill Lynch Global Research estimates

Table 11: Balance Sheet (€m)

	2010	2011	2012	2013	2014	2015E	2016E	2017E	2018E
Tangible Fixed Assets	32,399	34,983	36,117	34,313	31,142	31,103	29,058	28,685	28,298
Intangible Assets	17,350	16,946	16,017	13,409	12,797	12,797	12,797	12,797	12,797
Investments	4,444	4,949	4,584	4,170	4,156	4,189	4,249	4,302	4,352
Cash/Marketable Securities	5,672	7,004	5,276	6,763	7,581	9,659	11,755	12,738	12,610
Working Capital Assets	15,524	12,981	12,898	11,339	10,587	12,587	12,787	12,987	13,187
Other Assets	17,688	15,793	13,286	11,387	20,053	14,513	14,513	14,513	14,513
Total Assets	93,077	92,656	88,178	81,381	86,316	84,847	85,158	86,022	85,757
Short-Term Debt	(3,902)	(6,495)	(4,529)	(2,149)	(3,342)	(3,342)	(3,342)	(3,342)	(3,342)
Long-Term Debt	(15,908)	(15,428)	(15,417)	(16,539)	(15,224)	(15,161)	(14,329)	(14,229)	(13,250)
Working Capital Liabilities	(8,415)	(7,886)	(7,315)	(6,440)	(6,309)	(6,684)	(7,059)	(7,059)	(7,059)
Provisions	(29,057)	(29,156)	(32,802)	(33,740)	(33,113)	(33,718)	(34,320)	(34,938)	(35,500)
Other Liabilities	(18,378)	(16,609)	(11,626)	(10,376)	(16,556)	(14,293)	(13,759)	(13,142)	(12,458)
Total Liabilities	(75,660)	(75,574)	(71,689)	(69,244)	(74,544)	(73,199)	(72,810)	(72,710)	(71,609)
Shareholders' Equity	16,333	15,738	14,873	10,439	10,093	9,656	10,082	10,754	11,296
Minority Interest/Other	1,084	1,344	1,616	1,698	1,679	1,992	2,266	2,557	2,851
Total Equity	17,417	17,082	16,489	12,137	11,772	11,648	12,348	13,311	14,148

Source: Company data, BofA Merrill Lynch Global Research estimates

Price objective basis & risk

RWE (RWNFF / RWEOY)

We calculate our €19.1 (US$21.48) PO based on the following methodology: we take an equal weighting of our P/E valuation, SOTP and a dividend discount model. Our dividend discount model implies a €14.3 valuation, based on zero terminal growth, and 50% long-term payout ratio and a 8.2% cost of equity. Our P/E valuation is €19.9 based on a 12.5x P/E on 2016E ex-nuclear tax earnings (RWE's 10-year Y+1 P/E average above 50th percentile). Our €23.1 SOTP valuation is based on divisional DCF models, with WACC ranging from 5.1% for German distribution to 9.5% for CEE. We use a long-run German power price assumption of €32/MWh. However, we do not expect RWE to trade at SOTP. The risks to our PO are: further volatility in German power prices, the outcome of nuclear litigation, disappointing UK capacity prices, the imposition of the EEG surcharge and/or carbon levy on lignite and/or coal in Germany and a decline in margins across RWE's midstream and downstream activities.

Analyst Certification

I, Peter Bisztyga, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

EMEA - Utilities Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
BUY				
	Abengoa B	AGOAF	ABG/P SM	Pinaki Das
	Abengoa B	ABGB	ABGB US	Pinaki Das
	E.ON	ENAKF	EOAN GR	Peter Bisztyga
	E.ON	EONGY	EONGY US	Peter Bisztyga
	EDP	EDPFY	EDPFY US	Unai Franco
	EDP	ELCPF	EDP PL	Unai Franco
	EDP Renovaveis	EDRVF	EDPR PL	Pinaki Das
	Enagas	ENGGF	ENG SM	Unai Franco
	Enel	ESOCF	ENEL IM	Harry Wyburd
	Gamesa	GCTAF	GAM SM	Pinaki Das
	Iberdrola	IBDSF	IBE SM	Unai Franco
	National Grid	NGGTF	NG/ LN	Fraser McLaren
	National Grid	NGG	NGG US	Fraser McLaren
	REN	RENZF	RENE PL	Fraser McLaren
	Saeta Yield	XSTAF	SAY SM	Pinaki Das
	Severn Trent	SVTRF	SVT LN	Fraser McLaren
	Snam	SNMRF	SRG IM	Harry Wyburd
	Suez Environnement	SZEVF	SEV FP	Harry Wyburd
	Terna	TERRF	TRN IM	Harry Wyburd
	Vestas	VWSYF	VWS DC	Pinaki Das
NEUTRAL				
	Acciona	ACXIF	ANA SM	Pinaki Das
	Centrica	CPYYF	CNA LN	Fraser McLaren
	Centrica	CPYYY	CPYYY US	Fraser McLaren
	Endesa	ELEZF	ELE SM	Unai Franco
	Enel Green Power	XENLF	EGPW IM	Pinaki Das
	GDF Suez	GDSZF	GSZ FP	Peter Bisztyga
	Nordex	NRDXF	NDX1 GR	Pinaki Das
	Red Electrica Corporacion S.A.	RDEIF	REE SM	Unai Franco
	SSE	SSEZF	SSE LN	Fraser McLaren

EMEA - Utilities Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
	SSE	SSEZY	SSEZY US	Fraser McLaren
	United Utilities	UUGWF	UU/ LN	Fraser McLaren
	Veolia	VEOEF	VIE FP	Harry Wyburd
	Veolia	VEOEY	VEOEY US	Harry Wyburd
UNDERPERFORM				
	Drax Group Ltd	DRXGF	DRX LN	Fraser McLaren
	EDF	ECIFF	EDF FP	Harry Wyburd
	Fortum	FOJCF	FUM1V FH	Peter Bisztyga
	Pennon	PEGRF	PNN LN	Fraser McLaren
	RWE	RWNFF	RWE GR	Peter Bisztyga
	RWE	RWEOY	RWEOY US	Peter Bisztyga

iQmethod SM Measures Definitions

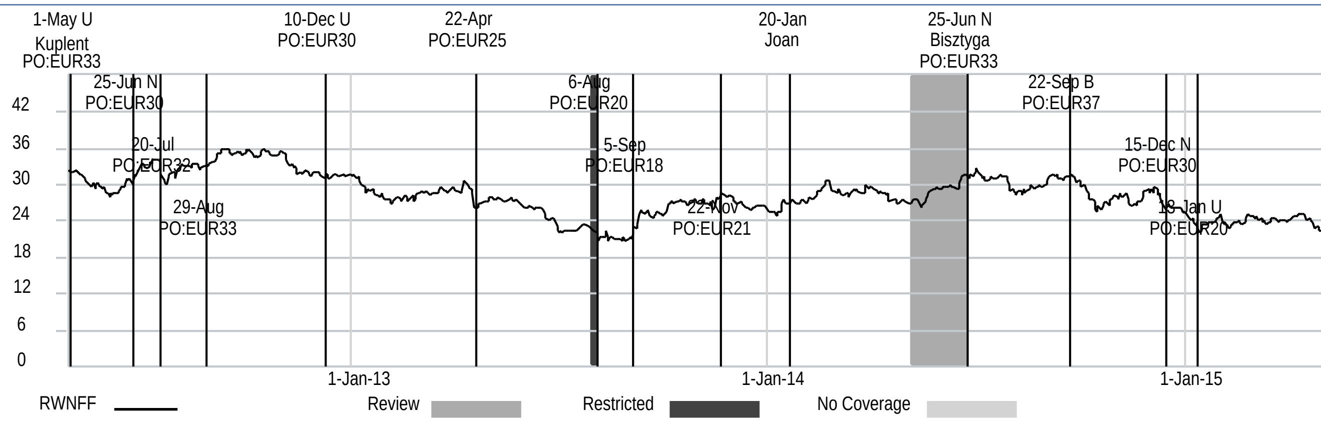
Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

iQmethod SM is the set of BofA Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

iQdatabase ® is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by BofA Merrill Lynch.

Important Disclosures

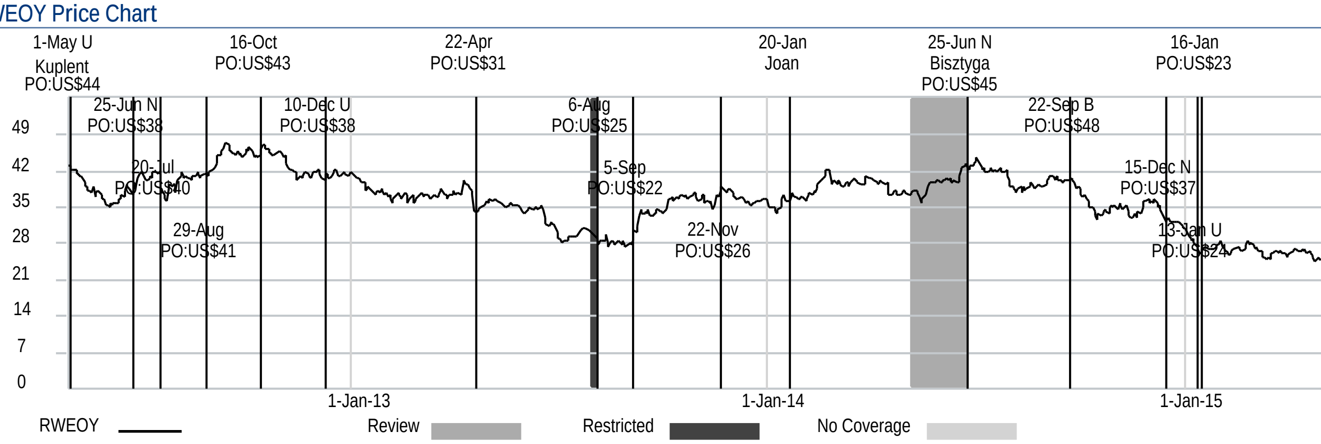
RWNFF Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR:No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of April 30, 2015 or such later date as indicated.

RWEOY Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR:No Rating

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Investment Rating Distribution: Utilities Group (as of 31 Mar 2015)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	66	50.38%	Buy	57	86.36%
Neutral	32	24.43%	Neutral	26	81.25%
Sell	33	25.19%	Sell	27	81.82%

Investment Rating Distribution: Global Group (as of 31 Mar 2015)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1696	50.89%	Buy	1258	74.17%
Neutral	805	24.15%	Neutral	586	72.80%
Sell	832	24.96%	Sell	539	64.78%

* Companies that were investment banking clients of BofA Merrill Lynch or one of its affiliates within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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