Figure 6. Valuation Multiples

E.On share price at close on 2 February 2007 (€)			109.4
Value of 6.4% Gazprom stake per E.On share (€)			16.8
E.On share price ex Gazprom (€)			92.6
P/E ratios	FY06E	FY07E	FY08E
Standalone P/E	**16.7**	**14.0**	**13.2**
Standalone P/E ex Gazprom	14.2	11.8	11.2
P/E with Endesa		12.7	11.1
P/E ex Gazprom with Endesa		**10.7**	**9.4**
Sector P/E	17.9	15.6	14.6
E.On with Endesa ex Gazprom at sector average		152	161
EV/EBITDA ratios	FY06E	FY07E	FY08E
Standalone EV/EBITDA	**7.6**	**6.7**	**6.4**
Standalone EV/EBITDA ex Gazprom		6.7	6.4
EV/EBITDA with Endesa		8.7	7.3
EV/EBITDA ex Gazprom with Endesa		**8.7**	**7.3**
Sector EV/EBITDA		8.4	8.0
E.On at sector average		98	141
Dividend yield	FY06E	FY07E	FY08E
Standalone dividend @ 60% PoR	4.00	4.70	4.96
Dividend with Endesa @ 60% PoR		5.18	5.93
Standalone dividend yield	**3.6%**	**4.3%**	**4.5%**
Dividend yield with Endesa		**4.7%**	**5.4%**
Sector dividend yield	3.8%	3.9%	4.1%
E.On at sector average		133	145

Source: Citigroup Investment Research

Where could it go wrong?

Although we think the valuation arguments are strong under our base case, the E.On share price is likely to continue to be volatile over the coming weeks. However, we think it should rise close to our €130 target as the hurdles are (hopefully) steadily overcome.

We think the *main remaining potential pitfalls are* as follows.

A minority stake is possible

E.On may settle for 40-45% if it has to

First, E.On could end up with a smaller stake than we have assumed. Possibly even a minority stake. The bid is formally conditional on the acquisition of at least 50.01% of Endesa. However, we suspect E.On would be prepared to live with a stake as low as 40-45% on the expectation that it should be able to raise this to a majority stake over the medium term. We expect the stock market would not be hugely enthusiastic about such a move, although we would still see scope for upside from the current share price.

Were E.On to acquire 45%, we estimate the underlying FY08E P/E (ex Gazprom) would be 10.1x, while the FY08E dividend yield assuming a 60% payout ratio would be 5%. These numbers should be sufficient, in our view, to drive the share price up towards €120 or so, although the residual uncertainty over E.On eventually converting its stake into a majority would probably prevent our €130 target price being achieved in the near future.

Figure 7. Different Scenarios For Result of Offer

Stake acquired	E.On post-deal SoP (€ per share)	FY08E EPS enhancement	FY08E net debt + pension and nuclear provisions/EBITDA	Comment
0%	134	0%	1.2x	
45%	129	10%	2.4x	Assuming no synergies are realised
55%	129	14%	3.0x	
65%	130	17%	3.1x	
75%	130	19%	3.3x	Neglects possible need for asset disposal/ equity issuance
85%	131	22%	3.5X	Neglects need for asset disposal/ equity issuance
100%	131	26%	3.8x	Neglects need for asset disposal/ equity issuance

Source: Citigroup Investment Research

E.On could end up with nothing

Changing the voting rights may prove impossible

Second, the deal could fail because Endesa shareholders fail to vote through the required change in the voting rights. An EGM on this issue is likely to be held during the second half of March and a 50.1% majority of those entitled to vote is required (i.e. not just of those who exercise that entitlement). Although we suspect more than one vote could be held should the first vote fail, it is possible that this hurdle cannot be overcome in which case E.On would have to return to a standalone strategy. The key issue would be how E.On would then seek to deploy its balance sheet.

We would see scope for a significant return of value to shareholders, although E.On would, of course, retain substantial flexibility to make acquisitions. Under this scenario, we would be looking to new CFO Marcus Schenck to promote a new policy at E.On of actively managing the balance sheet. Again, we would still see upside in E.On shares, but would not view our target price as likely to be achieved in the near future.

E.On might issue equity

E.On's share price may be hit by equity issuance

Third, E.On could issue equity to finance the deal. E.On has plainly indicated that it could issue equity (or equity-linked instruments) to the tune of 10% of its current share capital and that an A flat credit rating is to be preserved. However, the company also stated on the 3 February conference call that asset disposals would first be sought before equity is issued.

On the same conference call, CFO Schenck also indicated that no disposals or equity issuance would probably be needed unless the stake acquired amounted to more than 60-70%. Under our base case, then we would expect to see E.On to look to raise perhaps €5bn by selling assets or issuing equity. Figure 9 sets out the likely candidates, in our view, although E.On has given no indication of the possible disposals, nor of the debt ratios it thinks would be consistent with an A flat rating.

Overall, we think there is a good chance that equity issuance will be avoided.

Figure 8. Balance Sheet Ratios

	E.On current targets "compatible with A+"*	E.On post-Endesa base case in FY08E	E.On post-Endesa in FY08E assuming 100% *acquired*
EBITDA/net interest	about 10x	6.4x	5.6x
EBITDA/net debt	0.5-1.0x	0.4x	0.3x
Net debt+provisions/EBITDA	N/a	3.3x	3.8x

*E.On has so far given no indications for ratios compatible with new target of A flat

Source: Citigroup Investment Research

Figure 9. Possible Sources of Cash For E.On

Item	Citigroup Valuation	Comment
E.On's US business (LG&E)	€4.2bn	Local regulatory clearance could take 12-18 months
6.4% of Gazprom	€11.6bn	May be politically awkward to sell
E.On's transmission grid in Germany	€3.1bn	Sale would be welcomed by the EU. Infrastructure funds would probably pay a high price.
E.On's distribution assets in the UK	€3.9bn	Infrastructure funds would probably pay a high price.
Financial assets other than Gazprom	€10.1bn	Chiefly stakes in regional German utilities
New equity up to 10% of the E.On total	€7bn at current share price	

Source: Citigroup Investment Research

E.On may fail to be re-rated even after the uncertainties are resolved

E.On could be a "mega-cap" trap

Fourth, E.On could fail to be re-rated by the stock market because of its "megacap" status. Because E.On is too large to be acquired, it is likely to trade at a discount to sector average multiples, which in part reflects the bid premiums we think are already factored into some stocks. Similarly, E.On may fail to be re-rated because of the diversity of its geographic portfolio, or because of a perception that it has taken on too much additional risk in Spain and Latin America.

These are arguments that we have some sympathy with. However, even at our target price the stock would still trade on an underlying FY08E P/E some 10% below the sector average. We think this is enough to account for these issues.

In addition, we think the E.On management team will be heavily incentivised to present a compelling equity story to investors and we have a high regard for the persuasive powers of CEO Wulf Bernotat assisted now by Marcus Schenck as his CFO.

Figure 10. Divisional Breakdown (€m)

Adjusted EBIT	2004A	2005A	2006E	2007E	2008E	2009E	2010E
Central Europe	3,602	3,930	4,416	4,954	5,591	5,850	5,764
Pan-European Gas	1,344	1,536	1,946	2,072	2,041	1,926	1,818
UK	1,017	963	1,211	1,255	1,332	1,279	1,430
Nordic	701	806	575	798	922	994	1,068
US-Midwest	354	365	367	372	373	370	468
Corporate centre/consolidation	-338	-399	-299	-299	-299	-299	-299
Core businesses	6,680	7,201	8,216	9,152	9,960	10,121	10,250
Viterra	0	0	0	0	0	0	0
Degussa	107	132	0	0	0	0	0
Total continuing operations	6,787	7,333	8,216	9,152	9,960	10,121	10,250

Source: Company Reports and Citigroup Investment Research

Figure 11. Key Financial Items (€m Unless Stated)

	2004 A	2005 A	2006 F	2007 F	2008 F	2009 F	2010 F
EPS from ongoing operations (€)	6.62	6.63	5.28	7.84	8.27	8.24	8.19
EPS from discontd. operations/other (€)	-0.01	4.60	0.23	0.00	0.00	0.00	0.00
Total reported group EPS (€)	6.61	11.24	5.51	7.84	8.27	8.24	8.19
Adjusted EPS (€)	4.96	5.49	6.54	7.84	8.27	8.24	8.19
DPS (€)	2.35	7.00	4.00	4.70	4.84	4.99	5.14
Cashflow/share (€)	9.6	11.2	9.0	12.6	13.4	13.7	14.0
Free cash flow (€m)	3,228	3,611	906	1,564	1,051	1,291	1,501
Net cash (debt) (E.On definition) (€m)	-5,483	3,863	-2,890	-4,188	-6,471	-8,618	-10,665
Gearing	17%	-5%	8%	11%	15%	18%	21%
Payout ratio based on clean earnings	48%	127%	76%	60%	59%	60%	63%
EBITDA/net cash interest expense	17.3	45.7	46.9	38.3	29.1	23.4	19.8

Source: Company Reports and Citigroup Investment Research

Figure 12. Click here to add title

Profit and Loss	**2004 A**	**2005 A**	**2006 F**	**2007 F**	**2008 F**	**2009 F**	**2010 F**
Sales	46,742	56,399	67,278	67,823	66,698	65,799	66,351
Operating costs	37,698	47,009	56,636	56,303	54,166	52,903	53,136
Adjusted EBITDA before associates	9,044	9,390	10,642	11,520	12,532	12,896	13,215
Adjusted EBITDA including associates	9,741	10,272	11,407	12,299	13,326	13,705	14,039
Depreciation	-2,954	-2,939	-3,191	-3,147	-3,366	-3,584	-3,789
Adjusted EBIT	6,787	7,333	8,216	9,152	9,960	10,121	10,250
of which associates & income from investments	697	882	764	779	794	809	824
Adjusted interest income	-1,031	-1,027	-1,229	-1,042	-1,204	-1,359	-1,509
Net book gains	589	491	819	0	0	0	0
Restructuring costs and non-operating earnings	-100	-29	0	0	0	0	0
Other non-operating earnings	110	440	-2,538	0	0	0	0
Pre-tax profit	6,355	7,208	5,268	8,110	8,756	8,762	8,741
Tax	-1,850	-2,276	-1,338	-2,468	-2,809	-2,807	-2,796
Minorities	-478	-553	-450	-473	-496	-521	-547
Discontinued items/other	312	3,028	150	0	0	0	0
Net attributable profit	4,339	7,407	3,630	5,169	5,451	5,434	5,398
Adjusted net attributable profit	3,256	3,621	4,311	5,169	5,451	5,434	5,398

Cash flow	**2004 A**	**2005 A**	**2006 F**	**2007 F**	**2008 F**	**2009 F**	**2010 F**
Gross cash flow	5,840	6,601	5,565	7,923	8,460	8,700	8,910
Capex	-2,612	-2,990	-4,659	-6,359	-7,409	-7,409	-7,409
Acquisitions/other investments	-2,882	-1,826	-6,600	0	0	0	0
Disposal proceeds	2,606	6,599	3,800	0	0	0	0
Dividends	-1,598	-1,794	-4,859	-2,862	-3,334	-3,439	-3,547
Issue/(redemption) of group equity	-59	3	0	0	0	0	0
Other/change in scope of consolidation	1,224	2,427	0	0	0	0	0
Change in net debt	2,519	9,020	-6,753	-1,298	-2,283	-2,148	-2,046

Balance Sheet	**2004 A**	**2005 A**	**2006 F**	**2007 F**	**2008 F**	**2009 F**	**2010 F**
Intangible assets	3,788	4,125	3,726	3,366	3,041	2,747	2,482
Property plant and equipment	43,563	41,323	44,390	47,962	52,830	56,949	61,335
Financial assets	17,263	21,686	16,949	17,339	17,735	18,140	18,552
Stocks	2,647	2,457	2,494	2,531	2,569	2,608	2,647
Receivables	18,436	24,054	24,219	24,388	24,560	24,736	24,915
Cash and equivalents	12,016	15,119	5,000	5,000	5,000	5,000	5,000
Other assets	1,895	2,435	2,435	2,435	2,435	2,435	2,435
Total assets	99,608	111,199	99,214	103,021	108,171	112,615	117,365
Debt	-18,333	-12,416	-9,050	-10,348	-12,631	-14,778	-16,825
Provisions	-34,242	-33,862	-29,204	-29,826	-30,470	-31,138	-31,829
Trade creditors	-3,662	-5,288	-5,394	-5,502	-5,612	-5,724	-5,838
Other liabilities	-13,516	-17,358	-14,861	-14,833	-14,438	-14,046	-13,658
Minorities	-4,144	-4,734	-4,959	-5,195	-5,443	-5,704	-5,977
Shareholders Funds	33,560	44,484	42,690	44,260	46,520	48,168	50,181

Source: Company Reports and Citigroup Investment Research Estimates

E.ON AG

Company description

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

Investment thesis

We rate E.ON Buy/ Medium Risk (1M) with a €130 target price. Our base case is that the tender offer for Endesa ends up with E.ON owning a 75% stake in the business. The transformational impact the deal has on the E.ON balance sheet coupled with the claimed €600m synergies are more than enough to offset the high price we think E.ON is offering for Endesa. The new E.ON that emerges from this transaction is too compellingly valued to be ignored, in our view. However, we have yet to be convinced about the strategic benefits of the deal, which seem too long-term in nature to have a significant share price impact.

Valuation

We use a sum-of-parts method applying a variety of valuation techniques to the various divisions. We chiefly rely on a mix of DCF valuations, regulatory asset basis and EV/EBITDA multiples. Financial assets are taken at book value, save for the stake in Gazprom, which is marked to market. Nuclear liabilities are subtracted at a value generated by a separate DCF model. Pension provisions are deducted at book value and a portion of the book value of "other" provisions is also subtracted. Our latest SOP valuation is €130 per share on the assumption that E.ON acquires a 75% stake in Endesa at a price of €38.75 per share. We cross check our sum-of-parts valuation by reference to valuation multiples at group level. At our target price, E.ON would trade on a FY08E P/E of 13.1x if the value of the Gazprom stake is stripped out of the E.ON share price. This is a c10% discount to the sector average, which we think reasonably reflects E.ON's "megacap" status and the geographic diversity of its assets.

Risk

We rate E.ON as Medium Risk. The risk rating on the stock is derived after consideration of a number of factors. These factors include an assessment of industry-specific risks, financial risk and management risk. In addition, we consider historical share price volatility, based upon the input of the Citigroup quantitative research team, as a possible indicator of future stock-specific risk. Risks elsewhere include the risk that power prices might fall, as well as regulatory risks in both the gas and the electricity markets. There is also a significant risk that the bid for Endesa may fail. With regard to the investment thesis and achievement of our target price, these could be undermined by renewed competition in German generation, or by regulatory change proving more severe than we anticipate. In addition, E.ON may fail to acquire Endesa and instead make a value-destructive acquisition elsewhere. If competition does erupt in the German gas market, then Ruhrgas would probably need to renegotiate its long-term gas purchasing contracts.

Appendix A-1

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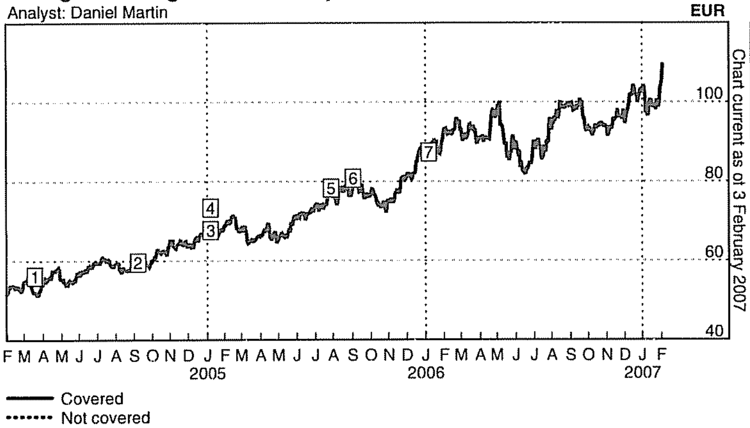
IMPORTANT DISCLOSURES

E.ON (EONG.DE)

Ratings and Target Price History - Fundamental Research

Analyst: Daniel Martin



#	Date	Rating	Target Price	Closing Price
1:	18 Mar 04	*2H	*60.00	51.55
2:	8 Sep 04	*1M	*70.00	58.10
3:	7 Jan 05	1M	*75.00	67.71
4:	7 Jan 05	1M	75.00	67.71
5:	28 Jul 05	1M	*86.00	76.40
6:	2 Sep 05	1M	*90.00	78.84
7:	6 Jan 06	1M	*100.00	88.18

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JPMorgan

E.ON

Awaiting April 3

€97.38
07 March 2007

Electric Utilities

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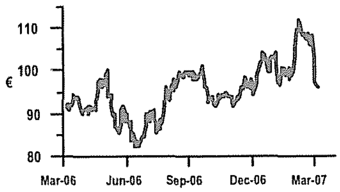
E.ON have chosen to play a "business as usual" approach with 2006's dividend and 2007 guidance, but we still see the prospect of a value-adding "post-Endesa plan" in due course. However, before we get to that the next hurdle is the April 3 completion of the Endesa deal.

- **FY06 results in line**: FY06 results were in line with our expectations at the EBIT line, although some disappointments in the gas business presage the ongoing tough regulatory outlook in Germany. DPS of €3.35/share was a touch below our €3.5/share. We had hoped E.ON would be more generous than this, but clearly management have taken a "business as usual" approach.

- **Cutting our numbers to ex-Endesa**: Following recent developments we have decided to take Endesa out of our numbers, as well as trim 2007E in light of the new guidance (see Table 4). We see new management guidance as achievable, and believe a €4/share dividend is possible in 2007E. Our new numbers put E.ON on a 11.1x 2008E P/E and 4.1% 2007E dividend yield, vs the sector's 14.5x and 3.6% respectively.

- **Awaiting April 3**: Management made it clear on the conference call that all options regarding Endesa are still possible, but that no decisions / discussions will be made until April 3. On this date the CNMV will communicate the level of acceptances of E.ON's offer. After (perhaps at 1Q07 on May 9) this we see the potential for E.ON to enunciate a value-adding "plan B" that could add €1/share to our 2008E EPS.

Price Performance



	YTD	-1M	-3M	-12M
Absolute	-6.6%	-11.9%	-1 2%	5 2%

Source: RIMES, Reuters

Table 1: E.ON Estimates

	2005A	2006A	2007E	2008E	2009E	2010E
EBITDA	10,272	11,353	11,934	12,586	13,591	14,067
EBIT	7,333	8,150	8,767	9,242	10,068	10,377
Net attributable income	7,407	5,057	5,083	5,139	5,657	5,917
Headline EPS	11.24	7 67	7.71	7.79	8.58	8.97
Dividend, gross	7.00	3.35	3.99	4.29	4.72	4.93
Headline P/E	9.9	12.8	12.7	12.6	11.5	10.9
Gross Yield	6.30%	3.4%	4.1%	4.4%	4.8%	5.0%
EV/EBITDA	10 3	7 5	6.9	6.5	5.9	5.5
FCF Yield	1.1%	-3.6%	2.7%	3.1%	5.6%	5.4%

Source: JPMorgan estimates.

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Revised financials

2006 results analysis

E.ON 2006 operating profit came in more-or-less in line with our €8.2bn forecast, although in the mix the weak 4Q06 outcome in the regulated gas businesses was a disappointment, offset by strong results in upstream gas, the USA and in the regulated UK operations.

Table 2: E.ON Adjusted EBIT for 2006A

€m, EBIT	9M05A	4Q05A	FY05A	9M06A	% y-o-y	4Q06A	% y-o-y	FY06A	% y-o-y
Group	5,505	1,828	7,333	6,064	10.2%	2,086	14.1%	8,150	11.1%
Central Europe	2,945	985	3,930	3,243	10.1%	925	-6.1%	4,168	6.1%
West, Power	2,568	821	3,389	2,643	2.9%	907	10.5%	3,550	4.8%
West, Gas	218	89	307	257	17.9%	15	-83.1%	272	-11.4%
East	172	65	237	243	41.3%	26	-60.0%	269	13.5%
Other / consolidation	-13	10	-3	100		-23		77	
Pan-European Gas	1,125	411	1,536	1,596	41.9%	510	24.1%	2,106	37.1%
Up/Midstream	712	276	988	1,222	71.6%	462	67.4%	1,684	70.4%
Downstream	405	146	551	367	-9.4%	64	-56.2%	431	-21.8%
Other / consolidation	8	-11	-3	7	-12.5%	-16	45.5%	-9	
UK	715	248	963	710	-0.7%	519	109.3%	1,229	27.6%
Regulated	327	124	451	347	6.1%	141	13.7%	488	8.2%
Unregulated / other	388	124	512	363	-6.4%	378	204.8%	741	44.7%
Nordic	581	225	806	437	-24.8%	182	-19.1%	619	-23.2%
US Mid-West	278	87	365	285	2.5%	106	21.8%	391	7.1%
Corporate Center/other	-139	-115	-254	-207	48.9%	-156	35.7%	-363	42.9%

Source: JPMorgan estimates, Company data

Further down the P&L, a higher than expected finance expense (in large part due to lower than expected returns on pension plan assets) led to a small underperformance at the recurring EPS lin vs our €6.98/share forecast.

The main disappointment, though, came in the dividend. Whilst this was only 4% below our stated €3.5/share forecast we had hoped that management would be more generous in light of dividend payments by competitors.

Nonetheless, 2006 was a solid "business as usual" set of figures.

Table 3: E.ON Group FY06 P&L analysis

€m	9M05A	4Q05A	FY05A	9M06A	% y-o-y	4Q06A	% y-o-y	FY06A	% y-o-y
EBIT	**5,505**	**1,828**	**7,333**	**6,064**	**10.2%**	**2,086**	**14.1%**	**8,150**	**11.1%**
Interest expense	-791	-236	-1,027	-848	7.2%	-233	-1.3%	-1,081	5.3%
Capital gains	403	88	491	819		386		1,205	
Restructuring costs	-14	-15	-29	0		0		0	
Other non-operating	50	390	440	-2,538		-603		-3,141	
PBT	**5,153**	**2,055**	**7,208**	**3,497**	**-32.1%**	**1,636**	**-20.4%**	**5,133**	**-28.8%**
Tax	-1,639	-637	-2,276	-730		1,053		323	-114.2%
% rate	*-31.8%*	*-31.0%*	*-31.6%*	*-20.9%*		*64.4%*		*6.3%*	
Minorities	-381	-172	-553	-270	-29.1%	-256		-526	-4.9%
% share	*-10.8%*	*-10.0%*	*0.0%*	*-9.8%*					
Net income from cont	**3,133**	**1,246**	**4,379**	**2,497**	**-20.3%**	**2,433**		**4,930**	**12.6%**
Net income from discont	3,247	-212	3,035	132		-5		127	
Net income	6,380	1,027	7,407	2,629	-58.8%	2,428		5,057	-31.7%
Net debt (cash)	3,150	-7,013	-3,863	1,039					
EPS	9.71	1.53	11.24	3.99	-58.9%	-3.99			
EPS recurring	**4.08**	**1.20**	**5.27**	**5.14**	**26.0%**	**1.51**	**26.4%**	**6.65**	**26.1%**
DPS			7.00					3.35	

Source: JPMorgan estimates, Company data.

Cut in forecasts

Following the announcement of FY06E, and in light of the recent moves by Enel with regards to Endesa, we have decided it is prudent to shift our forecasts back to a "pre-Endesa" basis, and to trim our forecasts in line with new management guidance. We have not changed our DPS payout forecast (55%) hence a fall in DPS as well as earnings.

Table 4: Revision to our EBIT, earnings & dividend guidance

€	2006A	2007E	2008E	2009E	2010E
EBIT - €m					
Old	8,211	15,022	15,785	17,119	17,482
New	8,150	8,767	9,242	10,068	10,377
% change ex Endesa effect	-0.7%	-5.4%	-2.9%	-2.8%	-2.9%
Recurrent EPS					
Old	6.98	9.85	10.65	11.93	12.47
New	6.65	7.25	7.79	8.58	8.97
DPS					
Old	3.49	5.42	5.86	6.56	6.86
New	3.35	3.99	4.29	4.72	4.93

Source: JPMorgan estimates, Company data.

Table 5: E.ON 2007 earnings guidance vs JPM forecasts

2007 ex Endesa	JPM esimates	Guidance
Group EBIT	**7.6%**	**"slightly surpass"**
o/w Central Europe	8.5%	"slightly above"
o/w Pan European Gas	-4.0%	"below"
o/w UK	3.2%	"remain at"
o/w Nordic	82.8%	"significantly above"
o/w US	-5.0%	"below"
Group net income	0.5%	"slightly higher"

Source: JPMorgan estimates, Company data.

Revised financial forecasts

Even without Endesa, or a "Plan B" of cost cutting & buy-back, we still estimate that E.ON should be able to generate an 8% recurrent earnings and 10% dividend CAGR to 2010E whilst still financing its significant capex programme from organic cash flow. The net cash position illustrates the potential waiting to be released.

On these revised forecasts we estimate E.ON is trading on an 11.1x 2008E P/E (adjusted for the 6.5% Gazprom stake) and 4.1% 2007E dividend yield, vs the sector's 14.5x and 3.6% respectively.

Table 6: E.ON Financial Snapshot

€m, Dec 31 y/e	2006A	2007E	2008E	2009E	2010E	4yr CAGR
Revenues	67,759	61,174	64,413	76,153	82,797	5.1%
EBITDA	11,353	11,934	12,586	13,591	14,067	5.5%
EBIT	**8,150**	**8,767**	**9,242**	**10,068**	**10,377**	**6.2%**
Central Europe	4,168	4,523	4,635	5,393	5,421	6.8%
Pan Euro Gas	2,106	2,023	2,113	2,197	2,285	2.1%
UK	1,229	1,268	1,205	1,110	1,240	0.2%
Nordic	619	1,132	1,265	1,340	1,395	22.5%
US Mid-West	391	371	374	378	387	-0.3%
Net income, reported	5,057	5,083	5,139	5,657	5,917	4.0%
Net income, adjusted	**4,386**	**4,783**	**5,139**	**5,657**	**5,917**	**7.8%**
EPS, recurrent	6.65	7.25	7.79	8.58	8.97	7.8%
DPS, reported	**3.35**	**3.99**	**4.29**	**4.72**	**4.93**	**10.2%**
Payout ratio	50%	55%	55%	55%	55%	2.2%
Cash from operations	7,194	9,056	9,361	10,066	10,393	9.6%
Capex & investments	-5,161	-6,143	-6,184	-5,282	-5,751	2.7%
Free cash flow, adj	-2,306	1,777	2,017	3,622	3,469	
Net financial position	268	-316	-543	-2,173	-3,370	
P/E		11.8x	11.1x	10.0x	9.6x	
Declared Yield		4.1%	4.4%	4.8%	5.0%	
FCF Adjusted		2.7%	3.0%	6.0%	5.7%	
EV/EBITDA		6.9x	6.5x	5.9x	5.5x	

Source: JPMorgan estimates, Company data

Plan B – An extra €1/share of earnings

E.ON still has significant room for reinvestment in CE Europe and Russia, in LNG and in generation/networks in its existing geographies. We estimate that E.ON could replicate part of the earnings benefits from Endesa via a €600m cost cutting programme (in line with that which RWE has just announced) and a 10% buy-back. We could also expect a hike in the payout ratio to say 70%.

This could add around €1/share to earnings, and result in a 2008E DPS of €6.0/share (with room for growth). This, in turn, would leave E.ON trading on just 10.0x 2008E P/E and a 5.5% dividend yield.

Table 7: E.ON forecasts under a €600m cost cutting, 10% buy-back and 70% payout ratio policy

€ per share	2007E	2008E	2009E	2010E
Recurrent EPS	7.25	7.79	8.58	8.97
plus: €600m cost cuts by 2009E	0.21	0.42	0.64	0.64
plus: Impact of 10% buy-back	0.31	0.37	0.46	0.50
EPS under "regular strategy"	7.78	8.59	9.67	10.11
P/E adj for Gazprom	11.0x	10.1x	8.9x	8.5x
DPS at 70% payout ratio	5.44	6.01	6.77	7.08
Dividend yield	5.5%	6.1%	6.9%	7.2%

Source: JPMorgan estimates

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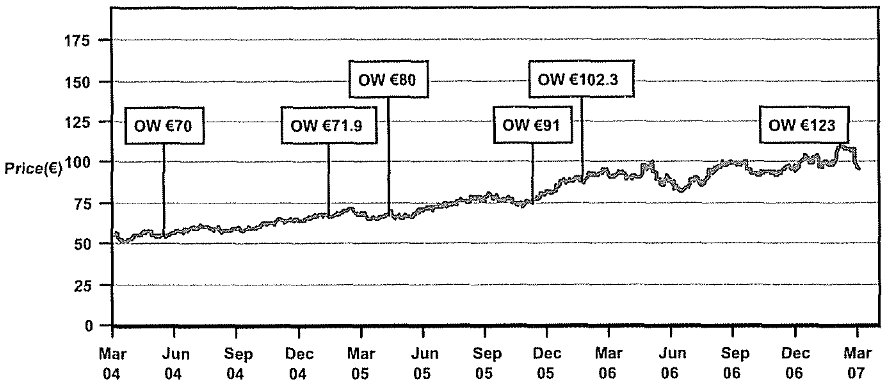
E.ON (EONG.DE) Price Chart



Date	Rating	Share Price (€)	Price Target (€)
17-May-04	OW	54.65	70.00

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
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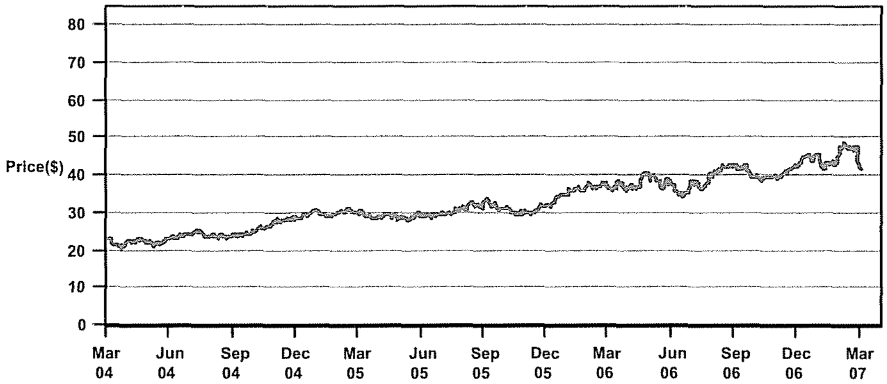
E.ON (EON) Price Chart



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Revised January 30, 2007.

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E.ON: Summary of Financials

Profit & loss statement
€ million, year-end 31 December

	FY06A	FY07E	FY08E	FY09E	FY10E
Sales	67,759	61,174	64,413	76,153	82,797
Gross Operating Profit	***11,353***	***11,934***	***12,586***	***13,591***	***14,067***
Depreciation & Amortisation	(3,203)	(3,167)	(3,344)	(3,523)	(3,690)
Operating Profit	**8,150**	**8,767**	**9,242**	**10,068**	**10,377**
Non-operating income	(1,936)	300	0	0	0
Finance costs - net	(1,081)	(1,060)	(973)	(909)	(820)
Profit before tax	**5,133**	**8,007**	**8,269**	**9,160**	**9,557**
Income tax	323	(2,235)	(2,398)	(2,748)	(2,867)
Minority interests	(526)	(689)	(731)	(755)	(772)
Discontinued items	127	0	0	0	0
Group net profit	**5,057**	**5,083**	**5,139**	**5,657**	**5,917**

Cashflow statement
€ million, year-end 31 December

	FY06A	FY07E	FY08E	FY09E	FY10E
Funds from operations	8,455	8,394	9,775	11,438	11,160
Working Capital	(1,261)	662	(414)	(1,372)	(768)
Cash from operations	***7,194***	***9,056***	***9,361***	***10,066***	***10,393***
Capex & acquisitions	(1,207)	(6,143)	(6,184)	(5,282)	(5,751)
Other investing cash flows	(3,294)	0	0	0	0
Cash from investing	**(4,501)**	**(6,143)**	**(6,184)**	**(5,282)**	**(5,751)**
Dividends	(4,856)	(2,512)	(2,950)	(3,155)	(3,446)
Cash from financing	**(5,849)**	**(2,512)**	**(2,950)**	**(3,155)**	**(3,446)**
Free cash flow before dividends	2,480	2,597	2,841	4,437	4,288
Free cash flow, adjusted	**(2,306)**	**1,777**	**2,017**	**3,622**	**3,469**

Balance sheet
€ million, year-end 31 December

	FY06A	FY07E	FY08E	FY09E	FY10E
Fixed assets	96,344	99,341	102,352	104,282	106,513
Current assets	30,888	29,263	30,177	34,309	36,922
Total assets	***127,232***	***128,604***	***132,529***	***138,591***	***143,438***
Total debt	13,399	13,217	13,217	13,217	13,217
Total equity	52,878	55,405	59,592	65,200	70,065
Other liabilities	60,955	59,982	59,720	60,174	60,153
Total liabilities	**127,232**	**128,604**	**132,529**	**138,591**	**143,438**
Net debt	268	(316)	(543)	(2,173)	(3,370)
Capital employed	53,146	55,089	59,049	63,027	66,695

Source: Company data, JP Morgan estimates

Valuation ratios
x

Unadjusted	FY06A	FY07E	FY08E	FY09E	FY10E
P/E (recurrent)	14.8x	13.5x	12.6x	11.4x	10.9x
P/E (*reported*)	12.8x	12.7x	12.6x	11.4x	10.9x
Price to book value	1.4x	1.3x	1.2x	1.1x	1.0x
EV / EBITDA	8.2x	7.8x	7.3x	6.6x	6.3x
EV / EBIT	11.5x	10.6x	10.0x	8.9x	8.5x
FCF yield (pre divs, post mins) %	-3.6%	2.7%	3.1%	5.6%	5.4%
Dividend yield %	3.4%	4.1%	4.4%	4.8%	5.0%

Per share
€

	FY06A	FY07E	FY08E	FY09E	FY10E
Recurrent EPS	6.65	7.25	7.79	8.58	8.97
Reported EPS	7.67	7.71	7.79	8.58	8.97
Reported DPS	3.35	3.99	4.29	4.72	4.93
Adjusted Free Cash Flow	(3.50)	2.69	3.06	5.49	5.26

Performance, leverage and return ratios
%

	FY06A	FY07E	FY08E	FY09E	FY10E
Gross operating margin	16.8%	19.5%	19.5%	17.8%	17.0%
Operating margin	12.0%	14.3%	14.3%	13.2%	12.5%
Operating profit growth y-o-y	11.1%	7.6%	5.4%	8.9%	3.1%
Recurrent income growth y-o-y	20.5%	9.1%	7.4%	10.1%	4.6%
Reported RoE	10.6%	10.4%	9.9%	9.8%	9.5%
RoCE (EBIT)	11.7%	16.5%	15.7%	16.0%	15.6%
Net debt / (equity+minorities) %	0.5%	-0.6%	-0.9%	-3.3%	-4.8%
Net debt / EBITDA %	3%	-3%	-4%	-16%	-24%
EBITDA / net interest	8.4x	8.1x	8.7x	9.6x	10.4x
Reported net income / dividends	2.3x	1.9x	1.8x	1.8x	1.8x

Market valuation
€ million

	FY06A	FY07E	FY08E	FY09E	FY10E
Share price (year-end / current)	98.2	98.2	98.2	98.2	98.2
Number of shares (million)	659	660	660	660	660
Market capitalisation	64,751	64,772	64,772	64,772	64,772
EV adjustment	28,909	28,027	27,294	25,109	23,313
Enterprise value	93,660	92,799	92,066	89,882	88,085

Company In-Depth

4 April 2007 | 15 pages

E.ON AG (EONG.DE)

Next Trigger: Capital Return in June?

Rating change ☐
Target price change ☐
Estimate change ☑

- **Reinstating Coverage: Buy/ Medium Risk** — We are resuming coverage of E.On with a price target of €130. E.On looks set to emerge from the Spanish saga with a consolation package of assets chiefly in Italy, France and Spain. We project FY08E EPS enhancement of 7%, placing E.On on an underlying P/E of 11.1x.

- **€3-4 per E.On Share of Value Creation** — We expect the deal will complete in about 6 months, assuming no further obstacles in Spain. The €10bn E.ON will pay is in line with our valuation of the assets concerned. Operational synergies might account for a further €0.5 per share of value for E.ON, while the benefit of leveraging up the E.ON balance sheet provides a further €2.9-3.7 per share.

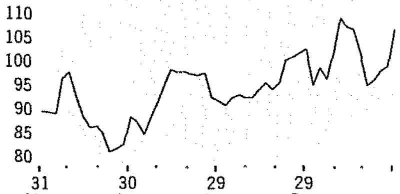
- **Strategically Incremental** — The Italian assets appear to be the most attractive, but we think E.On will struggle to grow this business significantly. Acquisition and investment opportunities appear even more limited in Spain and France.

- **€15-30bn Residual Firepower** — The deal leaves E.On with some €15bn of additional debt capacity on its balance sheet, with a further €15bn of resources in the form of non-strategic financial assets (€11bn of which is accounted for by the 6.4% stake in Gazprom).

- **Capital Return in June?** — Concerns over reinvestment risks remain, but are likely to diminish as investors become convinced that E.On is not about to embark on a major new bid elsewhere. The key trigger in this regard is the planned announcement of new financial targets in June. We think a share buy-back of, say, 10% of E.On's capital might be simultaneously announced.

Buy/Medium Risk	**1M**
Price (04 Apr 07)	€107.04
Target price	€130.00
Expected share price return	21.4%
Expected dividend yield	3.8%
Expected total return	***25.3%***
Market Cap	€74,072M
	US$98,771M

Price Performance (RIC: EONG.DE, BB: EOA GR)



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

E.ON AG (EUR)

Year to 31 Dec	2005A	2006A	2007E	2008E	2009E
Sales (€M)	51,616.0	64,197.0	64,640.8	65,018.9	64,652.8
Net Income (€M)	3,640.0	4,337.0	4,931.1	5,090.8	5,155.8
Diluted EPS (€)	5.52	6.58	7.48	7.72	7.82
Diluted EPS (Old) (€)	5.49	6.54	7.84	8.27	8.24
PE (x)	19.4	16.3	14.3	13.9	13.7
EV/EBITDA (x)	9.1	7.2	6.7	6.5	6.5
DPS (€)	7.00	3.35	4.10	4.20	4.30
Net Div Yield (%)	6.5	3.1	3.8	3.9	4.0

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Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	19.4	16.3	14.3	13.9	13.7
EV/EBITDA adjusted (x)	9.1	7.2	6.7	6.5	6.5
P/BV (x)	1.6	1.5	1.4	1.4	1.4
Dividend yield (%)	6.5	3.1	3.8	3.9	4.0
Per Share Data (€)					
EPS adjusted	5.52	6.58	7.48	7.72	7.82
EPS reported	11.24	7.60	7.48	7.72	7.82
BVPS	67.49	72.59	74.19	75.66	77.14
DPS	7.00	3.35	4.10	4.20	4.30
Profit & Loss (€M)					
Net sales	51,616	64,197	64,641	65,019	64,653
Operating expenses	-45,564	-57,452	-56,663	-56,608	-55,934
EBIT	**6,052**	**6,745**	**7,978**	**8,411**	**8,719**
Net interest expense	-736	-687	-735	-891	-1,076
Non-operating/exceptionals	1,836	-974	795	810	826
Pre-tax profit	**7,152**	**5,084**	**8,038**	**8,330**	**8,470**
Tax	-2,261	323	-2,607	-2,715	-2,763
Extraord./Min.Int./Pref.div.	2,516	-399	-500	-525	-551
Reported net income	**7,407**	**5,008**	**4,931**	**5,091**	**5,156**
Adjusted earnings	3,640	4,337	4,931	5,091	5,156
Adjusted EBITDA	9,234	10,337	11,249	11,900	12,420
Growth Rates (%)					
Sales	21.8	24.4	0.7	0.6	-0.6
EBIT adjusted	5.3	12.2	12.9	5.4	3.5
EBITDA adjusted	-1.2	11.9	8.8	5.8	4.4
EPS adjusted	11.3	19.1	13.7	3.2	1.3
Cash Flow (€M)					
Operating cash flow	**6,466**	**7,086**	**7,095**	**7,324**	**7,605**
Depreciation/amortization	2,901	3,203	3,131	3,347	3,564
Net working capital	-1,010	-1,291	-649	-652	-654
Investing cash flow	**1,751**	**-1,978**	**-6,337**	**-7,387**	**-7,387**
Capital expenditure	-2,990	-4,083	-6,337	-7,387	-7,387
Acquisitions/disposals	4,741	2,105	0	0	0
Financing cash flow	**-10,414**	**-8,926**	**-1,598**	**410**	**129**
Borrowings	-8,567	-4,099	852	3,362	3,160
Dividends paid	-1,788	-4,856	-2,450	-2,952	-3,031
Change in cash	**-2,197**	**-3,818**	**-840**	**347**	**347**
Balance Sheet (€M)					
Total assets	**126,562**	**127,232**	**130,077**	**134,782**	**139,282**
Cash & cash equivalent	9,897	6,187	5,000	5,000	5,000
Accounts receivable	7,179	9,756	9,951	10,150	10,353
Net fixed assets	41,323	42,712	46,258	50,607	54,712
Total liabilities	**77,344**	**74,470**	**76,010**	**79,478**	**82,729**
Accounts payable	5,288	5,305	5,411	5,519	5,630
Total Debt	14,362	13,399	14,251	17,613	20,773
Shareholders' funds	**49,218**	**52,762**	**54,066**	**55,304**	**56,554**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	17.9	16.1	17.4	18.3	19.2
ROE adjusted	9.3	9.4	10.2	10.3	10.2
ROIC adjusted	5.7	10.2	7.2	7.2	7.2
Net debt to equity	9.1	13.7	17.1	22.8	27.9
Total debt to capital	22.6	20.3	20.9	24.2	26.9

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Next Trigger: Capital Return in June?

Reinstating Coverage: Buy/ Medium Risk

E.On is set to emerge from the bidding battle in Spain with a consolation prize in the form of assets chiefly in Spain, Italy and France. We think these assets are strategically incremental for E.On, rather than transformational. But E.On is not overpaying, in our view, and this is a much better outcome than the stalemate that was looking increasingly likely. We estimate E.On's FY08E EPS will be enhanced by some 7% should the deal complete, on which basis we calculate that the stock is currently trading on an FY08E P/E of just 11.1x (ex Gazprom). With €15-30bn of firepower still in its coffers, concerns over reinvestment risk at E.On may linger. However, we think no major acquisition is likely for at least the next 12 months or so, and we look to the potential announcement of a capital return in June as the next major trigger for the stock.

Strategic Fit

E.On announced on 2 April 2007 that it had reached an agreement that should hopefully see it emerge from the Spanish M&A saga with a consolation prize: a selection of assets in Spain, Italy and France, for which it will pay around €10bn (an exact number will be determined in due course). The assets are predominantly made up of around 12GW of generating capacity, with some near-term development opportunities.

Incremental rather than transformational

The final outcome of the Spanish M&A saga is pretty much as good as E.On's shareholders could have hoped for given the direction recent developments were taking. Nonetheless, we believe that the assets that E.On has agreed to acquire are of mixed quality and that growth opportunities will be incremental, rather than transformational, to E.On's strategy:

- **Italy.** E.On should end up with a minimum 70% share in 7.0GW of capacity in Italy. We believe this is the most attractive set of existing assets that E.On will acquire. It should build upon E.On's existing undersized Italian presence with a mix of repowered gas plant, wind and hydro. There is also a fit with E.On's gas strategy: the Italian assets include a 2bcm share of regasification capacity at the Livorno LNG terminal, due onstream in 2008. Although there are some development opportunities, including 216MW of new wind and 800MW of new CCGT (on top of the 800MW E.On is already developing itself), we believe the nature of the Italian market limits scope for significant further expansion. For example, it is very difficult to obtain permits for new CCGT build in Italy and there are virtually no opportunities for significant acquisitions.

- **Spain.** Through Viesgo and the other Spanish assets that E.On has agreed to pick up, E.On will gain access to 4.3GW of generating capacity. In addition, CCGT development currently underway should see capacity grow to 6.4GW by 2010. This will leave E.On the no.4 player in Spain, but with limited market power and relatively old assets. This could prove challenging in an increasingly competitive generation market where we foresee growing overcapacity in the next 2-3 years. While there are opportunities for organic growth, we believe E.On will struggle to achieve significant market share through acquisitions, given the complex Spanish cross-shareholdings in other incumbent utilities.

- **France.** E.On should also receive 100% of SNET in France. SNET has 2.5GW of dispersed coal-fired generating capacity. However, this amounts to market share of less than 3%. While there are some limited organic development opportunities for CCGT and repowering, we think it is unlikely that E.On could ever be a significant player in France as long as EdF and GdF are allowed to dominate the energy market. Indeed, E.On itself is unclear at this stage about its French ambitions.

Not a done deal yet

It is also important to remember that this €10bn transaction is not yet a done deal. The board of E.On's original target in Spain eventually backed E.On's offer because the board did not want to see its business broken up. It is possible that it could seek to create obstacles that prevent this new transaction from completing.

The new transaction will also need regulatory approvals from the EU and the CNE in Spain, although we do not anticipate any issues here. The EU approved the original bid, while the CNE is likely to find the new transaction more palatable than before.

Valuation and Earnings Implications

Proposed price appears value neutral

A €10bn acquisition prices implies an FY07E EV/EBITDA of 7.3x, according to our estimates. This does not seem unreasonable, given our view that 7-8x EBITDA is a fair multiple range for mid-life coal and CCGT generation assets[1]. The €10bn acquisition price is also broadly consistent with our bottom-up valuations for the assets (Figure 1). So, it seems the expected acquisition price is broadly value neutral.

Figure 1. Valuation of Asset Package (€M)

	Valuation	Comment
Italy (70%)	4,347	€600+/kW thermal, €1400+/kW renew. (70% stake), dev. pipeline at €250/kW
Spain - Viesgo	2,925	8.5x FY07E EV/EBITDA (includes generation at €590/kW)
Spain - Other	1,346	€590/kW, development @ €250/kW
France - SNET	1,467	€500/kW inc. Poland/Turkey
Total	**10,085**	

Source: Citigroup Investment Research

Leverage

Tax shield worth €2.0-2.6bn

While the proposed €10bn price seems to be broadly value neutral, we also need to consider the leverage benefits. E.On is likely to pay some €550m additional interest in the back of this debt, which would shield €215m of tax using a tax rate of 39% (or, if German tax reforms are successful, €165m using a 30% tax rate). Placing this saving on a 12.0x P/E multiple implies a valuation benefit of €2.0-2.6bn, or €2.9-3.7/share.

[1] See p.26-27 of our January sector report, "Utilities 2007: Winter Edition" https://www.citigroupgeo.com/pdf/SEU03846.pdf

Synergies

Synergies potentially worth €0.5/share

E.On does have some areas of overlap with the assets it is planning to acquire. In Italy, E.On has a supply and trading operation, as well as 0.85m gas customers and an 800MW CCGT under the course of construction. In addition, there is a small gas and power sales operation. Based on E.On's previous indications, we think synergies are likely to amount to around €50m a year. Based on a 7x EBITDA multiple, these might have a value in the region of €350m, or €0.5 per E.On share.

Earnings Enhancement

7% EPS enhancement in FY08

Figure 2 sets out our estimates for the assets E.On is buying as well as the potential impact on E.On's financials assuming the deal completes at the beginning of 4Q06. As a debt-financed transaction on a relatively low multiple, the impact on earnings is significant. We estimate 7% earnings enhancement in FY08. These forecasts, however, do not take into account any potential asset revaluation which may accompany the integration into E.On.

Figure 2. Impact of Acquisition on Financial Forecasts (€M Unless Stated)

	2007 E	2008 E	2009 E	2010 E
Italian assets (70%)				
EBITDA	651	672	680	663
EBIT	522	530	525	500
SNET (100%)				
EBITDA	220	253	276	322
EBIT	114	139	154	192
Viesgo (100%)				
EBITDA	285	328	358	389
EBIT	211	242	264	286
Other generation in Spain				
EBITDA	210	243	282	282
EBIT	147	171	201	207
TOTAL to EON				
EBITDA	1366	1496	1596	1656
EBIT	993	1082	1144	1185
Capital expenditure	1352	1326	1105	678
Capital employed	10,000	10,912	11,565	11,772
ROCE	9.9%	9.9%	9.9%	10.1%
E.On standalone EBITDA	12,043	12,710	13,246	13,601
E.On EBITDA with these assets	12,385	14,206	14,842	15,257
E.On standalone EPS (€)	7.48	7.72	7.82	7.77
E.On EPS with these assets (€)	7.47	8.24	8.37	8.36
EPS enhancement	**0%**	**7%**	**7%**	**8%**
E.On standalone net debt	2,307	5,669	8,829	11,891
E.On net debt with these assets	12,548	16,465	19,923	22,806
E.On standalone net debt+provisions/EBITDA	1.7	1.9	2.1	2.3
E.On net debt+provisions/EBITDA with these assets	2.5	2.5	2.6	2.8
remaining balance sheet capacity for 3.5x		**14,815**	**13,049**	**11,253**
E.On standalone ROCE	14.0%	13.8%	13.4%	13.0%
E.On ROCE with these assets	12.4%	13.2%	13.0%	12.6%

Source: Citigroup Investment Research

Valuation Multiples

FY08E underlying P/E of 11.1x

Figure 3 provides the *valuation multiples at the current E.On share price*. If the 6.4% stake in Gazprom is stripped out at the current stock market value (€15 per E.On share), then E.On is trading on an FY08E P/E of just 11.1x if the acquisition is factored into our forecasts.

Assuming a payout ratio in the middle of the stated 50-60% range, E.On would also be trading at a modest yield premium to the sector.

Figure 3. Valuation Multiples

	FY07E	FY08E
PE (pre-exceptional)		
E.On	14.3	13.9
E.On with acquisition	14.3	13.0
E.On ex Gazprom	12.2	11.9
E.On with acquisition ex Gazprom	12.3	11.1
Sector average	16.8	15.7
EV/EBITDA (adjusted, pre-associates)		
E.On	6.6	6.5
E.On with acquisition	8.2	7.0
Sector average	8.3	8.0
Dividend yield based on 55% payout ratio		
E.On	3.8%	4.0%
E.On with acquisition	3.8%	4.2%
Sector average	3.6%	3.9%

Source: Citigroup Investment Research

Sum of Parts

SoP €132 on a leveraged basis

Our latest E.On SoP is set out in Figure 4. This is a standalone SoP which does not factor in the potential acquisition of the assets as a result of the current deal. As set out above, we think E.On is paying a reasonable price for these assets so that the deal should have more or less a neutral impact on the SoP.

Note that our SoP is a leveraged SoP, based on discount rates and EBITDA multiples that are appropriate for a business with a reasonable amount of leverage rather than for the existing underleveraged E.On balance sheet. As a result, we expect the share price only to reach this goal over the next 12-18 months if E.On manages to achieve a net debt/EBITDA multiple of, says, 3.0-3.5x over that timeframe.

Figure 4. E.On Sum of Parts

	Value (€m)	Value per share (€m)	Method	FY07E EBITDA (€m)	Realitly check
Central Europe	51,856	75	Chiefly based on DCF of component parts	6,003	8.6x FV/EBITDA multiple in 2007E
Pan-European gas	15,941	23	DCF/RAB benchmarking	1,975	8.1x FV/EBITDA multiple in 2007E
UK	13,643	20	£0.4m perMW, £160 per customer and 10% premium to RABs	1,875	7.3x FV/EBITDA multiple in 2007E
Nordic	9,951	14	Assumed EBITDA multiple - in line with Fortum SoP	1,244	8.0x FV/EBITDA multiple in 2007E
US-Midwest	3,981	6	Assumed EBITDA multiple	531	7.5x FV/EBITDA multiple in 2007E
Corporate centre	-2,653	-4	Assumed EBITDA multiple	-379	7.0x FV/EBITDA multiple in 2007E
Total core businesses (ex associates)	92,720	134		11,249	8.2x FV/EBITDA multiple in 2007E
Financial assets	22,475	32	Book value at 30/9/06 save for Gazprom which is marked to market	795	
of which 6.43% of Gazprom	10,664	15	Current market value		
Total	115,195	166		12,043	11.3x FV/EBITDA multiple in 2007E
Net cash	-2,307	-3	Forecast book value at 31/12/07		
Pension liabilities	-3,930	-6	Forecast book value at 31/12/07		
Nuclear liabilities	-8,171	-12	Based on our model - current book value is €12.3bn		
Other liabilities	-4,254	-6	Based on our model - current book value is €13.0bn		
Minorities	-5,167	-7	Forecast book value at 31/12/07		
Net equity value	91,366	132			15.6x P/E multiple (ex Gazprom) in 2007E

Source: Citigroup Investment Research

What Next?

€15bn of debt capacity

The transaction leaves E.On with plenty of firepower for further deals. Pure net debt/EBITDA would stand at just 1.2x for FY08E according to our estimates. However, if pension and nuclear provisions are also included in the net debt estimate, this rises to 2.5x.

Assuming a ceiling of 3.5x (on the basis that this is likely to be the maximum that is consistent with E.On's goal to preserve an A flat credit rating), we estimate E.On has around €15bn of additional debt capacity on its balance sheet.

In addition, E.On has substantial additional capacity in its financial assets. Aside from the financial assets included in E.On's net debt definition and stripping out equity accounted assets, we estimate an additional c€15bn of financial resources is accounted for by these assets.

€15bn of financial assets

Figure 5. Financial Assets at E.On

	Amount (€bn)	Comment
6.4% of Gazprom	10.7	Based on stock market valuation post-tax on 4 April 2007.
Other financial assets	3.8	Based on book value at 31 December 2006
Total	14.5	

Source: Company Reports, Reuters and Citigroup Investment Research

In total, then, E.ON could still muster some €30bn for a future debt-financed acquisition.

There is clearly danger that reinvestment risk continues to overhang the share price. Our view, however, is that a further major acquisition is pretty unlikely in the next 12 months or so.

Russia, LNG and Upstream

CEO Wulf Bernotat has clearly indicated that no additional major acquisitions are currently contemplated. Instead, E.On will seek to make investments in the existing areas it has already highlighted (i.e. Russia, LNG, upstream oil and gas). Our view is that these are likely to be in the sub €5bn range.

Continued speculation may surround Scottish & Southern and (perhaps) Suez from time to time. Our view is that Suez is highly unlikely as a target for E.On given the politics of the situation. Scottish & Southern is more plausible, but having walked away from Scottish Power at 570p, Bernotat is hardly likely to stump up the £20/share or so that we think the SSE management team would be looking for.

Share Buy-back in June?

Next major trigger

We look to the E.On management team to reassure investors on this front on future roadshows. However, the greatest reassurance could come from the planned announcement by E.On of new financial targets in June.

We think these are likely to involve a commitment to a particular set of balance sheet ratios. Ideally, we would like to see E.On shift to a new policy of actively managing its balance sheet using, for example, an ongoing share buy-back as a means of keeping the capital structure in trim. We think there is a chance that E.On could announce an immediate 10% share buy-back at the same time as the targets are unveiled. This would clearly have a significantly positive impact on the shares, in our view.

Financial Forecasts

On the following tables we provide our latest financial forecasts for E.On on a standalone basis. These have been fully updated for the FY06 results announcement, which prompted a modest downgrade to our earnings expectations amounting to 5% in FY07.

Figure 6. Divisional Breakdown (€m)

Adjusted EBIT	**2005A**	**2006A**	**2007E**	**2008E**	**2009E**	**2010E**	**2011E**
Central Europe	3,930	4,168	4,803	5,059	5,290	5,209	5,211
Pan-European Gas	1,536	2,106	1,992	2,145	2,034	1,930	1,829
UK	963	1,229	1,296	1,211	1,339	1,451	1,565
Nordic	766	619	890	1,016	1,089	1,165	1,242
US-Midwest	365	391	347	348	346	494	493
Corporate centre/consolidation	-399	-416	-416	-416	-416	-416	-416
Core businesses	7,161	8,097	8,913	9,363	9,682	9,833	9,924
Viterra	0	0	0	0	0	0	0
Degussa	132	53	0	0	0	0	0
Total continuing operations	7,293	8,150	8,913	9,363	9,682	9,833	9,924

Source: Company Reports and Citigroup Investment Research

Figure 7. Key Financial Figures

	2005 A	2006 A	2007 F	2008 F	2009 F	2010 F	2011 F
EPS from ongoing operations (€)	6.60	7.48	7.48	7.72	7.82	7.77	7.67
EPS from discontinued operations/other (€)	4.64	0.19	0.00	0.00	0.00	0.00	0.00
Total reported group EPS (€)	11.24	7.67	7.48	7.72	7.82	7.77	7.67
Adjusted EPS (€)	5.52	6.65	7.48	7.72	7.82	7.77	7.67
DPS (€)	7.00	3.35	4.10	4.20	4.30	4.40	4.50
Cashflow/share (€)	11.1	12.5	11.4	11.7	12.1	12.4	12.6
Free cash flow (€m)	3,554	3,111	758	-63	218	396	583
Net cash (debt) (E.On definition) (€m)	1,917	-268	-2,307	-5,669	-8,829	-11,891	-14,845
Gearing	9%	14%	17%	23%	28%	33%	37%
Payout ratio based on clean earnings	50%	50%	55%	54%	55%	57%	59%

Source: Company Reports and Citigroup Investment Research

Figure 8. Group Financial Forecasts (€m)

Profit and Loss	2005 A	2006 A	2007 F	2008 F	2009 F	2010 F	2011 F
Sales	56,141	67,759	64,641	65,019	64,653	65,436	66,248
Operating costs	46,829	57,363	53,392	53,119	52,233	52,677	53,222
Adjusted EBITDA before associates	9,312	10,396	11,249	11,900	12,420	12,758	13,026
Adjusted EBITDA including associates	10,194	11,353	12,043	12,710	13,246	13,601	13,885
Depreciation	-2,901	-3,203	-3,131	-3,347	-3,564	-3,768	-3,961
Adjusted EBIT	7,293	8,150	8,913	9,363	9,682	9,833	9,924
of which associates & income from investments	882	957	795	810	826	843	859
Adjusted interest income	-1,027	-1,081	-875	-1,033	-1,212	-1,384	-1,551
Net book gains	491	1,205	0	0	0	0	0
Restructuring costs and non-operating earnings	-29	0	0	0	0	0	0
Other non-operating earnings	424	-3,141	0	0	0	0	0
Pre-tax profit	7,152	5,133	8,038	8,330	8,470	8,448	8,373
Tax	-2,261	323	-2,607	-2,715	-2,763	-2,748	-2,712
Minorities	-536	-526	-500	-525	-551	-578	-607
Discontinued items/other	3,052	127	0	0	0	0	0
Net attributable profit	7,407	5,057	4,931	5,091	5,156	5,122	5,054
Adjusted net attributable profit	3,640	4,386	4,931	5,091	5,156	5,122	5,054

Cash flow	2005 A	2006 A	2007 F	2008 F	2009 F	2010 F	2011 F
Gross cash flow	6,544	7,194	7,095	7,324	7,605	7,783	7,971
Capex	-2,990	-4,083	-6,337	-7,387	-7,387	-7,387	-7,388
Acquisitions/other investments	-1,553	-1,849	0	0	0	0	0
Disposal proceeds	6,294	3,954	0	0	0	0	0
Dividends	-1,788	-4,856	-2,450	-2,952	-3,031	-3,110	-3,190
Issue/(redemption) of group equity	-59	29	0	0	0	0	0
Other/change in scope of consolidation	-4,596	-3,136	0	0	0	0	0
Change in net debt	1,852	-2,747	-2,039	-3,362	-3,160	-3,062	-2,954

Balance Sheet	2005 A	2006 A	2007 F	2008 F	2009 F	2010 F	2011 F
Intangible assets	4,125	3,749	3,409	3,100	2,819	2,563	2,331
Property plant and equipment	41,323	42,712	46,258	50,607	54,712	58,586	62,245
Financial assets	27,867	29,696	30,093	30,498	30,912	31,333	31,763
Stocks	2,457	3,990	4,050	4,111	4,172	4,235	4,235
Receivables	19,240	19,754	19,949	20,148	20,351	20,558	20,769
Cash and equivalents	9,897	6,187	5,000	5,000	5,000	5,000	5,000
Other assets	1,054	957	957	957	957	957	957
Total assets	105,963	107,045	109,717	114,422	118,922	123,232	127,300
Debt	-14,362	-13,399	-14,251	-17,613	-20,773	-23,835	-26,789
Provisions	-33,862	-32,093	-32,673	-33,092	-33,494	-33,886	-34,260
Trade creditors	-5,288	-5,305	-5,411	-5,519	-5,630	-5,742	-5,857
Other liabilities	-15,412	-15,760	-15,762	-15,341	-14,920	-14,499	-14,080
Minorities	-4,734	-4,917	-5,167	-5,429	-5,705	-5,994	-6,298
Shareholders Funds	44,484	47,845	48,899	49,875	50,849	51,723	52,463

Source: Company Reports and Citigroup Investment Research

E.On AG

Company Description

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

Investment Thesis

We rate E.On Buy/ Medium Risk (1M) with a €130 target price. Now that clarity is emerging in Spain, we think the fundamental value that we see in the stock should increasing be translated into the share price. We think further major acquisitions are unlikely in the near future and that a possible return of capital in June should help convince investors that reinvestment risk is now limited.

Valuation

We use a sum-of-parts method applying a variety of valuation techniques to the various divisions. We chiefly rely on a mix of DCF valuations, regulatory asset basis and EV/EBITDA multiples. Financial assets are taken at book value, save for the stake in Gazprom, which is marked to market. Nuclear liabilities are subtracted at a value generated by a separate DCF model. Pension provisions are deducted at book value and a portion of the book value of "other" provisions is also subtracted. Our latest SOP valuation is €132 per share on a standalone basis, and we have €130 as our target price. We cross-check our sum-of-parts valuation by reference to valuation multiples at group level. At our target price, E.On would trade on a FY08E P/E of 14.9x if the value of the Gazprom stake is stripped out of the E.On share price. Factoring-in the planned €10bn asset acquisition, this would fall to 13.9x, representing a c.10% discount to the sector average, which we think reasonably reflects E.On's "megacap" status and the geographic diversity of its assets.

Risks

We rate E.On as Medium Risk. Risks that may affect the achievement of our target price include the possibility that power prices might fall, as well as regulatory risks in both the gas and the electricity markets. There is also a risk of further uncertainty in Spain. With regard to the investment thesis and achievement of our target price, these could be undermined by renewed competition in German generation or by regulatory change proving more severe than we anticipate. In addition, E.On may make a value-destructive acquisition outside Spain. If competition does erupt in the German gas market, then Ruhrgas would probably need to renegotiate its long-term gas purchasing contracts.

Appendix A-1

Analyst Certification

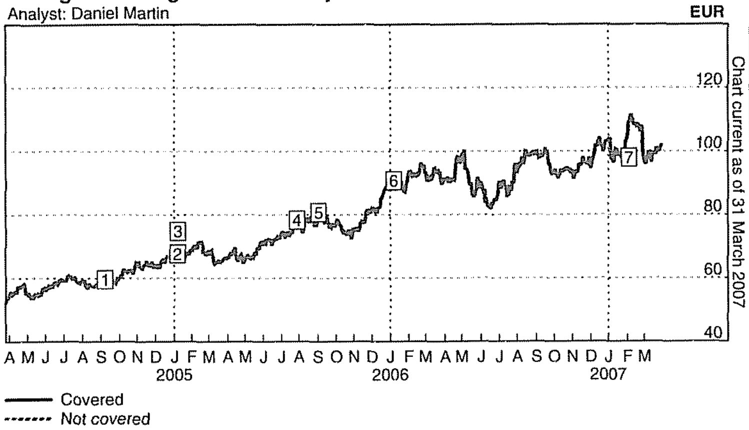
We, Daniel Martin, Peter Bisztyga and Alberto Ponti, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

E.ON (EONG.DE)

Ratings and Target Price History - Fundamental Research

Analyst: Daniel Martin



#	Date	Rating	Target Price	Closing Price
1:	8 Sep 04	*1M	*70.00	58.10
2:	7 Jan 05	1M	*75.00	67.71
3:	7 Jan 05	1M	75.00	67.71
4:	28 Jul 05	1M	*86.00	76.40
5:	2 Sep 05	1M	*90.00	78.84
6:	6 Jan 06	1M	*100.00	88.18
7:	5 Feb 07	1M	*130.00	108.97

*Indicates change

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ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

E.ON AG

Catalysts for a re-rating

Coverage Resumed **BUY**

Equity | Germany | Electric Utilities
30 April 2007

Merrill Lynch

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Time for strategic shift

E.on has reached a strategic crossroads in our view, following the demise of the Spanish bid. The company now needs a credible and achievable strategy which meets three main ends: firstly, generates superior medium term earnings growth; secondly, re-leverages the balance sheet to improve financial efficiency; and thirdly, boosts the share price rating. We believe management should give serious thought to a shift in investment focus away from transforming M&A deals to organic growth, a major share buyback programme; as well as a progressive dividend policy.

PO 130/sh, higher upside potential

The shares have underperformed the sector by 20% since early 2006, and are cheap on most measures, trading at 7.1x 2008E EV/EBITDA - well below the utility sector on 8.5x. A shift in strategy, implying higher EPS growth, and a buyback, would be significant catalysts for a re-rating in our view. We can envisage upside valuation potential to EUR133/sh; and as high as EUR173-185/sh *if management ran the business to maximise shareholder returns.*

We are resuming coverage with a Buy recommendation and Price Objective of EUR130/share implying 21% upside.

Added to Europe 1

We are also adding E.on to our Europe 1 list of preferred stocks.

Estimates (Dec)

(EUR)	2005A	2006A	2007E	2008E	2009E
	IFRS	IFRS	IFRS	IFRS	IFRS
EPS (Reported)	11.24	7.67	7.25	8.07	8.34
EBITDA (Adjusted)	10,194	11,353	11,923	12,968	13,395
EPS (Adjusted)	5.52	6.66	7.25	8.07	8.34
EPS Change (YoY)	NA	20.5%	8.9%	11.4%	3.4%
Dividend / Share	2.75	3.35	3.98	4.44	4.59
ADR EPS (Adjusted - US$)	2.29	2.78	3.29	3.67	3.79
ADR Dividend / Share (US$)	1.14	1.52	1.81	2.02	2.09

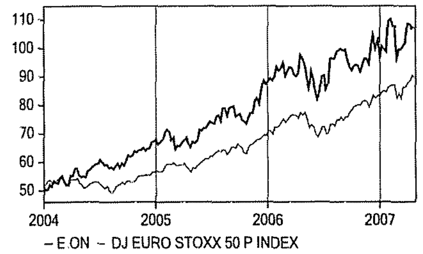
Valuation (Dec)

	2005A	2006A	2007E	2008E	2009E
P/E	19.4x	16.1x	14.8x	13.3x	12.9x
Dividend Yield	2.55%	3.11%	3.70%	4.12%	4.26%
EV / EBITDA*	10.4x	9.31x	8.87x	8.15x	7.89x
Free Cash Flow Yield*	3.67%	2.87%	0.17%	3.03%	3.77%
EV/EBITDA (Adjusted)	NA	NA	7.70x	7.10x	6.91x

* For full definitions of *iQmethod*SM measures, see page 16

Stock Data

Price (Common / ADR)	EUR107.32 / US$48.89
Price Objective	EUR130.00 / US$59.30
Date Established	30-Apr-2007 / 30-Apr-2007
Investment Opinion	A-2-7 to B-1-7 / A-2-7 to B-1-7
Volatility Risk	MEDIUM / MEDIUM
52-Week Range	EUR81.05-EUR113.72
Market Value (mn)	EUR70,831
Shares Outstanding (mn)	660.0 / 1,982.0
Average Daily Volume	4,674,696
ML Symbol / Exchange	EONAF / GER
ML Symbol / Exchange	EON / NYS
Bloomberg / Reuters	EOA GR / EONG.DE
ROE (2007E)	9.4%
Net Dbt to Eqty (Dec-2006A)	0.5%
Est. 5-Yr EPS / DPS Gwth	6.6% / 8.5%
Free Float	91.1%



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Refer to important disclosures on page 17 to 18. Analyst Certification on page 15. Price Objective Basis/Risk on page 15.

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iQprofile℠ E.ON AG

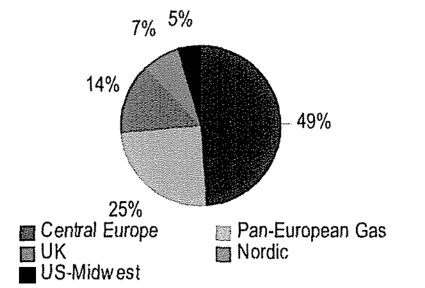
Key Income Statement Data (Dec)	2005A	2006A	2007E	2008E	2009E
(EUR Millions)	IFRS	IFRS	IFRS	IFRS	IFRS
Sales	56,141	67,759	67,093	67,527	69,580
EBITDA Adjusted	10,194	11,353	11,923	12,968	13,395
Depreciation & Amortization	(2,901)	(3,203)	(3,245)	(3,330)	(3,373)
EBIT Adjusted	7,293	8,150	8,678	9,638	10,022
Net Interest & Other Income	(1,027)	(1,081)	(1,157)	(1,105)	(1,084)
Tax Expense / Benefit	(2,261)	323	(2,106)	(2,389)	(2,503)
Net Income (Adjusted)	3,640	4,386	4,782	5,327	5,507
Average Fully Diluted Shares Outstanding	659	659	660	660	660
Key Cash Flow Statement Data					
Net Income (Reported)	7,407	5,057	4,782	5,327	5,507
Depreciation & Amortization	2,901	3,203	3,245	3,330	3,373
Change in Working Capital	(532)	(1,568)	18 9	(145)	(264)
Deferred Taxation Charge	0	0	0	0	0
Other Adjustments, Net	(3,232)	502	(380)	701	771
Cash Flow from Operations	6,544	7,194	7,665	9,212	9,388
Capital Expenditure	(3,941)	(5,161)	(7,546)	(7,059)	(6,709)
(Acquisition) / Disposal of Investments	(985)	(1,078)	(1,443)	(441)	(441)
Other Cash Inflow / (Outflow)	5,368	1,738	1,443	441	441
Cash Flow from Investing	442	(4,501)	(7,546)	(7,059)	(6,709)
Share Issue / (Repurchase)	(26.0)	1.00	0	0	0
Cost of Dividends Paid	(1,788)	(4,856)	(2,502)	(3,006)	(3,357)
Cash Flow from Financing	(6,458)	(5,849)	(2,502)	(3,006)	(3,357)
Non Cash Changes to Debt	(295)	(38 0)	0	0	0
Change in Net Debt	(5,434)	2,096	2,383	853	679
Net Debt	(1,917)	268	2,277	3,244	3,922
Key Balance Sheet Data					
Property, Plant & Equipment	45,448	46,461	53,059	56,789	60,125
Goodwill	15,363	15,124	14,608	14,728	14,728
Other Intangibles	NA	NA	NA	NA	NA
Other Non-Current Assets	21,505	23,215	24,658	25,098	25,539
Trade Receivables	8,269	9,756	9,660	9,723	10,018
Cash & Equivalents	16,279	13,131	10,748	9,895	9,217
Other Current Assets	19,698	19,545	18,798	18,818	18,955
Total Assets	126,562	127,232	131,531	135,051	138,582
Long-Term Debt	14,362	13,399	13,025	13,139	13,139
Other Non-Current Liabilities	43,930	41,857	40,228	40,113	39,956
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	19,052	19,214	19,098	19,040	19,193
Total Liabilities	77,344	74,470	72,351	72,292	72,288
Total Equity	49,218	52,762	59,180	62,759	66,294
Total Equity & Liabilities	126,562	127,232	131,531	135,051	138,582
Key Metrics					
iQmethod*℠ - Bus Performance					
Return On Capital Employed	4.48%	6.81%	5.66%	6.05%	6.11%
Return On Equity	9.33%	9.50%	9.40%	9.60%	9.40%
Operating Margin	13.0%	12.0%	12.9%	14.3%	14.4%
Free Cash Flow (MM)	2,603	2,033	119	2,153	2,678
iQmethod*℠ - Quality of Earnings					
Cash Realization Ratio	1.80x	1.64x	1.60x	1.73x	1.70x
Asset Replacement Ratio	1.36x	1.61x	2.33x	2.12x	1.99x
Tax Rate	36.1%	NM	28.0%	28.0%	28.0%
Net Debt/Equity	-3.89%	0.51%	3.85%	5.17%	5.92%
Interest Cover	7.05x	7.36x	7.33x	8.52x	9.03x

* For full definitions of *iQmethod*℠ measures, see page 16

Company Description

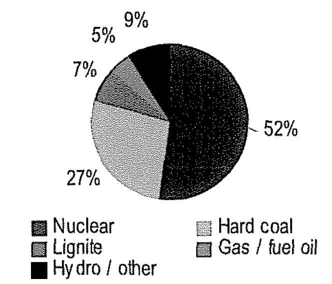
E.ON has transformed itself from domestic conglomerate to Europe's biggest energy utility, with a portfolio of mainly vertically integrated assets across Germany, Central Europe, the Nordic Region, the UK and the US. It is active in both electricity and gas and its subsidiary Ruhrgas is likely to be central to future growth from this platform as power/gas convergence gathers pace over the next decade.

Chart 1: 2006A EBIT



Source: Company Data

Chart 2: Generation Output Germany



Source: Company data

Stock Data

Shares / ADR	0.33
Price to Book Value	1.3x

Time for strategic shift

The end of the campaign in Spain could be the best thing to happen to E.on, and its shareholders. The failure to execute a major M&A deal and lack of opportunities elsewhere should, in our view, force management to recognise that it has reached a strategic crossroads.

E.on now needs a credible and achievable strategy which meets three main ends. Firstly, **generates superior medium term earnings growth**; secondly, **re-leverages the balance sheet** to improve financial efficiency; and thirdly, **improves the share price rating**. All of these should be axiomatic for any aspirant industry leader, but have been neglected during the last two years of attempted empire building.

The month elapsed since the bid failed should have provided sufficient time for consideration of these challenges. We expect management to be aiming to present plans to the Supervisory Board at the quarterly meeting on May 2nd.

We think that the first step in any re-alignment of the strategy should be a recognition, enunciated to shareholders, that the pursuit of transforming M&A deals is not feasible for the time being. Instead, **the investment focus could be shifted to organic growth**, increasing expenditure on capital projects through the gas and power chain. Bolt-on, infill acquisitions could augment this approach. A clear roadmap for specific projects, and timing, will be needed to bolster the credibility of any material increase in spending plans.

Re-leveraging could be accelerated near term by share buybacks of up to 10% (EUR7.5bn) and a progressive dividend policy. We think **E.on should also consider selling EUR25-30bn of underperforming assets,** which are currently destroying shareholder value. These include the EUR11bn Gazprom stake.

The Supervisory Board may therefore be asked to rubber stamp a complete U-turn in the strategy of the last two years. Plans could be unveiled to shareholders as early as the AGM on May 3rd. Table 1 shows alternative dates during Q2.

Table 1: E.on's Key Dates in Q2

Supervisory Board Meeting	02-May-07
AGM	03-May-07
Q1 Results	09-May-07
Capital Markets Day	25-Jun-07

Source: E.ON

Strategic shift could be a re-rating catalyst

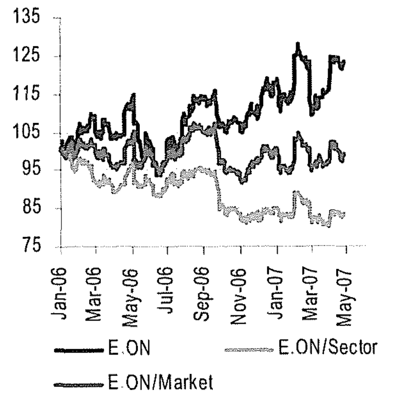
E.on's shares are cheap on most measures, trading at 7.1x 2008E EV/EBITDA, well below the sector on 8.5x. Our Base Case SOP valuation is EUR123/share, implying a multiple of 8.0x. We regard this as a 'business as usual' valuation; with no change to the strategy, for us there is no reason for a re-rating of the shares.

A shift in strategy, implying higher medium term EPS growth and higher returns from a buyback would be significant catalysts to realising substantial upside for investors in our view. We have presented three valuation sensitivity cases, which gives an indication of the potential value release from a more shareholder return-focused strategy.

- **Upside to EUR133**: assumes re-leveraging via a 40-60% increase in organic investment and a 10% share buy-back
- **Upside to EUR173**: releveraging via EUR22.5bn of rolling share buy-backs
- **Upside to EUR185**: releveraging via EUR22.5bn of share buy backs and special dividend of EUR10bn from the sale of the Gazprom stake.

We are resuming coverage with a Buy recommendation and Price Objective of EUR130/share.

Chart 3: E.ON Price Performance



Source: Datastream

What's Next?

The demise of E.on's large scale Iberian venture might, in the end, have been greeted by management with a sense of relief. After all, the Spanish political quagmire, in which E.on's efforts became increasingly bogged down, probably gave a glimpse of what lay ahead had it succeeded. Time to move on....

But move on to what? Fourteen months of gruelling, and largely fruitless, M&A activity in Spain has resulted in a lack of strategic progress. Investors have stuck with E.on through a two-year M&A phase, but two major frustrations need to be addressed if patience is not to wear thin.

- **Poor share price performance**: Since E.on embarked on M&A in Spain in early 2006, the shares have underperformed the sector by 20%; and at the same time underperformed every other large cap utility (even RWE, which has been hit in 2007 by tough CO2 allocations and its own strategic hiatus);

- **Low stock market rating**: *Why do E.on's shares trade at such a discount to the sector?* Ex-Gazprom (and other associates) the discounts are substantial (see Table 2). A priority should be to get E.on trading on a premium rating.

Table 2: Valuation multiples

	EV/EBITDA			EBITDA	P/E			EPS	Div Yield			DPS	FCF Yield		
	2007E	2008E	2009E	CAGR	2007E	2008E	2009E	CAGR	2007E	2008E	2009E	CAGR	2007E	2008E	2009E
Eon	7.7x	7.1x	6.8x	5.1%	14.9x	13.3x	12.9x	6.6%	3.7%	4.1%	4.3%	8.5%	0.2%	3.0%	3.8%
RWE	7.2x	6.7x	6.5x	3.4%	14.3x	12.3x	12.1x	8.8%	4.9%	4.8%	5.3%	1.5%	na	na	na
Fortum	12.7x	10.9x	9.7x	9.4%	19.1x	15.4x	13.4x	11.1%	3.4%(1)	3.9%	4.5%	11.1%	5.6%	5.4%	7.1%
SSE	10.8x	10.0x	9.4x	10.1%	15.2x	13.7x	12.9x	11.9%	3.6%	4.0%	4.4%	11.6%	3.7%	4.1%	4.6%
Competitive Energy	*9.4x*	*8.5x*	*7.9x*	*6.4%*	*20.2x*	*17.2x*	*15.6x*	*9.1%*	*3.1%*	*3.4%*	*3.7%*	*12.0%*	*3.5%*	*4.6%*	*5.4%*

Source: Source: Merrill Lynch estimates, Bloomberg consensus for RWE (1) *Based on regular DPS (Mle €0.77ps)* 4.9% of total DPS (Mle €1.11ps)

Now that any hope of the Spanish 'cure all' major acquisition has disappeared, it seems to us that management needs to acknowledge three main shortcomings.

- **Unexecutable corporate strategy:** The aim to grow via transformational M&A has proven too difficult to achieve, in our view. The premia for control required in the current market may not be justifiable; European opportunities are extremely limited and can be politically 'challenging'; those further afield (say the US) would have dubious fit. Senior management's appetite for any renewed M&A of scale in the near future must be questionable.

- **Under gearing/value deterioration:** The inability to releverage via a major acquisition leaves E.on with minimal net debt. Ongoing balance sheet inefficiency will continue to deteriorate share holder value, which we estimate is costing shareholders EUR1.1bn pa. in EBITDA or almost EUR8bn capitalised (based on the delta between E.on's published WACC (theoretical) and an actual WACC reflective of current debt levels.

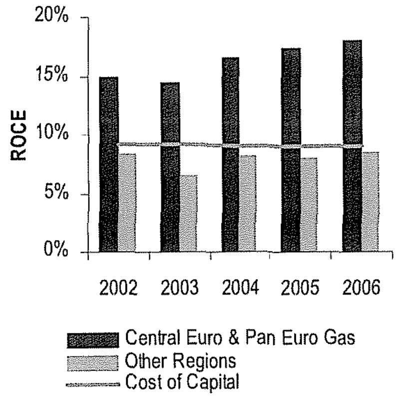
- **Underperforming assets:** The balance sheet is bolstered by EUR20bn of under performing financial assets, of which Gazprom (EUR11bn) is the most glaring example. These comprise an astonishing 27% of current market cap.

A Strategic Shift

We would expect E.on's senior management to recognise investors' frustrations and react to the opportunity for change. A shift away from large scale M&A may appear a capitulation after the bullish messages on growth via consolidation of the last two years.

However, a superficial examination of E.on's returns from previous acquisitions might make the decision a little easier. The UK, Nordic and US businesses, all acquired by E.on between 2001 and 2003, barely meet E.on's WACC – let alone the WACC plus 300bp target for acquisitions for Year 3. The comparison in ROCE between these 'Other Regions' and the domestic businesses are shown in Chart 4. These figures are presented on p.40 of E.on's 2006 Annual Report.

Chart 4: E.ON ROCE and cost of capital



Source: Company Data, Merrill Lynch estimates; Other Regions is an average of UK, Nordic, USA

From M&A to Organic Growth?

If there are superior returns available elsewhere with commensurate or perhaps lower associated risks, a U-turn is right course of action for the Management Board, led by Wulf Bernotat. An absence of quick-fix acquisitions may push the strategic emphasis in favour of *organic investment* to drive growth and shareholder returns into the medium term.

The arrival of a new CFO in Dr Marcus Schenk in December 2006, could, in our view, open the door for such a re-examination of strategy. As a former senior investment banker Dr Schenk will be well versed in the options open to E.on.

Less easy to anticipate is the attitude of the Supervisory Board, which has endorsed the global M&A vision and indeed has invested in its political connections to it help to succeed. To the outsider, it is not always obvious that Supervisory Boards hold shareholders' interests closest to heart.

It may be galling for E.on's Supervisory Board to consider proposals for a more conservative approach to growth which are strangely similar to those espoused by RWE for the last few years. (Equally galling for RWE in Essen is that one of reasons cited for the abrupt departure of Dr Harry Roels as CEO is to follow an E.on-like M&A strategy!).

How Much Balance Sheet Flexibility?

Any new direction in corporate strategy will come hand in hand with a re-aligned financial strategy. E.on needs to releverage; and we estimate that there is a minimum of EUR16-18bn of debt capacity on the balance sheet.

E.on stated during its Spanish venture that it had balance sheet capacity to fund up to cEUR30bn using debt without resorting to issuing equity or selling assets. This limit was based on a 3.0-3.5x Net Debt/EBITDA ratio and assumed no change in credit rating.

Subsequently Moody's reduced its credit rating from A2 to Aa3, in our view bizarrely given no transaction took place. Rightly or wrongly, we believe that E.on will not countenance a lower credit rating than flat A or A2.

This implies a reduction in debt capacity from EUR30bn to cEUR23-25bn, and our own numbers broadly confirm the range. E.on's subsequent agreement to acquire EBITDA-generating Spanish and Italian assets for EUR10bn effectively reduces the debt capacity to cEUR16-18bn.

This EUR16-18bn debt capacity is what we would deem the *'steady state'* estimate. However, there could be significantly more depending on how radical an approach to balance sheet efficiency management chooses to take. If E.on were to pursue ROCE aggressively and sell down underperforming assets such as Gazprom, the figure could be as high as EUR23bn. We examine the 'stretch' a little later.

We would also suggest that 3.0-3.5x net debt/EBITDA is on the conservative side for an integrated utility business. Veolia – a completely different, asset light water services business – has debt covenants set at 3.5-4.0x net debt/EBITDA.

Higher Investment, Buy backs and Dividends

We expect a new financial strategy to embrace three main levers: 1) re-leverage the balance sheet progressively primarily via increased growth capex, 2) initiation of a major share buy back programme, and 3) growth in ordinary dividends. These broad strategic and financial aims are likely to be supported by clear financial targets for growth and gearing, to be delivered within a defined timeframe, probably five years.

1. Increased Growth Investment

A substantial increase in organic investment, based on a medium term plan (say five years from 2007-11) could replace M&A as the main focus for driving earnings growth. We think the present investment budget could be increased by 40-60% (including any potential infill acquisitions), and extended by two years. This would potentially absorb around EUR10-12bn of the EUR16-18bn balance sheet capacity.

E.on has hinted that the current EUR25bn capital programme 2007-09 or EUR8bn p.a. was 'restrained' by the prospect of Spanish M&A. The current split is generation (45%), power networks (29%) gas infrastructure (10%) and financial investments (11%). The focus would likely be more of the same.

A clear roadmap for specific projects and timing will be needed to bolster the credibility of such a shift in spending plans.

Are there enough projects out there? There has been underinvestment in the power and gas industry over the last two or three decades. Like much of the industry, we believe higher investment is needed to ensure continued security and improved reliability of supply.

Generally, project returns should eventually deliver superior returns to acquisitions given there are rarely entry premia to pay. The flip side is that there are near term negative cash flow implications.

2. Share Buy Back

A buy back of EUR5-7.5bn (up to 10% of E.on's equity) could be initiated immediately after Q1 results. E.on will seek renewal at the AGM for permission to buy back up to 10% of its shares. Buy backs are more palatable politically than special dividends, deliver sustained tension in the share price and higher EPS accretion (assuming the shares are cancelled).

3. Dividends/Payout Ratio

E.on's dividend growth has averaged 19% since 2000 (ex-special DPS), at the upper end of the sector average. We expect the payout ratio to remain in the 50-60% range (E.on paid 50% in 2006A), and we assume 55% from 2007E. Essentially ordinary dividends will be another lever to reach balance sheet efficiency.

4. Financial targets

We expect E.on will set clear and aggressive growth targets for EBIT 2006A-11E, based on its investment plans. We also anticipate a target range for dividend payout ratio and gearing ratios.

Levers to Reach Target Gearing

The different parts of such a financial strategy are inter-linked. Infill acquisitions might have an instant impact, capex on projects will take time to feed through to the P&L - on average 3 years in our judgement. Therefore the expected acceleration of EBIT growth is likely to be at the back end of the five year plan.

Meantime, there are the twin levers of dividends and buy-backs to tighten the balance sheet. A buy-back programme is more likely to be front-end loaded, and could be initiated almost immediately after the Q1 results (May 9th). We have assumed a dividend pay-out ratio of 55% for 2007E and beyond, but a higher ratio could be used to weak gearing in individual years particularly if an increase in capital spending is slow to get off the ground.

Raising Cash from Underperforming Assets

A more radical approach to balance sheet management could raise far more than the EUR16-18bn indicated. E.on has around EUR20bn of Other Financial assets on its balance sheet, representing over 25% of the current market cap. There is also another EUR8bn of equity tied up in infrastructure assets that E.on could consider either re-gearing or even selling.

Gazprom

The biggest individual asset is the 6.4% of Gazprom, currently worth EUR11bn or c15% of E.on's market cap. The stake was acquired via the Ruhrgas acquisition in mid-2003. The capital return on the investment has been excellent, with the market value rising nine-fold in Euro-terms in four years.

Yet E.on's cash income from Gazprom in 2006A was a mere EUR55m, an effective yield of 0.5%. A near-doubling of dividends in 2008E (which ML Oils Research expects) would still constitute a poor annual return. Redeployed, we would expect E.on to generate EBIT of at least cEUR1.0bn, based on the company's WACC.

The sale of the stake would be feasible in our view – Gazprom is listed, liquid, and gas is a strong, long term investment theme. In practice, it is more complicated. Around half, or 3.5%, is in E.on's hands (held via Ruhrgas) and technically theirs to sell. The remaining 2.9% is tied up in a complex legal structure inside a Russian entity in which E.on holds a minority stake. This could prove difficult to unwind quickly.

Political considerations also weigh heavily against a sale in our view. E.on clearly sees Gazprom as means of protecting and developing its Russian position. *Would E.on be able to keep its stake in the giant Yushno Russkoje gas project if it sold Gazprom? Would the company be welcomed to develop assets in the liberalising Russian power market without the Gazprom stake?*

Yet a sale at some stage is inevitable in our view. One option that might be politically acceptable would be to sell down Gazprom to balance any new investments in Russian power, for example – EUR1bn in, EUR1bn out, allowing E.on to maintain its overall exposure to Russia but not increase it.

We suspect that the sale of Gazprom will not be on the table for the foreseeable future, and is unlikely to be included in any package of strategic changes in 2007.

We have not therefore included the sale and reinvestment of Gazprom proceeds in our base valuation. However, to assess the potential 'lost value' to shareholders, we have run a sensitivity analysis to include the return of the Gazprom stake to shareholders via special dividends (EUR10bn, assuming a discount to market price on sale).

Shares in associated companies

Another EUR10bn of 'Other Financial Investments' is made up of a collection of investments mainly in Stadtwerke. We are dubious of the real value in E.on holding non-controlling stakes in municipal utilities, but accept that these could be regarded as relevant to the core power and gas business in Germany.

The contribution to EBITDA of these assets is included in the SOP.

Network assets

E.on is one of the biggest network owners in Europe, with T&D assets in all its main businesses. These operations, with predictable earnings, lend themselves to high gearing. Typically we would expect a regulated asset to be geared up at least to 5x net debt/EBITDA.

The bundled presentation of the accounts in Central Europe and Pan Europen Gas means that EBITDA for these networks is not reported. Nevertheless, we have made a judgement of the proportion of EBITDA from these predominantly regulated businesses (gas transmission is not regulated); and added this to the UK and Nordic regulated contribution.

We estimate that E.on could release up to EUR8bn of equity from networks if it geared up to 5x Net Debt/EBITDA. This could fund an additional 10% buy back/return or could be reallocation into growth investment.

Valuing E.on

E.on shares look cheap, currently trading at a discount to the Pan-European utility sector on most measures. For example, the 2008E EV/EBITDA multiple is 7.1x (adjusted for associates) versus the peer group competitive energy sub-sector at 8.5x. This discount may reflect the market pricing in strategic uncertainty, lack of growth and the inefficient capital structure among other things.

Any clarification of the strategy, with improved better growth prospects from investment and a share buy back to tighten the balance sheet ratios, should boost E.on's rating.

Conceptually, stocks which deliver above average equity returns can trade above the sector average multiple. For example, Fortum and Scottish and Southern Energy trade on EV/EBITDA multiples significantly higher than those of E.on. It is likely no coincidence that both have consistently delivered well above average shareholder returns via dividend growth based on strong earnings growth. In Fortum's case, ordinary dividends have been supplemented by special dividends and buy-backs.

E.on trades on similar 2010E PE multiples to both Fortum and SSE, despite having half the 5-year EPS growth.

We think E.on should justify at least a 12x 2010E PE multiple if the company can deliver both similar, double digit EPS growth rates and a consistent focus on shareholder returns to its best-in-class peers.

Our sensitivity analysis examines the potential upside for EPS and the implied valuation based on a 12x 2010E PE multiple.

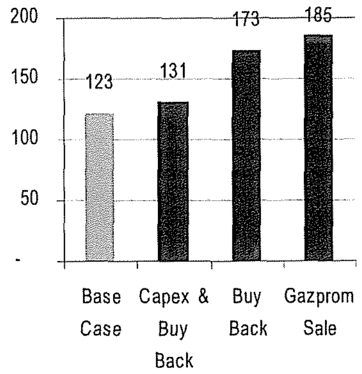
Table 3: P/E Multiple and EPS Growth Comparisons

	P/E			EPS
	2008E	2009E	2010	CAGR
E.ON	13.3x	12.9x	12.1x	6.6%
Fortum	15.4x	13.4x	12.1x	11.1%
SSE	13.7x	12.9x	12.3x	11.9%
Competitive Energy	*17.2x*	*15.6x*	*14.5x*	*9.1%*

Source: Merrill Lynch estimates

Sensitivities Around the Base Case Valuation

Chart 5: Sensitivity analysis (EUR ps)



Source: Merrill Lynch estimates

We have presented our base case valuation for E.on, along with three sensitivity cases. The sensitivity cases range from what we might deem a probable releveraging case (investment and share buy back) to two less likely cases where E.on releverages entirely by share buy backs and capital returns (e.g. Gazprom).

The last two give an indication of the ultimate potential for hidden value in E.on's portfolio of assets and balance sheet were the company to be run purely to maximise returns for shareholders.

A. ML Base Valuation - EUR123/sh

Our base case SOP for E.on is EUR123/share, 14% above the current share price. The SOP excludes the planned EUR10bn acquisition in Spain/Italy which we assume to be value neutral at present.

The valuation implies an EV/EBITDA (adjusted) multiple for 2008E of 8.0x, still below the sector on 8.5x.

We argue that this is E.on in 'business as usual' mode i.e. current capital structure. *Without the catalyst of strategic change, there is no reason to believe that the current share price discount should close.*

Table 4: Base Case Sum of the Parts

Division	EUR m	EUR p.s.	% EV	Method	Implied multiple	
Central Europe	54,473	79	*49%*	DCF, 7.5-8% WACC	8.8x	07E EBITDA
Pan-European Gas (ex Gazprom)	19,465	28	*17%*	DCF, 7.5% WACC	8.5x	07E EBITDA
United Kingdom	14,365	21	*13%*	Multiples per kW, Premium to RAV	8.1x	07E EBITDA
Nordic	10,991	16	*10%*	DCF, 7.5% WACC	9.8x	07E EBITDA
US	4,540	7	*4%*	DCF, 6% WACC	8.1x	07E EBITDA
Gazprom	9,742	14	*9%*	PE, Market Value post tax		
Corporate Center	-5,040	-7	*-4%*	8.0x 07E Cash costs	8.0x	07E Cash Costs
EV	108,536	157	*97%*			
Treasury Shares	3,536	5	*3%*	Market value		
Total Enterprise Value	**112,072**	**162**	***100%***		8.7x	07E EBITDA
(Net Financial Debt) / Cash	-2,277	-3				Dec 07E
Provisions	-18,819	-27				
Nuclear	-14,023	-20				Dec 07E
Pension	-2,494	-4				Dec 07E
Mining / Environmental	-2,302	-3				Dec 07E
Minority Interests	-6,134	-9				Dec 07E Adj. Book
Equity Value	**84,841**	**123**				

Source: Merrill Lynch estimates

B. Higher Capex, Share Buyback - EUR133/sh

We have assumed E.on acquires the Spanish/Italian assets, increases capex by c60% 2008-20011E (€16bn), and buys back 10% of its equity over 2008E and 2009E (EUR7.5bn). The net debt/EBITDA ratio stays within the range 3.0-3.5x.

The returns from higher investment increase 2006-11E EBITDA CAGR from 6% to 10%. Combined with the share buy back EPS CAGR rises from 7% to 10%. The EPS accretion reaches 10% by 2010E and 17% by 2011E.

Table 5: Higher Capex Scenario

2010E EV/EBITDA: E.On Pro Forma	6.9x
2010E EV/EBITDA Peers	7.5x
EV implied by re-rating	**115,149**
Share price implied by re rating (EURps)	122
Cash received from buy back (EURps)	11
Total E.On Value (EURps)	**133**

Source: Merrill Lynch estimates

The analysis highlights the delay in returns from organic investment due to the 3 year delay we have assumed before new capex generates a return. The buy-back compensates for near-term EPS dilution from higher capex, as well as generating front end EPS accretion.

This sensitivity indicates potential value of EUR133/share. This is based on a 12x 2010E PE multiple (in line with Fortum/SSE) and adding back the 10% buy back.

C. Return the Cash to Shareholders - EUR173-185/sh

Our final two sensitivities consider the equity value if all cash is returned to shareholders. We have assumed that E.on concludes its EUR10bn Spanish/Italian acquisition, but then devotes all available balance sheet flexibility to share holders. We have factored in a rolling buy back of 10% of the company's shares p.a. (EUR7.5bn p.a.) through 2008-10E. The total cost is EUR22.5bn, and net debt/EBITDA ranges between 3.0-3.5x through the period.

EPS CAGR 2006-11E increases from 7% to 13%, and EPS accretion climbs progressively to 21% in 2010E and 32% in 2011E. There is no incremental EBITDA, other than from the Spanish/Italian acquisition.

This sensitivity indicates potential value of EUR173ps. This is based on a 12x 2010E PE multiple (in line with Fortum/SSE average) and adding back the 10% buy back.

Table 6: Cash Return to Shareholders

2010E P/E E.On Pro Forma	9.8x
2010E P/E Peers	12.0x
Share price implied by re rating (EURps)	**141**
Cash received from buy back (EURps)	32
Total E.On Value (EURps)	**173**

Source: Merrill Lynch estimates

Including the Sale of Gazprom

Lastly – the sale of Gazprom. To the previous analysis we have assumed that the Gazprom stake is sold in two tranches in 2008E (3.5%) and 2010E (2,9%), and the cash is returned to shareholders via special dividends in those years.

EPS CAGR 2006-11E increases from 7% to 12%, and EPS accretion climbs progressively to 30% in 2010E. Again, there is no incremental EBITDA, other than from the Spanish Italian acquisition.

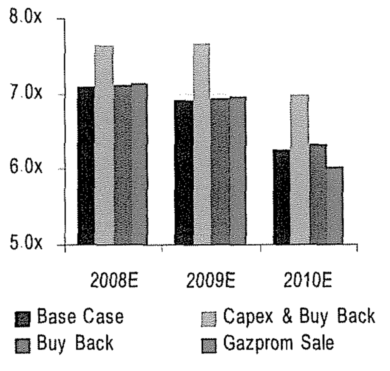
This sensitivity indicates a value of EUR185/share. This is based on a 12x 2010E PE multiple (Fortum/SSE average) and adding back the buyback and capital return.

Table 7: Gazprom Sale Scenario

2010E P/E E.On Pro Forma	7.6x
2010E P/E E.On Peers	12.0x
Share price implied by re rating (EURps)	**138**
Cash received from special div (EURps)	14
Cash received from buy back (EURps)	32
Total E.On Value (EURps)	**185**

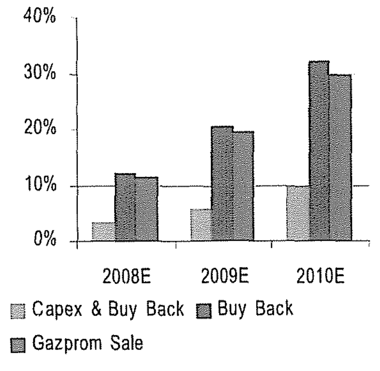
Source: Merrill Lynch estimates

Chart 6: Releveraging - EV/EBITDA Multiples



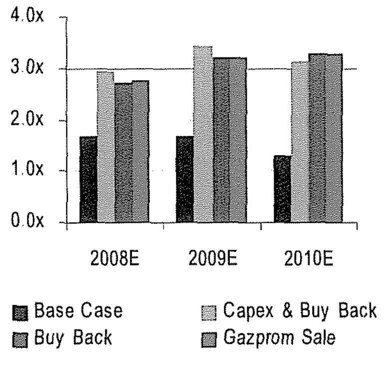
Source: Merrill Lynch estimates

Chart 7: Releveraging - EPS Accretion



Source: Merrill Lynch estimates

Chart 8: (Net Debt + Fin Provisions) / EBITDA



Source: Merrill Lynch estimates

Financials

Table 8: Profit and Loss Account (EURm)

	2005A	2006A	2007E	2008E	2009E	2010E	2011E	06A -11E CAGR
Total Sales	**56,141**	**67,759**	**67,093**	**67,527**	**69,580**	**70,613**	**71,324**	
Adjusted EBITDA	**10,194**	**11,353**	**11,923**	**12,968**	**13,395**	**14,293**	**14,881**	*5.6%*
Central Europe	*5,284*	*5,484*	*6,166*	*6,879*	*7,017*	*7,542*	*7,906*	
Pan-European Gas	*1,939*	*2,839*	*2,637*	*2,859*	*2,922*	*3,085*	*3,171*	
UK	*1,550*	*1,790*	*1,779*	*1,651*	*1,710*	*1,768*	*1,822*	
Nordic	*1,115*	*992*	*1,123*	*1,344*	*1,488*	*1,592*	*1,605*	
US-Midwest	*560*	*590*	*562*	*582*	*611*	*663*	*737*	
Corporate Center/Consolidation	*-386*	*-342*	*-344*	*-347*	*-352*	*-356*	*-360*	
Degussa	*132*	*0*	*0*	*0*	*0*	*0*	*0*	
Adjusted EBIT	**7,293**	**8,150**	**8,678**	**9,638**	**10,022**	**10,701**	**11,139**	**6.4%**
Central Europe	*3,930*	*4,168*	*4,787*	*5,425*	*5,582*	*5,950*	*6,227*	
Pan-Euro Gas	*1,536*	*2,106*	*1,904*	*2,112*	*2,157*	*2,308*	*2,394*	
UK	*963*	*1,229*	*1,237*	*1,124*	*1,156*	*1,196*	*1,243*	
Nordic	*766*	*619*	*745*	*961*	*1,092*	*1,188*	*1,193*	
US-Midwest	*365*	*391*	*370*	*384*	*409*	*436*	*463*	
Corporate Center/Consolidation	*-399*	*-363*	*-365*	*-369*	*-374*	*-378*	*-382*	
Degussa	*132*	*0*	*0*	*0*	*0*	*0*	*0*	
Financial expenses	-1,027	-1,081	-1,157	-1,105	-1,084	-1,165	-1,343	
PBET	6,266	7,069	7,521	8,533	8,938	9,536	9,796	
Extraordinary items and non operating income	886	-1,936	0	0	0	0	0	
PBT	**7,152**	**5,133**	**7,521**	**8,533**	**8,938**	**9,536**	**9,796**	
Income tax	-2,261	323	-2,106	-2,389	-2,503	-2,670	-2,743	
Minority interests	-536	-526	-633	-816	-928	-1,009	-1,014	
Net income, continuing	4,355	4,930	4,782	5,327	5,507	5,857	6,040	
Income from disct / Other	3,052	127	0	0	0	0	0	
Group Net Income	7,407	5,057	4,782	5,327	5,507	5,857	6,040	3.6%
Recurrent Group Net Income	**3,640**	**4,386**	**4,782**	**5,327**	**5,507**	**5,857**	**6,040**	6.6%
Growth	*6%*	*20%*	*9%*	*11%*	*3%*	*6%*	*3%*	
Reported EPS (EUR p.s.)	11.24	7.67	7.25	8.07	8.34	8.87	9.15	3.6%
Recurrent EPS (EUR p.s.)	5.52	6.66	7.25	8.07	8.34	8.87	9.15	6.6%
DPS (EUR p.s.)	2.75	3.35	3.98	4.44	4.59	4.88	5.03	8.5%
Of which exceptional	4.25							
Payout ratio (on recurrent earnings)	*50%*	*50%*	*55%*	*55%*	*55%*	*55%*	*55%*	

Source: Merrill Lynch estimates

Table 9: Cash Flow (EURm)

	2005A	2006A	2007E	2008E	2009E	2010E	2010E	06A -11E CAGR
Net income	7,407	5,057	4,782	5,327	5,507	5,857	6,040	
Minority Interests	536	526	633	816	928	1,009	1,014	
Income from discontinued operations	-3,059	-127	0	0	0	0	0	
Depreciation, Amortisation, Impairments	3,030	3,751	3,245	3,330	3,373	3,592	3,742	
Gains / Losses on Disposals	-478	-1,322	0	0	0	0	0	
Change in provisions	-380	-1,769	-1,014	-116	-157	-204	-259	
Change in deferred taxes	0	0	0	0	0	0	0	
Change in working capital	-532	-1,568	19	-145	-264	-197	-133	
Other non-cash items	20	2,646	0	0	0	0	0	
Cash Flow from Operations	**6,544**	**7,194**	**7,665**	**9,212**	**9,388**	**10,057**	**10,404**	*7.7%*
Disposals	6,294	3,954	0	0	0	0	0	
Investments	-3,941	-5,161	-7,546	-7,059	-6,709	-3,249	-3,249	
Change in securities > 3 months and other liquid funds	-1,911	-3,294	0	0	0	0	0	
Cash Flow from Investments	**442**	**-4,501**	**-7,546**	**-7,059**	**-6,709**	**-3,249**	**-3,249**	
Free cash flow	**3,588**	**3,111**	**119**	**2,153**	**2,678**	**6,809**	**7,155**	*18.1%*
Net change in treasury stock	-33	28	0	0	0	0	0	
Payment of cash dividends	-1,788	-4,856	-2,502	-3,006	-3,357	-3,493	-3,688	
Net proceeds from financial liabilities	-4,611	-1,022	0	0	0	0	0	
Cash flow from Financing	**-6,458**	**-5,849**	**-2,502**	**-3,006**	**-3,357**	**-3,493**	**-3,688**	
Net cash income / outgoings	528	-3,156	-2,383	-853	-679	3,315	3,468	
Forex impact on net cash	77	0	0	0	0	0	0	
Cash from discontinued operations	-372	-38	0	0	0	0	0	
Change net cash & equivalents	**233**	**-3,194**	**-2,383**	**-853**	**-679**	**3,315**	**3,468**	
Cash at y/e	**4,346**	**1,152**	**-1,231**	**-2,084**	**-2,762**	**553**	**4,020**	

Source: Merrill Lynch estimates

Table 10: Balance Sheet (EURm)

	2005A	2006A	2007E	2008E	2009E	2010E	2011E
Net Goodwill	15,363	15,124	14,608	14,728	14,728	14,728	14,728
PPE & Intangibles	45,448	46,461	53,059	56,789	60,125	59,782	59,288
Financial Assets	25,808	28,302	29,745	30,185	30,626	30,626	30,626
Fixed Assets	**86,619**	**89,887**	**97,412**	**101,702**	**105,479**	**105,136**	**104,642**
Inventories	2,457	3,990	3,951	3,976	4,097	4,158	4,200
Receivables	24,473	24,062	23,966	24,029	24,324	24,473	24,575
Liquid Funds, Non-Cash	5,551	5,035	5,035	5,035	5,035	5,035	5,035
Cash & Cash Equivalents	4,346	1,152	-1,231	-2,084	-2,762	553	4,020
Non-Fixed Assets	**37,508**	**34,849**	**31,721**	**30,956**	**30,694**	**34,219**	**37,831**
Other	2,435	2,496	2,399	2,393	2,409	2,410	2,411
TOTAL ASSETS	**126,562**	**127,232**	**131,531**	**135,051**	**138,582**	**141,764**	**144,884**
Shareholders' Equity	**44,484**	**47,845**	**53,921**	**57,059**	**60,093**	**62,922**	**65,742**
Minority Interests	4,734	4,917	5,259	5,700	6,201	6,746	7,293
Provisions	33,862	32,093	31,079	30,964	30,807	30,603	30,344
Financial Liabilities	14,362	13,399	13,025	13,139	13,139	13,139	13,139
Operating Liabilities	19,052	19,214	19,098	19,040	19,193	19,206	19,217
Other	9,237	9,149	9,149	9,149	9,149	9,149	9,149
TOTAL EQUITY & LIABILITIES	**126,562**	**127,232**	**131,531**	**135,051**	**138,582**	**141,764**	**144,884**

Source: Merrill Lynch estimates

Table 11: Balance Sheet Ratios

	2005A	2006A	2007E	2008E	2009E	2010E	2011E
Net Debt (Net cash)	1,917	-268	-2,277	-3,244	-3,922	-607	2,861
Net Debt/Capitalisation	4%	-1%	-4%	-6%	-7%	-1%	4%
Net Debt + Fin Prrovisions	26,033	19,565	16,542	15,460	14,625	17,736	20,944
(Net Debt + Fin Prov)/(Capitalisation + Fin Prov)	37%	29%	23%	21%	20%	22%	24%
ROCE	12%	13%	13%	14%	14%	15%	16%
EBITDA/Total net interest expenses	9.9x	10.5x	10.3x	11.7x	12.4x	12.3x	11.1x
EBITDA/Net interest on financial debt	39.8x	58.5x	45.0x	66.4x	85.4x	65.4x	39.5x

Source: Merrill Lynch estimates

Table 12: Companies Mentioned

Company	ML Symbol	Footnotes	Q-R-Q		Price
RWE	RWNFF	Lijopqsvw	B-2-7	EUR	77.92
RWE (ADR)	RWEOY	Lijopqsvw	B-2-7	USD	105.95
Scottish & Southern Energy	SSEZF	LNgijoqsvw	A-1-7	GBP	1512
Scottish & Southern Energy (ADR)	SSEZY	BLNbgijoqsvw	A-1-7	USD	30.1
Gazprom	RGZPF	LNijpqsv	C-1-7	USD	10.05
Veolia Environnement	VEOEF	Loijpqsvx	B-2-7	EUR	60.42
Veolia Environnement	VE	BLObjipsvx	B-2-7	USD	82.78
Fortum	FOJCF	Lv	B-2-7	EUR	22.71

Source: Merrill Lynch estimate

Price Objective Basis & Risk

E.ON: EUR130

Our Base Case Sum of the Parts valuation is EUR123ps. The long term nature of E.On's assets lends itself to DCF. We use discount rates between 7.5% and 8.0% for the Central Europe, Pan European Gas and Nordic divisions, and multiples per installed capacity, customers and of RAB for the UK, in line with the industry average, market value for Gazprom. This valuation implies an 08E EV/EBITDA of 8.0x, below the sector average of 8.5x.

Our sensitivity analysis suggests a range of EUR133ps to185ps, should E.on re-align its strategy and releverage either through increased organic growth, or share buy backs or a combination of both. We set our Price Objective at the modest end of the range, at EUR130/share.

The risks to our valuation and price objective are lower wholesale electricity, gas and oil prices. E,On is also exposed to regulatory risk through its transmission and distribution businesses. The discount rate used in our DCF calculation is based on the prevailing cost of debt and equity, which may change with market conditions.

Gazprom: US$14

Our price objective of US$14/share (US$56/ADR) is based on DCF analysis (WACC 9.1%, TV growth 3% nominal). At our target price, Gazprom would trade at 2008E PE of 11.4x, in line with its historical average forward earnings multiple.The risks to our price objective are oil prices, failure to contain costs, lower domestic gas price increases, adverse tax changes, value destruction from diversification into non-core businesses and failure to execute huge investment projects on-time and within budget. Gazprom's increased size has raised expectations for corporate disclosure, which the company may not be able to match.

Scottish & Southern Energy: 1,640p

Our 1,640p PO strikes a balance between an SOP-based valuation (DCF analysis incorporating a group discount rate of c7%, a terminal value growth rate of 2% and multiples) and dividend discount model. Regulated asset valuations are based on Regulated Asset Base as defined by UK regulators. Risks to our price objective are deterioration of margins in the UK energy business and failure to integrate the acquired regional gas businesses.

Analyst Certification

I, Simon Flowers, 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.

*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 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.

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Investment Rating Distribution: Energy Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	137	57.81%	Buy	48	41.03%
Neutral	92	38.82%	Neutral	24	30.38%
Sell	8	3.38%	Sell	0	0.00%

Investment Rating Distribution: Utilities Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	62	37.35%	Buy	19	37.25%
Neutral	89	53.61%	Neutral	39	51.32%
Sell	15	9.04%	Sell	2	14.29%

Investment Rating Distribution: Global Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1562	45.16%	Buy	415	30.09%
Neutral	1615	46.69%	Neutral	446	30.65%
Sell	282	8.15%	Sell	49	19.76%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months

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E.ON AG

Signs of Change

Company Update **BUY**

Equity | Germany | Electric Utilities
04 May 2007

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Shifting towards organic investment and buybacks

There were clear signs in yesterday's AGM statement that E.on is on the brink of a significant shift in strategic direction which will be more share holder friendly. There was little detail but, importantly, management has set a date of May 31 to flesh out its plans.

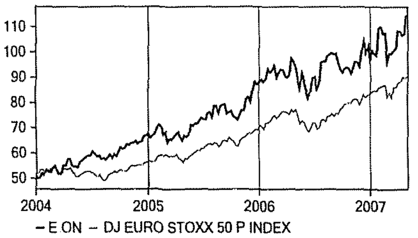
We have argued that E.on needs a shift in strategy which achieves three main ends: generates superior medium term earnings growth, releverages the balance sheet to improve financial efficiency, and boosts the share price rating. A growth-oriented strategy based on organic investment and share buybacks, as alluded to in the AGM, could be catalysts to closing the rating discount.

Reiterate Buy, PO EUR130

E.on's shares remain cheap on most measures, trading at 7.6x 2008E EV/EBITDA, well below the competitive energy sector on 8.5x. We can envisage upside valuation potential to EUR133/sh; and as high as EUR173-185/sh if management ran the business to maximise shareholder returns. We reiterate our Buy recommendation and Price Objective of EUR130.

Stock Data

Price (Common / ADR)	EUR115.20 / US$50.70
Price Objective	EUR130.00 / US$59.30
Date Established	30-Apr-2007 / 30-Apr-2007
Investment Opinion	B-1-7 / B-1-7
Volatility Risk	MEDIUM / MEDIUM
52-Week Range	EUR81.05-EUR115.74
Market Value (mn)	EUR76,032
Shares Outstanding (mn)	660.0 / 1,982.0
Average Daily Volume	4,565,630
ML Symbol / Exchange	EONAF / GER
ML Symbol / Exchange	EON / NYS
Bloomberg / Reuters	EOA GR / EONG.DE
ROE (2007E)	9.4%
Net Dbt to Eqty (Dec-2006A)	0.5%
Est. 5-Yr EPS / DPS Gwth	6.6% / 8.5%
Free Float	91.1%



Estimates (Dec)

(EUR)	2005A	2006A	2007E	2008E	2009E
	IFRS	IFRS	IFRS	IFRS	IFRS
EPS (Reported)	11.24	7.67	7.25	8.07	8.34
EBITDA (Adjusted)	10,194	11,353	11,923	12,968	13,395
EPS (Adjusted)	5.52	6.66	7.25	8.07	8.34
EPS Change (YoY)	NA	20.5%	8.9%	11.4%	3.4%
Dividend / Share	2.75	3.35	3.98	4.44	4.59
ADR EPS (Adjusted - US$)	2.29	2.78	3.28	3.65	3.78
ADR Dividend / Share (US$)	1.14	1.40	1.80	2.01	2.08

Valuation (Dec)

	2005A	2006A	2007E	2008E	2009E
P/E	20.9x	17.3x	15.9x	14.3x	13.8x
Dividend Yield	2.39%	2.91%	3.46%	3.85%	3.98%
EV / EBITDA*	10.9x	9.75x	9.28x	8.54x	8.26x
Free Cash Flow Yield*	3.43%	2.68%	0.16%	2.83%	3.52%
EV/EBITDA (Adjusted)	NA	NA	8.20x	7.57x	7.37x

* For full definitions of *iQmethod*SM measures, see page 5

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Refer to important disclosures on page 6 to 7. Analyst Certification on page 5. Price Objective Basis/Risk on page 5. 10612482

iQprofile[SM] E.ON AG

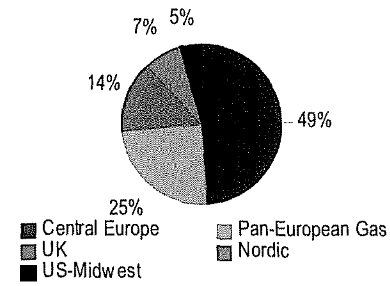
Key Income Statement Data (Dec)	2005A	2006A	2007E	2008E	2009E
(EUR Millions)	IFRS	IFRS	IFRS	IFRS	IFRS
Sales	56,141	67,759	67,093	67,527	69,580
EBITDA Adjusted	10,194	11,353	11,923	12,968	13,395
Depreciation & Amortization	(2,901)	(3,203)	(3,245)	(3,330)	(3,373)
EBIT Adjusted	7,293	8,150	8,678	9,638	10,022
Net Interest & Other Income	(1,027)	(1,081)	(1,157)	(1,105)	(1,084)
Tax Expense / Benefit	(2,261)	323	(2,106)	(2,389)	(2,503)
Net Income (Adjusted)	3,640	4,386	4,782	5,327	5,507
Average Fully Diluted Shares Outstanding	659	659	660	660	660
Key Cash Flow Statement Data					
Net Income (Reported)	7,407	5,057	4,782	5,327	5,507
Depreciation & Amortization	2,901	3,203	3,245	3,330	3,373
Change in Working Capital	(532)	(1,568)	18.9	(145)	(264)
Deferred Taxation Charge	0	0	0	0	0
Other Adjustments, Net	(3,232)	502	(380)	701	771
Cash Flow from Operations	6,544	7,194	7,665	9,212	9,388
Capital Expenditure	(3,941)	(5,161)	(7,546)	(7,059)	(6,709)
(Acquisition) / Disposal of Investments	*(985)*	*(1,078)*	*(1,443)*	*(441)*	*(441)*
Other Cash Inflow / (Outflow)	5,368	1,738	1,443	441	441
Cash Flow from Investing	442	(4,501)	(7,546)	(7,059)	(6,709)
Share Issue / (Repurchase)	(26.0)	1.00	0	0	0
Cost of Dividends Paid	(1,788)	(4,856)	(2,502)	(3,006)	(3,357)
Cash Flow from Financing	(6,458)	(5,849)	(2,502)	(3,006)	(3,357)
Non Cash Changes to Debt	(295)	(38.0)	0	0	0
Change in Net Debt	(5,434)	2,096	2,383	853	679
Net Debt	*(1,917)*	268	2,277	3,244	3,922
Key Balance Sheet Data					
Property, Plant & Equipment	45,448	46,461	53,059	56,789	60,125
Goodwill	15,363	15,124	14,608	14,728	14,728
Other Intangibles	NA	NA	NA	NA	NA
Other Non-Current Assets	21,505	23,215	24,658	25,098	25,539
Trade Receivables	8,269	9,756	9,660	9,723	10,018
Cash & Equivalents	16,279	13,131	10,748	9,895	9,217
Other Current Assets	19,698	19,545	18,798	18,818	18,955
Total Assets	126,562	127,232	131,531	135,051	138,582
Long-Term Debt	14,362	13,399	13,025	13,139	13,139
Other Non-Current Liabilities	43,930	41,857	40,228	40,113	39,956
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	19,052	19,214	19,098	19,040	19,193
Total Liabilities	77,344	74,470	72,351	72,292	72,288
Total Equity	49,218	52,762	59,180	62,759	66,294
Total Equity & Liabilities	126,562	127,232	131,531	135,051	138,582
Key Metrics					
iQmethod*[SM] - Bus Performance					
Return On Capital Employed	*4.48%*	*6.81%*	*5.66%*	*6.05%*	*6.11%*
Return On Equity	9.33%	9.50%	9.40%	9.60%	9.40%
Operating Margin	13.0%	12.0%	12.9%	14.3%	14.4%
Free Cash Flow (MM)	2,603	2,033	119	2,153	2,678
iQmethod*[SM] - Quality of Earnings					
Cash Realization Ratio	1.80x	1.64x	1.60x	1.73x	1.70x
Asset Replacement Ratio	1.36x	1.61x	2.33x	2.12x	1.99x
Tax Rate	36.1%	NM	28.0%	28.0%	28.0%
Net Debt/Equity	-3.89%	0.51%	3.85%	5.17%	5.92%
Interest Cover	7.05x	7.36x	7.33x	8.52x	9.03x

* For full definitions of *iQmethod*[SM] measures, see page 5

Company Description

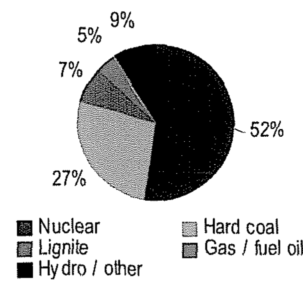
E.ON has transformed itself from domestic conglomerate to Europe's biggest energy utility, with a portfolio of mainly vertically integrated assets across Germany, Central Europe, the Nordic Region, the UK and the US. It is active in both electricity and gas and its subsidiary Ruhrgas is likely to be central to future growth from this platform as power/gas convergence gathers pace over the next decade.

Chart 1: 2006A EBIT



Source: Company Data

Chart 2: Generation Output Germany



Source: Company data

Stock Data

Shares / ADR	0.33
Price to Book Value	1.4x

Clear Signs of Change

There wasn't much detail, but in our view there were clear signs in yesterday's AGM statement that E.on is on the brink of a significant shift in strategic direction, which will be more share holder friendly. Importantly, management has set a date of May 31 to unveil and flesh out its plans for investment, growth and capital structure in full, a month ahead of the scheduled capital markets day.

We have argued that E.on needs a shift in strategy which achieves three main ends: generates superior medium term earnings growth, releverages the balance sheet to improve financial efficiency, and boosts the share price rating (see *Catalyst for a re-rating* - 30 April 2007). If our interpretation is correct, management is moving in the right direction.

E.On sketched out its current thinking, and we have paraphrased what in our view are the key messages:

- **M&A:** the company's recent strategic byword does not appear until the last sentence in Dr Bernotat's speech - E.on may consider "*targeted acquisitions*". We see this as a signal that *transforming* M&A is being relegated from the agenda, albeit that bolt on acquisitions may form part of any new investment strategy.

- **Achieving Growth**: '*The industry (in Europe) is about to enter a huge capital cycle…in power generation and energy infrastructure*'. We expect E.on to focus mainly on organic investment to deliver growth in the medium term, given these cyclical opportunities. We think the current investment plan for EUR8bn p.a. 2007-9E could be increased by 50%. We hope to see a road map and project inventory on May 31 to underpin higher capex levels.

- **Capital structure and dividends**: '*…we want to actively manage our balance sheet…systematically ensure that we use our investors' and creditors' money prudently and efficiently…we are interested in an ongoing process to deliver sustained value growth*'. We think E.on should use a share buy back of EUR5-10bn to improve financial efficiency (and earnings accretion) until a new investment programme starts to deliver. '*We are looking at our dividend policy.*' We think the payout will stay in the 50-60% range (55% from 2007E in our numbers); any increase above that (even as a short term measure) would be a positive surprise in our view.

- **Enhancing Profitability:** '*We expect to set ambitious new targets for our operating performance*'. We anticipate aggressive EBIT growth targets to lift current expectations (MLe 7% 2006-11E) towards the sector leaders (c10%).

Two other points are worthy of mention.

- **Outlook for 2007 raised**: E.on expects 2007 adjusted EBIT to "*surpass*" 2006 level, vs previous guidance of a "*slight increase*" in EBIT. This means the company's expectations now "*exceed the capital markets expectations*". Our forecast shows a increase in 6.5% in 07E EBIT to EUR8.68bn, vs consensus at +5% (EUR8.58bn). We are leaving our numbers unchanged for now. Q1 results are due 9 May.

- **CEO Contract Extension**: The Steering Committee of the Supervisory Board will recommend extending CEO Wulf Bernotat's mandate by two years ;the current contract expires in April 2008.

Valuation Range: EUR123-185ps

We are leaving our estimates, valuation, Price Objective of EUR130ps unchanged at this stage.

Our base case valuation is EUR123ps (based on the Dec 06 investment program, 55% payout ratio from 07E and no buy back).

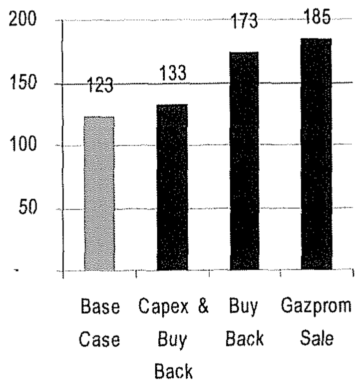
A growth/releveraging strategy using up to EUR23bn of balance sheet flexibility (MLe) could generate a valuation rage of EUR133-185ps:

- **Upside to EUR133**: assumes re-leveraging via a 40-60% increase in organic investment and a 10% share buy-back
- **Upside to EUR173**: releveraging via EUR22.5bn of rolling share buy-backs
- **Upside to EUR185**: releveraging via EUR22.5bn of share buy backs and special dividend of EUR10bn from the sale of the Gazprom stake.

For further details, please refer to our previous note *Catalyst for a re-rating (30 April 2007)*

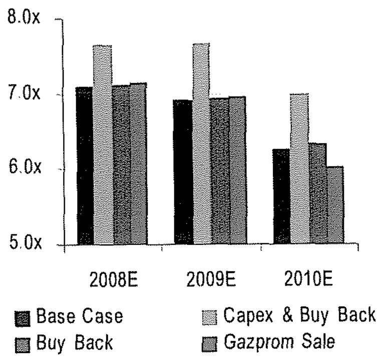
At current levels, E.On shares is still among the cheapest utilities on multiples, trading at 7.6x 08E EV/EBITDA, and 08E P/E of 14.3x (competitive energy sector at 8.5x and 17.0x respectively). We re-iterate our Buy recommendation

Chart 3: Sensitivity analysis (EUR ps)



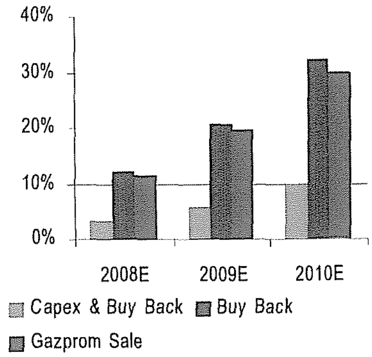
Source: Merrill Lynch estimates

Chart 4: Releveraging - EV/EBITDA Multiples



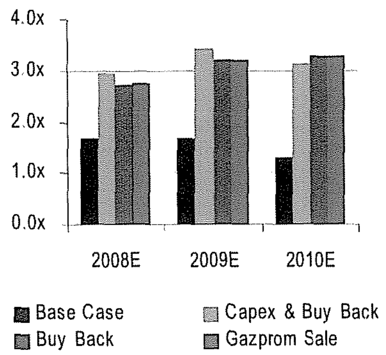
Source: Merrill Lynch estimates

Chart 5: Releveraging - EPS Accretion



Source: Merrill Lynch estimates

Chart 6: (Net Debt + Fin Provisions) / EBITDA



Source: Merrill Lynch estimates

Price Objective Basis & Risk

Our Base Case Sum of the Parts valuation is €123ps. The long term nature of E.ON's assets lends itself to DCF. We use discount rates between 7.5% and 8.0% for the Central Europe, Pan European Gas and Nordic divisions, and multiples per installed capacity, customers and of RAB for the UK, in line with the industry average, market value for Gazprom. This valuation implies an 08E EV/EBITDA of 8.0x, below the sector average of 8.5x.

Our sensitivity analysis suggests a range of €133ps to185ps, should E.ON re-align its strategy and releverage either through increased organic growth, or share buy backs or a combination of both. We set our Price Objective at the modest end of the range, at €130/share.

The risks to our valuation and price objective are lower wholesale electricity, gas and oil prices. E.ON is also exposed to regulatory risk through its transmission and distribution businesses. The discount rate used in our DCF calculation is based on the prevailing cost of debt and equity, which may change with market conditions.

Analyst Certification

I, Simon Flowers, 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.

*iQmethod*SM Measures Definitions

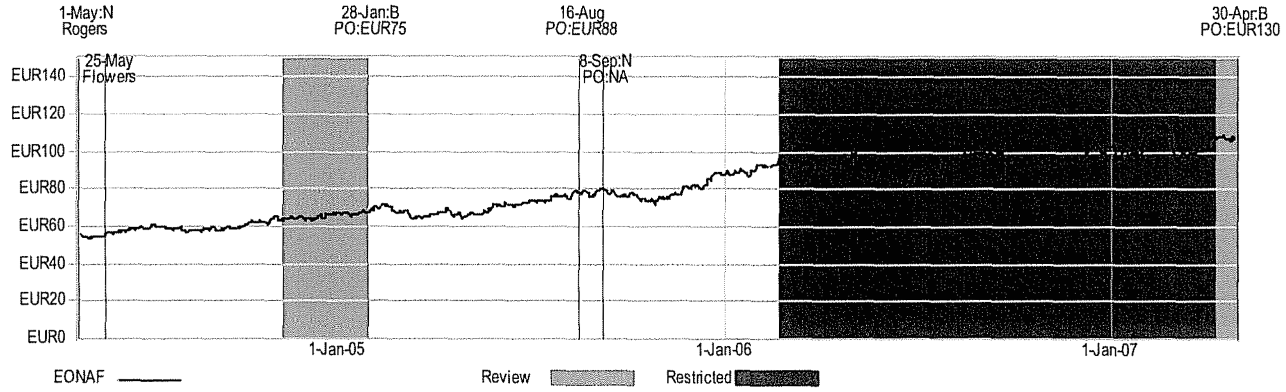
Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating 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 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 Merrill Lynch

Important Disclosures

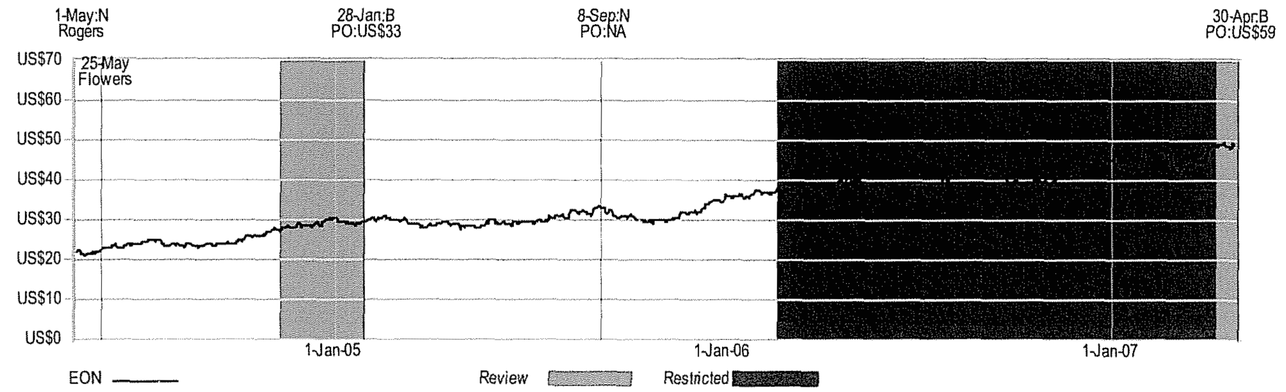
EONAF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

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 Light Grey shading indicates the security is under review with the opinion withdrawn Chart current as of March 31, 2007 or such later date as indicated

EON Price Chart



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Investment Rating Distribution: Utilities Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	62	37.35%	Buy	19	37.25%
Neutral	89	53.61%	Neutral	39	51.32%
Sell	15	9.04%	Sell	2	14.29%

Investment Rating Distribution: Global Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1562	45.16%	Buy	415	30.09%
Neutral	1615	46.69%	Neutral	446	30.65%
Sell	282	8.15%	Sell	49	19.76%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months

FUNDAMENTAL EQUITY OPINION KEY: Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. VOLATILITY RISK RATINGS, indicators of potential price fluctuation, are: A - Low, B - Medium, and C - High. INVESTMENT RATINGS, indicators of expected total return (price appreciation plus yield) within the 12-month period from the date of the initial rating, are: 1 - Buy (10% or more for Low and Medium Volatility Risk Securities - 20% or more for High Volatility Risk securities); 2 - Neutral (0-10% for Low and Medium Volatility Risk securities - 0-20% for High Volatility Risk securities); 3 - Sell (negative return); and 6 - No Rating. INCOME RATINGS, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure); 8 - same/lower (dividend not considered to be secure); and 9 - pays no cash dividend.

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Company In-Depth

21 May 2007 | 17 pages

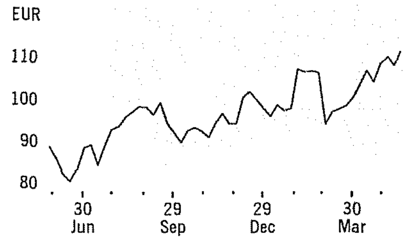
E.ON AG (EONG.DE)

Buy Ahead of E.On's Big Day

- **Capital markets day** — E.On is holding a capital markets day in London on 31 May. The company has recently emerged from a 12-month battle trying to acquire Endesa in Spain, during which time its shares underperformed the utilities sector by over 10%. We believe management now faces a challenge to restore credibility and deliver a coherent set of strategic and financial targets.
- **€4bn share buyback** — We expect E.On to announce a target 3-3.5x net debt/EBITDA by 2010. As part of its plan to achieve this, we believe E.On will announce a 5% share buyback, equivalent to €4bn. We also expect E.On to target a 60% dividend payout ratio by 2010 (versus 50% in 2006).
- **€40bn investment plan** — We expect E.On to increase its 2007-2009 investment plan from €25.3bn to around €40bn. This includes the €10bn acquisition cost of assets from the ENEL/Acciona agreement, €3bn of associated capex and maybe €2bn of other new initiatives. Our analysis suggests E.On typically underspends versus plan, but at least €34bn of the total should be deliverable.
- **€2.5bn increase in Adjusted EBIT** — We expect E.On to target an increase in Adjusted EBIT of €2.5bn by 2010. We anticipate a new cost saving target of €600m will be announced, with the remainder of the EBIT increase driven by investment. We believe €2.3bn of the total should be deliverable in practice.
- **Buy rating reiterated** — If E.On meet the expectations we outline above, we believe it could lead to consensus EPS upgrades of over 10%. This would leave E.On trading at 10.9x FY08E P/E (ex-Gazprom) and 4.2% dividend yield – cheap relative to the utilities sector. This should be enough to drive a progressive re-rating.

Buy/Medium Risk	**1M**
Price (18 May 07)	€113.09
Target price	€130.00
Expected share price return	15.0%
Expected dividend yield	3.6%
Expected total return	**18.6%**
Market Cap	€78,258M
	US$105,719M

Price Performance (RIC: EONG.DE, BB: EOA GR)



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

E.ON AG (EUR)

Year to 31 Dec	*2005A*	*2006A*	*2007E*	*2008E*	*2009E*
Sales (€M)	51,616.0	64,197.0	64,640.8	65,018.9	64,652.8
Net Income (€M)	3,640.0	4,337.0	4,931.1	5,090.8	5,155.8
Basic EPS (€)	5.52	6.58	7.48	7.72	7.82
Basic EPS (Old) (€)	5.52	6.58	7.48	7.72	7.82
PE (x)	20.5	17.2	15.1	14.6	14.5
EV/EBITDA (x)	9.6	7.6	7.1	6.9	6.8
DPS (€)	7.00	3.35	4.10	4.20	4.30
Net Div Yield (%)	6.2	3.0	3.6	3.7	3.8

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Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	20.5	17.2	15.1	14.6	14.5
EV/EBITDA adjusted (x)	9.6	7.6	7.1	6.9	6.8
P/BV (x)	1.7	1.6	1.5	1.5	1.5
Dividend yield (%)	6.2	3.0	3.6	3.7	3.8
Per Share Data (€)					
EPS adjusted	5.52	6.58	7.48	7.72	7.82
EPS reported	11.24	7.60	7.48	7.72	7.82
BVPS	67.49	72.59	74.19	75.66	77.14
DPS	7.00	3.35	4.10	4.20	4.30
Profit & Loss (€M)					
Net sales	51,616	64,197	64,641	65,019	64,653
Operating expenses	-45,564	-57,452	-56,663	-56,608	-55,934
EBIT	**6,052**	**6,745**	**7,978**	**8,411**	**8,719**
Net interest expense	-736	-687	-735	-891	-1,076
Non-operating/exceptionals	*1,836*	*-974*	*795*	*810*	*826*
Pre-tax profit	**7,152**	**5,084**	**8,038**	**8,330**	**8,470**
Tax	-2,261	323	-2,607	-2,715	-2,763
Extraord./Min.Int./Pref.div.	2,516	-399	-500	-525	-551
Reported net income	**7,407**	**5,008**	**4,931**	**5,091**	**5,156**
Adjusted earnings	3,640	4,337	4,931	5,091	5,156
Adjusted EBITDA	9,234	10,337	11,249	11,900	12,420
Growth Rates (%)					
Sales	21.8	24.4	0.7	0.6	-0.6
EBIT adjusted	5.3	12.2	12.9	5.4	3.5
EBITDA adjusted	-1.2	11.9	8.8	5.8	4.4
EPS adjusted	11.3	19.1	13.7	3.2	1.3
Cash Flow (€M)					
Operating cash flow	**6,466**	**7,086**	**7,095**	**7,324**	**7,605**
Depreciation/amortization	2,901	3,203	3,131	3,347	3,564
Net working capital	-1,010	-1,291	-649	-652	-654
Investing cash flow	**1,751**	**-1,978**	**-6,337**	**-7,387**	**-7,387**
Capital expenditure	-2,990	-4,083	-6,337	-7,387	-7,387
Acquisitions/disposals	4,741	2,105	0	0	0
Financing cash flow	**-10,414**	**-8,926**	**-1,598**	**410**	**129**
Borrowings	-8,567	-4,099	852	3,362	3,160
Dividends paid	-1,788	-4,856	-2,450	-2,952	-3,031
Change in cash	**-2,197**	**-3,818**	**-840**	**347**	**347**
Balance Sheet (€M)					
Total assets	**126,562**	**127,232**	**130,077**	**134,782**	**139,282**
Cash & cash equivalent	9,897	6,187	5,000	5,000	5,000
Accounts receivable	7,179	9,756	9,951	10,150	10,353
Net fixed assets	41,323	42,712	46,258	50,607	54,712
Total liabilities	**77,344**	**74,470**	**76,010**	**79,478**	**82,729**
Accounts payable	5,288	5,305	5,411	5,519	5,630
Total Debt	14,362	13,399	14,251	17,613	20,773
Shareholders' funds	**49,218**	**52,762**	**54,066**	**55,304**	**56,554**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	17.9	16.1	17.4	18.3	19.2
ROE adjusted	9.3	9.4	10.2	10.3	10.2
ROIC adjusted	5.7	10.2	7.2	7.2	7.2
Net debt to equity	9.1	13.7	17.1	22.8	27.9
Total debt to capital	22.6	20.3	20.9	24.2	26.9

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Buy Ahead of E.On's Big Day

Buy ahead of 31 May

E.On is holding a capital markets day in London on 31 May. The company has recently emerged from a 12-month battle trying to acquire Endesa in Spain, during which time its shares underperformed the utilities sector by over 10%. Management now faces a challenge to restore credibility and deliver a coherent set of strategic and financial targets. This report sets out our expectations for 31 May, as well as an analysis of how E.On has performed against its targets in the past. If E.On can meet our expectations, it could lead to significant earnings upgrades for a stock that already looks cheap. We reiterate our Buy/Medium Risk (1M) rating and €130/share price target.

Capital Markets Day: What To Expect

Strategic review

E.On is holding a capital markets day on 31 May 2007 in London, where management will update the investment community on the outcome of its strategic review. Specifically, E.On's management has indicated that it will discuss the following topics:

- **Strategy.** How E.On will be managed on a Pan-European basis.
- **Investment plan.** An update to its 2007-2009 investment plan.
- **Performance targets.** How E.On expects Adjusted EBIT to develop through investment and performance improvement.
- **Capital structure.** E.On has stated that it will define what it views as an appropriate leverage structure, and how and when it will get there.

In this report, we outline our own expectations for E.On's capital markets day. We also discuss credibility and the potential implications for earnings and valuation. Our expectations are summarised in Figure 1.

Figure 1. Capital Markets Day: What To Expect

	Expected Announcement	Comment
Investment Plan	€40bn 2007-2009	We would probably only include €34bn in our numbers
Operational Improvements	€600m by 2010	Achievable in our view
Adjusted EBIT	+€2.5bn by 2010	We would probably only include €2.3bn in our numbers
Capital Structure	3.0-3.5x Net debt/EBITDA by 2010	Attainable through a combination of factors
Share Buyback	€4bn, 5% of capital over 18 months	With scope to return surplus capital in future
Dividend	60% payout ratio by 2010	Consistent with European utilities sector average

Source: Citigroup Investment Research

1. Strategy

Can E.On convince the market of the merits of a Pan-European footprint?

CEO Wulf Bernotat's indicated in the 1Q07 conference call that E.On will not be announcing any major changes in strategic direction. Instead, E.On will define how it intends to manage its business on a Pan-European basis.

As it stands, we have two conceptual problems with E.On's Pan-European strategy: firstly, we still think a true Pan-European market is several years away; secondly, the €10bn of assets that E.On is expected to acquire through its agreement with ENEL/Acciona will still leave it with relatively undersized positions in Spain, France and Italy.

It is important, therefore, that E.On discusses issues such as where it can continue to improve transfer of best practice across regions; how it can realistically build stronger regional presences; and what the scope is for delivering financial benefits from optimizing power generation and commodity positions across different regions.

Increased investment in reducing carbon emissions

E.On has also signalled that it will discuss climate change issues. In our view, E.On's updated strategy here could have three aspects to it:

- A long-term commitment to investment in new nuclear build, particularly in the UK and Nordic regions.
- Increased R&D expenditure in clean coal generation.
- Investment in emissions reduction projects outside Germany, along the lines of RWE's €150m investment plan in Joint Implementation/Clean Development Mechanism projects.

2. Investment Plan

€40bn investment plan

Based on our analysis, we would expect E.On to increase its current €25.3bn 2007-2009 investment plan to €40bn.

Figure 2. What We Expect From A New Investment Plan (€bn)

	Fixed Assets	Financial Investments	Total
2007-09 Investment Plan	22.4	2.9	25.3
ENEL/Acciona Agreement	2.8	10.0	12.8
New Initiatives	1.0	1.0	2.0
Total	26.2	13.9	**40.1**

Source: Company Reports and CIR Estimates

This might break down as follows:

- A €10bn increase in financial investments reflecting the anticipated acquisition cost for the assets that E.On has agreed to acquire from ENEL/Acciona as part of their planned acquisition of Endesa.
- A €3bn increase in fixed asset investment associated with ENEL/Acciona assets. This is expected to be a mix of new CCGT in Spain, repowerings and renewables in Italy and maintenance capex (see Figure 3).
- A €2bn increase in new initiatives, split between fixed asset and financial investments. The additional fixed asset investment is most likely to be focused on reducing emissions and Central/Eastern Europe. Additional financial investments are likely to be focused on Russia as E.On seeks to participate in the restructuring of the generation industry.

Figure 3. Expected Fixed Asset Investment Associated With ENEL/Acciona Transaction (€M)

	4Q07E*	2008E	2009E	Comment
Italy - Endesa Italia	(50)	(450)	(450)	Repowerings and new wind
France - SNET	(50)	(200)	(200)	Mainly maintenance some growth in renewables
Spain - Viesgo	(206)	(575)	(375)	2.9GW new CCGT capacity + Distribution/maintenance
Spain - Other	(32)	(101)	(80)	Mainly maintenance
Total	**(338)**	**(1,326)**	**(1,105)**	**€3.0bn in 2007-2009 timeframe**
Maintenance	(125)	(476)	(455)	
Growth	(213)	(850)	(650)	

* Our analysis assumes that the transaction closes at the start of 4Q07.

Source: CIR Estimates

How Credible is a €40bn Investment Plan?

E.On has a history of underspend versus plan

E.On outlined its 2007-2009 investment plan in December 2006, with a €6.7bn step up versus its previous 2006-2008 plan. The increase was principally focused on power generation, with some uplift in gas storage/LNG expenditure. Much of the new investment in power generation appeared to be related to projects with an uncertain outlook (e.g. clean coal in Germany) or with poor visibility (Eastern Europe). Therefore, while we anticipate that E.On may add another €2bn of new initiatives on 31 May, we will take some convincing that these will be delivered in full.

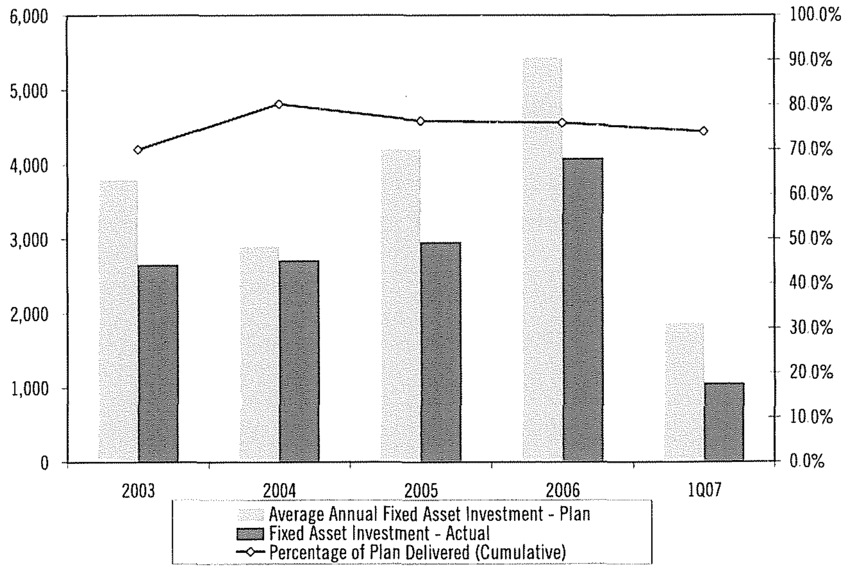
Indeed, E.On has a history of underspending versus its fixed asset investment plans. As shown in Figure 4, E.On has spent only around 75% of its planned fixed asset investments since 2003. Our forecasts for E.On are slightly more generous than this: we assume €21bn of total investment between 2007-2009. At this stage, we feel we are unlikely to raise this figure post 31 May.

Notwithstanding, we are comfortable with our estimate of around €3bn of additional capex associated with the ENEL/Acciona assets. We will likely include this (and the €10bn acquisition cost) in our forecasts once we have more visibility on the timing of the transaction, which we may get on 31 May.

We would maybe factor in €34bn

Overall, therefore, we could raise our investment forecast to €34bn.

Figure 4. E.On Has Historically Underspent Against Plan (€M)



Source: Company Reports and CIR Estimates

3. Performance Targets

€2.5bn of additional EBIT by 2010

We expect E.On to announce a new target for increasing Adjusted EBIT by €2.5bn between 2006-2010.

Figure 5. Potential Adjusted EBIT Growth Target (€bn)

	Growth	Maintenance	ROCE Target	Potential 2010 EBIT Impact (€M)
2007-09 Investment Plan	13.0	12.3	10.5%	683
ENEL/Acciona Acquisition	10.0		10.5%	1,050
2007-2009 ENEL/Acciona Capex	1.7	1.1	10.5%	90
New Initiatives	2.0		10.5%	105
Totals	26.7	13.4	10.5%	1,927
Operational Improvements				600
Overall Adjusted EBIT Impact				**2,527**

Source: Company Reports and CIR Estimates

This increase might be driven by the following factors:

- We expect E.On to maintain the 10.5% ROCE target from its "on.top" strategy. Based on this rate of return, we anticipate that E.On can target just under €2bn of additional Adjusted EBIT from its investment plan by 2010. The analysis in Figure 5 assumes that 50% of the projects associated with the 2007-2009 investment plans are operational by 2010.

- We expect E.On to announce a €600m cost efficiency and operational improvement plan over the period 2006-2010. This number is based on a benchmarking exercise against RWE's latest €600m efficiency programme, shown in Figure 6, which assumes both companies have similar efficiency. This exercise is admittedly oversimplified, but given that E.On's 2002-2006 efficiency plan was €1bn, another €600m does not seem an unreasonable expectation.

Figure 6. E.On Scope for Efficiency Savings (€M)

	RWE Financials	RWE €600m Efficiency as %	E.On Financials	E.On Potential Efficiencies Based on RWE Benchmark
2006 SG&A	9,930	6.0%	6,115	369
2006 EBITDA	7,861	7.6%	11,353	867
Average				**618**

Source: Company Reports and CIR Estimates

Are E.On's Performance Targets Credible?

E.On appears to have delivered against its operational improvement targets

In 2003, E.On announced its last major strategic review. This involved the "on.top" plan to deliver €1bn of operational improvements and €2bn of overall growth in EBIT between 2002-2006. E.On completed its on.top at the end of last year, claiming to have delivered €1,156m operational improvements.

It is difficult for us to verify accurately whether E.On has delivered against its targets. We have, nonetheless, attempted a fairly rough and ready analysis Figure 7. We find that of the €3.5bn increase in Adjusted EBIT since 2002, we can directly attribute €1.9bn to factors such as rising power prices and changes in regulation. This leaves around €1.6bn of improvements from other factors such as organic growth, cost savings and acquisitions. This is less than E.On's €2bn target, although the shortfall can at least in part be explained by E.On's underspend against its financial investment. As for operational improvements, we cannot with conviction dispute that E.On has delivered its €1bn target.

Figure 7. Has E.On Delivered Its EBIT Targets?

Total Growth in Adjusted EBIT 2002-2006	3,501
Attributable to Changes in Commodity Prices	2,621
Attributable to Changes in Regulation	(731)
Attributable to Acquisitions	**583**
Other Growth	**1,028**

Source: Company reports and CIR Estimates

The bottom line is that E.On is probably still relatively inefficient by the standards of e.g. Scottish & Southern Energy and Iberdrola. Factors such as the introduction of incentive-based regulation and the competitive threat of full deregulation of European retail markets, should incentivise management to cut costs more aggressively.

We may be prepared to lift our 2010E EBIT forecast by €320m

If we are correct and E.On does announce a target of €2.5bn of additional EBIT between 2006-2010, we would be inclined to include the full €600m of cost savings, the full EBIT contribution from the existing ENEL/Acciona assets and 75% of the EBIT from E.On's planned investments. This would amount to €2.3bn — around €320m more than we give E.On credit for.

4. Capital Structure

€4bn buyback expected

Although we mention it last, the investment community is probably going to be most interested in E.On's financial strategy. We expect E.On to announce the following:

- **3-3.5x net debt/EBITDA target by 2010.** We believe that E.On will set a target of net debt/EBITDA of 3-3.5x EBITDA. This is consistent with an A-grade credit rating and the same as Fortum's target. E.On has indicated that it will set a timetable and a method for achieving this.

  We suspect management will want leave itself plenty of flexibility with respect to its leverage target. We would, therefore, anticipate that the timetable is unlikely to be sooner than 2010. As regards the method, we believe management will aim to achieve the target through its investment plan and a (potentially rather vague) combination of acquisitions, dividends and share buybacks.

- **€4bn share buyback.** As part of a policy of "active balance sheet management" we believe E.On will commit to return any surplus capital through an ongoing share buyback programme. We would like to see E.On commit to a buyback of 10% of share capital initially (€7.6bn). However, in our view, this is initially likely to be limited to 5%(€3.8bn) for two reasons:

  Firstly, E.On's ability to return capital to shareholders is limited by law by its company-level German GAAP distributable reserves, which were €4,318m as at 31 December 2006.

  Secondly, E.On already holds 4.7% of its capital as treasury stock (allocated to pay for exercised share options). This would first need to be cancelled for E.On to buyback shares up to its 10% authorization limit.

  Although a 5% buyback may fall short of many existing investors' wishes, it could still do a lot to change investor perceptions about E.On's willingness to return capital.

- **60% dividend payout ratio by 2010.** In 2006, E.On paid out 50% of earnings as dividends, and its target is a 50-60% payout ratio by 2007. We think E.On could afford to raise its target payout ratio to 70% by 2010, but it is too optimistic to expect such a commitment today: we believe E.On already views its dividend policy as generous, and such an increase may be considered foolhardy given the political scrutiny utilities are facing in Germany.

  On balance, it is more likely that E.On will commit to a specific target of a 60% payout ratio by 2010. This would be consistent with the average Continental European sector average payout ratio of 60%, and above our forecast of 56%.

- **Pension funding.** E.On may chose to further fund its gross pension fund obligation of €17.2bn, of which €13.4bn is already funded. If E.On did contribute further, it would not change our view of E.On's balance sheet capacity since we already take net pension liabilities and other provisions into account.

Can E.On Deliver Balance Sheet Efficiency?

E.On could hit 3.5x debt/EBITDA without acquisitions

We have run three scenarios to assess how E.On may view its balance sheet flexibility. We factor in to our calculations the full €40bn investment plan and full €2.5bn of EBIT benefits we outlined above. We use E.On's definition of economic net debt, which includes net pension and nuclear provisions.

Figure 8 suggests that if E.On delivered the investment plans outlined above, as well as a 10% buyback and a 60-70% payout ratio, it would meet a 3.5x net debt/EBITDA target by 2010 — without any further acquisitions.

Figure 8. How Might E.On View Balance Sheet Headroom (€M)

	2007E	2008E	2009E	2010E
EBITDA (based on E.On's anticipated targets)	12,615	14,666	15,532	16,077
Scenario 1 - 10% Buyback and 70% Payout Ratio by 2010				
Net Debt/EBITDA	2.8x	3.2x	3.4x	3.5x
Balance Sheet Headroom	8,959	4,706	1,768	15
Scenario 2 - 10% Buyback and 60% Payout Ratio by 2010				
Net Debt/EBITDA	2.8x	3.2x	3.4x	3.5x
Balance Sheet Headroom	8,959	4,706	1,878	337
Scenario 3 - 5% Buyback and 60% Payout Ratio by 2010				
Net Debt/EBITDA	2.7x	2.9x	3.1x	3.2x
Balance Sheet Headroom	10,245	8,556	5,719	4,181

Source: CIR Estimates

...though E.On probably still has big ambitions

Realistically, we think E.On *will* want to leave itself more headroom for acquisitions. This supports our view that a 5% share buyback, at least in the first instance, is more likely than 10%.

Of course, should E.On decide to do another major acquisition it will be able to borrow against the business it is acquiring, as well as sell down existing assets. Figure 9 shows that E.On could, if pushed, come up with some €26bn of additional firepower to fund a major acquisition, before needing to worry about issuing equity.

With this in mind, we think Scenario 3 in Figure 8 is the most likely. As a result, we feel comfortable that our base case expectations for 31 May are realistic.

Figure 9. Possible Sources of Cash For E.On

Item	Potential Valuation	Comment
E.On's US business (LG&E)	€4.2bn	TXU multiple; Local regulatory clearance could take 12-18 months
6.4% of Gazprom	€10.7bn	Market value; may be politically awkward to sell
E.On's transmission grid in Germany	€3.1bn	Sale would be welcomed by the EU. Infrastructure funds would probably pay a high price.
E.On's distribution assets in the UK	€4.5bn	Infrastructure funds would probably pay 25% premium to RAB
Financial assets other than Gazprom	€3.8bn	e.g. Austria One
Total	**€26.3bn**	

Source: Citigroup Investment Research

Enough For a Re-Rating?

We have summarised what we expect E.On to announce at its capital markets day on 31 May in Figure 10 below. The question is, will all of this be enough to trigger a progressive re-rating of E.ON's shares?

Figure 10. Capital Markets Day: What To Expect

	Expected Announcement	Comment
Investment Plan	€40bn 2007-2009	We would probably only include €34bn in our numbers
Operational Improvements	€600m by 2010	Achievable in our view
Adjusted EBIT	+€2.5bn by 2010	We would probably only include €2.3bn in our numbers
Capital Structure	3.0-3.5x Net debt/EBITDA by 2010	Attainable through a combination of factors
Share Buyback	€4bn, 5% of capital over 18 months	With scope to return surplus capital in future
Dividend	60% payout ratio by 2010	Consistent with European utilities sector average

Source: Citigroup Investment Research

The expectations we outline will almost certainly fall short of some investors' wish lists. For example, in an ideal world E.On would do a 10% share buyback and sell its stakes in the US, Gazprom and other non-core financial assets, and return that capital to shareholders as well. But we think it is simply not realistic to expect this at this stage.

Nonetheless, we believe E.On's shares will be progressively re-rated if it can match the expectations we have set out in this report:

- We would see 20% earnings enhancement potential versus our forecasts. Also, we would expect to see around 10% increase in consensus earnings forecasts (see Figure 11).

Figure 11. What E..On Could Look Like If It Delivers

	2007E	2008E	2009E
EPS - Potential New EPS	7.72	8.97	9.53
EPS - Current CitiForecast	7.48	7.72	7.82
Potential Upgrade	*3.2%*	*16.1%*	*21.8%*
EPS - *Reuters* Consensus Forecast	7.57	8.15	8.58
Potential Upgrade	*2.0%*	*10.0%*	*11.1%*
Potential Headline P/E	14.7x	12.6x	11.9x
Potential P/E - Ex-Gazprom	12.7x	10.9x	10.3x
Potential New Dividend DPS	3.86	4.80	5.38
Potential Dividend Yield	3.4%	4.2%	4.8%
	7.72	8.97	9.53
Utilities Sector Average			
P/E	17.1x	16.0x	15.2x
Dividend Yield	3.6%	3.7%	4.0%

Source: CIR Estimates and Reuters

- E.On would be left looking very cheap relative to the sector. It would trade on a FY08E P/E (ex-Gazprom) of just 10.9x versus a sector average of 16x. Dividend yield could be 4.2% versus a sector average of 3.7%.
- We believe that there is still a lot of scepticism in the market around whether E.On will return any capital to shareholders. Even a 5% buyback announcement could trigger a positive change in perception about E.On.

Figure 12. E.On — Sum of Parts

	Value (€M)	Value per share (€)	Method	FY07E EBITDA (€M)	*Reality check*
Central Europe	51,856	75	Chiefly based on DCF of component parts	6,003	8.6x FV/EBITDA multiple in 2007E
Pan-European gas	15,941	23	DCF/RAB benchmarking	1,975	8.1x FV/EBITDA multiple in 2007E
UK	13,643	20	£0.4m perMW, £160 per custom. and 10% premium to RABs	1,875	7.3x FV/EBITDA multiple in 2007E
Nordic	9,951	14	Assumed EBITDA multiple - in line with Fortum SoP	1,244	8.0x FV/EBITDA multiple in 2007E
US-Midwest	3,981	6	Assumed EBITDA multiple	531	7.5x FV/EBITDA multiple in 2007E
Corporate centre	-2,653	-4	Assumed EBITDA multiple	-379	7.0x FV/EBITDA multiple in 2007E
Total core ops. (ex assoc.)	92,720	134		11,249	8.2x FV/EBITDA multiple in 2007E
Financial assets	22,475	32	Book value at 30/9/06 save for Gazprom	795	
of which 6.43% of Gazprom	10,664	15	Current market value		
Total	115,195	166		12,043	11.3x FV/EBITDA multiple in 2007E
Net cash	-2,307	-3	Forecast book value at 31/12/07		
Pension liabilities	-3,930	-6	Forecast book value at 31/12/07		
Nuclear liabilities	-8,171	-12	Based on our model - *current book value is €12.3bn*		
Other liabilities	-4,254	-6	Based on our model - current book value is €13.0bn		
Minorities	-5,167	-7	Forecast book value at 31/12/07		
Net equity value	***91,366***	***132***			

Source: Citigroup Investment Research

Figure 13. Divisional Breakdown (€M)

Adjusted EBIT	**2005**	**2006**	**2007E**	**2008E**	**2009E**	**2010E**	**2011E**
Central Europe	3,930	4,168	4,803	5,059	5,290	5,209	5,211
Pan-European Gas	1,536	2,106	1,992	2,145	2,034	1,930	1,829
UK	963	1,229	1,296	1,211	1,339	1,451	1,565
Nordic	766	619	890	1,016	1,089	1,165	1,242
US-Midwest	365	391	347	348	346	494	493
Corporate centre/consolidation	-399	-416	-416	-416	-416	-416	-416
Core businesses	7,161	8,097	8,913	9,363	9,682	9,833	9,924
Degussa	132	53	0	0	0	0	0
Total continuing operations	7,293	8,150	8,913	9,363	9,682	9,833	9,924

Source: Company Reports and Citigroup Investment Research

Figure 14. Key Financial Figures

	2005	**2006**	**2007E**	**2008E**	**2009E**	**2010E**	**2011E**
EPS from ongoing operations (€)	6.60	7.48	7.48	7.72	7.82	7.77	7.67
EPS from discontinued operations/other (€)	4.64	0.19	0.00	0.00	0.00	0.00	0.00
Total reported group EPS (€)	11.24	7.67	7.48	7.72	7.82	7.77	7.67
Adjusted EPS (€)	5.52	6.65	7.48	7.72	7.82	7.77	7.67
DPS (€)	7.00	3.35	4.10	4.20	4.30	4.40	4.50
Cashflow/share (€)	11.1	12.5	11.4	11.7	12.1	12.4	12.6
Free cash flow (€m)	3,554	3,111	758	-63	218	396	583
Net cash (debt) (E.On definition) (€m)	1,917	-268	-2,307	-5,669	-8,829	-11,891	-14,845
Gearing	9%	14%	17%	23%	28%	33%	37%
Payout ratio based on clean earnings	50%	50%	55%	54%	55%	57%	59%

Source: Company Reports and Citigroup Investment Research

Figure 15. Group Financial Forecasts (€M)

Profit and Loss	2005	2006	2007E	2008E	2009E	2010E	2011E
Sales	56,141	67,759	64,641	65,019	64,653	65,436	66,248
Operating costs	46,829	57,363	53,392	53,119	52,233	52,677	53,222
Adjusted EBITDA before associates	9,312	10,396	11,249	11,900	12,420	12,758	13,026
Adjusted EBITDA including associates	10,194	11,353	12,043	12,710	13,246	13,601	13,885
Depreciation	-2,901	-3,203	-3,131	-3,347	-3,564	-3,768	-3,961
Adjusted EBIT	7,293	8,150	8,913	9,363	9,682	9,833	9,924
of which associates & income from investments	882	957	795	810	826	843	859
Adjusted interest income	-1,027	-1,081	-875	-1,033	-1,212	-1,384	-1,551
Net book gains	491	1,205	0	0	0	0	0
Restructuring costs and non-operating earnings	-29	0	0	0	0	0	0
Other non-operating earnings	424	-3,141	0	0	0	0	0
Pre-tax profit	7,152	5,133	8,038	8,330	8,470	8,448	8,373
Tax	-2,261	323	-2,607	-2,715	-2,763	-2,748	-2,712
Minorities	-536	-526	-500	-525	-551	-578	-607
Discontinued items/other	3,052	127	0	0	0	0	0
Net attributable profit	7,407	5,057	4,931	5,091	5,156	5,122	5,054
Adjusted net attributable profit	3,640	4,386	4,931	5,091	5,156	5,122	5,054
Cash Flow	**2005**	**2006**	**2007E**	**2008E**	**2009E**	**2010E**	**2011E**
Gross cash flow	6,544	7,194	7,095	7,324	7,605	7,783	7,971
Capex	-2,990	-4,083	-6,337	-7,387	-7,387	-7,387	-7,388
Acquisitions/other investments	-1,553	-1,849	0	0	0	0	0
Disposal proceeds	6,294	3,954	0	0	0	0	0
Dividends	-1,788	-4,856	-2,450	-2,952	-3,031	-3,110	-3,190
Issue/(redemption) of group equity	-59	29	0	0	0	0	0
Other/change in scope of consolidation	-4,596	-3,136	0	0	0	0	0
Change in net debt	1,852	-2,747	-2,039	-3,362	-3,160	-3,062	-2,954
Balance Sheet	**2005**	**2006**	**2007E**	**2008E**	**2009E**	**2010E**	**2011E**
Intangible assets	4,125	3,749	3,409	3,100	2,819	2,563	2,331
Property plant and equipment	41,323	42,712	46,258	50,607	54,712	58,586	62,245
Financial assets	27,867	29,696	30,093	30,498	30,912	31,333	31,763
Stocks	2,457	3,990	4,050	4,111	4,172	4,235	4,235
Receivables	19,240	19,754	19,949	20,148	20,351	20,558	20,769
Cash and equivalents	9,897	6,187	5,000	5,000	5,000	5,000	5,000
Other assets	1,054	957	957	957	957	957	957
Total assets	105,963	107,045	109,717	114,422	118,922	123,232	127,300
Debt	-14,362	-13,399	-14,251	-17,613	-20,773	-23,835	-26,789
Provisions	-33,862	-32,093	-32,673	-33,092	-33,494	-33,886	-34,260
Trade creditors	-5,288	-5,305	-5,411	-5,519	-5,630	-5,742	-5,857
Other liabilities	-15,412	-15,760	-15,762	-15,341	-14,920	-14,499	-14,080
Minorities	-4,734	-4,917	-5,167	-5,429	-5,705	-5,994	-6,298
Shareholders Funds	44,484	47,845	48,899	49,875	50,849	51,723	52,463

Source: Company Reports and Citigroup Investment Research

E.ON AG

Company Description

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

Investment Thesis

We rate E.On Buy/ Medium Risk (1M) with a €130 target price. Now that clarity is emerging in Spain, we think the fundamental value that we see in the stock should increasing be translated into the share price. We think further major acquisitions are unlikely in the near future and that a possible return of capital in June should help convince investors that reinvestment risk is now limited.

Valuation

We use a sum-of-parts method applying a variety of valuation techniques to the various divisions. We chiefly rely on a mix of DCF valuations, regulatory asset basis and EV/EBITDA multiples. Financial assets are taken at book value, save for the stake in Gazprom, which is marked to market. Nuclear liabilities are subtracted at a value generated by a separate DCF model. Pension provisions are deducted at book value and a portion of the book value of "other" provisions is also subtracted. Our latest SOP valuation is €132 per share on a standalone basis, and we have €130 as our target price. We cross-check our sum-of-parts valuation by reference to valuation multiples at group level. At our target price, E.On would trade on a FY08E P/E of 14.9x if the value of the Gazprom stake is stripped out of the E.On share price. Factoring-in the planned €10bn asset acquisition, this would fall to 13.9x, representing a c.10% discount to the sector average, which we think reasonably reflects E.On's "megacap" status and the geographic diversity of its assets.

Risks

We rate E.On as Medium Risk. Risks that may affect the achievement of our target price include the possibility that power prices might fall, as well as regulatory risks in both the gas and the electricity markets. There is also a risk of further uncertainty in Spain. With regard to the investment thesis and achievement of our target price, these could be undermined by renewed competition in German generation or by regulatory change proving more severe than we anticipate. In addition, E.On may make a value-destructive acquisition outside Spain. If competition does erupt in the German gas market, then Ruhrgas would probably need to renegotiate its long-term gas purchasing contracts.

Appendix A-1

Analyst Certification

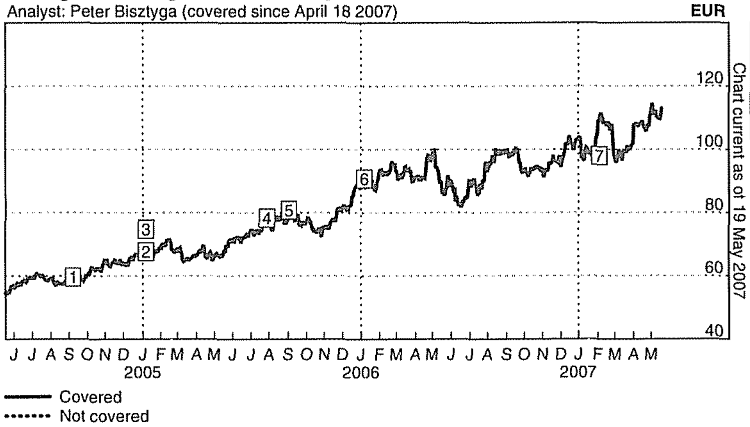
I, Peter Bisztyga, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

E.ON (EONG.DE)

Ratings and Target Price History - Fundamental Research

Analyst: Peter Bisztyga (covered since April 18 2007)



#	Date	Rating	Target Price	Closing Price
1:	8 Sep 04	*1M	*70.00	58.10
2:	7 Jan 05	1M	*75.00	67.71
3:	7 Jan 05	1M	75.00	67.71
4:	28 Jul 05	1M	*86.00	76.40
5:	2 Sep 05	1M	*90.00	78.84
6:	6 Jan 06	1M	*100.00	88.18
7:	5 Feb 07	1M	*130.00	108.97

*Indicates change

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Citigroup Investment Research Global Fundamental Coverage (3215)	45%	40%	15%
% of companies in each rating category that are investment banking clients	45%	42%	32%
Utilities -- Europe (31)	35%	52%	13%
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Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target

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1 June 2007 | 13 pages

E.ON AG (EONG.DE)

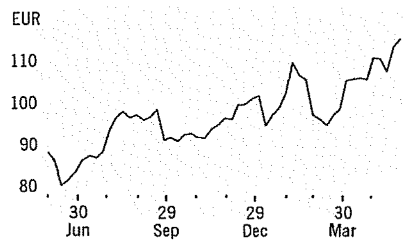
Now For A Progressive Re-Rating

Rating change ☐
Target price change ☑
Estimate change ☑

- **Investor perceptions should improve** — The package of initiatives from E.On's capital markets day exceeded our expectations. But most importantly, E.On's decision to return capital to shareholders and establish clear targets demonstrates that its attitude towards investors has changed. We believe this will drive a positive shift in investor perceptions.
- **Earnings growth target is realistic** — Our analysis in this brief report suggests that E.On's €60bn investment plan is rather ambitious. We factor in only 80% into our numbers. Nonetheless, we are optimistic about the impact that rising power prices and operational improvements will have on earnings growth, so we believe E.On's €12.4bn EBIT target is deliverable.
- **30% earnings upgrade** — A combination of €1bn of operational improvements (deliverable, in our view), the €7bn share buyback, the €10bn Endesa asset/ Viesgo acquisition, growth investment and lower taxes drives a material upgrade to our forecasts. Our new EPS forecast for FY10E implies compound EPS growth of 13% over the next 3 years, sufficient to comfortably sustain at least 15% nominal growth in DPS.
- **Maintain Buy** — E.On still looks cheap relative to the sector. Stripping out Gazprom, the *FY08E P/E is just 11.4x against a sector multiple of 16x.* A positive shift in investor perceptions will, in our view, help close this discount by driving a progressive re-rating. We raise our price target to €140/share and reiterate our Buy/Medium Risk (1M) recommendation.

Buy/Medium Risk	**1M**
Price (31 May 07)	€122.18
Target price	€140.00
from €130.00	
Expected share price return	14.6%
Expected dividend yield	3.2%
Expected total return	**17.7%**
Market Cap	€84,549M
	US$113,536M

Price Performance (RIC: EONG.DE, BB: EOA GR)



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

E.ON AG (EUR)

Year to 31 Dec	2005A	2006A	2007E	2008E	2009E
Sales (€M)	51,616.0	64,197.0	64,640.8	68,758.7	69,973.4
Net Income (€M)	3,640.0	4,337.0	4,942.8	5,800.5	6,173.5
Basic EPS (€)	5.52	6.58	7.61	9.30	10.17
Basic EPS (Old) (€)	5.52	6.58	7.48	7.72	7.82
PE (x)	22.1	18.6	16.1	13.1	12.0
EV/EBITDA (x)	10.3	8.2	7.7	7.5	7.5
DPS (€)	7.00	3.35	3.85	4.43	5.09
Net Div Yield (%)	5.7	2.7	3.2	3.6	4.2

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Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	22.1	18.6	16.1	13.1	12.0
EV/EBITDA adjusted (x)	10.3	8.2	7.7	7.5	7.5
P/BV (x)	1.8	1.7	1.7	1.7	1.6
Dividend yield (%)	5.7	2.7	3.2	3.6	4.2
Per Share Data (€)					
EPS adjusted	5.52	6.58	7.61	9.30	10.17
EPS reported	11.24	7.60	7.61	9.30	10.17
BVPS	67.49	72.59	73.09	72.32	75.17
DPS	7.00	3.35	3.85	4.43	5.09
Profit & Loss (€M)					
Net sales	51,616	64,197	64,641	68,759	69,973
Operating expenses	-45,564	-57,452	-56,577	-59,435	-59,578
EBIT	**6,052**	**6,745**	**8,063**	**9,324**	**10,395**
Net interest expense	-736	-687	-801	-1,378	-2,001
Non-operating/exceptionals	1,836	-974	795	810	826
Pre-tax profit	**7,152**	**5,084**	**8,057**	**8,756**	**9,221**
Tax	-2,261	323	-2,614	-2,431	-2,497
Extraord./Min.Int./Pref.div.	2,516	-399	-500	-525	-551
Reported net income	**7,407**	**5,008**	**4,943**	**5,801**	**6,173**
Adjusted earnings	3,640	4,337	4,943	5,801	6,173
Adjusted EBITDA	9,234	10,337	11,334	13,123	14,548
Growth Rates (%)					
Sales	21.8	24.4	0.7	6.4	1.8
EBIT adjusted	5.3	12.2	14.0	15.4	11.3
EBITDA adjusted	-1.2	11.9	9.6	15.8	10.9
EPS adjusted	11.3	19.1	15.6	22.2	9.4
Cash Flow (€M)					
Operating cash flow	**6,466**	**7,086**	**7,107**	**8,344**	**9,075**
Depreciation/amortization	2,901	3,203	3,131	3,657	4,016
Net working capital	-1,010	-1,291	-649	-652	-654
Investing cash flow	**1,751**	**-1,978**	**-6,662**	**-19,012**	**-10,563**
Capital expenditure	-2,990	-4,083	-6,662	-9,012	-10,563
Acquisitions/disposals	4,741	2,105	0	-10,000	0
Financing cash flow	**-10,414**	**-8,926**	**-1,285**	**11,015**	**1,835**
Borrowings	-8,567	-4,099	3,499	18,399	4,788
Dividends paid	-1,788	-4,856	-2,450	-2,717	-2,952
Change in cash	**-2,197**	**-3,818**	**-840**	**347**	**347**
Balance Sheet (€M)					
Total assets	**126,562**	**127,232**	**130,402**	**146,421**	**153,646**
Cash & cash equivalent	9,897	6,187	5,000	5,000	5,000
Accounts receivable	7,179	9,756	9,951	10,150	10,353
Net fixed assets	41,323	42,712	46,583	62,247	69,075
Total liabilities	**77,344**	**74,470**	**78,422**	**97,082**	**102,299**
Accounts payable	5,288	5,305	5,411	5,519	5,630
Total Debt	14,362	13,399	16,898	35,296	40,084
Shareholders' funds	**49,218**	**52,762**	**51,980**	**49,339**	**51,347**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	17.9	16.1	17.5	19.1	20.8
ROE adjusted	9.3	9.4	10.4	12.8	13.8
ROIC adjusted	5.7	10.2	7.3	8.1	8.2
Net debt to equity	9.1	13.7	22.9	61.4	68.3
Total debt to capital	22.6	20.3	24.5	41.7	43.8

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Now For A Progressive Re-Rating

We maintain our Buy/Medium Risk (1M) recommendation

E.On's package of initiatives from its capital markets day presentation has exceeded our expectations. Our analysis in this brief report outlines what we believe E.On can actually deliver. Our conclusions lead us to upgrade our price target to €140/share and our EPS forecasts by some 30%. But most importantly, we believe E.On's attitude towards its shareholders has changed. We believe this will drive a positive shift in investor perceptions that should result in a progressive re-rating of a stock that is still, in our view, undervalued. We maintain our Buy/Medium Risk (1M) recommendation.

The key announcements from E.On's capital markets day are summarised in Figure 1 below.

Figure 1. Capital Markets Day: E.On Beats Our Expectations

	Expected	Actual	Comment
Investment Plan	€40bn 2007-2009	€60bn initiated by 2010	We believe E.On can spend €45bn by 2010
Operational Improvements	€600m	€1bn	Achievable in our view
Adjusted EBIT	+€2.5bn by 2010	€12.4bn (+€4bn) by 2010	Achievable in our view
Capital Structure	3.0-3.5x Net debt/EBITDA by 2010	3.0x Net debt/EBITDA	Achievable in our view
Share Buyback	€4bn, 5% of capital over 18 months	€7bn, 9% of capital by end 2008	Potential for further buyback if E.On undershoots gearing target
Dividend	60% payout ratio by 2010	10-20% growth to 2010	We assume 15% growth p.a.

Source: Company Reports and CIR Estimates

A New Attitude

Investor perceptions should change for the better

E.On's capital markets day contained a number of strategic initiatives that will no doubt be analysed for weeks to come (we present some of our own analysis below). In our view, though, the most important aspect of the announcements was a significant improvement in E.On's attitude towards its investors:

- E.On's decision to announce a share buyback has confounded many sceptics who thought it unlikely that E.On's supervisory board could be convinced to return capital to shareholders. The fact that E.On went for a near 10% buyback rather than the 5% we had expected, shows that E.On had listened to its shareholders.

- E.On has set out a clear set of targets against which it can be measured. This has several benefits. Investors now have a clear understanding of how E.On will reach and manage its 3x debt/EBITDA target, and can potentially look forward to greater returns of capital if E.On undershoots this (incidentally, our new forecasts suggest E.On should maintain 3x debt/EBITDA based on the €7bn buyback and 15% DPS growth). Also, by creating a separate reporting line for new generation projects, investors will be able to value properly new investments that may otherwise have been overlooked. Finally, we believe investors can probably look forward to disposal of assets such as LG&E in the US (our valuation US$4bn) by 2010, although an element of acquisition risk also still remains.

Importantly, we see the influence of E.On's new Finance Director, Dr Marcus Schenck (who joined in December 2006) in the strategic initiatives. His clear, methodical approach demonstrates an understanding of the investment community's requirements, which we welcome. We also welcome the news that Wulf Bernotat's contract has been extended to 2010, since this will provide stability at the top level.

Clearly, management now needs to deliver on these promises, but, as we discuss below, we think the earnings growth targets are deliverable (if not all the capex). We have upgraded our EPS forecast by 30%.

We believe this change in E.On's attitude will drive a positive shift in investor perceptions that should result in a progressive re-rating of a stock that is still, in our view, undervalued.

Investment Plan: Can E.On Deliver?

We think €45bn is deliverable by 2010

In our view, the most contentious area of E.On's strategic initiatives is its investment plan. E.On has set out a total investment plan of €60bn, of which it intends to deliver €54bn by end-2010. Our view is that €45bn is a more realistic expectation, around 80% of E.On's target.

The table in Figure 2 shows how we believe E.On's investment plan is profiled, while Figure 3 shows how we think it is split between growth and maintenance capex, based on the information available in E.On's presentations.

Figure 2. How We Think E.On's Investment Plan is Profiled (€bn)

	2007E	2008E	2009E	2010E	2011E+	Total
Original 2007-2009 Plan	8.4	8.4	8.4	2.6	4.8	32.7
Endesa Assets/Viesgo	-	11.3	1.1	0.7	1.2	14.3
New Projects	-	1.8	4.1	4.1	-	10.0
New Maintenance	-	-	-	3.0	-	3.0
Total		**30.0 by '08**		**54.0 by '10**		**60.0 total**

Source: Company Reports and CIR Estimates

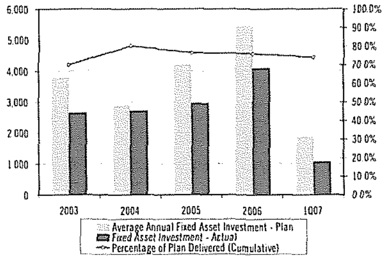
Figure 3. How We Think E.On's Investment Plan Splits Growth vs. Maintenance (€bn)

	2007	2008	2009	2010	2011+	Total
Maintenance Capex - Old	4.1	4.1	4.1			
Maintenance Capex - New	0.9	0.9	0.9	3.0		**18.0 maint**
Growth Capex	3.4	6.6	8.6	7.4	6.0	
Acquisitions		10.0				**42.0 growth**

Source: Company Reports and CIR Estimates

There are two areas where we believe investors need to be sceptical about E.On's ability to deliver its investment plan:

Figure 4. E.On Has Under-spent in the Past (€M)



Source: Company Reports and CIR Estimates

- **Growth capex.** E.On has historically under-spent against growth capex by around 25%, as shown in Figure 4. We think it is reasonable to assume that this trend will continue. While E.On claims all of its projects have passed a stringent economic test, there are several more hurdles to jump. Firstly, several projects are likely to still need planning approval, which may not be forthcoming. Secondly, some projects are of a cutting-edge nature, e.g. supercritical coal generation, and may not go ahead if the economic, political and regulatory environment is not sufficiently attractive, or if the technology proves too challenging. Finally, E.On may fail to secure all the investments it is targeting in Russia for instance, since many other players are competing for these as well. The biggest risk on the downside here is that E.On fails to secure a 25% stake in the Yushno Rosskoje gas field.

- **Maintenance capex.** We cannot get comfortable with E.On's maintenance capex number which implies only €3bn for 2010 but €5bn p.a. for 2007-2009 inclusive. We therefore take a haircut on this number.

The table in Figure 5 shows our assessment of what is likely to be deliverable in practice: in total, some €45bn by 2010. Ignoring the Endesa asset/Viesgo acquisition cost and associated capex, this is only some €3bn more than we had previously factored in. This additional investment reflects:

- Generation projects in areas such as Eastern Europe that E.On had withdrawn when it bid for Endesa (due to lack of capital and management capacity) but has now reintroduced.

- We expect at least some success in bidding for OGK/TGK stakes in Russia, given E.On's good bargaining position.

- Around 500MW of new renewable projects.

Figure 5. The Investment We Think is Deliverable (€bn)

	2007E	2008E	2009E	2010E	Total
Maintenance/Replacement	4.1	4.1	4.1	3.0	15.3
Growth	2.6	4.9	6.5	5.5	19.5
Acquisition		10.0			10.0
Total	6.7	19.0	10.6	8.5	**44.8**

Source: CIR Estimates

We think E.On can deliver €12.4bn by 2010

We believe a €45bn investment programme is still sufficient to deliver E.On's €12.4bn EBIT target by 2010. Although we think investment will be lower than E.On is expecting, we seem to be more optimistic about the impact that rising power prices in Germany and the Nordic region will have on E.On's underlying profitability.

Figure 6 shows how we get to our FY10E EBIT forecast of just under €12.4bn. We have made two key assumptions:

- **Operational Improvements.** In our view, E.On can deliver its target of €1bn of operational improvements by 2010. We make three arguments here: 1) we believe that E.On has delivered against its operational improvement targets in the past; 2) E.On is targeting just €300-400m of efficiency savings, which appears conservative versus RWE's €600m target; 3) One only needs to compare E.On and RWE's 1Q07 results to see how the latter's unified and well-managed trading platform — something that E.On is now seeking to establish — can deliver real cash benefits to earnings.

- **Investment returns.** Using data from E.On's original 2007-09 investment plan we have concluded that around 50% of growth capex will result in projects that are operational in 2010. We think it is reasonable to assume that E.On can earn a 10% pre-tax ROCE on these.

Figure 6. The Adjusted EBIT Growth We Think Is Deliverable (€M)

	2007	2008	2009	2010	Total	
Net Margin Improvements	705.0	416.7	133.0	(18.0)	1,236.8	E.On expect only €700m of net margin improvements, but this seems pessimistic
Operational Improvements	250.0	250.0	250.0	250.0	1,000.0	We think E.On's €1bn is deliverable
Return on Investment		128.8	246.3	323.8	698.8	Assumes 10% ROCE and 50% of projects up and running by 2010
Endesa		1,082.2			1,082.2	Our forecasts
Total					**4,017.7**	
Adjusted EBIT in 2006 (IFRS)					8,356.0	
Adjusted EBIT in 2012 (IFRS)					12,373.7	

Source: Company Reports and CIR Estimates

Outlook for Earnings

EPS upgraded by 30%

We are upgrading our earnings forecasts for 2008-2010E by around 30% on average. Our new EPS forecast for FY10E implies compound EPS growth of 13% over the next 3 years, sufficient to comfortably sustain at least 15% nominal growth in dividend per share. This significant upgrade in earnings is driven by a number of factors, summarised in Figure 7. We have taken this opportunity to factor in the expected change in German corporation tax, which we estimate will reduce E.On's tax charge to 33% from 2008 onwards.

Figure 7. EPS Upgraded by 30% (€/share)

	2007E	2008E	2009E	2010E	07-'10 Average Enhancement
Old	7.48	7.72	7.82	7.77	
+ Endesa/Viesgo Assets		+0.51	+0.57	+0.61	7.3%
+ Eur7bn Buyback	+0.05	+0.21	+0.36	+0.36	4.0%
+ 15% DPS Growth				-0.01	0.0%
+ Eur700m Operational Improvements	+0.08	+0.23	+0.37	+0.62	5.3%
+ Eur6bn Growth Investment	-0.01	+0.02	+0.20	+0.62	3.6%
+ German Tax Law Change/Other		+0.60	+0.84	+1.08	10.8%
New	**7.61**	**9.30**	**10.17**	**11.05**	**30.9%**

Source: CIR Estimates

Outlook for Valuation

Target price raised to €140/share.

We upgrade our price target by €10/share to €140/share, in line with our new sum-of-parts valuation (our sum-of-parts rises by €8/share). Our justification for this is relatively straightforward:

- **Operational Improvements.** We have included the incremental €700m of operational improvements (from the €1bn total) that we did not already have in our model. We have simply used a conservative 6x EBITDA multiple (this allows for some of the benefits to be competed/regulated away over time) to get a valuation of around €6/share.
- **Growth investment.** We have given E.On an additional €2/share for new growth investments that we have included in our revised forecast, assuming a ROCE-WACC spread of 1%.

Based on our price target, E.On still looks good value, with an expected total return of nearly 18%. Valuation multiples support our view, where E.On trades at what we consider to be an unjustifiably large discount to the sector. We believe that this discount will close through a progressive relative re-rating as E.On begins to deliver on operational improvements, its share buyback and growth capex.

Figure 8. E.On's Relative Valuation Still Looks Compelling

	2007E	2008E	2009E
Headline P/E	16.1x	13.1x	12.0x
P/E - Ex-Gazprom	14.0x	11.4x	10.4x
Dividend Yield	3.2%	3.6%	4.2%
Utilities Sector Average			
P/E	17.1x	16.0x	15.2x
Dividend Yield	3.6%	3.7%	4.0%

Source: CIR Estimates

Figure 9. E.On — Sum-of-Parts Valuation

	€M	€/share	Method
Central Europe	51,535	77	Chiefly based on DCF of component parts
Pan-European gas	15,941	24	DCF/RAB benchmarking
UK	13,643	20	£0.4m perMW, £160 per customer and 10% premium to RABs
Nordic	9,951	15	Assumed EBITDA multiple - in line with Fortum SoP
US-Midwest	3,981	6	Assumed EBITDA multiple
Corporate centre	-2,653	-4	Assumed EBITDA multiple
Additional Investments	4,200	6	
Additional Operational Improvements	1,246	2	
Financial assets	22,464	33	Book value save for Gazprom which is marked to market
of which 6.43% of Gazprom	10,653	16	Current market value
Total EV	120,309	179	
Net cash	-4,954	-7	Forecast book value at 31/12/07
Pension liabilities	-3,930	-6	Forecast book value at 31/12/07
Nuclear liabilities	-8,171	-12	Based on our model - current book value is €12.3bn
Other liabilities	-4,254	-6	Based on our model - current book value is €13.0bn
Minorities	-5,167	-8	Forecast book value at 31/12/07
Net equity value	**93,834**	**139**	

Source: CIR Estimates

Figure 10. E.On — Divisional Breakdown (€M)

	2005A	2006A	2007E	2008E	2009E	2010E	2011E
Central Europe	3,930	4,168	4,953	5,240	5,916	6,673	6,894
Pan-European Gas	1,536	2,106	1,942	2,095	1,984	1,880	1,779
UK	963	1,229	1,282	1,182	1,294	1,392	1,492
Nordic	766	619	890	1,016	1,089	1,165	1,242
US-Midwest	365	391	347	348	346	494	493
Endesa/ENEL assets	-	-	-	812	1,144	1,185	1,517
Corporate centre/consolidation	-399	-416	-416	-416	-416	-416	-416
Core businesses	7,161	8,097	8,998	10,276	11,359	12,373	13,001
Degussa	132	53	0	0	0	0	0
Total continuing operations	**7,293**	**8,150**	**8,998**	**10,276**	**11,359**	**12,373**	**13,001**

Source: Company Reports and CIR Estimates

Figure 11. Key Financial Figures

	2005 A	2006 A	2007 F	2008 F	2009 F	2010 F	2011 F
EPS from ongoing operations (€)	6.60	7.48	7.61	9.30	10.17	11.05	11.60
EPS from discontinued operations/other (€)	4.64	0.19	0.00	0.00	0.00	0.00	0.00
Total reported group EPS (€)	11.24	7.67	7.61	9.30	10.17	11.05	11.60
Adjusted EPS (€)	5.52	6.65	7.61	9.30	10.17	11.05	11.60
DPS (€)	7.00	3.35	3.85	4.43	5.09	5.86	6.74
Cashflow/share (€)	11.1	12.5	11.6	14.0	15.6	16.8	17.9
Free cash flow (€m)	3,554	3,111	445	-668	-1,488	1,332	3,188
Economic Net Debt (€m)	-	-18,231	-23,065	-41,882	-47,072	-49,848	-51,229
Net Debt/EBITDA	-	1.6	1.9	3.0	3.1	3.0	2.9
Payout ratio based on clean earnings	50%	50%	51%	48%	50%	53%	58%

Source: Company Reports and CIR Estimates

Figure 12. E.On — Group Financial Forecasts (€M)

Profit and Loss	2005 A	2006 A	2007 F	2008 F	2009 F	2010 F	2011 F
Sales	56,141	67,759	64,641	68,759	69,973	70,957	73,350
Operating costs	46,829	57,363	53,307	55,636	55,425	55,187	56,634
Adjusted EBITDA before associates	9,312	10,396	11,334	13,123	14,548	15,770	16,716
Adjusted EBITDA including associates	10,194	11,353	12,128	13,933	15,375	16,613	17,576
Depreciation	-2,901	-3,203	-3,131	-3,657	-4,016	-4,240	-4,574
Adjusted EBIT	7,293	8,150	8,998	10,276	11,359	12,373	13,001
of which associates & income from investments	882	957	795	810	826	843	859
Adjusted interest income	-1,027	-1,081	-941	-1,520	-2,137	-2,333	-2,434
Net book gains	491	1,205	0	0	0	0	0
Restructuring costs and non-operating earnings	-29	0	0	0	0	0	0
Other non-operating earnings	424	-3,141	0	0	0	0	0
Pre-tax profit	7,152	5,133	8,057	8,756	9,221	10,040	10,568
Tax	-2,261	323	-2,614	-2,431	-2,497	-2,751	-2,914
Minorities	-536	-526	-500	-525	-551	-578	-607
Discontinued items/other	3,052	127	0	0	0	0	0
Net attributable profit	7,407	5,057	4,943	5,801	6,173	6,711	7,046
Adjusted net attributable profit	3,640	4,386	4,943	5,801	6,173	6,711	7,046
Cash Flow	**2005 A**	**2006 A**	**2007 F**	**2008 F**	**2009 F**	**2010 F**	**2011 F**
Gross cash flow	6,544	7,194	7,107	8,344	9,075	9,843	10,576
Capex	-2,990	-4,083	-6,662	-9,012	-10,563	-8,511	-7,388
Acquisitions/other investments	-1,553	-1,849	0	-10,000	0	0	0
Disposal proceeds	6,294	3,954	0	0	0	0	0
Dividends	-1,788	-4,856	-2,450	-2,717	-2,952	-3,369	-3,847
Issue/(redemption) of group equity	-59	29	-2,333	-4,667	0	0	0
Other/change in scope of consolidation	-4,596	-3,136	0	0	0	0	0
Change in net debt	1,852	-2,747	-4,686	-18,399	-4,788	-2,384	-1,006
Balance Sheet	**2005 A**	**2006 A**	**2007 F**	**2008 F**	**2009 F**	**2010 F**	**2011 F**
Intangible assets	4,125	3,749	3,409	3,100	2,819	2,563	2,331
Property plant and equipment	41,323	42,712	46,583	62,247	69,075	73,602	76,648
Financial assets	27,867	29,696	30,093	30,498	30,912	31,333	31,763
Stocks	2,457	3,990	4,050	4,111	4,172	4,235	4,235
Receivables	19,240	19,754	19,949	20,148	20,351	20,558	20,769
Cash and equivalents	9,897	6,187	5,000	5,000	5,000	5,000	5,000
Other assets	1,054	957	957	957	957	957	957
Total assets	105,963	107,045	110,042	126,061	133,286	138,248	141,703
Debt	-14,362	-13,399	-16,898	-35,296	-40,084	-42,468	-43,474
Provisions	-33,862	-32,093	-32,673	-33,092	-33,494	-33,886	-34,260
Trade creditors	-5,288	-5,305	-5,411	-5,519	-5,630	-5,742	-5,857
Other liabilities	-15,412	-15,760	-15,527	-15,262	-15,179	-15,156	-15,205
Minorities	-4,734	-4,917	-5,167	-5,429	-5,705	-5,994	-6,298
Shareholders Funds	44,484	47,845	46,813	43,910	45,642	47,449	49,056

Source: Company Reports and CIR Estimates

E.ON AG

Company Description

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

Investment Thesis

We rate E.On Buy/ Medium Risk (1M) with a €140 target price. The strategic initiatives outlined by E.On's management team represent a step change in the attitude of this company towards investors. A clearly defined, visible set of targets plus an ongoing commitment to return capital should allow investors to see the value within E.On. There is substantial growth potential, even if the €60bn investment plan is only partially executed, that is not reflected in E.On's current multiples and valuation.

Valuation

We use a sum-of-parts method applying a variety of valuation techniques to the various divisions. We chiefly rely on a mix of DCF valuations, regulatory asset basis and EV/EBITDA multiples. Financial assets are taken at book value, save for the stake in Gazprom, which is marked to market. Nuclear liabilities are subtracted at a value generated by a separate DCF model. Pension provisions are deducted at book value and a portion of the book value of "other" provisions is also subtracted. Our latest SOP valuation is €139 per share on a standalone basis, and we have €140 as our target price. We cross-check our sum-of-parts valuation by reference to valuation multiples at group level. At our target price, E.On would trade on a FY08E P/E of 13x if the value of the Gazprom stake is stripped out of the E.On share price.

Risks

We rate E.On as Medium Risk. Risks that may affect the achievement of our target price include the possibility that power prices might fall, as well as regulatory risks in both the gas and the electricity markets. With regard to the investment thesis and achievement of our target price, these could be undermined by renewed competition in German generation or by regulatory change proving more severe than we anticipate. In addition, E.On may still make a value-destructive acquisitions. If competition does erupt in the German gas market, then Ruhrgas would probably need to renegotiate its long-term gas purchasing contracts.

Appendix A-1

Analyst Certification

I, Peter Bisztyga, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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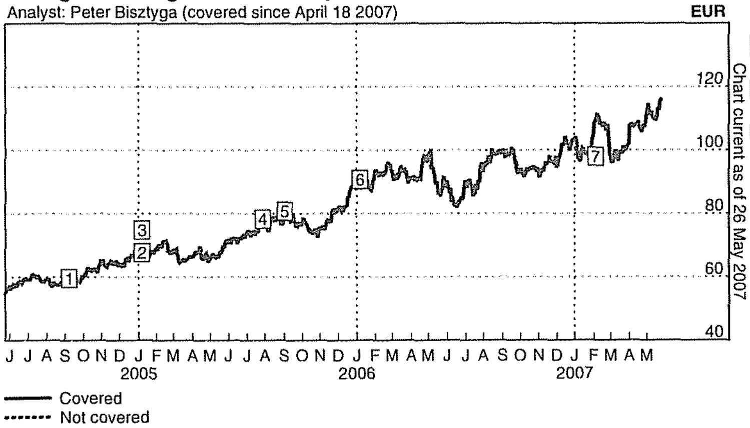
E.ON (EONG.DE)

Ratings and Target Price History - Fundamental Research

Analyst: Peter Bisztyga (covered since April 18 2007)



#	Date	Rating	Target Price	Closing Price
1:	8 Sep 04	*1M	*70.00	58.10
2:	7 Jan 05	1M	*75.00	67.71
3:	7 Jan 05	1M	75.00	67.71
4:	28 Jul 05	1M	*86.00	76.40
5:	2 Sep 05	1M	*90.00	78.84
6:	6 Jan 06	1M	*100.00	88.18
7:	5 Feb 07	1M	*130.00	108.97

*Indicates change.

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% of companies in each rating category that are investment banking clients	55%	56%	25%

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JPMorgan

E.ON

Time for consensus upgrades to PERcolate through

Overweight

€122.18

31 May 2007
Price Target: €140.00

Electric Utilities

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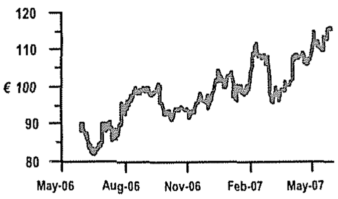
Price Performance



	YTD	-1M	-3M	-12M
Absolute	12.3%	4.7%	16.5%	27.7%

Source: RIMES, Reuters

E.ON's strategy plan sets the stage for significant upgrades to consensus earnings, and coupled with a range of catalysts we are happy to maintain our OW stance with a raised target price of □140/share.

- **Buckets of EBIT, Capex & Payout**: Following May 31st's analyst meeting we are confident E.ON can meet their €4bn EBIT growth target through a mixture of: €1.4bn of organic growth; €2.3bn from growth investments; €0.3bn of cost cutting. The capex programme is higher-sooner / lower-later than we expected, but still has the positive impact we hoped for. The buy-back was bigger than expected, and the DPS outlook better given its basis on net income.
- **Upgrades to our numbers**: These changes lead us to raise our 2010E EBIT by 13%, EPS by 15% and DPS by 26% (see Table 6). We raise our Dec 07 SOP-based TP from €130 to €140, with the benefits outlined offset by a lower Gazprom valuation.
- **Consensus upgrades due**: We estimate consensus is now 10% light at the EBIT line for 2010E, 26% to low at EPS (16% for 2008E) and 32% at DPS.
- **Stay Overweight**: The stock offers 13% upside to our revised target price (22% annualized return), and we see the upgrade process and the buy-back process (amongst other catalysts) justifying our continued OW rating.

E.ON (EONG.DE;EOA GR)

	2006A	2007E	2008E	2009E	2010E
EBITDA FY (€ mn)	11,353	11,972	14,393	15,928	16,524
EBIT FY (€ mn)	8,150	8,797	10,626	11,956	12,351
Net Attributable Income FY (€ mn)	5,057	6,205	5,859	6,344	6,508
Adj. EPS FY (€)	6.65	7.54	9.60	10.69	10.96
Dividend (Gross) FY (€)	3.35	4.26	5.43	5.88	6.58
Adj P/E FY	18.4	16.2	12.7	11.4	11.1
Gross Yield FY	2.7%	3.5%	4.4%	4.8%	5.4%
EV/EBITDA FY	9.9	9.6	8.9	8.1	7.9

Source: Company data, Reuters, JPMorgan estimates

Company Data	
Price (€)	122.18
Date Of Price	31 May 07
52-week Range (€)	117.68 - 81.05
Mkt Cap (€ bn)	80.5
Fiscal Year End	Dec
Shares O/S (mn)	659

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Investment thesis

E.ON's strategy plan sets the stage for significant upgrades to consensus earnings, and coupled with a range of catalysts we are happy to maintain our OW stance with a raised target price of □140/share.

Buckets of EBIT, Capex & Payout

E.ON strategy plan and analyst conference has confirmed our thesis – initially outlined in our May 10 research – that it would be able to significantly outperform consensus earnings targets. In terms of the announcements made, we'd focus on three areas:

EBIT target of €12.4bn
E.ON outlined in detail how they plan to increase EBIT from €8.4bn in 2006A to €12.4bn in 2010E. As outlined in the table below, they described three "buckets", which during the analyst conference call were further broken down:

- **Current growth investment & net margin improvements**: This bucket was based on the €25bn capex programme that was outlined in December 2006, and incorporates part of the margin improvements resulting in Germany and other European power markets.
- **New growth investments**: The group outlined an increased capex programme (see below) that they expect to generate around €1.7bn of EBIT during the period to 2010E.
- **Operational improvements including Trading**: A total of €1bn, which under Q&A the management split into a cost cutting element and other margin improvements.

Table 1: E.ON's EBIT growth "buckets"

A) Current growth investments & net margin improvements	**1,300**
A.1) Operational effects	700
A.2) Capex and others	600
B) New growth investment	**1,700**
C) Operational improvements including Trading	**1,000**
C.1) Cost cutting	300
C.2) Margin improvements	700
Total	**4,000**

Source: JPMorgan estimates, Company data.

Re-arranging these "buckets" into a more user-friendly form shows our original forecasts were fairly near the mark – although perhaps a little disappointing with regards to the potential for organic growth.

We'd also note that management have delivered a relatively conservative cost cutting plan at c€300m - we'd seen the potential to be up to €820m, although we can understand a conservative stance at this stage in the (a) regulatory cycle and (b) negotiations with Enel and Acciona on the southern European asset purchase.

Table 2: E.ON's EBIT growth buckets rearranged

	E.ON	JPM e	% vs JPMe
D) Organic growth	**1,400**	**1,488**	**-6%**
A.1) Operational effects	700		
C.2) Margin improvements	700		
E) Growth investments	**2,300**	**2,399**	**-4%**
A.2) Capex and others	600		
B) New growth investments	1,700		
F) Cost cutting	**300**	**0**	
Total	**4,000**	**3,887**	**3%**

Source: JPMorgan estimates

Aggressive capex programme

The €60bn capex programme outlined by management is a significant number, and whilst it is above the €25bn original programme on a like for like basis, it is roughly in line with what we expected.

What we did not expect, however, was how aggressive the capex plan is from a timing perspective – we had expected something a lot more back-end loaded than has finally emerged. This has a negative impact from an earnings perspective given that interest expenses will ramp up well ahead of EBIT.

It's also worth noting, with reference to the capex buckets above, that of the c€4bn of extra EBIT that E.ON expect their €42bn of growth capex to generate only around €2-2.3bn is to be delivered during the period to 2010E.

Table 3: Capex programme by period

2007 & 2008	**30,000**
o/w Maintenance	8,000
o/w Southern Europe acquisition	10,000
o/w Growth capex	12,000
2009 & 2010	**24,000**
o/w Maintenance	7,000
o/w Growth capex	17,000
Total to 2010	**54,000**
Beyond 2010	6,000
Total	**60,000**

Source: JPMorgan estimates, Company data.

Buckets of value return

Within the context of management's new "debt factor" (economic net debt to EBITDA) of 3x, they have decided to launch a €7bn buy-back programme by the end of 2008. This is above the €4bn over three years that we had originally expected, and should go a long way to addressing investor concerns.

We'd also note that, within the context of this "debt factor" there is even the potential for a little more in the mid term. Management have indicated that if they fall behind this factor "significantly" they would act to add investments or value return "within 24 months".

Table 4: Debt factor assessment & potential extra debt

	2006A	2007E	2008E	2009E	2010E	2011E	2012E
Economic net debt	18,231	22,542	39,463	42,427	45,325	39,388	33,315
EBITDA	11,353	11,972	14,393	15,928	16,524	16,898	17,325
Debt factor - END:EBITDA	1.61	1.88	2.74	2.66	2.74	2.33	1.92
Extra debt at 3x	**15,828**	**13,373**	**3,715**	**5,358**	**4,246**	**11,305**	**18,662**

Source: JPMorgan estimates, Company data.

Additionally, from a dividend perspective, the combination of a commitment to a 50-60% payout of adjusted net income, a 10-20% growth rate promise and the buy-back means a significant uplift in DPS should be possible.

Table 5: Dividend payout potential

	2006A	2007E	2008E	2009E	2010E	% CAGR
Adjusted net income	4,386	4,850	5,859	6,344	6,508	10.4%
Payout ratio	50%	55%	55%	55%	60%	
Dividended income	2,210	2,667	3,223	3,489	3,905	15.3%
Shares ranking	660	627	594	594	594	-2.6%
DPS	**3.35**	**4.26**	**5.43**	**5.88**	**6.58**	**18.4%**

Source: JPMorgan estimates, Company data.

Upgrades to our numbers

We raise our EBIT by around 13%, earnings by 15% and dividend by 25% by 2010E. This is driven principally by four factors:

- **Incorporation of E.ON's new targets** working through both the EBIT and capex "buckets". Note within this, though, that E.ON's capex outline involves more spending sooner and less later than we originally accounted for. As such the interest expense rises more rapidly than we originally expected, trimming around 4-5% off of 2011 numbers.
- **Inclusion of proposed southern Europe asset purchase**: These add around €1.3bn at 100% consolidation to EBIT, and accrete earnings by around 13% including the effect of minority interests.
- **Share buy-back programme**: The proposed 10% buy-back, if completed at c€120/share should add around 6% to EPS on a full year basis.
- **Dividend payout increased**: Management have indicated the dividend is based on net income, not EPS, with a 50-60% payout ratio. Assuming a steady increase to 60% by 2011E, and allowing for the 10% fall in shares issued by 2010, the DPS should achieve around 17% CAGR (vs management targeted 10-20%).

Table 6: Earnings revisions

	2007E	2008E	2009E	2010E	2011E
Old EBIT	8,797	9,284	10,516	10,931	11,118
New EBIT	8,797	10,626	11,956	12,351	12,526
% EBIT revision	**0%**	**14%**	**14%**	**13%**	**13%**
Old EPS	7.30	7.82	9.01	9.51	9.77
New EPS	7.54	9.60	10.69	10.96	11.23
% EPS revision	**3%**	**23%**	**19%**	**15%**	**15%**
Old DPS	4.01	4.30	4.95	5.23	5.37
New DPS	4.26	5.43	5.88	6.58	6.74
% DPS revision	**6%**	**26%**	**19%**	**26%**	**25%**

Source: JPMorgan estimates.

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Table 8: Valuation multiples

Dec 31 y/e, ex Gazprom	2007E	2008E	2009E	2010E	2011E
Multiples at €140 target price					
P/E	16.0x	13.2x	12.2x	11.9x	11.6x
Declared Yield	3.0%	3.9%	4.2%	4.7%	4.8%
FCF Adjusted	-4.9%	-20.8%	-2.1%	-1.8%	10.0%
EV/EBITDA	9.7x	9.3x	8.6x	8.4x	8.1x
Multiples at €124 share price					
P/E	13.9x	11.5x	10.6x	10.3x	10.1x
Declared Yield	3.4%	4.4%	4.7%	5.3%	5.4%
FCF Adjusted	-5.6%	-23.9%	-2.4%	-2.1%	11.6%
EV/EBITDA	8.8x	8.6x	7.9x	7.8x	7.4x

Source: JPMorgan estimates, Company data.

Catalysts

We see five significant events in the coming months that could drive the shares:

- **Upgrades to consensus earnings**: As discussed already, we expect to see consensus earnings upgrades of around 26% on 2010E earnings and 32% on dividends. We'd expect these to be implemented in the coming weeks, which in turn will likely also lead to E.ON being flagged in many general investors' earnings revision screens.
- **Share buy-back process**: E.ON shares turn over an average 4.5m / day, making the buy-back programme equivalent to around 15 days trade over the next c350 trading days. Assuming management "dribble" the programme rather than doing a single block, this should act as solid support for the shares.
- **Capital Markets Day**: E.ON postponed their "East Europe" capital markets day in order to make room for the strategy presentation. We'd look for this to be re-established for soon after the summer. We believe a focus on these relatively high growth markets should help drive upgrades if they have not already happened.
- **Completion of Southern Europe purchase**: Enel have stated that they expect their offer for Endesa to complete by the end of September. Following this the negotiations with E.ON can be completed, and consensus forecasts upgraded if they are not already.
- **Clarification of regulatory uncertainties**: Near term we remain concerned regarding negative news flow in Germany on: CO2 allocations, where we expect the government to implement auctioning; finalisation of incentive regulation rules, due for early July; network price applications due for end June for decisions in September; competition reviews against RWE. However, once these are resolved any residual uncertainty should lift, freeing the shares to perform.
- **Possible disposals**: Looking longer term management have made it clear that they will look to sell any assets that are not meeting strategic or financial criteria. Given RoCE is c250bp below WACC we'd see the US operations (LG&E) as being a candidate for sale. Timing could be extensive though - management have made a commitment to do this only by end 2010E.

Key risks to our target price and recommendation can be found on page 13 of this report.

Fusebox

Where do we differ to consensus?

- **Earnings forecasts**: We factor in E.ON's new targets, and arrive at a 2008E EPS that is 16% above Bloomberg consensus, and 2010E EPS that is 26% above. We believe the market will come around to these numbers in due course.
- **Valuation**: Our revised €140 target price compares to around €130 in the consensus currently – again we'd expect to see upgrades as the market factors in E.ON's new data.

Forthcoming events

- **Consensus upgrades**: We'd expect this process to proceed naturally in the coming months, but would see: a potential East Europe capital markets day; completion of the southern Europe asset purchase; and a lifting of regulatory uncertainties as being ongoing catalysts.
- **Share buy-back programme**: We expect E.ON to buy back probably half its allowance during 2007, and the remainder in 2008. In total the buy-back should account for 15 of the next c350 trading days.
- **Disposals**: We wouldn't expect immediate action, but the future of the underperforming assets in the group - especially LG&E - has to be in question. We'd see disposal news (subject to pricing of course) as potentially positive.

Table 9: Key financial ratios

Sum of Parts, y/e '07E	**€m**	**€p.s.**	**% EV**	**'07E EV/EBITDA**
Central Europe	49,065	78.3	37%	8.2x
Pan-Euro Gas	35,402	56.5	27%	13.3x
UK	14,699	23.5	11%	8.0x
Nordic	14,832	23.7	11%	10.1x
US Mid-West	5,188	8.3	4%	9.0x
Southern Europe	12,777	20.4	10%	7.1x
Corporate Center	740	1.2	1%	
Enterprise value	**132,704**	**211.8**	**100%**	**11.1x**
less: Net debt	-14,946	-23.9	-11%	-1.2x
less: Provisions/other	-29,968	-47.8	-23%	
Equity Value	**87,789**	**140.1**	**66%**	
Dec 31 y/e, ex Gazprom	**2007E**	**2008E**	**2009E**	**2010E**
Multiples at €140 target price				
P/E	16.0x	13.2x	12.2x	11.9x
Declared Yield	3.0%	3.9%	4.2%	4.7%
FCF Adjusted	-4.9%	-20.8%	-2.1%	-1.8%
EV/EBITDA	9.7x	9.3x	8.6x	8.4x
Multiples at €124 share price				
P/E	13.9x	11.5x	10.6x	10.3x
Declared Yield	3.4%	4.4%	4.7%	5.3%
FCF Adjusted	-5.6%	-23.9%	-2.4%	-2.1%
EV/EBITDA	8.8x	8.6x	7.9x	7.8x

Source: JPMorgan estimates.

Table 10: Key earnings drivers

€m, Dec 31 y/e	2007E	2008E	2009E	2010E	2011E	2011E vs 2006A
Change in group PBET	704	1,502	881	262	242	3,590
o/w Wholesale power, Germany	836	-60	864	-61	-45	2,044
o/w Regulation, Germany	-334	-227	0	0	0	-561
o/w East Europe (power & gas)	69	319	118	124	129	759
o/w Wholesale power, Nordic	436	175	115	54	29	810
o/w Interest expense	56	-328	-448	-133	67	-785
o/w Southern Europe	0	1,342	98	-20	-12	1,440
o/w UK Gentailing margins	44	-50	-98	114	-119	-109
o/w New investments & Others	-403	330	232	184	192	-9
% change PBET y-o-y	*12.1%*	*10.0%*	*19.3%*	*9.5%*	*2.6%*	*8.0%*

Source: JPMorgan estimates.

Table 11: Key sensitivities

Variable	Our assumption	Flex	PBT effect - €m	S-o-P effect €/share
German electricity				
Network regulation	20% price cut	5% points	187	3.8
Nuclear plant lives	32 years	40 years		3.6
Long term price, Germany	€52.5/MWh	€5/MWh	575	11.6
Other divisions				
Gas network regulation	20% price cut	5% points	43	0.8
Long term price, UK	£39.0/MWh	£3/MWh	154	2.0
UK supply l.t. EBIT margin	6.5%	100bp	97	1.8
Nordpool price	€46.0/MWh	€5/MWh	165	3.3
Long term price, Italy	€56.6/MWh	€5/MWh	178	1.5
Long term price, Spain	€56.0/MWh	€5/MWh	146	2.0
US return on rate base	9.4%	100bp		1.6
Group				
CO2 price	€20/t	€10/t	785	12.1
Average WACC	5.60%	+50bp		-7.7

Source: JPMorgan estimates.

Table 12: Financial snapshot

€m, Dec 31 y/e	2006A	2007E	2008E	2009E	2010E	'10E vs '06A CAGR
Revenues	67,759	60,229	70,315	82,854	89,444	7.2%
EBITDA	11,353	11,972	14,393	15,928	16,524	9.8%
EBIT	**8,150**	**8,797**	**10,626**	**11,956**	**12,351**	**11.0%**
Central Europe	4,168	4,558	4,356	5,348	5,417	6.8%
Pan Euro Gas	2,106	2,079	2,446	2,656	2,816	7.5%
UK	1,229	1,269	1,207	1,105	1,221	-0.2%
Nordic	619	1,068	1,246	1,370	1,433	23.3%
US Mid-West	391	373	380	386	395	0.2%
Net income, reported	5,057	6,205	5,859	6,344	6,508	6.5%
Net income, adjusted	**4,386**	**4,850**	**5,859**	**6,344**	**6,508**	**10.4%**
EPS, recurrent	6.65	7.54	9.60	10.69	10.96	13.3%
DPS, reported	**3.35**	**4.26**	**5.43**	**5.88**	**6.58**	**18.4%**
Payout ratio	50%	56%	57%	55%	60%	4.5%
Cash from operations	7,194	9,092	10,552	11,634	12,047	13.8%
Capex & investments	-5,161	-7,490	-21,109	-11,680	-11,801	23.0%
Free cash flow, adj	-2,306	-3,411	-15,598	-1,136	-854	
Net financial position	268	4,946	22,446	26,042	29,621	

Source: JPMorgan estimates, Company data.

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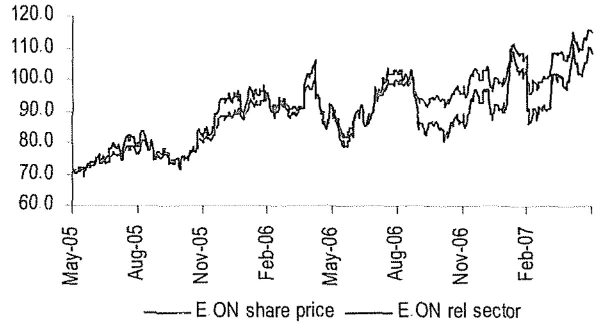
Share price & P/E Bands analysis

Up until the failure of the offer in February, E.ON's stock price had been driven primarily for a year by the trials and tribulations of the bid for Endesa. More recently the recovery in commodity prices (especially CO2), coupled with expectations for the strategy plan presentation have driven the shares steadily up.

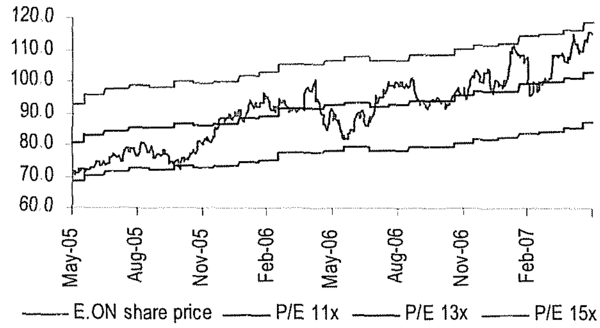
From a P/E perspective E.ON is trading close to the top of its historic range on consensus FY1 numbers. However, as we note elsewhere in this report, we see a c15% upgrade to 2008 and 30% for 2010, suggesting the stock could easily go higher from here.

Figure 1: E.ON share price performance



Source: Datastream

Figure 2: E.ON P/E band analysis - FY1 consensus



Source: Datastream

Financial forecasts & valuation

Table 13: Divisional contributions to E.ON Group Adjusted EBIT

€m, Dec y/e	2005A	2006A	2007E	2008E	2009E	2010E	2011E	5y fcst CAGR
Central Europe	**3,930**	**4,168**	**4,558**	**4,356**	**5,348**	**5,417**	**5,503**	**5.7%**
o/w German Electricity	3,389	3,550	3,971	3,724	4,648	4,646	4,660	5.6%
o/w German Gas	307	272	211	196	204	213	222	-4.0%
o/w East Europe	237	269	298	355	414	473	534	14.7%
o/w Other	-3	77	79	81	83	85	87	2.4%
Pan-European Gas	**1,536**	**2,106**	**2,079**	**2,446**	**2,656**	**2,816**	**2,985**	**7.2%**
o/w Up/Midstream	988	1,684	1,477	1,640	1,802	1,906	2,015	3.7%
o/w Downstream	551	431	627	815	868	925	986	18.0%
o/w Industries/Other	-3	-9	-25	-9	-13	-16	-16	12.2%
United Kingdom	**963**	**1,229**	**1,269**	**1,207**	**1,105**	**1,221**	**1,107**	**-2.1%**
o/w Regulated	451	487	483	471	467	469	473	-0.6%
o/w Unregulated	512	742	786	736	638	752	633	-3.1%
Nordic	**806**	**619**	**1,068**	**1,246**	**1,370**	**1,433**	**1,471**	**18.9%**
o/w Regulated	332	200	636	811	927	981	1,010	38.2%
o/w Unregulated	474	419	432	435	443	452	461	1.9%
US Mid West	**365**	**391**	**373**	**380**	**386**	**395**	**403**	**0.6%**
Southern Europe		**1,312**	**1,405**	**1,342**	**1,440**	**1,420**	**1,408**	**1.4%**
Spain		465	484	534	607	650	615	5.7%
Italy		749	833	693	691	589	571	-5.3%
France & Other		98	88	116	142	181	222	17.6%
Other/Consolidation	**-267**	**-363**	**-550**	**-350**	**-350**	**-350**	**-350**	**-0.7%**
E.ON Group	**7,333**	**8,150**	**8,797**	**10,626**	**11,956**	**12,351**	**12,526**	**9.0%**

Source: JPMorgan estimates, Company data.

Table 14: Divisional dynamics within E.ON Group EBIT

	% Change y-o-y						% Group Total					
	2006A	2007E	2008E	2009E	2010E	2011E	2006A	2007E	2008E	2009E	2010E	2011E
Central Europe	**6.1%**	**9.4%**	**-4.4%**	**22.8%**	**1.3%**	**1.6%**	**51%**	**52%**	**41%**	**45%**	**44%**	**44%**
o/w German Electricity	4.8%	11.9%	-6.2%	24.8%	0.0%	0.3%	44%	45%	35%	39%	38%	37%
o/w German Gas	-11.4%	-22.4%	-7.3%	4.3%	4.2%	4.2%	3%	2%	2%	2%	2%	2%
o/w East Europe	13.5%	10.7%	19.3%	16.4%	14.4%	12.9%	3%	3%	3%	3%	4%	4%
o/w Other							1%	1%	1%	1%	1%	1%
Pan-European Gas	**37.1%**	**-1.3%**	**17.6%**	**8.6%**	**6.0%**	**6.0%**	**26%**	**24%**	**23%**	**22%**	**23%**	**24%**
o/w Up/Midstream	70.4%	-12.3%	11.0%	9.9%	5.8%	5.7%	21%	17%	15%	15%	15%	16%
o/w Downstream	-21.8%	45.5%	30.0%	6.5%	6.6%	6.5%	5%	7%	8%	7%	7%	8%
o/w Industries/Other							0%	0%	0%	0%	0%	0%
United Kingdom	**27.6%**	**3.2%**	**-4.9%**	**-8.4%**	**10.4%**	**-9.4%**	**15%**	**14%**	**11%**	**9%**	**10%**	**9%**
o/w Regulated	8.0%	-0.9%	-2.4%	-0.8%	0.4%	1.0%	6%	5%	4%	4%	4%	4%
o/w Unregulated	44.9%	5.9%	-6.4%	-13.3%	17.8%	-15.8%	9%	9%	7%	5%	6%	5%
Nordic	**-23.2%**	**72.5%**	**16.7%**	**9.9%**	**4.6%**	**2.6%**	**8%**	**12%**	**12%**	**11%**	**12%**	**12%**
o/w Regulated	-39.8%	217.9%	27.6%	14.2%	5.9%	3.0%	2%	7%	8%	8%	8%	8%
o/w Unregulated	-11.6%	3.1%	0.7%	1.9%	1.9%	1.9%	5%	5%	4%	4%	4%	4%
US Mid West	**7.1%**	**-4.5%**	**1.7%**	**1.6%**	**2.3%**	**2.2%**	**5%**	**4%**	**4%**	**3%**	**3%**	**3%**
Southern Europe		**7.0%**	**-4.5%**	**7.3%**	**-1.4%**	**-0.8%**	**16%**	**16%**	**13%**	**12%**	**11%**	**11%**
o/w Spain		4.0%	10.3%	13.8%	7.0%	-5.3%	6%	5%	5%	5%	5%	5%
o/w Italy		11.2%	-16.8%	-0.2%	-14.9%	-3.0%	9%	9%	7%	6%	5%	5%
o/w France/Other		-10.3%	31.4%	22.1%	28.2%	22.2%	1%	1%	1%	1%	1%	2%
Other/Consolidation							**-4%**	**-6%**	**-3%**	**-3%**	**-3%**	**-3%**
E.ON Group	**11.1%**	**7.9%**	**20.8%**	**12.5%**	**3.3%**	**1.4%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: JPMorgan estimates, Company data.

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Table 15: E.ON Group Profit & Loss Account

€m, Dec y/e	2005A	2006A	2007E	2008E	2009E	2010E	2011E	5y fcst CAGR
Revenues, ex taxes	56,399	67,759	60,229	70,315	82,854	89,444	90,861	6.0%
EBITDA	**10,272**	**11,353**	**11,972**	**14,393**	**15,928**	**16,524**	**16,898**	**8.3%**
% change	*-2.7%*	*10.5%*	*5.4%*	*20.2%*	*10.7%*	*3.7%*	*2.3%*	
Depreciation / Amortisation	-2,939	-3,203	-3,174	-3,766	-3,972	-4,173	-4,372	
EBIT	**7,333**	**8,150**	**8,797**	**10,626**	**11,956**	**12,351**	**12,526**	**9.0%**
% change	*-0.4%*	*11.1%*	*7.9%*	*20.8%*	*12.5%*	*3.3%*	*1.4%*	
Financial expenses	-1,027	-1,081	-1,025	-1,352	-1,801	-1,933	-1,866	
PBET	6,306	7,069	7,773	9,274	10,155	10,417	10,659	8.6%
% change	*1.4%*	*12.1%*	*10.0%*	*19.3%*	*9.5%*	*2.6%*	*2.3%*	
Non-operating items	902	-1,936	1,355	0	0	0	0	
o/w Net book gains	491	1,205	0	0	0	0	0	
o/w Restructuring expense	-29	0	885	0	0	0	0	
o/w others	440	-3,141	470	0	0	0	0	
PBT	**7,208**	**5,133**	**9,128**	**9,274**	**10,155**	**10,417**	**10,659**	**15.7%**
Income tax	-2,276	323	-2,254	-2,690	-3,047	-3,125	-3,198	
Minority interests	-553	-526	-669	-726	-764	-784	-796	
Net income, continuing	4,379	4,930	6,205	5,859	6,344	6,508	6,666	6.2%
Net income, discontinued	3,035	127	0	0	0	0	0	
Reported net income	7,407	5,057	6,205	5,859	6,344	6,508	6,666	5.7%
% change	*70.7%*	*-31.7%*	*22.7%*	*-5.6%*	*8.3%*	*2.6%*	*2.4%*	
Adjusted net income	**3,640**	**4,386**	**4,850**	**5,859**	**6,344**	**6,508**	**6,666**	**8.7%**
% change	*-3.4%*	*20.5%*	*10.6%*	*20.8%*	*8.3%*	*2.6%*	*2.4%*	

Source: JPMorgan estimates, Company data.

Table 16: E.ON Group Balance Sheet

€m, Dec y/e	2005A	2006A	2007E	2008E	2009E	2010E	2011E	% '07E Equity
Tangible/Intangible assets	45,448	46,447	50,777	68,119	75,827	83,456	81,931	99%
Goodwill	15,363	15,124	15,131	15,302	15,473	15,644	15,815	29%
L.T. financial assets	21,686	34,773	34,773	34,773	34,773	34,773	34,773	68%
Inventories	2,457	3,990	3,547	4,141	4,879	5,267	5,350	7%
Operating receivables	21,354	17,698	16,614	18,066	19,871	20,820	21,024	32%
Cash & securities	15,119	6,187	6,327	5,828	6,231	5,652	8,850	12%
Other assets	5,135	3,013	2,311	2,398	2,522	2,590	2,602	4%
Total assets	**126,562**	**127,232**	**129,478**	**148,626**	**159,577**	**168,202**	**170,345**	**252%**
Shareholders' equity	44,484	47,961	46,162	47,775	53,911	59,230	63,585	90%
Minority interests	4,734	4,917	5,278	5,670	6,082	6,506	6,935	10%
Pension provisions	8,720	3,769	3,396	2,813	2,175	1,490	746	7%
Nuclear provisions	13,362	13,646	13,651	13,656	13,661	13,666	13,671	27%
Financial liabilities	14,362	13,399	18,217	35,217	39,217	42,217	40,217	35%
Other liabilities	40,900	43,540	42,774	43,495	44,529	45,093	45,191	83%
Total equity/liabilities	**126,562**	**127,232**	**129,478**	**148,626**	**159,577**	**168,202**	**170,345**	**252%**
Net financial position	**-3,863**	**268**	**4,946**	**22,446**	**26,042**	**29,621**	**24,423**	**10%**

Source: JPMorgan estimates, Company data

Table 17: E.ON Group Cash Flow Statement

€m, Dec y/e	2005A	2006A	2007E	2008E	2009E	2010E	2011E	5y fcst CAGR
Net income	7,407	5,057	6,205	5,859	6,344	6,508	6,666	
Depreciation etc	3,068	3,751	3,174	3,766	3,972	4,173	4,372	
Net working capital	-1,027	-1,261	761	-1,325	-1,509	-773	-189	
Other non-cash items	-2,847	-353	-1,048	2,252	2,826	2,139	1,439	
Cash flow from operations	**6,601**	**7,194**	**9,092**	**10,552**	**11,634**	**12,047**	**12,287**	11.3%
Investments	-4,337	-5,161	-7,490	-21,109	-11,680	-11,801	-2,847	-11 2%
Disposals	6,599	3,954	0	0	0	0	0	
Others	-1,863	-3,294	0	0	0	0	0	
Cash flow from investments	**399**	**-4,501**	**-7,490**	**-21,109**	**-11,680**	**-11,801**	**-2,847**	
E ON group dividends	-1,549	-4,614	-2,195	-2,649	-3,199	-3,464	-3,876	-3 4%
Minority dividends	-245	-242	-308	-334	-352	-361	-366	
Others	-4,671	-993	1,040	13,040	4,000	3,000	-2,000	
Cash flow from financing	**-6,465**	**-5,849**	**-1,463**	**10,058**	**450**	**-824**	**-6,242**	
Other items	77	-38	0	0	0	0	0	
Change in cash & securities	612	-3,194	140	-499	403	-579	3,198	
Free cash flow (adj)	-770	-2,306	-3,411	-15,598	-1,136	-854	8,336	

Source: JPMorgan estimates, Company data.

Table 18: E.ON Group per Share & Key Ratios

€m, Dec y/e	2005A	2006A	2007E	2008E	2009E	2010E	2011E	5y fcst CAGR
Shares in issue (avg)	659	659	643	610	594	594	594	
EPS (reported)	**11.24**	**7.67**	**9.65**	**9.60**	**10.69**	**10.96**	**11.23**	7.9%
% change	*70.3%*	*-31.7%*	*25 8%*	*-0.5%*	*11.3%*	*2.6%*	*2.4%*	
EPS (adjusted)	5.52	6 65	7.54	9.60	10.69	10.96	11.23	11.0%
% change	*-3.7%*	*20.5%*	*13.4%*	*27 3%*	*11.3%*	*2.6%*	*2.4%*	
DPS declared	**7.00**	**3.35**	**4.26**	**5.43**	**5.88**	**6.58**	**6.74**	**15.0%**
% change	*197.9%*	*-52.1%*	*27.1%*	*27.5%*	*8.3%*	*11.9%*	*2.4%*	
Payout ratio (reported)	**127%**	**50%**	**56%**	**57%**	**55%**	**60%**	**60%**	3.6%
FCFPS (adjusted)	-1.17	-3.50	-5.30	-25.57	-1.91	-1.44	14.04	
RoE (reported)	16 7%	10.5%	13.4%	12.3%	11 8%	11.0%	10.5%	
RoCE (E.ON)	**12.1%**	**13.2%**	**13.6%**	**13.5%**	**17.0%**	**17.0%**	**16.7%**	
Gearing (D/E)	-7.8%	0 5%	9.6%	42.0%	43 4%	45.1%	34.6%	
Gearing (D/CE)	-8.5%	0.5%	8.8%	29.6%	30.3%	31.1%	25.7%	
Gearing (FFO:ND)	32.7%	36 0%	37.4%	25.6%	26.3%	25.6%	29 9%	
Gearing (ND/EBITDA)	**-0.1x**	**0.6x**	**1.0x**	**2.0x**	**2.1x**	**2.2x**	**1.9x**	

Source: JPMorgan estimates, Company data.

Valuation

We base our €140/share formal target price on a sum-of-parts valuation, itself driven by discounted cash flow analyses for each division. On average we apply a WACC of 5.9% post tax and an average 1.5% terminal growth rate.

Whilst the implied multiple on an EV/EBITDA basis is significantly higher than that for RWE we'd note that (a) the E.ON valuation includes c€20/share from the group's Gazprom stake, which contributes little to earnings and (b) the growth potential, returns, and average remaining asset life are all much better for E.ON vs RWE.

Table 19: E.ON Group DCF-based Sum-of-Parts valuation

Division	€ m	€ p.s.	% EV	Comparator	Measure
Central Europe	**49,065**	**78.3**	**37.0%**	**8.2x**	**'07E EBITDA**
Germany	41,405	66.1	31.2%	7.9x	'07E EBITDA
International	7,660	12.2	5.8%	10.5x	'07E EBITDA
Pan-European Gas	35,402	56.5	26.7%	13.3x	'07E EBITDA
Operating Businesses	25,004	39.9	18.8%	10.8x	'07E EBITDA
Gazprom	10,398	16.6	7.8%	3.4%	'07E Income Yield
United Kingdom	**14,699**	**23.5**	**11.1%**	**8.0x**	**'07E EBITDA**
Energy Services	11,417	18.2	8.6%	9.6x	'07E EBITDA
Generation	4,238	6.8	3.2%	320	GBP/kW
Supply	7,179	11.5	5.4%	578	GBP/customer
Central Networks	3,282	5.2	2.5%	-8%	Premium to RAV
Nordic	**14,832**	**23.7**	**11.2%**	**10.1x**	**'07E EBITDA**
LG&E	**5,188**	**8.3**	**3.9%**	**9.0x**	**'07E EBITDA**
Southern Europe	**12,777**	**20.4**	**9.6%**	**7.1x**	**'07E EBITDA**
Spain	5,057	8.1	3.8%	8.5x	'07E EBITDA
Italy	5,540	8.8	4.2%	5.4x	'07E EBITDA
France / Other	2,179	3.5	1.6%	11.6x	'07E EBITDA
Corporate Center & assets	740	1.2	0.6%		
Enterprise Value	**132,704**	**211.8**	**100.0%**	**9.6x**	**'07E EBITDA adj**
Net Financial Position	-14,946	-23.9	-11.3%		'07E Book adj
Provisions	-19,349	-30.9	-14.6%		Sum-of-Parts
Nuclear	-13,651	-21.8	-10.3%		'07E Book
Pension	-3,396	-5.4	-2.6%		'07E Book
Mining / Environmental	-2,302	-3.7	-1.7%		'07E Book
Minority Interests	-10,619	-16.9	-8.0%		'07E Adjusted Book
Equity Value	**87,789**	**140.1**	**66.2%**		
EV ex Gazprom	**122,305**			**9.1x**	**07E EBITDA**

Source: JPMorgan estimates, Company data.

Key risks and sensitivities

The tables on page 8 illustrate the key drivers of our earnings forecasts and sensitivities to valuation. From a recommendation perspective the key risk is that management fail to deliver on their targets and path-to-achievement presented on May 31. Worse still would be a return to "big deals", but we see a relatively low probability here.

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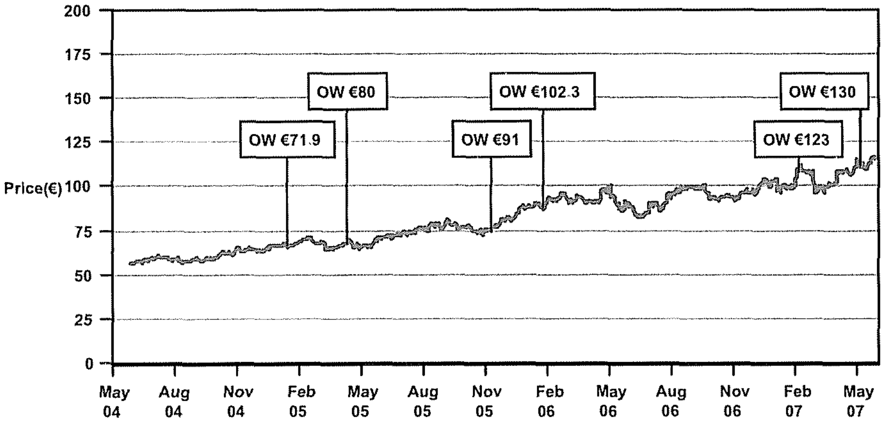
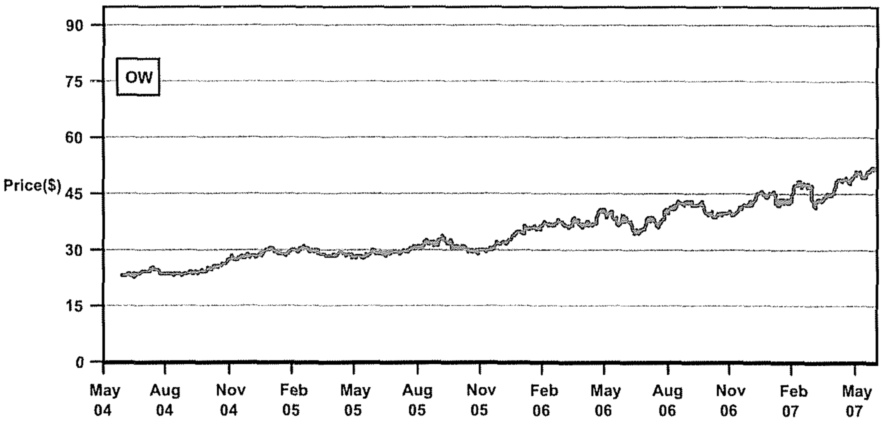
E.ON (EONG.DE) Price Chart



Date	Rating	Share Price (€)	Price Target (€)
12-Jan-05	OW	66.91	71.90
12-Apr-05	OW	67.57	80.00
10-Nov-05	OW	75.00	91.00
23-Jan-06	OW	87.80	102.30
05-Feb-07	OW	108.97	123.00
08-May-07	OW	111.89	130.00

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
JPMorgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

E.ON (EON) Price Chart



Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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E.ON: Summary of Financials

Profit & loss statement
€ million, year-end 31 December

	FY06A	FY07E	FY08E	FY09E	FY10E
Sales	67,759	60,229	70,315	82,854	89,444
Gross Operating Profit	**11,353**	**11,972**	**14,393**	**15,928**	**16,524**
Depreciation & Amortisation	(3,203)	(3,174)	(3,766)	(3,972)	(4,173)
Operating Profit	**8,150**	**8,797**	**10,626**	**11,956**	**12,351**
Non-operating income	(1,936)	1,355	0	0	0
Finance costs - net	(1,081)	(1,025)	(1,352)	(1,801)	(1,933)
Profit before tax	**5,133**	**9,128**	**9,274**	**10,155**	**10,417**
Income tax	323	(2,254)	(2,690)	(3,047)	(3,125)
Minority interests	*(526)*	*(669)*	*(726)*	*(764)*	*(784)*
Discontinued items	127	0	0	0	0
Group net profit	**5,057**	**6,205**	**5,859**	**6,344**	**6,508**

Cashflow statement
€ million, year-end 31 December

	FY06A	FY07E	FY08E	FY09E	FY10E
Funds from operations	8,455	8,331	11,877	13,143	12,820
Working Capital	(1,261)	761	(1,325)	(1,509)	(773)
Cash from operations	**7,194**	**9,092**	**10,552**	**11,634**	**12,047**
Capex & acquisitions	*(1,207)*	*(7,490)*	*(21,109)*	*(11,680)*	*(11,801)*
Other investing cash flows	(3,294)	0	0	0	0
Cash from investing	**(4,501)**	**(7,490)**	**(21,109)**	**(11,680)**	**(11,801)**
Dividends	(4,856)	(2,503)	(2,982)	(3,550)	(3,824)
Cash from financing	**(5,849)**	**(1,463)**	**10,058**	**450**	**(824)**
Free cash flow before dividends	*2,480*	*(2,665)*	*(14,850)*	*(398)*	*(115)*
Free cash flow, adjusted	**(2,306)**	**(3,411)**	**(15,598)**	**(1,136)**	**(854)**

Balance sheet
€ million, year-end 31 December

	FY06A	FY07E	FY08E	FY09E	FY10E
Fixed assets	96,344	100,681	118,194	126,073	133,873
Current assets	30,888	28,798	30,432	33,503	34,329
Total assets	**127,232**	**129,478**	**148,626**	**159,577**	**168,202**
Total debt	13,399	18,217	35,217	39,217	42,217
Total equity	*52,878*	*51,440*	*53,445*	*59,993*	*65,736*
Other liabilities	60,955	59,821	59,964	60,366	60,249
Total liabilities	**127,232**	**129,478**	**148,626**	**159,577**	**168,202**
Net debt	268	4,946	22,446	26,042	29,621
Capital employed	53,146	56,387	75,891	86,036	95,357

Source: Company data, JPMorgan estimates

Valuation ratios
x

Unadjusted	FY06A	FY07E	FY08E	FY09E	FY10E
P/E (recurrent)	18.6x	16.4x	12.9x	11.6x	11.3x
P/E (reported)	16.2x	12.9x	12.9x	11.6x	11.3x
Price to book value	1.7x	1.7x	1.5x	1.4x	1.2x
EV / EBITDA	9.9x	9.6x	8.9x	8.1x	7.9x
EV / EBIT	13.8x	13.0x	12.0x	10.7x	10.6x
FCF yield (pre divs, post mins) %	-2.8%	-4.3%	-20.6%	-1.5%	-1.2%
Dividend yield %	2.7%	3.4%	4.4%	4.7%	5.3%

Per share
€

	FY06A	FY07E	FY08E	FY09E	FY10E
Recurrent EPS	6.65	7.54	9.60	10.69	10.96
Reported EPS	7.67	9.65	9.60	10.69	10.96
Reported DPS	3.35	4.26	5.43	5.88	6.58
Adjusted Free Cash Flow	(3.50)	(5.30)	(25.57)	(1.91)	(1.44)

Performance, leverage and return ratios
%

	FY06A	FY07E	FY08E	FY09E	FY10E
Gross operating margin	16.8%	19.9%	20.5%	19.2%	18.5%
Operating margin	12.0%	14.6%	15.1%	14.4%	13.8%
Operating profit growth y-o-y	11.1%	7.9%	20.8%	12.5%	3.3%
Recurrent income growth y-o-y	20.5%	10.6%	20.8%	8.3%	2.6%
Reported RoE	10.6%	13.4%	12.3%	11.8%	11.1%
RoCE (EBIT)	11.7%	18.0%	14.0%	13.9%	13.0%
Net debt / (equity+minorities) %	0.5%	9.6%	42.0%	43.4%	45.1%
Net debt / EBITDA %	3%	37%	156%	163%	179%
EBITDA / net interest	8.4x	8.1x	7.3x	6.5x	6.3x
Reported net income / dividends	2.3x	2.3x	1.8x	1.8x	1.7x

Market valuation
€ million

	FY06A	FY07E	FY08E	FY09E	FY10E
Share price (year-end / current)	124.0	124.0	124.0	124.0	124.0
Number of shares (million)	659	643	610	594	594
Market capitalisation	81,763	79,744	75,652	73,606	73,606
EV adjustment	30,604	34,914	51,835	54,799	57,697
Enterprise value	112,366	114,658	127,487	128,405	131,303

E.ON AG

Price Objective Change

BUY

Equity | Germany | Electric Utilities
01 June 2007

Merrill Lynch

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Set for re-rating

Strategy for growth and higher returns

The major strategic initiatives in all aspects met or beat our highest expectations. Transforming M&A appears implicitly off the agenda. The key elements are substantially higher capital expenditure, a major buy back programme and aggressive dividend growth. Together, these should a) boost the company's medium term growth prospects b) deliver balance sheet efficiency promptly and c) raise shareholder returns in the coming years. The EBIT and implied EPS targets are much higher than market forecasts. The financial strategy aims to manage the portfolio aggressively – we think, in time, underperforming assets could be sold.

Price Objective raised to EUR140/sh

We are raising our Price Objective to EUR140/sh (previously EUR130/sh). This is based on assumed higher 2010E EBITDA broadly in line with E.on's assumptions, and using a sector average 2010E EV/EBITDA multiple. We believe that the focus on improving returns paves the way for a potentially material re-rating - which could unfold progressively over the next year or two. Delivery on key milestones (e.g. the share buy back) and meeting or exceeding targets will be critical in building market confidence and bringing about a higher rating. We reiterate our BUY recommendation.

Estimates (Dec)

(EUR)	2005A	2006A	2007E	2008E	2009E
	IFRS	IFRS	IFRS	IFRS	IFRS
EPS (Reported)	11.24	7.67	7.24	8.07	8.34
EBITDA (Adjusted)	10,194	11,353	11,924	12,969	13,396
EPS (Adjusted)	5.52	6.66	7.24	8.07	8.34
EPS Change (YoY)	NA	20.5%	8.8%	11.4%	3.4%
Dividend / Share	2.75	3.35	3.98	4.44	4.59
ADR EPS (Adjusted - US$)	2.29	2.78	3.24	3.61	3.73
ADR Dividend / Share (US$)	1.14	1.40	1.78	1.98	2.05

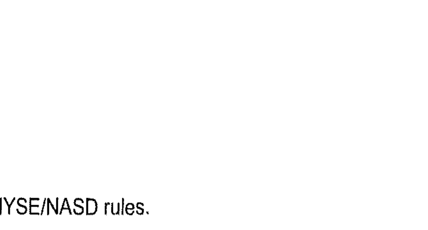
Valuation (Dec)

	2005A	2006A	2007E	2008E	2009E
P/E	22.1x	18.3x	16.8x	15.1x	14.6x
Dividend Yield	2.55%	3.11%	3.70%	4.12%	4.26%
EV / EBITDA*	10.4x	9.30x	8.85x	8.14x	7.88x
Free Cash Flow Yield*	3.67%	2.87%	0.37%	3.03%	3.77%
EV/EBITDA (Adjusted)	NA	NA	8.66x	7.99x	7.78x

* For full definitions of *iQmethod*℠ measures, see page 7

Stock Data

Price (Common / ADR)	EUR121.84 / US$55.21
Price Objective	EUR140.00 / US$63.86
Date Established	1-Jun-2007 / 1-Jun-2007
Investment Opinion	B-1-7 / B-1-7
Volatility Risk	MEDIUM / MEDIUM
52-Week Range	EUR81.05-EUR125.08
Market Value (mn)	EUR80,414
Shares Outstanding (mn)	660.0 / 1,982.0
Average Daily Volume	4,369,165
ML Symbol / Exchange	EONAF / GER
ML Symbol / Exchange	EON / NYS
Bloomberg / Reuters	EOA GR / EONG.DE
ROE (2007E)	9.4%
Net Dbt to Eqty (Dec-2006A)	0.5%
Est. 5-Yr EPS / DPS Gwth	6.6% / 8.5%
Free Float	91.1%



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Refer to important disclosures on page 8 to 9. Analyst Certification on page 7. Price Objective Basis/Risk on page 7.

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*iQprofile*SM E.ON AG

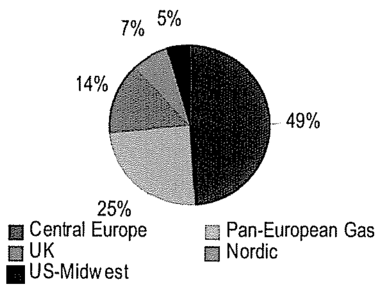
Key Income Statement Data (Dec)	2005A	2006A	2007E	2008E	2009E
(EUR Millions)	IFRS	IFRS	IFRS	IFRS	IFRS
Sales	56,141	67,759	65,752	66,137	68,151
EBITDA Adjusted	10,194	11,353	11,924	12,969	13,396
Depreciation & Amortization	(2,901)	(3,203)	(3,245)	(3,330)	(3,373)
EBIT Adjusted	7,293	8,150	8,680	9,639	10,024
Net Interest & Other Income	(1,027)	(1,081)	(1,161)	(1,112)	(1,091)
Tax Expense / Benefit	(2,261)	323	(2,105)	(2,388)	(2,501)
Net Income (Adjusted)	3,640	4,386	4,780	5,323	5,503
Average Fully Diluted Shares Outstanding	659	659	660	660	660
Key Cash Flow Statement Data					
Net Income (Reported)	7,407	5,057	4,780	5,323	5,503
Depreciation & Amortization	2,901	3,203	3,245	3,330	3,373
Change in Working Capital	(532)	(1,568)	165	(140)	(259)
Deferred Taxation Charge	0	0	0	0	0
Other Adjustments, Net	(3,232)	502	(380)	701	771
Cash Flow from Operations	6,544	7,194	7,809	9,213	9,388
Capital Expenditure	(3,941)	(5,161)	(7,546)	(7,059)	(6,709)
(Acquisition) / Disposal of Investments	(985)	(1,078)	(1,443)	(441)	(441)
Other Cash Inflow / (Outflow)	5,368	1,738	1,443	441	441
Cash Flow from Investing	442	(4,501)	(7,546)	(7,059)	(6,709)
Share Issue / (Repurchase)	(26.0)	1.00	0	0	0
Cost of Dividends Paid	(1,788)	(4,856)	(2,502)	(3,005)	(3,355)
Cash Flow from Financing	(6,458)	(5,849)	(2,502)	(3,005)	(3,355)
Non Cash Changes to Debt	(295)	(38.0)	0	0	0
Change in Net Debt	(5,434)	2,096	2,239	851	676
Net Debt	(1,917)	268	2,133	3,097	3,773
Key Balance Sheet Data					
Property, Plant & Equipment	45,448	46,461	53,059	56,789	60,125
Goodwill	15,363	15,124	14,608	14,728	14,728
Other Intangibles	NA	NA	NA	NA	NA
Other Non-Current Assets	21,505	23,215	24,658	25,098	25,539
Trade Receivables	8,269	9,756	9,467	9,523	9,812
Cash & Equivalents	16,279	13,131	10,892	10,041	9,365
Other Current Assets	19,698	19,545	18,706	18,722	18,857
Total Assets	126,562	127,232	131,390	134,902	138,427
Long-Term Debt	14,362	13,399	13,025	13,139	13,139
Other Non-Current Liabilities	43,930	41,857	40,228	40,113	39,956
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	19,052	19,214	18,972	18,910	19,059
Total Liabilities	77,344	74,470	72,225	72,161	72,153
Total Equity	49,218	52,762	59,165	62,741	66,273
Total Equity & Liabilities	126,562	127,232	131,390	134,902	138,427
Key Metrics					
iQmethod*SM - Bus Performance					
Return On Capital Employed	4.48%	6.81%	5.66%	6.05%	6.11%
Return On Equity	9.33%	9.50%	9.40%	9.60%	9.40%
Operating Margin	13.0%	12.0%	13.2%	14.6%	14.7%
Free Cash Flow (MM)	2,603	2,033	264	2,154	2,679
iQmethod*SM - Quality of Earnings					
Cash Realization Ratio	1.80x	1.64x	1.63x	1.73x	1.71x
Asset Replacement Ratio	1.36x	1.61x	2.33x	2.12x	1.99x
Tax Rate	36.1%	NM	28.0%	28.0%	28.0%
Net Debt/Equity	-3.89%	0.51%	3.61%	4.94%	5.69%
Interest Cover	7.05x	7.36x	7.31x	8.47x	8.97x

* For full definitions of *iQmethod*SM measures, see page 7

Company Description

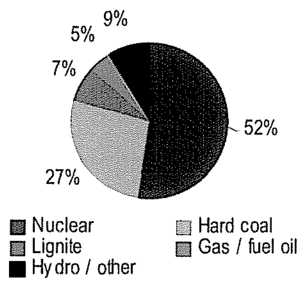
E.ON has transformed itself from domestic conglomerate to Europe's biggest energy utility, with a portfolio of mainly vertically integrated assets across Germany, Central Europe, the Nordic Region, the UK and the US. It is active in both electricity and gas and its subsidiary Ruhrgas is likely to be central to future growth from this platform as power/gas convergence gathers pace over the next decade

Chart 1: 2006A EBIT



Source: Company Data

Chart 2: Generation Output Germany



Source: Company data

Stock Data

Shares / ADR	0.33
Price to Book Value	1.3x

Scene set for a re-rating

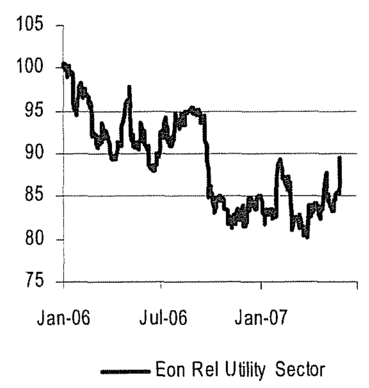
E.on has announced a series of major strategic measures which in all aspects met or beat our highest expectations. These address, in our view, the key strategic shortcomings of the recent past. The three key elements of the package are:

- Substantially higher capital expenditure
- A major buy back programme
- Aggressive dividend growth

New growth and financial targets provide a framework for the new strategy. The combination should a) boost the company's medium term growth prospects, b) deliver balance sheet efficiency promptly, and c) raise shareholder returns in the coming years.

Transforming M&A appears to be sidelined - not a single slide in a 37 page presentation referred to M&A. This is an important signal, we believe, of management's realignment of the strategy to organic growth and shareholder returns. M&A uncertainty has been a singular depressant of E.on's share price rating for the last two years in our view. Without this negative element, we believe that there is potential for a significant re-rating.

Chart 3: The start of a re-rating?



Source: Merrill Lynch estimates

The shares have already partially responded in the last few weeks with anticipation of strategic change, outperforming the MSCI by 11% since end April (see Chart 3). The shares still trade at a substantial discount to the utilities, on 8.0x 2008E EV/EBITDA vs the Pan Euro sector on 8.8x.

Moreover, the growth prospects envisaged in E.on's new plan are materially ahead of our current forecasts and consensus. Among these are:

- EBIT of EUR12.4bn by 2010E, or 16% above current MLe; and EBIT growth of 10% p.a.
- EPS for 2010E approaching EUR11-12/share, 30% above our forecasts. (EPS deduced from DPS policy and using a 60% payout ratio). The implied EPS CAGR is 15%.

These growth rates are not only well above consensus forecasts, but top quartile for the sector. If E.on can deliver, we believe that a re-rating to at least the sector multiple will be justified.

Price Objective raised to EUR140ps

We are raising our Price Objective to EUR140/share (previously EUR130/sh) and reiterate our Buy recoomendation. This is based on assumed higher 2010E EBITDA broadly in line with E.on's assumptions, and using 8.0x 2010E EV/EBITDA, in line with the sector multiple in that year.

Table 1: ML Pro Forma Valuation

2010E EV/EBITDA. E.On Pro Forma	7.9x
2010E EV/EBITDA Peers	8.0x
EV implied by re-rating	122,151
Share price implied by re rating (EURps)	131
Cash received from buy back (EURps)	10
Total E.On's Value (EURps)	**141**

Source: Merrill Lynch estimates

Management indicated that financial management would be rigorous to maintain balance sheet efficiency. All assets in the portfolio, operating and financial would be monitored for their contribution to returns.

Our analysis has previously suggested that better use of underperforming assets in E.on's portfolio could indicate a valuation of EUR173-185/share (see *Catalysts for a Re-Rating*, April 30th 2007). The fresh and disciplined approach to portfolio management suggests that such values may not be entirely fanciful.

A Package of Strategic Initiatives

E.on's package of initiatives had four central elements – increased growth investment, capital structure, dividend policy and financial targets.

Increased Growth Investment

The EUR60bn capex programme by 2010 (or EUR15bn pa) appeared to be roughly double the previous plan of EUR25bn over 2006-08E (EUR8bn pa). However, the inclusion of Spanish assets to be acquired (and associated capex in subsequent years) and an additional year (2010E) explained much of the difference. EUR6bn out of the EUR60bn will actually be spent after 2010E, but still committed within the 2007-10 period. EUR42bn of the EUR60bn is growth investment.

There is 'only' an additional EUR10bn of new projects – investments which had been 'constrained' in the December 2006 plan by the intended major Spanish acquisition. The mix of the new projects is similar to the previous plan - power generation, upstream gas/LNG (EUR3bn), renewables (EUR2bn) and Russia/Turkey (EUR3bn). We are reasonably comfortable that E.on has the inventory of projects and that the increased spend is not hypothetical.

Bolt-on acquisitions were not specifically identified (not surprisingly), but flexibility will be maintained should these arise in core markets.

Capital Structure

The highlight of the package unveiled was undoubtedly a EUR7bn buy back programme, designed to address the immediate issue of an undergeared balance sheet. E.on intends to buy back EUR7bn of shares by the end of calendar 2008E, just shy of 10% of current market cap. This is at the top end of our aspirations (we had modelled EUR7.5bn by end 2009E in our *'Catalysts for Change'* note of 30th April), and is well above our perceptions of market forecasts (EUR3-4bn).

The buy back effectively delivers almost immediate gearing, which would otherwise be progressive from an investment programme. The expected cancellation of shares will deliver EPS accretion in 2007-8E, whilst earnings generated from new investment will be back-end loaded in the 2007-10E period (and indeed beyond for some projects).

The aim to preserve a single A rating (as expected) defines a 'debt factor' of 3x. This is Net Debt/EBITDA, but with net debt including most financial provisions (mostly nuclear and pension). The target 3x debt factor is expected to be delivered by end 2008E, a year earlier than we had anticipated.

A key message on financial strategy was the intention to manage actively 'in both directions'. If the debt factor falls below the 3x benchmark, cash will be returned to shareholders if there are no investments that match value-creating criteria. If the benchmark is exceeded, assets will be sold (or equity raised).

All assets, operational and financial will be monitored rigorously for their contribution to returns. This includes, we understand, financial assets on E.on's balance sheet, which amount to EUR20bn.

Dividend Policy and Earnings Growth

Growing the ordinary dividend is clearly seen as another tool to releverage as well as sending a strong message to shareholders on returns. E.on aims to deliver 10-20% dividend CAGR to 2010 (vs MLe 10%). The top of the range indicates a 2010E dividend of EUR6.95 and 2010 yield of 6% - well above the sector's 3.8% that year.

Temporary adjustments to the payout ratio may be used to maintain the efficient capital structure (as indeed, may further share buy backs).

Higher DPS also implies higher earnings. Applying a 60% payout ratio (guidance is still 50-60%) suggests 2010E EPS of EUR11.5 - 30% above current MLe EPS 2010E forecast of EUR8.87.

Growth and Financial Targets

The target is EUR12.4bn 2010E EBIT or 10% CAGR. The expectation is that EUR42bn of growth investment delivers more than EUR4bn of EBIT, with cEUR3bn by 2010E. Some longer term projects begun during the 2007-10E period will not contribute until later.

The remaining EUR1.0bn EBIT enhancement by 2010E is expected from operational improvements. This includes part of EUR300-400m of cost cutting and integration of Trading operations. We believe that there may be greater scope for EBIT enhancement from existing assets as management refocuses on the core business following the two year M&A drive.

E.on's EBIT target of EUR12.4bn is 16% above the current 2010E MLe of EUR10.7bn or 7% CAGR. It also compares very well with EDF (MLe 10%) which trades on a high PE multiple; and RWE (MLe 8%), both comparable large caps.

Pro Forma Financials and Multiples

The table below shows the pro forma financials and ratios for E.On, assuming their new capex and buy back programs. We assume a 10% pre tax return on capex, starting 2 years after investment and a 60% payout ratio.

Table 2: Top down amendments to financials and multiples - MLe

	2007E	2008E	2009E	2010E	Total 07E-10E
Total Capex (EURbn)*	19.5	12.6	10.7	11.2	54.1
Buy Back (EURbn)	3.5	3.5	0.0	0.0	7.0
					CAGR 06A/10E
EBITDA	11,924	14,369	15,076	16,744	
EBIT	8,680	10,639	11,224	12,452	10%
Recurrent EPS (EUR ps)	7.4	8.6	8.9	9.6	10%
DPS	4.5	5.2	5.4	5.8	15%
EV/EBITDA	9.8x	8.5x	8.4x	7.9x	
P/E	17.7x	15.6x	15.1x	14.0x	
Net Debt + Prov (EURbn)	68.0	81.1	88.8	96.2	
(Net Debt + Prov) / EBITDA	2.8x	3.0x	3.1x	3.1x	

Source: Merrill Lynch estimates * EUR60bn capex committed less EUR6bn spent after 2010 only

Table 3: Companies Mentioned

Company	ML Symbol	Footnotes	Q-R-Q		Price
RWE	RWNFF	Lijopqsvw	B-2-7	EUR	84 20
RWE (ADR)	RWEOY	Lijopqsvw	B-2-7	USD	110.25
EDF	ECIFF	LNgijoqsvw	A-1-7	EUR	68 93

Source: Merrill Lynch estimates

Price Objective Basis & Risk

Our Base Case Sum of the Parts valuation is €123ps. The long term nature of E.ON's assets lends itself to DCF. We use discount rates between 7.5% and 8.0% for the Central Europe, Pan European Gas and Nordic divisions, and multiples per installed capacity, customers and of RAB for the UK, in line with the industry average, market value for Gazprom. This valuation implies an 08E EV/EBITDA of 8.0x, below the sector average of 8.5x.

Our sensitivity analysis suggests a range of €141ps to185ps, should E.ON re-align its strategy and releverage either through increased organic growth, or share buy backs or a combination of both. We set our Price Objective at the modest end of the range, at €140/share.

The risks to our valuation and price objective are lower wholesale electricity, gas and oil prices. E.ON is also exposed to regulatory risk through its transmission and distribution businesses. The discount rate used in our DCF calculation is based on the prevailing cost of debt and equity, which may change with market conditions.

Analyst Certification

I, Simon Flowers, 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.

*iQmethod*SM Measures Definitions

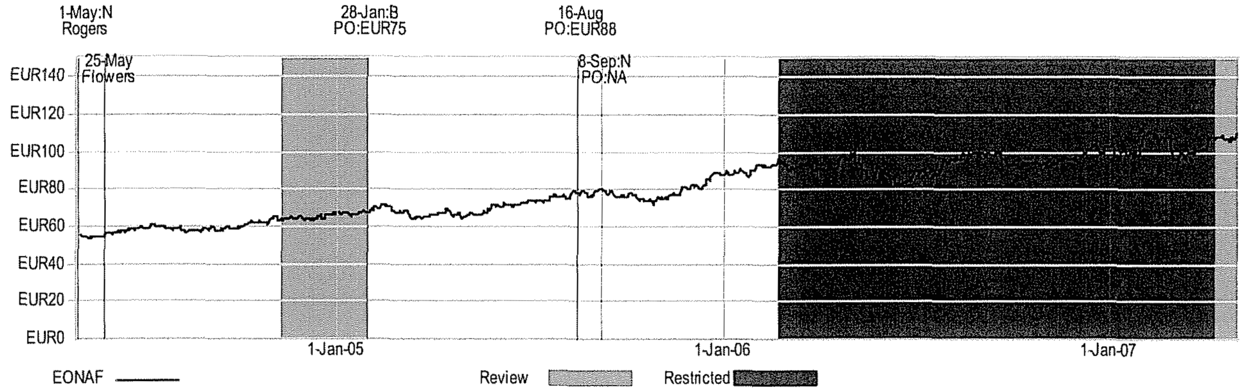
Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating 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 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 Merrill Lynch

Important Disclosures

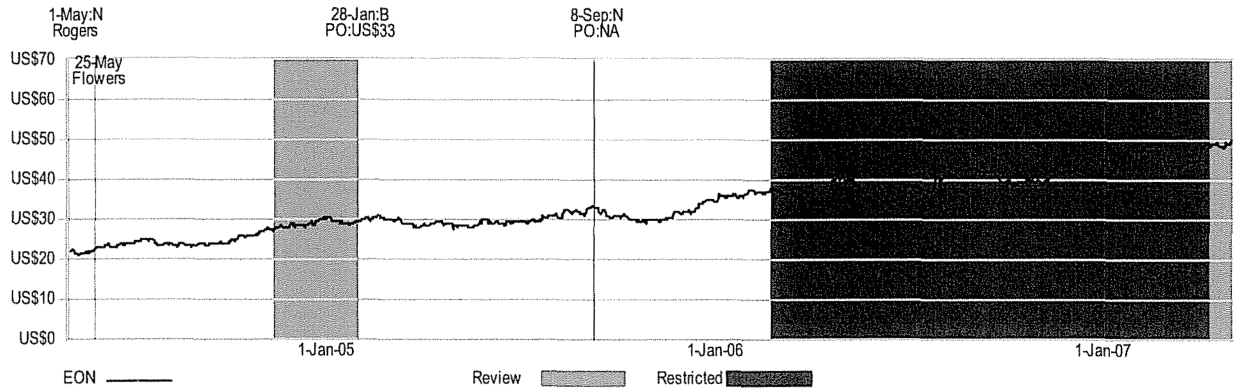
EONAF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

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 Light Grey shading indicates the security is under review with the opinion withdrawn Chart current as of April 30, 2007 or such later date as indicated

EON Price Chart



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Investment Rating Distribution: Utilities Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	62	37 35%	Buy	19	37.25%
Neutral	89	53 61%	Neutral	39	51 32%
Sell	15	9.04%	Sell	2	14.29%

Investment Rating Distribution: Global Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1562	45.16%	Buy	415	30.09%
Neutral	1615	46.69%	Neutral	446	30.65%
Sell	282	8.15%	Sell	49	19.76%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months

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E.ON

PERsuing a deeper bucket of growth - Adding to Analyst Focus List

Overweight

€117.80

14 June 2007
Price Target: €140.00

A further analysis of E.ON's growth targets suggests to us that they can be comfortably beaten. We upgrade our 2010E EPS by a further 9% and are now nearly 25% ahead of Bloomberg consensus. Higher bond yields lead us to retain our Dec 07 SOP-based €140 TP and we add the stock to the JPMorgan Analyst Focus List.

- **Recent weakness explained**: E.ON has given up nearly 2/3 of its pre-strategy day gains due to: bond yields; confusion regarding the new targets; and delay in launching the buy-back programme.
- **A second look - targets look conservative**: A further analysis of E.ON's targets reveals that more efficiency improvements appear possible than we first thought. Given the potential strength in growth in the East European, Nordic and UK businesses, we think management targets are cautious.
- **Upgrades necessary**: Adding higher efficiency improvements leads us to upgrade our 2010E EBIT to €13.2bn (vs management guidance of €12.4bn) and EPS by 9% (see Table 2, page 5). Our TP is unchanged due to higher bond yields since our last updated WACC. Consensus is, we estimate, 12% too light on EBIT, 24% too light on EPS.
- **Reiterate OW, add to AFL**: E.ON's valuation, earnings growth and potential catalysts from consensus upgrades, launched buy-back and East Europe capital markets day that should focus attention on the organic growth of the group, lead us to reiterate our OW and add E.ON to the JPMorgan Analyst Focus List.

Electric Utilities

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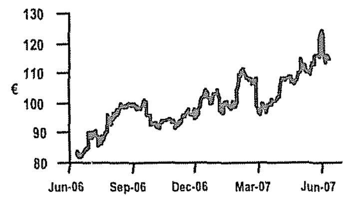
Price Performance



	YTD	-1M	-3M	-12M
Absolute	11.3%	4.1%	15.8%	36.4%

Source: RIMES, Reuters.

E.ON (EONG.DE;EOA GR)

	2006A	2007E	2008E	2009E	2010E
EBITDA FY (€ mn)	11,353	12,182	14,813	16,558	17,354
EBIT FY (€ mn)	8,150	9,007	11,046	12,586	13,181
Net Attributable Income FY (€ mn)	5,057	6,356	6,166	6,802	7,116
Adj. EPS FY (€)	6.65	7.78	10.11	11.46	11.99
Dividend (Gross) FY (€)	3.35	4.39	5.71	6.30	7.19
Adj P/E FY	17.7	15.1	11.7	10.3	9.8
Gross Yield FY	2.8%	3.7%	4.8%	5.4%	6.1%
EV/EBITDA FY	9.5	9.1	8.3	7.5	7.3

Source: Company data, Reuters, JPMorgan estimates.

Company Data	
Price (€)	117.80
Date Of Price	14 Jun 07
52-week Range (€)	125.08 - 81.05
Mkt Cap (€ bn)	77.6
Fiscal Year End	Dec
Shares O/S (mn)	659

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Investment thesis

A further analysis of E.ON's growth targets suggests to us that they can be comfortably beaten. We upgrade our 2010E EPS by a further 9% and are now nearly 25% ahead of Bloomberg consensus. Higher bond yields lead us to retain our €140 TP and we add the stock to our Analyst Focus List.

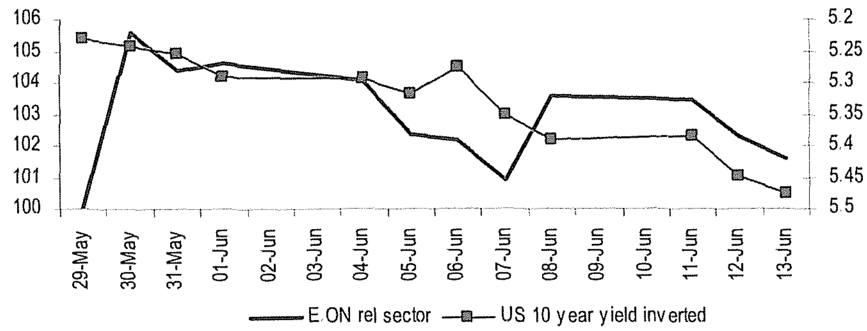
Suffering for the sector's art

E.ON has given up around two thirds of its pre-strategy day share price gains. We believe this is due to:

Bond yields

We believe E.ON has been unfairly marked down following its analyst meeting in late May as a result of rising bond yields. Effectively we believe the market has sought to underweight the sector, but not reduce weight in "M&A plays". Given E.ON is the most liquid stock in the sector, it is likely to have been a key "bond short".

Figure 1: E.ON performance relative to utilities sector rebased (29 May=100) & US 10 year bond yields



Source: Bloomberg, JPMorgan estimates.

This is not consistent with E.ON's longer term position as being below average on local bond yield correlations and at the average on US$ correlations over a five year view. We believe a correction of some sort is due once the market calms down.

Table 1: Correlation of utilities to local and US 10 year bond yields - 5 year historical

	Local 10yr	US 10yr	Beta
NATIONAL GRID	-0.37	-0.52	0.22
ENEL	-0.45	-0.44	0.40
SCOT.& SOUTHERN ENERGY	-0.28	-0.36	0.25
VEOLIA ENVIRONNEMENT	-0.25	-0.31	0.84
RWE (XET)	-0.23	-0.31	0.89
UNITED UTILITIES	-0.32	-0.29	0.39
ENERGIAS DE PORTUGAL	-0.23	-0.29	0.66
FORTUM CORP	-0.32	-0.29	0.17
Average	**-0.33**	**-0.36**	**0.45**
E ON (XET)	**-0.22**	**-0.26**	**0.65**
KELDA GROUP	-0.33	-0.26	0.16
SEVERN TRENT	-0.25	-0.25	0.44
UNION FENOSA	-0.37	-0.20	0.82
IBERDROLA	-0.25	-0.19	0.35
CENTRICA	-0.12	-0.19	1.05
PUBLIC POWER	-0.23	-0.16	0.22
SUEZ	-0.15	-0.08	1.36

Source: Datastream, JPMorgan estimates.

Confusion on the targets

Our discussions with investors suggest that there is still a lot of confusion as to the mechanics underlying the "10 by 10" targets – namely €12.4bn of adjusted EBIT by 2010E – outlined by management. These relate principally to: timing on capex-induced EBIT increases; quantity of cost-cutting in the earnings growth mix; impact of "ex-Germany" growth factors in the mix and completion risk on the potential acquisition of assets from Enel/Acciona.

We believe that this is also holding back upgrades on the sell-side – so far only 9/37 of the analysts covering the stock have adjusted their forecasts since the analyst meeting (according to Bloomberg consensus) and even then only a handful have moved their figures in line with company guidance.

Absence of buy-back support

Normally the presence of an extensive buy-back programme would discourage active stock shorting. However, it is quite clear that E.ON has yet to appoint banks to handle the €7bn buy-back programme, let alone begin implementing it. Once it does start – as discussed below – we should see the shares begin to outperform.

A second look at the targets

We believe the central problem is that E.ON outlined their growth targets in the context of three "buckets" of growth that did not directly equate to what we would associate with being traditional value drivers for a utility: "Current growth investments & net margin improvements: €1.3bn"l; "New growth investment: €1.7bn"; "Operational Improvement: €1bn".

Our subsequent discussions with the company have allowed us to reform these "buckets" into five more traditional areas spread over time: growth capex €925m; Southern European assets €1.1bn; efficiency measures €625m; reorganization of trading €400m; margin improvements €950m. We'd focus on two areas:

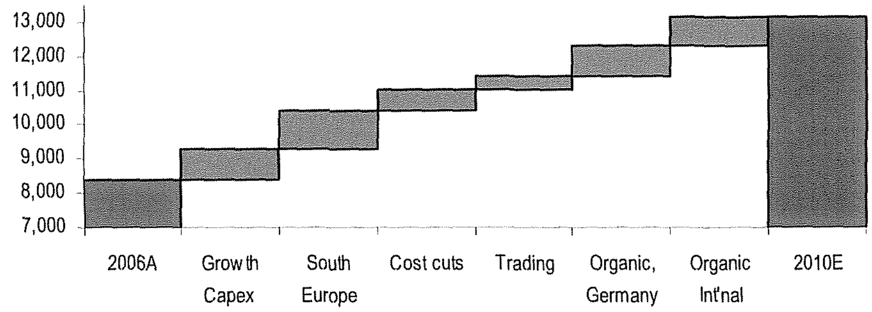
Margin Improvements

Stripping out the impact of: wholesale power price increases; higher CO2 costs; regulated network price cuts in electricity, and possibly in gas; suggests that all the growth from the businesses in the UK, East Europe and the Nordic markets only comes to €95m, or a 0.5% CAGR for those operations.

We believe that this is a very conservative estimate to take. Indeed, we estimate that these businesses can grow by at least 4% CAGR per year through a combination of: volume growth in East Europe; price convergence between the Nordic and German markets; recovering UK retail margins.

Factoring in this instead would suggest an EBIT figure of €13.2bn in 2010E vs the company guidance of €12.4bn.

Figure 2: E.ON Group EBIT growth potential to 2010E - JPMorgan estimates



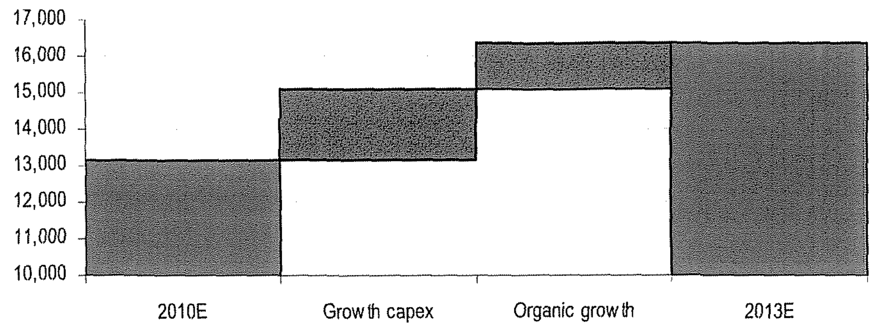
Source: JPMorgan estimates.

Growth capex impact beyond 2010E

We estimate that only around half of the potential €4.2bn EBIT uplift from the 2007-2010 capex programme will actually take effect by 2010. The remainder – around €2.2bn – will only impact in 2010-2013 when the last of the assets being built comes online.

This suggests to us that, when added to ongoing organic growth of just 3% per year, a target of €16.3bn of EBIT by 2013E is possible – equivalent to a 7 year CAGR of 10% in EBIT and around 11.4% in EPS.

Figure 3: E.ON Group EBIT growth potential to 2013E - JPMorgan estimates



Source: JPMorgan estimates.

This potential for very long term double digit growth makes E.ON a very attractive investment proposition, we believe.

Upgrades necessary

We are upgrading our EBIT forecast by c7% in 2010E and EPS by around 9%. Effectively our previous figures had included the growth from the East Europe, Nordic and UK businesses, but had not factored in enough for cost cutting or the impact of reorganising the Trading business.

We do recognize that, as a consequence, our forecasts are above guidance and would therefore see them as having little in the way of upside risk absent a major leg up in commodity prices.

Table 2: Revised forecasts

€ in millions, except per share data

	2007E	2008E	2009E	2010E
Old EBIT	8,797	10,626	11,956	12,351
New EBIT	9,007	11,046	12,586	13,181
% Revision	2.4%	4.0%	5.3%	6.7%
Old Adj EPS	7.54	9.60	10.69	10.96
New Adj EPS	7.78	10.11	11.46	11.99
% Revision	3.1%	5.2%	7.2%	9.3%
Old DPS	4.26	5.43	5.88	6.58
New DPS	4.39	5.71	6.30	7.19
% Revision	3.1%	5.2%	7.2%	9.3%

Source: JPMorgan estimates.

More importantly, though, we believe that consensus is too light now by the tune of around 12% at the EBIT line (reliable data is only available to 2009) and nearly a quarter at the EPS line.

Table 3: Forecasts vs consensus

€ in millions, except per share data

	2007E	2008E	2009E
JPM Adj EBIT	9,007	11,046	12,586
Consensus Adj EBIT	8,700	10,100	11,200
Consensus % JPM	3.5%	9.4%	12.4%
JPM Adj EPS	7.78	10.11	11.46
Consensus Adj EPS	7.68	8.5	9.18
Consensus % JPM	1.3%	18.9%	24.8%

Source: JPMorgan estimates, Bloomberg consensus estimates.

Three positive catalysts, one negative

We believe that, relative to our unchanged (due to bond yield increases driving WACC up) €140 valuation and relative to the sector E.ON looks attractively valued currently:

Table 4: Valuation multiples excluding E.ON's Gazprom stake at market value

Dec 31 y/e, ex Gazprom	2007E	2008E	2009E	2010E
Multiples at €140 target price				
P/E	15.5x	12.5x	11.4x	10.9x
Declared Yield	3.1%	4.1%	4.5%	5.1%
FCF Adjusted	-4.7%	-20.4%	-1.5%	-1.0%
EV/EBITDA	9.5x	9.0x	8.2x	8.0x
Multiples at €117.8 share price				
P/E	12.7x	10.3x	9.3x	8.9x
Declared Yield	3.7%	4.8%	5.4%	6.1%
FCF Adjusted	-5.7%	-24.9%	-1.9%	-1.2%
EV/EBITDA	8.3x	8.0x	7.3x	7.1x

Source: JPMorgan estimates.

Looking over the next few months we see one negative and three potential positive catalysts for the stock, of which two are effectively interconnected:

- **German energy issues**: In early July we expect the German cabinet to pass legislation that will (a) implement incentive regulation (b) formalize auctioning of CO2 permits for phase 2 and (c) enact the changes to the competition laws (GWB) that will alter the burden of proof in market manipulation cases. Whilst we account for these already in our views, in a momentum-driven market any news on regulation / price controls could be negative for the shares. We would buy on any weakness.
- **Upgrade path 1: Consensus earnings updates post May 31 presentation**: As mentioned already, only around a quarter of sell-side analysts have updated their figures. As this proportion increases we would expect E.ON to appear in more and more "earnings momentum" value screens with investors (we understand it has already begun to do so in some cases) which in turn should drive a more general interest in the shares.
- **Upgrade path 2: East Europe Capital Markets Day**: On September 20 E.ON are scheduled to hold a capital markets day in Budapest to discuss their East European operations. This should draw attention to the growth potential inherent in the business and hence could drive another round of upgrades.
- **Buy-back programme**: We understand that E.ON has yet to appoint banks to handle its buy-back programme - and obviously in the absence of stock exchange statements so far it would appear the programme certainly hasn't started. We estimate that E.ON needs to be active on one third of all trading days to end Dec08 if it limits volumes to 20% of daily averages, and 13% of all trading days at 50% of daily volume. We believe the buy-back programme – if fully executed – should therefore provide good trading support for the shares.

Table 5: Boundary conditions of buy-back programme

Shares to buy back	**59.4**
Buy-back volume - €m	7000
Current price - €/share	117.8
90 day average shares traded	**5.3**
Eligible buy-back days left	**175**
Total trading days left to Dec 08	385
less: closed period days	210
Days/closed period	30
Closed period to Dec 08	7
% of days active at 20% of daily vol	**32%**
% of days active at 50% of daily vol	13%

Source: JPMorgan estimates.

We therefore retain our OW stance, and add the stock to the JPMorgan Analyst Focus List.

Fusebox

Where do we differ to consensus?

- **Earnings forecasts**: We believe E.ON can deliver above its 2010E EBIT target of €12.4bn, and as a consequence are 19% ahead of 2008E Bloomberg consensus EPS and 25% ahead in 2009. We believe the market will come around to these numbers in due course as the market gets more comfortable with the drivers of the growth.
- **Valuation**: Our Dec 07 €140 target price compares to around €130 in the consensus currently – again we'd expect to see upgrades as the market factors in E.ON's new data.

Forthcoming events

- **Consensus upgrades**: We'd expect this process to proceed naturally in the coming months, but would see: a potential East Europe capital markets day; completion of the southern Europe asset purchase; and a lifting of regulatory uncertainties as being ongoing catalysts.
- **Share buy-back programme**: We expect E.ON to buy back probably half its allowance during 2007, and the remainder in 2008. We expect E.ON to be active on one third of all trading days.
- **Disposals**: We wouldn't expect immediate action, but the future of the underperforming assets in the group - especially LG&E - has to be in question. We'd see disposal news (subject to pricing of course) as potentially positive.

Table 6: SOP Valuation, Dec 07

	€m	€p.s.	% EV	'07E EV/EBITDA
Central Europe	49,065	78.3	37%	8.2x
Pan-Euro Gas	35,402	56.5	27%	13.3x
UK	14,699	23.5	11%	8.0x
Nordic	14,832	23.7	11%	10.1x
US Mid-West	5,188	8.3	4%	9.0x
Southern Europe	12,777	20.4	10%	7.1x
Corporate Center	740	1.2	1%	
Enterprise value	**132,704**	**211.8**	**100%**	**11.1x**
less: Net debt	-14,946	-23.9	-11%	-1.2x
less: Provisions/other	-29,968	-47.8	-23%	
Equity Value	**87,789**	**140.1**	**66%**	
Dec 31 y/e, ex Gazprom	**2007E**	**2008E**	**2009E**	**2010E**
Multiples at €140 target price				
P/E	15.5x	12.5x	11.4x	10.9x
Declared Yield	3.1%	4.1%	4.5%	5.1%
FCF Adjusted	-4.7%	-20.4%	-1.5%	-1.0%
EV/EBITDA	9.5x	9.0x	8.2x	8.0x
Multiples at €117.8 share price				
P/E	12.7x	10.3x	9.3x	8.9x
Declared Yield	3.7%	4.8%	5.4%	6.1%
FCF Adjusted	-5.7%	-24.9%	-1.9%	-1.2%
EV/EBITDA	8.3x	8.0x	7.3x	7.1x

Source: JPMorgan estimates.

Table 7: Key earnings drivers

€m, Dec 31 y/e	2007E	2008E	2009E	2010E	2011E	2011E vs 2006A
Change in group PBET	**917**	**1,720**	**1,103**	**477**	**256**	**4,473**
o/w Wholesale power, Germany	836	-60	864	-61	-45	2,044
o/w Regulation, Germany	-334	-227	0	0	0	-561
o/w East Europe (power & gas)	69	319	118	124	129	759
o/w Wholesale power, Nordic	436	175	115	54	29	810
o/w Interest expense	60	-319	-437	-118	81	-733
o/w Southern Europe	0	1,342	98	-20	-12	1,440
o/w UK Gentailing margins	44	-50	-98	114	-119	-109
o/w New investments & Others	-193	540	442	384	192	821
% change PBET y-o-y	*12.1%*	*13.0%*	*21.5%*	*11.4%*	*4.4%*	*9.2%*

Source: JPMorgan estimates.

Table 8: Key sensitivities

Variable	Our assumption	Flex	PBT effect - €m	S-o-P effect €/share
German electricity				
Network regulation	20% price cut	5% points	187	3.5
Nuclear plant lives	32 years	40 years		3.6
Long term price, Germany	€52.5/MWh	€5/MWh	575	10.8
Other divisions				
Gas network regulation	20% price cut	5% points	43	0.8
Long term price, UK	£39.0/MWh	£3/MWh	154	1.9
UK supply l.t. EBIT margin	6.5%	100bp	97	1.7
Nordpool price	€46.0/MWh	€5/MWh	165	3.2
Long term price, Italy	€56.6/MWh	€5/MWh	178	1.5
Long term price, Spain	€56.0/MWh	€5/MWh	146	1.9
US return on rate base	9.4%	100bp		1.5
Group				
CO_2 price	€20/t	€10/t	785	11.9
Average WACC	6.00%	+50bp		-11.0

Source: JPMorgan estimates.

Table 9: Financial snapshot

€m, Dec 31 y/e	2006A	2007E	2008E	2009E	2010E	'10E vs '06A CAGR
Revenues	67,759	60,229	70,315	82,854	89,444	7.2%
EBITDA	11,353	12,182	14,813	16,558	17,354	11.2%
EBIT	**8,150**	**9,007**	**11,046**	**12,586**	**13,181**	**12.8%**
Central Europe	4,168	4,768	4,776	5,978	6,247	10.6%
Pan Euro Gas	2,106	2,079	2,446	2,656	2,816	7.5%
UK	1,229	1,269	1,207	1,105	1,221	-0.2%
Nordic	619	1,068	1,246	1,370	1,433	23.3%
US Mid-West	391	373	380	386	395	0.2%
Southern Europe	0	0	1,342	1,440	1,420	
Net income, reported	5,057	6,356	6,166	6,802	7,116	8.9%
Net income, adjusted	**4,386**	**5,001**	**6,166**	**6,802**	**7,116**	**12.9%**
EPS, recurrent	6.65	7.78	10.11	11.46	11.99	15.9%
DPS, reported	**3.35**	**4.39**	**5.71**	**6.30**	**7.19**	**21.1%**
Payout ratio	50%	56%	57%	55%	60%	4.5%
Cash from operations	7,194	9,247	10,861	12,097	12,657	15.2%
Capex & investments	-5,161	-7,490	-21,109	-11,680	-11,801	23.0%
Free cash flow, adj	-2,306	-3,257	-15,289	-673	-244	
Economic Net Debt	18,231	22,387	39,082	41,751	44,289	

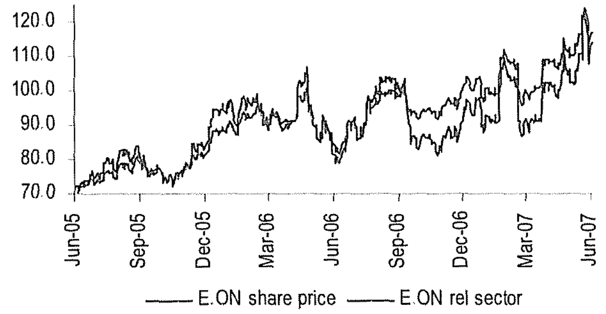
Source: JPMorgan estimates, Company data.

Share price & P/E Bands analysis

Up until the failure of the offer in February, E.ON's stock price had been driven primarily for a year by the trials and tribulations of the bid for Endesa. More recently the recovery in commodity prices (especially CO2), coupled with expectations for the strategy plan presentation, drove the shares steadily up. We believe the recent drop-off has in part been driven by the market using E.ON to short the sector on bond yield concerns.

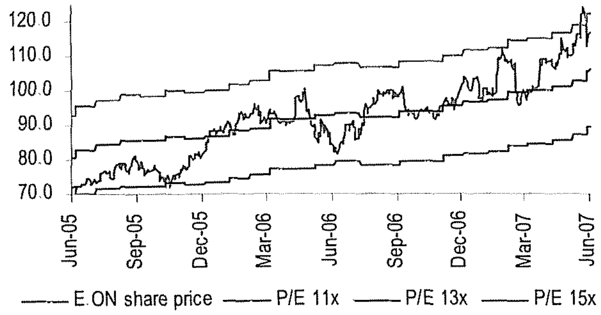
From a P/E perspective E.ON is trading close to the top of its historical range on consensus FY1 numbers. However, as we note elsewhere in this report, we expect a c15% upgrade to 2008 and 30% for 2010, suggesting the stock could easily go higher from here.

Figure 4: E.ON share price performance



Source: Datastream

Figure 5: E.ON P/E band analysis - FY1 consensus



Source: Datastream

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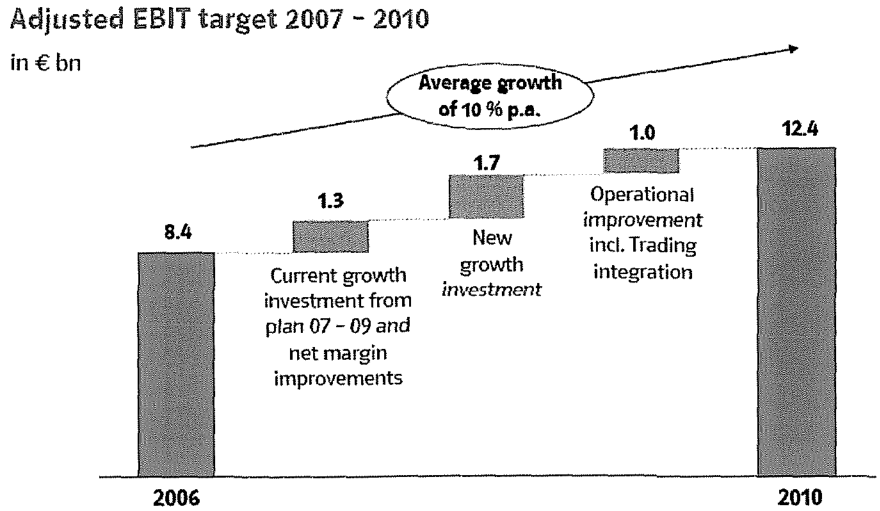
Analysing the buckets once more

An updated analysis of E.ON's explanation of its growth drivers (characterized in 3 "buckets" in their May 31 analyst meeting) suggests to us a higher level of efficiency improvements (in cost cutting and trading) than we previously thought. We believe this implies management are being too cautious on the outlook for their businesses outside of Germany.

Analysing the buckets

On May 31 2007 E.ON outlined their new strategy plan and financial targets – "10 until 10". At the heart of this, as far as we are concerned, was the commitment to grow EBIT by €4bn, or 10% CAGR, between 2006 and 2010. This was explained via the following chart that appeared in the May 31 chart pack:

Figure 6: E.ON – "10 until 10": E.ON will increase its adjusted EBIT by 10% p.a. until 2010



Source: Company data

Subsequent to the meeting we have worked out a further level of granularity to these "buckets":

Bucket 1: "Current Growth Investment & net margin improvements - €1.3bn"

- Net margin improvements – 50% of €1.3bn, coming mostly from Germany between 2007-2009.
- Cost cutting – 25% of €1.3bn, a programme launched in late 2006 to help restructure the German network operations, to be completed by end 2009
- Contribution from growth investments made in 2007-2009 to EBIT by 2010 – 25% of €1.3bn

Bucket 2: "New growth investments - €1.7bn"

- Acquisition of Southern European assets - €1.1bn we estimate based on E.ON comments on April 2 that the EBIT of the acquired businesses would be equivalent to somewhat more than that of the Nordic & US businesses combined.

- Other projects, mostly small acquisitions, gas storage and pipelines and others - €0.6bn.

Bucket 3: "Operational improvements including trading - €1.0bn"

- Bundling of Trading operations - €400m
- Efficiency measures (cost cutting) made in 2010 - €300m
- Net margin effects (rising prices, tightened regulations & CO2 allocations) taking place in 2010 - €300m

Reconciling the buckets to growth potential

We would reclassify the contents of the three E.ON buckets into five somewhat more user friendly buckets, which can be forecast through time also:

Table 10: Reclassified EBIT growth "buckets" and EBIT forecast by year

	Total/2006	2007	2008	2009	2010
Total	**4,000**	**656**	**1,756**	**656**	**931**
1. Growth capex	**925**	**231**	**231**	**231**	**231**
o/w 2007-2009 capex	325	81	81	81	81
o/w New growth capex	600	150	150	150	150
2. Southern European assets	**1,100**		**1,100**		
3. Efficiency measures	**625**	**108**	**108**	**108**	**300**
o/w 2007-2009 ("Bucket 1")	325	108	108	108	
o/w 2010 ("Bucket 2")	300				300
4. Trading bundling	**400**	**100**	**100**	**100**	**100**
5. Margin improvements	**950**	**217**	**217**	**217**	**300**
o/w 2007-2009 ("Bucket 1")	650	217	217	217	
o/w 2010 ("Bucket 3")	300				300
EBIT projection	**8,400**	**9,056**	**10,813**	**11,469**	**12,400**

Source: JPMorgan estimates.

Our concern here is with reconstituted "bucket 5" – Margin improvements. We note here that the €950m of growth is only equivalent to a like-for-like CAGR of 2.7% - which seems very low given E.ON's potential to benefit from higher wholesale margins, and positions in a number of growth markets.

Indeed, taking out projected gains in Germany suggests that the "ex Germany" margin improvements are only €95m, or a 0.5% CAGR to 2010E. The Germany earnings drivers include:

- **Rising wholesale power achieved prices**: Driven through a mixture of the rising forward curve and steady forward contracting of volumes we estimate that achieved prices should increase from €37/MWh in 2006 to €54/MWh in 2010E.
- **Higher CO2 costs**: We believe that the German utilities will be hit by the full impact of CO2 auctioning in Germany. When combined with the ongoing cut in the NAP2, we estimate E.ON may get as little as half of its required CO2 permits for free.
- **Regulation price cuts**: We anticipate a c5% cut in network prices in late 2007 to apply for 2008. We assume that the incentive regulatory scheme ends up being a wash – ie inflation and capex allowances are offset by efficiency factors. We factor in the risk that regulation comes to German gas transmission pipelines. Note that the price cuts made in 2006 for 2007 are already effectively factored into the 2006 EBIT via the provisions taken.

Table 11: Implied EBIT from ex-German business - €m

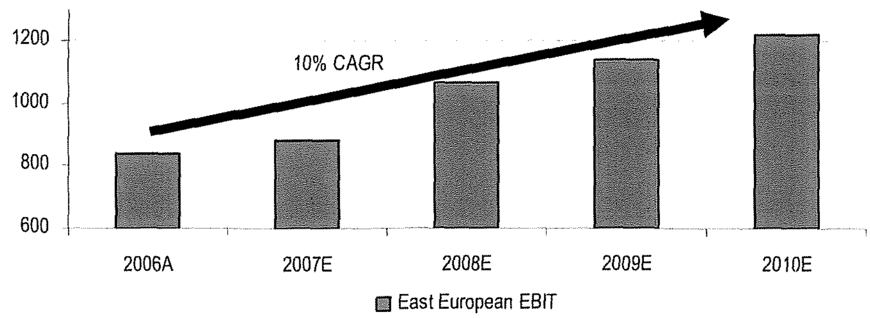
Margin improvements	**950**	
o/w Wholesale power in Germany	1955	115GWh x increased price €54-37/MWh
o/w CO2 costs	-500	50mt position, 50% shortfall at €20/t
o/w Regulation	-600	Impact of 2007 cuts in electricity, risk of cuts in gas networks
o/w All other businesses	95	Nordic, UK, CEE, US M-W, Pan Euro Gas
% CAGR of margin improvement	***0.5%***	

Source: JPMorgan estimates.

We would argue that this represents a significant under-estimation of the growth potential in E.ON's non German businesses:

- **East Europe**: E.ON has significant generation, network, supply and gas operations in Hungary, the Czech Republic and Slovakia and also has significant equity stakes in SPP and Gazprom. We estimate that all these businesses together should be able to grow EBIT at around 10% per year.

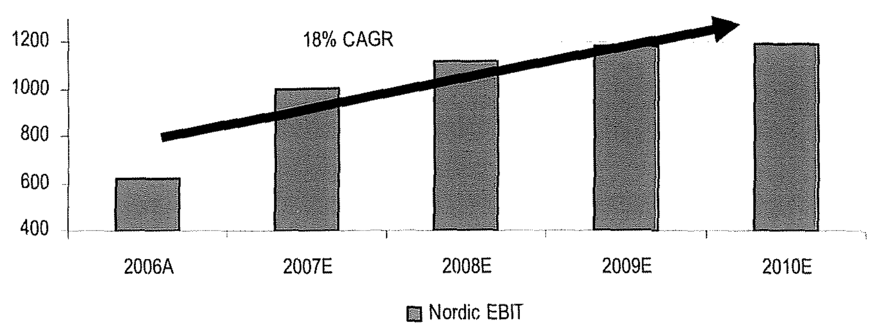
Figure 7: E.ON's East European EBIT, includes Central Europe and Pan-European Gas, excludes acquisitions & growth capex



Source: JPMorgan estimates, company data.

- **Nordic**: We are bullish on the prospects for growth in the Nordic market as a result of (a) recovery in generation mix after an unusually weak 2006 and 1Q07 and (b) convergence of Nordic prices to German levels as a result of a need for new capacity, physical interconnecting capacity and CO2-arbitraging. This should generate an 18% CAGR, although much of it comes in years 1 and 2 of the forecast.

Figure 8: E.ON Nordic's EBIT, excluding the impact of growth capex



Source: JPMorgan estimates, company data.

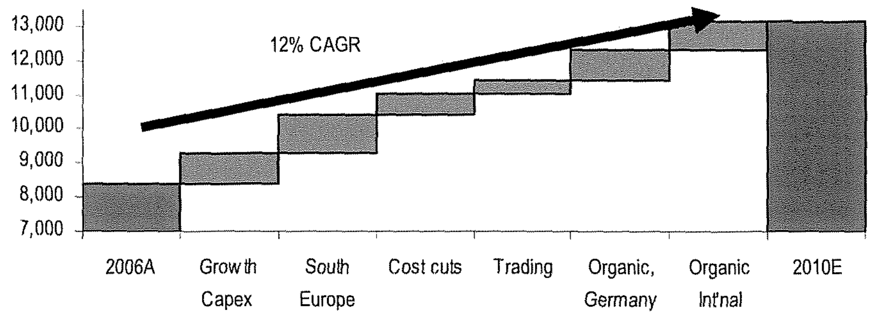
- **UK & US Mid-West**: Whilst more stable areas than E.Europe and Nordic, we nonetheless expect to see earnings roughly flat on average during the period from the two integrated divisions inherited from the Powergen acquisition.

If we average all of these areas together, we see the potential for the "ex Germany Margin Improvements" to run at a CAGR of nearer 5-7% over the forecast period.

Growth potential – 2010 & beyond

If we factor in this higher growth rate for the international businesses, we estimate that E.ON can actually hit a €13.2bn EBIT figure in 2010E, equivalent to a 12% CAGR vs the company estimate of 10%.

Figure 9: Our estimate of E.ON's EBIT to 2010E, €m

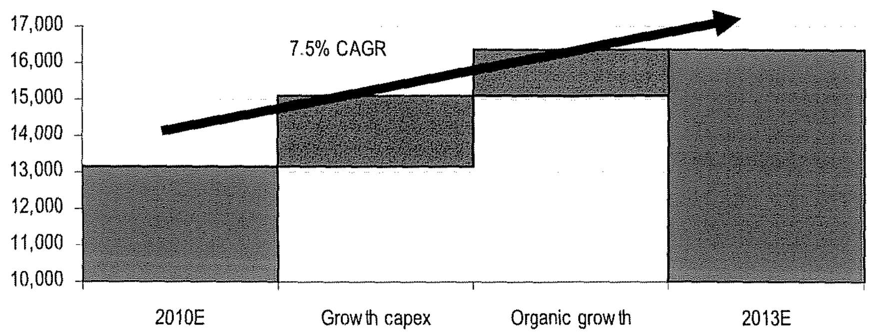


Source: JPMorgan estimates.

Furthermore, we believe the market needs to factor in the full impact of the group's growth capex longer term. Of the €32bn of growth capex (outside the southern European acquisition) to be spent by 2010E, we estimate only around €925m has an impact on EBIT in 2010E.

The remainder will have an impact as the remaining equipment is switched on – ie around another €2.17bn - by 2013E. We estimate that this alone should generate a 4% CAGR in EBIT. Adding on a relatively modest 3% CAGR in underlying EBIT suggests that **E.ON's target should be "10 until 13" - ie a 10% annual CAGR in EBIT 2006-2013, equivalent to a 11.4% CAGR in EPS over the same period**.

Figure 10: Our forecast of E.ON's EBIT to 2013E, €m



Source: JPMorgan estimates

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Financial forecasts & valuation

Table 12: Divisional contributions to E.ON Group Adjusted EBIT

€m, Dec y/e	2005A	2006A	2007E	2008E	2009E	2010E	2011E	5y fcst CAGR
Central Europe	**3,930**	**4,168**	**4,768**	**4,776**	**5,978**	**6,247**	**6,333**	**8.7%**
o/w German Electricity	3,389	3,550	*4,181*	*4,144*	*5,278*	*5,476*	5,490	9.1%
o/w German Gas	307	272	211	196	204	213	222	-4.0%
o/w East Europe	237	269	298	355	414	473	534	14.7%
o/w Other	-3	77	79	81	83	85	87	2.4%
Pan-European Gas	**1,536**	**2,106**	**2,079**	**2,446**	**2,656**	**2,816**	**2,985**	**7.2%**
o/w Up/Midstream	988	1,684	1,477	1,640	1,802	1,906	2,015	3.7%
o/w Downstream	551	431	627	815	868	925	986	18.0%
o/w Industries/Other	-3	-9	-25	-9	-13	-16	-16	12.2%
United Kingdom	**963**	**1,229**	**1,269**	**1,207**	**1,105**	**1,221**	**1,107**	**-2.1%**
o/w Regulated	451	487	483	471	467	469	473	-0.6%
o/w Unregulated	512	742	786	736	638	752	633	-3.1%
Nordic	**806**	**619**	**1,068**	**1,246**	**1,370**	**1,433**	**1,471**	**18.9%**
o/w Regulated	332	200	636	811	927	981	1,010	38.2%
o/w Unregulated	474	419	432	435	443	452	461	1.9%
US Mid West	**365**	**391**	**373**	**380**	**386**	**395**	**403**	**0.6%**
Southern Europe		**1,312**	**1,405**	**1,342**	**1,440**	**1,420**	**1,408**	**1.4%**
Spain		465	484	534	607	650	615	5.7%
Italy		749	833	693	691	589	571	-5.3%
France & Other		98	88	116	142	181	222	17.6%
Other/Consolidation	**-267**	**-363**	**-550**	**-350**	**-350**	**-350**	**-350**	**-0.7%**
E.ON Group	**7,333**	**8,150**	**9,007**	**11,046**	**12,586**	**13,181**	**13,356**	**10.4%**

Source: JPMorgan estimates, Company data.

Table 13: Divisional dynamics within E.ON Group EBIT

	% Change y-o-y						% Group Total					
	2006A	2007E	2008E	2009E	2010E	2011E	2006A	2007E	2008E	2009E	2010E	2011E
Central Europe	**6.1%**	**14.4%**	**0.2%**	**25.2%**	**4.5%**	**1.4%**	**51%**	**53%**	**43%**	**47%**	**47%**	**47%**
o/w German Electricity	4.8%	17.8%	-0.9%	27.4%	3.8%	0.3%	44%	46%	38%	42%	42%	41%
o/w German Gas	-11.4%	-22.4%	-7.3%	4.3%	4.2%	4.2%	3%	2%	2%	2%	2%	2%
o/w East Europe	13.5%	10.7%	19.3%	16.4%	14.4%	12.9%	3%	3%	3%	3%	4%	4%
o/w Other							1%	1%	1%	1%	1%	1%
Pan-European Gas	37.1%	-1.3%	17.6%	8.6%	6.0%	6.0%	26%	23%	22%	21%	21%	22%
o/w Up/Midstream	70.4%	-12.3%	11.0%	9.9%	5.8%	5.7%	21%	16%	15%	14%	14%	15%
o/w Downstream	-21.8%	45.5%	30.0%	6.5%	6.6%	6.5%	5%	7%	7%	7%	7%	7%
o/w Industries/Other							0%	0%	0%	0%	0%	0%
United Kingdom	27.6%	3.2%	-4.9%	-8.4%	10.4%	-9.4%	15%	14%	11%	9%	9%	8%
o/w Regulated	8.0%	-0.9%	-2.4%	-0.8%	0.4%	1.0%	6%	5%	4%	4%	4%	4%
o/w Unregulated	44.9%	5.9%	-6.4%	-13.3%	17.8%	-15.8%	9%	9%	7%	5%	6%	5%
Nordic	-23.2%	72.5%	16.7%	9.9%	4.6%	2.6%	8%	12%	11%	11%	11%	11%
o/w Regulated	-39.8%	217.9%	27.6%	14.2%	5.9%	3.0%	2%	7%	7%	7%	7%	8%
o/w Unregulated	-11.6%	3.1%	0.7%	1.9%	1.9%	1.9%	5%	5%	4%	4%	3%	3%
US Mid West	7.1%	-4.5%	1.7%	1.6%	2.3%	2.2%	5%	4%	3%	3%	3%	3%
Southern Europe		7.0%	-4.5%	7.3%	-1.4%	-0.8%	16%	16%	12%	11%	11%	11%
o/w Spain		4.0%	10.3%	13.8%	7.0%	-5.3%	6%	5%	5%	5%	5%	5%
o/w Italy		11.2%	-16.8%	-0.2%	-14.9%	-3.0%	9%	9%	6%	5%	4%	4%
o/w France/Other		-10.3%	31.4%	22.1%	28.2%	22.2%	1%	1%	1%	1%	1%	2%
Other/Consolidation							-4%	-6%	-3%	-3%	-3%	-3%
E.ON Group	11.1%	10.5%	22.6%	13.9%	4.7%	1.3%	100%	100%	100%	100%	100%	100%

Source: JPMorgan estimates, Company data.

Table 14: E.ON Group Profit & Loss Account

€m, Dec y/e	2005A	2006A	2007E	2008E	2009E	2010E	2011E	5y fcst CAGR
Revenues, ex taxes	56,399	67,759	60,229	70,315	82,854	89,444	90,861	6.0%
EBITDA	**10,272**	**11,353**	**12,182**	**14,813**	**16,558**	**17,354**	**17,728**	**9.3%**
% change	*-2.7%*	*10.5%*	*7.3%*	*21.6%*	*11.8%*	*4.8%*	*2.2%*	
Depreciation / Amortisation	-2,939	-3,203	-3,174	-3,766	-3,972	-4,173	-4,372	
EBIT	**7,333**	**8,150**	**9,007**	**11,046**	**12,586**	**13,181**	**13,356**	**10.4%**
% change	*-0.4%*	*11.1%*	*10.5%*	*22.6%*	*13.9%*	*4.7%*	*1.3%*	
Financial expenses	-1,027	-1,081	-1,021	-1,340	-1,777	-1,895	-1,814	
PBET	6,306	7,069	7,986	9,706	10,809	11,286	11,542	10.3%
% change	*1.4%*	*12.1%*	*13.0%*	*21.5%*	*11.4%*	*4.4%*	*2.3%*	
Non-operating items	902	-1,936	1,355	0	0	0	0	
o/w Net book gains	491	1,205	0	0	0	0	0	
o/w Restructuring expense	-29	0	885	0	0	0	0	
o/w others	440	-3,141	470	0	0	0	0	
PBT	**7,208**	**5,133**	**9,341**	**9,706**	**10,809**	**11,286**	**11,542**	**17.6%**
Income tax	-2,276	323	-2,316	-2,815	-3,243	-3,386	-3,462	
Minority interests	-553	-526	-669	-726	-764	-784	-796	
Net income, continuing	4,379	4,930	6,356	6,166	6,802	7,116	7,283	8.1%
Net income, discontinued	3,035	127	0	0	0	0	0	
Reported net income	7,407	5,057	6,356	6,166	6,802	7,116	7,283	7.6%
% change	*70.7%*	*-31.7%*	*25.7%*	*-3.0%*	*10.3%*	*4.6%*	*2.3%*	
Adjusted net income	**3,640**	**4,386**	**5,001**	**6,166**	**6,802**	**7,116**	**7,283**	**10.7%**
% change	*-3.4%*	*20.5%*	*14.0%*	*23.3%*	*10.3%*	*4.6%*	*2.3%*	

Source: JPMorgan estimates, Company data.

Table 15: E.ON Group Balance Sheet

€m, Dec y/e	2005A	2006A	2007E	2008E	2009E	2010E	2011E	% '07E Equity
Tangible/Intangible assets	45,448	46,447	50,777	68,119	75,827	83,456	81,931	98%
Goodwill	15,363	15,124	15,131	15,302	15,473	15,644	15,815	29%
L.T. financial assets	21,686	34,773	34,773	34,773	34,773	34,773	34,773	67%
Inventories	2,457	3,990	3,547	4,141	4,879	5,267	5,350	7%
Operating receivables	21,354	17,698	16,614	18,066	19,871	20,820	21,024	32%
Cash & securities	15,119	6,187	6,481	6,208	6,907	6,688	10,134	13%
Other assets	5,135	3,013	2,308	2,393	2,515	2,581	2,592	4%
Total assets	**126,562**	**127,232**	**129,630**	**149,002**	**160,245**	**169,229**	**171,620**	**251%**
Shareholders' equity	44,484	47,961	46,334	48,190	54,639	60,335	64,937	90%
Minority interests	4,734	4,917	5,278	5,670	6,082	6,506	6,935	10%
Pension provisions	8,720	3,769	3,396	2,813	2,175	1,490	746	7%
Nuclear provisions	13,362	13,646	13,651	13,656	13,661	13,666	13,671	26%
Financial liabilities	14,362	13,399	18,217	35,217	39,217	42,217	40,217	35%
Other liabilities	40,900	43,540	42,754	43,455	44,470	45,015	45,113	83%
Total equity/liabilities	**126,562**	**127,232**	**129,630**	**149,002**	**160,245**	**169,229**	**171,620**	**251%**
Economic Net Debt	**20,238**	**18,231**	**22,387**	**39,082**	**41,751**	**44,289**	**38,104**	**43%**

Source: JPMorgan estimates, Company data.

Table 16: E.ON Group Cash Flow Statement

€m, Dec y/e	2005A	2006A	2007E	2008E	2009E	2010E
Net income	7,407	5,057	6,356	6,166	6,802	7,116
Depreciation etc	*3,068*	*3,751*	3,174	3,766	3,972	4,173
Net working capital	-1,027	-1,261	741	-1,345	-1,529	-792
Other non-cash items	-2,847	-353	-1,026	2,274	2,851	2,160
Cash flow from operations	**6,601**	**7,194**	**9,247**	**10,861**	**12,097**	**12,657**
Investments	-4,337	-5,161	-7,490	-21,109	-11,680	-11,801
Disposals	6,599	3,954	0	0	0	0
Others	-1,863	-3,294	0	0	0	0
Cash flow from investments	**399**	**-4,501**	**-7,490**	**-21,109**	**-11,680**	**-11,801**
E.ON *group dividends*	-1,549	-4,614	-2,195	-2,731	-3,366	-3,713
Minority dividends	-245	-242	-308	-334	-352	-361
Others	-4,671	-993	1,040	13,040	4,000	3,000
Cash flow from financing	**-6,465**	**-5,849**	**-1,463**	**9,975**	**282**	**-1,074**
Other items	77	-38	0	0	0	0
Change in cash & securities	612	-3,194	294	-273	699	-219
Free cash flow (adj)	-770	-2,306	-3,257	-15,289	-673	-244

Source: JPMorgan estimates, Company data

Table 17: E.ON Group per Share & Key Ratios

	2005A	2006A	2007E	2008E	2009E	2010E
Shares in issue (avg)	659	659	643	610	594	594
EPS (reported)	**11.24**	**7.67**	**9.88**	**10.11**	**11.46**	**11.99**
% change	*70.3%*	*-31.7%*	*28.9%*	*2.2%*	*13.4%*	*4.6%*
EPS (adjusted)	5.52	6.65	7.78	10.11	11.46	11.99
% change	*-3.7%*	*20.5%*	*16.9%*	*30.0%*	*13.4%*	*4.6%*
DPS declared	**7.00**	**3.35**	**4.39**	**5.71**	**6.30**	**7.19**
% change	*197.9%*	*-52.1%*	*31.0%*	*30.1%*	*10.3%*	*14.1%*
Payout ratio (reported)	**127%**	**50%**	**56%**	**57%**	**55%**	**60%**
FCFPS (adjusted)	-1.17	-3.50	-5.06	-25.06	-1.13	-0.41
RoE (reported)	16.7%	10.5%	13.7%	12.8%	12.4%	11.8%
RoCE (E.ON)	**12.1%**	**13.2%**	**13.9%**	**14.0%**	**17.9%**	**18.2%**
Gearing (D/E)	-7.8%	0.5%	9.3%	41.0%	41.8%	42.8%
Gearing (D/CE)	-8.5%	0.5%	8.5%	29.1%	29.5%	30.0%
Gearing (FFO.ND)	32.7%	36.0%	38.3%	26.6%	27.8%	27.5%
Gearing (ND/EBITDA)	**-0.1x**	**0.6x**	**1.0x**	**2.0x**	**2.0x**	**2.0x**

Source: JPMorgan estimates, Company data.

Valuation

We base our €140/share formal target price on a sum-of-parts valuation, itself driven by discounted cash flow analyses for each division. On average we apply a WACC of 6.0% post tax (up from 5.7% previously due to higher bond yields) and an average 1.5% terminal growth rate.

Whilst the implied multiple on an EV/EBITDA basis is significantly higher than that for RWE we'd note that (a) the E.ON valuation includes c€20/share from the group's Gazprom stake, which contributes little to earnings and (b) the growth potential, returns, and average remaining asset life are all much better for E.ON vs RWE.

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Table 18: E.ON Group DCF-based Sum-of-Parts valuation

Division	€ m	€ p.s.	% EV	Comparator	Measure
Central Europe	**51,390**	**82.0**	**38.8%**	**8.3x**	**'07E EBITDA**
Germany	44,085	70.4	33.2%	8.1x	'07E EBITDA
International	7,305	11.7	5.5%	10.0x	'07E EBITDA
Pan-European Gas	34,254	54.7	25.8%	12.9x	'07E EBITDA
Operating Businesses	23,856	38.1	18.0%	10.3x	'07E EBITDA
Gazprom	10,398	16.6	7.8%	3.4%	'07E Income Yield
United Kingdom	**14,018**	**22.4**	**10.6%**	**7.6x**	**'07E EBITDA**
Energy Services	11,102	17.7	8.4%	9.4x	'07E EBITDA
Generation	4,238	6.8	3.2%	320	GBP/kW
Supply	6,863	11.0	5.2%	552	GBP/customer
Central Networks	2,916	4.7	2.2%	-18%	Premium to RAV
Nordic	14,832	23.7	11.2%	10.1x	'07E EBITDA
LG&E	4,988	8.0	3.8%	8.6x	'07E EBITDA
Southern Europe	12,344	19.7	9.3%	6.9x	'07E EBITDA
Spain	4,880	7.8	3.7%	8.2x	'07E EBITDA
Italy	5,369	8.6	4.0%	5.3x	'07E EBITDA
France / Other	2,095	3.3	1.6%	11.2x	'07E EBITDA
Corporate Center & assets	778	1.2	0.6%		
Enterprise Value	**132,605**	**211.6**	**100.0%**	**9.5x**	**'07E EBITDA adj**
Net Financial Position	-14,792	-23.6	-11.2%		'07E Book adj
Provisions	-19,349	-30.9	-14.6%		Sum-of-Parts
Nuclear	-13,651	-21.8	-10.3%		'07E Book
Pension	-3,396	-5.4	-2.6%		'07E Book
Mining / Environmental	-2,302	-3.7	-1.7%		'07E Book
Minority Interests	-10,725	-17.1	-8.1%		'07E Adjusted Book
Equity Value	**87,738**	**140.0**	**66.2%**		
EV ex Gazprom	**122,206**			**9.0x**	**07E EBITDA**

Source: JPMorgan estimates, Company data.

Key risks and sensitivities

The table on page 8 illustrates the key drivers of our earnings forecasts and sensitivities to valuation. From a recommendation perspective the key risk is that management fail to deliver a convincing set of targets and path-to-achievement on May 31. Worse still would be a return to "big deals", but we see a relatively low probability here.

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- **Market Maker/ Liquidity Provider:** JPMSL and/or an affiliate is a market maker and/or liquidity provider in E.ON.
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- **Beneficial Ownership (1% or more):** JPMSI or its affiliates beneficially own 1% or more of a class of common equity securities of E.ON.
- **Client of the Firm:** E.ON is or was in the past 12 months a client of JPMSI; during the past 12 months, JPMSI provided to the company investment banking services, non-investment banking securities-related service and non-securities-related services.
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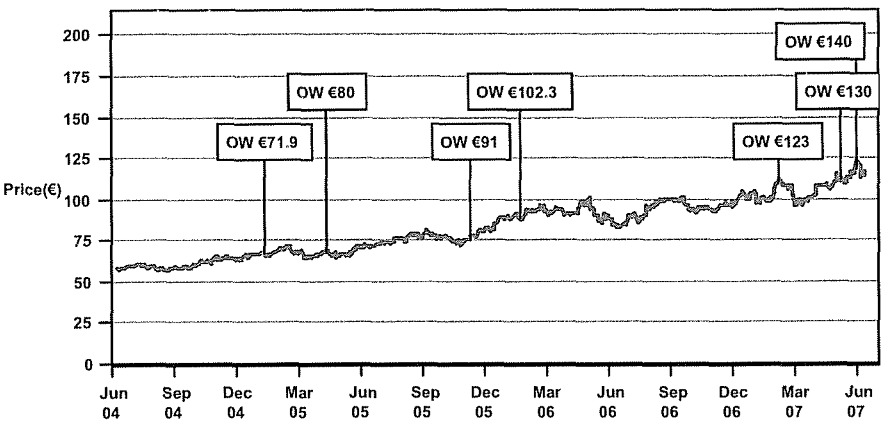
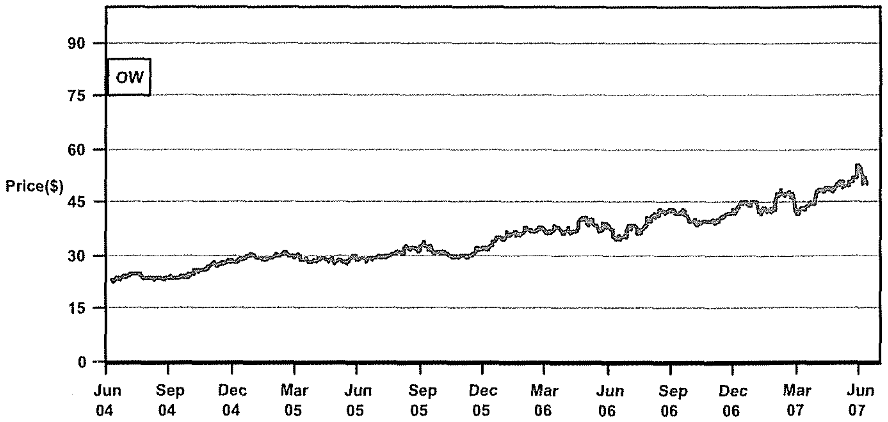
E.ON (EONG.DE) Price Chart



Date	Rating	Share Price (€)	Price Target (€)
12-Jan-05	OW	66.91	71.90
12-Apr-05	OW	67.57	80.00
10-Nov-05	OW	75.00	91.00
23-Jan-06	OW	88.48	102.30
05-Feb-07	OW	109.43	123.00
08-May-07	OW	111.89	130.00
31-May-07	OW	117.35	140.00

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
JPMorgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

E.ON (EON) ***Price Chart***



Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over ***the entire period.***
JPMorgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

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	Overweight (buy)	**Neutral** (hold)	**Underweight** (sell)
JPM Global Equity Research Coverage	42%	41%	17%
IB clients*	49%	51%	38%
JPMSI Equity Research Coverage	38%	48%	14%
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