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SCHRODER SALOMON SMITH BARNEY

Industry Report

EQUITY RESEARCH: EUROPE

Utilities

6 August 2002

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German Utilities

Brighter Outlook, Lower Share Prices

- **E.ON and RWE have underperformed the DJ STOXX by 7%-9% since mid-July**
- **However, the fundamentals are actually improving as next week's 1H results should show**
- **E.ON looks particularly attractive: coal prices have continued to slide and should contribute to an estimated 40% profits growth for E.ON Energie**
- **Weaker US utility share prices and a lower US dollar should also play into E.ON's hands**
- **We do not believe there is a great deal of shareholder value at risk with Ruhrgas**
- **RWE also looks cheap, but we think E.ON should benefit from brighter newsflow**
- **We rate E.ON 1M *(Buy, Medium Risk)* with a €70 price target; our RWE recommendation is 2M *(Outperform, Medium Risk)* with a €50 price target**

Table of Contents

Convertibles: Yes | Warrants: Yes | Estimate: Unchanged | Frankfurt (Germany)

EONG.DE **Price: €48.80**

Year to Dec	Sales (€m)	EBITDA (€m)	EPS (€)	EPS (Old) (€)	P/E	P/E Relative	FV/ EBITDA	Net DPS (€)	Div Yield (%)
2000A	88,858	8,041	1.80	1.80	27.1	2.0	7.5	1.35	2.8
2001A	79,664	8,626	3.95	3.95	12.4	0.7	7.0	1.60	3.3
2002E	54,118	9,251	3.19	3.19	15.3	1.0	6.5	1.76	3.6
2003E	58,600	10,689	4.36	4.36	11.2	1.0	5.6	1.94	4.0
2004E	60,931	11,205	4.66	4.66	10.5	1.0	5.4	2.13	4.4

52W Price Range: €62.07 to 47.20		Stock Price Performance	Ytd (%)	-1m (%)	-3m (%)	-12m (%)
Shares Outstanding	652.0m	Absolute	-15.50	-16.70	-13.60	-19.40
Market Capitalisation	€31,884.3m	Relative to Local	23.43	-1.06	21.43	31.83
ROE (Curr Yr)	8.5%	Relative to DJ STOXX	14.13	-5.38	14.20	15.32

Sources: Company reports and Schroder Salomon Smith Barney estimates.

Convertibles: Yes | Warrants: Yes | Estimate: Unchanged | Frankfurt (Germany)

RWEG.DE **Price: €33.40**

Year to Dec	Sales (EURm)	EBITDA (EURm)	EPS (EUR)	EPS (Old) (EUR)	P/E	P/E Relative	FV/ EBITDA	Net DPS (EUR)	Div Yield (%)
2000A	47,918	5,009	2.24	2.24	14.9	1.1	10.5	1.00	3.0
2001A	62,878	6,880	2.48	2.48	13.5	0.8	7.6	1.00	3.0
2002E	60,044	7,673	2.09	2.09	16.0	1.1	6.8	1.08	3.2
2003E	67,917	9,159	1.80	1.80	18.6	1.6	5.7	1.17	3.5
2004E	74,868	9,919	2.28	2.28	14.6	1.4	5.3	1.26	3.8

52W Price Range: EUR51.70 to 35.93		Stock Price Performance	Ytd (%)	-1m (%)	-3m (%)	-12m (%)
Shares Outstanding	562.4m	Absolute	-18.10	-13.30	-16.20	-26.80
Market Capitalisation	EUR18,784.2m	Relative to Local	19.63	2.98	17.78	19.73
ROE (Curr Yr)	16.3%	Relative to DJ STOXX	10.62	-1.52	10.76	4.73

Sources: Company reports and Schroder Salomon Smith Barney estimates.

Executive Summary

Both E.ON and RWE have suffered in the recent stock market slump. In fact, the two stocks have underperformed the market by some 7%-9% since mid-July. We think this is at odds with the strong fundamentals, particularly for E.ON, as the 1H results next week should show. Lower coal prices should help E.ON Energie profits to grow by an estimated 40%, while the weak US dollar and falling US share prices mean the risks of the US strategy have diminished.

Share prices are down sharply

E.ON and RWE are now both trading more than 30% below our price targets after being hit heavily in the recent stock market slump. This slump has come at a time when, unlike much of the market, the most important fundamentals for both businesses (but particularly for E.ON) are improving, as we expect the next set of results will show. This report briefly reviews the investment cases for both companies and provides detailed 1H results previews.

Core business profits should grow strongly

Spot coal prices have fallen by 42% year on year, while German power prices have been stable. The upshot is that German electricity profits are growing strongly. E.ON generates some 30% of its power from coal, compared with just 5% for RWE. As a result, although RWE's profits are likely to be strong on Monday 12 August, E.ON's figures two days later should be stronger still. We are forecasting 40% growth in internal operating profit for E.ON Energie.

Acquisition risks have arguably diminished

Aside from German electricity profits, the most important share price driver for E.ON is the US strategy. With E.ON's market value now €15 billion below our fair value estimate, we believe the risks here are more than taken into account. We also think that the recent weakness in the US dollar and the fall in US utility share prices mean that the risks of overpayment by E.ON have fallen.

We are relaxed about Ruhrgas

E.ON has fared marginally worse than RWE in recent weeks, falling by 13% since 15 July, compared with 11% for E.ON. We think this reflects the fact that E.ON's plans to buy Ruhrgas received a blow last Friday with the decision by the Düsseldorf court to uphold the injunction against the deal. However, we are relaxed about this situation for two reasons. First, we do not believe there is a significant amount of shareholder value at risk; and, second, we think there is a chance that E.ON may overcome these difficulties reasonably quickly.

We still favour E.ON over RWE

RWE is also attractive at the current share prices, but we continue to favour E.ON, which we believe has more obvious triggers to drive its share price in the forthcoming newsflow. The challenge for RWE at the analysts' briefing accompanying its results next week is to persuade the stock market that its business adds up to a coherent whole after the recent string of acquisitions. We rate E.ON 1M *(Buy, Medium Risk)* with a €70 price target and RWE 2M *(Outperform, Medium Risk)* with a €50 price target.

Brighter Outlook, Lower Share Prices

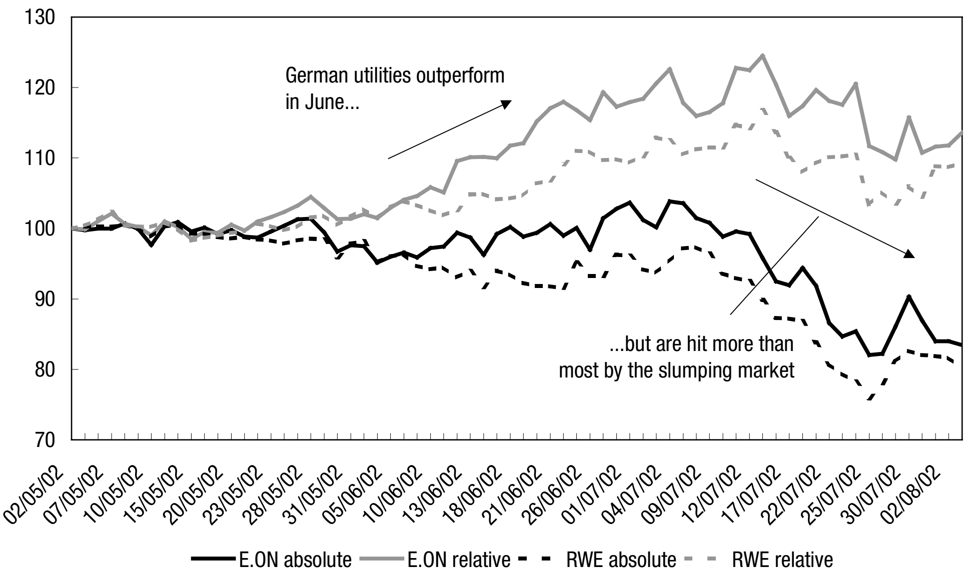
- **The German utilities have both suffered in the recent stock market slump**
- **E.ON and RWE have even underperformed the market by 7%-9% over the last few weeks**
- **This is at odds with the most important fundamentals, particularly for E.ON**
- **Coal prices have fallen further and should lead to strong 1H profits in German electricity next week**
- **Falling US utility share prices and a weaker US dollar mean the risks of E.ON's US strategy have diminished**
- **We do not believe a great deal of shareholder value is at risk in E.ON's controversial plans to acquire Ruhrgas**

Recent performance: E.ON & RWE both look cheap

The recent stock market slump has been fairly undiscriminating. Stocks in all sectors have been hit hard, and the utilities sector is no exception. E.ON and RWE have suffered more then most. As Figure 1 makes clear — even though the stock market as a whole has carried on falling — the two stocks have slid around 8% in relative terms since mid-July.

Figure 1. Share Price Performance Since 1May 2002 Absolute and Relative to DJ STOXX (Indexed to 1 May 2002 = 100)

E.ON and RWE have tumbled in recent weeks



Sources: Reuters and Schroder Salomon Smith Barney analysis.

True, this bout of underperformance comes after a couple of months of strong relative performance from both stocks. This is particularly true for E.ON, which has fared marginally worse than RWE in recent weeks on the back of some unhelpful newsflow on its planned acquisition of Ruhrgas. However, now the two stocks are trading more than 30% below our price targets.

Unlike much of the stock market, E.ON and RWE have improving fundamentals

We think this provides an outstanding opportunity for investors in both stocks. Unlike much of the rest of the market, we believe the most important fundamentals for both German utilities are actually improving. We think this is particularly the case for E.ON, despite the ruling last week by the Düsseldorf court on the Ruhrgas deal.

Evidence of the improved business environment should come through next week when both companies are due to report their 1H results. This brief report provides previews of those results for both companies. However, we begin by highlighting the key reasons why we think E.ON in particular is worth another look.

The investment case for E.ON

There are four chief components to the E.ON investment case.

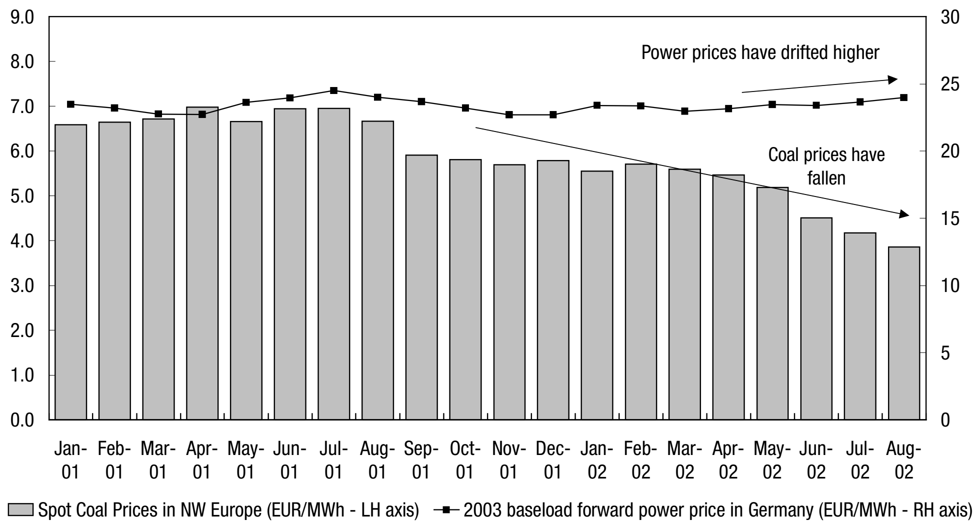
1. Bright core business outlook

We believe the environment is improving for both companies particularly in the core German electricity business, which delivered a very strong performance in the 1Q results. Since then, the situation has got even better. As Figure 2 sets out, not only has the electricity price risen modestly, but coal prices have carried on falling. Spot coal prices are currently some 40% lower than in August last year.

For E.ON, which generates some 30% of its power from coal, this combination of factors should contribute to core business profits growth in the region of 40% year on year in the 1H results.

Figure 2. Coal Prices and German Power Prices, Jan 01-Aug 02 (€/MWh)

Coal prices are down 40% year on year

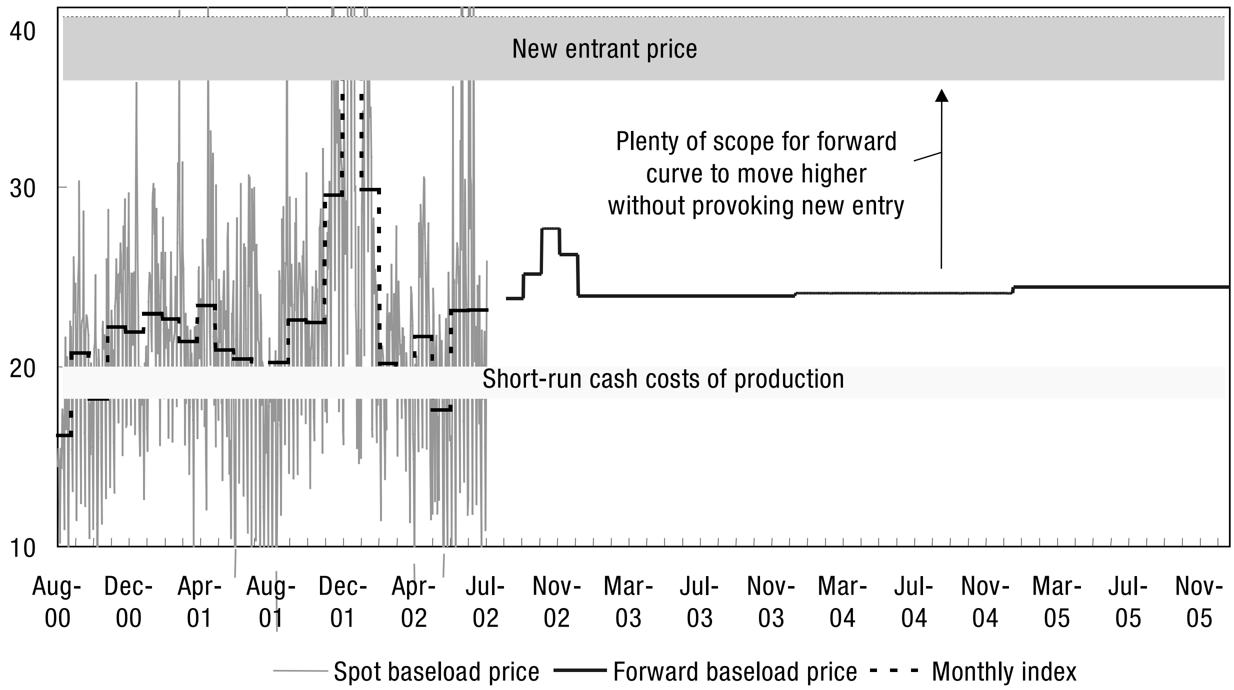


Source: Platts European Power Daily.

RWE should also benefit, but to a lesser extent as coal only accounts for some 5% of the electricity generated by its power stations.

The long-run outlook for power prices remains positive. Figure 3 provides the current forward curve, which shows wholesale power prices rising at 1%-2% a year over the next three-to-four years. The forward curve itself has shifted upwards in recent months, with forward power prices at peak times rising by 3%-5% over the last three months.

Figure 3. German Historical Spot Power Prices and Current Forward Prices (€/MWh)



Sources: European Energy Exchange and RWE Trading.

We think the forward curve could yet drift higher

We believe that there may yet be more upside to come. We think it is very encouraging that power prices have risen at a time when coal prices have been weak. The implication is that competition is no longer effective and that the fruits of the consolidation of the German market — over 90% of generating capacity is now in the hands of four players — are now starting to be reaped.

We think the ruling quartet can afford to manage the forward curve upwards by another €10/MWh or so without sucking in new entrants to build new power stations. However, this will need to be done slowly and cautiously to avoid the obvious regulatory and political pitfalls.

2. Risks of US strategy are decreasing

We have long argued that E.ON's US strategy stands a much better chance of being at least value neutral than the stock market seems to believe. We think there are opportunities to cut costs and achieve merger synergies that should offset the bid premium that is likely to be paid.

E.ON has a competitive advantage in the US market

In addition, the danger that acquisition prices will be driven up by competition from other companies also seeking to act as a consolidator in the US market is not as severe as it is in Europe. For example, unlike the indigenous consolidators in the US (eg AEP) and the two other European players (ScottishPower and National Grid), E.ON is the only company that is clearly able to finance its strategy using cash.

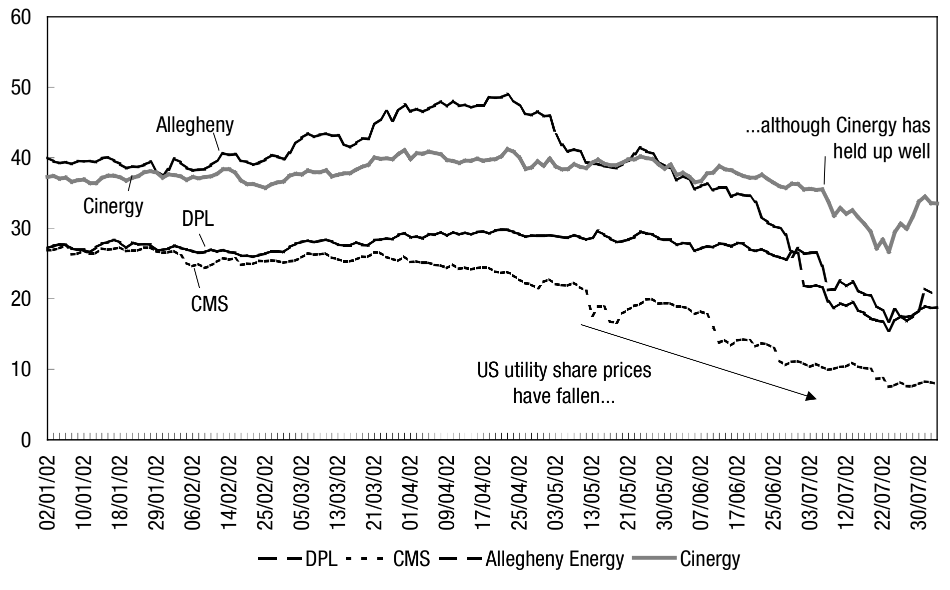
Although these considerations are important, our view is that the most important ingredient for success in M&A in the utility sector is to get the timing right: to buy assets when they are cheap in the first place. We think the time could be right now for E.ON in the US market, for two reasons.

US share prices have been weak and so has the US dollar

- **First**, US utility share prices have come under pressure in the wake of recent accounting scandals, the Enron collapse and general market weakness.
- **Second**, the recent weakness in the US dollar has pushed down the potential cost of an acquisition in euro terms. Of course, E.ON will be buying cash flows in US dollars, so the value of what it will be buying may also have fallen in euro terms (depending on the long-run outlook for the exchange rate). However, it is clearly far better to be a buyer when the dollar is weak rather than strong.

Figure 4 sets out how the share prices of four potential targets for E.ON in the Mid West region have changed.

Figure 4. US Utility Share Prices, 1 January 2002 to 2 August 2002 (Euros)



Sources: Reuters and Schroder Salomon Smith Barney analysis.

3. Ruhrgas is not a major share price issue

Our price target does not assume any benefits from owning Ruhrgas

The Ruhrgas issue continues to generate newspaper headlines, but we do not believe there is a great deal of shareholder value at risk. E.ON is perfectly viable, in our view, both with and without Ruhrgas. Although ownership of Ruhrgas would bring some strategic benefits[1], these are fairly long term in nature and their value is offset by the full price E.ON is paying for Ruhrgas in the first place.

The chief negative impact would be the shelving of the Degussa exit, but we believe E.ON should be able to find an alternative exit route from that business within the same broad timescale (ie by 2004) as envisaged in the deal with Ruhrgas.

The current situation is that the High Court in Düsseldorf has upheld its injunction against the deal proceeding and is now set to launch a full investigation into whether the proper procedure was applied by the government in reaching its decision to wave the deal through.

This decision means the acquisition could be delayed until the court reaches its full decision, expected around the end of the year. If this goes against E.ON, it could be up to a new German government to decide on the Ruhrgas deal and there can be no guarantee that it will reach the same decision as the current government.

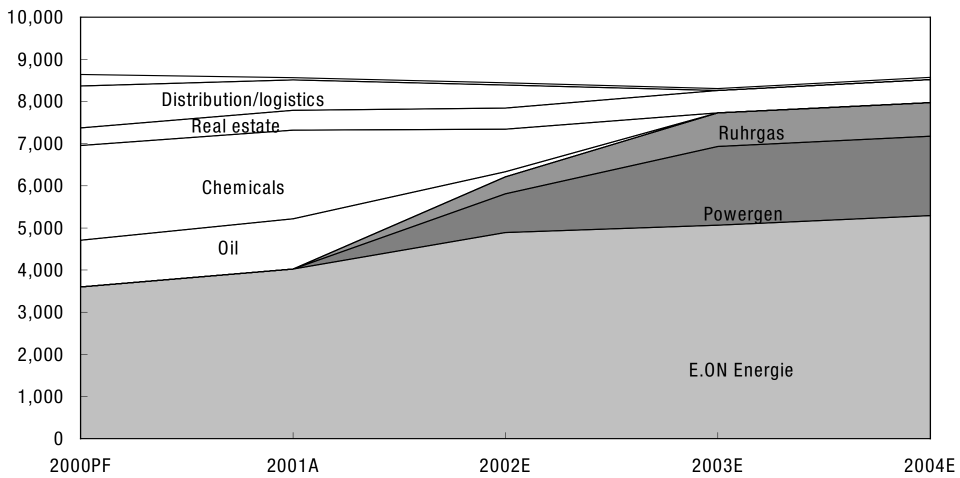
In the meantime, E.ON says it is committed to the deal and is exploring the legal options it has to get the injunction lifted. These options, in our view, include an appeal to the Federal Supreme Court and/or an out-of-court settlement with the complainants (energy broker Ampere, trader Trianel and two municipal utilities — Stadtwerke Aachen and Stadtwerke Rosenheim). In addition, the government says it is also searching for ways around the injunction.

4. Focus and valuation

After the bout of disposals there is now significantly more certainty over the value of E.ON. Figure 5 sets out how the EBITDA mix should change, with over 90% coming from gas and electricity in 2002.

E.ON is now a much simpler business

Figure 5. E.ON — EBITDA Outlook, 2000-04E (Euros in Millions)



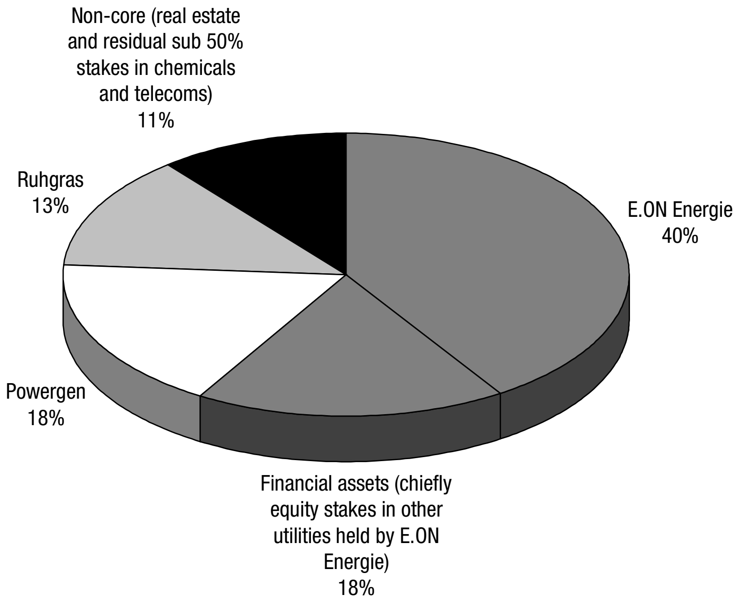
Sources: Company accounts and Schroder Salomon Smith Barney estimates.

[1] See *E.ON: Keep the Gain, Pass on the Pain*, Schroder Salomon Smith Barney, 8 May 2002.

Meanwhile, Figure 6 sets out how E.ON's enterprise value should break down at the end of this year, assuming the Ruhrgas and Degussa deals go ahead. Electricity and gas businesses should account for over 80% of the enterprise value, according to our estimates.

Electricity and gas should account for over 80% of the enterprise value

Figure 6. Breakdown of E.ON Enterprise Value



Source: Schroder Salomon Smith Barney.

Our latest sum of parts for E.ON is set out on page 13 and suggests a value of €70 per share.

RWE also looks attractive

We think RWE is cheap too at current levels and we also have a positive recommendation on the stock. In fact, in terms of absolute value, our calculations suggest RWE is slightly cheaper, trading on a 34% discount to the sum of the parts compared with 32% for E.ON.

However, for now, we continue to favour E.ON. This is for two chief reasons.

We struggle to see the triggers for RWE

- **First**, we find it hard to identify triggers in the forthcoming newsflow to prompt a rerating of RWE's shares. Yes, the 1H profits should be strong for the core business on 12 August, but we think E.ON's figures will be stronger still a couple of days later. An early exit from the remaining non-core assets (printing machinery and construction) might help, but this seems unlikely while the share prices of these listed businesses remain depressed.

Does the jigsaw puzzle fit together?

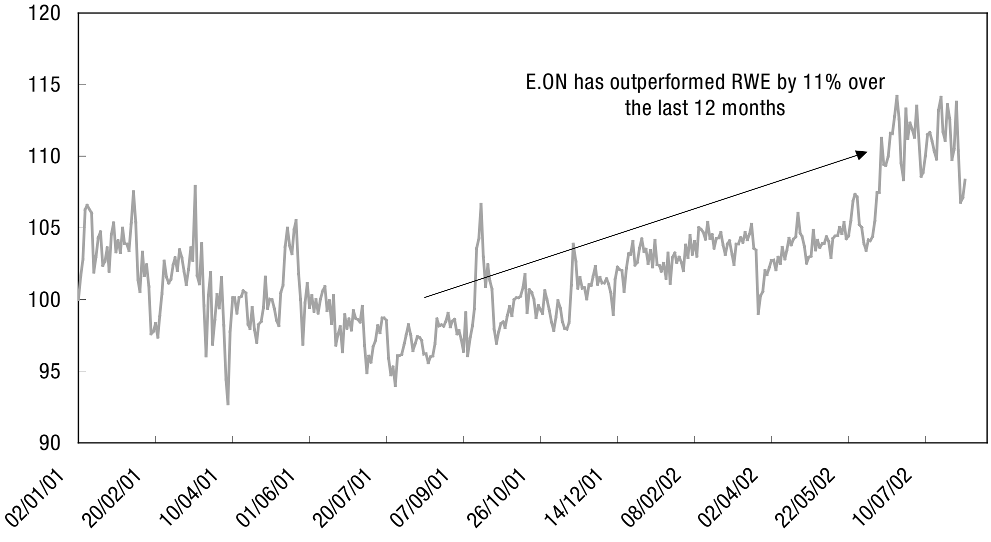
- **Second**, after the acquisition spree over the last two years, RWE has yet to demonstrate how the pieces of the jigsaw puzzle fit together into a coherent overall picture. The same charge could be levied against E.ON, to some extent. However, with its additional focus on water and waste management, as well as electricity and gas, RWE faces a greater challenge to persuade investors that it has done more than turn an industrial conglomerate into a utility conglomerate.

The analysts' briefing accompanying the 1H results could provide an opportunity for RWE to rectify this situation and we will take stock of our recommendations after the 1H figures. At this stage, however, we continue to favour E.ON.

We continue (for now) to favour E.ON

As Figure 7 shows, E.ON has been the right way to play the German utilities for much of the last 12 months, although we confess that the deviation between the two stocks has not been huge.

Figure 7. Switch Chart — E.ON Relative to RWE, Jan 01-Year to Date



Sources: Reuters and Schroder Salomon Smith Barney analysis.

E.ON Results Preview

- **We expect 40% growth in profits at the core E.ON Energie business**
- **Veba Oil, VAW and Stinnes now reclassified to discontinued operations**
- **Growth of around 20% expected for group internal operating profit**
- **We will be looking for hints about when the US move is likely to be made and also for E.ON's plans in the UK**
- **Sum-of-the-parts value remains €70 per share**

Financial forecasts

With all the disposals and acquisitions going on, not to mention the cessation of goodwill amortisation, the 1H net profit figures for the E.ON group as a whole are unlikely to be easy to interpret.

Most interest should focus on the E.ON Energie figures

Instead, we expect most attention will focus on the German electricity business, where higher power prices, lower fuel costs and general cost cutting should contribute to a strong result. At the 1Q stage, E.ON Energie profits rose by 89%, although this was partly due to one-off items including new acquisitions. For the 1H results, we are projecting a rise of 40%, which compares with our full-year expectation of 33% growth.

Oil, aluminium and distribution/logistics are all now reclassified to discontinued operations so, with Powergen and Ruhrgas not yet consolidated in 1H, the remainder of the operational business is now made up of just chemicals and real estate. Taking these into account our group internal operating profit forecast is €1,948 million, representing a rise of some 20% on the prior-year restated level.

Figure 8 provides our forecasts for 1H in detail, including our estimates for the restated prior-year comparators. Note that we forecast a €9 billion net cash position as a result of the sales of VAW, Veba Oil and the stake in Orange, but before taking into account the €17 billion acquisition of Powergen.

We should also get more guidance on the Ruhrgas process

Away from the figures, we will be looking for more news on E.ON's plans to contest the injunction granted by the Düsseldorf court against the Ruhrgas deal. We will also be watching for any hints on the likely timing of the expected move in the US market, for an update on E.ON's plans to develop the UK business it has acquired through Powergen.

Figure 8. E.ON — Financial Forecasts, 1H01-1H02E (Euros in Millions Unless Otherwise Stated)

	2001 1HA As reported	2001 1HE As restated by SSSB*	2002 1HE SSSB forecasts	Comments
Group profit and loss account				
Sales	44,535	17,828	19,260	
EBITDA			3,722	
EBIT			2,375	
Group internal operating profit	1,964	1,601	1,948	
Net book gains	193	193	441	Disposals by E.ON Energie of Steag and rhenag
Cost-management/restructuring	-97	-97	-100	
Other non-operating earnings	-288	-288	300	
Foreign E&P taxes	263	0	0	Veba Oil now in discontinued
Pre tax income	2,035	1,409	2,589	
Taxes	-1,155	-493	-906	
Income after taxes	880	916	1,683	
Minority interests	-48	-200	-500	Rise reflects Sydkraft consolidation
Net income continued operations	832	716	1,183	
Net income discontinued/other		416	2,875	VAW, Oil and Stinnes
Net income all operations		1,132	4,058	
Internal operating profit breakdown				
E.ON Energie	984	1,104	1,546	40% growth expected
Veba Oil (discontinued)	288	0	0	Discontinued
E.ON Chemicals	189	290	240	17% decline
Real estate management	54	57	63	11% growth
Telecommunications	-86			Now included in 'Other'
Distribution/logistics (discontinued)	166	0	0	Discontinued
Aluminium (discontinued)	162		0	Discontinued
Silicon Wafers (discontinued)	-105		0	Discontinued
Other	312	150	100	
Total	1,964	1,601	1,948	22% growth
Key figures				
Earnings per share (€)	1.22	1.66	6.22	
-from continuing operations		1.05	1.81	
-from discontinued operations/other		0.61	4.41	
Net debt	-645	-645	-8,877	
Number of shares (m)	684	684	652	

*Restatements reflect cessation of goodwill amortisation and classification of oil, aluminium, distribution/logistics, silicon wafers and some chemicals operations to discontinued activities.

Sources: Company accounts and Schroder Salomon Smith Barney estimates.

Valuation

Figure 9 sets out our latest valuation for E.ON taking into account recent disposals.

Figure 9. E.ON — Sum-of-the-Parts Valuation

	€m	€ per share	
E.ON Energie total	**31,096**	**48**	**Sum of parts as set out below. Equates to 2002E EV/EBITDA of 7x.**
German electricity	20,120	31	Sum of parts including DCF of each power station. Equates to €0.4m per MW.
German water	696	1	E.ON owns 80% of Gelsenwasser. Our valuation is based on 8x 2001A EBITDA.
German gas	2,828	4	Our valuation is based on 7x 2001A EBITDA of €404m.
International	7,451	11	Sydkraft in Sweden and EZH in the Netherlands are the chief fully consolidated international investments.
Powergen total	**13,309**	**20**	**Sum-of-parts of UK generation, networks and supply plus LG&E in the US.**
UK generation	2,425	4	7430MW of chiefly coal and CCGT capacity at £0.2m/MW.
Distribution	1,665	3	At 15% premium to regulatory asset base.
Supply	1,124	2	Based on £275 per electricity household customer.
LG&E	6,505	10	Acquired for £2,238m valuing LG&E's assets at an enterprise value of £3,986m.
Other	1,591	2	International, CHP and renewables
Non-core total	**33,781**	**52**	
Degussa	13,536	21	E.ON's 64.6% stake is worth €4,453m at current share prices.
Viterra	4,068	6	Largely based on estimated value of housing portfolio.
Stinnes (sold)	3,727	6	E.ON's 66.4% stake is worth €1,628m at the price to be paid by Deutsche Bahn.
Telecommunications	2,850	4.4	17.5% of Bouygues Telecom, 50% of Connect Austria plus €950m from Orange.
Veba Oel (sold)	6,500	10	In line with price paid by BP.
VAW (sold)	3,100	5	€1.2bn for financial liabilities plus pension provisions plus €1.9bn for equity.
Financial assets	**13,397**	**21**	**Book value**
Total enterprise value	**91,582**	**140**	
Powergen payment	-16,786	-26	€8,364m for equity (765p per share) plus €8,422m of estimated assumed debt.
Net cash	-843	-1	Balance sheet amount at 31 December 2001.
Pension liabilities	-8,748	-13	Balance sheet amount at 31 December 2001.
Nuclear liabilities	-6,549	-10	Estimate of NPV of liability according to SSSB model.
Other liabilities	-6,657	-10	50% of balance sheet amount of other provisions at 31 December 2001.
Minorities	-6,362	-9	Balance sheet amount at 31 December 2001.
Value of equity	**45,638**	**70**	**652m shares outstanding at 31 December 2001**

Source: Schroder Salomon Smith Barney estimates.

RWE Results Preview

- **We expect just over 30% profits growth in the electricity business, driven by the turnaround in Germany**
- **Water, gas and waste are unlikely to provide major surprises**
- **Non-core profits are likely to be weak, restraining profits growth at group level to just 5% on our forecasts**
- **However, most interest will focus on the accompanying analysts' briefing**
- **Will RWE be able to persuade investors that its jigsaw puzzle fits together into an attractive picture?**
- **Sum-of-the-parts valuation now €49 per share, but €50 price target retained**

Financial forecasts

Core profits should be healthy, but the non-core is likely to be weak

The message from the RWE results is likely to be reasonable growth from the core divisions, offset by a weaker performance in the non-core businesses, particularly at the downstream oil business, which has now been sold. We are expecting growth of just 5% in the overall operating result to €2,135 million, although stripping out the non-core businesses would boost growth to 20%.

As with E.ON, we expect strong growth in the core electricity business of just over 30%, compared with 50% at the 1Q stage. Like E.ON, higher power prices and lower costs should support growth, but performance at the US Consol coal mining business (which is included in this division) is likely to be weak.

Gas profits are likely to be slightly lower as a result of low gas and oil prices, while water profits are likely to show steady growth.

Although Innogy and Transgas will be fully consolidated in the next set of results, the net debt figure should reflect the payments made for these businesses which were made during 2Q. As a result, we expect group net debt in the region of €9 billion.

A full analysts' briefing has been scheduled

Unlike E.ON, RWE is holding a full-scale analysts' briefing on the day the figures are released. In recent company meetings the message has been that RWE is now focusing on consolidation and integration. This briefing provides RWE with an opportunity to generate enthusiasm among investors about the potential of the new businesses.

Figure 10. RWE — Financial Forecasts (Euros in Millions Unless Otherwise Stated)

	2001	2002	
Group profit and loss	**1HA***	**1HE**	**Comments**
External net sales	27,014	27,500	
Profit from operating activities	1,753	1,584	
Result of investments	352	749	Reflects partial sale of Heidelberger, Steag profits, etc.
Financial result	-837	-1,085	Reflects growing net debt.
PBT	1,268	1,248	
Tax	-195	-250	
PAT	1,073	998	
Minority interests	-302	-210	
Net profit before goodwill		963	
Net profit inc goodwill	771	788	We expect only very modest growth.
Key figures	**1HA***	**1HE**	
Net debt	-1353	9,401	After purchase of Innogy and Transgas.
Earnings per share			
pre goodwill		1.71	
inc goodwill	1.37	1.40	
Reconciliation to operating result	**1HE****	**1HE**	
Profit from operating activities	1,753	1,584	
+ Result from investments	373	749	Disposal profits and operating result from investments.
- Non-operating result	97	198	Disposal profits stripped out.
Operating result	2,029	2,135	5% growth expected.
Operating result breakdown	1HE**	1HE	
Electricity	**820**	**1,085**	
Electricity generation	20	180	Cost cutting, higher power prices.
Lignite generation and coal	150	255	Cost cutting, higher power prices, but US coal business weak.
Trading	50	40	
Net	240	300	
Supply and regional utilities	290	290	
Industrial services	5	-10	
Other	65	30	
Gas	**430**	**420**	
Gas	250	240	
RWE-DEA upstream	180	180	
Water	**450**	**490**	
Thames Water	450	490	
Waste and recycling	**58**	**60**	
Non core	**458**	**250**	
Oil refining and marketing	198	0	Weak refining margins — but this business has now been sold.
Printing systems	250	200	Economic slowdown.
Construction	10	50	
Other	**-187**	**-170**	
Total	**2,029**	**2,135**	Growth rises to 20% after stripping out the non-core.

*Calculated by subtracting 6m results to 31 December 2000 from 9m results to 31 March 2001.

**Restatements reflect rephasing of Heidelberger income, exclusion of 1.5m of TW and Hochtief now included only at equity.

Sources: Company accounts and Schroder Salomon Smith Barney estimates.

Valuation

Our sum-of-the-parts valuation is set out in Figure 11. This valuation takes into account the current share prices of Hochtief and Heidelberger, as well as the recent disposal of the downstream oil business. Although of our sum of the parts has fallen to €49 per share, we have opted to retain a €50 price target.

Figure 11. RWE — Sum-of-the-Parts Valuation

	€m	€ per share	Basis
Electricity (fully consolidated only)	**25,300**	**45**	**Sum of parts as set out below**
Electricity generation	6,177	11	DCF of individual power stations assuming a 7% real post-tax discount rate.
Lignite generation and coal mining	6,865	12	DCF of individual power stations assuming a 7% real post-tax discount rate and €24/MWh average selling price plus €3bn for Consol based on current market value of equity plus net debt and provisions.
Trading	372	1	Based on 5x 2002E FV/EBITDA multiple.
Transmission and distribution	5,368	10	Benchmarked to regulatory valuations of network assets in other European markets.
Supply & regional utilities(networks)	2,950	5	Benchmarked to regulatory valuations of network assets in other European markets.
Supply & regional utilities (supply)	2,610	5	€300 per customer applied to 8.7m directly supplied and fully consolidated customers.
Supply & regional utilities (other)	397	1	Hungarian assets at market value.
Industrial services	560	1	Based on 6x 2002E FV/EBITDA multiple.
Gas	**5,415**	**10**	
RWE Gas (distribution and supply)	2,943	5	Based on 8x 2002E FV/EBITDA multiple.
RWE-DEA (E&P)	2,472	4	Based on 6x 2002E FV/EBITDA multiple.
Water	**11,764**	**21**	
Thames Water	11,764	21	
Thames Water regulated (UK)	6,967	12	Published regulatory asset base at 31 March 2002 after logging down adjustments.
Thames Water unregulated	4,798	9	Based on 9x 2002E EBITDA.
Waste and recycling	**2,748**	**5**	**Based on 8x 2002E FV/EBITDA multiple.**
Non-core	**5,455**	**10**	
Oil refining and marketing	2,000	3.6	Price to be paid by Shell.
Printing	3,455	6	Based on current market value of equity plus net debt and provisions.
Total asset value before financial investments	**50,682**	**90**	
Financial assets	8,370	15	Book value at 31 December 2001.
Construction	707	1	Market value of Hochtief (now reclassified to financial assets).
Total asset value after financial investments	**59,760**	**106**	
Net cash	-1,343	-2	Book value at 31 December 2001.
Pension provisions	-13,915	-25	Book value at 31 December 2001.
Nuclear provisions	-3,795	-7	Based on SSSB model.
Other provisions	-7,932	-14	50% of other provisions.
Minorities	-3,399	-6	Book value at 31 December 2001.
Total equity value	**29,376**	**52**	
Acquisitions	**-1,857**	**-3**	
American Water Works premium	-1,253	-2	Based on SSSB valuation — represents a 30% equity premium.
Innogy premium	-604	-1	Based on SSSB valuation — represents a 15% equity premium.
Transgas premium	0	0	Based on SSSB valuation.
Net equity value	**27,519**	**49**	
Number of ordinary shares	531		
Value per ordinary share	49		
Number of preference shares	39		
Value per preference share	39		Assuming a 20% discount to the ordinary shares.

Source: Schroder Salomon Smith Barney estimates.

Valuation and Risks

E.ON (EONG.DE — €48.8; 1M — *Buy, Medium Risk*)

Valuation

We use a sum-of-the-parts method applying a variety of valuation techniques to the various divisions. For the German electricity business we use discounted cash flow for generation and use comparable company analysis to value the networks. We apply EV/EBITDA multiples to the gas, water and international businesses. For Powergen, we value the power stations and supply business in line with recent trade sale multiples and derive a network valuation based on the regulatory asset base. We value LG&E at the purchase price less subsequent disposals. Non-core valuations are based on agreed sales prices or estimated market values. Financial assets are taken at book value, while nuclear liabilities are subtracted at a value generated by a separate discounted cash flow model. Pension provisions are deducted at book value and 50% of the book value of 'other' provisions is also subtracted.

Risks

German power prices appear to be rising, but may yet be volatile depending on the development of the European power market. Network prices in Germany are high and are likely to come under pressure. UK power prices may yet fall further and supply margins may decline. E.ON may fail to achieve the price we expect for its non-core disposals. The company has a strategy of growth by acquisition, particularly in the US market, and future acquisitions may not prove value enhancing.

RWE (RWEG.DE — €33.4; 2M — *Outperform, Medium Risk*)

Valuation

We use a sum-of-the-parts method applying a variety of valuation techniques to the various divisions. For the German electricity business we use discounted cash flow for generation and use comparable company analysis to value the networks. We apply EV/EBITDA multiples to the gas, water and waste businesses and the unlisted non-core assets. The listed assets are included at market valuations. For Innogy, we value the power stations and supply business in line with recent trade sale multiples and we estimate RWE will pay a €1.3 billion premium for American Water Works when the deal completes next year. Transgas is included at the acquisition price. Financial assets are taken at book value, while nuclear liabilities are subtracted at a value generated by a separate discounted cash flow model. Pension provisions are deducted at book value and 50% of the book value of 'other' provisions is also subtracted.

Risks

German power prices appear to be rising but may yet be volatile depending on the development of the European power market. Network prices in Germany are high and are likely to come under pressure. UK power prices may yet fall further and supply margins may decline. RWE has a history of growth by acquisition, and future acquisitions may not prove value enhancing, although we do not expect any further major moves during 2002. The UK and US water businesses are exposed to regulatory risks, as is the gas business in the Czech Republic.

ANALYST CERTIFICATION

We, Daniel Martin, Sven Strasser and Guy Farmer, hereby certify that the views expressed in this research report accurately reflect our personal views about the subject companies and its securities. We also certify that we have not been, are not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendations in this report.

Notes

Notes

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