IBERDROLA S.A.

COMPANY REPORT

UTILITIES SECTOR

6 JANUARY 2014

STUDENT: ANDRÉ CHEN

A dim path for renewable

Regulatory pressure pushing away recovery

- **We initiate coverage Iberdrola with a SELL rating and a YE14 target price of EUR 4.51.** The stock is currently trading at a premium over its main European peers (EV/EBITDA of 7.72 versus industry 6.30). We expect this trend to correct as the full impact of renewable policy is still not embedded in the stock's valuation.
- **Regulatory uncertainty in home market still affecting performance.** With the recently withdrawal of government's contribution to the tariff deficit, we still expect pressure on the balance sheet in the short term. Additionally we estimate the new remuneration for renewable energy to impact Iberdrola by EUR 205 million annually, which is still not fully priced in the market.
- **More risk around the corner.** Some EU countries like UK, are currently discussing the affordability of the energy policy mainly regarding renewable energy. We foresee additional risk for Iberdrola due to regulatory cuts outside Spain.
- **We value the stock at EUR 4.51 implying a 2.1% downside.** We base our TP on a SOTP methodology, including a set of alternative scenarios (80:20 split). Regulated business contributes the highest to the stock's value (52%) with generation and renewable contributing with 27% and 22% respectively. The main risks to our valuation comprise a worse regulatory outcome, decline in power prices and more volatile forex than expected.

Company description

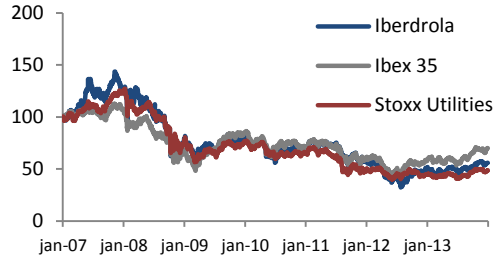
Iberdrola is a Spanish based company that operates in the utility sector. The company specializes in clean energy, more specifically wind energy. Its main operations include distribution and transmission of electricity, production under the ordinary and special regime, supply of energy to end-users and other non-core business (construction and telecommunication business).

Recommendation:	**Sell**
Price Target FY14:	**EUR 4.51**
Downside risk	*2.1%*
Price (as of 3-Jan-2014)	**EUR 4.61**

Reuters: IBE.MC, Bloomberg: IBE SM

52-week range (€)	3.47–4.79
Market Cap (€m)	28,772.52
Outstanding Shares (m)	6,240
Free-Float	63.43%
30-Day Average Volume	40,288,850
YTD Price return	10.49%

Source: Bloomberg; Reuters



Source: Bloomberg

(Values in € millions)	2012	2013E	2014F
Revenues	34,201	32,824	32,542
EBITDA	7,727	7,361	6,794
Net Profit	2,868	2,709	2,311
EPS (EUR)	0.47	0.43	0.37
DPS (EUR)	0.34	0.28	0.28
P/E (x)	9.80	10.70	12.54
Dividend Yield (%)	7.44%	6.07%	5.98%
EV/EBITDA (x)	7.84	8.13	8.81
Net Debt/EBITDA (x)	3.96	3.84	3.99
Net debt/Equity (x)	0.90	0.81	0.78
Debt/Assets (x)	0.34	0.32	0.32
ROIC (%)	6.02%	5.37%	4.76%

Source: Company Data; Analyst's estimates

Table of Contents

INVESTMENT CASE 3

COMPANY OVERVIEW 4

BUSINESS DESCRIPTION 4
SHAREHOLDER STRUCTURE 6
LEVERAGE ANALYSIS 6
STRATEGIC OUTLOOK 8

MACROECONOMIC ENVIRONMENT 8

ECONOMIC PROFILE 8
ENERGY DEMAND AND SUPPLY 10
POWER PRICES 12
SPANISH TARIFF DEFICIT 13
RENEWABLE ENVIRONMENT 15

BUSINESS FORECAST 16

NETWORK BUSINESS 16
GENERATION AND SUPPLY BUSINESS 20
RENEWABLE BUSINESS 24

FAIR VALUE 26

DISCOUNT FACTORS 27
FINANCIAL INVESTMENTS 28
SUM-OF-THE-PARTS 29
ALTERNATIVE SCENARIOS 30
SENSITIVITY ANALYSIS 31

APPENDIX 32

APPENDIX I: INTERNATIONALIZATION PROGRAM 32
APPENDIX II: INVESTMENT PLAN 32
APPENDIX III: ELETRICITY MARKET DYNAMICS 33
APPENDIX IV: TECHNOLOGY COSTS 33
APPENDIX V: SPANISH REGULATION 34
APPENDIX VI: SPANISH DEFICIT FORECASTS 35
APPENDIX VII: COMPARABLES 35
APPENDIX VIII: COST OF CAPITAL 36
APPENDIX IX: SUM-OF-THE-PARTS 36

FINANCIAL STATEMENTS 37

DISCLOSURES AND DISCLAIMER 38

Investment Case

Largest utility company in Spain, generating around 135 TW per year

Iberdrola is Spain's largest utility company by market capitalization, currently representing 7% of Ibex 35. It is responsible for producing each year around 135 TW and currently operates a total of 44,866 MW of installed capacity across the world. Iberdrola is placed as the world leader in wind energy, with a total installed capacity of 14 GW. It operates in the main businesses of the energy sector, being one of the main players in the market.

Spanish tariff deficit is still an issue for 2013

The situation in the domestic market is not the most favorable one. Recent regulatory changes implemented to reduce the deficit have so far reduced EBITDA by EUR 503 million with the impact for 2014 being much larger. The Spanish state has withdrawn its commitment (five months after announcing it) to a EUR 3.6 billion contribution for the system, clearly showing the lack of support from the Spanish government[1].

Leader in renewable energy but also the one bearing the highest risk

Renewable regulation in Spain is still unclear at this stage. We make a first approach analysis on the impact on Iberdrola based on the 7.5% "fair return" (Spanish 10 year bond yield plus a 200 bps spread). We reach an annual average impact of EUR 208 million for 2014-2018 (resulting in a EUR 0.49 reduction in share price). We consider this the main catalyst for Iberdrola as it currently owns around 18% of total renewable capacity in Spain. We believe this measure is still not fully incorporated in the market. The recent discussions regarding the affordability of EU energy policy (namely renewable incentives) are also a major source of risk for Iberdrola as it is one of the most exposed companies to this technology[2].

Healthy deleverage and attractive returns should be considered

The tariff deficit is a major constraint on the deleveraging story. However we believe Iberdrola will be able to deleverage without harming future performance. The focus on cost-cutting, Capex reduction and the disposals of non-core assets should be the trigger here. Additionally, the deconsolidation of NeoEnergia will also reflect positively on this issue. The attractive dividend yield (5.37%) and high returns from regulated markets (US and UK) should also be considered.

We attribute a SELL rating based on a EUR 4.51 target price

We cover the stock with a SELL rating, based on 2.1% downside to our YE14 target price of EUR 4.51. Currently the market is not fully valuing the regulatory changes in Spain, namely concerning renewable energy. This is observed in the negative relation between market price and EPS during this period. Iberdrola is trading at a premium towards its peers either in terms of EV/EBITDA (7.72 versus 6.30) and PE ratio (12.77 versus 12.40), thus reiterating our recommendation.

[1] See section *"Spanish Tariff Deficit"* for a more detailed discussion on this subject.
[2] See sections *"Renewable Environment"* and *"Renewable Business"* for a more detailed discussion on this subject.

Company Overview

Iberdrola is the largest Spanish utility company

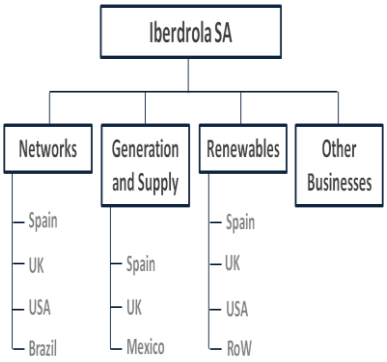
Founded in 1992 as a result of a merger between *Hidroeléctrica Española* and *Iberduero,* Iberdrola is nowadays the largest utility company in Spain by market capitalization, representing around 7% of the spanish stock index IBEX 35. The company is present across approximatly fourty countries with special focus on Iberia, United Kingdom, United States, Mexico and Brazil. The main operations of Iberdrola include distribution and transmission of electricity and gas, electricity production under ordinary and special regimes and supply of energy to end-users. Iberdrola also owns other non-core business mainly construction, real estate and telecommunication. Troughout the decade, Iberdrola has made a clear bet on the renewable energy segment, being the world leader in wind energy with 14 GW of installed capacity (31% of its total installed capacity).

Iberdrola is the world leader in wind energy, with an installed capacity of 14 GW

Business Description

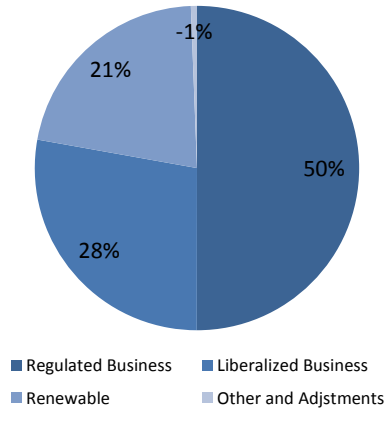
Iberdrola is established as a vertically integrated business, operating in the major areas of the energy business. Iberdrola structures its business in four main areas: 1) the network (regulated) business that comprises the transmission and distribution of electricity and is present in Spain, UK, USA and Brazil; 2) the generation and supply (liberalized) business that comprises the production of electricity under the ordinary regime (hydroelectric, nuclear, combined cycle gas turbine/CCGT and coal) and the sale to the end-user in the liberal market or through the last resort service of electricity and gas. This business is present in Spain (Iberia), UK and Mexico[3]; 3) the renewable business (mostly through wind – 90% of capacity) which is present across the world with special focus in Spain, UK and USA; 4) and other non-energy businesses that includes *Iberdrola Ingeniería y Construcción* and *Iberdrola Inmobiliária*.

Figure 1: Lines of business



Source: Company data

Figure 2: EBITDA 3Q13 per business



Source: Company data

A large part of the income generated by Iberdrola is originated by the regulated segment (around 50%) and renewable business (21%). These units are less exposed to market risk but are still subject to regulatory risk (remuneration changes). The liberalized business on the other hand is highly exposed to the market. Here is also included Mexico's long term contracted business (4%) which is dependent on market conditions as to avoid the default of the counterparty. The recent discussions around renewable subsidies and their impact in the end-user electricity bills[4] poses in our view some specific risks to Iberdrola's value given their positioning versus the industry (represents 21% of 3Q13 EBITDA, versus 9% of peers). Iberdrola would be one of the most affected companies if renewable incentives were to be reduced (as it already is happening in Spain).

Specific risk coming from renewable positioning

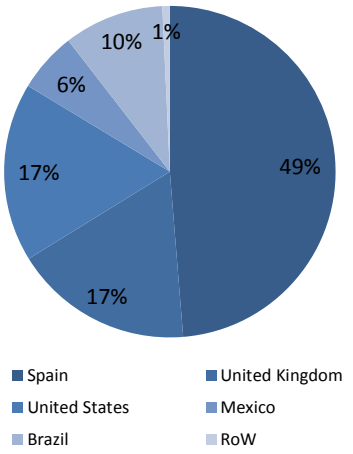
[3] Small presence in USA as well, which is included in the "Other Businesses" segment due to its small value.
[4] More detailed discussion in *"Renewable Environment"* and *"Renewable Business"* chapters of this report.

Geographically diversified portfolio

One major driver during the last decade in Iberia has been the diversification of operations, reducing the exposure to the maturing domestic market and looking at growth opportunities mainly in Latin American countries[5]. In 2012 Iberdrola's international segments represented around 52% of the company's operating income (versus 50% of the industry). As most of its major European peers, Iberdrola developed its internationalization plan via acquisition of local companies financed mostly with financial debt (see section *"Leverage Analysis"* for more details). This, together with the easy access, created the huge leverage situation that utility companies face. Now we start seeing divestments occurring in some of those assets considered as non-strategic[6].

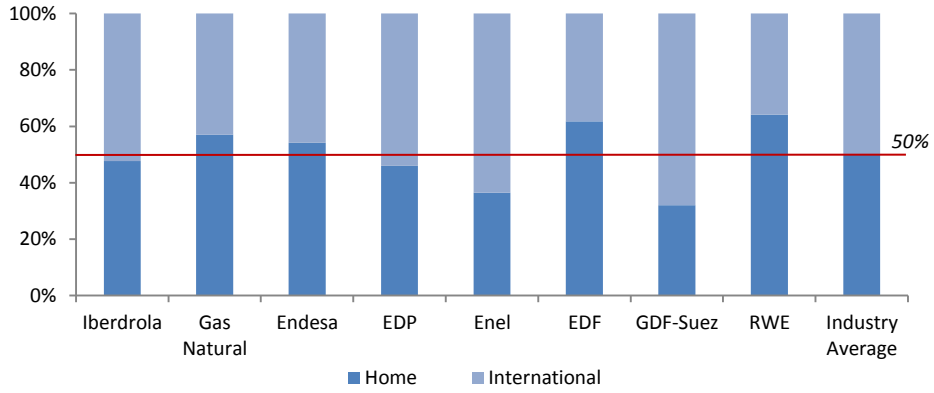
Correcting previous leverage flamboyance

Figure 3: EBITDA 3Q13 per country



Source: Company data; Analyst's estimates

Figure 4: International exposure (2012 EBITDA values)



Source: Company data

Table 1: Operating data

	3Q13
Installed Capacity (MW)	44,866
Electricity Distributed (GWh)	159,861
Gas Supplied (GWh)	68,309
End-users (million)	31.9
Electricity	28.3
Gas	3.6
Employees	30,651

Source: Company data

Growth propelled by Latin American markets

Most of Iberdrola's power plant facilities are located in Spain, with this country representing 57% of the installed capacity held by the group (and 25% of the total installed capacity in Spain). At a group level, installed capacity reached the values of 44,866 MW with the most corresponding to renewable, gas and hydro sources of energy (31%, 29% and 22% respectively).

Throughout the last five years Iberdrola has invested a large bulk into its network segment and as a consequence electricity distributed has been able to grow at 1.4% p.a. as the growing demand coming from LatAm markets more than offsets the lower demand in the domestic market. The same growing pattern has being achieved in the users connected to Iberdrola (2.7% p.a.).

Employing around 30,651 people across the world (figure that is still expected to reduce as a consequence of the efficiency program) Iberdrola is nowadays considered a benchmark in terms of operating efficiency.

[5] Iberdrola became one of the largest utilities after the program, avoiding also the risk from takeovers.
[6] Iberdrola, for instance, has used the cash considerations from the sale of Turkish renewable, Gas Natural Mexico, and Central Europe renewable, among others, to reduce its debt position.

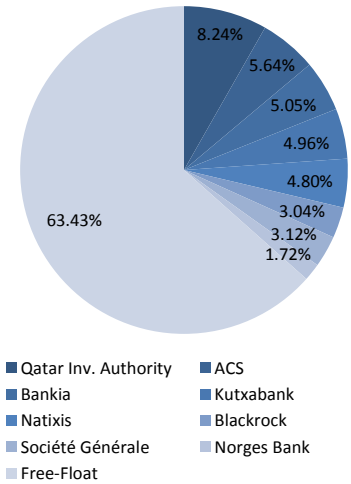
Shareholder Structure

Disperse ownership

Iberdrola presents a dispersed ownership structure being the main shareholder *Qatar Investment Authority* with a mere 8.24% of the voting rights[7]. In 2011, *Actividades de Construcción y Servicios* (ACS) held the largest stake in Iberdrola (18.8%), however the losses originated by the power reform in Spain and the high indebtedness of the construction company led to the reduction of the position up until now, with the company using the funds to repay the expensive debt it had contracted when acquiring Iberdrola's stake. The latest development on this issue was the issuance of EUR 720 million bonds convertible into Iberdrola's shares (up to 2% of total share capital)[8], which will further disperse the ownership. Another overhanging risk is coming from Bankia's stake (*Banco Financiero de Ahorros*). The recently nationalized financial institution is under strict conditions by the European Commission that impose the sale of its participations if certain conditions are met[9]. The company had announced the sale for the period after the third quarter earnings announcement but so far no movement has been done. We see here some benefits for Iberdrola in the long-run as potentially sounder companies replace the constrained shareholders.

Overhanging risk coming from ACS and Bankia's stake

Figure 5: Shareholder structure



Source: Bloomberg

As the result of the integration of Energy East (now Iberdrola USA), the acquisition of more than 10% of Iberdrola's group stake is subject to prior approval of several regulatory authorities in the United States. We believe this to be a major constraint in consolidating participation in the company structure thus leaving space for new investors to enter Iberdrola's ownership. This fact potentially hinders the company's ability to raise capital as shareholders will look at Iberdrola more from a return perspective rather than a strategic perspective (looking for the attractiveness of the dividend and share price movements rather than for the attractiveness of the business itself) as a consequence of the diluted stakes, being more reluctant to capital inflows into the company.

Disperse ownership resulting in a difficult position to raise capital

Figure 6: Financial leverage (ex-deficit)

Source: Company data and Analyst's estimates

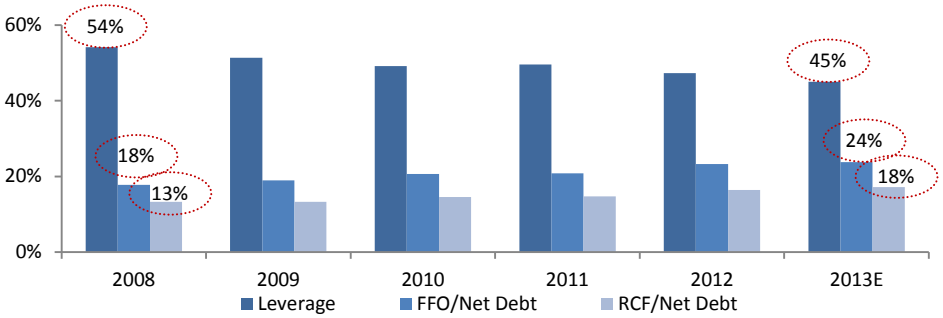
Leverage Analysis

The internationalization program (see Appendix I) started by 2001 and has been the major driver of Iberdrola's leverage position, as referred. The integration of Scottish Power in 2007, for a consideration of EUR 17 billion (financed 54% with debt) contributed for a 53% increase in debt (leverage reduced thanks to the capital increase for Energy East deal and proceeds from Renewable IPO). With the Lehman Brothers failure, the access to money was much more constrained making a priority for Iberdrola (and other utility companies) to deleverage.

[7] Each share corresponds to one voting right.
[8] The bonds were contracted with *Natixis, Santader, Deutsche Bank, HSBC and Société Générale* and will pay 2.625%.
[9] The conditions comprise: 1) enough liquidity in the market; 2) market price above the acquisition price.

Clear commitment to deleverage

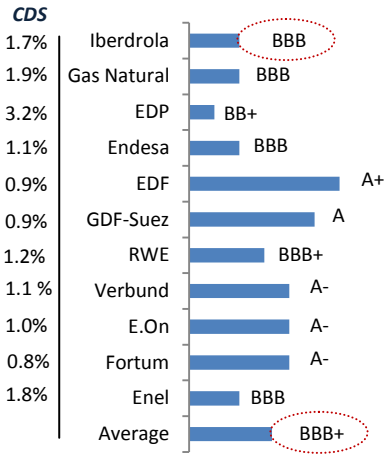
Figure 7: Iberdrola's credit metrics[10]



Source: Company data; Analyst's estimates

Utilities dragged by Spanish downgrade

Figure 8: S&P rating versus peers

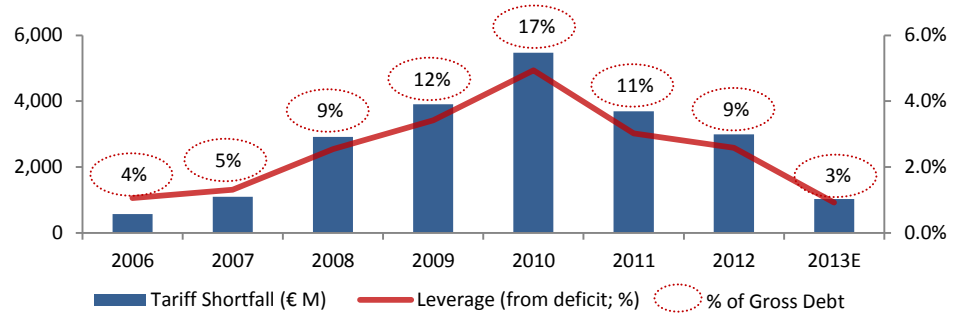


Source: Bloomberg
Note: Iberian utilities are graded below average as they were dragged by the Spanish sovereign rating.

Despite the focus on the improvement of the credit metrics, the ratings attributed by the three major rating agencies have deteriorated (and consequently on yield). This happened mostly due to the more demanding ratio requirements to reflect the added risk from sovereign risk. Iberdrola is rated as Baa1, BBB+ and BBB from Moody's, Fitch and S&P respectively, with negative and stable outlooks.

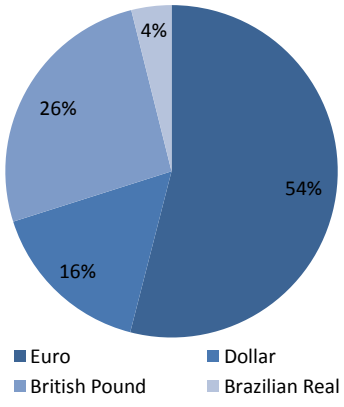
A considerable part of the debt raised in the period was generated by the deficit created in the Spanish market. By 2010, debt used to finance the shortfall peaked reaching approximately 17% of the total debt or EUR 5.5 billion. With the introduction of the securitization program in 2011, the impact of the deficit on the company's balance sheet has reduced significantly[11].

Figure 9: Tariff Shortfall and debt



Source: Company data; Analyst's estimates

Figure 10: Debt by currencies



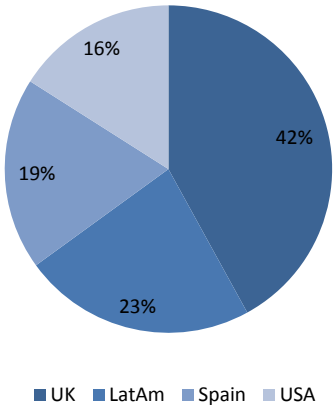
Source: Company data

Most of Iberdrola's debt is denominated in Euros with close to half in foreign currency. This debt allocation provides a natural hedge to the international equity (a higher currency appreciation will reduce consolidated EBITDA, but also the euro value of debt). As part of its financial strategy, Iberdrola has been increasing its exposure to fixed rate debt (65.6% at 3Q13 versus 61.9% the year before) moving towards its target of 70% to optimize costs and risks. In terms of liquidity Iberdrola at this time has EUR 12,220 million of available liquidity being able to cover more than thirty months of its financing needs (40% of existing debt).

[10] $Leverage\ (book\ values\ and\ including\ deficit) = \frac{Net\ Debt}{Net\ Debt+Equity};\ FFO = Op.Cash\ Flow;\ RCF = FFO - Dividends\ Paid.$
At market values, leverage stands at 49% (using our valuation market capitalization).
[11] See section "Spanish Tariff Deficit" for more details.

Strategic Outlook

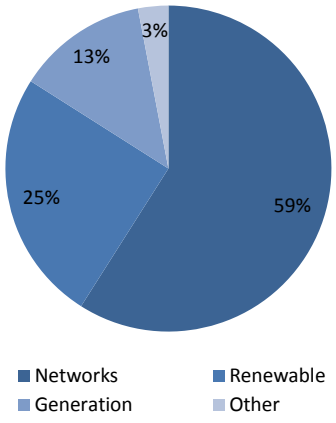
Figure 11: 2012-2014 net investments per country



Source: Company data

Investment focus on more stable environments

Figure 12: 2012-2014 net investments per segment

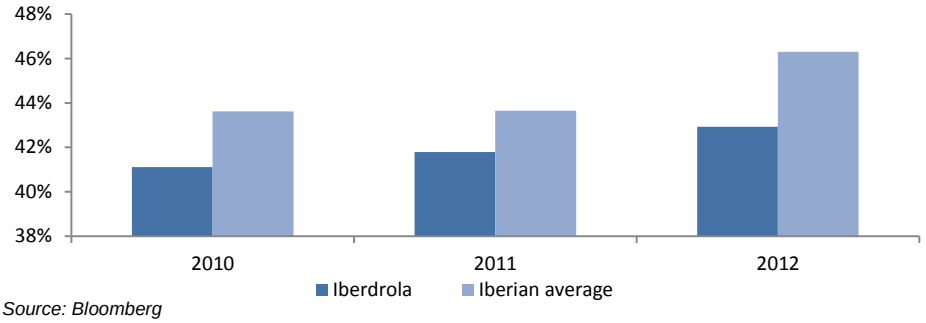


Source: Company data

As a consequence of the measures announced mid-2013, Iberdrola has decided to postpone its investor day to February 2014 as it waits for the uncertainty around the regulatory measures to dissipate. The Spanish regulator is however considering a new royal decree just for renewable policy (with no major changes estimated in the renewable hit) to avoid some legal constraints, and as such detail on this issue is only expected to be known by February 2014.

Despite this, we consider Iberdrola's equity story to remain similar in the upcoming years: a strong commitment in achieving the EUR 6 billion debt reduction in 2014. Management expects to achieve this positioning by 1) reducing the level of investments (expected around EUR 10.5 billion between 2012 and 2014, 37% lower than the previous three years[12]). At this level the focus of investments will be in countries with more regulatory visibility (42% of the investments in UK) and higher growth prospects (23% in LatAm countries). For the same reasons Iberdrola is expected to invest more into network facilities and renewable plants (59% and 25% respectively). 2) Divesting from non-strategic assets into a total of EUR 2 billion. Around EUR 1.2 billion already achieved mainly with the sale of Medgaz and of renewable assets in Central Europe. 3) And finally through a better cash flow generation resulting from lower CAPEX and improving efficiency. Currently Iberdrola is already a benchmark in terms of efficiency and we expect this to remain as more headcount reduction is expected.

Figure 13: Efficiency benchmarking[13]



Source: Bloomberg

Macroeconomic Environment

Economic Profile

Emerging economies driving the 3.4% world's growth

According to OECD[14], the world's economy is expected to grow at a 3.4% pace driven mostly by the growth in emerging economies (non-OECD countries growth

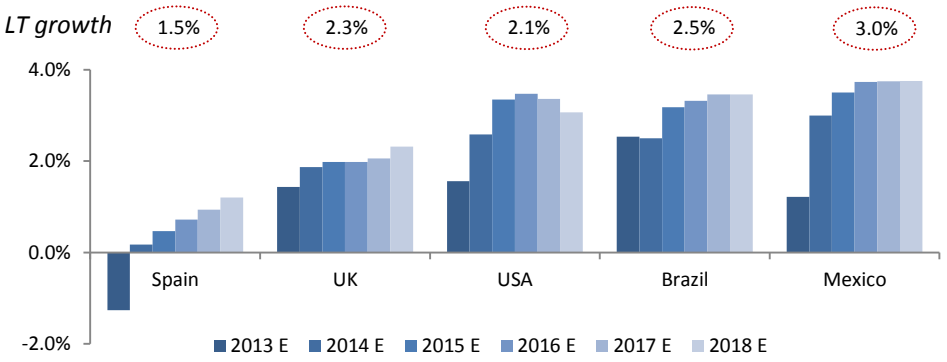
[12] See Appendix II for more details.
[13] Efficiency measured in terms of operating expenses over gross margin.
[14] OECD Economic Outlook (2012): Chapter 4 – Medium and long-term scenarios for global growth and imbalances. Growth values all in real terms.

expected around 6.9%). In the last decade the same aspect has been experienced, with China growing at 10.1% p.a. since 2000 (and expected to grow 7.2% p.a. in the next five years, surpassing USA's GDP).

Position in Brazil and Mexico are the main drivers for Iberdrola's growth

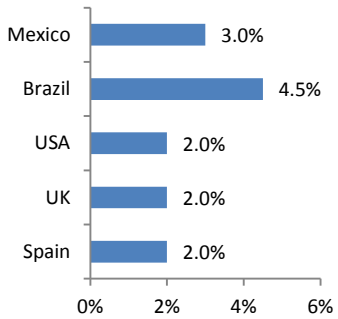
Iberdrola's portfolio is captures part of the growth in these economies, especially in Brazil and Mexico which represent more than 15% of EBITDA[15]. The two economies are expected to grow at 3.2% and 3.5% in the next five years respectively. Spanish economy, on the other hand, has been in a period of economic recession with unemployment peaking at 26.88% in 2013. In the last quarter Spanish GDP was able to grow 0.1% QoQ, officially ending the two-year downturn of the sovereign crisis. Despite this, the cumulative growth for 2013 in Spain is still expected to be negative (-1.27%), starting to recover only in the following year into a 0.7% growth p.a. for the following five years. A much favorable outlook is expected from UK and USA (2.0% and 3.2% respectively).

Figure 14: GDP real growth estimates



Source: IMF estimates (October 2013); OECD estimates (2012)

Figure 15: Target (long-term) inflation



Source: OECD estimates (2012)

Further depreciation of LatAm currencies, impacting results in EUR 299 million

The risk of high inflation is still expected in LatAm countries, especially in Brazil, with negative effects in business confidence and investors requiring a higher remuneration rate. Another issue that arises from the expected inflation gap between the LatAm countries and the developed countries is the depreciation of its currencies, reflecting the lower purchasing power in LatAm countries. This is a pattern already expected by the market (as shown by the futures market). These movements have already impacted Iberdrola's results in the 3Q13 (around EUR 150 million) and are expected to keep having a determinant impact in Iberdrola's results in the following years (average EBITDA impact for 2014-18 expected at EUR 299 million). Latin American countries inflation standards are not as strong as European ones, as governments are very supportive in stimulating the domestic economy enlarging their public debt figures and inflation. We do not expect this pattern to change in the short/medium-term.

[15] Notice that the business in these economies is either regulated or based on long term contracts, thus will benefit less from the demand expansion. Still we believe this position will bring growth to Iberdrola as more and better networks will be needed, and contracted production will follow closely demand as more energy must be distributed or contracted.

Table 2: End-year exchange rate projections[16]

	2012	2013	2014E	2015E	2016E	2017E	2018E
Euro-dollar	1.32	1.38	1.36	1.36	1.38	1.40	1.41
Euro-pound	0.81	0.83	0.83	0.84	0.85	0.86	0.87
Euro-real	2.71	3.25	3.50	3.51	3.55	3.59	3.62
Euro-peso	17.06	18.06	18.29	18.48	18.70	18.92	19.08

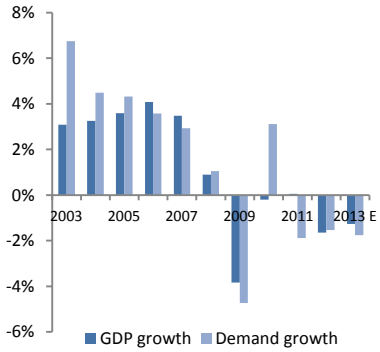
Source: Bloomberg

Energy Demand and Supply

Electricity demand in 2013 expected to reach 2005 values

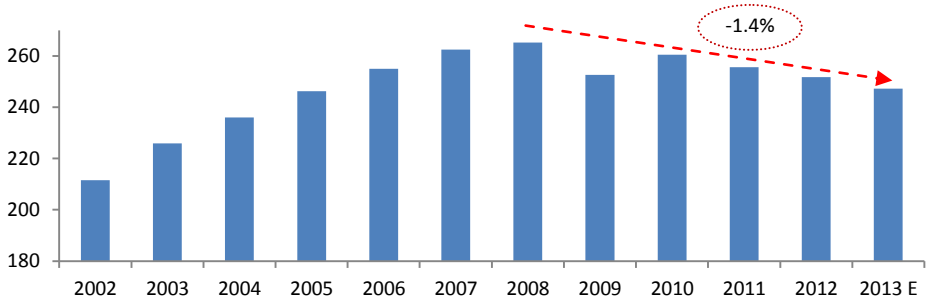
Energy demand has taken a descending path in most of economies during the last five years as a consequence of the economic downturns suffered. The Spanish market is a clear example of this event. We expect electricity demand in 2013 to achieve 247,285 GWh, values only matched in 2005. The Portuguese electricity market should also be considered in the analysis as it represents 13% of the total electricity supplied in Iberia. Here the trend is thinner, with demand reaching 50,300 GWh in 2013 after a 1.8% cumulative decline since 2008.

Figure 16: Spanish GDP and demand relation



Source: IMF, REE and Analyst's estimates

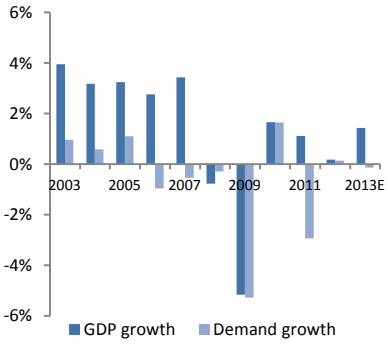
Figure 17: Spanish electricity demand (TWh)



Source: REE and Analyst's estimates

Demand shows a positive relation with the overall economy growth, mostly as a consequence of industrial consumption. Though this not the only trend in the electricity market. The concerns about energy wasting and efficient use of energy in EU and the establishment of the 20% target reduction of primary energy consumption is a major conditioner to the electrical demand growth. We expect Iberian demand to grow 0.2% p.a. in the next five years (a much lower growth than the one expected for the economy). An additional constraint into the Spanish demand is the effect of the Royal Decree 9/2013 as it requires end-users to contribute to the deficit reduction via increased tariffs.

Figure 18: British GDP and demand relation

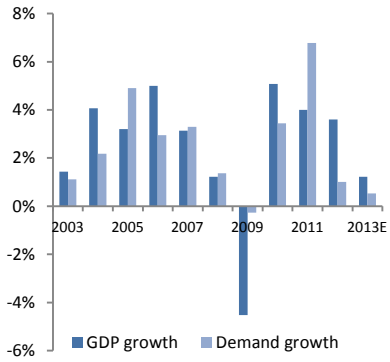


Source: IMF, Gov.uk and Analyst's estimates

The same conditions are expected from the British market as it is also subject to the EU's energy directives. We expect the British demand to grow at 0.5% in the next five years, gradually decoupling from the GDP growth. As for Mexico we expect energy efficiency practices to be far from now (as concerns are more focused towards the availability of energy for all population) thus Mexico should

[16] Using Chicago Mercantile Exchange Futures (at 03/01/2014) as a reference and assuming no arbitrage opportunities.

Figure 19: Mexican GDP and demand relation

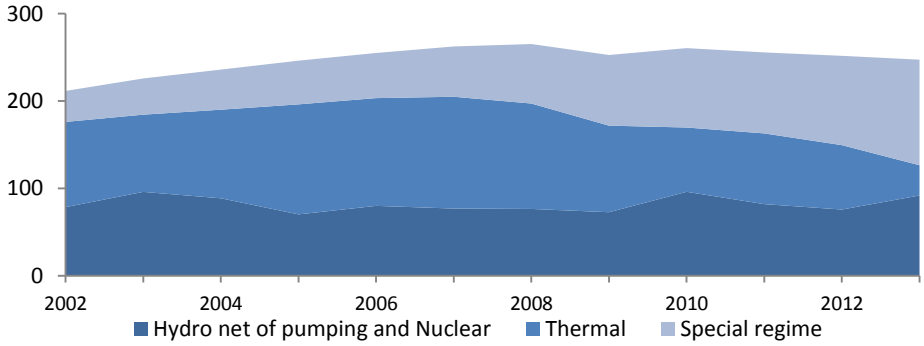


Source: IMF, Secretaría de Energía (SER) and Analyst's estimates

experience a much higher growth in demand (expected to grow annually by 3% during the next five years)[17].

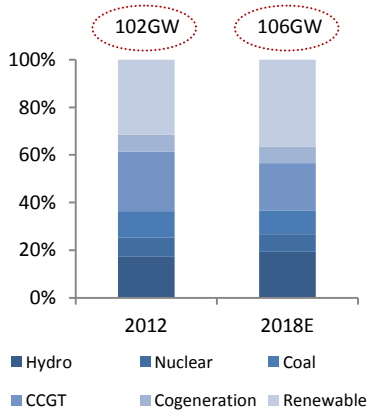
As for supply we expect the trend in the last years to remain the same. The EU's directives for reaching 20% of energy consumption from renewable sources at 2020 imply a renewable weight of 34%[18] in total electricity generation output by that period. A movement towards this objective has already been pursued in Spain and Portugal, with renewable energy already achieving 32% in 2013E (72% in Portugal). On the other hand thermal generation has reduced dramatically (-5.2% annually) reducing the viability of those power plants.

Figure 20: Spanish electricity generation (TWh)



Source: REE and Analyst's estimates

Figure 21: Spanish capacity mix



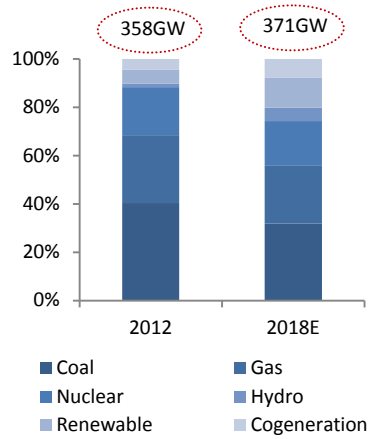
Source: Analyst's estimates

As a consequence of this market and regulatory trend we expect capacity coming from thermal sources to reduce in the coming years as low load factors (which are expected to remain due to the excess capacity observed in Spain and due to a slow recovery of demand) make the plants unprofitable. By 2018 we expect that 37% of Spanish capacity to be base on renewable sources and thermal to gradually reduce to 30% (from 36%).

In the United Kingdom the presence of renewable energy is not yet fully in place as it currently only represents 9% of the total energy produced (the largest bulk comes from coal – 37% - and CCGT – 28%). In the UK it is required a lot of investments by the companies to secure the availability of energy, making thermal energy more recommended due to its stability in output. However, regulatory policies have been recently implemented in order to incentivize the use of clean plants (see *"Renewable Environment"* and *"Renewable Business"* section). Thus we expect by 2018 thermal output to reduce 15% from 2012 values, being substituted by renewable production (target renewable energy by 2020 of 30%, including hydro and cogeneration). Moreover several old coal and

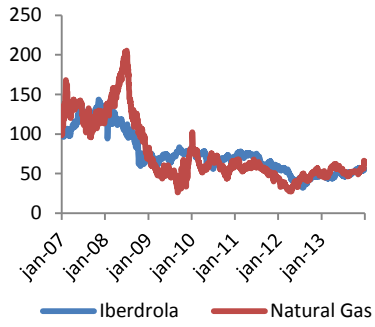
[17] The American and Brazilian markets are not considered in this analysis as Iberdrola is not directly exposed to the energy demand of those countries (network business is regulated and special regime enters always in the market, independently of demand).
[18] Other sectors like transportation are expected to have a weight much below 20% hence the higher weight on electricity production. Source: EDP – DPE.

Figure 22: British generation mix



Source: Analyst's estimates

Figure 23: Stock performance vs natural gas price (€/mmbtu)



Source: Bloomberg

We expect natural gas price to drive wholesale prices in Spain and UK

nuclear plants are expected to retire by the end by 2020[19].

In non-OECD countries, the generation mix is expected to be satisfied mostly by hydroelectric power[20]. Currently gas is the main input in Mexico's production, but we expect hydro technology to have the highest expansion in the coming years. In Mexico the interconnection Agreement for renewable sources (required for private generators to connect to the grid) was set to promote renewable energy and incentives started to be provided, like accelerated tax depreciation. Renewable targets in this country are set at 35% for 2024 however there are no sanctions if not met, thus we do not expect such rapid shift in production mix.

Power Prices

Most of Iberdrola's generation output is originated by renewable sources (including hydro). These technologies only comprise fixed costs as no primary energy input is required, thus not relying in the commodity prices. The profitability of such plants depend however from the price movements of commodities, as they are (most of the days) the marginal technology determining both baseload and peakload power prices (see appendix III). This effect is clearly shown in the relative performance of Iberdrola's stock and natural gas commodity price.

Historically in Spain, coal has been marginally more expensive than natural gas as a result of the CO2 prices. However in Spain national coal is subsidized putting coal ahead of gas in the merit curve. For the future we expect marginal cost of coal to fall below the natural gas as production of natural gas in Europe continues to decline (leading to higher prices[21]) and CO2 prices keep flat in 2014 (recovering only afterwards as we expect a rationalization of allowances - backloading). Overall, we do not expect a shift in the marginal technology (in Spain and UK), as coal remains less expensive than natural gas.

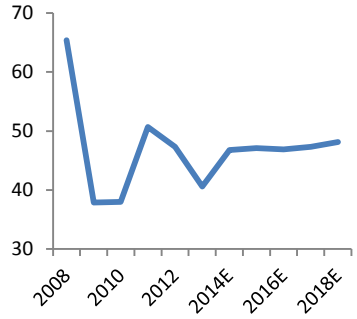
Table 3: Power price forecasts[22]

	2012	2013E	2014E	2015E	2016E	2017E	2018E
Nat. Gas ($/mmbtu)	2.75	3.70	4.34	4.32	4.28	4.34	4.41
Coal ($/mt)	94.56	84.00	83.93	84.93	88.25	89.90	89.90
CO2 (€/mt)	7.93	4.52	4.75	4.91	5.09	5.31	5.58
Marginal cost of CCGT (€/MWh)	***11.70***	***12.01***	***13.44***	***13.54***	***13.46***	***13.59***	***13.82***
Marginal cost of coal (€/MWh)	***16.88***	***12.24***	***12.22***	***12.51***	***12.93***	***13.20***	***13.39***

Source: Bloomberg and Analyst's estimates

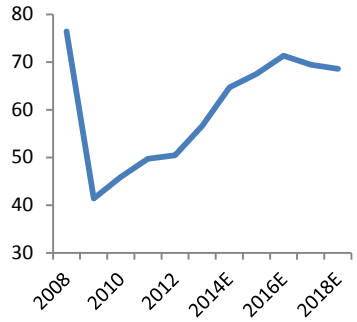
[19] A new nuclear plant is being built by EDF, but will only enter in function by 2023. Source: Timera Energy.
[20] Source: EIA's Energy Outlook (2013).
[21] A more intensive exploration of shale gas would lead to a shift in the marginal technology to coal. However we believe that an intensive exploration of shale gas in Europe is less likely (than in US for instance) given the high population density. Additionally we consider that this scenario is already imbedded in futures market price (with a certain probability).
[22] Considering that one mmbtu converts to 293 KWh and one coal mt to 8141 KWh. In the forecast we used commodity futures price: Nat. Gas and Coal Future from Nymex Exchange; CO2 Futures from the European Energy Exchange. We exclude fixed costs from this analysis as most of the cost in these technologies arises from fuel prices (see Appendix IV).

Figure 24: Spanish average wholesale price (€/MWh)



Source: EDP – DPE, OMEL and Analyst's estimates

Figure 25: British average wholesale price (£/MWh)



Source: Department of Energy and climate Change (DECC) and Analyst's estimates

We estimate Spanish average wholesale price to reduce in 2013 achieving 41 €/MWh (from 47 €/MWh in 2012). The main catalysts here are the reduction of commodity prices, the increase of renewable energy in the production mix, excess capacity and the mild recovery of demand. For the period afterwards electricity prices should start to recover as renewable production stabilizes and fuel prices increase.

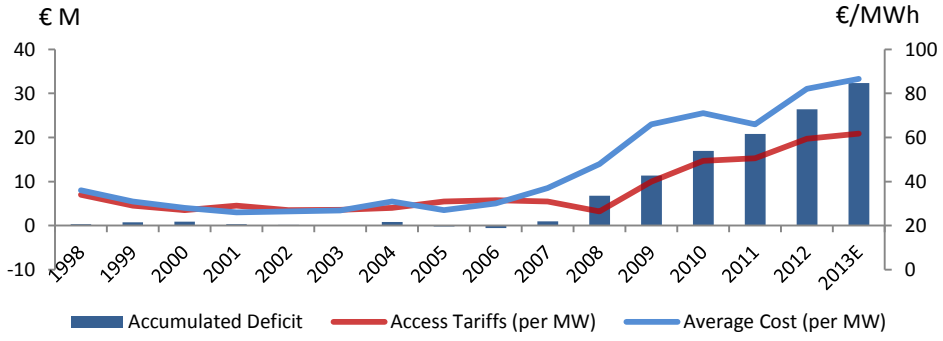
In UK the story is slightly different has there is no problem of overcapacity due to the overshoot of renewable and CCGT plants. In 2012, thermal facilities were still responsible for satisfying 68.5% of the total electricity demand. Average wholesale price in UK has been increasing since the commodity price slump in 2008 and is still expected to increase as commodity prices (namely gas) continue to pick up. In the long-run we forecast it to reduce as pressures coming from renewable production increase[23].

Spanish Tariff Deficit

In the last five years, Spanish utilities have been recording an increasingly higher shortfall in their accounts as the Spanish electrical system is unable to entirely cover its costs. As analyzed before, Spanish demand tightened a lot after the banking crisis in 2008 (demand felt around 5% in 2009) leading to a lower dilution of the system fixed cost[24] as the contraction was not expected by the regulator. The gap remained as demand remained flat or decreasing and tariffs did not accompany the ramp up of costs (as the government was not keen in increasing tariffs, and consequently end-user price, tremendously to cover the costs). Additionally there was a boom in renewable energy in that period, increasing significantly the system costs[25]. By end 2012 the accumulated tariff deficit was around EUR 26,384 million[26].

Unexpected demand decrease, inability to raise tariffs and renewable boom led to the EUR 26 billion deficit

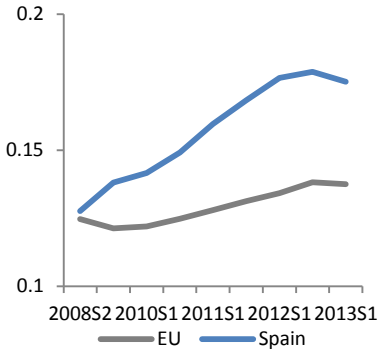
Figure 26: Spanish system deficit



Source: CNE and Analyst's estimates

[23] Mexican's power prices are also estimated to increase as gas prices increase. Notice that this country operates under a PPA agreement, where the prices are set for a longer period. However we consider that prices should follow the market to avoid default from the counterparty.
[24] Most of system costs, like distribution and transmission remunerations, are fixed and established each year.
[25] The renewable premium over wholesale price is supported by the system.
[26] Figure excluding securitization efforts.

Figure 27: European end-user prices (€/KWh)



Source: Eurostat
Note: Prices before taxes.

During 2011 concerns about the sustainability of such system started to be raised as Spanish public deficit aggravated. Regulators were committed on reducing system costs and avoid the increase in tariffs even further (Spanish users already pay on average more 27.6% per KWh than the average EU citizen[27]). However, until this year, no considerable change had been implemented with Spanish government withdrawing some contributions throughout the period (as it happened with the withdrawn of the EUR 3.6 billion contribution for 2013).

Major changes only occurred in 2013 with the application of RD 15/2012 and RD 9/2013 (see appendix V for more details). The latest one, the most aggressive, was expected to reduce the annual differential by around EUR 4.5 billion: 1) EUR 2.7 from the reduced remuneration of utility companies; 2) EUR 0.9 billion to be included in the state budget (concerning non-mainland costs); 3) and EUR 0.9 billion to be paid by costumers via the increase of tariffs (tariffs should adjust to expected deficit). Additionally it was proposed a EUR 2.2 billion credit line from the government. However, the Spanish Senate has removed all state contribution for the system in 2013 (a total EUR 3.6 billion contribution). In our figures we expect the deficit to reach a EUR 3.7 billion in 2013.

Tariff deficit to reach EUR 3.7 billion

With the implementation of these measures, there is a good improvement of costs, being the system able to break-even by 2017 (assuming the EUR 900 million contributions for non-mainland costs from 2014 onward still holds – see appendix VI). The main drivers here are the generation taxation and renewable remuneration (expected to reduce 22% yoy in 2014). Full details in this side of regulation are still not available, however we do not expect large changes in the cuts expected for renewable companies (estimated at EUR 1.5 billion p.a.). These changes have mixed effects on Spanish utilities as the system gets more efficient (with companies able to remove the deficit from their balance sheet) at the expense of lower returns (higher taxation) to the utilities themselves. Overall we see consider it as positives since the regulatory risk from deficit dissipates.

Spanish system to become more efficient

Table 4: Contribution to deficit financing

	Contribution
Endesa	44%
Iberdrola	35%
EDP - HC	6%
E.On	1%
Gas Natural	14%
Total	***100%***

Source: FADE

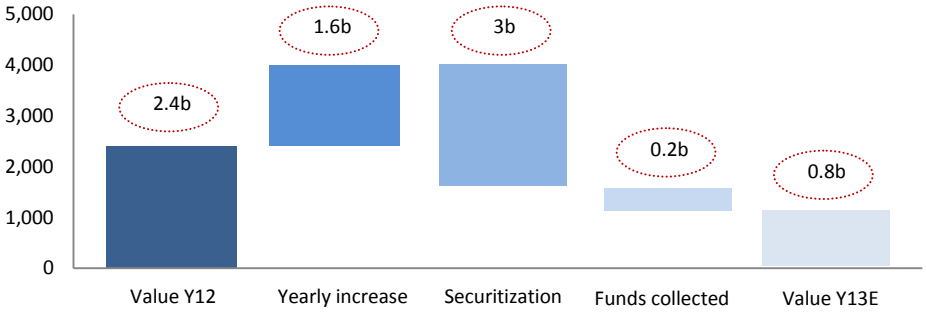
To eliminate the accumulated deficit the Spanish government as established a securitization vehicle, *Fondo del Amortización del Deficit Electrico* (FADE)[28]. In total it was already transferred to FADE EUR 18 billion of the cumulated deficit. Iberdrola is entitled by regulation to finance 35% of the shortfall or EUR 10,530 million of total cumulative tariff deficit for 2013. Part of this was already

[27] In Europe, production mix are very disperse (in France 82% comes from nuclear; Portugal 97% from renewable incl. hydro; Poland 84% from coal; Netherlands 89% from natural gas). Spain is among the countries with the highest renewable share (with 40% versus 18% of EU-27 average) which are more costly than traditional technologies. This cost is not incorporated in the wholesale price but goes to the system being latter on passed to the end-user (or to the deficit). Source: Eurostat – Key figures on Europe 2012.
[28] FADE works as a vehicle to finance the regulatory receivables via capital markets, having the guarantee of the Kingdom of Spain.

transferred into FADE (around EUR 7,729 million[29]) and another part already collected (EUR 1,908 million), being expected to remain EUR 831 million in 2013 in Iberdrola's books (from EUR 2,409 million in 2012). The Spanish government has increased the guarantees for securitization to EUR 26 billion, however, under the current policies, the need for additional securitization is diminished and we do not include in our analysis any further securitization.

Net tariff deficit for Iberdrola expected to reduce to EUR 831 million

Figure 28: Iberdrola's revenue shortfall evolution (€ M)



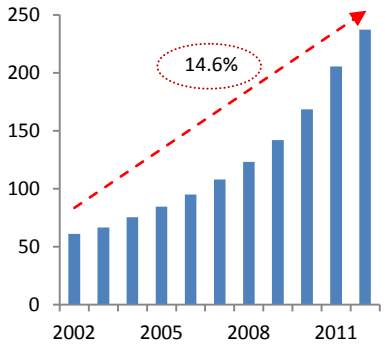
Source: Company data and Analyst's estimates

Renewable Environment

Renewable was a growing driver…

Renewable consumption in the world has experienced a huge expansion in the last ten years (more than tripled) with European countries on the front of the expansion. This happened mostly due to the support from governing bodies for these technologies. In Europe it was established for 2020 three main objectives regarding energy policy: 1) reduce the CO2 emissions by 20%; 2) increase the renewable share in production to 20%; 3) and reduce by 20% the primary energy consumption (not binding policy). Additionally, incentives for companies to invest in this segment were established by local governments[30], as renewable energies were not (and still are not) competitive against conventional sources of energy[31].

Figure 29: Renewable world consumption (TW)



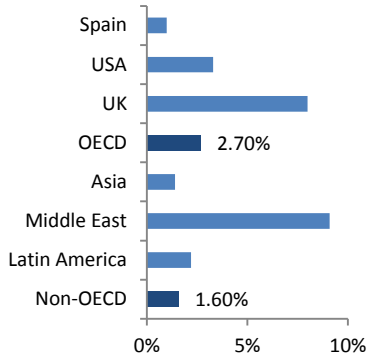
Source: BP

…and is still a growing…

We still expect the market to grow though at a more moderate level. In Spain, around 32% of energy is already supplied by renewable sources so we don't expect much more growth coming from this market anymore (we estimate renewable output annual growth of 1% as demand recovers slowly and load factors stabilize). The same does not hold for the UK as renewable sources are currently only responsible for 9% of total energy supplied. With the purpose of increasing that figure, the UK government has implemented further incentives for investments in non-polluting sources, like the carbon price floor (extra payment for CO2 emissions) and the renewable obligation certificates (ROCs[32]). We

[29] Source: company data and FADE.
[30] In Europe mostly through fee-in tariffs, that is, each MWh is remunerated at a fixed tariff established as a spread to the average wholesale price.
[31] See appendix IV for the cost comparison between technologies.
[32] Renewable Obligation Certificates: for each MWh supplied, the company must hold a number of renewable certificates.

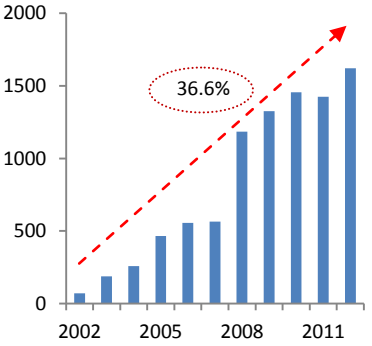
Figure 30: Renewable growth outlook



Source: IEA World Energy Outlook 2012, EIA and Analyst's estimates

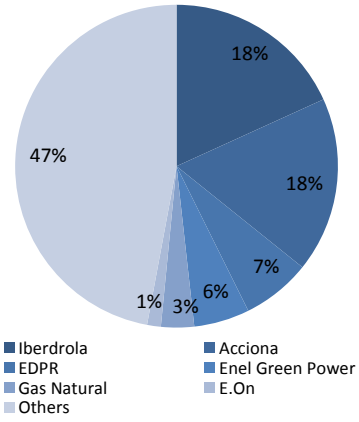
…but concerns start to arise

Figure 31: Iberdrola Renewable EBITDA (€ M)



Source: Company data

Figure 32: Renewable capacity share in Spain



Source: Company data and Analyst's estimates

expect UK's renewable output growth to be around 8%, reaching the 30% target in 2020 (including hydro and cogeneration). In the US there are also targets for renewable energy per State[33] but on average less demanding. Energy Information Administration (EIA) expects renewable energy share in US to be around 16% in 2040 (from 13% in 2011) as technologies get more economic and their costs decrease. With this it is expected a moderate growth around 3.3% p.a.

However there is a growing concern in this segment, especially in the more mature countries (in terms of energy markets), regarding the over cost of renewable energies. The EU program to invest in renewable energies together with weak growth in disposable income has increased pressure in households' bills. This conflict generated debates about the affordability of the energy policy, especially in countries with power prices expected to increase. In Spain measures have already been considered to reduce renewable remuneration as part of the tariff deficit solution. We consider that there is also potential risk that other countries might follow the same route. Reducing feed-in tariffs, increasing taxes on the sector or reducing other regulated remunerations are some of the possible ways that governments have to fight the over cost tendency. This will particularly harm companies highly exposed to the renewable market.

Iberdrola has positioned itself as the world leader in wind energy (14 GW installed capacity – CAGR of 8.7%) and over the years has taken advantage of the huge sector growth (renewable EBITDA growing at 36.6% per year). This makes the company extremely exposed to this regulatory uncertainty, especially in Spain. Just in Spain Iberdrola is responsible for around 18% of the total installed capacity in renewable energy. We deem regulatory policies over renewable energy as extremely important for Iberdrola's value. To comprise this risk inherent in Iberdrola's value we included in our valuation model a scenario where more regulatory intervention would occur, especially in the renewable sector (see section *"Alternative Scenarios"*).

Business Forecast

Network Business

The network business comprises all regulated activities of Iberdrola, including both transmission and distribution of electricity in Spain, UK, USA and Brazil. This is the most relevant sector for the company in terms of EBITDA and fair value. Currently it holds 1,044,220 km of power lines (96.6% low voltage) and is responsible for distributing 210,622 GWh of energy. Under this segment, a large part of earnings arise within the domestic market (35.7% in 2012), however this

[33] These values range from 15% in Arizona by 2025, to 40% by 2030 in Hawai.

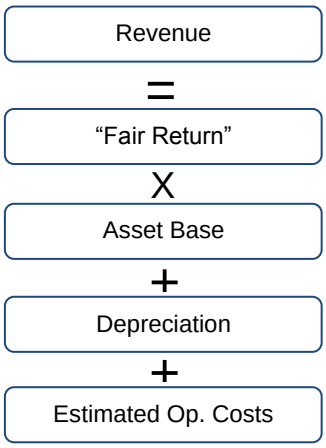
Most important segment for Iberdrola

International presence is gaining importance

figure has been decreasing due to regulatory cuts and higher investments outside Spain. For 2012-2014 the expected investment is around EUR 6,150 million from which EUR 5,400 million will be allocated to international markets (mostly UK and USA). The strategy is to invest in countries where the regulatory environment is more stable, as opposed to the macroeconomic outlook in Spain.

As a regulated business, operating income in each country is determined by the regulator. In the Spanish case the entity responsible for regulation and supervision of the energy sector is Comission Nacional de Energia (CNE). According to this entity, remuneration of energy distributors is based on a reference network model[34]. This implies remunerating three items: 1) investments; 2) costs necessary to operate; 3) and costs occurred to maintain the assets. The remuneration is established for a regulatory period of four years, being updated each year by the CPI and IPRI[35] and for the new investments made. Additionally there is also a yearly incentive on quality and losses. With the introduction of RD 9/2013 by mid-2013 the remuneration scheme for distributors was reduced, being investments remunerated at the yield of Spanish 10 year government bonds plus a 200 bps spread (currently 6.5% pre-tax return). In our estimates revenues are reduced by EUR 155 million in 2014 (versus company guidance of EUR 115 million). As a consequence of the announced cuts Iberdrola is focused on cost cutting: 1) reducing workforce; 2) lower contractor costs; 3) and re-engineering processes. These pillars were established during the last investor day and we expect Iberdrola to keep the same focus on cost cutting.

Figure 33: Remuneration approach in Spain



Source: BOE and Analyst's research

Squeezed returns following new regulation

In our analysis we assumed RAB decreasing in 2013 as a consequence of the low investments in Spain and the assets revaluation[36], reaching an operating income of EUR 386 million in 2013[37]. Under this regulation efficiency plays an important role (we assumed an EBITDA margin varying between 75.7% and 74.3% throughout our explicit horizon) to achieve returns above cost of capital.

Table 5: Income forecasts for Networks Spain (€ M)

	2011	2012	2013E	2014E	2015E	2016E	2017E	2018E
Reg. Revenue	1,785	1,591	1,543	1,460	1,403	1,402	1,403	1,415
Operating Costs	654	690	614	573	566	564	569	575
Depreciation	321	339	378	356	352	362	367	375
After tax EBIT	***567***	***393***	***386***	***372***	***339***	***333***	***327***	***325***
Net Fixed Assets	5,763	6,137	5,995	5,875	6,010	6,126	6,249	6,372
Realized Return	***9.84%***	***6.41%***	***6.43%***	***6.33%***	***5.65%***	***5.44%***	***5.23%***	***5.10%***
WACC	***5.75%***	***5.75%***	***5.75%***	***5.75%***	***5.75%***	***5.75%***	***5.75%***	***5.75%***

Source: Company data and Analyst's estimates

[34] This is a model that maps, for all Spanish territory, the power lines needed and the necessary costs to operate them.
[35] Consumer Price Index and Manufacturing Price Index.
[36] We considered as a proxy to RAB, total operating fixed assets as no disclosure was provided.
[37] This figure excludes other revenues as well as levies and capitalized staff costs.

Stable environment in UK

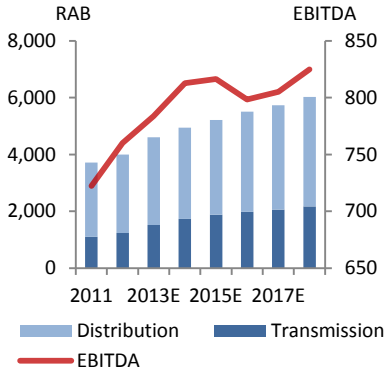
Table 6: RIIO regulation

	RPI-X (A)	RIIO (E)
Regulator	OFGEM	OFGEM
Period	2010-15	2015-2023
Cost of debt	3.60%	2.90%
Cost of equity	6.70%	6.70%
Leverage	65%	65%
Tax rate	24%	24%
WACC (after tax)	4.0%	3.8%
WACC (before tax)	4.7%	4.2%

Source: OFGEM and Analyst's research
Note: Rates in real values and GBP.

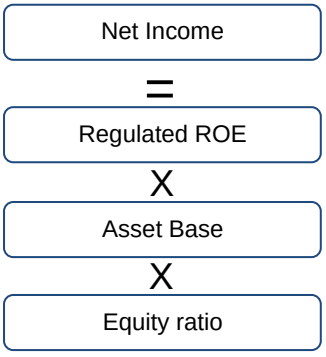
Large investments expected due to RIIO-ED1

Figure 34: UK RAB and EBITDA evolution (£ M)



Source: Company data and Analyst's estimate

Figure 35: US regulatory method



Source: Analyst's research

In UK, Iberdrola faces a much more stable outlook than in the Spanish one. In this market Iberdrola operates through SP Manweb and SP Distribution (two distribution companies) and SP Transmission (transmission business). It currently manages around 118,116 km (mostly low voltage) over a 38,410 km^2 and 3.4 million of supply points. The main regulator in this market is the Office of Gas and Electricity Markets (OFGEM). The current remuneration policy for distributors is based on RPI-X which attributes a remuneration based on the costs of an efficient network operator, capital programme required and a target return with yearly updates at inflation (RPI in UK's case)[38]. The remuneration was established in 2010 at 4.7% (real before tax) for a period of five years. A new regulatory period, RIIO ED1, is already being discussed. RIIO model is similar to the RPI-X with the exception of the introduction of a longer amortization period for new assets (from 20 years to 45 years)[39]. We estimate a real remuneration before tax for Scottish Power around 4.2% (10% lower than under RPI-X)[40] under this policy, based on lower forward average interest rates. Unlike Spain, UK is a very stable market with no large changes in policies and with long regulatory periods (eight years for RIIO). Iberdrola expects to invest around EUR 2,290 million in this country mostly in the transmission network with the development of a subsea cable between Scotland and England. Moreover, RIIO requires a huge capital investment. According to the business plan sent to OFGEM, Iberdrola plans to invest during that period a total of £ 5,155 million (we assumed a lower figure of EUR 652 million per year). With this we estimate RAB to reach £ 4,604 million (+15% than 2012) driven by the increase in transmission business RAB (+23%). At EBITDA level, we forecast a 1% annual growth (in £) propelled by RIIO investments with margins ranging from 76.6% to 75.0% in 2013-18.

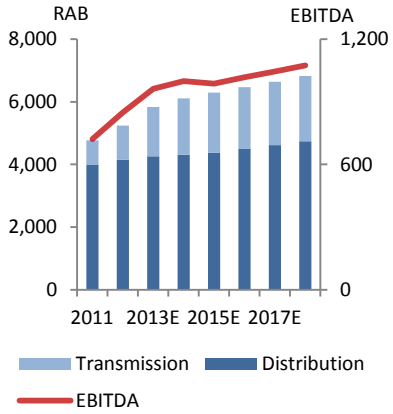
The third most relevant regulated market for Iberdrola is the USA. In this country Iberdrola operates mostly through New York State Electric & Gas Corporation (NYSEG) and Rochester Gas and Electric Corporation (RG&E), companies that distribute both electricity and gas, and Central Maine Power (CMP), mostly electricity transmission. Currently it distributes 31,573 GWh of energy to over 2.4 million customers and 120,672 km of power lines. The regulatory environment in US is also very stable like in UK. The tariffs for distribution companies in New York have been set in 2010 for a period of three years and four months, that is, until end 2013. During this period companies were remunerated at a 10% ROE. We extended this remuneration scheme for our explicit horizon as Iberdrola has the right to expand the tariff agreement further in 2014. For the transmission business in Maine, the same methodology is used but under a different ROE.

[38] It is a similar methodology to the Spanish one.
[39] The regulatory period will be a transitory period for this policy.
[40] Value based on Western Power Distribution draft already published by OFGEM.

Growth potential, with high compensating returns

CMP currently receives a 12.89% ROE (11.14% base ROE, 0.5% NETO and 1.25% incentives). During 2011 some state officials filed a complaint on the excessive remuneration for transmission companies requesting a 1.4% reduction on ROE. This litigation however will only be resolved by early 2014. In the meanwhile, CMP has already filled a request for a new tariff agreement for the next five years. During our analysis we considered the drop in the remuneration rate as we believe the current rate to be unsustainable. During the latest investor day, Iberdrola has announced a total net investment in US of EUR 1,585 between 2012 and 2014. The investment is mainly on the development of Maine's connection with Canada (expected to total $ 1.4 million). We include these figures in our analysis reaching a RAB increase of 11.5% in 2013 mostly driven by the increase in transmission assets. We see growth potential for Iberdrola in the US market, especially in the transmission business, given its substantial remuneration for capital (we estimate cost of equity for this market around 6.78%, much lower than the actual remuneration). Considering our estimates of regulated asset, and incorporating management's target NOE/GM[41] ratio of 34% for 2014 (5.5% lower than in 2012), reaching an EBITDA of EUR 729 million in 2014 (10% higher than in 2012).

Figure 36: US RAB and EBITDA evolution ($ M)



Source: Company data and Analyst's estimates

Figure 37: Regulatory framework in Brazil

Remuneration

- After tax allowed remuneration reduced to 7.5%

Costs

- Based on a benchmark model: direct comparison of companies costs

Quality Factor

- Frequency and duration of interruptions

Asset Base

- Assets in beginning of cycle plus investments and D&A

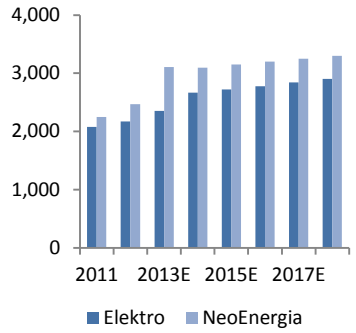
Source: Company data and Analyst's research
Note: Nominal remuneration and in BRL.

Brazil has been the fastest growing country within Latin America (growing at 2.6% p.a. in real values in the last five years) and Iberdrola has been able to explore this with its participation in NeoEnergia (owns 39%) and Elektro (acquired 100% in 2011 to enlarge the presence in this country and integrate with NeoEnergia[42]). Total energy distributed by the company has increased 5% per year in the last five years reaching 49,006 GW in 2012, growth that has not been totally accompanied by EBITDA (+0.6%) due to the increase in operating costs (+15%)[43]. During this year, companies have also been penalized by the drought as costs to buy energy (which is pass-through) were higher than the ones set by the regulator. These differences will be repaid in 2014[44]. Between 2009 and 2011, 5.8% of investments were directed to Brazil. This figure has tripled (15%) for the period between 2012 and 2014, showing the clear focus of Iberdrola's investment in LatAm countries for growth. The regulatory system in Brazil is based on a price-cap framework and is set by Agência Nacional de Energia Elétrica (ANEEL). Each regulatory period lasts for four or five years depending on the concession. During the third cycle of periodic tariff reviews, ANEEL reduced the after tax remuneration rate from 9.95% to 7.5%, reflecting a lower risk

[41] Net Operating Expenses over Gross Margin.
[42] This move was blocked by the remaining shareholders of NeoEnergia (Banco do Brasil and PREVI, a pension fund of Banco do Brasil). Iberdrola considered at that time the sale of NeoEnergia, but recently it has pointed the strategic importance of Brazil, as such we disregarded that scenario.
[43] Values adjusted for the consolidation of Elektro.
[44] Companies can ask ANEEL for an early tariff review due to extraordinary events.

premium (below our cost of capital estimate). To counteract this negative effect, Iberdrola has launched an efficiency plan in Elektro, positioning the company among the most efficient ones for ANEEL's benchmark model. Given Iberdrola's investment plan in Brazil, we estimate RAB of distribution companies to increase 2.6% per year during the next five years. Iberdrola also holds stakes in generation facilities (mostly hydro and CCGT – non regulated facilities), being currently attributable to Iberdrola 744 MW (expected to more than double by 2018). We forecast an average EBITDA margin of 25.6% throughout our explicit horizon (300 bps higher than 2013). From 2014 onwards, NeoEnergia will be equity consolidated as a consequence of accounting policy IFRS 11 (from proportionally consolidated). This will be the most relevant event to affect Iberdrola's income for 2014 (with no effect on valuation). We estimate a cut of 48% (reaching R$ 1,034) in 2014 for the Brazilian unit (5.6% at the group level).

Figure 38: Brazil RAB evolution (R$ M)



Source: Company data and Analyst's estimates

Comparing the several regulations that Iberdrola is exposed to, we can see that the American one is the most advantageous one, that is, with the highest regulatory return. However, considering our own estimates of WACC for US (4.89%), we consider that this regulation is not sustainable hence we consider the complaint followed by state officials to reduce the remuneration as a very likely scenario in the short term (if reduced by 1.4%, regulated remuneration would drop to 6.4%, still above our estimate of WACC). The british regulation presents also an attractive environment for Ibedrola with remuneration above its WACC, being the RIIO's investments able to create value. The current Spanish remuneration on the other hand is below our estimates of WACC, thus destroying value and corroborating Iberdrola's decision of lower investment in this country.

Table 7: Comparison of regulations in €

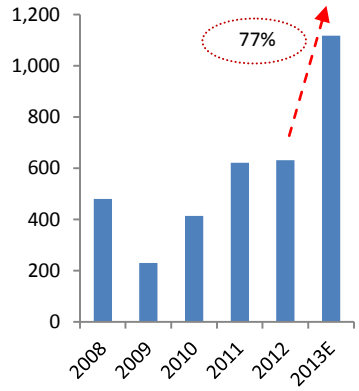
	Regulated WACC (after tax)
Spain	4.55%
UK	4.80%
US	7.08%
Brazil	4.33%

Source: Regulator data and Analyst estimates
Note: US regulated WACC calculated based on 12.89% equity rate and 48% equity.

Generation and Supply Business

This business segment comprises the production of electricity through ordinary regime plants (hydro, nuclear, coal and gas) and the supply of both electricity and gas to end-users. Since 2011, Iberdrola has bundled its generation and supply businesses in Spain, UK and Mexico into one single bucket to achieve efficiency gains from the synergies between countries. However this measure has not been enough to counteract against the pressure upon margins (especially in Spain and UK). With the large slump in demand after the 2008's crisis and consequent reduction of power prices, generation units suffered a huge fall in their earnings (Iberdrola's generation EBITDA reduced by 9.7% in 2009). The last couple of years haven't been very favorable as well, especially for the more mature markets (in Iberdrola's case Spain and UK), with regulatory taxation increasing around 77% this year only. Additionally, in Spain, overcapacity has been an issue due to the renewable energy boom. In sum, we are assisting at a business increasingly less attractive in mature markets with margins totally squeezed.

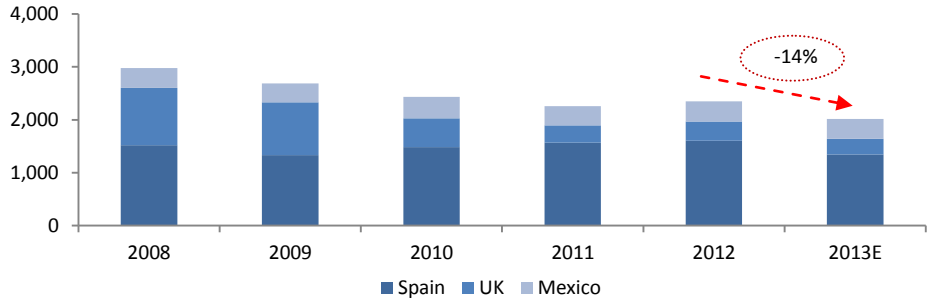
Figure 39: Evolution of generation levies (€ M)



Source: Company data

Lower power prices and higher levies led to cut in earnings

Figure 40: Generation and Supply EBITDA breakdown (€ M)

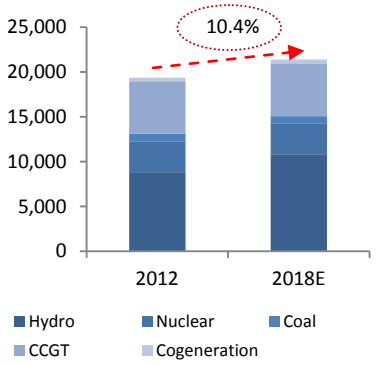


Source: Company data and Analyst's estimates

Currently Iberdrola owns a total of 29,850 MW of installed capacity (19,378 MW in Spain, 4,865 MW in K and 5,607 MW in Mexico). Most of energy produced by Iberdrola in Spain comes from low carbon energies (hydro and nuclear) while on the other markets Iberdrola is more expose to the emitting CO2 energies (almost 90% of installed capacity in UK and Mexico comes from coal and/or CCGTs). In October Iberdrola has inaugurated a 2.2 GW hydroelectric plant located in Valencia, the largest pumping in Europe. In the medium term the company also expects to develop an additional 1.9 GW CCGT plant in UK but apart from that no other large investments in capacity are forecasted (management's guidance for investment between 2012 and 2014 is smaller, EUR 1,370 million).

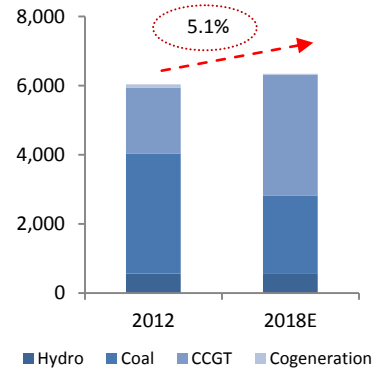
Looking in more detail into the Spanish market, the current year has been dramatic. The implementation of RD 15/2012 and RD 9/2013 (discussed previously) have impacted third quarter earnings by around EUR 363 million and we expect to reach the EUR 678 million in 2014 (EUR 539 million for the RD 15/2012 and EUR 139 million for RD 9/2013). Regarding the generation side, we estimate a moderate 1% annual growth for production in the next five year period (reaching 46,809 GW in 2018) as thermal load factors are kept at low values (consequence of the overcapacity in the market) and renewable load factors stabilize. This implies a stable generation market share for Iberdrola, around 25% (historically this market share has varied as a consequence of the lower/higher hydro output, being only partially compensated by the higher thermal output).

Figure 41: Installed capacity in Spain (MW)



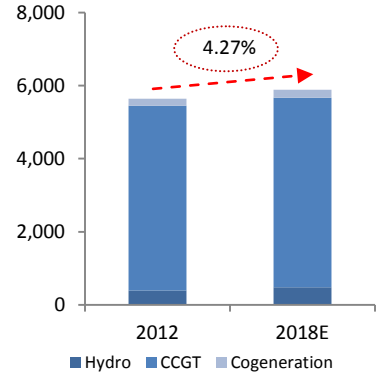
Source: Company data and Analyst's estimates

Figure 42: Installed capacity in UK (MW)



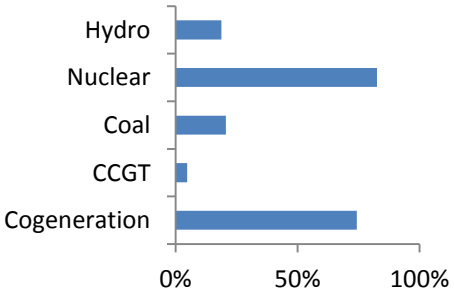
Source: Company data and Analyst estimates

Figure 43: Installed capacity in Mexico (MW)



Source: Company data and Analyst's estimates

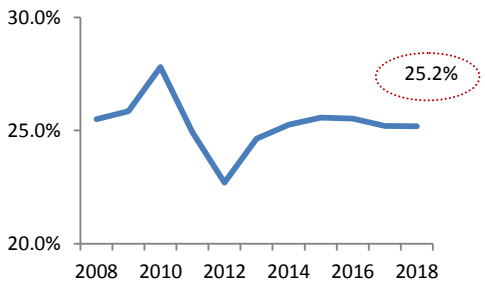
Figure 44: Iberdrola's average load factors in Spain (13-18E)



Source: Analyst's estimates

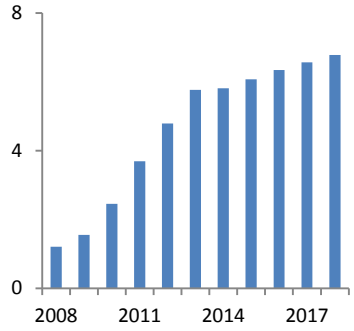
$$Load\ Factor = \frac{generation\ (MW)}{installed\ capacity\ (MW)} * 365 * 24$$

Figure 45: Share in Spanish generation



Source: Company data, REE and Analyst's estimates

Figure 46: Spanish users in liberal market (M)

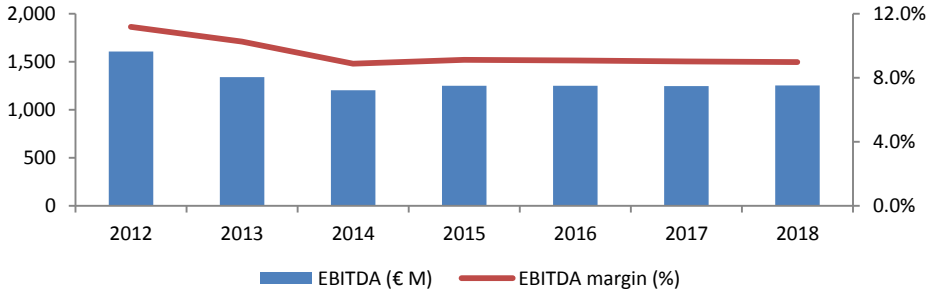


Source: Company data and Analyst's estimates

Regarding the supply business, clients will keep converging to the liberalized business (as it has been the tendency so far), as the competition among electricity suppliers will pressure down prices (reducing margins for the supply business), but at a slower pace. This increase in client base will however not translate in a relevant increase in the total energy supplied as population is increasingly aware of efficiency practices and with concerns regarding energy waste. Additionally we do not expect achieved prices to increase in the short-term as wholesale prices are expected to remain flat. Summing up, we expect EBITDA to reduce in the upcoming years as a consequence of the increased regulatory costs and deteriorating market conditions for thermal energies. The efficiency policies implemented contribute significantly to a lower impact of this market issues. We expect operating expenses to reduce by 1.4% p.a. between 2012 and 2018 offsetting part of the impact from regulatory costs. From 2015 onwards we estimate EBITDA to recover slowly as margins remain flat.

Efficiency gains reducing impact of market distortions

Figure 47: Gen&Supply Spain EBITDA estimates

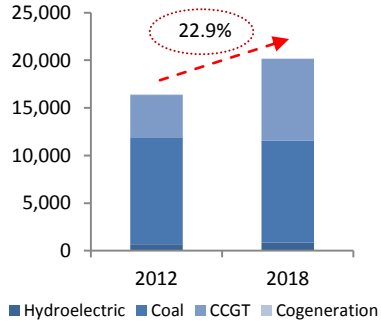


Source: Company data and Analyst's estimates

Pressure from renewable incentives

Iberdrola operates in the British generation and supply market through Scottish Power since its integration in 2008. As stated previously, in UK margins have been reducing in the last years mostly as a consequence of increased costs for environmental incentives and system costs (transmission, renewable over costs). Recently Scottish Power has announced it would raise its household charges (both for gas and electricity) following other major players in the British market. Overall we expect EBITDA margins to slightly increase as regulatory pressures will still exist. By April 2013 the carbon tax, another measure to incentivize the usage of renewable energy, was implemented in the market. We estimate this to have an impact on EBITDA of EUR 194 million by 2014. Another relevant regulatory cost arises from the ROCs (Renewable Obligation Certificates). This currently requires Scottish Power to hold 20.6% (to reach long-term target of 30%) of its supplied energy coming from renewable sources. This will impact EBITDA on an additional EUR 254 million.

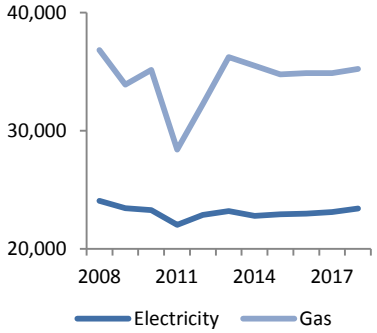
Figure 48: Generation in UK (GWh)



Source: Company data and Analyst's estimates

In UK the three main sources of revenue come from the wholesale market and from the sale of electricity and gas. Regarding the production we expect it to

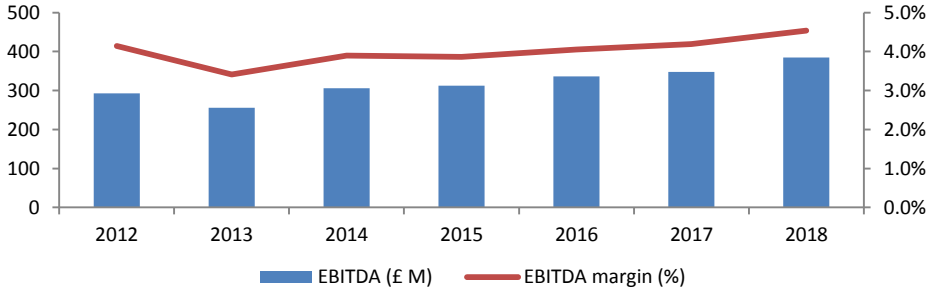
Figure 49: Energy sales in UK (GWh)



Source: Company data and Analyst's estimates

increase by 22.9% from 2012 to 2018 as a consequence of the entry of a 1.9 GW CCGT plant in 2015[45]. The generation mix will start to change has a result from the environmental policies (ROCs and carbon taxes) which are increasingly less favorable for coal generators as opposed for gas generators. As such our estimates of load factors for coal facilities reduce overtime as well as the installed capacity. As for supply revenues, we estimate an increase in the volumes sold in the short-run as the overall economy is growing, stabilizing afterwards.

Figure 50: Gen&Supply UK EBITDA estimates

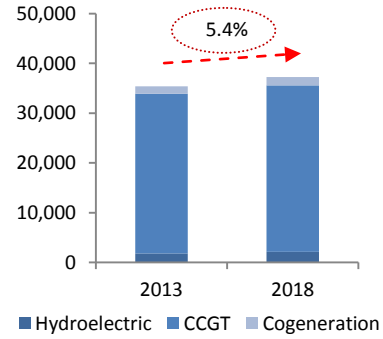


Source: Company data and Analyst's estimates

Mexico operating with stable PPA agreements

The last unit within this business is Iberdrola Mexico. This company operates mostly in PPA agreements (long-term contracts) with more than 90% of total energy produced being sold to Comisión Federal de Electricidad (CFE)[46]. This implies a much more stable business than in the other countries. Another particularity of this market is its program of incentives for renewable energies. It passes by providing tax advantages rather than subsidies (as in USA). With this consumers do not have a direct impact in their electricity bills making regulatory changes unlikely due to pressures like the ones UK and Spain are suffering.

Figure 51: Mexico production (GW)

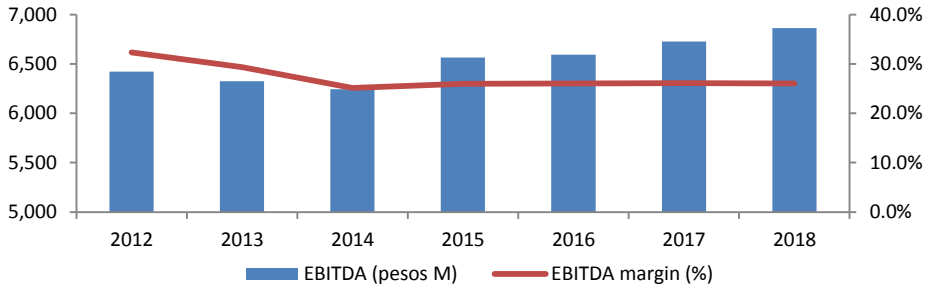


Source: Company data and Analyst's estimates

Most of Iberdrola's production in Mexico is derived from gas combined cycle (32,105 GWh in 2013E) and at current capacity load factors are well above the reality in other markets (73% vs 3% in Spain and 36% in UK), meaning that there is a high demand for these plants. We expect generation to increase 1% p.a. as demand in Mexico keeps increasing. Iberdrola is the largest private producer in Mexico. However, its market capture has been decreasing in the last years. We expect this tendency to continue, reaching to 12.25% in 2018 (from 14.8% in 2012), as Mexico is an increasingly attractive country (increasing demand) for new competitors and renewable start to kick-off. Overall we expect EBITDA growth to reflect the growth of the overall economy.

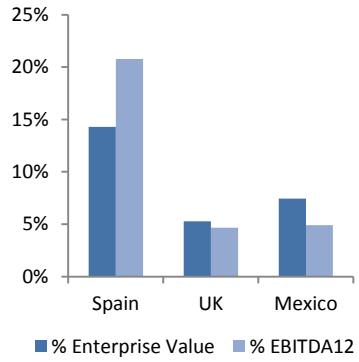
[45] We assumed the investment would be phased out in five years (2015-2020) as investment has not been announced yet, there is only a plan for that expansion.
[46] It is a public institution responsible for the planning of the national electricity system, generation, transmission, distribution and sale of electricity.

Figure 52: Gen&Supply Mexico EBITDA estimates



Source: Company data and Analyst's estimates

Figure 53: Value forecast



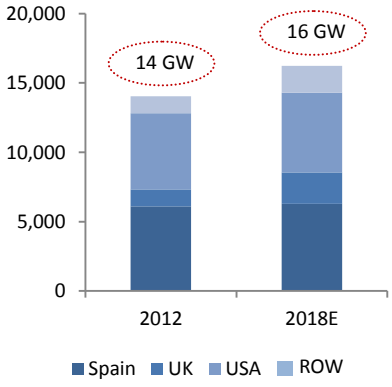
Source: Company data and Analyst's estimates

Table 8: Renewable technologies

Technology	Installed Capacity (MW)
Onshore Wind	13,686
Offshore Wind	2
Mini Hydro	306
Photovoltaic	56
Hybrid Gas-Solar	50
Wave	1
Total	***14,101***

Source: Company data

Figure 54: Renewable capacity (MW)



Source: Company data and Analyst's estimates

Summing up, we expect value to be driven mostly from the LatAm business unit (percentage of EV larger than current percentage of EBITDA) as the regulatory outlook is much more favorable. According to Ben Warren, partner at Ernst&Young, developing countries tend to look at renewable energy in a more strategic perspective (how it can boost growth), while mature countries focus on the cost per se, thus increasing pressure on taxation and other sources to finance the increasing costs of renewable.

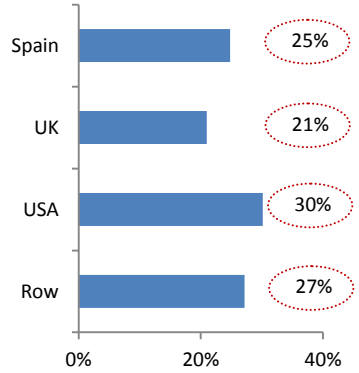
Renewable Business

Iberdrola operates in the renewable business through its subsidiary Iberdrola *Renovables*[47]. Most of its facilities comprise onshore wind (more than 97%) giving to Iberdrola a unique renewable mix as this technology is the most economical within the renewable choice (see appendix IV). Currently it operates more than 14 GW (from 9 GW in 2008) across the world focusing mostly on Spain (6 GW), USA (5.5 GW) and UK (1.4 GW). As pointed previously this sector has expanded enormously in the last ten years followed by the huge investments undertaken by Iberdrola (just between 2009 and 2011 EUR 6,742 million were invested in new capacity – mostly in USA). Investments at this stage are expected to be much more moderated (management's guidance is to reach a net investment of EUR 2,600 million between 2012 and 2014 - 40% of previous investment) as Iberdrola is already comfortably positioned in this three main countries and regulatory incentives start to phase out (as outlined in the previous section *"Renewable Environment"*). In sum, we expect total renewable capacity to increase by 2.5% p.a. being UK and Row the ones representing the largest growth (management has already plans to develop onshore and offshore wind facilities in UK, Brazil, Mexico, Germany and France – we expect net CAPEX to average EUR 0.9 billion in the next five years). As opposed to thermal energies (like coal and gas), this technology is not dependent on energy demand as special regime production has priority in the merit order curve (zero marginal

[47] Iberdrola *Renovables* was merged on Iberdrola by mid-2011 (EUR 5.30 share price), after its IPO in 2007 (EUR 3.08).

costs). So the main issue regarding renewable energy is its predictability[48] as output is dependent on weather conditions (if there is more or less wind in the day). In our estimates we assume average load factors around the same levels of the previous years (Spain 25%; UK 21%; USA 30%; Row 27%), totalling a generation output of 37 TW in 2018 (+17% than 2012). In the main countries where Iberdrola is present, renewable energy is remunerated by a feed-in tariff established according to the technology[49]. This tariff is fixed for a certain period usually with a descending factor (to incentivize the technological cost reduction). In our estimates the gross margin per KWh decreases almost 4% in 2014 as a consequence of the regulatory measures to be approved in Spain regarding renewable remuneration. In the medium term we expect it to increase as power prices recover until the point where descending factor is greater than the increase in prices.

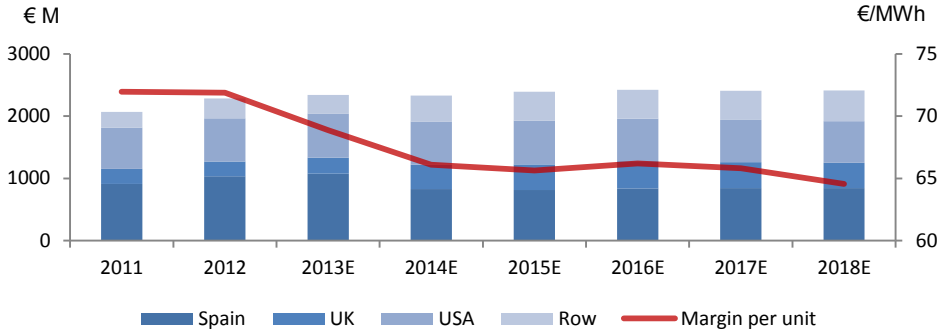
Figure 55: Average load factors (2013-18E)



Source: Analyst's estimates

Growth expected outside mature markets

Figure 56: Gross margin estimates for renewable segment

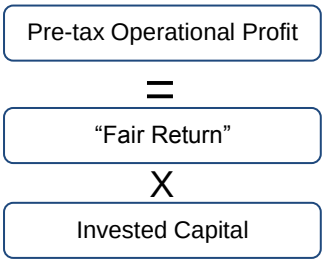


Source: Company data and Analyst's estimates

A first approach estimate to RD 9/2013 indicates a EUR 208 million cut for 2014

We also make a first approach estimate to the recent regulatory measures announced by mid-2013 in Spain regarding renewable remuneration. According to the RD 9/2013 special regime facilities will be remunerated by a "fair return" for its investments (considered the Spanish 10 year government bonds plus a 300 bps spread – expected to be around 7.5% pre-tax). By making a similar approach as it happens in the distribution and transmission remuneration (that is determining remuneration consistent with a return on capital invested equal to the "fair return"[50]) we reach an impact on gross margin level of around EUR 208 million in 2014. The regulation here is still unclear, namely regarding on how the asset base is calculated and how efficient company costs are calculated, but we would not expect the hit to be lower than this value. The measure targets a EUR 1.5 billion cut each year in renewable remuneration and if we consider that Iberdrola holds 18% of the total installed capacity in Spain the hit would reach EUR 270 million. We consider this as the upper boundary of the impact as the cut

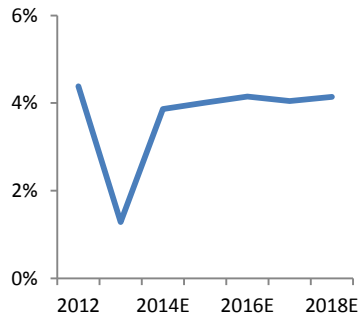
Figure 57: New remuneration approach



Source: BOE and Analyst's research

[48] Several concerns regarding security of supply are also being raised in Europe, namely in Germany (a measure very discussed is the introduction of capacity guarantees by renewable producers).
[49] Wind technology receives a lower tariff than solar technology as costs are lower.
[50] Total revenue=7.5%*Invested Capital + Depreciation + Operating Costs

Figure 58: Renewable return on Investment



Source: Company data and Analyst's estimates

Note: $Return\ on\ Invest_t = \frac{NOPLAT_t}{Inv.Capital_{t-1}}$

should not be distributed evenly (more expensive technologies, like solar, will take a higher hit as opposed to wind). At EBITDA level, the 7% generation tax introduced in Spain in the beginning of 2013 will also impact results though at a much lesser extent (expected to be EUR 43 million in 2014).

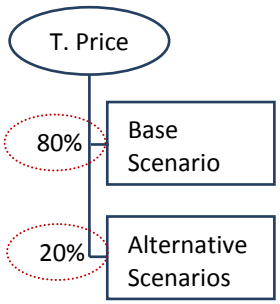
We estimate Iberdrola *Renovables* to yield a ROIC around 4%[51] in the short to medium term (with a tendency to increase as renewable technological costs decrease). The industry average return on investment for Iberdrola's peers is around 3.36%[52] actually. This spread over the average reflects clearly Iberdrola's bet on the "good" renewable energy, that is, wind energy rather than other more expensive technologies and the more effective management of those assets.

Fair Value

We value Iberdrola at EUR 4.51 with a Sell rating

We value Iberdrola with a Sell rating at EUR 4.51 based on a blended sum-of-the-part valuation (80% attributed to the base scenario and 20% to three different adverse scenarios). The core businesses (network, generation and renewable businesses) are valued using a discounted cash-flow model in order to better track the value generating units for Iberdrola. The other non-energy business is valued with a mere multiples approach as it represents a small portion of Iberdrola's results (0.4% of EBITDA). As for the financial participations, we value EDP and Gamesa based on their current share price and others at book values.

Figure 59: Valuation approach

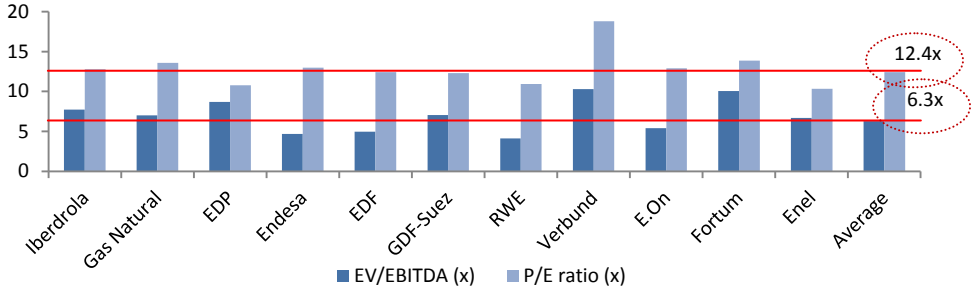


Source: Analyst's Research

We attribute to Iberdrola a Sell rating in light of the 2.1% downside. The market is still not totally incorporating the impact of Spanish regulation on renewable business as full details are still not available. By including in our estimates those impacts we reach a share impact of EUR 0.49 (due to the average EUR 208 million impact for 2014-2018). Iberdrola is currently trading at a premium against its main European peers: 23% in terms of EV/EBITDA (7.72x versus industry 6.30x) and 3% in terms of P/E ratio (12.77 versus 12.40 of industry). We expect these trends to revert in the medium term, thus reiterating our Sell rating.

Figure 60: Iberdrola's multiples versus European peers

Iberdrola is currently trading at premium and we expect it to revert



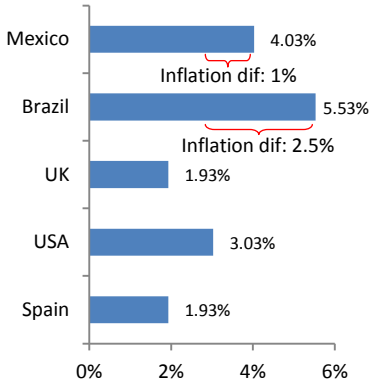
Source: Bloomberg

[51] Note that in the 3st quarter of 2013, Iberdrola had recorded a EUR 602 million write-off hence the sudden drop in ROIC.
[52] Average based on EDPR, Enel Green Power and NextEra. Source: Reuters.

The main risks of our valuation arise from 1) the market, as exchange rates and commodity prices may vary considerably from the trends expected. 2) Regulation, as reduction of the tariff deficit may be overestimated (driven mostly by overestimated demand) thus adding more regulatory pressure. 3) Lower load factors, as Iberdrola's output mix makes it dependent on the weather conditions. 4) And finally the potential overhang risk from ACS and Bankia's stakes.

Discount Factors

Figure 61: Risk-free rates



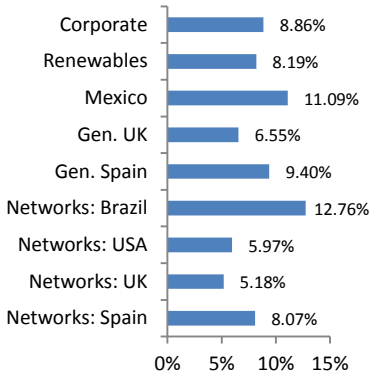
Source: Bloomberg and Analyst's estimates

We estimate each segment cost of equity based on the capital asset pricing model (CAPM)[53] and applying a global (equal for each segment) market risk premium of 6%[54]. As for the risk-free rate we consider the German 10 yr Bund as the benchmark for European countries and the US 10 yr Bond for the USA business. For LatAm countries we assumed the same rate as for the American business plus the spread of inflation to take into account that investors in those markets will require a higher return to compensate the lower purchasing power.

Lower systematic risk on networks, but higher in Brazil

In what concerns the beta, we assumed an individual beta for each of the segments based on the corresponding competitors in those areas. For the network business we used comparable companies like REN and REE that operate only in the transmission business, as systematic risk of transmission and distribution is similar. For the generation and supply business we established a comparable base of integrated companies with a large part of the results coming from both production and supply of energy. As for the renewable business it was used renewable specific utilities detached from the parent's stock (EDPR, Enel Green Power and NextEra). Finally for the Corporate and Adjustments segment we assumed the weighted average of all the comparable considered. With this we reach an average industry beta of 0.45, 0.59, 0.52 and 0.55 respectively. The network beta is significantly lower due to its lower dependence on the economic cycle (regulated business). Additionally we added a country beta based on the local indices returns (vs MSCI World)[55] to reflect each country risk. This analysis yields a higher risk for Spain, Brazil and Mexico (with betas of 1.46, 1.49 and 1.26 respectively) while for US and UK there is no significant additional risk.

Figure 62: Cost of equity

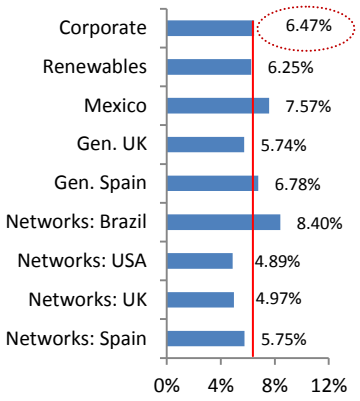


Source: Analyst's estimates

As for Iberdrola's leverage[56] we assumed that in the long-run it will tend towards the industry value. We considered the industry leverage as 0.81. According to Prof. Damodaran it is the average leverage for a western utility company. Using this value we reach the cost of equity for each segment (see appendix VIII).

[53] $R_e = R_f + \beta_{industry} * \beta_{country} * MRP$.
[54] According to Prof. Pablo Fernandez's market survey, the average market risk premium in mature markets used by scholars and analysts varies between 5.5% and 6%. Source: Fernandez, Pablo, Aguirreamalloa, Javier and Corres, Luis, 2012 – *Market Risk Premium used in 82 countries in 2012 a survey with 7,192 answers.* IESE Business School
[55] The indices used were IBEX35, S&P500, FTSE100, IBOV and MEXBOL for a five year period.
[56] Figure considered at market values.

Figure 63: Estimated nominal WACC



Source: Analyst's estimates

Regarding cost of debt we looked at the corporate rating, attributed by the major credit analysts (S&P, Moodys and Fitch) to determine the market expectation on implied cost of debt. The average attributed rating is BBB, which according to Prof. Damodaran, should reflect an average spread of two percent against the riskless asset. Assuming this value and adding it to the German 10 year bund we reached the 3.93% cost of debt (for Brazil and Mexico it was added the inflation differential as well). The weighted average cost of capital is obtained using these rates[57], being on average around 6.47% (see appendix VIII for calculation).

Growth coming from emerging markets

As for the terminal growth, we have assumed for the mature markets values ranging from 0.5% (in generation UK as a consequence of its low return on investment) and 1.5% (in network UK due to higher return). We considered this rate as plausible given the low potential of the markets (rate well below the long-term nominal growth for each country) as the energy sector is already very developed in those markets (most population has access to energy for instance). For the LatAm countries we assumed a higher terminal growth of 3% in Brazil and in Mexico. In the US the GDP contribution of the electricity business is around 1.94% while in Brazil is 3.10%. We considered that in the long-term LatAm electricity contribution will reach the same value of the mature countries (assume equal to US). This equated with Brazil and Mexico's growth (2.3% and 3% respectively) leads to a real growth in the electricity sector of 1.54% and 2.04%. Additionally we considered the terminal return on investment of each segment to determine the final growth rate reasonability. For the renewable we assumed a 1.5% growth as most of investments are located in mature markets. The implicit average payout rate given this growth rates is 78%, which is consistent with our estimates (upper bound of company's guidance used).

Financial Investments

We consider NeoEnergia as a strategic asset, while EDP and Gamesa might be used for delevaraging

Iberdrola currently holds several equity investments in its books, having some been already sold during the year (like the cases of Euskaltel and Megaz stakes). The most determinant stakes held are the participations in Energias de Portugal (EDP), Gamesa and, in 2014, NeoEnergia. We value EDP and Gamesa using the current market value of its stocks as it best reflects its current value in case Iberdrola decides to sell part of those stakes (as part of the divestments support for deleveraging). This translates in an added value for Iberdrola of EUR 474 million. We value NeoEnergia using a DCF method as we consider this business as core for Iberdrola's international position and growth strategy. We make the same assumptions as for Elektro's business (8.41% WACC and a 3% growth rate) reaching a final valuation of EUR 2,429 million for the 39% stake in the

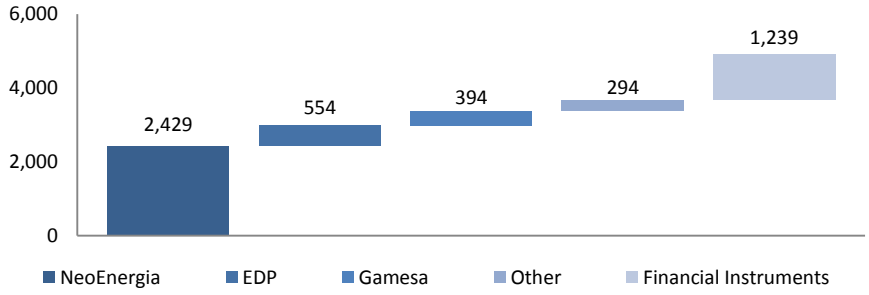
[57] $WACC = \frac{D}{D+E} * R_d * (1-t) + \frac{E}{D+E} * R_e$

Figure 64: NeoEnergia ROIC vs WACC

Source: Analyst's estimates

company. Based on our valuation assumptions we forecast NeoEnergia's ROIC to fluctuate around 9.60% over the next five years, a figure relatively higher than our cost of capital, hence the strategic value. The remaining equity stakes (Amara, Anselmo Leon and other minor stakes) are valued using the book values as these are only minor stakes. Additionally we incorporate here the financial instruments used by the company to hedge risks (both exchange rate and interest rate risk). We expect these values to reach EUR 1,533 million in 2014[58].

Figure 65: Financial instruments valuation (€ M)



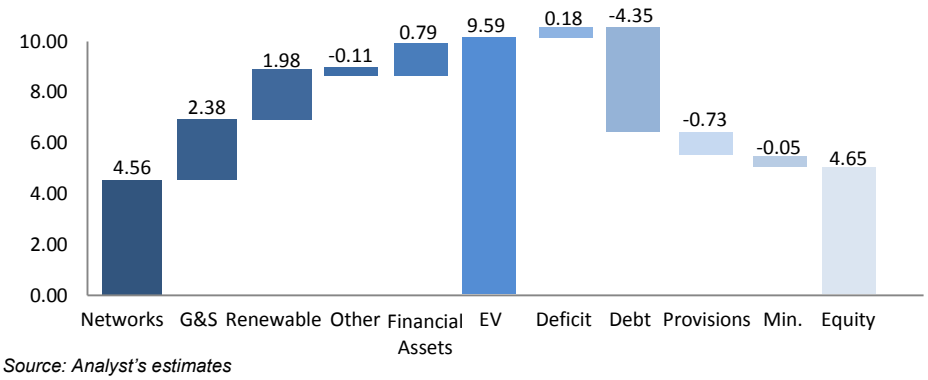
Source: Company data and Analyst's estimates

Sum-of-the-parts

Network business is the most valuable for Iberdrola

Our base scenario implies a EUR 4.65 value per share. As highlighted previously we believe most of the value is derived from the regulated network business (more than 50% of the enterprise value) as it presents a more stable environment and capital needs are lower. As presented by Iberdrola's management, all segments are cash flow positive this year. The renewable business exhibits the higher growth profile to Iberdrola, with a contribution to enterprise value higher than the current contribution to EBITDA (22% versus 21%). As for the generation business no large growth is expected in the mature markets, being Mexico a good opportunity for the segment to grow (7% of EV vs 5% of EBITDA).

Figure 66: Sum-of-the-parts (€)[59]



Source: Analyst's estimates

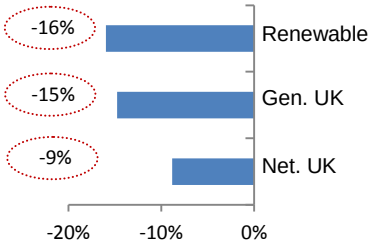
[58] We consider the book value as the fair value of the instruments since derivative contracts are very liquid and no arbitraging opportunities exist here (no major difference between book and market value).
[59] The deductions on enterprise value were considered at the book values of 2014.

Table 9: Scenario analysis

Scenario	Prob.	Value(€)
Base Case	80%	4.65
Regulatory Changes in Europe	10%	4.06
Lower Load Factors	7.5%	4.35
New Financial Crisis	2.5%	2.55
Expected Value	***100%***	***4.51***

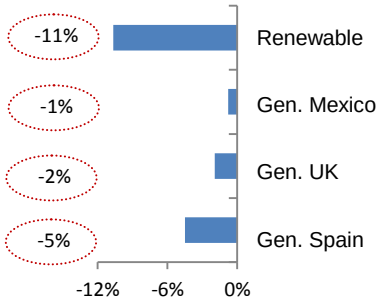
Source: Analyst's estimates

Figure 67: Regulatory scenario impact



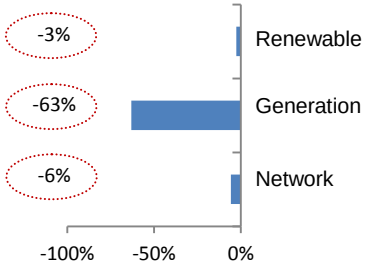
Source: Analyst's research

Figure 68: Weather scenario impact



Source: Analyst's research

Figure 69: Financial crisis scenario impact



Source: Analyst's research

Alternative Scenarios

Our DCF analysis is based on several set of assumptions that can change substantially our final recommendation (as we highlighted in our risk statement). To reduce this risk it was included in our valuation three different scenarios where a set of assumptions were stressed. It was attributed an 80:20 split between the base case scenario and the alternative stressed scenarios.

One scenario considered regards the regulatory pressure in Europe. As highlighted, in several European countries (like UK and Germany) discussions about the affordability of the energy policy is being discussed as the increase of renewable energy in the generation mix is increasing the burden of household bills. In this scenario we assumed a deteriorated environment for renewable energy, with lower remuneration schemes and higher taxation on energy[60], creating fewer incentives to renewable investments (making thermal load factors increase in the long run as the repowering of renewable facilities does not occur). We assumed a 20% reduction in feed-in tariffs, consistent with our forecasts for the RDL 9/2013 in Spain, an increase in levies and reduction of network revenue. Under this scenario a much lower valuation is reached, of EUR 4.06 per share.

The second scenario considered regards weather conditions. Iberdrola is placed as one of the top player in renewable energy both in wind and hydro energy. The output of these technologies is very unpredictable as weather conditions are the main driver and these are uncontrollable (if there is more wind in the region the output will be higher). As such we introduced a scenario where wind and hydro load factors are stressed (assumed by 5% reflecting year 2012 Spanish values), being replaced by gas. This scenario reflects a cut of 6% to our base case.

As referred in the section *"Economic Profile"*, Spain, and other peripheral countries in Europe, is recovering from a sovereign debt crisis that occurred due to the high deficit in the country. So far we assumed that Spain and Portugal will recover from this crisis starting next year but the situation may deteriorate specially in Portugal has the excessive cuts in public spending are reflecting negatively in the overall economy creating a snow ball effect (more public employees being fired, lower private spending, more difficulties for small companies). This is a major source of risk for Iberdrola. Despite its international presence (that mitigates some of this risk) the dragging of the sovereign crisis will harm countries all over Europe spreading also to the international areas of Iberdrola. We assumed here a scenario where growth perspectives deteriorate (GDP growth two percent lower and inflation cut to half) reflecting also on demand for electricity and achieved prices. Additionally it will be harder to charge

[60] In this scenario it was only included UK as in Spain regulatory measures have already been made.

clients and even some will go bankrupt. Using these stressed assumptions, the impact on the share price would be of 45%, reducing to EUR 2.55.

Sensitivity Analysis

Table 10: Share price sensitivity to growth determinants (€)

RR (% change) \ ROIC (% change)	-10%	-5%	0%	5%	10%
-10%	4.35	4.41	4.48	4.55	4.63
-5%	4.41	4.49	4.56	4.64	4.72
0%	4.48	4.56	4.65	4.73	4.82
5%	4.55	4.64	4.73	4.82	4.92
10%	4.63	4.72	4.82	4.92	5.03

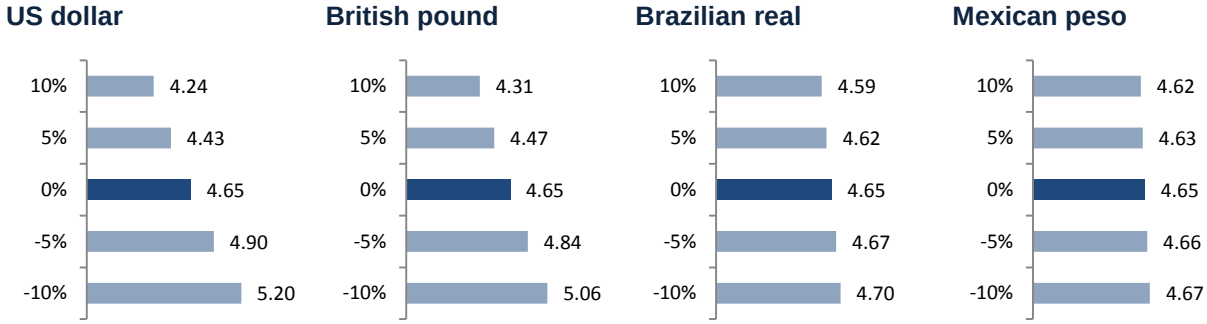
Source: Analyst's research

In addition to the scenarios included in the valuation we also performed a sensitivity analysis to our base valuation. Again, a DCF analysis is very dependent on its inputs making it important to analyze the impact of changes in assumptions. One of the main inputs regards the terminal growth, being especially important for LatAm countries as they present Iberdrola's drivers for growth. We analyzed the sensibility of our base valuation to the inputs of growth (return and reinvestment rate) and reached values ranging from EUR 4.35-5.03.

Higher sensibility to developed currencies

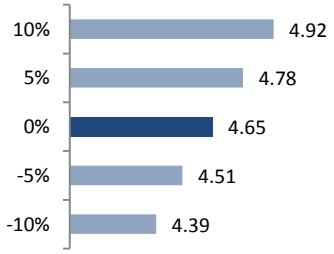
A second analysis that should be made regards the sensibility to exchange rate. Currently more than 50% of Iberdrola's EBITDA is originated outside Spain and more specifically in countries with a different currency. This makes earnings sensible to changes in exchange rate (as occurred during the last nine months – euro appreciation lead to an EBITDA loss of EUR 150 million). Therefore we also performed a sensitivity analysis on our exchange rate assumptions. Unsurprisingly Iberdrola is more exposed to US dollar and British pound (even considering the hedge from the local currency debt) given that commodity prices are pegged to dollars and the size of Iberdrola's operations in those markets. Regarding real and pesos, the value is less sensible as the weight on those markets is lower (notice that these currencies are also the most volatile ones).

Figure 70: Share price sensitivity to changes in exchange rate (€)



Source: Analyst's research

Figure 71: Share price sensitivity to changes in gas price (€)



Source: Analyst's research

During the section *"Power Prices"* we highlighted the positive correlation between natural gas prices on Iberdrola's stock performance. The evolution of natural gas prices is very important for utility companies in general not only because this is one of the major sources for electricity production but also because it drives wholesale electricity prices (higher natural gas price leads to higher wholesale price – assuming it is the marginal technology). In our analysis a 10% increase in natural gas prices would lead to a 5.3% increase in Iberdrola's stock value. On the other hand a decrease would lead to a 5.0% decrease in stock price.

Appendix

Appendix I: Internationalization Program

2001: - Start of strategic plan of internationalization

2007: - Acquisition of Scottish Power for a total of EUR 17.1 bn (financed 54% with debt)

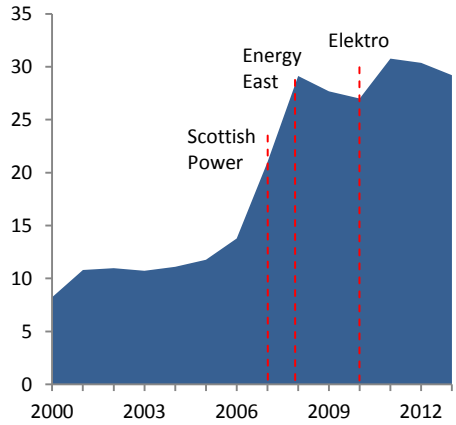
- Iberdrola Renewable's IPO (cash received amounted EUR 4.5 bn)

2008: - Acquisition of Energy East for EUR 6.4 bn (48% debt)

2011: - Acquisition of Elektro financed with cash and debt in a total of EUR 1.6 bn

- Merger of Iberdrola Renewable for an amount of EUR 2.5 bn

Figure 72: Historical indebtedness[61]



Source: Company data and Analyst's estimate

Appendix II: Investment Plan

Table 11: Investment details for upcoming years

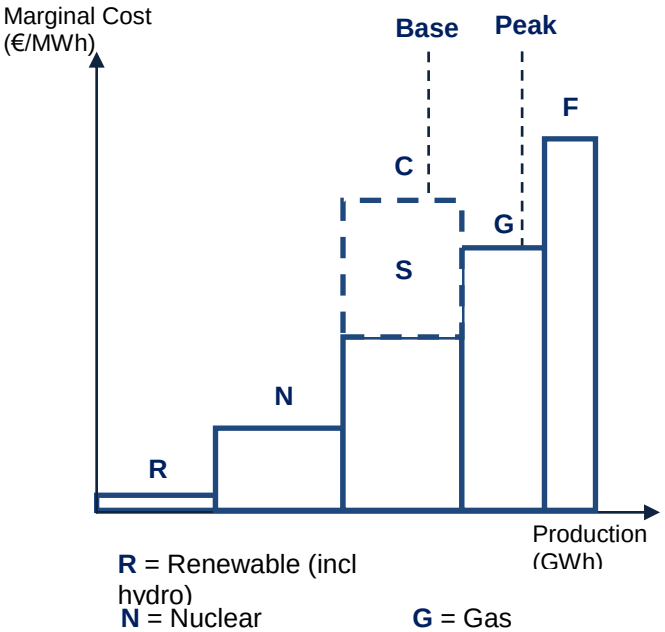
Name/Location	Type	Capacity (MWh)	Beginning
2012-2014			
West Duddon Sands offshore, UK	Wind		2014
Whitelle extension onshore, UK	Wind		2014
Onshore, Brazil	Wind		2013
Teles Pires, Brazil	Hydro	900	2014
Baixo Iguaçu and Belo Monte, Brazil	Hydro	1,500	2016
RIIO-T1 and DPCR5, UK	Networks		
MPRP, US	Networks		2014
Smart meters	Networks		
2015 - onwards			
MPRP, US	Networks		2016
Main Power Connection, US	Networks		
Western Main, US	Networks		
Energy Highway in NY, US	Networks		
RIIO-T1 and RIIO-ED1, UK	Networks		
Eastern HVDC and Transmission, UK	Networks		
Smart meters	Networks		
CCGT, UK	Gas	1,900	
Off and onshore projects (UK/Germ/Fr/Br/Mex)	Wind		
Baixo Iguaçu and Belo Monte, Brazil	Hydro	1,500	2016

[61] When comparing the acquisition values and our valuation of each segment (as proxy) we can see that there was some overpayment (even considering annual synergies, expected to be EUR 266 for Scottish Power in 2010 according to the company), which reflected in the stock performance (started decreasing in 2008 – after realization of synergies).

Appendix III: Eletricity Market Dynamics

1) Each day is determined an estimate for the next day demand and supply (daily market).
2) Special regime production has priority in supply.
3) Ordinary regime producers bid the energy at their marginal cost.
4) The plants capable of producing at lower costs will be the ones satisfying demand.
5) The most expensive one at satisfying demand determines the wholesale price.
6) At the intraday market, the adjustments to the estimates are made (i.e. if there is less wind than estimated more marginal plants will enter).
7) In Spain there is a subsidy for national coal, which makes the less competitive energy (coal) to enter the market rather than gas.

Figure 73: Merit order system

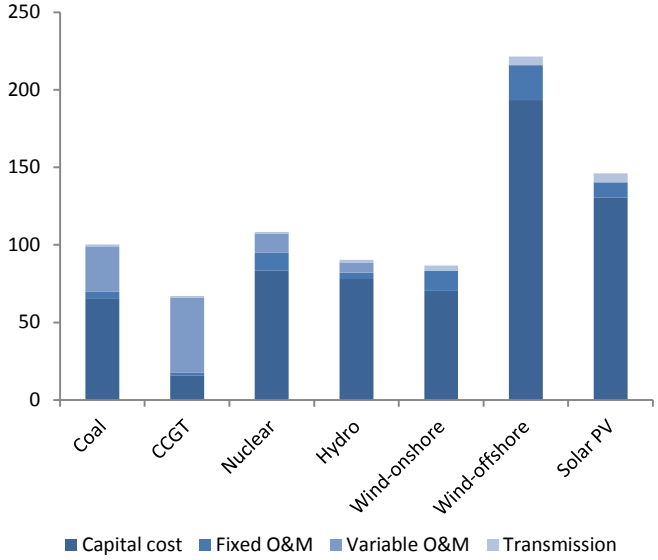


R = Renewable (incl hydro)
N = Nuclear
G = Gas
C = Coal
F = Fuel-oil
S = Subsidy to national coal

Appendix IV: Technology Costs

1) Figure 74 presents EIA's estimates of the levelized costs for operating a new plant in 2018.
2) CCGT plants will still be more competitive than coal, but marginal costs (variable O&M) will be higher than coal.
3) Mature (onshore) wind will be competitive with remaining technologies.
4) By 2040 it is expected that wind energy will be the most competitive one, as variable costs of fuel increase.
5) Government's expectation is that capital costs for other renewable energy reduce, hence the support for the development of the technology.

Figure 74: Levelized costs ($/MWh)



Source: EIA

Appendix V: Spanish Regulation

Table 12: Spanish regulatory changes in 2013

Royal Decree 15/2012	Royal Decree 9/2013
Tax on energy generation: All producers of electricity must pay a 7% tax on the amount collected from the sale in the market. **Impact on System:** EUR 819 million in 2014 **Impact on IBE:** EUR 153 million in 2014 Tax on nuclear production: Nuclear producers must spend 2.19 € per kg of heavy waste resulting from electricity generation. **Impact on System:** EUR 375 million in 2014 **Impact on IBE:** EUR 143 million in 2014 New Green Cent: Taxation on units producing hydrocarbons according to technology: gasoil 307 €/1000 liters; natural gas 1.15 €/gj[62]. **Impact on System:** EUR 898 million in 2014 **Impact on IBE:** EUR 58 million in 2014 Hydro cannon: The utilization of continental waters is subject to a 22% tax on the amount received from production. **Impact on System:** EUR 285 million in 2014 **Impact on IBE:** EUR 186 million in 2014	Distribution and transmission remuneration: New regulatory remuneration based on the costs of an efficient company and remuneration based on the Spanish 10yr government bonds plus a 2% spread. **Impact on System:** EUR 1,000 million in 2014 **Impact on IBE:** EUR 155 million in 2014 Capacity payments: Incentives for new capacity investment are reduced to 10,000 €/MWh at an extended 20 years period. **Impact on System:** EUR 300 million in 2014 **Impact on IBE:** EUR 84 million in 2014 New remuneration for renewable plants: The remuneration system will be based on a return, before taxes, equal to the yield of the Spanish 10yr bond plus a 300 bps spread. **Impact on System:** EUR 1,500 million in 2014 **Impact on IBE:** EUR 208 million in 2014 Social bonus: Chargeable to parent companies instead of being transferred to customers. **Impact on System:** EUR 250 million in 2014 **Impact on IBE:** EUR 55 million in 2014 Non-mainland costs[63]: Half to be included in State's budget. **Impact on System:** EUR 910 million in 2014

Source: BOE and Analyst's estimates

[62] More detail in Boletín Oficial del Estado: Ley 15/2012 – Disposiciones Generales.
[63] This contribution was withdrawn for 2013 only.

Appendix VI: Spanish Deficit Forecasts

Table 13: Spanish tariff deficit (€ M)

	2012	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
Demand (GWh)	247,500	242,097	241,350	241,812	242,329	243,256	244,925	246,792	248,614
Access Tariff (€/MWh)	59.37	61.75	62.67	62.99	63.30	63.62	63.94	64.26	64.58
Tariff Revenue	***14,695***	***14,949***	***15,126***	***15,231***	***15,340***	***15,475***	***15,659***	***15,858***	***16,055***
Other Revenues	209	172	188	201	192	188	192	193	192
Generation Tax		759	883	884	884	894	916	945	985
Hydro cannon		384	308	305	301	302	305	312	321
Nuclear Waste[64]		372	375	369	373	372	374	374	374
Green Cent		696	898	891	894	895	900	904	909
Emission Allowances		94	121	120	120	121	121	122	122
Total System Revenue	***14,904***	***17,426***	***17,898***	***18,000***	***18,104***	***18,247***	***18,468***	***18,708***	***18,958***
Renewable Overcost	8,586	8,898	6,950	6,849	7,044	7,067	7,066	7,077	7,127
Transmission Cost	1,477	1,542	1,549	1,557	1,565	1,573	1,581	1,588	1,596
Distribution Cost	5,005	5,153	4,878	4,685	4,682	4,686	4,725	4,765	4,795
Bono Social	202	253	0	0	0	0	0	0	0
Non-Mainland Costs	1,650	1,733	910	888	899	894	896	895	896
Previous Deficit[65]	3,184	3,302	3,689	3,667	3,593	3,521	3,421	3,295	3,140
Other System Costs[66]	376	183	341	278	207	227	247	260	244
Total System Cost	***20,481***	***21,064***	***18,317***	***17,925***	***17,990***	***17,967***	***17,936***	***17,881***	***17,798***
Other Differences	-32	-55	-35	-97	-153	-74	-83	-83	-88
Superavit/(Deficit)	***-5,609***	***-3,693***	***-453***	***-22***	***-39***	***206***	***449***	***744***	***1,073***

Source: CNE and Analyst's estimates

Appendix VII: Comparables

Table 14: Market comparison

	Last Price (€)	Market Cap. (€ M)	EV/EBITDA 13	EV/EBITDA 14	P/E 13	P/E 14	Dividend Yield	Net Debt to EBITDA	Beta
Gas Natural	18.71	18,723	6.90	7.03	13.33	13.59	4.79%	2.90	0.96
EDP	2.68	9,803	8.61	8.70	9.89	10.77	6.90%	5.13	0.95
Endesa	21.34	22,588	4.53	4.69	12.69	12.98	7.03%	0.12	0.85
EDF	25.62	47,368	5.16	4.98	13.61	12.41	4.88%	2.27	1.01
GDF Suez	16.75	40,403	6.91	7.05	11.97	12.31	8.96%	2.34	0.98
RWE	25.59	15,603	3.58	4.14	6.56	10.93	3.90%	1.10	0.96
Verbund	15.48	5,376	8.17	10.31	12.51	18.80	3.88%	1.86	0.81
E.On	13.18	26,373	5.05	5.41	11.01	12.88	8.37%	1.78	0.99
Fortum	16.53	14,685	9.64	10.05	13.34	13.86	6.05%	3.26	0.78
Enel	3.18	29,884	6.46	6.68	9.96	10.35	4.72%	3.35	1.02
Iberdrola	4.61	28,773	7.49	7.72	11.53	12.77	5.86%	4.68	1.06
Average			***6.25***	***6.45***	***11.74***	***12.44***	***6.20%***	***2.57***	***0.97***

Source: Bloomberg (Date: 3/1/2014)

[64] We assumed that the average nuclear (same logic for other technologies) facility for Iberdrola represented the average Spanish facility. Using Iberdrola's estimated taxation and production we forecasted the whole Spanish taxation.
[65] This figure includes remuneration for the securitized deficits.
[66] This figure includes capacity payments, network quality payments and costs from the national operator.

Appendix VIII: Cost of Capital

Table 15: Segmental cost of capital

	Unlevered Beta	D/E	Tax Rate	Levered Beta	Risk-Free	Country Premium[67]	Market Premium	Cost of Equity	Cost of Debt	WACC
Networks: Spain	0.45	0.81	0.30	0.71	1.93%	1.46	6.00%	8.19%	3.93%	5.75%
Networks: UK	0.45	0.81	0.24	0.73	1.93%	1.06	6.00%	6.58%	3.93%	4.97%
Networks: USA	0.45	0.81	0.35	0.69	3.03%	0.90	6.00%	6.78%	3.93%	4.89%
Networks: Brazil	0.45	0.81	0.34	0.70	5.53%	1.49	6.00%	11.78%	6.43%	8.41%
Gen. Spain	0.59	0.81	0.30	0.93	1.93%	1.46	6.00%	10.06%	3.93%	6.79%
Gen. UK	0.59	0.81	0.24	0.95	1.93%	1.06	6.00%	7.97%	3.93%	5.74%
Mexico	0.59	0.81	0.30	0.93	4.03%	1.24	6.00%	10.92%	4.93%	7.58%
Renewables	0.52	0.81	0.31	0.82	1.93%	1.46	6.00%	9.11%	3.93%	6.24%
Corporate	0.55	0.81	0.30	0.86	1.93%	1.46	6.00%	9.49%	3.93%	6.47%

Source: Analyst's research

Appendix IX: Sum-of-the-Parts

Table 16: Sum-of-the-parts

(€ Millions)	Enterprise Value	% of Value	EBITDA Multiple	Methodology
Networks	***28,427***	***52%***	***8.63***	
Spain	12,147	22%	9.48	DCF @ 5.75%
UK	7,779	14%	7.96	DCF @ 4.97%
USA	6,581	12%	9.03	DCF @ 4.89%
Brazil	1,919	3%	6.26	DCF @ 8.41%
Generation and Supply	***14,848***	***27%***	***7.76***	
Spain	7,852	14%	6.53	DCF @ 6.79%
UK	2,900	5%	7.88	DCF @ 5.74%
Mexico	4,096	7%	11.92	DCF @ 7.58%
Renewables	12,327	22%	7.69	DCF @ 6.23%
Non-Energy Business	244	0%	6.58	EV/EBITDA14Y
Corporate and Adjustments	-921	-2%		DCF @ 6.63%
Core Business	***54,924***	***100%***	***8.08***	
Financial Investments	4,910			Book/Market Value
Total Enterprise Value	***59,833***			
Revenue Shortfall	1,123			
Adjusted Net Debt	26,317			
Tax Equity Investment	366			
Hybrid Debt	447			
Pension Funds	1,957			
Other Provisions	2,584			
Minorities	301			
Equity Value	***28,985***			
Shares Outstanding	6,240			
SOTP Share Value	***4.65***			

Source: Analyst's research

[67] Standard deviation and R-squared are: Spain (0.14; 0.64), USA (0.03; 0.94), UK (0.05; 0.90), Brazil (0.15; 0.63) and Mexico (0.09; 0.76). Despite some of this risk being diversifiable we deem this metric in the risk analysis.

Financial Statements

EUR million	2011	2012	2013E	2014E	2015E	2016E	2017E	2018E
Income Statement								
Revenue	31,648	34,201	32,824	32,542	32,784	32,953	33,000	33,382
Procurement	-19,622	-21,623	-20,198	-20,615	-20,718	-20,823	-20,817	-21,058
Gross Margin	***12,026***	***12,578***	***12,626***	***11,927***	***12,066***	***12,130***	***12,183***	***12,324***
EBITDA	***7,650***	***7,727***	***7,361***	***6,794***	***6,845***	***6,863***	***6,878***	***6,977***
Depreciation and Amortization	-3,145	-3,350	-4,833	-2,758	-2,760	-2,863	-2,896	-2,898
EBIT	***4,505***	***4,377***	***2,528***	***4,036***	***4,085***	***3,999***	***3,982***	***4,079***
Other Results	11	-202	-3	26	-6	-46	-47	-16
Net Financial Costs	-1,062	-1,100	-1,254	-1,103	-1,052	-1,058	-1,072	-1,090
Earnings before Taxes	***3,454***	***3,075***	***1,270***	***2,959***	***3,027***	***2,895***	***2,863***	***2,973***
Income Taxes	-549	-207	1,479	-613	-620	-552	-516	-578
Minorities	-101	-28	-41	-35	-35	-35	-35	-35
Net Profit	***2,805***	***2,841***	***2,709***	***2,311***	***2,372***	***2,309***	***2,313***	***2,360***
Balance Sheet								
Fixed Assets	73,202	73,346	70,581	68,980	69,992	70,765	71,472	72,262
Financial Investments	7,978	6,811	4,493	5,478	5,341	5,245	5,075	4,796
Receivables	6,761	6,894	6,495	6,625	6,629	6,644	6,692	6,778
Cash and Equivalents	2,091	3,044	1,856	1,853	1,764	1,833	1,816	1,806
Other Assets	6,986	6,721	8,784	8,184	7,588	7,696	7,800	8,117
Total Assets	***97,017***	***96,816***	***92,208***	***91,119***	***91,313***	***92,182***	***92,854***	***93,759***
Financial Debt	34,464	33,361	29,892	28,723	28,608	28,809	29,054	29,289
Payables	9,516	8,976	8,044	8,475	8,573	8,626	8,674	8,765
Other Liabilities	19,829	20,394	19,199	19,211	19,497	19,803	19,820	20,048
Total Liabilities	***63,809***	***62,732***	***57,134***	***56,408***	***56,678***	***57,239***	***57,549***	***58,102***
Shareholder's Equity	***33,209***	***34,085***	***35,073***	***34,711***	***34,636***	***34,944***	***35,306***	***35,657***
Cash Flow Statement								
EBIT	4,505	4,377	2,528	4,036	4,085	3,999	3,982	4,079
NOPLAT	***3,637***	***3,777***	***3,621***	***3,092***	***3,142***	***3,110***	***3,125***	***3,163***
Depreciation and Amortizations	3,145	3,350	4,833	2,758	2,760	2,863	2,896	2,898
Gross Operating Cash Flow	***6,782***	***7,127***	***8,454***	***5,850***	***5,902***	***5,973***	***6,020***	***6,060***
Net CAPEX	7,503	3,494	2,069	3,355	3,773	3,636	3,602	3,688
Changes in Working Capital	724	673	515	-291	-180	51	-32	6
Other Cash Flows	-1,549	-900	-230	-73	-1,016	-282	-33	-198
Free Cash Flow	***105***	***3,860***	***6,099***	***2,859***	***3,326***	***2,568***	***2,484***	***2,564***
Changes in Financial Debt	1,993	-1,103	-3,470	-362	-115	201	245	235
Interest Paid	-1,062	-1,100	-1,254	-1,103	-1,052	-1,058	-1,072	-1,090
Tax Shield	324	335	385	339	323	324	329	335
Dividends Paid	1,982	1,842	1,761	1,733	1,779	1,731	1,735	1,770
Cash to Reserves[68]	***622***	***-150***	***0***	***0***	***-703***	***-304***	***-251***	***-274***

Source: Analyst's research

[68] Includes share buy-backs from script dividend.

Disclosures and Disclaimer

Research Recommendations

Buy	Expected total return (including dividends) of more than 15% over a 12-month period.
Hold	Expected total return (including dividends) between 0% and 15% over a 12-month period.
Sell	Expected negative total return (including dividends) over a 12-month period.

This report was prepared by André Chen, a student of the NOVA School of Business and Economics, following the Masters in Finance Equity Research – Field Lab Work Project, exclusively for academic purposes. Thus, the author, which is a Masters in Finance student, is the sole responsible for the information and estimates contained herein and for the opinions expressed, which reflect exclusively his own personal judgement. This report was supervised by Professor Rosário André (registered with Comissão do Mercado de Valores Mobiliários as financial analyst) who revised the valuation methodology and the financial model. All opinions and estimates are subject to change without notice. NOVA SBE or its faculty accepts no responsibility whatsoever for the content of this report nor for any consequences of its use.

The information contained herein has been compiled by students from public sources believed to be reliable, but NOVA SBE or the students make no representation that it is accurate or complete, and accept no liability whatsoever for any direct or indirect loss resulting from the use of this report or its content.

The author hereby certifies that the views expressed in this report accurately reflect his personal opinion about the subject company and its securities. He has not received or been promised any direct or indirect compensation for expressing the opinions or recommendation included in this report.

The author of this report may have a position, or otherwise be interested, in transactions in securities which are directly or indirectly the subject of this report.

NOVA SBE may have received compensation from the subject company during the last 12 months related to its fund raising program. Nevertheless, no compensation eventually received by NOVA SBE is in any way related to or dependent on the opinions expressed in this report.

The Nova School of Business and Economics, though registered with Comissão do Mercado de Valores Mobiliários, does not deal for or otherwise offers any investment or intermediation services to market counterparties, private or intermediate customers.

This report may not be reproduced, distributed or published without the explicit previous consent of its author, unless when used by NOVA SBE for academic purposes only. At any time, NOVA SBE may decide to suspend this report reproduction or distribution without further notice.