

EQUITY NOTE: PANNERGY NYRT.

Recommendation: BUY

Target price (12M): HUF 1,032

21 March 2018

Highlights

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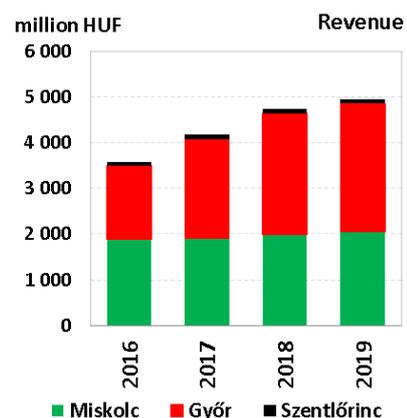
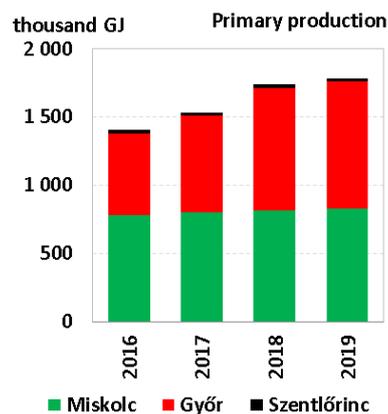
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Pannergy's performance in 2017 was slightly better than we had thought. This is because of the slightly better-than-expected output and the stronger-than-expected cost reduction, which improved profitability ratios significantly compared to 2016. The financial results are mainly in line with our view on the company, but in recent months the outstanding amount of shares increased (due to the managerial share option programme) which warrant a small adjustment to our target price. But this effect was compensated by the increase in secondary heat sales and the lower-than-expected net debt levels at the end of the year. Moreover, we updated the relative valuation analysis as new data arrived for the peer companies as well. As a result, **our target price for the next 12 months changed from HUF 1,024 to HUF 1,032, which is 41% above Tuesday's closing price, and we maintain our BUY recommendation.**

No dividend will be paid this time, but Pannergy wants to initiate a share buyback programme worth HUF 1 bn, with a maximum purchase price of HUF 950. We see this move as neutral to our target price, but this could send a positive signal, as it could mean that the company sees itself as a good investment.

Financial highlights of Q4 earnings report

Revenue is up 4% compared to 2016. In 2017 overall 1,538,556 GJ heat was sold; this is 11% more than in 2016. The main driver behind this increase was the fact that the Győr project operated at almost full capacity, but the small rise in the production of the Miskolc plant also contributed. Overall revenue was HUF 4.7 billion, of which revenue from geothermal heat sales was almost HUF 4 bn. In the Győr project there was a delay in production in September and October, for which the company was fully compensated, but this compensation appears among other revenues.

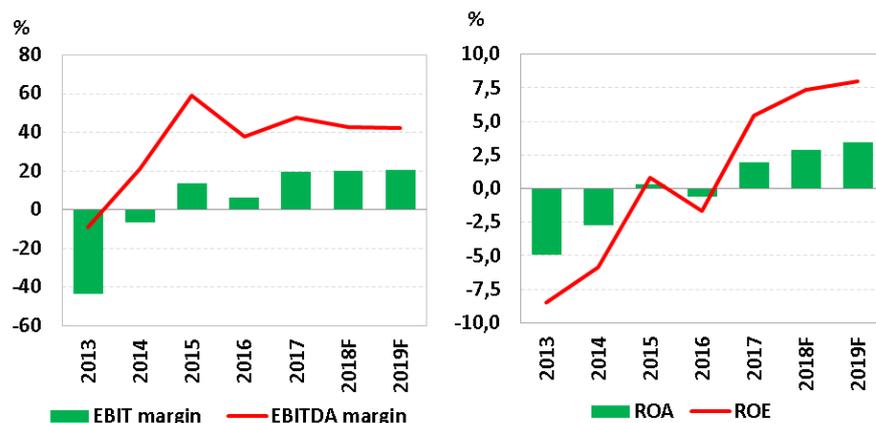


General and administrative expenses fell by 28% compared to 2016. The numbers show that Pannergy was successful in reducing non-production-related costs, its priority in 2017. Among the general and administrative costs, all types of costs dropped except the cost of banking, which rose slightly.

Depreciation and amortization grew from HUF 1,196 million to 1,300 million. The higher depreciation reflects the effect of previously realized investments, which is mainly related to the Győr Project.

Due to the expanding production and smaller non-operational costs, EBITDA was HUF 2,245 bn, a 31% increase compared to 2016. Looking ahead, Pannergy's EBITDA is likely to improve further due to the following: (1) the new capacity will come online in Győr in 2018, (2) further improvement in the production efficiency of the Miskolc and Győr projects is possible. Both of them are included in our forecast.

Pannergy's EBIT increased from HUF 280 million to HUF 923 million. Net financing costs fell significantly, from HUF 411 million to HUF 297 million. This improvement stems from the fact that Pannergy refinanced some of its loans in 2017, taking advantage of the low interest rate environment. As we mentioned in our initiation report, these loans are effectively fixed-rate loans (through the use of interest rate swaps), so any rise in interest rates would leave the company's existing financing costs largely unaffected.



Accordingly, net income grew impressively, from HUF -151 million to HUF 488 million. Overall, the company's profitability ratios improved substantially. **Looking ahead, we expect the profitability ratios to improve further in the next two years, albeit at a smaller pace.** The increase in profitability will come from the completion of the Győr Project and the possible increase in production efficiency in Győr and Miskolc projects. A significant increase in the secondary heat sales could further improve Pannergy's financial position.

Share buyback programme and dividend policy

The board of directors will propose the general meeting that Pannergy launches a new round of treasury share purchase programme. The available amount for the purchases would be worth HUF 1 bn, and purchases would be possible with the share prices ranging from HUF 1 to HUF 950. The upper limit is based on our latest valuation, minus – possibly – a safety threshold.

It is worth noting that Pannergy had initiated two rounds of share buyback programme before: one in 2016 with HUF 300 million, and another one in April 2017 with HUF 1 bn. The latter was not utilized during its lifetime.

If the general meeting accepts and the management deploys the new share buy-back programme, that would **increase the financial leverage of the company through the decline in cash and cash equivalents, and it will increase earnings per share as the number of shares outstanding decline, but it will not necessarily have any effect on the share price.**

Moreover, the company does not seem to be planning dividend payment this year, which is in line with our previous reasoning. In our initiation report we assumed that dividend could only come when the major investments are finished, and the management has a safe, sound and clear view on the operational and financial capability of the company. **In agreement with our previous view, we maintain that dividend payment could come in 2019 and 2020.**

Theoretically speaking, in some cases **share buyback programmes** could be superior over dividend payment as **it gives** the management **additional financial flexibility** on the amount and timing of the share buyback. Additionally, share buyback programmes could have **a positive signalling effect on the share price**, as it signals that the company views its own stock as a good investment. Finally, share buyback programmes **could be used to offset the dilution effect of the managerial options programme.** Since December 2017, the company's management has called more than 600,000 shares under its programme so it also could be a reason.

Overall, we see this news as neutral to our view on the company, despite the fact that it may have an effect on the share price. Looking ahead, we think that dividend payment is increasingly likely in 2019 and 2020, but its amount will be based on how the management views the company's future. If it sees no additional investment worth making, then dividend could be significant compared to net income, but if the management is looking for new opportunities, then the dividend could only be symbolical.

Other recent news:

On 20.03.2018 Pannergy announced to have bought a minority stake in the Szentlőrinc Geotermia Kft (a Pannergy subsidiary, which manages the Szentlőrinc Project) from the local government of Szentlőrinc for HUF 1 million. Because the transaction is very small, it is a neutral concerning our target price or view on the company.

Change in our valuation based on recent information

Since our initiation report, our broad view on the company's fundamentals has not changed much. However, due to some small changes surrounding the main variables, we updated both our FCFE and relative valuation. The main reasons are the following:

Fundamental valuation:

- The secondary heat sales for the first customer (Innovativ Special Transport Kft) in the Győr location started in November 2017. The company's revenue was around HUF 1 bn and its balance sheet total was HUF 834 million for 2016. Secondary heat sales started in November 2017. We project around HUF 5 million additional revenue on our forecast horizon.
- The amount of outstanding shares grew from 17.7 million to 18.42 million, which weighs on the share price. The increase was due to the calling of shares in the managerial share option programme.

Relative valuation:

- EBITDA for 2017 slightly overshoot our expectation
- New data came in for the peer companies as well and these companies had a very good year as well, which was reflected in their share price as well.

Final valuation:

Taking into account the above reasons, our fundamental share price valuation for the next 12 months decreased from HUF 1,210 to HUF 1,140. The relative valuation of the share price for the next 12 months increased to HUF 924. **Overall, our final valuation changed from HUF 1,024 to HUF 1,032 for the next 12 months, which is 41% above Tuesday's close price.**

Risks surrounding Pannergy's economic activity

1. **Price risk:** The administered price is set at a level that takes into account the cost of doing business and providing a fair profit. However, the administered price setting has inherent risks related to the administrative authority.

Moreover at the moment Pannergy provides heat at a lower cost than its peers (natural gas). However, if natural gas prices fall significantly, then customers who do not have mandatory purchase agreement with Pannergy could switch to other sources of heat.

2. **Environmental risks:** Extreme weather conditions during the heating season could harm the profit target of the company. If the winter season is too short or too cold –due to global warming or other extreme weather conditions– the costs are higher, as the output from the drilling wells drops.

3. **Operational risks:** Maintenance costs increased significantly at the Győr Project in 2016 due to scaling issues concerning the tubing and pumps, and this has reduced

production. Although the problem was dealt with, we identify it as a source of risk in the future as well. This could be a risk to our depreciation forecast as well.

4. **Győr concession project:** Although the geological quality of the area is well researched and known by Pannergy as it has two operating wells nearby, the expected yield on the new well could be a source of risk. Moreover, if the completion of the investment is delayed or it is subject to cost overrun, then this could lower our revenue forecast.

5. **Improving energy efficiency risk:** It is not necessarily a Pannergy-specific risk, but in the long term, the building of passive houses and the coming investment – which increases the energy efficiency of houses and flats – could decrease demand for heat.

Appendix:

| P/L Table consolidated (million HUF) | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F |
|--------------------------------------|-------|-------|-------|-------|-------|-------|
| Revenue | 2 290 | 2 726 | 4 529 | 4 699 | 5 546 | 5 762 |
| Revenue from other operations | 602 | 540 | 897 | 675 | 675 | 675 |
| Revenue from geothermal-heat | 1 688 | 2 186 | 3 632 | 4 024 | 4 732 | 4 954 |
| Other revenue | 55 | 871 | 101 | 537 | 139 | 133 |
| OPEX | 1 808 | 1 983 | 2 914 | 3 012 | 3 178 | 3 319 |
| from which: Depreciation | 635 | 1 241 | 1 435 | 1 300 | 1 259 | 1 249 |
| EBITDA | 482 | 1 614 | 1 715 | 2 241 | 2 368 | 2 443 |
| EBIT | -153 | 373 | 281 | 923 | 1 109 | 1 194 |
| EBT | -434 | 217 | -131 | 626 | 839 | 981 |
| Income Taxes | 95 | 183 | 28 | 121 | 101 | 118 |
| Non-controlling interest | 12 | -44 | -8 | 17 | 23 | 27 |
| Net income | -541 | 78 | -151 | 488 | 716 | 837 |
| EPS (HUF) | -30 | 4 | -9 | 28 | 39 | 45 |

| Key income ratios (%) | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F |
|-----------------------|-------|------|------|------|-------|-------|
| EBITDA margin | 21,0 | 59,2 | 37,9 | 47,7 | 42,7 | 42,4 |
| EBIT margin | -6,7 | 13,7 | 6,2 | 19,6 | 20,0 | 20,7 |
| Net profit margin | -23,6 | 2,9 | -3,3 | 10,4 | 12,9 | 14,5 |
| ROE | -5,8 | 0,8 | -1,7 | 5,4 | 7,4 | 7,9 |
| ROA | -2,7 | 0,3 | -0,6 | 1,9 | 2,9 | 3,4 |

| Cash flow statement (million HUF) | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F |
|-------------------------------------|--------|--------|--------|--------|--------|-------|
| Profit before taxes | -434 | 217 | -131 | 626 | 839 | 981 |
| Cash flow from operations | 561 | -173 | 775 | 1 895 | 1 976 | 2 052 |
| Cash flow from investment | -2 248 | -4 153 | -1 632 | -1 142 | -1 297 | -342 |
| Cash flow from financing activities | 1 661 | 5 089 | 473 | -201 | -555 | -954 |
| Change in cash and cash equivalents | -26 | 763 | -384 | 552 | 124 | 756 |

| Balance sheet - consolidated (million HUF) | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F |
|---|--------|--------|--------|--------|--------|--------|
| Intangible assets | 1 375 | 1 130 | 892 | 1 329 | 1 264 | 1 199 |
| Property, plant and equipment | 15 375 | 20 648 | 20 711 | 19 722 | 19 506 | 18 349 |
| Other non-current assets | 549 | 723 | 678 | 582 | 582 | 582 |
| Non-current assets | 17 299 | 22 502 | 22 282 | 21 633 | 21 352 | 20 130 |
| Inventories | 993 | 312 | 148 | 120 | 129 | 118 |
| Trade receivables | 307 | 1 029 | 1 671 | 1 369 | 1 423 | 1 624 |
| Cash and cash equivalents | 357 | 1 121 | 736 | 1 489 | 1 668 | 2 478 |
| Other current assets | 762 | 1 855 | 422 | 411 | 345 | 245 |
| Current assets | 2 419 | 4 317 | 2 978 | 3 389 | 3 565 | 4 465 |
| Total assets | 19 718 | 26 819 | 25 259 | 25 022 | 24 917 | 24 595 |
| Total equity | 9 259 | 9 331 | 8 889 | 9 025 | 9 733 | 10 558 |
| Long-term loans | 3 887 | 9 143 | 8 858 | 8 795 | 8 367 | 7 339 |
| Other-non current liabilities | 3 204 | 4 885 | 4 621 | 4 271 | 4 308 | 4 059 |
| Non-current liabilities | 7 091 | 14 028 | 13 479 | 13 066 | 12 675 | 11 398 |
| Short-term loans | 553 | 785 | 1 098 | 1 207 | 1 080 | 1 154 |
| Trade payables | 1 363 | 1 696 | 1 170 | 900 | 1 017 | 1 170 |
| Other current liabilities | 1 452 | 978 | 623 | 824 | 412 | 315 |
| Current liabilities | 3 368 | 3 459 | 2 891 | 2 931 | 2 509 | 2 639 |
| Total equity and liabilities | 19 718 | 26 819 | 25 260 | 25 022 | 24 917 | 24 595 |

| Valuation summary (million HUF) | 2018F | 2019F | 2020F | 2021F | 2022F | 2023F | 2024F | 2025F | 2026F | 2027F | Terminal year |
|---------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|---------------|
| Revenue from geothermal heat | 4 732 | 4 954 | 5 053 | 5 154 | 5 257 | 5 362 | 5 469 | 5 579 | 5 690 | 5 804 | 5 920 |
| EBITDA | 2 368 | 2 443 | 2 463 | 2 482 | 2 501 | 2 441 | 2 459 | 2 475 | 2 442 | 2 457 | 2 506 |
| Depreciation | 1 259 | 1 249 | 1 258 | 1 267 | 1 276 | 981 | 990 | 999 | 717 | 726 | 726 |
| Working capital sales | 150 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Capex | 1 043 | 93 | 93 | 93 | 93 | 93 | 93 | 93 | 93 | 93 | 93 |
| FCFF | 1 042 | 2 207 | 2 225 | 2 244 | 2 261 | 2 174 | 2 190 | 2 206 | 2 142 | 2 156 | 2 200 |
| WACC | 7,5 | 7,5 | 7,5 | 7,5 | 7,5 | 7,5 | 7,5 | 7,5 | 7,5 | 7,5 | 9,0 |
| PV(FCFF) | 969 | 1 908 | 1 789 | 1 678 | 1 572 | 1 405 | 1 317 | 1 233 | 1 114 | 1 043 | 13 157 |

| Share price estimation | |
|--------------------------------------|--------|
| Enterprise value | 27 187 |
| Net debt (-) | 8 488 |
| Equity value | 18 699 |
| Number of shares | 18 420 |
| Required return on equity | 12 |
| Target price for the next 12 M (HUF) | 1140 |
| Current price (HUF) | 734 |
| Upside /Downside (%) | 55 |

| Company name | Country | Market capitalization (billion HUF) | EV/EBITDA |
|--------------------|---------|--|-------------|
| US Geothermal | USA | 26,6 | 11,3 |
| Ormat Technologies | USA | 719,6 | 10,4 |
| Alterra Power Corp | Canada | 88,1 | 15,4 |
| ARISE | Germany | 13,2 | 10,0 |
| FERSA | Spain | 19,1 | 9,2 |
| ABO Invest | Germany | 20,7 | 6,7 |
| Northland Power | Canada | 776,8 | 12,8 |
| Falck | Denmark | 202,4 | 8,5 |
| | | Average | 10,5 |
| | | Median | 10,2 |

Notes:

[The initiation report, which contains the assumptions of the models used, is available here.](#)

[The valuation methodology used in this present equity research note to determine our price targets and recommendations is available here. \(Also available in Hungarian\)](#)

This investment recommendation has not used proprietary models.

The risk warning, which includes the adequate explanations of the length of time of the investment to which the recommendation relates as well as a sensitivity analysis of the assumptions, is indicated in the part of this recommendation where the length of time and the risks of the investment are presented.

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OTP Bank Plc's recommendations and price targets history for Pannergy in the past twelve months:

| Date | Recommendations | Target Price | Publication |
|------------|-----------------|--------------|------------------------|
| 15/12/2017 | BUY | HUF 1,024 | Initiation of coverage |
| 16/01/2018 | BUY | HUF 1,024 | Equity note |
| 13/02/2018 | BUY | HUF1,024 | Equity note |

[The list of all recommendations made in the past 12 months is available here.](#)

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