

EQUITY NOTE: PANNERGY NYRT.

Recommendation: BUY

Target price (12M): HUF 1,196

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Highlights

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Overall the production report came in as expected. **In Q4 geothermal heat production amounted to 587,822 GJ, which is 15% higher than a year earlier.** The increase is mainly attributed to base effects stemming from unfavourable weather conditions in Q4 2018. Pannergy's total yearly production was 1,716,718 GJ, almost 20% higher than a year before. The increase can be attributed to two factors: (1) favourable weather conditions in 2019 and (2) the effect of the third well at the Győr location. **Total revenue from geothermal operations could be somewhat above HUF 5 bn in 2019, while the EBITDA margin may have improved to around 50%,** mainly due to an increase in administrative prices (in effect from October 2019). Since the incoming data is in line with our view, the valuation was left unchanged, with a **target price of HUF 1,196 and a maintained buy recommendation.**

Main takeaways from the production report:

Pannergy published its Q4 production report yesterday. The report shows that its overall production was 587,822 GJ in the last quarter of 2019, broadly in line with the management's expectation (590,266 GJ). The fourth-quarter production grew by 15% YoY. Since the figure is in line with the management's expectation, it means that the weather was close to its optimum levels (no negative or positive weather effect) and it also means there were no problems on the cost side.

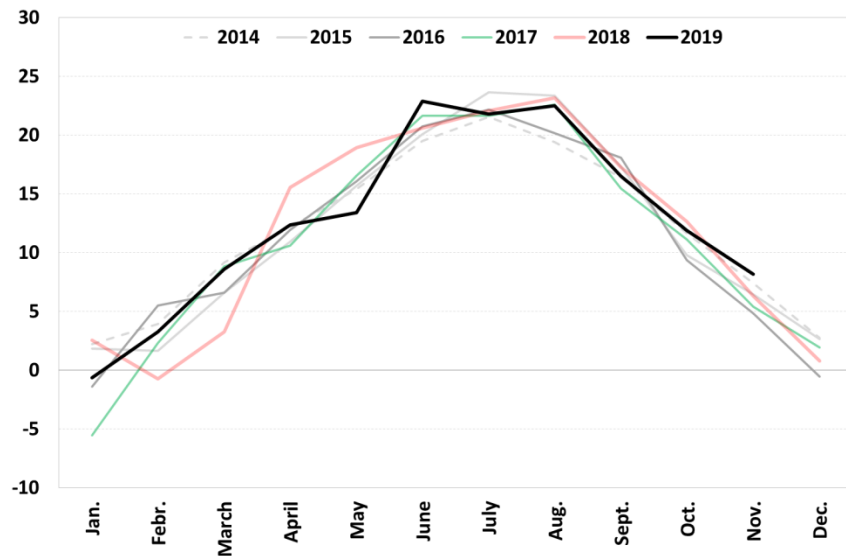
Based on the whole-year number, the revenue from geothermal heat production could amount to HUF 5 bn in 2019 (note that this does not contain the effect of other revenues and one-off items). The EBITDA margin could have improved to around 50% due to an increase in administrative prices in effect from October 2019. All in all, yearly EBITDA could be around HUF 2.6 bn in 2019.

Looking at the breakdown of Q4 production, the Miskolc site produced 289,778 GJ energy, in a 20% growth compared to the same period of 2018. Most of this production improvement can be attributed to base effects: (1) In Q4 2018, the somewhat higher-than-average temperature had reduced demand for heat, (2) due to a smaller problem at the Miskolc site, last year's production was smaller than it could have been. The production report also mentioned that part of the increase (probably a smaller one) stemmed from the better utilization of existing capacity.

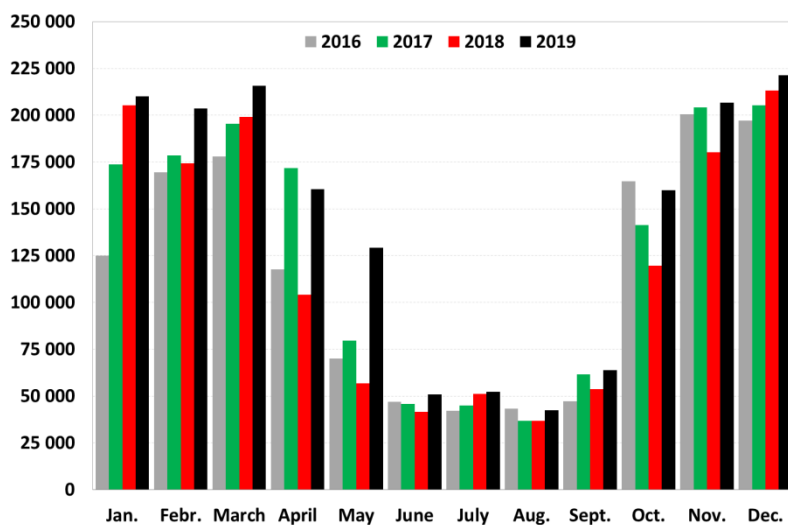
Production at the Győr site grew by 11%, to 291,089 GJ. Just like at the Miskolc site, the surge is attributed to base effects, and it is worth noting that the third well at the Győr site became fully operational in Q4 2018.

In Szentlőrinc, the 6,067 GJ energy production represents 17% contraction compared to the same quarter of the previous year. The smaller output is due to the fact that the well in Szentlőrinc covers the total heat demand of the district, which means that its production is more sensitive to weather developments than those in Győr or Miskolc, where the wells cover only part of these cities' heat demand.

Combined average monthly temperatures (°C) in Miskolc and Győr



Consolidated heat sales (GJ)



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 costumers 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 taken care of, 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. **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.

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.

Any information relating to the date and time for the price mentioned in this recommendation is revealed in the part of the recommendation where the given price is indicated.

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	HUF 1,024	Equity note
21/03/2018	BUY	HUF 1,032	Equity note
17/04/2018	BUY	HUF 1,032	Equity note
17/07/2018	BUY	HUF 1,032	Equity note
03/08/2018	BUY	HUF 1,032	Equity note
04/09/2018	BUY	HUF 1,046	Equity note
02/10/2018	BUY	HUF 1,072	Equity note
16/10/2018	BUY	HUF 1,072	Equity note
16/01/2019	BUY	HUF 1,090	Equity note
25/03/2019	Under revision	-	Equity note
16/04/2019	Under revision	-	Equity note
30/04/2019	BUY	HUF 1,106	Equity note
16/07/2019	BUY	HUF 1,106	Equity note
04/09/2019	BUY	HUF 1,106	Equity note
16/10/2019	BUY	HUF 1,196	Equity note

Period	Recommendations	Percent of recommendation
2017Q4	BUY	100%
	HOLD	0%
	SELL	0%
2018Q1	BUY	100%
	HOLD	0%
	SELL	0%
2018Q2	BUY	100%
	HOLD	0%
	SELL	0%
2018Q3	BUY	100%
	HOLD	0%
	SELL	0%
2018Q4	BUY	100%
	HOLD	0%
	SELL	0%
2019Q1	BUY	93,5%
	HOLD	0%
	SELL	0%
	Under revision	6,5%
2019Q2	BUY	67%
	HOLD	0%
	SELL	0%
	Under revision	33%
2019Q3	BUY	100%
	HOLD	0%
	SELL	0%
2019Q4	BUY	100%
	HOLD	0%
	SELL	0%

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

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