otp Research

EQUITY NOTE: PANNERGY NYRT.

Recommendation: BUY

Target price (12M): HUF 1,106

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Highlights

PannErgy's H1 financial performance, without the one-off factors, is in line with our forecast and valuation. Thanks to the favourable weather conditions and the sale of a property in the Csepel district of Budapest in H2 2019, Pannergy generated **HUF 3,121 million revenue, while EBITDA amounted to HUF 1,451 million,** surpassing the management's half-year target (55% of the yearly EBITDA of HUF 2,320-2,380 million). However, if we look under the hood and **set aside the effect of favourable weather and other one-off factors** – which should not have an effect of valuation –, **EBITDA would be around HUF 1,300 million**, which is close to the management's and our half-year target. Therefore **the valuation was left unchanged** (HUF 1,106). We will revisit our valuation in the last week of September, when the new administrative prices are set for the next year.

Financial highlights of the H1 earnings report

Pannergy's 2019H1 financial performance was outstanding, especially compared to 2018H1. As it was mentioned in the Q2 production report, the favourable weather conditions enabled the company to boost sales above expectations. Moreover, the capacity at the Győr location also increased last year, which was an additional positive factor.

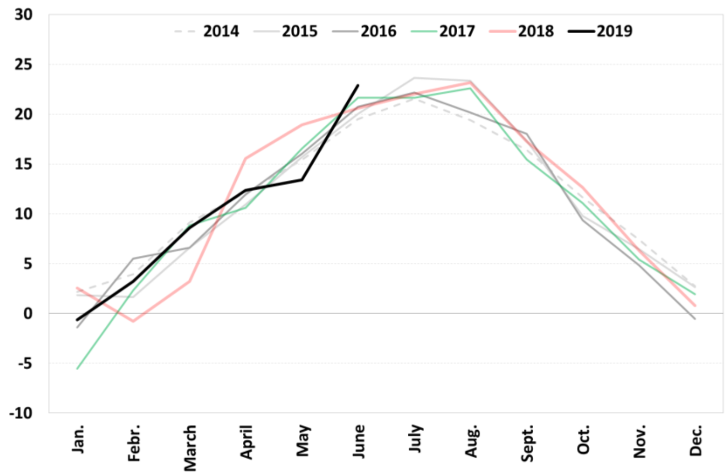
In 2019H1 heat sales amounted to 969,804 GJ, which was 24% higher than a year earlier. Importantly, heat sales in 2018H1 were dampened by unfavourable weather effect. Without it, the increase between 2019H1 and 2018H1 would have been somewhat lower.

The higher-than-expected heat sales translated into **HUF 3,121 million revenue,** which is a 30% YoY growth. In addition to the increased production, higher administrative prices also played a role: in September 2018, administrative prices were increased by 5.6% in Miskolc and 5.8% in Győr. Overall, the management's expectations were surpassed by 8%.

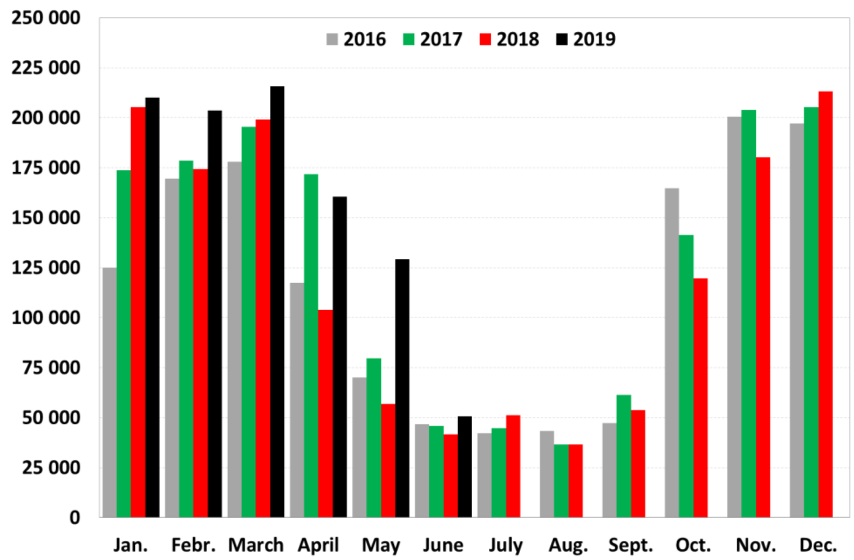
Direct costs increased from HUF 1,867 million **to HUF 2,214 million** (+19% YoY) due to stronger heat sales. Among the main components: direct costs, maintenance, operating costs, facility management costs, rental costs, maintenance materials grew by 31%, electric power costs surged by 39%, COGS rose by 19%, while amortization remained almost the same.

Due to the higher revenues and because direct costs rose to a lesser extent than revenues did (due to an increase in administered prices), **gross profit surged** from HUF 535 million to HUF 907 million.

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



Consolidated heat sales (GJ)



General and administrative expenses fell around 2% compared to 2018H1. This is reassuring, but the slowdown in the reduction of SG&A expenses also shows that further opportunities to reduce the SG&A expenses may be limited. However, the current figures are in line with the existing strategy – to improve operational efficiency.

Net other revenue amounted to HUF 106 million, down from HUF 174 million in 2018H1. Among other revenues, HUF 68 million came from selling of the industrial property in Csepel.

This brings the EBIT to HUF 780 million, higher than in 2018H1 (HUF 472 million). **EBITDA hit HUF 1,451 million, which is an excellent result. A breakdown of EBITDA reveals that, taking into account the seasonality of heat sales, the weather effect and other one-off items (selling the industrial property) it is in line with our, and the**

management's target for this year. First of all, in the past two years around 55% of heat sales were completed in H1, and the management had also expected 55% for 2019, which would bring EBITDA to around HUF 1,300 million (55% of the yearly EBITDA target). Second, HUF 100 million EBITDA is due to the favourable weather conditions. Third, the remaining part is attributed to selling the industrial property. Therefore **the EBITDA without one-offs is matching the management' and our estimation**. EBITDA margin declined somewhat, to 46.5% from 47.7%.

Financial highlights of the 2019H1

P/L Table consolidated (million HUF)	2019H1	2018H1	2017H1	2016H1	2015H1
Revenue	3 121	2 402	2 519	2 129	1 326
Net other revenue	106	174	120	133	2
OPEX	2 447	2 104	2 196	2 155	1 214
From which:					
* SGA	233	237	297	475	229
* Depreciation	671	675	588	541	359
EBITDA	1 451	1 147	1 095	734	470
EBIT	780	472	443	107	112
EBT	618	33	381	-226	-1
Income Taxes	15	9	26	22	53
Net income	603	24	355	-252	-58
EPS (HUF)	32,90	1,60	19,77	-13,78	-3,18

	2019H1	2018H1	2017H1	2016H1	2015H1
EPS (HUF)	32,90	1,60	19,77	-13,78	-3,18
EBITDA (HUFm)	1 551	1 147	1 095	734	470
Gross profit rate (%)	29,1%	22,3%	24,6%	21,1%	25,6%
EBIT rate (%)	25,0%	19,7%	17,6%	5,0%	8,4%
EBITDA rate (%)	46,5%	47,8%	43,5%	34,5%	35,4%
ROE (%)	5,9%	0,3%	3,9%	-2,8%	-0,6%
ROA (%)	2,3%	0,1%	1,5%	-1,0%	-0,2%
ROS (%)	19,3%	1,0%	14,1%	-11,8%	-4,4%

The company's H1 financial loss of HUF 162 million is considerably lower than the HUF 439 million in 2018H1. The difference stems from the fact that the effect of unrealized loss from FX revaluation was considerable lower in 2019H1. It is worth reiterating that some of the company's revenues are denominated in foreign currency, so from a valuation point of view, if the HUF depreciates this year – causing unrealized FX loss –, it will be compensated in future years by higher FX revenue denominated in HUF, leaving the valuation unchanged.

The HUF 603 million net income in the report is considerably higher than it was in 2018H1. The excellent number is the result of the above-mentioned factors: increased overall capacity and administered prices, favourable weather in H1, and the sale of the industrial property in Csepel.

Finally, despite the good financial report, the management did not change its guidance, reflecting the fact that the base performance (without one-offs) is in line with the targets of **HUF 2,320-2,380 million for 2019, and HUF 2,580-2,640 million for 2020**.

Other important highlights in the H1 financial report:

- **The purchase of the third reinjection well of Miskolc:** In 2015, PannErgy Plc's subsidiary DoverDrill Mélyfúró Ltd sold reinjection well KIS-PE-01B, drilled in Kistokaj and connected to the geothermal system of Miskolc, along with certain rights in relation to the utilization of the well. The foreseeable purchase price, covering the 100% business stake of the target company and the loan outstanding to the owner of the target company, is HUF 740 million. At the potential time of the closing of the transaction, the amount of the bank loans at the target company will be around HUF 340 million. **As a result of the transaction, the expected growth in PannErgy's consolidated annual EBITDA will be HUF 164 million.** The transaction is anticipated to be concluded at the end of the first half of 2019. At present, detailed negotiations are being conducted on the conditions of the transaction and contract documents. Preparations are in progress to obtain bank funding for the transaction. **Overall, the deal will add HUF 1,080 million to net debt, but EBITDA will be higher by the mentioned amount, due to lower costs in the future.**

- **Share repurchase programme**: Under the share repurchase programme, Pannergy bought back 430,896 treasury shares. A total of 540,896 shares were bought under the share repurchase programme, while 110 000 shares were sold under the share option program, which ended on 30 June 2019.

Recent information's effect on our valuation

The better-than-expected financial results are mainly due to the favourable weather effect and one-off factors (like selling the industrial property in Csepel), but looking under the hood, Pannergy's performance is broadly in line with our expectation. As was stated before, EBITDA without the effect of the favourable weather conditions and other one-off factors would be as expected for the first half-year (55% of the full-year EBITDA). However, the decrease in net debt would justify a slight upward revision of the target price, but we will wait until administered prices are set, in the last week of September.

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 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. **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.

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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	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

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

The list of all recommendations made in the past 12 months is available here.

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