

EQUITY NOTE: PANNERGY NYRT.

Recommendation: BUY (unchanged)

Target price (12M): HUF 1,997 (revised up)

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Highlights

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PannErgy produced record 646,259 GJ energy in Q1, which is 1.3% higher YoY, and it is also 1.9% higher than the management's plan was for the quarter. The strong performance was primarily due to efficiency and operational safety developments despite the unfavourable weather conditions in February and March and was also supported by leap year impact. The heat sales target for 2024 remains 1,773,116 GJ and management also confirmed the previously published HUF 3.9-4.1bn EBITDA target.

We have also updated our valuation, which incorporates recent changes in the economic and interest rate environment, FY2023 figures and the expected impact of the new Miskolc well. Our updated EBITDA forecast is HUF 3.94bn for this year (vs. HUF 3.83bn previously), which is within the range provided by management and HUF 4.12bn for 2025. The estimated EBITDA impact of the new Miskolc well is ~40m HUF in 2024 and ~110m HUF in 2025, which is included in the above figures. The new project is expected to be completed by the commencement of the 2024/2025 district heating season and has remaining total contractual cost of over HUF 2bn. In our calculations we assumed that the project will be financed using a mix of self-financing, debt and grant (ex-post financing feature). We expect a gradual ramp up of heat sales up to 140 TJ over time, which would correspond to an EBITDA contribution of over HUF 200 million if realized. However, from a valuation perspective the contribution of the Miskolc project is smaller as the higher EBITDA generation potential is largely offset by the significant CAPEX requirement. Nonetheless, it is a valuable addition, and we also note that it will greatly improve operational continuity. Furthermore, we expect administrative prices to keep trending lower in line with natural gas and electricity market trends, but this has a limited impact on profitability as there is a corresponding decline in cost items. We also note that while inflation has been trending down over recent months, but it still seems somewhat sticky in nature, which resulted in relatively higher long-term WACC figures that had a negative impact on our valuation. On the other hand, the company kept purchasing its own shares at a strong pace, which resulted in lower number of non-treasury shares and had a significant positive impact on the target price.

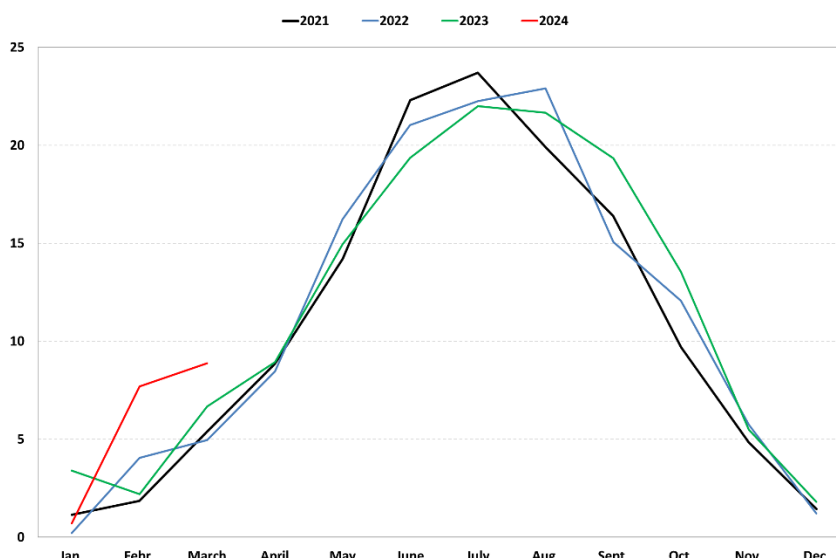
Overall, the 12M target price for PannErgy is increased from HUF 1,908 to HUF 1,997 and we maintain our BUY recommendation.

Main takeaways from the quarterly production report:

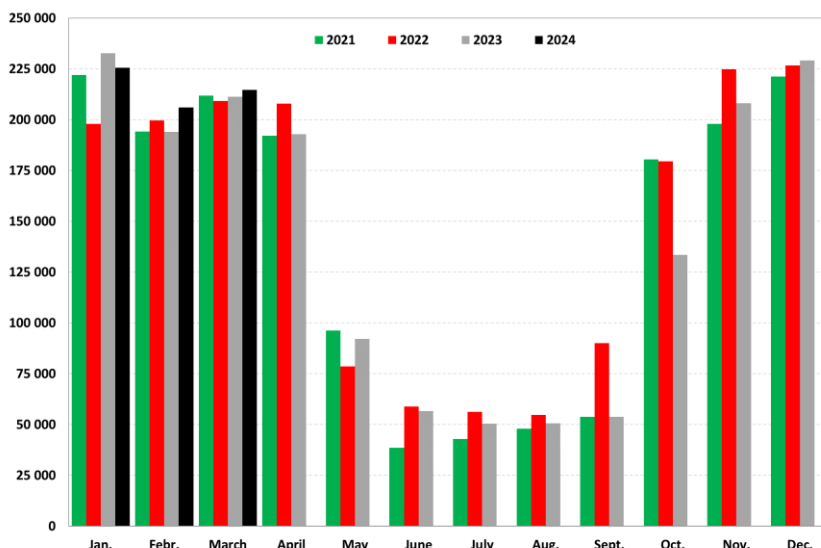
In the first quarter, PannErgy produced 646,259 GJ energy, which is 1.3% higher than a year earlier, and it is also 1.9% higher than the management’s plan was for this quarter (634,509 GJ). **This means that the company achieved record Q1 heat sales** despite the relatively warm weather in February and March, mostly due to efficiency and operational safety developments and it was also supported by the positive impact of the leap year.

Regarding the performance of individual sites, Miskolc produced 272,666 GJ in Q1, a 1.2% increase YoY (269,345 GJ) and roughly flat after adjusting for the leap year impact. At the same time, production in Győr was a record 364,186 GJ in Q1, a 1.4% increase compared to the base period (359,250 GJ), a smaller rise even after adjusting for the leap year. Overall, the Győr project accounted for ~56.4% of heat sales volume in Q1, while the Miskolc project for ~42.2% (in the base period Győr accounted for ~56.3% of heat sales and Miskolc for ~42.2%). **The management also confirmed the expected fulfilment of the 2024 EBITDA target range of HUF 3.9-4.1bn that was published previously.**

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



Consolidated heat sales (GJ)



Updated valuation:

We updated our valuation for PannErgy to incorporate recent changes in the economic and interest rate environment, FY2023 results and the impact of the new Miskolc well. Overall valuation is increased to HUF 1,997 / share from HUF 1,908 (+4.7%), the recommendation is maintained at BUY given the price target is well above the current market price.

- As mentioned, management confirmed the 2024 EBITDA range of HUF 3.9-4.1bn considering the Q1 performance. **Our updated EBITDA forecast is HUF 3.94bn for this year (vs. HUF 3.83bn previously), which is within the range provided by management and HUF 4.12bn for 2025. The figures now include the estimated impact of the new Miskolc well, which is expected to be completed by the commencement of the 2024/2025 district heating season. We assumed heat sales volumes that are in line with management's guidance for 2024 including ~20TJ contribution from the new well per our estimate, which will jump to ~60TJ in 2025. The estimated EBITDA impact of the new Miskolc well is ~40m HUF this year and ~110m HUF in 2025.**
- In the FY2023 report management mentions that HUF 382 million was booked in relation to the new Miskolc project as investment in progress among tangible assets, while **the remaining total contractual cost of the project is over HUF 2bn.** In our CAPEX estimate we assumed the latter to be ~2.1bn HUF to remain slightly conservative on top of normal capital requirements. The company was also awarded a grant of up to HUF 994 million in relation to the new well (Ministry for Energy issued the Grant Instrument on 24 Aug 2023). We assumed on a conservative basis that ~600 million HUF will be used up from the grant, which has an ex-post financing feature (as such at the time of the annual report none of the grant has been drawn down). Furthermore, we assume that ~25% of the project cost will be self-financed (not covered by the grant), while the remaining portion will be financed by debt.
- As already mentioned above we assume ~20TJ contribution from the new well in 2024, which will jump to ~60TJ in 2025 and it gradually ramps up to 140TJ over time. According to the FY2023 report the project is expected to increase the usable capacity of the Miskolc system by up to 15-20%. **We note that Miskolc production in 2023 was ~715TJ, hence 140TJ additional heat sales would represent ~20% of that potentially. This would correspond to an EBITDA contribution of over HUF 200 million if realized.**
- Overall, **from a valuation perspective the contribution of the Miskolc project is smaller as the higher EBITDA generation potential is largely offset by the significant CAPEX requirement** even after accounting for the grant. Nonetheless, we think **it is a valuable addition and we also note that it will greatly improve operational continuity.** It provides the means to restart heat production in the event of failure within hours instead of a well-pump replacement that could take up to 12 days or more.

- We expect that administrative prices will keep trending somewhat lower in line with natural gas and electricity market trends, but this has a limited impact on profitability as there is a corresponding decline in cost items (ie. lower electricity charges). We assume that prevailing administrative prices are valid until the end of September 2024.
- **Inflation has been trending down over recent months, but it still seems somewhat sticky in nature, which means that rates may stay elevated for longer.** This resulted in somewhat lower WACC figures in the short-term but higher ones over the long-term compared to previous calculations, which had an overall negative impact on our valuation.
- We also note that the company has a net debt of HUF 7.733bn (~2x net debt / EBITDA), which is 26.5% lower on a YoY basis, but it is slightly higher compared to H1 2023 net debt (+3.5%), which was used in our previous valuation. Overall, the small change in the level of net debt did not have much impact on the target price.
- On the other hand, **the company kept purchasing its shares at a strong pace, which resulted in a lower number of non-treasury shares, which had a significant positive impact on the target price.**
- Considering the above effects together, the FCF valuation gave a HUF 1,997 share price.

| Income statement | | | | | | |
|--------------------------------------|-------|-------|-------|-------|-------|-------|
| P/L Table consolidated (million HUF) | 2021 | 2022 | 2023 | 2024F | 2025F | 2026F |
| Revenue from geothermal-heat | 5 323 | 6 238 | 9 230 | 7 301 | 7 668 | 7 932 |
| Other revenue | 215 | 380 | -277 | 72 | 93 | 93 |
| OPEX | 3 776 | 3 913 | 5 461 | 3 839 | 4 051 | 4 184 |
| from which: Depreciation | 1 595 | 1 716 | 1 852 | 2 013 | 2 093 | 2 093 |
| EBITDA | 2 878 | 3 612 | 3 930 | 3 944 | 4 119 | 4 250 |
| EBIT | 1 283 | 1 896 | 2 078 | 1 930 | 2 026 | 2 157 |
| EBT | 964 | 1 416 | 1 837 | 1 657 | 1 788 | 1 955 |
| Income Taxes | 67 | 106 | 121 | 199 | 215 | 235 |
| Non-controlling interest | 0 | 0 | 0 | 0 | 0 | 0 |
| Net income | 897 | 1 310 | 1 716 | 1 458 | 1 574 | 1 720 |
| EPS (HUF) | 59 | 87 | 114 | 97 | 104 | 114 |

| Balance sheet | | | | | | |
|--|--------|--------|--------|--------|--------|--------|
| Balance sheet - consolidated (million HUF) | 2021 | 2022 | 2023 | 2024F | 2025F | 2026F |
| Non-current assets | 22 933 | 22 695 | 22 076 | 22 143 | 20 052 | 17 998 |
| Current assets | 3 950 | 4 636 | 4 176 | 4 888 | 6 752 | 8 679 |
| Total assets | 26 883 | 27 331 | 26 252 | 27 032 | 26 804 | 26 678 |
| Total equity | 9 980 | 10 534 | 11 458 | 12 916 | 14 126 | 15 452 |
| Non-current liabilities | 13 704 | 12 669 | 11 686 | 10 821 | 9 325 | 7 830 |
| Current liabilities | 3 199 | 4 128 | 3 108 | 3 295 | 3 353 | 3 395 |
| Total equity and liabilities | 26 883 | 27 331 | 26 252 | 27 032 | 26 804 | 26 678 |

| Cash flow statement | | | | | | |
|-------------------------------------|--------|--------|--------|--------|--------|--------|
| Cash flow statement (million HUF) | 2021 | 2022 | 2023 | 2024F | 2025F | 2026F |
| Profit before taxes | 964 | 1 416 | 1 837 | 1 657 | 1 788 | 1 955 |
| Cash flow from operations | 2 859 | 1 868 | 4 963 | 3 610 | 3 451 | 3 607 |
| Cash flow from investment | -1 475 | -2 106 | -1 503 | -1 985 | -520 | -525 |
| Cash flow from financing activities | -774 | -615 | -2 575 | -1 368 | -1 190 | -1 190 |
| Change in cash and cash equivalents | 610 | -647 | 885 | 257 | 1 741 | 1 892 |

FCFF valuation

| Valuation summary (million HUF) | 2024F | 2025F | 2026F | 2027F | 2028F | Terminal year |
|---------------------------------|-------|-------|-------|-------|-------|---------------|
| Revenue from geothermal heat | 7 301 | 7 668 | 7 932 | 8 242 | 8 443 | 8 612 |
| EBITDA | 3 944 | 4 119 | 4 250 | 4 404 | 4 469 | 4 558 |
| Depreciation | 2 013 | 2 093 | 2 093 | 2 093 | 2 093 | 2 093 |
| Working capital sales | 60 | 66 | 48 | 56 | 36 | 36 |
| Capex | 2 310 | 215 | 220 | 230 | 230 | 230 |
| FCFF | 1 342 | 3 595 | 3 723 | 3 841 | 3 917 | 3 996 |
| WACC | 11,4 | 12,0 | 12,6 | 13,0 | 13,0 | 13,1 |
| PV(FCFF) | 1 204 | 2 880 | 2 649 | 2 418 | 2 182 | 20 450 |

| Share price estimation | |
|--------------------------------------|--------|
| Enterprise value | 31 783 |
| Net debt (-) | 7 733 |
| Equity value | 24 050 |
| Number of shares | 15 082 |
| Required return on equity | 13,4 |
| Target price for the next 12 M (HUF) | 1997 |

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 consumers 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 company's profit target. 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.

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 |
|------------|-----------------|--------------|-------------|
| 06/10/2022 | BUY | HUF 1,670 | Equity note |
| 15/10/2022 | BUY | HUF 1,670 | Equity note |
| 23/11/2022 | BUY | HUF 1,670 | Equity note |
| 02/01/2023 | BUY | HUF 1,670 | Equity note |
| 18/01/2023 | BUY | HUF 1,747 | Equity note |
| 27/03/2023 | BUY | HUF 1,747 | Equity note |
| 17/04/2023 | BUY | HUF 1,747 | Equity note |
| 18/07/2023 | BUY | HUF 1,747 | Equity note |
| 20/09/2023 | BUY | HUF 1,747 | Equity note |
| 05/10/2023 | BUY | HUF 1,908 | Equity note |
| 17/10/2023 | BUY | HUF 1,908 | Equity note |
| 01/17/2024 | BUY | HUF 1,908 | Equity note |
| 02/04/2024 | BUY | HUF 1,908 | Equity note |

| Period | Recommendations | Percent of recommendation |
|--------|-----------------|---------------------------|
| 2023Q2 | BUY | 100% |
| | HOLD | 0% |
| | SELL | 0% |
| 2023Q3 | BUY | 100% |
| | HOLD | 0% |
| | SELL | 0% |
| 2023Q4 | BUY | 100% |
| | HOLD | 0% |
| | SELL | 0% |
| 2024Q1 | BUY | 100% |
| | HOLD | 0% |
| | SELL | 0% |
| 2024Q2 | BUY | 100% |
| | HOLD | 0% |
| | SELL | 0% |

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

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