

EQUITY NOTE: PANNERGY NYRT.

Recommendation: BUY

Target price (12M): HUF 1,072

2 October 2018

Highlights

Due to the higher-than-expected increase in administered prices, we raised our target price from HUF 1,046 to HUF 1,072 for the next 12 months. The new target price is 57% above Monday's closing price.

Besides, two more announcements were made: (1) the completion of the new well in Győr, which will operate in the coming winter season already, boosting capacity by at least 20%, and (2) a 2% increase in the Miskolc plant's capacity due to improvement in operational efficiency.

Based on previous information, we largely anticipated these developments. But they also demonstrate that the management is able to achieve its strategic goals: to improve operational efficiency where it is possible, keep costs at reasonable levels, and gradually gain new costumers for secondary heat sales. **Over the past one year we saw exactly that: the third well in Győr was completed, EBITDA margin improved, and two new customers will buy secondary heat. Overall, we think the company is on the right track to achieve its strategic objectives.**

Announcement 1:

Pannergy announced the successful completion of its third well (BON-PE-03) in Győr. With water extraction capacity as large as 1,100 m³/h, it is expected to boost the output of the Győr project by more than 20%. The new well will operate with pumping (because the well is deeper) while the other two ones will have self-flowing regimes. It will run in self-producing mode in the first few weeks of the heating season, and then the well pump will be installed in the BON-PE-03 wells in the first half of October, PannErgy said.

Announcement 2:

With the implementation of the heat exchangers in Kistokaj after a comprehensive conversion, the summer maintenance works of the Geothermal Power Plant of Miskolc were completed on schedule. The system, working at full capacity, is now available for Pannergy's customers. Concurrently with the maintenance works, activities to enhance pump performance were carried out. As a result, the rate of heat delivery in the system will improve by nearly 2% (by about 20 m³/h, i.e. to 12 TJ p.a.) in the coming heating season, compared to the previous one.

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Announcement 3:

The official rates for district heat production in effect from 1 October 2018, which also affect PannErgy's subsidiaries that are subject to the central regulation of district heating rates, are as follows. [The announcement was published in issue 146 of 2018 of the Hungarian Official Gazette (Magyar Közlöny) the Minister for Innovation and Technology published Decree 19/2018 (Sept 27.) of the Ministry for Innovation and Technology.]

Location of the wells	Company names	in effect until 30 September 2018	in effect from 1 October 2018	Change
Szentlőrinc	Szentlőrinci Geothermal Ltd	3 654 HUF/GJ	3 654 HUF/GJ	0,0%
Miskolc	Miskolci Geothermal Ltd	2 382 HUF/GJ	2 515 HUF/GJ	5,6%
Miskolc	KUALA Ltd	2 382 HUF/GJ	2 515 HUF/GJ	5,6%
Győr	Arrabona Geothermal Ltd	2 939 HUF/GJ	3 108 HUF/GJ	5,8%

Source: Hungarian Official Gazette, issue 146/2018

Analyst's comments:

Announcement 1: The completion of the third well is excellent news and proves that the management's initial assessment regarding the expected boost in capacity was correct. In previous reports we noted that the already operating two wells suggested that the management had the sufficient expertise to accurately estimate the expected growth in capacity. Therefore our previous analysis **already factored in this 20% higher capacity. However, if the actual capacity improvement turns out to be higher than 20%, we will update our model accordingly.**

Regarding **Announcement 2:** Improving the operational efficiency is one of the cornerstones of the management's current strategy (along with enhancing secondary heat production). **The current 2% growth in output at the Miskolc plant exemplifies the realization of this strategy. Our initiation report incorporated a small rise in capacity as well, so this information is reassuring, confirming that our initial estimate was largely correct.**

Concerning the increase in administrative prices (Announcement 3), we expected only 2% overall change because Pannergy's production process is established, therefore significant changes in the cost structure or in the profitability ratios are not expected. However, the administrative price setting process is a multi-step approach and it takes into account various aspects of production. These factors may include the change in the cost-structure in the 'look-back period' (usually one year), the government's strategy toward the source of heat production (for example renewable energy may be preferred), and the hike in energy (natural gas) prices. But, beyond the above, there could be other factors as well. That is why forecasting the change in administered prices is more than challenging.

As Pannergy's cost structure has not changed much, the higher administrative prices will raise revenue, therefore profit and cash-flow will improve. But we left our price forecast unchanged for industrial consumers who pay contract prices, and use different pricing structure. (This is for one of Pannergy's subsidiaries in Győr, DD Energy, which provides roughly 53% of the revenue from the Győr operation through heat sales to Audi.)

All in all, the higher administrative prices made us modify our target price for the next 12 months, raising it from HUF 1,046 to HUF 1,072.

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, costumers who do not have mandatory purchase agreement with Pannergy may 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 – because of global warming or other extreme weather conditions– the costs are higher, as the output from the drilling wells drops.

3. **Operational risks:** Usually the main source of risk in valuing a utility company is forecasting the maintenance costs, as it could be highly unpredictable. For example, maintenance costs increased significantly at the Győr Project in 2016 due to scaling issues concerning the tubing and pumps, and this has reduced production. If in subsequent periods, maintenance cost starts to rise for period to period, than the valuation may change accordingly.

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 reduce 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	5 329	5 861
Revenue from other operations	602	540	897	675	675	675
Revenue from geothermal-heat	1 688	2 186	3 632	4 024	4 515	5 053
Other revenue	55	871	101	537	139	132
OPEX	1 808	1 983	2 914	3 012	3 053	3 372
from which: Depreciation	635	1 241	1 435	1 300	1 259	1 249
EBITDA	482	1 614	1 715	2 241	2 276	2 488
EBIT	-153	373	281	923	1 017	1 239
EBT	-434	217	-131	626	433	1 027
Income Taxes	95	183	28	121	52	123
Non-controlling interest	12	-44	-8	17	12	28
Net income	-541	78	-151	488	369	876
EPS (HUF)	-30,0	4,3	-8,5	27,6	20,0	47,5

Balance sheet - consolidated (million HUF)	2014	2015	2016	2017	2018F	2019F
Non-current assets	17 299	22 502	22 282	21 633	21 352	20 130
Current assets	2 419	4 313	2 978	3 389	3 706	4 647
Total assets	19 718	26 815	25 259	25 022	25 058	24 777
Total equity	9 259	9 331	8 889	9 025	9 387	10 250
Non-current liabilities	7 091	14 028	13 479	13 066	13 239	12 212
Current liabilities	3 368	3 459	2 887	2 931	2 432	2 316
Total equity and liabilities	19 718	26 819	25 256	25 022	25 058	24 777

Cash flow statement (million HUF)	2014	2015	2016	2017	2018F	2019F
Profit before taxes	-434	217	-131	626	433	1 027
Cash flow from operations	561	-173	775	1 895	1 422	1 966
Cash flow from investment	-2 248	-4 153	-1 632	-1 142	-1 047	-92
Cash flow from financing activities	1 661	5 089	473	-201	-121	-1 074
Change in cash and cash equivalents	-26	763	-384	552	254	799

Valuation summary (million HUF)	2018F	2019F	2020F	2021F	2022F	2023F	2024F	2025F	2026F	2027F	Terminal year
Revenue from geothermal heat	4 765	5 053	5 154	5 256	5 361	5 468	5 576	5 687	5 801	5 916	6 035
EBITDA	2 386	2 488	2 508	2 528	2 547	2 488	2 506	2 523	2 489	2 504	2 554
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	1 058	2 247	2 266	2 284	2 302	2 214	2 231	2 247	2 184	2 198	2 242
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)	984	1 943	1 822	1 708	1 601	1 432	1 342	1 256	1 135	1 063	13 413

* Weather effect for the 2018 data is removed as it is a temporal effect.

Share price estimation	
Enterprise value	27 698
Net debt (-)	8 300
Equity value	19 398
Number of shares	18 420
Required return on equity	12
Target price for the next 12 M (HUF)	1183
Current price (HUF)	684
Upside /Downside (%)	73

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	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

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%

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

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This document was finalized at 5:27:39 PM on 02 October 2018