

EQUITY NOTE: PANNERGY NYRT.

Recommendation: BUY

Target price (12M): HUF 1,196

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Highlights

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We updated our target price for the next 12 months to HUF 1,196, from HUF 1,106, which is 62% higher than the last closing price (HUF 738). The increase in target price comes from the following: (1) from 1 October 2019, **administrative prices have increased** (+3.1% in Győr and +7.2% in Miskolc). This increases yearly EBITDA not only in 2019 but in later years as well. Moreover, higher profitability means that the company could reduce its net debt faster than before. This warranted an update in the fundamental model. (2) We **updated** the **relative valuation** as well, which also points toward somewhat higher valuation.

Pannergy's Q3 production report came mainly as expected. **Quarterly production surged by 11.8%** compared to the same period of the previous year. Most of this increase stemmed from the higher heat sales at the Győr location. Importantly, the Q3 report does not inform about any problems concerning the summer maintenance of the well, which can be considered good news.

Overall, the fundamentals of the company changed in a way that is in line with our view of the company and consistent with our valuation.

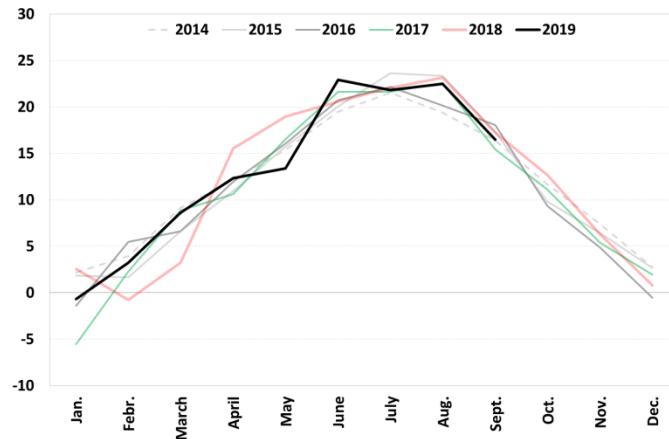
Main takeaways from the production report:

Pannergy published its Q3 report, and as usual, the third quarter is the period that affects yearly sales the least, because the summer months are the least heat intensive periods. Nonetheless, overall production grew from 141,691 to 158,552 GJ from a year ago, which is an 11.8% increase year on year.

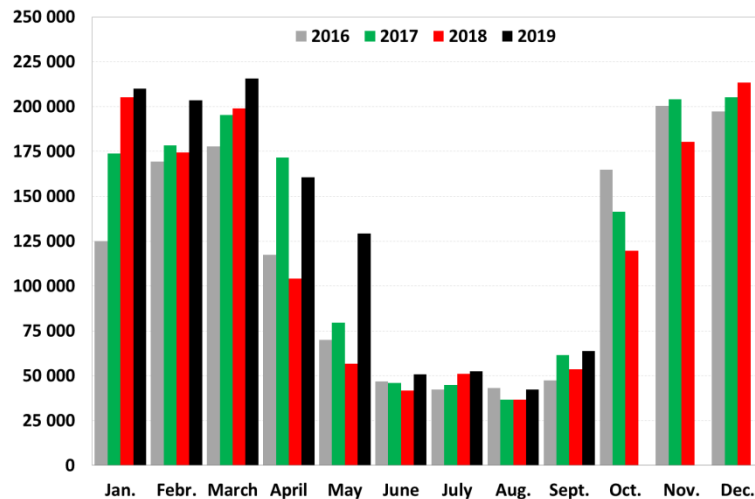
A geographical breakdown indicates that production in Győr expanded by 24% while in Miskolc the production was roughly the same as last year (+1.5% year on year). The Szentlőrinc plant produced 1,077 GJ heat in Q3, up from 1,058 GJ in the base period, in a 1.7% year-on-year increase. Overall, most of the growth came from two sources: (1) stronger heat sales in Győr, (2) favourable weather conditions in September.

But in our view the most important piece in the production report was that the usual summer maintenance did not discover any problem that could affect the existing cost structure of the company or would warrant higher amortization than expected. This is definitely reassuring news.

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



Consolidated heat sales (GJ)



Administrative prices have risen since October:

The official rates for district heat production, in effect from 1 October 2019, 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 161 of 2019 of the Hungarian Official Gazette (Magyar Közlöny), where the Minister for Innovation and Technology published Decree 37/2019 (Sept 30.) of the Ministry for Innovation and Technology.]

Location of the wells	Company names	in effect until 30 September 2019	in effect from 1 October 2019	Change
Szentlőrinc	Szentlőrinci Geothermal Ltd.	3 654 HUF/GJ	3 654 HUF/GJ	0%
Miskolc	Miskolci Geothermal Ltd.	2 515 HUF/GJ	2 695 HUF/GJ	7,2%
Miskolc	KUALA Ltd.	2 515 HUF/GJ	2 695 HUF/GJ	7,2%
Győr	Arrabona Geothermal Ltd.	3 108 HUF/GJ	3 204 HUF/GJ	3,1%

Source: Hungarian Official Gazette, issue 161/2019

The rise in administrative prices is very good news for Pannergy. It increases revenue and profit margins at the same time, while it enables the company to repay its debt faster or accumulate reserves in order to invest them in the future.

We updated our forecast to reflect the above effects. We also updated the relative valuation part. It is important to note that, for the purposes of calculation, we cleaned the 2019 EBITDA from the positive one-offs such as weather effects. Based on the above, the fundamental valuation gave HUF 1,408 target price for the next 12 months, while the relative valuation gave a HUF 985 target price for the next 12 months. So our final valuation is HUF 1,196 for the next 12 months (with a BUY recommendation) which is 62% above the latest close price (HUF 738).

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.

Appendix:

P/L Table consolidated (million HUF)	2016	2017	2018F	2019F	2020F	2021F
Revenue from geothermal-heat	4 529	4 699	4 679	5 195	5 005	5 105
Other revenue	101	537	407	136	142	143
OPEX	2 914	3 012	2 903	3 229	3 082	3 160
from which: Depreciation	1 435	1 300	1 317	1 367	1 376	1 385
EBITDA	1 715	2 241	2 231	2 629	2 591	2 615
EBIT	281	923	906	1 262	1 216	1 230
EBT	-131	626	525	1 018	1 007	1 066
Income Taxes	28	121	90	122	121	128
Non-controlling interest	-8	17	1	28	27	29
Net income	-151	488	434	868	859	909
EPS (HUF)	-30	4	25	49	48	51

Balance sheet - consolidated (million HUF)	2016	2017	2018F	2019F	2020F	2021F
Non-current assets	22 282	21 633	22 780	22 413	20 957	19 493
Current assets	2 978	3 389	3 030	3 033	3 518	4 250
Total assets	25 259	25 022	25 810	25 446	24 475	23 743
Total equity	8 889	9 025	9 867	10 523	11 382	12 291
Non-current liabilities	13 479	13 066	12 256	11 803	10 239	8 324
Current liabilities	2 887	2 931	3 687	3 120	2 855	3 128
Total equity and liabilities	25 256	25 257	25 258	25 259	25 260	25 261

Cash flow statement (million HUF)	2017	2018F	2019F	2020F	2021F
Profit before taxes	451	525	1 018	1 007	1 066
Cash flow from operations	1 895	2 266	2 485	2 539	2 273
Cash flow from investment	-1 142	-2 766	-1 105	-368	-369
Cash flow from financing activities	-201	320	-964	-1 554	-1 189
Change in cash and cash equivalents	552	-180	416	617	715

Valuation summary (million HUF)	2019F	2020F	2021F	2022F	2023F	2024F	2025F	2026F	2027F	2028F	Terminal year
Revenue from geothermal heat	5 195	5 005	5 105	5 207	5 311	5 418	5 526	5 636	5 749	5 864	5 982
EBITDA	2 629	2 591	2 615	2 638	2 583	2 605	2 626	2 597	2 616	2 633	2 686
Depreciation	1 367	1 376	1 385	1 394	1 099	1 108	1 117	834	839	839	839
Working capital sales	150	0	0	0	0	0	0	0	0	0	0
Capex	93	93	93	93	93	93	93	93	93	40	40
FCFF	2 235	2 353	2 375	2 396	2 312	2 332	2 352	2 293	2 310	2 378	2 426
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)	2 078	2 035	1 909	1 792	1 608	1 508	1 414	1 282	1 201	1 150	14 512

Share price estimation	
Enterprise value	30 489
Net debt (-)	8 221
Equity value	22 268
Number of shares	17 764
Required return on equity	12,3
Target price for the next 12 M (HUF)	1408

Relative valuation			
Company name	Country	Market capitalization (billion HUF)	EV/EBITDA
Polaris Infrastructure	Canada	46,6	4,6
Ormat Technologies	USA	1125,9	13,3
ARISE	Germany	28,0	8,8
ABO Invest	Germany	29,0	9,5
Northland Power	Canada	1140,4	13,1
Falck	Denmark	406,8	9,7
		Average	9,8
		Median	9,6

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

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%

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

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