otp Research

EQUITY NOTE: PANNERGY NYRT.

Recommendation: Under revision

Target price (12M): Under revision

25 March 2019

Equity Analyst:
Dániel Módos

Phone:
+36 1 301 2810

Email:
modosd@otpbank.hu

Highlights

With regard to the forthcoming important rate decision of the MNB (which may have a material effect on interest rates and the forint), to Pannergy's general meeting on 12 April, and to its quarterly production report due out on 15 April, we postpone upgrading our model until then. But based solely on the financial performance of 2018, we see no major changes in the company's fundamentals compared to our previous view. Therefore our recommendation temporarily changes from **BUY to UNDER REVISION**.

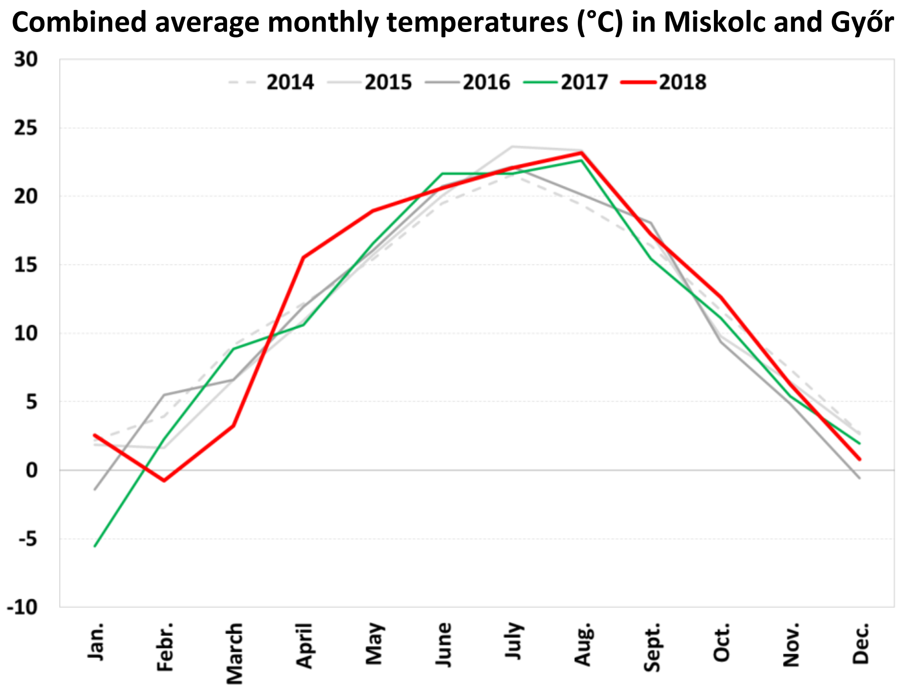
Concerning the financial reports from 2018, Pannergy's EBITDA was somewhat short of our forecast for 2018 due to the unfavourable weather conditions, but based on the previous production reports, this came as no surprise. EBITDA was **HUF 2,231 vs our forecast of HUF 2,288. Net income stood at HUF 434 million.** This was reduced by the HUF 200 million increase in unrealized FX loss, owing to the depreciating HUF in 2018 compared to 2017. **On the positive side, the maintenance costs, general and administrative expenses all decreased, which shows the improving operational efficiency.**

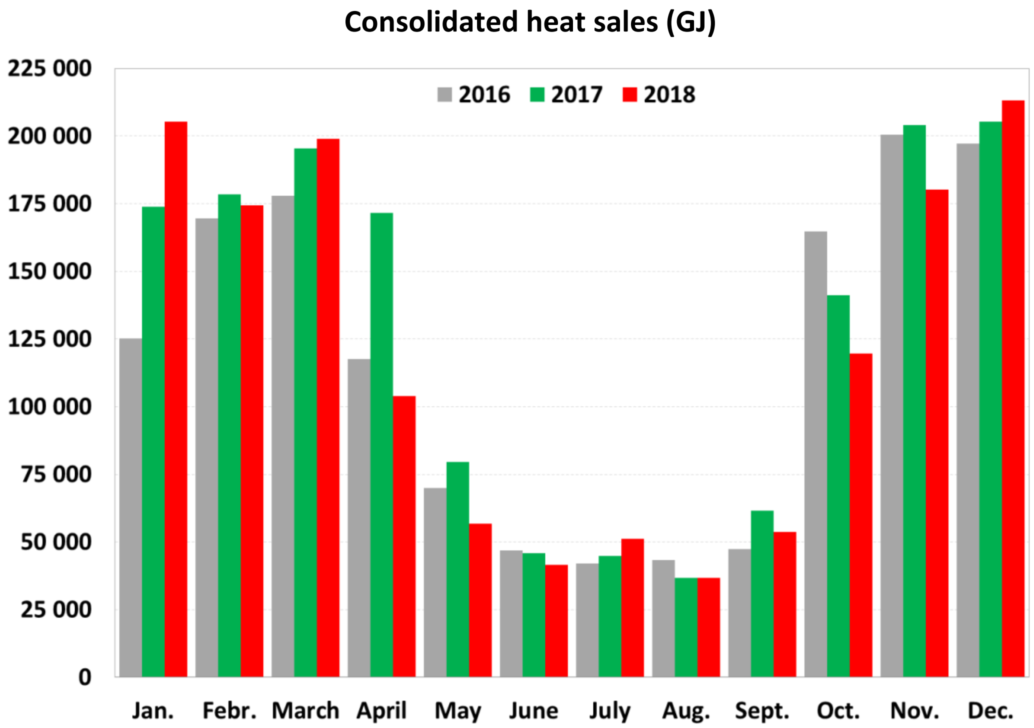
The management also provided forward guidance for 2019 and 2020. It expects the EBITDA to be HUF 2,320-2,380 million in 2019, and HUF 2,580-2,640 million in 2020. The forward guidance already contains the announced repurchase of the third reinjection well in Miskolc for a price of HUF 740 million. As part of the transaction, PannErgy will assume a debt load of HUF 340 million, so overall the company's **net debt will grow by HUF 1,080 million, but EBITDA will increase by HUF 164 million per year.**

The company also has announced that it intends to continue its share repurchase programme for another year with the same conditions but the existing share option programme will not continue.

Financial highlights of the H2 earnings report

Overall, the main parameters of the financial report are broadly in line with our expectations. In 2018, heat sales amounted to 1,435,653 GJ, which is 6.8% lower than a year earlier. This is mainly due to the fact that average temperature was significantly higher in April, May, October and November. Due to the weather effect, revenue is around HUF 300 million lower. This level of production translated into **HUF 4.68 billion revenue, which was slightly below the revenue generated in 2017.**





Direct costs dropped by 2.5%, from HUF 3,820 million to HUF 3,725 million. The reduction is higher than the HUF 20 million decrease in production. Much of this reduction stems from the lower maintenance costs (HUF 130 million reduction). Its effect was partly offset by the increase in electricity costs (by HUF 12 million) owing to the higher electricity prices (the price of natural gas spiked in 2018H2). Amortization was HUF 1,317 million, which is higher than our HUF 1,258 estimate, but due to the uncertain nature of estimating amortization, this is within the margin of error.

As the direct cost of production decreased more than the revenue did, gross profit grew to 20.4%, from 18.7% in 2018.

General and administrative expenses fell by 7.5% compared to 2017. The reduction in general and administrative expenses slowed compared to the 2016-2017 period. The reduction in 2018 stemmed from almost every elements in the G&A expenses. This is in line with the company’s existing strategy, which is to improve it operational efficiency.

Net other revenue amounted to HUF 409 million. This brings the **EBIT to HUF 906 million, almost matching last year’s HUF 923 million. This is below our forecast of HUF 1,030 million. Most of the difference stems from the estimated difference of the amortization, and a smaller part comes from the smaller-than-expected revenue.**

EBITDA was HUF 2,231 million (47.7% EBITDA margin), almost the same as in 2017. Our forecast was slightly higher, HUF 2,288 million. The difference could be attributed to the weather effect in 2018Q4, as stated previously.

The company reported a financial loss of 381 million, which is HUF 80 million higher than in 2017. In 2018 the HUF depreciated almost 3% against the EUR, which translated into HUF 220 million unrealized FX loss due to the revaluation of FX-denominated debts. This was partly compensated by the HUF 64 million one-off rise in financial revenue.

The company reported **HUF 434 million net income,** versus HUF 489 million in 2017. Our forecast was HUF 482 million. One year ago we forecasted HUF 719 million net income for 2018, which is significantly higher than the actual HUF 434 million. The almost HUF 300 million difference can be attributed to two factors: (1) FX effect, and (2) lower revenue due to the weather conditions. Without these one-off factors, PannErgy's profit would have been closer to our initial forecast.

Finally, the annual report included the management's guidance about EBITDA in 2019 and 2020. **The management expects around HUF 2,320-2,380 million EBITDA in 2019, and HUF 2,580-2,640 million in 2020. Our EBITDA forecast was HUF 2,345 million for 2019 and HUF 2,414 million for 2020.** It is worth noting that for for 2019, the management's estimation contains the HUF 82 million increase in EBITDA and for 2020 HUF 164 million increase in EBITDA, due to the purchase of the reinjection well in Miskolc.

Financial highlights of the 2018 report

P/L Table consolidated (million HUF)	2015	2016	2017	2018
Revenue	2 726	4 529	4 699	4 679
Net other revenue	871	101	537	407
OPEX	1 983	2 914	3 012	2 903
From which:				
* SGA	1 180	684	492	456
* Depreciation	1 241	1 435	1 300	1 317
EBITDA	1 614	1 715	2 241	2 231
EBIT	373	281	923	906
EBT	217	-131	626	525
Income Taxes	183	28	121	90
Net income	78	-151	488	434
EPS (HUF)	4,28	-8,47	27,60	23,55

	2015	2016	2017	2018
EPS (HUF)	4,28	-8,47	27,60	23,55
EBITDA (HUFm)	1 614	1 715	2 241	2 231
Gross profit rate	25,0%	19,0%	18,7%	20,4%
EBIT rate	13,7%	6,2%	19,6%	19,4%
EBITDA rate	59,2%	37,9%	47,7%	47,7%
ROE	0,8%	-1,7%	5,4%	4,6%
ROA	0,3%	-0,6%	1,9%	1,7%
ROS	2,9%	-3,3%	10,4%	9,3%

Concession project in Győr:

Previously PannErgy said that the BON-PE-03 production well came online in 2018Q4. In 2018Q4 production at the Győr location was 14% higher than a year before, despite the unfavourable weather conditions. Overall the third well could increase production in the Győr location by 20-25%, going forward. The cost of the project was HUF 1,068 million for 2018, which is slightly higher than our HUF 1,043 million estimate. But because the technical aspects of the drilling always contain some element of uncertainty (the exact geological composition, etc.), we deem it an acceptable difference.

PannErgy started negotiations concerning 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 option programme, share repurchasing programme, and dividend policy

PannErgy's share option programme will end in April 2019. In 2018, 733,000 shares were bought, at an average price of HUF 349, in agreement with the conditions of the programme. Based on the proposal (or the lack thereof) for the general meeting, the current programme will be not replaced by a new one.

Concerning **the share repurchase programme**, only one transaction with an amount of 8,000 was reported for 2018. However overall, 378,000 shares were bought under the programme until last Friday, at an average price of HUF 759. From the HUF 1 bn, HUF 287 million were spent. Importantly, the start of the share repurchasing programme suggests that as the financial health of the company improved, the management's attitude toward the redistribution of profits changed.

The yearly financial report and the proposals for the general meeting state that the share repurchase programme will continue for another year with the same conditions and dividend will not be paid.

In our initiation report we stated that, in our opinion, dividend could come in 2019/2020 unless the management sees new major investment opportunities. Based on the information in the financial statements and management commentary section of the annual report, we uphold the view that dividend could come in the not-so-distant future. **We think that the temporary factors (weather and FX effects) that lowered the profit in 2018, and the expected financial costs of the planned purchase of the third reinjection well in Miskolc are the main causes for the lack of dividend this year.** But our basic tenets still hold: if there is no new major investment on the horizon, dividend could be paid. Concerning the announced share repurchase programme, the question is how much Pannergy will buy back under the programme in 2019.

Recent information's effect on our valuation

The purchase of the third reinjection well, and thus the increased yearly EBITDA, could change our valuation, but for **now we postpone upgrading our forecast until after the general meeting of 12 April (or 26 April if the first general meeting is inquorate) and until the quarterly production report is out on 15 April, for the following reasons**:

1) As Hungary's constant-tax core inflation increased above 3%, **tomorrow's rate-setting decision of the MNB could be very important, and may have lasting effect on interest rates and the HUF.** A change in the interest rate and HUF exchange rates may have an external effect on our valuation through various channels, so it is prudent to wait until these external factors are clarified in the very near future.
2) **Until the end of 2018, the company's share repurchase programmes were unutilized, but that changed at the end of December.** Therefore it is an important question to what extent the newly announced share repurchase program will be utilized. So far we have no information on the issue. This, and other important questions, may be clarified at the general meeting in April.
3) For the above point, looking ahead, PannErgy's cash-flow generating capacity will increase. This could provide an opportunity for the redistribution of profits and/or new investments or acquisitions. **We deem it important to know that, looking ahead, which option the management favours, and under what conditions.**
4) The **quarterly production report will come out in next to no time**, providing an opportunity for our upgraded model to take into account the latest information as well.

To recap, based on the financial performance for 2018, our view on Pannergy's business model and its opportunities did not change, the valuation under review will reflect only the important information that comes to light in the very near future (production report and the MNB's rate decision) and which may have a material effect on it.

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. **Győr concession project:** Although the geological quality of the area is well researched and known by PannErgy as it has two operating wells nearby, the expected yield on the new well could be a source of risk. Moreover, if the completion of the

investment is delayed or it is subject to cost overrun, then this could lower our revenue forecast.

5. **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

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%

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

Disclaimer 1

This research/commentary was prepared by the assignment of the Budapest Stock Exchange Ltd. (registered seat: 1054 Budapest, Szabadság tér 7. Platina torony I. ép. IV. emelet; company registration number: 01-10-044764, hereinafter: BSE) under the agreement that was concluded by and between BSE and OTP Bank Plc (registered seat: H-1051 Budapest, Nádor utca 16., Hungary, company registration number: 01-10-041585, hereinafter: OTP Bank or Investment Service Provider).

The BSE shall not be liable for the content of this research/commentary, especially for the accuracy and completeness of the information therein and for the forecasts and conclusions. The Service Provider is entitled to all copyrights regarding this research/commentary however BSE is entitled to use and advertise/disseminate it without amending its content.

This research/commentary shall not be qualified as investment advice specified in Point 9 Section 4 (2) of Act No. CXXXVIII of 2007 on Investment Firms and Commodity Dealers and on the Regulations Governing their Activities. Furthermore, this document shall not be qualified as an offer or call to tenders for the purchase, sale or hold of the financial instrument(s) concerned by the research/commentary.

Disclaimer 2

1. Pursuant to the Commission-delegated regulation 2017/565/EU of the European Parliament, the content of this document shall be considered as an investment research, which recommends or suggests an investment strategy, explicitly or implicitly concerning one or more financial instruments or the issuers of financial instruments, including any opinion as to the present or future value or price of such instruments. The statements in this investment research contain objective or independent explanation. Furthermore, pursuant to Directive 2014/65/EU of the European Parliament and of the Council, this document shall be considered as investment recommendation. This document does not take into account investors' individual interests, circumstances, or objectives; therefore, in the absence of personal recommendation, it shall not be considered as an investment advice.
   OTP Bank intends to make this document available to its clients or to the public, or to make it accessible to other persons in a way that allows this document to be disseminated to the public.

2. Information herein reflects the market situation at the time of writing. It provides only momentary information and may change as market conditions and circumstances develop. Additional information may be available on request. Where a figure relates to a period on or before the date of communication, the figure relates to the past and indicates a historic data. Past performance is not a reliable indicator of future results and shall be not treated as such. OTP Bank makes no representation or warranty, express or implied, is made regarding future performance of any financial instrument mentioned in this communication. OTP Bank shall have no liability for the information contained in this for any loss or damage whether direct, indirect, financial, economic, or consequential, whether or not caused by the negligent act or omission of OTP Bank, provided that such limitation of liability shall not apply to any liability which cannot be excluded or limited under the applicable law.

3. The issuer of this report does not claim that the information presented herein is perfectly accurate or complete. However it is based on sources available to the public and widely believed to be reliable. Also the opinions and estimates presented herein reflect a professional subjective judgment at the original date of publication and are therefore subject to change thereafter without notice. Furthermore there can be no guarantees that any market developments will unfold as forecasted. Opinions and estimates constitute our judgment and are subject to change without notice.

4. The issuer(s) of the product(s) mentioned in this document do not hold more than 5% of OTP Bank's registered capital. OTP Bank is a market maker of the financial instrument that is discussed in this document. Neither was OTP Bank a lead-manager (organizer) or joint lead manager (organizer) of any public placement of the issuer's financial instruments (e.g. securities) in the previous 12 months. Regarding investment services defined in Sections A and B of Annex 1 of Directive 2014/65/EU, OTP Bank is not a party of the agreement with the issuer. OTP Bank maintains a conflict of interest policy and it keeps such records, and is has requirements that regulate the transmission of bank secrets and securities secrets, which requirements shall be considered as the effective

internal organizational and management solutions as well as information barriers to prevent or manage conflicts of interest. The remuneration of the person(s) participating in preparing the recommendation is not directly related to the transactions carried out as part of the investment services specified in Sections A and B of Annex 1 of Directive 2014/65/EU, or to transactions carried out by them or by other legal entities of the same group or to trading fees that they or another legal person of the same group receive. OTP Bank does not hold net long or short positions that exceed 0.5% threshold of the issuer's total registered capital.

5. OTP Bank has developed appropriate internal procedures for (i) the personal transactions and tradings of financial analysts and other relevant persons, (ii) the physical separation of the financial analysts involved in the production of investment research and other relevant persons; moreover, information barriers have been implemented, (iii) for accepting and managing incentives and remuneration.

6. This communication does not contain a comprehensive analysis of the described issues; it is only for information purposes. No part, chapter, or the entirety of this information shall be considered as investment advice, not even if any part of this document contains a description of a certain financial instrument in terms of its possible price or yield development, and the related investment options. This information shall not be considered as legal, tax or accounting advice.

7. This information reflects the market situation at the time when the document was prepared. You may request more information from OTP Bank. This document was prepared based on publicly accessible information made available to OTP Bank from one or more sources. This document was prepared using data, facts and information from the following essential sources: Bloomberg, Reuters, Hungarian Central Statistical Office, Eurostat, Magyar Nemzeti Bank (Hungary's central bank), and European Central Bank (ECB). Although the information in this document has been prepared in good faith from sources that OTP Bank believes to be reliable, we do not represent or warrant its accuracy or completeness. This document represents the opinion and estimations of analysts at OTP Research, based on publicly available data. You may receive different recommendation from the staff of OTP Bank, in particular if you are provided investment advice based on an investment advice agreement. The content of this document is based on the opinion of OTP Research's analyst at the time when the document was prepared, and they may be subject to change at any time in the future without further notice.

8. Please be informed that, irrespective of the statements of this investment research, OTP Bank is entitled to deal or trade as market maker, acting in good faith and in accordance with the usual way of market-making, with the financial instruments distributed by the issuer(s) specified in this document, as well as to provide other investment activities or ancillary (investment) services, and/or other financial or ancillary financial services to the issuer and other persons.

9. This document shall not be a basis for any further analysis in relation to the financial instruments contained therein. Any reference in this document to the future distribution of a financial instrument shall be construed as indicative, preliminary and informative, and any analysis of such financial instrument is exclusively based on publicly available information listed in the respective prospectus or announcement. The content of this document shall not imply that OTP Bank acts as an agent, a fiduciary, or an advisor to, or on behalf on, any prospective purchaser of the financial instruments discussed herein.

10. For certain persons, access to the products and/or services discussed in this document may not be granted, or it may be limited. The act of preparing this document by OTP Bank, its uploading to the website, its publication may under no circumstances be considered as OTP Bank's intention to make available product and/or service information in the prospectus to persons whom any country or state prohibits from having or obtaining the given product and/or service, including the promotion and the advertisement thereof. This communication and any of the financial instruments and information contained herein are not intended for the use of private investors in the UK and US. OTP Bank is not allowed to provide direct investment services to US investors. Any individual decision or investment made based on this publication is made solely at the risk of the client and OTP Bank shall not be held responsible for the success of the investment decisions or for attaining the Client's target.

11. This publication contains generic presentation of information and knowledge, thus it does not take into account the individual clients' unique and special interests, financial condition, or their ability and willingness to take risks. Therefore please contact our staff or contact your banking consultant for advice before you make an

investment decision. The assessment and the consideration of the individual circumstances is provided by the suitability and compliance tests that assess clients' financial knowledge, experience, risk-taking abilities, as well as the examination of the target market.

12. Before making an informed decision to invest and to use the services, please carefully read through all documents, including the documentation, prospectus, regulations, terms and conditions, announcements and key information documents for that product/service, and carefully consider the subject, the risk, the fees and costs of your investment, the possibility of any loss, and seek information about the tax regulations regarding the product and the investment. The prices of financial instruments and securities are changing, outrights sales are realized at then current market prices, which may involve losses. The information and opinions in this document do not substitute or take the place of the issuance documentation for the given financial assets (e.g. prospectus, fund management rules), or their brochures or announcements.

13. You assume total responsibility and risk for any specific decision or investment; OTP Bank shall not be held responsible for the effectiveness of investment decisions or for reaching your purpose, nor for the individual investment decision made based on this document or any part thereof, or for their consequences.
    Investments in financial instruments carry a certain degree of risk, which may affect the effectiveness of the investment decision, and investors may not receive the whole amount they had expected the investment to yield in their investment targets; they may not preserve even the invested amount, therefore the invested capital might even decrease, be wholly lost, or even lead to additional payment obligation.

14. Trading with leveraged products (such as foreign exchange contracts, or shares and indices that have underlying products) carries a considerable amount of risk, and these products are not suitable for all investors. Trading with leveraged products carries the risk of losing all capital, and it may incur losses that exceed the amount invested.

15. **The figures and information described herein refer to the past, and past performance is not a reliable indicator of future yields, changes, or performance.** The changes on money and capital markets, the fluctuation of prices, the development of investments and their yields are influenced by the combined effect of multiple factors; one important factor of them is the change in investors' expectations. **The development of prices, the future yield of financial assets, indices or indicators, the examination of their changes, trends, and future performance is based on estimations and forecasts, which forecasts do not allow reliable conclusions to be drawn about the future moves of prices, real future yields, changes, or performance.** For each product and service, please assess their tax accounting implications, and other tax consequences, taking into account that they cannot be precisely assessed without knowing the effective tax regulations of the client's individual circumstances; and these legislative provisions as well as the circumstances may change over time.

16. OTP Bank reserves the right to modify this document in the future, without prior notice.
    The planned frequency of updates to the recommendation is quarterly. The initiation report preceding this research was published on 18 December 2017.

17. OTP Bank (business registration number: 01-10-041-585; registered seat: Nádor utca 16., Budapest H-1051, Hungary; authorised by Magyar Nemzeti Bank (former supervisory authority: Hungarian Financial Supervisory Authority, 'PSZÁF'). Supervisory authority: Magyar Nemzeti Bank (National Bank of Hungary – H-1054 Budapest, Szabadság tér 9); financial customer services: H-1013 Budapest, Krisztina krt. 39. The terms and conditions of this equity research and disclaimer shall be governed by and construed in accordance with Hungarian law.

18. Please note that the Internet is not a secure environment and OTP Bank does not accept any liability for any loss caused by the result of using this report in a form altered or delayed by the wilful or accidental interception, corruption or virus infection.

19. OTP Bank, in compliance with the applicable law, assumes no responsibility, obligation, warranty or guarantee whatsoever for any direct or indirect damage (including losses arising from investments), or for the costs or expenses, detrimental legal consequences or other sanctions (including punitive and consequential damage)

sustained by any natural or legal person as a result of the purchase or sale of financial instruments or engaging investment services described herein, even if OTP Bank was warned of the possibility of such occurrences.

20. If you received this document from OTP Bank Plc, then it was sent to you with your previous consent. You may withdraw this permission by sending an e-mail to research@otpbank.hu or writing a letter addressed to 'Research Center', Hungary H-1051, Budapest, Nádor utca 21. Please refer to your name and e-mail address in both cases.

21. The personal data in this investment research are processed by OTP Bank. The legal basis for processing the data is the legitimate interest of OTP Bank. The detailed information about the processing of personal data and the related rights of data subjects is available here.

This document was prepared by:
Dániel Módos
Senior Equity Analyst
OTP Research

This document was finalized at 8:19:01 PM on 25 March 2019