

EQUITY NOTE: PANNERGY NYRT.

Recommendation: BUY (unchanged)

Target price (12M): HUF 1,747 (revised up)

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Highlights

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The 12M target price for PannErgy is increased from HUF 1,670 to HUF 1,747. This can be essentially attributed to the positive impact of higher heat prices, volumes, and efficiency, which more than offsets the increases on the cost side including electricity and personnel costs. This is reflected in our revised 2023 EBITDA estimate as well, which we have raised from HUF 3.49bn to HUF 4.07bn. This falls within the company's expected 2023 EBITDA range, which is HUF 3.95-4.15bn. We note, however, that our estimates do not incorporate the positive impacts of the potential 3rd Miskolc well, where we await further information. We have also updated our WACC figures to reflect changes in the interest rate environment, which somewhat offset the positive effects of the higher EBITDA assumptions. We maintain our BUY recommendation.

Main takeaways from the quarterly production report:

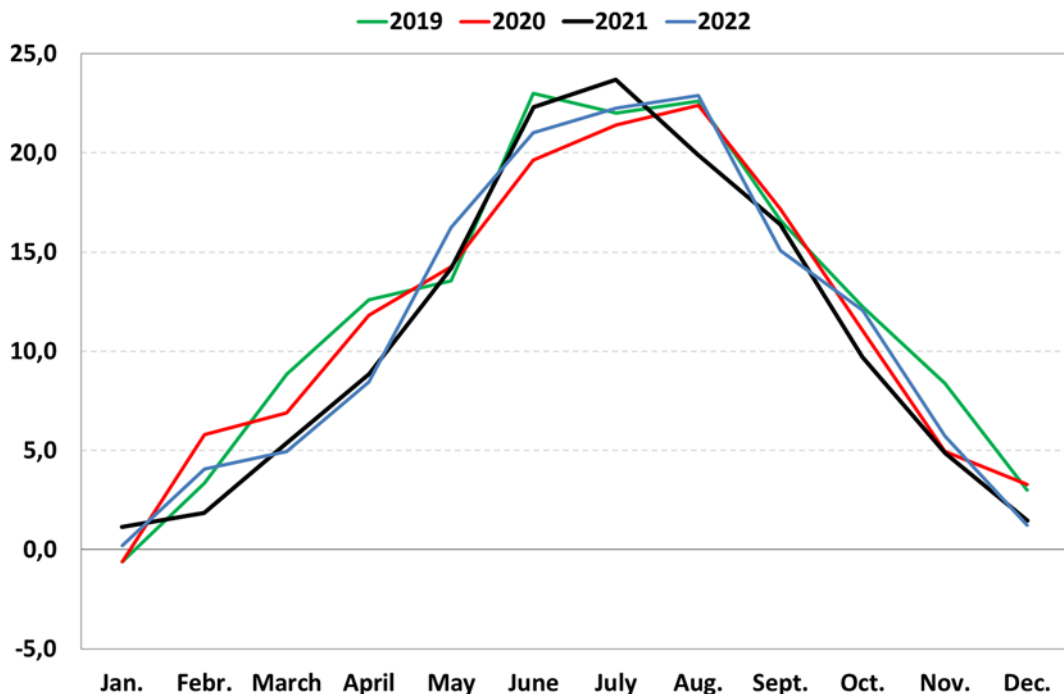
In the fourth quarter, PannErgy produced a record 631,094 GJ energy, which is 5.3% higher than a year earlier and roughly in line with the management's plan for the last quarter of 2022 (626,790 GJ). The good performance was primarily due to weather conditions and ongoing investments into increasing efficiency, operational safety, and capacity expansion. Overall, 1,784,507 GJ was sold in 2022, 1.9% higher than the management had expected and 5% higher YoY.

Regarding the performance of individual sites, Miskolc produced 273,325 GJ in Q4, a 5.1% increase YoY, mainly due to lower-than-average production in the base period (temporary service failure). At the same time, production in Győr hit a total record volume of 349,530 GJ in Q4, a 5.8% increase compared to the previous year. The production report mentions that the improvement can be attributed to: (1) investment activity in recent periods, (2) weather conditions and (3) the commercial agreement with GYŐR-SZOL Zrt., which gives priority to geothermal energy over other alternatives. **This also means that the total annual heat sold in Győr exceeded 1 million GJ for the first time in PannErgy's history (1,004,165 GJ).** The smaller Szentlőrinc site produced 15.6% less energy in YoY in Q4, amounting to 7,235 GJ. The company noted that from 2023 only projects with a sales performance of more than 5% of consolidated sales revenue will be detailed in the production report, hence Szentlőrinc will be excluded. Overall, the Győr project accounted for ~56% of heat sales volume in 2022, while the Miskolc project for ~43%.

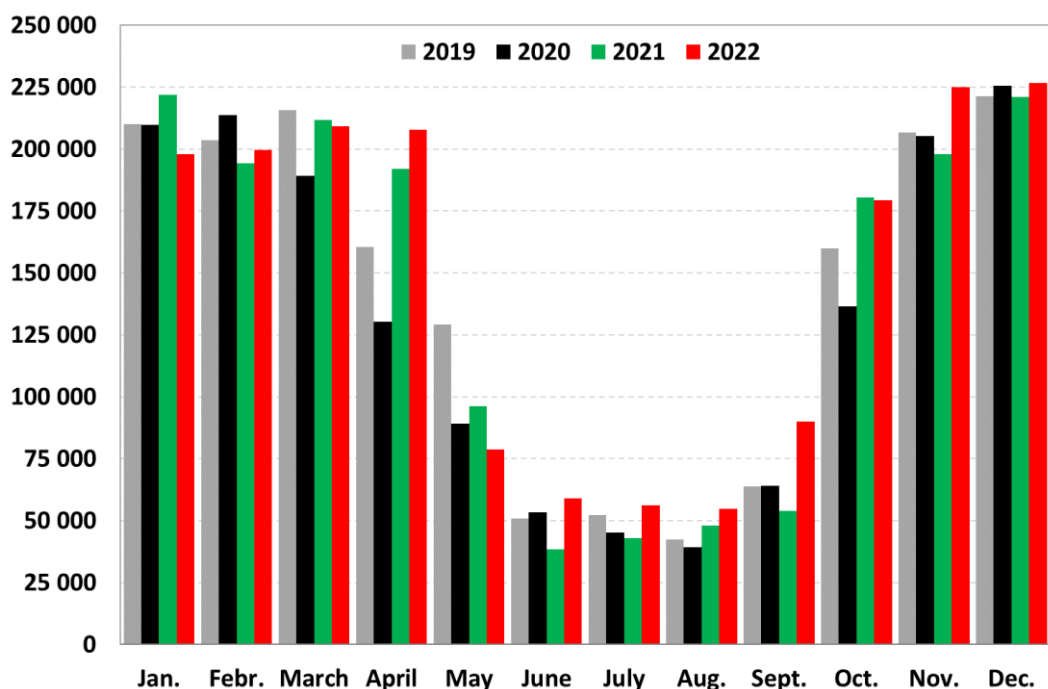
The management highlighted that **the company is projected to overperform the previously published HUF 3.25-3.35bn EBITDA range in 2022 and now expects**

consolidated EBITDA to be in the range of HUF 3.6-3.65bn. This can be primarily attributed to: (1) reliable operations in Q4, (2) strong sales, (3) efficiency and (4) increase in regulated prices.

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



Consolidated heat sales (GJ)



The company's production target for 2023 is 1,789,697 GJ (+0.3% YoY) and the EBITDA could be between HUF 3.95-4.15bn, an increase of 11.7% compared to the expected 2022 EBITDA (on a mid-point basis). The 2023 EBITDA range includes the (1) impact of capacity expansion and efficiency investments, including the boring of the 3rd Miskolc well and (2) the increase in regulated pricing, which recognizes the significant increases in material

and personnel costs (e.g., more than 4.5x increase in the price of electricity required for geothermal heat generation).

Other notable highlights:

- 1) The **new administrative prices** that are applicable from 2023 January were set, but we note that unlike in previous cases, these now do not have an end of validity date. We assume this is the case given there are still considerable uncertainties regarding energy prices, so these could be adjusted on a more flexible basis for the time being.

| Location of the wells | Company names | in effect until 31 December 2022 | in effect from 1 January 2023 | Change |
|-----------------------|------------------------------|----------------------------------|-------------------------------|--------|
| Szentlőrinc | Szentlőrinci Geothermal Ltd. | 4 620 HUF/GJ | 6 715 HUF/GJ | 45,4% |
| Miskolc | Miskolci Geothermal Ltd. | 3 176 HUF/GJ | 5 211 HUF/GJ | 64,1% |
| Miskolc | KUALA Ltd. | 3 176 HUF/GJ | 5 211 HUF/GJ | 64,1% |
| Győr | Arrabona Geothermal Ltd. | 4 023 HUF/GJ | 6 225 HUF/GJ | 54,7% |

Source: Hungarian Official Gazette, issue 219/2022

- 2) **Treasury share transactions:** the company has spent so far (up to 12th January) HUF 416 million on share repurchases, which is ~69% of the authorized amount under the current program. Overall, this means that PannErgy purchased under the current program 381,600 shares (~1.9% of total shares and ~2.4% of total non-treasury shares) for an average price of HUF 1,090 / share. The current program is valid until 13th April 2023 with a limit on share repurchases of HUF 600 million at a price not exceeding HUF 1,400 and 25% of total shares (~20.31% at the moment).

Updated valuation:

- We have previously estimated an EBITDA of HUF 3.32bn for 2022 and HUF 3.49bn for 2023. The company's updated 2022 expected consolidated EBITDA range of HUF 3.6-3.65bn is 9% higher and its 2023 EBITDA range of HUF 3.95-4.15bn is 16% higher in comparison on a mid-point basis. As the company noted the improvement in EBITDA in 2022 is primarily attributable to reliable and efficient operations, strong sales, and the increase in regulated pricing. The 2023 EBITDA target also includes some of the effects of the 3rd Miskolc well (expected commissioning by the end of the year).
- Considering these positive developments and higher than expected 2023 EBITDA range we have revisited our DCF model as well. **Our updated 2023 EBITDA is HUF 4.07bn, which reflects higher heat prices and volumes, which more than offsets the increases on the cost side including electricity and personnel costs.** We note that this alone would have a positive impact on valuation ceteris paribus. On the other hand, we have also updated our WACC figures to reflect changes in the interest rate environment, which somewhat offset the positive effects of the higher EBITDA assumptions.
- The EBITDA figures and the valuation model does not incorporate the impact of the potential 3rd Miskolc well as we await further information.
- Overall, **the FCFF valuation gave a HUF 1,747 12-month target price, which is ~30% higher than the current price.** We also maintain our BUY recommendation.

| Income statement | | | | | | |
|--------------------------------------|-------|-------|-------|-------|--------|--------|
| P/L Table consolidated (million HUF) | 2019 | 2020 | 2021 | 2022F | 2023F | 2024F |
| Revenue from geothermal-heat | 5 060 | 5 070 | 5 583 | 6 549 | 11 240 | 11 301 |
| Other revenue | 192 | 132 | 215 | 270 | 270 | 270 |
| OPEX | 2 982 | 3 320 | 3 776 | 3 942 | 7 723 | 7 827 |
| from which: Depreciation | 1 468 | 1 660 | 1 595 | 1 580 | 1 580 | 1 580 |
| EBITDA | 2 666 | 2 735 | 2 878 | 3 613 | 4 074 | 4 031 |
| EBIT | 1 198 | 1 075 | 1 283 | 2 032 | 2 493 | 2 450 |
| EBT | 782 | 262 | 964 | 1 765 | 2 227 | 2 183 |
| Income Taxes | 47 | 25 | 67 | 212 | 267 | 262 |
| Non-controlling interest | 0 | 0 | 0 | 0 | 0 | 0 |
| Net income | 728 | 236 | 897 | 1 554 | 1 959 | 1 921 |
| EPS (HUF) | 46 | 14 | 55 | 97 | 123 | 121 |

| Balance sheet | | | | | | |
|--|--------|--------|--------|--------|--------|--------|
| Balance sheet - consolidated (million HUF) | 2019 | 2020 | 2021 | 2022F | 2023F | 2024F |
| Non-current assets | 23 177 | 23 634 | 22 933 | 22 107 | 21 306 | 19 706 |
| Current assets | 2 796 | 3 099 | 3 950 | 4 212 | 5 638 | 6 983 |
| Total assets | 25 973 | 26 733 | 26 883 | 26 318 | 26 944 | 26 689 |
| Total equity | 10 213 | 9 747 | 9 980 | 10 782 | 12 353 | 13 784 |
| Non-current liabilities | 11 910 | 14 441 | 13 704 | 12 508 | 10 812 | 9 116 |
| Current liabilities | 3 850 | 2 545 | 3 199 | 3 029 | 3 779 | 3 789 |
| Total equity and liabilities | 25 973 | 26 733 | 26 883 | 26 318 | 26 944 | 26 689 |

| Cash flow statement | | | | | | |
|-------------------------------------|--------|--------|--------|--------|--------|--------|
| Cash flow statement (million HUF) | 2019 | 2020 | 2021 | 2022F | 2023F | 2024F |
| Profit before taxes | 782 | 262 | 964 | 1 765 | 2 227 | 2 183 |
| Cash flow from operations | 2 601 | 1 238 | 2 859 | 3 177 | 2 963 | 3 753 |
| Cash flow from investment | -1 790 | -1 639 | -1 475 | -1 564 | -1 564 | -614 |
| Cash flow from financing activities | -575 | -278 | -774 | -1 096 | -1 082 | -1 082 |
| Change in cash and cash equivalents | 236 | -679 | 610 | 517 | 317 | 2 057 |

FCFF valuation

| Valuation summary (million HUF) | 2022F | 2023F | 2024F | 2025F | 2026F | 2027F | Terminal year |
|---------------------------------|-------|--------|--------|--------|--------|--------|---------------|
| Revenue from geothermal heat | 6 549 | 11 240 | 11 301 | 11 527 | 11 755 | 11 987 | 12 227 |
| EBITDA | 3 613 | 4 074 | 4 031 | 4 051 | 4 067 | 4 082 | 4 164 |
| Depreciation | 1 580 | 1 580 | 1 580 | 1 580 | 1 580 | 1 580 | 1 580 |
| Working capital sales | 469 | 844 | 11 | 11 | 11 | 11 | 11 |
| Capex | 950 | 950 | 150 | 150 | 150 | 150 | 150 |
| FCFF | 1 950 | 1 980 | 3 576 | 3 594 | 3 608 | 3 621 | 3 693 |
| WACC | | 13,5 | 12,7 | 11,9 | 11,9 | 11,9 | 11,9 |
| PV(FCFF) | | 1 744 | 2 794 | 2 510 | 2 252 | 2 020 | 21 254 |

| Share price estimation | |
|--------------------------------------|--------|
| Enterprise value | 32 575 |
| Net debt (-) | 8 895 |
| Equity value | 23 680 |
| Number of shares | 15 938 |
| Required return on equity | 16,7 |
| Target price for the next 12 M (HUF) | 1747 |

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.
5. **Pandemic risks:** Based on our current knowledge, covid-19 has no material effect on the company. However, the covid crisis and its economic effects may change rapidly and unpredictably in the future. This may pose some unforeseen risks for PannErgy as well.

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 |
|------------|-----------------|--------------|-------------|
| 06/10/2021 | BUY | HUF 1,450 | Equity note |
| 18/10/2021 | BUY | HUF 1,450 | Equity note |
| 17/01/2022 | BUY | HUF 1,450 | Equity note |
| 18/02/2022 | BUY | HUF 1,450 | Equity note |
| 26/03/2022 | BUY | HUF 1,420 | Equity note |
| 19/04/2022 | BUY | HUF 1,420 | Equity note |
| 19/07/2022 | BUY | HUF 1,420 | Equity note |
| 02/09/2022 | BUY | HUF 1,420 | Equity note |
| 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 |

| Period | Recommendations | Percent of recommendation |
|--------|-----------------|---------------------------|
| 2022Q1 | BUY | 100% |
| | HOLD | 0% |
| | SELL | 0% |
| 2022Q2 | BUY | 100% |
| | HOLD | 0% |
| | SELL | 0% |
| 2022Q3 | BUY | 100% |
| | HOLD | 0% |
| | SELL | 0% |
| 2022Q4 | BUY | 100% |
| | HOLD | 0% |
| | SELL | 0% |
| 2023Q1 | BUY | 100% |
| | HOLD | 0% |
| | SELL | 0% |

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

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