

EQUITY NOTE: PANNERGY NYRT.

Recommendation: BUY (unchanged)

Target price (12M): HUF 1,420 (unchanged)

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Highlights

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Pannergy delivered a solid H1 performance aided by last year's administered price hikes, ongoing investments into increasing efficiency and capacity expansion and record heat sales in Győr, where the agreement concluded in Q1 with Győr-Szol CPlc. that ensures priority to geothermal energy supply for the town contributed to the good results as well. Production was basically flat YoY due to weaker Miskolc figures, while revenue from geothermal heat sales was up by 5%. The management confirmed that the HUF 1.735 billion H1 EBITDA is an adequate basis for the HUF 3.25-3.35 billion EBITDA plan in 2022. This is in line with our EBITDA forecast of HUF 3.28bn for this year. In addition, the company continues its share repurchase program, which supports the share price. We also note that energy market conditions significantly changed over recent months given the spike in European natural gas prices, which could be an upside risk to the administrative heat sales price-setting process, which will be determined around the end of September. The outcome of this will depend, however, on multiple factors. At the same time, the economic environment keeps deteriorating and central banks are raising interest rates to fight inflation, which has a negative impact on the company's valuation via higher WACC. We maintain our BUY recommendation and current price target of HUF 1,420 given this already includes partially the impact of the unfavourable rate environment and it will be re-evaluated in the context of the new administrative prices once they are available.

Main takeaways from the H1 report:

Revenue for H1 2022 was HUF 3.686 billion (+7% YoY), while revenue from geothermal heat sales amounted to HUF 3.093 billion (+5% YoY). Over the first half of the year, heat sales reached 951,639 GJ, which is basically the same amount that the company sold in H1 2021 (954,882 GJ), but it is slightly smaller than the management's plan of 961,569 GJ (-1%). In Q1 2022 the company sold 606,790 GJ, which was 6.1% lower than the target amount and 3.4% lower YoY, mainly due to temporary technical intervention needs and operational specificities arising in relation to the well pump in Miskolc in January. This was only partially offset by the historic record performance of heat sales in Győr. On the other hand, in Q2 2022 PannErgy sold a record 344,849 GJ, which was 9.3% above management's plan and 5.5% higher YoY because of ongoing investments into increasing efficiency and capacity expansion.

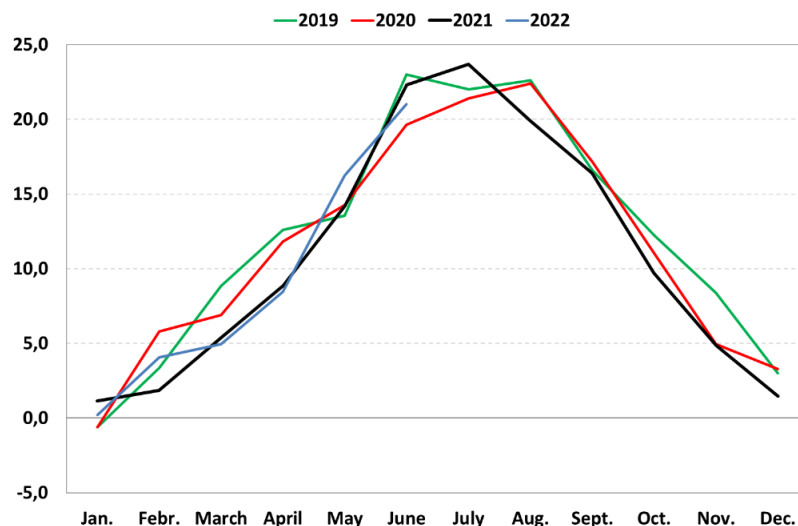
In terms of sales revenue by project, **Győr contributed HUF 1.997 billion to the sales revenue in H1 2022 (+12% YoY)**, which is ~64.5% of heat sales related revenues (~56.9% of H1 volume). Out of this, sales to Győr-Szol CPlc. amounted to HUF 1.166 billion

(+26.5%), while HUF 831 million (-4.4%) is related to the company's automotive industry customer. Sales from the **Miskolc project amounted to HUF 1.044 billion (-7% YoY)**, which is ~33.8% of heat sales related revenues (~41.8% of H1 volume). Most of the heat was sold to MIHŐ Heat Distribution Ltd. (HUF 1.005 billion). The two smaller projects, Szentlőrinc and Berekfürdő, contributed to sales by HUF 43 million and HUF 65 million.

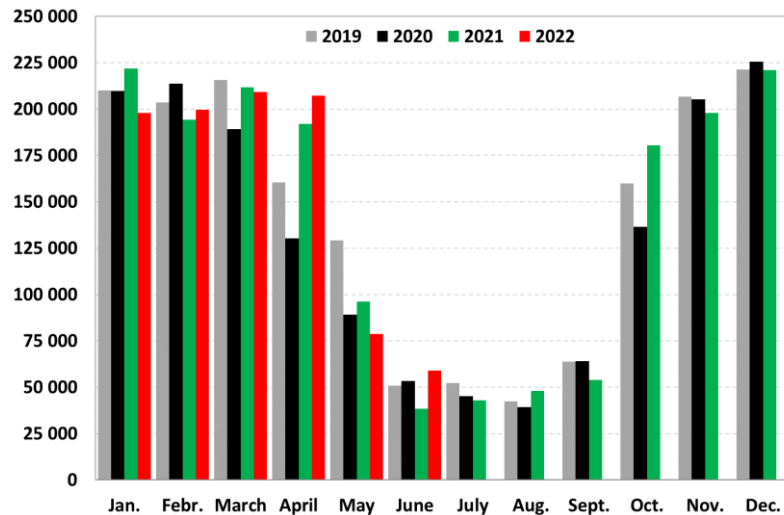
Direct costs amounted to HUF 2.7 billion (+11.9% YoY), which is mainly the result of an increase in maintenance, operation, and facility management costs (+15.5% YoY) and an increase in direct depreciation costs (+8% YoY) related to more intensive investment activities. Given the increase in direct costs was higher than revenue growth, **gross profit margin declined from 29.9% to 26.7%**. The average gross profit margin between 2018 and 2021 was 27.2%. Overall, gross profit was HUF 983 million down 4.4% YoY.

The Group's **administrative and overhead costs** increased by 5.8% on YoY to HUF 273 million including an increase of 22.7% in indirect personnel-type costs. At the same time, other revenues were significantly higher, up 76.3% YoY to HUF 335 million. This includes HUF 90 million in connection with the sale of tangible assets (the Group sold its utility distribution system in Debrecen, TT-Geotermia). Other expenditures amounted to HUF 117 million (-21% YoY), mostly related to local business tax and mining fee. This brings EBIT to HUF 928 million (+14.3% YoY). **EBITDA amounted to HUF 1.735 billion (+11.2% YoY), while the EBITDA ratio increased to 47.1% from 45.3%**.

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



Consolidated heat sales (GJ)



The company reported a net financial loss of HUF 194 million in H1, which is 128.2% higher YoY. This is mainly driven by an **unfavourable change in the non-realised FX loss** at the end of the period due to the significant weakening of the HUF against the EUR (HUF 103 million loss).

Overall, the company reported HUF 732 million net income after tax, which is 10.2% higher YoY. The recognised tax payment obligation, however, was only HUF 2 million in H1 2022 as opposed to HUF 63 million a year ago.

Looking ahead, the company maintains its plan to sell a total of 1,752,012 GJ in 2022 (+3.1% YoY) and in H1 delivered 54.3% of that. The **management also confirmed that the HUF 1.735 billion H1 EBITDA is an adequate basis for the HUF 3.25-3.35 billion EBITDA plan in 2022. This is in line with our EBITDA forecast of HUF 3.28bn for this year.**

Other news:

- 1) **Share capital decrease:** the company's AGM decided on the reduction of the share capital on 29 April 2022. As a result, the number of PannErgy ordinary shares decreased from 21,054,655 to 20,000,000. Concurrently, the subscribed capital is reduced from HUF 421 million to HUF 400 million. The number of treasury shares was reduced by 1,054,655. At the end of August 2022, **the company had 3,869,100 treasury shares (19.35% of total shares).**
- 2) **Treasury share transactions:** the AGM held on 29 April authorized management to purchase own shares up to HUF 600 million at a price not exceeding HUF 1,400 and 25% of total shares. The program is valid for the period 2 May 2022 – 13 April 2023 and PannErgy intends to purchase 2,200 shares / trading day until withdrawal. **The company has spent so far (up to 26th August) HUF 184,5 million on share repurchases, which is ~30.75% of the authorized amount.** Overall, this means that PannErgy purchased under the current program 182,600 shares (~0.9% of total shares and ~1.1% of total non-treasury shares) for an average price of HUF 1010.2 / share.
- 3) **Dividends:** the company paid gross HUF 18.11 / share dividends for FY21 (~1.8% dividend yield), a total of HUF 294 million.

Assessment & outlook:

Overall, PannErgy delivered a solid H1, the company sold basically the same amount of heat YoY and close to the management's target, while revenue from heat sales was up by 5%. The Győr project delivered record results - despite slightly lower YoY revenue from its automotive customer - partially because of the agreement with Győr-Szol CPlc., under which geothermal energy is given preference over other types of energy sources supplying the district heating system (surplus heat sales potential of 25 TJ in Q2 and Q3 and 15 TJ in Q4). Direct and administrative costs grew as well, but this is not surprising given the current inflationary environment. At the same time, the negative impact of the non-realised FX loss was largely offset by another one-off item, the revenue from the sale of TT-Geotermia. The management also confirmed that the company is on track to achieve its EBITDA target for 2022. There was no update provided regarding the deepening and commissioning of the 3rd production well in Miskolc.

P/L Table consolidated (million HUF)	2022H1	2021H1	2020H1	2019H1	2018H1	2017H1
Revenue	3 686	3 444	3 197	3 121	2 402	2 519
Net other revenue	218	42	-13	106	174	120
OPEX	2 976	2 674	2 572	2 447	2 104	2 196
From which:						
* SGA	273	258	247	233	237	297
* Depreciation	807	748	798	671	675	588
EBITDA	1 735	1 560	1 461	1 451	1 147	1 095
EBIT	928	812	612	780	472	443
EBT	734	727	106	618	33	381
Income Taxes	2	63	13	15	9	26
Net income	732	664	93	603	24	355
EPS (HUF)	45,10	39,82	5,01	32,90	1,60	19,77

	2022H1	2021H1	2020H1	2019H1	2018H1	2017H1
EPS (HUF)	45,10	39,82	5,01	32,90	1,60	19,77
EBITDA (HUFm)	1 735	1 560	1 461	1 451	1 147	1 095
Gross profit rate (%)	26,7%	29,9%	27,3%	29,1%	22,3%	24,6%
EBIT rate (%)	25,2%	23,6%	19,1%	25,0%	19,7%	17,6%
EBITDA rate (%)	47,1%	45,3%	45,7%	46,5%	47,8%	43,5%
ROE (%)	7,1%	6,7%	0,9%	5,9%	0,3%	3,9%
ROA (%)	2,8%	2,6%	0,4%	2,3%	0,1%	1,5%
ROS (%)	19,9%	19,3%	2,8%	19,3%	1,0%	14,1%

Over the past few months there has been a substantial increase in European natural gas prices, the Dutch TTF spot spiked above EUR / MWh for a few days, which is almost 7x higher YoY and 30-40x higher compared to the levels seen in 2020 August. We think this could be an upside risk to the administrative heat sales price-setting process, which will be determined around the end of September. This will depend, however, on multiple factors. The significant changes in the energy market conditions also highlighted the importance of energy independence, where geothermal energy generation could play an important role. László Palkovics, minister of technology and industry also recently mentioned the need to invest in renewable sources, which includes solar, wind and geothermal as well.

At the same time, the external economic environment keeps deteriorating and central banks are raising interest rates to fight inflation. Higher rates also mean higher WACC rate, which has a negative impact on the company's valuation. **For now, we maintain our**

current price target of HUF 1,420 given this already includes partially the impact of the unfavourable rate environment and it will be re-evaluated in the context of the new administrative prices once they are available within the next few weeks (current figures can be seen below).

Location of the wells	Company names	in effect until 30 September 2021	in effect from 1 October 2021	Change
Szentlőrinc	Szentlőrinci Geothermal Ltd.	3 654 HUF/GJ	3 791 HUF/GJ	4%
Miskolc	Miskolci Geothermal Ltd.	2 626 HUF/GJ	2 650 HUF/GJ	0,9%
Miskolc	KUALA Ltd.	2 626 HUF/GJ	2 650 HUF/GJ	0,9%
Győr	Arrabona Geothermal Ltd.	3 204 HUF/GJ	3 397 HUF/GJ	6,0%

Source: Hungarian Official Gazette, issue 179/2021

Risks surrounding PannErgy's economic activity

- 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.
- 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.
- 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.
- 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.
- 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.

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
29/03/2021	BUY	HUF 1,387	Equity note
19/04/2021	BUY	HUF 1,387	Equity note
16/07/2021	BUY	HUF 1,387	Equity note
06/09/2021	BUY	HUF 1,387	Equity note
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

Period	Recommendations	Percent of recommendation
2021Q2	BUY	100%
	HOLD	0%
	SELL	0%
2021Q3	BUY	100%
	HOLD	0%
	SELL	0%
2021Q4	BUY	100%
	HOLD	0%
	SELL	0%
2022Q1	BUY	100%
	HOLD	0%
	SELL	0%
2022Q2	BUY	100%
	HOLD	0%
	SELL	0%

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

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