SUMMARY

ALTEO Group is considered as a utility group regarding industry classification. The Group is a key player within the utility sector by offering Smart Energy Management solutions. The Group's activities include power generation (electricity and heat/thermal production), energy service and energy trading too. The Group builds or acquires small power plants and provides decentralized energy production. The power generation is based on renewables and natural gas. The Group's growth is based on the successful investments. We consider the Group as a growth story, which is based on its heavy capex spending, despite being a utility company.

Company data:

Recommendation: Buy

Price: HUF 715 (07 Feb 2018)

52 week range: HUF 531.25-800

Market cap (HUF, mn): 11,7

Average daily turnover: 12400 (last month)

Price target: HUF 970

Code: Bloomberg: ALTEO HB Equity; Reuters: ALTS.BU

During the last week the Group bought the remaining 49% stake in the Zugló-Therm Ltd., hence, it will be the sole owner of Zugló-Therm Ltd., which will almost double its earnings contribution. In addition, few economic factors have changed in recent months; therefore, **we lifted our price target to HUF 970 from HUF 823**.

Since December the risk-free rate (the 10 year Hungarian bond yield) has risen from 2% to 2.7%. During this time the equity risk premium changed only slightly, because the earnings yield of the Hungarian stock market is 9%, which is in line with the values of the last few months. The unlevered beta of the renewable sector didn't change much, but the utility sector's beta decreased from 0.38 to 0.23. The levered beta of the Group decreased from 1.53 to 1.33. Based on the above the WACC decreased from 7.5% to 6.1%.

According to our updated model and the expected investments, our recommendation is buy with a one year price target of HUF 970. According to our updated DCF-model the new price target represents approximately 30-35% upside potential to the actual market price and is higher by 18% than our previous price target. Based on our analysis our recommendation is buy as the stock's return is expected to be above 10% in the next 12 months.

Key figures:

In Millions of HUF 12 Months Ending	FY 2009 12/31/2009	FY 2010 12/31/2010	FY 2011 12/31/2011	FY 2012 12/31/2012	FY 2013 12/31/2013	FY 2014 12/31/2014	FY 2015 12/31/2015	FY 2016 12/31/2016	FY 2017E 12/31/2017	FY 2018E 12/31/2018	FY 2019E 12/31/2019
Revenue	**1 091**	**5 658**	**4 856**	**5 546**	**6 172**	**5 860**	**10 447**	**13 948**	**14 615**	**15 962**	**20 385**
Cost of Revenue	991	4 818	4 090	4 666	5 187	4 890	8 126	10 882	11 838	12 929	16 512
Gross Profit	100	940	766	880	985	970	2 321	3 067	2 777	3 033	3 873
Depreciation & Amortization	9	186	166	271	420	404	627	601	830	982	1 233
EBITDA	**-89**	**402**	**453**	**591**	**816**	**719**	**1 394**	**2 314**	**1 900**	**2 075**	**2 650**
EBITDA Margin (T12M)	-8	7	9	11	13	12	13	17	13	13	13
Net Income, GAAP	96	70	-102	95	-57	-346	1 087	728	n.a.	n.a.	n.a.
Capex	-161	-197	-686	-313	-140	-181	-206	-152	-4 500	-4 500	-4 500
Aqusition of business	-671	-1 235	0	-340	-97	0	697	0	n.a.	n.a.	n.a.

Source: Bloomberg, ALTEO, MKB

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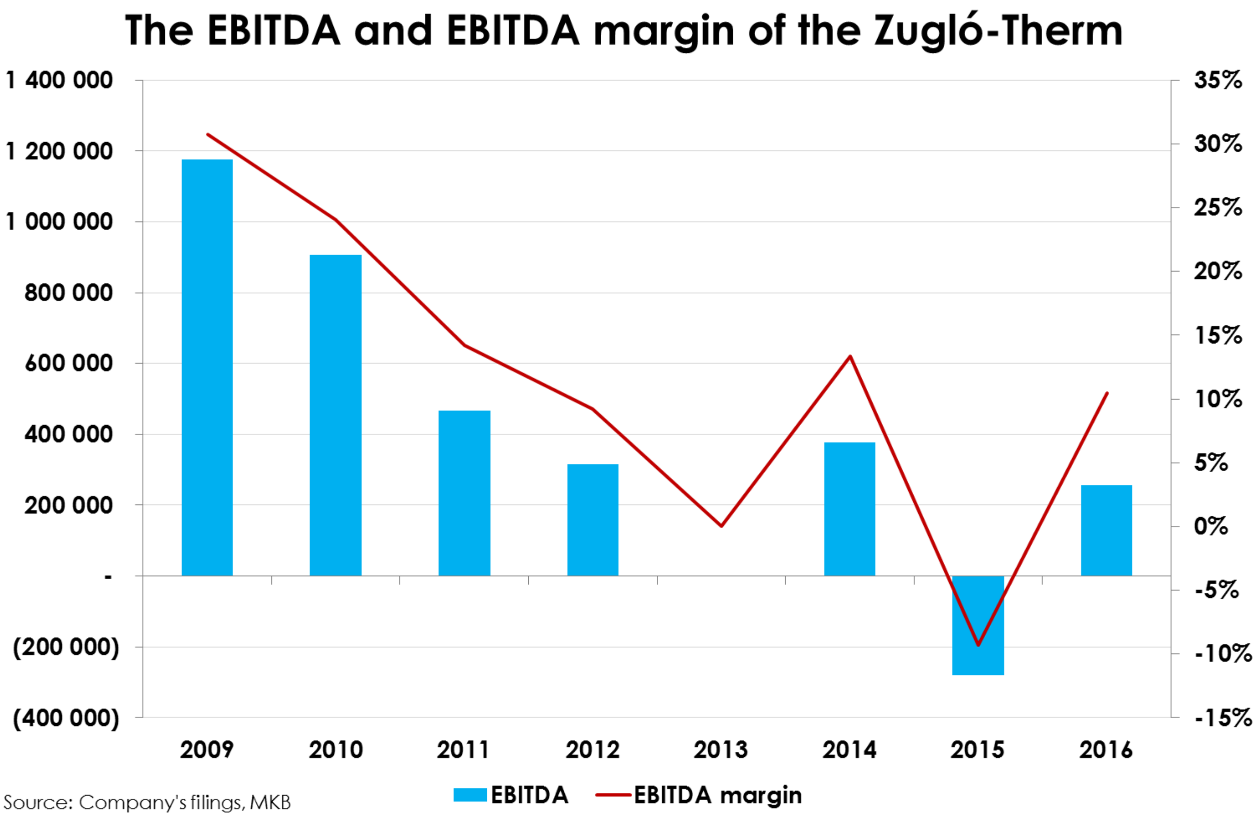
THE ACQUISITIONS CONTINUE

On 29 January 2018 Sinergy Ltd., which is fully owned by the ALTEO Group, acquired the 51% of the Zugló-Therm Ltd. Prior to the transaction Zugló-Therm Ltd was an associated company because ALTEO owned 49% of the company. Zugló-Therm Ltd. may operate fully under the Alteo Group by May, upon receiving the approvals of both the Hungarian Energy and Public Utility Regulatory Authority and the Hungarian Competition Authority.

Zugló-Therm Ltd. is already a member of ALTEO's Virtual Power Plant and ALTEO provides the operation and the maintenance of its assets. Zugló-Therm Ltd. has 18MW of electricity and 17MW of heat power plant. It covers 30% of the area's district heating demand, and provides heat energy based on a 15-year contract.

The acquisition fits well into the Group's small scale power plant strategy. It is crucial to have high-efficiency gas fired plants to balance the renewable energy generation. (See Initiation Report page 12. and 21.) The volatility of the renewable energy sector is high, the production is strongly weather dependent (the number of sunshine hours or the wind power and speed), and the water yield. In such environment the gas-fired power plants can balance the energy production.

The EBITDA of Zugló-Therm in 2016 was more than 250 million HUF, so in our opinion the Group's earnings will be higher. Zugló-Therm's EBITDA margin varied between -10% to 30% in the last 8 years, and in the last 4 years it was very volatile. Our assumption is that it will reach 10-15% in the next years, so the company EBITDA can reach 250-350 million HUF, further improving the Group's results.



Source: Company's filings, MKB

THE UPDATED DCF MODEL

In recent months a number of fundamental factors have changed. The 10-year risk free rate increased from 2.0% to 2.7% in the previous month. During this time the equity risk premium changed only slightly, because the earnings yield of the Hungarian stock market is 9%, which is in line with the value of the last 1-2 months. Moreover, the unlevered beta of the renewable sector didn't change much, but the utility sector's beta decreased from 0.38 to 0.23. The levered beta of the company decreased from 1.53 to 1.33. Based on the above the WACC (weighted average cost of capital) decreased from 7.5% to 6.1%.

The remaining assumptions didn't change, so in our opinion:

- The EBITDA will grow significantly in 2019/2020, because the early investments will have been realized by the end of 2018;
- The EBITDA without investments can grow in line with inflation or GDP;
- The capex will cost 10-15 billion HUF in the next two years; from 2020 onwards the company will spend 300 million to maintenance (we increase the maintenance capex by 50 million HUF);
- The effective tax rate is ca. 12-13% because of the extra tax (see Initiation Coverage's Key Risk Factors at page 12.);
- The terminal value is based on the EV/EBITDA (three different scenarios: 5x, 6.5x and 8x).

		Total Equity Value		
		Terminal EBITDA Multiple		
		5,0x	6,5x	8,0x
Discount	4,1%	**13 894**	**17 857**	**21 820**
Rate	6,1%	**12 306**	**15 909**	**19 512**
(WACC)	8,1%	**10 887**	**14 169**	**17 450**
		One Year Target Price		
		Terminal EBITDA Multiple		
		5,0x	6,5x	8,0x
Discount	4,1%	**847**	**1 089**	**1 330**
Rate	6,1%	**750**	**970**	**1 190**
(WACC)	8,1%	**664**	**864**	**1 064**

Source: ALTEO, Bloomberg, MKB

Key figures:

million HUF	2009	2010	2011	2012	2013	2014	2015	2016	2017E	2018E	2019E	2020E	2021E	2022E
EBITDA	-88	401	453	591	816	719	1428	2312	1900	2075	2650	3025	3126	3230
D&A	9	186	166	291	420	404	950	829	830	982	1233	1397	1460	1527
Capex	-1432	-832	-686	-652	-237	-181	-206	-152	-4500	-4500	-4500	-300	-300	-300
FCFF									-2664	-2492	-1957	2592	2687	2787

Source: ALTEO, Bloomberg, MKB

Our former price target was HUF 823. According to our updated DCF-model the new one year price target is HUF 970, which represents approximately 30-35% upside potential to the actual market price and is higher by 18% than our previous price target. Based on our analysis our recommendation is buy as the stock's return is expected to be above 10% in the next 12 months.

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Prior researches

MKB Bank wrote an initiation report on 15 December 2017. The research is available on the web page of the BSE (Budapest Stock Exchange):

https://bet.hu/pfile/file?path=/site/Magyar/Dokumentumok/Tozsdetagoknak/Tozsdetagok-elemzesei/MKB-Bank-Alteo-initation-report-20171215.pdf

MKB Bank wrote flash notes on 12 January 2018, and on 31 January 2018. The researches are available on the web page of the BSE (Budapest Stock Exchange):

https://bet.hu/pfile/file?path=/site/Magyar/Dokumentumok/Tozsdetagoknak/Tozsdetagok-elemzesei/MKB_Bank_Zrt._-_Alteo_elemzoi_kommentar_-_2018.01.12..pdf1

https://bet.hu/pfile/file?path=/site/Magyar/Dokumentumok/Tozsdetagoknak/Tozsdetagok-elemzesei/MKB_Bank_Zrt._-_Alteo_elemzoi_kommentar_-_2018.01.31..pdf1

Methodology used for equity valuation and recommendation of covered companies

The discounted cash flow valuation is a method of valuing a company (or project, assets, business, etc.) with the time value of the money. The model forecasts the company's free cash flow (free cash flow to firm) and discounts it with the average cost of capital (WACC). The cash flow is simply the cash that is generated by a business and which can be distributed to investors. The free cash flow represents economic value, while accounting metric like net earning doesn't. The WACC represents the required rate of return by the investors. If a business is risky the required rate of return, the WACC will be higher.

Discounted cash flow model (DCF): We analyze the companies using five year forecast period and set a terminal value based on the entity's long term growth or on different exit multiples like EV/EBITDA or EV/EBIT. In certain cases the forecast period may differ from five years. In this case the analysts must define the reason for difference. The cash flows are discounted by the company's WACC unless otherwise specified.

In the first step we have to forecast the company's cash flow. The free cash flow to firm (FCFF) is based on the earnings before interest and taxes (EBIT), the tax rate, depreciation and amortization (D&A), net change in working capital (which is based on the current assets and current liabilities) and the capital expenditures (CAPEX). The model requires a terminal value which can be based on the long term growth or on an exit multiple like EV/EBITDA, or EV/EBIT. Forecasting the terminal value is a crucial point because in most cases it makes up more than 50% of the net present value.

The discount rate (WACC): The average cost of capital of the company is dependent on the industry, the risk free rate, tax, the cost of debt and the equity risk premium. The cost of equity is calculated by the CAPM model, where the independent variables are the risk free rate, the industry specific levered beta, and the equity risk premium. The WACC is dependent on the capital structure, so the forecast of the equity/debt mix is crucial.

At the end we get the enterprise value (EV). The EV is the market capitalization plus the total debt and preferred equity and minority interest, minus the company's cash. In the last step we have to reduce the EV with the net debt. This figures divided by the shares outstanding we arrive at the target share price.

The discounted cash flow model includes sensitivity analysis which takes the effects of the change in the WACC, the long term growth or the used exit multiples on which the terminal value is based.

Our target price is based on a 12 month basis, ex-dividend unless stated otherwise.

Peer group valuation: For comparison we use peer group valuation. The analysis based on important indicators and multiples like P/E, EV/EBITDA, EV/EBIT, market capitalization, P/S, EBITDA margin, net debt to EBITDA, EBITDA growth, dividend yield and ROIC. If the industry justifies we may use other multiples. The peer group is compiled according to the companies' main business, with respect to the region (DM or EM market).

Recommendations

- Overweight: A rating of overweight means the stock's return is expected to be above the average return of the overall industry, or the index benchmark over the next 12 months.
- Underweight: A rating of underweight means the stock's return is expected to be below the average return of the overall industry, or the index benchmark over the next 12 months.
- Equal-weight: A rating of equal-weight means the stock's return is expected to be in line with the average return of the overall industry, or the index benchmark over the next 12 months.
- Buy: total return is expected to exceed 10% in the next 12 months.

- Neutral: Total return is expected to be in the range of -10 - +10% In the next 12 months.
- Sell: Total return is expected to be below -10% in the next 12 months.
- Under revision: If new information comes to light, which is expected to change the valuation significantly.

Change from the prior research

Our first research was published on 05. December 2017. In that Initial Coverage our price target was HUF 823, but the changes in fundamental factors and the latest acquisition justified the update of our model. Our new price target is HUF 970 which is higher by 18% than our first price target.