

EQUITY NOTE: PANNERGY NYRT.

Recommendation: BUY

Target price (12M): HUF 1,032

17 July 2018

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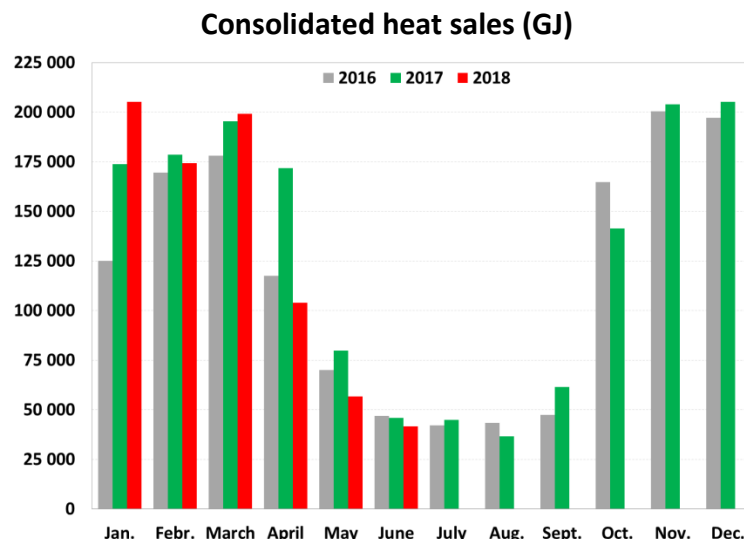
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Pannergy Nyrt has released its quarterly production report for Q2 2018. As it could have been expected, production in Q2 was short of expectations, due to extreme weather conditions. We see this as a one-off effect, which does not change the business fundamentals or our valuation.

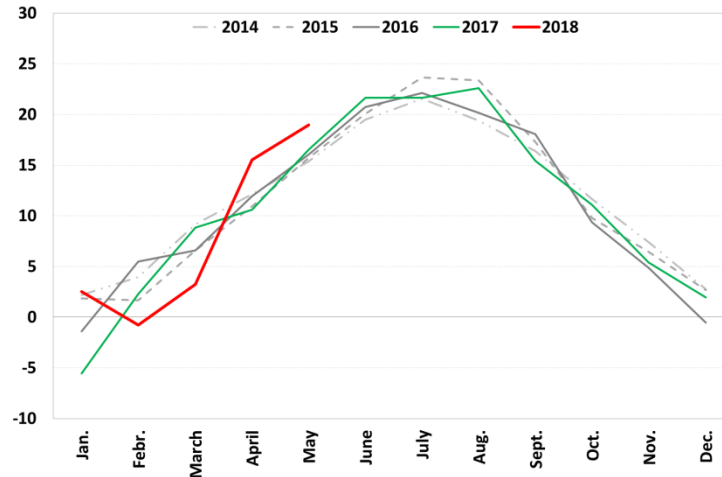
Main takeaways from the production report:

- Heat production in Q2 was 202,424 GJ, which is 32% lower than in the same period of the previous year. This figure came as no surprise as the average monthly temperature was above historical averages in Q2. In Miskolc, heat sales amounted to 95,602 GJ which 34% less than in Q2 2017. In Győr, heat sales were 104,562 GJ, 30% lower than in the second quarter of 2017.



- For Pannergy the ideal environment for heat production is when outdoor temperature is 2-8°C, preferably with minimal variance during the day. Compared to 2017, the first quarter in 2018 was advantageous as more days fell into the optimal temperature range. However, this turned around in Q2 when conditions were less ideal for heat production. For example in April, which is usually the last month when heat sales are high, the average temperature was 4.15 °C higher this year than between 2014 and 2017 (11.4 vs 15.55 °C).

Combined average monthly temperature (°C) in Miskolc and Győr¹



- On the positive side, the report implicitly contains two reassuring pieces of news:
 - First, it seems that the Concession Project in Győr is going ahead as planned. The report states that 'During the period under review, the Concession Project of Győr saw the commencement of the deepening of the exploratory drilling on 17 April at the site designated on the basis of the evaluation of the geological studies. In the drilling operations consisting of three sections of different dimensions, the second section has been completed. The deepening of the third section was also started.'
 - Second of all, the report does not mention any unexpected problem for any wells concerning additional maintenance needs, or unexpected shutdowns.

How does the Q2 production report affect our valuation?

- In our initiation report, we stated that 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.
- That risk was realized in Q2, causing lower-than-expected revenue and profit margins. Due to weather effect, revenue may have been lower around HUF 250 million which could reduce profits by around HUF 38 million in Q2.
- However, we see the effects of weather conditions as a one-off, and the underlying fundamentals of the business operation have not changed, therefore we leave our target price unchanged. For the same reason, even if weather conditions had been supportive for Pannergy (and therefore profit margins were higher) we would not have changed our target price either, because weather effects are temporary and do not change the business fundamentals in the short term. This was reflected in the fact,

¹ On the Hungarian Statistical Office's website data was only available for Mosonmagyaróvár, which is less than 50 km away from Győr. We use this data as a proxy for Győr's average monthly temperature.

that in Q1 the weather conditions was slightly favourable, but we also saw it as a one – off, therefore we leaved our valuation unchanged.

Risks associated with the business operations

- **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.
- **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.
- **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.
- **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.
- **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

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%

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

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