

# EQUITY NOTE: PANNERGY NYRT.

**Recommendation: BUY**

**Target price (12M): 1,196 HUF**

**30 March 2020**

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## Highlights

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Pannergy's financial performance in 2019 was in line with the management's guidance in terms of revenue and EBITDA, both of them grew by almost 20%. The increase is due to (1) the installed third well in Győr, (2) higher administrative prices since September and (3) favourable weather conditions in H1. **Net profit surged to HUF 738 million from HUF 435 million.** Due to the company's strong financial performance and to the fact that all major investment started to produce income and operate as planned, the company proposed a dividend payment of 17 HUF per share (2.86% dividend yield based on the current share price). Additionally, the share repurchase program is planned to continue in 2020 with the same parameters as last year's, if the General Assembly approves it.

Concerning the effect of the COVID-19 virus, Pannergy states that the virus has no material effect on the company, based on the currently available information. This is because (1) two of the company's biggest costumers sell heat to households, (2) although heat sales to Audi may be affected but the unused heat can be sold to households, (3) the COVID-19 virus has its effect on the economy mainly outside the heating season. Therefore, **Pannergy is among the few companies that probably will not feel the negative consequences of the crisis.** This is especially important, compared to other non-renewable utility companies, which may be adversely affected by the reduction in industrial demand.

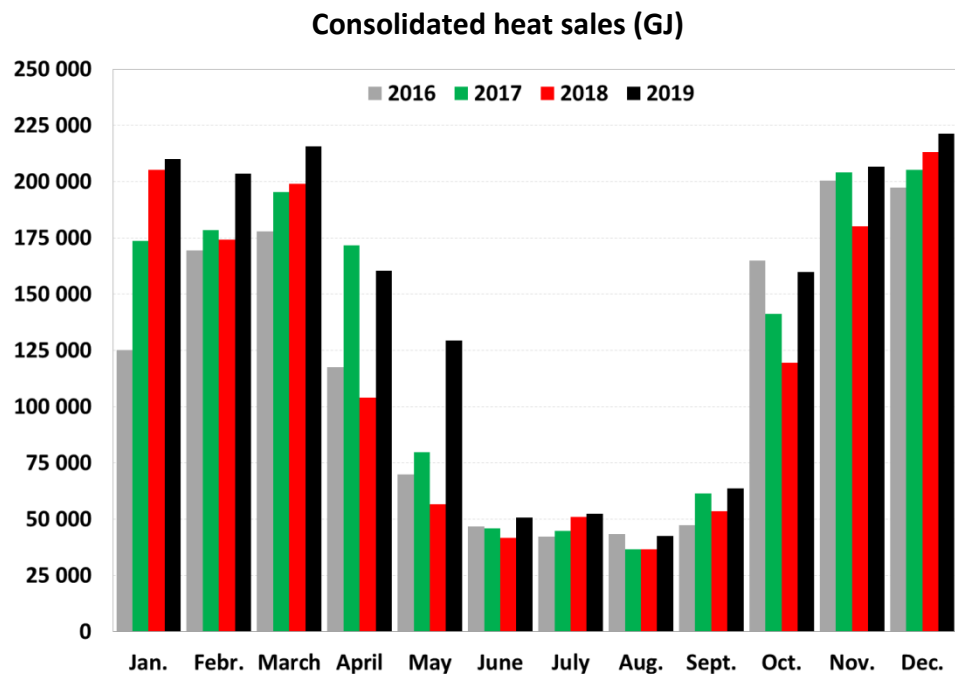
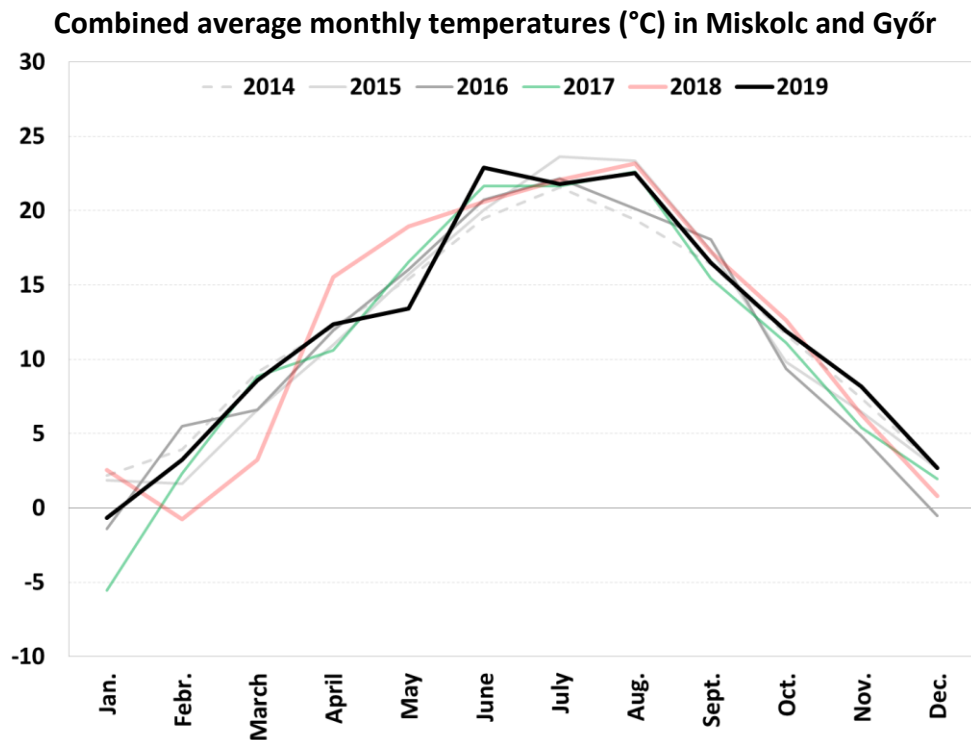
Overall, the company's 2019 performance broadly came in line with our expectations, therefore only minor adjustment was made in the valuation. The value of the company increased somewhat from the FCFF-model; however, the relative valuation gave a smaller number due to the declining performance of the peer group (smaller EBITDA multiple). All in all, we left the valuation unchanged at **HUF 1,196 with a BUY recommendation**, which is around 90% higher than the current market price.

## Financial highlights of the H2 earnings report

Overall, the financial performance of the company in 2019 was broadly in line with our expectation in terms of revenue and EBITDA, while net profit margin was somewhat below it as we assumed somewhat stronger HUF for the end of 2019.

In 2019, heat sales amounted to 1,716,178 GJ, which is 19.5% higher than a year earlier due to the third well in Győr and the favourable weather conditions in the first half of

2019. This level of production translated into **HUF 5.65 billion revenue overall, which was almost 20% increase compared to 2018.**



**Direct costs were up 12.5%, from HUF 3,725 million to HUF 4,193 million, growing slower than revenue.** This is due to the administrative price increase for Q42019 and to the fact that some of the elements of the direct cost of sales is fixed costs (like rental costs, etc.). The maintenance and operational costs expanded by 35%, by more than heat sales did. We suspect that the additional increase may be related to the setting and optimization of the third well in Győr. Amortization and depreciation amounted to HUF 1,468 million.

As the direct cost of production increased less than the revenue did, gross profit margin grew to 25.8%, from 20.4% in 2018.

General and administrative expenses remained roughly the same, showing that the company's cost reduction programme may have reached its optimum levels last year. Net other revenue amounted to HUF 192 million. This brings the EBIT to HUF 1,198 million, surpassing last year's HUF 906 million by 32%.

Growing by 19%, EBITDA hit HUF 2,667 million (47.2% EBITDA margin), slightly increasing our EBITDA forecast for 2019. The company reported a financial loss of HUF 415 million, which is HUF 30 million higher than in 2018. From that, paid interest was 277 million, while the unrealized FX loss was almost HUF 200 million as the HUF depreciated more than 3% in 2019.

The company reported HUF 735 million net income, versus HUF 435 million in 2018. Our forecast was HUF 868 million. Most of the difference can be attributed to our assumption of somewhat lower EUR/HUF exchange rate for the end of 2019. However, overall, the company performed as expected at every level, showing strong and stable performance.

#### Financial highlights of the 2019 report

P/L Table consolidated (million HUF)	2015	2016	2017	2018	2019
Revenue	2 726	4 529	4 699	4 679	5 648
Net other revenue	871	101	537	407	192
OPEX	1 983	2 914	3 012	2 903	2 982
From which:					
* SGA	1 180	684	492	456	457
* Depreciation	1 241	1 435	1 300	1 317	1 468
EBITDA	1 614	1 715	2 241	2 231	2 666
EBIT	373	281	923	906	1 198
EBT	217	-131	626	525	782
Income Taxes	183	28	121	90	47
Net income	78	-151	488	434	728
EPS (HUF)	4,28	-8,47	27,60	23,55	40,77

	2015	2016	2017	2018	2019
EPS (HUF)	4,28	-8,47	27,60	23,55	40,77
EBITDA (HUFm)	1 614	1 715	2 241	2 231	2 666
Gross profit rate	25,0%	19,0%	18,7%	20,4%	25,40%
EBIT rate	13,7%	6,2%	19,6%	19,4%	21,20%
EBITDA rate	59,2%	37,9%	47,7%	47,7%	47,2%
ROE	0,8%	-1,7%	5,4%	4,6%	7,3%
ROA	0,3%	-0,6%	1,9%	1,7%	2,8%
ROS	2,9%	-3,3%	10,4%	9,3%	12,9%

### ***Redistribution of profits***

Pannergy announced that it intended to pay HUF 17 dividend per share (2.86% dividend yield, based on Friday's closing price) starting from November 2020, while continuing its share repurchase programme with the same conditions as last year (the amount is maximum HUF 1 billion, while the daily purchase cannot exceed 8,000 shares).

When the coverage was initiated for Pannergy back in 2017, we expected that dividend payment could start in 2019 or in 2020 when the investment projects are finished and the exact profitability of the company can be estimated with high certainty. But more importantly, the announcement of the dividend marks an important turning point for the company and could affect the share price positively, even though in theory it has no effect on the value of the company. This is because:

- 1) Dividend-paying companies are viewed as more stable and reliable companies, which could give additional reassurance for investors.
- 2) Clientele effect: Some investors target specifically dividend-paying companies. Additionally for a utility company the final goal is to pay dividend.

In our view, the announcement of the dividend payment is an excellent and very important development, because it signals that the company stepped into the mature phase, which also mean a less volatile, more reliable operation. The only question regarding the dividend is how it will evolve in the future. For our calculation we supposed that the company will apply a constant dividend pay-out policy, which means that it will pay about 40% of the year's profit in the future. However, this is subject to change if the management gives other signal in the future.

Finally the company announced a share repurchase program with the same conditions as last year. The main question regarding the program is the number of shares Pannergy will buy back this year.

### ***The effect of the COVID-19 virus on the company***

As the COVID-19 virus has started to spread outside of China, international and the Hungarian stock markets both tanked. The S&P500 slid around 25%, while the BUX dived near 30% from their 19 February highs. In a sense, it is understandable that the pandemic's economic consequences adversely affected many sectors of the economy.

However, based on the available information and common sense, Pannergy is not one of these businesses. First of all, two of the three biggest consumers of Pannergy are providing heat for households, whose heat consumption may increase somewhat as they spend more time at home during the stay-at-home order. The third significant customer, Audi announced to halt production for two weeks. But this comes mainly outside the heating season and if heat sales to Audi decline, the difference can be sold to households in Győr. Therefore, based on our current knowledge, Pannergy is unaffected by the devastating fallout from COVID-19. Still, its price has declined by around 20% since 19 February.

### ***Management expectations for 2020***

Based on the management's guidance, production for 2020 could be around 1,658,066 GJ, while EBITDA could reach HUF 2,530-2,600 billion. Given that the COVID-19 virus has no material impact on the company, we think this target for 2020 can be achieved with the existing capacity. However, net profit could be lower than expected in 2020 due to the strong HUF depreciation. So far in 2020, the HUF has weakened by around 8% against the EUR. This means that the unrealized FX loss could be around HUF 400 million, due to the revaluation of the FX debt. However, this will not affect the cash flow, thus dividend payments or the share repurchase programme.

### ***Recent information's effect on our valuation***

Overall, we are satisfied with Pannergy's 2019 report. The revenue, the EBITDA and other main financial variables broadly came in line with our expectation, while the announced dividend payment and share repurchases mark a new stage in the company's life. Importantly, the COVID-19 virus does not have a material effect on Pannergy.

Despite the decline in share price in recent weeks, from a fundamental perspective, only positive developments were seen at the company. But the majority of these developments were not new to us, therefore only minor adjustments were made on the FCF model. The FCF valuation increased to HUF 1,467. However, owing to the market sell-off in recent weeks, the relative valuation gave a somewhat smaller value per share (HUF 926). Therefore the average valuation remained at HUF 1,196.

## Appendix:

## Income statement

P/L Table consolidated (million HUF)	2017	2018F	2019F	2020F	2021F	2022F
Revenue from geothermal-heat	4 699	4 679	5 060	5 005	5 105	5 207
Other revenue	537	407	192	142	143	144
OPEX	3 012	2 903	2 982	3 143	3 221	3 301
from which: Depreciation	1 300	1 317	1 468	1 376	1 385	1 394
EBITDA	2 241	2 231	2 666	2 591	2 615	2 638
EBIT	923	906	1 198	1 216	1 230	1 244
EBT	626	525	782	607	1 066	1 125
Income Taxes	121	90	47	73	128	135
Non-controlling interest	17	1	0	0	0	0
Net income	488	434	728	534	938	990
EPS (HUF)	4	25	41	30	53	56

## Balance sheet

Balance sheet - consolidated (million HUF)	2016	2017	2018F	2019F	2020F	2021F	2022F
Non-current assets	22 282	21 633	22 780	23 177	21 721	20 256	18 813
Current assets	2 978	3 389	3 030	2 796	2 712	2 770	2 938
Total assets	25 259	25 022	25 810	25 973	24 433	23 026	21 751
Total equity	8 889	9 025	9 867	10 213	10 389	10 942	11 527
Non-current liabilities	13 479	13 066	12 256	11 910	10 401	8 541	6 681
Current liabilities	2 887	2 931	3 687	3 850	3 644	3 543	3 543
Total equity and liabilities	25 259	25 022	25 810	25 973	24 433	23 026	21 751

## Cash flow statement

Cash flow statement (million HUF)	2017	2018F	2019F	2020F	2021F	2022F
Profit before taxes	451	525	782	607	1 066	1 125
Cash flow from operations	1 895	2 266	2 601	2 126	2 550	2 384
Cash flow from investment	-1 142	-2 766	-1 790	-313	-314	-220
Cash flow from financing activities	-201	320	-575	-1 495	-1 840	-1 640
Change in cash and cash equivalents	552	-180	236	318	396	524

## FCFF valuation

Valuation summary (million HUF)	2019 last year	2020F	2021F	2022F	2023F	2024F	2025F	2026F	2027F	2028F	2029F	Terminal year
Revenue from geothermal heat	5 060	5 005	5 105	5 207	5 311	5 418	5 526	5 636	5 749	5 864	5 981	6 101
EBITDA	2 666	2 591	2 615	2 638	2 583	2 605	2 626	2 597	2 616	2 633	2 650	2 703
Depreciation	1 468	1 376	1 385	1 394	1 099	1 108	1 117	834	839	839	839	839
Working capital sales	150	0	0	0	0	0	0	0	0	0	0	0
Capex	93	93	93	93	93	93	93	93	93	40	40	40
FCFF	2 279	2 353	2 375	2 396	2 312	2 332	2 352	2 293	2 310	2 378	2 393	2 441
WACC		7,5	7,5	7,5	7,5	7,5	7,5	7,5	7,5	7,5	7,5	9,0
PV(FCFF)		2 188	2 053	1 927	1 729	1 622	1 521	1 379	1 292	1 237	1 157	14 599

Share price estimation	
Enterprise value	30 703
Net debt ( - )	7 708
Equity value	22 995
Number of shares	17 602
Required return on equity	12,3
Target price for the next 12 M (HUF)	1467

## Relative valuation

Relative valuation			
Company name	Country	Market capitalization (billion HUF)	EV/EBITDA
Polaris Infrastructure	Canada	42,3	6,1
Ormat Technologies	USA	1502,0	13,5
ARISE	Germany	28,8	6,7
ABO Invest	Germany	31,5	9,3
Northland Power	Canada	1176,0	10,0
Falck	Denmark	405,0	9,2
		<b>Average</b>	<b>9,1</b>
		<b>Median</b>	<b>9,3</b>

### ***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. **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, the COVID-19 virus has no material effect on the company. However the situation concerning the virus and its economic effects may change rapidly and unexpectedly 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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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
25/03/2019	Under revision	-	Equity note
16/04/2019	Under revision	-	Equity note
30/04/2019	BUY	HUF 1,106	Equity note
16/07/2019	BUY	HUF 1,106	Equity note
04/09/2019	BUY	HUF 1,106	Equity note
16/10/2019	BUY	HUF 1,196	Equity note
16/01/2019	BUY	HUF 1,196	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%
2018Q3	BUY	100%
	HOLD	0%
	SELL	0%
2018Q4	BUY	100%
	HOLD	0%
	SELL	0%
2019Q1	BUY	93,5%
	HOLD	0%
	SELL	0%
	Under revision	6,5%
2019Q2	BUY	67%
	HOLD	0%
	SELL	0%
	Under revision	33%
2019Q3	BUY	100%
	HOLD	0%
	SELL	0%
2019Q4	BUY	100%
	HOLD	0%
	SELL	0%

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

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This document was finalized at 6:21:44 PM on 30 March 2020