

EQUITY NOTE: PANNERGY NYRT.

Recommendation: BUY

Target price (12M): HUF 1,219

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Highlights

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So far, the COVID-19 crisis has had no material effect on PannErgy's performance. Despite a 9% decline in overall production, its EBITDA surpassed the management's expectation for H1, and this year's HUF 2,530-2,600 million EBITDA target is sustained.

Due to the depreciating HUF, PannErgy's non-realized FX loss amounted to HUF 375 million, which reduced net income to HUF 93 million. This came as no surprise as we already took it into account in March, when updating our forecast.

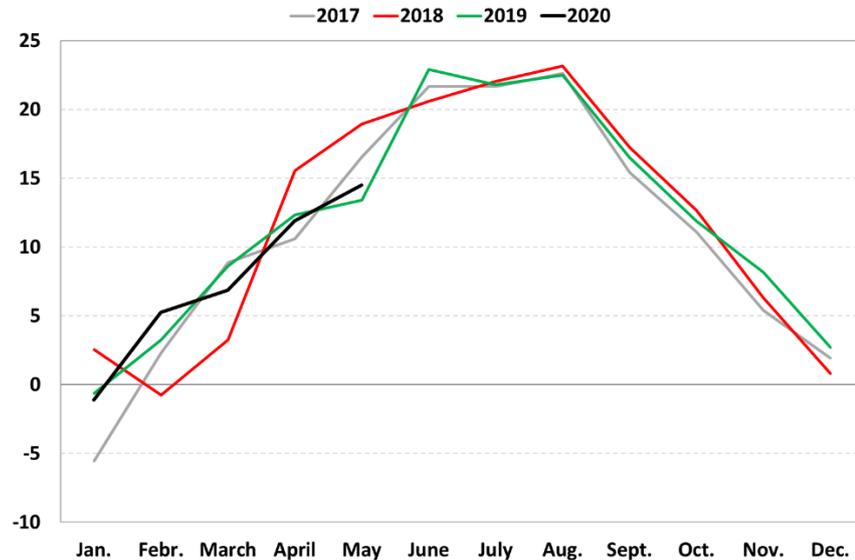
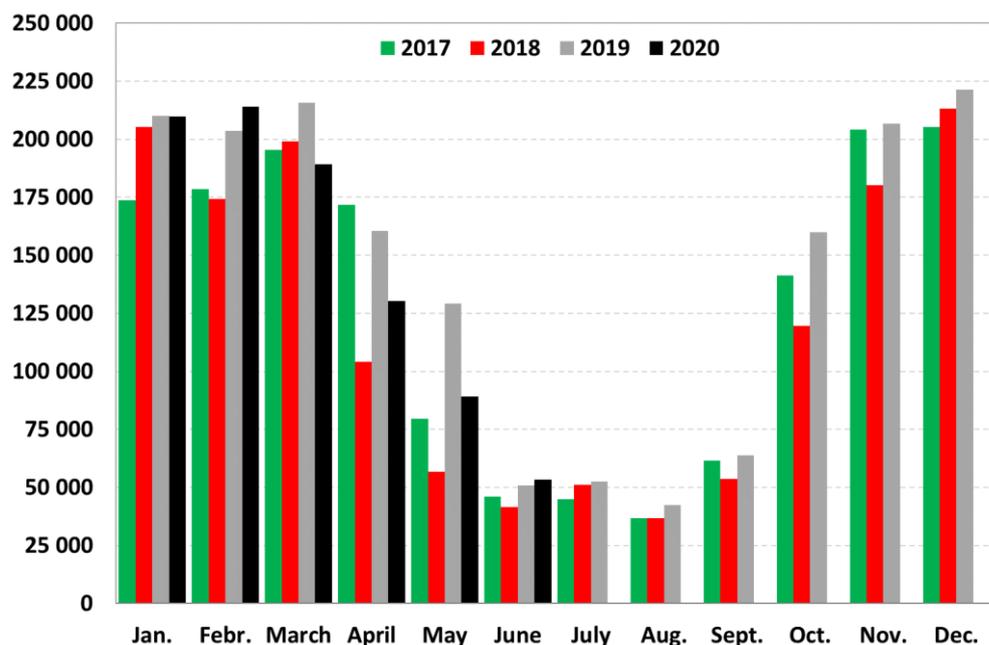
As was noted before, the management replaced all of PannErgy's loans to longer-term, mostly fixed-rate ones. Additionally, HUF 1.5 billion worth of loans will be available if the utility company needs it for investment or other goals. This gives it a great flexibility to operate in these uncertain times.

Overall, the valuation was lifted – with a maintained buy rating - to HUF 1,219 from HUF 1,196, mainly due to the increased EV to EBITDA multiple of the peers, which lifted PannErgy's relative valuation.

Main takeaways from the H1 report

Although the COVID-19 crisis devastated economies around the world, it had no material effect on PannErgy in the first half of 2020. The only negative effect may have been the temporary shutdown of Audi in Győr between 23 March and 14 April, but PannErgy transferred the unutilized capacity to the city's district heating system, therefore profitability remained unharmed.

Overall production was 9% lower than last year due to the favourable weather in the base year (2019). But without the weather effect, it exceeded the management's expectations by 2%. The management maintains its 1,647 TJ production forecast for 2020.

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

Consolidated heat sales (GJ)


Looking at the income statement, the **HUF 3,197 million revenue reflects 2% YoY increase**. In Győr, revenue declined by 8%, while in Miskolc it grew by 2%.

Indirect costs rose by 5%, because of two effects: (1) depreciation and amortization increased due to the installation of the third well in Győr last year, and (2) in the Debrecen property, electricity costs, which are EUR-denominated, have risen due the weaker HUF. However, the second effect increased revenue to the same extent, so overall it had no material effect.

SG&A costs grew by 6%, because of the additional costs related to the refinancing of all of the company's loans. Net other income fell from HUF 106 million to HUF -13 million as no other income was realized in H1.

Gross cash flow margin climbed from 50.6% to 52.2%, but EBIT margin dropped from 25% to 19%, while EBITDA margin declined from 46.5% to 45.7%.

The management said it was still confident it would achieve the HUF 2,530-2,600 EBITDA target for 2020. Between 2016 and 2019, an average of 53% of the heat sales was made in H1, which would imply HUF 1,340-1,380 EBITDA for H1. The current HUF 1,460 million EBITDA is 6-9% higher than expected.

Financial loss was HUF 506 million, of which HUF 375 million loss is due to the effect of the HUF's depreciation against the EUR.

As a result of the above factors, **net income amounted to HUF 93 million, which is lower than the base period's HUF 603 million net profit.** However, this is due to at least two one-off factors: (1) the weakening HUF increased financial loss, and (2) the weather was extremely favourable last year. **Overall, without FX effects, the first half-year's net income would have been around HUF 420 million, in line with our previous forecast.**

P/L Table consolidated (million HUF)	2020H1	2019H1	2018H1	2017H1	2016H1	2015H1
Revenue	3 197	3 121	2 402	2 519	2 129	1 326
Net other revenue	-13	106	174	120	133	2
OPEX	2 572	2 447	2 104	2 196	2 155	1 214
From which:						
* SGA	247	233	237	297	475	229
* Depreciation	798	671	675	588	541	359
EBITDA	1 461	1 451	1 147	1 095	734	470
EBIT	612	780	472	443	107	112
EBT	106	618	33	381	-226	-1
Income Taxes	13	15	9	26	22	53
Net income	93	603	24	355	-252	-58
EPS (HUF)	5,01	32,90	1,60	19,77	-13,78	-3,18

	2020H1	2019H1	2018H1	2017H1	2016H1	2015H1
EPS (HUF)	5,01	32,90	1,60	19,77	-13,78	-3,18
EBITDA (HUFm)	1 461	1 451	1 147	1 095	734	470
Gross profit rate (%)	27,3%	29,1%	22,3%	24,6%	21,1%	25,6%
EBIT rate (%)	19,1%	25,0%	19,7%	17,6%	5,0%	8,4%
EBITDA rate (%)	45,7%	46,5%	47,8%	43,5%	34,5%	35,4%
ROE (%)	0,9%	5,9%	0,3%	3,9%	-2,8%	-0,6%
ROA (%)	0,4%	2,3%	0,1%	1,5%	-1,0%	-0,2%
ROS (%)	2,8%	19,3%	1,0%	14,1%	-11,8%	-4,4%

Recent news:

Secured long-term, fixed-rate financing:

Previously, PannErgy announced a HUF 11 billion refinancing deal, under which its HUF 9.5 billion outstanding loan will be replaced with 10-year maturity, lower interest-bearing loans. Furthermore, a HUF 1.5 billion loan will be available for investment purposes, and it could also protect against the negative effects of COVID-19.

From the activated HUF 9.5 billion, HUF 2.75 billion is EUR- denominated, while the rest is in HUF. The HUF part is a fixed-rate loan, while the EUR part is a variable-rate one, which essentially was converted to fixed loan with the use of interest rates swaps.

No dividend this year, but a new share repurchase programme was launched

Although the company planned to pay dividend this year, it was postponed for two main reasons: (1) share repurchases provide greater flexibility in times of economic uncertainty, (2) as long as the share price is materially below its fundamental value, share repurchases make more economic sense.

Under its share repurchase programme, PannErgy will buy 7,000 shares a day until the share price reaches HUF 750. The programme will be in effect until 29 April 2021.

We expected the first dividend payment to come in 2020, and we would have been right, but the pandemic postponed this. Although PannErgy has not been materially affected by the covid-19 pandemic so far, caution is warranted. Overall, the new share repurchase programme is quite good news, as it shows strength and the determination to reward shareholders. Looking around in Hungary and on international markets, only a handful of companies are able to continue their payout policy unscathed.

Valuation

Based on the incoming data, we updated our valuation, which increased from HUF 1,196 to HUF 1,219 as a combined effect of several factors. First of all, although the interest rates on PannErgy's loans dropped (which would have reduced the WACC), we increased the WACC in order to more accurately reflect the current uncertain market environment. This had a negative effect on valuation. But this was more than offset by the fact that PannErgy's peers became more expensive on the EV to EBITDA multiple (rose to 9.4, from 9.1). It was mainly the combination of these two effects that caused the upgrade in the valuation.

Looking ahead, district heating prices for next year will be set at the end of September 2020. In recent years, it was a positive surprise, but this year might be the other way due to the low natural gas prices and the COVID-19 pandemic.

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	632	1 066	1 125
Income Taxes	121	90	47	76	128	135
Non-controlling interest	17	1	0	0	0	0
Net income	488	434	728	556	938	990
EPS (HUF)	4	25	41	32	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	10 411	10 964	11 549
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	23 048	21 773

Cash flow

Cash flow statement (million HUF)	2017	2018F	2019F	2020F	2021F	2022F
Profit before taxes	451	525	782	632	1 066	1 125
Cash flow from operations	1 895	2 266	2 601	2 151	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	343	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	2 439
WACC		7,7	7,7	7,7	7,7	7,7	7,7	7,7	7,7	7,7	7,7	9,2
PV(FCFF)		2 185	2 048	1 919	1 720	1 611	1 509	1 366	1 278	1 222	1 142	14 113

Share price estimation	
Enterprise value	30 111
Net debt (-)	8 192
Equity value	21 919
Number of shares	17 640
Required return on equity	12,9
Target price for the next 12 M (HUF)	1403

Relative valuation

Relative valuation			
Company name	Country	Market capitalization (billion HUF)	EV/EBITDA
Polaris Infrastructure	Canada	52,6	5,3
Ormat Technologies	USA	892,8	12,3
ARISE	Germany	43,5	9,3
ABO Invest	Germany	33,9	9,6
Northland Power	Canada	1591,7	11,0
Enel	Italy	27490,3	9,2
		Average	9,4
		Median	9,5

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
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
16/01/2020	BUY	HUF 1,196	Equity note
30/03/2020	BUY	HUF 1,196	Equity note
15/04/2020	BUY	HUF 1,196	Equity note
20/07/2020	BUY	HUF 1,196	Equity note

Period	Recommendations	Percent of recommendation
2017Q4	BUY HOLD SELL	100% 0% 0%
2018Q1	BUY HOLD SELL	100% 0% 0%
2018Q2	BUY HOLD SELL	100% 0% 0%
2018Q3	BUY HOLD SELL	100% 0% 0%
2018Q4	BUY HOLD SELL	100% 0% 0%
2019Q1	BUY HOLD SELL Under revision	93,5% 0% 0% 6,5%
2019Q2	BUY HOLD SELL Under revision	67% 0% 0% 33%
2019Q3	BUY HOLD SELL	100% 0% 0%
2019Q4	BUY HOLD SELL	100% 0% 0%
2020Q1	BUY HOLD SELL	100% 0% 0%
2020Q2	BUY HOLD SELL	100% 0% 0%

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

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