

EQUITY NOTE: PANNERGY NYRT.

Recommendation: BUY

Target price (12M): HUF 1,046

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Highlights

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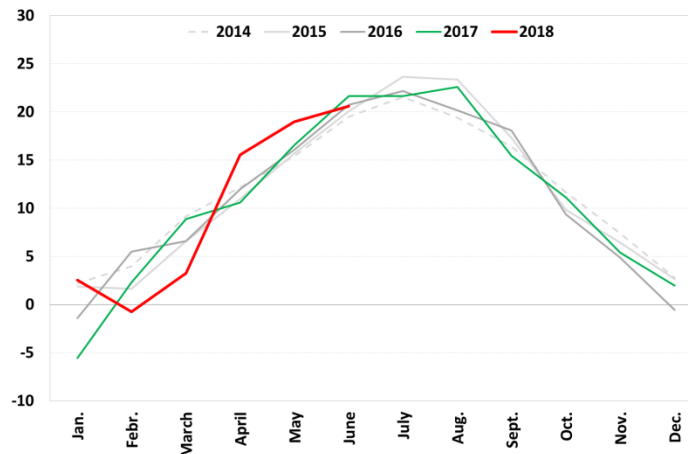
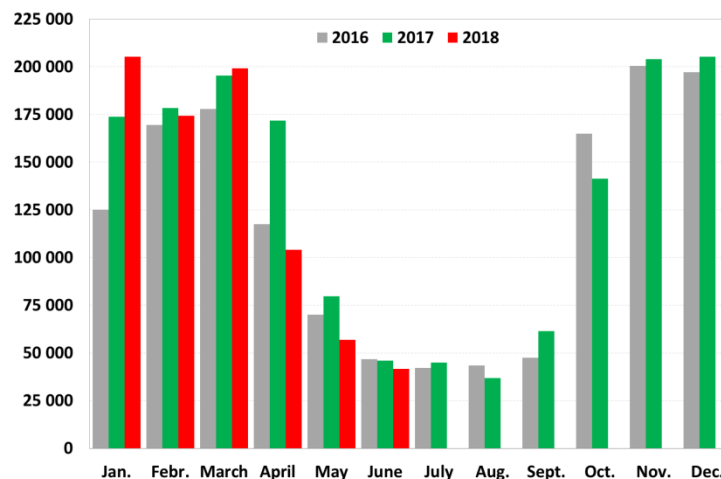
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PannErgy's improving performance in 2018H1 was masked by higher than expected average temperature (weather-related effect) and the HUF's depreciation against the EUR. The company's revenue fell by 4.7% because in April and May the average temperature was significantly higher than expected, which resulted in lower heat sales. **This is a temporary factor and does not change the company's basic fundamentals.** Despite the lower reported revenue, EBITDA was 4.5% higher than in 2017H1 and EBIT increased as well, owing to the decrease in direct and indirect costs. However, net income fell from HUF 355 million to HUF 24 million due to the HUF 314 million unrealized financial loss, which stemmed from the revaluation of FX-denominated debt at the end of period as the HUF depreciated against the EUR in 2018H1 by almost 6%. **But the company has a natural FX-hedge**, as part of its revenue is denominated in FX and this offsets the risen debt repayment costs, and will provide somewhat higher revenue and net income in the future which will compensate over time for the unrealized financial loss. Therefore **we see its effect on the company as neutral.** Additionally, the Half-year report suggests that the **Győr project is going ahead as planned** and the new well could start operation by the winter season, as expected. The new well is now in the testing phase, during which its exact performance can be accurately measured. Finally, last week **PannErgy** announced that one of its subsidiaries **obtained HUF 500 million non-repayable EU-funds for development purposes.** Overall, after removing the above-mentioned temporary effects, the company is on the right track and mostly in line with our forecast. **The granted EU-funds made us modify our price target for the next 12 month from HUF 1,032 to HUF 1,046, while we maintained the BUY rating.**

Financial highlights of H1 earnings report

Due to weather effects, revenue declined by 4.7% compared to 2017H1. In April and May, average temperatures were significantly above the average of previous years, which lessened heat demand. Therefore heat sales were 781,013 GJ, down from 844,915 GJ in 2017H1. According to PannErgy's own estimate, the higher average temperature in those two months may have reduced heat sales by 95,000 GJ. This translates into approximately HUF 257 million loss in revenue, which is in line [with our initial estimate.](#)

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

Consolidated heat sales (GJ)


Direct costs dropped by 2%, from HUF 1,899 million to HUF 1,867 million. This is because of the lower production (weather effect), but this was partly offset by the 15% increase in amortization (capitalization of tangible assets and the reclassification of indirect amortization).

As the direct cost of production decreased by less than the revenue did, gross profit declined to 22.3%, from 24.6% in 2017H1.

General and administrative expenses fell by 21% compared to 2017H1. Most of the reduction (HUF 48 million) comes from the reclassification of some indirect depreciation to direct depreciation, due to a change in the company's accounting policy. Without it, general and administrative expenses would have still decreased by HUF 12 million. This is in line with the company's existing strategy, which is to improve its operational efficiency.

Net other revenue amounted to HUF 120 million. This brings the **EBIT to HUF 470 million, which is a 6.5% increase compared to 2017H1.** **EBITDA was HUF 1,147 million** (48% EBITDA margin), which is 4.5% growth compared to 2017H1 (44% EBITDA margin). The company reported a financial loss of HUF 439 million compared to the HUF 62 million loss in 2017H1. From that **HUF 314 million unrealized loss** is the effect of the

revaluation of FX debt outstanding at the end of the period as the HUF depreciated against the EUR by almost 6% in 2018H1. **It is very important to note that Pannergy is not affected by the fluctuations in the EUR/HUF as it has a natural hedge for FX fluctuations because some of its revenues are denominated in FX.** This basically means that if the HUF depreciates against the EUR, the company reports – ceteris paribus – a financial loss (revaluation of FX debt and higher interest payment in HUF). But because a part of the revenue is in FX, it can cover the increased debt repayment costs and higher revenue (the same amount of EUR revenue translates into higher revenue in HUF) in later periods will compensate for this period reported financial loss. Based on the half-year report, we suppose that the overall net effect on the company's valuation is zero or negligible. It is worth noting that, as the company gradually pays back its debt, the FX liabilities will decrease but its FX-denominated revenue – ceteris paribus – will stay the same, which will create an FX risk if the HUF appreciates against the EUR.

Because of the above, profit before tax was HUF 33 million, compared HUF 381 million in 2017H1. **Net profit was HUF 24 million.** As was noted previously, the lower-than-expected net income figure was caused by the higher average temperatures in 2018Q2 and mainly by the unrealized financial loss due to the depreciation of the HUF against the EUR.

Financial highlights of the 2018H1 report

P/L Table consolidated (million HUF)	2018H1	2017H1	2016H1	2015H1
Revenue	2 402	2 519	2 129	1 326
Net other revenue	174	120	133	2
OPEX	2 104	2 196	2 155	1 214
From which:				
* SGA	237	297	475	229
* Depreciation	675	588	541	359
EBITDA	1 147	1 095	734	470
EBIT	472	443	107	112
EBT	33	381	-226	-1
Income Taxes	9	26	22	53
Net income	24	355	-252	-58
EPS (HUF)	1,60	19,77	-13,78	-3,18

	2018H1	2017H1	2016H1	2015H1
EPS (HUF)	1,60	19,77	-13,78	-3,18
EBITDA (HUFm)	1 147	1 095	734	470
Gross profit rate	22,3%	24,6%	21,1%	25,6%
EBIT rate	16,6%	17,6%	5,0%	8,4%
EBITDA rate	47,8%	43,5%	34,5%	35,4%
ROE	0,3%	3,9%	-2,8%	-0,6%
ROA	0,1%	1,5%	-1,0%	-0,2%
ROS	1,0%	14,1%	-11,8%	-4,4%

Concession project in Győr:

PannErgy reported that the operations, which started on 17 April, to deepen the BON-PE-03 production site had been completed. **In the next few weeks, comprising the testing, measuring and cleaning processes will follow.** It will determine the precise geophysical and hydrodynamical results and exact capacity. If the final result matches the management's initial expectations, it can be viewed as good news. **The above information also suggests that the new well will be operational for the upcoming winter season as well.**

Share option programme and share repurchasing programme

In 2018H1 741,001 shares were called down from the 900,000 potentially callable shares as part of the share option programme. The timing of the calls was concentrated in 2018Q1.

In April 2018, the company's previously started share repurchase programme ended without any purchase. A new share repurchase programme worth HUF 1,000 million was initiated in April 2018, which will last for a year. Since its initiation, no transaction has occurred. In [one of our previous equity notes](#) we already analysed the potential effects of the above mentioned programmes.

Recent news – A subsidiary of PannErgy obtained EU-funds

Last week PannErgy announced that one of its subsidiaries (DoverDrill Deep Drilling Ltd.) obtained a non-repayable EU-funds of HUF 500 million, under the Economic Development and Innovation Operational Programme (GINOP) and it may have access to an additional HUF 250 million loan with preferential interest rate as well.

The announced new project is classified as a corporate R&D&I activity. PannErgy describes it as a 'niche and innovative technology which is unique in Europe and can extend the lifetime of geothermal wells, thus improving the sustainability of geothermal systems.' Once the project is closed, the company is planning to market the technological innovation domestically and internationally.

We assume that this may be related to the ongoing investment activity in Győr, as the drilling and testing of the new well provide an excellent and reasonable opportunity to experiment with new technological innovations. If that is the case, then the subsidy could lower the share of own financing.

Change in our valuation based on recent information

In 2018H1, the company's improving performance was impaired by temporary factors. (1) The temperature in April and May was significantly above the average, which lowered heat sales, and (2) the depreciating HUF caused an unrealized FX loss. The first one is a weather effect, which does not change our valuation (as it was pointed out [in our previous Equity note](#)). The second one is an unrealized financial loss but in subsequent years it will be compensated by higher revenue as some parts of the company revenue are denominated in FX (natural FX-hedge), although, on the negative side, debt level is – ceteris paribus - higher by the effect of the revaluation of FX debt.

However, the company obtained HUF 500 million in non-repayable EU-funds. Before the announcement, we supposed that the new construction in Győr, and the R&D&I activity related to it will be financed without this grant. If we incorporate the new information, the overall result is that net debt is lower. **Therefore we change our overall valuation from HUF 1,032 to HUF 1,046 and maintain our BUY rating.**

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. **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.
5. **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.

Appendix:

P/L Table consolidated (million HUF)	2014	2015	2016	2017	2018F	2019F
Revenue	2 290	2 726	4 529	4 699	5 296	5 787
Revenue from other operations	602	540	897	675	675	675
Revenue from geothermal-heat	1 688	2 186	3 632	4 024	4 482	4 979
Other revenue	55	871	101	537	139	133
OPEX	1 808	1 983	2 914	3 012	3 038	3 333
from which: Depreciation	635	1 241	1 435	1 300	1 259	1 249
EBITDA	482	1 614	1 715	2 241	2 258	2 454
EBIT	-153	373	281	923	999	1 205
EBT	-434	217	-131	626	415	992
Income Taxes	95	183	28	121	50	119
Non-controlling interest	12	-44	-8	17	11	27
Net income	-541	78	-151	488	354	846
EPS (HUF)	-30,0	4,3	-8,5	27,6	19,2	45,9

Balance sheet - consolidated (million HUF)	2014	2015	2016	2017	2018F	2019F
Non-current assets	17 299	22 502	22 282	21 633	21 352	20 130
Current assets	2 419	4 317	2 978	3 389	3 691	4 593
Total assets	19 718	26 819	25 259	25 022	25 043	24 733
Total equity	9 259	9 331	8 889	9 025	9 372	10 205
Non-current liabilities	7 091	14 028	13 479	13 066	13 239	12 212
Current liabilities	3 368	3 459	2 891	2 931	2 432	2 316
Total equity and liabilities	19 718	26 819	25 260	25 022	25 043	24 733

Cash flow statement - consolidated (million HUF)	2014	2015	2016	2017	2018F	2019F
Profit before taxes	-434	217	-131	626	415	992
Cash flow from operations	561	-173	775	1 895	1 406	1 936
Cash flow from investment	-2 248	-4 153	-1 632	-1 142	-1 047	-92
Cash flow from financing activities	1 661	5 089	473	-201	-121	-1 074
Change in cash and cash equivalents	-26	763	-384	552	238	769

Valuation summary (million HUF)	2018F	2019F	2020F	2021F	2022F	2023F	2024F	2025F	2026F	2027F	Terminal year
Revenue from geothermal heat	4 732	4 979	5 078	5 179	5 282	5 387	5 494	5 604	5 715	5 829	5 946
EBITDA	2 368	2 454	2 474	2 493	2 512	2 452	2 470	2 486	2 453	2 468	2 517
Depreciation	1 259	1 249	1 258	1 267	1 276	981	990	999	717	726	726
Working capital sales	150	0	0	0	0	0	0	0	0	0	0
Capex	1 043	93	93	93	93	93	93	93	93	93	93
FCFF	1 042	2 217	2 235	2 253	2 271	2 183	2 200	2 215	2 152	2 166	2 209
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)	969	1 917	1 797	1 685	1 579	1 412	1 323	1 239	1 119	1 047	13 216

Share price estimation	
Enterprise value	27 303
Net debt (-)	8 300
Equity value	19 003
Number of shares	18 420
Required return on equity	12
Target price for the next 12 M (HUF)	1159
Current price (HUF)	678
Upside /Downside (%)	71

Company name	Country	Market capitalization (billion HUF)	EV/EBITDA
US Geothermal	USA	26,6	11,3
Ormat Technologies	USA	719,6	10,4
Alterra Power Corp	Canada	88,1	15,4
ARISE	Germany	13,2	10,0
FERSA	Spain	19,1	9,2
ABO Invest	Germany	20,7	6,7
Northland Power	Canada	776,8	12,8
Falck	Denmark	202,4	8,5
		Average	10,5
		Median	10,2

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

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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