

# EQUITY NOTE: PANNERGY NYRT.

**Recommendation: BUY**

**Target price (12M): HUF 1,420**

**26 March 2022**

## Highlights

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The 12M target price for PannErgy is decreased from HUF 1,450 to HUF 1,420. This can be essentially almost solely attributed to the unfavourable rate environment, the 10Y bond yield is 6.4% now, which is significantly higher than it was a few months ago (~3-4%). Consequently, the corresponding WACC rate is higher as well (9.2% vs. 7.7%), which results in a lower EV. At the same time, we note that the overall financial results were good, the EBITDA outlook is improved, net debt is lower YoY and share repurchases continued.

Production in 2021 was somewhat higher YoY and **EBITDA increased from HUF 2.735 billion to HUF 2.878 billion (+5.2%), which means that the company achieved the high end of the planned range of HUF 2.8-2.88 billion.** Net income increased from HUF 236 million to HUF 897 million (+278% YoY). The difference is mainly the result of the much lower exchange rate loss on FX credit and loans and higher revenues from geothermal heat sales.

Additionally, the **management improved its EBITDA guidance** as well. For 2022, the company expects the EBITDA to be around HUF 3.15-3.25 billion (+11.2% midpoint basis) and HUF 3.35-3.45 billion for 2023 (+6.2% midpoint basis). The latter is, however, conditional on the deepening and commissioning of the third production well of the Miskolc Project this year. In the event of a failure to deepen the well, the EBITDA plan is HUF 3.3-3.4 billion.

**The company may pay HUF 18 per share dividends (~1.8% yield) this year if the proposal is accepted on the General Meeting** and the share repurchase program could continue as well. We note that shareholders collectively owning at least one percent of the votes proposed a roughly HUF 37 dividend (~3.7% yield), somewhat higher level of share repurchases (HUF 800 million vs. HUF 600 million) and share capital reduction by cancelling some of the treasury shares (~5% of total shares).

### **Financial highlights of the earnings report:**

**Revenue for 2021 was HUF 6.439 billion (+8.7% YoY), while revenue from geothermal heat sales amounted to HUF 5.583 billion, exceeding our forecast of HUF 5.485 billion.** Revenue from other operations increased from HUF 853 million to HUF 856 million, however, a significant part of this amount is made up of pass-through items (96%) so the margin on this kind of sales is almost zero; therefore, it has no effect on profitability.

**In 2021, heat sales reached 1,699,190 GJ, an increase of 6% YoY but slightly smaller than the management's plan of 1,732,569 GJ (-2%).** The small miss relative to the target can be attributed to less favourable weather conditions in Miskolc during Q2 2021 and because of a service interruption over the period 2-11 November, similarly in Miskolc.

**Direct costs amounted to HUF 4.859 billion (+8.5% YoY), which is mainly the result of an increase in "maintenance and operating costs" and "electricity charges" items.** The

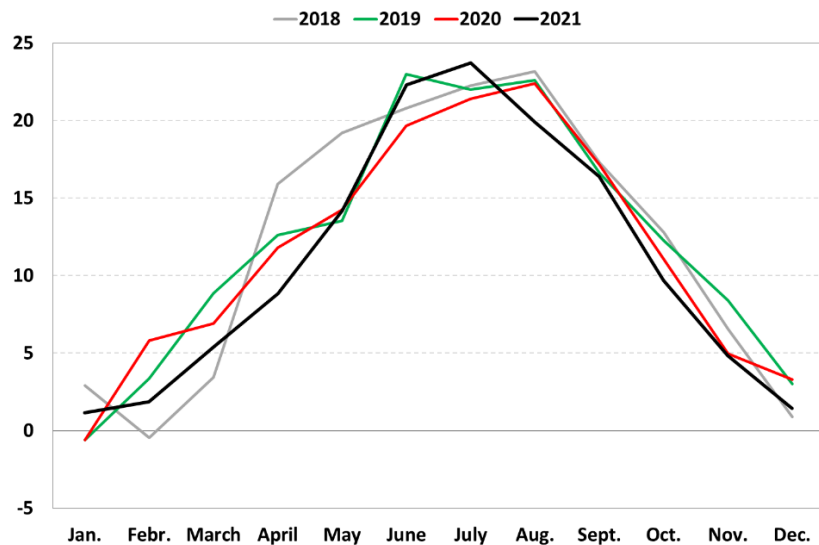
growth of maintenance, operational and facility management costs (+13% YoY) is attributable to additional tasks related to the operation and maintenance of the geothermal projects along with efficiency improving and capacity increasing projects. The **substantial increase in the costs of electricity** (+22% YoY) required for heat generation and sale was a result of the price increase in the electricity market during the period.

**Depreciation** decreased from HUF 1.66 billion to HUF 1.595 billion (-4% YoY), of which HUF 213 million was for intangible assets, HUF 1.37 billion for tangible assets and HUF 12 million for investment properties. The company also incurred HUF 109 million **research and development costs**, which were related to geothermal production during the period, this was nil in 2020. The other items were broadly in line. Because of the interaction of revenue and direct costs, gross profit margin slightly increased from 24.4% to 24.5%. The average gross profit margin between 2017 and 2019 was 21.6%.

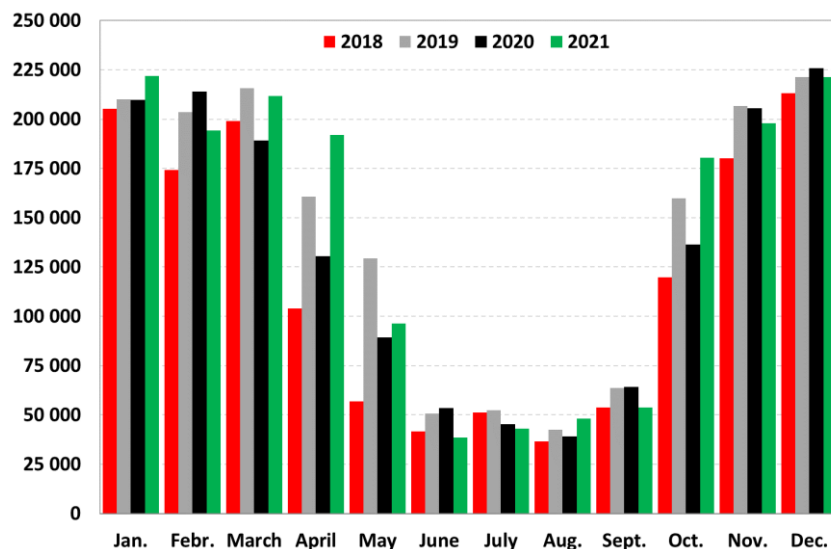
The Group's **administrative and overhead costs** increased by 2% on YoY including an increase of 19% in indirect personnel-type costs (labour market processes and fluctuation), while banking costs decreased by 57% (higher base figure due to one-off impacts). This brings EBIT to HUF 1,283 million (+19.3% YoY).

**EBITDA amounted to HUF 2.878 billion (+5.2% YoY)**, while the EBITDA ratio declined to 44.7% from 46.2%. This means that the company achieved the high end of the planned EBITDA range (HUF 2.8-2.880 billion) for the financial year 2021.

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



#### Consolidated heat sales (GJ)



The company reported a net financial loss of HUF 319 million (HUF 112 million financial income and HUF 431 million financial expenditure), which is almost HUF 500 million lower than it was in 2020. This is mainly the result of substantially lower financial expenditures, which were down by HUF 487 million YoY largely because **exchange rate loss on FX credit and loans was only HUF 43 million compared to HUF 453 million** booked under the same heading in 2020.

**Overall, the company reported HUF 897 million net income after tax, which is significantly higher than the HUF 236 million net income in 2020 (+278% YoY).** The difference is mainly the result of the much lower exchange rate loss on FX credit and loans and higher revenues from geothermal heat sales.

**Looking ahead, the company expects heat sales to reach 1,752,012 GJ in 2022 (+3.1% YoY) and EBITDA could be between HUF 3.15-3.25 billion (+9.5-12.9%).** This is expected to reflect the effect of completed or in-progress capacity expansion and efficiency improving projects and changes in the energy market environment. **The EBITDA target for 2023 is updated to HUF 3.35-3.45 billion (+6.2% YoY midpoint basis).** This is conditional, however, on the deepening and commissioning of the third production well of the Miskolc Project this year. **In the event of a failure to deepen the well, the EBITDA plan is HUF 3.3-3.4 billion.**

#### Financial highlights of the 2021 report

P/L Table consolidated (million HUF)	2016	2017	2018	2019	2020	2021
Revenue	4 529	4 699	4 679	5 648	5 923	6 439
Net other revenue	101	537	407	192	132	215
OPEX	2 914	3 012	2 903	2 982	3 320	3 776
From which:						
* SGA	684	492	456	457	501	512
* Depreciation	1 435	1 300	1 317	1 468	1 660	1 595
EBITDA	1 715	2 241	2 231	2 666	2 735	2 878
EBIT	281	923	906	1 198	1 075	1 283
EBT	-131	626	525	782	262	964
Income Taxes	28	121	90	47	25	67
Net income	-151	488	434	728	236	897
EPS (HUF)	-8,47	27,60	23,55	40,77	14,01	54,71

	2016	2017	2018	2019	2020	2021
EPS (HUF)	-8,47	27,60	23,55	40,77	14,01	54,71
EBITDA (HUFm)	1 715	2 241	2 231	2 666	2 735	2 878
Gross profit rate	19,0%	18,7%	20,4%	25,8%	24,4%	25,0%
EBIT rate	6,2%	19,6%	19,4%	21,2%	18,2%	20,0%
EBITDA rate	37,9%	47,7%	47,7%	47,2%	46,2%	44,7%
ROE	-1,7%	5,4%	4,6%	7,3%	2,4%	9,1%
ROA	-0,6%	1,9%	1,7%	2,8%	0,9%	3,3%
ROS	-3,3%	10,4%	9,3%	12,9%	4,0%	13,9%

#### **Announcements and proposals for the General Meeting:**

There are several proposals for the GM (13 April 2022); we only highlight those, which may have an impact on the valuation of the company.

- 1) **Dividends:** HUF 294 million is proposed, which would represent roughly HUF 18 per share paid out of profit after tax for the current year (~1.8% dividend yield). The first date of payment of the dividend is 14 July 2022. The record date for dividend payment

is 30 June 2022. Shareholders collectively holding at least one percent of the votes proposed a dividend payment of HUF 600 million (roughly HUF 37; ~3.6% yield).

- 2) **Share-repurchases:** the board proposes to purchase treasury shares up to an amount of HUF 600 million at a share price of at least HUF 1 and no more than HUF 1,400. The period would be almost one year (2 May 2022-13 April 2023). The shares may be purchased solely in trading at the stock exchange. Shareholders collectively owning at least one percent of the votes proposed HUF 800 million for HUF 1,400 / share at most.
- 3) **Reduction of share capital by cancelling some of the treasury shares:** shareholders collectively owning at least one percent of the votes proposed the reduction of the share capital by cancelling 1,054,655 shares (~5% of total shares) with a total nominal value of HUF 21 million. After the reduction, the share capital of the company would be HUF 400 million (20 million shares). The company held 4,729,144 shares (22.46% of total) as of 20 March 2022.

For now, we do not incorporate the effects of dividends, share repurchases and share capital reduction until they are accepted on the General Meeting.

### ***Other notable highlights:***

In 2022, the company will continue its investment projects aimed at increasing capacity and improving efficiency. As part of the plan **PannErgy intends to commence of the boring of a new production well in Miskolc until the spring of 2023** (conditional on the assessment of the relevant grant application and evaluation of seismic data and delivery deadlines), expand heat exchange capacities and other engineering conversions for capacity expansion.

As we already noted in our previous note the company announced on 17 February 2022 that the range of its EBITDA plan for the 2022 fiscal year of HUF 3-3.1bn has been revised upward to HUF 3.15-3.25bn, an increase of ~5% on a midpoint basis. This is the result of an earlier MEKH announcement, which is related to the treatment of profits made by MAVIR in the separate coffers of the KÁT and Premium schemes due to high electricity prices. Consequently, large consumers, including **members of the PannErgy Group, can expect to receive monthly payments in the future as long as the revenues from the sale of electricity at market prices exceed the costs related to the KÁT and METÁR subsidies.** The payment amounts will depend mainly on the level of electricity prices in a given month and the amount of electricity subsidised under the KÁT and METÁR schemes. We also note that the **administrative prices set for the period between 2021 October and 2022 September are somewhat higher** than previous figures, which will also help to achieve the higher EBITDA target.

Location of the wells	Company names	in effect until 30 September 2021	in effect from 1 October 2021	Change
Szentlőrinc	Szentlőrinci Geothermal Ltd.	3 654 HUF/GJ	3 791 HUF/GJ	4%
Miskolc	Miskolci Geothermal Ltd.	2 626 HUF/GJ	2 650 HUF/GJ	0,9%
Miskolc	KUALA Ltd.	2 626 HUF/GJ	2 650 HUF/GJ	0,9%
Győr	Arrabona Geothermal Ltd.	3 204 HUF/GJ	3 397 HUF/GJ	6,0%

Source: Hungarian Official Gazette, issue 179/2021

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

**Overall, the 12M target price for PannErgy is decreased from HUF 1,450 to HUF 1,420.** This can be almost entirely attributed to the **unfavourable rate environment**, the 10Y Hungarian government bond yield is 6.4% now, which is significantly higher than it was a few months ago (~3-4%). Consequently, the corresponding WACC rate is higher as well (9.2% vs. 7.7%), which results in a lower EV. Furthermore, **risks are likely pointing to the upside given the inflationary effects of the Russia-Ukraine conflict** and slowing global growth, persistent supply-chain issues, and high commodity prices.

On the positive side, the **EBITDA outlook is improved**, management expects 2022 EBITDA to be around HUF 3.15-3.25 billion (+11.2% midpoint basis) and HUF 3.35-3.45 billion for 2023 (+6.2% midpoint basis). The latter is, however, conditional on the deepening and commissioning of the third production well of the Miskolc Project this year. In the event of a failure to deepen the well, the EBITDA plan is HUF 3.3-3.4 billion. For the purpose of our valuation, **we have not included the expected positive EBITDA impact of the new production well in Miskolc.** We will incorporate it later when there is more certainty about it. We did include, however, the **effects of the recent MEKH announcement**, which is related to the treatment of profits made by MAVIR in the separate coffers of the KÁT and Premium schemes due to high electricity prices. This resulted higher EBITDA estimates for the period of 2022-2024 as higher electricity prices might be stickier. **Our estimated 2022 EBITDA is HUF 3.28bn, which is slightly higher than the company's target range**, while our 2023 figure of HUF 3.29bn is basically at the lower end of management's target range. We note that the level of net debt is lower YoY by ~9% and as a result of continued share repurchases the number of shares is also lower YoY by 0.6%. These factors had a positive impact on the valuation, however, they could only partially offset the negative effects of the higher WACC rate.

We have not used relative valuation for our target price estimate, but international peer data is disclosed.

## 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.

## Appendix:

Income statement						
P/L Table consolidated (million HUF)	2019	2020	2021	2022F	2023F	2024F
Revenue from geothermal-heat	5 060	5 070	5 583	5 666	5 778	5 892
Other revenue	192	132	215	251	228	228
OPEX	2 982	3 320	3 776	3 824	3 902	4 042
from which: Depreciation	1 468	1 660	1 595	1 479	1 479	1 479
EBITDA	2 666	2 735	2 878	3 279	3 291	3 265
EBIT	1 198	1 075	1 283	1 800	1 812	1 786
EBT	782	262	964	1 522	1 533	1 507
Income Taxes	47	25	67	183	184	181
Non-controlling interest	0	0	0	0	0	0
Net income	728	236	897	1 339	1 349	1 326
EPS (HUF)	45	14	55	82	83	81

Balance sheet						
Balance sheet - consolidated (million HUF)	2019	2020	2021	2022F	2023F	2024F
Non-current assets	23 177	23 634	22 933	22 034	21 135	19 586
Current assets	2 796	3 099	3 950	4 388	4 658	5 552
Total assets	25 973	26 733	26 883	26 421	25 792	25 138
Total equity	10 213	9 747	9 980	11 025	12 039	13 029
Non-current liabilities	11 910	14 441	13 704	12 543	10 882	9 220
Current liabilities	3 850	2 545	3 199	2 853	2 871	2 889
Total equity and liabilities	25 973	26 733	26 883	26 421	25 792	25 138

Cash flow statement						
Cash flow statement (million HUF)	2019	2020	2021	2022F	2023F	2024F
Profit before taxes	782	262	964	1 522	1 533	1 507
Cash flow from operations	2 601	1 238	2 859	2 691	2 992	2 966
Cash flow from investment	-1 790	-1 639	-1 475	-1 364	-1 364	-614
Cash flow from financing activities	-575	-278	-774	-1 096	-1 047	-1 047
Change in cash and cash equivalents	236	-679	610	231	581	1 305

## FCFF valuation

Valuation summary (million HUF)	2022F	2023F	2024F	2025F	2026F	2027F	2028F	2029F	2030F	2031F	Terminal year
Revenue from geothermal heat	5 666	5 778	5 892	6 008	6 127	6 248	6 371	6 497	6 625	6 756	6 758
EBITDA	3 279	3 291	3 265	3 239	3 272	3 288	3 321	3 354	3 386	3 418	3 454
Depreciation	1 479	1 479	1 479	1 479	1 479	1 424	1 424	1 424	1 424	1 424	1 424
Working capital sales	310	20	21	21	21	21	21	21	21	21	21
Capex	750	750	100	100	100	100	100	100	100	100	100
FCFF	2 003	2 303	2 930	2 907	2 937	2 944	2 973	3 002	3 030	3 058	3 090
WACC	9,2	9,2	9,2	9,2	9,2	9,2	9,2	9,2	9,2	9,2	9,3
PV(FCFF)	1 680	1 769	2 060	1 872	1 732	1 590	1 470	1 359	1 257	1 264	13 705

Share price estimation	
Enterprise value	29 757
Net debt ( - )	9 794
Equity value	19 963
Number of shares	16 325
Required return on equity	16,2
Target price for the next 12 M (HUF)	1420

## International peer data

Company name	Country	Market capitalization (billion HUF)	EV/EBITDA
Polaris Infrastructure	Canada	89,6	7,9
Ormat Technologies	USA	1503,2	16,8
ARISE	Germany	63,5	15,9
ABO Invest	Germany	45,1	11,1
Northland Power	Canada	2531,9	11,6
Falck	Denmark	1074,8	19,8
		<b>Average</b>	<b>13,9</b>
		<b>Median</b>	<b>13,8</b>

**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
20/07/2020	BUY	HUF 1,216	Equity note
16/10/2020	BUY	HUF 1,204	Equity note
18/01/2021	BUY	HUF 1,204	Equity note
29/03/2021	BUY	HUF 1,387	Equity note
19/04/2021	BUY	HUF 1,387	Equity note
16/07/2021	BUY	HUF 1,387	Equity note
06/09/2021	BUY	HUF 1,387	Equity note
06/10/2021	BUY	HUF 1,450	Equity note
18/10/2021	BUY	HUF 1,450	Equity note
17/01/2022	BUY	HUF 1,450	Equity note
18/02/2022	BUY	HUF 1,450	Equity note

Period	Recommendations	Percent of recommendation
2021Q1	BUY	100%
	HOLD	0%
	SELL	0%
2021Q2	BUY	100%
	HOLD	0%
	SELL	0%
2021Q3	BUY	100%
	HOLD	0%
	SELL	0%
2021Q4	BUY	100%
	HOLD	0%
	SELL	0%
2022Q1	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 6:00:44 PM on 26 March 2022