

# EQUITY NOTE: PANNERGY NYRT.

**Recommendation: BUY (unchanged)**

**Target price (12M): HUF 1,747 (unchanged)**

**27 March 2023**

## Highlights

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**Financial results and management guidance:** production in 2022 was 5% higher YoY and slightly above management's plan. Group revenue for the year was HUF 7.145 billion (+11% YoY), while revenue from heat sales amounted to HUF 6.238 billion, which is 17.2% higher YoY. **EBITDA increased from HUF 2.878 billion to HUF 3.612 billion (+25.5% YoY).** The company substantially surpassed the EBITDA range of HUF 3.25-3.35 billion originally set for FY22 and it was in line with their updated range of HUF 3.6-3.65 billion. Net income increased from HUF 897 million to HUF 1.31 billion (+46% YoY). **The good performance is largely related to Győr, which sold a historical seasonal record volume of geothermal energy in all quarters of 2022,** but Berekfürdő electricity sales and one-off items also helped, while administrative prices were also higher. Looking ahead, the company expects to achieve similar level of heat sales this year as it did in 2022. **The target EBITDA range is between HUF 3.95-4.15 billion for 2023 (+12.1% midpoint basis YoY).**

**Proposals for the GM:** we note that the **board does not recommend dividend payments this year, which we view as prudent given higher investment needs due to the expected commissioning of the 3<sup>rd</sup> Miskolc well this year and the current economic uncertainty** (e.g., inflationary pressures, energy costs, high interest rate environment). Last year the company paid HUF 294 million dividends (HUF 18.11 / share). **On the other hand, the board proposes to purchase treasury shares up to an amount of HUF 900 million (~3.9% of current market cap), which is up 50% YoY** (from HUF 600 million).

**Valuation and target price:** we have slightly raised our 2023 EBITDA estimate to HUF 4.13 billion from HUF 4.07 billion, which is a result of smaller adjustments given additional information on revenue and cost items provided in the annual financials. This is in line with management's HUF 3.95-4.15 billion EBITDA range for 2023. However, the company has a higher level of net debt relative to H1 2022, which offset the positive impact of our higher EBITDA forecast. This is primarily the result of lower level of cash and cash equivalents and an increase in short-term credits. The jump in short-term credits is the result of a working capital loan received in relation to FX-denominated electricity purchases of the Group, while the decrease in cash can be partially attributed to an increase in receivables. The EBITDA figures and the valuation does not yet incorporate the impact of the potential 3<sup>rd</sup> Miskolc well as we await further information. **Overall, the 12M target price for PannErgy is unchanged at HUF 1,747 and we also maintain our BUY recommendation.**

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

Revenue for 2022 was HUF 7.145 billion (+11% YoY), while revenue from heat sales amounted to HUF 6.238 billion, which is 17.2% higher YoY. Electricity sales were down by 25% to HUF 631 million but it is worth noting that this has two components: (A) sale of electricity related to Berekfürdő project, which was HUF 177 million (+378% YoY) and has a higher margin and (B) re invoicing electricity charges related to the operation of properties in Debrecen, which was HUF 454 million (-43.5% YoY) and is a pass-through item with practically no margin. The significantly higher Berekfürdő revenue can be attributed to higher volume sold (1,844 MWh vs. 1,017 MWh) and to the steep increase in electricity prices. On the other hand, the decrease in pass-through revenues is related to the company's decision to divest the utility distribution system of Debrecen in June 2022.

In 2022, heat sales reached 1,784,507 GJ, an increase of 5% YoY and were 1.9% higher than the management's plan of 1,752,012 GJ. The good performance is largely related to Győr, which sold a historic seasonal record volume of geothermal energy in all quarters of 2022. This means that total annual heat sold in Győr exceeded 1 million GJ (+10.5% YoY) for the first time in PannErgy's history and accounted for ~56% of all heat sales. The increase in heat sales is partially thanks to last year's agreement with Győr-Szol Zrt., which prioritizes geothermal energy over other alternatives. Heat sales in Miskolc were basically flat YoY (758,127 GJ vs. 768,264 GJ) and accounted for ~42.5% of total heat sales.

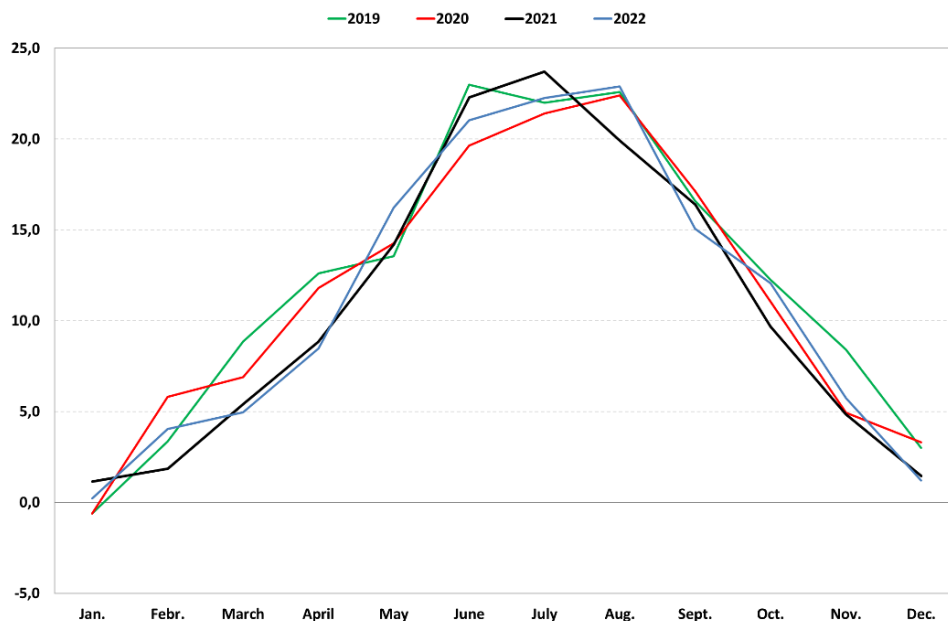
Direct costs amounted to HUF 5.047 billion (+3.9% YoY), which is mainly the result of an increase in electricity costs (+22% YoY) to HUF 1.076 billion. High electricity prices have been a general issue in the European market last year, which was the result of several factors (e.g., drop in Russian gas flows, issues in French nuclear power generation, higher thermal coal, and LNG prices and so on). There has been also an increase in direct depreciation, maintenance, operational and facility management costs. The cost increases were somewhat offset by a drop in "Cost of goods sold, mediated services" item, which is mostly related to the earlier mentioned pass-through electricity sales.

Depreciation increased from HUF 1.595 billion to HUF 1.716 billion (+7.6% YoY), of which HUF 181 million was for intangible assets, HUF 727 million for land and buildings, HUF 795 million for machines and equipment and HUF 13 million for investment properties. Because of the interaction of revenue and direct costs, gross profit margin substantially increased from 24.5% to 29.4%.

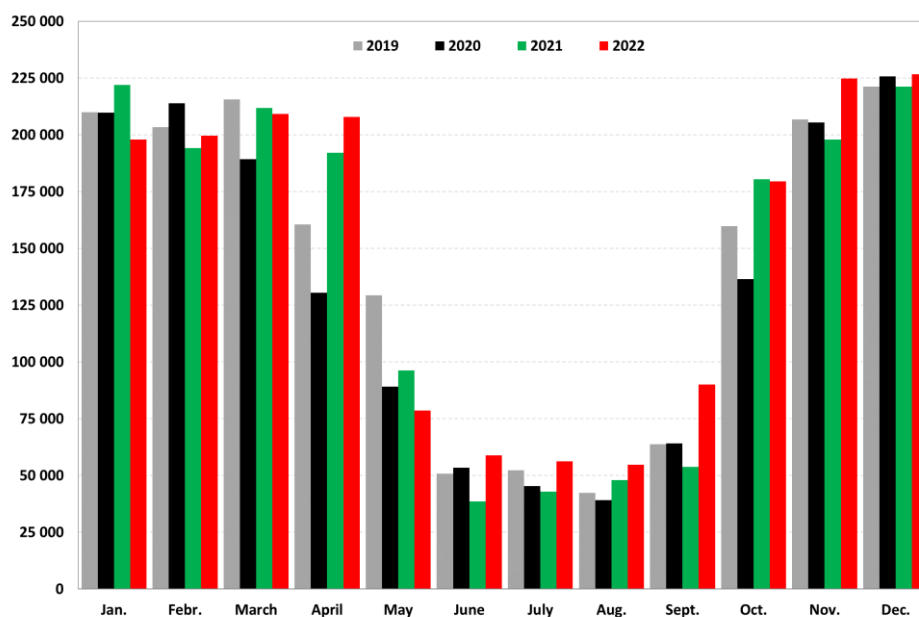
The Group's administrative and overhead costs increased by 13.7% YoY including an increase of 15.2% in indirect personnel-type costs in line with labour market processes, while consultancy and office related costs were also up. Other incomes were up 72.4% YoY to HUF 748 million, the increase is mainly related to (A) profit of HUF 90 million on sale of the Debrecen properties and (B) compensations and penalties received relating to insured events and projects implemented in earlier periods as well as ex-post discounts (HUF 359 million). At the same time, other expenditures amounted to HUF 368 million (+68% YoY).

This brings EBIT to HUF 1.896 billion (+47.8% YoY). EBITDA amounted to HUF 3.612 billion (+25.5% YoY), while EBITDA ratio increased to 50.6% from 44.7%. This means that the company substantially surpassed the EBITDA range of HUF 3.25-3.35 billion originally set for the financial year 2022 (and in line with the revised range of HUF 3.6-3.65 billion).

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



Consolidated heat sales (GJ)



The company reported a **net financial loss of HUF 480 million** (HUF 390 million financial income and HUF 870 million financial expenditure), which is HUF 161 million higher than it was in 2021. This is **mainly the result of FX loss on various foreign currency items**.

Overall, the **company reported HUF 1.31 billion net income after tax, which is significantly higher than the HUF 897 million net income in 2021 (+46% YoY)**. The difference is mainly the result of higher revenues from geothermal sales, while Berekfürdő electricity sales and various one-off items also helped.

Looking ahead, the company expects heat sales to reach 1,789,254 GJ in 2023, a level basically equivalent to 2022. The **target EBITDA range is between HUF 3.95-4.15 billion (+9.4-14.9%)**. This is expected to reflect the impact of implemented and ongoing capacity expansion and efficiency improvement, including the 3<sup>rd</sup> Miskolc well (expected commissioning by the end of the year), and changes in regulated pricing and cost items.

### Financial highlights of the 2022 report

P/L Table consolidated (million HUF)	2017	2018	2019	2020	2021	2022
Revenue	4 699	4 679	5 648	5 923	6 439	7 145
Net other revenue	537	407	192	132	215	380
OPEX	3 012	2 903	2 982	3 320	3 776	3 913
From which:						
* SGA	492	456	457	501	512	582
* Depreciation	1 300	1 317	1 468	1 660	1 595	1 716
EBITDA	2 241	2 231	2 666	2 735	2 878	3 612
EBIT	923	906	1 198	1 075	1 283	1 896
EBT	626	525	782	262	964	1 416
Income Taxes	121	90	47	25	67	106
Net income	488	434	728	236	897	1 310
EPS (HUF)	28	24	41	14	55	82

	2017	2018	2019	2020	2021	2022
EPS (HUF)	28	24	41	14	55	82
EBITDA (HUFm)	2 241	2 231	2 666	2 735	2 878	3 612
Gross profit rate	18,7%	20,4%	25,8%	24,4%	24,5%	29,4%
EBIT rate	19,6%	19,4%	21,2%	18,2%	20,0%	26,5%
EBITDA rate	47,7%	47,7%	47,2%	46,2%	44,7%	50,6%
ROE	5,4%	4,6%	7,3%	2,4%	9,1%	12,8%
ROA	1,9%	1,7%	2,8%	0,9%	3,3%	4,8%
ROS	10,4%	9,3%	12,9%	4,0%	13,9%	18,3%

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

There are several proposals for the GM (14 April 2023); we only highlight those, which may have an impact on the valuation of the company.

- 1) **Dividends:** the **board does not recommend dividend payments** in view of anticipated investment possibilities and needs for 2023 and to maintain a high level of financial and operational stability while allowing for flexibility. Last year the company paid HUF 294 million dividends, which was HUF 18.11 / share. **We view the proposal as prudent given higher investment needs due to the expected commissioning of the 3<sup>rd</sup> Miskolc well this year and the current economic uncertainty** (e.g., inflationary pressures and energy costs, deteriorating growth outlook, high interest rate environment).

- 2) **Share repurchases (new):** the board proposes to purchase treasury shares up to an amount of HUF 900 million at a share price of at least HUF 1 and no more than HUF 1,670. The period would be almost one year (2 May 2023 – 13 April 2024). The shares may be purchased solely in trading at the stock exchange and the portfolio of treasury shares may not exceed 25% of total shares issued. We note that **the budget available for share repurchases is up 50% YoY** (from HUF 600 million) and the upper limit purchase price per share is up ~19% (from HUF 1,400).

### **Other notable highlights:**

- 3) **Share repurchases (current):** the company has spent so far (up to 19<sup>th</sup> March) HUF 539 million on share repurchases, which is ~90% of the authorized amount under the current program. Overall, this means that PannErgy purchased under the current program 479,400 shares (~2.4% of total shares and ~3% of total non-treasury shares) for an average price of HUF 1,124 / share. The current program is valid until 13<sup>th</sup> April 2023 with a limit on share repurchases of HUF 600 million at a price not exceeding HUF 1,400 and 25% of total shares (~20.8% at the moment).
- 4) **Grants awarded:** PannErgy announced last November that it was awarded two grants related to planned investment projects by the Ministry of Technology and Industry: HUF 994.4 million for the boring of the 3<sup>rd</sup> geothermal production well of the Miskolc Geothermal Project and HUF 1,623 million for the boring of a geothermal production well near Budapest, which could form part of a complex geothermal heat supply system (drilling could start in 2024).
- 5) **New Miskolc well:** as we noted in our previous note (23 November 2022) the new Miskolc well could initially provide ~70TJ / year added heat sale potential (approx. +9% to Miskolc production) based on previous management indication, which would be first fully realized in 2024 as expected commissioning is at some point later this year. We estimated that this would contribute ~HUF 120 million to EBITDA annually (+3.3% compared to 2022 EBITDA). However, the project would increase Miskolc system capacity by 15-20% (+120-160 TJ / year), which means that the initial 70 TJ added heat sale could be ramped up over time significantly, but this will depend on the company's ability to find willing buyers.
- 6) **Prevailing administrative prices:** the new administrative prices that are applicable from 2023 January were set, but we note that unlike in previous cases, these now do not have an end of validity date. We assume this is the case given there are still considerable uncertainties regarding energy prices, so these could be adjusted on a more flexible basis for the time being.

Location of the wells	Company names	in effect until 31 December 2022	in effect from 1 January 2023	Change
Szentlőrinc	Szentlőrinci Geothermal Ltd.	4 620 HUF/GJ	6 715 HUF/GJ	45,4%
Miskolc	Miskolci Geothermal Ltd.	3 176 HUF/GJ	5 211 HUF/GJ	64,1%
Miskolc	KUALA Ltd.	3 176 HUF/GJ	5 211 HUF/GJ	64,1%
Győr	Arrabona Geothermal Ltd.	4 023 HUF/GJ	6 225 HUF/GJ	54,7%

Source: Hungarian Official Gazette, issue 219/2022

### Updated valuation:

- We have previously estimated an EBITDA of HUF 3.613 billion for 2022 in our January update, which is essentially the same what the company reported (HUF 3.612 billion).
- The company expects 2023 consolidated EBITDA to be in the range of HUF 3.95-4.15 billion, which is the same that was announced in the Q4 production report. **In January we have estimated an EBITDA of 4.074 billion for 2023, which we now slightly raise to HUF 4.127 billion. This only includes smaller adjustments given the additional information on revenue and cost items provided in the annual financials.** Our revised 2023 EBITDA is still in line with the range provided by the management, but it is now closer to the upper range. We note that this alone would have a positive impact on valuation ceteris paribus.
- On the other hand, **the company has a higher level of net debt relative to H1 2022** (HUF 10.517 billion vs. HUF 8.895 billion). This is primarily the result of: (A) lower level of cash and cash equivalents and (B) an increase in short-term credits. The jump in short-term credits is the result of a working capital loan received in relation to FX-denominated electricity purchases of the Group, while the decrease in cash can be partially attributed to an increase in receivables (marginally longer credit period open to buyers, which affected the reporting date). At the same time, the company continued its share repurchase program, which partially offset the negative valuation effects of the higher level of net debt.
- The EBITDA figures and the valuation model does not yet incorporate the impact of the potential 3<sup>rd</sup> Miskolc well as we await further information.
- Overall, **the FCFF valuation gave a HUF 1,747 12-month target price, which is equivalent to our January target price and ~50% higher than the current price.** We also maintain our BUY recommendation.

Income statement						
P/L Table consolidated (million HUF)	2020	2021	2022	2023F	2024F	2025F
Revenue from geothermal-heat	4 906	5 323	6 238	10 657	10 706	10 920
Other revenue	132	215	380	358	358	358
OPEX	3 320	3 776	3 913	7 281	7 326	7 518
from which: Depreciation	1 660	1 595	1 716	1 704	1 704	1 704
EBITDA	2 735	2 878	3 612	4 127	4 134	4 154
EBIT	1 075	1 283	1 896	2 422	2 430	2 449
EBT	262	964	1 416	2 189	2 224	2 272
Income Taxes	25	67	106	263	267	273
Non-controlling interest	0	0	0	0	0	0
Net income	236	897	1 310	1 926	1 957	1 999
EPS (HUF)	14	55	82	122	124	126

Balance sheet						
Balance sheet - consolidated (million HUF)	2020	2021	2022	2023F	2024F	2025F
Non-current assets	23 634	22 933	22 695	21 711	19 926	18 159
Current assets	3 099	3 950	4 636	5 398	6 979	8 603
Total assets	26 733	26 883	27 331	27 109	26 905	26 762
Total equity	9 747	9 980	10 534	12 460	13 936	15 446
Non-current liabilities	14 441	13 704	12 669	10 981	9 293	7 606
Current liabilities	2 545	3 199	4 128	3 668	3 676	3 710
Total equity and liabilities	26 733	26 883	27 331	27 109	26 905	26 762

Cash flow statement						
Cash flow statement (million HUF)	2020	2021	2022	2023F	2024F	2025F
Profit before taxes	262	964	1 416	2 189	2 224	2 272
Cash flow from operations	1 238	2 859	1 868	3 456	3 920	3 938
Cash flow from investment	-1 639	-1 475	-2 106	-1 547	-747	-747
Cash flow from financing activities	-278	-774	-615	-2 477	-1 091	-1 091
Change in cash and cash equivalents	-679	610	-647	-568	2 082	2 100

FCFF valuation						
Valuation summary (million HUF)	2023F	2024F	2025F	2026F	2027F	Terminal year
Revenue from geothermal heat	10 657	10 706	10 920	11 136	11 356	11 583
EBITDA	4 127	4 134	4 154	4 172	4 189	4 273
Depreciation	1 704	1 704	1 704	1 704	1 704	1 704
Working capital sales	437	9	9	9	9	9
Capex	950	150	150	150	150	150
FCFF	2 449	3 684	3 701	3 717	3 732	3 805
WACC	13,6	12,8	11,9	11,9	11,9	11,9
PV(FCFF)	2 156	2 876	2 581	2 317	2 078	22 027

Share price estimation	
Enterprise value	34 035
Net debt ( - )	10 517
Equity value	23 518
Number of shares	15 832
Required return on equity	16,6
Target price for the next 12 M (HUF)	1747

## Risks surrounding PannErgy's economic activity

- 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.
- 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.
- 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.
- 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.
- 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.

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
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
26/03/2022	BUY	HUF 1,420	Equity note
19/04/2022	BUY	HUF 1,420	Equity note
19/07/2022	BUY	HUF 1,420	Equity note
02/09/2022	BUY	HUF 1,420	Equity note
06/10/2022	BUY	HUF 1,670	Equity note
15/10/2022	BUY	HUF 1,670	Equity note
23/11/2022	BUY	HUF 1,670	Equity note
02/01/2023	BUY	HUF 1,670	Equity note
18/01/2023	BUY	HUF 1,747	Equity note

Period	Recommendations	Percent of recommendation
2022Q1	BUY	100%
	HOLD	0%
	SELL	0%
2022Q2	BUY	100%
	HOLD	0%
	SELL	0%
2022Q3	BUY	100%
	HOLD	0%
	SELL	0%
2022Q4	BUY	100%
	HOLD	0%
	SELL	0%
2023Q1	BUY	100%
	HOLD	0%
	SELL	0%

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



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