

EQUITY NOTE: PANNERGY NYRT.

Recommendation: BUY (unchanged)

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

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Highlights

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PannErgy delivered an excellent H1 performance aided by significantly higher regulated heat tariffs and record heat sales in Győr, while Miskolc also performed well both in terms of volume and revenue. Production was slightly higher YoY (+2.9%) in H1, and above management' target (+3.2%), revenue from heat sales was up by 89%. Direct and administrative costs grew as well, especially electricity charges, that were up 336% YoY in H1 and represented ~51% of direct costs in H1 2023 as opposed to ~18% in H1 2022. Of course, this is mostly the result of the extreme volatility seen in natural gas and electricity prices last year. Due to higher heat tariffs, record heat sales, interest income and various FX gains the company managed to more than offset the negative effects of higher costs, which resulted in record H1 EBITDA and net profit. The management confirmed that the HUF 2.265bn H1 EBITDA is an adequate basis for the HUF 3.95-4.15bn EBITDA plan in 2023. This is in line with our EBITDA forecast of HUF 4.13bn this year. In addition, the company continues its share repurchase program, which supports the share price. In relation to the new Miskolc well the company received the Grant Instrument required for taking recourse to the grant approved for the project last year up to a maximum HUF 993m, which we view as a very positive step. On the other hand, we note that natural gas and electricity prices have significantly fallen by late spring this year, and this could result in somewhat lower future regulatory heat tariffs but also lower costs for the company. The currently applicable prices were set at the end of last year (applicable from 1 January 2023), which unlike in previous cases did not have an end of validity date. Heat supply tariffs are typically announced for a full year, which are usually applicable from October each year. Considering the change in the market environment we expect that new tariffs may be announced in the coming weeks. As a result, for now we maintain our HUF 1,747 / share target price and BUY recommendation and it will be re-evaluated later.

Main takeaways from the H1 report:

Revenue for H1 2023 was HUF 6.051bn (+64% YoY), while revenue from geothermal heat sales amounted to HUF 5.855bn (+89% YoY). Over the first half of the year, heat sales reached 979,653 GJ, which is slightly higher than the amount the company sold in H1 2022 (952,243 GJ) and above the management's plan of 949,343 GJ (+3.2%). In Q1 2023 the company sold 638,049 GJ, which was 1.7% higher than the target amount and 5.2% higher YoY, mainly due to lower-than-average production in the base period (Miskolc well issues). In Q2 2023 PannErgy sold 341,604 GJ, which was 6.1% above

management's plan but 1.1% lower YoY. It is worth mentioning that **Győr sold historic seasonal record volume in both quarters** (359,250 GJ in Q1 and 199,360 GJ in Q2, respectively). Overall, the Győr project accounted for ~57% of heat sales volume in H1, while the Miskolc project for ~42%.

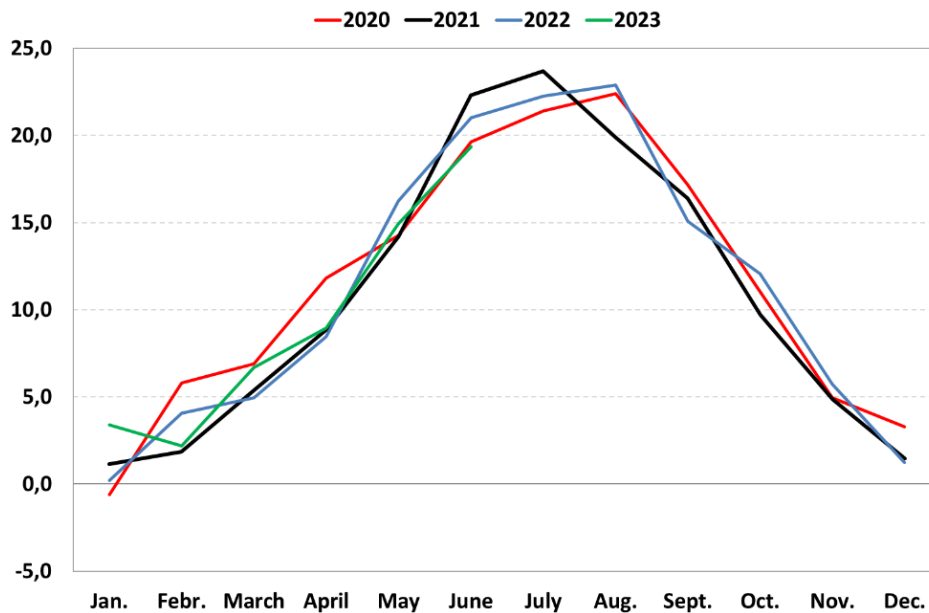
In terms of sales revenue by project, **Győr contributed HUF 3.622bn to the sales revenue in H1 2023 (+81% YoY), which is ~61.8% of heat sales related revenues** (~57% of H1 volume). Out of this, sales to Győr-Szol CPlc. amounted to HUF 2.298bn (+97% YoY and ~63.5% share of Győr sales), while HUF 1.323bn (+59% YoY and ~36.5% share of Győr sales) is related to the company's automotive industry customer. Sales from the **Miskolc project amounted to HUF 2.14bn (+105% YoY), which is ~36.5% of heat sales related revenues** (~42% of H1 volume). Most of the heat was sold to MIHŐ Miskolci Hőszolgáltató Ltd. (HUF 2.092bn). The two smaller projects, Szentlőrinc and Berekfürdő, contributed to sales by HUF 76m and HUF 158m.

Direct costs amounted to HUF 4.06bn (+50% YoY), which is mainly the result of an increase in electricity costs (+336% YoY), but direct depreciation costs (+19.2% YoY) and maintenance, operation, and facility management costs (+10.7% YoY) are also up somewhat. Given the increase in direct costs was lower than revenue growth, **gross profit margin improved to 32.9% from 26.7%**. Overall, gross profit was HUF 1.991bn up 102.5% YoY.

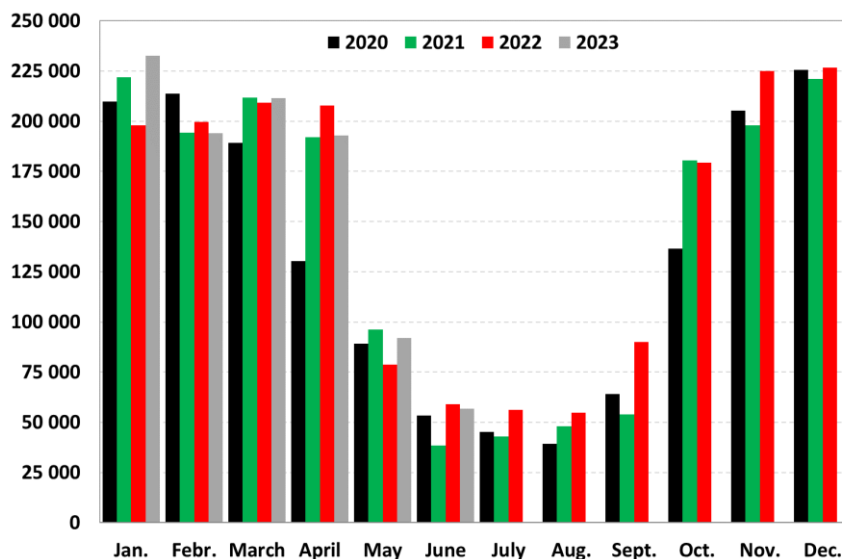
The Group's administrative and overhead costs increased by 35.5% on YoY to HUF 370m including an increase of 60.5% in indirect personnel-type costs and 50.9% in office and operating costs. At the same time, other revenues were significantly lower, down 55.8% to HUF 148m (last year's figure included HUF 90m in connection with the sale of the Group's utility distribution system in Debrecen). Other expenditures amounted to HUF 470m (+302% YoY), mostly related to provisioning and local taxes and mining fee.

This brings **EBIT to HUF 1.299bn (+40% YoY). EBITDA amounted to HUF 2.265bn (+30.5% YoY)**, while the EBITDA ratio decreased to 37.4% from 47.1%. We note that the drop in the EBITDA ratio is primarily the result of the distorting effect of significantly higher heat tariffs that have been adjusted to reflect higher production and indirect costs, while depreciation costs did not jump proportionately. We expect some reversion in the EBITDA ratio over time considering the drop in electricity prices (ie. somewhat lower future heat tariffs as well).

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



Consolidated heat sales (GJ)



The company reported a net financial loss of HUF 98m in H1, which is 49.5% lower YoY (higher interest payments and loss on derivative transactions were partially offset by interest income and various exchange gains). **The company had a HUF 140m FX gain from revaluations compared to a loss of HUF 103m in the base period due to the strengthening of the HUF against the EUR.**

Overall, the company reported HUF 1.159bn net income after tax, which is 58.3% higher YoY. The recognised tax payment obligation was HUF 42m in H1 2023 compared to HUF 2m a year ago.

Looking ahead, the company maintains its plan to sell a total of 1,789,697 GJ in 2023 (+0.3% YoY) and in H1 delivered 54.7% of that. **The management also confirmed that the HUF 2.265bn H1 EBITDA is an adequate basis for the HUF 3.95-4.15bn EBITDA plan in 2023.** This is in line with our EBITDA forecast of HUF 4.13bn this year.

Other notable highlights:

- 1) **Treasury share transactions:** the company has spent (up to 17th September) HUF 247m on share repurchases, which is 27.4% of the authorized amount under the program approved this year. Overall, this means that PannErgy purchased under the program 217,325 shares (~1.1% of total shares and ~1.4% of total non-treasury shares) for an average price of HUF 1,135 / share. The program is valid until 13th April 2024 with a limit on share repurchases of HUF 900 million at a price not exceeding HUF 1,670 and 25% of total shares (~22.15% at the moment).
- 2) **New Miskolc well:** the company aims to implement the boring of the new production well after the end of the 2023/2024 heating season and expects to integrate it into the system by 30 September 2024. On August 25th PannErgy announced that the Ministry for Energy has issued the Grant Instrument required for taking recourse to the grant approved for the project last year up to a maximum amount of HUF 993m. The company incurred investment costs of HUF 306m related to the preparations for the project up to 30th June (planning, pre-drilling works etc.).
- 3) **Budapest geothermal project:** consultations about the Grant Instrument are ongoing, the exact scheduling and feasibility related criterias etc. will be determined only after the completion of these.

Assessment & outlook:

Overall, PannErgy delivered an excellent H1, the company sold a slightly higher amount of heat YoY (+2.9%) and above management's target (+3.2%), while revenue from heat sales was up by 89% due to higher regulated heat tariffs. The Győr project delivered historic seasonal record volume in both quarters and revenues from both major clients increased (+97% YoY for Győr-Szol CPlc. and +59% YoY for the automotive industry customer). At the same time, Miskolc also performed well both in terms of volume and revenue. Direct and administrative costs grew as well, especially electricity charges, that were up 336% YoY in H1 from HUF 477m to HUF 2080m. This means that electricity charges represented ~51% of direct costs in H1 2023 as opposed to ~18% in H1 2022. Of course, this is mostly the result of the extreme volatility seen in natural gas and electricity prices last year. The company also benefited from the strengthening of the HUF against the EUR in H1 through FX revaluations. Due to higher heat tariffs, record heat sales, interest income and various FX gains the company managed to more than offset the negative effects of higher costs, which resulted in record H1 EBITDA and net profit. As a result, management confirmed that the company is on track to achieve its HUF 3.95-4.15bn EBITDA plan in 2023.

P/L Table consolidated (million HUF)	2023H1	2022H1	2021H1	2020H1	2019H1	2018H1
Revenue	6 051	3 686	3 444	3 197	3 121	2 402
Net other revenue	-322	218	42	-13	106	174
OPEX	4 430	2 976	2 674	2 572	2 447	2 104
From which:						
* SGA	370	273	258	247	233	237
* Depreciation	965	807	748	798	671	675
EBITDA	2 265	1 735	1 560	1 461	1 451	1 147
EBIT	1 299	928	812	612	780	472
EBT	1 201	734	727	106	618	33
Income Taxes	42	2	63	13	15	9
Net income	1 159	732	664	93	603	24
EPS (HUF)	74,00	45,10	39,82	5,01	32,90	1,60

	2023H1	2022H1	2021H1	2020H1	2019H1	2018H1
EPS (HUF)	74,00	45,10	39,82	5,01	32,90	1,60
EBITDA (HUFm)	2 265	1 735	1 560	1 461	1 451	1 147
Gross profit rate (%)	32,9%	26,7%	29,9%	27,3%	29,1%	22,3%
EBIT rate (%)	21,5%	25,2%	23,6%	19,1%	25,0%	19,7%
EBITDA rate (%)	37,4%	47,1%	45,3%	45,7%	46,5%	47,8%
ROE (%)	10,2%	7,1%	6,7%	0,9%	5,9%	0,3%
ROA (%)	4,3%	2,8%	2,6%	0,4%	2,3%	0,1%
ROS (%)	19,2%	19,9%	19,3%	2,8%	19,3%	1,0%

- We have seen extreme volatility in natural gas and electricity markets last year, however, prices have significantly fallen by late spring this year (still relatively high in a historical context). This **change in the market environment could result in somewhat lower future regulatory heat tariffs.**
- The company benefited from the strengthening of the HUF against the EUR in H1, but we note that the HUF has been slightly weakening in recent months.
- With inflation slowing down in recent months and the focus possibly shifting towards the labour market, interest rates may fall over future periods (a positive from a WACC perspective and for defensive stocks), but outcome is still uncertain.
- The company expects to integrate the new Miskolc well into the system by 30 September 2024. We have not yet included this into our valuation, but we note that the issuance of the related Grant Instrument is a very positive step.
- We also note that the **REPowerEU chapter of Hungary's Recovery and Resilience Plan contains supportive elements regarding geothermal power** including (A) further improvements to the current regulatory framework and (B) investment support with a budget of HUF ~160bn (~417m EUR) in the form of aid and subsidized loan. The investment support would include mitigating the risk of geothermal drilling activities and providing financing for some construction related activities (subsidized loan). Supported activities of projects financed under the RRF scheme are not eligible for support under the KEHOP Plus geothermal framework.
- The currently applicable administrative prices were set at the end of last year (applicable from 1 January 2023), which unlike in previous cases did not have an end of validity date. We assume that the prices did not have an end of validity date

given the considerable uncertainties regarding energy markets. Furthermore, heat supply tariffs are typically announced for a full year, which are usually applicable from October each year. Considering that natural gas and electricity prices have fallen significantly since the beginning of the year we expect that new heat tariffs may be announced in the coming weeks. **As a result, for now we maintain our HUF 1,747 / share target price and BUY recommendation as well.**

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.

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
18/02/2022	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
27/03/2023	BUY	HUF 1,747	Equity note
17/04/2023	BUY	HUF 1,747	Equity note
18/07/2023	BUY	HUF 1,747	Equity note

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

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

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