

Tuesday, March 26, 2019 | update

PGE: buy (reiterated)

PGE PW; PGE.WA | Power Utilities, Poland

Too much pessimism on 2019 EBITDA guidance

The quotations of utilities in Europe are climbing to new highs (sector index + 13% YTD) on the wave of reversals of long-term trends on results. WIG Energetyka, after a good beginning of the year, lost its correlation with the European peer group and deepened the discount on EV/EBITDA. The catalyst for this deterioration of sentiment became PGE itself, which first informed about the preventive reserve for compensations, and later surprised with pessimistic projections for 2019. Meanwhile, in our opinion, 2019 may still surprise positively, especially that market expectations have been lowered. The temporary deterioration of the model FWD margins on TGE (a large share of weather factors) should not obscure the prospect of continuing improvement of EBITDA in following years (investments completion, capacity market) and significant FCF. Under these circumstances and also the growing needs of the state budget, the dividend should cease to be taboo. We are sustaining a buy rating. However, we take into account the greater pressure on payroll costs and lower prices of green certificates, hence we are lowering forecasts by 3% on EBITDA on average and we are adjusting the target price to PLN 13.77.

2019 may surprise in plus

The expected directions of EBITDA changes in 2019 provided by the Management Board have contributed to, in our opinion, too pessimistic thesis about the necessity of a significant revision of the consensus. In our projections, we take into account the main negative catalysts: a loss of result due to the heat (PLN -0.4 billion), payroll costs (PLN -0.3 billion), however, we see positive surprises, among others in the area of portfolio management (low by PLN 0.3 billion reference base), due to the contribution of new blocks of flats in Opole (PLN 0.2 billion) or the final implementation of CDS by the coal fleet. Obviously the necessary condition is the neutral impact of compensations, which is still possible despite the current chaos in that matter.

The perspective of getting higher FCF

The outlays on the largest projects (Opole, Turów) have already been executed in 80% and the next 3 years should bring significant surpluses of cash flows (PLN 6.6 billion FCF'19-21), and thus a reduction of already relatively low net debt. This will be an argument in the discussion on the dividend policy, especially since this topic can regain significance for the state budget. We would also like to remind you that the CFO was infected for about PLN 1 billion in 2018 by changing the policy of CO2 purchases and the need to top up deposits on TGE.

Slightly weaker session on TGE, but CDS still high

In February and March, the model term margin of the coal-fired power plant for 2020 has been compressed mainly due to weather conditions (drop in demand and high wind power increasing the production of wind farms) and a drop in imported coal prices. In our opinion, this is a temporary phenomenon and the CDS should recover soon, especially that according to the current PSE forecast the reserve level in the system will drop again in May and June.

(PLN m)	2017	2018	2019E	2020E	2021E
Revenue	23,100.0	25,946.0	39,389.9	43,237.6	41,684.6
EBITDA	7,650.0	6,364.0	7,423.6	8,219.3	9,624.1
EBITDA margin	33.1%	24.5%	18.8%	19.0%	23.1%
EBIT	3,552.0	2,471.0	3,341.4	3,958.3	5,330.1
Net profit	2,600.0	1,498.0	2,446.9	2,929.8	4,065.3
P/E	7.1	12.4	7.6	6.3	4.6
P/CE	2.8	3.4	2.8	2.6	2.2
P/BV	0.4	0.4	0.4	0.4	0.3
EV/EBITDA	3.6	4.6	3.9	3.4	2.6
DPS	0.00	0.00	0.00	0.33	0.39
DYield	0.0%	0.0%	0.0%	3.3%	4.0%

Current Price	PLN 9.88
Target Price	PLN 13.77
Market Cap	PLN 18.52bn
Free Float	PLN 7.89bn
ADTV (3M)	PLN 48.7 m

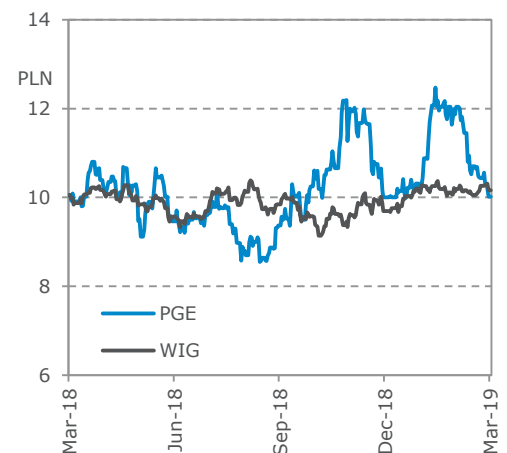
Ownership

State Treasury	57.39%
Others	42.61%

Business Profile

PGE is the largest energy holding in Poland, comprised of power plants and combined-cycle plants with a combined capacity of 16 GW and an annual output of 66 TWh, (representing a 40% market share). PGE produces about 60% of electricity from coal provided by its own lignite mines. In addition to power generation, the company also operates its own distribution network (covering about 27% of the Polish market), and a retail company which sales electricity to end users (40.4 TWh).

PGE vs. WIG



Company	Target Price		Rating	
	new	old	new	old
PGE	13.77	14.47	buy	buy

Company	Current Price	Target Price	Upside/Downside
PGE	9.88	13.77	+39.0%

Forecast revision since last update	2019E	2020E	2021E
EBITDA	-2.7%	-3.7%	-3.9%
Net profit	-11.3%	-10.6%	-8.9%
Power price (EUR/MWh)	-0.7%	+3.1%	+2.9%
Coal price (PLN/t)	-3.6%	-1.0%	-0.7%
EUA price (EUR/t)	+17.6%	+15.3%	+13.0%

Analyst:

Kamil Kliszcz
+48 22 438 24 02
kamil.kliszcz@mbank.pl

List of abbreviations and ratios contained in the report:

EV – net debt + market value
EBIT – Earnings Before Interest and Taxes
EBITDA – EBIT + Depreciation and Amortisation
P/CE – price to earnings with amortisation
MC/S – market capitalisation to sales
EBIT/EV – operating profit to economic value
P/E – (Price/Earnings) – price divided by annual net profit per share
ROE – (Return on Equity) – annual net profit divided by average equity
P/BV – (Price/Book Value) – price divided by book value per share
Net debt – credits + debt papers + interest bearing loans – cash and cash equivalents
EBITDA margin – EBITDA/Sales

OVERWEIGHT (OW) – a rating which indicates that we expect a stock to outperform the broad market
NEUTRAL (N) – a rating which indicates that we expect the stock to perform in line with the broad market
UNDERWEIGHT (UW) – a rating which indicates that we expect the stock to underperform the broad market

Recommendations of Dom Maklerski mBanku:

A recommendation is valid for a period of 9 months, unless a subsequent recommendation is issued within this period. Expected returns from individual recommendations are as follows:

BUY – we expect that the rate of return from an investment will be at least 15%
ACCUMULATE – we expect that the rate of return from an investment will range from 5% to 15%
HOLD – we expect that the rate of return from an investment will range from -5% to +5%
REDUCE – we expect that the rate of return from an investment will range from -5% to -15%
SELL – we expect that an investment will bear a loss greater than 15%
Recommendations are updated at least once every nine months.

mBank S.A. with its registered office in Warsaw at Senatorska 18 renders brokerage services in the form of derived organisational unit – Brokerage Office which uses name Dom Maklerski mBanku.

This document has been created and published by Dom Maklerski mBanku. The present report expresses the knowledge as well as opinions of the authors on day the report was prepared. The opinions and estimates contained herein constitute our best judgment at this date and time, and are subject to change without notice. The present report was prepared with due care and attention, observing principles of methodological correctness and objectivity, on the basis of sources available to the public, which Dom Maklerski mBanku S.A. considers reliable, including information published by issuers, shares of which are subject to recommendations. However, Dom Maklerski mBanku S.A., in no case, guarantees the accuracy and completeness of the report, in particular should sources on the basis of which the report was prepared prove to be inaccurate, incomplete or not fully consistent with the facts. mBank S.A. bears no responsibility for investment decisions taken on the basis of the present report or for any damages incurred as a result of investment decisions taken on the basis of the present report.

This document does not constitute an offer or invitation to subscribe for or purchase any financial instruments and neither this document nor anything contained herein shall form the basis of any contract or commitment whatsoever. It is being furnished to you solely for your information and may not be reproduced or redistributed to any other person. This document nor any copy hereof is not to be distributed directly or indirectly in the United States, Australia, Canada or Japan.

Recommendations are based on essential data from the entire history of a company being the subject of a recommendation, with particular emphasis on the period since the previous recommendation. Investing in shares is connected with a number of risks including, but not limited to, the macroeconomic situation of the country, changes in legal regulations as well as changes on commodity markets. Full elimination of these risks is virtually impossible.

It is possible that mBank S.A. in its brokerage activity renders, will render or in the past has rendered services for companies and other entities mentioned in the present report.

mBank S.A. does not rule out offering brokerage services to an issuer of securities being the subject of a recommendation. Information concerning a conflict of interest arising in connection with issuing a recommendation (should such a conflict exist) is located below.

The present report was not transferred to the issuer prior to its publication.
mBank S.A. received compensation for services provided to the Issuer in the last 12 months.

The production of this recommendation was completed on March 26, 2019, 8:32 AM.
This recommendation was first disseminated on March 26, 2019, 8:32 AM.

mBank S.A., its shareholders and employees may hold long or short positions in the issuer's shares or other financial instruments related to the issuer's shares.

This document is an extract from a recommendation produced by Dom Maklerski mBanku.

Copying or publishing the present report, in full or in part, or disseminating in any way information contained in the present report requires the prior written consent of mBank S.A.

Recommendations are addressed to all Clients of Dom Maklerski mBanku.

All investment recommendations and strategies issued by mBank S.A. over the last 12 months are available at:
http://www.mdm.pl/ui-pub/site/market_and_analysis/analysis_and_recommendations/fundamental_analysis/recommendations?recent_filter_active=true&lang=en

The activity of mBank S.A. is subject to the supervision of the Polish Financial Supervision Commission.

Individuals who did not participate in the preparation of recommendations, but had or could have had access to recommendations prior to their publication, are employees of Dom Maklerski mBanku authorised to access the premises in which recommendations are prepared and/or individuals having to access to recommendations based on their corporate roles, other than the analysts mentioned as the authors of the present recommendations.

This publication constitutes investment research within the meaning of Art. 36.1 of Commission Delegated Regulation (EU) 2017/565.

The compensation of the research analysts responsible for preparing investment research is determined independently of and without regard to the compensation of or revenue generated by any other employee of the Bank, including but not limited to any employee whose business interests may reasonably be considered to conflict with the interests of the persons to whom the investment research prepared by the Research Department of Dom Maklerski mBanku is disseminated. With that being said, since one of the factors taken into consideration when determining the compensation of research analysts is the degree of fulfillment of annual financial targets by customer service functions, there is a risk that the adequacy of compensation offered to persons preparing investment research will be questioned by a competent oversight body.

For U.S. persons only: This research report is a product of mBank SA which is the employer of the research analyst(s) who has prepared the research report. The research analyst(s) preparing the research report is/are resident outside the United States (U.S.) and are not associated persons of any U.S. regulated broker-dealer and therefore the analyst(s) is/are not subject to supervision by a U.S. broker-dealer, and is/are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with U.S. rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.

This report is intended for distribution by mBank SA only to "Major Institutional Investors" as defined by Rule 15a-6(b)(4) of the U.S. Securities and Exchange Act, 1934 (the Exchange Act) and interpretations thereof by U.S. Securities and Exchange Commission (SEC) in reliance on Rule 15a 6(a)(2). If the recipient of this report is not a Major Institutional Investor as specified above, then it should not act upon this report and return the same to the sender. Further, this report may not be copied, duplicated and/or transmitted onward to any U.S. person, which is not the Major Institutional Investor.

In reliance on the exemption from registration provided by Rule 15a-6 of the Exchange Act and interpretations thereof by the SEC in order to conduct certain business with Major Institutional Investors, mBank SA has entered into an agreement with a U.S. registered broker-dealer, Cabrera Capital Markets. ("Cabrera"). Transactions in securities discussed in this research report should be effected through Cabrera or another U.S. registered broker dealer.

Strong and weak points of valuation methods used in recommendations:

DCF – acknowledged as the most methodologically correct method of valuation; it consists in discounting financial flows generated by a company; its weak point is the significant susceptibility to a change of forecast assumptions in the model.

Relative – based on a comparison of valuation multipliers of companies from a given sector; simple in construction, reflects the current state of the market better than DCF; weak points include substantial variability (fluctuations together with market indices) as well as difficulty in the selection of the group of comparable companies.

Economic profits – discounting of future economic profits; the weak point is high sensitivity to changes in the assumptions made in the valuation model.

Discounted Dividends (DDM) – discounting of future dividends; the weak point is high sensitivity to changes in the assumptions as to future dividends made in the valuation model.

NAV – valuation based on equity value, one of the most frequently used method in case of developing companies; the weak point of the method is that it does not factor in future changes in revenue/profits of a company.

mBank issued the following investment recommendations for PGE in the 12 months prior to this publication

Rating	buy	buy	buy	buy
Rating date	2019-02-04	2018-11-29	2018-05-29	2018-04-06
Target price (PLN)	14.47	14.82	13.60	12.89
Price on rating day	11.86	11.47	9.28	9.81

Dom Maklerski mBanku

Senatorska 18
00-082 Warszawa
<http://www.mbank.pl/>

Research Department

Kamil Kliszcz

director
+48 22 438 24 02
kamil.klischcz@mbank.pl
energy, power generation

Jakub Szkopek

+48 22 438 24 03
jakub.szkopek@mbank.pl
industrials, chemicals, metals

Aleksandra Szklarczyk

+48 22 438 24 04
aleksandra.szklarczyk@mbank.pl
construction, real-estate development

Michał Marczak

+48 22 438 24 01
michal.marczak@mbank.pl
strategy

Paweł Szpigel

+48 22 438 24 06
pawel.szpigel@mbank.pl
media, IT, telco

Piotr Poniatowski

+48 22 438 24 09
piotr.poniatowski@mbank.pl
industrials

Michał Konarski

+48 22 438 24 05
michal.konarski@mbank.pl
banks, financials

Piotr Bogusz

+48 22 438 24 08
piotr.bogusz@mbank.pl
retail

Mikołaj Lemańczyk

+48 22 438 24 07
mikolaj.lemanczyk@mbank.pl
financials

Sales and Trading

Traders

Piotr Gawron

director
+48 22 697 48 95
piotr.gawron@mbank.pl

Jędrzej Łukomski

+48 22 697 49 85
jedrzej.lukomski@mbank.pl

Tomasz Galanciak

+48 22 697 49 68
tomasz.galanciak@mbank.pl

Krzysztof Bodek

+48 22 697 48 89
krzysztof.bodek@mbank.pl

Adam Prokop

+48 22 697 47 90
adam.prokop@mbank.pl

Magdalena Bernacik

+48 22 697 47 35
magdalena.bernacik@mbank.pl

Tomasz Jakubiec

+48 22 697 47 31
tomasz.jakubiec@mbank.pl

Andrzej Sychowski

+48 22 697 48 46
andrzej.sychowski@mbank.pl

Sales, Foreign Markets

Marzena Łempicka-Wilim

deputy director
+48 22 697 48 82
marzena.lemicka@mbank.pl

Bartosz Orzechowski

+48 22 697 48 47
bartosz.orzechowski@mbank.pl

Private Client Sales

Kamil Szymański

director
+48 22 697 47 06
kamil.szymanski@mbank.pl

Jarosław Banasiak

deputy director
+48 22 697 48 70
jaroslaw.banasiak@mbank.pl