

Tuesday, June 25, 2019 | update

Power Utilities

Poland, Czech Republic

How much more of the WIG-Energy drama?

Our November report sustained a positive recommendation for the Polish energy sector in the expectation that surprising capacity auction decisions and a vision of positive cash flows would help WIG-Energy to further recover. However, an escalation of turbulences around the energy price freeze combined with disappointing PGE results have yet again put the industry on the defensive. Yet, in our opinion, a scenario of a sharp FCF improvement in the coming years stands strong. The scenario may be discounted as a result of eventual decisions approving energy price reduction compensations, which seem to loom just around the corner after the legislative amendment. We note an evolution in the government's approach to the transition to RES combined with massive funding available from the modernisation fund. Given the current industry sell-off, one should not underestimate the "risk" of a dividend comeback, especially that the public budget may be in need in the coming years while the balance sheets will no longer inflate (Net Debt/EBITDA should drop from 2.3x now to 1.4x at 2021 YE). In this context, we maintain our positive view on the industry.

Stoxx Utilities at its highs, WIG-Energy at its lows

After strong performance v. the market in 2018, the European utility stock index continues to outperform the benchmark in 2019, rising more than 20% YTD. The interest rate environment combined with prospects of improved results and, consequently, dividends, work as an effective incentive for global capital. Against this backdrop, WIG-Energy looks truly dramatic with a YTD drop of 15% and EV/EBITDA 15% below the already low 3Y average. In the last five years, the Polish energy stock EV dropped 13% while the EBITDA stream grew 8% (it is poised to rise 18% in 2013-2020 and 33% in 2013-21), which is a good proxy for the size of the derating.

FCF major improvement prospects

According to our estimates, the average annual capex 2020-23 will be PLN 12.4bn v. PLN 15bn in 2015-19 (capex gap after the completion of large coal projects). Combined with an expected higher potential of the industry's adjusted EBITDA, expected to grow from PLN 14.9bn in 2015-19 to PLN 18.6bn in 2020-23, the scenario implies a sharp increase in cash flows generated in the coming years. Simplified FCF (EBITDA-CAPEX after tax) in the next five years (2019-23) should reach PLN 19bn (32% of EV), or PLN 14bn (55% of current MCap) net of FCFE interest cost. In our opinion, weaker cash flows in 1Q'19 must not be extrapolated to future periods in view of a range of one-off factors which reduced CF in 1Q'19.

Strong support for the energy transition

It seems that the final draft of the government energy policy by 2040 will follow the mainstream trend in the industry (RES development, regulatory gas capacity). Importantly, the transition will be supported by massive public funding, from the capacity market (new and secured contracts for CCGT units, including PLN 2.9bn per year under 5-15Y contracts), to RES auctions, to a modernisation fund (potentially up to EUR 17bn, or EUR 10bn net of the solidarity fund). Furthermore, the announced development of distributed PV systems will take place outside the professional energy industry.

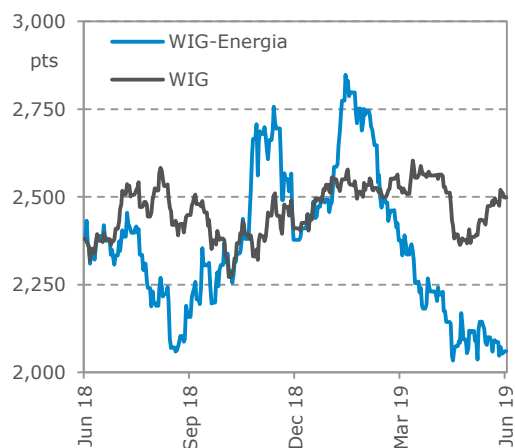
Company	P/E		P/CE		EV/EBITDA		P/B
	2019E	2020E	2019E	2020E	2019E	2020E	2018
CEZ	16.2	14.1	6.2	5.8	7.6	7.0	1.2
Enea	3.2	2.9	1.4	1.3	3.2	3.0	0.3
Energa	4.1	4.6	1.7	1.8	3.8	4.2	0.3
PGE	8.0	6.2	2.7	2.4	3.9	3.5	0.4
Tauron	2.5	2.3	0.9	0.8	4.1	3.6	0.2

WIG-Energy	2,099
WIG	60,003
2019E P/E	6.8x
2019E EV/EBITDA	4.5x

Sector Outlook

Energy prices in Europe dropped below 50 EUR/MWh following a correction of coal and gas prices but they still remain well above the 5Y average, mainly due to high prices of allowances. Poland follows the trend as 1Y forwards are oscillating around 270 PLN/MWh. Positive trends in generation have encouraged an upgrade of the market consensus about the results and future dividends of Stoxx Utilities. However, margins will not rise until 2020-21 due to hedging policies.

WIG-Energy vs. WIG



Stock	9MTP		Rating	
	new	old	new	old
CEZ (CZK)	597.80	565.50	accumulate	hold
Enea	12.41	12.51	buy	buy
Energa	12.67	12.21	buy	buy
PGE	13.26	13.39	buy	buy
Tauron	2.52	2.89	buy	buy

Stock	Current Price	Target Price	Upside
CEZ (CZK)	544.00	597.8	+9.9%
Enea	8.53	12.41	+45.6%
Energa	7.33	12.67	+72.9%
PGE	9.00	13.26	+47.3%
Tauron	1.57	2.52	+61.1%

Analyst:

Kamil Kliszcz
+48 22 438 24 02
kamil.klisczcz@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

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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.

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Rating	buy	buy	buy
Rating date	2019-04-02	2019-02-04	2018-11-29
Target price (PLN)	12.51	13.12	15.58
Price on rating day	8.76	10.73	10.50

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

Rating	buy	buy	buy	buy
Rating date	2019-04-02	2019-02-04	2018-11-29	2018-09-03
Target price (PLN)	12.21	13.26	13.54	15.27
Price on rating day	8.58	10.14	9.16	8.40

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

rekomendacja	buy	buy	buy	buy	buy	buy
Rating date	2019-06-03	2019-05-09	2019-04-02	2019-03-26	2019-02-04	2018-11-29
Target price (PLN)	13.39	13.38	13.66	13.77	14.47	14.82
Price on rating day	9.23	8.61	10.10	9.88	11.86	11.47

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

Rating	buy	buy	buy	buy
Rating date	2019-04-02	2019-02-04	2018-11-29	2018-09-03
Target price (PLN)	2.89	3.12	3.06	2.77
Price on rating day	2.03	2.37	2.21	2.00

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

Rating	hold	hold	hold	sell
Rating date	2019-04-02	2019-02-04	2018-11-05	2018-07-04
Target price (CZK)	565.50	537.80	518.72	440.96
Price on rating day	540.50	568.00	549.00	550.00

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 Szpigiel
+48 22 438 24 06
pawel.szpigiel@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, gaming

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