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Thursday, February 20, 2020 | update

CEZ: buy (reiterated)

CEZ CP; CEZP.PR | Utilities, Czech Republic

Undervalued and Overdue For a Catch-Up Rally

The European utilities sector has rallied over 50% since the beginning of 2019, but the return on CEZ in the period has been next to nothing. Compared to an average 12M forward EV/EBITDA ratio of 8.7x, up from 7.2x last January, at the current level the Czech utility is trading at a discount of 20%. There is no question that CEZ still has further to go in terms of ESG, but its strengths include a low-carbon fleet (with the earnings potential positively correlated with prices of emission allowances), a firm plan to phase out coal, and EBITDA which is more than 50% comprised of environmentally safe/ clean businesses. Dividends are another of CEZ's strong suits, with stable yields well above Stoxx Utilities averages and the risk-free rate. Last but not least, it is worth pointing our CEZ's growing involvement in renewables, supported by the Czech government's Modernization Fund vehicle. We maintain a buy rating for CEZ, with the target price trimmed to CZK 592.91 to reflect reduced expectations as to future power and energy prices, combined adjustments for higher peer multiples.

Strong earnings potential

CEZ is set for continued EBITDA growth in 2020, supported by price hedging and increasing generator output. Growth in 2021 might be capped by a reduction in the WACC used to calculate the regulatory asset value, combined with coal plant closures and CDS thinned by higher EUA prices. The development of the ESCO business should be a mitigating factor next year, with the energy service companies expected to contribute as much as CZK 3.6bn to annual EBITDA by 2025. Other potential drivers, not currently factored into our models, include larger-than-expected volumes from nuclear and solar power plants and planned efficiency measures.

Reliable dividends

We assume that CEZ will spend CZK 34bn a year on average on capital investment in the next five years (in 2022 this would be a 15% higher amount than actually budgeted). Accordingly, our EBITDA estimates indicate average FCF/EV yield of 5%, enough to keep paying generous dividends to shareholders over the medium term, with the 2020-2022 dividend yield averaging 6% without a need to raise the net debt/EBITDA ratio above 2.6x. At this level, CEZ's dividend yields are 3pp higher than the average for the utilities sector, and 5pp higher than the yield on Czech 10Y Treasuries.

Undeserved discount

The three main arguments raised against buying CEZ include its still-substantial reliance on coal against a relatively small share of renewables in the energy mix, and the impending investment in a new nuclear unit. Meanwhile the coal argument is no longer valid since CEZ pledged to cut coal from 41% below 30% by 2030 by closing half of the current capacity. Next, CEZ generates over 40% of EBITDA from distribution and trading. As for sustainability, we believe CEZ will be able to step up RES investment with the help of Modernization Fund money. Finally, CEZ's profits are positively correlated with prices of emission allowances.

(CZK m)	2017	2018	2019E	2020E	2021E
Revenue	205,092	184,486	205,752	229,058	231,603
EBITDA	55,155	49,664	57,287	63,680	58,827
EBITDA margin	26.9%	26.9%	27.8%	27.8%	25.4%
EBIT	25,620	19,759	27,101	33,219	28,660
Net profit	18,765	10,327	16,099	20,812	16,197
P/E	14.4	26.2	16.8	13.0	16.7
P/CE	5.6	6.7	5.8	5.3	5.8
P/BV	1.1	1.2	1.1	1.1	1.1
EV/EBITDA	7.6	8.6	7.5	6.6	7.2
DPS	33.0	32.7	24.0	28.8	34.8
DYield	6.5%	6.5%	4.8%	5.7%	6.9%

Current Price	CZK 503.00
Target Price	CZK 592.91
Market Cap	CZK 270.6bn
Free Float	CZK 81.8bn
ADTV (3M)	CZK 204.21 m

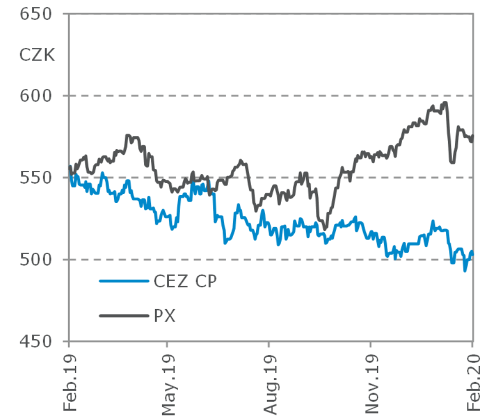
Ownership

Czech Republic	69.78%
Others	30.22%

Business Profile

CEZ is the leading producer of electric power in the Czech Republic (58.8 TWh, 65% market share), as well as being the largest distributor (with a 65% market share) and seller (28%). The Company also operates power plants in Poland, and it distributes electricity to end users in Bulgaria (where it has a 28% market share) and in Romania (12%) where it also owns two large wind farms. An acquisition in Turkey gave CEZ a 3% share in the local market for power distribution. Recently CEZ is also expanding its presence in the Western European market for renewable energy through wind farms in Germany and France.

CEZ vs. PX



Company	Target Price new	Target Price old	Rating new	Rating old
CEZ	592.91	597.80	buy	buy

Company	Current Price	Target Price	Upside
CEZ	503.00	592.91	+17.9%

Forecast Update	2019E	2020E	2021E
EBITDA	-2.3%	+1.7%	-7.3%
Net Profit	-10.7%	+0.2%	-21.4%
Power (EUR/MWh)	+0.4%	-14.7%	-13.2%
EUR/CZK	-0.0%	-1.8%	-1.8%
CO_2 (EUR/t)	+5.0%	+0.0%	+0.0%

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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%
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mBank issued the following investment recommendations for CEZ in the 12 months prior to this publication:

Recommendation	buy	accumulate	hold	hold
Date issued	05.12.2019	25.06.2019	02.04.2019	04.02.2019
Target price (PLN)	597.80	597.80	565.50	537.80
Price on rating day	502.00	544.00	540.50	568.00

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