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PGE – Agrees To Buy Polish Assets of EDF

Rating: hold | target price: PLN 10.63 | current price: PLN 11.36

PGE PW; PGE.WA | Power Utilities, Poland

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PGE signed a conditional agreement to buy the Polish power and heating assets of the French utility EDF (the final agreement is to be signed by July 26th) for enterprise value as of 31 December 2016 of PLN 4.51bn. Including all additional costs and charges, we expect the actual price may reach PLN 5.5bn, implying a 2016 EV/EBITDA ratio of 5.06x. The enterprise multiple is close the current multiple of PGE (at ca. 5.0x), which may be viewed as a positive surprise given that EDF's state-regulated cogeneration assets are valued at higher multiples than conventional assets (we had a PLN 6bn EV forecast for the deal). PGE says it expects extended state aid for cogeneration under planned new legislation. The Company had no comment on its plans as regards EDF's shelved coal-fired power plant project in Rybnik. All in all, we have a positive view on the EDF deal given the lower-than-expected price, though keep in mind that the EV/EBITDA calculations have to factor in EDF's minority holdings in the Wrocław-based listed power generator Kogeneracja.

EDF Assets

The assets that PGE has agreed to buy from EDF have combined generation capacity of 3.3 GWe and 4.4 GWt, and they produce 12.4 TWh of electricity and 32.8 PJ of heat per year. Also part of the deal is a heat distribution network spanning 390 kilometers. Specifically, the plants in question include a power station in Rybnik (1.8 GW of capacity launched in 1972-78, of which 900 MW upgraded to operate until 2030), the Wrocław-based CHP 'Kogeneracja' (560 MWe, 1.4 GWt), a CHP in Krakow (460 MWe), and another in Toruń (375 MWt, 2.2 MWe), and the 'EDF Wybrzeże' complex of heat and power stations in Gdańsk and Gdynia (332 MWe, 1.2 GWt). Combined, these will boost PGE's installed power capacity by 25%, and increase the generation volumes by 23%. When it comes to heat, the expected growth in installed capacity and output is 114% and 177%, respectively, giving PGE a 15% market share.

The Terms

EDF Polska's enterprise value (EV) as of end December 2016 was determined at **PLN 4.51bn**, including PLN 2.45bn of equity value and PLN 2.06bn net debt, of which PLN 1.68bn of obligations to EDF which have to be paid back upon takeover. In addition, PGE has to **pay interest on EDF's intercompany loans in the amount of \$40m** (approximately PLN 152m), and it will pay for the **economic benefits** on the operations of EDF Polska achieved from January 2017 (the pricing date) until the acquisition, up to the amount of **PLN 107m**.

Further, since the assets bought from EDF include a 50% stake in the WSE-listed power generator Kogeneracja (KGN), the enterprise value calculations for the deal should include

the estimated future value of minority interests in KGN, the current market value of which is **PLN 782m** (PGE will have to make a tender offer to attempt to reach a 66% stake in KGN, but it will recognize 100% of KGN's EBITDA in its consolidated accounts).

EDF Polska generated EBITDA of PLN 1.1bn in 2016 (a detailed earnings breakdown is not available).

All told, taking into consideration all the factors described above (with EV adjusted as shown in the following table), we arrived at a 2016 **EV/EBITDA ratio for the transaction of 5.06x**. PGE says the costs of implementing best available technology at the EDF plants will be in the range of PLN 600-700m.

State Subsidies

PGE expects based on recent statements by the Energy Ministry that the current **subsidy scheme** for cogeneration may be **extended beyond 2018**. The Ministry is also working on an auction mechanism for electricity and heat from cogeneration to encourage its further growth.

Plans For Further Consolidation of Heating Capacity

PGE sees potential for further acquisitions and/or partnerships with heat-generating plants in smaller Polish districts. It has identified **200 possible targets so far (1-50 MWt), all plants in need of radical overhaul**. PGE also wants to expand and develop the district heating network in Rybnik, where demand for heat is set to increase soon as the local utility prepares to shut down its own generation infrastructure.

Valuation of EDF Polska acquisition

(PLN m)	2016
Revenue of EDF Polska	4,850.0
EBITDA of EDF Polska	1,098.0
of which Kogeneracja	351.3
%	32%
Net debt (eop)	2,060.0
Estimated price of EDF Polska (EV)	5,551.3
Equity value	2,450.0
Net debt	2,060.0
Interest on debt owed to EDF	152.0
Max cost of economic benefits (2017)	107.0
Market value of minority holdings (50%) in KGN	782.3
Implied EV/EBITDA	5.06

Source: PGE, EDF, estimates by Dom Maklerski mBanku

List of abbreviations and ratios contained in the report:

EV – net debt + market value (EV – economic value)
EBIT – Earnings Before Interest and Taxes
EBITDA – EBIT + Depreciation and Amortisation
PBA – Profit on Banking Activity
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
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