| Electric Utilities | **12m target upgrade** | Poland |

Polenergia

Unlocking sustainable FCF generation potential

Buy

Price 10/11/15	**PLN26.4**
12m target	**PLN44.8**
Upside to TP	**69.7%**
12m f'cast div	**0**
12m TSR	**69.7%**

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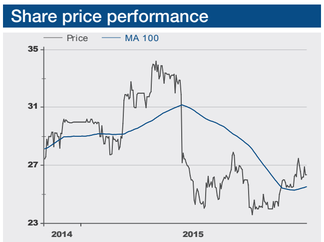
Sector stance
Underweight (Europe)

Preferred stock
PGE, Energa, Polenergia

Least preferred stock
Tauron

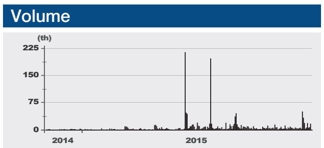
Investment trigger
Undervalued
Growth

Share price performance



Source: SG Cross Asset Research/Equity

Volume



Source: SG Cross Asset Research/Equity

Update In light of its Q1, Q2, and Q3 figures, Polenergia has already achieved 80% of its FY15 guidance (unchanged so far) in terms of EBITDA and 88% in terms of adjusted net income. We now expect guidance to be exceeded by 12% and 23% respectively. We have fine-tuned our model to incorporate a lower electricity price and marginally lower green certificate price projections for the coming quarters and to adjust the amount of farm capacity ready for the first auction to 279MW. Consequently, we inch up our TP for Polenergia to PLN44.8 (from PLN42.4) which also captures better cash flow generation (and hence lower net debt) than we had initially anticipated for 2015.

SG view The market seems very doubtful about a rebound in green certificate prices, which we expect to take place following the introduction of the new RES law in January 2016 (already up by 20% from this year's lows), and does not in our view take into account the company's potential for FCF generation. After completion of 62MW in new capacity in Q4 15, Polenergia should be poised to unlock impressive FCF generation potential. Assuming the business will be run for cash (no further development capex, very low maintenance capex), the company would be able to produce sustainable FCF of more than PLN100m per annum (after debt repayment outflows) for its shareholders, translating into a yield of >9%. We also expect an end-2015 cash balance exceeding PLN400m (33% of the current market cap). Should the company continue investing in new wind farms (a much more likely scenario), we calculate that sustainable FCF to equity generation and required equity input for new wind projects would still allow the company to pay a hefty DPS per annum exceeding PLN1.7 in FY17e-FY20e. Additionally, when the first dividend is due (assuming at FY17), Polenergia should have more than PLN450m of cash available to distribute after adjusting for capex needs (SGe).

How we value the stock Our PLN44.8 target price (was PLN42.4) is SOTP based, with wind farms constituting the bulk of our valuation (under the old RES regime of PLN39.1 per share (EV) and the new RES regime at PLN8.4). We input a 5.5% WACC for wind farms under the old regime, 4.2% WACC for the new regime, and 5.8% for the other operations. The cost of equity amounts to 8.0%.

Events, catalysts & risks Implementation of the new RES regime in 2016. **Risks to TP**: no recovery in green certificate prices; intensified competition in feed-in tariff auctions; falling CO_2 and electricity prices; inability to deliver wind farm projects; subdued load factors.

Share data			
RIC PEPP.WA, Bloom PEP PW			
52-week range			34.2-23.6
EV 15 (PLNm)			2,035
Mkt cap. (PLNm)			1,198
Free float (%)			14.9
Performance (%)	**1m**	**3m**	**12m**
Ordinary shares	1.3	-2.2	-4.0
Rel. Eurofirst 300	-2.8	2.1	-12.7

Financial data	12/14	12/15e	12/16e	12/17e
Revenues (PLNbn)	2.66	2.72	2.87	2.93
EBIT margin (%)	3.3	5.1	5.2	5.9
Rep. net inc. (PLNm)	49.6	75.8	78.1	116
EPS (adj.) (PLN)	1.09	1.67	1.72	2.55
Dividend/share (PLN)	0.00	0.00	0.00	0.00
Payout (%)	0	0	0	0
Interest cover (x)	2.01	2.98	2.44	4.67
Net debt/equity (%)	19	59	43	91
Prev. EPS (changed as of 12/11/15)		1.89	2.00	2.48

Ratios	12/14	12/15e	12/16e	12/17e
P/E (x)	25.2	15.8	15.3	10.3
FCF yield (/EV) (%)	-10.5	-26.7	14.1	-30.0
Dividend yield (%)	0.0	0.0	0.0	0.0
Price/book value (x)	0.94	0.85	0.81	0.75
EV/revenues (x)	0.57	0.75	0.64	0.91
EV/EBIT (x)	17.2	14.7	12.2	15.4
EV/IC (x)	0.9	0.8	0.8	0.8
ROIC/WACC (x)	1.0	0.9	0.9	0.9
EPS CAGR 14-17e: +32.8%				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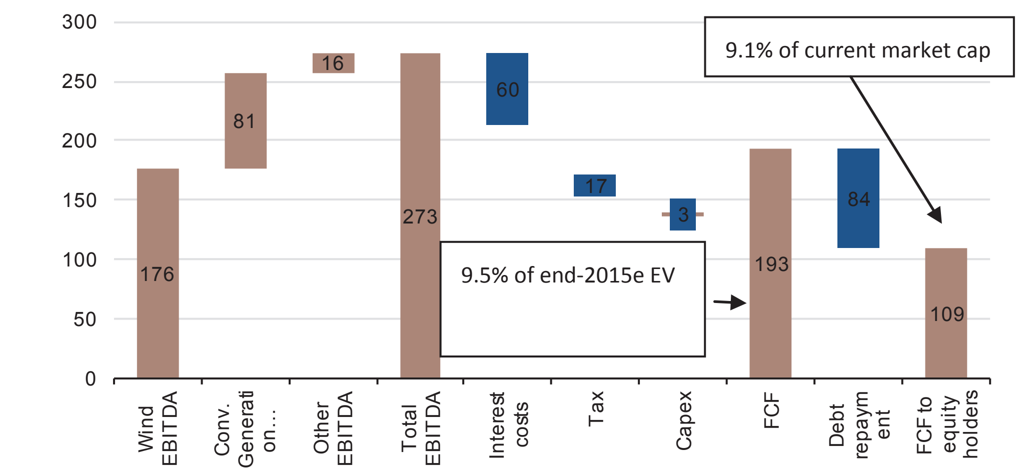
Unlocking sustainable FCF generation potential

Polenergia's portfolio of wind farms in operation at the end of Q3 15 reached an installed capacity of 183.5MW and is scheduled to rise by another 61.8MW in Q4 15, totalling 245MW by the end of this year. We expect these assets to generate about PLN176m of EBITDA next year (8.7% of end-2015e EV) with only minor maintenance capex (expensed and included in our opex calculations). Additionally, we estimate Polenergia will generate almost PLN100m of EBITDA from non-wind operations (predominantly from its quasi-regulated CHP CCGT plant in Nowa Sarzyna) which in total require very little capex as well (SGe c.PLN3m). Tax and interest should amount to c.PLN82.5.

In sum, we expect around PLN193m of FCF (without adjusting for working capital, which should be insignificant anyway) i.e. c.9.5% of end-2015e EV. Furthermore, taking into account debt-repayment outflows (for simplicity, we take end-2015e gross debt and divide it by 15 years) of c.PLN80m per annum, we derive free cash flow available to equity holders of PLN109m, i.e. 9% of the current market cap.

We believe Polenergia will be able to generate this kind of free cash flow without any significant capex requirements, and the company should be able to distribute this to its shareholders without impacting the business if there are no additional investments. This would be the level of FCF if the business were run for cash following the completion of this year's wind farm investments.

FCF generation potential from 2016e on without additional wind farm capex



Source: SG Cross Asset Research/Equity

Nonetheless, Polenergia does not aim to run the business for cash but plans to grow given its impressive portfolio of wind farms (totalling 279MW) that can participate in the first auction (SGe Q2 16) and another 514MW for auctions in 2017-2019e. We assume a >50% probability of winning the first auction, which would imply Polenergia building 152MW by the end of 2017, which would require roughly PLN1bn of capex spending; of that, 20% should be equity (according to the company). We assume that in the new auctioning system, given the fact that a wind farm operator will not be subject to a market risk premium anymore and the counterparty will be the government, the cost of financing should drop and potential leverage on the projects should rise from 70% currently to 80%.

We estimate that given Polenergia's end-2015e cash (SGe PLN430m) and FCF generation post debt service expenditures in 2016 (excluding any additional capex needed to fund wind farms to be potentially won in the auctioning system), Polenergia's cash balance will exceed PLN560m, of which PLN210m will probably be needed to co-finance wind farms to be auctioned in 2016 (SGe).

Furthermore, we project that in the years 2017-2020, in order to commission 536MW of wind farms (our base case, i.e. 68% of the current wind farm portfolio designed to participate in the auction system in FY16-FY20), Polenergia will need PLN3.75bn, of which (20%) PLN750m should constitute equity. We also estimate that most of this equity (PLN500m, i.e. c.70%) will be covered with FCF to equity (i.e. after debt repayment) generated in FY17e-FY20e.

In conclusion, we believe that Polenergia could be able to distribute around PLN300m in FY17e-FY20e (25% of the current market cap) to its shareholders and still be able to co-finance its ambitious capex program). After the completion of 536MW of wind farms in FY20e (SGe), Polenergia should be generating c.PLN150m of annual FCF to equity, i.e. 12.5% of the current market cap. With no further developments (for instance offshore wind farms), these cash flows could be fully used to remunerate investors. Should the company decide to run the business for cash now (less likely) and decide not to develop any more wind farms beyond FY15e, more than PLN100m of FCF to equity (>9% of the current market-cap) would be generated annually, which could easily be deployed as dividend to Polenergia's shareholders; running the business for cash means at least a 9% dividend yield from FY17e (not to mention the outstanding cash balance estimates at PLN550m at the end of 2015).

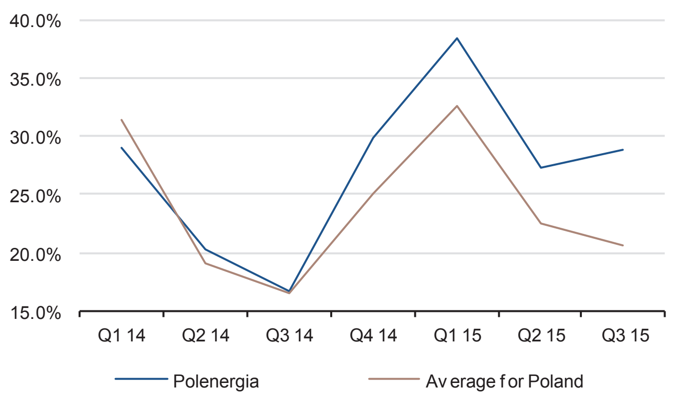
However, in our base-case scenario including further wind farm development until the end of 2020, we believe Polenergia will be able to pay out around PLN81m annually to its shareholders (6.7% dividend yield, DPS of PLN1.77) in order to have its cash inflows and outflows balanced at the end of the decade. We simply take the expected end of FY20e cash balance and divide it by four dividend payouts in 2017, 2018, 2019 and 2020 (assuming Polenergia will start paying dividend in 2017). The predictability of the business will also increase upon completion of the first wind farms under the auction system. (As Polenergia does not have a clear dividend policy yet, we currently do not include any dividend payments in our model).

Clearly, all of the aforementioned depends on the capacity of wind farms to be constructed in the new auction system, cash flow to be potentially generated from the disposal of core and non-core assets, as well as decisions on developing/building offshore farms.

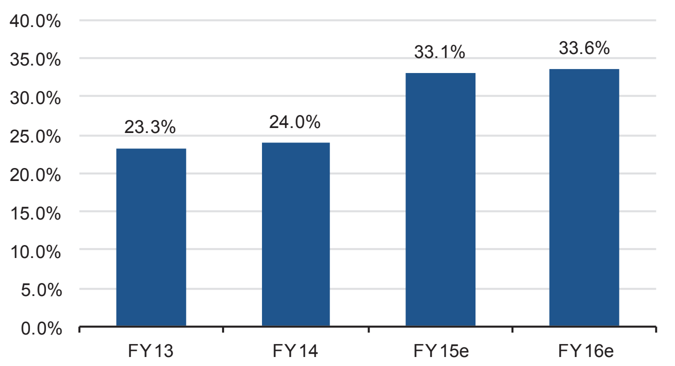
Average load factor on the rise

Thanks to new technologies and better locations for the wind farms Polenergia is currently building, the company has managed to improve its average load factor gradually. After the commissioning of the Gawlowice (41MW) and Rajgrod (25MW) farms, Polenergia began significantly outpacing average load factors estimated for all wind farms in Poland (approximately, based on PSE data). Moreover, we believe the company will be able to lift its FY14e average load factor across the whole portfolio from 24% to more than 33% in FY16e. Obviously, wind conditions matter as well as we see the old factors to have been producing significantly more electricity this year than in the last one; nonetheless access to more efficient technology as well as greater expertise also matter.

Polenergia's and Poland's average wind farm load factors



Polenergia's load factors have been improving



Source: SG Cross Asset Research/Equity, Polenergia, PSE

Changes to estimates

We make a few changes to our estimates due to the company's excellent performance so far this year (see our note Good figures supported by wind project completion, strong CFO) and to the fact that the company has already achieved 80% and 88% respectively of its adjusted EBITDA and net income guidance (PLN204m and PLN72.4m) indicating potential upside to management's FY15 guidance as well as our previous estimates.

We also incorporate new power price assumptions as presented in Polish Utilities: de-rating seems to price in most of the risks – look for good value. However, we marginally cut our FY16e assumption for green certificate prices (from PLN180/MWh to PLN170/MWh) given Polenergia's higher exposure to current green certificate spot prices after Tauron cancelled off-take contracts with two of Polenergia's farms. In addition to that, we also cut our long-term green certificate prices assumptions (beyond FY20e) from PLN270/MWh to PLN250/MWh to be closer to Polenergia's long-term expectations (and hence more conservative).

Polenergia: macro assumptions

	2015e	2016e	2017e	2018e	2019e	2020e
CO_2 price (EUR/t)	7.70	8.20	8.30	8.40	8.50	8.80
EUR/PLN	4.16	4.12	4.03	4.00	3.91	3.90
Coal price (PLN/GJ)	9.50	9.50	9.73	9.98	10.23	10.48
Clear dark spread (PLN/MWh)	20.0	20.0	20.0	20.0	20.0	20.0
Forward baseload electricity price (PLN/MWh)	161.4	163.2	165.5	168.3	170.6	174.5
Green certificate price (PLN/MWh)	150	170	200	220	250	250

Source: SG Cross Asset Research/Equity

Furthermore, based on Polenergia's new guidance for wind farms ready to take part in the auctioning system, we assume 279MW of capacity will take part in the first auction in 2016e, 338MW in 2017e and 176MW in 2018e. Moreover, in line with CEO Prokopowicz's remarks, wind farms to be constructed in the new RES regime (auctions) will have 80% of debt in the group's financing structure (as opposed to 70% now) and a lower cost of debt (SGe -1pp) vs current funding. We have adjusted our auction system model to reflect this (details of the calculations are available upon request).

We have upped our EBITDA assumptions slightly for FY15e-20e on the back of better load factors and the capacity to be auctioned (the 53MW Szymankowo wind farm is not for sale anymore). This is partially offset by lower power prices and green certificate price assumptions. We have cut our FY15e net income forecast due to the high effective tax rate in H1 (>27%) and worse-than-previously-expected financial result. Our estimates for FY16e are mostly affected by lower projections for power and green certificate prices.

Polenergia: new and old estimates

Revenues	2015e	2016e	2017e	2018e	2019e	2020e
New	2,723	2,873	2,932	3,150	3,389	3,338
Old	2,665	2,804	2,855	3,098	3,317	3,289
%	2.2%	2.4%	2.7%	1.7%	2.2%	1.5%
EBITDA (reported)	**2015e**	**2016e**	**2017e**	**2018e**	**2019e**	**2020e**
New	226	273	295	400	528	573
Old	200	281	280	411	523	564
%	13.1%	-2.8%	5.5%	-2.8%	1.0%	1.7%
Net income (reported)	**2015e**	**2016e**	**2017e**	**2018e**	**2019e**	**2020e**
New	76	78	116	129	145	123
Old	86	91	113	126	150	127
%	-12.0%	-14.2%	2.7%	2.5%	-3.0%	-3.5%

Source: SG Cross Asset Research/Equity

The aforementioned figures are as reported. We estimate that adjusted EBITDA could amount to PLN229m in FY15 (112% of the company's official guidance) with adjusted net income of PLN89m (122.5% of the company's official guidance).

Valuation

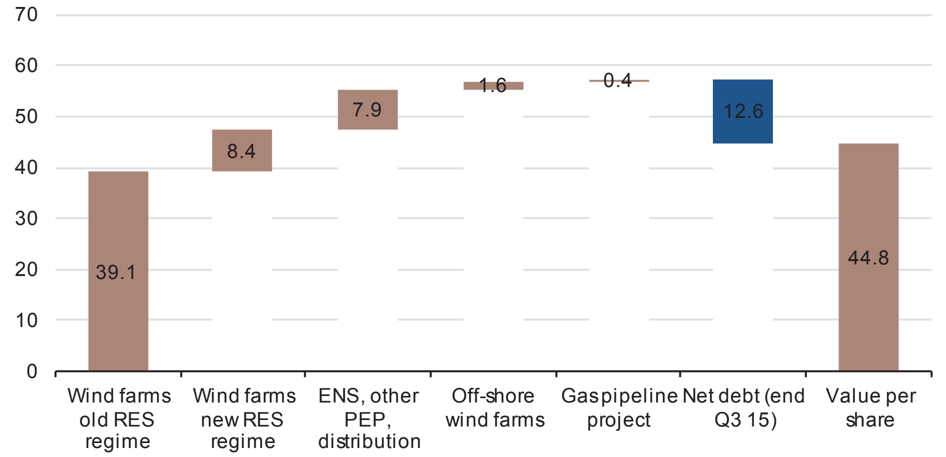
We apply a sum-of-the-parts methodology to value Polenergia (for details please refer to: Market is pricing in no regulatory change and the worst case (and unlikely) scenario). We value the wind farms until the year when their operations are assumed to end, i.e. 25 years after commissioning and 15 years of being subsidised. Other business segments (distribution, trade, biomass, management costs and others) are valued separately. The Hand project (gas pipeline) and the offshore plants we value at a 50% discount to book value (per share impact of PLN0.44 and PLN1.61, respectively). We will not take the Polnoc Power Plant into account in our valuation until a capacity market has been established in Poland.

Contrary to our previous valuations, we have changed our approach (in terms of WACC estimates) for wind farms to be developed under the auction system regime. We now apply an 80% debt share in the financing structure (as opposed to 70% for farms under the old RES regime) and a lower risk premium for the cost of debt which falls by 1pp to 2pp.

Consequently, we apply a WACC of 5.5% for wind farms to be constructed until the end of this year, after which the RES regime will change from being based on green certificates to auctions (and thus guaranteed prices). We apply a WACC of 4.2% (after tax) for wind farms commissioned in the auction system (higher debt share and lower cost of debt) and a WACC of 5.8% for the remaining business. We assume a cost of equity of 8% based on 1.1x beta, a 2.5% risk-free rate, and a 5% market risk premium.

As a result we derive a target price of PLN44.8 per share (vs PLN42.4). The 5.7% TP increase comes from the higher valuation of the wind farms under the auction regime (PLN8.4 per share vs PLN5), lower-than-previously-expected capex in FY15e (and thus net debt) as well as the roll forward of our model (discount factor) by three quarters.

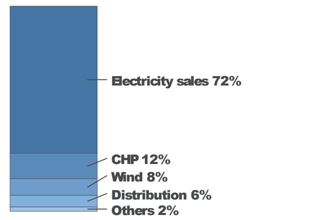
Polenergia's valuation (PLN)



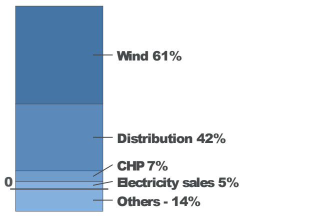
Source: SG Cross Asset Research/Equity

Polenergia

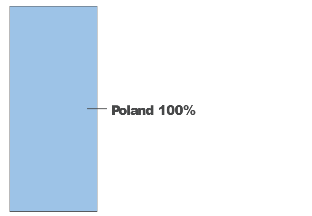
Sales/division 16



EBIT/division 16



Sales/region 16



Major shareholders (%)

Kulczyk Investments	50.2
CEE Equity	16.0
Aviva OFE	6.7

Valuation (PLNm)	12/10	12/11	12/12	12/13	12/14	12/15e	12/16e	12/17e
Nb. of shares basic year end/outstanding	na	na	na	45.4	45.4	45.4	45.4	45.4
Share price (average)	34.9	27.0	26.3	28.0	27.5	26.4	26.4	26.4
Average market cap. (SG adjusted) (1)	0	0	0	1,270	1,250	1,198	1,198	1,198
Restated net debt (-)/cash (+) (2)	na	na	na	-167	-253	-837	-632	-1,458
Value of minorities (3)	na	na	na					
Value of financial investments (4)	na	na	na					
Other adjustment (5)	na	na	na					
EV = (1) - (2) + (3) - (4) + (5)	na	na	na	1,438	1,503	2,035	1,830	2,656
P/E (x)	na	na	na	33.1	25.2	15.8	15.3	10.3
Price/cash flow (x)	na	na	na	9.7	4.1	16.2	5.8	5.0
Price/free cash flow (x)	na	na	na	41.4	nm	nm	5.86	nm
Price/book value (x)	na	na	na	1.42	0.94	0.85	0.81	0.75
EV/revenues (x)	na	na	na	1.29	0.57	0.75	0.64	0.91
EV/EBITDA (x)	na	na	na	10.4	8.7	9.0	6.7	9.0
Dividend yield (%)	na	na	na	0.0	0.0	0.0	0.0	0.0
Per share data (PLN)								
SG EPS (adj.)	na	na	na	0.84	1.09	1.67	1.72	2.55
Cash flow	na	na	na	2.88	6.67	1.62	4.56	5.32
Book value	na	na	na	19.6	29.3	31.0	32.7	35.3
Dividend	na	na	na	0.00	0.00	0.00	0.00	0.00
Income statement (PLNm)								
Revenues	na	na	na	1,118	2,659	2,723	2,873	2,932
Gross income	na	na	na	138	173	226	273	295
EBITDA	na	na	na	138	173	226	273	295
Depreciation and amortisation	na	na	na	-72	-86	-88	-123	-123
EBIT	na	na	na	66	87	139	150	172
Impairment losses	0	0	0	0	0	0	0	0
Net interest income	na	na	na	-20	-30	-40	-54	-29
Exceptional & non-operating items	0	0	0	0	0	0	0	0
Taxation	na	na	na	-8	-8	-23	-18	-27
Minority interests	na	na	na	0	0	0	0	0
Reported net income	na	na	na	38	50	76	78	116
SG adjusted net income	na	na	na	38	50	76	78	116
Cash flow statement (PLNm)								
EBITDA	na	na	na	138	173	226	273	295
Change in working capital	na	na	na	32	136	-170	-4	-2
Other operating cash movements	0	0	0	-39	-7	17	-61	-52
Cash flow from operating activities	na	na	na	131	303	74	207	242
Net capital expenditure	na	na	na	-100	-481	-657	-3	-1,067
Free cash flow	na	na	na	31	-178	-584	204	-826
Cash flow from investing activities	na	na	na	0	0	0	0	0
Cash flow from financing activities	na	na	na	-46	644	480	-68	784
Net change in cash resulting from CF	na	na	na	-15	465	-104	136	-42
Balance sheet (PLNm)								
Total long-term assets	na	na	na	1,253	1,968	2,538	2,418	3,362
of which intangible	0	0	0	7	242	242	242	242
Working capital	0	0	0	-75	-212	-42	-37	-36
Employee benefit obligations	na	na	na	0	0	0	0	0
Shareholders' equity	na	na	na	892	1,333	1,409	1,487	1,603
Minority interests	na	na	na	1	1	1	1	1
Provisions	na	na	na	1	2	2	2	2
Net debt (-)/cash (+)	na	na	na	-167	-253	-837	-632	-1,458
Accounting ratios								
ROIC (%)	na	na	na	na	5.4	5.1	5.0	4.9
ROE (%)	na	na	na	na	4.5	5.5	5.4	7.5
Gross income/revenues (%)	na	na	na	12.3	6.5	8.3	9.5	10.1
EBITDA margin (%)	na	na	na	12.3	6.5	8.3	9.5	10.1
EBIT margin (%)	na	na	na	5.9	3.3	5.1	5.2	5.9
Revenue yoy growth (%)	na	na	na	na	nm	2.4	5.5	2.1
Rev. organic growth (%)	na	na	na	0.0	129.9	5.9	5.5	2.1
EBITDA yoy growth (%)	na	na	na	na	25.7	30.4	20.8	8.1
EBIT yoy growth (%)	na	na	na	na	32.1	58.8	8.2	14.8
EPS (adj.) yoy growth (%)	na	na	na	na	29.1	53.0	3.0	48.7
Dividend growth (%)	na	na	na	na	na	na	na	na
Cash conversion (%)	na	na	na	88.3	nm	nm	nm	nm
Net debt/equity (%)	na	na	na	19	19	59	43	91
FFO/net debt (%)	na	na	na	65.9	53.6	19.5	31.8	16.4
Dividend paid/FCF (%)	na	na	na	0.0	nm	nm	0.0	nm

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Source: SG Cross Asset Research/Equity

APPENDIX

COMPANIES MENTIONED
Energa (ENGP.WA, Buy)
Polenergia (PEPP.WA, Buy)
Polska Grupa Energetyczna (PGE.WA, Buy)
Tauron (TPE.WA, Hold)

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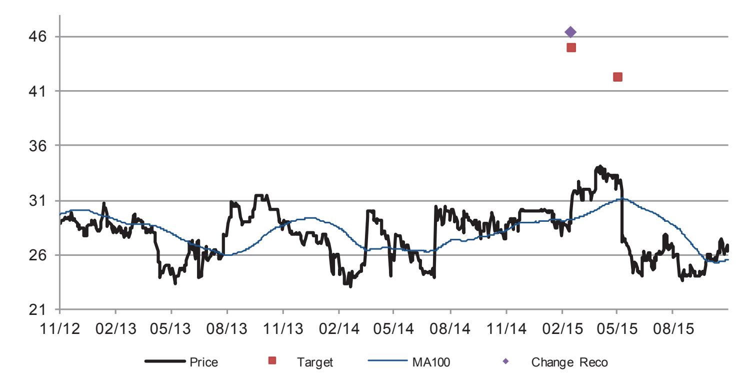
The following named research analyst(s) hereby certifies or certify that (i) the views expressed in the research report accurately reflect his or her or their personal views about any and all of the subject securities or issuers and (ii) no part of his or her or their compensation was, is, or will be related, directly or indirectly, to the specific recommendations or views expressed in this report: **Bartlomiej Kubicki**

The analyst(s) who author research are employed by SG and its affiliates in locations, including but not limited to, Paris, London, New York, Dallas, Hong Kong, Tokyo, Bangalore, Mumbai, Frankfurt, Madrid, Milan, Seoul, Warsaw and Moscow.

Historical Price: Polenergia (PEPP.WA)



Source: SG Cross Asset Research/Equity

2012/2013	Change	2014/2015	Change
		26/02/15	New Rating: Buy
		26/02/15	New Target: 45.1
		13/05/15	New Target: 42.4

SG EQUITY RESEARCH RATINGS on a 12 months period

BUY: absolute total shareholder return forecast of 15% or more over a 12 month period.

HOLD: absolute total shareholder return forecast between 0% and +15% over a 12 month period.

SELL: absolute total shareholder return forecast below 0% over a 12 month period.

Total shareholder return means forecast share price appreciation plus all forecast cash dividend income, including income from special dividends, paid during the 12 month period. Ratings are determined by the ranges described above at the time of the initiation of coverage or a change in rating (subject to limited management discretion). At other times, ratings may fall outside of these ranges because of market price movements and/or other short term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by research management.

Sector Weighting Definition on a 12 months period:

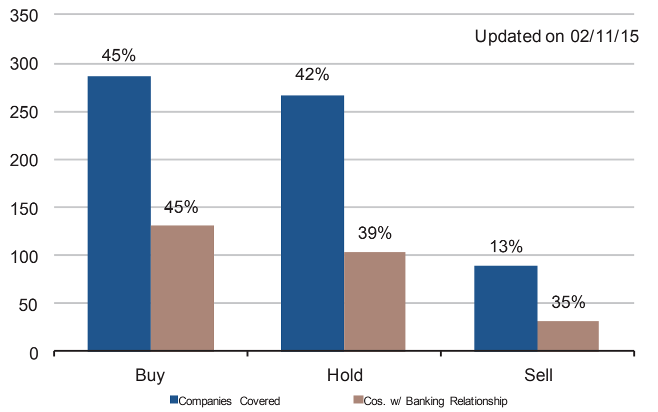
The sector weightings are assigned by the SG Equity Research Strategist and are distinct and separate from SG equity research analyst ratings. They are based on the relevant MSCI.

OVERWEIGHT: sector expected to outperform the relevant broad market benchmark over the next 12 months.

NEUTRAL: sector expected to perform in-line with the relevant broad market benchmark over the next 12 months.

UNDERWEIGHT: sector expected to underperform the relevant

Equity rating and dispersion relationship



Source: SG Cross Asset Research/Equity

broad market benchmark over the next 12 months.

The Preferred and Least preferred stocks are selected by the covering analyst based on the individual analyst's coverage universe and not by the SG Equity Research Strategist.

All pricing information included in this report is as of market close, unless otherwise stated.

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