COMPANY NOTE

15 October 2015

CEZ

An Unlike Buyer Of Vattenfall Assets

UTILITIES

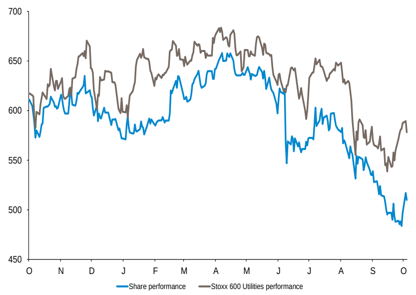
CZECH REPUBLIC

CURRENT PRICE 492 CZK

TARGET PRICE (6M) 555 CZK

ACCUMULATE

RATING UPGRADE



Source: Bloomberg

FY/e 31.12.	2014	2015E	2016E	2017E
Sales (CKZ th)	200 657	184 282	182 979	175 791
EBITDA (CZK th)	64 651	68 069	67 230	62 787
Net earnings (CZK th)	22 403	26 952	25 597	22 082
EPS (CZK)	55	50	48	41
Dividend (CZK)	40	40	38	33
P/E	9,0	9,8	10,3	12,0
EV/EBITDA	7,5	6,7	6,7	7,0
Free cash flow yield	5,2%	11,3%	9,3%	11,0%
Dividend yield	8,1%	8,1%	8,2%	7,7%

Bloomberg	CEZ CP
Reuters	CEZP.PR
www.cez.cz	
Market Cap	264 422.0M CZK
Shares outst.	538.0M
Vol. (SMAVG 15D)	0.538M
Free float	30 %
Next corporate event	
Results 3Q14:	11 November 2015

Performance	1M	3M	12M
Absolute	-6%	-16%	-16%
Rel. PX	-3%	-12%	-20%
Rel. SX6E	-10%	-7%	-19%
12-m Hi/Lo			CZK 683 / 483

Baseload electricity forward prices for 2016-18 fell to a multiple year record low of 28-30 EUR/MWh in Central Europe (CE). The decline is mostly attributable to another fall in the market price of thermal coal (from 65 to 50 USD/t YTD) as well as to a prevailing low gas prices. We are lowering our 6M target price of CEZ to 555 CZK from 625 CZK as we are reducing our marginal power price forecast by 5% in avg. during next 3 years. Nevertheless, regarding latest development of the share price, we upgrade CEZ to ACCUMULATE from HOLD.

- We are lowering our power price forecast for CE on the back of lower coal price assumption. We expect the company might hedge their planned production at 35 EUR/MWh in 2016, 32 EUR in 2017 and 34 EUR in 2017. We reduce our 2015 EBITDA estimate in-line with company guidance reduction to 68bn CZK. We cut our 2016-2018 earnings estimates as a result of lower power price assumption of about 5% in average.
- The company confirms its interest in Vattenfall assets in Germany. We estimate EV of assets close to 2bn EUR. Due to limited debt headroom, CEZ and the government most likely have to decide between such a large-scale acquisition and high dividend pay-out ratio. We expect investors would favour high cash dividend in coming years over the acquisition that leads to larger exposure both to structurally challenged CE power prices and regulatory risks related to willingness of emission lowering in Germany.
- We expect investors view the acquisition as rather negative, nevertheless, we do not expect CEZ will buy these assets at the end of the day due to a government S-T dividend preference and/or rather low bid price. Therefore, CEZ has a potential to pay 40 CZK in 2016, 38 CZK in 2017 and 33 CZK in 2018 as a dividend according to us. Repricing of the “acquisition risk” and attractive dividend yield are the main triggers for our ACCUMULATE rating.

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INVESTMENT CASE

CEZ is an unlike buyer of Vattenfall assets in Germany in our view

Vattenfall announced in October 2014 that it was seeking to sell the German lignite business to switch to renewable energy and reduce its CO2 emissions. Consequently, Vattenfall AB invited potential bidders to state their interest this September. Vattenfall offer all its lignite generation and mining assets in Germany will be included in the sale. The plants have a capacity of more than 8,000 megawatts combined. Bidders can also make offers for 10 hydro plants with about 3,000 megawatts capacity.

Vattenfall assets (enterprise) value estimates in media vary from 2bn-5bn EUR. Due to a limited debt headroom, CEZ (and the government) most likely have to decide between such a large-scale acquisition and high dividend pay-out ratio (upper-bound of 80% is necessary to maintain dividend above 30 CZK during next 3 years according to our estimates).

Unfortunately, information about Vattenfall asset in Germany has not yet been publicly disclosed in a desired detail, so we are not able to value these assets properly. Nevertheless, based on the already known information (capacity, production, impairments, spreads), we would rather expect total price (selling price + undertook liabilities) at the lower est. end of 2bn EUR.

CEZ sent AUG-13 a Statement of Interest to acquire Vattenfall's German lignite and hydro activities. Nevertheless, we do not expect CEZ is to succeed in the tender (or to decide not to participate in the tender). Simply, we assume Czech government (holding 70% shares) prefers high cash dividends in coming years and might force CEZ to push down the bidding price. Therefore, EPH-PPF will more likely succeed in the tender in our view with their acquisition appetite in energy business.

Additionally, investment into Vattenfall lignite asset is bearing a significant regulatory risk with respect to German (so far not much successful) effort in meeting its emission reduction goals. Despite a state-backed expansion of clean energy, Germany remains heavily reliant on lignite, the most polluting fossil fuel. Lignite-fired power plants generated 25% of the country's electricity output last year, nearly the same share as renewables and Germany might weight (again) raising emissions charges for older coal-fired power stations which should also prevent CEZ/government to from bidding the high price.

Repricing of the "acquisition risk" and DY main triggers for our ACCUMULATE

We expect investors view the potential large-scale acquisition as rather negative (including us) which has been pushing the share price further down (along with coal/power prices) during recent weeks. Therefore, a repricing of the "acquisition risk" and above sector average dividend yield (7.5% Current FY vs. 5.5% Pan-European Sector Average and 5.4% in case of Polish utilities) are the main triggers for our ACCUMULATE rating.

Moreover, we continuously prefer CEZ to its Polish peers during last months as in comparison within CE3 utilities CEZ has both notably higher dividend yield prospects and also significantly higher dividend yield spread vs. (10Y) sovereign yield when compare to Polish peers (7% vs 3%).

Although we estimate that the earnings trough has not been reached yet and expects EPS to rebound only post 2018, regarding healthy balance sheet and hedging strategy of CEZ, shares should be well supported on the downside from strong FCF and above average dividend yield at current levels close to 500 CZK per share in our view.

VALUATION

6M Target Px for CEZ at 555 CZK by using DCF; Upgraded to ACCUMULATE

We upgrade our rating for CEZ to ACCUMULATE (from HOLD) and decrease our 6-month target price to 555 CZK per share (from 625 CZK).

We value CEZ by using a discounted free cash flow (DCF) model. We adjust the free cash flow generation by nuclear decommissioning costs. To arrive at CEZ's equity fair value, we then subtract CEZ's net interest bearing debt and decommissioning expected reserves at the end of 4Q14. For the terminal value we use no long term growth (0.0%) and (perpetuity) WACC of 5.9%. Within our valuation methodology we do not apply cost of equity to derive our target price but use the current fair value as our target.

(CZK mn)	2015e	2016e	2017e	2018e	2019e	Norm.
Sales growth	-8,2%	-0,7%	-3,9%	-0,1%	7,1%	0.0%
EBIT	39 664	37 944	33 193	32 329	32 707	34 919
EBIT margin	21,5%	20,7%	18,9%	18,4%	17,4%	17,1%
Tax rate	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%
Taxes on EBIT	-7 933	-7 589	-6 639	-6 466	-6 541	-6 984
NOPLAT	**31 731**	**30 355**	**26 554**	**25 863**	**26 165**	**27 935**
- Capital expenditures	-30 500	-35 000	-27 000	-25 000	-21 435	-28 794
+ Depreciation	28 404	29 285	29 594	29 454	29 213	28 794
+/- Change in working cap.	164	13	72	2	(125)	-95
Free cash flow to the firm	**29 799**	**24 654**	**29 220**	**30 320**	**33 818**	**27 840**
Terminal value (0.0% TV growth rate)						470 276
Discounted FCF	13 445	3 092	8 794	12 654	16 654	68 287
Enterprise value	**518 844**					
Net debt (inc. provisions)	-220 419					
Equity value	**298 425**					
Number of shares (mn)	538,00					
Target price	**555**					

WACC = 4.2 % based on 2.0% RFR and 5.0% ERP

We derived our (annuity) WACC assumption to 4.2%, based on a blended 2.0% risk free rate (4Y average of Czech 10-year government bond yield) and an equity risk premium of 5.0 %. We use a levered beta of 0.80 derived from unlevered sector beta for European utilities of 0.50 and adjusted for a target capital structure of CEZ, which is close to 60% equity and 40% of debt in our view or officially stated 2.3x normalized EBITDA. Relatively low RFR (vs. L-T historical averages) partly offsets the negative valuation impact of the decline in our generation earnings estimates.

PEER GROUP COMPARISON

CEZ with premium on EV/EBITDA, discount on DY to its peers

CEZ is traded with notable (12-24%) premium to its peers, comparing EV/EBITDA (16-17) ratios. However, there are several reasons justifying the premium in our view.

Firstly, CEZ is one of the most profitable European utilities with EBITDA margin of 36% (number 2 in 2014) thanks to the combination of relatively low (fixed) costs production in its nuclear (48%) and brown coal fleet (46%) and fully liberalized Czech power prices driven by the same fundamentals as the German ones. Please note, other high-margin producers as Fortum (EBITDA margin 39%) or Verbund (29%) historically also tends to trade at premium to peers. Additionally, current leverage of CEZ's Net financial debt/EBITDA of 2.0x and Net economical debt (net financial debt+provisions)/EBITDA of 2.5x is relatively low comparted to (Pan) European utilities standards of 3.4x. Also, regulated utilities (and hybrids) trading at premiums to unregulated and in case of CEZ, the distribution (regulated business) contributes to about 1/3 of total EBITDA.

Peer Group Comparison also supports our idea of CEZ's relative attractiveness regarding the dividend yield. Nevertheless, we must point out that we assume 80% pay-out ratio in coming years (i.e. upper bound of current 60-80% pay-out ratio). If there is an acquisition of Vattenfall assets (unlikely in our view), we expect pay-out ratio close to its lower bound (60%) during coming years. In such a case (60% pay-out ratio) we assume dividend in 2016 to be 30 CZK with potential decline to 25 CZK till 2018 depending on an acquisition price and full-consolidation of Vattenfall's assets timing. As a result, CEZ would (at least temporarily) loose most of its dividend yield discount to its peers.

			Mcap	EV/EBITDA			P/E			DVD yield		
Company	**BBG Ticker**	**Price**	**(EUR bn)**	**2015e**	**2016e**	**2017e**	**2015e**	**2016e**	**2017e**	**2015e**	**2016e**	**2017e**
PGE SA	PGE PW	14,3	6,32	3,5	3,9	4,0	8,5	9,1	10,3	5,5%	5,0%	4,5%
TAURON SA	TPE PW	3,2	1,31	3,6	3,8	3,8	23,1	7,2	8,3	4,5%	3,4%	2,9%
ENEA SA	ENA PW	13,5	1,41	3,9	4,2	3,8	7,3	9,0	8,7	4,1%	3,9%	4,2%
ENERGA SA	ENG PW	17,6	1,73	5,0	5,4	5,2	8,7	10,8	9,8	7,4%	6,9%	6,8%
VERBUND AG	VER AV	12,6	4,38	9,5	10,4	10,0	19,2	21,3	19,0	2,6%	2,4%	2,6%
EVN AG	EVN AV	10,0	1,80	6,2	6,4	6,2	11,6	11,9	11,3	4,2%	4,2%	4,5%
E.ON SE	EOAN GY	9,4	18,84	3,6	3,7	3,6	11,3	11,8	11,2	5,3%	5,4%	5,8%
RWE AG	RWE GY	12,6	7,66	1,2	1,4	1,3	7,0	10,6	9,6	5,6%	4,9%	5,0%
FORTUM OYJ	FUM1V FH	14,1	12,53	8,6	9,3	9,1	16,1	17,6	16,9	8,9%	7,0%	6,9%
EDF	EDF FP	17,6	32,64	3,4	3,4	3,3	8,7	9,2	9,7	7,1%	7,0%	6,9%
ENGIE	ENGI FP	15,0	36,60	5,8	5,5	5,4	12,5	11,2	11,1	6,8%	6,7%	6,9%
ENEL SPA	ENEL IM	4,0	37,95	6,7	6,7	6,5	12,6	12,5	11,6	4,0%	4,5%	5,1%
ENDESA SA	ELE SM	19,1	20,22	7,7	8,0	7,8	17,0	17,1	16,8	5,7%	6,0%	6,2%
EDP SA	EDP PL	3,3	12,14	9,1	9,0	8,7	13,6	12,7	11,9	5,7%	5,7%	5,6%
Median				5,4	5,5	5,3	12,1	11,5	11,2	5,5%	5,2%	5,4%
CEZ	**CEZ CP**	**491,5**	**9,76**	**6,0**	**6,1**	**6,6**	**9,8**	**10,3**	**12,0**	**8,2%**	**7,7%**	**6,7%**
prem/disc				*12%*	*12%*	*24%*	*-19%*	*-10%*	*7%*	*-32%*	*-32%*	*-20%*

Source: Bloomberg, Patria Research

RISKS (TO OUR ACCUMULATE RATING AND TARGET)

- Lower energy commodity prices (coal, gas, carbon permits) than expected by us;
- FX volatility, especially weaker USD vs. EUR/CZK;
- Value destructive or a large scale investments with negative S-T impact on dividend payout ratio;
- High-cost investment acquisitions/investments leading to increase in leverage;
- Introduction of transmission fee (circa 20% of CEZ production is exported);
- More restrictive regulation;

FINANCIAL DATA

Income statement (mCZK)	2013	2014	2015E	2016E	2017E	2018E
Sales	217 273	200 657	184 282	182 979	175 791	175 557
Cost of sales	(93 043)	(90 650)	(79 241)	(78 681)	(75 590)	(75 490)
Gross profit	124 230	110 007	105 041	104 298	100 201	100 068
OPEX	(50 531)	(45 356)	(32 696)	(31 676)	(30 900)	(30 803)
EBITDA	82 121	64 651	68 069	67 230	62 787	61 783
EBIT	45 755	36 946	39 664	37 944	33 193	32 329
Pre-tax profit	44 440	28 656	33 727	32 032	27 638	26 855
Net income after minorities	35 885	22 403	26 952	25 597	22 082	21 455

Cash flow statement (mCZK)	2013	2014	2015E	2016E	2017E	2018E
EBIT	45 755	36 946	39 664	37 944	33 193	32 329
TAX	(9 478)	(7 389)	(7 933)	(7 589)	(6 639)	(6 466)
NOPAT	36 277	29 557	31 731	30 355	26 554	25 863
Depreciation	27 944	27 705	28 404	29 285	29 594	29 454
Capex	(52 000)	(43 700)	(30 500)	(35 000)	(27 000)	(25 000)
WC change	(4 324)	166	164	13	72	2
FCFF	7 897	13 728	29 799	24 654	29 220	30 320

Performance criteria (CZK)	2013	2014	2015E	2016E	2017E	2018E
Sales growth	1%	-8%	-8%	-1%	-4%	0%
EBITDA growth	-4%	-21%	5%	-1%	-7%	-2%
EBIT growth	-21%	-19%	7%	-4%	-13%	-3%
NI growth	-12%	-36%	20%	-5%	-14%	-3%
Gross margin	57%	57%	57%	57%	57%	57%
EBITDA margin	38%	32%	37%	37%	36%	35%

Per share data (CZK)	2013	2014	2015E	2016E	2017E	2018E
EPS	67	55	50	48	41	40
Payout ratio	52%	60%	73%	80%	80%	80%
DPS (60-80% of EPS)	40	40	40	38	33	32
FCFF per share	15	26	55	46	54	56

Valuation data	2013	2014	2015E	2016E	2017E	2018E
P/E	7,3	8,8	9,7	10,2	11,8	12,2
EV/EBITDA	6,5	7,4	6,7	6,6	6,9	6,9
FCF yield	3,0%	5,3%	11,4%	9,4%	11,2%	11,6%
Dividend yield	8,2%	8,3%	8,3%	8,3%	7,8%	6,8%

OPERATING DATA

Power Production	2013	2014	2015E	2016E	2017E	2018E
Hedged price (EUR/MWh)	51,5	44,0	40,0	35,0	32,0	34,0

15 October 2015

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Stock rating	Definition
BUY	Expected total return (including dividends) of 10% or more over a 6-month period
ACCUMULATE	Expected total return (including dividends) between 0% and 15% over a 6-month period
HOLD	Expected total return (including dividends) between -5% and 5% over a 6-month period
REDUCE	Expected total return (including dividends) between –15% and 0% over a 6-month period
SELL	Expected total return (including dividends) of -10% or worse over a 6-month period

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Stock rating	% of covered universe	% of covered universe with investment banking relationship during last year
BUY	13%	0.00%
ACCUMULATE	13%	0.00%
HOLD	61%	0.00%
REDUCE	0%	0.00%
SELL	13%	0.00%

Below is an overview of the stock ratings and target price history for the stock described in this report.

Date	Rating	Target price
12-AUG-14	Hold	625 CZK
10-APR-14	Hold	600 CZK
11-FEB-14	Buy	600 CZK
31-OCT-13	Accumulate	600 CZK
11-SEP-13	Hold	500 CZK
13-JUN-13	Reduce	475 CZK
16-APR-13	Reduce	550 CZK

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15 October 2015

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- (7) notified the issuer with the analysis prior to its dissemination, or whether a given analysis was amended as a result of such notification;

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Company	Conflicts of Interest
CEZ	2

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