CEZ DISTRIBUTION (3CZ) AND CEZ ELECTRO (1CZ)
INDUSTRY: UTILITIES

AFTER THE SHORT CIRCUIT

BUY

ONE YEAR PRICE TARGET: BGN 206.00
CURRENT PRICE: BGN 141.40

LARGEST UTILITY COMPANIES ON THE BULGARIAN STOCK EXCHANGE. CEZ DISTRIBUTION OPERATES AND MANAGES THE ELECTRICITY DISTRIBUTION NETWORK IN WESTERN BULGARIA. CEZ ELECTRO BULGARIA SUPPLIES THE ELECTRICITY IN THE SAME REGION AND MANAGES THE GROUP'S MARKETING AND SALES STRATEGY. THE ONGOING REGULATORY REFORM IN THE SECTOR IS THE NEEDED FACTOR FOR IMPROVEMENT OF FINANCIAL RESULTS AND RETURN TO NORMAL OPERATIONS.

FIRST STEP OF THE NEEDED REFORMS IN THE SECTOR
The energy market in Bulgaria needs substantial reform to cover the large deficits of the Public Provider and state-owned companies. CEZ Distribution and CEZ Electro have been negatively affected from the low retail electricity prices. Nevertheless, the government started renegotiating the high wholesale prices with private-owned power companies and the same time increased retail electricity prices. Thus, the sector slowly returns to a normal level of investments and profits. Although the reform should take years, positive effects are already in place.

EXPOSURE INTO A DEFENSIVE SECTOR
Investors presume that electricity distributors are defensive stocks. However, regulatory pressure has made CEZ Distribution and CEZ Electro's stock prices very volatile during the last two years. The major reasons were politically motivated license revoke procedures which were later dismissed. Thus, the stocks managed to recover and the regulator started to normalize the market conditions in the segment. The dividend of CEZ Distribution in 2014 was due to the pressure from minority shareholders, rather than the beginning of regular payment. The afore-mentioned improvement of financial results might become prerequisite for stable dividend policy and high yields.

THE STOCK WILL ATTRACT MORE INDIVIDUAL INVESTORS
Shareholders of CEZ Distribution are mainly institutional investors. The expected improvement of financial results should attract the attention of Bulgarian speculators and will provide a boost to the stock price. Institutional investors are very active. They proposed the stock split in 2014 that had improved liquidity and the solid dividend of BGN 25 per share. Active minority shareholders is a guarantee for transparency.

VALUATION: We value only CEZ Distribution and our one year price target is BGN 206 per share which provides a substantial premium of 44% to the current market price. The valuation is based on a DCF model that assumes a moderate recovery of revenue and the return to operating margin in line with the average for the past four years. The stock is cheap when considering the book value.

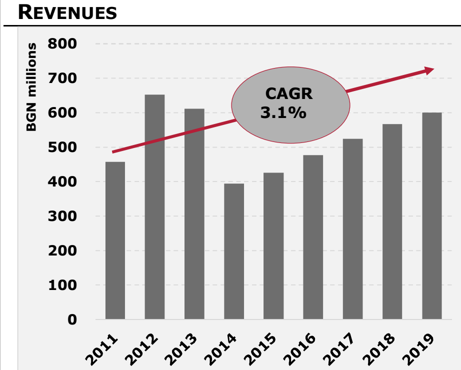
RISKS: Slower economic growth; a contraction of industrial production or household income will lead to a decrease of consumption; Additional regulatory measures to cover the large deficit in the state-owned companies in the sector might result in a decrease of approved costs of electricity distributors, thus further limiting the investments of CEZ Distribution and suppressing its financial performance.

EXCHANGE RATES
EUR/BGN(FIXED): 1.95583
USD/BGN: 1.7110

MARKET DATA FOR CEZ DISTRIBUTION

Shares Outstanding:	**1.3m**
Share Capital:	**BGN 1.3m**
Free-float:	**14.97%**
Treasury Shares	**0%**
Market Cap.:	**BGN 280.0m**
Avg. Daily Vol.:	**BGN 10,000**
52 Weeks Range:	**BGN 132-184**
BSE Ticker	**3CZ**
Bloomberg	**3CZ BU**

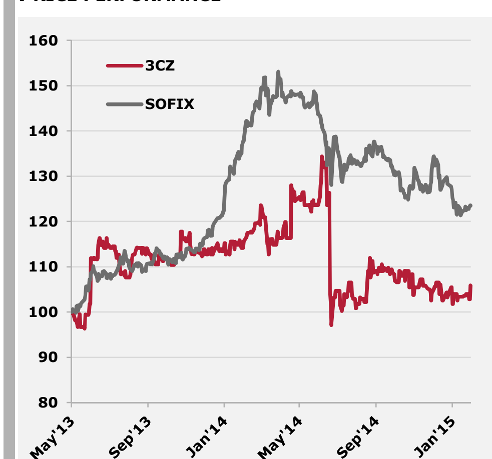
REVENUES



Source: Company data, ELANA Trading estimates

CEZ Distribution in kBGN, excl. ratios	2014	2015F	2016F	2017F
REVENUES	394,385	425,936	477,048	524,753
EBITDA	69,272	75,497	87,181	97,027
EBIT	6,866	12,778	21,467	26,238
NET PROFIT	4,389	11,285	19,020	22,912
EQUITY	576,713	587,998	607,017	629,929
ROE	0.74%	1.94%	3.18%	3.70%
ROA	0.55%	1.46%	2.34%	2.66%
EBITDA MARGIN	17.56%	17.73%	18.28%	18.49%
NET PROFIT MARGIN	1.11%	2.65%	3.99%	4.37%
EPS	2.28	5.85	9.86	11.88
DEBT/EQUITY	0.06	0.07	0.08	0.09
P/E	62.11	24.16	14.33	11.90
P/B	0.47	0.46	0.45	0.43
EV/EBITDA	4.09	3.54	3.06	2.99

PRICE PERFORMANCE



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EXECUTIVE SUMMARY

WE INITIATE COVERAGE WITH A BUY RATING OF CEZ DISTRIBUTION. OUR ONE YEAR PRICE TARGET IS BGN 206 OR 44% UPSIDE POTENTIAL TO THE CURRENT MARKET PRICE.

THE COMPANY

CEZ Distribution and CEZ Electro are managing the electricity distribution network and are supplying electricity on the territory of West Bulgaria. They cover an area of 40 000 sq. km that has 2,930,000 residents (40% of Bulgaria's population). The majority shareholder in both companies is CEZ Group, Czech Republic, and 33% are owned by other minority shareholders - legal entities and individuals. Currently, CEZ Distribution and CEZ Electro are the biggest utility companies in the country. At the beginning of 2007 the activities related to electricity distribution and the operation of the distribution networks and the activities related with electricity supply were legally and organizationally unbundled. The electricity supply was taken over by a newly-established company - CEZ Electro, whereas the transmission and distribution of electric power remained in CEZ Distribution.

Revenue breakdown: CEZ Distribution and CEZ Electro have very different scopes of activities. Revenues of CEZ Electro represent the turnover from the deliveries of electricity to consumers, while CEZ Distribution receives fees to maintain the network. The fixed assets of CEZ Distribution are substantial as network and other equipment are property of the company. CEZ Electro is obliged to buy the electricity of all renewables in its area of operations and the rest from the Public Provider (i.e. the National Electricity Company) that is the distributor of high-voltage electricity from generators. At the same time CEZ Electro pays to CEZ Distribution to cover the distribution costs that also are determined by the regulator.

Regulations: CEZ Distribution and CEZ Electro are regulated by the State Energy and Water Regulatory Commission (SEWRC) in accordance with the European and local legislation. As a natural monopoly, the distribution of electricity is under strict regulation for all the aspects of its operations. SEWRC determines electricity prices and all fees that CEZ Distribution receives as revenues for the distribution of electricity. The regulation of prices and fees are not allowing cross-subsidies between them. Their financial results depend only on regulations on costs and the electricity prices. The forecasting of financial results is difficult as any change in price regulation have the potential to distort profits for the period.

Reform in the sector: The electricity market in Bulgaria needs substantial reform to withstand its challenges. The deliveries to households and small businesses, called regulated market segment, must gradually equalize with the free market, thus leading to the elimination of regulated quotas for suppliers. It also requires a detailed step-by-step roadmap for household price increases. The renegotiation of the long-term power purchase agreements at fixed/preferential prices (TPPs and RES) is a must. RES support schemes have to be reviewed and replaced by a more cost-efficient mechanism. This process started last year with an increase of electricity prices, although they remain below the average costs and continues to increase the deficit in the system. At the same time the pressure rises on producers with long-term contracts to lower prices. Those measures already improved the conditions for both companies and will gradually increase their profits. Nevertheless, return on equity will remain below the level defined by the law. We expect that CEZ companies to operate on profits that will gradually increase.

THE COUNTRY AND THE MARKET

Bulgaria is under a Currency board and the Lev is pegged to the Euro at fixed rate of 1.95583. We expect a modest economic growth in 2015, as it will be negatively affected by the global slowdown and the stall of growth in EU.

The main areas of operations of the two CEZ companies are related to the economic activities in the country, represented by the industrial production, the business climate and the personal consumption. Their performance depends on the regulation in the sector, as the demand of electricity is not elastic. The country operated in line with a model, under which a part of the transactions for sale of electricity were concluded at regulated prices, approved by the regulator, and the rest were traded on the liberalized market at freely negotiated prices between the participants in the electricity market, under the Energy Act. End suppliers supply and sell electricity to "protected customers" - households and business consumers connected to the distribution network at low voltage in the licensed territory, when those customers have no supplies from another supplier. In accordance with Directive 2009/72/EC and the Third energy package, the law permits the negotiations on electricity market for SME.

THE VALUATION

We initiate coverage of CEZ Distribution with a BUY recommendation. Our valuation model suggests a very comfortable upside potential (44%) from the current market prices. Moreover, it is based on conservative expectations for the recovery of revenues. The profit margins in the model correspond to the averages from the past few years that are the toughest years in terms of regulations and market environment. We consider the latest report as a sign for turnaround in the positive direction. We give preferences to the investments in CEZ Distribution as the company have more assets and is the operator of the grid. Both stocks trade at low P/B – 0.46 for CEZ Distribution and 0.37 for CEZ Electro.

THE MAIN RISKS

The risks are related to the economic activity in Bulgaria and the deficit in the electricity system of the country. A contraction of industrial production or household income will lead to a decrease of consumption. However, the main risk lies in the regulation of the system and especially the possible steps that should cover the large deficit of the Public Provider, concerning its payments to private-owned generation companies, and the state-owned electricity generators. The regulator might again decrease the payments to distribution companies.

COMPANY OVERVIEW

The largest electricity distribution companies in Bulgaria

The electricity distribution and supply in Bulgaria is divided in three regions. Each of them is serviced by two companies – a distributor and a supplier. CEZ Group is the majority owner of the largest electricity distribution companies in the countrym, run under the umbrella company of CEZ Bulgaria. The main assets of the Group constitutes of the following:

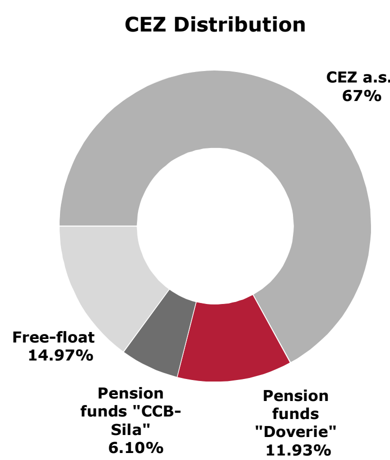
- The public listed CEZ Distribution Bulgaria (3CZ) has a license for distribution of electricity. The scope of activities includes operation and management of the electricity distribution network, consisting of MV, LV and HV electricity power lines and electricity systems, which is used for transmission and distribution of electric power in order to supply electricity to supplier companies. The company also performs the construction of new electricity distribution and metering systems and maintenance of the operated facilities and equipment;
- The public listed CEZ Electro Bulgaria (1CZ) that has a license for public supply of electricity and a license for electricity trade. It performs the following activities: electricity supply, product and service development, marketing and sales strategy, LV and MV customer service on general and individual basis.
- CEZ Trade Bulgaria that has a license for electricity trade. It is 100% owned by CEZ. It operates in electricity wholesale trading (import, export, transit, participation in cross-border capacity auction) and supply of electricity to eligible customers (industrial and commercial end users);
- TPP Varna that has a license for electricity generation. It is the second largest thermoelectric power plant in Bulgaria and on the Balkan Peninsula. The TPP was temporarily excluded from the national power system at the beginning of 2015 because it did not meet the European ecological standards.

The regulations prevent the subsidizing between a distributor and a supplier. The financial results of the companies might vary according to the current electricity prices and other regulated costs. We consider shares of CEZ Distribution as more appropriate for exposure in the sector due to its larger size of assets and bigger market capitalization. On the other hand, CEZ Electro is considered as an addition to the investments in CEZ Distribution. Its return on equity should be more stable, although the reform and the changes in regulations might again increase the profit of CEZ Electro to unreasonably higher levels.

SHAREHOLDERS' STRUCTURE

The majority shareholder in both CEZ Distribution and CEZ Electro is the well-known Czech utility company CEZ Group. It holds 67% of their shares as it acquired the shares through its subsidiary CEZ Bulgaria during the privatization of electricity distribution companies in 2005. The other stocks were sold through the stock exchange in 2012. Despite expectations, CEZ did not participate as a buyer in the sale of the minority stakes.

Main buyers of CEZ Distribution's shares were pension companies Doverie and CCB-Sila. Their shares are owned by the funds in each pension company. The free-float is 15% but the participation of individual investors is negligible.



POTENTIAL CATALYSTS

Changes in regulated prices: The Bulgarian energy system faces enormous deficits due to the structural overcapacity, a relatively small-sized internal market and long-term contracts with power producers at higher than the price for households. The regulator acknowledges the problem and already took measures that included an increase of electricity prices and a sizable decrease of preferential prices from renewable energy sources (RES). Although its policy change aims at decreasing the deficits in the state-owned companies, it also had positive impact on the financial performance of the CEZ companies. Moreover, we expect additional measures that will cover the discrepancies in the system, including electricity price increase for consumers and renegotiations of long-term contracts with power companies.

Increase of investments: SEWRC recognizes the need for investments in the distribution of electricity, which leads to the decrease of electricity losses and lower costs. The policy measures in decrease of prices for consumers forced CEZ Distribution to cut investments in 2014. The return to the previous level should continue to improve the transmission costs and will have positive impact on the financial results of the company.

Recovery of industry and consumption: Another short-term driver for the performance of CEZ companies is the economic growth in the country. The industrial production stalled during the past few years, whereas personal income grew moderately. The acceleration of GDP growth should improve demand of electricity and might provide ground for gradual increase of prices, thus leading to lower deficits in the system.

SECTOR OVERVIEW

BULGARIAN ELECTRICITY MARKET

Export supports the electricity generation

Generation: The electricity generation registered two consecutive years of decline prior to 2014. One of the reasons was the reduced domestic consumption. The second was the lower export due to the significant increase as of 01 July 2012 of the so-called "surcharges" ("green energy" surcharge, "high efficient cogeneration" surcharge and "stranded costs" surcharge) over the electricity transmission network price. Data for the first eleven months of 2014 pointed to a 7.4% increase in electricity generation. The reduced prices for transmission and access to the transmission network resulted to increase in electricity exports, especially concerning the electricity generators working with local raw materials and NPP Kozloduy. By tradition, Bulgaria is a net electricity exporter to the countries in the Southeast European region. During the first eleven months of 2014 the share of net country exports was 8.34 TWh, which represents 21.7 % of the net electricity output.

Slow liberalization of the free market

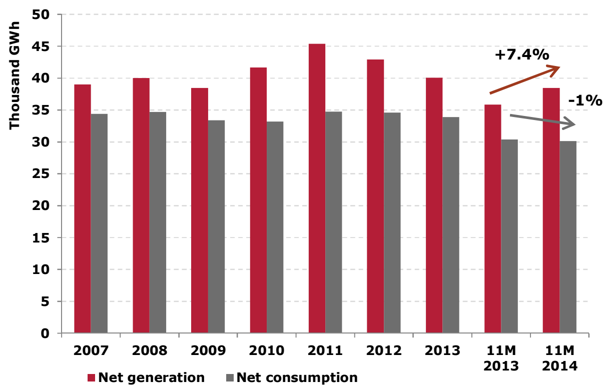
Wholesale market: The electricity market in the Republic of Bulgaria has been fully liberalized since 1 July 2007. It is organized and administered by the Electricity System Operator (ESO), which is a subsidiary of the National Electric Company (NEK, the Public Provider), fully owned by the government through Bulgarian Energy Holding (BEH).

The open electricity market is carried out on the basis of bilateral contracts between the trading participants: producers, traders and consumers of electricity, including the bigger part of the business consumers, connected to high (HV) voltage network and a part of the medium voltage (MV) consumers. Electricity exports are free and done by energy traders and NEK. The only problem the export companies face is ESO which frequently restricts exports to protect the local market.

The balancing market is the second part of the open market and has the purpose to cover all deficits in the system. It is still fully governed by ESO and most of the balancing energy comes from NEK. The balancing market was given the green light on June 1, 2014. The day-ahead or hour-ahead trading is very restricted due to the absence of an energy exchange market and the overall underdevelopment of the energy market.

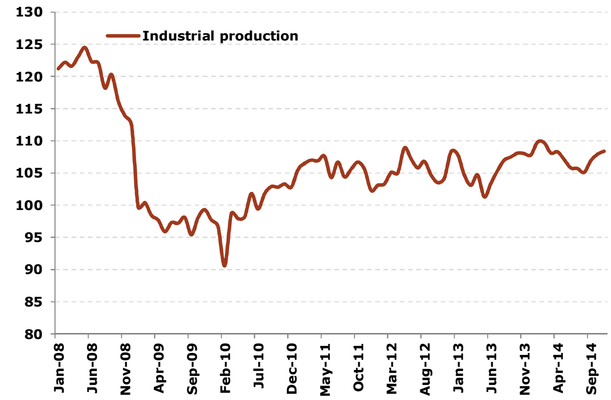
However, there are two other more important factors behind the slow liberalization. The first factor is the long-term power purchase agreements (PPAs), both from the renewable and conventional power plants which cover approximately 60% of the energy produced. Second, NEK is the only supplier for the regulated market (representing 58% of the total electricity market). The company is heavily indebted and a contracting party to all PPAs. The extreme concentration of compulsory purchased energy at various long-term contracts– on one hand, the TPP, including AES 3C Maritsa East 1 and Contour Global Maritsa East 3 and on the other, the renewable energy sources (RES) makes it impossible to realize this energy on the free market.

Exhibit 1: The increased export leads to net energy generation, while consumption stagnates



Source: National Statistical Institute

Exhibit 2: The industry is not growing enough to support electricity demand



Source: National Statistical Institute

Retail prices are subsidized by large consumers

Retail market: The electricity retail market segment is the supply to low voltage (LV) customers – small businesses and households. The sale of electricity is concluded at regulated prices, approved by the SEWRC. The "protected customers" are households and business consumers.

The main difference between the regulated and the free market is the way retail prices are formed. Regulated prices are fixed every year by the SEWRC. They are based on the so-called "expense plus" method. Therefore, it is not a "price", but rather a "charge", because the producers do not compete to sell their electricity. The current electricity price for households is below its production value and the difference is subsidized by the business consumers.

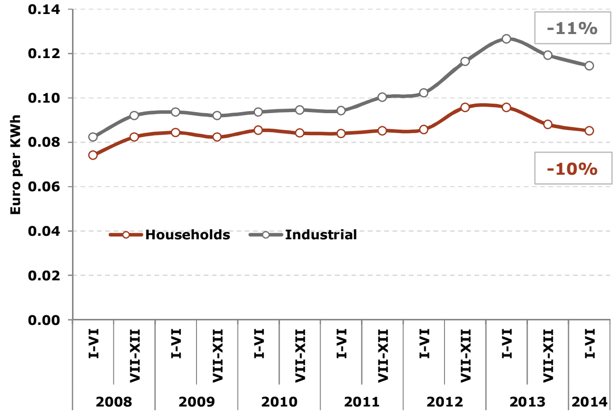
Price regulations hurt distributors and suppliers

Price regulations: A certain share of the electricity output quantities generated by different producers was purchased by NEK and supplied to protected consumers at regulated prices. The quantities of electricity purchased with the framework of the "quota" are set by the regulator.

The regulated price for protected consumers in the country is formed as a mix price of the electricity producers from different primary energy sources (nuclear, coal, water, renewable sources). The rest of the electricity output could be sold by the producers on the liberalized market as equal participants.

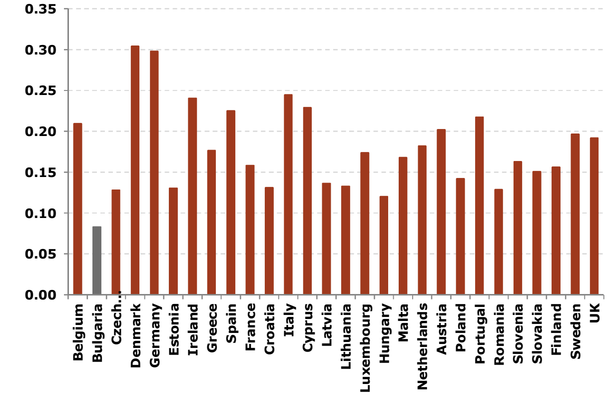
Prices for clients of different suppliers depend on production and distribution costs and are determined by the regulator. The decrease since the beginning of 2013 has been accomplished to ease the tensions among consumers. Suppliers took losses as the generation and HW grid transmission costs remained the same. Distributors also faced losses due to the decrease of payments for operation and management of the electricity networks. The overall low retail prices (the Bulgarian households enjoy the lowest electricity prices in the EU, but as a percentage of the disposable income they are the highest) are achieved with regulatory pressure on the grid transmission and distribution companies which have one of the lowest fees in the EU.

Exhibit 3: Electricity prices in Bulgaria on the regulated market were artificially lowered for political reasons



Source: National Statistical Institute

Exhibit 4: Bulgaria has the lowest electricity price for households in EU



Source: Eurostat, EUR per KWh

Renewable Energy

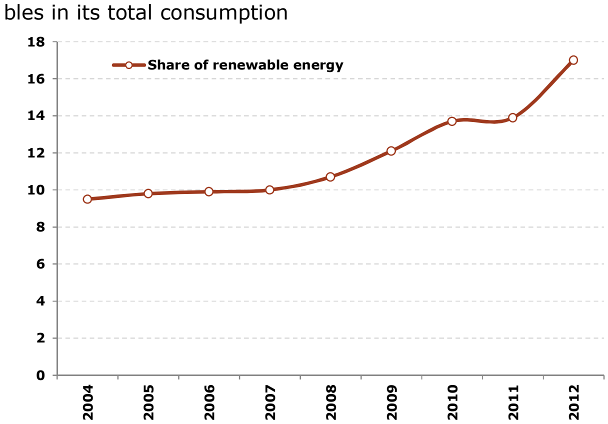
Target for renewable energy is fulfilled

Renewable sources of energy (wind power, solar power, hydroelectric power, ocean energy, geothermal energy, biomass and biofuels) are alternatives to fossil fuels that contribute to reducing greenhouse gas emissions, diversifying energy supply and reducing dependence on unreliable and volatile fossil fuel markets, in particular oil and gas. The new Renewable Energy Directive put a mandatory 20% share of EU energy consumption from RES by 2020, broken down into nationally binding sub-targets taking account of the Member States' different starting points. The Member States adopted their plans in 2010.

The electricity generation from RES experienced a fast development in Bulgaria. The renewables share in the overall structure of the installed capacity in the country was 41.37% in 2013 and the share of energy generated from renewable sources in the total production in the country reached 16.6%. The renewables have been strongly supported by feed-in-tariffs in the recent years. This fact has made the enormous growth of renewable energy possible and is in line with the environmental targets for 2020. This support has resulted in distortion of competition and huge discrepancies in wholesale prices. The average price of photovoltaics is EUR 273 per MWh, of the new coal-fired power plants is EUR 64-73 per MWh, while NPP Kozloduy sells its electricity for EUR 29 per MWh on average to both the regulated and free markets.

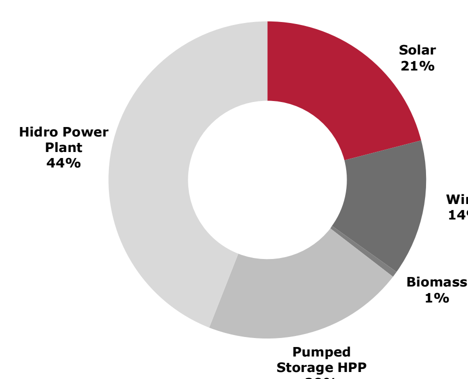
Among the additional factors for the overfulfilment of RES target in Bulgaria is the contraction of consumption since the crisis in 2009. The protection of the sector raised its share even without the increase in nominal volumes of generation. 2012 registered an eightfold growth of generation from solar plants, while the increase from wind plants was 50%. Facing an enormous deficit in the system the regulator decided to lower the preferential prices for RES and hydro power plants with less than 10 MW installed capacity from July 2014. The decrease was as follow: photovoltaic plants by 28%, wind power by 22% and HPP by 5%.

Exhibit 5: Bulgaria fulfilled its target for energy from renewables in its total consumption



Source: National Statistical Institute

Exhibit 6: RES installed capacity as of end-2013



Source: SEWRC

OUTLOOK

The deficit in the system is due to low prices for households and high power costs from generators

The regulator presses producers to sell their electricity at very low prices on the regulated segment of the market, which results in higher prices on the free market. Just an example: the price at which the Kozloduy Nuclear Power Plant supplies the free market is more than 2 times higher than the regulated price set by the public watchdog SEWRC.

The measures to support RES are unreasonably expensive and not market-driven. 40% of the installed capacities (all the three lignite thermal power plants at Maritza East basin) are locked by long-term power purchase agreements at high prices. Thus, the Bulgarian energy system suffers from a significant, structural overcapacity and a relatively small-sized internal market. The current trend in export cannot provide sufficient resources to maintain the existing plants and new RES without further price increases.

SEWRC formally acknowledged that NEK's short-term liabilities amount to BGN 1.5 billion. Personal income in Bulgaria is low (the country has the lowest GDP per capita in the EU), so the energy regulator keeps the price of household electricity down to the lowest in EU. Deliberately low regulated electricity prices for household customers are cross-subsidized by industrial low-voltage energy prices, which are 32% higher than those for households.

Further liberalization is needed along with changes in long-term contracts

Non-government organizations and experts suggest that the electricity market in Bulgaria needs substantial reform to withstand its challenges. The regulated market segment must gradually equalize with the free market, thus leading to the elimination of regulated quotas for suppliers. It requires a detailed step-by-step roadmap for household price increases, accompanied by well-targeted, more adequate and effective support for vulnerable customers. The review of long-term power purchase agreements at fixed/preferential prices (TPPs and RES) is a must, but only in a market-based way, by motivating producers to sell part of their energy on the free market. RES support schemes have to be reviewed and replaced by a more cost-efficient mechanism. Renewables have to be gradually integrated into the market.

The regulator acknowledges the problems in the system. Moreover, the increase of prices for households during the second quarter of 2014 is a step in solving the problem with the deficit but the next measure should be a renegotiation of long-term contract with power companies.

OPERATIONS OF CEZ DISTRIBUTION

The distribution company has most assets in its balance sheet

CEZ Distribution manages the electricity distribution network of MV, LV and HV power lines and facilities across 1/3 of the county's territory. It distributes electricity to the end customers, connected to the electricity distribution grids (EDGs) within the territory where the Company has been granted license by SEWRC. The territory includes the city of Sofia and districts of Sofia (most populated), Pernik, Kyustendil, Blagoevgrad, Vidin, Montana, Vratsa, Pleven and Lovech. CEZ Distribution is responsible for the maintenance of EDGs, the sites and equipment as well as the construction of new equipment for distribution and measurement of electricity consumption of users. The investment program of the Company should be in compliance with the prospects for electricity consumption in the region.

The company has been granted a license in 2004 for a period of 35 years. The SEWRC issues general and individual administrative acts, related to the licensed activity of the Company, that are obligatory for execution, including the price-formation.

The assets of CEZ Distribution include:

- High-voltage network (HV): The electricity network 110кV of CEZ Distribution is of distributive function. The Company is the only distributor in the country that also operates HV grid;
- Medium-voltage network (MV): The MV network consists mainly of direct terminals from 110kv/MV switchgears. The total length of the network is 23,408 km, including 6,491 km cable lines and 16,917 km overhead lines;
- Low-voltage network (LV): The total length of the LV network is 34,494 km, including 9,212 km cable lines and 25,282 km overhead lines. The network is supplied by 14,669 transformer units. It is paid monthly.

For 2014 CEZ Distribution has distributed 10,292,118 MWh of electricity through its grid, from which technological costs were 1,193,338 MWh or 11.59%. SEWRC determined the maximum acknowledged technological costs at 8% for 2014, which artificially decreased the return on equity of all distribution companies in the country.

The Company had 2,660 employees at the end of 2014.

PRICE REGULATIONS

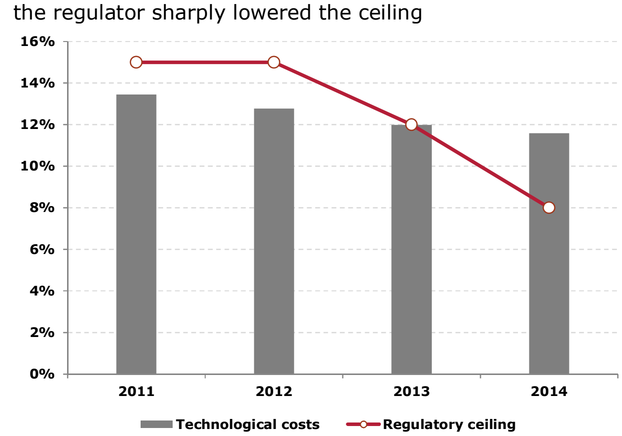
Regulations decreased revenues of CEZ Distribution

The regulations concerning revenues and income of CEZ Distribution include:

- Distribution fee through the LV and MV grid. SEWRC determines the level per kWh. Following the constant decrease of transmission prices, CEZ Distribution reported a sizable decline of revenues;
- Access fee to the grid. It is calculated based on the provided capacity for commercial consumers and it is paid for each day. Access fee for households is for kWh of distributed electricity.

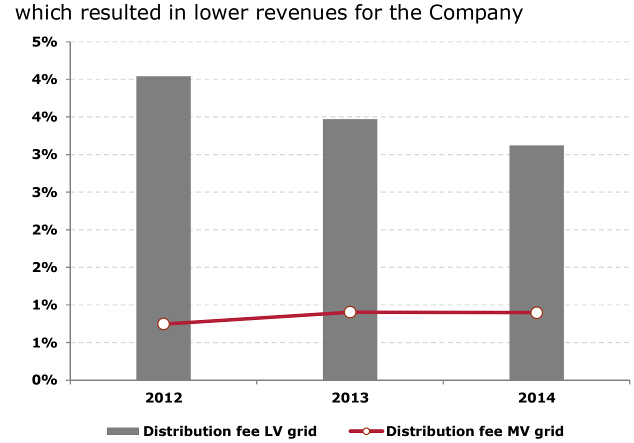
In mid-2014 the Company issued an application to the regulator with the request for higher prices for transmission and access, based on the technological losses of 11.7%. Despite the calculations, the regulator did not approve a technically justified level of costs.

Exhibit 7: Technological costs declined due to investments but the regulator sharply lowered the ceiling



Source: Company data

Exhibit 8: Distribution fees were decreased by the regulator, which resulted in lower revenues for the Company



Source: Company data

OPERATIONS OF CEZ ELECTRO

The turnover of CEZ Electro represents the consumption of electricity

In the beginning of 2007, the activities related to electricity distribution and the operation of the distribution networks and the activities related with electricity supply and other EDC activities were legally and organizationally unbundled. The electricity supply was taken over by a newly-established company - CEZ Electro, whereas the transmission and distribution of electric power remained in CEZ Distribution.

The activities of CEZ Electro also include product and service development; marketing and sales; LV and MV customer service on general and individual basis. The Company has been granted a license for public supply of electricity by SEWRC, valid until 2039. It has license for trade with electricity until 2017. In brief, CEZ Electro calculates the monthly bills and collects the payments of customers.

Prices for households are divided in two tariffs: day-time and night-time. The latter is substantially lower and do not cover the costs for electricity that the Company pays to power plants.

REGULATORY RISKS

The pressure from the regulator will remain

The regulation represents the biggest risk for the electricity distributors and suppliers in Bulgaria. On one hand, is the growing deficit in the state-owned BEH that requires reforms in many aspects from the electricity generation to the framework and practices in the liberalized market. Those reforms are limited by the long-term contracts for the AES 3C Maritsa East 1 and Contour Global Maritsa East 3 thermo-power plants and all renewables. The only way of action for the government is to increase prices of electricity to consumers and to renegotiate the prices on long-term contracts. Both changes look hard to achieve, especially the further increase of prices for households. Moreover, the civil unrest in early 2013 that lead to resignation of the government was a consequence of high utility bills. Following those events, the regulator decreased prices, lowered the revenues for utility companies and even started procedures for revoke of their licenses. Although no reasons were found for the revoke of licenses, SEWRC did not take into account all operating expenses needed for distribution activities. Therefore, electricity distribution companies will continue to be under regulatory pressure.

FINANCIAL ANALYSIS AND VALUATION

Toughest period for the companies is over

CEZ Distribution and CEZ Electro have very different scopes of activities. The regulation of prices and fees are not allowing cross-subsidies between the companies. The forecasting of financial results is difficult as any change in price regulation has the potential to distort profits for the period. Nevertheless, we are confident that the government will not increase their pressure on utilities at the expense of state-owned generation companies that have financial difficulties. The decline in investments of CEZ Distribution suggests that the company can limit the negative impact on its financial results. We consider that the toughest period is over for distributors.

Key factor for the performance lies in the market capitalization of both stocks. CEZ Distribution is more than 7 times bigger than CEZ Electro. Its fixed assets are also substantially bigger as network and other equipment are property of CEZ Distribution. Revenues of CEZ Electro represent the turnover from the deliveries of electricity to consumers, while CEZ Distribution receives fees to maintain its assets. Regarding the costs, there is difference too. CEZ Electro is obliged to buy the electricity of all renewables in its area of operations and the rest from NEK. At the same time it pays to CEZ Distribution the distribution costs that are determined by the regulator. Thus, one of the companies can perform better than the other while the current regulations are in force.

Abovementioned factors make CEZ Electro incomparable by the multiples. For example, latest net profit resulted to P/E ratio of 1.19, while the loss in 2013 was substantial. The Company is traded at P/B ratio of 0.37. The table below presents the multiples of CEZ Distribution. The profit has been hurt by the lower approved expenditures than the operating costs. Our expectations are positive, considering the shift of SWERC’s focus to electricity generating companies, rather than further squeeze of distributors’ profits.

Therefore, we see the possibility to limit the risk on the stock of CEZ Distribution by adding certain amount of shares of CEZ Electro. Part of the sizable profit of the latter for 2014 might be distributed as dividends if shareholders decide not to cover the previous year’s big loss.

We value the stock of CEZ Distribution based on our expectations for gradual improvement of profit and increase of investments.

CEZ Distribution

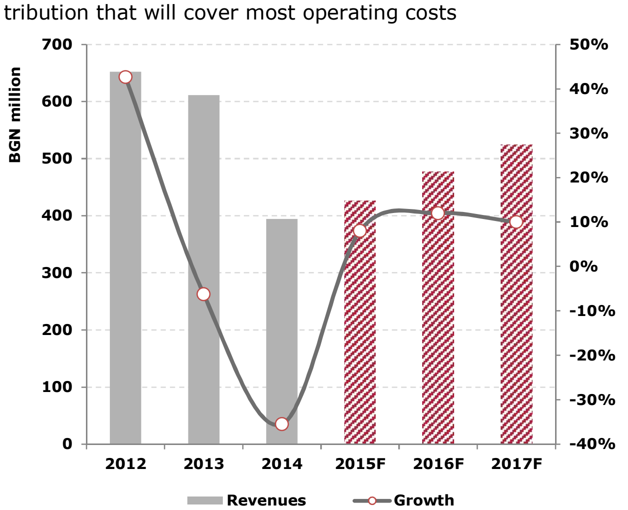
	2012	2013	2014	2015E	2016E
Last Price	**161.00**	**156.10**	**141.40**	**141.40**	**141.40**
Number of Shares	1,928,000	1,928,000	1,928,000	1,928,000	1,928,000
Market Capitalization	310,408,000	300,960,800	272,619,200	272,619,200	272,619,200
Net Profit	47,243,000	17,682,000	4,389,000	11,284,556	19,019,678
P/E	**6.57**	**17.02**	**62.11**	**24.16**	**14.33**
Equity	598,910,000	616,420,000	576,713,000	587,997,556	607,017,233
P/B	**0.52**	**0.49**	**0.47**	**0.46**	**0.45**
Sales	652,229,000	611,385,000	394,385,000	425,935,800	477,048,096
P/S	**0.48**	**0.49**	**0.69**	**0.64**	**0.57**
EV	263,353,000	239,135,800	283,171,200	267,301,819	267,159,616
EBITDA	112,386,000	81,066,000	69,272,000	75,497,121	87,180,540
EV/EBITDA	**2.34**	**2.95**	**4.09**	**3.54**	**3.06**
ROE	8.21%	2.91%	0.74%	1.94%	3.18%
ROA	6.06%	2.09%	0.55%	1.46%	2.34%

Financial Performance Analysis

The profits of CEZ Distribution and CEZ Electro are very volatile and suggest a large dose of unpredictability regarding the regulations in the sector. Our forecasts are based on the process of normalization of operations, following a gradual increase of electricity prices in Bulgaria, conducted by the regulator for the next several years. The losses of state-owned companies in the sector will create the fundament for rising prices of electricity until the system covers its deficits and liabilities that are measured at billions. This is the reason to expect a gradual increase of revenues of CEZ Distribution that should recover after the 35% decrease in 2014.

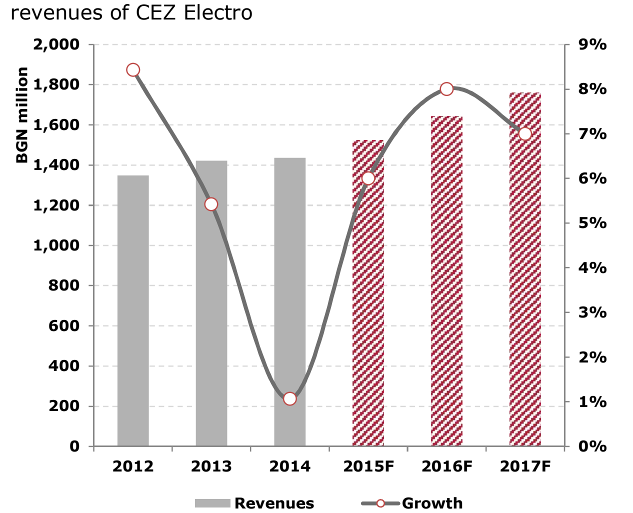
The regulator will maintain its strict control over the price determination and will continue to limit the profit of the distribution companies but in less degree. We expect CEZ Distribution to recover its 2013 level of capex in 2016, following the necessity of larger investments in the sector. Moreover, the growth needs to compensate the underinvestment during the past few years and the substantially higher technological losses due to the regulatory approved costs. The other distribution companies also have high technological losses and the 8% ceiling of the regulator is nonsense. They have to increase investments to lower operational costs and as a result there will be an improvement in profit margins. This should support our expectations for level of operating margin to 6.5% within the next 5 years.

Exhibit 9: Our expectations for growth of revenues of CEZ Distribution that will cover most operating costs



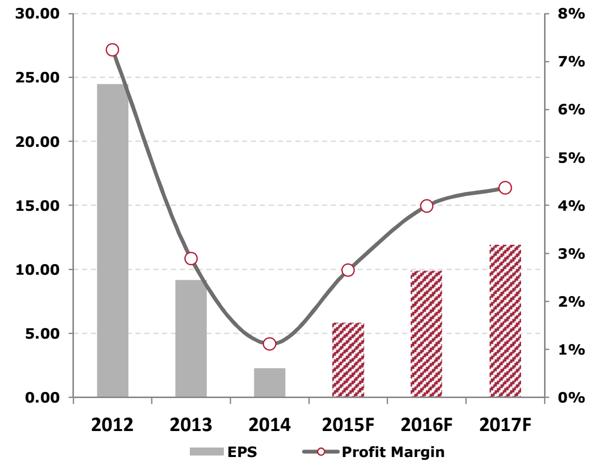
Source Elana Trading estimates, company data

Exhibit 10: The electricity price increase will provide a boost to revenues of CEZ Electro



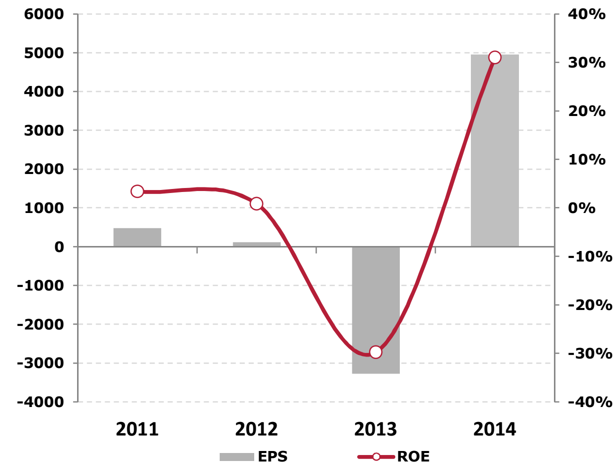
Source: Source Elana Trading estimates, company data

Exhibit 11: EPS recovery of CEZ Distribution is expected at the back of higher payments to distribution companies



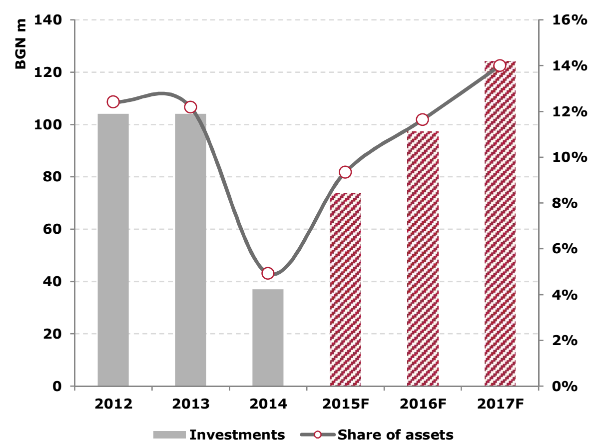
Source: Elana Trading estimates, company data

Exhibit 12: Volatility of EPS of CEZ Electro is consequence of the regulator's policy



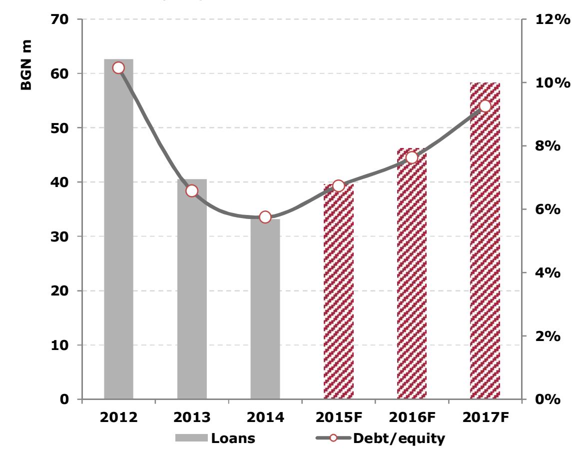
Source: Company data

Exhibit 18: We expect investments of CEZ Distribution to return to pre-2014 level in 2016



Source: Elana Trading estimates, company data

Exhibit 19: CEZ Distribution should increase debt to finance its investment program



Source: Elana Trading estimates, company data

VALUATION OF CEZ DISTRIBUTION

The biggest hurdle for the cash flows is the level of investments. As mentioned above, CEZ Distribution should increase its investments if and when SWERC provides the necessary environment for it. Our expectations for revenues are very cautious, regarding the uncertainties in the sector. According to the model, the decline in 2014 should be compensated in five years. The profit will grow and the stock should trade at the more normal P/E ratio of 14 next year with the expectation for further improvement afterwards.

The intrinsic value of CEZ Distribution's share is BGN 206.33, calculated by our forecasts for WACC.

Estimations

	2015	2016	2017	2018	2019	2021	2021	2022	2023	2024	Terminal Year
Revenue	425,936	477,048	524,753	566,733	600,737	633,778	665,467	695,413	726,706	755,774	782,226
Growth	*8.00%*	*12.00%*	*10.00%*	*8.00%*	*6.00%*	*5.50%*	*5.00%*	*4.50%*	*4.50%*	*4.00%*	*3.50%*
EBITDA	75,497	87,181	97,027	103,712	108,793	114,777	120,516	125,939	131,606	136,871	141,661
EBITDA Margin	*17.73%*	*18.28%*	*18.49%*	*18.30%*	*18.11%*	18.11%	18.11%	18.11%	18.11%	18.11%	18.11%
Depreciation	62,719	65,713	70,789	75,376	78,757	83,088	87,243	91,169	95,271	99,082	102,550
Investments	73,791	97,233	124,219	123,653	114,347	88,092	92,019	95,661	99,966	103,422	106,480
EBIT	12,778	21,467	26,238	28,337	30,037	31,689	33,273	34,771	36,335	37,789	43,022
EBIT Margin	*3.00%*	*4.50%*	*5.00%*	*5.00%*	*5.00%*	5.00%	5.00%	5.00%	5.50%	5.50%	5.50%

WACC Calculation

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Terminal Year
Risk free rate	2.20%	3.00%	3.25%	3.50%	3.50%	3.50%	4.00%	4.00%	4.00%	4.00%	4.00%
Equity risk premium	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%	8.00%
Beta	0.73	0.73	0.75	0.75	0.75	0.85	0.85	0.85	0.85	0.85	0.85
Cost of equity	**8.04%**	**8.84%**	**9.25%**	**9.50%**	**9.50%**	**10.30%**	**10.80%**	**10.80%**	**10.80%**	**10.80%**	**10.80%**
Cost of debt	3.00%	3.00%	3.50%	3.50%	3.50%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%
Effective tax rate	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%
After-tax cost of debt	**2.70%**	**2.70%**	**3.15%**	**3.15%**	**3.15%**	**3.60%**	**3.60%**	**3.60%**	**3.60%**	**3.60%**	**3.60%**
Weight of equity	94%	93%	92%	91%	92%	65%	65%	65%	65%	65%	65%
WACC	**7.70%**	**8.41%**	**8.73%**	**8.96%**	**8.96%**	**7.96%**	**8.28%**	**8.28%**	**8.28%**	**8.28%**	**8.28%**

Discounted Cash Flows

BGN'000	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Terminal Year
EBIT	12,778	21,467	26,238	28,337	30,037	31,689	33,273	34,771	36,335	37,789	43,022
EBIT(1-T)	11,500	19,320	23,614	25,503	27,033	28,520	29,946	31,294	32,702	34,010	38,720
Add: D&A	62,719	65,713	70,789	75,376	78,757	83,088	87,243	91,169	95,271	99,082	102,550
Less: Investments	73,791	97,233	124,219	123,653	114,347	88,092	92,019	95,661	99,966	103,422	106,480
Less: Change NWC	28,673	-14,652	-3,769	-10,936	-6,234	114	-4,500	-4,252	-4,444	-4,128	-3,888
FCF	-28,244	2,453	-26,047	-11,838	-2,324	23,402	29,669	31,054	32,451	33,798	38,678
PV FCF	-26,224	2,088	-20,261	-8,400	-1,513	14,784	17,001	16,433	15,860	15,255	
Sum of PV FCF	25,022										
PV of Continuing Value	365,216										
Total PV Free Cash Flows	390,238										
Less: Outstanding Debt	36,842										
Plus: Financial Assets	44,411										
PV of Equity	**397,807**										
Number of Shares (‘000)	1,928										
Price Per share	206.33										

Recommendation and Price Target

Recommendation: BUY

Target Price: BGN 206

Upside: 44%

We initiate coverage of CEZ Distribution with a BUY recommendation. Our valuation model suggests a very comfortable upside potential from the current market prices. Moreover, it is based on conservative expectations for the recovery of revenues. The profit margins in the model correspond to the averages from the past few years that are the toughest years in terms of regulations and market environment. We consider the latest report as a sign for turnaround in the positive direction.

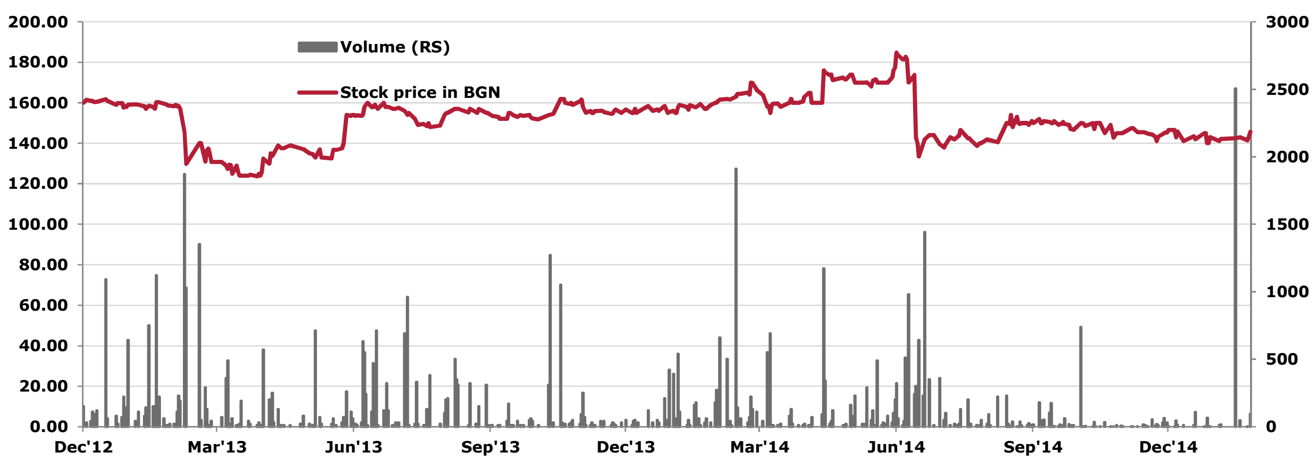
Investors might prefer to buy shares of both CEZ Distribution and CEZ Electro as a hedge from other changes in regulations. We don’t exclude the possibility of large dividend payment for shareholders of CEZ Electro but it seems unlikely at the back of the large loss in 2013. Both companies should have good profitability in a normal market. We give preferences to the investments in CEZ Distribution as the company have more assets and is the operator of the grid. Both stocks trade at low P/B – 0.46 for CEZ Distribution and 0.37 for CEZ Electro.

The stock price of CEZ Distribution did not recover after the steep drop in mid-2014 when the regulator started the procedure to revoke the license. Although this risk is minimal, investors remain cautious due to the decline of profit and the ongoing changes in regulation of electricity prices.

In terms of significant investors involved in our stock market, we share the following observations:

- Foreign investors might be driven back by the volatility in the financial performance of both companies. We see positive trend in the profit of the electricity distribution company that might make the stock interesting for buyers.
- Bulgarian institutional investors are not very active at the moment. However, the stock is considered an interesting investment with several large active local institutional investors (pension and mutual funds).
- Domestic private investors are more susceptible to the latest news flow and are not active buyers.

STOCK PRICE DYNAMICS



Annual Financial Data (Audited)

Income Statement ('000 BGN)	2011	2012	2013	2014	2015F	2016F
Revenue	**457,252**	**652,229**	**611,385**	**394,385**	**425,936**	**477,048**
Operating expenses	443,257	600,256	591,551	387,519	413,158	455,581
Change in inventories	0	0	0	0	0	0
Cost of material	10,817	11,813	11,404	8,517	9,371	10,972
Cost of labor	52,686	53,012	52,510	48,923	50,260	50,090
Cost of external services	65,605	67,505	69,772	70,402	68,150	71,557
Depreciation and amortization	60,669	60,413	61,232	62,406	62,719	65,713
Net book value of assets sold	655	494	1,582	3,082	426	477
Other costs	252,825	407,019	395,051	194,189	222,232	256,771
Operating income	**13,995**	**51,973**	**19,834**	**6,866**	**12,778**	**21,467**
Interest expense	0	1,404	1,261	932	1,092	1,288
Foreign exchange losses (gains)	0	0	0	0	0	0
Net non-operating losses (gains)	(1,419)	(1,928)	(1,626)	(388)	(852)	(954)
Pretax income	**15,414**	**52,497**	**20,199**	**6,322**	**12,538**	**21,133**
Income tax expense	1,547	5,254	2,517	1,933	1,254	2,113
Income before XO items	**13,867**	**47,243**	**17,682**	**4,389**	**11,285**	**19,020**
Extraordinary loss net of tax	0	0	0	0	0	0
Minority interest	0	0	0	0	0	0
Net income	**13,867**	**47,243**	**17,682**	**4,389**	**11,285**	**19,020**
Earnings per share in BGN	**7.19**	**24.50**	**9.17**	**2.28**	**5.85**	**9.86**

Balance Sheet ('000 BGN)	2011	2012	2013	2014	2015F	2016F
Cash and near cash items	67,023	109,687	102,351	22,606	44,929	51,733
Short-term investments	0	0	0	0	0	0
Accounts and notes receivable	81,642	103,906	75,273	67,938	68,150	73,942
Inventories	147	383	2,640	2,514	4,259	4,770
Other current assets	2,322	2,136	302	2,320	2,130	1,908
Total current assets	**151,134**	**216,112**	**180,566**	**95,378**	**119,468**	**132,354**
LT investments and LT receivables	0	0	0	0	0	0
Net fixed assets	558,800	612,184	665,044	649,129	660,200	691,720
Other long-term assets	10,471	9,744	8,986	8,372	9,797	11,449
Total long-term assets	**569,271**	**621,928**	**674,030**	**657,501**	**669,997**	**703,169**
Total assets	**720,405**	**838,040**	**854,596**	**752,879**	**789,465**	**835,523**
Accounts payable	77,097	91,368	98,031	58,158	63,890	72,511
Short-term borrowings	0	14,737	7,368	14,737	14,056	15,266
Other short-term liabilities	28,968	31,499	56,009	44,178	51,112	62,016
Total current liabilities	**106,065**	**137,604**	**161,408**	**117,073**	**129,059**	**149,793**
Long-term borrowings	0	47,895	33,158	18,421	25,556	31,008
Other long-term liabilities	62,673	53,631	43,610	40,672	46,853	47,705
Total long-term liabilities	**62,673**	**101,526**	**76,768**	**59,093**	**72,409**	**78,713**
Total liabilities	**168,738**	**239,130**	**238,176**	**176,166**	**201,468**	**228,506**
Total preferred equity	0	0	0	0	0	0
Minority interest	0	0	0	0	0	0
Share capital & APIC	1,928	1,928	1,928	1,928	1,928	1,928
Retained earnings & other equity	549,739	596,982	614,492	574,785	586,070	605,089
Total equity	**551,667**	**598,910**	**616,420**	**576,713**	**587,998**	**607,017**
Working capital	**(21,954)**	**(31,179)**	**(83,193)**	**(44,301)**	**(54,520)**	**(69,172)**

Number of shares:	**1,928,000**	**1,928,000**	**1,928,000**	**1,928,000**	**1,928,000**	**1,928,000**
Price in BGN - period end:		**161.00**	**156.10**	**141.40**	**141.40**	**141.40**
Market cap in BGN - period end:		**310,408**	**300,961**	**272,619**	**272,619**	**272,619**

CASH FLOW STATEMENT ('000 BGN)	2011	2012	2013	2014	2015F	2016F
NET INCOME	13,867	47,243	17,682	4,389	11,285	19,020
DEPRECIATION& AMORTIZATION	60,669	60,413	61,232	62,406	62,719	65,713
OTHER NON-CASH ADJUSTMENTS	(40,703)	(31,467)	(10,872)	(16,320)	4,803	(250)
CHANGES IN NON-CASH CAPITAL	21,954	9,225	52,014	(38,892)	10,219	14,652
CASH FROM OPERATIONS	**55,787**	**85,414**	**120,056**	**11,583**	**89,025**	**99,135**
DISPOSAL OF FIXED ASSETS	487	93	111	2,318	0	0
CAPITAL EXPENDITURES	(63,512)	(104,026)	(104,112)	(37,063)	(73,791)	(97,233)
INCREASE IN INVESTMENTS	(3,000)	(10,000)	0	0	0	0
DECREASE IN INVESTMENTS	15,000	10,000	0	0	0	0
OTHER INVESTING ACTIVITIES	0	0	0	0	(1,425)	(1,653)
CASH FROM INVESTING ACTIVITIES	**(51,025)**	**(103,933)**	**(104,001)**	**(34,745)**	**(75,215)**	**(98,885)**
DIVIDENDS PAID	0	0	0	(48,200)	0	0
CHANGE IN SHORT-TERM BORROWINGS	0	14,737	(7,369)	7,369	(681)	1,210
CHANGE IN LONG-TERM BORROWINGS	0	47,895	(14,737)	(14,737)	7,135	5,452
INCREASE IN CAPITAL STOCKS	0	0	0	0	0	0
DECREASE IN CAPITAL STOCKS	0	0	0	0	0	0
OTHER FINANCIAL ACTIVITIES	(159)	(1,449)	(1,285)	(1,285)	2,059	(107)
CASH FROM FINANCING ACTIVITIES	**(159)**	**61,183**	**(23,391)**	**(56,583)**	**8,513**	**6,555**
NET CHANGES IN CASH	**4,603**	**42,664**	**(7,336)**	**(79,745)**	**22,323**	**6,804**
END-OF-PERIOD CASH	**67,023**	**109,687**	**102,351**	**22,606**	**44,929**	**51,733**
CASH PER SHARE	**34.76**	**56.89**	**53.09**	**11.73**	**23.30**	**26.83**

FINANCIAL AND PERFORMANCE INDICATORS	2011	2012	2013	2014	2015F	2016F
VALUATION						
PRICE/EARNINGS (P/E)		6.57	17.02	62.11	24.16	14.33
PRICE/BOOK (P/B)		0.52	0.49	0.47	0.46	0.45
PRICE/SALES (P/S)		0.48	0.49	0.69	0.64	0.57
PRICE/CASH FLOW PER SHARE		2.88	3.81	4.08	3.68	3.22
EV (IN '000 BGN)		263,353	239,136	283,171	267,302	267,160
EV/EBITDA		2.34	2.95	4.09	3.54	3.06
PROFITABILITY						
RETURN ON COMMON EQUITY	5.03%	8.21%	2.91%	0.74%	1.94%	3.18%
RETURN ON ASSETS	3.85%	6.06%	2.09%	0.55%	1.46%	2.34%
RETURN ON INVESTED CAPITAL	5.03%	8.00%	2.85%	0.80%	1.98%	3.15%
EBITDA MARGIN	16.33%	17.23%	13.26%	17.56%	17.73%	18.28%
OPERATING MARGIN	3.06%	7.97%	3.24%	1.74%	3.00%	4.50%
NET INCOME MARGIN	3.03%	7.24%	2.89%	1.11%	2.65%	3.99%
DIVIDEND						
DIVIDEND YIELD	0%	0%	16.02%		0%	0%
DIVIDEND PER SHARE	-	-	25.00		-	-
LIQUIDITY						
CURRENT RATIO	1.42	1.57	1.12	0.81	0.93	0.88
QUICK RATIO	1.40	1.55	1.10	0.77	0.88	0.84
CREDIT						
LT DEBT/EQUITY	0.00	0.08	0.05	0.03	0.04	0.05
TOTAL DEBT/EQUITY	0.00	0.10	0.07	0.06	0.07	0.08
TOTAL DEBT/TOTAL ASSETS	0.00	0.07	0.05	0.04	0.05	0.06
EBITDA/INTEREST EXPENSE		80.05	64.29	74.33	69.17	67.67

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BUY	Target price is more than 10% above the current quotes
HOLD	Target price in +/-10% range of the current quotes
SELL	Target price is more than 10% below the current quotes

Frequency of Recommendations: No schedule of recommendations is available. The frequency of recommendations depends on specific factors to individual companies and the opinion of the analyst(s) for the necessity of minor or major changes.

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