

## CEZ Electro Bulgaria (1CZ) CEZ Distribution Bulgaria (3CZ)



The last electro distribution companies will become public at the end of October 2012. The Government will sell its 33%-stakes in CEZ Electro Bulgaria and CEZ Distribution Bulgaria. The most probable scenario is the same as the situation with EVN and Energo-Pro companies. Last year, representative of the majority owner said that CEZ is considering participation in the auctions.

CEZ Electro Bulgaria supplies electricity to above 1.79 million households and above 0.28 million legal entities, mainly in West Bulgaria. As from July 16, 2012 the renewable energy costs are transferable to the suppliers, which is having negative effect on the company's financial results.

CEZ Distribution Bulgaria – The company is the largest electricity distributor in Bulgaria by market share – around 40%. The losses from transmission are average 14.3% for the last three years. Since the beginning of the year, the transmission losses are 12.37% and the percentage will increase in 4<sup>th</sup> quarter due to seasonal factors. The company is decreasing their level by 0.2-0.25% a year, because of investments in modern equipment. 1% of the receivables are non-collectable. For 12 days the taxes from access to renewable energy set up BGN 1.3 million profits.

The energy sector is highly regulated. Advantage of the companies is the relatively stable demand and the opportunity for transferring the negative effect from increased costs to the consumers with some lag.

The share of both companies will be offered for privatization on **October 29** on BSE through the method of mixed, close auction. The minimum price of each issue is as follows:

- **1 650 shares of CEZ Electro Bulgaria** with BGN 10.00 par value will be offer with initial price **BGN 8 660** per share under the ticker **1CZ**. The total amount of the 33%-stake will be at least BGN 14.3 million.
- The initial price for **63 624 shares of CEZ Distribution Bulgaria** is **BGN 1 415** per share with the ticker **3CZ** and BGN 10 par value. The total amount of the Government stake will be minimum BGN 90 million.

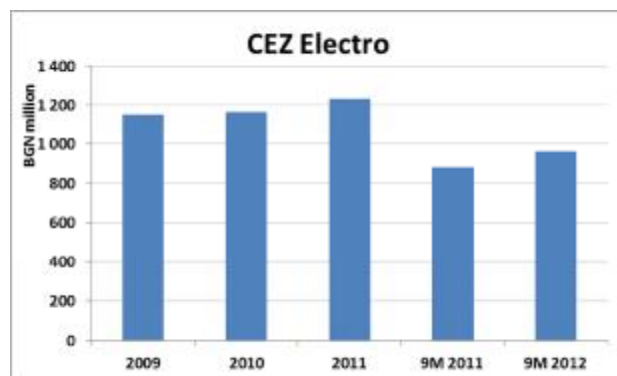
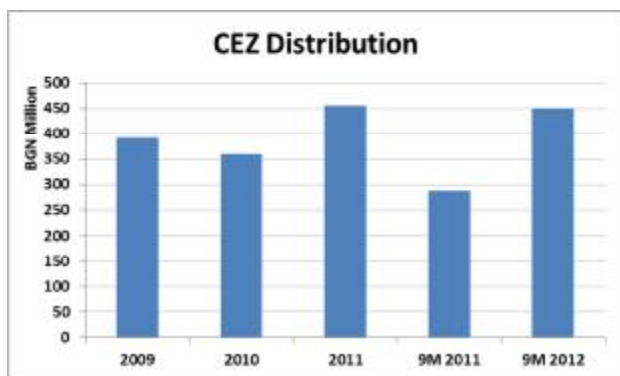
The auction will be **30 days** or until the sale of all the offered shares. The securities are already listed on BSE, Privatization Segment.

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**Financial Analysis**

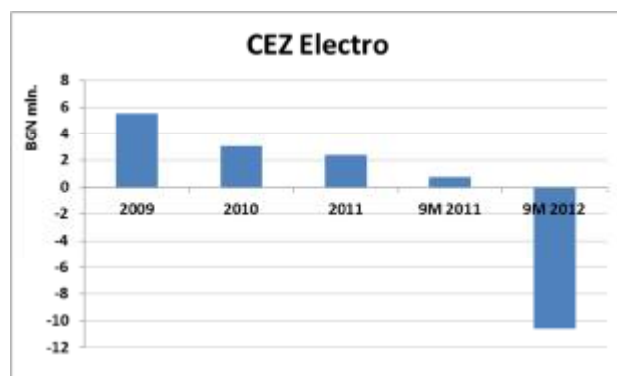
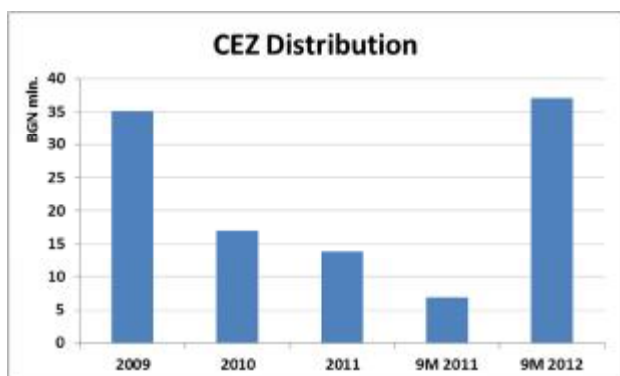
**Revenues**

The CEZ-companies posted sales increase in 2011. The improvement in CEZ Distribution's revenues is more sizable – 26% as compared to 8% decrease a year ago. CEZ Electro has stable sales growth rate, but this is expected as the company is selling to the end consumers. The transmission costs recognized in the price of electricity are 15%, according to the last changes of the regulations on July 01, 2011. Currently, the transmission losses remain high – around 14%. The increase of the revenues was mainly due to regulation changes, after which the company began to invoice access and distribution costs, including renewable projects and energy from high-efficiency cogeneration. The sales growth came with the increased payments to National Electricity Company (NEC). CEZ Distribution added BGN 100 million to the costs in this category in 2011 as compared to the previous year. This trend will remain as well in 2012. CEZ Electro has lower sales growth – for the last 9 months the revenues increased by 9% on yearly basis. This is mainly due to the weather conditions – cold winter, which improved the consumption along with higher prices. The liberalization of the market next year will lead to higher sales growth of CEZ Distribution.



**Profits**

The profits of both companies decreased despite the sales growth, due to regulator's decision that affected prices of transmission and access to a distributional network, which became effective since July 2010. After the changes, CEZ Distribution Bulgaria buys the services from NEC and Electricity System Operator (ECO) and transfers the costs to CEZ Electro Bulgaria to the end consumers. The change of financial results in 2012 is sizable and is mainly due to regulations. The renewable energy costs are transferred to the suppliers, which generated the high net loss of CEZ Electro. The price for access to renewable energy led to increased net profit for CEZ Distribution along with decreasing transmission losses, improved revenues during the winter and taxes for new renewable energy generation.



**Valuation**
**Table 1  
Multiples  
Comparison**

|                              | CEZ Distribution | CEZ Electro   |
|------------------------------|------------------|---------------|
| <b>Minimum Price</b>         | 1 415.00         | 8 660.00      |
| <b>Number of Shares</b>      | 192 800          | 5 000         |
| <b>Market Capitalization</b> | 272 812 000      | 43 300 000    |
| <b>Government Stake</b>      | 90 027 960       | 14 289 000    |
| <b>Net Profit</b>            | 44 059 000       | -8 918 000    |
| <b>P/E</b>                   | <b>6.19</b>      | <b>-4.86</b>  |
| <b>Equity</b>                | 588 731 000      | 60 294 000    |
| <b>P/B</b>                   | <b>0.46</b>      | <b>0.72</b>   |
| <b>Sales</b>                 | 618 777 000      | 1 315 229 000 |
| <b>P/S</b>                   | <b>0.44</b>      | <b>0.03</b>   |
| <b>RoE</b>                   | 7.48%            | -14.79%       |
| <b>RoA</b>                   | 5.46%            | -5.02%        |

Source: CEZ  
Calculations: ELANA Trading

The minimum prices on the auctions will be respectively BGN 1 415 for CEZ Distribution and BGN 8 660 for CEZ Electro. The multiples of both companies, calculated by the minimum price of the offering, lead to more expensive shares as compared to the other distribution companies. The price-to-equity ratio is respectively 0.46 and 0.72 for CEZ Distribution and CEZ Electro. For a comparison, the P/B ratio of EVN was 0.39 and P/B of Energo-Pro was 0.44, based on the minimum prices. The data is calculated as of the end of September and due to the increased profit of CEZ Distribution, its multiples correspond to those of the competitors. The regulation changes and the approval of the different costs' categories and investments make the profit volatile and unpredictable. CEZ Distribution has better perspectives for growth and profits.

**Sector comparison**

The comparison of CEZ subsidiaries to the largest utility companies worldwide has the purpose to be a starting point in the valuation and the recommendation before the privatization. We don't consider the comparison to peer group as good concept for the fair price of the two stocks due to the division of functions in the process of electricity distribution and the large divergence to the regulatory determined return on investments. The multiples for comparison are price-to-earnings, price-to-book and price-to-sales.

**Table 2  
Comparison  
to the sector**

| CEZ Distribution                    |             |             |             |
|-------------------------------------|-------------|-------------|-------------|
| Multiples                           | P/E         | P/B         | P/S         |
| Median                              | 13.85       | 1.30        | 0.93        |
| Market Capitalization               | 610 002 627 | 588 731 000 | 618 777 000 |
| Price                               | 3163.91     | 3053.58     | 3209.42     |
| Weight                              | 30%         | 60%         | 10%         |
| Minimum Price                       |             | 1415.00     |             |
| Fair Price                          |             | 3102.27     |             |
| Premium (Discount) to Current Price |             | 119.24%     |             |

Source: Bloomberg  
Calculations: ELANA Trading

**Table 3**  
**Comparison**  
**to the sector**

| CEZ Electro                         |              |            |               |
|-------------------------------------|--------------|------------|---------------|
| Multiples                           | P/E          | P/B        | P/S           |
| Median                              | 13.85        | 1.30       | 0.93          |
| Market Capitalization               | -123 470 878 | 78 149 465 | 1 229 364 275 |
| Price                               | -24694.18    | 15629.89   | 245872.85     |
| Weight                              | 20%          | 80%        | 0%            |
| Minimum Price                       |              | 8660.00    |               |
| Fair Price                          |              | 7565.08    |               |
| Premium (Discount) to Current Price |              | -12.64%    |               |

Source: Bloomberg  
Calculations: ELANA Trading

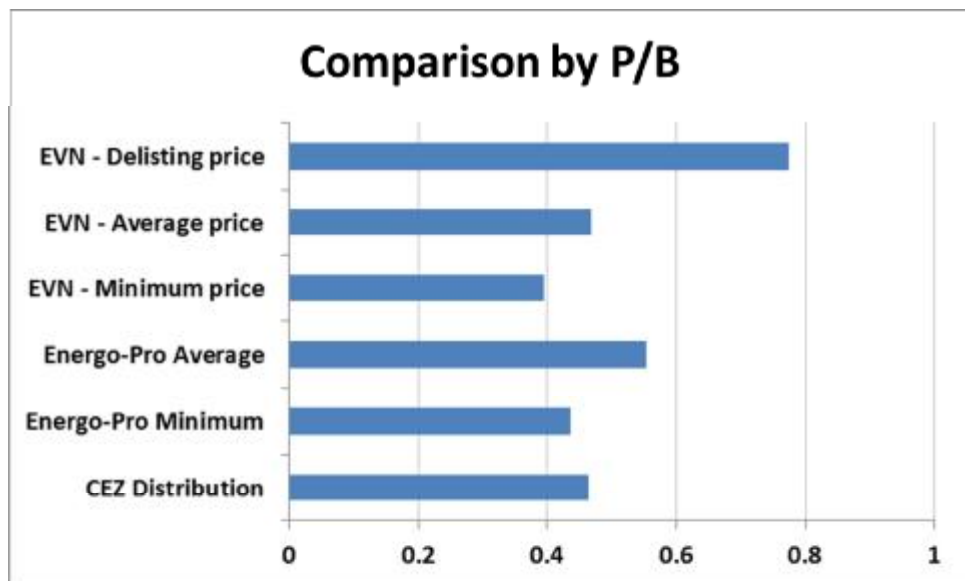
We give different weight on each multiple in both companies. Equity and profitability are the most important factors, whereas P/B is mainly used for the comparable valuation of CEZ Distribution. We exclude the P/S ratio in the calculations of CEZ Electro's fair price as sales are significant and cannot be used for comparison to electricity generating companies. The share price of CEZ Distribution looks very attractive due to the strong increase of net profit this year. The trailing data are decreasing the fair value of CEZ Electro as compared to the 2011 data. Profits are not adjusted to include the one-time effect of some revenues and profits.

#### Comparison to majority stake deal

The privatization deal for the electricity distribution companies in 2004 took place at much higher value when comparing to the valuation of the two CEZ subsidiaries at minimum price. CEZ bought 67% of the capital at a price that corresponds to BGN 826 million for both companies. Their combined value at minimum prices for the privatization is 2.6 times lower or BGN 316 million. The difference is significant and is due to the worsening financial results. CEZ subsidiaries were not able to achieve the RoC according to regulations.

#### Comparison to the privatization of other distribution companies

**Graph 7**  
**Comparison**  
**by P/B**



Calculations: ELANA Trading

The graph is comparing the P/B ratios of Energo-Pro Grid, EVN Distribution and CEZ Distribution. The stock is offered at level that is very close to the average during the two privatization deals of the comparable companies. It is likely

that we will see an average price on the first auction at least 10 to 15% higher than the minimum. When considering the price-to-earnings ratios, CEZ Distribution also looks attractive but after the adjustments for the one-time profits P/E should increase substantially. The loss of CEZ Electro will most likely be compensated by changes in regulatory framework.

### Recommendation and Price Target

The privatization of Government stakes in Energo-Pro companies changed the market's point to the forthcoming deals. The speculative interest toward Energo-Pro predominated. Currently, both shares have near-zero return since the privatization, despite the strong start of the trading on Secondary market. A lot of individual investors won't participate because of the insignificant return and the administrative requirements for buy orders.

The institutional investors' interest will predominate due to several factors:

- The minimum prices are low but are near the level of previous privatization-deals. The sale of the majority stake in 2004 is non-comparable to the current situation.
- The valuation of shares shows attractive level of CEZ Distribution and serious impediment to the CEZ Electro's activity as both companies are facing the difficult to predict energy sector in Bulgaria. The one-time effect in part of the net profit means that CEZ Distribution will not retain its financial results next year.
- The most probable scenario is the participation of the majority owner and the expectations for delisting of the shares next months.
- The long term perspectives in front of the company are highly depending of the regulations. The investments are important, including the buying of transmission equipment to renewable energy projects, change in the calculation of profits as a surplus above the price of electricity for the next period and the capital structure.
- Currently, the regulator recognizes only BGN 70 million investments. This decreases the transmission losses by 0.2-0.25% each year. CEZ Distribution will buy electricity transmission equipment for renewable energy projects at the total amount of BGN 131 million.
- The capital structure of CEZ Distribution was changed as the company increased its debt by BGN 60 million this year. The Regulator puts equal stakes of equity and the debt when calculating the return on investments for each company and the rising loans will improve the profit margin.

CEZ Distribution is attractive share for the market. Long-term investors will look at the stability and growth prospects of the sector along with the participation of the majority owner. CEZ Electro will most likely be aside of the speculators' attention, which will limit the secondary trading and the price volatility.

Our recommendation to investors will be to participate in the auction with market orders with the presumption of large demand from the majority owner. In case of absence of large bids, the risks of buying at high prices are low as most demand will be at the minimum prices. Investors could place limit orders but the large offers could outbid them.

In terms of the structure of investments we recommend to buy shares of CEZ Distribution.

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**CEZ Distribution**

| <i>BGN `000</i>             | 2009    | 2010    | 2011    | 9M 2011 | 9M 2012 |
|-----------------------------|---------|---------|---------|---------|---------|
| Revenues                    | 393 105 | 360 949 | 456 599 | 288 476 | 450 654 |
| Operating costs, incl.      | 361 411 | 344 819 | 442 604 |         |         |
| labor costs                 | 50 954  | 51 484  | 52 686  |         |         |
| external services           | 73 463  | 58 929  | 65 605  |         |         |
| transmission and access     | 1 561   | 2 052   | 100 966 |         |         |
| losses from transmission    | 143 149 | 135 337 | 138 202 |         |         |
| Operating profit            | 31 694  | 16 130  | 13 995  | 6 562   | 41 851  |
| Financial income/(expenses) | 4 269   | 2 845   | 1 419   |         | -403    |
| Profit before tax           | 35 963  | 18 975  | 15 414  |         | 41 448  |
| Net profit                  | 35 104  | 17 027  | 13 867  | 6 872   | 37 064  |

| <i>BGN `000</i>         | 2009    | 2010    | 2011    | 9M 2011 | 9M 2012 |
|-------------------------|---------|---------|---------|---------|---------|
| PP&E                    | 555 746 | 550 782 | 558 800 |         | 596 890 |
| Non-current assets      | 1 697   | 10 720  | 10 741  |         | 9 874   |
| Receivables             | 74 123  | 39 274  | 80 411  |         | 65 855  |
| Cash                    | 131 068 | 62 420  | 67 023  |         | 131 639 |
| Current assets          | 223 835 | 119 226 | 151 134 |         | 200 602 |
| Total assets            | 223 835 | 119 226 | 151 134 |         | 807 366 |
| Equity                  | 601 815 | 537 798 | 551 667 | 544 688 | 588 731 |
| Provisions              | 41 772  | 37 472  | 31 449  |         | 28 652  |
| Deferred income         | 17 342  | 16 277  | 15 789  |         | 20 173  |
| Non-current liabilities | 63 575  | 68 897  | 61 067  |         | 125 187 |
| Payables                | 34 914  | 31 295  | 16 698  |         | 68 059  |
| Short-term debt         | 61 305  | 21 835  | 30 233  |         |         |
| Current liabilities     | 115 974 | 74 033  | 107 671 |         | 93 448  |

**CEZ Electro**

| <i>BGN '000</i>             | 2009      | 2010      | 2011      | 9M 2011 | 9M 2012 |
|-----------------------------|-----------|-----------|-----------|---------|---------|
| Revenues                    | 1 154 318 | 1 167 661 | 1 234 434 | 882 275 | 959 060 |
| Electricity                 | 1 149 428 | 1 163 660 | 1 236 286 |         |         |
| Others                      | 4 890     | 4 001     | 7 148     |         |         |
| Electricity costs           | 769 759   | 814 346   | 788 931   |         |         |
| Transmission costs          | 358 728   | 326 135   | 420 005   |         |         |
| External services           | 16 881    | 15 451    | 16 319    |         |         |
| Labor costs                 | 1 928     | 1 841     | 2 085     |         |         |
| Operating profit            | 1 462     | 1 118     | 1 193     |         | -12 234 |
| Financial income/(expenses) | 4 683     | 2 289     | 1 475     |         | 994     |
| Profit before tax           | 6 145     | 3 407     | 2 668     |         | -11 241 |
| Net profit                  | 5 528     | 3 051     | 2 401     | 728     | -10 591 |

| <i>BGN '000</i>         | 2009    | 2010    | 2011    | 9M 2011 | 9M 2012 |
|-------------------------|---------|---------|---------|---------|---------|
| Non-current assets      | 3 068   | 3 707   | 4 655   |         | 5 304   |
| Receivables             | 105 698 | 113 741 | 123 598 |         | 94 580  |
| Cash                    | 103 503 | 66 917  | 89 714  |         | 76 907  |
| Current assets          | 224 858 | 181 094 | 213 663 |         | 172 471 |
| Total assets            | 227 926 | 184 801 | 218 318 |         | 177 775 |
| Equity                  | 108 870 | 68 486  | 70 885  |         | 60 294  |
| Non-current liabilities | 14 042  | 14 379  | 11 942  |         | 10 444  |
| Payables                | 51 987  | 62 639  | 44 826  |         | 39 948  |
| Short-term debt         | 50 836  | 38 996  | 85 959  |         | 62 979  |
| Current liabilities     | 105 014 | 101 936 | 135 491 |         | 107 037 |



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|             |   |
|-------------|---|
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| <b>HOLD</b> | Market performance, +/-5% as compared to SOFIX and BG40       |
| <b>SELL</b> | More than 5% lower as compared to SOFIX and BG40 performance  |

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