

CEZ DISTRIBUTION (3CZ)

INDUSTRY: UTILITIES

DEFENDING THE PROFIT

THE STRONG RESULTS SINCE THE BEGINNING OF 2015 SHOWED AN IMPROVEMENT OF PROFIT MARGIN FOR SECOND CONSECUTIVE QUARTER. CEZ DISTRIBUTION REPORTED 4.78 EPS, BUT SALES WERE DOWN AS THE REGULATOR DETERMINED LESS TRANSMISSION FEES TO DISTRIBUTION COMPANIES.

BETTER PROFIT FOR SECOND CONSECUTIVE QUARTER

In Q1 2015, CEZ Distribution reported the largest quarterly profit since the second quarter of 2013 and set a positive tone for the year. The largest utility company in Bulgaria had a minor loss a year ago. The improvement followed the increase of electricity prices in October 2014 and the cut of investments of CEZ as counter to the lower revenues for transmission, imposed by the regulator.

ONGOING NORMALIZATION OF THE SECTOR

The results are definitely supporting our expectations for turnaround in the electricity sector of Bulgaria as higher tariffs are needed to balance the system in addition to the renegotiations of prices with suppliers. Nevertheless, another electricity price hike is not expected this year. The private-owned companies remain under pressure from the regulator, which is concerned with the big deficits of the state-owned companies. The next steps include renegotiations of prices for large conventional power plants and producers of renewable energy. The distribution companies require higher transmission fees from the regulator that should support investments and further reduction of technological losses.

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 reason was politically motivated license revoke procedures which were later dismissed. The dividend of CEZ Distribution in 2014 (BGN 25.00 per share, 14.9% yield) was due to the pressure from minority shareholders, rather than the beginning of regular payment. Nevertheless, the afore-mentioned improvement of financial results allows for the start of a stable dividend policy and high dividend yields.

VALUATION: We confirm our initial valuation of CEZ Distribution. 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 4% ROE and 20% EBITDA margin in three year period. 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.

RESULTS ANALYSIS

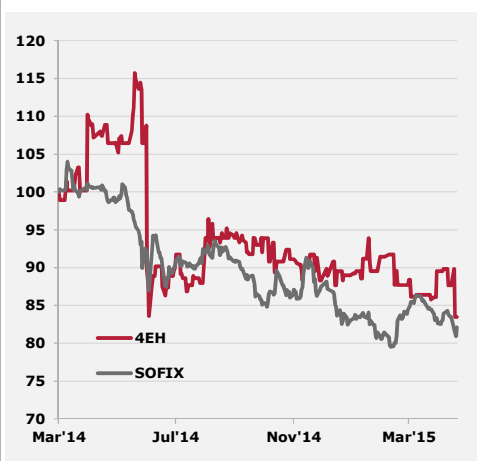
PREVIOUS RATING: BUY
ONE YEAR PRICE TARGET: BGN 206
 (FEBRUARY 18, 2015)
CURRENT PRICE: BGN 133.31

EXCHANGE RATES
EUR/BGN (FIXED): 1.95583
USD/BGN: 1.7150

MARKET DATA

Shares Outstanding:	1.3m
Share Capital:	BGN 1.3m
Free-float:	14.97%
Treasury Shares	0%
Market Cap.:	BGN 257.0m
Avg. Daily Vol.:	BGN 10,000
52 Weeks Range:	BGN 132-184
BSE Ticker	3CZ
Bloomberg	3CZ BU

PRICE PERFORMANCE



in kBGN, excl. ratios	3Q 2013	4Q 2013	1Q 2014	2Q 2014	3Q 2014	4Q 2014	1Q 2015
REVENUES	113,398	130,969	109,261	90,314	73,244	121,501	97,233
EBITDA	19,170	7,823	15,235	11,002	16,850	26,573	24,761
EBIT	4,060	(8,027)	(182)	(4,246)	1,752	9,704	9,217
NET PROFIT	3,422	(7,940)	(182)	(4,792)	1,300	8,063	9,217
EQUITY	624,532	616,420	616,238	563,246	564,546	576,713	586,107
ROE	5.80%	2.86%	1.28%	-1.57%	-1.97%	0.76%	2.41%
ROA	29.28%	13.88%	6.22%	-6.72%	-8.14%	3.34%	11.04%
EBITDA MARGIN	14.98%	13.53%	14.00%	11.99%	12.61%	17.67%	20.71%
NET PROFIT MARGIN	5.22%	2.89%	1.55%	-2.14%	-2.88%	1.11%	3.61%
EPS	0.01	-0.03	0.00	-0.02	0.00	0.03	0.03
DEBT/EQUITY	0.06	0.07	0.07	0.07	0.07	0.06	0.05
P/E	8.29	17.01	38.30	-28.44	-24.82	62.38	19.58
P/B	0.48	0.49	0.49	0.45	0.49	0.47	0.47
EV/EBITDA	2.01	2.89	3.61	3.97	5.51	4.08	3.35

ANALYST'S COMMENT

We consider the big profit during the last quarter of 2014 as a logical result of the changes in the regulations in the electricity sector. This, however, is not lifting all concerns regarding the challenging market environment. Examples can be found in the loss of the sister company CEZ Electro and the decrease of investments of CEZ Distribution.

The latter reported BGN 9.2 m profit before tax as compared to the minor loss during the first quarter of 2014 and the BGN 8 m profit after tax during the fourth quarter. Revenues were 11% down on yearly basis as the Company received less fees from corporate clients and households.

The profit depends on technological losses for the transmission of electricity. They represented 12.9% of total distributed electricity for the period and remained below the maximum determined costs of the Company for winter months. The determined by the regulator level of technological losses is lower, which might subdue the financial profit of CEZ Distribution latter this year.

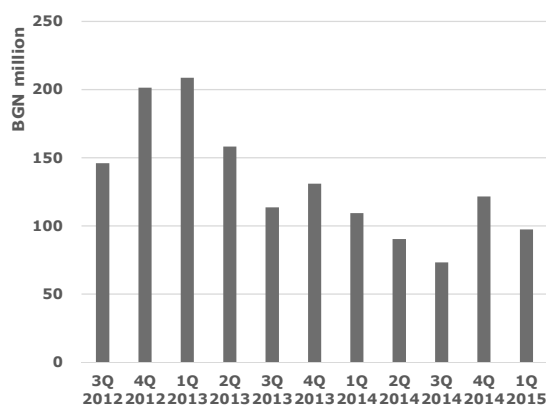
CEZ companies have another distinctive difference with the other utility companies in Bulgaria – the lower percentage of renewables on its territory and the associated smaller costs.

Investments were the primary factor for the steady decline of technological losses during the past few years. Nevertheless, CEZ Distribution made a substantial cut of its investments from BGN 13.9 m in 1Q 2014 to BGN 2.6 m in the past three months. We consider this move as a consequence of the regulatory pressure on all electricity distribution and supply companies in the country. It should improve profits at the expense of the long-term effect on cost efficiency.

The other distribution companies also were negatively affected by the regulations. Thus the imbalance in the electricity system might provoke additional measures from the regulator toward an easing of conditions for distribution companies and more investments in the modernization of the grid.

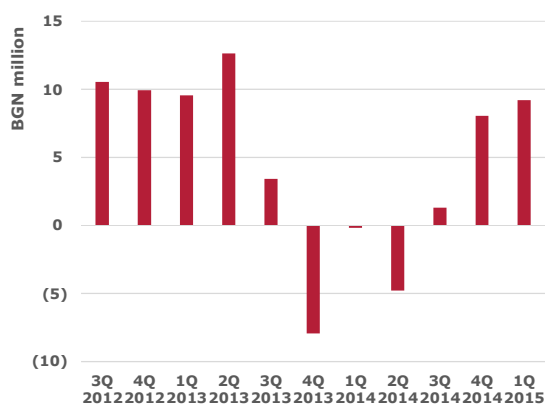
We have more moderate expectations for 2015 as compared to the extrapolated profit from the past two quarters. The next step of the regulator is to optimize the generation costs for different power plants but this should have only limited effect on CEZ Distribution.

QUARTERLY REVENUES



Source: Company data

QUARTERLY PROFITS



Source: Company data

QUARTERLY DATA (UNAUDITED)

Income Statement ('000 BGN)	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015
Revenue	201,398	208,752	158,177	113,398	130,969	109,261	90,314	73,244	121,501	97,233
Operating Expenses	191,292	197,820	144,767	109,608	139,356	109,286	94,831	71,568	111,834	87,848
Change in Inventories	0	0	0	0	0	0	0	0	0	0
Cost of Material	2,839	2,753	2,408	2,328	3,915	2,414	2,014	1,714	2,375	2,080
Cost of Labor	15,045	12,624	12,868	12,485	14,533	11,632	12,219	11,401	13,671	11,576
Cost of External Services	17,407	18,890	18,140	16,355	16,387	16,747	19,408	16,201	18,046	15,754
Depreciation and Amortization	15,778	15,320	14,952	15,110	15,850	15,191	15,248	15,098	16,869	15,357
Net Book Value of Assets Sold	298	753	121	149	559	844	1,763	274	201	186
Other Costs	0	0	0	0	0	0	0	0	0	0
Operating Income	11,481	10,953	14,474	4,060	(8,027)	44	(4,246)	1,752	9,704	9,404
Interest Expense	432	385	376	257	243	246	239	236	211	192
NET INCOME	9,940	9,547	12,653	3,422	(7,940)	(182)	(4,792)	1,300	8,063	9,217

Balance Sheet ('000 BGN)	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015
Cash & Near Cash Items	109,687	111,116	116,263	129,969	102,351	86,799	98,992	44,411	22,606	34,227
Accounts & Notes Receivable	103,906	96,317	76,927	49,650	75,273	58,929	44,399	49,260	67,938	56,918
Inventories	383	344	200	209	2,640	3,317	2,876	2,911	2,514	2,402
Total Current Assets	216,112	209,563	195,119	181,002	180,566	150,974	147,883	97,830	95,378	95,455
Net Fixed Assets	612,184	616,015	626,827	635,664	665,044	660,549	655,791	651,552	649,129	641,659
Other Long-Term Assets	9,744	9,551	9,457	9,176	8,986	8,812	8,650	8,494	8,372	8,246
Total Long-Term Assets	621,928	625,566	636,284	644,840	674,030	669,361	664,441	660,046	657,501	649,905
Total Assets	838,040	835,129	831,403	825,842	854,596	820,335	812,324	757,876	752,879	745,360
Accounts Payable	91,368	79,604	77,843	69,838	98,031	64,884	114,151	62,617	58,158	46,937
Short-Term Borrowings	14,737	11,053	0	0	7,368	7,368	7,368	3,684	14,737	11,053
Other Short-Term Liabilities	31,499	34,932	37,903	37,043	56,009	55,403	47,207	46,576	44,178	42,778
Total Current Liabilities	137,604	125,589	115,746	106,881	161,408	127,655	168,726	112,877	117,073	100,768
Long-Term Borrowings	47,895	47,895	40,526	40,526	33,158	33,158	33,158	33,158	18,421	18,421
Other Long-Term Liabilities	53,631	53,195	54,028	53,903	43,610	43,284	47,194	47,295	40,672	40,064
Total Long-Term Liabilities	101,526	101,090	94,554	94,429	76,768	76,442	80,352	80,453	59,093	58,485
Total Liabilities	239,130	226,679	210,300	201,310	238,176	204,097	249,078	193,330	176,166	159,253
Total Equity	598,910	608,450	621,103	624,532	616,420	616,238	563,246	564,546	576,713	586,107
Total Liabilities & Equity	838,040	835,129	831,403	825,842	854,596	820,335	812,324	757,876	752,879	745,360
Cash Flow Statement ('000 BGN)	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015
Cash From Operations	5,325	21,901	53,977	37,757	6,421	(1,424)	14,797	5,169	(6,959)	17,170
Cash From Investing Activities	(23,129)	(16,399)	(29,985)	(23,832)	(33,785)	(13,866)	(2,309)	(7,623)	(10,947)	(1,669)
Cash from Financing Activities	(4,148)	(4,073)	(18,845)	(219)	(254)	(262)	(295)	(52,127)	(3,899)	(3,880)
Net Changes in Cash	(21,952)	1,429	5,147	13,706	(27,618)	(15,552)	12,193	(54,581)	(21,805)	11,621
End-of-period cash	109,687	111,116	116,263	129,969	102,351	86,799	98,992	44,411	22,606	34,227

COMPANY OVERVIEW

COMPANY PROFILE

CEZ Distribution performs the operation of the electricity distribution network and facilities. It distributes electricity to the end customers in West Bulgaria. The fixed assets of CEZ Distribution are substantial as network and other equipment are property of the company. It covers an area of 40 000 sq. km and 2.9 m residents. For 2014 the Company has distributed 10,292,118 MWh of electricity, from which technological losses were 11.59%. CEZ Electro supplies the electricity in the same region and manages the Group's marketing and sales strategy. As a natural monopoly, the distribution of electricity is under strict regulation, including the determination of electricity prices and all fees that the Company receives as revenues. CEZ Distribution and CEZ Electro depend on the retail electricity prices set by the regulator.

FUNDAMENTAL STORY

The energy market in Bulgaria needs substantial reforms to cover the large deficits of the state-owned companies. The electricity distribution and supply companies have been affected negatively from the low prices for households. The revenues of CEZ Distribution are strictly determined by the regulator and were lowered in 2013 and 2014 to redirect more funds to state-owned companies. The profit has been hurt by the lower approved expenditures than the operating costs.

The last year's increase of prices and the forthcoming renegotiation of the high prices with private-owned power companies already improved the financial conditions for electricity distribution companies. Although the reform should take years, positive effects are already in place.

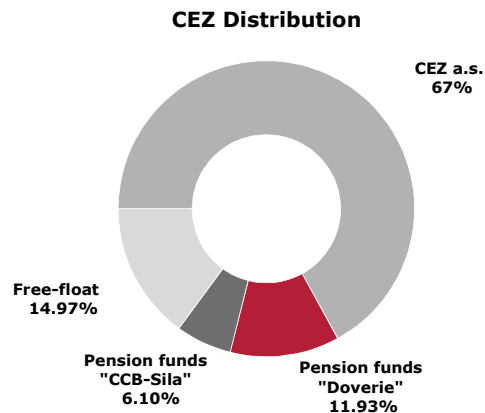
STRENGTHS AND OPPORTUNITIES

- Defensive sector with stable turnover and regulatory approved level of profits. Although the past two years increased the unpredictability of the companies and the sector as whole, the regulator already addressed the structural problems in the system.
- 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.
- CEZ Distribution is the least affected in the sector by the penetration of renewables among distribution companies.

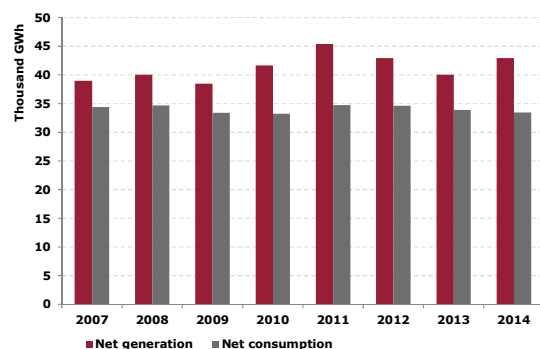
WEAKNESSES AND THREADS

- Resumption of pressure on private-owned companies in an attempt to decrease the deficit in the state-owned.
- Discontinuation of investment program, which could disrupt the long-term improvement of profitability.

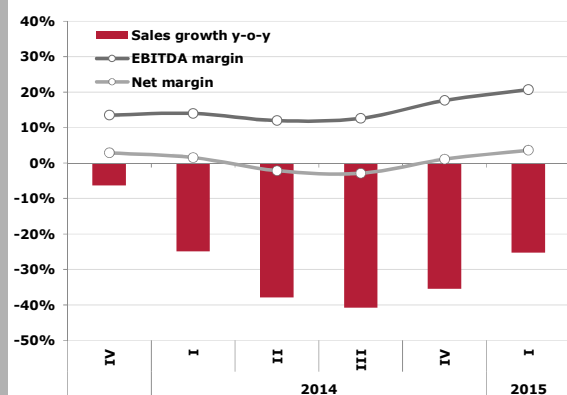
SHAREHOLDERS' STRUCTURE



BULGARIAN ELECTRICITY MARKET



MARGINS



Source: Company data; 12 months trailing data

PRICE TRIGGERS

- Recovery of Bulgarian stock market.
- Increase of electricity prices.
- Dividend announcement.

YEARLY DATA

STATEMENT OF INCOME (IN '000 BGN)	2011	2012	2013	2014
SALES	108,085	87,220	153,754	132,340
OPERATING EXPENSES	99,796	76,753	140,079	114,159
CHANGE IN INVENTORIES	(4,219)	(4,192)	(2,791)	1,003
COST OF MATERIAL	17,562	17,967	20,806	24,263
COST OF LABOUR	1,477	1,890	2,236	3,848
COST OF EXTERNAL SERVICES	7,371	9,097	11,444	13,168
DEPRECIATION AND AMORTIZATION	3,138	3,926	2,951	3,681
NET BOOK VALUE OF ASSETS SOLD	73,749	47,983	104,678	67,866
OTHER COSTS	718	82	755	330
OPERATING INCOME	8,289	10,467	13,675	18,181
INTEREST EXPENSE	2,187	2,726	3,123	2,954
FOREIGN EXCHANGE LOSSES (GAINS)	366	91	(37)	22
NET NON-OPERATING LOSSES (GAINS)	672	709	597	376
PRETAX INCOME	5,064	6,941	9,992	14,829
INCOME TAX EXPENSE	502	776	598	0
INCOME BEFORE XO ITEMS	4,562	6,165	9,394	14,829
EXTRAORDINARY LOSS NET OF TAX	0	0	0	0
MINORITY INTEREST	0	0	0	0
NET INCOME	4,562	6,165	9,394	14,829
EARNINGS PER SHARE IN BGN	0.67	0.91	1.38	2.18
BALANCE SHEET (IN '000 BGN)	2011	2012	2013	2014
CASH AND NEAR CASH ITEMS	578	674	2,008	3,261
SHORT-TERM INVESTMENTS	0	0	0	0
ACCOUNTS AND NOTES RECEIVABLE	17,039	20,073	40,522	36,622
INVENTORIES	32,585	58,208	36,106	36,923
OTHER CURRENT ASSETS	213	115	236	203
TOTAL CURRENT ASSETS	50,415	79,070	78,872	77,009
LT INVESTMENTS AND LT RECEIVABLES	5	5	5	5
NET FIXED ASSETS	39,152	45,871	51,501	63,278
OTHER LONG-TERM ASSETS	4,853	7,251	12,900	13,017
TOTAL LONG-TERM ASSETS	44,010	53,127	64,406	76,300
TOTAL ASSETS	94,425	132,197	143,278	153,309
ACCOUNTS PAYABLE	2,230	7,677	12,316	12,783
SHORT-TERM BORROWINGS	25,413	53,822	51,317	39,712
OTHER SHORT-TERM LIABILITIES	272	21	735	1,027
TOTAL CURRENT LIABILITIES	27,915	61,520	64,368	53,522
LONG-TERM BORROWINGS	19,272	14,631	13,144	24,646
OTHER LONG-TERM LIABILITIES	1,051	4,411	5,021	4,152
TOTAL LONG-TERM LIABILITIES	20,323	19,042	18,165	28,798
TOTAL LIABILITIES	48,238	80,562	82,533	82,320
TOTAL PREFERRED EQUITY	0	0	0	0
MINORITY INTEREST	0	0	0	0
SHARE CAPITAL & APIC	6,800	6,800	6,800	6,800
RETAINED EARNINGS & OTHER EQUITY	39,387	44,835	53,945	64,189
TOTAL EQUITY	46,187	51,635	60,745	70,989
WORKING CAPITAL	94,425	132,197	143,278	153,309
NUMBER OF SHARES:	6,800,000	6,800,000	6,800,000	6,800,000
PRICE IN BGN - PERIOD END:	3.05	3.15	4.95	8.50
MARKET CAP IN '000 BGN - PERIOD END:	20,747	21,413	33,653	57,800

CASH FLOW STATEMENT (IN '000 BGN)	2011	2012	2013	2014
NET INCOME	8,283	15,676	14,067	9,128
DEPRECIATION & AMORTIZATION	16,636	15,256	14,413	13,968
OTHER NON-CASH ADJUSTMENTS	7,399	4,239	(3,570)	(2,997)
CHANGES IN NON-CASH CAPITAL	(4,368)	(4,577)	5,823	3,975
CASH FROM OPERATIONS	27,950	30,594	30,733	24,074
DISPOSAL OF FIXED ASSETS	40	247	819	0
CAPITAL EXPENDITURES	(10,970)	(7,876)	(21,185)	(45,890)
INCREASE IN INVESTMENTS	(206)	(14)	(88)	0
DECREASE IN INVESTMENTS	13	21	15	19
OTHER INVESTING ACTIVITIES	52	79	41	(41)
CASH FROM INVESTING ACTIVITIES	(11,071)	(7,543)	(20,398)	(45,911)
DIVIDENDS PAID	(1,622)	(1,280)	(2,575)	(1,600)
CHANGE IN SHORT-TERM BORROWINGS	(6,477)	(670)	4,698	92
CHANGE IN LONG-TERM BORROWINGS	(16,467)	(14,870)	(8,834)	12,974
INCREASE IN CAPITAL STOCKS	0	0	641	0
DECREASE IN CAPITAL STOCKS	0	0	0	0
OTHER FINANCIAL ACTIVITIES	1,451	(3,670)	(4,332)	10,733
CASH FROM FINANCING ACTIVITIES	(23,115)	(20,490)	(10,402)	22,199
NET CHANGES IN CASH	(6,236)	2,561	(67)	362
END-OF-PERIOD CASH	894	3,455	3,385	3,747
CASH PER SHARE	0.22	0.83	0.82	0.90

FINANCIAL AND PERFORMANCE INDICATORS	2011	2012	2013	2014
VALUATION				
PRICE/EARNINGS (P/E)	4.55	3.47	3.58	3.90
PRICE/BOOK (P/B)	0.45	0.41	0.55	0.81
PRICE/SALES (P/S)	0.19	0.25	0.22	0.44
EV (IN '000 BGN)	64,854	89,192	96,106	118,897
EV/EBITDA	5.67	6.20	5.78	5.44
PROFITABILITY				
RETURN ON COMMON EQUITY	10.59%	12.60%	16.72%	24.19%
RETURN ON ASSETS	5.28%	5.44%	6.82%	10.39%
RETURN ON INVESTED CAPITAL	8.02%	8.14%	10.05%	13.92%
EBITDA MARGIN	10.57%	16.50%	10.81%	16.52%
OPERATING MARGIN	7.67%	12.00%	8.89%	13.74%
NET INCOME MARGIN	4.22%	7.07%	6.11%	11.21%
DIVIDEND				
DIVIDEND YIELD			14,39%	
DIVIDEND PER SHARE			25	
LIQUIDITY				
CURRENT RATIO	1.81	1.29	1.23	1.44
QUICK RATIO	0.63	0.34	0.66	0.75
CREDIT				
LT DEBT/EQUITY	0.42	0.28	0.22	0.35
TOTAL DEBT/EQUITY	0.97	1.33	1.06	0.91
TOTAL DEBT/TOTAL ASSETS	0.47	0.52	0.45	0.42
EBIT/INTEREST EXPENSE	3.79	3.84	4.38	6.15

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BUY	More than 5% higher as compared to SOFIX and BG40 performance
HOLD	Market performance, +/-5% as compared to SOFIX and BG40
SELL	More than 5% lower as compared to SOFIX and BG40 performance

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For more information, please contact:

Research analyst	Phone:	E-mail:	Internet:
Tatyana Vasileva	+359 2 810 00 24	vasileva@elana.net	www.elana.net
Tsvetoslav Tsachev	+359 2 810 00 23	tsachev@elana.net	www.elana.net
Lyubomir Peshev	+359 2 810 00 27	peshev@elana.net	www.elana.net