KBC Securities

*Flash*

# E-Star

11 August 2011

## Appealing price for strong fundamentals

**Energy services**

**Hungary**

| Performance over | 1M | 3M | 12M |
|---|---|---|---|
| Absolute | -21% | -32% | -3% |
| Rel. to BUX index | -6% | -11% | 13% |
| 12M Lo/Hi | HUF 12,430/6,100 | | |
| Reuters | ESTAR.BU | | |
| Bloomberg | ESTAR HB | | |
| Market cap | US$ 109m | | |
| Free float | app. 25% | | |
| Next corporate event | | | |
| 2Q11 result on 31 August 2011 | | | |

| | | |
|---|---|---|
| **Current price*** | HUF 7,800 | **Buy** |
| **Fair value** | HUF 14,600 | Rating maintained |

| HUF m | 2010A | 2011F | 2012F | 2013F |
|---|---|---|---|---|
| Sales (HUF m) | 7,895 | 19,477 | 27,429 | 38,141 |
| EBITDA (HUF m) | 2,091 | 4,182 | 6,676 | 8,791 |
| EBIT (HUF m) | 1,797 | 3,318 | 5,494 | 7,280 |
| Net profit (HUF m) | 1,447 | 3,157 | 3,191 | 4,594 |
| EPS (HUF) | 603 | 1,196 | 1,209 | 1,740 |
| DPS (HUF) | 0 | 0 | 0 | 0 |
| P/E (x) * | 11.0 | 6.5 | 6.5 | 4.5 |
| EV/EBITDA (x)* | 10.7 | 8.9 | 6.1 | 4.7 |

*Source: KBC Securities* ** Priced at COB 10 August 2011*

**E-Star's share price has plunged a significant 24% in the last 10 days, underperforming the BUX index by 5% and also the region's other indices. While the primary value drivers remain strong, we believe the weaker performance can be attributed to the following issues. First, the volatile market situation has raised concerns about the firm's ability to fund outstanding projects. Second, the difficult financial situation of Hungarian municipalities due to the record high CHF cross-rate might endanger E-Star's revenues in the next few years. However, we believe these concerns have been overblown, as according to the firm's management financing is well secured by imminent bank agreements, while the potential effect of municipality non-payments on the firm's value is negligible. After the recent plunge the valuation looks more attractive than ever for E-Star given the unchanged strong underlying fundamentals. We reiterate our Buy recommendation with a fair value of HUF 14,600 per share, which implies 87% upside.**

## Buy rating maintained

- **Excellent business model:** E-Star has taken up a niche position in the almost competition-free district heating market, which is by nature resilient to economic downturns. The firm's business is subsidy neutral and relies on long-term contracts with municipalities and industrial consumers, which ensures future cash flows.
- **Impressive earnings growth:** We forecast E-Star's EBITDA to grow at a CAGR of 27% between 2011 and 2015. This outstanding growth should be due primarily to the increasing EBITDA margins of the large Romanian projects, further new projects in Romania and Poland, and new Hungarian projects. The latter provide notably higher margins than E-Star's average.
- **Project financing looks secure:** According to the management, E-Star is in close and successful refinancing discussions with several financial institutions and negotiations to secure a € 28.5m loan are in the final stages. We believe this amount will be sufficient to implement the planned investment in Romania and to refinance expiring loans (some € 4m).
- **Municipality non-payment would have a negligible impact on net sales:** The debt problems of Hungarian municipalities could have a moderate negative impact on E-Star's revenues. However, we believe a non-payment rate above 50% in the next three years (which we believe is highly improbable) would have a negligible impact on net sales and our fair value estimate.
- **Historically undervalued:** On a 2011F P/E of 6.5x, E-Star trades 34% below its historical average of 9.9x. The discount looks even higher on long-term multiples. We believe a premium is warranted given the firm's superior growth potential.

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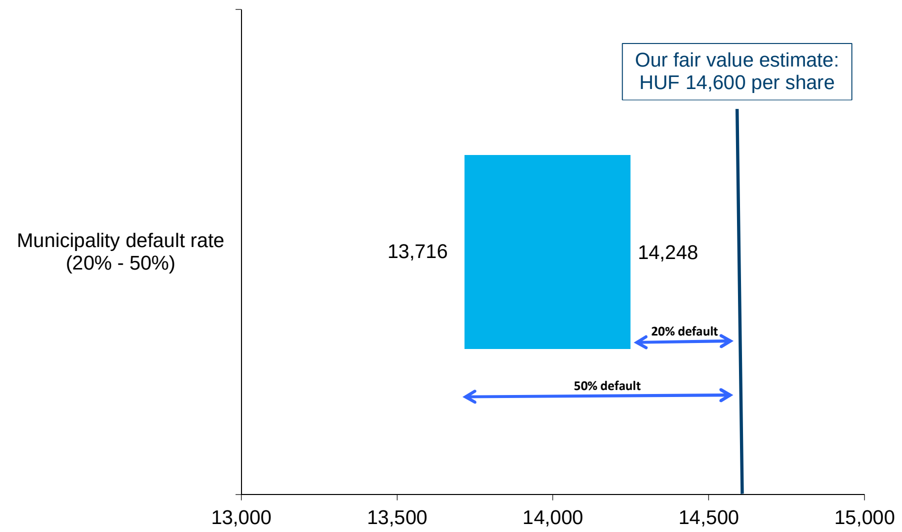
## Sufficient bank financing available to support planned investments

Recent turmoil on the financial markets and the fact that the majority of the EETEK acquisition was financed by equity rather than through banks has fuelled investors' doubts about E-Star's ability to raise bank loans to fund its investments. We believe these concerns have been overblown. First, the EETEK acquisition was equity financed primarily because of the complicated structure of the deal rather than the firm's inability to raise debt. Second, the management has told us that the firm is in close and successful refinancing discussions with several financial institutions and negotiations to secure a € 28.5m loan are already in the final stages. This amount should cover both the company's refinancing (€ 4m) and investment needs for 2011. E-Star is also in the due diligence phase to receive an additional € 25m loan and the outcome should become known in the months ahead. If the company failed to secure the above-mentioned sources of financing, reconstruction work would be delayed on projects in Targu Mures and Zalau (Romania): this would lead to lower EBITDA margins in the heating season and cut off HUF 420m (-6%) from our estimated EBITDA for 2012 and cause a negligible decrease (some HUF 120 per share) to our fair value. However, we see only a very low probability of this happening and we do not include this scenario in our model assumptions; instead we expect the company to start work on the projects in Targu Mures and Zalau as early as 2011.

## Possible local government insolvency might pose a risk to E-Star's revenues

Rapid weakening of HUF versus CHF raised the cost of debt for local Hungarian governments and prompted them to ask for delay in their CHF loan repayments to avoid insolvency. The main concern is how this might be reflected in the ability of local governments to pay for E-Star's services. We believe there is only a very small chance of the local municipalities becoming insolvent: as a last resort we believe the Hungarian government would bail out municipalities, otherwise state institutions, kindergartens and elementary schools would find themselves without heating or hot water. Moreover, as our model analysis shows, the potential impact of non-payments on our fair value for E-Star is rather limited. Due to the increasing share of foreign projects, an average of only 12% of total revenues are forecast to stem from Hungarian municipalities in 2011-2013. A prominently high non-payment rate of 50% would decrease our fair value estimate by 6%, or HUF 884 per share (see table below). However, even in this case the estimated fair value of HUF 13,716 implies 76% upside from the current share price.

**Sensitivity analysis: Municipality default rate**




*Source: E-Star, KBC Securities*

## Relative valuation shows E-Star is historically cheap

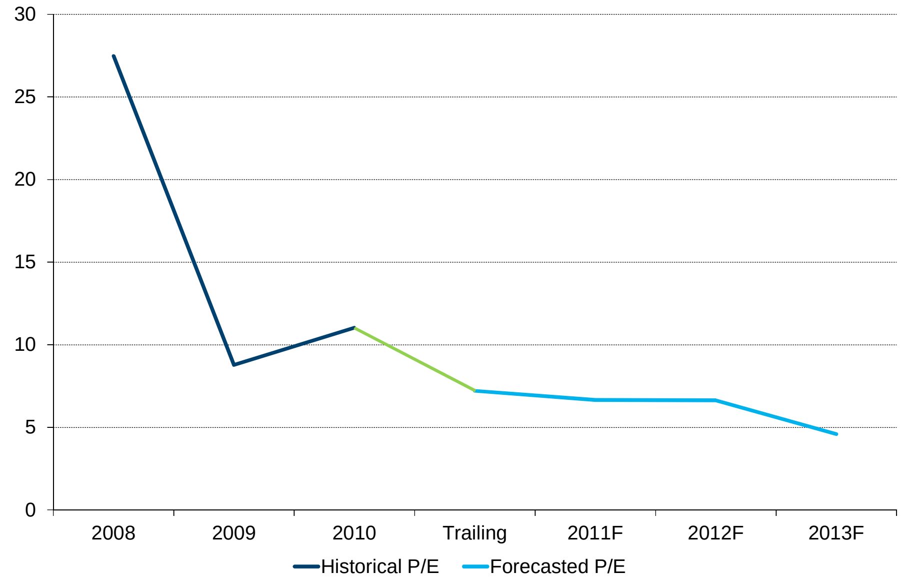
E-Star has a unique business approach and strategy, which makes it hard to find a comparable peer group. Therefore we note that the peer group valuation can be used as a sanity check only and does not give a fair picture of the company's comparative valuation. For the peer group we chose various companies across CEE and Western Europe but we emphasise that none of them offer similar characteristics: they differ in size, earnings growth, risk profiles, etc. On the forecast P/E multiples, E-Star trades at high discounts to the median of peers. We believe this discount is unwarranted given the company's impressive growth potential. While in our opinion the firm is cheap compared to the peer group, E-Star now appears to be trading below its historical valuation as well. While the 12-month trailing P/E of 7.2x is 27% below the average of the last two years, the 2011F P/E of 6.5x is already 34% below.

**E-Star: Peer comparison**

| Company | Country | Market capitalization (€ m) | EV/EBITDA | | | P/E | | |
|---|---|---|---|---|---|---|---|---|
| | | | 2011F | 2012F | 2013F | 2011F | 2012F | 2013F |
| **E-Star** | **HUN** | **76.8** | **8.9** | **6.1** | **4.7** | **6.5** | **6.5** | **4.5** |
| Hera Spa | ITA | 1,353.6 | 5.2 | 5.0 | 4.8 | 11.3 | 10.7 | 10.1 |
| MVV Energie AG | GER | 1,453.9 | 7.6 | 7.3 | 7.3 | 14.6 | 14.1 | 14.1 |
| Sechilienne Sidec | FRA | 407.1 | 9.0 | 8.6 | 8.6 | 10.2 | 10.7 | 10.9 |
| Polish Energy Partners | POL | 127.6 | 7.7 | 5.3 | 4.0 | 7.1 | 5.7 | 5.3 |
| **Median** | | | **7.7** | **6.3** | **6.1** | **10.8** | **10.7** | **10.5** |
| E-Star relative to median | | | 16% | -3% | -22% | -40% | -39% | -57% |

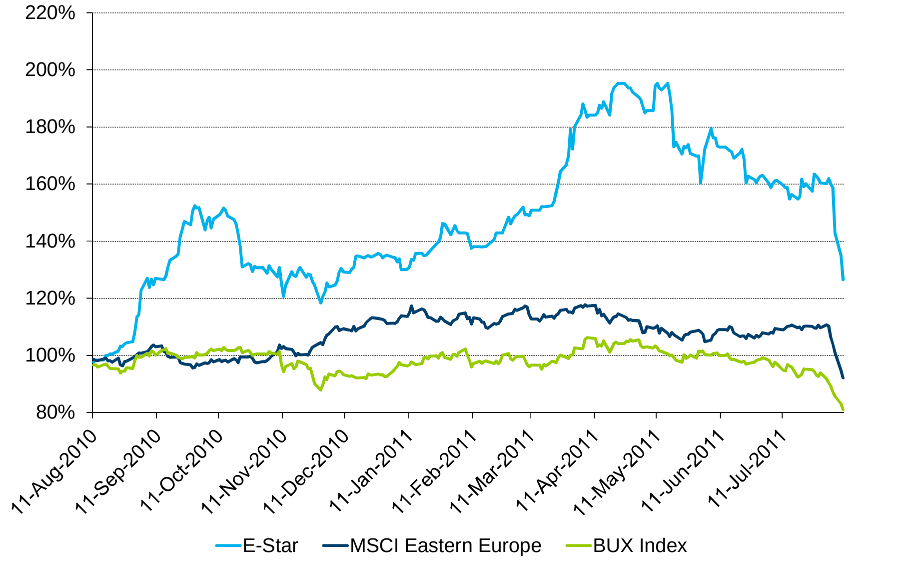
*Source: Bloomberg, KBC Securities estimates*

**E-Star: Historical versus forecast P/E**



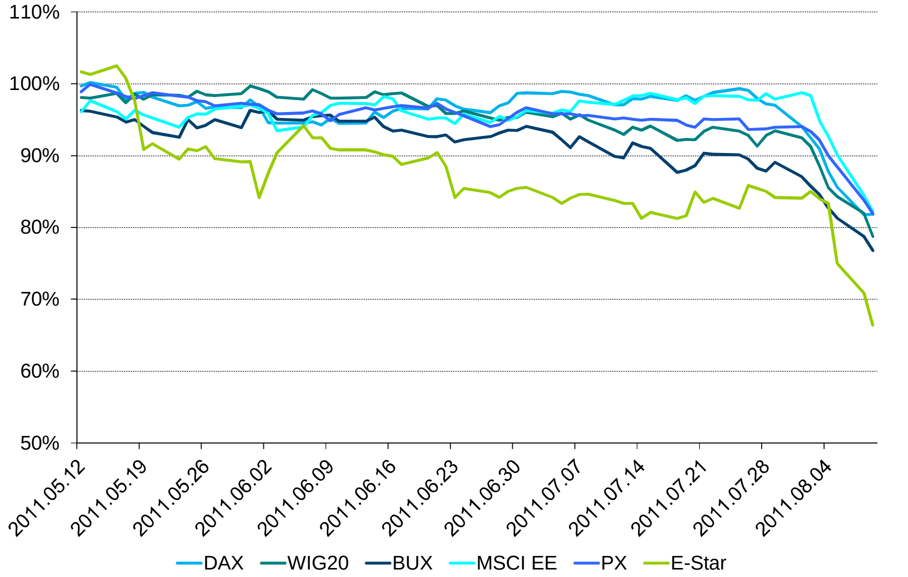

*Source: E-Star, KBC Securities*

**Rally until April on strong fundamentals…**




*Source: Bloomberg, KBC Securities*

**...still strong fundamentals coupled with underperformance in the last three month**




*Source: Bloomberg, KBC Securities*

## DCF valuation

**E-Star: Two-stage FCFF valuation**

| HUF m, unless stated otherwise | 2011F | 2012F | 2013F | 2014F | 2015F | 2016F | 2017F | 2018F | 2019F | 2020F | TV |
|---|---|---|---|---|---|---|---|---|---|---|---|
| EBIT | 3,318 | 5,494 | 7,280 | 7,957 | 8,906 | 9,126 | 9,427 | 9,434 | 9,464 | 9,631 | |
| Tax on EBIT | 612 | 992 | 1,291 | 1,404 | 1,556 | 1,602 | 1,654 | 1,659 | 1,666 | 1,697 | |
| **NOPLAT** | **2,706** | **4,502** | **5,989** | **6,554** | **7,350** | **7,525** | **7,773** | **7,775** | **7,798** | **7,933** | |
| Depreciation | 864 | 1,183 | 1,511 | 1,848 | 2,097 | 2,248 | 2,331 | 2,373 | 2,394 | 2,415 | |
| Gross cash flow | 3,570 | 5,685 | 7,500 | 8,402 | 9,447 | 9,773 | 10,104 | 10,147 | 10,192 | 10,348 | |
| Change in working capital | -3,581 | -2,478 | -196 | -1,593 | -926 | -35 | -62 | -6 | -52 | -152 | |
| Capital expenditure | -7,039 | -5,693 | -7,459 | -6,002 | -3,979 | -2,060 | -1,242 | -421 | -426 | -433 | |
| **Free cash flow** | **-7,051** | **-2,486** | **-155** | **807** | **4,542** | **7,678** | **8,801** | **9,720** | **9,714** | **9,764** | **105,698** |
| NPV of free cash flow | 15,040 | | | | | | | | | | |
| PV of average terminal value | 38,606 | | | | | | | | | | |
| Enterprise value | 53,646 | | | | | | | | | | |
| Net debt | -14,116 | | | | | | | | | | |
| Minorities | -986 | | | | | | | | | | |
| Fair equity value | 38,545 | | | | | | | | | | |
| Number of shares* (million) | 2.64 | | | | | | | | | | |
| **Per share value (HUF)** | **14,600** | | | | | | | | | | |

*Source: KBC Securities estimates*

**E-Star: DCF assumptions**

| WACC calculation | For 2010-16 | Term. value | |
|---|---|---|---|
| Risk-free rate | 7.34% | 7.00% | The yield of the 10-year Hungarian government bond. |
| Beta | 0.75 | 0.75 | Using linear regression with weekly prices. Intuitively, a beta lower than one is justified given the resilient business of the company (mainly district heating). |
| Equity premium | 6.00% | 5.50% | A market risk premium of 4.5% (common KBC methodology) with an add-on 1.5% to represent the small size of the company and its low liquidity. |
| Cost of equity | 11.84% | 11.13% | Using a CAPM model. |
| Cost of debt (before tax) | 10.25% | 10.25% | A 300-350bp debt premium over the risk-free rate and the average interest rate on corporate bond are incorporated. |
| Effective tax rate | 18.5% | 18.5% | Increasing share of Romanian operations should be positively reflected in the effective tax rate. |
| After tax cost of debt | 8.36% | 8.36% | |
| Debt | 16.6% | 20.0% | Market value of debt |
| Equity | 83.4% | 80.0% | Market value of equity |
| *WACC* | 11.26% | 10.57% | |

| Terminal value | HUF m | |
|---|---|---|
| FCFF/(WACC-g) | 115,458 | Using LT WACC of 10.57% and a LT growth rate of 2.0% |
| EV/EBITDA exit multiple | 95,938 | Fair EV/EBITDA is 8.0x |
| *Average* | *105,698* | Future value in 2020 |
| PV of terminal value | 38,606 | Using WACC of 10.57% to discount |

*Source: KBC Securities estimates*

# Financial statements and ratios

| INCOME STATEMENT (HUF m) IFRS cons. | 2008 | 2009 | 2010 | 2011F | 2012F | 2013F |
|---|---|---|---|---|---|---|
| Net sales | 3,221 | 3,911 | 7,895 | 19,477 | 27,429 | 38,141 |
| COGS | -2,068 | -1,783 | -4,734 | -10,772 | -14,644 | -20,970 |
| **Gross profit** | **1,154** | **2,128** | **3,161** | **8,705** | **12,786** | **17,171** |
| Operating expenses | -473 | -652 | -1,070 | -4,523 | -6,110 | -8,379 |
| **EBITDA** | **680** | **1,475** | **2,091** | **4,182** | **6,676** | **8,791** |
| Depreciation & amortization | -130 | -188 | -294 | -864 | -1,183 | -1,511 |
| **EBIT** | **550** | **1,287** | **1,797** | **3,318** | **5,494** | **7,280** |
| Net interest | -173 | -188 | -69 | 419 | -1,735 | -1,889 |
| **Pre-tax profit/(loss)** | **377** | **1,099** | **1,728** | **3,737** | **3,759** | **5,391** |
| Taxes on income | -98 | -298 | -290 | -689 | -678 | -956 |
| Net income before minorities | 279 | 801 | 1,438 | 3,047 | 3,080 | 4,435 |
| Minority interests | 10 | 5 | 8 | 110 | 111 | 160 |
| **Net income after minorities** | **289** | **806** | **1,447** | **3,157** | **3,191** | **4,594** |
| Dividends paid to shareholders | 0 | 0 | 0 | 0 | 0 | 0 |
| Retained earnings | 289 | 806 | 1,447 | 3,157 | 3,191 | 4,594 |
| Basic EPS (in HUF) | 144 | 336 | 603 | 1,196 | 1,209 | 1,740 |
| Basic DPS (in HUF) | 0 | 0 | 0 | 0 | 0 | 0 |

| BALANCE SHEET (HUF m) IFRS cons. | 2008 | 2009 | 2010 | 2011F | 2012F | 2013F |
|---|---|---|---|---|---|---|
| Intangible assets | 36 | 36 | 2,303 | 7,540 | 7,349 | 7,159 |
| Property, plant and equipment, net | 2,178 | 4,830 | 7,694 | 14,059 | 18,760 | 24,898 |
| Investments in associated companies | 0 | 0 | 1 | 0 | 0 | 0 |
| Other assets | 0 | 16 | 23 | 23 | 23 | 23 |
| **Total non-current assets** | **2,214** | **4,882** | **10,020** | **21,621** | **26,132** | **32,080** |
| Inventories | 93 | 21 | 241 | 2,213 | 3,009 | 2,873 |
| Trade receivables | 1,905 | 1,760 | 4,170 | 4,803 | 6,763 | 7,837 |
| Other current assets | 0 | 7 | 1,730 | 2,435 | 3,429 | 4,767 |
| **Total current assets** | **1,998** | **1,788** | **6,140** | **9,450** | **13,201** | **15,477** |
| Trade payables | -1,177 | -770 | -4,316 | -3,541 | -4,814 | -6,894 |
| Other short-term liabilities | 0 | 0 | 0 | 0 | 0 | 0 |
| **Net capital employed** | **3,035** | **5,900** | **11,844** | **27,530** | **34,519** | **40,663** |
| | | | | | | |
| **Total stockholders' equity** | **644** | **2,550** | **3,996** | **8,367** | **11,558** | **16,153** |
| Minority interest | 6 | 1 | -5 | 986 | 1,096 | 1,256 |
| **Total equity** | **650** | **2,551** | **3,991** | **9,353** | **12,655** | **17,409** |
| Total debt | 2,452 | 3,271 | 7,685 | 16,075 | 19,946 | 23,564 |
| Cash and cash equivalents | -141 | -147 | -1,313 | -433 | -1,194 | -4,203 |
| **Net debt** | **2,310** | **3,124** | **6,372** | **15,641** | **18,752** | **19,361** |
| Deferred tax liabilities | 69 | 214 | 265 | 327 | 391 | 483 |
| Other non-current liabilities | 6 | 11 | 1,216 | 2,209 | 2,721 | 3,411 |
| **Net capital employed** | **3,035** | **5,900** | **11,844** | **27,530** | **34,519** | **40,663** |

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| CASH FLOW STATEMENT (HUF m) IFRS | 2008 | 2009 | 2010 | 2011F | 2012F | 2013F |
|---|---|---|---|---|---|---|
| **Funds from operations** | **453** | **1,118** | **1,777** | **2,355** | **2,072** | **3,175** |
| Change in net working capital | -581 | -197 | -355 | -3,581 | -2,478 | -196 |
| **Cash flow from operating activities** | **-119** | **921** | **1,423** | **-1,227** | **-405** | **2,979** |
| Capital investments | -294 | -2,898 | -5,080 | -7,039 | -5,693 | -7,459 |
| **Free cash flow** | **-413** | **-1,977** | **-3,657** | **-8,266** | **-6,098** | **-4,481** |
| Other investments/disposal | -10 | 63 | 409 | -4,746 | 702 | 880 |
| **Cash flow from investing activities** | **-305** | **-2,836** | **-4,671** | **-10,247** | **-2,816** | **-3,747** |
| Dividends | 0 | 0 | 0 | 0 | 0 | 0 |
| Change in debt | 472 | 819 | 4,415 | 8,389 | 3,872 | 3,618 |
| New capital/share buyback | 0 | 1,100 | 0 | 2,400 | 0 | 0 |
| **Net cash flows from financing activities** | **472** | **1,919** | **4,415** | **10,594** | **3,983** | **3,778** |
| **Net increase in cash and cash equivalents** | **48** | **5** | **1,166** | **-880** | **761** | **3,009** |

| VALUATION RATIOS* (x) | 2008 | 2009 | 2010 | 2011F | 2012F | 2013F |
|---|---|---|---|---|---|---|
| P/E | 27.5 | 8.8 | 11.0 | 6.5 | 6.5 | 4.5 |
| P/BV | 12.3 | 2.8 | 4.0 | 2.5 | 1.8 | 1.3 |
| P/CF | -66.8 | 7.7 | 11.2 | -16.9 | -48.9 | 6.9 |
| EV/EBITDA | 15.1 | 6.9 | 10.7 | 8.9 | 6.1 | 4.7 |
| EV/Sales | 3.2 | 2.6 | 2.8 | 1.9 | 1.5 | 1.1 |
| FCF yield (%) | -4.0% | -19.4% | -16.4% | -22.2% | -15.1% | -10.9% |
| Dividend yield (%) | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |

| COVERAGE RATIOS (x) | 2008 | 2009 | 2010 | 2011F | 2012F | 2013F |
|---|---|---|---|---|---|---|
| EBIT / net interest | 3.17 | 6.83 | 26.01 | -7.92 | 3.17 | 3.85 |
| CFO / net debt | -0.05 | 0.29 | 0.22 | -0.08 | -0.02 | 0.15 |
| Dividend payout ratio (%) | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Net debt / EBITDA | 3.40 | 2.12 | 3.05 | 3.74 | 2.81 | 2.20 |
| Gearing (%) | 355.1% | 122.4% | 159.7% | 167.2% | 148.2% | 111.4% |

| PROFITABILITY RATIOS (%) | 2008 | 2009 | 2010 | 2011F | 2012F | 2013F |
|---|---|---|---|---|---|---|
| EBITDA margin | 21.1% | 37.7% | 26.5% | 21.5% | 24.3% | 23.0% |
| EBIT margin | 17.1% | 32.9% | 22.8% | 17.0% | 20.0% | 19.1% |
| Net profit margin | 9.0% | 20.6% | 18.3% | 16.2% | 11.6% | 12.0% |
| ROE | 57.0% | 50.3% | 44.2% | 47.3% | 29.0% | 30.6% |
| ROIC | 15.0% | 21.0% | 17.1% | 14.6% | 15.5% | 16.3% |

| GROWTH RATIOS (%) | 2008 | 2009 | 2010 | 2011F | 2012F | 2013F |
|---|---|---|---|---|---|---|
| Revenue | 71.9% | 21.4% | 101.9% | 146.7% | 40.8% | 39.1% |
| EBITDA | 15.3% | 116.9% | 41.7% | 100.0% | 59.6% | 31.7% |
| EBIT | 11.1% | 133.9% | 39.6% | 84.7% | 65.6% | 32.5% |
| EPS | 1.4% | 132.7% | 79.5% | 98.8% | 0.4% | 44.6% |
| BVPS | 86.2% | 229.9% | 56.7% | 90.3% | 38.0% | 39.8% |

*Source: E-Star, KBC Securities estimates*

*Historic valuation data are based on historic prices

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The date of the closing rate indicated in the publication is the day directly preceding the date of publication of this publication/report.

**The definitions of terms applied in the publication:**

EBITDA = EBIT + amortization and depreciation
EPS = Net profit / No of shares outstanding
DPS = Dividend per Share
NBV per share = Net Book Value / No of shares outstanding
EBITDA margin = EBITDA / Revenue
EBIT margin = EBIT / Revenue
CFPS = Cash flow / No of shares outstanding
Net Financial Debt = Financial debt – Cash equivalents
ROE = Net profit / Average Equity
EV = Market Capitalization + Net Financial Debt
P/E = Stock Price / EPS
P/CF = Stock Price / (Net Profit + amortization and depreciation)
P/BV = Stock Price / NBV per share
P/S = Market Capitalization / Revenue
Gross Dividend Yield = Dividend per share / Stock

- **List of recommendations concerning E-star issued by KBC Securities NV Branch in Hungary**

| | Valuation | Market price | Recommendation | Date of issue |
|---|---|---|---|---|
| E-Star | HUF 14,600 | HUF 9,920 | Buy | 26 July 2011 |
| E-Star | HUF 14,600 | HUF 7,800 | Buy | 11 August 2011 |

The recommendations and estimates relating to market values published by KBC Securities Hungarian Branch Office shall be valid for 12 months or until modified. We intend to update the recommendations quarterly.

KBC Securities Hungarian Branch Office applied the following assessment methods to compile this investment recommendation: discounted cash-flow (DCF), sector comparison and summary of parts (SOTP). An advantage of using DCF is that future financial profits are also calculated, on the other hand, it is a disadvantage of the model that predictions relating to future financial performance are greatly influenced by the analyst's opinion. Sector comparison is more independent of the analyst's opinion but it is usually based on current financial results that might differ from future performance. Analysis based on the summary of parts (SOTP) is advantageous inasmuch as it can be used to compare assessments in cases when a company to be assessed has significant fixed assets and reserves; on the other hand, the method will not take into consideration either the short term or long term growth potential.

**Interpretation of the recommendation:**

**BUY** – total return is expected to appreciate 10% or more **HOLD** – total return is expected to be between 10% and –10% **SELL** – total return is expected to depreciate 10% or more

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