

13 September 2010

Update


**Power Utilities**

Poland, Czech Republic

<b>FY10 P/E</b>	<b>12.1</b>
<b>FY10 EV/EBITDA</b>	<b>5.4</b>
<b>WIG Energia</b>	<b>4 098.42</b>

# Power Utilities

## Sentiment Set for a Change

The stocks of regional power utilities have underperformed the broad market in the past few weeks, mostly due to the investors' concerns over additional share supply (PGE, CEZ). With high-quality second-quarter earnings, electricity price hikes likely to occur next year (CEZ being the exception here due to hedging) and a strong interest in the privatization of ENEA, investor sentiment towards the industry is gradually changing. We reiterate our view that the biggest upside potential lies with PGE (best exposure to potential growth in electricity prices) and Tauron (according to our estimates, the market currently values its electricity generation business, which brings PLN 1bn per year in EBITDA, at "0"). Following the recent increases in the price of the stock, we are downgrading our rating for ENEA from accumulate to hold. We remain neutral on CEZ.

	9MTP	Rating
CEZ	140.3	Hold
ENEA	21.43	Hold
PGE	27.53	Buy
TAURON	8.87	Buy
	9MTP	Upside
CEZ	140.3	6.9%
ENEA	21.43	4.5%
PGE	27.53	15.8%
TAURON	8.87	58.3%

\* closing prices as of 10.09.2010

### Growing Importance of Exchange-Based Trading in Poland

The introduction of the requirement that a portion of every utility's electricity output be sold through power exchange, and PGE's declaration that it will sell all its output this way, may not only lead to the introduction of a transparent pricing benchmark, but could also streamline negotiations with the energy regulator URE, which reduces the profits of Poland's listed utilities by some PLN 400m per year as it questions wholesale prices in the market. That this scenario is being played out may be confirmed by the considerable increase in volumes traded through the Polish Power Exchange and the poee online platform that has been observed in the past few months, both in the spot market (+75%) and the futures markets (PPE transactions for 3.9 TWh to be supplied next year).

### Market Balance: Operating Reserve to Decline in 2013-2014

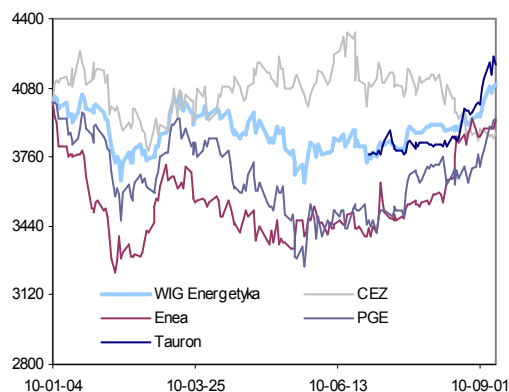
Polish power utilities are launching an enormous investment program. However, according to our estimates we cannot expect a significant increase in installed capacity before 2015-2016, which means that, taking into account the capacity that is scheduled to be switched off and the rising demand, Poland's operating reserve may considerably decline in 2013-2014 (resulting in a pressure on prices) while interconnectors will not be able to provide sufficient transmission capacity.

### Distribution: Stable Earnings Growth at Polish Utilities

In the near future, distribution will be a source of stable growth for PGE, ENEA and Tauron, which might even double their distribution EBIT over the next 6 years as they reach full return on regulatory asset value. As for CEZ, such adjustment can only be expected for Bulgarian and Albanian assets.

### Climate Package: New Ideas

A proposal that is currently being discussed in Germany – a EUR 22/MWh "climate tax" which would be imposed on the country's nuclear power plants in exchange for an extension in the period over which they are allowed to remain operational – means that the current breakdown into "clean" and "dirty" energy producers might have a much lesser impact on their future valuations. Let us also point out that, counterintuitively, the expected increase in electricity prices in Germany in 2013 could lead to wider margins for power utilities in countries in which the Climate Package is subject to derogation. The fact that these additional profits will have to go to efficiency-increasing investment projects does not make this scenario any less attractive.

**WIG Energia vs. CEZ, ENEA, PGE and Tauron**


	2010F P/E	2011F P/E	2010F EV/EBITDA	2011F EV/EBITDA	P/BV
CEZ	9.6	9.1	6.5	6.1	2.02
ENEA	13.8	13.4	5.0	4.8	0.97
PGE	14.2	11.8	6.1	5.4	1.29
TAURON	10.8	10.6	4.1	3.8	0.71

\* multiples factor in share capital increases at PGE and Tauron

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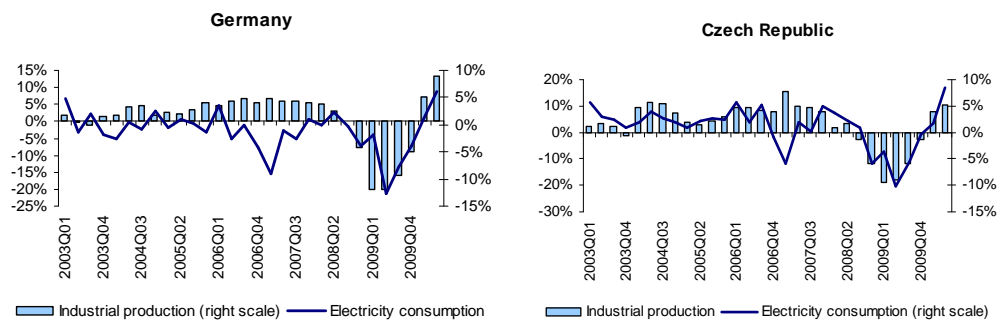
# CEE Electricity Market

- The regional electricity market is systematically recovering as industrial production grows while weather conditions are favorable (+6-8% y/y in the second quarter)
- For now, the rising demand has had little impact on EEX electricity prices due to a high supply of German renewable energy and the consistently low gas prices.
- Any revisions to our long-term forecasts for the price of electric energy should be cosmetic and related to foreign-exchange rate fluctuations.

## Volume Rebound Without Impact on Prices

The onset of the European electricity crisis in Q3/Q4 2008 was a direct consequence of falling industrial production. Therefore, it comes as no surprise that the clear growth in economic activity observed in 2010 leads directly to increased energy consumption. In the first quarter, electricity consumption was additionally supported by the cold winter, but in Q2, when weather-related factors played a much lesser role, demand for electricity in the individual countries of the region was rising at 6-8% y/y, i.e. on a par with industrial output readings. Of course, this rapid growth vs. 2009 should not be surprising given the economic revival we are currently witnessing, and it should be seen in the context of the impact of the crisis on last year's comparable base (by way of example, electricity consumption declined by a staggering 6.5% y/y in Germany in 2009). Even if the current trends persist in the Czech Republic and Germany, electricity consumption in 2010 will be below the peak levels seen in 2007-2008.

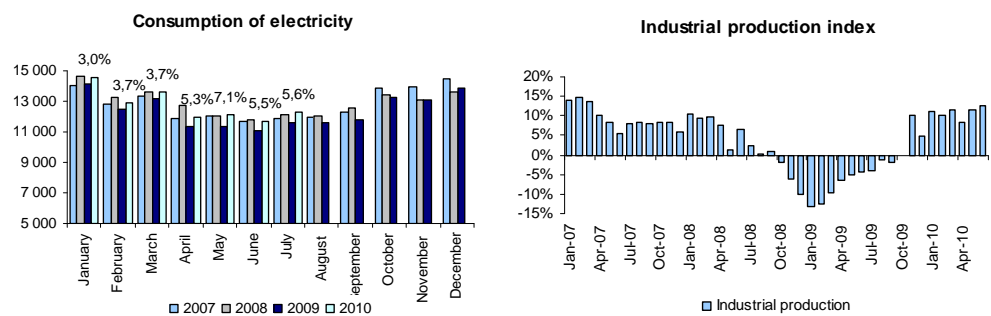
## Electricity consumption in Germany & Czech Republic vs. industrial production



Source: Eurostat

In Poland, the situation is slightly better, as there are reasons to believe the demand for electricity in 2010 may be only a notch (ca. 1%) below the 2008 record-high level. Of course, these data should be seen in the context of Y/Y differences in weather (take for example the clearly colder May), and they could inflate the base of comparison for 2011. A crucial parameter that will determine the demand for electricity in the upcoming years across the region will be the economic situation, which remains uncertain as of now. In fact, doubts as to how lasting the current revival is going to be are the main reason while the price of electricity in European exchanges fails to grow despite the rising demand.

## Electricity consumption in Poland vs. industrial production growth

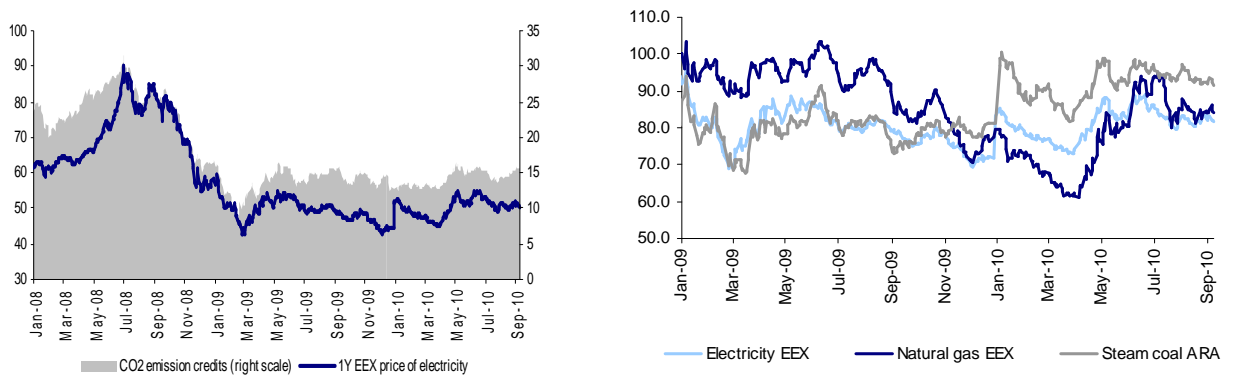


Source: GUS, PSE

While contracts for the supply of electricity in 2011 are over 10% above the April minimum, they have been moving in the EUR 50-55/Mwh range practically since May (towards the lower end of the range in the past few weeks). These tendencies diverge from trends observed in the main

commodity markets (copper, crude oil and even steam coal), as the main driver of commodity prices is demand from Asia. Of course, given the nature of the electricity market it is hard to expect the EEX to be correlated with the situation in the Chinese economy, which has a short-term negative effect on the theoretical margin of coal-fired plants in Europe (the clean dark spread calculated from the German spot prices is currently negative). Until now, such pricing relationships have not led to structural problems in the industry, as a vast majority of sales volumes were hedged in the preceding year (the biggest power utilities have already secured contracts covering ca. 80-90% of their 2011 output). However, should coal prices remain at the current levels next year, they will exert considerable pressure on prices for contacts for energy supplies in 2012. Another factor that may support electricity prices could be the price of gas, which, given the increasing share in the European basket of petroleum-price-indexed Russian gas, will follow the price of Brent crude oil ever more closely. At the end of the day, everything will depend on macroeconomic conditions. Let us point out that our forecasts are based on a conservative scenario.

**Prices of electricity futures in Germany (EEX) in EUR/MWh vs. prices of CO2 emission credits and prices of coal and gas (January 2008 =100)**

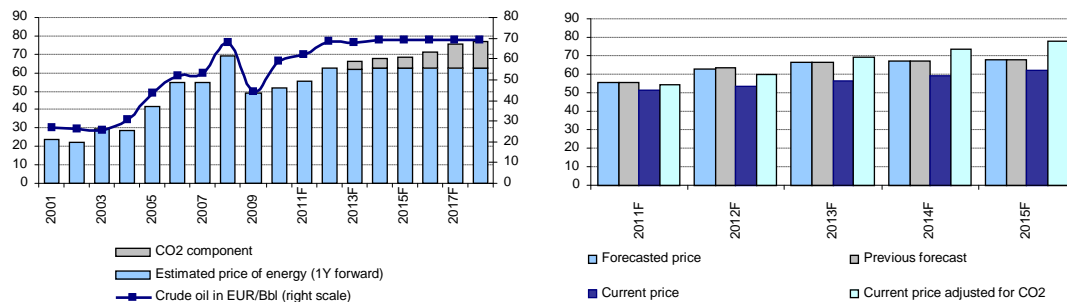


Source: Eurostat, Bloomberg

**Long-Term Forecast Update**

We based our long-term forecasts of electricity prices on their correlation with crude oil prices. In view of the scheduled implementation of the EU Climate Package in 2013, our estimates take into account the effects of the resulting increase in CO<sub>2</sub> emission credit costs. We assume that these costs (the European Commission set the target carbon-credit prices at EUR 40/t) will become fully reflected in electricity prices by 2020, after discontinuation of free emissions allocations. Relative to our last update, we have only made cosmetic revisions to our forecasts of EEX prices (less than +/- 1%). Following updates to our foreign-exchange rate assumptions, we have also introduced slight revisions to the effective prices obtained by CEZ and Polish power utilities. Below, we present our new forecasts compared to the current EEX prices of 2011-2106 electricity futures. Just as in the case of our previous report, the negative discrepancy can be explained by differing assumptions with regard to CO<sub>2</sub> emission credits which are now traded at about EUR 15/t, and which we expect to rise to EUR 30/t after the implementation of the EU Climate Package in 2013 (note that the allowances can be saved for use in future years, and some producers are probably buying them now while they are still cheap).

**Old and new electricity price forecasts, current EEX quotes\***



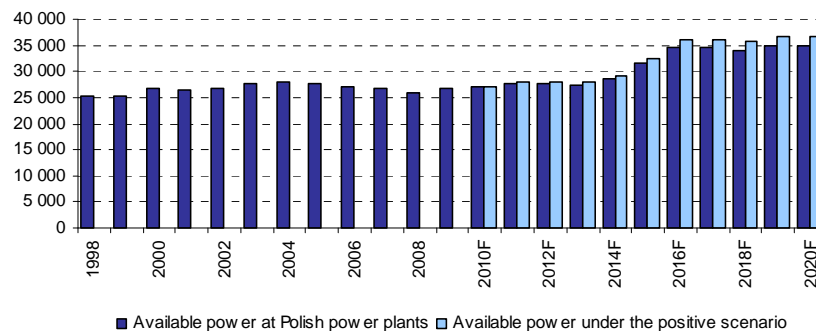
\*price quotes and forecasts for 1Y futures contracts (e.g. a 2010 price estimate is for a contract for delivery in 2011)  
Source: Bloomberg, F –forecasts by BRE Bank Securities

## Outlook for the Polish Electricity Market Equilibrium

- The Polish electricity market became considerably strained in 2008 when, with demand at a record-high level and the number of unscheduled downtimes increasing, the operating reserve fell to the lowest level ever observed (7% of peak demand),
- The crisis and the concomitant decline in consumption improved market balance, and the launch of a new unit in Bełchatów, scheduled for next year, should provide a further buffer against increasing demand for electricity.
- An analysis of the Polish energy sector investment schedule and the planned closures of old units suggests that a considerable demand/supply strain may recur in 2013-2014.
- A sudden reduction in operating reserve, at a time when trans-border transfer capacity remains limited, could lead to an increase in electricity prices.

The issue of balancing the Polish electricity market has been discussed numerous times, although in our opinion it is worthwhile to re-approach the topic comparing the most current investment plans of companies from the industry to energy consumption forecasts adjusted for the effects of the crisis. A simplified picture of the Polish market over the past few years is as follows: demand has been rising steadily with the expansion of installed capacity progressing much slower (with only two new units, at Pałnów and Łagisza), leading to a decline in operating reserve, especially at demand peaks. A crisis situation was quite near in 2008 when, due to the record-high demand and a number of installation failures, available surplus power at peak demand declined to a dangerously low level in January. In the following year, however, demand broke down, considerably reducing strain on the system. This year's PSE's data suggest, however, that demand has returned to pre-crisis levels. While this was certainly facilitated by weather-related factors, the issue of how to balance the market in the next few years has resurfaced.

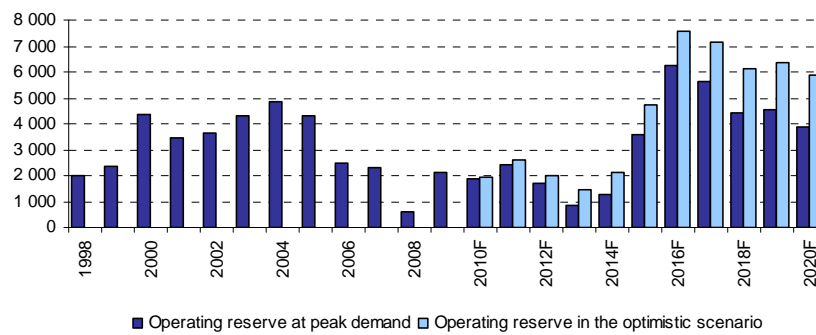
### Available power of Polish power plants under two scenarios\*



\*Our first scenario takes into account our base-level estimates of new capacity growth; in the optimistic scenario, we assume that new wind farms will be constructed as per PSE's surveys.  
Source: PSE, estimates by BRE Bank Securities

Of course, all calculations concerning the supply and demand balance in the electricity market are sensitive to assumptions concerning consumption growth on the one hand (which is directly correlated with the GDP and industrial production, as well as potential "weather-related disturbances") and with timely execution of the utilities' investment plans on the other. In our analyses, we present two scenarios: one is based on new power plant construction schedule based on what the individual utilities are saying and on a forecast of the increase in the demand for electricity prepared by PSE for ENTSO (+2.4% CAGR in 2010-2014 and +2.1% in 2015-2020), and in the second scenario we also include wind farm openings (5.3 GW of capacity through 2015 as per a survey prepared by PSE). We consider the second scenario optimistic due to the considerable delays in new wind farm construction we are currently observing. It seems that the utilities are reviewing their plans in this respect. At the moment, installed capacity in wind farms figures to 914 MW. Therefore, adding 4.4 GW in new capacity within four years does not seem likely, despite the huge number of network access applications (note that in its annual forecasts for 2011-2012 foresees installed capacity growth of just ca. 500 MW per year in this category).

**Operating reserve at peak demand\* under two scenarios\*\***



\* We assume that demand will increase as per the forecasts prepared by PSE for ENTSO.

\*\*Our first scenario takes into account our base-level estimates of new capacity growth; in the optimistic scenario, we assume that new wind farms will be constructed as per PSE's surveys.

Source: PSE, estimates by BRE Bank Securities

As presented in the chart above, we have calculated that regardless of the scenario accepted, the situation in Polish electricity might be the most strained in 2012-2014, when several units will be switched off (Turów, Halemba, Łagisza), but no significant capacity will have been added yet (this will not happen until 2014, and the current schedule foresees the greatest accumulation of new power-plant openings in 2015-2016). Within that period, little will also change as far as inter-system links are concerned (820 MW transfer capacity at the moment). Currently, there are some investment plans in this area, which could bring this capacity up to 1.9 GW by 2014 (phase shifters at the synchronic junction DE/CZ/SK), but such projects will take 4-5 years to complete. In this context, we cannot preclude a situation whereby the declining operating reserve in Poland pushes prices up, significantly boosting the profitability of existing installations. In our valuation models we do not assume such a scenario, however, but we base our forecasts on more conservative macroeconomic parameters.

## Climate Package and Its Impact on the Sector

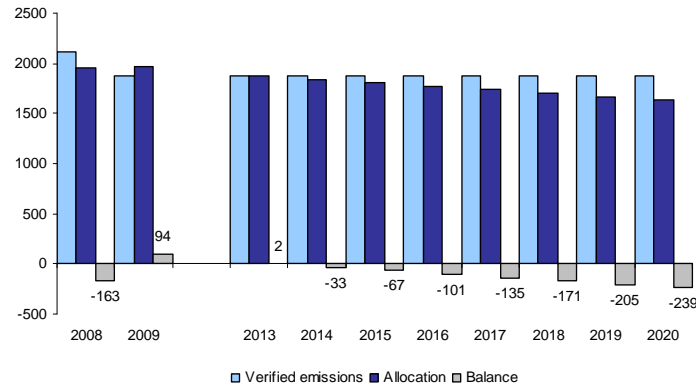
- Given the derogation granted to, inter alia, Poland and the Czech Republic, the Climate Package may paradoxically widen the margins of power utilities in these countries through an increase in electricity prices driven by the EEX.
- Gains on certificates must be used towards the cost of efficiency-improving projects, which does not seem to be a problem at the time when Polish power utilities have such extensive investment plans.
- The premium for “clean” producers may not be as obvious given the proposed changes in the industry’s administrative framework (e.g. the idea of a “climate tax” to be imposed on nuclear power plants).

### Climate Package: a Review

The Climate Package, approved by EU member states in December 2009, will force electricity producers to buy 100% of their CO<sub>2</sub> emission credits in auctions starting in 2013. Emission credits will be auctioned by the individual member states, and no less than 50% of the funds obtained from them will be spent on carbon dioxide reducing investments (construction of highly efficient power plants, CCS installations), projects which boost energy efficiency, forestation and the construction renewable energy capacity. The main objective of the program is cutting the European Union’s carbon dioxide emissions by 21% relative to 2005 (the total pool of credits will decrease linearly in 2013-2020 by 1.74% p.a., from 1.9 Gt to 1.7 Gt). The EU did take into account the needs of some of the member countries, including Poland and the Czech Republic, and granted a period of derogation to electricity producers from countries that meet one of three criteria ( per-capita GDP in 2006 below 50% of the Union’s average, over 30% dependence on one fossil fuel, and low integration with the UCTE-managed transfer network). The countries that have been granted a period of derogation will be able to continue to award free credits limited to 70% of their total emissions pool, but this ratio will gradually decrease towards zero as 2020 approaches. Free emission credits will be awarded on the basis of actual emissions in 2005-2007, or emission indicators weighed by the type of fuel. At the moment, detailed regulations concerning implementation have not been approved yet, but it seems that the auctions will be run jointly by all member states, and the price for credits will be a market price, the same for all countries. In addition to power utilities, financial institutions, commodity trading firms and individuals will be allowed to participate in the auctions. This broad access to auctions should guarantee a liquid secondary market that is capable of appropriate valuation of these credits. The

plan is for emission credits for the second phase of EU ETS (2013-20) to be available for purchase even before it starts through "early auctions" (or futures contracts available within existing exchanges).

### Estimated balance of CO<sub>2</sub> emissions in the EU following the introduction of the Climate Package

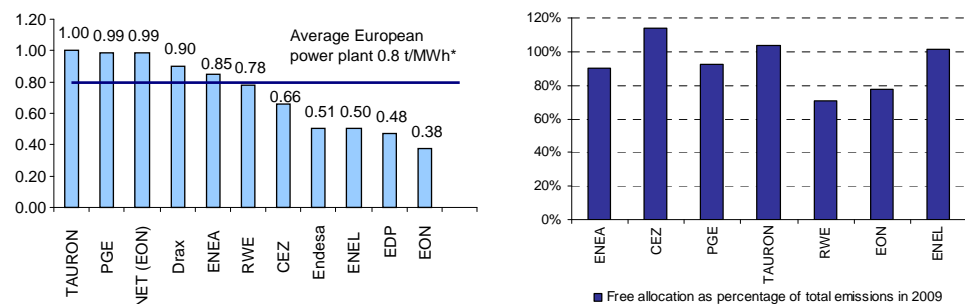


Source: EC, national emission credit trading administrator, estimates by BRE Bank Securities

### Emission Credit Pricing and Price of Electricity

Given the planned structural shift in the Polish electricity market, it is very hard to forecast the price of carbon dioxide emission credits after 2012. Quite recently, the European Commission's analyses assumed that the introduction of the Climate Package could push emission credit prices up to EUR 40/t. In the meantime, however, the global economic crisis happened, leading to a drop in the demand for energy (a general decline in industrial output – electricity generation accounts for 55% of EU's total output) and a drop in carbon dioxide emissions, which had a direct impact on the price of emission credits (not merely through a reduction in demand, but also increased supply of freed certificates when actual emissions turned out to be 11% lower than expected). In this context, when constructing a scenario for emission credit prices upon the implementation of the Climate Package one must take into consideration not only the expected gradual reduction in emission limits, but also the forecasted state of the global economy. Below, we present a chart which compares the allocation of emission credits to carbon dioxide emissions in 2008-2009 as well as the expected deficit of credits with reference to emissions in 2009, estimated by KASHUE, Poland's administrator of the ETS. In the future, the gap will expand as industrial production grows (as YTD data show an economy in a state of recession) and shrink with emissions-reducing investment. However, it seems that in the early days of the Climate Package, a pressure on emission credit prices will be visible.

### Carbon dioxide emissions and proportion of free certificates within the NAP II program\*\* to emissions



\*estimates by CEZ

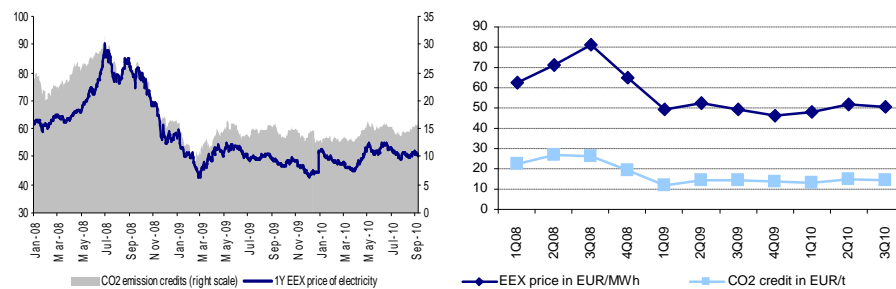
\*\* Emissions indicator based on gross electricity production (our earlier calculations were based on the net price of electricity).

Source: Companies, PWC, analysis by BRE Bank Securities.

From the point of view of the power industry, an important question is not just how much the certificates will cost, but also to what extent their price will be reflected by the price of electricity. What has happened so far in the German market suggests that these parameters are very highly correlated (at 95%, based on quarterly data for 2008-2010), which means that electricity producers are able to transfer the cost of emission credits onto their customers almost in full. Of course, such a system awards clean generators, who are able to attain a higher unit margin.

According to CEZ's estimates, European power plants emit ca. 0.8 tonne of carbon dioxide per 1 MWh of energy produced, though taking into account investment plans of the biggest European utilities, this parameter can be expected to systematically decline. In this context, the cost of carbon dioxide need not be fully transferred onto the price of electricity, which will make the "dirty" producers less competitive. Such a scenario could, however, be undermined by various administrative decisions and modifications of the Climate Package, one example of which is currently being discussed in Germany: a tax on nuclear fuel. The local government believes that following the introduction of the Climate Package, nuclear power plants, with their zero emissions, will be generating above-average profits from the rising electricity prices, and they should "give back" this surplus in the form of a tax of EUR 22/MWh in exchange for the extension of the period over which they are allowed to operate. Without doubt, such a solution would help sustain the high correlation between the prices of carbon dioxide and electricity.

### Price of CO<sub>2</sub> emission credits vs. EEX electricity prices



Source: Bloomberg

### Derogation Will Help the Power Industry

The derogation system created for some countries (including Poland and the Czech Republic) during Climate Package negotiations is an instrument aimed at preventing surges in electricity prices in the local markets starting in 2013. Power-generating companies will not have to buy all their emission credits at auctions. The mandatory contribution of such energy in their total sales will increase gradually from the current 30% (the precise rate of growth will be determined by national governments). In our opinion, this does not mean that power utilities will give up on electricity price increases in these countries while prices in the neighboring markets shoot up, driven by full emissions credit auctioning (e.g. inter-system links between Germany and the Czech Republic). As a result, without any other price-limiting administrative mechanisms (which seem impossible to introduce in a deregulated market), the derogation system will support the industry rather than the end buyers. Of course, as per the EU directive, the utilities' profits from free emission credits will have to be used for efficiency-boosting and emissions-reducing projects, but in the context of their huge CAPEX plans this should not be a problem. In the early years of the Climate Package, PGE, CEZ or Tauron may paradoxically benefit from the new measures being introduced. In addition, if they prove able to carry out investment processes skillfully, our "dirty" utilities need not become less competitive in the new, more green market of 2020 and beyond.

## Distribution: Who Stands to Gain the Most

- Operations in Poland and the Czech Republic rely on a return on assets used to transmit energy through the mechanism of regulated return on regulatory asset value (RAV). Note, however, that the divergent approaches of the Polish and Czech regulators result in divergent financial performance of the companies from these countries.
- In the case of CEZ, the operating profit in this area is practically identical to the theoretical RAV calculation based on the WACC. Polish utilities will not get there for 5-6 years.
- In our opinion, Tauron has the biggest upside potential under the model aimed at providing utilities with full return on RAV (+163%). At the moment, the Distribution segment accounts for 31% of the Company's EBIT and a staggering 75% of its EV.
- In Poland, a change in accounting rules concerning the recognition of network access fees in revenue (carried out by CEZ one year ago) will boost the segment's earnings by PLN 50-90m (so far, these cash payments were amortized they way subsidies are).

- **The distribution business in the Czech Republic is experiencing a temporary profitability setback as solar power plants expand rapidly and operators are mandated to buy the energy they generate – we estimate the negative impact on this year’s EBIT of CEZ at over CZK 2bn.**

Electric energy distribution seems to be a fairly straightforward business given both the nature of services provided (the hiring of transfer capacity) and the profit-generation formula (as a natural monopoly, it is based on tariffs that assume a certain return on transfer assets). Given, however, the differences between individual regulatory systems, it would be good to once again review the most important points. The tariff-setting models are based on similar principles in both countries, i.e. regulatory revenue is calculated on the basis of a sum of operating expenses, tax on distribution-related properties, network losses, transfer fees payable to the national grid operator, depreciation charges and a return on assets used (WRA\*WACC), which should approach the reported operating profit. The table below shows that at the moment the Czech market seems to approach this ideal model the most: CEZ’s return on RAV is comparable to the WACC as determined by the regulator. In the case of Poland or Bulgaria, the gap is quite wide, suggesting that power utilities in these countries are not yet receiving full return on RAV, but we already know that in the upcoming years this situation will evolve to the benefit of these companies. According to our estimates, the compromise struck last year between Polish power utilities and the regulator URE (whose details are outlined below) means that distribution revenue will rise systematically towards 100% return on RAV in 2016-17. This will directly lead to a clear increase in profits generated in the segment (by way of example, Tauron’s EBIT should theoretically increase over 2.5-fold). This cannot be expected in the case of CEZ, which this year also faces another profitability-eroding problem, namely the costly requirement of purchasing solar energy, which is not fully reflected in the current tariffs.

**Basic figures for the Distribution segment of power utilities**

	RAV	EBIT*	Return on RAV	Regulatory WACC	Target RAV**	Target EBIT	Upside	Share in EV***	Share in EBIT
PGE	12 900	591	4.6%	10.5%	12 900	1 355	129%	22%	14%
Tauron	9 836	392	4.0%	10.5%	9 836	1 033	163%	75%	31%
ENEA	5 485	341	6.2%	10.5%	5 485	576	69%	63%	76%
CEZ (Czech R.), CZK m	62 000	4 624	7.5%	7.9%	69 400	5 499	19%		
CEZ (Romania), CZK m	10 361	1 459	14.1%	10.0%	10 361	1 036	-29%	15%	9%
CEZ (Bulgaria), CZK m	7 295	468	6.4%	12.0%	8 061	967	107%		
CEZ (Albania)	5377	-804	-	-	-	-	-		

\* For the Polish companies, we have used the FY 2010 EBIT forecast, for CEZ, data for 2009 (distribution and sales forecasted jointly).

\*\* For the Polish companies, RAV as determined by the regulator URE, for CEZ, RAV postulated by the company itself.

\*\*\* For the Polish companies, the value of the segment is calculated on the basis of a simple DCF model, where free cash flows comprise EBIT minus tax and net investment (this number is than compared to the current EV of the companies).

Source: CEZ, Enea, PGE, Tauron, estimates by BRE Bank Securities.

The nature of the business environment should directly affect the market valuation of their assets. In theory, in the model variant (EBIT = WACC\*RAV), the segment’s value (EV) should approach regulatory asset value (CEZ). In the case of Polish utilities, a discount must be applied to the RAV, as full return on RAV will not be reached until several years from now. In our calculations, we have used a simplified DCF model, where free cash flows comprise EBIT less tax and net investment. As a result, we arrived at an average discount to the current RAV of ca. 20%. Next, we compared these estimates to the current value of the companies (EV = MCap + net debt + minority interest). Our analysis shows that while in the case of CEZ the share of the distribution segment in EV is comparable to its share in consolidated EBIT, in the case of the Polish utilities there is a considerable disproportion between these two figures. This disproportion may be a consequence of either a big discount applied by the market to the valuation of the utilities’ other areas of business, or of the investors’ lack of faith that full return on RAV will be attained as planned. Therefore, further down in the report we have decided to carry out a Sum of the Parts valuation of our power utilities. At this stage, we may only point out that Tauron may have the most undervalued non-distribution segments, which account for just 25% of its current market value vs. 69% of its consolidated EBIT.

**Evolution of the Tariff System in Poland**

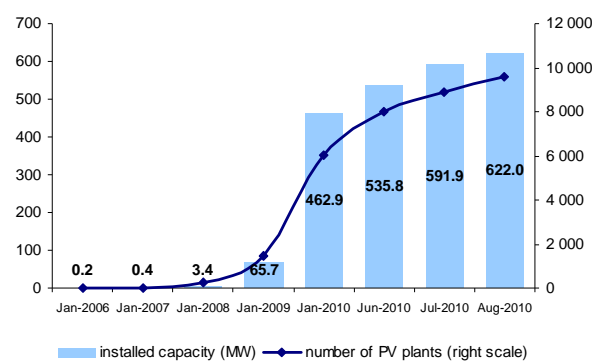
The URE’s approach to the determination of what percentage of RAV will be used to calculate a utility’s return has changed quite often over the past few years. In 2004-2007, regulatory asset value was calculated on the basis of fair value (which, however, differs considerably from balance-sheet value), but the return on capital was not calculated on RAV in its entirety, but on a portion of it (e.g. 50% in 2005, rising to 100% in 2007). In 2008 and 2009, net investment was added in, and in 2009 the companies were also allowed to add 0.5% of their regulatory revenue

for 2008. Meanwhile, power utilities and the regulator launched negotiations aimed at developing a long-term path towards achieving full return on distribution assets (considerable discrepancy between RAV and the balance-sheet value of the assets). In the end, it was decided that in 2010 and beyond return on capital will be calculated as the sum of the return on capital in the preceding year ( $ROC_{t-1}$ ), 1.5% of regulated revenue in the preceding year ( $RR_{t-1}$ ) and return on net investment after 2008 ( $ROI_t$ ), i.e.  $ROC_{t-1} + 1.5\% * RR_{t-1} + WACC * ROI_t$ . The formula will remain in force as long as its result is lower than  $WACC * RAV_t$ , where  $RAV_t$  is the regulatory asset value at the end of 2008 calculated on the revenue-loss basis adjusted for net investment in individual periods starting in 2009. According to our estimates, the second formula, which foresees a full return on RAV, will not come into force until late 2016 or early 2017. In a shorter perspective, the EBIT may also be boosted by operating savings and reduction in network losses following infrastructural upgrades.

### Solar Power Plants and Return on Distribution in the Czech Republic

An analysis of the impact of new solar power plants on Czech electricity distributors should start with a look on the country's regulations aimed at supporting renewable energy. Unlike in Poland, it is not based on "colored certificates" that need to be redeemed by electricity traders, but on "feed-in" tariffs used in many other European countries. This solution forces distributors to buy renewable energy from power plants connected to their networks. "Green" energy prices (depending on the source) are set by the regulator at a level meant to encourage investment in such projects (with the so called "green premium"), i.e. frequently far ahead of the market price of "black" energy. As a result, owners of the infrastructure face the risk that their regulated revenue, which is calculated ex-ante, may not fully cover the cost of purchasing renewable energy, if, for example, more such capacity is created than was expected. This is indeed the case of solar power plants in the Czech Republic in 2010. Until recently, there had been little interest in such installations due to their high cost and low efficiency in the local environment, but the situation changed dramatically in 2008, when the crisis led to a plunge in the price of photovoltaic cells, while the preferential pricing of solar energy did not change much as the relevant law guaranteed that tariffs for electricity from renewable sources may not decrease by more than 5% y/y. An increase in the profitability of such projects led to a rapid increase in their number. Early this year, 460 MW of such capacity was connected to the network, and output figured to 50 GWh in May. Given that the price per 1 MWh of electricity from solar power plants opened in 2009 was set at CZK 13,100 (and the average effective selling price of CEZ's "black" energy in 2010 is CZK 1,300), the value of energy distributors have to purchase each month exceeds CZK 650m. In the summer, we have observed continued growth in photovoltaic installed capacity that has not been provided for in the tariffs, which will have a direct impact on the profitability of CEZ's Distribution segment. In May, this deficiency of the Czech law was removed (the amendment makes it possible to cut feed-in tariffs by more than 5% y/y if the payback period on a project falls below 11 years), which will facilitate tariff determination for the regulator and allow distributors to return to full return on RAV.

### Growth of solar power plants in Czech Republic (power, number of projects)



Source: ERU

### Change in Accounting Approach to Network Access Fees

In 2010, Polish power utilities changed their accounting approach to network access fees charged of new clients connected to their distribution networks. Until then, the companies had recognized the value of access fees and assets received for free (e.g. city street lighting systems) as accruals in liabilities in the balance sheet. These sums were then recognized as revenue in proportion to the depreciation of the associated assets (over 35 years). Starting in 2010, Polish utilities follow the IAS and recognize these payments as revenue at the time of receipt (CEZ introduced a similar change in 2009). This new interpretation has a direct impact on

the value of revenue reported in Distribution and leads to an increase in cash, albeit, of course, nothing changes as far as cash flow generation is concerned, and therefore the DCF valuation as well (though the change may have an indirect impact on our multiple-based valuation). According to our estimates and the data presented by the individual companies, if this bookkeeping approach had been in place already last year, Enea's earnings for 2009 would have been some PLN 53m higher, PGE's PLN 90m higher and Tauron's, PLN 61m higher. In H1'2010, the utilities' revenue on this account, recognized under the new methodology, figured to PLN 35m, PLN 39m and PLN 49m, respectively. In the future, the value of this line of revenue will depend on the number of new clients being connected to their networks, but in general it should be assumed that it will structurally support their results.

## Exchange-Based Electricity Sales: Changes in Poland

- Since the start of the year, there has been a clear increase in volumes traded on the spot market as the economic situation started to improve (+76% combined in a 12% increase in prices in transactions).
- The new requirement that 15% of the output must be sold through the power exchange, and PGE's declaration that it will sell all its volumes this way are building the futures market – over the past two months, PPE saw transactions for 2.9 TWh to be supplied in 2011 with prices approaching PLN 194/MWh.
- Exchange-based trading could create a transparent pricing benchmark that could be used in settlements with URE, which so far has questioned wholesale prices, which has had an impact on the utilities' profits in retail and in distribution.
- Were the regulator to accept market prices, the earnings of Polish utilities would increase considerably. In the case of Enea and Tauron, the NPV of this additional revenue figures to a staggering 7% of their current market cap.

It seems that the Polish wholesale electricity market is moving towards a structural shift from the current system where the biggest players in the market enter into bilateral contracts for the following year sometime in late Q3 or Q4, to one based on exchanges, as is the case in Germany or the Czech Republic. This revolution has been triggered by new provisions of Polish energy regulations, which force electricity producers to sell at least 15% of their output through an exchange, although what really makes its quick success likely is the recent declaration of the PGE Management that the Company will sell all the electricity it produces this way. We are already seeing the first signs that a futures market is emerging both on Polish Power Exchange and on other platforms. One sign of this scenario playing out may also be the clear increase in volumes in the spot market. We expect a clear increase in the number of transactions after the Ministry of the Economy introduces regulations concerning tenders, which will flesh out the new law and the companies' duties with regard to exchange-based trading. Of course, we are not assuming that a change in the trading model will have an automatic effect on prices, as it should be of no importance for the parties where the contract they are entering into is concluded, and the price will reflect a demand and supply equilibrium. In our opinion, the most important element of this change, and one that will have a direct impact on Polish utilities, will be the determination of a transparent pricing benchmark which they will be able to use in their negotiations with the energy regulator URE. As a reminder, at the moment the URE questions prices for the purchase of wholesale electricity which retail and distribution companies use in their tariff applications (for network losses in the latter case). Below, we present our calculations concerning the exposure of the individual power utilities to the risk stemming from the URE's determination of a reference price in the wholesale market. According to our estimates, in this scenario of a benchmark being set (for example at PPE) for the price of electricity that URE could accept in its tariff calculations, Enea and Tauron would gain the most in relative terms (with fair value of freed profits amounting to 7.2% and 6.8% of their current value, respectively).

**Income elements exposed to the risk of URE decision with respect to the reference price of electricity**

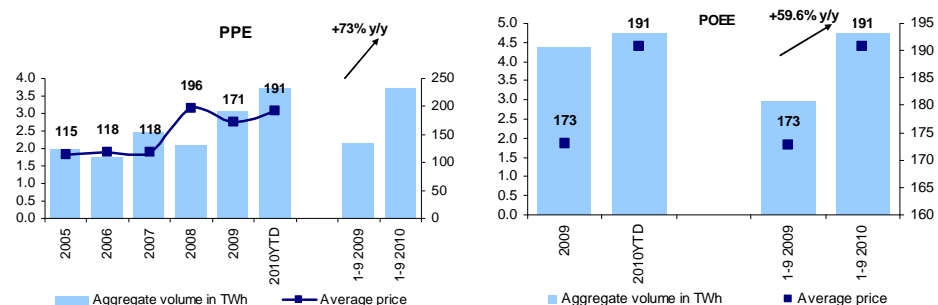
	ENEA	PGE	TAURON
Electricity sales to households (G Tariff)	4.37	8.8	7.5
Average wholesale price in PLH/MWh	190	190	190
Price accepted by the URE, PLN/MWh	175	175	175
<b>Loss on sales to households, PLN m</b>	<b>66</b>	<b>132</b>	<b>113</b>
Distribution volumes	15.7	29.9	30.9
Network losses	1.3	1.7	2.15
Unit cost to cover network losses, PLN/MWh	190	190	190
Cost accepted by the URE	170	170	170
<b>Loss on network losses in distribution</b>	<b>26</b>	<b>34</b>	<b>43</b>
Potential earnings upside per year	92	166	156
EV/EBITDA multiple	5.0	5.0	5.0
<b>Potential added value</b>	<b>458</b>	<b>830</b>	<b>778</b>
As percent of current EV	7.2%	2.1%	6.8%

Source: companies, estimates by BRE Bank Securities

**Current Pricing Trends and Volumes on Trading Platforms**

At the moment, the Polish wholesale electricity market is based primarily on bilateral contracts, which is by and large a consequence of the domination of integrated power utilities. With the top three producers holding 58% of the total installed capacity, the bulk of the trading volumes are generated between their respective power plants and sales units. In 2009, power plants sold a mere 0.3% of their output through the power exchange. Total volumes on the PPE (inclusive of secondary market) were a mere 3.1 TWh (2.1% of total electricity consumption). The alternative trading platform, POEE (owned by PGE) is similar in scale, with 4.4 TWh sold in 2009. This year, however, we are seeing increased activity at the exchanges, which is on the one hand a consequence of the producers' decision to leave a bigger share of their output in the spot market (prices for 2010 in contracts available in late 2009 were below the 2009 average), and on the other might show that the biggest players are testing this channel. At PPE's next-day market, YTD trading volumes figure to 3.7 TWh, which entails a 73% y/y increase. At the same time, the improving economy, and the concomitant increase in the demand for electricity, have pushed spot prices up (YTD average is PLN 191/MWh, +12% y/y). Similar tendencies for trading volumes have been observed on the POEE platform (4.7 TWh YTD, +59%). As a result, these two major exchanges jointly accounted for 8% of the total demand for electricity in H1'10. In addition, we have been observing this year an increase in the number of transactions on the PPE futures market, which was virtually non-existent before. Contracts with supply in 2011 executed so far total 3.9 TWh, of which 76% came in July and August, indicating that the players' activity has to do with the introduction of the legal requirement to sell at least 15% of total output through the exchange, as well as with the advent of the traditional next-year contracting period in August. Given PGE's declarations, we can expect a further increase in volumes traded in exchanges, which should facilitate the development of a transparent pricing benchmark which has been missing so far due to the predomination of bilateral agreements. The average price in contracts for 2011 executed over the past two months on the PPE was PLN 193.9/MWh, which might suggest that prices will rise. For sure, PPE pricing is a factor to watch increasingly closely, as they will reflect the general situation in the market more and more.

**Volumes and prices in spot transactions on PPE, POEE**



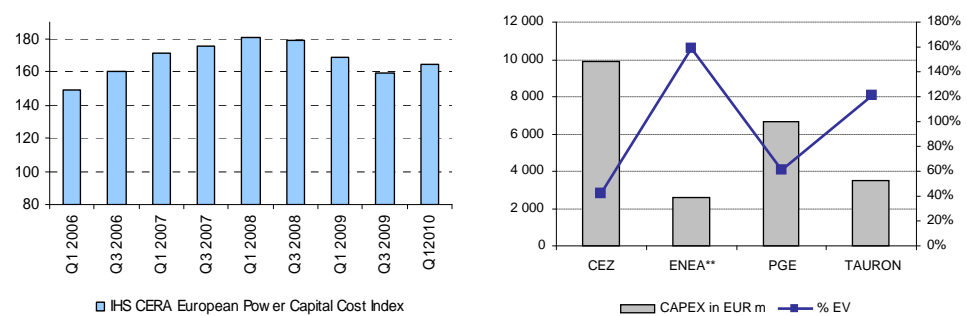
Source: TGE, POEE, estimates by BRE Bank Securities

## Investment Outlays: Overview of the Industry

- The regional electricity market is entering a period of intensified investment efforts, which could be estimated at EUR 23bn for the four listed utilities (conventional generation).
- In the upcoming months, first contracts for new units will be awarded, and this will make it possible to verify the unit cost of capacity construction.
- However, recent contracts signed in Europe and in the world indicate that the cost of investment has decreased, and the IHS CERA index confirms this as well.
- Should it be necessary to reduce the forecasted model by 10%, we would have to increase the valuations of the companies we cover by 5 to 16%.

Polish power utilities are currently entering a period of intensified investment efforts in order to replace old assets and build new capacity, which will allow to accurately respond to the increasing demand. The scale of the planned expenditures is considerable both in terms of the current value of the holdings, as well as their future cashflows. This makes their valuation very sensitive to changes in the unit cost of new capacity construction. In our forecasts, we assume PLN 1.5m and PLN 0.75m as the benchmark cost of additional capacity of 1MW in coal-fired and gas-fired power plants, respectively, which corresponds to the pre-crisis market averages. However, the decline in the cost of steel and in the number of orders, seen last year, has led to a reduction in the average cost of investment in the industry, as shown, for example, by IHS CERA Power Capital Cost Index, which, in the case of Europe, declined by 12% in 2009 relative to the 2008 peak. This year, the index has gone up slightly, but the average costs still remain ca. 10% below those seen during the boom. The data seems to find confirmation in what we learn of prices in contracts signed by the world's major technology suppliers (Alstom, Hitachi, GE). One example could be the contract for the construction of a coal-fired power plant in Slovenia signed towards the end of last year which suggested a per-1MW price of EUR 1.2m. Analogous contracts for gas and steam fired units would suggest investment outlays of EUR 0.5-0.6m. For now it is of course too early to factor in such prices into long-term forecasts, as they will be crucially affected by the situation in the global economy. However, the first contracts to get signed in Poland will surely set a benchmark (towards the end of the year, contracts for new units at Opole PP and Siekierki CHP in Warsaw should be awarded, as well as, possibly, a 1 GW unit at the Kozienice PP), but let us point out that most of these projects are brownfield projects (new units built next to existing infrastructure), which suggests that unit costs should be below the benchmarks (cf. network access costs, water supply etc.) A 10% reduction in investment outlays in 2010-15 would be beneficial for the valuations of all the utilities, but this upside potential is only 6% of the current market cap for CEZ, 6.9% for PGE, 11.6% for Enea and a staggering 16.6% for Tauron.

### Investment costs in the power industry\* and outlays on new capacity\*\*\* and their share in the current value (EV) of power utilities



\* The index does not factor in the cost of construction of nuclear power plants

\*\* In the case of Enea, the CAPEX figure does not include the second new unit at the Kozienice PP (1 GW), as the final decision whether to go ahead with it is yet to be made.

\*\*\* For Polish companies, we only take into consideration spending on conventional generation (2010-2015 CAPEX)  
Source: CERA, estimates by BRE Bank Securities

## Sum of the Parts Valuation

- We have prepared a sum of the parts valuation for reference purposes, which shows that there are considerable differences in how the market views the value of the individual utilities.
- Polish power utilities are trading at a discount to CEZ, which can partially be attributed to the quality of its power-generation assets (their age, emissions) and

to the scale of investment projects under planning; these discrepancies should partially offset by the expected convergence of electricity prices (e.g. in 2009: CEZ EUR 54/MWh, PGE EUR 47.5/MWh).

- The results are surprising for Enea and Tauron, for which the high CAPEX discounts are irrational – particularly at Tauron, where the “worthless” Generation segment brings PLN 1bn in EBITDA per year.

Given the big discrepancies between the valuations of regional power utilities, not only between CEZ and the Polish companies, but also among the latter, we have prepared a sum of the part valuation for the four companies. In the calculations presented below, we have used the same valuation methods for individual segments, so as to obtain the current “market value” of assets involved in electricity generation, which is the most controversial issue and the likely factor behind valuation differences. It is worth pointing out that in the case of the distribution business, this methodology results in similar value per volume transferred being obtained for all the networks (all within 7% of the mean). Considerable differences appear in the case of electricity sales, where, given profitability differences, the implied value of 1MWh of electricity sold varies between EUR 6.6-15.2. However, we believe it is the implied valuation of the generation segment that is most informative. The intuition that CEZ's generation assets should be valued the most (nuclear power plants, low emissions) gets confirmed: investors estimate the average value of the Company's installed capacity at ca. EUR 2m, vs. PLN 0.6m for PGE. Of course, an analysis of such multiples must be carried out in the context of the quality of power plants, their age, any capacity shut-down plans, and investment plans. By way of example, a comparison of FY2011 EV/EBITDA (generation) for these two companies, while still suggestive of a relative undervaluation of PGE, implies a lower discount of 14%. Disproportions are greater for Enea and Tauron, in whose case, although they have considerable generation assets that generate considerable cash flows, investors tend to focus on their relatively expensive investment programs. In our opinion, however, it is hard to find a rational justification for such big discounts in the valuation of these power plants, best illustrated by the “0” value implied for Tauron's 5.4 GW installed capacity, which generates PLN 1bn in EBITDA per year (PLN 0.65bn excluding compensation for long-term contracts).

### Sum of the Parts Valuation

	CEZ	ENEA	PGE	TAURON
Share price	820.5	20.5	23.78	5.56
MCap	441 421	9 050	44 463	9 744
FY2009 net debt	158 596	-2 387	-2 015	744
Minority interests	6 314	24	4 281	347
<b>EV</b>	<b>606 331</b>	<b>6 687</b>	<b>46 730</b>	<b>10 835</b>
<b>Minority interest in companies, other assets</b>	<b>46 660</b>	<b>227</b>	<b>3 417</b>	<b>0</b>
<b>Distribution</b>	<b>92 432</b>	<b>4 194</b>	<b>9 279</b>	<b>8 188</b>
2010 transfer volumes in TWh	54.1	16.7	31.7	31.8
value in EUR/MWh	68.7	62.7	73.1	64.3
<b>Coal Mining</b>	<b>23 616</b>	<b>0</b>	<b>2 595</b>	<b>1 071</b>
EBITDA	4 723	0	519	214
EV/EBITDA	5.0	5.0	5.0	5.0
<b>Renewable Energy</b>	<b>66 931</b>	<b>0</b>	<b>2 509</b>	<b>719</b>
EBITDA	8 366	0	314	90
EV/EBITDA	8.0	8.0	8.0	8.0
<b>Trade</b>	<b>15 886</b>	<b>938</b>	<b>1 665</b>	<b>823</b>
2010 EBITDA	3 971	234	416	206
EV/EBITDA	4.0	4.0	4.0	4.0
volume	41.9	17.5	30.48	31.312
value in EUR/MWh	15.2	13.4	13.7	6.6
<b>Implied value of the Generation segment</b>	<b>360 806</b>	<b>1 327</b>	<b>27 264</b>	<b>33</b>
Installed capacity (GW)	14.6	2.9	10.8	5.4
value in EUR/MWh	993	115	632	2
Output in TWh	70.0	12.2	52.1	18.7
value in EUR/TWh	206.9	27.1	130.7	0.4
2010 EBITDA	60 348	489	4 072	1 074
FY10 EV/EBITDA	6.0	2.7	6.7	0.0
2011 EBITDA	54 552	505	4 706	1 017
FY11 EV/EBITDA	6.6	2.6	5.8	0.0
Effective electricity price (EUR/MWh)	54.0	47.5	47.5	47.5

Source: CEZ, Enea, PGE, Tauron, estimates by BRE Bank Securities.

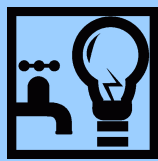


### Assumptions Underlying the Above Calculations

- In the case of PGE and Tauron, we take into account share capital increases which reduce minority interest as part of consolidation processes.
- We adjust all the companies' net debt as of the end of 2009 for any possible dividend payments this year.
- We reduce enterprise value by the value of non-operating assets (minority stakes in other companies).
- We estimate the value of the distribution business from the current RAV (CEZ) or based on a simplified DCF model.
- We have valued the coal mining businesses using an arbitrary EV/EBITDA.
- In the case of the renewable energy business, we have used a multiple of 8x FY10 EBITDA; in the case of CEZ, this segment includes Romanian wind farms and solar power plants in the Czech Republic (2011 EBITDA), which are then ignored in the analysis of the generation segment.
- We have valued the trading business using a multiple of 4x FY10 EBITDA (in the case of CEZ we have separated distribution companies out of its Distribution and Sales segment).
- The implied value of the electricity generation business is the difference between the current market EV and the estimated value of all the other segments.

13 September 2010

Update


**Energy**

Czech Republic

<b>Current price</b>	<b>PLN 131.0</b> (CZK 827.8)
<b>Target price</b>	<b>PLN 140.3</b> (CZK 878.8)*
Market cap	PLN 70.5bn (CZK 441bn)
Free float	PLN 20.7bn (CZK 130bn)
Average daily trading (3M)	PLN 8.8m

\*at CZK/PLN=0.1597
**Shareholder Structure**

Czech Finance Ministry	69.37%
Czech Labor Ministry Treasury stock	0.41%
Treasury stock	0.89%
Others	29.33%

**Sector Outlook**

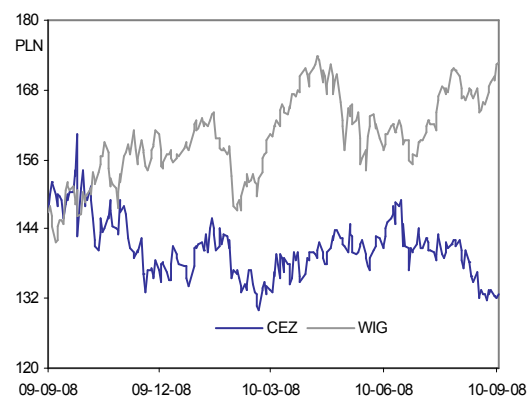
In 2009, European energy companies sold electricity at record-high prices, hedged back in 2007-2008. 2010 is much less buoyant price-wise because the effective hedged levels are much lower, and no rebound for volumes and spot prices is in sight. It appears that these trends might persist into next year.

**Company Profile**

CEZ is the leading Czech producer (60.9 TWh, 73% market share) and supplier (45% market share) of electric power. In addition to the Czech Republic, the company runs power-generation operations in Bulgaria and Poland, and distributes electricity in Bulgaria (40% market share) and Romania (18%). Through recent acquisitions, CEZ has also established itself in Turkey.

**Important Dates**

09.11- Q3 2010 report

**CEZ vs. WIG**

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# CEZ

CEZP.WA; CEZ PW

## Hold

(Reiterated)

### 2011 Electricity Prices Now Set

**CEZ's 2010 profits are being weighed down by additional costs of mandatory solar-energy purchases which might prevent the company from delivering its full-year EBITDA target. Next year, price hedges at EUR 52/MWh entered into for the bulk of the projected output are going to act as a screen against any positive price movements on the EEX, but the earnings of the Power Production segment will be supported by new wind- and solar-energy projects. That said, we still consider CEZ a less attractive investment than more reasonably priced Polish power producers, and we rate the Czech utility as a hold while raising our price target to PLN 140.3 per share.**

**Distribution earnings under pressure from solar energy costs**

CEZ's Power Distribution business disappointed with Q2 2010 EBITDA of CZK 3.7bn vs. our CZK 4.6bn estimate. The main source of the disappointment were the Czech operations, which incurred higher expenses on mandatory purchases of solar energy (in Q1, a seasonally lower renewable-energy output kept these expenses within budget) from photovoltaic power plants which have been driving up their capacities and production levels. For CEZ, which controls about 65% of the Czech electricity distribution network, this means green-energy expenses in excess of CZK 2bn this year. The impact of the renewable-energy requirement on next year's earnings of the Distribution segment will be minimized after CEZ factors the increased production in the new tariff, and thanks to regulatory amendments which will reduce the profitability of solar power.

**Investment in renewable energy**

The launch of operations at Romanian wind farms is expected to reflect positively on CEZ's profits in H2 2010. In 2011, after all the turbines are up and running (the company is determined to keep to the schedule in spite of administrative bottlenecks), the farms may generate an EBITDA of over CZK 5bn. The 2011 earnings of the Power Generation segment (which has already hedged a major portion of next year's sales volumes at a level EUR 2 lower per megawatt hour than last year's prices) will be further supported by solar power plants. CEZ intends to purchase solar cells with a combined capacity of 300 MW (the cells are already connected to the grid to ensure that they fall under the high tariffs provided for in the "old" laws) for CZK 25 billion. We estimate the 2011 "solar" EBITDA at CZK 3.3bn, with the added benefit of a tax vacation.

(CZK m)	2008	2009	2010F	2011F	2012F
Revenue	183 958.0	196 352.0	199 223.5	204 001.5	215 865.0
EBITDA	88 744.0	91 075.0	85 877.8	91 344.5	97 774.8
<i>EBITDA margin</i>	48.2%	46.4%	43.1%	44.8%	45.3%
EBIT	66 654.0	68 199.0	61 928.9	64 924.4	69 864.7
Net income	46 510.0	51 547.0	46 176.3	48 508.5	52 872.8
DPS	40.00	49.34	53.00	48.99	51.46
P/E	10.4	8.6	9.6	9.1	8.3
P/CE	7.1	5.9	6.3	5.9	5.5
P/BV	2.8	2.2	2.0	1.8	1.7
EV/EBITDA	6.6	6.3	7.4	7.3	7.0
DYield	4.9%	6.0%	6.5%	6.0%	6.3%

## CEZ Reports Weaker-Than-Expected Q2 2010 EBIT In Distribution

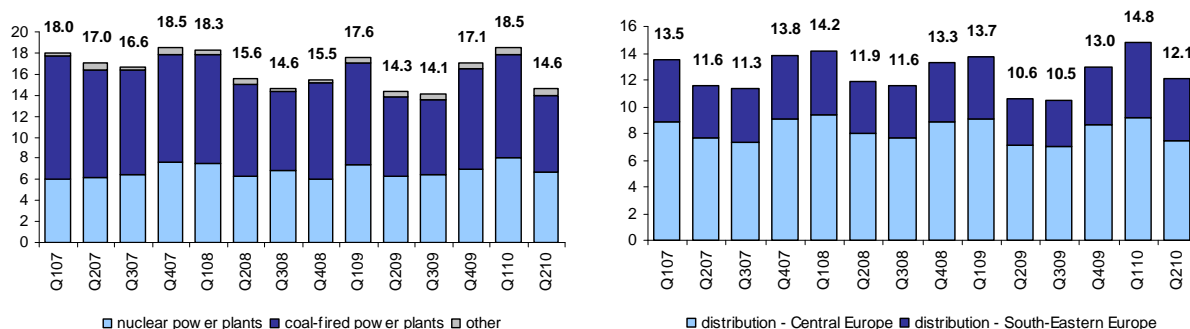
### Reported vs. forecasted Q2 2010 results

(PLN m)	2Q 2010	2Q 2009	change	2Q 2010F	Actuals vs. Forecasts	Consensus Estimates	Actuals vs. Consensus
Revenues	44 797.0	43 109.0	3.9%	42 323.1	5.8%	44 040.2	1.7%
EBITDA	19 856.0	21 599.0	-8.1%	20 420.6	-2.8%	20 443.7	-2.9%
EBITDA margin	44.3%	50.1%	-11.5%	48.2%	-	46.4%	-
EBIT	14 065.0	16 047.0	-12.4%	14 883.6	-5.5%	14 601.7	-3.7%
Pre-tax income	13 292.0	19 176.0	-30.7%	14 446.9	-8.0%	13 844.4	-4.0%
Net income	11 204.0	15 766.0	-28.9%	11 493.3	-2.5%	11 155.5	0.4%

Source: CEZ, F – forecasts by BRE Bank Securities; Consensus estimates by PAP

CEZ's Q2 2010 EBITDA in excess of CZK 19.8bn missed the forecasted figure by a little under 3%, and represents 54% of our full-year estimate. The gap between expected and reported EBIT was higher because of high D&A expenses. A breakdown by business segments shows a strong EBITDA in Power Generation (at CZK 13.8bn vs. CZK 13.6bn forecasted) which booked additional gains from revaluation of CO<sub>2</sub> allowances (CZK 1.1bn) on 5% lower production volumes.

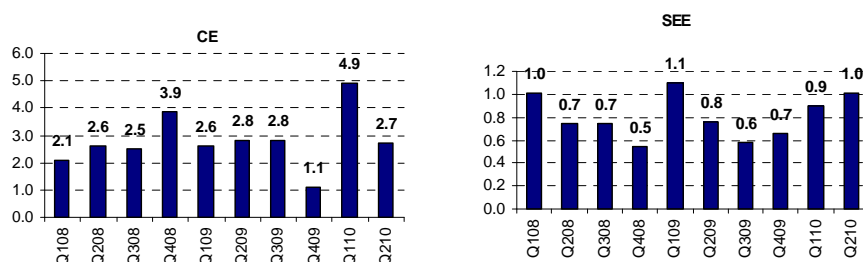
### Quarterly generation volumes for Czech operations, distribution volumes by region (TWh)



Source: CEZ

CEZ's Power Distribution business disappointed with a second-quarter EBITDA of CZK 3.7bn vs. our CZK 4.6bn estimate. The main source of the disappointment were Czech operations, which incurred higher expenses on mandatory purchases of solar energy (in Q1, a seasonally lower renewable-energy output kept these expenses within budget). This indicates that the segment's strong first-quarter results were a one-off, and that any increase in future tariff revenues will be more than offset by higher expenditure on renewable energy, prompting revisions in our forecasts for the segment.

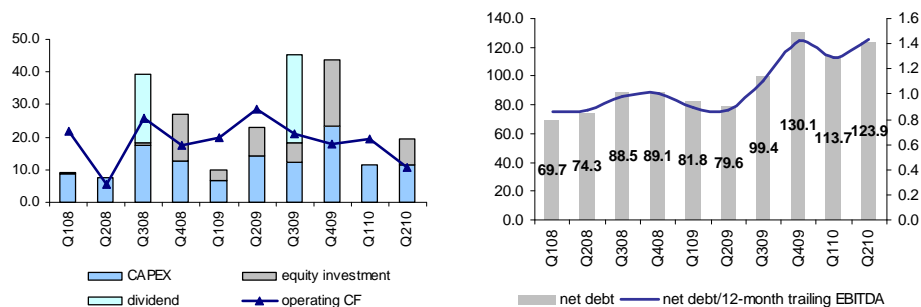
### Power Distribution EBITDA by region (CZK bn)



Source: CEZ

In Mining, an unpredicted increase in unit coal costs caused EBITDA to miss our estimate by an 11% margin. Further, CEZ reported higher-than-predicted financial expenses (CZK 773m vs. CZK 436m) because of high finance losses generated by investments accounted for using the equity method (a CZK 435m charge), arising on acquisitions in Turkey and Germany. Thanks to a lower-than-expected tax charge (the effective tax rate was 15%), the second-quarter net profit missed our estimate by just 2.5%.

### Consolidated cash flows and net debt



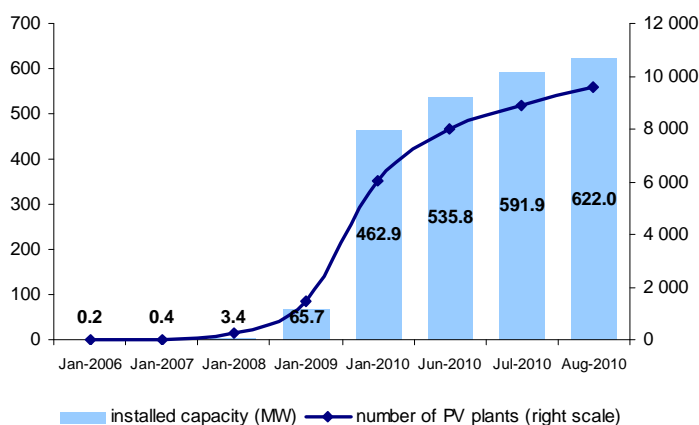
Source: CEZ

We want to point out CEZ's low Q2 operating cash flows which were affected by a negative working capital. A high CAPEX, combined with the acquisitions of Dalkia CR and Dalkia Usti nad Labem, drove net debt up to 123.9bn from 113.7bn crowns reported in the preceding quarter. After a CZK 28.5bn dividend payout in Q3, net debt this quarter is even higher.

## Solar Energy Investment and Costs

The Czech Republic has adopted a feed-in tariff policy to promote energy production from renewable sources, under which electric utilities are required to purchase green energy from all eligible producers. These purchases are considered reasonable costs and are factored in energy tariffs, however, since the tariffs are determined based on the regulator's advance production estimates, there is a risk of miscalculation. This is the case with solar energy this year, as flawed regulation has led to a boom in solar plants (which generate higher returns at lower costs) leading to production volumes that have far exceeded expectations: at the beginning of the year, over 460 MW of solar power was connected to the Czech grid, compared to 65 MW at the start of 2009 (with May volumes at 50 GWh). With the price of one solar megawatt set at CZK 13,100 (the 2010 average effective selling price of CEZ's coal-fired energy is CZK 1,300), the cost of mandatory purchases for power distributors can be as high as CZK 650m in a sunny month. The continued expansion of photovoltaic (PV) capacity observed this summer, not foreseen in transmission tariffs, is going to affect the profitability of CEZ's distribution business (which controls 62% of the national distribution network). We estimate the resulting charges against Q3 profits at CZK 1.5-2.0 billion.

### Expansion of Czech solar power plants (by capacity and number of plants)



Source: ERU

In May, Czech lawmakers adopted measures to curb the solar boom (allowing distributors to reduce the feed-in tariffs by 5% annually for PV plants that provide a return on investment in less than 11 years), facilitating more accurate tariff projections by the regulator, and allowing distributors to recover full returns on the regulatory asset base – prospects which are factored in our financial forecasts. Our forecasts also include CEZ's own plans with respect to solar energy – the company plans to acquire PV projects that are scheduled to be connected to the grid by December 2010 under the old lucrative tariffs. CEZ's original solar-investment budget

was set tentatively at CZK 25 billion, covering about 300 MW of installed photovoltaic cell capacity. Given that the company has purchased 102.5 MW-worth of capacity to date, it seems that project delays will prevent it from spending the whole budget by the end of the year. Nevertheless, we are assuming that CEZ will launch ca. 300 MW of solar power capacity in 2011, and we estimated the earnings-generating potential of this new business outlined in the following table.

**Earnings projections for CEZ solar power plants**

(CZK m)	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F
<b>Revenues</b>	<b>3 432</b>	<b>3 484</b>	<b>3 536</b>	<b>3 589</b>	<b>3 643</b>	<b>3 698</b>	<b>3 753</b>	<b>3 810</b>	<b>3 867</b>
power output (GWh)	283	283	283	283	283	283	283	283	283
feed-in tariff	12 150	12 332	12 517	12 705	12 896	13 089	13 285	13 485	13 687
<i>CUR</i>	10.8%	10.8%	10.8%	10.8%	10.8%	10.8%	10.8%	10.8%	10.8%
<b>Operating expenses</b>	<b>1 013</b>	<b>1 016</b>	<b>1 016</b>	<b>1 016</b>	<b>1 016</b>	<b>1 016</b>	<b>1 016</b>	<b>1 016</b>	<b>1 016</b>
Depreciation	833	833	833	833	833	833	833	833	833
running costs	180	183	183	183	183	183	183	183	183
<b>EBIT</b>	<b>2 419</b>	<b>2 468</b>	<b>2 520</b>	<b>2 573</b>	<b>2 627</b>	<b>2 682</b>	<b>2 737</b>	<b>2 794</b>	<b>2 851</b>
<b>EBITDA</b>	<b>3 252</b>	<b>3 301</b>	<b>3 354</b>	<b>3 407</b>	<b>3 460</b>	<b>3 515</b>	<b>3 571</b>	<b>3 627</b>	<b>3 684</b>
Tax	0	0	0	0	0	510	520	531	542
<b>Net income</b>	<b>2 419</b>	<b>2 468</b>	<b>2 520</b>	<b>2 573</b>	<b>2 627</b>	<b>2 172</b>	<b>2 217</b>	<b>2 263</b>	<b>2 309</b>

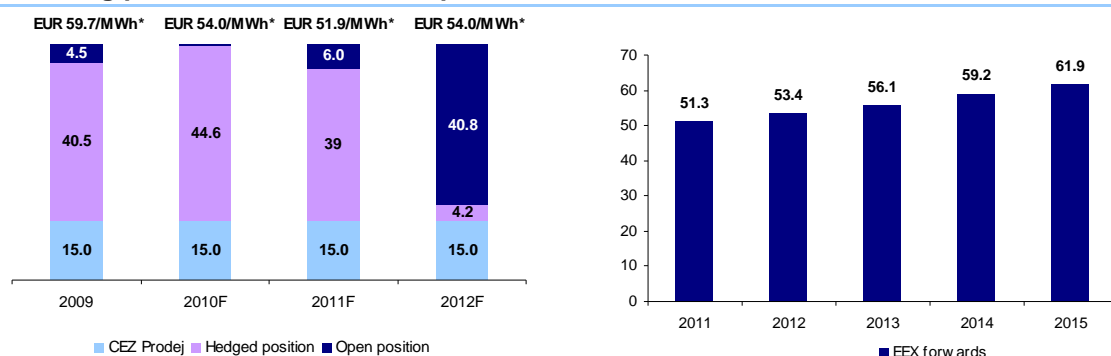
Source: BRE Bank Securities, CEZ

These forecasts are based on the following assumptions:

- CEZ buys 300 MW of PV capacity for CZK 25bn by December;
- Average CUR at 10.8%;
- Average unit cost at CZK 0.6m/MW
- PV plants benefit from five-year tax holidays;
- The depreciation period is 30 years;
- Feed-in tariff for solar power at CZK 12,150/MWh, to be adjusted for PPI (1.5% annually, the same as for unit operating costs).

**Energy Price Hedging**

In its latest presentation for investors, CEZ announced that it had hedged 90% of its 2011 power-generation output at an average 52 EUR/MWh at 31 July. Further, the company entered into hedging contracts for 32% of the volumes projected for 2012 and 8% of the 2013 output, at respective levels of 51 EUR/MWh and 54 EUR/MWh, slightly lower than recent EEX quotes. The hedged 2012-13 volumes are not high enough to stop CEZ from benefitting from potential price hikes in Europe, but it must be noted that there is a lag between movements in market energy quotes and their materialization in earnings. 2011 will still see a decline in effective electricity prices, but this will be partly offset by the expected increase in volumes and revenue contributions from new Romanian wind farms. Hence, our 2011 EBIT forecast for the Generation Segment is similar to this year's estimate. Note also that CEZ stands to benefit from a possible further increase in the prices of CO<sub>2</sub> emission credits (which led to a CZK 2bn revaluation gain on held-for-trading credits in H1 2010).

**CEZ's selling price estimates vs. EEX quotes**


\*based on our forecasts of forward electricity prices  
Source: BRE Bank Securities, CEZ, Bloomberg

## Romanian Wind Farms

CEZ commenced trial runs of the first of its two planned large wind farms in Romania in June. Located in the village of Fantanele, the farm will eventually consist of 139 turbines with a combined capacity of 347.5 MW. At 30 June, 114 turbines were completed, and 47 were connected to the grid, indicating a delay about six months relative to the original schedule. Phase two of the project, based near the village of Cogealac (101 turbines, 252.5 MW capacity), should be completed on time in late 2010 in spite of administrative bottlenecks (CEZ's permits are being questioned). The total costs of the Romanian wind project are estimated at PLN 1.1bn (CZK 30bn), of which CZK 10.6bn is the price paid for the project in 2008, and CZK 10.5bn has already been spent on construction by June 2010. The cost of one megawatt implied by these values is ca. EUR 1.8m, which is more than the average estimated by EWEA for 2009 (EUR 1.2m). The higher cost stems from the premium that CEZ had to pay to the project developer, and it should be offset by the incentives put in place by the Romanian government, under which wind energy producers are given two green certificates per each megawatt hour delivered into the grid (the allocations will be reduced to one certificate per MWh in 2017). The certificates can be sold to power suppliers required to meet green-energy quotas, by way of bilateral contracts or via the OPCOM power exchange. Until 2014, the prices of green certificates are fixed at EUR 27 minimum and EUR 55 maximum. Suppliers who do not meet the annual green energy quotas (the 2010 quota is 8.3%, to be raised to 17% by 2020) are fined 110 EUR/MWh. Because of a shortage of renewable energy, Romanian green certificates are currently trading at the top end of their regulatory price range, i.e. at EUR 55.

### Earnings projections for CEZ's Romanian wind farms

(CZK m)	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F
<b>Revenues</b>	<b>663</b>	<b>5 682</b>	<b>5 541</b>	<b>5 622</b>	<b>5 556</b>	<b>5 753</b>	<b>5 913</b>	<b>4 180</b>	<b>4 298</b>	<b>4 374</b>
electricity sales	177	1 515	1 583	1 768	1 910	2 107	2 267	2 357	2 475	2 551
green certificates	486	4 167	3 959	3 854	3 646	3 646	3 646	1 823	1 823	1 823
power output (GWh)	169	1 452	1 452	1 452	1 452	1 452	1 452	1 452	1 452	1 452
<b>Operating expenses</b>	<b>358</b>	<b>1 568</b>	<b>1 540</b>	<b>1 526</b>	<b>1 497</b>	<b>1 497</b>	<b>1 497</b>	<b>1 497</b>	<b>1 497</b>	<b>1 497</b>
Depreciation	292	1 000	1 000	1 000	1 000	1 000	1 000	1 000	1 000	1 000
running costs	66	568	540	526	497	497	497	497	497	497
<b>EBIT</b>	<b>305</b>	<b>4 114</b>	<b>4 001</b>	<b>4 097</b>	<b>4 059</b>	<b>4 256</b>	<b>4 416</b>	<b>2 682</b>	<b>2 801</b>	<b>2 877</b>
<b>EBITDA</b>	<b>597</b>	<b>5 114</b>	<b>5 001</b>	<b>5 097</b>	<b>5 059</b>	<b>5 256</b>	<b>5 416</b>	<b>3 682</b>	<b>3 801</b>	<b>3 877</b>

Source: BRE Bank Securities, CEZ

These forecasts are based on the following assumptions:

- The rate of wind-capacity addition to the grid is as scheduled by CEZ (600 MW to be connected after the beginning of 2011);
- CUR at 28% (based on measurements by the developer);
- Prices of green certificates at EUR 55 throughout the farms' useful life (30 years);
- Energy prices in Romania remain at the current EUR 40/MWh in 2010 and 2011, followed by a period of convergence to EEX levels (expected to be reached in 2016);
- Running costs equivalent to the averages recorded by EWEA for onshore wind farms (EUR 15/MWh);
- Depreciation period is 30 years.

Using these assumptions, we estimate that the Romanian wind farms can generate an EBITDA of CZK 5bn in 2011. The project's net present value (at a WACC of 7%) is estimated at over CZK 23bn, and the ROI period is about 10 years.

## Joint Ventures and Minority Investments – Update

In 2009, CEZ became involved in a number of new projects, either as a minority stakeholder or a 50% joint-venture partner. These investments amounted to CZK 25bn before a CZK 3.6bn acquisition of a 15% interest in Dalkia CR in H1 2010. The following is a recapitulation of the major investments (which are included at cost in our valuation model), with updated projections concerning their earnings potential and impact on CEZ's profits.

### MIBRAG Lignite Mine

In June 2009, CEZ's subsidiary Severoceske Doly bought a 100% stake in the German mining company MIBRAG in a 50:50 joint venture with J&T for a total price of EUR 404m. MIBRAG operates two lignite mines near Leipzig (Profen and United Schleenhain) with a total output of 19M tons and estimated coal reserves of 530M tons. Most of the lignite is sold through long-term contracts to two big power plants, Lippendorf (1800 MW) and Schkopau (900 MW), as well as to three MIBRAG CHPs whose total installed capacity is 208 MW (cogeneration of heat and energy). CEZ recognizes the earnings of the joint venture that made the acquisition in its consolidated statements, including the acquisition costs which, until recently, comprised interest on borrowings from CEZ and J&T, EUR 270m of which were refinanced with a bank loan in Q2 2010. The refinancing should not affect the JV's profit contributions, but it will cause a small reduction in CEZ's interest income (the interest charged on the JV loan was probably higher than the market rate for deposits).

#### Overview of MIBRAG's financial and operating data

(EUR m)	2006	2007	2008	2009	2010F	2011F	2012F
Revenues	371.6	372.5	404.7	419.7	406.5	426.3	439.4
EBITDA	124.0	128.5	120.6	139.5	129.1	134.0	135.5
EBITDA margin	33%	34%	30%	33%	32%	31%	31%
EBIT	50.9	50.8	39.2	63.4	56.2	64.1	68.4
Net income	36.8	39.8	31.8	51.9	48.8	58.2	64.5
CEZ's equity in income*	0.0	0.0	0.0	8.2	14.7	16.9	19.1
Coal output (MMT)	19.9	18.6	19.0	19.7	19.7	19.7	19.7
P/E*	11.0	10.2	12.7	7.8	8.3	6.9	6.3
EV/EBITDA**	3.5	3.4	3.6	3.1	3.3	3.2	3.2

\*after JV costs of financing

\*\*calculated based on EUR 404m acquisition price and net debt as at year-end 2009

Source: CEZ

### Investment in Dalkia CR

In November 2009, CEZ acquired an 85% stake in Dalkia Usti nad Labem, with an option to buy the remaining 15% interest, from Dalkia Ceska Republika (CR), for CZK 6.3bn (the payment consists of a fixed component and a variable component determined on the basis of financial performance). Under the same agreement, CEZ will also pay CZK 3.6bn for a 15% stake in Dalkia CR, which is currently controlled by Dalkia, a joint venture of EDF (34%) and Veolia Environment (66%). Dalkia Usti nad Labem is fully consolidated by CEZ as Teplarna Trmice, while the 15% interest in the earnings of Dalkia CR is recognized as equity in income of investments accounted for under the equity method. In 2009, Dalkia CR contributed CZK 362m, or 0.7%, to CEZ's consolidated net earnings. Dalkia CR is included in our valuation model at cost which implies FY2009 P/E and EV/EBITDA ratios of 9.9 and 5.8 respectively.

#### Financial and operating data for Dalkia CR

(CZK m)	2006	2007	2008	2009
Revenues	9 455	10 055	10 979	12 761
heat	-	5 601	6 056	6 512
electricity	-	4 165	4 536	5 939
other	-	289	387	310
EBITDA	3 263	4 037	4 062	4 263
EBITDA margin	34,5%	40,1%	37,0%	33,4%
EBIT	2 202	2 929	2 899	3 108
Net income	1 593	2 204	2 163	2 415
Net debt	1 787	1394	1 115	703
Heat output (TJ)	17 919	17 941	18 394	16 340
Electricity output (GWh)	2 440	2 432	2 055	2 574

Source: CEZ

### Prazska Teplarenska

CEZ signed an agreement concerning the acquisition of a 48.67% interest in Prazska Teplarenska (PT) back in July 2009, but the deal has not been finalized yet pending deliberations by the Czech anti-monopoly authority and the European Commission. However, CEZ has already paid the agreed price of CZK 12.9bn, implying a FY2009 P/E of 12.2 and an

EV/EBITDA of 7.1. Pending necessary approvals, CEZ has classified PT as a long-term financial asset which does not contribute to consolidated earnings. We assume that PT will start to materialize in CEZ's per-tax income from investments accounted for under the equity method in Q1 2011 (the contribution to 2009 pre-tax income would have been CZK 1bn, i.e. 2.1% of the consolidated total). As a reminder, PT is the largest heat supplier to the residents of Prague, and its installed heat- and electric-power capacity is 1.7 GW and 138 MW respectively. Further, PT's subsidiary Energotrans owns a combined-cycle plant with an installed capacity of 352 MW, in Melnik (where CEZ wants to build a CCGT unit). Last but not least, Prazska Teplarenska owns over 600 kilometers of heating pipes and caters to 250,000 households. PT's other shareholder (47.33%) is the Prazska Teplarenska Holding, which is 51% owned by the City of Prague and 49% owned by Germany's EnBW Energie-Baden Württemberg AG. PT is included in our valuation model at cost (CZK 24 per CEZ share).

#### Historical and forecasted earnings of Prazska Teplarenska

(CZK m)	2005	2006	2007	2008	2009	2010F	2011F	2012F
<b>Revenues</b>	<b>6 639</b>	<b>7 109</b>	<b>7 074</b>	<b>8 235</b>	<b>8 919</b>	<b>8 380</b>	<b>9 152</b>	<b>9 447</b>
heat	4 616	4 866	4 749	5 284	5 467	5 260	5 853	6 035
electricity and other sales	2 023	2 243	2 325	2 951	3 452	3 120	3 298	3 413
<b>EBITDA</b>	<b>2 368</b>	<b>3 114</b>	<b>2 573</b>	<b>2 883</b>	<b>3 440</b>	<b>3 176</b>	<b>3 019</b>	<b>3 051</b>
EBITDA margin	36%	44%	36%	35%	39%	38%	33%	32%
EBIT	1 576	2 320	1 785	2 132	2 666	2 372	2 185	2 191
<b>Net income</b>	<b>1 148</b>	<b>1 776</b>	<b>1 549</b>	<b>1 760</b>	<b>2 175</b>	<b>1 898</b>	<b>1 749</b>	<b>1 753</b>
CEZ's equity in net income	0	0	0	0	0	0	851	853

Source: Prazska Teplarenska, forecasts by BRE Bank Securities

#### Investments in Turkey

In February 2009, CEZ together with its Turkish partner Akkok and Akasterii (in which CEZ owns a 37.4% stake) finalized the purchase of the Turkish distributor SEDAS for a total of USD 600m, of which USD 300m has already been paid, with the remainder to be paid in two equal installments in 2010 and 2011. The transaction was carried out by a special purpose vehicle called Akcez Enerii, owned by CEZ (27.5%), Akanerii (45%) and Akkok (27.5%). CEZ purchased a 37.36% stake in Akenerji in May 2009 for US \$302m, and, together with Akkok, it now controls 75% of the company's equity (the two shareholders acquired US \$200m in new shares in April 2010, of which CEZ paid \$76m). As a reminder, SEDAS serves some 1.3m clients (half of whom are industrial buyers) and distributes 8 TWh of energy per year (Turkey's total consumption is approximately 170 TWh per year), and Akenerji's total natural-gas-fired capacity of 357 MW represents a 2% market share (2009 output was 2.1 TWh). CEZ's non-controlling interests in the Turkish investments are recognized as equity in investments accounted for under the equity method (SEDAS is consolidated through the acquiring joint venture Akcez Enerji, and its contributions include costs of financing). Akenerji generated a net loss of \$19m in H1 2010 because of high debt-service costs, lower prices and excess supply of electricity in Turkey, and losses generated by SEDAS (\$7.7m). As a result, CEZ reported a H1 2010 loss of ca. \$12m (CZK 230m) under investments accounted for under the equity method. This line item is expected to show better results in the future, thanks to new power-plant launches (including 373 MW of hydroengineering capacity and a 900 MW gas-fired plant scheduled to start operations in mid-2013). A gradual earnings improvement is also expected of SEDAS, which will benefit from new regulation concerning returns on the regulatory asset base. CEZ's Turkish investments are recognized in our valuation model at cost, but we want to point out that the implied total price paid for Akenerji is about \$1 billion, while its current market cap is \$930m.

**Historical and forecasted earnings of Akenerji**

(USD m)	2006	2007	2008	2009	2010F	2011F	2012F	2013F
Revenues	302.0	346.6	464.9	298.5	210.4	403.9	442.1	844.0
EBITDA	0.7	-2.8	75.6	33.2	41.7	115.7	130.0	222.0
EBITDA margin	0%	-1%	16%	11%	20%	29%	29%	26%
EBIT	-39.7	-42.2	51.5	15.2	20.5	91.5	103.5	189.3
Net income	-41.5	-30.4	68.3	16.0	-2.2	45.2	55.4	118.9
CEZ's equity in net income	0.0	0.0	0.0	3.0	-0.8	16.9	20.7	44.4
P/E	-	-	11.8	50.4	-361.2	17.9	14.6	6.8
EV/EBITDA	-	-	12.7	28.8	23.0	8.3	7.4	4.3
<b>Installed capacity (MW)</b>	<b>541</b>	<b>541</b>	<b>496</b>	<b>358</b>	<b>417</b>	<b>659</b>	<b>689</b>	<b>1 196</b>
gas-fired	541	541	496	358	358	358	358	808
hydroelectric	-	-	-	-	44	286	316	373
wind	-	-	-	-	15	15	15	15
USD/TRY exchange rate	1.44	1.30	1.31	1.55	1.52	1.50	1.43	1.39

Source: Akenerji, forecasts by BRE Bank Securities

**Earnings Forecast and Valuation**

Using DCF analysis and relative valuation, we set the price target on CEZ at CZK 878.8, or PLN 140.3, per share (CZK/PLN=0.1597), and we rate the stock as a hold.

	Weight	Price
Relative valuation	50%	719.9
DCF analysis	50%	928.8
	price	824.3
	<b>9M target price</b>	<b>878.8</b>

**DCF analysis****DCF Model Assumptions**

- The model is based on the following assumptions concerning the prices of electricity, and fuels, F/X rates and production and sales volumes.

	2007	2008	2009	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F
<b>Electric-power output (TWh)</b>	<b>73.8</b>	<b>67.6</b>	<b>65.3</b>	<b>70.0</b>	<b>72.0</b>	<b>72.7</b>	<b>81.9</b>	<b>83.2</b>	<b>89.0</b>	<b>90.0</b>	<b>86.0</b>	<b>82.0</b>	<b>82.0</b>
nuclear power	26.2	26.6	27.2	28.4	29.1	29.8	29.8	29.8	29.8	29.8	29.8	29.8	29.8
lignite-fired	37.3	32.1	29.3	32.6	32.6	32.6	36.4	36.4	37.0	33.0	29.0	25.1	25.1
hard coal-fired	8.7	7.4	6.7	6.9	6.9	6.9	6.9	5.7	6.0	6.0	6.0	6.0	6.0
gas-fired	0.0	0.0	0.0	0.0	0.0	0.0	5.4	7.8	12.8	17.7	17.7	17.7	17.7
hydroelectric power	1.7	1.5	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
wind power	0.0	0.0	0.0	0.2	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
<b>Electric-power sales (TWh)</b>	<b>37.7</b>	<b>37.9</b>	<b>40.7</b>	<b>41.9</b>	<b>42.3</b>	<b>43.4</b>	<b>44.5</b>	<b>45.6</b>	<b>46.7</b>	<b>47.8</b>	<b>48.7</b>	<b>49.5</b>	<b>50.0</b>
<b>Power distribution volumes (TWh)</b>	<b>50.2</b>	<b>51.0</b>	<b>49.8</b>	<b>54.1</b>	<b>54.6</b>	<b>55.9</b>	<b>57.3</b>	<b>58.8</b>	<b>60.2</b>	<b>61.6</b>	<b>62.7</b>	<b>63.7</b>	<b>64.4</b>
<b>1Y forward electricity prices (EUR/MWh)</b>	<b>54.9</b>	<b>69.1</b>	<b>49.3</b>	<b>52.2</b>	<b>55.4</b>	<b>62.8</b>	<b>66.2</b>	<b>67.4</b>	<b>68.2</b>	<b>71.5</b>	<b>75.5</b>	<b>77.1</b>	<b>78.8</b>
<b>Prices of CO2 certificates (EUR/T)</b>	<b>20.6</b>	<b>23.9</b>	<b>13.8</b>	<b>14.6</b>	<b>18.3</b>	<b>22.2</b>	<b>30.0</b>	<b>31.5</b>	<b>33.0</b>	<b>34.6</b>	<b>36.3</b>	<b>38.1</b>	<b>40.0</b>
<b>EUR/CZK</b>	<b>27.7</b>	<b>25.0</b>	<b>26.4</b>	<b>26.1</b>	<b>26.1</b>	<b>24.8</b>	<b>24.1</b>	<b>23.5</b>	<b>23.5</b>	<b>23.5</b>	<b>23.5</b>	<b>23.5</b>	<b>23.5</b>
<b>USD/CZK</b>	<b>20.3</b>	<b>17.1</b>	<b>19.0</b>	<b>20.0</b>	<b>20.0</b>	<b>19.0</b>	<b>18.5</b>	<b>18.0</b>	<b>18.0</b>	<b>18.0</b>	<b>18.0</b>	<b>18.0</b>	<b>18.0</b>
<b>TRY/CZK</b>	<b>15.5</b>	<b>13.1</b>	<b>12.2</b>	<b>13.2</b>	<b>13.3</b>	<b>13.3</b>	<b>13.3</b>	<b>13.3</b>	<b>13.3</b>	<b>13.3</b>	<b>13.3</b>	<b>13.3</b>	<b>13.3</b>



2. Cash flows are discounted to their present value as at 31 August 2010. Equity value was calculated based on FY2009 net debt plus a CZK 28.5bn dividend payout.
3. The cash flows projected for 2010 and 2011 take into account payments due for equity investment in SEDAS, Dalkia, and Akenerji.
4. We add equity in subsidiaries consolidated under the equity method to the DCF-calculated enterprise value. CEZ's 7% stake in MOL is valued at the current market price.
5. CAPEX and D&A charges in our DCF model factor in payments for nuclear fuel.
6. The depreciation and amortization expense projected for FY2019 is lower than CAPEX, prompting a revision to CZK 52bn when calculating the terminal value.
7. When calculating  $FCF_{TV}$ , we based terminal-value calculations on the sales growth rate and EBITDA margins projected for 2019.
8. We assume that FCF after FY2019 will grow at a rate of 2%. The risk-free rate is 4.4% throughout the forecast horizon, and beta is 0.9%.



**DCF model for CEZ**

(CZK m)	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F	2019+																																				
<b>Revenues</b>	<b>199 224</b>	<b>204 001</b>	<b>215 865</b>	<b>233 399</b>	<b>242 658</b>	<b>254 319</b>	<b>267 916</b>	<b>268 559</b>	<b>274 924</b>	<b>281 324</b>	<b>284 138</b>																																				
change	-	2.4%	5.8%	8.1%	4.0%	4.8%	5.3%	0.2%	2.4%	2.3%	1.0%																																				
<b>EBITDA*</b>	<b>89 188</b>	<b>95 291</b>	<b>102 757</b>	<b>103 080</b>	<b>104 182</b>	<b>101 855</b>	<b>102 586</b>	<b>107 684</b>	<b>110 798</b>	<b>110 490</b>	<b>111 595</b>																																				
EBITDA margin	44.8%	46.7%	47.6%	44.2%	42.9%	40.1%	38.3%	40.1%	40.3%	39.3%	39.3%																																				
D&A expenses*	27 259	30 367	32 892	38 032	39 266	40 495	42 638	44 487	47 258	45 186	52 000																																				
<b>EBIT</b>	<b>61 929</b>	<b>64 924</b>	<b>69 865</b>	<b>65 048</b>	<b>64 916</b>	<b>61 360</b>	<b>59 949</b>	<b>63 197</b>	<b>63 540</b>	<b>65 305</b>	<b>59 595</b>																																				
EBIT margin	31.1%	31.8%	32.4%	27.9%	26.8%	24.1%	22.4%	23.5%	23.1%	23.2%	21.0%																																				
EBIT tax	11 766	11 876	12 805	11 880	11 845	11 159	11 390	12 007	12 073	12 408	11 323																																				
<b>NOPLAT</b>	<b>50 162</b>	<b>53 048</b>	<b>57 059</b>	<b>53 168</b>	<b>53 071</b>	<b>50 201</b>	<b>48 558</b>	<b>51 189</b>	<b>51 467</b>	<b>52 897</b>	<b>48 272</b>																																				
CAPEX*	-92 472	-78 737	-76 094	-72 601	-52 000	-52 000	-52 000	-52 000	-52 000	-52 000	-52 000																																				
Working capital	-104	-173	-429	-635	-335	-422	-492	-23	-230	-232	-230																																				
Equity investment	-10 740	-1 501	0	0	0	0	0	0	0	0	0																																				
<b>FCF</b>	<b>-25 895</b>	<b>3 004</b>	<b>13 429</b>	<b>17 964</b>	<b>40 002</b>	<b>38 274</b>	<b>38 704</b>	<b>43 653</b>	<b>46 495</b>	<b>45 851</b>	<b>48 042</b>																																				
WACC	6.8%	6.8%	6.8%	6.8%	6.9%	7.0%	7.1%	7.1%	7.2%	7.3%	7.6%																																				
discount factor	97.8%	91.6%	85.8%	80.4%	75.2%	70.3%	65.6%	61.3%	57.1%	53.3%	53.3%																																				
<b>PV FCF</b>	<b>-25 333</b>	<b>2 753</b>	<b>11 525</b>	<b>14 440</b>	<b>30 082</b>	<b>26 903</b>	<b>25 405</b>	<b>26 743</b>	<b>26 570</b>	<b>24 429</b>																																					
<b>WACC</b>	<b>6.8%</b>	<b>6.8%</b>	<b>6.8%</b>	<b>6.8%</b>	<b>6.9%</b>	<b>7.0%</b>	<b>7.1%</b>	<b>7.1%</b>	<b>7.2%</b>	<b>7.3%</b>	<b>7.6%</b>																																				
Cost of debt	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%	5.4%																																				
Risk-free rate	4.4%	4.4%	4.4%	4.4%	4.4%	4.4%	4.4%	4.4%	4.4%	4.4%	4.4%																																				
Risk premium	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%																																				
Effective tax rate	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%																																				
Net debt / EV	46.4%	47.4%	46.9%	47.0%	44.4%	42.3%	40.1%	38.7%	37.5%	36.3%	28.0%																																				
Cost of equity	8.9%	8.9%	8.9%	8.9%	8.9%	8.9%	8.9%	8.9%	8.9%	8.9%	8.9%																																				
Risk premium	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%																																				
Beta	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9																																				
FCF growth after the forecast horizon	2.0%		<b>Sensitivity Analysis</b>																																												
Terminal value	852 908		<b>FCF growth in perpetuity</b>																																												
Present value of terminal value (PV TV)	454 424		<table border="1"> <thead> <tr> <th></th> <th>0.0%</th> <th>1.0%</th> <th>2.0%</th> <th>3.0%</th> <th>4.0%</th> </tr> </thead> <tbody> <tr> <td>Present value of FCF in the forecast horizon</td> <td>163 517</td> <td>163 517</td> <td>163 517</td> <td>163 517</td> <td>163 517</td> </tr> <tr> <td>Equity value</td> <td>617 941</td> <td>617 941</td> <td>617 941</td> <td>617 941</td> <td>617 941</td> </tr> <tr> <td>Net debt</td> <td>158 596</td> <td>158 596</td> <td>158 596</td> <td>158 596</td> <td>158 596</td> </tr> <tr> <td>Minority interests</td> <td>6 314</td> <td>6 314</td> <td>6 314</td> <td>6 314</td> <td>6 314</td> </tr> <tr> <td>Equity value</td> <td>453 031</td> <td>453 031</td> <td>453 031</td> <td>453 031</td> <td>453 031</td> </tr> </tbody> </table>										0.0%	1.0%	2.0%	3.0%	4.0%	Present value of FCF in the forecast horizon	163 517	163 517	163 517	163 517	163 517	Equity value	617 941	617 941	617 941	617 941	617 941	Net debt	158 596	158 596	158 596	158 596	158 596	Minority interests	6 314	6 314	6 314	6 314	6 314	Equity value	453 031	453 031	453 031	453 031	453 031
	0.0%	1.0%	2.0%	3.0%	4.0%																																										
Present value of FCF in the forecast horizon	163 517	163 517	163 517	163 517	163 517																																										
Equity value	617 941	617 941	617 941	617 941	617 941																																										
Net debt	158 596	158 596	158 596	158 596	158 596																																										
Minority interests	6 314	6 314	6 314	6 314	6 314																																										
Equity value	453 031	453 031	453 031	453 031	453 031																																										
Investment in MOL	13 999																																														
Investments accounted for using the equity method	32 660																																														
Number of shares (millions)	537.99																																														
<b>Equity value per share (CZK)</b>	<b>928.8</b>																																														
Cost of equity	6.9%																																														
<b>Target price (CZK)</b>	<b>990.1</b>																																														
<b>Target price (PLN)</b>	<b>158.1</b>																																														
EV/EBITDA ('10) for the target price	7.3																																														
P/E ('10) for the target price	11.5																																														
TV to EV	74%																																														

\*incl. expenses related to nuclear fuel



## Relative Valuation

We compared CEZ's P/E and EV/EBITDA multiples with the multiples of its peers estimated for FY2010 through FY2012. The peer group includes international power producers and distributors, as well as Polish power utilities PGE, ENEA, Tauron, and gas utility PGNiG. Compared to its European peers, CEZ appears to trade at a small premium, both in the case of P/CE and EV/EBITDA.

	Price	P/CE				EV/EBITDA*			
		2009	2010F	2011F	2012F	2009	2010F	2011F	2012F
EDF	32.85	5.6	5.2	5.0	4.7	6.3	5.9	5.7	5.3
E.ON AG	23.24	5.0	5.1	5.3	5.1	6.3	6.3	6.5	6.3
IBERDROLA SA	5.73	6.3	6.0	5.7	5.2	8.9	8.3	7.9	7.3
ENEL SPA	3.96	3.9	3.8	3.7	3.6	6.1	5.8	5.7	5.5
RWE AG	53.39	5.6	4.9	4.9	4.7	6.4	5.6	5.7	5.4
ENDESA SA	19.71	4.4	4.7	5.0	4.8	5.8	5.9	5.9	5.6
FORTUM OYJ	19.19	9.4	8.8	8.9	8.5	10.0	9.6	9.6	9.2
ENEA	20.50	7.7	6.8	6.6	6.1	5.9	5.0	4.8	4.2
PGE	23.78	7.6	6.7	6.1	5.4	6.1	5.4	4.7	0.0
PGNiG	3.47	6.5	4.9	5.1	4.9	6.5	4.5	4.7	4.5
Tauron	5.56	4.7	4.2	4.1	3.7	4.2	4.1	3.8	3.4
Maximum		9.4	8.8	8.9	8.5	10.0	9.6	9.6	9.2
Minimum		3.9	3.8	3.7	3.6	4.2	4.1	3.8	0.0
<b>Median</b>		<b>5.6</b>	<b>5.1</b>	<b>5.1</b>	<b>4.9</b>	<b>6.3</b>	<b>5.8</b>	<b>5.7</b>	<b>5.4</b>
CEZ	820.5	6.0	6.3	5.9	5.5	6.2	6.5	6.1	5.7
(premium / discount)		7.6%	23.9%	15.7%	10.5%	-1.5%	12.4%	8.2%	6.4%
<b>Implied price</b>									
Median		5.6	5.1	5.1	4.9	6.3	5.8	5.7	5.4
Multiple weight			50.0%				50.0%		
Year weight		0.0%	33.3%	33.3%	33.3%	0.0%	33.3%	33.3%	33.3%
<b>Implied value of CEZ (CZK)</b>		<b>719.9</b>							

\*EV/EBITDA based on FY2009 net debt

**Income Statement**

<b>(CZK m)</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>	<b>2013F</b>
<b>Revenues</b>	<b>174 563.0</b>	<b>183 958.0</b>	<b>196 352.0</b>	<b>199 223.5</b>	<b>204 001.5</b>	<b>215 865.0</b>	<b>233 399.2</b>
<i>change</i>	17.1%	5.4%	6.7%	1.5%	2.4%	5.8%	8.1%
<b>EBIT, incl.:</b>	<b>53 203.0</b>	<b>66 654.0</b>	<b>68 199.0</b>	<b>61 928.9</b>	<b>64 924.4</b>	<b>69 864.7</b>	<b>65 047.8</b>
Generation and Trade	37 357.0	50 445.0	54 612.0	45 889.2	46 595.0	50 858.8	45 792.0
Distribution and Sales	9 774.0	9 594.0	7 237.0	10 580.9	12 477.6	13 319.8	14 166.6
Mining	3 670.0	3 593.0	3 872.0	3 147.7	3 512.1	3 544.3	3 394.5
Other	2 402.0	3 022.0	2 478.0	2 311.1	2 339.7	2 141.9	1 694.7
One-time income/expenses	2 900.0	0.0	0.0	0.0	0.0	0.0	1.0
<b>EBIT (adjusted)</b>	<b>50 303.0</b>	<b>66 654.0</b>	<b>68 199.0</b>	<b>61 928.9</b>	<b>64 924.4</b>	<b>69 864.7</b>	<b>65 046.8</b>
<i>change</i>	32.8%	25.3%	2.3%	-9.2%	4.8%	7.6%	-6.9%
<i>EBIT margin</i>	28.8%	36.2%	34.7%	31.1%	31.8%	32.4%	27.9%
Financial activity	-2 052.0	-5 938.0	-3 253.0	-3 890.3	-4 522.0	-3 988.2	-4 736.8
Extraordinary gains/losses	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Pre-tax income</b>	<b>51 151.0</b>	<b>60 716.0</b>	<b>64 946.0</b>	<b>58 038.6</b>	<b>60 402.4</b>	<b>65 876.5</b>	<b>60 310.0</b>
Tax	8 387.0	13 365.0	13 091.0	11 027.3	11 016.8	12 047.6	10 980.2
Minority interests	1 209.0	841.0	308.0	835.0	877.1	956.1	876.2
<b>Net income</b>	<b>41 555.0</b>	<b>46 510.0</b>	<b>51 547.0</b>	<b>46 176.3</b>	<b>48 508.5</b>	<b>52 872.8</b>	<b>48 453.5</b>
<i>change</i>	50.0%	11.9%	10.8%	-10.4%	5.1%	9.0%	-8.4%
<i>margin</i>	23.8%	25.3%	26.3%	23.2%	23.8%	24.5%	20.8%
D&A expenses	22 166.0	22 090.0	22 876.0	23 948.9	26 420.1	27 910.1	32 920.9
<b>EBITDA (adjusted)</b>	<b>72 469.0</b>	<b>88 744.0</b>	<b>91 075.0</b>	<b>85 877.8</b>	<b>91 344.5</b>	<b>97 774.8</b>	<b>97 967.7</b>
<i>change</i>	17.0%	17.7%	6.3%	-9.0%	6.4%	7.0%	0.2%
<i>EBITDA margin</i>	41.5%	48.2%	46.4%	43.1%	44.8%	45.3%	42.0%
Shares at year-end (millions)	541.8	592.2	538.0	538.0	538.0	538.0	538.0
EPS	76.7	78.5	95.8	85.8	90.2	98.3	90.1
CEPS	117.6	115.8	138.3	130.3	139.3	150.2	151.3
ROAE	22.7%	27.0%	27.6%	22.1%	21.2%	20.9%	17.7%
ROAA	11.2%	11.0%	10.3%	8.2%	7.8%	7.9%	6.7%

**Balance Sheet**

<b>(CZK m)</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>	<b>2013F</b>
<b>ASSETS</b>	<b>370 942.0</b>	<b>473 175.0</b>	<b>530 259.0</b>	<b>594 897.9</b>	<b>647 152.6</b>	<b>696 271.4</b>	<b>739 586.0</b>
<b>Fixed assets</b>	<b>313 420.0</b>	<b>346 237.0</b>	<b>414 955.0</b>	<b>490 908.2</b>	<b>540 779.7</b>	<b>583 981.0</b>	<b>618 549.6</b>
Property, plant and equipment	270 182.0	284 539.0	323 366.0	382 580.1	426 735.0	466 928.9	499 116.7
Intangible assets	19 060.0	18 074.0	18 653.0	23 612.0	27 424.1	31 063.9	34 206.0
Equity investment	248.0	1 907.0	17 250.0	17 250.0	17 250.0	17 250.0	17 250.0
Other fixed assets	23 930.0	41 717.0	55 686.0	67 466.1	69 370.5	68 738.2	67 976.8
<b>Current assets</b>	<b>57 522.0</b>	<b>126 938.0</b>	<b>115 304.0</b>	<b>103 989.7</b>	<b>106 372.9</b>	<b>112 290.4</b>	<b>121 036.4</b>
Inventories	5 341.0	7 873.0	7 903.0	8 018.6	8 210.9	8 688.4	9 394.1
Short-term receivables	23 880.0	41 729.0	46 350.0	47 027.8	48 155.7	50 956.2	55 095.2
Other current assets	15 872.0	60 033.0	34 324.0	34 758.4	35 481.3	37 276.1	39 928.9
Cash and cash equivalents	12 429.0	17 303.0	26 727.0	14 184.8	14 525.0	15 369.7	16 618.2
<b>(CZK m)</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>	<b>2013F</b>
<b>LIABILITIES</b>	<b>370 942.0</b>	<b>473 175.0</b>	<b>530 259.0</b>	<b>594 897.9</b>	<b>647 152.6</b>	<b>696 271.4</b>	<b>739 586.0</b>
<b>Equity</b>	<b>171 352.0</b>	<b>173 252.0</b>	<b>200 361.0</b>	<b>218 023.8</b>	<b>240 177.8</b>	<b>265 365.0</b>	<b>283 643.0</b>
Capital stock	59 221.0	59 221.0	53 799.0	53 799.0	53 799.0	53 799.0	53 799.0
Other equity	112 131.0	114 031.0	146 562.0	164 224.8	186 378.8	211 566.0	229 844.0
<b>Minority interests</b>	<b>12 874.0</b>	<b>12 158.0</b>	<b>6 314.0</b>	<b>6 314.0</b>	<b>6 314.0</b>	<b>6 314.0</b>	<b>6 314.0</b>
<b>Long-term liabilities</b>	<b>125 151.0</b>	<b>136 614.0</b>	<b>192 516.0</b>	<b>200 307.2</b>	<b>217 958.1</b>	<b>230 017.8</b>	<b>241 380.6</b>
Loans	51 984.0	66 526.0	118 921.0	126 712.2	144 363.1	156 422.8	167 785.6
Other	73 167.0	70 088.0	73 595.0	73 595.0	73 595.0	73 595.0	73 595.0
<b>Short-term liabilities</b>	<b>61 565.0</b>	<b>151 151.0</b>	<b>131 068.0</b>	<b>170 252.9</b>	<b>182 702.8</b>	<b>194 574.7</b>	<b>208 248.4</b>
Loans	21 274.0	39 875.0	37 889.0	75 950.0	86 529.7	93 758.2	100 569.0
Trade creditors	25 737.0	93 646.0	76 853.0	77 976.9	79 847.0	84 490.5	91 353.4
Other	14 554.0	17 630.0	16 326.0	16 326.0	16 326.0	16 326.0	16 326.0
Debt	73 258.0	106 401.0	156 810.0	202 662.2	230 892.8	250 180.9	268 354.5
Net debt	60 829.0	89 098.0	130 083.0	188 477.3	216 367.7	234 811.2	251 736.4
(Net debt / Equity)	35.5%	51.4%	64.9%	86.4%	90.1%	88.5%	88.8%
(Net debt / EBITDA)	0.8	1.0	1.4	2.2	2.4	2.4	2.6
<b>BVPS</b>	<b>316.2</b>	<b>292.6</b>	<b>372.4</b>	<b>405.3</b>	<b>446.4</b>	<b>493.3</b>	<b>527.2</b>

**Cash Flows**

(CZK m)	2007	2008	2009	2010F	2011F	2012F	2013F
<b>Operating cash flows</b>	<b>59 219.0</b>	<b>70 583.0</b>	<b>87 354.0</b>	<b>77 838.9</b>	<b>84 822.5</b>	<b>92 046.9</b>	<b>94 183.0</b>
Net income	41 555.0	46 510.0	51 547.0	46 176.3	48 508.5	52 872.8	48 454.5
D&A expenses	22 166.0	22 090.0	26 171.0	23 948.9	26 420.1	27 910.1	32 920.9
Working capital	-3 880.0	37 604.0	-23 920.0	330.5	549.9	1 365.5	2 018.2
Other	-622.0	-35621.0	33556.0	7383.2	9344.1	9898.5	10789.4
<b>Cash flows from investing activities</b>	<b>-37 033.0</b>	<b>-60 170.0</b>	<b>-99 022.0</b>	<b>-103 212.4</b>	<b>-80 238.1</b>	<b>-76 093.8</b>	<b>-72 600.9</b>
CAPEX	-34 066.0	-46 186.0	-70 791.0	-92 472.1	-78 737.1	-76 093.8	-72 600.9
Other	-2967.0	-13984.0	-28231.0	-10740.3	-1501.0	0.0	0.0
<b>Cash flows from financing activities</b>	<b>-40 120.0</b>	<b>-5 917.0</b>	<b>22 230.0</b>	<b>12 831.3</b>	<b>-4 244.3</b>	<b>-15 108.4</b>	<b>-20 333.7</b>
Stock issue	-54 443.0	-12 535.0	146.0	0.0	0.0	0.0	0.0
Debt	26 248.0	27 607.0	48 918.0	45 852.2	28 230.6	19 288.2	18 173.6
Dividend (buy-back)	-11 694.0	-21 218.0	-26 545.0	-28 513.5	-26 354.5	-27 685.6	-30 176.5
Other	-231.0	229.0	-289.0	-4507.4	-6120.4	-6711.0	-8330.8
<b>Change in cash</b>	<b>-18 503.0</b>	<b>4 874.0</b>	<b>9 424.0</b>	<b>-12 542.2</b>	<b>340.2</b>	<b>844.7</b>	<b>1 248.4</b>
Cash at period-end	12 429.0	17 303.0	26 727.0	14 184.8	14 525.0	15 369.7	16 618.2
DPS (CZK)	20.0	40.0	49.3	53.0	49.0	51.5	56.1
FCF	26 136.0	66 797.0	-16 727.0	-17 291.1	2 140.5	10 998.9	16 404.8
(CAPEX / Sales)	19.5%	25.1%	36.1%	46.4%	38.6%	35.3%	31.1%

**Market multiples**

	2007	2008	2009	2010F	2011F	2012F	2013F
P/E	10.7	10.4	8.6	9.6	9.1	8.3	9.1
P/CE	7.0	7.1	5.9	6.3	5.9	5.5	5.4
P/BV	2.6	2.8	2.2	2.0	1.8	1.7	1.6
P/S	2.5	2.6	2.2	2.2	2.2	2.0	1.9
FCF/EV	5.0%	11.4%	-2.9%	-2.7%	0.3%	1.6%	2.3%
EV/EBITDA	7.2	6.6	6.3	7.4	7.3	7.0	7.1
EV/EBIT	10.3	8.8	8.5	10.3	10.2	9.8	10.8
EV/S	3.0	3.2	2.9	3.2	3.3	3.2	3.0
DYield	2.4%	4.9%	6.0%	6.5%	6.0%	6.3%	6.8%
<b>Price (CZK)</b>	<b>820.5</b>						
Shares at year-end (millions)	541.8	592.2	538.0	538.0	538.0	538.0	538.0
MC (CZK m)	444 580	485 909	441 421	441 421	441 421	441 421	441 421
Equity attributable to minority shareholders (CZK m)	12 874	12 158	6 314	6 314	6 314	6 314	6 314
EV (CZK m)	518 283	587 165	577 818	636 212	664 102	682 546	699 471

13 September 2010

Update


**Energy**  
 Poland

<b>Current price</b>	<b>PLN 20.50</b>
<b>Target price</b>	<b>PLN 21.43</b>
Market cap	PLN 9.0bn
Free float	PLN 1.6bn
Average daily trading (3M)	PLN 6.8m

**Shareholder Structure**

State Treasury	60.4%
Vattenfall	18.7%
EBOiR	2.5%
Others	18.4%

**Sector Outlook**

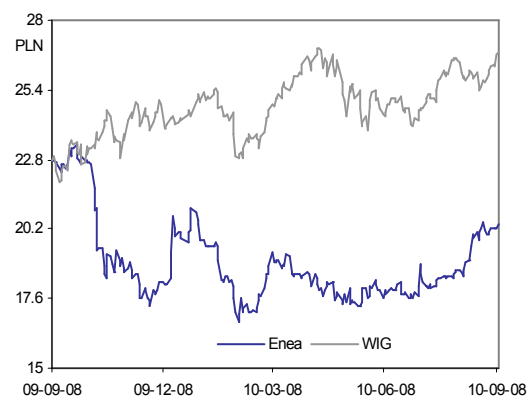
The Polish energy sector is expected to correlate increasingly with EU markets, and energy prices are converging to EU averages. The convergence process should be supported by increasing electricity usage accompanied by a hiatus in capacity expansion – a combination which could lead to power shortage during peak demand periods in the future.

**Company Profile**

Enea is one of Poland's biggest integrated energy groups, with a 14% share in the distribution market (2.3m customers). The Group includes the Koziencice power plant (2.88GW), which generates ca. 11.8TWh of energy per year (8% of Polish output). Investment plans foresee capacity expansion by a further 2GW by 2016. Enea is also planning to expand its renewable energy portfolio with wind farms and biogas plants.

**Important dates**

15.11- Q3 2010 report

**ENEA vs. WIG**

**Kamil Kliszczyk**

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# ENEA

ENAE.WA ENA.PW

## Hold

(Downgraded)

### Tender Offer Premium A Real Prospect

Enea's shares rallied almost 15% in the two-month period following the announcement of the list of candidates for its future owner, but then retreated on weak second-quarter earnings which, contrary to what we anticipated, provided no reasons for upward revisions in our full-year forecasts. We are downgrading Enea to hold because its stock is currently hovering close to our target (PLN 21.43). However, based on recent statements from the State Treasury, and given the determination of the prospective investors (for whom the acquisition is the last chance to establish a presence in the Polish market), we reckon that whoever wins the bid will afterwards offer a 10-15% premium to obtain a 100% interest in Enea.

**Disappointing Q2 2010 results**

Enea reported lower-than-expected net profit and EBITDA figures for Q2 2010. The EBIT of the Generation segment amounted to just PLN 56.6m versus our forecast of PLN 90m in spite of an unforeseen long-term contract compensation adjustment in the amount of PLN 15.6m. Distribution generated an EBIT of PLN 54.2m compared to our PLN 91m estimate. The weaker-than-forecasted performance of the two segments can be partly explained with a quarter-on-quarter expansion in two cost components: third-party services (which increased by PLN 17.3m, due probably to maintenance work) and payroll (a PLN 27m increase caused by higher benefits allowances). The disappointing second-quarter results did not affect our full-year forecasts, which are based on conservative assumptions.

**Privatization**

The primary factor which has been shaping Enea's market performance is its impending privatization. After due diligence audits and meetings with the Management Board scheduled for next week, the company's suitors have until 27th September to submit final bids. As a reminder, the State Treasury announced that it will be more partial to bidders who promise to hold a tender offer for 100% of Enea shares after they get their 51% stake. The power utility's current market value calculated using multiples comparison is about PLN 20 a share, and expectations with respect to the tender-offer premium range from 10% to 20%. Considering the number of interested buyers, including French power giants who may be determined to capitalize on Poland's nuclear-power plans, we think that these expectations will be met. Enea's price average for the last three and six months hovers around PLN 18.6.

(PLN m)	2008	2009	2010F	2011F	2011F
Revenue	6 157.8	7 167.3	7 629.3	7 882.6	8 458.3
EBITDA	882.7	1 167.0	1 371.6	1 417.3	1 610.2
<i>EBITDA margin</i>	14.3%	16.3%	18.0%	18.0%	19.0%
EBIT	251.4	505.6	699.7	726.1	900.8
Net profit	215.4	513.6	654.6	676.8	762.8
DPS	0.23	0.46	0.38	0.74	0.61
P/E	42.0	17.6	13.8	13.4	11.9
P/CE	10.7	7.7	6.8	6.6	6.1
P/BV	1.0	1.0	0.9	0.9	0.8
EV/EBITDA	7.6	7.1	4.9	5.5	5.9
DYield	1.1%	2.2%	1.9%	3.6%	3.0%

## Disappointing Second-Quarter Results

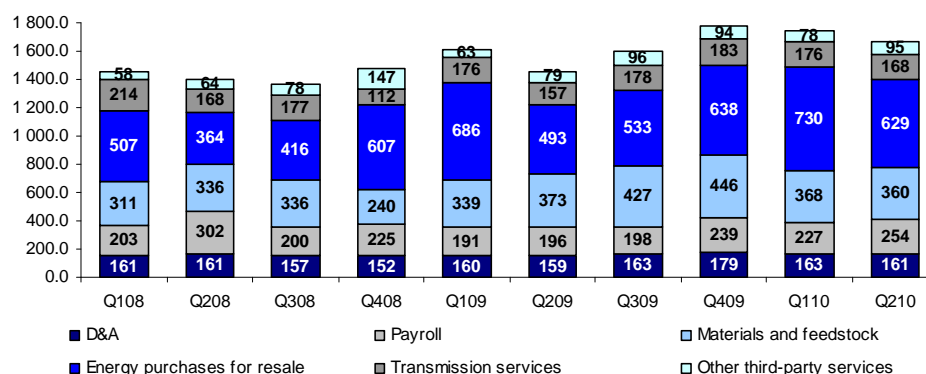
### Reported vs. forecasted Q2 2010 results

(PLN m)	Q2 2010	Q2 2009	change	Q2 2010F	Actuals vs. Forecasts	Consensus Estimates	Actuals vs. Consensus
Revenues	1 896.4	1 707.2	11.1%	1 978.3	-4.1%	1 872	1.3%
EBITDA	328.3	359.0	-8.6%	385.1	-14.8%	391	-16.0%
EBITDA margin	17.3%	21.0%	-	19.5%	-	-	-
EBIT	167.0	200.3	-16.7%	222.0	-24.8%	202	-17.3%
Pre-tax income	185.6	240.3	-22.8%	260.9	-28.9%	-	-
Net income	145.8	190.2	-23.3%	211.4	-31.0%	194	-24.9%

Source: ENEA, F – forecasts by BRE Bank Securities; Consensus estimates by PAP

Enea reported lower-than-expected net profit and EBITDA figures for Q2 2010. EBIT fell a full 25% short of forecasts because of the weak performance of the Power Generation and Distribution lines. The EBIT of the Generation segment amounted to just PLN 56.6m versus our forecast of PLN 90m in spite of an unforeseen long-term contract compensation adjustment in the amount of PLN 15.6m. Distribution generated an EBIT of PLN 54.2m compared to our PLN 91m estimate. The weaker-than-forecasted performance of the two segments can be partly explained with a quarter-on-quarter expansion in two cost components: third-party services (which increased by PLN 17.3m, due probably to maintenance work) and payroll (a PLN 27m increase caused by higher benefits allowances). On a more positive note, the Trade segment exceeded expectations with an EBIT of PLN 83.8m (we forecasted PLN 52m), and an EBITDA margin showing 4.7% quarter-on-quarter expansion at 8% (an effect of growing demand from the manufacturing industry, and higher spot prices).

### Quarterly cost breakdown



Source: ENEA

Income from financial operations was a mere PLN 19m, much less than our forecasted PLN 39m, which came as a surprise given Enea's expanded cash base (net cash increased by PLN 54m to PLN 2.65bn in Q2). The company generated positive net cash flows, driven by high cash flows from operations (PLN 335m) which offset capital expenses and dividends. Enea's Management Board revealed in the Q2 2010 report that it expected a favorable resolution of an ongoing dispute with energy regulator the URE, and a resulting award of PLN 190m in back-LTC compensation.

### Consolidated quarterly results by business segment

(PLN m)	Q108	Q208	Q308	Q408	Q109	Q209	Q309	Q409	Q1'10	Q2'10
Revenues	1 573.3	1 465.3	1 487.7	1 623.2	1 884.7	1 707.2	1 647.5	1 927.9	2 021.4	1 896.4
EBIT	83.7	12.2	59.1	79.5	223.6	200.3	15.4	66.2	226.6	167.0
Power Generation	35.4	2.3	11.1	11.1	123.5	100.7	-70.5	61.8	69.7	56.6
Power Distribution	78.1	-4.4	22.1	-17.1	48.2	64.1	54.8	-26.3	126.4	54.2
Trade	10.4	14.4	46.0	94.6	69.8	47.1	34.7	83.9	55.1	83.8
eliminations/unattributed expenses	-40.2	-0.1	-20.1	-9.1	-18.0	-11.5	-3.5	-53.1	-24.7	-27.6
Power output (GWh)	n/a	n/a	n/a	n/a	2 888	2 937	3 135	3 162	2 995	2 914
Power distribution volumes (GWh)	4 570	4 275	4 250	4 358	4 247	3 741	3 767	3 942	3 933	3 449

Source: ENEA, BRE Bank Securities, PAP

## Macroeconomic Assumptions

The table below outlines the macroeconomic assumptions underlying DCF valuation.

	2006	2007	2008	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F
Prices of Brent crude (USD/Bbl)	65.4	72.8	98.0	62.0	77.0	80.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0
EEX energy prices (EUR/MWh)	41.8	54.9	54.9	69.1	49.3	52.2	55.4	62.8	66.2	67.4	68.2	71.5	75.5	77.1
<b>Polish energy prices (PLN/MWh)</b>	<b>138.6</b>	<b>142.8</b>	<b>154.3</b>	<b>195.0</b>	<b>190.0</b>	<b>195.0</b>	<b>210.6</b>	<b>232.3</b>	<b>231.6</b>	<b>235.9</b>	<b>238.6</b>	<b>250.2</b>	<b>264.3</b>	<b>269.9</b>
Prices of CO2 certificates, EUR/T	21.6	20.6	23.9	13.8	14.6	18.3	22.2	30.0	31.5	33.0	34.6	36.3	38.1	40.0
Prices of thermal coal (PLN/T)	158.0	161.0	193.0	277.9	252.2	264.8	295.1	284.9	274.7	274.7	274.7	274.7	274.7	274.7
Avg. PLN/USD exchange rate	3.11	2.77	2.42	3.12	3.07	3.10	2.90	2.80	2.70	2.70	2.70	2.70	2.70	2.70
Avg. EUR/PLN exchange rate	3.90	3.79	3.48	4.33	4.00	4.00	3.80	3.70	3.50	3.50	3.50	3.50	3.50	3.50
<b>Power output (TWh)</b>	<b>12.5</b>	<b>11.7</b>	<b>11.9</b>	<b>12.2</b>	<b>12.2</b>	<b>12.2</b>	<b>12.5</b>	<b>12.7</b>	<b>13.0</b>	<b>13.0</b>	<b>20.1</b>	<b>27.0</b>	<b>25.5</b>	<b>24.7</b>
hard coal-fired	12.5	11.6	11.8	12.1	12.1	12.1	12.1	12.1	12.1	12.1	19.0	25.9	24.2	23.4
hydroelectric power	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
wind power	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.5	0.7	0.7	1.0	1.0	1.2	1.2
<b>Distribution volumes (TWh)</b>	<b>15.9</b>	<b>16.2</b>	<b>16.5</b>	<b>15.7</b>	<b>16.7</b>	<b>17.5</b>	<b>18.5</b>	<b>19.4</b>	<b>20.2</b>	<b>21.0</b>	<b>21.8</b>	<b>22.4</b>	<b>23.1</b>	<b>23.8</b>

Source: ENEA, Bloomberg, forecasts by BRE Bank Securities

## Earnings Forecast and Valuation

Using DCF analysis and relative valuation, we set the nine-month price target on ENEA at PLN 21.42 per share. We attach more weight to the DCF valuation given the expected huge CAPEX levels in 2013-2015 (relative to current cash flows).

	Weight	Price
Relative Valuation	30%	19.92
DCF Analysis	70%	19.94
	price	19.94
	<b>9M target price</b>	<b>21.43</b>

### DCF Analysis

#### DCF Model Assumptions

1. Cash flows are discounted to their present value as at 31 August 2010. Equity value calculations factor in minority interests and FY2009 net debt adjusted for dividends.
2. The macroeconomic assumptions are as laid out above.
3. Our valuation takes into account investments in subsidiaries accounted for under the equity method (PLN 190m, consisting mostly of the stake in the Białystok CHP plant, and a 1.4% stake in LW Bogdanka (PLN 37.1m)).
4. We increased our valuation by the expected refund of overpaid excise tax on network losses, which we estimate at PLN 65m, and PLN 187m in long-term contract compensation due to the Koziernice power plant.
5. We increased forecasted FY2019+ CAPEX (factored in the terminal value) to 10% of revenues, similarly to the model applied to PGE, to reflect ENEA's long-term capacity replacement needs. D&A expenses are adjusted to CAPEX levels, i.e. PLN 1.5bn.
6. When calculating  $FCF_{TV}$ , we based terminal-value calculations on the sales growth rate and EBITDA margins projected for 2019.
7. We assume that FCF after FY2019 will grow at a rate of 2%. The risk-free rate is 5.6%, and beta is 0.9.



**DCF model for ENEA**

(PLN m)	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F	2019+
<b>Revenues</b>	<b>7 629</b>	<b>7 883</b>	<b>8 458</b>	<b>9 225</b>	<b>9 473</b>	<b>9 750</b>	<b>11 943</b>	<b>14 850</b>	<b>15 025</b>	<b>15 053</b>	<b>15 080</b>
change	-	3.3%	7.3%	9.1%	2.7%	2.9%	22.5%	24.3%	1.2%	0.2%	0.2%
<b>EBITDA</b>	<b>1 371.6</b>	<b>1 417.3</b>	<b>1 610.2</b>	<b>1 828.6</b>	<b>1 938.6</b>	<b>1 917.9</b>	<b>2 704.5</b>	<b>3 167.9</b>	<b>3 370.3</b>	<b>3 400.9</b>	<b>3 407.1</b>
EBITDA margin	18.0%	18.0%	19.0%	19.8%	20.5%	19.7%	22.6%	21.3%	22.4%	22.6%	22.6%
D&A expenses	671.9	691.2	709.3	794.0	842.7	882.8	1 750.9	1 756.0	1 769.8	1 807.6	1 550.0
<b>EBIT</b>	<b>699.7</b>	<b>726.1</b>	<b>900.8</b>	<b>1 034.6</b>	<b>1 095.9</b>	<b>1 035.1</b>	<b>953.6</b>	<b>1 411.9</b>	<b>1 600.5</b>	<b>1 593.3</b>	<b>1 857.1</b>
EBIT margin	9.2%	9.2%	10.7%	11.2%	11.6%	10.6%	8.0%	9.5%	10.7%	10.6%	12.3%
EBIT tax	132.9	138.0	171.2	196.6	208.2	196.7	181.2	268.3	304.1	302.7	352.9
<b>NOPLAT</b>	<b>566.7</b>	<b>588.1</b>	<b>729.7</b>	<b>838.0</b>	<b>887.7</b>	<b>838.4</b>	<b>772.5</b>	<b>1 143.6</b>	<b>1 296.4</b>	<b>1 290.6</b>	<b>1 504.3</b>
CAPEX	-1 170	-2 105	-2 764	-3 507	-5 016	-4 088	-2 196	-1 396	-1 320	-1 353	-1 550
Working capital	-78.5	-10.4	-23.6	-31.5	-10.2	-11.4	-90.1	-119.4	-7.2	-1.1	-1.1
Equity investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>FCF</b>	<b>-9.8</b>	<b>-836.0</b>	<b>-1 348.2</b>	<b>-1 906.8</b>	<b>-3 295.4</b>	<b>-2 378.4</b>	<b>237.5</b>	<b>1 383.8</b>	<b>1 739.1</b>	<b>1 744.3</b>	<b>1 503.1</b>
WACC	10.1%	10.1%	10.0%	9.1%	7.8%	6.9%	6.9%	7.4%	8.0%	8.4%	8.8%
discount factor	96.8%	88.0%	80.0%	73.3%	68.0%	63.6%	59.5%	55.4%	51.3%	47.4%	47.4%
PV FCF	-9.5	-735.4	-1 078.5	-1 397.5	-2 239.9	-1 512.8	141.4	767.2	892.9	826.4	
<b>WACC</b>	<b>10.1%</b>	<b>10.1%</b>	<b>10.0%</b>	<b>9.1%</b>	<b>7.8%</b>	<b>6.9%</b>	<b>6.9%</b>	<b>7.4%</b>	<b>8.0%</b>	<b>8.4%</b>	<b>8.8%</b>
Cost of debt	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%
Risk-free rate	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%
Risk premium	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Effective tax rate	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%
Net debt / EV	0.0%	0.0%	3.0%	20.0%	47.9%	68.1%	68.1%	57.6%	44.5%	36.4%	28.0%
Cost of equity	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%
Risk premium	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Beta	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
FCF growth after the forecast horizon						2.0%	<b>Sensitivity Analysis</b>				
Terminal value					22 207		<b>FCF growth in perpetuity</b>				
Present value of terminal value (PV TV)					10 521		<b>0.0%</b>	<b>1.0%</b>	<b>2.0%</b>	<b>3.0%</b>	<b>4.0%</b>
Present value of FCF in the forecast horizon					-4 346	WACC +1.0ppt	13.57	15.59	18.14	21.44	25.88
Equity value					6 175	WACC +0.5ppt	14.53	16.79	19.68	23.48	28.73
FY2009 net debt					-2 219	WACC	15.59	18.14	21.44	25.88	32.18
Minority interests					31	WACC -0.5ppt	16.79	19.68	23.48	28.73	36.44
Investment in LWB Bogdanka					37	WACC -01.0ppt	18.14	21.44	25.88	32.18	41.83
LTC compensation					187						
Other assets					190						
Taxes refundable on network losses					65						
Equity value					8 804						
Number of shares (millions)					441.4						
<b>Equity value per share (PLN)</b>					<b>19.94</b>						
9M cost of equity					7.5%						
<b>Target price</b>					<b>21.44</b>						
EV/EBITDA('10) for target price					5.3						
P/E('10) for target price					14.5						
TV /EV					170%						

## Relative Valuation

We compared ENEA's P/E and EV/EBITDA multiples with the multiples of its peers estimated for FY2010 through FY2012. The peer group includes international power producers and distributors, and natural gas supplier PGNiG, which also meets the definition of a utility. Compared to European energy companies, ENEA's current price carries a substantial discount of as much as 16% to average EV/EBITDA, and a premium on P/CE. The attractiveness of EV-based multiples is mostly a consequence of the high post-IPO cash levels. These multiples are not fully reliable, however, due to the expected increase in CAPEX in 2013-2015, which will be significantly higher than current cash flows, leading to considerable changes in the structure of the company's balance sheet.

	Price	P/CE				EV/EBITDA*			
		2009	2010F	2011F	2012F	2009	2010F	2011F	2012F
EDF	32.85	5.6	5.2	5.0	4.7	6.3	5.9	5.7	5.3
E.ON AG	23.24	5.0	5.1	5.3	5.1	6.3	6.3	6.5	6.3
IBERDROLA SA	5.73	6.3	6.0	5.7	5.2	8.9	8.3	7.9	7.3
ENEL SPA	3.96	3.9	3.8	3.7	3.6	6.1	5.8	5.7	5.5
RWE AG	53.39	5.6	4.9	4.9	4.7	6.4	5.6	5.7	5.4
ENDESA SA	19.71	4.4	4.7	5.0	4.8	5.8	5.9	5.9	5.6
FORTUM OYJ	19.19	9.4	8.8	8.9	8.5	10.0	9.6	9.6	9.2
PGE	23.78	7.4	7.6	6.7	6.1	5.4	6.1	5.4	4.7
PGNiG	3.47	6.5	4.9	5.1	4.9	6.5	4.5	4.7	4.5
CEZ	820.50	6.0	6.3	5.9	5.5	6.2	6.5	6.1	5.7
Tauron	5.56	4.7	4.2	4.1	3.7	4.2	4.1	3.8	3.4
Maximum		9.4	8.8	8.9	8.5	10.0	9.6	9.6	9.2
Minimum		3.9	3.8	3.7	3.6	4.2	4.1	3.8	3.4
<b>Median</b>		<b>5.6</b>	<b>5.1</b>	<b>5.1</b>	<b>4.9</b>	<b>6.3</b>	<b>5.9</b>	<b>5.7</b>	<b>5.5</b>
ENEA	20.5	7.7	6.8	6.6	6.1	5.9	5.0	4.8	4.2
(premium / discount) to median		38.6%	34.3%	29.9%	24.3%	-6.9%	-16.2%	-15.8%	-23.5%
<b>Implied price</b>									
Median		5.6	5.1	5.1	4.9	6.3	5.9	5.7	5.5
Multiple weight			50.0%				50.0%		
Year weight		0.0%	33.3%	33.3%	33.3%	0.0%	33.3%	33.3%	33.3%
<b>Implied value of ENEA (PLN)</b>		<b>19.9</b>							

\*EV/EBITDA based on FY2009 net debt

**Income Statement**

(PLN m)	2007	2008	2009	2010F	2011F	2012F	2013F
<b>Revenues</b>	<b>5 445.8</b>	<b>6 157.8</b>	<b>7 167.3</b>	<b>7 629.3</b>	<b>7 882.6</b>	<b>8 458.3</b>	<b>9 225.0</b>
<i>change</i>	1.2%	13.1%	16.4%	6.4%	3.3%	7.3%	9.1%
of which LTC compensation	0.0	81.0	-77.4	0.0	0.0	0.0	0.0
<b>EBIT, incl.:</b>	<b>83.3</b>	<b>251.4</b>	<b>505.6</b>	<b>699.7</b>	<b>726.1</b>	<b>900.8</b>	<b>1 034.6</b>
Power Generation	11.8	68.0	215.5	226.4	219.2	392.4	495.2
Trade	75.9	244.2	235.5	233.7	232.2	233.9	233.2
Power Distribution	79.9	69.1	140.8	341.2	372.9	376.8	407.4
Other	39.0	6.2	29.8	16.0	21.2	29.8	39.4
Intercompany Eliminations	-6.9	-14.4	-54.5	-27.6	-27.1	-37.6	-43.7
Unattributed costs	-116.3	-121.6	-61.4	-90.0	-92.3	-94.6	-96.9
<b>EBIT</b>	<b>83.3</b>	<b>251.4</b>	<b>505.6</b>	<b>699.7</b>	<b>726.1</b>	<b>900.8</b>	<b>1 034.6</b>
<i>change</i>	-63.9%	201.6%	101.1%	38.4%	3.8%	24.1%	14.8%
<i>EBIT margin</i>	1.5%	4.1%	7.1%	9.2%	9.2%	10.7%	11.2%
Financial activity	25.6	41.7	139.7	100.7	101.7	33.2	-78.8
Extraordinary gains/losses	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Other	0.1	0.4	7.8	7.8	7.8	7.8	7.8
<b>Pre-tax income</b>	<b>109.1</b>	<b>293.5</b>	<b>653.1</b>	<b>808.1</b>	<b>835.6</b>	<b>941.8</b>	<b>963.6</b>
Tax	-412.6	78.1	139.4	153.5	158.8	178.9	183.1
Minority interests	0.2	0.0	0.0	0.0	0.0	0.0	0.0
<b>Net income</b>	<b>521.5</b>	<b>215.4</b>	<b>513.6</b>	<b>654.6</b>	<b>676.8</b>	<b>762.8</b>	<b>780.5</b>
<i>change</i>	156.1%	-58.7%	138.5%	27.5%	3.4%	12.7%	2.3%
<i>margin</i>	9.6%	3.5%	7.2%	8.6%	8.6%	9.0%	8.5%
D&A expenses	470.6	631.4	661.3	671.9	691.2	709.3	794.0
<b>EBITDA</b>	<b>553.9</b>	<b>882.7</b>	<b>1 167.0</b>	<b>1 371.6</b>	<b>1 417.3</b>	<b>1 610.2</b>	<b>1 828.6</b>
<i>change</i>	-12.7%	59.4%	32.2%	17.5%	3.3%	13.6%	13.6%
<i>EBITDA margin</i>	10.2%	14.3%	16.3%	18.0%	18.0%	19.0%	19.8%
Shares at year-end (millions)	348.2	441.4	441.4	441.4	441.4	441.4	441.4
EPS	1.5	0.5	1.2	1.5	1.5	1.7	1.8
CEPS	2.8	1.9	2.7	3.0	3.1	3.3	3.6
ROAE	9.4%	2.7%	5.6%	6.8%	6.8%	7.3%	7.1%
ROAA	6.4%	2.0%	4.2%	5.2%	5.2%	5.4%	4.6%

**Balance Sheet**

(PLN m)	2007	2008	2009	2010F	2011F	2012F	2013F
<b>ASSETS</b>	<b>9 816.2</b>	<b>11 985.9</b>	<b>12 229.7</b>	<b>12 761.1</b>	<b>13 135.7</b>	<b>15 322.8</b>	<b>18 299.7</b>
<b>Fixed assets</b>	<b>7 951.1</b>	<b>8 204.0</b>	<b>8 374.7</b>	<b>8 872.8</b>	<b>10 286.6</b>	<b>12 340.8</b>	<b>15 054.0</b>
Property, plant and equipment	7 871.2	7 944.8	8 060.7	8 540.0	9 910.0	11 885.2	14 502.3
Intangible assets	40.5	36.6	48.0	66.8	110.5	189.6	285.8
Equity investment	5.2	189.9	189.9	189.9	189.9	189.9	189.9
Other fixed assets	34.2	32.7	76.1	76.1	76.1	76.1	76.1
<b>Current assets</b>	<b>1 865.1</b>	<b>3 781.9</b>	<b>3 855.0</b>	<b>3 888.3</b>	<b>2 849.2</b>	<b>2 982.1</b>	<b>3 245.7</b>
Inventories	149.1	270.0	300.8	320.2	330.9	355.0	387.2
Short-term receivables	715.1	780.1	925.5	985.2	1 017.9	1 092.2	1 191.2
Other current assets	60.1	111.1	1 726.1	73.6	73.6	73.6	73.6
Cash and cash equivalents	940.8	2 620.7	902.5	2 509.3	1 426.9	1 461.2	1 593.7
<b>(PLN m)</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010F</b>	<b>2011F</b>	<b>2012F</b>	<b>2013F</b>
<b>LIABILITIES</b>	<b>9 816.2</b>	<b>11 985.9</b>	<b>12 229.7</b>	<b>12 761.1</b>	<b>13 135.7</b>	<b>15 322.8</b>	<b>18 299.7</b>
<b>Equity</b>	<b>6 763.2</b>	<b>8 993.2</b>	<b>9 348.9</b>	<b>9 827.9</b>	<b>10 169.7</b>	<b>10 654.0</b>	<b>11 426.7</b>
Capital stock	494.8	588.0	588.0	588.0	588.0	588.0	588.0
Other equity	6 268.4	8 405.2	8 760.8	9 239.9	9 581.6	10 066.0	10 838.7
<b>Minority interests</b>	<b>3.2</b>	<b>31.1</b>	<b>23.8</b>	<b>23.8</b>	<b>23.8</b>	<b>23.8</b>	<b>23.8</b>
<b>Long-term liabilities</b>	<b>1 387.2</b>	<b>1 518.0</b>	<b>1 450.4</b>	<b>1 496.1</b>	<b>1 496.1</b>	<b>2 707.0</b>	<b>4 272.5</b>
Loans	184.4	152.8	107.1	152.8	152.8	1 363.7	2 929.2
Other	1 202.8	1 365.2	1 343.3	1 343.3	1 343.3	1 343.3	1 343.3
<b>Short-term liabilities</b>	<b>1 662.6</b>	<b>1 443.7</b>	<b>1 406.7</b>	<b>1 413.3</b>	<b>1 446.2</b>	<b>1 938.0</b>	<b>2 576.7</b>
Loans	69.2	52.6	46.6	52.6	52.6	469.5	1 008.5
Trade creditors	787.7	865.6	991.5	992.1	1 025.0	1 099.9	1 199.6
Other	805.7	525.5	368.6	368.6	368.6	368.6	368.6
Debt	253.6	205.4	153.7	205.4	205.4	1 833.3	3 937.7
Net debt	-687.2	-2 415.3	-748.9	-2 303.9	-1 221.5	372.0	2 344.1
(Net debt / Equity)	-10.2%	-26.9%	-8.0%	-23.4%	-12.0%	3.5%	20.5%
(Net debt / EBITDA)	-1.2	-2.7	-0.6	-1.7	-0.9	0.2	1.3
<b>BVPS</b>	<b>19.4</b>	<b>20.4</b>	<b>21.2</b>	<b>22.3</b>	<b>23.0</b>	<b>24.1</b>	<b>25.9</b>

**Cash Flows**

(PLN m)	2007	2008	2009	2010F	2011F	2012F	2013F
<b>Operating cash flows</b>	<b>650.5</b>	<b>825.5</b>	<b>850.1</b>	<b>1 139.6</b>	<b>1 248.2</b>	<b>1 407.6</b>	<b>1 614.0</b>
Net income	521.5	215.4	513.6	654.6	676.8	762.8	780.5
D&A expenses	470.6	631.4	661.3	671.9	691.2	709.3	794.0
Working capital	20.2	-150.6	-210.2	-78.5	-10.4	-23.6	-31.5
Other	-361.8	129.4	-114.6	-108.5	-109.5	-40.9	71.0
<b>Cash flows from investing activities</b>	<b>232.9</b>	<b>-899.5</b>	<b>-2 332.5</b>	<b>595.1</b>	<b>-1 991.1</b>	<b>-2 662.4</b>	<b>-3 394.3</b>
CAPEX	-334.1	-631.7	-764.3	-1 170.0	-2 105.0	-2 763.5	-3 507.3
Other	567.0	-267.9	-1568.2	1765.1	113.9	101.2	113.0
<b>Cash flows from financing activities</b>	<b>-294.3</b>	<b>1 753.9</b>	<b>-235.7</b>	<b>-127.9</b>	<b>-339.5</b>	<b>1 289.2</b>	<b>1 912.8</b>
Stock issue	0.0	1 940.2	0.0	0.0	0.0	0.0	0.0
Debt	-252.9	-64.9	-50.6	51.7	0.0	1 627.9	2 104.5
Dividend (buy-back)	-39.8	-100.6	-203.1	-167.7	-327.3	-270.7	0.0
Other	-1.6	-20.8	18.0	-11.9	-12.2	-68.0	-191.7
<b>Change in cash</b>	<b>589.1</b>	<b>1 679.9</b>	<b>-1 718.1</b>	<b>1 606.7</b>	<b>-1 082.4</b>	<b>34.4</b>	<b>132.4</b>
Cash at period-end	940.8	2 620.7	902.5	2 509.3	1 426.9	1 461.2	1 593.7
DPS (PLN)	0.11	0.23	0.46	0.38	0.74	0.61	0.00
FCF	652.6	22.4	53.0	-30.4	-856.8	-1 356.0	-1 893.3
(CAPEX / Sales)	6.1%	10.3%	10.7%	15.3%	26.7%	32.7%	38.0%

**Market multiples**

	2007	2008	2009	2010F	2011F	2012F	2013F
P/E	13.7	42.0	17.6	13.8	13.4	11.9	11.6
P/CE	7.2	10.7	7.7	6.8	6.6	6.1	5.7
P/BV	1.1	1.0	1.0	0.9	0.9	0.8	0.8
P/S	1.3	1.5	1.3	1.2	1.1	1.1	1.0
FCF/EV	10.1%	0.3%	0.6%	-0.4%	-10.9%	-14.4%	-16.6%
EV/EBITDA	11.7	7.6	7.1	4.9	5.5	5.9	6.2
EV/EBIT	77.4	26.5	16.5	9.7	10.8	10.5	11.0
EV/S	1.2	1.1	1.2	0.9	1.0	1.1	1.2
DYield	0.6%	1.1%	2.2%	1.9%	3.6%	3.0%	0.0%
<b>Price (PLN)</b>	<b>20.50</b>						
Shares at year-end (millions)	348.2	441.4	441.4	441.4	441.4	441.4	441.4
MC (PLN m)	7 138.5	9 049.6	9 049.6	9 049.6	9 049.6	9 049.6	9 049.6
Equity attributable to minority shareholders (PLN m)	3.2	31.1	23.8	23.8	23.8	23.8	23.8
EV (PLN m)	6 454.5	6 665.4	8 324.5	6 769.5	7 851.9	9 445.4	11 417.4

13 September 2010

Update


**Energy**  
 Poland

<b>Current price</b>	<b>PLN 23.78</b>
<b>Target price</b>	<b>PLN 27.53</b>
Market cap*	PLN 44.5bn
Free float	PLN 9.5bn
Average daily trading (3M)	PLN 27.2m

\*after an equity increase by 139.7 million shares

**Shareholder Structure**

State Treasury	78.6%
Others	21.4%

**Sector Outlook**

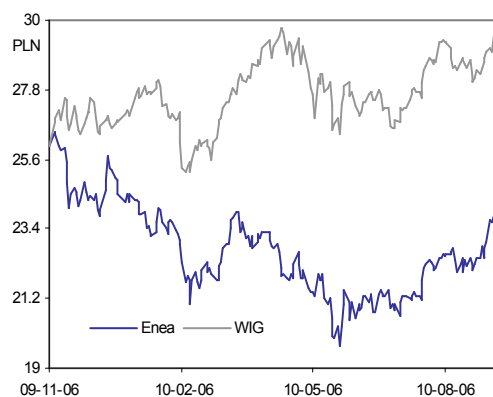
The Polish energy sector is expected to correlate increasingly with EU markets, and energy prices are converging to EU averages. The convergence process should be supported by increasing electricity usage accompanied by a hiatus in capacity expansion – a combination which could lead to power shortage during peak demand periods in the future.

**Company Profile**

PGE is the largest energy holding in Poland, comprised of power plants and combined-cycle plants with a combined capacity of 12.4 GW and an annual output of 56 TWh, (representing a 42% market share). PGE produces about 68% of electricity from coal provided by its own lignite mines. In addition to power generation, the company also operates its own distribution network (covering about 26% of the Polish market), and a retail company which sales electricity to end users. Last but not least, PGE owns a 21.85% stake in telecom operator Polkomtel.

**Important dates**

15.11- Q3 2010 report

**PGE vs. WIG**

**Kamil Kliszcz**

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# PGE

PGE PW; PGEP WA

# Buy

(Reiterated)

## Poised For Electricity Price Appreciation

**A combination of high operating cash flows, buoyant earnings prospects for next year, and major asset divestment plans, suggests that PGE will be paying handsome dividends in 2011, preceded by an advanced payout later this year. We are reiterating PGE as a buy, and we are setting our new price target on the stock at PLN 27.53 per share (including a PLN 0.76 dividend for shareholders on record on September 22nd). Looking at current trends on the TGE energy exchange, we see a source of upside potential in prices of electric power, which may increase more than we assume for the purposes of our financial forecasts for PGE.**

**Strong Q2 2010 results**

PGE reported an in-line second-quarter EBITDA, but it is worth noting the strong operating cash flows generated in the period (PLN 1.9bn vs. PLN 1.5bn in Q1). Combined with reduced capital expenses (PLN 850m), this boosted the company's cash base to PLN 4.1bn.

**New power plant will drive 2011 earnings**

PGE is scheduled to start a trial run of its new 858 MW power plant in Bełchatów in Q4 2010. The new unit is going to become noticeable in the company's earnings starting in April 2011 (until then, any profits will be credited to CAPEX). According to our conservative estimates, the annual EBITDA contribution of the new unit will approximate PLN 600m.

**Organizational streamlining**

As part of an ongoing internal reorganization process, PGE increased its capital stock in Q3 by 139.7 million shares, issued to the company's employees in exchange for minority holdings in key assets. As a result, minority interests are set to decrease by an estimated PLN 3.4bn, while net earnings attributable to the shareholders of the parent company will increase (a change already factored in our forecasts). The new shares will start trading in late October, raising free float by 53%.

**Acquisition of Energa**

PGE is one of the two candidates to take over a majority stake in Energa. The winner will be announced on September 15th. The value-creation potential of this acquisition depends on the price, but recent statements seem to suggest that, at worst, the deal will have a neutral impact on PGE's value. Energa is worth between PLN 6.9 and 9.1 billion according to our estimates (the top end of the range is capped by PGE's 2010 multiples). In the long term, the acquisition should generate cost synergies for both utilities (it is worth mentioning that Energa is in no need of major capacity replacements).

(PLN m)	2008	2009	2010F	2011F	2011F
Revenue	19 408.7	21 623.4	21 029.7	22 398.2	24 499.9
EBITDA	5 846.9	7 983.4	6 995.8	7 984.6	9 083.4
EBITDA margin	30.1%	36.9%	33.3%	35.6%	37.1%
EBIT	3 262.3	5 344.7	4 288.2	5 090.0	5 967.5
Net profit**	1 920.2	3 370.7	3 124.5	3 774.5	4 208.4
DPS	0.29	0.71	0.70	0.84	1.01
P/E	18.2	12.2	14.2	11.8	10.6
P/CE	7.8	6.8	7.6	6.7	6.1
P/BV	1.5	1.3	1.2	1.2	1.1
EV/EBITDA*	7.6	5.4	6.2	5.6	5.7
DYield	1.2%	3.0%	3.0%	3.5%	4.2%

\*incl. investment in Polkomtel

\*\*factors in post-merger reduced minority interests

## High-Quality Q2 2010 Earnings

PGE reported Q2 2010 EBIT and EBITDA figures in line with expectations. The EBIT of the Conventional Power Generation segment exceeded our PLN 567m estimate at PLN 657m (with LTC compensation receipts at PLN 104m vs. our expected PLN 125m). Since the period's power output matched our forecasts, the higher-than-expected operating profit must have been achieved thanks to lower costs (which included provision reversals at the Opole Power Plant and damages received by the coal miner KWB Turów). The segment of Renewable Energy also did better than predicted with an EBIT of PLN 75.4m vs. our forecast of PLN 20m owed to higher hydroelectric power volumes (+19% y/y), higher prices of green certificates, lower D&A expenses (which decreased PLN 18m vs. Q1). In Distribution, EBIT fell slightly short of our PLN 158m estimate at PLN 140m, due probably to lower volumes. The Retail segment generated an EBIT of PLN 54m (we forecasted PLN 76m), and a lower-than-predicted margin affected by more intense competition (the same effect is seen in the second-quarter results of Tauron and Enea). The Wholesale segment was the only source of major disappointment, reporting an EBIT loss of PLN 12m vs. our expected PLN 103m profit (and PLN 109m posted in Q1 2010) in spite of favorable macroeconomic conditions (high spot prices).

### Reported vs. forecasted Q2 2010 results

(PLN m)	Q2 2010	Q2 2009	change	Q2 2010F	Actuals vs. Forecasts	Consensus Estimates	Actuals vs. Consensus
Revenues	4 770.8	5 752.6	-17%	5 445.2	-12%	5 114.3	-7%
EBITDA	1 602.6	1 969.0	-19%	1 631.8	-2%	1 624.5	-1%
EBITDA margin	33.6%	34.2%	-	30.0%	-	31.8%	-
EBIT	945.5	1 318.3	-28%	959.1	-1%	947.7	0%
Pre-tax income	902.6	1 419.5	-36%	1 115.8	-19%	-	-
Net income	600.4	920.7	-35%	729.5	-18%	630.4	-5%

Source: PGE, F – forecasts by BRE Bank Securities; Consensus estimates by PAP

PGE generated financial losses of PLN 43m (we expected gains of PLN 150m) in the second quarter, stemming from PLN 90m FX losses, a higher-than-predicted discount reversal against the environmental reserve (PLN 51m vs. PLN 30m in Q1), and high interest expenses incurred on an early loan repayment by the Bełchatów power plant. Minority interests proved lower than predicted, but the Q2 2010 bottom-line profit missed our estimate by 18%. It is worth noting PGE's strong operating cash flows generated in the period (PLN 1.9bn vs. PLN 1.5bn in Q1), with the working-capital balance PLN 141m in the positive territory. Combined with relatively low capital expenses (PLN 850min Q2 and PLN 1.9bn in H1 2010; the CAPEX budget for 2010 is PLN 4.8bn), this led to another increase in net cash (to PLN 4.1bn).

### Quarterly earnings results by business segment

(PLN m)	Q308	Q408	Q109	Q209	Q309	Q409	Q1'10	Q2'10
Revenues	4 220	4 500	5 348	5 753	4 770	5 753	5 340	4 771
EBIT	673	1 023	1 594	1 318	1 113	1 319	1 335	946
Power Generation	561.7	1 314.7	1 236.0	940.8	788.8	1 060.6	927.8	656.8
Renewable Energy	34.4	29.7	33.6	6.3	19.6	18.1	27.1	75.4
Power Distribution	87.6	-154.4	132.7	75.2	60.2	-4.8	172.6	139.9
Wholesale	-45.2	-189.5	55.9	143.9	149.4	90.3	109.1	-11.6
Retail	25.3	4.4	109.7	96.5	82.6	109.0	82.1	53.9
Other	9.4	18.5	26.5	55.7	12.5	40.8	16.5	27.7
EBITDA	1 253	1 693	2 239	1 969	1 755	2 020	1 992	1 603
Power output (GWh)	13.9	14.6	14.0	12.4	13.2	14.2	14.0	12.2
Power distribution volumes (GWh)	b/d	7.8	7.7	7.0	7.4	7.9	8.0	7.1

Source: PGE, BRE Bank Securities

## New Power Plant

PGE's main capital-investment project at the moment is construction of a new 858MW lignite-fired power station at the Bełchatów electricity-generating complex. The unit is scheduled for trial runs in Q4 2010, but an official launch and commencement of recognition of its earnings by PGE is slated for Q1 2011 (until that time, any financial inflows will be credited to CAPEX). PGE estimates the new plant's annual gross output at 6 TWh (5.7 TWh net), with net efficiency at 42% implying usage of 6.5MT of lignite, and average fixed costs at the standard level of PLN 0.19m/MWh. This implies an annual EBITDA of PLN 600m (with electricity prices at PLN 195/MWh), which seems a conservative projection considering the plant's cutting-edge technology and lower-than-usual staff headcount (maintenance will be performed by existing teams). The total cost of the new power plant is PLN 4.2bn (of which PLN 3.6bn was spent at 30 June), and the expected depreciation expenses will approximate PLN 140m, suggesting a contribution to EBIT of as much as PLN 460m. Further, the new power plant is going to derive feedstock from the "Pole Szczerców" coal field owned by PGE's coal miner KWB Bełchatów, which is expected to generate an additional EBITDA of PLN 60m from the sales. All told, therefore, the new power station's contribution to the consolidated EBITDA may approximate PLN 660m.

### Expenditure on new power plant for Bełchatów

(PLN m)	2006	2007	2008	2009	1H'2010	total
858 MW power plant	26	762	1 726	661	460	3 635
Pole Szczerców coal field	181	267	316	252	157	1 173

Source: PGE, BRE Bank Securities

## Divestments

Assets earmarked for sale are an important component of PGE's valuation. The most valuable of these assets are the 21.85% holdings in mobile telephony operator Polkomtel, whose book value as shown in PGE's balance sheet is PLN 1.26 billion. The actual market value of these holdings is closer to PLN 3.5bn according to our estimates (suggesting a cash inflow of PLN 3.1bn and net proceeds of PLN 2.2bn on the divestment). All of Polkomtel's Polish stockholders (PGE, KGHM, PKN Orlen, Węglokoks) plan to sell their stakes in a coordinated manner some time in Q1 2011, but experience teaches us that a delay is inevitable. However, we can probably assume that the deals will go through next year, suggesting that PGE's shareholders can look forward to an additional dividend of PLN 1.17 per share (calculated based on raised equity), and a yield of 5%. PGE recognizes Polkomtel's earnings under equity in profits of investments accounted for under the equity method, and their contributions to this income line amounted to PLN 239m in 2008, PLN 241m in 2009, and PLN 112m in H1 2010.

Another upcoming major divestment is a 95% stake in fiber-optic network operator Exatel. PGE has hired PricewaterhouseCoopers as the divestment advisor, and it has already received statements of interest from Netia and GTS. Exatel's current book value is PLN 402m. Last year, the company generated a net profit of PLN 56.5m and an EBITDA of PLN 153m (including PLN 24m in released provisions), on a revenue of PLN 551m. We believe that Exatel will go for PLN 580-600m, and, since it is a fully consolidated subsidiary, its divestment will necessitate a revision of our DCF model.

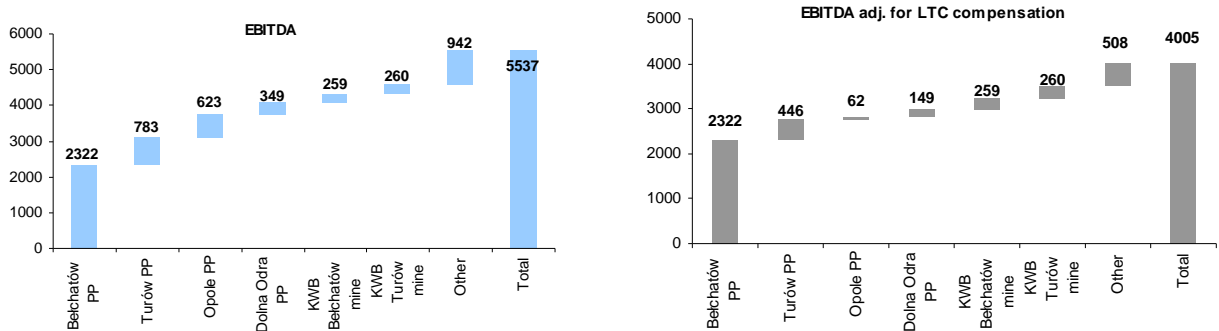
Finally, PGE has earmarked for sale its 20% interest in motorway operator "Autostrada Wielkopolska (AW)", whose carrying value is PLN 115m. The power producer is also the holder of PLN 238m in AW's bonds, which makes for a potential profit on the divestment in the vicinity of PLN 350m. PGE hopes to unload Exatel and AW still this year.

## Impact of Flood Damage on Turów Power Plant

After a dam forming the artificial lake Witka broke in early August, flooding the mine which supplies coal to PGE's power plant in Turów, the plant was forced to cut down production (only two out of seven generating units were left up), and move its employees and most of the mining equipment to another site. Turów's grid supplies were compensated by other PGE power plants. According to latest reports, the mine has resumed normal operations, and the power plant is now using five generators. Since insurance is expected to cover the losses, the

disruptions should not affect PGE's third-quarter profits, however, made an attempt at calculating the potential lost profits of Turów in case the insurer decides not to pay compensation for lost margins, only for damaged equipment. According to latest financial reports by PGE companies, the Turów energy complex (the mine and power plant) generated a recurring EBITDA of PLN 705m, representing 17.6% of the figure reported by PGE's Power Generation segment. We estimate Turów's monthly fixed costs at PLN 95m (PLN 74m after D&A expenses), suggesting that PGE would lose PLN 3m in these costs alone (PLN 2.5m cash costs), plus PLN 1.2m in margins, per day of downtime. In actuality, these losses were lower since the mine was down only for three days, and two generators at the power plant continued to work. Taking into account Turów's recovery schedule, we estimate the potential negative impact of the flood on Q3 2010 EBIT at PLN 15-20m. The diagrams below show a breakdown of PGE's Power-Generation EBITDA by source to give an idea how potential failures at each may affect earnings.

### EBITDA-generating units in the Mining and Generation segment

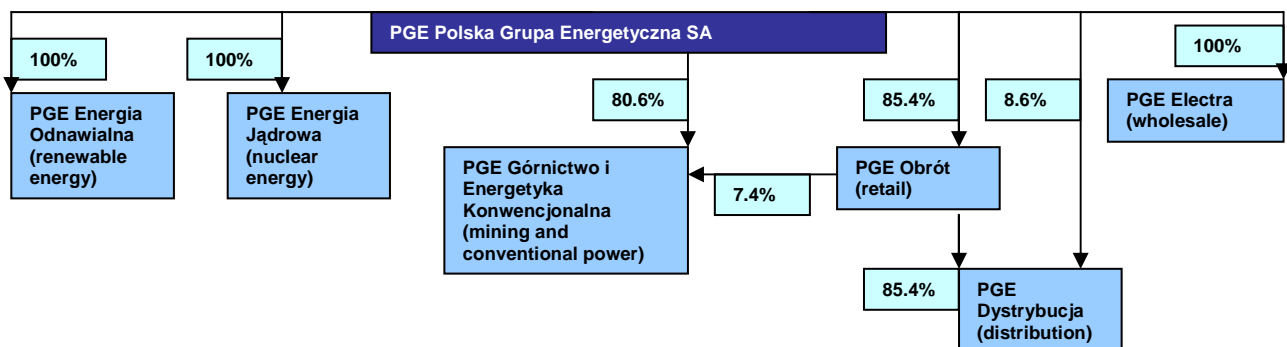


Source: PGE, BRE Bank Securities

## Merger Stock Issue

PGE has completed an organizational integration by absorbing certain operations and issuing 139,696,727 shares (which increased the company's equity by 7.5%) as consideration for 15% stakes in subsidiary holding companies PGE Energia and PGE Górnictwo i Energetyka (GiE) which allowed for their merger with their parent. The equity increase was registered on 31 August, and the new shares are scheduled for a listing in the second half of October. After a rounding-down, the remaining unallocated 22,897 shares were repurchased by PGE for PLN 0.58m, and they are earmarked for retirement. The equity issue, which was worth PLN 3.3bn based on current prices, will result in a reduction in minority interests (the company estimated that the PLN 7.7bn minority interests as at 31 December 2009 will decrease by PLN 3.4bn, or 44%). Further, 40% of the earnings to have to date been attributed to minorities will be shifted to earnings attributable to the shareholders of the parent (in 2009, this would mean a deduction of PLN 390m from minority interests of PLN 967m). We adjusted PGE's 2010 first-half earnings (which included minority interests of PLN 342m) accordingly for the purposes of our full-year forecasts (by shifting about PLN 96m to profits attributable to the shareholders of PGE).

### Organizational chart for post-integration PGE



Source: PGE, BRE Bank Securities

The organizational realignment is going to change PGE's direct and indirect holdings in key assets, which will increase from ca. 75% to 87% in case of the Generation segment and from 72% to 85.4% in case of the Distribution and Trade segment (with minority interests reduced to 13%-15% from 25%-28%). Non-controlling interests are now mostly held by the Polish State Treasury (employees, who were the other former minority owners, opted to convert a total of 96% of interests in PGE Energia, and 92.8% of interests in PGE GiE), and PGE will probably buy them back as well in the future. PGE's Management believe that the savings generated thanks to the reorganization will amount to PLN 1 billion in three years. The company has not shared any more specifics with investors, leaving us skeptical about the savings potential in light of the agreements that it had signed with trade unions before the mergers, allowing the workers retain their old privileges and benefits. We would say that the cost-cutting potential that can be realized without engaging in a conflict with the unions lies in expenses incurred on maintenance of Supervisory and Management Boards, and financial costs which can be reduced by consolidating all debts at the parent-company level.

## Potential Acquisition of Energa

PGE has been shortlisted as one of two candidates to take over the power utility Energa from the Polish government (the other bidder is Czech Energetický Průmyslový Holding). If the State Treasury selects PGE, the transaction will be delayed by the anti-trust authority UOKiK which sees the merger as a potential threat to fair competition. PGE's defense is that it can prevent market concentration by selling electricity through an exchange, and divesting some of its generation assets, and it plans to invoke national energy security if need be. For PGE shareholders, the key consideration is the value-enhancing potential of the transaction. We provide a summary overview of Energa's financial performance in the table below. The utility's main assets are hydroelectric power plants with an installed capacity of 0.4 GW (these plants generated 31% of the consolidated H1 2010 EBITDA, equivalent to PLN 253m), a distribution network with an annual transmission capacity of 20 TWh (42% of H1 EBITDA), an electricity-trading company (19% of H1 EBITDA), and a power plant in Ostrołęka (7.3% of H1 EBITDA).

### Financial and operational data of Energa

(PLN m)	Energa				
	2007	2008	2009	1H'2010	1H'2009
<b>Revenues</b>	<b>3 682.0</b>	<b>8 311.2</b>	<b>8 600.0</b>	<b>4 448.0</b>	<b>4 148.0</b>
EBIT	113.1	754.2	n/a	n/a	n/a
D&A expenses	487.2	632.7	n/a	n/a	n/a
<b>EBITDA, incl.:</b>	<b>600.3</b>	<b>1 386.9</b>	<b>1 100.0</b>	<b>818.0</b>	<b>580.1</b>
Hydroelectric power stations	n/a	243.1	n/a	251.0	185.9
Ostrołęka Power Plant	n/a	89.2	n/a	60.1	114.3
Power Distribution	n/a	811.1	n/a	341.0	243.6
Trade	n/a	111.5	n/a	152.0	45.0
Other	n/a	132.0	n/a	13.9	-8.6
EBITDA margin	16.3%	16.7%	12.8%	18.4%	14.0%
Minority interests in net income	16.4	96.7	n/a	n/a	n/a
<b>Net income</b>	<b>56.5</b>	<b>435.3</b>	<b>425.0</b>	<b>442.0</b>	<b>263.1</b>
Net margin	1.5%	5.2%	4.9%	9.9%	6.3%
Cash	449.4	838.4	n/a	n/a	n/a
Loans	537.3	281.7	n/a	n/a	n/a
Net debt	87.9	-556.6	n/a	n/a	n/a
Minority interests	783.4	791.4	n/a	n/a	n/a
Equity	4 906.3	5 231.5	n/a	n/a	n/a

Source: Energa, BRE Bank Securities

PGE's CEO Tomasz Zadroga considers the price set on Energa very reasonable (it is below the 7-13 EV/EBITDA ratios recorded in similar transactions completed recently) considering that cost savings achievable just on feedstock and third-party services can reach PLN 100m per year. We compared Energa's valuation multiples with other power producers listed on the Warsaw Stock Exchange. Energa had net cash of PLN 556m in 2008, but it paid dividends of PLN 99.4m this year. Note also the 2008 minority interests totaling PLN 791m. Like most other power utilities, Energa is currently undergoing a reorganization, and, by the time the takeover by PGE takes place, these minority interests may be significantly lower. Further, our valuation

is based on the assumption that Energa will generate an EBITDA of PLN 1.3bn (YTD EBITDA at 30 July was PLN 909m) and a net profit of PLN 788m (PLN 488m at 30 July) in 2010. Depending on the time horizon and peer group used, Energa's value estimates range between PLN 6.9 and 9.1 billion, and the top end of this range should be the cutoff point for PGE in our view (it is equivalent to PGE's market value). When assessing the value-enhancing potential of the acquisition, it is important to note that Energa's power-generating assets do not need major upgrades and replacements, and that its huge CAPEX budget plans for future years have as their goal further expansion. Energa plans to spend PLN 23bn over the next few years on new capacity additions (gas-fired power plants in Gdańsk and Grudziądz with combined capacity of 1 GW, hydroelectric power plants, a new 1 GW generator for the Ostrołęka Power Plant, wind farms), and network development and modernization (for which the company secured PLN 2.2bn in financing from EBRD and EIB).

### Relative valuation of Energa

	Price	P/CE		P/E		EV/EBITDA		P/BV
		2009	2010F	2009	2010F	2009	2010F	2009
ENEA	20.40	7.7	6.8	8.2	9.6	5,8	4,9	1,0
PGE	23.90	7.4	7.7	13.3	14.3	5,4	6,2	1,3
TAURON	5.60	4.8	4.3	13.4	10.8	4,2	4,1	0,7
<b>Average</b>		<b>7.4</b>	<b>6.8</b>	<b>13.3</b>	<b>10.8</b>	<b>5,4</b>	<b>4,9</b>	<b>1,0</b>
<b>(PLN billion)</b>								
Energa's value (average)		7.9	9.6	5.6	8.5	5,6	6,1	5,0
Energa's value (PGE)		7.9	10.9	5.6	11.3	5.6	7,7	6,8
<b>Value based on average (2009-10)</b>		<b>6.92</b>		<b>Value based on average (2010)</b>		<b>7.33</b>		
<b>Value according to PGE (2009-10)</b>		<b>7.96</b>		<b>Value according to PGE (2010)</b>		<b>9.16</b>		

Source: Energa, Enea, PGE, Tauron, BRE Bank Securities

## Macroeconomic Assumptions

The table below outlines the macroeconomic assumptions underlying DCF valuation.

	2006	2007	2008	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F
Prices of Brent crude (USD/Bbl)	65.4	72.8	98.0	62.0	77.0	80.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0
EEX energy prices (EUR/MWh)	41.8	54.9	54.9	69.1	49.3	52.2	55.4	62.8	66.2	67.4	68.2	71.5	75.5	77.1
<b>Polish energy prices (PLN/MWh)</b>	<b>138.6</b>	<b>142.8</b>	<b>154.3</b>	<b>195.0</b>	<b>190.0</b>	<b>195.0</b>	<b>210.6</b>	<b>232.3</b>	<b>231.6</b>	<b>235.9</b>	<b>238.6</b>	<b>250.2</b>	<b>264.3</b>	<b>269.9</b>
Prices of CO2 certificates, EUR/T	21.6	20.6	23.9	13.8	14.6	18.3	22.2	30.0	31.5	33.0	34.6	36.3	38.1	40.0
Prices of thermal coal (PLN/T)	157.8	161.6	192.7	274.1	252.2	264.8	295.1	284.9	274.7	274.7	274.7	274.7	274.7	274.7
Avg. PLN/USD exchange rate	3.11	2.77	2.42	3.12	3.07	3.10	2.90	2.80	2.70	2.70	2.70	2.70	2.70	2.70
Avg. EUR/PLN exchange rate	3.90	3.79	3.48	4.33	4.00	4.00	3.80	3.70	3.50	3.50	3.50	3.50	3.50	3.50
<b>Power output (TWh)</b>	<b>56.7</b>	<b>54.2</b>	<b>56.1</b>	<b>53.8</b>	<b>53.1</b>	<b>58.0</b>	<b>61.2</b>	<b>60.2</b>	<b>61.4</b>	<b>70.5</b>	<b>72.6</b>	<b>73.8</b>	<b>73.6</b>	<b>73.2</b>
lignite-fired	37.7	35.8	38.2	35.9	35.3	40.2	43.4	42.1	42.1	42.1	40.4	40.4	40.4	40.4
hard coal-fired	15.5	15.6	14.8	14.6	14.8	14.8	14.8	14.8	14.8	20.1	20.1	20.1	19.6	19.2
natural gas-fired	2.1	1.9	2.0	2.0	2.0	2.0	2.0	2.0	2.0	4.6	8.2	9.2	9.2	9.2
wind power	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.3	1.5	2.8	3.0	3.3	3.5	3.5
other	1.4	0.9	1.0	1.2	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9

Source: PGE, Bloomberg, F –forecasts by BRE Bank Securities

## Earnings Forecast and Valuation

Using DCF analysis and relative valuation, we set the nine-month price target on PGE at PLN 27.53 per share.

	Weight	Price
Relative Valuation	50%	21.51
DCF Analysis	50%	29.72
	price	25.62
	<b>9M target price</b>	<b>27.53</b>

### DCF Analysis

#### DCF Model Assumptions

1. Cash flows are discounted to their present value as at 31 August 2010. Equity value calculations factor in FY2009 net debt and minority interests adjusted for the PLN 3.4bn merger-stock issue.
2. The macroeconomic assumptions are as laid out above.
3. The valuation factors in PGE's non-operating assets including a 21.85% investment in Polkomtel (PLN 3.1bn) and Autostrada Wielkopolska (PLN 350m including bond holdings).
4. We added an expected PLN 320m refund of an excise tax on network losses to the valuation.
5. We adjusted the free cash flows projected for the forecast years for disputed LTC compensation, by increasing accounts payable.
6. The depreciation and amortization expense projected for FY2019 is higher than CAPEX, which is unsustainable over a long term, prompting a revision in the D&A expense to PLN 3.8m for purposes of terminal value estimations.
7. When calculating  $FCF_{TV}$ , we based terminal-value calculations on the sales growth rate and EBITDA margins projected for 2019.
8. We assume that FCF after FY2019 will grow at a rate of 2%. The risk-free rate is 5.6%, and beta is 0.9.



**DCF model for PGE**

(PLN m)	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F	2019+
<b>Revenues</b>	<b>21 030</b>	<b>22 398</b>	<b>24 500</b>	<b>26 387</b>	<b>27 376</b>	<b>30 038</b>	<b>31 116</b>	<b>32 643</b>	<b>34 284</b>	<b>35 049</b>	<b>35 049</b>
change	-	6.5%	9.4%	7.7%	3.7%	9.7%	3.6%	4.9%	5.0%	2.2%	0.0%
<b>EBITDA</b>	<b>6 995.8</b>	<b>7 984.6</b>	<b>9 083.4</b>	<b>9 397.6</b>	<b>9 571.8</b>	<b>10 870.5</b>	<b>10 825.9</b>	<b>11 558.3</b>	<b>11 769.5</b>	<b>12 069.3</b>	<b>12 069.3</b>
EBITDA margin	33.3%	35.6%	37.1%	35.6%	35.0%	36.2%	34.8%	35.4%	34.3%	34.4%	34.4%
D&A expenses	2 707.7	2 894.6	3 115.9	3 590.7	4 126.5	4 622.8	4 870.6	5 056.7	5 229.0	5 418.4	3 845.5
<b>EBIT</b>	<b>4 288.2</b>	<b>5 090.0</b>	<b>5 967.5</b>	<b>5 806.8</b>	<b>5 445.3</b>	<b>6 247.7</b>	<b>5 955.2</b>	<b>6 501.7</b>	<b>6 540.5</b>	<b>6 650.9</b>	<b>8 223.8</b>
EBIT margin	20.4%	22.7%	24.4%	22.0%	19.9%	20.8%	19.1%	19.9%	19.1%	19.0%	23.5%
EBIT tax	814.8	967.1	1 133.8	1 103.3	1 034.6	1 187.1	1 131.5	1 235.3	1 242.7	1 263.7	1 562.5
<b>NOPLAT</b>	<b>3 473.4</b>	<b>4 122.9</b>	<b>4 833.6</b>	<b>4 703.5</b>	<b>4 410.7</b>	<b>5 060.7</b>	<b>4 823.7</b>	<b>5 266.3</b>	<b>5 297.8</b>	<b>5 387.2</b>	<b>6 661.3</b>
CAPEX	-3 978	-6 452	-11 987	-9 078	-9 978	-6 151	-4 078	-4 078	-4 059	-3 845	-3 845
Working capital	-504.3	-297.4	-365.3	-346.1	-234.9	-399.2	-218.0	-260.0	-170.7	-79.4	-79.4
Equity investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>FCF</b>	<b>1 698.7</b>	<b>267.9</b>	<b>-4 402.6</b>	<b>-1 129.3</b>	<b>-1 675.7</b>	<b>3 133.8</b>	<b>5 398.9</b>	<b>5 985.0</b>	<b>6 297.6</b>	<b>6 880.7</b>	<b>6 581.9</b>
WACC	10.1%	10.2%	9.3%	8.9%	8.4%	8.5%	8.8%	9.1%	8.9%	8.9%	8.8%
discount factor	96.8%	87.9%	80.4%	73.8%	68.1%	62.8%	57.7%	52.9%	48.6%	44.6%	44.6%
PV FCF	1 645.1	235.5	-3 539.6	-833.8	-1 141.5	1 967.7	3 116.5	3 165.6	3 058.4	3 068.2	
<b>WACC</b>	<b>10.1%</b>	<b>10.2%</b>	<b>9.3%</b>	<b>8.9%</b>	<b>8.4%</b>	<b>8.5%</b>	<b>8.8%</b>	<b>9.1%</b>	<b>8.9%</b>	<b>8.9%</b>	<b>8.8%</b>
Cost of debt	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%
Risk-free rate	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%
Risk premium	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Effective tax rate	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%
Net debt / EV	0.0%	-1.4%	16.0%	25.5%	35.9%	33.9%	27.9%	20.3%	25.0%	25.0%	28.0%
Cost of equity	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%
Risk premium	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Beta	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
FCF growth after the forecast horizon	2.0%										
Terminal value	97 237										
Present value of terminal value (PV TV)	43 359										
Present value of FCF in the forecast horizon	10 742										
Equity value	54 101										
FY2009 net debt (adjusted)	-2 015										
Minority interests	4 281										
Investment in Polkomtel	3 067										
Other non-operating assets	350										
Network loss excise receivable	320										
Final value of PGE	55 572										
Number of shares (millions)	1 870										
<b>Equity value per share (PLN)</b>	<b>29.72</b>										
Cost of equity	7.5%										
<b>Target Price</b>	<b>31.94</b>										
EV/EBITDA ('10) for the target price	8.2										
P/E ('10) for the target price	19.1										
TV to EV	80%										

**Sensitivity Analysis**

		0.0%	1.0%	2.0%	3.0%	4.0%
FCF growth in perpetuity						
WACC +1.0ppt	24.29	26.26	28.74	31.94	36.27	
WACC +0.5ppt	25.22	27.42	30.23	33.93	39.04	
WACC	26.26	28.74	31.94	36.27	42.40	
WACC -0.5ppt	27.42	30.23	33.93	39.04	46.54	
WACC -0.10ppt	28.74	31.94	36.27	42.40	51.78	

## Relative Valuation

We compared PGE's P/E and EV/EBITDA multiples with the multiples of its peers estimated for FY2010 through FY2012. The peer group includes international power producers and distributors, and natural gas supplier PGNiG, which also meets the definition of a utility. Compared to European energy companies, PGE's current price carries a discount to average EV/EBITDA and a premium on P/CE.

	Price	P/CE				EV/EBITDA*			
		2009	2010F	2011F	2012F	2009	2010F	2011F	2012F
EDF	32.85	5.6	5.2	5.0	4.7	6.3	5.9	5.7	5.3
E.ON AG	23.24	5.0	5.1	5.3	5.1	6.3	6.3	6.5	6.3
IBERDROLA SA	5.73	6.3	6.0	5.7	5.2	8.9	8.3	7.9	7.3
ENEL SPA	3.96	3.9	3.8	3.7	3.6	6.1	5.8	5.7	5.5
RWE AG	53.39	5.6	4.9	4.9	4.7	6.4	5.6	5.7	5.4
ENDESA SA	19.71	4.4	4.7	5.0	4.8	5.8	5.9	5.9	5.6
FORTUM OYJ	19.19	9.4	8.8	8.9	8.5	10.0	9.6	9.6	9.2
ENEA	20.50	7.7	6.8	6.6	6.1	5.9	5.0	4.8	4.2
PGNiG	3.47	6.5	4.9	5.1	4.9	6.5	4.5	4.7	4.5
CEZ	820.50	6.0	6.3	5.9	5.5	6.2	6.5	6.1	5.7
Tauron	5.56	4.7	4.2	4.1	3.7	4.2	4.1	3.8	3.4
Maximum		9.4	8.8	8.9	8.5	10.0	9.6	9.6	9.2
Minimum		3.9	3.8	3.7	3.6	4.2	4.1	3.8	3.4
<b>Median</b>		<b>5.6</b>	<b>5.1</b>	<b>5.1</b>	<b>4.9</b>	<b>6.3</b>	<b>5.9</b>	<b>5.7</b>	<b>5.5</b>
PGE	23.78	7.4	7.6	6.7	6.1	5.4	6.1	5.4	4.7
(premium / discount)		33.1%	50.0%	30.9%	22.8%	-14.3%	4.7%	-5.9%	-14.6%
<b>Implied price</b>									
Median		5.6	5.1	5.1	4.9	6.3	5.9	5.7	5.5
Multiple weight			50.0%				50.0%		
Year weight		0.0%	33.3%	33.3%	33.3%	0.0%	33.3%	33.3%	33.3%
<b>Implied value of PGE (PLN)</b>		<b>21.51</b>							

\*EV/EBITDA based on FY2009 net debt

**Income Statement**

(PLN m)	2007	2008	2009	2010F	2011F	2012F	2013F
<b>Revenue</b>	<b>23 090.7</b>	<b>19 408.7</b>	<b>21 623.4</b>	<b>21 029.7</b>	<b>22 398.2</b>	<b>24 499.9</b>	<b>26 387.3</b>
<i>change</i>	-5.1%	-15.9%	11.4%	-2.7%	6.5%	9.4%	7.7%
incl. LTC	0.0	1 322.0	1 532.3	420.0	397.5	405.7	357.8
<b>EBIT, incl.</b>	<b>2 134.3</b>	<b>3 262.3</b>	<b>5 344.7</b>	<b>4 288.2</b>	<b>5 090.0</b>	<b>5 967.5</b>	<b>5 806.8</b>
Mining and Generation	1 485.9	2 650.1	4 026.3	3 012.0	3 454.7	4 132.1	3 760.7
Renewable Energy	87.6	135.7	77.6	202.9	185.3	171.1	245.7
Distribution	213.4	229.9	263.2	591.5	710.1	821.8	929.1
Wholesale	201.7	74.5	439.4	76.3	321.7	335.6	326.4
Retail	41.4	76.7	397.7	284.6	288.2	359.0	411.5
Other	104.2	95.3	140.5	120.9	130.1	147.8	133.5
<b>EBIT</b>	<b>2 134.3</b>	<b>3 262.3</b>	<b>5 344.7</b>	<b>4 288.2</b>	<b>5 090.0</b>	<b>5 967.5</b>	<b>5 806.8</b>
<i>change</i>	-8.1%	52.8%	63.8%	-19.8%	18.7%	17.2%	-2.7%
<i>EBIT margin</i>	9.2%	16.8%	24.7%	20.4%	22.7%	24.4%	22.0%
Profit/loss on financial activity	-396.0	-331.3	-208.4	-137.6	-61.5	-287.9	-637.5
Extraordinary gains/losses	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Other	239.2	238.6	242.2	220.0	220.0	220.0	220.0
<b>Pre-tax income</b>	<b>1 977.5</b>	<b>3 169.5</b>	<b>5 378.5</b>	<b>4 370.6</b>	<b>5 248.5</b>	<b>5 899.5</b>	<b>5 389.4</b>
Tax	-948.1	499.3	1 041.3	830.4	997.2	1 120.9	1 024.0
Minority interests	803.0	750.1	966.5	415.7	476.8	570.2	519.0
Income from discontinued operations	1 845.3	0.0	0.0	0.0	0.0	0.0	0.0
<b>Net income</b>	<b>3 967.9</b>	<b>1 920.2</b>	<b>3 370.7</b>	<b>3 124.5</b>	<b>3 774.5</b>	<b>4 208.4</b>	<b>3 846.4</b>
<i>change</i>	130.3%	-51.6%	75.5%	-7.3%	20.8%	11.5%	-8.6%
<i>margin</i>	17.2%	9.9%	15.6%	14.9%	16.9%	17.2%	14.6%
D&A expenses	3 840.8	2 584.6	2 638.7	2 707.7	2 894.6	3 115.9	3 590.7
<b>EBITDA</b>	<b>5 975.1</b>	<b>5 846.9</b>	<b>7 983.4</b>	<b>6 995.8</b>	<b>7 984.6</b>	<b>9 083.4</b>	<b>9 397.6</b>
<i>change</i>	-3.0%	-2.1%	36.5%	-12.4%	14.1%	13.8%	3.5%
<i>EBITDA margin</i>	25.9%	30.1%	36.9%	33.3%	35.6%	37.1%	35.6%
Shares at year-end (millions)	1 470.6	1 470.6	1 730.1	1 869.8	1 869.8	1 869.8	1 869.8
EPS	2.7	1.3	1.9	1.7	2.0	2.3	2.1
CEPS	5.3	3.1	3.5	3.1	3.6	3.9	4.0
ROAE	16.3%	8.7%	12.5%	9.3%	10.2%	10.7%	9.4%
ROAA	7.9%	4.2%	6.6%	5.7%	6.6%	6.7%	5.5%

**Balance Sheet**

(PLN m)	2007	2008	2009	2010F	2011F	2012F	2013F
<b>ASSETS</b>	<b>45 309.4</b>	<b>47 192.3</b>	<b>54 447.8</b>	<b>55 746.9</b>	<b>57 951.9</b>	<b>67 293.4</b>	<b>73 220.8</b>
<b>Fixed assets</b>	<b>38 419.9</b>	<b>40 701.2</b>	<b>41 964.4</b>	<b>43 234.9</b>	<b>46 792.5</b>	<b>55 663.5</b>	<b>61 150.3</b>
Property, plant and equipment	36 282.6	37 811.6	38 945.7	40 228.6	43 792.6	52 630.7	58 140.5
Intangible assets	138.6	142.0	153.3	140.8	134.5	167.3	144.3
Investments	726.1	1 479.1	1 354.8	1 354.8	1 354.8	1 354.8	1 354.8
Other fixed assets	1 272.6	1 268.6	1 510.6	1 510.6	1 510.6	1 510.6	1 510.6
<b>Current assets</b>	<b>6 889.4</b>	<b>6 491.1</b>	<b>12 483.4</b>	<b>12 512.0</b>	<b>11 159.4</b>	<b>11 629.9</b>	<b>12 070.5</b>
Inventories	798.9	1 128.0	1 271.2	1 236.3	1 316.7	1 440.3	1 551.2
Short-term receivables	2 335.2	1 792.6	2 059.1	2 002.6	2 132.9	2 333.0	2 512.8
Other current assets	1 028.9	1 429.6	1 440.2	2 006.2	2 161.4	2 308.2	2 458.1
Cash and cash equivalents	2 726.4	2 140.8	7 712.8	7 266.9	5 548.4	5 548.4	5 548.4
<b>LIABILITIES</b>	<b>45 309.4</b>	<b>47 192.3</b>	<b>54 447.8</b>	<b>55 746.9</b>	<b>57 951.9</b>	<b>67 293.4</b>	<b>73 220.8</b>
<b>Equity</b>	<b>21 252.4</b>	<b>22 809.7</b>	<b>31 168.3</b>	<b>36 158.0</b>	<b>38 150.3</b>	<b>40 251.4</b>	<b>41 773.7</b>
Share capital	14 705.8	14 705.8	17 300.9	17 300.9	17 300.9	17 300.9	17 300.9
Other equity	6 546.6	8 103.9	13 867.4	18 857.1	20 849.4	22 950.5	24 472.8
<b>Minority interests</b>	<b>8 168.0</b>	<b>7 365.9</b>	<b>7 681.4</b>	<b>4 020.5</b>	<b>4 164.8</b>	<b>4 353.6</b>	<b>4 416.4</b>
<b>Long-term liabilities</b>	<b>10 469.8</b>	<b>9 519.9</b>	<b>9 762.3</b>	<b>9 762.3</b>	<b>9 762.3</b>	<b>15 368.2</b>	<b>18 796.3</b>
Loans	5 739.4	4 470.8	4 056.3	4 056.3	4 056.3	9 662.1	13 090.2
Other	4 730.4	5 049.1	5 706.1	5 706.1	5 706.1	5 706.1	5 706.1
<b>Short-term liabilities</b>	<b>5 419.1</b>	<b>7 496.8</b>	<b>5 835.7</b>	<b>5 806.0</b>	<b>5 874.5</b>	<b>7 320.2</b>	<b>8 234.4</b>
Loans	1 312.1	3 038.1	969.9	969.9	969.9	2 310.4	3 130.1
Trade creditors	1 554.0	1 012.1	1 082.6	1 052.9	1 121.4	1 226.6	1 321.1
Other	2 553.0	3 446.6	3 783.2	3 783.2	3 783.2	3 783.2	3 783.2
Debt	7 051.5	7 508.9	5 026.2	5 026.2	5 026.2	11 972.5	16 220.4
Net debt	4 325.1	5 368.0	-2 686.6	-2 240.7	-522.2	6 424.1	10 672.0
(Net debt / Equity)	20.4%	23.5%	-8.6%	-6.2%	-1.4%	16.0%	25.5%
(Net debt / EBITDA)	0.7	0.9	-0.3	-0.3	-0.1	0.7	1.1
<b>BVPS</b>	<b>14.5</b>	<b>15.5</b>	<b>18.0</b>	<b>19.3</b>	<b>20.4</b>	<b>21.5</b>	<b>22.3</b>

**Cash Flows**

(PLN m)	2007	2008	2009	2010F	2011F	2012F	2013F
<b>Cash flows from Operating Activities</b>	<b>5 683.4</b>	<b>5 386.6</b>	<b>7 298.9</b>	<b>5 661.1</b>	<b>6 690.0</b>	<b>7 597.2</b>	<b>8 027.6</b>
Net income	3 967.9	1 920.2	3 370.7	3 124.5	3 774.5	4 208.4	3 846.4
D&A expenses	3 840.8	2 584.6	2 638.7	2 707.7	2 894.6	3 115.9	3 590.7
Working capital	4.6	-904.6	-499.5	-504.3	-297.4	-365.3	-346.1
Other	-2129.9	1786.4	1789.0	333.2	318.3	638.1	936.5
<b>Cash flows from investing activities</b>	<b>-3 511.5</b>	<b>-5 444.5</b>	<b>-3 628.6</b>	<b>-3 678.1</b>	<b>-6 066.3</b>	<b>-11 580.1</b>	<b>-8 636.3</b>
CAPEX	-3 635.3	-4 124.1	-4 022.2	-3 978.1	-6 452.2	-11 986.9	-9 077.5
Other	123.8	-1320.3	393.6	300.0	385.9	406.8	441.3
<b>Cash flows from financing activities</b>	<b>-2 761.2</b>	<b>-528.3</b>	<b>1 898.3</b>	<b>-2 429.0</b>	<b>-2 342.2</b>	<b>3 982.9</b>	<b>608.7</b>
Stock offering	0.0	0.0	5 917.5	0.0	0.0	0.0	0.0
Debt	-1 716.8	288.2	-2 449.3	0.0	0.0	6 946.3	4 247.8
Dividends (buyback)	-229.8	-424.4	-1 227.4	-1 314.8	-1 562.3	-1 887.3	-2 104.2
Other	-814.6	-392.1	-342.6	-1114.2	-779.9	-1076.2	-1534.9
<b>Change in cash</b>	<b>-586.4</b>	<b>-582.7</b>	<b>5 572.0</b>	<b>-445.9</b>	<b>-1 718.5</b>	<b>0.0</b>	<b>0.0</b>
Cash at end of period	2 726.4	2 140.8	7 712.8	7 266.9	5 548.4	5 548.4	5 548.4
DPS (PLN)	0.16	0.29	0.71	0.70	0.84	1.01	1.13
FCF	3 292.5	318.9	2 420.4	1 683.0	237.8	-4 389.7	-1 050.0
(CAPEX / Sales)	15.7%	21.2%	18.6%	18.9%	28.8%	48.9%	34.4%

**Market multiples**

	2007	2008	2009	2010F	2011F	2012F	2013F
P/E	8.8	18.2	12.2	14.2	11.8	10.6	11.6
P/CE	4.5	7.8	6.8	7.6	6.7	6.1	6.0
P/BV	1.6	1.5	1.3	1.2	1.2	1.1	1.1
P/S	1.5	1.8	1.9	2.1	2.0	1.8	1.7
FCF/EV	7.4%	0.7%	5.6%	3.9%	0.5%	-8.4%	-1.9%
EV/EBITDA*	7.4	7.6	5.4	6.2	5.6	5.7	6.0
EV/EBIT	20.8	13.7	8.1	10.1	8.8	8.7	9.7
EV/S	1.9	2.3	2.0	2.1	2.0	2.1	2.1
DYield	0.7%	1.2%	3.0%	3.0%	3.5%	4.2%	4.7%
<b>Price (PLN)</b>	<b>23.78</b>						
Shares at year-end (millions)	1470.6	1470.6	1730.1	1869.8	1869.8	1869.8	1869.8
MC (PLN m)	34 970.3	34 970.3	41 141.5	44 463.5	44 463.5	44 463.5	44 463.5
Equity attributable to minority shareholders (PLN m)	8168.0	7365.9	7681.4	4020.5	4164.8	4353.6	4416.4
EV (PLN m)	44 396.1	44 636.9	43 068.9	43 175.9	45 038.6	52 173.8	56 484.4

**Power Utilities**

Poland

<b>Offering price</b>	<b>PLN 5.56</b>
<b>Target price</b>	<b>PLN 8.87</b>
Market cap	PLN 9.7bn*
Free float	PLN 5.2bn
Avg. daily trading volume (3M)	PLN 83.7m

\*taking into account a share capital increase by 163m shares

**Shareholder Structure**

State Treasury	42.11%
KGHM	4.67%
Others	53.22%

**Sector Outlook**

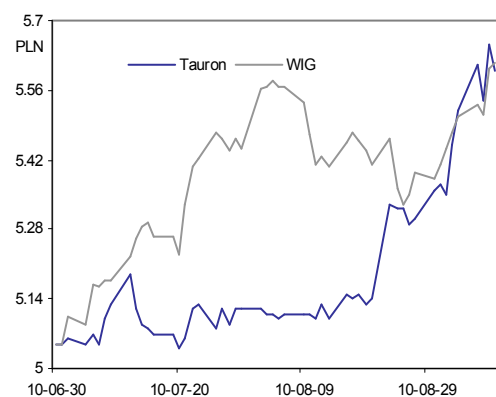
The Polish power utilities sector is expected to correlate increasingly with EU markets, and electricity prices are converging to EU averages. The convergence process should be supported by increasing electricity usage accompanied by a hiatus in capacity expansion – a combination which could lead to power shortage during peak demand periods in the future.

**Company Profile**

Tauron Polska Energia is the second largest vertically-integrated power company in Poland, with a generation capacity of 5.6 GW, and annual coal-production capacity of 5 Mt. The utility is the number-one retailer in the country, supplying over 30.4 TWh of electricity a year, and it sent 30.9 TWh of electricity in 2009 via its distribution infrastructure.

**Important dates**

15.11 — Q3 2010 report

**Tauron vs. WIG****Kamil Kliszczyk**

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# Tauron

TPE.PW; TPE.WA

**Buy**

(Reiterated)

## PLN 1 Billion EBITDA Per Year Worth 0??

In the second quarter Tauron confirmed its ability to generate high cash flows, and the quality of its earnings is further enhanced by the positive decisions with regard to long-term contract compensation that the regulator URE has recently announced. On EV/EBITDA, the Company is trading at a 30% discount to sector median, and the degree to which it is undervalued can be illustrated by our sum-of-the-parts valuation, according to which at the current price of the stock the Energy Generation segment, which brings an EBITDA of PLN 1bn per year, is worth almost nothing. The share offering currently being prepared (in exchange for the Treasury's minority interests in subsidiaries) is very advantageous for current shareholders, prompting us to raise our valuation to PLN 8.87 per share. We are reiterating a buy rating.

**Positive Surprise in Q2'10**

Tauron outperformed our expectations in Q2 2010. In terms of individual segments, Generation surprised us the most. However, that this discrepancy was caused by higher-than-expected compensation for long-term contracts (LTC, PLN 151m vs. PLN 50m). Mining, in turn, disappointed, with a decline in output due to unfavorable geological conditions and an operating loss of PLN 38m (we expected a profit of PLN 35m). We expect, however, that this situation will not be repeated in the following quarters. In Q2 2010, Tauron generated a staggering PLN 880m in cash flows from operations, which, given its PLN 372m CAPEX, allowed it to reduce net debt to PLN 474m.

**Share Issue Will Benefit Shareholders**

The Company is currently preparing an offering of shares which will be acquired by the State Treasury in exchange for its minority interests in PKE, Enion, EnergiaPro and ESW. 163.1m shares will be issued, and the price has been set by expert assessment at PLN 10.44 apiece (as previously reported in the IPO prospectus), which means that minority interest will decline by a further PLN 1.7bn. Given the issuing price and the relatively low dilution, the offering is beneficial for current shareholders of Tauron (the market value of shares to be issued is PLN 0.9bn, implying a PLN 0.44 per-share discount in the transaction).

**Exchange-Based Pricing Benchmark Could Bring Gains**

As the importance of exchange-based electricity trading increases, it becomes possible to set a pricing benchmark that would not be questioned by URE in its tariff decisions. Today, due to the regulator's practice of setting wholesale prices too low in the calculations of the "G" (household) tariff and distribution tariffs (purchases to cover network losses), Tauron loses some PLN 156m per year. Were this parameter to be deregulated, the holding's value would increase by 6.8%.

(PLN m)	2008	2009	2010F	2011F	2012F
Revenue	12 448.7	13 633.6	13 864.0	14 685.2	15 848.2
EBITDA	1 615.8	2 580.8	2 651.0	2 833.0	3 182.2
EBITDA margin	13.0%	18.9%	19.1%	19.3%	20.1%
EBIT	347.0	1 259.7	1 257.3	1 360.4	1 608.7
Net profit*	130.8	732.4	904.6	918.2	1 067.8
DPS	0.02	0.04	0.00	0.15	0.16
P/E	66.0	11.8	10.8	10.6	9.1
P/CE	6.2	4.2	4.2	4.1	3.7
P/BV	0.8	0.7	0.7	0.6	0.6
EV/EBITDA	7.4	4.5	4.1	4.1	4.0
DYield	0.4%	0.7%	0.0%	2.8%	2.8%

\*Net profit factors in a decline in minority interest following the upcoming share issue

## Tauron Reports Strong Q2 Cash Flows

Tauron's second-quarter EBIT outperformed our expectations and the market consensus by 27.9% and 9.5%, respectively. The strongest performance was recorded in the Power Generation segment, which posted an EBIT of PLN 176m vs. our expected PLN 89.7m. Note, however, that this discrepancy was caused by higher-than-expected compensation for long-term contracts (LTC, PLN 151m vs. PLN 50m). The Mining segment fell short because of a production drop (to 0.8MT from 1.2MT a year earlier and 1.4MT in Q1 2010) caused by unfavorable geological conditions, leading to an operating loss of PLN 38m (we expected a PLN 35m profit). This loss should be compensated in future quarters. The segment of Renewable Energy generated a higher-than-forecasted EBIT of PLN 28.6m (vs. our PLN 13.9m estimate and an EBIT of PLN 19.5m posted in Q2 2009) on steady production volumes, owed mainly to higher prices of green certificates. Distribution EBIT was also much better than expected (PLN 110.5m vs. PLN 29m), thanks to higher volumes (8 TWh vs. 7.25 TWh expected and 8.4 TWh in Q1 2010). Our forecasts were based on the assumption that the segment's earnings may be reduced by maintenance work postponed from Q1 due to the inclement weather. EBIT from Electricity Trade figured to PLN 27.7m vs. PLN 63m expected, probably due to a higher than expected cost of green certificates. Finance losses exceeded our expectations (PLN -35m vs. PLN -19m), perhaps due to investment revaluation losses. All in all, the bottom line was PLN 190m.

### Reported vs. forecasted Q2 2010 results

(PLN m)	Q2 2010	Q2 2009	change	Q2 2010F	Actuals vs. Forecasts	Consensus Estimates	Actuals vs. Consensus
Revenue	3 466.0	3 229.8	7.3%	3 180.3	9.0%	3 121	11.1%
EBITDA	648.6	701.6	-7.5%	578.5	12.1%	622	4.3%
EBITDA margin	18.7%	21.7%	-	18.2%	-	-	-
EBIT	306.7	377.1	-18.7%	239.9	27.9%	280	9.5%
Pre-tax income	271.7	369.1	-26.4%	220.4	23.3%	-	-
Net income	190.0	238.6	-20.4%	145.3	30.7%	170	11.9%

Source: Tauron, F – forecasts by BRE Bank Securities; Consensus estimates by PAP

In Q2 2010, Tauron generated a staggering PLN 880m in cash flows from operations, which, given its PLN 372m CAPEX, made it possible to reduce net debt to PLN 474m. To sum up, Tauron reported operating earnings much ahead of our estimates. While this is largely due to higher-than-expected LTC compensation, the recent decisions of courts and the regulator mean that this revenue will actually translate into cash (in its FY adjustment, the regulator confirmed Tauron was right to use the bookkeeping approach to LTC compensation it had used). LTC compensation inflows amounted to PLN 225m in H1 2010, prompting an upward revision of our PLN 141m forecast for the whole year.

## Stock Conversions

Until recently, because of dispersed ownership, minority interests in Tauron's core assets totaled PLN 2.4bn (as of 31 December 2009). The company is currently undergoing an organizational realignment aimed at reducing the interests of minority owners in key operations to an estimated PLN 347m by the end of 2010. In the first stage of the reorganization, completed before the IPO, Tauron merged with subsidiaries Enion ZA and Energomix Servis. To achieve 100% control over these operations, the company issued shares which increased its equity by PLN 318.6m. The second stage of the integration process is another stock placement to the State Treasury in exchange for its minority holdings in PKE, Enion, EnergiaPro, and Elektrownia Stalowa Wola. The 163.1 million shares will be issued at PLN 10.44 apiece (the price was set based on a professional valuation), suggesting a reduction of minority interests by a further PLN 1.7bn. The issue price, and the fact that the resulting equity dilution will be relatively small, work to the advantage of Tauron's shareholders (the market value of the issue is PLN 0.9bn, implying a PLN 0.44-per-share discount). The final stage of the process will be the acquisition of the remaining shares in Południowy Koncern Węglowy in exchange for new shares placed to Kompania Węglowa (most likely, on the same occasion Tauron will take over the Bolesław Śmiały mine from KW). The resulting dilution is not expected to exceed 6%.

## Macroeconomic Assumptions

The table below outlines the macroeconomic assumptions underlying DCF valuation.

	2007	2008	2009	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F
Prices of Brent crude (USD/Bbl)	72.8	98.0	62.0	77.0	80.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0	90.0
EEX energy prices (EUR/MWh)	54.9	54.9	69.1	49.3	52.2	55.4	62.8	66.2	67.4	68.2	71.5	75.5	77.1
<b>Polish energy prices (PLN/MWh)</b>	<b>142.8</b>	<b>154.3</b>	<b>195.0</b>	<b>190.0</b>	<b>195.0</b>	<b>210.6</b>	<b>232.3</b>	<b>231.6</b>	<b>235.9</b>	<b>238.6</b>	<b>250.2</b>	<b>264.3</b>	<b>269.9</b>
Prices of CO2 certificates, EUR/T	20.6	23.9	13.8	14.6	18.3	22.2	30.0	31.5	33.0	34.6	36.3	38.1	40.0
PKW coal prices (PLN/T)	161.6	182.9	241.6	233.8	245.6	261.6	254.5	245.4	245.4	245.4	245.4	245.4	245.4
Avg. PLN/USD exchange rate	2.77	2.42	3.12	3.07	3.10	2.90	2.80	2.70	2.70	2.70	2.70	2.70	2.70
Avg. EUR/PLN exchange rate	3.79	3.48	4.33	4.00	4.00	3.80	3.70	3.50	3.50	3.50	3.50	3.50	3.50
<b>TAURON's power output (TWh)</b>	<b>22.5</b>	<b>19.5</b>	<b>18.6</b>	<b>19.5</b>	<b>19.8</b>	<b>19.8</b>	<b>19.0</b>	<b>20.1</b>	<b>21.5</b>	<b>24.3</b>	<b>24.6</b>	<b>24.8</b>	<b>25.6</b>
lignite-fired	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
hard coal-fired	22.1	19.1	18.2	19.1	19.4	19.3	18.4	18.7	19.0	21.7	22.1	22.3	22.6
natural gas-fired	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.9	1.5	1.5	1.5	1.5	1.5
wind power	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.6	0.6	0.6	0.6	1.1
hydroelectric power	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4

Source: Bloomberg, Tauron, F – forecasts by BRE Bank Securities

## Earnings Forecast and Valuation

Our DCF analysis produced a per-share price for Tauron of PLN 8.40, and relative valuation yielded PLN 8.06. We set our nine-month price target on the stock at PLN 8.88 a share.

	Weight	Price
Relative Valuation	50%	8.04
DCF Analysis	50%	8.40
	price	8.22
	<b>9M target price</b>	<b>8.87</b>

## DCF Analysis

### DCF Model Assumptions

1. Cash flows are discounted to their present value as at 31 August 2010. Equity value estimates include net debt as at year-end 2009, and minority interests adjusted for a merger stock issue of PLN 163.1m at PLN 10.44 a share.
2. The macroeconomic assumptions and equity investment plans are as laid out above.
3. We added an expected PLN 85m refund of an excise tax on network losses to the valuation.
4. For the purposes of terminal value calculations, we adjusted the amount of D&A expenses to PLN 2.1bn, to match the amount of capital expenses.
5. We assume that FCF after FY2019 will grow at a rate of 2%. The risk-free rate is 5.6%, and beta is 0.9.



**DCF model for Tauron**

(PLN m)	2010F	2011F	2012F	2013F	2014F	2015F	2016F	2017F	2018F	2019F	2019+
<b>Revenues</b>	<b>13 864</b>	<b>14 685</b>	<b>15 848</b>	<b>17 234</b>	<b>17 755</b>	<b>18 440</b>	<b>19 032</b>	<b>19 681</b>	<b>20 312</b>	<b>20 528</b>	<b>20 746</b>
change	1.7%	5.9%	7.9%	8.7%	3.0%	3.9%	3.2%	3.4%	3.2%	1.1%	1.1%
<b>EBITDA</b>	<b>2 651.0</b>	<b>2 833.0</b>	<b>3 182.2</b>	<b>3 095.3</b>	<b>3 314.5</b>	<b>3 719.9</b>	<b>4 176.4</b>	<b>4 593.8</b>	<b>4 782.6</b>	<b>5 270.2</b>	<b>5 326.3</b>
EBITDA margin	19.1%	19.3%	20.1%	18.0%	18.7%	20.2%	21.9%	23.3%	23.5%	25.7%	25.7%
Amortization and depreciation	1 393.8	1 472.6	1 573.5	1 701.4	1 832.7	1 994.2	2 296.4	2 391.4	2 478.7	2 609.3	2 117.1
<b>EBIT</b>	<b>1 257.3</b>	<b>1 360.4</b>	<b>1 608.7</b>	<b>1 393.9</b>	<b>1 481.8</b>	<b>1 725.7</b>	<b>1 880.0</b>	<b>2 202.4</b>	<b>2 303.9</b>	<b>2 661.0</b>	<b>3 209.1</b>
EBITDA margin	9.1%	9.3%	10.2%	8.1%	8.3%	9.4%	9.9%	11.2%	11.3%	13.0%	15.5%
Tax rate on EBIT	238.9	258.5	305.7	264.8	281.5	327.9	357.2	418.4	437.7	505.6	609.7
<b>NOPLAT</b>	<b>1 018.4</b>	<b>1 101.9</b>	<b>1 303.1</b>	<b>1 129.1</b>	<b>1 200.3</b>	<b>1 397.8</b>	<b>1 522.8</b>	<b>1 783.9</b>	<b>1 866.2</b>	<b>2 155.4</b>	<b>2 599.4</b>
CAPEX	-1 990	-2 644	-3 259	-4 692	-6 330	-5 392	-4 183	-2 715	-2 276	-2 117	-2 117
Working capital	-330.7	-266.9	-230.6	-196.1	-36.1	-47.5	-41.1	-44.9	-43.8	-15.0	-15.0
Capital investments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>FCF</b>	<b>91.0</b>	<b>-336.0</b>	<b>-612.7</b>	<b>-2 057.7</b>	<b>-3 332.7</b>	<b>-2 047.1</b>	<b>-404.7</b>	<b>1 415.1</b>	<b>2 024.8</b>	<b>2 632.5</b>	<b>2 584.4</b>
WACC	9.9%	9.6%	9.3%	8.6%	7.6%	6.9%	6.7%	7.0%	7.4%	7.9%	8.8%
discount factor	96.9%	88.4%	80.8%	74.4%	69.2%	64.7%	60.6%	56.7%	52.8%	48.9%	48.9%
PV FCF	88.2	-297.0	-495.3	-1 531.2	-2 304.8	-1 324.0	-245.3	802.0	1 068.8	1 287.6	
<b>WACC</b>	<b>9.9%</b>	<b>9.6%</b>	<b>9.3%</b>	<b>8.6%</b>	<b>7.6%</b>	<b>6.9%</b>	<b>6.7%</b>	<b>7.0%</b>	<b>7.4%</b>	<b>7.9%</b>	<b>8.8%</b>
Cost of debt	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%	6.6%
Risk-free rate	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%	5.60%
Risk premium	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Effective tax rate	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%
Net debt / EV	5.1%	9.7%	15.9%	30.8%	52.7%	66.7%	71.6%	65.9%	57.5%	46.0%	28.0%
Cost of Equity	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%	10.1%
Risk premium	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Beta	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
FCF growth after the forecast horizon				2.0%	<b>Sensitivity Analysis</b>						
Terminal value				38 181	<b>FCF growth in perpetuity</b>						
Present value of the terminal value (PV TV)				18 675		<b>0.0%</b>	<b>1.0%</b>	<b>2.0%</b>	<b>3.0%</b>	<b>4.0%</b>	
Present value of FCF in the forecast horizon				-2 951	WACC +1.0ppt	5.61	6.54	7.72	9.25	11.32	
Equity value (EV)				15 724	WACC +0.5ppt	6.05	7.10	8.43	10.20	12.65	
FY2009 net debt				744	WACC	6.54	7.72	9.25	11.32	14.28	
Minority interests				347	WACC -0.5ppt	7.10	8.43	10.20	12.65	16.29	
Network loss excise receivable				85	WACC -0.10ppt	7.72	9.25	11.32	14.28	18.86	
Equity value				14 718							
Number of shares (millions)				1 752.5							
<b>Equity value per share (PLN)</b>				<b>8.40</b>							
9M cost of equity				7.5%							
<b>Target price</b>				<b>9.03</b>							
EV/EBITDA('10) for DCF=based valuation				6.0							
P/E('10) for DCF valuation				16.3							
TV / EV				119%							



## Relative Valuation

We compared Tauron's P/E and EV/EBITDA multiples with the multiples of its peers estimated for FY2010 through FY2011. The peer group includes international power producers and distributors, It also includes PGNiG, which is the closest to meeting the definition of a public utility among Polish companies.

	Price	P/CE				EV/EBITDA*			
		2009	2010F	2011F	2012F	2009	2010F	2011F	2012F
EDF	32.85	5.6	5.2	5.0	4.7	6.3	5.9	5.7	5.3
E.ON AG	23.24	5.0	5.1	5.3	5.1	6.3	6.3	6.5	6.3
IBERDROLA SA	5.73	6.3	6.0	5.7	5.2	8.9	8.3	7.9	7.3
ENEL SPA	3.96	3.9	3.8	3.7	3.6	6.1	5.8	5.7	5.5
RWE AG	53.39	5.6	4.9	4.9	4.7	6.4	5.6	5.7	5.4
ENDESA SA	19.71	4.4	4.7	5.0	4.8	5.8	5.9	5.9	5.6
FORTUM OYJ	19.19	9.4	8.8	8.9	8.5	10.0	9.6	9.6	9.2
PGE	23.78	7.4	7.6	6.7	6.1	5.4	6.1	5.4	4.7
PGNiG	3.47	6.5	4.9	5.1	4.9	6.5	4.5	4.7	4.5
CEZ	820.5	6.0	6.3	5.9	5.5	6.2	6.5	6.1	5.7
ENEA	20.50	7.7	6.8	6.6	6.1	5.9	5.0	4.8	4.2
Maximum		9.4	8.8	8.9	8.5	10.0	9.6	9.6	9.2
Minimum		3.9	3.8	3.7	3.6	5.4	4.5	4.7	4.2
<b>Median</b>		<b>6.0</b>	<b>5.2</b>	<b>5.3</b>	<b>5.1</b>	<b>6.3</b>	<b>5.9</b>	<b>5.7</b>	<b>5.5</b>
Tauron	5.6	4.7	4.2	4.1	3.7	4.2	4.1	3.8	3.4
(premium / discount) to median		-20.7%	-18.3%	-22.8%	-27.2%	-33.7%	-31.8%	-33.7%	-39.0%
<b>Implied price</b>									
Median		6.0	5.2	5.3	5.1	6.3	5.9	5.7	5.5
Multiple weight			50.0%				50.0%		
Year weight		0.0%	33.3%	33.3%	33.3%	0.0%	33.3%	33.3%	33.3%
<b>TAURON – implied value per share (PLN)</b>		<b>8.04</b>							

\*EV/EBITDA based on FY2009 net debt



**Income Statement**

(PLN m)	2007	2008	2009	2010F	2011F	2012F	2013F
<b>Revenues</b>	<b>12 264.0</b>	<b>12 448.7</b>	<b>13 633.6</b>	<b>13 864.0</b>	<b>14 685.2</b>	<b>15 848.2</b>	<b>17 234.2</b>
<i>change</i>	<i>n/a</i>	1.5%	9.5%	1.7%	5.9%	7.9%	8.7%
incl. LTC	0.0	192.2	484.0	420.0	300.0	200.0	0.0
<b>EBIT, incl.</b>	<b>186.9</b>	<b>347.0</b>	<b>1 259.7</b>	<b>1 257.3</b>	<b>1 360.4</b>	<b>1 608.7</b>	<b>1 393.9</b>
Mining	-71.5	62.9	147.0	47.7	169.3	221.5	194.2
Power Generation	70.8	-0.7	677.1	568.2	518.8	611.6	324.8
Renewable Energy	45.5	44.0	55.1	69.2	67.6	105.7	117.5
Distribution:	109.5	193.9	94.6	392.6	443.5	501.1	560.2
Trade	18.7	90.1	301.8	199.5	190.7	187.2	199.1
Other	-15.2	-24.6	6.6	12.2	4.5	18.4	38.0
Unattributed	29.0	-24.6	-22.6	-32.1	-34.0	-36.7	-39.9
<b>EBIT</b>	<b>186.9</b>	<b>347.0</b>	<b>1 259.7</b>	<b>1 257.3</b>	<b>1 360.4</b>	<b>1 608.7</b>	<b>1 393.9</b>
<i>change</i>	<i>n/a</i>	85.7%	263.0%	-0.2%	8.2%	18.3%	-13.4%
<i>EBITDA margin</i>	1.5%	2.8%	9.2%	9.1%	9.3%	10.2%	8.1%
Profit on financing activity	-37.3	-96.8	-94.7	-116.6	-142.2	-179.6	-299.9
Extraordinary gains/losses	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Pre-tax income</b>	<b>149.6</b>	<b>250.3</b>	<b>1 165.0</b>	<b>1 140.7</b>	<b>1 218.2</b>	<b>1 429.1</b>	<b>1 094.0</b>
Tax	-0.2	68.0	266.3	216.7	231.4	271.5	207.9
Minority interests*	-3.7	51.4	166.3	19.3	68.5	89.7	78.7
Discontinued operations	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Net income</b>	<b>153.5</b>	<b>130.8</b>	<b>732.4</b>	<b>904.6</b>	<b>918.2</b>	<b>1 067.8</b>	<b>807.5</b>
<i>change</i>	<i>n/a</i>	-14.8%	459.7%	23.5%	1.5%	16.3%	-24.4%
<i>Net margin</i>	1.3%	1.1%	5.4%	6.5%	6.3%	6.7%	4.7%
Amortization and depreciation	1 197.7	1 268.7	1 321.0	1 393.8	1 472.6	1 573.5	1 701.4
<b>EBITDA</b>	<b>1 384.6</b>	<b>1 615.8</b>	<b>2 580.8</b>	<b>2 651.0</b>	<b>2 833.0</b>	<b>3 182.2</b>	<b>3 095.3</b>
<i>change</i>	<i>n/a</i>	16.7%	59.7%	2.7%	6.9%	12.3%	-2.7%
<i>EBITDA margin</i>	11.3%	13.0%	18.9%	19.1%	19.3%	20.1%	18.0%
Shares at year-end (millions)	1 554.0	1 554.0	1 554.0	1 752.5	1 752.5	1 752.5	1 752.5
EPS	0.1	0.1	0.5	0.5	0.5	0.6	0.5
CEPS	0.9	0.9	1.3	1.3	1.4	1.5	1.4
ROAE	2.8%	1.2%	6.4%	6.8%	6.1%	6.8%	4.9%
ROAA	1.5%	0.6%	3.4%	4.0%	3.9%	4.3%	2.9%

\*as of 2010, minority interests include Tauron's fully-controlled trade operation

\*\*EBITDA is not adjusted for asset impairment which amounted to PLN 25.3m in 2007, PLN 26.3m in 2008, and PLN 0.9m in 2009

**Balance Sheet**

(PLN m)	2007	2008	2009	2010F	2011F	2012F	2013F
<b>ASSETS</b>	<b>20 247.7</b>	<b>20 823.1</b>	<b>22 160.2</b>	<b>22 979.8</b>	<b>23 761.8</b>	<b>25 793.8</b>	<b>29 119.2</b>
<b>Fixed assets</b>	<b>17 387.0</b>	<b>17 984.2</b>	<b>18 480.5</b>	<b>19 077.2</b>	<b>20 248.2</b>	<b>21 933.3</b>	<b>24 924.0</b>
Property, plant and equipment	16 469.7	17 098.8	17 260.6	17 869.1	19 047.5	20 734.1	23 702.0
Intangible assets	285.2	533.3	824.8	813.0	805.5	804.0	826.7
Other financial assets	537.1	176.9	179.7	179.7	179.7	179.7	179.7
Other non-financial assets	84.6	61.5	58.5	58.5	58.5	58.5	58.5
Deferred tax assets	10.4	113.6	156.9	156.9	156.9	156.9	156.9
<b>Current assets</b>	<b>2 860.7</b>	<b>2 839.0</b>	<b>3 679.7</b>	<b>3 902.6</b>	<b>3 513.6</b>	<b>3 860.6</b>	<b>4 195.2</b>
Inventories	267.3	395.2	536.2	545.3	577.6	623.3	677.8
Trade debtors	1 230.0	1 275.3	1 875.0	2 092.3	2 199.1	2 350.3	2 530.4
Other current assets	387.5	217.1	230.4	230.4	230.4	230.4	230.4
Assets held for sale	1.7	1.7	6.0	6.0	6.0	6.0	6.0
Cash and cash equivalents*	974.2	949.7	1 032.1	1 028.6	290.6	290.6	290.6
<b>LIABILITIES</b>	<b>20 247.7</b>	<b>20 823.1</b>	<b>22 160.2</b>	<b>22 979.8</b>	<b>23 761.8</b>	<b>25 793.8</b>	<b>29 119.2</b>
<b>Equity</b>	<b>11 026.8</b>	<b>11 125.9</b>	<b>11 816.5</b>	<b>14 742.6</b>	<b>15 389.4</b>	<b>16 181.8</b>	<b>16 775.7</b>
Share capital	13 698.6	13 698.6	13 986.3	16 007.8	16 007.8	16 007.8	16 007.8
Other equity	-2 671.9	-2 572.7	-2 169.8	-1 265.1	-618.3	174.0	767.9
<b>Minority shares</b>	<b>2 179.3</b>	<b>2 219.5</b>	<b>2 367.7</b>	<b>365.5</b>	<b>418.6</b>	<b>453.5</b>	<b>460.4</b>
<b>Long-term liabilities</b>	<b>4 042.7</b>	<b>4 098.3</b>	<b>4 078.7</b>	<b>4 078.7</b>	<b>4 078.7</b>	<b>4 801.7</b>	<b>6 519.3</b>
Loans	1 535.1	1 426.2	1 179.4	1 179.4	1 179.4	1 902.3	3 619.9
Other	2 507.6	2 672.2	2 899.3	2 899.3	2 899.3	2 899.3	2 899.3
<b>Short-term liabilities</b>	<b>2 999.0</b>	<b>3 379.4</b>	<b>3 897.2</b>	<b>3 792.9</b>	<b>3 875.0</b>	<b>4 356.8</b>	<b>5 363.8</b>
Loans	460.9	649.7	596.3	596.3	596.3	961.8	1 830.3
Trade creditors	1 373.4	1 240.1	1 490.7	1 386.4	1 468.5	1 584.8	1 723.4
Other	1 164.6	1 489.5	1 810.2	1 810.2	1 810.2	1 810.2	1 810.2
Debt	1 996.1	2 075.9	1 775.7	1 775.7	1 775.7	2 864.2	5 450.2
Net debt	1 021.8	1 126.2	743.6	747.1	1 485.1	2 573.6	5 159.6
(Net debt / Equity)	9.3%	10.1%	6.3%	5.1%	9.7%	15.9%	30.8%
(Net debt / EBITDA)	0.7	0.7	0.3	0.3	0.5	0.8	1.7
<b>BVPS</b>	<b>7.1</b>	<b>7.2</b>	<b>7.6</b>	<b>8.4</b>	<b>8.8</b>	<b>9.2</b>	<b>9.6</b>

\*there is a difference between the cash shown on the balance sheet and in the cash flow statement which stems from Tauron's overdraft facility balances

**Cash Flows**

(PLN m)	2007	2008	2009	2010F	2011F	2012F	2013F
<b>Cash flows from operating activities</b>	<b>1 471.3</b>	<b>1 615.5</b>	<b>1 963.2</b>	<b>2 103.6</b>	<b>2 334.6</b>	<b>2 680.0</b>	<b>2 691.4</b>
Net income	153.5	130.8	732.4	904.6	918.2	1 067.8	807.5
Amortization and depreciation	1 197.7	1 268.7	1 321.0	1 393.8	1 472.6	1 573.5	1 701.4
Working capital	-130.1	-222.0	-462.7	-330.7	-266.9	-230.6	-196.1
Other	250.2	437.9	372.5	135.9	210.7	269.4	378.6
<b>Cash flows from investing activities</b>	<b>-1 755.6</b>	<b>-1 514.2</b>	<b>-1 354.0</b>	<b>-1 955.2</b>	<b>-2 606.8</b>	<b>-3 226.6</b>	<b>-4 650.8</b>
CAPEX	-1 819.4	-1 792.2	-1 440.3	-1 990.5	-2 643.5	-3 258.6	-4 692.1
Other	63.8	278.0	86.2	35.3	36.7	31.9	41.3
<b>Cash flows from financing activities</b>	<b>118.4</b>	<b>-95.7</b>	<b>-543.5</b>	<b>-151.9</b>	<b>-465.8</b>	<b>546.6</b>	<b>1 959.4</b>
Stock offering	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt	338.2	92.0	-329.3	0.0	0.0	1 088.5	2 586.0
Dividend (buy-back)	-32.3	-33.9	-58.2	0.0	-271.4	-275.4	-213.6
Other	-187.5	-153.9	-155.9	-151.9	-194.4	-266.4	-413.1
<b>Change in cash</b>	<b>-166.0</b>	<b>5.6</b>	<b>65.7</b>	<b>-3.5</b>	<b>-738.0</b>	<b>0.0</b>	<b>0.0</b>
Cash at the end of period	901.4	906.9	972.7	969.2	231.2	231.2	231.2
DPS (PLN)	0.02	0.02	0.04	0.00	0.15	0.16	0.12
FCF	-564.7	-466.4	411.5	113.1	-308.9	-578.5	-2 000.7
(CAPEX / Sales)	14.8%	14.4%	10.6%	14.4%	18.0%	20.6%	27.2%

**Market multiples**

	2007	2008	2009	2010F	2011F	2012F	2013F
P/E	56.3	66.0	11.8	10.8	10.6	9.1	12.1
P/CE	6.4	6.2	4.2	4.2	4.1	3.7	3.9
P/BV	0.8	0.8	0.7	0.7	0.6	0.6	0.6
P/S	0.7	0.7	0.6	0.7	0.7	0.6	0.6
FCF/EV	-4.8%	-3.9%	3.5%	1.0%	-2.7%	-4.6%	-13.1%
EV/EBITDA	8.5	7.4	4.5	4.1	4.1	4.0	4.9
EV/EBIT	62.9	34.3	9.3	8.6	8.5	7.9	11.0
EV/S	1.0	1.0	0.9	0.8	0.8	0.8	0.9
DYield	0.4%	0.4%	0.7%	0.0%	2.8%	2.8%	2.2%
<b>Price per share (PLN)</b>	<b>5.56</b>						
Shares at year-end (millions)	1554.0	1554.0	1554.0	1752.5	1752.5	1752.5	1752.5
MC (PLN m)	8 640.2	8 640.2	8 640.2	9 744.2	9 744.2	9 744.2	9 744.2
Equity attributable to minority shareholders (PLN m)	2179.3	2219.5	2367.7	365.5	418.6	453.5	460.4
EV (PLN m)	11 756.8	11 901.4	11 667.0	10 772.2	11 563.3	12 686.7	15 279.5



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**List of abbreviations and ratios contained in the report:**

**EV** – net debt + market value

**EBIT** – Earnings Before Interest and Taxes

**EBITDA** – EBIT + Depreciation and Amortisation

**P/CE** – price to earnings with amortisation

**MC/S** – market capitalisation to sales

**EBIT/EV** – operating profit to economic value

**P/E** – (Price/Earnings) – price divided by annual net profit per share

**ROE** – (Return on Equity) – annual net profit divided by average equity

**P/BV** – (Price/Book Value) – price divided by book value per share

**Net debt** – credits + debt papers + interest bearing loans – cash and cash equivalents

**EBITDA margin** – EBITDA/Sales

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**HOLD** – we expect that the rate of return from an investment will range from -5% to +5%

**REDUCE** – we expect that the rate of return from an investment will range from -5% to -15%

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**Previous ratings issued for CEZ**

Rating	Hold	Hold	Hold
Rating date	2009-11-04	2010-02-12	2010-03-03
Price on rating day	143.80	134.00	133.90
WIG on rating day	37391.24	37322.52	39635.50

**Previous ratings issued for Enea**

Rating	Buy	Accumulate	Accumulate	Buy	Accumulate
Rating date	2010-02-12	2010-03-05	2010-03-30	2010-06-02	2010-09-03
Price on rating day	17.44	18.90	18.91	18.17	20.10
WIG on rating day	37322.52	39885.37	42346.66	40931.54	42704.39

**Previous ratings issued for PGE**

Rating	Buy	Buy
Rating date	2010-02-12	2010-03-30
Price on rating day	21.00	23.00
WIG on rating day	37322.52	42346.66

**Previous ratings issued for Tauron**

Rating	Buy
Rating date	2010-08-16
Price on rating day	5.10
WIG on rating day	42167.93