

Transelectrica – update (July 2007)

Price 6.07.07	47.2 RON/share
Market Capitalization	RON 3,459.6 mn
Operating revenues '06	RON 2,454.6 mn
Net Profit	RON 277.2 mn

Introduction

The consolidated financial statements posted in 2006 by Transelectrica showed a sharp increase in profit figures, up by 2.6-times from the previous year. Consequently, the profitability margin went up 4%. A positive effect could be noticed at the level of the debt ratio as well, which decreased from 60% to 40%.

The applied DCF analysis method took into account both the consolidated financial statements released in 2006 and the figure posted in Q1/2007, along with the capital expenditure strategy and our estimates regarding the macroeconomic environment.

According to the two methods employed in our analysis - *Discounted Cash Flows* and *the Multiples Method (Peers comparison)* – Transelectrica's target average market capitalization stands at EUR 1.2 bn corresponding to a target price of RON 52.2

Our recommendation is: **Hold**

Shareholding Structure

CNTEE TRANSELECTRICA has the following shareholding structure:

- The Romanian Government via the Ministry of Economy and Commerce holds 76.5% stake in the company
- "Proprietatea" Fund - 13.5%
- Free – float 10%.
- [Source: Transelectrica's official website](#)

The free-float might hike in the upcoming 6-12 months up to 14% by allocating 5% of the share capital for the compensation of the abusively expropriated individuals during the communist regime, who did not opt for other means of compensation. Following the shares' allotment process, which is expected to be completed in August, the shareholders will not be able to sell the granted shares

earlier than 6 months, thus the possible selling pressure would not be felt immediately.

The individuals who will be compensated in the aforesaid manner will receive a number of shares derived by dividing the compensation value by the average trading price of the first six months since listing: 31.2 RON/share. The total amount to be used for the shareholders' compensation will represent 4% of the company's share capital.

Economic Environment

Transelectrica plays a key role in both the Romanian and European electricity markets. Transelectrica manages and operates the electricity transmission system in Romania. The company does not trade electricity, but buys only the quantity needed to cover internal transmission losses.

The long-term increase of Transelectrica's activity and its sales figure implicitly, is tightly related to the considerable rise in electricity consumption within the Romanian economy, in a quantitative measurement of 2-3% per year, and to the steady growth in tariffs in RON terms. The costs of electricity transmission in Romania are considered to be average on a European scale. Considering these factors it is likely possible for the sales figure to surge by at least 8-10% in the upcoming 3 – 5 years, whereas in euro terms it might exceed 10% based on a steady appreciation of the domestic currency.

Recently, Transelectrica announced a 10% increase in system services tariffs. The company's officials stated that this increase aims to improve safety practices as well as to create a capacity market. This factor shall allow the adjustment of electricity generation whenever an increase in consumption is marked. The raise in system services tariffs might heavily influence the profit figure, despite the fact that this capacity market incurs additional expenses.

When computing the base tariff, the following three elements are taken into account: transmission tariffs, system services tariffs and market administration tariffs

<i>RON mn</i>	<i>2006</i>	<i>% of total</i>
<i>Transportation services revenues</i>	889.9	<i>36%</i>
<i>System services revenues</i>	774.2	<i>31%</i>
<i>Balancing market revenues</i>	776	<i>31%</i>
<i>Other revenues</i>	63.5	<i>3%</i>
<i>TOTAL operating revenues</i>	2503.5	<i>100%</i>

2007 – 2012 Capital expenditures

The capital expenditure budget for the upcoming years forecasts a level in excess of EUR 750 mn disbursed in tranches until 2012, for the upgrading of some generator-transformer units and the increase in the number of high-voltage stations.

The latest project carried out by Transelectrica was focused on the construction of a high-voltage plant in Brazi Vest. Transelectrica expended some EUR 27 mn in the aforementioned project, this being financed via external credits. The Japanese consortium Itochu-Toshiba was the contractor of the project.

Currently, Transelectrica is also carrying out a project for the upgrading of the Isalnita-based generator-transformer unit. The execution period is estimated at 29 months, within the period 2007-2009. Once the aforementioned project is completed, Transelectrica will operate on a higher safety degree and the maintenance costs will be lower.

2006 Financial Results

Transelectrica's consolidated financial statements comprise the financial statements of its subsidiaries as well: SC TRANS SA, TELESMA RT SA, ICEMENERG SA, OPCOM SA, FORMENERG SA, ICEMENERG – SERVICE SA.

In 2006, the electricity transporter "Transelectrica" SA gained EUR 87.9 mn in net profit, up by 2.54-times from 2005. According to the consolidated financial statement, the company's sales hiked 49% against the previous year, standing at EUR 747 mn in 2006. The surge in revenues was accomplished due to:

- The increase in electricity supply to which the value of provided services is added;
- The adjustment of tariffs for the services provided in the electricity market to the increase in revenues derived from the allotment of the interconnection capacity;
- The surge in financial revenues, due to the favorable exchange rate differences brought about by the appreciation of the domestic currency against the currencies in which the company has taken out credits for capital expenditures.

App. 96% of the consolidated profit was obtained by CNTEE Transelectrica SA, whereas 99.8% of the sales figure was made via the sale of its production.

Source: [Transelectrica official statement](#)

The company grew soundly in 2006 marking a sharp increase in sales. The profit rate also seized +4% hike throughout the previous year, mainly due to the

favorable Forex effect. The EBITDA margin was relatively steady over the last couple of years, at around 18%.

If in 2005 long-term debts were in the foreground, in 2006 the situation encountered a slight change. Thus, long-term debts went down 2.8-times and the 2006 debt ratio decreased from 60% to 40%.

For 2006, Transelectrica paid out dividends in amount of EUR32 mn, accounting for 36% of the total net profit. The dividend's value per share was of RON 1.47. Compared to the market price, the dividend yielded an app. 3% return.

The year 2007

Following the 57% surge in sales and a profit rate of 11.4% registered in 2006, for the current year Transelectrica budgeted slightly lower sales (EUR 772.3 mn vs. EUR 783.6 mn) and prudent net profit of only EUR 18.5 mn. This scenario would correspond to a net profit rate of only 2.4%. The company's management believes that Transelectrica's favorable position during the previous year, was a conjunctural one due to reduced capital expenditures.

The Q1 results already denote the fact that the estimated budget might be exceeded, the net profit figure reaching EUR 13.5 mn. For 2007 computations we will use the profit estimate of EUR 58 mn.

2006 – 2007 Financial Results

EUR mn	2005	2006	Q1'07	2007 Buget	2007 Vanguard estimate
Sales	501	783.6	173.0	772.3	850.5
Operating Profit (EBIT)	53.3	84.8	18.4	32.9	82.7
EBIT (%) Margin	10.6%	10.8%	10.6%	4.3%	9.7%
Net Profit	35.0	89.1	13.0	18.5	58.0
Net Profit Margin (%)	7.0%	11.4%	7.5%	2.4%	6.8%

Source: company info, Vanguard estimates

2007 – 2013 Financial Outlook

(EUR mn)	2007e	2009e	2010e	2011e	2012e	2013e
Total Revenues	861.9	1042.9	1147.2	1204.6	1264.8	1328.1
Increase in revenues	10.0%	10.0%	10.0%	5.0%	5.0%	5.0%
EBITDA	161.4	208.6	229.4	253.0	265.6	278.9
EBITDA (%) Margin	18.7%	20.0%	20.0%	21.0%	21.0%	21.0%
Net Profit	58	83.4	91.8	108.4	113.8	119.5
Net Profit Margin (%)	6.7%	8.0%	8.0%	9.0%	9.0%	9.0%

Source: Vanguard estimates

In the revenues' estimate we forecasted a steady increase of 10 % within the period 2007 – 2010 and slightly lower y-o-y increase of 5% within the interval 2011-2013. For the “long-term” increase we used a value of 2%. We also believe that in the long-term the net profit rate might be settled around the value of 9%.

Transelectrica Valuation (TEL)

1) The Discounted Cash Flow Method

We put together an estimate of the operating cash-flow for a 7-year period, taking into account the financial statements posted over the last couple of years along with the figures released in Q1/2007, the company's capital expenditure strategy and our own estimates regarding the evolution of the macroeconomic environment within which Transelectrica operates.

In the base scenario for the estimate of the weighted average cost of capital we considered:

- Long-term weight 40% equity vs. 60% cost of debt;
- cost of debt 3.36% and „cost of equity” (k) 13%

Thus, the weighted average cost of capital reached 7.22%.

We considered that the long-term increase for Transelectrica (following 2013) would be of $g = 2\%$.

Capex

EUR Mn*	2007	2008	2009	2010	2011	2012	2013
Capital Expenditures	170	120	115	110	100	90	90

* Vanguard Research Estimates

Discounted Cash Flows

	2007	2008	2009	2010	2011	2012	2013
CFO	106.1	135.7	159.7	185.9	195.2	205.0	215.2
CAPEX	-170.0	-120.0	-115.0	-110.0	-100.0	-90.0	-90.0
FCFF	-63.9	15.7	44.7	75.9	95.2	115.0	125.2
PV of FCFF	-59.6	13.7	36.3	57.4	67.2	75.7	76.9
Terminal value (g=2%)							2,448
PV of TV							1,503

Source: Vanguard info

Enterprise Value	1770.7	EUR mn
Debt	484	EUR mn
Equity	1286	EUR mn
Price/share	17.5	EUR
Price/share	54.5	RON

Sursa: Vanguard Research

Therefore, via the DCF method we obtained a theoretical price of 54.5 RON/share.

Sensitivity

For the sensitivity analysis we oscillated the long-term increase rate between the interval 1.5% - 2.5%, and the cost of the shareholders' capital between 12% -14%.

	g=1.5%	g=2%	g=2.5%
k=14%	43.3	48.2	54.2
k=13%	48.7	54.6	61.7
k=12%	55	61.9	70.5

Source: Vanguard Research

2) The multiples method

For the current year, Transelectica budgeted a more conservative profit than the figure released last year. We believe that the estimated figure will be exceeded, however it will be lower than the one gained in 2006. In order to compare Transelectica multiples we used the Spain-based RedElectrica company as benchmark, on grounds that it is the only company operating within an average developed European economy.

From the point of view of the P/E and P/B historical multiples, Transelectica is better placed than RedElectrica with a 2006 P/E of 12.5 vs 23.1. The Spain-based company is to augment its net profit by at least 20% in 2007.

Employing the correlation principle between P/E and the medium-term profit growth perspective of both companies we will consider the year 2007 as a starting point, eliminating the effect of Traselectrica's profit decrease.

RedElectrica estimates a CAGR of the net profit figure in excess of 15% per year until 2011. According to our financial estimates, within the interval 2007 – 2011 Transelectica will attain a 17% growth rate in net profit, thus comparable with the figure released by RedElectrica.

	P/E 2006	P/E 2007e	P/B 2006	Profit Margin	ROE
Red Electrica (Spain)	23.1	19.2	4.5	21%	20%
<i>Transelectrica (Romania)</i>	12.5	18.8	1.7	12%	13%

Source: Vanguard Research

Considering the similar growth rates, the comparable P/E multiples are quite justifiable, therefore we estimate that Transelectrica will have a 2007 P/E of 19.2. Based on the aforementioned estimate derives a target market capitalization of EUR 1.12mn and a theoretical price of RON 48.4.

Conclusion

We will determine the target level for the upcoming 12 months for TEL shares – as an average between these two methods:

<i>mln euro</i>	
<i>Target capitalization DCF</i>	1286
<i>Target capitalization Peers</i>	1121
Average Market Cap	1204
Target price - 12 months - RON	52.3

Source: Vanguard Research

From our analysis and valuation derives a target price of **52.3 RON/share** (+ 10.8% vs. Friday's – July 6 – closing price) for **TEL** shares.

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