

Utilities

TRANSGAZ

Higher risks but still solid

Buy (12m)

Price 26/09/2011 12m target
 RON 189 RON 237.8

Sector
 Weighting
Neutral

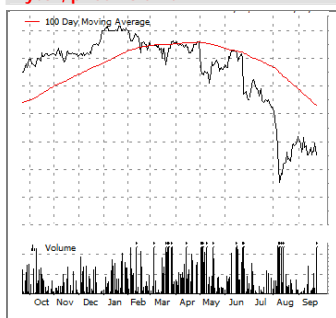
Market Share
100%

Last Recommendation
BUY (May 13, 2011)

Type of investment

Defensive ✓
 Dividend play ✓
 Regulatory risk ✓

1 year, price-volume



Source: Factset, BRD GSG

▼ **Investment case** We have adjusted our target price for Transgaz to **RON 237.8** and we have maintained our **BUY** recommendation given the market price of RON 189 registered on September 26, 2011. Gas transported has registered a 5.3% yoy advance in H1'11, while for end 2011 we expect a 3.4% growth because of a slowdown in the second half of the year. On medium term (2012 – 2020) we have changed our CAGR from 3% to 2% because of weaker than expected economic recovery and negative effect of gas price liberalization. The tariff for 2011/2012 has not been amended by ANRE, for the second time in this regulatory period and we conservatively projected no change in tariffs until mid 2012 and an average 4-5% annual increase for the third regulatory period. According to the budget approved on July 12, 2011, the company expects operating revenues worth RON 1.25bn (-6.7% yoy) and a net profit of RON 124m (-67% yoy), in 2011, according to RAS. Our IFRS forecasts point now to higher values of RON 1.28bn for revenues and RON 230m for the bottom line, on the back of a mild increase of transported gas (3.4%) and no change in tariffs.

▼ **Catalysts for the share price** Just as in the case of Transelectrica, the main catalyst is the upcoming listing of an additional 15% by the State. This will bring more liquidity to the stock and attract new investors looking to undertake a larger position in the company. The generous levels of net profit have historically provided holders of TGN stock with a substantial dividend and 2011 budget was also constructed with a payout of 90%.

▼ **12m target price and methodology** The new target price is **RON 237.8** based on a DCF valuation method. Our explicit period stretches between 2011 and 2020. We have assumed a perpetual growth of 1% and a WACC between 14% and 11.9%, calculated considering a risk-free rate of 7% in 2011 and declining thereafter towards 6%. The peer valuation positions TGN at significant discounts to its peers (43% for P/E 2011e and 51% for EV/EBITDA 2011e), partially explained by higher risks (transit activity situation, regulatory risks).

▼ **Alternative scenarios and risks to our valuation** We appreciate Transgaz's regulatory risk has increased lately, as the end of the second regulatory period is approaching with no change in tariffs since September 2009 and the odds to lose some tariff adjustments are higher. Additionally, the transit business is subject of renegotiations, but because of the lack of information we have not modeled any change yet.

▼ **Next events** RAS 9M'11 financial statements will be released on November 10, 2011.

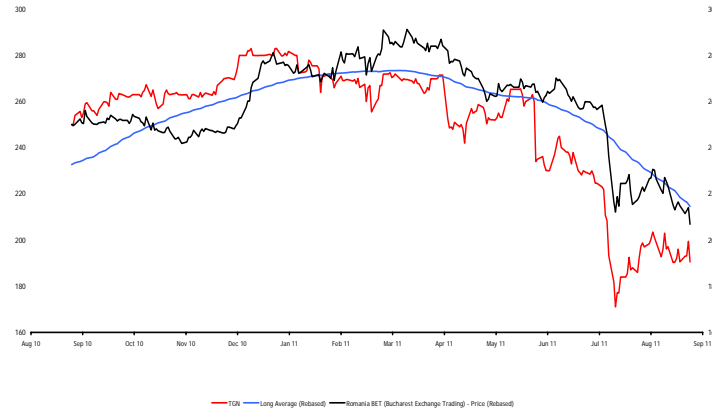
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Share data				Financial data (RON)				Ratios					
	12/09	12/10	12/11e	12/09	12/10	12/11e	12/12e	12/09	12/10	12/11e	12/12e		
RIC TGNM.BX, Bloomberg TGN RO				Total Revenues (m)	1214	1338	1278	1293	P/E (x)	9.25	6.06	9.67	10.37
52-week range	171.05-283			Net Profit (m)	241	367	230	215	Price/CFO (x)	5.69	4.91	5.32	5.73
EV '11 (RONbn) - DCF	2.35			CFO/share	33.2	38.5	35.5	33.0	EV/EBITDA (x)	4.33	3.74	5.27	5.59
Market cap. (RONbn)	2.22			EPS	20.43	31.21	19.54	18.23	EV/EBIT (x)	5.97	4.99	8.66	9.58
Free float (%)	11.5			BVPS	238.58	256.77	247.55	245.89	P/Sales (x)	1.83	1.66	1.74	1.72
Performance (%)	1m	3m	12m	Dividend/share	13.0	28.8	19.9	14.3	Dividend yield (%)	6.89	15.2	10.5	7.6
Ordinary shares	-4.1	-19.6	-25.6	Payout (%)	55%	91%	90%	75%	Price/book value (x)	0.79	0.74	0.76	0.77
Relative to BET	5.1	5.3	-7.8	Net debt/equity (%)	-3%	-3%	2%	4%	ROIC/WACC (x)	0.66	1.01	0.62	0.58

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Market performance

TGN vs. BET share price performance, rebased



Transgaz lost 25.6% yoy (vs -19.3% for BET). The stock is still providing a generous DPS on the back of solid profits.

TGN vs. peers share price performance, rebased, EUR denominated



The EUR denominated share price of Transgaz has underperformed its peers during last year, returning approx -26.6% yoy compared to the -7.4% registered by its comparables.

Source: FactSet, BRD GSG

Valuation

Target price calculation and fundamental valuation

- We value the share based on a two stages DCF model with an explicit period of 10 years (2011-2020) and a second mature period.
- ANRE did not issue any new order regarding the regulated transport tariffs at end June 2011, meaning that Transgaz entered in the last year of the 5Y regulatory period (ending June 2012) with no change in tariffs since September 2009. In our opinion, the regulatory risk for Transgaz has increased significantly and in consequence we have assumed no change in tariffs until mid 2012 and no adjustments to be transferred to the next regulatory period. For the third regulatory period (mid 2012 – mid 2017) we have projected a conservative tariffs growth of 4%-5% annually. In terms of transported quantities we considered a 3.4% growth in 2011 based on 5.3% increase yoy at end June 2011 and a slowdown in H2'11 and then a smaller CAGR of 2% after 2012 taking into account a weaker economic recovery and the negative effect of gas price liberalization. Under these assumptions, transport revenues should climb by 6.2% CAGR between 2011 and 2020.
- The transit contracts both with Bulgargaz and Gazprom are subject of negotiations because the infringement clause impose by EU (see details in Key drivers and outlook section), but no other data have been disclosed yet by the company. For the moment we decided to keep the contracted transit amounts constant throughout the explicit period (in FX values), as we have no data regarding the new conditions which will result after the negotiations.
- The quantity of gas used for technological consumption decreased in 2010 to 2.3% of transported gas compared to 2.6% in 2009, while in H1'11 the company registered a decline of 7% yoy. We assumed a 2.1-2.2% percentage of transported gas as benchmark for own consumption for the next years, as we consider efficiency improvements will slow down. We have also projected a gradual domestic gas price convergence to international level during the explicit period and in consequence the corresponding price for purchased gas should climb by 7.2% CAGR within the 2011-2020 period. We also see staff expenses climbing by approximately 8.3% CAGR in our explicit period. Although the maintenance expenses lagged behind the program in H1'11, we expect this to recover in the second half of the year up to RON 180m. Additionally, the company announced significant repair and maintenance works in the next few years followed by stabilization at a lower level. Consequently, our EBITDA margins might hover between 30% and 38% within 2011-2020. Financial result should not impact bottom line in a significant way, due to the company's low debt levels, so we see net profit margins within the 18%-22% interval in our explicit period.

DCF valuation and main assumptions

- We obtain an equity value of RON 2.43bn on the back of our DCF calculation. The 12M target price reaches RON 237.8, which implies a **BUY** recommendation considering our reference price of RON 189.

Indicator (RONth)	2011e	2012e	2013e	2014e	2015e	2016e	2017e	2018e	2019e	2020e
EBIT	262,992	244,775	345,036	370,434	383,561	417,044	416,238	413,046	407,057	398,056
EBIT*(1-t)	220,914	205,611	289,830	311,165	322,191	350,317	349,640	346,958	341,927	334,367
+D&A expenses	169,108	174,745	175,996	182,352	177,168	181,049	187,587	194,361	201,380	208,398
- CAPEX	202,929	209,694	228,795	237,057	230,318	235,364	243,863	252,669	252,669	261,793
-Change in WC	19,060	(707)	(20,821)	(4,572)	(4,535)	(4,810)	(5,102)	(5,412)	(5,741)	(505)
FCFF	206,152	169,955	216,210	251,887	264,506	291,192	288,262	283,238	284,897	280,467

WACC	14.0%	14.0%	12.9%	12.9%	12.9%	11.8%	11.8%	11.8%	11.8%	11.9%
Discounted FCFF	199,133	144,019	162,225	167,397	155,745	153,301	135,686	119,199	107,196	94,349
Present value of FCFFs ('11-'20e)	1,438,250									
Present Value of Terminal Value	916,508									
Firm fair value	2,354,758									
(-) net debt (Dec'10)*	(80,030)									
Equity value	2,434,788									
Fair value per share	206.8									
Target price 12M	237.8									
Closing Price as of 31/03/2011	189									
Upside/downside potential	25.8%									

Source: BRD GSG estimates

WACC assumptions

- As parameters for calculating the company's target WACC, we have used a cost of equity that considers a premium which declines from 7.5% in 2011 to 6.5% in 2020 (Damodaran) and a risk-free rate between 7% and 6% over the 2011-2020 period. The diminishing levels for the risk-free rate are consistent with our macroeconomic view of long-term economic stability. Transgaz had traditionally exhibited a low indebtedness level, so we maintained a dismal leverage throughout our explicit period. The stock beta stands at 0.9. Consequently, we used a variable WACC for the explicit period between 14% and 11.9%. For the terminal period we used a 11.4% WACC based on a risk free rate of 6%, an equity risk premium of 6% and a beta of 0.9.

Indicator	2011e	2012e	2013e	2014e	2015e	2016e	2017e	2018e	2019e	2020e
LT Risk Free Rate	7.0%	7.0%	6.5%	6.5%	6.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Equity Risk Premium	7.50%	7.50%	7.00%	7.00%	7.00%	6.50%	6.50%	6.50%	6.50%	6.50%
β	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Cost of Equity	14.1%	14.0%	13.0%	12.9%	12.9%	11.9%	11.9%	11.9%	11.9%	11.9%
Cost of Debt (before tax)	8.0%	8.0%	7.5%	7.5%	7.5%	7.0%	7.0%	7.0%	7.0%	7.0%
WACC	14.0%	14.0%	12.9%	12.9%	12.9%	11.8%	11.8%	11.8%	11.8%	11.9%

Source: BRD GSG estimates

Sensitivity analysis

- We conducted a sensitivity analysis on our valuation results. The variation in target price as a function of long-term growth rate and WACC are showed in the table below:

12m target price

g/WACC	WACC-2%	WACC-1%	WACC	WACC+1%	WACC+2%
0.50%	282.5	255.4	233.3	214.9	199.4
0.75%	286.3	258.3	235.5	216.6	200.7
1.00%	290.4	261.3	237.8	218.4	202.2
1.25%	294.8	264.5	240.3	220.3	203.6
1.50%	299.4	267.9	242.8	222.3	205.2

Source: BRD GSG estimates

Upside/Downside potential

g/WACC	WACC-2%	WACC-1%	WACC	WACC+1%	WACC+2%
0.50%	49%	35%	23%	14%	5%
0.75%	51%	37%	25%	15%	6%
1.00%	54%	38%	26%	16%	7%
1.25%	56%	40%	27%	17%	8%
1.50%	58%	42%	28%	18%	9%

Source: BRD GSG estimates

Peers comparison

At a forward 2011 P/E of 7.0x and a EV/EBITDA of 4.0x, Transgaz trades at discounts to its peers, a fact partially justified by a higher level of information asymmetry with its regulatory body and an older/less integrated asset base. The discounts are apparent also for the 2012 and 2013 multipliers.

Company	Price* (EUR)	Mcap (EUR m)	P/E			EV/EBITDA			EV/EBIT			ROE (%)
			11e	12e	13e	11e	12e	13e	11e	12e	13e	11e
Enagas	12.70	3,032	8.6 x	8.0 x	7.5 x	7.5 x	7.0 x	6.7 x	11.0 x	10.4 x	9.7 x	19.55%
Fluxys	2,780.00	1,953	16.2 x	16.3 x	20.3 x	7.9 x	8.0 x	9.7 x	13.4 x	13.7 x	16.3 x	9.00%
SNAM Rete Gas SpA	3.42	12,213	12.2 x	11.8 x	11.7 x	9.1 x	8.9 x	8.9 x	12.3 x	12.1 x	12.0 x	16.16%
average			12.3 x	12.0 x	13.2 x	8.2 x	8.0 x	8.4 x	12.2 x	12.0 x	12.7 x	14.9%
Transgaz	43.9	517	7.0 x	7.4 x	7.6 x	4.0 x	4.2 x	4.1 x	5.8 x	6.1 x	5.9 x	11.6%
Discount/ Premium			-43%	-38%	-43%	-51%	-47%	-51%	-53%	-49%	-53%	-22%

Source: Facset, BRD GSG estimations
 Pices as of September 26, 2011

H1'11 RAS and 2010 IFRS Results

Transported gas quantities advanced by 5.3% yoy in the first half of 2011, which drove transport revenues 5.1% higher yoy, considering unchanged tariffs. Transit revenues were negatively influenced by RON appreciation against USD and registered a decline of 5.3% yoy in H1'11. Additionally, other operating revenues have posted a hike of 64.3% yoy, as Transgaz cashed some penalties from two significant clients, i.e. Termoelectica and Interagro. Consequently, H1'11 total operating revenues reached RON 745m, +4.9% yoy and also slightly above Reuters' consensus (RON 721m) and BRD-GSGe (RON 728m).

Operating expenses advanced faster than revenues in H1'11 (+7.9% yoy) fuelled by higher depreciation expense (+11.7% yoy, due to new tangibles registered after June 2010), increased taxes (+6% yoy, because of higher transported gas) and slightly up personnel expenses (+3.5% yoy). Maintenance works were delayed by the late approval of the budget and the related expenses reached only RON 50m in line with the same period last year.

H1'11 EBIT reached RON 310m, almost flat yoy (+0.9%) and slightly up vs. consensus (+5%) but in line with our forecast. Financial result had a small negative impact on

bottom line which came in at RON 255m, 6.7% above Reuters' consensus and 2.7% up vs. BRD-GSGe.

In August 2011 Transgaz published 2010 IFRS financial statements. The main change resulted from the adoption of IFRIC 12 regarding the Service Concession Agreements which recommends that the assets under concession from the state (the national gas pipeline grid) should be treated as intangibles because the company did not really own the assets but instead it can charge the users of the grid (producers, distributors and end consumers) a tariff for the transport service, so an intangible asset should be recognized for that right. The company restated the financial statements from 2009 up to present and the most significant change was a lower depreciation expense, closer to RAS figures. The conclusion is that the difference between net profit under RAS and IFRS diminished and the dividend forecast became more accurately.

Key drivers and outlook

We raised our forecast for the gas transported in 2011 from 1% yoy to 3.4% yoy based on a stronger than expected H1'11 growth (+5.3% yoy) and an estimated slowdown in the second half of the year. As well, for the explicit period we slightly decreased our gas consumption CAGR from 3% to 2% because of a weaker expected economic recovery, negative influence of higher imports (in the conditions that domestic resources are drying) and negative influence of price liberalization which should happen in the medium term. Regarding transport tariffs, Transgaz entered at July 1st, 2011 in the last year of the current regulatory period with no change in tariffs since September 2009 and for the second time the annual adjustments resulted from the application of the revenue cap method are not recognized by ANRE. In our view, the regulatory risk of Transgaz increased significantly and in order to reflect this we have modeled no change in tariffs until mid 2012 and also no adjustments to be transferred to the next regulatory period. We expect an average tariffs growth of around 4-5% for the third regulatory period (mid 2012 – mid 2017) and of 4% after mid 2017 for the rest of explicit period. Consequently, transport revenues should climb by 6.2% CAGR between 2011 and 2020.

Transit activity which is the second source of operating revenues for Transgaz is also subject of significant changes starting 2012. Currently, transit contracts offer to Transgaz's partners (Gazprom and Bulgargaz) exclusive access to the transit pipelines and a negotiated tariff. These stipulations are in contradiction with EU regulations regarding gas transport which impose that all pipelines have regulated tariff and open access to everyone who is interested to use this service and to pay that tariff. EU imposed to Romania an infringement clause on energy until the terms of gas transit contracts will respect the EU regulations.

The company disclosed little details regarding the stage of transit contracts negotiations. The contract with Gazprom is part of an international agreement between Romania and Russian Federation which was automatically prolonged for another five years and the negotiations are still at government level. According to Transgaz's management, the negotiations with the Bulgarian partner are more advanced as the current contract expires at the end 2011. Transgaz has already submitted to ANRE a documentation regarding the settlement of a regulated tariff for the transit pipeline with Bulgaria and expects the authority decision in order to continue negotiations with Bulgargaz. The pipeline will be considered as a subsystem of the national gas pipeline system with its own RAB, operating expenses and so on, and the tariff should be determined through the same revenue cap method.

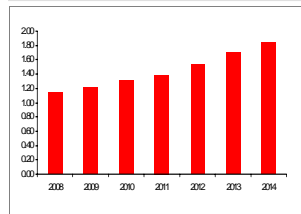
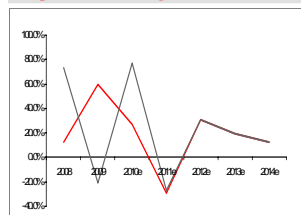
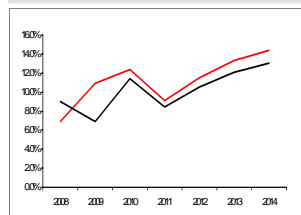
Because of the lack of material information regarding the new conditions of the transit contracts we decided to maintain our estimations for the transit revenues in the explicit period and to wait for further details from Transgaz and ANRE part.

CAPEX and investment program

In H1'11 Transgaz participated with EUR 4.4m to the share capital increase of Nabucco Gas Pipeline International Austria and it plans to contribute with another EUR 2m in September 2011, totalizing EUR 6.4m in 2011. Nabucco project is still in the phase of negotiations regarding the gas sources which will supply the pipeline and until this is settled no major investments are made.

Related to the interconnections pipelines with the neighboring countries, the Szget – Arad pipe was finalized in 2010 following an investment of EUR 33.5m out of which EUR 8.3m were co-financed through European funds. The connection with Bulgaria through Giurgiu – Ruse route it should be also finalized this year following a total investment of EUR 27.5m out of which Transgaz contribution is around 46%. The approved co-financing from European funds is EUR 8.93m out of which EUR 4.55m for the Romanian side. Additionally, Transgaz restarted the negotiations with Serbia regarding an interconnection pipeline between the two national gas grids and currently are discussing the possible pipe routes. For the moment there are no other details regarding the estimated costs and estimated completion date. As well, in 2010, several steps were made regarding the connection with Moldova Republic (several meetings of the working group from the two countries, a first draft of the technical study and the initiation of the requested steps in order to include this project on the list of projects financed by EU through the Trilateral Program Romania – Ukraine – Republic of Moldova 2007 – 2013.

Other on the run investments projects are the completion of SCADA system implementation, which suffered some delays and the deadline of end 2012 will be probably postponed to H1'13 and the development of new pipes in the western part of the country (Apuseni Mountains). The management did not disclose any other details regarding the cost and the time schedule of these projects.

Operating revenues

Net profit and EBIT growth

ROE and ROIC evolution

Major shareholders (%)

MEF	73.51
Proprietatea Fund	14.99
Others	11.50

Utilities (Romania)

TRANSGAZ

Price 26/09/2011 12m target

BUY
RON 189 RON 237.8

Valuation* (RON m)	2008	2009	2010	2011e	2012e	2013e	2014e
Average nb of shares (diluted)	11.77	11.77	11.77	11.77	11.77	11.77	11.77
Share price (eop)	189	189	189	189	189	189	189
EV	2,095	2,129	2,145	2,279	2,344	2,283	2,242
P/E adjusted (x)	9.17	9.25	6.06	9.67	10.37	7.35	6.79
Price/cash flow (x)	8.85	5.69	4.91	5.32	5.73	4.86	4.40
EV/EBITDA (x)	5.72	4.33	3.74	5.27	5.59	4.38	4.06
EV/EBIT (x)	10.91	5.97	4.99	8.66	9.58	6.62	6.05
Price/book value (x)	0.83	0.79	0.74	0.76	0.77	0.73	0.71
P/S(x)	1.96	1.83	1.66	1.74	1.72	1.59	1.51
Dividend yield	5.54%	6.89%	15.22%	10.52%	7.57%	10.21%	11.04%
Per share data (RON)							
BRDS EPS (adj.)	20.61	20.43	31.21	19.54	18.23	25.73	27.83
CFO	228.62	238.58	256.77	247.55	245.89	257.31	265.84
Book value	21.4	33.2	38.5	35.5	33.0	38.9	42.9
Dividend	9.7	10.5	13.0	28.8	19.9	14.3	19.3
Income statement (RON m)							
Transport revenues	917	939	1054	1029	1050	1166	1242
Transit revenues	200	243	254	239	232	224	224
Total Operating revenues	1133	1214	1338	1278	1293	1401	1478
EBITDA	366	492	573	432	420	521	553
Depreciation, depletion and amort.	(174)	(136)	(143)	(169)	(175)	(176)	(182)
EBIT	192	356	430	263	245	345	370
Net financial income/expense	2	18	8	11	11	16	20
EBT	194	374	439	274	255	361	390
Corporate tax	(48)	(134)	(71)	(44)	(41)	(58)	(62)
Reported net income	243	241	367	230	215	303	328
Cash flow statement (RON m)							
Net income	243	241	367	230	215	303	328
Depreciation, depletion and amort.	(174)	(136)	(143)	(169)	(175)	(176)	(182)
Change in working capital	52	8	47	(19)	1	21	5
Cash flow from operating activities	252	391	453	418	389	458	505
Cash flow from investing activities	(203)	(387)	(428)	(213)	(220)	(229)	(237)
Cash flow from financing activities	(98)	(109)	(25)	(291)	(255)	(211)	(246)
Total CF	(49)	(105)	1	(86)	(86)	19	22
Balance sheet (RON m)							
Total long-term assets	2719	2992	3297	3341	3386	3439	3494
of which tangible	747	726	732	701	844	987	1144
Working capital	26	34	81	62	63	83	88
Long term liabilities	268	329	486	528	503	479	455
of which long term debt	99	42	79	121	96	72	48
Shareholders' equity	2692	2809	3023	2915	2895	3030	3130
Net debt	(130)	(96)	(80)	53	119	58	16
Accounting ratios							
ROIC	6.9%	12.5%	13.9%	8.7%	8.2%	11.1%	11.7%
ROE	9.0%	8.6%	12.2%	7.9%	7.4%	10.0%	10.5%
ROA	5.8%	10.2%	11.1%	6.9%	6.5%	8.9%	9.4%
Sales growth (%)	8.58%	7.15%	10.19%	-4.45%	1.14%	8.39%	5.48%
EBITDA margin	32.3%	40.5%	42.9%	33.8%	32.5%	37.2%	37.4%
EBIT margin	16.9%	29.4%	32.2%	20.6%	18.9%	24.6%	25.1%
Net income margin	21.4%	19.8%	27.5%	18.0%	16.6%	21.6%	22.2%
Current ratio	1.7	1.4	1.6	1.3	1.0	1.2	1.2
Net debt/equity	-5%	-3%	-3%	2%	4%	2%	1%
Payout ratio	51%	55%	91%	90%	75%	75%	75%

*Valuation ratios for past years are based on current price