



Transelectrica

Power transmission

BUY

20 October 2014

Last Close
Target price

RON 25.69
RON 29.00

Company Update

RIC: TEL.BX	BQ: TEL RO	
Target Price	RON 29.00	€ 6.6
Previous	RON 22.42	€ 5.1
Total stock return	13%	

Valuation	2012A	2013A	2014E	2015F	2016F
P/E	23.4x	5.2x	5.5x	6.7x	7.0x
P/BV	0.3x	0.4x	0.7x	0.7x	0.6x
P/Sales	0.3x	0.4x	0.7x	0.7x	0.7x
Div Yield	3.7%	15.8%	13.3%	11.0%	10.4%

Per share	2012A	2013A	2014E	2015F	2016F
EPS	0.47	2.74	4.67	3.86	3.69
DPS	0.40	2.23	3.41	2.82	2.68
BVPS	33.16	35.66	38.38	39.06	40.15
EPS growth	-69%	482%	70%	-17%	-4%

BS Data (RON m)	2012A	2013A	2014E	2015F	2016F
Cash & Equiv.	295	601	900	842	808
Sh Equity	2,431	2,614	2,813	2,863	2,943
Equity & Liab	4,945	5,153	5,356	5,398	5,554

P&L Data (RON m)	2012A	2013A	2014E	2015F	2016F
Adjusted revenue	1,192	1,275	1,381	1,360	1,381
EBITDA	398	584	745	716	729
EBIT	83	249	397	343	331
Net Income	34	201	342	283	270

Trading data	1w	1m	3m	12m	YTD
Abs. Performance	-7%	3%	18%	117%	78%
H L 52w	RON 27.70		RON 11.18		
Market cap. (m)	RON 1,883m		€ 426.0m		
Shares outstanding	73.3				
Free float (%)	41.3%				

'14 outstanding. Outlook still positive

We update our view on Transelectrica with a **BUY recommendation** and a **target price of RON 29** per share (previously RON 22.42) revealing an **upside potential of 13%** against current trading levels.

Outlook remains positive for Transelectrica in 3rd regulatory period as increased efficiency and high investments continue to support profitability for the long run. However, compared to our previous report, growth perspectives were hampered by ANRE's decision of lowering TEL's regulated rate of return to 7.7% vs. 8.52% previously.

However, **expect outstanding profit for 2014 due to strong cost control alongside higher tariffs**. Transelectrica's performance should be supported this year by a cumulated 6.3% increase in transmission tariff and an impressive cut in operating expenses, mostly related to grid losses and repairs & maintenance costs. Overall, we see 2014 more a one off due to strong tariff hikes generated by transit between two regulatory periods. Further on, we see a slight deterioration in TEL's performance compared to the outstanding 2014. Expect **TEL's bottom line to consolidate in a range of RON 250m–RON 300m**, should no significant changes occur.

Further on, we anticipate tariffs to be propped by strong CAPEX plans, while we envisage a more conservative approach from ANRE in adjusting tariffs as cost optimisation process and lower WACC rate should lead to less pressure. Thus, **we see tariffs picking up at a faster pace only in second half of regulatory period**, when investments should enhance RAB.

On costs side, we consider 2014 as a reference year for minimum level of expenses necessary to safely operate the national power grid. **Further on, we expect operating expenses to slightly increase, but we are confident on Transelectrica's management ability to contain cost at levels considered now 'normal'**. Expect grid losses to consolidate at 2.4% of high voltage grid energy, in line with ANRE's target of 2.5%-2.4%.

Strong CAPEX plan (~RON 2b over next 5 years) should enhance Transelectrica profitability by the end of 3rd regulatory period, when we expect ANRE to acknowledge the RAB growth.

On a less positive tone, risks of a negative adjustment of tariff emerge, as potential higher rates of return on RAB vs. regulated levels create an unprecedented situation. Bear in mind, Transelectrica has a highly regulated activity. Our estimates rely on a low volatility of tariffs for the next couple of years. However, annual corrections for forecasts vs. estimates could lead to cuts in tariffs.

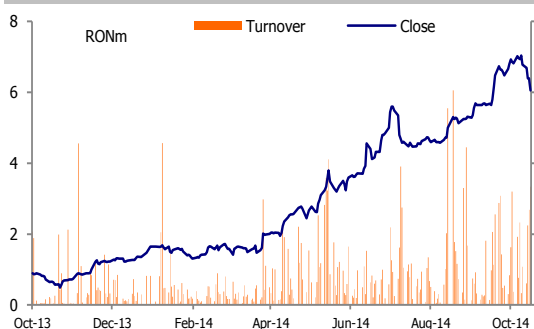
Moreover, **should CAPEX plans be postponed or delayed due to bureaucracy (like it happened in 2014) TEL's profitability might be negatively affected** as tariff hikes are highly depended on RAB growth.

Compared to its European peers, **TEL continues to be highly undervalued**, as it trades at ~63% discount to '14 P/E and ~72% discount to 14' EV/EBITDA multiples.

Moreover, expect an appealing dividend for FY'14 of RON 3.4 per share (based on a 73% pay-out ratio), implying a **yield of ~13%** at current market price.

Recently, market turbulences lead to high volatility and affected all stocks, both international and local traded ones. Should corrections continue further on, expect all equities performance to be influenced. However, **utility sector, strong core fundamentals, bottom line and dividend perspectives, all promote TEL as one of the best defensive stocks with high potential of outperforming the market even under a corrective environment, supporting thus our positive view**.

Wrapping up, we continue to believe in Transelectrica's strong fundamentals.



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Contents |

Investment case	3
Valuation	4
H1'14 Financial results.....	11
Financials	13



Investment case

Transelectrica target price: RON 29/share

We give TEL a BUY rating...

We update our view on Transelectrica with a **BUY recommendation** and a **target price of RON 29** per share (previously RON 22.42) revealing an **upside potential of 13%** against current trading levels. We used a DCF model with a 6-year explicitly forecasted period, in line with 3rd regulatory period, after which a terminal free cash flow with a perpetual growth of 1% is employed.

...as we remain positives on TEL's outlook despite lower regulated rate of return...

Outlook remains positive for TEL in 3rd regulatory period (July 2014 – June 2019) as increased efficiency and high investments continue to support strong core fundamentals and sustainable profitability for the long run. However, compared to our previous report, we downwardly adjusted our estimates for tariffs growth perspectives as ANRE decided to cut TEL's regulated rate of return to 7.7% vs. 8.52% previously.

...while 2014 is expected to be an outstanding year...

However, **expect outstanding profit for 2014 due to strong cost control alongside higher tariffs**. Transelectrica's performance should be supported this year by a cumulated 6.3% increase in transmission tariff and an impressive cut in operating expenses, mostly related to grid losses and repairs & maintenance costs.

...followed by a consolidation of profits at slightly lower levels.

Overall, we see 2014 more a one off due to strong tariff hikes generated by transit between two regulatory periods. Further on, we see a slight deterioration in TEL's performance compared to the outstanding 2014. Expect **TEL's bottom line to consolidate in a range of RON 250m–RON 300m**, should no significant changes occur.

We expect tariffs to pick up again in second half of 3rd regulatory period...

Further on, we anticipate tariffs to be propped by strong CAPEX plans, while we envisage a more conservative approach from ANRE in adjusting tariffs as cost optimisation process and lower WACC should lead to less pressure. Thus, **we see tariffs picking up at a faster pace in second half of regulatory period**, when investments should enhance RAB.

...while profitability should be supported by a strong cost control.

On costs side, we consider 2014 as a reference year for the minimum level of expenses necessary to safely operate the national power grid. **Further on, we expect operating expenses to slightly increase, but we are confident on Transelectrica's management ability to contain cost at levels considered now 'normal'**. Expect grid losses to consolidate at 2.4% of high voltage grid energy, in line with ANRE's target of 2.5%-2.4%, while the 16% plunge in wholesale energy prices (according to OPCOM) should also contribute to diminishing costs.

High CAPEX plan should also support performance.

Strong CAPEX plan (~RON 2b over next 5 years) should enhance Transelectrica profitability by the end of 3rd regulatory period, when we expect ANRE to acknowledge the RAB growth. Investments focus lies on strengthening the national grid, connecting renewables power to the grid and increasing interconnection capacity allocation on exports.

On the other hand, risk of a negative tariff adjustment emerge

On a less positive tone, risks of a negative adjustment of tariff emerge, as potential higher rates of return on RAB vs. regulated levels create an unprecedented situation. Bear in mind, Transelectrica has a highly regulated activity. Our estimates rely on a low volatility of tariffs for the next couple of years as according to current methodology, efficiency gains should be shared with consumers only in next regulatory period. However, annual corrections for forecasts vs. estimates could lead to cuts in tariffs.

...while delays on CAPEX implementation could also hamper TEL's performance.

Moreover, **should CAPEX plans be postponed or delayed due to bureaucracy (like it happened in 2014) TEL's profitability might be negatively affected** as tariff hikes are highly depended on RAB enhancement, while repairs&maintenance costs will probably need to increase in order to compensate for lack of investments.

Significant discount to peers...

Compared to its European peers, **Transelectrica continues to be highly undervalued**, as it trades at ~63% discount to '14 P/E and ~72% discount to 14' EV/EBITDA multiples. These massive discounts are partially justified by high regulatory risk, alongside market risk and significantly lower margins (~13% vs. 20% '14 median).

...and dividend prospects...

Moreover, expect an appealing dividend for FY'14 of RON 3.4 per share (based on a 73% payout ratio), implying a **yield of ~13%** if current market price is considered.

...further support TEL's strong performance.

Recently, market turbulences lead to high volatility and affected all stocks, both international and local traded ones. Should corrections continue further on, expect all equities performance to be influenced. However, **utility sector, strong core fundamentals, bottom line and dividend perspectives, all promote TEL as one of the best defensive stocks with high potential of outperforming the market even under a corrective environment, supporting thus our positive view.**

Wrapping up, we continue to have faith in Transelectrica's strong fundamentals.



Discounted Cash Flow Model

To value the company, we used a DCF model with a 6-year explicitly forecasted period, after which a terminal free cash flow with a perpetual growth of 1% is employed. The forecast period is representative for the third regulatory period, scheduled for July 2014 - June 2019.

The DCF reveals a **fair share price** of **RON 29** per share, which implies a **13% upside potential** from current trading levels and justifies a **BUY** recommendation.

TRANSELECTRICA DISCOUNTED CASH FLOW						
(RONm)	2014 E	2015 F	2016 F	2017 F	2018 F	2019 F
EBIT	397	343	331	335	346	346
Less: Adjusted taxes	64	55	53	54	55	55
NOPLAT	334	288	278	281	291	291
Plus: Depreciation	348	374	397	423	449	476
Capital expenditures	(208)	(493)	(572)	(617)	(546)	(515)
(Increase)/decrease in working capital	(25)	4	(4)	(10)	(13)	(8)
Free cash flow	448	172	100	77	182	244
WACC	8.3%	8.1%	8.1%	8.1%	8.1%	8.1%
PV of FCFF	441	157	84	60	131	163
Terminal Value	2,308					
Perpetual growth rate	1%					
PV of explicit period value	1,035					
Net present value of terminal value	1,538					
Enterprise value	2,573					
Less: net debt	447					
Equity value	2,126					
Shares outstanding (m)	73					
Target price/share (RON)	29.00					
Total return potential: upside/(downside)	13%					
WACC calculation						
Risk free rate	3.25%	3.00%	3.00%	3.00%	3.00%	3.00%
Market premium	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
Levered Beta	1.13	1.13	1.14	1.14	1.14	1.08
Cost of equity	10.1%	9.8%	9.8%	9.9%	9.8%	9.5%
Cost of debt (after tax)	3.7%	3.7%	3.7%	3.7%	3.7%	3.7%
Debt/(Debt + Equity)	27.5%	27.4%	27.8%	28.1%	27.8%	23.5%

Source: Transelectrica, AFR estimates



Key DCF assumptions

Expect an outstanding performance in 2014

...while further on, perspectives remain positives, even though growth perspectives are hampered by a lower regulated rate of return.

At a glance, expect 2014 net profit to jump 70% Y/Y...

...driven by 8% higher Y/Y adjusted revenues...

...propped by positive adjustments of tariffs...

...despite diminishing volumes.

Further on, strong CAPEX plan might boost tariffs...

We upwardly adjust our estimations regarding Transelectrica's FY'14 financial results as the company's management accomplished significant cuts in operating expenses in H1'14. **We see 2014 as an outstanding year**, mostly due to increased efficiency and positive adjustment of tariffs.

Further on, we still find positive TEL's outlook for 3rd regulatory period (July 2014 – June 2019) **despite a lower rate of return settled by the Energy Watchdog** (ANRE) to 7.7% vs. 8.52% previously as increased efficiency should support strong fundamentals. **On a less positive tone, we slightly adjust our tariff growth perspectives in line with the new regulated rate of return.** Risks of a downward adjustment of tariffs emerged as TEL's activity is highly regulated and potential higher rates of return on RAB vs. regulated levels create an unprecedented situation. However, **we expect 3rd regulatory period tariffs to have a low volatility and should be driven especially by investments recognition in RAB.**

Meanwhile, worth mentioning is that the company sued ANRE requesting a higher WACC rate. Should court decide in favor of Transelectrica and approve a higher WACC (9.87% or 8.52% as requested by the company), we might see an upward adjustment.

At a glance, **we pencil TEL's FY'14 bottom line to surge 70% to RON 342m, driven by 8% higher Y/Y adjusted revenues (excluding non-profit activities) and strong cost control.** In the 3rd regulatory period (2014-2019) we expect net profit to increase at CAGR of ~6%, while revenues from profit making activities to rise at a ~3% CAGR rate.

We see FY'14 adjusted revenues reaching RON 1,381m, 8% higher Y/Y, driven by increasing tariffs which should more than compensate for declining volumes (-2% Y/Y).

In 2014, the company benefited by two rises of transmission tariff:

- + 4.7% to RON 22.16/MWh in the beginning of the year (January 2014)
- + 1.5% to RON 22.50/MWh at the start of third regulatory period (July 2014)

Transelectrica's effective tariff is usually higher than the approved one, due to volume adjustments for different regions. 2013 effective tariff was 2.8% higher than approved by ANRE. In H1'14 TEL's average transmission tariff stood at RON 23.30/MWh vs. RON 22.16/MWh approved (+5%). Thus, for H2'14 we anticipate actual tariffs to stand 3% above approved level, reaching an average of RON 23.24/MWh. Further on, we anticipate effective tariffs to stand also 3% above approved.

In terms of volumes, we see energy consumption decreasing around 1% in 2014 (after a 5% plunge in 2013), as in first eight months National Institute of Statistics acknowledged a 1.1% Y/Y decrease, while exports surged 5.7x. We see management's perspectives of a 4% decrease in TEL's volumes too conservative as **we anticipate tariffed volumes to be ~2% lower compared to previous year.** Transelectrica's tariff base was modified in H2'13, as exports and imports were exempted from extraction and injection tariff respectively. However, **TEL can still benefit from the injection tariff for export quantities**, which accounts for 46% of current transmission tariff (average RON 10.3/MWh out of RON 22.50/MWh). Further on, as adjustments for new energy volume base will fade away in H2'14, we see Transelectrica's figures of energy transported and tariffed slightly picking up.

For 2014-2019 we anticipate increases in tariffs to be mainly driven by strong investments. We envisage a more conservative approach from ANRE in adjusting tariffs and therefore a lower volatility, in line with new methodology. Moreover, the company's management already stated that cost optimisation process should lead to less pressure on tariffs further on. Thus, **considering the lower WACC rate of 7.7%, we see tariffs increasing at a CAGR of 2% in 3rd period**, while strong investments that should be recognised by ANRE in 2017 could boost 2018 tariffs.



TRANSELECTRICA Revenues (IFRS unconsolidated)									
(RONm)	2011	2012	2013	2014 E	2015 F	2016 F	2017 F	2018 F	2019 F
Volume transported & tariffed (TWh)	56.1	53.9	51.9	50.8	50.3	50.3	50.4	50.6	50.7
Transmission revenues	1,115	1,080	1,156	1,240	1,228	1,246	1,282	1,327	1,361
Transmission tariff ANRE(ROn/MWh)	18.77	18.77	21.16	22.16/22.50	22.59	23.13	23.75	24.61	24.85
Transmission tariff realised(ROn/MWh)	18.82	19.00	21.75	23.24	23.22	23.55	24.15	24.91	25.47
System services revenues	779	565	624	736	702	716	732	749	766
System services tariffs (ROn/MWh)	13.90	10.21	11.96	14.49	13.96	14.24	14.52	14.81	15.11
Balancing market revenue	1,189	1,068	632	682	675	685	705	730	749
Others	48	55	60	62	61	62	64	66	67
TOTAL Operating Revenue	3,132	2,768	2,472	2,719	2,666	2,709	2,783	2,871	2,943

Source: Transelectrica, Note: year end realised transmission tariffs computed as an average of two periods, 3% above ANRE level

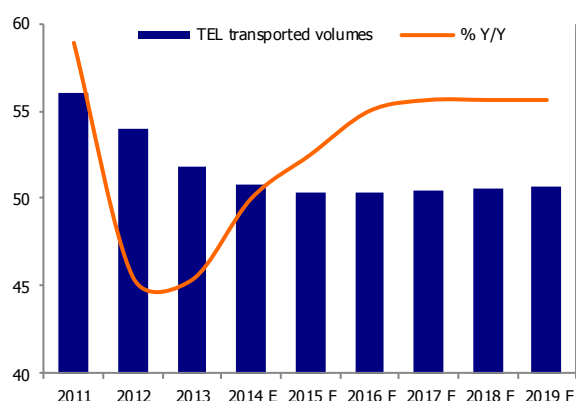
..while for next year we anticipate tariffs to hover around current levels, although risks of a downward adjustment in tariff emerge.

For 2015, our DCF exercise is based on expectation that tariffs will hover around current levels. However, bear in mind that risk for a downward adjustment of tariff emerged, as we see Transelectrica operating at returns higher than regulated levels. At H1'14 Transelectrica already recorded a return on RAB of ~7%, while in 2013 return stood at ~8%. For first year of 3rd regulated period we envisioned a RRR of ~12%, while further on we expect it to fall closer to 9%. Thus, should TEL obtain the recognition of a higher RRR (vs. 7.7% currently) risks of downward adjustment should be significantly diminished.

Expect impact of tariff adjustments to be diminished on a fiscal year, as tariffs are changed starting with July every year, according to the new methodology. Only exceptional situations might lead to tariff modification during a tariff period.

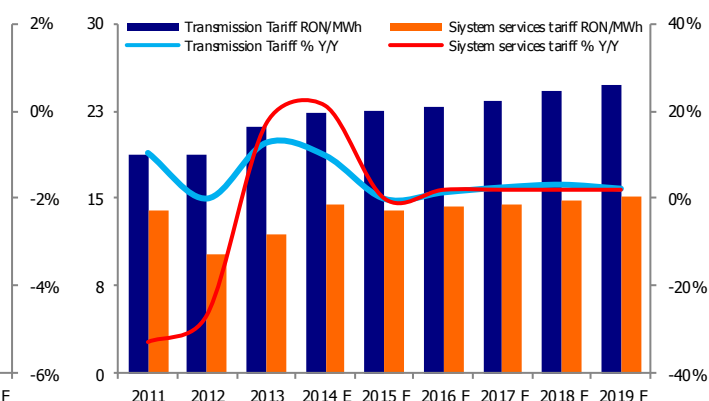
Transelectrica: Volumes & Tariffs

Transported volumes evolution



Source: Transelectrica, AFR computation

Transmission and system services tariffs



Source: Transelectrica, AFR computation

Expect system services to have a modest evolution

ANRE cut system services tariffs by 7% to RON 13.96/MWh vs. RON 15.02/MWh previously in July 2014, after a 12% rise in December 2013. Out of system services tariffs, functional segment tariff was reduced 18.4% to RON 1.42/MWh, while technological segment tariff was cut by 5.6%. Technological system services, which should be a non-profit activity, generated in H1'14 RON 33m gains, which are expected to be reversed in H2'14, considering the lower tariff. We pencil system services tariffs to be maintained at current levels in 2015, while further on we anticipate a 2% annual growth rate.

We pencil **interconnection capacity allocation revenues jumping 2.3x higher in 2014** propped by 5.7x hike in exports. Thus, expect RON 53m revenues from this segment in FY'14.

Overall, FY'14 revenues are seen 10% higher Y/Y...

Considering all above, we anticipate FY'14 **operating revenues to increase ~10% Y/Y to RON 2,719m** supported by 7% higher Y/Y transmission revenues to RON 1,240m and 18% Y/Y increase in revenues from system services to RON 740m. Moreover, we anticipate balancing market activity, which is a non-profit segment, to reach RON 682m.



Company Update – October 2014

...while strong cost control...

On cost side, the company's management already proved its ability in containing operating costs at what should be now considered 'normal levels'. We expect to see adjusted operating costs landing at RON 984m (excluding costs directly linked to non-profit activities), 3.2% lower on an annual basis (after a 7% plunge recorded last year). **Further on, we see expenses from profit making activities increasing at a mere 2% CAGR.**

...should be supported by diminished grid losses...

We pencil FY'14 **grid losses plunging 19% Y/Y** to RON 180m, after a 12% decline in 2013, **driven by lower quantities and diminishing power prices.** We anticipate grid losses to land at 2.42% of HV grid energy (high voltage grid) vs. 2.52% in 2013, in line with H1'14 figures. **Moreover, 2014 weighted average energy prices** on wholesale market (according to OPCOM data) **are seen 16% lower Y/Y** to RON 177/MWh vs. RON 210/MWh. Thus, expect grid losses to decline and to stand below ANRE's target of 2.5%-2.4% grid losses (equivalent of 0.98TWh to 0.94TWh) at RON 190/MWh, mostly due to lower prices.

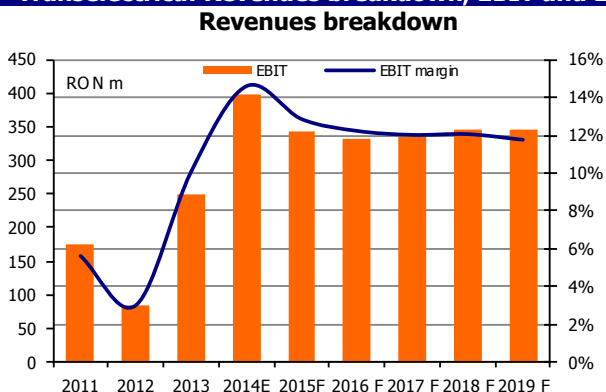
...and significantly lower repairs & maintenance costs.

Repairs and maintenance costs should fall 25% lower this year to RON 80m, as the company changed its direction towards investments rather than rehabilitation of old and deteriorated structures. **We see expenses bottoming up in 2014** and therefore we anticipate costs to slightly increase further on.

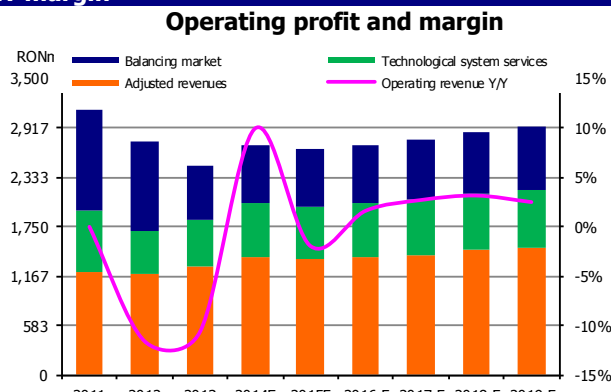
We pencil personal costs increasing ~2.3% Y/Y in 2014 to RON 175m, driven mainly board's remuneration, while afterwards we see personal expenses increasing line with inflation rate.

Expect a small reduction of costs with monopoly tax as starting with January 2015 it should not apply anymore. However, the amount is modest as in 2013 Transelectrica paid ~RON 8m for this tax.

Transelectrica: Revenues breakdown, EBIT and EBIT margin



Source: Transelectrica, AFR computation



Source: Transelectrica, AFR computation

All in all, we see FY'14 EBITDA surging 27%...

Considering all above, **expect FY'14 EBITDA to jump 27% higher to RON 745m**, while adjusting for D&A, operating result should reach RON 397m, +59% Y/Y. Further on, **expect EBIT to grow at a CAGR of ~6% in 2014-2019 period.** For 2014, we expect positive FX effects to overshadow higher interest expenses due to bond issuing from last year. We don't anticipate another bond issuing this year.

...leading to a 70% higher Y/Y net profit.

Overall, expect for 2014 a record high net profit for Transelectrica driven by solid cuts in operating expenses and positive adjustments of transmission tariffs. Thus, we pencil net profit reaching RON 342m, 70% higher compared to last year. Forward looking, expect less pressure on tariffs and costs slightly picking up to more sustainable levels, which should lead to an ~17% plunge Y/Y in FY'15 net profit to ~RON 283m. **However, margins remain appealing even for 2015 and further on, as we envision a 10% - 11% net profit margin vs. 13% in FY'14.**

Transelectrica's performance could be influenced by a positive court decision regarding the regulated rate of return level, while on a less positive tone a downward adjustment of tariffs should have the opposite effect. However, bear in mind that impact of tariffs change in diminished as adjustments are made mid-year.

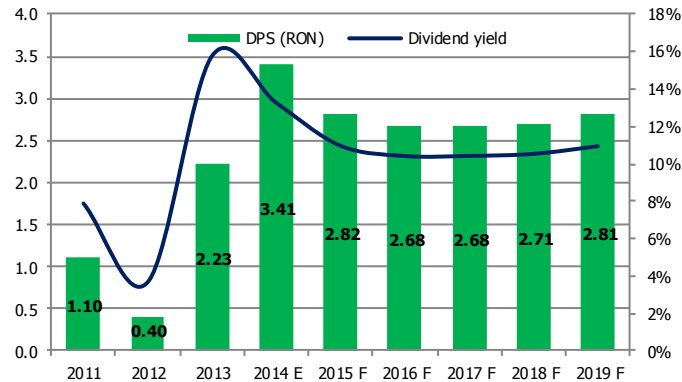


Dividends

Expect a dividend yield of ~13%

Transelectrica distributed RON 163m from last year net profit, implying a dividend per share of RON 2.228 (11% at cum-dividend date) and a pay-out of 81%. Regarding 2014 results, in line with management's guidance, we anticipate a **pay-out ratio of ~73%**. **Expect outstanding net profit to compensate for diminished pay-out as we pencil a dividend of RON 3.40 per share, implying a dividend yield of ~13%**, if current market price is considered. Forward looking, we continue to expect strong dividends from Transelectrica, considering the budgeted pay-out ratio (~73%).

Expected dividend evolution



Source: Transelectrica

Third regulatory period: July 2014 –June 2019

Outlook for 3rd regulatory period remains positive...

Third regulatory period (July 2014–June 2019) just begun and a new methodology was enforced. We should see some positive changes on revenues side as new methodology allows for a better adjustment of tariffs, while key parameters revealed by Transelectrica indicate a lower rate of return recognised by ANRE (7.7% vs. 8.52% previously) and a strong CAPEX plan for 3rd regulatory period.

...despite lower regulated rate of return, even though at this level profitability is less appealing...

The new regulated rate of return set at 7.7% was a little surprising as we consider an 8.52% rate more appropriate, in line with our own computation. **Transelectrica filed a lawsuit against ANRE, requesting the WACC rate to be adjusted to 9.87%, or if not approved, TEL seeks at least 8.52%** (transit period level). According to company's representatives, new rate of return could generate RON 138m lower regulated earnings during the next five years compared to potential revenues at 8.52% regulated return. ANRE based its call on a lower beta factor of 0.43, while Transelectrica considers a beta of 1.0359 (computed from August 2006) as the fair value. Computed on a 3-year basis, considered by us far more appropriate for TEL stock, unleveraged beta indicator lies closer to 0.9, which should lead to a WACC value of around 8.5%.

Although we see TEL's sue fairly justified, we tend to believe that Transelectrica's move is more forward looking as overpassing the regulated rate of return might lead to a downward adjustments of tariffs further on.

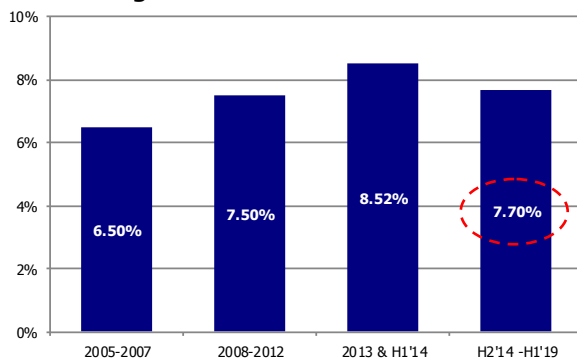
According to the current methodology, in 3rd regulatory period tariffs can be mainly propped by RAB enhancement. Should ANRE acknowledge a higher WACC rate, positive impact on TEL's performance might emerge.

Moreover, **new transmission tariff methodology offers Transelectrica the possibility of recognising tariff adjustments during a financial year** (instead of year-end only), even above 7% threshold if it is necessary, by reporting the increase over the next years. It takes into consideration also a 0.5% increase in RAB return for major European projects. However, bear in mind that excluding inflation (BNR's estimate: 2.2%), annual growth should stay below the 7% threshold approved by revenue cap methodology for average tariffs and 10% threshold for regional tariffs.



Third regulatory period

Regulated rate of return evolution



Source: Transelectrica

Key parameters

WACC	7.70%
Investments recognised by ANRE (RONm)	2,041
Grid losses	2.5% - 2.4%
Energy Price (RON/MWh)	190
OPEX controllable RON m	387
Efficiency factor	1.50%
Transported energy (TWh)	50
RAB opening (RONm)	3,006
Depreciation period	20 years

Source: Transelectrica

...while efficiency gains recorded in 2013 and 2014 should be kept until next regulatory period...

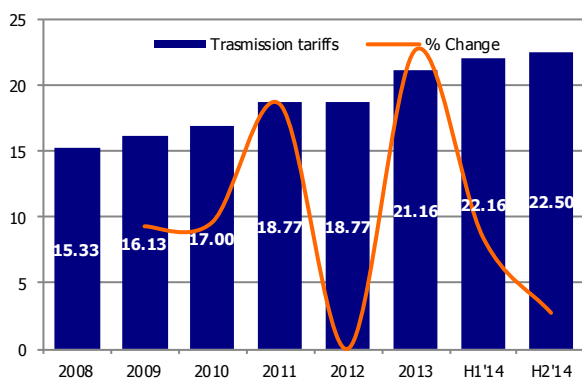
TEL will benefit in this regulatory period from efficiency gains that current management obtained. Efficiency gains recorded above ANRE target in previous regulatory period are shared with consumers in next period (ANRE's Order No. 53/2013). Thus, 50% of surplus should be cut from regulated income in next regulatory period and returned to consumers through smaller tariffs. Moreover, if necessary, revenues should also be adjusted for unaccomplished investment plans from previous regulated period. According to company's representatives, TEL's revenues were downwardly adjusted for unaccomplished investment plans, but the cuts were offset by other positive corrections. Moreover, as reference income was set based on last year of previous regulatory period, which for TEL was 2012, it was not the case to establish adjustments for significant efficiency gains.

New parameters for 3rd regulatory period include variable grid losses from 2.5% to 2.4% of energy transported through power grid vs. only 2.2% recognised into tariffs previously. The new target, which should decrease 25 basis points every year, lies closer to Transelectrica's own target of 2.4%.

On a less positive tone, **new methodology doesn't allow adjustments for tariffs if actual volumes have a variation of less than +/-3% vs. anticipated volumes**, as it previously did. This could negatively impact TEL's results, as low volatility of volumes will probably not be recognised in revenues.

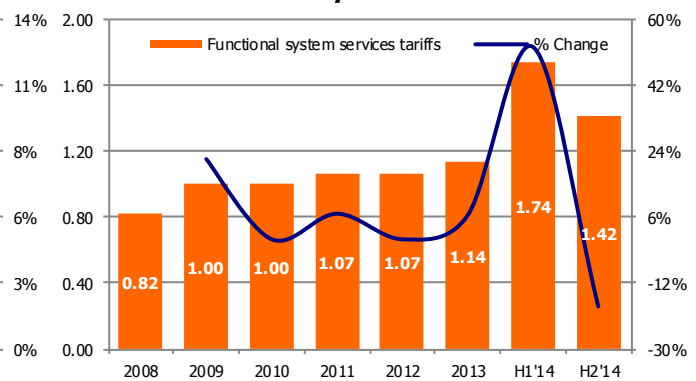
Transelectrica: Tariffs for profit making activities 2008 - 2014

Transmission tariff



Source: Transelectrica

Functional system services tariff



Source: Transelectrica

Further on, binomial tariff might also apply.

The company plans to introduce **binomial tariffs, which could lead to more stability in revenues**. Binomial tariffs create a link between costs and revenues, which should reflect into better adjustment when volumes decrease, while taking into consideration the power transported and the transport capacity. However, according to company's management, the binomial tariff, if approved by ANRE, will be tested first simultaneously with current tariffs and applied on a stand-alone basis only later on. Thus, we do not expect to see significant changes in near future.

Major impact on TEL's activity will probably come from the new methodology for functional system services (ANRE Order No. 87/2013) as it changed from 'revenue cap methodology' to 'cost plus' methodology allowing a full recognition of operating and maintenance costs. Moreover, Transelectrica is allowed to obtain gains from technological system services due to increase in efficiency and retain 20% of their value.

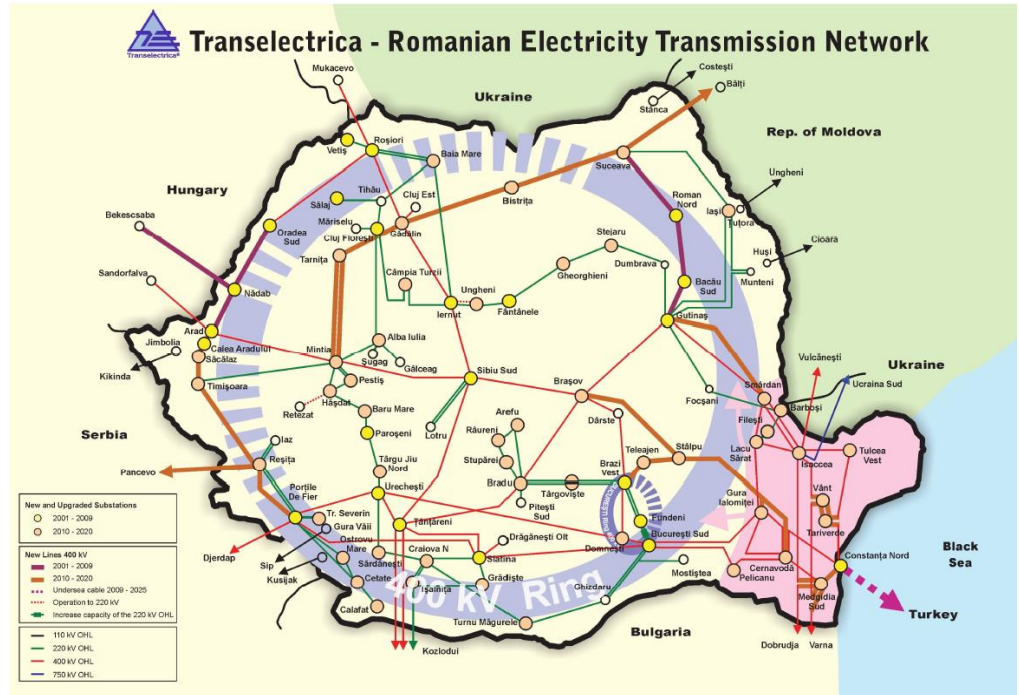


Investments

Forward looking, expect high investments to boost TEL's profitability...

One of main catalyst for TEL expected positive evolution is high investment plan settled for 3rd regulatory period. Focus lies on development of national grid, connection to the national grid of renewable energy and increasing power interconnection capacity allocation. According to company's management, **investments recognised by ANRE into regulated asset base during July 2014 and June 2019 should reach RON 2.04b.** Thus, **expect impressive CAPEX plan to boost regulated asset value** later on (when they will be recognised by ANRE) and therefore to **enhance TEL's profitability.**

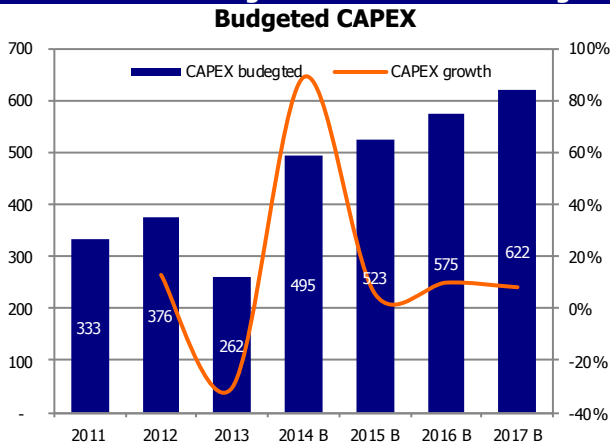
Romanian Electricity Transmission Network



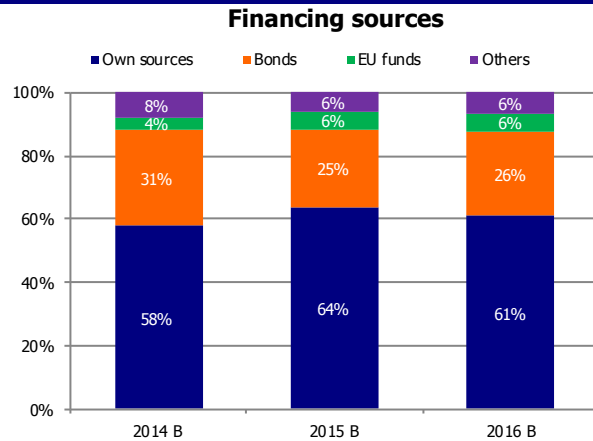
Source: Transelectrica

Moreover, ANRE approved Transelectrica's development plan for national power transmission grid for the next 10 years (2014-2023). The investment plan focuses on increasing interconnection capacities for exports (especially with Hungary, Serbia and Bulgaria), development of national power grid system and replacing all equipment for '60-'70 in order to increase efficiency and power system security. **Total investments in 2014-2023 should reach RON 5.3b.**

Transelectrica: Budgeted CAPEX and financing sources



Source: Transelectrica, AFR computation



Source: Transelectrica, AFR computation



The company plans to finance some of investments through bond issuing (~RON 900m during 2013-2019), and remaining from international financing institutions. Thus, further on **financing structure should improve, leading to cost optimisation alongside reduction of interest rates and FX risk.**

On a less positive tone, according to company's data, by the end of **H1'14 investments worth RON 31m were concluded out of RON 495m envisaged for FY'14.** Thus, expect 2014 CAPEX plan not to be accomplished, while our anticipations depend on a better investment plan management for 2015 and further on.

Peers valuation

Transeletrica is significantly undervalued compared to its peers as it trades at ~72% discount compared to '14 EV/EBITDA and ~63% discount to '14 P/E multiples. These massive discounts are partially justified by high regulatory risk, alongside market risk. Moreover, Transeletrica is operating at significantly lower profit margins (8% vs. 20% median in FY'13) and diminished ROEs (8% vs. 18% median). TEL should trade at a discount, but lower. We consider the current discount unjustified. Our valuation places TEL at a 68% discount to '14 EV/EBITDA and a 58% discount to '14 P/E.

C.N.T.E.E. TRANSELECTRICA PEER GROUP														
Company name	Ticker	Market Cap (EUR m)	EV/EBITDA			P/E			ROA		ROE		Net profit margin	
			FY'13	FY'14	FY'15	FY'13	FY'14	FY'15	FY'13	FY'14	FY'13	FY'14	FY'13	FY'14
Elia System Operator	ELI	2,174	10.1x	11.7x	11.3x	12.4x	13.8x	14.6x	5.2%	4.7%	8%	7%	13%	14%
National Grid	NG	39,403	10.3x	9.7x	9.2x	15.4x	15.0x	14.0x	3.8%	5.5%	18%	17%	14%	14%
Red Electrica Corporacion	REE	8,481	10.0x	9.5x	9.0x	16.0x	15.3x	14.4x	5.7%	7.4%	27%	23%	30%	30%
Terna Rete Elettrica Nazionale	TRN	7,538	9.6x	9.7x	9.2x	14.7x	14.8x	14.1x	3.4%	5.6%	18%	17%	27%	27%
Median of peers			10.0x	9.7x	9.2x	15.0x	14.9x	14.2x	4%	6%	18%	17%	20%	20%
Transeletrica (current price)	TEL	425	2.8x	2.8x	3.0x	5.2x	5.5x	6.7x	4.0%	6.5%	8%	13%	8%	13%
<i>Premium / (Discount)</i>			-73%	-72%	-68%	-66%	-63%	-53%	-11%	17%	-56%	-26%	-60%	-38%
Transeletrica (target price)		480	4.6x	3.1x	3.3x	10.6x	6.2x	7.5x						
<i>Premium / (Discount)</i>			-54%	-68%	-64%	-30%	-58%	-47%						

Source: Transeletrica, Thompson Reuters, data as of October 16, 2014

H1'14 Financial Results

Transeletrica posted **outstanding results for Q2'14** as net profit hiked 8.16x compared to same period of last year to RON 90m. Strong cost control and higher revenues due to increased tariffs pushed H1'14 figure 2.2x higher vs. H1'13 to RON 226m.

Higher tariffs offset 1.6% Y/Y drop in volumes (-2.9% in H1'14) leading to 11% Y/Y increase in Q2'14 adjusted revenues to RON 691m. Average transmission tariff reached RON 23.5/TWh, 6% over regulated tariff pushing electricity transmission revenues 9% higher Y/Y to RON 281m. Meanwhile, interconnection revenues jumped to RON 10.8m as exports weighed. Non-profit activity climbed 19% Y/Y to RON 293m, leading to a 16% increase in total revenues to RON 620m.

On cost side, Transeletrica's management proved once again its ability of containing operating costs at what should be now considered normal levels. **Q2'14 system operating losses decreased 15% Y/Y** to RON 53m as grid losses decreased 15% Y/Y due to pressuring power prices and diminishing volumes (2.42% vs. 2.75% previously). Moreover, repairs and maintenance costs plunged even further to RON 20.6m, -30% Y/Y. On the other hand, Transeletrica reported an impairment of RON 22.22m for ANAF litigations.

Technological system services (a non-profit activity) generated another RON 15m profit, pushing H1'14 gain from this segment to RON 33m.

All in all, Q2'14 EBITDA surged 66% Y/Y to RON 174m, while operating result reached RON 84.9m, 4.1x higher. Dividend income (RON 13m) and interest revenues (RON 6.4m) propped TEL's financial result to RON 22m. Thus, increased operating efficiency alongside gains from



non-profit activities and strong financial result pushed Q2'14 net profit to a record high of RON 90m.

H1'14 figures show an impressive performance for Transelectrica. **Bottom line exceeded FY'13 figure (RON 201m), reaching RON 226m**, 2.2x higher vs. H1'13 due to 11% higher adjusted revenues and strong cost control (-8% Y/Y excluding non-profit activities).

TRANSELECTRICA: PROFIT&LOSS (IFRS unconsolidated)							
(RON m)		FY'12	FY'13	% Δ	H1'13	H1'14	% Δ
	Energy tariffed (TWh)	53.9	51.9	-4%	26.2	25.5	-3%
Adjusted revenue, o/w:		1,192	1,275	7%	624	691	11%
	Transmission revenue	1,080	1,156	7%	574	620	8%
	<i>RON/MWh</i>	19	21	13%	21	23	9%
	Revenue from functional system serv.	58	59	2%	30	44	48%
	Other revenues	55	60	9%	20	27	32%
	Technological system services revenue	507	565	11%	261	340	30%
	Balancing market revenue	1,068	632	-41%	229	287	25%
	Operating revenues	2,768	2,472	-11%	1,114	1,319	18%
	Grid losses	252	222	-12%	115	88	-23%
	Congestions	6	3	-51%	3	0	-100%
	Own consumption	17	20	15%	10	7	-26%
	Repairs and maintenance	138	108	-22%	52	37	-28%
	Third parties expenses	55	50	-10%	24	21	-12%
	Depreciation & amortisation	315	335	6%	169	171	1%
	Personnel expenses	170	171	0%	79	82	4%
	Expenses from technological services tariff	523	574	10%	255	307	20%
	Balancing market expenses	1,068	632	-41%	229	287	25%
	Other operating expenses	139	110	-21%	50	69	38%
	Operating expenses	2,685	2,223	-17%	985	1,069	9%
	EBITDA	398	584	47%	298	421	41%
	<i>EBITDA margin</i>	14.4%	23.6%	64%	26.7%	31.9%	19%
	EBIT	83	249	N/M	129	250	94%
	<i>EBIT margin</i>	3.0%	10.1%	N/M	11.6%	18.9%	64%
	Financial result, o/w	(36)	(9)	-74%	(6)	20	N/M
	EBT	47	240	410%	123	269	119%
	Net profit	34	201	482%	103	226	120%
	<i>Net profit margin</i>	1.2%	8.1%	552%	9.2%	17.2%	86%

Source: Transelectrica, AFR

TRANSELECTRICA: BALANCE SHEET (IFRS unconsolidated)							
(RON m)		FY'12	FY'13	% Δ	H1'13	H1'14	% Δ
	PPE	3,683	3,573	-3%	3,578	3,462	-3%
	Intangible assets	51	45	-11%	47	42	-10%
	Other investments	52	52	0%	52	57	9%
	Long-term assets	3,787	3,671	-3%	3,668	3,561	-3%
	Inventories	40	37	-8%	39	37	-4%
	Account receivables	823	844	3%	756	1,013	34%
	Cash & cash equivalents	295	601	103%	246	635	158%
	Current assets	1,158	1,482	28%	1,040	1,685	62%
	Total assets	4,945	5,153	4%	4,718	5,246	11%
	Total equity	2,431	2,614	8%	2,503	2,682	7%
	Deferred income	539	536	-1%	557	541	-3%
	Borrowings	955	951	0%	873	857	-2%
	Deferred tax liability	41	34	-18%	35	30	-15%
	Employee benefits	23	26	13%	23	26	13%
	Non-current liabilities	1,558	1,547	-1%	1,489	1,455	-2%
	Trade and other liabilities	738	712	-3%	340	788	132%
	Current tax liability	16	18	14%	34	60	75%
	Deferred income	4	35	692%	22	36	63%
	Current portion of LTD	199	226	14%	329	226	-32%
	Current liabilities	957	992	4%	726	1,110	53%
	Total equity and liabilities	4,945	5,153	4%	4,718	5,246	11%

Source: Transelectrica, AFR



Company Update – October 2014

Financials

TRANSELECTRICA PROFIT & LOSS ITEMS (IFRS unconsolidated)									
(RONm)	2011	2012	2013	2014 E	2015 F	2016 F	2017 F	2018 F	2019 F
Adjusted revenue o/w:	1,223	1,192	1,275	1,381	1,360	1,381	1,420	1,469	1,507
<i>Adjusted revenue growth</i>		-2%	7%	8%	-2%	2%	3%	3%	3%
Total operating revenue	3,132	2,768	2,472	2,719	2,666	2,709	2,783	2,871	2,943
<i>Total revenue growth</i>		-12%	-11%	10%	-2%	2%	3%	3%	3%
EBITDA	473	398	584	745	716	729	757	796	822
<i>EBITDA margin</i>	15%	14%	24%	27%	27%	27%	27%	28%	28%
EBIT	176	83	249	397	343	331	335	346	346
<i>EBIT margin</i>	6%	3%	10%	15%	13%	12%	12%	12%	12%
EBT	143	47	240	407	337	322	320	323	336
<i>EBT margin</i>	5%	2%	10%	15%	13%	12%	12%	11%	11%
Net profit	110	34	201	342	283	270	269	272	282
<i>Net profit margin</i>	4%	1%	8%	13%	11%	10%	10%	9%	10%

TRANSELECTRICA BALANCE SHEET ITEMS (IFRS unconsolidated)									
(RONm)	2011	2012	2013	2014 E	2015 F	2016 F	2017 F	2018 F	2019 F
Long term assets	3,656	3,787	3,671	3,531	3,650	3,825	4,020	4,116	4,155
Inventories	42	40	37	32	33	34	35	35	36
Receivables	1,178	823	844	893	873	887	911	939	962
Cash	305	295	601	900	842	808	771	797	665
Total assets	5,181	4,945	5,153	5,356	5,398	5,554	5,736	5,887	5,817
Short term debt	202	199	226	175	148	138	320	309	87
Current liabilities	1,196	758	766	784	769	780	795	810	826
Long term debt	943	955	951	893	934	994	867	892	903
Long term liabilities	414	603	596	690	684	699	723	753	778
Shareholders funds	2,424	2,431	2,614	2,813	2,863	2,943	3,032	3,123	3,224
Equity & liabilities	5,181	4,945	5,153	5,356	5,398	5,554	5,736	5,887	5,817

TRANSELECTRICA CASH FLOW ITEMS (IFRS unconsolidated)									
(RONm)	2014 E	2015 F	2016 F	2017 F	2018 F	2019 F			
Net income	342	283	270	269	272	282			
(+) Depreciation	348	374	397	423	449	476			
(-) (Increase) / Decrease in working capital	69	(2)	11	15	16	17			
Cash flow from operations	759	654	679	706	737	775			
Capital expenditures/long term investments	(208)	(493)	(572)	(617)	(546)	(515)			
Cash flow from investing	(208)	(493)	(572)	(617)	(546)	(515)			
Cash surplus (deficit) generated before financing	551	161	107	89	192	261			
Increase (decrease) in debt	(109)	14	50	55	15	(211)			
Equity changes	20	17	16	16	16	17			
Dividends paid	(163)	(250)	(207)	(196)	(196)	(198)			
Cash flow from financing	(252)	(219)	(140)	(126)	(166)	(393)			
Total change in cash	299	(58)	(34)	(37)	26	(132)			
Cash Balance - Beginning of Period	601	900	842	808	771	797			
Cash Balance - End of Period	900	842	808	771	797	665			

TRANSELECTRICA KEY RATIOS									
	2011	2012	2013	2014 E	2015 F	2016 F	2017 F	2018 F	2019 F
Per Share Data									
EPS (RON)	1.50	0.47	2.74	4.67	3.86	3.69	3.67	3.71	3.85
<i>EPS growth</i>		-69%	482%	70%	-17%	-4%	0%	1%	4%
BVPS (RON)	33.07	33.16	35.66	38.38	39.06	40.15	41.36	42.61	43.98
DPS (RON)	1.100	0.404	2.228	3.407	2.817	2.677	2.678	2.706	2.811
Profitability									
RoavGA	2.1%	0.7%	4.0%	6.5%	5.3%	4.9%	4.8%	4.7%	4.8%
RoavGE	4.5%	1.4%	8.0%	12.6%	10.0%	9.3%	9.0%	8.8%	8.9%
Asset management									
Inventory turnover (Days)	60	77	90	90	90	90	90	90	90
Days sales outstanding	173	215	165	160	160	160	160	160	160
Payables days	247	310	244	240	240	240	240	240	240
Leverage and liquidity									
Leverage (Total liab/equity)	1.1	1.0	1.0	0.9	0.9	0.9	0.9	0.9	0.8
Gearing (Net debt/equity)	0.3	0.4	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Net debt/EBITDA	1.8	2.2	1.0	0.2	0.3	0.4	0.5	0.5	0.4
Current ratio	1.1	1.2	1.5	1.9	1.9	1.9	1.5	1.6	1.8
Valuation multiples									
P/E	9.3x	23.4x	5.2x	5.5x	6.7x	7.0x	7.0x	6.9x	6.7x
P/B	0.4x	0.3x	0.4x	0.7x	0.7x	0.6x	0.6x	0.6x	0.6x
EV/EBITDA	3.9	4.2	2.8	2.8	3.0	3.0	3.0	2.9	2.7
Dividend yield	7.9%	3.7%	15.8%	13.3%	11.0%	10.4%	10.4%	10.5%	10.9%

Source: Transelectrica, AFR estimates



DISCLOSURE APPENDIX

Analyst Certification

The research analyst(s) undersigned and responsible for the preparation of this report certify (-ies) that a) the views expressed in this report accurately reflect their (his/her) personal views about any and all of the securities or issuers mentioned in this report and b) no part of the analyst's compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed in this research report. Analysts receive compensation based upon various factors, including the quality of research, productivity, experience, individual reputation, competitive factors and feedback from clients.

Company specific regulatory disclosures

Disclosure checklist for companies mentioned & other price data information

Company	Reuters	Rating	Price	Price date	Disclosure
C.N.T.T.E. Transelectrica SA	TEL.BX	BUY	25.69	17/10/2014	NONE

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7. Following 6, Alpha Finance Romania has changed the contents of the initially sent research report, with respect to: no change
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Major changes vs. previous research reports

Date of previous report	Previous vs. current market prices (RON)	Previous vs. current TP (RON)	Previous vs. current Rating
28/05/2014	18.55 / 25.69	22.42 / 29.00	BUY / BUY

Rating history for Transelectrica

Date	Rating	Share Price (RON)	Target Price (RON)
16/04/2009	Update - BUY	10.10	12.89
20/10/2009	Update - HOLD	12.50	12.95
15/01/2010	Update - BUY	14.90	18.28
16/04/2010	Update - BUY	21.20	29.05
11/11/2010	Update - BUY	18.00	21.35
12/04/2011	Update - BUY	21.00	32.00
14/09/2011	Update - BUY	18.60	32.11
13/07/2012	Update - HOLD	12.39	13.53
04/09/2012	Update - HOLD	12.98	12.57
17/06/2013	Update - BUY	13.13	15.10
28/05/2014	Update - BUY	18.55	22.42
20/10/2014	Update - BUY	25.69	29.00

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FUNDAMENTAL RATING

TRP > 12%	12% > TRP > -12%	TRP < -12%
BUY	HOLD	SELL

TRP: Total Return Potential



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