EDISON Scale research report - Update

2G Energy

Alternative energy

14 May 2020

Market and balance sheet resilience

2G Energy appears relatively resilient to the impact of the coronavirus pandemic. Its manufacturing facility in Germany has been operational throughout. New order intake remains robust, with minimal exposure to the leisure sector, which is where investment in co-generation projects is most likely to be affected. Longer-term demand is linked to phasing out nuclear and coal-fired power generation plants, which could potentially be delayed if the pandemic causes a severe and lengthy recession.

Record revenues in FY19

Group sales rose by 12.7% y-o-y to a record €236.4m, ahead of management guidance of €220–230m. Growth was driven by a 15% rise in service revenues and a 14% increase in sales outside Germany. EBIT grew by 35% to €15.5m, demonstrating the benefit of operational leverage and the 'Lead-to-Lean' initiative. EBIT margin grew by 1.1pp to 6.5%, which was near the top end of management guidance (5.5–7.0%). Net cash dropped from €6.3m net cash at end FY18 to €0.1m, reflecting management's decision to hold higher volumes of engines to enhance the group's competitive position by offering short delivery times.

Minimal impact of coronavirus

The impact of the coronavirus pandemic on 2G Energy's business does not appear material so far. The manufacturing facility in Heek remains operational. The high levels of engine inventory meant that assembly schedules have not been affected. Noting that new order intake remained robust despite the COVID-19 pandemic, rising by 15% year-on-year during Q120 to €45m, management has reiterated its FY20 revenue guidance of €235–250m with an EBIT margin of 5.5–7.0%.

Valuation: Looking for long-term resilience

The share price has recovered to the level at the start of FY20 as investors have realised 2G Energy is relatively resilient to the impacts of the pandemic. At the current level, a comparison with established boiler manufacturers shows 2G Energy trading on multiples broadly in line with our sample averages. However, consensus estimates show 2G Energy's revenues growing a little more quickly than the sample average, potentially justifying multiples that are at a premium to the sample mean and indicating scope for further share price improvement once it is clear that any coronavirus-linked recession is not affecting investment in co-generation projects.

Consensus estimates

Year-end	Revenue (€m)	PBT (€m)	EPS (€)	DPS (€)	P/E (x)	Yield (%)
12/18	209.8	11.2	1.72	0.45	26.0	1.0
12/19	236.4	15.3	2.33	0.45	19.2	1.0
12/20e	242.1	15.3	2.20	0.58	20.3	1.3
12/21e	262.6	18.3	3.04	0.70	14.7	1.6

Source: Refinitiv, company data

Price	€44.7
Market cap	€197m

Share price graph

Share details

Code	2GB
Listing	Deutsche Börse Scale
Shares in issue	4.4m
Last reported net debt at end December 2019	€0.1m

Business description

2G Energy is a leading international manufacturer of highly efficient combined heat and power plants (CHP). These are deployed in the housing industry, agriculture, commercial and industrial companies, public energy utilities, and municipal and local government authorities.

Bull

- Increasing demand for flexible and decentralised generation of power and heat worldwide as coal-fired power stations closed down.
- Decentralised CHP solutions reduce CO_2 emissions by improving conversion efficiency.
- Hydrogen-fuelled systems offer mechanism for storing surplus power from renewables.

Bear

- Uptake affected by green regulation.
- Economics depends on spark spread.
- Low free float (47.7% at end December 2019).

Analyst

Anne Margaret Crow +44 (0)20 3077 5700

industrials@edisongroup.com

Edison profile page

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FY19 performance

Record sales

Group sales rose by 12.7% y-o-y to a record €236.4m, ahead of management guidance of €220–230m. Growth was driven by a 15% rise in service revenues, supported by investment in service operations in France and the US and in a new US management team. The group also benefited from a 14% increase in sales outside Germany. Additionally, there was continued demand in Germany for biogas-powered CHP systems capable of providing a more flexible output to complement electricity generated from renewable sources. Demand for natural gas-powered systems rose significantly during the second half following the Bundestag agreeing two significant amendments to the German Renewable Energy Sources Act and the German Co-generation Act in June 2019. These amendments provided clarity on the how the mandatory levy on energy produced by new CHP plants installed since August 2014 and consumed in-house rather than exported to the grid, would be structured. Overall, services accounted for 38% (FY18: 37%) of total revenues and exports 39% (FY18: 40%). Service revenues are particularly useful in the current economic environment, as demand for replacement parts is typically unchanged during a downturn, providing a steady, predictable cash flow.

Cost of materials as a proportion of total operating revenue declined by 2.4pp year-on-year to 64.9% as a result of the wider adoption of better procurement and production processes throughout the company as part of the 'Lead-to-Lean' efficiency programme. Personnel costs increased as a proportion of operating revenue (by 1.3pp to 17.2%) because of higher average costs per employee, reflecting a switch to a more highly skilled workforce to support the 'Lead-to-Lean' initiative. EBIT grew by 35% to €15.5m, demonstrating the benefit of operational leverage. EBIT margin grew by 1.1pp to 6.5%, which was near the top end of management guidance (5.5–7.0%).

Substantial investment in inventory

Net cash dropped from €6.3m at end FY18 to €0.1m at end FY19. The major factor behind this shift was a €14.3m increase in inventories, reflecting management's decision to hold higher volumes of engines to enhance the group's competitive position by offering short delivery times. This negative movement in cash is unusual, because working capital requirements are generally satisfied through staggered advance payments on CHP orders and payments for services. Capex totalled €4.3m, including conversion measures at the operating site in Heek, Germany, which allow 2G Energy to purchase spares in bulk, thus improving profitability, as well as ensuring availability of parts for customers. €1.4m was invested in acquiring the outstanding 20% minority stake in 2G Drives, which conducts R&D and engine assembly for the group.

Favourable outlook supported by order book

No material impact on operations from coronavirus pandemic

The impact of the coronavirus pandemic on 2G Energy's business does not appear material so far. The manufacturing facility in Heek remains operational. While there have been some minor supply issues relating to components sourced within Europe, the high levels of engine inventory meant that assembly schedules have not been affected. It has not been possible to install some CHP systems because construction sites, particularly in the UK, have been closed, but this is not affecting H120 revenues because invoices are raised at the latest 60 days after completion of factory acceptance tests. Each installation requires only two or three days on site, so management is confident that the group will be able to complete outstanding installation during H220.

Management reiterates FY20 guidance

New order intake grew by 15% year-on-year during Q120 to €45m. This growth was driven primarily by a 76% jump in orders for natural gas-operated systems in Germany to €9.0m, driven by the greater clarity regarding the generation levy. The order book at end March 2020 totalled c €150m compared with €156.3m a year previously. Based on the order book position and the current general business trend in Germany and elsewhere, as of early May management was cautiously optimistic about the group's prospects, reiterating the guidance given at the end of February of €235–250m net sales in FY20. While management noted some delays in the acquisition and project planning phase in April, especially in Italy and the UK, it believes that these orders will be received eventually. Management has also reiterated the EBIT margin guidance given in February of 5.5–7.0%. Management expects that the result of the extensive employee protective measures it has implemented, the additional cost incurred in purchasing hard-to-get parts and installation delays will cause a reduction in efficiency, offsetting the leverage benefit from higher revenues.

With regards to the impact of the coronavirus on demand, management notes that typically less than 5% of sales are from the leisure/hospitality sector, which is likely to be most affected over the next six months by the pandemic. It expects that institutions such as hospitals and nursing homes will continue to invest in co-generation projects because the technology provides a cost-effective way of providing heat and hot water as well as generating electricity. It expects investments to be unaffected in the food industry, although investment in other industrial sectors may be affected. Investment in biogas installations will probably be unaffected. Relatively few new biogas plants are being installed in Germany, but customers are replacing older systems with ones able to provide more flexible output. The existing subsidies supporting this replacement programme will be phased out at the end of November 2020, so customers are likely to try to complete projects by then, after which domestic orders for biogas systems are likely to decline.

Long-term investment case intact

Management has reiterated its target of achieving an EBIT margin of 10% on net sales of around €300m by 2024. It expects the likely reduction in domestic sales of biogas systems noted above to be more than offset by a resurgence in demand for natural gas systems in Germany, export activity, and adoption of new hydrogen-fuelled systems.

Replacing coal and nuclear generation with natural gas

In May 2019, the final report from Germany's coal exit commission set out an advisory schedule for the country to phase out coal-fired power production by 2038 at the latest. The plan means that more than 40GW of electricity capacity will gradually be withdrawn from the market, in addition to more than 9GW of capacity loss because of the phasing out of nuclear power by the end of 2022. In total, this represents around 40% of the available base load capacity being withdrawn, 22GW of which will be withdrawn by 2022. Gas-based CHP plants such as those offered by 2G Energy represent a solution for bridging the immediate generation capacity shortfall. This is because 2G Energy's systems have a flexible output; they can be installed close to the point of consumption, reducing investment in transmission and distribution grids; and their planning and construction time is substantially less than that for wind farms or utility-scale, gas-powered generation facilities. We note that it is possible that a severe recession may result in delays to phasing out coal-fired power stations. Conversely, confirmation of the link between air pollution and the severity of COVID-19 could potentially accelerate phase-out.

Storing surplus renewable energy as hydrogen

Utility-scale battery energy storage systems are increasingly being proposed as a mechanism for addressing the imbalance between supply from renewable energy sources and demand. An alternative, which does not rely on finite supplies of lithium, cobalt and nickel, is to use hydrogen as the medium for energy storage, using surplus electricity to generate hydrogen by electrolysing water. In September 2018, 2G Energy received its first order for a CHP system powered by hydrogen for a project realised together with the public utility of Haßfurt. In July 2019, 2G Energy received an order from Siemens for a trial system for installation in a large solar park on the Arabian Peninsula. More recently, APEX Energy Teterow in Rostock-Laage commissioned 2G to supply a hydrogen cogeneration plant.

Valuation

A comparison of prospective peer multiples for companies providing equipment for generating renewable energy yields limited information because few of the companies have reached commercial revenues and even fewer are generating meaningful profits. 2G Energy is trading on multiples that are lower than our sample mean, which is to be expected given that it has been generating substantial revenues and profits for several years.

Exhibit 1: Peer multiples comparison

Name	Ytd performance (%)	Market cap (€m)	EV/sales 1FY (x)	EV/sales 2FY (x)	EV/EBITDA 1FY (x)	EV/EBITDA 2FY (x)	P/E 1FY (x)	P/E 2FY (x)	Revenue CAGR*
AFC Energy	(14.4)	76	N/A	25.8	(10.2)	(10.9)	(10.8)	(11.7)	N/A
Ballard Power Systems	48.8	2,230	18.1	14.0	(120.3)	(95.9)	(69.8)	(120.2)	28.4%
Ceres Power Holdings	58.6	814	31.4	25.1	(94.2)	(213.5)	(84.8)	(174.5)	31.6%
Enertime	(36.7)	4	1.1	0.9	(7.0)	(12.2)	(3.5)	(4.5)	73.3%
FuelCell Energy	(16.3)	410	9.7	7.6	(101.4)	(120.4)	(5.3)	(7.7)	24.4%
ITM Power	130.9	893	135.6	43.7	(46.9)	(63.0)	(36.8)	(67.6)	102.1%
Nordex	(37.2)	812	0.2	0.2	5.9	4.5	(55.0)	43.4	9.1%
Plug Power	44.0	1,366	5.3	4.1	100.8	38.7	(13.7)	(19.2)	29.0%
SFC Energy	1.9	131	2.3	1.8	80.8	17.1	(48.7)	76.2	11.9%
Vestas Wind Systems	(11.8)	15,818	1.1	1.1	9.2	8.2	22.8	17.4	3.8%
Renewable energy equipment mean			**8.7**	**9.0**	**49.2**	**17.1**	**22.8**	**45.7**	**34.9%**
Briggs & Stratton	(70.3)	78	0.4	0.4	8.8	6.2	(4.8)	37.7	-0.7%
China Yuchai International	(2.4)	492	0.2	0.1	1.0	1.0	4.5	3.9	1.6%
DEUTZ	(36.1)	431	0.4	0.3	5.8	3.5	(41.3)	9.7	1.2%
Generac Holdings	3.3	6,028	3.5	3.1	17.9	14.9	24.7	20.2	5.1%
Honda Siel Power Products	(32.5)	102	0.9	0.8	6.2	5.3	10.2	9.0	10.8%
Conventional generation equipment mean			**1.1**	**0.9**	**7.9**	**6.2**	**13.2**	**16.1**	**3.6%**
2G Energy	**(0.4)**	**199**	**0.8**	**0.8**	**10.3**	**8.9**	**20.3**	**14.7**	**4.2%**

Source: Refinitiv. Note: Grey shading indicates exclusion from mean. *Year 3 to year 0. Prices at 11 May 2020.

In common with its peers in both the conventional and renewable energy generation segments, 2G Energy's shares slumped in March as investors panicked over the potential impact of the coronavirus pandemic. The share price has since recovered to the level at the start of the year (€46.2/share) as investors have realised that the company is relatively resilient to the impacts of the pandemic. At the current level, a comparison with companies manufacturing conventional power generation equipment shows 2G Energy trading broadly in line with the mean multiples of our sample, ie at a small discount to the sample mean for prospective EV/Sales multiples, at a premium to the sample mean for prospective EV/EBITDA multiples and a discount to the sample mean with regards to year two P/E multiple. Consensus estimates show 2G Energy's revenues growing a little more quickly than the sample average, potentially justifying multiples that are at a premium to the sample mean and indicating scope for further share price improvement once it is clear that any coronavirus-induced recession is not affecting investment in co-generation projects.

EDISON

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1,185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia